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Why the UK's Fiscal Charter is Doomed to Fail

An Analysis of Austerity Economics during the First and the Second Cameron Governments*

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Abstract The economic rationale for austerity policies harks back to a highly controversial proposals that originated in the 1990s known as 'expansionary fiscal contraction.' This paper explores these ideas relating to austerity and suggests that matters have not worked out as George Osborne expected. Furthermore, since the broad assumptions made by HM Treasury and the OBR remain the same in 2015 as they were in 2010, the paper presents an argument why austerity plans for the period 2016–2020 are also unlikely to succeed.

The core arguments in the paper can be summarised by the following bullet points:

- Politically motivated suggestions that the economy crashed in 2007–08 because of Labour's overspending are not supported by the data. Indeed, by the time it left office the Labour government had adopted a more realistic basis for economic forecasting than the following government.
- In contrast to the generally perceived view, austerity only hit current spending per head from 2013 onwards, from which time on a significant downward trend in current spending per head of population is noticeable in the available data and forecasts.
- Despite the rhetoric of increasing and intolerable debt interest burden, the actual cost per head in 2015–16 is unlikely to be greater than pre-crisis levels on a per capita basis.
- The second Cameron government is planning to increase government spending, particularly in discretionary areas at around the time of the next general election in 2020.
- There has been a fundamental shift in the way that government spending benefits people in the UK. 'Feel good items' spending (health, education, infrastructure) per capita has declined sharply since 2008, while annually managed spending (mainly welfare and debt interest) has increased. These diverging trends clearly have differential effects on groups in society.
- Government policy aims to increase income tax and national insurance as a proportion of overall revenue, and at rates in excess of GDP growth, in the next five years, whilst reducing corporation taxes significantly.
- The government forecaster – the Office for Budget Responsibility (OBR) – is adopting a low, and in our view, unrealistic multiplier for government spending (range of 0.6 to 1.0). This is much lower than the one adopted by the IMF (0.9 to 1.7) or Standard & Poor (up to 2.5). The low multiplier adopted by the OBR has led to persistent overestimation of the benefit of austerity and constant upwards revision of public borrowing needs.
- The Office for Budget Responsibility forecasts for balancing the books by 2020 is premised on very significant, and in our view unrealistic, changes in the pattern of behaviour of the private sector within the UK economy and the external sectors over the next few years.
- The Fiscal Charter is neither feasible, nor desirable, for the UK economy.
- It is not desirable because it is premised on considerable growing debt burdens shouldered by the private sectors (households and business community) and overseas trade sector.
- It is not feasible because it assumes a linear and highly magnified projections of growth trends in the private and external sectors that began an either in the middle or 2014 or the early 2015 into the future but are very unlikely to continue unabated.
- If the rate of inaccuracy of OBR forecasts from 2011–12 to 2015–16 was replicated in the years 2015–16 to 2019–20 then, based on the July 2015 OBR forecast, an additional £162 billion would be borrowed over this period, and at the end of the 2015-2020 parliament the budget would not be running a surplus of £10.2 billion but would instead be showing a deficit of £39.3 billion.

Part 1: Introduction

The term austerity entered the political narrative in the UK with the ascent to office of George Osborne in 2010.[1] The economic rationale for austerity policies was based on three premises. First was the premise that the UK economy was 'broken' and needed radical structural change. Second was the premise that governments must 'balance the books', and hence cannot borrow to invest, and third, that balancing the books is the appropriate policy in any event to stimulate growth. It is not our intention in this paper to recall the historical evolution of these ideas. We note, however, that at early stages the three premises were not necessarily linked to one another and were not considered part of a comprehensive philosophy. At the initial stage, the Cameron government simply found itself in a position that it described as 'running out of money' meaning that it resisted calls for 'debt-fuelled tax cuts and extra spending'.[2] It was only towards the end of its first year in office that the theme of 'running out of money' was replaced by the theme of the 'broken economy,' and the causes of the 'broken economy', in turn, were linked firmly to Labour's stewardship of the economy prior to the crisis.[3]

The core argument for austerity economics as the harbinger of economic growth harks back to highly controversial proposals that originated in the 1990s known as 'expansionary fiscal contraction.'[4] The idea behind these proposals is that the public and private sectors compete over the same pool of capital. It follows that if a policy of deliberate deflation in wages, prices and public spending through reduction in the state's budgets, deficits and debts was pursued, then business confidence would be created as the foundation for growth. The state would no longer be 'crowding out' the private sector in a race to command scarce capital, resources or labour. The assumption is that private sector's use of these resources (lower cost of capital, resources or labour) would result in higher growth than if they were used by the state (for discussion see: Barry & Devereux, 1995; Blyth, 2013).

Expansionary fiscal contraction theory is predicated, in other words, on three linked, but highly controversial assumptions: first, that there is a finite pool of available capital at a national level; second, that interest rates at national level are determined by a simple demand and supply curve; and third, that private sector investment (and correspondingly, debt) is always preferable to the public sector investment (and hence also debt).[5]

[1]The political economy of the UK was almost wholly unfamiliar with the concept of austerity before 2010. It is true that Gordon Brown had spent much of the previous thirteen years discussing what he called prudence, and in the process persuaded his main political opponents that this was a policy that they too must pursue, but his meaning was very different from the austerity that was to follow his period of office. Gordon Brown defined prudence in two ways in 1998: there was the golden rule that said that over the economic cycle the Government would borrow only to invest and not to fund current spending; and then there was the sustainable investment rule that required that net public debt as a proportion of GDP would be held over the economic cycle at a stable and prudent level (Chancellor of the Exchequer, 1998). In practice this was interpreted as balancing the government's books over an economic cycle. It was unfortunate for Brown's legacy that he declared an intention to end the end of boom and bust cycles in the UK economy when that did not happen. See Chancellor of the Exchequer, 1999, para 1.6 (Kirkup, 2008).

[2]See for instance: http://www.telegraph.co.uk/news/politics/9107485/George-Osborne-UK-has-run-out-of-money.html

[3]The argument was that by running a controlled borrowing program prior to the crisis at an acceptable level, the British government found itself unprepared to deal with a major exogenous shock of the magnitude of the crisis of 2007–8 and 'ran out of money' at a crucial point. Hence, Gordon Brown's 'prudence' was no longer the appropriate policy.

[4]There is an ongoing debate with regards to adopting policies of balanced budget rule (BBR). The European Union is introducing the so-called fiscal compact that would require government budgets to be balance in surplus with a maximum level of annual structural deficit of 0.5% of GDP (Ghilardi & Rossi, 2014). This paper is not intended as a contribution to the considerable theoretical work on BBR. Rather we analyse current and planned policies of the UK government in order to gauge their feasibility or indeed, desirability.

[5]It is not our intention to discuss in depth the arguments that drive such theories. Suffice to say that in our view, none of these assumptions corresponds to the reality of modern, globalized financial markets.

This belief in the superior performance of the private sector has been implicit in the forecasting methodology adopted by the UK Office for Budget Responsibility (OBR), which George Osborne established in 2010 to audit the Treasury's economic forecasts (a task previously undertaken for Labour by the National Audit Office). The OBR has worked on the assumption since 2010 that the multiplier[6] to be applied to government revenue spending has been around 0.6 on average. The OBR has been a little more generous with the multiplier impact of government investment spending, where it has assumed the multiplier to be 1 (Office for Budget Responsibility, 2015, 39). The implications of the OBR's methodology are far reaching: Controversially, as we will discuss below, the OBR's forecasting methodology assumes that government revenue spending actually reduces GDP, whilst government investment could at best just recover cost. It follows from this methodology that any transfer of resources to the private sector – whether by tax cuts or reduction in spending – is bound to increase the growth rate in the economy.

In addition to these assumptions, 'expansionary fiscal contraction' is accompanied by another implicit but equally debateable assumption that can be described as front-loading transmission mechanism. This is that once the state has announced its intention to reduce demand for resources and tax revenues, the private sector responds by borrowing more in anticipation of that combination of growing income and reduced taxation since these would, in an ideal world, provide the means for repayment of that borrowing. This point is crucial. It meant that government could be indifferent to rising private sector debt because they argued that reduced government activity would make that private sector debt affordable.

The assumption of a front-loading transmission mechanism can be further dis-aggregated into two related theories. The first is that the private sector reacts in anticipation to future impact of declared policy which is matched by the commensurate belief that government must develop and nurture the credibility of its own policy announcements in order to ensure that these announcements have their intended effects.

Second, but not necessarily related, is the belief that private sector borrowing would increase once a policy of austerity is announced because the private sector believes in the notion of expansionary fiscal contraction theory. Although rarely presented in these terms, in effect, *a policy of expansionary fiscal contraction would shift, then, the debt burdens in the economy from the public to private sectors.* An argument for increasing private sectors debt, however, does not sound like a winnable political formula. Not surprisingly, perhaps, this side of the equation is rarely advertised in the political debates in the UK. One of the arguments presented in this paper is that it should be discussed.

This paper explores these ideas relating to austerity and suggests that matters have not worked out as George Osborne expected. Furthermore, since the broad assumptions made by HM Treasury and the OBR remain the same in 2015 as they were in 2010, the paper analyses the reasons why the austerity plans for the period 2016 to 2020 is unlikely to succeed. To reach these conclusions the paper is split into a number of parts.

Part 2 of the paper examines whether or not the first Cameron government adopted austerity policy. The question is relevant since some economists, including Paul Krugman (Krugman, 2015), have suggested that after 2012 this policy was largely abandoned, even if the rhetoric was not.

[6]In economics, the fiscal multiplier is the ratio of a change in national income to the change in government spending that causes it. When this multiplier exceeds one the enhanced effect on national income is called the multiplier effect. The mechanism that can give rise to a multiplier effect is that an initial incremental amount of spending can lead to increased consumption spending, increasing income further and hence further increasing consumption, etc., resulting in an overall increase in national income greater than the initial incremental amount of spending. In other words, an initial change in aggregate demand may cause a change in aggregate output (and hence the aggregate income that it generates) that is a multiple of the initial change. Source: https://en.wikipedia.org/wiki/Fiscal_multiplier

Part 3 explores what the implications of the policy of austerity have been on tax revenues and various types of spending and explains as a consequence why the focus of austerity policy has now come to rest on social security benefits.

Part 4 looks at what the outcome of austerity programmes has to suggest about the quality of economic forecasting since 2010, in particular, and considers in that context whether the multipliers for government spending were ever close to those assumed by the Office for Budget Responsibility.

Part 5 looks at whether austerity can succeed in balancing the UK government's books on the basis of the July 2015 projections, with a focus on sector balances.

Part 6 concludes with the suggestion that considerable political stress may arise before 2020 if the austerity programme fails, as this paper suggests, to deliver economic outcomes that match the current government political rhetoric.

Part 2: Has there been austerity?

The practical interpretation of the policy of austerity, whatever its already noted theoretical justifications might be, is that government spending should be reduced in order to reduce deficits and government debt. The theory is that deflation in prices, wages and government spending will provide the foundations for expansion in private sector market activity. Considering the degree of 'spin' associated with the political narratives of the 'broken' British economy, or the often-mentioned reduction in borrowing (calculated from its absolute peak),[7] it is worth asking whether an austerity policy was pursued with any rigour during the first Cameron government – or whether or not it was pursued at all (Krugman, 2015).

To test whether the government in office from 2010–2015 has indeed pursued a policy of austerity, a number of economic indicators have been assessed. First, data on actual government income and expenditure over the period from 2000 has been collected. This proved not to be as straightforward an exercise as might be presumed: the Treasury did not publish whole of Government Accounts throughout much of this period and those that are now produced are not consistent in format with HM Treasury of Office or Budget Responsibility forecasting formats. As a result, data on actual annual out-turns have been collected from successive HM Treasury budget reports published throughout this period. It is important to note that these appear subject to subsequent, usually poorly explained, revisions, but these appear immaterial to this exercise.

