Truss needs to make her borrowing work for the markets. Which may mean her spending review rethinking whole functions of the state.

Ryan Bourne

September 7, 2022

The combination of sterling weakness and increased gilt yields suggests that markets may be slightly unsettled about British economic policy.

Liz Truss, the incoming prime minister, has sought to assuage jitters by reaffirming her commitment to central bank independence, to raising the growth rate of the economy, and to reversing supply-constraining tax hikes. But as the scale of the energy crisis and likely interventions have crystallised, the cost of government borrowing has jumped.

In recognition, Kwasi Kwarteng must soon set out a longer-term framework for ensuring fiscal probity – and that requires him regripping government spending.

Our editor likens this moment to war. Clearly, the scale of the energy shock and its impact on borrowing is a highly unusual crisis situation, with talk even of price controls and rationing. While those are undesirable, there will inevitably be large borrowing. Spreading the financial costs of this over time, akin to war debts, is prudent.
Yet after wars, demobilisation typically means sharp spending cuts and then entrenched fiscal discipline. Every government ran a primary budget surplus (with revenues exceeding spending excluding interest costs) from 1948 until 1967. After the Napoleonic Wars, the UK ran primary surpluses every year from 1815 right through 1899. For context: we've not run a primary surplus now since 2001.

What markets ultimately care about is this long-term commitment to sustainable budgeting, not emergency borrowing. We've just lived through the fiscal effects of the Covid-19 pandemic and are going to cancel tax rises worth tens of billions of pounds per year.

To then cushion the effects of the energy price spike and raise defence spending, on top of the demands of an ageing population, is it any wonder borrowing costs are rising? A medium-term plan for spending restraint to avoid spiralling debt is necessary.

Truss initially made two policy commitments on this, with one further indication from her Chancellor. The first commitment was for a spending review later this year. The second was to ensure that public spending grows less quickly than the private sector over time

The more recent indication is that Kwarteng will also overhaul Rishi Sunak's fiscal rules, trading shorter term budgetary loosening for longer-term tightening. He has implied that a new target will focus on getting the debt-to-GDP ratio back falling again.

Let's work backwards through these.

A plethora of fiscal rules have come and gone since 2010. There's virtue to the simplicity of just committing to get debt-to-GDP back on a downward path.

But it does tend to be a rule open to gaming. Since 2010, there's only been one two-year period during which public net debt relative to GDP has fallen consecutively – 2016/17 to 2018/19. It therefore needs some sort of teeth to be an actual credible commitment, rather than just a rolling aspiration for some time in the future.

Truss's target of government spending growing more slowly than the private sector over the economic cycle is, likewise, a reasonable goal. It creates strong incentives to enhance private sector growth – Truss's stated priority.

Whether musing on the need to revise employment law or telling Laura Kuenssberg that there's been too much focus on distribution, the message Team Truss has expressed has been clear: governments have not prioritised economic growth recently, and I will make growth a priority again.

History suggests, though, that spending restraint will still be needed for the size of government to shrink relative to GDP sustainably, even with better growth prospects. Government spending has fallen as a percentage of GDP meaningfully over three periods in the past four decades (1981-1988, 1992-1996, and 2009-2018). All required austere periods from the Treasury.

While it's all very well promising fiscal probity sometime in the future, then, if I were Truss or her Chancellor, I'd consider making a down payment today.

One such indicator could be over public sector pay. The Government needs to attract the workforce to deliver services, so cannot hold pay down without consequence. But the energy price shock has made us poorer as a country, and so real pay cuts should be expected for public sector workers, just as with private.

Ministers should push back hard on analyses that imply public sector workers can be made whole from inflation. Pay awards should continue to go no further with uplifts than pay bodies suggest.

More generally, Kwarteng should stick to a nominal departmental spending baseline: allowing inflation to cut real spending uplifts unless ministers can proactively justify the need for further cash. In some areas, further funds will clearly be necessary. But because a large proportion of our inflation is caused by supply-shocks, which impact relative prices, the needs of different departments will vary. The Government should reject claims that compensating all of government to ensure the "real spending" promised is delivered is the default, sensible path.

Politically, Truss must also reset expectations. The public should be reminded of the exceptional borrowing we've seen. In making ministerial and Cabinet appointments, one hopes Truss has cleared her big picture aims on spending with appointees too. A big resignation and row about not spending enough on something between now and the general election would be unhelpful.

This is especially true if it is triggered by a full spending review later this year. Talk of that has gone quiet, but, if green-lighted, Truss and Kwarteng should think carefully about its terms of reference to ensure they get the results they want.

International evidence suggests spending reviews work best alongside public sector reform. Previous spending reviews, though, have largely focused on headline departmental totals or a massive array of different "outcomes" that inevitably mean quite arbitrary salami slicing and unforeseen budget pressures.

Far less thought has been given to rethinking whole functions of the state, including activities governments should shed entirely.

One promising reform for the overall approach could be so-called "priorities-based budgeting." The basic idea is that you fix the total amount you are willing to spend, consistent with your debt goals. You use that to fund the basic functions of government first, then decide what your broader political priorities are, ranking every spending programme across government according to its cost-effectiveness. You then buy your way down the list until you are out of funds.

Stuff that doesn't make the cut is wound down. Given Truss has prioritised increasing growth, programmes could be heavily weighted to that ambition.

The big picture point is that, now campaigning is over, Truss and her team must assure investors that they don't believe in limitless borrowing. That requires a medium-term plan on debt that is centred on what governments can best control – its own spending.

Ryan Bourne is Chair in Public Understanding of Economics at the Cato Institute.