Section 2 Commentary

Chapter 1

Economic prospects and public expenditure

As the economic recovery continues, the government's spending plans confirm that it intends to move beyond crisis management and towards a permanent reduction in the role of the state. Meanwhile, as the labour market also recovers it is clear that there has been a significant tilting of the balance between full- and part-time employment. Moreover, there has also been a significant squeeze on real earnings.

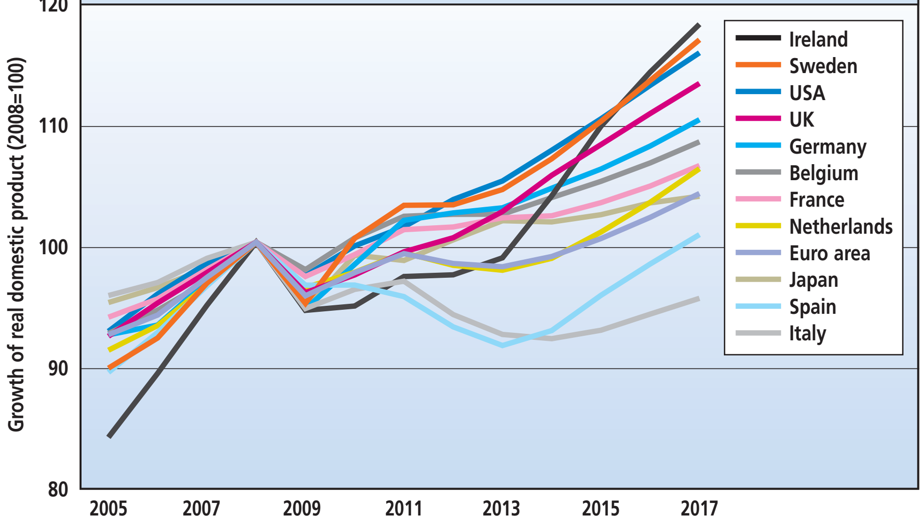
Economic prospects

As last year's *Review* observed, recovery from the 2007-09 recession was slower than after those of the early 1980s and 1990s. That the recovery is firmly established is confirmed across a range of indicators, and the Office for Budget Responsibility (OBR) forecasts that growth will continue throughout this parliament.

The UK economy has now been growing for six consecutive years (see Compendium Table 9). The growth rate of 2.9 per cent in 2014 has not been matched by the 2015 figure, which is expected to fall to 2.4 per cent. Nonetheless the OBR expects growth to continue at around this rate every year up to and including 2020.[1] In 2013, the economy at last grew beyond its pre-recession peak, and, if the OBR forecasts are correct, by the end of this parliament the economy will have become one-fifth larger than it was on the eve of the recession. Moreover, the OBR's forecasts for sustained economic growth are made taking into account that the world economy – and within it China – has slowed.

The UK economy is now 7.5 per cent larger than it was in 2008, whilst the US economy has grown by almost ten per cent since then (see Figure 2.1.1). In contrast the eurozone, which was slower to adopt quantitative easing, has only recently recovered to its 2008 level. Indeed, of the countries covered in Figure 2.1.1, the UK's real GDP was higher in 2015 compared to 2008 than was the case for any of the others apart from the USA, Sweden, and the resurgent Republic of Ireland. Although new quantitative easing has now been ended in the UK, the Bank of England Monetary Policy Committee has retained base rates at the historically low level of 0.5 per cent since 2010, in large part because inflation remains below target which in turn reflects the fall in the world oil price.

Figure 2.1.1 **Trends in real GDP since 2008**



Source: Calculated from Compendium Table 9.

