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Controlling public spending: the scale of the challenge

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Executive summary

There have been two separate surges in spending under Gordon Brown: the first rise took spending from of 36.3% of GDP in 1999/2000, to 41.3% by 2005/6. Arguably this is what the Government had been elected in 1997 to do. Spending then stabilised – remaining at 41% of GDP until 2007/8. But since then an unprecedented second surge has begun. In 2008/9 public spending rose to above 43% of GDP. The 2009 Budget envisages spending rising to 47.5% of GDP in 2009/10 and the 48.1% in 2010/11 – a rise of more than 7% of GDP in just three years.

Even this is based on rosy assumptions– spending is likely hit a record of over 50% of GDP. The Budget's forecasts for public spending as a share of the economy are based upon highly optimistic forecasts about growth. For example, the IMF thinks that by 2010 the UK economy will be 2.2% smaller than the Treasury thinks. Taking just this difference in growth, that implies 2010/11 spending of 49.2% of GDP. That's a rise of 8.2% in just three years - larger even than the wild rises of the 1970s. That would bring the total spending increase since 1999 to a stunning 12.9%. The European Commission also predicts a bigger increase than the Treasury. It forecasts that its (rather broader) measure of public spending will rise from 44% of GDP in 2007 to 52.4% of GDP in 2010 – a rise of 8.4% over three years, and an increase of 13.2% since 1999. The further out the projection, the more rosy the Treasury forecast looks: e.g. the independent forecasters surveyed by the Treasury think that by 2011 the economy will be 3% smaller than the Treasury estimates.

The second surge in spending is huge - in both historic and international context. The surge in public spending is much bigger than during the last two recessions. It is even bigger than the loss of control which led to the IMF bail-out in 1976. Compared to other countries, our public spending rise is bigger - despite similar or worse economic problems elsewhere.

Table 1a: Historic rises in spending (% of GDP)	
1972/3 - 1975/6	7.8
1979/80 - 1982/3	3.5
1988/9 - 1992/3	4.8
1999/2000 - 2005/6	5.0
2007/8 - 2010/11 (Budget spending and growth)	7.1
2007/8 - 2010/11 (Budget spending, IMF growth)	8.2
2007 - 2010 (European Commission)	8.4

Table 1b: Rise in spending 2007-2010 (% of GDP)		Average growth 2007-2010
UK	8.4	0
USA	6.4	0.3
Euro area	4.9	-0.2
Germany	4.8	-0.3
France	4.1	-0.1
Italy	3.2	-0.9

Only a third of the second surge in spending is the result of the recession – most simply reflects a choice to increase Government consumption spending. Between 2007/8 and 2010/11 spending is forecast to rise by £119 billion. But little more than a third (38%) of this increase in spending reflects the costs of the recession – like rising social security bills, and higher debt interest. None of the cost of the banking bailout is included in the total. About 6% of the increase is related to an increase in capital spending – which you *could* argue is a sort of Keynesian "public works" programme. That still leaves 56%, over half of this increased expenditure, which is the result of chosen increases in consumption expenditure. £19 billion of this is current spending on the NHS, £9 billion is Education and £41 billion goes to other departments.

Why splurge next year, only to cut back? Given that the Treasury argues the UK will have started growing by late 2009, and that most of the spending has nothing to do with combating the recession, it's difficult to see the case for continuing to increase spending into 2011. In fact the 2009 Budget acknowledges that the increase will be swiftly followed by cuts after the election: between 2010/11 and 2013/14 public spending will be cut by 2.5% of GDP, then there will be a further tightening (either spending cuts or tax rises) of 3.5% of GDP in the years to 2017/18.

There should be an emergency budget after the next general election to call off the planned increase in spending. It is much easier not to raise spending than it is to cut it later. The next general election must be held by 3 June 2010, but is likely to be earlier. If we just abandoned the discretionary increases in consumption spending (i.e. still allowing social security etc to rise) between this financial year (April 2009/10) and the financial year (April 2010/11) we would save £21.6 billion. If, instead, 2008/9 formed the base, the savings in the first year would exceed £50 billion.

Did people think public spending in 2007-2008 was too low? Even before the second surge in spending, public opinion had shifted against ever-higher spending. According to the British Social Attitudes survey, as late as 2002, 63% of people supported higher tax and spending, while 35% wanted the same level or less. But by 2007 only 42% wanted more tax and spending, while 54% wanted the same or less. Public attitudes are likely to have shifted further since then. The Government has already announced that it will increase tax for everyone earning more than £20,000 a year by raising NI contributions.

Higher spending will reduce the rate of growth: An ECB study by Afonso & Furceri (2008) found that *"a percentage point increase in the share of total revenue (total expenditure) would decrease output by 0.12 and 0.13 percentage points respectively for the OECD and for the EU countries"* – Mo (2007) writing in Fiscal Studies finds an even higher figure: *"a 1 percentage point increase in the share of government consumption in GDP reduces the equilibrium GDP growth rate by 0.216 percentage points"*. In other words, a 10% GDP rise in spending could cut growth by 1-2% a year.

We are unlikely to tax our way back to stability. The Government has already announced that it will increase tax for everyone earning more than £20,000 a year by raising NI contributions. The

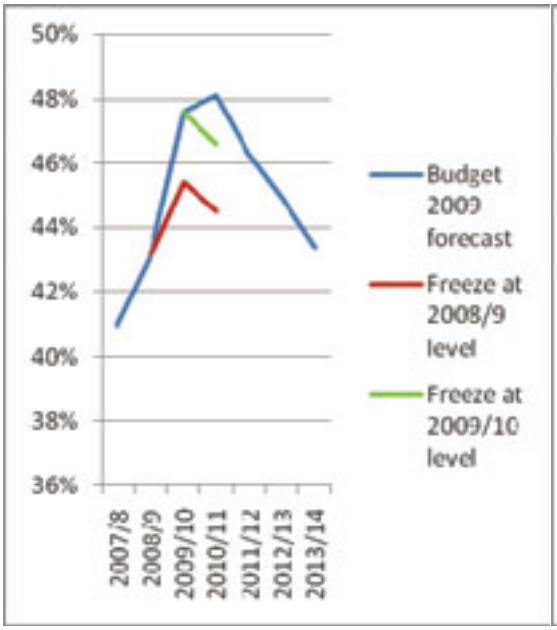
Treasury thinks a 1p increase in the basic rate of tax raises about £4 to £5 billion, so trying to fix the £175 billion a year deficit without controlling spending would require absurdly high tax rates.

The risk of a crisis is rising: the 2009 Budget predicts record borrowing: 12% of GDP (£175 billion a year) and a doubling of the national debt. Many analysts think even this is too optimistic and Standard and Poor's have already warned that the UK's credit rating may be downgraded, which could spark a vicious circle of rising borrowing costs and higher borrowing. If we do not think that the UK will return to strong growth, and we think that oversized public spending will hold back growth, then it is essential to put the public finances back on a sustainable footing more quickly. The best place to start is by cancelling the planned rise in discretionary government consumption spending.

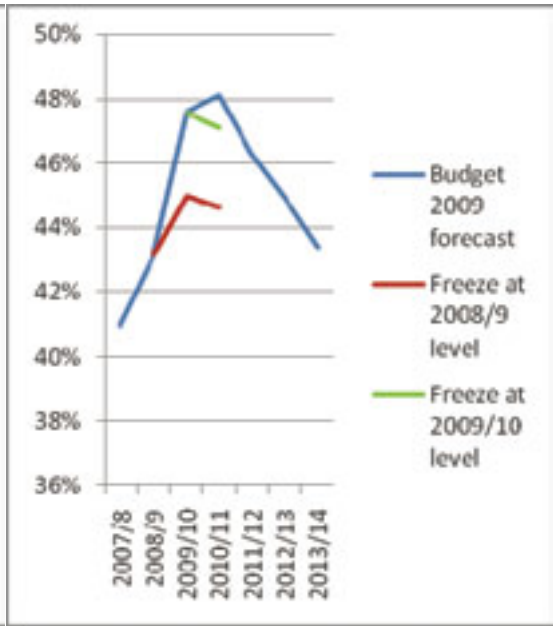
So why put off until tomorrow what needs to be done today? The effect of freezing spending on everything other than social security, tax credits debt interest and capital is simply to move us more quickly towards fiscal stability. ***It would not represent a spending "cut", but instead a choice not to increase discretionary spending which has nothing to do with the recession***. It would simply accelerate the slowdown in spending which the Government itself acknowledges needs to happen.

