More ambition needed to repair public finances, but don’t squeeze too soon

Whoever forms the Government after the forthcoming general election should put in place a fiscal tightening more ambitious over the next Parliament than that set out in the Pre-Budget Report (PBR), but without putting the recovery at undue risk with significant extra tax increases or public spending cuts in the coming year, researchers from the Institute for Fiscal Studies argue in this year’s IFS Green Budget.

We are delighted to have produced this year’s Green Budget in collaboration with Barclays Capital and Barclays Wealth. We are very grateful to them for their support and for the chapters they have contributed. We are also grateful to the Economic and Social Research Council for supporting much of the day-to-day research at IFS that underpins the analysis in this volume.

The tax increases and cuts in spending announced in the 2008 PBR, the 2009 Budget and the 2009 PBR together amount to a fiscal tightening of 4.1% of national income or £57 billion in today’s terms between 2010–11 and 2015–16. The need to reassure investors that the public finances will be repaired promptly and the possibility that the structural damage to the public finances from the financial crisis may be greater than the Treasury anticipates all suggest that it would be sensible to be somewhat more ambitious.

The authors suggest the government should aim for a total tightening of around 5% of national income or £70 billion over the five years to 2015–16. This would imply the need to identify another £13 billion of tax increases or spending cuts by 2015–16 on top of those necessary to achieve the plans in the PBR.

To make the planned repair job credible, the government should spell out as clearly and promptly as possible how and when it intends to deliver the overall tightening. The plans would also be more credible if an independent body was to produce or oversee official forecasts for the public finances.

In their chapter on the economic outlook, Michael Dicks of Barclays Wealth and Simon Hayes of Barclays Capital argue that the economic recovery is likely to be slower than the Treasury hopes. Their central forecast shows growth averaging less than 2% a year over the next five years, compared to the PBR forecast averaging 3% a year. They foresee weak consumer spending, a setback for the housing market, and a muted rebound in capital investment.

Given the likelihood of a slow and tentative recovery, the IFS authors caution against significant further tax increases and spending cuts during 2010–11. The fiscal tightening set out in the PBR is already front-loaded and – notwithstanding ministerial claims – the UK is withdrawing its temporary fiscal support for the economy earlier than almost all other G20 countries.

The short-term outlook for the public finances may actually be better than the PBR suggested. Trends so far this year suggest the Government will need to borrow about 0.7% of national income or £10 billion less in 2009–10 than it forecast in the PBR. But, if the economy evolves as the Treasury expects over the next few years, we expect tax revenues to grow less quickly
than the Treasury does, so that borrowing in 2014–15 would be just 0.3% of national income or £4 billion less than the PBR predicted in today's terms.

If the economy was to perform as the Treasury has predicted, and the public finances were to respond as we would expect, a fiscal tightening of 5% of national income over the five years to 2015–16 would be sufficient to achieve the fiscal targets set out by the Government in the Fiscal Responsibility Bill and also those proposed by the Conservatives (as far as we can interpret them) by the end of the next Parliament, should it run to five years. But if the Barclays authors’ central estimate is correct – that the structural damage to the economy and the public finances is greater than the Treasury thinks – then in the absence of even greater action in the next Parliament there would be significant tightening still to do in the Parliament after next.

One overarching lesson from the analysis in this year's Green Budget is that there is enormous uncertainty both about the size of the fiscal tightening that will eventually be necessary and about the likely strength and resilience of the recovery. Policymakers can best maintain their credibility not by insisting their forecasts (or even those of an independent body) will be correct, but by explaining how they would respond if things turned out differently.

Other conclusions from the report include:

1. **The UK's productive capacity: surveying the damage:** Judged using a scorecard of factors that help explain the severity of past financial crises, the UK looks very poorly placed. The Treasury estimates that the crisis will permanently reduce the UK's productive potential by around 5%, but Barclays argue that the loss is more likely to be around 7½% or perhaps even 10%. In any event, they do not believe that the long-term trend growth rate of the economy will be as high as the 2¾% estimated by the Treasury.

2. **Fiscal tightening: why and how?** The Conservatives want to ensure non-investment spending is no higher than tax revenues at the end of the forecast horizon, adjusting for the strength of the economy. If the PBR public forecasts are correct, this would probably require tax increases or spending cuts worth 1.1% of national income (or £15 billion in today's terms) by 2015–16, on top of those implied by the current Government's PBR plans. Chancellor Alistair Darling claims that halving the overall budget deficit a year earlier than he already plans to would mean £26 billion in additional tax increases and spending cuts. This is an overstatement – the true figure implied by his forecasts is £11 billion in today's terms. The PBR forecasts also imply a big rise in the number of people facing the Government’s planned 50% and (effective) 60% income tax rates on high incomes over the next 5 years.

3. **Fiscal stimulus and the consumer:** The end of the temporary VAT cut is likely to mean that consumption will be around 1% lower than if the rate had stayed at 15%, reversing the increase it produced. The immediate impact on purchases may be greater as consumers are likely to have brought these forward from early 2010 to late 2009. Similarly car sales are likely to fall back after the end of the scrappage scheme. The environmental benefits of the scheme are likely to be small.