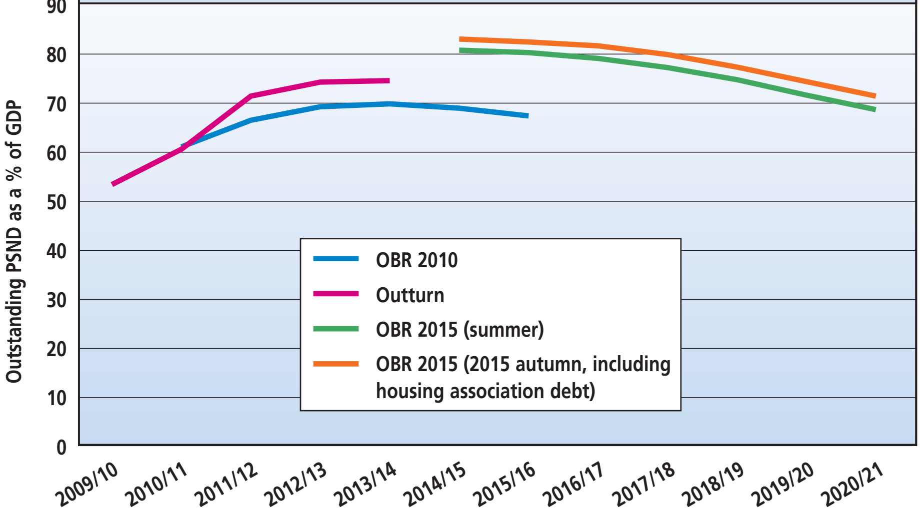
ILO unemployment fell to 5.5 per cent in 2015, although it is forecast to bottom out at a rate marginally lower than this. Employment has risen to record levels (both as a proportion of the working-age population and in absolute numbers), and real earnings may have bottomed out after a long squeeze. Their growth is expected to exceed both RPI and CPI inflation over the forecast period to 2020 (see Compendium Table 11).

Government debt

When deficit reduction was placed at the heart of the Coalition Agreement in 2010, it was justified by the parties as an essential response to the Greek economic crisis and suggested that the UK too would find it difficult to finance its deficit unless it made credible steps to reduce it.

In 2010, OBR forecasts suggested that Public Sector Net Debt (PSND, the UK government's measure of outstanding debt) would peak at 69.7 per cent of GDP in 2013/14 and fall back to 67.2 per cent in 2015/16. As Figure 2.1.2 shows, these

Figure 2.1.2 **Outstanding government debt (Public Sector Net Debt)**



Source: HM Treasury, Spending Review and Autumn Statement 2015, Table 1.2; OBR Economic and Fiscal Outlook, Nov 2010, Table 4.26.

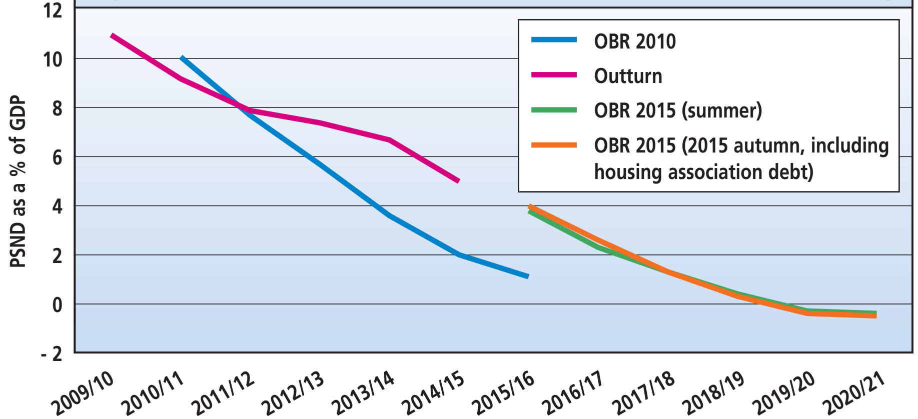
forecasts were overly optimistic because growth rates, especially in 2012, fell behind expectations. By 2014/15, PSND (excluding housing association debt) was more than ten percentage points higher than forecast in 2010. This is now forecast to be the peak year, and by 2020/21 it is expected to fall back to 68.5 per cent – about the same level as the 2010 forecast anticipated would be reached six years earlier.

Figure 2.1.2 also shows the impact of the Office for National Statistics decision to reclassify housing associations as public corporations, so their loans now count within PSND. This rose by £59 billion as a consequence, equating to 3.2 per cent of GDP.[2] The government explanation that this 'is a statistical reclassification which does not affect the underlying performance of the economy'[3] lends support to the *Review's* long-standing view that the UK government should adopt international conventions for measuring debt, whereby the debts of public corporations are kept off the government books. Thus the reclassification of housing association debt makes no difference to the UK's debt when monitored for international purposes, such as the Maastricht Treaty.

