



Perspectives by Ruth Lea

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Budget 2009: an exercise in irresponsible procrastination

Introduction

Last week's Budget, released on 22 April, painted a picture of the public finances for both borrowing and indebtedness that was breathtakingly, shockingly bad.¹ Even so, the Chancellor did not paint the whole picture. There are several reasons for this, including:

- The GDP forecasts are over-optimistic and are unlikely to be met, thus raising public borrowing even further.
- Two of the Chancellor's fiscal tightening measures are an increased top tax rate for high earners and increased "value for money efficiency savings". It is unlikely that either will deliver the tightening factored into his public sector projections.
- The fiscal projections were consistent with the Government's "temporary fiscal operating rule", which comprises the return to a cyclically-adjusted current balance and debt falling as a proportion of GDP by FY2017, when the Treasury claims the global shocks will have fully worked their way through the economy. But, according to the IFS, the Chancellor's measures announced in 2008 PBR and Budget 2009 taken together result in only 50% of the necessary tightening. (And as just pointed out, the impact of some of these measures is dubious.) More measures are still required. The Chancellor shirked, avoided, making the necessary announcements. The hard decisions have still to be made.
- The Chancellor's projections still show alarmingly high public borrowing and debt figures well into the middle years of the next decade. Given the huge gilt issuance, it is likely that far more reassurance will have to be given to the markets, and further tightening over the next 2-3 years will be required, to retain investor confidence.

The Budget failed to do what it should have done. And that was to give an honest and sober account of how the public finances are going to be restored. Instead there were irrelevant political points on taxing high earners. It was an exercise in irresponsible procrastination.

The Treasury's economic forecast

The Chancellor's forecasts of GDP were widely regarded as over-optimistic on the day of the Budget but their implausibility was underlined by the 2009Q1 GDP preliminary estimate released by the ONS just two days later. The ONS figures showed a worse-than-expected quarterly fall of 1.9%, compared with the 1.6% fall factored in, apparently, in the Treasury forecast. The table below shows the Treasury's forecast compared with that of the IMF ² which was released on the same day as the Budget.

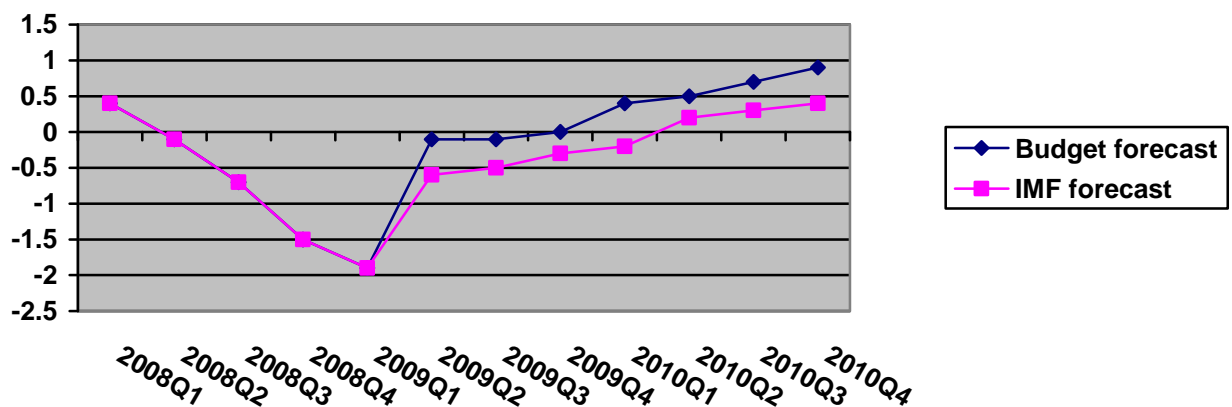
GDP forecasts (%)

	2008	2009	2010	2011
2008 Pre-Budget Report	$\frac{3}{4}$	-1 $\frac{1}{4}$ to - $\frac{3}{4}$	1 $\frac{1}{2}$ to 2	2 $\frac{3}{4}$ to 3 $\frac{1}{4}$
Budget 2009	$\frac{3}{4}$	-3 $\frac{3}{4}$ to -3 $\frac{1}{4}$	1 to 1 $\frac{1}{2}$	3 $\frac{1}{4}$ to 3 $\frac{3}{4}$
IMF	0.7	-4.1	-0.4	Na

Sources: (i) HM Treasury, *Budget 2009*, April 2009; (ii) IMF "Global economy contracts, with slow recovery next year", 22 April 2009, www.imf.org

If the Treasury's central case forecast for 2009 is to be achieved and the first quarter figure is not favourably revised by the ONS, then the economy will have to show little further overall deterioration over the remaining 3 quarters of this year. This is implausible. The chart below includes a worked scenario for the quarterly path of GDP which would enable the Treasury's forecasts to be achieved. A worked scenario for the IMF forecast is also included. Even on the more gloomy IMF forecast, the fall in GDP needs to be significantly lower in the second quarter of 2009 than in the first.

