Centre for Policy Studies

Number 96

13 July 2017

Economic Bulletin

ABANDONING AUSTERITY IS NO SOLUTION

- **In 2011, public sector pay was 18% higher than private sector pay and the UK had the highest structural budget deficit in the OECD. Restraint was essential.**

- **Tories plan to balance the books by 2025-26, which would mean the UK is due to be in deficit for 25 years. Softening this programme would be dangerous.**

- **The UK's tax burden is set to be the highest in nearly four decades by 2025.**

- **For OECD countries with high budget deficits in 2010, a larger fall in government spending has been associated with larger deficit reductions, higher economic growth, higher wage growth and lower unemployment.**

- **Ireland's fiscal consolidation has been 2½ times as large as the UK's, yet Ireland has seen unemployment fall by twice as much proportionally.**

- **If public sector pay is to be eased, this should involve re-gearing government priorities or examining ways of regionalising pay.**

1. BACKGROUND

Since 2011, there has been significant restraint in public sector pay. There were freezes for all but the lowest paid in 2011-12 and 2012-13, and then increases of 1% per year every year since 2013-14. Under initial Conservative Party plans, this was due to last until 2019-20.

2. THE JUSTIFICATION FOR THE POLICY

In the immediate aftermath of the financial crisis in 2008, public sector pay rose significantly compared to private sector pay. At one stage, the differential in annual pay growth was nearly four percentage points and occurred at a time when private sector earnings were falling in real terms (see Figure 1). By 2011, public sector pay was, on average, over 18% higher than that in the private sector, falling to just over 6% when controlling for workers' characteristics (see Figure 2). Of course, in the early part of this decade the Coalition Government also inherited an enormous budget deficit, which was – on some measures – the largest in the G20. The combination of these two factors meant that restraint in public sector pay was essential.

Figure 1: Average earnings growth in the private and public sector

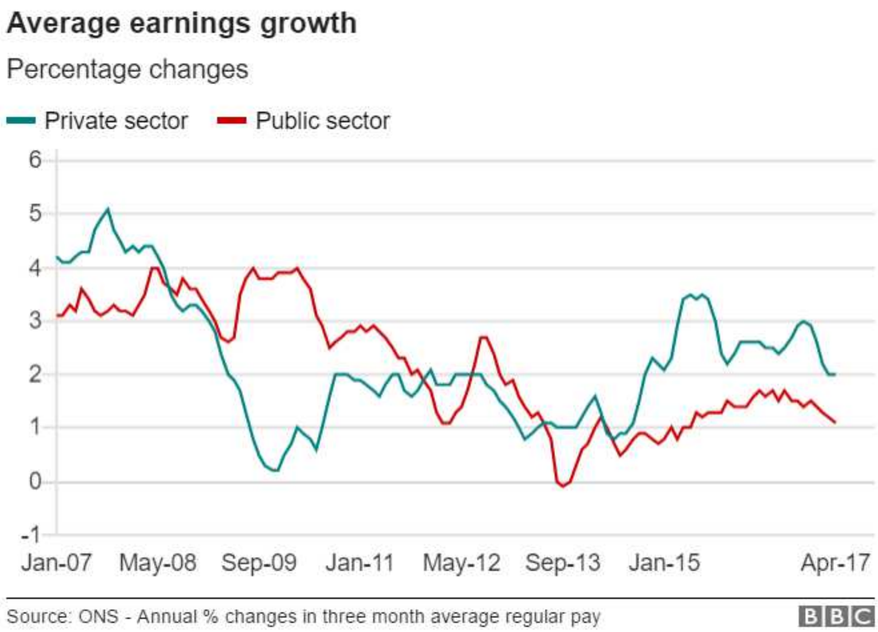
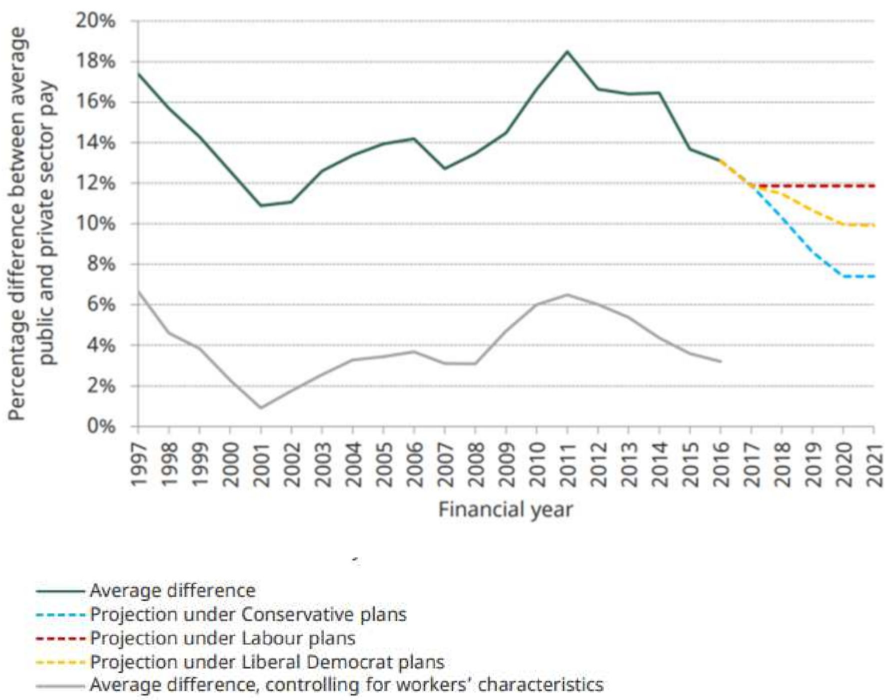


