Summary

Chapter 1
The UK's productive capacity: surveying the damage

- Typically, past financial crises have had a marked impact on the level of potential GDP, with the effects building up gradually over a four- to five-year period.
- The overall impact varies from one crisis to another depending, among other things, upon: how the economy was performing pre-crisis; how severely the economy first contracted when the crisis struck; the level of pre-crisis 'imbalances' (such as the current account balance); whether or not the currency also came under severe pressure; and how other countries were faring when the crisis struck.
- Judged against these yardsticks, the UK currently looks very poorly placed. Most likely it will therefore suffer a further, and marked, deterioration in its productive capacity, and one that leaves the total decline in potential GDP greater than the 5% that the Treasury has assumed when making its projections. Our central estimate is for a 7½% fall; under a more pessimistic scenario, it could be 10%.
- More worryingly still, the growth rate of potential GDP will probably also be significantly reduced. Rather than the 2¾% per annum that the Pre-Budget Report suggests as a central estimate, it is more likely that potential GDP growth will run at something close to 1¾% per annum.
- The labour market is likely to be severely affected too, with the non-accelerating wage rate of unemployment (or 'natural' rate of unemployment) set to rise markedly – perhaps by 3 percentage points, to around the 9% mark at end-2015.
- The precise impact will depend upon how fast fiscal policy is tightened, and the policies used to achieve this tightening. A government that tightens fiscal policy aggressively, and relies more upon spending cuts than tax hikes to do so, is likely to experience a lower rise in the NAWRU, other things being equal.
- All in all, it would now appear that the output gap is rather smaller than many analysts imagine (at less than 4% of potential national income) – and that the structural cost of the crisis will therefore be greater than generally envisaged.

Chapter 2
Fiscal tightening: why and how?

- The December 2009 Pre-Budget Report estimates that the recession and financial crisis have punched a permanent hole worth 5.2% of national income (or £73 billion in 2009–10 terms) in the public finances. This is large, but smaller than the 6.4% of national income (or £90 billion) that the Treasury thought in the April 2009 Budget. In the absence of policy action, public sector debt would be set to rise unsustainably.
- Estimates produced by Barclays suggest that the Treasury may be optimistic about the extent to which the economy will recover from the crisis. The central Barclays scenario would imply a further £25 billion damage done to the public finances, while a 'pessimistic' scenario would imply a further £50 billion.

- Over the next eight years, the government intends to implement a fiscal tightening worth 5.5% of national income (£77 billion). If delivered, this would more than offset the permanent increase in borrowing that the Treasury believes has been caused by the crisis and would bring debt back onto a sustainable path.
- The government intends to implement just over 60% of the tightening between 2010–11 and 2014–15, achieving two-thirds through spending cuts and one-third through tax increases. (The biggest losers from the tax rises will be individuals with incomes over £100,000 a year, many of whom will face marginal income tax rates of 50% or 60%. The number of people facing these rates is set to rise significantly.)
- The remaining 40% of the tightening is to come from further increases in tax or deeper cuts to current spending after 2014–15. Continuing two-thirds spending cuts and one-third tax rises would take spending to 39.9% of national income, slightly higher than in 2003–04, and tax revenues to 38.8%, the level in 2007–08.
- If the interest rate on government debt rises to be in line with growth in the economy (an increase of almost 1 percentage point), then keeping borrowing constant beyond 2017–18 would be sufficient to see debt returning back below 40% of national income in 2032–33. But new measures would need to be implemented to mitigate the costs of an ageing population, and any further significant rises in interest rates would push this date back significantly.
- The Conservatives want to ensure that non-investment spending is no higher than tax revenues at the end of the forecast horizon (adjusting for the strength of the economy). This would likely require borrowing to be 1.1% of national income (or £15 billion in 2009–10 terms) lower in 2015–16 than Labour's plans. While this might help reduce the risk of rising interest rates, doing the same total tightening more quickly would do little to alter the forecast path of debt. If the quicker tightening were implemented two-thirds through spending cuts and one-third through tax rises, it would require a further £11 billion cut to public spending and a £5 billion rise in taxes in 2015–16. Under Labour's plans, the pain from these changes would be deferred until 2017–18.

