EREP

Economists for Rational Economic Policies

# The Gap Widens

## Budget 2016 Report

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By Economists for Rational Economic Policies

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# Introduction

This pre-budget report aims to set out the context and issues in relation to Budget 2016. The political context (the EU referendum) means that the Chancellor is unlikely to take budget steps at this time that raise too much ire.

But the economic context makes it harder than it may have earlier seemed. This is because domestic economic data (as well as trade data) have trended downwards in recent months. Real GDP in 2015 rose by just 2.2%, with the last quarter coming in at 1.9% year-on-year. Nominal GDP in 2015 increased by just 2.6%, 1% less than the OBR had forecast. This explains the Chancellor's assertion that "the economy is smaller than we thought".

EREP contributors are not at all surprised by the weak data. Back in December, we published a short report, "The Cracks Begin to Show: A Review of the UK Economy in 2015" in which we predicted the difficulties that lay ahead. For example, after citing the downward drift in real GDP over recent quarters, we underlined this:

> More worryingly still, the rate of change in nominal GDP (i.e. current prices) in Q3 was also 2.1%. It is exceptionally rare for nominal GDP not to be greater than real GDP, and besides being an indicator of deflation, has a negative impact on the government finances…
>
> These recent GDP and public finance figures were published just before Christmas – and just a few weeks after the November Autumn Statement and Spending Review. The Office for Budget Responsibility had – thanks to some assumptions on GDP and tax receipts that were queried by many as being over-optimistic – helped the Chancellor to sidestep short-term political problems over working tax credit by allowing a slower path to his promised budget surplus. Those OBR and government assumptions now suffer from considerable scepticism…

And indeed, as this EREP Budget 2016 Report points out, it is the low rate of change in nominal GDP that is at the heart of the problems that Mr Osborne faces when he presents his budget – problems not just for 2016/17, but for the years ahead. We concluded our December Report:

> So indeed, as the year has progressed, the economy has slowed and regressed. The public finances are built on hopes and assumptions that appear to be fragile indeed, and economic activity in many key areas has decelerated whilst the property boom helps the asset-rich. The weaknesses in the UK economy are more and more apparent, like a building with a flashy design but poor

construction. The cracks begin to show. Let's hope there's no earthquake coming…

This remains the case. But back in November, the Chancellor was helped out of a difficult political fix (over working tax credits) thanks to some strangely optimistic economic assumptions by the Office for Budget Responsibility (OBR). We will be reading their new Economic and Fiscal Outlook report with more than usual interest.

# The British economy is even “smaller” than the Chancellor asserts

*By Ann Pettifor and Jeremy Smith*

**The Chancellor and journalists on the Financial Times have claimed that Britain’s economy in 2015 was “smaller” than forecast by £18 billion. However, we can reveal that for the financial year of 2015-16 the gap between what was anticipated by almost all economists, and the almost certain outturn is far bigger – at around £30 billion. This naturally has an adverse effect on the public finances, as a smaller economy produces lower tax receipts. At the same time public debt as a percentage of GDP expands as a share of the economic “cake”.**

Furthermore, the economy’s new, lower starting point brings down the level of activity in future years, and will lead to a higher debt-to-GDP ratio than has been forecast.

Astonishingly, the Chancellor’s response appears to be to contract the economy further, and with it national income, by proposing to cut government spending by “50p in every £100” by 2020.

Britain’s weakness and Mr O’s new problems are largely home-grown, and not in any significant way down to “global headwinds” or “dangerous cocktails” forced upon us by foreigners. The remedy? A major change in economic policy. Because the slowing private economy is caused by a lack of aggregate demand, it is vital that the government supports the private sector by expanding national income. This is best done by increased public investment and spending on activity that generates skilled, well-paid employment. This increased investment will, thanks to the multiplier, expand national income, and lead to higher tax receipts for the Exchequer – with which to “balance the books”. No other economic strategy will work. Indeed, taking account of global weakness, a strategy to shrink the economy further by cutting government expenditure, will only worsen the public finances.

**How we calculate the £30 billion “hole” in the British economy**

So far, commentators are focusing on the GDP outturn for the calendar year 2015. Two things have happened. “Real” GDP (after allowing for inflation) increased in 2015 by 2.2%, below the Chancellor’s and OBR’s estimate – as recently as last November – of 2.4%. But more significantly, nominal (or current price) GDP has come in far below the Treasury/OBR assumption – at £1864 billion, it has risen by just 2.6% as against the assumed 3.6%. The extent of OBR unpreparedness for this 1% reduction in the economy is to be seen from paragraph 3.62 of their November 2015 Economic and Fiscal Outlook.

