



Perspectives by Ruth Lea

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The public finances: time for a radical reappraisal

Introduction: shocking public finances

The public finance projections in the Pre-Budget Report (PBR) were as bad as expected – if not worse. Even allowing for the fiscal stimulus, which amounted to £9.3bn in FY2008 and £16.3bn for FY2009 (compared with the budget and including the announcements already made since the budget on, for example, the compensation for the losers of the abolition of the 10p tax band), the deterioration since the March Budget was dramatic.

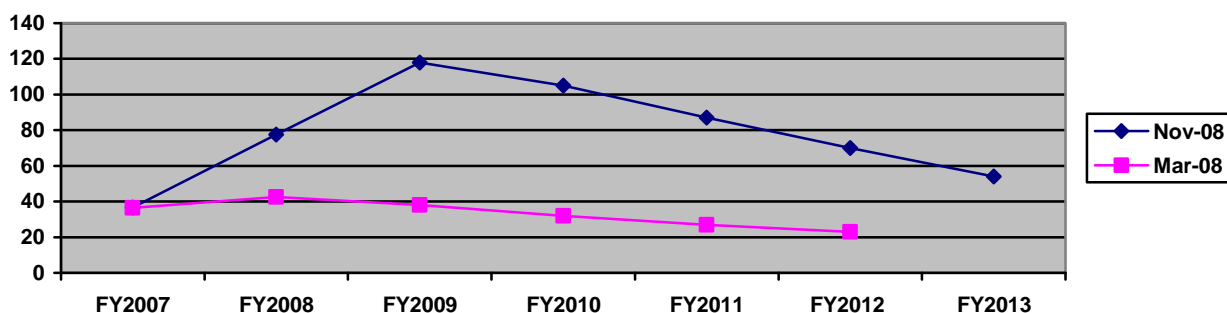
Projections for the public finances, £bn

	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
Current balance:							
Mar 08	-7.9	-10	-4	+4	+11	+18	Na
Nov 08	-6.7	-41.2	-78	-73	-54	-37	-21
Revision between:							
Mar 2008 & PBR 2008	+1.2	-31.2	-74	-77	-65	-55	Na
Net borrowing:							
Mar 08	36.4	43	38	32	27	23	Na
Nov 08	36.6	77.6	118	105	87	70	54
Revision between:							
Mar 2008 & PBR 2008	0.2	34.6	80	73	60	47	Na

Sources: (i) HM Treasury, *Budget 2008: Stability and opportunity: building a strong, sustainable future*, March 2008, HC388 and (ii) HM Treasury, *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, Cm 7484, November 2008.

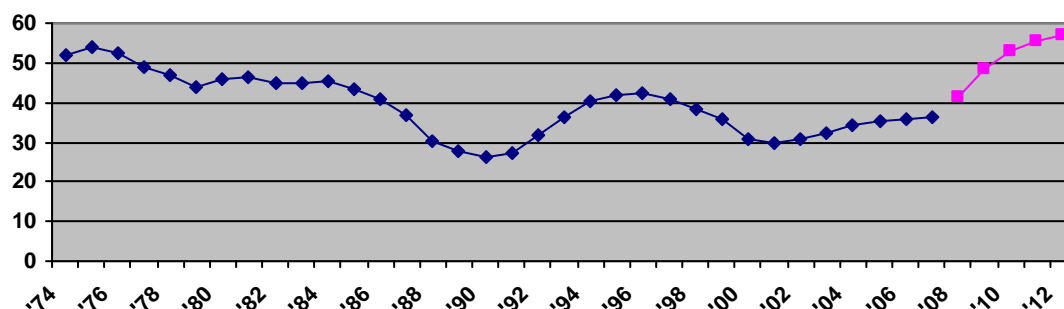
The chart shows the deterioration in the borrowing data. At the time of the Budget, the Treasury estimated there would be total borrowing of about £160bn between FY2008 and FY2012, in the PBR the equivalent figure was nearly £460bn - a worsening of an unprecedented £300bn.

