Background to the 2008 Pre-Budget Report

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This note sets out the economic and public finance background to the 2008 Pre-Budget Report which will be delivered on 24th November.

This version has been updated to include the public finance data published on 20th November.

Contents

1 Introduction

The Government announced on 12th November that the 2008 Pre-Budget Report (PBR) will be presented to Parliament on 24th November.[1]

The PBR will update the Government's forecasts for the economy and public finances. It is also expected to announce a fiscal boost to the UK economy.

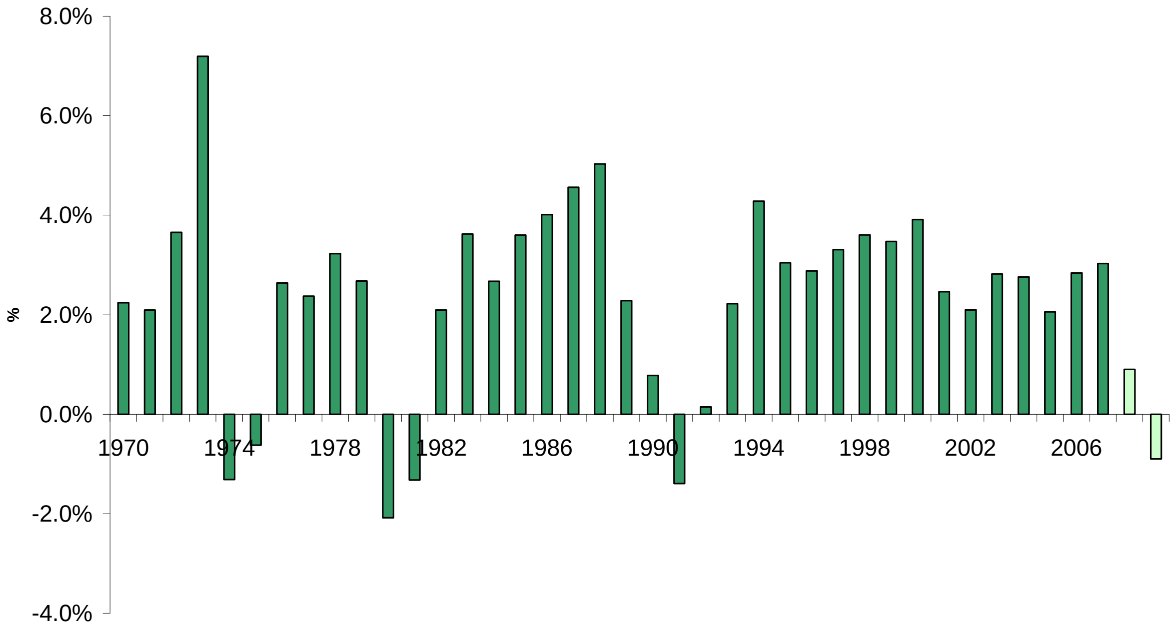
2 The Economic Outlook

2.1 Economic growth

The economic outlook has deteriorated sharply during 2008, against a background of extreme instability in financial markets and the banking industry. After many years of steady expansion, the economy stopped growing in Q2, 2008 and output fell in Q3, 2008. This was the first quarter of negative economic growth since Q2, 1992. According to the Bank of England, the "economy probably entered recession in the second half of 2008 and output is likely to contract further."[2] A number of major economies including Japan, Germany, Italy and the eurozone are already in recession.[3]

Chart 1 below shows economic growth since 1970. It shows the current average independent forecast which is for growth of 0.9% this year and -0.9% in 2009.[4] This is the slowest rate of growth since the early 1990s.

