



# Perspectives by Ruth Lea

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## The Pre-Budget Report: yet more irresponsible procrastination

### *Introduction*

In last week's Perspective we posed the question whether the Pre-Budget Report would primarily be a political exercise.<sup>1</sup> So it proved to be. And, as with the April Budget, the Chancellor procrastinated over the necessary medicine, the required repairs, for Britain's damaged public sector finances.<sup>2</sup>

The main conclusions of this Perspective on the PBR are:

- The projections for public borrowing were little changed from the Budget. The Treasury expects a cumulative £707bn of borrowing for FY2009 to FY2013.
- Many of the measures – including the windfall tax on bankers and the freezing of the IHT threshold – were more for political reasons than economic.
- Even though tax revenues were raised, especially reflecting the increase in NICs rates, spending was increased more and the Chancellor announced a modest fiscal loosening over the next 3 years, despite the shocking state of the public finances.<sup>3</sup> There was, therefore, no attempt to repair the public finances any quicker than in the Budget.
- The first Fiscal Consolidation Plan (FCP), under the new Fiscal Responsibility Bill, aims to cut borrowing as a share of GDP by half over 4 years and ensure debt as a share of GDP is falling in FY2015, after peaking in FY2014. The Treasury forecast debt will be nearly 78% of GDP in FY2014.
- As we have argued before, the Government's fiscal consolidation plans are not sufficiently rapid. Further tightening, preferably in the form of spending cuts, will be needed – and quicker.
- But even with the PBR's spending plans, and given the protection afforded to schools, the NHS and the police, there will be a squeeze on the other departments for the years FY2011 to FY2013. Under these circumstances the Government should have released a Comprehensive Spending Review for these years detailing the implications for the electorate as well as the markets.
- According to the IFS, of the eventual £76bn costs of the "repairs" factored into the PBR, announced measures account for only 60% of the costs. 40% of the factored costs will come from measures, tax hikes or spending cuts, yet to be announced.<sup>4</sup>
- Given the huge gilt issuance, £225bn this year alone, and the uncomfortable comments from some of the ratings agencies about the UK's "triple-A" status there is a rising risk of a buyers' strike.

### The main forecasts

The Chancellor's economic forecast was as we expected last week. The 2009 fall in GDP was revised to 4¾% but the rest of the GDP forecast was unchanged from the Budget. Whilst the growth rate of 1% to 1½% may be regarded as feasible for 2010, growth rates of 3½% for 2011 and 2012 are very optimistic given the further fiscal tightening that must surely be imposed by the next Government. The CPI inflation forecasts for 2009 and 2010 were revised higher.

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

	2008	2009	2010	2011	2012
Budget 2009:					
GDP growth	¾	-3¾ to -3¾	1 to 1½	3¾ to 3¾	Na
CPI inflation (Q4)	4	1	1	2¼	Na
PBR 2009:					
GDP growth	½	-4¾	1 to 1½	3¾ to 3¾	3¾ to 3¾
CPI inflation (Q4)	4	2	1¾	1½	2

Sources: (i) HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009;  
(ii) HM Treasury, *Pre-Budget Report, Securing the recovery: growth and opportunity*, December 2009, Cm 7747.

The public finances forecasts were also, on balance, little changed from the Budget, as shown in the next table, though it should be noted that borrowing increased by £5bn for FY2008 and net debt by nearly £9bn. The Treasury's forecasting record on public finances is poor, as shown in annex tables 1 and 2, however. There is an alarming bias towards the positive.