Figure 2: Difference between average public and private sector pay



Source: Institute for Fiscal Studies

Note: These figures do not include non-pay remuneration, such as pensions, which are still more generous on average in the public sector than in the private sector, despite cuts in their value since 2010.

Click here to sign up to the CPS newsletter

3. WHAT ABOUT GOING FORWARD?

The restraint on public sector pay has meant that the discrepancy between public sector and private sector wages has somewhat diminished since the early part of this decade, returning to its pre-crisis level (although, even controlling for workers' characteristics, public sector pay is still over 3% higher than private sector pay, which does not even account for the more generous pensions in the public sector – see Figure 2). Moreover, the budget deficit is down by over two thirds as a proportion of national income since 2010, meaning that the UK's fiscal position – albeit far from ideal – is no longer as big a threat to the nation's economic security. This had led to calls for the Government to review its policy on public sector pay.

Higher inflation has added to this pressure. From December 2014 – July 2016, the CPI level of inflation was below 1%, meaning that public sector wages were seeing small increases in real terms. However, inflation has rapidly picked up since then reaching 2.7% in May 2017, leading to a significant effective pay cut for many public sector workers. Private sector workers are also currently seeing an effective pay cut, with average pay only increasing by 2% in April 2017.

4. IS MORE BORROWING THE ANSWER?

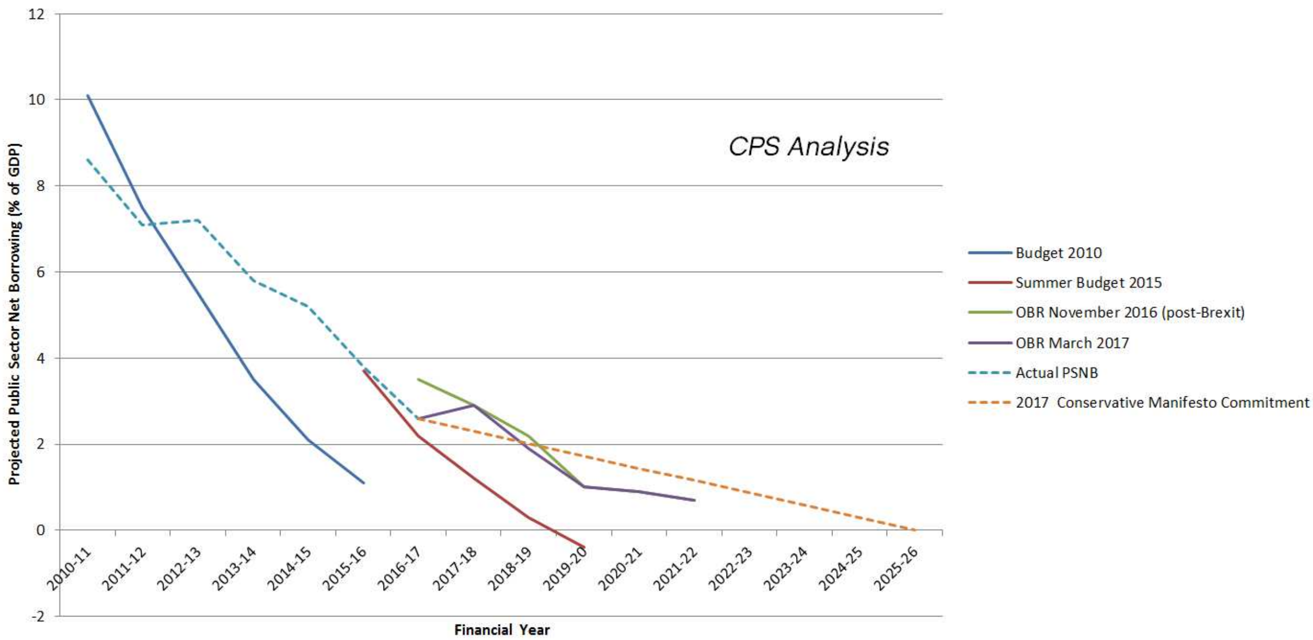
Prior to the election, it was reported that the Conservative Party was planning to achieve a budget surplus by 2025. This very modest deficit reduction plan would mean that the UK Government is due to run a budget deficit for a quarter of a Century. The key points are as follows:

1. In 2010-11, the Coalition Government pledged to eliminate the cyclically adjusted current budget deficit by 2014-15. Public sector net borrowing was planned to reach 2.1% of GDP by 2014-15. Substantial progress was made in reducing the budget deficit, which was – on some measures – the highest of any OECD country in 2010. However, both of the budget deficit targets were missed. The cyclically adjusted current budget deficit was 2.5% of GDP in 2014-15 and public sector net borrowing was 5.2% (OBR public finances databank).

2. In 2015-16, the Summer Budget projected that public sector net borrowing would be in surplus by 2019-20. This target was dropped after the UK's decision to leave the European Union. It has been reported that the Conservatives will pledge to get public sector net borrowing in surplus by 2025-26.

3. The last time that public sector net borrowing was in surplus was in 2000-01 (OBR public finances databank). This was due to the Labour Party being elected on a pledge to follow the Conservative Party's fiscal plans from 1997 – 2001, and then successfully implementing it. However, Labour subsequently dramatically increased public sector spending. This means that, according to the Conservative Party's current plans, public sector net borrowing is due to be in deficit for 25 consecutive years.

