

3. The fiscal impact of the credit crunch

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Summary

- The credit crunch has probably imposed a permanent cost on the exchequer of around 3.5% of national income – just over £50 billion a year in 2008–09 terms. The government has responded with a fiscal squeeze starting next year that will reach 2.6% of national income a year (or around £38 billion in 2008–09 terms) by 2015–16. This will largely take the form of a cut in spending as a share of national income.
- The Pre-Budget Report forecasts imply that public sector net debt will be 21.1% of national income higher in 2013–14 than in 2007–08. This is equivalent to almost £10,000 for every family in the UK. But only about one-fifteenth of this increase is due to the temporary fiscal stimulus announced in the PBR. The weaker outlooks for the economy and asset markets are the main drivers.
- If the average interest rate faced by the government remains at current low levels, then the fiscal squeeze may still have to remain in place until the early 2030s before public sector debt falls back below 40% of national income. But the cost to the taxpayer of financing this debt would remain low by historical standards, with net interest payments remaining well below the 3.0% of national income paid in the last year that the Conservatives were in office, 1996–97.
- But if the interest rate faced by the government rose to that of the mid-1990s, then the burden of financing debt would rise gradually but unsustainably, requiring a bigger fiscal tightening – further tax increases or spending cuts – to keep it in check. An even sharper rise in borrowing costs would make the intensification of the squeeze more urgent just to avoid debt and interest payments exploding.
- Much of the focus on the PBR has been on those who will lose from the increases in tax. But to return tax and spending to around their pre-credit-crunch levels, the PBR cut spending by much more than it increased taxes. As a result, real spending by government departments in 2013–14 could be around 3% or £22 billion lower than projected at Budget time. Thus the largest group of losers from the PBR will be those who would have benefited from this forgone public spending.

3.1 Introduction

When Alistair Darling delivered the November 2008 Pre-Budget Report (PBR), he revealed a sharp deterioration in the outlook for the public finances, with public sector net borrowing set to rise to a post-war high next year and public sector net debt set to rise to a peak in 2013–14 not exceeded since the early 1970s (see Chapter 2).

The government will add to borrowing and indebtedness this year and next, by cutting taxes and increasing spending to provide a short-term fiscal stimulus that it hopes will make the recession shorter and shallower than it otherwise would be. From 2010–11 onwards, the government proposes to reduce borrowing and eventually bring public sector net debt down again by cutting spending and increasing taxes.

This prospect has provoked lively debate among politicians, commentators and even bishops, regarding the burden that the underlying increase in public sector indebtedness will impose upon future generations. This chapter briefly explores some of these issues. Section 3.2 looks at the outlook for public sector net debt and interest payments. Section 3.3 looks at the fiscal tightening announced in the PBR and asks how this affects people in their capacity as taxpayers and as consumers of public services. Section 3.4 concludes.

This chapter focuses on the impact of the current recession on government revenues and spending, and in particular focuses on the impact of the tax and spending measures that were explicitly costed in the PBR. There have also been a series of measures announced to deal specifically with issues related to the financial sector – including, for example, the state interventions in Northern Rock, Bradford & Bingley, RBS and the Lloyds Banking Group. These are not discussed in this chapter. In what follows, we implicitly assume that, in the long run, these interventions have no net impact on the level of public sector debt. Chapter 8 argues that the eventual cost is likely to be small and that the taxpayer may even make a profit. But clearly the nature of the guarantees and insurance that the government is offering poses the risk of big losses.

3.2 Public sector debt and debt interest

The cost of the crunch and the policy response

In simple terms, judging from the forecasting changes made by the Treasury between the March 2008 Budget and the PBR, we can think of the fiscal cost of the current crisis as having four main components.

The most important is the loss over two years of 4% of the economy's productive potential. This will permanently cost the exchequer around 2.8% of national income (or £41 billion in 2008–09 terms) a year in lost revenue and higher social security spending. There is a further permanent hit of around 0.6% of national income (or £9 billion in 2008–09 terms), predominantly reflecting the fact that the Treasury assumes that property and share prices will stay well below the levels assumed at Budget time.

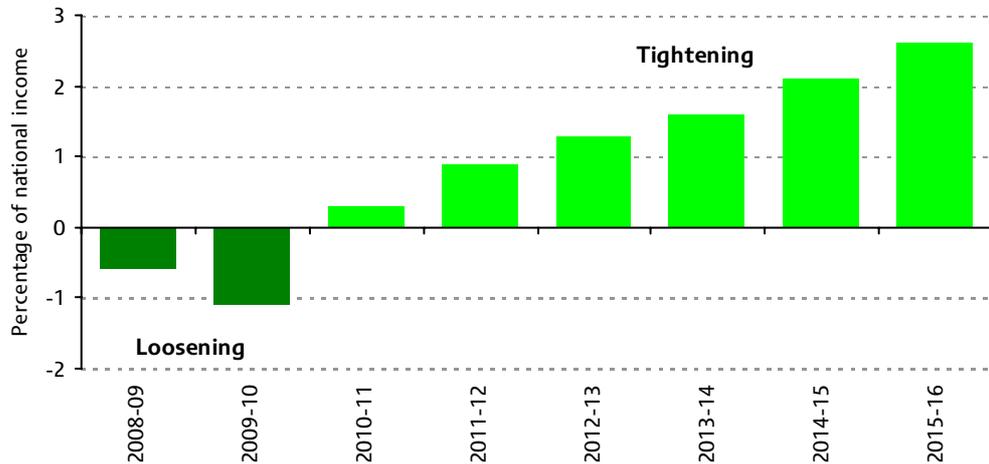
In addition to these permanent additions to the structural budget deficit, there is also a temporary addition to borrowing of around £51 billion in cash terms between now and when the economy is expected to return to full potential in 2014–15, reflecting the fact that economic activity is expected to fall further below its potential than thought at Budget time (implying lower tax revenues and higher social security spending). The government has also chosen to increase borrowing by £25 billion this year and next through its discretionary fiscal stimulus package. The equivalent permanent cost of financing these two temporary increases in borrowing would be around £3.5 billion a year in perpetuity, shrinking as a share of national income over time.

Overall, we could summarise the cost of the crunch as a permanent loss to the exchequer of around 3.5% of national income or just over £50 billion a year in 2008–09 terms.

