



Perspectives by Ruth Lea

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A tough, necessary Budget: a true “game-changer”

We recently speculated that June’s Emergency Budget would be a “game-changer”.¹ It was. It was a tough, hard Budget but, as we have argued on previous occasions, necessary after the years of profligacy. Its main objective was to close the public sector deficit and restore confidence in Britain’s public finances.² Provided the plans are delivered and the economy does not seriously falter, admittedly two very significant provisos, the public sector deficit should be closed by the middle of this decade. Fitch’s statement that the Budget, if delivered upon, will materially strengthen the UK’s “triple A” rating was the logical response to the Budget.

The Chancellor put two new fiscal “targets” at the heart of forecast, to replace the previous Government’s tarnished Golden Rule and Sustainable Investment Rule. They were:³

- A forward-looking **fiscal mandate** to achieve a cyclically-adjusted current balance by the end of the rolling, 5-year forecast period. For the current Budget, the end of the forecast period is FY2015. The Budget added that “once the public finances are closer to the balance the period over which the cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint”.
- This fiscal mandate will be supplemented by a **target for Public Sector Net Debt** (as a % of GDP) “to be falling at the fixed date of FY2015”, “ensuring that public finances are restored to a sustainable path”. The Chancellor plans to announce a more specific debt target “once the exceptional rise in debt has been addressed”.⁴

It should be noted that the fiscal mandate is based on:

- The current balance: to protect the most productive public investment expenditure.
- A cyclically-adjusted aggregate: to allow some fiscal flexibility at a time of economic uncertainty.

Fiscal tightening: the measures

In order to achieve the fiscal mandate, the Chancellor announced a combination of further spending cuts against plans and tax rises in order to deliver an extra £40bn of belt-tightening by FY2014, over and above the fiscal retrenchment plans announced by the previous Government. The Chancellor estimated that 77% of the total consolidation would be achieved through spending reductions and 23% through tax increases. (See annex table 1.)

The main measures are shown in table 1 immediately below. Table 2 in the annex provides more detail – especially on the specific tax measures.⁵

Table 1 Budget policy decisions, announced in June 2010 Budget

	FY2010	FY2011	FY2012	FY2013	FY2014
Tax measures					
Of which:					
VAT: increase main rate to 20% (4 Jan 2011)	+2,850	+12,100	+12,500	+12,950	+13,450
Corporation Tax: decrease to 27% (FY2011), 26% (FY12), 25% (FY13), 24% (FY14)	-10	-400	-1,200	-2,100	-2,700
Small profits rate: decrease to 20% from FY2011	0	-100	-1,000	-1,300	-1,400
Capital allowances: decrease main rate to 18% & special rate to 8% from FY2012	0	0	+1,000	+1,900	+1,800
Bank Levy: introduce from Jan 2011	0	+1,150	+2,320	+2,500	+2,400
Employer NICs: increase threshold in FY2011	0	-3,130	-3,150	-3,510	-3,720
Personal allowance: increase by £1,000 in FY2011, with adjustments	0	-3,490	-3,700	-3,770	-3,910
CGT: increase rate for higher rate taxpayers to 28% & increase Entrepreneurs' Relief to £5m from 23/6/10	0	+725	+825	+850	+925
Total tax policy decisions	+2,830	+6,255	+6,950	+8,515	+8,230
Spending measures					
Changes to current measures	+3,465	+6,835	+15,230	+21,700	+29,780
Changes to capital spending	+1,780	+2,020	+2,070	+2,120	+2,160
Total spending decisions	+5,245	+8,855	+17,300	+23,820	+31,940
Total policy decisions	+8,075	+15,110	+24,250	+32,335	+40,170
Of which: specific welfare measures	+385	+2,010	+4,710	+8,150	+11,040

Source: HM Treasury, *Budget 2010*, HC61, June 2010, table 2.1.

Note: a "+" sign indicates tightening (increased taxes, reduced spending), a "-" sign loosening (decreased taxes, increased spending)

Improved public finances

The result of this tough belt-tightening is a significant improvement in the forecasts for the public finances. Table 2 below compares the OBR's forecasts pre- and post-Budget.

