2019 UK GENERAL ELECTION BRIEFING: WHERE IS THE MONEY COMING FROM?

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OVERVIEW

The main political parties have meticulously set out costings of their spending plans for the next Parliament and how they would finance them if elected. This briefing focuses on:

- The fiscal rules adopted by the political parties.
- The underlying fiscal position and how it has changed since the last Office for Budget Responsibility (OBR) forecast was published in March.
- The fiscal outlook on the basis of each of the political parties' plans.
- The credibility of the fiscal plans.

KEY TAKEAWAYS

- The fiscal outlook has weakened since the last OBR forecast in March. We see no headroom for extra spending or reduced taxes within the existing settlement. This means that all parties could breach their fiscal rules in the next parliament if their plans are not amended.
- There are material differences between the parties' plans, but none imply levels of spending or taxation outside of previous UK historical experience.
- All parties stress the importance of only borrowing to pay for investment. In all cases overall borrowing is expected to increase from current levels.
- The fiscal outlook is very uncertain with known risks associated with Brexit and demographic change. This means that promises not to raise taxation are not credible and unhelpful.
- There should be more consideration of long-term fiscal challenges and how the public might be prepared for dealing with them.

This briefing note is a companion piece to 'Fiscal Rules' by Jagjit Chadha that discusses the case for fiscal rules and the need for reform of the process for setting fiscal policy.

Fiscal rules

- Each of the main political parties has set out its own rules to guide its fiscal plans. The fiscal rules are summarised in table 1.

Table 1 Fiscal rules of the main political parties

Political Party	Fiscal Rules
Conservative	• Balance the current budget within three years. • Public investment will not exceed 3% of GDP. • The ratio of debt interest cost to tax revenue to remain below 6 per cent.
Labour	• Public sector net worth to rise in value over the Parliament. • Balancing the current budget at the end of a rolling 5-year forecast period. • The ratio of debt interest cost to tax revenue to remain below 10 per cent.
Liberal Democrats	• 1 per cent surplus on current spending • Borrowing would only be allowed to pay for capital investment projects judged by an independent watchdog to generate more money for the taxpayer than their initial cost • Ensure overall national debt continues to decline as a share of national income.

- All political parties now agree that borrowing should only be used to finance investment and not day-to-day spending. This means that the current budget – the difference between revenue and day-to-day spending – should normally be balanced or in surplus. The Liberal Democrats have adopted the toughest fiscal stance in aiming for a 1 per cent surplus on current spending.

- This means that any plans for additional day-to-day spending need to be matched by additional tax revenue, assuming that there is no headroom of revenue over day-to-day spending within the existing tax and spending settlement.

The underlying fiscal position

- The main political parties have all made announcements about their plans for additional spending and its funding without having a clear independent guide to the most likely fiscal outlook based on existing policies. This is because the most recent public finance forecast by the Office for Budget Responsibility (OBR) was in March.

- Back in March the OBR was expecting the overall deficit to decline from 1.1 per cent of GDP in 2018-19 to 0.5 per cent of GDP by 2023-24. Within this, there was expected to be a current budget surplus – the balance between revenue and day-to-day spending - of 1.0 per cent of GDP in 2018-19, rising to 1.6 per cent of GDP in 2023-24. These forecast numbers **provided a reasonable amount of headroom for additional spending or lower taxation** against the government's then fiscal mandate of aiming for the structural budget deficit to lie below 2 per cent of GDP in 2020-21. But the OBR noted that, as well as more conventional risks, anticipated changes to the accounting treatment of student loans would 'absorb almost half the Government's current headroom of 1.2 per cent of GDP against the fiscal mandate as well as making a balanced budget harder to achieve'.

- Since the March OBR forecast there have been **several developments that have weakened the fiscal outlook**. These are: first, a more realistic accounting treatment of student loans that now takes account of expected future write-offs at the time when loans are made; second, new estimates of capital depreciation that alters how spending is split between day-to-day spending and investment; third, additional spending announced in the 2019 Spending Round in September; fourth, a changed, predominantly weaker, outlook for the economy.