Chart 1: Real GDP growth



The Treasury will update its economic forecasts in the PBR. In March's Budget, the Treasury forecast GDP growth of 1¾ to 2¼% this year and 2¼ to 2¾ % in 2009. These now look optimistic compared with current independent forecasts (see table 1 below). A fairer

1 HC Deb 12 November 2008 c55WS
2 Bank of England, Inflation Report November 2008, page 5
3 A recession is defined as two successive quarters of negative growth.
4 HM Treasury, Forecasts for the UK economy, November 2008

comparison is with independent forecasts being made at the time of the Budget. On this basis, the Treasury's forecasts were slightly more optimistic than independent forecasters who were predicting growth of 1.7% and 1.9% in 2008 and 2009 respectively.[5]

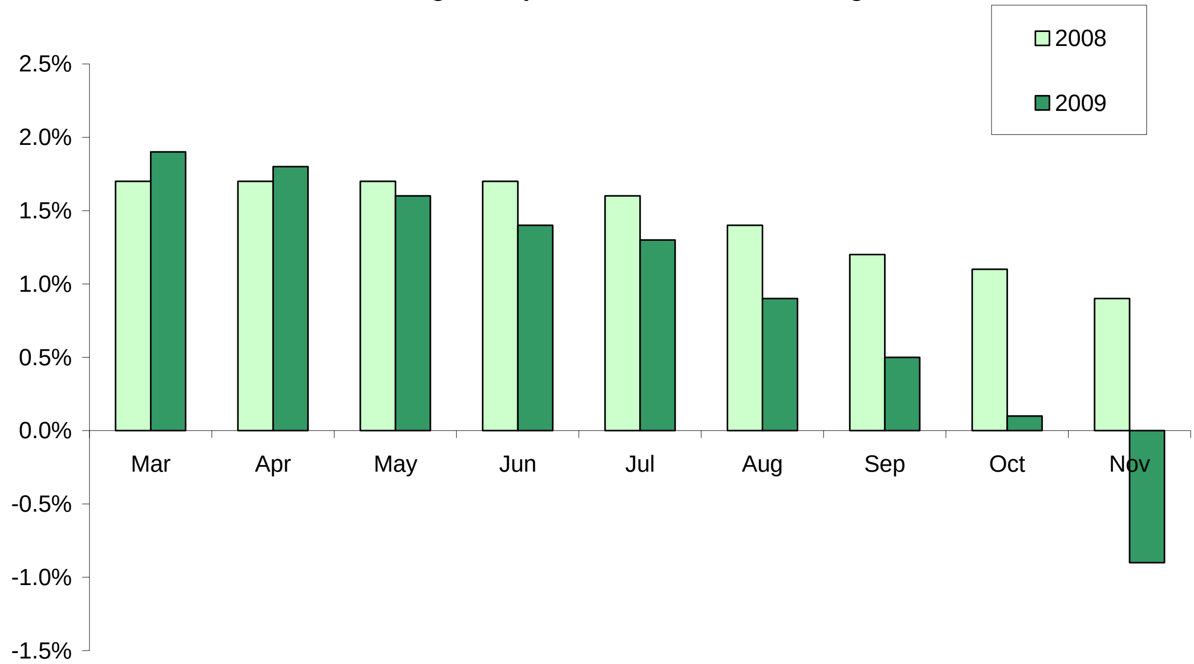
Table 1
Forecasts for GDP growth (%)

	2008	2009
HM Treasury Budget forecast, March 2008	1.75 - 2.25	2.25 - 2.75
Average independent forecast, March 2008	1.7	1.9
Average independent forecast, November 2008	0.9	-0.9

Source: HM Treasury

The chart below shows how forecasters have become less optimistic about the prospects for growth. It shows the average independent forecast for growth in 2008 and 2009 made each month since March. The deterioration in the outlook for 2009 is particularly marked: in March forecasters predicted growth of 1.9%. They are now predicting that GDP will fall by 0.9%.

Chart 2: Average independent forecast for GDP growth



The International Monetary Fund (IMF) forecast a fall in GDP of 1.3% in 2009[6] and the National Institute of Economic and Social Research (NIESR) forecast a fall of 0.9%.[7] Both of these forecasters expect GDP to fall by more in the UK than any other G7 country.

