Summary

• Budget 2014 is the fifth presented by the coalition, and the last before the next General Election. The full document is available here.

• The ‘headline’ provisions in the budget have been dealt with in earlier briefings (particularly those relevant to local government), and there have also been preview briefings, including the ‘Green Book’ analysis provided by the IFS.

• This briefing supplies some additional commentary and detail on selected aspects of the Budget, particularly on economic prospects and the programme for deficit reduction. Part of this is drawn from the accompanying report from the OBR available here.

• This briefing will be of interest to members and officers in all types of authority with an interest in finance, strategic planning, housing and planning, local growth, and welfare reform.

Briefing in full

Background

Budget 2014 (available here) is the fifth presented by the coalition, and the last before the next General Election. Mostly, they have been somewhat bleak affairs, with the economy performing below forecast, and announcements of missed deficit reduction targets. On this occasion, the Chancellor is able to declare that the recovery is firmly established, and that real earnings growth is at last beginning to recover. However, the programme for deficit reduction will not be complete, on current policy settings, until 2018, and there will remain a large overhang of debt well into the next decade.

Budget 2014 has also contained some very popular measures, including a higher personal tax allowance, relief on savings, and changes to pensions. These and other measures have been dealt with in earlier briefings. This briefing provides some further commentary and detail on the state of the economy, the programme for deficit...
reduction, its distributive implications, the AME cap, childcare and early years, and the (admittedly modest) additional provisions for growth and housing. The economic and fiscal commentary draws on the accompanying OBR report available here.

The economic outlook

The OBR has revised upwards its forecast for GDP growth in 2014 to 2.7 per cent, which is in line with the average of outside forecasts. The rate of growth is expected to slow slightly in 2015 to 2.3 per cent, and to remain at around 2.6 per cent to 2.5 per cent until 2017-18. The revised estimate for GDP growth for 2013 stands at 1.8 per cent and at 0.3 per cent for 2012.

Of the expenditure components driving GDP growth, consumption was the most important in 2013, which increased faster than household disposable incomes in 2013, being financed largely through savings. Consumption expenditure is expected to slow to rates more aligned with household income in 2014, with a growth in business investment taking up the slack as a driver of growth. Growth in government consumption (or current spending) is positive throughout 2012-14, but is forecast to decline in each year between 2014-18, at the end of which it will have reached its lowest point as a share of GDP since 1948. Labour income is forecast to grow more slowly than GDP in the near term, as employment growth slows and productivity and earnings growth remain subdued. Labour income picks up from 2015 as productivity growth recovers. Corporate profits have grown faster than GDP in 2013-14 and are forecast to continue to do so.

CPI inflation is expected to remain close to the Bank of England’s 2 per cent target through the forecast period. The extra downward pressure on inflation ensues from a slightly stronger exchange rate. Annual house price inflation is forecast to peak at more than 9 per cent later this year.

Unemployment fell to 7.2 per cent in the final quarter of 2013 and is forecast to fall steadily over the coming years, reaching 7 per cent shortly, 6 per cent by the end of 2016, and settling at an estimate of what is considered to be a ‘sustainable rate’ of unemployment at around just over 5 per cent in 2018.

Average earnings in the OBR document are expected to grow by 2.5 per cent in 2013-14, up from 1.5 per cent in 2012-13. In 2013-14, average earnings growth was about 0.6 percentage points higher than CPI inflation, and in 2014-15, at 3.2 per cent, is expected to be 1.2 percentage points higher. However, there is more to the story on real earnings growth, which is returned to below.