GDP growth scenarios, consistent with Budget and IMF forecasts, quarterly growth rates (%)



Source: author's calculations. Data up to and including 2009Q1 are ONS estimates.

The Treasury's growth scenario for the next 2 years, therefore, does not look plausible. The Budget forecast for 2011 of 3 $\frac{1}{2}$ % and implied similar growth rates for following years have also been widely questioned - not least of all because the Treasury has not made any

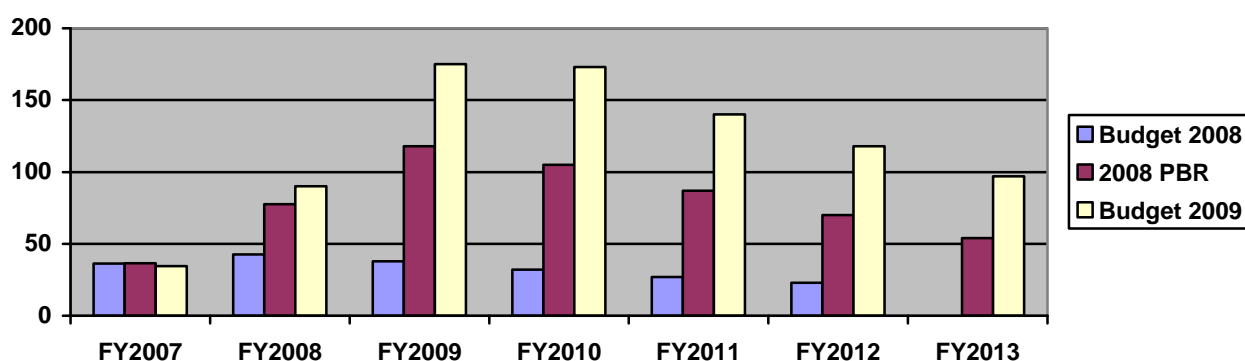
allowance for any medium-term damage to trend “productive potential” growth from the financial crisis. (Productive potential growth is trend GDP growth with unchanged capacity utilisation.) Given the likely ongoing problems in, for example, the financial services sector, this seems implausible.

If the Budget forecasts are significantly undershot, then the public borrowing forecasts will deteriorate even faster than the Budget projected, 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 fall of 3¾% is used for 2009 and a rise 1% is used for 2010. The Treasury’s traditional 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 IMF is right about 2010 and GDP contracts overall by around ½% instead of growing by 1% (lower end of Treasury’s range) the loss of GDP is around 1½% and public borrowing could be expected to be 0.75% of GDP worse in year one alone than otherwise would be the case. This amounts to around £11bn of extra borrowing.⁴

The Treasury’s fiscal forecasts: borrowing

The Budget projections for Public Sector Net Borrowing (PSNB) were breathtakingly bad and the chart below shows the speed with which the figures have deteriorated since last year’s Budget.⁵ Even as recently as the 2008 PBR total borrowing between FY2009 and FY2013 was estimated to be “only” £434bn. In this year’s Budget the estimate was £703bn – some £269bn higher. Borrowing as a % of GDP is at its highest level since World War II. The table behind these figures is in the annex (table 2).

