SHRINKING THE STATE

The difficulty of cuts and what can be done

Meghnad Desai and Peter Kenway

new policy institute

ABOUT THE AUTHORS

Meghnad Desai is Professor Emeritus of Economics at the LSE. He is founder of LSE Global Governance. From 1990-1995 he was Director of LSE's Development Studies Institute and has been at the LSE for over 30 years. In 1991, Meghnad Desai was created Lord Desai of St Clement Danes. His latest book is *Marx's Revenge: The Resurgence of Capitalism and the Death of Statist Socialism*.

Peter Kenway is director and co-founder of the New Policy Institute, an independent think tank established in 1996. A professional economist, his interests range from the many aspects of poverty and social exclusion (arising from NPI's long collaboration with the Joseph Rowntree Foundation) to the history of the (mis)management of the economy. He is a member of the Wales Assembly Government's Ministerial Advisory Group on child poverty. He recently served as a special adviser to the House of Lords Committee on the Barnett Formula.

SHRINKING THE STATE

The difficulty of cuts and what can be done

MEGHNAD DESAI AND PETER KENWAY

CONTENTS

Summary

All major political parties now accept that the public sector deficit must be cut and the growth in the debt brought under control. With total public spending as a share of GDP close to the 1975 record, and with current spending (excluding investment) at record levels now, all parties must also accept that the great bulk of the adjustment must come through getting spending down rather than putting taxes up.

History show how difficult it is to get current spending down (investment spending is a different matter). Years in which current spending has been cut in real terms are rare: just four in the last forty years, none of them (contrary to what both left and right fondly believe) in the tumultuous early 1980s. Over these four decades, there has never been a year in which current public spending has been cut in cash terms.

Against the historical difficulty of cuts must be set the strength and longevity of the period of growth in current public spending, in excess of GDP, not just during the recession but since 2002/03. If the 40 year spending record means that a sustained programme of real cuts proposed by the next government would be unprecedented, the more recent growth means that what is unprecedented should not be unthinkable.

To succeed, the new government must develop a language of priorities to adjudicate between competing claims for public money. With social protection, health and education absorbing two thirds of current public spending, choices have to be made both between these three large areas and also within them, for example between children and pensioners. Politicians and public alike also need to appreciate how things like the aging population, or the growing number with the qualifications and ambition to enter university, drive public spending and mean that is only ever partially under political control.

The Comprehensive Spending Review promised for after the election is the place where these choices will be made. All previous reviews have been conducted in periods of growing public expenditure. This one won't. Not only does the public have a right to be involved, only by involving it can the next government expect to get through.

Introduction: the challenge of fiscal policy

All the major political parties agree that cutting the deficit and bringing the burden of debt under control is the principal challenge facing the next government - though none is willing to face the full extent of it before polling day. There are some differences among them as to when to start: immediately and risk the recovery or delay and lose credibility with the markets. Either way the size of the task is unprecedented. In this essay we ask whether the past experience of the British economy can be any guide.

The task is daunting. The UK deficit is, at 11.8% for 2009-10 and 11.1% in 2010-11, the highest in recent memory. While some of this deficit is due to the recession which struck in 2008, almost three quarters of it (8.4% in 2009-10) is 'structural', that is, it predates the recession.[1] Even if the cyclical deficit melts away as the economy recovers, the structural deficit will remain. It is the size of this structural deficit that makes the task unprecedented.

