Section 2 Commentary

Chapter 1

Economic prospects and public expenditure

Introduction

These are difficult times. Not only are national and international economic prospects limited – they are highly uncertain not least in respect of the unresolved issues about the very high levels of debt carried by some European governments, and the associated risks to the banks that have funded those debts.

UK economic forecasts have tumbled over the year, and the government has had to acknowledge that even with the expenditure plans it set out in 2010 (see 2010/11 edition of the *Review*) it will take longer than it planned to bring down levels of UK borrowing.

The focus of this chapter is first on the revised prospects for the UK economy, and the measures announced by the government in the 2011 Autumn Statement. It then returns to the case, which will be familiar to regular readers of the *Review*, for the UK to adopt international spending rules, rather than the unique UK conventions. It is argued that these conventions unnecessarily constrain the opportunities for public sector financial and trading activities to support the wider economy and housing market.

Economic prospects

The revised lower forecasts for UK economic growth are set out in Table 2.1.1. The extent of their downward revision can be seen by comparing the figures with the forecast made at the time of the 2011 Budget that are set out in Compendium Table 11.

While the more limited prospects for exports are an important factor in the revised forecasts, they are not the only one. Investment in private dwellings is now forecast to decline in 2011, and grow far more slowly in 2012. Household consumption is also now forecast to decline in 2011, and grow far more slowly in both 2012 and 2013.

It is already the case that the current economic downturn is more severe than both the 1980 and 1990 downturns (see Figure 2.1.1). The latest forecasts from the

Table 2.1.1 **Office for Budget Responsibility Autumn Statement Economic Forecast**

Percentage change on a year earlier (unless otherwise stated)

	2009	2010	2011	2012	2013	2014	2015	2016
	outturn		forecasts					
Gross Domestic Product at constant prices	- 4.9	1.8	0.9	0.7	2.1	2.7	3.0	3.0
Expenditure components of GDP								
Domestic Demand	- 5.5	2.7	- 0.5	0.3	1.5	2.4	2.8	2.9
Household consumption[1]	- 3.2	1.1	- 1.1	0.2	1.2	2.2	2.7	2.9
General government consumption	1.0	1.5	2.2	- 0.1	- 1.6	- 2.3	- 3.2	- 3.5
Fixed Investment	- 15.4	2.6	- 2.1	3.5	7.4	8.5	10.0	9.5
Business	- 18.9	0.8	- 0.8	7.7	8.9	9.4	12.6	12.4
General government	16.9	2.8	- 6.8	- 9.4	- 4.2	- 0.1	- 1.1	- 2.3
Private dwellings	- 25.5	6.4	- 1.5	2.5	9.9	10.5	9.0	7.5
Exports of goods and services	- 10.1	6.2	4.0	3.1	5.8	5.6	5.4	5.1
Imports of goods and services	- 11.9	8.5	0.1	1.8	3.8	4.4	4.6	4.7
Inflation CPI Q4	2.2	3.3	4.5	2.7	2.1	2.0	2.0	2.0
Labour market								
Employment (millions)	29.0	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Wages and salaries	- 0.1	1.9	1.4	1.8	3.5	5.1	5.5	5.6
Average earnings[2]	1.8	2.1	0.9	2.0	3.1	4.3	4.5	4.5
ILO unemployment (percentage)	7.6	7.9	8.1	8.7	8.6	8.0	7.2	6.2
Claimant count (Q4 millions)	1.53	1.50	1.54	1.75	1.77	1.67	1.45	1.23
Household sector								
Real household disposable income	1.1	0.1	- 2.3	- 0.3	0.9	2.0	2.5	2.5
Savings ratio (level, percentage)	6.0	7.5	6.7	6.5	6.2	6.1	6.0	5.7
House prices	- 7.8	7.2	- 0.9	- 0.2	1.9	4.3	4.5	4.5
Fiscal aggregates (Percentage of GDP)[3]								
Public sector net borrowing	11.2	9.3	8.4	7.6	6.0	4.5	2.9	1.2
Public sector net debt	52.9	60.5	67.5	73.3	76.6	78.0	77.7	75.8
General government net borrowing[4]	11.6	9.5	8.4	7.6	6.1	4.6	3.0	1.3
General government gross debt[4]	71.5	76.5	84.2	90.1	93.1	93.9	92.6	89.7

Source: Autumn Statement 2011, HM Treasury

Notes: 1. Includes households and non-profit institutions serving households.
2. Wages and salaries divided by employees.
3. Fiscal aggregates are for the financial year (ie 2009 is 2009/10).
4. General government borrowing and debt measures on a Maastricht basis.

