Background to the June 2010 Budget

Standard Note: SN/EP/5577

Last updated: 18 June 2010

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The new Conservative-Liberal Democrat Coalition Government will hold its first Budget on Tuesday 22 June. The main focus of the Budget will be on measures to reduce the budget deficit which is forecast to be over 10% of GDP this year. The Coalition Agreement identifies reducing the deficit and ensuring the economic recovery as the main priority of the new Government. The Government has already indicated that it wants to reduce the structural deficit more quickly than the previous government and that the bulk of the adjustment should come through spending cuts rather than tax increases. The Budget will provide further detail on how this will be achieved. It will set out the Government's fiscal policy objectives and the outlook for the public finances for the rest of the Parliament. The Budget is expected to provide public spending totals for the duration of the Parliament but individual departments' budgets will not be set until the Spending Review in the Autumn. Given the scale of the deficit, the Budget is widely expected to be one of the toughest for many years.

With regard to tax, commentators have focused on the fact that the Coalition Agreement includes Liberal Democrat proposals for a tax cut – by raising the personal income tax allowance, and a tax increase – by increasing the rate of capital gains tax on non-business assets. Notably, the Agreement postpones the Conservative proposal for a cut to inheritance tax while taking up the Liberal Democrat suggestion of higher taxes on air travel. Liberal Democrat proposals for restricting tax relief on pension contributions, and for a 'mansions tax' were not included.

The Budget measures will be announced against the backdrop of a fragile economic recovery. The economy has recorded only one quarter of positive economic growth since the recession. The newly created Office for Budget Responsibility (OBR) expects growth of only 1.3% this year, in line with independent forecasters. Independent forecasters and the OBR both forecast growth of more than 2% in 2011. This will be the first Budget which will use the economic and public finance forecasts produced by the independent OBR.

A separate Library note will be published after the Budget setting out its main points and the reaction to it.

Contents

1 Introduction

This note sets out the economic, taxation and public finance background to the new Government's first Budget which will be held on 22 June. It provides details of recent trends and forecasts for the economy and public finances as well as international comparisons. It also contains a discussion of taxation issues.

2 The Office for Budget Responsibility

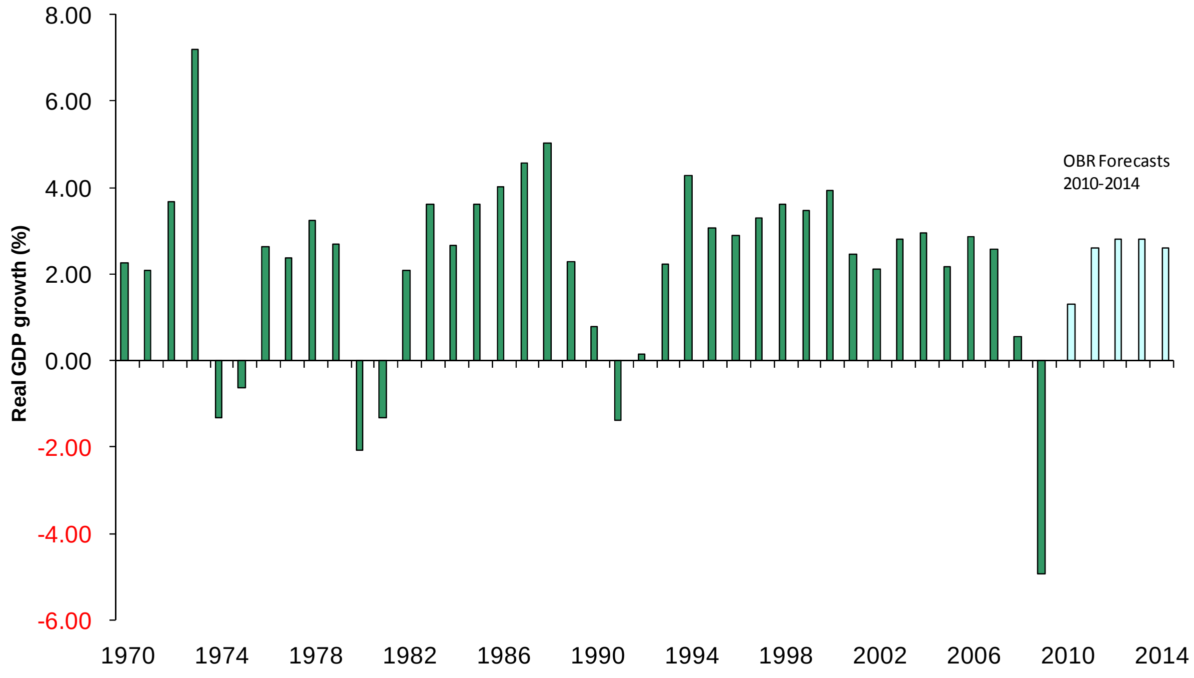
This will be the first Budget based on forecasts produced by the new Office for Budget Responsibility (OBR). The OBR's forecasts were published on 14 June 2010.[1] Details of these forecasts are given in the sections on the economy and public finances below. These forecasts are based on the previous Government's policy measures. They do not include any measures announced by the new Government. For the Budget, the OBR will produce a new forecast for the economy and the public finances taking account of the policy measures announced in the Budget. It will also report its judgement as to whether the Government's policy is consistent with a better than 50% chance of meeting the fiscal policy mandate set by the Chancellor. The creation of the OBR was described as "welcome innovation" in a *Financial Times* leader.[2] The same article noted that the OBR "did not find any market-rattling skeletons in the Treasury's cupboards".

3 The economy

3.1 GDP

2009 was a very challenging year for the UK economy. In 2009 as a whole, the economy saw the sharpest fall in GDP (-4.9%) in a calendar year since official figures began in 1949 and the highest fall since 1931, excluding the recession following the Second World War.

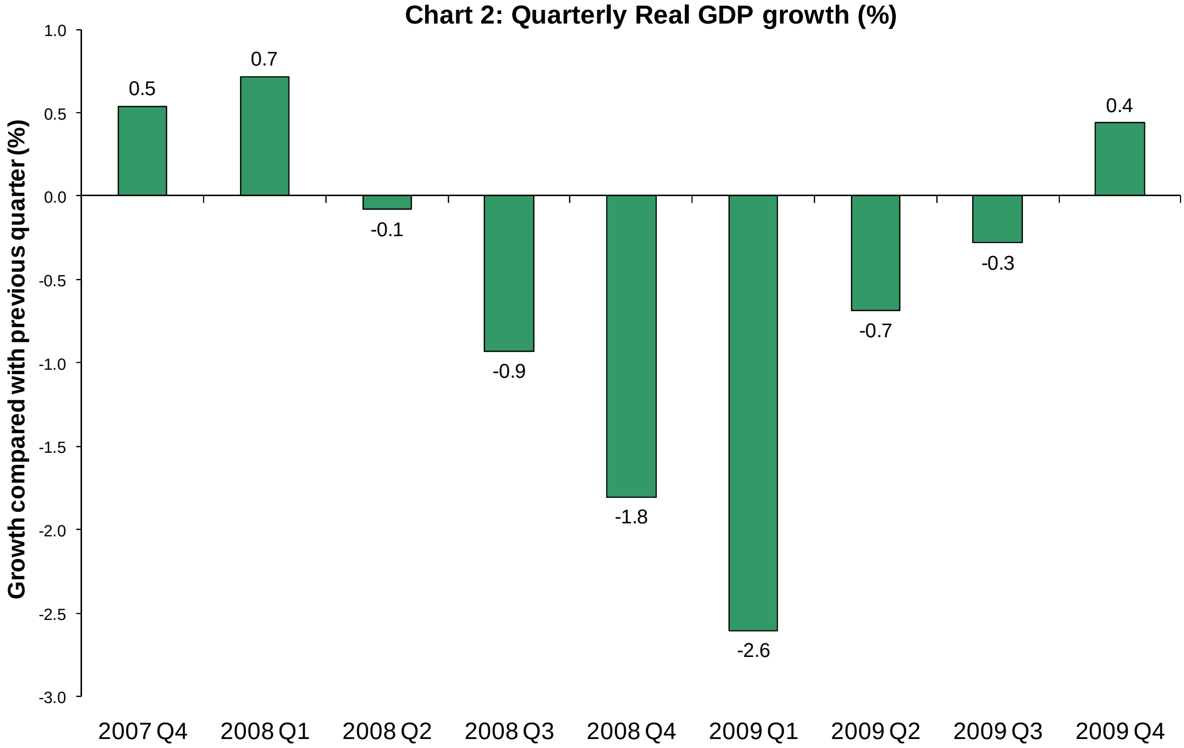
Chart 1: Real GDP growth 1970-2014



[1] Office for Budget Responsibility, *Pre-Budget forecast*, June 2010
[2] "Low-key debut for a high-profile body", [leader], *Financial Times*, 15 June 2010