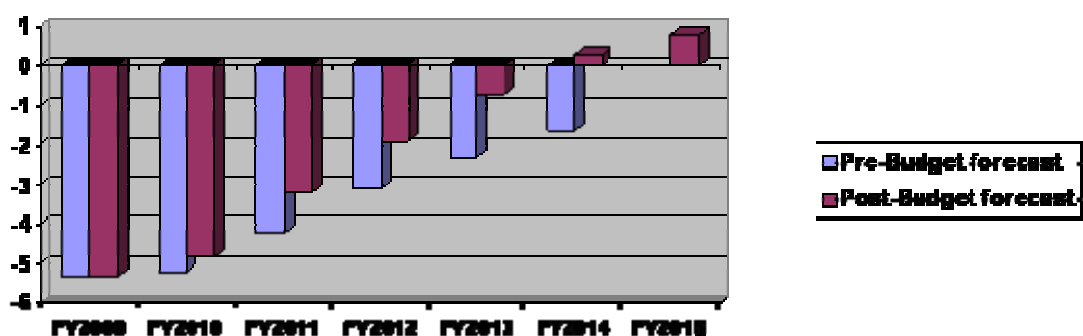
Table 2 OBR forecasts of the main fiscal aggregates

	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Cyclically-adjusted current budget, % of GDP:							
Pre-Budget forecast	-5.3	-5.2	-4.2	-3.1	-2.3	-1.6	
Post-Budget forecast	-5.3	-4.8	-3.2	-1.9	-0.7	+0.3	+0.8
Public Sector Net Borrowing (PSNB, £bn):							
Pre-Budget forecast	156	155	127	106	85	71	
Post-Budget forecast	155	149	116	89	60	37	20
Public Sector Net Debt (% of GDP), end year:							
Pre-Budget forecast	53.5	62.2	68.2	71.8	73.7	74.4	
Post-Budget forecast	53.5	61.9	67.2	69.8	70.3	69.4	67.4

Sources: (i) Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 4.5, (ii) HM Treasury, *Budget 2010*, HC61, June 2010, OBR forecast.

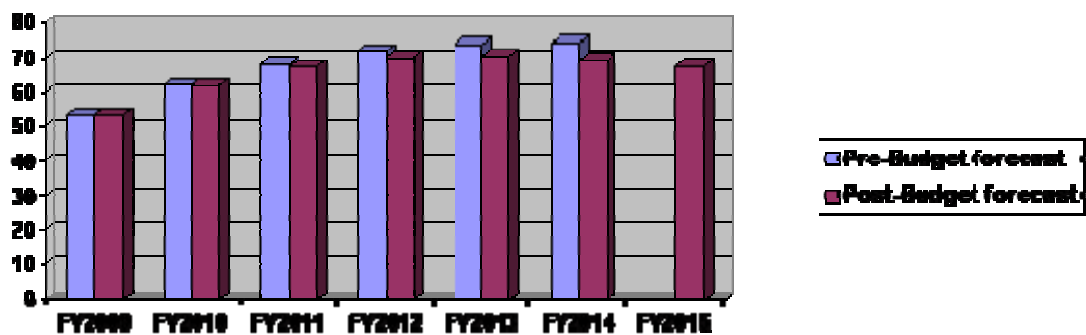
The OBR is forecasting, as its central case, that the cyclically-adjusted current budget will return to positive territory in FY2014. This is a year earlier than the end of “the forecasting period” (FY2015) as specified under the new fiscal mandate. The OBR, in accordance with its adoption of Bank of England style probability analysis, assesses that “there is a greater than 50% chance of achieving the fiscal mandate in FY2014, a year ahead of the date set by the Government”.⁶

Chart 1: Cyclically-adjusted current budget, % of GDP



Turning to Public Sector Net Debt (PSND) as a % of GDP, the OBR now forecasts that it will peak at end year FY2013 (at 70.3%) and then begin to fall. This more than satisfies the second of the Chancellor’s targets: namely that PSND (as a % of GDP) “to be falling at the fixed date of FY2015”. In its Pre-Budget forecast the OBR projected a rising PSND/GDP ratio to the end of the then forecasting period (FY2014), albeit flattening out.

