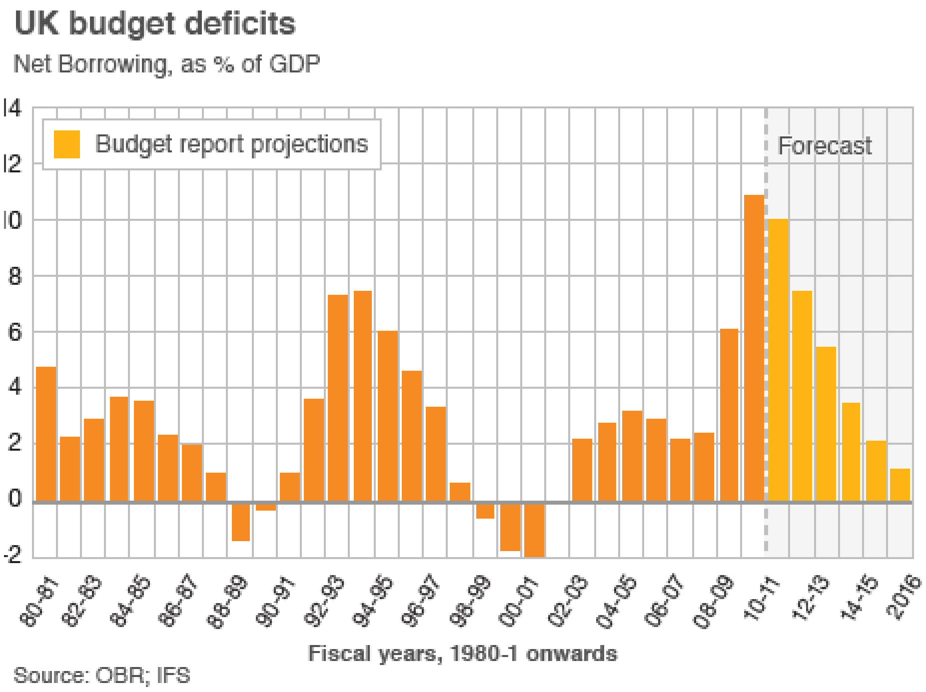
Construction Industry Council

The Spending Review – 20th October 2010

The Spending Review on 20th October 2010 has been watched with keen interest by all those involved in construction as capital spending and maintenance work by the public sector underpins much of the industry's workload. The main objective of the Spending Review will be to reduce the sizeable "structural" budget deficit. Besides public expenditure cuts, tax rises and an efficiency drive are other elements in reducing this deficit. The total fiscal squeeze by the end of this Parliament will be around £110 billion, most of which will be achieved by £81bn in spending cuts over a four year period with the other £29 bn coming from tax rises, most notably the VAT rise in January 2011.

Background

While the UK has run deficits for a considerable period, the size of the deficit was rising steeply even before the financial crisis of 2008. Since then, the deficit has increased due to: the recession which followed the crisis; major rises in Government spending designed to alleviate the effects of the crisis; rising levels of welfare costs due to growing unemployment; and falls in tax revenue due to the widening gap between Government spending and receipts. While economic growth (which the OBR estimates to be 1.2% this year and 2.3% in 2011) will alleviate the cyclical element due to the recession, the emphasis now is on dealing with the underlying structural deficit.



Fears of a sovereign debt crisis which have occurred in some heavily indebted countries in the Eurozone, underline importance of this issue. Recent IMF reports have also indicated that in the UK, factors such as pension commitments in relation to both the public sector and rising levels of state pension provision, as "baby boomers" retire, also emphasize the need for action.

All political parties have been aware of the problem. The last Government has proposed many of the tax rises which have been adopted by the coalition. Indeed a central debate in the last election was on the balance of expenditure cuts versus tax rises which should be adopted to tackle the deficit.

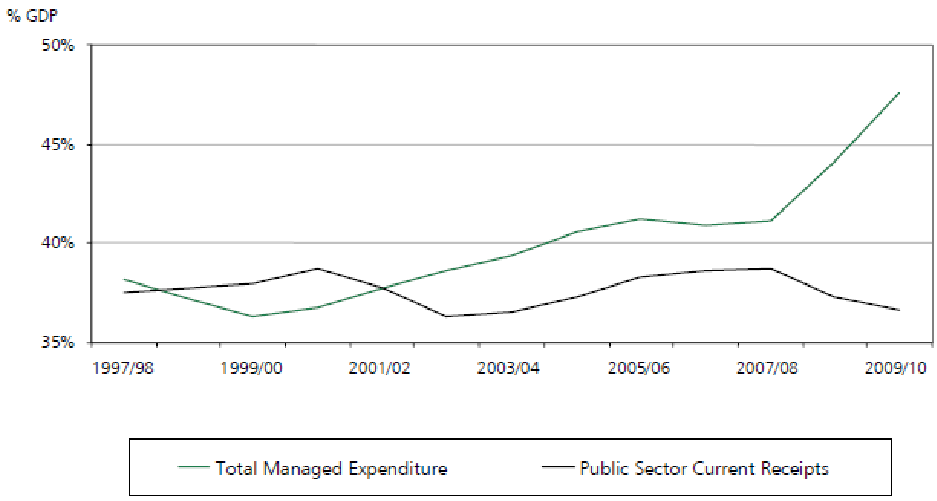
Other key issues are: the speed at which deficit reduction should take place and how cuts should be allocated across departments. This debate may continue but the Spending Review provides an outline of the direction ahead.