Chapter 3
Fiscal stimulus and the consumer

- The recession has been associated with a substantial fall in household spending and a rapid rise in the saving rate. Partly as a consequence, the government implemented a fiscal stimulus, including a temporary cut in the main rate of VAT from 17.5% to 15% and a car scrappage scheme.
- The VAT cut has ended and the car scrappage scheme expires in February 2010. The return of VAT to 17.5% will increase prices by about 1% on average. This is likely to mean consumption is about 1% lower than it would have been had the rate remained at 15%, reversing the 1% consumption increase brought about by the temporary cut. The immediate impact on purchases may be a more than 1% fall, as consumers may have brought forward purchases at the end of 2009 that they were planning to make later to take advantage of the lower VAT rate, with a consequent reduction of purchases in 2010.
- If the government wishes to raise more revenue in the future by increasing the VAT rate further, and if the downturn proves more prolonged than anticipated, then pre-

announced increases in the rate could help stimulate consumption ahead of the increases. Relative to increases in income tax, higher VAT may be an economically efficient way to raise revenue. But some may think it inequitable towards those with savings.

- The car scrappage scheme allows for up to 400,000 old vehicles to be scrapped and replaced by a new one, with a £2,000 incentive split between government and manufacturers. The scheme has been associated with a large short-term increase in car registrations compared with their 2008 levels. The largest impact may well be to encourage people to replace old cars with new rather than second-hand vehicles.
- Economic theory and studies of previous schemes suggest that there is likely to be a substantial and enduring 'payback' effect after the scheme ends. Sales will be reduced relative to a no-subsidy baseline as people have brought forward their purchases.
- The environmental benefits of the scrappage scheme are likely to be very small. Households are choosing relatively clean new cars, but may well drive them more than they drove their old vehicles.

Chapter 4
The economic outlook

- The recent performance of the UK economy has been rather alarming. The UK has suffered the largest shortfall in activity relative to its pre-crisis trend of any G7 economy, and has been the slowest of the G20 economies to emerge from recession. At the same time, however, inflation has been stronger than expected.
- A lower pound and reluctance to pass on the temporary cut in the main rate of VAT may account for some of the surprising strength of inflation, but the combination of unexpectedly weak activity and unexpectedly strong inflation suggests a big fall in the UK's capacity to supply goods and services. In addition to reducing the UK economy's productive potential, we believe the financial crisis has also reduced its trend rate of growth.
- If this is true, the economy may not be able to return to the growth rates of close to 3% per annum that it enjoyed between the mid-1990s and 2007 without quite quickly running into the inflation buffers. In our central scenario, we expect GDP growth to average just under 2% per annum between 2010 and 2014 – similar to the average independent forecast, but more subdued than the Treasury's.
- The consumer is likely to bear much of the burden of adjustment, reflecting higher unemployment, more subdued real wages, a rising tax burden and increased debt-service costs. We do not expect the strong housing market recovery seen through the middle of last year to be sustained. Capital expenditure is also likely to be muted, held back by tight credit availability but also reflecting subdued consumer demand and a rather lacklustre improvement in export sales.
- We see the risks around this forecast as evenly balanced, and consider two alternative scenarios to our central case. In an optimistic scenario, to which we attach a 25% probability, the decline in potential GDP is close to the 5% assumed by the Treasury, although we continue to doubt the Treasury's assumption that potential growth is as high as 2¾%. In a pessimistic (indeed, dire) scenario – to which we also assign a 25% probability – the deterioration in potential GDP would be close to 10%,

and the potential growth rate might drop nearer to 1½% per annum. This would be especially testing for the authorities, not just in terms of public finances but because it would also necessitate major structural reforms.

