



# Perspectives by Ruth Lea

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**Of course there will have to be public spending cuts: and big ones at that**

Several Perspectives have dealt with the issue of public sector indebtedness and public sector spending in recent months. But as the political debate on the public finances intensifies, it is timely to return to the subject.

Both the IMF and the ratings agency Standard and Poor's have recently issued warnings about Britain's public finances, as already discussed: <sup>1</sup>

- The IMF warned that there needed to be a "more ambitious medium-term fiscal adjustment path for implementation once the economic recovery is established. The focus of this adjustment profile should be to put public debt on a firmly downward path faster than envisaged in the 2009 Budget". <sup>2</sup>
- Standard and Poor's threatened to downgrade the UK's coveted triple-A rating if they concluded that, following the next election, the next government's fiscal consolidation plans were unlikely "to put the UK debt burden on a secure downward trajectory over the medium term". <sup>3</sup>

Clearly neither of these organisations is satisfied with the Budget projections and the Treasury's current endeavours to control the public finances. The Budget projections are consistent with "a cyclically-adjusted current balance" in FY2017 and "debt falling as a proportion of GDP by FY2015" (sic). And the Budget projects that cyclically-adjusted net borrowing will remain over 1% of GDP for the three years FY2017 to FY2019. <sup>4</sup> But these targets are regarded as inadequate in terms of both the speed and the magnitude of adjustment.

Other independent authorities have also expressed their concerns about Britain's finances. The OECD in its latest survey of the British economy forecast that public sector borrowing may reach 14% of GDP next year (nearly £200bn) and urged the Chancellor to plan to control spending. <sup>5,6</sup>

The European Commission also shot a fresh warning at the Treasury about the soaring budget deficit, with borrowing forecast to reach 12.75% of GDP in 2010, £10bn higher than the Treasury predicts. The Commission classed Britain alongside the Irish Republic and Latvia as the EU economies whose national finances had been most dangerously hit by the costs of the financial and economic crisis. As with the OECD, the Chancellor was urged to take more urgent and radical measures to bolster Britain's budgetary position. The Commission said the Chancellor should take significant steps to raise taxes or cut spending, starting in FY2010, and set out plans for a long-term financial improvement. <sup>7</sup>

Thirdly, Bank of England Governor Mervyn King in his evidence to the Treasury Select Committee (of 24 June 2009) insisted that the government's "extraordinary" and "enormous" levels of borrowing had to be reduced faster than the Chancellor planned.

#### *The size of the problem*

There is, therefore, an overwhelming consensus of independent bodies saying that the Budget measures to stabilise the public finances are wholly inadequate. At the time of the Budget we said that the tightening inadequate. In addition, we reported that the Chancellor had only announced measures to cover half of his putative tightening. Moreover, some of the measures, for example the "efficiency savings", were not robust enough. And the timescale for balancing the current budget by FY2017 was insufficiently urgent.<sup>8</sup>

As it is increasingly accepted that more needs to be done, the main issue now turns on the scale of the fiscal retrenchment. John Kay, one-time director of the Institute for Fiscal Studies, estimates that "at least half of the current deficit will need to be eliminated by cuts in public expenditure and increases in tax rates."<sup>9</sup> (Note that the Chancellor forecast current budget deficits of £132bn and £137bn for FY2009 and FY2010 respectively.)

Kay hypothesised that "a tax package to raise £70bn, was probably the minimum to stabilise Britain's public finances. This might put 4 points on the rate of income tax, take VAT to 20%, freeze personal allowances and tax thresholds, add 5 points to corporation tax and collect a bit of extra revenue from...alcohol, petrol and cigarettes."

These tax increases show the enormity of the challenge ahead if higher taxes are to be the main tool of tightening. As annex table 1 shows, 4 points on the basic income tax rate would raise nearly £20bn, 5 points on corporation tax could raise £5bn and raising the standard rate of VAT to 20% could yield nearly £12bn.<sup>10</sup> This would raise less than £40bn in any one year and yet seriously risk undermining business competitiveness and individual incentives. The other big earner is raising National Insurance Contributions for both employers and employees. However, the Chancellor has already announced in his 2008 Pre-Budget Report, an increase of ½% in NICs rates to operate from April 2011.

