

Institute for  
Fiscal Studies



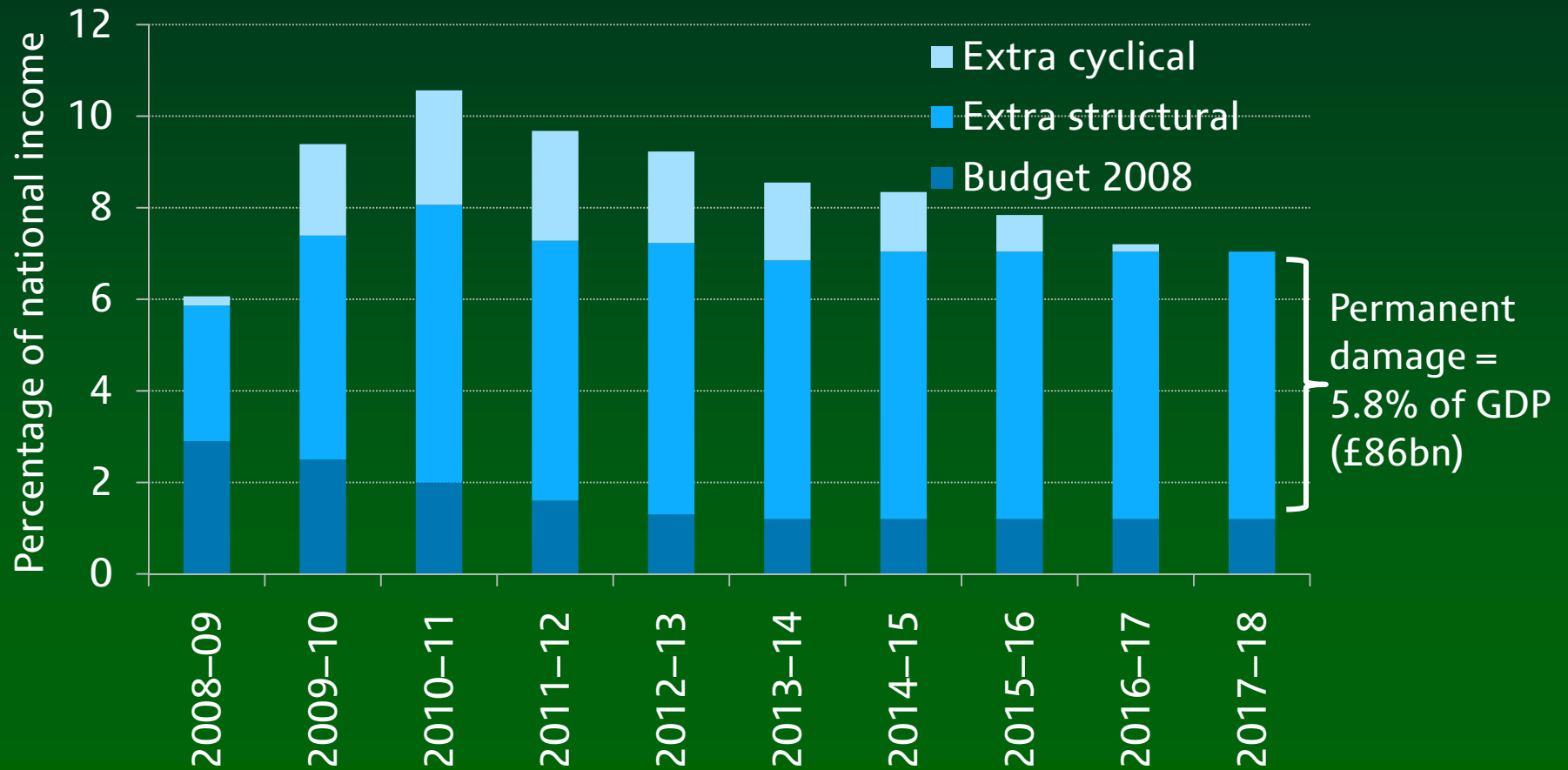
## Disease and cure in the UK: The fiscal impact of the crisis and the policy response

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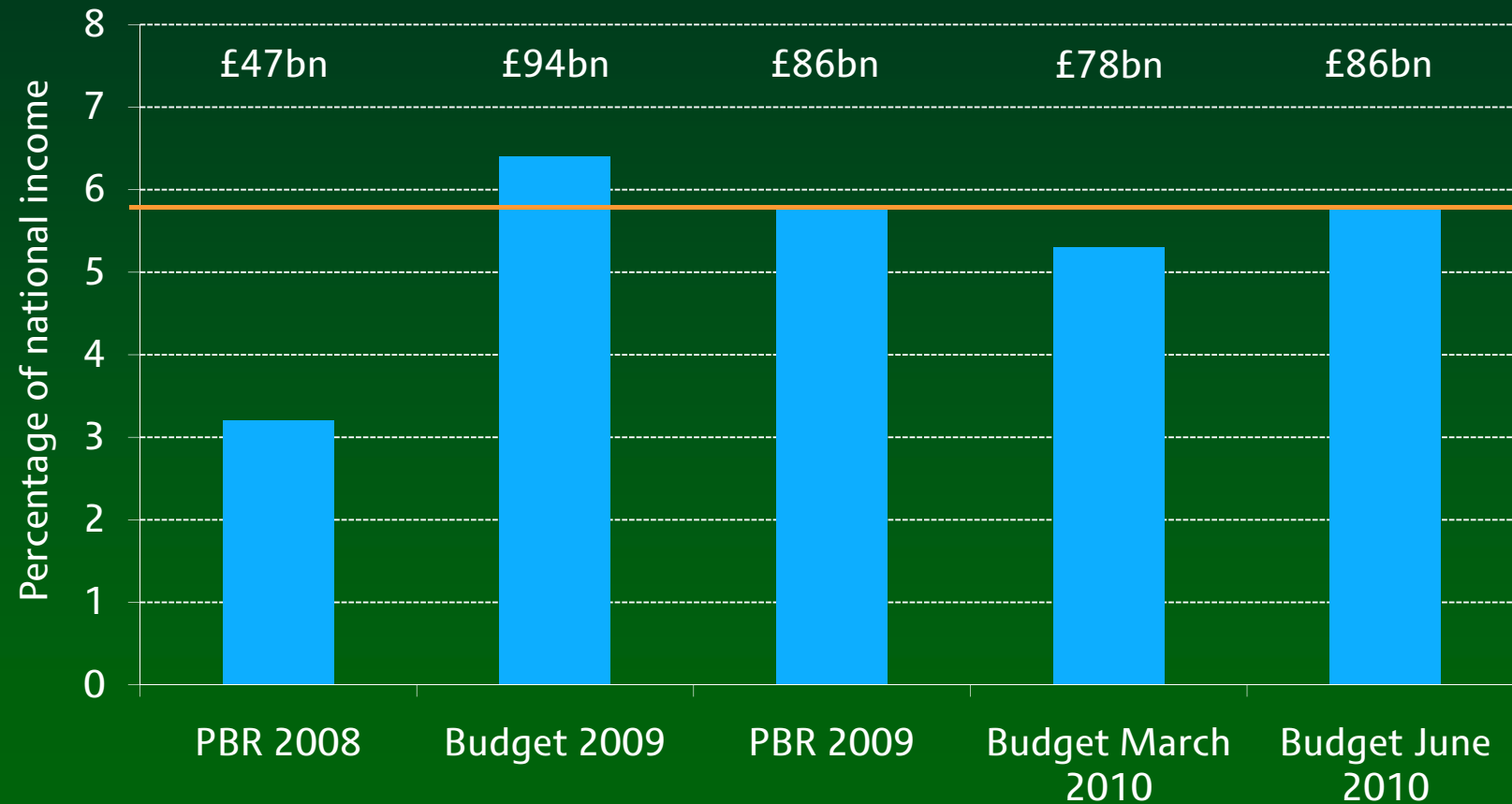
Carl Emmerson (with Robert Chote, Rowena Crawford and Gemma Tetlow)

