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UK Economics Weekly

How Big is Political Risk in Fiscal Policy?

- This week's note aims to assess the political risks over fiscal policy, both before and after the election (scheduled for 7 May). Our key point is that, despite escalating political rhetoric, fiscal policy differences between the parties are relatively small. All major parties support the Charter for Budget Responsibility (CBR), and they all share a general consensus in favour of deficit reduction, a lower public spending/GDP ratio, and a falling debt/GDP ratio.

- In our view, the key difference between Labour and Conservatives is over whether to emphasise tax cuts or extra public spending once the CBR targets (cyclically adjusted current balance and falling debt/GDP ratio) have been met (hopefully in 2-3 years' time), rather than whether to implement enough fiscal consolidation to achieve the CBR targets. In our view, Labour's fiscal plans do not pose a significantly greater risk to the fiscal outlook for 2015-20 than those of the Conservatives or Lib Dems. There are still political risks for the UK, but these centre on business tax and regulation (in the event of a Labour-led government) or the UK's EU membership (in the event of a Conservative-led government).

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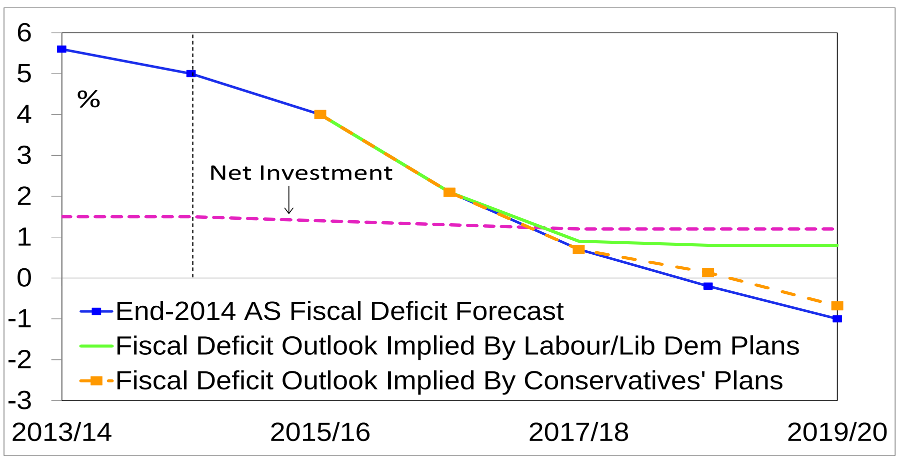
Figure 1. Citi Monetary Policy Forecasts

	Mid-2015	End-2015	End-2016	End-2017
Base Rate	0.50	0.75	2.00	3.00
QE Target	£375bn	£375bn	£315bn	£315bn

Source: Citi Research

Figure 2. UK — Fiscal Deficit Outlook Under Alternative Fiscal Policies, Pct of GDP, 2013/14-2019/20



Note: Fiscal policy scenarios detailed inside, all based on OBR figures for nominal GDP and tax revenues.
Sources: OBR and Citi Research

Assessing Fiscal Risks

As we discussed last week, there are major uncertainties over the outcome of the election (scheduled for 7 May). Opinion polls consistently point to a doubly hung parliament, ie neither the Conservatives nor Labour will have a parliamentary majority, and the Lib Dems will not have enough MPs to hold the balance of power. In our view, the most likely government in this scenario would be a left-leaning "rainbow coalition" (including Labour, the SNP, Lib Dems and perhaps also the Greens and Plaid Cymru), with the next most likely outcome being a right-leaning minority coalition of the Conservatives and Lib Dems -- with UKIP giving support on a case by case basis but not formally in the coalition. This week's note aims to assess the political risks over fiscal policy, both before and after the election.

We stress a key caveat. None of the political parties have yet published their manifesto, which would usually give a definitive list of policy proposals. For all of the parties it is possible to construct a long list of fiscal policy aims and aspirations which have been floated at some point in the last few years, but which probably would not in practice be priorities in government. We focus on specific policy proposals made recently by each party's leader and finance spokesman, specific pledges on the main pages of each party's web site, and (where available) published fiscal plans.

