Chapter 2
The PSBR and public expenditure

In recent years governments have declared a policy of reducing the scale of public sector borrowing (the PSBR) through cuts in the growth or level of public expenditure. This chapter examines how far these objectives have been achieved and assesses the consequences for taxation and for the allocation of resources within the public sector.

We shall show that PSBR targets, although not fully achieved, have resulted in extremely deflationary fiscal policies. Under the last Labour government the level of public spending was reduced in real terms. The present government has not yet reduced total public spending but plans to do so in future. At the same time the tax burden has been increased.

The pattern of adjustment has been very uneven. The central government has made no significant contribution on its own account to reducing the PSBR. It has pushed up its revenues by increasing taxes and social security contributions while simultaneously *increasing* its own spending. But it has cut grants to local authorities and required local authorities and public corporations to reduce their borrowing. The resulting squeeze has forced local government to cut spending and to increase the rate burden. Public corporations have had to cut their investment and increase their prices much in excess of general inflation.

We shall see that the policy of cutting public spending cannot be justified on the grounds that public spending in the UK is higher, or has increased more rapidly, than in other European countries. On the contrary, by comparison with the rest of Europe, Britain is a low-spending, low-tax country with meagre social provision.

2.1 PSBR targets and fiscal policy

During 1976 there was a wave of criticism by financial commentators about the level of public borrowing which in the previous year had risen to 10% of GNP. The government, in its April 1976 budget, estimated that the PSBR in the coming financial year would amount to £12 billion, equivalent to 9½% of GNP. There ensued a financial crisis in which the government had difficulty in selling bonds to finance its borrowing and the exchange rate for sterling fell rapidly. The crisis was not resolved until November when the government reached an agreement with the IMF which committed it to a sharp reduction in public borrowing. A PSBR target of £8½ billion was set for each of the next two financial years. The Conservative government which came into office in 1979 maintained exactly the same money target for the PSBR in its budgets for 1979/80 and 1980/81. With continuing inflation, these PSBR targets fell as a share of GDP from 6% in 1977/8 to 4% last year. This year the target has been relaxed slightly for the first time (rising to £10½ billion or 4½% of GDP) but the government envisages that it will be reduced to 2% of GDP in two years' time.

The primary rationale of PSBR targets since 1976 has been that they would help to bring about a progressive reduction in growth of the money supply. Here we are concerned not with the rationale but with its consequences for fiscal policy. For this purpose we need to exclude the part of the public sector borrowing requirement arising from transactions in financial assets (such as government purchases or sales of shares and other corporate debt) leaving the part which arises on account of the excess of ordinary public spending over taxation and other sources of revenue. We shall refer to this, the major part of the PSBR, as the budget deficit (in official statistics it is termed the public sector financial deficit or PSFD).

Table 2.1 sets out target budget deficits from 1976/7 onwards with actual out-turns for comparison. It will be seen that the actual deficit in the crisis year of 1976/7 was much less than had been expected (mainly because of underspending by government departments and public authorities). Nevertheless the targets for subsequent years were tighter than the out-turn in 1976/7 and, although the targets were in practice exceeded, the budget deficit was indeed reduced by nearly 2% of GDP over the next three years. Last year, however, the target was missed by a

Table 2.1 PSBR targets and budget deficits (per cent of GDP at market prices)

	PSBR target	Planned asset transactions	Target budget deficit	Actual budget deficit
1976/7	9.4	1.1	8.3	5.7
1977/8	5.9	0.6	5.3	4.3
1978/9	5.3	0.8	4.5	4.9
1979/80	4.2	0.6	3.6	3.9
1980/1	3.8	0.7	3.1	5.3
1981/2	4.4	1.2	3.2	. .

Sources: Targets as given in Financial Statement and Budget Report (FSBR) at the beginning of the financial year.

Out-turns from Financial Statistics (out-turn for 1980/1 from FSBR, March 1981).

large amount and the budget deficit was little smaller as a share of GDP than it had been in 1976/7.