Office for Budget Responsibility (OBR) effectively suggest it will be another three years before the economy returns to its 2008 level. It should, however, be noted that this central OBR forecast is predicated on 'policy makers finding a way through the current crisis over the next two years'.

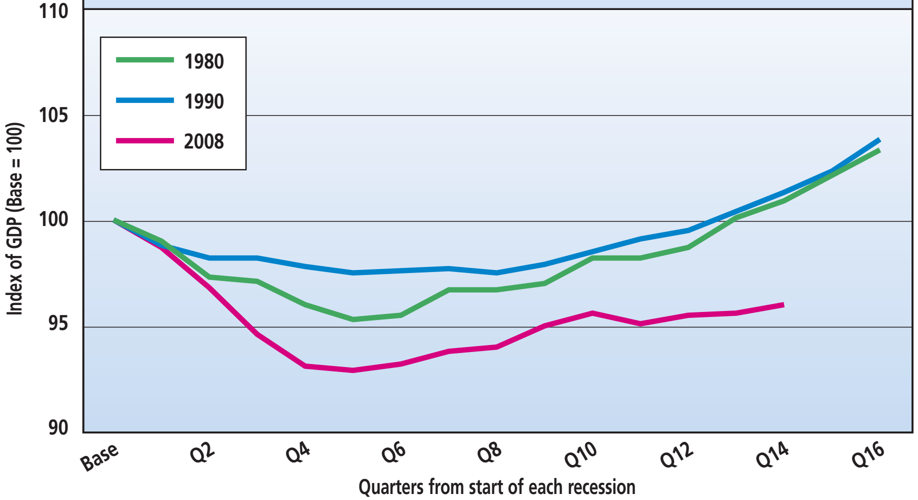
The downside risks to their forecast should that not happen are readily acknowledged, but given the uncertainties about just how the euro crisis might unravel, and how many euro countries that might involve, the OBR (and the Bank of England) have understandably declined to quantify those risks. A fuller assessment of the risks can be found, however, in the latest edition of the *OECD Economic Outlook*.

But as noted above there are domestic as well as international factors at play in the slower than hoped-for rate of UK economic recovery. The government's hopes for private sector growth to offset the cutbacks in the public sector have been dampened both by the reduced prospects for exports and the reduced prospects for household consumption and the housing market.

The depressed housing market is, of course, one of the contributors to the downturn in household consumption. The limited level of borrowing for new investment in private housing, as well as accelerated mortgage repayments by existing owners, saw 'negative equity withdrawal' (i.e. positive net investment) deepen in 2010, to the equivalent of 3.1 per cent of GDP (see Figure 2.1.2). This contrasts with positive levels of equity withdrawal of 6.3 per cent just three years earlier. In other words, there has been a nine per cent swing in households' housing equity withdrawal/ investment over the period, and this is clearly one of the major factors that have dampened levels of household consumption expenditure.

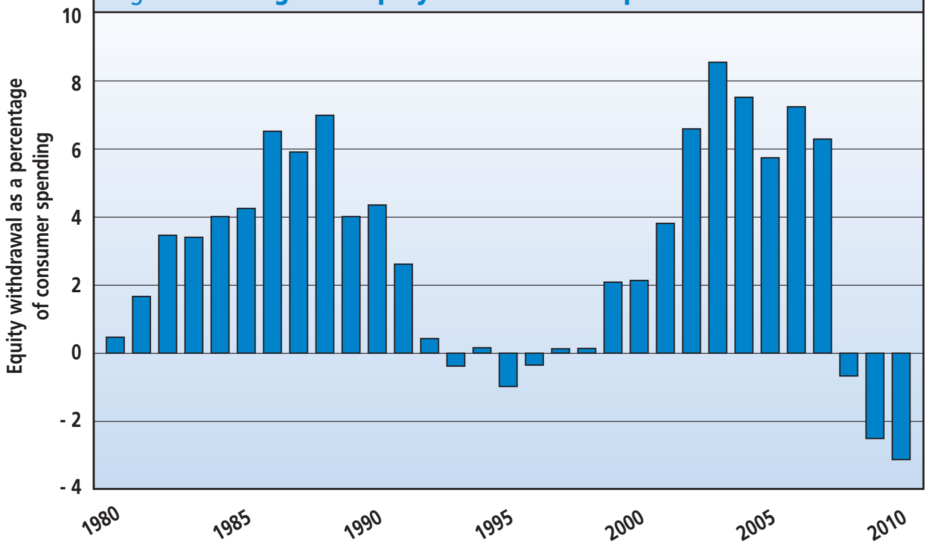
If these disappointments have raised questions about the economic efficacy of the government's strategy in seeking to reduce public spending so rapidly, it has not caused any major rethink of their spending plans. The 2011 Autumn Statement saw the introduction of a number of policies intended to promote economic growth, including a mortgage guarantee scheme to support low-deposit mortgages for new house building (see Commentary Chapter 3). However, while the various measures make far more extensive use of government guarantees, they only add to the