> 3.62 We expect annual nominal GDP growth to fall back from 4.7 per cent in 2014 to 3.6 per cent in 2015, largely reflecting slower quarterly growth of nominal GDP in the second half of 2014 that affects the annual growth rate in

2015. Nominal GDP growth is then expected to pick up steadily from 2016 as CPI inflation moves back towards target.

As it happens, the biggest falls in nominal GDP in 2015 took place in the last half of the year. Remarkably, nominal GDP rose by no more than real GDP, meaning that inflation in the economy was zero. Real and nominal GDP both rose 2.1% year on year in Q3, and 1.9% in Q4. The last time that nominal GDP was no bigger than *real* GDP for half a year was way back in 1960. And we can expect that in Q1 of 2016, nominal GDP will outpace real GDP – if at all – by a very modest margin.

***This means that for the financial year 2015/16, it is almost certain that nominal GDP will have fallen by much more than £18 billion. The "hole" in the economy we are almost certain will be closer to £30 billion than £18 billion.***

To arrive at this figure, all we have done is to take actual GDP figures published (25th February) by ONS for 2014/15, and then add up the published figures for Qs 2-4 of 2015 (for the first three Quarters of the financial year), and make a judgment on the GDP level for Q1 2016 (the final Quarter). We make an estimate of nominal GDP growth of 0.6% for Q1 compared to Q4 2015 (n.b. if we increase the assumption to an unlikely 1%, it only makes some £2 billion difference).

This means that nominal GDP in 2015/6 will have risen by just 2.2% year on year. *Or £30 billion less than OBR have to date forecast.*

Here is the PRIME chart, showing the OBR November assumption, and our estimate as above.

| | OBR Nov nominal GDP £bn | % increase yr/yr | PRIME Feb nominal GDP £bn | % increase yr/yr | Difference in £bn |
|---|---|---|---|---|---|
| 2014/15 | 1829 | 4.2 | 1833 | 4.4 | +4 |
| 2015/16 | 1903 | 4.0 | 1873 | 2.2 | -30 |
| 2016/17 | 1980 | 4.0 | 1936 | 3.4 | -44 |
| 2017/18 | 2065 | 4.3 | 2010 | 3.8 | -55 |
| 2018/19 | 2157 | 4.5 | 2094 | 4.2 | -61 |

Note too that the OBR November forecast 4% rise of nominal GDP in 2016/17 now seems very high – our working assumption (in effect combining likely real GDP and likely inflation) is 3.4%. Thus the "hole" in the economy may widen in future years, but in any event is larger than we are being told.

If nominal GDP is lower than expected, this has a real impact on the public finances. People pay taxes in "nominal" pounds. If pay and activity are at lower levels, government receipts are naturally lower too. We estimate that (barring last minute one-off asset sales) there will be a shortfall of £5 billion or more in receipts this financial year, making the deficit somewhat higher than the OBR and Chancellor expected. The impact on government receipts for future years will also be significantly

higher. The debt to GDP ratio – a key political indicator – will be a little higher, as both debt and GDP are defined in nominal terms.

On Sunday, the Chancellor told us – based on his claim that the "hole" is just £18 billion not £30 billion, that he expects to cut spending further by "50p from every £100 the government spends" by 2020. "That formulation would amount to about £4bn", the FT tells us.

But since the "hole" is certain to be bigger, the cuts that would required – if the Chancellor sticks to his present damaging policy - are bound to be bigger. They may not be unveiled this coming week – the coming EU referendum requires no apple-carts to be overturned or even set in motion – but they will emerge. The Chancellor is aiming for public spending to be around 37% of GDP in the coming years. So if annual GDP is £30 billion less than previously estimated, this would imply (all else being unchanged) a reduction in spending of around £10 billion.

But what is absurd is that government policy – faced with a "smaller economy" and slowing private economic activity – is to cut national income further, by reducing government spending. And in so doing, to target the disabled and least well-off. The *current* budget deficit (i.e. excluding investment) is so far estimated by OBR at just 0.7% of GDP next financial year. Even if this is more likely to be 1%, it represents no danger to the country's economic security. The rest of the deficit is for the government's long-term investment purposes. And economists are overwhelmingly supportive of the case for borrowing for investment for the long-term benefit of our country, at near zero rates of interest. What is economically unsound is to make cuts which tend to reduce national income, even if they are done to satisfy a random fiscal rule or target. (Except where the economy is at risk of over-heating, which is certainly not now, aiming for a fiscal surplus is a policy for contracting the real economy).

