PROMOTING
GROWTH AND
SHARED PROSPERITY
IN THE UK

IPPR

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STATEMENT
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GEORGE OSBORNE PERFORMS A U-TURN BUT NOT ON THE ISSUE THAT MATTERS

BRIEFING

Tony Dolphin

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ABOUT THE AUTHOR

Tony Dolphin is senior economist and associate director for economic policy at IPPR.

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IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

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IDEAS to
CHANGE OPINIONS

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Eighteen months ago, George Osborne set out the Coalition government's approach to economic policy. Deficit reduction was the priority for government. If it was delivered, he argued, growth and new jobs would be generated in the private sector. The government could help the private sector only by getting out of its way: by cutting corporation tax rates and axing regulations.

With the economy having expanded by just 0.5 per cent over the last year and unemployment at its highest rate since 1996, this approach is no longer sustainable politically. The government has to be seen to be doing something more positive to support the economy, hence the raft of announcements – on infrastructure, youth unemployment, housing and credit easing – that preceded the autumn statement.

This change of heart is welcome and the new measures are well-targeted at some of the current weaknesses in the UK economy. However, the chancellor has stuck rigidly to his Plan A for deficit reduction. Rather than increase government spending (or cut taxes) to tackle the economy's problems, he has had to find alternative solutions. In some cases, this means he is saving money in one place to spend more in another; in others, the solutions will only be delivered slowly. As a result, he is not tackling directly the most urgent problem facing the economy: a shortage of aggregate demand.

His argument is that to do so – by altering his medium-term fiscal plans and setting a slower path for deficit-reduction path – would risk losing the confidence of investors in bond markets. The result would be higher interest rates, which would damage economic growth and more than offset any benefits from extra government spending or lower taxes. This claim is fiercely disputed by his critics, who argue that the bigger risk is not supporting the economy at a time when household and business confidence is depressed and the effects of the eurozone crisis are about to be felt in the UK.

The latest economic indicators offer more support for the chancellor's opponents than for the chancellor. They suggest private sector spending is unlikely to expand in coming months, leaving the economy teetering on the brink of a return to recession and unemployment likely to increase further. The OECD's latest forecasts, released just one day before the autumn statement, show the UK economy falling back into recession, with real GDP contracting at an annual rate of 0.1 per cent in the final quarter of 2011 and of 0.6 per cent in the first quarter of 2012.[1]

Economic outlook

The autumn statement is accompanied by the latest forecasts from the independent Office for Budget Responsibility (OBR). These are unremitting bad news for the chancellor.

Growth is expected to be significantly lower than previously forecast in both 2011 and 2012. The economy is not forecast to grow at all between Q3 2011 and Q1 2012, coming as close as it is possible to get to falling into recession without actually doing so. On the basis of the latest forecasts, output will not return to its pre-recession peak until the first quarter of 2014, making this the deepest recession and slowest recovery in the last 100 years. As a result, unemployment in 2013 will still be 8.6 per cent, compared to 5.2 per cent at the end of 2007. In 17 months, the forecast for unemployment in 2013 has increased from 6.8 per cent in the OBR's first forecast, made ahead of the June 2010 budget, to 8.6 per cent.

1 http://www.oecd.org/dataoecd/46/43/49113691.pdf

Table 1
OBR real GDP growth forecasts (%)

	2011	2012	2013	2014	2015
June 2010 pre-budget	2.6	2.8	2.8	2.6	
March 2011 budget	1.7	2.5	2.9	2.9	2.8
Nov 2011 autumn statement	0.9	0.7	2.1	2.7	3.0

Table 2
OBR unemployment rate forecasts (%)

	2011	2012	2013	2014	2015
June 2010 pre-budget	7.9	7.4	6.8	6.3	
March 2011 budget	8.2	8.1	7.6	7.0	6.4
Nov 2011 autumn statement	8.1	8.7	8.6	8.0	7.2

For the chancellor, the OBR's forecasts of the 'output gap' are crucial to the fiscal arithmetic. The output gap is an estimate of the difference between actual GDP and potential GDP (when the economy's resources were fully employed). It is used to calculate how much of the budget deficit will disappear as the economy fully recovers from recession and how much will only be eliminated by discretionary measures (spending cuts and tax increases). The OBR has reduced its estimate of the output gap since the March budget, so it thinks more of the deficit will have to be eliminated through discretionary measures.

