

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 Budget and Autumn Statement – we produce detailed forecasts for the coming five years, assessing the likely impact of policy decisions and expected developments in the economy. We then use these forecasts to assess the Government's performance against the two fiscal targets that it has set itself for the management of the public finances.



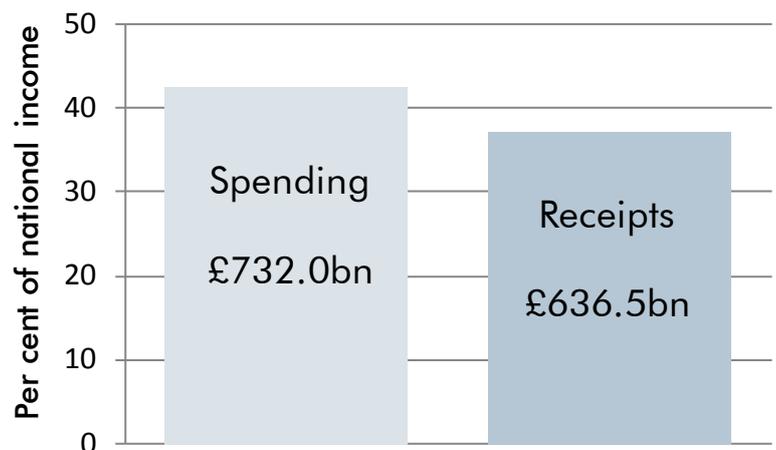
This guide provides a brief introduction to the UK public finances and to the terms used to describe them in the official statistics. In doing so we are looking at the finances of the public sector as a whole – which encompasses not just central government, but also the devolved administrations, local councils and public corporations. The figures presented in this guide are taken from our March 2014 Budget forecast, which covers the five fiscal years up to 2018-19. Each fiscal year runs from April to March.

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 2014-15, we expect it to raise £636.5 billion, equivalent to £23,000 per household or 37.0 per cent of national income.
- **how much it will spend** on things like public services, state pensions and debt interest. In 2014-15, we expect it to spend £732.0 billion, equivalent to £27,000 per household or 42.5 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 2014-15, we expect a deficit of £95.5 billion. Because receipts are forecast to rise much faster than spending, we expect the deficit to get smaller each year and a small surplus in 2018-19.

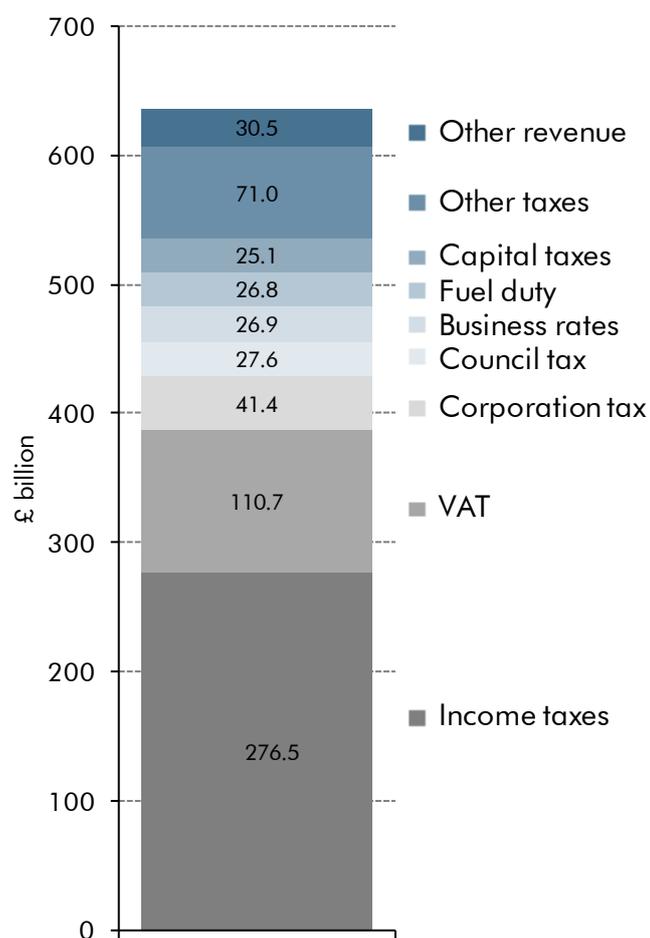
Spending and receipts in 2014-15



- **how much will be added to – or paid off – the national debt** in each year. We expect public sector net debt to reach £1,355 billion in 2014-15, equivalent to £50,000 per household or 77.3 per cent of national income. Directly comparable data are not available, but this is probably the highest share of national income it has reached since 1969. (Net debt was less than 40 per cent of national income prior to the financial crisis.) As the deficit shrinks, we expect net debt to start falling as a share of national income in 2016-17 and to reach 74.2 per cent of national income by 2018-19. But, in cash terms, we expect net debt to continue rising at least until 2018-19, reaching £1,548 billion in that year.