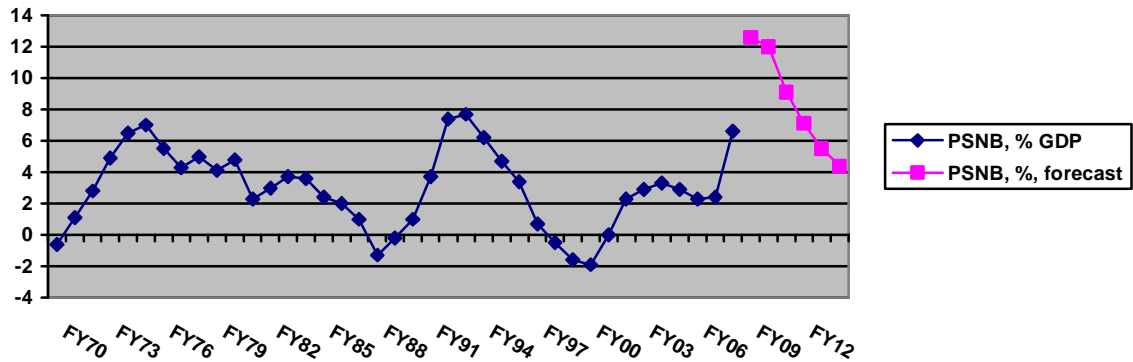
Table 2 Budget and PBR: public finances

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
2009 Budget:							
Current Budget (£bn)	-52.3	-132	-137	-111	-91	-74	Na
PSNB (£bn)	90	175	173	140	118	97	Na
PSNB (% of GDP)	6.3%	12.4%	11.9%	9.1%	7.2%	5.5%	Na
Debt (£bn)*	609.1	792	977	1130	1262	1370	Na
Debt (% of GDP)	43.0%	55.4%	65.0%	70.9%	74.5%	76.2%	Na
2009 PBR:							
Current Budget (£bn)	-50.1	-128.1	-137	-111	-91	-74	-59
PSNB (£bn)	95.4	177.6	176	140	117	96	82
PSNB (% of GDP)	6.6%	12.6%	12.0%	9.1%	7.1%	5.5%	4.4%
Debt (£bn)	618.8	798.9	986	1139	1270	1379	1473
Debt (% of GDP)	44.0%	55.6%	65.4%	71.7%	75.4%	77.1%	77.7%

Sources: (i) HM Treasury, *Budget 2009, Building Britain's future*, HC407, April 2009;  
(ii) HM Treasury, *Pre-Budget Report, Securing the recovery: growth and opportunity*, December 2009, Cm 7747.  
\* Public sector net debt, at end financial year.

Whilst the forecast data have changed little since the Budget, this should not detract from the seriousness of the public finances predicament. Chart 1 shows public borrowing data as % of GDP. Public sector borrowing as a share of GDP is expected to be over 12½% in FY2009. This compares with “only” 7% in FY1975, just before the Government called on the IMF for a loan owing to its inability to fund its borrowing.<sup>5</sup> And it compares with “only” 7.7% in FY1993 after the recession of the early 1990s.

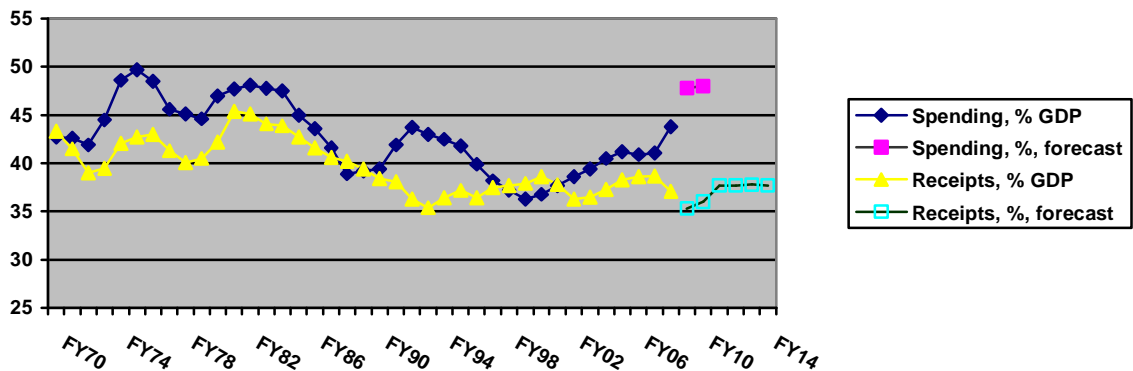
Chart 1 Public Sector Net Borrowing, FY1970 to FY2014, % of GDP



Source: 2009 PBR, tables B14 and B23

Chart 2 shows the rocketing public spending (Total Managed Expenditure) as a % of GDP compared with the weak current receipts data. Spending is expected to be around 48% of GDP in both FY 2009 and FY2010 – almost back to the levels of the mid-1970s. Meanwhile current receipts as a % of GDP have fallen back from over 38.7% in FY2007 to an expected 35.3% in FY2009 reflecting recession. Even though they are projected to recover over the forecast period they are still expected to be less than 38% of GDP - even by FY2014.