As we shall see later, in the absence of a policy response a permanent increase in the structural deficit of this size would have moved the public finances onto an unsustainable path, with debt and debt interest payments rising remorselessly as shares of national income. So the government responded in the PBR by announcing tax increases and cuts in projected spending plans from 2010–11 onwards. As we describe in more detail in Chapter 2, these policy measures will have the effect of reducing the structural deficit

gradually over the six years from 2010–11 – and eventually by 2.6% of national income (or around £38 billion in 2008–09 terms) in 2015–16 (see Figure 3.1). Roughly speaking, by then the tightening would be made up of a net tax increase of 0.25% of national income, a cut in investment spending of 0.5% of national income and a cut in current spending of 1.85% of national income, relative to the figures projected or implied in the Budget.

Figure 3.1. Discretionary policy change projected in the PBR



Sources: HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); authors' calculations.

The PBR forecasts for debt and debt interest

The combined effect of these forecasting changes and discretionary policy changes is that the Treasury forecast in the PBR that public sector net debt would climb from £526.8 billion at the end of 2007–08 to £1,084 billion at the end of its debt forecasting horizon in 2013–14, an increase in cash terms of £557.2 billion. This is expected to equate to a rise from 36.3% to a peak of 57.4% of national income over the same six years, an increase of 21.1% of national income. This is equivalent to about £310 billion in today's terms, or almost £10,000 for each of the 31.6 million families in the UK.

Table 3.1 attempts a rough decomposition of this increase in indebtedness between the various factors we have discussed. It suggests that at Budget time, the government was already looking for debt to increase by about 1.4% of national income.¹ We estimate that the permanent loss of potential output will increase public sector net debt by around 13% of national income by the peak year of 2013–14. The additional cyclical borrowing is projected to add about another 2.6% of national income, while the loss of revenues from house and share prices being expected to stay below the levels anticipated at Budget time (plus other smaller factors) will add about 4.3% of national income.

¹ The Treasury did not publish a forecast for net debt in 2013–14 in the 2008 Budget. We assume here that the Treasury would have been forecasting a strengthening of the current budget by a further 0.3% of national income in 2013–14, as it was forecast would happen in the two preceding years, and that net investment would remain at 2.3% of national income.

Table 3.1. Change in public sector net debt, 2007–08 to 2013–14

	% of national income
Rise already implied in Budget 2008	+1.4
Pre-Budget Report forecast changes	+22.0
‘Denominator’ effect of lower GDP in 2013–14 on a given cash debt stock	+1.9
4% loss of potential output	+13.2
Additional cyclical borrowing	+2.6
Revenue losses from asset markets etc.	+4.3
Fiscal stimulus (2008–09 to 2009–10)	+1.4
Policy tightening (2010–11 to 2013–14)	–3.7
Total change	+21.1

Sources: HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); authors’ calculations.

So, the Budget legacy and the forecasting changes in the PBR would have left the Treasury expecting public sector net debt to rise by a further 22% of national income – to a peak of 59.8%. To this largely crisis-related increase, the Chancellor has chosen to add a further 1.4% of national income in 2013–14, reflecting the cost of the fiscal stimulus package (of which the temporary cut in the standard rate of VAT – discussed in Chapter 10 – contributes around half). This would have taken debt in 2013–14 to 61.1% of national income. Then, in the opposite direction, the tightening from 2010–11 onwards reduces the forecast level of public sector net debt in 2013–14 by 3.7% of national income.

This decomposition puts the recent debate over the scale of the fiscal stimulus in some context. In December 2008, the Conservative Shadow Chancellor George Osborne seized on criticism of the temporary VAT cut by German Finance Minister Peer Steinbrück:

As David Cameron and I have been doing throughout this financial crisis, Mr Steinbrück pointed out that fiscal stimulus will achieve nothing except to ‘raise Britain’s debt to a level that will take a whole generation to work off’.²

But, as Table 3.1 makes clear, the VAT cut and the fiscal stimulus package more broadly will make little difference to the scale of the deterioration in the UK’s public finances over the next five years. The stimulus package contributes only around one-fifteenth of the increase in public sector net debt that the Treasury expects by 2013–14. And the cost of the giveaway is more than recouped before then by the subsequent spending cuts and tax increases announced in the PBR, as is clear from Figure 3.1.

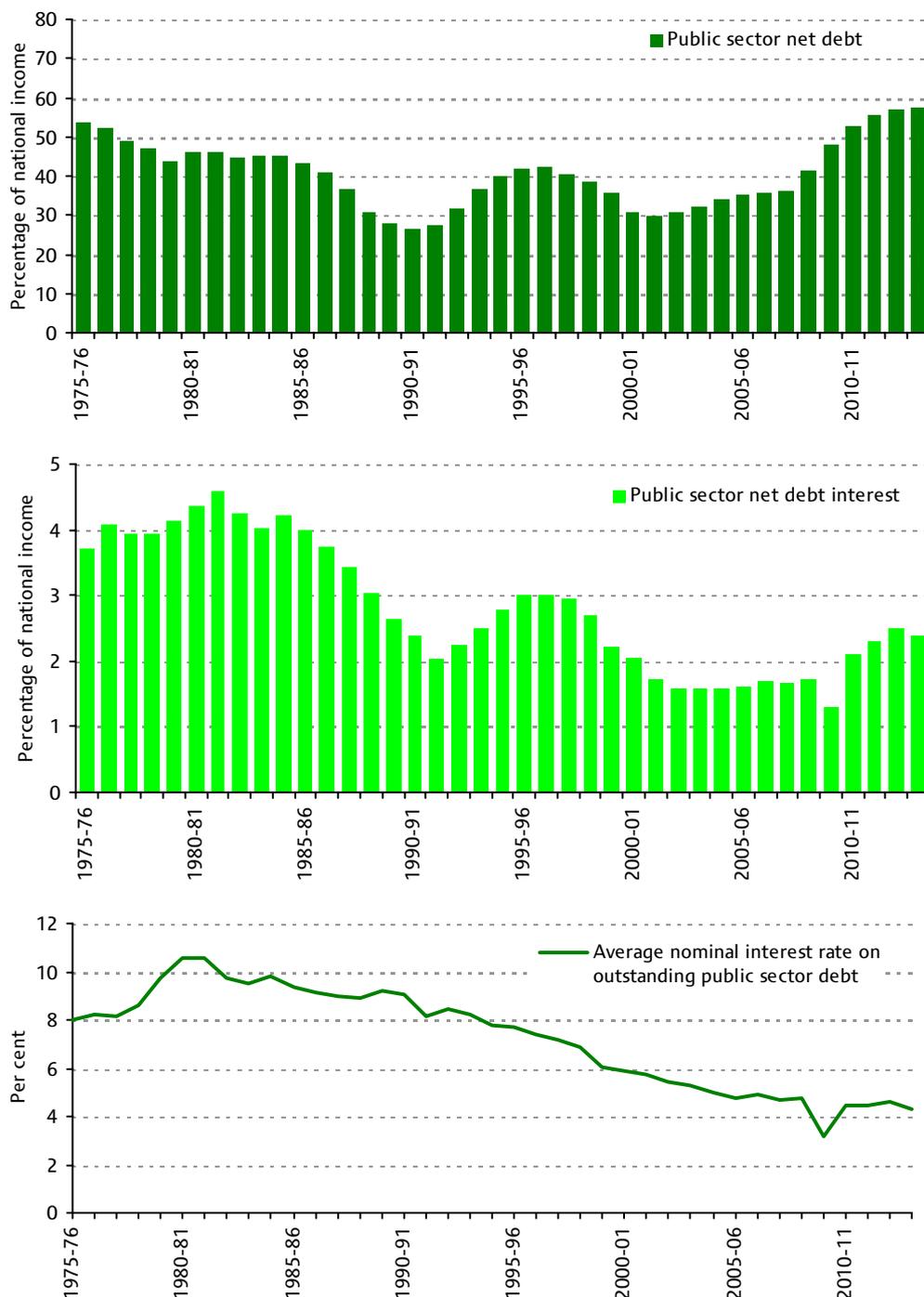
The projected rise in the stock of debt over the next five years certainly makes for a dramatic headline. But what matters more to individuals and families is what resources we are going to have to use each year to service and pay off this debt. This depends not only on the stock of debt, but also on how much it costs the government to borrow.