Figure 1: Total Managed Expenditure as % of GDP

Freezing budgets except Social Security, Tax Credits, debt interest and capital spending



Freezing budgets except Social Security, Tax Credits, debt interest

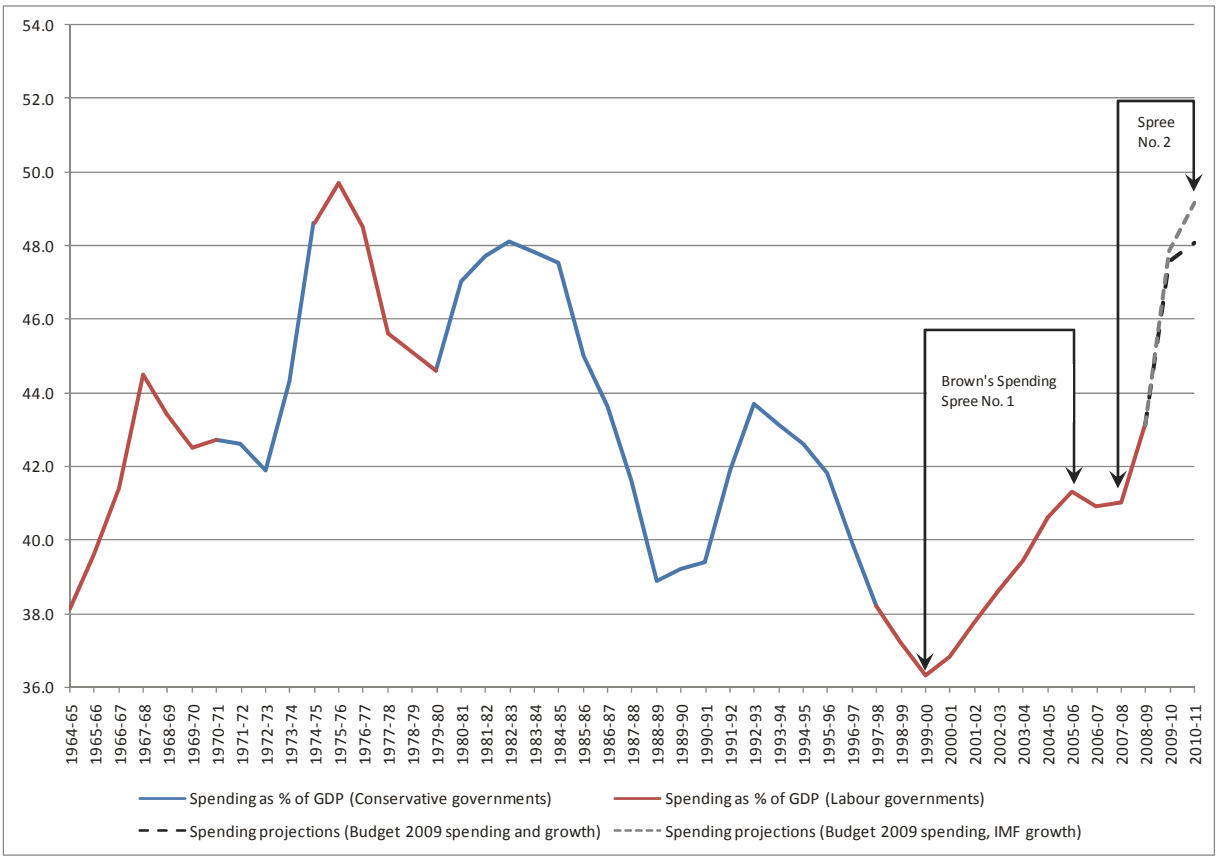


New Labour's Spending Programme: A Tragedy in Two Acts

Act One: Sharing the proceeds of growth...or not

Consider Figure 2 below. In the 1960s there was a rapid rise in public expenditure, ending with the Sterling crisis of 1967. Then in the 1970s UK public expenditure ran wildly out of control, peaking at 49.7% of GDP just prior to the IMF's intervention. A condition of the IMF assistance programme to the UK was much stricter expenditure control and we see the effects in the chart as expenditure fell as a percentage of GDP to 44.6% over a four year period. As the IMF strictures came off and as the government battled with deep recession in 1979-82, expenditure rose again briefly above 48%, before falling back rapidly during the extended growth boom of the mid-1980s. It bottomed out at just under 39% of GDP in 1988/9 before rising again during the recession of the early 1990s.

Figure 2: Total Managed Expenditure as % of GDP (1964/5 - 2007/8)



Note: Area shaded in red is Labour government; blue is Conservative governments; grey is the future

We can see that periods of recession have been associated with rises in the proportion of public expenditure in GDP – a 3.5 percentage points rise in the early 1980s and a 4.8 percentage points rise in the early 1990s. The total loss of control of the 1970s involved a 7.8 percentage points rise.

Overall, however, the period after the IMF assistance programme was characterised by fairly sustained reductions of the proportion of public expenditure in GDP, taking it apparently decisively below 40% of GDP by the mid-1990s. It appeared that two decades of struggle had succeeded in returning public expenditure to the levels of the early 1970s, or perhaps even slightly below.

In its first two years in office, New Labour maintained the outgoing Conservative government's spending plans (by and large). This allowed public expenditure to fall to a low of 36.3% of GDP in 1999/2000 – the era of "prudence" and the "Iron Chancellor".

However, there then followed Gordon Brown's first spending spree – from 1999/2000 to 2005/6. Total Managed Expenditure grew at 4.8% per year in real terms, and expenditure as a proportion of GDP rose to 41.3% by 2005/6, then stabilised – remaining at 41% by 2007/8. This was clearly an aggressive rise in the role of the state in a short period – a 5 percentage points rise (roughly equivalent to the recession-combatting rises of the early 1990s) – and reflected a policy choice not to allow expenditure to fall as a proportion of GDP as it had done in previous boom periods (e.g. in the mid 1980s) – but instead to rise very significantly.

This was the era of not fixing the roof whilst the sun was shining. There is much to say about this period: Was the money well spent? Did it give a good return in terms of improved services? Was it wise to raise expenditure so rapidly, even if one agreed with the judgement that it should have been raised at all? Was it wise to believe that the institutions receiving the extra expenditure could make good use of it without organisational reform? Was it prudent to raise expenditure in this way in a boom time, rather than allowing the boom to create scope for expenditure to rise when, the next recession (inevitably) arrived?

One thing in particular is worth noting for our purposes here. The rises in expenditure in this period were the result of ***choices***, not accidents — New Labour was not aspiring to keep expenditure down but defeated by events. Much the same will be true in the next phase of our story, also...