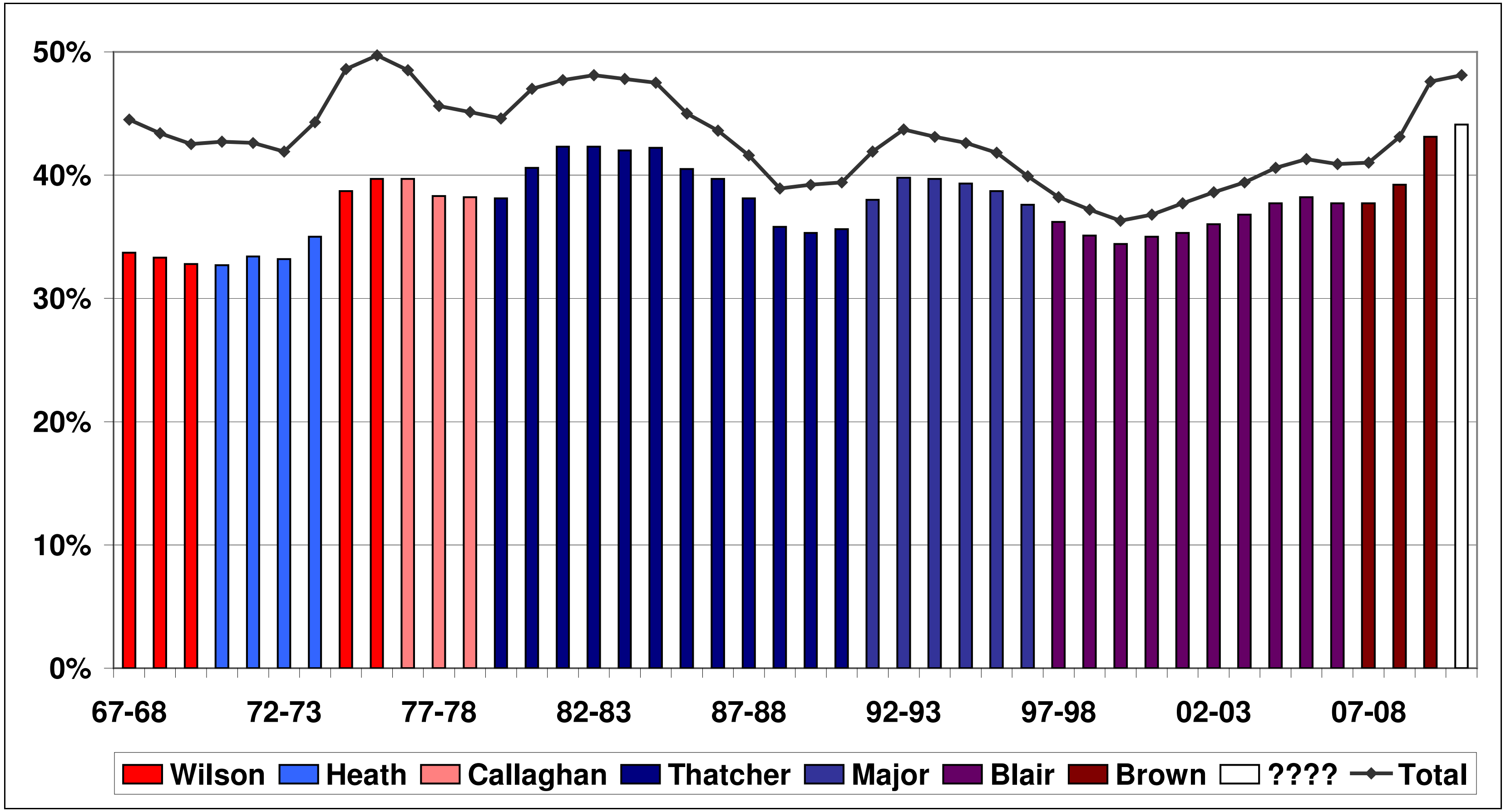
There is a related problem of the Debt-GDP ratio. We take it that the urgent task of any incoming government will be to control expenditure so as to rein in the deficit. The outcome on debt will depend among other things on how markets perceive the government's determination to tackle the deficit and thus lend money at reasonable interest rates. The deficit problem has to be tackled in the course of the next parliament. Debt will take more than one parliament to get under control.

Although the debate so far has been about the deficit and the consequent growth in public sector debt, the fundamental issue is the size of the State as measured by the overall level of public spending. The reason why we say this is that public spending as a proportion of GDP (that is, as a share of all spending in the economy) is, at a projected 48% in 2010/11, close to a record high (figure 1). While the deficit could in principle be reduced by raising taxes, that cannot be sufficient when the spending share is at a near record level. In short, there is no alternative but that the State must shrink: This is the challenge of fiscal policy. The question then is: how far should we aim to go?

---

[1] HM Treasury, *Budget 2010*, table C2

Figure 1: Current and total public expenditure as a share of GDP, 1967-68 to 2010-11



Source: HM Treasury, *Public Expenditure Statistical Analysis 2009,* table 4.1.

The politics of welfare spending

The mythology of British public life is that Labour chooses a large State while Conservatives choose a small one. Labour warns against the dire history of Tory cuts, especially Thatcher's cuts, while Conservatives warn of Old Labour's love of a bloated State. History alas is not friendly to such mythmaking.

Looking at the historical data since Harold Wilson's 1960s government, the surprising thing is that the size of the State is not a matter of political ideology. It is simply not the case that the Tories have always had a smaller State and Labour a larger one. Both the lowest level (36% of GDP in 1999/00) and the highest (50% in 1975/76) occurred under Labour governments. If we judge Prime Ministers by the average share during their years in office, Wilson and Callaghan are at the top with 46% while Blair at 39% is at the bottom. Brown, like Thatcher, is on 44%.

But in debating how far to shrink the State, *total* public spending is not quite the proper focus of attention. That is because this total includes public investment. There are several reasons why investment should be excluded from consideration. First, the scale of public investment used to be much higher than it is now. Until the mid 1970s, net investment was as high as 5-6% of GDP. In the 2000s, net investment was just 1-3%. From the 60s to the 80s, public spending cuts fell mainly on investment, largely the investment projects of nationalised industries. During the 1980s the Thatcher Government got net investment down as low as 0.3% by 1988-89 Net investment did not hit 2% till 2007-08. Investment is thus best left out if one is to consider the urgent task of deficit reduction. [2]

Second, investment decisions involve long run considerations which go beyond one or even two parliaments. Since investment creates long-lasting assets it is also an appropriate way to spend borrowed money. Gordon Brown's Golden Rule, that the government should only borrow for investment purposes, reflected this. The Rule was breached often . Yet it is a sound principle. In line with it, we take *current* public spending ('total managed expenditure' less 'gross public investment') as the measure of the size of the State . This is the sum which will need to be cut even as we protect investment programmes for green or other initiatives.

