BRIEFING

Cutting the deficit

There *is* an alternative

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Challenging ideas – Changing policy

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Introduction

The Spending Review to be announced on 20 October is certain to be one of the most significant political events of this Parliament. The country is braced for spending cuts on a scale without precedent in the post-war period. Progressive economists believe the Coalition's plan for rapid and deep deficit reduction will put at risk the fragile economic recovery and undermine prospects for future growth and shared prosperity.

However, beyond simple protest, it is incumbent upon those who are critical of the Coalition government's plans to propose credible and costed alternatives. This briefing paper sets out to do just that.

In summary, the ippr's alternative plan for deficit reduction states that the government should:

- **Maintain investment on capital projects** such as transport and housing at 1.8% of GDP, as this will promote economic growth and higher employment
- **Reduce the underlying deficit more slowly**, in six years rather than four – the financial markets can be reassured without a faster reduction
- **Maintain a 65:35 ratio between spending cuts and taxes**
- **Accept that the 20% rate of VAT will not be reversed**
- **Tax universal benefits** such as Child Benefit and winter fuel allowance, rather than means-testing them, and remove free bus passes for better-off older people
- **Lift the ring-fence on NHS spending** to ensure all departmental areas, except international development, are considered for cuts. If all areas are considered for cuts, ippr estimates no single department would need to reduce its budget by more than 10%, compared to 25% for some departments under the government's plan

The Osborne Plan

The main elements of Chancellor George Osborne's plan*1* to tackle the UK's budget deficit are:

- There is a new fiscal mandate, which is to eliminate the cyclically-adjusted deficit on the current budget by 2015–16, but the plan is to achieve this one year earlier, in 2014–15
- There is a supplementary target of getting public sector net debt (as a percentage of debt) on a downward path by 2015–16
- Net investment falls from 2.6% of GDP in 2010–11 to 1.1% of GDP in 2015–16 (in line with the plans set out in Alistair Darling's last budget)
- Current receipts increase from 37.2% of GDP in 2010–11 to 38.7% in 2013–14, as a result of the economic recovery and an increase in the standard rate of VAT from 17.5% to 20% from January 2011
- Spending on the NHS is to be maintained in real terms and spending on international development will increase to 0.7% of GDP by 2013–14
- Welfare spending is to be cut by at least £11 billion and (unless there is scope for further cuts in this area) spending by government departments other than health and international development will be cut by up to 25% in real terms between 2010–11 and 2014–15
- Overall (including measures inherited from the previous government), there will be a total consolidation of £113 billion by 2014–15, of which £83 billion (74%) will be spending cuts and £29 billion will be tax increases. (Comparable figures for 2015–16 are £128 billion, £99 billion, 77% and £29 billion respectively.)

This approach places a huge amount of faith in one particular economic view: that private spending is being held back by worries about the scale of government borrowing. George Osborne believes that a promise to eliminate the structural current budget deficit over the next four years will encourage households to spend and companies to invest, and that this extra activity will offset contraction in the public sector.

The risk is that, with confidence still fragile after the recent recession, households will react to the increase in VAT and the prospect of hundreds of thousands of jobs being lost in the public sector with more caution, not less. And if households are not spending – and demand is weak in the euro zone, the UK's main export market – companies will be reluctant to invest. The Chancellor may be doing too much too soon to reduce borrowing and the tentative economic recovery could be snuffed out. A recent study of previous episodes of deficit reduction by the IMF[2] suggests rapid deficit reduction has a negative effect on growth – and the effect is likely to be larger when all the major nations are cutting at the same time. This led the *Economist*[3] to conclude that George Osborne has not got the overall fiscal stance right. Whatever the Chancellor says, there is always an alternative.

1 As set out in the June 2010 Budget, www.hm-treasury.gov.uk/2010_june_budget.htm
2 *World Economic Outlook*, October 2010, chapter 3, www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf
3 *Economist*, 2 October 2010: 14–15

The ippr alternative plan

1. Maintain investment on capital projects

George Osborne basically accepted the spending plan for net investment that was set out by Alistair Darling in his last budget. This plan envisaged sharp reductions in spending over the next five years.