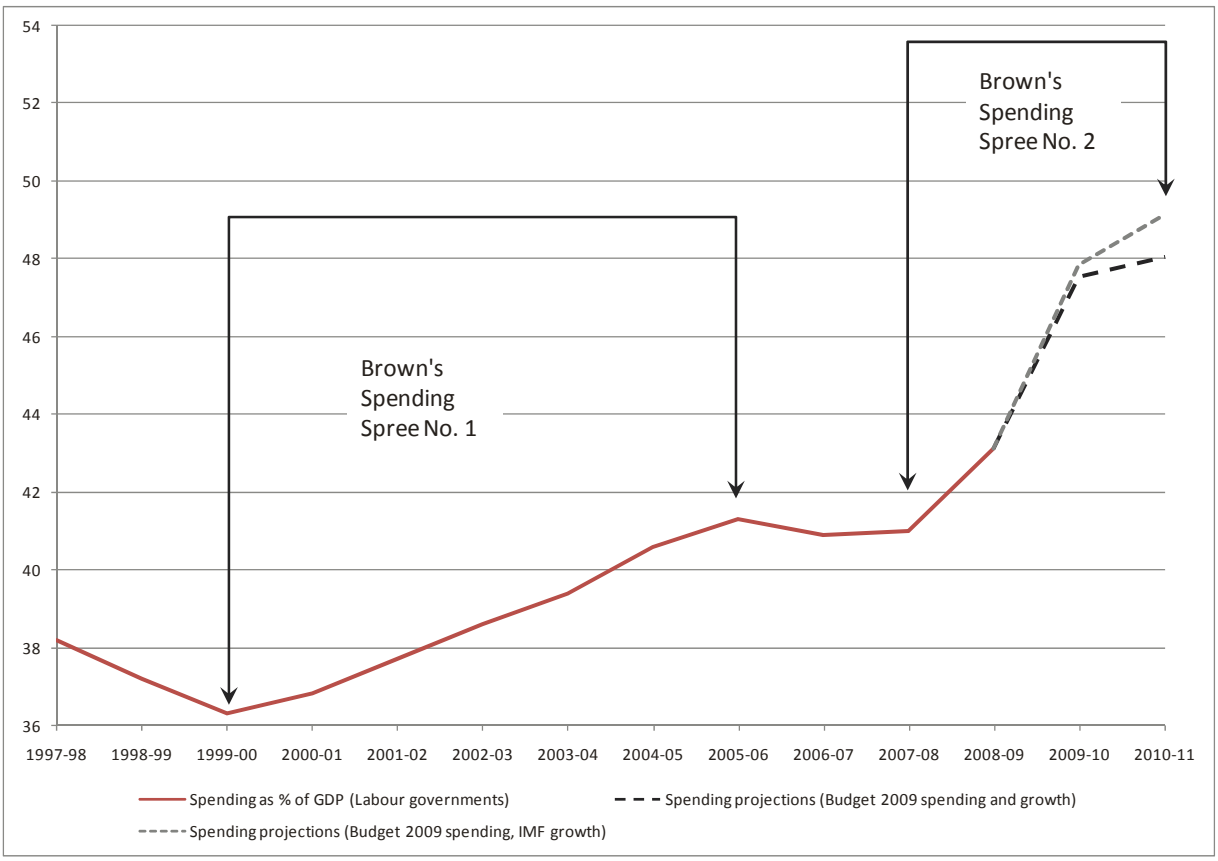
Act Two: You can spend your way out of recession...?

Consider Figure 3. Spending in 2007/8 was still 41% of GDP. In 2008/9 it rose to above 43% of GDP. The 2009 Budget envisages spending rising to 47.5% of GDP in 2009/10 and 48.1% in 2010/11 – a rise of more than 7% of GDP in just three years – twice as rapid as the recessionary rises of the early 1980s, and much more than the rises of 1999/2000 to 2005/6. Of course, the Budget's projections were based upon its forecasts of 3.5% GDP contraction in 2009 and 1.25% growth in 2010 – now widely regarded as highly optimistic. At the time of writing the IMF forecasts a contraction of 4.1% in 2009 and a further 0.4% contraction in 2010.[1]

[1] See Table 1.1 in http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf

Taking just this difference in growth[2], then 2010/11 spending would actually rise to 49.2% of GDP — an increase of 8.2% in just three years, larger even than the wild rises of the 1970s.

Figure 3: Total Managed Expenditure as % of GDP, 1997/8 to 2010/11



Note: Area shaded in red is Labour government; Area shaded in grey is the future

Table 2: Rises in spending (% of GDP)

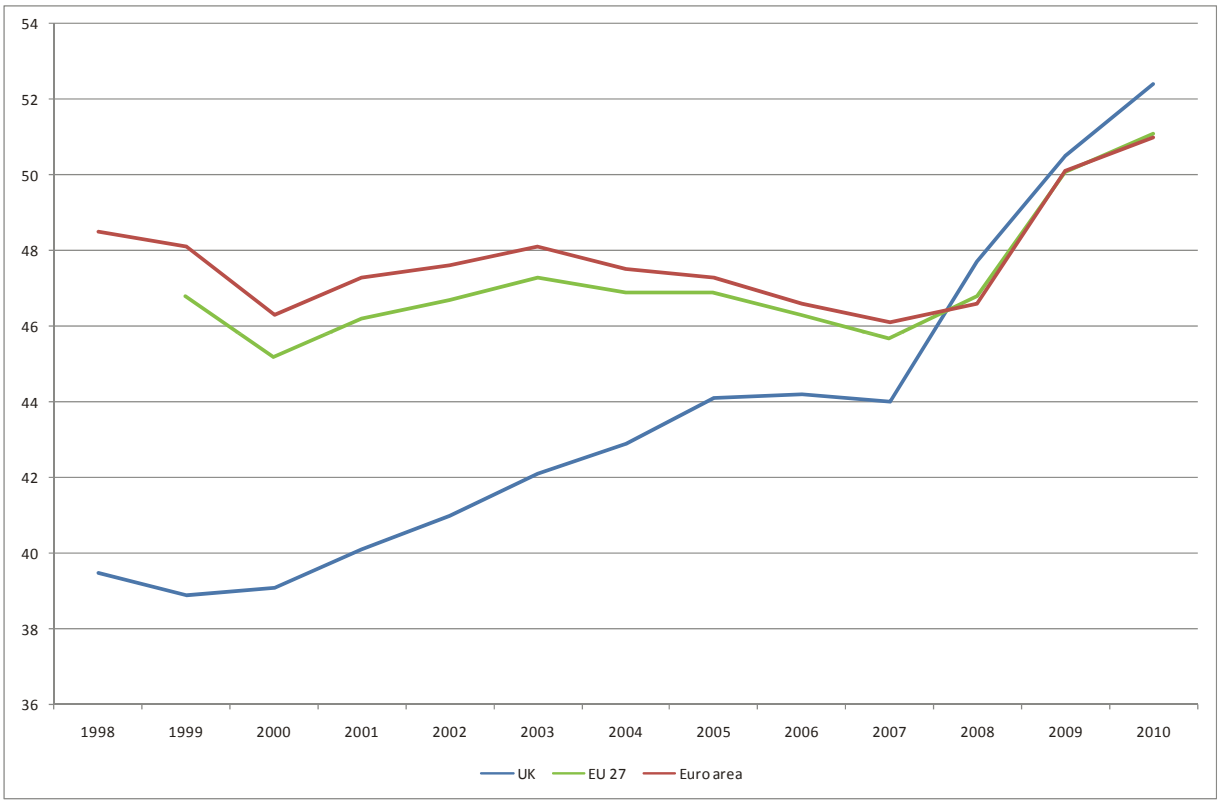
1972/3-1975/6	7.8
1979/80-1982/3	3.5
1988/9-1992/3	4.8
1999/2000-2005/6	5.0
2007/8-2010/11 (Budget spending and growth)	7.1
2007/8-2010/11 (Budget spending, IMF growth)	8.2
2007 – 2010 (European Commission)	8.4

[2] The IMF also forecasts higher unemployment than the Budget, and a higher figure for the losses on bank support. In combination these would take public spending to above 50% of GDP. Here, we focus on the narrow growth effect.

Another measure of this incredible second phase of spending rises can be seen in the European Commission definitions of government expenditure, in Figure .[3] We can see here that the rise in UK government expenditure is markedly more rapid than for either the Eurozone or the EU as a whole, and, remarkably, is expected to take UK GDP from well below to well above the EU or Eurozone average, and well above 50% of GDP (52.4% in 2010).

