A brief guide to the UK public finances

Office for **Budget Responsibility**

THE independent Office for Budget Responsibility was established in 2010 to monitor the public sector's finances. Twice a year – usually alongside each Budget and Spring or Autumn Statement – we produce detailed forecasts for the coming five years, assessing the likely impact of any policy decisions and expected developments in the economy. We then use these forecasts to assess the Government's performance against the fiscal targets that it has set itself for the management of the public finances.

This guide provides a brief introduction to the UK public finances and to the terms used to describe them in the official statistics. In doing so we are looking at the finances of the public sector as a whole – which encompasses not just central government, but also the devolved administrations, local councils and public corporations. The figures presented in this guide are taken from our March 2021 forecast, which covers the five fiscal years up to 2025-26. Each fiscal year runs from April to March.

Overview

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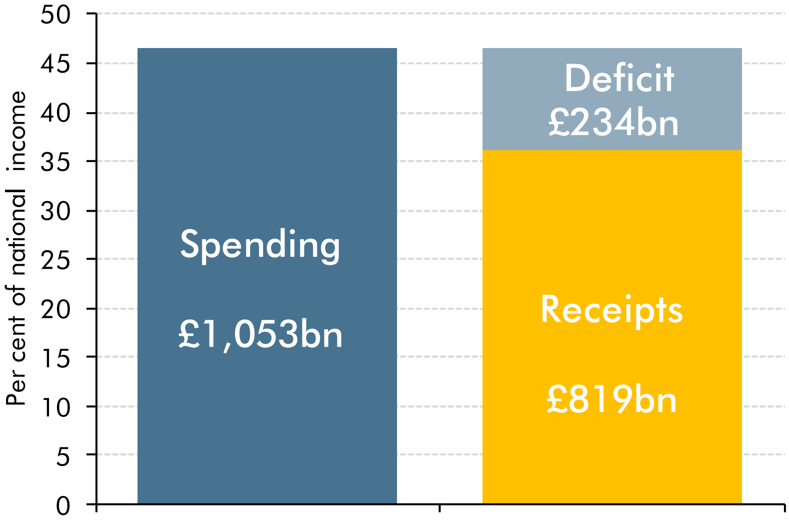
IN each forecast we assess how the public finances are likely to evolve on the basis of existing Government tax and spending policies and our best guess at the likely evolution of the economy. In particular we try to estimate:

- **How much money the public sector will raise** from taxes and other sources of revenue. In 2021-22, we expect it to raise £819.3 billion, equivalent to around £28,000 per household or 36.2 per cent of national income.

- **How much it will spend** on things like public services, state pensions and debt interest. In 2021-22, we expect it to spend £1,053.3 billion, equivalent to around £36,000 per household or 46.5 per cent of national income.

- Whether it will spend more or less than it raises – in other words **whether it will run a budget deficit or surplus**. In 2021-22, we expect a large deficit of £233.9 billion due to the ongoing costs of the pandemic. Because receipts are forecast to rise faster than spending, we expect the deficit to fall over the next 5 years to reach £73.7 billion.

Spending and receipts in 2021-22



- **How much will be added to – or paid off – the national debt** in each year. In 2021-22, we expect debt to be equivalent to 107.4 per cent of national income – the highest ratio since 1959-60. It is equivalent to around £2.5 trillion or £86,000 per household. From 2021-22 we expect the ratio of net debt to national income to increase slightly and peak at 109.7 per cent in 2023-24 before falling to 103.8 per cent in 2025-26. In cash terms we expect it to stand at £2.8 trillion by then. Taking out the effect of Bank of England loans to banks and building societies, which are expected to be repaid by 2025-26, the debt ratio peaks at 97.1 per cent in 2023-24 and falls slightly over the following two years.