Chart 2: Public Sector Net Debt, % of GDP



The improved outlook for the public finances has of course implications for DMO's funding of the borrowing. The Net Financing Requirement (NFR) for FY2010 has been revised down £20.2bn to £162.5bn from £182.7bn and the planned gilt issuance has accordingly been reduced by £20.2bn to £165bn.

Implications for spending

The degree of reliance on spending cuts implies some very tough decisions – especially for non-annually managed departmental spending.⁷

But beginning with Annually Managed Expenditure (AME), the Government has identified welfare cuts worth £11bn by FY2014. More than half comes from indexing benefits to an inflation rate (CPI) that tends to be lower than the RPI currently used (see annex table 2). But, even in real terms, the AME budget is still expected to rise by over 8% between FY2010 and FY2014 (see annex table 3b). Unless more savings can be found from the welfare budget, and the Government is clearly keen to find more, there will be a significant “hit” on total Departmental Expenditure Limits (DELs) of around 13-14% in real terms between FY2010 and FY2014 (again see annex table 3b).

In addition, the Government has promised to “protect” the spending on the NHS and overseas aid. Under these circumstances, the implications for the “unprotected” departments are severe – they face an average real reduction of 25% by FY2014.⁸ If, say, the defence and schools budgets are cut by “only” 10%, the implication for the remaining departments such as higher education, Home Office, justice, transport and housing, is even grimmer. They could be facing cuts of 33% by FY2014 in real terms.⁹ Such implications put pressure on the Government to press for further welfare cuts and/or even revisit their pledges on the NHS and, especially, on overseas aid. Whatever happens, capital spending is sure to be a big loser (see annex table 3a).¹⁰

The Chancellor announced in his Budget speech that the 2010 Spending Review, with detailed departmental plans for the period FY2011 to FY2014, will be released on 20 October 2010.¹¹

The economic forecast

As we speculated in last week's Perspective, the OBR downgraded its GDP forecasts for 2010 and especially 2011.¹² Thereafter, they were a little firmer on the whole than in the Pre-Budget forecast. They remain, arguably, on the optimistic side given the ongoing credit conditions restrictions and difficulties in the eurozone. The inflation forecast has been increased for 2010 and 2011 reflecting higher oil price assumptions and the hike in the standard rate of VAT from 17.5% to 20% (4 January 2011). Thereafter it is assumed that the 2% CPI target (confirmed by the Chancellor in his Budget a speech) is achieved.

Table 3 The OBR's economic forecast

	2009	2010	2011	2012	2013	2014	2015
Pre-Budget forecast:							
GDP (YOY, %)	-4.9	1.3	2.6	2.8	2.8	2.6	
Inflation (Q4, YOY, %)	2.1	2.3	1.6	2.0	2.0	2.0	
ILO unemployment rate (%)	7.6	8.1	7.9	7.4	6.8	6.3	
Post-Budget forecast:							
GDP (YOY, %)	-4.9	1.2	2.3	2.8	2.9	2.7	2.7
Inflation (Q4, YOY, %)	2.1	2.7	2.4	1.9	2.0	2.0	2.0
ILO unemployment rate (%)	7.6	8.1	8.0	7.6	7.0	6.5	6.1

Sources: (i) Office for Budget Responsibility, *Pre-Budget Forecast June 2010*, table 3.1, (ii) HM Treasury, *Budget 2010*, HC61, June 2010, table C2.

As we surmised last week the OBR's hit on GDP growth of the fiscal retrenchment was relatively modest. The June Budget report contained some useful information on the fiscal multipliers used to estimate the impact of spending and tax policy decisions on the economy.^{13, 14} The multipliers are shown in table 4 below.

Table 4 Estimates of fiscal multipliers

	Impact multipliers
Change in VAT rate	0.35
Changes in the personal tax allowance & NICs	0.3
AME welfare measures	0.6
Implied Resource Departmental Expenditure Limits (RDEL), current spending	0.6
Implied Capital Departmental Expenditure Limits (CDEL)	1.0

HM Treasury, *Budget 2010*, HC61, June 2010, table C8.

