INTRODUCTION

This papers discusses the path for UK fiscal policy over the coming years and outlines a fiscal objective that would ensure that the public finances remain on a sustainable path, whilst also allowing for an increase in investment in public services above the levels planned by the UK Government.

The key results in the paper are summarised below.

- Targeting a current budget balance from 2019-20 onwards would mean that there would be no borrowing to fund day to day public services. Limited borrowing would still be undertaken to support capital investment as this will boost the country's long term productive capacity and in turn its ability to create jobs and future tax revenues.

- Such a target could be accompanied by an intention to increase public sector net investment to approximately 2% of GDP by 2019-20. This is in line with the long run level of capital spending and would provide an additional net investment over the period 2016-17 to 2019-20 compared to the UK Government's current plans.

- Taken together, meeting the above objectives would ensure that public sector debt and borrowing were on a downward path from 2016-17 to 2019-20. They would also provide an additional £150 billion in cumulative investment in public services over this period compared to the UK Government's current plans. Maintaining these objectives in subsequent years would also ensure that public sector debt continued to fall as a share of GDP beyond 2019-20.

- The UK Government has adopted an alternative fiscal target. It is seeking to achieve an overall budget surplus of £10 billion in 2019-20 and to maintain a surplus in 'normal times' in future years. This means that rather than achieving a current budget balance in 2019-20, it intends to achieve a current budget surplus of £40 billion.

- The UK Government's proposed fiscal mandate means that significant further fiscal consolidation will be required in future years. By 2019-20, the UK Government plans to implement £12 billion in cuts to welfare, £5 billion in tax rises and anti-evasion measures and approximately £20 billion of cuts to public services.

OPTIONS FOR THE UK FISCAL MANDATE

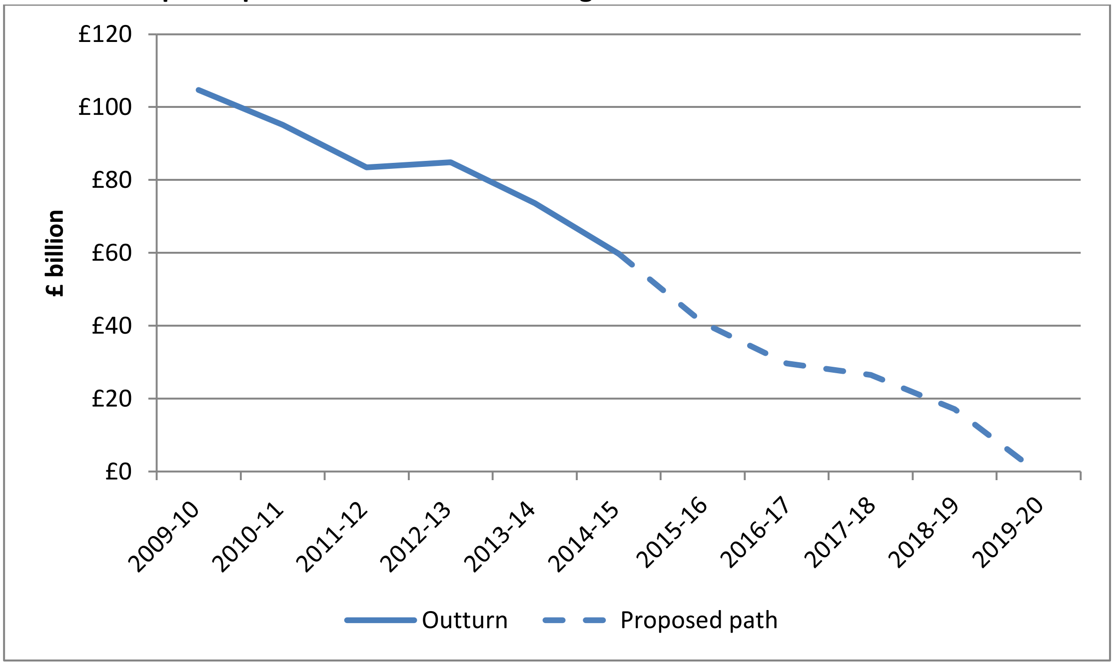
A fiscal mandate must ensure the sustainability of the public finances and provide an appropriate level of investment in public services and wider government functions.