Table 1
Net investment – June 2010 Budget

	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
£ billion	49.0	39	27	24	20	21	21
% of GDP	3.5	2.6	1.8	1.5	1.2	1.2	1.1

Both Chancellors are following the example set by their predecessors: when cuts in spending are needed, make them first to capital spending. This can be the easy option politically, particularly when it involves cancelling projects that have not yet been started (and so are less likely to be missed).

But it is not the correct economic option. **Capital spending – including building schools and hospitals and developing high-speed rail-links – means investing in assets that will support the future growth of the economy.** It might have to be financed by increased government debt, but that debt will be matched by the acquisition of assets. **Cutting capital spending aggressively not only puts growth at risk in the short-term, but over time it could lower the potential growth rate of the UK economy.**

The last government boosted investment spending in 2008–09 and 2009–10 to support the economy during the recession, and it would not be appropriate to maintain these artificial levels. Our proposal is that **spending should not fall below 1.8% of GDP** – this is the level currently planned for 2011–12 and the level it was at in 2005–06, before the onset of the financial crisis.

Table 2
Net investment – ippr alternative proposal

	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
£ billion	49.0	39	28	29	31	32	34
% of GDP	3.5	2.6	1.8	1.8	1.8	1.8	1.8

2. Reduce the underlying deficit more slowly

George Osborne proposes eliminating the cyclically-adjusted deficit on the current budget (that part of the deficit that will not go away even when the economy is operating at full capacity) by 2014–15. The actual deficit on the current budget is eliminated one year later, in 2015–16.

Table 3
Cyclically-adjusted surplus on current budget – June 2010 Budget

	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
£ billion	-75	-71	-49	-31	-12	5	15
% of GDP	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8

Osborne argues that aggressive action is needed, in light of the Greek government's debt crisis earlier this year, to maintain the confidence of bond markets and the UK's AAA credit rating. In fact, there are few similarities between the Greek and UK positions. Government debt is much higher in Greece and of much shorter average duration than in the UK. There is little to suggest that bond investors were demanding tougher action than that proposed in the last Labour budget. **A credible plan to reduce the deficit more slowly would still command the support of investors** in government debt and, crucially, would also reduce the risk of the economy relapsing into a period of very sluggish growth because government support is withdrawn too quickly.

The previous government's plan was to halve public sector net borrowing (which adds net investment spending to the actual deficit on the current budget) as a percentage of GDP between 2009–10 and 2013–14. On current figures, this would necessitate reducing it from 11% to 5.5%. Osborne plans for public sector net borrowing of 3.5% in 2013–14 – a difference of 2% of GDP, or around £34 billion.

However, Osborne has chosen to focus on the deficit on the current budget, rather than on public sector net borrowing, and he is right to do so. There is an important difference between borrowing to fund investment spending, which involves acquiring assets, and borrowing to fund current spending. Osborne also focuses on the cyclically-adjusted measure of the deficit. This has one major advantage: it avoids the need to make extra cuts should economic growth weaken and the actual deficit turn out larger than forecast. It does, however, rely on the ability of the Office for Budget Responsibility to identify what part of the deficit is due to the weakness of the economy and what part due to the accumulation of past policy decisions – a difficult task.

In this context, therefore, the alternative to Osborne's plans involves a slower elimination of the cyclically-adjusted deficit on the current budget. **Instead of reducing this deficit to zero over a four-year period, by 2014–15, it should instead be eliminated over six years, by 2016–17.**

Table 4
Cyclically-adjusted surplus on current budget – ippr alternative proposal

	'09–10	'10–11	'11–12	'12–13	'13–14	'14–15	'15–16	'16–17
£ billion	-75	-71	-62	-52	-41	-29	-15	0
% of GDP	-5.3	-4.8	-4.0	-3.2	-2.4	-1.6	-0.8	0.0

On the basis of the numbers in the June Budget, the actual deficit on the current budget would be 4.0% of GDP in 2013–14. So, if net investment spending were 1.8% of GDP, public sector net borrowing would be 5.8% – just a little more than half its level in 2009–10.

