The Party is Over

A Blueprint for Fiscal Stability

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About the Author

Nigel Hawkins is an investment analyst, who specializes primarily in the electricity, gas, water and telecoms sector; he also covers several other sectors. He has worked in the City since 1988, notably for Hoare Govett (now RBS), Yamaichi and Williams de Broe (now Evolution).

He is a regular features writer for Utility Week and Cleantech magazines and frequently contributes to the financial media. In addition, he undertakes various research projects on energy, water and economic policies for Westminster-based think-tanks. He has written three previous publications for the Adam Smith Institute, namely:

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Prior to joining the City, he worked for six years in politics, including three years as Political Correspondence Secretary to Lady Thatcher at 10 Downing Street. In 1987, he stood in the general election as Conservative Party candidate in Sedgefield against Tony Blair.

He was awarded a degree in law, economics and politics from the University of Buckingham and subsequently qualified as an Associate of the Institute of Chartered Secretaries and Administrators (ACIS), whilst working as Export Sales Manager for Marlow Ropes, Hailsham, East Sussex.

Executive Summary

- As the plight of some heavily indebted Mediterranean countries – such as Greece – demonstrates, there is one compelling economic priority for the new Coalition Government – debt reduction. With a Public Sector Net Borrowing (PSNB) figure of over £160 billion projected for this year, urgent action – in addition to the £5.7 billion (net) of public expenditure cuts announced on May 24th – is essential. Otherwise, the UK's sovereign credit rating may be downgraded and its debt interest costs would rise even further.

- Assuming the previous Government's economic growth forecasts are met, the UK's public sector net debt (PSND) will reach 63% of GDP during this year and will be almost 70% by 2011/12, when PSND is projected to be c£1.1 trillion. In 2006/7, the figures were 37% and £500 billion respectively.

- Whilst the 18-month recession, which has recently ended, savagely cut projected tax revenues, the overriding factor has been the massive surge in public expenditure – Total Managed Expenditure (TME) rose from £419 billion in 1997/98 to £630 billion in 2008/09 (at 2008/09 prices).

- To reverse this very damaging trend, this Report proposes average real cuts of c3% per year, excluding debt interest, for the next five years beginning in the current year; these cuts are based on the 2009/10 projection in the 2010 Budget for TME, excluding debt interest, of £643 billion.

- By implementing these proposed cuts, pre debt interest savings of c£20 billion annually would accrue. The post debt interest TME annual reduction is rather lower – at £12 billion, the equivalent of an annual TME cut of c2%.

- If these proposals were fully implemented, the budget deficit would be eliminated by 2014/15, whilst PSND would be c70% of GDP at March 2015 – assuming that the previous Government's economic growth projections are broadly accurate.

- With widespread concerns about a W-shaped recession, these relatively modest cuts should avoid the adverse economic impact that some economists argue more severe cuts would produce. Indeed, this Report concludes that the financial risks – including a possible run on the £ Sterling – of deferring public expenditure cuts far outweigh the risks of depressing the economy.

- Initially, these cuts should apply to all departments; however, in this Report's modelling, a more modest 2% annual reduction for current health expenditure has been assumed. No departments, though, should be completely 'ring-fenced'.

- The focus on generating savings should be on attacking the 'soft underbelly' of public expenditure – social security benefits, NHS inefficiencies, education costs, MOD procurement shortcomings (especially in aircraft purchasing) and local government bureaucracy: for the latter pair, the Gray Report and the Wandsworth model are key.

- In delivering these departmental cuts, like the Chief Executive of a FTSE-100 company, the responsibility should lie with the relevant Secretary of State in deciding where the savings should be made and ensuring they are achieved. If the Secretary of State is unable to deliver the necessary cuts, he or she should expect to be replaced. Cutting public expenditure is politically difficult, so a degree of ruthlessness is needed to deliver the specified savings.

- The new Government should also act to reduce its massive unfunded pension liabilities, especially the c£770 billion for public sector employee pensions. In the latter case, higher employee contributions and less attractive benefits should be prescribed.

- Furthermore, a new privatization programme should be undertaken – it could generate one-off cash proceeds (before any sale of the Government's bank shareholdings) of c£16 billion. And, assuming that the share prices of both RBS and Lloyds continue to recover, the Government should start selling down these shareholdings, whose combined value, after an assumed 10% discount, is currently c£31 billion.

- On a more philosophical note, there should be a major cultural effort to highlight the benefits of thrift and saving, along with the need to use public money efficiently and responsibly. More specifically, the overt waste of taxpayers' money – as demonstrated by yet another massive over-run within MOD procurement, by the 231 staff at Transport for London (TfL) earning £100,000 or more per year, or by the pernicious diet of bogus public sector 'diversity' jobs advertised weekly in the Guardian newspaper – should cease.

NB: Throughout this document, constant prices have been used, unless otherwise specified; hence, no allowance has been made for inflation in the projections until 2014/15.

1 Introduction

In recent decades, public expenditure levels have risen sharply in most G20 countries: the UK has been no exception in this respect.

Indeed, according to the Institute of Fiscal Studies (IFS), the average annual real increase between 1948/49 and 2008/09 in Total Managed Expenditure (TME) has been 3.4%. Over the 12 years of the previous Labour Government until March 2009, the increase has been slightly lower at 3.2% – almost double the rate between 1979 and 1997 when a Conservative Government was last in power.

Significantly, there has been a pronounced switch in the percentages of national income devoted to individual programmes – with social security and health being obvious gainers at the expense of defence – as Figure 1 clearly illustrates.

Undoubtedly, the last two years have seen a massive transformation in the UK's public finances, as the financial crisis and the ensuing recession wreaked havoc on the optimistic growth projections of 2006 and 2007. It now seems likely that the worst of the financial crisis has passed, although Royal Bank of Scotland (RBS), which has been by far the largest recipient of public funds, remains in a fragile state.

Having experienced a 1.5% fall in Gross Domestic Product (GDP) in 2008/09, the economy, too, is recovering. The UK has now edged out of recession, with a provisional 0.2% growth figure confirmed for the last three months of 2009/10, although a 3.75% GDP decline is still expected for 2009/10 as a whole.

The combined impact on public finances of both these events has been far-reaching – it has pushed the UK's Public Sector Net Borrowing (PSNB) and Public Sector Net Debt (PSND) to unprecedented levels. Similar scenarios have occurred in most leading industrial nations.

Figure 1: Percentage of national income for major programmes

% of National Income	1958/59	1978/79	1996/97	2008/09
Social security	6.0	9.8	13.1	11.9
Health	3.2	4.4	5.1	7.8
Education	3.3	5.2	4.6	5.7
Defence	6.4	4.5	2.8	2.6
Public order/safety	n/a	1.5	2.0	2.4
Transport	n/a	1.6	1.2	1.5
Net debt interest	2.7	3.9	2.9	1.7
TME of which:	36.9	45.1	39.9	43.2
Net investment	3.4	2.5	0.7	2.5
Current expenditure	33.5	42.6	39.2	39.4

Source: ONS/Treasury

Very few countries have escaped relatively unscathed, although Norway's economy remains extremely robust – with a substantial ongoing public sector surplus being achieved on the back of extensive oil and gas revenues.

Furthermore, Canada's refusal to emulate the excessive lending policies of most leading banks on Wall Street has placed it in a relatively favourable position: its economy is growing strongly. China, too, is an undoubted beneficiary of the profound economic problems experienced throughout most of the western world. Its recent annual growth figures exceed 8%, although doubts about the veracity of this data persist.

The Financial Crisis

Over the last two and a half years, the UK has undergone a profound financial crisis, which escalated into a deep recession – many other countries have suffered similarly.

The collapse of Northern Rock in the autumn of 2007, which was offering its notorious Together mortgages on the basis of 125% of the property's value, was followed by a series of major financial failures. Eventually, Northern Rock was nationalized, along with other demutualized former Building Societies.

Far more seriously, two of the UK's leading banks, RBS and Lloyds, saw their share prices plunge on the back of soaring liabilities: both needed massive injections of public money to boost their seriously depleted Tier One capital ratios.

Following its successful £13.5 billion rights issue, Lloyds has now been able to opt out of the Asset Protection Scheme (APS): the Government, though, still retains a 41% stake.

RBS's plight has been infinitely worse – and barely credible. To date, the Government, which now has an 84% shareholding, has put £45.5 billion of taxpayers' money into RBS; a further £8 billion of contingency capital funds has also been available for emergency use. These sums are astonishing.

In terms of the APS, no less than £282 billion of RBS' so-called 'toxic' assets have now been placed into this Scheme, with RBS being liable for the first £60 billion of losses.

More generally, given the colossal financial impact of the banking crisis, which has affected virtually every leading economy, it is no surprise that the adverse impact on the UK economy has been very considerable – all the more so given the country's disproportionate dependence upon earnings from the financial services sector.

The Impact of the Recession

However, the UK's plight has been worsened by the sharp shift from solid annual economic growth over the last decade to a deep recession, within a very short time span. From annual growth rates in excess of 2.5% over the last decade, the latest Government figures in the 2010 Budget indicate economic contraction of 1.5% for 2008/9 and of 3.75% for 2009/10.

For 2010/11, the recent Budget projected a 2% growth figure. Whether this forecast will be reached – or indeed exceeded – is a moot point.

Last year's very substantial economic contraction – notwithstanding the 1.5% decline in 2008/09 – has had a dramatic impact on public finances, with tax revenues falling well short of the projections made before the recession. The situation has been compounded by the fact that the UK's public sector finances were more stretched than those of most other EU members, in terms of public borrowing levels, prior to the onset of the recession.

Furthermore, the proposals put forward by the previous Government in its 2010 Budget to cut total government expenditure from 2011/12 onwards are widely seen as being inadequate, although the much higher level of debt interest masks significant cuts in investment expenditure.

Against this background, this Report focuses heavily on the UK macro-economic environment and how some of the key metrics, such as PSNB and PSND, can be restored to a more sustainable position.

Public Borrowing

In recent years, the relative level of public borrowing has been uncomfortably high – and may soon exceed the levels of the mid-1960s. Interestingly, throughout the 1950s, PSND exceeded 100% of national income. Significantly, though, the record-breaking IMF loan in 1976 was required when PSND was markedly lower, as a percentage of GDP, than the forecast figure for 2009/10.