Next: Income

Income

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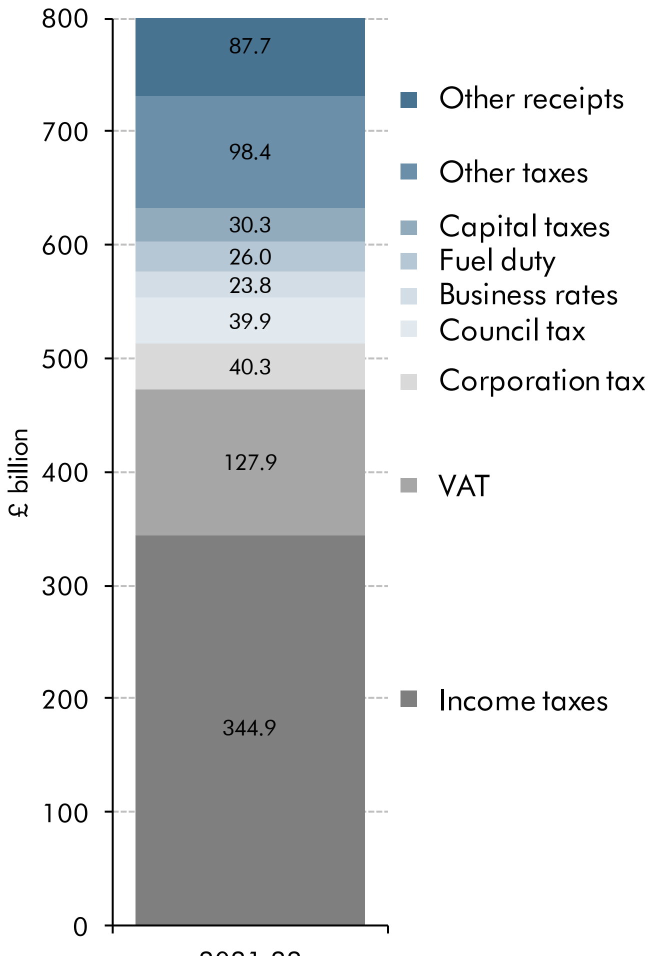
IN 2021-22, we expect the public sector's income to amount to £819.3 billion, equivalent to £28,000 per household or 36.2 per cent of national income. These are called 'public sector current receipts' in the official statistics and come from many sources. Taxes are the most important at 89 per cent of the total in 2021-22. The taxes that bring in the most money are income tax and National Insurance contributions, which together are expected to raise around £340 billion. Value added tax (VAT) is the next most important, expected to raise £128 billion. Other big taxes include corporation tax, council tax, business rates and fuel duty. No other tax is expected to raise more than £20 billion.

Sources of public sector receipts



Source: OBR

The public sector also receives other revenues, including interest earned on its assets (such as foreign exchange reserves and student loans), while public corporations generate some income.

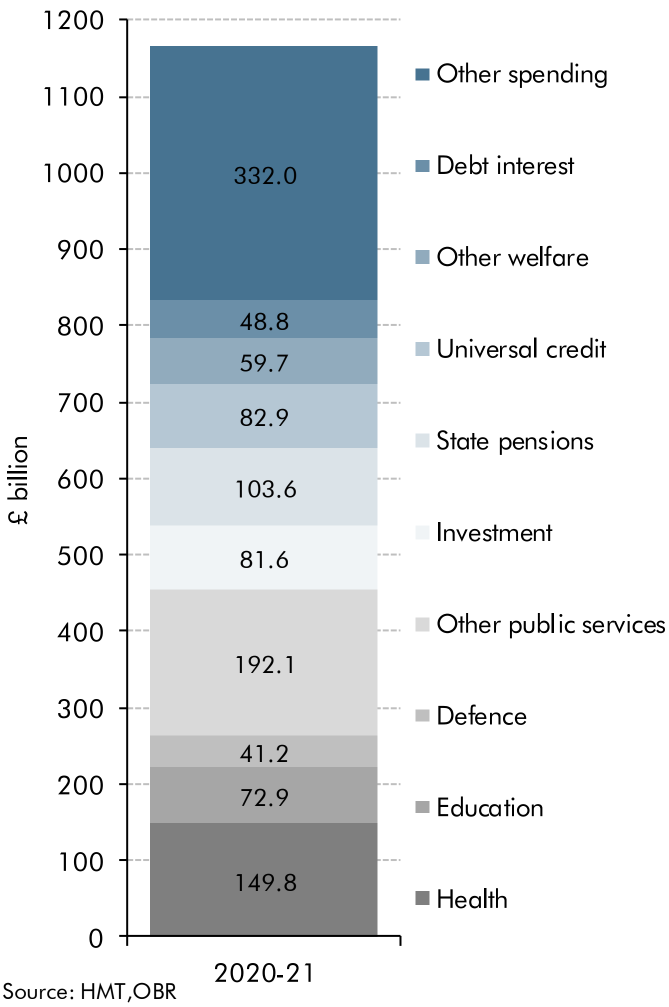
Over the next five years, we expect total receipts to rise by 27 per cent, which is faster than the growth in the cash size of the economy. We expect some taxes to rise more quickly than the economy as a whole, including capital gains tax (driven by asset markets, like housing and the stock market) and corporation tax (as overall business profits rebound after the coronavirus outbreak and the headline corporation tax rate is raised). But some tax receipts are expected to rise more slowly, including council tax (because of limits on annual increases) and tobacco duty (because people are smoking less).

