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Research Note 68

The economic cost of high spending

With Britain facing a severe fiscal crisis, there is a pressing need to reduce the deficit. To do so, it will be necessary to put in place serious cuts in spending, but the pressure on families and businesses will be mitigated if the country enjoys strong economic growth.

The existing literature suggests that higher government spending is associated with lower economic growth. That means the rapid rise in spending since 2000 – far greater in the UK than in other developed economies – may seriously affect Britain's trend rate of economic growth and GDP.

The key findings in this research note are:

- Over the last decade, there has been a rapid increase in government spending. OECD figures show that **the UK increased total government outlays from 36.6 per cent of GDP in 2000 to a projected 53.4 per cent in 2010**. That is a 45.9 per cent increase against a 15.7 per cent increase across the developed world.
- Treasury figures suggest that Total Managed Expenditure has risen from 36.3 per cent of GDP in 1999-00 to 48.1 per cent in 2010-11. Based on European Central Bank research estimates of the effect of spending increases on growth, that **increase in spending may be reducing the trend rate of growth by 1.53 percentage points**.
- The same analysis suggests that **GDP in 2010-11 is already £111 billion lower than it would have been** without the increase in spending since 2000. That is equivalent to over £4,000 per family.

To discuss the research or arrange broadcast interviews, please contact:

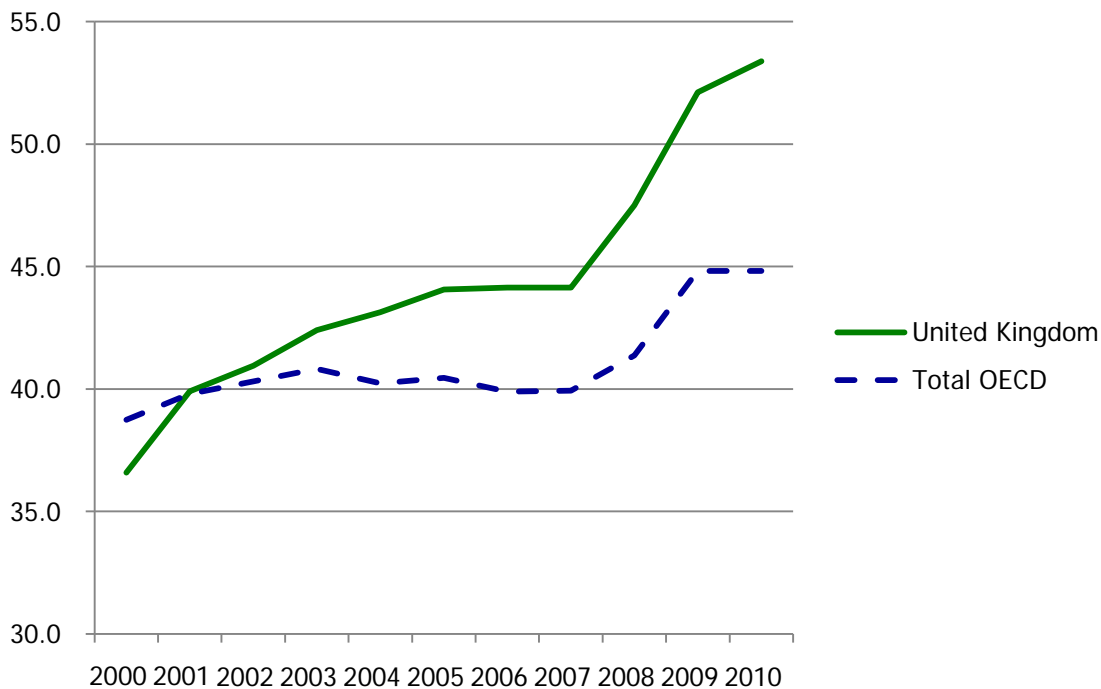
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Growth in spending

The OECD provides figures for general government total outlays – including central, state and local government plus social security spending – which give a comparable picture of changes in spending in different developed economies.¹ Those statistics show that the UK increased spending from 36.6 per cent of GDP in 2000 to 53.4 per cent of GDP in 2010. That will partly have been driven by policy decisions to increase spending and partly by the recession, due to increases in the numbers claiming unemployment benefits for example. Across the OECD developed economies, spending increased from 38.7 per cent of GDP in 2000 to 44.8 per cent of GDP in 2010:

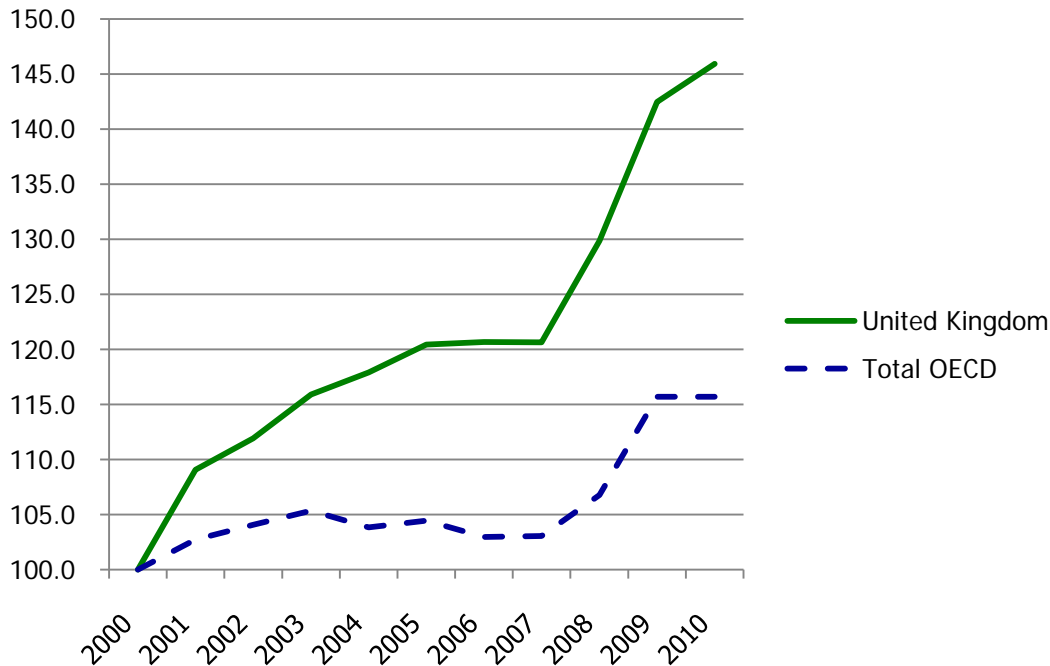
General government total outlays, per cent of nominal GDP



The increase in public spending was considerably more rapid than in other developed economies. In the UK, spending increased by 45.9 per cent, whereas spending increased by 15.7 per cent across the OECD.

¹ OECD *Economic Outlook No. 86*, November 2009, Annex Table 25: General government total outlays

General government total outlays, per cent of nominal GDP, 2000=100



Existing literature on the effect of spending on growth

A series of institutions and academics have produced estimates of the effect of an increasingly large state on economic growth. Some of the most prominent are discussed below and used in this research note.



The European Central Bank (2008) – Based in Frankfurt and responsible for monetary policy covering the 15 member countries of the Eurozone, the European Central Bank also maintains a research programme which releases regular working papers. One of those working papers provided an estimate that each 1 percentage point growth in government consumption as a share of GDP leads to a 0.13 percentage point fall in GDP growth.² The working paper was produced by António Afonso, from the ECB's UECE – Research Unit on Complexity and Economics, and Davide Furceri, from the University of Palermo and the University of Illinois at Chicago.

² Afonso, A. & Furceri, D. 'Government size, composition, volatility and economic growth', European Central Bank, Working Paper no. 849, January 2008



Study.⁴

Robert J. Barro (1997) – Currently rated by IDEAS/RePEc as the third most influential economist in the world.³ Robert Barro is Paul M. Warburg Professor of Economics at Harvard University and has produced numerous widely cited studies on a diverse range of subjects and has a particular reputation for his work on economic growth. His estimate that each 1 percentage point increase in government consumption as a proportion of GDP leads to a 0.136 percentage point fall in economic growth is contained in a 1997 book *The Determinants of Economic Growth: A Cross-Country Empirical*



Folster & Henrekson (2001) – Researchers at the Swedish Research Institute of Trade and the Stockholm School of Economics estimated the effect of the size of government on economic growth using an econometric panel study on a sample of rich countries over the period 1970-95.⁵ They found that as econometric problems were addressed the relationship

between small government and high economic growth became more robust and found that each 1 percentage point increase in government consumption as a proportion of GDP leads to a 0.07-0.08 percentage point fall in economic growth.

