Public Spending in Hard Times

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(If revenue could not be increased) ['Great Britain'] 'should endeavour to accommodate her future views and designs to the real mediocrity of her circumstances.'

Adam Smith *Wealth of Nations*, 1776, last book, final sentence

Lessons from the Past and Implications for the Future

Attempts to brake or reverse the growth of public spending in the UK are not new: Adam Smith (left) discussed the problem over 200 years ago. So what can we learn from earlier periods of restraint or cutback in public spending?

This paper briefly reviews two key historical cases, the 'Geddes Axe' era of 1920s and the 1975 –1985 era which included the 1976 IMF loan and subsequent attempts to restrain public spending under both Labour and Conservative governments. It also analyzes public spending in relation to the economic cycle over the last 60 years. What can these data tell us about:

- How easily can major cuts be made by regular Treasury processes?
- How easily can public-service jobs be cut and how far does cutting jobs save money?
- How easily can cuts be made without eating the seed-corn investment?
- Whether counter-cyclical increases in spending in periods of recession is matched by equivalent spending declines in periods of boom and recovery?

1920 to 1930: The 'Geddes Axe'

The 1920s was the last time (apart from post-WWII) when public spending went substantially into reverse. This period saw big cuts in civil service jobs and deep and sustained reductions in public spending.

The Problem As the post-World War I boom turned into recession and deflation, the Liberal-coalition government came under strong pressure to cut taxes and rein in public spending and civil service numbers which had ballooned as a result of the war and the Liberal welfare policies of the early 20th century.

The Solution In 1921 Liberal PM David Lloyd George set up a high-powered committee of businessmen under Sir Eric Geddes to find cuts of £100m on top of the £75m the Treasury had persuaded government departments to offer.

The Outcome The Geddes committee in fact proposed £87m of extra cuts. Departments did not quite reach the ambitious 'Geddes Axe' target, but central government (current) spending fell by about 25 per cent (this percentage of current public spending is roughly £100 billion in today's terms) between 1920 and 1925 and did not start to rise substantially again until 1931.

Where the Geddes Axe Fell and What it Spared

The axe fell on programme spending as well as on government's running costs (Figure 2, below, and Table 1, opposite). While spending on health was protected (indeed it rose, see Table 1), there were heavy cuts in defence as well as on some of the social, welfare and pension provision introduced in the previous decade. While the jobs of ex-servicemen in the civil service were protected, civil service numbers were cut by about 35% (Figure 1) and the brunt of those cuts came from dismissing temporary staff who had been recruited in the war, most of whom were women.

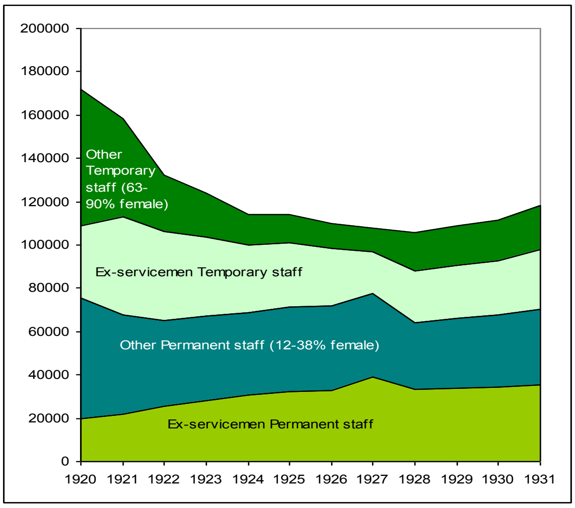

***Figure 1.** White-collar civil service employment 1920–1931*

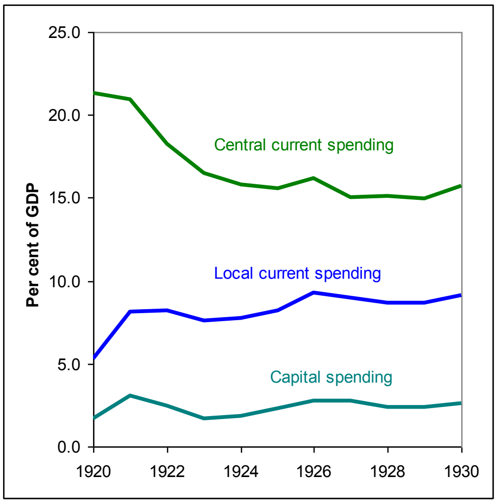

***Figure 2.** 1920–1930 public spending as percentage of GDP*

1975 to 1985: The IMF Loan, Early Labour Cuts and Later Conservative Ones

The Problem The early 1970s was a time of 'stagflation' (high inflation with low economic growth), associated with huge increases in oil prices, a national coal strike, failure of wage agreements and, in 1975, the highest public spending to GDP ratio since the end of World War II.