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

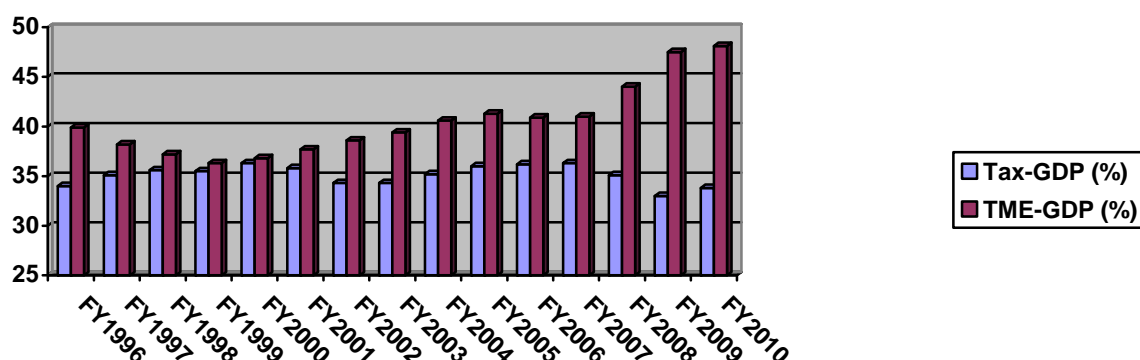


Sources: (i) HM Treasury, Budget 2008, March 2008, HC388, (ii) HM Treasury, 2008 Pre-Budget Report, Cm 7484, November 2008, (iii) HM Treasury, Budget 2009, HC407, April 2009.

Public sector borrowing has exploded reflecting a sharp increase in public spending, with higher social security and debt interest payments, and falls in tax revenue reflecting lower VAT payments, lower corporation tax receipts (especially for the financial sector), less tax from high earners and weaker revenues from the housing sector.

As the chart below shows, the tax-GDP ratio is projected to slump to 33% in FY2009. Over the projected period the ratio is expected to remain subdued despite the forecast return to GDP growth. Meanwhile the TME-GDP ratio is expected to reach 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%). 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.

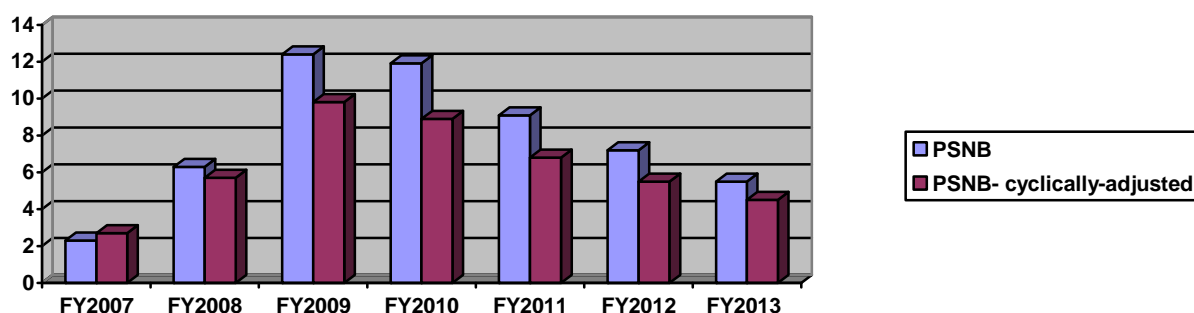
Budget 2009: Tax-GDP and TME-GDP ratios (%)



Source: HM Treasury, Budget 2009, HC407, April 2009. Data to FY2007 are recorded, FY2008 is estimated and FY2009 and FY2010 are projected. TME stands for Total Managed Expenditure, i.e. total public spending.

The Chancellor’s forecast that the Government would need to borrow £175bn this year, almost 12½% of GDP, had been well trailed in advance. Much more surprising was the Treasury’s assessment that four-fifths (9.8% of GDP) of this borrowing will be “structural” and therefore impervious to economic recovery - whenever it comes and however strong it is. The chart below shows cyclically-adjusted, or “structural”, borrowing figures, which stay stubbornly positive even after the fiscal tightening measures announced in the 2008 PBR and Budget 2009. Structural borrowing is still expected to be 4.5% of GDP in FY2013. This is unsustainable.

Public Sector Net Borrowing (% GDP): actual and structural (cyclically-adjusted)



Source: HM Treasury, *Budget 2009*, April 2009, table C2.

Fiscal tightening: the measures to FY2013

The Chancellor announced a minor fiscal stimulus for FY2009 in his Budget compared with the 2008 PBR, followed by fiscal tightening in the form of higher taxes and public sector efficiency savings. The main measures of the Budget are listed in annex table 3.