IN 2014-15, we expect the public sector's income to amount to £636.5 billion, equivalent to £23,000 per household or 37.0 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, providing 95 per cent of the total in 2014-15.

Sources of public sector receipts



Source: OBR

2014-15

The taxes that bring in the most money are income tax and National Insurance Contributions, which together are expected to raise £276.5 billion. Value Added Tax (VAT) is the next most important, expected to raise £110.7 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.

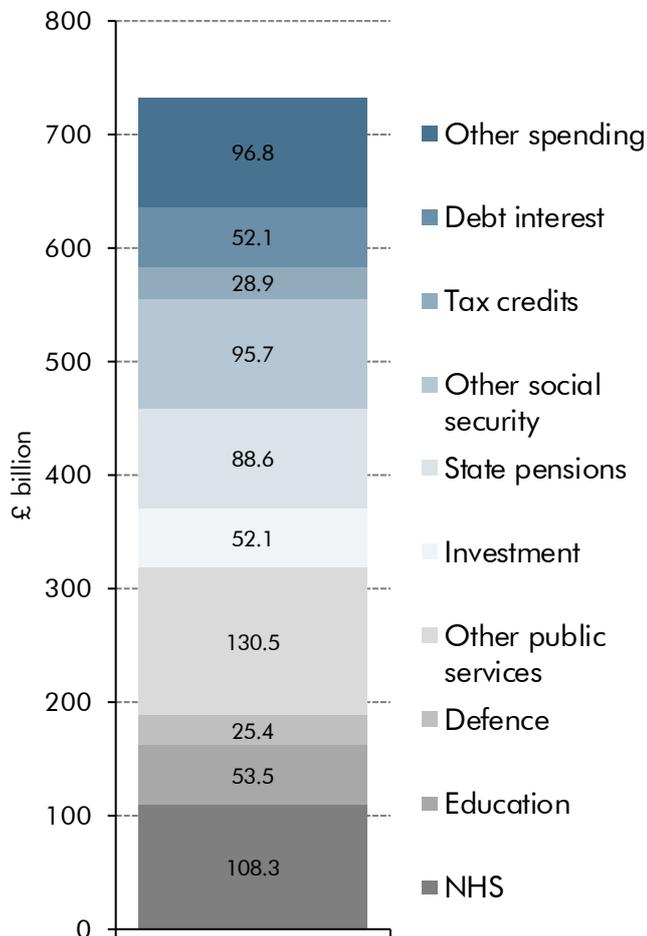
The public sector also receives interest payments on its assets (such as foreign exchange reserves), while public corporations generate some income. (In recent years, one important source of income has been cash transferred from the Bank of England earned on the assets it bought under 'quantitative easing'. As these flows are likely to be only a temporary boost to the public finances, the figures we present here exclude them.)

Over the next five years, we expect total receipts to grow by 28 per cent, a little faster than the cash size of the economy. We expect the fastest growing taxes to be those driven by asset markets, like housing and the stock market. In particular, receipts from capital gains tax, inheritance tax and stamp duty on property are expected to almost double. But some tax receipts are expected to fall, for example oil and gas revenues (due to an expected fall in oil prices) and vehicle excise duty (because people are buying more fuel-efficient cars and these cars pay lower tax rates).

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 different types of individuals.

In 2014-15, we expect public spending to amount to £732.0 billion, which is equivalent to £27,000 per household or 42.5 per cent of national income. This is called 'Total Managed Expenditure' and covers many different types of spending.

Public sector spending



Source: OBR, HMT 2014-15

In 2014-15, we expect central government departments to spend £317.8 billion on the day-to-day ('current') running costs of public services and administration. This is 43 per cent of public spending. The biggest items are the NHS (£108.3 billion), education (£53.5 billion) and defence (£25.4 billion). This spending is subject to multi-year limits determined and managed by the Treasury - 'Resource Departmental Expenditure Limits' or 'RDEL'.

We also expect the public sector to spend £52.1 billion - around 7 per cent of the total - on capital investment, for example roads and buildings. About 70 per cent of this capital spending will be carried out by government departments, again subject to multi-year Treasury limits - 'Capital Departmental Expenditure Limits' or 'CDEL'. The remainder will be carried out by local authorities (mostly roads, schools and housing) and by public corporations (for example, by Transport for London).

