

The UK Government's Fiscal Strategy

C. Smewing*

Over the pre-crisis decade, developments in the UK economy were driven by unsustainable levels of private sector debt and rising public sector debt. The pattern of unbalanced growth and excessive debt was revealed by the financial crisis and has helped create exceptional economic and fiscal challenges.

This presentation explains how the imbalances developed, and sets out the action the Government is taking to tackle the fiscal position, through carrying out a comprehensive deficit reduction plan and reform of the fiscal framework. Other steps the Government is taking to provide the conditions for sustainable, balanced and private-sector led growth, including through reform of financial regulation and reform of the supply side of the economy though *The Plan for Growth* are not covered in detail.

Keywords: United Kingdom, fiscal policy, government debt, financial crisis crisis

1. Unsustainable Growth

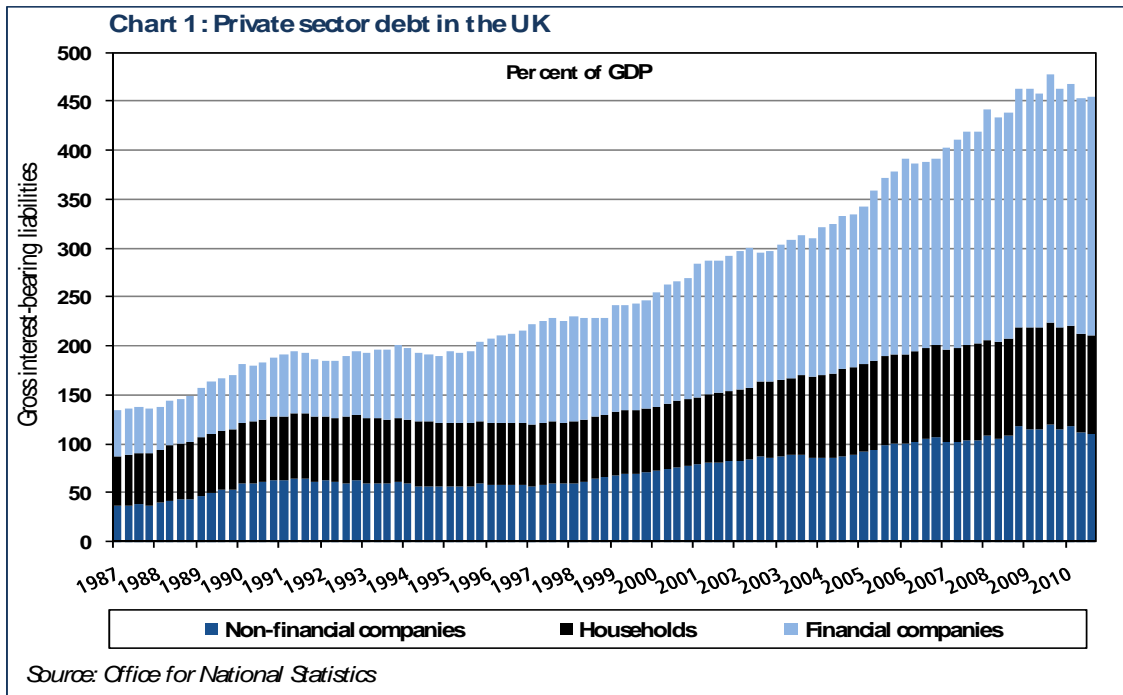
In recent years, economic growth in the UK has been underpinned by the accumulation of unsustainable levels of private sector debt and rising public sector debt.

Chart 1 highlights the rise in private sector debt in the UK. Households took on rising levels of mortgage debt to buy increasingly expensive housing, while by 2008 the debt of non-financial companies reached 110 per cent of GDP. Within the financial sector, the accumulation of debt was even greater. By 2007, the UK financial system had become the most highly leveraged of any major economy.

