



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



Spending cuts: a necessary and painful debate begins

There is little doubt that one of the greatest economic problems facing the country, if not the greatest, is the state of the public finances. Last week the August figures for public sector borrowing were released and showed a shortfall of some £16bn, compared with borrowing of less than £10bn the year before.¹ Tax receipts have fallen, even after allowing for the reduction in the VAT take because of the cut in the standard rate from 17.5% to 15% last December. Income tax receipts have fallen and the corporation tax take has plummeted. Spending, not least of all social security payments, has increased as unemployment has picked up.

The following table shows that taxes have fallen faster so far in the current financial year than the Treasury expected for the full year at the time of the Budget. Granted spending has increased by less than expected (so far), but the arithmetic suggests that borrowing will have to slow if the Treasury is to hit its forecast for the year as a whole. There are some good reasons to expect that this will in fact be the case, with additional revenue to be brought in from this month's increase in fuel duties and the planned increases in stamp duty on residential property and VAT, due to happen on New Year's Day. But it remains to be seen whether this rebound will be sufficient to prevent borrowing from overshooting the Treasury's Budget forecast for the year as a whole (£175bn). It seems doubtful.

Central government finances: comparisons with a year earlier

	August 2009	Cumulative April to August 2009	Budget projections for 2009-2010
Central government receipts	-9.2%	-11.4%	-7.6%
Central government current spending	+3.0%	+5.3%	+7.4%

Source: "IFS analysis of today's public finance figures", 18 September 2009, www.ifs.org.uk

As we have discussed several times before, the current public finances are quite simply unsustainable.² The current political debate suggests, however, that there is an increasing realisation that this is the case. And last week's release on employment data underlined the unsustainable nature of Britain's public sector. In the year to June 2009, public sector jobs actually expanded by 289,000 whilst employment in the private sector fell by 889,000 as the recession took its toll. Comparing June 2009 with June 1997, public sector employment had increased by 860,000 (an increase of nearly 17%), whereas jobs in the private sector had risen by just 1,537,000 (7%).

Employment in the public and private sectors, June data

	Public sector		Private sector	
	Thousands	% of total	Thousands	% of total
1997	5179	19.5	21315	80.5
2007	5766	19.7	23433	80.3
2008	5750	19.5	23741	80.5
2009	6039	20.9	22852	79.1

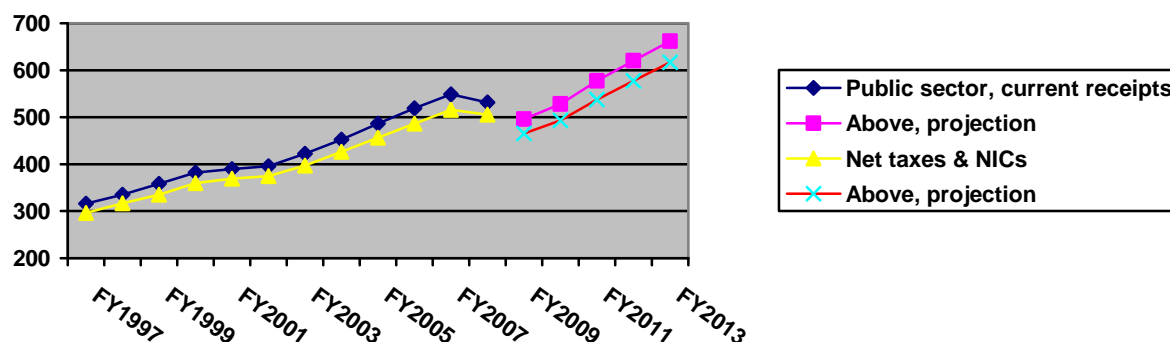
Sources: (i) ONS, "Labour market statistics statistical bulletin", 16 September 2009 and (ii) ONS, "Public sector employment statistical bulletin, Q2 2009", 16 September 2009, www.ons.gov.uk

Fiscal tightening: the 2009 Budget

As we discussed at the time of the Budget, the 2009 Budget projections did include some fiscal tightening.³ The Treasury's objective at the time of the Budget was to balance the cyclically-adjusted current budget by FY2017.⁴ And the tax and spending measures announced and projected in the 2008 Pre-Budget Report and the 2009 Budget would deliver a fiscal tightening equal to 6.4% of national income by FY2017 (over 8 years including FY2010 when restraint is due to start) relative to the projections set out in the 2008 Budget. The IFS provisionally concluded at the time that, of this 6.4% of GDP (around £90bn in current terms), 10% could come from tax increases, 40% from spending cuts and 50% would have to come from measures yet to be announced. Table 1 in the annex shows the detailed breakdown.

