



Perspectives by Ruth Lea

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A new government's priority will be to tackle its lamentable fiscal legacy

Introduction: a hung parliament

At the time of writing Gordon Brown remains Prime Minister and discussions are in progress between the Conservatives and the LibDems with a view to forming a power-sharing government. If these discussions break down the Labour party has offered talks with the LibDems. The most likely options for a new government are, however, a Conservative-LibDem power-sharing arrangement or a Conservative minority government. A Lab-LibDem arrangement (possibly including other parties to reach an overall majority) looks less likely. These inter-party negotiations are, of course, necessary because the hung parliament outcome of the 6 May General Election.

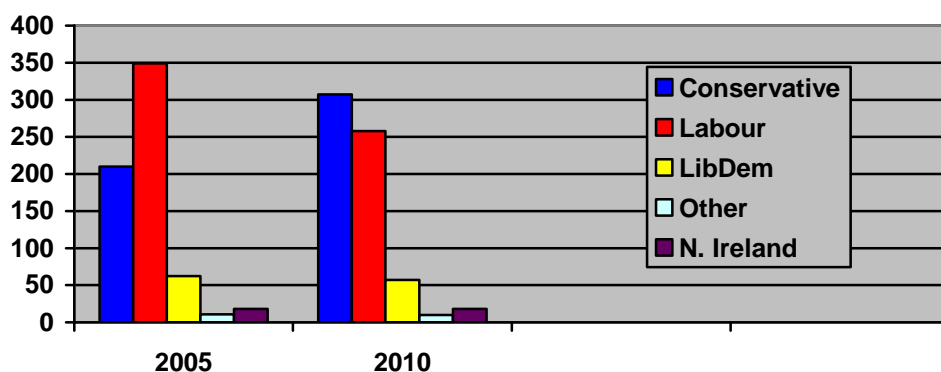
The following table and chart shows that the Conservatives, whilst gaining 97 seats (net), fell short of gaining an overall majority. The 2010 outcome is shown below compared with the 2005 notional, boundary-adjusted outcome.

General Election results: 6 May 2010

Party	Seats	Net change	Share of vote (%)	Change to share of vote (%)
Conservative*	307	+97	+36.1	+3.8
Conservative minus Speaker*	306			
Labour	258	-91	29.0	-4.2
Liberal Democrat	57	-5	23.0	+1.0
Democratic Unionist Party (DUP), NI	8	-1	0.6	-0.3
Scottish Nationalist Party (SNP)	6	0	1.7	+0.1
Sinn Fein, NI	5	0	0.6	-0.1
Plaid Cymru	3	+1	0.6	-0.1
Social Democratic & Labour Party (SDLP), NI	3	0	0.4	-0.1
Green	1	+1	1.0	-0.1
Alliance Party, NI	1	+1	0.1	0
Ulster Conservatives & Unionists, NI	0	-1	0.3	-0.1
Respect	0	-1	0.1	-0.1
Independent (health)	0	-1	0.1	0
Others	1 (NI)	0	1.1	0
Total	650			

* Including the safe seat of Thirsk and Malton where the election has been postponed until 27 May 2010 because of the death of the UKIP candidate. The non-partisan Speaker is the Conservative MP for Buckingham.

2005 (notional seats) and 2010 (seats) elections



In order to obtain an overall majority the winning party (or parties in a power-sharing agreement) strictly require 326 seats. Allowing for the fact that the 5 Sinn Fein MPs will not take their seats this figure drops to 323. If the Conservatives form an alliance with the LibDems the total would be 363 (excluding the Speaker), which gives a comfortable overall majority. The equivalent figure for Labour and the LibDems is 315, which does not represent an overall majority but given the probable support of the Scottish and Welsh nationalists may prove to be adequate to govern.

