BRIEFING

Deficit Reduction Averaging

A Plan B for fiscal tightening

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March 2011

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Acknowledgments

We are grateful for comments on an earlier version of this paper from David Claydon, Dan Corry, Nick Pearce, Howard Reed and Duncan Weldon.

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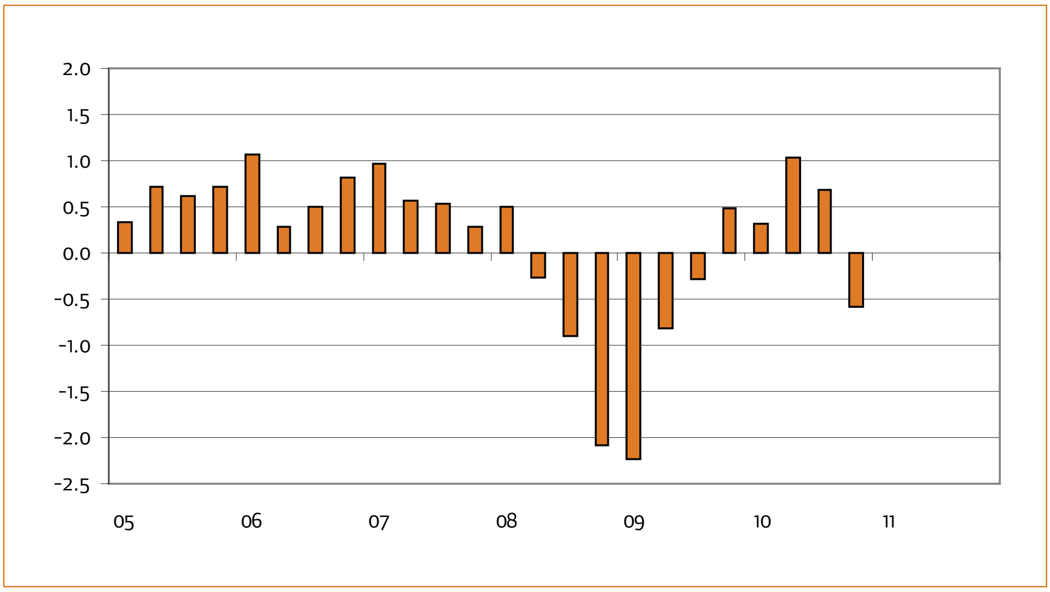
Introduction

In recent weeks, the news that the UK economy shrank by 0.6 per cent in the final quarter of 2010 – together with Richard Lambert, the outgoing head of the Confederation of British Industry, berating the government for not having a plan for economic growth – has reawakened the debate about the pace of deficit reduction.

Figure 1
Real GDP growth (quarterly change, %)



Critics of the Coalition's approach to deficit reduction – and we would include ourselves among their number – believe this contraction of output, even allowing for the effect of bad weather in December, suggests the economy is too weak to cope with the substantial tax increases and public spending cuts scheduled for 2011. GDP growth this year is likely to be below trend as household spending power is squeezed by large increases in food and energy prices. The increase in VAT, higher national insurance contributions and large cuts in public spending will make matters worse. It is true that manufacturing output grew very rapidly during 2010, and has maintained this momentum into the early months of 2011, but should the eurozone's problems worsen and sterling appreciate against the euro, it will prove difficult to sustain this performance. In any case, manufacturing now makes up only one-sixth of UK output. What happens in the much bigger service sector is more important, and it is here that the effects of the squeeze on household spending power will be most apparent.

These concerns were reflected in comments made last year by the Secretary of State for Energy and Climate Change, Chris Huhne, who suggested that deficit reduction in the UK could be slowed should economic conditions demand.[1] More recently, the Institute for Fiscal Studies and the National Institute for Economic and Social Research have argued that the Chancellor needs a 'Plan B'.[2] However, George Osborne is considerably less flexible, and has regularly stated that there is no Plan B, nor will there be. He has even gone so far as to suggest that should the economy weaken, the imperative to press ahead with a deep fiscal consolidation will be all the greater in order to maintain market confidence.[3]

Notwithstanding the Chancellor's resolute stance, this paper asks what form a Plan B might take should GDP growth in 2011 (or at any point during the deficit reduction programme) turn out to be so weak that unemployment starts to rise significantly. We do not consider what might be required should the economy face another severe recession or a genuine liquidity trap. In those circumstances, the case for another round of coordinated monetary and fiscal stimulus would be very strong. Instead, we consider whether fiscal policy could be adjusted if the risks of sustained poor growth appear to have increased.

