CENTRE for ECONOMIC PERFORMANCE

LSE THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

#ElectionEconomics: The research evidence on key issues for voters in the 2015 UK General Election

Executive Summary

Executive Summary and Introduction to 2015 CEP Election Analysis

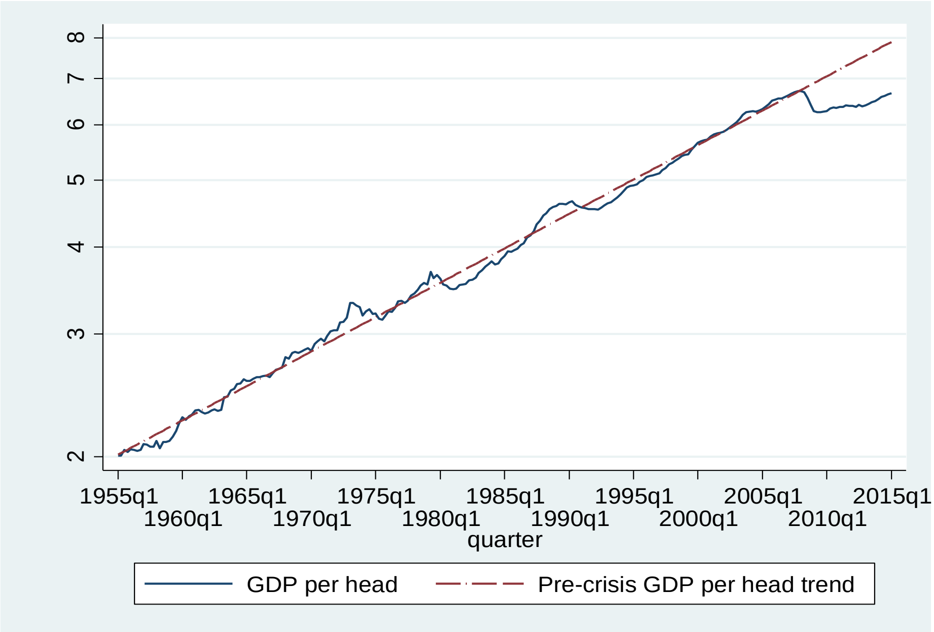
The 2015 UK General Election is extraordinarily close and no single party is likely to win an outright majority. Given the importance of every vote, having a clear understanding of the policy issues is more important than it has been for decades.

Citizens do not vote based on promised policies alone. But in an age of fragmented politics where tribal loyalties hold much less sway, having a clear view of what politicians are saying – and, as importantly, what they are *not* saying – about the key issues of the day is vital.

With this in mind, the Centre for Economic Performance (CEP) has produced 15 briefings on key election issues – from immigration to austerity, and from health to housing. Our aim is not to advocate the policies of any party, but to use the best research and data to inform the public of what really matters for a policy area, how it has changed and what influence the coalition government has had on it since 2010. We also evaluate the proposals for what the main parties think *should* be done about it. The Election Analysis briefings are deliberately kept short and non-technical.

The starting point for our analysis is the fact that in a historical context, the UK's recent economic performance has been poor. Figure 1 shows a key measure of material wellbeing, GDP per head over the last 60 years through to the most recent data released this week by the Office of National Statistics (ONS). Compared with the trend over the last half century, GDP per head is 17% below where we would have expected. Not only was there a big fall in GDP in the 2008-09 global financial crisis, the recovery has been very anaemic – the worst for a century.

Figure 1: UK GDP per head, 1955Q1 to 2015Q1



Notes: Quarterly GDP (in £1000) per head on log scale (ONS series IHXW, downloaded April 28th 2015). http://www.ons.gov.uk/ons/datasets-and-tables/data-selector.html?cdid=IHXW&dataset=ukea&table-id=X11. 2015Q1 estimated using GDP growth http://www.ons.gov.uk/ons/dcp171778_402219.pdf. Trend line at 0.57% per quarter (linear trend from 1955Q1 to 2008Q1 when recession began).

What is the cause of this predicament? Have the coalition government's policies contributed to the poor recovery or would things have been even worse without their interventions? What are the main parties proposing to improve the wealth of UK citizens? And finally, what are the robust policy solutions that are being ignored?

In this introduction, we focus on five areas of contention germane to these debates: austerity, the UK's place in the world, long-term growth, public services reform and living standards.