Since 2008, the widespread impact of the recession, notably through much lower tax revenues than anticipated, has seen PSND soar. An indication of the very rapid deterioration of the UK's public finances is provided by the 2007 Budget, which was presented in March of that year. Budget forecasts then indicated net borrowing of £28 billion for 2009/10 and £26 billion for this year – the latter projection gave rise to a PSND, which was below 40% of GDP.

Just three years later, these forecasts have proven to be a vast under-estimate. For 2009/10, the Treasury is now projecting net borrowing of £156 billion, which would imply PSND of c£770 billion – the cost of various temporary financial interventions is excluded. As a percentage of GDP, this projection equates to c54%.

This year, a net borrowing level of £163 billion was forecast in the latest Budget. In 2011/12, a much lower figure is anticipated, although difficult public expenditure decisions in the wake of the recent General Election will be a key determinant of future public borrowing trends. Ominously, too, there is a high structural component – as opposed to the cyclical element – of the deficit within the PSNB projections.

Whilst the focus of this Report is on how to deliver sizeable – and enduring – cuts in public expenditure, the degree to which tax revenues have plunged has often been overlooked.

In its 2007 Budget, the Government was projecting tax receipts for 2007/08 of £553 billion. Yet, three years later, the current forecast for this year is just £541 billion; this compares with the £648 billion of tax receipts for 2010/11, as projected in the 2007 Budget.

Figure 2 below, extracted from the 2010 Budget, shows how the four most important tax generators – Income Tax (net of tax credits), National Insurance (NI) contributions, VAT and Corporation Tax – are expected to have delivered significantly lower receipts this year than in 2008/09.

Given much lower tax revenues and with PSNB for 2009/10 now expected to be almost 12% of GDP, reducing public expenditure is now the compelling priority. When the UK last applied for – and received – an IMF loan in 1976, the relevant percentage was just 7% of GDP.

To reduce PSNB and to curtail increases in PSND, a return to economic growth and substantial public expenditure cuts are needed. Policies to achieve these aims should be based on the determination of a detailed – and credible – medium-term financial strategy.

It should be pointed out that the UK's public borrowing level is far from being unique. Most leading economies have borrowed excessively, including the US and Japan – the latter's public borrowing figures are quite unprecedented for an economy of such a size.

Indeed, within the EU – and despite the five financial ratios prescribed by the Maastricht criteria – excessive borrowing has been the norm rather than the exception. In addition to the UK, France, Germany, Italy and Spain all have very high levels of public borrowing.

In Greece's case, there are grave concerns about both its sovereign debt and whether it can sustain its membership of the Euro, given the massive difficulties faced by its current Government in delivering public expenditure cuts. Its Government recently agreed a c£95 billion bailout from a combination of the IMF and other Eurozone members.

But the UK's plight is particularly serious, because the PSNB figure was already disproportionately high as the recession started – unlike that of several other countries, including Germany.

Consequently, as per the recent OECD figures for leading economies, the UK's position is the worst – for 2010 and 2011 – in terms of the general government financial balance as a percentage of GDP: these figures pre-date the revised PSNB projections in the 2010 Budget. By contrast, Norway's public finances – boosted by its formidable oil and gas revenues – are enviably strong, as Figure 3 indicates.

Financing the Deficit

Despite widespread concerns about the possible downgrading of its sovereign debt by the credit rating agencies, the UK Government has had little difficulty to date in funding its

Figure 2: Tax receipts (£bn)

Tax	Outturn 2008/09	Estimate 2009/10	Projection 2010/11
Income tax (net)	147.8	138.8	140.5
NI contributions	96.9	94.9	97.0
VAT	78.4	70.0	78.0
Corporation tax	43.7	36.0	42.1

Source: Budget 2010

borrowing, which is rising very sharply. In fact, as a result of the unprecedented banking crisis, nominal yields on gilt-edged stock have remained quite low as investors have sought security in the form of government-backed stocks.

In the early 1980s, the average nominal interest on gilts was c10% – the current figure is c4%. Despite this lower nominal – if not real – return, funding the Government's current borrowing has been surprisingly straightforward.

It is clear, though, that the key to this success has been the Bank of England's £200 billion Quantitative Easing programme, which has now ended – at least for the moment. Moreover, tighter capital rules have obliged leading banks to buy more gilts.

Gilt yields, though, continue to fluctuate, with the 10-year 2020 benchmark 4.75% Treasury Stock currently yielding just below 4%. Figure 4 overleaf shows how the yield on 10-year gilts has moved over the last year.

However, demand for gilts looks likely to change, a very worrying scenario given the Government's PSNB projections: the market expects c£190 billion of gilts to be issued this year.

Given that many other economies are running formidably high deficits, the UK may find it increasingly difficult to find buyers for its massive gilt issues. However, this risk is offset by the fact that the UK's average maturity period for gilts is c13 years – twice the length of that of many EU members, including Greece.

Figure 3: General government financial balance (%age of GDP)

Country	2008	2009	2010	2011
Australia	1.0	-4.0	-3.5	-2.6
Austria	-0.5	-4.3	-5.5	-5.8
Belgium	-1.2	-5.7	-5.6	-5.2
Canada	0.1	-4.8	-5.2	-4.5
Czech Republic	-2.0	-5.7	-5.6	-5.0
Denmark	3.4	-2.5	-5.4	-4.0
Finland	4.4	-2.3	-4.8	-5.2
France	-3.4	-8.2	-8.6	-8.0
Germany	0.0	-3.2	-5.3	-4.6
Greece	-7.8	-12.7	-9.8	-10.0
Hungary	-3.7	-4.3	-4.1	-3.6
Iceland	-13.6	-15.7	-10.1	-5.8
Ireland	-7.2	-12.2	-12.2	-11.6
Italy	-2.7	-5.5	-5.4	-5.1
Japan	-2.7	-7.4	-8.2	-9.4
Netherlands	0.7	-4.5	-5.9	-5.3
Norway	18.8	9.6	9.9	10.8
Poland	-3.7	-6.4	-7.8	-6.8
Portugal	-2.8	-6.7	-7.6	-7.8
Slovakia	-2.3	-5.9	-6.3	-5.0
Spain	-4.1	-9.6	-8.5	-7.7
Sweden	2.5	-2.0	-3.0	-2.0
Switzerland	1.6	-0.7	-1.3	-1.3
United Kingdom	**-5.3**	**-12.6**	**-13.3**	**-12.5**
US	-6.5	-11.2	-10.7	-9.4
Average	***-3.5***	***-8.2***	***-8.3***	***-7.6***

Source: OECD

Figure 4: Ten-year gilt yields

Source: Bloomberg

Nevertheless, last January's decision by Pimco, the world's leading bond house, to reduce its exposure to UK gilts and to US government bonds is undoubtedly a negative development.

If demand for UK gilts falls steeply, yields will rise – with a pronounced impact on Government debt interest payments, which are treated by the Treasury as part of TME. For this year, the Government has projected a debt interest cost of £41.6 billion – a vast sum which may prove to be an under-estimate, especially given the interest-compounding element.

To reduce the risk of substantial increases in the cost of funding PSND, widespread cuts in public expenditure are vital. At present, political considerations are preventing the implementation of this policy. Clearly, the current deficit is unsustainable but the real risk is that the markets take fright and make it unfinanceable – or financeable but only at excessive interest costs.

As such, given soaring PSNB and PSND – notwithstanding the lacklustre response of the previous Government to devise a clear and credible medium-term plan to cut public expenditure – it is no surprise that the credit rating agencies have been carefully analysing whether the UK's sovereign credit rating of AAA should be cut.

For the moment, the world's three leading credit rating agencies – Standard & Poor's, Moody's and Fitch Ratings – have adopted a 'wait and see' policy. Following the General Election on May 6th, there is a widespread expectation that very substantial public expenditure cuts will be specified in the new Government's emergency Budget on June 22nd – in addition to the relatively modest £5.7 billion (net) cuts announced on May 24th.

If that is the case, credit downgrades from any of the three leading rating agencies may be averted. However, it remains to be seen whether the outcome of this year's General Election – a hung Parliament, resulting in a Coalition between the Conservatives and the Liberal Democrats – will lead to initiatives to bring down the UK's excessive borrowing levels being deferred on political grounds.

If so, there is a greater risk that the UK's sovereign debt may be downgraded by the credit rating agencies – this would push up borrowing costs still further. Consequently, the projected £41.6 billion debt interest cost for this year may be exceeded. In future years, borrowing costs would rise further, unless concerted action were implemented to cut the UK's PSND.

In fact, the UK is far from being alone in terms of facing cuts in its sovereign credit rating. Many of the smaller – and newer – EU member states have suffered very badly from the recession and have seen their credit ratings fall. Iceland's plight has been particularly grave, as its banking sector effectively collapsed. Both Latvia and Lithuania have also faced savage declines in GDP – of c20%: Hungary's economy, too, has undergone massive strains.

The sovereign credit rating of Ireland, whose economy had boomed previously, was cut along with that of several southern Mediterranean countries, including Spain and Portugal. The most seriously affected EU country at present is probably Greece, whose public finances are in a desperate state; whether Greece can retain its Euro membership remains to be seen.

Off-Balance Sheet Liabilities

In the UK, as with many commercial companies – of which the collapsed Enron is the obvious example – there are also increasing concerns about the Government's off-balance sheet liabilities. In particular, unfunded pension obligations account for a very large element of total public sector off-balance sheet liabilities – inevitably, they impact the UK's credit standing.

Historically, the UK's basic state retirement pension system has operated on a pay-as-you-go funding principle. In essence, this means that current earners are funding the state retirement pension of those eligible – a minimum age currently of 65 for men and of 60 for women.

However, with an ageing population, stemming both from the post-war baby boom and especially from the peak birth rates reached in the early 1960s, future pension liabilities are rising sharply.

In fact, successive Governments have sought to limit the increasing costs of pension provision. The new Government's commitment to hold a review to set the date at which the state pension age starts to rise to 66 is heavily cost-related. However, its related proposal to restore the earnings link for the basic state pension from April 2011, and to raise it thereafter by the higher of earnings, prices or 2.5%, cuts in the opposite direction.

It is the case, too, that average life spans are moving upwards quite significantly, on the back primarily of medical advances and generally healthier lifestyles.

More specifically, the scope for reducing the vast liability for public sector employee pensions is clear-cut. The Government's own figures indicate a funding liability of c£770 billion whilst an Institute of Economic Affairs publication has calculated a figure of over £1 trillion.