Figure 3.2 shows public sector net debt and public sector net debt interest payments as shares of national income, along with the implicit average interest rate paid on public sector net debt for the period from 1975–76. Since 2001–02, public sector net debt interest has consumed around 1.7% of national income, the lowest share since the Second

² <http://www.independent.co.uk/opinion/commentators/george-osborne-labours-folly-has-finally-been-laid-bare-1062876.html>.

World War. Although public sector net debt was rising over this period, the cost was held in check by a fall in the average interest rate the government was paying on it.

Figure 3.2. Public sector net debt, interest payments and average interest rates



Sources: Public sector net debt interest is gross interest paid less gross interest received. Measures of gross interest are ONS series ANLO and ANBQ, from table 2.3C of *Financial Statistics Freestanding Time Series Data*. Projections are from HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm). The average effective interest rate is calculated as cash net debt interest paid as a percentage of the cash value of the stock of net debt in the previous financial year. Figure 7.2 shows the average real interest rate, as measured by the consol rate less long-term expected inflation.

Since 2004, the government has in effect paid a nominal interest rate of between 4% and 5% on the public sector's net debt, compared with between 6% and 8% over most of the 1990s and between 8% and 11% over most of the 1980s. It has been relatively cheap for all industrial country governments to borrow in recent years, a trend currently maintained by investors' desire to hold what they see as relatively safe investments (see Chapter 7).

For the time being, the government seems confident that it can continue to service its debt relatively cheaply – its forecasts imply that the average interest rate will remain below 5% through to 2013–14. As a result, although the Treasury expects public sector net debt to rise well above the peak it reached in the mid-1990s (57.4% of national income in 2013–14 versus 42.5% of national income in 1996–97), it expects the peak in public sector net debt interest payments to be significantly lower than the level that Labour inherited from the Conservatives when they came into office in May 1997 (2.5% of national income in 2012–13 versus 3.0% of national income in 1996–97).

The increase in indebtedness resulting from the crisis and the fiscal stimulus has pushed expected public sector net debt interest payments higher since the Budget. At Budget time, they were expected to remain unchanged at 1.7% of national income between 2007–08 and 2012–13, compared with a forecast increase in the PBR from 1.7% of national income to 2.5% of national income. This increase in debt interest payments will absorb 0.8% of national income of the 1.3% of national income increase in total public spending expected over the period (see Chapter 9 for a discussion of the likely implications for Spending Review 2010).

Debt and debt interest beyond the PBR forecasting horizon

Mr Steinbrück and Mr Osborne may have overstated the long-term fiscal significance of the fiscal stimulus package, but what about their assertion that public sector net debt overall is set to rise to levels that will take a generation to pay off?