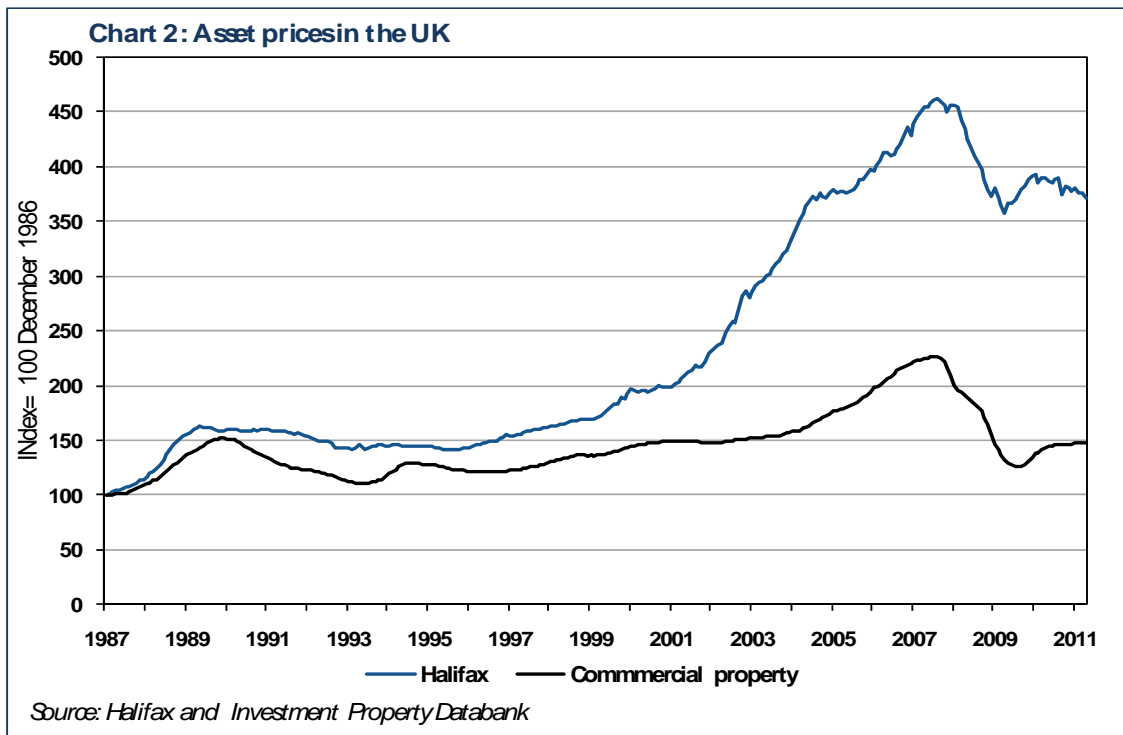
While rising debt was an international phenomenon, it was more pronounced in the UK than in most other countries. It has been estimated that the UK has become the most indebted country in the world¹.

The unsustainable accumulation of private debt contributed to inflated property bubbles, with property prices rising steeply in the decade preceding the financial crisis, (see Chart 2). This trend was particularly clear in the prices of residential property, which in 2007 were four and a half times as high as in 1987.

1 Debt and deleveraging: The global credit bubble and its economic consequences, McKinsey Global Institute, January 2010.



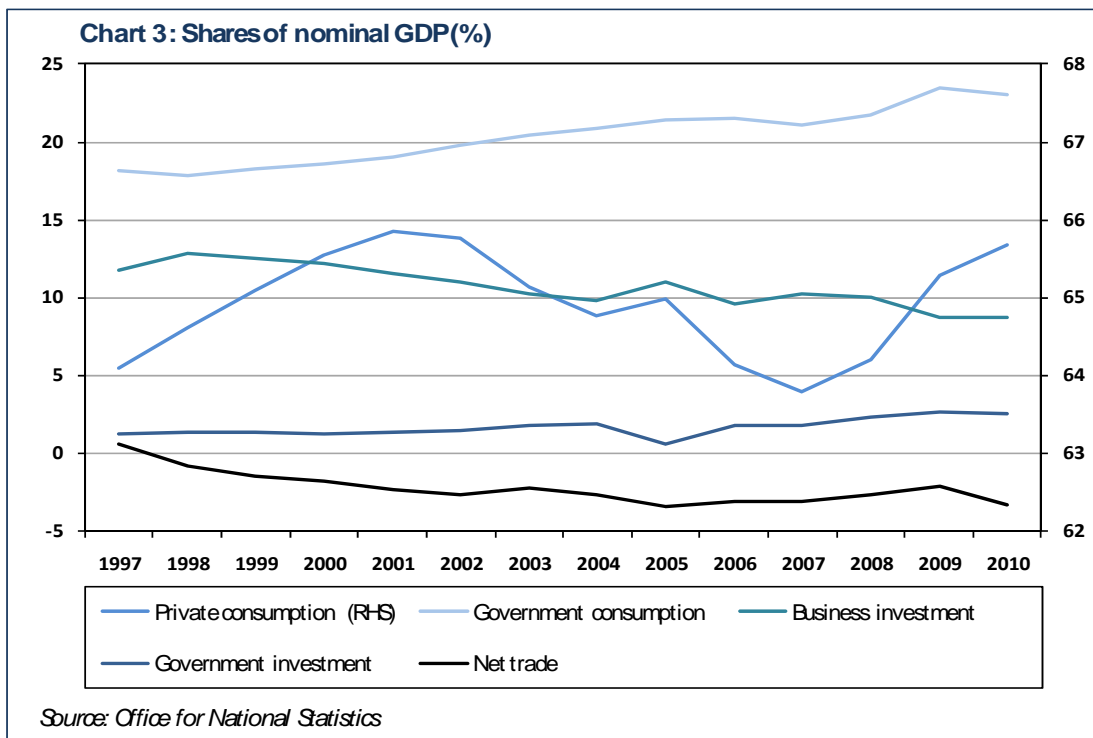
As the Office for Budget Responsibility (OBR) have stated, over the past decade the UK household sector has, in aggregate been a net borrower, with the sum of household consumption and investment exceeding income. Over this period "households increased their residential investment spending – effectively borrowing money to purchase increasingly expensive houses".²