Next: Spending

Spending

THE public sector raises money in order to spend it, mostly on the day-to-day costs of providing public services, on capital investment and on cash transfer payments that support the incomes of various individuals and families.

Public sector spending



Source: HMT,OBR

In 2021-22, we expect public spending to amount to £1,053.3 billion, which is equivalent to around £36,000 per household or 46.5 per cent of national income. This is called 'Total Managed Expenditure' and covers many different types of spending.

In 2021-22, we expect central government departments to spend £413.6 billion on the day-to-day ('current') running costs of public services, grants and administration. This is 39 per cent of public spending. The biggest items are health (£156.4 billion), education (£76.4 billion) and defence (£46.0 billion). This spending is usually subject to multi-year limits set by the Treasury – known as 'Resource Departmental Expenditure Limits' or 'RDEL'.

We also expect the public sector to spend £118.8 billion – around 11 per cent of the total – on capital investment (such as roads and buildings), including some costs associated with loans to businesses and individuals. Around 70 per cent of this will be spent by government departments, again usually subject to multi-year Treasury limits – 'Capital Departmental Expenditure Limits' or 'CDEL'. Some of the remainder will be carried out by local authorities (mostly roads, schools and housing) and public corporations (like Transport for London). Around 10 per cent relates to business and student loans.

The Government set out detailed department-by-department plans for RDEL and CDEL in the 2021-22 fiscal year in its 2020 Spending Review. Some departments have multi-year settlements: the NHS settlement (announced in June 2018) runs to 2023-24; the schools settlement runs to 2022-23; while the defence settlement runs to 2024-25.

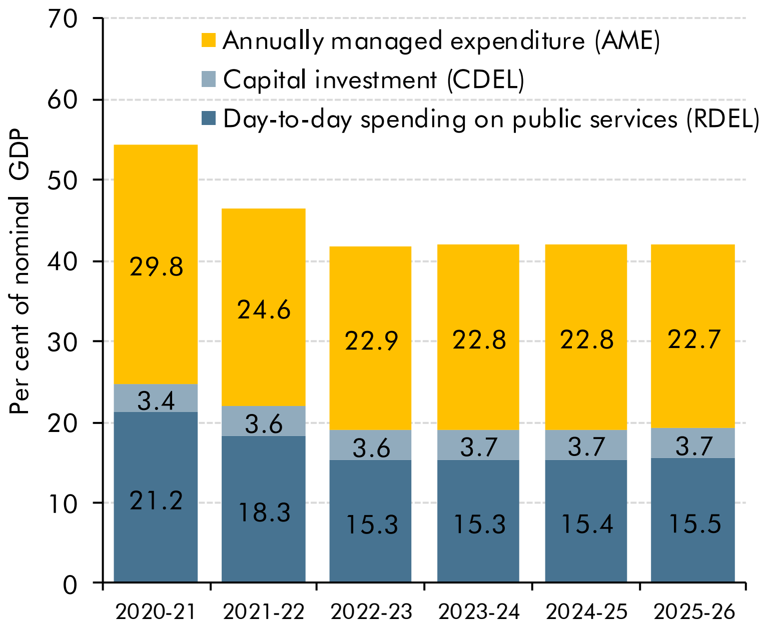
Next: Spending continued

Spending that is not covered by DEL plans is called 'Annually Managed Expenditure' (AME). The biggest component of AME is cash transfers through the welfare system, expected to cost £252.4 billion in 2021-22. Around 53 per cent of these are paid to pensioners, with state pensions the largest item at an expected £107.9 billion. Other big items include universal credit and the tax credits and benefits it is replacing (£80.2 billion) and disability benefits (£30.4 billion).

