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Economic Bulletin

THE RED HERRING OF DEPARTMENTAL SPENDING CUTS

- Conservative plans for departmental spending cuts are only half those implied by the OBR.
- Real challenge for deficit reduction is boosting productivity and cutting welfare.
- UK's economic outlook is improving but globally the outlook has deteriorated.
- Much more needs to be done to boost housebuilding and exports.

1. ECONOMIC OUTLOOK

In its latest labour market update, the ONS announced that the UK's employment rate had reached a record high of 73.3%. This latest statistic reflects the strong performance of the labour market generally with youth unemployment, long term unemployment and part-time employment all on downward trajectories. In addition, the British economy in 2014 was the fastest growing in the G7 and further progress has been made on cutting the deficit both in absolute terms and relative to GDP. The ONS release on the public sector finances confirm that progress.

It was within this positive economic background that the Chancellor delivered the final Budget speech of this Parliament last Wednesday. Indeed, in its new Economic and Fiscal Outlook, the OBR has revised its economic forecasts almost entirely in welcome directions. Growth is expected to pick up slightly this year to reach 2.5% and then stay at 2.3% in the following years. The unemployment rate is also expected to fall more than the OBR anticipated at the Autumn Statement. However, the forecast for business investment growth has been revised down in 2015 by 3.3 percentage points; something we argued was likely back in December.

Expectations for borrowing have improved; annual public sector net borrowing is now expected to be a cumulative £6.3 billion lower between 2014/15 and 2018/19 relative to the Autumn Statement forecast. In addition, the national debt as a percentage of GDP is now on the verge of falling; although as the IFS pointed out, this is largely due to increased asset sales. The OBR made small downward revisions on its estimate of the size of the structural deficit. On living standards, lower inflation will help to make subdued nominal income growth more meaningful in real terms. Also, it does seem that average real household incomes (as opposed to earnings) should this year surpass their 2010 levels.

2. DEPARTMENTAL SPENDING CUTS

In his speech, the Chancellor restated the need for the deficit reduction programme and correctly pointed out that spending cuts in this Parliament have come alongside improvements in public service quality, falls in crime and falling child poverty. It was also important to highlight the sensitivity of deficit reduction to debt interest payments. Central government gross debt interest payments are now forecast to be a cumulative £34.4 billion less between 2014/15 and 2019/20 compared to at the Autumn Statement.

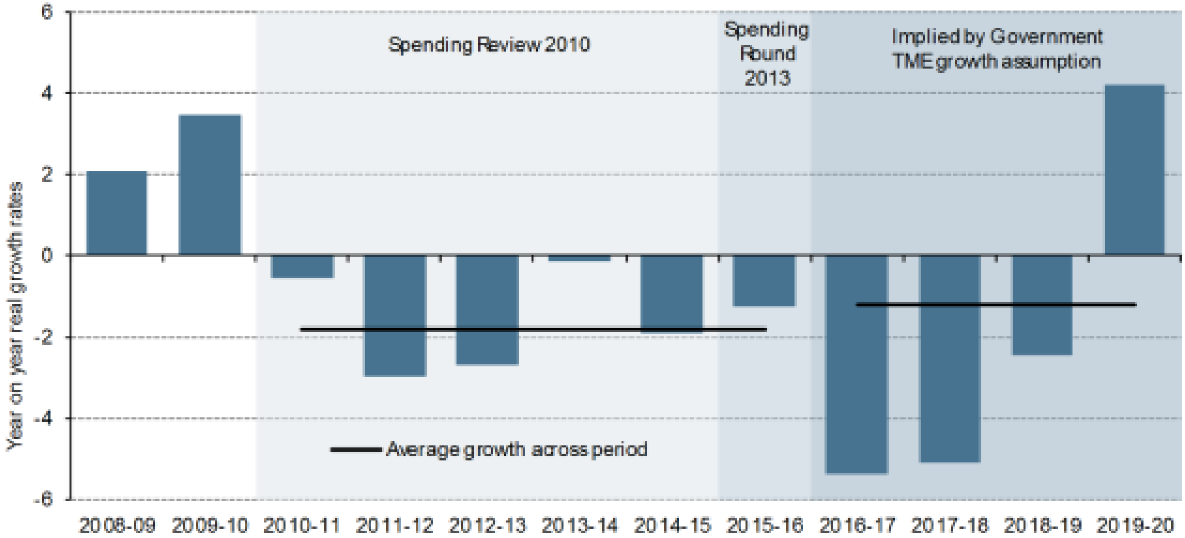
A reduction in the expected surplus in 2019/20 from £23 billion to £7 billion means that public spending will be 36% of GDP in that year. This means that the size of the state will still be higher than when Gordon Brown was Chancellor in 2000. Also, given that Total Managed Expenditure has already fallen from 45.7% in 2009/10 to an expected 40.7% in 2014/15, this means that more than half of the reduction in the size of the state relative to GDP has been completed.

