The state of the public finances

Since 2010, the UK Government has been striving to eliminate its budget deficit to deliver – as former Chancellor George Osborne described – a public sector "that lives within its means". But this year's vote to leave the EU will disrupt those plans, and economic uncertainty in the wake of the referendum looks set trigger a shift in the Government's fiscal priorities away from austerity and towards investment to stimulate growth.

This section of *The State of the State* explores the state of the public finances – and what Brexit could mean for their outlook.

Economy, interrupted

After the 2008 global financial crisis, the UK entered its deepest recession since quarterly data was first published in 1955. The economy finally returned to its pre-crisis level in 2014, and the UK began to benefit from growth levels among the best of major advanced economies.

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However, uncertainty began to drive a slowdown in hiring and investment after February 2016 when former Prime Minister David Cameron announced the June referendum date. Deloitte's quarterly CFO survey – the recognised barometer for corporate sentiment – found confidence amongst the UK's big businesses sank to a three year low as the vote loomed.[5] The Office for Budget Responsibility (OBR) revised its growth forecasts down accordingly, by 0.3 percentage points to an average 2.1 per cent a year to 2020.[6]

In the immediate aftermath of the referendum, economic indicators were mixed. Within one month, the FTSE 250 – which tracks companies reliant on UK income and sterling – was down £27 billion and the pound had fallen 13.5 per cent against the dollar. But at the same time, the FTSE 100 of more international companies was up by £70 billion. Consumer confidence suffered its fastest monthly fall in 26 years according to the GfK index, yet figures from the Office for National Statistics (ONS) suggested that the UK's economic growth improved in the three months leading up to June 2016 – so any uncertainty around the referendum period did not appear to affect growth at the time.[7] However, a post-Brexit meeting of G20 finance ministers concluded with a clear statement that the referendum result had added to uncertainty in the global economy.

Recent months have also seen a collapse in global bond yields, with some £6.9 trillion of them now yielding below zero. July 2016 saw Germany issue bonds with a negative yield for the first time as investors preferred to hold on to Europe's benchmark bonds, even at the risk of less money in return when the bonds mature. UK Government debt – issued in the form of bonds – is performing better than German debt, suggesting that the markets are less concerned about the UK's solvency than they were after the global financial crisis.

The Bank of England was decisive in its monetary reaction after the referendum. Within six weeks of the vote, the Bank reduced interest rates to their lowest ever level to stimulate spending and announced plans to buy £60 billion of government bonds and £10 billion of corporate bonds from companies outside the financial sector that contribute to the UK economy. Quantitative easing of this kind is undertaken by central banks when interest rates are close to zero in order to increase the amount of money in the system, encouraging businesses and people to borrow and therefore create jobs and spend more money. Its effect will, as with all quantitative easing measures, be subject to interpretation and debate.

Economists continue to study individual indicators as they arise, but a more comprehensive picture of the referendum result's immediate economic impact will not become clear until the Chancellor's Autumn Statement and the full OBR data that informs it. In the meantime, Deloitte's latest quarterly CFO survey shows that a heightened sense of uncertainty continues among UK corporates, with most expecting their investment spending and hiring to be weaker over the next three years as a result of Brexit. The consensus view among economists is that the UK economy will slow in 2017, but will probably avoid recession.