² OBR (November 2010), Economic and Fiscal Outlook.

Increasing reliance on debt-financed consumer and government spending and on the financial sector also drove growing imbalances elsewhere in the UK economy. From 2001 onwards public spending grew steadily as a share of the economy and a structural deficit began to emerge. According to the OECD, by 2007 the UK had the largest structural budget deficit in the G7³. Public and private sector borrowing relied on finance from abroad. The UK's current account went from near balance in 1997 to a deficit of more than 3 per cent of GDP by 2006, which was, in absolute terms, the third largest in the world. The current account deficit was around 2¾ per cent of GDP in 2007, a figure that was flattered by a 2¼ per cent surplus on trade in financial services.

Between 1997 and 2007, government consumption increased from 18 to 21 per cent of GDP, while business investment fell from 11¾ to 10¼ per cent of GDP (see Chart 3). The recession has only compounded these imbalances, with government consumption accounting for 23½ per cent of GDP in 2009 and business investment falling over 25 per cent from its peak, to trough at just 8¾ per cent of GDP.



Between 2002 and 2007 there was a near tripling of UK bank balance sheets⁴ and the UK financial system had become the most highly leveraged of any major economy in 2007. As a result, the UK was particularly vulnerable to financial instability and was hit hard by the financial crisis. The loss of confidence and withdrawal of credit that followed precipitated the deepest and longest recession since the Second World War: output fell just under 6½ per cent according to the Office for National Statistics (ONS). More than a

3 OECD (May 2011), *Economic Outlook No. 89*, OECD.

4 Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 16 June 2010.

quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009.

2. Public Sector Imbalances

In addition to the trend described within the private sector, imbalances in the public sector also built up over a number of years. In the UK, a property boom and unsustainable profits and remuneration in the financial sector in the pre-crisis years drove rapid growth in tax receipts. The spending plans set out in the 2007 Comprehensive Spending Review were based on these unsustainable revenue streams, and on assumptions about trend economic growth that were later revised down significantly⁵.

The level of UK economic activity in current prices (money GDP) is estimated to be around 10 per cent lower in 2010-11 than it was forecast to be at Budget 2008. In other words, the economy is now around 10 per cent smaller than it was forecast to be only three years ago, reducing the resources available for government spending.

As tax receipts fell away during the crisis, the persistent gap between spending and revenue widened, with total public spending rising to around 47½ per cent of GDP by 2009-10.

Chart 4 later in this paper shows both the persistent gap between spending and revenue in the pre-crisis years, and the dramatic widening of that gap in more recent years. The result has been to leave the UK with one of the most rapidly deteriorating fiscal positions of any major economy. This unsustainable fiscal position is a key economic vulnerability, reinforcing the case for urgent action to put the UK's public finances back on a sustainable footing.

