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The Blunt Axe

How systemic failure to tackle the root causes of
Government over-expenditure will strangle UK recovery

A Special Report by Brian Reading



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Introduction

By Peter Allen

On the eve of the May 2010 General Election, we published *Sharpening the Axe* drawing lessons from the three episodes in the last century when the axe was wielded. My introduction concluded

"I sincerely hope, indeed believe, that this Lombard Street Research special report will make a worthwhile contribution to the next government in assessing and addressing the hard decisions it must make in these difficult times."



Sharpening the Axe
Lombard Street Research
2010

My hope was disappointed. I therefore asked my colleague Brian Reading to review what has followed, notably the decisions that were made in the October 2010 Spending Review, the way in which they were made and where we are now. His devastating report shows that the Coalition has fallen into all the pitfalls we identified and more. This Report is therefore called *The Blunt Axe*.

I must emphasise that this is not a party-political attack on the Coalition Government or Chancellor. Had we intended it to be, it would have been called *The Economic Consequences of Mr Osborne*. It is an attack on The

Establishment, on Westminster and Whitehall. Inevitably the Government is directly in our line of fire. Governments act, while Oppositions talk. Labour's talk has never addressed the detailed faults and failings revealed here. Incompetence is not the unique prerogative of parties in power.

Coalitions governed Britain on both occasions between the wars when the axe had to be wielded. They commissioned expert advice from independent committees, headed by Sir Eric Geddes in 1921 and Sir George Earnest May in 1931. The politically 'hard choices' proposed by Geddes and May helped to bring down both governments. The IMF 1976-77 sterling bailout was conditional upon severe spending cuts

(shades of Greece and Portugal). Callaghan's Labour minority government almost split and was thereafter crippled. Perhaps Cameron and Clegg feared the axe-wielder's fate. They made 'hard' decisions in the 'easy' way – traditional Westminster horse-trading between departments and between partners.

Sharpening the Axe described short-comings in the Treasury's traditional approach to spending control. They have been vividly exposed.

- No priority was given to economic growth. It could not have been. No attempt was made to measure the impact of any of the cuts upon growth, neither before nor after the event.
- Capital investment, to be protected, was castrated. Odd that, it was specifically excluded from the Coalition's mandated current budget target. Before the Spending Review began, the OBR warned that capital spending cuts did the most damage to growth.
- No attempt was made to measure how much was spent on health or education and other 'functions of Government'. Cuts were based on departmental budgets – who spends what, not who does what. The Department for Education's budget, for example, excludes universities and includes child protection (law and order spending). One-third of education spending is done by other departments. Over one-tenth of DfE spending is not on education.
- Bogus claims were made for real resources added or subtracted from departmental budgets. Cash spending was deflated by average inflation (the GDP deflator) not the relative price increases for different types of public spending. Public spending is more labour- and skills-intensive than private. Its costs rise faster than average inflation. Bogus estimates hide the pain, but not from three-hour queues at Heathrow.
- Front line workers and front line work (not the same) were neither defined nor identified. For Law and Order the notion was 'Count the pounds and the coppers will look after themselves'.

- No attempt was made to plan or forecast public sector job losses. It was left to public sector employers to determine how pay-bills were split between pay and heads. The OBR guessed 66,000 jobs would be lost in the first two years. The total came to 372,000. The public sector pay freeze failed and the axe fell on heads.
- The burden of bureaucracy was given a face-lift to improve its appearance – performance contracts were re-branded as Business Plans.

Ill-prepared and ill-considered spending cuts did needless harm to growth and the economy. 'Expansionary fiscal contraction' was consequently a delusion, yet 'recovery tomorrow' was always promised to fulfil the rolling fiscal mandate.

But to me, one of Brian Reading's macro-arguments also stands out. If the Government had believed its own fiscal mandates, it would have increased capital expenditure to offset the damage from current spending cuts. Neither the current budget balance nor net debt would have been increased. It must have supposed that markets were less sophisticated, fixated on total borrowing and gross debt.

In November comes the parting of the ways. The OBR can no longer maintain the fiction that the Government remains on track to meet its own mandated fiscal targets. Recovery remains as distant as ever. Real GDP, little changed from two years ago, is shrinking. The ratio of debt to GDP will not be falling three years hence, let alone in the originally promised two years. The budget deficit in the 12 months to July exceeded the bequeathed 2009-10 deficit. Either further cuts must be imposed or the fiscal mandates abandoned.

Above all, the budget deficit has still to be tackled. That is why commissioning an independent Geddes-style enquiry remains an urgent and crucial necessity - crucial if the 2013 Spending Review is to get it right this time, indeed more urgent and crucial than before. The current fiscal consolidation strategy has lost all credibility. The groundwork needs to be laid, cleaning the Augean stable of official statistics of sacred cows' droppings.

Brian Reading acknowledges the assistance of his Lombard Street Research colleague Jamie Dannhauser in preparing this report.



The Blunt Axe

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Chapter 1

The Axemen's fate

This chapter describes what happened to the governments that wielded axes in the 20th Century

During the 20th Century two coalition governments and one minority government were forced to retrench: Lloyd-George's Conservative-Liberals in 1921-22; Ramsey Macdonald's Labour-led government in 1931 and James Callaghan's minority government, with Liberal support, in 1976-77. The first two sought independent advice on how to go about it – from Sir Eric Geddes' Committee and its successor, Sir George Earnest May's Committee. Denis Healey, Callaghan's Chancellor, had external conditionality forced upon him due to sterling's IMF bail-out (shades of Greece today). These episodes were described in detail in *Sharpening the Axe*, our Special Report of April 2010.

Retrenchment Twenty-two: To save the Taxpayer

All episodes differed. Retrenchment 1922 was to save the Taxpayer. The choice was not spending cuts or tax hikes, but spending cuts to pay for tax cuts. The Great War left a legacy of a bloated state and a blood-curdling budget deficit. The latter was, however, rapidly reduced, helped by demobilisation and war-surplus sales. The political issue was the size of the state and the level of taxation. Waste was believed to be rampant and Geddes went after it with a will. He grilled mandarins mercilessly. The Navy had a 20-year stock of ammunition at its Great War expenditure rate, but the Admirals wanted to spend two million pounds buying more. He dirtied his hands on the shop floor finding, for example, that the army had one man to clean each of its four-wheeled vehicles while bus companies' employees cleaned five apiece. The call to eliminate extravagance, whipped up by the press, had become a nation-wide political movement. Anti-Waste candidates won by-elections. Balancing the

budget was less of a priority than reducing public spending.

The Chancellor took a gamble on income tax cuts and it paid off in growth

Geddes faced an easy task. His meticulous approach was therefore even more meritorious. He swam with the falling tide of post-war disarmament. Cuts to the armed forces, bitterly opposed by the right, accounted for 60% of his proposed £87m reductions¹. But they were the

easier for the coalition to swallow. The remaining proposed cuts fell heavily on social spending and particularly education².

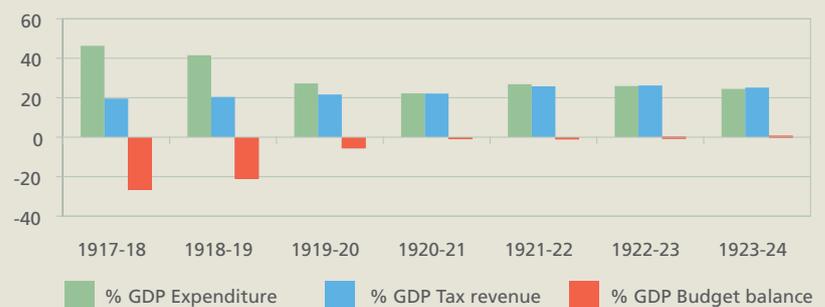
'Tough choices', in today's politicians' self-serving hype, were demanded – not good news to Liberal radical reformers who pre-war had taken the first steps towards creating a welfare state.

The Cabinet and Sir Robert Horne (Scottish son-of-the-Manse, Conservative Chancellor) watered down Geddes social spending

cuts giving priority to education. They settled for only three-quarters of his recommendations, but reduced the blow to education by two-thirds. But the Chancellor took a gamble on income tax cuts and it paid off in growth. In 1921-22 the income tax rate was still 30%. It was cut to 25% in 1922 and 22½% in 1923. It hit bottom at 20% in 1926³. It paid off. The 1919-20 post-war bubble-boom had burst in 1921-22 but recovery was under way by 1922-23. In the following chart Bank of England calendar year data is converted to financial year data using the ratios 75% and 25%⁴. Public spending approached 50% of GDP

during the Great War – about the same as in 2009-10. It came down sharply after the war but rebounded in 1921-22 (due to the slump). Geddes helped to stabilise it. Tax revenues, despite rate cuts, increased as a GDP share. The budget was, in fact, near balance between 1920-21 and 1923-24. Bank rate fell from 7% at end-1920 to 3%, helping to reduce the drag from retrenchment. But sterling's effective exchange rate rose 16% to 1923 and 25% by the time sterling returned to Gold in 1925. Indeed after 1922 fiscal ease was required to offset the monetary stringency imposed to allow sterling to return to gold at its pre-war parity against the dollar.

1.1 Budget balances 1917-18 to 1923-24, %GDP



Retrenchment in 1922 marked the death-knell for the Liberal Party's prospects of ever again forming a majority government. It was not the direct or major cause of its demise. It had been dysfunctional for decades, split over whatever became the issue of the day. Its fate was sealed by its Tory coalition partner, not the infant Labour party that was still cutting its parliamentary teeth.

Retrenchment Thirty-One: To save the Pound

The 1931 May Report was designed to save the pound – to keep sterling on the gold standard. Labour, led by Ramsey MacDonald, was in power having become the largest party in the May 1929 general election. It was supported by Lloyd-George's Liberals⁵. The chart, again with calendar

for nominal GDP public spending, revenues and budget balances.

⁵ It could be called either a minority or a coalition government. Liberal support was short of a full coalition.

¹ £3.3bn in today's money but 2% of 1922 nominal GDP

² The 1918 Education Act had been expected to cost £3m a year and instead cost £30m. See *Sharpening the Axe* for details.

³ 6 shillings in the pound in 1921-22, 5s then 4s6d and finally 4s.

⁴ Bank of England Quarterly Bulletin 2010 Q4, *Three Centuries of Data* gives calendar year data



year data crudely converted to financial years, shows the budgetary story. It was near balance prior to the onset of depression. Public spending had been reduced from almost half of GDP to under a quarter. The slump hammered GDP which fell 10% in nominal terms between 1929 and 1932. Nonetheless spending and tax revenues crept higher and the budget deficit which emerged was modest by any present standard.

benefits. Education costs were to be cut £13.9m, teachers' pay down 20%. Police pay was to be cut 12½%. The defence of sterling demanded no less in a national emergency. It is hard to imagine a more contractionary and unpopular fiscal policy, designed to ensure no relief from the depression would come from monetary policy or the exchange rate. Bank rate peaked at 6% on the eve of Sterling's 1931 escape from its 'golden fetters'⁶.

1.2 Budget balances 1928-29 to 1934-35, % GDP



The Labour Chancellor of the Exchequer, Philip Snowden, was a social radical, but tight-fisted Yorkshire man who believed borrowing was an evil. He repudiated Keynes, who was already advocating public spending in recession. Instead Snowden was determined to balance the budget despite the impact of recession on tax revenue. This called for spending cuts, not unwelcome

to the Conservative opposition. Snowden was a Gladstonian Liberal.

The May Report was presented to Parliament in July 1931. It recommended £97m public spending cuts – 2¼% of 1931 GDP,

but also £24m tax hikes. But defence could no longer be hammered. Instead the dole was to be savaged – saving £67m – by cutting 20% off

As with Geddes, the Government whittled proposed cuts down to £56m, but half the Cabinet could not stomach so profound a sacrifice. Labour split. In August 1931 the Government fell. MacDonald resigned, but promptly returned to No 10 as Prime Minister in a National Government including Conservatives and Liberals. Only two cabinet ministers⁷ were among the 15 labour MPs who stayed with him. The new coalition imposed tariffs on trade and pursued pay cuts, leading to a Royal Navy 'mutiny' which helped precipitated the final crisis that pushed sterling off gold in September⁸.

The Conservatives forced a general election in October 1931 which slaughtered the Labour Party. It lost 206 seats to become a rump of 46. The Conservatives gained 207 seats to reach 470 MPs out of a National Government total of 554. The

⁶ Title of an excellent book on the interwar gold standard by Barry Eichengreen.

⁷ Philip Snowden and J H Thomas

⁸ A Labour member is supposed to have said "They never told us we could do that". I can only trace this to Sydney Webb's diary and he had by then left the Commons for the Lords.

It is hard to imagine a more contractionary fiscal policy, denying relief from monetary policy or the exchange rate

opposition was reduced to 113 seats. Departure from gold rescued Britain from the worst of the depression, but set back Labour for a decade and a half.

Retrenchment Seventy-Six: To save the Economy

Junior coalition partners are on a hiding-to-nothing

Retrenchment in 1976-77 was to save the economy from stagflation. The Labour Government had already embarked on it before calling for the IMF bail-out. Inflation had peaked at 27% during 1975. Real GDP shrank 1% in 1974 and ½% in 1975⁹. The budget deficit had reached 7½% of GDP. Debt was 63% and rising. Sterling threatened to go into free-fall and Gilt yields to explode, the former adding to inflation with the latter subtracting from growth.

monetary targets. Retrenchment, however, did relatively little to reduce the budget deficit¹⁰ although it did restrain public expenditure. In the event confidence in sterling was restored, but at the expense of the 'winter of discontent' that spending cuts provoked. The current account was rescued when North Sea oil came on stream.

Retrenchment Twenty-Ten: To save the next generation

What was the Coalition's aim? It was not to save the Taxpayer. Taxes were planned to rise. It was not to save the pound. Depreciation was to be welcomed. It was not to save the economy from stagflation. The risk was debt-deflation. It was surely aimed at saving the next generation from debtor goal – although how it could achieve this without exacerbating deflation remained to be seen. It was to save Gilt.

1.3 Budget balances 1976-77 to 1982-83, %GDP



The Callaghan Government struggled on with Lib-Lab pact support until defeated in a confidence motion in March 1979. The general election in June brought Mrs Thatcher to power. The tiny Liberal party lost two of its remaining 13 seats. Junior coalition partners are on a hiding-to-nothing.

Margaret Thatcher is generally credited with the monetarists' victory over Keynesians. But it was James Callaghan, Prime Minister from 1976-79, who rejected Keynes, while the IMF imposed

⁹ Bank of England, latest estimate – 1974 affected by the miners' strike and three-day week.

¹⁰ Chart data taken from *March 2012 OBR Fiscal Supplementary Tables, Historical Series of Fiscal Aggregates*.



Chapter 2

The Axeman's Task

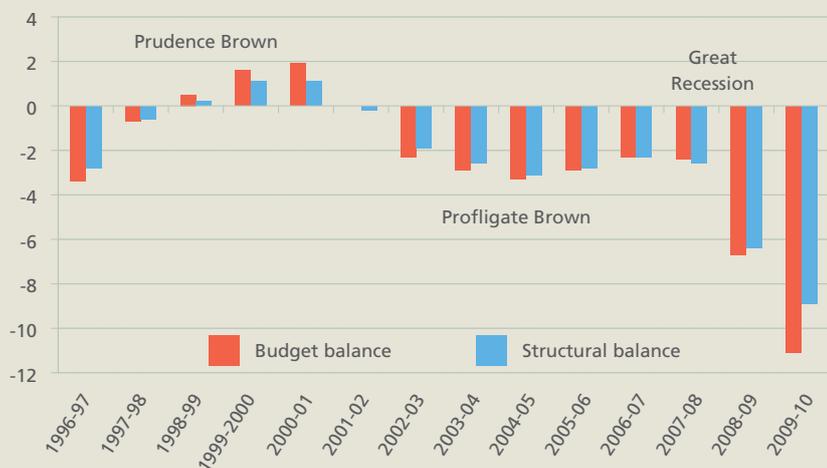
This chapter examines the problems the Coalition Government, elected in May 2010, faced in dealing with a record peace-time budget deficit.

Where to start? Britain has suffered 'squeeze-easy' fiscal cycles since Keynesian demand management became fashionable following WW2. These frequently matched electoral cycles, whatever the government. 1997 is a good time to start and not because of the landslide which brought Tony Blair's Labour Government to power. All crises are blamed on others. New governments blame their predecessors. Most inherit a mess, which is why they win. Time-serving governments blame events beyond their control, i.e foreigners.¹¹ Gordon Brown's stock excuse was the financial crisis and Great Recession, in which he saved the world from Depression. But 1997 is chosen for good luck. The Asian crisis that year spawned the savings glut which, together with globalisation, led to the Great Moderation.