- Table 2 shows our estimate of a neutral fiscal benchmark, derived by updating the March 2019 OBR forecast for known developments including recent data and a different economic outlook. This is produced by re-running NIESR's November 2019 forecast to include only announced public spending commitments (the NIESR forecast had anticipated some post-election spending increases over and above those that had been announced). The forecast assumes continuing Brexit-related uncertainty but no change in the UK's trading relationship with the EU. This would be consistent with a range of Brexit outcomes that involve a long transition period.

Table 2 **A revised 'neutral' fiscal benchmark (£ billion and % of GDP in italics))**

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2014-25
Total current receipts	811.4	833.1	864.3	894.8	925.6	958	992.4
	37.5	*37.2*	*37.2*	*37.3*	*37.3*	*37.3*	*37.4*
Total current expenditure	757.2	796.2	817.1	842.4	871.2	904.2	941.1
	35.1	*35.5*	*35.2*	*35.1*	*35.1*	*35.2*	*35.4*
Depreciation	48.8	50.3	51.9	53.5	55.2	57.1	59.1
	2.3	*2.2*	*2.2*	*2.2*	*2.2*	*2.2*	*2.2*
Current budget surplus	5.4	-13.4	-4.7	-1.1	-0.8	-3.3	-7.8
	0.3	*-0.5*	*-0.2*	*0.0*	*0.0*	*-0.1*	*-0.2*
Gross investment	95.6	98.6	104.9	109.2	110.8	111	113.5
	4.4	*4.4*	*4.5*	*4.5*	*4.5*	*4.3*	*4.3*
Net investment	46.8	48.3	53	55.7	55.6	53.9	54.4
	2.2	*2.2*	*2.3*	*2.3*	*2.2*	*2.1*	*2.0*
Total managed expenditure	852.8	894.8	922	951.6	982	1015.2	1054.6
	39.5	*39.9*	*39.7*	*39.6*	*39.5*	*39.5*	*39.7*
Public sector net borrowing	41.4	61.7	57.7	56.8	56.4	57.2	62.2
	1.9	*2.8*	*2.5*	*2.4*	*2.3*	*2.2*	*2.3*
Memo:							
Nominal GDP	2160.4	2240	2321	2401.3	2483	2567.2	2656.5

Source: ONS (Public Sector Finances, 21 November 2019) and NIESR.

- According to the latest data, public sector net borrowing was £41 billion (1.9 per cent of GDP) in 2018-19. There was a **small current surplus of £5.4 billion** (0.25 per cent of GDP) once borrowing to finance net investment of £46.8 billion is excluded. The neutral fiscal benchmark builds in slightly higher spending in the current fiscal year (2019-20) to take account of preparations for a no-deal Brexit, but otherwise shows little change in spending and revenue items as a share of GDP over the coming years. This **implies public sector borrowing of between 2 and 3 per cent of GDP and a small current deficit in most years**.

- These figures show a significant change from the outlook presented by the OBR in March. The upward revision in public sector net borrowing in 2018-19 from £22.8 billion to £41 billion is largely due to accounting changes. The most significant accounting change is the new treatment of student loans that added £12.4 billion to borrowing in 2018-19. Compared with the old method, interest and dividends received is reduced because less interest accrues to the government. This reduces current receipts and so makes the current surplus smaller. At the same time, capital grants to the private sector are increased to reflect the expected cancellation of student loans. This does not affect the current deficit but it does add to total net investment and net borrowing.

- There has also been a substantial change to **the current surplus. This has been revised down from £20.4 billion in March to £5.4 billion in the latest data**. This has been affected by a significant accounting change to the treatment of depreciation. Blue Book revisions to capital stock and depreciation data add £8.4 billion to depreciation in 2018-19, raising current spending and reducing net investment in equal measure. This reduces the current surplus, but leaves public sector net borrowing unchanged.
- The other major change is the extra spending announced in the 2019 Spending Round. This adds £2.1 billion to spending in 2019-20 and £13.4billion in 2020-21, which we assume would continue into future years although this was not announced.

- The projected small current budget deficit contrasts with the underlying surpluses assumed by the political parties. Conservative plans are based on an underlying current surplus of around £4 billion per year, while Labour plans are based on a current surplus of £6 billion in 2023/24. It is unclear what assumption the Liberal Democrats are making, but it appears that they are assuming a current surplus of around 1 per cent of GDP as their manifesto proposes roughly equal increases in taxation and day-to-day spending.

