

Public Sector Finances and the Crisis

A VAT rise could help

The financial crisis and the resulting strong economic contraction have significantly deteriorated the UK national fiscal position. With a deficit over 12% of GDP in 2009 the United Kingdom has one of the highest deficits among the EU(15) members (Figure 1).

The reason why the UK deficit soared can be traced to the public spending plans set out in the 2007 Comprehensive Spending Review before the crisis materialised to its full extent (Figure 2).¹ Nominal public expenditure was projected to grow at an average of 5.2% per year (solid red line in Figure 2). This was matched by a projected average annual increase in nominal GDP of 4.8% and in government revenues of 5.9% (blue dotted line). In fact, public spending has turned out to be slightly higher than projected in 2007 (blue solid line) whilst revenues have declined substantially since 2007 (red dotted line).

Rapid growth in previous years led to procyclical spending and optimistic growth forecasts over the period 2007/08 to 2010/11 which in turn spurred large increases in planned expenditure. Had the Government projected more modest spending increases in 2007, the deficit would now be smaller. The beginning of a crisis would have been a bad time to restrain public spending. The opportunity to do so was missed during the boom years before 2007.

What actions can and should the Government take now?

The most obvious cost of maintaining high levels of debt is that of servicing it through interest payments. In 2008/09 interest payments were about 5% of government debt. The interest on newly issued debt is currently lower. At a deficit of approximately 12% of GDP, with interest rates for newly issued debt equal to, say, 4%, the additional interest costs associated with one year's deficit are likely to be around 0.5% of GDP a year. These costs clearly cumulate over time.

Michael P Devereux, Clemens Fuest and Giorgia Maffini, of the Oxford University Centre for Business Taxation, consider some solutions for the restraint of the nation's public finances

The cost will rise as interest rates rise (as they are likely to do) above their current low levels when the quantitative easing programme is withdrawn. The interest rate facing the UK Government also depends on the market perception of the risk of its debt, which in turn depends on the size of the outstanding debt, on

the rate at which that debt is increasing, and on the state and prospects of the economy. It also depends on the state of the guarantees for bank debt which could in principle result in large liabilities not reflected in the current stock of public debt.

The spreads of credit default swaps

Figure 1: Public sector deficit 2009 (% of GDP)

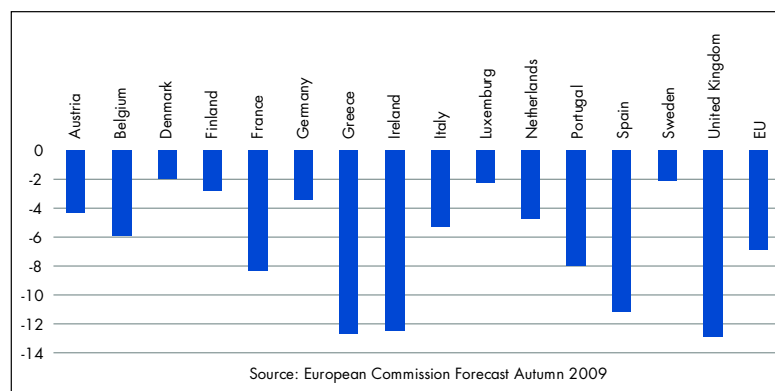


Figure 2: UK Government revenue and spending plans before and after the beginning of the crisis

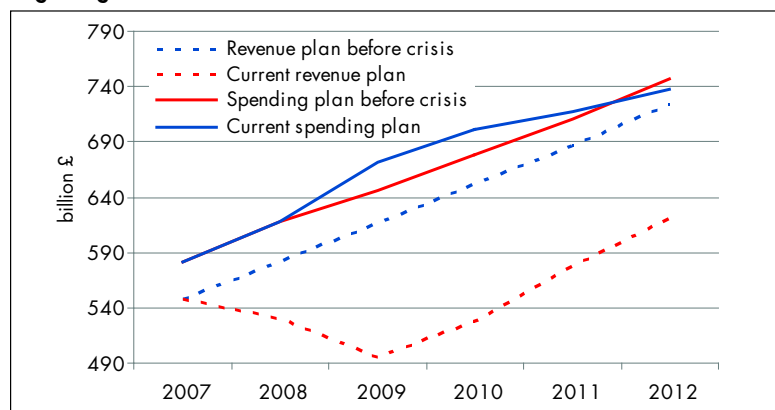


Figure 3: German and UK sovereign CDS spreads (10 years maturity)