4. **The economic outlook:** The UK has suffered the largest shortfall in economic activity relative to its pre-crisis trend of any G7 economy, yet inflation has been stronger than expected. Under Barclays' central
scenario, the economy is expected to grow by 1.8% this year and by 2.3% in 2011. To keep inflation on target, official interest rates are forecast to rise to 2.3% next year. Barclays see a 25% probability of an optimistic scenario more like the Treasury’s (but with a lower long-term growth rate) and a 25% probability of a pessimistic scenario in which credit rating downgrades are likely and major structural reforms are needed.

5. **The public finances and sterling:** In 2008–09 sterling fell further against the US dollar than in its 1967 devaluation, the 1976 IMF crisis and its 1992 exit from the European Exchange Rate Mechanism, and recorded its biggest trade-weighted fall since figures were first calculated in the early 1980s. Barclays judge that borrowing costs are likely to rise as quantitative easing ends, but debt costs should remain manageable. The UK’s credit rating should remain strong as long as the authorities act to maintain confidence in fiscal and monetary policy.

6. **Green Budget public finance forecasts:** The fiscal tightening set out in the December 2009 PBR comes two-thirds from spending cuts and one-third from tax increases through to 2014–15. Continuing this policy to the subsequent year would mean that the full five-year tightening of 4.1% of national income would involve a 2.7% of national income cut to spending and 1.3% of national income increase in tax. Increasing the tightening to 5% of national income over the same period would require an additional £9 billion spending cut and a £4 billion tax increase. Increasing the tightening to 5% of national income and moving back to an 80:20 split between spending cuts and tax increases (as was policy at the time of Budget 2009) would require an extra £18 billion spending cut but would allow a £5 billion net tax cut relative to the plans in the PBR.

7. **Options for fiscal tightening: tax increases and benefit cuts:** Significant revenue could be raised by increasing rates of income tax, National Insurance and VAT, each of which would weaken work incentives and, on average, hit the rich harder than the poor (albeit to different degrees). But significant revenue could also be raised from tax reforms that would also make the system more efficient, such as extending the full rate of VAT to more goods, charging NI on employers’ pension contributions, charging more NI on the self-employed, increasing the small companies rate of corporation tax, a new carbon tax and taxing capital gains more heavily. There are many ways to save money from the welfare budget, provided the next government is clear what role it wants social security benefits to play, and what its distributional priorities are.

8. **Public services: deep cuts coming:** The December 2009 PBR pencilled in a real freeze in total public spending from 2011–12 to 2014–15. We estimate that this would imply a real cut of 2.9% a year (or a total of 10.9% or £42 billion by 2014–15) in Whitehall spending on public services and administration, reversing the increase in public services spending as a share of national income seen under Labour to date. The Government’s promise to ‘protect’ spending in areas like schools, the NHS and overseas aid in 2011–12 and 2012–13 would require real cuts elsewhere of 6.7% a year (or a total of 12.9% or £25.8 billion by 2012–13). The Conservatives plan to protect a smaller subset of services spending, but might cut harder overall.
9. **Public sector pay and pensions:** The public sector pay bill has recently been cut modestly as a share of national income, but an even tighter squeeze looms. Pay levels in the public sector do not appear to be significantly out of line with those of comparable private sector workers overall, but regional divergences should be addressed. A couple of years of pay freezes or similar restraint could save significant money in the short term and are unlikely to cause big recruitment problems. But the tendency for public sector pay to 'catch up' suggests that lasting savings are more likely to be achieved by shrinking the public sector workforce. Savings could also be made by further increasing the contributions that public sector workers have to make towards their relatively generous pensions.

10. **Support for research and development:** The 'patent box' proposed in the December 2009 PBR will do little to address market failures that discourage innovation, will be expensive and will predominantly benefit a few large companies. The money would better achieve the Government's stated objectives if spent maintaining spending on the science base and other infrastructure.

11. **Reforming UK fiscal institutions:** Voters and investors need to be reassured that government will repair the public finances and that they can trust official public finance forecasts. The Government's Fiscal Responsibility Bill is unlikely to be any more convincing than the old Code for Fiscal Stability. Significantly boosting the role of the National Audit Office could help, but it is not obvious that combining this role with its existing one would be sensible. The Conservatives’ proposal for an Office for Budget Responsibility has merit, but risks replacing one well-resourced and well-organised fiscal forecasting function with two weaker ones. The best approach might be to have their proposed Budget Responsibility Committee oversee, challenge and sign off forecasts by officials still well-integrated in the Treasury.

ENDS

Notes to Editors:

1. The Green Budget 2010 will be launched at 10am on Wednesday 3rd February 2010 at the British Museum. To reserve your place please contact Bonnie Brimstone at bonnie_b@ifs.org.uk.

2. For embargoed copies of the report or other queries, contact: Emma Hyman or Bonnie Brimstone at IFS: 020 7291 4800, emma_h@ifs.org.uk, bonnie_b@ifs.org.uk;

3. Past Budget documentation, including our 2009 Green Budget and 2009 Budget analysis can be found at: http://www.ifs.org.uk/budgets