If services and benefits are to be cut further, this is for ideological, not economic reasons. And the cuts will only serve to widen the budget gap, which will only start to close when new economic policies and models – based on increasing aggregate demand and real pay and thereby government receipts - replace the failed ones that are causing the damage.

# A Growing Record in Fiscal Mismanagement

*By John Weeks*

Over the last twelve months through January, George Osborne can boast of reducing public borrowing by £1.3 billion per month measured on an annual basis. This represented an improvement on the previous twelve months when the decline was slightly over one billion per month. At that rate the overall budget would blossom into surplus at the earliest in the second half of 2021, almost 18 months beyond his self-imposed target ("would" because he may no longer be Chancellor).

There is little mystery why deficit reduction has been so slow and why the Spring Budget will bring no change. Over the 12 months including January 2016 the ratio of changes in revenue to changes in GDP was .26, i.e. for every one pound that GDP increased, revenue increased by 26 pence. During the first twelve months of Mr Osborne's residence at 11 Downing Street, when the revenue structure still reflected the policies of the previous Labour government, increases in GDP generated revenue at twice that rate (calculations from Tables psa1 & psa6b_1, *Public Sector Finances* January 2016).

To state the cause simply, Mr Osborne's repeated failure to hit his targets results from his own policies. The poor revenue performance logically follows from Mr Osborne's fiscal mismanagement. The failure in fiscal management appears on both sides of the ledger: 1) the budget cuts depressed demand so that GDP grew slower, thus generating less tax; and 2) tax shifting and rate reductions resulted in less revenue for any £100 increase in GDP.

A reasonable definition of failure might be 1) repeatedly taking actions that make achieving stated goals more difficult or impossible; and 2) those actions generate dangerous and harmful unintended consequences. As he takes centre stage for his Spring Budget performance, Mr Osborne qualifies on both criteria. He repeatedly fails to meet his own measures of success as a result of mismanagement of expenditure and revenues, and that mismanagement has produced the slowest and most unbalanced recovery on record.

To use a word favoured by the media, as a Chancellor, Mr Osborne lacks credibility.

# A weakening economy, reliant on consumption and debt

*By Jo Michell*

At the end of February, Chancellor George Osborne made an admission: 'the economy is smaller than we thought in Britain'. The tone has changed since November when, following the unexpected discovery of a spare £27bn by the OBR, the Chancellor triumphantly declared, 'our long term economic plan is working.' As it turns out, the UK economy is around one per cent, or £18bn, smaller than the OBR predicted, leaving the Chancellor with at least £5bn in missing tax revenues this year alone, and more in future years (estimated at £9bn per year by the Institute for Fiscal Studies). There is no chance he will keep to his own misguided fiscal rule.