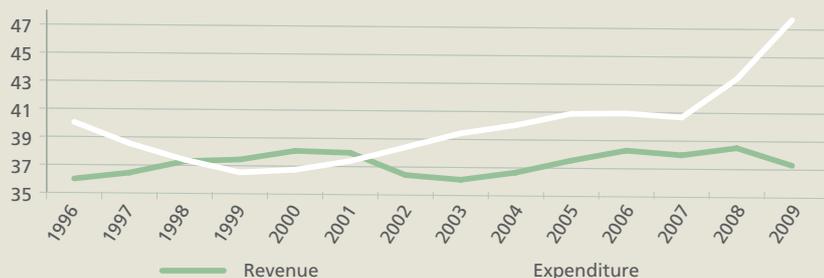
The business cycle was 'abolished'. The newly independent Bank of England later claimed credit for the 'Goldilocks' economy- steady growth with near-stable prices. Financial innovation had reduced systemic risk, or so it was said. Fast potential growth could confidently be projected for the future and with it buoyant tax revenues. In Labour's first term 'Prudence' Brown ran budget surpluses. He then became 'Profligate' Brown, hoping to balance the budget over the business cycle. Early-year surpluses were deemed structural. Near-stable prices indicated the absence of any significant positive output gap. Prior to the financial crisis, Labour budgets were based on

11 Sir Arthur Cockfield, interviewing Prime Minister Harold Wilson following the 1967 devaluation, asked what had been his greatest mistake. Wilson uncharacteristically paused before answering "under-estimating the power of the gnomes of Zurich".

2.1 Budget balances 1996-97 to 2009-10, % GDP



2.2 General Government Revenue and Expenditure, % GDP



false expectations - over-optimistic growth and tax buoyancy forecasts spawned over-ambitious spending plans. Deficits in the good years were then exacerbated by the Great Recession. Chart

2.1 shows the budget history that the Conservative/ Lib-Dem coalition inherited in May 2010.

The Great Recession destroyed illusions. Labour's synchronised fiscal stimulus was the

right thing to do. But it added structural excesses to the cyclical havoc wrought by recession. The cyclical deficit, the difference between overall and structural balances, had been small throughout the Great Moderation. But the budget was in structural deficit by 2% to 3% of GDP leading up to the crisis. This was a bad starting point.

We do not dispute the need for budget

retrenchment. It is sufficient to say here that fiscal puff is not unlimited and always necessitates a subsequent pause for breath. Some credible 'Plan A' was unavoidable in 2010. Size, timing, content and the ever-changing global context must all be considered. Whether the government got it right at first and subsequently will be discussed in Chapters 5 and 6. Here we concentrate on content. A choice between spending less or taxing more had first to be made. Chart 2.2¹² shows the case for the former was overwhelming. While expenditure's GDP share ran ahead of revenue during Brown's profligate years, it exploded in the Great Recession, from 40.6% of GDP in 2006 to 47.3% in 2009. Part of the blame lay with the denominator, a fall in nominal GDP. If government spending had been the same as it turned out to be, but nominal growth continued at its former rate, the expenditure/GDP share would have fallen to 38.2%.¹³ This is mere arithmetic. If growth had been different, so would have been spending. But it shows that the overriding priority should have been to re-establish growth. Slow growth both increases the numerator and reduces the

denominator in the public expenditure/GDP ratio.

The Coalition scattered its 'priorities' here, there and everywhere. The 2010 Spending Review individually and explicitly "prioritised" - the NHS; early year provision; capital investment to support long term growth; overseas aid; fairness; social mobility; education; low carbon technologies; essential maintenance and equipment at St Helier, Royal Oldham and West Cumberland hospitals;

The Coalition scattered its 'priorities' here, there and everywhere. Growth should have been The Priority.

12 Note that this chart uses calendar years, whereas much of budgetary analysis is based on financial years. The distinction, the latter covering the four quarters from the second quarter of each year, makes life a little difficult.

13 In the three years to 2009 public spending increased by 13.9% and nominal GDP contracted by 2.1%. The share of expenditure rose to 47.3%. Had nominal growth continued at the average of the previous quarter century, 6.8%pa, it would have risen by 21.2% and the spending share would have fallen to 38.2%.



Policy changes and the structural budget balance

Structural' and 'cyclically-adjusted' are terms used throughout this report with reference to budget balances. They normally have the same meaning. The budget affects the economy and the economy affects the budget. The structural budget balance is the overall balance adjusted for the effect of the economic cycle as measured by the output gap, i.e. cyclically-adjusted. Changes in the structural budget balance so defined are frequently taken to equal budget policy changes in the same year. But this is not necessarily true. Some budget changes occur with a lag – tax increases set to come into effect in the following year. Some non-cyclical budget changes are due to the structure of the economy. When the Great Recession reduced the potential GDP level the negative output gap was reduced. This translated into a smaller cyclical adjustment and thereby a larger structural deficit, which could not be attributed to policy changes.

The changing structure of the economy affects the structural balance in other ways, which may have the opposite effect. Pre-crisis tax revenues were artificially swollen by the financial and housing bubbles. Rising house prices and buoyant sales, for example, boosted stamp duty revenues. The tax system was mistakenly taken permanently to deliver a higher share of revenue out of a given national income. The contraction in the financial sector and construction following the crisis revealed this mistake. This meant that the change in the structural deficit was greater than budget measures.

world class science and research; transport projects; high value local transport; personal choice; and devolution in the 'Big Society'. Promiscuous sex springs to mind.

Multiple priorities are oxymoronic – bound to conflict one with another. Growth should have been The Priority. Thus the coalition needed, as a first step, to seek independent advice on how best to do the least economic damage. Career politicians these days have little business

experience or acumen. Businessmen have little political experience or acumen. Governments bribe voters with Taxpayers' money¹⁴. Businessmen bribe shareholders with profits, when not rewarding themselves with shareholders' money. A 'Geddes' commission should have been asked to recommend the best way to achieve the government's target spending cuts with 'absolute priority'¹⁵ given to protecting growth. Politicians could then have reached informed decisions based on rival political priorities.

The axeman's task was set by the coalition's self-imposed fiscal targets. Gordon Brown set himself flawed 'Golden Rules'. In particular, the current budget should balance over the course of the cycle – meaning the government should

only borrow to finance investment. But the length of a cycle can only be determined in retrospect. Early surpluses became a licence for later deficits. Moreover the Treasury, its own judge and jury, forecast the cycle, moving the 'goal posts' to ensure penalty kicks were never missed. Perhaps a better analogy would be the goal keeper (the Treasury) was on the penalty kicker's (the Chancellor's) side.

The Coalition also set itself 'Golden Rules' rebranded 'Fiscal Mandates'. The first was that the cyclically-adjusted current budget should balance at the end of a rolling five-year forecast period, initially taken to be 2015-16. The goal posts were fixed, but missed penalties could be retaken the following year. An independent goal-keeper, the Office for Budgetary Responsibility (OBR) took forecasting responsibility from the Treasury. The second Mandate was to ensure the government's net-debt/GDP ratio would be falling in 2015-16

The Coalition's fiscal Mandates were as flawed as Brown's Golden Rules. They were a delayed-action landmine

¹⁴ Geddes always used a capital 'T' for Taxpayers, a practise followed here.

¹⁵ Nick Clegg, in announcing a massive increase in state-backed lending for housing and infrastructure, told the FT it would be an "absolute priority" (22 May 2012). Perhaps 'priority priority' or 'priority-squared' would be better. Then there could be 'priority-cubed' or '10 to the power n'.

compared with 2014-15 with no rolling forward.

The Coalition's Mandates were the result of muddled thinking, as flawed as Brown's Golden Rules. The Government itself did not have faith in its own fiscal mandates. If it had, it would have boosted capital investment to offset the damage to demand from current spending cuts. Neither the current budget deficit, nor net debt, would have been increased. Undoubtedly it believed markets were less sophisticated, fixated upon total borrowing and gross debt. The mandates were a delayed-action landmine that, as we shall see later, has now exploded.

The OBR was asked to examine twice a year whether the government was on track to meet its targets. The exam results, prepared with Whitehall's full knowledge and co-operation, allowed for the latest budget and autumn pre-budget measures. This was like knowing the exam questions when preparing the answers. If failure beckoned, measures could be taken to correct course. The OBR was biased towards awarding pass marks. It coached the candidate.

But the flaws went deeper. The 'cyclically-adjusted' refinement to the target balance was unnecessary (see box on page 7 above). Looking five years ahead, the OBR uses a 'dynamic stochastic general equilibrium' (DSGE) forecasting model. This assumes GDP will equal its trend level in five years time, meaning no output gap. The projected growth rate equals the estimated trend growth rate plus whatever is necessary to eliminate the current output gap. The OBR therefore projects a zero output gap five years hence and consequently the cyclically-adjustment is also zero and the overall and cyclically-adjusted budget balances are the same.

Taking growth to equal potential growth plus eliminating the output gap has other malign consequences. If meanwhile growth slows below potential and the negative output gap increases, slower growth today means faster growth tomorrow. Some course changes may be required if planned cuts are not delivered as planned. But normally these should be minor. In effect, the DSGE forecasting model assumes that fiscal policy has no effect on growth. Monetary policy is equally neutered. The Bank of England is assumed to succeed whatever it does.

The fixed target date by which the net-debt/GDP ratio is falling is another matter. Initially this was

the same as the first five-year term for the rolling current balance. Capital investment increases assets. The cost adds to gross debt, but not to net debt. Unless nominal GDP is falling, a currently balance budget means the net-debt/GDP ratio must be falling.

Unwittingly both fiscal Mandates were delayed-action landmines. The debt target's fixed date gets nearer every year. Forecast GDP need no longer equal its potential level, but may lag well below it. In the shorter run, growth does depend upon fiscal measures and the success of monetary policy. The debt/GDP ratio is more sensitive to the denominator, nominal GDP, than the budget balance ratio¹⁶. A relapse into recession becomes fatal for the fixed-dated debt target.

Renewed recession is also fatal for the rolling budget target. If a negative output gap is not soon closed by rising demand it is closed by falling supply – the potential growth rate is reduced. Business investment falls and existing plant is scrapped before it is worn out. The capital stock erodes. The long term unemployed become unemployable. The supply and quality of labour is diminished. Reducing the estimated potential growth rate lowers the forecast GDP level five years hence. It then becomes less likely that existing measures will balance the budget. On the one hand, further tightening is required to hit the Mandate; on the other easing is desirable to foster recovery to hit the Mandate. The landmine explodes.

The 'multiplier' impact of the budget on actual and potential GDP growth is of the greatest importance, a controversial matter (discussed in Appendix A). Nor can it be judged in isolation from the fiscal policies adopted by other countries. Moreover sustainable debt ratios are also a function of interest rates, largely determined by financial markets. There can be no unambiguous rule to predict how markets will react to fiscal retrenchment. The government may be rewarded for its prudence, or punished for imposing politically intolerable austerity. Multiplier implications would weigh heavily on an independent 'Geddes' commission's

16 If the budget deficit were £10bn and public sector debt £60bn and GDP £100bn they would be 10% and 60% of GDP respectively. But were GDP £90bn they would be 11.1% and 66.7%. If GDP is 10% lower, shares are 11% higher.



recommendations, given an unambiguous priority to protect growth.

A balanced budget target says spending and revenues must take the same GDP shares. It says nothing about what these shares should be. Gordon Brown's golden rules required ratios to be stabilised, a reasonable task given Labour's 1997 inheritance. But starting in 2010 from an unprecedented peacetime budget deficit, shares had to change. The coalition determined that 80% of the adjustment relative to GDP should come from reduced spending.

Following the May 2010 election, the coalition presented its first budget in June. The 2009-10 budget deficit was put at 11% of GDP and the target for 2015-16 was 1%¹⁷, a 10% points cut. This assumed an 8% structural tightening, plus 2% coming from above trend growth eliminating the negative output gap¹⁸. Tax revenues were predicted to rise by 2% points from 37% of GDP to 39% and public spending to fall from 48% to 40%¹⁹. These targets look startlingly different in cash terms, Table 2.1.

The budget deficit was planned to be cut by £135bn by 2015-16 – the necessary cash amount calculated from forecast nominal growth and chosen tax and expenditure target shares. Tax

revenue was projected to rise by £222bn, a 43% increase. Public spending was projected to rise, not fall, by £88bn or 13%. The forecast 35% increase in nominal GDP gave rise to the claim that 80% of the cuts came from reduced public expenditure, the spending cash rise converted into a GDP share fall. In cash terms, higher taxes were supposed to do the heavy lifting in cutting the budget deficit.

When Chancellors talk of 'saving' Taxpayers' money or 'giving' more government money to health, education or

whatever, they don't mean what we mean. They mean compared with previous plans or projections. The government's 2012 U-turn, to buy jump-jet F35Bs and not install 'cats and traps' on the aircraft carriers 'saved' £2bn. Call these "phantom" cuts – akin to saving money by deciding to buy a Ford Focus instead of a Rolls-Royce Phantom. The government claimed to spend less, but compared with what? The coalition inherited spending plans from Labour's March 2010 budget. These went up to 2014-15. Chart 2.3 (next page) shows how these rival

In cash terms, higher taxes were supposed to do the heavy lifting in cutting the budget deficit

plans differed. In its pre-election budget, the Labour government also promised retrenchment. The incoming coalition's 'cuts' went further and faster²⁰. Neither budget gave detailed departmental spending targets beyond the current financial year.

The only detailed breakdown in spending plans beyond 2010-11 was between current and

Table 2.1 June 2010 Budget Projection

£bn	2009-10	2015-16	Change	% change
Nominal GDP	1,408	1,902	494	35.1
Revenues	515	737	222	43.2
Spending	669	757	88	13.1
Budget balance	-155	-20	135	
% GDP	2009-10	2015-16		% pts Change
Revenues	36.6	38.7		2.2
Spending	47.5	39.8		-7.7
Budget balance	-11.0	-1.1		9.9

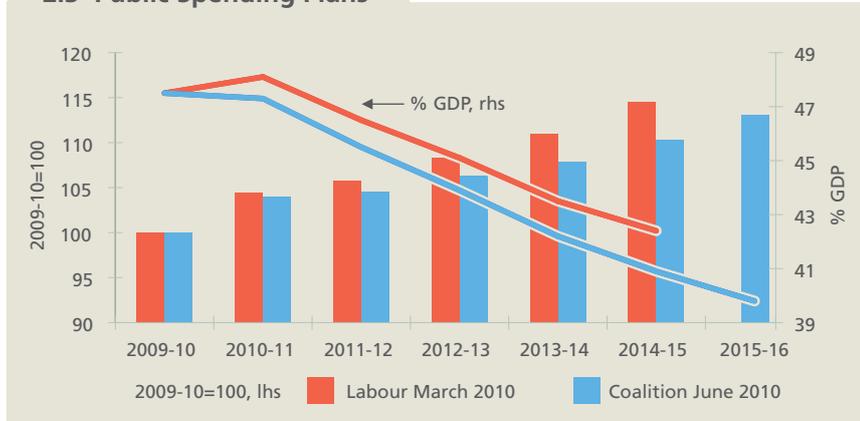
¹⁷ The balance target would be met in the final quarter.

¹⁸ The gap was assumed to be zero in 2016 Q1. The cyclically-adjusted deficit for the whole of 2015-16 was put at 0.3%, down from 8.7% in 2009-10.

¹⁹ Overall deficit down from 11.1% to 1.1% of which 0.8% was still cyclical.

²⁰ Labour's data used here is drawn from the March 2010 Budget Report ('Red Book'). The OBR updated Labour's data in its June 2010 pre-budget forecast. This adjusted GDP and 2009-10 outturn estimates for the latest information. The up-dates were only marginally different from the June budget numbers, but showed a slightly closer profile to the June budget estimates.

2.3 Public Spending Plans



capital spending. This reflected Gordon Brown's Golden Rule to balance the current budget and only borrow to finance investment. The Coalition budget presented fiscal projections with the same breakdown, despite the changed rules. A current balance rule is better than seeking to balance the overall budget. When interest rates are exceptionally low in a recession, it pays to borrow for infrastructure investment, provided the return exceeds the interest cost²¹. Both governments paid only lip-service to placing the burden of cuts on consumption rather than capital investment. Both governments planned to cut public sector

net investment by more than half. Gross investment's GDP share, already small, was to be almost halved.

Budget balance targets simply show that current spending should equal revenue and the shares of each in nominal GDP should be the same. But the volume shares in real GDP will differ. The prices paid for public sector purchases do not rise at the same rate as those paid for private purchases. The 'real' or volume of expenditure ought therefore to be estimated using differing inflation rates, in detail as well as in aggregate, for private and public current and capital spending. Capital spending is normally less labour-intensive than current. Wages generally rise faster

Rival plans show that both governments paid only lip-service to placing the burden of cuts on consumption rather than capital investment

Table 2.2 Current and Capital Spending Plans, 2010 Budgets

	Current			Capital gross			Capital net		
	2009-10	2014-15	2015-16	2009-10	2014-15	2015-16	2009-10	2014-15	2015-16
Labour									
£bn	604.6	725		69.5	47		50	23	
% from 2009-10		19.9			-32.4			-54.0	
% GDP	43.0	39.7		4.9	2.6				
% total expenditure	89.7	93.9		10.3	6.1				
Coalition									
£bn	600.6	692.7	711.4	68.7	44.9	46.1	49	20.6	20.9
% from 2009-10		15.3	18.4		-34.6	-32.9		-58.0	-57.3
% GDP	42.8	38.4	37.4	4.9	2.5	2.4			
% total expenditure	89.7	93.9	93.9	10.3	6.1	6.1			
	Nominal GDP			GDP deflator 2002-10=100			Real GDP 2009-10 prices		
Labour	1,406	1,824		100	112.3	1,406	1,624		
Coalition	1,404	1,803	1,902	100	113.0	116.1	1,404	1,596	1,638

²¹ The present value of the returns exceeds the present value of its costs.



than prices. Capital goods' prices do not rise at the same rate as consumer goods', fixed capital formation deflators have been falling in recent years. Import prices may rise faster or slower than the price of domestic products – and so on. The volume or 'real' changes in government spending, both in aggregate and in detail, depend upon price indices specific to each kind of expenditure.