Table 3
OBR output gap forecasts (%)

	2011	2012	2013	2014	2015
June 2010 pre-budget*	-3.1	-2.4	-1.9	-1.4	
March 2011 budget	-3.9	-3.6	-3.0	-2.2	-1.4
Nov 2011 autumn statement	-2.7	-3.1	-2.9	-2.4	-1.7

*Forecasts for financial years 2011/12, 2012/13, 2013/14 and 2014/15

Fiscal outlook

Weaker growth means that the outlook for the budget deficit has also deteriorated. Economists focus on two measures of the deficit – overall public sector net borrowing and the cyclically-adjusted current deficit[2] – as well as on the overall level of debt. The chancellor has set himself fiscal objectives for two of these measures:

1. To achieve a cyclically-adjusted current balance by the end of the rolling, five-year forecast period
2. To have public sector net debt (as a percentage of GDP) falling by 2015/16.

At the time of the March 2011 budget, the OBR judged that he was on course to achieve both of the objectives one year early (that is, in 2014/15). Its latest forecasts show this is no longer the case. The cyclically-adjusted current balance only moves into surplus in 2016/17 and net debt starts to fall in 2015/16. The chancellor is only still on course to achieve his first objective because the end of the five-year period has been rolled forward from 2015/16.[3]

2 The deficit that requires discretionary measures to eliminate it.
3 A cynic might point out that by setting himself a rolling, five-year target the chancellor never actually has to achieve a cyclically-adjusted current balance, he only has to appear to be on course to do so.

There are two important implications of these forecasts. First, more deficit reduction will be required in the first two years of the next parliament. Previously, the chancellor had created a bit of room for a pre-election giveaway in March 2015; that has now disappeared. The next election, rather than being fought over how to spend the benefits of growth, will be fought over where spending should be cut, with implications for all parties.

Second, there is virtually no more room to manoeuvre on the debt rule. Any future upgrading of borrowing for 2015/16 – whether cyclical or structural – will have to be offset by discretionary fiscal tightening. This is very important. If the eurozone crisis deepens, leading the OBR to further downgrade its growth forecasts for 2012 and 2013 and to increase its borrowing forecasts over the next five years, then it will also be forecasting an increase in debt after 2014/15. Unless, the chancellor is prepared to relax his second rule, he will have to cut spending or increase taxes more than currently planned to get back on track. In other words, from here on fiscal policy will be pro-cyclical: weaker growth will lead to fiscal tightening.

Table 4
Cyclically-adjusted current balance (% of GDP)

	2011 /12	2012 /13	2013 /14	2014 /15	2015 /16	2016 /17
June 2010 pre-budget	-4.2	-3.1	-2.3	-1.6		
March 2011 budget	-3.2	-2.0	-0.6	0.4	0.8	
Nov 11 autumn statement	-4.6	-3.9	-2.7	-1.6	-0.5	0.5

Table 5
Net public debt (in March, % of GDP)

	2011 /12	2012 /13	2013 /14	2014 /15	2015 /16
June 2010 pre-budget	68.2	71.8	73.7	74.4	
March 2011 budget	66.1	69.7	70.9	70.5	69.1
Nov 2011 autumn statement	67.5	73.3	76.6	78.0	77.7

In aggregate, public sector net borrowing is expected to total £111 billion more over the five years 2011/12–2015/16 than was expected in March. This makes the chancellor vulnerable to the accusation that not only is his plan not working in terms of supporting growth and reducing unemployment, it is not even working in terms of reducing government borrowing.