To reduce its public sector employee pension liabilities, the Government should introduce a range of measures including levying higher employee contributions, reducing benefits and specifying longer periods of employment for eligibility purposes.

Furthermore, over the last fifteen years, a large number of Private Finance Initiative (PFI) deals have been signed. The PFI system uses a mix of public and private funding; many NHS building and transport projects have been funded by PFI contracts.

Some of the Government's PFI liabilities are off-balance sheet. With the dire state of much of the UK building sector, these liabilities may well increase. Although the figures fall well short of the amount of the two major pension-related liabilities, the total amount outstanding for off-balance sheet PFI liabilities is still very material.

Recently, a senior Treasury official confirmed to the Public Accounts Committee that, on a discounted cash flow basis, the Government's total long-term PFI-related liabilities were £91 billion.

In order to clean up the balance sheet of UK plc, a more transparent approach is required to deal with liabilities that are not directly accounted for. Liabilities for state retirement pensions, for public sector employee pensions and for the off-balance sheet element of PFI deals should be more clearly stated and duly recognized as such.

Public Expenditure

The level of public expenditure has soared in recent years, reaching a projected £643 billion, excluding debt interest, in 2009/10. Given this factor and the financial impact of the recession with far lower tax revenues, it is no surprise that borrowing levels have risen very sharply. For 2009/10, the Government is forecasting PSNB of £156 billion.

The Table in Appendix I illustrates the seemingly inexhaustible rise in Total Managed Expenditure (TME) since 1990/91. Based on 2008/09 prices, TME rose from £369 billion in 1990/91 to £630 billion in 2008/09.

To finance this soaring public expenditure programme during a recession, which has seen tax revenues plunge, is immensely challenging. To date, little effort has been made to curb the growth in public expenditure.

2 Strategy to Deliver Public Expenditure Savings

In putting forward credible proposals to cut public expenditure, it is argued that a concerted five-year strategy should be adopted rather than seeking ad hoc solutions to the problem of sharply rising public expenditure. Hence, knee-jerk type proposals, such as simply scrapping individual programmes, are not advocated. Instead, a more rational scientific approach is required.

From 1998 onwards, UK public expenditure has been divided into two categories – Departmental Expenditure Limits (DEL) and Annual Managed Expenditure (AME): this distinction was made primarily to promote greater efficiency and to safeguard public investment programmes.

- The DEL budget covers projected expenditure for the current year and subsequent years – c60% of TME, excluding debt interest costs, is categorized as such;

- The AME budget is less predictable in that the Government judges that it cannot be projected with real accuracy for future years.

In respect of social security – by some way, the largest element of public expenditure – the concept of shrinking benefits should be adopted. In particular, the level of benefit payments and their eligibility criteria need careful consideration. The value of some benefits could be reduced by c5% and have their eligibility numbers cut by c5% – with the 5% least deserving cases being denied the relevant benefit. On this basis, the total annual cost of the benefit provision would be reduced by almost 10%.

Health and education – the latter is primarily accounted for within the Department for Education (DfE) budget – represent the largest components within the DEL segment, which – pre depreciation – is projected to be c£400 billion in 2009/10. Including capital expenditure, the health and DfE figures are £105 billion and £57 billion (a small element of which is not strictly education expenditure) respectively: the £48 billion defence budget is the next largest programme.

In the AME segment, which is more sensitive to the state of the economy, social security is the dominant element, accounting for an estimated £164 billion in 2009/10: tax credits should cost a further £23 billion.

Progressive across-the-board cuts in public expenditure – with a very few prescribed exceptions – over an extended time period would return public finances to equilibrium and reverse the recent surge in public borrowing. Such a policy could be sensibly implemented over a five-year period.

Of course, any policy to impose substantial cuts in public expenditure has to be considered in the context of its overall economic impact. However, this Report concludes that the financial risks – including a possible run on the £ Sterling – of deferring public expenditure cuts outweigh the risks of depressing the economy.

Hence, this Report advocates that the new Government imposes an overall 3% real terms cut in public expenditure – excluding debt interest – for this year. A similar annual reduction should apply each year until 2014/15, by which time annual PSNB should have fallen sharply.

Figure 5 illustrates how TME would decline from an estimated £643 billion for 2009/10, excluding debt interest: more detailed information about departmental budget changes is set out in Appendix II.

From 2011/12 onwards, the prescribed cuts can be more judicial between individual departments, but they should amount to c3% per year in real terms off the previous year's TME figure, excluding the debt interest cost.

Figure 5: Projected TME 2010/11 to 2014/15

Year	TME (F)*	Cut p.a (%)
2010/11	624	3
2011/12	605	3
2012/13	587	3
2013/14	569	3
2014/15	552	3

**Pre debt interest*
Source: Budget 2010 and Nigel Hawkins Associates' Estimates

On a departmental basis, as set out until 2014/15 in Appendix II, the projected 3% per year cuts do vary, with some allowance being made for the ease with which material savings can be expected to be delivered. In the case of health, a 2% real terms cut in current expenditure has been assumed. Furthermore, the projected departmental capital expenditure cuts are significantly higher than the 3% per year used for most current expenditure programmes.

The Soft Underbelly of Public Expenditure

In the medium-term, a more focussed cost-cutting approach is required, which would assess in depth the potential for delivering very substantial savings from the key five programmes – social security, health, education, defence and local government.

In seeking these cuts, specific attention should focus on areas where public expenditure controls are lax – the 'soft underbelly' of public expenditure.

Aside from prescribing a much-needed freeze on most public sector recruitment, payroll costs – wages, National Insurance (NI) contributions and pension contributions – need to be addressed. This issue straddles departmental boundaries, but particularly affects the five largest spending programmes.

According to the IFS, the total public payroll cost in 2008 was £174 billion. Figure 6 identifies the most prominent categories of public sector employees.

This year's public payroll cost is expected to be somewhat higher and equivalent to c28% of TME, excluding debt interest. Figure 7 illustrates the recurring savings that would arise from annual reductions – varying between 1% and 3% – in our assumed payroll costs of £180 billion per year.

Given that average private sector earnings grew by just 0.1% in 2009, whilst public sector earnings growth was 3.8%, there is a very persuasive case on equity grounds – notwithstanding the sound economic justification – for a material reduction in public sector payroll costs. Even if nurses' pay levels remain unchanged, a 3% cut off other public sector payroll costs would yield savings of c£5 billion per year, although there would also be a negative impact on tax receipts.

Figure 6: Major categories of public sector employees

Category	000s
Civil servants	522
Teachers (England & Wales)	476
Nurses (England)	408
Police	285
HM Forces	193
Doctors	134
Teaching assistants (England)	125
Others	3,635
Total	**5,778**

Source: IFS

Figure 7: Projected annual savings off public sector payroll cost

Projected Cost	-1% (£bn)	-2% (£bn)	-3% (£bn)
£180bn p.a.	1.8	3.6	5.4

Source: IFS, Nigel Hawkins Associates

The recent budget in Ireland provides an example of how a government can address – head-on – the issue of excessive public sector payroll costs and soaring debts. Cuts of between 5% and, for the highest paid employees, of up to 15% have been prescribed.

In terms of budgeting, the paramount figure is the total annual payroll cost of public sector staff. Any savings should be a combination of lower individual wage and other employment-related costs and, where appropriate, reduced staffing levels.

The projected overall 3% average cost saving for this year and subsequent years will be heavily dependent upon delivering markedly lower staff costs, especially in the high-spending departments, such as health, education, defence and local government.

In some areas, especially with respect to nurses, delivering these savings may be neither desirable nor achievable. But it is vital that, like any over-staffed company, the bloated UK public sector employment payroll is tackled – efficiently and fairly.

Aside from the public pay issue, it is clear that – in addressing this 'soft underbelly' – one-off cuts, such as simply reducing aircraft procurement orders, are not sufficient. Instead, what are needed are ongoing – and recurring – reductions in the cost base, which can endure for many years.

In particular, there should be a focus on those departments where there has been a pronounced level of expenditure growth over the last decade. Figure 8 below compares the annual real growth in public expenditure of the largest programmes since 1997.

Figure 8: Real growth of major public expenditure programmes

Programme	4/1997-3/2008 Rise p.a. (%)
Social security	1.4
Health	6.3
Education	4.3
Defence	1.4 (est.)
TME – Current	3.0
TME – Capital	13.9 (net)

Source: Treasury

It is also the case that, given the current size of PSNB, the key savings need to be measured in £billions. To locate – and deliver – savings of that size, it is inevitable that the majority will arise from within the five largest public expenditure programmes outlined above, which account for almost 65% of TME, excluding debt interest.

Social Security

Unlike many other spending programmes, most social security expenditure, such as unemployment pay and income support, is extremely sensitive to the economic cycle. However, the c£60 billion spent annually on state retirement pensions is a notable exception. The September inflation rate, which determines the following April's annual up-rating, is more influential.

Nonetheless, with last year's social security benefits forecast to have cost almost £164 billion, there is clearly scope to achieve substantial savings even if the percentage cut is quite modest. With the application of a 3% real terms cut for this year and similar cuts thereafter, the budget would fall to below £150 billion by 2012/13 – a saving of over £14 billion when compared with the 2009/10 figure.

As a general principle, it is proposed that the Secretary of State for Work and Pensions should determine how the social security budget should be cut in the same way as the Chancellor of the Exchequer decides which taxes should be raised and which should be lowered – and effectively therefore who will gain and who will not. What is paramount, though, is to work within the top-line budget figure, which has been specified.

Whilst some commentators have advocated straightforward cuts in an individual benefit, the more scientific approach is to reduce eligibility in some cases and to cut the value of individual benefits in others – in some instances, both these shrinkage strategies can be pursued in order to reach the appropriate out-turn. In any event, all major social security benefits should be carefully analysed in the search for savings; this also includes Tax Credits, which are projected to 'cost' almost £22 billion this year.

The most obvious way to deliver material social security savings within the next two years is by limiting the payment of Child Benefit to the least well-off – currently, families paying the highest rates of Income Tax are eligible for it. The IFS has estimated annual savings from the tapering of Child Benefit at £4.5 billion, a figure that could be raised to almost £5.8 billion annually if similar changes were made for the related Tax Credits.

The abolition of the Child Trust Fund policy, whose impact has been minimal, is also desirable: annual savings from such a change would equate to c£500 million per year. In fact, the new Government has announced in its first round of public expenditure cuts on May 24th that Treasury payments into Child Trust Funds are to be phased out.