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 ceilings, it is known as 'Annually Managed Expenditure' or 'AME'.

Detailed department-by-department RDEL and CDEL plans have now been set out through to 2015-16. Beyond 2015-16, the Government sets a 'policy assumption' for total spending. By subtracting our forecasts for AME from that assumption, we can calculate what would be left to spend on public services and capital investment.

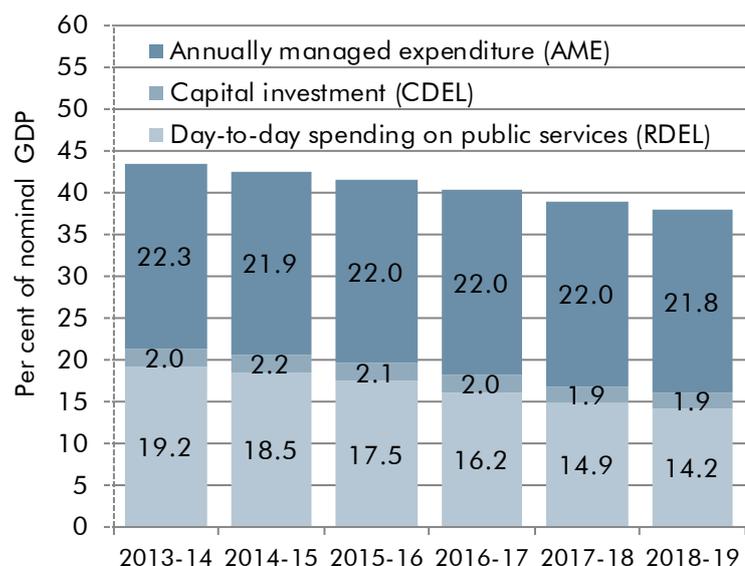
The biggest component of AME is cash transfers through the social security and tax credits system, which we expect to cost £213.2 billion in 2014-15. Around 46 per cent of these are paid to pensioners, with state pensions the largest item at an expected £88.6 billion. Other big items include tax credits (£28.9 billion, mostly paid to people of working age) and Housing Benefit (£24.7 billion, around three-quarters paid to people of working age). Jobseekers' Allowance - paid to the unemployed - costs £3.8 billion.

Interest payments on the national debt are expected to cost the Government £52.1 billion in 2014-15. Debt is forecast to have increased by more than 150 per cent since 2007-08 (before the financial crisis), but the debt interest bill will have risen by less than 75 per cent. This reflects a fall in the interest rates at which the Government can borrow.

Over the next five years, we expect public spending to grow by 8 per cent, much slower than the cash economy. This is based on the

Government's detailed plans to 2015-16 and its assumption for total spending thereafter. We expect AME to grow by 21 per cent, with debt interest increasing by 55 per cent as interest rates rise. That would leave less for public services and administration – our forecasts suggest that RDEL will fall by 8 per cent in cash terms and by about a quarter as a share of national income by 2018-19. Directly comparable data are not available, but this would probably take day-to-day spending on public services to its lowest share of national income at least since 1948.

Public spending to 2018-19



Source: OBR, HMT

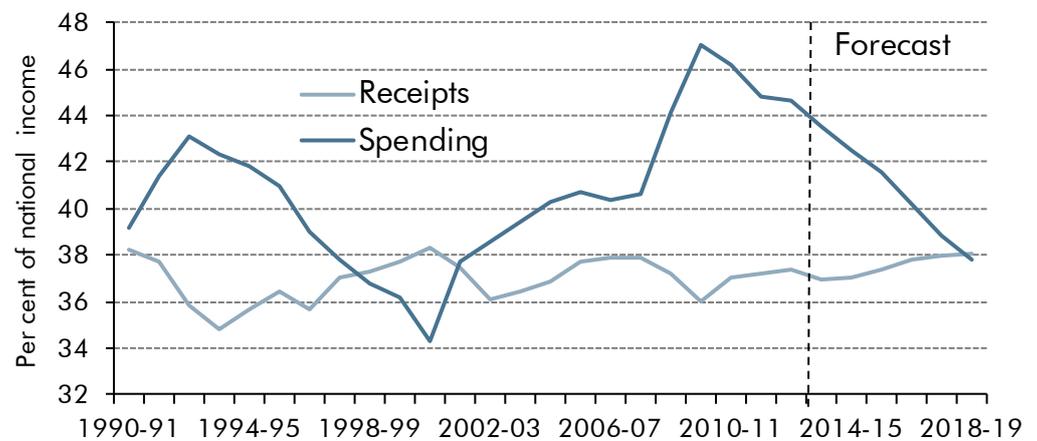
Memo: AME includes Single Use Military Equipment

Deficits or surpluses

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 like losses or profits for a company.