---

[2] HM Treasury, *Budget 2010*, table C18

Third, once investment is excluded, current public spending as a share of GDP *has been, and continues to be,* at record levels: 43% in 2009/10 and 44% in 2010/11. This is well above the average since the late 1960s of 38%. It is also up even more than the 36% that Labour inherited in 1997. While it may reasonably be said that even New Labour believed in increasing public spending, the important point here is that current spending as a share of GDP still stood at only 36% as recently as 2002/03.

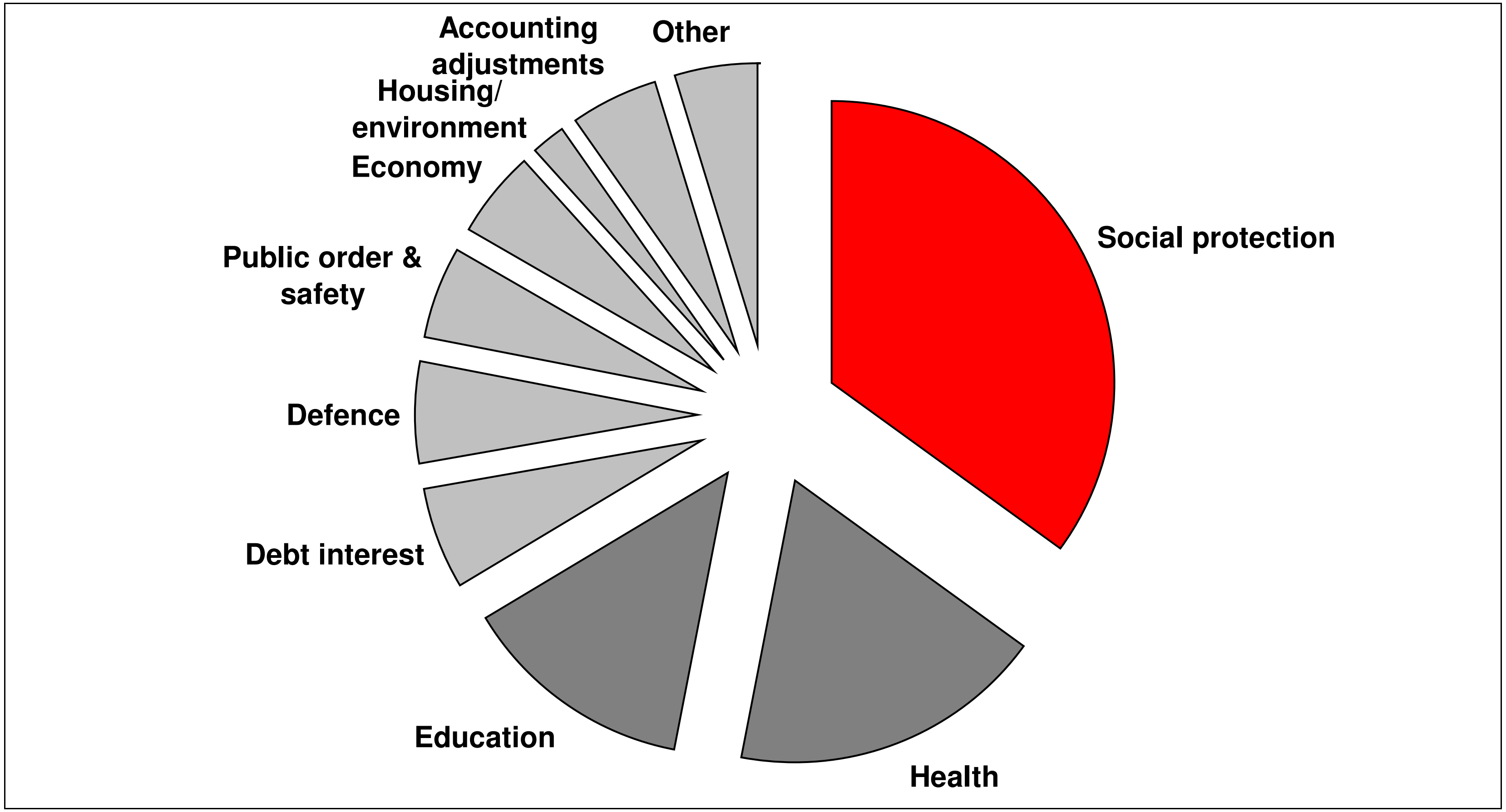
Where the money goes

If current public expenditure has risen by a half in real terms over the last decade, where has the money gone? Clearly enough, that question cannot be answered in detail without venturing into a quagmire of statistics. Since that is not a place we want to go in this paper, our answers for the most pat are restricted to be what can be concluded from high level statistics only. In addition, statistics can only safely be compared if they have been put together on exactly the same basis. As a result, the analysis here is based on data published in the annual *Public Expenditure Statistical Analysis*.