Net borrowing (£bn): March Budget and PBR projections compared



The deterioration in the debt/GDP data was just as shocking. By FY2007 end year public sector debt totalled £526.8bn (36.3% of GDP). By end year FY2013 it is projected to be £1084bn (57.4% of GDP) which, in nominal terms, is more than double than in FY2007.^{1,2} The debt/GDP ratio in FY2013, if achieved, would be the highest on record for this statistical series, which has been compiled since FY1974. These figures, of course, allow for the tax rises that were announced in the PBR and that will “kick in” in FY2008 (higher alcohol and tobacco duties), FY2010 (the changes in tax-free personal allowance for those earning over £100,000) and FY2011 (the increases in the NICs rates and the new 45% top rate for those earning more than £150,000).

Debt/GDP ratio (%) FY1974 to FY2007 (outturns) and FY2008 to FY2012 (forecasts)



Source: HM Treasury, *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, Cm 7484, November 2008.

But even though the projections for the public finances are appalling, there are at least two good reasons to doubt their accuracy and take the view that the outturns will be worse. The first is the Treasury’s track record in forecasting the public finances. As we have discussed previously the Treasury has a strong bias to over-optimism.³ The second reason relates to the PBR’s GDP growth assumptions. Even on their “cautious scenario” the PBR assumes that recovery will begin in the second half of next year and steady 2¾% annual growth will be achieved by FY2011. Many commentators regard this as too optimistic.⁴

GDP annual growth rate (%) assumptions for public finance projections

	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
GDP growth	(3)	-½	-¾	1¾	2¾	2¾	2¾

Source *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, HM Treasury, Cm 7484, November 2008, table B1.

But even on the Treasury's arithmetic, gilt issuance will be around £350bn over the next three years (including gilt issuance of £146bn for this year). This is not a trivial figure and it is to be hoped that investors (a good proportion of whom will be overseas investors) will continue to regard gilts as good and sound investments.

The need for fiscal consolidation

There is a pressing need for a disciplined package of fiscal consolidation to be implemented once it is felt that the worst of the recession is over. The tax rises already mentioned, especially the increases in NICs from FY2011, will raise revenue and cut borrowing. But, unless a scalpel is taken to public spending, there will almost certainly be further, very considerable, tax rises. 1p on the basic rate of income tax would bring in at least £4bn and a 1 percentage point increase in the main VAT rate would raise £5bn. (See annex table 1 for further examples.) If a Labour Government were to be returned at the next General Election then, with the totem top 40% income tax rate consigned to history, higher rates (almost certainly higher than 45%) on "high earners" (from £100,000 or even lower?) would be a likely target.

One way of mitigating the size of the tax rises is, of course, to tighten public expenditure. There were very tentative signs of this in the PBR. Current spending is projected to increase by an annual average 3.85% in nominal terms (1.2% in real terms, as deflated by the GDP deflator) from FY2011 to FY2013, well down on the growth rates since 2000, and net investment is projected to fall in FY2010 after its splurge in FY2009.

Public spending projections, £bn, current prices

	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Budget, Mar 2008							
Current spending	540.1	566	592	622	650	680	Na
Depreciation (current spending)	17.7	19	20	21	22	23	Na
Net investment	28.5	33	35	37	38	41	Na
Total	586.3	618	647	680	710	744	Na
PBR, Nov 2008:							
Current spending	536.4	568.0	594	628	653	679	705
Depreciation (current spending)	17.8	18.7	20	21	22	23	24
Net investment	29.9	36.5	40	33	33	33	33
Total	584.1	623.2	654	682	708	735	762

Source: Source *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, HM Treasury, Cm 7484, November 2008, table B1.