The fiscal outlook under different parties' plans

- The manifestos have set out the political parties' plans in meticulous detail.

- The additional spending measures in the **Conservative Party** manifesto are limited, amounting to an extra £2.9 billion in day-to-day spending and £8.1 billion in capital spending in 2023-24. This would be sufficient to raise Total Managed Expenditure to 39.9 per cent of GDP in 2023-24, almost exactly equal to its post-war average of 39.7 per cent.

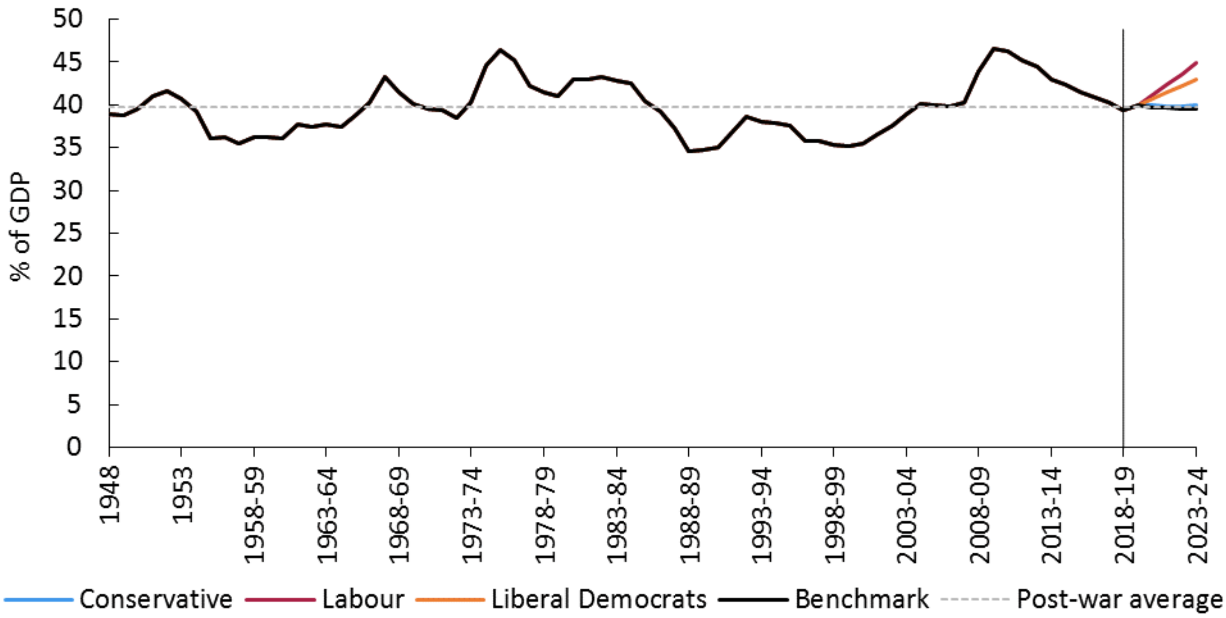
- The additional spending measures in the **Labour Party** manifesto are substantial, amounting to an extra £82.9 billion in day-to-day spending and £55 billion in capital spending in 2023-24. This would be sufficient to raise Total Managed Expenditure to 44.9 per cent of GDP in 2023-24, around 5 percentage points above its post-war average of 39.7 per cent.

- The additional spending measures in the **Liberal Democrat** manifesto are also substantial, amounting to an extra £62.9 billion in day-to-day spending and £26 billion in capital spending in

2023-24.[i] This would be sufficient to raise Total Managed Expenditure to 43.0 per cent of GDP in 2023-24, over 3 percentage points above its post-war average of 39.7 per cent.

- Figure 1 shows the parties' spending plans in historical perspective. It shows the sharp differences between the spending plans of the political parties. The Conservative plans involve a continued tight grip on public spending, with spending as a share of GDP continuing at a lower level than throughout the past ten years. Given the ageing of the population, we doubt that these plans ease austerity sufficiently to meet demands for public service provision. At the other end of the scale, Labour Party plans for spending are unusually high but not unprecedented. TME as a share of GDP was higher in 1975-77 and 2009-12. However, on both previous occasions, emergency action was taken to reduce public spending from what was deemed as an undesirably high level.

