UK public finances: Borrowing and debt

ED Hello, and welcome to the Commons Library Podcast, where our experts give you an informed and impartial take on issues being discussed in Westminster and where you live. I'm Eleanor Davis, and last week I met with Matt Keep, a researcher in the economic policy and statistics research section of the House of Commons Library. We discussed the UK's public finances. We spoke about Government borrowing and debt, as well as future challenges to public finances, including the impact of Brexit.

So welcome to the podcast, Matt.

MK Thank you for having me.

ED Public finances, it's a broad term and we're going to be focusing specifically on Government borrowing and debt in today's episode – what is the difference between the two?

MK So when the Government spends more than it receives in income from taxes and other income, it needs to borrow to make up the difference and that's its borrowing, sometimes referred to as the deficit. The debt is broadly speaking the outstanding amount of borrowing the government has made, so it's a stock of all its past borrowing accumulated over time.

ED And what's the current state of Government borrowing?

MK So Government borrowing's fairly low by recent historical standards. In the financial year 2018 the Office for Budget Responsibility, the UK's public finance watchdog, expects it to be around 1% of GDP, which is around £20 billion. So that's the lowest it will have been since the financial year 2001; and in 2019 the UK Government's borrowing is expected to be lower than France's, Spain's, the US's, Italy's, Japan's, for example.

ED So how does this compare to when the UK was in recession?

MK Following the recession, so in say 2009, the Government borrowing was equivalent to around 10% of GDP, so significantly higher than it is now. So in that same year the Government borrowed around £150 billion, and for every £5 the Government spent, £1 of that was borrowed. Now, it's closer to £1 in ever £35 spent by the Government is money they borrowed.

ED And what measure have been used to bring borrowing down?

MK So generally with public spending, with the Government controlling public spending, they've done this in different ways. So a lot of it has been the result of controlling departments' spending, and this has fallen relative to the size of the economy. The Government has also controlled investment spending, so capital spending, and that has come down relative to the size of the economy. And also through some welfare spending controls. Welfare's a bit harder for the Government to control because it's largely driven by demand, for people requiring benefit payments etc, etc. So the Government introduced policies which would in theory slow down the growth in those spending areas.

Tax revenues have also had some impact on borrowing, so increases in tax revenues have helped bring borrowing down, but to a lesser extent that all these different spending items have.

ED In efforts to bring it down, have any Government departments been affected in particular?

MK So the Government offered protection to some departments, particularly the NHS budget, so other departments which weren't protected obviously saw bigger decreases. Funding for local government is one area which does stand out; also, funding for Justice and DEFRA as well.

ED So presumably the high levels of borrowing following the recession increased levels of debt?

MK Yes. Before the recession, in the years of 2006, 2007, the debt was equivalent to around 35% of GDP. It's now over 85%, around that sort of mark. Obviously, whilst borrowing was slowly decreasing after the recession, the Government was always borrowing in those years, following the recession, and this was adding to the debt. Debt of around 85% of GDP was last seen, before now, in the mid to late 1960s, when debt was coming down from the very high levels it saw following and during the Second World War.

And there have been more significant debts for the UK Government than there is now, notably the Second World War when the debt was around 200% of GDP, but going back further into the past, there were debts of over 100% following wars with France and Spain in the late 1700s and early 1800s.

ED We're not seeing levels from the late 1700s, early 1800s but with debt at 85% of GDP, is that a problem?

MK Not necessarily. The key thing is the Government being able to be seen to make its debt interest payments. So as long as investors think that the Government will make its debt interest payments, there shouldn't be a problem in a mature economy like the UK having such a level of debt. However, obviously that debt incurs debt interest so if you were to have lower debt, all other things being equal, you would have less spending on that debt interest. So I mean, that's one good reason for bringing debt down.

Others argue that the UK is going to inevitably face a future recession, and with debt being at the levels it is, it may make it more difficult for the government to deal with that, because inevitably when a recession comes along the Government will want to borrow more, to help the UK economy through.

ED Just to be clear, we're not predicting the next recession then?

MK No, I'm not predicting that one is necessarily coming soon but, I mean, history tells us that they do come around every ten years or so.

ED We had the Spring Statement in March, which was somewhat buried among Brexit votes – what did we learn about borrowing and debt?

MK So the OBR, the Office for Budget Responsibility, publish lots of data around those forecasts. We got a lot of information from that, but it's hard to know in some ways what to take away from that, but if I start by saying what the OBR did say. So their forecast suggests that borrowing will increase over the forecast period. They forecast for a five-year period, and at the end of that period they expect borrowing to be lower than it is currently, and they expect debt to fall to around 73% of GDP by the end of the five-year forecast period.

However, forecasting is uncertain at the best of times, and the Brexit process only makes it more uncertain. The OBR have assumed that the UK will leave the EU in an orderly manner, with an orderly departure into a transition to a new relationship that will begin in December 2020. However, it's not clear what this new relationship will be, therefore the OBR have assumed that whatever it is, the likely outcome is that there'll be fewer imports and fewer exports, so lower trade intensity. These will net off, the fewer imports and fewer exports, so you get the same net trade but, as I say, lower trade intensity. And the OBR have also assumed that there'll be lower net migration in whatever the future relationship is. So that's the assumptions they've put forward and have used.

