

Pre-Budget Report

December 2006

Bridget Rosewell, Volterra Consulting

Introduction

It is hard to discern the purpose of this report, beyond a list of achievements and of lengthy descriptions of minor schemes.

Thinking back to a decade ago, the Pre-Budget Report was billed to increase the transparency of the Budget process by adding to the interim review of the state of the economy and the old process of setting out spending plans a more balanced view of government finances which also signalled new tax initiatives.

If only this was the outcome. It is impossible in this report to easily separate the new from old announcements. Some tables do this – here we discover that the Chancellor is proposing to raise another £2bn in taxes, half of which comes from airline passengers and the other half from various changes to corporation tax and other business tax arrangements. However, this is not a ‘Pre-Budget’ announcement but a ‘Budget’ one. No consultation required.

And on the state of government finances, and how they are projected to perform, there is little until after p140. The previous pages are a paean of praise for the government’s record in everything that you could possibly imagine and proposals on everything from children’s reading to women’s enterprise and why the business formation rate by women is lower in the UK than in the US. For example, we find described a scheme called ‘Every Child a Reader’, which aims to help 30,000 children with their reading. This is not to say the scheme is not worthy – it may or may not be – but can hardly be judged or evaluated as part of a report such as this.

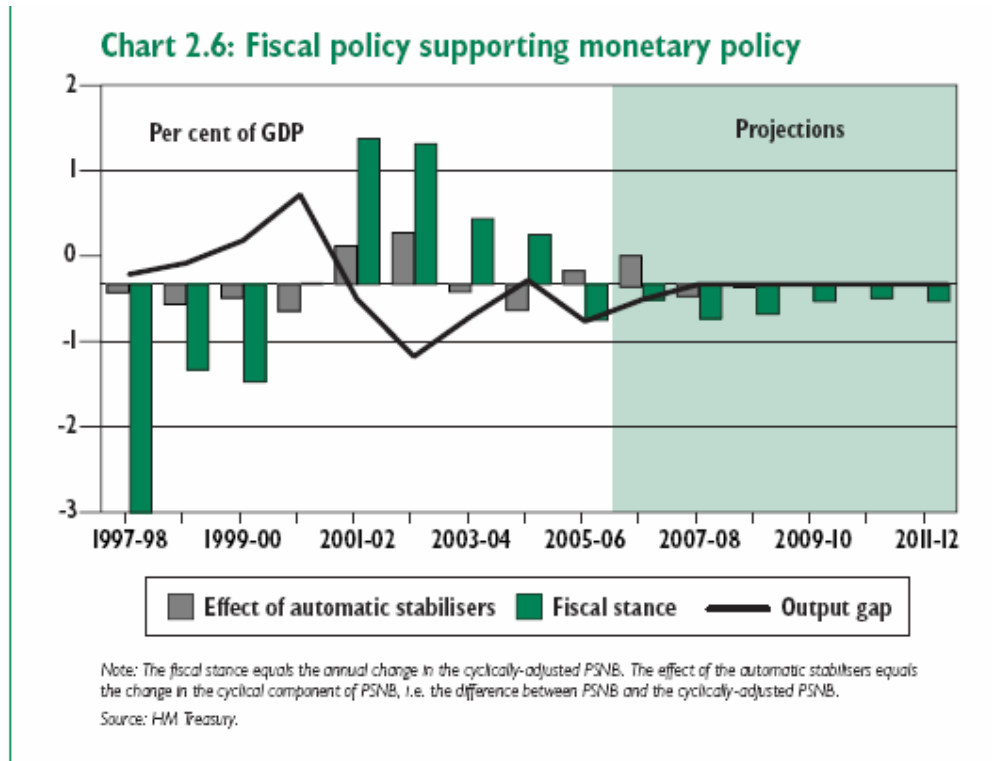
The report is therefore full of waffle and twiddle and commissions and reports and investigations. It is probably also full of twaddle but it is very hard to tell. When you contemplate the cost of preparing this magnum opus and the time also spent trying to read it and work out what it means by all of the commentators and economists, it is hard to see whether the benefits outweigh the costs. And it is hard not to be suspicious that the purpose of all the flowery phrases is to disguise reality. Discomfort might not be so acute if some of the pronouncements – around efficiency in the public services and cost savings for example – were not so reminiscent of the pronouncements of achievements under Soviet 5 year plans.

So here are some reality checks.

Meeting the Golden Rule and financing investment

The golden rule will be met because the economic cycle is about to come to an end. This is planned for early 2007 and will therefore mean that the public finances have been just in surplus over this cycle. But ‘the cycle’ is not a simple concept. The start and end of a cycle are meant to be identified as points where the economy is in balance and on trend.

The chart on p33 of the PBR illustrates this. The output gap apparently closed but then opened again in 2004, and so the cycle was not held to be complete.



Indeed if the chart's projections are correct the cycle will never be complete, as the economy does not pass into a position in which it is above trend.

There are several issues here. One is what the trend position might be and the other is how it is in any case dependent on the actions of government itself. The rhetoric suggests that the economy operates in one place while the government manages the fiscal position. But since the government itself takes such a large share of resources and uses them directly as well as in redistribution, there is no independence of management.

Further, there are still no well established and empirically verified theories of the cycle which could be used to anchor points at which a cycle begins or ends. Each cycle is unique. In these circumstances, policy has been locked onto a base which can only be created by the application of considerable amounts of judgement and all the arcane discussions cannot disguise this. Appropriate choice of dates will always produce some kind of answer, and since data is so often revised, backward looking analysis will then always produce a different answer, so no position can ever be falsified subsequently.

