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Budget preview: time for the scalpel

The economic forecast

The economic background to the Budget remains dire, despite the tentative signs that the rate of decline of economic growth may actually now be easing.[1] And it is expected that the Chancellor will radically revise his GDP forecasts compared with those he made less than 6 months ago in his 2008 Pre-Budget Report (PBR). These were widely criticised at the time for being overly-sanguine. The table below compares the PBR forecasts with expectations for 2009 Budget.

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

	2008	2009	2010
November 2008 PBR:			
GDP growth	¾	-1¼ to - ¾	1½ to 2
CPI inflation (Q4)	3¾	½	2¼
Current consensus forecasts:			
GDP growth	0.7	-3.0	0.5
CPI inflation (Q4)	3.9	0.5	2.2
Current Arbuthnot Banking Group forecasts:			
GDP growth	0.7	-3.8	0.5
CPI inflation (Q4)	3.9	0.75	2.5

Sources: (i) HM Treasury, Pre-Budget Report, “Facing global challenges: supporting people through difficult times”, November 2008, Cm 7484. (ii) *Consensus Forecasts*, Survey date 9 March 2009, Consensus Economics.

The consensus forecast is for a fall in GDP for the current year of around 3.0% followed by weak overall growth in 2010. Our forecasts are more pessimistic than consensus and incorporate NIESR’s first estimates of a GDP decrease of 1.5% for 2009Q1.[2] We expect the economy to stabilise in the 4th quarter of 2009 with some return to growth through 2010.

Projections for the public finances
Even though the PBR economic forecasts were over-optimistic, the PBR nevertheless included projections for the public finances which showed a dramatic deterioration compared with the 2008 Budget.[3, 4] Revenue is not just being reduced because of the general effects of recession and lower economic activity, but also because a significant proportion of government revenue came from the financial sector and its high earners prior to the current financial crisis. The down-grading of the economic forecasts can only worsen the already appalling expectations for the public finances.

The following table shows the alarming deterioration in the public finances, comparing the 2008 Budget, the 2008 PBR and our expectations for the 2009 Budget.

Short-term projections for the public sector net borrowing, £bn

	FY2008	FY2009	FY2010	FY2011	FY2012	Total, FY2008 to FY2012
Budget March 2008	43	38	32	27	23	163
PBR November 2008	78	118	105	87	70	458
Budget April 2009, forecast	95	160	170	140	110	675
Revisions between:						
March 2008 & PBR 2008	35	80	73	60	47	295
PBR 2008 & April 2009	17	42	65	53	40	217
March 2008 & April 2009	52	122	138	113	87	512

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, (iii) our forecast for the 2009 Budget is more pessimistic than the IFS's latest paper. [5, 6]

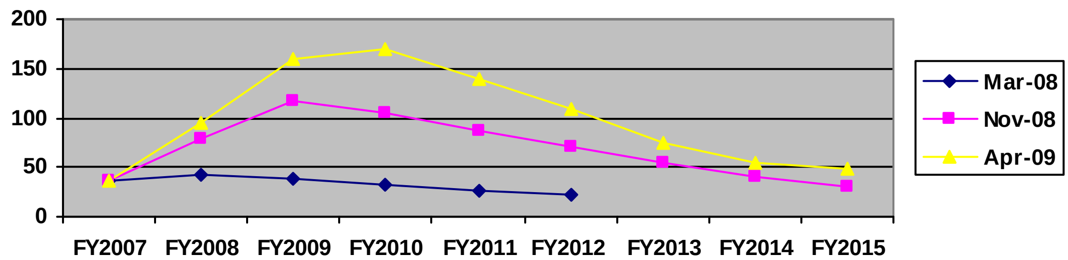
At the time of the last Budget, the Treasury estimated there would be total borrowing of about £163bn between FY2008 and FY2012, in the PBR the equivalent figure was about £458bn - a worsening of an unprecedented £295bn. If our expectations for the 2009 Budget are realised then total borrowing for the period FY2008 to FY2012 will be around £675bn, on a no policy change scenario, some £512bn worse than projected just 12 months ago.

In January the IFS expected gross gilt issuance to average more than £130bn a year for the next 3 years – even on their relatively benign projections of public borrowing at the time.[7] These are almost certainly underestimates to the tune of £30-40bn a year. These levels of borrowing are simply unsustainable and risk a collapse in confidence in the credibility of Britain's government debt and an investor strike.[8] Moreover such borrowing is taking place against an international background of rising public sector deficits. As Frank Field has written: [9]

> "The House of Commons Library has calculated for me what the G8 governments will attempt to borrow over the next 2 years. The sums are of gob-smacking proportions: a debt total of $2,245bn this year, rising to $2,521bn in 2010. …the government not only has a moral duty now to cut public expenditure, but may be forced to do so by its inability to borrow on the scale necessary."

