Chapter 1

Economic prospects and public expenditure

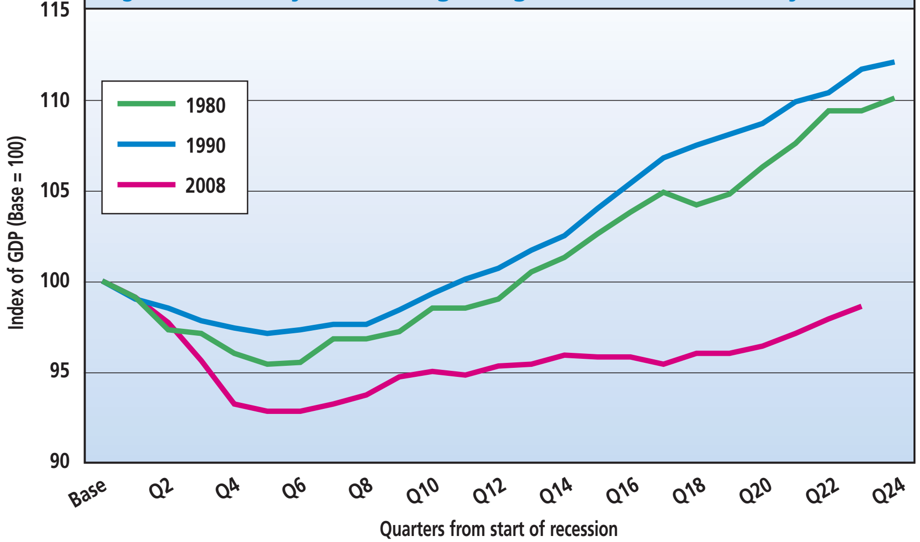
There are at last signs of economic recovery in the UK, albeit that the downturn has been more extended than necessary as a result of the combined impact of the UK and other governments' public spending austerity measures, as outlined in this chapter in last year's edition of the *Review*.

But if the UK economy is beginning to recover, UK public sector debt continues to rise, and the 2013 Spending Review has confirmed the current government's intentions to continue to squeeze public spending through to 2015/16. And while the economic recovery has seen a welcome reduction in levels of unemployment, earnings have continued to fall in real terms.

Economic prospects

The UK economy recovered more rapidly than anticipated in 2013, although at the same time revised economic outturn data showed that the current economic downturn was deeper than previously thought. Nonetheless the 2014 Budget forecast is that the UK economy will now return to pre-downturn levels (as at the beginning of 2008) in 2014 – a year earlier than anticipated in the previous Budget forecast (see Compendium Table 11). Even so the post-2008 downturn will by then have lasted for more than twice as long as the 1980 and 1990 downturns, as well as having been more severe (see Figure 2.1.1).

Figure 2.1.1 **Five years on: beginnings of economic recovery**



Source: Computed from ONS Quarterly GDP data (ABMI).

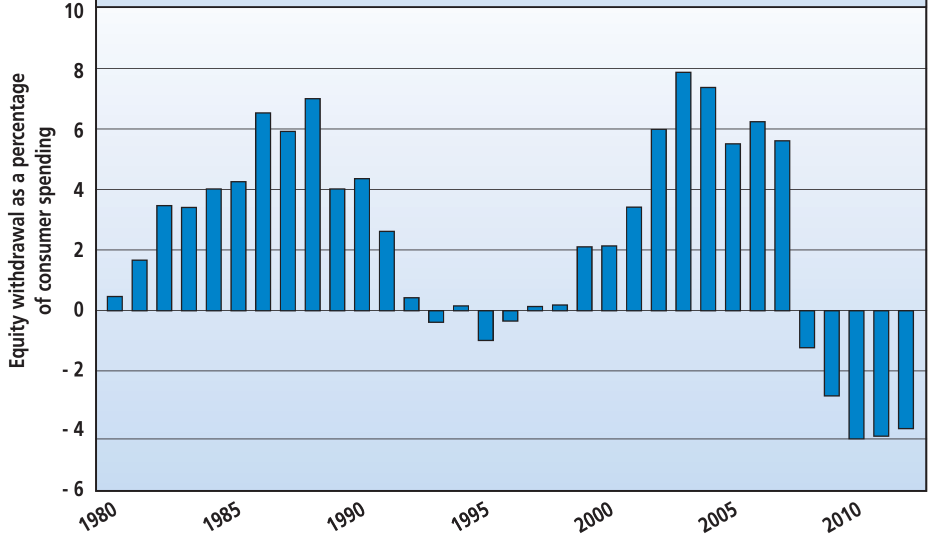
If there are continuing concerns about the potential for economic and debt management policies to unravel in the more challenged European economies, those fears are less pronounced than they were a year ago. Even so, as ever, there remains the potential for UK economic recovery to be derailed by international events, regardless of the wisdom or otherwise of the policies adopted by the UK government.