A number of these forecasts have been revised sharply downwards in recent months. For example, the IMF forecast for growth in 2009 was cut by 1.2 percentage points between October and November. In November, the CBI forecast that output would fall by 1.7 per cent in 2009 compared with September's forecast of 0.3 per cent growth.[8]

5 HM Treasury, Forecasts for the UK economy, March 2008
6 IMF, World Economic Outlook Update, 6 November 2008
7 NIESR, National Institute Economic Review, No 206, October 2008, page 107
8 "Recession to be as harsh as 1991, says sharply revised CBI forecast", *Financial Times*, 17 November 2008

There are a number of reasons behind the deterioration in the economic outlook. Clearly, the global financial crisis and the problems in UK banking industry have had a large effect. Demand has been adversely affected by tighter credit conditions. House prices fell by 14.6% over the year to October, according to the Nationwide, and the number of transactions is low. This is likely to reduce consumer spending and have an adverse effect on the construction industry. Confidence in the economy is fragile, as unemployment starts to rise. Slower global economic growth will affect exports, although this may be offset by the decline in sterling. The IMF forecasts global growth of 2.2% in 2009 compared with 5.0% in 2007.

2.2 Inflation

While inflation is high compared with recent years, it fell sharply in October and is forecast to continue falling. On the Consumer Prices Index (CPI), inflation was 4.5% in October down from 5.2% in September. This is well above its 2% target and considerably higher than a year ago (2.1% in October 2007). On the Retail Prices Index (RPI), inflation is currently 4.2%, down from 5.0% last month.

Inflation is expected to fall sharply reflecting lower commodity prices and the effect of the economic slowdown. These factors contributed to the Bank of England's decision to cut interest rates by 1.5 percentage points on 6 November, despite inflation currently being above target. There has been speculation that the Bank of England may cut interest rates further. Independent forecasters expect RPI inflation to be 1.2% in Q4, 2009 and CPI inflation to be 1.7%

2.3 Unemployment

Unemployment has started to increase. In the three months to September 2008, unemployment was 1.8 million (5.8%).[9] This is an increase of 140,000 on the previous three month period and 182,000 higher than a year ago. Unemployment was last at this level in 1997. A number of large scale jobs cuts have been announced over the last few days with over 20,000 redundancies announced in a single week.[10] Some forecasters expect unemployment to reach 2.7 million by 2010.[11]

3 The public finances

The PBR will update the Treasury's forecasts for the public finances. Government borrowing will be higher than forecast in the Budget as a result of:

- the worsening economic outlook compared with the time of the Budget;
- the fiscal measures introduced since the Budget; and
- any fiscal stimulus announced in the PBR.

The PBR is also expected to set out the Government's approach to the public finances in the medium term.

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[9] These figures refer to the International Labour Organisation measure of unemployment.
[10] "Darkness descends", *Financial Times*, 15-16 November 2008
[11] "More bad news feared as jobless total tops 1.8m" *Financial Times*, 13 November 2008

3.1 The fiscal rules

When the Labour government came to power, it introduced two fiscal rules: the “golden rule” and the “sustainable investment rule.” The golden rule said that the government would only borrow to invest, over the course of an economic cycle. The sustainable investment rule required public debt to be kept below 40% of GDP. These were designed to ensure sound public finances.

In the Mais Lecture, delivered on 29th October 2008, the Chancellor said that the Government’s “core objective” was to help the economy through the current difficult times. He said that sticking to the fiscal rules in a “rigid” manner would be “perverse” and would exacerbate “an already difficult situation”. He said:

> the fiscal rules we adopted over ten years ago – which target debt and promote investment – enabled us to triple public investment, at the same time as cutting debt to one of the lowest levels among the world’s major economies. But to apply these rules rigidly in today’s changed conditions would be perverse. We must respond to the challenges and uncertainty we face today – supporting the economy now and maintaining public investment – while at the same time ensuring that we live within our means in the medium term.[12]

The Government has said that it will support the economy and that it is able to do this because the public finances start from a strong position with public debt low as a share of national income and low compared with other countries.[13] The Government has said that borrowing and debt will be restored to sustainable levels, once the current economic turmoil is over. The PBR will set out the Government’s plans for keeping the public finances on a sustainable path in the medium term. This will be of particular interest, given the speculation that the PBR may be used to give the economy a fiscal boost (see section 4 below).

The Institute for Fiscal Studies (IFS) has argued that the fiscal rules were not designed to cope with a crisis on the current scale but that, nevertheless, the underlying state of the public finances gives cause for concern:

> Extraordinary circumstances call for extraordinary measures. Mr Brown's fiscal rules were never designed to cope with a meltdown in the banking system and it would be ridiculous to suggest that adhering to them should take priority over the need to stabilise the financial system. The costs of failing to do so would probably be even larger.
>
> But even in the absence of the current turmoil, the underlying level of debt was already perilously close to the Government's ceiling. Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face. To that extent the Government failed to learn the lessons of the last slowdown.[14]

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[12] Speech by the Chancellor of the Exchequer at the Cass Business School, London, 29 October 2008 [Mais lecture].