Figure 2.1.1 **Faltering recovery from sharp downturn of credit crunch recession**



Source : Computed from ONS Quarterly GDP data (ABMI)

Figure 2.1.2 **Negative equity withdrawal deepens**



Source : Compendium Table 7.

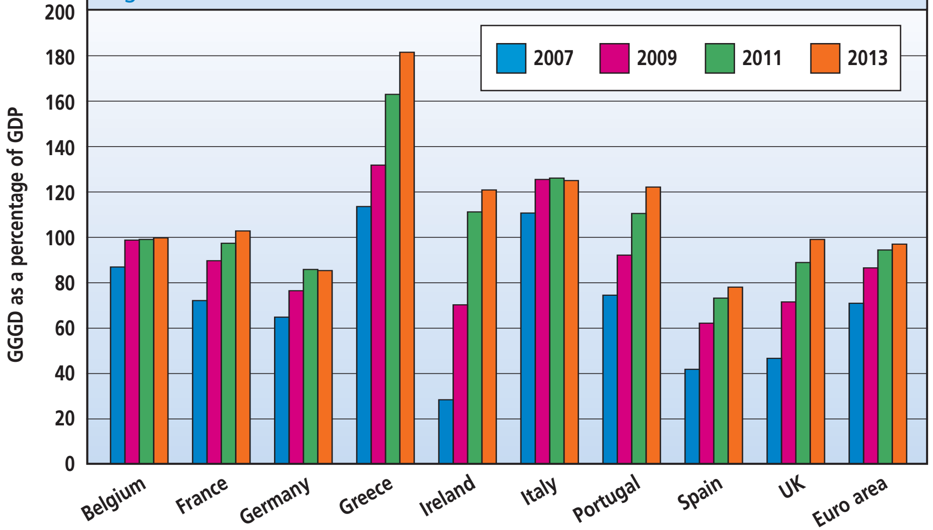
provisions for contingent liabilities to the public sector balance sheet; the private sector borrowing it promotes is off balance sheet.

Moreover, the positive impact of the additional government funding for a wide range of infrastructure projects, while welcome, will be offset by the negative consumption effect of the working tax credit freeze, the CPI-only increases in child tax credits, and the constraints imposed on public sector pay.

The potential net economic stimulus of the Autumn Statement measures will thus predominantly come from the guarantees and other 'off balance sheet' measures intended to promote private sector investment in the infrastructure and new build housing sectors.

This approach reaffirms the government's commitment to reduce the levels of net public sector borrowing (albeit now over a slightly longer timescale), with a view to maintaining the international financial confidence in the UK that underpins the low costs of UK government borrowing.

Figure 2.1.3 **General Government Gross Debt**



Source: OECD Economic Outlook 2011.

The government can rightly claim that the UK credit rating, and access to low-cost borrowing, have been maintained, in stark contrast to the much higher costs of borrowing facing Greece, Italy and other southern European countries. It can, however, be argued that the government has taken an excessively cautious view of the risks to the UK's credit rating, given that UK debt levels remain well below those of the euro countries where higher costs of borrowing are a more critical issue (see Figure 2.1.3).

As can be seen, UK general government gross debt is set to reach the average level for the eurozone countries by 2013, and after a small further increase in 2014 (less than one per cent of GDP) is forecast to start declining by 2015 (see Table 2.1.1). This compares with the much higher debt levels of Ireland, Italy and Portugal where by 2013 debt levels are forecast to exceed 120 per cent of GDP. The unique difficulties for Greece, with its projected debt figure of just over 180 per cent of GDP, are also apparent – albeit that this is still low compared to the 227 per cent of GDP debt level forecast for Japan by 2013. This comparison also implicitly makes the point that market concerns about the security of lending to different countries reflect a view not just on the absolute levels of debt, but also the future financial risks to which countries are exposed, and their capacity to manage their way out of their financial difficulties.

