National Institute of Economic and Social Research

# A statement for the rites of spring

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# A statement for the rites of spring

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*Abstract*

Chancellor Phillip Hammond presented the first *Spring Statement* yesterday. This was not the occasion to expect new fiscal policies or for rabbits out of a hat – we were told that in advance – even the symbolic red budget box was missing. The Chancellor kept to his promise and made this a non-event but in our assessment, he missed the opportunity to address some important long-term challenges facing the economy and public finances such as the pressures form an ageing population and also a shorter-term strategy to neutralise the impact of Brexit.

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## Introduction

Chancellor Phillip Hammond presented the first *Spring Statement* yesterday. This was not the occasion to expect new fiscal policies or for rabbits out of a hat – we were told that in advance – even the symbolic red budget box was missing. The Chancellor kept to his promise and made this a non-event but in our assessment, he missed the opportunity to address some important long-term challenges facing the economy and public finances such as the pressures form an ageing population and also a shorter-term strategy to neutralise the impact of Brexit.

As before, the Office for Budget Responsibility (OBR) published an updated forecast of the economy and public finances. The economic growth forecast remained broadly unchanged compared with the forecast prepared for Autumn Statement 2017 and if these new forecasts are realised, the UK economy will continue to remain a laggard compared with other G7 economies. The combination of no new fiscal actions and a broadly unrevised economic outlook implies no major changes to the fiscal forecasts. The OBR unsurprisingly declared that all the three fiscal targets will be met and that the available fiscal headroom against these targets is broadly unchanged.

Given that the Chancellor is set to be on course to meet the fiscal targets with some headroom, the is a strong case for the government to prepare a strategy for the causes of our long term relative economic decline, which has accelerated since the start of the financial crisis and once again in response to the Brexit referendum. An urgent action point might be to create a range of shovel-ready projects across the country and specifically in regions and sectors that are most vulnerable to an exit from the EU and to simultaneously prepare a strategy for the longer terms consequences of Brexit.

## Latest OBR forecasts

The OBR believes that the economy will expand by 1.5 per cent this year and 1.3 per cent next year and on average of 1.4 per cent over the five years of the forecast. This compares with our forecast of 1.9 per cent for 2018 and 2019. The main difference reason for the difference between our forecast and the OBR appears to be the assumptions related to our future relationship with the EU. We have assumed a 'soft' Brexit where the trading relationship with the EU for both goods and services remains more or less unchanged. The OBR instead allowed for trade frictions that weigh down on both exports and imports.

**Table 1: GDP growth forecast comparison**

| GDP growth | | | |
|---|---|---|---|
| | **OBR Autumn '17** | **OBR Spring '18** | **NIESR February '18** |
| **2017** | 1.5 | 1.7 | 1.8 |
| **2018** | 1.4 | 1.5 | 1.9 |
| **2019** | 1.3 | 1.3 | 1.9 |
| **2020** | 1.3 | 1.3 | 1.7 |
| **2021** | 1.5 | 1.4 | 1.6 |
| **2022** | 1.5 | 1.5 | 1.6 |

Source: OBR, NIESR

Going by past history, one might argue that the risks to the OBR's GDP growth forecast are to the downside. After all, OBR forecasts have tended to be too optimistic (Figure 1), but this time we believe that the risk to their forecast is tilted to the upside. The trade deal with the EU is one important risk. There is also a risk to its underlying productivity forecast. Official ONS suggests that productivity growth was surprisingly strong in second half of 2017. We discuss this further below. For now, though, the OBR has treated that productivity data as noise rather than a signal of better long-term growth prospects.

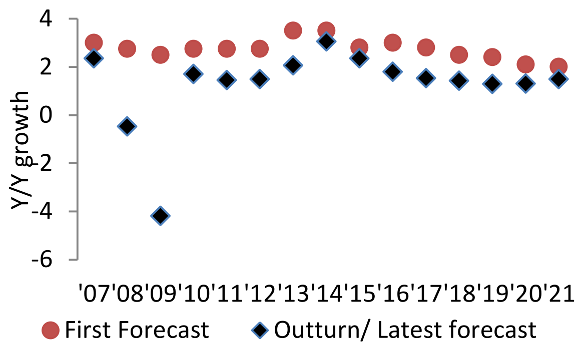
**Table 2: Fiscal deficit forecast comparison**

| Public Sector Net Borrowing (% of GDP) | | | |
|---|---|---|---|
| | **OBR Autumn '17** | **OBR Spring '18** | **NIESR February '18** |
| **2017** | 2.4 | 2.2 | 2.4 |
| **2018** | 1.9 | 1.8 | 1.9 |
| **2019** | 1.6 | 1.6 | 1.3 |
| **2020** | 1.5 | 1.3 | 1.0 |
| **2021** | 1.3 | 1.1 | 0.5 |
| **2022** | 1.1 | 0.9 | 0.1 |

