The economic recovery and the budget deficit

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Economic recovery will help reduce the deficit but discretionary policy tightening is also needed

Reducing the budget deficit will be the central economic challenge of the new Parliament. The deficit is forecast to be £163 billion (11.1% of GDP) this year: a very high level by historical standards. The Treasury forecasts that this will fall to £74 billion (4.0% of GDP) by 2014/15. This would still be higher, as a share of GDP, than any year between 1996/97 and 2007/08.

Much of the high deficit can be attributed to the recession. However, the recession has affected the public finances in a number of ways: in temporary effects related to the economic cycle and other more permanent or structural effects.

CYCLICAL EFFECTS

Firstly, there is a temporary effect on the level of government borrowing related to the downturn in the economic cycle. In a recession, government borrowing tends to increase as tax receipts are reduced and spending on unemployment benefit increases. A 100,000 increase in unemployment costs the Treasury £500 million. The reverse happens when the economy is growing strongly. These effects happen without any changes in government policy and are sometimes known as the economy's "automatic stabilisers".

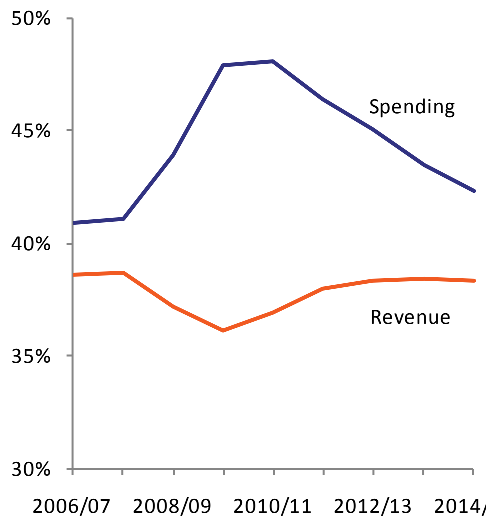
As the economy recovers, the deficit will automatically be reduced as tax revenues increase and unemployment falls.

However, there is no clear consensus on the pace and timing of the recovery. In the 2010 Budget, the Treasury was optimistic about the economic outlook, forecasting growth of 3% or more in 2011 and 2012 after more modest growth of 1 to 1½% this year. Independent forecasters take a more cautious view, expecting growth of 1.3% this year and 2.1% in 2011. If the economy were to grow at this slower rate, the deficit would fall more slowly.

STRUCTURAL EFFECTS

These temporary effects, related to the economic cycle, are only part of the story. The fiscal crisis has also had significant permanent or structural effects on the economy. The Treasury assumes the crisis has had a permanent downward effect on the economy's productive potential. The fiscal crisis has also had an important structural effect on the financial and housing sectors of the economy. Before the crisis, these were important sources of tax revenue. The fiscal crisis means a permanent loss of revenue from these sectors of the economy.

The gap between spending and revenue is forecast to narrow
% of GDP, outturn and forecasts



HM Treasury

As a result, a large part of the budget deficit is structural, as it is not related to the ups and downs of the economic cycle. The Treasury estimates that the structural deficit currently accounts for around two-thirds of the total, with cyclical factors accounting for only a third. These estimates are, however, subject to a considerable degree of uncertainty.

A large structural deficit raises concerns, as this will not be reduced by the economic recovery. This explains the importance of discretionary measures to cut the deficit.

The Labour Government announced a freeze in public spending over the next few years as well as a number of tax increases, such as the rise in national insurance due in April 2011. The 2010 Budget set out projections for government spending and revenue showing a fall in the structural deficit from 7.3% of GDP this year to 2.5% in 2014/15. The Conservatives have said that they would hold an emergency budget within 50 days of taking office, which would set out a plan to reduce the structural deficit.

The challenge for the incoming Government is to balance the need to protect the recovery with measures to reduce the deficit.

DIFFICULTIES OF FORECASTING THE BUDGET DEFICIT

It is not easy to forecast the budget deficit accurately.

The deficit is the difference between two large, uncertain numbers: government revenue and spending. If spending were 1% lower than forecast and revenue 1% higher, the deficit would be £12 billion (over 7%) lower.

Unexpected differences in spending or revenue tend to be in opposite directions. For example, if the economy performs worse than expected, tax revenue will tend to be lower and spending higher. This magnifies the effect.

These problems are illustrated by the change in the Treasury's estimate of borrowing for 2009/10, which fell by £11 billion in the three months between the 2009 Pre-Budget Report and the 2010 Budget. This is the equivalent of more than 2p on the basic rate of income tax.