Charter for Budget Responsibility

The key constraint on the fiscal policies of all parties will be the updated Charter for Budget Responsibility (CBR), which on 13 Jan 2015 was voted through Parliament with strong support from all major parties. This commits the government to:

- A forward-looking aim to achieve cyclically-adjusted current balance (ie deficit ex investment) by the end of the third year of the rolling, 5-year forecast period. With public investment at 1.5% of GDP now and (on the current coalition plans) 1.2% of GDP in 17/18 onwards, this rule would allow modest overall budget deficits of up to 1.2% of GDP per year for 2017/18 onwards.

- A supplementary aim for public sector net debt as a share of GDP to be falling in 2016-17. This requires the deficit in that year to be below about 2½% of GDP.

- A second supplementary aim that the government must set a cap on welfare spending over the rolling 5-year forecast period.

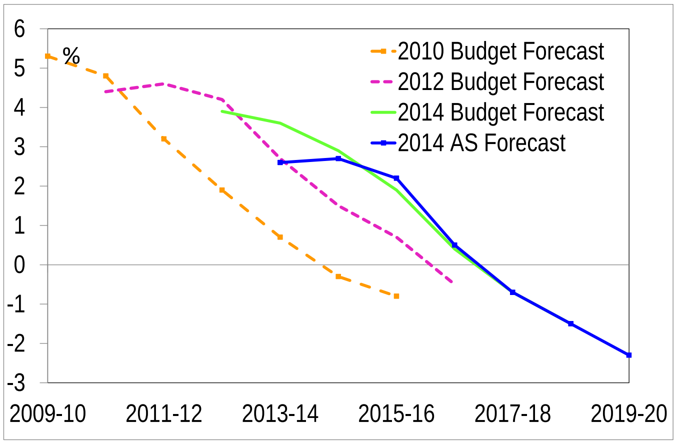
This updated CBR has echoes of the original CBR[1], with the supplementary debt/GDP aim moving to 16/17 from 15/16. One significant change is that the target for the cyclically adjusted current balance is shortened to three years ahead from five years ahead. This is a modest improvement, because the government generally only has detailed public spending plans for roughly two years ahead, with outline plans beyond that. Hence, the shorter horizon increases the need for the government to produce detailed plans to meet the CBR targets. But the new CBR still has broadly the same weaknesses as the old one:

- The first aim (the key one) simply requires the OBR to forecast that proposed measures will achieve a cyclically adjusted current balance in a few years. Strictly speaking, the government never need actually achieve a current budget surplus – the OBR just has to be able to forecast that it will do so. The current coalition has always met this forward-looking target, even though the current budget remains in deficit and has turned out worse than previously forecast.

[1] This was published in April 2011, and set two aims: (1) cyclically-adjusted current balance by the end of the rolling, five-year forecast period; and (2) a falling debt/GDP ratio for 2015-16.

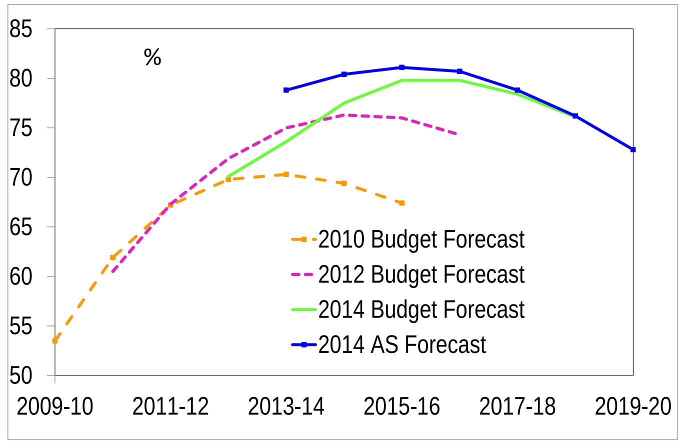
- Second, the CBR is not legally binding: there is no penalty for failure other than embarrassment. The current coalition accepted fairly early (in the end-2012 Autumn Statement or AS) that it would fail to achieve the supplementary debt aim (falling debt/GDP ratio in 15/16) and did not tighten fiscal policy to get back on track. That may well have been the correct judgment in the circumstances (EMU crisis, disappointing growth) but highlights that the government is not legally compelled to meet the CBR targets.