However, due to the decision to increase public spending in line with nominal GDP in 2019/20, there has been criticism from Ed Balls and others that this would mean "extreme" cuts between 2016 and 2018. This argument is based on Chart 4.7 from the OBR's Economic and Fiscal Outlook. Real spending in resource DEL ie day to day departmental spending is now forecast to fall by 5.8% and by 5.4% in 2016/17 and 2017/18. It should then fall by 2.6% in 2018/19 and then rise by 4.3% in 2019/20. This compares to an average annual real terms fall of 2.4% between 2010 and 2014.

This comparison is entirely misleading. Even if we accept the premise of that argument, the average annual reduction in day-to-day departmental spending will be slightly slower between 2016 and 2020 compared to between 2010 and 2016.

Most importantly, the rhetoric about extreme or implausible cuts rests on the assumption that the remaining consolidation will come almost exclusively from departmental spending. No political party is suggesting that this would happen. Given the lack of consensus between the Conservatives and Liberal Democrats on tax and welfare, the OBR has merely channelled the extra £30 billion in discretionary consolidation between 2015/15 and 2017/18 into day-to-day departmental spending cuts.

Chart 4.7: Year-on-year real growth in resource DEL



The reality is that the cuts in departmental spending will be not anywhere as severe as implied in the OBR's latest forecasts. Labour plans to borrow more and so does not need as large a fiscal consolidation. The Liberal Democrats are arguing in favour of £12 billion in tax rises and slightly more borrowing. The Conservatives meanwhile are arguing in favour of £12 billion in welfare savings, alongside another £5 billion in extra revenue from measures aimed at reducing tax avoidance and evasion.

This means that even under the Conservative's plans, the total reduction in departmental spending between 2015/16 and 2019/20 will be about half as those currently implied by the OBR; a 3.7% fall compared to a 7.2% implied by the OBR. As the IFS points out, this would mean that under Conservative plans, departmental spending cuts in the next Parliament would be similar to under this Parliament.

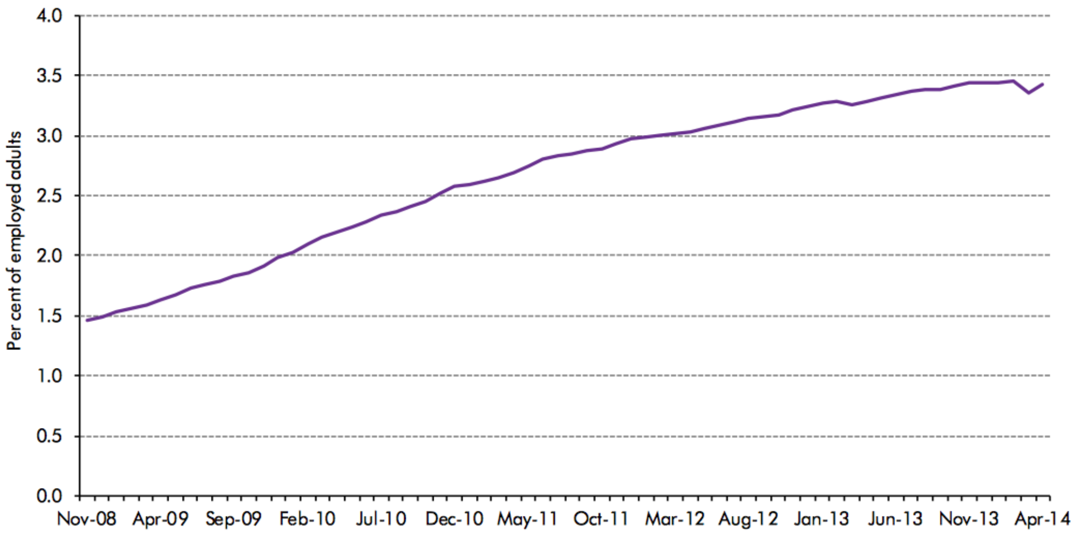
An extra £13 billion in departmental spending cuts will still not be easy to implement but certainly quite feasible given the progress in this Parliament. What will be significantly more difficult is the £12 billion reduction in welfare spending. To put this into context, this required saving would amount to 10% of the £120 billion spending within the Welfare Cap i.e. excluding JSA and the state pension. Again, this is far from impossible but would imply further difficult decisions. Extending freezes in benefits, reducing eligibility of some benefits and reforms to boost productivity will all be essential.