The medium-term scenario is no less comforting. At the time of the PBR, the Treasury took the view that borrowing would be down to less than 2% of GDP by FY 2015. This, in itself, is an inadequate policy response. At the very least, the Treasury should be aiming to balance the books by FY2015. But, as in the case of their short-term projections, their expectations beyond FY2012 are likely to be significantly over-optimistic as the chart below demonstrates. A great deal more fiscal retrenchment is required than has been announced to date.

Medium-term public borrowing (£bn): 2008 PBR and 2009 Budget projections, with 2008 Budget data to FY2012 for comparison

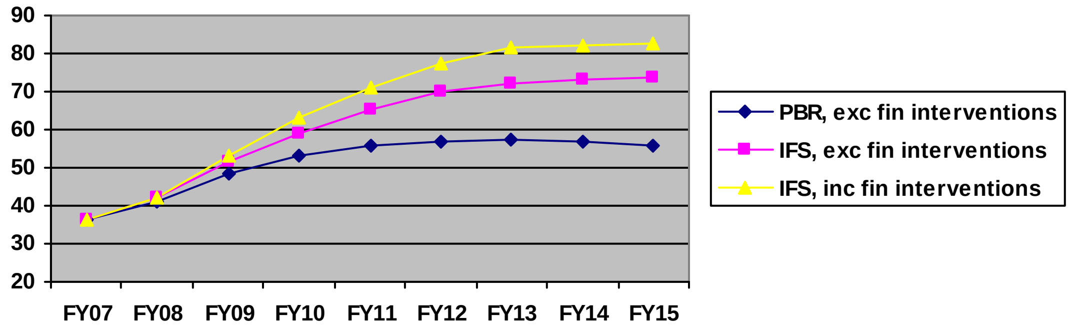


Sources: (i) HM Treasury, *Budget 2008,* March 2008, HC388 and (ii) HM Treasury, *2008 Pre-Budget Report,* Cm 7484, November 2008

Increasing indebtedness

As borrowing explodes, government indebtedness is inevitably rising, underlying the unsustainability of the current fiscal situation. The IFS expects the debt to GDP ratio to rise to 73.5% by FY2015, excluding financial sector interventions, compared with just 36.5% in FY2007.[10] This projection is significantly worse than that of the 2008 PBR as shown in the chart below.

Debt/GDP ratio (%), by financial year



Sources: (i) HM Treasury, 2008 *Pre-Budget Report,* Cm 7484, November 2008, (ii) IFS, *Budget 2009: tightening the squeeze?*, IFS Briefing Note BN83, April 2009.

Turning to the cost of the financial interventions, the eventual profit or loss remains very uncertain, but the IMF, among others, has made some estimates that should be allowed for. As the IFS states, "it would be prudent for the government to take these into account in judging what measures might be necessary to restore the public finances to health in the longer term, rather than to make the implicit judgement that there will be no net profit or loss". The IMF has estimated the eventual cost to the taxpayer at 9.1% of GDP or around £130bn.[11] The IFS's estimate of the debt to GDP ratio, incorporating the IMF's estimate, rises to 82.4% in FY2015, compared with 73.5% excluding the IMF's estimate.

No discussion of Britain's public sector indebtedness is complete without consideration of the public sector obligations that do not figure in the official data for borrowing and debt. The table below gives an idea of the enormous size of these obligations.

Estimated value of various future public sector obligations based on official estimates, including the net debt estimate

	£bn	% of GDP
Public sector net debt, March 2008	526.8	36.5
Estimated unfunded public sector pension liabilities, March 2006 (official estimate), private estimates are nearer to £1trillion	≈650	≈45
Estimated future PFI payments, signed current deals, October 2008 (IFS estimate based on official numbers)	≈130	≈9
Total	≈1,300	≈90

Source: *IFS Green Budget*, IFS, January 2009.