The figures in Table 2.1 make no allowance for the effects of recession on government spending and revenues. In practice unless deliberate changes are made to spending policies and tax rates, recession tends to increase the budget deficit by augmenting social security outlays and cutting tax revenues and the profits of nationalised industries. Each 1% shortfall in GDP due to recession typically increases the budget deficit by about ½% of GDP*. Moreover it is widely accepted that the budget deficit ought to be allowed to rise to some extent in a recession. For example the Financial Secretary in a recent speech stated that:

> In a recession it would be wholly appropriate . . . for the PSBR to be allowed to rise above the medium term trend line.

We can evaluate the severity of budget targets in the context of recession by seeing what level of GDP the government was expecting at the beginning of each financial year and adjusting the announced budget deficit for the expected shortfall in GDP from a non-recessionary trend. The figures in Table 2.2 show budget targets adjusted in this manner for GDP shortfalls relative to a 3% growth trend. It will be seen that on this criterion the targets have been tightened since 1976 by 10% of GDP, making no allowance in practice for the degree of recession which was anticipated. Thus the level of GDP forecast by the government in its budget this year was no less than 15% below our non-recessionary trend line (starting from actual GDP in 1974). Yet fiscal policy is now so tight that there would be a budget *surplus* equal to about 5% of GDP if output were on trend. The adjusted budget target this year is 3½% tighter as a ratio to GDP than last year's out-turn. Indeed fiscal policy is now more deflationary than at any time since the war (including the notorious Jenkins 'squeeze' in 1969-70)*.

Although the adjusted targets for recent years were not entirely fulfilled, the tight fiscal and monetary policies pursued since 1976 have in our view been the cause of recession in Britain (see the preceding chapter). The fiscal stance, adjusted for recession and allowing for slippage between plans and performance, was tightened by nearly 5% of GDP in the past four years. The fact that the actual *ex post* budget deficit last year was almost as large as it had been four years previously was entirely due to the recession. In this sense fiscal policy aimed at reducing the PSBR has been self-defeating.

* See Economic Progress Report, HM Treasury, February 1981.

* See Ward and Nield, The Measurement and Reform of Budgetary Policy, Heinemann 1978, for estimates of fiscal stance in earlier postwar years.

Table 2.2 Budget deficits adjusted for recession

(per cent of GDP at market prices)

	Expected GDP shortfall	Implicit demand-adjusted target for budget deficit	Actual demand-adjusted budget deficit	Actual GDP shortfall
1976/7	4.8	5.9	3.7	4.0
1977/8	8.9	0.9	1.7	5.2
1978/9	8.2	0.4	2.4	5.0
1979/80	7.4	–0.1	0.6	6.6
1980/1	12.6	–3.2	–1.0	12.6
1981/2	15.7	–4.7	. .	. .

Note: GDP shortfalls measured relative to a 3% per year real growth path starting from actual GDP in 1974. Demand-adjusted budget deficits calculated as target or actual deficits less 50% of the expected or actual GDP shortfall.

Sources: Expected GDP and target budget deficit from FSBR at the beginning of the financial year. Actual GDP and budget deficit from Financial Statistics and Economic Trends (1980/1 figures from FSBR, March 1981).

2.2 Public expenditure cuts

In its first set of public expenditure plans published in January 1975 the last Labour government envisaged modest growth of total public spending† over the four years up to 1978/9. By previous standards the plans were cautious. The total was planned to rise by 7% over a period when it was hoped that GDP would increase by some 12%. But these plans were quickly thrown into disarray when it was found that the current level of public spending was already much higher than had been estimated because of unforeseen increases in public sector pay and subsidies. In April 1975 the government announced the first of a series of cuts in public spending plans, culminating in a final round agreed with the IMF in November 1976. The planned cuts were in the end made effective (see Table 2.3). In the government's last year of office total public spending was 4% less in real terms than the level of spending in its first year of office and 5% below the level originally envisaged for the final year.

The present government has dedicated itself to making further large cuts in public spending. It inherited plans entailing growth of total public spending by about 2% per year up to 1982/3 but managed to reduce public spending in its first year of office below the level envisaged by the Labour government (see Table 2.4). Last year, however, there was a 4% increase bringing total public spending up to the level of Labour's plans. This year the government hopes to keep the level of spending constant and next year to reduce it by 2%.