Where problems are more significant is in the reporting of planned government departmental spending. The OBR has admitted in correspondence with the authors of this paper to having difficulty in tracking HM Treasury reporting on this issue. Budget reports for total planned departmental and annually managed spending are used in this report in the main when considering spending. When departmental analysis is presented the data used comes from annual forecasts from HM Treasury budget reports against which it appears outcomes are rarely reported. These forecasts may in some periods (e.g. 2009) be unreliable as a result, but we consider them useful nonetheless in indicating the expectations of the Treasury, which is of significance to the current discussion.

Figure 1 shows raw data on the noted variables for the periods 2000–01 to 2014–15 (outcomes) and 2015–16 to 2020–21 (forecasts from the OBR report supporting the July 2015 'emergency' budget). The only adjustment has been to restate the data in constant 2014–15 prices using the GDP deflator for this purpose since this is macroeconomic data:

[7] David Cameron: "It is this Government who have cut the deficit we inherited by a quarter'; 'Claire Perry MP: "The deficit down by 25% since the election" (BBC Question Time, 25 October 2012). For discussion see: https://fullfact.org/factchecks/budget_deficit_public_sector_net_borrowing_current_quarter-28563

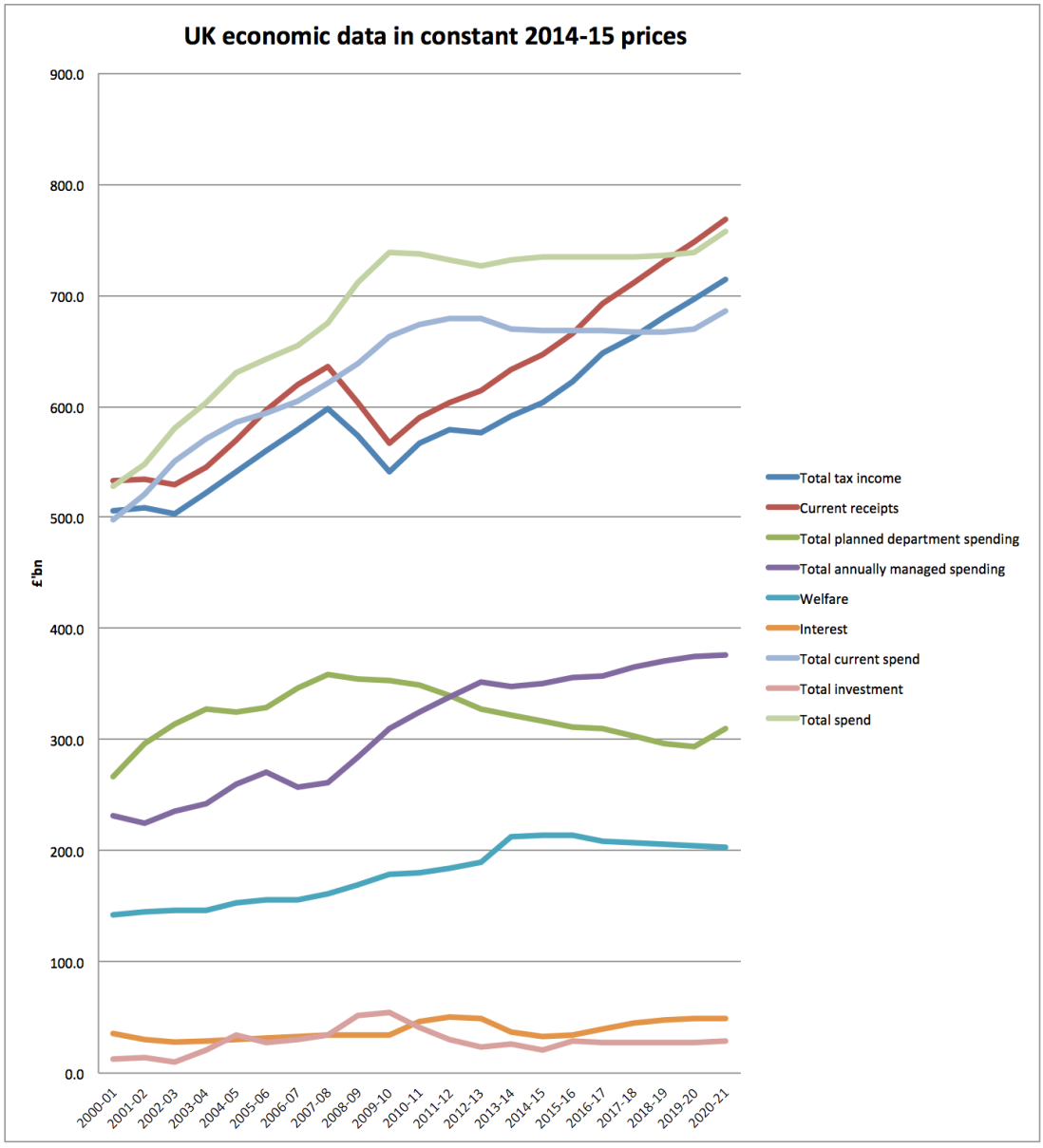

Figure 1. *Source: HM Treasury budget reports 2000–2015 and OBR forecasts, July 2015*

A number of points should be noted. First, this data clearly shows that there was a significant increase in government spending between 2000 and 2009. Such increases were matched by a similarly significant increase in government revenues. In fact, during this period revenues are closely correlated with the spending of the previous year. It appears therefore that increase in debt over this period was due to a time-lag effect. Deficit spending arose dramatically only from 2007–08 onwards (Figure 2). Hence, our first conclusion: *the politically motivated suggestion that the economy crashed in 2007–08 because of Labour's overspending is not supported by the data.* On the contrary, Figure 2 supports the impression of an economy managed in a fashion consistent with Gordon Brown's stated economic objectives before that date.[8]

This view is supported by a recently published IMF review of the British Economy. It is worth quoting the report at length not because we necessarily agree with the IMF's report or conclusions but, crucially, because the current government claims to adopt the IMF's methodology in its policy and forecasting. The IMF, it appears, does not seem to share the theory of the 'broken' British economy prior to the crisis:

> Business investment played an important role in boosting the UK's pre-crisis growth. In the decade leading to the global financial crisis, business investment grew 4 percent a year on average, with the capital-to-labor ratio rising faster than in many other economies. Alongside, capital productivity (measured as output divided by net capital stock) grew faster than in many other advanced economies, reaching the highest level just before the global financial crisis erupted.
>
> Supply-side growth accounting confirms that growth in the UK was broad-based in the pre-crisis years (1997–2007).
>
> Capital was the most important driver of overall growth. Moreover the large accumulation of capital in information and communication technology (ICT) boosted growth directly and indirectly (through its contribution to higher productivity growth).
>
> The UK's strong growth performance was also supported by an efficient allocation of resources
>
> But the crisis appears to have broken the UK's positive growth pattern.
> (IMF, 2015, pp. 20–21)

This last point is important: *the IMF is of the view that Labour's government stewardship of the economy prior to the crisis was good, but that the policy was broken by an exogenous shock: the financial crisis.* The terminology used by the IMF about a broken economy due to an exogenous shock was then mangled for political expediency to present an argument that 'Labour left behind a broken economy'.

To return to the data. As Figure 1 illustrates, once the drastic decline in income in 2008–09 and 2009–10 was over, the rate of growth in government income broadly matches pre-crisis trend in the UK economy. Austerity economics did not much touch revenue trends after the initial period of financial shock, but only spending. Here austerity appears to result in the forecasted flat line for total spending in current prices for a period of almost a decade, as shown by Figure 1.

This is not the only possible way, however, to interpret this data. If data is restated as a proportion of GDP (Figure 3), it is clear that spending did in fact peak in 2008-09 and has

[8]The diagnosis is shared by the IMF: 'Business investment played an important role in boosting the UK's pre-crisis growth. In the decade leading to the global financial crisis, business investment grew 4 percent a year on average, with the capital-to-labor ratio rising faster than in many other economies. Alongside, capital productivity (measured as output divided by net capital stock) grew faster than in many other advanced economies, reaching the highest level just before the global financial crisis erupted' (IMF, 2015, 21).

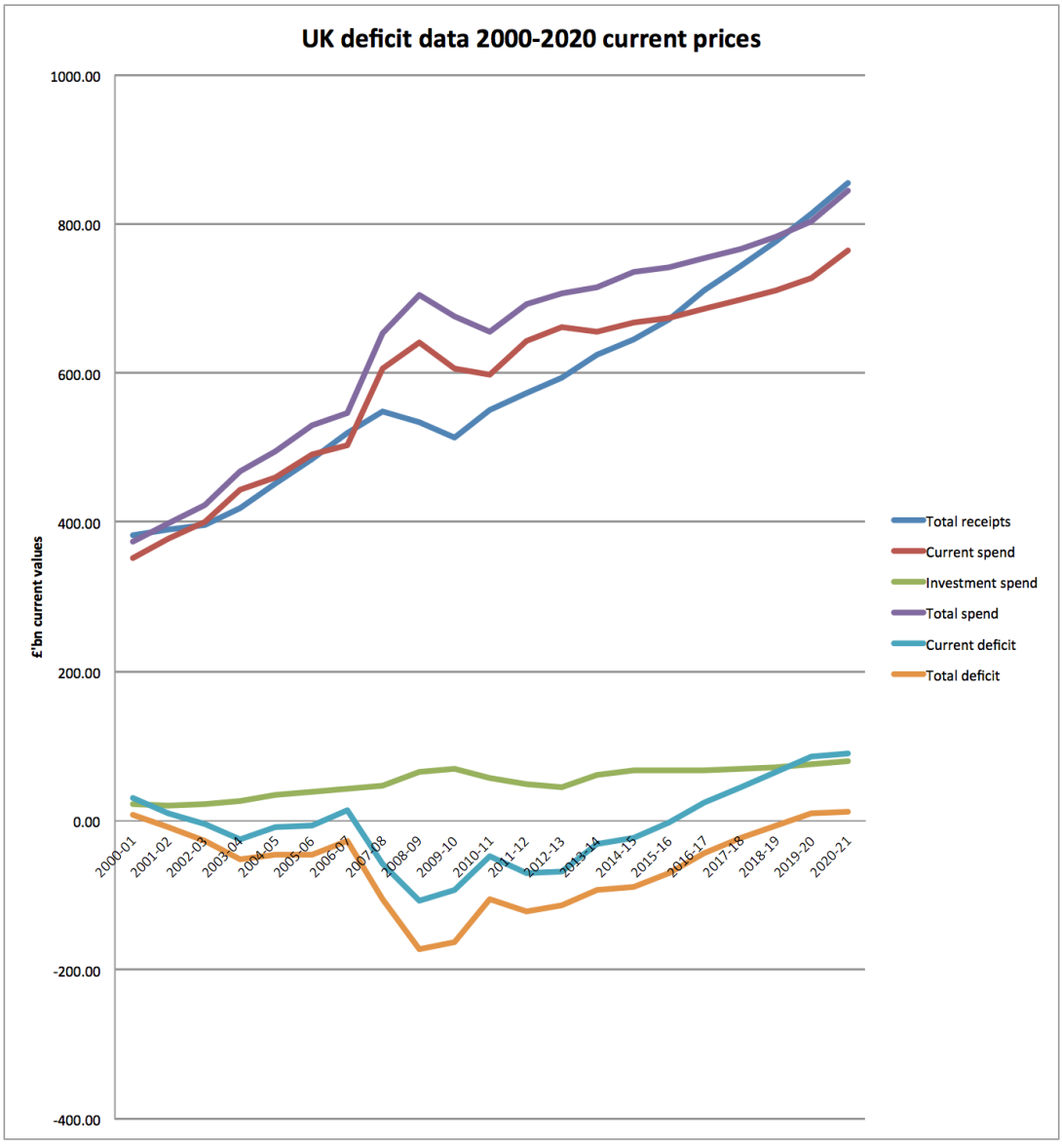

Figure 2. *Source: HM Treasury budget reports 2000–2015*

declined at a remarkably steady rate since then whereas income, stated on this basis, has been the factor to have flat-lined: the narrative inverts when viewed in this way. Figure 3 does confirm, therefore, that there is an argument that a steady austerity was in place from 2008–09.