Figure 3. UK – OBR Forecasts for Cyclically Adjusted Current Deficit as Pct of GDP), Fiscal Years 2009/10 to 19/20



Note: Positive figure implies deficit. Sources: OBR and Citi Research

Figure 4. UK – OBR Forecasts for Net Public Debt/GDP Ratio,, Fiscal Years 2009/10 to 19/20



Sources: OBR and Citi Research

Nevertheless, even with these issues, we do regard the CBR as a useful device to ensure a general commitment to fiscal sustainability within a multi-year framework. And the fact that there is now a multi-party consensus on the issue, with the Conservatives, Labour and Lib Dems all voting in favour of it, helps underpin the credibility of the UK's commitment to medium-term fiscal stability. Moreover, the need to meet the CBR targets in the next 2-3 years probably helped ensure there was no pre-election giveaway in the AS, and probably will also ensure there is no net giveaway in the pre-election 2015 Budget (18 March).

The Coalition's Fiscal Plans

The current coalition's outline fiscal plans, as published in the end-14 AS, over-achieve against the CBR targets. These plans imply a drop in the public spending share of GDP from roughly 40.5% in 14/15 to 36.9% in 17/18. On the OBR's forecasts, this is enough to achieve a falling debt/GDP ratio in 16/17 (meeting the supplementary CBR target) and a cyclically adjusted current surplus of 0.7% of GDP in 17/18 (meeting the first CBR target), with the overall fiscal deficit in 17/18 at 0.7% of GDP. The AS plans then imply a further drop in the public spending share of GDP to 35.2% in 2019/20, which for 2019/20 would produce a cyclically adjusted current surplus of 2.3% of GDP (£51bn) with an overall budget surplus of 1% of GDP (£23bn). This path would put the debt/GDP ratio on a marked downtrend, falling from 81% in 2015/16 to 73% in 19/20, with this ratio falling by 2-3 percentage points per year.

This is clearly in excess of CBR targets, which could be met by keeping the cyclically adjusted current surplus at the 0.7% of GDP level projected by the OBR for 17/18 (or even a little lower). If, for example, the coalition merely aimed to stabilize the cyclically adjusted current balance at a surplus of 0.5% of GDP for 2017/18 onwards (which is fully consistent with the CBR), then this would create

significant extra fiscal space (£4bn in 17/18, rising to £40bn in 19/20) that could be used for either higher public spending or tax cuts.

The Conservatives' Fiscal Plans

It is unclear whether the Conservatives' fiscal aim is to meet the CBR targets or to meet the tougher AS forecasts – ie outright fiscal surpluses.

There is some evidence that the Conservatives genuinely want to aim for an overall budget surplus, and not just the cyclically adjusted current surplus required by the CBR. For example, in his Royal Society Lecture[2], the Chancellor argued "*Indeed, the Treasury analysis we've published has found that, if you allow for regular shocks consistent with those experienced in the UK over the last 6 decades, running a balanced current budget alone would only reduce debt as a share of GDP by 5% over the next 20 years. In 2035 our debt would still be 76% of GDP. Instead, countries like Canada and Sweden have demonstrated that the only reliable way to reduce debt levels in a low inflation world is to operate some kind of balanced budget or surplus rule…So let me sum up what I'm proposing today. We need a plan to keep Britain secure. So in the good times we stay in surplus – raising more money than we spend and using that to pay down our debts. And when the bad times come, the government will have to set out a clear plan to get back to health*." The Chancellor made a similar point in both the 2014 Budget and AS speeches.