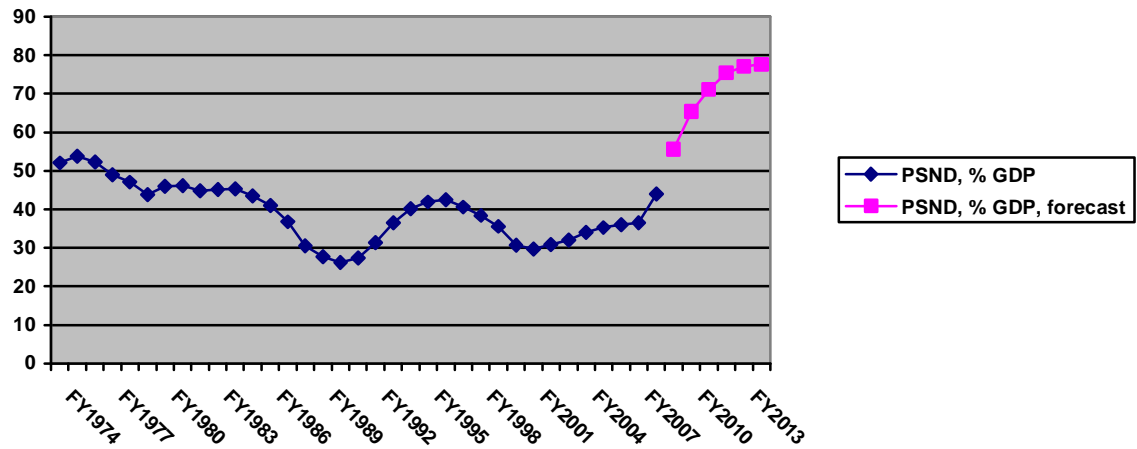
Chart 2 Public sector spending (FY1970 to FY2010) and current receipts (FY1970 to FY2014), % of GDP



Source: 2009 PBR, tables B14, B23 and B24, and chart B2. Spending is Total Managed Expenditure (TME).

Chart 3 shows the equivalent data for public sector debt. The rapid escalation of the ratio of debt to GDP is, quite simply, unprecented in peacetime.

Chart 3 Public sector net debt, FY1974 to FY2014, % GDP



Source: 2009 PBR, tables B14 and B23. No allowance is made for the net impact of unrealised losses on financial sector interventions, which the Treasury now estimates to be £10bn.

*The main PBR measures and the overall fiscal stance*

The PBR measures were mainly aimed at scoring political points and raising tax from the higher paid and the better off. Hence the windfall tax on banking bonuses, the freezing of the higher rate threshold for income tax, the freezing of IHT thresholds and restricting pensions tax relief for those earning £150,000 or more. Most of these moves were well-trailed. More surprising was the announcement of an extra ½% on National Insurance Contributions rates – bringing the total % increase to a full 1% for NICs rates in April 2011. The VAT rate was confirmed as reverting to 17.5% in January 2010.

On the spending side there were lollipops by way of up-rating benefits normally linked to RPI inflation (which was negative in September) by 1.5% or 2.5%.

Table 3 2009 Pre-Budget Report, main measures, revenues/costs (£bn)

	FY2009	FY2010	FY2011	FY2012
<u>Tax measures:</u>				
Freeze higher rate threshold	0	0	0	0.4
Increase NIC's primary threshold	0	0	-1.5	-1.5
Increase employer NIC's rate by 0.5%	0	0	+2.35	+2.5
Increase main employee & self-employed NIC's rate by 0.5%	0	0	+2.0	+2.1
Increase additional employee & self-employed NIC's rate by 0.5%	0	0	+0.3	+0.3
Pensions tax: updated income definition	0	0	0	+0.5
Freeze IHT threshold	0	0.1	0.2	0.2
Bank payroll tax	+0.55	0	0	0
Small companies rate of CT: defer increase to 2011	0	0	-0.4	-0.1
<u>Spending measures:</u>				
Benefits uprating	0	-0.7	0	0
<u>Total policy decisions</u>	<u>+0.4</u>	<u>-1.2</u>	<u>+3.5</u>	<u>+5.1</u>

Source: HM Treasury, *Pre-Budget Report, Securing the recovery: growth and opportunity*, December 2009, Cm 7747, table 1.2. A negative sign indicates increased borrowing (greater spending or less revenue), a positive sign indicates decreased borrowing.

