Budget Reflections: A welcome end to Austerity but more to be done

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The Budget marked the point at which the government finally recognised what many economists have been saying for years: with low interest rates, government can borrow cheaply to boost growth.

This is going to be needed after a last ‘lost decade’, with an already stagnant economy facing dark clouds on the horizon in the shape of coronavirus disruption and Brexit uncertainty. Indeed, over the next five years, UK economic growth is forecast to stutter along at an average of 1.4%, significantly below its long-run trend.

Before the budget, there was much talk about the government’s ‘levelling up’ agenda and doing more to raise productivity and prosperity across the whole of the UK – especially in ‘left-behind’ regions. And this is what the new chancellor has delivered.

The announcement of £600 billion for new infrastructure investment by 2025 is, on the face of it, pretty eye watering. But bear in mind that this figure only represents an additional £100 billion on the government’s existing plans and some of this new money is partly a reversal of the substantial cuts in infrastructure spending over the past decade.

Nevertheless, it will bring public investment up to around 3% of GDP – the highest level since 1979 (though not as high as percentage of GDP as in the 1948-1979 era). This new public investment should hopefully stimulate more private investment too. We wait for more details in the publication of the government’s National Infrastructure Strategy, which has been delayed.

Levelling up?

Proposed changes to how the Treasury calculates the benefits of infrastructure projects may also benefit lagging regions. Rather than solely focusing on public projects most likely to generate a higher return – which tends to favour those in London and the south-east – the new proposals will hopefully give more weight to projects across the country to reduce regional inequalities.

And there are plans to create dedicated trade envoys for the regions, and to relocate Treasury officials around the country. The crucial question here is whether this will actually shift power to the regions? There is likely to be an increasing focus on the devolution agenda and implementing local industrial strategies.

There is no easy fix when it comes to reviving lagging regions. New money for infrastructure projects will only go so far. Renewal also requires investment in better skills, support for business and knowledge networks, strong local public services and good local government. Many of these have been significantly weakened through a decade of austerity cuts.

The abolition of business rates for small firms will be welcome, especially for those in retail in struggling towns and city centres. Most of this revenue goes to local councils – and it will be interesting to see if they will be compensated by central government.

New Rules?

And the Chancellor has said that he will review the government's 'fiscal rules' later this year.

The current fiscal rules (agreed last year between the previous Chancellor Sajid Javid and PM Boris Johnson) place a lid on current (day-to-day) spending and commit the government to cutting public debt. It's thought that Javid had planned to keep his forthcoming budget close to what was set out in the Conservative election manifesto.

However, with Javid effectively forced out, the Chancellor and PM can now rewrite the fiscal rules. So what are those rules? Under Javid's guidelines the government pledged to cut debt, keep the public sector net investment at or below 3% of GDP, and to balance the books on current spending over a three year period.

This could open up the scope for further infrastructure projects – which Johnson is a fan of. That could be politically advantageous in terms of Johnson's wish to be seen as 'levelling up' the regions – although – as noted – on its own infrastructure won't do the job in closing deep seated and challenging regional inequalities.

And there is an argument for looser fiscal policy. The economy stagnated in the last quarter of 2019 with growth at 0%. For 2019 overall, growth came in at 1.4%, well short of Javid's target of 2.8%. Years of austerity contributed to the slowest recovery on record in the wake of the global Financial Crisis.

What might happen? History gives us one clue. Gordon Brown's 'Golden Rule' also limited current spending while allowing capital spend (investment) over the full course of the economic cycle (that gave him more wriggle room while keeping the City happy). He also extended the definition of the length of the cycle to give himself even more flexibility in hitting the target.

So we could see the three year period extended – maybe to five years or even longer. That could push back any need for fiscal tightening (such as tax rises or spending cuts) until after the next General Election.

The UK government might – say – come up with a 5% deficit limit – which would allow more space for an expansionary fiscal policy. That would mean the government accepting a rising debt to GDP figure, which governments since 2010 have aimed to reduce, so would further entrench a distinct change in policy direction.

A rising debt-to-GDP ratio shouldn't be a worry. Bond yields are very low at the moment; investors are looking for safe places to invest and the UK government can offer that while at the same time investing to improve infrastructure.

The point is that we are going to see a marked fiscal expansion after years of austerity, likley enabled by new rules later this year. Indeed, this is likely to be the biggest fiscal expansion since Gordon Brown was in office, and could help boost economic growth at a time when Brexit uncertainty continues to stymie business investment and the threat of Coronavirus looms large.

Also, a no trade deal at the end of 2020 (which remains a possibility) or even a minimalistic free trade agreement could hit major manufacturing sectors like automotive and aerospace in regions like the West Midlands, as our recent research has suggested. That won't help 'levelling up'.

The government will need to be seen politically to be spending in such regions if they are to keep seats won in the last election when Labour's 'red wall' crumbled. Johnson will want the fiscal firepower to spend big on infrastructure or public services or in other ways (like further supporting business) in such regions if Coronavirus and/or Brexit has a marked negative impact.

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