

6 THE COALITION AND THE ECONOMY

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The 2008 financial crisis, which developed into the deepest recession experienced in the UK since before the 1930s, formed the backdrop to the 2010 election and the formation of the coalition government. In 2010, the coalition stated that its first priority was to ‘reduce the deficit and restore economic growth’.¹ The story of fiscal retrenchment will surely be one of the main things for which this government is remembered: cuts to public spending on a scale unprecedented in modern times have, in the main, been successfully delivered. However, the return to growth proved more elusive, making the path to deficit reduction much slower and rockier even than predicted in 2010.

Indeed, the coalition government has had to steer a course through economically uncharted waters. The slowdown has lasted longer, and had a more profound impact on household incomes and productivity, than any since at least the 1920s. Despite healthy economic growth since 2013, wages and national income per capita remain lower than they were pre-recession. Employment, on the other hand,

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¹ Queen’s Speech 2010, Lords Hansard, 25 May 2010, col. 5.

has held up astonishingly well. Despite the upturn since 2013, the economy remains far from ‘recovered’, with labour productivity 16 per cent below the level implied by the pre-crisis trend.²

Much lower-than-expected economic growth during 2010–12 means that deficit reduction has not gone to plan. The original expectation was that the ‘structural current budget deficit’ – that bit of the deficit that is not explained by spending on investment and that which will not disappear automatically as the economy returns to trend levels of output – would have been dealt with in time for the 2015 general election. That has not happened. That itself has profound political consequences. The coalition cannot go to the electorate saying ‘job done’ on the deficit. Rather, they have signed up to another very tough spending settlement for 2015–16 and the coalition government’s plans imply further cuts to spending in 2016–17 and 2017–18. The state of the public finances creates an obvious challenge for whoever forms the next government.

On the overall scale of ‘austerity’ there seems to have been remarkably little disagreement between the coalition parties. A Liberal Democrat Chief Secretary to the Treasury was intimately involved in, and signed up to, both the 2010 Spending Review which set departmental budgets up to 2014–15, and the 2013 review which set budgets for 2015–16. There is little evidence either of a different set of views about the appropriate fiscal response to poor economic performance up to 2013 – notwithstanding some signs of discontent from the Business Secretary. The Labour opposition found it hard at times to communicate a clear stance, while changing economic circumstances quickly rendered their stated ambitions from their time in government effectively redundant.

The shape of austerity has inevitably been subject to more debate both within parties and between them, with, for example, the opposition decrying the scale of cuts to the working-age welfare budget, and some uncertainty as to whether a Conservative government unconstrained by coalition would have gone further. On the other hand, there has been significant cross-party consensus on the need to protect certain areas of spending, including on the NHS, schools and overseas aid.

² Alina Barnett, Sandra Batten, Adrian Chiu, Jeremy Franklin and María Sebastián-Barriel, ‘The UK productivity puzzle’, *Quarterly Bulletin* (2014: Q2), pp. 114–28.

We start this Chapter with a very brief overview of the performance of the economy under the coalition government. We then turn to the two economic issues which have dominated public debate over the past five years: in the second section we look at the government's efforts to restore the public finances, while in the third section we chart the unprecedented squeeze on living standards since the 2008 recession. Finally, we turn to an assessment of policies to restore the economy to growth, noting the central role of the independent Bank of England.

The economy under the coalition

Figure 6.1 neatly encapsulates the background to the economy and the challenges faced by the coalition.

The top dashed line shows the official forecast for the growth path of the economy as at the March 2008 Budget, just before the scale of the subsequent recession became apparent. Instead a very deep recession followed. By the time of the coalition's first Budget in June 2010 (the

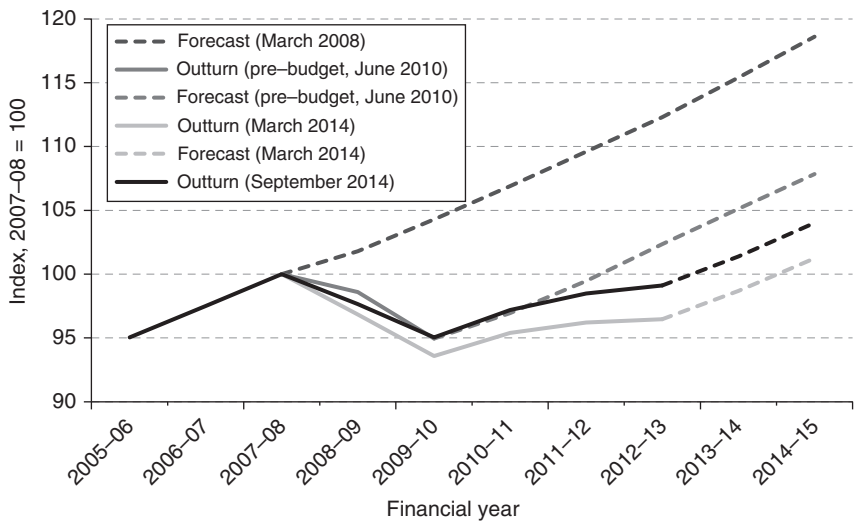


Figure 6.1 Actual and projected real national income (GDP)

Note: the most recent (December 2014) estimates of GDP are based on a new definition of GDP which cannot be directly compared to previous estimates (see footnote 3).

Source: author's calculations using GDP forecasts from HM Treasury (Budget: March 2008) and Office for Budget Responsibility (Pre-Budget forecast: June 2010, Economic and fiscal outlook: March 2014, and Economic and fiscal outlook: December 2014).

second and third lines in Figure 6.1) it was expected by both the newly created Office for Budget Responsibility and most independent forecasters that steady growth would return. But even then the expectation was that the economy in 2015 would be more than 10 per cent smaller than had been forecast back in 2008. The solid and dashed black lines show more recent estimates and forecasts of GDP since 2008, incorporating recent revisions to Office for National Statistics (ONS) measurement methods and to their definition of GDP.³ It shows that growth was broadly in line with June 2010 expectations for the first year of the coalition (2010–11) but was more sluggish than expected in 2011–12 and 2012–13. The latest estimates suggest that the economy returned to its pre-recession peak at some point in Q3 2013. However, the growth in population means that, even by 2015, national income per head still lags behind its pre-recession level, with the unsurprising consequence that household incomes remain below their real-terms peak. The focus on living standards and the ‘cost of living crisis’, as the Opposition refers to it, is a direct consequence of this.

The first three years of coalition government were marked by a series of dramatic downwards revisions to official forecasts for the UK economy, reaching a nadir in the March 2013 Budget. It is important to recall just how difficult economic circumstances were in the early years of the parliament. Beyond dealing with the deficit the government was faced with uniquely challenging external circumstances and in particular a Eurozone crisis which at the time looked quite likely to result in a break-up – a possibility that only really receded after ECB president Mario Draghi made his famous promise ‘to do whatever it takes to preserve the Euro’ in July 2012.

As is often the way, though, just as everything seemed at its worst, so the recovery was in fact beginning. Office for Budget Responsibility

³ In 2014 the ONS introduced major changes to its measurement methods and its definition of GDP (in order to implement the ESA 10 guidelines for the National Accounts), which it said were ‘the most wide-ranging in more than a decade’. The biggest impact has been on estimates of the level of nominal GDP, which has increased by an average of 4 per cent a year for the period 1997–2012. The impact on growth in real GDP has been more muted: the ONS now believes that the downturn in 2008–9 was shallower than previously estimated and that subsequent growth was stronger, but they conclude that the broad picture for the recession is unchanged, and it remains the case that ‘the UK experienced the deepest recession since ONS records began in 1948 and the subsequent recovery has also been the slowest’ (Office for National Statistics (ONS), *Economic Review: September 2014*).

(OBR) forecasts in autumn 2013 and Budget 2014 finally moved in a positive direction, and the economic debate started to move away from its focus on the lack of growth and the role of fiscal policy in supporting or hampering growth. Moreover, revisions to ONS data in 2014 meant that things hadn't even been quite as bad as they had seemed: the lines at the bottom of Figure 6.1 represent estimates and forecasts of GDP in March 2014, while the solid black line represents estimates following these ONS revisions. The new estimates put real GDP growth between 2007 and 2012 0.5 percentage points per year higher than previous estimates.⁴ The consequences of these errors in official statistics were perhaps not as grave as those created by erroneous estimates of borrowing requirements which were partially responsible for driving Chancellor Healey into the arms of the IMF in 1976, but they did not help the economic debate. In any case by mid-2013 a significant economic recovery was becoming apparent, and the last two years of coalition government have seen the UK economy outperform most other European and G7 economies. The OECD puts real GDP growth in the UK in 2014 at 3.0 per cent, compared to 0.8 per cent for the Euro area and 1.8 per cent for the OECD overall.⁵

Dismal economic growth in the initial years of the coalition translated into falling real earnings and falling living standards – an important theme we examine in more detail below. But what it did not translate into, to the surprise of most commentators, was mass unemployment or sustained high levels of long-term unemployment. Unemployment rose from a low of 5.3 per cent in early 2008 to a peak of 8.5 per cent in late 2011, falling back to 6.5 per cent in the middle of 2014.⁶ The flip side of the very strong employment record has been a very weak productivity record. By 2014 the Bank of England estimated that hourly productivity was still below its pre-crisis peak and 16 per cent below its pre-crisis trend.⁷

All of this – slow growth, high employment, low wage growth, very poor productivity – was unanticipated by Chancellor and Treasury back in 2010. There are no parallels between this period of emergence from recession and the 1980s and 1990s. The deep recession at the start of the 1980s, for example, was followed by almost exactly the opposite

⁴ ONS, *September 2014*.