As the 2015 edition of the *Review* noted, the UK's level of outstanding debt is slightly lower than the eurozone average, and much lower than some of the 'crisis' countries. In its most recent forecast, the OECD expects the UK's debt in 2017 to be some six percentage points below the eurozone average. Measuring it on the General Government Gross Debt basis, the accepted international measure, gives a higher figure than under PSND: the UK's level of outstanding debt is expected to fall on this basis from 87.5 per cent of GDP in 2014 to 76 per cent in 2020 (Compendium Table 11). This is still some 16 percentage points above the original 'Maastricht' criterion of 60 per cent of GDP.

Outstanding debt represents the accumulation of annual deficits. These peaked in 2009/10 as a consequence of the then government's response to the banking and wider economic crisis. The UK's current deficits became high both historically and by contemporaneous European standards, at least outside the 'crisis' countries (see Compendium Table 10). Figure 2.1.3 reflects the fact that the government's aim to move towards a fiscal surplus has been extended from the lifetime of one parliament to two. In 2010, the OBR forecast that the deficit would be 80 per cent lower in 2014/15 than it had been in 2009/10, but in the event it was 55 per cent lower. So, in 2015, the UK's deficit is almost twice that in the eurozone. The OBR now forecasts that the UK will not move into financial surplus until 2019/20.

Figure 2.1.3 **Annual deficits 2009/10-2020/21 (Public Sector Net Borrowing)**



Source: HM Treasury, Spending Review and Autumn Statement 2015, Table 1.2; OBR Economic and Fiscal Outlook, Nov 2010, Table 4.26.

The new government has set a target of removing the deficit. Also worthy of note is the government's Charter for Budget Responsibility which is intended to bind future governments to running fiscal surpluses, except when there is a severe recession, which is recognised by four consecutive quarters of growth below one per cent of GDP. This approach is consistent with the government's claim that its predecessor had failed to 'fix the roof when the sun was shining', and as a consequence had left the country poorly equipped to deal with the economic crisis. Since no government can bind its successors' hands this protocol is largely symbolic, but is clearly intended to shift the terms of debate in favour of sustained fiscal restraint.

Spending plans

In November, the government's Autumn Statement and Spending Review presented its spending forecasts up to and including 2020/21. The outcome of the Spending Review covers revenue expenditure for the four years 2016/17 to 2019/20, although capital budgets for all departments and revenue budgets for the departments with protected budgets have been set for 2020/21. For reference, tables for resource and capital spending detailed at departmental and devolved administration level are presented at the end of this chapter (see Tables 2.1.3 and 2.1.4).

The government outlined its intention to achieve a budget surplus by 2019/20 in its Summer Budget which followed the general election. In order to meet this target, it estimated that £37 billion of fiscal 'consolidation' would be required. The Chancellor identified the sources of £17 billion of these savings in the Summer Budget. Some £12 billion of the cuts would come from 'welfare' (i.e. social security and tax credits), and a further £5 billion from measures to reduce tax avoidance. This left a gap of £20 billion in savings that would need to be identified following the completion of the Autumn Statement/Spending Review.

The government's defeat in the House of Lords over the cuts to tax credits announced in the Summer Budget caused the Chancellor to reconsider his proposals. His decision, announced in the Autumn Statement, to retract the proposed reduction in thresholds and increased rate of withdrawal through the taper, is expected to cost almost £3.4 billion in 2016/17,[4] but this will decline each year to £0.9 billion in 2019/20 as recipients are transferred to universal credit (see Contemporary Issues Chapter 2). In this regard, the Chancellor was assisted by the OBR's improved forecast for tax receipts, which reduced the overall need for 'consolidation' by £2 billion to £18 billion. A further £6 billion in revenue was identified in the Spending Review (from the apprenticeship levy, improvements in tax administration and further reductions in tax avoidance). This left £12 billion to be identified from departmental budgets.

As in the last parliament, such cuts do not fall evenly because the cost of financing protected groups (notably pensioners), and expenditure commitments (notably the NHS, international development and defence) mean that the savings have to be met from elsewhere. So, although overall 'resource' (i.e. non-capital) departmental expenditure is expected to fall by a cumulative total of about four per cent in real terms over five years,[5] the cumulative real reductions in the budgets of unprotected departments are almost 20 per cent. The cut to the Department for Communities and Local Government is even larger – 29 per cent.