Source: OBR, NIESR

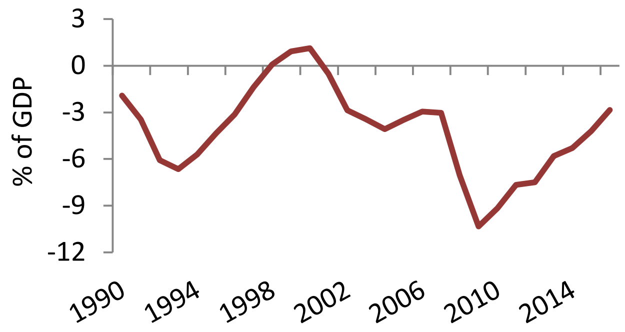
With the exception of the current fiscal year where the forecast for the fiscal deficit has been revised down by £5 billion, the forecast for the next five years is broadly unchanged. The fiscal deficit is forecast to be 2.2 per cent of GDP in 2017-18, the lowest since 2001 and a little lower than the 2.4 per cent expected at the time of the November forecast (Table 2 and Figure 2). The OBR expect the deficit to drop to 1.6 per cent next year and gradually thereafter but even after five years the government continues to run a deficit of around 0.9 per cent of GDP or around £20 billion in today's money. On our soft Brexit scenario, the budget returns to a close to balance position in 2022.

**Figure 1: Real GDP growth forecast and outturns**




Source: OBR, ONS and NIESR

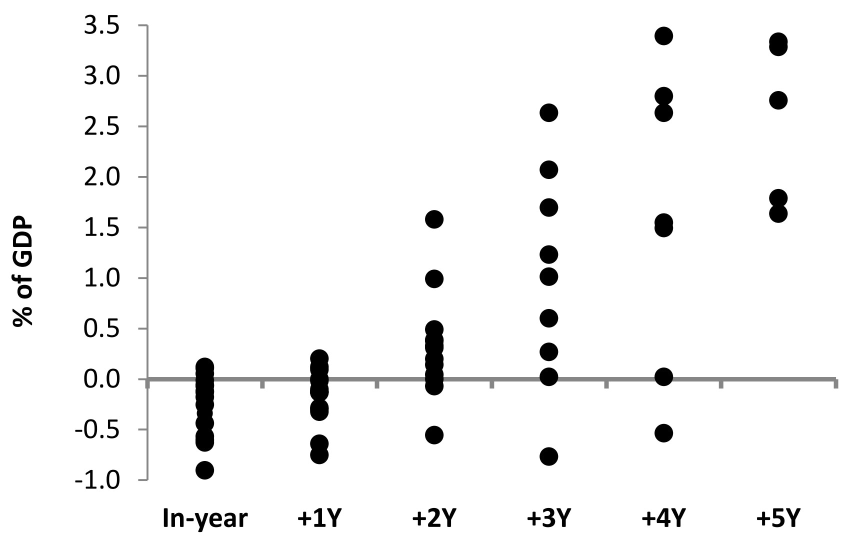
**Figure 2: Public sector net borrowing**




Source: OBR, ONS and NIESR

The news on this year's budget deficit data is less impressive if we compare this year's fiscal performance against the forecast two years ago. Back then the OBR expected the deficit for 2017-18 to be 1.9 per cent and 1.0 per cent for the next year. Figure 3 below places the forecast errors for the fiscal balance in perspective. It shows the OBR's forecast errors for the fiscal deficit since inception ranging from the in-year forecast up until 5 years out. The one year forecast error averages -0.2 percentage points of GDP and the five year error is much larger at around 2.6 percentage points. More broadly though, the figure highlights the importance of interpreting forecast data with caution and for the Chancellor to refrain from short term fiscal measures based on near term fiscal and economic data.

**Figure 3: OBR PSNB forecast errors**




Source: OBR, ONS and NIESR

**Fiscal targets and objective**

The current government has set for itself three fiscal targets and one fiscal objective. Successive governments have either ignored the targets or altered the rules especially when there was a risk of breaching the rules. The table below shows the frequency of the changes to these rules ever since the OBR was created in 2010. Although the Chancellor did not tinker with the rules this time, the quest to create a durable and clear set of fiscal rules remains elusive.

Against that backdrop, the cyclically adjusted net borrowing is expected to fall from 2.3 per cent this year to 1.3 per cent in 2020-21, meeting the first of the three fiscal targets with 0.7 per cent of GDP or £15 billion to spare. Fiscal debt will start falling from 2018-19, some two years before the Supplementary target and this is primarily because the Bank of England's four year Asset Purchase Facility scheme will mature that year.  The OBR is also comfortable with that on current fiscal plans the government will restrict welfare spending to a level below the cap set for 2022-23, thereby achieving the third fiscal target.