One option is for governments to seek to achieve a current budget balance. This means that public sector receipts are sufficient to fund day to day spending on public services, but that limited borrowing is still undertaken to support capital investment, reflecting the fact that such expenditure will both produce an asset which will generate benefits for future generations and increase the country's productive capacity.

In 2014-15, the UK Government ran a current budget deficit of 3.3% of GDP. One option would be for the UK Government to seek to return the current budget to balance by 2019-20, and target to maintain this in future years.[1] In the years prior to 2019-20, such an approach would ensure that public sector debt and public sector net borrowing, as a share of GDP, both declined each year. In subsequent years, it would ensure that public sector debt remained on a downward trajectory, as a share of GDP, whilst still allowing borrowing to support long term capital investment.

The path of the UK current budget balance under the above scenario is summarised in the chart below.

Chart 1 – Proposed path for the UK current budget balance



With this option there would be flexibility over the level of public sector net investment, as this does not impact on the current budget balance. In setting an appropriate level of investment there is a trade-off between the rate at which public sector debt is reduced, and the level of investment which is made in the economy's infrastructure, and in turn its future growth potential.

Public sector net investment in the UK has fallen from 3.2% of GDP in 2009-10 to 1.7% in 2014-15. It is forecast to fall further, as a share of GDP, in subsequent years and is expected to reach 1.4% GDP in 2019-20 – an overall reduction of 1.8% of GDP. To put this reduction into perspective it is equivalent to £40 billion in 2019-20.

Public sector investment in the UK is also low by international standards. In 2013, the UK ranked 23 out of 32 OECD countries for government investment as a percentage of GDP.[2]

[1] A current budget balance means that tax revenues equal non-investment spending.

[2] This uses the OECD measure of general government gross investment. This differs slightly from public sector net investment, which is the measure used by the OBR.

Therefore, there remains a case for increasing capital investment above current levels. This is particularly true in the current economic environment where government borrowing costs are at near record lows. For example, at present the interest rate on UK 10 year government gilts is 1.8%.[3]

Within this option, therefore, it is proposed that achieving a current budget balance should be accompanied by a rate of public sector net investment of around 2.0% GDP per annum. This is both close to the long run average level of public sector net investment (1.9% of GDP[4]) and would be compatible with ensuring that public sector net debt remained on a downward trajectory as a share of GDP.

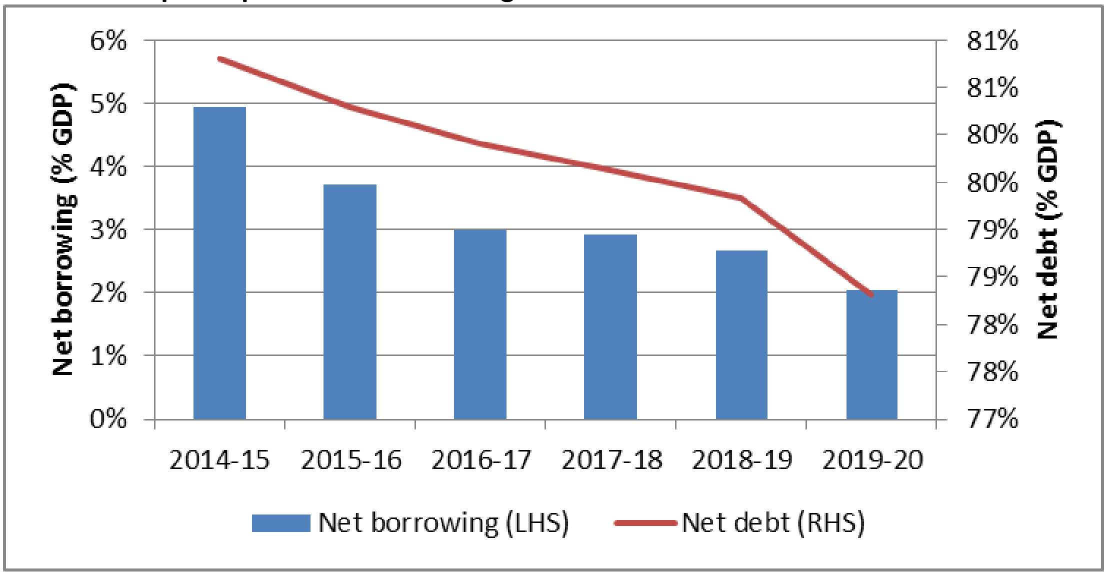
Fiscal Implications

Under the above proposal, public sector net debt would fall each year from 2016-17 to 2019-20. If it was maintained in subsequent years, public sector debt would remain on a downward trajectory.