With regard to Incapacity Benefit, there is clear evidence that some existing claimants would not satisfy tighter physical and mental eligibility criteria. If these were introduced and properly enforced, annual savings could exceed £1 billion.

Despite the very high annual cost, no changes are put forward in this Report to reduce either the coverage or the value of the basic state retirement pension. With an ageing population, the number of eligible pensioners continues to rise – along with the total cost.

To mitigate this trend, it is suggested that the move towards an older and more flexible retirement age should continue. Furthermore, the new Government should also decline – on economic grounds – to re-link increases in the basic state retirement pension to the rise in average earnings, or to introduce the proposed 'triple lock', whereby the basic state retirement pension would be raised in line with earnings, prices or 2.5% – whichever was the highest.

Many retired people are eligible for both Winter Fuel payments and – for a household with an occupant aged 75 or over – a free TV licence. Whilst it is not proposed that either benefit should be removed, the total cost of almost £3 billion – funded by other taxpayers – is clearly significant.

With regard to Income Support, its eligibility criteria should also be carefully reviewed by the new Government to ensure that only really deserving claimants are actually eligible.

The search for social security savings should focus on:

- Shrinking benefit payments and eligibility criteria;
- Reducing Child Benefit entitlements;
- Limiting Tax Credit offset concessions;
- Abolishing Child Trust Funds;
- Prescribing tighter criteria for Incapacity Benefit payments;
- Declining to re-link basic pension increases to earnings.

Health

Since 1979, the annual real increase in health expenditure has exceeded 4%. In recent years, especially since 2001, the health budget has increased very rapidly indeed. In part, this surge reflects rising demographic trends, the increasing cost of new equipment and a higher drugs bill – all place severe upward financial pressure on the health budget. And, unlike some countries, the UK private health sector is quite modest, at around 13% of the market.

Currently, over 1.5 million people work in the NHS, a vast employment force in which there must be scope for serious savings. In England, there are now over 44,600 NHS managers – an increase of 84% since 1999. Hence, it is hardly surprising that a large part of the NHS budget is accounted for by employee payroll costs.

Last year, the NHS is expected to have accounted for £105 billion of public expenditure, just under £100 billion of which is current expenditure: virtually all of it is spent in England. The health budgets in Scotland, Wales and Northern Ireland are devolved.

The overall 3% year-on-year real terms reduction figure has been adjusted to 2% for current NHS expenditure over the five-year period. With the hospital building programme now tailing off, a 4% reduction figure has been used in respect of NHS capital expenditure for this year and 7% thereafter. On this basis, overall NHS expenditure in 2012/13 would decline to under £99 billion compared with £105 billion currently, thereby equating to annual savings of over £6 billion.

Given the high employment cost component, reducing overall NHS payroll costs is crucial. In some cases, this will mean lower staffing levels. But there is a strong case for omitting nurses from any wage cuts. As such, efforts to reduce the payroll bill should focus on NHS managers – many of whom are overpaid – administrative staff and back office employees.

It is estimated that the occupation of a bed in a District General Hospital costs c£300 per day net. It is vital, therefore, that each bed is used to the optimum and that any hospital patient 'bed-blockers' are moved into more suitable – and cheaper – accommodation if they have no clinical need for use of the available hospital facilities. A more advanced bed reservation policy, especially for non-urgent medical care, could also yield efficiencies.

Improving the performance of the Primary Care Trusts (PCTs) is also a priority, especially in terms of their expanding role as service commissioners. Many PCTs are poorly managed – there is considerable scope for delivering efficiencies.

The NHS drugs bill, too, is ripe for cost-cutting measures, although it is accepted that there is always upward pressure on this programme; currently, it accounts for between 10% and 15% of overall NHS expenditure.

The infamous NHS national computer project has massively exceeded its original budget. The latest projections by the TaxPayers' Alliance (TPA) assume a cost of £10 billion, more than four times over budget. There is considerable doubt, too, about how effective the new IT network system will prove to be – assuming it is eventually completed. In any event, cutting back the least useful parts of this ill-fated project would be an obvious saving.

In recent years, there has been a pronounced increase in capital expenditure on both new hospitals and on new PCT facilities. This investment programme is now beginning to wind down. Hence, capital expenditure costs within the health budget should fall significantly over the next few years.

In the medium-term, Monitor, the health regulatory body, should undergo a step-change so that it can become the driver of a far better operating performance throughout the NHS. Monitor currently regulates the 129 hospitals that have so far secured Foundation Status – the majority have not. Indeed, the performance differential between the best and worst hospitals remains very pronounced.

On a similar timescale, some NHS functions are ripe for privatization, including imaging, pathology and instrument decontamination services. Such a policy, if implemented, should enable an elite group of UK niche health companies to emerge in these specialist fields, which could also create major business opportunities overseas.

The search for health savings should focus on:

- Reducing payroll costs outside nursing;
- Managing hospital bed occupation more effectively;
- Creating greater efficiencies within PCTs;
- Cutting the annual drugs bill;
- Regaining control of the disastrous NHS IT project;
- Scaling back the hospital-building programme.

Education

Like the health budget, public expenditure on education has risen steeply in recent years – there has been an annual increase of over 4% since 1997. In fact, over £45 billion of the £57.1 billion central government allocation, which is due to have been spent through the Department for Education (DfE) budget in 2009/10, is represented by education costs in England: Scottish, Welsh and Northern Ireland education budgets are devolved.

Not surprisingly, schools in England, including sixth forms, will have accounted for the overwhelming share of DfE public expenditure in 2009/10 – the split between secondary and primary schools is broadly 60%/40%. Most of this expenditure is allocated to local government education departments via the Dedicated Schools Grant (DSG).

Based on a 3% real cut per year for current expenditure and a 4% real cut per year in respect of capital expenditure for this year – and a 7% cut thereafter for the latter – the out-turn in 2012/13 would fall to below £52 billion. Over £5 billion of the departmental DfE budget would be saved annually by that date.

Clearly, the payroll costs of teachers, teachers' assistants and support staff account for most of this expenditure programme. It seems clear that limiting any increases in these costs, along with moving the least effective teachers out of the profession, are key to delivering a material part of the necessary projected savings.

After all, average state school teachers' salaries have risen by c25% in real terms over the last decade. Moreover, the annual contribution into teachers' pension schemes now costs over £10 billion.

The scope to deliver savings through lower staff numbers is illustrated by the sharp increases since 1997 in state school teaching staff and their assistants in England – by 40,000 and 116,000 respectively. Support staff costs, too, have risen by c40% over the last decade.

Inevitably, there will be understandable concerns about the adverse impact on education standards if staff levels were cut back. But there may be some off-setting benefits from this policy, especially if the best – and most in demand – teachers could be better compensated.

Whilst there is a very strong case for providing special help for secondary school children who are struggling with english and maths, it seems unnecessarily expensive to provide one-on-one tuition to the estimated 300,000 individuals affected. There should be more economic ways of tackling this problem.

Within the DfE budget, there is scope for other savings, including the reduction of the notorious bureaucracy within the education profession and closing down the very worst schools.

The Sure Start initiative has been a flagship programme of the previous Labour Government. It has expanded rapidly in recent years – and is now ripe for a greater assertion of cost control, which should generate material savings.

In common with the health sector, capital expenditure in education, especially through the Building Schools for the Future programme, has risen steeply in recent years. As such, it should certainly be possible to defer some of the capital expenditure earmarked for education, particularly in secondary schools, over the next five years.

The search for education savings should focus on:

- Cutting the total costs (including pensions) of the teachers' payroll;
- Reducing the number of education support staff;
- Re-thinking the one-on-one tuition policy for struggling children;
- Minimising institutional bureaucracy within education;
- Delivering cost savings from the Sure Start programme;
- Deferring the Building Schools for the Future programme.

Defence

Over the last two decades, following the ending of the Cold War, UK defence expenditure has moved in an opposite direction compared with that of the health and education programmes. The core defence budget has fallen by almost 10% since the late 1980s, which has had a profound impact both upon personnel numbers – down by some 40% – as well as on the equipment portfolio, as illustrated in Figure 9 below.

In the medium-term, the Strategic Defence Review will clearly be crucial in determining the UK's overall defence strategy. More immediately, within the MOD, there is undoubtedly scope for delivering major costs savings. The Government's projections assumed £48.3 billion of expenditure last year – broken down into £39.1 billion of current expenditure and £9.2 billion of capital expenditure.

Figure 9: Key MOD data

Item	1988/89	2008/09
Core defence expenditure (£bn)	35.8	32.4
Major vessels	108	57
Aircraft	1,250	840
Ground formations	134	97
Civilian personnel	142,000	86,500
Service personnel	326,300	193,100

Source: RUSI

Based on our assumption of real cuts of 3% per year in current expenditure and of a 4% per year in capital expenditure, the figures for 2009/10 and 2012/13 would be £48.3 billion and £43.8 billion respectively, thereby saving over £4 billion between last year and 2012/13. These figures are prior to the increase in the contingency fund for war-related costs, most obviously in Afghanistan.

According to the Royal United Services Institute (RUSI), the largest component of the annual defence budget is the 36% share allocated to the direct costs of employing service and civilian personnel. A further 20% is spent on new equipment; the costs are generally defrayed over many years.

Despite the proportionately higher MOD payroll costs, the emphasis on achieving savings should be directed primarily to the defence procurement element of the budget. Having been originally suppressed by the previous Government, the Gray Report, The Review of Acquisition, was finally published in October 2009.

This very thorough and analytical Report should provide the overall blueprint for eliminating many of the serious inefficiencies within the MOD procurement programme, where cost and time overruns are legendary.

The Gray Report concluded that the average cost overrun for major procurement projects was an astonishing 40% – and 80% from the first estimate – whilst the time overrun was a staggering five years.

In its recent publication on defence procurement, the Centre for Policy Studies (CPS) was equally scathing in its criticism of the MOD's management of its purchasing responsibilities and of its very expensive participation in EU defence *grand projets*.

More specifically, with regard to individual procurement projects, the initial focus should be on the very costly aircraft purchasing programme, including the £18 billion Eurofighter Typhoon F2 multi-role fighter. In particular, in the quest for savings, the UK's Tranche 2 off-take contract, announced in 2004, should be carefully analysed.

