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 – alongside each Autumn Budget and Spring 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 2018 forecast, which covers the five fiscal years up to 2022-23. Each fiscal year runs from April to March.

Next: Overview

Overview

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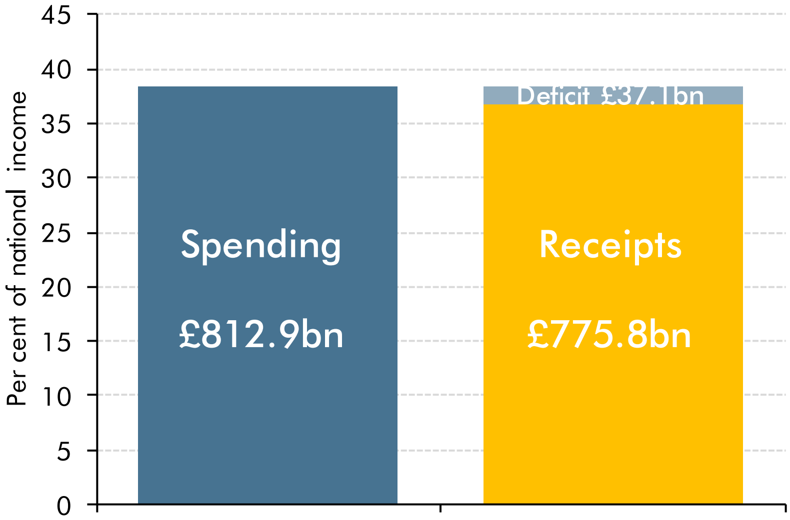
IN each forecast we assess how the public finances are likely to evolve on the basis of existing Government tax and spending policies and our best guess at the likely evolution of the economy. In particular we try to estimate:

- **How much money the public sector will raise** from taxes and other sources of revenue. In 2018-19, we expect it to raise £775.8 billion, equivalent to around £27,000 per household or 36.7 per cent of national income.

- **How much it will spend** on things like public services, state pensions and debt interest. In 2018-19, we expect it to spend £812.9 billion, equivalent to around £29,000 per household or 38.4 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 2018-19, we expect a deficit of £37.1 billion. Because receipts are forecast to rise a little faster than spending in future, we expect the deficit to get smaller over time, and reach £21.4 billion in 2022-23. We do not expect to see a surplus in the next five years.

Spending and receipts in 2018-19



- **How much will be added to – or paid off – the national debt** in each year. In 2018-19, we expect debt to be equivalent to 85.5 per cent of national income – the highest ratio since the early 1960s – which is around £1,835 billion or £63,000 per household. (Net debt was less than 40 per cent of national income prior to the financial crisis.) As the deficit shrinks, we expect the ratio of net debt to national income to fall year by year and to reach 77.9 per cent in 2022-23. In cash terms we expect it to stand at £1,893 billion by then.