Economic implications of spending increases

Using the figures above, combined with Treasury statistics for the growth in government spending, Total Managed Expenditure (TME), it is possible to estimate the likely reduction in the trend rate of growth thanks to increases in government spending.

It would be possible to use the OECD figures for spending as a proportion of GDP quoted above instead of the Treasury TME figures. While those OECD figures are more suitable for international comparison, using TME figures provides for a more cautious estimate and works more cleanly with other variables needed such as nominal GDP and inflation.

Table 1 provides estimates of the effect on trend growth from spending increases over the last decade. We show three scenarios based on research from Barro and researchers at the European Central Bank (“ECB”) and Stockholm School of Economics (“SSE”).

³ IDEAS/RePEc, ‘Economist Rankings at IDEAS’, January 2008, <http://ideas.repec.org/top/top.person.all.html>

⁴ Barro, R. J. ‘*Determinants of Economic Growth: A Cross-Country Empirical Study*’, MIT Press, 1997

⁵ Fölster, S. & Henrekson, M. ‘*Growth effects of Government Expenditure and Taxation in Rich Countries*’, Stockholm School of Economics: Working Paper no. 503, Research Institute of Industrial Economics, June 2000

Table 1: Effects on growth rates from increases in spending since 1999-00

	Total Managed Expenditure, % GDP	Increase in TME from 1999-00, % GDP	Fall in growth, ECB, %	Fall in growth, Barro, %	Fall in growth, SSE, %
2000-01	36.8	0.5	0.07%	0.07%	0.04%
2001-02	37.7	1.4	0.18%	0.19%	0.11%
2002-03	38.6	2.3	0.30%	0.31%	0.17%
2003-04	39.4	3.1	0.40%	0.42%	0.23%
2004-05	40.5	4.2	0.55%	0.57%	0.32%
2005-06	41.2	4.9	0.64%	0.67%	0.37%
2006-07	40.9	4.6	0.60%	0.63%	0.35%
2007-08	41.1	4.8	0.62%	0.65%	0.36%
2008-09	43.9	7.6	0.99%	1.03%	0.57%
2009-10	47.9	11.6	1.51%	1.58%	0.87%
2010-11	48.1	11.8	1.53%	1.60%	0.88%

That is likely to mean that GDP is already significantly lower than it would otherwise have been in 2010-11 had spending not increased as a share of national income. Table 2 shows the actual path of nominal GDP, inflation measured by the GDP deflators and real GDP.

Table 2: Nominal and real GDP and inflation since 1999-00

	Nominal GDP £ billion	GDP Deflators, change on previous year	Real GDP, 1999-00 prices £ million	Real GDP growth, %
2000-01	989.5	1.31%	976.8	3.4%
2001-02	1,031.5	2.23%	995.9	2.0%
2002-03	1,092.1	3.23%	1,021.4	2.6%
2003-04	1,157.4	2.82%	1,052.9	3.1%
2004-05	1,214.7	2.78%	1,075.1	2.1%
2005-06	1,270.8	1.87%	1,104.1	2.7%
2006-07	1,346.2	2.96%	1,136.0	2.9%
2007-08	1,418.2	2.89%	1,163.2	2.4%
2008-09	1,434.0	2.51%	1,147.2	-1.4%
2009-10	1,406.0	1.75%	1,105.5	-3.6%
2010-11	1,464.0	2.25%	1,125.8	1.8%