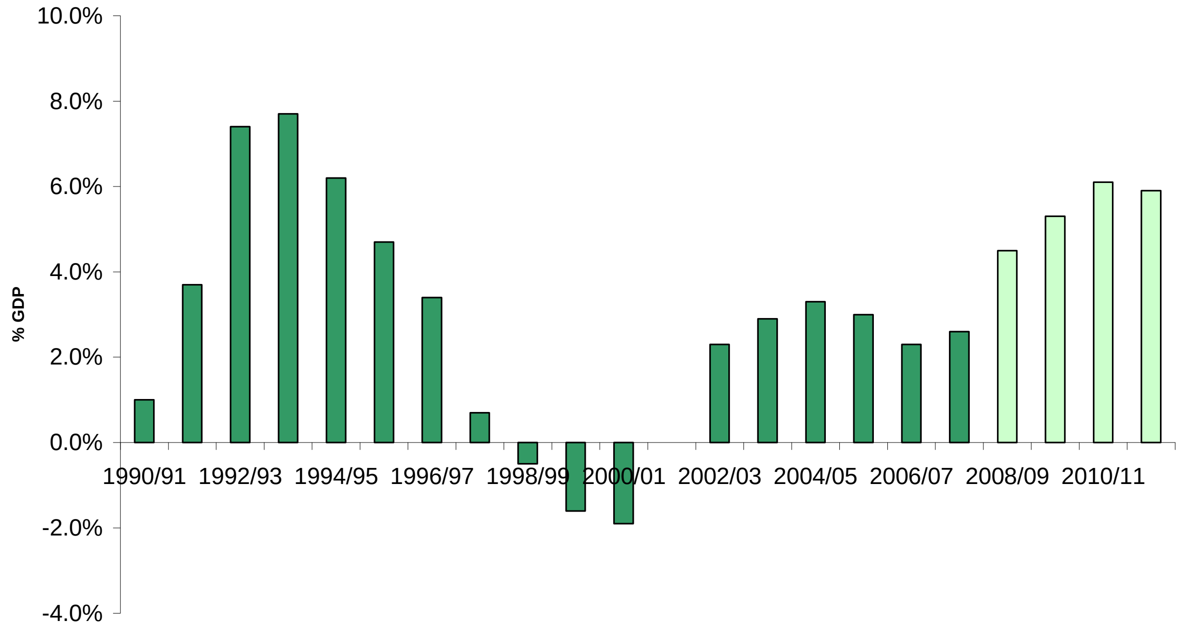
[13] Ibid

[14] “Costly dangers of the unclenched fiscal fist”, *The Times*, 13 October 2008 [by Carl Emmerson of the IFS]

3.2 Government borrowing

In 2007/08, public sector net borrowing was £36.6 billion (2.6% of GDP). Chart 3 below shows that borrowing has been above 2% of GDP since 2002/03.[15]

Chart 3: Public sector net borrowing as % of GDP



In March's Budget, the Treasury forecast net borrowing of £43 billion (2.9% of GDP) in 2008/09 before falling to £38 billion (2.5% of GDP) in 2009/10. Figures for the first seven months of this financial year indicate that borrowing has already reached £37 billion - much higher than the Budget forecast. This is illustrated in the chart below which shows cumulative net borrowing over the current financial year compared with last year.