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

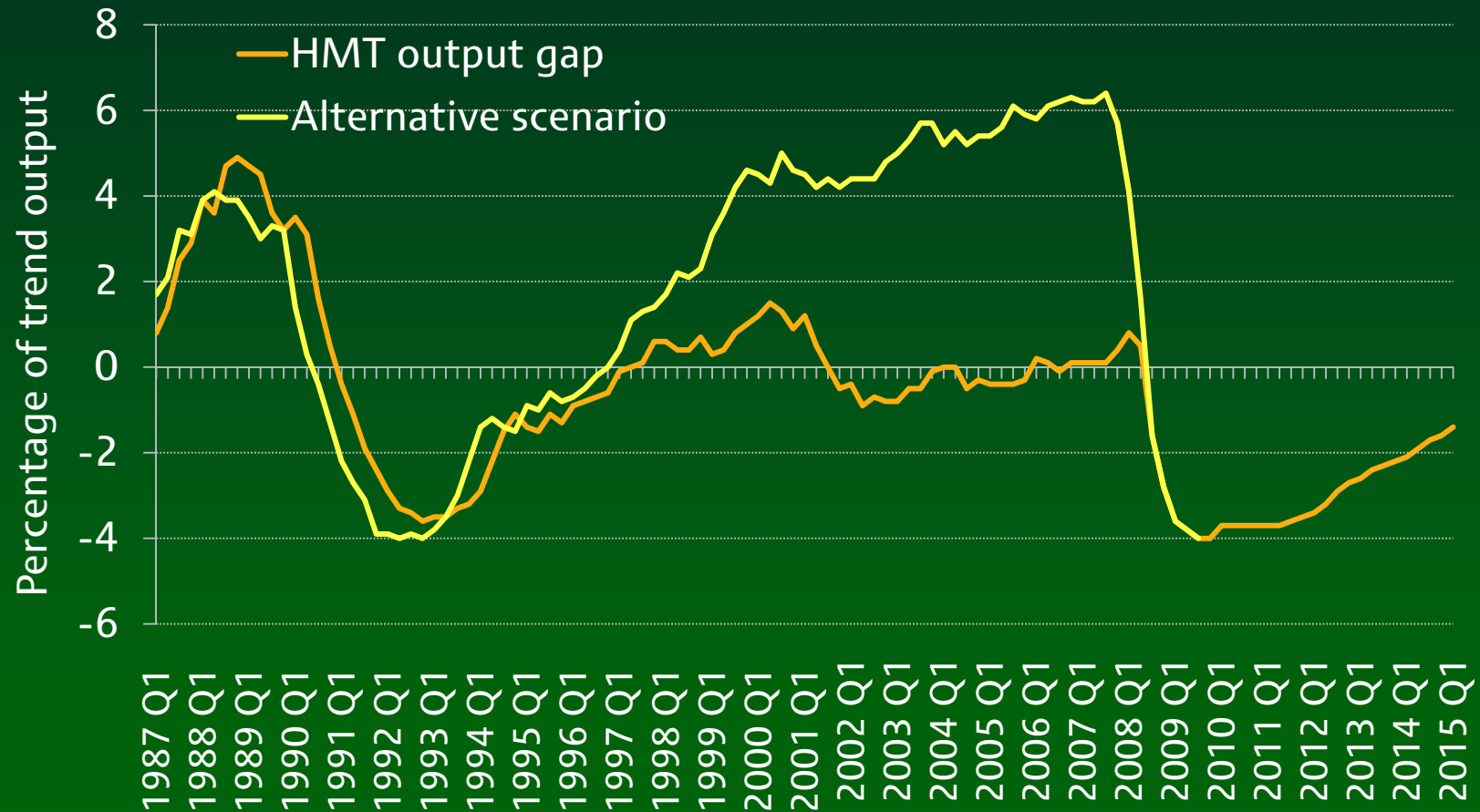
# Diagnosis



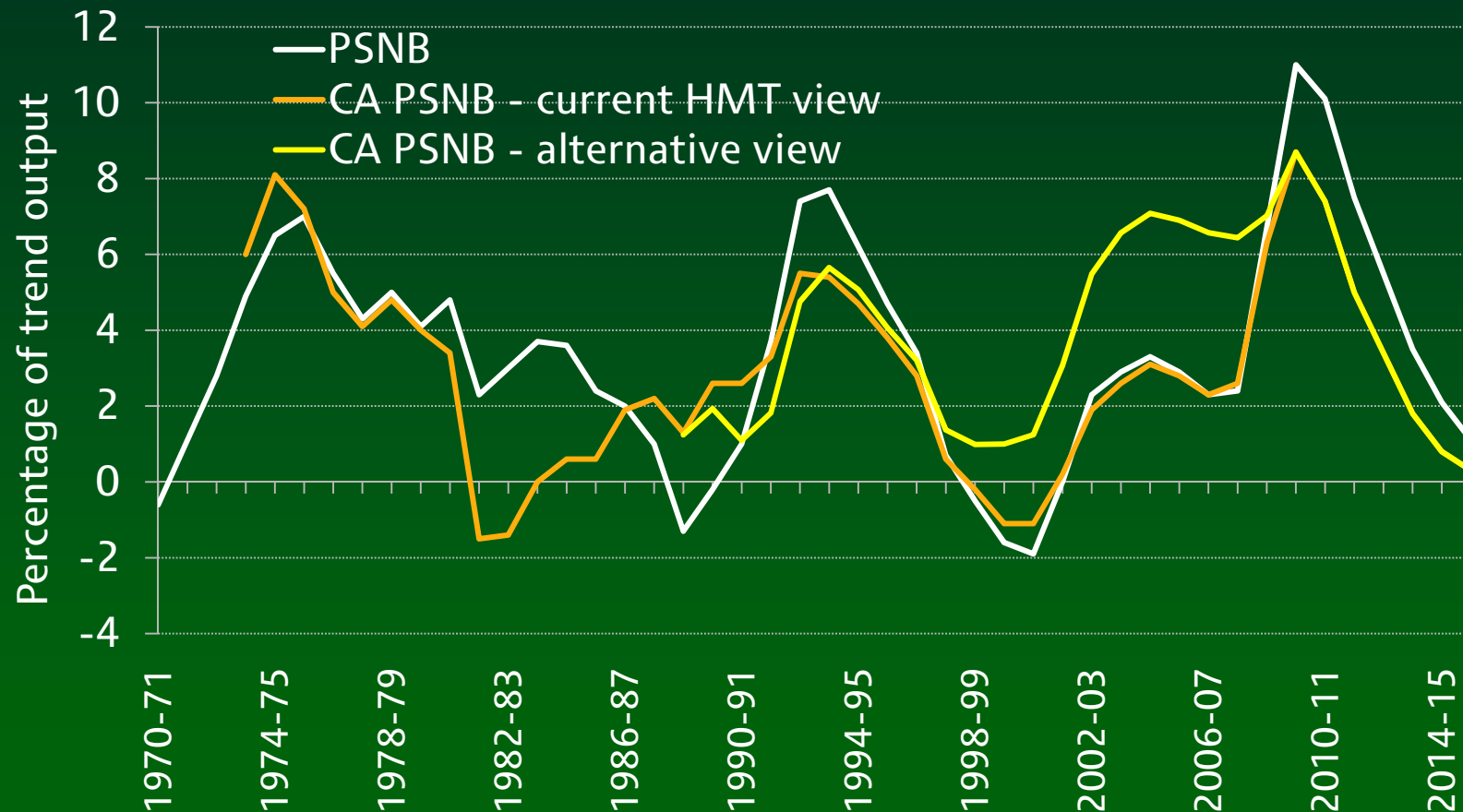
# Diagnosis: change over time



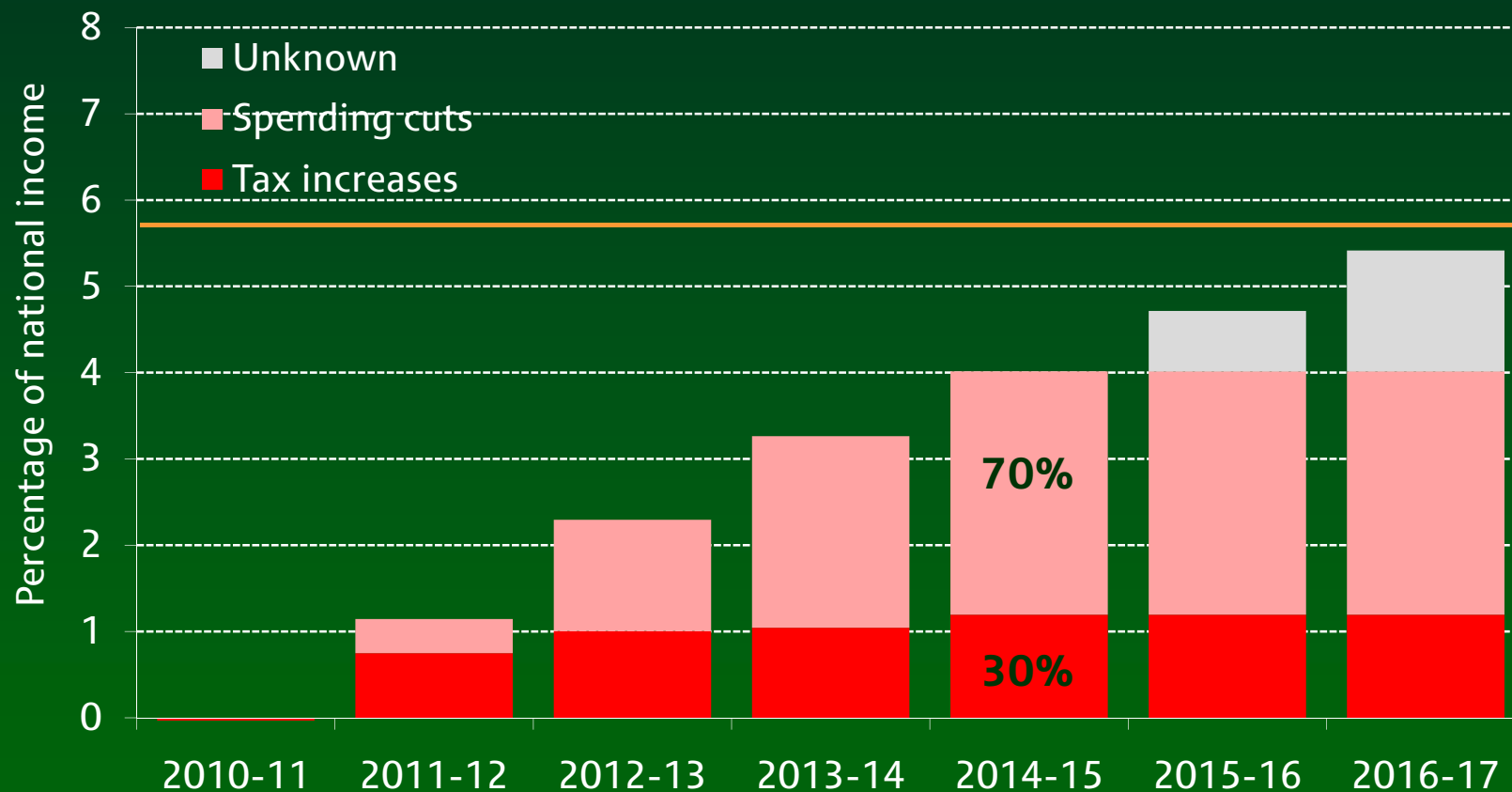
# A bust without a boom?



