

# Can Budget 2020 Deliver Growth?

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## Executive Summary

- **We expect the economy to grow some 1.3% this year, with some downside risks emanating from the nature of EU exit and the impacts from uncertainty over future trade deals**
- **As a very open economy, the UK is quite exposed to any sustained falls in world growth as a result of the coronavirus outbreak**
- **We estimate a downside risk of up to 0.5% to UK GDP growth this year from a sustained economic impact from the Coronavirus if the world growth slows by an equivalent amount**
- **The impact on the current balance of a 0.5pp hit on UK growth would be to add around £5 billion to the deficit (or 0.25% of GDP)**
- **The best response from the Chancellor is not to alter his expenditure plans and let debt rise temporarily**
- **In any case, the government's fiscal rules may have to be revisited if they are not to restrain growth unnecessarily by limiting public investment**
- **Raising productivity growth in the regions, after a decade of stagnation, will require a sustained programme of well-targeted fiscal policy**
- **But while additional public investment of around £20bn is likely to raise capacity by around 0.4% of GDP it will take at least a decade for this to pass through**

## Introduction

On Wednesday 11<sup>th</sup> March, Chancellor Rishi Sunak will deliver his first Budget only 27 days after being appointed. The Chancellor will deliver his Budget as part of a Government with a strong mandate after its comprehensive election victory in December. We can therefore expect him to use this Budget to set an agenda for the next five years. It is neither a pre-election Budget nor one set against the uncertainty of whether we will leave the EU. The Chancellor now has a chance to build for the future with public investment but the process cannot yield benefits very quickly and may be hampered if he decides to be constrained by the fiscal rules. He may be further constrained if he allows the economic downturn likely to result from the effects of the Coronavirus to limit his room for manoeuvre. **It would be better in our view to scrap these rules and move towards plans to build up net worth in the public sector balance sheet rather the short-term agenda of balanced budgets.**

This first section of this report outlines our view on the outlook for weaker economic growth. The second section provides a short overview of the issues raised by the current set of fiscal rules. The third section assesses the issues raised by the “levelling up” agenda and the fourth section examines the extent to which capacity can be augmented by public investment. The final section concludes.<sup>1</sup>

### 1. Outlook for weaker economic growth

The economy weakened towards the end of last year. We estimate that GDP in the fourth quarter was unchanged from the previous quarter. But business surveys have signalled an improvement in sentiment since the decisive outcome of the 2019 general election and a substantial reduction in the risk of a disorderly no-deal Brexit. While business surveys have provided an unreliable signal in the past, notably in the immediate aftermath of the 2016 referendum, investment and hiring intentions for 2020 are significantly higher than in recent months. There are also signs that the global manufacturing slowdown has now bottomed out.

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<sup>1</sup> Thanks to Jagjit Chadha, Barry Naisbitt and Iana Liadze for helpful comments and suggestions. We also thank Patricia Sanchez Juanino for compiling the database. Unless otherwise stated, the source of all data reported in the figures and tables is the NiGEM database and forecast baseline. The UK forecast analysis was completed on 24 January 2020, more recent data is incorporated in the text. Thanks to the ESRC for funding the production of this report.

On 31 January, the UK entered a transition period which maintains access to the EU single market and customs union but excludes UK policymakers from European legislative processes. For businesses this means that trade with the EU can continue for this year without additional frictions. However, uncertainty continues to be a chronic feature of the economy as details of the future trading arrangements between the UK and the EU and other major trading partners remain unclear.

In our forecast, investment and productivity growth pick up only gradually as economic and political uncertainty lifts over time. In the short term, economic conditions are therefore set to continue roughly as they have been with slow growth and output close to capacity. **GDP is expected to grow by around 1½ per cent in 2020 and in 2021, unchanged from 2019. The main risks to this forecast arise from the economic impact of the Coronavirus and the steps taken to limit its spread, and from the possibility later this year of an exit from the EU on WTO rules.**

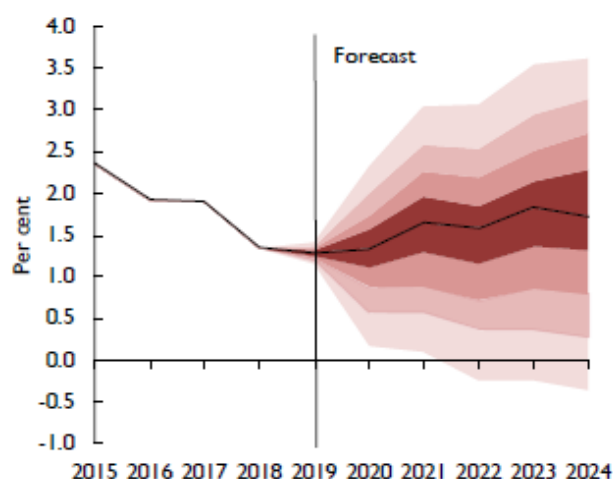
We have changed our long-term forecasting assumption regarding UK-EU trade and now assume that trade will take place on the basis of a bare-bones free trade agreement. We assume the adjustment towards this new trading relationship is smooth and major disruptions to supply chains can be avoided at the end of 2020. Relative to our previous forecasts, the long-run level of labour productivity is assumed to be 1–2 per cent lower. As a result, long-run economic growth is slightly weaker than previously forecast. (see Figures 1, 2 and 3).