Figure 1 **Total Managed Expenditure (as a per cent of GDP)**



Source: OBR Public Sector Finance databank and NIESR calculations.

- While the main political parties have sharply different plans for public spending, they all agree that additional day-to-day spending should be financed by additional taxes and other revenue, while additional capital investment can be financed by borrowing.

- The revenue measures in the **Conservative Party** manifesto consist of some measures that raise revenue, notably the decision to keep the corporation tax rate at 19 per cent, rather than cutting it as previously announced, and tax cuts. The net effect is to increase revenue to more or less pay for additional spending. These measures would result in Total Current Receipts rising from 37.2 per cent of GDP to 37.4 per cent of GDP, again almost exactly equal to the post-war average of 37.2 per cent, but a little higher than has been common in the past thirty years.

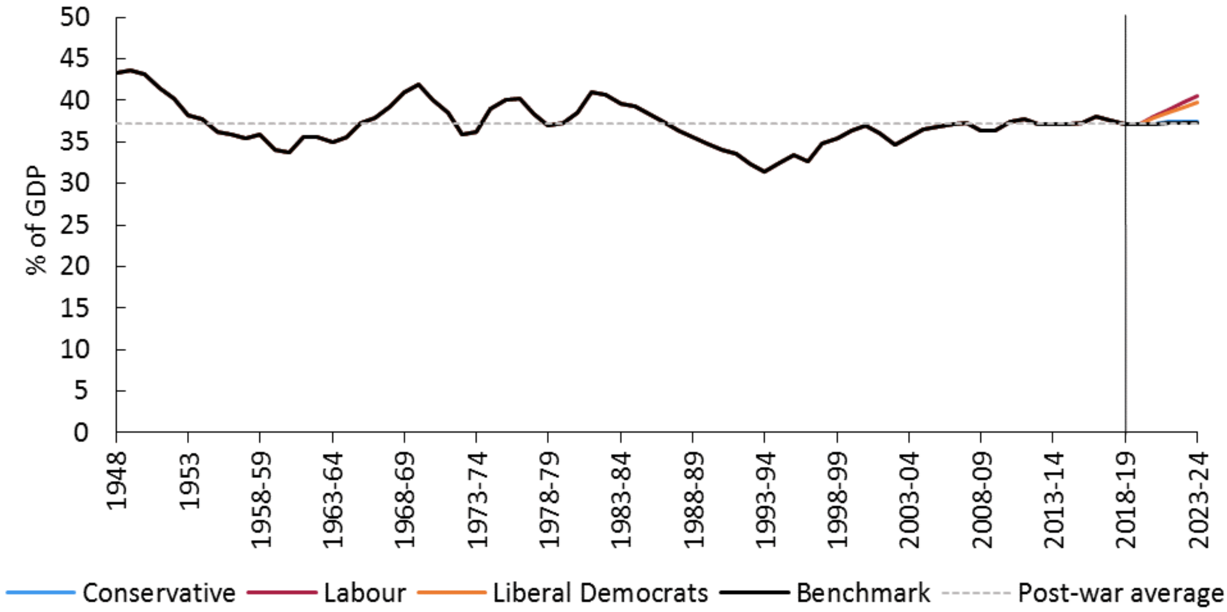
- The revenue measures in the **Labour Party** manifesto are more substantial. They are focused on raising more revenue from companies and wealthy individuals to pay for additional spending.

They also include additional tax revenue from a higher level of activity generated by the fiscal measures.[ii] These measures would result in Total Current Receipts rising from 37.2 per cent of GDP to 40.5 per cent of GDP, the highest level since 1982-83.

- The revenue measures in the **Liberal Democrat** manifesto are also substantial, but different to Labour. As with Labour, the effect of the revenue raising measures is intended to pay for additional spending. They include a 'Remain bonus' in 2024/25 that is assumed to come from the economy being stronger as a result of not leaving the EU. These measures would result in Total Current Receipts rising from 37.2 per cent of GDP to 39.8 per cent of GDP.

- Figure 2 shows the parties' revenue plans in historical perspective. The Conservative plans involve maintaining the current level of receipts as a share of GDP, while Labour and the Liberal Democrats are planning rises towards 1970s levels.