Next: Income

Income

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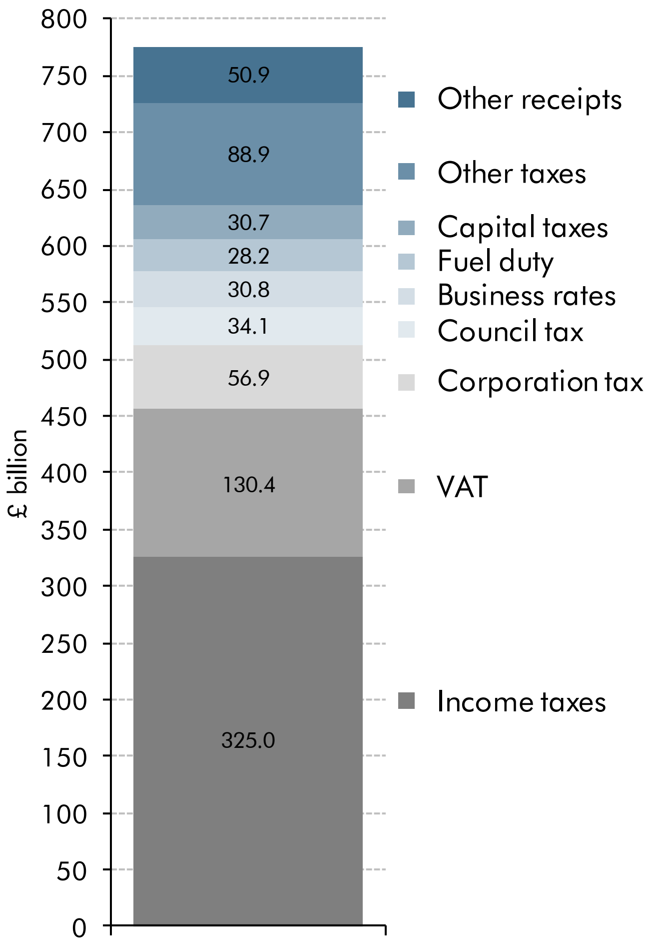
IN 2018-19, we expect the public sector's income to amount to £775.8 billion, equivalent to £27,000 per household or 36.7 per cent of national income. These are called 'public sector current receipts' in the official statistics and come from many sources. Taxes are the most important at 93 per cent of the total in 2018-19. The taxes that bring in the most money are income tax and National Insurance contributions, which together are expected to raise around £325 billion. Value added tax (VAT) is the next most important, expected to raise £130 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 17 per cent, similar to growth in the cash size of the economy. We expect some taxes to rise more quickly, including capital gains tax and inheritance tax (driven by asset markets, like housing and the stock market) and income tax (as earnings growth leads to more income being taxed at the higher rates). But some tax receipts are expected to rise more slowly than the economy as a whole, including corporation tax (where the tax rate is being reduced over time), fuel duty (because cars are becoming more fuel efficient) and tobacco duty (because people are smoking less).

Spending

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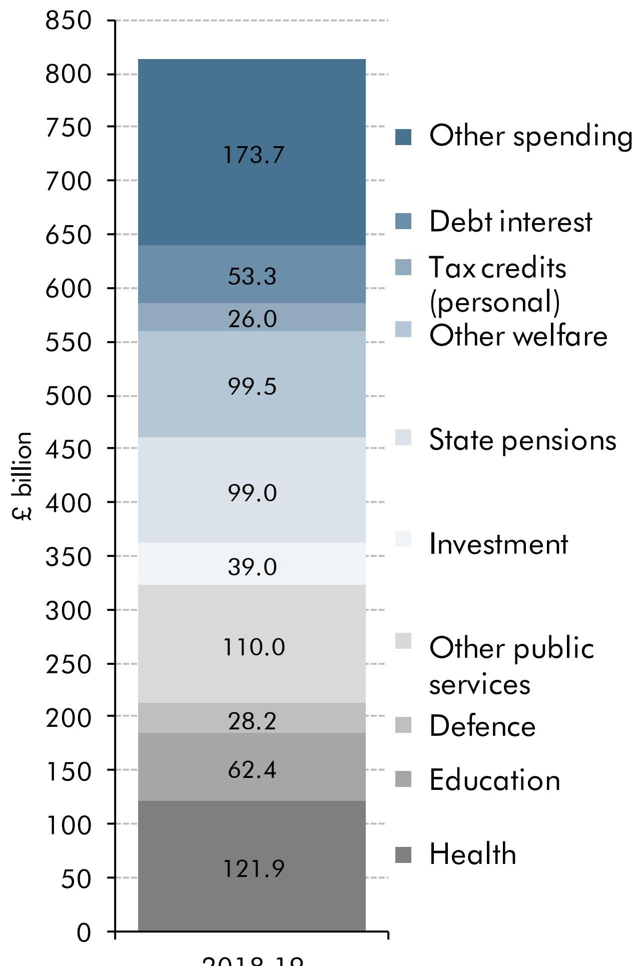
THE public sector raises money in order to spend it, mostly on the day-to-day costs of providing public services, on capital investment and on cash transfer payments that support the incomes of various individuals and families.

Public sector spending



Source: HMT,OBR

In 2018-19, we expect public spending to amount to £812.9 billion, which is equivalent to around £29,000 per household or 38.4 per cent of national income. This is called 'Total Managed Expenditure' and covers many different types of spending.