#### *The need for spending cuts*

Bearing in mind the inevitable damage to competitiveness and incentives, the emphasis should be on spending cuts – and large ones at that. It should, however, be noted that the background to this path of fiscal consolidation will not be benign. The cost of servicing public debt will rise reflecting the ballooning debt levels, and the spending of local authorities and the NHS will be squeezed by commitments they have made under PFI as well as the ageing population. In addition, there is the enormous burden of public sector unfunded pensions. According to the British-North American Committee (BNAC) Britain's unfunded pension liability, at £1.18 trillion, amounts to 85% of annual GDP. The ratio is 28% and 27% respectively in the US and Canada where the majority of public sector schemes are now funded.<sup>11</sup>

### Spending cuts: two scenarios

Any calculations of the “required spending cuts” are necessarily dependent on many uncertainties and assumptions, both political and economic. The figures shown in this Perspective should, therefore, be regarded as illustrative rather than as forecasts. Even so, they give “ball-park” figures of the magnitude of the cuts that may well be required if much of the future tightening is to come from spending cuts rather than tax increases and borrowing is to be brought under control sooner than implied in the Budget.

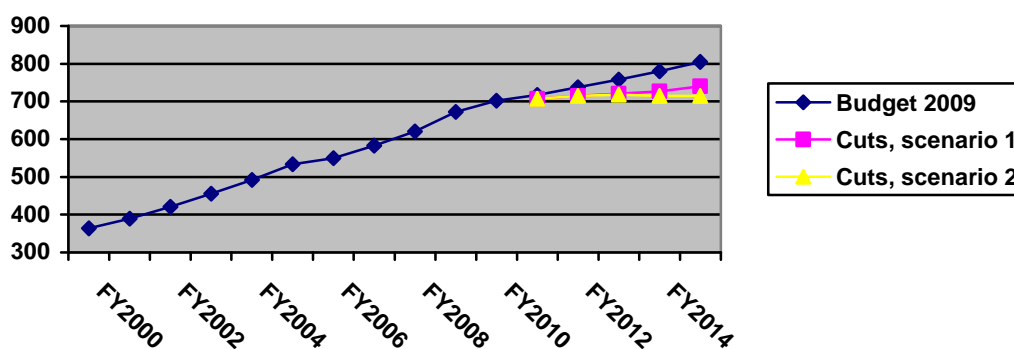
As already stated, the Budget assumed a cyclically-adjusted current balance by FY2017 and shows cyclically-adjusted net borrowing at over 1% of GDP for the three years FY2017 to FY2019. In the “cuts” scenarios below, it is assumed that public sector net borrowing, rather than just the current budget, is brought into balance by the earlier year of FY2015. This implies a quicker achievement of a tighter target – and one that may find more support from the IMF and the ratings agencies than the Budget’s target.

The chart below shows the Budget spending figures and the two spending cuts scenarios. (See annex tables 2 and 3a for the detailed figures):

- Spending cuts scenario 1: assumes that the Budget forecasts for borrowing are accurate. In this scenario spending would need to be £65bn lower than the Budget figure (extrapolated) by FY2015 and the annual increase in spending (cash terms) would be restricted to around 1% from FY2010 to FY2015 (see annex table 3b).
- Spending cuts scenario 2: assumes that the Budget forecasts are too optimistic. In this scenario spending would need to be £90bn lower than the Budget figure (extrapolated) by FY2015 and the annual increase in spending (cash terms) would be restricted to around ½% from FY2010 to FY2015 (see annex table 3b).

The current price figures shown in these scenarios are in the same “ball-park” as John Kay’s estimate of the need for a £70bn tax package, so £70bn of spending restrictions seems a reasonable “median” figure to quote for the necessary tightening. £70bn is around 5% of current GDP. But given the unsustainable expansion of the public sector since the turn of the millennium, a retrenchment in the public sector is arguably long overdue.