In 2014-15, excluding transfers from the Bank of England, we expect a deficit of £95.5 billion or 5.5 per cent of national income – down from its post-war peak of £157.3 billion of 11 per cent of GDP in 2009-10.

The gap between receipts and spending

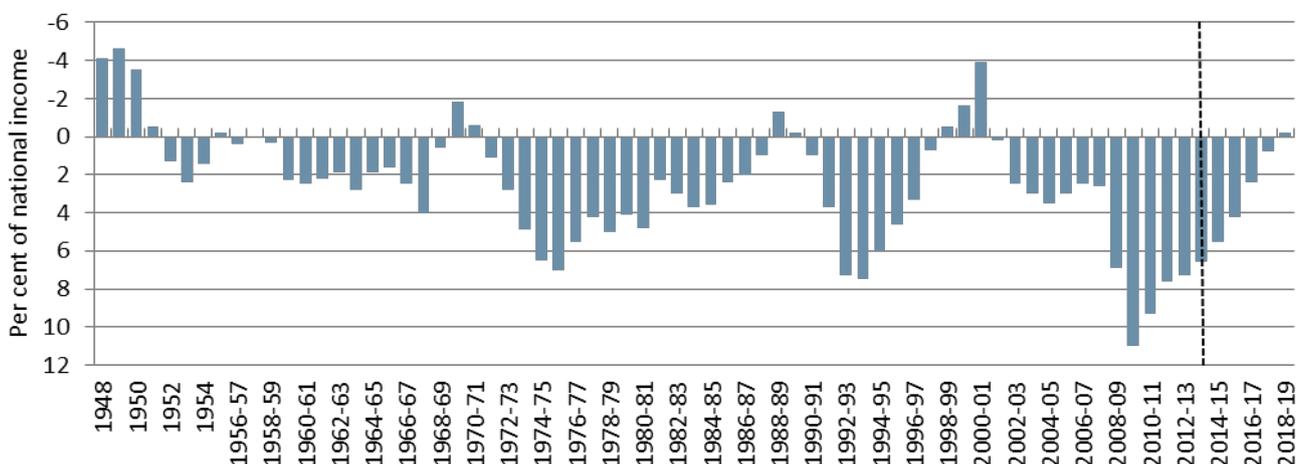


Source: ONS, OBR

We expect receipts to rise much faster than spending over the next five years, so we forecast that the deficit will get smaller each year. Indeed, by 2018-19 we expect the Government to be running a small surplus on current policy, at which point receipts would be slightly above 38 per cent of national income and spending slightly below.

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.

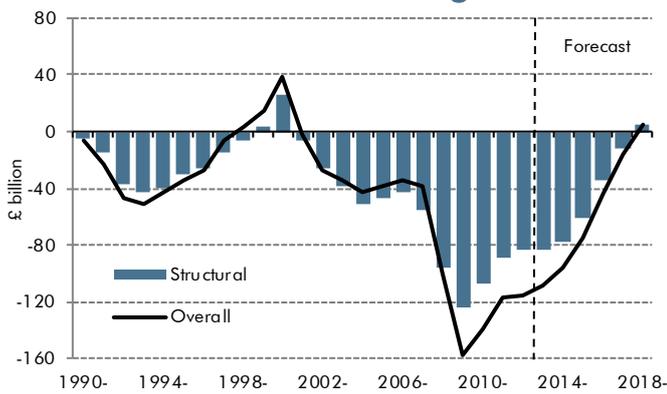
Public sector net borrowing since 1948



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 costs are reduced. The opposite is true when the economy is weak.

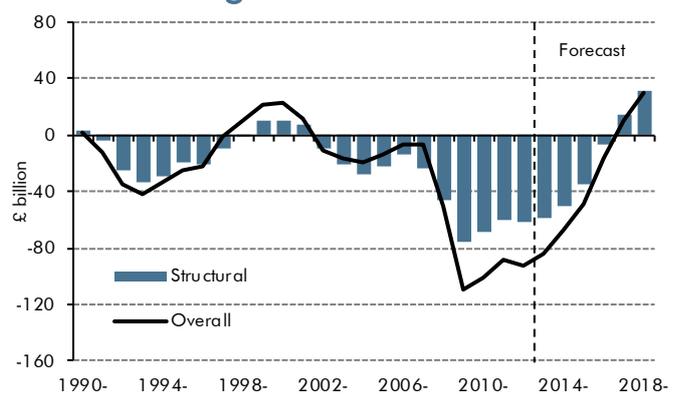
The 'structural' budget deficit is an estimate of how large the deficit would be if the economy was operating at a normal, sustainable level of employment and activity. We never know precisely what this 'normal' level would be, so these estimates are always uncertain. We currently estimate that the economy will be running 1¼ per cent below normal capacity in 2014-15, partly because there are fewer people in work than we think is sustainable in the longer term. So we judge that the structural deficit is a little lower than the overall deficit. The remaining 'cyclical' part of the deficit will disappear automatically as the economy returns to a normal level of activity.

