

WebMemo



Published by The Heritage Foundation

No. 3043
October 26, 2010

The U.K. Budget Cuts: Lessons for the United States

Nile Gardiner, Ph.D., Ted R. Bromund, Ph.D., and J. D. Foster, Ph.D.

British Chancellor of the Exchequer George Osborne unveiled a series of major austerity cuts on October 20 aimed at eliminating Britain's structural budget deficit by 2015, which currently stands at 11.4 percent of GDP.¹ The Conservative-led coalition government in London plans to cut a total of £81 billion (\$130 billion) from public spending over the next four years, as well as 490,000 public sector jobs.

British government departments will lose on average around 19 percent of their budgets, though the National Health Service and International Development have been ringfenced and Education has been largely spared with a 3.6 percent cut. Welfare spending is to be reduced by a further £7 billion in addition to the £11 billion in welfare cuts outlined in an emergency budget in June as part of a comprehensive welfare reform package spearheaded by Work and Pensions Secretary Iain Duncan Smith.

The U.K. budget cuts are the most ambitious undertaken since the reforms initiated by Margaret Thatcher in the 1980s. They are intended to roll back 13 years of excessive spending under the Labour governments of Gordon Brown and Tony Blair, which has seen government spending as a proportion of GDP rise from 37.5 percent in 1997 to 47.5 percent in 2010.²

Important Caveats Regarding the U.K. Spending Review. The British cuts will be closely watched by policymakers in the United States, who are keen to address the bloated budget deficit on this side of the Atlantic. And with good reason: Public spending

in the U.S. has ballooned in recent years, and America is heading for a rude awakening of Greek-style proportions unless it reverses course—and rapidly. But for several reasons, the U.K. cuts cannot simply be used as a blanket role model for the U.S. to follow.

First, the cuts in most areas do not go far enough, and overall levels of government spending will still increase—from £696 billion to £739 billion between now and 2014.³ Second, the decision to cut defense spending by 7.5 percent was misguided and will significantly undercut Britain's war-fighting capacity over the coming decade. Third, the British government took the extraordinary decision to increase spending on foreign aid by a staggering 37 percent at the expense of critically important defense programs.

Fourth, Prime Minister David Cameron's decision to leave in place the higher capital gains tax rate of 28 percent, implemented in June, was a significant mistake. A higher capital gains tax blocks new enterprise and drains energy from an economy. Starting and growing small businesses provides much of an economy's vitality, often requiring venture capital of one form or another. Unfortunately, in the U.S., President Obama is moving in the same direction, having signed into law a 3.8 percent sur-

This paper, in its entirety, can be found at:
<http://report.heritage.org/wm3043>

Produced by the Margaret Thatcher Center for Freedom

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

charge on capital gains while threatening to raise the federal rate up to 31.8 percent.

Finally, the National Health Service's £110 billion annual budget should not have been exempted from the spending review. According to recent reports, President Obama's deficit commission is likely to follow U.S. tradition and the British example and declare Social Security, Medicare, and Medicaid off limits in its budget-cutting deliberations. This is a recipe for failure that will have to be subsequently and painfully reversed.

Defense Cuts Will Weaken Britain's Military.

The 7.5 percent reduction in the defense budget is a particularly serious error that will inflict significant long-term damage on Britain's ability to provide for its defense and ultimately weaken the Anglo-American Special Relationship. The Treasury cuts would have been far more severe had it not been for the valiant efforts of the U.K. Defence Secretary Liam Fox.

The government's first mistake was including defense spending in the spending review. From 1997 through 2004, even as Britain fought a series of wars and spending on the social services increased, defense spending declined as a share of national income. And it has continued to fall as a share of the British budget. Today, Britain spends £40 billion annually on its own defense; that is less than 6 percent of its budget of £697 billion.⁴ Britain's fiscal position is indeed serious, but past Labour governments have already squeezed defense spending.

Its second error was to conduct a strategic defense and security review at the same time it carried out its spending review. Britain undertook its last security review in 1998, and an updated review

was badly needed. But by conducting its assessment of its security needs in parallel with its efforts to bring its finances under control, the government guaranteed that the conclusions of the security review would be shaped by the Treasury rather than responsible military professionals. The result is a review that pretends that Britain can keep on doing more while spending ever less.