Chapter 5
The public finances and sterling

- Currency crises often go hand in hand with fiscal crises, and international investors have become concerned about the UK's public sector debt dynamics.
- In 2008–09, sterling registered an even larger depreciation against the US dollar than in its 1967 devaluation, the 1976 IMF crisis and its 1992 exit from the European Exchange Rate Mechanism. In trade-weighted terms, the decline was the biggest since figures were first calculated in the early 1980s. This large depreciation was driven partly by concerns about the sustainability of the public finances.
- Despite the large projected rise in the government debt stock, the cost of borrowing remains low, assisted by quantitative easing. The latter is likely to be temporary, however, and the cost of the debt burden is set to increase.
- Our central expectation is that debt costs will not become unmanageable and we expect the UK's credit standing to remain strong, notwithstanding the prospective rise in the share of tax revenue that the UK government will have to devote to debt servicing.
- Even so, sustainability cannot be taken for granted: there are plausible scenarios in which the UK's debt sustainability measures stray uncomfortably close to concerning levels. To minimise the risks of a further disruptive fall in sterling, it is crucial that the authorities do all they can to reassure financial markets that both fiscal and monetary probity will be maintained.

Chapter 6
Green Budget public finance forecasts

- Smaller-than-expected falls in tax revenues and lower spending growth over the year to date suggest that the government will need to borrow £10.4 billion, or 0.7% of national income, less in 2009–10 than it forecast in the 2009 Pre-Budget Report.
- But our relative optimism diminishes thereafter. If the economy were to evolve broadly as the Treasury predicted in the PBR, we forecast that borrowing would be just 0.3% of national income (or £4 billion in today's terms) lower than the PBR 2009 forecast in 2014–15.This narrowing gap reflects the fact that we would expect weaker growth in tax revenues for a given economic outlook than the Treasury.
- We forecast that the current budget deficit would fall from 8.8% of national income in 2010–11 to 2.9% of national income in 2014–15 under this scenario. Of this 5.9% of national income reduction in the current budget deficit, 4.4 percentage points would come from a fall in current spending as a share of national income and 1.5 percentage points from an increase in the tax burden. With slightly lower borrowing over the next five years, we forecast that public sector net debt would peak at a slightly lower level (76.0% of national income) than the Treasury forecast.
- But if the economy were to evolve along the Barclays central scenario, we forecast that the current budget deficit would be 2.5% of national income larger in 2014–15

than in our baseline scenario. Even under their 'optimistic' scenario for the macroeconomy, our fiscal forecasts suggest borrowing would persist at a higher level than forecast by the Treasury. Meanwhile, under the Barclays 'pessimistic' scenario for the macroeconomy, most of the borrowing expected this year would be permanent.

- There is already a sizeable tightening of 1.6% of national income between 2009–10 and 2010–11 from the unwinding of the fiscal stimulus package. We suggest that no further significant tightening is implemented in 2010–11, given the likely fragility of the nascent recovery and the fact that monetary policy remains very loose.
- The government plans a 4.1% of national income (£57 billion) fiscal tightening between 2010–11 and 2015–16. By increasing this to 5% of national income (or an additional £13 billion), our baseline forecast would show the structural current budget deficit eliminated by 2015–16. Aiming to complete the repair job within one five-year Parliament would be more credible than the government's eight-year plan. It would also likely comply with the Conservatives' stated target for borrowing.
- It is very uncertain what policy settings would deliver the levels of borrowing that the government or the Conservatives want to achieve over the next few years. Both parties' plans might be more credible and sensible if they amounted to a challenging but achievable plan for tightening over the next five years, including an explanation of how they might need to change if the economy, the underlying health of the public finances or investor sentiment departed significantly from current expectations.