In 2018-19, we expect central government departments to spend £322.5 billion on the day-to-day ('current') running costs of public services, grants and administration. This is 40 per cent of public spending. The biggest items are health (£121.9 billion), education (£62.4 billion) and defence (£28.2 billion). This spending is 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 £79.8 billion – around 10 per cent of the total – on capital investment (such as roads and buildings). Around two thirds of this will be spent by government departments, again subject to multi-year Treasury limits – 'Capital Departmental Expenditure Limits' or 'CDEL'. Most of the remainder will be carried out by local authorities (mostly roads, schools and housing), public corporations (like Transport for London) and Network Rail.

The Government set out detailed department-by-department plans for RDEL and CDEL in its 2015 Spending Review. These cover the years to 2019-20 for all departments and to 2020-21 for some. For the remaining half of public spending, the amount spent each year is outside the immediate control of the Government. Because this spending is not subject to multi-year limits, it is known as 'Annually Managed Expenditure' or 'AME'.

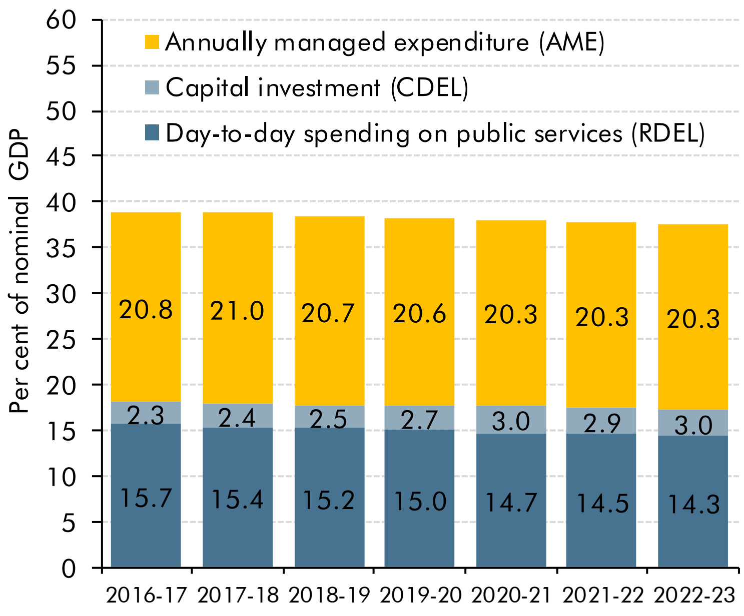
Next: Spending continued

The biggest component of AME is cash transfers through the welfare system, which we expect to cost £224.5 billion in 2018-19. Around 47 per cent of these transfers are paid to pensioners, with state pensions the largest item at an expected £99.0 billion. Other big items include personal tax credits (£26.0 billion, mostly paid to people of working age) and housing benefit (£24.0 billion, around three-quarters paid to people of working age). Jobseekers' allowance and the equivalent support in the new universal credit – paid to the unemployed – is expected to cost just £2.6 billion.

Interest payments on the national debt are expected to cost £53.3 billion in 2018-19. 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 after the late 2000s financial crisis and recession and again since August 2016.

Over the next five years, we expect public spending to rise by 13 per cent in cash terms – more slowly than the economy will in cash terms. This is based on the detailed plans for departmental spending set out in the Spending Review and our forecast for AME.

Public spending to 2022-23



Source: OBR, HMT

We expect AME to rise by 13 per cent. Spending on some items rises more quickly (e.g. the net cost of public service pensions as ageing increases the number of pensions in payment); on other items it rises more slowly (e.g. working-age welfare spending, where the amounts paid to recipients are currently frozen in cash terms). The Government's multi-year spending plans mean that RDEL will rise by only 8 per cent in cash terms by 2022-23, so it will fall by 1.1 per cent of national income.