The main tightening measures included:

- A 50% top rate of income tax from April 2010 (a broken election pledge) for those earning over £150,000, coupled with the withdrawal of personal allowances for those earning over £100,000. There is considerable scepticism that the projected revenue will be achieved.^{6,7}
- Note that increases in NICs rates from April 2011 were announced in the 2008 PBR.⁸
- Fuel duty increases above indexation.
- Concerning spending for the next Comprehensive Spending Review period (FY2011 to FY2013), additional “value for money spending efficiencies” rising to £9bn by FY2013 were announced.⁹ There is considerable scepticism that these savings will be achieved.¹⁰ The Budget 2009 set assumptions for spending growth from FY2011 onwards, with current spending growing by on average 0.7% a year in real terms and public sector investment “moving towards 1¼ % of GDP” by FY2013.¹¹
- Note that the 2008 PBR had already increased its “value for money savings” target in FY2010 by £5bn.

All in all, the Budget projected extra fiscal tightening of £27bn, with 70% from tighter public spending, in the year FY2013 as a result of the Budget’s announcements. The table behind these figures is in the annex (table 5). Given the scale of the borrowing this is clearly inadequate, even allowing for the tightening announced in the 2008 PBR.

Further tightening required

As already stated, even after the budget’s fiscal tightening measures (some of which look suspect), structural borrowing is still 4.5% of GDP in FY2013. Even the cyclically-adjusted current budget balance is 3.2% of GDP in FY2013. Further tightening is clearly needed.

In the 2008 PBR the Chancellor announced the “temporary fiscal operating rule” to replace the tarnished “Golden Rule”¹² and the mortally wounded “Sustainable Investment Rule”.¹³ The new-style rule involves setting policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have fully worked their way through the economy.¹⁴ The 2008 PBR forecasts claimed that these conditions were satisfied by FY2015.¹⁵ But in Budget 2009 the year has been moved back 2 years to FY2017.¹⁶ This is not rigorous forecasting but fitting the forecast to the fiscal disaster. Moreover, this is well into the next Parliament but one, assuming parliaments of 4-5 years. This is far too remote to be politically or economically meaningful.

In its post-Budget 2009 analysis the IFS calculated the requisite tightening that is subsumed by the Treasury for the current budget to be in balance by FY2017.^{17, 18}

The IFS's calculations show that the measures announced in the 2008 PBR and Budget 2009, taken together, account for only 50% of the requisite tightening. Further measures, yet to be announced, are required to cover the other 50%. The IFS suggested they would take place between FY2014 and FY2017 (i.e. by FY2017) and take the form of some combination of as-yet unannounced tax increases and cuts in non-investment spending. The Budget assumed no further cuts in investment spending.

Tightening required to achieve balanced current budget by FY2017

	% 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.

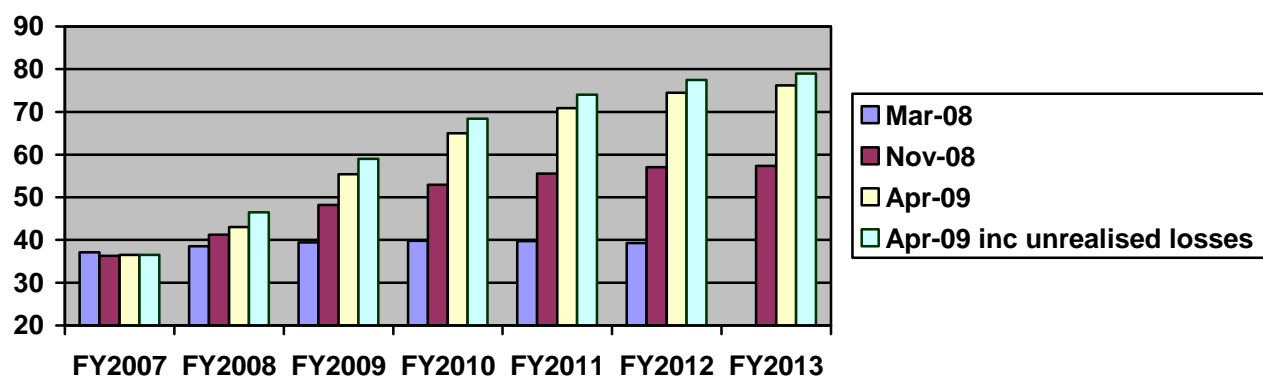
Of course, any incoming Government may decide to tighten much quicker than under the IFS scenario. Indeed it may find that it has little alternative. Some commentators take the view that waiting until FY2017 to balance the current budget is to wait too long.¹⁹ It is hard to disagree with them.