A further twist to the Spending Review is the increase in levels of capital investment, which is expected to be some £16.8 billion higher in 2020/21 than in 2015/16. It should be noted, however, that increases in capital investment are heavily back-end loaded, and that a jump in capital spending is forecast to occur in 2020/21, the year *after* the current Spending Review ends. Capital spending in 2019/20 shows a more modest rise of £5.6 billion over 2015/16. This includes the resources devoted to housing investment, which are discussed in Commentary Chapter 4. Increased investment will be in part counterbalanced by disinvestment of currently publicly-owned assets, notably shares held in RBS and Lloyds Banking Group, and land and property valued at £4.5 billion in public ownership (see Table 2.1.1).

The overall effect of the government's programme is to reduce public expenditure as a share of GDP (see Compendium Table 13). It has already fallen from around 46 per cent of GDP in 2009/10 to 41 per cent in 2014/15. By 2020/21 it is forecast to fall to 36 per cent. Whilst a similar level was reported in 2000/2001, it was an exceptional year. It is also clearly the government's intention that the share of GDP taken by government expenditure should remain low as part of its strategy of rebalancing the economy in favour of a 'higher wage, lower tax and lower welfare society.'

Table 2.1.1 **Spending Review 2015 – Current, Capital and Total Managed Expenditure to 2020/21**

£ billion

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Current expenditure						
Resource AME	**345.3**	**353.3**	**365.9**	**378.4**	**391.8**	**403.9**
Resource DEL excluding depreciation	**315.1**	**320.8**	**322.9**	**325.2**	**328.3**	**341.2**
Ring-fenced depreciation	**21.9**	**21.9**	**21.9**	**21.9**	**21.9**	**21.9**
Public Sector Current Expenditure	**682.3**	**696.0**	**710.7**	**725.5**	**742.0**	**767.0**
Capital expenditure						
Capital AME	**31.7**	**33.4**	**31.7**	**30.7**	**31.7**	**34.5**
Capital DEL	**41.7**	**44.0**	**45.0**	**45.0**	**47.3**	**55.7**
Public Sector Gross Investment	**73.4**	**77.4**	**76.7**	**75.7**	**79.0**	**90.2**
Total Managed Expenditure	**755.7**	**773.3**	**787.5**	**801.2**	**821.0**	**857.2**
Total Managed Expenditure (% GDP)	**39.7**	**39.1**	**38.1**	**37.2**	**36.5**	**36.4**

Source: HM Treasury, Spending Review and Autumn Statement 2015, Table 1.6.
Notes: 1. AME is Annually Managed Expenditure; DEL is Departmental Expenditure Limits.
2. Resource DEL excluding depreciation and Capital DEL form the envelopes for departmental settlements in the Spending Review.

Labour Market

With levels of employment above the pre-recession peak, broad patterns of labour market change are clearly evident.

The labour market continued to grow in 2015, but it did so at a slower rate than in 2014. Overall, employment grew by 1.2 per cent. This is accounted for by a net growth in full-time employment, as the number of part-time jobs fell slightly – which is notable because the level of part-time employment grew throughout the recession. Total employment is now 4.4 per cent above the 2008 peak – a level that was surpassed in 2013. However, whilst full-time employment is 2.6 per cent above the 2008 level, part-time employment has grown by almost ten per cent.

Notwithstanding the stagnation in part-time employment in 2015, this marks a dramatic shift in the balance between full- and part-time work and suggests that there is scope for increases in employment. Self-employment has also grown strongly since 2008. Although it fell back in 2015, this followed a year of very strong growth in 2014 (when it grew by almost ten per cent). Such fluctuations are a feature of self-employment: the numbers of self-employed people also fell a little in 2013, having grown by more than five per cent in the previous year. However, the picture is one of growth: the number of self-employed people is 17 per cent higher in 2015 than it was in 2008 (see Table 2.1.2).