The case for the UK to adopt international spending rules

As is evident from the analysis above, international comparisons of government debt are typically based on measures of 'general government' debt, and not the measures of 'public sector' debt that are the unique pre-occupation of UK governments. Public sector debt includes the debt of 'public corporations' (i.e. government-owned trading bodies), as well as the debts associated with the provision of central and local government services.

Although the UK public sector net debt figure (PSND) is thus wider in its sectoral scope than the general government gross debt (GGGD), it is also a net rather than a gross debt measure. Moreover, the UK government decided to exclude the debts associated with the purchase of its interest in the beleaguered banks from its public sector borrowing and debt measures, taking the view that these were only temporary arrangements. That approach does not, however, accord with international accounting conventions, and those debts are included in the international GGGD measure. For both those reasons the GGGD levels shown in Table 2.1.1 are higher than the PSND levels.

It follows from this that when the time comes for the UK government to dispose of its assets in the UK banking sector this will not only remove the anomaly in UK accounting conventions, but lead to a substantial reduction in the UK GGGD measure. The extent of the reduction will obviously depend on the value of the banking assets when the sales take place, but the costs of the government's 'temporary' interventions are equivalent to some eight per cent of GDP, and even if the asset sales result in a net loss there is still scope for a significant reduction in GGGD that will almost certainly move the UK back to a position where its total debt falls some way below the eurozone average.

The *Review* has regularly made the case for the UK to adopt international fiscal measures based on 'general government', rather than including public corporations. Most recently the case was set out in this chapter in the 2009/10 edition of the *Review*. The international financial markets have no interest in the unique public sector measures used in the UK; they are clearly focused on the international general government measures in common use not just in the eurozone but around the rest of the world.

Adopting those international fiscal measures would enable public corporations to play a far more active role in promoting economic growth at a time when the private sector, and especially the financial sector, is operating in very difficult circumstances. There are two obvious examples in terms of housing policy where switching to international fiscal measures would open the door to a far more active role for local government.

The first opportunity would be to extend the role of local councils either in providing 100 per cent or low-deposit mortgages for first-time buyers, or to provide the guaranteed slice of funding to enable banks or building societies to restore the flow of mortgage finance to households unable to provide a substantial deposit. The government has gone some little way towards this with its scheme backing builders to assist with low-deposit mortgages for newly built housing. Some local councils have also provided similar support for local first-time buyers. But there is much more scope for positive action to restore effective first-time buyer demand in the private housing market (see Commentary Chapter 3 for further details).

A second opportunity would follow on from the current debt restructuring exercise for council housing in England. That exercise will generate a substantial receipt for HM Treasury. This will not reduce debt on the UK PSND measure, as it involves a transfer payment from one arm of the public sector to another. It will, however, reduce debt on the GGGD measure as it will be a payment to central government from the council housing sector, which in accountancy terms is part of the wider public corporate sector.

More importantly, while the debt restructuring exercise removes the constraints and frustrations of the annual HRA subsidy regime from the council housing sector, HM Treasury has imposed caps over the level of borrowing councils can undertake, as this would inevitably count towards the current public-sector-based measures of borrowing and debt. Such borrowing would not, however, count against international general government measures of debt and borrowing. Removing those caps, and permitting the council housing sector to borrow prudentially against its revenue streams, would facilitate a much earlier increase in levels of investment in energy efficiency and other stock improvements (and additions) than will be the case with borrowing caps in place. This potential is already being illustrated in Scotland where the council housing sector has, to date, managed to escape the financial controls imposed in England and Wales (see Commentary Chapter 4).

The opportunities that would flow from freeing up the public corporate sector of course go far wider than those in the housing sphere. In these difficult times it seems perverse to persist with rules that are a barrier to economic recovery in the UK, and serve no purpose in securing confidence in the UK government's fiscal stance.

Key Reading

HM Treasury (2011) *Budget 2011*. HC 836. London: The Stationery Office.

HM Treasury (2011) *Autumn Statement 2011*. Cm 8231. London: The Stationery Office.

HM Treasury (2011) *Public Expenditure Statistical Analyses 2011*. London: HM Treasury (see www.hm-treasury.gov.uk/pespub_pesa11.htm).

OBR (2011) *Office for Budget Responsibility: Economic and fiscal outlook*. Cm 8036. London: The Stationery Office.

OECD (2011) *Economic Outlook No. 90*. Paris: OECD (see http://stats.oecd.org/Index.aspx?DataSetCode=EO90_INTERNET).

A very substantial volume of economic and financial data, and related papers, can now be accessed from the Office for National Statistics website.