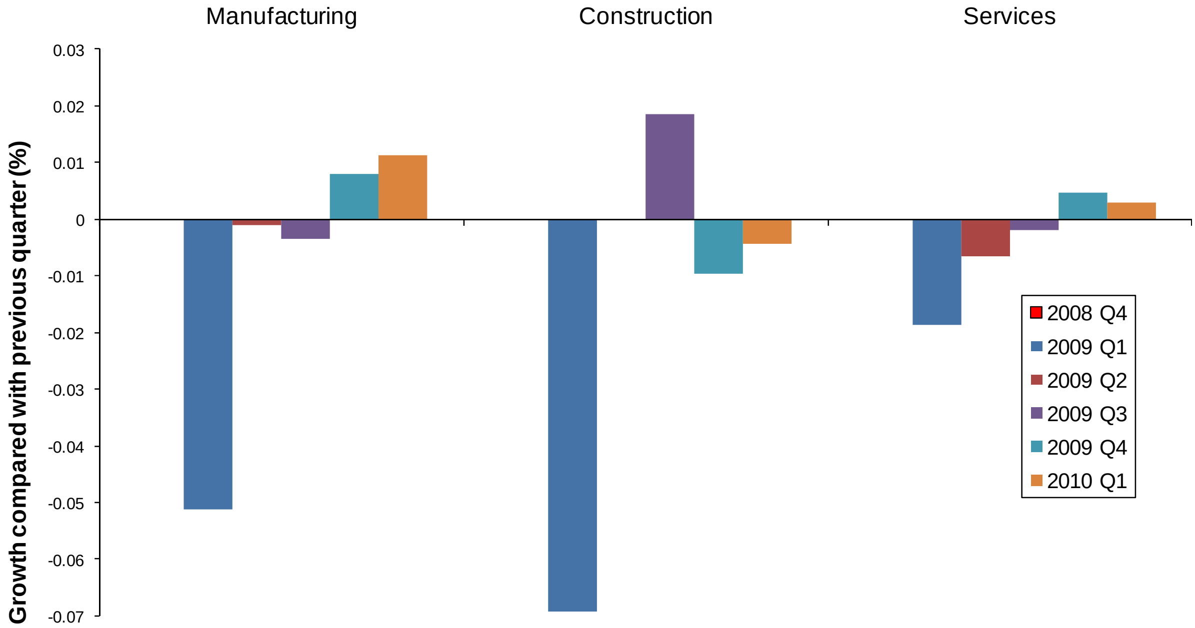
The economy moved into recession in 2008 Q3 as GDP fell for a second successive quarter. The economy moved out of recession in the last quarter of 2009, following six consecutive quarters of negative growth. The recent path of economic growth is shown in Chart 2 below.

Chart 2: Quarterly Real GDP growth (%)



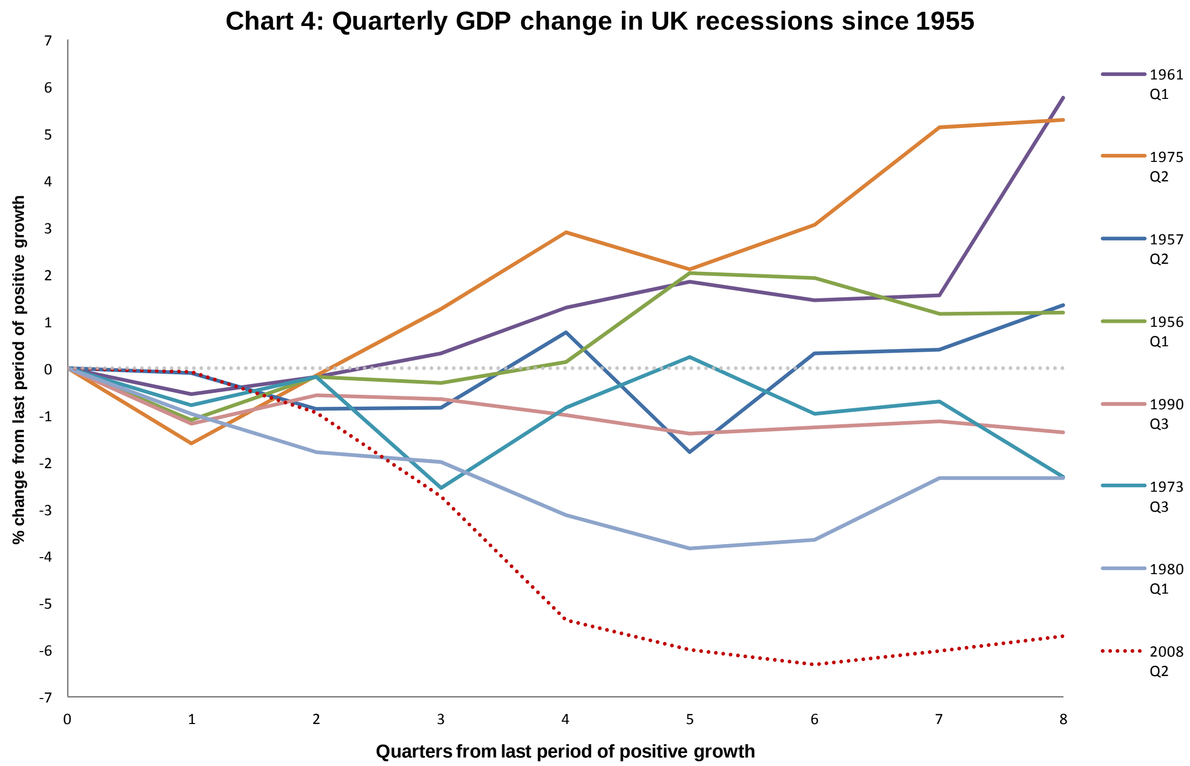
The recession has affected all sectors of the economy. The chart below shows that manufacturing and construction have been particularly affected.

Chart 3: Quarterly real change in GDP by sector (%)



Comparison with previous recessions

Chart 4 compares the path of UK GDP growth during (and following) the latest recession with previous recessions. The chart shows that the 2008/9 recession was the 'deepest' recession (in terms of lost output) in the UK since quarterly data were first published in 1955.



International comparisons of recessions

The downturn in global economic activity has been felt across the world, with many countries, including all G7 economies, falling into recession during 2008. All G7 countries have since exited (at least temporarily).

Apart from its length, the severity of the downturn can also be measured by the decline in economic output that occurred during the recession. Table 1 below summarises some features of the recessions in the G7 countries.

The UK remained in recession longer than the other G7 economies, with output declining for six consecutive quarters. Japan, Germany and France came out of recession in Q2 2009, with the US and Italy exiting in Q3. The UK came out of recession in Q4. However, by comparing OECD data, which shows the decline in GDP from pre-recession levels, the UK's 6.2% contraction is less severe than Japan's (-8.4%), Germany's (-6.7%) and Italy's (-6.4%). The US, France and Canada all experienced a decline in GDP of less than 4% during their recessions.

Table 1
G7 recessions

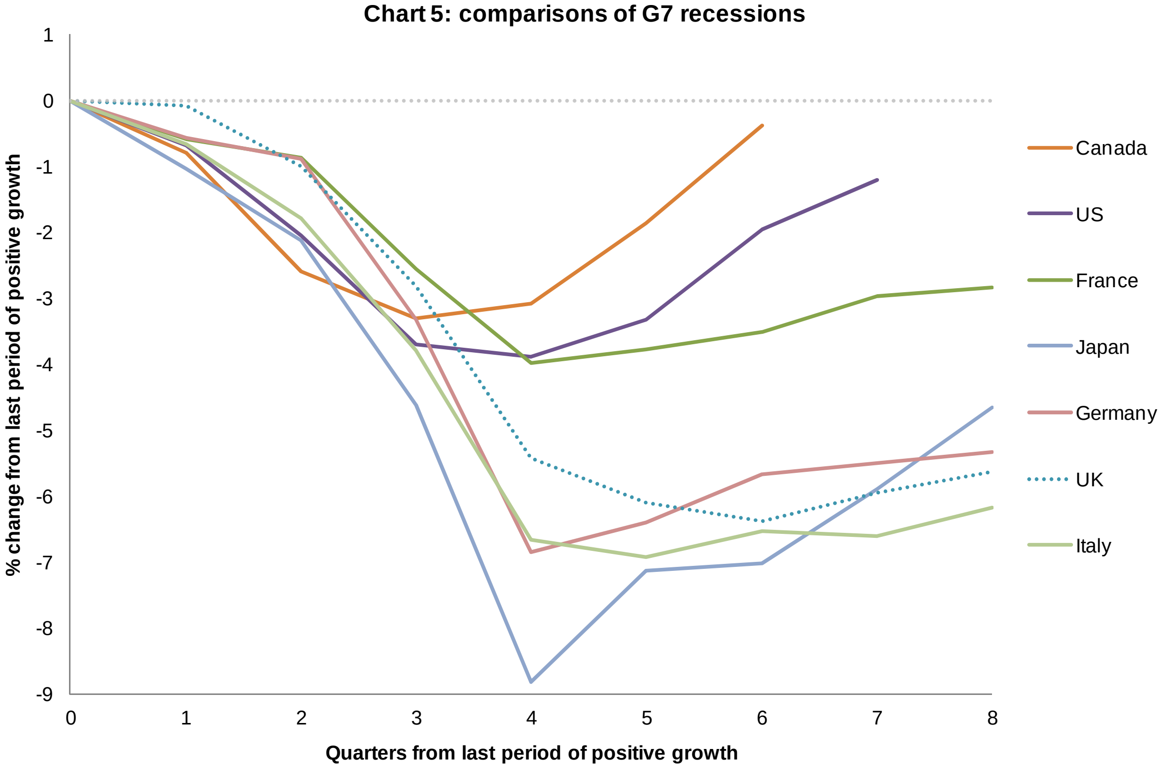
	Recession			
	Entered(a)	Exited	Length, qtrs(b)	decline in GDP(c)
Canada	Q4 2008	Q3 2009	3	3.6%
France	Q2 2008	Q2 2009	4	3.5%
Germany	Q2 2008	Q2 2009	4	6.7%
Italy	Q2 2008	Q3 2009	5	6.4%
Japan	Q2 2008	Q2 2009	4	8.4%
UK	Q2 2008	Q4 2009	6	6.2%
US	Q3 2008	Q3 2009	4	3.8%

Source: OECD, *Quarterly National Accounts*

Notes: (a) First quarter of contraction
(b) Total number of quarters of negative growth.
(c) From pre-recession levels

Chart 5 below tracks the path of GDP growth in the G7 economies during and since their recessions. The chart suggests that, so far, GDP in none of the G7 countries has returned to pre-recession levels.[3]

Chart 5: comparisons of G7 recessions



[3] Please note that not all countries' recessions started in the same quarter.

