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Tullett Prebon Research, a blog by Dr Tim Morgan

George and the black hole

by Tim Morgan on November 14, 2012

If the Social Market Foundation and the Royal Society of Arts are right – and I for one am pretty sure that they are – chancellor George Osborne is going to need to find further spending cuts (or, of course, a mixture of cuts and tax increases) totalling £48bn in his 5th December autumn statement if he is to put the government's deficit reduction plan back on track.

If you feel you've read, somewhere or other, that we might find ourselves in precisely this kind of a mess, then you have. It was predicted – in, I admit, almost ghoulish detail – in the *Project Armageddon* report that we published in July 2011.

What can George do?

Well, first let's note that the term "further" spending cuts is a bit of a misnomer, because cuts to date have been minimal. Whisper it who dares – because both Labour and the coalition are committed to variations around the theme of 'swingeing cuts' – but overall cuts to public spending thus far under this government have been minimal.

Now I know that there are people who will argue until they are blue (or red) in the face that black is white, but here, for the record, is spending data (both nominal and inflation-adjusted) for the period since 2008-09. I've included revenues, so that you can get a rounded picture:

	At current values			At constant 2011-12 values		
£bn	**Revenue**	**Spending**	**Deficit**	**Revenue**	**Spending**	**Deficit**
2008-09	£539	£630	£96	£571	£673	£103
2009-10	£513	£669	£156	£540	£705	£164
2010-11	£551	£692	£141	£563	£707	£144
2011-12	**£570**	**£696**	**£126**	**£570**	**£696**	**£126**

In real terms, spending in 2011-12 was slightly (£11bn) lower year-on-year, but remained £23bn higher than it was in 2008-09. The deficit has indeed fallen (by £38bn, or 23%) since its peak, but the vast majority (£30bn, or 80%) of this reduction has been paid for out of higher taxes, most notably VAT.

Can the government really find the £48bn that is required to put the Grand Plan back on track? Even based on the headline spending total (£696bn) for last year, this looks a tall order, calling for an across-the-board saving of 7%. But such a calculation is a huge understatement of the real challenge.

Within last year's spending total, £47bn was accounted for by debt interest, and a further £132bn by two areas – health and overseas aid – which are protected by pre-election promises. Of the remaining £517bn, a full £308bn is accounted for by 'transfer' payments, principally pensions and benefits. This means that the government could really be looking for savings of £48bn out of remaining departmental budgets totalling just £209bn.

Can these expenditures – which include education, defence, local government, housing and transport – really be cut by almost a quarter? This seems to me to be about as believable as the tooth-fairy. How would you do it? Sack a quarter of all public servants? Cut public sector wages by a quarter, perhaps? Put the police back on bicycles, put the Royal Navy in dinghies, and issue buckets to the fire service?

To be sure, Mr Osborne could seek cuts from the benefits bill, but he would be unlikely to cull more than £10bn from this source, which would still leave him trying to find savings of £38bn (18%) from unprotected departmental budgets of £209bn.

This may surprise you, coming from an advocate of lower taxation, but I believe that there are a couple of areas in which the chancellor could seek higher tax revenues. First, he could impose a General Anti-Avoidance Rule (in other words, a tax floor) on the British operations of foreign multinationals. If these businesses really cannot give the authorities accurate statements of their UK earnings, HMRC could be empowered to use estimated figures. Second, Mr Osborne could stop companies using debt interest to shelter the whole of their taxable profits, by limiting interest relief to 50% of PBIT (profit before interest and tax).

No studies exist, so far as I know, which could tell us quite how much these measures might yield, but I would be very surprised if it was much less than £15bn. If to this can be added savings of £10bn from the benefits bill – half of it to be achieved by freezing rates which, after all, rose by an eye-watering 5.2% last year – then the remaining target, at £23bn, starts to look a lot more manageable.

I don't think that ministers will actually do any of this, unfortunately. After all, is a government that ran scared of pasty-eaters, rich charity-donors and caravan dwellers – and might be about to back down on fuel duties (again) – really going to offend foreign multinationals?

Oh well. There's always ~~the printing press~~ quantitative easing and ~~creative accounting~~ reclassification, I suppose.