A figure of 0.35, for example, means that a measure which has the direct effect of raising revenue (VAT) by 1% of GDP is estimated to reduce GDP by 0.35% in the short-run. The impact is, therefore, dampened. But a figure of 1.0 means that a cut in spending (capital) has the direct effect of reducing GDP by 1.0%, in the short-run. The effect is therefore not dampened. It is therefore all the more regrettable that capital spending is being cut so hard in the plans ahead. And this omits its, possible, longer-term contributions to the infrastructure.

References

1. Ruth Lea, "A game-changing" Budget: the most important for a generation", Arbuthnot Banking Group, 21 June 2010.
2. Ruth Lea, "George's horrible medicine will do us good", *The Times*, 23 June 2010.
3. HM Treasury, *Budget 2010*, HC61, 22 June 2010, available from www.hm-treasury.gov.uk.
4. Gemma Tetlow, "Public finances: more done, more quickly", IFS, June 2010.
5. In addition to which the Treasury will be reviewing the restrictions to pensions tax relief for higher earners introduced by the previous Government. See HM Treasury, "Restricting pensions tax relief", June 2010.
6. HM Treasury, *Budget 2010*, HC61, June 2010: OBR forecast.
7. Total Managed Expenditure (TME) = Departmental Expenditure Limits (DELs) + Annually Managed Expenditure (AME). The largest component of AME is social security.
8. See HM Treasury, "Budget Statement by the Chancellor of the Exchequer, the Rt Hon George Osborne MP", 22 June 2010, available from www.hm-treasury.gov.uk.
9. Rowena Crawford, "Public services: serious cuts to come", IFS, June 2010.
10. See Ruth Lea, "Tackling the deficit: an excellent start but there's much to be done", Arbuthnot Banking Group, 7 June 2010.
11. HM Treasury, "Spending Review 2010 – the Government's approach", press release, 8 June 2010, announced that the autumn Spending Review will set spending limits for every Government department for the period FY2011 to FY2014.
12. Ruth Lea, "A game-changing" Budget: the most important for a generation", Arbuthnot Banking Group, 21 June 2010.
13. The fiscal multiplier is the ratio of the change in GDP to an exogenous change in the fiscal deficit (either a change in spending or taxation or both). Different types of multiplier can be used depending on the time period under consideration – eg initial impact, peak or cumulative multipliers. If, for example, public spending decreases by £1bn and GDP by the same amount, the multiplier is 1.
14. HM Treasury, *Budget 2010*, HC61, June 2010: OBR forecast, pages 95-96.

Annex: supporting tables

Table 1 Total consolidation plans over the forecast period

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
Discretionary policy, June Budget:	8.1	15	24	32	40	
Spending (£bn)	5.2	9	17	24	32	
Taxes (£bn)	2.8	6	7	9	8	
Spending share (%)	65	59	71	74	80	
Policy inherited:	0.8	26	42	57	73	
Spending (£bn)	0	14	25	38	52	
Taxes (£bn)	0.8	11	17	18	21	
Spending share (%)	0	56	60	68	71	
Total discretionary consolidation:	8.9	41	66	90	113	128
Spending (£bn)	5.2	23	42	63	83	99
Taxes (£bn)	3.6	18	24	27	29	29
Spending share (%)	59	57	64	70	74	77

Source: HM Treasury, *Budget 2010*, HC61, June 2010, table 1.1. The measures announced in the March 2010 Budget or earlier, which take effect from April 2011, are shown in Budget table 2.4.