The Solution The Labour government of 1974-9 aimed for economic recovery and in 1976 planned to stabilize public spending at 1977 levels for some years. But its plans were undercut by a major currency crisis leading to an emergency loan from the IMF in 1976. The terms attached to the loan involved immediate spending cuts and tax rises. The Conservative government from 1979 aimed for more cutbacks and a major reduction in civil service staff, in a conscious effort to roll back the state.

The Outcome Public spending proved to be very difficult for either Labour or Conservatives to reduce. Though it fell slightly in real terms between 1976 and 1977, it continued to rise (albeit at a slower rate than previously), ending higher in 1985 than it had been a decade before (Figure 4 and Table 1). Civil service employment rose until 1976, then showed a steady fall (Figure 3) largely due to outsourcing of work previously done by blue-collar 'industrial' civil servants.

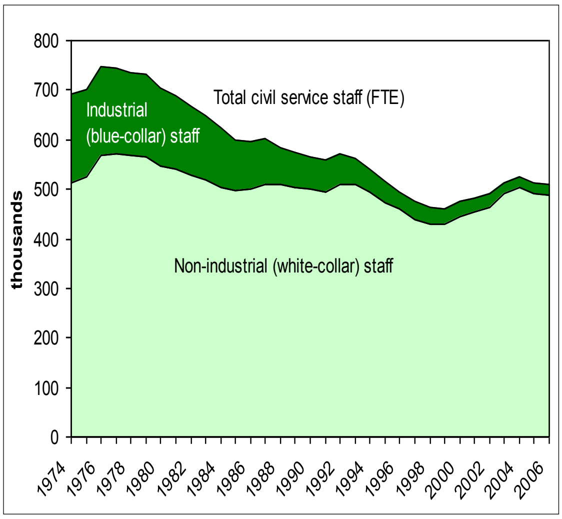

***Figure 3.** Civil service employment 1974–2006*

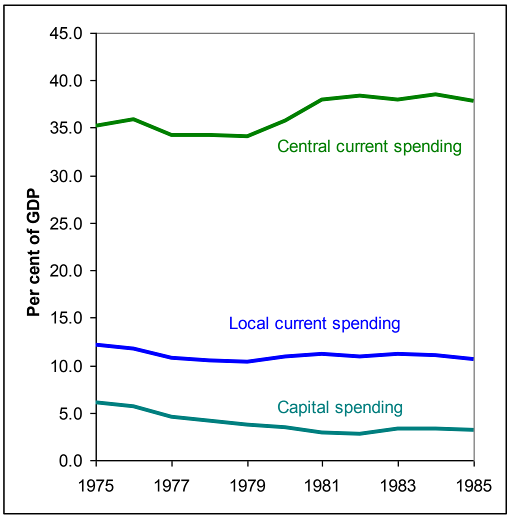

***Figure 4.** 1975–1985 public spending as percentage of GDP*

Winners and Losers Most of the civil service jobs lost were industrial or blue-collar jobs (mainly in the naval dockyards and ordnance factories). These jobs showed a 43 per cent decline, with much smaller cuts in the white-collar bureaucracy, which declined by only 12 per cent from its maximum in 1977 to 1985. There was no clear pattern of losses and gains among departments. Among the largest departments, the Departments of the Environment and of Industry, and the Ministry of Agriculture, Fisheries and Food lost out, while Health and Social Security and Defence both gained extra funding. There was a greater percentage fall in capital than current expenditure, and those cuts were mostly borne by local government.

***Table 1.** Summary of spending changes in the 1920s and 1970/80s*

(constant prices, GDP deflator 2003 = 100)

	1920/1 to 1930/1		1975/6 to 1985/6	
	Change in spending over decade £billion in 2003 prices	Change as % of 1920/1 value	Change in spending over decade £billion in 2003 prices	Change as % of 1975/6 value
Central (current + capital)	–8.4	–22 %	+60.0	+27 %
Local (current + capital)	+8.6	+94 %	–8.0	–9 %
Capital spending	+2.6	+103 %	–12.6	–36 %
Defence	–10.3	–65 %	+5.6	+17 %
Health	+1.5	+103 %	+9.2	+32 %
Education	+1.8	+61 %	–5.8	–15 %
Welfare benefits	+2.6	+41 %	+5.6	+17 %
Total spending	+2.7	+5 %	+52.0	+17 %

The Past 60 Years – an un-Keynesian Pattern

How does public spending relate to the economic cycle? Previous Treasury analysis has shown a tendency for real public spending to follow the ups-and-downs of the economic cycle from 1966–67 to 2002–03. That is, while total managed expenditure (TME)/GDP is countercyclical, cuts are less than expected in the good times and the peaks are lower than would be expected in bad (Figure 5).