The overall fiscal stance was, economically though perhaps not politically, surprising. Despite the shocking state of the public finances, the Chancellor increased planned spending by around £15bn in total over FY2011 and FY2012, while recouping less than £9bn through new tax increases.<sup>6</sup> The Chancellor said that extra spending in these 2 years would allow modest real increases on “frontline” schools, no real cuts in the “frontline” NHS and no cuts in police numbers. Efficiency savings, illusive though they may prove to be, were also invoked to support spending in key areas.

#### *The Fiscal Responsibility Bill and the need for further tightening*

The Chancellor announced further details of the Fiscal Responsibility Bill, as trailed in the Queen’s Speech, the objective of which is to “enshrine the Government’s fiscal consolidation plans in legislation”. The first Fiscal Consolidation Plan (FCP) will “extend from FY2009 to FY2015 and requires that the Government”:

- Halves public sector net borrowing as a % of GDP over 4 years from the forecast peak of FY2009. The target is for borrowing to be 5.5% or less by FY2013. As shown in table 2 above, this implies borrowing as high as £96bn!
- Reduces borrowing as a % of GDP in each year from FY2009 to FY2015.
- Ensures that public sector net debt is falling as a % of GDP in FY2015.

It seems churlish to criticise the aims of the Fiscal Responsibility Bill but, as with Chancellor Brown’s fiscal rules, its success or failure will depend on the Government of the day. Chancellor Brown’s fiscal rules were all too easily jettisoned when the public finances exploded.

More importantly, the FCP’s targets are inadequately ambitious. The 8-year “repair job” of aiming to balance the cyclically adjusted current balance by FY2017 (also stipulated in the Budget), is far too slow. And the PBR shows a far too gentle decline in public sector debt as a share of GDP. After reaching a peak of nearly 78% in FY2014, it is still expected to be as high as 74% in FY2017. As we have commented before, the fiscal consolidation progress mapped out by the Treasury at the time of the Budget was far too sedate.<sup>7</sup> The PBR is, if anything, slightly worse on some measures. There is still the need for further and more rapid tightening. The Chancellor has left this job to his successor.

There is, however, little doubt that spending will be tight even on the PBR trajectory for the public finances. Total spending is set to fall by 0.1% a year in real terms between FY2011 and FY2013 – little changed from the Budget figures. But much will be allocated to the mounting debt interest payments and higher welfare spending. According to the IFS, because of the higher cost of Afghanistan in FY2010, the subsequent squeeze on departmental spending will be even tighter than foreseen in the Budget.<sup>8</sup> From FY2011 to FY2013, departmental spending will drop by 3.2% a year (real terms), compared with the earlier prediction of 2.9% a year. Schools, hospitals and the overseas aid budgets will be protected (at least for FY2011 and FY2012), leaving other departments in areas such as defence, higher education, transport and housing facing cuts of up to 6.9% a year (real terms). Over 3 years these cuts could amount to a 20%.

There are two other points to make. The first is that, whilst we know the spending restrictions factored into the PBR for FY2011 to FY2013 will be tough for several departments, we do not know exactly which they may be and how they may be affected. A responsible Government should have produced a new Comprehensive Spending Review for this period, given the unprecedented collapse in the public finances and the need for a major squeeze on spending. They have not.

The second point is that the Chancellor has not announced all the necessary measures even to hit his repair targets. According to the IFS, of the eventual £76bn costs of the “repairs” factored into the PBR, announced measures account for only 60% of the costs. 40% of the factored costs will come from measures, tax hikes or spending cuts, yet to be announced. These “unknowns” amounted to 50% of costs in the Budget.

Table 4 Eventual cost of fiscal tightening by FY2017, IFS calculations

	Costs	Cost per family
Tax increases	£16bn	£490
Current spending cuts	£18bn	£570
Investment spending cuts	£13bn	£420
Unknown tax rises or spending cuts	£30bn	£925
Total	£76bn (5.4% of GDP)	£2,400

Source: Carl Emmerson, “Public finances”, 10 December 2009, available from [www.ifs.org.uk](http://www.ifs.org.uk)

#### *Comparison with Ireland*

By coincidence Brian Lenihan, the Irish finance minister, unveiled a tough budget on the same day as the PBR. He announced tough deficit-cutting measures, overwhelmingly on public spending, of €4bn (£3.6bn), some 7% of government spending and 2.5% of GDP. Taxes, apart from the introduction of a carbon tax, did not rise.