Its third error was to continue down the road that Labour took in the early 2000s, when it began to justify reducing Britain's expenditures on heavier weapons by arguing that Britain would only fight as part of a coalition—meaning alongside the U.S.—and that in any case future wars would look like Afghanistan, so such weapons were unnecessary. While it is certainly desirable that the U.S. and Britain fight alongside each other, Britain's approach increases the burden on the U.S.; cannot be reconciled with the continued existence of state-based powers such as Iran, North Korea, and China; and offers a convenient justification for other NATO members to reduce their own defense spending. This doctrine is a product not of considered strategy but of Treasury pressure.

The spending review holds defense spending flat from the 2010–11 baseline through 2014–15. This reduction of 7.5 percent after inflation takes no account of defense cost inflation—i.e., the tendency of defense costs to grow faster than the rate of inflation in the civilian economy.⁵ The result is that the projected cuts in the size of all of the armed forces—and the delays and cancellations of procurement programs⁶—are likely to deliver the worst of all possible worlds: They will endanger Britain's security while at the same time being insufficient to meet the spending review's financial targets.

1. Eurostat, October 22, 2010, at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22102010-AP/EN/2-22102010-AP-EN.PDF (October 26, 2010).
2. HM Treasury 2010 budget figures, at http://www.hm-treasury.gov.uk/d/junebudget_chapter1.pdf (October 26, 2010).
3. Christopher Booker, Spending Review: The "Cuts" That Mean Public Spending Soars, *The Daily Telegraph*, October 23, 2010, at <http://www.telegraph.co.uk/comment/columnists/christopherbooker/8083036/Spending-review-The-cuts-that-mean-public-spending-soars.html> (October 26, 2010).
4. HM Treasury, "Key Spending Review Announcements," at http://www.hm-treasury.gov.uk/spend_sr2010_keyannouncements.htm (October 26, 2010).
5. HM Treasury, "Spending Review 2010," October 2010, p. 10, at http://cdn.hm-treasury.gov.uk/sr2010_complereport.pdf (October 26, 2010).

The correct course for Britain—and the U.S.—to take is to remember that defense is the first duty of the state, to abandon the effort to cut their way to security, and to commit to stable defense budgets that seriously assess their national interests and adequately fund their armed forces appropriately.

U.S. and U.K. Need a Pro-Defense and Pro-Growth Agenda. The British government's spending review offers important lessons for the U.S., both good and bad. The U.K.'s aggressive plan, which calls for cuts to many government programs, offers a strong model for America to follow. Indeed, Washington will need to be equally aggressive and even more comprehensive to get federal spending under control, with one exception—defense spending. Defense spending is true mandatory spending as it is driven by each country's respective need to address existing and emerging security threats, none of which are abating.

Reducing budget deficits is far more difficult without the revenues that flow from a strong economy. Thus, Osborne's proposal to cut the corporate income tax rate from 28 percent to 24 percent is right on target and offers a good model for the U.S.,

which has a debilitating second-highest corporate income tax rate in the industrialized world.

But Britain needs to do more. To truly succeed, the proposed U.K. cuts must be matched by a strong pro-growth, pro-enterprise agenda designed to spur the creation of private sector jobs, reduce red tape for businesses, attract greater foreign investment, and maintain the city of London as a leading global financial center. Cameron should reverse the increase in capital gains tax, bring down the top rate marginal individual income tax rate from its current level of 50 percent, and resist the growing wave of European Union financial regulations, which threaten the competitiveness of the city.

—*Nile Gardiner, Ph.D., is Director of, and Ted R. Bromund, Ph.D., is Senior Research Fellow, in the Margaret Thatcher Center for Freedom, a division of the Kathryn and Shelby Cullom Davis Institute for International Studies, and J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

6. Ted R. Bromund, "Spending Cuts in British Defense Review: Less Than Expected, but Still Damaging," Heritage Foundation WebMemo No. 3039, October 22, 2010, at <http://www.heritage.org/Research/Reports/2010/10/Spending-Cuts-in-British-Defense-Review-Less-Than-Expected-but-Still-Damaging>.