### Public spending: including two “cuts” scenarios, £bn, current prices



Sources: (i) HM Treasury, *Budget 2009, Building Britain's future*, HC407, table C4, April 2009 for years to FY2013, (ii) HM Treasury, Public Sector Finance Statistics, Public Finances Databank, [www.hm.treasury.gov.uk](http://www.hm.treasury.gov.uk) for back data, (iii) author's calculations (annex table 3) including all extrapolations FY2014-FY2015.

### *Spending cuts: an intensifying debate*

The debate on spending cuts is intensifying.<sup>12</sup> Such a debate is also long overdue. Secret ‘doomsday’ plans for up to 20% cuts in public spending in certain departments are, apparently, being prepared by senior civil servants.<sup>13</sup>

And Steven Bundred, chief executive of the Audit Commission, has stated that:<sup>14</sup>

“...at a time when inflation is likely to be between 2% and 3%, a pain-free way of cutting public spending would be to freeze public sector pay, or at least impose severe pay restraint.”

### **References**

1. Ruth Lea, “The IMF is right: quicker action needed on the public finances”, *Arbuthnot Banking Group Perspective*, 1 June 2009.
2. IMF, *United Kingdom – 2009 Article IV Consultation; Concluding Statement of the Mission; Restoring Fiscal Sustainability*, 20 May 2009, [www.imf.org](http://www.imf.org)
3. Chris Giles and Dave Shellock, “Warning to Britain over high debt level”, *FT*, 21 May 2009.
4. HM Treasury, *Budget 2009, Building Britain’s future*, HC407, April 2009. See charts 2.2 and 2.3 for extrapolations up to FY2017 and even FY2019.
5. OECD, *Economic Survey of the United Kingdom 2009*, June 2009; Policy Brief available from [www.oecd.org](http://www.oecd.org)
6. Edmund Conway, “Cut spending to ease pain, OECD urges”, *Daily Telegraph*, 30 June 2009.
7. Gary Duncan, “Europe warns Britain of dangers of rising debt”, *Times*, 24 June 2009.
8. Ruth Lea, “Budget 2009: an exercise in irresponsible procrastination”, *Arbuthnot Banking Group Perspective*, 27 April 2009.
9. John Kay, Britain has sunk itself deep into a fiscal black hole, *FT*, 1 July 2009
10. The Chancellor’s reduction in the standard VAT rate to 15% from 1 December 2008 to 1 January 2010 is costing the Exchequer nearly £12.5bn. See HM Treasury, *Pre-Budget Report, Facing global challenges: Supporting people through difficult times*, Cm 7484, November 2008.
11. Philip Aldrick, UK pension shock worse than in US, *Daily Telegraph*, 5 July 2009.
12. Much of the recent debate politically has centred on the Conservative party’s “10% cuts”. Annex table 4 shows the derivation of these data.
13. Jonathan Oliver et al, “ ‘Doomsday’ plan for cuts in public services”, *Sunday Times*, 5 July 2009.
14. Steven Bundred, “We’ve had years of growth - so let’s not be afraid of cuts”, *Observer*, 5 July 2009.

## Annex

**Table 1: Direct effects of illustrative changes in selected taxes (£bn)**

	FY2009	FY2010	FY2011
Income tax:			
Change basic rate by 1p	4.1	4.9	5.0
Change higher rate by 1p	0.9	1.45	1.4
Allowances & reliefs by 10%	3.55	4.25	4.3
Corporation tax:			
Change main rate (currently 28%) by 1 percentage point	0.6	1.0	1.15
National insurance contributions:			
Change class 1 employee main rate by 1 percentage point	3.9	4.1	4.3
Change class 1 employee additional rate by 1 percentage point	0.95	1.0	1.1
Change class 1 employer main rate by 1 percentage point	4.95	5.2	5.5
VAT:			
Change standard rate by 1 percentage point	4.6	4.8	5.0
Stamp duty land tax:			
Change 1% rate by 1 percentage point	0.5	0.9	1.1
Change 3% rate by 1 percentage point	0.3	0.5	0.8
Change 4% rate by 1 percentage point	0.7	0.9	1.2