It is thus clear that the 2007-2010 rise in spending is much larger in the UK than elsewhere in the EU (despite recessions elsewhere in Europe being more severe than in the UK).

Figure 4: Total expenditure, general government as % of GDP



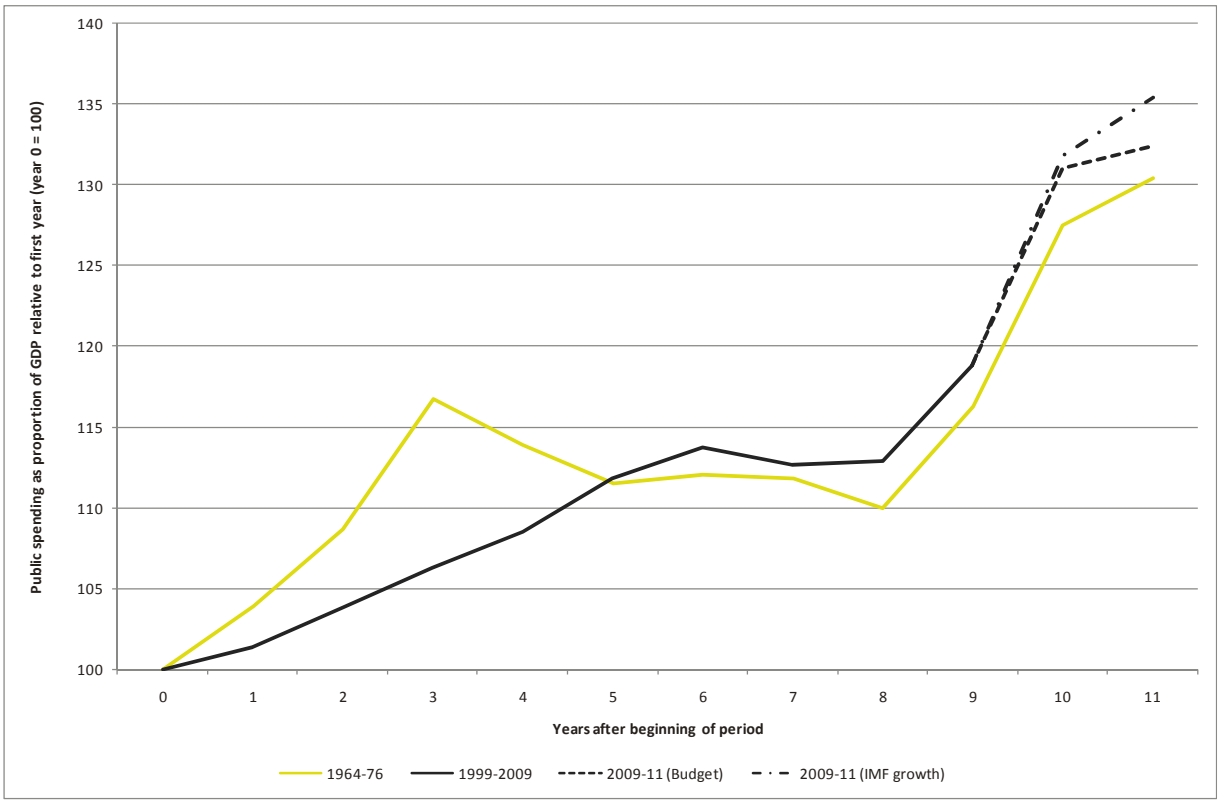
Source: European Commission. Note that 1998 data on EU27 is not available.

It's also instructive to compare the public expenditure paths of 1964-76 and 1999-2011, (see figure 5 below). The graph shows that in the early years of the 1960's expenditure programme — up to 1967 —expenditure rose more rapidly as a percentage of GDP than in the first phase of the New Labour spending expansion programme. But after 1967 spending falls back while the New Labour programme continues with its rise. Each programme then has a plateau to year 8 after its commencement, before the serious rises proceed to year 11.

[3] See for instance Table 35, p151, in *Economic Forecast*, Spring 2009, European Commission Directorate General for Economic and Financial Affairs - http://ec.europa.eu/economy_finance/publications/publication15048_en.pdf

However, though there is a striking similarity in pattern and total change, the overall combined effect of the two New Labour phases is actually greater than the combined effect of the rises 1964-76 which led to the IMF bailout.

Figure 5: Total Managed Expenditure as % of GDP, 1964-76 versus 1999-2011



Why is spending scheduled to rise so fast from 2007/8 to 2010/11?

In understanding this very rapid rise in public spending, let us begin by emphasizing that **the rise** we have identified **has** almost **nothing to do with money for banking bailouts** – the government figures for Total Managed Expenditure exclude support provided for the financial sector.

We can likewise **discount inflation as a factor**. Obviously rises in expenditure as a percentage of GDP are entirely independent of inflation. But even when considered in money terms, as opposed to in terms of proportion of GDP, inflation is insignificant to our story. The Budget assumes CPI inflation of 1.25% in 2009/10 and 1% in 2010/11, whilst RPI inflation is estimated at -3% (i.e. 3% *de*flation) in the year to September 2009 and 1.75% in the year to September 2010. (The figures for the year to September are the determinants of a number of social security benefit upratings.) Given the mix of deflation and inflation in the statistics, and the fact that it is debateable whether the net impact to 2010/11 will be a rise in the price level or a fall, we shall express cash values (as opposed to percentages of GDP) in nominal values hereafter.

A modest proportion arises because of quasi-automatic increases in certain budgets in a **recession**: benefits expenditures must rise to support the unemployed and the incomes of those

forced to accept shorter hours or lower rates of pay (see Table 3). If we attribute to automatic stabilisers the whole of the rises in the Social Security and Tax Credits budgets, the whole rise in the Work and Pensions budget (e.g. if there are more unemployment claimants, there may need to be more DWP staff to process claims[4]), along with all that increase in debt interest that is not the result of residual discretionary expenditure rises, we can estimate the extent to which expenditure has risen "automatically" as a consequence of recession as £43.2 billion — 38% of the total rise.

Table 3: Attributing the rise (£ billion except where % indicated)

	2007/8	2010/11	Change	*% of total change*
Total Managed Expenditure	582.7	701.7	119.0	
Social Security Benefits	138.7	170.9	32.2	27%
Tax Credits	17.2	21.8	4.6	4%
Work and Pensions	8.2	10.0	1.8	2%
Central government gross debt interest (adjusted*)	30	36.4	6.5	5%
"Maximum value for automatic costs of recession"			**45.1**	**38%**

**excludes interest paid on debt accrued through discretionary expenditure rises. Assumes a nominal interest rate of 5.25% on new discretionary debt.*

Indeed, it is quite likely that the rises scheduled for these areas are optimistic. The 2009 Budget assumes a claimant count of 2.44 million in 2010, but in the early 1990s this went above 3 million on a recession less than half as severe as the current one is expected to be. Most authoritative forecasts of peak-to-trough quarterly GDP loss for the UK now put it in the region of the recession of the early 1980s. In the early 1980s unemployment reached nearly 3.3 million. But that was on a labour force of 26.9 million in 1980, versus the 2008 labour force of 31.2 million. If the unemployment rate rose to match that in the early 1980s (and given a recession equal in severity, it is unclear why one should expect unemployment to be materially less), because of this larger labour force claimant unemployment would peak at over 3.8 million versus the government's forecast of 2.44 million, implying much higher expenditure on social security and work and pensions expenses. (The IMF forecasts for overall unemployment imply a claimant count of around 2.8 million — a conservative figure but still 15% higher than the 2009 Budget figure.) In addition, if the recession is more severe than the government expects, the lost tax receipts will be higher so the debt accumulated will be greater, and the debt interest cost will be higher.