**Figure 1:** Summary of the forecast

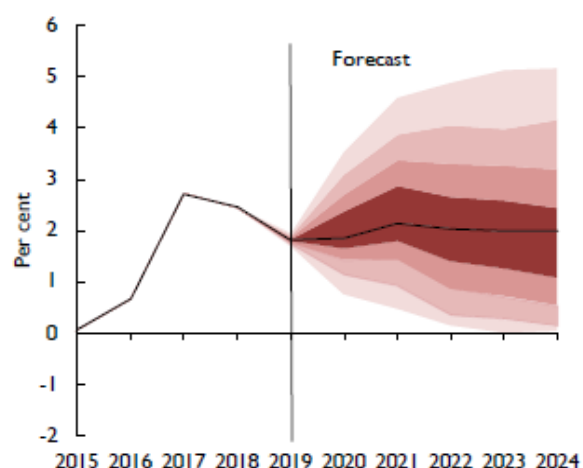
	2016	2017	2018	2019	2020	2021	2022	2023	2024
GDP	1.9	1.9	1.3	1.3	1.3	1.6	1.6	1.8	1.7
Per capita GDP	1.1	1.3	0.7	0.7	0.7	1.1	1.1	1.3	1.2
CPI Inflation	0.7	2.7	2.4	1.8	1.8	2.1	2.0	2.0	2.0
RPIX Inflation	1.9	3.8	3.3	2.6	2.7	2.9	2.7	2.7	2.6
RPDI	0.4	1.3	2.4	1.0	2.4	2.3	2.2	2.3	2.2
Unemployment, %	4.9	4.4	4.1	3.8	3.8	4.0	4.1	4.0	4.1
Bank Rate, %	0.4	0.3	0.6	0.8	0.5	0.5	0.7	0.9	1.2
Long Rates, %	1.3	1.2	1.4	0.9	0.9	1.3	1.6	1.9	2.1
Effective exchange rate	-9.9	-5.5	1.9	-0.4	2.3	0.2	0.4	0.3	0.3
Current account as % of GDP	-5.2	-3.5	-3.9	-4.1	-3.2	-3.4	-2.9	-2.5	-2.2
Net borrowing as % of GDP <sup>(a)</sup>	2.8	2.6	1.8	2.2	2.3	2.8	2.9	2.8	2.7
Net debt as % of GDP <sup>(a)</sup>	83.2	83.2	81.3	80.8	79.1	77.3	78.5	78.4	78.4

Notes: RPDI is real personal disposable income. PSNB is public sector net borrowing. PSND is public sector net debt. (a) Fiscal year, excludes the impact of financial sector interventions, but includes the flows from the Asset Purchase Facility of the Bank of England. Annual averages unless stated otherwise.

**Figure 2: GDP growth fan chart**



**Figure 3: Inflation fan chart**



The labour market remains tight and the slight softening observed since early 2019 is not expected to gain pace. The unemployment rate remains at 3.8 per cent and the number of vacancies has stabilised with levels remaining historically high. As a result, wage growth has been robust and is expected to stabilise at an annual rate of 3–4 per cent this year. With little productivity growth, this means that unit labour costs are growing at an annual rate of more than 3 per cent, although there is little sign yet of this translating into significant price pressures. With regulatory changes leading to lower prices for utilities and competitive pressures high, we forecast average consumer price inflation to remain a little below the Bank of England’s 2 per cent target in 2020. Since our last forecast, the sterling effective exchange rate has appreciated by nearly 5 per cent, which further offsets domestic inflationary pressures through lower import prices.

With hard economic data remaining weak, inflationary pressures contained, and global monetary policy in easing mode, we have conditioned our forecast on the assumption of Bank Rate being cut by 25 basis points at the end of March and then remaining at 0.5 per cent until the end of 2021. **The potential impact of the Coronavirus on the economy makes that cut much more likely.** The Bank of England Monetary Policy Committee left rates on hold at its January 2020 meeting in the expectation that demand growth would soon outrun weakened supply growth.

Our forecast accounts for additional fiscal loosening which we expect to be announced in the Budget. We assume that public investment growth will be lifted but expect this to be a gradual process that will not have much of an effect on the economy before the end of the calendar year.

Compared to our November update, risks around our forecast now appear to be more symmetric. This is because of a considerable reduction in the risk of a disorderly Brexit outcome in the near term, although a cliff edge scenario at the end of 2020 remains a possibility should

trade negotiations with the EU fail. The global trading environment also remains uncertain. Should global trade further deteriorate this would lead us to revise down our forecast.

In our forecast, we have been cautious about the economic effects of an improvement in business sentiment at the beginning of this year and it is possible that there could be a more significant bounce in activity than we have allowed. A faster than expected pick-up in investment and productivity growth constitutes an upside risk to our forecast, as does a sharper than expected loosening of fiscal policy.

Taking downside and upside forecast risks together, we now expect there to be a chance of less than 10 per cent that average output growth is negative in 2020. This is illustrated by our fan chart (Figure 2) and is lower than at the time of our last forecast when we thought there was a 15 per cent chance of negative year-on-year growth in 2020. The recent outbreak and spread of the Coronavirus mean that GDP growth this year is more likely than not to be in the bottom half of the fan chart. **We will report on our update estimate of Q12020 GDP on Budget Day itself.**

We see the risks to our CPI inflation forecast as being roughly symmetric around the 2 per cent target.