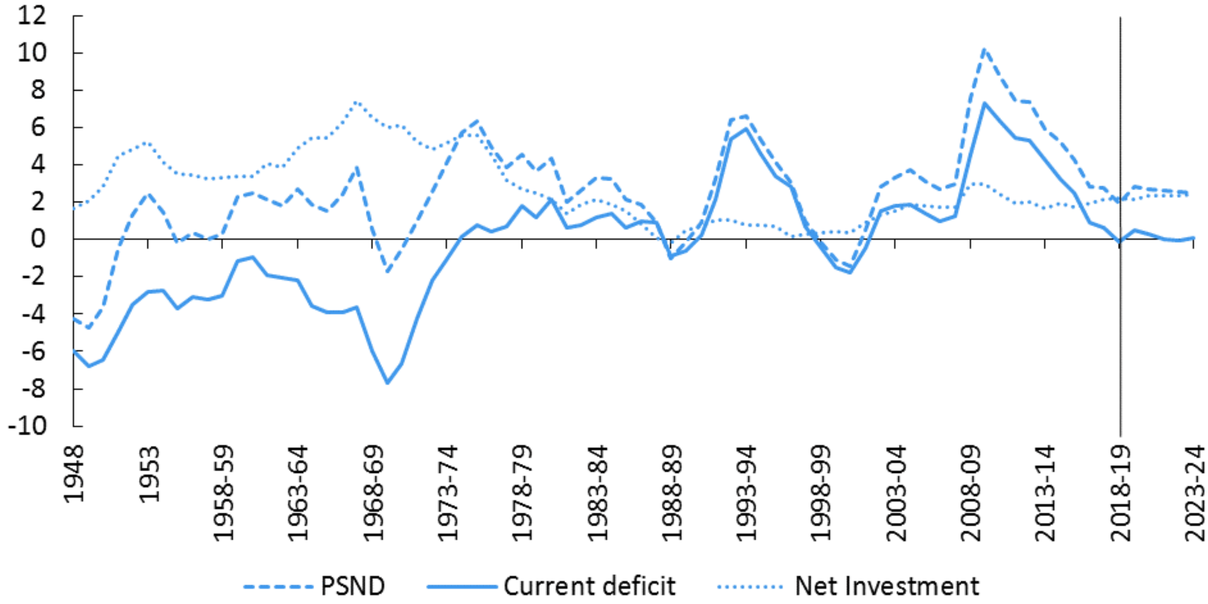
Figure 2 **Total current receipts (as a per cent of GDP)**



Source: OBR Public Sector Finance databank and NIESR calculations.

- Figure 3 draws out the implications for **borrowing** over the next five years **of the Conservative Party plans**. It shows net borrowing running at around 2.5 per cent per year, the post-war average, to pay for a similar level of net investment.

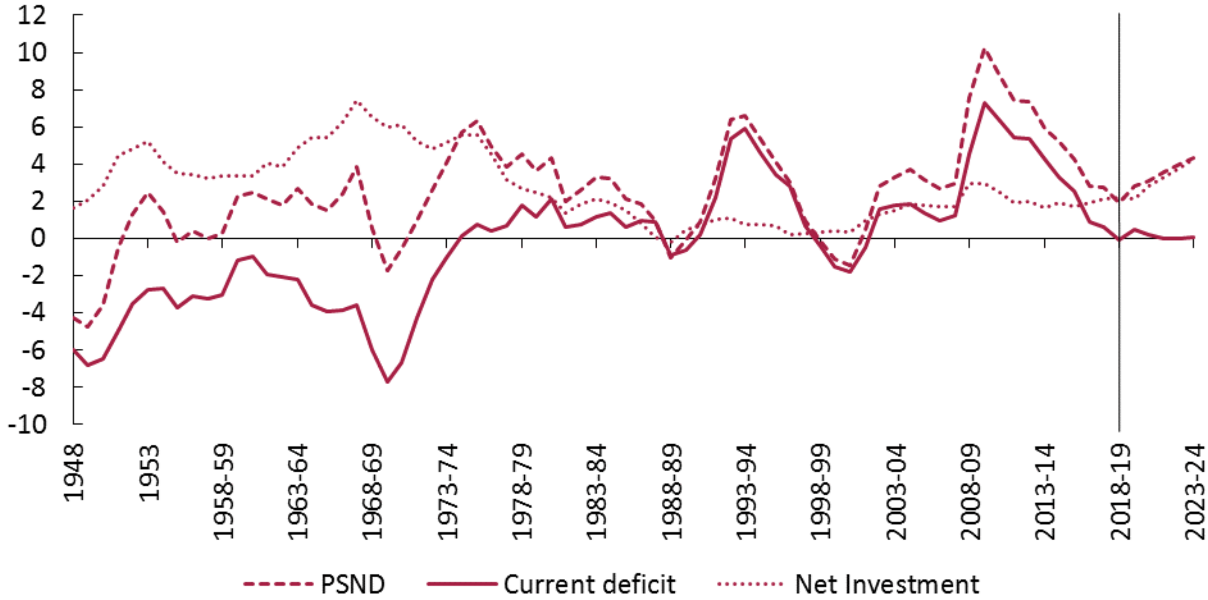
Figure 3 **Implications of Conservative plans for borrowing (as a per cent of GDP)**



