Perspectives by Ruth Lea

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A "do little" Budget: pain yet to come

Introduction and the economic forecasts

Last week's Budget, released on 24 March, was a "do little" Budget - more of a holding or "treading water" exercise before the General Election.[1] The projections for the public finances for both borrowing and indebtedness were marginally better than in December's Pre-Budget Report.[2] But the numbers remain shockingly bad. Very few policy initiatives of fiscal significance were announced and on the key issue of where the axe will fall on individual departments commentators are left to wait for the next Comprehensive Spending Review.

The Chancellor slightly downgraded the GDP growth figure for 2011 – from an implausible 3¼% to 3¾% to a slightly less implausible 3% to 3½%. The higher figures were however retained for 2012. It is argued in some quarters that after a sharp drop in output, recovery tends to be rapid. This indeed happened in the early to mid 1990s. But we do not share this optimism principally because of the unprecedented debt overhang in both the public and private sectors. Our lack of optimism is widely shared.

The Budget's CPI forecasts are reasonable. Even though CPI is currently running above the 2% target, much of the recent spike in inflation reflects "base effects" and the annual rate has already fallen back to 3% (February) after January's 3.5%.

Table 1 GDP and CPI forecasts (year-on-year, %)

	2008	2009	2010	2011	2012
PBR 2009:					
GDP growth	½	-4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾
CPI inflation (Q4)	4	2	1¾	1½	2
Budget 2010:					
GDP growth	½	-5	1 to 1½	3 to 3½	3¼ to 3¾
CPI inflation (Q4)	4	2	2	1½	2
Current Consensus forecast: GDP growth	0.6	-5.0	1.4	2.3	Na

Sources: (i) HM Treasury, Pre-Budget Report, Securing the recovery: growth and opportunity, December 2009, Cm 7747, (ii) HM Treasury, *Budget 2010, Securing the recovery*, HC451, March 2010, (iii) Consensus Forecasts, Survey date 8 March 2010, Consensus Economics for 2010 and 2011. Out-turns for 2008 and 2009 are from the ONS.

If the demand components of GDP are analysed separately, it becomes clear that the Treasury is expecting much of the buoyant growth for 2011 and 2012 to come from business investment and net exports, as shown in table 2. Whilst the exports forecast looks plausible, given the weak state of sterling, doubts must be cast over the very bullish forecast for investment in 2011 and, especially, 2012 and the weakness of imports growth.

Table 2 Budget 2010 GDP forecasts, components (year-on-year, %) +

	2008	2009	2010	2011	2012
GDP	½	-5	1 – 1½	3 – 3½	3¼ - 3¾
Of which:					
Household consumption	1	-3	¾ - 1¼	2¼ - 2¾	2½ - 3
General Government consumption	2 ½	2	1¾	-1½	-2
Fixed investment	-3½	- 14½	-2¾ to -2¼	4½ to 5	9 to 9½
Inventories, change +	- ½	-1¼	1¼	½	0
Exports of goods and services	1	-11	2¾ to 3¼	4 to 4½	5¼ to 5¾
Imports of goods and services	-½	-12	2 to 2½	1 to 1½	2¾ to 3¼
Net trade +	½	¾	¼	¾	¾

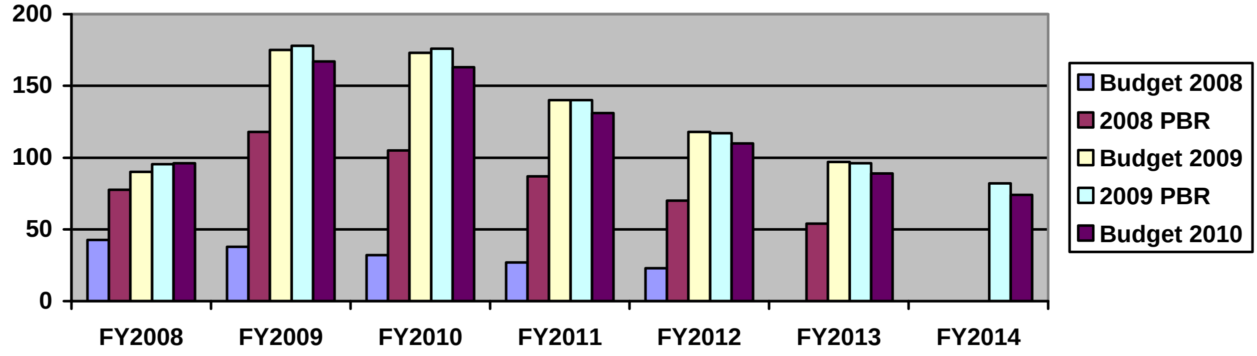
Source: HM Treasury, *Budget 2010, Securing the recovery*, HC451, March 2010.
+ represents the contribution to GDP growth.

