Ending austerity?

The priorities, price tags and practicalities for a government changing course on spending cuts

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July 2017

Ending austerity: *can the government change course?*

RF

Britain is seven years into a prolonged period of fiscal consolidation, in which constraints on public spending have been the central feature and are set to continue for some years to come. Following the general election there has been a significant debate about the extent to which the result – and the failure of the Conservative party to secure a majority – reflected a rejection of this continued 'austerity' and whether the government should now change course.

But this debate has largely focused on the desirability of easing specific spending constraints, without engaging with broader questions of prioritisation, price tags or practicalities of trade-offs with tax increases or additional borrowing. In this note we look at what 'ending' austerity might actually mean and the trade-offs for anyone wanting to make it a reality:

- *In Section 1 we consider what **Living With Austerity** has meant, outlining the shape of spending cuts that have already arrived and those still to come;*
- *In Section 2 we look briefly at the question of **Austerity Fatigue**, both in terms of shifting public opinions and within government itself;*
- *In Section 3 we ask what **Ending Austerity?** might actually look like, highlighting the costs associated with changing approach on public service spending, public sector employment and welfare;*
- *In Section 4 we look at options for **Plugging The Gap**, exploring the trade-offs the government faces in tax rises or higher borrowing; and*
- *We offer some **Conclusions** in Section 5.*

1) LIVING WITH AUSTERITY

Post-2010 spending cuts and the consequences for public services and social security

Post-2010 'austerity' is on course to be the longest pause in real-terms spending growth on record

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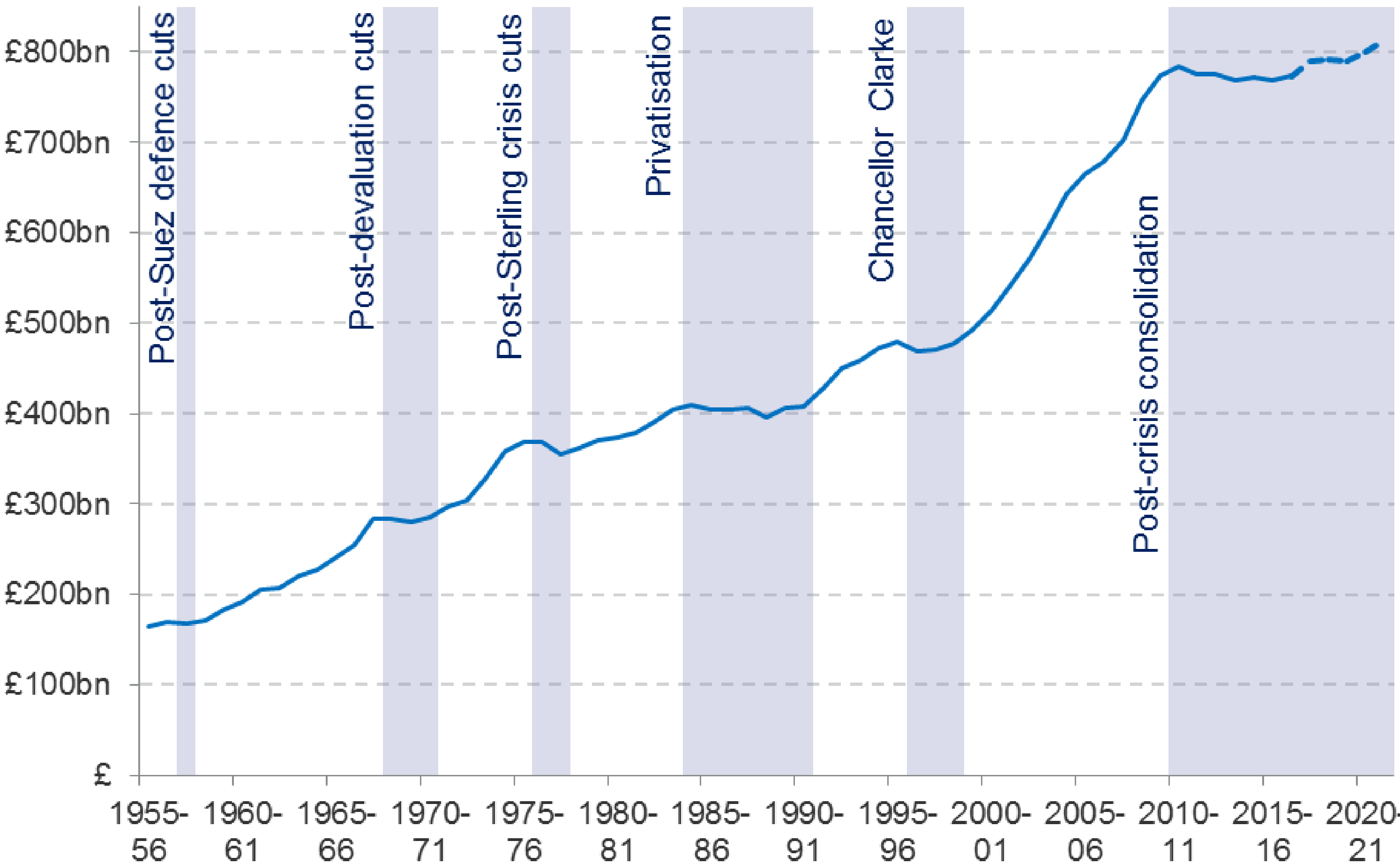
Real-terms government spending: 2015-16 terms (GDP deflator)



Source: OBR, *Economic and Fiscal Outlook*

At £790bn, total managed expenditure in 2017-18 is set to be just £5bn (or 0.7 %) higher in real-terms than in 2010-11

Annual spending growth averaged 2.9% between 1955-56 and 2010-11, but is due to amount to just 0.3% between 2010-11 and 2021-22

Given continued population growth, this flat overall trajectory has *reduced* government spend per person

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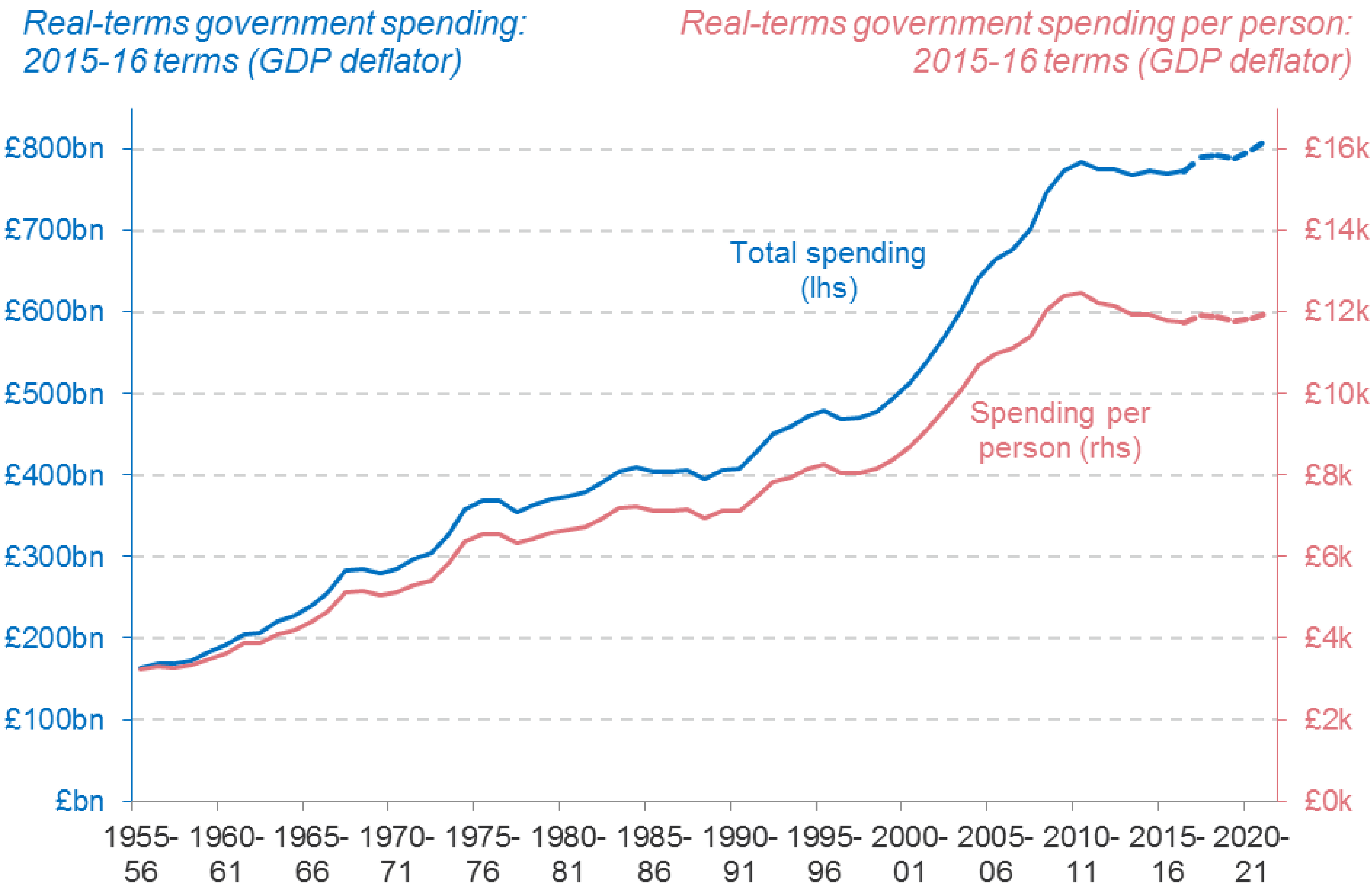


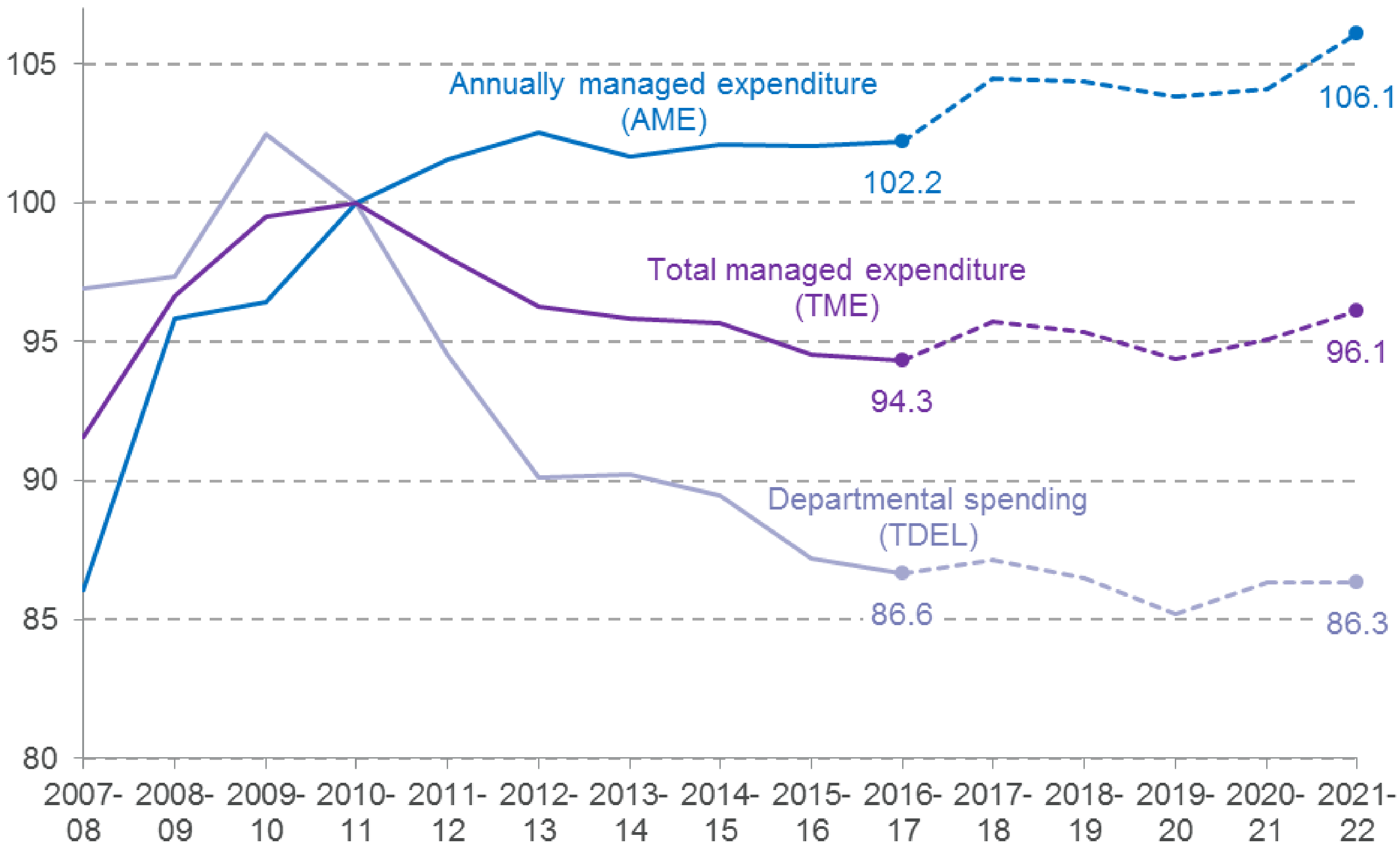
Source: OBR, *Economic and Fiscal Outlook*

Broadly flat real-terms spending comes against a backdrop of a growing (and ageing) population

Spending per person is set to be 3.9% lower in real-terms by 2021-22 than it was in 2010-11

The overall decline in per capita spending planned includes a 14% reduction in departmental spending and a 6% increase in annually managed expenditure

Indices of real-terms spending: 2010-11 = 100 (GDP-deflator)