There are two drawbacks with this. First, other than at the aggregate level, this publication provides a detailed breakdown of current spending up to 2008/09 but not beyond. Second, it does not offer a consistent series for the different current expenditure back to 1997/98. Although the first problem cannot really be got round, meaning that we have data for only one year of the recession, we can get round the second by exploiting the fact that at current expenditure's share of GDP in 2002/03 was almost identical to the 36% in 1997/98. For the purposes of this comparison, therefore, 2002/03 will serve as the baseline.

Over the six year period from 2002/03 to 2008/09, current expenditure grew 43% in cash terms and 23% in real terms. In the latter year, total current expenditure totalled £564bn. By way of introduction, and before looking at where the extra money went, figure 2 shows how that £564bn was distributed across ten categories of spending in 2008/09.

Figure 2: The share of annual current spending in 2008/09 by category



Source: HM Treasury, *Public Expenditure Statistical Analysis 2009,* table 5.4. Of the categories shown there but not here, 'housing and community amenities' and 'environmental protection' have been combined. Note that the colour scheme here is purely for effect.

The first point to note is that the total can be divided into three roughly equal groups. The first of these, and by far the largest single category in its own right, is what is called social protection with 35%. The second group is made up of health (18%) and education (13%): The final group, containing all the other categories, accounts for the rest. With the exception of housing and environment with just 2% of current spending, all the other categories in this group each accounted for about 5% of total current spending.[3]

Most of the categories of spending shown here can be left to stand without further explanation.[4] The one exception to this is 'social protection', by far the largest category totalling some £200bn in 2008/09. In round terms, some 15% went on personal social services with the remainder going on 'benefits' of all kinds including tax credits. In round terms, the main components of that remaining 85% are (in round terms) as follows:[5]

- State Retirement Pensions (to which people are entitled through the national insurance contributions they have made): 30%.[6]
- Other contribution-based benefits: 5%
- Non-contributory, non income-based benefits (chiefly for disability): 10%.
- Child Benefit: 5%.
- Income-based (means-tested) benefits 20%.[7]
- Tax Credits: 10%.

---

3 Housing and environment is more significant when it comes to capital spending. Indeed, when combined together like this, they were the largest single category in 2008/09, accounting for nearly a quarter of all gross investment.

4 As a matter of definition: 'economy' is made up economic development, science and technology, employment policies, agriculture and transport; 'other' includes general public services, recreation and culture, and the EU.

5 Source: *Department for Work and Pensions*, 2009, Benefit Expenditure Tables (table 5). The components do not sum to 85% because of rounding.

6 This includes both the Basic State Pension and the State Second Pension and its predecessor SERPS.

7 Of this, the biggest single element (accounting for two fifths) is Housing Benefit while the next biggest (one fifth) is means-tested Pension Credit.

One point to note here: the share of all this that is there simply to supplement the incomes of workless, working-age adults is about £10bn, or just 5% of the total amount for social protection. This sum represent the total amount shown for working-age, income-related benefits less Housing and Council Tax Benefits.

The growth in spending before the recession

We now turn to the question of how current spending has risen from 36% of GDP in 2002/03 to more than 43% now.

Outside of a recession, rising real spending will only cause the spending *share* to rise if its growth rate is faster than that of GDP. Over the five years prior to the recession, from 2002/03 to 2007/08, real GDP grew 14%. Figure 3 therefore divides the change in annual real expenditure for each of the main categories of current expenditure over that period into two parts:

- 'GDP-matching' real growth equal to 14% of spending in 2002/03. If every category of spending had grown by this amount, the share of GDP in 2007/08 would have been the same as in 2002/03:

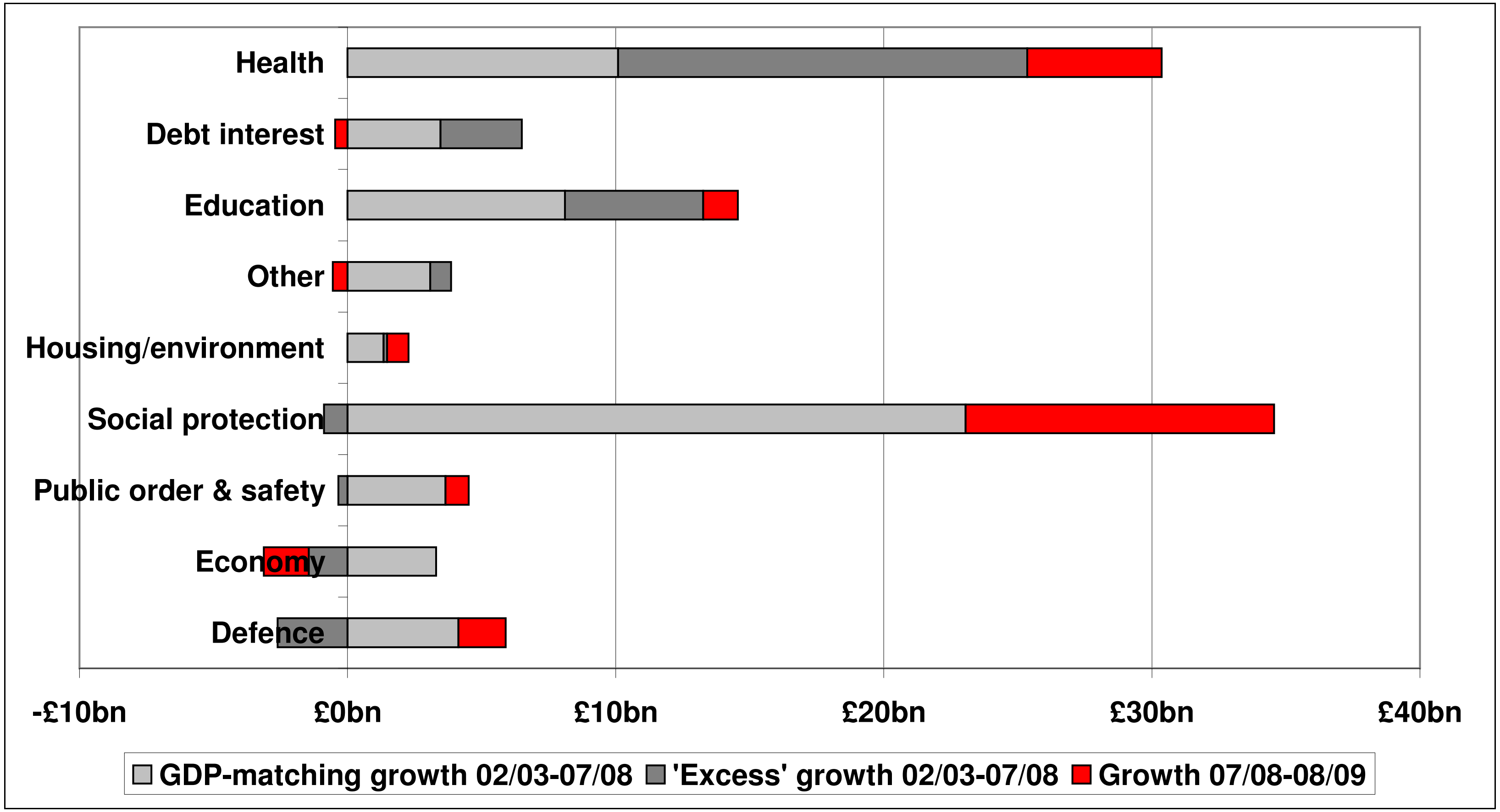
- The 'excess' of actual real growth to 2007/08 over the 'GDP-matching' real growth. In practice, this 'excess' can be positive or negative depending on whether actual real growth was more or less than 14%.

Figure 3 then also shows the total real growth in the one recession year shown here, 2008/09.

So what can we conclude? To start with, over the five years prior to the recession, *all* categories of current expenditure grew in real terms. Some grew faster than GDP (chiefly health, education and debt interest) and some slower (chiefly defence and economy), but all nevertheless grew.

The category of expenditure which grew the most over the five years was health. Its £25bn real growth was more than twice what was needed to match GDP. The resulting 'excess' of £15bn, taken together with the £5bn in education, account for almost all of the total 'excess' over the five years. As a result, almost all of the increase in the share of total current spending in GDP over that period can be attributed to the excess growth in these two categories alone.

Figure 3: Change in real annual current spending, 2002/03 to 2008/09



Source: HM Treasury, *Public Expenditure Statistical Analysis 2008* and *2009,* table 5.4. Of the categories shown there but not here, 'housing and community amenities' and 'environmental protection' are combined while 'accounting adjustments' is omitted. Real expenditure by category is derived from the published cash figures by applying the deflator for total current expenditure.

Although social protection grew by only a little less than health in total, its rate of growth rate was actually slightly less than that of GDP (hence the negative ‘excess’). Yet since the cash value of most social security benefits only goes up each year in line with prices rather than incomes or GDP, it should have grown by much less still. So why didn’t it?

Although a full answer is beyond this paper, it is worth noting the main factors because they exemplify points that will crop up elsewhere. First, while most benefits rise only with prices, neither tax credits nor pension credit are so restricted. This reflects a deliberate choice by government.

Second, spending on Housing Benefit (the single biggest means-tested benefit) is only partly and indirectly the result of policy choice. Third, rising State Pension payments reflect the rising number of pensioners, that is, the demographic factor. Finally, sharp rises in payments for the State Earnings Related Pension reflect both demographics as well as policy decisions in the distant past about which little can now be done.

Analysis of spending in health, education or any other area would no doubt reveal a similar combination of factors only some of which, and even then only to some extent, are within the government’s control.

