

Managing Change: Responding to reduced public expenditure in Yorkshire and Humber



Annex A: The Context for Public Spending Cuts

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A decade of investment in public services

The Labour government was elected in 1997 on a platform of investment in public services. Their decision to adhere to the previous administration's tight spending plans meant that public expenditure actually fell in real terms by 0.2 per cent a year during its first two years in power: the public sector began to accumulate budget surpluses in 1998/1999 which reached over 2 per cent of GDP in 2000/01.¹

The 2000 Budget set out a target of doubling public sector net investment to 1.8 per cent of GDP by 2003/4², a target that was increased to 2 per cent of GDP by 2005/6 in the 2002 Budget.³ Meanwhile the 2000 Spending Review marked the beginning of a commitment to the large increases in investment in public services – and education and health in particular – that had formed a key part of the 1997 Labour Party election manifesto. Across Great Britain, employment in the public sector rose in line with higher levels of investment: employment in the health and education sectors rose by 26.3 per cent or 439,600 and 32.6 per cent or 623,000 between 1998 and 2008.⁴

However, whilst public spending began to increase as a share of GDP, tax revenues rose at a slower than expected rate as a result of the global downturn of 2001. This had a negative impact on public finances, with the budget swinging from a surplus of 2.4 per cent of GDP at the end of the first term to a deficit which peaked at 1.6 per cent in the second term.⁵ With public sector net borrowing hovering at around 3 per cent of GDP for much of the Labour government's third term, the 2007 Comprehensive Spending Review announced measures to substantially reduce growth in public spending.

The onset of recession

The onset of the global economic slowdown and then recession in the second half of 2008 led to further deterioration in the state of public finances. As unemployment has increased and businesses have struggled financially during six consecutive quarters of negative growth, expenditure on automatic stabilisers, such as welfare, has increased, whilst tax revenues have collapsed. By November 2009 government revenues were down 9.1 per cent, whilst expenditure had increased by 6.0 per cent. Oxford Economics estimate that automatic stabilisers will, on average, keep the budget deficit 3 per cent of GDP higher each year between 2009 and 2013.⁶ In addition, the full and partial nationalisation of British banks has added significantly to government debt.

A tentative recovery

Following the most severe drop in economic output since the 1930s, the UK economy finally emerged from recession in the third quarter of 2009. Growth – of just 0.4 per cent between October and December

¹ HM Treasury (2002) Pre Budget Report. Annex B: Part 1, http://www.hm-treasury.gov.uk/prebud_pbr02_repannxb1.htm

² HM Treasury (2000) Budget 2000

³ HM Treasury (2002) Budget 2002

⁴ Annual Business Inquiry – Workplace Analysis (1998 – 2008), based on The Work Foundation definition of Education and Health. All figures rounded to the nearest 100

⁵ Oxford Economics analysis for the Core Cities

⁶ Oxford Economics analysis for the Core Cities

2009 and 0.2 per cent between January and March 2010⁷ – restarted slowly and it is clear from recent employment, public borrowing and business investment figures that the recovery remains tentative and fragile.

- **Public sector borrowing:** Public sector net borrowing – the difference between the Exchequer's tax-take and its spending – stood at £43 million in January⁸ and £12.4 billion in February. The result of falling tax revenues, this compares with a repayment of £5.27bn in January 2008.
- **Business investment:** ONS figures show that business investment in the last quarter of 2009 slumped by 5.8 per cent from the previous quarter and by 24.1 per cent compared to the fourth quarter of 2008.⁹ This represents the largest annual decline since records began in 1967.
- **Trade deficit:** Despite the devaluation of sterling and hopes of an export-led recovery, the UK's trade deficit widened to £8.0 billion in January 2010.¹⁰
- **The labour market:** Whilst ILO unemployment¹¹ fell slightly by 3,000 to 2.46 million in the last quarter of 2009 the number of people claiming Job Seekers Allowance rose by 23,500 between December 2009 and January 2010 to reach 1.64 million.
- **Employment outlook:** The latest CIPD quarterly Labour Market Outlook¹² suggests that redundancies in both the public and private sectors are set to accelerate during the first three months of 2010. According to the survey of 700 HR professionals, one in four employers across all sectors planned to make redundancies in the first three months of the 2010, cutting an average 6.2 per cent of their workforce (compared with 3.8 per cent in the previous quarter).

The combination of weak economic growth, continuing unemployment, high public debt and high demands on the public purse are such that central government is projected to run a record deficit in 2010/11. The need to reduce the deficit has clear implications for public spending over the next decade and beyond.

