

public sector finances and the credit crunch

David Walker asks what effect the current economic turmoil will have on the public sector's finances.

■ **How distant, antediluvian even, the March Budget now seems. Back then, before the storm became a hurricane, the Treasury was projecting that the UK economy would grow by up to 2.25% in 2008–2009.**

“Despite the impact of financial market disruption” – it said with bland self-confidence – “the Government is meeting its strict fiscal rules”. Public sector net debt, it went on, will stabilise below the 40% ceiling...

Since then, the winds have howled, producing the spectacular events of September – with consequences for spending, now and in years to come. Bail-out for banks pushes up debt, which piles up interest payments. The Chancellor, Alasdair Darling, also cut his own revenues with May's income tax rebate, postponement of fuel duty increases and September's stamp duty holiday.

tattered balance sheet

The result is a public sector balance sheet looking somewhat tattered. But it still looks a lot more wholesome than those of many a bank. In the run up to the Pre-Budget Report, Mr Darling – the man who sounded the alarm when he was on holiday in August – will be choosing his words carefully. As he puts it in his understated way “there will be bumps along the way”.

It is not obvious, yet, that they need disturb the spending plans on the table for 2008–2011 nor, in the medium run, directly impact on public sector staff and clients. But the background is bleak. Economic growth rates are sliding. Projections for this year have scaled back to just over 1%. There was no growth in the April-July quarter and when the Office for

National Statistics reports next, the word in the headlines will be ‘recession’.

As of August, tax receipts were still buoyed by the proceeds from the energy companies' profits, but the public sector deficit was also up – between April and August it was £19.3bn, compared with £10bn the previous year. Provisionally, the state spent £38.7bn more than it received in revenues in 2007–2008, which was about 2.7% of gross domestic product.

spending gap

Mr Darling now faces deceleration in revenues as the economy slows, while extra calls on spending pile in, on top of what the 2007 Spending Review allowed for. The gap between spending and revenue is where attention will focus. Just how much can the UK government borrow to cover it without jeopardising market confidence (pushing up the cost of borrowing or leading to a run on sterling) or opening another flank for attacks by opposition politicians who will want to run down ministers' credibility?

The line taken by the Chancellor and Prime Minister has been that earlier ‘prudence’ (in its early years the Blair/Brown government had pushed public borrowing down to under a third of GDP) now permits them “to let borrowing rise to support the economy and families now when they need it most”, as Mr Darling said at Labour's conference in September.

Some analysts use racier language. “Borrowing is going to rocket,” says Charles Davis of the Centre for Economics and Business Research. The Institute for Fiscal Studies projects the gap to be financed by borrowing at £65bn by the end of 2008–2009, getting on for twice the previous year's estimated total.

Gemma Tetlow of the IFS notes “this would bring the deficit to 4.4% of national income, which would be the highest level since before Labour came to power”.

size of public debt

But the big question remains not the size of public debt but when it becomes excessive or even ‘unsustainable’. Mr Darling himself says: “make no mistake, discipline in public finances is essential. In the medium term, governments everywhere have to live within their means.”

To counter recessionary forces – the collapse of the private construction industry for instance – the Government might even feel justified in expanding its capital investment programme. As it is, Building Schools for the Future, the £45bn plan for re-building all England's secondary schools by 2020 has become (an unfortunate metaphor these days) a bit of a banker for the building trades.

Together Mr Darling and his Conservative shadow, George Osborne, face the same arithmetic. Whoever is in power in mid-2010 faces an annual deficit approaching 5% of GDP and public debt well north of 40% (north of 45% if you accept that bank debt offloaded on the public accounts is there to stay). Those figures are of course dependent on how bad the financial crisis gets.

political interpretation

But it's a matter of political interpretation whether they are excessive. As for the markets, after recent events it would be naïve to claim that traders are wont to make cool and rational calculations – their judgements are often highly subjective. In fact the market judgement so far is that government debt on this scale is sustainable. Yields on long-dated gilts would be trending up if buyers feared the UK was putting its basic financial position at risk. In fact, as of early October, they are not.

The Institute for Fiscal Studies says: “the



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For his part Mr Darling has ruled out raising taxes, saying it would be 'nonsense' to take money out of the economy at this stage in the economic cycle. When borrowing needs to be cut, it's hard to see any space for going the other way and reducing tax revenues. Yet at their party conference in September the Liberal Democrats promised a 4p cut in income tax and at theirs the Conservatives were careful in what they said without concealing their fervent wish to reduce taxation.

For all those who work in the public sector – as for those who depend upon its services – the big question has to be: how far the Treasury (and behind it the Prime Minister) will push

at the envelope containing tax, spending and borrowing. Hardline economists say its boundaries ought to be fixed: the International Monetary Fund, for example, said firmly in a report in August that state borrowing should not exceed 40% of gross domestic product, with the clear implication that public spending should be slashed in order to make the adjustment.

But these are times when rules are being broken left, right and centre. And besides, to cut employment in the public sector when the jobless total is rising in the economy at large could sound like the wisdom of the Great Depression. ■

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But 'good shape' isn't a technical term from economics; it's a contested matter of judgement. Public debt would still be lower than it has been. The annual budget deficit was up around 7% in the early 1990s – in the midst of an earlier recession. High levels of

borrowing are to be expected in a downturn, it can be argued.

expand revenues

The obvious way to stabilise the public sector balance sheet is to expand revenues. But as the *Financial Times* commentator Philip Stephens asks: "what politician wants to threaten the voters with higher taxes when banks are crashing, house prices are tumbling and incomes are being squeezed by rising fuel and food prices? The snag is that politics and economics are hopelessly out of sync."