This vulnerability is exacerbated by the interaction between the fiscal position and UK's large financial sector. As the IMF have noted, "*any renewed turbulence in sovereign debt markets could trigger an adverse feedback loop between sovereign debt markets and the financial sector, inflicting major damage on the recovery.*"⁶ The Government is undertaking domestic reforms to counter such risks; including action to tackle the budget deficit but also radical reforms to the financial regulatory framework. Domestic reforms in the financial services sector are, moreover, complemented by a historic set of international reforms agreed by the Seoul G20 meeting in November 2010.

5 For example, the March 2010 Budget estimated that trend growth between mid-2007 and mid-2010 would average just under 1 per cent, as a result of the financial crisis (and for trend growth to return to 2¾ per cent beyond mid-2010) – compared to a central assumption of 2¾ per cent a year assumed at the 2007 Comprehensive Spending Review. The OBR's forecast at June Budget 2010 was based on the judgment that the current level of trend output was lower still than assumed in the March Budget. See 'Box 1.4': Output gap assessment' of June Budget 2010.

6 IMF (October 2010), *World Economic Outlook*.

3. Role for Government

Given the challenges set out, there is a need for the UK to move away from unbalanced growth reliant on a narrow range of sectors, unsustainably high government spending and an unsustainable accumulation of private debt, which inflated asset prices and ultimately paved the way into the banking crisis and sharp falls in output.

The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries. The Government has announced action to meet this objective. Providing the right macroeconomic conditions will help correct the imbalance between the public and private sectors that built up over a number of years, underpinning a sustainable recovery.

Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimizing risks to the recovery. The Government has set out a strategic policy response to the UK's exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK's post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;
- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government's ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

The Government has been clear that it is committed to delivering deficit reduction, while continuing to ensure economic recovery. The historically high level of public borrowing risked undermining fairness, growth and economic stability in the UK. A plan was therefore needed to accelerate deficit reduction and bring debt as a share of the economy under control in order to restore sustainability to the public finances. Tackling the budget deficit is essential to:

- reduce the UK's vulnerability to further shocks or a loss of market confidence, which could force a much sharper correction;
- underpin private sector confidence, supporting growth and job creation over the medium term;
- help keep long-term interest rates down, helping families and businesses through the lower costs of loans and mortgages;
- keep debt and debt interest paid by the Government – and ultimately the taxpayer – lower than would otherwise have been the case; and
- avoid accumulating substantial debts to fund spending that benefits today's generation at the expense of tomorrow's, which would be irresponsible and unfair.

The Office for Budget Responsibility's Pre-Budget forecast⁷ in June 2010 showed that, without further action to tackle the deficit: public sector net borrowing would remain at 4 per cent of GDP in 2014-15; the structural deficit would be 2.8 per cent of GDP and the structural current deficit still 1.6 per cent; and, public sector net debt would still be rising in 2014-15, to 74.4 per cent of GDP, with debt interest payments set to reach £67 billion in that year.

4. Policy and Framework Reform

As a consequence of unsustainable public finances and the need to provide the right macroeconomic conditions to underpin a sustainable recovery, the Government has set out a comprehensive set of policies to bring the public finances back under control.

The Government's Budget in June 2010 delivered additional consolidation plans on top of those set out by the previous Government. These plans totaled £40 billion a year by 2014-15, £32 billion of which were spending reductions. The remaining £8bn is the net effect of changes to tax policy, including the increase in VAT.

When combined with the policies and assumptions set out by the previous Government, and adjusted for the results of the Spending Review, the total consolidation in this Parliament amounts to £80 billion of spending cuts by 2014-15 and a further £30 billion of tax increases. Approximately three-quarters of the planned consolidation is to be delivered through lower spending in 2014-15, with the proportion attributable to spending rising further in 2015-16.

The major contribution to the consolidation from public spending reductions, rather than tax increases, is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint are more successful in supporting growth.⁸ Tax measures are an effective tool for reducing the deficit quickly and supporting consolidation, allowing for phased reductions in public spending.

Therefore, the Government's fiscal consolidation plans have been designed with growth and fairness in mind, as far as possible:

- protecting the most productive public investment expenditure;
- avoiding punitive increases in tax rates on capital and labor; and,
- reforming the welfare system to reward work.

