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Cutting the fiscal deficit

The workout begins

George Osborne and David Laws have an unenviable job to do. Tax rises and welfare cuts are inevitable

IF THERE is one reason why a hung parliament produced Britain's first coalition government for 65 years, it is the dire state of the public finances. The Conservatives realised that they needed a formal coalition with the Liberal Democrats for the full five-year lifetime of the parliament to push through the politically perilous slashing of public borrowing. The Lib Dems, for their part, feared that hanging back on the sidelines at a time of national emergency could undermine their credibility as a serious political force.

The starting point for the new team at the Treasury is a towering deficit of £163 billion ($235 billion) in 2009-10, the fiscal year that ended in March. At 11.6% of national income, this was by far the biggest since the second world war. According to forecasts published by the IMF on May 14th, Britain's deficit will be the highest in the G7 both this year and next (see chart).

This week the government lost no time in signposting how it will bring the public finances under control—a task so formidable that it will test the resolve and staying power of the coalition. George Osborne, the Conservative chancellor of the exchequer, said that spending cuts worth £6 billion in 2010-11 would be announced on May 24th. As for the other £157 billion, the "emergency" budget he pledged before the election will be unveiled on June 22nd. This will set out the broad outline for the fiscal retrenchment that lies ahead and get the bad news out on planned tax rises. A spending review conducted by David Laws, the Lib Dem chief secretary to the Treasury, will go where both parties feared to tread in the campaign and specify this autumn where the axe will actually fall.

The decision to press ahead with immediate spending cuts marked one of the first compromises of the coalition. Before the election the Lib Dems had criticised the Conservative intention to make reductions this year, arguing that cuts should be delayed until 2011 when the recovery would be more secure. But the fiscal crisis in Greece has shown the price that governments pay when they lose credibility in the markets. The Lib Dems now agree with the Tories on the need to demonstrate that the new government means business, although they have secured a minor concession in that a small part of the savings will be used to support jobs.

Both Mr Osborne and Mr Laws stuck this week to the supposed difference between "front-line" services, which must be protected, and other spending on the public services and administration, where "wasteful" expenditure can be eliminated. The distinction is spurious: could the new ministers function in their "front-line" jobs without the back-up of civil servants? The first round of cuts will also include a pruning of quangos, a catch-all phrase for public bodies that exist outside the formal confines of government departments. They may be an easy target but Colin Talbot, a public-management specialist at Manchester Business School, says there is no evidence that quangos are inherently more wasteful than departments.

Another weakness in the new team's approach to cutting spending is that some public services are protected from real cuts. This follows the decision to ring-fence the National Health Service (a Tory commitment) while continuing to raise the small overseas-aid budget (a pledge made by both parties). And for this year defence will also be shielded while a strategic review is carried out. The drawback of protecting some budgets is that others face a more intense squeeze.

The first round of cuts may arouse controversy but it will be as nothing compared with the ire likely to be provoked by the budget Mr Osborne will deliver in June. This will be the defining moment of the new coalition, as the chancellor sets out his long-term plan to rein in the deficit. It is bound to include tax rises and far harsher spending cuts than this year's £6 billion.

The budget will be preceded by a crucial report from the new Office for Budget Responsibility (OBR), which will set out independent economic and fiscal forecasts (see box). Headed by Sir Alan Budd, a former Treasury economic adviser, the OBR is widely expected to paint a bleaker picture than the fiscal projections in Labour's last budget, in March. These were founded on an optimistic outlook for annual GDP growth, expected to run at over 3% in 2011 and beyond. This would be a rattling pace for an economy that has been badly damaged by the financial crisis. Independent forecasts made in the first half of April and compiled by the Treasury expected on average GDP growth of just 2% next year.

A more realistic assessment from the OBR about Britain's economic and fiscal prospects will surely pave the way for higher taxes. Taxation is already starting to rise this year with a new 50% rate of income tax on high earners. That, and other measures in the previous Labour government's pipeline, will eventually push up tax by about one percentage point of GDP.

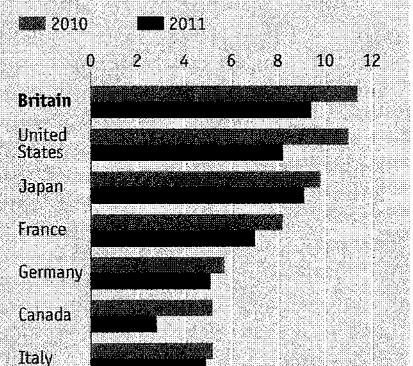
This is not enough, and a rise in the main rate of VAT, a consumption tax, is widely expected. There were few squeals of anguish from the public when this was restored on January 1st to its usual rate of 17.5% after 13 months at 15% as part of the fiscal stimulus to fight the recession. A rise next year to 21%, for example, would generate extra revenues worth 1% of GDP.

Painful though higher taxes will be, the hardest job of the coalition government will be clamping down on spending. Public net investment is already scheduled to fall by a whole percentage point of GDP between this year and 2012-13. But that is an easy cut to make compared with reducing the running cost of public services, which will involve pay curbs and a jobs cull. The impact on unprotected departments will be draconian unless the welfare budget, which makes up nearly 30% of total spending, is curtailed.

The one consolation is that even if fiscal consolidation is tough, monetary policy can probably remain lenient, which will help Britain's heavily indebted households. Consumer-price inflation jumped in April to 3.7%, raising worries about the persistence of the upsurge. But the Bank of England remains convinced that inflation will retreat later this year as spare capacity bears down on prices. If it is right, it can offer monetary balm to ease the pain of the fiscal workout. ■

Sinner of the pack

General-government deficit as % of GDP, forecasts



Source: IMF