The Treasury's forecasts: public sector net debt

Suffice to say that the horrendous borrowing figures are leading to a rapid build-up of public sector net debt. In addition the Budget included estimates in its debt projections for the net impact of unrealised losses on financial sector interventions, which the Treasury

provisionally estimates lie within a potential range from £20bn to £50bn (1½% to 3½% of GDP). In the chart below the upper estimate (equal to 3½% of GDP) is included. The IMF has, however, estimated the eventual cost to the taxpayer may be 9.1% of GDP or around £130bn.²⁰

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

An investors' strike?

Where does all this leave the credibility of fiscal policy? It almost goes without saying, that if investors are not convinced that the public finances will be repaired over a sensible timescale, yields will have to rise – adding to the already rapidly increasing debt interest payments.

The size of the gilt issuance is breathtaking. The Debt Management Office (DMO) has planned for gross gilt issuance of £220bn in FY2009.²¹ Over the next 5 years £900bn of gilts is estimated to need to be issued.²² There are expected to be at least two ready sources of buyers in the near-term. Banks will be obliged to hold more gilts as liquid assets under new FSA rules and the Bank of England, through the roundabout route of Quantitative Easing, is buying gilts. (This is really “under-funding” by any other name.) Pension funds and large investors desperate for “secure” income will also probably be ready buyers. But there is some evidence of a fall-off in interest by overseas investors, who currently hold about a third of the current stock of gilts.

Given the huge gilt issuance over this period, investors may however shun buying British government debt. Steve Bundred, chief executive of the Audit Commission, wrote in February:

“On the basis of the planned levels of borrowing, it [public debt] could exceed 65% of GDP in 2010-11. And at that scale of indebtedness, the Armageddon scenario most feared by the Treasury - that there will be insufficient lenders to match the planned level of borrowing - begins to look a distinct possibility.”²³

In Budget 2009 the debt-GDP ratio was 65% for FY2010. Including unrealised losses on financial sector interventions it was 68.4%.

Two of Britain's most respected commentators have voiced their concerns that investors may "strike". Willem Buitter has written: ²⁴

"If the necessary fiscal tightening is not forthcoming, markets could panic and Britain could face an emerging market-style "sudden stop", with the rest of the world withholding financing from its public and private sectors."

And Martin Wolf has written: ²⁵

"Should investors decide a return to fiscal stability has become a remote prospect, they may turn against Britain suddenly."

The Chancellor could, should, have made a serious effort in his Budget to set the markets' minds at rest and honestly mapped out a route to fiscal stability and the restoration of the public finances. He comprehensively failed to do so. He simply put off the hard decisions – leaving them to his successor who will have no alternative but to make some very hard decisions indeed.

References

1. HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009.
2. IMF "Global economy contracts, with slow recovery next year", 22 April 2009, www.imf.org
3. IFS, "Budget 2009: tightening the squeeze?", IFS Briefing Note BN83, April 2009.
4. GDP in 2008 was about £1,475bn 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. Mike Brewer and James Browne, "Can more revenue be raised by increasing income tax rates for the very rich?", *IFS Briefing Note BN84*, April 2009. This paper argued that the proposed income tax rate of 45% (2008 PBR) on incomes above £150,000 could cost rather than raise money, on balance.
7. Patrick Hennessy et al, "Revealed: the real motivation behind the 50p tax rate", *Sunday Telegraph*, 26 April 2009, reported that a Treasury source had suggested that 69% of those affected by the new 50p rate will avoid or evade paying at least some of the tax.
8. HM Treasury, *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, Cm 7484, November 2008.
9. 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.
10. National Audit Office, *The Efficiency Programme: a second review of progress*, HC156-1, 6 February 2007 concluded that of the £13.3bn of reported efficiency gains, 26% fairly represented efficiencies made, 51% represented efficiency "but carry some measurement issues and uncertainties" and 23% may have represented efficiency, "but the measures used either do not yet demonstrate it or the reported gains may be substantially incorrect."
11. See annex tables 4a and 4b for more on public spending.

12. The golden rule: stated that, on average over the cycle, the government will borrow only to invest and not to fund current spending
13. The sustainable investment rule: stated that public sector debt as a proportion of GDP would be held over the cycle at a stable and prudent level. The government believed that, other things being equal, it was desirable that public spending net debt should be below 40% of GDP over the cycle.
14. Source: HM Treasury, www.hm-treasury.gov.uk
15. IFS, "Budget 2009: tightening the squeeze?", IFS Briefing Note BN83, April 2009.
16. HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009, paragraph 2.31.
17. IFS, "Two parliaments of pain", April 2009, analysis on www.ifs.org.uk
18. Norma Cohen, "IFS fears 'two parliaments of pain' ", *FT*, 24 April 2009.
19. David Smith, "Radical surgery still needed – and it is going to hurt", *Sunday Times*, 26 April 2009.
20. 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.
21. HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009.
22. Ian King, "Could we become a banana republic?", *The Times*, 25 April 2009.
23. Steve Bundred, "Our public debt is hitting Armageddon levels", *The Times*, 27 February 2009.
24. Willem Buiter, "Timid Darling is left with little room for manoeuvre", *FT*, 23 April 2009.
25. Martin Wolf, "Indebted UK is flying on a wing and a prayer", *FT*, 23 April 2009.