As always, the OBR’s forecasts are presented with some cautions. The first of these concerns the likely movement of interest rates. Under the new ‘activist’ monetary policy announced in Budget 2013 (see related briefings), the Bank of England has effectively enlarged its remit for monetary stability (i.e., controlling inflation) to protecting prospects for economic growth. Hence the Governor, Mark Carney, said that the Bank would not consider raising interest rates (its key mechanism for
controlling inflation) until a threshold unemployment rate (7 per cent) had been
passed, although it is now clear that a review of interest rates will not happen until
the unemployment rate is some distance below 7 per cent. A rise in interest rates will
inevitably restrict credit but will also hit already highly indebted consumers. It could
also affect bond markets and hence raise the servicing costs of government debt. The
OBR assumes that monetary policy follows the path implied by the pricing of risk
in financial markets, and the first quarter in which a rise in Bank Rate to 0.75 per
cent is fully priced in is the second quarter of 2015. The Bank Rate is expected to
reach 2.0 per cent in the first quarter of 2017.

A related issue is the estimate of what is known as the ‘output gap’, or the extent to
which the economy is operating below full potential. For obvious reasons, much
productive capacity remains unused during a recession, but is re-employed during
the recovery phase, during which the economy ‘bounces back’ at a faster-than-trend
rate as underused capacity is restored. If the output gap is small, then the economy
will return to its trend rate of growth rapidly. In the current context, this could mean
that the Bank will want to raise interest rates sooner than expected in order to
dampen down upward pressure on prices (as the economy runs into supply
bottlenecks).

Economists derive endless hours of harmless fun from estimating the ‘output gap’,
and their conclusions tend to vary quite widely. Unsurprisingly, there is some
considerable uncertainty as to how large the output gap actually is. But more
importantly as far as deficit reduction is concerned, the estimated output gap enters
into the calculation of the cyclically adjusted deficit – or the amount of money the
government would owe if the economy was running at full capacity. The cyclically
adjusted current balance (CACB) is one of the Coalition’s targets for deficit reduction
(see below). However, if the output gap is smaller than currently estimated, it means
that a larger proportion of the deficit is structural, and hence will take longer to pay
off even after the economy fully recovers.

The combination of a slightly stronger near-term outlook for GDP growth and a
slightly narrower output gap than forecast in December means the output gap is now
expected to close by mid-2018. It is assumed that growth will be in line with its trend
rate once the output gap has closed, and hence the GDP growth forecast in 2018 is
2.5 per cent.

Deficit reduction

The Coalition’s two fiscal targets set in 2010 have been explained in detail in earlier
briefings. To re-cap, the first of these, the fiscal mandate, was meant to achieve a
cyclically-adjusted current balance (CACB), whereby total public sector receipts
would be at least equal to total public sector current spending by the end of each
rolling, five-year forecast period. The second, the supplementary target, required
public sector net debt (PSND) as a percentage of GDP to be on a downward path by
2015-16. It excludes the temporary effects of financial interventions (or bank bail-
outs).
Public sector net borrowing (PSNB) – the gap between what the Government spends and raises in revenue – is expected to be £107.8 billion this year (excluding transfers related to the Royal Mail Pension Plan and quantitative easing), but is forecast to fall by a further £12.4bn in 2014-15, to £95.5bn, moving below £100bn for the first time in six years. The largest drivers of are an upward revision to stamp duty receipts (due to higher house prices and property transactions) and a downward revision to debt interest costs.

In 2018-19, the public finances are forecast to move into surplus for the first time in 18 years, having fallen by 11.2 per cent of GDP from its post-war peak in 2009-10 (around £190bn in today’s terms). Just over 80 per cent of the reduction is accounted for by lower public spending. Just under 20 per cent of the drop in borrowing is accounted for by higher receipts, with the majority having taken place by 2012-13, largely as result of rises in the standard rate of VAT.

The CACB is forecast to be in surplus in 2018-19, at 1.5 per cent of GDP. PSND is expected to peak at 78.7 per cent of GDP in 2015-16, to fall by a small margin in 2016-17 and then to fall more rapidly to 74.2 per cent of GDP by 2018-19. This means that the supplementary target has been missed.