Public sector net borrowing would fall each year from 4.9% in 2014-15 to 2.0% in 2019-20. This is below the average deficit of 3.6% that the UK has had over the past 40 years. Any borrowing which was undertaken from 2019-20 onwards would be to support capital investment and would therefore help to increase the country's long run productive capacity.

The paths of public sector net debt and borrowing under this proposal are summarised in the chart below.

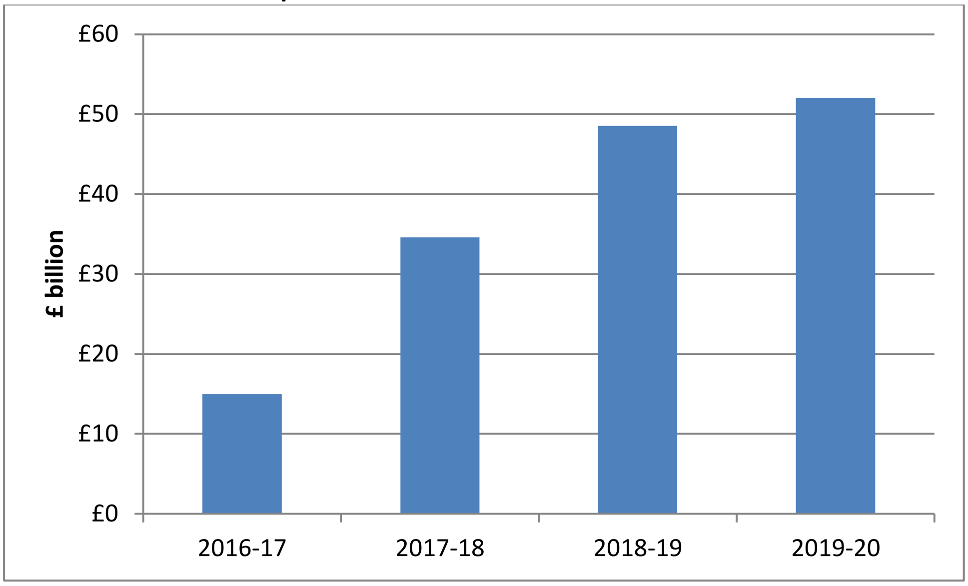
Chart 2 – Proposed path for UK borrowing and debt



Compared to the UK Government's current spending plans, this proposal would enable an additional £150 billion of cumulative investment in public services over the period 2016-17 to 2019-20, split between current spending (£120 billion) and capital investment (£30 billion). The proportion of this increase that would accrue to Scotland would depend on the allocation across UK Government departments and the consequentials that Scotland subsequently receives via the Barnett Formula. Assuming a population share, this would correspond to a cumulative increase in public spending in Scotland of around £12 billion over the next four years compared to the UK Government's current plans.

[3] Financial Times, 7 October 2015
[4] Average level of public sector net investment over the last 40 years (1975-76 to 2014-15)

Chart 3 – Additional spending on UK investment and public services compared to UK Government's current plans



Note: Increased spending smaller than increase in borrowing as increased debt interest spending has been netted off.

