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Treasury Committee

Pre–Budget Report 2008

Second Report of Session 2008–09

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5. The insurance bond market, which was savaged in the last Budget, will also be further undermined for people with income in excess of £100,000.

December 2008

Memorandum from Professor David Heald,[6] specialist adviser to the Committee

PRE-BUDGET REPORT 2008: THE RETURN OF HARD TIMES

Introduction

1. This Pre-Budget Report (Treasury 2008b) is more important than most Budgets and therefore requires close Parliamentary attention. Extensive comments could be made on the PBR itself and associated documents, but this memorandum will concentrate on a restricted range of topics:

- the sudden deterioration of the fiscal position;
- fiscal rules in the last cycle and in the current one;
- public expenditure changes in PBR 2008;
- the implications for public expenditure of the move to International Financial Reporting Standards (IFRS); and
- issues for Parliament to take up.

The Sudden Deterioration of the Fiscal Position

2. For convenience, Table B4 (Treasury 2008b, p 192) is reproduced below. The deterioration from March 2008 to November 2008 is startling. Taking Net borrowing, for example, 2008–09 increases by 82.6%, followed by 210.5% (2009–10), 228.1% (2010–11), 222.2% (2011–12) and 204.3% (2012–13). Checking back to the comparable table in Budget 2008 (Treasury 2008a, Table C2, p 179), which compares PBR 2007 with Budget 2008, there was then only a small deterioration in the projection years. This raises questions as to:

(a) whether the Budget 2008 projections were excessively optimistic on the basis of information available at the time; and

(b) whether the PBR 2008 projections involve taking "a big bath" (so that future shocks are avoided) or there is the likelihood of further deterioration in Budget 2009.

One way of highlighting the dramatic deterioration is that the United Kingdom is projected to breach the 60% Maastricht Treaty limit in every year from 2009–10 to 2013–14 (Treasury 2008b, Table B3 on p 190).

3. Examination of Table B17 (Treasury 2008b, p 211) shows that net increases to TME since Budget 2008 are positive but small in the projection years 2009–10 (1.1%) and 2010–11 (0.3%). In contrast, the deterioration of current receipts (Table B13 on p 203) is dramatic: down by £29.8 billion in 2008–09 (5.2%) and £72.7 billion in 2009–10 (12.0%). The issue is not yet one of expenditure control in the sense of overspending against plan.[7] However, the sudden and dramatic scale of the worsening of UK public finances does reinforce the frequently made point that the UK Government was running a deficit that was too high given the general health of the economy. However, this is a criticism of expenditure policy, not of the control system.

4. Of the £74 billion deterioration in the Surplus on current budget in 2009–10 (Table B4) between Budget 2008 and PBR 2008, 17.6% is attributable to discretionary changes and 82.4% attributable to revisions and forecasting changes. Table 1.2 (Treasury 2008b, p 10) shows total policy decisions since Budget 2008 to be costing £16.330 billion in 2009–10.

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[6] Declaration of interest: the author is a member of the Financial Reporting Advisory Board, nominated as an independent economist by the Head of the Government Economic Service. The views expressed are entirely his own.

[7] This view is supported by the End of Year Fiscal Report (Treasury 2008d), which covers 2006–07 and 2007–08.

Table B4

FISCAL BALANCES COMPARED WITH BUDGET 2008

	Outturn[1]	*Estimate*[2]		*Projections*		
	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
Net borrowing (£ billion)						
Budget 2008	**36.4**	**42.5**	**38**	**32**	**27**	**23**
Changes to current budget	−1.2	31.6	74	77	65	56
Changes to net investment	1.4	3.5	5½	−4	−5½	−8
2008 Pre-Budget Report	**36.6**	**77.6**	**118**	**105**	**87**	**70**
Surplus on current budget (£ billion)						
Budget 2008	**−7.9**	**−9.6**	**−4**	**4**	**11**	**18**
Effect of revisions and forecasting changes	1.2	−23.3	−61	−78	−75	−72
Effect of discretionary changes[3]	0.0	−8.3	−13	1	10	16
2008 Pre-Budget Report	**−6.7**	**−41.2**	**−78**	**−73**	**−54**	**−37**
Net investment (£ billion)						
Budget 2008	**28.5**	**32.9**	**35**	**37**	**38**	**41**
Effect of revisions and forecasting changes	1.4	2.5	2½	−½	−2	−1½
Effect of discretionary changes[3]	0.0	1.0	3½	−3½	−4	−6½
2008 Pre-Budget report	**29.9**	**36.5**	**40**	**33**	**33**	**33**
Cyclically-adjusted surplus on current budget (per cent of GDP)						
Budget 2008	−0.7	−0.5	0.1	0.5	0.8	1.0
2008 Pre-Budget Report	**−0.8**	**−2.8**	**−4.4**	**−3.4**	**−2.3**	**−1.6**
Cyclically-adjusted net borrowing (per cent of GDP)						
Budget 2008	2.7	2.7	2.2	1.8	1.5	1.2
2008 Pre-Budget Report	**2.9**	**5.3**	**7.2**	**5.6**	**4.3**	**3.5**
Net debt (per cent of GDP)[4]						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
2008 Pre-Budget Report	**36.3**	**41.2**	**48.2**	**52.9**	**55.6**	**57.1**

