

DRAFT REPLACEMENT LONDON PLAN

EXAMINATION IN PUBLIC

PUBLIC EXPENDITURE AND THE LONDON PLAN STRATEGY – PAPER BY THE MAYOR

Introduction

This paper has been prepared by GLA Economics on behalf of the Mayor to help inform the examination in public (EiP) into the draft replacement London Plan (DRLP) and follows calls from a number of EiP participants that consideration should be given to the potential effects of public expenditure cuts on the projections underlying the DRLP and the strategy it outlines. It addresses two main issues:

- How Much Difference Will Public Sector Cutbacks Make to London's Trend Rate of Growth?
- Legislative and Other Policy Events That Will Bear On The EiP

As explained at both the technical seminar on 21 June and at the EiP discussions on Matter 1, although there have been announcements of early spending cuts since the General Election in May and the Emergency Budget on 22 June, a detailed appraisal of expenditure cuts affecting London and their implications will not be possible until the Comprehensive Spending Review now under way reports towards the end of October.

At the EiP session, participants were invited to give comments on these issues to the Mayor's representatives to inform preparation of this paper, particularly on the potential impact of changes in public expenditure on particular communities and groups within London. No such comments have been received.

The Impact of Public Spending Cuts on London's Growth

Public spending data by region are not published. There is a conceptual issue here: spending on the Police, Defence or Education (and on many other public goods) cannot be allocated by region. It is for the nation in total – and is indivisible by region. We therefore analyse the trends in public spending (summing spending on both current and capital goods) and compare it with growth in national GDP.

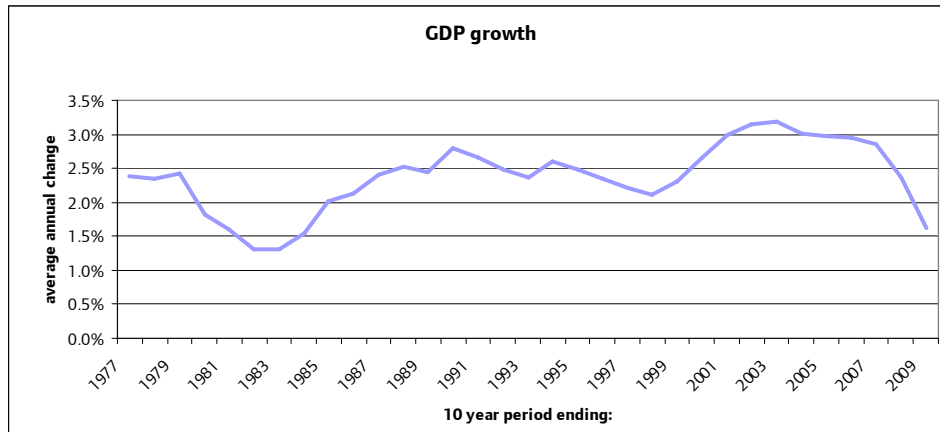
It is important to remember the long term nature of the London Plan – out to 2031 – and the employment and population forecasts that are among its building blocks. We therefore look at ten year moving averages¹ to analyse the correlation between public spending and GDP.

¹ Of financial years, since the public spending data are published for financial – not calendar – years, see for example Table C16 in the 2010 Budget 'Red Book'.