The economic legacy: horrendous public sector finances

When Gordon Brown became the Chancellor in 1997, he inherited from the outgoing Conservative Government a “golden legacy”. The public finances were returning to surplus, growth was well-established after the ERM debacle of the early 1990s, inflation was under control, unemployment was falling and the current account of the balance of payments was in balance.¹ Even by the mid-2000s, before the credit crunch, the financial and the economic recession, it was clear that the golden legacy was losing its shine. A rapidly expanding and underperforming public sector was undermining productivity growth and the solidity of the public finances and the balance of payments were deteriorating as the country consumed beyond its means.²

In the wake of the economic recession, the 1997 golden legacy has now become tarnished beyond recognition. The most lamentable feature is, as discussed many times, the horrendous public sector deficit which amounted to 11½% of GDP in FY2009 – the worst of any major economy. And the economy, rather than growing robustly, is just about coming out of recession. Unemployment has reached 2.5 million and is likely to continue rising.

The fiscal challenge

Suffice to say, a new government’s first task should be to convince the financial markets that they are serious is tackling the public deficit. As we argued in the last Perspective, a hung parliament would almost certainly increase the difficulties involved in achieving this.³ A minority Conservative government or a coalition (of whatever political hue) is highly unlikely to prove as stable and cohesive as a majority single-party government. Indeed the speculation is already mounting about a second election later this year as occurred after the February 1974 election, which had led to a minority Labour government. And, as we anticipated, the markets reacted badly to the outcome of last week’s election despite some reassurances from some commentators prior to the election that the market had already “priced in” the prospect of such an outcome.

Sterling fell overall to under \$/£1.47 (from nearly \$/£1.50) and to €/\$1.16 (from nearly €/\$1.18) against a sickly euro on 7 May. Gilts wobbled during the day, ending modestly down, with the financial markets remaining anxious about the timetable for cutting the budget deficit. Credit ratings agencies Moody's and Standard and Poor's did, however, offer some reassurance that the "triple A" sovereign rating was not under immediate threat.⁴ The FTSE 100 fell over 2½% but this largely reflected the impact on global equities of the eurozone crisis and fears that a Greek debt default could paralyse major parts of the world's financial system (as with the Lehmans collapse in September 2008) and throw the economic recovery off track. The British General Election was something of a sideshow in the equities markets.

So it is now clear that the financial markets are profoundly concerned about the implications of a hung parliament. And it is imperative that party leaders form a credible government as soon as possible. We hope that this is achieved early this week (beginning 10 May).

Assuming that a new government can at least be agreed this week, the political timetable would then be:

- 18 May 2010: Parliament assembles.
- 25 May 2010: the State Opening of Parliament.

It will then be for the new Government to show the markets that credible fiscal retrenchment programmes will be implemented on a credible timetable. This is all the more crucial as prior to the election the Institute of Fiscal Studies identified very large "holes" in all three major parties plans for repairing the public finances. The table below gives an indication of the magnitude of these "holes".

The "holes" in the parties' fiscal repair plans: cuts required and announced so far

	Labour		LibDems	Conservatives
	2 year protection	4 year protection		
Total required FY2009-FY2014	£82bn	£82bn	£80bn	£96bn
Total required FY2010-FY2014	£84bn	£84bn	£84bn	£92bn
Announced	£10bn	£19bn	£5bn	£21bn
To be found	£74bn (from £546bn)	£65bn (from £370bn)	£79bn (from £546bn)	£71bn (from £411bn)

Source: Chote, Crawford, Emmerson and Tetlow, "Filling the hole: how do the three main UK parties plan to repair the public finances", IFS, April 2010.

Note: Under Labour's 2 year protection scenario the IFS assumes that the "ring fenced" spending for hospitals, schools etc would last 2 years; under the 4 year protection scenario they would last 4 years.

It is apparent from this table that the lion's share of the cuts required to meet the pre-election fiscal plans of the three major parties have yet to be identified. For example, the IFS calculates that for the LibDems just £5bn of the £84bn "required" cuts (by FY2014) have been adequately identified, leaving £79bn to be found. For the Conservatives £71bn of further cuts needs to be found. These are very substantial amounts and indicate how many more, painful decisions need to be taken.

Assuming a Conservative-led government (either in a power-sharing agreement with the LibDems or as a minority government), we note the Conservative party manifesto promised: "...[to] provide an emergency Budget within 50 days of taking office to set out a credible plan for eliminating the bulk of the structural current deficit over a Parliament."⁵

This would suggest a Budget in late June/early July at the very latest. It would be expected to cover:

- An economic forecast. The 2010 Budget GDP forecast of 3¼% for 2011 and 3½% for 2012 has been widely criticised as too optimistic. A new Budget may revise the forecasts, with implications for the public finances.
- The possibility of tax rises, with an increase in the VAT standard rate to 20%, introduced 1 January 2011, a strong possibility.
- More information about spending cuts up to FY2014. And, presumably, further details would be provided in the next Comprehensive Spending Review. This CSR is due in July 2010 (arguably) and would cover FY2011 to FY2013 if the three-year planning period is retained.⁶ The current CSR covers the three-year period FY2008 to FY2010.