Table 2a Budget policy decisions, announced in June 2010 Budget

	FY2010	FY2011	FY2012	FY2013	FY2014
Tax measures					
1 Deficit reduction:					
VAT: increase main rate to 20% (4 Jan 2011)	+2,850	+12,100	+12,500	+12,950	+13,450
Insurance Premium Tax: increase standard rate to 6% & higher rate to 20% (4 Jan 2011)	+115	+455	+445 (sic)	+455	+455
2 Enterprise & growth:					
Corporation Tax: decrease to 27% (FY2011), 26% (FY12), 25% (FY13), 24% (FY14)	-10	-400	-1,200	-2,100	-2,700
Small profits rate: decrease to 20% from FY2011	0	-100	-1,000	-1,300	-1,400
Capital allowances: decrease main rate to 18% & special rate to 8% from FY2012	0	0	+1,000	+1,900	+1,800
Annual Investment Allowance: decrease to £25,000 from FY2012	0	0	+100	+1,200	+1,000
Video games tax relief: not introduce	0	+40	+50	+50	+50
Bank Levy: introduce from Jan 2011	0	+1,150	+2,320	+2,500	+2,400
Business Rates: backdated bills in FY2011	+30	-70	-15	-15	-20
Employer NICs: relief for new businesses in targeted regions	-50	-320	-390	-180	0
Employer NICs: increase	0	-3,130	-3,150	-3,510	-3,720

threshold in FY2011					
3 Fair taxes:					
Personal allowance: increase by £1,000 in FY2011, with adjustments	0	-3,490	-3,700	-3,770	-3,910
Basic rate limit, freeze in FY2013	0	0	0	+320	+740
CGT: increase rate for higher rate taxpayers to 28% & increase Entrepreneurs' Relief to £5m from 23/6/10	0	+725	+825	+850	+925
Council Tax: reduction in receipts due to a one year freeze in FY2011	0	-625	-630	-635	-640
Landline Duty: not introduce	-90	-175	-175	-175	-175
Cider Duty: reverse increase	-10	-15	-15	-15	-20
Furnished holiday lettings: reverse plans to repeal existing rules	-5	-30	-15	-10	-10
Managed payment plans: not introduce	0	+140	0	0	0
Total tax policy decisions	+2,830	+6,255	+6,950	+8,515	+8,230
Spending measures					
Changes to current measures	+3,465	+6,835	+15,230	+21,700	+29,780
Changes to capital spending	+1,780	+2,020	+2,070	+2,120	+2,160
Total spending decisions	+5,245	+8,855	+17,300	+23,820	+31,940
Total policy decisions	+8,075	+15,110	+24,250	+32,335	+40,170
Of which: specific welfare measures	+385	+2,010	+4,710	+8,150	+11,040
Memo: debt interest savings in the next Spending Review period as a result of policy decisions	0	-820	+1,030	+1,810	+3,020
Memo: total policy decisions excluding debt interest savings	+8,075	+15,930	+23,220	+30,525	+37,150

Table 2a Budget policy decisions, announced in June 2010 Budget: specific welfare measures

	FY2010	FY2011	FY2012	FY2013	FY2014
Specific welfare measures:	+385	+2,010	+4,710	+8,150	+11,040
Benefits, tax credits & public service pensions: switch to CPI indexation in FY2011	0	+1,170	+2,240	+3,900	+5,840
DLA: reform gateway from FY2013	0	0	0	+360	+1,075
Lone parent benefits: extend conditionality from Oct 2011	0	0	+50	+150	+180
Health in pregnancy grant: abolish	+40	+150	+150	+150	+150
Sure Start maternity grant: apply to 1 st child only, from FY2011	0	+75	+75	+75	+75
Support for mortgage interest: set payments at average rate from Oct 2010	+15	-70	-10	+40	+65
Saving gateway: not introduce	+10	0	+75	+110	+115
Housing benefit reforms	0	+220	+600	+1,640	+1,765
Tax credit reforms	0	+1,180	+2,860	+3,110	+3,220
Child tax Credit: increase the child element by £150 in FY2011 & £60 in FY2012 above indexation	0	-1,200	-1,845	-1,930	-1,995
Child Benefit: freeze rates for 3 years from FY2011	0	+365	+695	+940	+975
Basic state pension: introduce triple guarantee from FY2011	0	0	-195	-420	-450
Pensions credit minimum income guarantee matching state pension cash increase in FY2011	0	-415	-535	-535	-535
Child Trust Funds: phased abolition of Government contributions from FY2010	+320	+540	+550	+560	+560

Source: HM Treasury, *Budget 2010*, HC61, June 2010, table 2.1.