The growth in spending during the recession

Moving onto the recession, figure 3 shows that in its first year, most categories of expenditure grew in real terms. Social protection (£11bn) and health (£5bn) account for most of that growth, but defence, public order and education also saw significant rises. These increases are large but (as per figure 4), hardly exceptional. Had the economy continued to grow at 2½%, the share of spending in GDP would have increased only slightly.

Some of the increase in social protection is a direct result of the recession, for example, higher spending on Jobseeker's Allowance (JSA) for those made unemployed. In fact, however, the total rise in JSA that year was just £0.6bn, a fraction of the overall increase in social protection.[8] Certainly, some of the extra money going on tax credits, sickness benefits, and housing benefits should also be counted as an effect of the recession.[9]. Yet as in the preceding years, both discretionary decisions (about the level of tax credits) and demographic factors (affecting pensions) also had a big effect.

When the real increases in health, education, defence, public order, housing and environment are taken into account (as well as the real reductions in other categories of spending), it is likely that no more than one third of the total real increase in spending in 2008/09 is a direct result of the recession.

Comparable data for 2009/10, broken down by category, has not yet been published. To the extent that indicative conclusions can be drawn from published data on capital and current spending combined, it would appear as if current expenditure rose in real terms across most spending functions, with social protection and health once again taking the largest share.[10]

---

8 Source: *Department for Work and Pensions*, 2009, Benefit Expenditure Tables (table 5).

9 The effect of the recession on tax credits comes both from a higher overall number of recipients and from an increase in the amounts claimed as people with still jobs reduce their hours worked.

10 Based on our analysis of the figures for total managed expenditure in H.M. Treasury, *Public Sector Finances Statistical Bulletin*, February 2010 table B4.

Information published as part of the Budget shows that spending on benefits and tax credits rose £17bn in 2009/10, a 10% increase. Within this total, payments on JSA rose by £2bn while spending on tax credits rose by £3bn.[11] Even if we allow all of this increase to be ascribed to the recession, with similar amount again for other benefits, the automatic increases in social protection due to the recession represents no more than a quarter of the total increase in spending.[12] In both years, therefore, most of the increase in current spending coincident with the recession has nevertheless not been a direct consequence of it.

Shrinking the state

In deciding how far to go in shrinking the State, we are a making a judgement about the size of the 'core' of the welfare state. Is the optimum size of the State whatever it is at present or even what it was before recession hit the UK economy? Or is there a lower size which we should aim for? Should we aim to get all the way back there – or do we take the view that the recent increases in the provision of health, education and social transfer payments are now part of the core and the size should be 40%?

These questions, and the political choices they present, are among the most pressing facing the next government. We are not going to try to answer them here because it is not the place to do so. But what we can do is see what history says about the prospects. Is cutting a matter of political ideology? Does history show who cuts deepest? There is much talk of 'swingeing' or 'deep' cuts but what does this mean? For those politicians intent on cuts, whether enthusiastically or not, is it just a matter of emulating illustrious predecessors – or actually of going further?

---

[11] The source for the total spending on benefits and tax credits is HM Treasury, *Budget 2010*, table C9. The source for the increase in JSA is *Department for Work and Pensions*, 2009, Benefit Expenditure Tables (table 5). These sources may not be consistent.

[12] The 2010 Budget (table C9) forecasts an increase in current spending in 2009/10 of £41bn.

The record on cuts

The most striking thing in the record is that contrary to what both left and right imagine, the much-hyped Thatcher/Howe cuts that took place during the recession of the early 1980s were restricted to investment only. Current spending continued to grow steadily at 2% a year in real terms (that is, on top of inflation) through to the middle of the decade (see figure 4). In only one year out of the eleven during which she was PM did Mrs Thatcher manage a cut in current spending in real terms at all. That was in 1988/89 – at the height of the boom.