If the economic forecasts are significantly undershot, then the public borrowing forecasts will be worse than projected in the Budget, even after allowing for the fact that the Treasury uses the lower end of its forecast range for GDP for the public sector projections. Thus a GDP rise 1% is used for 2010 rather than 1¼%. The Treasury's rule of thumb on such matters is that a 1% loss of GDP increases borrowing by 0.5% of GDP in year one and 0.2% in year two.[3] If, for example, the "Consensus" is right about 2011 and GDP grows by around 2¼% rather than the Treasury's 3¼% the loss of GDP is around 1% and public borrowing could be expected to be 0.5% of GDP worse in year one than otherwise would be the case. This would amount to around £7½bn of extra borrowing in 2011.[4]

The Treasury's fiscal projections

The Budget projections for Public Sector Net Borrowing (PSNB) are still breathtakingly bad despite some marginal improvements announced in last week's Budget, as shown in the chart below.[5] Even as recently as the 2008 PBR cumulative borrowing for FY2009 to FY2013 was estimated to be "only" £434bn. In the 2009 PBR this had swelled to £707bn. In the 2010 Budget it was down to £660bn – thus "saving" £47bn.

Chart 1 Public Sector Net Borrowing (£bn): Budget 2008, 2008 PBR, Budget 2009, 2009 PBR and Budget 2010: projections



Sources: (i) HM Treasury, Budget 2008, March 2008, HC388, (ii) HM Treasury, 2008 Pre-Budget Report, Cm 7484, November 2008, (iii) HM Treasury, Budget 2009, HC407, April 2009, (iv) HM Treasury, Budget 2010, HC451, March 2010.

In line with the new Fiscal Consolidation Act, borrowing as a share of GDP is set to halve between FY2009 (11.8% of GDP) and FY2013 (5.2%).

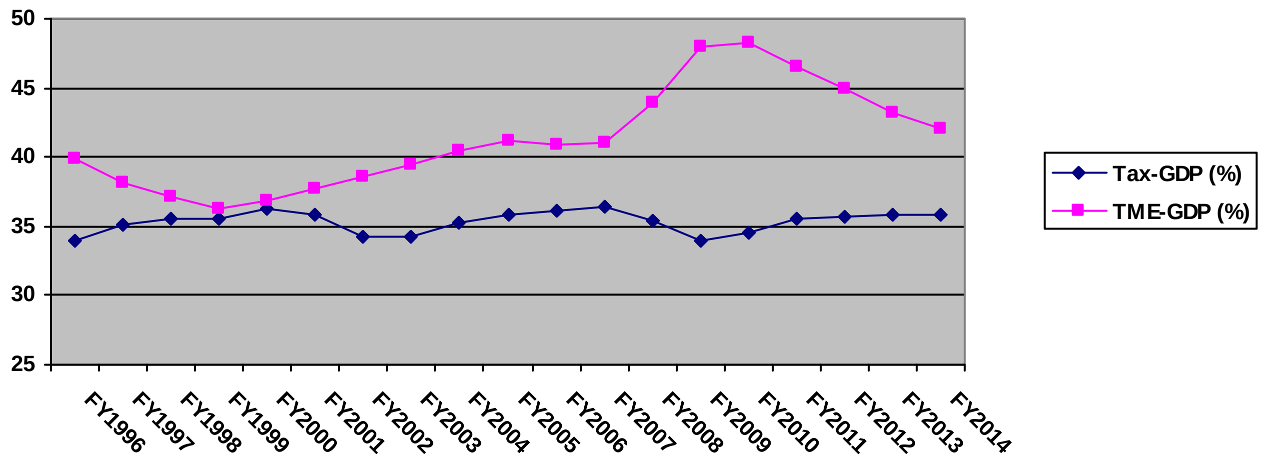
Public sector borrowing has exploded since FY2007 reflecting a sharp increase in public spending, with higher social security and debt interest payments, and falls in tax revenue reflecting lower VAT payments (partly reflecting lower activity, partly the temporary cut in the standard VAT rate), lower corporation tax receipts (especially for the financial sector), less tax from high earners and weaker revenues from the housing sector. But not all the deficit can be explained by the effects of recession. In the 2008 Budget before the recession had hit,[6] the Treasury was forecasting a borrowing requirement of £43bn for FY2008, when the public finances should have been well in surplus (£30-40bn?) after nearly 15 years of continuous growth. If such prudent behaviour had been undertaken, much of the current fiscal crisis could have been avoided.

