

The Budget: An assessment from The Work Foundation

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Section 1: The Budget and Jobs

In our statement, *Cut, Tax, Grow?*¹, we said that the coalition had to solve two problems simultaneously. The first was to address the deficit. The second was to have a credible strategy on growth. The Budget was much stronger on the first than the second.

The new forecasts from the independent Office for Budget Responsibility (OBR) show on the face of it an encouraging picture, with economic growth picking up strongly after a weaker start and a substantial fall in unemployment by 2015-2016. However, this assumes that the significantly larger cuts in public sector activity than previously planned and implied cuts in jobs have very little macro-economic effect. This assumption is critical to whether the forecasts are credible and it remains untested. The public spending cuts now announced amount to a withdrawal from the economy of £61bn (the £44bn by Labour and a further £17bn in this Budget). Implementing these while also strengthening the labour market will take exceptionally strong private sector growth.

How realistic are these forecasts for falling unemployment totals? Much depends on the scale of public sector job cuts and the ability of the private sector to absorb those displaced from the public sector. In our paper, *The Jobs Gap*, we argued that in principle the UK labour market could absorb about 500,000 job cuts in public service jobs over five years, provided they were well managed and staggered. However, cuts closer to 1 million would overwhelm any plausible private sector recovery. The OBR forecasts in the Budget have not caused us to revise these estimates.

We also identified a number of reasons why it was risky to assume that large cuts in public sector payrolls could be effortlessly absorbed by the private sector. Recoveries in private sector employment in the past have taken root first in the more prosperous regions, leaving more dependent regions behind. The new government, to its credit, has announced regionally targeted job generation measures. However as we show below, they may not prove to be very effective. There is also the problem of potential miss-matches between the skills and experience of public sector workers and the new jobs created in the private sector.

Impact on public sector employment

It is very hard to get a clear idea of the exact implications for public sector employment. The two-year wage freeze could, with the introduction of greater flexibility on hours, help offset employment cuts that would have otherwise have been made. However, it is inconceivable that the sort of cuts being contemplated in parts of the public sector – 25% or more in some Departments – will not lead to large lay-offs.

¹ Brinkley, Levy, Morris (2010) *Cut, Tax, Grow?* The Work Foundation

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In the first quarter of 2010 the public sector employed nearly 6.1 million people, although this included around 500,000 who work in the publicly owned and controlled banks. About 3.9 million worked in health, education, defence and the police where either explicitly (health) or implicitly (education, defence, police, social work) the cuts will be less severe. That leaves about 2 million working in public administration (with 530,000 in the civil service) and in the rest of the public sector (excluding the banks) where the bulk of the cuts are likely to fall.

Impact on the private sector

The impact of the cuts will not just be felt in the public sector because a large share of public spending is spent on goods and service supplied by the private sector. OECD definitions and estimates suggest at least 25% of public spending in the UK goes on private sector goods and services. This is a high rate compared to most other OECD economies, as shown in the chart below. This particular measure may overstate the UK's relative position once other forms of public sector support for private sector activity are taken into account², but the important point is that cuts in public sector activity can feed straight through in reduced orders for private sector firms. When all kinds of public procurement are taken in account, using national definitions, the UK figure could be as high as 38%. We estimate that in 2008-2009, total current and capital procurement was worth £230 billion out of a total public spend of £602 billion³.

² The OECD also identifies what it calls "market sector in kind" public spending which mainly consists of rebates, refunds and vouchers used by citizens using privately provided services in areas such as education and health-care. These payments account for a significant share of public spending in countries such as Germany, the Netherlands, and Japan.

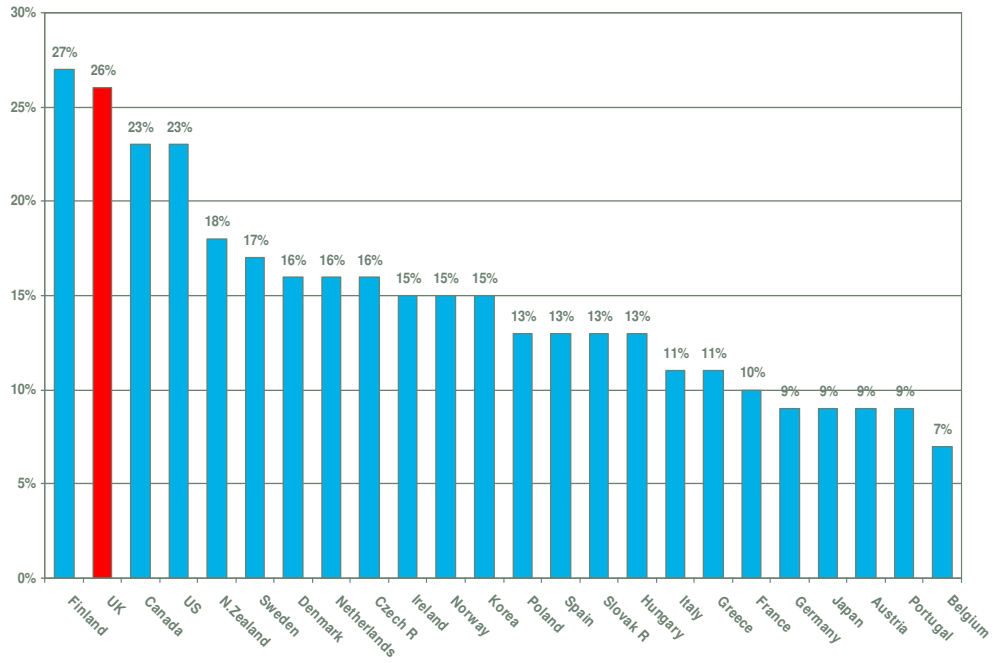
³ PESA interactive tables.