⁵ Annex Table 1, in OECD, *Economic Outlook*, vol. 2014, Issue 2.

⁶ ONS, ILO unemployment rate, all aged 16–64 (LF2Q).

⁷ Alina Barnett, Sandra Batten, Adrian Chiu, Jeremy Franklin and María Sebastián-Barriel, 'The UK productivity puzzle', *Quarterly Bulletin* (2014: Q2), pp. 114–28.

set of economic indicators: robust growth, fast growth in wages and productivity but high and persistent levels of unemployment. So one of the stories of economic management over this period has been the extent to which fiscal, monetary and other policy has had to adapt to unexpected change.

Before moving on to some of the policy responses to this economic inheritance it is worth mentioning one important development in economic policy over this period, illustrated perfectly by the sourcing of Figure 6.1: the creation of the OBR. It was set up immediately after the 2010 election in response to concerns about the lack of independence from politically motivated wishful thinking in official economic and fiscal forecasts. It quickly became an accepted part of the political and economic landscape and by 2013 the Shadow Chancellor was calling for its powers to be significantly extended to enable it to cost the policies put forward by the major parties in their general election manifestos.

We will come on to a discussion of other aspects of the economy in later sections, not least the falls in real incomes and earnings, the robustness of the labour market, and the role of monetary policy. But for now we move on to look at the central plank of coalition policy – deficit reduction.

Fixing the public finances

A record deficit precipitated by the recession of 2008–9 formed the backdrop to the 2010 general election.⁸ The opposition parties inevitably blamed the then government for racking up unsustainable levels of spending and borrowing. The government claimed that it was all down to the consequences of a global recession over which they had no control. There is some truth in both claims.

⁸ Where possible, outturns and forecasts of the public finances in this chapter are based on the most recent (December 2014) OBR data, which incorporates the substantial revisions made by ONS in 2014 to their estimates of GDP (see footnote 3) as well as changes to their public finance statistics following the ONS Public Sector Finance review. These revisions increased estimates of nominal GDP, thereby reducing all ratios expressed as a share of GDP. The Impact on public sector net borrowing is more complex (positive in some years, negative in others) and is discussed in some detail in the OBR's Economic and fiscal outlook: December 2014 (London: Office for Budget Responsibility).

The UK was running a deficit of nearly 3 per cent of national income in 2007 at a time when the economy had, as the then Chancellor never tired of reminding us, been growing for the longest continuous period in centuries. The UK entered the recession with one of the biggest structural deficits in the OECD – having done less than most other advanced economies to reduce its debt and deficit over the preceding decade.⁹ And the scale of fiscal consolidation now being carried out is one of the biggest in the OECD. The fiscal rules being followed pre-recession were inadequate, and were described as such by many commentators. Even then they were barely followed and the government's behaviour was enough to suggest that they weren't taken terribly seriously. In the words of the OBR:

Having briefly delivered budget surpluses in the early 2000s, the then Government chose to increase public spending as a share of GDP into its second term in the belief that this would be paid for by a rise in receipts as a share of GDP. But – in line with the predictions of many external observers – receipts did not perform as strongly as the Government hoped and in the run-up to the crisis it consistently ran deficits that were larger than forecast and larger than in most other developed economies.¹⁰

The case for the defence is that nobody saw the crisis coming. On the basis of the best information then available, forecasts suggested that the public finances were sustainable into the medium term. Spending increases had largely been matched by tax increases. And even if the fiscal rules were sub-optimal and barely honoured in the breach, they did exert a real constraint on behaviour and ensured that neither government debt nor government borrowing looked unsustainable at the time.

The truth is of course not as black and white as either of these summaries would suggest. What is clear is that, just as happened in the late 1980s, a degree of hubris allowed the government to convince

⁹ See for example Robert Chote, Carl Emmerson and Gemma Tetlow, *The UK Public Finances: Ready for Recession?* (IFS Briefing Note No. 79, 2008) (accessed at www.ifs.org.uk/bns/bn79.pdf, 11 November 2014).

¹⁰ Jon Riley and Robert Chote, *Crisis and Consolidation in the Public Finances* (OBR working paper number 7, 2014) (accessed at <http://budgetresponsibility.org.uk/word-press/docs/WorkingPaper7a.pdf>, 11 November 2014), para. 2.31.

itself that it had achieved what no government had previously achieved – in Nigel Lawson’s case that the trend growth of the economy had risen to much higher levels and in Gordon Brown’s case that he had abolished the economic cycle, or ‘boom and bust’ as he put it.

Looking back there are clear lessons here. ‘Boom and bust’ had not been abolished and economic policy should never assume that it has been. Relying on pro-cyclical revenue streams can create particular problems. Running substantial deficits on the basis that an ill-conceived backward-looking fiscal rule ‘allows’ it makes little sense. But even if all these mistakes had been avoided, a substantial deficit and subsequent consolidation could not have been. And it is worth remembering that before the crisis hit, the Conservatives in opposition signed up to supporting the then Labour government’s spending plans, rather as the Labour Party in opposition had signed up to Conservative plans after the 1997 election and have again signed up at least to the plans for 2015–16.

In any case all three main parties entered the 2010 general election with ‘plans’ to fix the deficit. In fact there was little to choose between them in terms of their stated intentions with respect to the scale of deficit reduction intended. A detailed analysis by IFS researchers after the 2010 election manifestos had been produced, but before the 2010 election, concluded:

As best we can tell from the statements they have made to date, all three parties aim to implement a fiscal tightening of 4.8% of national income, or £71 billion, by 2016–17. The only real difference is that the Conservatives would aim to get most of the job done a year earlier by 2015–16.

This does not make an enormous difference to the total amount of government borrowing over the next few years or to the long-term profile for government debt. Over the next seven years (2010–11 to 2016–17 inclusive), Labour and the Liberal Democrats plan to borrow £643 billion, while the Conservatives would end up borrowing £604 billion, about £38 billion or just 6% less.¹¹

¹¹ Robert Chote, Rowena Crawford, Carl Emmerson and Gemma Tetlow, *Filling the Hole: How do the Three Main UK Parties Plan to Repair the Public Finances?* (London: Institute for Fiscal Studies, 2010).

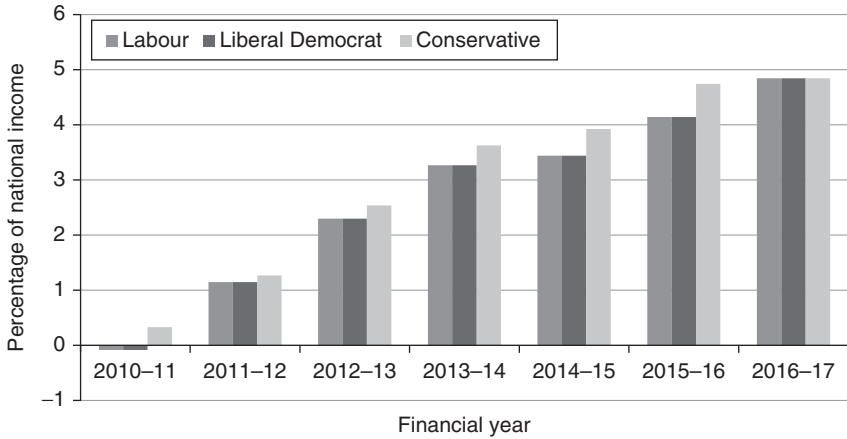


Figure 6.2 The timing and size of the fiscal tightening: the main parties' plans
 Source: Figure 3.1 in R. Chote, R. Crawford, C. Emmerson and G. Tetlow, *Filling the Hole: How do the Three Main UK Parties Plan to Repair the Public Finances?* (London: Institute for Fiscal Studies, 2010).

To the extent that there were differences it was Labour and Liberal Democrat plans which appeared near enough identical and the Conservatives who were promising a modestly swifter tightening. This is all perhaps best illustrated in Figure 6.2, drawn from the same source.

There were bigger, but still not enormous, differences between the parties in the planned composition of the fiscal tightening. Based on analysis of their manifestos at the time, IFS researchers concluded that the Conservatives were planning £57 billion of spending cuts and £14 billion of tax increases, against £47 billion of cuts and £24 billion of tax rises by Labour. The Liberal Democrat plans at the time appeared to roughly split the difference, with a slight leaning towards Labour, planning £51 billion of spending cuts and £20 billion of tax increases. As we shall see in a moment any detailed differences were soon overwhelmed by the deteriorating economic situation.