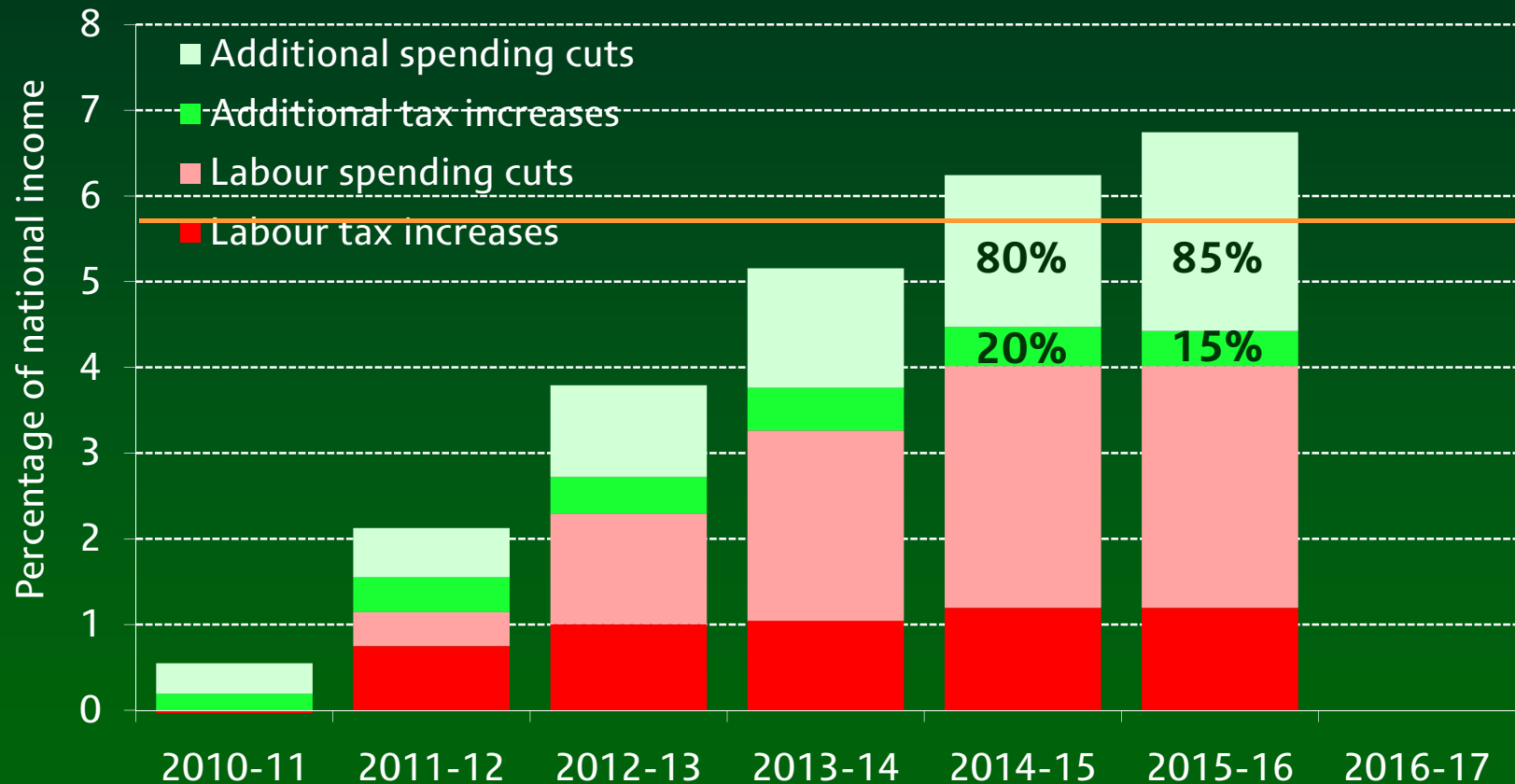
# Diagnosis: an alternative



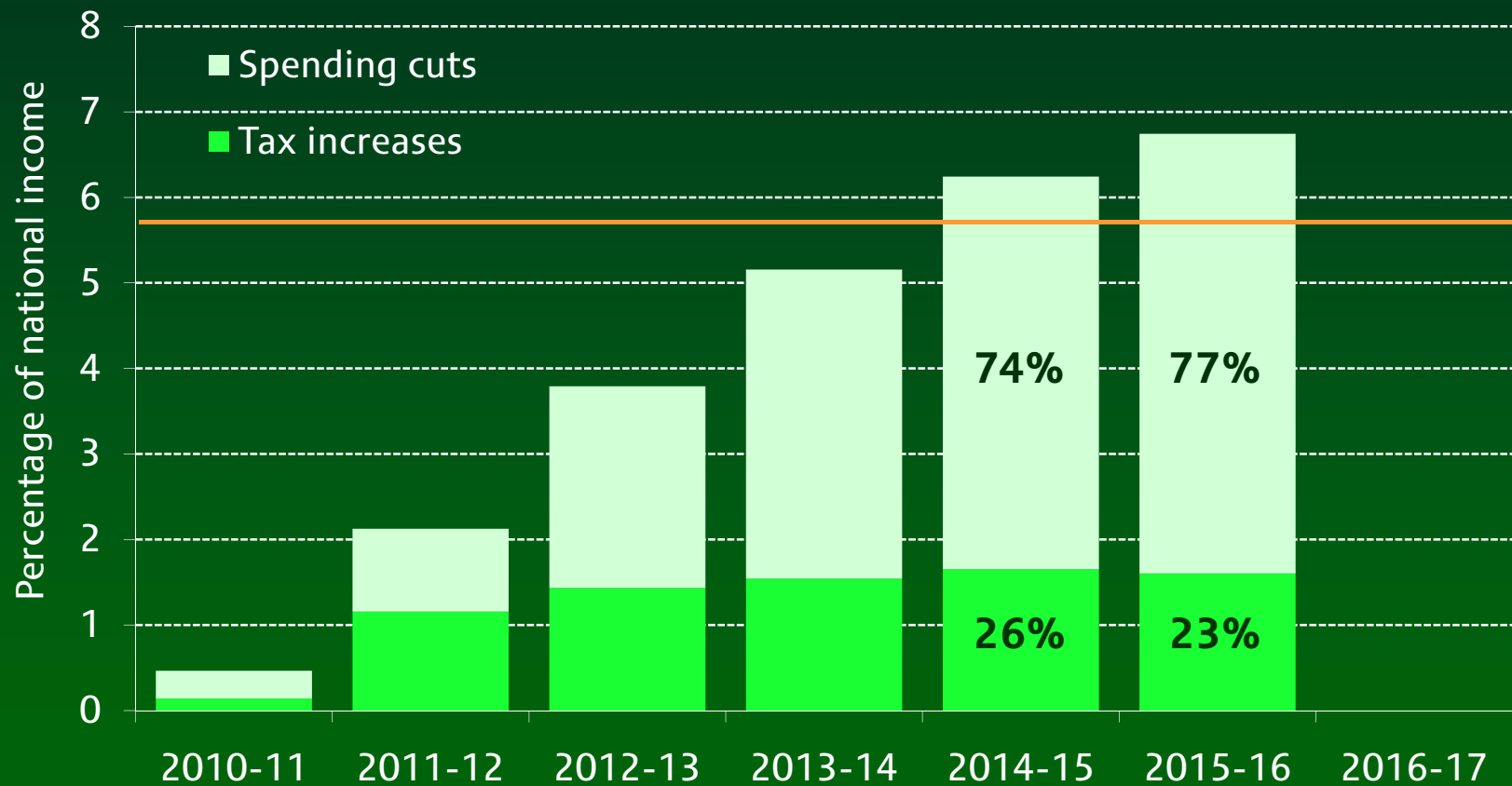
# Cure: Labour's plans



# Cure: new coalition Government's additions

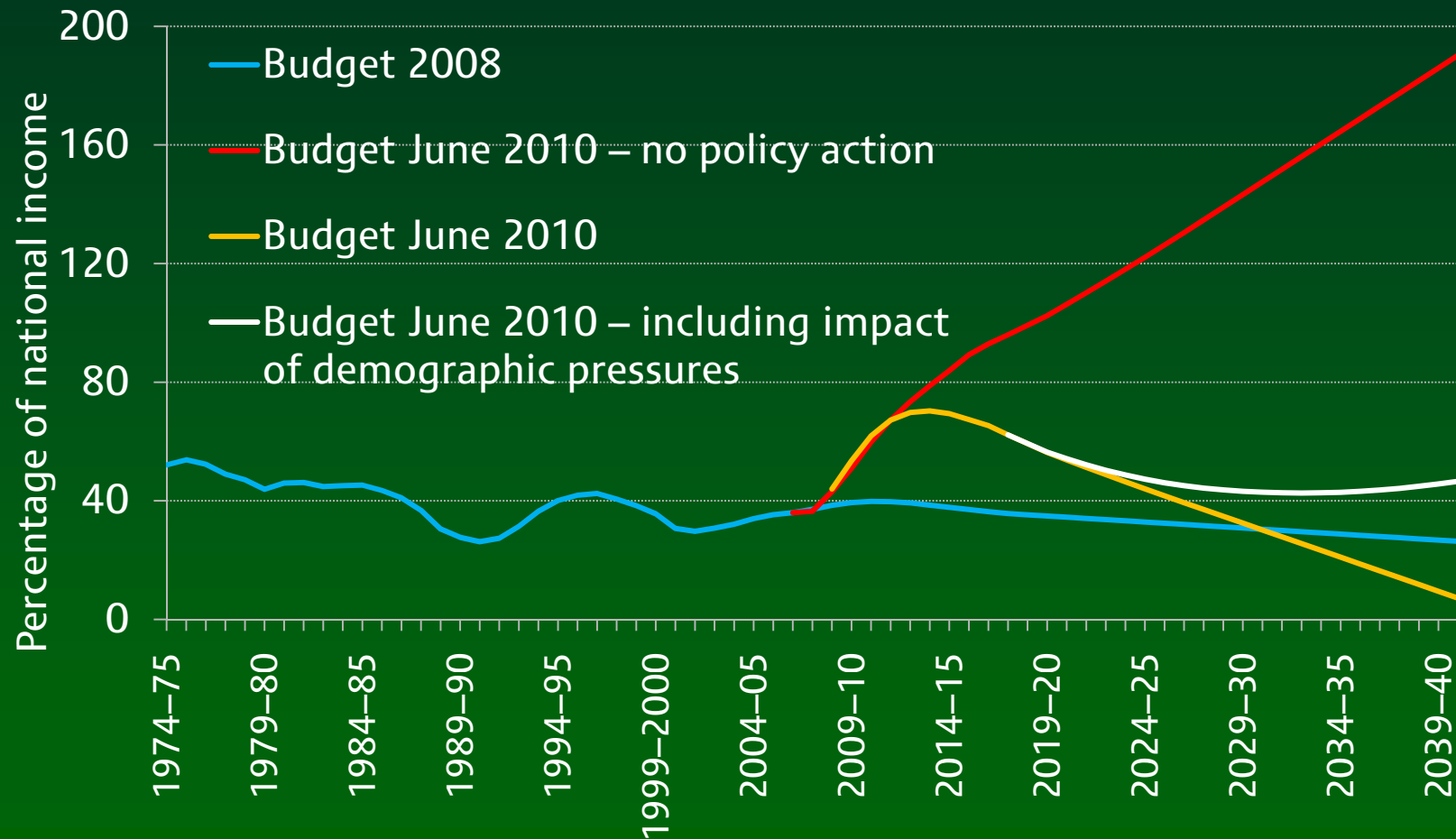


# Cure: new coalition Government's plans