3. PRODUCTIVITY

Despite the recovering economy, productivity fell again in the last quarter of 2014 which means that it grew by only 0.2% last year. The UK's productivity also compares poorly internationally; indeed the average French or German worker produces more for every four days of work than the average British worker produces in five days. This is a point that we have made regularly. It is therefore encouraging to see this issue being increasingly discussed; for example in Ed Miliband's response to the Budget. Unfortunately, his proposals for higher taxes and heavier regulation of business will do little to boost productivity growth.

The weakness of productivity growth remains one of the key drags on real wages and deficit reduction. Without productivity growth, employers cannot afford to pay higher wages. The result is that living standards will fail to rise in the long term and increased demands on welfare payments to supplement stagnant real wages. Housing benefit and tax credits in particular are two of the most significant drivers of higher welfare spending. As the OBR made clear in its Welfare Trends report, the percentage of those in employment claiming housing benefit has more than doubled in recent years. Boosting productivity and boosting real wages is thus essential in reaching the targeted reductions in welfare spending and the budget deficit.

Chart 9.7: Housing benefit claimants in employment



Source: DWP, ONS, OBR

However, in its latest report, the OBR has argued that even the meagre productivity growth of 2014 was in large part due to the fall in oil prices which helped business investment by reducing operating costs of buildings and machinery. Furthermore, in its scenarios published in December, the OBR points out that the difference between the high and low productivity scenarios with respect to growth and borrowing is significantly greater than the difference between the Conservative and Labour spending plans.

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4. WELCOME POLICIES

There were a number of policies announced in the Budget which should help to boost productivity growth. For example, the direct tax cuts will continue to boost incentives to work, save and invest. The rise in the Personal Allowance to £11,000 by 2017/18 for example is to be strongly welcomed. Although faster rises would have been desirable, it is an income tax cut which will help both lower earners and the middle class. In addition, fuel duty cuts, the abolition of class two National Insurance contributions for the self-employed and the abolition of the annual tax return system are all also positive. Furthermore, it was important that the Chancellor rejected proposals to increase corporation tax; a policy which our analysis shows would cut employment by tens of thousands.

Substantial reform to the North Sea fiscal regime has become essential. Whilst the collapse in the oil price has generally been positive across the economy, it has imperilled thousands of jobs in the North Sea and accelerated the decline in domestic energy production. Cutting the Petroleum Revenue Tax from 50% to 35% and the Supplementary Charge from 30% to 20% as well as instituting a simpler, more powerful investment allowance as suggested by the CPS will go some way to alleviating the difficulties facing the sector.

A series of policies aimed at boosting saving should also be welcomed. Abolishing the 55% penalty charge on unauthorised sales of annuities will extend pension freedoms to millions of people who already receive an income from an annuity. Increasing the flexibility of ISAs by allowing savers to replace withdrawals once the ISA limit has been reached along with expanding the list of qualifying investments is also a good step. Creating a new savings income allowance will allow basic rate taxpayers to keep £1,000 of savings income free from tax and £500 for higher rate taxpayers. Effectively this will act as a £1 billion income tax cut in 2016/17 and will help to improve the returns to saving after six years and counting of ultra-low interest rates.