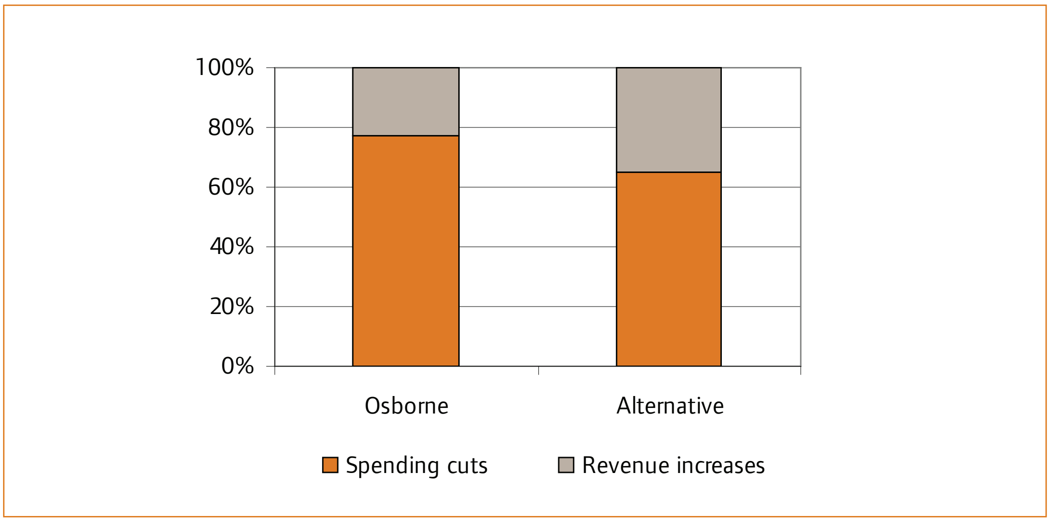
3. Target a 65:35 mix of spending cuts and tax increases

Following George Osborne's budget, tax changes are expected to raise £29 billion by 2015–16. This is the result of measures announced by the previous government, such as higher taxes for those at the top of the income distribution and the increase in the standard rate of VAT from 17.5% to 20% in January 2011. Some politicians and analysts have spoken of these measures as though they may be temporary: the reality of the fiscal situation is that all sides need to accept that they will not be reversed for many years.

By 2015–16, under Osborne's plans, 23% of the deficit reduction will have been achieved through higher taxes and 77% through spending cuts. Under the ippr alternative plan, assuming the same revenue measures, **65% of deficit reduction would be achieved through spending cuts and 35% through tax increases**.

Beyond 2015–16, our proposal would be to maintain this ratio at 65:35. This means that additional revenue-raising measures would have to be implemented over the next two years. These might include a comprehensive carbon tax and a wealth or property tax, as well as a higher levy on the financial sector.

