HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

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The budget deficit: a short guide

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1. What is the budget deficit and how big is it?

When the government spends more than it receives in tax and other revenues it borrows to cover the difference. This borrowing is known as 'public sector net borrowing' but is often referred to as the deficit.

In 2019/20, government revenue – from taxes and other receipts – was £828 billion while government spending was £884 billion. The deficit was therefore £56 billion, equivalent to 2.5% of GDP.[1,2]

Borrowing financed around 7%, or nearly £1 in every £16, of public spending in 2019/20. Borrowing of £56 billion is equivalent to around £840 per head of UK population.

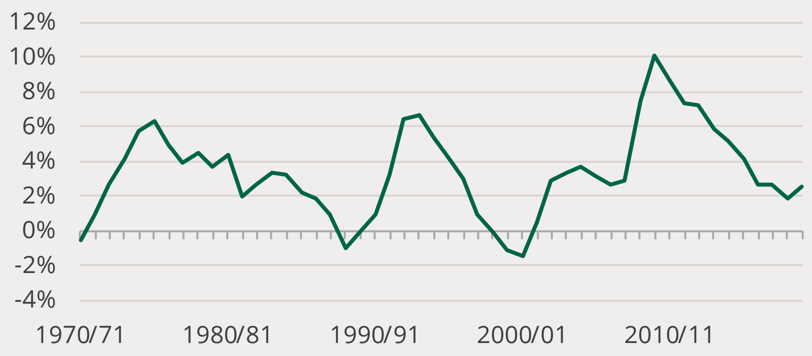
2. What are the trends over time?

It is not unusual for the government to borrow. Since 1970/71, the government has had a surplus (spent less than it received in revenues) in only six years.

The average annual budget deficit has been 3.4% of GDP since 1970. It has varied significantly over this period as the chart below shows. Large budget deficits occurred in the mid-1970s and early 1990s and more recently after the financial crisis. Borrowing peaked over the period at £158 billion (10.1% of GDP) in 2009/10.

Borrowing will reach a peacetime high in 2020/21 as a result of the coronavirus pandemic.[3] There is more on this in the following section.

Budget deficit, % of GDP

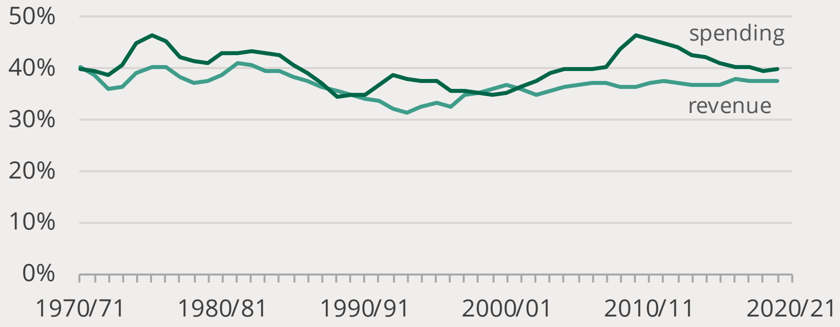


Source: Office for National Statistics. Series J5IJ

The big increase in the budget deficit from 2008 onwards – arising from the financial crisis – was caused by both an increase in government spending and a fall in government revenue. Public spending increased from 40% of GDP in 2007/08 to 46% in 2009/10. At the same time, government revenue fell from 37% of GDP to 36%.

1 Unless stated otherwise all figures in this briefing exclude public sector banks.
2 GDP (Gross Domestic Product) is a measure of the total output in the economy. It's sometimes described as national income.
3 OBR. Economic and fiscal outlook – November 2020, para 1.30

Public spending and revenue, % of GDP



Source: Office for National Statistics. Series KX5Q, JW2O, BKTL

3. How will coronavirus affect the budget deficit?

The coronavirus has severely affected the economy. The effect on the government's finances has been significant. The budget deficit has ballooned as tax revenues have fallen and government spending has increased. The Government has spent hundreds of billions of pounds on steps to tackle the virus, and to support businesses, workers and incomes during the crisis.

2020/21

The Office for Budget Responsibility (OBR) forecast a budget deficit of £394 billion in 2020/21. This is equivalent to 19% of GDP, the highest level since 1944/45. The OBR say that around £280 billion of the deficit arises from Government steps to tackle the virus, and to support businesses, workers and incomes.