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Share of government spending on goods and services from rest of the economy

Note: proxy measure intermediate consumption by government as share of government spending in 2005. Excludes "social transfers in kind via market producers" such as rebates, vouchers, and refunds of charges for health, education, transport, and housing services. The latter are especially important in Netherlands, Germany and Japan (between 14 and 18 per cent of total government spending). There no comparable figures for the UK. Source: OECD Working Papers on Public Governance No 8, 2008, figures 4 & 5.



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Section 2: The Growth Agenda and the Budget

In terms of what might be described as ‘the growth agenda’, the Budget red book states, “The second element to rebalancing the economy is creating the conditions for enterprise and sustainable growth. If growth is to be sustainable, it needs to be based on an expansion in the private sector, not the public sector, and businesses across all regions and industries need the right conditions to be able to grow.”

In The Work Foundation’s previous publications, *Cut, Tax, Grow* and *The Jobs Gap*, we argued strongly for a growth strategy based on high growth potential sectors and industries in the knowledge intensive sectors of the economy. In particular we argued that the government must use the Budget to do the following:

- Invest in the UK’s high growth potential knowledge intensive sectors to grow more quickly than hitherto by identifying likely growth sectors and backing them to the hilt. These sectors are: advanced manu-services; the low carbon economy; creative and cultural activities; high-tech and business services
- Deliver smart government intervention quickly to the places and institutions that can aid growth and create a single low carbon economy fund to help encourage private sector investment
- Develop new high innovation eco-systems to provide the bedrock for new industries in green technology, bio-sciences and high tech manufacturing. This includes establishing UK versions of Germany’s technology transferring Fraunhofer institutes

The reports (both available at <http://www.theworkfoundation.com/research/publications.aspx>) went on to detail a number of specific ideas for the government to consider.

On face value it is difficult to discern, at this stage, what could be described as a knowledge economy strategy. There was little in the Budget that could be described as giving succour to the specific sectors that promise the highest rates of growth. Indeed some measures, such as reversing the previous government’s intention to offer a specific tax relief to the video games industry without offering an alternative means of support, seemed to be going in reverse.

It was already the case that the main government department responsible for encouraging growth, the Department for Business, Innovation and Skills (BIS), had taken a major hit in the previously announced £6 billion of cuts. In this round for 2010-2011 some £836 million of cuts had been

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planned. This included transferring £200 million of the *Train to Gain* budget to pay for more apprenticeships and £200 million saved from efficiencies in the Higher Education budget and over £200 million deferment of a new high-tech medical research centre.

The Budget's £61 billion spending cuts will mean cuts of around 25% on average for those departments not ring-fenced (Health and International Development). Furthermore, the Chancellor indicated in his speech that Education and Defence might receive some preferential treatment which would mean even deeper cuts for other departments unless welfare spending can be reversed even more than announced in the Budget.

Other measures were also equally broad brush. Reductions in corporation tax from 28% for larger firms to 24% by 2014 and from 21% to 20% for smaller companies (though these were offset, at least in part, by a reduction in tax reliefs on capital investment). So too was the news of continuing support for a better digital infrastructure even if the means to pay for it would change. Moreover the commitment not to reduce capital spending below the reductions already set by the previous government was also a sensible measure in helping stem the blood letting of public sector investment. In similar vein was a catch-all increase in the amount of lifetime capital entrepreneurs could enjoy – up from £2 million to £5 million and an increase in the Enterprise Finance Guarantee by £200 million up to £700 million for this fiscal year.

Knowledge economy specifics were few and far between. One proposal that The Work Foundation called for was a new green investment bank. But as we noted in ***A 2020 Low Carbon Economy***, current public policy and financial support for the low carbon economy is complex and highly nuanced. The lack of business and investor confidence is a major obstacle to developing internationally competitive low carbon industries. A key cause of this is a lack of clarity and commitment from the government.

