Section 2 Commentary

Chapter 1

Economic prospects and public expenditure

Mark Stephens

On the eve of the first lockdown, the economists Mervyn King and John Kay published a book entitled *Radical Uncertainty*. Radical uncertainty exists when uncertainty cannot be resolved by attaching probability to a range of outcomes. When radical uncertainty prevails, we simply do not know.[1]

Their book is timely because reading the country's economic prospects has seldom been more difficult, as the pandemic and Brexit have coincided. The medium- and long-term implications of Brexit remain unclear, not least because the relationship between the UK and the EU is evolving, and the outcome of future trade deals is unknown. The pandemic caused an unprecedented contraction of the economy in 2020, and although there has been a strong bounce back in 2021, only a few weeks after the emergence of the highly infectious Omicron variant in the UK in November, some sectors of the economy, notably hospitality, had been adversely affected. In early 2022 we simply did not know whether we would be in lockdown again in a few weeks' time. What was expected to be a severe but short shock in the spring of 2020 has become a long-term phenomenon with an uncertain trajectory.

Further, economic policy making within the UK is highly contested. Within the government, there is a division between proponents of low taxation and constrained public expenditure seeking to use Brexit to further deregulate the economy, and those, the prime minister included, who favour expenditure on large-scale infrastructure projects and wish to create a 'high skills, high productivity' economy. They are committed to 'levelling up' the 'left behind' regions of England that supported Brexit in 2016 and the 'red wall' seats that swung behind the Conservatives in 2019 to 'get Brexit done'. The Bank of England, too, is grappling with uncertain territory. After a decade of unconventional monetary policy and the fading boundary between monetary and fiscal policy it is having to grapple with inflation after a long period of almost effortless consumer-price stability. (The issue of asset-price inflation – notably in housing markets – was acknowledged by economists as being partly a side-effect of monetary policy, but against which central banks and governments were reluctant to act.)

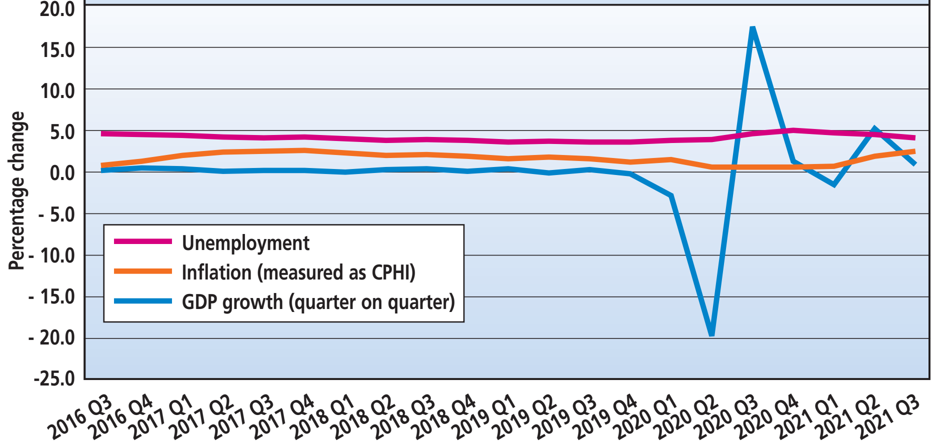
Structural economic change brought about by digitalisation will be taken further as economies seek to decarbonise to meet net zero commitments, in order to slow climate change. This will impose costs on households and governments and require tax bases to be broadened as tax revenues derived from carbon fuels decline. The post-cold-war assumptions of ever freer trade have already been challenged by trade wars between the US and China, and the importance of China becomes more apparent as it edges closer to becoming the world's largest economy. In December 2021 the Chinese real estate giant, Evergrande, with debts of $300 billion, defaulted on interest payments, threatening contagion across the whole property sector, and even systemic financial instability. Given the size of the Chinese economy this would have economic impacts across the world.

Many of these dilemmas are apparent in reviewing economic performance in 2021.

The economy in 2021

Having contracted by almost one-tenth in 2020 as a whole (the second largest fall among advanced economies), the UK economy bounced back strongly in 2021 as Covid-related restrictions were removed (see Figure 2.1.1). Indeed, the Office of Budget Responsibility's (OBR) October forecasts were substantially improved on those it had issued in March. The October forecast expected the UK economy to grow at 6.5 per cent in 2021 and to continue to grow strongly in 2022 before reverting to the anaemic growth rates that have become common in the post-financial crisis period.

Figure 2.1.1 **Key economic indicators 2016-2021**



Source: ONS.