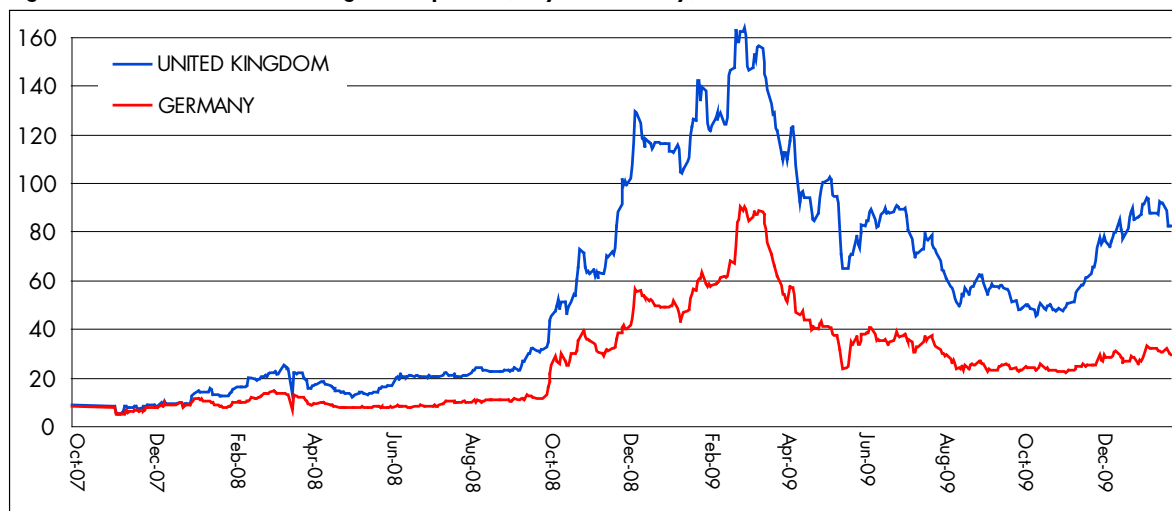
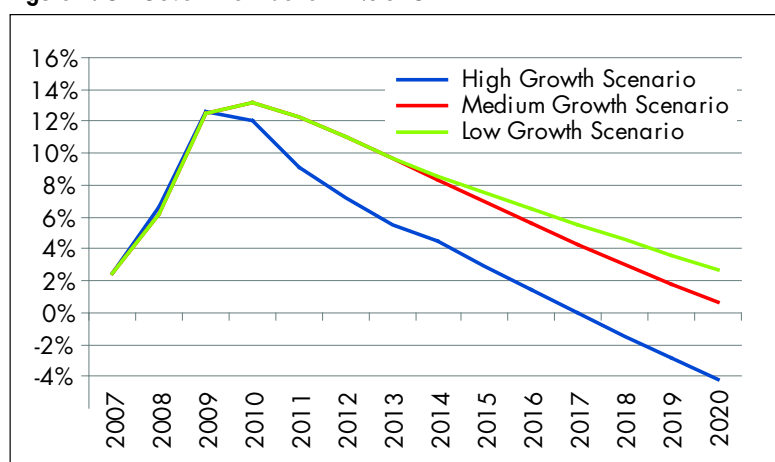


Figure 4: UK Government deficit in % of GDP



(CDS) on sovereign debt provide an approximate guide to the value of the risk premium demanded on government bonds (Figure 3). The current CDS spread on 10-year UK government bonds is around 0.8%, implying that due to risk, the interest rates faced by the Government are 0.8 percentage points higher than the risk-free rate.