Austerity

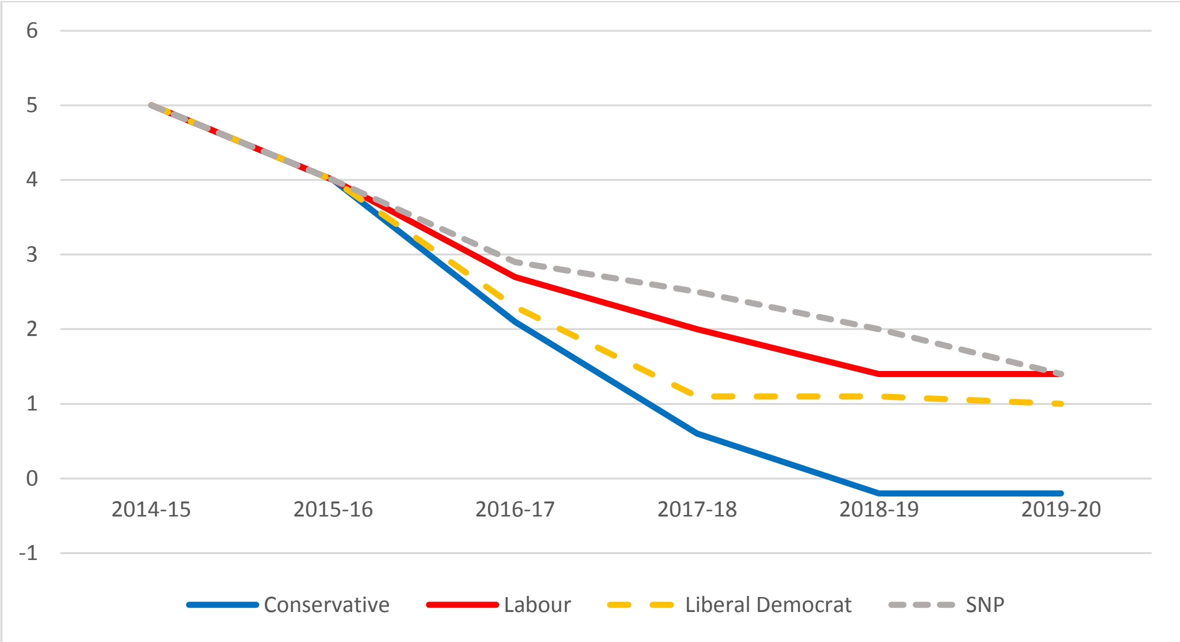
The backdrop to the election is continuing fiscal consolidation, also known as 'austerity'. This is the continued attempt to reduce the amount of government borrowing to sustainable levels. The financial crisis generated the worst global recession since the interwar period and this left its mark on the UK's public finances. The coalition of Conservatives and Liberal Democrats came into government promising an acceleration in the austerity programme with the ambition of eliminating the deficit by March 2015. This did not happen. The recovery stuttered out and rather than continuing to pursue this 'Plan A', the coalition government wisely decided to slow the pace of austerity from 2012-13. Borrowing stood at 10.2% of national income in 2009-10 and still remained at 5% in 2014-15.

As a consequence, whichever party or parties are in government after the election, there will be a need for some further austerity. Van Reenen (Chapter 1) discusses the past and future of austerity. The main differences between the parties are first, the target size of the budget deficit by the end of the next Parliament, and second, the proposed mix of tax and spending policies in the way that the deficit will be reduced.

The likely differences in the four main parties' fiscal plans are illustrated in Figure 2. The Conservatives are planning to run a surplus of 0.2% of national income by 2018-19, whereas Labour could run a deficit of 1.4% and still make their pledges. The reason for the difference is that Labour (and the Liberal Democrats) have a fiscal target of eliminating the current budget deficit in the next Parliament (Labour 'as soon as possible' and the Liberal Democrats in 2017-18). This would enable both Labour and the Liberal Democrats to borrow to finance public investment (which is currently planned to be 1.4% of GDP in 2018-19).[1] This is a large difference of around £35 billion in 2015-16 prices.

[1] The Liberal Democrats would allow borrowing only for 'productive' investment, which is why they end up with a slightly lower deficit than Labour. The exact definition of what is productive is unclear and would be a departure from ONS conventions.