The Office for Budget Responsibility forecasts 2.3 per cent growth in GDP in 2013/14, rising to 2.6 per cent in 2014/15 with similar levels for the next four years. New private housing investment is expected to grow at 9-10 per cent annually over 2014-17 then fall a little in 2018.

Unemployment (ILO measure) is forecast to fall below seven per cent this year and continue down to 5.4 per cent in 2018. Average earnings are forecast to grow just ahead of inflation on the CPI measure, but equal to or just below it on the RPI measure (see Compendium Table 11). In broad terms the Budget 2014 was fiscally neutral: reductions in taxation more or less matched further cuts in expenditure. In net terms 2018 is now forecast to offer the first (small) positive balance for public borrowing, with a surplus on the current expenditure budget a year earlier.

One factor in the economic recovery in 2013 has been an upturn in the housing market, albeit from a very depressed level (see Commentary Chapter 3). However although house building starts and levels of housing market transactions and mortgage advances began to recover in 2013, there are as yet no signs of any return to positive levels of housing equity withdrawal as a factor underpinning consumer expenditure. 2012 only saw a marginal reduction in levels of 'negative equity withdrawal' as high deposit requirements for new house purchases and accelerated mortgage repayments by existing owners continued (see Figure 2.1.2).

Figure 2.1.2 **Deep negative equity withdrawal continues**



Source: Compendium Table 7.

Spending plans

Despite signs of economic recovery the government reaffirmed its commitment to squeezing public spending in the June 2013 Spending Round, when it set out its departmental expenditure plans to 2015/16 and outline plans to 2017/18 (Table 2.1.1).

Table 2.1.1 **Summary of departmental expenditure plans 2013/14-2017/18**
£bn

	2013/14	2014/15	2015/16	2016/17	2017/18
Current Expenditure	**672.8**	**679.9**	**694.2**	**703.7**	**713.0**
Capital Expenditure	**47.1**	**50.4**	**50.4**	**51.3**	**52.1**
Totally Managed Expenditure (TME)	**720.0**	**730.3**	**744.7**	**754.9**	**765.1**

Source: Table 1.1, Spending Round 2013, HM Treasury.

While this shows a continuing small cash rise in public spending, in real terms it represents a 1.2 per cent overall reduction over the four years to 2017/18. As a proportion of Gross Domestic Product (GDP), public spending was forecast to fall from 45.2 per cent in 2013/14 to just 40.5 per cent in 2017/18.

Within that overall envelope by far the sharpest reductions in Departmental Expenditure Limits (DEL) have been reserved for the Department for Communities and Local Government, with both its Communities and its Local Government budgets reduced by more than half in cash terms between 2010/11 and 2015/16 (see Compendium Table 16).

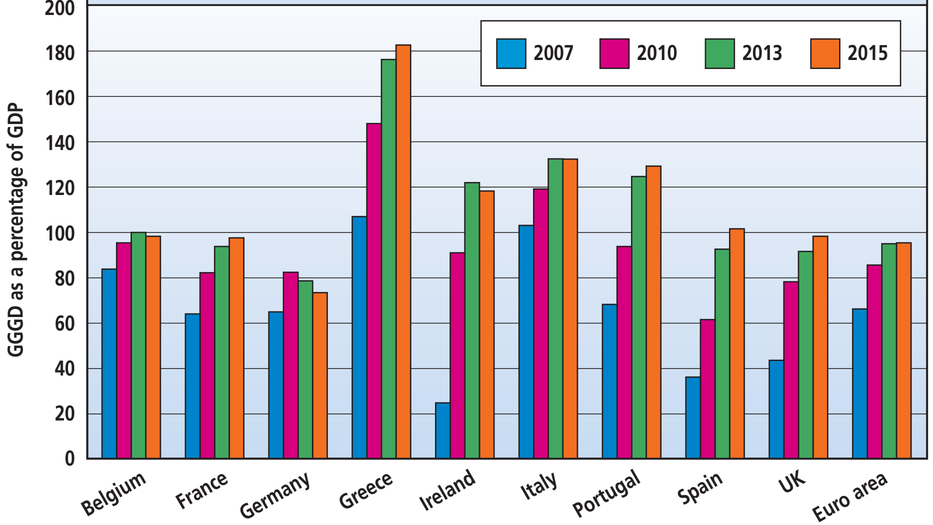
The Spending Round also took forward the 2013 Budget proposal to introduce a cap on future welfare spending from 2015/16. State pensions and the most counter-cyclical elements of welfare, such as jobseeker's allowances or 'passported' expenditures, are to be excluded: but the cap will apply to all other social security and tax credit expenditures.

