WHAT HAPPENS NEXT

Analysis by Stephen Parsons for Election Day 2010

Introduction

Whatever the result of the General Election, the economic situation of the UK will require a statement of intent from Her Majesty's ('new') Government whatever its political composition. Electors have been offered several different versions of the same 'pig in a poke' economic policy: unspecified 'painful' measures to deal with a collusively-defined 'crisis'.

I would like to suggest some measures that might be appropriate to resolve the imbalance in public finances and illustrate the time-horizons involved in resolution under plausible circumstances.

Background

Government debt has increased rapidly since 2007 and the 'global financial crisis'. It should however be noted that, on the basis of international comparisons (i.e. with other developed economies such as the USA and the EU eurozone states), UK public sector debt expressed as a proportion of national income started from a relatively low base (less than 40% in 2007). It might also be relevant to note that public sector net investment has risen swiftly to unprecedented levels since the turn of the century.

The onset of the economic recession caused by the crisis of the financial sector (with the attendant increases in unemployment, short-time working and pay-cuts) has led directly to a large budget deficit as tax receipts have fallen whilst benefit payments have risen; this deficit adds to the level of government debt (NB: the cost of 'bailing out the banks' is not directly reflected in the deficit or the debt according to national accounting conventions; as a simplification, this is because the state has taken shares in the banks which it can be presumed to be able to sell at a later date – thus funding the process and 'balancing the books'). It may be noted that the rise in UK unemployment that has occurred has been less substantial than might have been expected because of the return to home countries of EU migrant labour (also encouraged by exchange rate changes).

The Basis of Calculation

Data on the UK public sector finances can be downloaded from the HM Treasury website (http://www.hm-treasury.gov.uk/psf_statistics.htm) and supplemented by compilations and analyses from independent agencies such as the Institute for Fiscal Studies (e.g. http://www.ifs.org.uk/fiscalFacts/fiscalAggregates). The full documentation of the 2010 Budget is also available (http://www.hm-treasury.gov.uk/budget2010.htm).

Rather than adopting any of the (limited) programmes suggested by the main political parties, I have imposed my own preferred measures to restore order to the public finances (i.e. eliminate the budget deficit and reduce the level of the national debt) under what I consider to be plausible assumptions about the economic context.

Illustrative Measures

On the revenue side of the government's budget I have chosen to increase the headline rate of VAT to 20% and to remove all exemptions (items such as fresh food, financial services and children's clothing). This would increase the burden of taxation to 40% of GDP (38.7% in 2007; last at 40% in

1988; average 1974-2007 was 39.7%). I would not implement the existing government proposal to raise National Insurance contributions.

On the spending side of the government's budget, to meet anticipated objections to the taxation of fresh food and children's clothing I have chosen to apply a 'National Insurance Credit' to give ***all*** households a (recurrent) cash payment equivalent to the VAT payments incurred on fresh food and children's clothing by the 10% best-off households (who spend the most on these items). This would be a very progressive form of compensation since it would give the 10% worst-off households £15/week to compensate for £5/week extra cost and the average family £15/week to compensate for £10/week extra cost). It would offer some compensation for the overall VAT increase to the less well off.

The VAT measures proposed would still be a net money-raiser (and would raise most of the money from those who spend the most).

Economic Context

In projecting the consequences of the measures I have proposed there have to be some assumptions about the economic context: the rate of recovery from the recession (affecting the revenue side of the budget as taxes are raised and the cost side as the incidence of benefits is reduced) and the scope for improved efficiency in public services.

I believe that medium-term optimism is justifiable regarding the economic prospects of the UK because of the significant adjustments that have taken place in the sterling exchange rate and the relatively strong position of export industries. Since 2007 sterling has gone from £1=$2 to £1≈$1.5 and from £1=€1.5 to £1≈€1.1; overall the sterling exchange rate index has dropped by 20%.

Nevertheless I have built in to my basic scenario annual GDP growth of only 1% for 2010 and 2% for years after that (in Budget 2010 the government's assumptions for headline GDP growth are for over 4% in 2010 and 6% thereafter). I note that the National Institute for Economic and Social Research has recently forecast UK GDP growth as 1% for 2010 and 2% in 2011 and 2012. This cautious outlook reflects the requirement for the rest of the world to recover from recession before UK exports can expand significantly.

I am not optimistic about the scale of efficiency gains to be expected in the delivery of public services: I do not believe that the calibre of public sector management is adequate for the task of improvement in service quality or effective organisation. For this reason I have limited the overall reductions in budget cost that can be expected in real terms to a half of one percent per year (i.e. including the impact of unemployment reduction).

