POLITICAL CACOPHONY AND THE “SPRING STATEMENT”

Jagjit S. Chadha, Arno Hantzsche, Amit Kara and Garry Young

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Abstract
Political deadlock and constitutional crisis does not necessarily spell economic doom. The UK economy is at full employment and in desperate need of investment to enhance productive capacity. But waiting for the outcome of this tortuous EU Exit process has produced an economic delay. Output is now some 2 per cent lower than otherwise as a result of the EU referendum outcome for precisely the reasons outlined by reputable economic analysis: (i) demand and supply have been driven down by an expected deterioration in prospects and (ii) the fog of uncertainty about those prospects has led to a delay in activity and capacity building. Even now no-one can be sure what will happen in terms of the EU and our future trading relationships. How should we approach monetary and fiscal policy at this time? Both arms of stabilisation policy need to articulate that they stand ready to smooth the adjustment to the democratically picked long-run income path.

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Political Cacophony and the “Spring Statement”

Main Points

- Brexit uncertainty is taking its toll on the economy, with investment growth weaker than otherwise and a depreciated exchange rate depressing real incomes.

- To the extent that uncertainty delays investment while firms meet demand by hiring more workers it temporarily provides the Chancellor with his ‘very own Brexit dividend’ in the form of lower government spending and higher revenue.

- While the long-run economic impact of Brexit depends on the future trading relationship with the EU, there is room for monetary and fiscal policy to help the economy adjust, at the cost of higher inflation and higher public deficits.

- Weak productivity growth, an ageing population, the need for improved public services and the risk of an adverse Brexit outcome will mean that public expenditure will have to rise above current plans.

- In any case our analysis of required financing puts a large question mark over the existing tax regime and fiscal rules.

The Impact of EU Exit

Next week’s Spring Statement takes place in the final days of the UK’s membership of the EU (on current plans). The economic performance of the UK economy since the advisory referendum on 23 June 2016 has been relatively lacklustre and there is evidence from a wide range of indicators that it has been worse than it would have been had the referendum not taken place. This appears to reflect two key factors: the sudden depreciation of the sterling exchange rate immediately after the referendum which affected import prices, and the effect of EU Exit-related business investment decisions. Surveys of UK companies indicate that by autumn 2018, more than half of businesses reported EU Exit as among the top sources of uncertainty they faced and this seems to have been associated with a 3 per cent reduction in investment per year. We have now also had investment contracting in all four quarters of 2018, the first continuous decline of such length since the Great Recession of 2008-9.

A likely consequence of these developments is that UK economic growth has been weaker than it would otherwise have been since the referendum, and UK inflation was temporarily higher. While UK economic growth and business investment had been among the highest in the G7 prior to the referendum, they subsequently dipped below the growth rate of other advanced economies. This outcome can be explained by the effects of heightened uncertainty and downgrades of expected future output growth and are entirely consistent
with the central case of outcomes suggested by economists in the weeks leading up to the 2016 referendum.¹

Table 1: Comparison of EU Exit Deal impact studies

<table>
<thead>
<tr>
<th></th>
<th>Close relationship</th>
<th>FTA</th>
<th>Orderly no-deal</th>
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</thead>
<tbody>
<tr>
<td><strong>Long run</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NIESR % GDP</td>
<td>-2.8%</td>
<td>-3.9%</td>
<td>-5.5%</td>
</tr>
<tr>
<td>% GDP per capita</td>
<td>-1.9%</td>
<td>-3.0%</td>
<td>-3.7%</td>
</tr>
<tr>
<td>UK in a Changing Europe % GDP</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>% GDP per capita</td>
<td>-5.5%</td>
<td></td>
<td>-8.7%</td>
</tr>
<tr>
<td>HM Government % GDP</td>
<td>-2.1% to -3.9%</td>
<td>6.7%</td>
<td>-7.7% to -9.3%</td>
</tr>
<tr>
<td>% GDP per capita</td>
<td>-2.1% to -2.7%</td>
<td>-4.9% to -7.6% to -8.1%</td>
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<tr>
<td><strong>Medium run (2023)</strong></td>
<td></td>
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<tr>
<td>NIESR % GDP</td>
<td>-2.6%</td>
<td>-2.0%</td>
<td>-3.2%</td>
</tr>
<tr>
<td>Bank of England % GDP</td>
<td>-1.25% to -3.75%</td>
<td></td>
<td>-7.75%</td>
</tr>
</tbody>
</table>

Notes: 'Close relationship' encompasses comparable scenarios with stronger regulatory convergence compared to a free trade agreement but characterised by non-tariff barriers in particular to services trade. This includes NIESR's 'Deal + Backstop' scenario and the scenario by HM Government called 'White Paper w/ 50% NTB sensitivity'.