The borrowing figures have implications for the Debt Management Office's plans. The DMO plans to sell £187bn of gilts in FY2010, fewer than the £227.6bn in FY2009. But the Bank of England bought £185bn of gilts through its Quantitative Easing programme in FY2009 leaving the required net market take-up of gilts at some £42bn. In comparison, the Bank bought just £13bn and market over £130bn of gilts in FY2008. (The DMO sold a total of £146.5bn in that year.)

If the Bank continues its QE "pause" in FY2010 the market will have to absorb substantially more gilts - not just more than in FY 2009 but also more than in FY2008. It is hoped that banks seeking liquid assets will bridge the potential demand for gilts. But this cannot be guaranteed and the gilt market could face a choppy year – even without the threat of a hung parliament. Given this situation more QE cannot be ruled out.

As the chart below shows, the tax-GDP ratio is estimated to have fallen to just under 34% in FY2009. Over the projected period the ratio is expected to recover, reflecting the forecast of buoyant economic growth. Meanwhile the TME-GDP ratio is expected to peak at just over 48% in FY2010, compared with 36.3% in FY1999. Total public spending is therefore expected to consume nearly half of total economic activity – as it was in the mid-1970s (in FY1975 the ratio was 49.7%).[7] Moreover this ratio, though projected to fall steadily between FY2010 and FY2014, is expected to be still just over 42% by FY2014. The public sector is "crowding out" the private sector as it did in the 1970s. This is nothing short of disastrous for the future entrepreneurial vitality of the British economy.

Chart 2 Budget 2010: Tax-GDP and TME-GDP ratios (%)

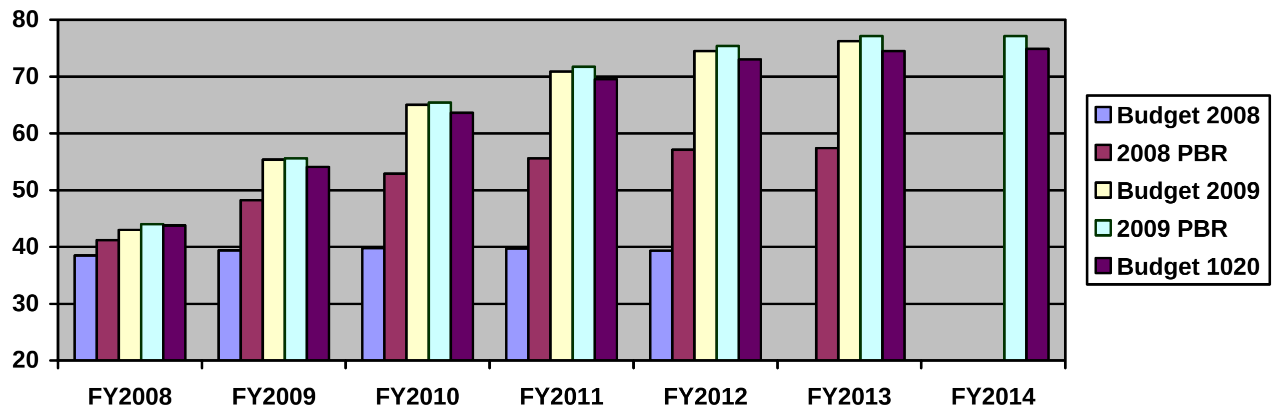


Source: HM Treasury, Budget 2010, HC451, March 2010. Data to FY2008 are recorded, FY2009 is estimated. TME stands for Total Managed Expenditure, i.e. total public spending.

The Treasury's forecasts: public sector net debt

Suffice to say that the still horrendous borrowing figures are leading to a rapid build-up of public sector net debt. The revised Budget figures are shown in the chart below.

Chart 3 Public Sector Net Debt/GDP ratio (%), by financial year: Budget 2008, 2008 PBR, Budget 2009, 2009 PBR and Budget 2010: projections



Sources: as for chart 1. The data exclude the temporary effects of financial interventions.