Figure 3: Changing borrowing forecasts since 2010



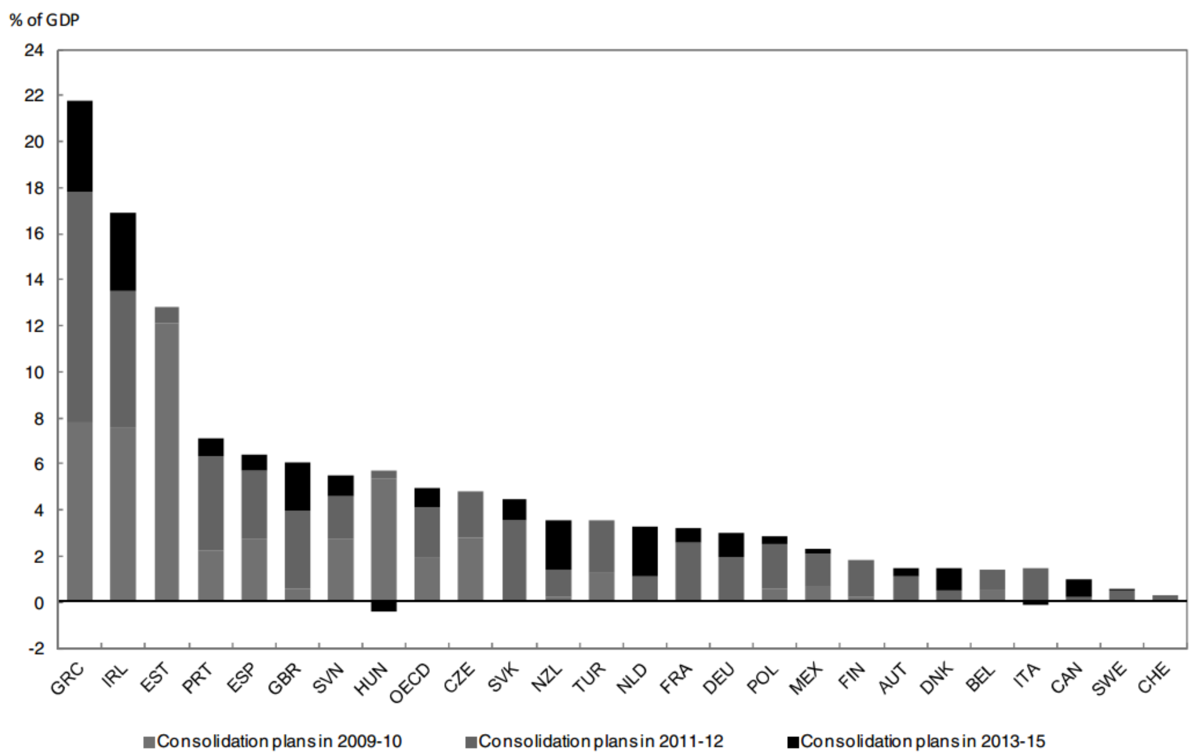
Sources: Budget Red Books and the Office for Budget Responsibility

In 2010 the UK's economic position was dire. The country had the highest structural budget deficit in the G20, and, of course, this largely came about due to the financial crisis. However, it was made worse by the fact that the Labour Party was running successive budget deficits in the lead up to the financial crisis when the economy was experiencing economic growth.

Achieving a budget surplus at the earliest opportunity is crucial in ensuring intergenerational fairness. Government borrowing is effectively passing debt obligations onto future generations in order to pay for the current generation's overspending. However, another critical reason for the UK achieving a surplus is that it will allow future governments more flexibility to respond to global economic shocks. It would therefore be irresponsible to deviate from the Government's already modest deficit reduction plans.

5. HAS AUSTERITY WORSENED THE UK'S OUTLOOK?

Figure 4: Announced fiscal consolidation plans of OECD countries (2009-10, 2011-12 and 2013-15)



Source: OECD

Notes: The figures are the sum of annual incremental consolidation for 2009-15 as reported by the national authorities and/or calculated by the OECD Secretariat. Fiscal consolidation comes from cuts in spending and increases in taxes compared to plans previously set out.

The UK's fiscal consolidation programme has been slightly larger than the average OECD country (see Figure 4). In reality, this has meant that the UK's overall spending has remained flat in real terms. Spending has only fallen in comparison to what was planned at the 2008 Budget. This has been an essential restraint in public spending, considering the UK's fiscal position was on some measures the worst among all OECD countries.