Deficits or surpluses

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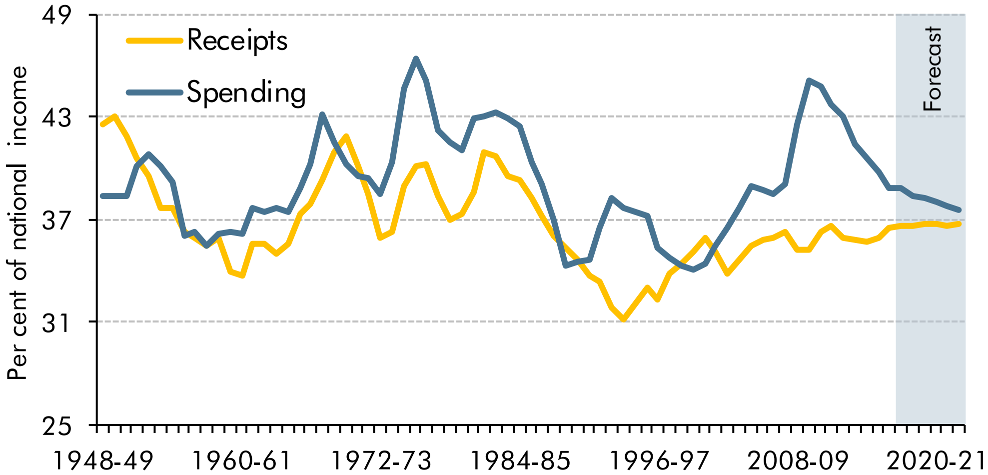
WHEN total spending in a year is higher than total receipts, the Government needs to borrow to cover the difference. This gap is known as the budget deficit or 'public sector net borrowing'. When receipts are higher than spending, the government runs a surplus. Deficits and surpluses are similar to losses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

The gap between receipts and spending

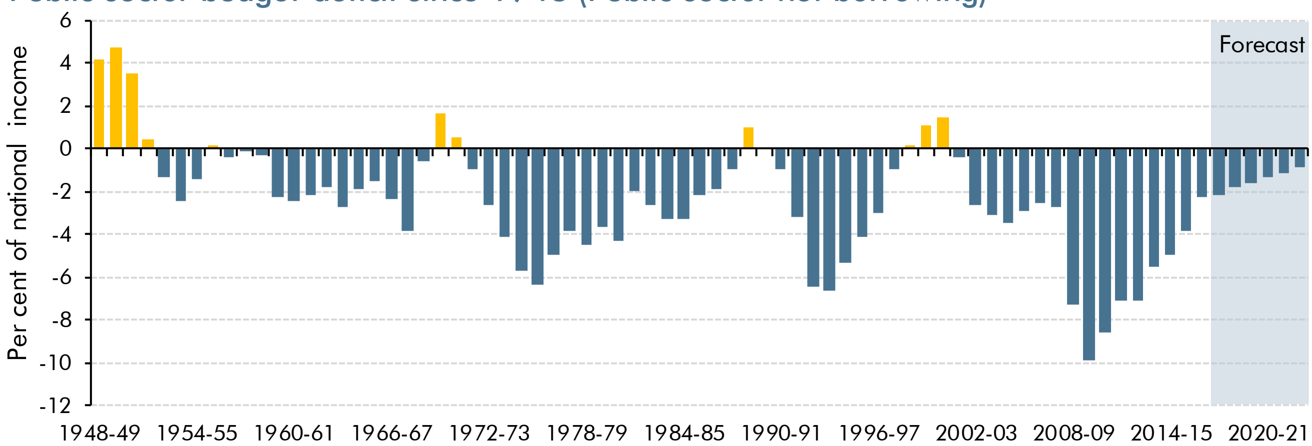


Source: ONS, OBR

In 2018-19, we expect a deficit of £37.1 billion or 1.8 per cent of national income – down from its post-war peak of £153.0 billion or 9.9 per cent of national income in 2009-10. We expect receipts to rise faster than spending in the coming years, so we forecast that the deficit will get smaller each year. But we do not expect the budget to be in surplus at any point in the next five years. By 2022-23, we expect the deficit to have fallen to £21.4 billion, by when receipts would be 36.7 per cent of national income and spending 37.6 per cent.

Swings into deficit have become steadily more pronounced over the post-war period. And budget surpluses have been achieved in only 12 years since 1948 and only five years since 1971-72.

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



Source: ONS, OBR

Next: Deficits or surpluses continued

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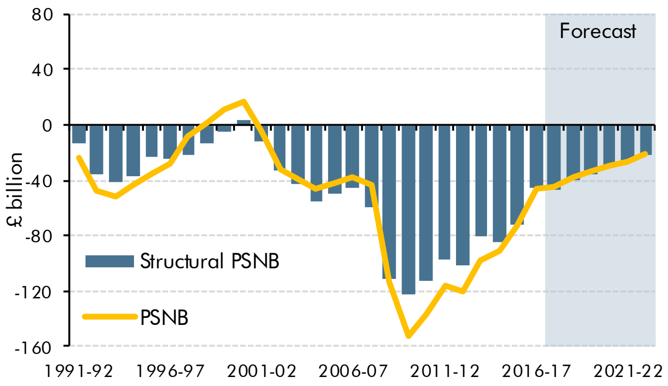
Movements in the budget deficit are in part the result of the ups and downs of the economy. When the economy is strong, the deficit will be lower as taxes flow in and welfare spending costs are reduced. The opposite is true when the economy is weak.