Immediately post-election, though, deficit reduction was at the heart of the Coalition Agreement. Indeed, in the list of contents in the coalition's programme for government there is no heading for 'growth' or 'the economy' – just 'deficit reduction'. The new Chancellor, George Osborne, set out the coalition's headline fiscal strategy in an 'Emergency' Budget in June 2010, outlining plans for a consolidation in the region of 7 per cent of GDP, with 77 per cent of this coming from cuts to public spending (to 2015–16, and including plans inherited from the outgoing

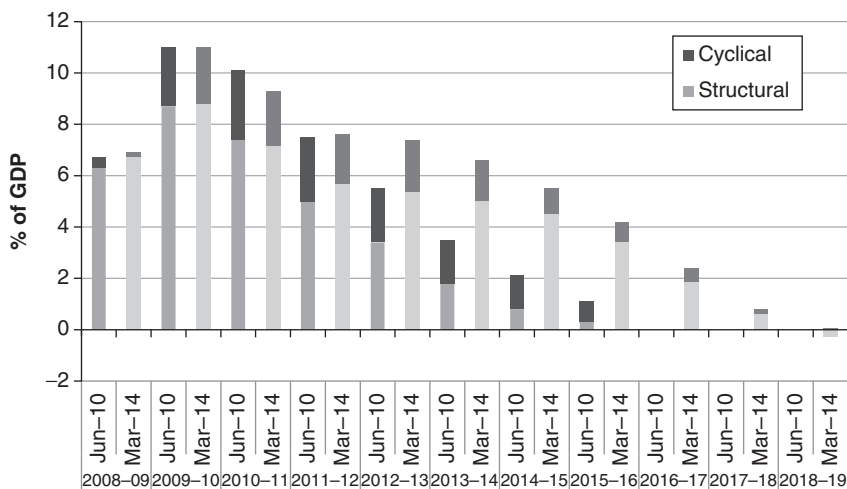


Figure 6.3 Structural and cyclical public sector net borrowing: March 2014 data compared to plans in June 2010 (% of GDP)

Note: excludes transfers relating to the Asset Purchase Facility (APF) and Royal Mail Pension Fund. We use data from the 2014 Budget ('March 2014'), rather than the more recent Autumn Statement in December 2014, because this is the last fiscal event where GDP and borrowing figures were provided on a basis consistent with those produced in June 2010. As a result, this figure does not reflect recent ONS revisions to the measurement and definition of GDP and public sector net borrowing (see footnote 8), or changes to the underlying borrowing forecasts between March and December 2014, which put borrowing higher in the initial years of the forecast and slightly lower from 2016-17 than was anticipated in March 2014 (see OBR Economic and fiscal outlook: December 2014).

Sources: OBR, *Economic and Fiscal Outlook: June 2010* and OBR Databank (May 2014).

Labour government). A range of tax measures were announced in the June Budget, including a hike in the VAT rate, with £20 billion of tax increases and £12 billion of cuts amounting to a net increase of £8 billion by 2014-15.¹² The budget was followed by a spending review, delivered at speed in November 2010, which set out the initial details of the substantial cuts to spending announced in the Budget, including a substantial increase in the amount coming from the working-age welfare budget.¹³

In its own terms, perhaps the greatest success of the coalition has been the successful delivery – indeed over-delivery – of those planned cuts (discussed in more detail below). However, in the face of the poor economic performance discussed above, the original plans proved nowhere

¹² Chote et al., *Filling the Hole*.

¹³ See chapter twelve, this volume for more details

near sufficient to deal with the deficit. This is simply illustrated by Figure 6.3, which shows borrowing planned in June 2010 and outcomes and plans as of mid-2014 (based on data prior to recent ONS revisions – see footnote 8). By 2014–15 borrowing was more than 3 per cent of GDP higher than had been planned. Rather than implement additional cuts or tax increases, the coalition pushed the task of deficit reduction into the next parliament, announcing additional cuts for 2015–16 in a second spending review, with plenty more to come thereafter.

This deterioration in the planned state of the public finances was associated with what was probably the defining economic debate of the first three years of coalition government – the impact of austerity on growth. According to the government, deficit reduction was a necessary precondition for growth – a position which was broadly in line with the economic views of the Treasury. They argued that reducing the deficit and bringing debt onto a sustainable long-term path would create macro-economic stability, allow very loose monetary policy, keep borrowing costs low for the government, provide greater certainty about the trajectory of public spending, and leave room for private sector spending and investment. However, as economic conditions continued to disappoint, the government came under increasing pressure to change course, or ditch ‘plan A’. The essential argument of the opposition was simple enough. The coalition was going ‘too far, too fast’ on spending cuts, resulting in lower economic growth and unnecessary damage to the economy. They held out the poorer-than-expected economic performance as evidence of this.

Even before the election, this question of the appropriate pace and scale of deficit reduction, and the likely impact on growth, was the subject of lively debate among economists. On 14 February 2010 the *Sunday Times* published an open letter to the (then Labour) government in which twenty respected economists called for faster action to reduce the deficit, and suggesting the government should seek to eliminate the ‘structural’ deficit in a single parliament. However, this was followed just days later by a reply, signed by a hundred similarly eminent economists and published in the *Financial Times*, which called on the government to prioritize returning the economy to growth, and warning against an accelerated programme of fiscal austerity. The debate continued through the first years of the parliament with a number of economists and commentators weighing in against austerity. As growth disappointed, the balance of opinion within the economics professions shifted towards the need for fiscal

stimulus: when the *New Statesman* surveyed the twenty signatories to the original *Sunday Times* letter, nine urged some form of fiscal stimulus to promote growth, while just one repeated their endorsement of the coalition's fiscal plans.¹⁴

The coalition was probably coming under most pressure to reverse its fiscal policies in early 2013. In February, Moody's stripped the UK of its triple-A credit rating, citing the UK's weak economic performance. In March, the OBR reduced its growth forecast once again, cutting in half expected GDP growth for 2013, but suggesting the UK would (narrowly) avoid a 'triple dip' recession (in fact, revisions to the data now suggest there was no 'double dip'). In April, the IMF – which had enthusiastically endorsed the coalition's fiscal strategy in 2010 – highlighted the weak outlook for the UK economy. The IMF's chief economist Olivier Blanchard suggested the government was 'playing with fire' and urged the government to consider a loosening of austerity.¹⁵ This period also saw perhaps the most direct criticism of the government's fiscal strategy from coalition ministers, as Business Secretary Vince Cable called for an expansion of capital spending and suggested that the changing economic climate might justify an increase in public borrowing.¹⁶ Naturally the return to growth in 2013, at a rate which took everyone by surprise – OBR, Bank of England and Treasury alike – left the coalition to claim that its strategy had been vindicated. The counterfactual, of course, is extremely hard to determine.

According to the OBR, the shortfall in GDP relative to expectations was driven above all by lower than expected private investment, followed (in order of importance) by weak net exports and low real consumption growth. There were clearly a number of external reasons for this, including the Eurozone crisis, which resulted in slow growth and great economic uncertainty in the UK's key trading partner, the continued tightness of credit conditions, and high commodity prices (particularly in oil). While the OBR acknowledged that the

¹⁴ George Eaton, 'Exclusive: Osborne's supporters turn on him', *New Statesman*, 15 August 2012 (accessed at www.newstatesman.com/blogs/politics/2012/08/exclusive-osbornes-supporters-turn-him, 11 November 2014).

¹⁵ Ed Conway, 'IMF inflicts "double blow" on George Osborne', *Sky News*, 16 April 2013 (accessed at <http://news.sky.com/story/1078887/imf-inflicts-double-blow-on-george-osborne>, 11 November 2014).

¹⁶ Vince Cable, 'When the facts change, should I change my mind?', *New Statesman*, 6 March 2013.

government's fiscal consolidation may have had a bigger impact on growth than was expected in 2010, they argued that this did not seem to be the most likely explanation for the fact that the economy performed so much worse than expected.¹⁷ In any case, it is worth remembering that – certainly into early 2011 – the expectation was that the Bank of England would be raising base rates in the foreseeable future, and a fiscal loosening could well have precipitated an offsetting monetary tightening.¹⁸

Perhaps more pertinent to ask, though, is whether the fiscal stance was really as tight as the rhetoric on both sides suggested. Look again at Figure 6.3. Both the headline and underlying deficits have been much higher than planned. The coalition did *nothing* to tighten fiscal policy in the face of failure to reduce the deficit anywhere near as fast as intended. Instead further tightening was pencilled in for future years – for the next parliament. This remained consistent with the Chancellor's main forward-looking fiscal target that there should be structural budget balance at the end of the five-year forecast horizon. That forward-looking rule has turned out to provide considerable flexibility in the face of poor economic performance. The Chancellor's supplementary target, stating that debt should be falling in 2015–16, looks likely to be breached, and the OBR has been forecasting a breach since late 2012.¹⁹ The fact of this likely breach of his own fiscal rule seems to have come at little or no political cost to the Chancellor, perhaps because in economic terms the target itself had little to commend it.

In fact the government's forward-looking fiscal target allowed it much more freedom than the rules set by the Labour Party in government. The Fiscal Responsibility Act 2010, legislated by the last Labour government, imposed legally binding constraints on borrowing and debt. One of the Act's three provisions was that borrowing in 2013–14 should be half its 2009–10 level. That was not achieved. It is to be presumed that a Labour government would not have stuck to this target. But this is a good illustration of the difficulties in constructing counterfactuals as to what might have happened under an alternative

¹⁷ Office for Budget Responsibility, *Forecast Evaluation Report* (London: Office for Budget Responsibility, 2013).

¹⁸ Rowena Crawford, Carl Emmerson and Gemma Tetlow, 'Green Budget public finance forecasts', in Mike Brewer, Carl Emmerson and H. Miller (eds.), *Green Budget 2011* (London: Institute for Fiscal Studies, 2011), pp. 108–29.

¹⁹ Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012* (London: Office for Budget Responsibility).