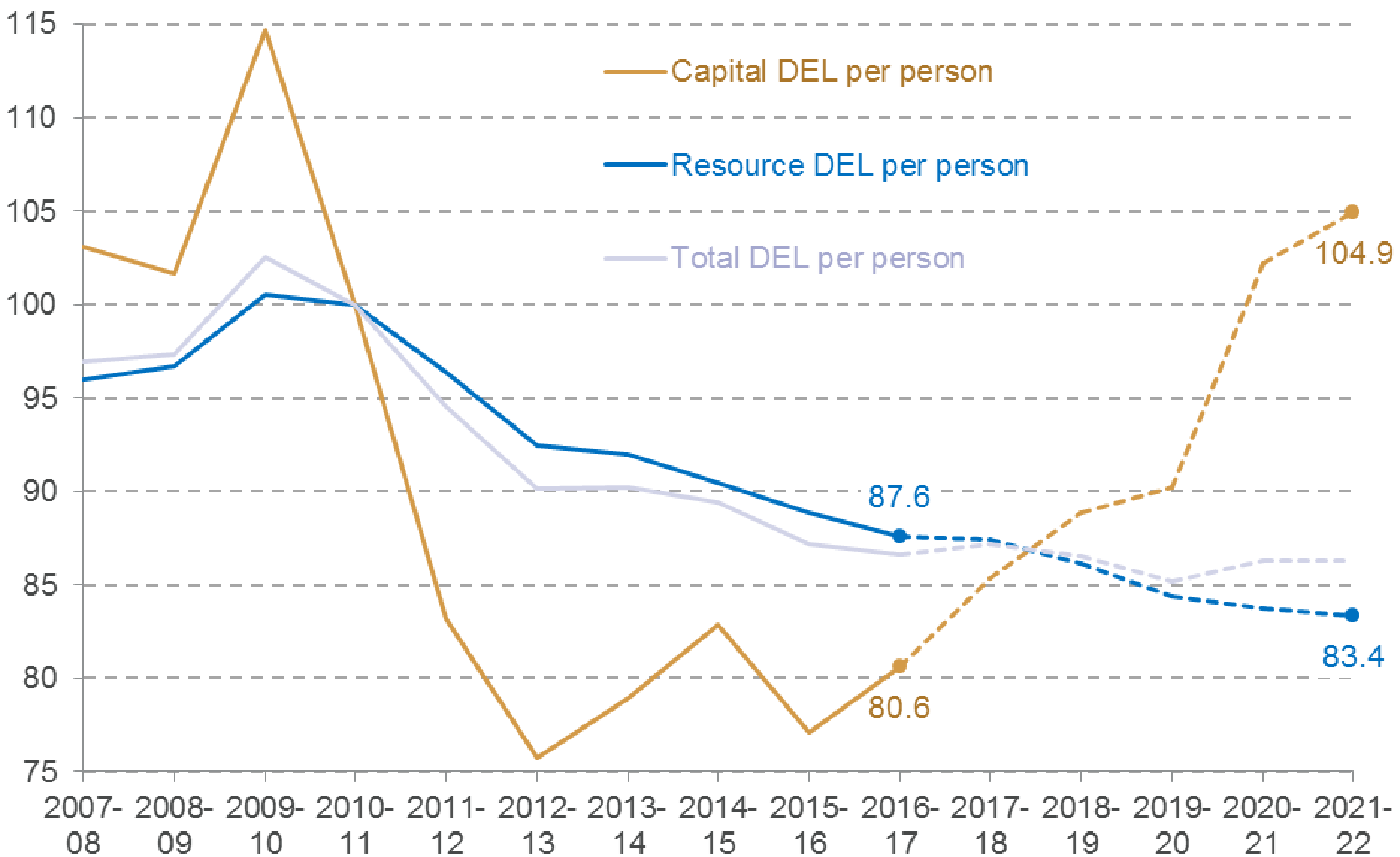
Notes: Series are adjusted to account for discontinuities between DEL and AME. Source: OBR, *Economic and Fiscal Outlook*

To date per capita DEL has fallen by 13% in real-terms and is set to decline a little further through to 2019-20, before a modest recovery at the end of the decade

AME covers welfare spending, debt interest payments and locally financed expenditure

Within the overall DEL trajectory, day-to-day spending per person is due to fall by 17% between 2010 and 2021

Indices of real-terms departmental expenditure limits: 2010-11 = 100 (GDP-deflator)



Notes: Series are adjusted to account for discontinuities between DEL and AME. Source: OBR, *Economic and Fiscal Outlook*

In terms of departmental spending, the (relatively small) capital budget has fallen by 19% since 2010-11 and is now due to rise

Day-to-day spending (resource DEL) has fallen by 12% and is projected to fall further over the coming years

Overall DEL cuts are (very) unequally distributed across government departments

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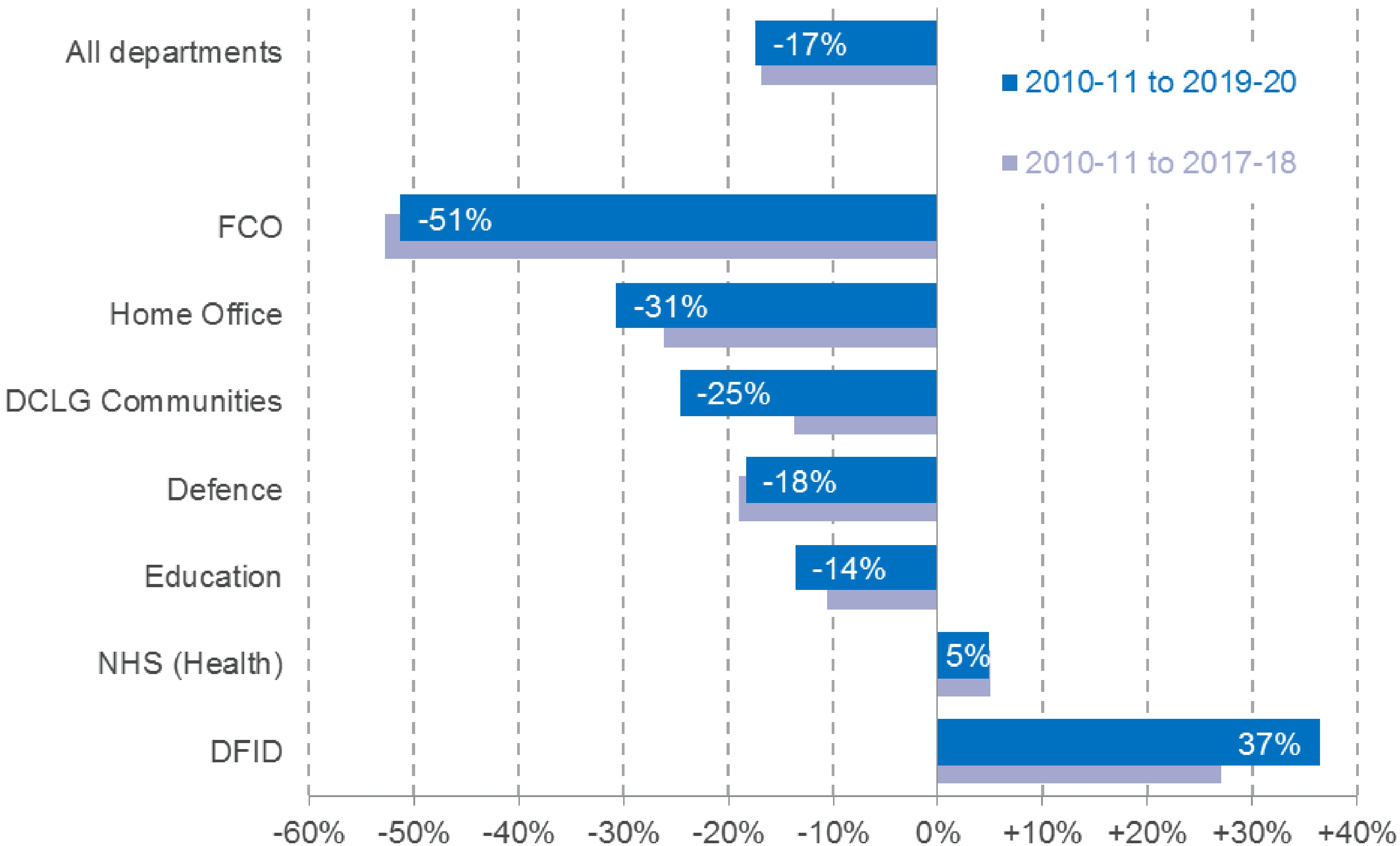
Cumulative real-terms change in departmental expenditure limits per person (GDP-deflator)

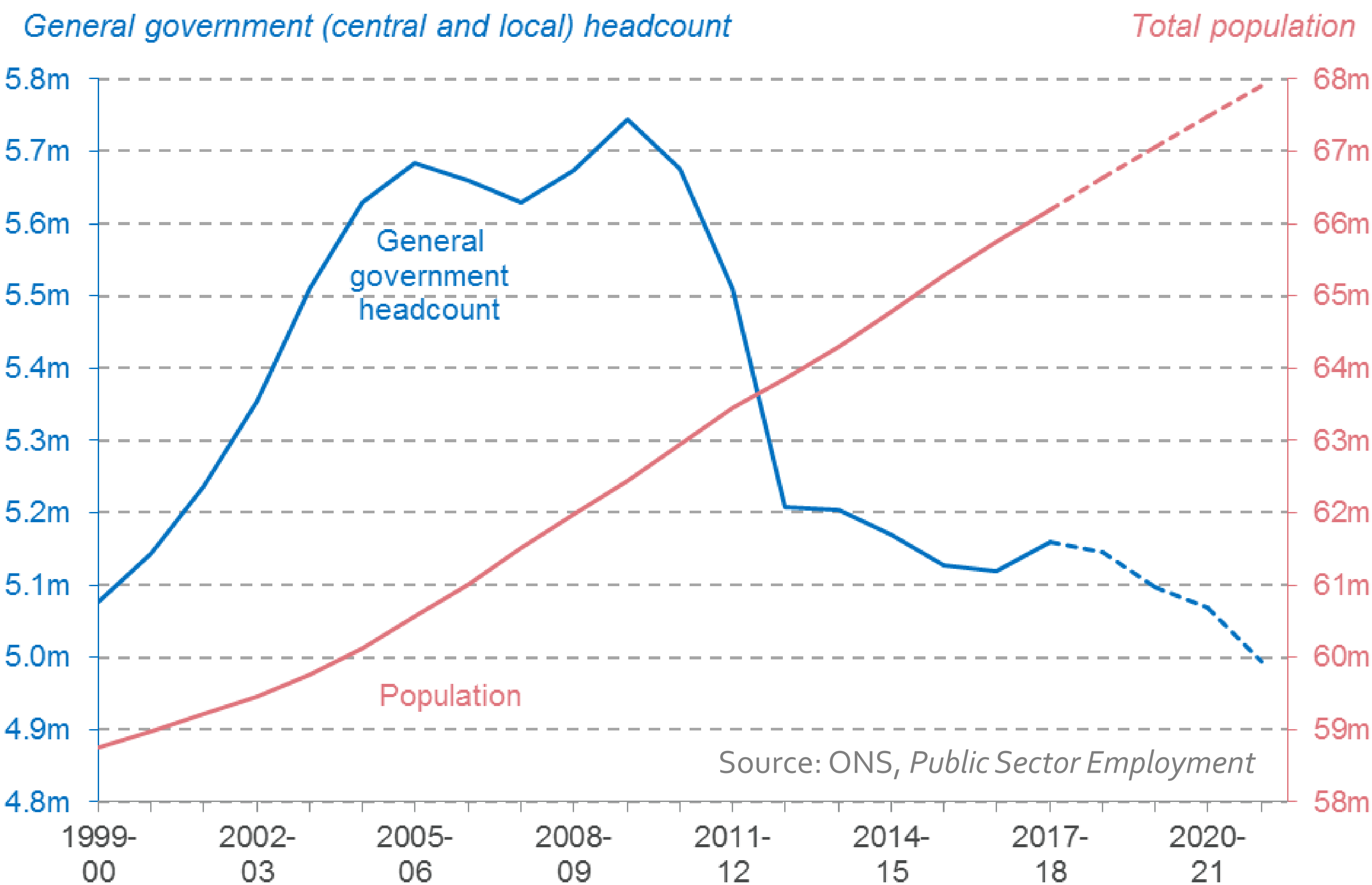


Source: HMT, *PESA*

Health and International Development have been protected since 2010-11

Other budgets have been substantially cut, with foreign office spending halved, home office spending down by one-third and the communities budget down by one-quarter

One consequence of lower DEL spending is a marked reduction in public sector employment that is set to go below 5 million for the first time this century



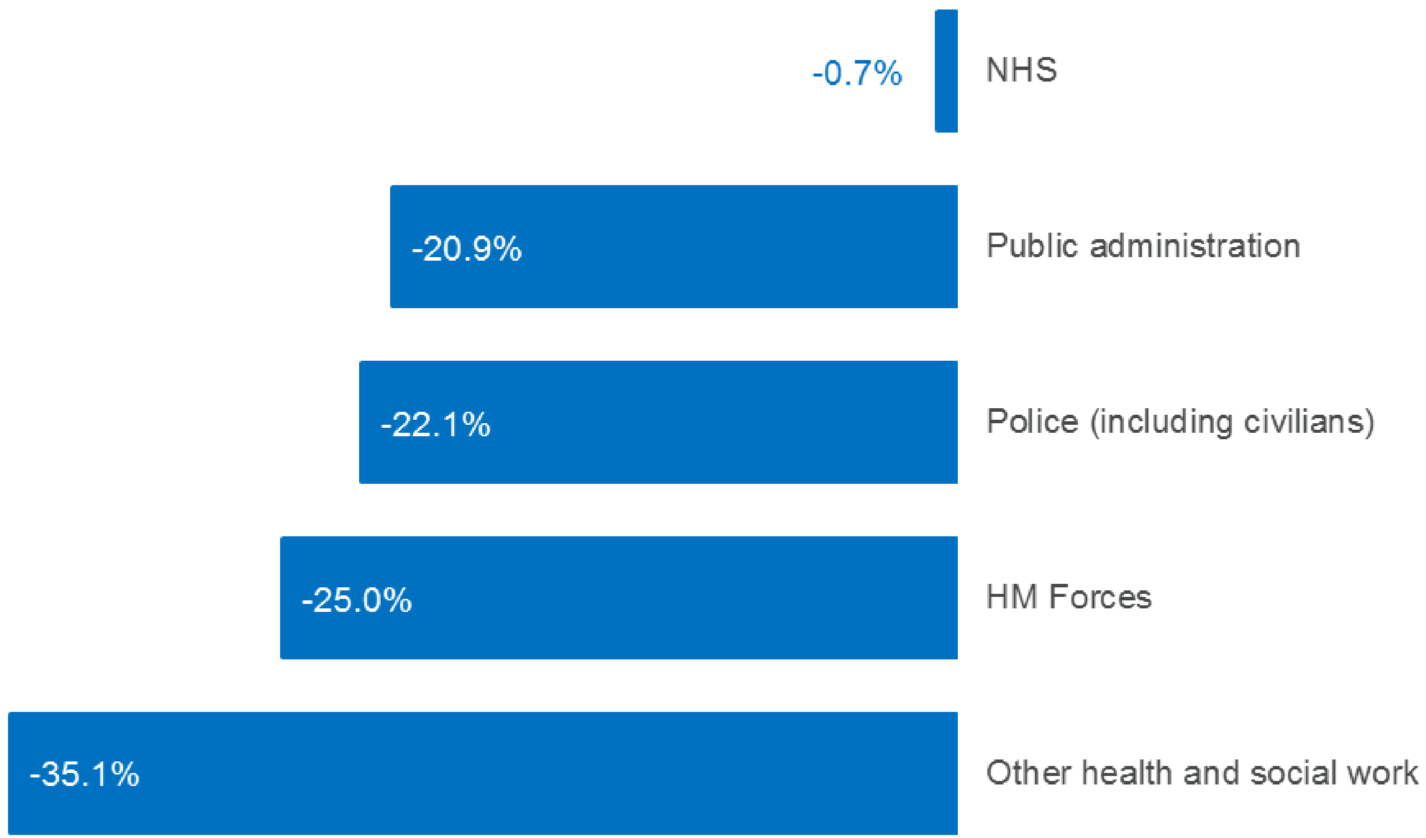
Notes: 'General government' includes local and central government numbers but not public corporations. OBR projections are derived from assumptions about changes in the general government pay bill. Source: OBR, *Economic and Fiscal Outlook*