Chapter 7
Options for fiscal tightening: tax increases and benefit cuts

- This chapter presents options, rather than advocating any of them. Which, if any, to pursue would depend on a government's distributional goals and wider priorities.
- From the big three taxes, 1% of national income (£15.4 billion in 2011–12 terms) could be raised by:
  - a 3 percentage point rise in the basic and higher rates of tax (to 23% and 43%);
  - a 3 percentage point rise in employee and self-employment National Insurance (NI) rates; or
  - a 3.5 percentage point rise in the standard rate of value added tax (VAT) (to 21%).
- These changes would weaken work incentives and hit the rich harder than the poor. The main differences are that the VAT rise would be less progressive than the others (as it would affect poor, non-income-tax-paying households) and that the retired and savers would not be affected by a rise in NI (which only taxes earnings).
- But significant amounts of revenue could also be raised from reforms that would simultaneously remove undesirable distortions in the tax system, such as:
  - charging the full rate of VAT on goods with a zero or reduced rate;
  - a comprehensive carbon tax;
  - increasing NI rates for the self-employed;
  - charging NI on employers' contributions to pension funds;
  - increasing the rate of small companies' corporation tax;
  - increasing the rate and cutting the allowance for capital gains tax.

- If cuts are desired in social security spending, then freezing the value of benefits and tax credits shares the pain over a large number of households. Freezing all benefits in April 2011 for one year would save £4.1 billion a year. A freeze over the next Parliament would save £24.6 billion a year by the fifth year (1.3% of national income in 2014–15), but would increase income inequality and measures of relative poverty.
- Removing benefits from better-off households would be less regressive, but would increase the scope of means-testing. Options include:
  - means-testing child benefit and the family element of the child tax credit (around £6.5 billion);
  - scrapping winter fuel payments and free TV licences and compensating pensioners on the pension credit (£1.4 billion);
  - abolishing carer's allowance (£0.5 billion);
  - time-limiting contributory incapacity benefit (IB) and employment and support allowance (ESA) (up to £2 billion).
- Fewer families could be means-tested by means-testing more aggressively, reversing the direction of reforms since 1999. This could cut £2 billion a year from benefits and tax credits for working-age households, and a similar amount from households with adults aged 60 or over. The impact on incentives would be mixed, but the losers will overwhelmingly be in the poorest half of the income distribution.

Chapter 8
Public services: deep cuts coming

- The December 2009 Pre-Budget Report pencilled in a real freeze in total public spending over the four years from 2011–12 to 2014–15. But spending on debt interest, social security and other 'annually managed expenditure' is likely to grow in real terms. Keeping to these overall spending plans would therefore require deep cuts in 'departmental expenditure limits' (DELs) – Whitehall spending on public services and administration (although the government could also cut welfare bills).
- In the absence of new measures to reduce spending on benefits and tax credits, we estimate that spending on public services and administration would have to be cut in real terms by 3.0% a year on average in 2011–12 and 2012–13 and by 2.7% a year on average in 2013–14 and 2014–15. This would be a cumulative cut of 10.9% after four years, or £42.0 billion by 2014–15 (in 2009–10 prices). This would reverse almost all of the increase in DELs as a share of national income seen since Labour took office. If we include the 0.5% cut in DELs confirmed for 2010–11, the total real cut over the next five-year parliament would be 11.4% or £43.8 billion.
- On a historically comparable definition of public service spending, we estimate that the four years from 2011–12 would be the tightest for spending on public services since April 1976 to March 1980 and that the five years 2010–11 to 2014–15 would be the first five consecutive years of real cuts since data began in 1948–49.
- The government has promised to 'protect' spending on priority areas, including health, schools and overseas aid, in the years 2011–12 and 2012–13. The commitment to freeze NHS spending in real terms in 2011–12 and 2012–13 would still imply the tightest two-year squeeze for the health service in the last 60 years.
- Protecting large areas of spending from cuts means that the pain will be even more severe for the remaining areas of departmental spending. These other areas –

including defence, higher education, transport and housing – would likely see their budgets cut by 12.9% on average over the two years or by £25.8 billion by 2012–13.

- Beyond 2012–13, the government has not promised to protect any area of spending except overseas aid. Were it to continue 'protecting' all its priority areas for a further two years, other budgets would have to be cut by a total of 23.8% (or £47.4 billion) by 2014–15 (including the £25.8 billion that would be required by 2012–13).
- The Conservative Party has promised to protect overseas aid (like Labour) and to increase NHS spending in real terms. Under Labour's plans for spending overall, this would imply £45.7 billion in cuts in unprotected areas by 2014–15. As the Conservatives propose to protect fewer services than Labour, the percentage cut required across other departments is substantially smaller, at 18.3%. However, if the Conservatives' plan to protect aid and the NHS were combined with the more ambitious tightening plan implied by their proposed fiscal targets, then the cuts in their unprotected areas could be more like 22.8% or £57.1 billion by 2014–15.