The overall context

The March 2010 budget forecast was that the UK budget deficit would be 11 per cent of GDP this year. Under the previous Government, public expenditure was set to reach £704 billion this year. This represents 48 % of GDP, a historically high level.

The situation now is that the UK has the highest budget deficit in the G7 and G20. Public sector debt will double between 2007 and 2015 to around 90 per cent. This high level of debt has to be tackled as interest rates would have to rise to compensate financial markets for the risk of holding this debt. Higher interest rates tend to reduce economic growth. Without urgent action debt, interest payments will rise significantly.

Chart 1.A: Total Expenditure and Current Receipts as a percentage of GDP



Source: HM Treasury[4]

The Spending Review

The Government has made it clear that the bulk of deficit reduction will be through cuts in spending rather than increased taxes. The Spending Review sets out the spending plans for the whole of the parliament, setting out departmental expenditure limits for every Government department for the next four years. Overall, the average cut across departments is 19% with some departments of most relevance to construction, BIS and CLG suffering most.

The new Government has ended the previous Government's system of Public Service Agreements which relied on a "target driven" approach. The present government intends to accompany the Spending Review with a number of measures designed to minimize the need to cut (e.g welfare reform). Those most relevant to the construction industry include: the publication of departmental plans showing resources, structural reforms and efficiency measures; and an efficiency drive which is being promoted with the Efficiency and Reform Group to renegotiate contracts, maximize collective buying power and use benchmarking.

Certain areas have been stated to be “protected” from spending cuts (e.g. the National Health Service and overseas aid), however, this protection refers to operational budgets rather than capital budgets. Thus, while certain priority hospital schemes will still go ahead, the capital budget for health will drop from £5.1 to £4.6 billion. In the June budget, it was declared that other areas such as education and defence are to be treated less harshly, the result of this being that other departments are being asked to make greater savings. It has also been stated that the effects of cutbacks on different groups in society and on different regions is also being taken into account.

Strategic approach

As expected, while some large infrastructure projects are protected (e.g Crossrail), in general capital spending is slashed. For instance in the education sector, although the capital settlement will allow for £15.8 billion over the spending review period to maintain the school estate, the end result is acknowledged as a cut of 60 per cent over this period. There is a declared policy priority to provide new places in areas of severe demographic pressure and also addressing essential maintenance needs but within a much restricted budget compared to recent years. Following the abandonment of the Building Schools for the Future programme, the commitment to rebuild or refurbish over 600 schools from this programme is continued.

Some departments are not so badly hit. Overall the capital spending for the Department of Transport has been cut by 11% from £7.7bn to £7.5bn. There are plans to spend £10 billion on road, regional and local transport schemes, with £14 billion for Network Rail and £6 billion for upgrades and capital maintenance on London’s underground system. There is also a commitment to the development of high speed rail but as this will not involve spending within the review period, this is simply a long term aspiration. It must be noted however that the timescales for some projects have been adjusted. Reports in Building magazine on October 20 indicate that Crossrail may be delayed by one year.

Probably the most worrying aspect of the Spending Review, is the impact on the affordable housing programme. In this area, the cut in the capital budget in the Spending Review is down from £8.4bn over the previous three year period to £4.4bn over the next four years. The coalition Government say that 150,000 new affordable homes can be built over the spending review period but one of the assumptions behind this is that social housing providers dramatically increase rents to fund new schemes. In tandem with a much reduced spending programme compared to recent years, major changes are planned in relation to tenancy arrangements to “free up” existing stock.

One area in which there is a clear indication of policy continuity with the last Government is climate change. In contrast to other areas, the Department of Energy and Climate Change will see capital spending rise 41% from £1.7bn to £2.7bn. This will involve a spend of £1 billion on a commercial scale carbon capture and storage plant and £200 million on the development of low carbon technologies, including offshore wind technology and manufacturing at port sites. The Spending Review document also states that there will be funding for continued investment in flood and coastal erosion risk management. Other measures mentioned include increased incentives for low carbon energy generation, through the Renewable Heat Incentive, and plans to improve energy efficiency of their homes through a “Green Deal”.