Local government numbers are already down by roughly one-third

The general government workforce is projected to decline by a further 0.2 million by 2021/22. In contrast the population is projected to increase by 1.7

The biggest workforce cuts have come in health/social work, the armed forces and the police

Change in full-time equivalent workers per 1,000 members of UK population: Q1 2010 to Q1 2017

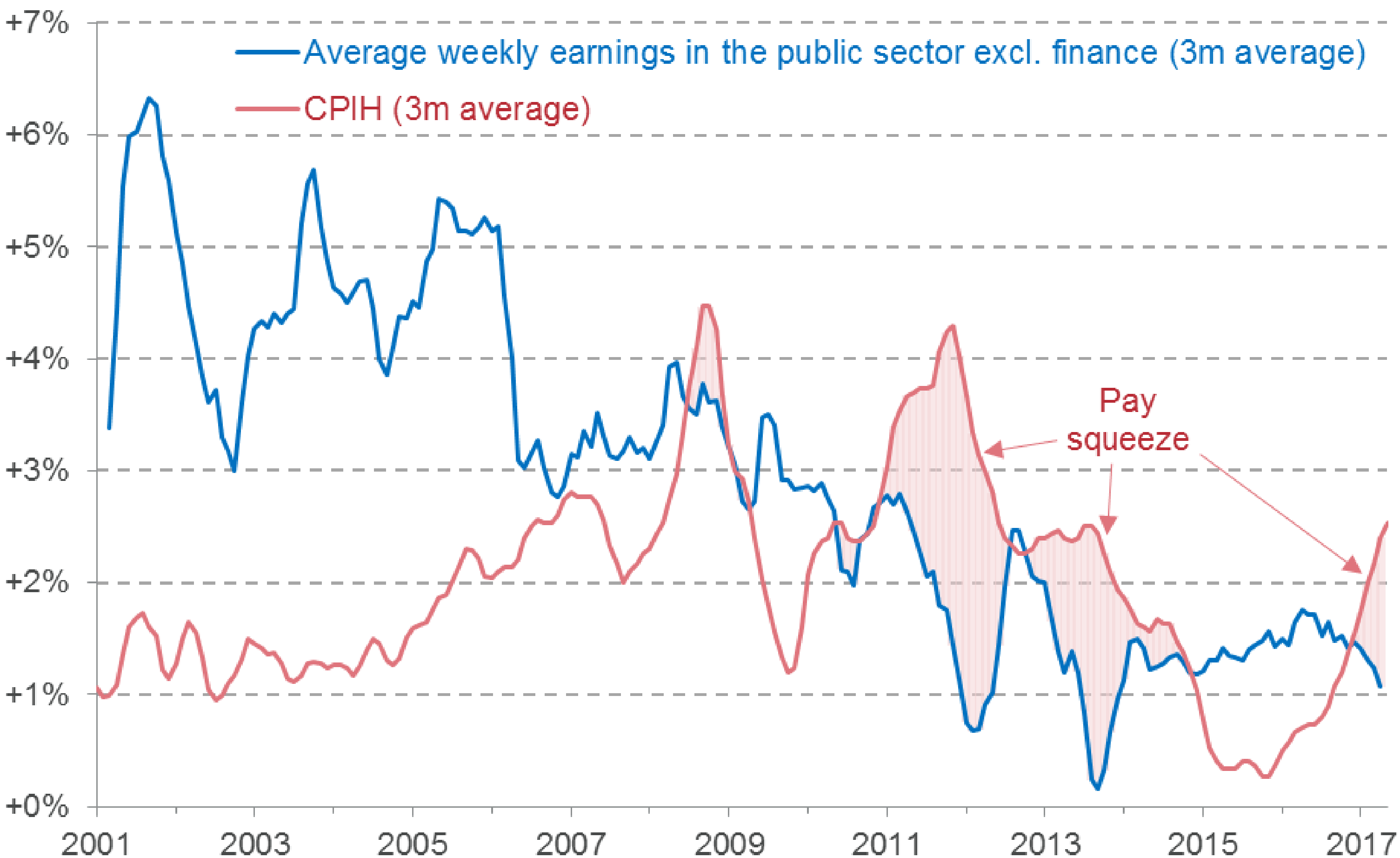


Removing the effects of series breaks and accounting for overall population growth, full-time equivalent numbers have fallen by one-third in health and social work outside the NHS, by one-quarter in HM forces and by more than one-fifth in the police

Notes: Figures only show those public sector categories for which we have consistent data. Source: ONS, *Public Sector Employment*

Alongside jobs, public sector pay has also been squeezed – falling in two-thirds of all months since the start of 2011

Consumer inflation and average public sector earnings growth, year-on-year change



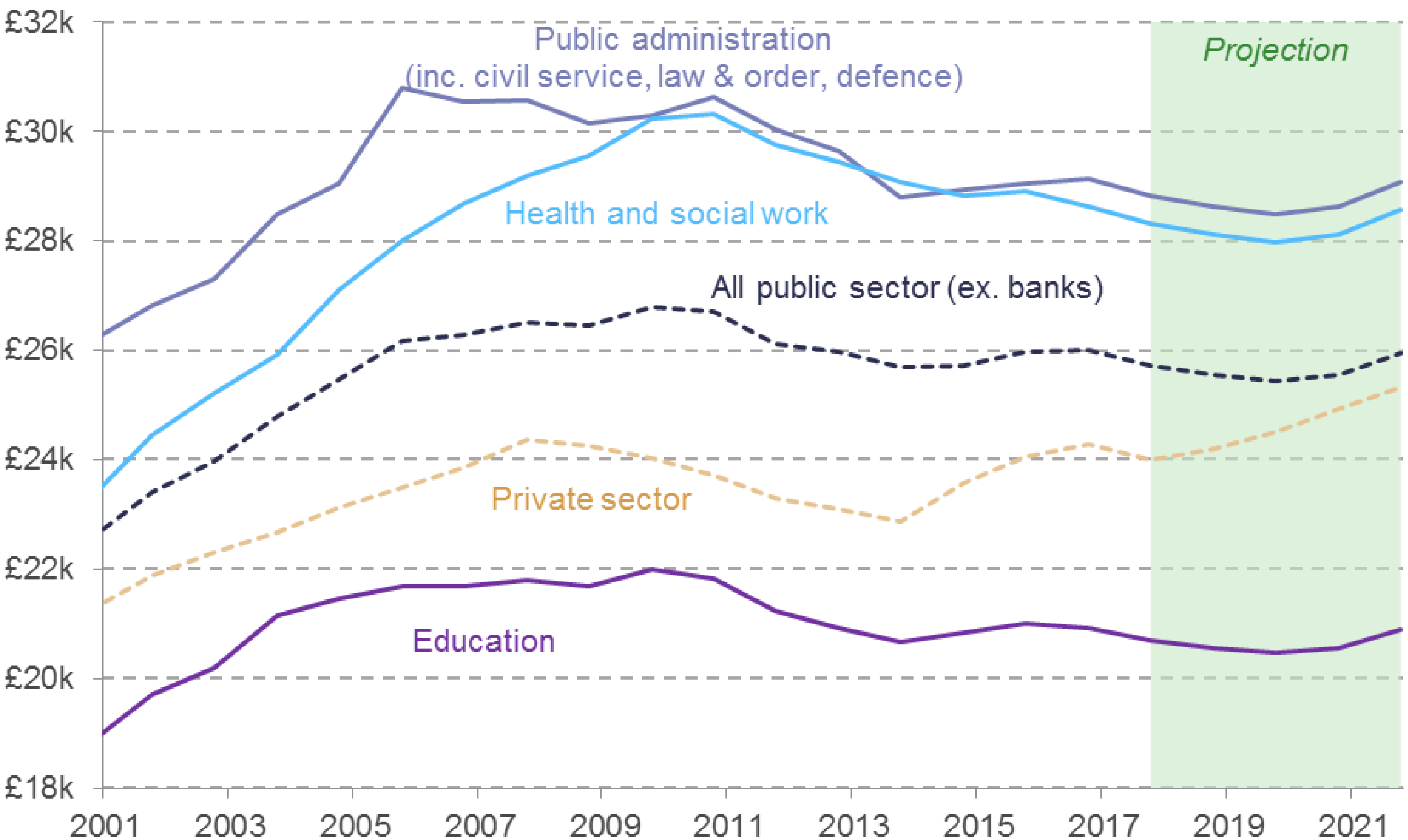
Source: ONS, *Labour Market Statistics*

Public sector pay was frozen for all but the lowest paid in 2011-12 and 2012-13, with annual growth in the total paybill then capped at 1 per cent in every subsequent year

Muted nominal pay growth has been eroded in real-terms across much of the post-crisis period

Average public sector pay is set to fall by £1,350 from peak, with bigger falls in public administration and health & social work

Average real-terms public sector earnings (excluding bonuses and arrears): 2016-17 prices, CPIH-adjusted (CPI in forecast period)



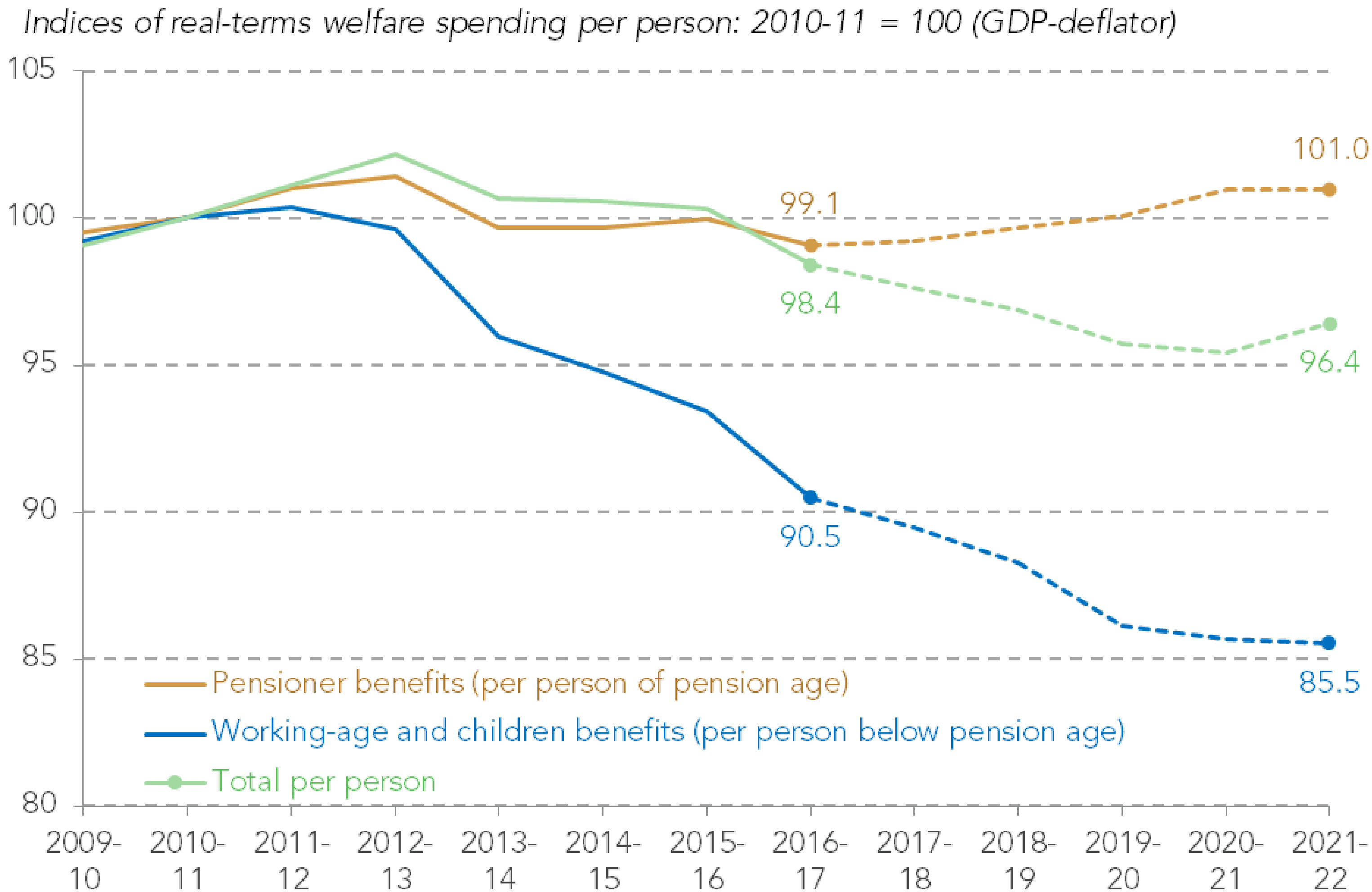
Source: RF modelling based on OBR figures for total and public sector specific employment and pay. In the projection period we apply the same growth rates to each of the public sector employment categories.