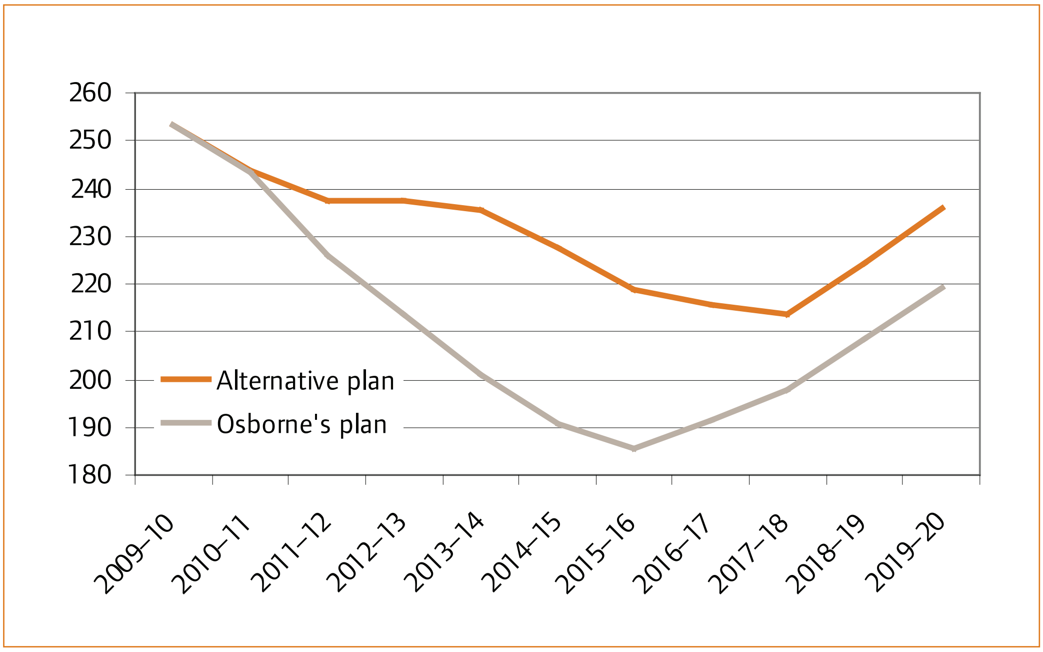
Figure 1
Consolidation by spending and tax (to 2015–16)



4. Do not ring-fence spending on the NHS

Cutting the underlying deficit more slowly would reduce significantly the scale of public spending cuts needed over the next four years. Departmental spending would suffer a real cut of 4% over the period from 2010–11 to 2014–15, rather than the 13% cut implied by George Osborne's budget. In part, this is because some of the spending cuts would be delayed into the next three years; in part it is because the overall scale of cuts would be lower.

Figure 2
Real departmental spending (£billion)



Figures for "Osborne's plans" beyond 2015–16 are illustrative only, as budget numbers end in 2015–16

These projections are based on the numbers for annual managed expenditure that were included in the June Budget, except that an allowance has been made for the higher level of public debt, and the higher interest payments, that would follow from implementing a slower timetable for deficit reduction.

Even allowing for a slower pace of departmental spending cuts, **it is a mistake to ring-fence large areas of spending**. The Labour government promised to protect spending on schools, the police and the NHS from cuts in real funding; the Coalition government will protect spending on the NHS and will increase spending on international development to 0.7% of GDP by 2013–14. This creates enormous pressures on other areas. Health spending is 17.5% of total government spending and 32% of departmental spending: protecting it from a 10% aggregate cut in spending means other departments must, on average, suffer cuts of 15%.

The only pledge that we would preserve is higher funding for international development, not because it is a relatively small amount of spending (although it is) but in recognition of the urgency of providing more funds to low-income countries hit badly by a financial crisis not of their making.

However, removing ring-fencing does not mean that it would be right to 'salami-slice' spending by the same amount across all departments. Tough political decisions would still have to be made to determine the scale of cuts allocated to each department. Changes that we would support include reducing the number of prison places and cutting back on teaching assistants in classrooms where they have been shown to add little to educational outcomes.

