Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group

Tackling the deficit: an excellent start but there's much to be done

The Coalition Government's first Budget will be announced on 22 June. It will be the most politically and economically significant Budget since the early 2000s, when Chancellor Gordon Brown turned on the spending taps and, in doing so, profoundly contributed to the dire state of the country's public finances. The contents and tone of the Budget will shape much of what the new Government will be able to achieve for the rest of the Parliament. The Government has already made it quite clear that the need for deficit reduction, much discussed in previous Perspectives,[1,2,3] will be their first priority.

Indeed the precise words used in the Queen's speech were:

- "The first priority is to reduce the deficit and restore economic growth. Action will be taken to accelerate the reduction of the structural budget deficit."[4]

The Budget will be followed by a comprehensive Spending Review, presumably for FY2011 to FY2013, in autumn.

So far, so good

The Government has already made some most encouraging steps towards tackling the finances.

Firstly, an Office of Budget Responsibility (OBR) has been set up which will provide independent forecasts for the economy and the public finances.[5] This is wholly to be welcomed as the Treasury's forecasts for the public finances have become tarnished. It has been clear since the early 2000s that a persistent "optimistic" bias was present in the projections. The borrowing forecasts the OBR will prepare for the Budget will provide the crucial fiscal background to the Budget. They are likely to be more pessimistic than those in last March's Budget.[6] And those forecasts were gloomy enough.[7] It should be noted that the Treasury's economic forecasts have been more accurate than their public borrowing ones.

Secondly, the new Chancellor has announced the details of £6.2bn of spending savings for the current financial year – FY2010. This step was Conservative policy before the election and the coalition has sensibly persisted with this policy despite warnings made by the other major parties prior to the election that such cuts would derail the recovery. £6bn is less than 1% of total public spending and under ½% of GDP. The chances that the recovery could really be derailed by such modest cuts are minimal.

The details were announced on 24 May 2010 and included the following: [8]

- £1.15bn in discretionary areas like consultancy and travel costs.
- £1.7bn from delaying and stopping contracts and projects, including immediate negotiations to achieve cost reductions from the major suppliers to government.
- £170m from reductions in property costs.
- At least £120m from a recruitment freeze across the civil service for the rest of FY2010.
- £600m from cutting the cost of Quangos.
- £1.165bn by reducing grants to Local Authorities.
- £320m reducing and then stopping the Child Trust Fund.

Thirdly, the Government has made an important step towards improving the transparency in the public spending debate. It is to make public the records of the Combined Online Information System (Coins), a vast database which includes what departments were authorised to spend, what they actually spent and what they are forecast to spend in future. The first two tranches of data from FY2008 and FY2009 have been released.[9,10] This transparency should allow a more informed and open discussion over the options for spending cuts and should act as a barrier to (alleged) corruption and fraud.

The Budget: broad strategy
As already stated, the Budget will be based on the forecasts for the public finances produced by the OBR. We do not, of course, know what they will be. But it is useful to build up, for the sake of illustration, 2 scenarios:

- Scenario 1 takes the Budget 2010 forecasts for borrowing, making allowance for the better-than-forecast outcome for FY2009 (£156bn) and reducing FY2010 by the £6bn of spending cuts announced last month. It is reasonable to extrapolate this £6bn beyond FY2010. But note that the impact on borrowing will be (partly) offset by the increased personal allowances and increase in the employer NI threshold from FY2011. We do not know what this offset will amount to – but have guessed £3bn. Given the better FY2009 figures it could be argued that FY2010 would, other things being equal, also be better. But for the purposes of illustration we make no further adjustments.
- Scenario 2 assumes that the borrowing forecasts for FY2012 onwards are worse than projected in the Budget 2010.