Budget commentary

Apart from the all-important analysis of the economic background and fiscal projections the main features of the Budget were:

- The Chancellor announced a minor fiscal stimulus for FY2010 (£1.4bn) in his Budget compared with the 2009 PBR, followed by marginal fiscal tightening for FY2011 (£150m) and FY2012 (£705m). The main measures of the Budget are listed in annex table 2.
- Populist announcements included a stamp duty land tax holiday for first time buyers for properties under £250,000 for 2 years (partly offset by 5% stamp duty for properties over £1 million from FY2011), the staging of the introduction of higher fuel duties (but higher than indexation increases for cider and tobacco duties), and the continuation of the additional payment for pensioner households alongside the Winter Fuel Payment.
- More funding for employment support and transport infrastructure and a Modernisation Fund to finance 20,000 additional student places.

- £11bn of efficiency savings were announced, the legitimacy of which was questioned by the Institute of Fiscal Studies (IFS).[8] The IFS referred the National Audit Office's disputes with the Government over the claimed savings from the Gershon Review (part of the 2004 Comprehensive Spending Review) to support its wariness.[9]
- A package for business including new lending commitments with RBS and Lloyds Banking Group, the creation of a Small Business Credit Adjudicator (applying to loans from all banks), a doubling of the Annual Investment Allowance and Entrepreneurs' Relief, increased business rate relief and the launch of UK Finance for Growth. Such initiatives are arguably poor recompense for the proposed NICs increase.
- A Green Investment Bank, with a mandate to invest in low-carbon infrastructure.
- The IHT allowance of £325,000 was frozen until FY2014. The income tax allowances were also unchanged - but note the April allowance up-rating is based on the previous September's RPI inflation rate, which was negative in September 2009.

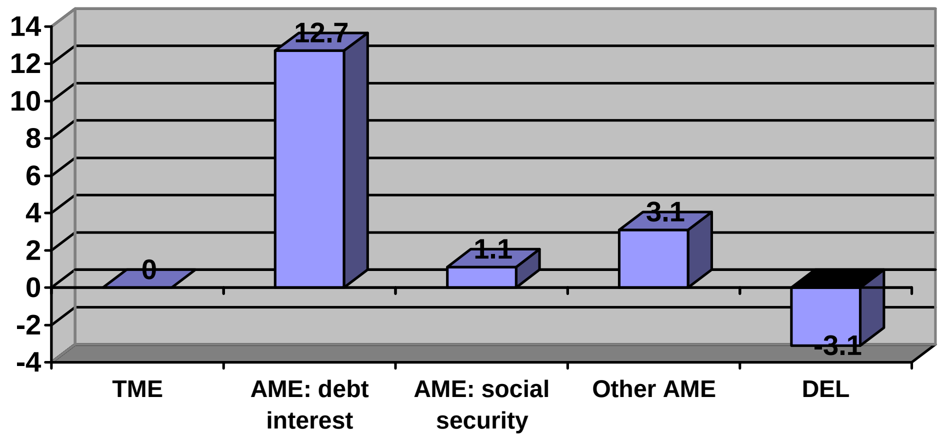
Departmental squeezes: pain to come

In previous Perspectives we have suggested that the rate of fiscal consolidation in the Chancellor's plans has been too slow. [10] But even on the Chancellor's plans, the implications for real terms spending in "unprotected" areas (see below) are especially tough. And, as the election approaches, the Chancellor has increasingly acknowledged this truth. On 25 March he conceded that if Labour were re-elected, cuts would be "tougher and deeper" than those carried out by Margaret Thatcher. [11]

The IFS's most recent analysis on public spending demonstrates the scale of the possible cuts over the 4-year period from FY2010 to FY2014 (for years FY2011 to FY2014 inclusive):[12]

- Total Managed Expenditure (TME = Annually Managed Expenditure (AME) + Departmental Expenditure Limits (DELs)) would be broadly flat in <u>real terms</u> over this period. AME comprises debt interest payments, social security spending and other items including public sector pensions and contributions to the EU.
- Debt interest is set to rocket from £30bn (FY2008) to about £70bn (FY2014), reflecting the soaring debt mountain. This is equivalent to an average annual real increase of 12.7% and acts to squeeze departmental spending significantly.
- Social security payments and "other AME" are expected to rise by 1.1% and 3.1% respectively in real terms (annual averages).
- The residual is what is left for the departments (DEL), which are faced with a "flat cash" situation and an average annual fall of 3.1% in real terms - a cumulative decline of 11.9% or £46bn in real terms by FY2014. The IFS estimate that public services spending accounted for around 20% of GDP in FY1998, rose to over 27% of GDP in FY2009 (a huge increase) and is now projected to fall back to 21% of GDP by FY2014 (a huge decrease).

