

Paul Johnson's opening remarks

26 November 2015

July's fiscal arithmetic implied average cuts of 27% to the resource spending of "unprotected" departmental spending – that is to day-to-day spending other than that on health, schools, ODA and defence which was explicitly protected. The comparable figure after yesterday's announcements is "just" 18%, one third less than implied in July. Yet the planned surplus for 2019-20 is largely unchanged.

The first thing to say is that this is not the end of "austerity". This spending review is still one of the tightest in post war history. Total managed expenditure is due to fall from 40.9% of national income in 2014-15 to 36.5% in 2019-20. A swathe of departments will see real terms cuts. The 3% *cumulative* increase in health spending over the next five years is not far off the average *annual* increase in spending in the last 50 years.

On the other hand there is no question that the cuts will be less severe than implied in July. The gap with what one might have expected based on the Conservative manifesto is substantially greater.

How has Mr Osborne done that whilst keeping to his surplus target in 2019-20? He has banked some changes in forecasts for lower debt interest payments and higher tax revenues. That was lucky. By adding some tax increases he has made some of his own luck.

He's going to need his luck to hold out. He has set himself a completely inflexible fiscal target – to have a surplus in 2019-20. This is not like the friendly, flexible fiscal target of the last parliament which allowed him to accept a bigger deficit when growth and tax revenues disappointed. This is fixed four years out. The forecasts will change again, and by a lot more than they have over the past few months. If he is unlucky – and that's almost a 50-50 shot – he will have either to revisit these spending decisions, raise taxes, or abandon the target.

Abandon it is just what the Chancellor has done with his self imposed welfare cap. He won't keep to it in any of the next three years. In the long run, though, the tax credit change has little effect on the public finances because the cuts to Universal Credit announced in July are unaffected.

Beyond the spending numbers and the welfare changes, though, we also saw yesterday glimpses of George Osborne the reforming Chancellor. He really is cutting spending on non pension benefits to its lowest level relative to national income for about 30 years. The changes to local government financing and devolution are genuinely radical and could transform both the role of local government and the UK's fiscal architecture. The same is true of additional devolution to Wales and Northern Ireland. The commitment to consult on reforming school funding is long

overdue – and would have been much more easily done when there was more money to go around.

The spending (and tax) numbers

There are still some very significant cuts ahead. Unprotected resource DELs (for these purposes all RDEL other than defence, aid, health, schools and devolved nations) are falling 18% by 2019-20.

That these cuts are now so materially different to what was expected is down to a “gearing” effect. Only about £90 billion of resource DEL spending is unprotected. By comparison with July’s implied numbers this spending will be cut by £5 billion less. That’s a very small number in the scheme of government spending, but accounts for nearly 6% of all unprotected spending. That’s why small changes to the forecast and relatively small tax increases can have such a big effect on the percentage cuts to be suffered by these departments.

So one story is that the police and the foreign office, for example, were spared expected cuts *because* there were modest changes to forecasts. Perhaps it is foolish to speculate about what might have been. But suppose the forecasting changes had moved in the other direction. Would it really in those circumstances have made sense to impose swingeing cuts on the police? It is odd that small corrections to forecasts are presented as driving big changes in policy.

Don’t forget though that this was also a tax raising budget. A £3 billion tax on the payrolls of companies with paybills over £3 million is substantial as is an increase in stamp duty land tax of nearly £1 billion on second homes and buy to let properties. The latter especially is also ill designed, not least because it reintroduces, albeit on a small scale, a cliff edge into the Stamp Duty schedule a mere year after the Chancellor made much of abolishing cliff edges in the Stamp Duty schedule. Allowing an extra 2% a year on council tax bills to help pay for social care will also raise revenues by £1.7 billion a year by 2019-20. The tax share of the overall consolidation since 2010 rose modestly as a result of yesterday’s announcements, but only from 14% to 17% of the total. Spending will still bear the brunt.

One spending cut that might have escaped your attention in the announcements about housing is in capital grants to Housing Associations. These will be cut by 40% in 2017-18 for example. As the OBR points out in paragraph B.38 despite these cuts “grants are higher over our forecast period as a whole, but this is mainly due to the increase in 2020-21 (*which is beyond the current spending review period*).” (My emphasis).