Note—Totals may not sum due to rounding.
1 The 2007–08 figures were estimates in Budget 2008.
2 The 2008–09 figures were projections in Budget 2008.
3 Including changes in forecasting assumptions on spending growth in 2011–12 and 2012–13.
4 Debt at end March; GDP centred on end March; excluding financial sector interventions.
Source: reproduced from Treasury (2008b, p 192).

Fiscal Rules Over the Last and Current Cycles

5. In The Government's Fiscal Framework (Treasury 2008c), the fiscal framework is given a clean bill of health for the last cycle. Table B2 (Treasury 2008b, p 189) presents data in a tabular form and Chart 2A (Treasury 2008c, p 27) focuses on the golden rule. The Treasury (2008e, p 3) has now dated the last economic cycle, as having started in the first half of 1997 and ended during the second half of 2006.

Table B2

SUMMARY OF PERFORMANCE OF FISCAL POLICY OVER THE PREVIOUS CYCLE

	Per cent of GDP										
	1996–97	*1997–98*	*1998–99*	*1999–2000*	*2000–01*	*2001–02*	*2002–03*	*2003–04*	*2004–05*	*2005–06*	*2006–07*
Golden rule											
Surplus on current budget		−0.1	1.2	2.2	2.4	1.2	−1.0	−1.5	−1.6	−1.1	−0.3
Average surplus since 1997–98		−0.1	0.5	1.1	1.4	1.4	1.0	0.6	0.3	0.2	0.1
Cyclically-adjusted surplus on current budget		−0.1	0.9	1.7	1.6	0.9	−0.7	−1.3	−1.5	−1.0	−0.3
Sustainable investment rule[1]											
Public sector net debt[2]	42.5	40.6	38.4	35.6	30.7	29.7	30.8	32.2	34.1	35.4	36.0
Core debt[2]	41.1	39.2	37.4	35.1	31.0	30.2	31.0	32.2	34.0	35.2	35.9

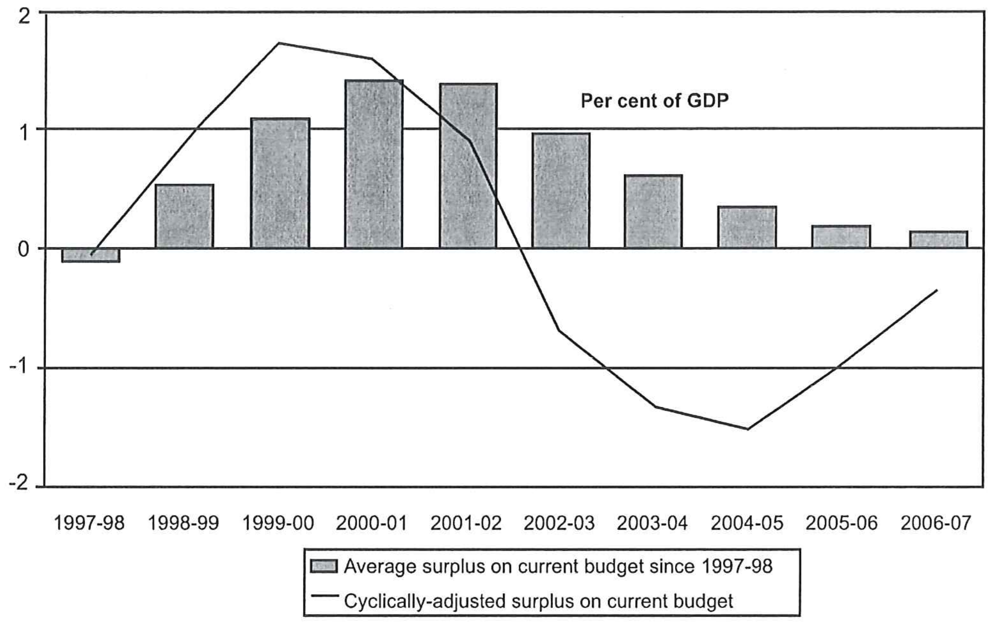
1. As debt is a stock measure, performance against the sustainable investment rule is measured against the end point of the previous cycle.
2. Debt at end March; GDP centred on end March.