#### *Implications for gilts*

It is a sobering thought that for the five years FY2009 to FY2013 borrowing as projected in the PBR will amount to a cumulative total of £707bn. The necessary issuance of gilts will be huge.<sup>9</sup> The market for gilts is currently being supported by the Bank of England’s Quantitative Easing programme. It is due to end in February 2010. The Bank may extend the programme and thus continue to support the market. But it is to be assumed that the programme will end at some point next year and this is when the market’s true demand for British Government debt will be tested. The road could be rocky. A buyers’ strike cannot be ruled out.

The markets immediate reaction to the PBR was a negative one. The yield on 10-year gilts rose to 3.8% on Thursday 10 December – it had been 3.53% as recently as 26 November<sup>10</sup>

The ratings agencies are clearly concerned about Britain's rising indebtedness. Standard and Poor's downgraded Britain's fiscal outlook from "stable" to "negative" in May. Fitch's said that the UK, of all the "triple-A" sovereigns, was most at risk of losing "triple-A" status in November. And Moody's recent adverse comments about the future of Britain's "triple-A" rating added to the negative sentiment - though Moody's have since "clarified" their views by arguing that there was no immediate threat to Britain's rating because the UK was "resilient" and could finance and afford the borrowing.

More generally, market concerns are increasing vis-à-vis Government debt. Fitch's recent downgrade of the credit rating of Greek government bonds has added to negative sentiment – as has Standard and Poor's downgrading of the fiscal outlook for Spain and Portugal. Capital markets have decided that sovereign debt is getting riskier.<sup>11</sup> Given the avalanche of sovereign debt issuance, this is unsurprising.

#### References

1. Ruth Lea, "The Pre-Budget Report: primarily a political exercise?" Arbuthnot Banking Group Perspective, 7 December 2009
2. Ruth Lea, "Budget 2009: an exercise in irresponsible procrastination", Arbuthnot Banking Group, 27 April 2009.
3. Robert Chote and Carl Emmerson, "Some initial reactions to the 2009 Pre-Budget Report", IFS, 9 December 2009.
4. IFS, Briefing on the PBR 2009, 10 December 2009, available on [www.ifs.org.uk](http://www.ifs.org.uk).
5. See Ruth Lea, "The IMF is right: quicker action needed on the public finances", Arbuthnot Banking Group, 1 June 2009 on the 1970s crisis.
6. Robert Chote and Carl Emmerson, "Some initial reactions to the 2009 Pre-Budget Report", IFS, 9 December 2009.
7. Ruth Lea, "Of course there will have to be public spending cuts: and big ones at that", Arbuthnot Banking Group, 6 July 2009.
8. IFS, Briefing on the PBR 2009, 10 December 2009, available on [www.ifs.org.uk](http://www.ifs.org.uk).
9. The PBR increased estimated gross gilt issuance by £5.1bn to £225.1bn for FY2009.
10. Chris Giles et al, "Fiscal fears spark sell-off", *FT*, 11 December 2009.
11. Leader, "Political risk comes back to the market", *FT*, 12 December 2009.

## ANNEX

Table 1 Public sector net borrowing, £bn, FY2004 onwards

Date of forecast	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Apr 02	13	17	18								
Nov 02	19	19	19	20							
Apr 03	24	23	22	22							
Dec 03	31	30	27	27	24						
Mar 04	33	31	27	27	23						
Dec 04	34.2	33	29	28	24	22					
Mar 05	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	90.0	175.4	173	140	118	97	
Dec 09					95.4	177.6	176	140	117	96	82

Table 2 Current balance, £bn, FY2004 onwards

Date of forecast	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Apr 02	9	7	9								
Nov 02	3	5	8	10							
Apr 03	-1	2	6	9							
Dec 03	-8	-5	0	4	8						
Mar 04	-11	-5	0	4	9						
Dec 04	-12.5	-7	1	4	9	12					
Mar 05	-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				-5.3	-52.3	-131.6	-137	-111	-91	-74	
Dec 09					-50.1	-128.1	-137	-111	-91	-74	-59

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

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