Forecasts of future growth

In the March 2010 Budget, the Treasury forecast growth in 2010 of between 1 and 1½%. It was more optimistic for 2011 and 2012 with forecasts of 3-3½% and 3¼-3 ¾% respectively. The 2010 Budget stated:

> Reflecting recent developments, the GDP growth forecast for 2010 remains unchanged from the 2009 Pre-Budget Report, with GDP forecast to rise by 1 to 1½ per cent. This is in line with the March average of independent forecasts.
>
> GDP growth is forecast to rise to 3 to 3½ per cent in 2011. This is slightly lower than the 2009 Pre-Budget Report forecast, reflecting a weaker outlook for the UK's largest trading partner, the euro area. GDP growth is then expected to rise to 3¼ to 3¾ per cent in 2012. The public finances projections run off the bottom end of the range. The Bank of England's mean forecast is around 3 per cent in both 2011 and 2012. The independent forecast average is rather weaker at 2.1 per cent in 2011,[[4]] but with a wide range of 0.9 to 3.4 per cent reflecting the degree of uncertainty.[5]

Table 2
March 2010 Budget economic forecasts

	2010	2011	2012
GDP growth, %	1.25	3.25	3.50
CPI inflation, %	2.00	1.50	2.00

Source: HM Treasury, 2010 Budget, Table 2.1

The chart below compares the March Budget forecast with the 2009 PBR forecast, the average independent forecast and the OBR's forecast. It takes the mid-point of the Treasury forecast range and the OBR's central forecast. The Treasury's forecast was similar to that of independent forecasters and the OBR for 2010 but more optimistic for 2011 and 2012.[6]

4 The latest average independent forecast is for a rise in GDP of 1.3% in 2010 and 2.1% in 2011 (HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, June 2010).

5 HM Treasury, *2010 Budget*, para 2.15 to 2.16

6 The independent forecasts for 2010 and 2011 are from the June edition of the Treasury's *Forecasts for the UK economy*. The forecast for 2012 is from the May edition.

Chart 6
Forecasts for real GDP growth, annual % change

Forecasts by the OECD, published in May, show that the UK economy is expected to grow by 1.3% in 2010, the lowest forecast of growth amongst the G7 except Italy (see table 3 below).

Table 3
OECD forecasts for real GDP growth, %

	2010	2011
Canada	3.6	3.2
France	1.7	2.1
Germany	1.9	2.1
Italy	1.1	1.5
Japan	3.0	2.0
UK	1.3	2.5
US	3.2	3.2
Euro area	1.2	1.8
Total OECD	2.7	2.8

Source: OECD, *Economic Outlook,* May 2010

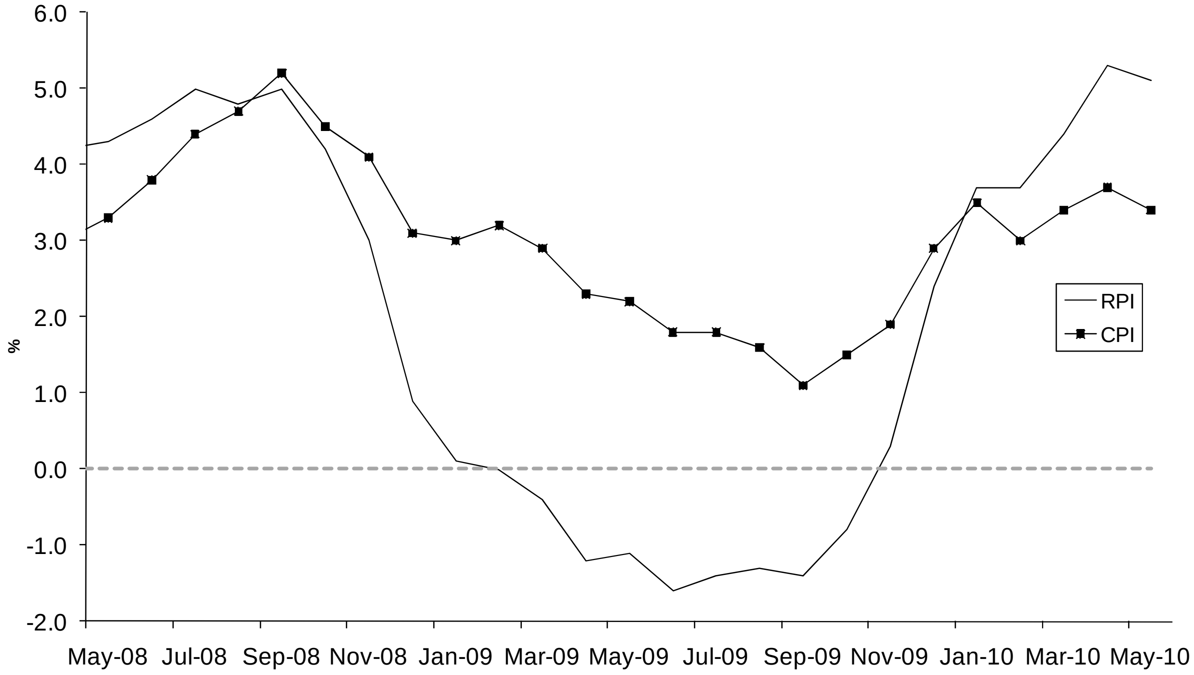
While the outlook remains uncertain, there are a number of factors which should work to boost the economy. Interest rates remain at historically low levels and sterling has declined by 25% since its peak in July 2007, which should provide a boost to exporters.

3.2 Inflation and deflation

Retail prices index (RPI) inflation remained negative (deflation) for most of 2009 but inflation rose sharply between the 2009 Pre-Budget Report and the 2010 Budget, measured by both the RPI and the consumer prices index (CPI): RPI inflation has risen from -0.8% in October 2009 to 5.1% in May 2010. CPI inflation has increased from 1.5% to 3.4% over the same period (see chart 7 above). The steep rise in inflation has been mainly due to the January

2010 increase in the standard rate of VAT, higher food costs and the continued increase in transport costs.

Chart 7: Inflation



Most forecasters expect RPI inflation to remain high for the immediate future as the impact of the restoration of VAT to 17.5% and high import prices remain. However, CPI inflation is expected to fall back towards the 2% target rate as these effects subside and spare capacity in the economy persists. The OECD forecasts CPI inflation in the UK of 3.0% this year and 1.5% next year, higher than most other G7 countries:

Table 4
OECD forecasts for inflation, %

	2010	2011
Canada	1.6	1.7
France	1.7	1.1
Germany	1.3	1.0
Italy	1.2	1.0
Japan	-0.7	-0.3
UK (CPI)	3.0	1.5
US	1.9	1.1
Euro area	1.4	1.0

Source: OECD, *Economic Outlook,* May 2010

3.3 Unemployment

Unemployment stood at 2.47 million in the three months to April 2010, up 23,000 from the last quarter and up 192,000 from a year earlier.[7] The unemployment rate is 7.9%, 0.1 percentage points higher than in the last quarter, and 0.6 percentage points higher than the same period a year ago.

7 Based on the ILO definition of unemployment. Source: ONS, *Labour Market Statistics June 2010*

Latest OECD forecasts from May 2010 expect the UK unemployment rate to average 8.1% in 2010 and 7.9% in 2011. Compared with other G7 economies, the OECD forecasts UK unemployment to be lower than in the US, France and Italy, but higher compared with Japan and Canada.

Table 5
OECD forecasts for unemployment, %

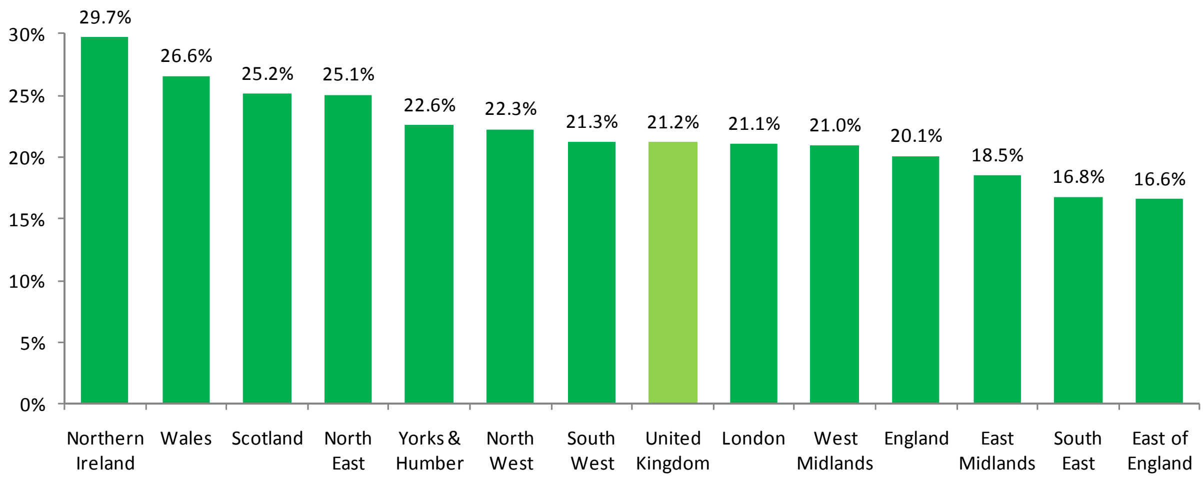
	2010	2011
Canada	7.9	7.2
France	9.8	9.5
Germany	7.6	8.0
Italy	8.7	8.8
Japan	4.9	4.7
UK	8.1	7.9
US	9.7	8.9
Euro area	10.1	10.1
Total OECD	8.5	8.2

Source: OECD, *Economic Outlook,* May 2010

Public sector employment

The proportion of people in employment in the public sector by region of the UK is shown in Chart 8 below:[8]

Chart 8: Public sector employment as a % of total employment, Q1 2010



Source: ONS, data not seasonally adjusted

In the UK as a whole there are 6.1 million employed in the public sector, 21.1% of total employment. Northern Ireland has the highest proportion of public sector employment (29.7%) while the East of England has the lowest (16.6%). This gives some indication of the regions potentially most at risk from cuts in public sector employment.