## 2. Constraints on fiscal policy

In November the Government proposed a new set of fiscal rules that make room for more public sector investment than Theresa May's administration's aim of eliminating public sector borrowing by the mid-2020s. The proposed new rules are:

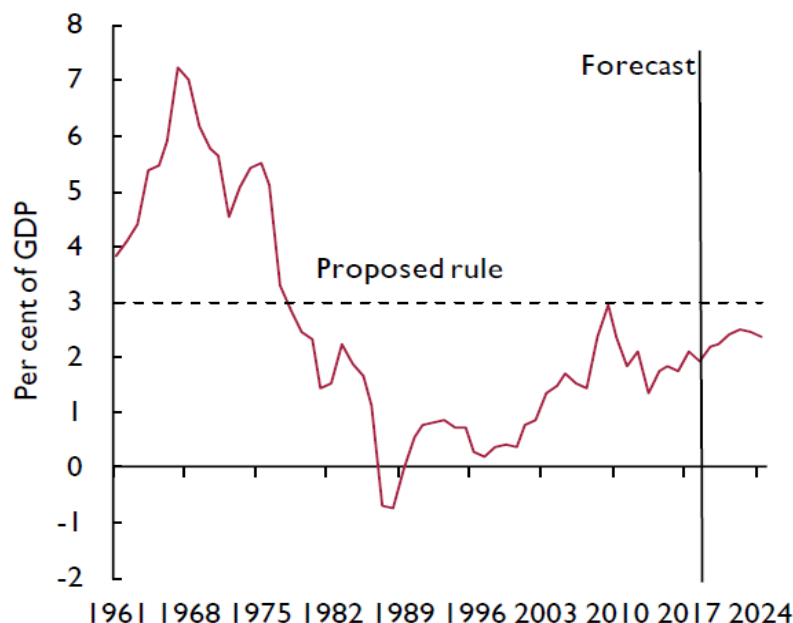
- Balance the current budget within three years.
- Public investment not to exceed 3 per cent of GDP.
- The ratio of debt interest cost to tax revenue to remain below 6 per cent.

Details on the new fiscal rules are expected to be announced in the Budget.

Our concern is that these rules might be excessively constraining and prevent the government from delivering on its productivity agenda.

**Currently, the government has room against its new rules to increase public investment by 1 per cent of GDP, or £20 billion per annum (Figure 4).** However, increasing investment quickly by this amount looks challenging and, with the economy operating close to potential, extra public investment is likely to crowd out some private sector activity. In our forecast, we assume a modest increase of public investment from 2 to 2½ per cent of GDP.

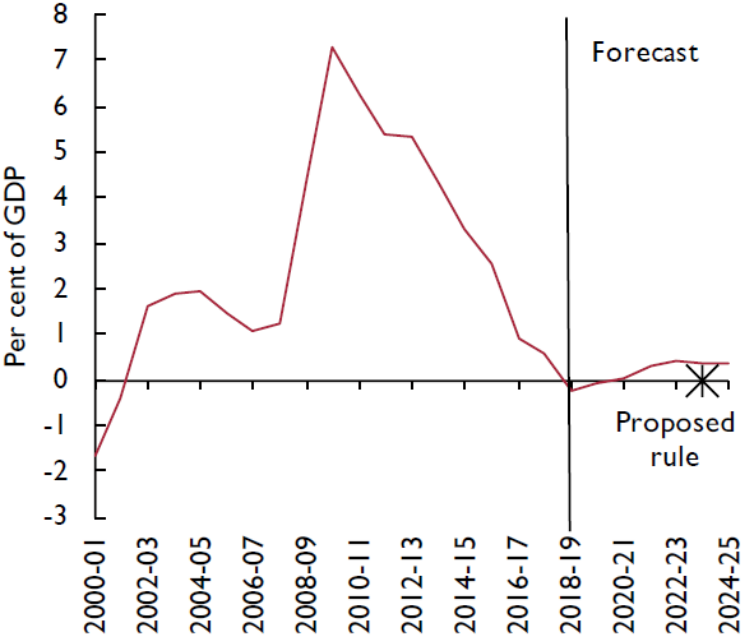
**Figure 4:** Net public investment as a share of GDP



Source: NiGEM database and NIESR forecast.

A further limitation is that the scope to raise public investment will also be constrained by limits on day-to-day spending. Most public investment projects require not only an increase in capital expenditure but also higher current spending to pay for operating costs. For instance, building more hospitals or schools will require paying for staff to run them. Against this backdrop, the government's proposed current spending rule leaves very little room. After reaching more than 7 per cent in the aftermath of the financial crisis, the current budget deficit has now fallen to zero after a decade of stringent fiscal restraint (Figure 5). **But, without tax rises, there will not be much scope to expand day-to-day spending and meet the balanced current budget rule, especially given the increasing demand for public services to meet the needs of an ageing society.** This constraint is likely to limit the effectiveness of additional public investment. Our forecast assumes that there will be some slippage in the current budget target.

**Figure 5:** Current budget deficit as a percentage of GDP



Source: ONS, NIESR calculations.

Another constraint on a substantial uplift in public investment is the proposed new rule limiting debt interest payments as a share of overall revenues. It is unclear exactly which definition will be used but room for additional borrowing would on all conceivable measures be limited (Figure 6). In our view, a plausible definition would focus on the ratio of general government interest payments to current receipts after netting off the savings made by the public sector being able to borrow at Bank Rate through Bank of England asset purchases financed by issuing central bank reserves. **On this rule, in 2018–19 there would have been room for interest payments to be higher by around £10 billion.** It would cover borrowing both by the central government and local authorities. At present, with low gilt yields, this rule appears unlikely to act as a constraint on plausible investment plans. But interest payments are hard to predict. This is partly because payments not only depend on gilt yields but also on the rate of RPI inflation through index-linked bonds and on Bank Rate which determines the interest paid on short-term debt and on funding through the Asset Purchase Facility.



**Figure 6:** Interest payments as a share of receipts on different measures

	Including APF transfers			Net of APF transfers		
	2018-19 ratio in %	Room against 6% (% of receipts)	Room against 6% £ billion	2018-19 ratio in %	Room against 6% (% of receipts)	Room against 6% £ billion
Public sector interest/Public sector receipts	7.0	-1.0	-7.8	5.6	0.4	3.6
Central govt interest/Central govt receipts	6.5	-0.5	-3.9	5.0	1.0	7.4
General govt interest/General govt receipts	6.2	-0.2	-1.8	4.8	1.2	9.5
Central govt interest/Public sector receipts	6.0	0.0	0.0	4.6	1.4	11.3

Sources: ONS, NIESR calculations.