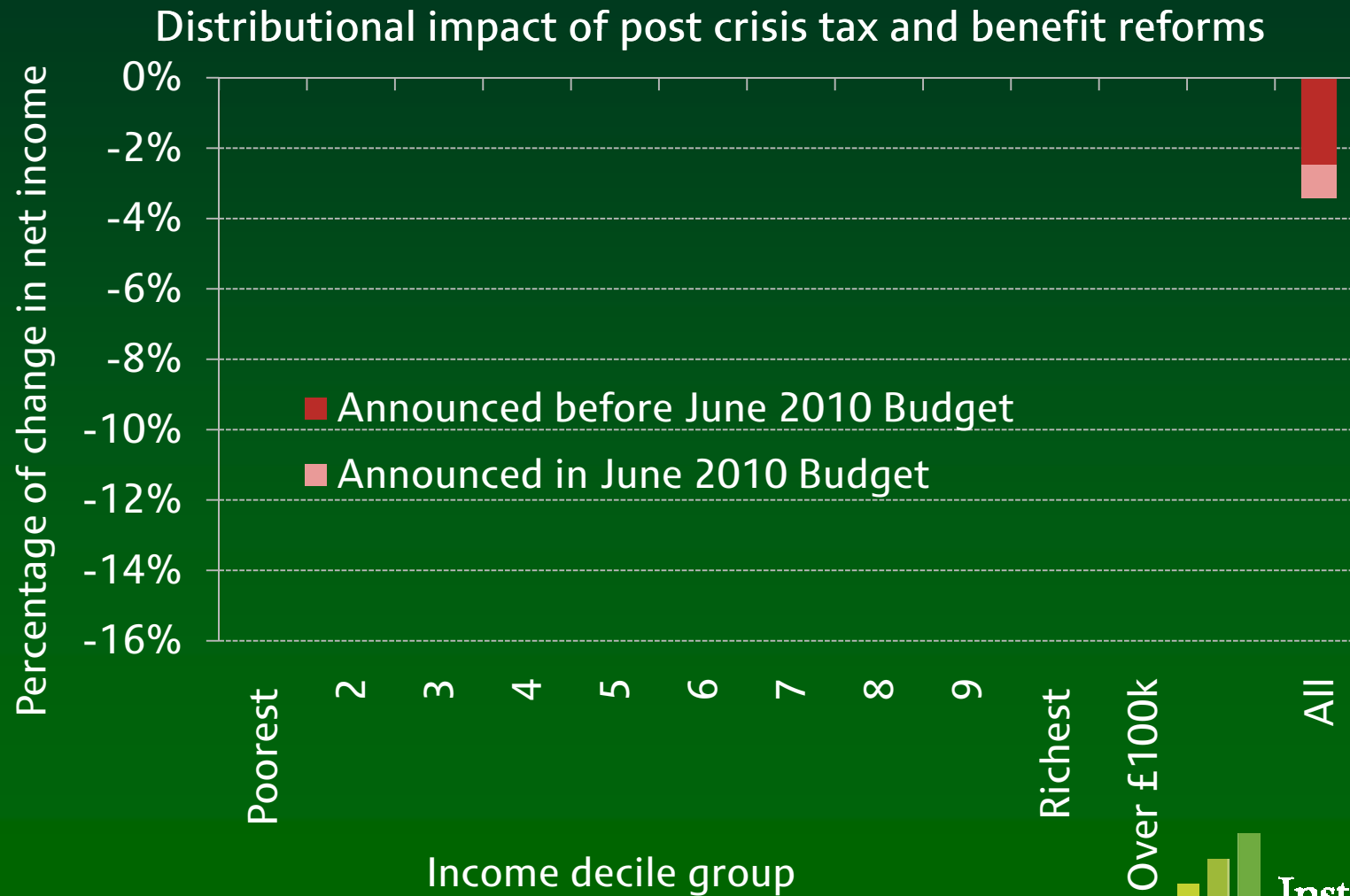




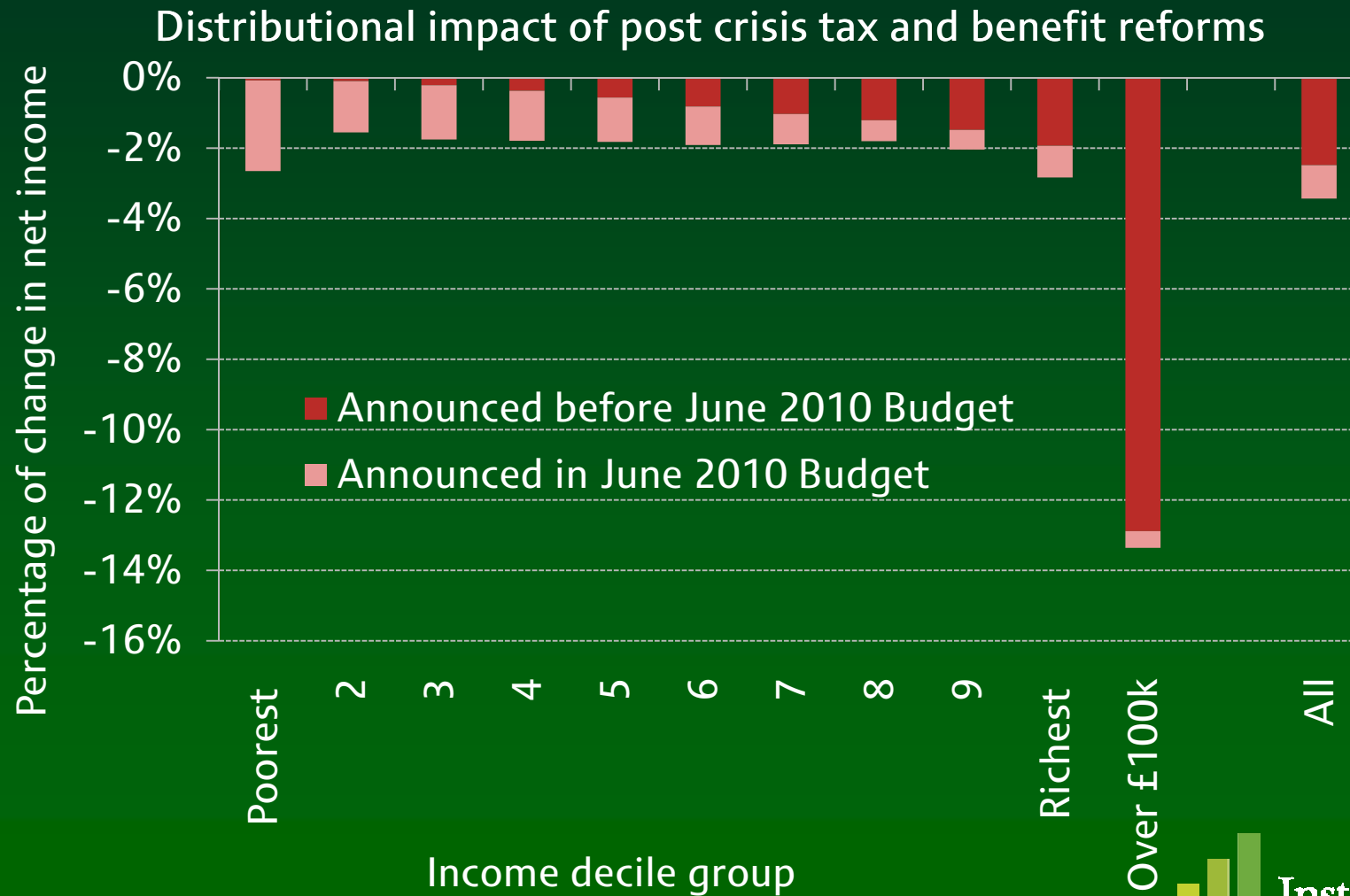
# Cure: debt sustainable but not back to pre-crisis levels for a generation



