

Section 2 Commentary



Chapter 1

Economic prospects and public expenditure

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In last year's *Review* we reported on the government's attempts to stabilise the economy and its management in the aftermath of the economic instability that had been caused by chancellor Kwasi Kwarteng's misjudged 'mini-Budget' during the short-lived administration of Liz Truss. Her government's 'Growth Plan', which sought to raise the trend growth rate to 2.5 per cent by making some £45 billion in unfunded tax cuts, whilst dispensing of both the advice of the Office for Budgetary Responsibility and the services of the Treasury's most senior civil servant, alarmed the markets. Interest rates on gilts soared as the value of sterling plummeted towards parity with the US dollar, and the Bank of England was forced to intervene to prevent some private pension schemes from failing.

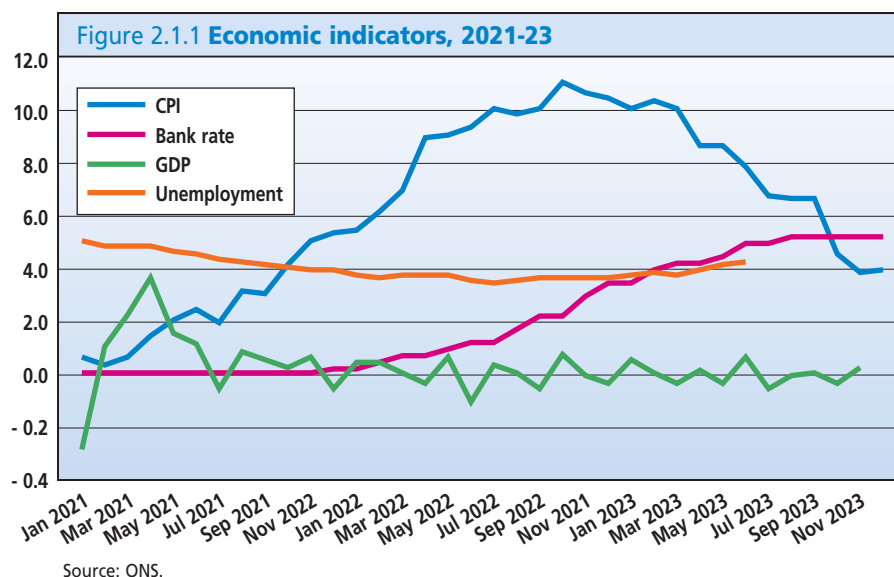
Certainly, the timing of the mini-budget – as inflation reached its peak of 11.1 per cent – was unfortunate, and it was widely feared that bringing inflation down rapidly towards its two per cent target would take the country into recession (see Figure 2.1.1). In the event, the Bank of England's Monetary Policy Committee (MPC) made four more increases to the base rate in 2024, taking it from 3.5 per cent in January to 5.25 per cent in August, its highest level since April 2008. Many economists believe that the base rate has now peaked, and it is only a question of

when the MPC decides to begin to reduce it. However, it is important to remember that the effects of interest-rate changes are lagged not least with respect to the housing market. Although around half of mortgages have been repriced since December 2021, the Bank of England expects some five million more mortgagors to experience average increases in monthly payments of £240, or 39 per cent.¹

Whenever the MPC feels able to cut interest rates depends on the progress made in reducing inflation. Consumer-price inflation fell from 10.1 per cent in January to 3.9 per cent in November. It edged up unexpectedly to 4.0 per cent in December, the rise being attributable to a rise in tobacco duties. Economists are looking to the labour market to judge whether this uptick is likely to be transient or whether a degree of persistence – as occurred in the 1970s – is setting in. Making a judgement is hindered by the difficulties that ONS is experiencing in gaining reliable statistics from the Labour Force Survey, caused by a drop in the response rate and related weighting issues since the pandemic. The most recently released statistics for earnings growth indicated some moderation from the peak of 8.5 per cent in July to 6.5 per cent in November. Vacancies have been falling continuously since their peak of 1.3 million in March-May 2022 and stood at 934,000 in the last quarter of 2023, although there is still some way to go before pre-pandemic levels (822,000 in November 2019-January 2020) are reached. Unemployment crept up from 3.8 per cent in January to 4.3 per cent in June, the latest available statistics, but estimates based on tax and benefits records suggest that it has remained stable since then.² These figures are rather better than many economists had feared. The Office for Budgetary Responsibility (OBR) forecasts unemployment to peak at 4.4 per cent in the second quarter of 2024.