There is a lengthy discussion in the budget document of the dangers of maintaining a large overhang of debt. It points to the likelihood of further recessions, and on average, the UK has experienced a recession once every eight years since 1955 (so on past performance, we can expect another one by 2018-20). Recessions (or ‘shocks’) make further calls on public spending and borrowing, and will deepen the existing debt burden. Panics in the markets could raise servicing costs. Further anxieties are raised over the prospect of the fiscal burdens accompanying an ageing population.

All of this strengthens the case for further debt reduction beyond 2015. Budget 2014 reaffirms a commitment to reduce Total Managed Expenditure (TME) by a further £2 billion each year from 2016-17. This takes account of permanent reductions to spending resulting from measures already announced for 2015-16 and action on public service pension schemes, which it is claimed will result in a permanent reduction to Annually Managed Expenditure (AME) of £725 million in 2015-16, rising to around £1bn a year from 2016-17 onwards.

Other than these measures and the welfare cap (see below) further proposals to reduce debt and control expenditure are somewhat piecemeal and occasionally vague. The 2014 Autumn Statement will announce further efficiency savings for central government. Most public sector pay rises will be limited to 1 per cent in 2014-15. Progress is being made towards removing civil service progression pay by 2015-16. Pay bill control is being piloted in two departments, including Defra. A potential £5bn has been identified through the sale of publicly-owned land and property. The expansion of the troubled families programme (to 40,000 additional families by 2014-15) is presented as a cost saving measure.

There is also some emphasis on measures to counter tax avoidance and reinforce benefits compliance. One of these is the extension of the Annual Tax on Enveloped
Dwellings (ATED) meant to stop avoidance of stamp duty on property placed in ‘corporate envelopes’. The government will work with the G20 and OECD to prevent multinational companies engaging in base erosion and profit shifting. Compliance checks on European Economic Area (EEA) migrants to establish whether they meet the entitlement conditions to receive Child Benefit or Child Tax Credit will be increased.

The welfare cap

The government announced at Spending Round 2013 that a cap on welfare spending will be introduced to improve spending control (see related briefings), although at the time the announcement focused on Annual Managed Expenditure (AME), from which welfare spending is funded. In Budget 2014, welfare spending in scope is capped for the years 2015-16 to 2018-19. The nominal level of the cap is set out as £119.5bn in 2015-16, at £122.0 in 2016-17 and £124.6bn in 2017-18, which is roughly in line with forecast inflation. There is a forecast margin of 2 per cent.

The welfare cap will be included in the ‘Charter for Budget Responsibility’ alongside the fiscal mandate. The OBR will make its first assessment of performance at Autumn Statement 2014.

The cap will apply to all welfare spending in AME, with the exception of the state pension and the ‘automatic stabilisers’. In future, it is stated, any new lines of spending that fall within the OBR’s social security or personal tax credits forecasts and impact upon Public Sector Current Expenditure will be presumed to be included within the cap.

The list of benefits in scope will be published at every Budget. Any subsequent changes to the list must be voted on.

Not in scope of the cap are:

- Jobseeker’s Allowance and its passported Housing Benefit
- Universal Credit payments to claimants subject to full conditionality and on zero income
- State Pension (basic and additional)
- Transfers within government (e.g. Over-75s TV licences)
- Benefits paid from Departmental Expenditure Limits (DEL)

Benefits paid for from DEL are presumed to be in any case under the control of departmental budgets. They include Sure Start Maternity Grants, Funeral Expense Payments, New Deal and employment programme allowances, New Enterprise Allowance, Specialised Vehicles Fund and Vaccine Damage Payments. War Pensions will be moved out of AME in future years.