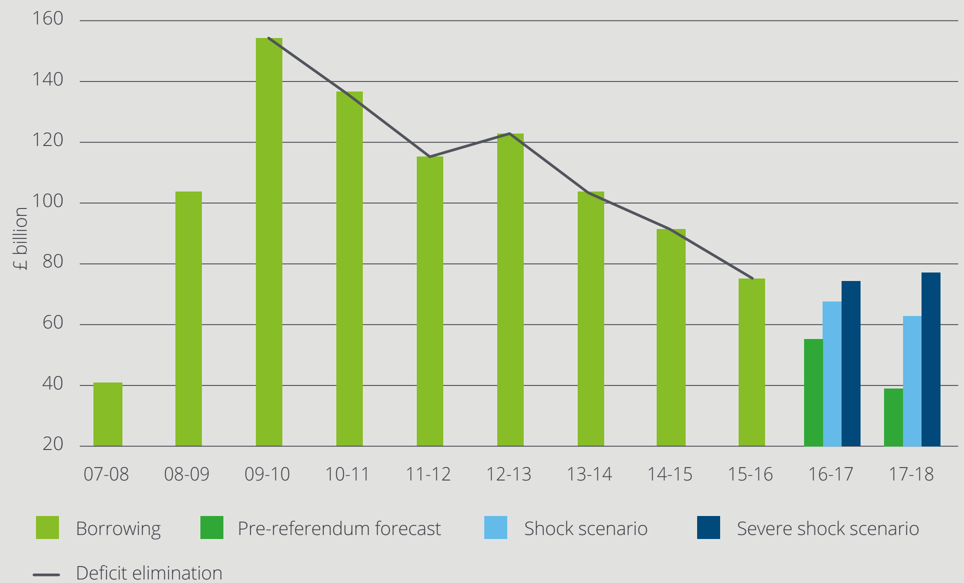
Public finances, disrupted

The global financial crisis hit the UK's public finances hard, triggering a recession that pushed tax income down and public spending up. The gap between what the Government was earning and what it was spending – the deficit – grew to a post-war record in 2010, when the state spent £154 billion more than it earned. Elected that same year, the UK Coalition Government unified behind a common purpose to eliminate that deficit and deliver an annual budget surplus so that the state's income exceeded its spending. Former Chancellor George Osborne described that fiscal objective as ensuring "a country that lives within its means".

The UK Coalition ultimately reduced the deficit by half over its five-year term, achieving 80 per cent of that reduction though austerity measures that cut public spending. The remaining £74.5 billion was forecast to be eliminated by 2019-20, but new Chancellor Philip Hammond has confirmed that the timetable will not be met.[8] He will set out details in November's Autumn Statement – which could be used to "reset fiscal policy if we deem it necessary", according to the Chancellor.[9]

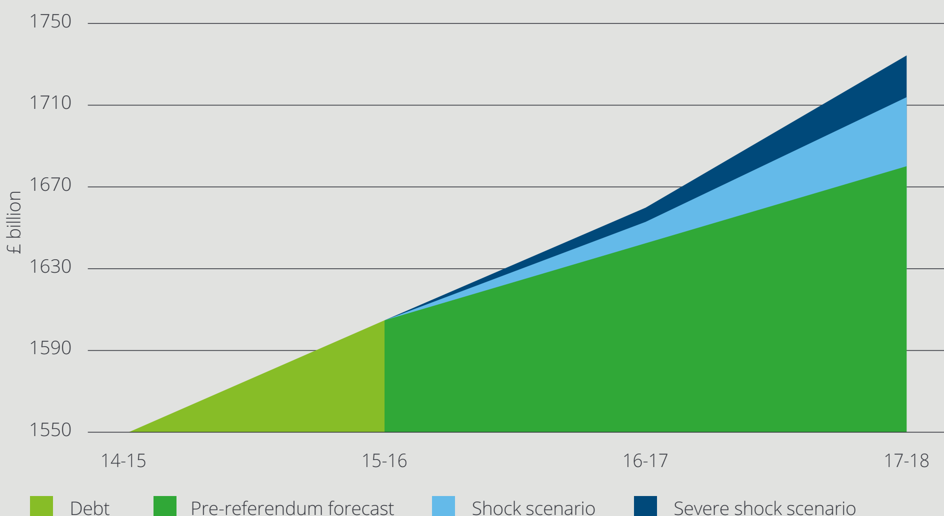
Figure 2 shows how the deficit has been reduced since its 2009-10 peak as well as the pre-referendum forecast for its continued reduction. The chart also shows HM Treasury modelling of how the referendum result could affect borrowing in the event of either a 'shock' or 'severe shock' in the economy as a result of the vote. According to the Treasury calculations, the deficit could be between £12.2 billion and £19 billion more in 2016-17 than if the UK had voted to remain in the EU. And by 2017-18, the Government could borrow between £24.2 billion and £38.5 billion more, taking the deficit higher than its 2015-16 level.