One reason for the higher level of borrowing is slow growth in government receipts. Over the first seven months of this financial year, central government current receipts have grown by 1.9% in nominal terms compared with the same period last year. The Budget forecast growth of 4.9%. The slowdown in the economy is a major factor behind this. The Budget's public finance forecasts assumed that the economy would grow by 1¾% in 2008/09 and 2½% in 2009/10. These assumptions now look highly optimistic (see section 2.1 above). Looking forward, certain benefit payments next year will be higher than the Government anticipated as they are linked to September's Retail Prices Index which increased by 5%, above the 3¼% assumed in the Budget. The IFS estimates that this could add £3 billion to benefit spending.[16]

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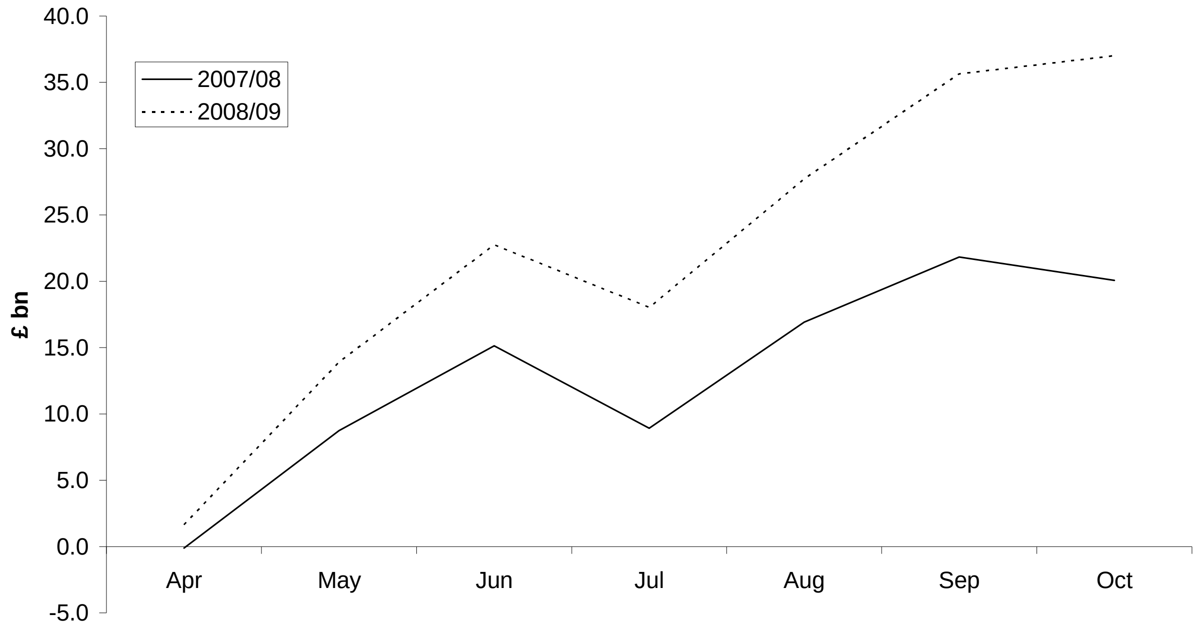
[15] Figures in the chart from 2008/09 onwards are NIESR forecasts.
[16] IFS Press release, Poorest households face highest average inflation rates, 14 October 2008

Chart 4: Cumulative borrowing, £bn



In addition, borrowing this year will be increased by the fiscal measures announced by the Government since the Budget. These include changes to personal taxation announced following the arguments over the 10p income tax rate (see section 5 below), suspension of the planned increase in fuel duties and the one year suspension of stamp duty on sales of certain residential properties. According to the IFS, these three measures will increase borrowing this year by £4 billion.[17]

Many commentators now expect that government borrowing will be much higher than forecast in the Budget. For example, the IFS has suggested that if current trends were to continue, borrowing could be £68 billion this year, nearly 60% higher than forecast in the Budget.[18] The IFS have commented on the outlook for the public finances:

> The outlook for the public finances over the next three years also seems very bleak. The central forecast from last week's Bank of England Inflation Report suggests that, without further interest rate cuts and/or a fiscal stimulus package, the current recession could be as deep as that in the early 1980s. Previous experience suggests that a downturn of this magnitude would add about 4% of national income or £60 billion in today's money to borrowing in 2010–11, leaving aside the impact of sharp falls in property prices and share prices and other factors. One of the most important issues for the Pre-Budget Report to address is how much of the additional borrowing we see over the next couple of years is likely to be purely temporary and how much will require a combination of new tax raising measures and lower public spending to reverse.[19]

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[17] "Costly dangers of the unclenched fiscal fist", *The Times*, 13 October 2008 [by Carl Emmerson of the IFS]