The lack of clarity is a particular issue for skills supply. If business does not demand skilled labour in low carbon activities then universities and other training institutions will not offer opportunities for training. The expectations of individuals of the likely future returns from investing in these skills are not adequate to support this demand, resulting in a potential skills gap when the low carbon economy grows. What was required but missing from the Budget's analysis was the need for bigger, bolder measures. Examples of recommendations from The Work Foundation included:

- **A low carbon technology implementation sector** – the successful development of economic activities focused on reducing carbon emissions through the implementation of existing and developing technologies;

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- **Manufacturing-led growth in low carbon activities** – the development of world class, export orientated low carbon activities based on manufacturing;
- **A low carbon services-led sector** – the development of world class, export orientated low carbon activities based on business, financial and technical services.

Of particular note is the announcement of the Growth Capital Fund. This fund is designed for some fast-growing SMEs where growth capital is not being provided by the market. But the total net new money additional to the existing £237 million programme of Enterprise Capital Funds is only £37.5 million in equity finance, funded through a £25 million government contribution and £12.5 million in private co-investment.

Section 3: The Budget and the regions

The Chancellor recognised the point that The Work Foundation and others have made in recent months that low levels of private sector growth and higher levels of dependency on the public sector leave the regions outside the Greater South East vulnerable to the direct, indirect and induced impacts of public spending cuts⁴. Measures to promote private sector growth in these areas is therefore a priority.

The Budget contained some very welcome measures such as the commitment to regional infrastructure projects including the upgrade of the Tyne and Wear Metro, the extension of the Manchester Metrolink, the redevelopment of Birmingham New Street station and improvements to rail lines between major regional hubs; and the creation of a Regional Growth Fund in England in 2011-12 and 2012-13 to invest in regional capital projects that support private sector employment and growth in the places and communities most dependent on public sector employment.

The Work Foundation has previously highlighted the limited prospects for private sector recovery outside the Greater South East and likelihood of a growing regional jobs gap in the UK over the next five years⁵. The temporary Regional Growth Fund should, if properly financed, help ameliorate the impacts of public spending cuts on employment in vulnerable areas but neither the Regional Growth Fund nor the reductions in employer National Insurance Contributions (NIC) will address the long-term structural weaknesses that exist in parts of the private sector outside the Greater South East.

Within the qualifying period, these employers will not have to pay the first £5,000 of Class 1 employer National Insurance Contributions due in the first twelve months of employment. This will apply for each of the first ten employees hired in the first year of business and operate in selected countries and regions. Subject to meeting the necessary legal requirements, the scheme is intended to start no later than September 2010. Any new business set up from 22 June 2010 which meets the criteria set out in the forthcoming announcement will benefit from the scheme.

However, while it is well-intentioned, we have doubts over the efficacy of this particular measure. In a review of the evidence for labour market measures carried out in 2009, we found little international or historical evidence that the proposed reduction in employer national insurance

⁴ Jones and Morris (2010) Managing Change: Responding to reduced public expenditure in Yorkshire and Humber, The Work Foundation.

⁵ Brinkley, Levy and Morris (2010) The Jobs Gap, The Work Foundation.

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payments could be effective⁶. Across the board subsidies of this type tend to have high ‘deadweight’ costs because they subsidise firms which would have taken on new people anyway.

In addition, there may be significant ‘displacement’ effects if new firms are given an unfair labour cost advantage over existing SMEs. This is especially likely in low wage industries where reductions in labour costs are likely to have the greatest impacts. Our research has shown that over the past decade there has been virtually no net employment growth among SMEs in less knowledge intensive more traditional services such as retailing and hospitality⁷. Expansion of new enterprises is therefore more likely to be at the expense of existing businesses. Instead, SME growth has been highly concentrated in the higher value added knowledge intensive businesses where the employment subsidy may be less effective than support for innovation, access to finance and skills and the quality of the digital infrastructure.

Moreover, the commitment to reduce employer NIC for start-up businesses does not reflect the most recent evidence on the contribution of SMEs to job growth which shows that the vast majority of net new jobs are created by relatively few ‘high growth’ firms⁸. The evidence also shows that the main challenge for the UK is not the number of new start-ups or indeed the number of small high growth firms but in getting more high growth small firms to become medium sized firms.

In our view, the money would have been better spent as part of a much more targeted refocusing of existing SME business support on firms able and likely to grow rapidly. There is an urgent need to fix the gap that exists in finance for businesses in the regions. The government’s commitment to work with the banking industry to disclose regional lending data should be the first step in a wholesale review of business support mechanisms and of access to finance for small and medium sized businesses in the regions.

The next steps

We will have to wait to see if a credible knowledge economy growth strategy emerges from the regional policy White Paper, due in the Summer, and the financing business Green Paper due in the Autumn. The Comprehensive Spending Review will also help fill in the gaps. As so often, the devil is in the detail and that is mostly missing from this Budget.

⁶ Brinkley, Clayton, Coats, Hutton and Overell (2008) *Hard Labour*, The Work Foundation.

⁷ Brinkley (2009) *Enterprise and the Knowledge Economy*. The Work Foundation.

⁸ <http://www.nesta.org.uk/library/documents/Measuring-Business-Growth-v18.pdf>

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