It is important to note that countries such as Ireland have experienced a much larger fiscal consolidation, which has amounted to around 2 ½ times the UK's as a % of GDP (see Figure 4). As a result, since 2010, Ireland's debt to GDP ratio has actually fallen from 86.3% of GDP to just 75.4% of GDP, while the UK's ratio has risen from 76% of GDP to 89.3%, according to Trading Economics. This was a point made by the former permanent secretary to the Treasury Sir Nicholas Macpherson a few weeks ago.

Despite having a larger fiscal consolidation than the UK, from 2010 – 2015 Ireland has experienced a larger fall in its deficit, a larger proportionate fall in unemployment and marginally better wage growth than the UK (see Table 1). This counteracts the narrative that a higher level of austerity leads to economically harmful outcomes. Instead, austerity should be viewed as a necessary adjustment for those OECD countries whose Governments were living well beyond their means after the financial crisis.

Table 1: Change in UK and Irish economic indicators (2010 – 2015)

	FISCAL CONSOLIDATION PROGRAMME*	PERCENTAGE POINT FALL IN DEFICIT**	PERCENTAGE POINT FALL IN UNEMPLOYMENT	% CHANGE IN REAL WAGES
UNITED KINGDOM	6% of GDP	5.1	2.49	-2.63
IRELAND	17% of GDP	9.85	4.45	-0.82

Note: The UK's fiscal consolidation from 2010 – 2015 comprised of 76% spending consolidation and 24% tax rises [See Budget 2011]. Ireland's fiscal consolidation from 2011 – 2014 comprised of 66.7% spending cuts and 33.3% tax rises [See Ireland's National Recovery Plan 2011 to 2014].

**Figures are from 2009 – 2015 (see Figure 4).*

***Figures exclude bank interventions.*

Moreover, when examining OECD countries that were left with a large budget deficit in 2010 (those countries with a deficit of over 5% of GDP in 2010), it appears that there is a strong correlation between those countries that cut spending by a higher degree, on average, and countries which achieved a larger reduction in deficit, higher average growth rates, a larger fall in proportionate unemployment and marginally better wage growth (see Figures 5, 6, 7 and 8). Of course, correlation does not necessarily mean causation. However, this provides strong evidence that there is no link between austerity and lower growth, higher unemployment and weaker wage growth.

Figure 5: Reduction in government spending vs deficit reduction for OECD countries with deficit higher than 5% of GDP in 2010