This cost in terms of higher interest payments is, however, modest relative to the overall cost of servicing the debt. The longer these risk premia are maintained, the more their cost will build up as additional debt is issued at relatively high risk premia. With the exception of Greece and Ireland, in November 2009, the spreads of CDS on UK government bonds have widened more than for any other country tracked by the *iTraxx SovX index*. This reveals some concern about the nation's public finances. To reduce these risk premia governments need to define credible deficit-reducing plans for

the medium term.

In its Fiscal Responsibility Bill (FRB) the Government set out targets for cutting the fiscal deficit over the next decade. In the optimistic scenario which underlies the figures of the 2009 Pre-Budget Report (PBR) and with real spending levels held constant, the deficit would be reduced in line with the FRB to around 4% of GDP by 2014/15 (blue line in Figure 4). Given an average of independent forecasts (red line) or an even lower growth rate (green line), however, it would not be possible to maintain current real tax and spending levels while meeting the objectives of the FRB. It would be necessary at some point to raise taxes, as it is unrealistic to assume that public spending could be cut consistently in real terms. In the last three decades, spending has fallen in real terms in only four years.

The current level of UK government spending as a proportion of GDP is high, but not unprecedented: it reached such

levels following the oil crisis in 1973/74 (Figure 5). It was eventually reduced in the 1980s as the Thatcher government held real spending approximately constant for several years. A further sharp fall occurred under the Major government in the first half of the 1990s, and initially continued under the Labour government. As a proportion of GDP, the rise in spending under the Labour government until 2008 was relatively modest, with the ratio standing at 41% until the crisis of 2008/09.

Revenues have generally moved in line with spending, though they have typically been lower (Figure 5). Since the early 1990s revenues have been between 36% and 38% of GDP and have only fallen a little during the recent crisis.

The Government should set a target for the ratio of spending and tax revenues as a proportion of GDP. Realistically, the spending target should match a feasible level of revenues. If we take the average ratio of revenues to GDP over the last 20 years, the target would need to be less than 40%, probably as low as 38%. Such a reduction in spending would not be unprecedented. The current ratio of spending to GDP is comparable to that in 1982/83, at around 48%. The then government reduced the ratio to 39% within around 7 years by holding real spending constant.

Such a policy would, though, require almost all of the adjustment to occur through a reduction in spending. A more credible strategy would be one in which part of the adjustment comes through higher taxes. For example, a target of between 40 and 42% for both

Figure 5: UK Government spending and revenue (% of GDP)

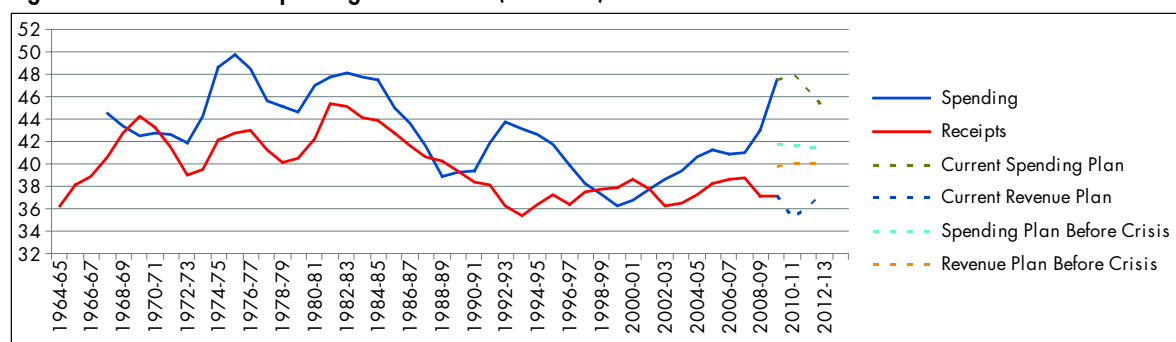
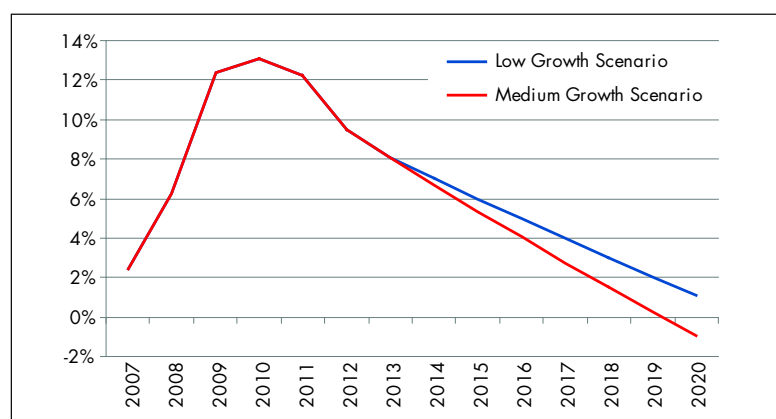


