



Daily Themes

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UK spending: Where will the axe fall?

While there is some debate about when it should begin, there is general agreement that substantial fiscal consolidation through a combination of spending cuts and tax increases will need to take place to maintain the UK's AAA credit rating. However, given existing commitments by the main political parties to protect significant areas of spending, other departments would have to bear the brunt of the adjustment needed and this would involve enormous cuts to their budgets of between 18-24% in real terms over the course of the next parliament. This is clearly unrealistic. For example, for the Ministry of Defence this would equate to lopping off a branch of the armed forces. In reality, the fiscal consolidation required for the UK can only be achieved by a combination of tax increases, departmental spending cuts and cuts in social security and pension benefits.

'I wouldn't start from here'

The starting point for determining where the axe will fall in terms of spending cuts is in understanding how the UK government currently spends its/our money and where the greatest leeway for spending cuts exists. Just as consumer spending can be divided into 'non-discretionary' (i.e. essentials such as food) and 'discretionary' items (e.g. foreign holidays), so too government spending can be divided in this way.

Interest payments on existing debt are non-discretionary, since the government has no option but to service its debt if it wishes to continue accessing capital markets and maintain the financial reputation of the UK. In addition, both Labour and the Conservatives have already announced 'ring-fencing' of certain departments' spending – notably

health, education and overseas aid. This suggests larger cuts elsewhere. What's more, some items of government spending increase automatically in economic downturns. For example, welfare payments such as unemployment benefit and income support increase as more people become unemployed, unless specific entitlements are cut. In addition, the gradual ageing of the population will lead to increased spending on pensions every year.

The UK Treasury expects that for the fiscal year 2009/10 as a whole total central and local UK government spending will be £676 bn. As usual, the largest items are social welfare, healthcare and education. Interest payments on existing government debt are expected to amount to £30bn, almost 4.4% of total government spending.

UK Government spending in 2009/10

	bn	% of total spending	Protected/ difficult to cut?
Welfare & state pensions	190	28.1	No*
Healthcare	119	17.6	Yes
Education	88	13	Yes
Defence	38	5.6	No
Public order & safety	36	5.3	No
Housing & environment	30	4.4	No
Social services	29	4.3	No
Transport	23	3.4	No
Industry, agriculture & employment	21	3.1	No
Other	72	10.7	No
Interest	30	4.4	Yes
Total Spending	676	-	-

Source: UK Treasury

* Some parts will increase automatically because of ageing population

Government revenues are expected to be only £498 bn, leaving a budget deficit of £178 bn (26% of government expenditure) and highlighting the need for action. Indeed, this year the UK recorded its first monthly budget deficit for the month of January since 1993. There is normally a surplus in

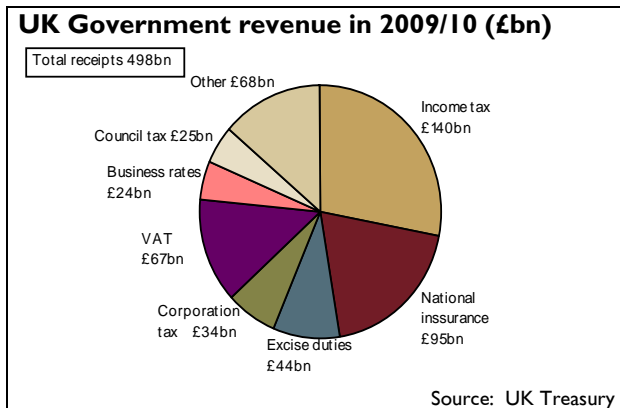
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January, since it represents the peak month for tax collections.



Where will the cuts take place?

Both Labour and the Conservatives have committed not to cut spending in real terms on 'frontline' health and overseas aid in the fiscal years 2011/12 and 2012/13. In addition, Labour has also committed not to cut spending on 'frontline' schools for these two years. Frontline is understood to mean non-investment spending in these areas, suggesting there could still be cuts to the capital spending budgets for these departments. Capital spending is spending on productive assets that have a life longer than one year, such as a new school, hospital building or IT equipment. In 2009/10 the Treasury expects capital spending to be £50 bn out of total spending of £676 bn.