Figure 2: Public sector net borrowing (over GDP) profiles compared



Source: IFS (2015), http://www.ifs.org.uk/publications/7725 based on OBR, Economic and Fiscal Outlook: March 2015 and Election 2015 Manifestos from each of the parties.

The Conservatives are committed to achieving this consolidation solely through spending cuts – in fact, they have promised net tax handouts of 0.1% of GDP mainly from increasing the personal allowance to £12,500 and the higher rate tax threshold to £50,000. By contrast, Labour have detailed tax rises amounting to 0.3% of GDP, including reintroducing a top 50p rate of income tax, plus a 'mansion tax' on homes worth over £2 million and increases in levies on banks and tobacco companies.

As a consequence, the Conservatives need to achieve much larger cuts in public spending. Overall spending on social security and public services would fall to 36.1% of national income in 2018-19, whereas with the other three parties, it would be around 38%. For example, between 2014-15 and 2018-19, the Conservatives would need to reduce real spending on public services by 7.1% overall and 17.9% in the 'unprotected' departments outside health, schools and overseas aid. Labour would also reduce real spending on these unprotected departments but at a much slower pace, to keep public spending as high as 38.3% of GDP.

The path of fiscal consolidation planned by the Liberal Democrats is somewhat faster than Labour's as they want to eliminate the current deficit a year earlier (2016-17). Their overall fiscal stance by 2019-20 is almost the same as Labour's (see Figure 2). Interestingly, the Scottish National Party, which is supposedly the 'anti-austerity' party, proposes nearly identical cuts in the budget deficit and public spending by the end of the next Parliament.

So all in all, there is a choice essentially between the Conservatives' plans and those of the other parties amounting to a difference of about 1.6% of GDP by the end of the next Parliament – or about £30 billion.

Who has got it right? Under all these plans, net debt would be falling as a proportion of national income, but it would fall faster under the Conservatives' plans. This means that there would be lower debt interest payments and it might mean that the public finances were in better shape for unforeseen shocks as happened in the global financial crisis.

But the magnitude of the cuts in public services is eye-watering. Unprotected departments face reductions in spending on a similar scale to those imposed over this Parliament, implying cuts of a third between 2010-11 and 2018-19 in areas like the police, transport, local government and defence. Given that much fat has already been cut and that it will be harder to hold down public sector wages as private sector wages rise, this looks like a very big ask.

In addition, the Conservatives' plans include £5 billion of tax revenues raised from anti-avoidance measures and a further £10 billion from wholly unspecified cuts in the welfare bill. If these are not realised, then the cuts to public services will be even deeper.

The Conservatives are not alone in their lack of fiscal detail. Labour have said that they would raise £7 billion in fabled tax avoidance and the Liberal Democrats have upped this to £10 billion a year by 2019-20. The Greens win the prize though by pencilling in £30 billion from such measures. These are numbers simply plucked out of thin air.

Labour have not been specific on whether they would increase investment (and therefore borrow more) or run a current surplus (and borrow less). The Liberal Democrats have laid out more detail on their spending plans than Labour and the Conservatives. But their promise to save £2 billion from reducing 'fraud and error' and getting more people into work is also largely pie in the sky.

Given the wishful thinking, if the parties are serious about 'balancing the books' in the next Parliament, they will almost certainly need to increase taxes by more than they have said. Ruling out increases in the main forms of tax - income tax, national insurance and VAT - as the main parties have done, makes no sense. Indeed, since unannounced tax rises have increased after each of the last five elections, it seems very likely that this will happen again. We should be asking more details about when and where this will happen.

The UK's place in the world: Europe and immigration

The second major economic question is the UK's relationships with the rest of the world, in particular the European Union (EU). The Conservatives (and UKIP) are committed to holding an in/out referendum on EU membership by 2017.

What would be the costs and benefits of leaving the EU – so-called 'Brexit'? As discussed by Dhingra et al in Chapter 2, one clear benefit would be fewer transfers from the UK to Brussels. But a clear cost would be less trade with the EU, the destination of just under half of all exports. Brexit optimists argue that UK access to EU markets would be as smooth as Switzerland's or Norway's. But pessimists see a more severe fall in exports, as regulations increasingly diverge. The UK will have less ability to benefit from future integration in services markets, in which the country has a strong comparative advantage.

