THE FISCAL CHALLENGE

The state of the public finances, which have deteriorated markedly since the onset of the recession, is a major Election issue. It provoked an exchange of letters in the 'Sunday Times' and the 'Financial Times', leading to media focus on the pace of tightening in the near term. Fellows of the British Academy were signatories on both sides of the debate. The British Academy Forum on 'The Fiscal Challenge', held on 4 March 2010, brought together participants in this debate, as well as other experts, to discuss the nature of the challenge and the response to it. The chairman, **Professor Tim Besley FBA***, summarises the discussion.*

The discussion was opened by Robert Chote, Director of the Institute for Fiscal Studies, who summarised the facts and the core questions. He noted that the government has planned a two-year fiscal stimulus followed by eight years of tightening, with an intent to eliminate the structural deficit by 2017/18. In spite of much of the rhetoric, the year of the greatest tightening is planned to be 2010/11. Current plans will see spending on public services returning to around 21% of GDP – a similar number to the early 2000s. This will be achieved by having a roughly flat profile of public spending. But with debt interest payments scheduled to rise at around 9% per year, this will mean that department spending will have to decline by around 3% per year.

Choices

However, the exact use of spending and tax measures will depend upon future political choices, and there is considerable uncertainty around the outlook for the economy with risks in both directions. There are three major uncertainties which policies need to confront. We do not know how large the final deficit will be, and the strength and resilience of the economic recovery is also uncertain. And we cannot be sure how participants in financial markets will respond to the policy choices and other factors. When one listens to the public debate, it is unrealistic to expect much movement on policy before an Election. But it is important that authorities confront the uncertainties that cloud these decisions; they should not hide behind them as an excuse not to give spending projections or predictions about how the economy will develop.

Four main themes emerged in the discussion.

Fiscal tightening

First, there was discussion of whether the pace of planned tightening is sufficient. One view was that markets will need appropriate reassurance that the government is serious about implementing the kind of tough action needed, with earlier action being needed to signal intent and to build confidence. Others argued that too much attention is being paid to market sentiment in a world where the financial market's own credibility has recently suffered a major shock. There was also a question of whether the markets are themselves sufficiently Keynesian in their perspective and recognise the need for continued government stimulus to protect the economy. But some participants took issue with this, arguing that the real issue is with the credibility of politicians rather than differences of view about the economy. More generally, there is a question of how far we can expect the deficit to close as the economy recovers, and whether the Treasury is being too pessimistic about the recovery. Some argued that there is now an excessively pessimistic view of the potential for economic recovery.

Fiscal policy and monetary policy

It was emphasised that the interplay of fiscal policy and monetary policy matters. Since the Bank of England was given its independence in 1997, these have run independently. But the current crisis has reminded us that there can be benefits of co-ordination. Fiscal policy is not the only game in town when it comes to providing support for the economy, and monetary policy will still be available when fiscal tightening begins.

Level of debt

It was widely agreed that the level of debt to GDP is not the issue right now, and that the historical record would not suggest that the UK is particularly highly indebted compared to the past. But at what point this might change did provoke some debate. One issue concerned whether a future government might prefer to deal with the problem by encouraging a bout of inflation. This could happen before any debt limit is reached, and was on the minds of financial market participants. Some contributors emphasised the need to get away from thinking of the issues narrowly in terms of the fiscal deficit. There are broader concerns about the nation's finances and the interplay between public and private sector saving/indebtedness.

Public investment

There was discussion of the need to avoid public spending cuts that fall excessively on productive investment, which often gets cut hardest and fastest when public spending is squeezed. And this comes on the back of many years of under-investment in infrastructure in the UK. It was stressed that this investment is what generates the productive capacity which will enable the UK to increase its tax base in the long term.

Institutional change

A second theme concerned the need for institutional change. Many macroeconomists are pleased that, over the last 15 years, we have roughly sorted out how to do monetary policy. This was achieved with an appropriate institutional change in which the Bank of England gained its independence. It was argued by some participants that it is important that political influence be more limited in the conduct of fiscal policy, particularly in relation to fiscal forecasts. If that does not happen, managing the current situation will be even more difficult. Just how far an independent fiscal body could improve the situation was debated. It was acknowledged that it could not have averted the current problems entirely, given the scale of the shock that the economy has experienced. But it might have prevented the UK from beginning the crisis in such a weak fiscal position, already running a structural deficit.