Budget priority: more fiscal tightening is required
The priority for the Chancellor in this week's budget is to convince the markets that he has a viable path back to a balanced budget. It is clear that there will have to be some very considerable further fiscal tightening if the government is going to get into a position of borrowing only what it needs to invest, in other words balancing the current budget, by FY2015. The retrenchment measures announced in the November PBR, outlined in annex 2, are not adequate. Incidentally, most (80%) of the PBR's tightening was in the form of "cuts" in public spending with annual growth reduced to a "mere" 1.1% (real terms) for the 5-year period from FY2011 to FY2015. Moreover, much of the projected growth in spending is likely to be swallowed up in higher welfare payments and debt interest payments and this will mean that spending on public services, on average, will have to be frozen in real terms.[12]

The IFS estimates that in order to balance the current budget by FY2015 this would require an additional fiscal tightening worth around 2.7% of GDP by FY2015 (£39bn in today's money), on top of the 2.6% of GDP (£38bn) tightening announced in the PBR.[13]

If this tightening were to be borne exclusively by restraining public spending, then instead of growing by 1.1% per year in real terms between FY2011 and FY2015, as currently pencilled in, spending would have to shrink by 1.1% per year. If this tightening were to be borne exclusively by the taxpayer then taxes would need to be raised by an average of £1,250 per family by FY2015. In practice much of the extra taxation, under such circumstances, would fall on business and undermine business competitiveness.

Public spending must be cut
Tax receipts as a % of GDP are already set to increase substantially, [14] public sector spending has grown significantly quicker than the economy as a whole over the last decade (see annex 3) and there is a wealth of economic literature that shows that "big states" harm growth.[15] Under these circumstances the major hit of fiscal tightening should be taken on public spending, including public sector pay and pensions. There is plenty of scope for cut-backs after nearly a decade of profligacy. As Denis McShane Labour MP for Rotherham has written: [16]

> "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."

As we have written previously, the productivity record of the public sector has been abysmal. Readily available productivity data for key public sector services, produced by the ONS, give an idea of the poor management and spending on non-productive jobs that have become the norm in the public sector. Take, for example, the health service.

The ONS estimates that productivity fell by 10% in the decade to 2006 at a time when it rose by over 20% in the private sector. If productivity had even been maintained in the decade, surely no great demand, the health service would have saved £10bn in 2006 (out of a total bill of £95bn) for the same output. If productivity had actually risen by 20% then over £25bn would have been saved.[17]

A 5% saving in total public spending (currently £640bn) would amount to around £32bn, a 10% saving around £64bn. These savings are big enough to matter in tackling the yawning gap in the public finances and would prevent what will otherwise be eye-watering and economically damaging tax increases. Arguably trimming back public expenditure should begin in financial year 2010, the final year of the current Spending Review, but they must start in earnest for the following year.[18] FY2011 marks the first year of the next 3-year Spending Review (for FY2011 to FY2013) – if such reviews survive a possible change of government. The Treasury had initially planned to release such a document this summer but, apparently, it has been postponed.[19]

Final comment
It's time for the scalpel to be applied to public spending. As for the other announcements that may or may not be made on 22 April in the Budget, they fade into insignificance with the enormous task required to sort out Britain's wrecked public finances.

References

1. Ruth Lea, "Keep the green shoots in perspective", Arbuthnot Banking Group Perspective, 6 April 2009.
2. Daniel Pimlott, "Steep economic decline goes on, says think-tank", *FT*, 8 April 2009.
3. Ruth Lea, "The public finances: time for a radical reappraisal", Arbuthnot Banking Group Perspective, 1 December 2008, discusses these figures further.
4. Annex 1 shows the persistent bias in the Treasury's projections of the public finances towards optimism.
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6. Chris Giles, "Borrowing to hit £175bn", *FT*, 16 April 2009, reported that the City consensus is for borrowing of £160bn in FY2009 and £167bn in FY2010.
7. *IFS Green Budget*, IFS, January 2009.
8. Steve Bundred, "Our public debt is hitting Armageddon levels", *The Times*, 27 February 2009.
9. Frank Field, "In this Budget, Brown has a moral duty to cut public spending – before he has to", *Spectator*, 18 April 2009.
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11. IMF, "Companion paper – the state of public finances: outlook and medium-term policies after the 2008 crisis", 6 March 2009, available from www.imf.org.
12. Robert Chote, "Public spending: outlook grim, with the threat of darker clouds", *Times*, 19 March 2009.

13. IFS, "Budget 2009: tightening the squeeze?", IFS Briefing Note BN83, April 2009.
14. OECD, *Economic Outlook*, December 2008.
15. Ruth Lea, "The "Big State" is back and undermining growth," Arbuthnot Banking Group Perspective, 18 February 2008.
16. Denis McShane, "The answer's obvious: cut taxes and spending", *Daily Telegraph*, 27 May 2008.
17. Ruth Lea, "The public finances: time for a radical reappraisal", Arbuthnot Banking Group Perspective, 1 December 2008.
18. HM Treasury, *2007 Pre-Budget Report & Comprehensive Spending Review, Meeting the aspirations of the British people*, Cm 7227, October 2007, covers the period FY2008 to FY2010.
19. Nicholas Timmins and George Parker, "Public services could face next election not knowing budgets", *FT*, 18 March 2009.