Source: OBR Public Sector Finance databank and NIESR calculations.

- Figure 4 draws out the implications for **borrowing** over the next five years of the **Labour Party plans**. It shows net borrowing rising to around 4 per cent per year, a high level by post-war standards, to pay for a similar level of net investment.

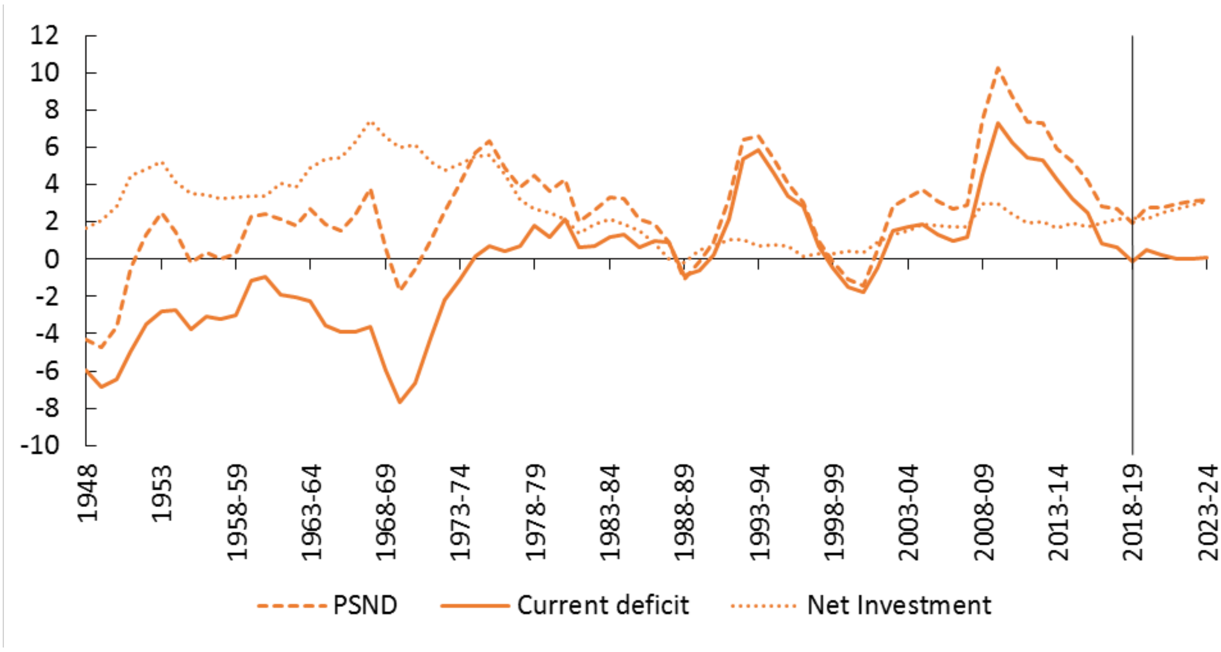
Figure 4 **Implications of Labour plans for borrowing (as a per cent of GDP)**



Source: OBR Public Sector Finance databank and NIESR calculations.