Source: reproduced from Treasury (2008b, p 189).

This is not the place to recount the saga of the dating of the last cycle, or how the Treasury has alienated many commentators and bred an air of cynicism about the fiscal rules. Although showing that the golden rule was met in the last economic cycle Table B2 also records that there was a deficit on the current budget in every year from 2002–03. For the same period, there was in each year a cyclically-adjusted deficit on current budget.

6. In Chart 2A, the bars plot cumulative achievement, showing that the surplus attributable to the first half of the economic cycle was almost eliminated in the second half. The solid line emphasises the same point by plotting each year's cyclically adjusted surplus on current budget. Table B2 shows that the sustainable investment rule, about which there has been ambiguity as to whether it applied to each and every year or over the cycle,[8] was met in every year except the first two (1996–97 and 1997–98) years of the last cycle.

Chart 2.A: Meeting the golden rule



Source: HM Treasury

7. A key decision in PBR 2008 has been to suspend these fiscal rules for the present cycle. This is permissible under the Code for Fiscal Stability (Treasury 1998, para 11):

> 11. The Government may depart from its fiscal objectives and operating rules temporarily, provided that it specifies:
>
> a. the reasons for departing from the previous fiscal policy objectives and operating rules;
>
> b. the approach and period of time that the Government intends to take to return to the previous fiscal policy objectives and operating rules; and
>
> c. the fiscal policy objectives and operating rules that shall apply over this period.

Given the exceptional circumstances, there will be a temporary operating rule for the current cycle:

> 3.11 Consistent with the Code for Fiscal Stability, the Government is setting a temporary operating rule: to set policies to **improve** the cyclically-adjusted current budget each year, **once** the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP **once** the global shocks have worked their way through the economy **in full**.
>
> 3.12 The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015–16 when the global shocks will have worked through the economy **in full**. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5% of GDP a year from 2010–11 (Treasury 2008c, p 47, emphasis added).

[8] "The Government's specification of the level below which public sector net debt should be held over the economic cycle developed over time. In the 1998 Economic and Fiscal Strategy Report (EFSR), the Government stated "other things equal, it is desirable that net public debt be reduced to below 40% of GDP over the economic cycle". At the 2001 Budget, the Government stated "other things equal, net debt will be maintained below 40% of GDP over the economic cycle". At the 2003 Budget, the Government stated that to "meet the sustainable investment rule with confidence, net debt will be maintained below 40% of GDP in each and every year of the current economic cycle" (Treasury 2008c, para 1.42).

This quotation, with certain words put in bold for emphasis, indicates the highly conditional nature of this policy commitment. Also, it places a huge weight on the technical process of cyclical adjustment.

8. The Treasury made two important innovations in PBR 2002, namely the annual publication of the End of Year Fiscal Report and the Long-Term Public Finance Report. Because of the early timing of PBR 2007 (which was combined with the Comprehensive Spending Review), the Long-Term Public Finance Report that would have been published then was published alongside Budget 2008. Notwithstanding the reversion to normal PBR timing, there is no Long-Term Public Finance Report in the set of associated PBR 2008 documents. PBR 2008 (Treasury 2008b, para 2.116 on p 41) states that "The next Long-term public finance report will be published in 2009". This presumably refers to Budget 2009. The long-term fiscal projections sit on top of the five-year medium-term forecast, which has dramatically deteriorated since Budget 2008. The size of the fiscal adjustments required to restore fiscal sustainability (as defined in successive issues of the Long-Term Public Finance Report) is a topic to which the Committee may wish to give priority at the time of Budget 2009.