In scope to the cap are:

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Among the more high-profile announcements in Budget 2014 is the raising of the personal allowance to £10,500 from April 2015, having already been raised to £10,000 in April 2014. This change has been widely anticipated, as has its effects, most notably in the IFS Green Budget (see related briefings). As a measure intended to help the low paid, the IFS concluded “Further increases to the income tax personal allowance would not be particularly effective in helping the low paid” (p. 141), not least because it offers no gains to those earning less than the new threshold. Secondly, it is not especially well-targeted, as people in the higher end of the income distribution will also benefit. The fact that the increase in the allowance benefits a large number of people accounts for its huge cost, which according to the Treasury’s own figures, will be about £1.4bn in 2014-15 alone. Finally, the full gain for some low income earners will be lost because the rise in after-tax income will reduce entitlements to in-work benefits.

The Treasury routinely publishes a distributional impact of tax and benefit changes at each budget. The net impact for each income decile for 2014-15 is shown in terms of a percentage of net equivalised household income. Households in the top income decile make the fourth greatest percentage contribution towards reducing the deficit, and the impact on the ninth and fourth decile is roughly neutral. The largest percentage losses are for those in the bottom three deciles, with those in the fifth to eighth decile actually gaining. Those in the bottom three deciles also lose more in absolute terms than all other deciles except the top tenth. Everyone except those in the top decile benefits from changes in direct taxes, but the greatest contributions to losses in the bottom three deciles has been through changes to tax credits and benefits, although indirect taxation has made a contribution too.
These distributional effects, however interpreted, need to be set in the context of overall earnings growth over the course of the recession. The recent modest upward revisions to the OBR’s economic forecasts are unlikely to make much more than a fraction of a percentage point difference (upwards) to the prognosis published in the IFS Green Budget, which was based on projections published by the OBR three months ago in December 2013. As shown above, average earnings growth only just exceeds CPI inflation in 2013-14, before rising slightly above CPI inflation over 2014-2018. Because of the steep fall in real earnings between 2009-13, the IFS prognosis that the real level of average earnings will not recover their 2009-10 position until 2018 still applies.

The Low Pay Commission’s recommendations for increases in the National Minimum Wage (NMW) rates have been accepted by the government. The adult NMW rate will increase by 3 per cent to £6.50 from October 2014, representing the largest cash increase since 2008 and the first real terms increase since 2007. There will also be increases of 2 per cent for the youth and apprentice NMW rates from October 2014. It is stated that the aim is for further real terms increases which will restore and exceed the real value of the NMW, provided economic conditions continue to improve. The NMW is currently £6.31, so it increases by 19p.

It is stated that proposals for a new fuel poverty target and strategy will be published shortly.

**Childcare and early years education**

At Budget 2013 the government announced an additional £200m support for childcare in Universal Credit, equivalent to 85 per cent support for families where both parents, or a single parent, pay income tax. All families eligible for Universal Credit will now benefit from additional support at this level. In line with the principles of the welfare cap, offsetting savings to fund this expansion will be found from within the Universal Credit programme. Further details will be set out at Autumn Statement 2014.

Budget 2014 confirms that the Tax-Free Childcare costs cap, against which parents can claim 20 per cent support, will be increased to £10,000 per year for each child, meaning that eligible parents can now expect greater support, worth up to £2,000 per child each year. Tax-Free Childcare is being rolled out more quickly than previously announced, and from autumn 2015 will be rolled out to all eligible families with children under 12 within the first year of the scheme’s operation.

Since 2010 the government has extended free early education for all three- and four-year-olds to 15 hours, and has rolled out this offer to 20 per cent of two-year-olds. This offer is being extended to around 40 per cent of two-year-olds from September 2014. Budget 2014 announces £50 million for an early years pupil premium, to help improve outcomes for the most disadvantaged three-and four-year-olds in government-funded early education. The government will allocate £350 million to increase the per-pupil school budgets of selected local areas in 2015-16.
Recent rises in planning approvals and housing starts are attributed to government reforms.