Politics

A third theme concerned the political economy of austerity. How would any government manage the cuts, and would they be able to protect the vulnerable? It was necessary to think through how this will be managed politically by the next government, and given the normal circumstances of adversarial party politics, this will be extremely challenging. Creating an office of fiscal responsibility, whatever the merits of that might be, does not address the problem of how to gain support for such a far-reaching package of cuts – not just in one year but sustained over such a long period. It is incredibly difficult for politicians to realise that a large part of the hole is created by failing to put enough money into paying for the pre-crisis structural deficit, and failing to explain to people that we will somehow have to pay for the costs of demographic change. However, this must be faced at some point in the future.

The British electorate has been singularly unprepared to pay for its social welfare ambitions in the last decade. The proportion of GDP going on these objectives has been rising, whereas the tax take has not. From 1997–2000, there was a pause in upward social spending which then resumed at an even faster pace. It is impossible to go on doing that. The current problem is overlaid by this structural-political problem, which is further compounded by the demography. Thus, with the projected rise in age-related public spending, it will become more and more difficult to sustain the kinds of commitments that have been made in the past. In the end, there will have to be a rethink of what the state can promise and deliver in a sustainable way over the medium term. There was discussion of how far a hung parliament after this year's Election would affect this. History suggests that we have a device that has been used once or twice, even in peacetime, which is a National Government. If you could get sufficient agreement, a National Government could set out a four- or five-year programme on which everyone was agreed. And perhaps the time has no come for this to be considered given the scale of the challenge.

Financial sector

A fourth theme went more to the origins of the crisis and the power of finance in the world. The power of financial capital, represented by Wall Street and the City of London, is exemplified in its ability to force the taxpayer to bail it out. Some participants saw this as the fundamental problem. Rather than worrying about how to get the poor and middle classes to pay for these crises, it is a question of how to curb the power of finance. We are witnessing one financial crises after another, and they are getting worse. Whether and how taxation could be raised on the financial sector is part of an important on-going debate at the international level. The crisis raised structural issues of how we want to run our economies, and how far economic power had been ceded to international financial markets.

But it was also noted that a large part of the fiscal problem that we are now facing has come about not because we were failing to collect tax from the financial sector or because of the money we have spent on bailing it out, expensive thought that is. It is more because we were collecting tax from the financial sector and that sector was inflating credit in a way which everyone said was a good thing. That technique was generating capital gains, most notably on land. The financial sector set up institutions which essentially collected commissions by allowing people to realise those capital gains. We collected tax on those commissions, which were underpinned by capital gains, and we called that current income. This was part of the reason why we ended up with a structural deficit in the boom years.

Full list of participants:

Professor Tim Besley FBA (London School of Economics)

Roger Bootle (Capital Economics Ltd)

Robert Chote (Institute of Fiscal Studies)

Bronwyn Curtis (Head of HSBC Global Research)

Gareth Davies (Strategy Unit, Cabinet Office)

Tony Dolphin (IPPR)

Professor Andrew Gamble FBA (University of Cambridge)

Chris Giles (*Financial Times*)

Professor Howard Glennerster FBA (London School of Economics)

Professor Charles Goodhart FBA (London School of Economics)

Professor John Hills FBA (London School of Economics)

Professor Stephen Machin FBA (University College London)

Professor Iain McLean FBA (University of Oxford)

Dan Mawson (Department for Business, Innovation and Skills)

Professor Marcus Miller (University of Warwick)

Mel Porter (History & Policy)

Jonathan Portes (Cabinet Office)

Sir Adam Roberts (President of the British Academy)

Bridget Rosewell (Volterra Consulting)

Lord Skidelsky FBA (University of Warwick)

Lord Turnbull (former Cabinet Secretary)

Professor David Vines (University of Oxford)

Martin Weale (National Institute of Economic and Social Research)

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