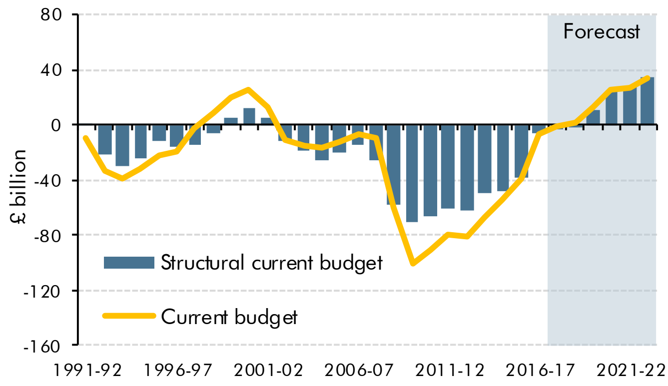
The 'structural' budget deficit is an estimate of how large the deficit would be if the economy was operating at a normal, sustainable level of employment and activity. We never know precisely what this 'normal' level would be, so these estimates are always uncertain. We currently estimate that the economy will be 0.2 per cent above normal capacity in 2018-19. So we judge that the structural deficit is almost the same as the overall deficit, with virtually no '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. We expect a small current surplus to be just £1.9 billion in 2018-19 and for it to reach £34.2 billion in 2022-23.

Public sector net borrowing



Current budget balance



Source: ONS, OBR

Debt

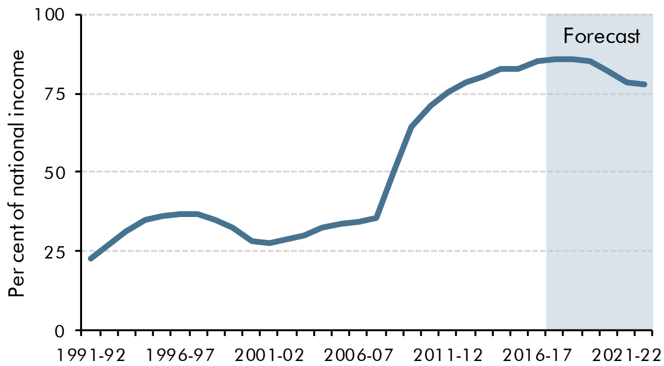
So far we have been looking at the flows of spending and receipts that take place each year and the deficits and surpluses they result in. But because governments run deficits much more often than they run surpluses, they have built up a significant stock of outstanding debt over time.

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 where the loans themselves are financial assets for the government.)

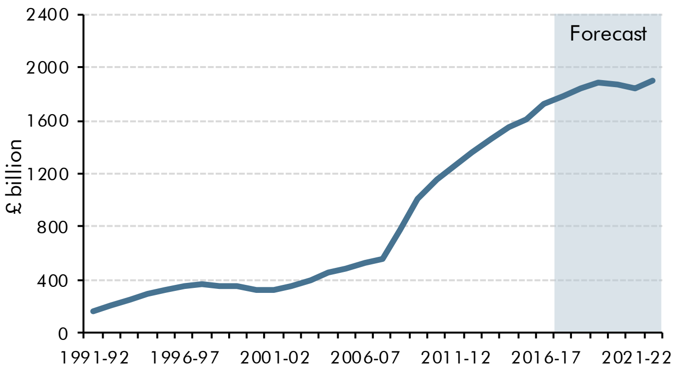
The most widely watched measure of debt in the UK is 'public sector net debt', which subtracts the relatively small amount of assets that the Government could readily turn into cash if required (for example, foreign exchange reserves) from the gross total. We expect public sector net debt to peak relative to national income in 2017-18 at 85.6 per cent, which is equivalent to £1,783 billion or £63,000 per household.