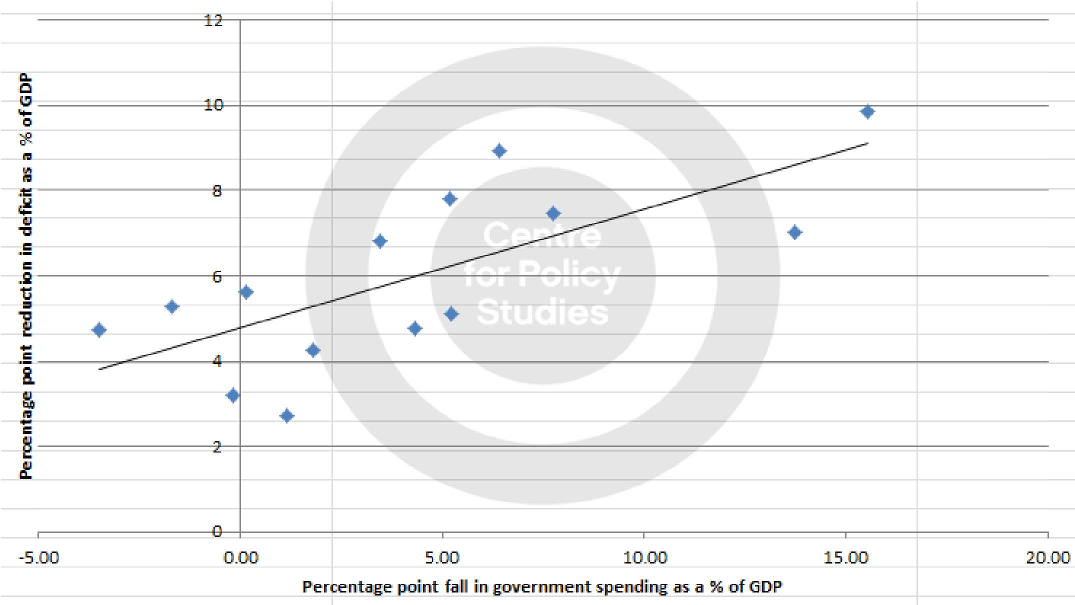
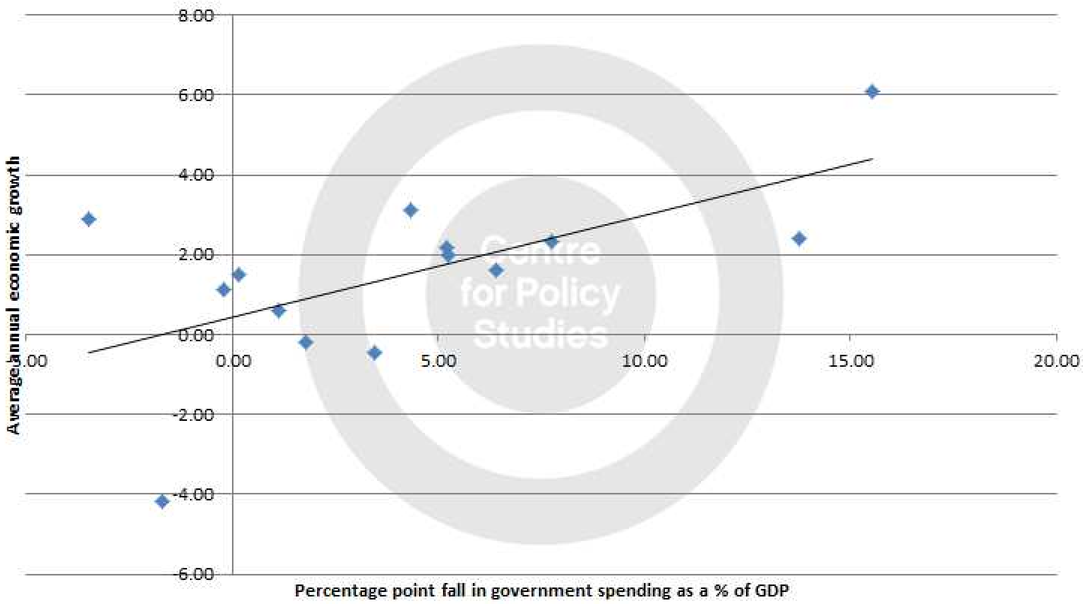