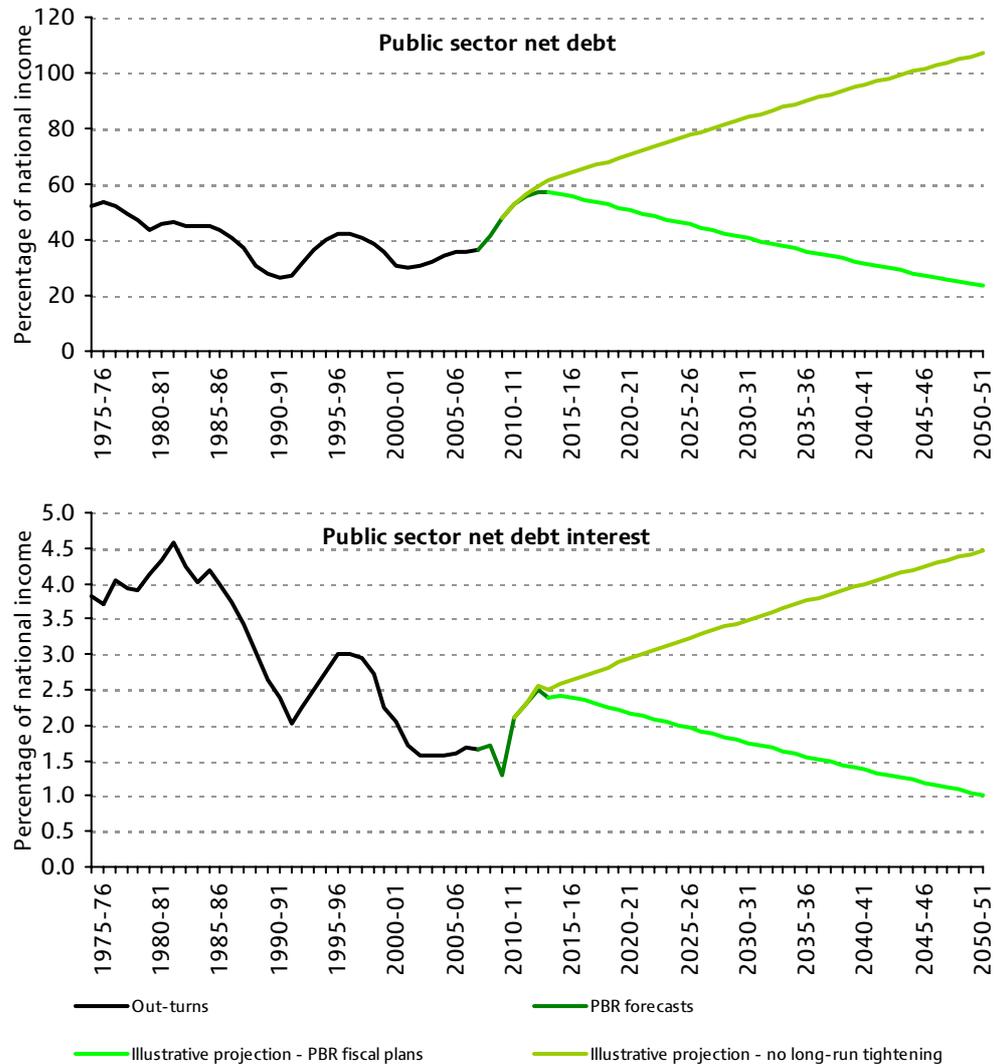
In this section, we make some illustrative projections of how debt and debt interest may evolve beyond the end of the Treasury's five-year forecasting horizon.

As we noted earlier, if the Treasury had not announced a tightening in the PBR, the cost of the crunch would have put the UK's public finances onto an unsustainable path. Whether a fiscal position is unsustainable depends on the existing stock of debt as a share of national income, the extent to which the interest rate on the debt exceeds the nominal growth rate of the economy and the size of the primary deficit, namely public sector borrowing minus debt interest payments.³ A given level of debt and debt servicing cost will only be sustainable if the primary surplus and/or nominal growth in national income are sufficiently large. Roughly speaking, the Treasury assumes that borrowing costs are around 4¼%, as we saw in Figure 3.2, and that the trend growth rate of nominal national income is around 5¼% of national income. Given these assumptions, the peak level of debt forecast by the Treasury in Budget 2008 (39.8% of national income in 2010–11) would only have been sustainable if the primary deficit were no larger than 0.4% of national income. In the Budget, the Treasury projected that it would be running a primary surplus of 0.4% of national income at the end of its then forecasting horizon, which would

³ Given that the debt ratio in period $t+1$ is defined as: $d(t+1) = d(t)[(1+r)/(1+g)] - PS$, the primary surplus (PS) consistent with a stable debt ratio is equal to $[(r-g)/(1+g)]d(t)$, where r is the nominal interest rate on debt and g is the nominal growth rate of national income.

have seen debt fall steadily as a share of national income. Adding a 3.5% of national income increase to structural borrowing, with a rise in the peak debt forecast to 57.4% of national income, would have pushed the fiscal position to the wrong side of the safety line. Roughly speaking, this debt level would require a primary deficit of no more than about 0.5% of national income to ensure sustainability – hence, the fiscal tightening of 2.6% of national income would be sufficient to pull it back to the right side again.

Figure 3.3. Debt and debt interest payments: the impact of the tightening



Notes: Authors' calculations based on HM Treasury assumptions about fiscal tightening in 2014–15 and 2015–16 from Pre-Budget Report 2008. The illustrative profile assumes that non-debt-interest spending and revenues remain constant as a share of national income from 2015–16 onwards. Average debt servicing costs are assumed to remain at 4.32% from 2013–14 onward, which implies that debt interest payments decline as a share of national income as the level of debt falls. This implies a strengthening of the current budget over time.

Sources: Historic data from HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls). Forecasts for 2008–09 to 2013–14 from HM Treasury, *2008 Pre-Budget Report: The Economy and Public Finances – Supplementary Material*, November 2008 (http://www.hm-treasury.gov.uk/d/pbr08_chartstables_501.pdf). Projections from 2014–15 onwards are authors' calculations.

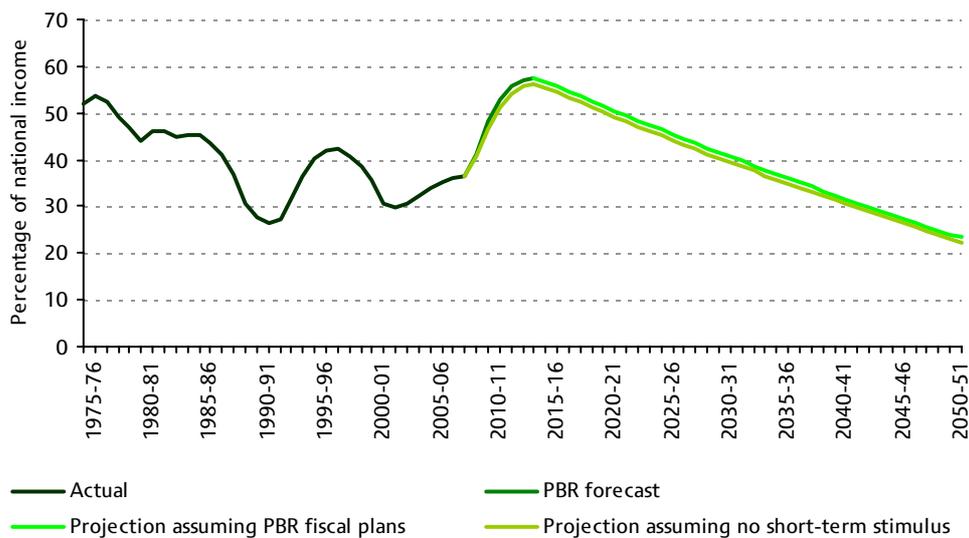
This is illustrated in Figure 3.3, in which we assume that non-debt current spending, investment spending and tax revenues all remain constant as shares of national income beyond the end of the Treasury forecasting horizon and that the government continues to be able to borrow at a rate of 4.32% (the average debt interest rate it forecast for 2013–14 in the PBR). Without any tightening, the ratio of debt to national income would rise substantially, passing through 100% of national income in 2044–45. Net debt interest payments would rise in parallel, surpassing the peak of the early 1980s in the 2050s, and likely much before this as the additional debt would put considerable upwards pressure on the effective interest rate faced by the government.