9. Box 2.4 (Treasury 2008b, p 31) contains an important statement:

> As any extra liabilities that may become classified to the public sector through these [financial sector] interventions will be temporary and backed by significant financial assets, they do not reflect future calls on the taxpayer. The long-term impact on the public finances, and any burden on future generations, would be determined by any eventual economic profit or loss incurred on the interventions. **As a result, consistent with the treatment of Northern Rock announced in Budget 2008, while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on public sector net debt both including and excluding the impact of these interventions.**
>
> The Government will base its fiscal policy, and measurement of its fiscal rules, on aggregates that exclude that impact. Any economic profit or loss on interventions will be included in both measures (and so within the fiscal rules) when that profit or loss crystallises for central government. Annex B sets out in full how the support has been accounted for in the public finances (emphasis in original).

This statement strikes an optimistic note as to whether these massive interventions will have a net Exchequer cost. Given their exceptional nature, the proposal to report both "including" and "excluding" is reasonable, provided that this is done clearly. Annex B is disappointing in this regard, containing not much more than the explanatory listing in Box 3 (p 220) and the composition of the public sector net cash requirement. Moreover, there is a question of what "crystallizes for central government" is taken to mean: for example, in the context of bank shares acquired at above current market prices.

Public Expenditure Changes in PBR 2008

10. The significance of the public expenditure changes exceeds their numerical value. The present author cannot remember any occasion since the Spending Review system was established in 1998 when the multi-year settlement has been re-opened in such a way. One of the features claimed for this system has been that it enables departments to plan ahead. The euphemism of "Public spending: additional value for money savings" in Table B5 (Treasury 2008b, p 194) marks a reduction of £5 billion in planned spending in 2010–11 (the third and final year of CSR 2007) and in 2011–12 (the first year of the next Spending Review). These have not yet been allocated to departments.[9] There has been a re-profiling of capital spending, with £3 billion brought forward from 2010–11 to 2008–09 and 2009–10.

11. Looking beyond the current CSR period, there has been a reduction in forecast real spending growth. Total Managed Expenditure (TME) is assumed to grow at 1.1% on average in real terms over the period 2011–12 to 2013–14 (Treasury 2008b, para 2.51). In contrast, Budget 2008 (Treasury 2008a, para 2.67) had forecast real-terms TME growth of 1.9% on average over the period 2011–12 to 2012–13. Giles (2008) calculated that reductions in public expenditure plans are forecast to contribute £35 billion of the £104 billion fiscal adjustment required to restore balance by 2015–16.[10] Given the complexity of problems confronting major functional areas of spending and the pressures arising from recession, the public expenditure climate on the ground is going to be very tough after many years of strong growth. For the first time since the Departmental Expenditure Limit/Annually Managed Expenditure distinction was introduced in 1998, it seems inevitable that, within a fixed TME, DEL will come under pressure from AME as a result of rising debt interest and recession-induced social security costs.

12. There is a clear indication from para 6.26 and Box 6.4 (Treasury 2008b, p 117 and p 119) that the Government will seek to dispose of public sector businesses and assets. Leaving aside the issue of whether or not the named businesses belong in the public or private sectors, hurried sales into depressed markets have a record of producing bad outcomes. In any case, asset disposals represent a portfolio adjustment (ie exchange assets for cash) and do not address the issue of properly measured deficits and debt.

[9] "The Barnett formula will be applied as usual to the devolved administrations' budgets when reductions to departments' budgets are announced" (Treasury 2008b, para 6.32).

[10] The other contributions come from tax increases (£19.5 billion), fiscal drag (£29.8 billion) and the effects of economic growth (£19.7 billion) (Giles 2008).

THE IMPACT OF IFRS ADOPTION IN 2009–10

13. In my memorandum to the Committee on Budget 2008 (Heald 2008), I drew attention to the implications of the adoption of International Financial Reporting Standards (IFRS), from 2009–10 in central government and 2010–11 in local authorities. It is widely expected that most Private Finance Initiative (PFI) assets currently off the public sector client's balance sheet will go on balance sheet under IFRS. However, this is a change relating to financial reporting (eg resource accounts) and not to the national accounts on which the fiscal aggregates are based. In terms of a spectrum as to the difficulty of keeping PFI assets off the public sector client's balance sheet, IFRS is stricter than FRS 5A (ASB 1998), which is stricter than Treasury Technical Note 1 (Revised) (Treasury Taskforce 1999). However, the Eurostat (2006) guidelines are even more permissive of off-balance sheet treatment than Treasury Technical Note 1 (Revised). Thus far, the Office for National Statistics has been following the financial reporting treatment, as it does not have the resources to make judgements on individual schemes: the implication is that more PFI is currently on balance sheet in the UK national accounts than is required by Eurostat guidance. There are very important questions as to how PFI assets and liabilities will be reported in fiscal documents after the implementation of IFRS brings most PFI assets on balance sheet in resource accounts.

