UK Spending Review 2013: A triumph of politics over reason?

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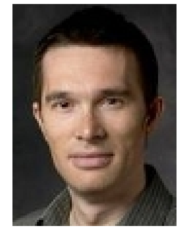
The UK's Spending Review has been forced on the British Chancellor because weak economic growth has blown a hole in the deficit reduction programme. **John Van Reenen** *welcomes the partial reversal of the hugely damaging cuts in public investment, but argues that it is too little, too late. Rock bottom interest rates mean the UK should be boosting investment substantially now. A longer term plan for re-building the country's broken economy is desperately needed.*



The 2013 Spending Review is a strange beast. Invented by Gordon Brown, it would normally cover 3 to 4 years instead of a single year, 2015-16. Chancellor George Osborne's 2010 Review covered a four-year period and aimed to eliminate the deficit in time for the 2015 election. As we know, this has spectacularly failed to happen with austerity now planned to go on until at least 2018.

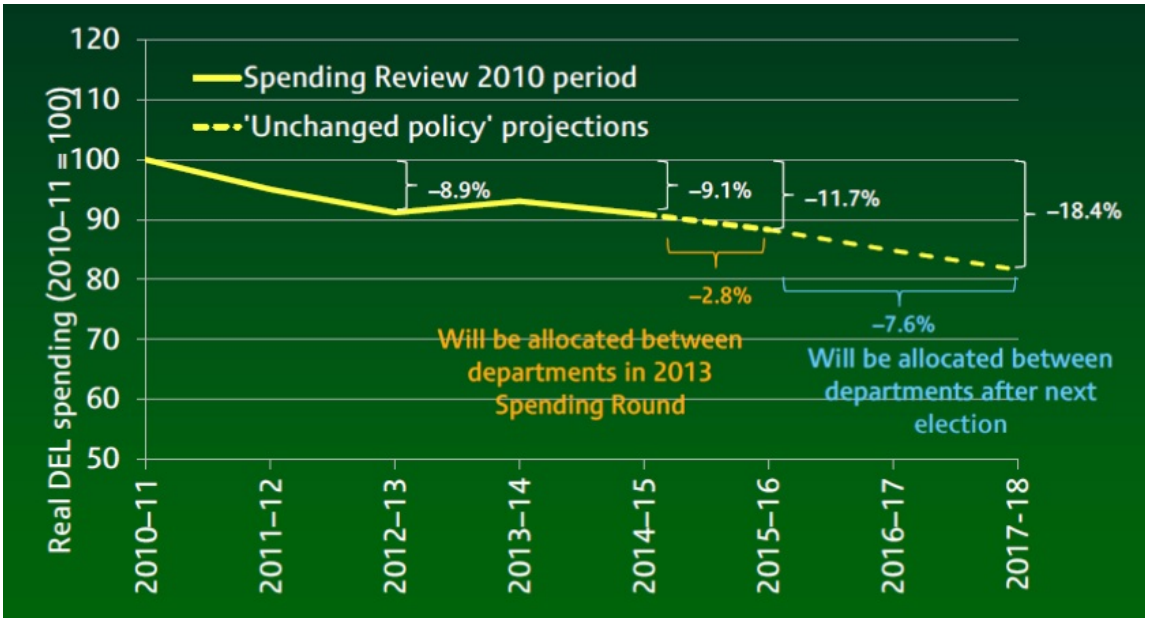
The Chancellor is looking for an extra £11.5bn cut from departmental expenditure (DEL), an extra 2.8% on average across the board. But since 60% of spending is "ring-fenced" in health, schools and overseas aid, this means an 8% average cut on the unprotected departments. Remember that this is on top of the big departmental already planned and implemented (e.g. 27% in Justice).

Three reasons for the curtailed one-year Spending Review includes:

- The government doesn't want to highlight the even more draconian cuts pencilled in for the years after 2016. Cuts for the following two years are predicted to be another whopping 7.6% (see Figure 1); although in reality some of this will undoubtedly be covered by further tax increases. But don't hold your breath to hear about these tax increases in the election campaign.
- The government wanted to force the Opposition Labour party to detail their own spending plans. Labour has duly signed up to the government's spending envelope, and predictably leader Ed Miliband is accused simultaneously of being "weak" for agreeing with the cuts and too weak to implement them.
- the coalition partners can't agree a common programme.

Although these motivations ring true, the basic cause of the Spending Review is that *spending has actually not fallen since 2010*. Despite the cuts in departmental money, the costs of pensions and welfare (AME) have risen inexorably upwards. On a like-for-like basis the deficit has been stuck at around £120bn for the last two years and this is because UK economic growth has been extraordinarily disappointing: GDP is still about 2.6% smaller than it was before the crisis – the worst "recovery" for over a century.

