



Perspectives by Ruth Lea

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2010 Spending Review: the Chancellor is likely to stick to his plans

Introduction

The Chancellor is due to reveal the details of the 2010 Spending Review for the four years from FY2010 to FY2014 on 20 October. The economic focus will be on the overall shape of the public spending plans rather than any detailed departmental breakdown and, more specifically, on whether the plans have been relaxed or tightened since the Emergency Budget of 22 June 2010.¹

There has been recent speculation that the plans may be relaxed in the sense that more of the cuts may be deferred until the latter years of the Spending Review's four-year time horizon. (There was some modest front-end loading in the Budget.) The reason would be to reduce the risk of a serious economic slowdown – or even a “double-dip” – in the near-term. But leaving more cuts until later in the Parliament could be politically difficult. For political reasons the timing suggests fiscal stringency earlier rather than later.

There has been less speculation that the Chancellor might actually seek to water down the fiscal retrenchment so that the Emergency Budget's fiscal targets are pushed further into the future. So instead of aiming to balance the cyclically-adjusted current budget by FY2014, he might aim for FY2015. But such a move would undermine the market's confidence in the Coalition Government's determination to correct the severe fiscal imbalances they inherited.

I am aware of no suggestions that the Chancellor might actually tighten his fiscal retrenchment policies. The probability that he would, thus increasing the risk of a “double-dip”, is vanishingly small.

So, in conclusion, I expect little change to the Budget's overall fiscal profile in the 2010 Spending Review. I expect the Government to stick to the overall commitments made in the June Budget. There may, of course, be some “reprofiling” between individual departmental budgets. Departmental contracts can be difficult to break and upfront enforced redundancies can be expensive. One suggestion is that the increase in the aid budget to 0.7% of national income by 2013 may be left until 2013 rather than more gradually phased in. And there will probably be more savings in the welfare budget.

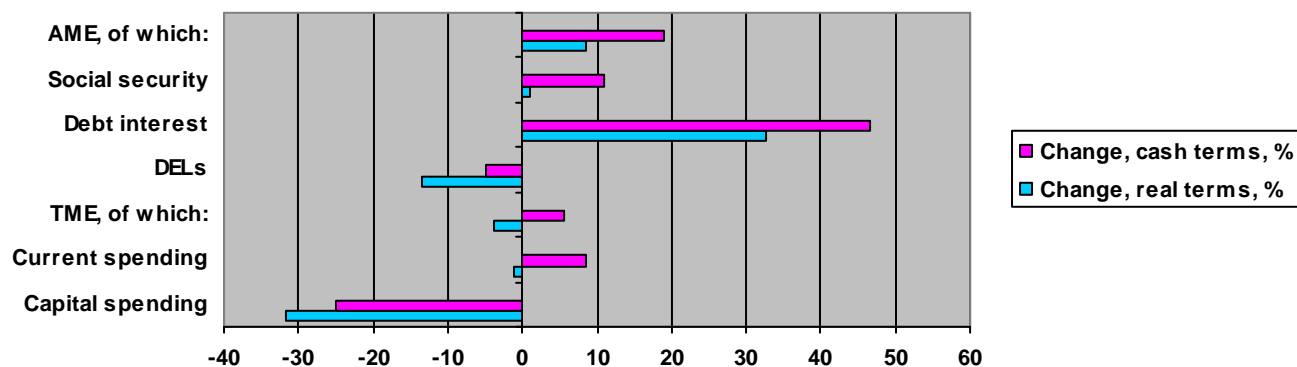
The Emergency Budget: spending plans

The interest in the Spending Review for economists will, therefore, be in how it differs from the Budget. The Budget's spending plans are, therefore, the focus for debate and analysis.