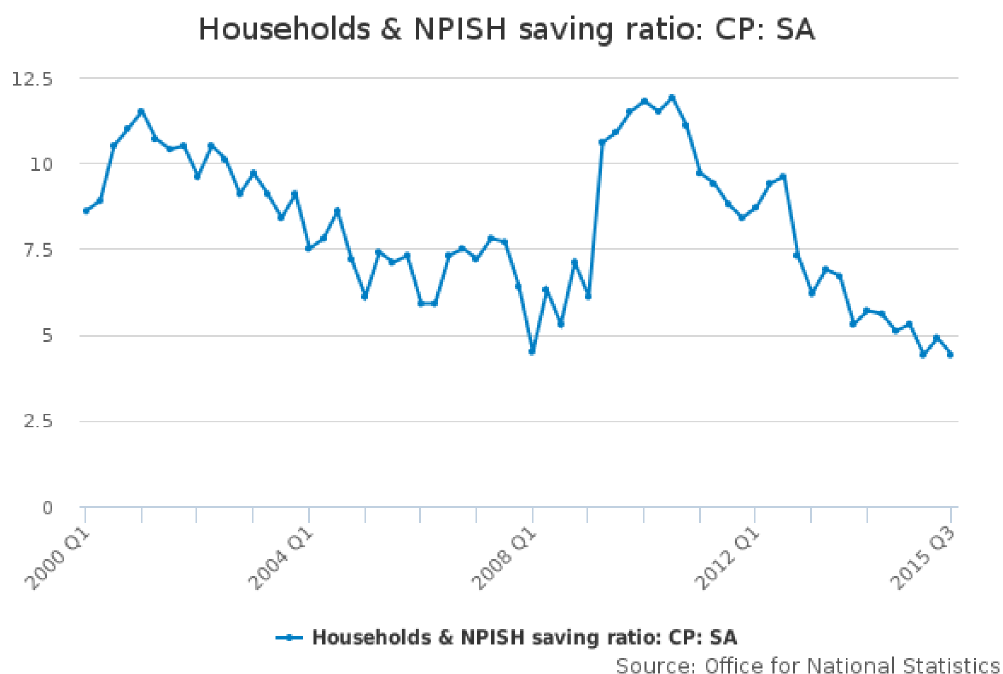
EREP have consistently argued that the supply-side optimism implicit in the OBR forecasts was unwarranted. We were right. Economic indicators across the board have deteriorated significantly since the November forecast. Even the service sector, the single remaining engine of the UK's imbalanced economy, is now showing signs of mechanical failure. The Markit UK services PMI – a key indicator of activity in the services sector – fell sharply in February. There is no chance that UK growth will be 2.4% in 2016, as claimed by the Chancellor in November.

Osborne's tax shortfall is the result of much lower than predicted wages and prices. The broadest measure of inflation, the GDP deflator, has fallen to zero, while wage growth has slowed substantially to around two per cent – the OBR had predicted wage growth of three to four per cent over the rest of this parliament.

Despite weakening wage growth, retail sales have remained strong: the most recent figures showed year-on-year spending increases in excess of two per cent. Retail sales strength has driven in part by lower prices resulting from the sharp decline in oil prices. But while households in other major economies largely saved the windfall from lower oil prices, those in the UK spent it, and more. The UK household savings ratio, at 4.4% of disposable income, is now the lowest on record.

And despite weakening wage growth, the UK economy is now entirely reliant on continued household consumption spending. Contrary to Osborne's claim that growth 'is more balanced than in the past', the UK trade deficit is a drag on economic activity and business investment – which only recently regained pre-crisis levels – fell sharply in February.

How have UK households increased spending despite wages remaining well below pre-crisis levels? Unsecured consumer credit is growing at around nine per cent per annum – the fastest rate since 2005. At over 140% of disposable income, UK household debt is higher than in the US, Japan or the largest European nations. Even the optimistic and now-discredited OBR forecasts predicted the household debt-to-income ratio would need to rise to 160% by 2020 for growth to be maintained and the deficit eliminated.




A recent report by the Money Advice Service – an independent body set up by the government – reports that 8.2 million adults in the UK – one in six of the population – are over-indebted. Among poorer regions, such as the Welsh valleys, the figure rises to one in four. The problem is particularly acute among young people, those in rented accommodation and those with children.

It is exactly these groups – working families and young people – whom the Chancellor will target in the next round of austerity. In the previous Parliament, austerity was targeted at the most marginalised: the sick, the disabled and the unemployed. Since these people have least voice in society, they are unable to put up resistance. Cutting the incomes of working families will be more difficult, as Osborne's U-turn on tax credits shows.

By reducing working peoples' incomes, Osborne is attempting push the burden of debt onto the household sector. The strategy will fail – without wage growth, consumer spending will eventually be constrained, dampening growth and pushing Osborne's deficit-reduction strategy yet further off track. That deficit reduction is not really the ultimate aim of Osborne's strategy is made plain by his intention to continue cutting tax for those on higher incomes.

There is no long-term economic plan; Osborne's strategy is one of redistribution by taking from those who least can afford it. As the latest figures show, his strategy has backfired.

# A History of Missing Fiscal Targets

*By Graham Gudgin and Ken Coutts*

You have to feel sorry for George Osborne. Life must feel like one long attempt to run up a down escalator. This is what happens when one does not believe in the Keynesian multiplier. It is perhaps not too much of a caricature to say that the Chancellor believes in 'crowding in' i.e. that the private sector will always compensate for any reduction in demand from the public sector. This is certainly what the Office for Budget Responsibility believe. The OBR forecasts, which played such a large role in the Chancellor's Autumn Statement, are dominated by 'supply-side' optimism. The forecasts are that GDP will grow at close to 2.4% per annum each year up to 2020 and essentially forever. This growth rate is based on an assumption that labour productivity will always grow at close to 2% per annum plus the ONS forecast of 0.5% per annum for working-age population.