Despite the withdrawal of the furlough scheme at the end of September, employment levels have held up, as the labour market has tightened. The furlough scheme supported some 11.7 million jobs in 1.3 million employers.[2] By the time it was withdrawn there were 1.16 million workers on furlough, down from a peak of 8.9 million in May 2020. Of those 1.16 million, some 329,000 workers had been on furlough continuously since the scheme's introduction in March 2020. In September 2021, unemployment stood at 4.2 per cent compared to 3.8 per cent in the same month of 2019 before the pandemic began.[3] At 75.5 per cent, the employment rate in September 2021 was only slightly lower than it had been in September 2019 (76.2 per cent).[4] At the time of writing, a full picture of the impact of the withdrawal of furlough was still not available.

However, a series of factors led to a rise in consumer-price inflation. The UK is not alone in experiencing an upward pressure on prices as consumer demand recovered strongly after lockdowns had artificially suppressed spending. The effect of the rapid rise in demand has coincided with disruptions to supply chains caused by the pandemic, leading to shortages in raw materials. These were worsened by labour shortages as patterns of labour supply changed and were periodically hit by renewed infections. In the UK's case, labour shortages have been exacerbated by Brexit which led many EU workers to return to their country of origin and made it difficult for UK businesses to recruit from the EU. Further, domestic gas and electricity prices are expected to increase by more than half to almost £2,000 annually as the price cap is raised in April.

As inflation has risen, there has been a debate among economists concerning the extent to which it is a blip that will disappear once supply-chain effects have worked their way through. Pragmatic economists – and indeed central banks including the European Central Bank and the US Federal Reserve as well as the Bank of England – take the view that inflation is temporary and will naturally begin to fall in 2022. In contrast, monetarists interpret the rise in inflation as being a consequence of increases in the money supply caused by ultra-low interest rates and central bank quantitative-easing programmes.

As inflation has intensified in the UK, more economic pragmatists have become concerned that inflation might become embedded in people's expectations, and thus become permanent. This was the view of the Bank of England's Monetary Policy Committee (MPC) when it decided to increase interest rates by 0.1 per cent to 0.25 per cent in December and by a further quarter point to 0.5 per cent in February. This followed the unexpectedly large increase in inflation to 5.1 per cent in November, the highest level in a decade. Nonetheless, some commentators were surprised by the decision which was made after the highly infectious nature of the Omicron variant had become known, and increased the prospects of economic disruption. However, as recently as October the OBR had forecast inflation of four per cent in 2021 falling back to 2.6 per cent in 2022. Now the Bank of England expects it to reach 7.5 per cent in 2022, and members of the MPC were reportedly anxious to signal their seriousness in containing inflation.

Rising interest rates could have some significant consequences. They will increase the cost of servicing government debt, which has tended to be at shorter maturities in recent years. (The Treasury warns that a one-percentage point rise in interest rates and inflation would add £20.3 billion in 2024/25 and £22.8 billion in 2026/27 to debt service costs.[5]) However, the cost base is exceptionally low historically. The Bank of England has previously signalled that it would start to reverse its quantitative-easing programme by selling bonds when they mature, once interest ates reached five per cent.[6] If rates rise again, it is possible that this process will begin in the spring and would be expected to tighten credit supply.

However, an important contrast with historic rises in interest rates, is that this time they should have relatively little impact on household finances through increased mortgage payments. Not only are there fewer households with mortgages now compared to the late 1980s and early 1990s, UK Finance notes that almost three-quarters of mortgages are to an extent fixed rate, so there will be no immediate impact on monthly interest payments.[7] It is also notable that levels of arrears have remained very low, indeed were lower in the third quarter of 2021 than in the corresponding quarter of 2019 before the pandemic.[8] A further contrast with previous periods of economic disruption is that it has come after the prudential regulation introduced in response to the financial crisis had bedded down. Moreover, the housing market has remained very strong, a reminder that the pandemic-related contraction and subsequent bounce back has been very different from conventional economic shocks.

The downside of prudential regulation is that it restricts access to homeownership at the margin. The Bank of England estimated in December 2020 that around two per cent of renters are (hypothetically) prevented from buying a median-priced home in their area by the so-called 'reversion test' under which the ability of a borrower to be able to afford a mortgage at three per cent above the lender's variable rate is assessed.[9] The Bank is currently reviewing the reversion test, although of course the effect of its removal would be a likely increase in mortgage lending, placing an upward pressure on house prices.

The rise in inflation has brought about a further possibility: that the UK could be heading towards a period of 'stagflation', whereby inflation is combined with low levels of economic growth. OBR's forecasts anticipate a return to low levels of nominal economic growth from 2023, with earnings growing more slowly than prices. This is reminiscent of the pattern that emerged after the financial crisis: low levels of growth, stagnating earnings, but high levels of employment. The principal uncertainty – after the trajectory of the virus – is whether inflation takes root or not.