Chart 1 shows the increase/decrease for public spending for FY2010 to FY2014 (cumulative %) for:

- Annually Managed Expenditure (AME), which includes social security benefits, tax credits and debt interest payments.
- The implied sums for the Departmental Expenditure Limits (DELs), which are the resources available for the other departments, including health, education, defence, transport, the Home Office, justice and business.
- Total Managed Expenditure (TME), total public spending.²

Chart 1 Change (cumulative %) between FY2010 and FY2014 for public spending, in cash terms and real terms



Source: HM Treasury, *Budget 2010*, HC61, June 2010, table C13, and author's calculations. Detailed figures are shown in the annex table. Tax credits are included in the figures above for social security benefits.

As can be seen from the chart, total public spending (TME, third from the bottom) is due to rise by nearly 6% in cash terms (£40bn) between FY2010 and FY2014. Even after allowing for inflation, TME is due to fall by only 4%, an annual average of 1%, over the next 4 years. When spending cuts are talked about in blood curdling language these numbers should be kept in mind.

But the cash terms increase is principally accounted for by two components of Annually Managed Expenditure – i.e. social security payments (even after the savings made in the Emergency Budget) and the rocketing debt interest payments, reflecting the dramatic increase in the stock of public sector debt in recent years. As recently as FY2008 debt interest payments were £30bn, by FY2014 they are projected to be £63bn. This is a huge transfer of resources to the holders of UK Government bonds, the majority of whom are located in the UK. The DELs (fourth from the bottom) are inevitably squeezed by rising AME, the “cuckoo in the nest”, and in cash terms they are projected to fall by nearly 5% from FY2010 to FY2014.

In real terms, the squeeze on all the DELs is nearer to 14% (an annual average of 3.5%).

When allowance is made for ring-fencing the NHS (£122bn in FY2010) and the commitment to increase the aid budget to 0.7% of GDP, the implications for the “unprotected” departments do start to look severe. They face an average real reduction of 25% by FY2014. If, say, the defence and schools budgets are cut by “only” 10%, the implied cuts for the remaining departments such as business and higher education, the Home Office, justice, transport and housing, are even grimmer. They could be facing cuts of up to 33% by FY2014 in real terms. So, perhaps, some of the blood curdling rhetoric is justifiable.

On 20 October we will, of course, find out which departments have suffered the most and, more specifically, whether there has been any re-profiling between the major budgets.

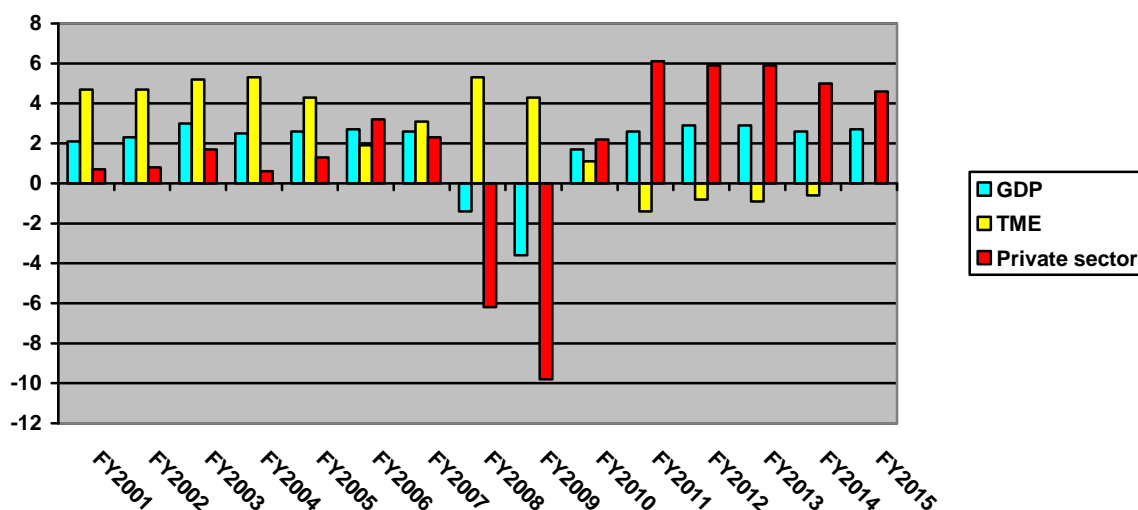
Economic challenges ahead: will there be a “double dip”?