The official forecast of 2.4% per annum was judged by the OBR to be sufficient to generate the tax-revenues necessary to meet the Chancellor's fiscal target of a balanced budget by 2019. Now the Chancellor is not so sure. The swathe of bad economic news after Christmas led him to begin downplaying expectations. The argument is that world conditions are creating head-winds (the down-escalator) slowing the UK economy's upward progress. We will see this week whether the OBR also adjust their optimism in light of a poorer world outlook and revised data.

In fact not everyone has become more pessimistic. Oxford Economics, which has a global model, currently expects global markets for UK exports to grow faster in 2016 than it did last Autumn. Admittedly, global markets are judged to grow slower from 2017 but only by a small amount. Either way, the forecasts generated by our CBR model of the UK economy predict a sharp slowdown from the pre-election heights of an economy growing at close to 3% per annum. Part of this slowdown has already occurred. The ONS judges GDP to have grown by 2.2% in 2015 although this may be revised up a little.

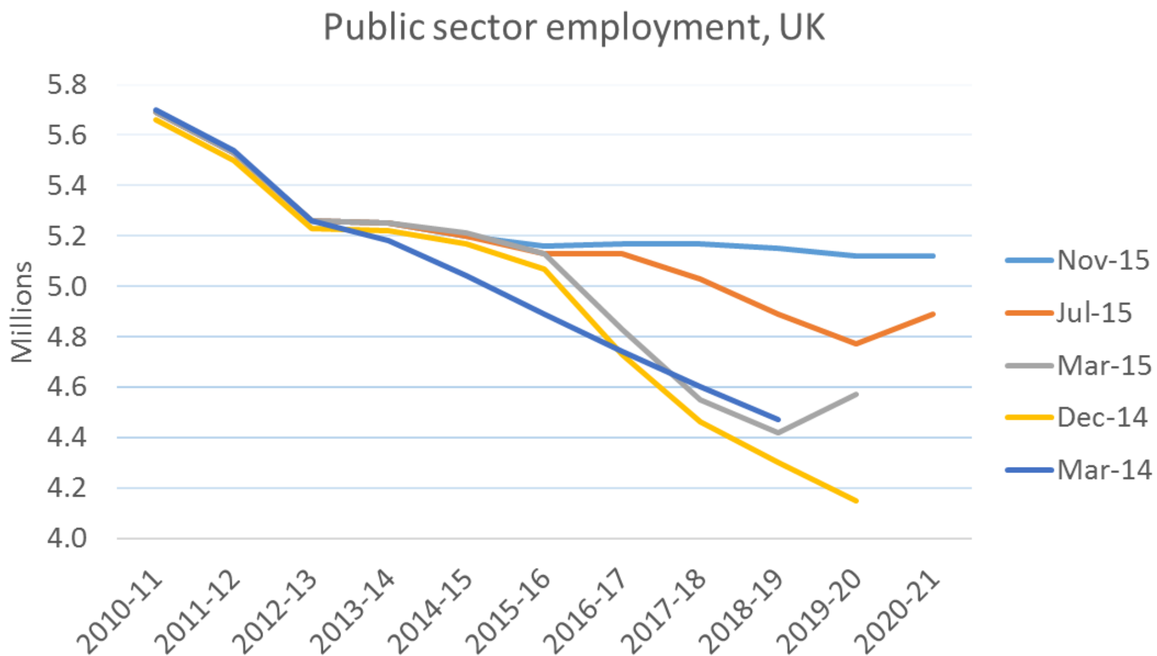
Our own forecasts for GDP in 2016 is 1.8%, a little below the IMF forecast, and averaging only 1.3% per annum in the following four years. These forecasts are from a Keynesian model, in which demand is paramount, and in which productivity depends on investment and not on an imposed assumption. What causes the forecast to be lower than that of the OBR is austerity in public spending and taxation. In principle, government austerity could be offset by a rapid increase in household consumption, but this would need a fast expansion in both unsecured and mortgage lending to households. The expansion in household indebtedness is in our view unlikely to be large enough to offset public sector austerity, not least because of the Chancellor's own efforts to rein-in the buy-to-let housing market.