UK GOVERNMENT'S PROPOSED FISCAL MANDATE

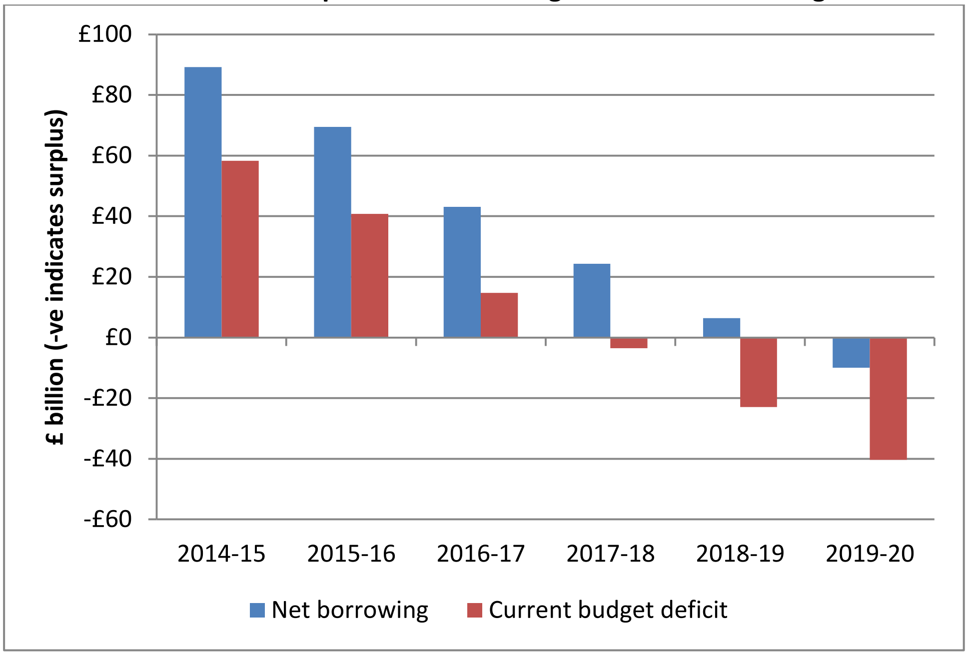
The Chancellor announced an updated Charter for Budget Responsibility in July 2015.[5] The mandate contains a number of targets. For the period from 2015-16 to 2019-20 it requires public sector debt to be falling as a share of GDP in each year and public sector net borrowing to be in surplus by 2019-20. In subsequent years, it requires public sector net borrowing to be in surplus during 'normal' times.[6]

The July Budget set out the UK Government's fiscal plans for the next five years to comply with its new fiscal mandate. It is forecast to achieve an overall surplus of £10 billion in 2019-20 and a current budget surplus of over £40 billion in the same year.

5 https://www.gov.uk/government/publications/charter-for-budget-responsibility-summer-budget-2015-update

6 When referring to the mandate applying in normal times, the UK Government states "These targets apply unless and until the Office for Budget Responsibility (OBR) assess, as part of their economic and fiscal forecast, that there is a significant negative shock to the UK. A significant negative shock is defined as real GDP growth of less than 1% on a rolling 4 quarter-on-4 quarter basis" HM Treasury - Charter for Budget Responsibility: Summer Budget 2015 update

Chart 4 – UK Government plans for borrowing and the current budget



To achieve these targets, the UK Government plans to implement a significant programme of fiscal consolidation over the coming years. This is illustrated in the table below. By 2019-20, the UK Government plans to implement fiscal consolidation worth £37 billion. Approximately £12 billion of these savings will come from cuts to the social security system, £5 billion will come from tax rises and measures to reduce evasion. The remaining £20 billion is expected to come from cuts to public services, with the final quantum and allocation across Whitehall departments and the devolved administrations announced at the UK Spending Review on 25th November 2015

Table 1 – Consolidation Plans over this Parliament

£ billion	**2016-17**	**2017-18**	**2018-19**	**2019-20**
Discretionary Consolidation	9	20	31	37
Of which:				
Reductions in welfare spending	5	7	9	12
Tax increases and avoidance measures	1	2	4	5
Further consolidation	3	11	18	20

Source: HM Treasury, Budget Table 1.5 (July 2015)

CONCLUSION

This paper has proposed an option for a fiscal mandate to achieve a balanced current budget by 2019-20. This is a sustainable approach with borrowing and debt both falling as a percentage of GDP between 2016-17 and 2019-20. This approach would also release an additional £150 billion of cumulative funding for infrastructure and public services between 2016-17 and 2019-20 compared to the UK Government's July 2015 Budget plans.