This austerity was initially achieved by steadily reducing investment spending in the period from 2010 to 2013. Changes to spending patterns thereafter are complex. In particular, the decline in investment spending ended in 2013. This may have led some to conclude that austerity was relaxed in 2013 but this is not consistent with data on planned departmental and annually managed government spending, both of which continued to decline, steadily, as a proportion of GDP after 2013.

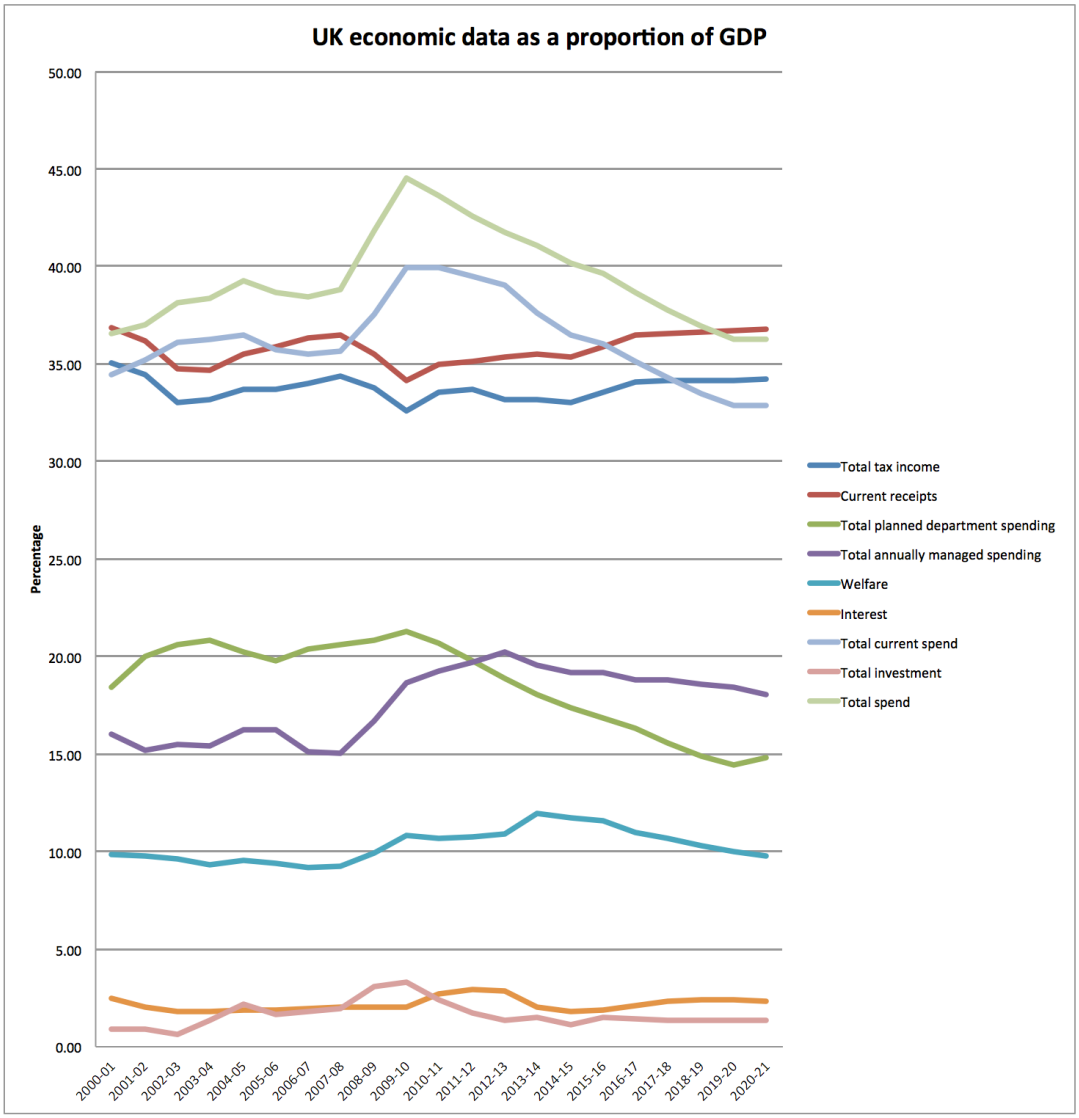

Figure 3. *Source: HM Treasury budget data 2000–2015 and HM Treasury Pocket Book data September 2015*

In fact this data does not support the view that austerity was relaxed: the ratio of spend to GDP did, of course, peak in 2008 because of the relative collapse in GDP growth in that year (in constant 2014–15 prices GDP fell in 2008-09 and 2009–10 by about £40 billion in each year). In that case the financial crisis of 2008-9 obviously distorts the impression given of additional spending in those years, but even with that being noted the rate of decline in total spend as a proportion of GDP has averaged 0.83 per cent per annum since 2010 and is broadly forecast to continue to do so. Figure 3 shows consistent decline in government spending since 2009 suggesting that the policy of austerity did not change in 2012, although its composition did. Just as investment spending recovered from the decline it suffered from 2010 to 2013 by entering into a period of relatively stable spending in constant prices current spending went into decline.

The same data is better understood if restated on the basis of spending per head in constant prices (Figure 4). When this is done further significant trends emerge, largely because population increased from 58.89 million in 2000 to 64.1 million in 2013–14 (after which date an increase at an equivalent annual rate is assumed) (See: www.ons.gov.uk/ons/.../uk-population-estimates-1851-2013.xls).

This data shows that current spending per head was largely maintained until 2012–13 despite the impression subsequently created that this was a period of more intense austerity: this impression of austerity was in fact only due to the significant decline in investment spending over the period from 2010–2013. Decline in current spending per head only really started in fact in 2013 on a per capita basis, a fact that informs our second conclusion: *in contrast to the generally perceived view, austerity only hit current spending per head from 2013 onwards.*

From that time a significant downward trend in current spending per head of population is noticeable although because of the increase in investment spending in 2013 it is clear there is an inflexion in the overall downward trend in total government spending per capita in that year that may have helped create the impression that austerity was, overall, relaxed. We, however, take the view that the change in composition in the overall spend in that year is critical from an analytical perspective because in our opinion the most critical variables in determining the perception most people will have of austerity are current overall, and (most especially) current planned government spending. This is particularly true because current planned spending, which has been and is planned to be in steady marked decline is on matters such as health, education, transport, the police and so on, which have high political significance attached to them and where perceptions of loss are significant, most especially amongst those with the greatest capacity to complain. Because the impact of overall current (as opposed to total) spending cuts per capita only really started in 2013 it is possible that during 2015 austerity might still have appeared to have had little impact on many people. The political understanding of this may suggest why a deliberate upturn in spend appears to be planned late in the current decade, possibly to coincide with the next general election. This confirms our third conclusion that a *political cycle appears to exist in this trend in current planned spending.*

The contrast in these two trends, where overall total and current period spending trends offer different perspectives on patterns of austerity is important in our opinion: as the public is likely to notice the impact of investment spending less than reduction in current spending, the austerity narrative has been sustainable in political rhetoric even though there was, at least on a per capita measure, a relaxation in austerity in total spending. To put it another way, the austerity narrative may have survived in popular perception despite the fact that the policy was temporarily relaxed from 2013 to 2015 on one item: spending on a per capita basis. This was politically acceptable to many people because current spending cuts only really began to be significant on the same per capita spending basis from 2013 onwards, which was too soon for the impact to have really been felt by the time of the 2015 general election.

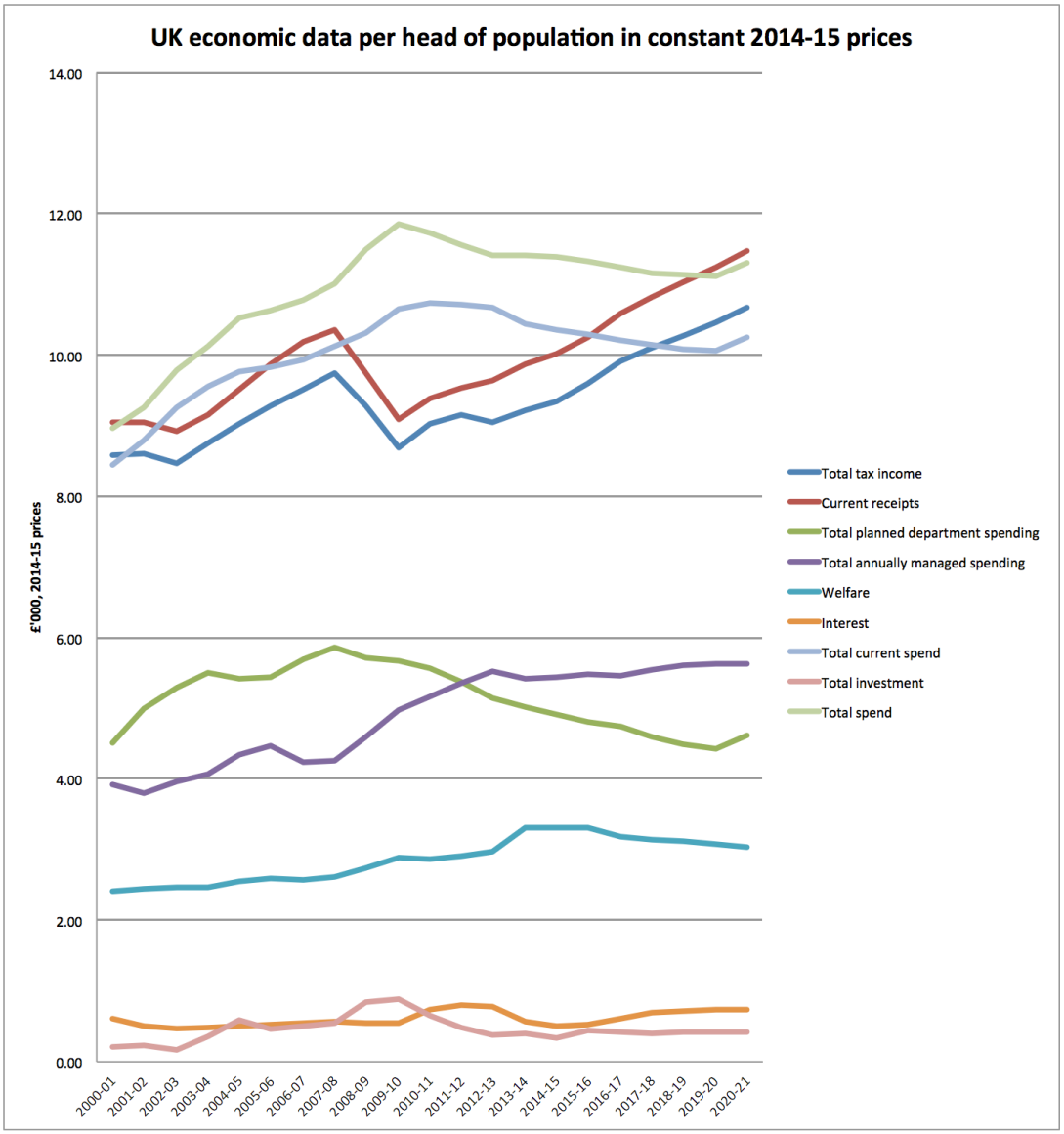

Figure 4. *Source: HM Treasury budget data 2000–2015 and ONS population data*

It is important to note at this point that all the suggestions made so far assume that the collapse in GDP after the 2007–08 financial crisis is an exogenous variable in this analysis. If, however, it is instead assumed that one of the goals of any government after the crisis should have been the restoration of the growth pattern seen prior to its onset then the scale of the challenge facing them is apparent from Figure 5. GDP is stated here in 2014–15 prices and has been projected from 2007-08 onwards at the average rate of growth prevailing from 2000-01 until 2007–08, i.e. 2.69% per annum. It is then apparent that there is a substantial element of missing GDP in the UK economy thereafter, worth £370 billion a year by 2020–21.