Table 2.1.2 **Changes in employment levels (% annual change)**

Year	Self- employment	Total in employment	Full-time	Part-time
2009	**- 0.4**	**- 2.1**	**- 3.2**	**1.0**
2010	**2.8**	**0.4**	**- 0.8**	**3.7**
2011	**1.5**	**0.9**	**0.8**	**1.0**
2012	**5.4**	**0.7**	**0.2**	**2.1**
2013	**- 0.5**	**0.9**	**1.2**	**0.1**
2014	**9.7**	**2.5**	**2.9**	**1.5**
2015	**- 2.1**	**1.2**	**1.6**	**0.0**
Overall 2008-2015	**16.9**	**4.4**	**2.6**	**9.8**

Source: Calculated from Compendium Table 4.

The number of people who are unemployed has fallen rapidly in 2014 and 2015, having peaked in 2012. The numbers of people claiming unemployment-related benefits fell by more than a quarter in 2014 and 2015, the previous peak of 1.6 million also being in 2012. The ILO's survey-based measure, which includes people who are actively seeking work who are not claiming unemployment-related benefits, also indicates large falls in the numbers of unemployed people in 2014 and 2015, although they are less dramatic than under the claimant count.

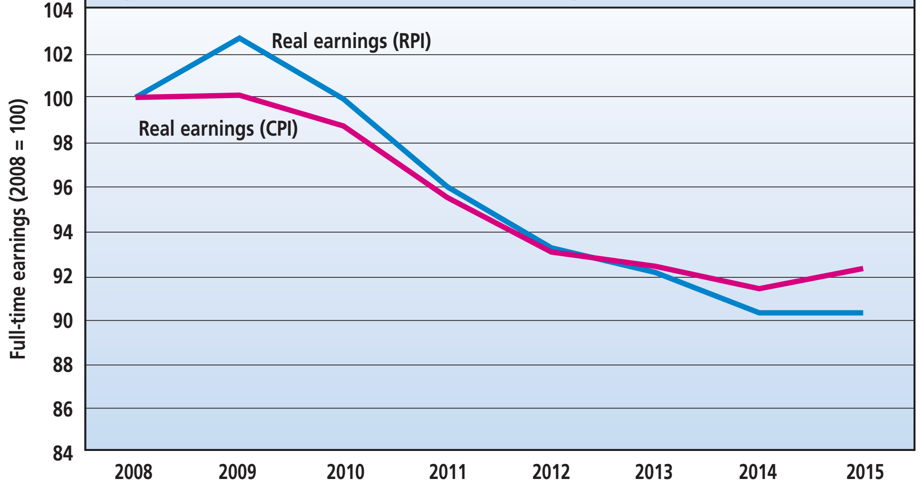
The changing behaviour of the labour market has surprised economists for the past 25 years. Unemployment fell much more rapidly after the early 1990s recession than was the case in the 1980s, when it continued to rise for some years after economic growth had resumed. In the post-2008 recession, unemployment did not rise as much as many commentators expected. Claimant count unemployment peaked (in absolute numbers) at a much lower level (1.6 million), whereas it exceeded three million in the 1980s and 2.5 million in the 1990s following the less severe recessions in those decades. Clearly benefit rules have had an impact, as the numbers of unemployed people show greater consistency between the different economic cycles than is the case with the claimant count. Although the differences between the ILO count and claimant count tend to diminish during recessions and widen in periods of jobs growth, the gap between the two measures was wider in 2015 than in 2008 (see Compendium Table 4).

In contrast to both employment and unemployment levels, the numbers of people who are economically inactive is a notably stable element. This group includes retirees, and also the working-age population who are not working and fall outside the ILO definition of unemployment (for example, if they are unable to work due to long-term sickness, or simply do not want to work). Levels of inactivity grew only slightly during the recession, and in 2015 were marginally below the 2008 figure. The ratio of people in either part- or full-time work to those who are economically inactive is of interest because it gives an idea of the numbers of people who – broadly speaking – depend on the taxes paid by the employed population. The ratio has now risen from 3.26 in 2008 to 3.45 in 2015, having fallen to 3.09 in 2010 (calculated from Compendium Table 4). However, this indicator does not take into account the relative shift towards part-time work.

Earnings

Another feature of the labour market has been the squeeze on real earnings (see Figure 2.1.4). Full-time earnings across Great Britain failed to keep pace with either retail or consumer prices indices for the six consecutive years from 2009 to 2014.

Figure 2.1.4 **Trends in real full-time earnings**



Source: Computed from Annual Survey of Hours and earnings, and ONS inflation data.