8 Public sector employment includes those employed in publically owned financial institutions such as RBS, Lloyds and Northern Rock.

4 Taxation

4.1 The tax system: past trends, future prospects

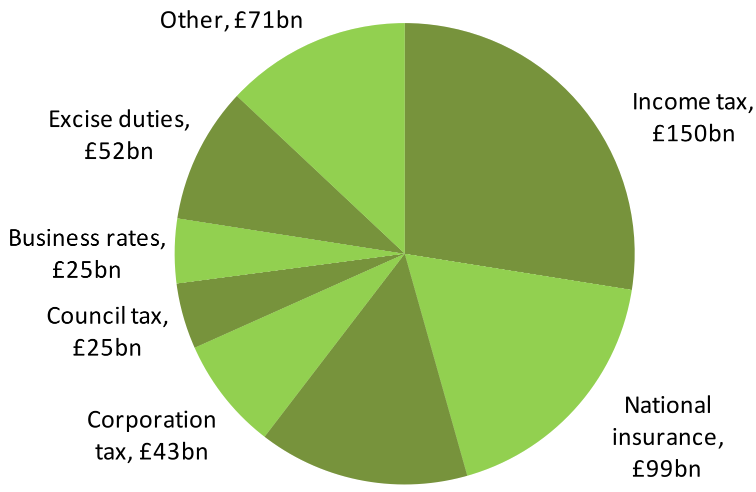
The last three years have seen a strong decline in the Government's tax revenues: from £548 billion in 2007/08 to £515 billion in 2009/10. This has been a striking reversal of fortune for the public finances. In the 2007 Budget, the Labour Government had projected that tax receipts would rise over the following three years – to reach an estimated £616 billion by 2009/10.[9] All told, the Exchequer received £158 billion less than was expected over this period.

The role of the financial crisis in this trend, through its impact on corporate profits, the property market and the availability of consumer credit, can be seen in the decline in receipts from three particular taxes (from 2007/08 to 2009/10):[10]

- Corporation tax receipts have fallen from £46.4bn to £36.5bn
- Stamp duties receipts have fallen from £14.1bn to £7.8bn
- VAT receipts have fallen from £80.6bn to £70.1bn.

Although the total size of the tax take has shrunk, the overall balance between different taxes remains broadly unchanged. Income tax, national insurance contributions (NICs) and VAT are by far the most important taxes with regard to the amounts of money they raise: taken together, they account for 60% of all Exchequer revenues as shown in the chart below.

Chart 9: Tax revenue, 2010/11



Source: OBR

Clearly this has implications for any decision to raise taxes to help restore the health of the public finances, as increases in the rates of income tax, NICs and VAT can raise large sums:[11]

9 HM Treasury, *Budget 2007* p278 (Table C4), HM Treasury, Public finances databank Table C4. Office for Budget Responsibility, *Pre-Budget forecast, June 2010*, p44

10 HM Treasury, Public finances databank Table C4. Office for Budget Responsibility, *Pre-Budget forecast, June 2010* p44

- Increase basic rate of income tax by 1p: £4.75 billion
- Increase higher rate of income tax by 1p: £0.78 billion
- Increase main NICs rate on employees by 1 percent point: £3.6 billion
- Increase NICs rate on employers by 1 percentage point: £4.3 billion
- Increase standard rate of VAT by 1 percentage point: £4.75 billion

By way of comparison, increasing the rates of duty on alcohol, tobacco, and road fuel by 1 percentage point would raise only £0.36bn in total.

It seems likely that there would have to be structural changes in the tax system to raise significantly more money than this in future years, a point made by the Institute for Fiscal Studies (IFS) in their most recent Green Budget report, published in February 2010.[12] Some examples of this type of change are: abolishing the zero and reduced rates of VAT which apply to selected goods and services (over £24 billion), applying capital gains tax to the sale of a person's principal private residence (around £3.7 billion), or removing the lower rate of corporation tax which applies to small companies (around £3.2 billion). None of these quite radical options appeared in the manifestoes of the three major parties for the 2010 General Election, but they illustrate the difficult choices before the new Government.

4.2 Tax measures in the March 2010 Budget

At the outset it should be noted that in its 2010 Budget in March, the Labour Government announced a number of measures to raise tax revenues over the next two years:

- From April 2010 a new higher rate of income tax of 50% on income over £150,000.
- From April 2010 the income tax personal allowance would be gradually withdrawn, for individuals with incomes above £100,000.
- From April 2011 the rates of NICs would be increased by 1 percentage point, for employees, employers and the self-employed – though the NI threshold for employees would be increased to mitigate the impact of this change on individuals with lower earnings.

At the time it was estimated that if all of these measures were implemented, they would raise £10.49 billion by 2011/12.

Following the Budget on 24 March this year, the Labour Government introduced a shortened Finance Bill, to take account of the relatively short amount of Parliamentary time available before the General Election. The Bill made provision for the new 50p rate, alongside the basic rate and higher rate and the level of personal allowances for 2010/11.[13] Parliamentary convention prohibits changes to National Insurance being included in the annual Finance Bill, so that the Government anticipated having a separate National Insurance Bill later this year.

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[11] HM Revenue & Customs, *National Statistics: Table 1.6 (Direct effects of illustrative changes)*, March 2010. Estimates are for 2011/12.

[12] Robert Chote et al. (eds), *The IFS Green Budget*, February 2010 pp161-163

[13] This provision is now contained in s1 of the *Finance Act 2010*. Provision for restricting the personal allowance for those with incomes of £100,000 or more was made last year (under s4 of the *Finance Act 2009*).

Both income tax and corporation tax are annual taxes, and the authority to collect them expires at the end of the tax year. As a consequence it is common practice when an Election is anticipated soon after a spring Budget for the Government of the day to pass a short Finance Act quickly, usually with cross-party co-operation, so that both taxes can be collected in the normal way. Often it reserves a good proportion of the measures set out in the Budget, in the expectation of introducing a second Finance Bill soon after Parliament is recalled. This was the case in 1992, when the then Conservative Government introduced a very short Finance Bill before the Election that April, and in 2005, when the Labour Government introduced shorter Finance Bills of roughly equal length, before and after the Election in May. Similarly when the party of government changes, the new Government will generally have a Budget in the weeks after the Election, followed by a Finance Bill. This occurred in 1997 when the new Labour Government had a Budget on 2 July, two months after its Election victory.[14]

Turning back to the March 2010 Budget, the Labour Government published its shortened Finance Bill on 30 March. On 6 April the Prime Minister announced that, as widely anticipated, the election would be held on 6 May, with the Dissolution on 12 April. This left 2 days of Parliamentary time for the conclusion of all legislative business, and the Finance Bill was debated, and approved, in its entirety in three hours on 7 April – with little reference being made to the new 50p rate, or the restrictions made to the personal allowance for those on £100,000 or more.[15]

4.3 Tax proposals in the Coalition Agreement

During the election campaign, none of the three major parties proposed reversing these two measures, or making other increases in income tax. In addition, neither the Conservatives nor the Liberal Democrats proposed reversing the increases in NI rates proposed by the Labour Government to take effect from April 2011. That said, the Conservatives argued for an additional increase in NI thresholds for both employers and employees from 2011/12.

In addition both the Conservatives and the Liberal Democrats made a series of tax proposals in their election manifestoes.[16]

The Conservatives' tax proposals included:

- A transferable tax allowance for some married couples.
- Increasing the inheritance tax threshold from £325,000 to £1 million.
- Extending the existing £30,000 flat-rate charge to all non-domiciled UK residents.[17]
- Making the temporary increase in the stamp duty threshold for first time buyers permanent.[18]

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[14] The procedure for the Budget and the annual Finance Bill, and the impact that an Election may have on its timing, is examined in more detail in *The Budget & the annual Finance Bill*, Library standard note SN/BT/813, 14 June 2010.

[15] HC Deb 7 April 2010 cc 1058-1105

[16] A summary of the three parties' tax policies was provided in, *Taxes and benefits: the parties' plans: Institute for Fiscal Studies Election Briefing Note BN100*, 27 April 2010

[17] The Labour Government introduced this charge in 2008 for longer-term residents with domicile outside the UK who elect to be taxed only on income they bring in to the UK.

[18] In the March 2010 Budget the Labour Government announced that for two years the zero-rate threshold would be doubled, to £250,000, for first time buyers only.

- Cutting the main rate of corporation tax to 25%, and the small companies' rate to 20%, while reducing the generosity of capital allowances.

- Introducing a levy on the wholesale liabilities of banks.

The Liberal Democrats' tax proposals included:

- Increasing income tax personal allowances to £10,000, while holding constant the level of income at which people start to pay higher-rate income tax.

- Restricting income tax relief on pension contributions to the basic rate.

- Introducing anti-avoidance and anti-evasion measures, including a 'General Anti-Avoidance Principle'.

- Reforming air passenger duty to operate per flight instead of per passenger and introducing additional tax for some domestic flights.

- Introducing an additional 10% tax on the profits of UK banks, prior to further reform to bank regulation.

- Reducing the capital gains tax allowance from £10,100 to £1,000 and taxing some capital gains above this at marginal income tax rates

- Introducing an annual 1% 'mansion tax' on domestic property values above £2m.

Following the election, some of these measures were incorporated in the Coalition Government's Agreement. Commentators focused on the fact that the Government had adopted Liberal Democrat proposals for a tax cut – by raising the personal income tax allowance, and a tax increase – by increasing the rate of capital gains tax on non-business assets.[19] The section from the Coalition Agreement on tax policy is reproduced in full below. Notably the Agreement postpones the Conservative proposal for a cut to inheritance tax while taking up the Liberal Democrat suggestion of higher taxes on air travel; that said, there is no mention of other Liberal Democrat proposals for restricting tax relief on pension contributions or a 'mansions tax':

> The Government believes that the tax system needs to be reformed to make it more competitive, simpler, greener and fairer. We need to take action to ensure that the tax framework better reflects the values of this Government.
>
> - We will increase the personal allowance for income tax to help lower and middle income earners. We will announce in the first Budget a substantial increase in the personal allowance from April 2011, with the benefits focused on those with lower and middle incomes. This will be funded with the money that would have been used to pay for the increase in employee National Insurance thresholds proposed by the Conservative Party, as well as revenues from increases in Capital Gains Tax rates for non-business assets as described below. The increase in employer National Insurance thresholds proposed by the Conservatives will go ahead in order to stop the planned jobs tax.