Overall, the UK economy appears to have been more robust than was previously believed. Revisions to 2022's GDP figures by ONS found that the UK economy had recovered more quickly from the pandemic than previously indicated, placing it in-line with many other advanced economies – and ahead of Germany – rather than being the worst performing.³

Similarly, the widespread expectation that the UK economy would enter recession in 2023 seemed unlikely to be realised, on the basis of GDP data to November (technically, a recession occurs when there are two successive quarters of negative



growth). Nonetheless, the UK economy did slip into a technical recession in the final quarter of 2023.

That said, the economy was hovering either side of zero throughout 2023, and exhibited no signs of sustained growth. The economy contracted in five of the twelve months up to and including November 2023, although none of these was consecutive. For example, the economy shrank by 0.3 per cent in October 2023, but grew by 0.3 per cent in November.

The OBR downgraded its November growth forecast by 0.6 percentage points compared to March and expects real GDP growth to be on average 1.5 per cent between 2024 and 2027, picking up from an anaemic 0.7 per cent in 2024.⁴ This kind of weakness led the Bank of England – whose forecasts tend to be among the more pessimistic – to estimate in November that there is an even chance of a recession by the middle of 2024.⁵ The consensus expectation is for growth of around 0.4 per cent in 2024.⁶

High interest rates are among the reasons for the prevalence of what has been called the ‘grey gloom’ surrounding the UK’s economic prospects. Moreover, the UK, like all other economies, remains vulnerable to international instability and conflict. It was the Russian invasion of Ukraine alongside disrupted post-pandemic supply chains that prompted the inflationary upsurge. Apart from the immediate humanitarian catastrophe, the Israel-Gaza war may prompt further instability in the Middle East. The attacks by Houthis on shipping using the Red Sea have already caused thousands of ships to be diverted around South Africa, adding significantly to costs.

Ending stagnation?

This chapter of the *Review* has frequently highlighted the stagnation of the UK economy since the global financial crisis. Since 2008, productivity in the UK has stalled and, along with it, real-income growth has stalled, too. The UK’s long-standing regional economic inequalities have become more exposed and were a factor driving Brexit which, in turn, has further weakened the UK economy. The government’s ‘levelling up’ agenda, analysed in Contemporary Issues

Chapter 1 of the 2023 *Review*, seems to have run out of steam and in any case will be subject to another iteration should there be a change in government in the coming year.

The final report of the Economy 2030 Inquiry (a collaboration between the Centre for Economic Performance and the Resolution Foundation) was published in December.⁷ It repeats some of the increasingly recognised features of the UK’s predicament. Fundamentally, both the UK’s public and private sectors underinvest, driving low productivity and so causing median incomes to lag behind those in comparator countries such as Germany, France, the Netherlands, Canada and Australia. Moreover, very high levels of income inequality shared not only by the labour market, but also by our system of taxation and social security, mean that low-income households’ incomes lag even further behind those of their counterparts in other countries.

The Inquiry’s report makes some persuasive recommendations, such as directing increased public investment on the transition to net zero, with reformed pension funds playing a key role, too. It envisages a wholesale reform of the labour market and social security system, moving towards something akin to Denmark’s ‘flexicurity’ model, whilst accepting that some low-productivity firms would not survive. The report also emphasises the importance of decentralising decision-making, particularly towards England’s biggest cities, as a means of raising their productivity levels – that are uniformly below the UK average. We might add to this the need for the Scottish and Welsh Governments to take their own economic strategies more seriously and to move away from the narrow political focus on public spending on services.

The Inquiry report recognises the role that the housing system can play as a part of economic strategy, as well as its social importance. It advocates increasing housing supply to the annual 300,000 units target that the main parties share (for England): planning should be local, but subject to national targets. It also advocates cutting stamp duty on primary residences to remove disincentives to downsize, believing that this would free up stock to be used more efficiently. Other proposals, such as the relinking of the local housing allowance to rents, are welcome, but limited.

The council tax is characterised as being a ‘near poll tax’, and it should be subject to revaluation, and fully localised. This falls far short of the more extensive proposals made in Contemporary Issues Chapter 1 of last year’s *Review* for a gradual adjustment of band multipliers until a proportionate property tax is created.