The £17 billion Airbus-derived A400M troop transporter plane project has faced well-publicized financial problems. The Franco-German EADS, its lead contractor, is seeking additional capital to continue the financing of this programme, whose cost overrun now apparently exceeds 50%. The UK should only contribute further funding if the case is quite compelling.

As the leader of the Air Tanker Consortium, EADS is also managing the very costly c£12 billion Future Strategic Tanker Aircraft project. Whilst the military case may be very solid, the costs per aircraft are staggering – and need very careful scrutiny.

With regard to the F-35 Joint Combat Aircraft (JCA), the new Government should seek to reduce future planned orders for this aircraft, whose unit price has apparently soared to over £100 million. In particular, it needs to minimize the number of JCAs required for the two new aircraft carriers.

Material savings should also accrue from the £5 billion aircraft carrier programme itself. The two new 65,000 tonne carriers – HMS Queen Elizabeth and HMS Prince of Wales – are due to enter service in 2016 and 2018 respectively. Whilst neither should be cancelled outright, every effort should be made to minimize their cost – subject to retaining their operational capability.

Furthermore, there must be potential savings to accrue from the contracts for the six Type 45 destroyers, which have faced major delays and cost overruns. HMS Daring, the first of the six, was two years late and £1.5 billion over cost.

The most obvious equipment cost savings within the Army lie with orders for the five types of wheeled and tracked military vehicles – Utility, Reconnaissance, Fires, Manoeuvre Support and Basic Capability Units – being built within the £16 billion Future Rapid Effects System (FRES) programme, which has faced serious cost increases and delays. Cutting the Armoured Scout Reconnaissance Vehicle order book should be a favoured option.

However, it has to be reluctantly accepted that the contractual issues for virtually all defence procurement programmes are immensely complex, with very little financial information being in the public domain. Hence, all large contracts need to be carefully analysed to assess where material short-term and mid-term savings can actually be delivered, especially in the context of cancellation penalties.

With regard to the proposed replacement of the existing four Trident submarines – HMS Vanguard, HMS Victorious, HMS Vigilance and HMS Vengeance – any material savings will not be forthcoming for some years.

In the medium term, though, there would be sizeable financial benefits in deferring the Trident replacement programme, especially if it could run in parallel with the US's own nuclear submarine replacement project. Furthermore, it may be that a fleet of three – as opposed to four – nuclear-armed submarines would constitute a credible nuclear deterrent.

In terms of personnel, the MOD bureaucracy, both in London and elsewhere, is an obvious target for material budgetary savings through lower payroll costs. An estimated 28,000 people currently work in areas such as defence procurement, personnel and finance.

Indeed, the delivery of substantial administrative savings in 2011/12 and 2012/13 should enable the financing of enhanced pay and better conditions for those soldiers actually deployed in war situations, such as those currently in Afghanistan.

Reducing the MOD's many locations certainly has attractions in terms of generating cost savings. Establishments in both Germany and Cyprus are obvious targets along with many sites in the UK, including under-employed air-force bases.

Some of the UK sites could be sold off as surplus land thereby delivering one-off capital receipts. However, the MOD argues that only relatively modest sums could be raised via this route although there is undoubtedly far greater scope for such sales than the MOD might publicly admit. Careful scrutiny of the MOD's property portfolio should reinforce this view.

The search for defence savings should focus on:

- Managing major procurement projects far more efficiently;
- Re-negotiating the largest aircraft purchasing contracts;
- Delivering savings from the naval procurement programme;
- Cutting payroll costs, especially of civilian staff;
- Reducing the notorious MOD bureaucracy;
- Closing down under-used bases in both the UK and overseas.

Local Government

In recent years, local government expenditure has continued to soar. In fact, much of local government activity revolves around the provision of education services – this issue has been addressed previously.

Within the local government element of the overall Communities and Local Government (CLG) programme, £25.7 billion is projected to have been spent last year, virtually all of which is current expenditure. This figure is in addition to the c£27 billion of locally-financed current expenditure, which is supported predominantly by proceeds from the Council Tax.

By applying an average 3% real terms cut per year against current expenditure, the local government share of the CLG budget would fall to £23.5 billion by 2012/13. In effect, this would save over £2 billion per year.

Compared with the corporate sector, local government has a poor reputation for efficiency, although the quality and costs of service provision vary quite considerably between councils. Hence, to deliver cuts of 3% per year in real terms should not be excessively challenging, despite the upward pressure placed on Local Authority social services' budgets.

Inevitably, given the high proportion of employee-related costs within the budget, it will be necessary to bear down on payroll costs. In particular, excess staff levels should be cut.

A recent BBC Research report projected that 25,000 local government jobs were at risk over the next five years. Birmingham City Council is apparently anticipating up to 2,000 job losses, whilst Nottinghamshire County Council is reported to be seeking savings of £200 million over five years through a 1,500 reduction in its head count.

Furthermore, in terms of salaries, savings should also come from the top of local government, where some Chief Executives are paid indefensibly large sums – of over £150,000 per year in many cases – for undertaking what are essentially administrative tasks. This 'salary creep' was demonstrated most egregiously by Transport for London (TfL) last year employing no less than 231 staff on salaries of £100,000 or more.

To address the excessively high level of local government remuneration – and to save public money – it is proposed that maximum emolument limits should be placed on all local government senior employees and consultants.

Aside from delivering payroll cost savings, local government should also tackle its bloated cost base so that central government can reduce its annual financial allocations to Local Authorities, although it is accepted that some of these savings would be passed on via a lower Council Tax.

With housing accounting for almost 20% of gross public investment – and the major component of local government capital expenditure – there would also be substantial savings if some local housing programmes could be scaled back or at least deferred.

More generally, for guidance to the relative efficiencies of local government, the CLG Secretary of State should study carefully the impressive records of both Wandsworth Council and of the Hammersmith & Fulham Council.

The former has pursued a highly successful service-driven, but cost-orientated, approach for over two decades. The Audit Commission recently judged that Wandsworth Council was 'performing excellently' and – at 73% – it has the highest percentage of people nationwide who agree that their Council provides value for money. For the third year in succession, there is no rise in its Council Tax.

In the case of Hammersmith and Fulham Council, savings amounting to £42 million have been delivered over the last three years, whilst the Council Tax has been cut by 3% for each year since 2007.

Both Councils, and especially Wandsworth, should be adopted as benchmarks for the incoming administration and be used as comparators with less efficient Local Authorities, against which central government financial support can be more fairly assessed.

For many years, individual Local Authorities have been criticized for wasting public funds through high-on-the-hog expenditure. All should address the costs of their PR and publishing operations, including free newspapers, along with their expenditure on bogus jobs. They should also ensure that vanity projects, including controversial sculptures, are simply not allowed to proceed. These constraints should also include junketing and especially the use of public funds for overseas trips with minimal benefits for local Council Tax payers.

In the longer term, extracting education expenditure from local government finances may be the best way of ensuring the Council Tax is more reflective of local costs – and of making Local Authorities more accountable to their electorate. In common with health, education is probably best funded on a regional basis, ideally through direct financial allocation to individual schools within the region, thereby minimising local government involvement.

The search for local government savings should focus on:
- Cutting local government payroll costs;
- Prescribing maximum emolument limits for senior staff;
- Attacking the bloated cost base in local government;
- Lowering the housing budget;
- Using Wandsworth as the benchmark Local Authority;
- Eliminating Local Authority high-on-the-hog expenditure.

Other Public Expenditure Programmes

With the exception of the programme for Scotland, which includes public expenditure there for education and health *inter alia* and is due to have cost just under £30 billion last year, no other individual programme exceeds £25 billion per year in cost. In the case of expenditure in Scotland, a 4% per year real terms cut has been assumed for this year and for the two subsequent years.

The much-criticized Barnett formula, which dates back to the 1970s, continues to be used as the basis for calculating the UK's subsidy for Scotland. Figure 10 below shows the identifiable public expenditure per capita on services in the UK for 2008/09.

The recent Lyons Report failed to recommend clear action to redress this obvious regional disparity. Following devolution, the anomalies have become more pronounced, with Scottish

Figure 10: Regional public expenditure breakdown

£	England	Scotland	Wales	Northern Ireland	UK
Social protection	3,144	3,522	3,656	3,883	**3,222**
Health	1,774	1,986	1,834	1,835	**1,796**
Education	1,330	1,485	1,369	1,446	**1,349**
Transport	341	536	308	306	**355**
Public order/safety	502	531	522	715	**512**
Others	880	1,478	1,473	1,818	**985**
Total	***7,971***	***9,538***	***9,162***	***10,003***	***8,219***

Source: Treasury

students being exempt from university fees for studies in Scotland: prescription charges have also been cut sharply in Scotland. Clearly, too, Northern Ireland benefits disproportionately; but this is partly due to serious security issues.

To achieve the specified cost savings, the new Government should substantially re-model the Scottish grant formula by assuming that Scottish taxpayers and Council Tax payers – and not the UK taxpayer generally – finance the subsidized services that are currently not available outside Scotland. The real terms cost reduction assumptions for Scotland average 4% per year and are predicated on the outdated Barnett formula being replaced.

For most other government departments, 3% per year real cuts in current expenditure have been projected for this year and for 2011/12. Clearly, such savings will be far smaller – well below £1 billion per year – but they will be valuable nevertheless.

Whilst the Home Office budget amounts to a relatively modest £10.5 billion per year, there is undoubtedly scope for savings, with the scrapping of the Identity Cards project and the National Identity Register being obvious targets as set out in the Queens Speech.

The financing of the police force is shared, with the Home Office providing the main central government component via its annual Police Grant: most of the remaining costs are funded locally. There are undoubtedly opportunities to generate short-term savings – especially on the administrative side – within the police force, which currently employs c240,000 people in England and Wales.

Despite its high profile, public expenditure on transport is relatively small compared with the costs of social security benefits. Given the disproportionately high capital expenditure element, transport costs are generally spread over several years: some projects are financed off-balance sheet.

However, savings are certainly achievable. In particular, deferring the long-delayed £16 billion Crossrail project is a favoured option – at least until public finances improve. In any event, there must be other ways of relieving central London congestion on the Underground during peak hours. Limiting stopping during the rush hours in Central London to a few core underground stations and removing seats on the Circle Line are just two of many options to address the over-crowding issue.

Whilst the overall costs of the proposed new London to Scotland railway line are vast, only comparatively modest expenditure will be incurred for this project by the Government-owned Network Rail over the next few years.