We calculate that the 'static' costs (net of fiscal savings) from export losses alone would run between 1.1% and 3.1%. Including dynamic productivity effects doubles these costs (to £100 billion in the pessimistic case). And this does not take account of the costs of uncertainty engendered by the referendum, the loss of foreign investment and worse access to future trade agreements – such as the proposed deals with the United States (the Transatlantic Trade and Investment Partnership, TTIP) and with Japan, which would benefit UK consumers by about £6.1 billion.

One of the reasons that the Conservatives are committed to a referendum in spite of these economic costs of Brexit is immigration. The coalition government had a target of reducing net migration to under 100,000 whereas the most recent figures are running at triple this level, as discussed in Chapter 3 by Wadsworth. This comes despite severe restrictions introduced on foreign students and skilled immigration, which have damaged the university sector.

The main reason for the failure of this policy has been large numbers of EU migrants to the UK. Both Labour and the Conservatives want to lower EU migration by restricting access to in-work benefits until immigrants have been resident in the country for a number of years.

Immigration is one of the top voter concerns. But the evidence shows that immigration has *not* reduced the wages or job chances of UK natives. Immigration has also not increased crime, nor had negative effects on public services like schools, health or social housing. In fact, since EU migrants tend to work more than UK natives and are relatively more skilled, they make an important contribution to *reducing* the budget deficit.

The political rows over the EU and immigration show the UK's uneasiness with its place in the world. Yet the evidence is that these fears are misplaced and policies to distance ourselves will end up being very expensive.

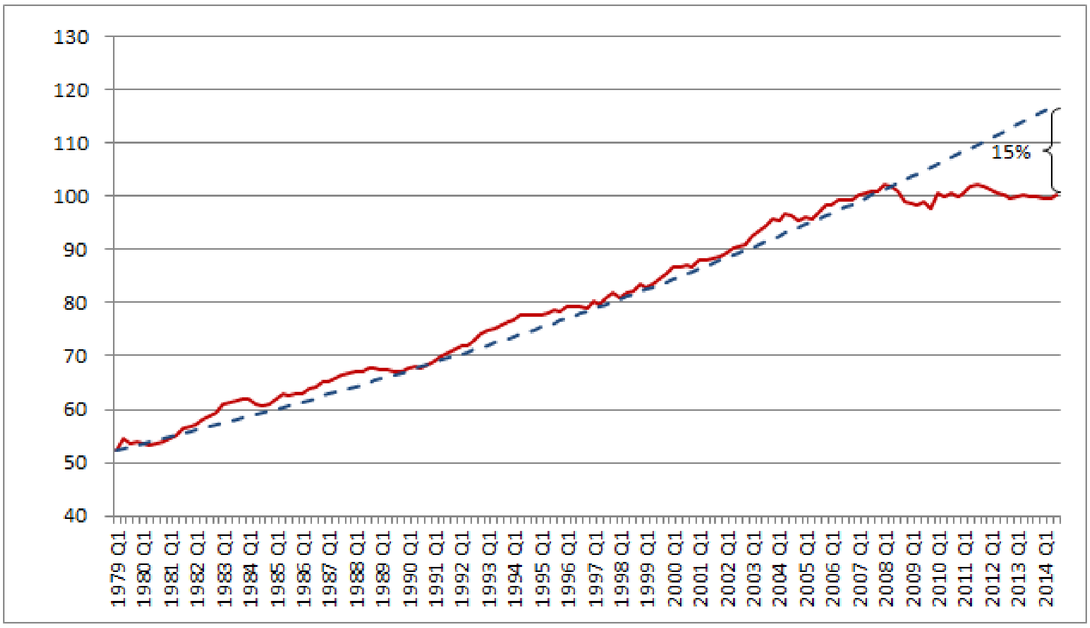
Growth and supply-side policies

Issues of long-run growth have received much less attention in the political debate than deficit reduction, immigration and Europe. This is shocking as the lack of growth is perhaps the main fact of the UK's recent economic performance, as shown in Figure 1. This is not due to a weak labour market – the proportion of working age adults in jobs is over 73%, back to pre-crisis levels. The problem is productivity (GDP per hour worked), which took a big hit during the crisis and has barely increased since then (Figure 3). Valero and Roland (Chapter 4) focus on the causes of the recent slowdown, which they attribute mainly to a mixture of austerity-driven low demand, a dislocated financial sector and poor investment.