Analogously, UK CPI inflation had been towards the bottom of the pack of other countries prior to the referendum, it subsequently rose above that in other countries as the effect of sterling’s depreciation passed through to import and consumer prices. One of the effects of sterling’s depreciation is that household real incomes and consumer spending are also likely

¹ See the Joint Statement issued by the Directors of the CEP, NIESR and IFS on 20th June 2016. https://www.ifs.org.uk/publications/8330
to be weaker than they would have been had the referendum not taken place. It has been estimated that UK household income was some 2-4 per cent lower than it would otherwise have been as a consequence of the referendum.

But with exit so near what can we expect from now? The Table below compares the Institute’s independently produced assessment of the economic impact to that of HMG and the Bank of England, as well as another independent study produced by UK in a Changing Europe. It is clear that the losses in GDP relative to something near to the status quo are larger the more distant the relationship with the EU that is established. The official models have used both a top-down approach from macroeconomic models of aggregate data and also an industry-by-industry sectoral model that builds the aggregate result from the bottom up. The Institute has interpreted the various scenarios and calibrated them into a numerical statement of impact on trade in goods and services, FDI, migration and labour productivity, i.e. the key drivers of any change in activity, and allowed the model to work out the impact on overall activity as all relative prices and quantities adjust to shocks. The consistent signal from these analyses, which were produced independently from each other, is remarkable.

Output Forecast

These possible outcomes, together with the weight of contradictions that afflicts all plausible scenarios, keep open the likelihood of any of them emerging. This is not to say that the impasse cannot be broken (Aidt et al., 2019) but until a mechanism emerges to resolve these contradictions, there is a non-negligible possibility of a wide variety of outcomes ranging from an extension of the Article 50 deadline, a second referendum or citizen assemblies, membership of the European Economic Area, no deal or even a version of the government’s negotiated deal emerging as the final outcome. Some of these will not be known until well after March 2019 for the simple reason that negotiations related to the future relationship will only begin after the UK exits the EU.

The impact of these different scenarios on GDP growth and other key macroeconomic metrics is so large some may legitimately ask why bother with forecasts? To us, the answer is clear: a projection gives us a scenario or set of scenarios to evaluate, think about and discuss. At the very least, a forecast enables us to think about possible futures and plan accordingly. Policymaking and planning have to continue even if the economic and political backdrop is uncertain and, in fact, it is under these challenging circumstances that the set of assumptions behind the forecasts should be most clearly explained.
It is against this uncertain backdrop that NIESR has published multiple economic scenarios that together capture that wide range of plausible Brexit outcomes (Hantzsche et al., 2018). Our central forecast has been conditioned on a soft Brexit where the UK and EU maintain a high level of market access for goods and services in each other’s markets during and after a transition period. This scenario has been contrasted with a hard (orderly) EU Exit that encompasses scenarios where the UK exits without a deal in place.

Our soft Brexit assumption is not driven by confidence that this scenario will materialise, it is simply because the Phase 1 agreement between the UK and the EU prioritised peace in Ireland and explicitly draws a link between peace and open and frictionless borders. As it happens, for short-term forecast purposes, the scenario is consistent with any deal as long as there is a transition. As noted above, the negotiations related to the future relationship between the UK and the EU will only begin after the UK exits in March and as such the fog of uncertainty that has afflicted the economy since the 2016 EU referendum will likely persist. We have incorporated a heightened level of uncertainty into our central scenario which is weighing down on our forecast for business investment.

![Output growth fan chart with 80% probability](image)

**Figure 1**: Output growth fan chart with 80% probability
The slowdown we observed in late 2018 has to be judged within a broader context where UK unemployment is at a record low, employment is at a record high, wage growth higher and public finance data repeatedly surprising to the upside. Looking further ahead, on our central scenario, we would expect the economy to expand at a speed close to its potential in 2020 and beyond and for inflation to settle at close to its target rate over this period.