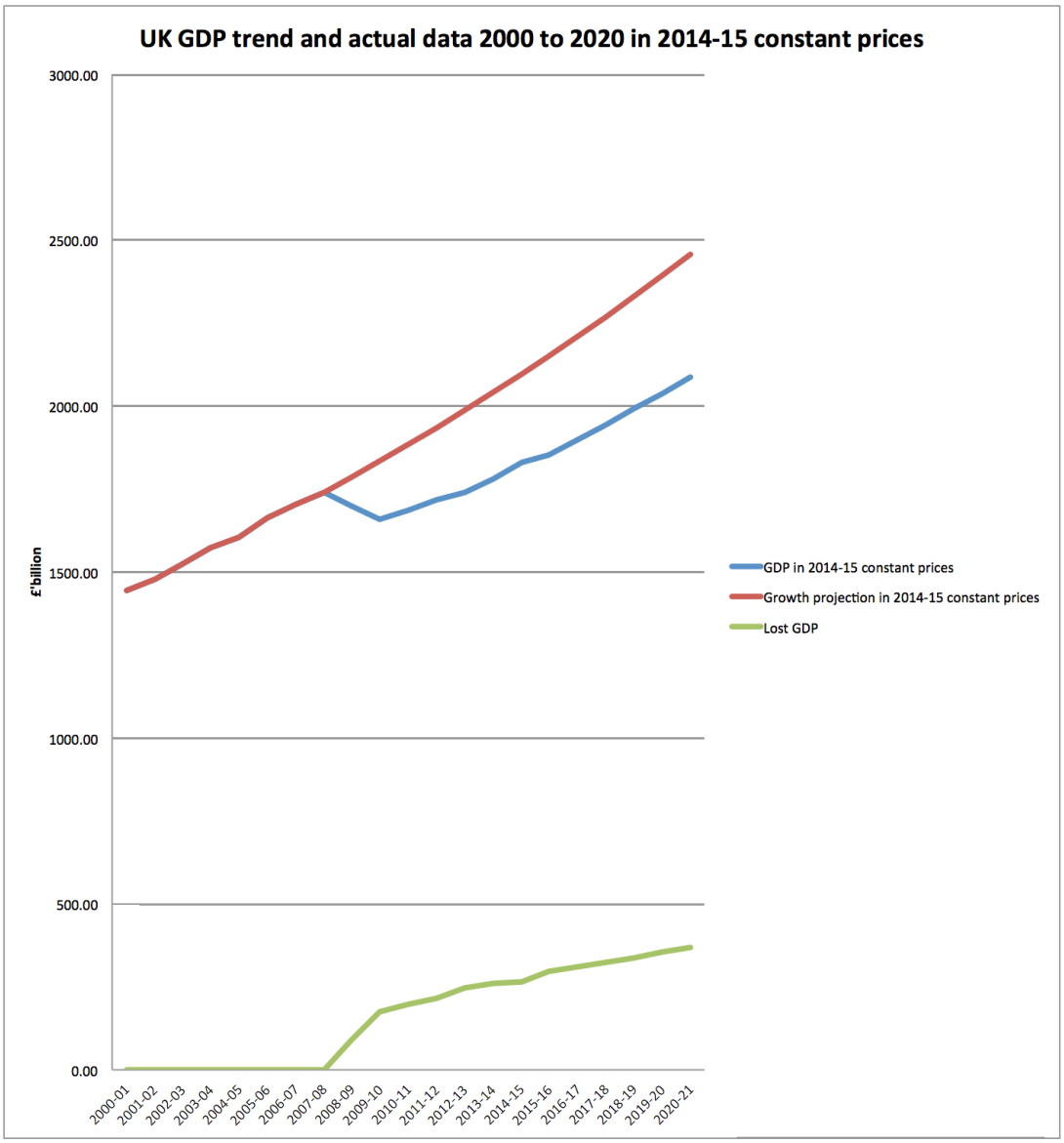

Figure 5. *Sources: As noted in text*

This has an impact on the perception of austerity, as figure 6 shows.

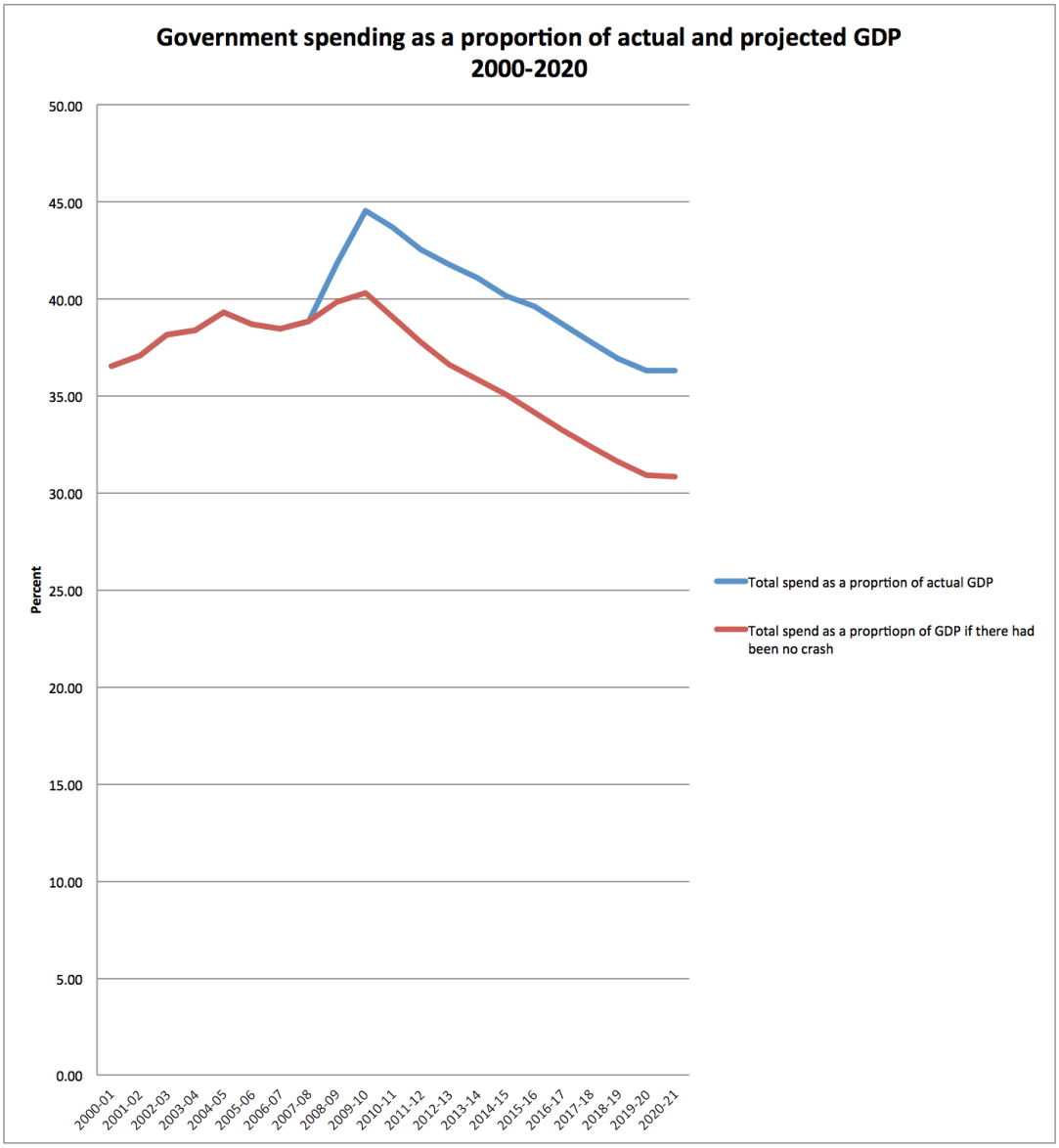

Figure 6. *Sources: As previously noted and authors' calculations as noted in text*

The collapse in GDP growth in 2007–08 and in the following years shown in Figure 5 results in the appearance shown in Figure 6 that actual spending as a proportion of GDP is generously high until 2015–16, only after which date it falls below the levels it might have reached in 2009–10 if GDP had not collapsed. That is because only in 2015–16 does the reported rate of government spending as a proportion of GDP begin to fall below levels planned by the Labour administration in office before 2007–08. However, that same austerity when compared to the rate of GDP that would have been enjoyed if GDP had continued to grow at pre-2008 levels is very marked indeed,

the proportion of government spending planned for 2020-21 being less than 31% of GDP on this bas**is.**

This is significant: government spending as a part of GDP grew from 2000 onwards as part of a deliberate plan. Government spending rose in order to meet perceived needs, and this spending does not appear to have hindered growth during that period, not least because tax revenues were growing as well. What that growth did then indicate was the ability of the UK economy to create increased economic capacity over this period, which we suggest is now significantly underutilized – possibly explaining the rise in employment without a corresponding rising in investment (IMF, 2015).

These facts may also exacerbate the perception of austerity. The demand for cuts to support the policy of austerity is taking place during a period when many are experiencing some or all of unemployment, under-employment, enforced self-employment in marginally profitable activities, insecure employment or low wages growth. Those in any of these situations are perfectly aware that their capacity is underutilized and for them austerity is likely to be hard to comprehend.

Part 3: Revenues, 2010–2015

Part 2 focused on government spending during the first Cameron government, in part 3 we shift our attention to the revenue side. There are two data sources on spending for the purposes of this review. One is budget data on actual performance, already used in Part 2 of this paper. The second is the annual forecast of departmental spending published in each budget since 2000. Some of these departmental spends are easily identifiable: health, education and defence spending categories obviously relate to departments of broadly similar name. Some of the available data is consolidated in government publications. For example, housing, agriculture and employment spending are combined although they spread across a number of departments. As a result, it is only possible to approximate from these forecast departmental spending the split between annually managed spending (welfare, interest, and some aspects of investment, for example) and departmental planned spending, which is the split used in Figures 1, 3 and 4. The Office for Budget Responsibility has advised the authors that time series data on department spending is difficult to obtain not least because of significant shifts in categorisation over time. It is important to note this when considering the data that follows. These issues being noted, the annual forecasts of spending when split to approximate between major items (with health and debt, because of their significance, being shown separately), when restated in constant 2014–15 prices and stated as spending per head are as shown in Figure 7.

The reduction in 'other spending' from 2012–13 onwards is notable. We suspect that the decline in this category at the very end of the period is due in part to reclassification of some items to specific departments. We note a marked rise in those department's spending as if to compensate. It is otherwise hard to explain the apparent significant increases in defence, transport, industry, housing and public order spending forecasts in 2015–16 as these do not appear to match any obvious policy announcements.

In contrast, debt spending forecasts fell in 2015–16 because almost £12 billion of profit on the Bank of England Asset Purchase Facility (its quantitative easing programme) was being recognised for these purposes for the first time. The result supports our fourth conclusion, namely, *despite the rhetoric of increasing and intolerable debt interest burden,*[9] *the actual cost per head in 2015–16 is unlikely to be greater than pre-crisis levels on a per capita basis.* Substantially lower interest rates do, of course, help explain this as well.