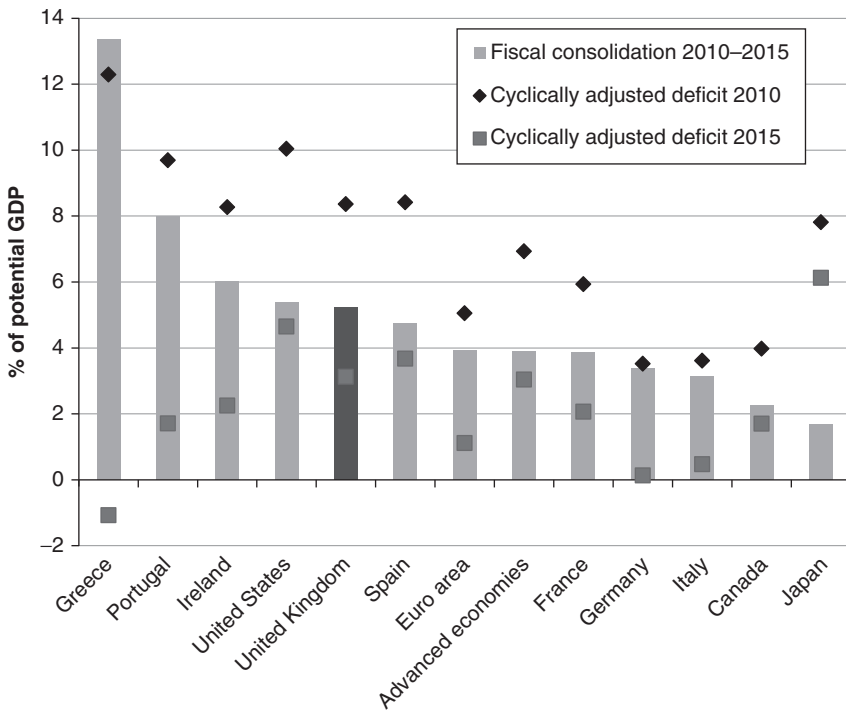


Figure 6.4 Fiscal consolidation in the UK compared to other countries, 2010–2015 (% of potential GDP)

Note and source: see Table 1.1 in IMF, *Fiscal Monitor*, April 2014.

government. One can also contrast the scale of the consolidation in the UK with that in other countries. This is illustrated in Figure 6.4. The scale of the UK's consolidation since 2010 has been only slightly greater than the Euro area average and leaves the UK with a cyclically adjusted Budget deficit well above the Euro area average.

The coalition's relative flexibility with respect to deficit reduction in the short run did nothing to change the fact that the poor economic performance required the total tightening to be greater than originally planned. The changing scale of the planned consolidation is illustrated in Figure 6.5 (incorporating recent ONS revisions – see footnote 8). It is notable not only that the scale of the fiscal problem rose over time but also that the scale of the planned consolidation increased even faster as the Chancellor announced his intention to achieve a budget surplus by 2018–19, and that all remaining fiscal tightening should come from spending cuts rather than tax increases. This pledge

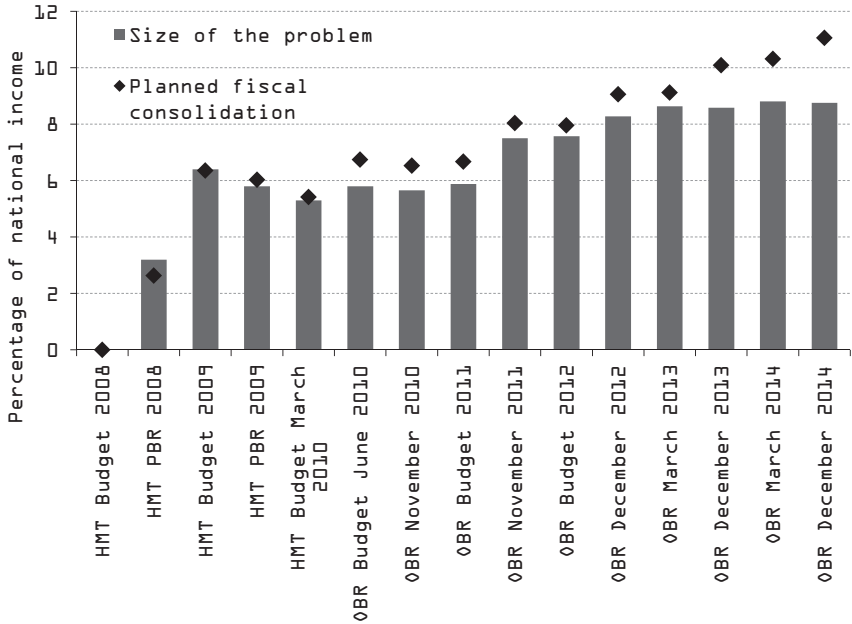


Figure 6.5 The changing size of the problem and cure

Note: estimated increase in medium-term cyclically adjusted borrowing (excluding policy response) and the size of the policy response since March 2008.

Sources: Authors' calculations using all HM Treasury Budgets and Pre-Budgets between November 2008 and March 2010 (available at www.hm-treasury.gov.uk/budget_archive.htm) and all OBR Economic and fiscal outlooks between June 2010 and March 2014 (available at <http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2014>).

to some extent moved the fiscal goalposts, and kick-started the debate about fiscal strategy in the next parliament. While the coalition's fiscal mandate commits them to ensuring that government revenues are sufficient to pay for current spending only, i.e. excluding investment spending, this new target would require more spending cuts, requiring the revenues to cover investment spending too. Promises of an additional £7 billion of income tax cuts made at the 2014 Conservative Party conference will make this already stretching target even more difficult to achieve.

Shadow Chancellor Ed Balls has said he will target balance on the current budget during the next parliament – similar to the existing fiscal mandate, but without cyclical adjustment. The Liberal Democrats have committed to something very similar: promising to achieve a balanced current budget by 2017/18, after which they intend to aim

for a ‘cyclically adjusted balanced total budget, excluding capital spending that enhances economic growth or financial stability’ – in other words, a (cyclically adjusted) balanced current budget.

The difference between the Conservatives on the one hand, and Labour and the Liberal Democrats on the other, is potentially substantial – as much as £25 billion in additional borrowing per year by 2019–20 (in 2015–16 prices).²⁰ Arguably, since the start of 2014 there has been more clear fiscal water between the parties than there was at the height of the rhetorical differences in 2012 and early 2013, and possibly more than there has been in the run-up to any election since at least 1992 and perhaps before. But whichever particular fiscal rule is targeted it is clear that much fiscal tightening will be required after the 2015 election. The Labour Party has already signed up to many of the additional cuts announced for 2015–16 and has no scope for additional spending commitments beyond that without tax increases to pay for them.

The spending cuts

The large majority of the fiscal consolidation in the period to 2015 was on the spending side. The Conservatives have said that further consolidation will also come entirely from controlling spending, not from any further tax increases. One can find an immediate explanation for that strategy in Figure 6.6. It shows, on the basis of plans laid out in the Autumn Statement 2014, how revenues and spending are expected to develop as a share of national income through to 2018–19, on the assumption that spending plans are met. Taxes will be at near enough their highest level as a share of national income since the late 1990s. Spending, will, as a share of GDP, be roughly back at its level in the early 2000s.

The pattern of spending in the chart is in part explained by the collapse in national income in 2008–9: as national income fell, public spending as a fraction of it rose. As national income has failed to recover as hoped, so less spending is possible. The scale of real-terms cuts has been genuinely unprecedented – of an entirely different scale and magnitude to those seen in the 1980s, for example.

²⁰ Rowena Crawford, Carl Emmerson, Soumaya Keynes and Gemma Tetlow, *Fiscal Aims and Austerity: The parties’ plans compared* (IFS Briefing Note BN158, 2014) (accessed at www.ifs.org.uk/uploads/publications/bns/BN158.pdf, 5 January 2015).

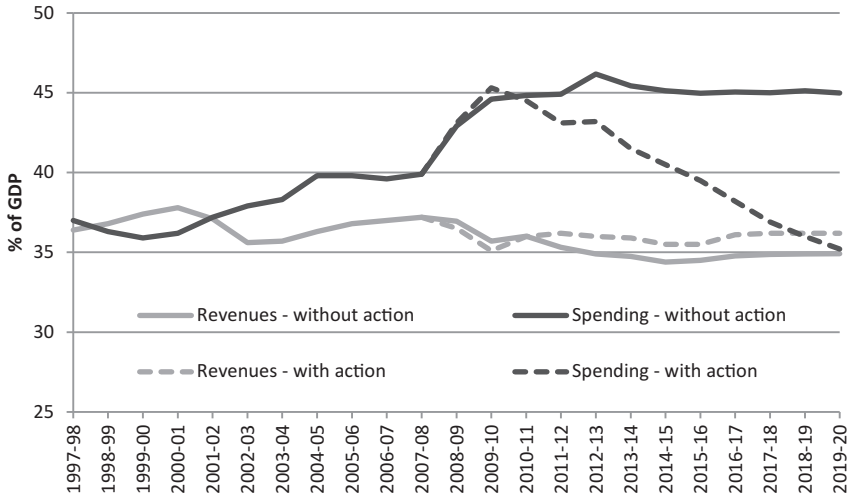


Figure 6.6 Taxation and spending without policy responses, as % GDP (2007 onwards)

Notes: Revisions to the method for calculating GDP mean that figures for the level of revenues and spending as a share of GDP are now substantially lower than the figures that were published a few years ago. As a result, it is not sensible directly to compare outturns for revenues and spending as a share of GDP to the forecasts produced in March 2008. Instead we scale the March 2008 forecasts by the difference between the outturn for spending/revenues in 2006–7 as was estimated in 2008 and the latest estimated outturn.