The forthcoming fiscal retrenchment will undoubtedly hit economic growth in the near-term. As the public sector pulls back, the private sector will have to “come up to the mark” and make good the lost output and create the lost jobs.

Chart 2 includes past data and, going forward, the Budget’s public spending plans, the Office for Budget Responsibility’s (OBR’s) post-Budget forecast and the required private sector growth in order to meet the OBR’s GDP forecasts. It shows that the growth of total public spending was significantly higher than for GDP as a whole for much of the 2000s. This was especially the case in the early 2000s, when Chancellor Brown turned on the spending taps, and in FY2008 and FY2009 when the recession hit the private sector. It is notable that growth of the private sector was fairly weak throughout the 2000s decade as resources were switched to the public sector and the private sector was, arguably, “crowded out”. We discussed these issues further in a recent Perspective.³

Looking ahead, TME will fall in real terms by 4% between FY2010 and FY2014 on Budget plans, as just discussed. It is modestly front-end loaded. Any growth in the economy will therefore have to come from the private sector. If the OBR’s post-Budget forecast is to be realised then the private sector will have to grow at around 4-6% a year over the forecast period. This is not without precedent. In the mid 1990s strong private sector growth drove buoyant GDP growth despite tightly controlled public spending. The economic environment is however much less favourable this time round and the OBR’s forecasts do look optimistic. But the private sector would have to perform very weakly indeed for the planned cuts in public spending to throw the economy into a “double-dip”. A “double dip” is not impossible, but it looks very unlikely.

Chart 2 GDP, total public spending (Total Managed Expenditure, TME) and the private sector, real terms, annual growth rates (%)



Sources: OBR’s post-Budget forecast, June 2010 and author’s calculations using FY2008 prices.

References

1. HM Treasury, *Budget 2010*, HC61, June 2010.
2. Total Managed Expenditure (TME) = Annually Managed Expenditure (AME) + Departmental Expenditure Limits (DELs). TME is total public spending.
3. Ruth Lea, “The OBR’s economic forecasts are “challenging”: but there’ll be no “double dip””, *Arbuthnot Banking Group*, 12 July 2010.

Annex: Total Managed Expenditure (TME) (£bn), cash and real terms: FY2010 to FY2014, Emergency Budget, June 2010

	FY10	FY11	FY12	FY13	FY14	FY14 minus FY10	FY10 to FY14 (%)
Cash terms (£bn):							
Annually Managed Expenditure (AME):							
Current spending	295	308	323	337	355	60	20.3%
Capital spending	8	7	7	6	6	-2	-25.0%
Total AME	303	315	330	343	361	58	19.1%
Memo:							
Social security benefits & tax credits	193	199	205	207	214	27	10.9%
Central Government debt interest (gross)	43	47	52	58	63	20	46.5%
Implied Departmental Expenditure Limits (DELs):							
Current spending	343	343	341	341	338	-5	-1.5%
Capital spending	52	41	40	37	39	-13	-25.0%
Total implied DELs	395	384	381	378	376	-19	-4.8%
Total Managed Expenditure (TME)	697	700	711	722	737	40	5.7%
Of which:							
Total current spending	638	651	664	678	693	55	8.6%
Total capital spending	60	48	47	43	45	-15	-25.0%
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%
Memo:							
Social security benefits & tax credits	193	195	197	193	195	2	1.0%
Central Government debt interest (gross)	43	46	50	54	57	14	32.6%
Implied DELs	395	377	366	353	342	-53	-13.4%
TME	697	686	683	674	671	-26	-3.7%
Of which:							
Total current spending	638	626	637	634	631	-7	-1.1%
Total capital spending	60	47	45	40	41	-19	-31.7%

Source: HM Treasury, *Budget 2010*, HC61, June 2010, table C13, and author's calculations.

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