Fiscal policy and public expenditure

The pandemic necessitated unprecedented peacetime borrowing, which has taken outstanding government debt close to 100 per cent of GDP, the highest level since the early 1960s. There were two Budgets in 2021: the first in March and a second in October which also included a three-year Spending Review, covering the period 2022/23 to 2024/25. Whilst heavy borrowing continued in 2021, the chancellor, Rishi Sunak, sought to use his second Budget and the Spending Review to chart a course to more normal levels of government borrowing.

In this he was assisted by the stronger than expected recovery in the economy and finances compared to the March Budget. This allowed him to increase spending whilst also reducing the deficit. The October OBR forecast anticipates Public Sector Net Borrowing (PSNB) falling from 15.2 per cent of GDP in 2020/21 (the highest level since the end of the Second World War) to 7.9 per cent in 2021/22. Thereafter a rapid fall in PSNB is forecast, falling to 1.7 per cent of GDP in 2024/25.[10] Public Sector Net Debt (PSND) is expected to peak in 2021/22 at 98.2 per cent of GDP and fall gradually thereafter.

The chancellor took the opportunity to adjust the fiscal rules that had been rendered fanciful by the necessity to respond to the pandemic. The amended fiscal rules suggest that government debt should be falling, and the 'current' budget should be in balance, both by the third year of the OBR's forecast (i.e. 2024/25). The current budget excludes capital spending which is to be capped at three per cent of GDP on average over the three-year forecast. The welfare cap continues. However, given the frequency with which fiscal rules have been interpreted and changed, it is unlikely that the markets (or indeed anyone) will take them overly seriously.

Earlier in 2021, the chancellor announced a series of tax rises. These included the freezing of the personal income tax allowance and upper-rate threshold; a new health and social care levy of 1.25 per cent on employers, employees and the self-employed, and increases to the main rate of corporation tax to 25 per cent. The tax rises will, according to the OBR, 'raise the tax burden from 33.5 per cent of GDP recorded before the pandemic in 2019-20 to 36.2 per cent of GDP by 2026-27 – its highest level since late in Clement Attlee's post-war Labour Government in the early 1950s'.[11]

The Conservatives' successful appeal to Brexit supporters in traditionally Labour seats in the 2019 general election means that a renewed 2010-style austerity is not politically possible. Further, a decade of squeezed expenditure leaves little room for further cuts. Even areas of 'protected' expenditure during austerity, notably health and social care, are stretched because of rising demand caused by the aging population and the effects of the pandemic in causing a huge backlog in elective surgery.

Consequently, these were the areas most favoured in the Spending Review, and the health and social care levy (in reality, a rise in national insurance contributions) represents a form of quasi-hypothecation echoing a similar move by Gordon Brown when the Blair government made a commitment to raise UK health spending to the European average. The revenue derived from the levy will have little to do with what is spent, and is essentially window dressing to make a tax rise more palatable to those on whom it falls. Nor, according to the assessment of most commentators, will the levy settle the social care question, as the demands of the NHS are likely to come before those of the care sector. Nonetheless, the Department of Health and Social Care will see expenditure grow at 4.1 per cent over the three-year spending period.

Whilst no department will experience a cut in overall funding over the Spending Review period, some, such as Education with an average increase in funding of two per cent annually, will experience relatively modest rises, which follow a decade of austerity. As Paul Johnson, the Director of the Institute for Fiscal Studies observed:[12]

> *'Over the whole period since 2010… health spending will have increased by over 40%, education spending by less than 3%. For the chancellor to have felt it appropriate to draw attention to the fact that per pupil spending in schools will have returned to 2010 levels by 2024 is perhaps a statement of a remarkable lack of priority afforded to the education system since 2010. A decade and a half with no growth in spending … is unprecedented. Spending per student in FE and sixth form colleges will remain below 2010 levels. This is not a set of priorities which looks consistent with a long term growth strategy. Or indeed levelling up.'*

The newly named Department for Levelling Up, Housing and Communities, fares rather better than education, with an average overall expenditure increase of 4.1 per cent over the three-year Spending Review period. The spending is predominantly for capital projects including housing, which has been allocated some £24 billion over the review period. Of this, £7.5 billion has been allocated to the Affordable Homes Programme – bringing the total budget for the programme to £12.99 billion over its lifetime (2021-26; for details see Commentary Chapter 4). Almost two-thirds of the funding is to be allocated to parts of England which are outside London, and the government claims that it will help to deliver 'up to' 180,000 homes. There is also a proportionately large increase in funding for the Rough Sleeping Initiative, which includes capital funding for the Rough Sleeper Accommodation Programme which aims to provide 6,000 housing units to provide longer-term accommodation for rough sleepers. There is also support (£5 billion, of which £3 billion falls within the Spending Review period) for the removal of dangerous cladding from buildings.