[19] "Coalition to increase capital gains tax", *Financial Times*, 12 May 2010; "Give and take", *Stephanomics* (BBC Newsonline blog by BBC economics editor, Stephanie Flanders, 12 May 2010).

- We will further increase the personal allowance to £10,000, making real terms steps each year towards meeting this as a longer-term policy objective. We will prioritise this over other tax cuts, including cuts to Inheritance Tax.

- We will also ensure that provision is made for Liberal Democrat MPs to abstain on budget resolutions to introduce transferable tax allowances for married couples without prejudice to the coalition agreement.

- We will reform the taxation of air travel by switching from a per-passenger to a per-plane duty, and will ensure that a proportion of any increased revenues over time will be used to help fund increases in the personal allowance.

- We will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities.

- We will make every effort to tackle tax avoidance, including detailed development of Liberal Democrat proposals.

- We will increase the proportion of tax revenue accounted for by environmental taxes.

- We will take measures to fulfil our EU treaty obligations in regard to the taxation of holiday letting that do not penalise UK-based businesses.[20]

- We will review the taxation of non-domiciled individuals.[21]

The agreement also stated that the Government would "reform the corporate tax system by simplifying reliefs and allowances, and tackling avoidance, in order to reduce headline rates" and "review the effectiveness of the raising of the stamp duty threshold for first-time buyers."[22]

Commenting on the agreement, the IFS speculated on how exactly the commitment to increase the personal tax allowance would be implemented:

> We might choose to read something into the promise that the benefits of the rise in the income tax personal allowance would be "focused on those with lower and middle incomes". This would certainly not have been the case with the increase in the personal allowance proposed by the Liberal Democrats, which would have benefitted all those with incomes below £100,000.
>
> It is not clear what is meant by this phrasing, but it is possible that the Government would reduce the basic rate limit (i.e. the band of income over which someone pays basic-rate tax) to remove all of the gains of a higher personal allowance from higher-rate taxpayers. This would mirror exactly the form of the changes to employee National Insurance proposed in the Conservative manifesto. In effect, the Conservative Party could forgo its manifesto proposal to cut employee National Insurance bills by £150 a year (while changing the Upper Earnings Limit to remove the benefits from higher-rate taxpayers) in order to fund a £150 a year cut in income tax bills (with a change to the basic-rate threshold to remove the benefits from higher-rate taxpayers).

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20 One of the 3 measures dropped from the Labour Government's Finance Bill on the insistence of the Opposition was the abolition of the 'furnished holiday lettings' rules: for more details see, *Furnished Holiday Lettings*, Library standard note SN/BT/5250, 10 June 2010

21 HM Government, *The Coalition: our programme for government*, 20 May 2010 pp30-1

22 HM Government, *The Coalition: our programme for government*, 20 May 2010 p10, p12

> If that is how they wanted to structure the change, this could take the income tax personal allowance in April 2011 close to around £7,300 (having incorporated the usual rise in line with inflation and the cut pre-announced by the last government) from its current £6,475, and would cost slightly more than the Conservative Party's proposed change to employee National Insurance (which we think would have cost around £2.5 billion). Of course, the new Government may wish to extend some benefits of the increased personal allowance to higher-rate taxpayers (which could cost more, or mean a smaller rise in the personal allowance). On the other hand, it says it will have additional revenues from CGT and possibly air passenger duty reforms which it could spend on a larger increase in the personal allowance.[23]

Naturally the Government have not published any more details on its tax plans in the run-up to the Budget itself.

In the last weeks most comment has focused on the proposed changes to CGT, although the Liberal Democrats had estimated that their original proposal, which included a substantial cut in the CGT allowance, would only raise £1.9 billion.[24] The debate is examined in more detail in a second Library note.[25] In the light of this, and the fact that the Labour Government had already announced increases to both income tax and NICs before the 2010 Election, many have speculated that the Government will look to increases in the standard rate of VAT or an extension of the VAT-base, to raise significant amounts of money in the medium term.[26]

5 The public finances

5.1 Introduction

The Coalition Government has said that reducing the budget deficit, together with ensuring the economic recovery, is the most important task facing the country. The Government has set out the reasons why a high level of borrowing "risks undermining fairness, growth and economic stability":

- Higher levels of debt tend to lead to higher interest rates for households and businesses as a well as the government. Higher interest rates tend to reduce economic growth;
- Unless steps are taken, debt interest will account for an increasing proportion of public spending;
- High levels of debt reduce the government's ability to respond to future economic shocks;
- It is "irresponsible" to build up a high level of debt which must be paid off by future generations.[27]

The Government has already provided some indications of its approach to the public finances. For example, it has said that it will "significantly accelerate" the speed at which the structural budget deficit will be reduced over the course of this Parliament and that the main burden will fall on cuts in spending rather tax increases.[28] It has also stated that the most

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23 IFS press notice, *Some initial thoughts on the Tory/Lib Dem coalition agreement*, 12 May 2010

24 *Liberal Democrat Manifesto 2010*, April 2010 p14, p100. For its part the IFS thought this was a conservative estimate (*Institute for Fiscal Studies Election Briefing Note BN100*, 27 April 2010 p41).

25 *Capital gains tax : recent developments*, Library standard note SN/BT/5572, 9 June 2010

26 For example, "Get ready for VAT rise to pay for £17bn Lib Dem tax cuts, economists warn", *Times*, 14 May 2010; "VAT looms as coalition deal adds estimated £10bn to debt", *Guardian*, 14 May 2010

27 HM Treasury, *The Spending Review Framework*, June 2010, p3

28 HM Treasury, *The Spending Review Framework*, June 2010, paras 1.3 and 1.5

vulnerable members of society are most at risk from high levels of debt and that arrangements will be made to protect those on low incomes from spending cuts.[29]

Details of the deficit reduction plan will be set out in the Budget including the fiscal mandate against which the OBR will make its assessment of government policy. The Budget will set out the overall figures for the public finances, including public spending for the rest of the Parliament.[30]

There has been considerable discussion about the size of the spending cuts to be announced in the Budget. It is important to remember that the March Budget set out a sharp reduction in the growth of public spending (see section 5.5 below). The IFS has commented on the possible scale of additional spending cuts, over and above those planned by the last government. It noted that the new government has yet to set out its target for borrowing or the detail of the balance between spending cuts and tax increases needed to achieve this. The IFS said:

> On January 5th, when Mr Osborne published draft legislation for the new OBR, he announced that he would aim for “a cyclically adjusted balanced current budget by the end of the forecast horizon”. If the new coalition Government chooses to retain this target for 2014–15 (the last year of the forecast horizon in today’s OBR report and in next week’s Budget), then this will necessitate spending cuts and tax rises of 1.6% of national income (£24 billion) on top of the 3.4% of national income (£51 billion) already planned by Labour.
>
> Prior to the financial crisis Gordon Brown and Alistair Darling chose to aim for a surplus on the cyclically-adjusted current budget of around 0.7% of national income by the end of the forecast period. Replicating this goal to incorporate caution would bring the required combination of spending cuts and tax rises up to 2.3% of national income (£34 billion) on top of the 3.4% of national income (£51 billion) already planned by Labour.
>
> This latter illustrative scenario suggests a total tightening of £85 billion would be needed by 2014–15. The Conservative Party general election manifesto states a preference for the tightening to be delivered in a ratio of 4:1 spending cuts to tax rises (i.e. 80% spending cuts and 20% tax rises). To achieve this would imply spending cuts of £68 billion and tax rises of £17 billion. We estimate that, based on Treasury figures, the tax rises put in place by Labour would increase tax revenues by £18 billion. This suggests that a 4:1 ratio of spending cuts to tax rises, with “a significantly accelerated reduction in the structural deficit over the course of a Parliament”, could be brought about without any further net increase in taxes. However it does imply that any new tax cuts would need to be financed through tax rises. So, for example, the new coalition Government’s commitments to increase the income tax personal allowances, to recognise marriage in the income tax system, and to offset the increase in employers’ National Insurance Contributions planned for April 2011 would need to be financed through tax rises elsewhere. At least in part these revenues could come from the pledges in the coalition agreement to increase Capital Gains Tax and to increase taxation on air travel.
>
> The spending cuts implied by this scenario would be deeper than those implied by Mr Darling’s March 2010 Budget. Without cuts to spending on welfare benefits, we estimate that spending on DELs would need to be cut in real terms by an average of 5.5% a year from 2010–11 to 2014–15, or by a cumulative 20.3% or £78 billion. The

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29 HM Government, *The Coalition: our programme for government*, page 15