Chancellors have the habit of claiming additional resources have been provided for health, etc, using bogus numbers

But this is not the way governments do their sums. Individual departmental budgets, current as well as capital spending, are all converted into constant prices using the same price index, the GDP deflator. This means that if price inflation for, say, the NHS is faster than the GDP average a 'real' increase is exaggerated. But if NHS prices rise slower the real increase is understated. Chancellors have the habit of claiming additional resources have been provided for health, etc, using bogus numbers.

This is not simply grist for the spin-doctors' mill, but has significant ramifications for public spending control. The 2010 Spending Review shows the Department of Health's budget to 2014-15 and claimed the *"settlement increases overall NHS funding in real terms every year, the total increase is 0.4% in real terms over the Spending Review period – meeting the Government's commitment on health spending"*. This is a classic example of decimal point inaccuracy. The settlement itself includes no evidence to indicate whether 'real' NHS expenditure will increase or diminish. That would require an estimate of the relative price effect – the difference between the health inflation and the GDP deflator – which the Review ignored. All that the Spending Review numbers reveal is that the share of NHS spending in GDP is the same whether measured at current or constant prices. Past experience suggests NHS prices rise ½% a year faster than the GDP deflator. If they continue to do so in the future, NHS resources will be reduced by 2% in real terms over the Spending Review period. But freezing public servants' pay

in theory should reduce health inflation below the average. Planned real increases will then be greater than the Chancellor claims. The truth is hard to discern (see Appendix B). It seems the pay freeze was singularly unsuccessful.

The OBR report in the June 2010 Budget Red Book estimated the impact effect of fiscal multipliers on GDP. Each 1% cut in departments' current spending was said to reduce GDP below what it would otherwise have been by 0.6%. The estimated impact of a departmental 1% capital spending cut was 1%. These estimates are now challenged as too low. They were based on experience prior to the Great Recession and allowed little for the impact of the financial crisis on private sector de-leveraging.

When households and companies are struggling to reduce debt, they are not inclined to save much less when incomes are reduced. Equally, the size of the multiplier increases when other countries are simultaneously retrenching. The expected exchange rate fall is smaller. Leakages through falling imports are offset by other countries' import reductions and increased net exports are less of an offset to weakened domestic demand.

A 1% reduction in GDP growth causes a negative output gap to increase by 1%. This causes the budget balance to deteriorate cyclically. A reasonable guess, based on tax and spending shares in GDP, is that each 1% worsening in the output gap causes the balance to deteriorate by around 0.4% of GDP. If so, £189 billion spending cuts would have been required to balance the budget, rather than the £135 billion supposed in the June 2010 budget. Less would have been needed if tax hikes had been made instead, where the fiscal multiplier impact was put at 0.3% for each tax increase.

Doubtless a 'Geddes' committee would have liaised closely with the OBR to assess the impact of its recommendations on growth and the cyclical balance. But this would have been futile so long as the OBR, as noted above, based its GDP projections on its dynamic stochastic general equilibrium model. In assuming that by 2015-16 the negative output gap is eliminated, the model implies that fiscal policy is matched by monetary offsets and has not the slightest impact on growth!²²

²² The model as used is also remarkable in that it assumes the Bank of England policy also has

In conclusion therefore, the terms of reference given to an independent 'Geddes' committee should have been as follows:-

- 1 To recommend measures that would reduce the ratio of public spending to GDP from 47.5% of nominal GDP in 2009-10 to 39.8% by 2014-15, while doing the minimum damage to growth.**
- 2 In accordance with the Government's priorities (notably to increase the real resources devoted to the NHS) to estimate relative price movements for health, education, defence and other government functions compared with GDP inflation .**
- 3 In consequence, to estimate the real resource consequences of proposed spending cuts.**
- 4 In order to protect front-line services, to identify the impact of cuts on front-line jobs and the productivity consequents of the Committee's recommendations.**

no impact on growth. Inflation at the projection's horizon equals the Bank's target 2% rate, meaning its policies are presumed to be perfect.



Chapter 3.

Spending Review Framework – madness in their method

This chapter examines how the Coalition Government set about dealing with the budget problems it inherited.

The 2010 general election on 6 May resulted in a hung parliament. It took most of the following week for the Conservative and Liberal Democrats to agree terms for the Coalition Government (12 May). It then acted with unseemly haste, which may have been necessary to convince financial markets and public opinion that the Coalition could work²³. Already more than one month of the current financial year had elapsed and it was two months since the outgoing Government's budget (24 March). Having attacked that, an early 'emergency'²⁴ budget (22 June) was needed to rectify its 'faults'. Indeed the new Chancellor George Osborne could not wait that long. Less than two weeks from taking office he announced £6¼ billion spending cuts (24 May). Civil service recruitment was frozen, Child Trust Funds were scrapped and economies on Whitehall travel were announced.²⁵

23 One Treasury official explained to the back-bench Treasury Select Committee that *"There were also market-related reasons why it was important for the Government to have a clear fiscal plan quickly. I don't think even if we had had more time, that it would have been wise in terms of market perceptions to have taken more times because people needed to see that we had a fully worked-up fiscal plan."*

24 Officially dubbed 'emergency'

25 The Chief Secretary (LibDem) gave up his

On this basis Osborne waxed lyrical:-

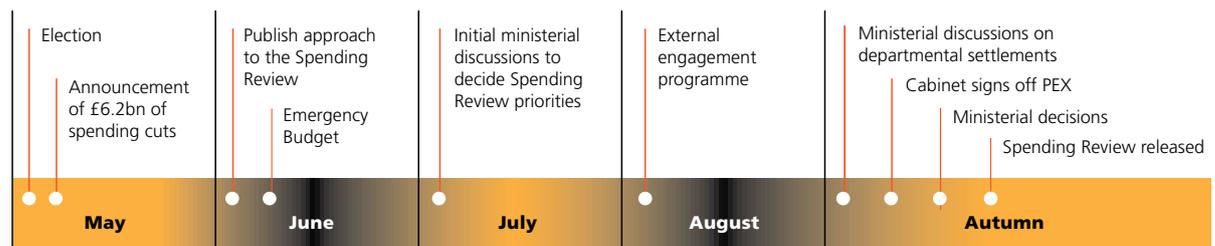
"We have conducted the fastest and most collegiate spending review in recent history ...rolling up our sleeves, getting on with the job, working together in the National Interest, delivering on promises, getting a grip. There were many who said it couldn't be done²⁶..... that only cuts in front line services were feasible because all the efficiencies possible had already been found. We have comprehensively demolished all these arguments. We have worked incredibly hard over the past week."

The incredibly hard work remained to be done, over months not one week, on the emergency budget and the *Spending Review* due by October. In *Sharpening the Axe* we observed that "A credible retrenchment plan is needed for 2011 onwards. Neither main party has produced one in the run up to the election. It is probable that neither has formulated one in detail".

This was the case. Consequently the job was rushed.

On 8 June the Government announced its High level timetable for Spending Review 2010 in a document entitled *The Spending Review Framework*.

High level timetable for Spending Review



The framework claimed that *"successfully reducing the largest deficit in Britain's peacetime history will mean approaching the Spending Review in a completely different way from how it has been approached in the past"*.

personal-use-only chauffeur-driven Jaguar, as did other ministers their official cars. First class air travel was restricted.

26 Jokingly it was said of Edward Heath *They said it couldn't be done
With a smile on his face he went to it
He tackled that job that couldn't be done
And couldn't do it.*

The main elements of the new approach were

- A *Star Chamber* to challenge departmental spending plans "using a series of key questions to promote innovative thinking"
- A *Spending Review Challenge Group* of experts from within government and outside – to act as "independent challengers and champions for departments"
- An *External Engagement Programme*.

Much of the following comment draws upon evidence taken by the House of Commons Treasury and Civil Service Select Committee in its assessment of the *Spending Review* and its conclusions. The *Spending Review* results were presented to Parliament on 20 October 2010 and the Treasury Committee reported on 26 November.

The *Star Chamber* was purportedly copied from Canada's successful retrenchment in the 1990s. It consisted of a cabinet level Public Expenditure Committee (PEX) chaired by the Chancellor and initially including his Treasury Chief Secretary (the only Lib-Dem member), the Foreign Secretary, the Paymaster General (Minister for the Cabinet Office) and his junior Minister of State.

The PEX committee would co-opt other ministers once their own departmental settlements had been reached. Lord Turnbull, former Chief Cabinet Secretary, explained to the Treasury Committee what this meant – *"A game of British bulldog: as you capture someone, they then play on your side."*

It is obvious that the *Star Chamber* was far from a new approach. *'Playing on your side'* simply meant competition between departments and horse-trading between ministers to determine where cuts will fall. Horse-trading between Coalition partners added a further ingredient to a traditional recipe. The Treasury Committee was



not taken in by the Coalition's propaganda²⁷. It reported:-

"The UK spending review followed a traditional route. The spending review committee was designed as a 'Star Chamber', there to act as judge and jury. This was a form of committee structure that the UK is used to employing, and in the relatively short timescales it could be argued it was the only choice."

Official evidence revealed that PEX met seven times while the spending review was being prepared. In addition there were nine 'quadrilateral' meetings between the Prime Minister, Deputy PM, Chancellor and Treasury Chief Secretary (two Conservatives and two Lib-Dems). The Quad was clearly the highest Court of Appeal. PEX and Quad meetings were described as a "collective process" to iron out party differences. Quad meetings gave a "political steer" that ensured "we took the best quality decisions that we could". Some would say 'worst' due to compromises. It is hard to see how 24 government departmental budgets could have been scrutinised during 16 PEX and Quad meetings in the intense manner that the Framework proclaimed they would be. Indeed official witnesses apparently made no mention of "key questions to promote innovative thinking" being asked.

The Spending Review Challenge Group was akin to the appointment of rival cheer-leaders or barristers for both plaintiff and respondent. On 8 June George Osborne told Parliament that it would contain "The brightest and the best to propose innovative ways to cut costs". He went further to suggest it might include "the inspirational head teacher, the far-sighted police chief, the nurse with new ideas for solving old-age problems". It actually contained 29 Whitehall civil servants out of 38 members, two local government civil servants and one Scottish. Five of the remaining six were from the City - HSBC, Goldman Sachs and KPMG executives plus a fund CIO and a private equity buy-out CEO. The remaining member was the bureaucratic head of a voluntary and community action association.

27 Why are official government publications now filled with egregious hyperbole? Propaganda or spin has reached the point at which it is so obvious that it fools nobody except possibly its authors.

It seems inspirational head teachers, far-sighted policemen and new-ideas nurses are extinct species.

The brightest and best civil servants no doubt championed their own departments and challenged all others with the utmost vigour. City interest possibly championed sound money, an innovative idea to those with no knowledge of economic history. After the Spending Review Group's membership was announced it disappeared virtually without trace. A Google search only reveals a leaked letter from one member protesting NHS cuts and tabloid 'exposures' of independent members' political donations and supposed conflicting interests.

The External Engagement Programme involved "a series of events over the summer to discuss and debate various aspects of public spending... A range of people will be invited to these events, to make sure they represent a wide spectrum of expertise and viewpoints. Invitees will include members of think tanks and interesting groups, academics, representatives of local government, business and trade unions²⁸, and public sector experts and watchdogs such as the Audit Commission."

These events also seem to have disappeared without trace from official and press records - not so the engagement programme's second component. This provided the opportunity for frontline workers and the general public to suggest money saving ideas through a 'Spending Challenge' website, opened on 9 July. Initially it was inundated by rabid and bigoted rants, many beginning with "I am not a racist but ...". By mid-August it had to be closed. It was re-opened at the end of the month with a filter installed and an innovative request for the public to vote on the best ideas. Top of the pops would be seriously considered. Contributors were assured, however, that every suggestion would be receive attention and be read.

In the event there were over 100,000 responses, with 63,000 from within the public services²⁹.

28 Bad grammar. The plural of 'trade union' is 'trades union' not 'trade unions'.

29 If it took 2 minutes to read each suggestion, it would take one man working 40 hours a week without holidays over a year-and-a-half to complete the task.

The Treasury estimated the resultant savings were £500 million (ie, £5,000 on average per suggestion). The Treasury Committee suspected double-counting. The best the Chief Secretary could come up with was £1 million a year from scrapping National Insurance plastic cards. The Committee wondered whether the results justified the means – *“set against the resources required to manage and review tools such as the Spending Challenge.”*

Hitherto annual budgets and less frequent longer term spending reviews (the previous one had been in 2007) involved the Treasury agreeing (or rather dictating) each department’s individual budget limits. For the 2010 Spending Review Whitehall came up with the term ‘envelopes’, implying departments would be left to decide what was stuffed into them. This was not altogether the case. Individual measures, to save or spend more, needed to be considered in the bilateral settlement negotiations between ministers and the Treasury – generally in the day-to-day hands of the Chief Secretary. Cabinet always had the last word. The Quad was a further layer in the settlement process, between the Treasury and Cabinet, needed to reflect the political compromises forced on coalition parties.

This arrangement still meant that departmental bureaucrats came up with spending proposals – apart from the meagre offerings gleaned from the External Engagement Programme. Administrators naturally prefer capital to current spending cuts – private employers are then responsible for any resultant unemployment. Equally back-line bureaucrats are loath to cut their own ranks and consequently front line workers tend to suffer. Despite priorities, pious hopes and platitudes, the Framework contained little new to counter this bias. Front line workers were neither identified nor quantified. Administrative budgets, however, received special attention with cuts of one-third targeted. As an indirect method to protect frontline workers, this could produce only modest results. Administration accounted for just 3.4% of departmental spending. The Department of Education’s administrative budget is less than 1% of its total spending because more than 80% goes in grants and subsidies to others, almost all to local governments who employ teachers and administer most schools. Civil servants account for just 10% of general government employment, 500,000 out of five million. Certainly saving 1%

of departmental spending is not to be sneezed at, but the difference it makes to front line workers could only be marginal.

The government did announce one important and potentially beneficial change. It scrapped Labour’s complex system of public service contracts and departmental ‘Performance Agreements’ with its mind-boggling multiplicity of ‘*politically-motivated*’ targets. They were replaced by Business and Transparency plans. Departments no longer report to the Government and Parliament on progress in meeting agreement targets. Instead they are required to publish input and impact indicators, plus a mind-boggling multiplicity of ‘*politically-correct*’ data to meet twin Coalition priorities – empowerment and fairness. Indeed, Lord Palmerstone’s reported answer to Queen Victoria’s insistence on reform springs to mind. *“Change, change, all this talk about change. Things are quite bad enough already!”* As the following quote from the November 2010 Department of Health Business Plan shows, it is a moot point whether the change was an improvement.

“We want the public, service users and local authorities to engage in service development, and to this end we are running public consultations on data transparency. Where appropriate, data is published by gender, age, race and socio-economic group to promote fairness for disadvantaged and vulnerable groups, and to help drive down costs by allowing further benchmarking. From this wealth of information, the Department’s business plan sets out the high-level indicators that we believe are the most important to increase transparency. More detailed supporting indicators will be set out in separate NHS, Public Health, and Social Care Frameworks.”

One should not neglect the imposed need to collect evidence of efforts to avert global warming – statistics for carbon footprints, waste recycling and water usage. It seems these efforts have been immensely successful this cold and wet summer.

Finally, the Spending Review indulged the Government by explaining how very fair it had been. It contained an appendix entitled *Distribution Impact Analysis* and provided supplementary information on the Treasury web site in an *Overview of the impact of Spending Review 2010 on equalities*. Nowhere was there an overview of the impact of Spending Review 2010 on the ‘*economy*’.



Chapter 4

Count the pounds and the coppers will look after themselves

This Chapter explains how the 2010 Spending Review failed to consider the economic and employment consequences of spending cuts.

In-house spending reviews are a fraud, and have always been, perpetrated by The Establishment (professional politicians, party hacks and bureaucrats), thinly disguised by spin, hype and Taxpayer-financed party-political propaganda as promoting growth and fairness – ‘apple-pies and motherhood’. They serve to reconcile differing political agendas, regardless of their economic consequences.

The 2010 Spending Review’s task was to fill in the detailed cuts required to achieve the Coalition’s fiscal mandates. It differed little from its predecessors other than its extended coverage. It focused on departmental budgets – who spends what, not who does what. ‘Real’ resource estimates were bogus, ignoring relatively faster price increases for public sector spending. Spending cuts consequences for growth and employment were ignored. The only economic distinction made was between current (called ‘resource’) and capital spending. This was purely out of habit, no further notice was taken of the difference. Treasury, ONS and OBR statisticians were left to work out the effects of spending cuts on growth and employment after the decisions had been taken. But that is the way public spending has always been managed in Whitehall and Westminster.

Public spending data can be presented in several other ways showing what the money is spent on instead of who spends it (which is not the

same thing) and how it is spent. These alternative presentations throw light on different aspects of public spending.