Real annual increases of 1.2% in real terms have been widely reported in the media as “eye-wateringly tight”. But for large swathes of the private sector, real annual increases of 1.2%, in present straightened times, would be regarded as a luxury. Moreover, given the huge boom in public sector spending since the turn of the century and the shocking record on public sector productivity, ⁵ there is a very good case for much tighter public spending than shown in the PBR, including real cuts, accompanied by serious public sector reform.

As the Times wrote recently: ⁶

“The State in Britain needs serious reform. The only possible silver lining of the dreadful state of the public finances is that it is now unavoidable.”

And as Denis McShane MP has written: ⁷

“I do not know of a single minister who privately does not despair at the waste of money on pointless projects, publications, or legions of press officers that add no value.”

The health service: an example

The health service has been a major beneficiary, along with education, of the Treasury’s munificence courtesy of the taxpayer over the past decade. Spending on the NHS was around £45bn in 1997, it is now well over £100bn. The PBR quoted the figure of £111bn for FY2008. According to the ONS, however, the booming inputs (spending) have not been accompanied by an equivalent boom in outputs. The productivity deterioration was especially marked after 2001, when the spending was accelerated. ⁸

Health care output (excluding quality adjustment), inputs and productivity, 1995=100

	1995	2006	Average annual change 1995-2006	Average annual change 2001-2006
Output	100.0	150.3	3.8%	3.9%
Input	100.0	167.4	4.8%	6.5%
Productivity	100.0	89.8	-1.0%	-2.5%

Source: ONS, Centre for the Measurement of Government Activity (CeMGA), *Public Service Productivity, Health Care: Summary*, January 2008. Productivity=output/input.

Between 1995 and 2006 there was, therefore, a 10% fall in productivity. Granted this excludes “quality adjustments” – but they are highly subjective and politically driven. The fall in productivity represents a monumental waste of hard-working taxpayers’ money. Even if productivity had been flat over the 11-year period 1995-2006 the savings would have been substantial. And if the health service had achieved an annual average 2% increase in productivity (which would have amounted to a total increase of nearly a quarter for 1995-2006), as expected in the rest of the economy, the savings would have been very much more substantial.

The table below shows illustrative savings that could have been achieved under two alternative productivity scenarios for 1995-2006: (A) flat productivity, (B) 2% annual average increase. Given £95bn actual spending in 2006 (approximately), £10bn could have been saved if productivity had been flat between 1995 and 2006 and over £26bn could have been saved if there had been a 2% annual average increase.

Maintaining health output for 2006, three productivity scenarios

Productivity, 1995-2006	Productivity, 2006 (1995=100)	Output, 2006=100	Output/ productivity =input	Illustrative spending on health, 2006, £bn	Saving, £bn
Outturn: 10% decline	89.8	100	100/89.8=111.4	95*	0
Scenario (A): flat productivity	100.0	100	100/100=100	95x100/111.4 = 85	10
Scenario (B): 2% annual average increase	124.3	100	100/124.3=80.5	95x80.5/111.4 =69	26

* The actual spending on health for FY2006 was £96bn. Source: HM Treasury, Pre-Budget Report, December 2005, Cm 6984.

Conclusion

Britain's public finances are unsustainable. Either taxes rise "eye-wateringly horribly" to repair them or public sector spending is severely curtailed and taxpayer-funded services are radically reformed to deliver value-for-money. By no stretch of the imagination are they delivering value-for-money at present.

References

1. The debt data exclude £77.3bn of off-balance sheet items - for the bank recapitalisation fund (£37bn), Bradford & Bingley (£18.2bn), Northern Rock (£14bn), Lansbanki Icesave accounts (£4.5bn) and Kaupthing Singer & Friedlander (£3.6bn). See HM Treasury, *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, Cm 7484, November 2008.
2. The debt data also exclude the full costs of the PFI and the unfunded public sector pensions liabilities.
3. Ruth Lea, "The public finances: prepare for even worse figures", Arbuthnot Banking Group, 20 October 2008.
4. Martin Wolf, "How Britain flirts with disaster", *FT*, 28 November 2008.
5. Ruth Lea, "Public sector productivity: a shocking record", *Perspective*, 17 March 2008. And see annex table 2 for an updated table on the ONS's work on public sector productivity estimates.
6. Times leader, "The politics of spending", *Times*, 26 November 2008.
7. Denis McShane, "The answer's obvious: cut taxes and spending", *Daily Telegraph*, 27 May 2008.
8. ONS, Centre for the Measurement of Government Activity (CeMGA), *Public Service Productivity, Health Care: Summary*, January 2008, available from www.statistics.gov.uk.

