How can Boris Johnson pay for his promises on tax and spending? [1]

Boris Johnson used his first speech outside Downing Street [2] to reiterate promises to spend more on police, schools and hospitals and to "fix the crisis in social care once and for all". During his leadership campaign, he also pledged to cut income and corporate taxes. Johnson has also said he will support the UK economy through leaving the EU, while his predecessor ramped up expectations by committing to "end austerity" – following nearly a decade of cuts to swathes of the public sector.

Without full details of the Prime Minister's proposals it is difficult to put a precise cost on these promises, but they could run to tens of billions of pounds a year. This begs the question: How will he pay for all of this? During the election campaign, Johnson said that it "is certainly true is at the moment [that] there is cash available [3]. There's headroom of about £22bn to £25bn at the moment."

Is it really that simple? And does it depend on the Brexit outcome?

Is there "£22bn to £25bn" of headroom? [4]

This figure for headroom refers to the gap between the latest official forecast for borrowing in 2020/21 and the maximum amount that is consistent with meeting Philip Hammond's fiscal mandate – that borrowing should be no more than 2% of GDP in 2020/21, after adjusting for the ups and downs of the economic cycle (which is typically referred to as "cyclically-adjusted" or "structural" borrowing).

Mr Hammond has bequeathed his successor a level of borrowing that is low by historical standards. The Office for Budget Responsibility's March forecast [5] suggested borrowing would be 0.9% of GDP (or £21bn) next year, virtually all of which would be structural. The fiscal mandate allows for a maximum of £48bn of borrowing – giving headroom of £27bn. Planned changes to the accounting of student loans [6] are likely to reduce the apparent headroom to around £15bn. However, this is just an accounting change and does nothing to affect the fundamental health of the public finances. As a result, the Government may wish to shift the goalposts to even out this change – that is, they could decide to increase the borrowing target sufficiently to restore the original £27bn of headroom.

This headroom would allow the Government to spend more next year without breaching the fiscal mandate. The precise figure depends on the economic forecasts, however, and those can move around. The Government would need to retain a bit of headroom if they wanted to have a better than 50/50 chance of borrowing coming in below target.

The latest forecast from the OBR assumed that the UK would leave the EU in an orderly manner, with a deal, and enjoy a transition period to adjust to a new trading relationship with the bloc.

The OBR figures overstate the Government's room for manoeuvre [7]

However, this apparent short-term headroom overstates how easy it will be for the Government to fund new tax and spending promises. This is because pressures on spending and tax revenues beyond 2020/21 will make it harder to fund the new Prime Minister's commitments in the medium- to long-term. While measures to support the economy through Brexit may be temporary, the other spending and tax promises that Johnson has made sound more permanent – that means money needs to be found not just next year but every year.

As a recent recent IfG report summarised [8], an ageing population means the Government will need to spend a greater share of GDP on health, social care and pensions simply to maintain the current scope and quality of what the state offers, let alone to expand it. Figures from the OBR [9] suggest the Government would need to spend an extra £25bn a year (in today's terms) by 2025/26 to meet these pressures. Previous UK governments have paid for additional health spending by cutting back other areas of spending – notably, the military. But there is much less, if any, scope to do that again.

At the same time as spending pressures are expected to grow, economic and behavioural trends are undermining the ability to raise revenues with the current tax system. These tax and spending trends mean that the Government's fiscal position will steadily worsen over the coming years unless the Government chooses to scale back the scope or quality of public services, pensions or the benefit system – or to raise taxes.

These pressures have long been known about and would have required any government to make important choices about its spending priorities and how to fund them. Johnson's additional promises add to the pressure to find other areas of spending that can be cut back or other ways to raise revenues to fund them. Exactly what the arithmetic will look like depends in part on what fiscal rules are adopted by Sajid Javid, the new Chancellor [10]. Philip Hammond pledged to eliminate borrowing altogether by the mid-2020s, although Government policy was not consistent with meeting that objective. The new Chancellor may choose to adopt a less stringent rule – for example, it has been suggested that the new Government might aim to keep debt falling as a share of GDP but to allow some more borrowing each year [11]. Throughout most of the UK's post-war history the UK government has borrowed some money each year. But some sort of constraint will still be needed – simply borrowing more and more each year would not be sustainable indefinitely.

Tougher choices would need to be made in the event of 'no deal' [12]

Recent analysis by the OBR suggests the Government's headroom in 2020/21 would be smaller if the UK left the EU without a deal. In the event of a 'benign' no deal, the OBR estimates that government borrowing in 2020/21 would be £30bn higher than its March forecast predicted. But very little of this would be structural, meaning the Government's headroom against the fiscal mandate next year would fall by only £4bn, to £23bn. A more disruptive exit from the bloc could further reduce the Government's headroom in 2020/21.

But economic evidence [13] suggests the longer-term economic and fiscal impact of leaving the EU without a deal would be more significant, even in the case of a benign no deal. This is because leaving the EU without a deal is likely to lead to an increase in trade barriers with the UK's major trading partners, which in turn would be likely to hamper economic growth and thus growth in tax revenues.