- **By function.** *This shows what services the money is actually spent on.*

HMT and ONS statisticians reshuffle departmental data to reveal spending by function, delightfully designated COFOG – the United Nations' 'Classification of Functions of Government'. Health and education services are functions provided by government; business, innovation and skills or grants to local government are not. The result is a matrix showing departments on the vertical axis and functions on the horizontal. COFOG splits spending into ten main functions³⁰ (level 1) and many sub-functions (level 2). In 2010-11, for example, the polyglot Department for Communities and Local Government was estimated to have spent 37% of its budget on 'housing and community amenities' accounting for 58% of spending on this function³¹. It is hard to see how the government could prioritise certain functions without indentifying what is spent upon them. Some departments are mostly responsible for the function by which they are named, Defence for example. The Department of Education accounts for two-thirds of expenditure on education, the Department for Business, Innovation and Skills accounts for about 15%, while Scottish, Wales and Northern Ireland offices come up with the rest.

- **By economic category.** *This shows who gets the money the government spends. It is crucial for all else that follows. It should be the starting point of every consolidation programme if it is to do minimal damage to growth and employment.*

Total current spending is split into pay bills, purchases of goods and services, grants, subsidies, public servants pensions and debt interest. Capital spending is split into

purchases and grants. HMT comments:- *"The economic significance of public spending, such as its impact on GDP, depends on its nature; firstly whether it is current or capital, but also whether it is, for example, a transfer payment or expenditure on goods and services."*³² The Spending Review claimed to be *"Prioritising growth enhancing spending"*, focussing on capital spending *"projects that deliver the highest economic returns"* and prioritising *"current spending which helps to deliver outcomes that support growth"*³³ One might have expected some economic breakdown to be provided, especially of pay, to support these claims.

- **At constant prices.** *This should show value for money, what the Taxpayers' pound spent on each service really buys.*

Bogus departmental 'real' expenditure plans based on the GDP deflator, disregarding relative prices, have already been described. This is also a lacuna in most official outturn statistics, although separate deflators are available for public consumption and investment and some function spending.

- **By employment.** *This is the most neglected field of all. It follows from pay bills and wage earnings per head.*

The only estimate of government employment numbers given in the Spending Review was to repeat the OBR's June forecast. *"At the Budget, the OBR forecast a reduction in general government employment of 490,000 by 2014-15..... Individual employers in the public sector will determine the workforce implications of spending settlements in their areas."*³⁴

Consolidation viewed as a whole

Possibly the Spending Review took Irish advice – *"If I were going to Balbriggan, I would not start from here."* It did not cover the whole of the Coalition's fiscal consolidation programme. Following convention, it took the forecast spending in the current year (2010-11) as its base line, rather than the reasonably known 2009-10 outturn

30 General public services; defence; public order and safety; economic affairs; environment; housing and community amenities; health; recreation, culture and religion; education; and social protection.

31 *Public Expenditure Statistical Analysis*, Table 5.1

32 *Public Expenditure Statistical Analysis* 2012, page 70

33 *Spending Review* 2010, page 22

34 *Spending Review*, page 38



Public Spending Acronymics

Public spending budgets must be voted by Parliament. Those given authority to spend Taxpayers' money are responsible to Parliament for how they spend it. Individual departments are responsible for the greater part of public spending. But this responsibility is significantly delegated. The Department of Health makes transfers to the NHS. Other departments make grants to local governments, Scotland, Wales and Northern Ireland. Arms-length bodies, better known as 'quangos', receive finance from sponsoring departments. Some expenditure falls outside departmental responsibility – notably government debt interest.

Spending reviews deal with how much departments spend and how they spend it. This now covers their quangos. How much money is granted to the NHS and local governments receive is included in reviews, but not how they spend it.

Departments are given 'departmental expenditure limits' called DELs. They can control only part of their spending budgets, determining how much they spend and how they spend it. Some they can't control, misleadingly called 'departmental' AMEs, 'annually managed expenditure'. It is money spent on entitlements, social security benefits, pensions etc., which depend on the number of people who qualify and benefit levels. 'Other AMEs' includes debt interest and so forth, not allocated by department. All AMEs are forecasts. They can be influenced by changes in benefit rules, but cannot otherwise be budgeted.

DELs plus AMEs equal 'total managed expenditure', TME. This is public expenditure with a small adjustment for local governments' self-financed spending from rates, etc (10% of LGs income).

DELs and AMEs are divided into current (called 'resource') and capital spending – hence RDELs and CDELs. RDELs includes capital depreciation, an accounting identity that departments cannot control. This is then netted off capital spending in CDELs to give government net investment.

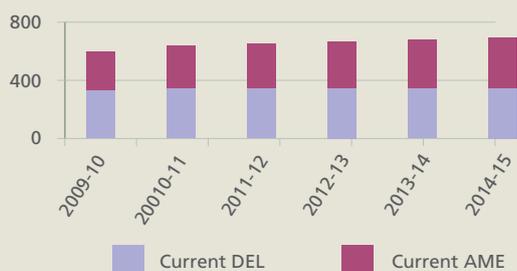
Net investment adds to government assets and therefore does not directly add to its net debts. Resource DELs plus resource AMEs equal government current expenditure, the measure used in the balanced budget mandate.

– the Coalition's legacy. Normally fair enough – current year budgets are water under the bridge. Yet the Axe had already begun chipping away and to judge the Government's retrenchment programme as a whole it is necessary to start from its beginning. The Spending Review changed the

figures for 2009-10 or earlier years³⁵.

Chart 4.1 (below) stitches together June 2010 budget estimates for 2009-10 and Spending Review projections from 2010-11 to 2014-15. Current spending accounted for 90% of public spending in 2009-10 and capital

4.1 A Current spending plans, £bn



4.1 B Capital spending plans, £bn



way departmental spending numbers are normally presented, but did not bother to give comparable

35 Departmental current 'resource' spending in budget tables includes depreciation. The Spending Review breakdown excludes it.

spending the remaining 10%. Expenditure limits (DEL) accounted for 60% and entitlement spending (AME) accounted for 40% (see Box). Retrenchment did not mean less public spending. Over five years the Coalition planned to increase spending by 10½% from £670bn to £740bn. Momentum was partly to blame. Spending was estimated to rise 4¼% in the Government's first year, leaving 6¼% over the Spending Review's remaining four years.

The momentum, understandably, was largely due to entitlement spending (total AME), up by over a quarter with a third of this in the first year. AME is virtually all current transfers. If departments' capital spending is excluded, public current spending plus AME was slated to increase 14% or £86bn over five years. Restraint was imposed by a slash and burn attack on public sector net investment, down 31% over five years and 21% over the Spending Review's four years. Obviously a large part of public investment was judged not to be "*projects that deliver the highest economic returns*". Allowing for big lumps, such as high speed rail and aircraft carriers, there can have been little left for other projects. Equally it is hard to see how "*current spending which helps to deliver outcomes that support growth*" could have been 'prioritised' in the absence of any analysis of their impact on growth.

Plans by functions

Analysing public spending by function is a quagmire in which COFOGs (UN Categories of Functions of Government) are plagued by MoGs. Departments continually change names and responsibilities (Management of Government changes - see Box). The Department for Business, Innovation and Skills' responsibilities range from universities, company law, regional and local economic development to 'outer space' (hopefully with ministerial visits). Doubtless 'innovation' covers new dishes created by top chefs. But maybe these come under the Department for the Environment, Food and Rural Affairs, which is also responsible for 'Noise', treading on the Department for Transport's toes. MoGs can be allowed for by unpicking departmental budgets and stitching them together again in COFOGs. 'Innovation' is not a government function in any sense of the word, although 'noise' may be.

Analysis by COFOG functions goes further. It adjusts departmental budgets to national income

and expenditure definitions. Small departments are collected in groups. Where departmental budgets include large transfer payments, such as to local government, these are reassigned to their functions, such as education or health. Moreover 'Other AME' spending is also re-assigned by departmental groups (such as debt interest to the Chancellor's). The result is that departmental spending totals differ from those given in budgetary allocations (other AME and accounting adjustments), and spending on functions differs from spending by the most relevant departments (where there is one).

The Treasury's annual Public Expenditure Statistical Analysis (PESA) contains spending estimates by

How MoGs breed

Education became a minor government responsibility in 1839 when a Privy Council Committee on Education was established. Its development was then as follows:-

- 1856 – Education Department
- 1899 – Board of Education
- 1944 – Ministry of Education
- 1964 - Department of Education and Science
- 1992 – Department for Education (losing Science)
- 1995 - Department for Education and Employment (merging two departments)
- 2001 – Department for Education and Skills (losing some of Employment)
- 2007 – Department for Education, Schools and Families (losing Universities and gaining broad responsibility for the young)
- 2010 – Department for Education (not much changed but the name)

function for past years, but not for future plans. It includes a matrix showing functional spending by departmental budgets. This shows how spending is allocated to departments in the functional analysis and their shares in the total for their main function. The following table is a simplified version.

Analysis by function is vastly more important than by departmental budgets. It shows what the



Department and Function Budgets 2010-11

Department	Nearest main function	Own budget £bn	Function budget £bn	% own budget	% function budget
Works and Pensions	Social protection	157	232	98	66
Home Office	Public order and safety	17	34	97	50
Defence	Defence	40	39	93	95
Health	Health	113	121	88	82
Education	Education	69	91	86	66
Energy & Climate Change	Environment protection	11	56	81	22
Environment	Environment protection	3	22	60	56
Communities & Local Government	Housing and community amenities	17	50	44	68
Business	Economic affairs	13	22	33	13

Taxpayers’ money is spent on, not who spends it. Even some fairly ‘pure’ department and function matches – health and education - show significant differences. Defence is near-pure but Business, Innovation and Skill is the mess to be expected from its multitudinous responsibilities – which might as well also include ‘wishful thinking’. Without analysis by function, priorities play blind-man’s-bluff.

The Spending Review, Treasury, ONS and OBR have all failed to published spending plans analysed by COFOG functions. An extremely crude method of converting departmental budgets into functions is to reallocate plans for 2014-15 to functions using the same shares as in departmental functions in 2009-10.

Priorities are largely meaningless until translated into expenditure by function

The numbers here are merely illustrative. It would require more time and resources than are available in this exercise to produce an accurate picture. But it could be done if official resources were diverted from less useful analysis of waste recycling and water usage. The point to be repeated and stressed is that priorities are largely meaningless until translated into expenditure by function.

Plans by Economic Category

Economic categories include pay, purchases of goods and services³⁶, transfer payments (grants³⁷ and subsidies³⁸), pensions³⁹, depreciation and some others. Their economic consequences differ. Transfer payments such as welfare benefits redistribute income. Their impact on demand and growth is uncertain and contentious. Increased equality may reduce average savings rates – rich save more than poor. But it may also destroy incentives. Purchases of goods and services add to demand. Pay bills help to determine public sector employment. The difference between creating demand (goods and services spending) and switching demand (transfer payments) needs to be considered.

The methodology used in departmental budgets and national income accounts differ. Unlike

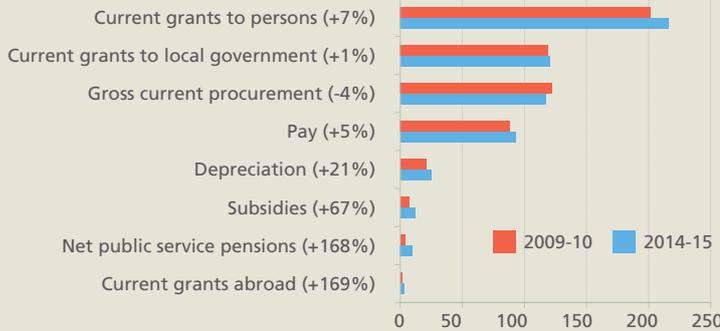
36 Called ‘procurement’ which include pay to contract and agency staff.

37 Mainly social security benefits in grants to persons and education etc., in grants to local authorities.

38 Include farm subsidies under the EU Common agricultural policy

39 Net pension payments, pensions paid to public sector retirees, less contributions from current employees, which are included in pay. Other ‘pension’ details include, inter alia, increases in pension fund liabilities which result from the pay-as-you-go system.

4.2 Spending plans major categories, 2009-10 and 2014-15. £bn



COFOG, the Treasury⁴⁰ has extended its analysis to give the aggregate breakdown for past and planned government current spending (Resource DEL). Chart 4.2 shows major categories spending in 2009-10 and planned for 2014-15⁴¹.

departments hand over. It does not measure what the local governments do with the money. This is particularly true of education. Fortunately the above analysis by functions of government helps. The most interesting issue is the shares going to pay and purchases of goods and services. Pay bills go up absolutely (though their share falls a little), purchases go down. Economising on purchasing is less unattractive than either cutting public servants' pay or sacking them. But it does more damage to demand.

Table 4.3 Spending by Economic Category, Change % 2009-10 to 2014-15

	Total	Pay	Goods and services	Private transfers	Transfers to local government	Depreciation	Other
All	7.6	5.3	5.0	10.1	5.5	20.9	3.3
Sample	6.8	-13.8	-13.2	11.8	9.6	8.6	29.1
Unallocated	8.3	13.4	13.3	5.6	1.2	23.7	-30.1
Education	10.1	23.3	-42.3				
Business	-23.7	-24.9	16.6				
Home	-8.0	-18.7	-3.4				
Justice	-18.1	-13.1	-19.5				
Defence	7.3	-3.2	-11.6				
Transport	-9.7	-49.9	-21.5				
Culture	-5.8	-29.7	9.1				
FCO	-38.6	-7.4	-43.2				
Energy	-24.7	-40.4	1.2				
Works	14.3	-34.8	-24.4				

Here it is to be noticed that spending cut-backs fall on welfare benefits, whose share diminishes. Local governments also lose out. Grants barely increase. But this just measures the share of taxes

Neither the Spending Review nor the Treasury's PESA attempts to probe below the aggregates. Individual departmental plans are not as yet analysed by economic category, but work on this is in hand. Some departments give estimates in their Annual Report and Accounts. These are published any time between early-July and mid-September for the previous financial year.

⁴⁰ Public Expenditure Statistical Analysis July 2011

⁴¹ Not exactly the same as in the Spending Review since the July 2011 analysis would take account of changes in the 2011 budget.



At the time of writing most are for 2011-12, but the latest available for a few are for 2010-11⁴². The format set by the Treasury is for 'core tables' and complete details were available for 2009-10 to 2014-15 in ten reports. These covered 50% of total departmental spending in 2009-10, but only 30% of pay and of procurement (goods and services). Total departments' spending on grants and subsidies was almost entirely captured due to the inclusion of Works and Pensions, Health and Education.

Table 4.3 summarises results by sample departments. Transfers are excluded as severely 'MOG'd'⁴³. The 'other' and 'depreciation' categories go all over the place and are left out of the table. In half the available reports planned pay bills for future years are on a different basis from those presented for past years. Planned pay is either MOG'd, changed to national income account methodology or for some unknown reason. The Department for Culture's RDEL⁴⁴ pay bill goes from £570m in 2009-10 and £566m in 2010-11 to £172m in 2011-12 and £154m in Olympic year 2012-13. No explanation is provided. When the apparently 'clean' pay plans of the five remaining departments are examined, the share of pay in current spending is largely unchanged by spending plans.

42 Six of the eleven major departmental reports examined here are for 2011-12 – Energy, Environment, Home, Transport, Work & Pensions and FCO. Reports for 2010-11 were Education, Justice, MoD, Business and Culture.

43 I was delighted to find in the 'Whitehall Monitor # 11' the Ministry of Justice explaining that its employment count had been increased because responsibility for the Residential Property Tribunal Service had been "MOG'd into MoJ from DCLG".

44 Resource department expenditure limit, pay is also included in RAME, resource annually managed expenditure. RAME pay went up partly offsetting the sharp decline in RDEL pay.

Really Real Spending

The 'relative price effect' (differing rates of inflation for public and private spending) is examined in greater detail in Appendix B. Public spending normally suffers faster inflation than private, largely because it is more labour intensive and pay normally rises faster than goods and services prices (real wages increase). Public sector pay is also higher by as much as 40%-50% on average⁴⁵.

But allowing for skills and the differing mix the gap is far less. It was estimated at 7.8% when the Coalition took office⁴⁶. In fact public and private pay play leapfrog while longer-term rising at similar rates. Private pay rises faster in booms and slower or falls in recessions. Public sector pay rises inexorably, except when governments impose pay freezes.

4.3 Adjusted public sector pay gap, %



Statistically public sector inflation rates are exaggerated as output is measured in terms of the cost of inputs with no allowance for productivity growth (if any). Private sector pay inflation, for instance, is generally measured by costs per unit output which allows for productivity growth. Nonetheless the analysis of departmental spending by economic categories provides a starting point for a rough calculation of relative prices and hence really real resource cuts (or increases).

The OBR's *Economic and Fiscal Outlook* gives

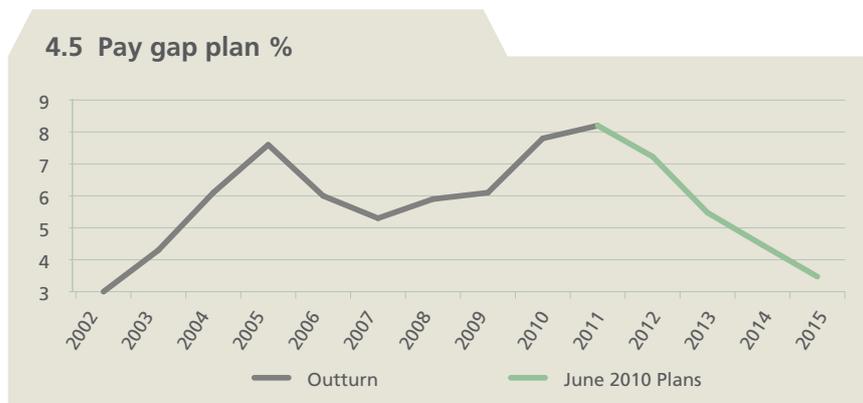
45 A paramedic driving an ambulance has additional skills compared with a bus driver. This is not to disparage bus drivers, negotiating city centres beset with cyclists.