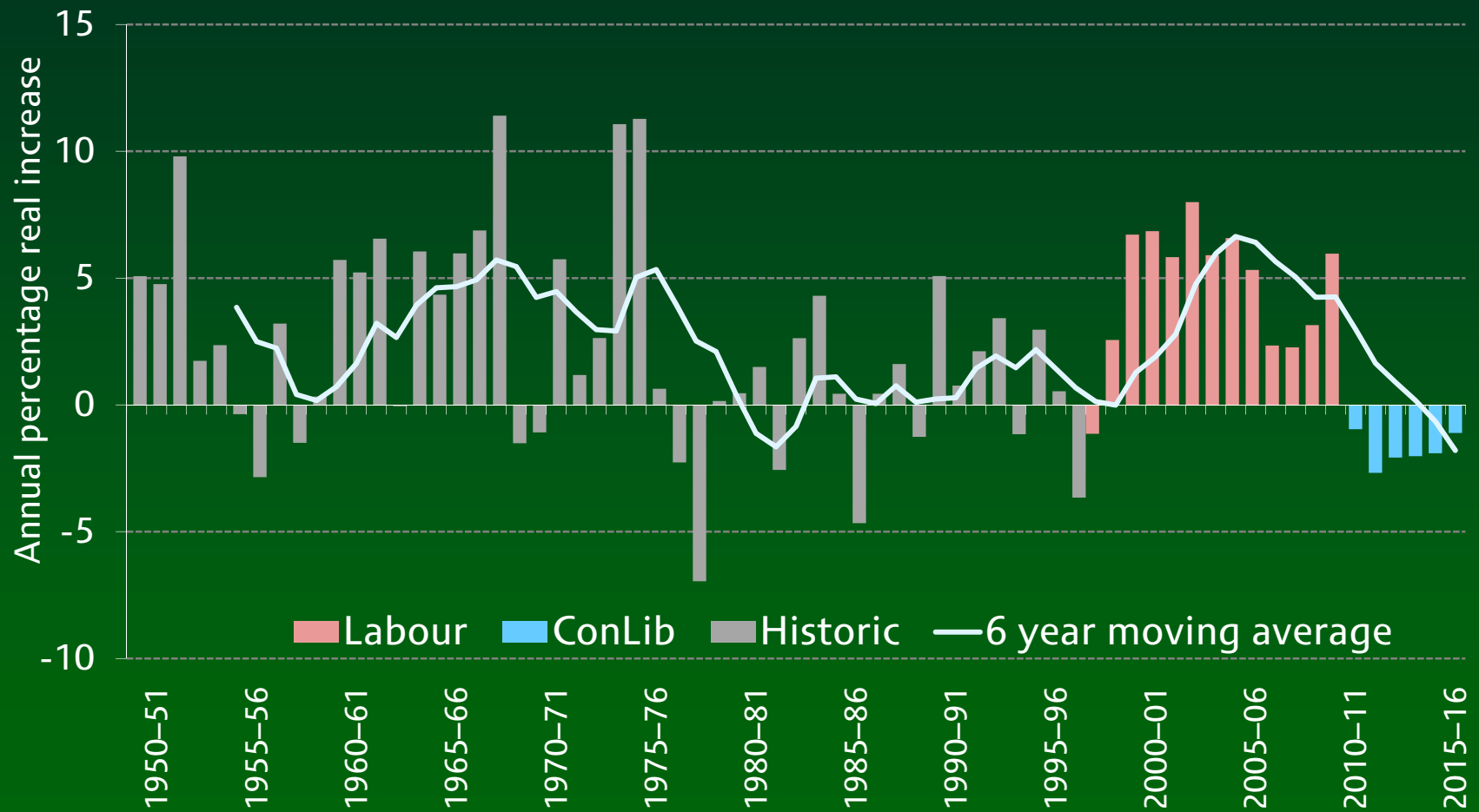
# Cure: all in this together?



# Cure: all in this together?

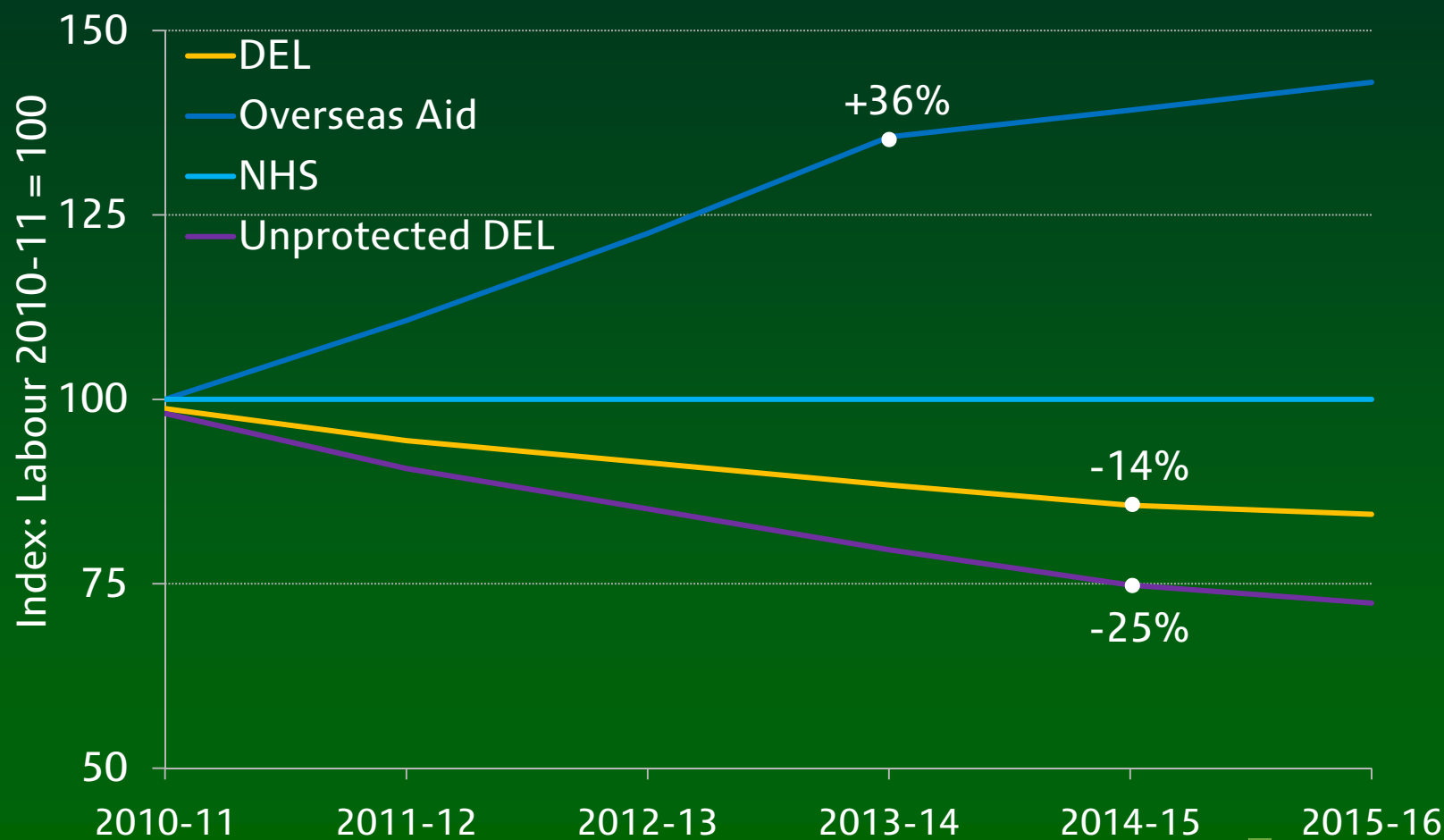


# Cure: public service spending set for a squeeze



Note: Figure shows total public spending less spending on welfare benefits and debt interest