The Government introduced two additional schemes to support the incomes of employees and the self-employed who have been adversely affected by pandemic-related public health measures. Combined, the coronavirus job retention scheme and the self-employment income support scheme are expected to cost £24.3 billion in 2021-22 (but currently nothing thereafter). They cost £79.7 billion in 2020-21.

Interest payments on the national debt are expected to cost £24.8 billion in 2021-22. This includes the interest government pays to private sector holders of the bonds it issues – known as 'gilts' – and also the interest paid by the Bank of England on the money created during the 'quantitative easing' of monetary policy since the late 2000s financial crisis and recession. Net debt interest (interest paid minus interest received) is expected to be 2.5 per cent of non-interest receipts in 2021-22 – very low by historical standards – and to stay around this level throughout the forecast period.

Public spending to 2025-26



Source: OBR, HMT

Over the next five years, we expect public spending to rise by only 6 per cent in cash terms as some virus-related spending ends in 2021-22.

We expect AME to grow by 8 per cent. Spending on some items rises more quickly (e.g. the cost of state pensions as ageing increases the number of claimants and the triple-lock increases the amount); on other items it is almost flat (e.g. universal credit spending, as unemployment falls back). The lack of virus-related spending in the Government's plans beyond 2021-22 means that RDEL falls by 1 per cent in cash terms by 2025-26, and by 2.8 per cent of national income.

Next: Deficits or surpluses

Deficits or surpluses

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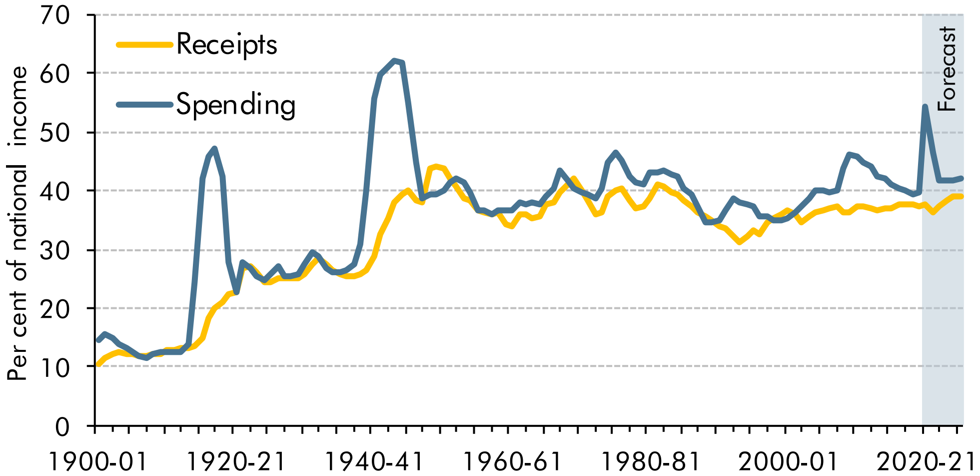
WHEN total spending in a year is higher than total receipts, the Government needs to borrow to cover the difference. This gap is known as the budget deficit or 'public sector net borrowing'. When receipts are higher than spending, the government runs a surplus. Deficits and surpluses are similar to losses or profits for a company.