[4] Of course, not *all* of the rises in these budgets is unarguably inevitable. However, for our purposes here we shall take them as being so.

We focus hereafter, however, on characterising the government's actual plans. The fact that additional unemployment will drive expenditure materially higher than the government predicts, were other expenditure not brought under control, only makes our discussion later even more pressing.

Government claims notwithstanding[5], **only a very small proportion of the increase in spending can be characterised as a "public works programme"**. Public sector net investment was 2.1% of GDP in 2007/8. This is scheduled to rise to 2.5% of GDP in 2010/11. Thus, perhaps only 0.4% of GDP of the rise — £6.9 billion, some 6% of the total spending rise — could be described as attached to capital programmes ("public works").

So, 38% can be attributed as automatic recessionary rises, and 6% as public works. Put another way, that is a rise of 3% to 4% of GDP that is due to automatic recessionary spending or public works. If expenditure had risen only this much, that would have left the increase in expenditure broadly comparable with the recessionary expenditure rises of the early 1980s and early 1990s quoted in Table 2.

But the Government's proposed spending increase is much higher, and therefore over half of this increased expenditure (56%), is the result of chosen increases in consumption expenditure. It seems clear that, rather than being an accident, this rise in consumption expenditure is a specific and chosen strategy.

Fiscal strategies in a recession

There are a number of potential strategies that could be followed for tax and spending policy ("fiscal policy") in a recession.

A natural response to recession is "fiscal consolidation" - to cut back on spending and perhaps also to raise taxes, so as to minimize borrowing. This will tend to be the appropriate response when either there are material issues of government solvency (concerns over whether governments might actually pay back their debts) or when the future growth path of the economy is highly uncertain. In this latter case, it is likely that fiscal consolidation will mainly take the form of spending cuts — when we are unsure of how large the economy might be in the future, we become less sure of whether it can support as large a public sector as we have previously planned.

When recessions were smallish, passing events — temporary blips in growth from which the economy would not merely recover but would actually catch up lost ground — a standard thought has been that the government might carry on consuming as it would have done had there been no recession. In due course the rest of the economy will catch up. In major recessions, however,

[5] See, for instance, http://www.telegraph.co.uk/finance/economics/3223224/Alistair-Darling-turns-to-Keynes-as-he-looks-to-spend-his-way-out-of-recession.html in which Alistair Darling is quoted as indicating that additional spending will go on "employment-creating sectors such as housing, energy and small businesses while big projects such as the 2012 London Olympics and the Crossrail train link in London will see taxpayers' billions helping shore up the jobs market at a time of rising unemployment".

such as that going on at present, this is simply implausible, and maintaining spending as if the economy were going to go back to the way it was is an exercise in denial.

Another approach - "active fiscal policy" - tries to use fiscal policy so as to manage the path of the economy through recession. There are two main forms such an approach might take. The first form is cutting taxes while leaving spending unchanged — i.e. borrowing-funded tax cuts. Ordinarily, one would not expect borrowing-funded tax cuts to increase economic activity. One way of thinking about this is that people would have to set money aside today so as to have money to pay the higher taxes required later to pay back the money borrowed for those tax cuts today. The reduced spending from this setting aside would offset the increased cash available from the tax cuts.[6]

However, this argument assumes that people in the economy are saving and borrowing the amount it would be efficient for them to save and borrow. But if financial market functioning is severely impaired, that might not be the case. For example, people that have future income prospects that would normally justify their receiving loans might not be able to obtain them. Under such circumstances, it ceases to be the case that all of the additional impetus of the tax cut becomes offset by saving — some tax cuts go to people that would prefer to be able to borrow more, and they do not save their tax cuts. Effectively, the government is acting as a (second-best) financial intermediary, lending to people via a tax cut that they will need to pay back later by tax rises.[7] There is empirical evidence that suggests tax cuts of an appropriate form can indeed have such an effect. The orthodox view is that it is best to provide tax cuts in the form of income tax rebates, paid in lump sums (maximising concentration and visibility).[8]

The second form of active fiscal policy is a public works programme. The concept of responding to difficult economic times by instituting a programme of building works of public interest goes back at least to Pericles. Experience in modern economies with public works programmes has been mixed, with many economists arguing that capital projects undertaken in times of recession often provide very poor value for money as well as being of little wider cultural value.

It has historically proved very hard for Governments to time major projects such that they countered the cycle. As Ed Balls pointed out in a lecture at York University in 2004, *"the existence of long decision and implementation lags meant that, too often, what governments thought were counter-cyclical policy decisions tended to be pro-cyclical and therefore destabilising".*

[6] This is the property called "Ricardian equivalence" after the economist Ricardo who first discussed it.
[7] Lilico (2008) argues that this is the only true fiscal stimulus strategy – see http://www.thersa.org/__data/assets/file/0003/143697/lecture121108.mp3
[8] This is the form that tax cuts stimulus packages have taken in the current recession and in the early 2000s.

The least attractive form of active fiscal policy, a form that would have far fewer serious economists supporting it, is the expansion of government consumption.[9] In this case, instead of money being spent on capital projects, it is spent on current consumption, often including make-work schemes. Insofar as such a policy has a rationale at all (beyond the obvious one of spending one's way to political popularity), the idea is that by creating public sector work — even if much of that public sector work is nothing more than pointless busy-work (activity rather than productivity) — people are not left idle in a recession and hence their job skills do not degrade as they might in unemployment.[10] This reflects an extremely pessimistic notion of markets and perhaps even of governments.

Over half of Gordon Brown's second spending spree is, quite straightforwardly, a short-term consumption programme. Argued for in its own terms (versus either tax cuts, public works programmes, a passive policy of allowing automatic stabilisers to work, or active policies of cutting expenditure in a recession to ensure the solvency of the state), it would receive virtually no support from economists. Many economists might want to spend or borrow in a recession. Virtually none of them would want to spend or borrow for *this*.[11]

Another issue arises in respect of the rises in 2010/11: the government contends that the recession will be over by late 2009 and that there will be growth in 2010/11. So it does not appear that the intention in 2010/11 is to be fighting recession with expenditure rises. So what are they for?

Public spending and growth

GDP growth in the UK averaged 2.7% from 1997 to 2008 (2.8% for 1997 to 2007). The Treasury estimates the sustainable growth rate of the economy is 2.75%, a figure that it believes has not been affected by the financial crisis and will not be affected by the rise in public spending as a proportion of GDP. However, raising public expenditure from around 40% of GDP to around 50% of GDP will certainly have an effect upon the growth rate of the economy — the 2009 Budget's position on this is not one that many economists would take seriously. One reason is that productivity growth is much higher in the private sector than in the public sector. To simplify our explanation, let us assume that productivity growth in the public sector is virtually zero and in the private sector it is 4%. If that were so, then if the private sector were 60% of the economy whilst the private sector were 40% we would have the following:[12]

Overall sustainable growth = 60% x 4% + 0% x 40% = 2.4%

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[9] Economists often refer to such a programme as "bread and circuses". The phrase originates in the Latin version *panis et circenses* — a quote from Juvenal's *Satire X*. It refers to the Roman practice of providing free wheat and chariot races, gladiatorial games and other such entertainment, so as to placate the Mob and gain political popularity.

[10] The technical term for this idea is "hysteresis".

[11] We shall discuss below why we believe that there has been so little opposition to this policy up to now.

[12] The calculation that follows includes certain other technical assumptions such as that the population is constant, but for illustrative purposes we shall ignore these.

