

Spring Statement 2022

Update on the UK public finances

April 2022

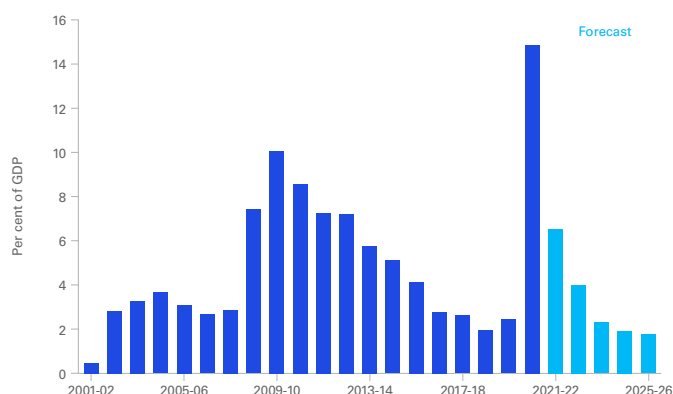


Better-than-expected performance of the public finances since the pandemic

The UK public finances have outperformed expectations during the recovery from COVID-19. Having peaked at nearly 15% of GDP in the first year of the pandemic (its highest level since the second world war), borrowing is now estimated to have more than halved in the 2021-22 financial year (**Chart 1**). This is quite remarkable considering that it took five years following the global financial crisis for that to happen.

On the receipts side, the main driver of the surprise in recent months has been a more 'tax-rich' economic recovery. This was largely a result of better-than-expected developments in economic growth and the labour market over the past year, which provided a boost across income tax, corporation tax, and other receipts, in particular among the high-income taxpayers and financial corporations.

Chart 1: Public sector net borrowing



Source: ONS, KPMG analysis.

On the spending side, the pressure has also weakened in recent months, with the ending of various pandemic-related government support schemes, while some investment projects have stalled as a result of the global supply bottlenecks. However, this was partly offset by higher debt servicing costs, which are estimated to have pushed interest spending in 2021-22 by £30bn relative to the previous year. That rise has been primarily driven by higher inflation.

Mixed impact of higher inflation on the public finances

Inflation is a double-edged sword for the public finances. It is good in the sense that it pushes people into higher tax brackets as their nominal incomes rise, resulting in tax revenues rising at a faster pace than nominal GDP. This is called a fiscal drag. We have seen this phenomenon during the pandemic alongside the various income support measures, which resulted in household gross disposable income staying broadly flat despite GDP falling.

Set against that, however, a quarter of UK debt is financed by index-linked gilts, the liability on which increases with RPI inflation. This proportion is significantly higher than for any other G7 country. Furthermore, most working-age welfare payments as well as public service pensions are also linked to inflation.

On balance, this means that in the long run it is actually quite difficult for the government to inflate away debt, especially when we factor in tighter monetary policy, which would try to counteract higher inflation by raising borrowing costs.¹ In addition, if higher inflation causes a big hit to household disposable incomes – as it will this year – that may prompt the government to step in and provide additional support, which will result in higher spending.

¹ For further detail, see Chapter 4 of the OBR's July 2021 Fiscal Risks Report.

Positive short-term outlook for the public finances despite modest giveaways

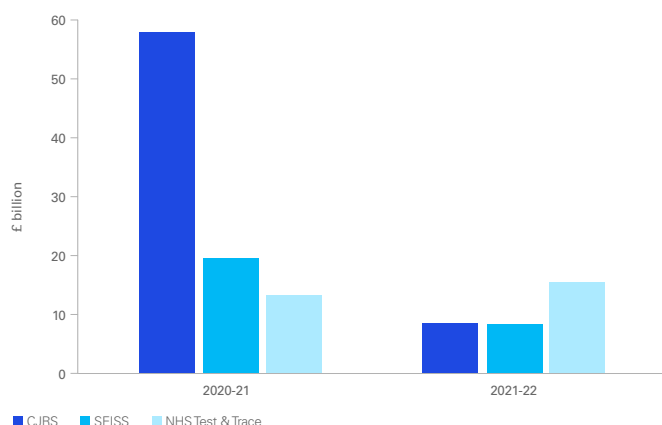
The outlook for borrowing naturally looks better in comparison to the pressures that pushed it up during the COVID-19 pandemic. For example, in the last financial year alone, the government's Coronavirus Job Retention (CJRS) and the Self-Employment Income Support (SEISS) schemes together cost the taxpayer £17bn, while the NHS Test & Trace scheme added a further £16bn (**Chart 2**).² These schemes have now been phased out.