Local government has been allocated additional funding, which has also been distributed more equitably than previously. The Local Government Finance Settlement for 2022/23 suggests that core spending could rise by 4.1 per cent in real terms, but only if councils use their full powers to increase council tax (by two per cent per year without a referendum). The IFS calculates that the settlement will mean that core spending power in 2022/23 will be 2.1 per cent higher in real terms than it was in 2015/16, but 2.2 per cent lower in real terms on a per-capita basis.[13] It will also remain far lower than in 2010 when the Coalition government's austerity programme began.

The demand-led nature of social security expenditure means that it falls outside the DEL (departmental expenditure limit) system. The key decisions that the government made included the suspension of the pension 'triple lock' introduced by the Coalition in 2010, whereby state pensions are increased by the highest of 2.5 per cent, CPI inflation or average earnings. However, earnings rose by an unusually large amount due to factors related to the pandemic, such as people who had been on furlough returning to work.

Generally, benefits for 2022/23 were uprated by CPI inflation of 3.1 per cent, the rate of inflation in October 2021. Since then inflation has risen, implying a squeeze. In October, the government also went ahead with the removal of the temporary £20 weekly uplift to universal credit that was introduced during the first lockdown, despite much pressure from anti-poverty groups to maintain it. However, the chancellor also reduced the rate at which universal credit is withdrawn as income rises from 63p in the pound to 55p. There were also some increases in the work allowance which determines the amount claimants can earn before universal credit is reduced. The national living wage (the minimum wage for workers aged 23 and over) will rise by 6.6 per cent to £9.50 per hour in April 2022. However, local housing allowance rates will be frozen (see Commentary Chapter 6).

The devolved administrations have been allocated funding growing annually at between 2.2 per cent (Northern Ireland) and 2.6 per cent (Wales) in real terms over the Spending Review period.[14]

Conclusion

The UK's economic prospects are mired in 'radical uncertainty' due to the pandemic and Brexit, among other factors. In the coming year the biggest challenge is likely to be the squeeze on living standards caused by the upsurge in consumer price inflation, which seems likely to outweigh earnings and benefits increases. The (so far modest) rise in interest rates is unlikely to have very much impact on household finances, as most mortgagors are protected from short-term fluctuations. The biggest unknown in the coming year is the trajectory of the pandemic, and the extent to which it will disrupt the economy and, if more extensive lockdowns recur, whether the Treasury will be willing to finance the kind of support provided to workers and businesses in 2020/21.

However, it is certain that what has become known as the 'cost of living crisis' will be of central importance to the economy. The combination of tax and energy price rises will squeeze incomes, notwithstanding the chancellor's support measures designed to moderate price rises. A key factor will be whether the upsurge in inflation turns out to be a temporary blip or becomes embedded in expectations.

In the longer term the OBR has reduced the estimated 'scarring effect' of the pandemic on the economy from three to two per cent, so the effects of Brexit and other structural changes are likely to assume greater importance over time. These structural changes will be key to determining whether the prime minister's so far largely rhetorical aspiration for a high-productivity, high-wage economy is realised.

References

1 See John Kay's blog, Radical Uncertainty, 12 February, 2020 (www.johnkay.com/2020/02/12/radical-uncertainty/).

2 Coronavirus Job Retention Scheme statistics: 16 December 2021 (see www.gov.uk/government/statistics/coronavirus-job-retention-scheme-statistics-16-december-2021/coronavirus-job-retention-scheme-statistics-16-december-2021).

3 ONS Unemployment rate (aged 16 and over, seasonally adjusted) (see www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment/timeseries/mgsx/lms).

4 ONS Employment rate (aged 16 and over, seasonally adjusted) (see www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/timeseries/lf24/lms).

5 HM Treasury (2012) *Autumn Budget and Spending Review 2021*. London: HM Treasury, p.152.

6 *Financial Times* (2021) 'Investors braced for Bank of England to cut bond holdings from March', 17 December.

7 *Financial Times* (2021) 'Bank of England seeks to prove it is in the price stability business', 15 December.

8 Bank of England/ Financial Conduct Authority, MLAR Statistics, Table 3 (Residential loans to individuals).

9 Bank of England (2021) *What impact are the Financial Policy Committee's mortgage tools having on prospective first-time buyers?* (see www.bankofengland.co.uk/bank-overground/2021/what-impact-are-the-fpc-mortgage-tools-having-on-prospective-first-time-buyers).

10 Office of Budget Responsibility (2021) *Economic and fiscal outlook*, October 2021. London: OBR, Table 1.3.

11 OBR, *ibid.*, p.17.

12 Johnson, P. (2021) *Autumn Budget and Spending Review 2021* (see https://ifs.org.uk/budget-2021).

13 Ogden, K. & Phillips, D. (2021) *An initial response to the Local Government Finance Settlement by IFS researchers* (see https://ifs.org.uk/publications/15889).

14 HM Treasury, *op.cit*.