The government's failure to hold spending down last year was not for want of trying. The government's plans were falsified by high interest rates (adding to the cost of debt service), by substantial increases in public sector pay, and by the deepening recession which obliged the government to support industry and employment on a larger scale than it had intended. The experience of the past year has changed the government's plans very considerably. Last year it was envisaged that by 1982/3 public spending would be 10% lower than Labour had planned. Now it is envisaged that the cut will only be 5% and that the level of spending in 1982/3 will still be 2% higher than in the government's first year of office.

† Measured in real 'cost' terms (relative to the GDP deflator).

Table 2.3 The Labour government's cuts

(indices of public expenditure in real terms)

	1974/5	1975/6	1976/7	1977/8	1978/9
Estimates in Labour government's first White Paper (January 1975)	100	101	102	104	107
Planned and unplanned changes	+6	+6	+3	–5	–5
Actual spending	106	107	105	99	102

Note: Total public expenditure including investment by public corporations but excluding debt interest, measured in cost terms (relative to the deflator for GDP at factor cost).

Sources: Public Expenditure White Papers, January 1975, March 1980 and March 1981.

Table 2.4 The Conservative government's cuts

(indices of public expenditure in real terms)

	1979/80	1980/1	1981/2	1982/3
Labour government plans (January 1979)	100	102	104	105
Planned and unplanned changes	–2	0	–2	–5
Actual spending and current plans (March 1981)	98	102	102	100

Note: Total public expenditure measured in cost terms on March 1981 official definitions.

Sources: Public Expenditure White Papers, January 1979 and March 1981.

Table 2.5 Budget plans and taxation

(per cent of GDP at market prices)

	Target budget deficit	Planned public spending less miscellaneous receipts	Planned revenue from taxation and national insurance contributions
1976/7	8.3	44.1	35.8
1977/8	5.3	41.9	36.6
1978/9	4.5	40.3	35.8
1979/80	3.6	39.3	35.7
1980/1	3.1	42.2	39.1
1981/2	3.2	44.4	41.2

Source: FSBR at the beginning of each financial year.

The consequences for tax policy are shown in Table 2.5. Up to and including the present government's first budget, public spending estimates came down more-or-less in line with target budget deficits, allowing Chancellors to maintain a roughly constant overall burden of taxation. But last year and this year the estimated cost of public spending rose as a percentage of GDP. Given tight targets for the budget deficit, the planned tax burden rose from under 36% of GDP in 1979/80 to 39% of GDP last year and 41% of GDP this year. In practice the mechanism now being used to hold the PSBR down is a steep rise in taxation.

2.3 The burden of adjustment

The PSBR is ultimately under central government control because the national government has the power to restrict borrowing by those parts of the public sector — local authorities and public corporations — for whose finances it is only

Table 2.6 The central government and the PSBR

(£ billion, 1980/1 purchasing power)[a]

	Calendar years		Financial years	
	1975	1979	1980/1	1981/2 forecast
Central government				
Revenue from taxation and national insurance contributions	67.9	74.4	77.7	81.6
Own spending[b]				
social security benefits	16.4	21.3	21.5	22.7
other	36.9	36.2	40.8	41.0
total	53.3	57.5	62.3	63.7
(as percent of revenue)	(78)	(77)	(80)	(78)
Debt interest and financial transactions (net)	4.9	6.9	6.3	6.9
Surplus[b]	9.7	10.0	9.1	11.0
Public sector borrowing				
Finance for local authorities[c]	22.4	18.4	18.7	15.6
Finance for public corporations[c]	7.9	6.8	3.9	5.0
	30.3	25.2	22.6	20.6
less Central government surplus[b]	–9.7	–10.0	–9.1	–11.0
PSBR	20.6	15.2	13.5	9.6

[a] Cash figures deflated by the price deflator for total public and private expenditure on goods and services.

[b] Excluding grants and subsidies to local authorities and public corporations.

[c] Central government grants and subsidies plus borrowing from central government and other sources.