The gap between receipts and spending

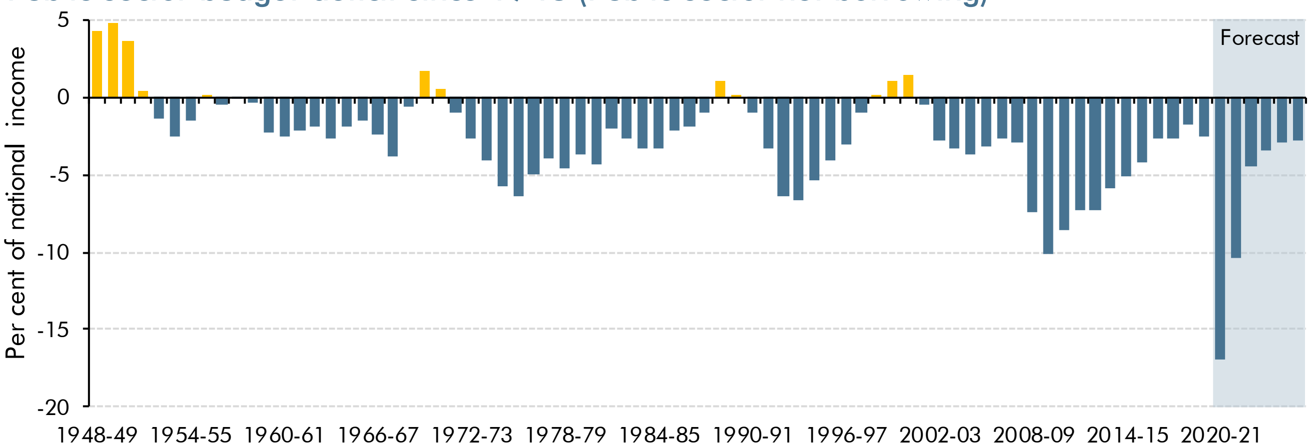


Source: ONS, OBR

In 2021-22, we expect a deficit of £233.9 billion or 10.3 per cent of national income – its second highest since the second world war (only last year was higher) and above the peak during the financial crisis (£157.7 billion or 10.1 per cent of national income in 2009-10). Spending drops next year as virus-related spending is assumed to end, so the deficit drops. Thereafter receipts rise faster than spending, so we forecast that the deficit will get smaller across the next five years. We expect the deficit to be £73.7 billion in 2025-26 (2.8 per cent of national income) at which point receipts are 39.1 per cent of national income and spending 41.9 per cent.

Swings into deficit have become steadily more pronounced over the post-war period, with the pandemic delivering the largest post-war deficit yet. Meanwhile budget surpluses have been recorded in only 12 years since 1948 and only five since 1971-72.

Public sector budget deficit since 1948 (Public sector net borrowing)



Source: ONS, OBR

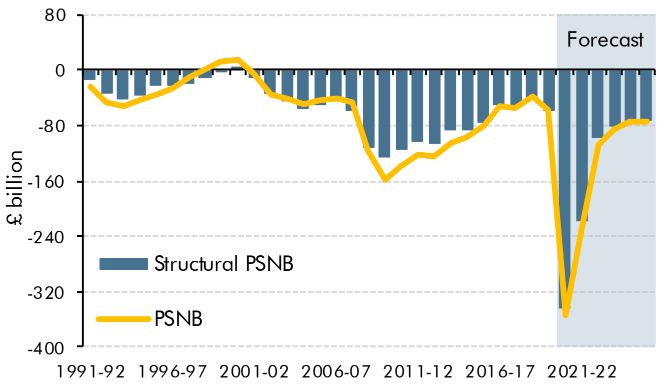
Next: Deficits or surpluses continued

Movements in the budget deficit are in part the result of the ups and downs of the economy. When the economy is strong, the deficit will be lower as taxes flow in and welfare spending costs are reduced. The opposite is true when the economy is weak.

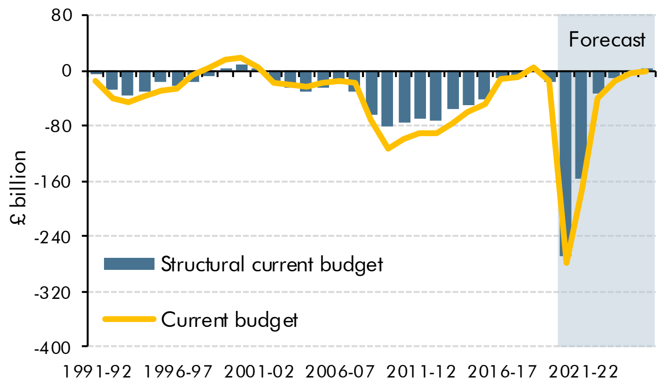
The 'structural' budget deficit is an estimate of how large the deficit would be if the economy was operating at a normal, sustainable level of employment and activity. We never know precisely what this 'normal' level would be, so these estimates are always uncertain. It is particularly difficult to judge at the moment because of the way temporary public health measures affect the economy. Setting those difficulties to one side, we currently estimate that the economy will be 0.9 per cent below normal capacity in 2021-22. So we judge that the structural deficit is slightly smaller than the overall deficit, with a modest 'cyclical' part of the deficit that would disappear automatically as the economy returns to a normal level of activity.