1 Winnett and Riddell 2010. More recently, he has drawn attention to the risk of a 1970s-style oil shock (Wintour 2011).
2 Guardian 2011, Inman 2011
3 Boxell 2011

Under such conditions, we believe any shift in fiscal policy would have to meet two criteria.

- First, it would need to maintain market credibility by convincing those holding or purchasing gilts that the government still has a credible medium-term plan to reduce the deficit in a transparent and methodical fashion (and not by inflating it away).
- Second, it would, nevertheless, need to incorporate some degree of flexibility to allow the process of deficit reduction to be slowed, or even halted, while the economy remained weak but then speeded up when output and job creation recovered.

In short, any Plan B would need to fulfil the difficult task of combining economic sensitivity with market sensitivity.

This paper assesses the extent to which the plans of the Coalition government and of the previous Labour government[4] meet these criteria. It then goes on to propose an alternative approach. It has nothing to say about the balance between spending cuts and tax increases as the means of achieving deficit reduction, although we acknowledge that these could have a bearing on market and economic sensitivity. The approach is independent of the date set for eventual elimination of the deficit – however, we do believe the current government is proceeding too rapidly and so we show how our approach would work based on a slower timetable.

Current plans

The Chancellor's deficit reduction plan is designed almost entirely around the notion of market sensitivity, with barely a passing nod to economic sensitivity. He has two targets:

- To eliminate the deficit on the cyclically adjusted current budget by 2015/16
- To have net public debt falling as a percentage of GDP, also by 2015/16

Because he has chosen to focus first on the cyclically adjusted (or structural) current budget, the Chancellor has allowed some room for the 'automatic stabilisers' to work. The cyclical part of the deficit can be allowed to increase if the economy grows less rapidly than anticipated, benefit payments exceed expectations and tax revenues fall short. In addition, while the Chancellor's target calls for the elimination of the structural deficit by 2015/16, his plan is to achieve these goals one year early, by 2014/15. He has, therefore, provided himself with some flexibility should it prove impossible or unwise to meet the 2014/15 target.

However, the extent of any room for manoeuvre is constrained by his second target, because any extra borrowing, whether cyclical or structural, would affect the level of public net debt. The economic sensitivity of the Chancellor's plans is, therefore, limited.

The last Labour government's alternative, as originally presented by Alistair Darling in 2009, seemed similarly to be driven largely by market sensitivity. Although much is now made of the fact that the opposition to cuts in 2010 and the longer timescale for deficit reduction, relative to the Coalition's plans, indicated greater economic sensitivity, Labour did not seem to have in place any mechanism for slowing or halting the pace of deficit reduction should economic conditions deteriorate.

The Labour government set itself the task of halving public sector net borrowing, as a share of GDP, by 2013/14 from its projected peak in 2009/10. It also aimed to have public sector net debt falling as a share of GDP by 2015/16. This was enshrined in law in the Fiscal Responsibility Act 2010 and would seem, on the face of it, to be a particularly insensitive approach, economically speaking, to deficit reduction. The Act makes no reference to suspending or slowing the pace of deficit reduction should the economy slow. Indeed, in the Parliamentary debate on the Act, government ministers made a virtue of the fact that any deviation from the plan would only be possible through subsequent primary legislation. A Liberal Democrat amendment to give the Chancellor the right to suspend the plan in the event of a return to recession was opposed by the government and defeated (which some will find highly ironic given Liberal Democrat support within the Coalition government for faster deficit reduction). Furthermore, the decision to focus on unadjusted public sector net borrowing left no room for the automatic stabilisers to operate should there be a slowdown.

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4 Recent statements by senior Labour figures suggest the party maintains its commitment to Alistair Darling's deficit reduction plans as outlined during 2009. As such, we have taken this as broadly the official policy of the opposition for consideration as the main alternative on offer to government plans.