Sources: National Income and Expenditure 1980
FSBR, March 1981
Public Expenditure White Paper, March 1981.

partially responsible. But there are many constituent elements of public sector spending and revenue which are wholly or partly devolved. The attempt to reduce total public spending has therefore involved the central government in bargaining with local authorities and nationalised industries. It is of considerable interest and importance to see how such pressures have worked out.

Table 2.6 displays the public accounts from the perspective of the national government, distinguishing its own revenues and spending from the grants, subsidies and loan authorisations which it accords to local authorities and public corporations. The striking point which emerges is that virtually the whole of the actual and planned reduction in the PSBR since 1975 (£11 billion at 1980/1 prices) has been and is expected to be achieved by cuts in finance for local government and public corporations. The central government had made no contribution at all, on its own account, to reducing the PSBR up to and including last year. This year it expects to contribute one half of the PSBR reduction.

This conclusion is all the more striking since there was a large increase in central government tax revenue (£14 billion at 1980/1 prices since 1975). Almost all the additional revenue has been absorbed by rising central government spending. Under Labour the extra spending consisted of higher social security and debt interest payments. Under the present government it has consisted of higher spending on defence and other programmes.

The squeeze on public corporations is illustrated by Table 2.7 which has to be interpreted in the light of mounting trading difficulties in the recession. Central government grants and subsidies to public corporations have been held in real terms at or below the 1975 level. Borrowing has been cut sharply. Thus public corporations have had to cut their capital spending and earn sustained trading surpluses, despite recession, by pushing their prices up well in excess of the general rate of inflation (between January 1974 and January 1981 electricity prices rose by 47%, rail fares by 44% and post and telephone charges by 14% more than the 'all items' retail price index).

Local government has suffered an even sharper financial squeeze (see Table 2.8). This year its spending is expected to be 20% lower in real terms than in 1975 while rates are on average 20% higher. This year there will also be large increases in rents charged to council tenants. Overall, local government will have contributed about £7 billion (at 1980/1 prices) to the £11 billion reduction in the PSBR since 1975.

Thus far we have looked at spending in cash terms adjusted for general inflation but not for differential changes in wage-and-salary and other costs paid by public authorities. The effect of cash limits on the volume of resources available to local authorities in particular has been very much influenced by changes in the level of public sector pay. Table 2.9 distinguishes cost and volume changes. It will be seen that up to 1979 local government was largely protected from the effect of budget cuts by a sharp reduction in the relative unit cost of its expenditure. Building costs fell in real terms as the construction industry suffered recession. More important, the pay of local government employees was held down under the

Table 2.7 The squeeze on public corporations

(£ billion, 1980/1 purchasing power)[a]

	Calendar years 1975	Calendar years 1979	Financial years 1980/1	Financial years 1981/2 forecast
Investment spending[b]	9.3	7.6	7.5	8.2
Interest, dividends and financial transactions (net)	2.9	4.6	1.0	2.1
	12.2	12.2	8.5	10.3
less Trading income[c] (excluding subsidies)	–4.3	–5.4	–4.6	–5.3
Deficit	7.9	6.8	3.9	5.0
Financed by:				
Grants and subsidies	2.7	2.4	2.3	2.8
Borrowing	5.2	4.4	1.6	2.2

[a] See note to table 2.5.

[b] Gross fixed capital formation plus increase in book value of stocks.

[c] Including stock appreciation, rent and income from abroad.

Sources: See table 2.5.

Table 2.8 The squeeze on local government

(£ billion, 1980/1 purchasing power)[a]

	Calendar years 1975	1979	Financial years 1980/1	1981/2 forecast
Local government spending:				
education	11.2	10.0	9.8	9.3
other[b]	18.6	16.9	17.0	14.5
total[b]	29.8	26.9	26.8	23.8
Debt interest and financial transactions (net)[c]	0.4	-0.5	0.6	1.2
	30.2	26.4	27.4	25.0
less Rates	-7.8	-8.0	-8.7	-9.4
Deficit	22.4	18.4	18.7	15.6
Financed by:				
grants and subsidies	16.9	15.6	16.2	14.7
borrowing	5.5	2.8	2.5	0.9

[a] See note to table 2.5.