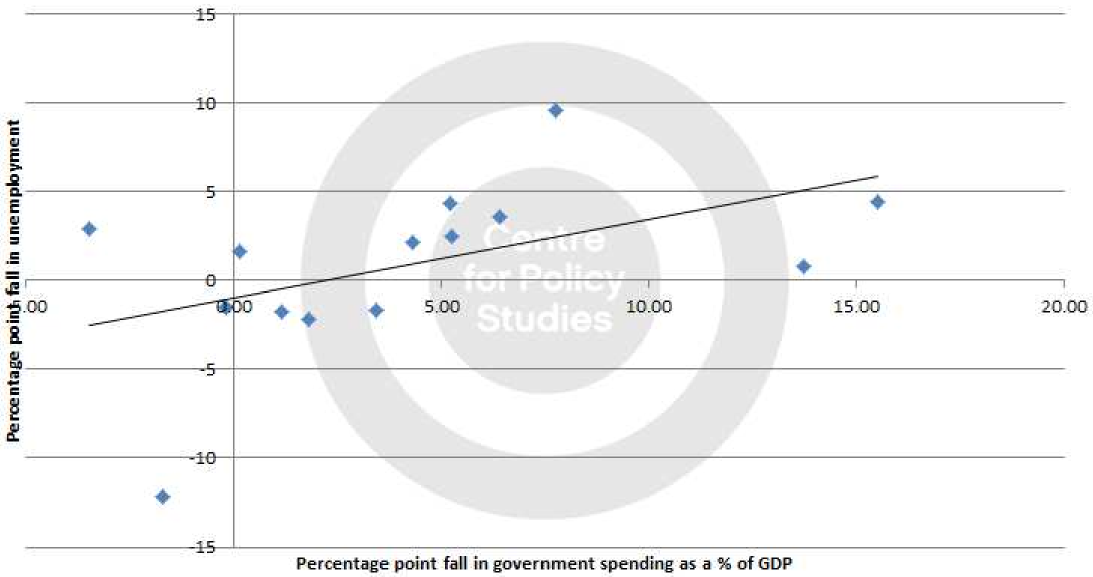