However, since the general election, some members of Labour's front-bench team have claimed there was in fact an element of economic sensitivity built into Darling's plan.[5] They appear to be referring to a clause in the Act which stated that any duty imposed on the Treasury by the Act 'must be consistent with the key principles as applied by the code for fiscal stability'. This code, which was originally laid before Parliament in 1998 and subsequently redrafted in 2010, requires the government to operate fiscal policy in a way that is 'consistent with the central economic objective of high and stable levels of growth and employment'.[6] So, they suggest, the Treasury had written a get-out clause into the Fiscal Responsibility Act should growth and employment have proved to be less than 'high and stable'.

Sensitive enough?

Both parties' plans appear, therefore, to contain a limited degree of economic sensitivity, but is that enough if economic output proves so weak that unemployment starts to increase persistently?

In the Darling plan, there is no clarity about what criteria would be employed to determine when the Treasury might allow deficit reduction to deviate from its course, because the wording in both the Fiscal Responsibility Act and the Code for Fiscal Stability is exceptionally vague.

The plan places a huge political obstacle in the way of achieving economic sensitivity. If the economy slows, a very deliberate decision by the Chancellor – and possibly parliamentary approval – would be required before the deficit reduction plan could be abandoned, even for a short period of time. This is a high political bar for any government and the key would be convincing financial markets that there was a real need for slower deficit reduction. It would need a cast-iron case to avoid putting its deficit-reducing credentials at risk. As a result, any decision would probably be delayed, even in the face of pressing economic conditions, thus making matters worse.

It is hard to avoid the impression that the plan was designed to impress the markets and the electorate of the government's hawkish credentials, but that it would have operated with far less clarity and speed in a scenario where the economy slows and a fiscal response might be appropriate.

George Osborne's plan, on the other hand, gives the appearance of an approach that has more carefully incorporated economic sensitivity into its workings. The government could remain on course to achieve its primary target while still allowing the automatic stabilisers to operate and possibly delaying by one year the date when the targets are achieved.

However, this plan is still insensitive to poor economic conditions should they demand anything more than could be delivered by automatic stabilisers and some minor re-profiling. If growth slowed and unemployment rose so that discretionary stimulus was required (thus forcing the government off its fiscal path), it is not clear that the Chancellor could survive the blow to his political credibility that would be involved in making such an adjustment. Any reversal of policy would, therefore, be tortuous and challenging.

George Osborne has not placed the legal obstacles in the way of economic sensitivity that Alistair Darling may have, but he has created a much larger political obstacle than existed before. This is a state of affairs exacerbated by the decision to outline a detailed Budget in June 2010 that spans the full five years of the Parliament and explains every spending cut and tax rise planned to reach the fiscal targets for 2014/15. This clearly makes any deviation from these plans look like a U-turn, and so raises the political stakes of any response to weakening economic conditions. Indeed, it seems to make it even more difficult for the Chancellor to take advantage of the opportunity for re-profiling he appears to have built into his plan.

5 See for example Byrne 2010
6 It will, however, be repealed when the Budget Responsibility and National Audit Bill receives royal asset.

'Deficit reduction averaging'

There is an alternative approach to the Darling and Osborne plans that combines both market and economic sensitivity in a simple and transparent fashion.

To achieve this, we suggest adopting an approach we have called 'deficit reduction averaging'. Under this plan, the government would commit to eliminating the structural deficit[7] by a particular financial year through a mixture of spending cuts and tax increases, with the pain initially planned to be spread evenly over the life of the deficit reduction plan. Then, in each subsequent year, the required annual reduction would be recalculated, based on the actual deficit in the latest fiscal year.

In addition, should the outlook for the economy deteriorate, the government could reduce the pace of deficit reduction until economic conditions improve, at which time the pace would be speeded up in order to return the plan to target.[8] This ensures economic sensitivity.

In effect, the Treasury would set an overall target to eliminate the deficit by a set date by achieving an *average* reduction in the size of the deficit each year. Because the goal for each year is an average of the remaining reduction required, rather than a pre-determined annual target (as in the current government's plans), there is greater opportunity to change the pace and depth of consolidation in response to short-term economic fluctuations.