While there will be a small margin above the cap to ensure that small fluctuations in spending forecasts do not automatically trigger policy action, the cap is nonetheless intended to impose a binding constraint on policy. The Budget 2014 has now set the cap at £119.5 billion in 2015/16, £122.0 billion in 2016/17, £124.6 billion in 2017/18 and £126.7 billion in 2018/19. The cap is somewhat above current levels of spending so will not necessarily require new cuts. However it effectively locks in those already made, leaving little headroom to soften them. It could in time become more problematic as it needs to be uprated for inflation, for population growth and for the increased demands of aging households. Simply exempting state pensions from the cap only goes some way to remove these upward pressures. Including their means-tested benefits in the cap might also indicate that the protection so far afforded to older households is unlikely to extend beyond the next election.

Government debt

The government has argued that it needs to cut public sector spending in order to reduce levels of government borrowing and to retain the confidence of the financial markets. However the impact of the austerity measures in slowing down the economic recovery has itself resulted in annual government deficits greater than those the government had anticipated.

Figure 2.1.3 **General Government Gross Debt**



Source: OECD Economic Outlook 2012.
Note: Maastricht definition of GGGD.

Figure 2.1.3 shows that while well below the levels of Greece, Ireland, Italy and Portugal, UK general government gross debt (GGGD) was forecast by the OECD to slightly exceed the average level for the eurozone countries by 2015. However the latest OBR forecast (Compendium Table 11) suggests that UK GGGD will remain below the EU average, peaking at 93.1 per cent of GDP in 2015/16, and then beginning to ease downwards.

While there is a strong case to be made for the UK to adopt the international conventions in measuring government debt, as has been regularly argued in the *Review*, this would not in itself reduce the levels of government debt. It would, however, permit increased investment by public corporations – which include council housing – without adding to the international general government-based measures of debt and borrowing that are the key indicators for the financial markets.

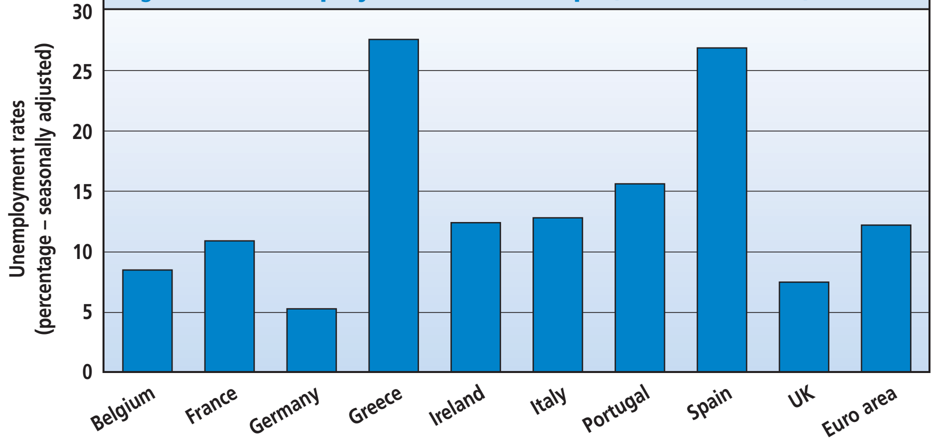
A further anomaly in the UK accounts discussed in last year's *Review* is the separate accounting of the finance used in the bank rescues of 2008-2009. When the UK government comes to dispose of its bank assets this will not only remove this anomaly but will substantially reduce the UK GGGD measure. The extent of the reduction will depend on the value of the banking assets at the time of sale, 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 well below the eurozone average.