Sources: Figures up to 2007–8 and figures for ‘with action’ from 2008–9 onwards are calculated using ONS series for total managed expenditure (KW5Q) and revenues (JW20) divided by GDP (series BKTL). Figures from 2008–9 onwards ‘without policy’ are authors’ calculations based on the estimated impact of discretionary policy measures enacted since the March 2008 Budget.

The scale of the cuts in some areas has been driven in part by the protection afforded to some of the biggest elements of spending, notably health and schools on the public services side, and state pensions within the benefits bill. There has been essentially no disagreement between the main parties on the protections afforded to the NHS and schools budgets, reflecting their widespread public support across the political spectrum, and the sheer practical difficulties of reducing spending, particularly for an NHS struggling to cope with an ageing population. For the Conservatives in particular, preserving hard-won public trust in their stewardship of the NHS was an important political priority.

In any case, this was a huge, fiscal decision with important consequences for the distribution of public spending. Spending on

the NHS, schools and overseas aid (which has grown with cross-party support) accounted for 39% of total departmental spending in 2010–11 and 46% by 2015–16. If they continue to be protected through to 2018–19 they could account for half of the total. Meanwhile, as of Budget 2014, real cuts to ‘unprotected’ departments are expected to have averaged 4.6% per year over the course of the parliament (2010–11 to 2014–15), amounting to a cumulative cut of just over 17%.²¹ Further cuts in departmental budgets were announced for 2015–16 in a second spending review held in July 2013, taking the total planned cuts to unprotected departments over the five years since 2010–11 to around 19%. By the end of 2015–16 spending by the Departments for Communities and Local Government; Culture, Media and Sport; Work and Pensions; Justice; and DEFRA will be down by 30% or more on 2010–11 levels, with Home Office spending down by 29%. The fact that spending cuts of this scale have been achieved with relatively little public outcry has surprised many observers and, perhaps, convinced Treasury ministers and leading members of the coalition of the possibility of quite radical reductions in the size of the public sector.

Within spending on public services, a significant fraction of the savings has inevitably come from the workforce – pay making up about half of total non-investment spending by departments. The bulk of savings has come from reductions in employment, though reductions in real pay – resulting from a pay freeze followed by a cap of 1 per cent on increases for most public sector workers – have also played a role.²² Such potentially contentious cuts have been made easier by broader labour market trends. Employment levels overall rose substantially, allowing the Chancellor to boast that reduced numbers of public sector employees had been more than offset by increased employment in the private sector in every region.²³ This strong employment growth in the private sector was accompanied by very weak earnings growth, which has also made the public sector pay freeze look sustainable. In fact, the

²¹ Gemma Tetlow, ‘Economy bouncing back more strongly but policy choices have increased long-run risks to the public finances’, Institute for Fiscal Studies, 20 March 2014 (accessed at www.ifs.org.uk/publications/7153, 11 November 2014)

²² Rowena Crawford, Jonathan Cribb and Luke Sibieta, ‘Public spending and pay’, in Carl Emmerson, Paul Johnson and Helen Miller (eds.), *Green Budget 2013* (London: Institute for Fiscal Studies, 2013), pp. 149–80.

²³ Jonathan Cribb, Richard Disney and Luke Sibieta, *The Public Sector Workforce: Past, Present and Future* (London: Institute for Fiscal Studies, 2014).

public–private wage differential actually increased during the recession, and as of mid-2013 it remained above its estimated level in 2007–8.²⁴ As real wages in the private sector, presumably, grow through the next parliament, savings from the public sector workforce will become less easy to access.

Despite the scale of these changes, within the coalition it seems that the main source of disagreement has been over the scale of cuts to social security spending. Given the size of the budget (social security benefits and tax credits comprised 30 per cent of total spending in 2010–11),²⁵ any programme of austerity was almost bound to include significant cuts in this area – though the commitment to protect pensioner benefits meant that cuts have come almost entirely from working-age benefits. Controversy deepened as the deteriorating economic situation led to the need for further spending cuts, with opposition to further welfare cuts appearing to come not just from the Liberal Democrats but also, at times, from Iain Duncan Smith, the Secretary of State for Work and Pensions.

The protection of key pensioner benefits emerged as a particular flashpoint. In the wake of the 2011 Autumn Statement, which confirmed that austerity would continue for two more years than originally planned, Deputy Prime Minister Nick Clegg called for certain pensioner benefits, such as free TV licences and bus passes, to be means-tested. However, with the Prime Minister unwilling to reopen this question, the debate shifted to the extent to which further cuts could be made to working-age benefits. Significant further cuts were announced in the Autumn Statement of 2012, as the Chancellor limited increases to most working-age benefits to 1 per cent per year for three years (saving £3.1 billion by 2017–18), though Clegg claimed to have halted some of the ‘more extreme reforms that had been put on the table’.²⁶ In the run-up to the 2015/16 Spending Review, Danny Alexander confirmed Liberal Democrat opposition to further welfare cuts, while Philip Hammond made a public plea for further cuts to welfare in order to spare other budgets, including (his own) defence budget. In the event, relatively

²⁴ *Ibid.*

²⁵ Office for Budget Responsibility, *Budget Forecast: June 2010* (London: Office for Budget Responsibility, 2010)

²⁶ Quoted in Rajeev Syal, ‘Nick Clegg risks Lib Dem–Tory coalition by spelling out differences’, *The Guardian*, 17 December 2012.

small welfare cuts (amounting to less than half a billion pounds) were announced, alongside a cap aimed at limiting future spending on most working-age benefits.

Looking forward, the biggest change in spending plans since the October 2010 spending review has been the extension of the period of spending reductions well beyond the 2015 election. Details of these cuts, at least for the financial year following the planned election (2015–16), were set out in a second spending review in July 2013. Despite substantial additional cuts planned for most departments this additional spending review would appear to have created remarkably little inter-party disagreement either between the coalition parties or between the coalition and the Labour Party, which has signed up to the proposed spending envelope for 2015–16, if not the detailed distribution of the cuts.

Beyond 2015–16, although we now know something of the different parties' broad fiscal plans, we know next to nothing of their specific plans to cut spending. The Budget Red Books have set out the fiscal plans as though all the additional savings will come from departmental budgets. If the NHS, schools and overseas aid continue to be protected, this would imply remarkably deep cuts in unprotected areas – averaging more than a third between 2010–11 and 2018–19. The Conservatives have intimated that they would look to protect departments from such swingeing cuts by cutting the social security budget further. George Osborne has come close to ruling out tax rises, saying to the Treasury Select Committee in July 2013 'I am clear that tax increases are not required to achieve this', while David Cameron unveiled proposals for substantial income tax cuts at the 2014 Conservative Party conference, cuts which might well mean that even greater spending reductions will be required if the Conservatives' fiscal targets are to be met.

Tax changes

While tax increases formed an important part of the initial consolidation, the overall plan is to rely much more heavily on spending cuts to address the deficit. But the coalition has also been active in tax policy. Indeed, in the context of such a major fiscal tightening some of the choices made have been quite remarkable, with very large tax *cuts* in some areas, most notably the very big increase in the income tax

personal allowance. This pledge was a key plank of Liberal Democrat policy in their manifesto which appeared in the Coalition Agreement and has been consistently pushed through. A constant theme of Budgets over the parliament has been one of how to pay for some of these tax cuts whilst sticking to the overall fiscal path.

The coalition inherited some substantial tax increases on those on the highest incomes implemented immediately before the election, including of course the new 50p rate of income tax on incomes over £150,000. Rather less salient was a new 60 per cent rate on incomes in a band over £100,000, proposed reductions to the generosity of pension tax relief and an increase in stamp duty on expensive properties. While the 50p rate has been reduced to 45p, the other measures hitting 'the rich' have been maintained or even, in the case of stamp duty and cutting pension tax relief, extended.

Easily the most substantial additional tax increase has been the rise in the standard rate of VAT from 17.5 to 20 per cent announced in the June 2010 Budget and implemented in January 2011. This passed with apparently little internal dissent within the coalition. In the search for additional revenue it was judged the least politically and economically damaging. One cannot know what a Labour government would have done, but we do know that Alastair Darling came very close to announcing an increase in VAT even before the election, before opting instead for a rise in National Insurance Contributions.

Beyond the extraordinary £11 billion a year or so that is now being invested in raising the income tax personal allowance the coalition has also pushed through big reductions in the main rate of corporation tax, with considerable enthusiasm for this on the Conservative side. Less strategic has been a substantial reduction in the real rate of fuel duty as the Chancellor has continually bowed to pressure from his own backbenches to delay and cancel planned upratings. This is beautifully illustrated in Table 6.1, which shows how each planned uprating has been gradually pushed back and eventually cancelled. Of course the government have compared their generosity to motorists with the significant increases planned by the Labour government and set out in their pre-election Budget. In fact the pattern illustrated in the Table almost replicates the behaviour of the last government whilst in office. Even maintaining the real value of fuel duties seems to have become close to politically impossible.