And, in terms of expenditure on new airport facilities, most of this investment will be undertaken by private sector airport owners, mainly the Ferrovial-led consortium at Heathrow – with some financial support from British Airways. Financing any new facilities at Gatwick, which is now under new private sector ownership, and Stansted will also probably be carried out by the private sector.

Recently, central government grants to universities have been pared back, thereby obliging universities to become increasingly focussed on cost control. In the medium term, sizeable savings would accrue if there were far more two-year undergraduate courses, with shorter holidays being permitted than at present.

Clearly, this option is not suitable for some courses, such as medicine, but for many arts courses – including law, history and English – two-year undergraduate courses are very feasible. Indeed, the University of Buckingham has been offering such courses for over 30 years. As a corollary, shorter undergraduate courses would also allow more students to pass through university over a given period.

Despite its application worldwide, the UK's Overseas Aid programme is actually quite small. However, the new Government has followed its predecessor in pledging to raise this budget to 0.7% of Gross National Income (GNI) – this would imply an extra c£2 billion of expenditure per year. Any attempt to do this should be deferred until the UK's public finances recover.

In its Report on public expenditure cuts, the TaxPayers' Alliance (TPA) identified savings of £42.6 billion over a full year – approximately double the implicit projections in this Report, which focuses on ongoing reductions from 2010/11 and thereafter.

Whilst most of the savings proposals from the TPA focus on major cost centres – Child Benefit and public sector pay – its Report also lists some 30 other potential savings. In fact, this Report's top-down approach effectively covers most of these items based on the assumption of average 3% per year real terms cuts.

Importantly, the TPA's conclusions effectively endorse this Report's view that significant reductions are very achievable, especially in public administration. Abolishing unnecessary quangos and re-locating many civil servants away from London are obvious options.

The search for other public expenditure savings should focus on:

- Imposing higher than average cuts for Scotland;
- Scrapping the Identity Cards project;
- Deferring the Crossrail scheme;
- Providing incentives for two-year university courses;
- Delaying major increases in the Overseas Aid budget;
- Pursuing aggressively lower cost savings in government.

3 The Challenges of Cutting Public Expenditure

As the debate about public expenditure continues, it should be recognized that material – and sustainable – cuts are difficult to achieve in practice. Indeed, the Conservative Government in the 1980s under Lady Thatcher was widely denounced for public expenditure cuts. The reality is rather different.

Between May 1979 and April 1991, a few months after Lady Thatcher's resignation as Prime Minister, TME rose from c£330 billion to c£369 billion – these figures are based on 2008/09 prices and include debt interest. Hence, during that turbulent period, public expenditure actually rose by c1% in real terms per year.

Against this background, delivering real cuts in public expenditure, excluding debt interest, of c3% per year, as proposed in this Report, requires a massive – and unremitting – effort by the incoming Government.

If this policy were vigorously pursued and the economy recovered, PSND – as a percentage of GDP – would be c70% of GDP by 2014/15, as set out in our financial modelling in Appendix III. However, if average economic growth rates until 2014/15 were materially lower than expected, this ratio could exceed 90%.

Some commentators, including those from other think-tanks, have suggested far deeper cuts in public expenditure, citing the relatively successful initiatives in other countries where large deficits have accumulated. Indeed, within the EU, two countries have had to take urgent action to redress excessive public expenditure and the soaring deficits that they have fuelled.

In the early 1990s, Finland's economic boom ended, with the budget deficit rising to 7% of GDP – well below the projected UK figure for both 2009/10 and 2010/11. In the seven years from 1993, Finland cut its primary expenditure by 14% of national income. Government employment fell, wage increases were restrained and local government received lower subsidies: expenditure on health, social care, education and pensions was also cut.

Importantly, as economic recovery began in 1994, Finland's budget deficit of 7% of GDP was transformed into a 7% surplus by 2000.

Following an overheated economy and a banking crisis, Sweden, too, faced a similar problem in the early 1990s, with its budget deficit reaching almost 13% of GDP, whilst its PSND was around 80% – both figures are close to the 2010 Budget's mid-term projections for the UK. Within seven years, public expenditure in Sweden had been reduced by over 15% following widespread cuts in social security and health programmes as well as in public sector employment.

Whilst some of the health cuts caused a public outcry, the budget returned to balance. Indeed, by 2006, Sweden had almost halved its PSND as a percentage of GDP – a seriously impressive achievement.

Perhaps the most notable turn-round in the last 20 years took place in Canada, whose PSND had risen to over 100% of GDP. Following a skilful public relations campaign, the electorate was prepared for large public expenditure cuts. In fact, central government expenditure was reduced by a formidable c5% per year during the 1990s, whilst public sector employment was also sharply cut.

As a result, Canada's budget was balanced within a few years, whilst the widespread public expenditure cuts brought about many efficiencies. In short, Canada's faltering economy had been dramatically restored and is now booming – a lesson for other democracies currently facing soaring borrowing levels.

By contrast, Japan's public finances remain in serious disarray with PSND being over twice its GDP figure – a ratio that is clearly unsustainable but one that has been ongoing for some time. That Japan has been able to survive – so far – with such dreadful public finances should not provide a justification for inaction by the new Government.

Tax Rises

Given the unprecedented size of the UK's PSND, it is hardly surprising that many commentators have advocated tax rises. In the short term, there may be a case for some modest tax increases, especially if they might prevent a general downgrading of the UK's sovereign debt.

Nevertheless, the overwhelming share of the financial contraction that is needed should be achieved by public expenditure savings – with tax increases being used only as a last resort.

Moreover, any tax rises should be both modest and, most importantly, temporary. A time-limited rise in the standard VAT rate from 17.5% to say 20% could be defended on this basis. It is estimated that such a change, assuming only minimal retail resistance, would raise up to £10 billion of additional revenues in a full fiscal year. A less attractive option would be to reduce the range of goods and services that are currently either zero-rated or exempt from VAT.

But, in the medium-term, the new Government should seek to reduce the overall tax burden, which – under the Laffer Curve principle – would provide greater incentives and should generate increased prosperity. However, this policy should only be implemented once control of the UK's public finances has been reasserted – and there is a substantial reduction in PSNB.

Any tax cuts are best focused on both raising Personal Allowances and cutting progressively the basic rate of Income Tax. A radical overhaul of the NI contribution system is also urgently required.

Privatization

During the 1980s and early 1990s, widespread privatizations were undertaken. This policy, which has been widely copied overseas, has generally proved successful. Heavy capital investment, greater efficiency, substantial consumer benefits and good shareholder returns have all – with a few exceptions – been achieved.

In the UK, there are still some businesses, which are suitable for privatization. An ASI publication in March 2008 – 'Privatization: Reviving the Momentum' – calculated that £20 billion could be raised through further privatizations.

With weaker markets and some subsequent sales, the estimate is now £16 billion – prior to any disposal of the Government's 84% stake in RBS and of its 41% stake in Lloyds as well as any proceeds from selling the 'good bank' division of Northern Rock. Figure 11 below lists the most marketable candidates and provides projections of the likely sales proceeds and how they have been calculated.

Clearly, there is unfinished business in the utilities sector. Scottish Water and Northern Ireland Water are obvious candidates for privatization. Similar comments apply to BBC Worldwide and the struggling Channel 4.

Royal Mail, despite its burgeoning pension liabilities, would also benefit from majority – as opposed to the recently proposed minority – private sector ownership. In particular, private sector ownership would enable a pronounced rise in its annual investment programme to modernize its operations.

Some transport businesses, including the larger Trust Ports – Dover is believed to be available for sale at a price of c£300 million – and the Government's stake in the restructured London and Continental Railways (accounted for under Others in Figure 11), are also suitable candidates.

In time, Network Rail and the London Underground should move into the private sector. Given the very substantial investment expenditure of both organizations, there is no immediate prospect of selling these assets. In the case of Network Rail, its net debt was a formidable £22.3 billion at March 2009 – and it will rise further.

In view of the major financial problems that Metro Lines has faced – TfL has now taken over its operations – and the persistent regulatory disagreements that have adversely impacted the shortly to be sold Tube Lines, any privatization of London Underground seems certain to be deferred for many years.

As such, with the exception of the Government's stake in London and Continental Railways which owns the High Speed One business on whose lines Eurostar trains operate, Figure 11 overleaf assumes that no proceeds will materialize from the privatization of either Network Rail or the London Underground for the foreseeable future.

In the medium term, the Government should seek to sell its 41% stake in Lloyds, which – based on a 10% discount to its current market valuation – is currently worth c£12 billion. Following Lloyds' decision to opt out of the APS, the Government should await a recovery in its share price and then progressively sell down its stake.

Given the fact that RBS has placed £282 billion of so-called 'toxic' assets in the APS, any major reduction in the Government's 84% stake is likely to take rather longer. Moreover, RBS's share price still remains very weak at well below 60p. In terms of valuation, the Government's stake, after deducting a 10% discount, is currently worth c£19 billion (some adjustments will need to be made for the warrants).

Since the start of the financial crisis, RBS's value destruction has been quite heroic. Against its current c£25 billion capitalization, it has received capital injections of £45.5 billion of taxpayers' money.

The Northern Rock proceeds projected in Figure 11 are based on the Government selling the 'good bank' division and retaining the 'bad bank' division on behalf of taxpayers.

Nevertheless, based on a combined current Stock Exchange valuation – after deducting the respective 10% discounts – of c£31 billion, the sale of the Government's stakes in Lloyds and RBS would have a sizeable impact on public finances, especially if their respective share prices moved sharply upwards.

As such, it should be a high priority for the Government to take advantage of any market enthusiasm to reduce these stakes, especially in RBS. Some form of City placing would probably be the preferred disposal route, given the immense complexity of the assets and liabilities of both banks.

To test investors' appetite, the Government should seek initially to sell up to a third of its 41% stake in Lloyds. If this offer draws in sufficient investors, further sales of its bank shareholdings can then be pursued, all the more so if the putative Initial Private Offering (IPO) of Grupo Santander's UK bank assets is successfully undertaken.