The key point is that slow growth in GDP, induced by austerity, will lead to a slow increase in tax revenues, and will cause the fiscal target for 2019 to be missed. Our expectation is that the fiscal deficit will be 2.5% of GDP by 2019 and that government

debt will still be close to its peak of 84% of GDP. The target zero deficit will be missed, in our view, by £50-60 billion. The Chancellor is tripping himself up. In the real world, devoid of supply-side optimism, cutting government expenditure leads to lower GDP and reduces tax revenues. Just as the fiscal target was missed by miles in the 2010-15 administration, it will be missed again, for much the same reason.

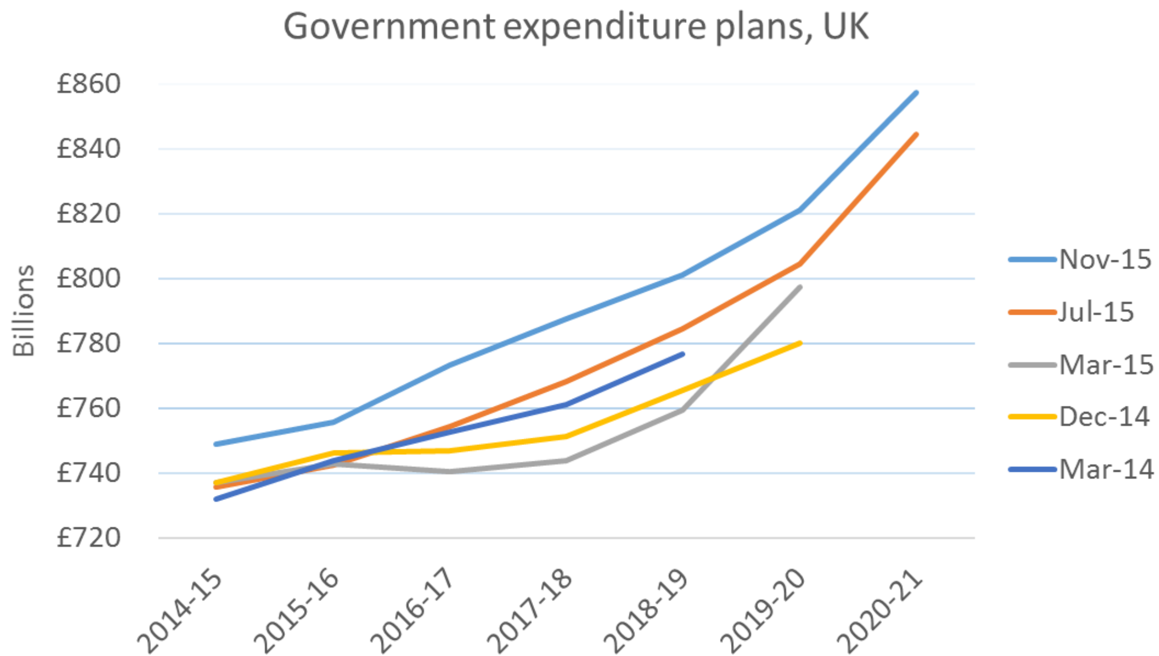
The paramount target of a balanced budget makes little sense and is in any case not within the power of the Chancellor to achieve. He can reduce government spending but cannot control revenues, which depend on decisions made by the private sector both in the UK and abroad. If the private sector wishes to save, the public sector is likely to have to run a deficit. This is determined not by the laws of politics but by the laws of arithmetic. National economies are not like family budgets and Mr Micawber's advice is not relevant.

In practice, the fiscal position is even murkier than this. The Government sets cash targets for government spending, but its real spending is determined by variations in the costs of public expenditure. Some of these costs can be controlled, including wage costs, albeit with difficulty as is obvious from the junior doctors' pay dispute. Costs are also determined by public sector productivity and this is quite variable and difficult to predict. The OBR seem quite unsure about public sector jobs, and hence productivity. The chart below shows OBR projections for public sector employment in successive Economic and Fiscal Outlooks. A little over a year ago the OBR predicted that a million government jobs would be lost by 2020. By last November this had been hugely reduced to only 80,000.




Note: *We are grateful to Professor Neil Gibson of Ulster University for this chart*

Predictions of government consumption and investment have also been volatile from Budget to Budget or Autumn Statement. Last March government consumption for 2019 was predicted to be £352 billion, but by November had increased by 8% in nominal terms or 5% in real terms (see second chart below). It seems likely that this week's Budget will reduce spending decisions down once again, to something nearer the March projection.