Taxation and public expenditure

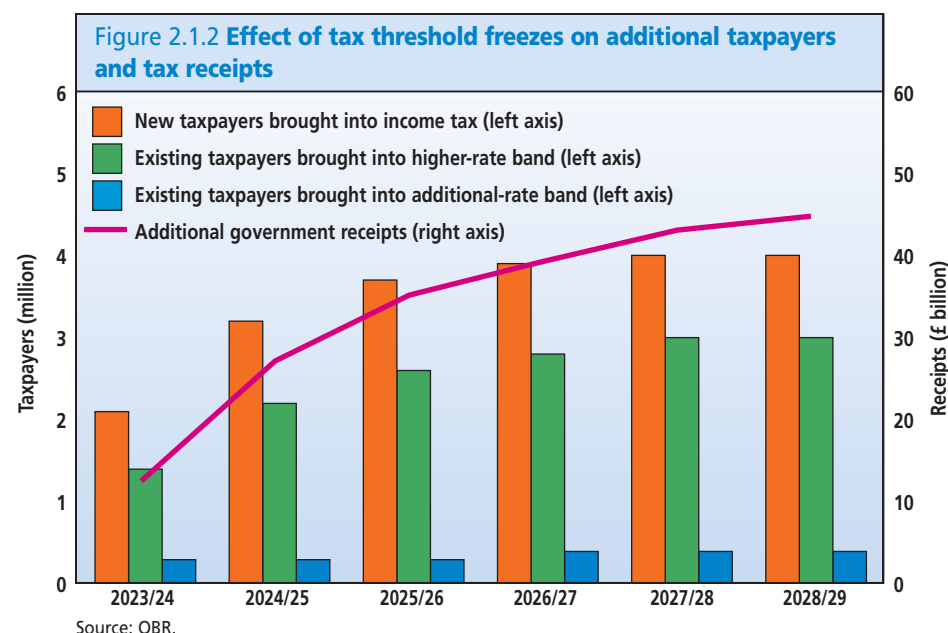
Such strategic considerations do not appear to feature in the realm of government, at least in the short term. Indeed, November’s Autumn Statement made the case for the UK’s relative economic *success*, noting, for example, that the UK government gross debt is the second lowest among the G7 economies. Sceptics might dismiss this as boosterism that ignores the economy’s underlying weaknesses, but the chancellor felt that gave him enough room to announce two tax cuts.

The first of these was to cut employees’ National Insurance Contributions (NICs) by two percentage points to ten per cent (and those of the self-employed by one percentage point to eight per cent) from January 2024. The second was to make permanent the ‘full expensing’ of corporation tax to encourage businesses to invest in plant and machinery by allowing them to offset against tax the whole amount in the first year.

Unexpected falls in debt-interest payments in the first nine months of the 2023/24 financial year were reported as helping to provide sufficient headroom for further tax cuts in the March 2024 Budget whilst remaining within the current iteration of the government’s fiscal rules. These are for government debt to be forecast to be falling, and for the government to be forecast to be running a current deficit of no more than three per cent of GDP, by the fifth year of the five-year forecast period.

However, this picture flatters to deceive.

At 30 per cent, the government suggests that the combined rate of income tax and NICs for a worker on an average wage (of £34,400) will be the lowest since the



1980s. However, this ignores the large increase in personal taxation primarily brought about by freezing the personal allowance and tax thresholds in cash terms for six years from April 2022 (see Figure 2.1.2). As cash wages have risen – especially in response to inflation – more people have been brought into the higher tax band and a greater proportion of the incomes of those already in it are taxed more heavily. The Institute for Fiscal Studies (IFS) estimates that the freeze will bring an additional 2.5 million workers into the 40 per cent and above tax bands, bringing the total to 7.8 million.⁸ Coming at a time of high inflation, the IFS says that the freeze has accelerated a long-term trend which will see the proportions of adults paying higher rates of tax go up from 3.5 per cent in 1991/92 to 14 per cent in 2027/28. Overall, the tax burden is expected to rise to 37.7 per cent of GDP by 2027/28, marginally higher than in the late 1940s, making it the highest since the Second World War.

Yet despite this high tax burden it is not resulting in improvements in public services. There are a number of reasons for this.