[9]See, for example, https://www.gov.uk/government/speeches/george-osborne-sets-out-his-priorities-for-the-spending-review

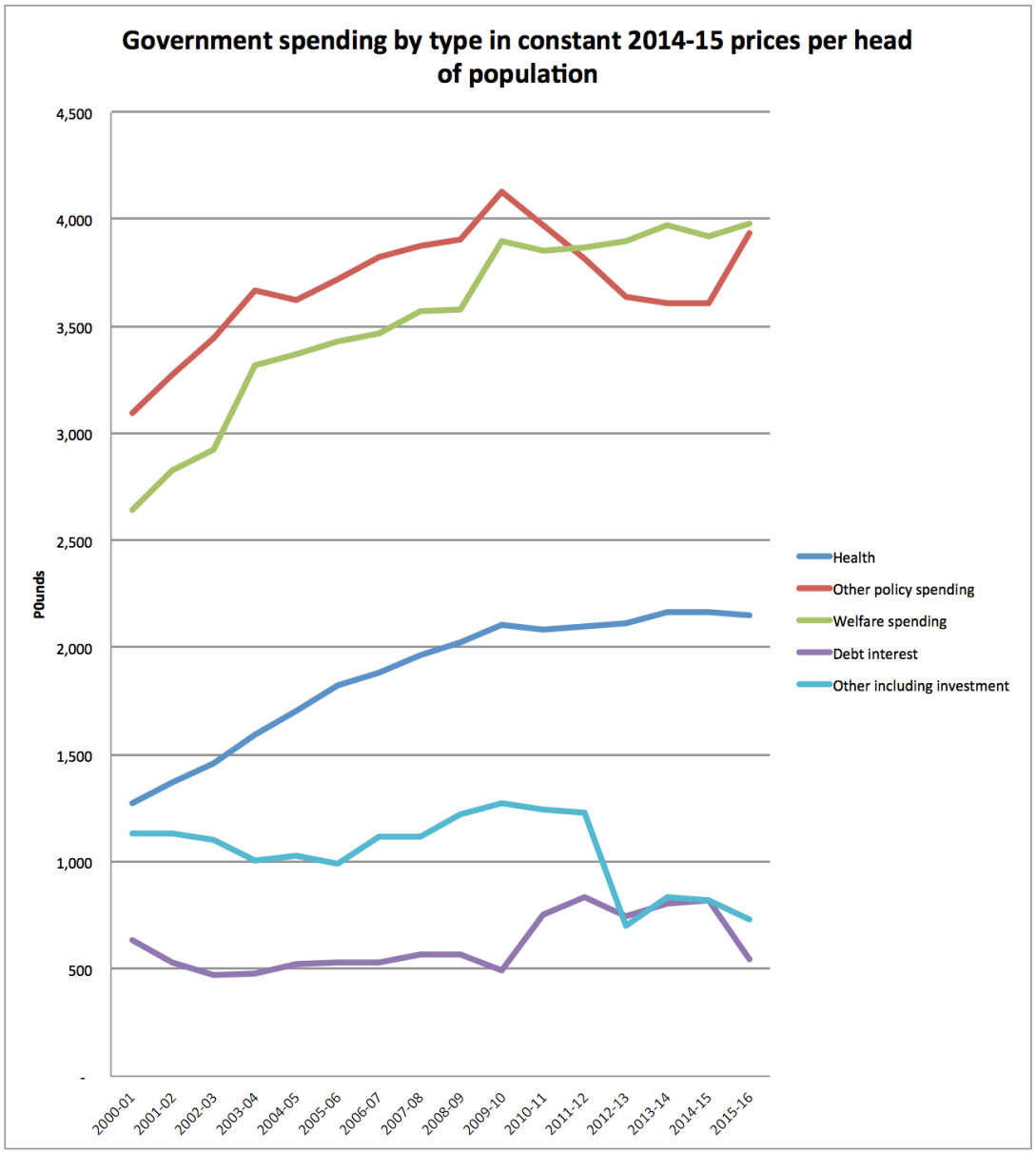

Figure 7. *Sources: As noted in text*

Three issues stand out for consideration: First, there has been a fundamental shift in the way that government spending benefits people in the UK. From 2000 until about 2007–08 there was a steady planned increase in 'feel-good factor' items represented by planned departmental spending. These include, for example, health, education and transport, all of which have a tangible impact on the quality of people's lives. After 2008, there was marked decline in these type of spending. From a peak of spend per head (expressed in constant 2014–15 prices) of 5,860 in 2007–08 to £4,430 in 2019–2020, a reduction in real term exceeding 24%. This data is reflected in Figure 8.

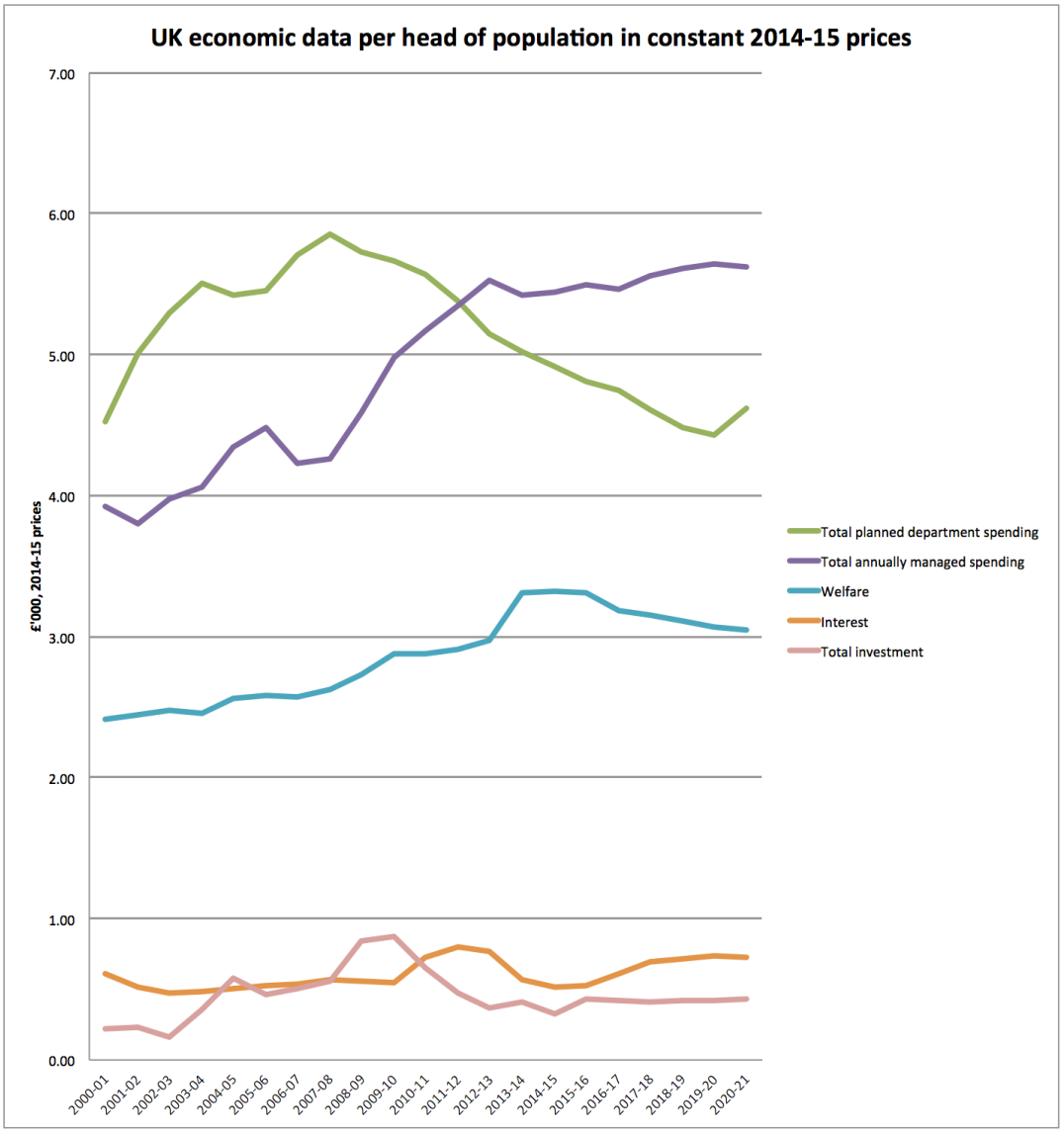

Figure 8. *Sources: Budget data 2000 to 2015 and OBR forecasts July 2015 and as noted in text*

As indication of the items covered by this decline these are the categories of spending covered by planned spending in 2015–16:

	£ billion Plans 2015-16
Departmental Programme and Administration Budgets (Resource DEL excluding depreciation[1])	
Education	53.5
NHS (Health)[2]	111.9
Transport	2.3
CLG Communities	2.5
CLG Local Government	10.6
Business, Innovation and Skills	13.1
Home Office	10.2
Justice	6.3
Law Officers' Departments	0.5
Defence[3]	28.1
Foreign and Commonwealth Office	1.8
International Development	7.4
Energy and Climate Change	1.4
Environment, Food and Rural Affairs	1.6
Culture, Media and Sport	1.1
Work and Pensions	6.3
Scotland[4]	25.5
Wales[5]	12.9
Northern Ireland	9.6
Chancellor's Departments	3.5
Cabinet Office	2.5
Small and Independent Bodies	1.6
Reserve	2.0
Special Reserve	0.2
Adjustment for Budget Exchange[6]	-0.5
Total Resource DEL excluding depreciation plans	**316.1**
OBR allowance for shortfall	*-1.0*
OBR Resource DEL excluding depreciation forecast	***315.1***

Table 1. *Source: HM Treasury Budget July 2015 page 77*

Second, in contrast to those 'feel good items', annually managed spending (mainly welfare and debt interest) increased from £4,270 per head to £5,640 per head in constant prices from 2007–08 to 2019–20. Or an increase of 32.2%. These diverging trends clearly have differential effects on groups in society. Some very vocal groups in society may well perceive (correctly, as the figures show) that they have lost out as a result of a shift in spending patterns. That might in itself be of little consequence but for changes that have taken place, or are planned to take place, in taxation. Figure 9 (with this data in aggregate representing total taxation in all years covered) shows the overall change in payments of taxes by type in constant 2014–15 prices per head of population.

Income tax receipts fell most heavily after 2008, followed by national insurance contributions, whereas the changes in VAT (especially the sharp decline in 2009–10) reflect the deliberate rate cuts introduced at that time to counter the immediate impact of recessionary tendencies within the economy. VAT receipts, however, are not forecast to increase as rapidly as income tax, national insurance and other taxes, including council taxes. *This is in stark contrast with corporation tax*, which has become the most public indicator of the tax contribution made by business. The contribution from this tax is steadily declining as tax rates have been cut from 28% at the start of the period under review to 18% at the end with the tax base also being reduced in the meantime, most especially after 2010.