[18] IFS Press Release, IFS analysis of today's public finance figures,20 November 2008

[19] Ibid

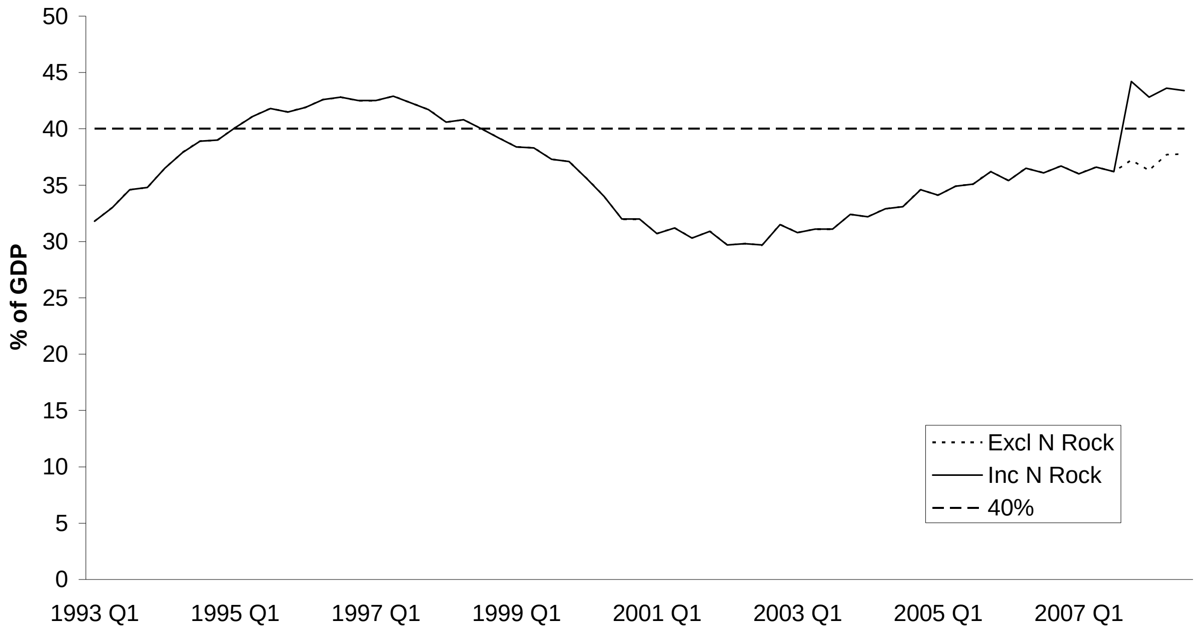
NIESR forecast borrowing of £66 billion in 2008/09 (4.5% of GDP) before peaking at 6.1% of GDP in 2010/11.[20] The European Commission's recent forecasts see a deficit of 6.0% of GDP in 2009/10 and 6.5% in 2010/11.[21] While these are high levels of borrowing, they are below the levels seen in the early 1990s when borrowing reached 7.7% of GDP (see chart 3 above and table at the end of this article).

3.3 Government debt

In 2007/08, public sector net debt was 36.3% of GDP (£527 billion). The 2008 Budget forecast that net debt would reach 38.5% of GDP this year before peaking at 39.8% of GDP in 2010/11. The ONS has decided that Northern Rock should be included in the measure of government debt increasing it to 43.4% of GDP in Q3, 2008 (see chart below).

If Bradford and Bingley and the £37 billion cost of the bank rescue package are included, debt could increase to over £700 billion or approaching 50% of GDP. The Government has said, however, that its investments in the banks are temporary, so the level of debt is better judged by excluding these exceptional factors. Even excluding Northern Rock, Bradford and Bingley and the recapitalisation of the banks, the IFS has concluded that debt is likely to exceed 40% of GDP next year.[22]

Chart 5: Public sector net debt as % of GDP



[20] National Institute of Economic and Social Research, National Institute Economic Review No 206, October 2008, p114.

[21] European Commission, Economic Forecast Autumn 2008, p117. These figures are on a slightly different basis to the other figures. European Commission forecasts are for the general government budget balance which excludes public corporations.