Chapter 9
Public sector pay and pensions

- Public sector pay cost £174 billion of public spending in 2008. The pay bill rose steadily as a share of national income from 2000 to 2005, partly because of increased employment and partly because of pay increases that were, on average, faster than those seen in the private sector. The pay bill has been cut modestly since then as a share of national income (although not yet in real terms). The fiscal retrenchment planned by the Treasury will soon require a tighter squeeze.
- Overall, pay levels in the public sector are probably not significantly out of line with those of similar workers in the private sector, once you take into account factors such as their age, education and qualifications. However, there are areas of divergence. In particular, there are gaps in favour of public sector workers in regions outside London and the South-East, which remains an area for reform in the long run.
- There is evidence that public sector workers have fared better than their private sector counterparts in the recession. A couple of years of pay freezes or other restraint could save significant money in the short run and, in current labour market conditions, would be unlikely to create recruitment problems. But, given the tendency for public sector workers to 'catch up' following periods of pay restraint, further cuts in the public sector workforce are more likely to deliver the lasting reductions in public spending as a share of national income sought by the Treasury.
- In the long run, a big anomaly remains the pension provision enjoyed by public sector workers. With salaries broadly in line with their private counterparts, the large pension advantage they enjoy translates into a total package that is substantially more generous. The only way to access this money in the short run would be to levy additional pension contributions on public sector workers.

Chapter 10
Support for research and innovation

- In the December 2009 Pre-Budget Report (PBR), the government announced its intention to introduce a 'patent box' – a new policy aimed at encouraging innovation in the UK by taxing income from patents granted after April 2013 at a reduced 10% rate of corporation tax.
- The proposed patent box would do little to address the market failures that typically justify government intervention in innovation markets. It is expensive even on the government's own costing (£1.3 billion a year), the bulk of the gains will accrue to a few large companies, and the money would be better spent supporting innovation by maintaining spending on the science base or other infrastructure investments.
- Spending cuts of £600 million have already been announced from the higher education and science and research budgets. This is likely to be followed by further cuts in these areas, as the government attempts to cut spending on public services.
- The PBR also announced minor reforms to the research and development tax credits to allow small and medium-sized companies to benefit from the scheme without the need to own the intellectual property resulting from the research. This is welcome.

Chapter 11
Reforming UK fiscal institutions

- Voters and investors need to be reassured that this or a future government will repair the damage to the public finances that has been created by the financial crisis. This creates a powerful case for institutional reform to increase people's confidence in official forecasts of the public finances.
- The Fiscal Responsibility Bill, which – once on the statute book – would place the government under a self-imposed legal obligation to deliver particular fiscal targets, is unlikely to achieve this. The government's existing Code for Fiscal Stability was enshrined in legislation in 1998, but this did not prevent the fiscal rules set out under it from losing their credibility once the then Chancellor Gordon Brown was widely thought to have 'moved the goalposts' to avoid a formal breach.
- The National Audit Office has a limited and inappropriate role in the current fiscal forecasting process, being required to audit a small number of assumptions chosen by the Treasury. The NAO could be given more power and an extended role, but it does not possess the expertise or resources to challenge the Treasury on a level playing field. It could be given those resources and expertise, but this would leave it with a combination of important responsibilities that would best be separated.
- Creating an independent Office for Budget Responsibility to produce or oversee official fiscal forecasts is a good idea, but such a body would require careful design. The key challenge is to provide independent and believable forecasts based on the information available, without losing the benefits of integrating fiscal forecasting and policy design. Taking fiscal forecasting out of the Treasury would threaten this synergy, while replicating the existing operation in the OBR would be expensive.
- The most promising route might be to have an independent Budget Responsibility Committee oversee, challenge and sign off forecasts by officials in the Treasury.