Chart 4 Growth in spending components: FY2011-FY2014, average annual real increase (%)



Source: Carl Emmerson, "Public services: the axe comes soon", IFS, March 2010.

As we discussed in a previous Perspective,[13] some areas within public services are to be "protected". They include development aid (to meet a spending target by 2013), "front-line" NHS (for FY2011 and FY2012) and some "front-line" education (also for FY2011 and FY2012). (The details are shown in table 3 in the annex.) The IFS have calculated the implications for the "unprotected" DELs of these "protections" and these are shown below in the table 3.

Table 3 IFS DEL cumulative spending scenarios, real terms growth (%)

	Total DELs+	"Protected" DELs	"Unprotected" DELs
FY2010-FY2012 (2 years)	-6.6% (£25bn)	+1.6%	-14.1%
Assuming protected DELs protected for 2 years only:			
FY2010-FY2014 (4 years)	-11.9% (£46bn)	-3.6%	-19.5%
Assuming protected DELs protected for all 4 years:			
FY2010-FY2014 (4 years)	-11.9% (£46bn)	+2.9%	-25.4%

Source: Carl Emmerson, "Public services: the axe comes soon", IFS, March 2010.
+ The size of the cut in brackets.

For the 4-year period FY2010 to FY2014, cumulative real terms spending for the "unprotected" areas could therefore be down by 19.5% to 25.4% depending on the assumptions made about the years of protection for the "protected" areas. These are potentially swingeing cuts.

The "unprotected" departments include Defence, Transport, BIS, DECC, Home Office, Justice, DEFRA and CLG (Communities and Local Government). Without spending limits being set for these areas it is impossible to say what the contribution will be to the deficit reduction. But one thing is certain. Much of the fall will be in investment spending, with current spending preserved as far as possible. The 2010 Budget shows "net investment" falling from £50bn (cash) in FY2009 to £22bn in F2013 and £23bn in FY2014.

References

1. HM Treasury, *Budget 2010, Securing the recovery*, HC451, March 2010.
2. HM Treasury, Pre-Budget Report, Cm7747, December 2009
3. IFS, "Budget 2009: tightening the squeeze?", IFS Briefing Note BN83, April 2009.
4. GDP in 2011 is forecast to be around £1.5 trillion in current prices.
5. Annex tables 1a and 1b show the persistent bias in the Treasury's projections of the public finances towards optimism.
6. Annex table 1c shows the Treasury's GDP forecasts.
7. On the OECD definition of public spending ("General Government public outlays") the spending to GDP ratio is estimated to have been 52.1% for 2009, rising to over 53% for 2010 and 2011. See OECD, "Economic Outlook", November 2009.
8. Chris Giles, "Efficiency savings alone will not curb deficit, says IFS", *FT*, 26 March 2010.
9. Robert Chote, "IFS post-budget briefing 2010: opening remarks", IFS, March 2010, www.ifs.org.uk
10. See for example Ruth Lea, "The Budget: the beginning of the election campaign", Arbuthnot Banking Group, 15 March 2010.
11. Daniel Pimlott, "Labour plans deepest spending cuts since 50s", *FT*, 27March 2010.
12. Carl Emmerson, "Public services: the axe comes soon", IFS, March 2010.
13. Ruth Lea, "The Budget: the beginning of the election campaign", Arbuthnot Banking Group, 15 March 2010.