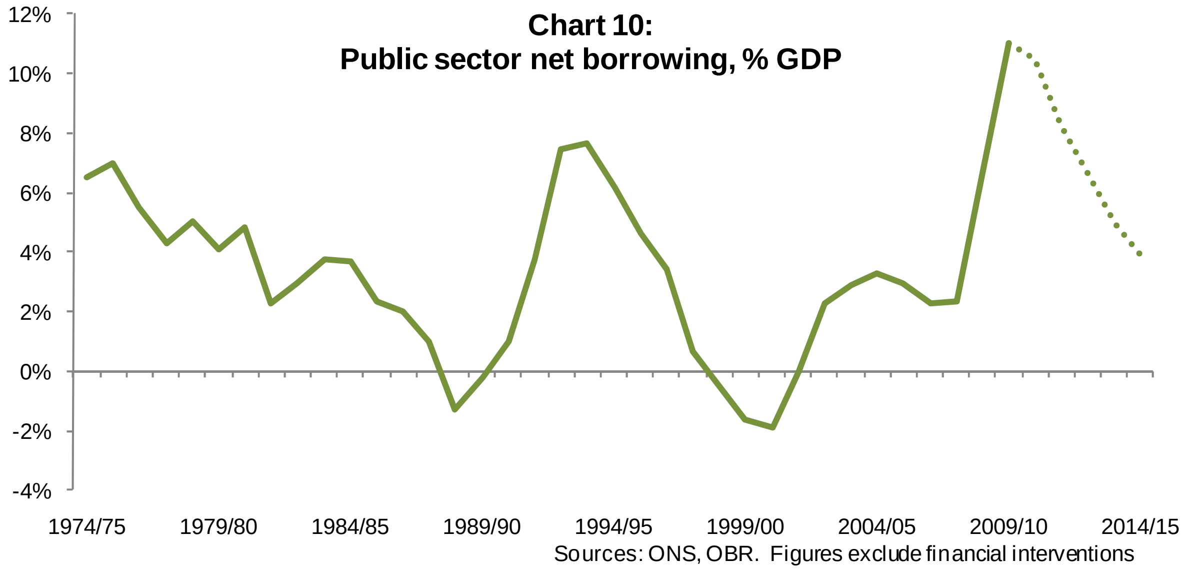
30 HM Treasury, *The Spending Review framework*, June 2010, para1.12

coalition agreement commits to year-on-year increases in the total NHS budget and to sharp increases in spending on overseas aid. Even if the NHS increase was just 0.1% a year this would increase the DEL cuts needed elsewhere to 9.4% a year, or a cumulative 32.7% or £82 billion. So far the coalition Government has announced cuts to unprotected departments amounting to around £6 billion; the remaining cuts required to unprotected DELs may well be deemed prohibitively large.

An alternative scenario would be to stick to the DEL totals implied by today's OBR report. This (as discussed above) would still require total DELs to be cut in real terms by an average of 2.7% a year from 2010–11 to 2014–15, or by a cumulative 10.2% or £39.3 billion; and DELs outside the NHS and overseas aid would be cut by an average of 4.6% a year from 2010–11 to 2014–15, or by a cumulative 17.3% or £44 billion. It would also require a cut to spending on welfare benefits of £30 billion: equivalent to reducing all welfare payments by 18%. Such welfare cuts are likely to seem prohibitively large. This suggests that next week's Budget may contain some combination of an additional squeeze on DELs, cuts in welfare payments and net tax increases so as to spread the pain. Alternatively the Government may adopt a less ambitious target than the one we have illustrated here.[31]

5.2 Government borrowing

Government borrowing, the difference between public spending and revenues, is at historically high levels. In 2009/10, the deficit was £155 billion. This compares with £96 billion in 2008/09 and £31 billion in 2006/07. As a share of GDP, the deficit was 11.0% of GDP in 2009/10. Borrowing as a share of GDP since 1974/75 is shown in the chart below, together with the OBR's forecasts. The 2009/10 level is higher than the previous peak of 7.7% of GDP in 1993/94.



The OBR forecasts a fall in net borrowing from 10.5% of GDP in 2010/11 to 3.9% by 2014/15 (£155 billion to £71 billion).[32] This is slightly lower than the forecasts in the March Budget (see table below). For this year, the OBR's forecast of £155 billion borrowing is £8 billion lower than the forecast in the March Budget. This is mainly due to higher expected

[31] IFS Press Release, *OBR sets the scene for a painful Budget*, 14 June 2010

[32] The OBR forecasts a range of outcomes for the deficit, reflecting uncertainty. The figures shown in the chart and table are its central forecast.

government revenues, particularly income tax and VAT. Over the five years from 2010/11 to 2014/15, the OBR borrowing forecast is £23 billion lower than that forecast in the March Budget.

Table 6
OBR and March 2010 Budget forecasts of public sector net borrowing

	OBR £ billion	March Budget £ billion	OBR % GDP	March Budget % GDP
2009/10	156.1	166.5	11.1	11.8
2010/11	155	163	10.5	11.1
2011/12	127	131	8.3	8.5
2012/13	106	110	6.6	6.8
2013/14	85	89	5.0	5.2
2014/15	71	74	3.9	4.0

Source: OBR, Pre-Budget forecast, June 2010, Table 4.5, p38

While the OBR forecasts for economic growth have been significantly reduced compared with March's Budget, its forecasts for the public finances are similar. Partly this is because in the past, the Treasury used more cautious assumptions about growth when forecasting the public finances than its central economic forecast. The OBR is, however, using its central growth forecast. The difference between the OBR and the March Budget in the growth assumption for forecasting the public finances is thus less than the difference in their "headline" growth forecasts. In addition, the OBR is more optimistic about VAT revenue and the cost of unemployment.[33]

Cyclical and structural elements of the deficit

A distinction is often drawn between the "cyclical" and "structural" elements of the budget deficit:

- **Cyclical** elements of the deficit refer to the effect of the economic cycle on the level of government borrowing. In a recession, government borrowing tends to increase as tax receipts are reduced and spending on unemployment benefit increases. The reverse happens when the economy is growing strongly. These effects are sometimes known as the economy's "automatic stabilisers".

- **Structural** elements of the deficit refer to underlying or persistent elements of government borrowing which are unrelated to the economic cycle. The structural deficit is measured by cyclically-adjusted measures of borrowing.

The distinction is important as the "headline" borrowing figures may mask underlying trends unless the economy's position in the economic cycle is taken into consideration. It should be pointed out, however, that estimating how much of the deficit is cyclical and how much is structural is far from easy. This requires an assessment of where the economy is in the economic cycle. It can be difficult to determine where the economy is in relation to its "trend" level of output. This is particularly the case when the economy is coming out of recession as it requires a calculation of how much of the lost output is purely cyclical and how much is

[33] "The official verdict is that we are not Greece", *Financial Times*, 15 June 2010

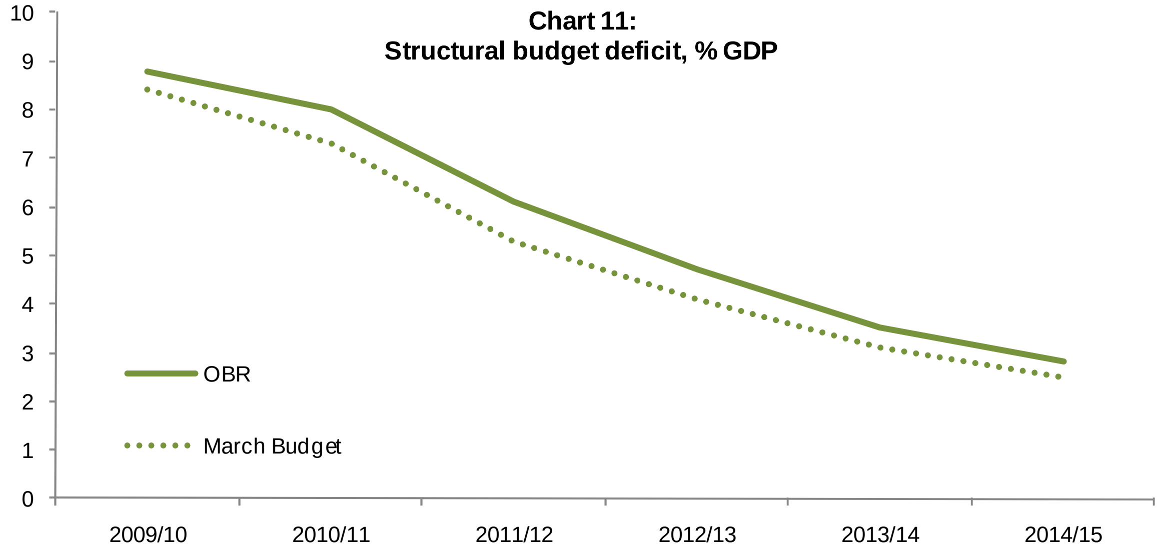
permanent. These problems mean that estimates of the structural deficit need to be treated with a degree of caution.

The OBR forecasts for the structural deficit are higher than those in the March Budget. For 2010/11, the OBR forecast that the structural deficit will be 8.0% of GDP compared with 7.3% in the March Budget. The OBR forecast is higher for every year up to 2014/15 (see table and chart below)

Table 7
OBR and March Budget forecasts of structural deficit
% GDP

	OBR	March Budget
2009/10	8.8	8.4
2010/11	8.0	7.3
2011/12	6.1	5.3
2012/13	4.7	4.1
2013/14	3.5	3.1
2014/15	2.8	2.5

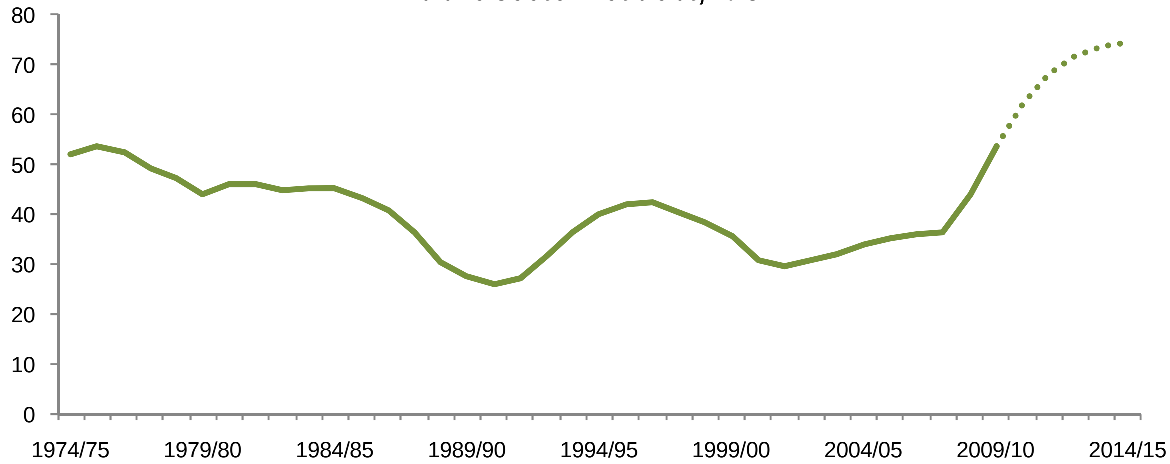
Source: OBR, Pre-Budget forecast, June 2010, p38



5.3 Debt and debt interest payments

Public sector debt, which represents the government's total indebtedness built up over the years, was £772 billion in 2009/10, equivalent to 53.5% of GDP. This compares with £527 billion (36.5% of GDP) two years earlier. The debt ceiling was 40% under the previous government's fiscal rules.