- Figure 5 draws out the implications for **borrowing** over the next five years of the **Liberal Democrat plans**. It shows net borrowing rising to around 3 per cent per year, not far above post-war averages, to pay for a similar level of net investment.[iii]

Figure 5 **Implications of Liberal Democrat plans for borrowing (as a per cent of GDP)**



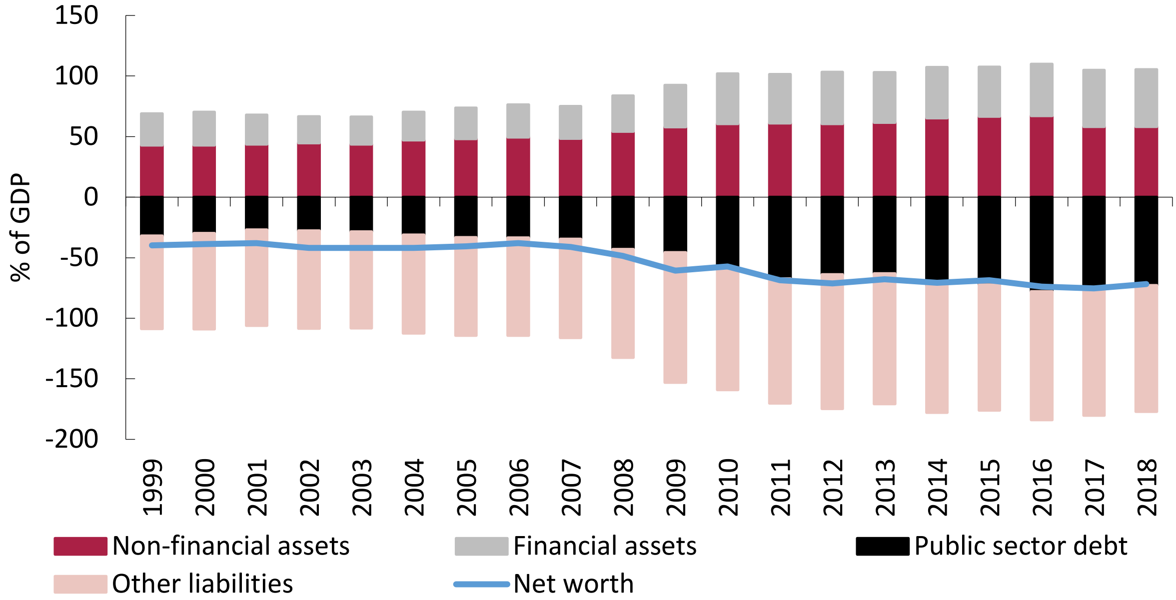
Source: OBR Public Sector Finance databank and NIESR calculations.

Credibility of the fiscal plans

- The fiscal rules are focused primarily on flows of borrowing and investment, but they have a counterpart in terms of debt and asset stocks, broadly the accumulated value of deficits and investment. Until recently the government had a target for the ratio of public sector debt to GDP to be falling in 2020-21; previous UK governments had targets to keep this ratio below 40 per cent. But with net debt (public sector net debt excluding public sector banks, PSND ex) at £1,798.5 billion or 80.4% of GDP at the end of October 2019, there is little appetite to try and hit such ambitious targets.

- Debt is only one part of the public sector balance sheet. The public sector balance sheet sets out what is owned and what is owed.[iv] Net worth is the difference between assets and liabilities. At the end of 2018/19, public sector net worth was estimated at - £1,567 billion, close to the value of public sector debt securities at £1,615 billion, with other liabilities, including the estimated cost of unfunded public sector pensions, roughly offsetting the value of public sector assets (figure 6).

Figure 6 **The public sector balance sheet (per cent of GDP)**



Source: ONS, International Monetary Fund's Government Finance Statistics framework in the public sector finances: Appendix E, 21 November 2019.

- The public sector balance sheet has weakened since the financial crisis, reflecting the long period where borrowing has been in excess of net investment. There are likely to be significant errors in the measurement of some items on the balance sheet that could mean that the measured deterioration exaggerates the actual change. But there is little appetite to rebuild the balance sheet. It is often argued that governments should 'fix the roof while the sun shines' by strengthening the balance sheet so that there is space for debt to rise to absorb shocks when they occur. But with long-term interest rates so low and the government having ample tax raising capacity in reserve there does not appear to be any urgency to levy higher taxes now to strengthen the balance sheet.