Table 6.1 *Actual and announced fuel duties since 2011*

Dates uprating originally due	Dates uprating due following policy announcement					
	Budget 2011	Autumn Statement 2011	June 2012	Autumn Statement 2012	Budget 2013	Autumn Statement 2013
Apr 2011	Jan 2012	Aug 2012	Jan 2013	<i>Cancelled</i>	<i>Cancelled</i>	<i>Cancelled</i>
Apr 2012	Aug 2012	<i>Cancelled</i>	<i>Cancelled</i>	<i>Cancelled</i>	<i>Cancelled</i>	<i>Cancelled</i>
Apr 2013	Apr 2013	Apr 2013	Apr 2013	Sep 2013	<i>Cancelled</i>	<i>Cancelled</i>
Apr 2014	Apr 2014	Apr 2014	Apr 2014	Sep 2014	Sep 2014	<i>Cancelled</i>
Apr 2015	Apr 2015	Apr 2015	Apr 2015	Sep 2015	Sep 2015	Sep 2015
Apr 2016	Apr 2016	Apr 2016	Apr 2016	Apr 2016	Apr 2016	Apr 2016

Politically, of course, the big tax story of the parliament has been the decision over the top 50p, now 45p, rate of income tax on incomes over £150,000. The 50p rate was announced by Chancellor Darling in Budget 2009 and introduced in April 2010 immediately before the election. This of course ensured that it was almost completely ineffective in its first year of operation because it gave those with very high incomes plenty of notice and allowed them to rearrange their affairs to take income early. This gave the coalition a problem. Convinced that this level of tax was likely to be economically damaging and would raise little additional revenue, the Conservatives did not want it as a long-term feature of the tax system. But politically, reducing a tax paid only by those on incomes over £150,000 – the top 1 per cent of taxpayers – was never going to be easy for a government claiming we were ‘all in it together’ and stung by accusations that they were out of touch with mainstream voters.

In the event an analysis was commissioned from HMRC to assess how effective the top rate had been in raising revenue. While stressing the great uncertainty around estimates based on only two years of data, HMRC concluded that only about £1 billion of additional revenue was being raised – rather less than the £2.7 billion originally envisaged and well short of the £6.8 billion a year that would have been raised if there had been no behavioural response. Their analysis also suggested that cutting the top rate from 50p to 45p would cost only around £100 million. The OBR signed these off as reasonable estimates and in his 2012 Budget the Chancellor acted to announce a cut from 50p to 45p from April 2013. At the same time, and at the insistence of the Liberal Democrats, a big increase of more than £1,000 in the

personal allowance was announced.²⁷ The horse-trading required that the two changes be made at the same time. Just as the previous government had made the fiscally expensive mistake of announcing the introduction of the 50p rate well in advance, so the coalition made the same mistake in reverse – announcing its demise well in advance. In each case the billions of pounds of income were shifted between financial years by those on high incomes seeking to take advantage of differential tax rates. The Labour Party has subsequently announced that it would, in office, return the top rate to 50p.

The immediate aftermath of the 2012 Budget was, however, dominated by controversy over a range of other smaller tax measures, largely aimed at recouping some of the costs associated with the big increase in the personal allowance. These included the phasing out of the additional income tax personal allowance enjoyed by pensioners – in a move dubbed the ‘granny tax’ – and a small movement in the VAT boundary to bring any food sold above room temperature into the VAT net. Bizarrely (at least bizarrely if looked at from any rational point of view) this small extension of VAT, which quickly acquired the name ‘pasty tax’, drew far more political flack than the massively more significant hike in the main rate which had come in only just over a year earlier, and was partially reversed.

More radical reform has been eschewed by the coalition. The need to repair the public finances has quite definitely not been used to force through measures such as a broadening of the VAT base,²⁸ which might have improved the efficiency of the tax system whilst also offering the potential for additional revenue. In many respects there has been considerable continuity with the (lack of) strategy pursued by the previous government. This lack of radical reform stands in stark contrast to policy on the spending side of the balance sheet. Perhaps some of that has come from difficulties in agreement across the coalition. The Liberal Democrats might well have imposed a ‘mansion tax’ – a higher council

²⁷ See Matthew d’Ancona, *In It Together: The Inside Story of the Coalition Government* (London: Penguin, 2013), p. 231.

²⁸ See the Mirrlees Review (James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James Poterba, *Tax by Design: The Mirrlees Review*, Oxford: Oxford University Press for IFS, 2011) for a comprehensive analysis and setting out of a tax strategy. Paul Johnson, ‘Tax without design: recent developments in UK tax policy’, *Fiscal Studies*, 35:3 (2014), pp. 243–73 analyses the coalition’s record in more detail.

tax charge on very expensive properties. But there has been little sign that either coalition partner has been interested in more fundamental reform of tax policy.

From the perspective of 2015, though, three aspects of coalition tax policy stand out. The first two we have already alluded to: the expenditure of colossal amounts of money on three measures – the personal allowance, corporation tax and fuel duties – and the general lack of any clear strategy for reform beyond one or two narrow areas. The third is the distributional consequences – the incomes of those in the middle to upper-middle parts of the household income distribution have been quite effectively protected from the direct effects of the tax and benefit changes introduced since January 2010. Taking tax and welfare changes into account, analysis by IFS researchers suggests that losses have been concentrated in the bottom half and the top 10 per cent of the income distribution. ‘Middle England’ has suffered remarkably little on average from tax and welfare changes over this period.²⁹

Living standards

For most people of working age it has not been changes to tax policy which have hit their incomes, rather it has been a historically unprecedented and long-lasting fall in real earnings. Figure 6.7 illustrates just how remarkable the period since 2008 has been by comparing the path of real hourly wages with their paths after the 1979 and 1990 recessions. The failure of wages to grow continued right through 2014 as economic recovery, as measured by national income, continued apace. Economic recovery was not leading to a recovery in earnings and living standards.

Largely as a result of this fall in earnings, real household incomes in 2015 remain well below their 2010 and pre-recession levels. To go such a period without a recovery in living standards is historically unusual if not unprecedented, at least since the last war. The political challenge created by this fall in living standards has been defined by its widespread nature. In complete contrast to the 1980s, when high

²⁹ David Phillips, ‘Personal tax and welfare measures’, Institute for Fiscal Studies, 2014 (accessed at www.ifs.org.uk/budgets/budget2014/personal_measures.pdf, 11 November 2014)

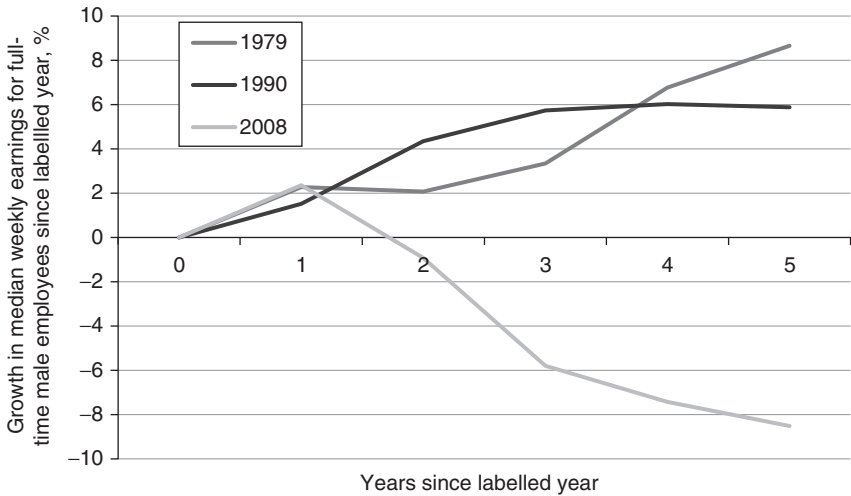


Figure 6.7 Changes to average real hourly wages in the UK, by recession
 Note: median gross weekly earnings for adult full-time male employees in Great Britain whose pay for the survey period was not affected by absence. We have not looked at men and women combined because data is only available from 1984. Source: 1970–1997 New Earnings Survey, 1997 onwards Annual Survey of Hours and Earnings. See www.ons.gov.uk/ons/about-ons/business-transparency/freedom-of-information/what-can-i-request/published-ad-hoc-data/labour/december-2012/gross-weekly-earning-1968-to-2013.xls.

unemployment hit a minority and earnings, especially for high earners, rose swiftly, the fall in income over this parliament has been experienced across most of the distribution. Employment has risen and earnings have fallen. Up to 2013 at least this has been a period of falling income inequality. Much more than the 1980s at least we are ‘in it together’. But for many people in work that has been a very uncomfortable experience as their living standards have fallen. And while the gap between rich and poor has not widened, the gap in experience between old and young has been quite dramatic. While the incomes of those over state pension age have continued to rise, 31–59-year-olds suffered an average 11 per cent fall in real incomes (measured after housing costs) between 2007–8 and 2012–13, and those in their 20s saw their incomes fall by an average 20 per cent.³⁰

³⁰ Chris Belfield, Jonathan Cribb, Andrew Hood and Robert Joyce, *Living Standards, Poverty and Inequality in the UK: 2014* (London: Institute for Fiscal Studies, 2014).

Some of the tax cuts described above were more or less deliberate attempts to help ameliorate the effects of falling earnings. The increase in the personal allowance has been particularly valuable for those on modest to middle earnings – at least up to £40,000 or so, where higher-rate tax starts to bite. Fuel duty freezes were explicitly linked to concerns about the cost of living, as have been council tax freezes. Beyond that the government has struggled to respond. With GDP per person still well below pre-recession levels it is in truth no surprise that income per person has not recovered.