ISSUES FOR PARLIAMENT TO TAKE UP

14. Governments display a general disdain for Parliament in budgetary matters, treating it as a rubber stamp or irrelevant. Each Budget or PBR is heavily trailed in the media beforehand, softening up public opinion and granting favours to chosen media outlets. Some of the leaks about PBR 2008 seem to have been genuine leaks discomforting the Government, rather than plants. Commendably, MPs secured an Emergency debate on PBR 2008, in recognition of that being a landmark financial statement. Deeply embedded characteristics of UK politics militate against constructive engagement by Parliament in budgetary matters. Nevertheless opportunities arise when governments are weakened. There follow three suggestions as to actions that Parliament in general, and the Treasury Committee in particular, might take up.

15. First, in The Government's Fiscal Framework (Treasury 2008c), the document showing that the fiscal rules were met in the last economic cycle, there are eight substantive references to the role of the National Audit Office (NAO) in auditing the assumptions behind the Treasury's macroeconomic forecasts. Heald and McLeod (2002, para 505) warned against this role for the NAO:

> The NAO does not audit the forecasts, its role being to ensure that these forecasts of the public finances are based on assumptions that are transparent and widely regarded as reasonable. However, the NAO can only audit the assumptions that the Treasury puts to it, though since the March 2000 Budget there has been a rolling review of previously audited assumptions. Thus far, the assumptions embodied in earlier macro forecasts have not been seriously tested by events. In such an eventuality, the NAO could be seen to be implicated in forecasts that later came under challenge, thus deflecting blame from the Treasury and potentially creating difficulties in its relationship to Parliament and its committees. Although the NAO only audits certain forecasting assumptions, and not forecasting systems or methodology, this distinction might be lost in practice.

There are two central problems in this role, the latest instalment being reported on in National Audit Office (2008).[11] First, the NAO does not have, nor could it have, the technical macroeconomic expertise to match that of the Treasury. Second, this arrangement ("look only at what we ask you to look at") breaches the fundamental postulate of auditing that there must be independence to investigate as well as independence to report. Parliament should ask the NAO how it proposes to gain release from this inappropriate task and then devise genuinely independent and competent monitoring arrangements.

16. Second, tax policy-making in the United Kingdom has become shambolic. Examples of this are easy to find: the saga of the abolition of the 10p rate; the taxation of Non Domiciles; the marginal income tax rate profile created by (partial) withdrawal of personal allowances at £100,000 and £140,000; and the effective closing down of future VAT options after the posting of the wrong document on the web. Whether this situation is the fault of ministers or of officials is difficult to judge from outside. Given the forthcoming fiscal consolidation, there is an obvious danger that, one by one, viable options will be ruled out by those facing immediate political pressure. There is a clear role for the Treasury Committee in examining taxation options, establishing an information base and perhaps building some form of consensus. The forthcoming Mirrlees Report, commissioned by the Institute for Fiscal Studies, might provide a convenient peg on which to hang such an inquiry.[12]

17. Third, the smell of pork barrel emanating from the passage of the US Troubled Assets Relief Program is offensive. However, Congress counts in budgetary matters in the way that the UK Parliament does not. Whereas the Treasury owns public expenditure aggregates and changes them at will, Parliament does own

[11] This included dating the end of the most recently completed economic cycle.

[12] Information about the Mirrlees Review, and draft versions of chapters that will appear in the supporting second volume, can be found at http://www.ifs.org.uk/mirrleesreview/publications.php.

the Estimates system.[13] The Treasury (2008f) is currently consulting Parliament and other stakeholders on the Alignment project, intended to simplify budgetary documents and—as far as possible—align Budgets with Estimates and Resource Accounts. Much of what the Treasury wants seems reasonable, though care is needed about the detail: for example, on the timing of information and on there being systematic overviews of departmental information. Implemented well, there are gains for Parliament as well as for the Government, but Parliament should exploit the leverage its ownership of Estimates potentially confers over the broader question of how financial information is reported to Parliament.

30 November 2008

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[13] "Under established usage ... important changes in the customary form of the Estimates should not be made without the previous approval of the Committee of Public Accounts ... and, since 1921, of originally the Estimates Committee, subsequently the Expenditure Committee and now the Treasury Committee, acting on behalf of the House of Commons" (Limon and McKay (eds) 1997, p 744).