Could the Conservatives and the Lib Dems find common ground on fiscal policy?

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*Is there enough common ground in the Conservative and Lib Dem fiscal plans to permit a renewal of their vows? In this post, **Matthew Whittaker** discusses the main differences between the two parties in terms of fiscal policy, and suggests that, given sufficient desire and flexibility, these parties may well be able to navigate through significant political differences.*

Amid recent discussion of the key role that parties such as UKIP and the SNP might play in 'propping up' a minority government after 7 May, less attention appears to have been given to the continued potential leverage of the Liberal Democrats. Of course, any future negotiations will revolve around a multitude of issues and red lines, but we can be sure that fiscal plans will loom very large in any discussion. At the Resolution Foundation, we've already considered how much overlap there might be between Labour and the Lib Dems, and concluded that – while far from straightforward – a compromise position could be found that would allow both parties to claim victories of sorts (see also our pre-budget look at SNP plans). But what of the current coalition partners: is there enough common ground in their fiscal plans to permit a renewal of their vows?

Recall the key fiscal commitments. The Lib Dems have said they would deliver a structural current budget balance by 2017-18, pencilling in around £24 billion of further consolidation after 2015-16 (in fact delivering a sizeable current *surplus*). They say they would then start raising spending and cutting taxes, at the same time as taking advantage of a growing economy to further build the current budget surplus. The Conservatives intend to go further by maintaining consolidation for a year longer (through to 2018-19) in order to deliver an *overall* budget surplus. However, they too are planning some loosening at the end of the parliament.

As the chart below shows, these timings mean the consolidation 'gap' between the Lib Dems (solid gold line) and the Conservatives (solid blue line) widens sharply from roughly £9 billion in 2017-18 to around £21 billion by the end of the parliament. That's highly significant – and could be a major blockage to a deal. But, with the next parliament having the potential for increased political instability – along with the usual high degree of uncertainty surrounding fiscal projections – negotiating parties might be more willing than was the case in 2010 to play down longer-term differences, as long as there's sufficient scope for near-term agreement.

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Notes: All figures in 2015-16 terms using GDP deflator. Conservative line equivalent to Budget 2015 plan; Liberal Democrat line based on 'yellow budget'. Dotted green line gives £1 billion overall surplus in 2018-19 and 2019-20.

Yet even if the parties *do* feel the need to set out a common position for the end of the parliament, the distance between the Lib Dems and the Conservatives may not be quite as insurmountable as it might first appear.

In part that's because the Conservative trajectory over-achieves relative to the party's stated aim of overall budget surplus. Our dotted green line in the chart shows an alternative path that only just delivers against this pledge, which on its own narrows the gap between the parties to around £15 billion in 2019-20.

Having made so much of their determination to deliver an overall surplus, let's assume the Conservatives can't shift any further than this. But the Lib Dems could edge closer towards this compromise position while upholding their post-2017-18 promise. That's because they're committed to an 'overall' surplus that excludes certain elements of 'productive' investment, but haven't yet defined what proportion of capital spending this covers. This gives them wriggle room: the less they choose to exclude from their target, the closer they drift to Conservative policy.

So the entirely speculative compromise position we set out – current surplus in 2017-18 followed by overall balance in 2018-19 – means delivering £25 billion of consolidation by 2017-18, rising to £34 billion by 2018-19. More than the Lib Dems have said, less than the Conservatives: extremely difficult but – with the right balance of measures – perhaps plausible.

What's much harder to speculate on is the mix of cuts and tax rises that might be used to deliver this consolidation. This is likely to be the most contested part of any deal. For example, the Conservative plans include £12 billion of welfare cuts, something Nick Clegg has said his party wouldn't accept (the Lib Dem plans call for £3 billion). Likewise, the Lib Dem reliance on £13 billion of new tax revenues (including £7 billion via clamping down on avoidance) is at odds with George Osborne's argument that his plan requires no new tax rises (beyond £5 billion of estimated anti-avoidance savings). Could common ground be found?

Say we assume that the Lib Dems insist on sticking to a maximum of £3 billion of welfare cuts and the Conservatives accept no tax increases beyond the £7 billion from tax avoidance, then achieving the consolidation set out by the dotted green line would require around £15 billion of cuts in departmental budgets by 2017-18 – going beyond the explicit intentions of either party and therefore implying deeper cuts to non-protected departments than either have pencilled in. If that looks difficult, it becomes even more so in 2018-19, when the overall job of consolidation rises by a further £9 billion.

The implication is that one – or more likely both – parties would face an embarrassing climb down on welfare cuts and tax-rises: probably not accepting all of their partner's position, but a large chunk of it. Taking all this pain purely in the form of ever more extreme cuts to (non-protected) departments would at some point shift from the realm of the implausible to the impossible.

The challenge is compounded by the need to deliver on pre-election pledges. We know that expensive promises can sometimes be the victim of coalition talks – cynics might even suggest that negotiations offer something of a welcome get-out. But with the Lib Dems and Conservatives having made some very similar pledges, we can be fairly sure of seeing at least two significant (and expensive) policies being upheld in any future agreement: both have promised to raise the income tax personal allowance to £12,500 (costing roughly £4 billion) and boost NHS spending by £8 billion.

The Lib Dems have identified explicit sources of funding for these policies, but these resources would clearly be significantly reduced if they shifted towards the much tighter compromise position we have set out. For their part, the Conservatives have intimated that they would fund the policies from the proceeds of growth and surplus. Again though, our hypothetical compromise appears to undermine such an approach by reducing the size of the planned surplus. Once again the implication is that the two parties would need to agree on tax rises or spending cuts in other areas that go beyond what they say they are comfortable with.

As 2010 demonstrated, we shouldn't be surprised if political parties are able to navigate a way through even major political differences if there is sufficient political desire and flexibility. But in 2015 this will require some substantial compromises, particularly in relation to *how* to achieve a given amount of consolidation. Given their respective commitments on the deficit it's almost impossible to see how a deal could be done that doesn't involve the Lib Dems accepting a big step towards the Conservatives on welfare cuts, and the Conservatives taking a similar step towards their partners on tax rises.

Finally, it's worth remembering that regardless of whatever deal is struck our fiscal path will be affected at least as much by economics as by politics. All fiscal projections over the life of a parliament are massively speculative (indeed, too much of the current debate is characterised by false precision about fiscal scenarios). The precise magnitude of the fiscal job at hand is subject to great uncertainty depending, not least, on what happens to productivity growth. Nor do our fiscal numbers take account of the 'dynamic effects' of different consolidation paths on growth (and tax revenues). Yet, despite all these uncertainties, it's important to try and shed a bit of light on the possible fiscal path ahead – and to understand what the different political parties might agree (and disagree) on.

Note: This article gives the views of the author, and not the position of the General Election blog, nor of the London School of Economics. Please read our comments policy before posting. This piece originally features on the Resolution Foundation's blog and can be found here.

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