Table 1: Public borrowing projections, £bn, 2 scenarios

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Scenario 1:						
Budget 2010	167	163	131	110	89	74
Adjusted	156 (actual)	157 (-6)	128 (-3)	107 (-3)	86 (-3)	71 (-3)
Scenario 2:						
Worse forecast	156	157	137	119	101	90
Difference from scenario 1	0	0	+9	+12	+15	+19

Given the borrowing forecasts, policy-makers then have to decide how far and how fast the deficit should be reduced. Budget 2010 had its own projections – as shown in the table above. Before the election the Conservatives talked about removing most of the structural deficit "in the life of the next Parliament", which implied a speedier process of fiscal consolidation than in the Budget. And the Coalition Government has stated:[11]

- "We will significantly accelerate the reduction of the structural deficit over the course of a Parliament."

Given a 5-year Parliament, and assuming the Government is planning to remove most of the structural deficit by the end of it, then they could be planning to remove the bulk of the structural deficit by FY2014. Quite how this will translate into hard numbers on actual borrowing, in other words not adjusted for the economic cycle, is impossible to say. But it is reasonable to assume that the Government still expect to run a deficit by FY2014 – possibly around 1½% of GDP (projected to be around £1,850bn), which would be consistent with the projections in Budget 2010. This would give a deficit of around £25-30bn for FY2014.

If this were the case, then the fiscal consolidation process would have to be far tougher than in Budget 2010. In the following table we have interpolated a deficit reduction path to £30bn by FY2014, for both scenarios. We emphasise that this is an interpolation and not a forecast. The Chancellor may choose to get more of the "pain" over in the early years of the Parliament for political reasons.

Table 2: Possible further borrowing cuts required, £bn,

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Scenario 1:						
Budget forecast adjusted	156	157	128	107	86	71
Targeted borrowing	156	157	120	88	56	**30**
Further "cuts" in borrowing	0	0	-8	-19	-30	-41
Scenario 2:						
Worse forecast	156	157	137	119	101	90
Targeted borrowing	156	157	124	91	57	**30**
Further "cuts" in borrowing	0	0	-13	-28	-44	-60

On the basis of these figures the £6bn of cuts already announced represent about one eighth of that "needed" for scenario 1 and less than a tenth for scenario 2.

Composition of the tightening: spending cuts and/or tax rises?
Regarding the composition of the tightening, the coalition agreement stated "…the main burden of the deficit reduction borne by reduced spending rather than increased taxes". But it did not specifically endorse either the 4:1 split proposed in the Conservative manifesto or the 2½:1 split implied by the Liberal Democrat manifesto.

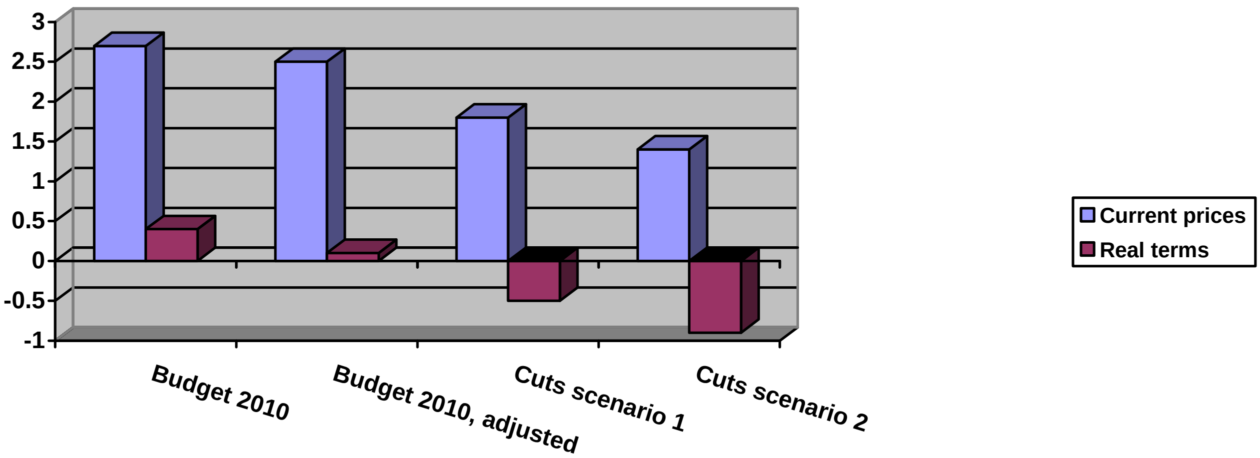
The agreement did, however, endorse the questionable Conservative plan for year-on-year real increases in NHS spending and a large real rise in overseas aid.[12] This suggests an intense squeeze on the budgets of other Whitehall departments in the Spending Review due in autumn, including the Ministry of Justice, HO, BIS, DECC, Communities and Local Government, DEFRA, and Transport. (Defence is undergoing its own review.) A tough squeeze on capital spending is already factored in.[13] It also leaves open the option of tougher action to cut social security spending, though it should be noted that state pensions will probably be increased. The coalition agreement stated that "we will restore the earnings link for the basic state pension from April 2011, with a 'triple guarantee' that pensions are raised by the higher of earnings, prices or 2.5%".