## Cure: much pain to come for unprotected DELs



# 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

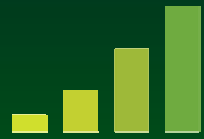


## The OBR: where next?

- 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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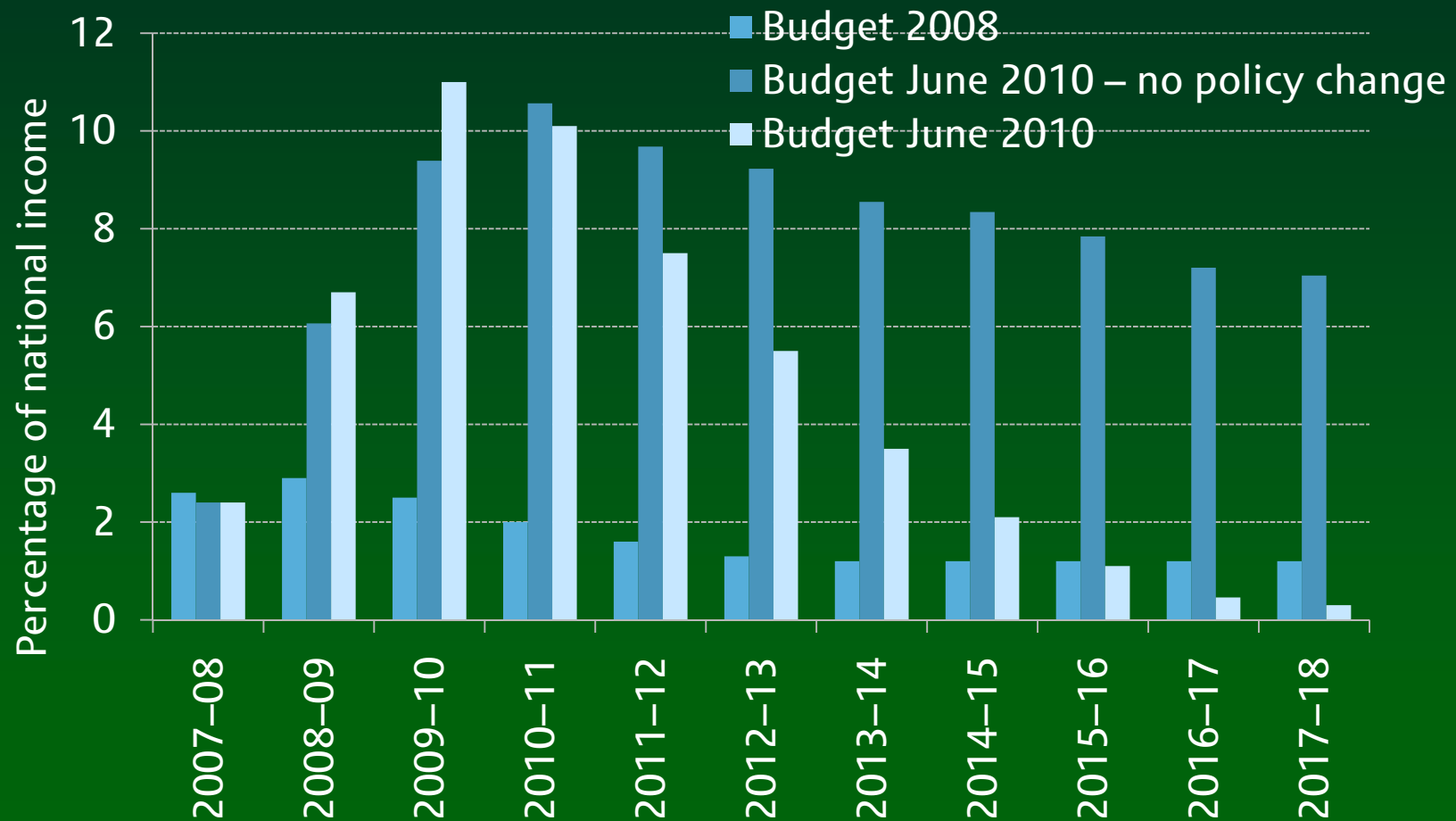
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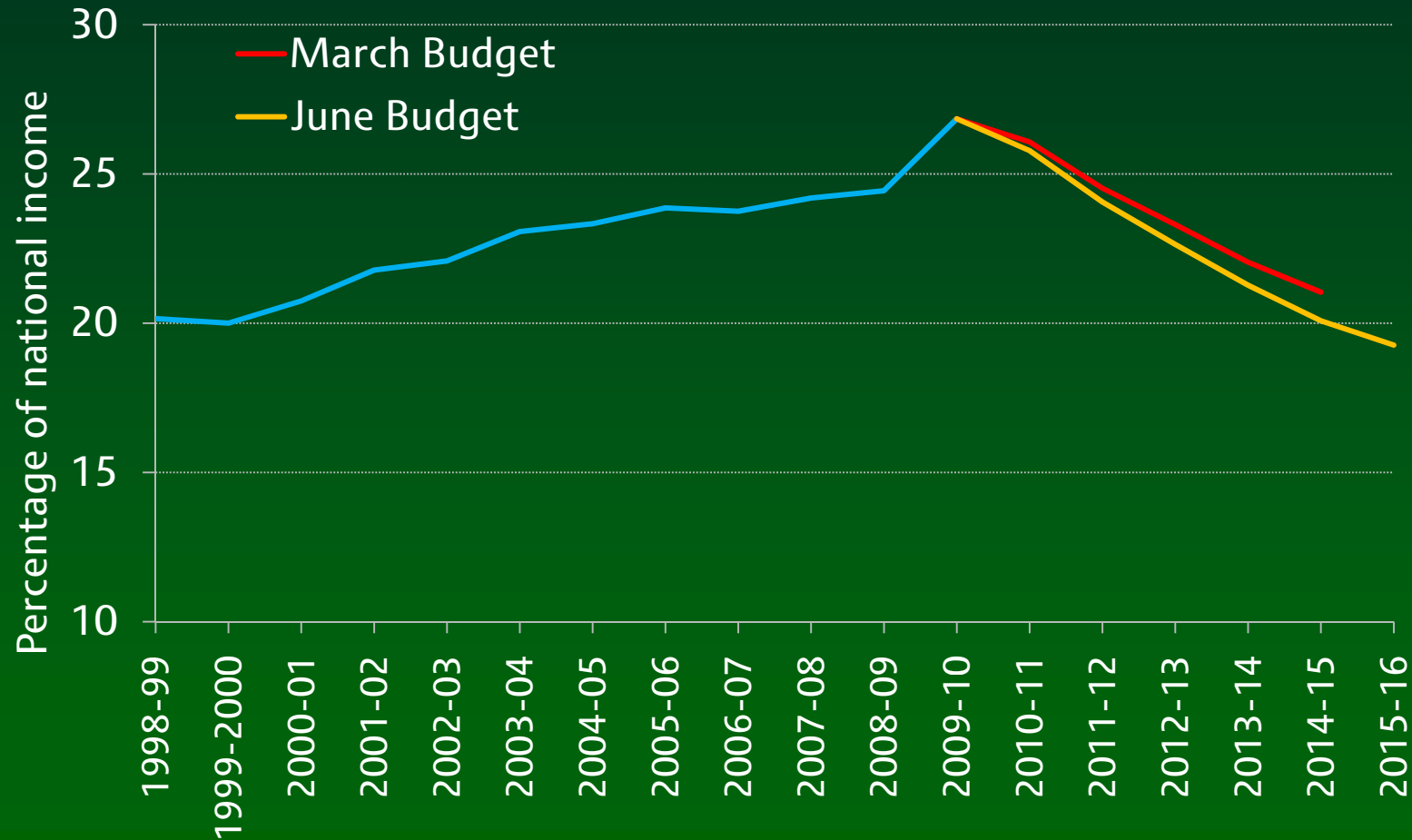
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## Cure: borrowing back to pre-crisis levels