All this raises a puzzle as to why the CBR does not set a target for an outright fiscal surplus. It is possible that this reflects the compromises of coalition. The Lib Dems may be unwilling to accept the aim of a fiscal surplus in the CBR, but willing to endorse outline plans that (according to the OBR) would produce a fiscal surplus in coming years on the grounds that the AS spending figures after 2015/16 are just assumptions rather than plans and hence carry less weight.

But, it also seems likely that the Conservatives are creating room for tax cuts, in line with PM Cameron's pledge at the Conservative Party Conference[3]: "*I can tell you now that a future Conservative Government will raise the tax-free personal allowance from £10,500 to £12,500…we will raise the threshold at which people pay the 40p rate. It's currently £41,900…in the next Parliament we will raise it to £50,000*." The IFS costs these aims at £7.2bn[4], and Cameron repeated these aims in the Times[5]: "*In the next parliament we plan to make £25 billion of savings while making £7.2 billion in income tax cuts*." These tax cuts are not included in the AS fiscal plans. Hence, it may be that the Conservatives do not really intend to over-achieve so much versus the CBR, but rather aim to squeeze spending enough to create scope under which a Conservative government could deliver sizeable tax cuts while meeting the CBR targets (and not achieving the surpluses forecast in the AS). Hence, we assume that this £7.2bn tax cut (0.3% of GDP) would be delivered once the CBR targets are met (2017/18 onwards according to the OBR).

The Lib Dem's Fiscal Plans

The Lib Dems support the CBR and, unlike the Conservatives, do not seek to over-achieve versus the CBR targets. As Danny Alexander said to the party conference, the Lib Dems are seeking "*a balanced budget, but allow for additional investment in productive economic infrastructure – roads, railways, broadband, housing – as long*

[2] 14 January 2015.

[3] Speech on 1 October 2014.

[4] Source: BBC, 1 October 2014.

[5] 30 October 2014

as the overall debt is falling as a share of the economy… We will balance the budget as planned, do it fairly, and then allow public spending to grow as the economy grows." Consistent with the CBR, this seems to imply a target of aiming for a modest but stable current surplus (as the OBR forecast for 2017/18), without the further public spending squeeze assumed in the AS for later years.

In addition, the Lib Dems propose a £1bn rise in NHS spending, funded by higher taxes: "*we will invest a further £1bn in real terms in 2016/17, as we set out at our Autumn Conference. This will be paid for by capping pensions tax relief for the richest pensioners (saving 500m), aligning dividend tax with income tax for those earning more than £150,000 (saving £400m) and scrapping the Conservative shares for rights scheme (saving £100m)*." [6] Moreover, the Lib Dems advocate a broadly revenue-neutral mix of a rise in the personal tax allowance to £12,500 (like the Conservatives), Mansion Tax on houses worth £2m or more (like Labour) and higher capital gains tax.

If we assume that the Lib Dems would aim for a cyclically adjusted current surplus of 0.5% of GDP (consistent with the CBR), then these plans would seem to allow extra spending versus the AS plans of £1bn for 16/17, £5bn for 17/18, rising to £41bn for 2019/20. Using the OBR's nominal GDP forecasts, this path would put the net debt/GDP ratio at 76% in 19/20, with this ratio falling by 1-2 percentage points per year.

Labour's Fiscal Plans

The Labour leadership opposed many of the spending cuts of the last few years. But, as the election approaches, they are emphasising fiscal prudence. They have voted in favour of the CBR, and endorse its targets of achieving a cyclically adjusted current balance and a falling debt/GDP ratio, including a sizeable nearterm drop in the public spending/GDP ratio. Shadow Chancellor Ed Balls has committed to a fiscally-neutral manifesto: "*So in our manifesto there will be no proposals for any new spending paid for by additional borrowing*."[7] Moreover, his recent open letter to the Shadow Cabinet was a clear statement of fiscal rectitude: "*We will cut the deficit every year, and deliver a surplus on the current budget and falling national debt as soon as possible in the next Parliament… In the meantime you should be planning on the basis that your departmental budgets will be cut not only in 2015/16, but each year until we have achieved our promise to balance the books*."[8]

If we assume a Labour-led government would aim for a cyclically adjusted current surplus of 0.5% of GDP (consistent with the CBR targets), they would have some fiscal space from 2017/18 onwards versus the AS plans. Moreover, Labour advocate a roughly fiscally-neutral mix of a higher tax burden plus extra spending.