Average public sector pay is due to fall from a peak of £26,780 in 2009-10 to £25,430 in 2019-20

The fall is projected to be £2,300 in public administration and £2,340 in health and social work

By 2020, average private sector earnings are expected to be £980 above peak

Welfare cuts are also biting – and due to bite harder – especially for working-age families



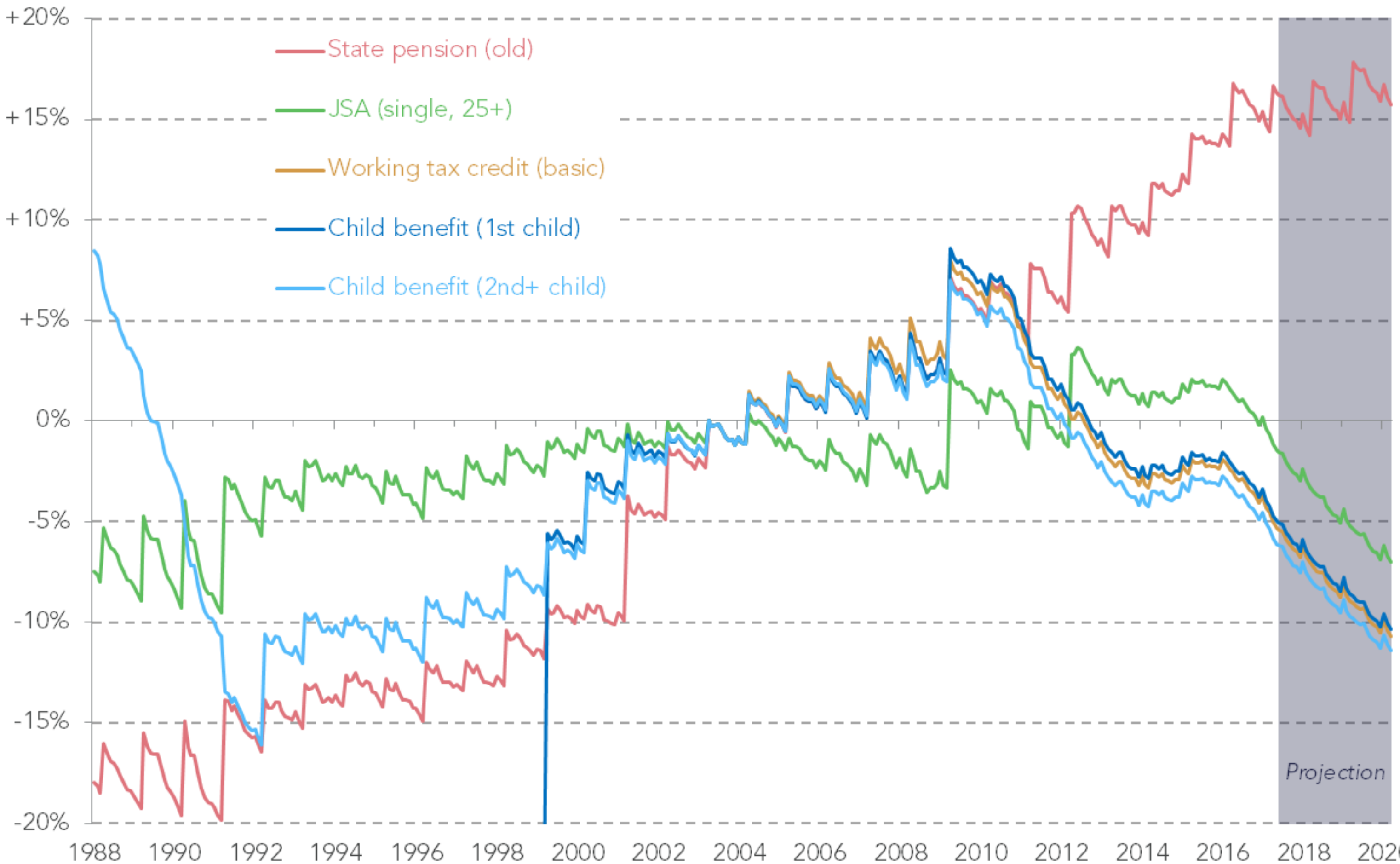
Pensioner benefits have been protected, as payments to working-age adults and children have fallen

More families (11.5 million) are affected by the freeze on working-age benefits than are affected by the public sector pay cap (4.3 million families).

Source: DWP *Welfare Projections*

The working-age welfare freeze means incomes for many will decline in real terms each month until 2020

Change in real value of benefits (CPIH-adjusted) relative to April 2003



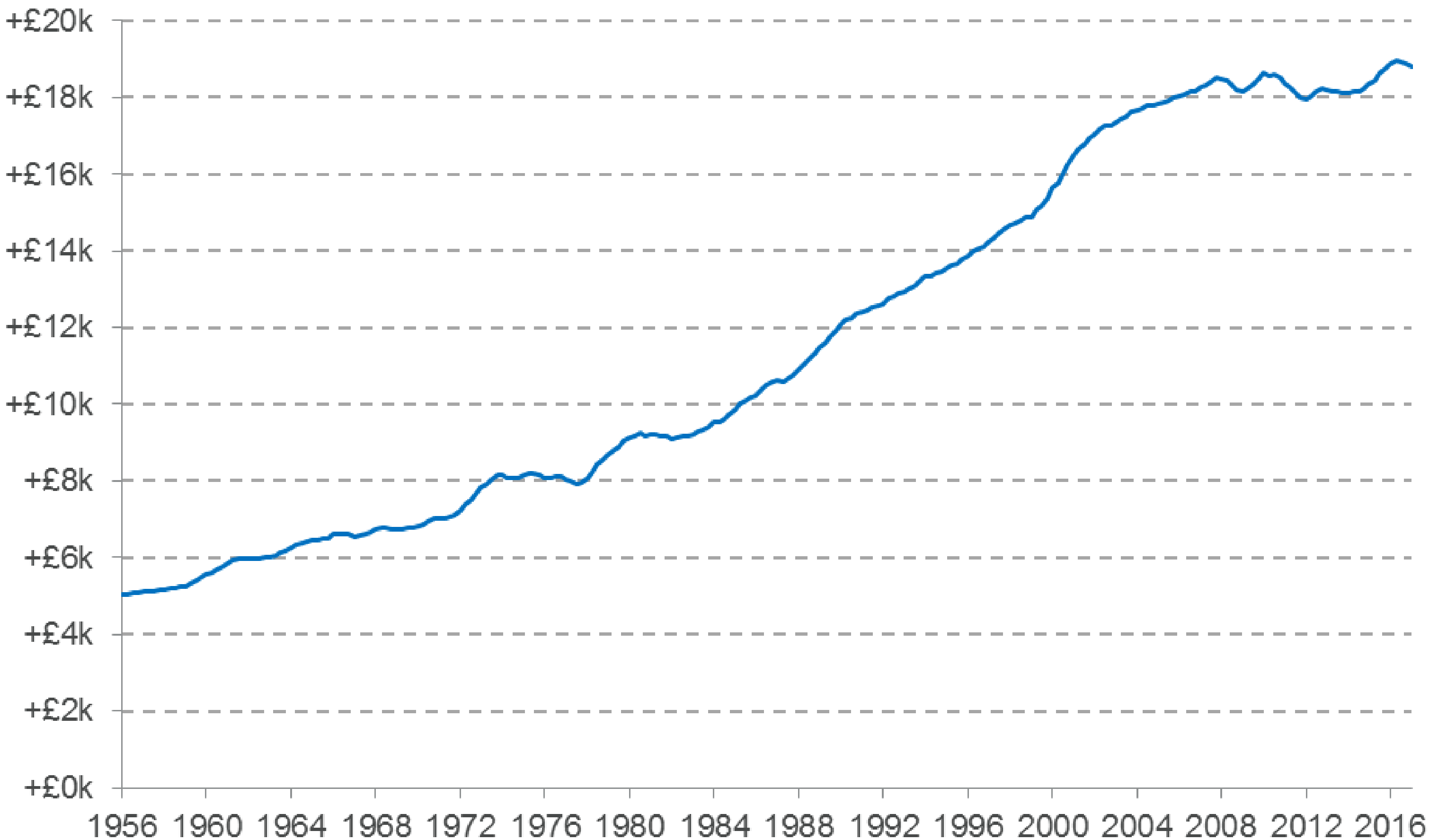
All real increases in child benefit between 1999 and 2009 have now been undone, while jobseeker's allowance is projected to reach its lowest value since 1991-92.

The decline relative to earnings – and the state pension – would be even steeper.

Source: RF analysis of IFS 'Fiscal facts', plus projection

All of which comes against the backdrop of an unprecedented pause in household income growth

Real household disposable income per capita: chained-volume measure (reference year 2013)



Source: ONS, *UK Economic Accounts*

Measured on a National Accounts basis, real-terms household disposable income per capita was just 1.1% higher at the start of 2017 than it was a decade ago

Having averaged 2.6% a year between 1956 and 2007, annual growth in income per person has amounted to just 0.3% since then

2) AUSTERITY FATIGUE?

Shifts in public and political attitudes towards further spending cuts are underway

Growing sense of 'austerity fatigue' and pressure to change course even within government

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- Public services and public sector pay
  - *Growing concern over public sector funding challenges and pressure to break the 1% pay cap, with pay review bodies noting growth in recruitment and retention difficulties*

Growing sense of 'austerity fatigue' and pressure to change course even within government

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itv

PM challenged to end austerity by backing police and fire services in Labour amendment to Queen's Speech

The Telegraph

Cabinet split over austerity tax row as Boris Johnson joins calls to end public sector pay cap

NHS Pay Review Body

We believe greater consideration needs to be given to the medium-term supply position of the NHS. The current rigid pay policy could be storing up problems for the future. The question is how, and when, to introduce greater flexibility. Should the government wait until there is evidence of significant damage to recruitment, retention and motivation outcomes?

theguardian

After seven years of pain, the austerity experiment is over

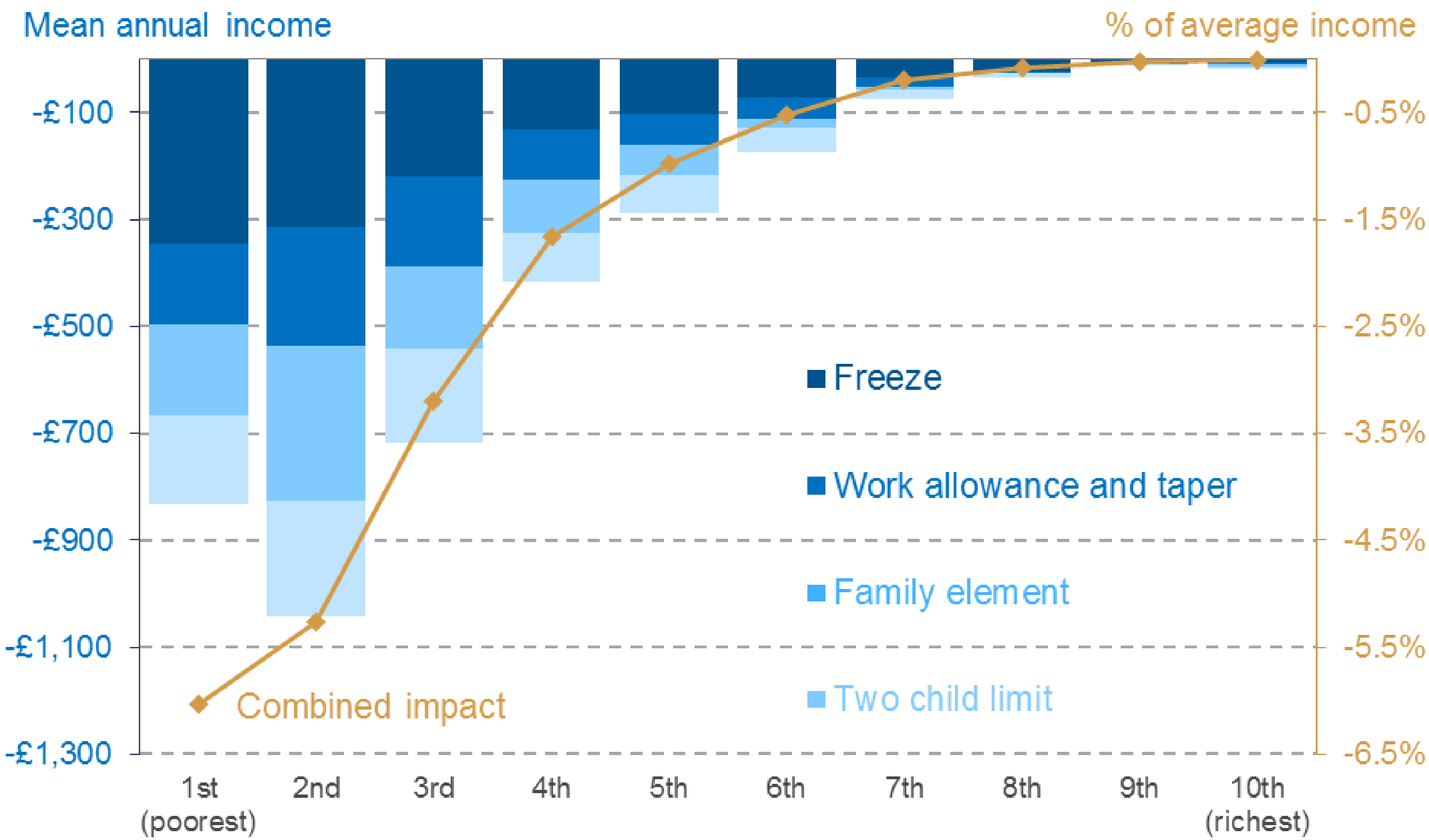
Cuts in welfare have featured less in the recent debate, but the strain associated with these spending reductions are set to grow rapidly in the coming years

- Public services and public sector pay
  - *Growing concern over public sector funding challenges and pressure to break the 1% pay cap, with pay review bodies noting growth in recruitment and retention difficult*

- Working-age welfare
  - *Sharp cuts in working-age welfare are set to lower already squeezed incomes in much of the bottom half of the income distribution and increase inequality*

Welfare cuts announced since the 2015 general election fall especially heavily on lower income households

Change in income in 2021-22 associated with selected post-2015 general election welfare cuts, by equivalised household income decile



Notes: Working-age benefit rates (excl. disability benefits premia, statutory entitlements & maternity allowance) will not be increased until April 2020. UC work allowance cuts lower the point at which earnings start to reduce benefit entitlements, with the taper reduction slightly lowering that rate of withdrawal. New tax credit and UC claims will no longer qualify for the 'family element', and no additional payments will be available beyond the first two children. Source: RF modelling using the IPPR tax/benefit model

The 2015 summer Budget set out welfare cuts summing to over £14bn by 2021-22

By the start of 2017-18, around £9bn of cuts directly affecting incomes were still to be delivered

Those welfare losses contribute to an outlook for income growth over the next four years that sharply increases inequality