To bridge the UK's 17% productivity gap with the rest of the G7, supply-side reforms are needed, as discussed by the LSE Growth Commission (http://www.lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/LSEGC-Report.pdf). No party stands out in having a coherent plan over how to reignite long-run growth. Yet the basic problems are pretty clear – there has been a failure to invest adequately for the long-term, especially in infrastructure (energy, transport and housing) and innovation.

Hilber in Chapter 5 shows how house prices have grown faster in the UK than in all other OECD countries over the past 40 years, leading to an 'affordability crisis'. The cause of this has simply been the failure to build enough homes to keep the supply of housing level with growing demand, and the major cause of the supply constraints has been the UK's planning system. This allows 'Nimbies' ('not in my back yard') to employ endless ways to block new developments, especially in London and the South East.

Figure 3: UK productivity (GDP per hour worked)



Source: Whole Economy GDP per hour, seasonally adjusted (Q2 2010 = 100). ONS Statistical Bulletin, Labour Productivity, Q3 2014, downloaded 6th February 2015.
Note: Predicted value after Q2 2008 is dashed line assuming a historical average growth of 2.3% a year (the average over the period Q1 1979 Q1 to Q2 2008).

Rather than tackle the problem by changing the planning system and allowing local councils to share more of the gains from development, the coalition government has been stoking demand by offering various subsidies for home ownership through 'Help to Buy' and 'Right to Buy'. Increasing demand without easing supply simply makes the problem worse by increasing house prices still further. Similarly, Labour's stamp duty holiday for first time buyers would just increase demand and rent controls would reduce supply.

Valero and Roland point to the UK's innovation gap as an explanation of low productivity. Spending on research and development (R&D) is a much lower share of output than in other major countries and this has been made worse by real cuts in the science budget. Innovation is also held back by a lack of finance, especially for growing small and medium-sized businesses, which makes evident the need to get more competition into banking.

UK infrastructure is also under strain in transport and energy. Political prevarication, reversals and uncertainty are epitomised by the debacle of the lack of airport capacity in the South East. Outsourcing such discussions to celebrity reviews is no solution. There is a pressing need for new institutions to make better decisions on national infrastructure. Creating institutions with autonomy from day-to-day political pressures has been shown to be successful in areas as disparate as competition policy (the Competition and Markets Authority), monetary policy (the Monetary Policy Committee of the Bank of England) and decisions on drug treatments (the National Institute of Clinical and Healthcare Excellence). A similar institution is needed for the strategic direction, delivery and financing of major infrastructure decisions.

In energy, there is both dangerously low capacity, leading to the risk of the lights going out, but also the pressing need to deal with climate change. This is an area of political consensus, but also as Colmer and colleagues show in Chapter 6, one of policy failure. The UK has met its climate change targets primarily by having a poor record on economic growth (Figure 1 again). The plethora of policies undermine each other and there is a need for coherency and simplicity.

Public services delivery

Since cuts in public services as a fraction of GDP are planned by all the main parties, there is a desperate need for improvements in efficiency. Without this, the quality of public services will severely decline. Again, there is little serious debate about how efficiency gains will be achieved with most of the debate being an 'auction' over who will provide the most money and/or manpower.

We examine health in Chapter 7 (McGuire), schools in Chapter 8 (McNally), higher education in Chapter 9 (Wyness) and the police in Chapter 10 (Bell).

Health
Labour have been incensed by NHS 'privatisation' despite the fact that under 1% of NHS care is provided privately. The substance of the complaint appears to be more about competition between *publicly* run NHS trusts. Ironically, competition – greater patient choice – was introduced by the Labour government from the early 2000s. And this competition worked: we have good evidence that these reforms boosted productivity and improved the quality of patient care (fewer people died). What's more, these improvements were strongest in poorer areas of the country.

Labour's dislike of their own NHS reforms that improved efficiency and equity is due to the botched 2012 Health Act, which caused huge organisational upheaval at a time of limited budgets without improving performance. Like accelerated austerity, it was a poor policy created in the first half of the Parliament, which resulted in a damage limitation exercise in the second half.

Schools
Radical change has happened in secondary schools with semi-autonomous academies becoming the major form of secondary school provision. It is clear that the early academies in disadvantaged areas successfully raised standards, but it is unclear whether this is true of the later waves, which have been based in more middle class areas.