Welfare

The OBR has significantly reduced its forecast of savings from disability benefit reforms – in particular the move from disability living allowance to personal independence payment. This is familiar. Year after year expected savings from this reform go down. In fact this change in forecast would have ensured that the welfare cap in 2020-21 would have been breached. Only a

reclassification (which the government argues is a policy change affecting behaviour) of a minor item of spending on temporary accommodation has allowed the cap to be met.

Of course the biggest welfare announcement was that tax credit cuts proposed for April 2016 will no longer happen. They have been abandoned entirely. The long term cost? Nil. Why? Because the equivalent cuts to Universal Credit, now legislated, were left untouched. The expected cost of the U turn is £3.4 billion in 2016-17 but less than £0.5 billion by 2020-21. If you thought the announced saving in 2016-17 was £4.4 billion not £3.4 billion you'd be right. The £4.4 billion number was just wrong. As the OBR puts it in Box 4.3 of the EFO this reflected:

”the challenge of estimating interactions between HMRC tax credits and DWP benefits in the run up to a fiscal event, where the Treasury’s policy costings process *does not permit us to call on the expertise of officials* across both departments on all measures that might be subject to interactions” (my emphasis again).

The policy change ensures that no family will take an immediate cash hit. And people will be protected in cash terms even as they roll off tax credits and on to Universal Credit. But the long term generosity of the welfare system will be cut just as much as was ever intended as new claimants will receive significantly lower benefits than they would have done before the July changes. Overall the shift from tax credits and other benefits to Universal Credit is complex. We estimate that in steady state UC will now involve 2.6 million working families being an average of £1,600 a year worse off than they would have been under the current system while 1.9 million will be £1,400 a year better off. UC was always designed to be less generous than the current system to non working families. We estimate that spending on 1.8 million non working families will be reduced by £2.2 billion relative to the current system.

There was also one small, but in the long run potentially important change made to Housing Benefit for social tenants. For new tenants only (a desire not to impose cash losses may be apparent here) housing benefit will be restricted to the equivalent private sector rate. That won't bite much initially, saving £225 million by 2020. Had it been imposed on all tenants immediately it would have saved more than £1 billion. The long run effect is likely to be larger than that. Private sector benefit rates only rise with inflation. Rents tend to rise faster than that. If that happens in the social sector (after the current policy of cutting rents expires) then the long run effect could be substantial.

Education, Local government and devolution

The chancellor has talked of a “devolution revolution”. Looking across local government and the constituent countries of the UK there is some reason to accept that a revolution is underway. This is not just political hype.

Additional powers are of course being devolved to Scotland. Wales is also to get some powers over income tax without the need for a referendum. Northern Ireland will get corporation tax

devolved and looks like it will cut the main rate to 12.5% to match that in the Republic. A flaw in the Barnett formula (pointed out by my colleague David Phillips in research published last year) is being fixed. As we showed in a paper published last week there is an increasingly urgent need though to work out the appropriate fiscal framework for this newly devolved United Kingdom. We still don't know how devolution to Scotland will work in practice and what (necessary) compromises to the mutually incompatible principles laid down by the Smith commission will be made.

We are also in the middle of a revolution in the funding of English local government. In part this reflects a big cut in central government support – cuts of over 50% in this spending review period, come on top of big cuts in the last parliament. These cuts in grants have had big distributional effects – those authorities more dependent on central government funding have seen their spending power reduced much more than others.

Following changes in April 2013, councils' spending power already depends, in part, on how much business rates are raised in their area. They get to keep up to 50% of the growth in their rates revenue that's due to new development. The Chancellor confirmed plans to go further. These changes have big effects on economic incentives, financial risk and funding patterns across the country. How much councils have to spend in future will depend much more on the performance of their tax base than it did in the past. This is a big change.

What isn't such a change are the 'new powers' for councils to cut or reduce these rates. Councils already have many of these powers, and they have been little used.

Finally, another change in prospect, is a long overdue reform to the way in which schools are funded. For more than a decade grants to local authorities to pay for schools have been based on little more than historic allocations, themselves based on complex funding formulae. Different local authorities have themselves taken very different views as to how to distribute money to their own schools. This has resulted in differential funding for schools which is hard to understand let alone justify.

Previous governments have signally failed to sort this out when there has been plenty of money around. It will be harder to make changes when money is tight. It is to be hoped that this government will be more successful than its predecessors in effecting rational reform.