[22] IFS Press Release, IFS analysis of today's public finance figures, 20 October 2008

4 Fiscal stimulus?

The scrapping of the fiscal rules means that the Government has greater room to use fiscal policy (taxation and public spending) to boost the economy. The Government has said that fiscal policy has role to play in stimulating demand in the economy. It has also said that the effect of this will be greater if there is international co-ordination. In a statement to the House on the G20 summit, the Prime Minister said:

> Crucially, and for the first time, our Washington statement agreed a broad and concerted international macro-economic policy response in fiscal policy, meaning measures to support families and businesses now. First, we agreed that fiscal policy has an essential role to play alongside monetary policy in sustaining demand, with quick-acting measures to encourage a rapid impact with help for households and businesses. Secondly, we agreed that the benefits of fiscal policy action will be greater for each country if all countries can act in a concerted way.[23]

In recent days, there has been much speculation that the PBR will announce a package of tax and spending measures to boost the economy to complement the 1.5 percentage point cut in interest rates announced by the Bank of England on 6 November 2008. It has been suggested that a fiscal stimulus could cost £15 -30 billion.[24] According to *The Times*, public spending will be brought forward using underspends from previous years. There has also been speculation that the PBR may contain tax cuts for low income families, as they are more likely to spend, rather than save, the extra income.[25] The Government has indicated that it is prepared to allow a short-term increase in borrowing to pay for this.

The Conservatives have opposed immediate and large scale increases in borrowing. In a speech on 18 November, Mr Cameron said:

> "And that brings me to fiscal policy - to taxation, to spending and to the gap between the two that is met by government borrowing. In a recession tax revenues fall and government spending, not least on benefits, rises. We should let these 'automatic stabilisers' operate. But should we embark on an immediate and large-scale exercise in additional borrowing - adding permanently to our national debt? "My answer is that we should not. I don't believe we can afford it. I don't believe it will work. And I believe it means running risks that we should try to avoid. [26]

Replying to the Prime Minister's Statement on the G20 summit, Mr Cameron said:

> Let us be absolutely clear about what this means: borrowing £30 billion now will mean an income tax bill for the average earner of nearly £1,500 later. Everyone knows the Prime Minister is planning a Christmas tax giveaway, but tax cuts should be for life, not just for Christmas. We need real tax cuts, not Labour tax cons.[27]

The Conservatives have also announced that they will no longer match Labour's spending plans.

The Liberal Democrats have called for permanent tax cuts directed at the less well-off, funded by closing tax loopholes for the rich. They have argued that borrowing should only be

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[23] HC Deb 17 November 2008 c22

[24] "Tax-cut gamble will let Britain buy now – but we'll certainly pay later", *The Times*, 20 November 2008

[25] "Billions to be spent on hospitals and schools" *The Times*, 17 November 2008

[26] http://www.conservatives.com/News/Speeches/2008/11/David_Cameron_The_choice_on_borrowing.aspx

[27] HC Deb 17 November 2008 c26

for long-term investment, and for reallocation of public expenditure away from "wasteful" spending.[28]

5 10p tax rate

In his 2007 Budget the then Chancellor, Gordon Brown, announced a series of changes to personal tax to take effect from 6 April 2008, including two major changes to income tax rates: the withdrawal of the 10% starting rate and a cut in the basic rate from 22% to 20%. The present Chancellor, Alistair Darling, confirmed these changes in his March 2008 Budget. It was estimated that 21 million households would be better off or no worse off as a result of these reforms, but that 5.3 million households would pay more in tax.[29] The Institute for Fiscal Studies calculated that 3.6 million households would lose by more than £1 a week.[30]

Growing concerns about the impact of these reforms led to the Chancellor announcing on 23 April that he would introduce compensation focused on two groups who had lost out: pensioners aged 60-64 and low paid families who do not qualify for tax credits.[31] It was anticipated that full details would only be given in the PBR. However, on 13 May 2008 the Chancellor gave a supplementary statement. The basic personal allowance would rise by a further £600 to £6,035 for 2008-09; the increased allowance would apply to all income for the current tax year and be backdated to 6 April. All basic rate taxpayers would gain £120 from this change. As Mr Darling said, "that will mean that 22 million people on low and middle incomes will gain an additional £120 this year. It will mean that 4.2 million households will receive as much, or more than, they originally lost. The remaining 1.1 million households will see their loss at least halved."[32]