This approach would still require the government to establish clear spending and tax plans designed to meet each year's fiscal target, together with an overall plan for medium-term deficit reduction. But the pace of reduction would be varied in response to different outcomes for the economy.[9]

Some may fear that this approach would reduce market sensitivity because the fiscal plans it implies appear less detailed and certain than those outlined by the Coalition government. However, the rigidity of the current plans is only a virtue if they appear to be working. Should economic conditions worsen considerably then the inability of the government to adapt its plans to changing circumstances might prove disturbing to financial markets. Market sensitivity certainly requires a clear target for the elimination of the structural part of the deficit, but markets are also aware that moving too fast can weaken the economy and lead to a wider cyclical component. So it should be possible to calibrate the pace of deficit reduction within an overall timeframe established by a medium-term target, without risking damage to the credibility of the government and its ability to restore fiscal balance.

Nevertheless, it is important to recognise that bond investors would be wary of any plan that lacked detail and might be more susceptible to deviation for political gain. There would, therefore, be an important role for the independent Office for Budget Responsibility (OBR), which would be charged with establishing the economic outlook and determining the appropriate pace of deficit reduction in the short-term. It would also ensure that the government's medium-term plans remain on course to achieve the ultimate target of eliminating the structural deficit by the specified date.

Only in the case where the economy performs very badly – when the pace of deficit reduction required during the remaining years of the plan might be prohibitively high – might the medium-term target be reviewed. This could be seen as taking a risk with market sensitivity. However, such difficult circumstances would present huge challenges to any deficit reduction plan whatever its structure and targets and would demand a significant deviation from overall targets. In this sense, deficit reduction averaging is no different from the Osborne or Darling plans. In fact, it has the advantage that the government's approach is clearly set out in advance, thereby reducing uncertainty.

Deficit reduction averaging in practice

The latest OBR forecasts show cyclically-adjusted public sector net borrowing (PSNB) will be 7.6 per cent of GDP in 2010/11, while the cyclically-adjusted deficit on the current budget will be 4.7 per cent (the difference between the two being accounted for by net investment). On the

7 Targeting the structural deficit is not ideal: it is not directly observable and so requires economists' estimates of the amount of spare capacity in the economy. But targeting the actual deficit does not allow the automatic stabilisers to operate, which we believe to be a more significant drawback.

8 It should be emphasised that this approach is totally symmetrical. If growth is expected to be strong, the pace of deficit reduction could be stepped up.

9 Given that public spending is set three or four years in advance, this adjustment would, at least initially, be mainly on the tax side.

government's plans, by 2015/16 cyclically adjusted PSNB will be 0.3 per cent and there will be a 0.9 per cent surplus on the current budget (so net investment will have fallen from 2.9 per cent to 1.2 per cent of GDP).

Table 1
Cyclically-adjusted deficit measures – George Osborne's plan (percentage of GDP)

	'10/'11	'11/'12	'12/'13	'13/'14	'14/'15	'15/'16
Current budget	4.7	3.3	1.8	0.5	–0.5	–0.9
PSNB	7.6	5.3	3.5	1.9	0.8	0.3

We believe that the government is right to aim for a surplus on the current budget, but that the planned pace of reduction in the next two years (equal to almost 3 per cent of GDP) is unnecessarily fast. We also think it is wrong to cut investment spending so aggressively.[10] In the medium-term, investment spending lifts the potential growth rate of the economy. We believe it should not be allowed to fall below 2 per cent of GDP – its level in 2007/08, before the onset of the financial crisis. Our proposal, therefore, would be for a baseline that eliminates the deficit on the cyclically-adjusted PSNB and shifts to a 2 per cent of GDP surplus on the current budget, but adopts a more moderate pace of deficit reduction, particularly over the next two years.

Table 2
Cyclically-adjusted deficit measures – deficit reduction averaging (percentage of GDP)

	'10/'11	'11/'12	'12/'13	13/14	'14/'15	'15/'16	'16/'17	'17/'18
Current budget	4.7	4.5	3.4	2.3	1.2	0.1	–1.0	–2.0
PSNB	7.6	6.5	5.4	4.3	3.2	2.1	1.0	0.0

One consequence would be a higher path for the debt:GDP ratio over the next few years, although it would stay well below the ratio in other triple-A rated economies, including France.