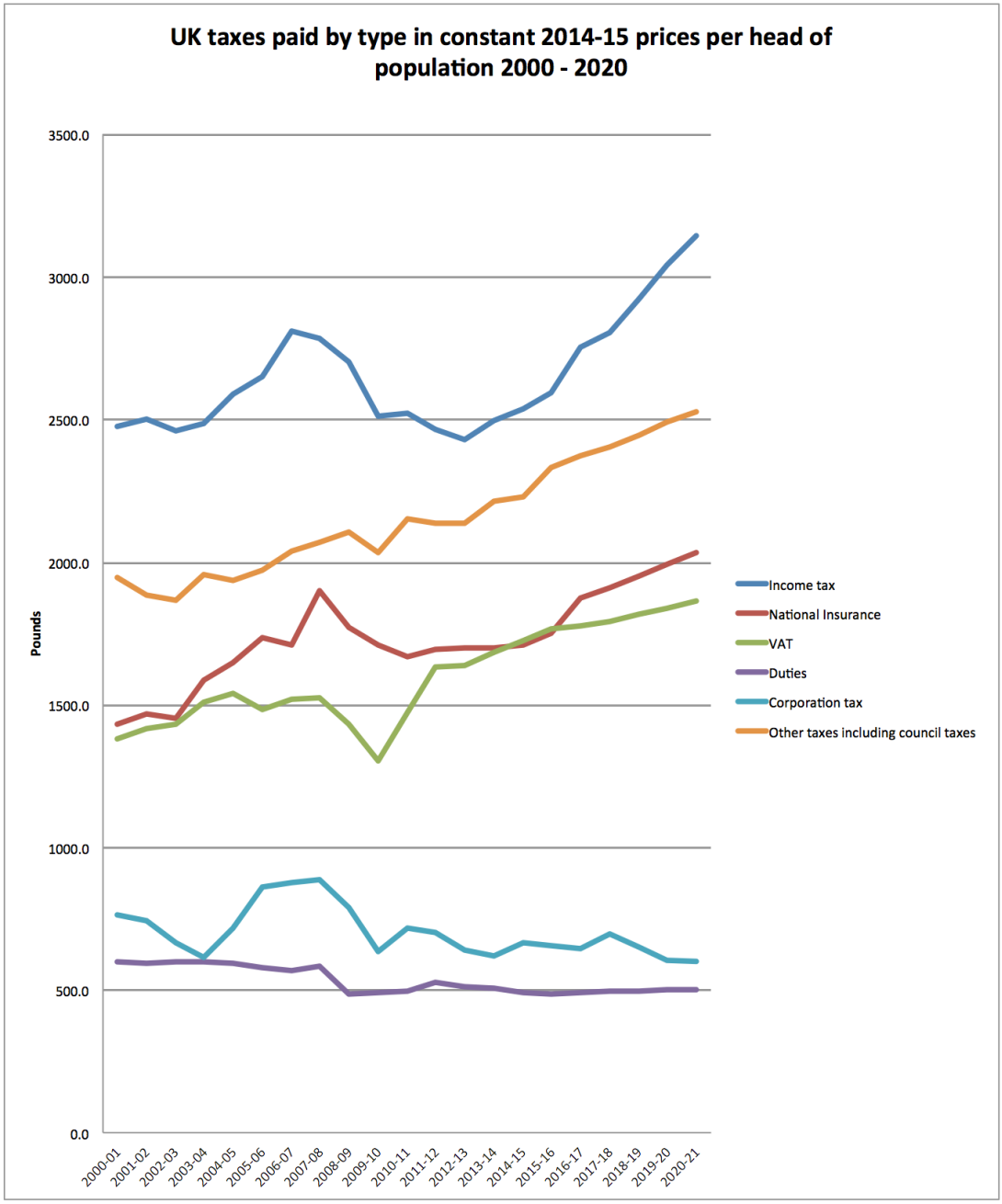

Figure 9. *Sources: UK HM Treasury Budgets 2000–2015 and July 2015 OBR projections and as noted in text*

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Income tax (gross of tax credits)[1]	163.7	170.2	184.8	192.6	205.8	219.9	234.6
National insurance contributions	110.3	114.8	125.8	131.2	137.4	144.2	151.6
Value added tax	111.3	115.9	119.2	123.1	127.9	132.9	139.2
Corporation tax[2]	42.9	43.1	43.4	47.7	45.9	43.7	44.8
Petroleum revenue tax	0.1	0.0	-0.1	0.1	0.0	0.2	0.1
Fuel duties	27.2	27.1	27.3	27.8	28.3	28.8	29.4
Business rates	27.3	28.0	29.0	29.4	30.6	31.7	32.9
Council tax	27.9	28.4	29.0	29.7	30.4	31.2	32.1
VAT refunds	13.7	13.6	13.8	13.7	13.6	13.8	14.7
Capital gains tax	5.6	6.4	7.4	8.3	9.1	10.0	10.8
Inheritance tax	3.8	4.2	4.6	4.8	4.9	5.2	5.7
Stamp duty land tax[3]	10.9	11.5	12.6	13.9	15.7	17.3	18.9
Total of the above taxes	544.7	563.2	596.8	622.3	649.6	678.9	714.8
Other taxes	58.9	65.7	68.4	71.2	74.8	78.4	81.5
National Accounts taxes	603.6	628.9	665.2	693.5	724.4	757.3	796.3
Increase in nominal GDP %		3.5	4	4.3	4.3	4.4	4.8
So, expected tax revenues on basis of nominal growth in GDP:							
Income tax (gross of tax credits)[1]	163.7	169.4	176.2	183.8	191.7	200.1	209.7
National insurance contributions	110.3	114.2	118.7	123.8	129.2	134.8	141.3
Value added tax	111.3	115.2	119.8	125.0	130.3	136.1	142.6
Corporation tax[2]	42.9	44.4	46.2	48.2	50.2	52.4	55.0
Petroleum revenue tax	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Fuel duties	27.2	28.2	29.3	30.5	31.9	33.3	34.8
Business rates	27.3	28.3	29.4	30.6	32.0	33.4	35.0
Council tax	27.9	28.9	30.0	31.3	32.7	34.1	35.7
VAT refunds	13.7	14.2	14.7	15.4	16.0	16.7	17.6
Capital gains tax	5.6	5.8	6.0	6.3	6.6	6.8	7.2
Inheritance tax	3.8	3.9	4.1	4.3	4.4	4.6	4.9
Stamp duty land tax[3]	10.9	11.3	11.7	12.2	12.8	13.3	14.0
Total of the above taxes	544.7	563.8	586.3	611.5	637.8	665.9	697.8
Other taxes	58.9	61.0	63.4	66.1	69.0	72.0	75.5
National Accounts taxes	603.6	624.7	649.7	677.7	706.8	737.9	773.3
And the difference is:							
							Total
Income tax (gross of tax credits)[1]	0.0	0.8	8.6	8.8	14.1	19.8	24.9	76.9
National insurance contributions	0.0	0.6	7.1	7.4	8.2	9.4	10.3	43.0
Value added tax	0.0	0.7	-0.6	-1.9	-2.4	-3.2	-3.4	-10.7
Corporation tax[2]	0.0	-1.3	-2.8	-0.5	-4.3	-8.7	-10.2	-27.8
Petroleum revenue tax	0.0	-0.1	-0.2	-0.0	-0.1	0.1	-0.0	-0.4
Fuel duties	0.0	-1.1	-2.0	-2.7	-3.6	-4.5	-5.4	-19.2
Business rates	0.0	-0.3	-0.4	-1.2	-1.4	-1.7	-2.1	-7.0
Council tax	0.0	-0.5	-1.0	-1.6	-2.3	-2.9	-3.6	-12.0
VAT refunds	0.0	-0.6	-0.9	-1.7	-2.4	-2.9	-2.9	-11.4
Capital gains tax	0.0	0.6	1.4	2.0	2.5	3.2	3.6	13.3
Inheritance tax	0.0	0.3	0.5	0.5	0.5	0.6	0.8	3.1
Stamp duty land tax[3]	0.0	0.2	0.9	1.7	2.9	4.0	4.9	14.6
Total of the above taxes	0.0	-0.6	10.5	10.8	11.8	13.0	17.0	62.4
Other taxes	0.0	4.7	5.0	5.1	5.8	6.4	6.0	33.1
National Accounts taxes	0.0	4.2	15.5	15.8	17.6	19.4	23.0	95.5

Table 2. *Source: Office for Budget Responsibility forecasts July 2015 table 4.5 and author calculations as noted*

The table above has been extracted from the OBR forecasts for tax revenue published in July 2015. Tax revenues for 2014–15 onwards shown in the first part of the table have been restated in the second part on the assumption that they will grow in line with GDP projections. The resulting expected revenues have then been compared with OBR forecasts for taxes to be collected and the differences are then identified in the second and third parts of the table respectively.

Those differences show that *government policy aims to increase the income tax and national insurance as proportion of overall revenue in the next five years whilst reducing corporation taxes significantly.* VAT is broadly neutral. Property taxes, such as council taxes, appear to make an unexpectedly high contribution to make. The implications of these forecasts are that increase in income and national insurance tax between 2015 until 2020 will be matched by decrease in benefits from the discretionary spending of government, or those activities from which they are most likely to perceive an increase in well-being. In other words, austerity during the second Cameron government will be experienced as higher taxes and lower net benefits from the state, and all as a consequence of the policy of seeking a balanced budget.

Whether or not such policy is politically sustainable over time is to be seen. The desire to balance the budget against this background of likely perceived personal cost as a consequence of what the government is seeking to do is, however, providing explanation for the risk the government is taking on welfare spending. Because pressure on planned spending has already reached a point where resistance to further cuts is likely, not least from those working in the public services as has been seen with strike action by lawyers working in the court system[10], these cuts are going to be hard to deliver. As shown in Figure 8, there is then no option left to a Chancellor determined to equate income and spending but to cut welfare spending, whatever the consequence for inequality and outright hardship.

Part 4: Retrospective Analysis of OBR's Forecasts, 2010–2015

Since 2010, the Office for Budget Responsibility has had the task of auditing HM Treasury's budget forecasts. It is interesting to see how a selection of those forecasts have turned out (Figure 10). The 2008 budget forecast in Figure 10 was one of the grossest economic mis-statements of all time. In fairness, the Labour government of the time had been a deliverer of what seems, in retrospect, to have been consistent economic performance, as indicated by Figures 1, 3 and 4.

The real interest in the data lies with various projections made from 2009 onwards. For clarity only some of these can be shown. Perhaps most surprisingly, Labour forecasts in 2009 and 2010 were too pessimistic in their early expectations, but by the end of the projection periods were acceptably close to outturns. In contrast the June 2010 forecast from the then new Coalition government was substantially too optimistic as to outcome and even the limited part of the 2012 Pre-Budget Report forecast shown (chosen because it was, in effect, a mid-term report by the Coalition government) contained major forecasting errors.

This paper does not seek to analyse in great detail why these differences arose, but it is important to note that the optimistic rhetoric of austerity delivered by governments since 2010 has not matched results whereas *by the time it left office the Labour government had adopted a more realistic basis for economic forecasting.*

One economic explanation for the divergence in forecasting success may have been provided unwittingly by the OBR. The July 2015 Office for Budget Responsibility report makes reference to the multipliers used for the purposes of the projections that the Treasury have used and the OBR have endorsed:

[10] http://www.independent.co.uk/news/uk/home-news/lawyers-strike-over-legal-aid-cuts-boosted-by-the-backing-of-major-firms-10349009.html

> In June 2010, the interim OBR estimated the impact that the additional fiscal tightening announced in the Coalition's first Budget would have on growth through the use of 'fiscal multipliers'. These implied that a discretionary tightening of 1 per cent of GDP would, in the first instance, reduce output by 1 per cent in the case of investment cuts; 0.6 per cent in the case of cuts to day to day public services and welfare spending; 0.35 for VAT increases; and 0.3 per cent for income tax and NICs increases.
>
> In this forecast, we have applied the same real multipliers that the interim OBR used in the June 2010 forecast.
> (Office for Budget Responsibility, 2015, 39)

It is only fair to note that some taper effects of the application of these multipliers was changed between 2010 and 2015 but, in the opinion of the authors of this paper, this is unlikely to have had material impact on the forecasts made. The multipliers adopted by the OBR produced forecasts where in most cases, excepting investment, the impact on growth of £1 of government spending was somewhat less than the pound expended. The Office for Budget Responsibility does, of course, write this in the negative context of cuts, but this does not change the inference. So, it was assumed that for every £1 of cuts the impact on GDP would be much less than the value of the cut itself, excepting investment, where a cut would reduce GDP by £1 for every £1 of reduction.

This view, which has been consistently held throughout this period, contrast sharply with two alternative opinions. The first is from the International Monetary Fund's World Economic Outlook Report in 2012, which states that:

> If the multipliers underlying the growth forecasts were about 0.5, as this informal evidence suggests, our results indicate that multipliers have actually been in the 0.9 to 1.7 range since the Great Recession. This finding is consistent with research suggesting that in today's environment of substantial economic slack, monetary policy constrained by the zero lower bound, and synchronized fiscal adjustment across numerous economies, multipliers may be well above 1.
> (IMF, 2012, 43)

In other words, for every £1 of cuts the impact may well have been a loss to GDP of more than £1, and could have been as high as £1.70. With average tax recovery of around 40% of GDP in the UK this meant that for every £1 of cuts up to 68p of tax might have been lost in revenue terms whilst overall people would feel worse off than the cuts themselves might imply: in effect, the cuts were cutting capacity as Figure 5 implied with a real perceived cost resulting as a consequence.