We agree that the fiscal rules are likely to be met. That has been our view for some time now. The more germane question is what policies we need to secure robust growth after EU exit. The fiscal space if not used wisely must be conserved.

**Table 3: Fiscal targets and rules since the creation of the OBR**

| Year | Rule | Definition |
|---|---|---|
| **2011** | Fiscal mandate | Achieve cyclically-adjusted current balance by the end of the forecast period (2015-16) |
| | Supplementary target | PSND as a % of GDP to be falling at a fixed date of 2015-16 |
| **2012** | Fiscal mandate | Achieve cyclically-adjusted current balance at the end of the forecast period (2016-17) |
| | Supplementary target | PSND to fall as a % of GDP between 2014-15 and 2015-16 |
| **2013** | Fiscal mandate | Achieve cyclically-adjusted current balance, five years ahead |
| | Supplementary target | Reduce PSND as a % of GDP in 2015-16 |
| **2014** | Fiscal mandate | Achieve cyclically-adjusted current balance, five years ahead |
| | Supplementary target | Reduce PSND as a % of GDP in 2015-16 |
| **2015** | Fiscal mandate | Borrow only to pay for investment- in the third year of the rolling five-year forecast period (2017-18) |
| | Supplementary target | Reduce PSND as a % of GDP in 2016-17 |
| **2016** | Fiscal mandate | Achieve budget surplus in 2019-20 and beyond |
| | Supplementary target | PSND to fall as % of GDP each year |
| | Welfare cap | Spending below cash limits set in July 2015 |
| **2017** | Fiscal mandate<br>Supplementary target | Structural deficit below 2% of GDP in 2020-21<br>Debt falls as a % of GDP in 2020-21 |
| | Welfare cap | Spending below cash limit in 2022-23 |
| | Fiscal objective | Achieve fiscal balance ASAP in next parliament |

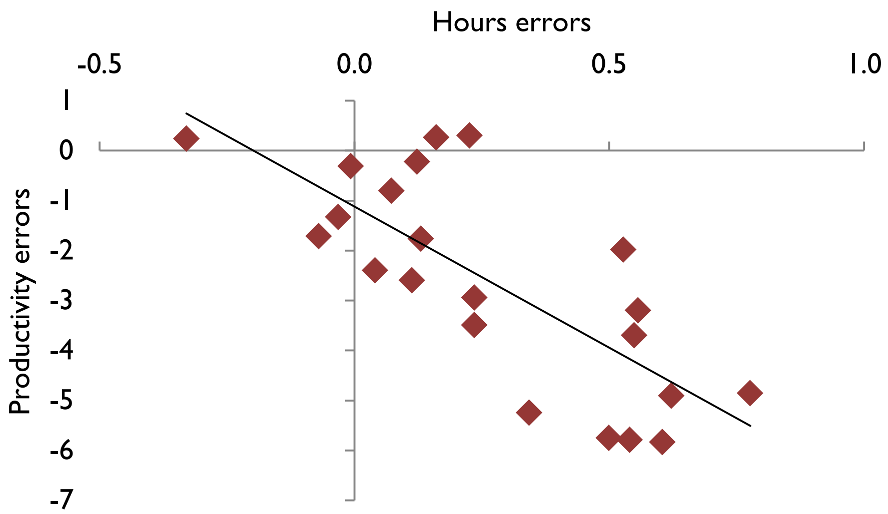
The government additionally, has a broader fiscal objective of achieving a balanced budget. The assumed date to achieve that objective is 2025-26, beyond the forecast horizon for the OBR. Under our soft Brexit scenario, there is every chance that the government will be able to achieve that objective, but against a backdrop of slower GDP growth, that target appears a lot more challenging especially with an ageing population. The Chancellor missed the opportunity to address these structural challenges.

**Productivity and employment**

The OBR had along with us revised lower the forecast for productivity growth in November last year. Since then the data for labour productivity related to the second half of 2017 has surprised to the upside and alongside that there are some early indicators of a small acceleration in wages and wage settlements. We and the OBR have treated this data as noise and retained our forecasts for productivity growth unchanged, but there is a risk that after more than a decade of lacklustre performance productivity is showing early signs of recovery.

The OBR will revisit its productivity forecasts in November, but it is important to note that there has been a pattern the errors that the OBR has made in its forecasts for productivity growth and employment. The OBR's forecast for productivity (output per hour) has proved to be too optimistic and at the same time their forecast for employment has been too pessimistic. In other words, the economic growth and the fiscal position of the government has benefitted from employment gains just at a time when productivity growth has suffered. The link between the two needs further investigation and as such an improvement in productivity growth going forward may not be all good news if that is accompanied by less employment.

**Figure 4: OBR productivity and employment growth forecast surprises**




Source: OBR, ONS and NIESR