Table 6
Public sector net borrowing (£ billion)

	2011 /12	2012 /13	2013 /14	2014 /15	2015 /16
June 2010 pre-budget	127	106	85	71	
March 2011 budget	122	101	70	46	29
Nov 2011 autumn statement	127	120	100	79	53

Table 7
Public sector net borrowing (% of GDP)

	2011 /12	2012 /13	2013 /14	2014 /15	2015 /16
June 2010 pre-budget	8.3	6.6	5.0	3.9	
March 2011 budget	7.9	6.2	4.1	2.5	1.5
Nov 2011 autumn statement	8.4	7.6	6.0	4.5	2.9

Bond markets

Throughout the last 18 months, the chancellor's fiscal plans have been framed by the expected response of bond markets. His oft-expressed view is that not cutting the deficit as fast as he is doing would make the UK less attractive to bond investors, risk the UK's AAA credit rating, and lead to higher interest rates. Events in parts of the eurozone and the current level of gilt yields in the UK – at around 2.25 per cent, close to their historical low – would appear to support his argument.

However, it is not so simple. Japan has a far higher level of public debt than the UK, and has done for many years, yet it has even lower bond yields. The US has a deficit that is around the same size, as a percentage of GDP, as that of the UK, it has two branches of government that cannot agree on even the basics of a medium-term deficit reduction plan, and it lost its AAA credit rating in the summer – yet it too has lower bond yields.

Bond yields are not determined by the size of a government's deficit (or the level of its debt) alone. They also depend on the level of demand for bonds, the outlook for growth and inflation, the level of short-term interest rates, and the degree of risk aversion in financial markets. The fall in bond yields in the UK this year is largely the result of continual downgrades to the outlook for growth, resulting in delayed expectations of increases in short-term interest rates.

If the government had no deficit reduction plan, yields would undoubtedly be higher. If it had started with a plan that reduced the deficit more slowly – say over six years rather than four – yields would probably be little different from current levels now.

Pre-announcements

Ahead of the autumn statement, each member of the so-called 'quad' – the government's decision-making group on economic matters – got to announce a policy initiative.

The Treasury chief secretary Danny Alexander outlined a £30 billion **National Infrastructure Plan**. This includes an immediate increase in government infrastructure spending of £5 billion over the next five years with a further £5 billion in the following five (although, as there are no spending plans for this period talk of 'extra' money is rather meaningless). In the short term, funds will come from within existing budgets where there is underspending[4] and from that old favourite: a crack-down on tax avoidance. In the longer term, it is hoped that private pension funds, and possibly China or other overseas investors, will invest £20 billion more in infrastructure. Some pension funds are said to be keen, but there are insufficient details about how the plan will work to be able to assess its likelihood of succeeding.

This is a step in the right direction, but only a small one. The £30 billion figure is eye-catching, but the spending will be spread over a decade. The immediate boost to aggregate demand in the economy is tiny and there is, as yet, no firm commitment from pension funds. It would have been better to announce an immediate £5 billion increase in infrastructure spending in 2011/12, rising to £10 billion in 2012/13. This could have gone into much-needed social housing and transport projects and created thousands of construction jobs.

The deputy prime minister Nick Clegg announced £1 billion of new funding aimed at alleviating the plight of **young unemployed people**. The money will be spent – over three

4 Switching resources from current to capital spending helps the chancellor achieve his first fiscal objective, though it has no effect on the aggregate debt level.

years – on subsidising 160,000 jobs, providing even more apprenticeships and funding 250,000 work experience placements. It is similar to the Labour government's Future Jobs Fund, except the Coalition hopes that by supporting temporary jobs in the private sector it is more likely to lead to a permanent job.

The basic idea – to give young people some experience of work and a stronger CV – is a good one, but the means of delivery are uncertain. The risk in the current climate, when firms are reluctant to recruit additional staff, is that there are insufficient opportunities available. It would have been better for the government to have introduced a job guarantee for all young people who have been out of work for more than a year – this group now numbers more than a quarter of a million. In being guaranteed a job, paid at the minimum wage or above, young people would be obliged to take up the offer or to find an alternative that does not involve claiming jobseekers' allowance.