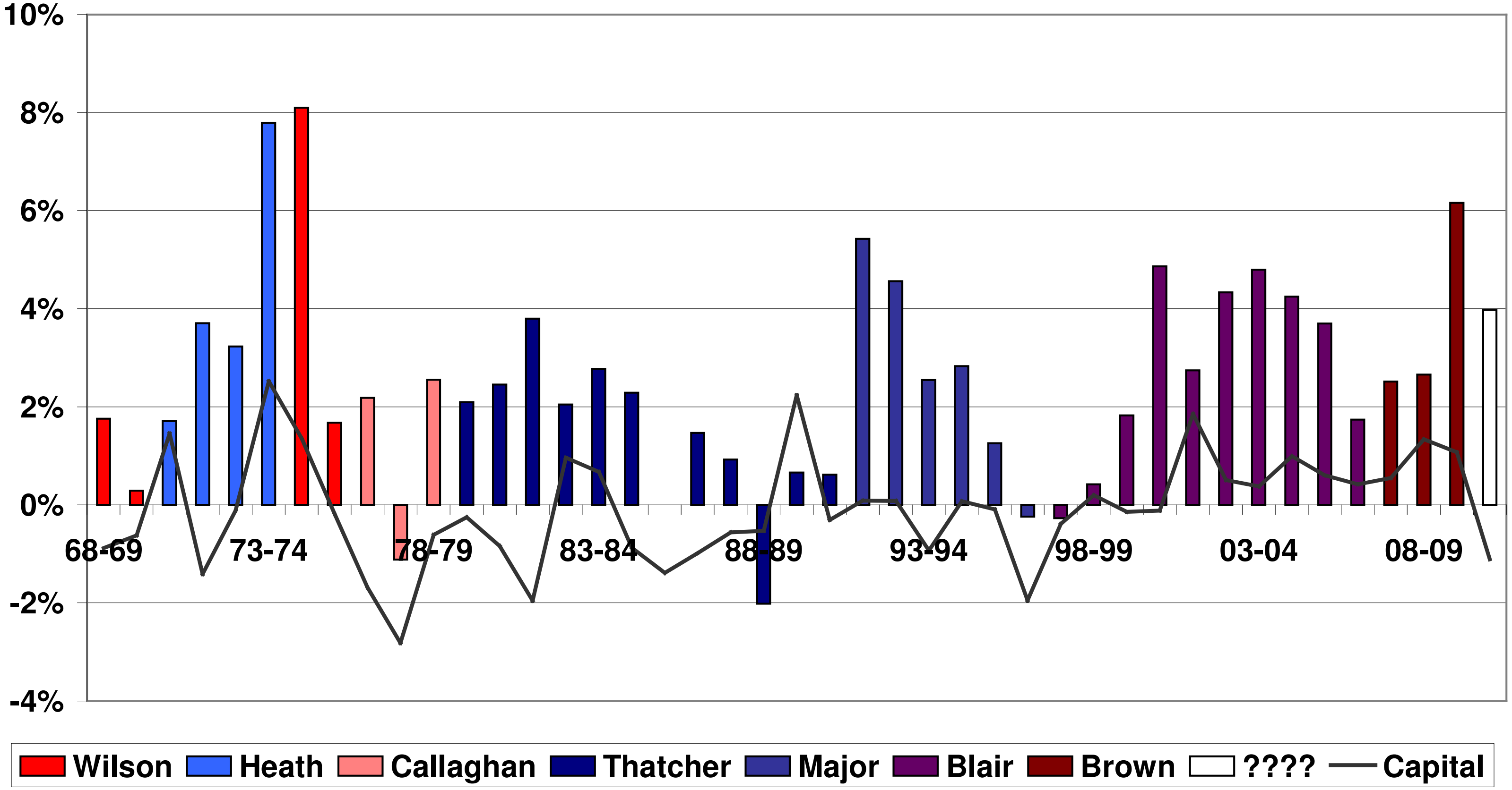
What this points to is the fact that years in which current spending has been cut in real terms are very rare – while those in which it has been cut in cash terms are non-existent . Only one other year in the last 40 saw a real terms cut of more than 1%, in 1977/78 following the IMF's visit to the Callaghan-led Labour government Only two other years (1996-97 and 1997-98) saw even small real cuts. So the overall Conservative-Labour score here is two all. The two successive cuts in the late 1990's were due to Kenneth Clarke's spending plans which were accepted by the incoming Blair government. It is a brave Chancellor who achieves a real cut in spending.

What we must conclude is that when people talk of cuts what they mean is that the growth rate of public spending is lower than that of GDP, a reversal of what is called a growth dividend. One could call it a *debt clawback*. With the exception of just one year, this century has so far had the reverse procedure when current spending rose faster than the GDP, particularly from 2002 onwards.

Unlike the isolated years in which current spending has actually been cut in real terms, there have been several periods of consecutive years in which it has grown more slowly than GDP. The steepest fall occurred in the five years starting in 1985/86 (the share coming down over that period from 42% to 35%), the longest period in which it fell was over the seven years from 1993/94 (down from 40% to 34%). While the Tories may therefore reasonably claim the political credit here, the key to the falling share in these period was, of course strong, sustained economic growth, averaging almost 4% a year in the second half of the 1980s and nearly 3½% in the last seven years of the 1990s.

If 'cuts' now mean growth of current spending at a slower rate than GDP, everything depends on the growth rate of GDP. But there is great uncertainty about what that may be. We have the latest Budget estimates: 2% in 2010-11, 3% in 2011/12 and 3¼% in each of the three years following. To reduce the share from its most recent level of 44% to even 40% will require enormous effort.

Figure 4: annual percentage change in real public expenditure, separately by current and capital expenditure, 1968-69 to 2010-11



Source: HM Treasury, Public Expenditure Statistical Analysis 2009, table 4.1.