46 *Estimating differences in public and private sector pay*, ONS March 2012

price⁴⁷ and public sector pay-per-head forecasts⁴⁸. This exercise takes the OBR's public sector pay forecast at face value. It will be shown in the next chapter that in the first two years pay-per-head rose three times as fast as the OBR forecast. Combined with analysis by economic category, these can be used to assess the importance of relative prices in public spending plans.

Chart 4.4 tells an important story. Public sector pay-inflation (lacking any allowance for productivity) normally exceeds consumer price inflation and largely explains why public spending relative prices rise faster than the GDP deflator. The Coalition's spending plans, as interpreted by the OBR in June 2010, mistakenly involved a slower rise in pay rates – ie, real income losses for public servants. The aim was to bring them back into closer line with recession-gouged private earnings. This comes out clearly when the pay gap is extended in the following chart to cover plan years⁴⁹.

The results of this exercise are shown in the following table which compares volume changes using the GDP deflator and those based on departments' expenditure by economic categories estimated in the previous section. **Warning! Department results must not be taken seriously.** They suffer from all the defects - MoGs, accounting adjustments, Other AME distribution – described above. They show that, on OBR pay projections, allowing for relative



Pay inflation, again with no allowance for productivity, equals public sector earning-per-head. Purchases of goods and services can be deflated by the total final expenditure deflator. Consumer prices can be used to deflate grants and subsidies (mostly welfare benefits). Grants to local government can use a composite index consisting of 50% pay, 30% TFE for goods and services purchases and 20% CPI for LG subsidies and grants.

price effects does not significantly change the picture for real or volume public sector spending compared with simply using the GDP deflator. It therefore follows that, given public sector pay is rising three times as fast as the OBR predicted and pay accounts for half of all public spending, real spending has so far been cut more savagely than the government claims.

⁴⁷ Price deflators are derived from OBR expenditure on the GDP projections that are given in both nominal and constant price terms (June 2010 EFO)

⁴⁸ 30 June OBR Employment Report

⁴⁹ Private sector earning per head have been deduced from OBR June 2010 projections for public sector and total earnings growth using forecast employment weights and adjusting to calendar years.

**Changes in Real Spending 2009-10 to 2014-15**

	By Relative Prices	By GDP deflator
Total Spending	-6.6	-6.0
Sample Spending	-7.2	-6.2
Unallocated Spending	-5.9	-5.7
Works and Pensions	-1.4	0.3
Education	-3.6	-3.4
Defence	-5.2	-5.8
Culture	-19.4	-19.4
Home	-19.6	-19.5
Justice	-23.5	-24.1
Transport	-30.4	-30.3
Energy	-31.2	-31.4
Business	-36.0	-34.2
FCO	-49.6	-49.4

Fewer jobs or less pay

The OBR's total employment estimates are guesswork. Neither the Spending Review nor the OBR attempts to project detailed employment numbers for each government department. The OBR explains "Our projection of general government employment (GGE) is based on projections of the growth of total government paybill and paybill per head".

The paybill is projected by assuming it takes a constant share of planned current public spending. Pay per head allows for the pay freeze and is based on assumed wage and salary increases plus normal rates of wage-drift. Employment is then arithmetically derived by dividing the guessed pay bill by the guessed pay-per-head.

This is called the 'top-down' approach, which the OBR admits is highly suspect. It asked the government to provide 'bottom-up' estimates, the sum of individual department's employment plans. It has received a blank refusal.

"Since our last forecast we have written to the Government to ask whether it intends to compile and publish specific departmental workforce plans, which would provide a more accurate projection than this top-down approach. The Government has told us that they have no plans to do this and we have therefore maintained our top-down approach. This approach is very

sensitive to small adjustments in spending plans, but is the best available in the absence of specific workforce plans."⁵⁰

The Government's and Spending Reviews' refusal to provide employment and pay bill numbers demonstrates the superficial nature of the spending plans. Were the pay bill reduced entirely by cutting pay or entirely by cutting number, the impact on services (and on total demand) would be substantially different. Without this information, the claim to be protecting front line services is dishonest. Placing the onus on 'individual employers in the public sector' asks managers to sack managers and spare workers. The Spending Review weakly pleads "However, the public sector pay bill accounts for half of departmental resource spending, so the spending review will inevitably have an impact on the public sector workforce". Moreover budget spending limits and pay settlements may determine how many are sacked, but not who is sacked – bureaucrats or front line workers. As mentioned already, the attack on administrative budgets is a feeble indirect attempt to protect front line workers. Departmental employees, mostly civil servants, account for only one-tenth of public sector employment.

50 OBR Economic and Financial Outlook, November 2011, Box 3.6 page 95

Chapter 5

Post Mortem

The operation was successful, but the patient died. This chapter reveals the Coalition's spending plans' success over its first two years and contrasts this with Plan A's failure.

The Coalition's spending plan was successful in cutting spending its first two years. In its second year budgets were under-spent by £5bn compared with spending targets hatched in the six months after the Coalition came to power. Departmental details are too MOG'd (plagued by Machinery of Government changes) readily to distinguish the thrifty from the profligate. There are reservations. This success has been the easy part. Early-year spending cuts trim fat, later years' must cut to the bone. The plan postponed savage cuts until its second year. But already post-operative complications have set in, the results of the botched job described in the previous chapters. For this and other reasons, Plan A has been a failure. It has not lived up to the Chancellor's 'mandated' deficit and debt ratio targets. Public sector employment cuts have been 300,000 more than predicted because pay has risen three times faster than expected. The front line has suffered from real cuts – and not just only anecdotally. Plan A contained the seeds of its own failure. It spawned recession. Some always said it was doomed to fail, scorning 'expansionary fiscal contraction' as a myth. But above all, austerity only succeeds if it retains popular support, however grudgingly. Without that, imposing austerity destroys credibility and guarantees political suicide.

In its June 2010 emergency budget the Coalition announced plans to limit the rise in public spending to £88bn over the following six years (2009-10 and 2015-16). Current spending⁵¹ could

51 A reminder: Public spending = total managed expenditure or TME. Public current spending is the total of resource DEL and resource AME.



go up by £111bn, public investment must go down by £23bn. These numbers got lost when attention shifted to the October 2010 Spending Review, which was limited to four years from 2010-11. Here the focus is on the Coalition's record in its first two years, based on June 2010 budget plans - a £30½bn public spending increase with current spending up £50½bn and investment slashed by £20bn.

In the event, public spending came in £5bn lower (current up £3.6bn less, investment down £1.4bn more). With the 2009-10 outturn £1bn higher than estimated in June 2010, public spending rose by £6bn less than was originally planned. But the under-spend was almost all in AME, annual managed expenditure – the entitlement-driven part of departmental budgets that they are unable to manage. Nonetheless budget cuts exceeded expectations.

Looked at another way, the spending programme was a remarkable triumph. The Coalition hoped to reduce administrative budgets by a third in its first two years. The cuts instead came to 42%. Administrative pay bills were planned

5.1 2010 Budget spending plans, £bn cumulative change from 2009-10

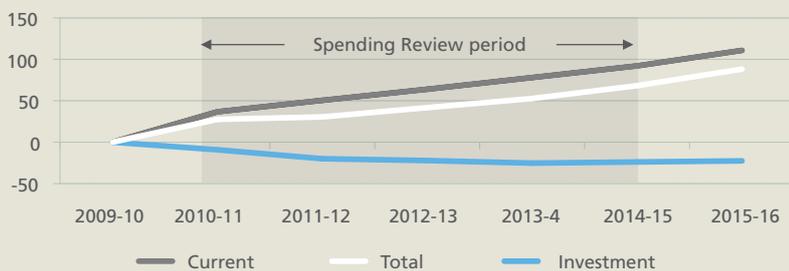


Table 5.1 Spending Plans and Outturn in Plan A's first two financial years

£bn		2009-10	2011-12	Change	Under/Over spend*	Base effect**	Under/Over	Under/Over
							spend plus base effect***	spend % budget plans
Resource DEL	2010 Budget	334.8	343.1	8.3				
	Outturn	333.2	340.7	7.5	-0.8	-1.6	-2.4	-0.2
Capital DEL	2010 Budget	56.6	41.4	-15.2				
	Outturn	57.0	42.2	-14.8	0.4	0.4	0.8	1.0
TOTAL DEL	2010 Budget	391.4	384.5	-6.9				
	Outturn	390.1	382.9	-7.3	-0.4	-1.3	-1.6	-0.1
Resource AME	2010 Budget	265.8	308.0	42.2				
	Outturn	269.1	305.0	35.8	-6.4	3.3	-3.0	-2.1
Capital AME	2010 Budget	12.1	7.3	-4.8				
	Outturn	10.9	7.0	-3.8	1.0	-1.2	-0.3	13.1
TOTAL AME	2010 Budget	277.9	315.3	37.4				
	Outturn	280.0	312.0	32.0	-5.4	2.1	-3.3	-1.7
Depreciation	2010 Budget	-19.7	-21.6	-1.9				
	Outturn	-19.3	-21.1	-1.8	0.1	0.4	0.5	
Public Spending	2010 Budget	669.3	699.8	30.5				
	Outturn	670.2	694.9	24.7	-5.8	0.9	-4.9	-0.8
Total Resource	2010 Budget	600.6	651.1	50.5				
	Outturn	602.3	645.7	43.4	-7.1	1.7	-5.4	-1.1
Total Cap	2010 Budget	68.7	48.7	-20.0				
	Outturn	67.8	49.2	-18.6	1.4	-0.9	0.5	2.8

Table 5.2 Public Spending by Function

£bn	2009-10	2011-12	Change	% Change
1. General public services	52.4	69.4	17.0	32.5
2. Defence	37.7	39.1	1.4	3.8
3. Public order and safety	34.2	32.3	-1.9	-5.5
4. Economic affairs	46.2	34.9	-11.3	-24.5
5. Environment protection	11.0	11.2	0.2	1.9
6. Housing and community amenities	16.3	10.3	-6.1	-37.0
7. Health	118.2	121.3	3.0	2.6
8. Recreation, culture and religion	13.4	13.2	-0.2	-1.1
9. Education	88.4	91.7	3.3	3.7
10. Social protection	224.6	242.3	17.6	7.9
Public sector current expenditure	667.5	693.5	26.1	3.9

public sector pay to others, not an overall reduction. Spending on goods and services was greatly under-spent in total, rising by £1bn instead of £6½bn. Grants and subsidies were over-spent.

Spending by function cannot be compared with plans. There were none. The table shows results from the Treasury’s ‘suck it and see’ 2012 Public Expenditure Statistical Analysis (PESA), which involved unscrambling and re-assembling detailed departmental spending after the event. Function outturns do not compare directly with departmental plans for reasons set out in the last

to fall by 38% overall and went down by 44%. Although administration accounts for a mere 3-3½% of public spending, these cuts made a powerful contribution to spending control. The administrative cut achieved was £9.6bn, all in resource DEL which nonetheless increased by £7.5bn. Non-administrative spending was thus able to increase by some £17bn. That looks like good news for the front line.

chapter. PESA data is COFOG’d and therefore not MOG’d. It does not matter from which departmental budget a reclassified spending item comes. It only matters where it goes. PESA supports the Coalitions’ claims to have given priority to health and education spending – when measured in cash terms. Real resources are a different matter.

5.2 Successive OBR forecasts, public sector job losses, (000s) from 2010 Q1



The Coalition also made no plans for general government employment (see last chapter). The OBR has instead produced a series of general government employment projections derived from expenditure plans in the manner already explained. It cannot be blamed that these have proved hopelessly wrong.

OBR got off on the wrong foot in June 2010, claiming that general government employment would fall only 6,000 in the year to 2011 Q1 (0.1%). It projected a 60,000 fall in following year, making 66,000 in all. Instead employment fell by 130,000 in the first year and 242,000 in the second (2¼% and 4¼%). Lost jobs totalled 372,000 in the Coalition’s first two years, a 6½% reduction. The OBR’s error was 306,000.

Analysis by economic categories suggests under-spending in areas that add most to demand and over-spending in those that add least. The public sector pay bills as a whole increased by some £1.7bn more than planned (up 2% instead of 1.6%)⁵². The administrative saving was a shift in

Why was the OBR so hopelessly wrong? It assumed resource spending (RDEL) plans would be the best that can be done. (There were no obvious ones.) It is compared with the PESA 2012 outturn. This is the best that can be done.

52 No pay plans were given in the 2010 budget. PESA 2011 was the first to give details of aggregate pay outcomes and plans. The 2011-12 ‘plan’ thus includes any changes in



Table 5.3 OBR General Government Employment Projection Errors

OBR June 2010	2009-10	2010-11	2011-12	2009-10 to 2011-12
Resource budget £bn, from 2010 budget red book	334.8	342.7	343.1	8.3
OBR assumed pay bill, % resource budget	26.1	26.0	25.9	-0.2
Implied pay bill, £bn	87.2	89.2	88.8	1.6
Implied pay bill, % change		2.2	-0.4	1.8
OBR estimated average earning per head, % change		2.3	0.8	3.1
Therefore, employment % change		-0.1	-1.2	-1.3
Therefore, employment (000)	553.6	5530	5470	-66
Therefore, government job losses (000)		-6	-60	-66
PESA July 2012 Outturn data	2009-10	2010-11	2011-12	2009-10 to 2011-12
Actual resource budget outturn, £bn	333.2	345.8	340.7	7.5
Actual pay bill outturn, £bn	87.2	89.6	88.9	1.7
Actual pay bill % resource spending	26.2	25.9	26.1	-0.1
Actual pay bill, % change		2.9	-0.8	2.0
Actual employment outturn (000)*	5,782	5,652	5,410	-372
Actual employment % change		-2.2	-4.3	-6.4
Actual government job losses (000)		-130	-242	-372
Therefore, earnings per head, % change		5.2	3.6	9.0
OBR Errors, Outturn -Budget	2009-10	2010-11	2011-12	2009-10 to 2011-12
Resource budget £bn	-1.6	3.1	-2.4	-0.8
Pay bill % resource budget	0.1	-0.1	0.2	0.1
Pay bill, % change		0.7	-0.4	0.2
Average earnings % change		2.9	2.8	5.9
Employment % change		-2.1	-3.1	-5.1
General government job losses (000)		-124	-182	-306

* Further education employment redefined as general government employment

be achieved. It assumed pay bills would take a stable share of resource spending. It estimated average earnings per head from pay rates and pay drift (assuming a successful freeze). It then divided pay bills by average earnings per head to get head-count employment. It inevitably got everything wrong. To repeat, it under-estimated jobs lost in the Coalition's first two years by about 300,000. If it had got resource spending right

and everything else wrong, its error would have been about 290,000. If it had got pay bill share of resource spending right and everything else wrong, its error would have been about 310,000. These errors cancel out. If both spending and share had been right, the error would still have been about 300,000. Average earnings were wildly out, estimated to rise 3% over two years. They rose by 9%. If earning per head had been

correctly forecast and everything else wrong, the employment error would have been just 10,000.

The OBR's error was explained by the *Financial Times*⁵³ which learned that "six Whitehall departments, as well as the National Health Service, armed forces and police, were unable to impose a full freeze". Most public servants are on pay scales according to grade and length of service. There is a contractual obligation to give annual scale increases to most staff, except to those who are already at the top of their scales. Most departments assumed contractual obligations took legal precedence over the pay freeze.

As pay accounts for half public spending, pay bills were bound to take a painful hit, which they did. But it proved far easier to lose jobs than

slash public servants' pay. Who did the cutting? Local governments did the most. The central government and local governments each account for half general government employment. But local governments shed three times as many jobs as the central government⁵⁴.

COFOG analysis by functions covers public sector employment. It shows that jobs were lost everywhere. But the armed forces, education and the NHS were 'relatively' unscathed. Non-NHS health service workers, however, did not escape the axe. Detailed analysis showing whether front line workers have been spared is beyond the scope and ability of this report (and seemingly the Government's). But in any case front line workers and front line work are not the same. Time is wasted filling in forms. Clinical qualifications give

Table 5.4 Job Losses in First Two Years

	2010 Q1 Employees head-count (‘000s)	2010 Q1		2010 Q1 Jobs lost to 2012 Q1 (‘000s)	% jobs lost	% of general gov't job losses	% of public secto job losses
		% Share General Gov't Employment	%Share Public Sector Employment				
By sector							
Central Government	2862	49.5	45.3	99	3.5	26.6	23.3
Local Government	2920	50.5	46.2	273	9.3	73.4	64.4
General Government GGE	5782	100	91.4	372	6.4	100	87.7
Public Corp x bail-outs	323		5.1	36	11.1		8.5
Bailed-out financial Corps	218		3.4	16	7.3		3.8
Total Public Sector PSE	6323		100.0	424	6.7		100
Public sector by function							
Construction	50		0.8	8	16.0		1.9
HM Forces	199		3.1	12	6.0		2.8
Police	294		4.6	32	10.9		7.5
Public Administration	1225		19.4	134	10.9		31.6
Education	1675		26.5	75	4.5		17.7
NHS	1606		25.4	45	2.8		10.6
Other Health Services	359		5.7	36	10.0		8.5
Other Public Sector	916		14.5	83	9.1		19.6
Civil Servants	528	9.1	8.4	64	12.1	17.2	15.1

⁵³ *Public Sector beats Osborne's pay freeze*
27 August

⁵⁴ ONS *Public Sector Employment, 2012 Q1*
20th June 2012



no indication of how long a hospital consultant spends in administrative meetings or conferences.