The measures announced on 13 May cover the current tax year only.[33] The PBR is expected to set out the Government's proposals for future years.[34] There is further information on this issue in a Library Standard Note.[35]

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28 HC Deb 17 November 2008 cc28-29

29 HC Deb 18 October 2007 cc1266-70W

30 The IFS Green Budget, January 2008 p282

31 Letter from Alistair Darling, Chancellor of the Exchequer, to Rt Hon John McFall MP, Chairman of the Treasury Committee, 23 April 2008 [Deposited paper DEP2008-1072]

32 HC Deb 13 May 2008 cc1201-2

33 Guidance on how this compensation is provided is on the HMRC website.

34 HC Deb 13 May 2008 c1202

35 Income tax: changes from April 2008 (SN/BT/4685)

6 Economic and public finances data

Economic data

	Real GDP growth (%)	Inflation (%) CPI (a)	Inflation (%) RPI	Unemployment (ILO) thousands	Unemployment (ILO) %
1990	0.8	7.0	9.5	2,053	7.1
1991	-1.4	7.5	5.9	2,530	8.9
1992	0.1	4.3	3.7	2,821	9.9
1993	2.2	2.5	1.6	2,928	10.4
1994	4.3	2.0	2.4	2,675	9.5
1995	3.0	2.6	3.5	2,435	8.6
1996	2.9	2.5	2.4	2,296	8.1
1997	3.3	1.8	3.1	1,988	6.9
1998	3.6	1.6	3.4	1,789	6.3
1999	3.5	1.3	1.5	1,728	6.0
2000	3.9	0.8	3.0	1,588	5.4
2001	2.5	1.2	1.8	1,490	5.1
2002	2.1	1.3	1.7	1,529	5.2
2003	2.8	1.4	2.9	1,489	5.1
2004	2.8	1.3	3.0	1,424	4.8
2005	2.1	2.1	2.8	1,465	4.9
2006	2.8	2.3	3.2	1,669	5.4
2007	3.0	2.3	4.3	1,653	5.3
Latest (b)	-0.5	4.5	4.2	1,825	5.8

Source: ONS

Notes (a) CPI estimated before 1997

(b) GDP: Q3, 2008 compared with Q2, 2008; Inflation: October; unemployment: 3 months to September

Public finances data

	Net borrowing £ billion	Net borrowing % GDP	Public sector net debt £ billion	Public sector net debt % GDP
1990/91	5.8	1.0	151.3	26.2
1991/92	22.6	3.7	166.1	27.4
1992/93	46.7	7.4	201.9	31.8
1993/94	51.0	7.7	249.8	36.5
1994/95	43.3	6.2	290.0	40.1
1995/96	34.7	4.7	322.1	41.9
1996/97	27.1	3.4	347.2	42.5
1997/98	5.8	0.7	352.0	40.6
1998/99	-4.5	-0.5	350.7	38.4
1999/00	-15.5	-1.6	344.4	35.6
2000/01	-18.3	-1.9	311.1	30.7
2001/02	-0.2	0.0	314.3	29.7
2002/03	25.0	2.3	346.0	30.8
2003/04	33.1	2.9	381.5	32.2
2004/05	39.6	3.3	422.1	34.1
2005/06	37.8	3.0	460.9	35.4
2006/07	30.4	2.3	497.9	36.0
2007/08 (a)	36.6	2.6	621.2	42.8

Source: HM Treasury

Note: (a) debt figures for 2007/08 include Northern Rock.

Excluding Northern Rock, the figures are £526.8 bn and 36.3% of GDP

7 Links to further information

HM Treasury

2008 Pre-Budget Report

2008 Budget

Public finances databank

Forecasts for the UK economy: A comparison of independent forecasts

Treasury Committee

Treasury Committee website

Institute for Fiscal Studies

Pre-Budget Report briefing

IFS analysis of public finance figures

Bank of England

Inflation Report, November 2008

House of Commons Library

Economic Indicators

Interest rates and inflation (SN/EP/3731)

Income tax: changes from April 2008 (SN/BT/4685)

G20

G20 Communique 15 November 2008

ONS

Public sector finances