It is against this backdrop that we have conditioned our forecast on a gentle upward path for Bank Rate. We contrast this ‘good’ central scenario with a no-deal scenario. We should, with complete reasonableness, expect policymakers to respond with contingency plans and stimulus measures, where possible, to mitigate any short-run disruption (Chadha, 2018). There are different flavours of no deal and policy can respond according to the specific circumstance. At one end of the spectrum is a disruptive outcome where the UK is cut off in much the same way that Iceland was in 2010 after the eruption of Eyjafjallajökull. The results shown in Figure 1 encompasses a more benign scenario where trade barriers restrict, but do not lead to a “sudden stop” in the movement of goods and services, and financial markets continue to function. More problematic scenarios skew the distribution to the downside.

Figure 2: UK GDP growth against G7 growth
To help drive home the importance of the various scenarios, figure 2 shows two versions of no-deal scenarios (against a swathe of outcomes for the rest of the G7): one where policy responds actively to ease the immediate disruptions to output (No-deal Brexit, accommodative policy), as was the case in 1992 when sterling fell out of the Exchange Rate Mechanism and again in wake of the EU referendum result in 2016 when the Bank of England and HM Treasury supported economic growth in spite of higher inflation. Under this scenario where policy helps support short-term activity, the Bank of England is assumed to set Bank Rate in line with the baseline scenario in spite of higher inflation and, at the same time, the Chancellor lowers taxes.

The other no-deal scenario represented in figure 2 assumes monetary and fiscal policy respond to standard rules which, in this case, has the central bank raising Bank Rate in response to higher inflation (No-deal, non-accommodative response).

The Spring Statement

In the October Budget, the government announced a rise in public spending, predominantly targeted at filling immediate gaps in health care spending. It is our judgement that, independent of the path EU Exit will take, planned spending increases will not be enough to accommodate sustainably the needs of an ageing population and to maintain the quality of public services.

We therefore base our forecast on the assumption that the share of government spending in total output remains stable at its long-run average over the forecast horizon, compared to a falling share on the government’s plans. With that level of spending and no changes to taxes, the public sector budget deficit continues to be around 2 per cent of GDP in our central forecast. Dealing with a more disruptive Brexit would in our view require additional fiscal effort. We have in recent work (see figure 3) shown that expenditure plans have been drifting up relative to the plans formulated in November 2017 and continue to think that a combination of responses to the state of the economy and discretionary increases in expenditures will tend to push expenditure upwards.
The Chancellor’s ‘very own Brexit dividend’?

The Chancellor referred to a situation whereby the decision over a Brexit deal would lift the fog of uncertainty and lead to a pick-up in investment growth with positive effects for the rest of the economy as a ‘Brexit dividend’. For several reasons this hope may not materialise. If firms believe a Brexit deal worsens their outlook of future profitability, they will not suddenly raise investment spending. Less than four weeks before the currently-agreed leaving date, it may also be too late for such a Brexit dividend to arise. Some of the investment that would otherwise have taken place in the UK has instead already been made in the rest of the EU or elsewhere, and therefore is unlikely to return.

But the Chancellor may have very well enjoyed his ‘own Brexit dividend’ already: in the form of better-than-expected public finances outcomes, partly resulting from elevated levels of Brexit uncertainty over the last two and a half years. While firms shied away from investment, leading to negative rates of investment growth in the last four quarters, consumption held steady, financed by an ever-decreasing saving rate. Demand for goods and services was met by hiring more workers, leading to a series of upward surprises to employment but depressing labour productivity. To be clear, in the long run we would
expect public finances to suffer from low productivity growth if it holds back real wage growth and raises unemployment. In the short run, if low productivity results from firms replacing capital with labour, effects may be positive. Higher employment than otherwise flatters public revenue and low unemployment brings lower levels of welfare pay-outs with it. In addition, the occupation of government with Brexit might also have distracted the Chancellor’s Cabinet colleagues from proposing spending measures to meet rising expenditure needs of an ageing population, or indeed spending all of the funds already allocated to them. This suggests that Brexit uncertainty may well have contributed to better-than-expected public finances outturns since the referendum.