Government analysis [14] published last October suggested that leaving the EU without a deal could increase annual government borrowing by £53bn a year (in today's terms) by 2035/36, even accounting for the savings that would result from no longer making contributions to the EU Budget and additional revenues from tariffs. That government analysis predicted that a no deal exit would result in the UK economy being 7.7% smaller by 2035/36 than it would have been had the UK remained in the EU. This estimate is in the middle – though towards the pessimistic end – of the range of estimates that have been produced of the economic consequences of no deal.

What about the £39bn that would be saved by not paying the 'divorce bill'? [15]

Boris Johnson has also insisted that he would not pay the so-called 'divorce bill' [16] in the event of no deal, making more money available – he has said – for domestic priorities. The OBR estimated in October 2018 that this financial settlement would total £39bn (a figure frequently quoted by Johnson).

But the obligations are denominated in euros, so changes in the euro-sterling exchange rate move the sterling figure around: as a result, in March 2019 [17] the OBR estimated the figure had fallen slightly to £37bn. That figure was predicated on the UK leaving the EU at the end of March 2019. Since the UK will now remain a member until the end of October 2019, some further payments have already been made by the UK as a member, which would otherwise have been owed as part of the 'divorce bill'. As a result, the net amount outstanding is now estimated to be £33bn [17]. This sum is due to be paid over the next 45 years – in other words, because this is a sum owed over many years, it is not directly comparable to the £23bn of headroom described above. The OBR estimates [5] that £10.5bn of the financial settlement with the EU would be paid in 2020/21, falling to £4.1bn by 2023/24. If this money was not paid to the EU, it could be available for domestic spending.

The EU's position is that the UK owes this money regardless of the Brexit outcome – it is not a payment for a deal. If the UK tried to walk away without paying, the EU might seek redress through the International Court of Justice or the Permanent Court of Arbitration, both located in The Hague. The result of such a court case would be hard to predict.

There is also other money currently unallocated in the OBR forecasts [18]

The OBR's forecasts for the next five years currently incorporate spending each year equivalent to the amount that would be paid to the EU if the UK remains a member. This totals around £13.5bn a year.

Some of this is currently earmarked for the financial settlement, as described above. Some of the remainder would need to be used to replace support currently received from the EU [19]that the Government has committed to continue – such as support for farmers (around £3.5bn), a new Shared Prosperity Fund (£1bn), overseas aid (£1.4bn) and support for science and education (around £2bn). The rest could be available for other domestic objectives in the short-term. But it would do little to mitigate the longer-term pressures described above and would not offset the negative economic and fiscal impact that most economists predict would result from higher trade barriers between the UK and the EU.

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Links
[1] https://www.instituteforgovernment.org.uk/explainers/how-can-boris-johnson-pay-his-promises-tax-and-spending
[2] https://www.gov.uk/government/speeches/boris-johnsons-first-speech-as-prime-minister-24-july-2019
[3] https://www.independent.co.uk/news/uk/politics/tory-leadership-contest-boris-johnson-borrowing-national-debt-a8981336.html
[4] http://twitter.com/intent/tweet?text=Is%20there%20%E2%80%9C%C2%A322bn%20to%20%C2%A325bn%E2%80%9D%20of%20headroom%3F%0A
[5] https://obr.uk/efo/economic-fiscal-outlook-march-2019/
[6] https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/methodologies/studentloansinthepublicsectorfinancesamethodologicalguide
[7] http://twitter.com/intent/tweet?text=The%20OBR%20figures%20overstate%20the%20Government%E2%80%99s%20room%20for%20manoeuvre%0A
[8] https://www.instituteforgovernment.org.uk/sites/default/files/publications/taxing-times-final.pdf
[9] https://obr.uk/fsr/fiscal-sustainability-report-july-2018/
[10] https://www.instituteforgovernment.org.uk/blog/sajid-javid-must-set-new-fiscal-targets-guide-tax-and-spending-choices
[11] https://www.independent.co.uk/news/uk/politics/boris-johnson-austerity-spending-plan-philip-hammond-fiscal-a9021356.html
[12] http://twitter.com/intent/tweet?text=Tougher%20choices%20would%20need%20to%20be%20made%20in%20the%20event%20of%20%E2%80%98no%20deal%E2%80%99%0A
[13] https://www.instituteforgovernment.org.uk/publications/understanding-economic-impact-brexit
[14] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760484/28_November_EU_Exit_-_Long-term_economic_analysis__1_.pdf
[15] http://twitter.com/intent/tweet?text=What%20about%20the%20%C2%A339bn%20that%20would%20be%20saved%20by%20not%20paying%20the%20%E2%80%98divorce%20bill%E2%80%99%3F%20%0A
[16] https://www.instituteforgovernment.org.uk/explainers/eu-divorce-bill
[17] https://cdn.obr.uk/EFO_October-2018.pdf
[18] http://twitter.com/intent/tweet?text=There%20is%20also%20other%20money%20currently%20unallocated%20in%20the%20OBR%20forecasts%0A
[19] https://obr.uk/docs/dlm_uploads/Fiscalrisksreport2019.pdf