One feature of the period has been the fact that lower-income households have faced higher effective inflation rates than those on higher incomes, in part because energy and food prices rose particularly quickly, especially over the first part of the parliament. Adams et al., for example, calculate that low-income households faced an effective inflation rate 1 per cent higher each year between 2008–9 and 2013–14 than did high-income households.³¹

Reflecting these concerns, the Labour Party moved from talking about the ‘cost of living crisis’ to offering at the 2013 party conference to freeze energy bills. This arguably represented a radical shift in the terms of political and economic debate. A promise of such direct political intervention in a market to control prices appeared to sit well outside not only the coalition’s economic policy framework but also that of the previous Labour government. The opposition followed a similar theme in later proposing some limited control of rents in the private rental sector.

Responding to concerns about energy bills the 2013 Autumn Statement included a set of measures to reduce the effect of ‘green’ taxes and levies, designed to reduce household energy bills by £50 a year. This response itself represented a compromise within and between the coalition parties over the importance of green policies.³²

The other significant policy initiatives, driven significantly by concerns about living standards, have been controversial interventions in the owner-occupied housing market. With the banks, in the wake of the financial crisis, making few mortgages available to buyers with deposits of less than 20 per cent of the purchase price, owner-occupation was

³¹ Abi Adams, Andrew Hood and Peter Levell, ‘The squeeze on incomes’, in Carl Emmerson, Paul Johnson and Helen Miller (eds.), *Green Budget 2014* (London: Institute for Fiscal Studies), pp. 90–125.

³² See chapter seven, this volume.

becoming unaffordable for many potential first-time buyers. Home ownership rates among those in their 20s and 30s had fallen to much lower levels than had been the case a decade or two decades previously. For those in their mid-20s ownership rates had halved.³³

The government responded by announcing the ‘Help to Buy’ scheme in the March 2013 Budget, aimed at both stimulating the market and reducing the upfront deposit costs of ownership. The policy has two parts, both of which are set to run for three years: ‘help to buy: equity loan’, launched in April 2013, provides interest-free government loans of up to 20 per cent to purchasers of newly built homes while ‘help to buy: mortgage guarantee’, launched in January 2014, allows mortgage lenders to purchase government-backed insurance for high loan-to-value (LTV) mortgages on all new and existing properties worth less than £600,000. The scheme represents a significant expansion of previous initiatives, with the government committing to provide £3.5 billion in equity loans over three years from April 2013, and insurance guarantees sufficient to support as much as £130 billion of high LTV mortgages insurance over three years from January 2014.

The equity loan scheme has been broadly welcomed as an attempt to increase access to the housing market while also stimulating the construction of new builds, addressing long-standing concerns about the inadequacy of new supply. While housing construction has picked up, there has been no evaluation of how far the equity loan scheme contributed to this change (NAO 2014). The mortgage guarantee scheme, on the other hand, has been subject to more criticism on grounds that, by stimulating demand without any direct link to new supply, it risks stoking a house price bubble which could put the recovery at risk. Whatever the role of these policies the pick-up in house prices, especially in London, has raised fears of a house price bubble, with the IMF and Bank of England, among others, seeing it as a potential threat to economic recovery.

Getting back to growth

Deficit reduction and living standards have dominated public debate over the parliament. As we have seen, the unexpectedly poor

³³ Belfield et al., *Living Standards*.

performance of the UK economy in the first three years of the period has underpinned both the difficulty of bringing down the deficit, and the continued squeeze on living standards. Unsurprisingly, then, there has also been considerable pressure on the coalition to ‘do something’, beyond deficit reduction, to restore the economy to growth and to make good on early promises about delivering a more sustainable and balanced model of growth.

In many respects the Bank of England has led the way, engaging in a remarkable policy of ‘quantitative easing’ whilst maintaining interest rates at their lowest level in history. From the Chancellor’s point of view it was his fiscal discipline that was a prerequisite for effective monetary activism. The Bank has also worked very closely with the Treasury at times – the funding for lending scheme, for example, being a joint effort by Bank and Treasury to increase the supply of credit in the economy. Beyond that, while the coalition has put in place a range of specific policies spanning tax policy, planning, schools, welfare, infrastructure and industrial policy, and financial reform, it is difficult to discern a coherent ‘growth strategy’, in particular one aimed at the long-term goal of ‘rebalancing the economy’. As economic historian Nicholas Crafts has pointed out, the absence of a wider economic strategy is thrown into sharp relief by comparison to the radicalism of governments in the 1930s and 1980s.³⁴

Monetary policy and the Bank of England

Although the Bank of England has been independent since 1997 (one of Gordon Brown’s first acts as Chancellor), and is therefore formally outside the remit of political influence and government policy, it is impossible to understand economic policy without it – particularly over the past five years.

As the severity of the recession unfolded between 2007 and 2009, the Monetary Policy Committee pursued an unprecedented loosening of monetary policy. In October 2008, central banks around the world, including those in the UK, USA, Canada, China and across

³⁴ The 1930s are associated with both loose monetary policy and a boom in housing construction, while the 1980s saw a range of radical supply-side reforms. For a summary and discussion, see Nicholas Crafts, ‘Returning to growth: Policy lessons from history’, *Fiscal Studies*, 34:2 (2013), pp. 255–82.

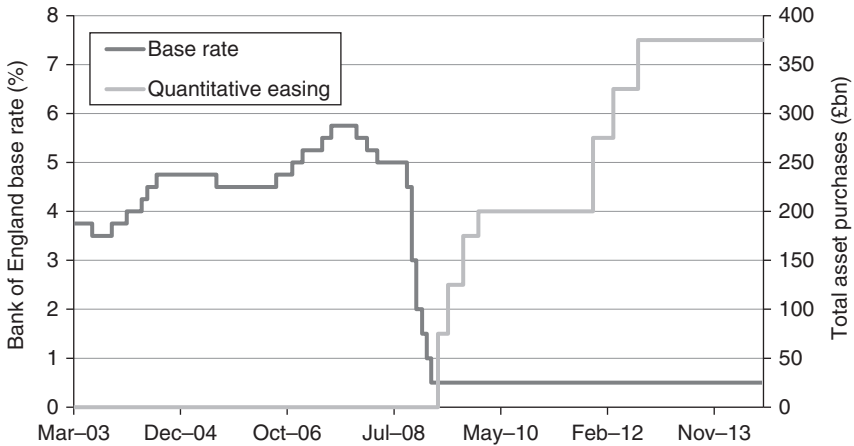


Figure 6.8 Conventional monetary policy and central bank asset purchases
Source: Bank of England

the Euro area undertook a coordinated cut in interest rates. As Figure 6.8 shows, the Bank of England cut its base rate by four and a half percentage points in just six months, from 5% in October 2008 to just 0.5% in March 2009 – the lowest rate in its more than 300-year history. In late 2014, the bank rate remains at this unprecedentedly low rate.

Despite the dramatic reduction in interest rates, the depth of the economic downturn persuaded the Bank that further monetary loosening was required and, along with a number of other central banks, it turned to ‘unconventional’ monetary policy measures, of which quantitative easing or QE is the most significant. This involves the Bank creating money to purchase (mainly) government bonds. The Bank first announced that it would undertake a policy of QE in March 2009, purchasing £75 billion of assets using money it would create. A series of announcements during 2009 more than doubled the scale of QE to £200 billion, a sum that was raised further as the economic situation continued to deteriorate between 2010 and 2012, reaching a peak of £375 billion in May 2012. The Treasury saw a clear ‘implicit contract’ involving fiscal credibility on the one side and monetary activism on the other.

Some gloomy speeches by governor Mervyn King in Autumn 2012,³⁵ in which he speculated about the limits of monetary policy,

³⁵ For example here: www.bankofengland.co.uk/publications/Pages/speeches/2012/613.aspx (accessed 12 November 2014).

were seen by some as threatening this implicit contract. Mark Carney, the replacement Chancellor Osborne had been wooing for some time, was more positive about what central banks could do. Initial speculation about whether the inflation target might be changed in any way was quashed in Budget 2013 and Carney sought to reassure the markets that interest rates would not rise in the short term by announcing a policy of ‘forward guidance’, suggesting that interest rates would remain low until unemployment fell below 7 per cent (an announcement the Bank subsequently revised in light of better-than-expected labour market performance).

The Chancellor will always be the key player in determining who will be the Governor of the Bank of England, though in this case the focus on securing a particular candidate was perhaps unusual. But the whole period has tested the theory of central bank independence. The funding for lending scheme, launched in July 2012 and designed to deal with the lack of credit supply by incentivizing banks to lend, was explicitly badged as a joint Bank/HM Treasury initiative. In the event the design of the policy incentivized more lending to households than to the main intended focus, business and especially SMEs. In fact it was the newly formed Financial Policy Committee of the Bank of England which in Autumn 2013 ensured that the policy was skewed away from lending to households because of concerns about its effect on the housing market – an effect potentially magnified by the ‘Help to Buy’ scheme described above, which acted on the demand side of the credit market.

Coalition policies for growth

Monetary policy, led by the Bank of England, albeit with the support of the government, has been the primary tool for returning the UK economy to growth. The Treasury would argue that it is tight fiscal policy which has provided the necessary space for this monetary activism. Given the severity of the recession, the coalition has been under pressure from the start to develop a wider growth strategy. Indeed, David Cameron used his first speech as Prime Minister to emphasize that the economy was the ‘first priority’ for his government, in terms of both the immediate priority of achieving growth and delivering a more sustainable and balanced model of growth for the long term.