In 2015, real earnings were stagnant (compared to the RPI) and rose by one percent (compared to the CPI). The cumulative effect of the wage squeeze is that real earnings in 2015 are almost ten percentage points lower than they were in 2008, as measured by the RPI, and almost eight percentage points lower when compared to the CPI.

References

1. HM Treasury (2015) *Spending Review and Autumn Statement 2015*. London: HM Treasury, Table 1.1.
2. *Ibid*, Table 1.2.
3. *Ibid*, para 1.30.
4. *Ibid*, Table 3.1.
5. *Ibid*, para 1.61.

Table 2.1.3 **Spending Review 2015 – Departmental Programme and Administration Budgets**

	£ billion						
	Baseline			Plans			Percentage cumulative
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	real growth
Resource DEL excluding depreciation							
Defence	**27.2**	**27.8**	**28.5**	**29.2**	**30.0**	**31.0**	**+ 2.3**
Single Intelligence Account	**1.8**	**1.8**	**2.0**	**2.1**	**2.2**	**2.3**	**+ 17.0**
Home Office	**10.3**	**10.7**	**10.6**	**10.6**	**10.6**	*	**- 4.8**
Foreign and Commonwealth Office	**1.0**	**1.0**	**1.0**	**1.0**	**1.0**	*	**+ 0.0**
International Development	**8.5**	**9.1**	**9.3**	**10.7**	**11.0**	*	**+ 21.0**
Health (including NHS)	**111.6**	**115.6**	**118.7**	**121.3**	**124.1**	**128.2**	**+ 3.3**
Work and Pensions	**5.8**	**6.1**	**6.3**	**5.9**	**5.4**	*	**- 14.0**
Education	**53.6**	**54.4**	**55.5**	**56.4**	**57.1**	*	**- 1.1**
Business, Innovation and Skills	**12.9**	**13.4**	**12.3**	**11.7**	**11.5**	*	**- 17.0**
Transport	**2.6**	**2.0**	**2.1**	**2.2**	**1.8**	*	**- 37.0**
Energy and Climate Change	**0.9**	**0.9**	**1.0**	**1.0**	**0.9**	*	**- 16.0**
Culture, Media and Sport	**1.1**	**1.2**	**1.2**	**1.2**	**1.1**	*	**- 5.1**
DCLG Communities	**1.5**	**1.4**	**1.4**	**1.3**	**1.2**	*	**- 29.0**
Scotland	**25.9**	**26.1**	**26.3**	**26.3**	**26.5**	*	**- 5.0**
Wales	**12.9**	**13.0**	**13.1**	**13.2**	**13.3**	*	**- 4.5**
Northern Ireland	**9.7**	**9.8**	**9.9**	**9.9**	**9.9**	*	**- 5.0**
Justice	**6.2**	**6.5**	**6.3**	**5.8**	**5.6**	*	**- 15.0**
Law Officers' Departments	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**	*	**- 2.1**
Environment, Food and Rural Affairs	**1.5**	**1.7**	**1.6**	**1.5**	**1.4**	*	**- 15.0**
HM Revenue and Customs	**3.3**	**3.5**	**3.4**	**3.1**	**2.9**	*	**- 18.0**
HM Treasury	**0.2**	**0.2**	**0.2**	**0.1**	**0.1**	*	**- 24.0**
Cabinet Office	**0.2**	**0.3**	**0.3**	**0.3**	**0.2**	*	**+ 4.4**
National Citizen Service	**0.1**	**0.2**	**0.2**	**0.3**	**0.4**	*	–
Small and Independent Bodies	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**	*	**- 6.6**
Reserves	**3.5**	**3.5**	**3.4**	**3.5**	**4.1**	*	–
Adjustment for non-baselined funding	**0.4**	-	-	-	-	*	–
Resource DEL plans (central government)	**304.6**	**312.2**	**316.5**	**320.5**	**324.4**	*	–
Local government spending	**40.3**	**38.6**	**38.9**	**39.7**	**40.5**	*	**- 6.7**
of which DCLG Local Government DEL	***11.5***	***9.6***	***7.4***	***6.1***	***5.4***	*	***- 56.0***
of which locally financed expenditure	***28.8***	***29.0***	***31.5***	***33.6***	***35.1***	*	***+ 13.0***
Total Resource DEL excluding depreciation plans	**316.1**	**321.8**	**323.9**	**326.7**	**329.8**	**342.7**	–
OBR allowance for shortfall	***- 1.0***	***- 1.0***	***- 1.0***	***- 1.5***	***- 1.5***	***- 1.5***	–
Resource DEL excluding depreciation	**315.1**	**320.8**	**322.9**	**325.2**	**328.3**	**341.2**	–