The Budget, too, suggested that for the 3 years FY2011 to FY2013, total spending in real terms would effectively be flat (falling marginally by 0.1%), with public investment spending taking the biggest hit. In the absence of a Comprehensive Spending Review for these years, it is impossible to know how spending will be allocated across the departments.⁵ Meanwhile current receipts were projected to bounce back robustly reflecting recovery, after dropping significantly during the recession.

Public sector, current receipts, £bn, to FY2013



Source: HM Treasury, Public finances databank, www.h-m.treasury.gov.uk. These data are consistent with the 2009 Budget projections.

The necessary debate begins

In recent weeks the politics of the public finances has changed. There is now the start of a debate on how Britain's dangerously vulnerable public finances are to be remedied. In a recent document, the IFS suggests some of the key questions that will need to be tackled by policy-makers:⁶

- How big will the fiscal tightening need to be?
- When should it start and how rapidly should it be completed?
- How should the pain be spread between tax increases, cuts in planned spending on public services and cuts in projected welfare payments and what specific measures could the politicians opt for?

These are huge issues and cannot be covered in this Perspective. But we would make the following observation. As we suggested in a recent Perspective, the Treasury's objective of balancing the cyclically-adjusted current balance by FY2017 is far too unambitious and risky given the sea of red ink in the public finances.⁷ We suggested then that the Treasury should aim for a balanced budget by FY2015 and estimated that there needed to be another £65bn of fiscal tightening by FY2015, assuming the 2009 Budget projections for the public finances were accurate (scenario 1). We also calculated an alternative illustrative scenario assuming worse outcomes (scenario 2). This resulted in the need for an extra £90bn of tightening by FY2015.

Tightening can come in the form of tax hikes, or spending cuts or a combination of both. By way of illustration we assumed all this extra projected tightening would come from spending cuts, though in practice there will surely be a combination of spending cuts and tax rises. The detailed figures are shown in annex table 2.

If all the tightening were to be taken in the form of spending cuts then the growth of spending would be severely curtailed in current prices and would turn strongly negative in real terms, as shown in the table below. If the pain were shared half-and-half with tax rises, there would still be falls in spending in real terms. On these differing, yet quite plausible, scenarios the conclusion is that for the period FY2010 to FY2015, total spending needs to fall by an annual average of around 1-2% in real terms to achieve balanced books by FY2015. Such a period of extensive fiscal consolidation is historically quite unprecedented - with the exception of the, exceptional, post war periods.

Fiscal tightening: 2 scenarios, FY2010 to FY2015, growth rates (%)

	FY2010 (£bn)	FY2015 (£bn)	Growth (%)	Annual growth rates (%), current prices	Annual growth rates (%), current prices+
Assuming all spending cuts:					
Budget 2009	702	805	14.7%	2.8%	≈ flat
Scenario 1	702	740	5.4%	1.1%	Minus 1.65%
Scenario 2	702	715	1.9%	0.4%	Minus 2.35%
Assuming half from spending cuts:					
Budget 2009	702	805	14.7%	2.8%	≈ flat
Scenario 1	702	772.5	10.0%	1.9%	Minus 0.85%
Scenario 2	702	760	8.3%	1.6%	Minus 1.15%

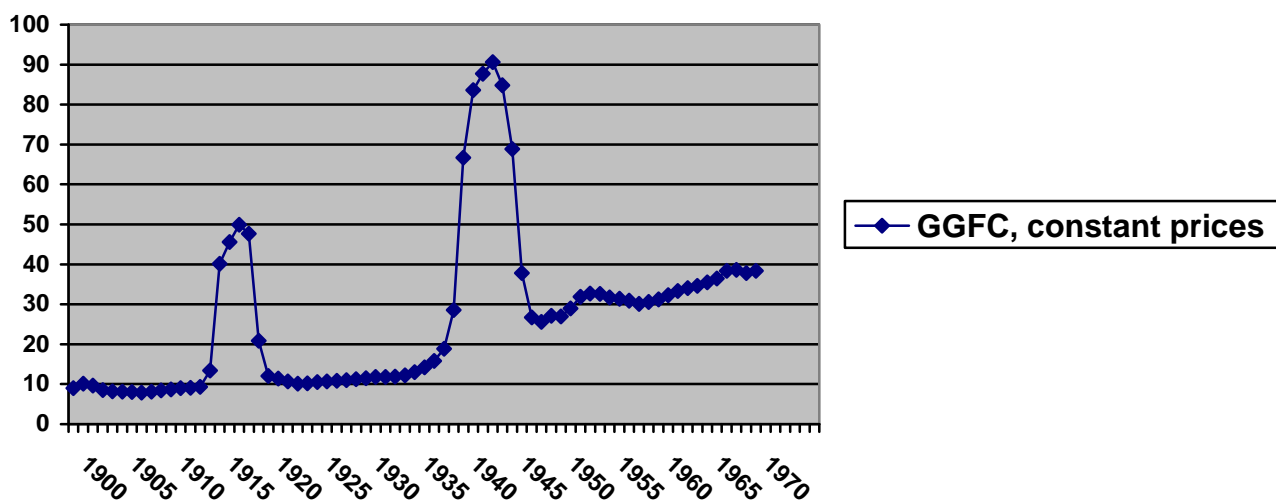
Source: Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group, Economic Perspective, 6 July 2009.

