Disease and cure in the UK: The fiscal impact of the crisis and the policy response

Carl Emmerson (with Robert Chote, Rowena Crawford and Gemma Tetlow)

Presentation at ECFIN country seminar “The UK economy, post-recession: Same as it ever was?”, Brussels, Tuesday 29th June 2010

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Diagnosis

Sources: Authors’ calculations using all Budgets and Pre-Budget Reports since March 2008 (all available at http://www.hm-treasury.gov.uk/).

Permanent damage = 5.8% of GDP (£86bn)
## Diagnosis: change over time

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of National Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>PBR 2008</td>
<td>£47bn</td>
</tr>
<tr>
<td>Budget 2009</td>
<td>£94bn</td>
</tr>
<tr>
<td>PBR 2009</td>
<td>£86bn</td>
</tr>
<tr>
<td>Budget March 2010</td>
<td>£78bn</td>
</tr>
<tr>
<td>Budget June 2010</td>
<td>£86bn</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations using all Budgets and Pre-Budget Reports since March 2008 (all available at http://www.hm-treasury.gov.uk/).
A bust without a boom?

© Institute for Fiscal Studies  Source: Authors’ calculations based on June 2010 Budget.
Diagnosis: an alternative

Source: Authors’ calculations based on June 2010 Budget.
Cure: Labour’s plans

<table>
<thead>
<tr>
<th>Year</th>
<th>Spending cuts</th>
<th>Tax increases</th>
<th>Unknown</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010-11</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>2011-12</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>2012-13</td>
<td>2%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>2013-14</td>
<td>3%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>2014-15</td>
<td>70%</td>
<td>30%</td>
<td>0%</td>
</tr>
<tr>
<td>2015-16</td>
<td>40%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>2016-17</td>
<td>40%</td>
<td>30%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Sources: Authors’ calculations using all Budgets and Pre-Budget Reports since March 2008 (all available at http://www.hm-treasury.gov.uk/).
Cure: new coalition Government’s additions

- Additional spending cuts
- Additional tax increases
- Labour spending cuts
- Labour tax increases

Sources: Authors’ calculations using all Budgets and Pre-Budget Reports since March 2008 (all available at http://www.hm-treasury.gov.uk/).
Cure: new coalition Government’s plans

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Sources: Authors’ calculations using all Budgets and Pre-Budget Reports since March 2008 (all available at http://www.hm-treasury.gov.uk/).
Cure: debt sustainable but not back to pre-crisis levels for a generation

Source: Authors’ calculations based on the March 2008 and June 2010 Budget.
Cure: all in this together?

Distributional impact of post crisis tax and benefit reforms

<table>
<thead>
<tr>
<th>Percentage of change in net income</th>
<th>Poorest</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>Richest</th>
<th>Over £100k</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>Announced before June 2010 Budget</td>
<td>-16%</td>
<td>-14%</td>
<td>-12%</td>
<td>-10%</td>
<td>-8%</td>
<td>-6%</td>
<td>-4%</td>
<td>-2%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Announced in June 2010 Budget</td>
<td>-16%</td>
<td>-14%</td>
<td>-12%</td>
<td>-10%</td>
<td>-8%</td>
<td>-6%</td>
<td>-4%</td>
<td>-2%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Note: Deciles exclude households containing individuals with incomes above £100,000.
Source: Browne (2010).
Cure: all in this together?

Distributional impact of post crisis tax and benefit reforms

![Graph showing the distributional impact of post crisis tax and benefit reforms across different income deciles. The graph includes bars indicating the percentage change in net income for different income groups. The bars are color-coded to show reforms announced before or in the June 2010 Budget.]