Annex tables

Table 1 Selected direct revenue effects of illustrative tax changes (£bn)

	FY2008	FY2009	FY2010
Income tax:			
Change basic-rate by 1p	3.45	4.15	4.2
Change higher-rate by 1p	0.9	1.52	1.49
Corporation tax:			
Change main rate by 1 percentage point	0.95	1.75	1.9
National Insurance Contributions:			
Change Class 1 employee main rate by 1 percentage point	3.65	3.85	4.05
Change Class 1 employee additional rate by 1 percentage point	1.2	1.3	1.4
Change Class 1 employer rate by 1 percentage point	5.0	5.25	5.55
VAT:			
Change higher rate by 1 percentage point	4.84	5.1	5.325

Source: HM Treasury, *Tax ready reckoner and tax reliefs*, October 2007.

Table 2 Public sector productivity: key ONS findings

Public sector	Productivity for the whole public sector fell by around 5% between 1998 and 2001.
Education	<p>Between 1996 & 2006 quality-adjusted productivity rose on average by 0.1% a year. But there are 2 distinct time periods:</p> <ul style="list-style-type: none"> • Between 1996 & 1999, productivity of publicly funded education services increased on average by 2.1% a year. • From 1999 onwards, productivity fell on average by 0.7% a year – the fall was associated with a decline in pupil numbers & in increase in school support staff.
Health Care	<p>Even without adjustment for quality change, the quantity (output) of health care provided was 50% higher in 2006 than in 1995. However, inputs have risen even more rapidly. The volume of resources going into the NHS was 67% higher in 2006 than in 1995.</p> <p>Productivity therefore fell over the period, 1996-2006, as a whole. Closer examination suggested 3 distinct time periods:</p> <ul style="list-style-type: none"> • From 1995 to 2001, productivity was stable, with growth in the quantity of health care matching growth in inputs. No adjustments for quality change in health care are available between these years. • From 2001 to 2005, productivity fell as growth in health care was lower than growth in inputs. With quality adjustment for output, productivity fell by

	<p>2.0% a year on average between 2001 and 2005. Without quality adjustment for output, productivity over the same period fell by 2.5% a year on average.</p> <ul style="list-style-type: none"> • From 2005 to 2006, productivity fell less quickly, by 0.2%. Quality adjustments are not yet available
Social Security Administration	<p>Two distinct periods:</p> <ul style="list-style-type: none"> • Productivity declined each year from 1998 to 2003. In 2003 productivity was around 25% lower than in 1998. • Productivity partly recovered in 2004 & 2005, but in 2005 was still around 15% lower than in 1998. • Productivity rose by 16% in 2007. (ONS News Release, "Rise in Social Security Administration output and administration", 26 June 2008.)
Adult Social Care	<p>Productivity fell by 17% over the period 1995 and 2005. However, the output index is not adjusted for quality changes & there is some evidence that quality has improved & also some evidence of increased levels of dependency of clients in care homes.</p>
Defence	<p>There are no easily-accessible productivity data for defence. But output rose by nearly 20% between 2001 and 2006, even though the increase in defence's inputs has been paltry in comparison with other programmes. (ONS News Release, "ONS proposes improved measures of Defence in National Accounts", 14 November 2008.)</p>

Source: Ruth Lea, "Public sector productivity: a shocking record", Perspective, 17 March 2008, Arbuthnot Banking Group, updated November 2008.

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