This opinion has been reinforced in 2015 by ratings agency Standards & Poor's. In a report published in January 2015, they argued with regard to the UK economy that[11]:

> We estimate that an increase in public spending in one year of 1% of GDP (coordinated across the EU) would result in a multiplier effect for the U.K. of 2.5 over three years. This is a higher effect compared with the boost to spending in the U.K. alone, which we estimated at 1.9. The main reason is the additional boost to U.K. GDP due to increased demand from its European trade partners. We also project that such investment would add more than 300,000 jobs in the same year as the increase occurred.
> (Standard and Poor, 2015)

[11] http://media.mhfi.com/documents/20150211-sprs-infrastructure.pdf

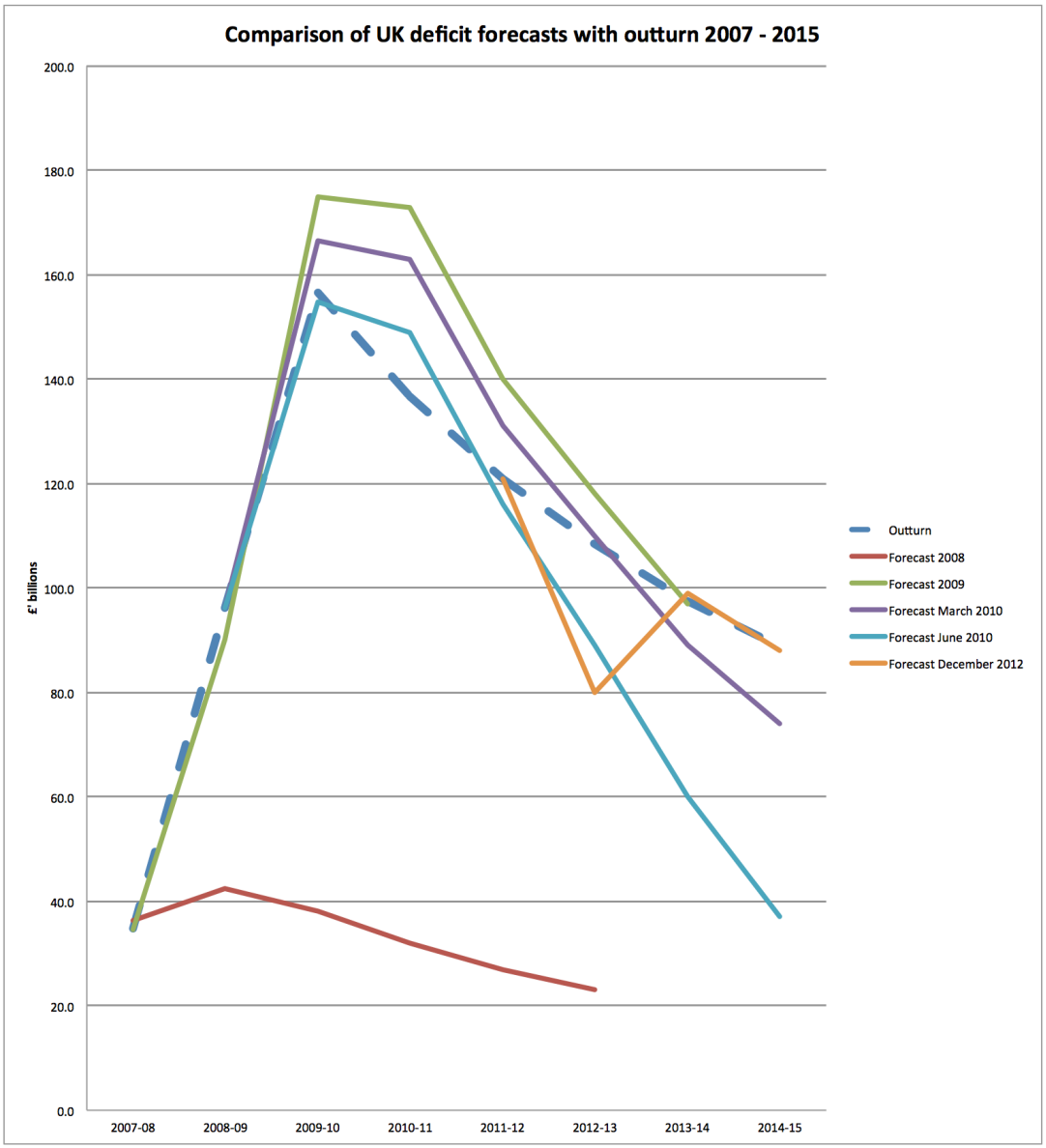

Figure 10. *Source: HM Treasury Budgets and Pre-Budget Reports as noted*

It should be noted that this multiplier relates only to investment spending. The similarity with the IMF estimate should be noted.

If the IMF or Standard & Poor's multipliers were to be used, then the OBR would have reached a far more pessimistic (but nonetheless, more accurate) estimate of the effects of austerity on the UK economy. Labour assumed a much lower rate of cuts than the Coalition (even if, as is likely, they used the same broad multiplier rates – budget reports for their period in office do not make this point clear) but as a result produced less distortive forecasts that, curiously, seemed to predict the Coalition government's actual achievements better than that government's own forecasts did.

The same error in estimating multipliers might also explain why David Blanchflower, who served on the Bank of England Monetary Policy Committee from 2006 to 2009, has suggested that the UK recovery from the 2008 financial crisis has been the worst of any recovery since the 1720 South Sea Bubble:

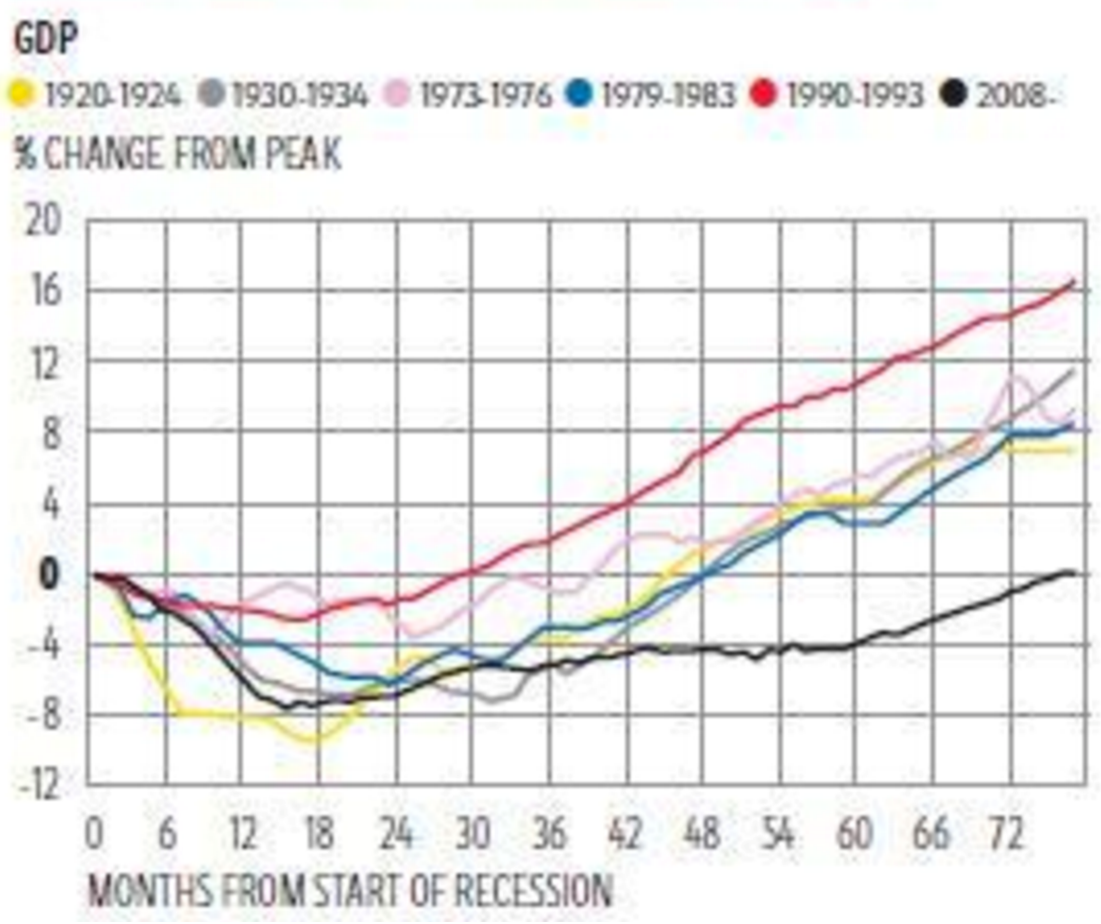

Figure 11. *Source: http://www.independent.co.uk/voices/comment/britain-has-taken-longer-to-recover-from-recession-than-at-any-time-since-the-south-sea-bubble-9645218.html*

Part 5: The Feasibility of the Fiscal Charter

In light of the above we now turn to the question of whether 'balancing the books' by 2020 – the self-imposed criterion for the success of George Osborne's austerity programme as enshrined in the UK Fiscal Charter adopted in October 2015,[12] is possible or even desirable. This question does demand consideration of whether the Office for Budget Responsibility forecasts for the UK's sectoral balances until 2020 are plausible, or not.

The concept of sectoral balancing employs double entry accounting rationale.[13] This approach assumes that 'sectoral accounts data constitute[s] a closed system in the sense that every asset item in one sector's balance sheet must have a counterparty liability item in another sector's balance sheet' (Antoun de Almeida, 2015, 16). At core the idea is very simple: for every borrower in a currency (in the UK's case, sterling) there must be a lender. It follows that lending between sectors must always balance. We stress that this is an accounting concept and not an economic concept. And from an accounting perspective it is a simple matter of fact that must be true.

The sectors usually considered for this purpose are the government, private consumers, private sector (usually considered to be business) investment, and the overseas sector. Figure 12 represents the OBR sectoral balances history and forecast in July 2015:

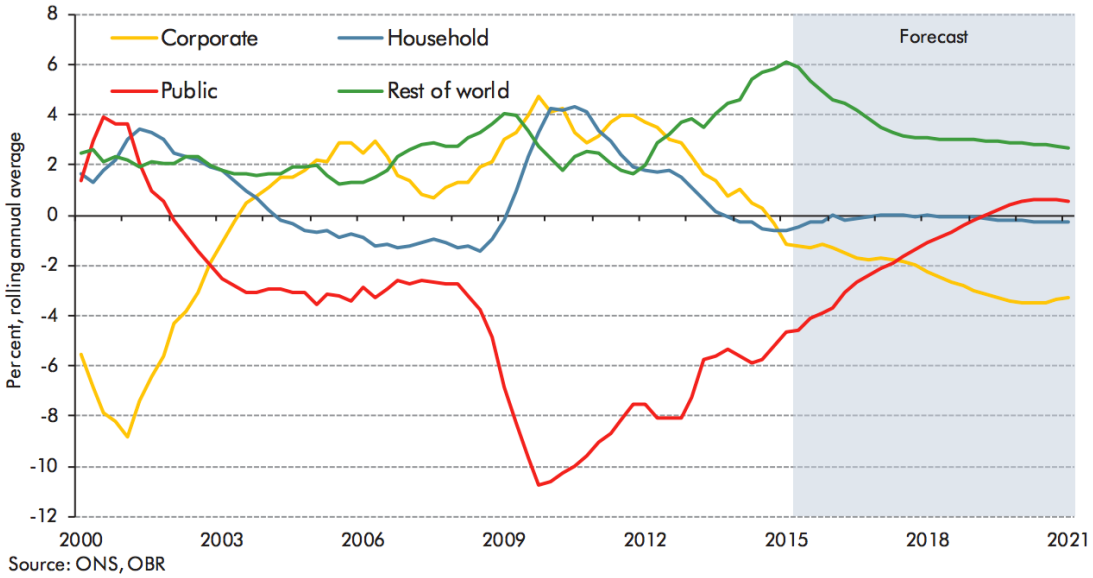

Figure 12. *Source: Office for Budget Responsibility, July 2015 Table 3.33*

[12] http://www.parliament.uk/business/news/2015/october/charter-for-budget-responsibility-autum-2015-update/

[13] More formally, the two key accounting identities from which the concept of sectoral balancing is derived are:

$$GDP = C + S + T \text{ (uses)}$$

$$GDP = C + I + G + (X - M) \text{ (sources)}$$

Where C is total consumption, S is Savings, T is Taxation, I is Investment, G is Government Spending, X is Exports and M is imports.