+: The annual increase in the GDP deflator, used for deflating public spending, is broadly extrapolated by the Treasury at 2¼%. In real terms the Budget spending figures are therefore flat, whilst there would, for example, be real terms annual falls in the two scenarios of around 1½% and 2%+ respectively between FY2010 and FY2015 if all the tightening were to be in the form of cuts.

Historical precedent

The following chart shows the history of public spending real terms from 1900 to 1970, a period that was dominated by the massive expansion of state spending in the two world wars and subsequent normalisation.

General Government Final Consumption, £bn, constant prices (1980 prices), 1900-1970

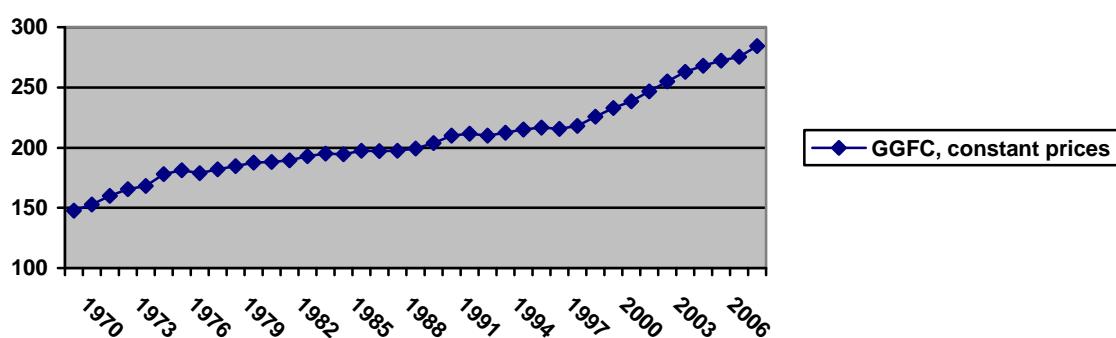


Source: Thelma Liesner, *Economic Statistics, 1900-1983*, Economist publications, 1985. General Government comprises central and local government.

Since 1970 there have been two periods of rapid growth in public spending. The first was in the early 1970s under the Heath and Wilson governments,⁸ which led to the public finance crisis of 1976 when the IMF was called in. Spending cuts were implemented and spending was 1.3% lower in real terms in 1977 than in 1976 before resuming, modest, growth. Growth was fairly tightly controlled by the Thatcher-Major governments despite the two recessions of the early 1980s and early 1990s.

The second period of rapid growth began 1999 and will almost certainly lead to a period of necessary and painful fiscal retrenchment and consolidation. If the eventual outcomes approach the scenarios discussed in the section above, as stated already, this will be without historical precedent.

General Government Final Consumption, £bn, constant prices (reference 2005), 1970-2008



Source: ONS website, www.statistics.gov.uk

Two final thoughts

So far this Perspective has only discussed aggregate public spending. But, in order to gain some notion of the eventual squeeze on departmental spending total “annually managed expenditure” (AME) has to be deducted to give the total available for the departments.⁹

The Treasury recently released (leaked?) the figures for the main components of AME for the years FY2011 to FY2013. According to IFS director Robert Chote these numbers make for grim reading. He reports that the Treasury expects debt interest payments to rise by 11.1% a year, social security costs by 1.4% a year and “other AME” (including public sector pension payments and contributions to the EU) by 3.1% a year. Taking these AME components into account leaves total spending for the departments falling by 2.9% a year (real terms) or 8.6% in total (real terms) for these three years.¹⁰ This would place enormous pressure on departments – even before any of the extra tightening illustrated in our scenarios. The enormity of the problem calls into question the affordability of, for example, public sector pensions, which are long overdue for reform.