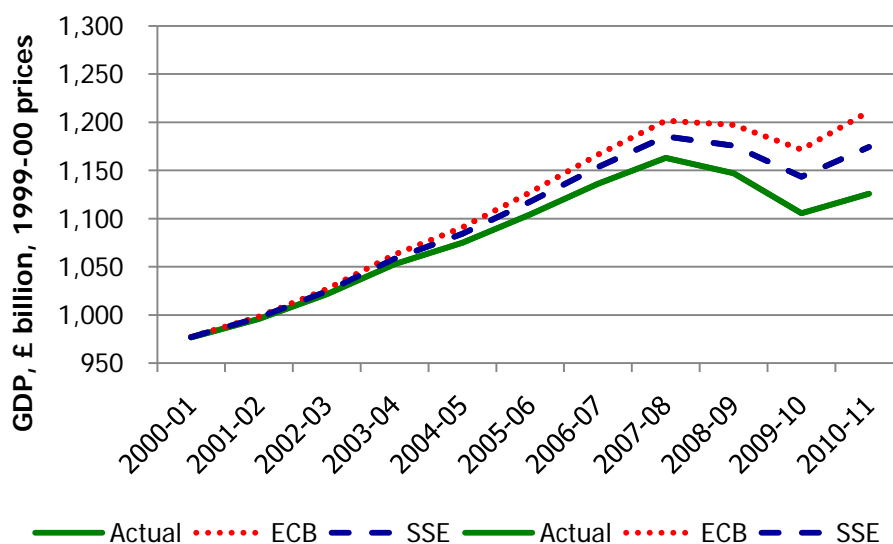
The growth in spending depressed real growth rates throughout the period as shown in Table 1. Table 3 shows what the path of real GDP would have been had growth been higher without the increase in TME over the last decade.

Table 3: Real GDP estimates with and without increases in TME since 1999-00

	Real GDP, 1999-00 prices £ billion	Real GDP, 1999-00 prices, without TME increase, ECB £ billion	Real GDP, 1999-00 prices, without TME increase, Barro £ billion	Real GDP, 1999-00 prices, without TME increase, SSE £ billion
2000-01	976.8	977.4	977.4	977.1
2001-02	995.9	998.3	998.4	997.3
2002-03	1,021.4	1,026.9	1,027.1	1,024.6
2003-04	1,052.9	1,062.6	1,063.1	1,058.5
2004-05	1,075.1	1,090.9	1,091.6	1,084.2
2005-06	1,104.1	1,127.3	1,128.3	1,117.4
2006-07	1,136.0	1,166.6	1,168.0	1,153.5
2007-08	1,163.2	1,201.7	1,203.5	1,185.3
2008-09	1,147.2	1,197.1	1,199.5	1,175.8
2009-10	1,105.6	1,171.8	1,174.9	1,143.3
2010-11	1,125.8	1,211.2	1,215.3	1,174.4

Figure 1 shows the actual pattern of real GDP and what it would have been if growth had been higher without the increase in TME over the last decade. The Barro estimate is omitted as it is very similar to the pattern under the ECB estimate.

Figure 1: Real GDP estimates with and without increases in TME since 1999-00



Putting those figures back in nominal terms shows the extent to which 2010-11 GDP is lower than it would have been without increases in TME. Table 4 shows the path of nominal GDP without the increase in TME seen over the last decade. Based on the ECB estimate, 2010-11 GDP would be £111 billion higher without the increase in TME.

Table 4: Nominal GDP estimates with and without increases in TME since 1999-00

	Nominal GDP £ billion	Nominal GDP, without TME increase, ECB £ billion	Nominal GDP, without TME increase, Barro £ billion	Nominal GDP, without TME increase, SSE £ billion
2000-01	989.6	990.2	990.2	989.9
2001-02	1,031.5	1,033.9	1,034.1	1,032.9
2002-03	1,092.1	1,097.9	1,098.2	1,095.4
2003-04	1,157.4	1,168.1	1,168.6	1,163.6
2004-05	1,214.7	1,232.5	1,233.3	1,225.0
2005-06	1,270.8	1,297.5	1,298.7	1,286.1
2006-07	1,346.2	1,382.4	1,384.1	1,367.0
2007-08	1,418.2	1,465.3	1,467.5	1,445.2
2008-09	1,434.0	1,496.3	1,499.3	1,469.7
2009-10	1,406.0	1,490.2	1,494.2	1,454.1
2010-11	1,464.0	1,575.0	1,580.3	1,527.2

Figure 2 shows the actual pattern of nominal GDP and what it would have been if growth had been higher without the increase in TME over the last decade. Again the Barro estimate is omitted.

Figure 2: Nominal GDP estimates with and without increases in TME since 1999-00