The commitments to ring-fence certain departments suggest substantial cuts to other departments, particularly those with large capital spending budgets. Defence is the largest single unprotected department and also has a large capital spend. Transport also has a large capital budget. Other departments that are likely to bear the brunt of spending cuts include higher education, housing and social services, and central government administration through efficiency drives.

Large capital projects will be at particular risk, such as plans to replace the nuclear Trident submarines in defence, and large IT schemes including identity cards and the children's database. In addition, the commitment to education is to frontline schools -

i.e. primary and secondary education - suggesting cuts to higher education budgets are possible.

A general public sector wage freeze for at least one year is also a distinct possibility. Labour has already announced a pay freeze for the 750,000 highest-paid public servants, such as judges and senior managers. The Conservatives have suggested extending this to all public sector workers earning over £18,000 per annum. Public sector pay cost £174 bn in 2008, and a pay freeze could save around £2 bn per year.

How much consolidation is required?

The December 2009 Pre-Budget Report estimated that the financial crisis has increased the structural deficit by 5.2% of national income (£73 bn in 2009 terms). Independent estimates suggest it could be even higher. The structural deficit is the deficit the government is running after adjusting for fluctuations in government revenue and expenditure over a normal economic cycle. Between 2000 and 2007, the structural deficit averaged just 1.8% of national income. As explained in a previous Daily, the structural deficit created by the financial crisis will have to be gradually closed to prevent the national debt rising to unsustainable levels and the UK losing its AAA credit rating.

To stabilise the public finances, the present government has said that it plans to implement a fiscal tightening of 5.5% of national income (£77 bn in 2009/10 figures), but spread over eight years so as not to derail the recovery. 60% of this tightening (£46 bn) would be delivered from 2010 to 2015, with two-thirds of this (£30 bn) achieved through spending cuts and the rest through tax increases.

Can 'other' departments take the pain?

Assuming the Labour Party's commitment to keep existing levels of spending on health, education and overseas aid is maintained for the whole of the next parliament, and taking into account the fact that other spending such as interest payments and pensions will continue to go up, this would imply a reduction in spending for unprotected departments (such as defence, housing, transport and higher education) of 24% in real terms (i.e. adjusted for inflation) by 2014/15. This would be an enormous

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cut. For example, for the Ministry of Justice, its share of a 24% cut would be equivalent to shutting two-thirds of all prisons.

The Institute for Fiscal Studies (IFS) has suggested trying to eliminate most of the structural deficit over one parliament. The Conservatives have also said they would be more ambitious than Labour in their deficit cutting plans. Taking into account the less extensive Conservative commitments to maintain spending in some areas and the fact that some areas of spending will increase automatically, this would imply a reduction in spending by unprotected departments of 23% in real terms by 2014/15.

If the Conservatives were less ambitious, and simply stuck to the Labour party's suggested timescale for deficit reduction (i.e. to close 60% of the structural deficit by 2014/15) this would still imply a reduction of at least 18% in real terms in the unprotected departments by 2014/15, according to the IFS. This would be the equivalent to the Ministry of Defence closing down the army and the Department of Transport ending all current and capital expenditure on roads to meet their shares of a 18% cut. Clearly, these sorts of cuts are not credible.

As the IFS suggests, the way to square the circle would be to cut the welfare & pensions' budget (£190 bn in 2009) as well. Specific proposals policymakers could consider include a one-year freeze on the value of benefits, which would save £4.1 bn per year, making child benefit means tested and scrapping winter fuel payments. Extending public sector pay freezes beyond one year may also be considered.

Conclusion

So far, the need for cuts in social security benefits and pensions has fallen under the radar. However, given existing commitments by the main political parties, substantial fiscal consolidation can only be realistically achieved by a combination of tax increases, departmental spending cuts *and* cuts in welfare and pensions benefits.

Even with cuts in social security and pensions benefits, the squeeze in public spending after the next election is likely to be substantial and fall disproportionately on some departments rather than others. Defence, transport, housing and higher education look most vulnerable. Capital spending projects, such as large IT schemes and the replacement of the Trident submarine programme, all look under threat. We will assess the sectoral impact for the UK economy of likely departmental spending cuts, and therefore the implications for equity sectors, in a separate Daily.

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