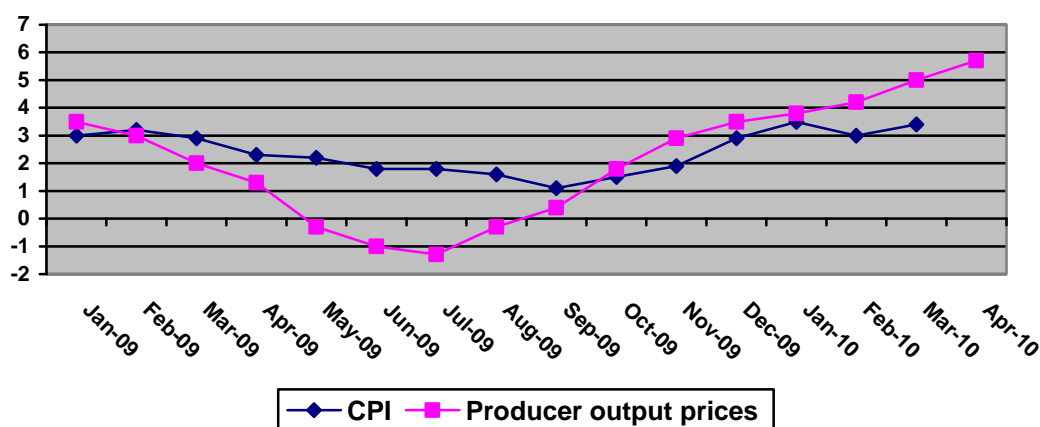
The Bank of England

The next decision of the Monetary Policy Committee of the Bank of England on interest rates is due today (10 May). No change to the 0.5% Bank Rate is expected and no further quantitative easing in addition to the £200bn already undertaken is expected.

On 12 May the Bank will release the May *Inflation report*. Recent figures for both consumer and producer prices have been firmer than expected - and this allows for the base effects, for example the impact of the VAT changes, which have distorted the figures. The MPC's Minutes for April noted in particular that, since the February forecasting round, sterling oil prices had risen 20%.⁷ This was partly because sterling was weaker, by 2.5% or so on its effective exchange rate.

Reflecting these numbers the May report is expected to project higher inflation than in the February report. But we still expect the Bank to forecast that the 2% CPI forecast will be met over a 2-year horizon reflecting the view that the margin of spare resources in the economy will be large enough to bear down on consumer prices and enable the target to be met. Under these circumstances and given the fiscal retrenchment ahead, the MPC seems likely to stick to its ultra-accommodative monetary stance for many months to come.

CPI and producer output prices year-on-year inflation rates (%)



Source of data: ONS.

References

1. Ruth Lea, *Whatever happened to the Golden Legacy?*, Centre for Policy Studies, March 2005
2. Ruth Lea, *The Chancellor's record: an audit of the last 10 years*, Centre for Policy Studies, December 2006.
3. Ruth Lea, "The markets are calm now: but a hung parliament would surely increase economic uncertainty", Arbuthnot Banking Group, 10 May 2010.
4. Reuters News Services, "Markets recoup most post-election underperformance", 7 May 2010.
5. *Invitation to join the Government of Britain*, Conservative Manifesto 2010, April 2010. The structural current deficit for FY2014 was projected to be 1.3% of GDP in the 2010 Budget, compared with an estimated 4.8% of GDP for FY2009.
6. The Labour Government's Spending Reviews were in July 1998 (for FY1999-FY2011), July 2000 (FY2001-FY2003), July 2002 (FY2003-FY2005), July 2004 (FY2008-FY2010) and October 2007 (FY2008-FY2010).
7. Bank of England, "Minutes of the Monetary Policy Committee meeting 7 and 8 April", 21 April 2010.

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