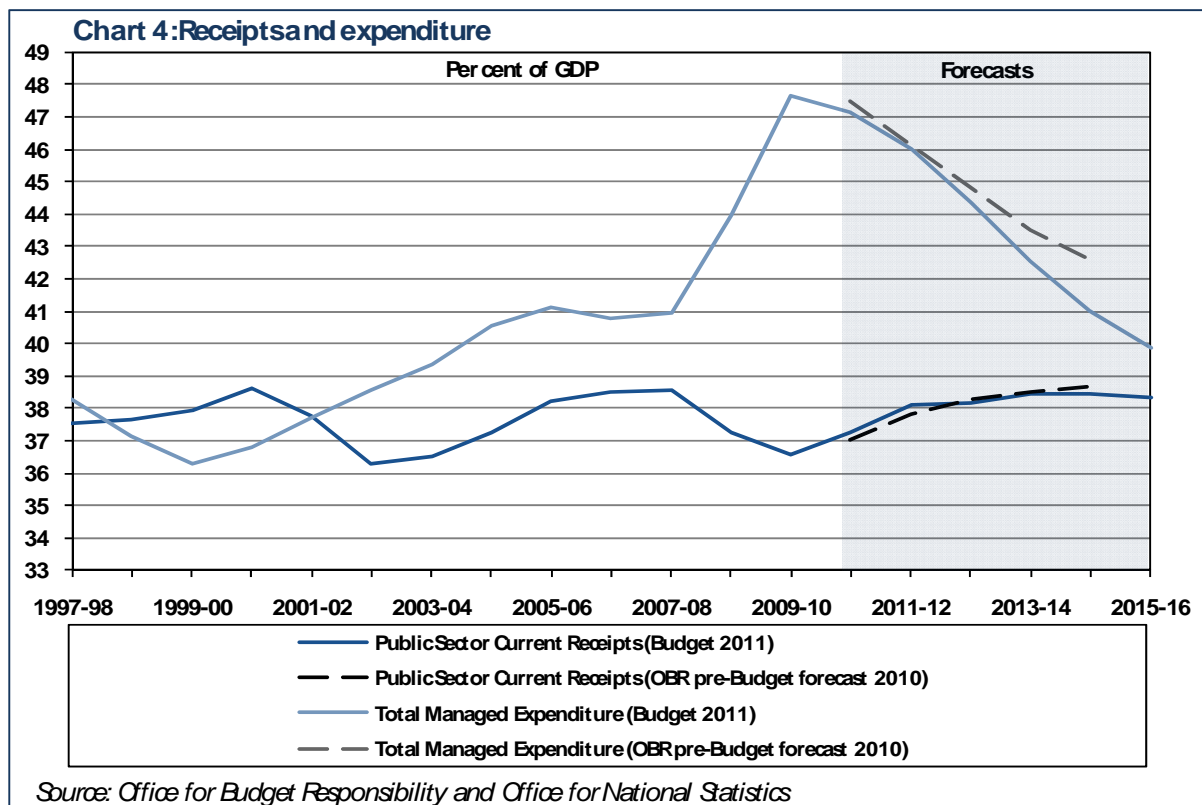
Budget 2011 reaffirmed the Government's commitment to fiscal consolidation by announcing a set of measures which had a neutral effect on the public finances with all costs of discretionary policy decisions being met by measures to raise revenue.

As a result of the Government's fiscal strategy, spending is now projected to fall from 47½ per cent of GDP to under 40 per cent of GDP by 2015-16 and receipts are expected to rise from 36½ to 38½ per cent. The structural deficit is forecast to be reduced by 8.4 percentage points, from 8.9 per cent of GDP in 2009-10 to 0.5 per cent in 2015-16.⁹

7 Office for Budget Responsibility (June 2010), *Pre-Budget forecast*.

8 See *UK Article IV Consultation*, IMF, May 2009 and OECD (June 2007), *Economic Outlook No.81*.

9 OBR EFO; March 2011.



These plans to accelerate deficit reduction and consolidate the UK public finances, returning them to a sustainable path, are underpinned by significant reform to the UK's fiscal policy framework.

At June Budget 2010, the Chancellor announced the Government's forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. Given the OBR's pre-Budget forecast and the projection of rapidly rising debt, the fiscal mandate was also supplemented by a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

The fiscal mandate, supplemented by the target for debt, will guide fiscal policy decisions over the medium term, ensuring the Government sets plans consistent with accelerating the reduction in the structural deficit so that debt as a percentage of GDP is restored to a sustainable, downward path.