[b] Including housing subsidies and rate and rent rebates.

[c] Including housing account. Total rents paid by council tenants (before rebates) are estimated as follows:

(£ billion, 1980/1 purchasing power)

1975	1979	1980/1	1981/2
2.3	2.4	2.4	3.2

Sources: See table 2.5.

Table 2.9 Government spending — costs and the volume of resources

(indices)

	Calendar years 1975	1979	Financial year 1980/1
Central government[a]			
Own spending in real cost terms[b]	100	108	117
Real unit cost[b]	100	101	102
Own spending in volume terms	100	107	114
social security benefits	100	130	133
other current spending	100	98	108
fixed investment	100	79	75
Local government			
Spending in real cost terms[b]	100	90	90
Real unit cost[b]	100	92	98
Spending in volume terms	100	98	91
education	100	104	99
other current spending	100	109	107
other fixed investment	100	65	47

[a] Excluding grants and subsidies to local authorities and public corporations.

[b] Relative to the deflator for total public and private expenditure on goods and services.

Sources: National Income and Expenditure, 1980
FSBR and Public Expenditure White Paper, March 1981.

Table 2.10 Taxation and government spending — some international comparisons

(per cent of GNP at market prices)

	1970		1978	
	Tax revenue and social security contributions	Government expenditure[a]	Tax revenue and social security contributions	Government expenditure[a]
Sweden	41	40	54	58
Netherlands	40	40	47	52
Belgium	34	33	43	44
France	35	35	38	42
West Germany	34	33	40	41
Italy	27	33	33	40
Austria	36	33	39	39
UK	36	33	34	37
USA	29	30	31	31

[a] Current expenditure on goods and services, gross capital formation, current grants and subsidies.

Source: National Accounts of OECD Countries, 1961-1978, vol. II.

Labour government's incomes policy. Although investment in housing and other areas was sharply cut back, the volume of spending on education and most other local government programmes was able to increase significantly. Last year the situation was reversed. The unit cost of local government spending rose sharply as the pay of its employees caught up again with pay in other sectors of the economy. The volume of spending was cut by about 7% without any saving on the overall budget. The central government appears not to have suffered the same degree of cost escalation and was able to increase the volume of its spending by about the same amount. In effect there was a switch of well over 10% in the volume of spending from local government to central government.

2.4 The UK compared with other countries

The Labour government, the present Conservative government and many commentators have laid some of the blame for Britain's poor economic performance relative to that of other Western countries on the supposedly excessive burden of public spending and taxation in this country. Statistical comparisons tell a different story (see Table 2.10). In 1970 public spending and taxation in Britain took about the same share of national income as in most Western European countries — more than in the USA but less than in Sweden and the Netherlands. By 1978 Britain had fallen to the bottom of the West European league so far as public spending is concerned. Germany, France and Belgium spent about 5% more, the Netherlands and Sweden 15-20% more. The burden of taxation and social security contributions in Britain was correspondingly lower. GDP had grown more in all other West European countries and was in most of them higher, per capita, than in Britain. By all tests, therefore, Britain had already become a low-spending, low-tax country as compared with the rest of Western Europe before the present government came to power.

The comparison is even more startling with respect to public spending on social welfare (education, health and income maintenance — Table 2.11). Already in the mid-1960s Britain was the most parsimonious of major West European countries in its social provision. By the mid-1970s Britain's public spending on social welfare was about 5% less as a share of GDP than that of most other West European countries and barely higher than that of the USA. Now, with a falling national income and a continued squeeze on public budgets, it seems certain that standards of social provision in Britain will fall further below those in the rest of Western Europe. Thus Britain's relative economic failure has not been associated with high public spending in general or social provision in particular.

Table 2.11 An international comparison of social welfare spending[a]

(per cent of GDP at market prices)

	early 1960s	mid 1970s
Netherlands	14	29
Belgium	19	23
Austria	20	23
Sweden	14	22
France	17	21
West Germany	16	21
Italy	14	20
UK	13	17
USA	10	16

[a] Public spending on education, health and income maintenance.

Source: Public Expenditure Trends, OECD, 1978.