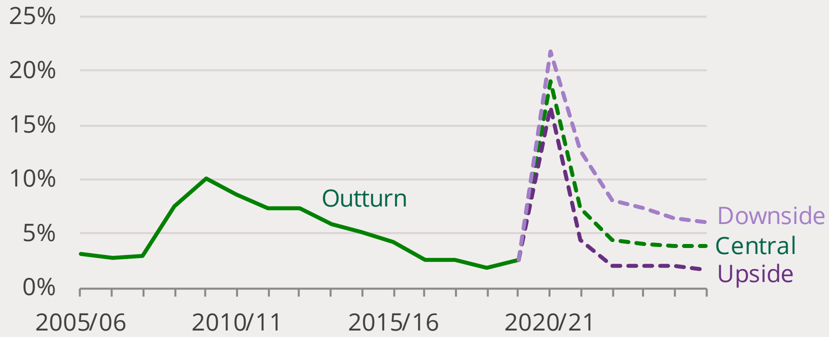
The OBR have produced two further forecasts to reflect the uncertainty that coronavirus brings. In the OBR's upside scenario, the second wave of infections is kept under control and an effective vaccine is rolled out rapidly. The OBR forecast a budget deficit of £353 billion (16.7% of GDP) in this scenario.

In the OBR's downside scenario lockdown is extended, and vaccines are ineffective in keeping the virus in check. The OBR forecast a budget deficit of £440 billion (21.7% of GDP) in this scenario.

The Office for Budget Responsibility (OBR) are the UK's independent public finances watchdog.

The OBR produce the official forecasts for the economy and public finances.

Budget deficit, % of GDP



Source: OBR. Economic and fiscal outlook – November 2020

Future years

It's hard to quantify how future deficits will be affected by coronavirus, even if we assume that a vaccine is successfully rolled out. Much depends on the extent of persistent economic damage, such as businesses permanently closing or people losing their jobs. If the Government's policy response is successful in limiting long-term economic harm, then the impact on future government deficits will be reduced.

However, if there is long-term economic harm there will be less scope for economic activity to recover. Consequently, there will be less scope for tax receipts to recover and for welfare spending to subside. This means that the Government will be left with a bigger structural deficit. We discuss the structural deficit below.

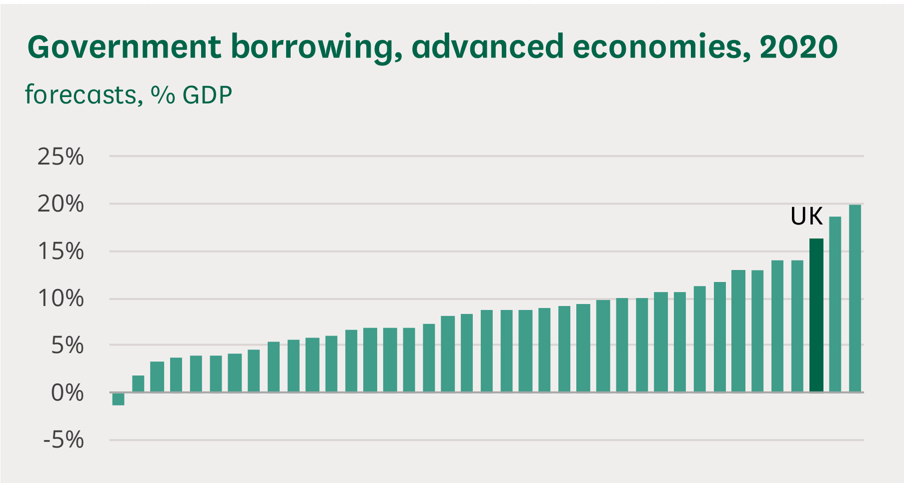
In their central forecast, the OBR assume that the pandemic will result in the UK economy remaining 3% smaller than it would otherwise have been. Consequently, the OBR forecast that budget deficit will be £102 billion in 2025/26, £46 billion higher than in 2019/20.

More detail is available from the Library briefing Coronavirus: Economic impact.