5. AREAS OF CONCERN

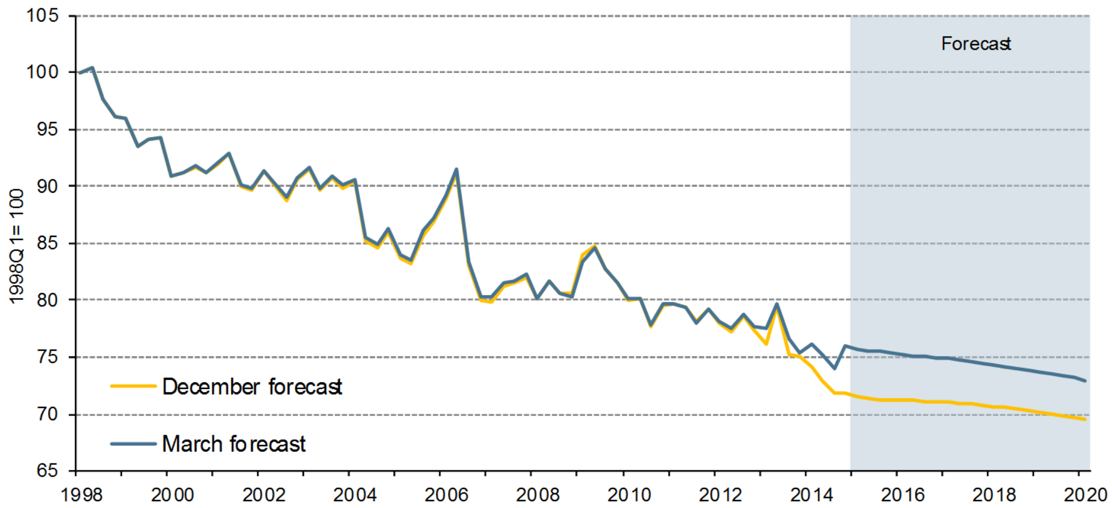
The current government has taken some measures to boost home ownership, for example by heavily ramping up the Right to Buy discount. Other measures such as Help to Buy and the Help to Buy ISA announced in the Budget, whilst of varying effectiveness and desirability, are also aimed at making it easier to buy and own property. However, these are still mostly demand-side policies to resolve a supply-side problem. Increasing home ownership is simply impossible without also boosting housing supply; something the UK is manifestly failing to do.

The Chancellor did announce 20 new housing zones which could lead to the development of 34,000 new homes on brownfield land. Unfortunately this goes nowhere near far enough given that we are building about 140,000 houses a year and we need nearer to 250,000 houses a year. More radical steps on the supply side to cut red tape and simplify planning procedures are necessary, along with measures boost mortgage lending, including through more banking sector competition.

On defence, it is important that the UK maintains its commitment to NATO especially given Putin's aggression in Ukraine and the turmoil in the Middle East. Given the fiscal situation, it will be difficult to reach the 2% defence spending target; indeed the IFS estimates that pledging to keep defence spending at the target would mean 16.3% cuts to unprotected departments in the next Parliament compared to 9.4% cuts in the absence of the pledge. However, the Government should still state a long term aim to reach the 2% target.

Also, the UK's current account deficit remains precarious at around 5% of GDP and growth in the Eurozone, China, Japan and elsewhere has disappointed. Net trade will subtract from growth in every year of the next Parliament; cutting 0.1% from GDP this year, 0.4% next year and 0.2% in the years after. In addition, despite an improvement since December, the UK's export market share seems likely to continue its apparently inexorable decline. The OBR increased its forecast for current account deficits by an average of 0.5% of GDP between 2014 and 2019. More measures to boost exports would therefore have been desirable; for example with bigger cuts to Air Passenger Duty.

Chart 3.35: UK Export market share



6. CONCLUSION

The cuts in departmental spending outlined by the OBR are far more than would be required and are about twice as large as even the Conservatives are proposing. Nevertheless, Britain must continue on the path of deficit reduction and whilst there were plenty of things to welcome in the Budget, there is still a lot more to do boost productivity and cut welfare spending. Boosting housebuilding, net exports and business investment are critical.

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