Chart 12
Public sector net debt, % GDP



Sources: ONS, OBR. Figures exclude financial interventions

The OBR forecast that debt will increase from 62% of GDP this year to 74% of GDP by 2014/15. In cash terms, this is an increase from £936 billion to £1,376 billion. These are very similar to the forecasts in the March Budget (see table below).

Table 8
OBR and March 2010 Budget forecasts of public sector net debt

	OBR £ billion	March Budget £ billion	OBR % GDP	March Budget % GDP
2009/10	772	777	53.5	54.1
2010/11	936	952	62.2	63.6
2011/12	1,076	1,095	68.2	69.5
2012/13	1,196	1,218	71.8	73.0
2013/14	1,294	1,320	73.7	74.5
2014/15	1,376	1,406	74.4	74.9

Source: OBR, Pre-Budget forecast, June 2010, Table 4.3 (p36) and Table 4.5 (p38)
HM Treasury, Budget 2010, Table C3, p189

The OBR report forecasts that government interest payments will increase from £42.1 billion in 2010/11 to £67.2 billion in 2014/15.[34]

5.4 International comparisons of government borrowing and debt

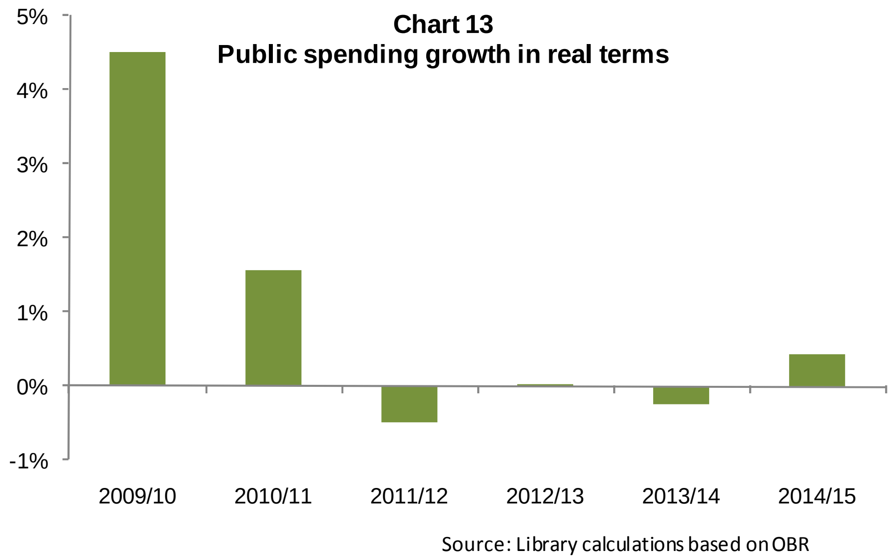
The UK's deficit is forecast by the OECD to be the second highest among the OECD countries in 2010 at 11.5% of GDP, slightly lower than Ireland at 11.7.% The OECD average is 7.8%. Turning to debt, the OECD forecast UK government net debt of 53.5% of GDP in 2010 compared with an OECD average of 57.7%.[35] A chart showing the OECD forecasts is in Appendix 2 at the end of this note.

[34] Office for Budget Responsibility, *Pre-Budget forecast June 2010*, Table 4.8, p48
[35] Source: OECD *Economic Outlook No 87* (May 2010) Annex Tables 27 and 33.

5.5 Public spending

Public spending is forecast to reach £701 billion in 2010/11 (47.5% of GDP). The growth of public spending in real terms implied by the OBR forecast, based on the policies of the previous government, is shown in the chart below. This shows a very sharp slowdown in the rate of growth of public spending. Public spending grows by 1.6% this year but there is no growth in public spending in real terms over the following four years.

As the new government has said that it wants to reduce the deficit more quickly than the last government and that this will be done more by spending cuts than tax increases, spending is almost certain to be reduced even more quickly than shown in the chart below. The Budget will set the path for public spending for the rest of the Parliament but detailed department spending totals will not be set until the spending review in the Autumn.



Cuts announced for 2010/11

The Government has already announced savings of £6.2 billion for this financial year. £500 million of this will be re-invested in further education, apprenticeships and social housing, leaving a net cut of £5.7 billion. Schools, Sure Start and education spending for 16-19 year olds will be protected from these cuts. In announcing the cuts, the Treasury said:

> Savings will be taken out of budgets, without affecting the quality of key frontline services, as set out in the coalition agreement. In addition to £6.2bn of savings in non-protected departments, savings in health, defence and international aid will be reinvested in front line services in those departments.[36]

The Treasury gave further details of where these savings will be made:

> Outside of Local Government and the Devolved Administrations, the savings are allocated across different areas as follows:
>
> • £1.15bn in discretionary areas like consultancy and travel costs
>
> • £95m through savings in IT spending

[36] HM Treasury Press notice, *Government announces £6.2 billion of savings in 2010-11*, 24 May 2010

• £1.7bn from delaying and stopping contracts and projects, including immediate negotiations to achieve cost reductions from the major suppliers to government

• £170m from reductions in property costs

• at least £120m from a recruitment freeze across the civil service for the rest of 2010-11

• £600m from cutting the cost of quangos

• £520m by reducing other lower value spend.

In addition, £1.165 bn of savings will be made in Local Government by reducing grants to Local Authorites to reflect their contribution to the £6.2bn. The Government will also remove the ringfences around over £1.7bn of grants to local authorities in 2010-11, to give them greater flexibility to re-shape their budgets and find savings in the areas set out above, while maintaining the quality of services to their customers.

As announced a week ago, the Devolved Administrations will have the option of making savings this year or deferring their share of the savings, which totals £704m, until the next financial year.

As well as savings from waste and efficiency, including £10m from cracking down on first class travel and £5m from restricting ministerial entitlement to a dedicated car and driver, specific low value programs included in the above list include:

• £320m from reducing and then stopping government contributions to the Child Trust Fund. The Government intends to introduce legislation to scale back payments from August this year and then stop payments from 1 Jan 2011. Payments to disabled children due this year will be made, and the Government will ensure that the funding allocated for these payments in future years will be redirected to other forms of support for disabled children.

• £150m from savings in the last Government's housing pledge, while seeking to protect social housing.

• £320m from ending ineffective elements of employment programmes, including ending further rollout of temporary jobs through the Young Person's Guarantee (the 'Future Jobs Fund') and removing recruitment subsidies from the 'Six-Month Offer'.

• £270m from ending lower value RDA spending.

• £80m from closing the British Educational Communications and Technology Agency (BECTA) and other savings in Department for Education quangos.[37]

In addition, on 17 June, the Government announced the suspension or cancellation of a number of projects following its review of all spending decisions taken since 1 January. Details are in a Treasury press notice.[38]

The 2010 Spending Review

The Spending Review (SR) will report in the Autumn and provide greater detail on the Government's spending plans. The SR will set spending limits for each government department. The SR will include social security, tax credits and public service pensions.

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[37] HM Treasury Press notice, *Government announces £6.2 billion of savings in 2010-11*, 24 May 2010

[38] HM Treasury Press notice, *Action to tackle poor value for money and unfunded spending commitments*, 17 June 2010

The Government has made pledges to protect certain areas of public spending. In particular:

- Health spending will increase in real terms in each year of the Parliament
- 0.7% of Gross National Income (GNI) will be spent on overseas aid by 2013.[39]

In addition, the Government has said that it will limit, as far as possible, the impact of reductions in spending on the poorest and most vulnerable in society and on regions which depend heavily on the public sector.[40] A chart in section 3.3 above shows proportions of public sector employment by region and thus gives some indication of which regions might be affected most by public spending cuts.

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[39] HM Treasury, *Spending Review 2010 – the Government's approach*, 8 June 2010, para 1.8
[40] HM Treasury, *Spending Review 2010 – the Government's approach*, 8 June 2010, para 1.8

6 Appendix 1: UK Economic and public finance data

Economic data

	Real GDP growth	Unemployment (a)		Inflation CPI (b)	Inflation RPI
	(%)	Thousands	%	%	%
1979	2.7%	1,414	5.3%	..	13.4%
1980	-2.1%	1,603	6.0%	..	18.0%
1981	-1.3%	2,476	9.1%	..	11.9%
1982	2.1%	2,813	10.5%	..	8.6%
1983	3.6%	3,008	11.3%	..	4.6%
1984	2.7%	3,263	11.9%	..	5.0%
1985	3.6%	3,169	11.4%	..	6.1%
1986	4.0%	3,151	11.3%	..	3.4%
1987	4.6%	3,090	11.0%	..	4.2%
1988	5.0%	2,569	9.0%	..	4.9%
1989	2.3%	2,140	7.4%	5.2%	7.8%
1990	0.8%	2,004	6.9%	7.0%	9.5%
1991	-1.4%	2,378	8.2%	7.5%	5.9%
1992	0.1%	2,782	9.8%	4.3%	3.7%
1993	2.2%	2,986	10.6%	2.5%	1.6%
1994	4.3%	2,768	9.8%	2.0%	2.4%
1995	3.1%	2,489	8.8%	2.6%	3.5%
1996	2.9%	2,350	8.3%	2.5%	2.4%
1997	3.3%	2,052	7.2%	1.8%	3.1%
1998	3.6%	1,799	6.3%	1.6%	3.4%
1999	3.5%	1,773	6.2%	1.3%	1.5%
2000	3.9%	1,654	5.7%	0.8%	3.0%
2001	2.5%	1,459	5.0%	1.2%	1.8%
2002	2.1%	1,522	5.2%	1.3%	1.7%
2003	2.8%	1,517	5.1%	1.4%	2.9%
2004	3.0%	1,437	4.8%	1.3%	3.0%
2005	2.2%	1,417	4.7%	2.1%	2.8%
2006	2.9%	1,627	5.3%	2.3%	3.2%
2007	2.6%	1,687	5.5%	2.3%	4.3%
2008	0.5%	1,655	5.3%	3.6%	4.0%
2009	-4.9%	2,280	7.3%	2.2%	-0.5%
Latest	-0.2%	2,472	7.9%	3.4%	5.1%