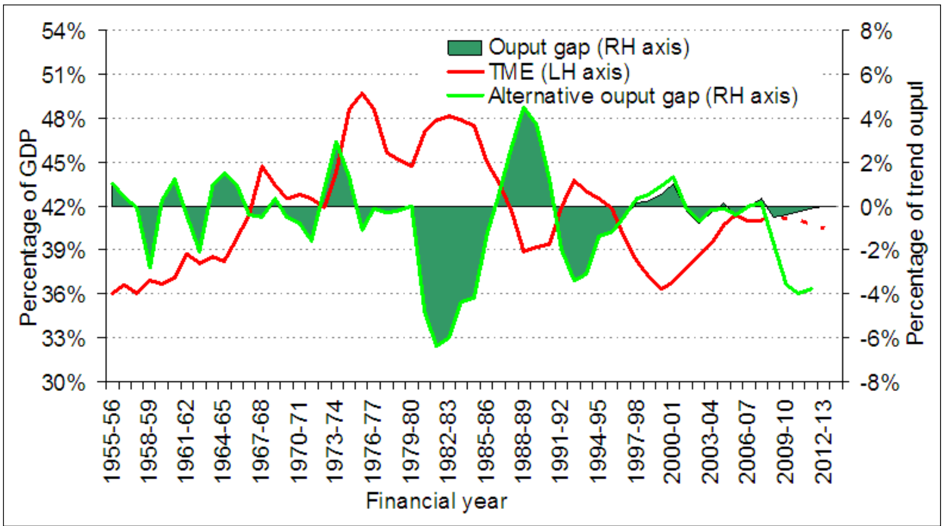

***Figure 5.** Output gap (the amount by which GDP exceeds (positive) or falls short of (negative) its potential value, given the resources available) and public spending (TME) as a percentage of GDP.*

Extending this analysis from 1955–56 to 2007–08 confirms that spending on public services (TME less spending on debt interest, benefits and tax credits) as a percentage of GDP, and some individual policy areas, showed a negative coefficient on the output gap that was less than that predicted by their share of GDP. This indicates that such spending is influenced by the economic cycle. Specifically there has been a tendency for spending plans to be topped up in booms and cut back during periods of recession. This was found to be true of health and education spending, but no evidence was found of defence spending being influenced by the economic cycle in this way.

Conclusions

The 1920s and the 1970s/80s Cutback Periods Compared

1920s: The "Geddes Axe" Committee on National Expenditure chaired by Sir Eric Geddes pushed for cuts beyond the £75m originally proposed in Treasury-Departmental negotiations, eventually acheiving cuts of £139m (23% of public spending) as against a target of £179m (29% of public spending). The overall cuts were equivalent to at least £100bn today with further cuts sustained until at least 1928.

1970s/80s: Brakes were first put on by the Labour government in 1976 to stablize public spending at 1976/7 levels, but the sterling crisis ensued, leading to an IMF loan of $4bn (about $30-50bn today) requiring immediate tax rises and spending cuts. BP privatization in 1977 and cash limits for public spending introduced by Labour in 1978; Conservatives from 1979 cut spending plans further with tougher cash limits and more asset sales.

- The 1970s/80s experience offers a model of how to 'brake' the growth of public spending. The 1920s experience offers a model of how to put public spending growth into reverse. But in neither of these cases was health spending cut back, and checking or reversing this category of spending (currently 17 per cent of the total and rising by 5 per cent a year in real terms over the last decade) is a major challenge for policy-makers dealing with public spending reductions today.
- Substantial job cuts were made in the public services in both periods, but (a) the methods used to cut jobs (axing 'temporaries' in the 1920s and 'industrials' in the 1970s/80s) would be harder to reproduce today and (b) removing one civil servant in five from the official payroll (and similar cuts in local government payroll) was not associated with substantial spending reductions in the 1970s/80s, while job cuts did go with spending reductions in the 1920s.
- In both of these instances, 'normal' Treasury processes of negotiating spending with departments were augmented by other institutional measures: in the 1920s by a special high-powered committee that effectively doubled the cuts made by the 'normal' processes, and in the 1970s by the conditions attached to a loan from the IMF in 1976, which served to change policy from a stance of spending stability and deferred tax rises to a stance of immediate spending cuts and tax increases.
- Experience since the mid-1950s suggests that the growth of public spending in times of prosperity has not been proportionately checked to compensate for spending increases in adverse economic conditions, offering a major challenge to current aspirations for a counter-cyclical policy stance.
- Taking the 2008 PBR and the 2009 Budget forecasts together shows that the financial crisis is estimated by the Treasury to have permanently weakened the public finances by about 6½ per cent of national income, or £90 billion a year. The Treasury's plan is to bring the public finances back on track over the 8 years to 2017–18, starting after the probable date of the 2010 general election. Half of the tightening is to come in the next Parliament and comprises tax rises (covering about 10 per cent of the tightening), cuts in capital spending (about 15 per cent) and so far unspecified cuts in departmental current spending, to amount to some 25 per cent. The remaining half is to come in the Parliament after next and is to come from so far unspecified increases in tax or cuts in current spending (investment spending is to be protected). Even if that forecast proves any more robust than previous Treasury forecasts, and if it proves politically durable, it means the equivalent of one-quarter to one-half of the spending cuts imposed by the Geddes Axe 90 years ago, making real cuts in some areas of spending on public services inevitable.

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