Note: 2018–19 financial year. Public sector excluding public sector banks. APF is the Asset Purchase Facility of the Bank of England.

Overall, there appears to be a conflict between the government’s aim of increasing public investment by as much as was promised during the election campaign and the proposed fiscal rules. This calls into question the purpose of the fiscal rules if they are likely to limit worthwhile public investment. The main constraint on public sector investment should be whether it meets sensible investment criteria and not whether it violates arbitrary, self-imposed fiscal rules.

We would make three points about the proposed fiscal rules.

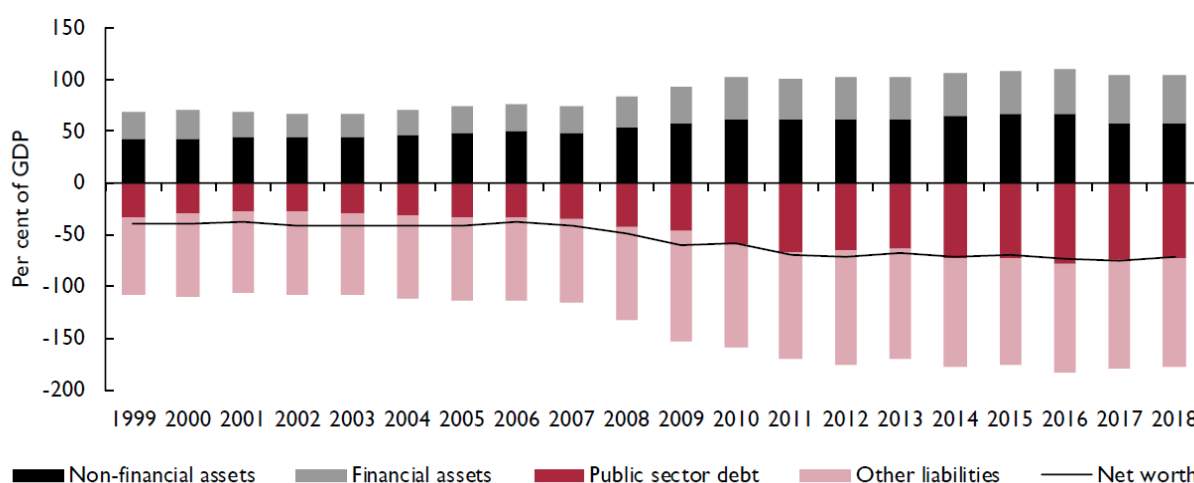
- First, limiting public investment to no more than 3 per cent of GDP when many projects pass well-designed cost-benefit tests is likely to force choices to be made between investment in different places. This would lead to some regions receiving less investment than they need, particularly in light of the government’s ambition to address regional inequalities and raise long-run growth prospects.
- Second, there is a risk that without some tax increases the new fiscal rules will be broken soon after they are applied. There is relatively little scope within them to allow for plausible changes in economic circumstances. In the past when this has happened governments have either made damaging adjustments to their spending priorities to meet fairly arbitrary self-imposed rules or changed the rules. Neither approach is a satisfactory way of running fiscal policy and adds to political and economic uncertainty.
- Third, the proposed rules appear arbitrary and it is not clear what analytical framework lies behind them, though this may be revealed in the Budget. A focus on the public sector balance sheet would allow more public sector investment to take place.

**By allowing a balanced current budget and investment spending of up to 3 per cent of GDP, the new rules imply that the debt-to-GDP ratio would be stabilised at around its current level of 80 per cent of GDP.** Significantly higher levels of public investment would lead to the debt-to-GDP ratio rising, but that would not be a problem provided that the investment was economically worthwhile because, in that case, it could generate future income streams that could service the debt.

In general, it would be better to frame fiscal policy decisions in terms of their implications for the overall public sector balance sheet rather than public sector debt alone.

The overall balance sheet takes account of the public sector assets that can generate income to service that debt, as well as other liabilities that are not included within standard measures of public sector debt. At the end of 2018–19, public sector net worth (the difference between public sector assets and liabilities) was estimated at £1,567 billion, close to the value of public sector debt securities at £1,615 billion, with other liabilities, including the estimated cost of unfunded public sector pensions, roughly offsetting the value of public sector assets (Figure 7).

**Figure 7:** The public sector balance sheet



Source: ONS, International Monetary Fund's Government Finance Statistics framework in the public sector finances: Appendix E, 21 November 2019.

The public sector balance sheet, as measured by net worth, weakened following the financial crisis, reflecting a long period of borrowing in excess of net investment. A reasonable case can be made that the government should be aiming to repair the public sector balance sheet now that the economy is in a better position, especially as there are many spending priorities on the horizon associated with an ageing population. The Office for Budget Responsibility has estimated that age-related spending will need to increase by 8.7 percentage points of GDP over the next fifty years. In our own analysis, we showed how age-related demands are increasing the amount of public services that are required in the next five years.

But, on the other hand, a case can be made that, with long-term gilt yields below the estimated long-run rate of growth of the economy, there is ample room to run even larger current deficits without the public sector balance sheet deteriorating. Presumably, this argument is one motivation for the new debt interest rule.

The key point though is that the choice over the most desirable future path of public sector net worth can be separated from the choice over how much public sector investment to do. The latter should be determined by how many projects pass cost-benefit tests rather than how many can be fitted within an arbitrary rule limiting public investment to 3 per cent of GDP. The proposed rules confuse these different fiscal policy choices.