The prime minister David Cameron set out what the government hopes to do to tackle some of the problems facing the **housing market**. This includes a mortgage indemnity scheme, which will allow buyers (mainly first-time buyers) to obtain mortgages for up to 95 per cent of the value of a newly-built home with the government underwriting part of the risk to lenders. It is hoped that this will encourage developers to build more houses, though critics have suggested it will only do so by distorting the housing market and enabling them to charge more for new homes. The prime minister also announced a £400 million 'Get Britain Building' fund to unblock stalled developments, and up to £150 million to bring empty houses back into use.

There are good grounds for making extra money for house-building a key element of efforts to boost growth. OBR estimates show that capital spending, and house-building in particular, have the largest 'multiplier effects'. That is, the government gets a bigger return, in terms of extra GDP, for every £1 million spent, than from other spending measures or tax cuts. However, the sums involved are small and will not be enough to lift the extent of house-building even close to the level needed to bring supply into line with demand.

The chancellor gave some details of how the new policy of **credit easing** would work. This scheme will underwrite £20 billion (potentially increasing to £40 billion) of bank lending to small and medium-sized businesses (those with a turnover of less than £50 million a year) in the UK.

The basic idea is a good one: banks will be more willing to lend to small businesses, and at lower rates, if there is a government guarantee. If it works – and it does require the co-operation of the banks – this should ease the credit constraints facing the small business sector and allow it to expand and take on more employees than would otherwise be the case.

Announcements

Other measures announced in the autumn statement include:

- a delay in the 3p increase in fuel duty scheduled for 1 January
- regulated rail fares to increase by inflation plus 1 per cent, not inflation plus 3 per cent
- a doubling of free childcare places for two-year-olds from the poorest families to 260,000
- an increase in the bank levy from 0.078 per cent to 0.088 per cent because it is not bringing in as much revenue as expected
- a cut in the overseas aid budget so that it does not rise above 0.7 per cent of GDP

- further wage restraint for the public sector
- an increase in the state pension age from 66 to 67 with effect from 2026
- cancellation of the indexation of some elements of the working tax credit.

The prospect of higher fuel duties and train fares in the New Year has attracted much criticism in recent weeks, so the chancellor could be accused of pandering to public opinion by deciding to delay the fuel duty increase and moderate the rise in rail fares. He might counter that these measures are designed to ease the squeeze on working families – something his opponents have urged him to do. However, his case is weakened by the fact that these measures appear to have been funded, in part, by extra savings from working tax credits.

The increase in free childcare places for two-year-olds is a welcome move that will help some parents get back into the workforce sooner. It should be a first step towards a system of universal childcare for preschool children. IPPR analysis to be published shortly shows that free childcare pays for itself through the extra taxes and national insurance contributions it generates.

The cut in aid spending is a consequence of the lower growth forecasts. The government still plans to increase spending to 0.7 per cent of GDP, but now that GDP is expected to be lower, this represents a smaller nominal amount – hence the cut.

Final thoughts

This was more like a mini-budget than an autumn statement.

The likelihood that the OBR's forecasts – and particularly its downgrading of the growth outlook – would dominate headlines following the autumn statement caused the government to preannounce a series of measures designed to support growth. The aim, no doubt, was to give the impression that the government had a 'plan for growth' as well as a 'plan for deficit reduction'.

However, it is not enough to agree a number of measures – even if some of them are welcome U-turns from the government's previous position – and call them a 'plan for growth'. A real plan for growth should start by identifying what is needed for the economy to grow. In the medium term, that means increased supplies of capital, labour and land, and better ways of utilising them.

But in the short term it means generating additional demand. With our main export market heading into recession and household and business confidence low, only the government is in a position to provide this extra demand. However, this would mean relaxing the pace of deficit reduction; that was a U-turn that the chancellor was not prepared to make on this occasion.

It remains to be seen whether the chancellor will take the same approach if the growth outlook continues to worsen next year. On the current rules, any further increase in the borrowing forecasts – whatever its cause – will necessitate spending cuts or tax increases, otherwise debt will not be falling by 2015/16. Will the chancellor be prepared to tighten fiscal policy as the economy deteriorates? If the eurozone crisis escalates, we may find out in March.

Annex: A brief history of OBR forecasts