The second thought concerns the macroeconomic impact of fiscal tightening and the fear that it would throw the economy back into recession. We take the view that the financial position is so dire that the most sensible objective would be to get the tightening over as quickly as possible and trust that the Bank of England could maintain overall spending power in the economy at a satisfactory level by keeping interest rates low, extending quantitative easing if necessary.

References

1. ONS, "Public sector finances statistical bulletin, August 2009", 18 September 2009, www.ons.gov.uk
2. Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group, Economic Perspective, 6 July 2009.
3. Ruth Lea, "Budget 2009: an exercise in irresponsible procrastination", Arbuthnot Banking Group, Economic Perspective, 27 April 2009.
4. HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009. See chart 2.2.
5. The last CSR was the "2007 Pre-Budget Report & Comprehensive Spending Review, Meeting the aspirations of the British people", Cm 7227, October 2007 covering FY2008-FY2010.
6. Robert Chote, Rowena Crawford, Carl Emmerson and Gemma Tetlow, *Britain's fiscal squeeze: the choices ahead*, IFS briefing note BN87, Institute for Fiscal Studies, September 2009.
7. Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group, Economic Perspective, 6 July 2009.
8. Post 1970 governments were as follows: 1970-74 Conservative (Heath); 1974-79 Labour (Wilson, Callaghan); 1979-97 Conservative (Thatcher, Major); 1997-present Labour (Blair, Brown).
9. Total Managed Expenditure (TME) = Departmental Expenditure Limits (DELs) + Annually Managed Expenditure (AME). AME includes debt interest payments, social security payments, public sector pensions and contributions to the EU.
10. Robert Chote, "The black hole is even deeper than I thought", *The Times*, 17 September 2009. Chote had originally estimated annual falls of 2.3% rather than 2.9%.

ANNEX TABLES

Table 1: Tightening required to achieve balanced current budget by FY2017 – tightening over 8 years

	% of GDP	Figure (£bn, today's money)	Burden on each family (today's money)
Total required (100%)	6.3-6.4%	About £90bn	£2,840
Announced so far (2008 PBR & Budget 2009):	3.1-3.2%		
Tax increases (10%)	0.7%	£9bn	£300
Spending cuts (40%):	(2.5%)	£36bn	(£1,115)
Current spending	1.5%		£690
Investment spending	1.0%		£425
Total (50%)	3.2%	£45bn	£1,415
Measures yet to be announced (50%)	3.2%	£45bn	£1,430

Source: IFS, "Two parliaments of pain", April 2009. There are rounding errors in the table. Note that the ratio of 1:4 of tax increases to spending cuts is available for the years FY2011 to FY2013 only – not for FY2014 to FY2017.

Table 2: Spending cuts: 2 scenarios, £bn, current prices

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Scenario 1:									
Budget borrowing	34.6	90	175	173	140	118	97	(83)	(65)
Target: zero by FY15	34.5	90	175	173	(130)	(95)	(60)	(30)	(0)
Cuts in borrowing	0	0	0	0	(-10)	(-23)	(-37)	(-53)	(-65)
Cuts in spending cet. par.	0	0	0	0	(-10)	(-23)	(-37)	(-53)	(-65)
Spending (Budget)	582.7	620.8	672	702	717	738	758	(780)	(805)
Spending (post-cuts)	582.7	620.8	672	702	(707)	(715)	(721)	(727)	(740)
Scenario 2:									
Worse borrowing	34.6	90	175	(195)	(160)	(138)	(115)	(100)	(90)
Target: zero by FY15	34.6	90	175	(195)	(150)	(115)	(75)	(35)	(0)
Cuts in borrowing	0	0	0	0	(-10)	(-23)	(-40)	(-65)	(-90)
Cuts in spending cet. par.	0	0	0	0	(-10)	(-23)	(-40)	(-65)	(-90)
Spending (Budget)	582.7	620.8	672	702	717	738	758	(780)	(805)
Spending (post-cuts)	582.7	620.8	672	702	(707)	(715)	(718)	(715)	(715)

Source: Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group, Economic Perspective, 6 July 2009. Scenario 1 assumes Budget borrowing figures and a balanced net borrowing target in FY2015. Scenario 2 assumes worse borrowing figures and a balanced net borrowing target in FY2015.

Note: "cet.par." means "other things being equal".

**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**