- On the basis of the fiscal plans in their manifestos, all political parties envisage a rise in underlying public sector debt reflecting forecast deficits.[v] Whether public sector debt falls as a share of GDP depends on whether nominal GDP growth is fast enough to offset the effect of deficits of 2.5 per cent of GDP and above.

- Both the Labour Party and Liberal Democrats have some aspiration to improve the state of the balance sheet gradually. Consistent with its emphasis on borrowing only to invest, the Labour Party now has a target for public sector net worth to rise in value over the Parliament. Net worth would also rise if the Liberal Democrats aspiration of a 1 per cent current budget surplus was achieved.
- While the fiscal rules are reasonably clear about the targets of policy, the political parties are less clear about how in government they would react were circumstances to change. Yet there are many uncertainties about the costings and huge risks to the outlook that are not quantified. Some of the known and unknown risks are described below.

- A well-understood long-term risk is how future governments will pay for an ageing population that will require more resources for both the NHS and social care. The Office for Budget Responsibility has estimated the cost of these effects.[vi] The OBR estimate that health spending would rise from 7.6 per cent of GDP in 2022-23 to 13.8 per cent of GDP in 2067-68, state pension costs would rise from 5.0 per cent of GDP in 2022-23 to 6.9 per cent of GDP in 2067-68, adult social care costs from 1.3 per cent of GDP in 2022-23 to 1.9 per cent of GDP in 2067-68, an overall increase in age-related spending of 8.7 percentage points of GDP. In our own analysis, we showed how age-related demands are increasing the amount of public services that are required in the next five years.[vii] This suggests that simply holding the spending to GDP ratio at its post-war average is no longer sufficient to meet the demand for public services. Rising spending will require rising taxation if future governments borrow no more than they invest. Some consideration should be given to building in a rising long-term tax to pay for long-term higher spending.

- An important well-understood medium-term issue is how to resolve Brexit. In an accompanying briefing, we have set out the impact on the public finances of different forms of Brexit. We outline that, compared with remaining in the EU, leaving the EU on the terms of the Prime Minister's deal would result in tax revenue being lower by about £10 billion per year in the next Parliament and by about £30 billion in the long term (by 2030). This type of calculation is behind the Liberal Democrats' assumption that there would be a 'remain bonus' if the UK stayed in the EU.

- On top of these known risks there are a vast range of unknowns, including uncertainty around the parties' costings, the possibility of a more severe economic slowdown than expected, and the emergence of new priorities for public spending. The promise by the Labour Party to compensate women born in the 1950s whose pension age was raised in 1995 and again in 2011 is an example of this. This compensation is estimated to have added £58 billion to Labour's planned spending in the next Parliament to the additional spending already announced in the manifesto.

- With such a background of uncertainty, future governments will need to be ready to react to unfavourable fiscal developments when they occur. Inevitably that is likely to mean raising taxes. Political parties should avoid pledging not to raise taxes in the next Parliament as such a promise is not robust to the possible circumstances that may arise. Often in the past governments have reacted to changed circumstances by changing the fiscal rules. While it may make some sense to adapt fiscal rules in the light of new circumstances, the lack of any consistency to the fiscal rules damages their credibility.

[i] This assumes that additional infrastructure investment of £130 billion would be spread evenly over the five-year Parliament.
[ii] This is based on NIESR analysis of the GDP effects of higher public investment.
[iii] In his 15 November speech, Liberal Democrat Treasury spokesman Ed Davey committed to current account surpluses of 1 per cent of GDP in every year in its five-year costings, though the manifesto shows additional income and spending of a similar magnitude.
[iv] The Resolution Foundation has recently proposed new fiscal rules based on net worth. See Hughes, R. Leslie, J., Pacitti, C. and Smith, J. (2019), '*Totally (net) worth it*', Resolution Foundation.
[v] Public sector net debt includes debt to finance Bank of England lending through the Term Funding Scheme that will decline when loans automatically mature. The Bank of England contribution to PSND was worth £181 billion in July 2019.
[vi] Office for Budget Responsibility (2018), '*Fiscal Sustainability Report*', July 2018.
[vii] Hantzsche, A. and Young, G. (2018), 'Light at the end of the fiscal tunnel?', *National Institute Economic Review*, No. 244, May 2018.

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