- Extra £2.5bn for NHS spending (Time to Care Fund) funded by a Mansion Tax (planned to raise £1.2bn), "*clamping down on tax avoidance schemes"* and *"introducing fees on tobacco companies so that they make a larger contribution towards the costs of tackling tobacco-related illness*"[9].

- Re-introduce a (narrow) 10p income tax rate at low pay levels, funded by scrapping the Married Couples Allowance (which would yield about £0.7bn).

[6] See http://www.libdems.org.uk/nhs-funding-increase-8bn.

[7] See speech to Labour Party Conference, 22 September 2014.

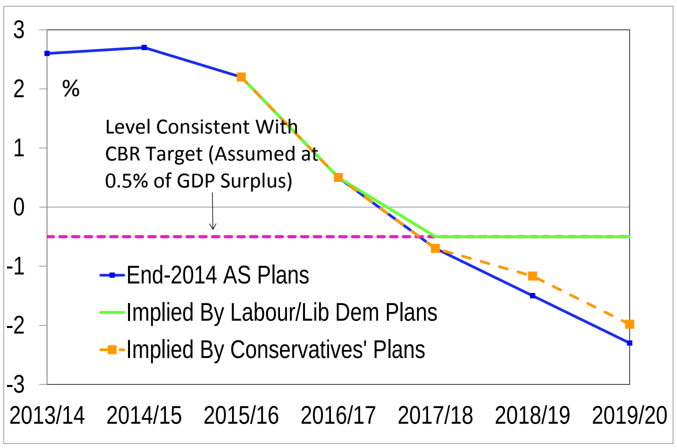
[8] See open letter of 11 December 2014.

[9] Quotes from http://www.labour.org.uk/issues/detail/nhs-time-to-care-fund.

- Hike Bank Levy (raising £0.8bn) to fund increased spending on childcare.
- Hike top rate tax to 50%, reversing the cut in the 2013 Budget. It is hard to judge potential revenue gains from this. Ed Balls has suggested a £3bn gain, but the Treasury's costings of the cut to 45% indicated a cost of only £0.1bn per year. It is unclear what, if anything, these revenues would be used for.

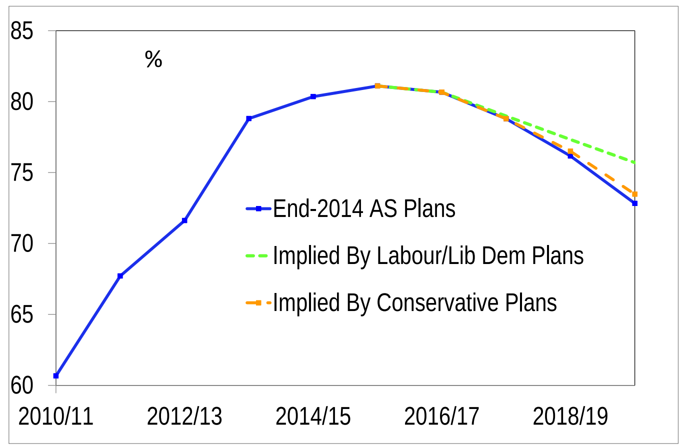
If we assume that the Labour would aim for a cyclically adjusted current surplus of 0.5% of GDP (consistent with the CBR), then these plans would seem to allow an extra spending versus the AS plans of £3.3bn for 15/16 and 16/17, £7bn for 17/18, rising to £43bn for 2019/20. In turn, assuming that nominal GDP matches the OBR's forecasts, this would (like the Lib Dems plans) put the net debt ratio at 76% in 2019/20 (and falling by 1-2 pp per year), versus 73% in the AS plans.