Public sector net borrowing



Source: ONS, OBR

Current budget balance



Source: ONS, OBR

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, 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 the current deficit to be £67.6 billion in 2014-15 and there to be a current surplus of £30.5 billion in 2018-19.

One of the Government's fiscal targets is to achieve balance or surplus on the structural current budget balance at the end of each five-year forecast horizon, thereby borrowing only to finance investment, which is presumed to deliver a lasting flow of benefits over time. We expect that target to be met by a big margin of £31.3 billion in 2018-19, which was the target year in the 2014 Budget forecast. We also expect a modest surplus in 2017-18, the target year for the 2012 Autumn Statement and 2013 Budget.

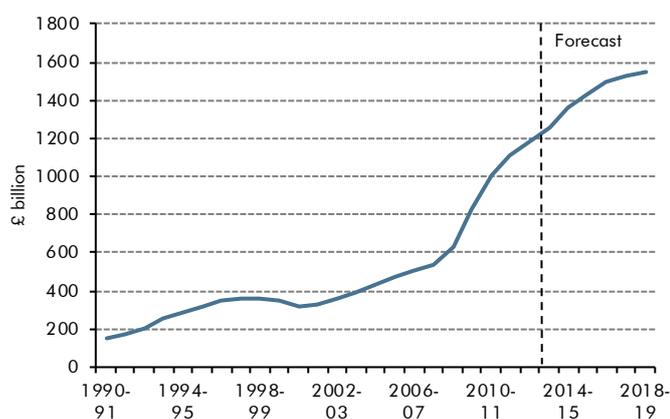
So far we have been looking at the flows of spending and receipts that take place each year and the deficits and surpluses they result in. But because governments run deficits much more often than they run surpluses, they have accumulated a significant stock of outstanding debt over time.

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 remember that some government activity adds to its debt without adding to the deficit in any given year, most significantly granting loans to students.)

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 £1,355 billion in 2014-15, which is equivalent to £50,000 per household or 77.3 per cent of national income. Direct comparison is not straightforward, but this is probably the highest share since 1969. (Before the financial crisis and recession, debt in the UK was less than 40 per cent of national income.)

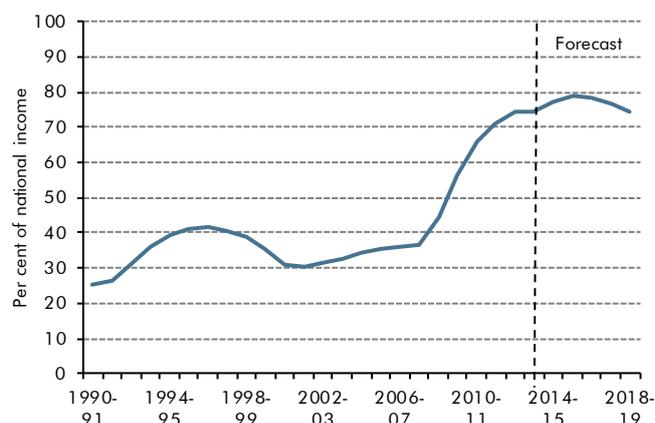
One of the Government's fiscal targets is to make sure that debt is falling as a percentage of national income by 2015-16, thereby beginning to reverse the big increase associated with the recession and financial crisis. We do not expect that target to be met. We expect net debt to start falling as a share of national income in 2016-17, reaching 74.2 per cent by 2018-19. In cash terms, we expect debt to continue to rise at least until 2018-19, reaching £1,548 billion in that year.

Debt in cash terms



Source: ONS, OBR

Debt as % of national income



Source: ONS, OBR

International comparisons

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 November 2013. Unfortunately, the OECD forecasts are not directly comparable with the ones 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 is higher as a share of national income in the UK than in the majority of other industrial countries – we spend much more than the US and Japan, but much less than Finland or France;
- spending more than most other countries, and at the same time raising less in revenue, leaves the UK running one of the largest budget deficits in the industrial world. (Only Japan, Spain and Slovenia have bigger ones. Norway has the largest surplus, thanks to oil and gas revenues that it saves rather than spends); and
- net debt in the UK is also high relative to that in most other industrial countries.