If we assume that the government implements the fiscal tightening of 2.6% of national income by 2015–16 that it projected in the PBR – and then sustains it thereafter – debt will come down, but it will not fall back below the ceiling of 40% of national income set out in the temporarily suspended ‘sustainable investment rule’ until 2031–32 (at which point the government might choose to unwind the policy tightening). Under this scenario, net debt interest payments would remain modest – falling gradually from their peak of 2.5% of national income and moving below the recent trough of 1.6% of national income in 2035–36.

In other words, it may well be (as Mr Steinbrück said) nearly a generation before debt returns to its pre-crisis level – although the cost of servicing it will not be particularly high. The PBR asserted that the government’s ‘fiscal policy objectives remain unchanged’ and that it would merely ‘depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full’. The fact that net debt is not on course to return below 40% of national income for more than 20 years suggests that the government will not be in a position to restore its original rules for quite some time.

Figure 3.4 confirms how little difference the decision to implement the fiscal stimulus package makes to the long-term outlook for the public finances. Without the stimulus package, debt would fall back below 40% of national income only one year earlier.

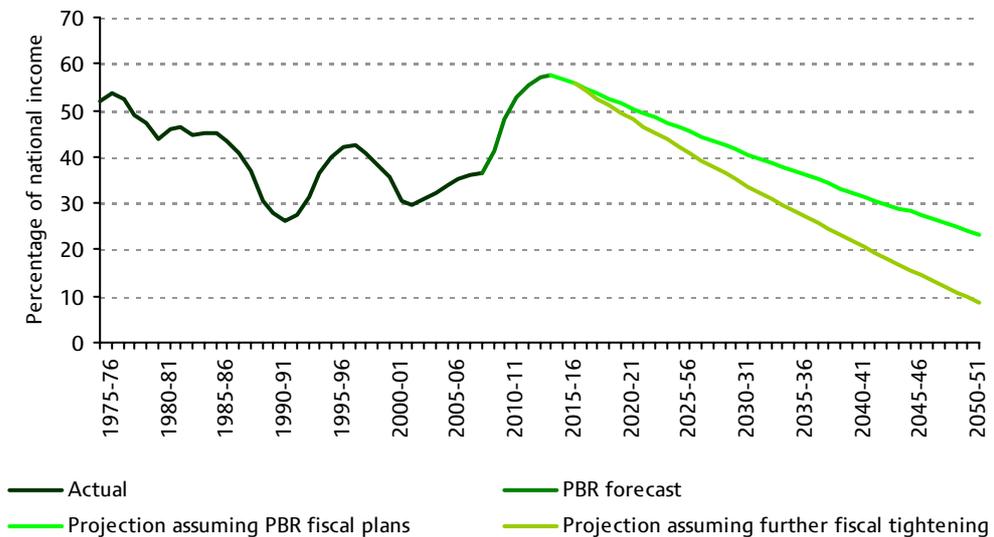
Figure 3.4. Net debt: with and without fiscal stimulus package



Notes: Figures for fiscal loosening are as shown in Figure 3.1. Also see Notes to Figure 3.3.
Sources: As Figure 3.3.

Conversely, the Chancellor – or his successor – could choose to do more to reduce the level of public sector borrowing more quickly. For example, increasing the tightening by a further 0.5% of national income (e.g. continuing the tightening currently pencilled in for 2014–15 and 2015–16 into 2016–17) would see net debt fall back below 40% of national income about five years earlier, as shown in Figure 3.5. The case for tightening more quickly clearly becomes stronger if one believes that borrowing costs may rise.

Figure 3.5. Net debt: with and without additional fiscal tightening



Notes: See Notes to Figure 3.3. The illustrative profile with additional fiscal tightening assumes that there is a further 0.5% of national income fiscal tightening in 2016–17 and that thereafter non-debt-interest spending and revenues remain constant as a share of national income.
Sources: As Figure 3.3.

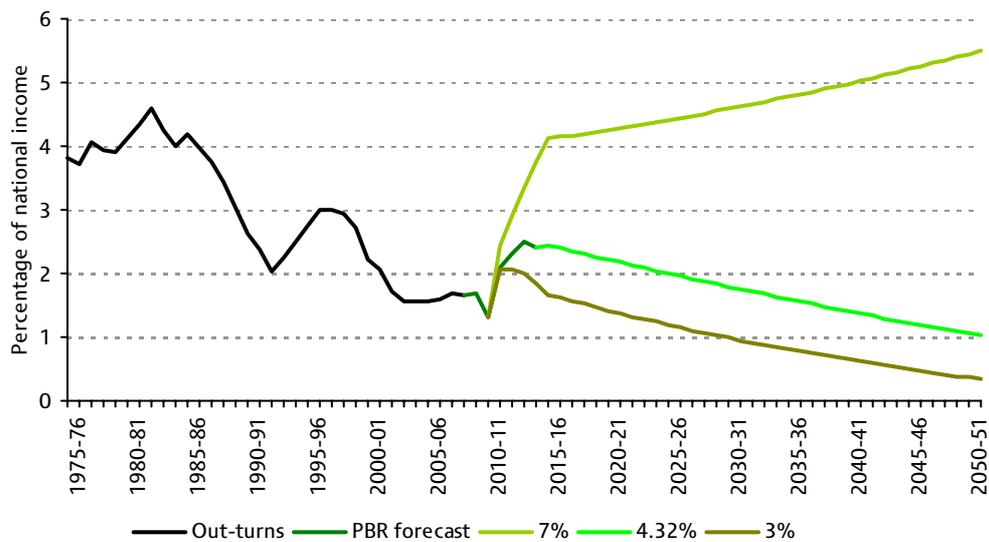
Chapter 7 argues that borrowing costs are likely to remain low for the time being, but that there is a risk that gilt yields increase if investors take fright at the deteriorating state of the public finances. If borrowing costs were to change in the future, what might this imply for the potential future burden of public sector interest payments? And at what level of borrowing costs does the burden of debt interest become unsustainable – in other words, what level of borrowing costs would imply that each year an ever-increasing share of national income would need to be devoted to servicing debt?