Labour market

Levels of unemployment in the UK did not increase as much as might have been feared given the depth of the downturn, and have now begun to fall back from the peak levels of 2012 (see Compendium Tables 4 and 5). They have also remained below the average for the eurozone countries, where Greece and Spain are both suffering from exceptionally high levels of unemployment as they grapple with the even more severe economic downturn in their countries (see Figure 2.1.4).

The economic downturn has, however, also affected those in employment. Both part-time and self-employment have grown relative to full-time employment since 2007 (see Compendium Table 4). The latest figures show close to three in ten of all those in employment working no more than 30 hours a week (see Table 2.1.2).

Figure 2.1.4 **Unemployment across Europe (November 2013)**



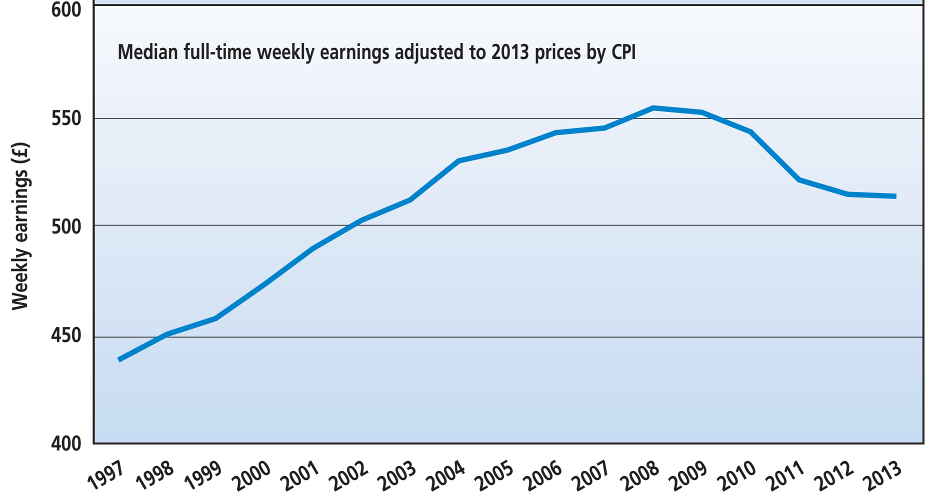
Source: Labour market statistics, ONS; derived from Eurostat.
Note: UK figure for September.

Table 2.1.2 **Usual weekly hours of work**

Hours of work	All	Men	Women
	Percentage of all in employment		
Less than 6 hours	**1.6**	**0.9**	**2.3**
6 up to 15 hours	**6.8**	**3.8**	**10.3**
16 up to 30 hours	**19.9**	**10.1**	**31.2**
31 up to 45 hours	**52.1**	**57.6**	**45.8**
Over 45 hours	**19.6**	**27.5**	**10.5**
Total (thousands)	**30,150**	**16,155**	**13,995**

Source: Labour market statistics, Office for National Statistics.

Figure 2.1.5 **Earnings growth falls below inflation**



Source: Patterns of Pay: Estimates from the Annual Survey of Hours and Earnings UK 1997 to 2013, Office for National Statistics.

Note: Figures adjusted to remove impact of changes to ASHE methodology that have at various points also tended to reduce returns for average earnings.

The proportion of women working no more than 30 hours is far higher – almost 44 per cent. It is also notable at the other end of the scale that almost one in five of those in work do so for over 45 hours a week.

As well as the growth of part-time work and self-employed work (itself often part-time), the UK has also seen real earnings fall in the post-credit-crunch years (see Figure 2.1.5). This shows that by 2013 earnings were some seven per cent lower in real terms than in 2008, and only marginally higher than the level prevailing in 2003.

While the 2014 Budget forecasts now suggest that average earnings will rise slightly relative to CPI, by 2018 those forecast increases would still leave real earnings a little below those in 2008.

Key Reading

HM Treasury (2014) *Budget 2014*. HC 1104. London: The Stationery Office.

HM Treasury (2013) *Public Expenditure, Statistical Analyses 2013. Cm 8663*. London: The Stationery Office.

HM Treasury (2013) *Spending Round 2013*. Cm 8639. London: The Stationery Office.

Office for Budget Responsibility (2014) *Economic and fiscal outlook March 2014*. Cm 8820. London: The Stationery Office.

OECD (2013) *Economic Outlook 94*. Paris: OECD.

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