Note: Deciles exclude households containing individuals with incomes above £100,000.
Source: Browne (2010).
Cure: public service spending set for a squeeze

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Note: Figure shows total public spending less spending on welfare benefits and debt interest
Cure: much pain to come for unprotected DELs

Note: Assumes no real growth in NHS spending. Unprotected DEL also assumes a £5 billion AME margin in 2014–15.
The Chancellor’s new fiscal targets

• Rule 1: balanced structural current budget by end of forecast horizon
  – forecast horizon runs to 2015–16 at the moment
  – requires additional fiscal tightening of 0.1% of GDP in addition to “filling the hole”
  – OBR forecasts suggest on course to over-achieve the target by 0.8% of GDP, approximately 60% chance that meet target

• Rule 2: debt as a share of GDP falling by end of forecast horizon
  – OBR forecasts show debt falling as % GDP from 2014–15
The Chancellor’s new fiscal targets: critique (1)

- Advantages of the first rule
  - forward-looking not inappropriately constrained by past borrowing performance

- Disadvantages of the first rule
  - easy continually to add an extra year of fiscal squeeze in last year of forecast horizon

- Budget stated that end of forecast horizon will shorten in future
  - advantage: reduces the scope for pencilling additional future tightening in every statement
  - disadvantage: if the horizon becomes too short, it becomes incredible that target will be sensibly met (e.g. Maastricht criteria)
The Chancellor’s new fiscal targets: critique (2)

- Second rule is not a sufficiently constraining fiscal target in the longer term
  - if first rule met, second rule unlikely to be binding under plausible scenarios for future investment spending
  - sensibly, Chancellor plans to announce a debt target “once the exceptional rise in debt has been addressed”
  - OBR to provide assessment of outlook for overall indebtedness
The OBR: where next?

- Interim OBR required to advise Chancellor on: “the permanent OBR’s roles and responsibilities, aims and objectives, and appropriate size, status, and funding”
- International experience offers no standard template
- Key decisions:
  - Scope – should it seek mainly to “keep the forecasts honest” or give advice on any issues it sees affecting fiscal sustainability?
  - Relationship with Treasury – independence versus inter-linkage
    - Transfer existing Treasury forecasting function to independent body?
    - Duplicate existing Treasury forecasting function in independent body?
    - Independent experts sign off output of existing Treasury forecasters?
Conclusions

• Permanent hit to public finances from financial crisis estimated at £84 billion a year

• Response is a £91 billion fiscal tightening by 2014–15, comprising a £24 billion tax rise and a £67 billion spending cut

• Overall post crisis tax and benefit reforms progressive and very focussed on richest 2%
  – despite the package of measures unveiled in June 2010 Budget hitting those on lower current incomes harder than those on higher incomes

• Current policies imply deep cuts to spending on public services
  – longest and deepest sustained cuts to spending on public services since at least WW2

• Issues remain with both the Government’s fiscal rules and how the new Office for Budget Responsibility should operate
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Cure: borrowing back to pre-crisis levels

Percentage of national income

0 2 4 6 8 10 12


Budget 2008
Budget June 2010 – no policy change
Budget June 2010

Sources: Authors’ calculations using all Budgets and Pre-Budget Reports since March 2008 (all available at http://www.hm-treasury.gov.uk/).

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Cure: Labour’s DEL increases to be reversed

Note: Figure shows Departmental Expenditure Limits (DELs) as a share of national income under current policies.
Spending Review 2010: allocating the pain

• Current policies imply unprotected DEL cuts of 25% in real terms by 2014–15 compared to Labour’s 2010–11 baseline
  – £13bn of AME cuts would reduce this to 20%
  – would need to come from £270bn of AME spending included in the spending review (4.8%)
  – but likely from £154bn of spending once state pensions, council tax financed spending and public corporation spending excluded (8.4%)

• Plausible SR2010 settlements?
  – NHS spending ‘protected’, ODA target met
  – Spending on schools and defence cut by 10% by 2014–15
  – Other unprotected DELs would need to be cut by 33%: includes areas such as higher education, home office, justice, transport and housing
  – Or cutting AME by a further £13 billion would leave these other unprotected areas facing cuts of 25%
Spending Review 2010: the DEL v AME trade-off

- NHS spending 'protected', overseas aid target met
- £13bn of AME cuts, 20% cut to unprotected DEL
- No further AME cuts, 25% cut to unprotected DEL

Note: Assumes no real growth in NHS spending, and a £5bn AME margin in 2014–15.
Meeting the fiscal mandate?

60% chance of a surplus on the structural current budget under current policies

Source: Office for Budget Responsibility
(http://budgetresponsibility.independent.gov.uk/d/fan_charts_intervals.xls)