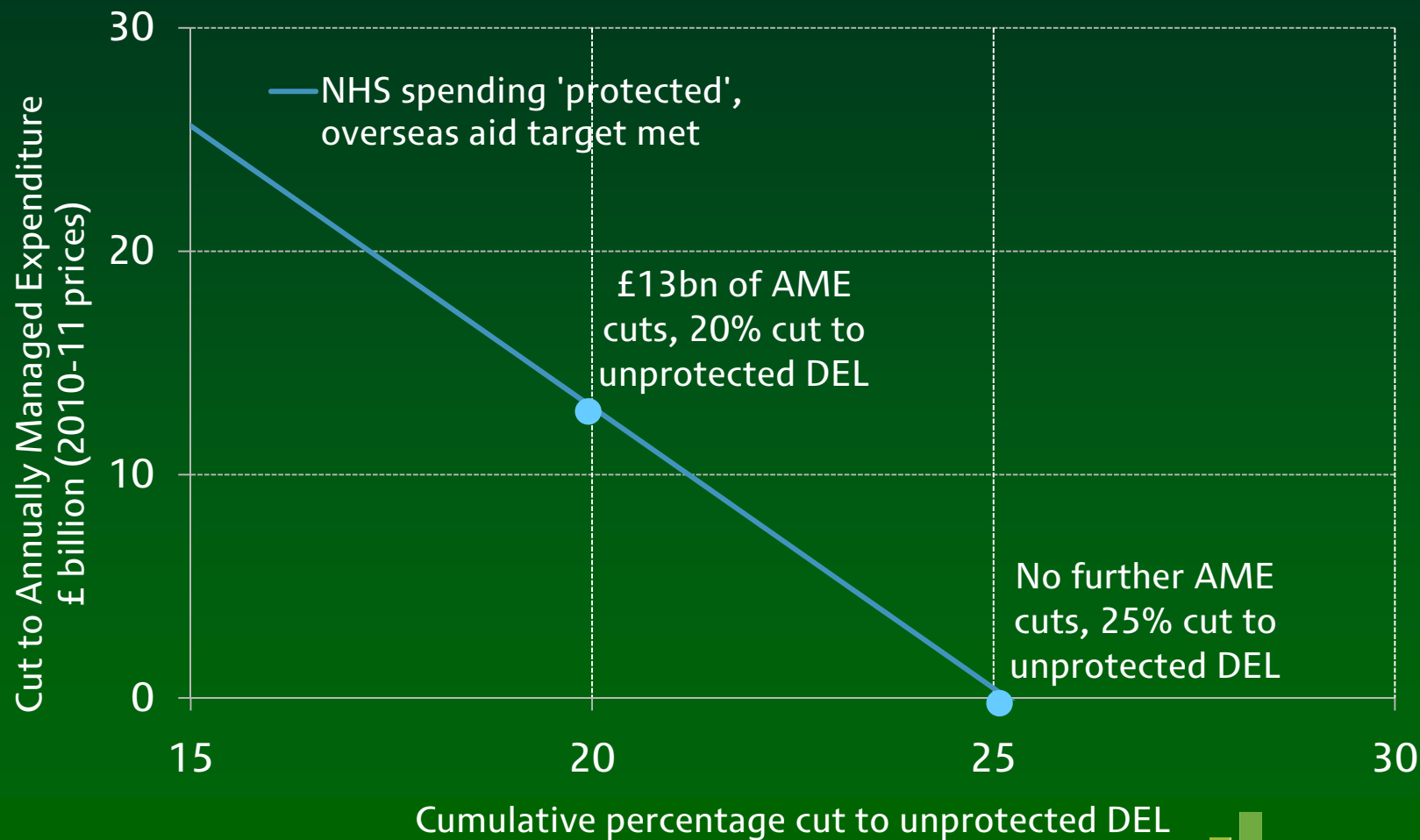
# Cure: Labour's DEL increases to be reversed



# Spending Review 2010: allocating the pain

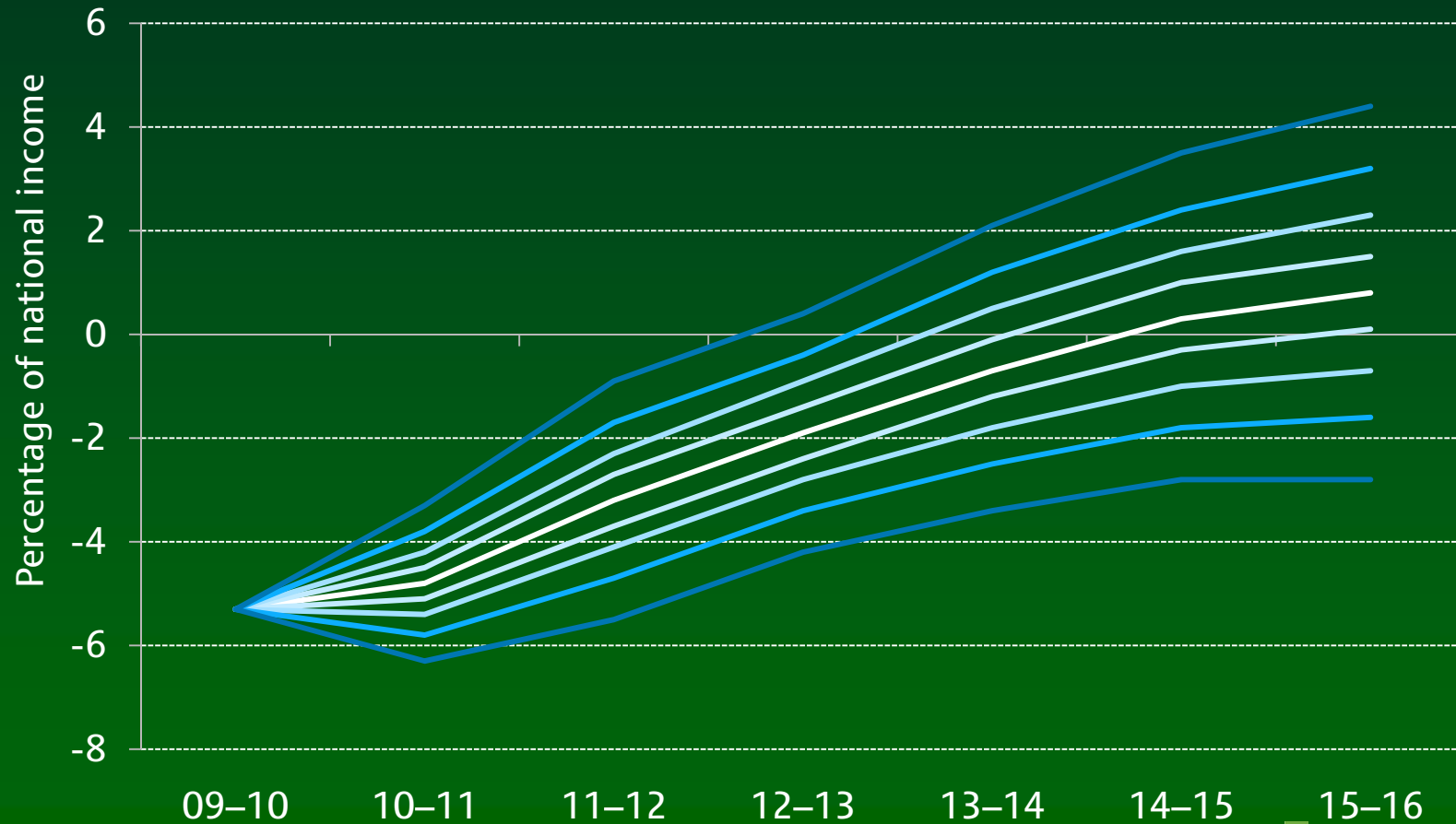
- Current policies imply unprotected DEL cuts of 25% in real terms by 2014–15 compared to Labour's 2010–11 baseline
  - £13bn of AME cuts would reduce this to 20%
  - would need to come from £270bn of AME spending included in the spending review (4.8%)
  - but likely from £154bn of spending once state 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



# 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](http://budgetresponsibility.independent.gov.uk/d/fan_charts_intervals.xls))