Now consider the same calculation with only 50% of the economy being private, and everything else unaffected:[13]

Overall sustainable growth = 50% x 4% + 0% x 50% = 2.0%

Office of National Statistics estimates of productivity growth in the public sector were below zero during the period of the first New Labour spending surge, e.g.:

- Overall public sector productivity fell 4% between 1997 and 2001.[14]
- Health sector productivity fell by a yearly average of 1.7% from 2001 to 2006.[15]
- Education productivity fell from 2000 to 2005.[16]

This notwithstanding, it is likely that public sector productivity growth will be above zero over the long term,[17] so our above calculation may somewhat exaggerate this effect. But there would only be no such negative effect on GDP growth if productivity growth in the private sector matched (or were less than) productivity growth in the public sector — which is implausible for a number of reasons.[18] Raising public expenditure this much for the long term (i.e. if public expenditure did not fall back to 40% eventually) would inevitably, through inexorable mathematical logic, reduce the sustainable growth rate of the economy.

But this is not the end of the effects. For in addition to this straightforward mathematical impact, there is also the impact of the increased tax burden. Standard estimates are that the cost of increased taxation, in terms of GDP lost through distortions created by the imposition of taxes, are around 30% of the tax raised (i.e. if the government raises tax by £100 million, GDP falls by £30 million); other estimates go above 50%.[19] Using the 30% figure, the implication is that if the

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[13] We shall, in a moment, consider some other factors that would be likely to be affected.

[14] See Pritchard, A. "Understanding government output and productivity", p31, http://www.statistics.gov.uk/articles/economic_trends/PritchardJuly03.pdf

[15] Average productivity growth was -2% from 2001 to 2005, and -0.2% in 2006. Source: Karen Dunnell, the National Statistician, 29 January 2008, News Release, "Health care output has risen, but productivity fell". See http://www.ons.gov.uk/about-statistics/ukcemga/publications-home/press-releases/health-care-output-has-risen--but-productivity-fell.pdf

[16] ONS News Release, 'New Estimates of Education Productivity', 4 September 2007, http://www.ons.gov.uk/about-statistics/ukcemga/publications-home/press-releases/new-estimates-of-education-productivity.pdf

[17] It may well be below zero in the short term — it is, for example, extremely unlikely that the public sector could expand by 20% in just three years whilst delivering government-wide positive productivity growth.

[18] Apart from anything else, public services tend not to produce goods, and goods experience more straightforward increases in productivity as technology advances. Services productivity increases tend to be more associated with organisational advances — i.e. reforms. Unless reformed, it is intrinsically most unlikely that public services could absorb 20% increases in a short period whilst delivering material productivity returns.

[19] See, for example, p165 of http://www.iea.org.uk/files/upld-book307pdf?.pdf or the following quoted from Smith, D.B., Living with Leviathan: Public Spending, Taxes and Economic Performance, Institute of Economic Affairs: *"the US Congressional Budget Office (CBO) has reported that the 'typical estimates of the economic cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised'"*.

economy has 50% of taxation, it adds the same amount to itself each year as would a 40% taxed economy of only 97% the size.[20] This effect reduces the sustainable growth rate of the economy by just under 0.1%.[21]

These rough calculations illustrate the likelihood of a reduction in GDP growth of perhaps as much as 0.5% if public expenditure rises from 40% to 50% of the economy for a sustained period. Academic estimates of the effect are typically much greater than this, including a number of authoritative studies. For example, Afonso & Furceri (2008) estimated for the European Central Bank[22] that *"a percentage point increase in the share of total revenue (total expenditure) would decrease output by 0.12 and 0.13 percentage points respectively for the OECD and for the EU countries"* — and thus a 10 percent increase in spending would decrease output by 1.3%, not 0.5%. Mo (2007) writing in Fiscal Studies[23] finds an even higher figure: *"a 1 percentage point increase in the share of government consumption in GDP reduces the equilibrium GDP growth rate by 0.216 percentage points"*.[24]

Thus the standard estimate is that each additional 1% of public spending as a proportion of GDP reduces growth by around 0.15% (or perhaps slightly more). This would imply that a rise in spending to 50% of GDP from 40% would, if sustained, mean the UK's long-term growth rate falling by 1.5%.

It obviously makes a fairly dramatic difference to the UK's prospects whether one prefers our rough estimate of a 0.5% reduction in the sustainable growth rate or the more dramatic implication of the academic evidence, a 1.5% reduction. We shall not attempt to address that question fully here.[25] But either way a reduction in the sustainable growth rate of the economy would have unhappy implications for the UK's ability to service its debts over the long term, and thus be highly relevant to the question of whether investors will be happy to purchase UK bonds over the next few years. A short-term period of very high expenditure might be tolerated by

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[20] 50% - 40% = 10%. 30% of 10% = 3%. 100% - 3% = 97%.

[21] An economy of 100 growing at 2.5% per year would add 2.5 in the first year. An economy of 97 growing at 2.5% per year would add 2.425 per year. The difference is 0.075, just a little under 0.1.

[22] Afonso, A. & Furceri D. (January 2008), "Government size, composition, volatility, and economic growth", *European Central Bank* working paper 849

[23] Mo, P.H. (2007), "Government expenditure and economic growth: the supply and demand sides", *Fiscal Studies* 28 (4), pp497-522

[24] Mo also finds that "the same increase in government investment raises the growth rate by 0.167 percentage points. This suggests that a reallocation of 1 percentage point of government consumption to government investment can raise the growth rate by 0.38 percentage points." This illustrates something of the relative merits of consumption-booster and public works programmes.

[25] For much more detail on this point, see especially Smith, D.B., Living with Leviathan: Public Spending, Taxes and Economic Performance, Institute of Economic Affairs.

[25] On 21 May 2009, Standard and Poor's placed the UK's AAA rating on a negative outlook, stating that further action would be required by an incoming government to address projected levels of debt above 100% of GDP.

investors, but only if there were a credible path for bringing expenditure down as a proportion of GDP over the longer term.[26]

The politics of spending

So, as we have seen, the main driver for the huge rise in public expenditure from 2007/8 to 2010/11 is a short-term consumption based anti-recession strategy, the consequence of which will certainly be almost no benefit in terms of productivity returns in public services and yet at the same time a material reduction in the sustainable growth rate of the economy. Given that such a policy, stated and argued for outright, would meet with virtually universal opprobrium among economists, it is of interest, perhaps, to pause for a moment to consider why this policy has met with so little discussion.[27]

Spending in 1999/2000 was at a 35 year low as a proportion of GDP. The first Brown spending spree took expenditure to 41% of GDP, a figure much more typical of recent decades in the UK. It is thus perhaps unsurprising that, whether or not their view was correct, many commentators felt that the rise to 41% of GDP was justified. This impression gained added piquancy from the fact that the Conservative Party fought two successive General Elections proposing to spend relatively modest sums less than New Labour's planned increases (of the order of only £20 billion less) and were soundly beaten. There was perhaps a sense that a new public expenditure settlement had been reached, with the true debate being about the next phase — as the economy grew, should we continue to raise public expenditure as a percentage of GDP or was something around 40%-42% reasonable?

Too open an opposition to spending rises came to be caricatured as the favouring of spending "cuts", even though actual cuts were almost never proposed, but, instead, the debate tended to be about greater or lesser future rises. The situation became particularly difficult since any serious programme of greater control of the increase in spending could not, realistically, leave unaffected the plans of major spending departments such as health or education. In order to have a material effect on the overall budget, mere spending control would not be adequate if the major spending departments were left sacrosanct — rather, other departments would have to experience actual (and painful) cuts.

So the choice in public expenditure became an unappetising one: challenging the government's claim that health and education expenditure must rise as rapidly as it promises to raise them; or proposing actual cuts (not mere control of rises) elsewhere.

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[26] On 21 May 2009, Standard and Poor's placed the UK's AAA rating on a negative outlook, stating that further action would be required by an incoming government to address projected levels of debt above 100% of GDP.

[27] It is an interesting reflection upon the UK policy debate how much discussion, debate and controversy there was in Autumn 2008 about the notion of a £12 billion tax cut versus the almost complete absence of any debate then or since about a £120 billion spending rise. The opposition parties must now meet the challenge of telling us whether their opposition to tax cuts was so that they could better afford the scheduled spending rises.