Annex: supporting tables

Table 1a Current balance, £bn, Treasury revisions, FY2005 onwards

Date of forecast	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Apr 03	2	6	9							
Dec 03	-5	0	4	8						
Mar 04	-5	0	4	9						
Dec 04	-7	1	4	9	12					
Mar 05	-6	1	4	9	12					
Dec 05	-10.6	-4	0	7	11	13				
Mar 06	-11.4	-7	1	7	10	12				
Dec 06	-15.1	-8	-1	4	7	10	14			
Mar 07	-15.0	-9.5	-4	3	6	9	13			
Oct 07		-4.7	-8	-4	3	9	14	20		
Mar 08		-4.3	-7.9	-9.6	-4	4	11	18		
Nov 08			-6.7	-41.2	-78	-73	-54	-37	-21	
Apr 09			-5.2	-52.3	-132	-137	-111	-91	-74	
Dec 09				-50.1	-128	-137	-111	-91	-74	-59
Mar10				-48.9	-117	-124	-102	-84	-67	-51

Table 1b Public sector net borrowing, £bn, Treasury revisions, FY2005 onwards

Date of forecast	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Apr 03	23	22	22							
Dec 03	30	27	27	24						
Mar 04	31	27	27	23						
Dec 04	33	29	28	24	22					
Mar 05	32	29	27	24	22					
Dec 05	37.0	34	31	26	23	22				
Mar 06	37.1	36	30	25	24	23				
Dec 06	37.5	37	31	27	26	24	22			
Mar 07	37.8	35.0	34	30	28	26	24			
Oct 07		31.0	38	36	31	28	25	23		
Mar 08		30.1	36.4	43	38	32	27	23		
Nov 08			36.6	77.6	118	105	87	70	54	
Apr 09			34.6	90	175	173	140	118	97	
Dec 09				95.4	178	176	140	117	96	82
Mar10				96.1	167	163	131	110	89	74

Table 1c Growth forecasts, % (YOY), Treasury revisions, CY2005 onwards

Date of forecast	2005	2006	2007	2008	2009	2010	2011	2012
Apr 03	3 – 3½							
Dec 03	3 – 3½	2½ - 3						
Mar 04	3 – 3½	2½ - 3						
Dec 04	3 – 3½	2½ - 3	2¼ - 2¾					
Mar 05	3 -3½	2½ - 3	2¼ - 2¾					
Dec 05	1¾	2 - 2½	2¾ - 3¼	2¾ - 3¼				
Mar 06		2 - 2½	2¾ - 3¼	2¾ - 3¼				
Dec 06		2¾	2¾ - 3¼	2½ - 3	2½ - 3			
Mar 07		2¾	2¾ - 3¼	2½ - 3	2½ - 3			
Oct 07		2¾	3	2 - 2½	2½ - 3	2½ - 3		
Mar 08			3	1¾ - 2¼	2¼ - 2¾	2 ½ - 3		
Nov 08			3	¾	-1¼ to -¾	1½ - 2	2¾ - 3¼	
Apr 09				¾	-3¼ to -3¾	1 - 1½	3¼ - 3¾	
Dec 09				½	- 4¾	1 - 1½	3¼ - 3¾	3¼ - 3¾
Mar10				½	-5	1 - 1½	3 - 3½	3¼ - 3¾

Sources: HM Treasury, successive Budget Reports and Pre-Budget Reports.

Table 2 Budget 2010 policy decisions: impact of main measures, in addition to indexation, £m (+ve is an Exchequer yield)

	FY2010	FY2011	FY2012
Annual investment allowance: increase to £100k	-30	-120	-110
Business rates: temporary increase in relief for small businesses	-210	-205	+5
Support for university places & innovation	-385	-	-
Investment in transport	-385	-	-
Reprioritised spending from DWP: extend Young Person's Guarantee	+475	-	-
Fuel duty: phase increase	-550	0	0
Stamp duty: temporary relief for first time buyers, 2 year	-230	-290	-30
Stamp duty: properties over £1m, from FY2011	+90	+70	+230
Support for mortgage interest	-165	-	-
Extension of additional payment, alongside Winter Fuel Payment	-600	-	-
Tobacco duty	+35	+95	+155
IHT: freeze threshold from FY2011-FY2014	0	+35	+110
Liechtenstein disclosure facility	+40	+320	+140
Total	-1,415	+150	+705

Source: HM Treasury, *Budget 2010, Securing the recovery*, HC451, March 2010.

Table 3 Government spending: "protected" areas

Area	Details
Overseas Development Assistance	Meet 2013 target of spending 0.7% of GNI.
In FY2011 & FY2012 (2-year protected):	
Health	Real freeze in "front-line" NHS spending.
Education	0.7% real increase in "front-line" school spending.
	0.9% real increase in "front-line" spending on 16-19 participation
	Real increase in "front-line" spending on Sure Start

Source: Carl Emmerson, "Public services: the axe comes soon", IFS, March 2010. The Treasury have not yet provided costings for these commitments.

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