What is more important, however, is that we would alter the pace of deficit reduction if the actual deficits in early years are different from forecasted levels or if economic circumstances demand it, while retaining the target for 2017/18. So, if cyclically-adjusted PSNB for 2011/12 was 5.4 per cent, rather than 6.5 per cent, and the OBR decided that GDP growth in 2012/13 was likely to be between 1.5 and 3 per cent after allowing for the effect of spending cuts and tax increases (its latest forecast is 2.7 per cent), the required pace of deficit reduction would be cut to an average of 0.9 per cent (5.4 divided by 6) from 1.1 per cent.[11] In addition, if lower growth was expected then there would be less deficit reduction, while faster growth would lead to greater reduction.

The deficit reduction averaging plan, therefore, has five key implications for economic management:

1. The cyclically-adjusted PSNB will be zero in 2017/18 – on current projections, this will require a 7.6 per cent cut in the cyclically-adjusted PSNB over seven years from its 2010/11 level.
2. From 2010/11, the cyclically-adjusted PSNB will be reduced by 1.1 per cent of GDP each year on average to achieve the overall 7.6 per cent cut.
3. In any year, this 1.1 per cent target will be reduced if, in the judgment of the OBR, the fulfilment of such a target would lead to an annual growth rate below 1.5 per cent. Conversely, it will be increased if growth is expected to be above 3 per cent.
4. In each year, subject to a satisfactory outlook for growth, the annual average target reduction will be reappraised based on the latest actual data, so that the plan stays on course to hit the 2017/18 cyclically-adjusted PSNB target of zero.
5. If the 2017/18 cyclically-adjusted PSNB target of zero cannot be met without reducing annual GDP growth below 1.5 per cent, then the total length of the deficit reduction programme may be extended.

By allowing a slower pace of deficit reduction in the next few years, the averaging approach would raise the prospects for growth in later years and so reduce the likelihood of the target of a zero PSNB in 2017/18 being missed than would otherwise be the case.

10 The last Labour government also planned a similar reduction in investment spending.

11 Based on the data to January, it appears the 2010/11 PSNB will be around £10 billion lower than previously forecast. If this is judged by the OBR to be structural, future deficit reduction would be fractionally slower over the next seven years under our plan.

In comparison with the Chancellor's plan, and the former Labour government's proposal, we believe our approach comes much closer to meeting the first two of IMF Chief Economist Olivier Blanchard's '10 commandments' for fiscal adjustment:[12]

1. 'You shall have a credible medium-term fiscal plan with a visible anchor (in terms of either an average pace of adjustment, or a fiscal target to be achieved within four to five years).
2. You shall not front-load your fiscal adjustment, unless financing needs require it.'

Conclusion

The approach of 'deficit reduction averaging' would allow the government to combine reassurance for the markets that an overall target for eliminating the fiscal deficit is in place with some freedom for the government, guided by the OBR, to recalibrate the pace of tax rises and spending cuts in the event that growth in the UK economy deviates significantly from expectations. Weaker growth would lead to a more moderate pace of deficit reduction; faster growth to an acceleration.

If this approach is combined with a slower pace of deficit reduction in the next few years, the likely result would be stronger GDP growth over the medium term, which will help to reduce the deficit in the long run.

The chances of the government adopting such an approach at this time are very slim, as the Chancellor and Prime Minister have persistently ruled out the need for any 'Plan B'. It would require significantly poor economic performance and probably major political upheaval (including a new Chancellor) for this approach to be adopted. Indeed, it is inherent in our argument that George Osborne has made a serious mistake by adopting an approach that makes it exceptionally hard for him to change his plans.

However, we believe there is considerable merit in the notion of 'deficit reduction averaging'. In light of the shocking GDP data for the fourth quarter of 2010, the economic outlook is more uncertain and seemingly more volatile than expected. If growth continues to disappoint, and the government struggles to achieve its fiscal targets, then a more economically sensitive approach will become all the more relevant.

12 Blanchard and Cottarelli 2010

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