Along with the baseline assumption of borrowing costs remaining at 4.32%, Figure 3.6 also shows the burden of public sector net debt interest payments under two alternative assumptions for average debt servicing costs: that they return to the levels of the 1990s (7%) and that they fall further to 3%.

If borrowing costs were to fall below their current levels to an average of 3%, the burden of debt servicing would, of course, decline even more quickly – dropping below 1% of national income in 2029–30. This assumes that the money saved from lower debt interest payments would be retained by the Treasury and used to reduce borrowing further each year, rather than used to cut taxes or increase non-debt-interest spending.

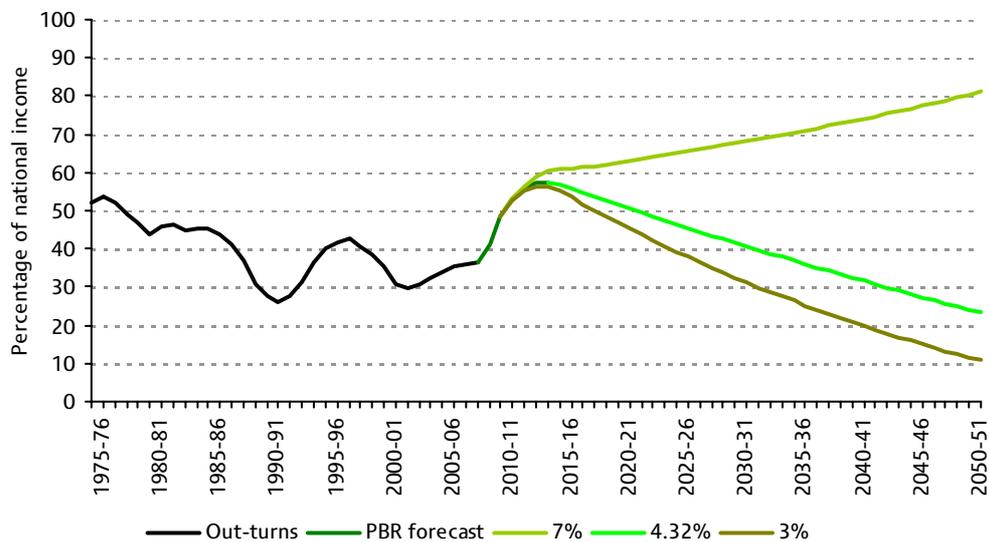
If, instead, borrowing costs were to rise, the burden of debt servicing would also rise. An average debt interest rate of 7% (about what the UK government experienced in the mid-1990s) would be sufficient to produce an ever-increasing path for debt and debt interest

Figure 3.6. Illustrative future debt interest payments – what difference would a change in average borrowing costs make?



Notes: See Notes to Figure 3.3. Forecasts for debt interest as a percentage of national income assume that the average interest payment on the stock of debt rises/falls from 4.32% to the new assumed level over a period of five years after 2013–14.
Sources: As Figure 3.3.

Figure 3.7. Illustrative future debt levels – what difference would a change in average borrowing costs make?



Notes: As Figure 3.6.
Sources: As Figure 3.3.

(as shown in Figures 3.7 and 3.6 respectively). Nominal growth in national income and the underlying primary surplus would not be sufficient to ensure the burden of debt servicing falls over the longer term. However, it is worth bearing in mind that the last time average nominal borrowing costs were this high, inflationary expectations were also higher. If interest rates were to rise in response to higher expected inflation, it is also

likely that nominal growth in national income would be higher, which would mitigate the effect. However, if real interest rates were to rise, then there would be no offsetting effect of stronger nominal growth in national income. Under the assumption made here – of an increase in borrowing costs but no change in nominal growth in the economy – an average borrowing cost of about 6.3% would be sufficient to lead to an ever-increasing path for debt. If borrowing costs of this level were to emerge, future governments would have to do more to reduce the debt burden in order to prevent this.

What is clear from Figure 3.6 is that the size of the debt interest burden imposed on future taxpayers by the current economic slowdown (and policy announcements made in PBR 2008) is extremely sensitive to what future borrowing costs turn out to be. If future borrowing costs are expected to remain at their current low levels, the burden on future taxpayers of additional borrowing in the short term is small. Conversely, if future borrowing costs are expected to be high – for example, if they returned to the levels seen in the mid-1990s – then future taxpayers would have to devote considerably more of their incomes to servicing the stock of debt that they inherit and further fiscal tightening may be required.

3.3 Policy measures in the Pre-Budget Report

As we have discussed, in the PBR the government announced a combination of net tax increases and cuts in projected public spending, to help reduce public sector net borrowing from 2010–11 onwards and thereby reduce the future burden of interest payments on the increase in debt that will result from the crisis and (to a much lesser extent) the fiscal stimulus. Having examined the scale of the fiscal tightening, how does its composition affect its likely impact on people’s finances and the public services that they consume?

Although much political attention has focused on the increases in income tax rates for people on high incomes and in National Insurance contributions (which are discussed in more detail in Chapter 11), it is striking that the squeeze on spending is quantitatively much more significant (Table 3.2).