Figure 6: Reduction in government spending vs average economic growth for OECD countries with deficit higher than 5% of GDP in 2010

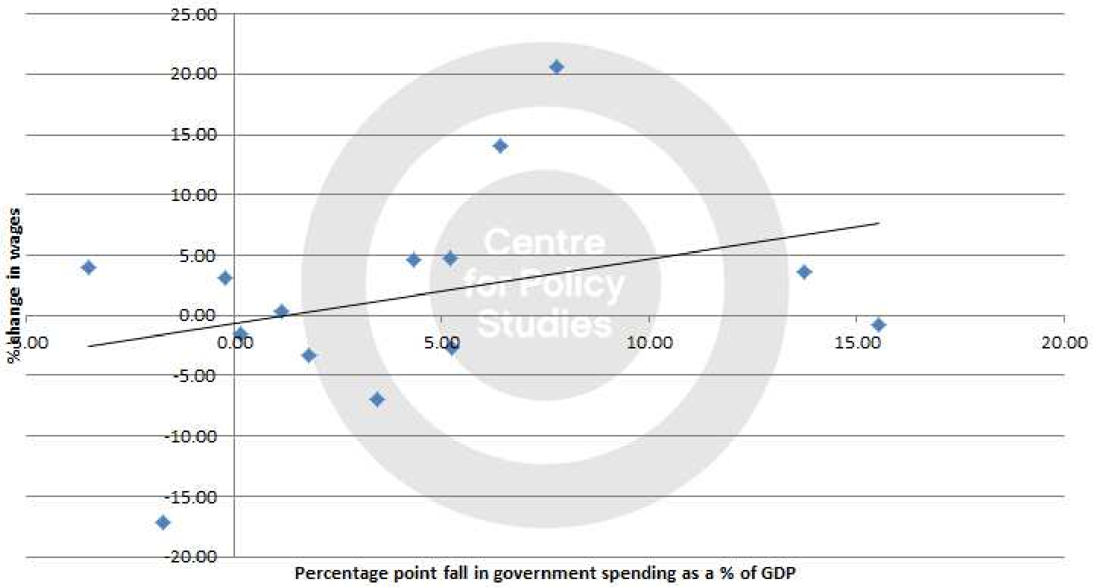


Click here to sign up to the CPS newsletter

<u>*Figure 7: Reduction in government spending vs fall in unemployment for OECD countries with deficit higher than 5% of GDP in 2010*</u>



<u>*Figure 8: Reduction in government spending vs wage growth for OECD countries with a deficit higher than 5% of GDP in 2010*</u>



Note: Data comes from the OECD. Full tables can be found at the Annex of this economic bulletin.