The Chancellor also provided a modest fiscal loosening in his Spring Statement last month, taking advantage of the windfall achieved in 2021-22. To help households with rising energy bills, he set out a package of support measures worth £11bn this year, and raised the National Insurance contributions thresholds costing over £6bn (**Chart 3**). But the overall fiscal giveaways in the following years (averaging around 0.3% of GDP per annum) are quite small in comparison with the windfall from a stronger fiscal position.

As a result, the Office for Budget Responsibility (OBR) revised down its borrowing forecast in all subsequent years, judging that the net tax cuts will be more than offset by stronger growth and a broadening tax base. This should nonetheless provide the Chancellor with some headroom for future giveaways, for example if the cost of living crisis intensifies later this year.

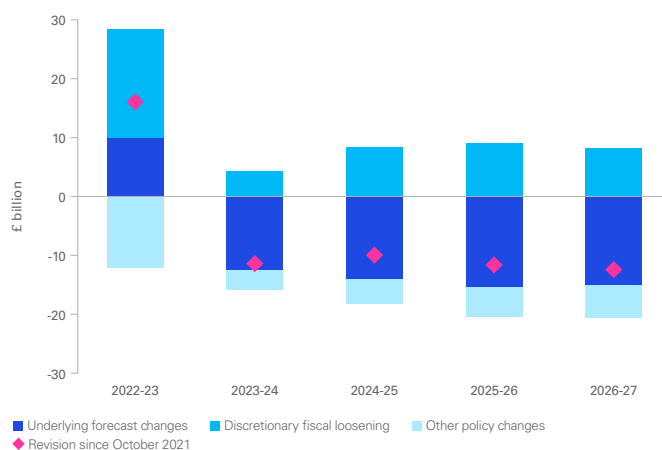
The better data on borrowing mean that public sector net debt is set to peak at a lower level than previously thought. We expect debt to reach around 97% of GDP in 2022-23 – equivalent to £2.5tn – its highest level since 1962-63 (**Chart 4**). We then see debt on a declining path as fiscal consolidation kicks in.

Chart 2: Cost of selected government schemes



Source: ONS, DHSC, Gov.uk, KPMG analysis.

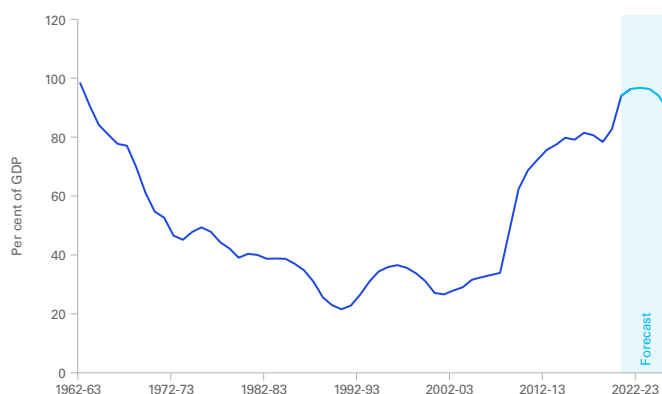
Chart 3: Impact of the Spring Statement on borrowing



Source: OBR, KPMG analysis.

Note: Other policy changes include student loans reforms, Bulb Energy bailout, and indirect effects.

Chart 4: The outlook for government debt



Source: ONS, OBR, KPMG analysis.

² PM statement on living with COVID: 21 February 2022.

The government still on track to meet its fiscal targets

Last autumn, the government set out two key targets to help guide it in achieving fiscal sustainability. The first target is about the trajectory of debt – specifically, that public sector net debt (excluding the Bank of England) should fall as a share of GDP in the third year of the forecast horizon (currently 2024-25). The second target is aimed at achieving a balance on the current budget – that is excluding borrowing to finance investment – by the same year.

On current forecasts, both targets are met with a margin of around £30bn. However, given the sensitivities of the public finances to the economic outlook, this headroom could be largely wiped out by relatively small changes to GDP growth or interest rates, of just 1%. This margin of error is not implausible considering the magnitude of historical forecast errors.

The flipside of that is that the fiscal targets are set on a rolling basis, where the target rolls forward each year. There is a rationale for that: it gives the Chancellor the flexibility to react to any sudden developments and raise spending temporarily. As such, the Chancellor could still find the wiggle room to reduce the tax-to-GDP ratio ahead of the 2024 general election, as the target year is pushed back. Nonetheless, this is still dependent on the favourable economic outlook and future forecasts made by the OBR.

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