Figure 11: Privatization candidates

Organization	Government stake (%)	Sales proceeds (£m)	Valuation methodology
Royal Mail	100	3,800*	Cf TNT & CVC offer
BBC Worldwide	100	1,800	BBC & press projections
Channel 4	100	600	Cf ITV
Scottish Water	100	2,800	Cf Quoted UK water/RAV^
Northern Ireland Water	100	500	Cf Quoted UK water/RAV^
Urenco	33	900	P/E projection
NATS	49	300	Cf Quoted UK utilities
Trust Ports	100	1,000	Cf Forth/Dover Ports
British Waterways	100	400	Net asset valuation
CDC	100	2,300	Net asset valuation
Tote	100	200	Cf Ladbrokes/William Hill
Others	n/a	1,400	Various
Total (ex Banks)		**16,000**	
RBS	84	18,900	Market cap. -10%
Lloyds	41	12,400	Market cap. -10%
Northern Rock	100	1,200	Treasury & press projections
Total (inc Banks)		**48,500**	

** Pre pension liabilities*
^ Regulatory Asset Value
Source: ASI Projections/Nigel Hawkins Associates

4 Summary of Recommendations

General

Impose, as a matter of urgency, average annual cuts in Total Managed Expenditure (excluding debt interest costs) of c3% per year in real terms, starting from 2010/11. If this policy were pursued, savings, excluding debt interest, would amount to c£20 billion per year. Assuming the previous Government's economic growth projections are broadly met, PSNB should be eliminated by 2014/15 when PSND would be c70% of GDP.

The focus on delivering such cuts should rest with the 'soft underbelly' of public expenditure – the five key programmes, namely social security, health, education, defence and local government. There are, too, other savings to be found outside these departments.

Despite the many cost-cutting opportunities elsewhere – notably in the social security budget and in MOD procurement – cutting the total public sector payroll bill should be a priority: it was estimated to cost c£174 billion per year in 2008.

Specific

The key elements within individual programmes that should be the prime focus of public expenditure cuts are summarized below.

Social Security

- Shrinking benefit payments and eligibility criteria
- Reducing Child Benefit entitlements
- Limiting Tax Credit offset concessions
- Abolishing Child Trust funds
- Prescribing tighter criteria for Incapacity Benefit payments
- Declining to re-link basic pension increases to earnings

Health

- Reducing payroll costs outside nursing
- Managing hospital bed occupation more effectively
- Creating greater efficiencies within PCTs
- Cutting the annual drugs bill
- Regaining control of the disastrous NHS IT project
- Scaling back the hospital-building programme

Education

- Cutting the total costs (including pensions) of the teachers' payroll
- Reducing the number of education support staff
- Re-thinking the one-to-one tuition policy for struggling children
- Minimising institutional bureaucracy within education
- Delivering cost savings from the Sure Start programme
- Deferring the Building Schools for the Future programme

Defence

- Managing major procurement projects far more efficiently
- Re-negotiating the largest aircraft purchasing contracts
- Delivering savings from the naval procurement programme

- Cutting payroll costs, especially of civilian staff
- Reducing the notorious MOD bureaucracy
- Closing down under-used bases in both the UK and overseas

Local Government

- Cutting local government payroll costs
- Prescribing maximum emolument limits for senior staff
- Attacking the bloated cost base in local government
- Lowering the housing budget
- Using Wandsworth as the benchmark Local Authority
- Eliminating Local Authority high-on-the-hog expenditure

Others

- Imposing higher than average cuts for Scotland
- Scrapping the Identity Cards project
- Deferring the Crossrail scheme
- Providing incentives for two-year university courses
- Delaying major increases in the Overseas Aid budget
- Pursuing aggressively lower cost savings in government

Appendix I: Trends in Total Managed Expenditure

Year	Expenditure (£bn – 2008/09 prices)
1990/91	369.3
1991/92	389.6
1992/93	407.7
1993/94	414.0
1994/95	426.2
1995/96	431.0
1996/97	421.8
1997/98	419.1
1998/99	421.7
1999/2000	428.7
2000/01	449.1
2001/02	469.7
2002/03	492.4
2003/04	517.9
2004/05	544.7
2005/06	569.1
2006/07	580.1
2007/08	597.4
2008/09	629.6

Source: Budget 2010

Appendix II: Departmental budgets post the proposed 3% cuts (£bn)

Public Expenditure			2009/10	% Cut	2010/11
Education	DEL	Current	49.6	0.97	48.1
Health	DEL	Current	99.6	0.98	97.6
Transport	DEL	Current	6.9	0.98	6.8
Business, Innovation & Skills	DEL	Current	19.5	0.97	18.9
CLG Communities	DEL	Current	4.5	0.97	4.4
CLG Local Government	DEL	Current	25.5	0.97	24.7
Home Office	DEL	Current	9.5	0.97	9.2
Justice	DEL	Current	9.9	0.97	9.6
Law Officers' Department	DEL	Current	0.7	0.97	0.7
Defence	DEL	Current	39.1	0.97	37.9
Foreign & Commonwealth Office	DEL	Current	2.3	0.97	2.2
International Development	DEL	Current	5.4	0.97	5.2
Energy & Climate Change	DEL	Current	1.2	0.98	1.2
Environment, Food & Rural Affairs	DEL	Current	2.7	0.97	2.6
Culture, Media & Sport	DEL	Current	1.7	0.99	1.7
Work & Pensions	DEL	Current	9.1	0.97	8.8
Scotland	DEL	Current	25.6	0.96	24.6
Wales	DEL	Current	14.0	0.97	13.6
Northern Ireland Executive	DEL	Current	9.0	0.97	8.7
Northern Ireland Office	DEL	Current	1.2	0.97	1.2
Chancellor's Department	DEL	Current	4.5	0.97	4.4
Cabinet Office	DEL	Current	2.2	0.97	2.1
Independent Bodies	DEL	Current	0.9	0.97	0.9
Modernisation Funding	DEL	Current	0.0	0.97	0.0
Reserve	DEL	Current	0.0	0.97	0.0
Allowance for Shortfall	DEL	Current	-1.2	0.97	-1.2
Total (DEL - Current)			**343.4**		**334.0**
Education	DEL	Capex	7.5	0.96	7.2
Health	DEL	Capex	5.4	0.96	5.2
Transport	DEL	Capex	8.3	0.99	8.2
Business, Innovation & Skills	DEL	Capex	3.0	0.96	2.9
CLG Communities	DEL	Capex	9.1	0.97	8.8
CLG Local Government	DEL	Capex	0.2	0.96	0.2
Home Office	DEL	Capex	1.0	0.97	1.0
Justice	DEL	Capex	0.9	0.97	0.9
Law Officers' Department	DEL	Capex	0.0	0.97	0.0
Defence	DEL	Capex	9.2	0.96	8.8
Foreign & Commonwealth Office	DEL	Capex	0.2	0.97	0.2
International Development	DEL	Capex	1.3	0.97	1.3
Energy & Climate Change	DEL	Capex	1.9	0.99	1.9
Environment, Food & Rural Affairs	DEL	Capex	0.7	0.97	0.7
Culture, Media & Sport	DEL	Capex	0.6	0.99	0.6
Work & Pensions	DEL	Capex	0.3	0.97	0.3
Scotland	DEL	Capex	3.9	0.96	3.7
Wales	DEL	Capex	2.0	0.97	1.9
Northern Ireland Executive	DEL	Capex	1.2	0.97	1.2
Northern Ireland Office	DEL	Capex	0.1	0.97	0.1
Chancellor's Department	DEL	Capex	0.4	0.97	0.4
Cabinet Office	DEL	Capex	0.5	0.97	0.5
Independent Bodies	DEL	Capex	0.0	0.97	0.0
Reserve	DEL	Capex	0.0	0.97	0.0
Allowance for Shortfall	DEL	Capex	-1.1	0.97	-1.1
Total (DEL - Capex)			**56.6**		**54.8**

% Cut	2011/12	% Cut	2012/13	% Cut	2013/14	% Cut	2014/15
0.97	46.7	0.97	45.3	0.97	43.9	0.97	42.6
0.98	95.7	0.98	93.7	0.98	91.9	0.98	90.0
0.98	6.6	0.98	6.5	0.98	6.4	0.98	6.2
0.97	18.3	0.97	17.8	0.97	17.3	0.97	16.7
0.97	4.2	0.97	4.1	0.97	4.0	0.97	3.9
0.97	24.0	0.97	23.3	0.97	22.6	0.97	21.9
0.97	8.9	0.97	8.7	0.97	8.4	0.97	8.2
0.97	9.3	0.97	9.0	0.97	8.8	0.97	8.5
0.97	0.7	0.97	0.6	0.97	0.6	0.97	0.6
0.97	36.8	0.97	35.7	0.97	34.6	0.97	33.6
0.97	2.2	0.97	2.1	0.97	2.0	0.97	2.0
0.97	5.1	0.97	4.9	0.97	4.8	0.97	4.6
0.98	1.2	0.98	1.1	0.98	1.1	0.98	1.1
0.97	2.5	0.97	2.5	0.97	2.4	0.97	2.3
0.99	1.7	0.99	1.6	0.99	1.6	0.99	1.6
0.97	8.6	0.97	8.3	0.97	8.1	0.97	7.8
0.96	23.6	0.96	22.6	0.96	21.7	0.96	20.9
0.97	13.2	0.97	12.8	0.97	12.4	0.97	12.0
0.97	8.5	0.97	8.2	0.97	8.0	0.97	7.7
0.97	1.1	0.97	1.1	0.97	1.1	0.97	1.0
0.97	4.2	0.97	4.1	0.97	4.0	0.97	3.9
0.97	2.1	0.97	2.0	0.97	1.9	0.97	1.9
0.97	0.8	0.97	0.8	0.97	0.8	0.97	0.8
0.97	0.0	0.97	0.0	0.97	0.0	0.97	0.0
n/a	1.5	2.00	3.0	1.33	4.0	1.25	5.0
0.97	-1.1	0.97	-1.1	0.97	-1.1	0.97	-1.0
	326.3		**318.9**		**311.2**		**303.8**
0.93	6.7	0.93	6.2	0.93	5.8	0.93	5.4
0.93	4.8	0.93	4.5	0.93	4.2	0.93	3.9
0.95	7.8	0.95	7.4	0.95	7.0	0.95	6.7
0.95	2.7	0.95	2.6	0.95	2.5	0.95	2.3
0.96	8.5	0.96	8.1	0.96	7.8	0.96	7.5
0.94	0.2	0.94	0.2	0.94	0.2	0.94	0.1
0.97	0.9	0.97	0.9	0.97	0.9	0.97	0.9
0.97	0.8	0.97	0.8	0.97	0.8	0.97	0.8
0.97	0.0	0.97	0.0	0.97	0.0	0.97	0.0
0.96	8.5	0.96	8.1	0.96	7.8	0.96	7.5
0.95	0.2	0.95	0.2	0.95	0.2	0.95	0.2
0.96	1.2	0.96	1.2	0.96	1.1	0.96	1.1
0.98	1.8	0.98	1.8	0.98	1.8	0.98	1.7
0.97	0.7	0.97	0.6	0.97	0.6	0.97	0.6
1.02	0.6	1.02	0.6	1.02	0.6	1.02	0.6
0.97	0.3	0.97	0.3	0.97	0.3	0.97	0.3
0.96	3.6	0.96	3.5	0.96	3.3	0.96	3.2
0.97	1.9	0.97	1.8	0.97	1.8	0.97	1.7
0.97	1.1	0.97	1.1	0.97	1.1	0.97	1.0
0.97	0.1	0.97	0.1	0.97	0.1	0.97	0.1
0.97	0.4	0.97	0.4	0.97	0.4	0.97	0.3
0.97	0.5	0.97	0.5	0.97	0.4	0.97	0.4
0.97	0.0	0.97	0.0	0.97	0.0	0.97	0.0
0.97	0.0	0.97	0.0	0.97	0.0	0.97	0.0
0.97	-1.0	0.97	-1.0	0.97	-1.0	0.97	-0.9
	52.3		**49.9**		**47.6**		**45.4**

Appendix II: Departmental budgets post the proposed 3% cuts (£bn) cont.