The stock of government debt has expanded greatly, first as a result of the global financial crisis, taking it from around one-third of GDP to around 85 per cent in 2015/16. It began to fall, but rose again in response to the Covid-19 pandemic, almost reaching 100 per cent. On some measures, it now exceeds 95 per cent of GDP.⁹ The UK's widespread use of RPI inflation-linked gilts caused the costs of servicing this debt to soar from 1.2 per cent of GDP in 2020/21 to 4.4 per cent in 2022/23.¹⁰ Whilst inflation has fallen, bringing down these costs, they remain a substantial burden on the finances.

In the March 2023 Budget, the chancellor announced that real resource spending would increase by one per cent annually from 2025/26. However, a second issue arises from the rising costs of delivering services, which are greater than those suggested by the Consumer Price Index (CPI). The GDP deflator – which captures inflation across the whole economy – has been running ahead of CPI and has been rising. The OBR's November estimates suggest that the GDP deflator was 6.7 per cent in 2022/23 and 6.1 per cent in 2023/24 (compared to 5.7 per cent and 2.5 per cent respectively in its March forecast). Paul Johnson, Director of the IFS, notes that the cumulative rise in costs across this parliament had been expected to be 13.3 per cent as recently as 2021, but the increase now stands at 21.4 per cent. He suggests that public services are poorer by £13 billion in real terms compared with where they were expected to be in the March 2023 forecast.¹¹ This translates to a day-to-day increase in service spending, in real terms, of only 1.9 per cent over the whole 2019/20-2024/25 period, rather than the 2.4 per cent forecast in March.¹² Moreover, IFS calculates that by 2027/28 the reduction in the spending power of departments between the March Budget and November Autumn Statement (£21.7 billion) slightly exceeds the cost of the tax cuts announced in the Autumn Statement (£19.8 billion). The implication is that, in effect, the tax cuts are being paid for by spending cuts.

Third, when GDP growth is very low – as it is now – the government's ambition to reduce debt as a proportion of GDP must rely to a greater extent on revenues exceeding expenditure than would be the case if growth were to be higher. As Johnson points out, governments have not been running budgetary surpluses since the turn of the century.

Finally, as was the case with post-2010 austerity, the public expenditure squeeze that we are likely to experience in the coming years will not fall evenly as spending by some departments – such as health – is 'protected', whilst others where spending is demand-led – notably social security – are subject to upward pressures.

All in all, the picture is not an optimistic one, and whichever party wins the general election will have some very difficult decisions to make on taxes and spending.

Housing in the Autumn Statement

In November's Autumn Statement, the chancellor announced that the local housing allowance would be restored to the 30th percentile of local rents from April 2024, but with no plans to increase it thereafter. In its first year, the government expects this to help 1.6 million households, increasing their annual support by £800 per year.

A number of announcements were intended to support housing supply. The Affordable Homes Guarantee which helps housing associations to borrow more cheaply was extended at a cost of £3 billion, with the government estimating that this will enable some 20,000 additional homes to be built (see Commentary Chapter 4). The preferential Public Works Loan Board rate for council housing investment is also being extended to the end of June 2025. Some £32 million was announced to help speed up planning decisions and support widening of permitted development, whilst £450 million is being made available to provide new temporary accommodation.

Prospective homeowners will also benefit from the extension of the mortgage guarantee scheme until the end of June 2025 (see Commentary Chapter 3).

However, there was little respite for local government services financed through their General Funds, with the settlement announced following the Autumn Statement judged to be insufficient and to leave many more councils facing insolvency. Five councils have already served 'section 114' notices, declaring insolvency, and one in five councils are said to be at risk of doing so.¹³

In January, DLUHC announced an additional £600 million for England's beleaguered local authorities, intended mainly to assist them with rising social care costs. This does little to help the many authorities also struggling to meet the rising costs of temporary accommodation for homeless people (see Commentary Chapter 5). The leader of Crawley Borough Council was reported as warning that their predicament could mean 'the end of local government'. More than 50 council leaders met at Westminster and there were calls for the subsidy cap on temporary accommodation, which has been frozen since 2011, to be raised.¹⁴