Table 3.2. Impact of PBR measures on public sector net borrowing

<i>£ billion</i>	2008–09	2009–10	2010–11	2011–12	2012–13
Net tax cut	6.6	12.4	3.3	-2.9	-4.0
<i>Of which</i>					
Tax giveaway	+6.9	+13.6	+5.5	+6.2	+6.6
Tax takeaway	-0.3	-1.2	-2.2	-9.1	-10.6
Net spending increase	2.7	3.9	-8.1	-11.2	-18.6
<i>Of which</i>					
Spending increases	+2.7	+4.1	+0.7	+0.3	+0.3
Spending cuts	0	-0.2	-8.8	-11.5	-18.9
Addition to borrowing	9.3	16.3	-4.8	-14.1	-22.6

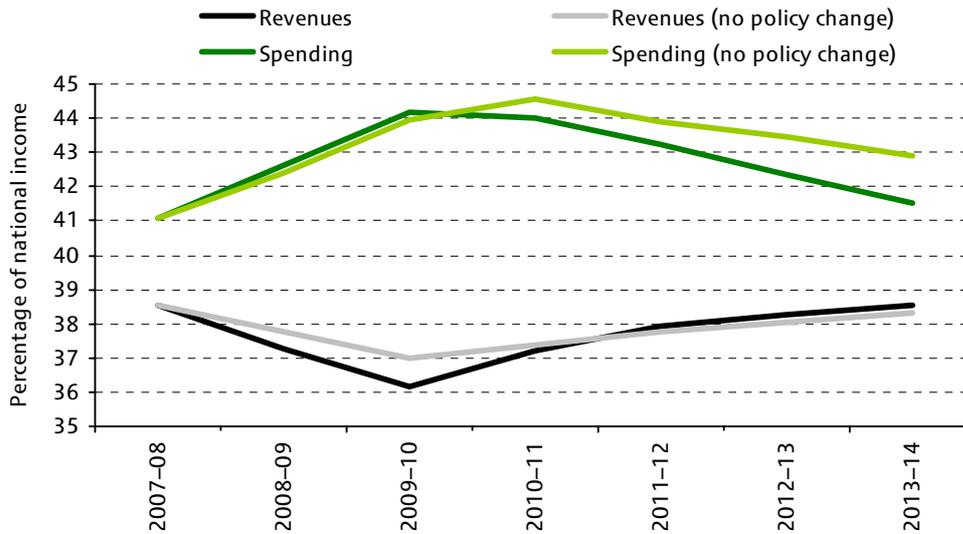
Note: Figures may not add due to rounding.

Sources: HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); authors’ calculations.

By 2012–13, the policy measures announced in the PBR are designed to reduce public sector net borrowing by £22.6 billion or 1.3% of national income. Of this tightening, less than 20% takes the form of net tax increases and more than 80% net spending cuts.

As Figure 3.8 shows, this asymmetry in the burden of adjustment helps ensure that both total spending and total revenues return to broadly their pre-crisis levels as shares of national income by the end of the PBR forecasting horizon in 2013–14. If the burden of tightening had been shared equally between spending and tax measures, there would have been a shift towards higher levels of spending and taxation over the period.

Figure 3.8. Impact of PBR measures on levels of spending and revenues



Sources: As Figure 3.1.

The net increase in tax of £4 billion a year in the medium term is also small in the context of the net tax increases announced in the two Budgets of 1993, which aimed to strengthen the public finances from an otherwise unsustainable position in the wake of the recession of the early 1990s. In total, these two Budgets implemented a net tax rise of 2.1% of national income by 1996–97, or £31 billion in today’s terms.

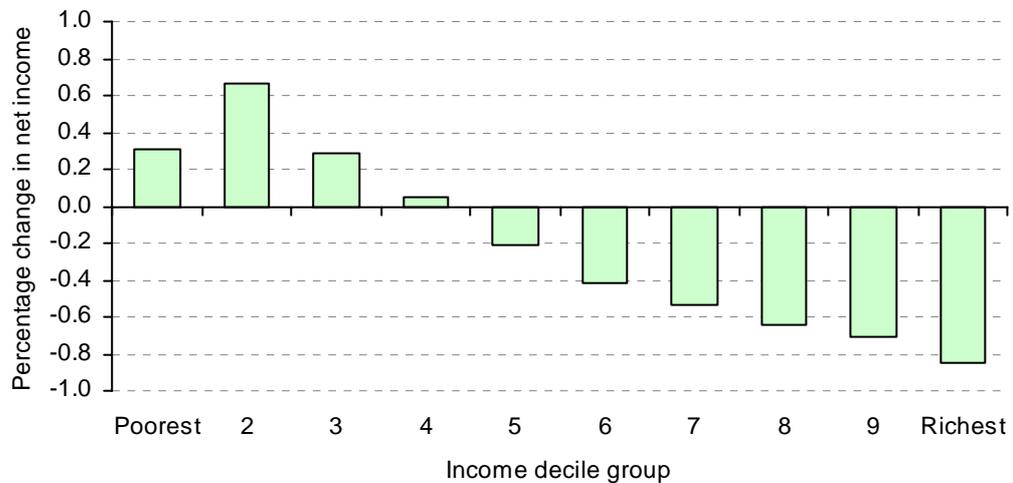
Tax measures and the tightening

Although the net tax increase announced in the PBR was pretty modest, it is worth noting that this comprises a relatively large gross tax increase offset by a smaller gross tax cut (as we saw in Table 3.2). In 2011–12, the gross tax increase totals £10.6 billion, including the increases in rates of National Insurance (£5.4 billion) and income tax (£2.1 billion). The gross tax cuts (since the Budget) total £6.6 billion, including the increase in the personal income tax allowance (£3.3 billion), the increase in the point at which employees pay National Insurance (£1.6 billion) and the watering-down of the government’s proposed vehicle excise duty reforms (£0.5 billion).

Taken together with increases in benefits and tax credits announced in the PBR, these measures are, on average, progressive – leaving the bottom four-tenths of the income distribution better off and the top six-tenths worse off, on average. This is illustrated in Figure 3.9, which excludes the impact of the income tax increases. The new 45% income tax rate and the two new 60% income tax rates for those with very high taxable incomes

are omitted, as – although they impose further losses on the top decile of the income distribution – they are confined to only the richest 2% of the population.⁴

Figure 3.9. Impact of tax and benefit measures announced for 2011–12



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.

Source: M. Brewer, J. Browne and D. Phillips, *The Distributional Effect of the 2008 Pre-Budget Report*, 2008 (<http://www.ifs.org.uk/bns/bn80.pdf>).

The spending squeeze and public services

In the PBR, the government made announcements that affect the level and composition of expected spending in 2010–11, and its projected growth rate thereafter. It is important to take all these into account in assessing the likely impact of the squeeze.

The Conservatives do not seem to believe that there is much of a squeeze on public spending in 2010–11 – and they would like to see a bigger one. David Cameron said on 9 December:

In the Pre Budget Report, the Chancellor revised down his spending plans, but only from 2011 onwards, for 2010 all he is promising is £5bn of unspecified ‘efficiencies’ ... So I can announce today that in order to keep spending at a responsible level and to ensure the quickest possible end to the recession and the strongest possible recovery, we will not match Labour’s new spending plans for 2010 and beyond.⁵

But the potential squeeze on public services in 2010–11 from the plans in the PBR may be greater than either the government or the Conservatives suggest.