In the light of subsequent events, even those that felt 40%-42% was a reasonable level of public spending, at a time of sustained economic boom, are likely to be reconsidering their view. But even if the conclusion of such a reconsideration were that 40%-42% was indeed reasonable, it does not follow that a rise to above 50% is reasonable. Put more baldly, just because you felt you had to accept 41% of GDP as public spending doesn't mean you have to accept 50%+. There must be *some* limit above which it becomes politically feasible to say no.

Consider Table 4, in which we see the proposed 18% rise in the Health budget over the next three years, the overwhelming majority of which is increased current expenditure. Such a rapid rise in such a short time raises the question: Did people think the health service so terribly underfunded in 2007/8 that it needed an 18% rise in just three years? Can the health service really absorb so much additional money so quickly without enormous inefficiency and waste?

Similar questions must be raised by the increases in expenditure in other departments. Did people really believe that public spending was far too low in 2007/8, such that it needed to be raised by some 20% in just three years?

Table 4 (£ billion except where % indicated)

	2007-8	2010-11	Change	% of total change	*% increase*
Total Managed Expenditure	582.7	701.7	119		*20%*
Social Security Benefits	138.7	170.9	32.2	27%	*23%*
Tax Credits	17.2	21.8	4.6	4%	*27%*
Work and Pensions	8.2	10.0	1.8	2%	*22%*
Debt Interest	30	42.9	12.9	11%	*43%*
of which discretionary rises		*6.4*	*6.4*		
Health	92.2	108.8	16.6	14%	*18%*
of which current expenditure	*88.4*	*104*	*15.6*		
DCSF + DIUS ("Education")	67.7	77.8	10.1	8%	*15%*
of which current expenditure	*60.4*	*69.2*	*8.8*		
Other	228.7	269.5	40.8	34%	*18%*

Is it really a politically unquestionable proposition that spending needs to be raised this much — even setting aside (which we do not) the issue of whether the UK's debt and deficit situations make this level of spending feasible? The challenge we raise is this: even in its own terms; even if there were no deficit problem; even if the UK did not have a rising problem of national debt; even if the UK government did not have serious challenges in meeting the liabilities of the nationalised

banks — even were there none of these other good reasons to be concerned about adding to government debt, would it really be a good idea to raise public spending by another £120 billion over just three years?

Do we have mainly a spending crisis, a deficit crisis, or a debt crisis?

Political debate over the past year has focused on government debt levels and the size of the deficit. Debt is indeed rising rapidly, from below 40% of GDP to perhaps 100% (even excluding the nationalised banks). Debt at such a level is much higher than the UK has been used to in recent years, and would have damaging effects upon the economy. However, this is not unmanageable — although the experience was not a happy one, the UK has serviced debt on this scale before. Were it not for other problems, debt on this scale would be damaging but not threatening.

One factor that exacerbates worries about debt levels is the level of the deficit. The UK's fiscal deficit is forecast by the Treasury at just over 12% GDP in 2009/10 and 2010/11. This would in itself be a post war record, but the real figure may well reach 15% of GDP — far above the levels of the 1990s or 1970s. A rapid accumulation of debt through such a high deficit might raise concerns about whether the deficit could really be brought under control in an orderly fashion that would allow straightforward repayment of debts. But even this problem is a contingent one. If public spending were 35% of GDP and taxes 20% as a result of a deliberate policy of cutting taxes so as to borrow during recession, and the economy had in the past managed with taxes of 40%+ of GDP, it might seem very plausible that the deficit could be brought straightforwardly under control when the moment came.

The UK's current problem is, however, different. The UK's situation raises concerns about the levels of debt *because of* the levels of the deficit, which are in their turn a problem *because* they are driven mainly by out-of-control expenditure. It is the wild rise in public spending that should be the key cause of concern to policy-makers. If public spending rises were drawn under control, it would be much more plausible that modest tax rises combined with growth (which would be faster, over the medium term, at lower spending levels) could reduce the deficit, so that the aggregate level of debt would peak at a manageable level.

Cutting the Gordian knot — If you don't raise spending, you won't have to cut it

It is much easier not to raise spending than to cut it later, so we shall now consider a number of scenarios under which certain components of expenditure were not raised as envisaged by the 2009 Budget. Under each scenario we shall first consider freezes at 2008/9 levels. Then we shall consider freezes at planned 2009/10 levels. All scenarios will be static — we shall not attempt to model either the extent to which spending is recycled as tax receipts (e.g. if someone is given a £100 pay rise that will appear as an additional £100 of spending but there will also be (say) £20 of additional income tax paid, along (perhaps) with some additional income on VAT receipts and excise duties); nor the question of whether spending rises would raise or lower GDP or raise or lower debt servicing costs. We thus focus narrowly on the question of how much cumulative expenditure is saved by spending freezes of different sorts.

(i) Freezing all budgets except Social Security, Tax Credits & debt interest

Our first set of scenarios considers the effect of freezing all budgets except Social Security, Tax Credits, Work and Pensions, and debt. This scenario thus envisages neither the public works nor discretionary consumption spending components of the rises in 2009/10 or 2010/11.

We see in Table 5 below that in 2008/9 total managed expenditure was £620.7 billion, of which £208.6 billion fell under the budgets we are treating as rising automatically in recession. This leaves £412.1 billion spending in areas over which the government had discretion as to whether spending should rise, fall, or stay unchanged. If spending in these other areas stayed at its 2008/9 level, total spending would £36.5 billion lower in 2009/10 and £50.5 billion in 2010/11. Cumulative savings would be £87 billion.

On the government's forecast for GDP growth, £651.2 billion would represent 44.6% of GDP — so, spending would have risen by 3.6% of GDP in three years. On the IMF growth forecasts, £651.2 billion would represent 45.6% of GDP and spending would have risen 4.6% during the recession. This range is broadly comparable to the increases in expenditure during the early 1980s and early 1990s.

Table 5: Freezing discretionary spending at 2008/9 levels (£billion)

	2008/9	2009/10	2010/11
Budget 2009 plans for Total Managed Expenditure	620.7	671.4	701.7
Social security, tax credits, Work and Pensions, and adjusted debt interest	208.6	222.8	239.1
Other spending	412.1	412.1	412.1
Total adjusted expenditure	620.7	634.9	651.2
Spending saved	0	36.5	50.5
Cumulative spending saved		**36.5**	**87.0**

On the other hand, in Table 6 we have the consequences if the 2009/10 budget formed the base of the freeze (one might imagine, for example, an incoming government in 2010 deciding not to deliver the 2010/11 spending rises even if these had already been announced in a Budget). The consequence is clearly a much lesser saving of just £14 billion in the first year.

Table 6: Freezing discretionary spending at 2009/10 levels (£ billion)

	2009/10	2010/11
Budget 2009 plans for Total Managed Expenditure	671.4	701.7
Social security, tax credits, Work and Pensions, and adjusted debt interest	222.8	239.1
Other spending	448.6	448.6
Total adjusted expenditure	671.4	687.7
Spending saved		**14.0**

(ii) Freezing all budgets except Social Security, Tax Credits, debt interest & capital spending

The next variant considers the effects of freezing just the current spending budgets but maintaining the programmed capital expenditure increases — crudely, abandoning the government consumption increases but maintaining the public works increases.

In Table 7 we see the result of freezing current spending but maintaining the capital programme. Total public sector net investment is £37.7 billion in 2008/9, while the components of spending that rise "automatically" in recession remain at £208.6 billion (as above).