Higher education
The main issue in higher education is whether to reduce the tuition fee cap from its current level of £9,000 to £6,000, as Labour propose. The hike in fees in 2012-13 seems to have done nothing to reduce demand for universities from low income students. Labour's proposal would cost £2.7 billion and would be regressive, benefitting wealthier students the most (as poor students get grants and no one pays a loan until they earn above the median wage).

Labour's proposals make as much economic sense as the Conservatives' restrictions on students working after their studies and clamping down aggressively on skilled immigrants. These hurt universities, one of the UK's strongest sectors of comparative advantage.

Policing
Unlike health and education, where demand for services is rising, crime is an area where the demand for police services is falling. We are living in an increasingly peaceful and low crime

society. The issue is whether there can continue to be very large cuts in police budgets with no uptick in crime. Although improved policing techniques can improve efficiency, there is good evidence that more manpower does keep a lid on criminal activity.

Living standards and the distribution of income across people and places

Living standards

Aggregate change in economic performance is one thing, but a stronger influence on voting is how people are personally affected by economic changes. Much media commentary seems perplexed by why the coalition government is not more popular given the 'health' of the economy. One answer to this is that the economy is *not* that healthy – the UK's growth rate of 2.4% over the year to March was better than most other advanced countries, but just about on historical trend. Given the depth of the recession and the tepidity of growth for most of this Parliament, we would have expected a much stronger growth rate at this stage of the cycle. Maybe voters' memories are not as short as many journalists believe they are.

Another factor in understanding the link between the economy and voting patterns is looking at how living standards have evolved. Machin in Chapter 11 shows that median real wages *fell* by between 8% and 10% since 2008 (depending on how inflation gets measured). This has not happened in previous post-war recessions and it helps to explain why unemployment rose much less than expected.

Machin shows how the earnings fall has been worst for the young: a 16% cut for 18-24 year olds. Indeed, although the tax and benefit system means that net income falls are less than gross earnings for those below the middle of the distribution, the only group whose living standards have *risen* since 2010 are the over 65 year olds. This group (who not coincidentally are more likely to vote than the young) have had their pensions and benefits protected as well as being rewarded with free cash handouts through pensioner bonds.

Inequality

Zucman in Chapter 12 shows how inequality has been consistently increasing since the late 1970s in the UK, especially for the richest 1%. A lot of this has been driven by wage inequality, as the demand for skill and top talent has risen relative to supply. But income from capital like shares and houses is becoming increasingly important. This strengthens the argument for tightening up the generosity that the tax system shows to the very wealthy. Zucman supports Labour's call to end 'non-dom' status for this reason.

Top taxes

Manning (Chapter 13) examines the impact of increasing the top rate of tax to 50% (as Labour propose) or reducing it to 40% (as the Conservatives aspire to do). He argues that there is no evidence that high taxes would reduce effort, but it would mean more attempts at tax avoidance, which would offset the amount of tax revenue actually raised by the Exchequer. Those who wish to raise taxes need also to reduce avoidance, something that all the parties claim they want to do though none get down to specifics over how they would do it. One way to reduce avoidance would be through simplifying the tax system, but there is no sign of this from the main parties. For example, Labour would complicate the tax system by reintroducing a 10p band that almost no one would pay and a mansion tax.

Inequality operates in many different ways. Overman shows how difficult it is to spread the benefits of growth to poorer cities (Chapter 14) and the consistent failure of policies to ignite local growth. The UK is unusual not in the strength of London, its first tier city, but in the relatively small size of its second tier cities. He emphasises the need to make it easier to let successful cities grow by easing planning constraints – a theme that echoes the housing discussion.

Gender
Although inequality has increased in many dimensions in the last four decades, differences in wages and employment between men and women have gone down. Azmat focuses (Chapter 15) on how the progress women have enjoyed can continue, and argues that childcare policies are the critical component in achieving this.

Conclusions

This is the closest election in living memory and it is very likely that compromises will have to be made on policies. But the public deserves to know better the real policy stances of the people they are voting for.

There are major choices facing the electorate: over the speed of austerity and its balance between tax and public spending; over whether we remain in the EU; over public services reform; and over the levels of taxation on the wealthier.

There are also questions that should be asked more of our leaders. How would you raise the poor level of productivity? How can real wage growth be restored? How would you deliver the increases in tax revenue from tackling avoidance? How can real efficiency improvements be achieved in schools, hospitals and the police? And how can the UK start building more houses?

Don’t let them off the hook.

And enjoy our whirlwind policy ride.

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