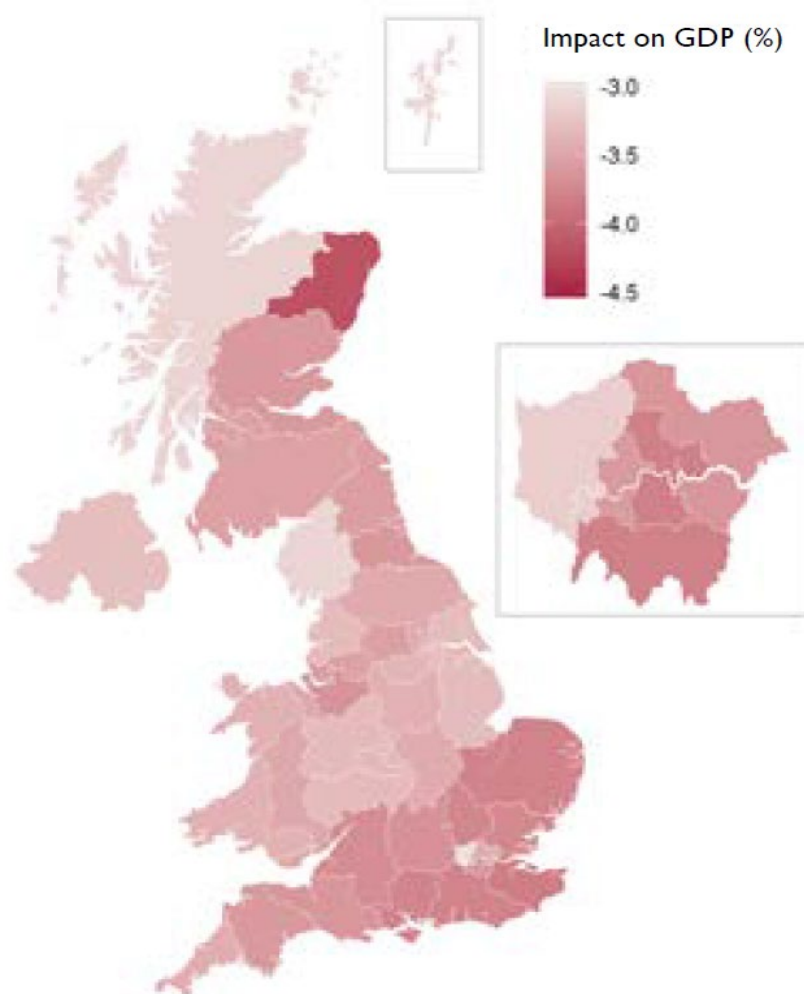
### 3. A 'levelling up' agenda

The General Election result delivered a clear mandate to the new government to 'get Brexit done' and 'unleash the potential of our whole country'. The former commitment has now been achieved in the sense that the United Kingdom formally left the European Union on 31 January. The latter commitment is widely interpreted as a promise to improve living standards around the country by 'levelling up' incomes and opportunities by tackling some of the regional disparities that are thought to have contributed to the 2016 vote to leave the European Union.

On Brexit, the government has made it clear that it wants to negotiate a deep free trade agreement with the EU by the time that the transition period ends on 31 December 2020. But the short timetable, and the government's apparent preference for regulatory divergence, is likely to result in a bare-bones agreement. As such, UK exporters will face increasingly costly non-tariff barriers to trade with the EU from next year. **In the long term leaving the EU single market and customs union is expected to reduce GDP by 3–4 per cent relative to what it would have been had the UK remained in the EU.**

**It is possible that Brexit could contribute to the levelling up of living standards across the country by slowing down the pace of expansion in better-off regions, though our own analysis is that its negative effect will be fairly evenly spread (Figure 8).**

**Figure 8:** Regional impact of a UK-EU Free Trade Agreement



Source: NIESR, NiGEM simulation.

Notes: Per cent of regional output relative to continued EU membership.

Insets: Shetland islands and London

Fiscal policy will be one of the key instruments used by the government to address regional disparities and promote economic growth. The Government has said that the focus for the Budget would be on 'people and place'. The new regional agenda is then expected to be set out in detail in the Spending Review in the Autumn. Ahead of this, HM Treasury has said that it intends to invest more in skills and promoting infrastructure schemes in the Midlands and North. It has also said that it wants to boost the UK growth rate to around 2¾ per cent a year, around the post-war average, but significantly faster than what has been achieved in recent years.

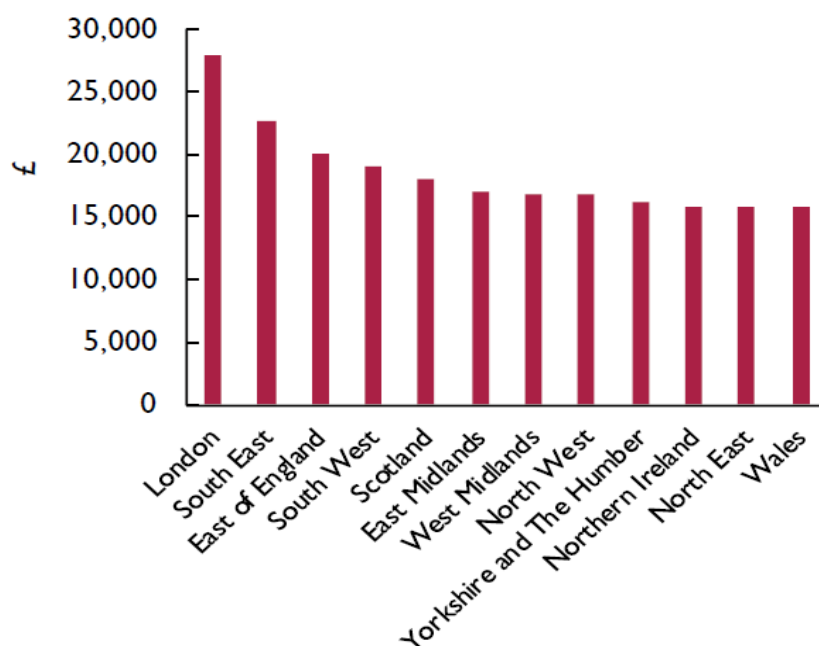
**There are significant challenges in aiming both to raise the overall growth rate and iron out longstanding regional disparities with fiscal measures that are expected to be limited in their effect and heavily constrained in their scope by rules aimed at maintaining fiscal discipline.**

