UK public finances: fiscal repair needed

Carl Emmerson

Presentation at Institute for Government, May 17th 2010
Size and timing of the fiscal tightening (1/2)

Repair job = 4.8% of GDP, £71bn

Percentage of national income

-1 0 1 2 3 4 5 6


Labour (Budget 2010) Conservative manifesto

Note and sources: Figure 3.1 of http://www.ifs.org.uk/publications/4848
Size and timing of the fiscal tightening (1/2)

Repair job = 4.8% of GDP, £71bn

© Institute for Fiscal Studies

Note and sources: Figure 3.1 of http://www.ifs.org.uk/publications/4848
Size and timing of the fiscal tightening (1/2)

“a significantly accelerated reduction in the structural deficit over the course of a Parliament”?

Repair job = 4.8% of GDP, £71bn

Note and sources: Figure 3.1 of http://www.ifs.org.uk/publications/4848
Size and timing of the fiscal tightening (2/2)

• Key Budget input will be the estimated size of the fiscal hole
  – role of the Office for Budget Responsibility key
  – forecasts should be central (not cautious), based on as transparent set of assumptions as possible and acknowledge key risks
  – explicit margin of error should be built into the policy target
Composition of the cure (1/3)

Liberal Democrats: 2½:1 ratio of spending cuts to tax rises
spending down to 2004–05 level
taxes up to 1989–90 level

Note and sources: Figure 4.2 of http://www.ifs.org.uk/publications/4848
Composition of the cure (2/3)

Conservatives: 4:1 ratio of spending cuts to tax rises
spending down to 2003–04 level
taxes up to 2006–07 level

Note and sources: Figure 4.2 of http://www.ifs.org.uk/publications/4848
Composition of the cure (3/3)

- Coalition agreement states: “the main burden of deficit reduction borne by reduced spending rather than increased taxes”
  - consistent with both parties manifesto commitments
  - but also leaves open the possibility of greater reliance on tax rises
- Key Budget judgement is over mix of tax rises and spending cuts
  - should cure be closer to what was prescribed in the Liberal Democrat manifesto or that prescribed in the Conservative manifesto?
  - judgement might depend on the size of the hole identified by the OBR
- A large increase in tax would likely involve an increase in income tax, national insurance or VAT
  - for example roughly 1% of national income would be raised through an increase in the main rate of VAT to 21% (£15.75 billion)
Scope of the Spending Review? (1/3)

Total Managed Expenditure

- Debt interest: -0.6, 12.7, 12.4
- Social security: 1.1, 1.0
- Other AME: 2.8, 2.7

Departmental Expenditure Limits

- Other AME: -2.8, -4.0

Average annual percentage real increase

Note: Increases are expressed relative to Labour’s planned 2010–11 spending levels
Source: Figure 6.1 and Tables 6.1, 6.2 and 6.3 of http://www.ifs.org.uk/publications/4848
© Institute for Fiscal Studies
Scope of the Spending Review? (2/3)

• Manifesto plans imply deep cut to spending on public services
  – **Liberal Democrats**: April 2011 to March 2015 set to be tightest four-year period since April 1976 to March 1980
  – **Conservatives**: April 2010 to March 2015 set to be tightest five-year period since (at least) World War II

• Coalition agreement commits Government to:
  – £3.8 billion increase in overseas aid spending
  – year-on-year real increases in NHS spending
  – state pension to rise by greater of 2.5%, prices and earnings from April 2011 instead of earnings from April 2012 (cost £300 million p.a.)

• Without significant cuts to welfare spending cuts to non-ODA non-NHS Whitehall departments would be very deep
  – average 25% by 2014–15 under 4:1 split of spending cuts to tax rises (total cut £63 billion)
Scope of the Spending Review? (3/3)

- Forthcoming Budget should
  - set out detailed forecast for all components of AME spending
  - indicate which are up for review in forthcoming Spending Review
  - could include parts of social security budget as cuts here might be sensible to lighten load on public services

- Return to “new control total” sensible
  - plan non-cyclical social security spending over the same horizon as departmental spending
  - help demonstrate a co-ordinated long-term strategy for support provided through public services and welfare benefits

- Advantages to extending Spending Review to five years
  - demonstrate intent to long-term government and increase credibility of deficit reduction
  - review at half way stage?
Summary

- Key Budget input will be estimated size of the fiscal hole
  - role of OBR key
  - should use central assumptions and have explicit margin of error
- Key Budget judgement is over mix of tax rises and spending cuts
  - should cure be closer to what was prescribed in the Liberal Democrat manifesto or that prescribed in the Conservative manifesto?
  - judgement might depend on the size of the hole identified by the OBR
- Scope of Spending Review should be broadened
  - include parts of social security budget as cuts here might be sensible to lighten load on public services
  - extension to five years, review at half way stage?
UK public finances: fiscal repair needed

Carl Emmerson

Presentation at Institute for Government, May 17th 2010

© Institute for Fiscal Studies