Of course the government has seen the deficit reduction programme itself as a ‘necessary precondition for sustained growth’.³⁶ The one element of that which came under most sustained attack in the early years of the coalition was the sharp cut in investment spending – a cut in fact inherited directly from the Labour government’s plans. Critics of the coalition’s fiscal strategy argued that it should take advantage of historically low interest rates by borrowing more to invest in infrastructure, providing both a short- to medium-term stimulus and investment which would improve long-run economic performance. Responding to these pressures, the government announced £5 billion of additional infrastructure spending (funded by cuts elsewhere) in the 2011 National Infrastructure Plan to be spent over the next three years. Despite concerns within the Treasury that turning on the investment spending taps at any speed was actually remarkably difficult, pressure to increase capital spending further continued to mount over 2012 and 2013, with the IMF suggesting that the government increase borrowing to bring forward infrastructure projects in the region of £10 billion (to be paid for by cuts later on). Internal coalition debates were publicly aired ahead of the 2013 Budget as Nick Clegg suggested it may have been a mistake to cut capital spending so fast and Vince Cable proposed an increase in government spending on house-building of the order of 1 per cent of GDP.³⁷ The government announced further spending on infrastructure in the 2013 Budget and Spending Review later in the year, but again this was to be paid for by cuts elsewhere, and additional spending was not planned to begin until 2015–16. In any case the scale of the increases in planned infrastructure spending has been small relative to the initial cuts the government inherited.

Beyond this, the coalition has at times been at pains to demonstrate that it has a more comprehensive growth strategy. Following the 2010 Autumn Statement, it announced a wide-ranging Growth Review, published in two phases alongside the 2011 Budget and Autumn Statement. The review sought to shift the focus beyond short-term recovery and towards longer-term goals, stating that ‘The Government’s

³⁶ HM Treasury, *National Infrastructure Plan 2010* (London: The Stationery Office, 2010).

³⁷ ‘Clegg says coalition was wrong to cut capital spending’, *BBC News*, 25 January 2013 (accessed at www.bbc.co.uk/news/uk-politics-21190108, 12 November 2014); Patrick Wintour, ‘Senior Liberal Democrats rebuff Vince Cable over plea for capital investment’, *The Guardian*, 10 March 2013.

economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries.’ In total, the growth review, plus the National Infrastructure Plan published alongside the 2011 Autumn Statement, set out more than 250 economic reforms and investments in infrastructure,³⁸ with the broad aims of improving the competitiveness of the UK tax system, encouraging investment and exports, making the UK an attractive place for entrepreneurs, and creating a more educated and flexible workforce. Specific reforms (sometimes building on previous announcements) included significant cuts to corporation tax, a £1 billion Regional Growth Fund to support growth in areas heavily dependent on the public sector, the removal of a range of regulations faced by businesses, a simplified planning regime, a range of policies to support small businesses including an extended business rate holiday, and increased funding for apprenticeships.

Few of these, with the possible exception of the remarkably large cuts to corporation tax, are likely to have had much short-term effect on growth. That is not a criticism. Growth policy is long-term by its nature. As ever, longer-term effects are hard to predict, though if the planning reforms with their presumption in favour of ‘sustainable development’ do lead to a change in behaviour and culture they might prove effective.

The period since the financial crisis has also seen a revival of interest in so-called ‘industrial policy’, which broadly refers to government policies to support or develop certain industries in order to support economic growth. The ‘Growth Review’ encompassed a range of ‘horizontal’ policies – policies aimed at improving the economic conditions for industry rather than supporting specific sectors directly – while Business Secretary Vince Cable has outlined a wider industrial strategy, including support for key sectors and technologies, improved access to finance, policies to develop certain types of skills and proactive use of government procurement to generate opportunities for UK firms and supply chains.³⁹ From time to time the coalition has also expressed ambitions to decentralize power and to spur economic growth at a more local level, despite abolishing the regional tier of government built up

³⁸ HM Treasury, ‘Budget 2012’ (accessed at <http://webarchive.nationalarchives.gov.uk/20120403141350/http://www.hm-treasury.gov.uk/budget2012.htm>, 12 November 2014).

³⁹ Chris Rhodes, *Industrial Policy since 2010* (House of Commons Library, 2014).

under Labour, including the nine Regional Development Agencies. The most radical voice on decentralization has been that of Lord Heseltine, whose report on the issue in 2012 'No stone unturned: In pursuit of growth' recommended a strengthening of local leadership combined with a radical devolution of powers and funding to the local level. This was probably the high point of enthusiasm for devolving economic power, though the close call on Scottish independence and the additional powers promised to Holyrood reawakened some more general calls for devolving tax and spending powers. Other announcements aimed at increasing growth around the country seem to have focused on the possibility of big long-term infrastructure projects such as HS2.

If it is hard to see a clear growth strategy and narrative in all of this, that is unsurprising. Whatever the merits of specific policies among those listed above there is little here that could be said to constitute a really substantial change to economic policy or the supply-side potential of the economy to match the big movements towards greater competition, labour market flexibility, openness to global markets, including global labour markets, and increased access to higher education, which characterized the previous decades. Nor has there been much movement to overcome some of the institutional barriers to growth identified by, for example, the LSE Growth Commission.⁴⁰

A final area worth touching on is reform of the financial sector – an obvious priority in the wake of the financial crisis that precipitated the recession. This has been an area of substantial activism and one perhaps deserving of a chapter of its own. The whole regulatory architecture has been overhauled. Responsibility for prudential regulation has been returned to the Bank of England, the Financial Services Authority wound up and the Financial Conduct Authority created. A new independent Financial Policy Committee of the Bank of England has been created with an objective to manage systemic risks, and a secondary objective to support the economic policy of the government.

An early decision of the coalition, indeed a commitment in the Coalition Agreement, was to establish an Independent Commission on Banking, led by Professor Sir John Vickers, to examine the case for structural reforms to the financial sector, including the need to address

⁴⁰ *Investing for Prosperity* (LSE Growth Commission, 2013) (accessed at www.lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/LSEGC-Report.pdf, 12 November 2014).

the problem that certain banks were ‘too big to fail’. In part the setting up of a commission was intended to help deal with differences between the coalition parties over the extent and type of reform required. The Commission published its final report in September 2011, advocating the ring-fencing of British retail banks (separating deposit and lending functions from investment banking) among other reforms. Following the public outcry over fixing of the LIBOR interest rate benchmark in 2012, a Parliamentary Commission on Banking Standards was established with a wide-ranging remit to look at professional standards and culture in the UK banking sector. The Commission made a series of recommendations to improve accountability and standards, including a tougher licensing regime for bankers and the proposal that bankers be jailed for ‘reckless misconduct’. The key recommendations of both groups – including the ring-fence, tougher licensing and criminal sanctions for misconduct – were brought into law via the Banking Reform Act 2013.

Conclusion

So how will the coalition be judged on its handling of the economy?

In its own terms its progress on deficit reduction must be seen as the defining issue. In the event, disappointing economic growth has meant that much less progress has been made than was planned. This despite the fact that George Osborne stuck to ‘plan A’, withstanding very considerable pressure to slow the pace of spending cuts in the first years of the parliament. For while he may not have deviated from ‘plan A’ in terms of planned spending cuts (and tax rises) he proved more flexible in his plans to eliminate the deficit than is often acknowledged: the forward-looking fiscal rule has allowed additional tightening to be put off into the next parliament. And this is the context that frames the 2015 election. The next parliament will be characterized by austerity on a comparable scale to that seen since 2010 – not at all the original intention of a Chancellor aiming to have the deficit all but eliminated in time for the 2015 election.

Indeed some very big fiscal and economic questions remain unanswered. It looks like the shape of the state in 2020 will be dramatically different to its shape pre-recession. It will be different not so much because of a change in its absolute size as a share of spending in the economy, but in the distribution of that spending. Health, pensions and

debt interest will take up a much larger share of the total. Nearly all other aspects of public spending will be much reduced.

There is little explicit sign of serious debate about these decisions, though one can read some substantial differences into the stances of the main parties as they enter the 2015 election. The Conservatives are committing to a combination of a balanced budget by 2018–19, protecting health spending and pension spending, and tax cuts. Labour is promising a budget balance only on the current budget – a significant difference made the greater by the Conservative tax promises.

In the end this period of government has been merely Act 1 of what looks like being at least a two-part process of fiscal consolidation. Act 2 could well be considerably tougher and bloodier than the opening act. It will perhaps be only at the end of the second act that we will be able to judge the long-term consequences of events so far.

As for the rest, the government has had to deal with an economy which continued to behave in unexpected ways. Growth was initially much lower than anticipated and even when recovery arrived it sprang surprises of its own. Employment has been much stronger than anybody expected. Productivity, wages and household incomes have suffered badly. The Bank of England, itself wrong-footed by the unexpected behaviour of the economy, has played a central and activist role, keeping interest rates at their lowest ever for far longer than anticipated, engaging in a huge programme of quantitative easing, and using a range of other unconventional monetary tools.

The Chancellor has cut corporation tax rates remarkably aggressively and a new totem has arisen in the income tax system – the level of the tax-free personal allowance apparently replacing the basic rate of income tax as the focal point of policy. Otherwise, beyond changes to the taxation of pensions, there has been little memorable on the tax reform front. As far as ‘rebalancing’ the economy is concerned, there has been a big shift in jobs from public to private sector. Some supply-side reforms, notably to corporation tax and perhaps to the planning regime, may bear long-term fruit. The challenge to find more coherent and effective long-term supply-side economic policy remains.