Annex 1 Public sector finances
Table 1a Current balance, £bn, FY2003 onwards

Date of forecast	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Apr 02	7	9	7	9							
Nov 02	-5	3	5	8	10						
Apr 03	-8	-1	2	6	9						
Dec 03	-19.3	-8	-5	0	4	8					
Mar 04	-21.3	-11	-5	0	4	9					
Dec 04	-21.1	-12.5	-7	1	4	9	12				
Mar 05	-20.4	-16.1	-6	1	4	9	12				
Dec 05		-19.9	-10.6	-4	0	7	11	13			
Mar 06		-19.0	-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

Table 1b Public sector net borrowing, £bn, FY2003 onwards

Date of forecast	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Apr 02	13	13	17	18							
Nov 02	24	19	19	19	20						
Apr 03	27	24	23	22	22						
Dec 03	37.4	31	30	27	27	24					
Mar 04	37.5	33	31	27	27	23					
Dec 04	34.8	34.2	33	29	28	24	22				
Mar 05	35.4	34.4	32	29	27	24	22				
Dec 05		38.8	37.0	34	31	26	23	22			
Mar 06		39.7	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

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

Annex 2 Pre-Budget Report measures
Table 2 2008 Pre-Budget Report, costs of main measures & other measures announced since Budget 2008 (£bn)

	FY2008	FY2009	FY2010	FY2011
Measures announced since Budget 2008:				
To offset removal of 10p tax band	-2.65	-0.3	+0.1	0
September housing package	-0.2	-0.7	-0.9	0
PBR measures:				
VAT rate reduction (to 15%, from Dec 2008 to Jan 2010)	-3.8	-8.6	0	0
Alcohol & tobacco duties	+0.3	+1.0	+1.0	+1.0
Capital spending brought forward	-0.4	-2.5	+2.9	0
Indexation of personal allowances & basic rate limit	0	-2.9	-3.3	-3.3
Restrict personal allowances (+£100,000)	0	0	+0.8	+1.3
Higher rate to 45% (+£150,000)	0	0	0	+0.7
NICs alignment	0	0	0	-1.6
Increase employee, employer, self-employed NICs	0	0	0	+5.4
Public sector spending “savings”	0	0	+5.0	+5.0
Additional help for pensioners etc	-0.9	0	0	0
Addition to DEL reserve	-1.0	0	0	0
Total policy decisions	-9.3	-16.3	+4.8	+7.6

Source: HM Treasury, Pre-Budget Report, “Facing global challenges: supporting people through difficult times”, November 2008, Cm 7484, table 1.2. A negative sign indicates increased borrowing, a positive sign indicates decreased borrowing.

Annex 3 Public Spending: Total Managed Expenditure
Table 3a Public spending plans (by Spending Review) and out-turns, (£bn)

	1998 SR	2000 SR	2002 SR	2004 SR	2007 SR	Out-turns & projections (current prices)	Out-turns (FY2007 prices)
FY1997						322.0	408.7
FY1998	333.6					330.9	411.1
FY1999	**351.6**					343.0	418.0
FY2000	**370.0**	371.6				364.0	437.9
FY2001	**389.7**	**392.9**				389.2	457.9
FY2002		**415.4**	418.4			421.1	480.1
FY2003		**439.6**	**454.6**			455.6	505.0
FY2004			**481.5**	487.6		492.5	531.4
FY2005			**511.4**	**520.8**		524.3	554.3
FY2006				**549.2**	550.1	550.2	566.2
FY2007				**580.0**	589.2	582.5	582.5
FY2008					**617.4**	(623.1)	
FY2009					**646.6**	(653.8)	
FY2010					**678.3**	(681.8)	

Sources: successive spending reviews and, for out-turns, HM Treasury's data bank, April 2009, available on www.hm-treasury.gov.uk. The data in brackets for FY2008 to FY2010 are the Treasury's latest projections for TME.

Total Managed Expenditure (TME) comprises Departmental Expenditure Limit (net of depreciation) (DEL) spending and Annually Managed Expenditure (AME), which includes social security benefit spending, public service pension payments and central government debt interest. The bold data show the new spending plans for each Spending Review.

Table 3b Public spending, annual average growth rates (%)

	Current prices	Constant prices
Compared with FY1997:		
FY2007	6.1	3.6
FY2010	5.9	Na
Compared with FY1999:		
FY2007	6.85	4.2
FY2010	6.4	Na

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