Scotland

After the 2014 independence referendum, the Scottish Parliament received additional powers. The historic block grant conferred by the UK government is now adjusted downwards (block grant adjustments – BGA) to reflect the devolution of earned income tax (excepting the personal allowance) to the Scottish Parliament. The BGA 'reflects what Scotland would have raised in income tax if it had retained the same tax policy as the rest of the UK and if Scotland's per-capita tax revenues had grown at the same rate as the rest of the UK'.¹⁵ The Scottish Parliament also gained some social security powers, which it has used to introduce a Scottish child payment (uprated to £26.70 per child per week from April 2024) to low-income households. Social security introduces a greater element of demand-led expenditure which is matched by a limited tax base and very limited revenue borrowing powers, which introduces a degree of risk. Nonetheless, the framework, modest though it may be, leaves the Scottish Government with considerable powers over taxation and expenditure.

This year, the block grant was reduced by £1 billion in real terms at a time when expenditure pressures have been intensifying due to inflation, public-sector wage settlements and policy choices. This has produced a shortfall of £1 billion compared with the BGA, which is set to rise to £15 billion by 2028/29. As a Scottish Parliament Briefing notes, health and social security have been prioritised over other areas, including business support, and capital expenditure.¹⁶

The Affordable Housing Supply Programme has been a major casualty of capital spending cuts. It suffered a 27 per cent real-terms decrease in the December Budget

for 2024/25, compared to a 4.3 per cent cut in the overall capital budget (had full borrowing powers been used).¹⁷ Whilst it is true that the financial transactions element (which mainly funds shared equity) has been cut most (by 72 per cent in real terms), the cut to the capital element (which funds new build) was still 14 per cent in real terms. The consequences are discussed in detail in Commentary Chapter 4.

Local authorities are also far from pleased. Having recently been promised greater respect and the use of multi-year budgets whenever possible, the Scottish Government promptly reintroduced the council-tax freeze (or more accurately offered local authorities £144 million in return for freezing the tax).

To counter the budgetary squeeze, the Scottish Government has raised income tax. It had adopted the policy of freezing the 'higher' rate threshold before the UK government. From April a new 45 per cent ('advanced') band is being introduced for incomes between £75,000 and £125,140, with a 'top' rate of 48 per cent for incomes over £125,140. The new advanced rate is expected to raise £74 million (some 50 per cent of the amount implied if there were no behavioural change) and the increased 'top' rate just £8 million (15 per cent of the 'static' estimate). More optimistically, income-tax revenues have been buoyant with revenue exceeding the BGA by £1.4 billion.¹⁸ However, the longer-term effects of diverging tax rates compared to the rest of the UK are unknown.

Wales

The Welsh Government enjoys less fiscal autonomy than its Scottish counterpart. Consequently, it depends primarily on the annual block grant from the UK government. The Welsh Government has control over several taxes, and from 2019 the Welsh rate of income tax (WRIT) allows it to vary taxes by 10p in the pound within the same bands set by the UK government. In contrast to Scotland, at present the Welsh Government has a policy of not diverging from England on income tax, but there is nonetheless a block grant adjustment. Again in contrast to Scotland, the Welsh Government is allowing local authorities to increase council-tax rates in 2024/25 and these are expected generally to exceed the inflation rate.

The Welsh Government suggests that its budget for 2024/25 is worth £1.3 billion less than when it was set in 2021. It has decided to prioritise health spending and transport over other areas. The budget for health and social services will rise by 2.6 per cent in real terms relative to the previous provision indicated in October.¹⁹ Transport has been prioritised because of the weak recovery in passenger numbers following the pandemic. Outside these areas, budgets are being cut in real terms, with Rural Affairs being worst hit.

The Welsh Government's social housing grant, used to fund new affordable housing, has been maintained in cash terms in 2024/25, which of course means it has been cut in real terms. The consequences are discussed in Commentary Chapter 4. Elsewhere the previously proposed increase in funding for homelessness prevention has been reduced from £5 million to £2 million.

Northern Ireland

The agreement that allowed the Northern Ireland Assembly to resume its operations came as this edition of the *Review* was being finalised. This may bring a welcome end to the position where Northern Ireland public services subsist on an annual Budget, usually announced late. However, at the time of going press, there was still only a draft Northern Ireland Budget covering the years 2022/23 to 2024/25, published back in 2022, and a confirmed Budget for 2024/25 was still awaited.

Notes and references

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