Sources: ONS series ABMI, MGSC, MGSX, D7G7, CZBH

Notes: (a) ILO measure, figures for Feb-Apr each year

(b) CPI estimated before 1997

(c) GDP, 2010 Q1 on 2009, Q1, Unemployment: Feb-Apr 2010, Inflation: May 2010

Public finance data, % GDP

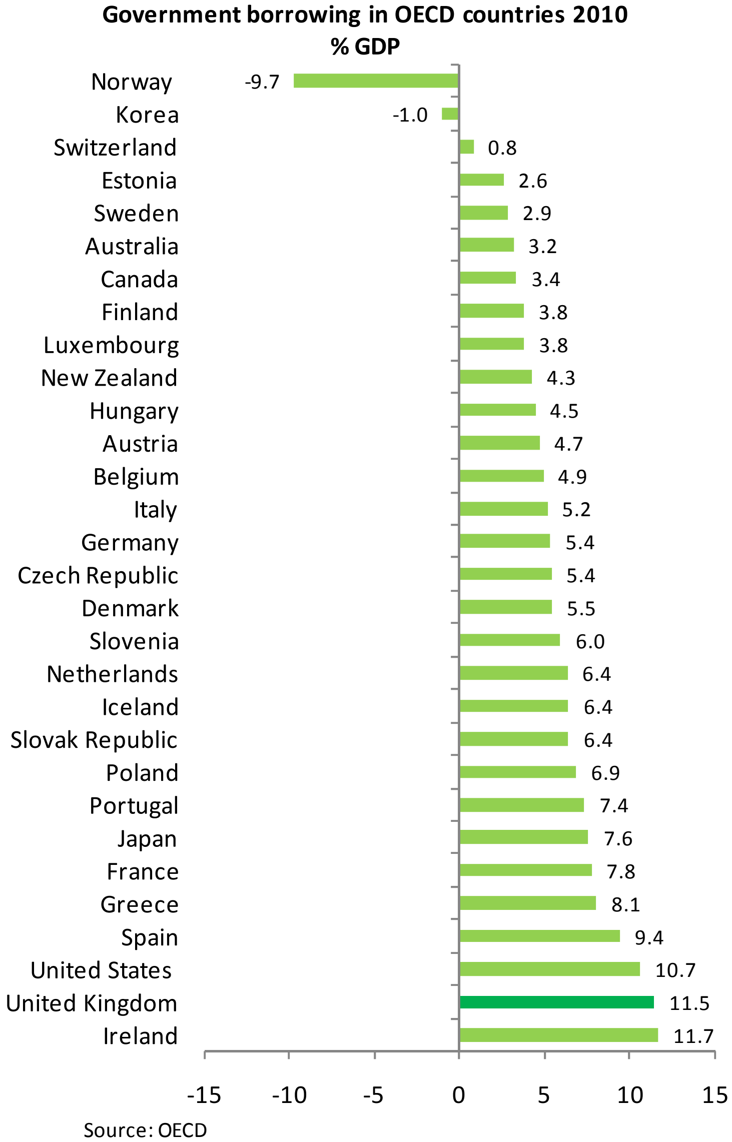
	Public sector net borrowing (a)	Structural borrowing (b)	Public sector net debt (a)
1979/80	4.1%	4.0%	44.0%
1980/81	4.8%	3.4%	46.1%
1981/82	2.3%	-1.5%	46.1%
1982/83	3.0%	-1.4%	44.8%
1983/84	3.8%	0.0%	45.1%
1984/85	3.7%	0.6%	45.1%
1985/86	2.4%	0.6%	43.2%
1986/87	2.0%	1.9%	40.9%
1987/88	1.0%	2.2%	36.6%
1988/89	-1.3%	1.3%	30.4%
1989/90	-0.2%	2.6%	27.5%
1990/91	1.0%	2.6%	26.0%
1991/92	3.7%	3.3%	27.2%
1992/93	7.4%	5.5%	31.4%
1993/94	7.7%	5.4%	36.5%
1994/95	6.2%	4.7%	40.1%
1995/96	4.7%	3.8%	41.9%
1996/97	3.4%	2.8%	42.5%
1997/98	0.7%	0.6%	40.6%
1998/99	-0.5%	-0.2%	38.4%
1999/00	-1.6%	-1.1%	35.6%
2000/01	-1.9%	-1.1%	30.7%
2001/02	0.0%	0.2%	29.7%
2002/03	2.3%	1.9%	30.8%
2003/04	2.9%	2.6%	32.1%
2004/05	3.3%	3.1%	34.0%
2005/06	2.9%	2.8%	35.3%
2006/07	2.3%	2.3%	36.0%
2007/08	2.4%	2.6%	36.5%
2008/09	6.7%	6.4%	44.0%
2009/10	11.0%	8.8%	53.5%

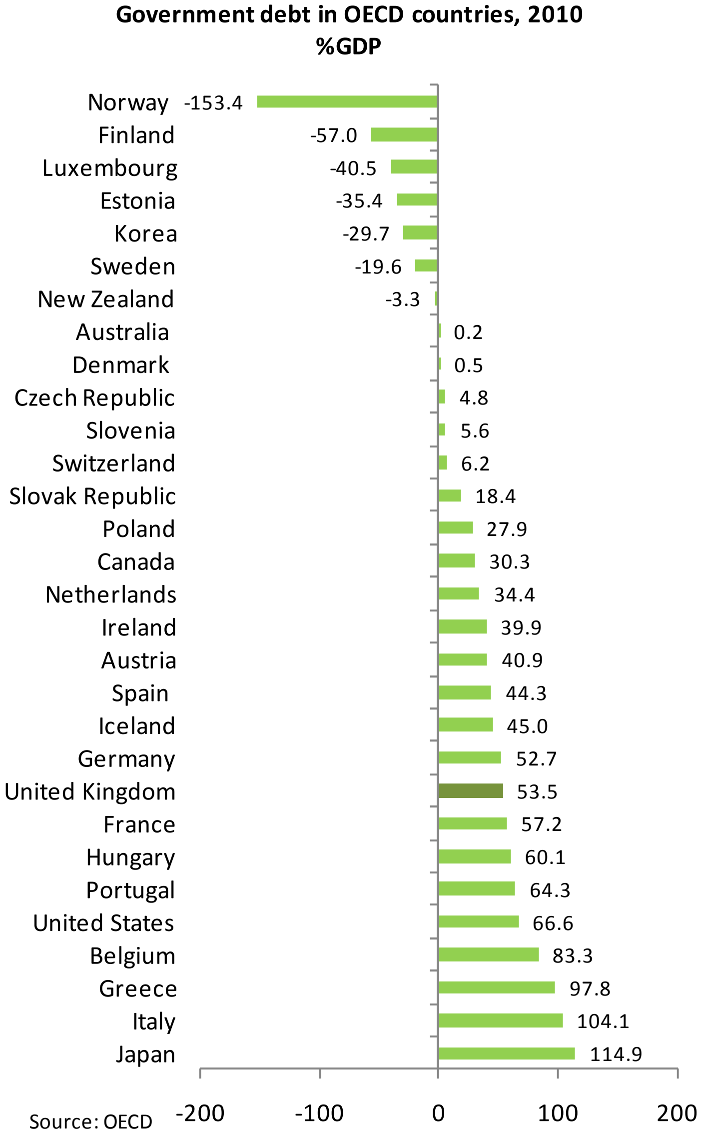
Sources: ONS, HM Treasury, OBR

Notes: (a) excluding financial transactions

(b) cyclically-adjusted public sector net borrowing

7 Appendix 2: International comparisons of government deficits & debt





Note: net debt measures are not entirely comparable across countries due to different definitions and treatment of debt and assets.

8 Appendix: Links to further information

HM Treasury

March 2010 Budget:
http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/budget2010.htm

The Spending Review Framework, June 2010:
http://www.hm-treasury.gov.uk/d/spending_review_framework_080610.pdf

Public finance databank:
http://www.hm-treasury.gov.uk/psf_statistics.htm

Forecasts for the UK economy: a comparison of independent forecasts
http://www.hm-treasury.gov.uk/data_forecasts_index.htm

Office for Budget Responsibility
http://budgetresponsibility.independent.gov.uk/

OBR Pre-Budget forecast June 2010:
http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf

Institute for Fiscal Studies

IFS Press Release, OBR sets the scene for a painful Budget, 14 June 2010
http://www.ifs.org.uk/pr/obr0610.pdf

IFS Green Budget 2010: http://www.ifs.org.uk/publications/4732

Treasury Select Committee

http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/

House of Commons Library

Economic Indicators Research Paper (June 2010 edition):
http://www.parliament.uk/briefingpapers/commons/lib/research/rp2010/RP10-039.pdf

The Budget and the annual Finance Bill, Library Standard Note SN/BT/813
http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-00813.pdf

Capital gains tax: recent developments, Library Standard Note SN/BT/5572
http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-05572.pdf

Income tax: the new 50p rate: Library Standard Note SN/BT/249
http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-00249.pdf