Figure 2. Eliminating the deficit



Source: HM Treasury and Office for Budget Responsibility, 2016

Figure 3. Public sector net debt



Source: HM Treasury and Office for Budget Responsibility, 2016

That higher deficit would of course increase the Government's debt. **Figure 3** shows how public sector debt has gone up in the past two years, as well as the pre-referendum forecast. According to Treasury modelling, the Government's debt could be between £11.3 billion and £17.3 billion more in 2016-17 than if the referendum result had been 'remain'. And by 2017-18, the Treasury calculates that the Government may need to increase its debt by £34.4 billion to £53.5 billion as a result of Brexit pressures.[10]

Resetting fiscal policy

Chancellor Philip Hammond has already indicated that the deficit elimination timetable – known as the fiscal mandate – will not be met. That raises four questions in relation to the public sector:

1. Will the mandate or the objective change?

In 2011, the UK Coalition established a Charter for Budget Responsibility that required it – and subsequent governments – to set out objectives for their fiscal policy as well as a 'fiscal mandate' against which progress could be assessed. The original mandate committed the Government to eliminating the budget deficit and beginning to see debt decline as a percentage of GDP. While the Chancellor adjusted the mandate's parameters in the years that followed, it has remained the Government's financial yardstick.

The fiscal mandate has been a constructive device that helped shore up confidence in the 2010-15 Government's management of the public finances during a period of global financial instability. It also provided a transparent measure by which the Government could be held to account, while maintaining flexibility to change according to economic circumstances. But as the UK prepares to leave the EU, those circumstances could be changing so significantly that the Government will consider whether to extend its timetable for the existing objectives, introduce new fiscal policy goals, or both. The 2011 Budget Responsibility and National Audit Act requires the Government to set and maintain fiscal objectives and a mandate – and it also describes how the Treasury can change them, explaining why it needs to do so to the House of Commons.

2. Will infrastructure spending replace austerity as the dominant fiscal theme?

In early 2016, the Organisation for Economic Co-operation and Development (OECD) called on governments in advanced economies to shift away from austerity measures and invest more in infrastructure in order to boost sluggish economic growth. The International Monetary Fund (IMF) has recommended since 2013 that the UK should increase infrastructure spending, and this year called on all G20 nations to scale up their infrastructure spending in a bid to stimulate short-term demand and catalyse private investment.

While austerity measures were recognised as a legitimate policy choice in the wake of the financial crisis, an alternative response now appears to be under consideration as the UK gears up for Brexit. Although the Government announced increases in infrastructure spending last year, the Autumn Statement may go further still in shifting the Government's emphasis from austerity to stimulus spending. The OECD and IMF views are backed up by OBR analysis that suggests spending on investment, public services and benefits are the interventions most likely to provide rapid economic boosts while providing a platform for medium and longer term growth.

Citizen polling for *The State of the State* shows that the public want to see greater infrastructure investment, especially in public transport and healthcare – and so a move towards investment at the Autumn Statement could be well received. Government will of course need to consider regional balances and the pressing need for housing as part of infrastructure plans. In 2015, the Government committed to releasing enough public sector land in England to build 160,000 homes by 2020. A year into those plans, the Government had only sold enough land to meet five per cent of that commitment. Multiple programmes across the public sector are identifying further surplus land and realising its potential is now key.

3. Will Brexit compromise or support public sector transformation?

Leaving the EU is an era-defining task for the Government. Political stakes are high and media scrutiny will be intense. But if the Government recalibrates spending plans as part of a fiscal reset, it needs to recognise the importance of continuing other change programmes across the system. Interviews with 40 public sector leaders for *The State of the State* found that many are concerned about the level of distraction Brexit will cause in Whitehall and the devolved governments, and whether it could jeopardise transformation programmes that are still needed to help public bodies make the most of their resources and cope with increased demand. Our survey of citizen expectations shows that the public sees the NHS as a greater policy priority than leaving the EU, suggesting an appetite for continued change and not a sole focus on Brexit to the detriment of public services.

4. For how long will the Government continue to run a deficit and increase its debt?

When governments run deficits, they make up the shortfall in their spending by borrowing. Even while the UK's deficit is reducing, the Government has still borrowed £471 billion since 2010-11, bringing its total debt to £1.62 trillion. That equals 84 per cent of the UK's GDP.

A secondary element of the fiscal mandate established in 2011 was that debt should decline as a share of GDP. In March 2016, the OBR assessed that the Government will miss this target in 2015-16 but is expected to achieve it in 2016-17. However, a fiscal reset and a shift to investment rather than austerity could change this outlook and the Government could decide to borrow while interest rates are low. A change in fiscal policy might of course see the deficit increased deliberately in order to fund investment.[11]