Political parties face the biggest economic challenges since the mid-1970s

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With the General Election date now firmly set for May 6th all three major parties face the formidable challenge of how to deal with the most serious set of economic problems facing the UK since the crises of the mid-1970s. The economy has contracted by more than 6 per cent over the past year, inflation is above target and the Treasury faces the twin problems of high levels of public borrowing and falls in revenue from tax receipts. The borrowing requirement will reach nearly £170 bn in 2009–10.

Public debt as a proportion of GDP will rise from its historic lows of the 2000s to perhaps as high as 80% of GDP (twice the EU Maastricht guideline) by the middle of the decade, fuelling fears that the UK's credit rating will be downgraded as financial markets fear such levels of debt cannot be sustained over the medium term. In addition, as a result of measures to protect the financial system in the wake of the failure of Northern Rock and the knock-on effect of the sub-prime debt defaults in the USA in 2007–8, the Treasury and Bank of England have put together packages of support worth more than £1.2 trillion over the past two years and the Treasury is the major shareholder in Banks such as the RBOS with liabilities totally more than UK GDP.

Recovery from the credit-crunch induced recession looks fragile throughout the G7 and the UK looks like it is in weakest position. There is a genuine fear of a W shaped recession (or worse an L shape one) as the economy struggles to return to trend growth. Monetary policy is effectively neutered with interest rates at 0.5 per cent and there is no scope for Keynesian style stimulus. The political and economic agenda of how to handle this has already produced debates about the speed at which public borrowing should be cut and what sort of public spending cutback is required. There are mixed messages coming from both the major parties – with debate between the Prime Minister and Chancellor over how when cutback should begin. The issue has split the economics profession. It will be a major fault line between the parties during the election.

But what is clear is that from 2011 onwards whoever wins the General Election will have to preside over cutbacks in public spending for a sustained period unprecedented since the 1970s, and arguably worse than at any time since the 1930s. The debate is about timing and speed, not about whether the public sector faces a major squeeze. What is open to doubt is the sort of political and administrative arrangements whoever is in Government will put in place. Will the Treasury be given a simple task of cuts across the board or will some of the impetus for reform in the public sector mean cuts will be more nuanced and targeted? Will the idea of flexible and consumer-led public services survive the pressures to achieve the bottom line of cutback?

Will the Treasury revert to its traditional role as a veto player less concerned about the quality of output from public spending and more interested in crude reductions? Politically all the major parties face a daunting task of reversing more than 12 years of public spending growth in a harsher economic climate. The Treasury is already looking back at the lessons of the 1970s, 1980s and 1990s to try and prepare the ground for whoever forms the next government on May 7th.

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To view Colin Thain's project web site visit **www.treasuryproject.org (http://www.treasuryproject.org/)**