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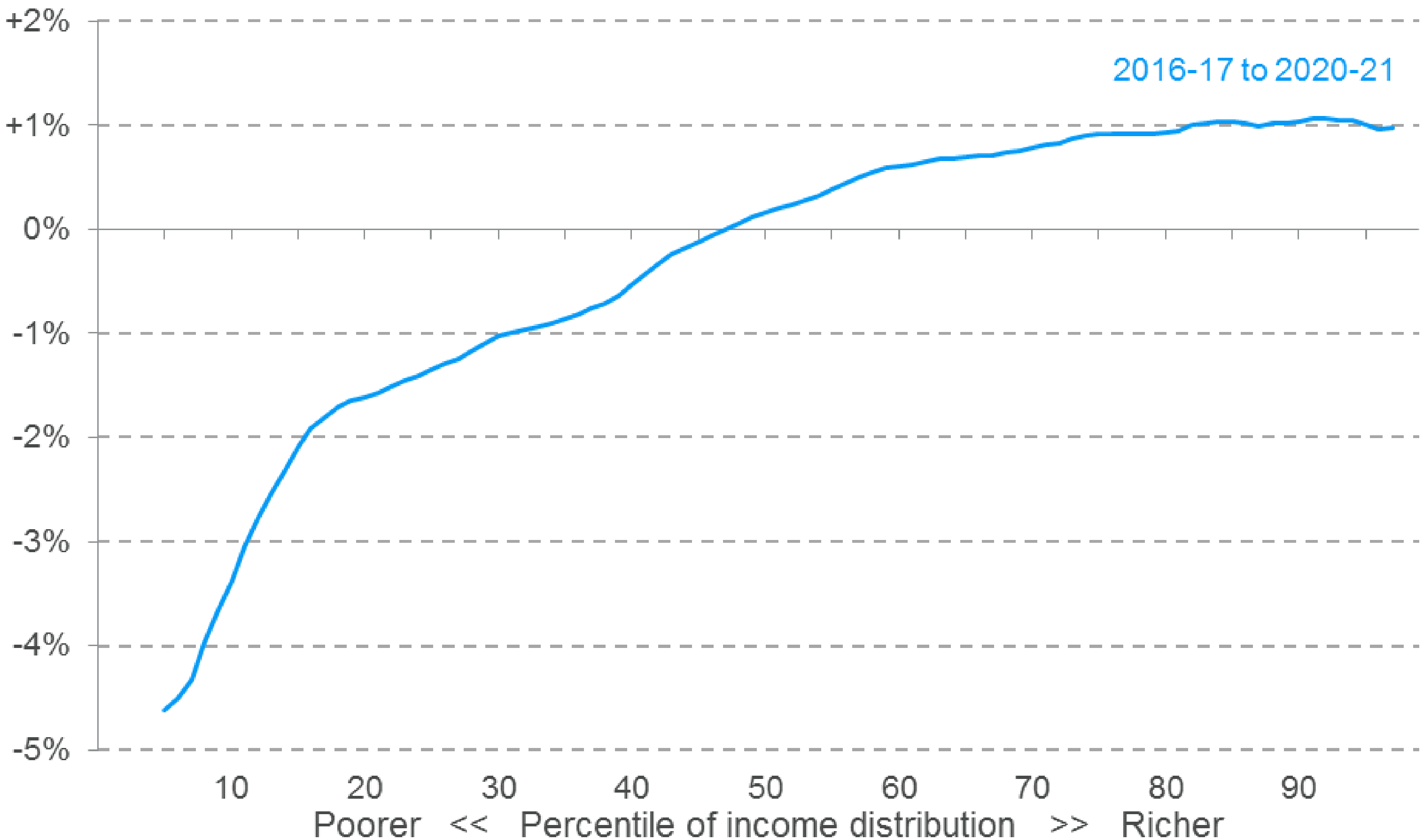
Average annual real-terms growth in equivalised after-housing costs incomes: working-age households



Source: RF analysis using OBR, *Economic and Fiscal Outlook* and *the IPPR tax/benefit model*

A combination of plateauing employment growth, a renewed pay squeeze across the economy and sharp benefit cuts create the prospect of falling incomes in the bottom half of the distribution and the biggest rise in inequality since the final Thatcher term

There is also clear evidence that public opinion on austerity has shifted: *two-in-five oppose further cuts in spending*

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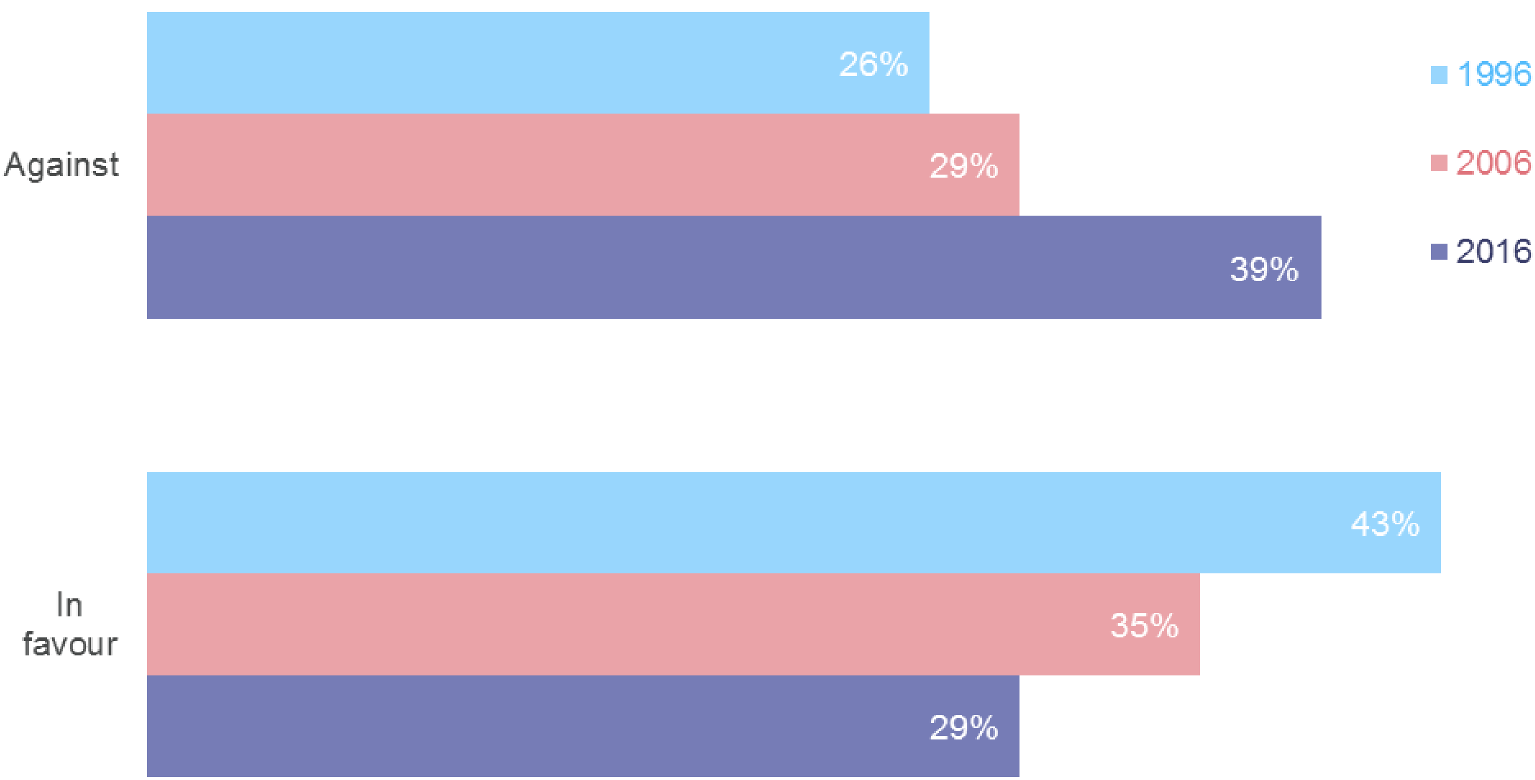
Proportion of respondents in favour of cuts in government spending



In 1996, just one-in-four were opposed to government spending cuts; by 2016 that proportion had increased to two-in-five

Likewise, the share actively in favour of cuts has fallen to 29%, having stood at 43% in 1996

Source: NatCen, *British Social Attitudes*

There is also clear evidence that public opinion on austerity has shifted: *nearly half favour higher taxes and higher spending*

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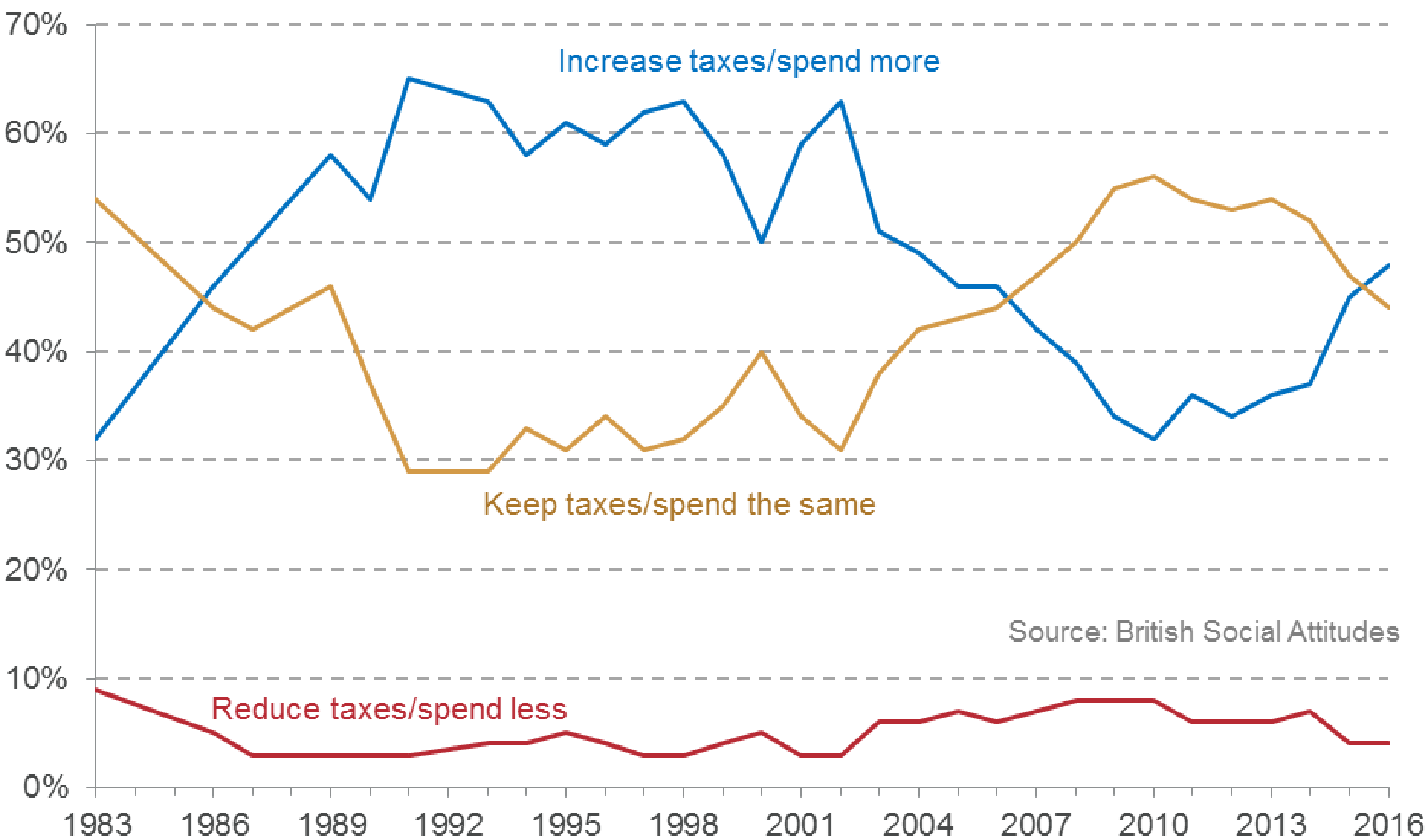
Atttitudes to tax and spending on health, education and social benefits



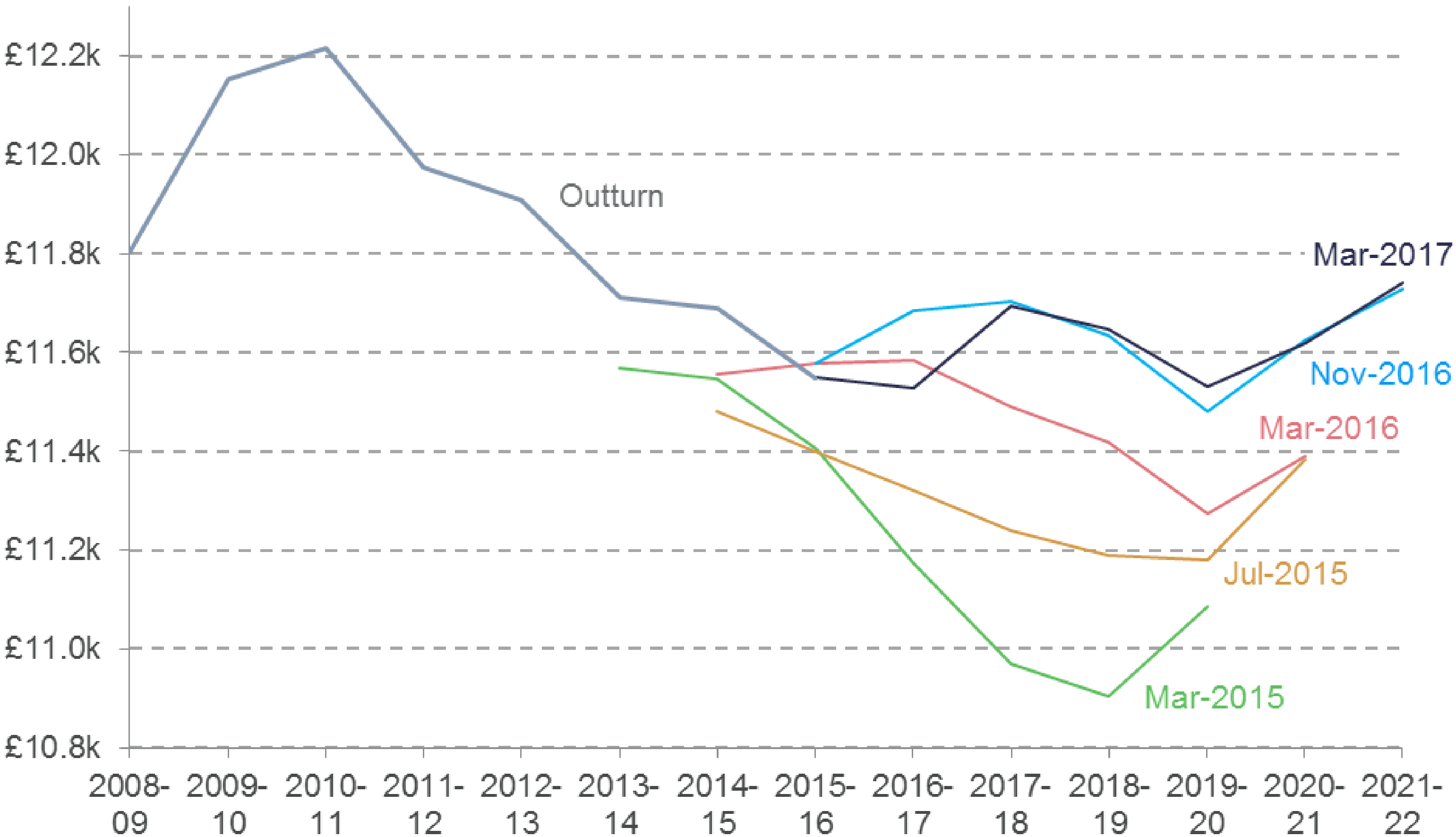
Source: NatCen, *British Social Attitudes*

Asked specifically about tax and spending in relation to health, education and social benefits, the share of respondents in favour of increases fell sharply over the 2000s, but has been rising steadily since 2009

In 2016, this position became the most favoured for the first time since 2006

The government has form on this: spending plans were relaxed after the 2015 election and again after the EU referendum

Successive OBR projections for real-terms government spending per person: 2015-16 prices (GDP-deflator)



Source: OBR, *Economic and Fiscal Outlook*

Following the post-referendum fiscal 'reset' implemented by Philip Hammond at Autumn Statement 2016, spending per person is set to remain broadly flat over the coming years – in contrast to the pre-2015 election plans of George Osborne which earmarked further sharp cuts

3) ENDING AUSTERITY?

What might the policy priorities and price tags of an 'end to austerity' look like?