But Brexit isn't a single event, there's going to be a whole set of changing policy areas, and there's no firm policy for the OBR to use from the Government at the moment on some of these. So we've already discussed the trading relationship. But other things such as immigration policy, there's a White Paper out but there's no firm Government policy on that, so the OBR doesn't have the firm details to work with, and they will all come together as the Brexit process moves on. So hopefully that will show that the forecasts made recently will have a great deal of uncertainty in them around the Brexit process.

ED Let me just say, we're speaking on the day that indicative votes are about to take place in the Commons, so who knows by the time this is released what the situation will be. But can we expect the OBR perhaps to reforecast or to kind of update based on as we do know more information?

MK Well, the OBR will do a forecast when the Government asks them to do a forecast. The law says that they must do two a year, and generally that's in time for the Autumn Budget and the Spring Statement. The OBR will take into account anything significant which has happened in their new forecast. So if it's clear exactly where the Brexit process is going and what the future trade relationship will be, then they can include that in their assumptions, but until that sort of concrete detail is there, they won't change their assumptions.

ED Going back to the finances, late last year the Library published Insights explaining how student loans are accounted and will increase the measure of borrowing – are these included yet in the figures?

MK No, and this is another reason why the OBR's recent forecast might not be telling us as much as normal. The change you refer to will add around £10 billion a year annually to the measure of Government borrowing. It's quite a complicated issue – it's worth having a look at the two Insights I've written on this to get the real background to it, but the key thing to note is that nothing real has changed here. So the way that student loans are administered, that hasn't changed, the terms of those, they haven't changed. What's changed is just the way it's accounted for in the borrowing measure, and the public finances themselves there's no underlying difference to them from this accounting change.

ED And when are they likely to be included?

MK The Office for National Statistics expect to incorporate the figures into the data by September 2019.

ED And let's look ahead now. In the Chancellor's Autumn Budget he said the Government would, to quote, 'return the public finances to balance at the earliest date in the next parliament,' which is due in 2025. This would mean the Government spends no more than it receives in income – is it on track?

MK You're referring here to the Government's overall objective for the public finances, and in its latest forecast the OBR said it appeared challenging for the Chancellor to meet this target. The OBR forecast doesn't currently go up to the year 2025, but at the end of their forecast period, 2023, they are still forecasting there to be a deficit, so the Government will be borrowing. And they expect the challenges in the future years, from demographic change and those sorts of issues, to only put upward pressure on borrowing. So this is the reason why they said it appeared challenging.

It's interesting that the Treasury Committee have questioned whether the Chancellor is really aiming at reaching this budget surplus in the middle of the 2020s. Their argument is that if we go back to the Autumn Budget in 2018, the OBR changed its forecast in such a way that would have meant that the Government would have been on course to reach a surplus at the end of the forecast period. Rather than take this surplus, the Chancellor actually spent money, which meant he was borrowing, so he spent the benefits of the forecast change, which led the Treasury Committee to question whether he really was wedded to that particular target. The Chancellor has been asked as well by the Chair of the Treasury Committee, Nicky Morgan, about this target reaching a surplus, and the Chancellor has replied along the lines of, 'Well, that's a choice we'll have to make'.

I should say that the Chancellor does have other targets that he is forecast to meet, so he has targets which should help him to achieve his overall objective. And he's on target, based on the forecast, to meet these other targets, which surround borrowing, debt and welfare payments.

ED And what about the Opposition? What do we know about their proposed targets?

MK So Labour has an alternative target which focuses on the current budget deficit. So this removes investment spending from the measure so it's only spending on the day-to-day running of services and this sort of thing. So Labour thinks it should be fine to borrow to invest because this brings you benefits in the future. So they are focusing on the current budget deficit, and their focus is on a rolling measure, so at the end of a five-year period the Labour Party say that the current budget should be in balance. They also have a target for debt, which broadly speaking is for the debt to be lower as a percent of GDP at the end of the parliament compared to the start of the parliament. They use a slightly modified version of GDP but that's broadly the target they would aim for.

ED Given what's currently happening in Parliament, we do need to touch a little bit more on the effect of Brexit – what can we say about the potential impact on public finances?

MK Well, the first thing to say is, it's very uncertain. And the key thing really for the public finances is what is the impact on the economy? The bigger the impact on the economy, the larger the impact on the public finances. We can discuss the short-term and potential long-term aspects. In the short term, if the UK leaves with a deal then the OBR's current forecasts, as we've already discussed, assume that there will be an orderly exit from the EU, so this will be obviously in line with leaving with a deal. So it would be fair to say that we wouldn't expect the forecast to change greatly on the basis of it being an orderly departure.