Annex: supporting tables

Table 1a Current balance, £bn, Treasury revisions, 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
Apr 09					-5.2	-52.3	-132	-137	-111	-91	-74

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

Apr 09					34.6	90	175	173	140	118	97
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Sources: HM Treasury, successive Budget Reports and Pre-Budget Reports.

Table 2 Public Sector Net Borrowing (£bn): Budget 2008, 2008 PBR and Budget 2009 projections

	FY08	FY09	FY10	FY11	FY12	FY13	FY09 to FY13, total
Budget 2008	43	38	32	27	23	Na	Na
2008 PBR	78	118	105	87	70	54	434
Budget 2009	90	175	173	140	118	97	703
Revisions between:							
Budget 2008 & 2008 PBR	35	80	73	60	47	Na	Na
2008 PBR & Budget 2009	12	57	68	53	48	43	269
Budget 2008 & Budget 2009	47	137	141	113	95	Na	Na

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.

Table 3 Budget 2009 policy decisions: impact of main measures, in addition to indexation, £bn

	FY2009	FY2010	FY2011
Business rates: deferral of payments	-0.7	+0.3	+0.3
1 st year capital allowances	-1.6	-0.2	+0.4
DWP additional employer funding	-0.6	-1.1	0
Employment guarantee, young people	-0.3	-0.9	0
Support housing supply	-0.4	-0.2	0
Fuel duty: increases	+0.6	+1.25	+1.75
Income tax: withdrawal of personal allowances from £100,000	0	+0.1	+0.2
Income tax: 50% top rate from £150,000	0	+1.1	+1.8
Pensions tax: restrict tax relief to 20% from £150,000	0	0	0.2
Total policy decisions	-5.2	-0.1	+5.2

Source: HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009, table 1.2.

Table 4a Total public sector spending, annual average changes, real terms (%), FY2011 to FY2013

	2008 PBR plans	Budget 2009
Current spending	+1.2%	+0.7%
Investment spending	-2.6%	-17.3% (“move to 1¼% of GDP in FY2013”)
Total	+1.1%	-0.1%

Table 4b Total public sector spending, annual average changes, real terms (%)

	Financial years	Current spending	Investment spending	Total
Conservative governments	FY1979 to FY1996	1.7%	-5.0%	1.5%
Labour, plans inherited from the Conservatives	FY1997 to FY1998	-0.1%	3.0%	0
Labour	FY1999 to FY2007	3.6%	16.4%	4.0%
Latest forecast	FY2008 to FY2010	4.6%	5.4%	4.7%
Latest forecast	FY2011 to FY2013	0.7%	-17.3%	-0.1%

Source: Gemma Tatlow, *Public Spending*, IFS, April 2009.

Table 5 Public sector borrowing: discretionary changes announced in Budget 2009, compared with 2008 PBR, £bn

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
2008 PBR	78	118	105	87	70	54
Revisions, excluding discretionary changes	12	50	67	62	65	70
Budget 2009, no discretionary changes	90	168	172	149	135	124
Discretionary changes	0	+7	+1	-9	-17	-27
Budget 2009, with discretionary changes	90	175	173	140	118	97
Increase in borrowing compared with 2008	12	57	68	53	48	43

PBR						
Discretionary changes, fiscal tightening:						
Net tax increase	0	-1.6	+2.8	+5.2	+7.3	+7.7
Net spending cut	0	-6.0	-3.4	+3.3	+10.2	+18.8
Total, rounded to nearest billion	0	-7	-1	+9	+17	+27

Sources: Carl Emmerson, "Public finances: two parliaments of pain", IFS, April 2009, www.ifs.org.uk and author's roundings.

Note: (i) there are rounding errors in the table, (ii) total borrowing, including discretionary changes = total borrowing, excluding discretionary changes MINUS fiscal tightening.

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