Source: HM Treasury, Spending Review and Autumn Statement 2015, Table 2.1.
Note:
1. Resource DEL excluding depreciation is the Treasury's primary control total and the basis on which Spending Review settlements were made.
2. Baselines exclude one-off and time-limited expenditure; cumulative real growth is calculated to 2019/20 from the 2015/16 baseline.
3. 2020/21 budgets have only been set for some departments; others (marked *) will be set in the next Spending Review.
4. DWP and HMRC allocations reflect the transition of tax credits into universal credit and from HMRC to DWP. Excluding this, the underlying reductions would be -16% (DWP) and -15% (HMRC).
5. Local government spending is the sum of DCLG Local Government DEL and locally financed expenditure in England, including growth in council tax/business rates but not the 100% retention of business rates.

Table 2.1.4 **Spending Review 2015 - Departmental capital budgets**

	£ billion					
	Baseline			Plans		
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Capital DEL						
Defence	7.1	7.3	7.5	7.8	8.1	8.7
Single Intelligence Account	0.4	0.4	0.4	0.4	0.5	0.5
Home Office	0.4	0.5	0.5	0.4	0.4	0.4
Foreign and Commonwealth Office	0.1	0.1	0.1	0.1	0.1	0.1
International Development	2.6	2.7	3.2	2.8	3.1	3.6
Health (including NHS)	4.8	4.8	4.8	4.8	4.8	4.8
Work and Pensions	0.2	0.3	0.4	0.3	0.2	0.2
Education	4.6	5.2	4.6	4.4	4.4	4.6
Business, Innovation and Skills	3.8	3.1	2.2	1.7	1.7	1.6
of which financial transactions in CDEL	*1.6*	*1.0*	*0.4*	*0.0*	*- 0.1*	*- 0.2*
Transport	6.1	6.3	7.6	8.9	11.4	12.4
Energy and Climate Change	2.3	2.4	2.5	2.4	2.3	2.8
Culture, Media and Sport	0.4	0.4	0.4	0.4	0.3	0.2
DCLG Communities	3.1	4.0	3.7	4.0	3.6	4.3
Scotland	3.0	3.2	3.2	3.2	3.4	3.5
Wales	1.5	1.5	1.5	1.6	1.6	1.7
Northern Ireland	1.1	1.1	1.1	1.2	1.2	1.2
Justice	0.4	0.7	0.7	0.7	0.4	0.1
Law Officers' Departments	0.0	0.0	0.0	0.0	0.0	0.0
Environment, Food and Rural Affairs	0.5	0.6	0.6	0.6	0.5	0.5
HM Revenue and Customs	0.1	0.2	0.2	0.2	0.2	0.2
HM Treasury	0.0	0.1	0.1	0.1	0.1	0.0
Cabinet Office	0.0	0.0	0.0	0.0	0.0	0.0
Small and Independent Bodies	0.1	0.1	0.1	0.1	0.1	0.1
Reserves	1.0	1.1	1.3	1.3	1.2	1.1
Capital spending not yet in budgets	–	–	–	–	–	3.0
Adjustment for non-baselined funding	0.3	–	–	–	–	–
Total Capital DEL plans	**43.7**	**46.0**	**47.0**	**47.5**	**49.8**	**55.7**
Remove CDEL not in PSGI	*- 5.9*	*- 5.0*	*- 4.9*	*- 3.4*	*- 3.3*	*- 2.9*
Allowance for Shortfall	*- 2.0*	*- 2.0*	*- 2.0*	*- 2.5*	*- 2.5*	–
Public Sector Gross Investment in CDEL	**35.8**	**39.0**	**40.1**	**41.6**	**44.0**	**52.8**

Source: HM Treasury, Spending Review and Autumn Statement 2015, Table 2.2.
Note: CDEL is capital spending within Departmental Expenditure Limits; PSGI is public sector gross investment.