From which we can easily get:

$$(I - S) + (G - T) + (X - M) = 0$$

This identity makes clear that the transactions between the sectors must always balance. The issue is explained in greater depth by, for example, Prof Malcolm Sawyer (http://www.feps-europe.eu/assets/b836e12f-8e4d-4d22-9310-a0a28a41860d/the-impossibility-of-balanced-structural-government-budgets.pdf)

What this figure indicates is that *the Office for Budget Responsibility forecasts for balancing the books is premised on very significant changes in patterns of behaviour within the UK economy over the next few years*. These are changes that we believe are unlikely to take place.

Anticipated changes in the sectoral balance are as follows: First, as Figure 12 shows, households are expected to abandon their cautious approach to saving that they have adopted since 2009. The OBR forecasts works on the assumption that from 2015 onward, the household sector as a whole will neither save nor borrow for the foreseeable future.

Second, the OBR assumes that the business will abandon its policy of hoarding cash and begin to invest heavily from 2015, using borrowed funds to do so.

Third, and most remarkably, it is assumed that the UK's overall balance of trade and financial flows with overseas will change radically, requiring far fewer inflows into the UK economy which are the current net consequence of the UK's significant trade deficits.

Fourth, Figure 12 shows gradual decrease in state borrowing to the point, sometimes in 2019, when the government will achieve its Fiscal Charter goal.

It is important to stress, however, that this fourth point is obtainable only if all three other sectors perform as anticipated in the forecast. Unless they do so, as a matter of fact, George Osborne will not clear the UK government's deficit.

The challenges that these forecasts imply for the household, private and rest of the world may appear innocuous, but they are not. Take, for example, the need for the household sector to net stay in the position of being broadly neutral with regard to saving and dis-saving. Since the sector as a whole is not, of course, homogenous, some will need to borrow for others to save, as has been the marked tendency over the past few years. As a result the OBR themselves forecast that for the net trend to be neutral the borrowing of those who do take credit will have to grow substantially:

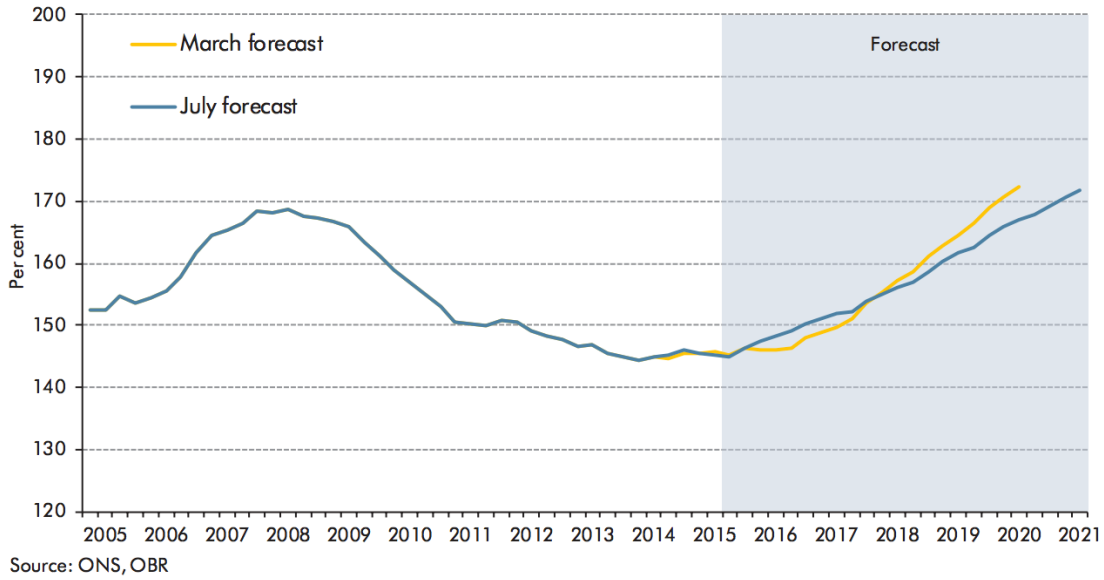

Figure 13. *Source: Office for Budget Responsibility, July 2015 Table 3.25*

Borrowing will have to reach and then exceed 2008 levels. This may be possible, according to the OBR's own forecast, if there is steady house price inflation over the coming five years,

increasing to a rate of almost six per cent per annum. Without that increase in prices there will be insufficient increase in mortgage lending to achieve this growth in borrowing However, not only is this a rather optimistic forecast, it also runs counter to another one of the government's cherished claims: making housing affordable. In effect, the Fiscal Charter is predicated on an ongoing housing bubble. It is not obvious to the authors of this paper why such a policy of encouraging a housing bubble is considered to be good economic policy. Indeed, a recent IMF report emphasises the unique position of the housing market in the UK, and the great volatility it imparts to the economy. The report notes:

> Although mortgage credit as a share of GDP has been declining in the current housing recovery, there are signs that there is a buildup of financial risks: loan-to-income ratios are increasing in London and among first time buyers [...]
>
> Given the uncertainty of the transmission of mechanism of macroprudential policies, there are merits in adopting macroprudential policy measures early and gradually.
> (IMF, 2015, 17)

In other words, the IMF strongly advises the UK against house prices inflation. In any event, we doubt that the OBR forecast is credible. In October 2015 a national estate agent forecast average house price inflation for the period of less than 3 per cent,[14] whilst the Bank of England has also made it clear that it will heavily monitor mortgage lending and even lending in general[15] – a move intended to restrict growth in borrowing. Neither suggestion supports the OBR view that personal or mortgage borrowing can increase as they forecast.

With regard to business, the condition for the forecast borrowing being met is that investment reaches levels not seen since before 1980. A recent IMF report believes that the current pick-up in business investment in the UK is likely to be sustained (IMF, 2015, 28) but warns:

> A challenge is to formulate appropriate policy prescription [...] First, efforts should continue to improve financial intermediation, especially aimed at ensuring adequate access to finance for business innovation and restructuring. Second, infrastructure should continue to be improved, especially in the areas of transport, energy, and housing. Third, as recommended by LSE Growth Commission (2013), corporate governance structure could be reviewed to address "short-termism" and encourage firms to invest more. Finally, policies should continue to support human capital development, including through enhancing vocational training and apprenticeship programs to help bolster productivity. In this regard, the UK should not halt efforts to attract foreign talents.
> (IMF, 2015, 28)

Needless to say, these policy efforts would require considerable additional investment and borroowing by the UK government, all of which appear to be a pre-condition of business sustaining its contribution to investment. The problem is that the Fiscal Charter policy is likely to prevent that necessary government investment. What is more, we believe that the IMF report is couched in polite political language: it presents a description of where the UK could be if, and only if, the UK would abandon its commitments to the Fiscal Charter. Like most commentators we believe the Fiscal Charter is no more than a political 'stunt', but there is enough political capital invested in the idea of austerity to ensure that none of the above wish-list will be pursued with any vigour. As such, the hoped-for levels of business investment forecast by the OBR, and shown in Figure 14, are very unlikely to happen.

[14] http://www.theguardian.com/money/2015/nov/05/uk-house-prices-forecast-savills

[15] https://next.ft.com/content/3ce277ac-83d9-11e5-8e80-1574112844fd?ftcamp=crm/email/2015115/nbe/InTodaysFT/product

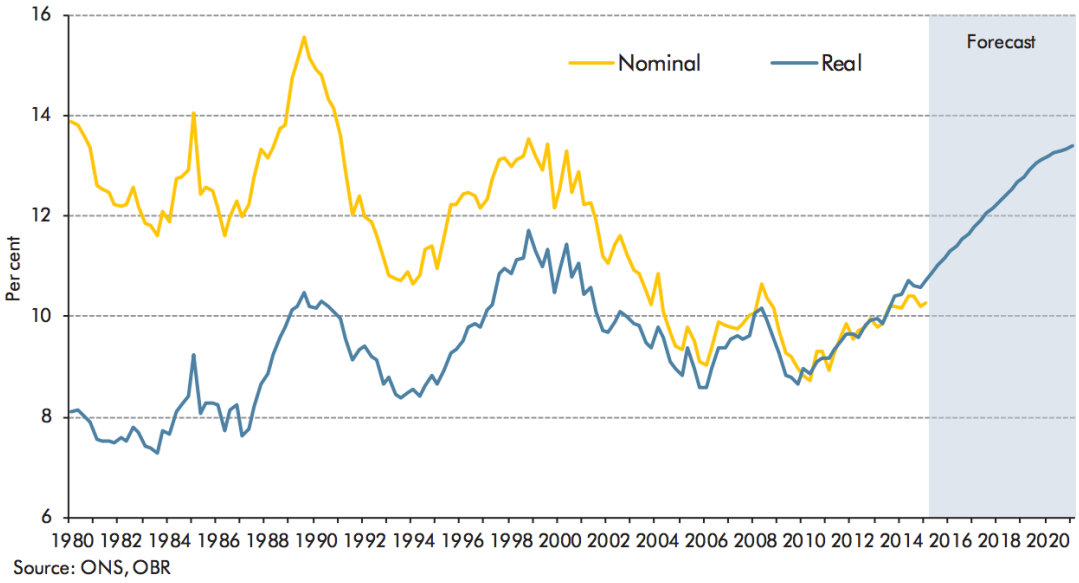

Figure 14. *Source: Office for Budget Responsibility, July 2015 Table 3.26*

The overseas sector forecast is, according to the Office for Budget Responsibility subject to 'significant uncertainty' (page 70). The chance that the UK will see a significant improvement in its balance of trade or see net financial outflows when it is currently a safe haven for investment on two counts (UK gilts and London property) seems very unlikely.

Given these observations the chance that the government will clear its deficit, which can only happen if it net saves, which by implication requires that households, business or the overseas sector must borrow more, appears to be remote.

What is more, we note *that if the rate of inaccuracy from 2011–12 to 2015–16 was replicated in the years 2015–16 to 2019–20 then, based on the July 2015 OBR forecast an additional £162 billion would be borrowed over this period, and at the end of the 2015-2020 parliament the budget would not be running a surplus of £10.2 billion but would instead be showing a deficit of £39.3 billion.* The scale of the potential inaccuracy in forecasts is, in that case, significant and the possibility that this could result in a significant mismatch between the political rhetoric of austerity and the apparent costs and benefits arising from the policy is high. The political ramifications of that mismatch are not for this paper to consider.

Part 6: Conclusions

As is now apparent, in our opinion the probability that the currently proposed programme of austerity will achieve its stated goal of a balanced budget in 2019–20 is low. The government appears, however, politically committed to achieve such a goal. This then presents a three-fold prospect for potential consequences, presuming that this mismatch between outcomes and expectations arises.

The first is that many people in the UK will pay increased income taxes and national insurance over the next few years while suffering significantly reduced services from the government. This will create an increased expectation gap between many on middle-income in the UK and the government, where payment made and perceived value received will increasingly differ.

Second, this is likely to be happening at a time when the political narrative of austerity may appear to be failing. The possibility of significant political stress as a consequence cannot be ignored. The likelihood that increased questioning of the motives of the government in imposing the stress required to achieve the goal of austerity is likely.

Third, if a balanced budget is not delivered, the risk is that the UK economy will appear to be out of economic control (even though that may not be true). If this resulted in pressure being brought to bear on the government via financial markets then risks to the UK's interest and exchange rate policies might arise, making achievement of balanced economy recovery (with or without a balanced state budget) significantly more difficult.

What is clear in all these scenarios is that the risk is one of perception. The 2010 – 2015 government failed to deliver on its promise of a balanced budget but the core philosophy of austerity survived possibly because no alternative narrative emerged and, for many, the impact of the policy was relatively limited during this period. The current forecasts suggest that during the life of the 2015–2020 government there will be an increased impact on the lives of many people in the UK as a result of the pursuit of austerity whilst the policy may still not succeed. This creates an entirely different political environment to that faced by the last government that may result in creating previously unknown stresses for a government seeking to shrink the size of the UK state. The consequences are not clear at present.

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