'Ending' austerity could including changing course on some combination of public service spending, public sector employment and welfare

- **Public service spending**

  The current Spending Review runs to 2019-20 (with CDEL totals set for 2020-21 as well), and total DEL is due to grow in line with the GDP deflator thereafter. 'Ending' austerity could mean increasing the pace of departmental spending after 2019-20 in line with growth of the economy, or a more immediate change. Below we consider the costs associated with both approaches.

- **Public sector employment and pay**

  As a subset of overall public service spending, we can isolate the costs associated public sector employment and pay, which has dominated much of the post-election debate. The 1% pay cap is set to remain in place until 2019-20 (other than in Scotland). OBR assumptions imply further reductions in headcount over the coming years too. Below we consider the costs associated with both raising general government employment in line with population growth and matching average pay growth to expectations for the private sector.

- **Working-age welfare**

  The savings associated with welfare cuts are set to grow over time, reflecting the cumulative nature of reductions in generosity and the increasing numbers affected by tighter eligibility rules – especially as Universal Credit rolls out. Below we set out broad estimates for the costs associated with reversing those working-age welfare cuts that directly affect incomes and that are biting from 2017-18 onwards. This does not include reversing cuts already made.

Raising public service expenditure in line with growth of the economy could cost between £12bn and £24bn a year by 2021-22

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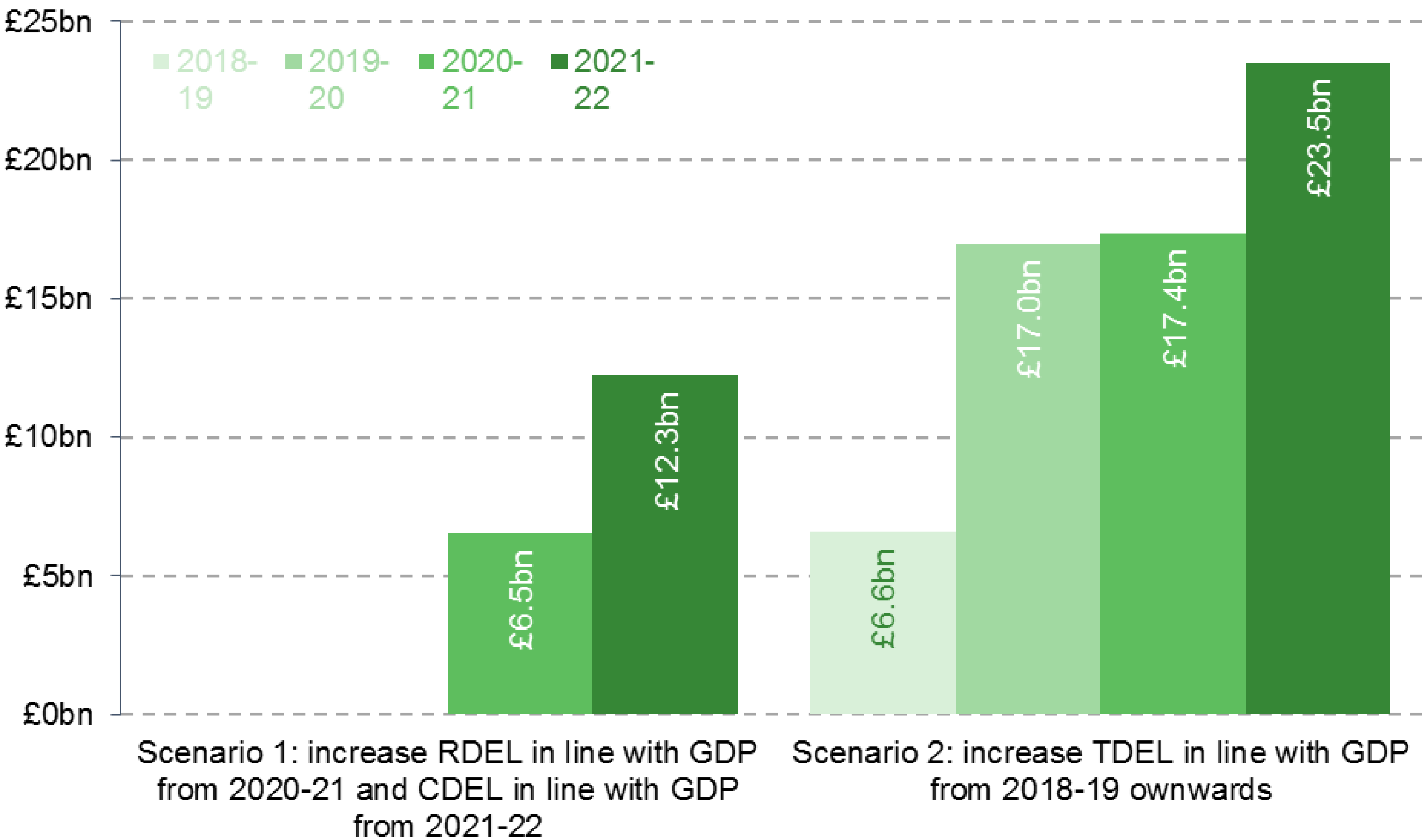
Additional annual nominal cost associated with different approaches to departmental spending



Notes: Under existing plans, CDEL is already expected to rise by more than GDP in 2020-21. As such, Scenario 1 holds RDEL constant as a share of GDP from 2019-20, but fixes CDEL at its 2020-21 share of GDP. Source: RF modelling using OBR assumptions on GDP growth

Waiting until the next Spending Review to alter the pace of departmental spending increases implies no near-term cost, rising to £12.3bn relative to current plans in 2021-22

Implementing immediate TDEL increases would instead cost £23.5bn in 2021-22

Action on public sector employment and pay could cost between £10bn and £22bn a year by 2021-22

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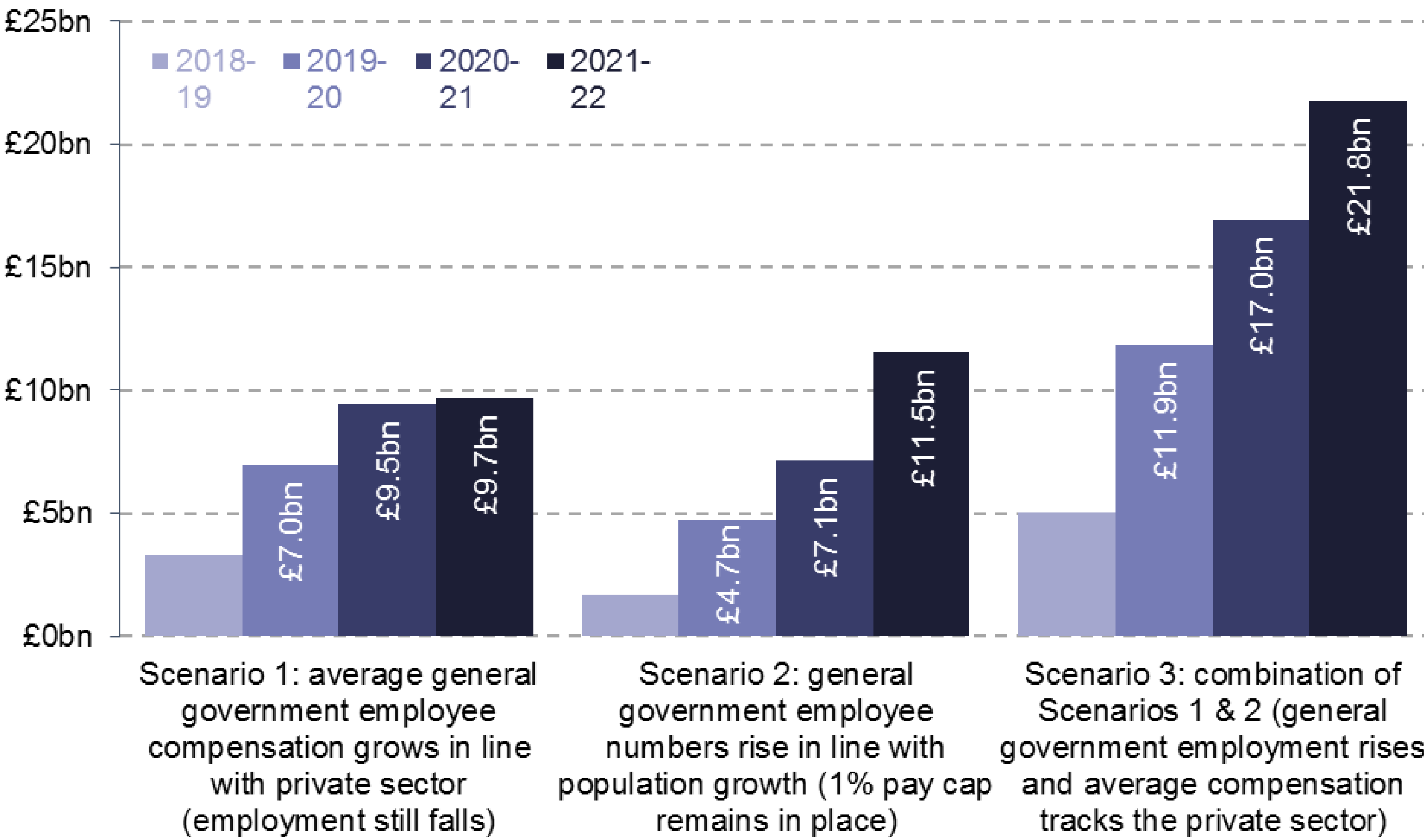
Additional annual nominal cost associated with different approaches to public sector pay and employment



Ending the public sector pay cap in 2018-19 would cost £9.7bn a year by 2021-22

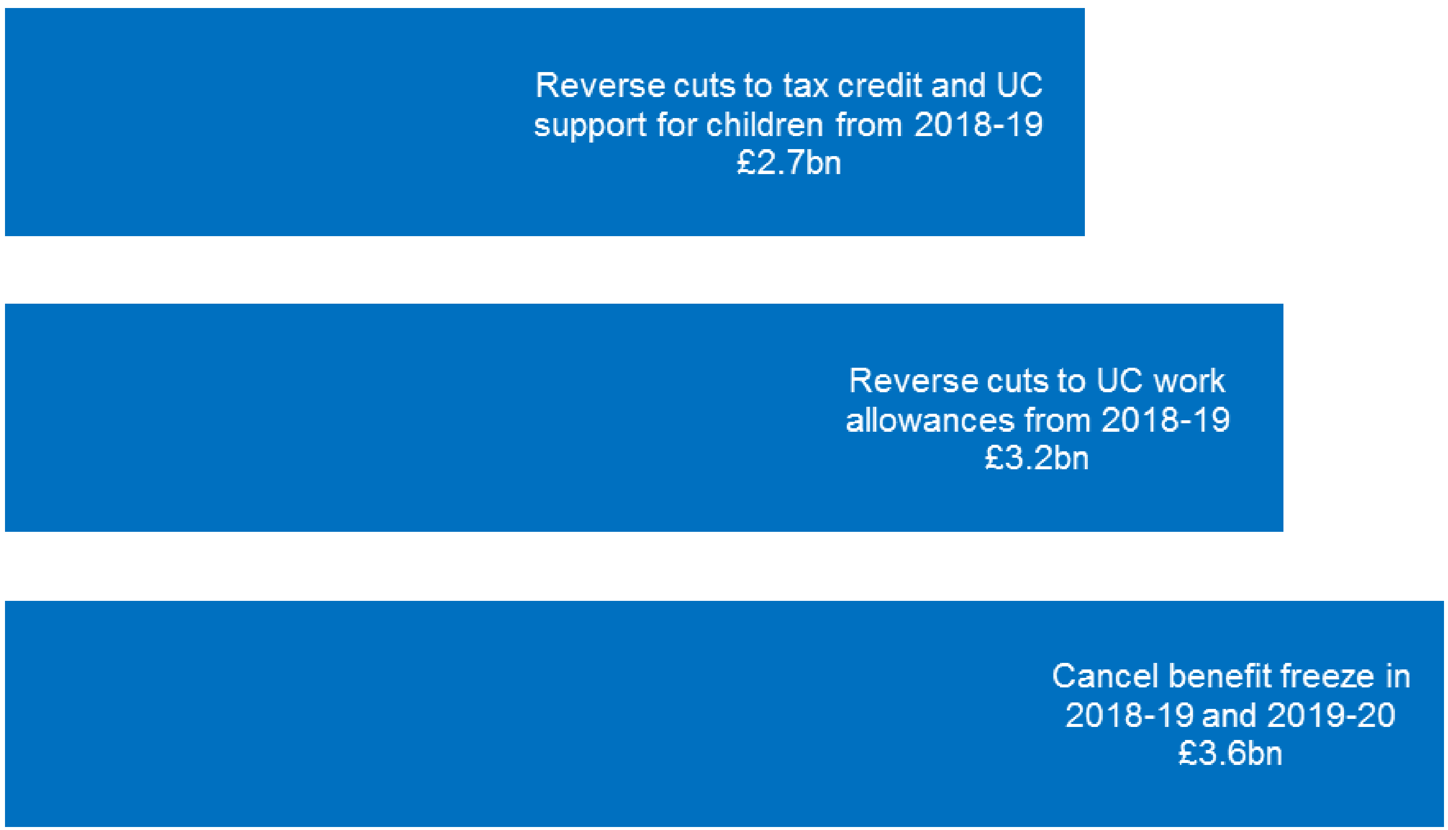
Matching employment growth to population growth would cost £11.5bn

Doing both simultaneously would cost £21.8bn

Notes: Figures relate to overall 'compensation' rather than just pay – that is, including the cost of pension contributions and employer NI. Source: RF modelling using OBR assumptions on general government pay and employment

Action on working-age welfare could cost up to £10bn a year by 2021-22

Additional nominal cost in 2021-22 associated with reversing or cancelling working-age welfare cuts still to be implemented



Notes: The UC work allowance reversal total is net of the taper reduction announced at Autumn Statement 2016. The totals are not directly additive due to interaction effects.
Source: OBR, *Policy Measures Database*

These costs cover those post-2015 welfare cuts that are yet to be fully implemented. We assume the policies are either cancelled (for those still to come such as the final two years of the benefit freeze) or reversed (for those affecting very few people to date but with more to come such as UC cuts and the two child limit)

Comprehensive action on public service spending and welfare could mean 'ending' austerity costing over £30bn

	2021-22
Estimated nominal terms costs associated with different elements of 'ending' austerity	
Increase pace of public service spending increases from 2020-21 in line with growth of economy	£12.3bn
Increase pace of public service spending increases from 2018-19 in line with growth of economy	£23.5bn
Match public service pay increases to the private sector from 2018-19	£9.7bn
Match general government employment to population growth from 2018-19	£11.5bn
Raising pay and employment in combination from 2018-19	£21.8bn
Reverse cuts to tax credit and UC support for children from 2018-19	£2.7bn
Reverse cuts to UC work allowances from 2018-19	£3.2bn
Cancel benefit freeze in 2018-19 and 2019-20	£3.6bn

4) PLUGGING THE GAP

The practicalities of 'ending austerity' mean some combination of higher borrowing and higher tax