Figure 5. UK – Cyclically Adjusted Current Deficit (% of GDP), 2013/14-2019/20



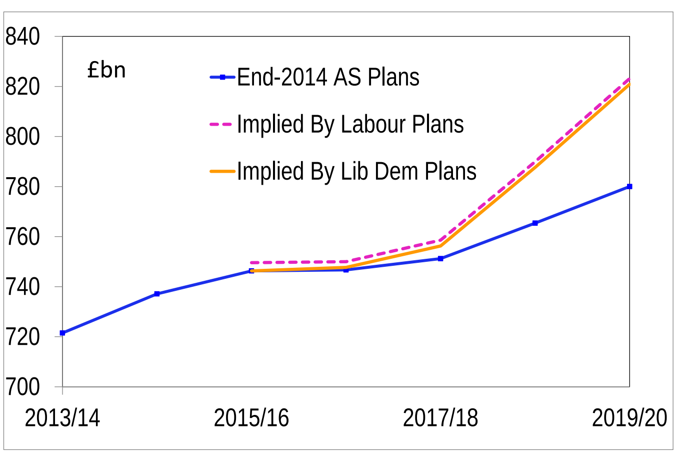
Note Negative figure implies surplus. We assume that the CBR targets can be met by a surplus of 0.5% of GDP for the cyclically adjusted current balance.
Sources: OBR and Citi Research

Figure 6. UK – Net Public Debt/GDP Ratio, 2010/11-2019/20



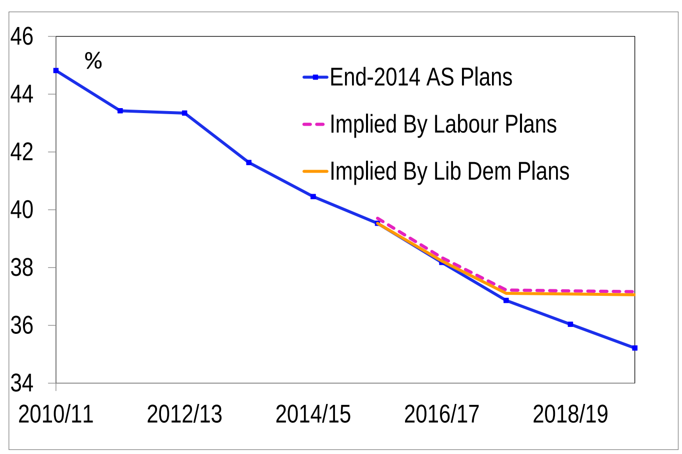
Note Negative figure implies surplus. We assume that the CBR targets can be met by a surplus of 0.5% of GDP for the cyclically adjusted current balance.
Sources: OBR and Citi Research

Figure 7. UK – Public Spending, £bn, Under Alternative Fiscal Policy Scenarios, £bn, 2013/14 to 2019/20



Note: We assume the Conservatives would follow the AS plans. Sources: OBR and Citi Research

Figure 8. Public Spending, Pct of GDP, Under Alternative Fiscal Policy Scenarios, £bn, 2010/11 to 2019/20



Note: We assume the Conservatives would follow the AS plans. Sources: OBR and Citi Research

Political Risks over Fiscal Policy are Modest and Not Very Different Among the Parties

In our view, despite political rhetoric, we believe the similarities between the fiscal plans of the three main parties are far greater than the differences. All three main parties' plans (such as they are) are fairly prudent and consistent with the CBR. All these parties would aim for a sharply lower public spending share in GDP, a cyclically adjusted current surplus, falling debt/GDP ratio and (at most) a low fiscal deficit. And, while a Labour government might find it politically harder than a Conservative government to squeeze spending, a Labour-led government also would find it politically easier to make up for spending slippage by tax hikes. Overall, in our view, Labour's plans do not pose a significantly greater risk to the fiscal outlook for 2015-20 than those of the Conservatives or Lib Dems. We note that the Lib Dems' fiscal aims seem much closer to Labour's than to the Conservatives, and on this issue would not pose any difficulties in forming a Labour/Lib Dem coalition.