Some have argued that business investment may be unlocked from the UK leaving with a deal because, I mean, it's clear from the data that business investment has slowed recently, and lots of people are putting that down to uncertainty about Brexit. So the argument goes, well, if there's a deal, some of this uncertainty will be lifted and businesses will invest and help to stimulate the economy, which generally speaking would have a positive impact on the public finances. However, there is one issue which is worth addressing and that is of corporation tax receipts. So business investment can be deducted from corporation tax, so therefore corporation tax receipts could be lower than otherwise expected. But on the whole with a deal you'd expect things to be similar to the current forecast position.

ED And what about in a 'no-deal' scenario?

MK Well, this is very difficult to say anything about, it's very uncertain, and it's really quite hard to estimate how any disruption may play out. It would depend on how large any economic shock is from leaving without a deal, how persistent it is, I mean how quickly the UK Government and the EU nations adapt to different arrangements to get them out of that period. It also depends on how it affects the composition of the economy, how financial markets react, how prepared the UK is, how amicable the no-deal situation is with the EU nations, and also how they react. It's not just what the UK government can do, it's what these other countries can do.

I mean, one thing we can say is there's likely to be a policy response so the Bank of England may well do something with interest rates to help the economy along, but it's also likely that the Government may do something with public spending or taxation to help stimulate the economy, and the Chancellor has certainly hinted at that already. But basically, the bigger the shock to the economy, the larger the impact on the public finances, but in the short term it's very hard to forecast when things could be turbulent in a way that we couldn't really guess at this point.

ED What about long-term impact – is that as difficult to predict?

MK In some ways the long term is easier to at least analyse; I'm not saying you're more likely to be right in your predictions but it makes an easier analysis possible, because what we would do is assume that the economy is in a steady state so you take out all the ups and downs of the economy and then look at the situation then. And this is what the Government did in their economic analysis ahead of the meaningful vote – well, ahead of the meaningful vote which didn't happen towards the end of 2018. And the Government modelled five different scenarios for the future trading relationship between the UK and the EU. And these range from a very close trading relationship, which is envisaged in the Chequers White Paper to the additional barriers that would be introduced form a no-deal outcome. And they then compared these outcomes and looked at what the impact on GDP would be relative to staying in the EU.

For all of those different options they found that there would be a negative impact on GDP, so GDP would be lower than otherwise it would have been if the UK remained in the EU. I should say, under all these scenarios the UK economy would be growing over time, it's just it would be growing faster under the remaining in the EU option. So, yes, all of these were negative and had negative impacts on GDP, and the impact was most negative where barriers to trade were estimated to be higher, so where there's friction in trade the impact on GDP was greater. And also, the impact was more negative when migration was assumed to fall as well.

So from this analysis the Government then looked at the impact on Government borrowing over the same period, and borrowing was expected to be larger in all scenarios compared to remaining in the EU. And again, the larger the negative impact on the economy, the larger the impact on borrowing.

The biggest impacts on Government borrowing came from the indirect economic impacts. If the economy were to be smaller, tax receipts are likely to be smaller as well, so these indirect economic impacts were the most significant in changing borrowing. There was less impact in the Government's analysis from the direct impacts of leaving the EU, such as no longer making EU budget contributions.

ED Then apart from the effects of Brexit, what can you tell us about the future challenges for public finance?

MK Well, I mentioned this earlier, and there's every chance that at some time, certainly in the future, a future recession will come along and that will pose challenges for the public finances. Outside of that, I would say that probably the biggest spending pressure is going to come in health and adult social care. It's pretty well known, I think, that the population is ageing, and the percentage of population aged over 85 is set to increase, and their per capita consumption of health and social care spending is greatest. Also putting on the pressure on health spending – as the incomes that people grow, they demand more of these sorts of services so that's likely to put more pressure on health spending.

Also, somewhat counter-intuitively, advances in technology in health can have an impact on spending, increasing spending. You may well think that these advances would lower the unit cost of providing health, but actually what seems to happen is, as technology advances, treatments become more widely used so it ends up costing more money than otherwise would have been the case. Also on this, more people are having chronic conditions, which means they will have increased service used during the final years of their life, again putting upward pressure on health spending.

The next thing coming up really for the public finances, the next big event, is the spending review. So this will take place over the summer of 2019, and the government will be looking at department spending and allocating spending to departments. So that's what the review will do, and the results of the review will report in Autumn 2019, and we should get three-year settlements for departments, so they would have their spending set out for three years from this Autumn.

ED Well, thank you very much for joining us today on the podcast, Matt.

MK Thank you.

ED Well, that's it for this episode of the Commons Library Podcast. For relevant briefing papers on public finances, remember to look at the episode notes, which we will publish alongside this recording. And to keep up to date with what our researchers are working on, visit commonslibrary.parliament.uk, and follow us on Twitter @commonslibrary.

Next week we'll be joined by the Louisa Brooke-Holland from the Library's international affairs and defence section, and we'll be discussing defence procurement.

The Commons Library Podcast is a House of Commons production. The producer is Grace Rowley, the editor is Chris Blanchett, and presenters are Andrew Mackley and Eleanor Davis. Music is by Tom Mackley.