One option for increasing spending is to make use of the £30bn borrowing headroom the government has relative to its 'fiscal mandate'

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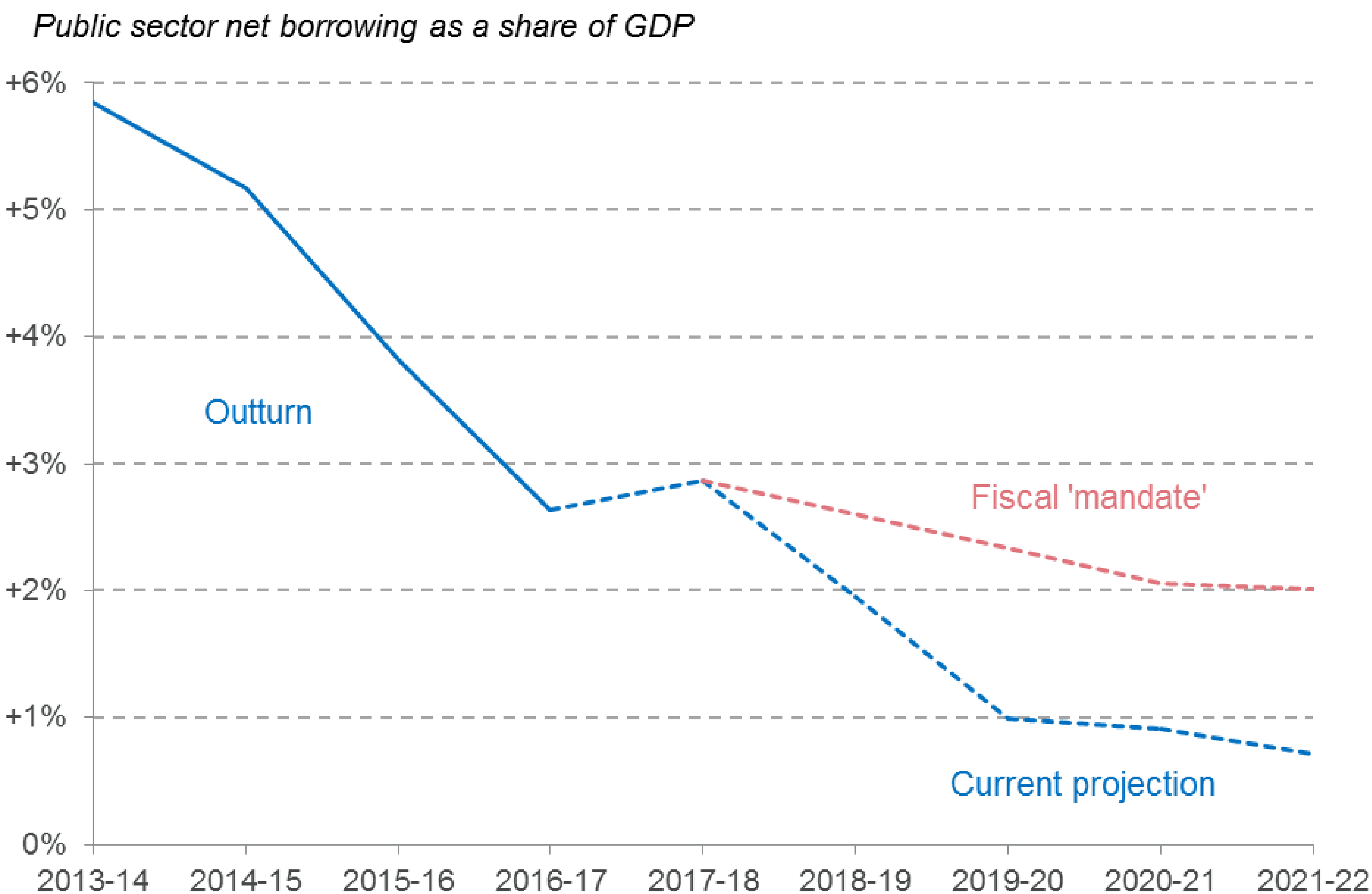

Source: OBR, *Economic and Fiscal Outlook* and RF analysis

The fiscal 'mandate' requires lowering cyclically-adjusted PSNB to below 2% of GDP by 2020-21. At the March Budget, the government was projected to instead achieve a deficit of 0.9% of GDP by that date

This Chancellor has fiscal headroom of £26bn, rising to £30bn in 2021-22

But… current projections are liable to be revised later this year and borrowing more would have major implications for the pace of debt reduction

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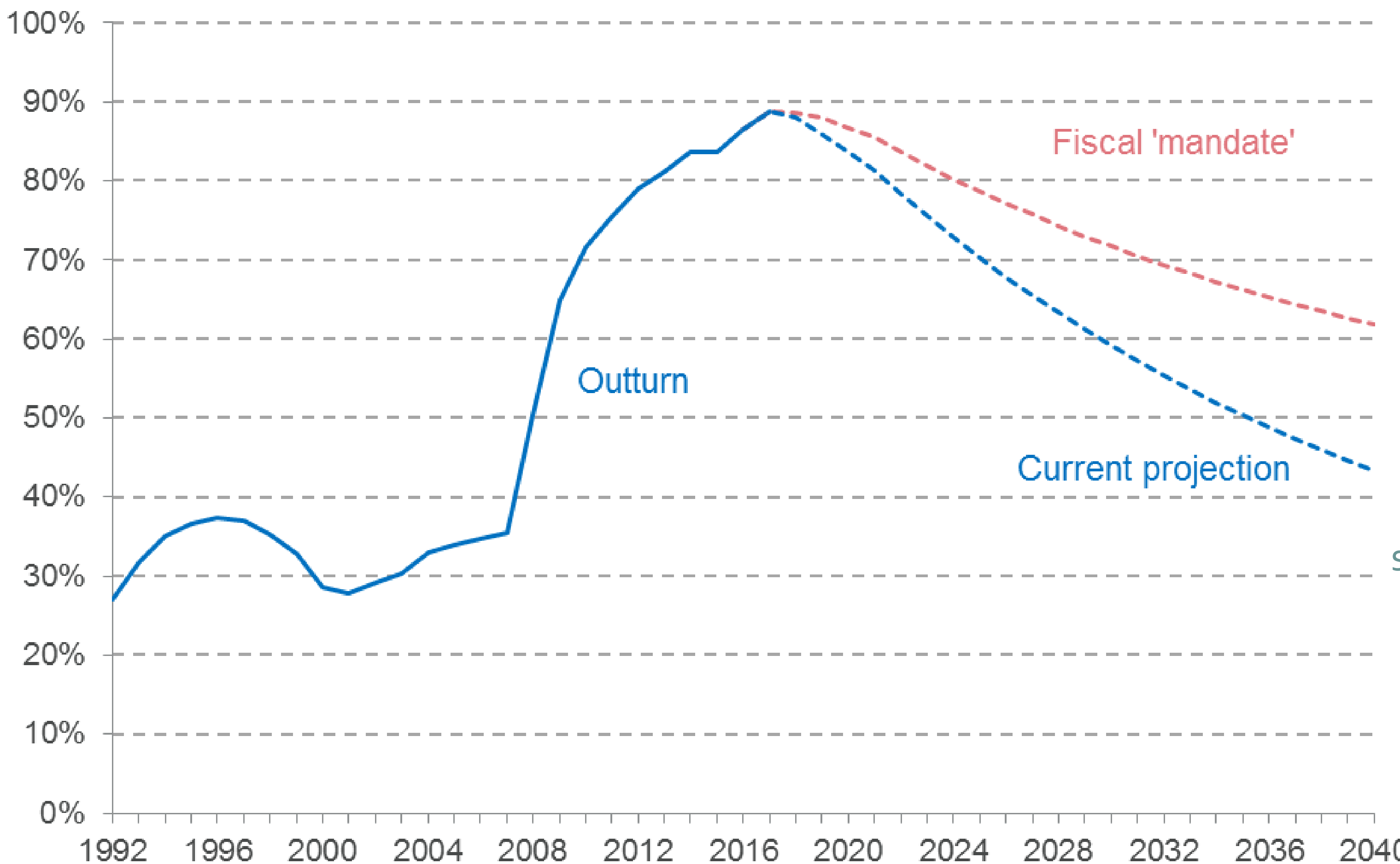
Public sector net debt as a share of GDP



Any increase in borrowing would slow the pace of debt reduction

The economy has underperformed relative to the OBR's March projections. The U-turn on raising NICs for the self-employed is also set to lower revenues by £500m. As such, the government's headroom may be reduced

Notes: 'Mandate' scenario excludes any second order effects in relation to growth or higher debt interest payments. In both scenarios, GDP is assumed to grow in line with existing forecasts through to 2021 and then at a steady 4.7 per cent thereafter. Source: OBR, *Economic and Fiscal Outlook* and RF analysis

And… the Chancellor has ruled out any further relaxation of the government's proposed deficit reduction strategy

higher discretionary borrowing to fund current consumption is simply asking the next generation to pay for something that we want to consume, but are not prepared to pay for ourselves, so we will remain committed to the fiscal rules set out at the Autumn Statement which will guide us, via interim targets in 2020, to a balanced budget by the middle of the next decade.

Philip Hammond, *Mansion House speech*, 20 June 2017

The implication is that the government must instead turn to tax if it wants to raise spending – though this isn't straightforward either

- The Chancellor has also cautioned against tax rises…

> *Higher taxes will slow growth, undermine competitiveness, and cost jobs, so the government will remain committed to keeping taxes as low as possible.*
>
> Philip Hammond, *Mansion House speech*, 20 June 2017

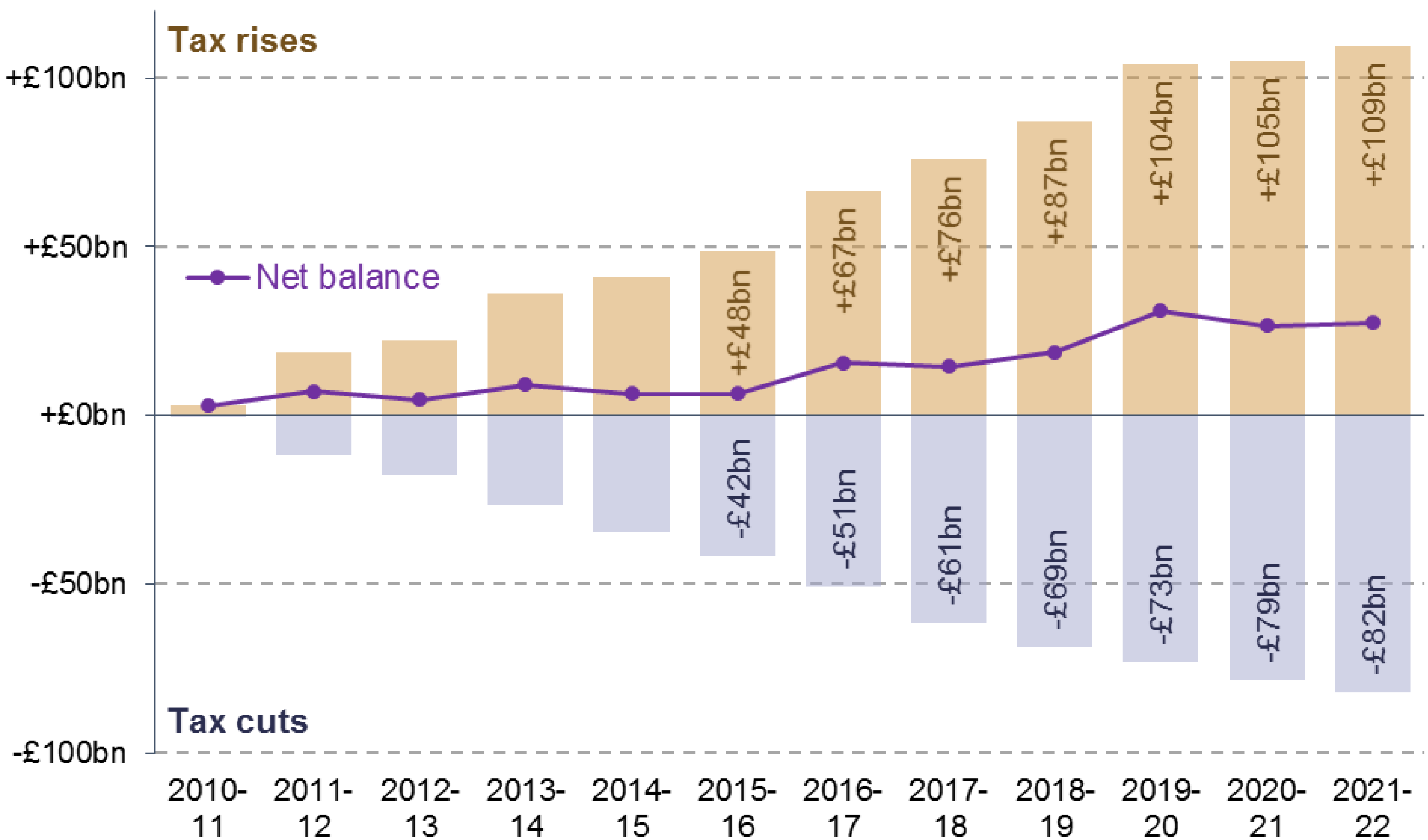
- And minority government makes it harder to legislate tax rises
- There is low hanging fruit in cancelling planned tax cuts. Greater use of fiscal drag may also be an option

THE TIMES

Scrap tax cuts to boost public sector pay, say ministers

To date, the fiscal consolidation benefit of some big tax rises has been largely offset by significant tax cuts elsewhere

Balance of all tax cuts and rises announced since Summer Budget 2010 (nominal terms)



Notes: Figures reflect OBR estimates of costs and revenues at the time the policy was introduced. Source: OBR, *Policy Measures Database*

Tax rises relate to VAT, bank levies, pension tax relief, dividend tax, capital allowances, IPT, contracting out & the apprenticeship levy

The biggest tax cuts relate to income tax thresholds, corporation tax, fuel duty & business rates

Tax cuts that have been announced (and scored) but not yet introduced are set to total £2.6bn by 2021-22