The key difference between Labour, the Lib Dems and Conservatives is over whether to emphasise tax cuts or extra public spending once the CBR targets (cyclically adjusted current balance and falling debt/GDP ratio) have been met (hopefully in 2-3 years' time), rather than whether to implement enough fiscal consolidation to achieve aim the CBR targets. To be sure, the debt/GDP ratio would fall a little faster over the next five years with an outright fiscal surplus rather than a cyclically adjusted current surplus (and small overall deficit). But, even for 2019/20, the difference is only about 3 percentage points of GDP. Moreover, given their tax cut aims, it is not clear if a Conservative government would actually seek to deliver the fiscal surplus projected by the CBR.

Moreover, while we believe that fiscal deficit risks are probably modest under all the fiscal plans of all three parties, we do believe that either a Conservative-led government or Labour-led government would pose other significant risks. First, a Conservative-led government or Labour-led government would probably be relatively weak – a minority government or multi-party coalition -- hence potentially making it harder to stay the course on fiscal consolidation if the economy worsens or voters become discontented. Second, both a Conservative-led or Labour-led government would create other policy risks. A Labour-led government would raise uncertainties over business tax and regulation, while a Conservative-led government would raise uncertainties over the UK's EU membership, given the Conservatives' commitment to hold a referendum on the issue and the significant share of Conservative MPs who probably favour EU exit. These worries differ, but both might hit business investment and the ability of firms to plan longer term. Given this prospect – that a relatively weak government seems likely and all likely outcomes create sizeable policy risks – we suspect that UK political risk will be a recurring theme for this year.

Figure 9. Economic Indicators

Wed 21 Jan	*LFS Unemployment, 3-M Avg (Sep-Nov)*	Forecast: -30,000 QQ, 5.9% Rate	Prior: -63,000 QQ, 6.0% Rate
	LFS Unemployment Rate, Single Month (Nov)	Forecast: 5.8%	Prior: 5.9%
	Claimant Count Unemployment (Dec)	Forecast: -25,000 MM, 2.6% Rate	Prior: -26.9 MM, 2.7% Rate
	Average Earnings Ex Bonus (Nov)	Forecast: 2.2% YY, 1.9% 3-M YY	Prior: 1.8% YY, 1.6% 3-M YY
	Surveys suggest that firms' hiring intentions remain very strong, and as a result we expect that job growth will stay high, hence producing another solid decline in the jobless rate – which we expect will fall below 6.0% for the first time since Sep-2008. There seems to be a sizeable backlog of pent-up demand for staff, with the level of job vacancies up 22% YoY and close to the precrisis peak.		
Thu 22 Jan	*Public Sector Net Borrowing (Dec)*	Forecast: £10.1bn deficit, £85.9 billion deficit fiscal year to date	
	(Ex Public Sector Banks)	Year Ago: £10.3bn deficit, £86.5 billion deficit fiscal year to date	
	There have been signs of better revenue growth recently, with central government receipts (ex APF transfers) up 5.0% YoY in October-November, versus the gain of 2.4% YoY in April-September. As a result, the fiscal deficit has edged below year-ago levels in the last two months. We suspect this better tone will continue this month, as the benefits of economic recovery continue to feed through, with the deficit again slightly below last year's levels.		
Thu 22 Jan	*CBI Industrial Trends Survey (Jan)*		
	Quarterly Industrial Confidence (Jan)	Forecast: +8%	Prior (Oct): +8%
	Monthly Output Expectations Net Bal. (Jan)	Forecast: +20%	Prior (Dec): +16%
	Monthly Order Books Net Balance (Jan)	Forecast: +2%	Prior (Dec): +5%
	Monthly Selling Prices Net Balance (Jan)	Forecast: +10%	Prior (Dec): +7%
	The January CBI survey usually shows a sharp rise in the balance of firms expecting to hike selling prices, with an average figure of +15% over the last 10 years (compared to +8% for the December survey. Hence, a figure in line with our forecast would imply weakness in seasonally adjusted terms, and indeed would be the lowest January price survey since 2010.		
Fri 23 Jan	*Retail Sales Volumes (Dec)*	Forecast: -0.2% MM, 3.4% YY	Prior: 1.6% MM, 6.4% YY
	The December retail sales tend to be relatively volatile (and indeed the retail sales figures as a whole are often volatile), and have shown a MoM decline in eight of the last 15 years (the most of any month). Given that, and the strength of the past two months, we pencil in a small decline this month. Even so, such a figure would leave Q4 volumes up 1.9% QoQ, the strongest quarter since 2004.		