Anecdotal evidence suggests that the quality of front line services has deteriorated. But there are always special interests with axes to grind or simply born grumblers. Not all complaints can be easily dismissed. The National Audit Office has found that the UK Border Agency has "so far cut personnel by 1,000 more than planned as part of the programme to save £350m between 2011 and 2015"⁵⁵. The Devon and Cornwall police admit they were unable to investigate 40% of reported crimes last year, up from 34% in the previous year. The acting Chief Constable blamed the loss of 700 officers⁵⁶. An *Evening Standard* report reads "The recent HMIC report says the Met faces cuts of 4 per cent of its officers compared to an average of 10 per cent across England and Wales. But the proportion of officers on the front line will be lower than the national figure. The Mayor has decided the only way he can make government cuts and keep the police numbers high is by sacking civilian staff. The result: more police officers on higher pay sitting behind desks, not walking the streets."

Much more anecdotal evidence could be produced, but the analysis above illustrates the point.

Turning now to Plan A's failure, which encompassed tax changes as well as spending cuts and fiscal mandates were defined as GDP percentages. Whereas cash spending targets were hit and more, Plan A's targets were missed. Tax revenues were projected to rise by £69½bn in the Coalition's first two years, more than offsetting the planned spending increase. Receipts fell short by £14bn, more than offsetting the £5bn under-spending. The budget deficit was targeted to fall by £39bn. The March 2012 estimates gave a £30bn deficit reduction. Revenue shortfalls more than explain the failure to achieve the Coalition's cash budget target.

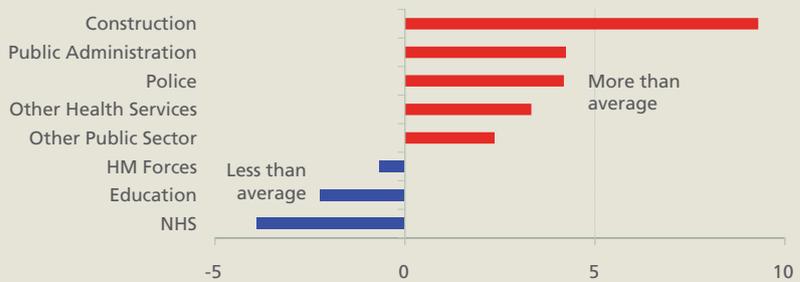
The budget deficit's GDP share was to fall by

55 *Financial Times* 17 July 2012

56 *BBC* 9 August 2012

one-third in the first two years. It fell, but only by a quarter. In detail the deficit was supposed to be cut by 3.5% points from an estimated 11% of GDP in 2009-10. Instead it was down 2.7% points. The denominator, GDP, was not the decisive factor. The OBR got its nominal GDP forecast only slightly wrong thanks to compensating errors. It over-estimated real GDP growth at 4¼% between 2009-10 and 2011-12, forecasting a rapid recovery to above-trend growth. It did not foresee the double-dip. By 2012 Q1 the economy was in recession. Real

5.3 Job losses, first two years, difference from 6.7% average



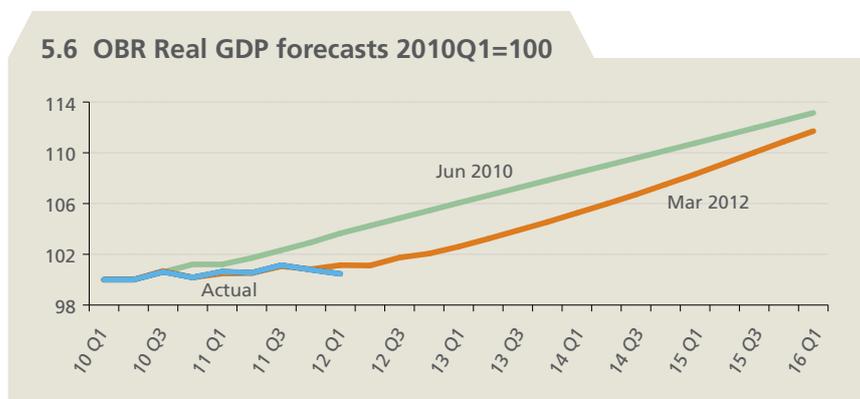
GDP rose 2¼% on financial year data, 2% less than predicted. But the OBR under-estimated inflation by 1%.

The nominal GDP error made little difference to the budget deficit/GDP ratio – it would have been 0.1% to 0.2% of GDP smaller had the nominal growth been as fast as expected. But the real growth error made a significant and perverse difference to the cyclically-adjusted current budget deficit. Slower than expected real

5.4 GDP growth, first two years, %



growth increases the negative output gap and so increases the cyclical-adjustment. The cyclically-adjusted (structural) deficit is reduced. Had the OBR not reduced its assumed potential GDP



growth rate, limiting the increase in the negative output gap, the 2011-12 deficit would have come in marginally below target. Plan A's needlessly demand-damaging spending cuts helped cause the double-dip.

Plan A is undoubtedly sick, but why dead? The deficit/GDP ratio has been cut, just rather less than ambitiously hoped. There are three reasons for turning off the life support system.

1 Percentage targets ignore denominators and numerators. Successful cuts with failed recovery are far worse than failed cuts with successful recovery. You cannot deflate your way out of a deficit.

- 2 The comparison between financial years is a snap-shot of the past. It conceals more recent trends. The Chart 5.5 plots the twelve month moving current budget deficit total. Although the deficit was reduced in 2010-11 and again in 2011-12, its downward path has been violently reversed since January this year. In the 12 months to July 2012 the current budget cash deficit was larger than one the Coalition inherited.
- 3 The OBR faces a rude awakening from its dream-world. In all five of its forecast since its first in June 2010 it has forecast a recovery to above trend growth. Its March 2012 budget forecast has real GDP little lower in 2016 Q1 than in its first forecast. Indeed postponed recover has led the OBR to forecast faster growth from now on. Yet real GDP is little higher than it was when the Coalition took office.

The time has come for the OBR belatedly to issue Plan A's death certificate.



Chapter 6

Inquest on Plan A

The Coroner must decide between manslaughter and death by misadventure. The weight of evidence suggests the former with mitigating circumstances.

Spending plans failed miserably to accomplish the Coalition's *"urgent priority to secure economic stability at a time of continuing uncertainty in the global economy"*. It employed the ill-designed conventional system of public expenditure control despite its obvious short-comings.

- It attached bells and whistles that detracted from its main priorities: its Star Chamber, Quadrilaterals, Spending Review Challenge Group and External Engagement Programme - were farcical.
- Its claim to secure economic stability was made without any attempt to assess the growth consequences of spending cuts
- It hid behind the fan of the OBR's rosy forecasts that had little regard for the uncertainty in the global economy
- It slashed and burnt investment except on expensive prestige projects
- It made no attempt realistically to identify where Taxpayers' money was to be saved, deciding instead who would be accountable.
- It made no to attempt realistically to measure the real resources provided to its priorities, using bogus price deflators.
- It failed to protect front line workers, identify them or determine what front line work they did.
- It made no plans for the inevitable cuts in government employment, delegating responsibility to public sector employers
- It exchanged one form of bureaucratic over-load for another: business and transparency plans in place of public service performance contracts.

Case for the Prosecution

Considering the above, it is surely clear that Plan A was flawed in content, commission and omission, as this report has amply demonstrated. Even on its own terms, it did far more damage to growth than needs be. But it was not flawed in concept. The need for fiscal consolidation was undeniable. Doing nothing was not an option. It was also long foreseeable. The stimulus required in 2007-08 to tame the Great Recession would inevitably have to be withdrawn - it was a growth-loan from the future at a potentially usurious interest rate. Both the former Labour Government and the future Coalition partners failed to prepare for the inevitable. The Spending Review was consequently a hurried and botched job.

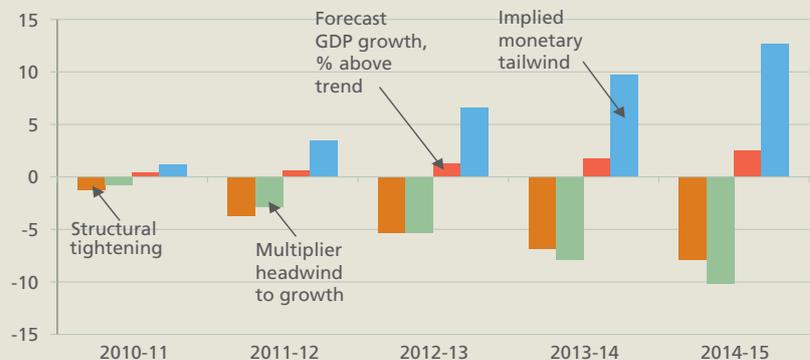
A credible Plan A was essential when the Coalition took office. Promised budget cuts, as in Labour's last budget, were not enough without 'how', 'where' and 'when'? Market patience was limited. Plan A's announcement effect can only be guessed contra-factually. Fiscal stringency depresses demand unless offset by monetary ease – policy and/or market-driven. The OBR estimated that the 2010 June budget reduced long term interest rates by 0.3% below what they might otherwise have been⁵⁷. This seems on the low side. Sterling's initial depreciation should not be forgotten, although largely unrelated to the fiscal squeeze⁵⁸. The

market reward for retrenchment may have done nothing to spur growth – that was too much to hope (except by the OBR and Government). But Plan A probably prevented the anaemic recovery relapsing immediately into renewed recession.

The Coroner's verdict depends upon how far misguided retrenchment has caused the economy to falter. Accumulated evidence suggested the treatment has made the patient worse. Why was this not foreseen? It also depends on how far the global double-dip and Euro-debacle pushed the economy back into recession (death by misadventure). But 'foreigners' cannot be completely to blame. The double-dip, if not the Euro-debacle, was foreseeable. Like the financial crisis, it could have been seen coming but wasn't – and for similar reasons.

Plan A was an act of hope and faith – hope that the global recovery had legs; faith in expansionary fiscal contraction. The fiscal multiplier headwind to growth from budget tightening was expected to be offset by monetary tailwinds. So despite

6.1 Illustrative expansionary fiscal contraction drivers, cumulative % GDP



⁵⁷ June 2010 Budget Red Book. Market interest rates are customarily forecast from market expectations. The difference between OBR pre- and post-budget on this basis is biased by market expectations of increased fiscal tightening. In stead the OBR produced an illustration based on regression analysis in which gilt yields were related, et alia, to the budget deficit and debt. This produced the quoted 0.3% estimate. But as the comparison was between Labour and Coalition fiscal plans it does not fully reflect the comparison with doing nothing.

⁵⁸ The Bank of England's effective sterling

planned cumulative tightening amounting to 8% of GDP by 2014-15 (as measured by the reduction in the cyclically-adjusted deficit) real GDP was forecast to grow in excess of its trend rate. The Chart 6.1 is purely illustrative. The cumulative effect of budget tightening assumes a first year multiplier of 0.645 (tax and spending weighted average of OBR June 2010 assumptions) increasing to over 1% by year five. The monetary

exchange rate index, Jan 2005 = 100, stood at 81.9 at end-June 2010. It dropped to a low of 77.7 at end-June 2011 and recovered to 84.0 by end-July 2012



policy and market tailwind shown here is merely the difference between assumed above-trend growth and the headwind. This ignores all other factors that would affect growth. This simply illustrates that the monetary benefits from fiscal contraction, given its size and duration, needed to be large and continuing. Arguably they were small and diminishing.

Multiplier assumptions are explained at greater length in Appendix A. Suffice it to say here that the models used two years ago were akin to rowing a boat backwards believing you are going where you have just been. They were based on experience prior to the financial crisis and Great Recession, which made the situation fundamentally different. Retrenchment's negative consequences were enhanced by:-

- Synchronised consolidation by major economies, which mutually reduced the benefits from net exports.
- Debt-ridden companies and households attempting simultaneously to deleverage. Governments, companies, households and foreigners cannot all restore balance-sheet health by reducing financial deficits (or increasing surpluses) at the same time. Monetary ease, tempting the over-indebted to borrow and spend more, is no solution.
- Broken banking intermediation that limits their ability to make loans to the healthy – exacerbated by stable-door tighter regulation.
- Collapsed asset prices which destroyed collateral.

In sum, the Government and OBR greatly over-estimated the monetary tailwind. This compounded the damage done from ill-considered cuts. Timing was ignored. Investment bore the brunt of early spending cuts. Large tax hikes came early. Both damaged demand more than necessary.

Latest analysis indicates that fiscal multipliers are smaller on the up-side and larger on the down-side when the output gap is negative. When businesses and households are burdened with debt, measures that increase income result largely in higher savings. Measures that reduce income result largely in reduced spending. A boost from fiscal easing is a growth-loan from the future. What is given today must be taken

back tomorrow. With an asymmetric multiplier, the repayment exceeds the original loan and at a usurious interest rate. A lasting benefit can only be obtained if, when public spending contracts, private spending recovers to fill the gap. Meanwhile retrenchment, according to the National Institute for Economic and Social Research, should best have been delayed until the economy was safely recovering. Its authors state⁵⁹:

“The modelling confirms that doing nothing was not an option; our ‘no fiscal consolidation’ scenario leads to unsustainable debt ratios. So some pain was inevitable; under both our ‘immediate consolidation’ scenario and that of ‘delayed consolidation’, deficit cutting worsens growth and unemployment, just as it has done.

But our estimates indicate that the impact would have been much less and less long-lasting, if consolidation had been delayed until more normal times. The cumulative loss of output over the period 2011-21 totals £239bn at 2010 prices, or 16 per cent of 2010 GDP. And unemployment is higher for some two to four years longer if tightening comes when the economy is depressed. So early tightening has real, large costs.”

Over-aggressive retrenchment, clobbering growth and exacerbating unemployment, can permanently reduce the economy's potential GDP level and growth, causing lasting damage and unrecoverable losses. NIESR says it need not have been so bad.

Viewed in isolation from the hostile global economic environment, the prosecution's case against the government is overwhelming - manslaughter. The case for the defence blames foreigners.

Case for the defence:

The global double-dip and Euro-debacle must be taken into account. Though grievous, they alone cannot absolve the Government from all blame. Back in 2010 the deteriorating global economic climate was not foreseen, although it was foreseeable. As the risk became increasingly apparent, its potential severity was under-

⁵⁹ UK should have waited to enforce austerity, Jonathan Portes (NIESR director) and Professor John Van Reenen (LSE), *Financial Times* 2 August 2012.

estimated. Precaution demanded 'fasten your seat belts'. The government failed to do so.

The global economy impacts the UK through trade, finance and confidence. To date the trade effect has been modest (although a contra-factual scenario would be needed for quantification). Compared with the OBR's original forecasts, net exports are not to blame for the recent disappointing UK growth performance. Sterling has become a safe haven without unduly damaging trade, although contra-factual analysis might suggest weaker sterling would have helped. There has been nothing even approaching the trade collapse that ushered in the first dip. Long term interest rates have remained at record lows. The FTSE does not appear to have suffered. The OBR's consumer spending and business investment forecasts were simply too optimistic and have remained so.

The key is confidence. Future prospects matter more than past performance, (although their perception is influenced by the past). The 'fandance' now so beloved of forecasters, is a cop-out. A weather forecaster, predicting a 10% chance of rain, cannot be said to have got it wrong if the heavens do open. Judgement depends upon successive 10% forecast failures. If the 10% chance occurs more often than 10% of the time, the forecaster is at fault. On this count the OBR's record is far from admirable. It has always forecast a 50% chance of a recovery to above-trend growth and has been wrong 100% of the time. The US fiscal cliff, China's hard landing and Grexit are more than just 'downside risks', to be mentioned and then forgotten. They have given British businessmen good reason to worry. The 2012 IMF 'Spillover Report' reckons Eurozone fragmentation would cost both the zone and UK 5% of GDP. (It does not compare this with the 'suicide pact's' cost). Such analysis feeds uncertainty.

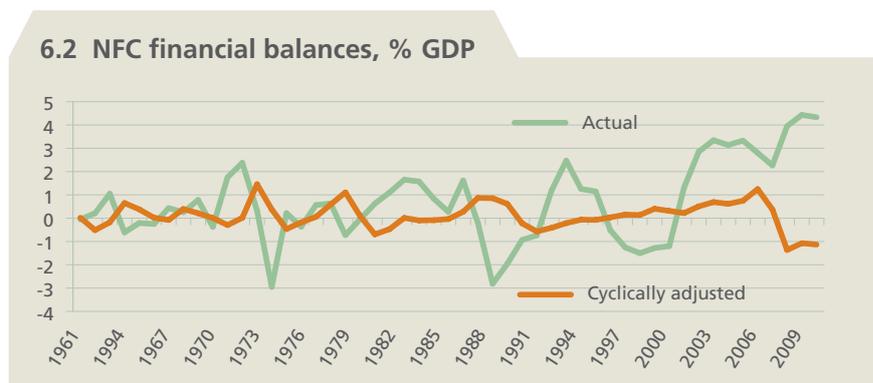
Investment decisions are crucial to recovery prospects. When fiscal ammunition is exhausted and monetary policy ineffective, as now, the multiplier/accelerator feedback cycle drives consumption and investment downwards.