### 3.1 Regional disparities

An indication of the need for some 'levelling up' can be drawn from the substantial variation in household incomes across places in the United Kingdom. At a broad regional level, average household incomes are highest in London and lowest in the North East, Wales and Northern Ireland (Figure 9). But aiming to level up at a broad regional level is not necessarily a well-targeted policy. As Andy Haldane, the chief economist at the Bank of England, has emphasised, "however striking the regional differences in economic and societal health across the UK relative to historical and international standards, these conceal even more striking differences in levels of health, wealth and happiness within regions".

It is also worth stressing that income 'does not necessarily buy happiness'. According to official statistics, London boroughs such as Lambeth, Hackney, Islington and Camden persistently have had some of the lowest personal well-being ratings since the ONS began measuring well-being in 2012, while some of the highest ratings have been in poorer Northern Ireland. This mismatch between measures of income and well-being likely reflects differences in pollution, crime, work-life balance and commuting. This again suggests that simply aiming to improve outcomes in poorer regions is not necessarily a well-targeted policy when there is also significant need in better-off places.

**Figure 9:** Disposable income per head by NUTS 1 region



Source: ONS.

Note: Gross disposable household income per head, 2017.

Attempting to raise the overall growth to around 2¾ per cent a year at the same time as levelling up the regions will require significant improvements in productivity throughout the economy, especially where productivity has hitherto been lagging. Productivity is 30–40 per cent higher in London than in all other regions and UK nations (figure 10). This reflects the concentration of higher-value and knowledge-intensive service industries in London. Regional differences in productivity levels have not changed much over the past twenty years despite the financial crisis impacting particularly on businesses based in London.

**Figure 10:** Regional productivity gap relative to London



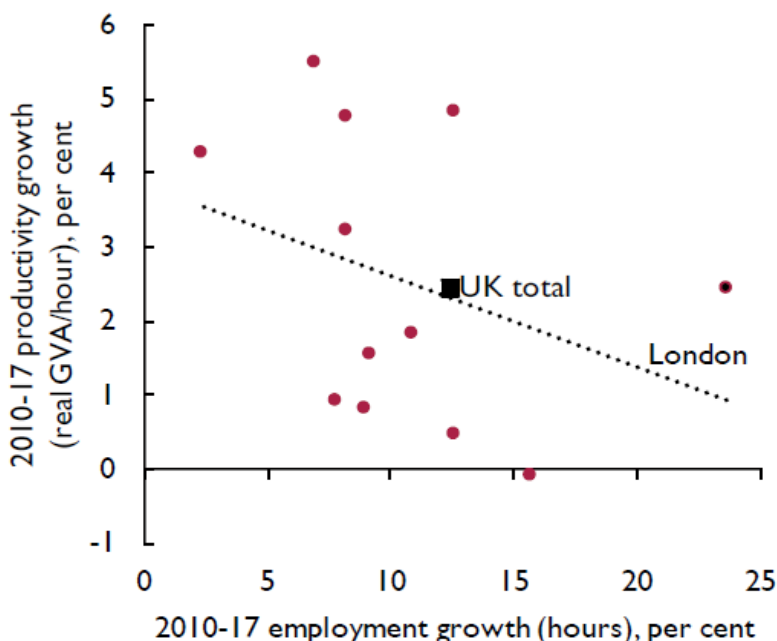
Source: ONS, NIESR estimates.

Note: Gross value added per filled job.

■ 2002    ■ 2010    ■ 2017

Given the fairly limited scope for significant employment growth in the coming years, except perhaps in the North East, productivity growth will need to average close to 2½ per cent a year if the Chancellor’s growth aim is to be met. To put this in context, output per hour in 2019 was only 2.9 per cent higher than at its 2007 peak. The reasons for the weakness in productivity growth have been widely debated. It is therefore a considerable challenge to achieve close to this rate of growth every year. This holds in particular given that past productivity advances in the UK were dependent on technological innovations made globally and on a trading environment that was more open than is currently foreseen. Nevertheless, there is clearly scope for a pick-up in productivity growth. **Since the 2008–9 recession, whole economy output growth has mainly been achieved by absorbing labour market slack rather than improving efficiency.** Figure 11 shows that at the regional level there has been a negative association between employment growth and productivity growth. With little labour market slack left to absorb, demand growth will increasingly need to be met by productivity growth if the economy is to grow at all.

**Figure 11:** Post-crisis productivity growth vs employment growth in NUTS 1 regions



Source: ONS, NIESR.

Note: Productivity defined as real GVA per hour, 2016 prices. Employment in hours.

Importantly, given the large productivity lead of London, growth in the less-productive regions contributes less to aggregate productivity growth than increases in productivity in London. This means that productivity growth would need to be faster in the poorer regions if overall growth is to meet the Chancellor’s aim while the regions are levelling up. A rough calculation suggests that if productivity in the London economy were to grow by only 1 per cent a year, then it would need to grow by 3.1 per cent a year in all other regions if the UK was to achieve productivity growth of 2½ per cent a year. Only two out of 168 NUTS3 areas in the UK (mid-Lancashire and Dorset county councils) achieved average annual growth rates in output per hour in excess of 3 per cent between 2010 and 2017.