The Help to Buy: Equity Loan Scheme is expected to help at least 74,000 households buy a new-build home by March 2016. The Equity Loan Scheme will be extended to March 2020, which, it is claimed, will help a further 120,000 households purchase a home and to continue to support house building. The Help to Buy: Mortgage Guarantee Scheme will continue to support access to high loan to value mortgages until the scheme ends on 31 December 2016.

To support housebuilding, the government will create a £500 million Builders Finance Fund, which will provide loans to developers to unlock 15,000 housing units stalled due to difficulty in accessing finance.

For people who want to build their own home, the government will consult on creating a new ‘Right to Build’, giving custom builders a right to a plot from councils, and a £150 million repayable fund to help provide up to 10,000 serviced plots for custom build. The Help to Buy: Equity Loan Scheme might also be available for custom build.

There will be a £150 million fund to support the regeneration of large housing estates through repayable loans. Bids will be invited from private sector developers, working with local authorities on estates that might be able to benefit. Following the Autumn Statement, expressions of interest have already been made through the GLA.

Among the more publicised announcements was that of support for a new Garden City at Ebbsfleet, with a capacity for up to 15,000 new homes based on brownfield land. A dedicated Urban Development Corporation will be formed for the area and up to £200 million of infrastructure funding will be made available.

The government will publish a prospectus by Easter 2014 setting out how local authorities could develop their own, locally-led proposals for bringing forward new garden cities.

Further to steps already taken to improve and streamline the planning system, there will be a review of the General Permitted Development Order (GPDO). Specific change of use measures, including greater flexibilities for change to residential use, for example from warehouses and light industry structures, will be consulted on, as will allowing businesses greater flexibilities to expand facilities such as car parks and loading bays within existing boundaries.

It is stated that Enterprise Zones are a key part of the government’s strategy for enabling growth in local areas. The availability of business rate discounts and Enhanced Capital Allowances will each be extended by 3 years.

A forthcoming Wales Bill will devolve new tax and borrowing powers to Wales.
The government will commit £100m to Greater Cambridge until 2019-20 to support its transport and infrastructure proposals through a gain share mechanism. This agreement could be worth up to £500m over 15 to 20 years, depending on the economic impact of their investments and, in addition to Greater Cambridge’s own plans, could deliver over £1bn of infrastructure investment in the Greater Cambridge area.

Following the announcement at Autumn Statement 2013, the government is in discussion with Glasgow to develop a city deal.

Supporting growth

The government is doubling the annual investment allowance (AIA) to £500,000 from April 2014 until the end of 2015. This, it is claimed, will particularly benefit small and medium sized firms. There will be an increase in the rate of the R&D tax credit payable to some firms from April 2014.

There is a package of reforms to reduce the costs of energy policy for business, particularly in manufacturing. These include capping the Carbon Price Support rate at £18.00 from 2016-17 to 2019-20, extending the compensation for energy intensive industries for the cost of the Carbon Price Floor (CPF) and EU emissions trading system to 2019-20, and introducing a new compensation scheme to help energy intensive industries with higher electricity costs resulting from the renewables obligation and small-scale feed in tariffs for renewable generation, from 2016-17.

Fuel used in Combined Heat and Power (CHP) plants for electricity generated to supply manufacturing firms will be exempt from the CPF. The government will provide £60 million for new low carbon innovation to support carbon capture and storage (CCS) technologies with potential to reduce the cost of low-carbon generation in the UK.

There are some modest measures announced to support exports, including doubling the UK Export Finance’s (UKEF) direct lending programme to £3bn and doubling the funding of UK Trade and Investment’s Global Entrepreneur Programme. Additional support for science and innovation is also on a small scale, and include £42m over 5 years for the Alan Turing Institute, £74 million over 5 years in a Cell Therapy manufacturing centre and a Graphene innovation centre as part of the UK’s Catapult network, and £106 million over 5 years for around 20 additional centres for Doctoral (PhD) training.

An extra £85 million in both 2014-15 and 2015-16 will be made available for the Apprenticeship Grants for Employers (AGE) scheme. Proposals for supporting postgraduate studies and will be put forward at Autumn Statement 2014.