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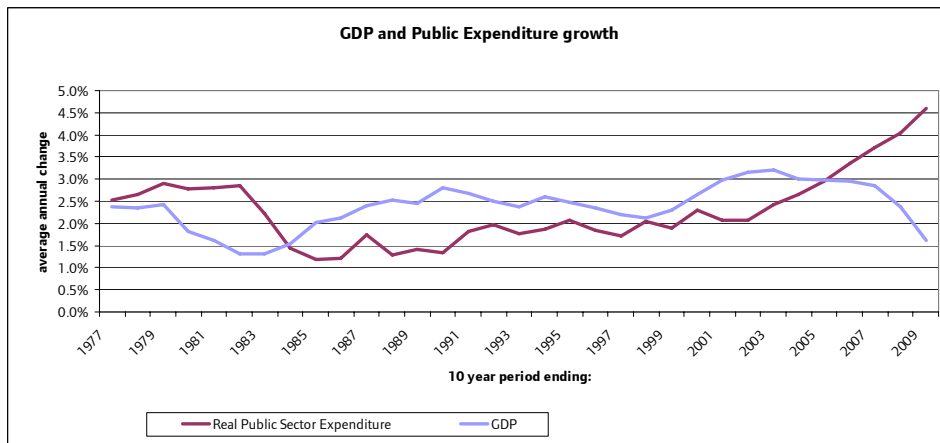
Chart 1 shows that since 1977, the ten year moving average of GDP growth has fluctuated around the postwar trend growth rate of 2.5 per cent. As the 'high interest rate' recession of the early 1980s increasingly dominated the calculation, the rate fell to a low of 1.3 per cent in 1982 and 1983, before recovering. It reached a high of over 3 per cent in 2002 and 2003, fuelled by strong growth in the developing world and by procyclical public spending, but then fell back, falling sharply in the most recent years down to 1.6 per cent in 2009. The average of these ten year growth rates is 2.4 per cent.

Chart 1



It is possible (Chart 2) to compare the ten year averages of output and public spending.

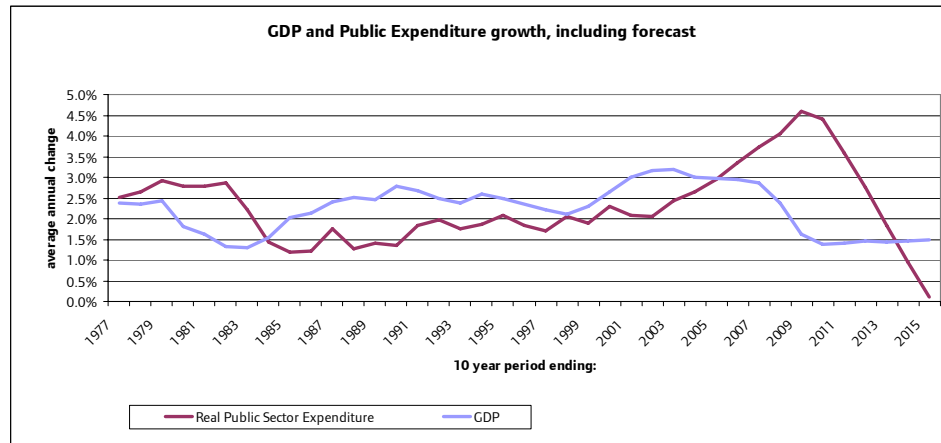
Chart 2



This shows little relationship over these long periods. In the most recent decade long term growth has been stable/declining while public spending growth has increased sharply. At the start of the chart, in the late 1970s, the ten year average of GDP growth was falling away despite stable growth in public spending. Throughout the 1980s/1990s the trend rate of growth of GDP was persistently above that of public spending. The correlation coefficient is insignificantly different from zero (-0.04 per cent).

Thus in considering a schema such as the London Plan which properly ignores short term fluctuations in growth, there is no historic support for downgrading growth because of policy cuts in public spending.