However, what is beyond dispute is that the public finances are in considerable disarray if we are so close to the end of the cycle. In both last year and this, borrowing has been bigger than planned. £15bn last year, and £8bn this. If it is indeed the case that the cycle is ending then finances should also be close to balance. They are not.

Plans for continued spending growth are also extensive, and again there is no clear presentation of why until you reach the appendices. The tax take is expected to rise by 6.6% in 2007/8 and will then be over 40% of GDP. At the same time, investment is set to rise by 13%, and then by hardly anything.

The report speaks extensively of taking forward the Eddington recommendations and the Barker review of planning and of making it possible for greater public and private investment. At the same time, it faces overruns on investments which are being made, such as the Olympics, and is failing to guarantee that the important investments in urban transport to keep London moving, such as Crossrail, can be made.

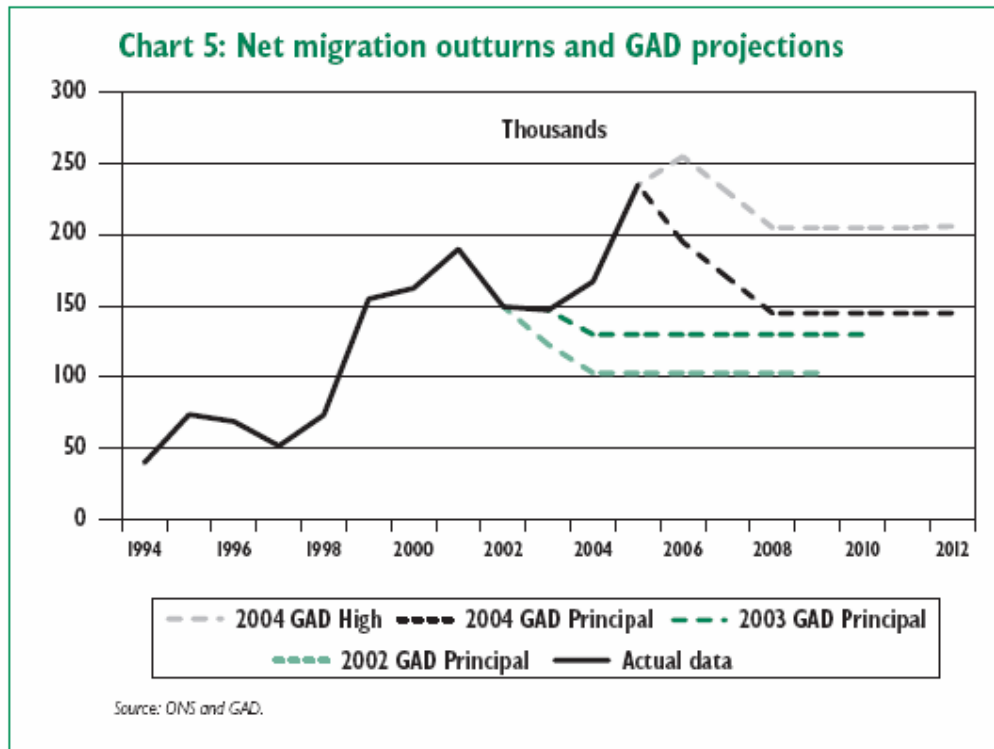
In the section on investment, the report discusses the incentives to make long term investment when costs of finance are low and how this creates an upside for business. Surely it should create an upside opportunity for the government as well.

What is the long term growth rate?

A simple person might think this is a simple question. In a developed economy, operating under market conditions, there is not much variation in long term growth. If we simply take the available statistics and an average, then this should be the answer. The usual answer is the same as the Treasury's previous view of the matter, that is 2.5%. However, in this Pre-Budget report, the rate has been raised to 2.75%.

It is important to realise that this is not what is meant by the trend growth concept as used by the Treasury. They want to ask what the potential growth rate is over the cycle. Such growth depends on two key factors, the number of people likely to be working and the productivity that they have. Employment multiplied by productivity equals total output. Thus the prospective growth over the next cycle, which is what the Treasury are trying to measure, depends on the assumptions made about these two elements. It is unfortunate that they are both uncertain.

Population growth is provided by demographers, immigration is guessed at by the same people. From this can be derived the number of people who might work, depending both on the ability to forecast the numbers of working age and the proportion who will work. All of this is difficult. The Chart shows how estimates and forecasts of migration have previously been wrong, and there may be considerable measurement error in the statistics themselves. They are based on 3000 interviews held at a limited numbers of ports and airports. They rely on individuals giving truthful answers to a question on their likely length of stay. If, as many suspect, there are indeed more people already here and working, then measured productivity will be too high and the government's view on its acceleration too rosy.



Output growth then depends on the estimate of productivity growth. The measurement of productivity is much more fraught than is usually thought. Industries in which the UK is a world leader such as retailing and financial services, apparently have poor productivity records. Equally, there are considerable revisions on a continuous basis to this series.

So this upward revision rests on some very uncertain areas of analysis. The Treasury buttress their conclusion by comparing their view with that of other forecasters. These are however also not looking at trend growth as the simple person understands it. These figures are the average growth numbers for future years published by the forecasters in question. They mostly use cyclical models which are driven by some underlying assumptions taken from the same kinds of sources as the Treasury models. So it is not surprising that the same results. In addition, most of the analysis in the most recent report on long term growth looks at only 2 cycles and concentrates on the most recent.

This is not of course to say that the conclusions are definitively wrong, but the caution that they say they are showing is likely still to be insufficient.

Moreover, there are distinct signs that pressures may be rising in the opposite direction which would reduce growth potential. Businesses and self-employed increasingly report that regulation and nannyism is stifling enterprise and innovation. The cost of form filling and the greatly increased numbers of persons employed to inspect, regulate and interfere produce a disincentive to take risks in the hope of reward. This is now too often described as greedy speculation.