The coalition agreement did not rule out the possibility of significant net tax increases in the forthcoming Budget. The debate so far has tended to focus on the agreement's statement that "we will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities". But any increase in CGT rates is unlikely to raise many billions – especially if there are generous concessions. More likely is an increase in the standard VAT rate from 17.5% to 20%, which could raise £12bn. There is also discussion on extending VAT on currently zero-rated goods such as books, food and children's clothes. Increases in VAT do, however, push up the CPI and arguably cause another headache for the Bank of England in its attempt to control inflation.

Under these circumstances the Conservatives 4:1 split seems highly unlikely to be achieved. Even a 3:1 split, with 75% of the borrowing cuts being achieved through spending cuts, seems unlikely especially as a sizeable VAT increase seems a "hot tip". For the sake of illustration, we will assume that, having "bagged" £6bn a year already (to be partly offset by already announced increases in personal allowances and employer NI thresholds), about 2/3^{rds} of the borrowing cuts going forward will be met by spending cuts and 1/3rd by higher taxes.

Under these circumstances average annual real spending would fall between FY2009 and FY2014 under both scenarios: by ½% annually for scenario 1 and by nearly 1% annually for scenario 2 as shown in the chart below. (Table 2 in the annex provides the details.)

Public spending, average annual growth rates (%): FY2010 to FY2014 inclusive: current prices and real terms



Whilst these cuts may not seem draconian by those experienced in parts of the private sector in recent years, the impact on some departments, as already stated, will be significant whilst others will experience no cuts at all. Indeed spending in the NHS will rise in real terms.

References

1. Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group, 6 July 2009.
2. Ruth Lea, "Spending cuts: a necessary and painful debate begins", Arbuthnot Banking Group, 21 September 2009.
3. Ruth Lea, "A new government's first priority must be to tackle its lamentable fiscal legacy", Arbuthnot Banking Group, 10 May 2010.
4. *Queen's speech 2010*, 25 May 2010, www.Number10.gov.uk
5. HM Treasury, press release, "Chancellor announces policies to enhance fiscal credibility: independent Office for Budget Responsibility created and Chief Secretary sets out £6bn reduction in 2010-11 spending", 17 May 2010, www.hm-treasury.gov.uk
6. HM Treasury, *Budget 2010: securing the recovery*, March 2010, HC451.
7. Ruth Lea, "A 'do little' Budget: pain yet to come", Arbuthnot Banking Group, 28 March 2010.
8. HM Treasury, press release, "Government announces £6.2bn of savings in 2010-11: action to cut Whitehall waste and protect schools spending", 24 May 2010, www.hm-treasury.gov.uk
9. BBC website, "Government spending details published", 4 June 2010.
10. HM Treasury, press release, "Publishing data from the COINS database", 4 June 2010.
11. HM Government, *The Coalition: our programme for government: freedom, fairness and responsibility*, May 2010.
12. See annex table 1 for the coalition agreement's statements on public spending and taxation.
13. See annex table 2.