Table 7: Freezing current spending at 2008/9 levels (£ billion)

	2008/9	2009/10	2010/11
Budget 2009 plans for Total Managed Expenditure	620.7	671.4	701.7
Social security, tax credits, Work and Pensions, and adjusted debt interest	208.6	222.8	239.1
Public sector net investment	37.7	43.8	36.2
Other spending	374.4	374.4	374.4
Total adjusted expenditure	620.7	641.0	649.7
Spending saved		30.4	52.0
Cumulative spending saved		**30.4**	**82.4**

Next, as above, we consider the freeze applied only in 2010/11. Curiously, comparing Table 8 to Table 6 we see that freezing current spending saves more than freezing the sum of current and capital spending, because in 2010/11 the government proposes to cut public sector net investment (while raising overall total managed expenditure by more than £30 billion).

Table 8: Freezing current spending at 2009/10 levels (£ billion)

	2009/10	2010/11
Budget 2009 plans for Total Managed Expenditure	671.4	701.7
Social security, tax credits, Work and Pensions, and adjusted debt interest	222.8	239.1
Public sector net investment	43.8	36.2
Other spending	404.8	404.8
Total adjusted expenditure	671.4	680.1
Spending saved		**21.6**

Is any of this enough?

Even on the most aggressive of these scenarios, in which all expenditure is frozen immediately at 2008/9 levels, expenditure rises (on the IMF growth figures) to 45.6% of GDP in 2010/11. By way of reference, this is far above the peak of the early 1990s recession and is above the level of expenditure Mrs Thatcher was faced with on coming into office. On the analysis of impacts on growth above, if sustained at this level, public spending of above 45% of GDP might result in annual growth rate reductions of 0.25%-0.75%, making projected debt levels tougher to service. So is even a freeze in expenditure adequate? Might one need to go further and actually cut expenditure from current levels (in contrast to the large rises the 2009 Budget has scheduled)?

If we could be confident that growth would resume after 2010/11 (of say, 3% or more), one way forward would be to schedule relatively modest public spending rises thereafter (say, 1% or so) and allow a growing economy to gradually outgrow the spending and the proportion of public spending in GDP to drift downwards. However, the growth outlook through the 2010s is very uncertain, and although growth must be part of the corrective process, it would not be prudent to rely solely upon growth. [28]

The government has scheduled spending cuts from 2011/12 to 2014/15, estimated by the IFS as 0.1% per year overall, and perhaps 2.3% per annum falls in departmental expenditure limits (around £9 billion reductions per year). It seems very likely that cuts will go further than this, with newspaper reports already suggesting the Treasury is looking for perhaps £50 billion[29] in additional fiscal tightening (the amount implied by the Treasury's own estimate of the structural deficit) or even £70 billion (the level of deficit implied by the Treasury's panel of independent

[28] For example, the 2009 Budget forecasts growth of 3.5% in 2011, 2012, and 2013. But the Treasury Panel of independent forecasters gives corresponding figures of 1.9, 2.4 and 2.6%. See http://www.hm-treasury.gov.uk/d/200905forecomp.pdf p18

[29] see http://business.timesonline.co.uk/tol/business/economics/article6350155.ece

forecasters)[30], mainly in the form of spending cuts (essentially equivalent to the effect of freezing spending at 2008/9 levels as discussed above).[31] Other commentary is more demanding, suggesting that cuts of up to £100 billion might be necessary.[32] It seems natural to suppose that, unless the economy does much better than currently envisaged by mainstream commentators, an ongoing Labour government would institute controls plus cuts of £50-£70 billion (the exact amount depending on how much the economic outlook darkens further). Presumably, therefore, since other parties appear to signal that they intend to spend less than the current administration, they should be aiming to identify ways to control and cut spending by above £70 billion.

We shall examine some of the implications of having lower spending than the 2009 Budget plans for 2010/11 at the £50, £75 and £100 billion levels.

Total Managed Expenditure for 2010/11 is projected to be £701.7 billion. If this were cut by £50 billion across the board, that would imply the health budget, for example, being £101 billion (up from £97.1 billion in 2008/9) instead of £108.8 billion as planned. If, instead, spending were £75 billion less than the 2010/11 plans across the board, that would imply health spending frozen (versus 2008/9 spending) at £97.1 billion, and if spending were £100 billion less than the budgeted plans health spending would fall to £93.3 billion.

Politicians in all the main parties appear to regard health and education spending as sacred cows. And social security, tax credits, and work and pensions spending are likely to rise as a fairly automatic consequence of high and sustained unemployment. If health, education, and social security-related spending were all set at their 2009 Budget planned levels, then a £50 billion reduction in the overall budget would require a 16% fall in other budgets versus their planned 2010/11 levels, or a 4.3% fall versus their 2008/9 levels. A £75 billion reduction would require a 24% fall in other budgets versus their planned 2010/11 levels, or a 13.5% fall versus their 2008/9 levels. For a £100 billion reduction, the figures are 32% and 22.6%.

Thus, it may be just plausible to achieve a £50 billion reduction in the 2010/11 plans while keeping health and education and social security spending intact, via significant but perhaps achievable cuts in other budgets. But if expenditure reductions are to go to £75 billion or £100 billion, it seems most unlikely that health and education spending could be insulated.

Cutting our spending to match our cloth

Let us set aside, for a moment, ambitions for clever fiscal management, and focus on two different questions: (i) how much of GDP do we wish to devote to public spending; and (ii) how much of GDP can we afford to devote to public spending?

[30] see http://www.telegraph.co.uk/finance/economics/5389398/Treasury-warns-of-70bn-hole-in-Budget-forecasts.html

[31] Note that the UK has no history of delivering a tax take materially above 40% of GDP.

[32] see http://business.timesonline.co.uk/tol/business/economics/article5734129.ece

The IMF forecasts that the UK economy will shrink by 4.1% in 2009, then by 0.4% in 2010. That would leave the economy at the end of 2010 at roughly the same size it was in the 2005/6 fiscal year. One natural thought, therefore, might be the following: We will have an economy in 2010/11 roughly the same size as in 2005/6. So why should we expect the State to spend more in 2010/11 than it did in 2005/6? Perhaps the economy will grow rapidly in 2011/12 and thereafter. It is not obvious that we should expect the economy to grow as rapidly from then on as we had expected it to grow from 2006/7 on, but if it does so, all to the good, and we can raise public spending accordingly. But why should our starting point be any larger public spending in 2010/11 than we thought appropriate when the economy was the same size in 2005/6?

If we *do* wish to engage in some clever fiscal management, should not the amount that we want to achieve be built up from a base position that is the 2005/6 startpoint?

Let's see what that would mean.

Total Managed Expenditure in 2005/6 was 41.3% of GDP. On the government's growth forecasts, 41.3% of 2010/11 GDP will be £603 billion; on the IMF growth forecasts the corresponding figure would be £589 billion. So, to return expenditure to 2005/6 levels would imply spending in 2010/11 of some £100 billion-£100 billion less than the 2009 Budget plans — broadly equivalent to not having implemented any of the second (2007/8-2010/11) spending spree.

If automatic stabiliser effects of £45 billion (as calculated above) are accepted[33], that would still imply spending of £55-£65 billion less elsewhere.[34] That is to say, if we spent the same proportion of GDP publicly as in 2005/6, on everything except social security, tax credits, work and pensions, and debt interest (all of which would rise as a result of recession), spending would be £55-£65 billion less than the 2010/11 plans. Given that there is now a widespread view that government spending in 2005/6 was too high, this should surely be the minimum ambition — a necessary first step, before establishing a wider set of controls to allow spending thereafter to drift downwards as a proportion of GDP over time. Later Policy Exchange reports will consider how this (and more) might be achieved.

[33] Of course, reforms to welfare provision might have a material impact on this.

[34] Since, as discussed above, unemployment will probably be materially higher than the 2.44m the 2009 Budget assumes, automatic stabiliser expenditure will probably be above £45.1 billion (excluding other reforms to welfare spending). Hence the aggregate final fall in spending, versus the 2009 Budget plans, would probably be less than £55 billion-£65 billion.