Overall, the government has revised up its estimate of total public spending in 2010–11 by £2 billion since the Budget. But this masks a £6.1 billion increase in expected debt

⁴ This group tends not to be captured well by the household survey data used for calculating Figure 3.9 and so reliably modelling the effect of the income tax change for this group is difficult. For more discussion, see Chapter 11.

⁵ http://www.conservatives.com/News/Speeches/2008/12/David_Cameron_Fiscal_responsibility_and_the_recession.aspx.

interest payments, a £4.2 billion increase in expected social security and tax credit payments, plus a £2.4 billion increase in other categories of annually managed expenditure (AME). Meanwhile, departmental expenditure limits (DELs) – which include most spending by central government on public services – have been revised down.

Of this cut, the government believes that £5 billion can be achieved painlessly through efficiency savings. But we should be cautious of such promises. When the government claimed to have made £13.3 billion of efficiency savings by September 2006 under the Gershon Review, the National Audit Office concluded in February 2007 that of these claimed savings, only around a quarter ‘fairly represent efficiencies made’. Roughly half ‘represent efficiency but carry some measurement issues and uncertainties’ and the remaining quarter ‘may represent efficiency, but the measures used either do not yet demonstrate it or the reported gains may be substantially incorrect’.⁶ The NAO has not indicated any greater confidence in government claims of efficiency savings since.

Even if the government can find and deliver efficiency savings, it is not clear that we should treat these as a way to make spending cuts ‘painless’. The government should be aiming to run the public services as efficiently as possible at all times, so presumably it would have wished to implement efficiency savings even if there were no need to make cuts – thereby increasing the quantity and quality of public services delivered for a given amount of spending. Efficiency savings improve the quality of services for a given level of public spending. Spending cuts mean that the quantity and quality of public services will be lower than they would have been in the absence of the cuts (and this is true whether or not efficiency savings are being made at the same time).

Some of the cuts in DELs in 2010–11 reflect forecasting changes and reallocations of spending from 2010–11 into the two preceding years – for example, £2.9 billion of capital spending that the government expected at Budget time to undertake in 2010–11, is now intended to be brought forward to 2008–09 and 2009–10. So it seems reasonable not to count this as a squeeze. However, there are some changes to the DEL spending projections for 2010–11 that look less like reallocations or genuine forecasting changes and more like straightforward cuts to spending plans (the revisions to spending plans are discussed in more detail in Chapter 9). In particular, there is a £1.4 billion cut to NHS capital spending in England, only £0.1 billion of which is brought forward into earlier years. (This is characterised as a forecasting change in the PBR, but is actually a policy change.)

So, overall, the PBR probably represents a real cut in spending on public services in 2010–11 of around £6.3 billion or 0.9% compared with the level set out at Budget time. This includes the £5 billion supposedly paid for by efficiency savings, as any efficiency savings should have been made whether or not there were any cuts.

The PBR pencilled in growth in total public spending of 1.1% a year in real terms over the three years 2011–12, 2012–13 and 2013–14. Chapter 9 argues that the outlook for debt interest and social security payments over this period makes it plausible that all this increase will have to be devoted to AME. This would leave DELs frozen in real terms, even without any additional funds being devoted to helping the government meet its child poverty target, or its aspiration to earnings-index the basic state pension from April 2012.

⁶ National Audit Office, *The Efficiency Programme: A Second Review of Progress*, February 2007 (http://www.nao.org.uk/publications/0607/the_efficiency_programme_a_se.aspx).

At Budget time, the Treasury was pencilling in growth in total spending of 1.8% of national income. If non-departmental spending, such as social benefit payments and debt interest, evolved as it is now expected to but total spending had grown at 1.8% (as forecast in the Budget), real DEL spending growth over the three years of Spending Review 2010 would be forecast to be about 1.3%, rather than the real freeze implied by the PBR figures. The real cut in departmental spending on public services implied by the announcements in the PBR, therefore, would rise from around £6.3 billion in 2010–11 to £11 billion in 2011–12, £17 billion in 2012–13 and £22 billion in 2013–14. In percentage terms, the cut compared with the levels implied by the Budget would rise from 0.9% in 2010–11 to 3.0% in 2013–14.

Chapter 9 examines the impact that zero real growth in DELs over Spending Review 2010 might have on the rates of growth enjoyed by individual Whitehall departments. It should be borne in mind that many public services are of greater absolute and relative value to poorer households than to richer ones (for example, social housing, health, compulsory education and social services).⁷ So, depending on how the government chooses to allocate the spending cuts, the regressive impact of the cuts in these ‘benefits in kind’ could outweigh the progressive impact of the tax and benefit changes described in the previous subsection.

3.4 Conclusions

Leaving aside any long-term cost from the government’s extensive intervention in the financial sector, the credit crunch has imposed a significant permanent cost on the exchequer – perhaps 3.5% of national income or a little over £50 billion a year in 2008–09 terms. On its own, this would have been enough to put the UK’s public finances on an unsustainable path. By announcing a fiscal tightening that will amount to 2.6% of national income (or around £38 billion a year in 2008–09 terms) by 2015–16, the government has avoided this being the most likely outcome. But this means that public sector net debt is likely to remain above the government’s old target ceiling for two decades.

The year-by-year cost of this generation-long increase in government debt will be relatively modest as long as the government’s borrowing costs remain at their current, historically low, levels. But if investors lose confidence in the government’s willingness and ability to implement the tough decisions necessary to get the public finances back into shape, and borrowing costs rise, the fiscal arithmetic will become increasingly unattractive. At best, the government will have to sustain its fiscal tightening for longer – and devote more tax revenue to servicing debt – before getting debt back below its old target ceiling. At worst, the government will be forced into a tougher fiscal squeeze just to prevent debt and debt interest rates exploding. Making this outcome less likely should be at the forefront of the government’s mind as it contemplates the Budget package.

⁷ See F. Jones, ‘The effects of taxes and benefits on household income, 2006/07’, *Economic and Labour Market Review*, 2(7), July 2008 (http://www.statistics.gov.uk/elmr/07_08/downloads/ELMR_Jul08_Jones.pdf).