Chart 3

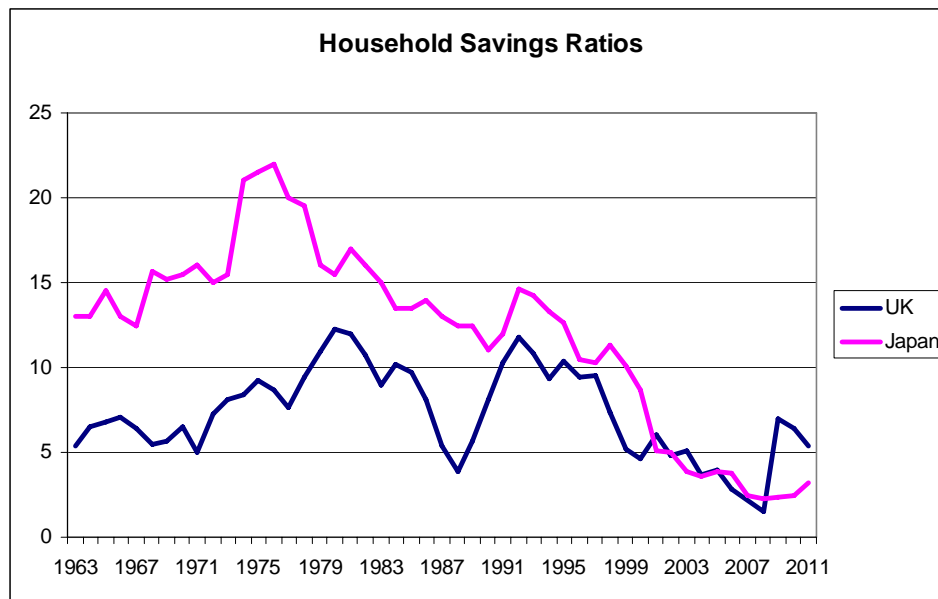


We can add (Chart 3) the likely forecast for public expenditure after the June Emergency Budget, together with the Budget-consistent GDP growth forecasts published along with the Budget by the new (independent) interim Office for Budget Responsibility. As Chart 3 shows, by 2015 the ten year moving average of growth in public spending falls 1.5 percentage points below the ten year moving average of GDP growth. This would certainly not be an extreme configuration – as shown in Chart 3 by the range of historic experience.

Those who believe that the public sector cuts faced by London over the next few years represent a paradigm shift of a kind which renders historic experience irrelevant may have in mind the Japanese 'Lost Decade' of the 1990s into the first decade of the 21st century, when growth was persistently stuck around zero. However the combination of factors at work in Japan were peculiar to that country and are certainly not echoed in the UK. First, the 'Lost Decade' followed a massive asset price bubble on a scale far higher than anything seen in the UK before the recent downturn, with stock prices and land prices trebling in the 1980s. Second there was little active regulation of banks. This allowed them to fuel the asset price bubble with incautious lending. Third, Japanese banks did not really act competitively, relying on 'guidance' from the Ministry of Finance. Fourth, after the bubble burst, a bank restructuring was delayed for political reasons, even though the banks were effectively bankrupt with assets worth far less than liabilities. Although UK bank lending certainly produced an asset bubble it was nowhere near on the Japanese scale and banks remained regulated, even if more lightly than hindsight has found wise.

Finally, Japan was almost certainly caught in a 'liquidity trap' where no matter how low interest rates went, households were unwilling to spend more. In such an environment the central bank is said to be "pushing on a string".

It is clear that the factors which led to Japan's 'Lost Decade' are (fortunately) not relevant for the UK. In particular Japanese households (at least during the 1980s and before) had a savings culture which was alien to UK households, as Chart 4 shows:

Chart 4

Sources: OECD, UK Office for National Statistics, "Why Has Japan's Savings Rate Remained High, Even In the 1990s?" (Shinobu Nakagawa, Bank of Japan Monthly Bulletin: April 1999).

Legislative and other Policy events that will bear on the EIP

<u>Date</u>	<u>Event</u>	<u>Relevance to EIP</u>	<u>Date of EIP Discussion</u>	<u>Will the 'Event' be ready for the EIP?</u>
"Later in Summer"	White Paper on Regional Policy	Throughout	6 September to 15 October	Possibly
Budget 2011 (interim September 2010, before CSR)	John Hutton reports on Public Sector Pensions	No	na	na
March 2011 (Interim Report Autumn 2010)	Will Hutton reports on fair pay in the public sector	Equal Life Chances; Health Inequality; Housing	4-8 October	Possibly
Autumn	Consultation ends on the balance sheet levy for banks and building societies	No	na	na

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20 October 2010	Comprehensive Spending Review	Throughout	6 September to 15 October	No
	?Devolution and localism bill	Throughout	6 September to 15 October	Possibly
?	Other bills on local government?	Throughout	6 September to 15 October	Possibly
June 2010	Mayor's Proposals for Devolution	Throughout	6 September to 15 October	Possibly