One of the Government's 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 recession and financial crisis. We expect that target to be met, with debt falling from 2018-19 onwards and reaching 77.9 per cent by 2022-23. In cash terms, we expect debt to stand at £1,893 billion in 2022-23.

Debt as % of national income



Debt in cash terms



Source: ONS, OBR

Next: International comparisons

International comparisons

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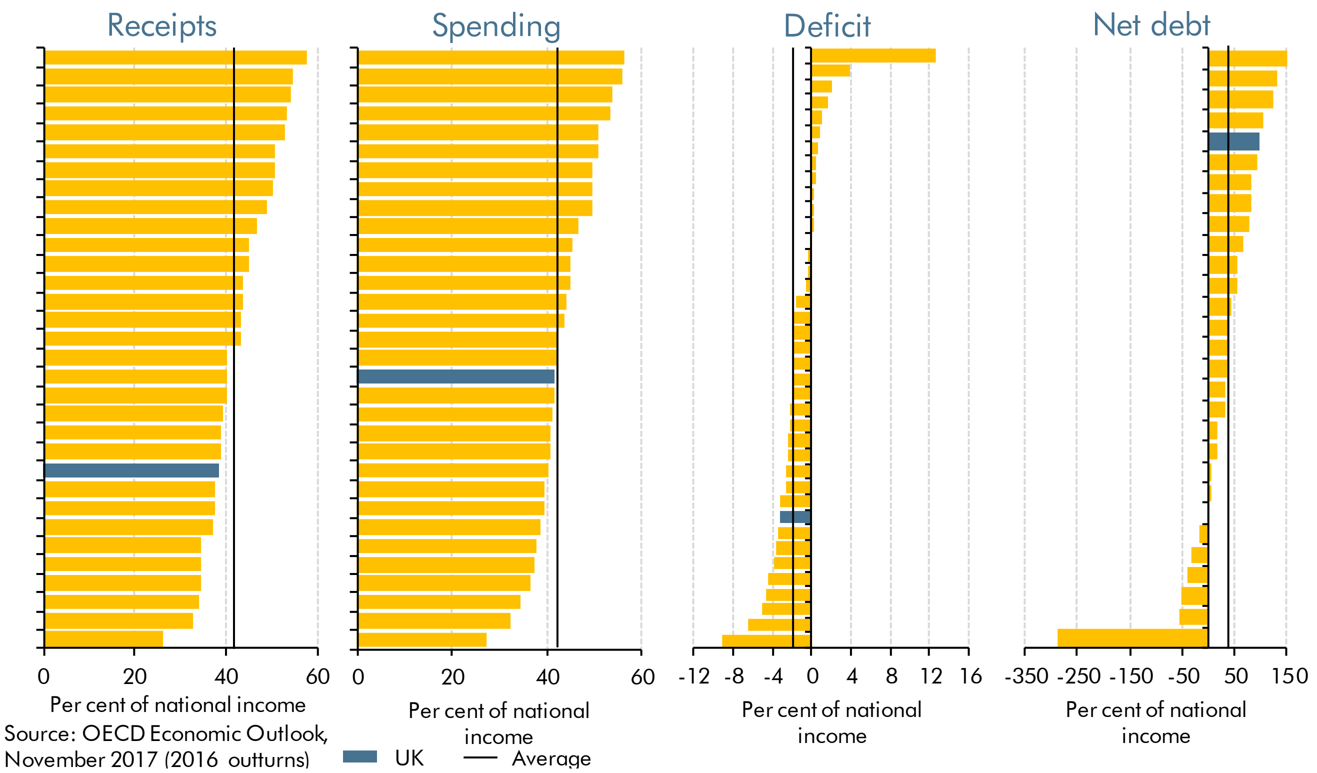
HOW do the public finances in the UK compare to those in other countries? To answer this question we can look at the forecasts for 32 industrial countries produced by the Organisation for Economic Cooperation and Development (OECD) in June 2017. Unfortunately, the OECD forecasts are not directly comparable with the ones that that we have presented so far: for example, the OECD does not cover public corporations, while it defines spending and revenue somewhat differently.

That caveat 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 Finland 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 at the same time raising less in revenue, leaves the UK running one of the larger budget deficits in the industrial world – seven countries have bigger ones. 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, November 2017 (2016 outturns)