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**Conclusion**

The Chancellor's expenditure projections tend to flip-flop from one announcement to another, but a constant feature is the tendency to miss fiscal targets. Should we be concerned? One answer is that zero budget balances are unnecessary and unhelpful, and hence missing targets is all to the good. A more considered conclusion is that continuing attempts to cut spending to meet unrealistic fiscal targets is confusing and counter-productive. In a world in which monetary policy has clearly run its course as a means of stimulating economic growth, it is clearly time to campaign for international co-ordinated fiscal reflation as both the OECD and IMF have recently suggested.

# Tax in the 2016 Budget

*By Richard Murphy*

The Times wrote recently that "one of the untold stories of 2016 has been the very gradual, almost unnoticed decline of George Osborne".

It is in this very personal context, and within the political constraints that the Brexit referendum imposes, that George Osborne has to decide what to do with taxation in his 2016 budget. Almost as an aside, the demands of the OECD and IMF that he now stimulate the economy rather than pursue a policy of austerity adds a little piquancy to the whole issue.

What we now know is that the biggest anticipated tax reform of this budget - which was the potential radical reform of pension tax reliefs - will not be happening. The policy was deeply unpopular in Tory homelands where local parties are dominated by the relatively prosperous self-employed. This is a demographic group who have long enjoyed the tax relief opportunities that pensions provide, as a means of mitigating what they see as the overly burdensome contribution required of them by a state for which they have little regard. When he needs that same group of naturally pro-EU business people to be on his side in the Brexit debate, George Osborne could not risk alienating them with such a reform, at least at this time.

What then will the Chancellor do instead to re-take the political initiative and re-inflate 'brand Osborne'? My suggestion is something very simple: look out for tax cuts. The reason is obvious. Osborne has 'form' in doing three things. The first is the unexpected. The second is what the opposition might superficially want but least expect. The third is sometimes (but not always) the politically astute move. Tax cuts might meet all these criteria.

First, Osborne has been so dedicated to austerity and balancing the budget that no one expects he will offer a stimulus by tax-cutting now. That though is precisely why he may do it. He has ample excuses. The so-called 'head winds' he spoke of recently are one. The opportunity to say that being in the EU but out of the Euro gives the UK the opportunity to anticipate such situations is another. And the third is to say that he is a man who learns.

What has he learned? He will claim, as the second reason for this action, that when you cut higher rates of tax then tax revenues go up. This is nonsense. His evidence base will be the supposed £8 billion increase in additional rate tax in 2013-14 which he has claimed arose as a result of the cut in the tax rate from 50% to 45% in that year. This is a claim that both tax barrister Jolyon Maugham and I have shown to be wrong, but economic realities have always been less important than current expediencies to Mr Osborne.

If this is the logic he uses, expect three things. One is a possible reduction in the top rate of tax. Second, and more likely, he will restore the personal allowance to those earning over £100,000, claiming that is a matter of tax justice. And third, anticipate an above average increase in tax bands, especially at the point where the higher rate starts, as he accelerates the timescale for raising this to £50,000. A token gesture at the other end of the scale - with a small above average increase in the start point for taxation will be the sop to popularity he will have to offer.

Why will he hope this nonplusses the opposition? Precisely because they have called for a stimulus and he will argue that this is the biggest one he can afford - and no doubt the Office for Budget Responsibility's forecasts will massaged (as they were last autumn) to make such changes look possible. The back of the sofa will be raided again.

Why is this politically astute? The answer is obvious: this would drag all the attention back from Boris Johnson on to…George Osborne.

So will there be compensating moves elsewhere if the books still need balancing (as they most certainly do not at present)? Almost certainly yes, but not from either benefits or tax changes this time.  Asset sales will be the missing link. Anything and everything is on the block now. Be prepared for the most unlikely.

My bet? Wait for the announcement on Housing Associations. He's already brought within the scope of government control. That was the precursor to sale. It may be a long shot, but that's my prediction for the real sting in the tail of this budget. And who might he raise the money from? The local authority pension funds he will also be bringing under his control are another not-so-long shot - a source of funding that he could claim is akin to People's QE, which would be a direct shot at Labour. When George Osborne is desperate, rule nothing out.

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*Cover Image: Junius Henderson 1919 *Standing between a giant fissure in glacier.*

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