4. How does the UK's budget deficit compare with other countries?

Governments across the world are borrowing more due to the coronavirus pandemic. The IMF forecast that across advanced economies borrowing will average 14% of GDP in 2020. For the G7 group of advanced economies borrowing of 16% of GDP is forecast.

The IMF forecast UK government borrowing of 16.5% of GDP in 2020. Only the US and Canada are forecast to borrow more than the UK, relative to the size of their economies.[4,5]



Source: IMF. World Economic Outlook Database: October 2020

4 IMF. *World Economic Outlook Database*, April 2020
5 Advanced economies as defined by the IMF.

5. How is the budget deficit financed?

The budget deficit is financed by sale of government bonds. These are essentially interest paying "IOUs" which the government sells to investors. Purchasers of government bonds include pension funds, insurance companies, households and overseas investors. The bonds make up most government debt. Further information is available in the Library Insight Coronavirus: Government debt, an explainer.

The Government is selling record amounts of bonds during the coronavirus pandemic as its deficit is high. Investors are still demanding the bonds which means that the interest rate paid by government remains low. Rates had been low before the pandemic.

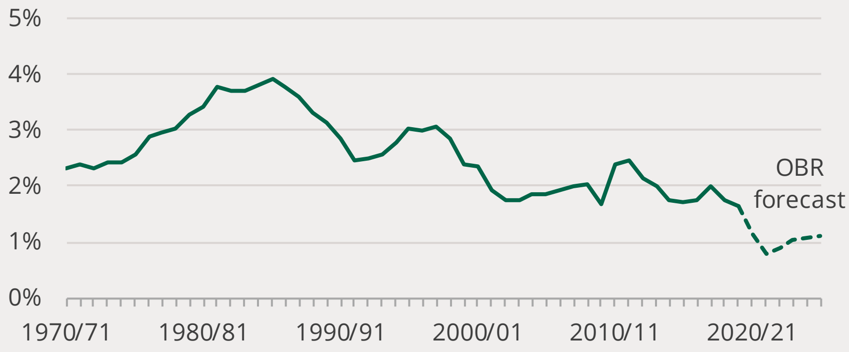
Some of the demand for government bonds is coming from the Bank of England who have been buying government bonds from investors (on so called secondary markets) in order to support the economy during the coronavirus pandemic, through its quantitative easing programme. Further information is available in the Library briefing paper Coronavirus: Economic impact.

6. How much interest does the government pay on its borrowing?

Interest payments on borrowing are a significant part of government expenditure. Interest is paid on all outstanding government debt, accumulated over many years. In 2019/20, gross debt interest payments were £48 billion; net debt interest payments were £37 billion.

The lower net interest figure is a consequence of the Bank of England holding significant amounts of government debt, following its quantitative easing programme. The Bank has bought government debt from private investors such as pension funds and insurance companies largely to get money into the economy. Government bonds held by the Bank are effectively refinanced at Bank Rate, which is usually a lower rate of interest.[6]

Central government debt interest, % of GDP



Source: Office for Budget Responsibly. Public finances databank (November 2020)

6 For further explanation see Library briefing paper Coronavirus: Economic impact.

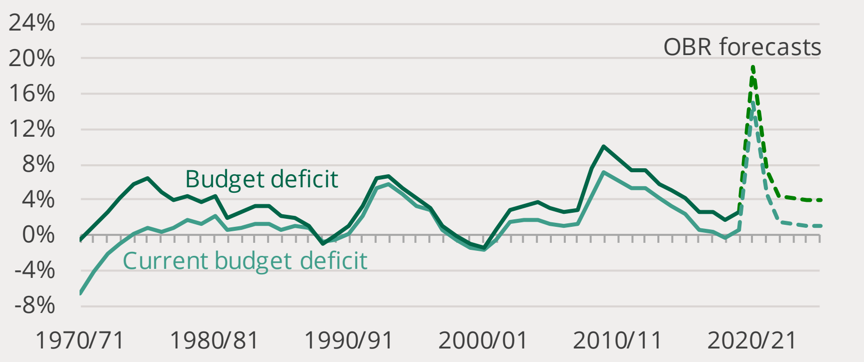
Government's debt interest payments are at historically low levels. The OBR forecast that they will remain so despite the coronavirus related increase in debt. This is because the OBR expect: interest rates on new borrowing to remain low; relatively low inflation (some interest on government bonds is linked to inflation); and the government to continue benefiting from the Bank holding around 30% of government bonds.[7]

7. What is the current budget deficit?

The current budget deficit is the difference between government's day-to-day spending and its revenues, or more formally its current spending and current receipts.[8] This measure differs from the overall budget deficit as it does not include government's net investment spending.

