Hard Choices in UK Public Policy – What to cut, not when

No matter who forms the new government in May 2010, the new set of ministers will have to tackle the worst deficit in UK public finance for decades. The 2010 to 2015 period will inevitably require policy-makers and citizens to make some hard choices – either raising taxes or pruning spending on previously highly valued public services.

In the second of our 'Hard Choices' series, and ahead of the last budget before the election, Joachim Wehner looks at how best to make cuts and potentially maintain economic growth.

The main focus of the public debate about the UK's fiscal health has been on how quickly to reduce the deficit. In fact, the more important question is which expenditures should be cut. Let's start with some basic facts: Empirical evidence on fiscal consolidation suggests that mainly revenue-based adjustments are less likely to be successful than those based predominantly on spending cuts. There is some room for tax increases, but successful adjustment calls for much of the pain to fall on the spending side. This may be politically inconvenient for some, but it is an empirical fact. This point is well known by experts, confirmed by a number of econometric studies (including an analysis by the OECD available here) and acknowledged by many politicians. Yet, political parties are unwilling to spell out in detail which spending items will be slashed after the election.

In a recent paper (available here), Alberto Alesina and Silvia Ardagna at Harvard build on earlier work and examine large-scale fiscal policy changes in OECD countries. Once again, they confirm that fiscal adjustments based on spending cuts are most suited to get deficits and debt under control. Moreover, they highlight the importance of the composition of fiscal adjustment for economic growth: "adjustments associated with higher GDP growth are those in which a larger share of the reduction of the primary deficit-to-GDP ratio is due to cuts in current spending, to the government wage and non-wage components, and to subsidies." In other words, fiscal consolidation does not necessarily have to be bad for economic growth – if the right items are targeted. These findings deserve attention in the UK, especially by those who argue that adjustment should be delayed so as not to endanger economic recovery.

The budget should be an occasion to set out the way forward for public spending over the coming years. It is not enough for political parties to say they will cut the deficit and to squabble about the timing of fiscal adjustment. Much more important is the balance between revenue and spending measures, and the composition of spending cuts. Unfortunately, every cut will mobilise some special interests, so politicians have incentives not to come clean about their intentions before the election. At some point, this spineless dithering will no longer be an option.