Can investment rise while consumption falls, or consumption rise while investment falls? An Irving Fisher debt-deflationary spiral becomes a serious possibility. The risk is greater in the second dip.

Uncertainty continues to depress investment. British non-financial companies have earned financial surpluses for a decade. Despite the relapse into recession, they are bigger now than at any time in the past half-century. Recessions normally cause business surpluses to shrink or disappear. Today bigger surpluses are a cause of recession instead of smaller surpluses being a consequence. The cyclical adjustment to the government's budget balance, like its financial balance, must be equal and opposite to the combined cyclical adjustments of the other sectors. A crude cyclically-adjusted non-financial companies' financial balance is shown in the chart⁶⁰. This illustrates how companies have built up impressive surpluses since the financial crisis despite stagnant GDP. On past experience they should now be running record cyclically-adjusted deficits.

Uncertainty for the future, over-leverage and fears of credit famines have encouraged large companies to hoard cash. Smaller and medium sized companies have been starved of credit. Fears for the future have extinguishing 'animal spirits' in all but the most adventurous⁶¹.

The double-dip and Euro-debacle were



⁶⁰ This is simply derived from the correlation with the output gap over 1961 to 2000 (pretty weak, R-squared 0.3, slope slightly positive).

⁶¹ Why 'animal spirits'? Most animals are risk-averse except of necessity and are neither innovative nor enterprising. 'Bovine spirits' could have been chosen to mean the opposite.



foreseeable and foreseen by some. While multi-causal, as are most major global developments, the incestuous relationship between big Asian savers and big American spenders is now recognised as fundamental to global imbalances. But there could have been no savings glut/spending spree without fixed exchange rates or dirty floating. Once these simple points are grasped, all else follows. There were two glut/spree crises not one, trans-Pacific and trans-Alps/Pyrenees. The latter was as inevitable as the former and as foreseeable.⁶² The Euro-debacle simply lagged the US financial crisis by two to three years.

The first dip, short and sharp, was precipitated when debt-satiated American citizens and companies stopped borrowing and spending. The result was deficient global demand. An American and British (Irish or Spanish) public spending spree provided temporary relief, but could not stop the Chinese or Germans from saving too much. It had to end in tears. The solution was to allow the foreign exchanges to repatriate the consequences of excess savings to their originators. The yuan's real effective appreciation has helped America to continue growing, albeit slowly. China now faces a hard landing of its own making. Meanwhile the Eurozone is being crippled by a suicide pact certain to kill not cure the euro. Global demand is not increased by Anglo-Saxons and Latinos spending less (which they must), but by Chinese, Japanese, German and Dutch spending more (which they won't). These simple observations have been largely ignored by most official and conventional forecasters.

The Verdict is Manslaughter

The Coalition can't escape censure. To change the metaphor, it set out safely to demolish with controlled explosions a dangerous public spending high-rise. It set the charges hurriedly and at random. In consequence the demolition was only partly successful at the cost of considerable collateral damage to surrounding structures.

This guilty verdict is based on two undeniable

propositions.

- 1 Plan A need not have savaged growth. Had the Coalition had faith in its own fiscal mandates, it would have substantially boosted capital investment to offset current spending cuts. Presumably it believed markets were less sophisticated and judged consolidation by progress in reducing overall budget deficits and gross debt.
- 2 The deteriorating global environment and Euro-debacle undoubtedly damaged the British economy, but were foreseeable. The OBR was an accomplice, persistently awarding pass-marks despite darkening skies.

The axe was blunt, the axeman blind. Random cuts exacerbated *economic instability at a time of continuing uncertainty in the global economy*.

⁶² Lombard Street Research's Charles Dumas predicted the euro break-up in 2006, saying it was certain in 5 to 6 years.

The author, and others, stressed the certainty of the double dip from 2008 onwards – but expected it to come sooner than it did.

Chapter 7.

The Way Ahead

This concluding chapter looks ahead to the triennial spending review due a year hence. It sets out the Coroner's recommendations in his Report.

The party conference season is upon us. Schisms between and within the coalition partners will be papered over by the platforms. The paper will be shredded on the floor. The global deterioration is approaching crisis proportions, which bodes ill for equities this autumn. Against this background the November pre-budget statement will be prepared and delivered, accompanied by the OBR's '*Economic and fiscal outlook*'. The Chancellor must look reality in the face. A year from now work must be underway on the next triennial Spending Review to plan public expenditure from 2013-14 to 2017-18, beyond the next election. These will be stormy times. It is hard to see how the OBR's November pre-budget forecast can show the government still on track to meet its rolling budget mandate. Any fudge will be transparent and destroy the OBR's claim to independent credibility. It is certain that the debt/GDP ratio will still be rising in 2015-16. It is harder to see what the government can do to get back on track in the mini-budget.

A fresh start is urgently needed RIGHT NOW. No odium should be attached to this (but will be). These are the Coroner's constructive recommendations.

1 A Geddes-style Independent Committee should immediately be established.

Terms of Reference. *To recommend measures that would reduce the ratio of public spending to nominal GDP to 40% within an appropriate timescale, having particular regard for the impact on present and future growth. In accordance with the Government's lesser priorities, notably to increase the real resources devoted to the NHS, to consider the extent*



to which the price of public expenditure on goods and services might move relative to the overall GDP deflator. As it is also the Government's desire to protect front line services, to examine the impact on front line jobs and productivity consequents of the Committees recommendations.

Membership. An exclusion rule, nobody over say 40 to 45, might be appropriate, though the chances of discovering a young Keynes are remote⁶³. To avoid the Challenge Group's farcical failure, other than in the most exceptional cases, the following should be excluded from membership:-

- The politically-correct 'Great and the Good', superannuated mandarins and emeritus professors. Few attain exalted status by defying convention.
- Captains of industry and City finance. They mostly grind their own axes.
- Econometricians with lifetime specialised experience of the intricacies of public spending accounting and control. They know too much and see too little. Fresh eyes are needed.
- MPs and serving civil servants. They represent political and bureaucratic special interests.

Submissions. These should in general be commissioned with payment, (not merely invited) from independent outside bodies, think tanks, consultancies and individuals (eg, journalists). The Institute for Fiscal studies and NIESR do excellent work in this field. A public engagement programme, as such, is to be avoided like the plague. But a 'Wolfson Prize' would be better and cheaper.

Timing. The Committee should be asked to report by January 2013, in advance of next year's budget decisions.

2 The House of Commons Treasury Committee should be invited to prepare a Special Report on the 2010 Spending Review's success and failure.

⁶³ Geddes was 41 when asked to chair his famous committee. Keynes was 36 when he published *The Economic Consequences of the Peace*.

The Committee produced an excellent probing report on the 2010 spending plans.

3 Clean the statistical Augean Stable⁶⁴.

The ground needs to be prepared for the 2013 Spending Review.

- 1 The Cabinet Office should supervise an immediate in-house drive to clean up departmental statistics, filling gaps which bedevil attempts to fathom the economic consequences of spending cuts.
- 2 The ONS should be directed greatly to accelerate its work on public sector productivity, to indicate where departmental performance differs.
- 3 The OBR should be directed to report on the resource and employment implications of spending plans. Relative prices and realistic average earnings projections are desperately needed.

4 A 'Doomsday' survey of front line work and workers.

Public sector workers in direct contact with the public need to be identified and counted. The work they do needs to be investigated. The independent commission should be provided with the resources to supervise this task, preparing an interim report by the start of the 2013 Spending Review.

5 A new commission on the distribution of income and wealth.

This is a longer term necessity. 'Fairness' is not measured simply by the impact of tax and spending measures. The squeeze on public sector pay and pensions recognised this point. Income inequality has so increased that a genuine effort to achieve a fairer society needs to begin analysing where and why it has become more unfair.

⁶⁴ For the fifth labour, Eurystheus ordered Hercules to clean up King Augeas' stables. Hercules knew this job would mean getting dirty and smelly, but sometimes even a hero has to do these things. Then Eurystheus made Hercules' task even harder: he had to clean up after the cattle of Augeas in a single day.

6 Work on business plans and transparency should be temporarily (permanently?) suspended.

These proposals would impose a considerable burden on limited statistical resources. It need not be an additional burden. Resources should be transferred from collecting politically-correct but relatively worthless statistics, mainly used to score party and special interest points.



Appendix A:

Multiplication versus Long Division

A two-way street connects the budget and the economy. The budget affects growth and growth affects the budget. The budget balance can be split into two parts, structural (ie, cyclically-adjusted) and cyclical. Structural deficit reductions (as a result of discretionary spending cuts and/or increased tax rates) slow economic growth. Slower growth increases the cyclical budget deficit (automatic stabilisers). The overall budget deficit is thereby reduced by less than the structural cuts. The fiscal multiplier measures the effect of the budget on the economy - the change in GDP that results from a 1% of GDP change in the structural budget balance. Elasticity measures effect of the economy on the budget - the change in the cyclical budget balance (per cent of potential GDP) that results from a 1% change in GDP.

Following budget cuts the multiplier is the combined effect of fiscal headwinds hampering growth and monetary tailwinds helping growth.

Fiscal headwinds

Discretionary public spending cuts directly subtract from demand. Tax hikes do so at one remove, causing taxpayers to curb private spending – except in the unlikely event that the whole of the increased tax payments comes out of current savings. Either way, fiscal retrenchment sets off a multiple decline in the circular flow of demand and income. The initial public spending cuts reduce income, the reduced incomes lead to further private spending cuts and another round of income cuts. But on each round the fall in spending is less than the fall in income that precedes it.

There are three 'leakages' from income to spending and back again to income.

- 1 **Tax.** Falling incomes and spending reduce tax payments, resulting in a smaller fall in real disposable income⁶⁵.
- 2 **Savings.** Some of the fall in income is not passed on in lower spending, but results in lower saving.
- 3 **Imports.** Some of the fall in spending is on imports, which reduces foreigners' incomes. Export demand may then fall, but this is likely to be less than the fall in imports.

Incomes continue to fall until the entire budget cut has been absorbed by these leakages. The strength of this headwind is determined by the combined size of the leakages. If each £100 reduction in income leads to a £50 fall in spending (half 'leaking') the multiplier is two⁶⁶. If the leakages are a quarter, £25, the multiplier will be four. Its size will also depend on how the budget deficit is cut. Generally speaking, cuts in public investment lead to the largest loss of income.

Monetary tailwinds

The monetary environment is affected by fiscal policy in three ways.

- 1 **Financial markets.** Fiscal tightening that

65 In a progressive tax system the marginal tax take from a change in income is greater than the average. So tax payments fall proportionately more than income falls and disposable income therefore falls less.

66 Suppose taxes fall by £30 – a 30% marginal tax rate; savings fall by £10, a marginal saving rate of about 14% out of the after-tax £70 fall in income; and imports fall by £10, a marginal rate of 17% out of the £60 fall in spending. The leakages will then be £50 from every fall in income. An original £100 budget cut will then lead to £100 income fall in round one, £50 in round two, £25 in round three, £12.50 in round four, and so on until the leakages equal (asymptotically approach) £100. Spending and income will then have fallen by £200. The cyclical budget deterioration will be £60 leaving an overall improvement of only £40 out of the original £100 cut.

slows growth reduces inflationary pressure. Money and capital markets may reward this with lower interest rates.

- 2 **The central bank.** Easier monetary policy, especially if it follows the Taylor rule⁶⁷.
- 3 **Foreign exchanges.** Lower interest rates can cause the exchange rate to fall, curbing imports and boosting exports.

In exceptional circumstances, the monetary effect may be so strong that the multiplier is negative – meaning that fiscal tightening boosts growth. This is called 'expansionary fiscal contraction'. In the opposite case, markets may react adversely to retrenchment that inflicts intolerable austerity that undermines the government's credibility. The monetary tailwind then switches to a headwind, increasing the multiplier's size.

How large is the UK multiplier?

When fiscal demand management became fashionable following WW2, the consensus believed Keynesian multipliers were large and monetary effects weak⁶⁸. Evidence from the Great Depression and the impact of rearmament supported this view. Experience in the 1960s and 1970s shattered the consensus. The problem was stagflation. Fiscal policy which boosted demand met powerful monetary headwinds for fear that it would exacerbate inflation. Moreover the bigger the budget deficit, the more markets would punish further discretionary easing. The consensus view became that fiscal policy was ineffective and multipliers negligible or even negative (ie, 'contractionary fiscal expansion').

An IMF staff position paper published in May 2009 reviewed studies published over the previous decade covering mainly the G7 countries. It found the average first-year multiplier was around 0.8 for public spending and 0.3 for tax changes⁶⁹. The

67 Named after a US economist John B Taylor. The rule says central bank policy may be determined by a combination of inflation and capacity utilisation. Slower inflation and a negative output gap argue for lower rates.

68 See J Bradford DeLong and Lawrence H Summers *Fiscal Policy in a Depressed Economy*, Brookings Institute March 2012

69 *Fiscal Multipliers* IMF SNP/09/11 by Antonio Spilimbergo, Steve Symansky and Martin



OBR in its June 2010 budget forecast assumed short-term 'impact' multipliers ranging from 0.3 to 1.0. A footnote (page 95) stated that these estimates were based on a range of studies published between 2003 and May 2009.

Table A1 Impact multipliers

Change in VAT rate	0.35
Changes in the personal tax allowance and National Insurance Contributions (NICs)	0.30
AME welfare measures	0.60
Implied Resource Departmental Expenditure Limits (RDEL)	0.60
Implied Capital Departmental Expenditure Limits (CDEL)	1.00

Given the incubation period for such studies, they were wholly or largely based on evidence prior to the Great Recession. It should have been obvious at the time (and was to this author) that they were about as much use as mortality rates from the Great Plague as a basis for life insurance premiums today⁷⁰. It is different this time. Multipliers are much enhanced by the Great Recession's legacy.

- 1 Negative output gaps.** The Great Recession generated negative output gaps which anaemic recoveries have failed to eliminate. Tightening in the teeth of recession does more to damage growth than tightening in a boom.
- 2 Simultaneous retrenchment.** When everybody tightens at the same time much of the advantage from falling imports is lost
- 3 Universal deleveraging.** When private sector debt is excessive, companies and households also seek to retrench. They save relatively more out of reduced incomes.
- 4 Zero-bound official interest rates.** Central banks have difficulty in easing further when policy interest rates are near zero. QE may succeed to some extent in raising asset prices. But 'unsound money' fears can make QE ineffective.

Schindler, 20 May 2009.

70 Although mortality rates from Asian 'flu during 1918-19 could be of relevance in the event of a new global pandemic

5 Broken banks. Shackled by stable-door regulations, banks are unable and unwilling to lend.

6 Markets may punish savage retrenchment.

Unrelenting austerity destroy government credibility.

Recent analysis supports larger multipliers. The April 2012 *IMF Fiscal Monitor* says "In the current recessionary context, the negative impact of fiscal adjustment on activity can be expected to be large, as confirmed by new work on the size of fiscal multipliers during periods of weak economic activity". The IMF now puts the

G7 government spending multiplier at 1.34. It argues multipliers are larger for fiscal tightening when output gaps are negative⁷¹. In any event, the multiplier applies to a one-off fiscal change and its impact (first year) effect is smaller than its cumulative effect. The expenditure-income-expenditure contractionary cycle wears out. But a multi-year fiscal consolidation programme keeps the contraction going – akin to pain from repeatedly banging one's head against a brick wall.

It is suggested that multipliers get larger with repeated doses of retrenchment. Companies try to ride out a bad patch. They hang onto labour they expect to need again shortly and hope investment plans need not be disrupted. Prolonged austerity enforces a more forceful response. Against this, offsetting monetary easing may have a lagged impact in reducing the fiscal multiplier's initial impact. But a series of budget cuts may exhaust the scope further monetary easing.

The OBR's most recent publications do not report any change in its 2010 multiplier assumptions shown above. The monetary tailwind has been limited since retrenchment began in April 2010. Although base rate has been zero-bound (unchanged at 1/2%), market Gilt yields have drifted irregularly downwards – from 4% at end-March 2010 to under 1 1/2% in June 2012. The sterling effective exchange rate has been less

71 *IMF Fiscal Monitor, Appendix 1. Fiscal Multipliers in Expansions and Contractions* April 2012

helpful. It has had a bumpy ride. Its downward trend from summer 2010 was reversed a year later. Sterling became a safe haven for funds fleeing the euro. But what was lost on the exchange swings was won back on capital

Chart A1 UK Monetary Ease

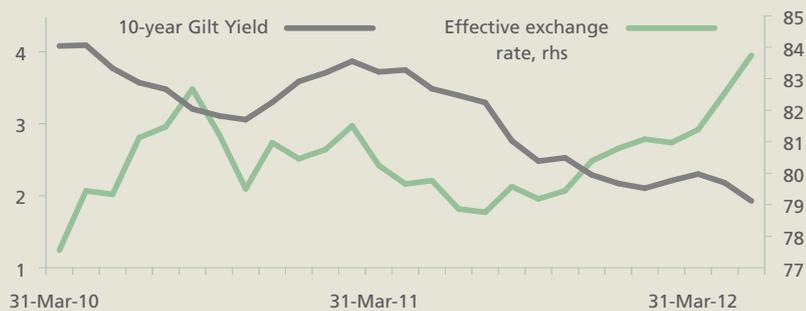


Chart A2 Cumulative lost growth from tightening, % GDP



market roundabouts. Chart A1 cannot separately show the impact of quantitative easing that is claimed to have boosted GDP.