Note: a "+" sign indicates tightening (increased taxes, reduced spending), a "-" sign loosening (decreased taxes, increased spending)

Table 3a Total Managed Expenditure (£bn), cash terms

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Current expenditure:								
AME	251	266	295	308	323	337	355	371
Implied DELs	313	335	343	343	341	341	338	340
Total	564	601	637	651	664	679	693	711
Capital expenditure (gross):								
AME	17	12	8	7	7	6	6	5
Implied DELs	48	57	52	41	40	37	39	41
Total	65	69	60	49	474	43	45	46
Total Managed Expenditure (TME)	630	669	697	700	711	722	737	757

Source: HM Treasury, *Budget 2010*, HC61, June 2010, table 2.3. There are rounding errors in the table.

Table 3b Total Managed Expenditure (£bn), cash and real terms: FY2010 to FY2014

	FY10	FY11	FY12	FY13	FY14	FY14 minus FY10	FY10 to FY14 (%)
Cash terms (£bn):							
AME:							
Current spending	295	308	323	337	355	60	20.3%
Capital spending	8	7	7	6	6	-2	-25%
Total AME	303	315	330	343	361	58	19.1%
Implied DELs:							
Current spending	343	343	341	341	338	-5	-1.5%
Capital spending	52	41	40	37	39	-13	-25%
Total implied DELs	395	384	381	378	376	-19	-4.8%
Total Managed Expenditure (TME)	697	700	711	722	737	40	5.7%
GDP deflator (% YOY)	2.9	1.9	2.3	2.6	2.7		
FY2010=100	100	101.9	104.2	107.0	109.8		9.8%
Total spending, real terms (£bn, at FY2010 prices):							
AME	303	309	317	321	329	26	8.6%
Implied DELs	395	377	366	353	342	-53	-13.4%
TME	697	686	683	674	671	-26	-3.7%

Source: HM Treasury, *Budget 2010*, HC61, June 2010, tables 2.3 and C5 and author's calculations. There are rounding errors in the table.

Table 4a Current balance, £bn, forecast revisions, FY2008 onwards

Date of forecast	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Mar 08	-9.6	-4	4	11	18			
Nov 08	-41.2	-78	-73	-54	-37	-21		
Apr 09	-52.3	-132	-137	-111	-91	-74		
Dec 09	-50.1	-128	-137	-111	-91	-74	-59	
Mar 10	-48.9	-117	-124	-102	-84	-67	-51	
Jun 10*	-49.3	-106	-114	-98	-80	-63	-48	
Jun 10	-49.7	-106	-110	-88	-65	-40	-17	0

Table 4b Public sector net borrowing, £bn, forecast revisions, FY2008 onwards

Date of forecast	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Mar 08	43	38	32	27	23			
Nov 08	77.6	118	105	87	70	54		
Apr 09	90	175	173	140	118	97		
Dec 09	95.4	178	176	140	117	96	82	
Mar 10	96.1	167	163	131	110	89	74	
Jun 10*	96.5	156	155	127	106	85	71	
Jun 10	96.1	155	149	116	89	60	37	20

Table 4c Growth forecasts, % (YOY), forecast revisions, CY2009 onwards

Date of forecast	2009	2010	2011	2012	2013	2014	2015
Mar 08	2¼ - 2¾	2 ½ - 3					
Nov 08	-1¼ to -¾	1½ - 2	2¾ - 3¼				
Apr 09	-3¼ to -3¾	1 - 1½	3¼ - 3¾				
Dec 09	- 4¾	1 - 1½	3¼ - 3¾	3¼ - 3¾			
Mar 10	-5	1 - 1½	3 - 3½	3¼ - 3¾	3¼ - 3¾	3¼ - 3¾	
Jun 10*	-4.9	1.3	2.6	2.8	2.8	2.6	
Jun 10	-4.9	1.2	2.3	2.8	2.9	2.7	2.7

Sources: HM Treasury, successive Budget Reports and Pre-Budget Reports. The asterisked June 2010 data are from the OBR, *Pre-Budget Forecast June 2010*.

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