The cuts to departmental budgets are the main thrust of the Spending Review but there are other cost-cutting measures including eliminating quangos - arms length bodies funded by Whitehall departments but not run by them. For construction, one notable victim has been CABE, which looks likely to have all public sector funding withdrawn. The fate of the CITB - Construction Skills is still unclear and it is known that other bodies such as the Homes and Communities Agency will be fundamentally re-organised to perform a smaller, more strategic role.

Impact on construction

The construction industry has had very severe problems in recent years. In 2009, construction suffered a 12% drop in output, the sharpest fall in 35 years, while in 2010 a further 3% fall is anticipated. By the end of 2010, the Construction Products Association (CPA) state that the construction industry will have endured a recession two and a half times as bad as the general economy.

Current figures from the Construction Products Association (CPA) indicate that the public sector accounts for some 40% of total construction output. The spring report of the CPA indicated that over the previous eighteen months, private sector construction had fallen by almost 20%, losing £14 billion of work with a further 4% fall anticipated during 2010. Public sector construction on the other hand rose due to the fiscal stimulus from Government. In this way contractors on Government frameworks were able to offset some of the falls experienced by the private sector. The public sector cutbacks will therefore reverse this trend.

The Budget statement issued in March 2010 stated that public spending on construction will fall from 3.6% of GDP in 2009/2010 to 1.25% of GDP in 2013/2014. In their spring forecast the CPA viewed this fall with some trepidation as they say that below the level of a 2.25% GDP spend, the state of schools, transport, hospitals and energy infrastructure inevitably deteriorate. The Spending Review now indicates that construction spending is expected to be about £3.5bn more over the next four years than was expected in the Budget but in some areas, particularly housing and education, it has been radically trimmed.

Overall, the CPA feel that the severity of public spending cuts and weak consumer confidence are such that they are expected to cause a double dip recession in the construction industry. The improvements in output during the first half of 2010 is not expected to be maintained, with output in the second half of 2010 and the first half of 2011 falling once again. A sustained recovery for construction is expected to be delayed until 2012 and growth will not return to the long term trend rate in 2013, following a recovery in economic prospects.

The effects of cuts on employment

Price Waterhouse Cooper in their publication Sectoral Regional Impact of the Fiscal Squeeze quote OBR estimates of likely public sector job losses of around 500,000 by 2014/15. These figures have also been quoted in the Spending Review document.

This will have significant knock-on effects in the private sector where another estimated 500,000 sector jobs will be lost. About 100,000 of these jobs will be lost in construction which PWC reckon will have an output loss of around 5%.

One of the few positive messages in the Spending Review document is the commitment to increase adult apprenticeship funding by £250 million a year by 2014-2015.

Minimizing the effects

The Government have stated that they will be mindful of effects of public spending cuts on regions which are heavily dependent on the public sector for employment (e.g Northern Ireland, Scotland, Wales and North-East England).

In relation to construction, an important consideration in minimizing the effects of the cutbacks will be to gear policy to maximizing opportunities for private sector financing. To this end, the endorsement on Tax Incremental Financing is a move which is to be welcomed. The proposed Green Investment Bank (GIB) is another initiative which indicates a step in the right direction.

The Government will initially capitalize this bank with £1 billion of DEL funding together with additional significant proceeds from the sale of Government assets. The new Bank is mandated to tackle risk that the market cannot adequately finance. The Government feel that the new institution will act as a catalyst for further private sector investment. Many however in the construction industry much more money is needed for the GIB.

To encourage private sector investment, reforms to the planning system remain a key policy area. The UK needs a clear planning system which incorporates long term national decision making and delivers certainty for large scale investment decisions. On a national level, there may be more information in the forthcoming National Infrastructure Framework to be produced by Infrastructure UK but, even more importantly, the UK needs good local planning.

Conclusion

The Spending Review is a framework for a much larger initiative which radically re-defines the role of the state. It is part of a much wider policy of "rebalancing" the economy towards the private sector and devolving power to local levels.

Key to this will be how the new Local Enterprise Partnerships (LEPS) are going to work, in particular their ability to generate funding. While the increase in funding for the Regional Growth Fund, from the £1 billion announced in the budget to £1.4 billion over three years in the Spending Review is welcomed, much is still unclear. It is hoped that the forthcoming white paper on local growth will provide more detail on LEPs, planning reform, incentives and regional economic policy.

The outcome of the Spending Review will unfold over the next four years. The end result is not at all certain but the direction at least is clear.

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