Source: Citi Research

Figure 10. Economic Calendar, 12 January — 30 January 2015

12 January	13 January	14 January	15 January	16 January
	Consumer Prices (Dec) Nov -0.3% MM, 1.0% YY Dec 0.0% MM, 0.5% YY CPI Ex F, D, T, E (Dec) Nov -0.1% MM, 1.2% YY Dec 0.2% MM, 1.3% YY Retail Prices (Dec) Nov -0.2% MM, 2.0% YY Dec 0.2% MM, 1.6% YY RPIX – Ex Mortgages (Dec) Nov -0.2% MM, 2.0% YY Dec 0.2% MM, 1.7% YY Producer Input Prices (Dec) Nov -0.7% MM, -8.2% YY Dec -2.4% MM, -10.7% YY Producer Output Prices (Dec) Nov -0.2% MM, -0.6% YY Dec -0.3% MM, -0.8% YY Ex F, D, T, E (Dec) Nov 0.0% MM, 0.9% YY Dec 0.0% MM, 0.8% YY	Profitability of UK Companies (Q3)	RICS House Price Survey (Dec, 00:01) Swiss National Bank: Ends Exchange Rate Cap, Cuts Rates 50bp to -0.75%	
19 January	**20 January**	**21 January**	**22 January**	**23 January**
		LFS Unemployment (Sep-Nov) Aug-Oct -63K QQ Sep-NovE -30K QQ LFS Unemployment Rate, 3-Month Avg (Sep-Nov) Aug-Oct 6.0% Sep-NovE 5.9% LFS Unemployment Rate, Single Month (Nov) Oct 5.9% NovE 5.8% Claimant Count Unemployment (Dec) Nov -26.9K MM, 2.7% Rate DecE -25.0K MM, 2.6% Rate Avg Earnings Ex Bonus (Nov) Oct 1.8% YY, 1.6% 3-M YY NovE 2.2% YY, 1.9% 3-M YY MPC Minutes (8 Jan)	Public Sector Net Borrowing (Ex Banks), (Dec) Dec13 £10.3bn Deficit Dec14E £10.1bn Deficit Fiscal Year To Date Apr-Dec13 £86.5bn Deficit Apr-Dec14E £85.9bn Deficit CBI Ind. Trends (Jan, 11:00) Qrtly Ind. Confidence (Jan) Oct +8% JanE +8% Mthly Output Expectations Dec +16% JanE +20% Monthly Order Books (Jan) Dec +5% JanE +2% Monthly Selling Prices (Jan) Dec +7% JanE +10% ECB Monetary Policy Mtg 12:45 Outcome 13:30 Press Conference	Retail Sales Volumes (Dec) Nov 1.6% MM, 6.4% YY DecE -0.2% MM, 3.4% YY
26 January	**27 January**	**28 January**	**29 January**	**30 January**
BBA Loans for House Purchase (Dec) *During The Week* Nationwide House Prices (Jan, 08:00) Eurogroup Meeting (Brussels)	Service Sector Output (Nov) GDP (Q4, Preliminary) EcoFin Meeting (Brussels) FOMC Meeting	FOMC Meeting	CBI Retail Survey (Jan, 11:00)	GfK Consumer Confidence (Jan, 00:01) Mortgage Approvals (Dec)

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.
Sources: BoE, CBI, ONS, national sources and Citi Research.

Appendix A-1

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