When the OBR multipliers shown above are weighted by the June 2010 budget planned tax hikes, public consumption and investment cuts the average impact multiplier is 0.645. The cumulative multiplier asymptotically approaches 1.8 over a period of years, reaching 1.6 by the fifth year – assuming leakages remain the same in each year. The 1.3% of GDP structural tightening planned for 2010-11 would have lopped 2.2% off GDP growth by 2014-15. This was to be followed by further cuts, bringing the structural deficit down 7.9% points from 8.7% of GDP in 2009-10 to 0.8% in 2014-15. This would have resulted in a cumulative 10.2% loss of GDP growth.

Elasticity

The multiplier's size cannot, however, be considered in isolation from elasticities – the effect of the economy on the budget. Financial markets are influenced by government debt ratios. While cuts reduce deficits and lower debt levels (the numerator) they also reduce GDP (the denominator). In the short term retrenchment frequently increase debt/GDP ratios (see below for explanation).

Estimating elasticities present serious problems. To recap: elasticity measures the **change** in the cyclical budget balance as a per cent of potential real GDP that results from a 1% **change** in GDP. The cyclical adjustment is measured by multiplying the elasticity by the output gap - the difference between the actual GDP level and its potential or trend⁷² level. When real GDP equals its potential level, the economy is neither too hot nor too cold. There is no output gap and cyclical adjustment is zero. A positive gap implies overheating and accelerating inflation, leading to a cyclical budget surplus. A negative gap implies slowing inflation and a cyclical deficit. The gap tells nothing about the rate of inflation, only whether it is rising or falling.

Unfortunately potential GDP cannot be observed. There is plenty of room for differing output gap estimates⁷³. Therefore cyclical elasticities cannot be observed, only estimated from tax and spending systems, marginal and average rates. The structural budget balance is arithmetically calculated as the

⁷² Although 'potential' and 'trend' are here and elsewhere treated as synonymous, in theory they differ. 'Potential' GDP is estimated using a production function that includes changes in the labour supply and capital stock plus a trend value for total factor productivity. 'Trend' GDP is a cyclically smoothed series using a Hodrich-Prescott filter. An April 2012 EC paper, *Cyclical Adjustment of Budgetary Balances* gives both UK potential and trend growth estimates. The output gaps cycles are the same but trend amplitudes are less.

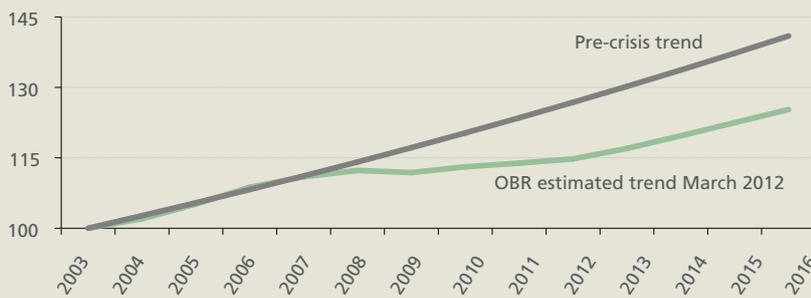
⁷³ The OBR spends a great deal of time and effort trying to come up with the best.



overall budget balance, less the cyclical adjustment. So it cannot be observed. The coalition fiscal policy thus aims at an unseen moving target (a structural budget balance), determined by unobservable metrics, potential GDP and cyclical elasticities.

The Great Recession had an immediate impact on potential growth. It slammed on the brakes. Chart A3 shows how the OBR's estimated that potential growth stalled during the recession, reducing trend GDP below its pre-crisis level. The recovery is estimated to have allowed trend growth to return towards its former rate, but at a permanently lower level.

Chart A3 Potential GDP, 2003=100



- the rate of inflation.
- 2 Like multipliers, elasticities need not be linear. They may be higher the larger a negative gap. Employers hoard labour during a recession expected to be short-lived. Layoffs increase as it is prolonged.
- 3 Potential GDP levels and growth rates are affected by the extent and duration of recessions. Falling investment reduced the capital stock. The long-term unemployed become unemployable. The labour force shrinks relative to the working-aged population. The

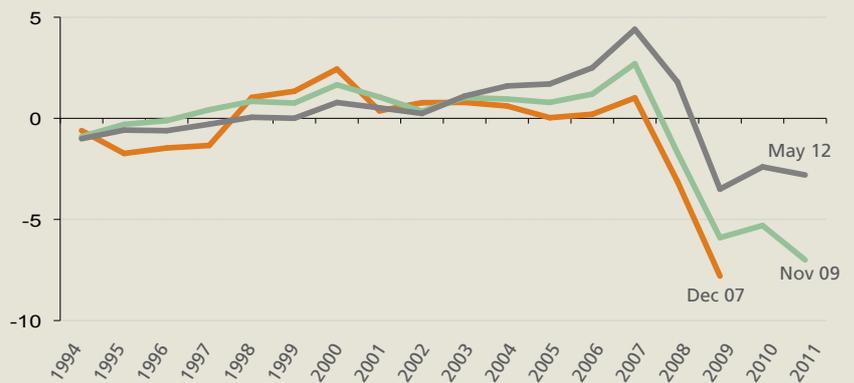
Great Recession and subsequent weak recovery may have permanently damaged potential growth.

Elasticities estimates are decomposed into the impact of the economy on tax revenues and public spending. Forecasters spend a great deal of time estimating their size. The results differ widely, both between forecasters and

for the same forecasters over time⁷⁴.

The downward revision in estimated potential GDP level and growth has cut the estimated negative output gap size. But it is now thought that potential growth was seriously over-estimated during the Great Moderation. Consequently backward revisions increase estimated positive gaps during the boom years. Thus pre-crisis cyclical surpluses are now thought to have been under-estimated and post-crisis deficits to have been over-estimated. Chart A4 compares the OECD's UK output gap estimates in December 2007 with those in November 2009 and May 2012. 2007 and 2009 gap estimates have been adjusted for differences between originally estimated GDP growth rates and subsequent actual growth.

Chart A4 OECD's UK output gap estimates, % potential GDP



Estimating elasticities entails other problems.

- 1 Output gaps and cyclical budget balances are measured as per cent of real potential GDP. Thus either elasticities assume public spending deflators equal the GDP deflator (see Appendix A), or they can differ over time depending on

74 Andrew Hughes-Hallett, Rasmus Kattai and John Lewis analysed revisions to OECD output gap and cyclically adjusted budget deficit estimates over 26 *Economic Outlook* issues from 1995 to 2008. They show substantial variation in both. *How Reliable are Cyclically Adjusted Budget Balances in Real Time?*, *Contemporary Economic Policy*, 24 March 2011.

Appendix B.

How real are ‘real terms’?

For the past 20 years successive governments have targeted public spending in nominal (cash) terms. Cash spending can be counted, so many pounds, millions or billions of pounds. ‘Real’ spending, known variously as ‘volume’, ‘at constant prices’, ‘chained volume measure (cvm)’, or ‘real resources’, can only be estimated. In the chained volume measures used by the ONS, the increase in this year’s cash spending is reduced, ie, ‘deflated’, by the rise in prices since last year. Cash terms show what you pay. Volume terms show what you get for your money. The answer obviously depends on what prices are used.

In measuring ‘real’ public spending, governments do not use specific indices showing the prices that it pays in providing different services – doctors’ pay and ambulances, teachers’ pay and desks; policemen’s pay and squad cars. Instead they use the average price change for everything everyone buys – the GDP deflator.

The House of Commons Treasury and Civil Service Select Committee, reporting on the 2007 *Comprehensive Spending Review* asked, “How real are ‘real terms’?”

It commented, “The use of the GDP deflator in describing public sector budgets is a long standing practise of the Treasury, but this measure can be of limited value in understanding the actual effect of expenditure allocations of a particular size in particular areas, partly due to the Relative Price Effect – in other words the movement over time of a specific price index relative to a general price index such as the GDP deflator. For example, although the Ministry of Defence no longer publishes an index of defence specific prices, there are independent analyses which suggest that defence equipment prices rise at about 10% a year.”

Public current spending is more labour-intensive than private and the labour is more skilled.



Ambulance drivers are paramedics, bus drivers are not – which is not to belittle their task. Real wages normally rise, meaning money wages increase faster than consumer prices. Public sector ‘inflation’ therefore normally exceeds private. Using the GDP deflator usually exaggerates the rise in real public spending.

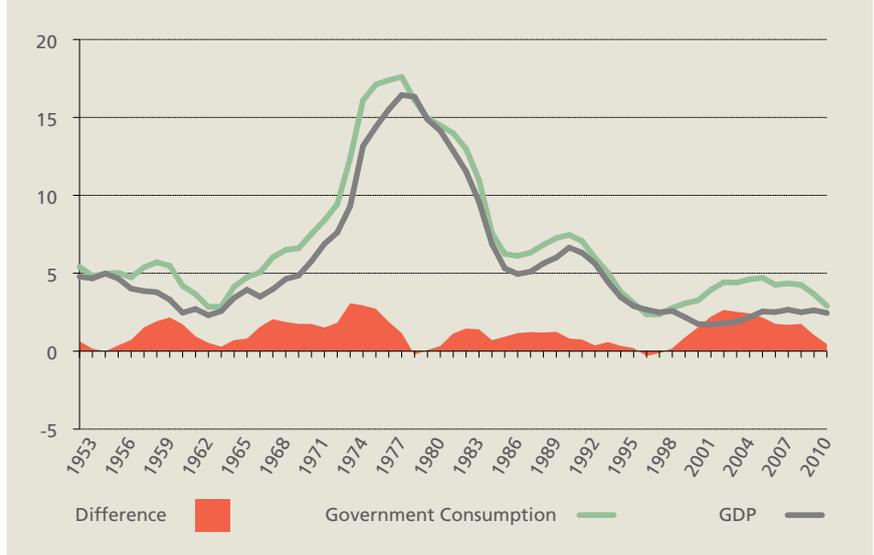
This issue is not new. The post-WW2 welfare state and nationalisation sharply increased the peacetime share of GDP pre-empted by government spending. Throughout most of the 19th century peacetime public spending averaged around 10% of GDP. After WW1 it rose to 20% and approached 50% after WW2. Controlling public spending became increasingly problematic in the 1950s. An internal Whitehall committee led by Edwin Plowden – businessman turned civil servant – was commissioned in 1959 to report on *Planning and Management in the Public Services*. Plowden’s 1961 report advocated, inter alia, departmental volume targets to replace cash limits. This meant, for example, telling the NHS how many ambulances it could buy, instead of how much it could spend buying ambulances. Departments were rather good at this. They no longer had to bother about the prices they paid. Volume targets were generally hit, but in the inflationary 1970s cash spending ran out of control. Consequently in 1976 Labour Chancellor Denis Healey supplemented volume targets with cash limits. This dual system of control led to great efforts being made to estimate relative price effects.

In 1982 the Conservative Chancellor Geoffrey Howe scrapped volume targets altogether and went back to the 1950s cash budget system. Volume estimates were no longer needed for public spending control. Bogus ‘real’ numbers, using the GDP deflator, became the norm.

Some relative prices are still calculated and published in national income and expenditure accounts. They are used to estimate the volume growth in broad expenditure categories. They are available for public current and capital spending. Aggregate data show that prices for public sector current spending on goods and services have historically risen 1¼% a year faster on average than the GDP deflator. Chart B1 shows five-year moving average rates of public consumption and

GDP deflators between 1948 and 2009. There were only ten individual years out of sixty in which the GDP inflation was faster than public spending inflation. The story from 1998 to 2009 was one of unremittingly faster public inflation, the gap averaging 2%.

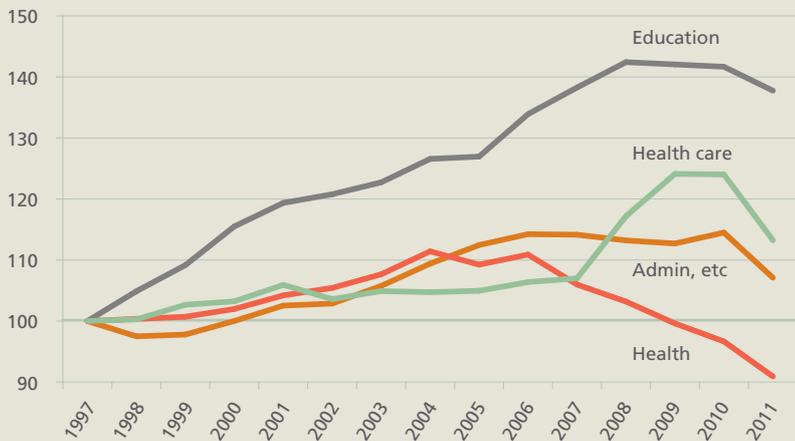
Chart B1 Deflators, 5-year moving average, %



The ONS produces limited price data for four broad-defined government functions: public administration, defence and social services bundled together; health unbundled into ‘human health’ and ‘residential care and social work’; and education. Chart B2 shows how prices have moved since 1997 relative to the GDP deflator. There are clear trend breaks. Education, health care and administration inflation have only recently fallen significantly below GDP inflation. But the cost of ‘human health’, meaning front line NHS treatment has been below GDP inflation since 2006 and is now nearly 10% cheaper than in 1997. This looks suspiciously like an attack of the MOGs.

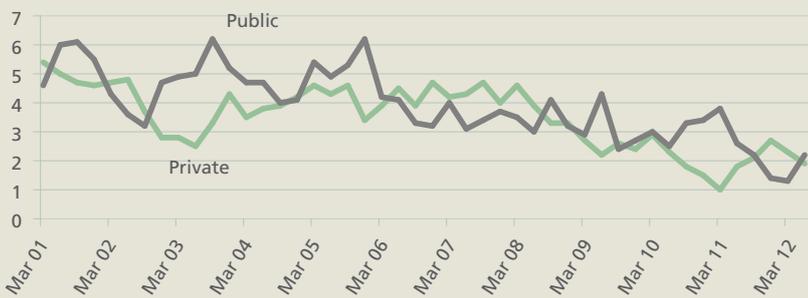
Inflation is the difference between what you pay and what you get for your money. Costing what you buy is not as easy as it seems. It is a restaurant visa receipt without details of food and drink consumed. Wage costs per unit output are used when measuring private sector pay inflation. But the value of public sector output cannot readily be measured as most services are given away free – law and order, health and education have limited comparable market prices. Statisticians have therefore simply assumed the value of output

Chart B2 Relative prices, function index/GDP deflator, 1997=100



equals the cost of inputs. This implies public sector productivity never goes up or down. Output equals input, wage inflation equals wage costs.

Chart B3 Weekly wage, 12-months % change



Following the 2005 Atkinson Review⁷⁵ the UK Centre for the Measurement of Government Activity was established within the ONS to look into this problem. Unfortunately the ONS has devoted limited resources to this project – it has many other things to do. Three studies in the past two years have covered health⁷⁶, education⁷⁷ and all public services⁷⁸. Unfortunately all are now

⁷⁵ *On the Management of government output and productivity for the National Accounts* January 2005

⁷⁶ *ONS Public Service Output, Inputs and Productivity: Healthcare* by Michael Hardie, Jonathan Cheers, Claire Pinder and Umama Kaiser, March 2011.

⁷⁷ *Public Service Productivity Estimates: Education 2010* by Fiona Massey, March 2010.

⁷⁸ *Total Public Service Outputs, Inputs*

based on out-of-date evidence.

In theory the public sector pay freeze explains the recent break in past trends. Episodes when public spending inflation has been slower than general inflation have coincided with public sector wage restraint. Chart B3 shows public and private sector average weekly earnings excluding bonuses and arrears. Over the past two years public sector pay has risen more than private. But from March 2011 onwards public sector weekly earning supposedly crashed while private sector earning marginally accelerated with aborted recovery.

Other evidence suggests the freeze has been less than successful due to movements up contractual pay scales, a rarity in the private sector. On the face of it, the Government may be doing itself no favour by measuring real resource spending on health using the GDP deflator. The collapse in real resources devoted to education, however, looks almost catastrophic.

The truth is hard to discern. The OBR has some doubts about ONS national income accounting showing the recent slowdown in public sector prices. In its spring 2012 report it says *“The weakness in prices is likely largely to reflect the way in which government consumption is*

measured: the majority is based on direct output measures (e.g. the number of hospital operations, or school pupils) rather than by deflating a nominal measure with a price index. Therefore if nominal spending growth falls, but the direct output measures are little changed, measured inflation will fall”. And *“the fall in government consumption inflation, since 2010, is largely a result of a fall in the contributions from the health and education sectors, in which output is primarily directly measured.”*

The government neglects the relative price effect at its peril. It and its predecessors have no excuse for the negligence shown in assessing what the public and Taxpayer gets from public expenditure.

and Productivity by Mike K Phelps, Sophia Kamarudeen, Katherine Mills and Richard Wild, *Economic and Labour Market Review*, October 2010.

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