Note: These datasets examine the period 2010 to 2015

Click <u>here</u> to sign up to the CPS newsletter

The UK's deficit reduction plan has been successful in many ways. The UK required a credible fiscal consolidation plan to ensure that the UK's borrowing could be financed and this was achieved. Moreover the budget deficit is down by over two thirds as a proportion of GDP since 2010. Yet there have been some problems in implementation. The first is that the ring-fencing of some government departments has led to perverse outcomes. Moreover, the way welfare reform has been carried out would appear to be unsustainable in the long run. While most of the savings in working age benefits have been necessary, pensioner benefits have been effectively ring-fenced during this period.

The UK's fiscal consolidation programme will be analysed by Daniel Mahoney of the CPS in a report that is due out in September of this year. It will form part of a series of essays from other Anglosphere countries.

6. WHAT SHOULD HAPPEN TO PUBLIC SECTOR PAY?

Prior to the 2017 election, the IFS claimed that increasing public sector pay in line with inflation will cost £5.3bn per year compared to current plans. There might be a case for somewhat easing the 1% pay cap on public sector pay or increasing spending in some government departments, but raising taxes or increasing the UK's budget deficit to do so would be undesirable. Even John Maynard Keynes argued that austerity should be used at the top of the business cycle, and it is vital that the UK's budget deficit continues on a downward trajectory so that Britain is in a good position to deal with any future economic crisis. In fact, the UK's budget deficit reduction programme is already very modest and the UK's tax burden is already set to climb to its highest level in four decades by 2025. The only responsible way would be to re-gear government priorities by, for example, making savings in areas that have recently seen large increases in spending such as the international aid budget and pensioner benefits. However, this does not seem to be on the cards.

Another possible way out for the Government could be to further extend regional pay. There is already some regional pay, with, for example, there being a London weighting for NHS staff (20% weighting for inner London, 15% weighting for outer London and a 5% weighting for the fringe of London). However, there is no difference in pay rates between other regions of England despite huge differentials in the cost of living. For example, in the North East the average house price is £124,000 against an average house price of £319,000 in the South East.

Daniel Mahoney and Tim Knox

DISCLAIMER: The views set out in the 'Economic Bulletin' are those of the individual authors only and should not be taken to represent a corporate view of the Centre for Policy Studies.

ANNEX

Changes in economic indicators from 2010 to 2015 for the OECD countries with a budget deficit of more than 5% of GDP in 2010.

	PERCENTAGE POINT REDUCTION IN GOVERNMENT SPENDING (% OF GDP)	PERCENTAGE POINT FALL IN BUDGET DEFICIT (% OF GDP)	AVERAGE ANNUAL ECONOMIC GROWTH (%)	PERCENTAGE POINT FALL IN UNEMPLOYMENT	CHANGE IN REAL WAGES (%)
FRANCE	-0.20	3.2	1.12	-1.49	3.09
GREECE	-1.70	5.27	-4.17	-12.18	-17.15
ICELAND	6.42	8.92	1.62	3.58	14.10
IRELAND*	15.53	9.85	6.10	4.45	-0.82
JAPAN	0.14	5.64	1.50	1.67	-1.57
LATVIA	7.76	7.46	2.34	9.6	20.61
NEW ZEALAND	13.76	7.01	2.41	0.8	3.55
POLAND	4.32	4.77	3.13	2.14	4.66
PORTUGAL	3.45	6.81	-0.44	-1.67	-6.93
SLOVAK REPUBLIC	-3.50	4.74	2.90	2.9	4.03
SLOVENIA	1.14	2.72	0.59	-1.72	0.31
SPAIN	1.80	4.25	-0.18	-2.2	-3.30
UNITED KINGDOM	5.24	5.1	1.99	2.49	-2.63
UNITED STATES	5.20	7.79	2.17	4.33	4.70

**Note: Ireland's figures for 2010 exclude bank interventions, which accounted for 20.3% of GDP in 2010.*