The headline deficit is the difference between total receipts and total spending, but people are also interested in the 'current deficit' (or surplus). This counts all receipts and all current spending, but excludes spending on net investment. As long as net investment is positive, the current deficit will be smaller than the overall deficit. The Chancellor used his Budget 2021 measures to bring this measure of the deficit close to balance, so we expect the current deficit to fall back from £171.8 billion in 2021-22 and to reach a very small deficit of £0.9 billion in 2025-26.

Public sector net borrowing



Current budget balance



Source: ONS, OBR

Debt

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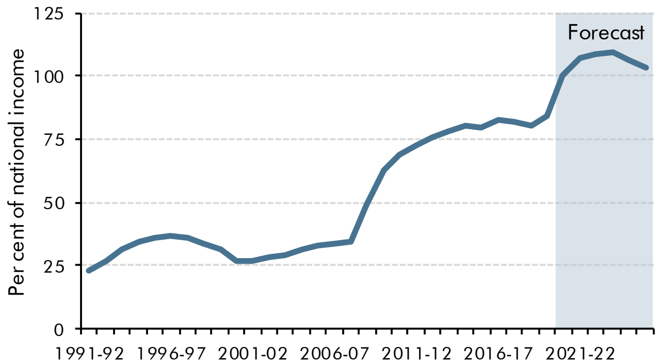
SO far we have been looking at the flows of spending and receipts that take place each year and the deficits and surpluses they result in. But because governments run deficits much more often than they run surpluses, they have built up a significant stock of outstanding debt over time.

Generally speaking, if the public sector runs a deficit in a particular year, debt will rise in cash terms. But it can still fall as a share of national income if the cash size of the economy is growing sufficiently strongly. (That said, it is also important to be aware that some government activity adds to its debt without adding to the deficit in any given year, most significantly providing loans to students and businesses where the loans are financial assets for the government, provided they are expected to be repaid in future.)

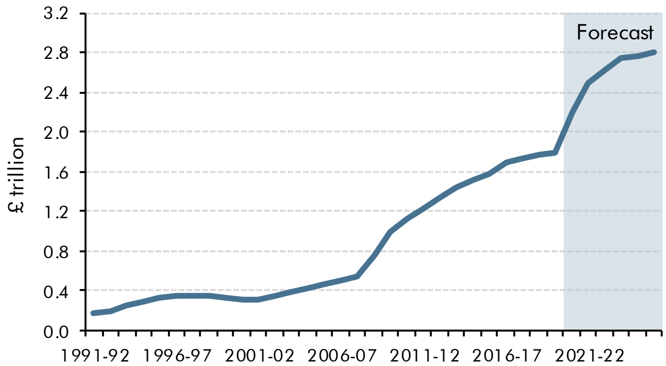
The most widely watched measure of debt in the UK is 'public sector net debt', which subtracts the relatively small amount of assets that the Government could readily turn into cash if required (for example, foreign exchange reserves) from the gross total. We expect public sector net debt to reach 107.4 per cent in 2021-22 – the highest level since 1959-60 – and equivalent to around £2.5 trillion or £86,000 per household.

One of the Government's legislated fiscal targets is to make sure that debt is falling relative to national income in 2020-21, thereby beginning to reverse the big increase associated with the financial crisis and associated recession. The huge rise in borrowing due to the coronavirus pandemic means that target is missed by a very wide margin, with debt rising from 2020-21 to 2023-24. In cash terms, we expect debt to stand at £2.8 trillion in 2025-26. Taking out the effect of Bank of England loans to banks and building societies, which are expected to be repaid by 2025-26, the debt ratio peaks at 97.1 per cent in 2023-24 and falls slightly over the following two years.