Differences in productivity across regions partly reflect differences in the skills and qualifications of the labour force, innovative activity and physical and digital infrastructure. In London, 57.5 per cent of the working population aged 25–64 have a university degree, compared with 33 per cent in the North East and West Midlands. London ranks lowly in terms of research and development spending as a share of GDP but has highest per capita spending on transport infrastructure. London is also the leader in terms of the share of premises with ultrafast broadband (75 per cent), though Northern Ireland is the leader in full fibre connections (25 per cent).

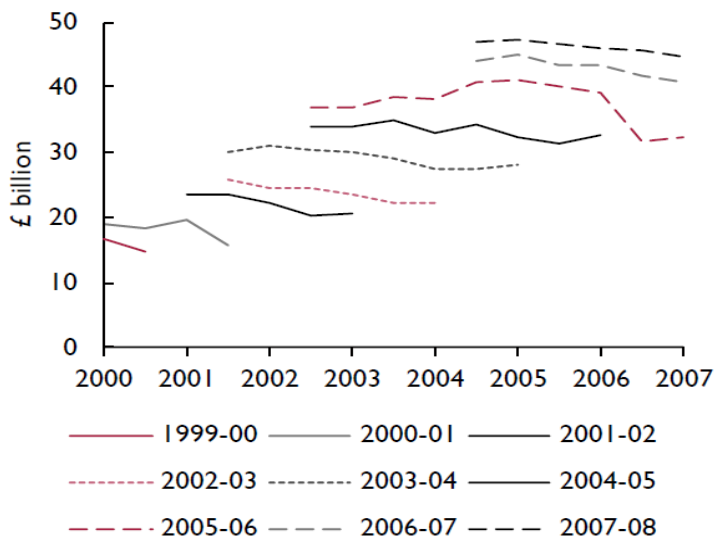
## 4. Addressing growth disparities through government investment

The General Election has moved the focus onto public investment and how this can contribute to economic growth. **Over the past five decades, public investment has fallen from more than 6 per cent of GDP to around 2 per cent today, partly resulting from the privatisation of capital-intensive utilities companies (figure 4).** The government aims to return the share of net public investment in GDP to 3 per cent, equivalent to an increase of about £20 billion per year. New rules in the way HM Treasury allocates funding across the country will enable the Chancellor to target regions that in the past have received a smaller share of public investment. The inequalities generated and reinforced by current Green Book rules argue in favour of a strategic view taking account of the whole of the UK when regional funding decisions are made.

**But it may not be straightforward to raise public investment quickly when the economy is operating at around full capacity.** The early-to-mid-2000s was one of the few periods when the public investment share of GDP rose as a result of deliberate government decision, outside of major recessions. In many ways, the economic backdrop was similar then to today, with GDP growth close to potential and unemployment low. Figure 13 shows revisions over time in nominal investment plans for different financial years between 2000 and 2007. It illustrates that the government's initially ambitious investment objectives could not be met and projections had to be revised down repeatedly. One reason for this was capacity constraints in the economy delaying the use of available funds. With employment currently at a record high and elevated labour shortages, the Chancellor may find it difficult to implement ambitious public investment plans.



**Figure 12:** Public investment plans and revisions 2000-07

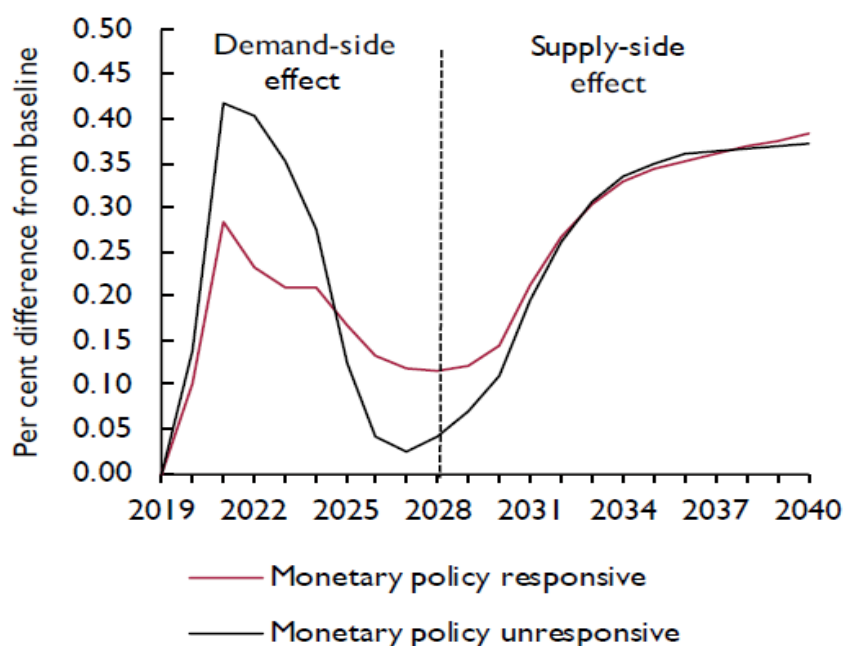


Sources: NIESR, HM Treasury/OBR Financial Statement and Budget Report, Economic and Fiscal Strategy Report and Financial Statement and Budget Reports, Economic and Fiscal Outlook, multiple issues.

Note: Public sector gross investment in nominal terms. Lines represent plans for a given financial year and revisions over time (forecast dates on horizontal axis).