Between April 2018 and January 2019, the government borrowed £21 billion, the lowest over a comparable period in 17 years. For the financial year as whole, the Office for Budget Responsibility (OBR) expects borrowing to reach £26 billion, or 1.2 per cent of GDP, while independent forecasters surveyed by HM Treasury in January expect £29 billion. Public sector net debt in January remained at 83 per cent of GDP, a decrease of 0.8 percentage points compared to a year earlier.

The more favourable state of public finances can in part be explained by better-than-expected labour market outcomes, which increased the tax base and reduced social security spending. It may signal that GDP growth has been underestimated but it might just be a seasonal factor, as employment is brought forward at the expense of business investment. For a discussion of changes in the fiscal outlook in response to revisions to economic data and forecasts see Chadha et al. (2018), where we show that improvements in growth outlooks tend to reduce expenditure. To the extent that a poorly managed exit might further damage our economic prospects, we can expect a large sequence of deficits. Figure 4 shows that a 1% revision to growth expectations leads to some 1-3% increase in expenditure plans, with employment surprises having similar effects.

In October, the OBR provided a revised fiscal forecast that, prior to taking new policy measures into account, implied that public sector net borrowing as a percentage of GDP would be 0.7 percentage points smaller on average than expected in March 2018 for the period 2018–19 to 2022–23. The downward revision reflected a more optimistic judgement that currently strong tax receipts as a share of economic output persist over the forecast horizon as well as more optimistic assumptions about unemployment, revised down from an average of 4.6 per cent of the labour force over 2019 to 2022 to an average of 3.8 per cent, boosting tax receipts and reducing welfare payments.
As we anticipated in our November Review, the government used the additional fiscal space to announce new spending measures, adding an average of £13 billion per year to borrowing between 2018–19 and 2023–24. The largest part of this increase reflected an increase in spending on the National Health Service in England (and knock-on effects for devolved administrations), summing up to £27.6 billion a year by 2023–24. Downward revisions to borrowing due to more optimistic economic forecasts and upward revisions due to new spending measures on the OBR’s calculations nearly cancel each other out, such that forecast public sector net borrowing as a share of GDP remained at an average of 1 per cent a year, only 0.2 percentage points smaller than the OBR had forecast in March 2018. Public sector net debt was projected by the OBR to fall to 74.1 per cent of GDP by 2023–24, at a somewhat faster pace than previously expected.

Public Finances Forecast

Soft Brexit central forecast for public finances

Our public finances projection deviates from that of the OBR in two dimensions: our economic forecast and our judgement of public expenditure needs. The OBR continued to apply broad-brush judgements on productivity, trade and migration that average over different possible Brexit outcomes. By contrast, our central forecast is based on a soft Brexit accompanied by elevated levels of uncertainty during the first half of 2019. While differences between our real GDP and inflation forecasts are small relative to the OBR’s, we
hold less optimistic assumptions about the unemployment rate (while forecasting somewhat stronger wage growth). At the same time, we believe that additional spending measures may suffice to fill immediate gaps in health care spending but will not be enough to accommodate sustainably the needs of an ageing population and maintain the quality of public services in the long run (Hantzsche and Young, 2018). We therefore assume that total managed expenditure at a minimum will have to remain close to its long-run average of 38–39 per cent of GDP, rather than fall below 38 per cent as planned by the government.

These assumptions imply that, on average over 2019–20 to 2023–24, the government will have an additional £30 billion per year at hand to meet rising spending needs. It also means that the public deficit will remain elevated for longer. We forecast public sector net borrowing to stay around 2 per cent over the forecast horizon. Public sector net debt is projected to reach around 73 per cent of GDP by 2023–24, which is similar to the OBR’s outlook given that we forecast nominal GDP to be around 1 per cent higher over that period.

**Risks to the forecast**

Were the UK to exit the EU without a deal in March, we would expect a sharper slowdown in economic activity than in the central case. How much the economy responds would depend on the extent to which policy steps in and eases the transition to a new trading equilibrium. We show that all other spending commitments held equal, an active fiscal policy intervention that would lift borrowing as a share of GDP by 2 percentage points by 2023–4, or £50–60 billion, in addition to the £500 million already earmarked for Brexit preparations in the 2018 Budget for 2019–20.