The fiscal mandate is based on:

- the current balance, to protect the most productive investment expenditure; and
- a cyclically-adjusted aggregate, to allow some flexibility at a time of economic uncertainty.

The choice of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflects the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which the deficit target must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of

GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

In order to enhance the credibility of the Government's fiscal policy and fiscal mandate, the new Office for Budget Responsibility (OBR) was established in May 2010. Taking on a role in the fiscal framework in some ways similar to the Dutch CPB, the OBR will produce the official economic and fiscal forecasts and also assess the Government's fiscal policy against the likelihood of achieving the fiscal mandate.

The creation of the OBR introduces independence, greater transparency and credibility to the economic and fiscal forecasts on which fiscal policy is based. The OBR has been welcomed by international bodies including the European Commission, the OECD and the IMF, which stated that "*the establishment of a new independent OBR is a welcome step toward strengthening the budget process*".¹⁰

For June Budget 2010, the independent OBR operated on an interim basis under the chairmanship of Sir Alan Budd. In its pre-Budget forecast, published on 14 June 2010¹¹ in advance of the June Budget, the OBR transparently laid out the full scale of the fiscal challenge. This included the OBR's judgment that the level of trend output and rate of trend growth were lower than assumed by the previous Government in its March 2010 Budget forecast, such that the projected trend output at the start of 2015 was around 2½ per cent below that implied by the assumption used for the March Budget public finances forecast. The OBR also produced its first Budget forecast on 22 June 2010, on the basis of the measures the Chancellor announced in June Budget 2010.

Legislation to place the OBR on a permanent, statutory footing received Royal Assent on the 22nd March 2011. In September 2010 the Chancellor appointed Robert Chote as the first permanent chair of the OBR, with his appointment approved by the Treasury Select Committee. In October 2010 Graham Parker and Professor Stephen Nickell were appointed as permanent members of the OBR's Budget Responsibility Committee (BRC). The permanent OBR produced its first economic and fiscal outlook on 29th November 2010 and its first Budget forecast on 23rd March 2011.¹²

As well as the official forecasts of the economy and public finances, the Budget Responsibility and National Audit Act 2011 also requires the OBR to make an assessment of whether the Government is on course to achieve its fiscal mandate and supplementary target for debt.

Taking account of uncertainty, the OBR's judgment is that the policies the Government has set out are consistent with a greater than 50 per cent chance of achieving the Government's fiscal mandate. It is also the OBR's assessment that the Government's policies have a greater than 50 per cent chance of meeting the target for debt in 2015-16.¹³

As the OBR highlight,¹⁴ all forecasts are subject to uncertainty, and this applies in particular to economic and fiscal forecasts at the present time. Recognizing this, the Government has set policy to achieve a surplus on the cyclically-adjusted current budget,

10 IMF (September 2010), UK Article IV Concluding Statement.

11 Office for Budget Responsibility (June 2010), Pre-Budget forecast.

12 OBR EFO November 2010 and OBR EFO March 2011.

13 OBR EFO; March 2011.

14 June Budget 2010 and OBR EFO; November 2010.

so that moderate shocks can be absorbed should they arise. The OBR's central forecast¹⁵ is for the fiscal mandate to be achieved in 2014-15, one year early. The forecast also shows the debt target being achieved a year early in 2014-15.

As part of the Stability and Growth Pact (SGP) framework in the European Union, the UK Government currently has an Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP by 2014-15. The consolidation plans are also consistent with reducing the Treaty deficit below 3 per cent of GDP by 2014-15 and placing the Treaty debt ratio on a downward path from 2014-15.

5. Conclusion

Unbalanced growth and excessive debt accumulation in the UK, contributed to the exceptional economic and fiscal challenges that the Government is now acting to address. The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries.

The Government's first priority is bringing the public finances back under control, by accelerating the reduction of the structural deficit, bolstered by fiscal framework reform. This involves the creation of the new independent Office for Budget Responsibility and setting of the new, forward-looking fiscal mandate.

Restoring sustainable public finances, alongside regulatory reform and microeconomic measures to boost the supply side of the economy through *The Plan for Growth*, will have an important role to play in minimizing the risks to the recovery and supporting the rebalancing of the UK economy.

Conrad Smewing

* Deputy Director, Fiscal Policy, HM Treasury, based on a paper by Dave Ramsden, Chief Economic Advisor, HM Treasury.

15 OBR EFO; March 2011.