Public Expenditure			2009/10	% Cut	2010/11
Social Security Benefits	AME	Current	163.7	0.97	158.8
Tax Credits	AME	Current	22.9	0.95	21.8
Net Public Service Pensions	AME	Current	3.4	0.95	3.2
National Lottery	AME	Current	0.9	0.97	0.9
BBC Domestic Services	AME	Current	3.5	0.96	3.4
Other Departmental Expenditure	AME	Current	-0.1	0.97	-0.1
Net Expenditure Transfers to EU Institutions	AME	Current	6.4	0.97	6.2
Locally-financed Expenditure	AME	Current	26.8	0.96	25.7
AME Margin	AME	Current	0.0	0.97	0.0
Accounting Adjustments	AME	Current	2.8	0.97	2.7
Total (AME - Current)			**230.3**		**222.6**
National Lottery	AME	Capex	1.0	0.97	1.0
Locally-financed Expenditure	AME	Capex	6.5	0.97	6.3
Public Corporations's Own-financed Capex	AME	Capex	7.0	0.97	6.8
Central Government Grants to Public Banks	AME	Capex	4.5	0.97	4.4
Other Capex	AME	Capex	1.8	0.97	1.7
AME Margin	AME	Capex	0.0	0.97	0.0
Accounting Adjustments	AME	Capex	-7.9	0.97	-7.7
Total (AME - Capex)			**12.9**	**0.97**	**12.5**
Depreciation	DEL/AME	Capex	-19.5	1.01	-19.7
Central Government Gross Debt Interest	**AME**	**Current**	**30.8**	**1.38**	**42.5**
DEL Current			**343.4**		**334.0**
DEL Capex			**56.6**		**54.8**
DEL Total			**400.0**		**388.8**
AME Current (pre Interest)			**230.3**		**222.6**
AME Current (post Interest)			**261.1**		**265.1**
AME Capex			**12.9**		**12.5**
AME Total (pre Interest)			**243.2**		**235.1**
AME Total (post Interest)			**274.0**		**277.6**
TME (pre Interest)			**643.2**		**623.9**
TME (post Interest)			**674.0**		**666.4**
Annual TME Cut (post Interest)					**-1.1%**
Annual TME Cut (pre Interest)					**-3.0%**

N.B. All figures are based on 2009/10 prices

% Cut	2011/12	% Cut	2012/13	% Cut	2013/14	% Cut	2014/15
0.97	154.0	0.97	149.4	0.97	144.9	0.97	140.6
0.94	20.4	0.94	19.2	0.94	18.1	0.94	17.0
0.95	3.1	0.95	2.9	0.95	2.8	0.95	2.6
0.97	0.8	0.97	0.8	0.97	0.8	0.97	0.8
0.96	3.2	0.96	3.1	0.96	3.0	0.96	2.9
0.97	-0.1	0.97	-0.1	0.97	-0.1	0.97	-0.1
0.97	6.0	0.97	5.8	0.97	5.7	0.97	5.5
0.96	24.7	0.96	23.7	0.96	22.8	0.96	21.9
0.97	0.0	0.97	0.0	0.97	0.0	0.97	0.0
0.97	2.6	0.97	2.6	0.97	2.5	0.97	2.4
	214.9		**207.5**		**200.3**		**193.5**
0.97	0.9	0.97	0.9	0.97	0.9	0.97	0.9
0.95	6.0	0.95	5.7	0.95	5.4	0.95	5.1
0.95	6.5	0.95	6.1	0.95	5.8	0.95	5.5
0.95	4.1	0.95	3.9	0.95	3.7	0.95	3.6
0.96	1.7	0.96	1.6	0.96	1.5	0.96	1.5
0.97	0.0	0.97	0.0	0.97	0.0	0.97	0.0
0.97	-7.4	0.97	-7.2	0.97	-7.0	0.97	-6.8
	11.8		**11.1**		**10.4**		**9.8**
1.01	-19.9	1.01	-20.1	1.01	-20.3	1.01	-20.5
1.16	**49.3**	**1.12**	**55.2**	**1.08**	**59.6**	**1.08**	**64.4**
	326.3		**318.9**		**311.2**		**303.8**
	52.3		**49.9**		**47.6**		**45.4**
	378.6		**368.7**		**358.8**		**349.2**
	214.9		**207.5**		**200.3**		**193.5**
	264.2		**262.7**		**260.0**		**257.9**
	11.8		**11.1**		**10.4**		**9.8**
	226.6		**218.5**		**210.8**		**203.3**
	276.0		**273.8**		**270.4**		**267.7**
	605.2		**587.3**		**569.5**		**552.4**
	654.5		**642.5**		**629.2**		**616.9**
	-1.8%		**-1.8%**		**-2.1%**		**-2.0%**
	-3.0%		**-3.0%**		**-3.0%**		**-3.0%**

Appendix III – Net debt projections until 2014/15

Financial Projections							
Mid Case - 2% GDP Growth	**2008/09A**	**2009/10F**	**2010/11F**	**2011/12F**	**2012/13F**	**2013/14F**	**2014/15F**
Current budget							
Current receipts	534	508	521	535	549	563	578
Current expenditure	-533	-574	-557	-541	-526	-511	-497
Debt interest	-30	-31	-42	-49	-55	-60	-64
Depreciation	-19	-20	-20	-20	-20	-20	-21
Surplus on current budget	**-49**	**-117**	**-98**	**-75**	**-52**	**-28**	**-4**
Capital budget							
Gross investment	-66	-70	-67	-64	-61	-58	-55
less depreciation	19	20	20	20	20	20	21
Net investment	-47	-50	-47	-44	-41	-38	-34
Net borrowing	**-95**	**-167**	**-145**	**-119**	**-93**	**-66**	**-38**
Adjustments	0	11	0	0	0	0	0
Public sector net debt	**-617**	**-773**	**-918**	**-1,037**	**-1,130**	**-1,196**	**-1,235**
GDP	**1,435**	**1,406**	**1,434**	**1,463**	**1,492**	**1,522**	**1,552**

Lower Case - 1% GDP Growth	**2008/09A**	**2009/10F**	**2010/11F**	**2011/12F**	**2012/13F**	**2013/14F**	**2014/15F**
Current budget							
Current receipts	534	508	515	521	528	535	542
Current expenditure	-533	-574	-557	-541	-526	-511	-497
Debt interest	-30	-31	-42	-49	-57	-64	-71
Depreciation	-19	-20	-20	-20	-20	-20	-21
Surplus on current budget	**-49**	**-117**	**-104**	**-89**	**-75**	**-60**	**-47**
Capital budget							
Gross investment	-66	-70	-67	-64	-61	-58	-55
less depreciation	19	20	20	20	20	20	21
Net investment	**-47**	**-50**	**-47**	**-44**	**-41**	**-38**	**-34**
Net borrowing	**-95**	**-167**	**-151**	**-133**	**-116**	**-98**	**-81**
Adjustments	0	11	0	0	0	0	0
Public sector net debt	**-617**	**-773**	**-924**	**-1,057**	**-1,173**	**-1,271**	**-1,352**
GDP (Treasury)	**1,435**	**1,406**	**1,420**	**1,434**	**1,449**	**1,463**	**1,478**

Appendix III – Net debt projections until 2014/15 cont.

Financial Projections							
Higher Case - 3% GDP Growth	**2008/09A**	**2009/10F**	**2010/11F**	**2011/12F**	**2012/13F**	**2013/14F**	**2014/15F**
Current budget							
Current receipts	534	508	528	548	570	592	615
Current expenditure	-533	-574	-557	-541	-526	-511	-497
Debt interest	-30	-31	-42	-49	-53	-57	-62
Depreciation	-19	-20	-20	-20	-20	-20	-21
Surplus on current budget	**-49**	**-117**	**-91**	**-62**	**-29**	**4**	**35**
Capital budget							
Gross investment	-66	-70	-67	-64	-61	-58	-55
less depreciation	19	20	20	20	20	20	21
Net investment	**-47**	**-50**	**-47**	**-44**	**-41**	**-38**	**-34**
Net borrowing	**-95**	**-167**	**-138**	**-106**	**-70**	**-34**	**1**
Adjustments	0	11	0	0	0	0	0
Public sector net debt	**-617**	**-773**	**-911**	**-1,017**	**-1,087**	**-1,121**	**-1,120**
GDP (Treasury)	**1,435**	**1,406**	**1,448**	**1,492**	**1,536**	**1,582**	**1,630**

Sensitivity Analysis							
PSND as % of GDP - 1% growth			**-65.1%**	**-73.7%**	**-81.0%**	**-86.9%**	**-91.5%**
PSND as % of GDP - 2% growth			**-64.0%**	**-70.9%**	**-75.8%**	**-78.6%**	**-79.5%**
PSND as % of GDP - 3% growth			**-62.9%**	**-68.2%**	**-70.8%**	**-70.8%**	**-68.7%**

Source: Nigel Hawkins Associates