**Revision of the fiscal policy framework?**

The government has set itself a number of fiscal targets. The targets constrain spending of government departments in the short run but are by no means necessarily optimal from a general welfare point of view and have been changed frequently in the past, reflecting different fiscal requirements in the aftermath of the financial crisis and in the face of subdued productivity growth. Figure 5 illustrates this point by showing the increasing shortfall in government expenditures at selected departmental levels with particularly pronounced shortfalls in education and health by 2016-17.
The fiscal mandate requires the government to reduce the cyclically adjusted deficit to below 2 per cent of GDP by 2020–21. On our central forecast, using current definitions of the public deficit and assuming growth close to potential, this is achievable, as is the supplementary target of having the share of net debt over GDP fall by 2020–21. However, meeting the so-called fiscal objective of achieving overall fiscal balance by the middle of the next decade does not look likely without tax increases. A no-deal Brexit would make it much harder to meet the fiscal mandate in the short run.

We have argued before that a more comprehensive review of the current fiscal framework will be needed that also includes a review of the tax system. In our view, the rise in future spending needs and a preference for balancing the budget will require additional tax revenue that cannot be raised with increases in single tax rates alone. Instead, a comprehensive overhaul of taxation and how the government charges for public services is needed that aims at raising revenue more efficiently and equitably than under the current system. The need for such a view is likely to become more urgent as a consequence of a significant change to the accounting treatment of student loans.
In December, the Office for National Statistics announced a change to the treatment of student loans in the national accounts and public finance statistics from September 2019 onwards. This will have important implications for headline fiscal figures. Currently student loans enter official statistics as any other loans provided by the government. However, around 70 per cent of loans are expected to be cancelled rather than repaid, mainly in cases where graduate earnings remain below the earnings threshold for the entire 30-year period relevant for repayment. Although the expected loss is known at the outset, the current practice is to recognise the loss with a long delay and, as a result, the near-term deficit data is flattered. Furthermore, the government is able to sell off tranches of loans below nominal value without impacting government expenditure at any time. Instead, a partitioned approach will be applied in the future, treating student loans partly as genuine loans as some portion will be repaid and partly as capital transfers.

**Figure 6:** Fiscal Deficits
While public sector net debt remains unaffected, given the cash flow is the same, the OBR estimates that this accounting change will increase public sector net borrowing figures by around £15 billion a year between 2018–19 and 2023–24. Figure 6 illustrates that our forecast for the fiscal deficit as a share of GDP would be around 0.6 percentage points larger, purely as a result of accounting changes. The government is very unlikely to tighten fiscal policy to accommodate the introduction of student loans in the deficit measure and will either raise the 2 per cent ceiling for the cyclically adjusted deficit that it has set for itself under the fiscal mandate or ignore the breach if it is temporary. The Chancellor may use the Spring Statement on 13 March to clarify his position on the fiscal rules.
Conclusion

We think an exit on near frictionless terms still seems most likely but possibly with a short delay. The betting odds (see Appendix) seem to suggest that possibility the most likely. Any view taken though is subject to considerable uncertainty. And therefore fiscal policy has a duty to flesh out likely responses in alternate scenarios to reduce economic concerns in the event of a poorly managed exit from the EU. If we go back to 2016, even though the cyclical impact of the referendum was well anticipated by economists, there was no strong case for a further fiscal policy response given the large exchange rate depreciation and the loosening of monetary policy.

Whatever type of EU exit occurs, there seems to us to be room for monetary policy to respond, and additionally the financial sector seems able to absorb shocks. There are though serious issues for fiscal policy to address. First, there is evidence of under-investment that has led to a shortfall in capacity to provide public goods in key areas. Secondly, there is an increasing need to offset a shortfall in investment, FDI and R&D at the national level with certain regions of particular concern. Alongside the spending review there is a question-mark over the tax regimes and its incidence on income, capital and firms. Finally, whilst the fiscal rules can perform a valuable service in helping the general understanding that public debt as a share of national income should be stabilised at lower levels than we currently observe, the current targets neither reflect a social optimum nor exploit opportunities for public investment that low funding costs and risk premia (see Appendix) may afford. The Spring Statement ought to provide some soothing accompaniment to the cacophony of EU Exit but runs the risk of neither saying enough nor addressing genuine economic concerns as decision-making once again gets crowded out by political calculus.
References


Appendix Charts: Betting odds

Will the UK leave the EU on the 31st March 2019?

Will there be no deal?

Will there be a second referendum before 2020?

Source: Betfair, NIESR