Suppose though that public investment could be increased sharply. Figure 14 plots the estimated dynamic response of economic output when government investment is increased by 1 per cent of GDP for a sustained 5-year period, calculated using the National Institute Global Economic Model (NiGEM). This assumes that the composition of investment is similar to historical investment projects. The dynamic impact of a government investment shock can roughly be divided into two parts: an initial boost to activity in the short term through the demand side, and a permanent boost to output through supply in the long run. In the short term, economic output would be 0.3–0.4 per cent higher for a shock similar to that envisaged by the government, but that impact would only last for about 4–5 years. The supply-side effect on the level of GDP would take much longer to materialise, reflecting the gradual boost to the stock of public sector capital. **The estimated long-run impact of less than half a per cent of GDP would not be sufficient to offset the estimated 3–4 per cent loss due to Brexit.**

**Figure 13:** The dynamic impact of a government investment shock on the economy

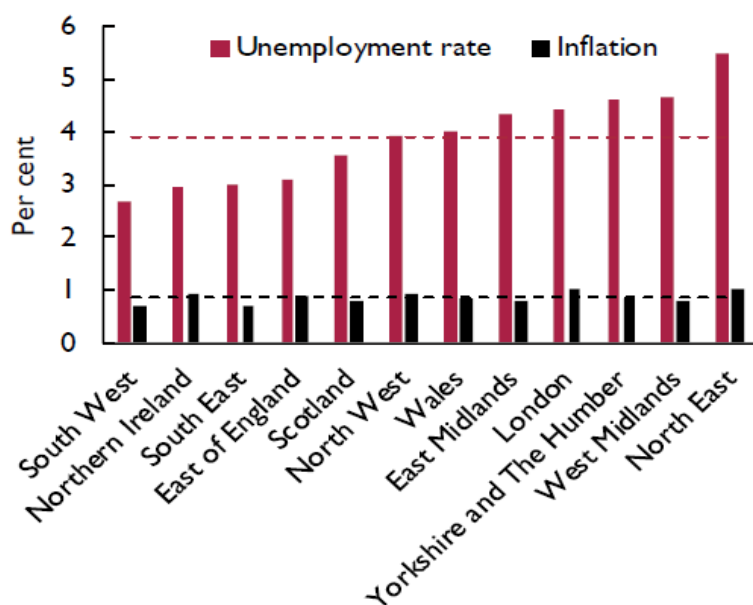


Source: NIESR, NiGEM simulation.

Note: GDP level response relative to base of an increase in government investment over the period 2020–24 of 1 per cent of GDP.

The two lines in Figure 14 show that the short-term impact would depend on the response of inflation and monetary policy and thus, on the state of the business cycle. With output close to potential, a boost to public sector investment would draw resources away from the private sector by pushing up wages, prices and interest rates. Public sector activity would crowd out activity in the private sector. **This suggests that investment activity should be targeted at areas with relatively more economic slack than in the rest of the economy.** Not unlike in a monetary union, this would contain inflationary pressures in the economy as whole, reduce the need for monetary tightening and support overall economic growth. The unemployment rate is above the national average in the North East, Wales, the Midlands and Yorkshire and the Humber while inflation is fairly similar across regions suggesting relatively larger output gaps compared to the rest of the country.

**Figure 14:** Regional output gaps



Sources: ONS, Datastream, NIESR CPI Tracker.

Note: Unemployment rate over 2018q4 to 2019q3. Trimmed mean (underlying) inflation, 2019 average.

By adding to the capital stock, higher public sector investment can be supportive of productivity growth, on our estimates increasing the level of productivity by an average of half a per cent in the long run (Figure 15). If targeted appropriately, this could help narrow wage gaps across the country. NIESR’s 2019 Election Briefing and November Review highlighted a number of policy fields in need of public investment, from education and skills development to physical infrastructure and digital infrastructure.

On our main forecast, the sustainable rate of economic growth is in the range of 1–2 per cent. The last time economic growth was persistently above 2 per cent was in the late-1990s to mid-2000s, a period of rapid globalisation. Public sector investment could add half a per cent to the level of potential GDP, or slightly more if crowding out effects are smaller than we estimate. However, it would be unrealistic to expect potential output growth to double as a result of a relatively small boost to investment.

**Figure 15:** Long run economic impact of government investment shock

Potential GDP	0.7	Real interest rate*	0.2
Labour productivity	0.4	Business investment	-0.3
Real wages	1.3	Public net debt/GDP*	8.8

Source: NIESR, NiGEM simulation.

Note: Response relative to base of an increase in government investment over 2020–24 of 1 per cent of GDP. Average effect 2035–40. Per cent difference from base, \* percentage point difference from base.

## Conclusion

The Chancellor needs to deliver a Budget for long term growth. But there are two separate problems. First action to boost demand through tax cuts or public expenditure will quickly uncover capacity constraints. Current estimates of trend capacity growth are barely much over 1 per cent and, given little estimated slack in the economy, a demand surge is likely to be inflationary and hence met with a response from the Monetary Policy Committee of the Bank of England. Secondly, even if policies were implemented that did create the conditions for faster non-inflationary growth by expanding supply, these policies simply cannot lay down that extra supply all that quickly. **Our estimates are that 1 per cent of GDP of government investment would increase long run supply by around 0.4 per cent in a decade or so.**

The determination to boost activity therefore carries two separate risks. The first that it brings forward a monetary policy tightening cycle that the real economy cannot yet bear. This would leave the MPC with the problem of either acting flexibly and hoping the inflation pressures will not persist or risk a severe stress of the financial system as we suspect the sensitivity of output to interest rate changes is relatively high given the level of private and public debt. The second is that having promised the electorate both faster growth and a “levelling up” in the economy, it simply cannot be delivered very quickly. And that may further frustrate a population that demands a significant improvement in economic prospects. Indeed, free trade deals will open up the economy to the gales of competition that will drive down prices in tradeable industries and may in the short run further accelerate job losses in those industries. **If the Budget can help deliver a plan to help us adjust to the new post-Brexit economy and buy some time from those who have already lost years, it will have done a very good job.**