Results

Table 1 (below) contains the dates at which key milestones are achieved under different scenarios.

The milestones referred to are:

1. Current Budget balances - the year in which the government's current expenditure (i.e. not including public sector investment and allowance for capital depreciation) is matched by current receipts from taxation;
2. Total Gov't Budget balances - the year in which the government's total expenditure (i.e. including public sector investment and allowance for capital depreciation) is matched by current receipts from taxation;
3. Year of Peak Gov't Debt - the year in which government debt is at a maximum;

4. Gov’t Debt returns to 40% of GDP - the year in which government debt returns to the level previously regarded as ‘prudent’ (i.e. pre-2007);
5. Gov’t Debt is completely eliminated - the year in which government debt is entirely eliminated!

Scenario Base (a) reflects the measures and economic context previously outlined above. Scenario Base (b) is a modification in which the VAT compensation (National Insurance Credit) is paid at a lower level reflecting the average household’s extra cost. Scenario Base (c) pays the National Insurance Credit only at the level of the 10% least well off households’ extra cost. The ‘No Efficiency’ scenario is what happens if Base (a) is modified so that there are no reductions in the cost side of the budget. The ‘Faster Growth’ scenario is Base (a) modified to reflect GDP growth of 3% from 2012 onwards. The ‘Even Faster!’ scenario has growth rates as follows: 1% in 2010; 2% in 2011; 3% in 2012; 4% from 2013 onwards.

Table 1: Dates at which key milestones are achieved under different scenarios

Scenario	Current Budget balances in..	Total Gov’t Budget balances in..	Year of Peak Gov’t Debt	Gov’t Debt returns to 40% of GDP in..	Gov’t Debt is completely eliminated in..
Base (a)	2017	2019	2018	2028	2032
Base (b)	2016	2019	2018	2027	2031
Base (c)	2016	2019	2018	2027	2031
No Efficiency	2018	2022	2021	2031	2036
Faster Growth	2015	2017	2016	2023	2027
Even Faster!	2015	2016	2015	2021	2025

Only if the most optimistic GDP growth scenarios are correct can a government adopting the fiscal remedies proposed expect be able to offer the electorate evidence of success (in the form of a balanced current budget) by the (latest) time of the next general election. This supports the widely-expressed assumption that it will take more than one parliament to restore the public finances. Alternatively, if a swifter adjustment is required, it suggests that measures more painful than those I have proposed will be needed: a 25% rate for VAT- not desperately out of line with continental Europe – allied to the faster growth rate scenarios would bring a government current budget into balance for 2013. I don’t myself think that this is a technical economic necessity.

I was interested to compare the absolute figures given by the Treasury for Budget 2010 with the outcome of my own basic scenario. The data are presented in Table 2.

Table 2: Comparison between Budget 2010 and Scenario Base (a)

Date	Budget 2010			Scenario Base (a)		
	Current Budget	Total Budget	Government Debt	Current Budget	Total Budget	Government Debt
	£billion					
2009/10	-97	-166	777	-97	-166	777
2010/11	-103	-163	952	-95	-155	932
2011/12	-80	-131	1095	-80	-130	1062
2012/13	-61	-110	1218	-65	-110	1172
2013/14	-43	-89	1320	-50	-95	1267
2014/15	-26	-73	1406	-35	-80	1347

It seems to me that the two sets of projections are not significantly different except that I consider my assumptions about growth and efficiency savings (both lower) to be more plausible.

Conclusions

The political system of the UK has failed to offer citizens a direct choice of policies to address the unbalanced state of the public finances and the lack of endogenous economic momentum. However, the public availability of information and data in electronic format via the internet makes it easier than it used to be for individuals to make independent appraisals of the UK economic situation and to assess the implications of alternative government policies.

Whilst the UK government's budgetary position is unbalanced following a sudden and unexpected international economic recession, some relatively minor changes to the rate and coverage of VAT would recover the situation under cautious and plausible assumptions regarding expected GDP growth and the limited scope for efficiency savings in public spending.

The timing of this recovery may be politically uncomfortable but this does not of itself justify more draconian measures in terms of increased taxation or reduced provision of public services. This certainly does not mean that improvements to the quality of public services or the effectiveness of public spending cannot be expected.

The critical determinant of whether the recovery in terms of the public finances takes place earlier than 2017 is the speed with which global economic recovery asserts itself. Because of adjustment that has taken place in the sterling exchange rate the UK is well-placed to benefit from renewed global economic expansion.