Figure 1: Spending down now, but even worse after 2016



Source: Emmerson (2013), http://www.ifs.org.uk/projects/418

The Big, Ugly Picture

So why has growth been so poor? All major nations are still struggling with the economic near-death experience of 2008-09. The implosion of the financial system meant that lending dried up as banks re-built balance sheets and households pay down debts. The fact that the UK households were more heavily in debt and that the UK financial sector is relatively large meant Britain took an especially hard knock. It's true that more fiscal surpluses should have been built up in the 2000s, but as Simon Wren-Lewis has shown, the idea that the major UK problem was reckless fiscal deficits prior to the bust is a myth.

With private sector retrenchment in full swing and Central Bank interest rates near zero, the usual medicine would be a fiscal stimulus. This happened during the crisis itself and continued to some degree in the United States. But the UK took a different path after 2010 of rapid deficit reduction through tax rises and spending cuts. Unlike the Eurozone countries bound by the single currency, Britain had a choice when embarking on this fiscal experiment. Unfortunately, the lab results are disappointing: no "expansionary contraction" as households became more confident in the soundness of the public finances. The impact of austerity was much worse as our biggest export market of the Eurozone was administering the same medicine. Although the government has retreated from its initial plans to reduce the debt ratio by next year, the accelerated austerity programme has caused more economic harm than necessary. Ironically, low public investment may have actually made it more difficult to bring down the deficit as slow growth begets higher deficits through lower tax revenues and more welfare payments.

Capital vs. current spending

The Chancellor's centrepiece of the Spending Review was infrastructure spending. Such spending *is* sorely needed for three reasons. The UK has a historical weakness (especially energy, transport and housing); these investments have big knock-on effects to growth; and the government can borrow at rock-bottom interest rates. There is a consensus that the cuts to public investment of over 40% since 2010 were a huge policy mistake. Net investment looks like it will average under £30bn p.a. over next five years, hardly making a major dent on these cuts. The efforts so far to boost infrastructure have been shambolic and ineffective. New orders for infrastructure have dropped to a 25 year low despite the "Infrastructure Plan" – a glorified wish-list – announced to great fanfare two years ago.

As announced in the last Budget, the increases in infrastructure spending have come at the expense of further cuts to current spending. We will have to wait until tomorrow to learn how "£100 billion of infrastructure investment will be allocated over the next Parliament" (i.e. nothing imminent). It does look like there will be £9.5bn more in transport in 2015-16. Although better than nothing, a superior policy would have been to simply increase capital spending without further cuts. Public investment is like borrowing for a mortgage, not borrowing to increase consumption.

The problem of further departmental cuts is that huge reductions on top of the current plans do not lead to sensible policy. For example, the Home Office has been called a winner as it only has an additional 6% fall of budget. Apparently, the cuts of the immigration budget will be much larger. Immigration is one of the surest ways to increase growth. It boosts skills, entrepreneurialism without bad effects on public services, wages or jobs. The government, however, wants to slow net immigration under 100,000 per year. Since we cannot control immigration from the EU, the government has tightened up on visas particularly on international students, thus damaging a valuable source of export earnings in universities. Cut-backs will mean slower processing of visas and hence dissuade even more talented people from India, China and the US locating to Britain. A superb example of an anti-growth policy.

What should be done?

The end to automatic increments for public sector staff, pooling local budgets and some minor restrictions on Winter Fuel Payments are overdue. But in terms of what should have been done three major things stand out:

First, the Chancellor should increase public investment by £10-£20bn. Second, there must be a series of reforms announced to alter the way we make long-run investment decisions in skills, innovation and infrastructure as proposed by the LSE Growth Commission and endorsed by the IMF. For example, we need to reduce the policy dithering over major infrastructure projects by reducing political meddling and rewarding local people properly when development takes place. Third, there are a wide number of ways to bridge the deficit such as removing VAT loopholes, ending the tax privileges of corporate debt, increasing the retirement age, and switching money away from useless schemes like Patent Box to better ways of financing innovation.

None of this is rocket science. Public services can be delivered more efficiently with better management, but just cutting willy-nilly without regard to evidence is not sensible. There must be a better way of mending our broken economy.

This article first appeared on our sister site, British Politics and Policy at LSE

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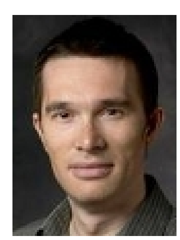

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