The death of fiscal demand management

Agenda

Despite a tough Budget, interest rates will absorb the shocks

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Fiscal demand management is dead. This is the message of Gordon Brown's first Budget. As a result, the Budget was definitely new Labour, not Old. Fiscal policy is not to be used to slow the economy. Instead, the role of fiscal policy is to reduce borrowing and finance government spending.

The task for fine tuning the economy will rest with monetary policy. Interest rates will act as the economy's shock absorber. The inflation outlook is unlikely to be as bad as the financial markets fear, in which case interest rates do not need to rise aggressively. But, with a new Monetary Policy Committee aiming to prove its credibility, the Bank of England's view will be that as inflation risks are on the upside, interest rates must rise. Expect base rates to reach 7.5% by the end of the year with the next increase this week. Although the pound is overvalued, it will head higher, causing untold problems for exporters and industry.

There were some positive aspects in the Budget – Brown's message of intent which points to radical future changes in tax and benefits, a new individual savings account and a comprehensive review of government spending. His longer-term measures to boost investment and reduce unemployment are welcome but it will take time to assess their impact.

Yet the Budget's shortfall is it may not achieve the balanced and sustained growth the Chancellor is looking for. Everything in the Chancellor's plans looks rosy, but the outcome is unlikely to be. The Chancellor predicts a slowdown to a steady pace of growth, with the public sector borrowing requirement (PSBR) falling significantly. The likelihood is the economic slowdown will not happen immediately and when it does it may not be as smooth as he is forecasting. Indeed, there is every likelihood the combination of a tough fiscal stance, higher interest rates and a stronger pound will eventually slow the economy abruptly, with exporters and manufacturers bearing the strain, just as they did in the recession of the early Eighties.

Tax increases for the consumer focus mainly on the housing market and do not feed through until next year. Despite this, it is still a very tough Budget, with tax increases concentrated on pension funds and utilities. Eventually these could be backdoor taxes for people and firms.

Higher taxes will drain a sizeable £12.6 billion from the economy over the next two years, and £7.4 billion excluding the windfall tax. This is tough, with the bulk of higher revenues being used to reduce Government borrowing. The attempt to improve the public finances and lower the PSBR was central to the Budget.

Yet the Chancellor's projection for the budget deficit lacks credibility. This is not just because the Treasury's PSBR forecast is often inaccurate. The economy could slow sharply in future years, undermining Government revenues, and it may still be difficult for the Government to achieve the tough public spending plans they remain committed to. The likelihood was some of the contingency reserve would be used to boost spending on health and education but the fact the Chancellor used this money at a time when no-one expected it may raise doubts about his ability to keep expenditure under control in the run-up to the next election, when higher spending will be demanded. Using the reserve has given the Chancellor some breathing space but his planned review of Government spending will need to find ways to release money for popular purposes.

The Chancellor outlined three projections for government spending, all of which have it falling as a proportion of GDP. Even the most pessimistic projects a budget surplus of 0.6% of GDP by 2002. This seems too good to be true. The Government's fiscal plans need a continuation of the 'growth dividend', but the independent Bank of England may prevent this.

The financial markets hoped the Chancellor would raise consumer taxes. But this seemed unlikely as it would have meant the Chancellor breaking the spirit or the letter of Labour's election manifesto. There is some case for slowing the economy, but not as aggressively as the financial markets want. It is still not clear how sustainable the recent pace of spending is, and as some of it is financed by temporary building society windfall gains this lessens the argument for permanent tax hikes to offset it.

The degree of fiscal tightening required depends on one's view of the economy. Here the Chancellor runs into trouble. If one believes, as Brown stated, that the output gap is zero, suggesting there are no spare resources in the economy, and consumer spending will remain strong, then there was a case for taking more action in the Budget. At least he could have abolished Miras, and with immediate effect, without seriously affecting labour mobility. Having admitted there was a problem the Chancellor should have done something about it.

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