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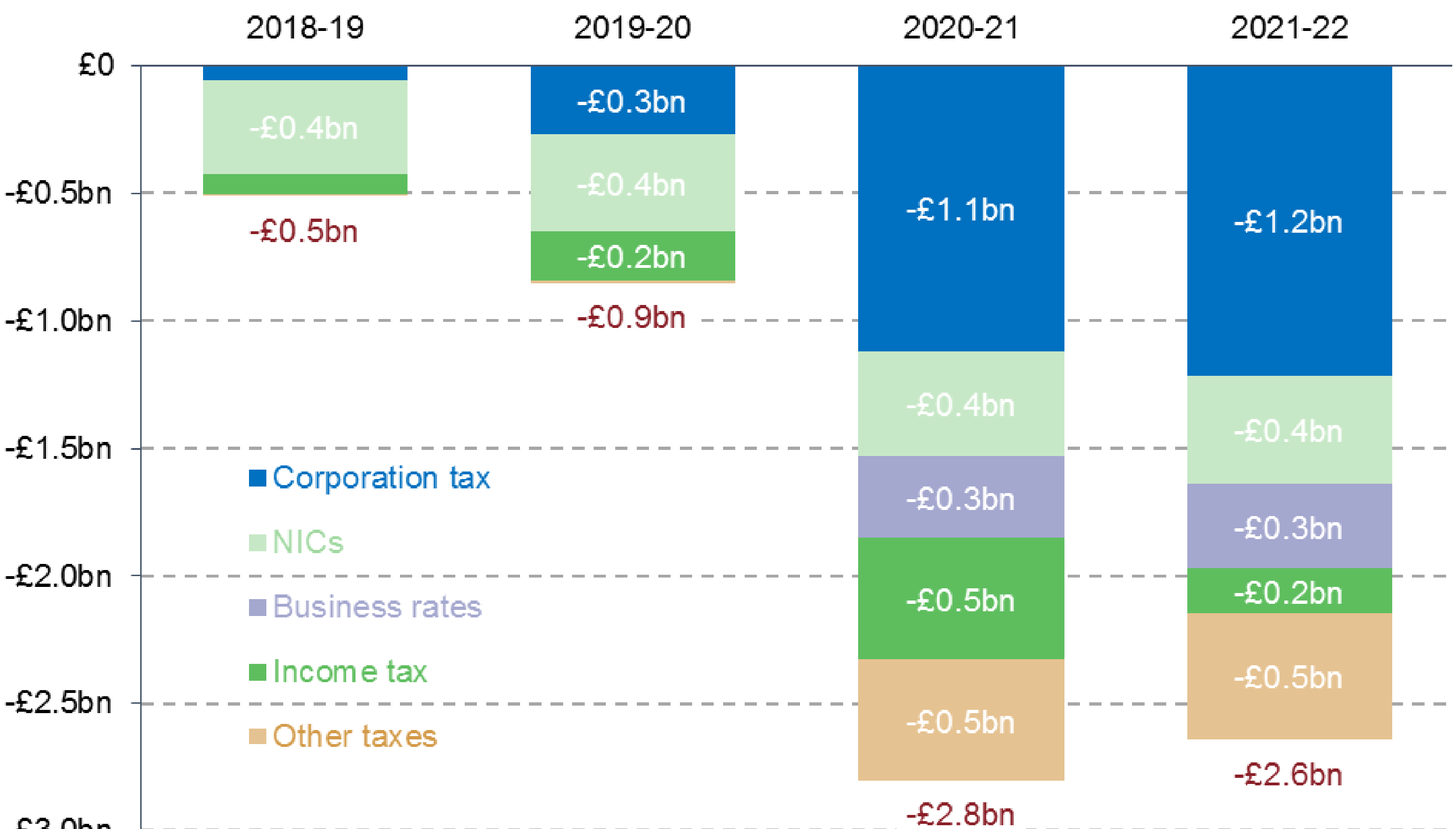
Costs associated with tax cuts that have been announced but not yet introduced (nominal terms)

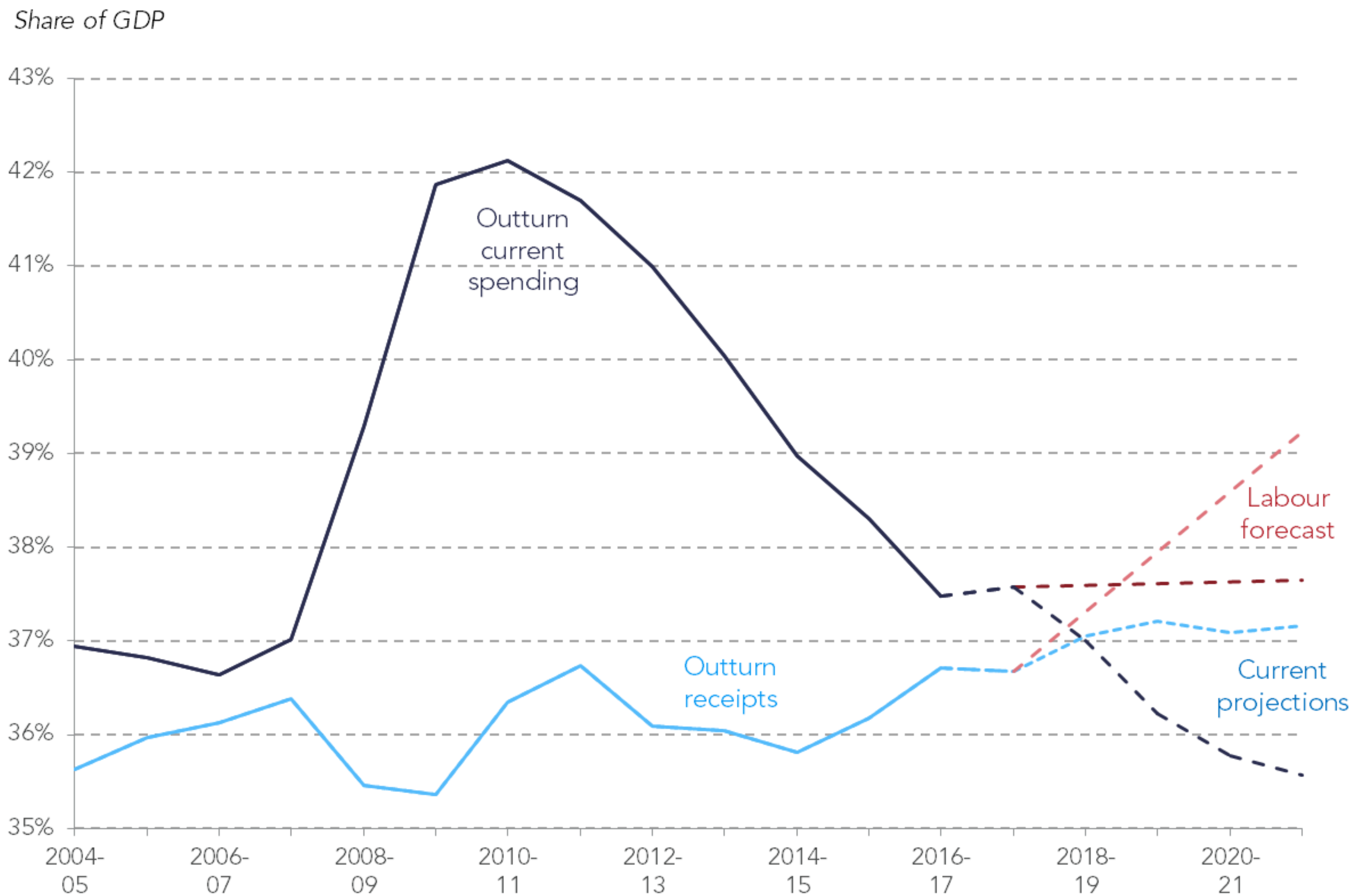


Notes: Figures reflect OBR estimates of costs and revenues at the time the policy was introduced. Source: OBR, *Policy Measures Database*

Simply scrapping existing tax cut plans could save the government £2.6bn by 2021-22

Corporation tax cuts have already been legislated for and so will be harder to reverse, although Labour has called for higher rates of CT.

Labour's plans included £49bn of tax rises, but much of this was earmarked for new spending rather than ending all planned cuts



Notes: Labour tax and spending figures are assumed to follow a straight line trajectory to 2021-22. Source: OBR, *Economic and Fiscal Outlook* and RF analysis

Labour planned to end the public sector pay cap and school cuts.

But significant spending was for new policy commitments, including on childcare and tuition fees, rather than 'ending austerity' of currently planned spending cuts. Welfare cuts were to be left largely intact.

Aggressive fiscal drag could generate a further £12.5bn by 2021-22, with four-fifths of the cost borne by the top half of the household income distribution

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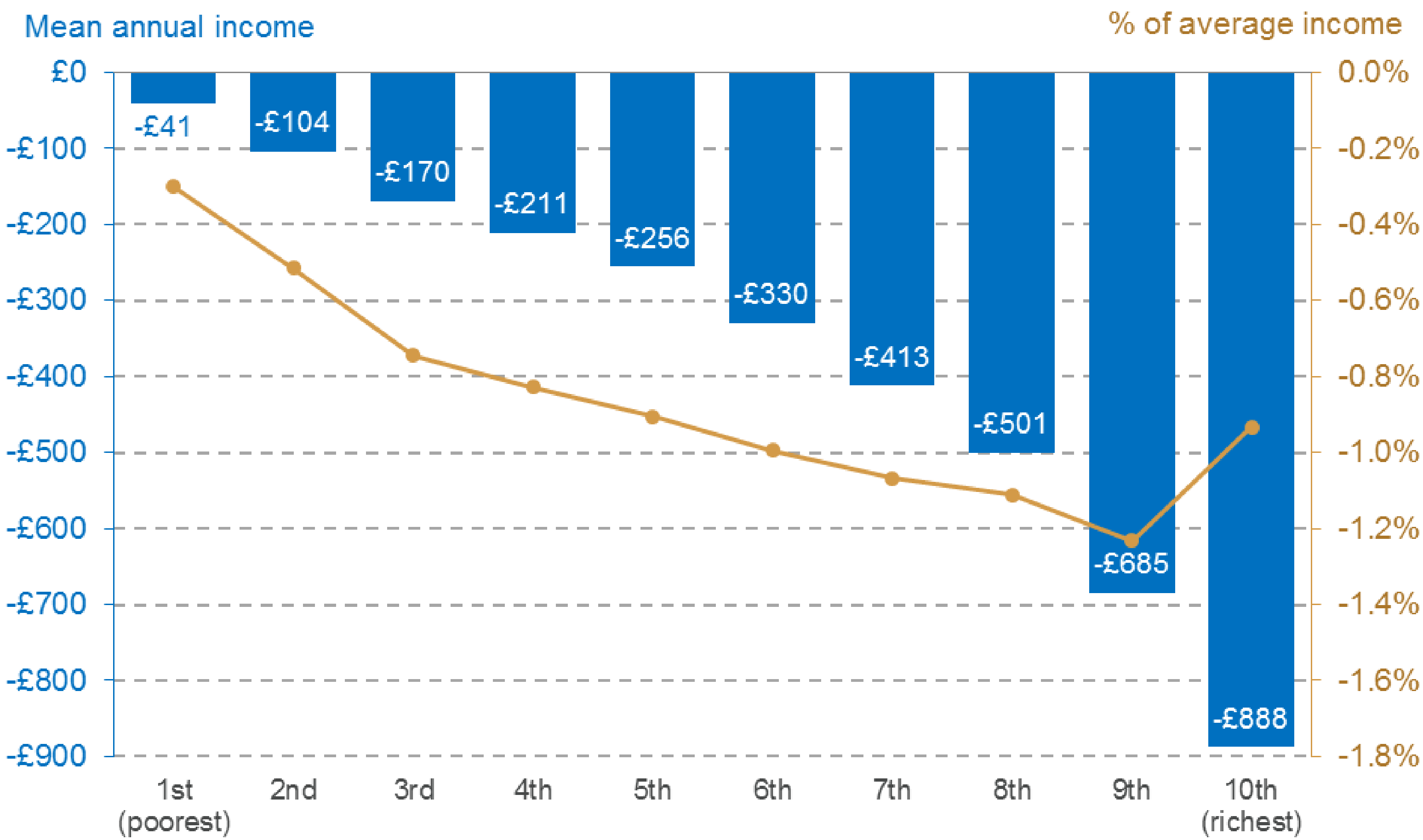
Change in income in 2021-22 associated with freezing various income tax and NI thresholds from 2018-19 onwards, by equivalised household income decile



Delivering on the pledge to raise the personal allowance to £12.5k and the higher rate threshold to £50k by 2020 would cost an extra £1.3bn, but hasn't been scored

Freezing multiple tax thresholds at 2017-18 levels would instead raise ~£12.5bn

Notes: Includes freezing the income tax personal allowance, the higher rate limit, the employee NICs primary threshold and upper earnings limit, the employer NICs secondary threshold and self-employed upper and lower profits limits. Source: RF modelling using the IPPR tax/benefit model and HMT *Ready Reckoner*

While raising significant sums, these tax measures wouldn't suffice to 'end' austerity, requiring clear prioritisation, further tax rises or increased borrowing

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Estimated nominal terms costs associated with different elements of 'ending' austerity	
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Cancel benefit freeze in 2018-19 and 2019-20	£3.6bn
Estimated nominal terms resources generated via different approaches to ending austerity	
Making use of borrowing headroom available under the 'fiscal mandate'	£30.3bn
Scrapping existing tax cut plans that are to be implemented from 2018-19	£2.6bn
Utilising fiscal drag by freezing various income tax and NI thresholds from 2018-19	£12.5bn

5) CONCLUSIONS

Faced with clear austerity fatigue, the government can and should change its approach to fiscal consolidation by making more use of tax to pull back on spending cuts…

- Seven years into what promises to be the longest sustained period of public spending restraint in at least 65 years, it is little surprise that austerity fatigue has kicked-in among the public and politicians alike. That fatigue is borne not just of the persistence of the squeeze on public spending, but by the fact that it comes against a backdrop of a squeeze on household finances too – with income growth largely absent for much of the last decade.
- The debate on 'ending austerity since June's election, has been very partial with some ministers calling for the relaxation of specific areas of spending restraint without any sense of the prioritisation amongst those areas, any recognition of the price tags involved or any suggestions on the practicalities of what meeting those price tags would mean in terms of higher taxes or public debt. The Chancellor has sought to remind his colleagues of these trade offs but offered little by way of his own answer.
- This paper has sought to provide material for anyone attempting to answer these questions and concludes that major moves towards 'ending austerity' are possible, but come with very significant price tags.
- Tax revenues can, and indeed should be, raised, reflecting the fact that the post-2010 fiscal consolidation has been much too weighted towards spending cuts rather than tax rises. Indeed, tax policy in the 2010 parliament made a *negative* contribution to the deficit reduction effort while public opinion has shifted over the last year towards the desirability of raising taxes in order to spend more.
- There is some relatively low hanging fruit on tax, in particular by scrapping tax cuts that are yet to be implemented and making greater use of discretionary fiscal drag.

…but the ‘ending austerity’ debate should recognise real trade-offs requiring further tax rises or a significant slow down in the pace of debt reduction

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- Going further, for example if you fully wanted to ‘end austerity’ and allowed borrowing to take the strain, would involve using up some of the £30.3bn fiscal headroom afforded by the ‘fiscal mandate’ established last year. The latter would have very significant effects on the level of national debt in the medium term, even before any deterioration in the public finances given recent evidence of data coming in worse than the OBR expected back in March.
- Because ‘ending’ austerity comes with large price tags, further major taxes rises are difficult and the Chancellor has ruled out significant extra borrowing, we are set for a debate requiring prioritisation of what spending restraints can be eased.
- To put it another way it’s time we had an adult debate not just about what taxes need to rise but what ‘ending austerity’ actually means.