Announcements for additional support for infrastructure investment are also modest and piecemeal. They include £140 million of new funding to repair and restore the condition of flood defences, an extra £200 million for a potholes challenge fund,
£270 million to support the Mersey Gateway Bridge. On flood defences, the government is developing a ‘long-term plan’ to be published later this year.

Comment

In many ways, this budget was a success for the Coalition. It is undoubtedly the case that a recovery of sorts is underway, unemployment is falling, and at last real earnings growth has started to recover. All of these developments are to be welcomed. Given that the budget has been able to combine favourable announcements for deficit reduction with those of higher tax allowances for the low paid (and others), it might appear reasonable to expect that all parts of the Coalition are content. Other measures have proved popular, notably those for pensions and savings. There is some consensus that the welfare cap is (intrinsically) a sensible change to the system of financial management – its distributional impacts will depend on how it is actually applied in practice.

However, it has not taken long for the initial euphoria to dissipate, and a number of problems and uncertainties remain. Taking the economy first, it should be borne in mind that UK GDP will only recover its pre-crisis level this year. This means the recovery follows six years of negative or near-zero growth. The recovery is not, as hoped, better balanced between consumption, exports, and investment, but so far has been driven by consumption financed by savings – which is not sustainable. Further, a relatively little remarked aspect of recent GDP growth is how much of it is driven by population growth. Despite a declining or sluggish economy, the UK population grew by about 1.9 million between mid-2008 and mid-2012, which could account for at least part of the decline in real income growth and probably means that per capita GDP has lagged overall GDP. (An economy can be big simply by having a large population – however poor people are, they have to spend some money and feeding, clothing, and housing themselves – in (sort of) Keynesian parlance, one person’s spending is another person’s income). Population growth is reflected in the denominator used to calculate the employment rate (the proportion of all of working age population employed) which has hardly budged over the course of the recession – from 72.4 percent September 2008 to 72.3 per cent January 2014, despite a record number of people employed.

On deficit reduction, the outlook remains grim indeed. Although few can query the importance of reducing the overall amount of debt, given its high servicing costs and the risks it creates in a volatile global economy, it is unlikely that the total debt-to-GDP ratio will not return to the levels of the mid-2000s until well into the 2020s – assuming no further crises in the financial system. Current spending is forecast to be in balance by 2018 (three years later than expected), and all of the further improvement in receipts over spending is to me made through reduced spending - but it is highly unclear where and how the further spending cuts will be made. Many of the assumptions in the Budget appear to be based on things that the government would like to happen – such as less tax avoidance – rather than things that will necessarily happen. In this context, some will question the wisdom of the tax give-
away. Contrary to some commentary, it is very generous, but also very expensive, as it affects a large part of the income distribution. And as we have seen, raising the personal allowance is not the best way of helping the low paid – respectable commentary suggest that a better way would have been lowering the rates at which in-work benefits are withdrawn, or raising the national insurance threshold. It is difficult to see how local government can escape further cuts even after the effects of the AME (or welfare) cap and proposed further reductions in working age benefits are taken into account.

Perhaps most disappointing for local government is the absence of any further measures to support the growth, although the Greater Cambridge development perhaps offers a model on which local government can build. However, the urgent need to allow local authorities more powers and freedoms to build more houses cannot be ignored for much longer. The shift in Help to Buy from mortgage guarantee to equity loan is welcome, because it stands a better chance of stimulating house building, thereby tackling the underlying supply problem, but it is unlikely to be enough. Whatever sort of government returns to power in 2015, it will be unable to ignore the housing crisis, which, on current trajectories, can only get worse. Local government will be an important agent and partner in tackling it.

For more information about this, or any other LGiU member briefing, please contact Janet Sillett, Briefings Manager, on janet.sillett@lgiu.org.uk

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