HM Treasury, "Tax ready reckoner and tax reliefs", November 2008, [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

**Table 2: Budget 2009, spending projections, £bn, current prices**

	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Current receipts	548.0	530.7	496	528	577	620	662
Current spending	535.6	564.5	608	645	666	689	712
Depreciation (current spending)	17.8	18.6	20	21	22	23	24
Current budget	-5.3	-52.3	-132	-137	-111	-91	-74
Net investment	29.3	37.7	44	36	29	26	22
Total spending	582.7	620.8	672	702	717	738	758
Borrowing	34.6	90	175	173	140	118	97

Source: HM Treasury, *Budget 2009, Building Britain's future*, HC407, table C4, April 2009. Spending is Total Managed Expenditure (TME), comprising 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.

**Table 3a: Spending cuts: 2 scenarios, £bn, current prices**

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Scenario 1:									
Budget borrowing	34.6	90	175	173	140	118	97	(83)	(65)
Target: zero by FY15	34.5	90	175	173	(130)	(95)	(60)	(30)	<b>(0)</b>
Cuts in borrowing	0	0	0	0	(-10)	(-23)	(-37)	(-53)	<b>(-65)</b>
Cuts in spending cet. par.	0	0	0	0	(-10)	(-23)	(-37)	(-53)	<b>(-65)</b>
Spending (Budget)	582.7	620.8	672	702	717	738	758	(780)	(805)
Spending (post-cuts)	582.7	620.8	672	702	(707)	(715)	(721)	(727)	(740)
Scenario 2:									
Worse borrowing	34.6	90	175	(195)	(160)	(138)	(115)	(100)	(90)
Target: zero by FY15	34.6	90	175	(195)	(150)	(115)	(75)	(35)	<b>(0)</b>
Cuts in borrowing	0	0	0	0	(-10)	(-23)	(-40)	(-65)	<b>(-90)</b>
Cuts in spending cet. par.	0	0	0	0	(-10)	(-23)	(-40)	(-65)	<b>(-90)</b>
Spending (Budget)	582.7	620.8	672	702	717	738	758	(780)	(805)
Spending (post-cuts)	582.7	620.8	672	702	(707)	(715)	(718)	(715)	(715)

Sources: author's extrapolations and calculations are in brackets. Basic extrapolations for FY2014 and FY2015 based on Budget charts 2.2 and 2.3. Scenario 1 assumes Budget borrowing figures and a balanced net borrowing target in FY2015. Scenario 2 assumes worse borrowing figures and a balanced net borrowing target in FY2015. Note: "cet.par." means "other things being equal".

**Table 3b: Spending cuts: 2 scenarios, FY2010 to FY2015, growth rates (%)**

	FY2010 (£bn)	FY2015 (£bn)	Growth (%)	Annual growth rates (%), current prices
Budget 2009	702	805	14.7%	2.8%
Cuts scenario 1	702	740	5.4%	1.1%
Cuts scenario 2	702	715	1.9%	0.4%

Note: the annual increase in the GDP deflator, used for deflating public spending, is broadly extrapolated by the Treasury at 2¼%. In real terms the Budget spending figures are therefore flat, whilst there would be real terms annual falls in the two spending cuts scenarios of around 1½% and 2%+ respectively between FY2010 and FY2015.

**Table 4: Conservative party “spending cuts”: calculations, £bn**

	FY2010	FY2013	Change
Budget TME, current prices	702	758	+8.0%
Budget TME, real terms (FY2010=100)	702	700	-0.3%
The above, minus IFS projections for debt interest & benefits	391	364	-6.9%
The above, protecting health spending	266	240	-9.8%

Source: [www.conservativehome.blogs.com](http://www.conservativehome.blogs.com)

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