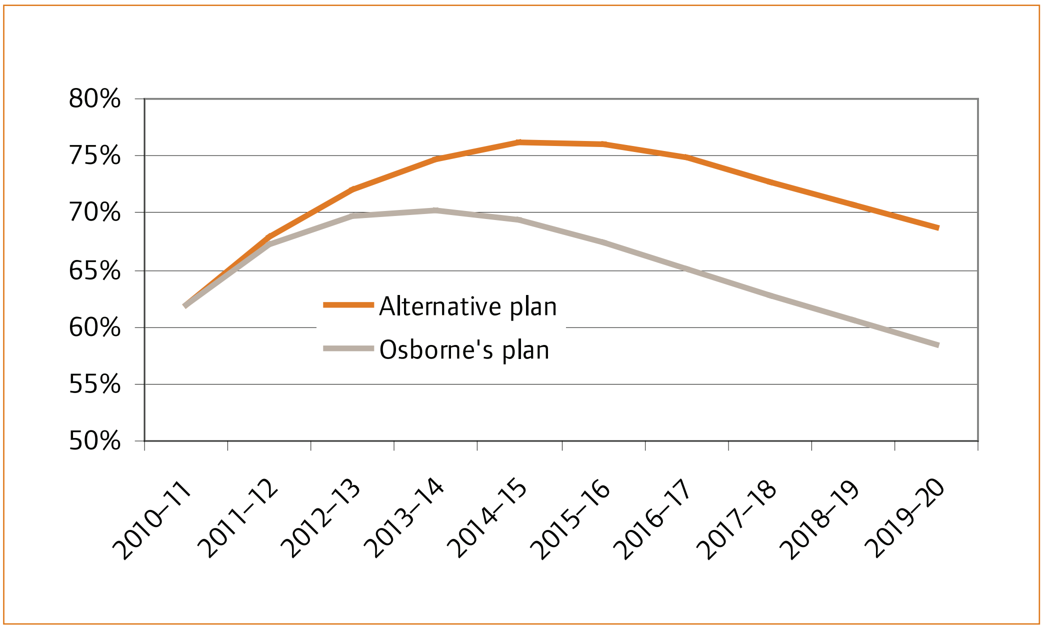
We estimate that, under our plan, no department would need to bear a real cut in spending of more than 10% over the next four years, compared to an average cut of potentially 25% for non-protected departments under Osborne's plans.

As the Coalition has made clear, cutting welfare payments further potentially allows departmental spending to be higher. While we do not agree with the Government's proposal to stop paying Child Benefit to families that include a higher rate taxpayer, we support the idea of taxing the benefit. Similarly, we support taxing winter fuel allowances for better-off older people. The principle of universal benefits is an important one, ensuring that every household feels it has a stake in the welfare system, but that is not to say that better-off families should receive the same level of Child Benefit or winter fuel allowance as poorer families. **Taxing these benefits would ensure that families always keep a proportion of any increase in income**, which will not be the case under the Government's proposal.

Implications for debt and debt interest payments

ippr's alternative plan would reduce the budget deficit more slowly than George Osborne proposes. That means more borrowing in the short-term, which in turn means a higher trajectory for public debt. Our calculations suggest that, under our alternative plan, **debt would peak at 76% of GDP and would be on a downward path by 2016–17**. This compares to a peak of 70% in Osborne's budget, which would see debt falling by 2014–15.

Figure 3
Public sector net debt (percentage of GDP)



The IMF publishes figures on a slightly different basis, but its latest assessment[4] suggests that the UK's net debt in 2015 (based on currently announced policies) would be 76% of GDP – putting it fifth-highest in the G7. The alternate plan would probably shift the UK one place higher. But debt in 2015 would still be lower than in Japan, the United States and Italy.

Table 5
Net general government debt (2015)

	% of GDP
Japan	153
Italy	100
United States	85
France	79
United Kingdom	76
Germany	62
Canada	32

Carmen Reinhart and Ken Rogoff (economics professors at the University of Maryland and Harvard respectively) have studied the effects of government debt on growth and they concluded that only when debt exceeds 90% of GDP does it have a clear negative impact on growth. Below this level the relationship between debt and growth is weak.[5] Under ippr's alternative plan, debt peaks at a level comfortably below this threshold.

Higher debt would, however, entail higher debt interest payments. These would be around £6 billion by the end of the official forecast period in 2015–16 and £12 billion, or 0.5% of GDP, by 2019–20 (assuming no effect on the level of interest rates). Of these extra payments, roughly 40% would reflect higher investment spending and 60% a slower pace of reduction in the current deficit.

4 *World Economic Outlook*, October 2010, table A8 www.imf.org/external/pubs/ft/weo/2010/02/pdf/tables.pdf#page=17

5 Reinhart C and Rogoff K *Growth in a Time of Debt*. www.nber.org/papers/w15639

Figure 4
Additional public spending in ippr alternative plan (£billion)