Annex
Table 1 Coalition agreement: public spending and taxation

Deficit reduction	We need immediate action to tackle the deficit in a fair and responsible way, ensure that taxpayers' money is spent wisely, and get the public finances back on track
	We will significantly accelerate the reduction of the structural deficit over the course of a Parliament, with the main burden of the deficit reduction borne by reduced spending rather than increased taxes.
	We will set out a plan for deficit reduction in an emergency budget.
	We will make modest cuts of £6bn to non-front-line services within FY2010.
	We will hold a full Spending Review reporting this autumn.
	We will reduce spending on the Child Trust Fund & tax credits for higher earners.
	We will reduce the number & cost of quangos.
International development	We will honour our commitment to spend 0.7% of GNI on overseas aid from 2013.
NHS	We will guarantee that health spending increases in real terms in each year of the Parliament, while recognising the impact this decision will have on other departments.
Pensions & older people	We will restore the earnings link for the basic state pension from April 2011, with a "triple guarantee" that pensions are raised by the higher of earnings, prices or 2.5%.
Schools	We will fund a significant premium fir disadvantaged pupils from outside the schools budget by reductions in spending elsewhere.
Taxation	We will increase the personal allowance for income tax to help lower & middle income earners. We will announce in the first Budget a substantial increase in the personal allowance from April 2011, with the benefits focused on those with lower & middle incomes. This will be funded with the money that would have been used to pay the increase in employee NI thresholds proposed by the Conservative Party, as well as revenues from increases in CGT rates for non-business assets as described below. The increase in employer NI thresholds proposed by the Conservatives will go ahead in order to stop the planned jobs tax. [See below for more on NICs.]
	We will further increase the personal allowance to £10k, making real terms steps each year towards meeting this as a longer-term policy objective.
	We will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities.

HM Government, *The Coalition: our programme for government: freedom, fairness and responsibility*, May 2010.

The proposed **National Insurance Contributions Bill**, mentioned in the Queen's speech, covers the following:

- The planned 1% increase in employees' NIC rates will go ahead in April 2011. There will be no change in thresholds.
- The planned 1% increase in employers' NI rates will go ahead in April 2011, but it will be partly offset by an increase the threshold.
- The £9bn raised will be partly used to finance the increase in income tax personal allowances & the employer NI threshold.

Source: Local Government Employers website, www.lge.gov.uk

Table 2a Public sector spending, £bn, current prices

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Public spending:						
Current expenditure	605	644	662	682	703	725
Capital expenditure (net)	50	40	29	26	22	23
Total: Budget 2010	655	684	691	708	725	748
Less £6bn	0	-6	-6	-6	-6	-6
"Current" plans	**655**	**678**	**685**	**702**	**719**	**742**
Scenario 1:						
Current borrowing forecast adjusted	156	157	128	107	86	71
Targeted borrowing	156	157	120	88	56	30
Further "cuts" in borrowing	0	0	-8	-19	-30	-41
Further spending "cuts" (2/3rds)	0	0	5	13	20	27
New spending plans	**655**	**678**	**680**	**689**	**699**	**715**
Scenario 2:						
Worse forecast	156	157	137	119	101	90
Targeted borrowing	156	157	124	92	57	30
Further "cuts" in borrowing	0	0	-13	-27	-44	-60
Further spending "cuts" (2/3rds)	0	0	9	18	29	40
New spending plans	**655**	**678**	**676**	**684**	**690**	**702**

Spending data taken from HM Treasury, *Budget 2010: securing the recovery*, March 2010, HC451.

Table 2b Fiscal tightening, growth rates (%)

	FY2009 (£bn)	FY2014 (£bn)	Growth (%)	Annual growth rates (%), current prices	Annual growth rates (%), current prices+
Budget 2010, no adjustments	655	748	14.2%	2.7%	0.4%
Budget 2010, less £6bn	655	742	13.3%	2.5%	0.1% ≈ flat
Scenario 1	655	715	9.2%	1.8%	Minus 0.5%
Scenario 2	655	702	7.2%	1.4%	Minus 0.9%

GDP deflator assumptions: 2¼% (FY2010), 1½% (FY2011), 2½% (FY2012), 2¾% (FY2013), 2¾% (FY2014). Average annual increase: 2.3%. Source: Budget 2010.

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