Implications for public spending

Politicians of all parties have committed to reducing the deficit over the four years from 2011/12 to 2015/16. Analysis by the Institute for Fiscal Studies (IFS) indicates that the tax increases and spending cuts that were announced in the 2008 Pre Budget Report, the 2009 Budget and the 2009 Pre Budget Report (PBR) will collectively amount to a fiscal tightening of 4.1 per cent of national income (£57 billion) between 2010/11 and 2015/16.¹³

Most commentators agree that further public spending cuts will be necessary. The IFS, for instance, recommends that the next government should aim for a total tightening of around 5 per cent of national

⁷ Office for National Statistics – <http://www.statistics.gov.uk/pdfdir/oienr0210.pdf>

⁸ Office for National Statistics. See <http://www.statistics.gov.uk/cci/nugget.asp?id=206>

⁹ Office for National Statistics. See <http://www.statistics.gov.uk/pdfdir/bi0210.pdf>

¹⁰ Office for National Statistics (2010) Statistical Bulletin: UK trade – January 2010, <http://www.statistics.gov.uk/pdfdir/trd0310.pdf>

¹¹ ILO unemployment

¹² CIPD & KPMG (2010) Labour Market Outlook: Winter 2009-10

¹³ IFS (2010) IFS Green Budget February 2010

income or £70 billion over the five years to 2015-16.¹⁴ This implies the need to identify a further £13 billion of tax increases or spending cuts by 2015-16 on top of those necessary to achieve the plans in the PBR. Oxford Economics suggest that a further £10 billion of tightening will be necessary to comply with the Fiscal Responsibility Bill, which commits the government to halving the deficit within four years.¹⁵

Whilst there is widespread political consensus that public spending cuts will form the bulk of fiscal tightening over the next five years, there is much debate over the timing, nature and extent of cutbacks in public spending.¹⁶

- **Timing:** The timing of public spending cuts is a key issue of contention. On the one hand, the UK must ensure that it maintains its 'triple-A' credit rating and the confidence of the markets if it is to avoid even bigger interest repayments. On the other hand, many commentators have warned that undertaking swingeing spending cuts over the next year could put the UK back into recession, given the apparently slow and tentative nature of economic recovery.¹⁷
- **Nature:** Commitments to date by the major political parties indicate that health, education and international development are likely to be spared the brunt of public spending reductions. Given that interest payments are increasing as a share of spending and that social spending is difficult to cut, this suggests that substantial cuts are likely to fall on public administration, defence and capital expenditure. Capital and infrastructure spending appears to be particularly vulnerable.
- **Scale:** The scale of public spending cutbacks over the next five years will depend to a significant degree on the nature of economic recovery: if the economy is recovering and tax receipts are growing, cuts will need to be lower; if the reverse happens, cuts will need to be higher – but finely balanced so as not to jeopardise the recovery, such as it is.

Much uncertainty over the nature, timing and scale of public spending cuts remains but a recent paper by CIPFA and SOLACE¹⁸ modelled two realistic public spending scenarios: a 7.5 per cent cut in public spending in real terms between 2011 and 2014 with the likelihood of similar cuts in the next spending round; and a 15 per cent cut over the same period, with the possibility of further, less severe, cuts in the next spending round. As the authors highlight, both scenarios involve cuts in public spending that exceed the reductions made following the recessions of the 1980s and 1990s and may well be deeper and more sustained than those made following the financial crisis of the mid 1970s, when the UK sought assistance from the International Monetary Fund.¹⁹

¹⁴ IFS (2010) IFS Green Budget February 2010

¹⁵ Oxford Economics modelling for the Core Cities

¹⁶ See for instance <http://www.timesonline.co.uk/tol/comment/letters/article7026234.ece> and <http://www.ft.com/cms/s/0/fa03538e-e2d0-11de-b028-00144feab49a.html>

¹⁷ See for instance IFS (2010) Green Budget 2010 and Daily Telegraph (2010) [Pound faces 'savage reaction' if deficit cut too aggressively](#), UBS warns, 24 February,

¹⁸ CIPFA & SOLACE (2010) After the Downturn: Managing a Significant and Sustained Adjustment in Public Sector Funding

¹⁹ CIPFA & SOLACE (2010) After the Downturn: Managing a Significant and Sustained Adjustment in Public Sector Funding

Implications for the wider economy

Reductions in public spending have relatively clear implications for public services and those employed directly within the public sector. There will inevitably be a need to increase efficiency, reduce capital spend (particularly if other sources of funding cannot be accessed), reduce headcount and the size of the wage bill.

Yet it is also important to consider the implications of public spending cuts for the private sector and wider economic growth. The relationships between the public and private sectors and wider economic growth are myriad and complex: public sector procurement of goods and services is a significant source of revenue for many private sector businesses. In addition, spending by public sector employees supports employment in a wide range of sectors, including manufacturing, retail and leisure.

Intuitively, it seems likely that broad-based cuts in public spending will have the greatest impact on places which are more dependent – directly and indirectly – on public spending and public sector employment.

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