Debt as % of national income



Debt in cash terms



Source: ONS, OBR

Next: International comparisons

International comparisons

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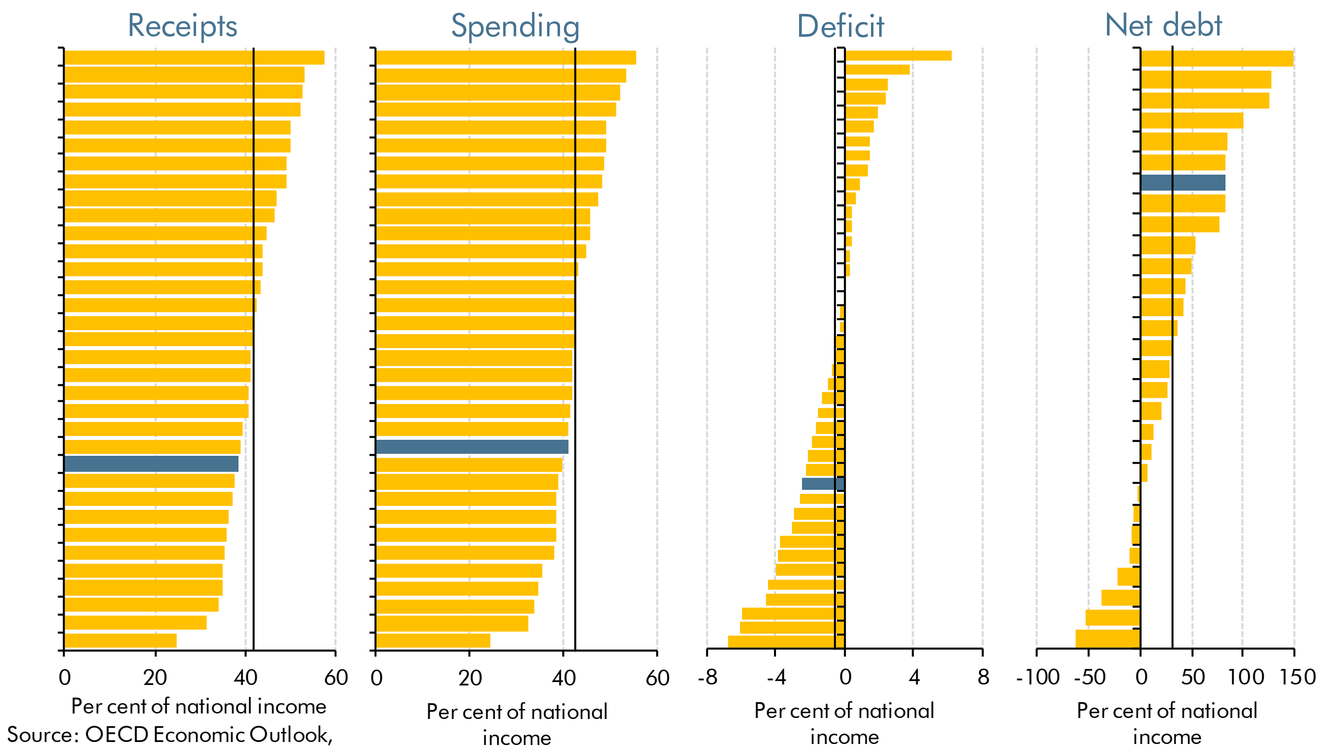
HOW do the public finances in the UK compare to those in other countries? To answer this question we can look at the data for 42 industrial countries produced by the Organisation for Economic Cooperation and Development (OECD). Unfortunately, the OECD data are not directly comparable with that we have presented so far: for example, the OECD does not cover public corporations, while it defines spending and revenue somewhat differently. These comparisons are also from before the coronavirus hit public finances worldwide, and the impact it had varies hugely between countries.

Those caveats aside:

- The UK government raises somewhat less revenue relative to national income than the majority of other industrial countries – more than the US, Japan and Korea, but less than Scandinavian countries like Denmark and Norway.
- Public spending as a share of national income in the UK is close to the average of other industrial countries – the UK spends much more than the US and Korea, but much less than Finland or France.
- Spending close to the international average, but raising less in revenue, leaves the UK running a budget deficit that is above the industrial world average. Norway has the largest surplus, thanks to oil and gas revenues that it saves rather than spends.
- Net debt in the UK is also higher than the average of other industrial countries.



Source: OECD Economic Outlook, December 2020 (2019 outturns)