The current budget deficit was £14 billion in 2019/20, equivalent to 0.6% of GDP.

Current budget deficit, % of GDP



Source: Office for National Statistics. Series J5IJ and JW2V

8. What is the structural deficit?

A distinction is often drawn between the cyclical and structural elements of the budget deficit. The size of the deficit is influenced by the state of the economy: in a boom, when the economy is above its potential, tax receipts are relatively high and spending on unemployment benefit is low. This reduces the level of borrowing. The reverse happens in a recession when borrowing tends to be high.

The structural deficit is that part of the deficit that is not related to the state of the economy. This part of the deficit will not disappear when the economy recovers. It thus gives a better guide to the underlying level of the deficit than the headline figure. The structural deficit cannot be directly measured so it must be estimated.

7 OBR. Economic and fiscal outlook – November 2020, paras 3.120-3.121
8 Spending includes depreciation on capital assets

9. How much did the financial crisis contribute to the budget deficit?

This is not a straightforward question. Government support for the banks took a variety of different forms, including share purchases, loans and guarantees which have different effects on the public finances. Guarantees, for example, are more likely to give rise to contingent liabilities which will only materialise under certain circumstances. This is quite different from purchases of bank shares where there is an outlay of cash.

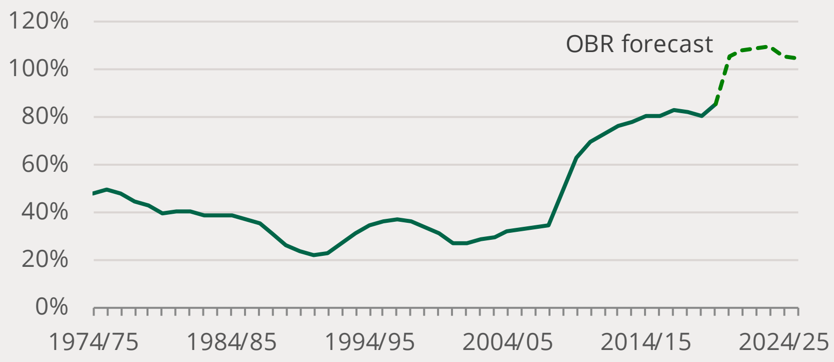
While the overall level of support for the banks was very large, the impact on the deficit was comparatively small. The Government has said that the financial crisis accounted for around 5%-6% of the deficit in 2008 and 2009.

10. What is the difference between the deficit and government debt?

The deficit is the difference between government revenue and spending, usually measured over a single financial year. Debt is the total amount owed by the government which has accumulated over the years. As a result, debt is a much larger sum of money. At the end of 2019/20 public sector net debt was £1,801 billion (i.e. £1.8 trillion), or 86% of GDP. This is equivalent to around £27,000 per person in the UK.

Government's borrowing during the coronavirus pandemic has meant that public sector debt has risen above 100% of GDP for the first time since 1960/61.

Public sector debt, % of GDP



Source: Office for National Statistics. Series HF6X

11. Where can I find more information?

The Office for Budget Responsibility (OBR) has produced a brief guide to the public finances, which provides a brief introduction to the UK public finances and to the terms used to describe them in the official statistics.

In March 2016, the ONS produced a data driven explanation of the deficit and debt.

Those wishing to delve further into technical areas are pointed towards the Office for National Statistics' (ONS') Public Sector Finances Methodology Guide. The ONS have also produced a public sector finance glossary.

Data on the deficit, debt, expenditure and receipts are available from the OBR's public finances databank. Some of the series begin in the 1920s, and the data includes forecasts.

The Library has published the following relevant briefings:

- Public finances
- Government borrowing, debt and debt interest: statistics
- Coronavirus: Government debt, an explainer
- Coronavirus: Effect on the economy and public finances
- Public sector debt: a Q&A

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