Figure 6: UK Government deficit in % of GDP with spending cuts and tax increase in 2012



spending and revenues would require a more modest reduction in spending, though also a rise in revenues.

While trying to cut the deficit, the Government may generate a contractionary effect, reducing or even overturning any economic recovery. Given the depth of the recession, the Government should be cautious in raising taxes or cutting expenditure in the short run. The costs associated with a delay in such policies are relatively small compared with the possible costs of restricting economic growth. At the same time, it is important to present a credible strategy for fiscal consolidation. For the reasons discussed above, it is likely that this strategy will include tax hikes which raise important timing issues.

The increase in National Insurance contributions from April 2011, announced in the PBR, is part of an attempt to develop a credible deficit-reducing strategy. If the rise had been implemented immediately, it would have generated a reduction in private spending, which would be a negative shock to the economy. Since it will be introduced in over a year's time, the Government is presumably delaying the reduction of the deficit in the hope of

allowing the economy to recover before implementing the change. The problem is that individuals are in any case likely to reduce their spending now. The reduction may not be as large as if the rise had been implemented immediately but it might still be quite significant. For this reason, the announcement of a future tax rise may not be an attractive alternative to the announcement of an immediate tax rise.

Taxes on consumption, such as VAT and excise duties, are exceptions to this. Suppose the Government announced an increase in the VAT rate in one year's time. This could provide an important fiscal stimulus, since there would be an incentive to bring forward spending to benefit from the lower VAT rate before it was increased. This would provide an immediate fiscal stimulus, despite raising additional revenue in the medium term. An additional advantage of changing the VAT rate is that – unlike income and corporation tax – such a tax reform should not induce individuals or corporations to move abroad, as the incidence of VAT is primarily determined by the consumer's location.

Announcing a future rise in the VAT rate mirrors the fiscal stimulus measure announced by the Government in December 2008, when the VAT rate was cut from

17.5 to 15% for about one year. Arguably the most effective element of this stimulus was its fixed time period. A permanent reduction in the VAT rate may not have had a large effect when the country entered the recession. But the fact that the rate has now increased again is likely to have had a more significant impact on private spending in 2009.

Figure 6 revisits the path of the deficit if a rise in VAT equal to 1.5% of GDP were implemented in 2012. This relatively modest tax rise – combined with holding spending constant – moves the path of the deficit closer to the targets of the FRB. Achieving these targets would require a tax increase in 2012 of 3% and 4% of GDP in the medium growth and in the low growth scenario, respectively.

The 2009 PBR did not include substantial revenue raising measures. However, if growth forecasts turn out to be too optimistic, tax hikes will have to be contemplated in the near future. Timing issues and the type of taxes considered will be crucial factors for the next government as it attempts to prevent the restraint of public finances limiting the pace of economic recovery.

Notes

¹ Data after 2009 are government's forecasts from the 2009 Pre-Budget Report (PBR).

² For the average of independent forecasts, the assumed rate of growth is 2.7% from 2013. For the low growth rate scenario, we assume a rate of growth of 2% from 2014 onwards.

³ The Figure does not take into account any behavioural change induced by the announcement of the reform, or the reform itself.

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