Let us give an example. The Budget document gives projections for GDP over several years and for current expenditure this year.[13] The resulting 44% share for 2010/11 represents current expenditure of £644bn compared with GDP of £1,464bn. To see the size of the squeeze required: a level of 43% in 2011-12 would mean restricting current spending to a 2.3% increase over the previous year. 42% in 2012-13 would allow a 3.3% increase; 41% in 2013-14 a 3.5% increase and 40% in 2014-15 a 3.5% increase again. Given that the Budget document also projects an RPI inflation rate of 2.5% for 2011-12 and 3.25% for the following three years, the rates of growth of spending consistent with reducing the size of the State from 44% to 40% by the first year of the next parliament (assuming the one about to start lasts four years) are low or even slightly negative in real terms.

The important thing to bear in mind about this projection is that the assumed rate of GDP growth – 3% and more from 2011/12 onwards – is at the more optimistic end. If the economy were to grow at 2.5% as the IMF projects in its latest forecast, the GDP level – and therefore the level of current spending required to achieve any particular target share – would be some 3% lower than in the above projection. Some real cuts in current spending would be required. If GDP grew more slowly still (by no means unlikely), deeper and/or longer cuts would be required.

Cutting public expenditure – a ready reckoner

The prospect is thus both dire and fraught with uncertainty. One way to make this clear is to construct a ready reckoner of the number of years required to bring the size of the State, as measured by the share of current spending in GDP, down to some target level under various assumptions about (a) the rate of growth of GDP and (b) the level of real current public spending. The target levels used in the table are 40% (corresponding to roughly where we were before the recession) and 36% (the 2002/03 New Labour 'floor'). Given the debate about whether one should cut during 2010-11, the first year of a parliament, we assume no cuts in year one.

[13] HM Treasury, *Budget 2010*, tables C1 (p.182) and C9 (p204).

Table 1: current spending share ready reckoner

Current real spending	*GDP growth*	*Years (from 2010/11) to reach 40%*	*Years (from 2010/11) to reach 36%*
2% cut in 2011/12; frozen thereafter	4.00%	**2**	**5**
	3.25%	**3**	**6**
	2.50%	**3**	8
	1.75%	5	11
Frozen from 2011/12	4.00%	**3**	**6**
	3.25%	**3**	**7**
	2.50%	4	9
	1.75%	6	12
2% cut in 2011/12; 1% annual growth thereafter	4.00%	**3**	**6**
	3.25%	**3**	**8**
	2.50%	5	12
	1.75%	9	23
Frozen in 2011/12; 1% annual growth thereafter	4.00%	**3**	**7**
	3.25%	4	9
	2.50%	6	13
	1.75%	12	26
Years shown in bold indicate the 40% target reached within one parliament (i.e. not more than three years after 2010/11) or the 36% one reached within two.			

If the economy were to grow at 3.25% from 2011-12 onwards, with no cut in the first year, it would take three years for the current spending share to reach 40% and seven years to reach 36%. Whereas if the growth rate was 2.5% for four years with zero cut in the first year, the years required will be four and nine respectively

As the GDP growth rate lowers so the time taken to reach any particular target increases. By the same token a cut in spending in the first year reduces the interval for reaching the target size. Thus with 2.5% growth rate, a 2% cut in 2011/12 followed by a freeze sees the 40% target reached almost one year earlier. On the other hand, if current spending is allowed to start growing again, the interval is extended.

The problem is that if the economy were to grow at a faster rate than its historical norm, cutting spending would be easier but less urgent. In particular, if GDP grew at a sustained rate of 4%, there is plenty of room for more modest rises in current spending even while reaching the targets within one and two parliaments respectively. It is if the economy falters that the need to cut remains but the desirability of cuts becomes debatable.

Conclusion: a language of priorities

It is not for us to recommend this or that strategy. The question of the size of the deficit also depends on choices about tax rates and the elusive 'efficiency gains'. We have laid out the seriousness of the task which the new government will face after 7 May and set out the historical background against which decisions will be taken.

In surveying this background, there are two points which stand out above all others. The first is how rare it has been for current public expenditure to fall in real terms from one year to the next. The other is the strength and longevity of the period of growth in current spending, in excess of GDP, since 2002/03. If the first of these means that a sustained programme of real cuts proposed by the next government would be unprecedented, the second means that what is unprecedented should not now be unthinkable.

To cope with this difficult situation, political leadership of the highest calibre is required. What that leadership must win support for is a language of priorities to help adjudicate between competing claims on public spending. Ring-fencing of whole budgets is the opposite of this. With social protection, health and education absorbing two thirds of current public spending, choices have to be made both between these three large areas and also within them, for example between children and pensioners. Besides the basic facts about what money goes where, the public needs to appreciate the social and demographic factors (such as an aging population or the growing number with the qualifications and ambition to enter university) which drive public spending and mean that it can only ever partially be under political control.

The Comprehensive Spending Review promised for after the election is the place where these choices will be made. All previous reviews have been conducted in periods of growing public expenditure. This one won't. Given the difficulties that will be faced, and the serious consequences for the future of the country over the next decade whatever the decision, this cannot be an exercise conducted behind closed doors. Not only does the public have a right to be involved, only by involving it can the next government expect to get through.