3. Risks to the UK public finances

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Key findings

- **Borrowing has now returned to pre-crisis levels, and is lower than successive post-referendum forecasts.** At £40 billion, or 1.9% of national income, the deficit in 2017–18 was the smallest annual borrowing figure since 2001–02. It was also over £18 billion lower than the OBR forecast in March 2017, and at a similar level to the last pre-referendum forecast in March 2016. This is not because the OBR's economic forecasts were too gloomy in November 2016; rather, the public finances have proved more robust than expected given economic performance.

- **Developments since March suggest that the outlook for borrowing has improved.** Data from the first five months of 2018–19 suggest that borrowing this year might be around £5 billion lower than the OBR's forecast of £37 billion. By 2022–23, it might be around £6 billion lower than the OBR's forecast of £21 billion.

- **On the narrowest possible definition, 'ending austerity', as the Prime Minister has promised, would require the Chancellor to find £19 billion of additional public service spending relative to current plans by 2022–23.** That would leave unprotected day-to-day departmental spending just constant in real terms, and falling as a share of national income. It would still leave in place £7 billion of further cuts to social security.

- **Without much higher growth than forecast or substantial tax rises, 'ending austerity' is not compatible with eliminating the deficit by the mid 2020s.**

- **The deficit is down to pre-crisis levels, but debt is higher than it was by 50% of national income (over £1 trillion in today's terms).** Running a deficit of 1.8% of national income (as forecast for 2018–19) in 'good times' could easily leave debt on a rising path as a share of national income over the long term, while in the past it would have been consistent with projected debt falling fairly quickly. This is due to a combination of low growth forecasts and student loan accounting flattering the headline borrowing measure.

- **There is a lot of uncertainty around any public finance forecast, but current levels of uncertainty are higher than usual.** Based on historical forecast accuracy, the central forecast implies a one-in-three chance that the deficit will be eliminated in 2022–23, but a similar chance that the deficit in that year will rise from its current level. Brexit uncertainties raise the chances of the deficit turning out a lot different from forecast.

- **We should worry that the Chancellor seems to treat forecast improvements and deteriorations differently.** Evidence since 2010 suggests that Chancellors are more willing to spend windfall improvements than to enact a fiscal tightening when the forecast worsens. If this pattern of behaviour were to continue, this effect would push up the central forecast of the deficit in 2022–23 by £10 billion.

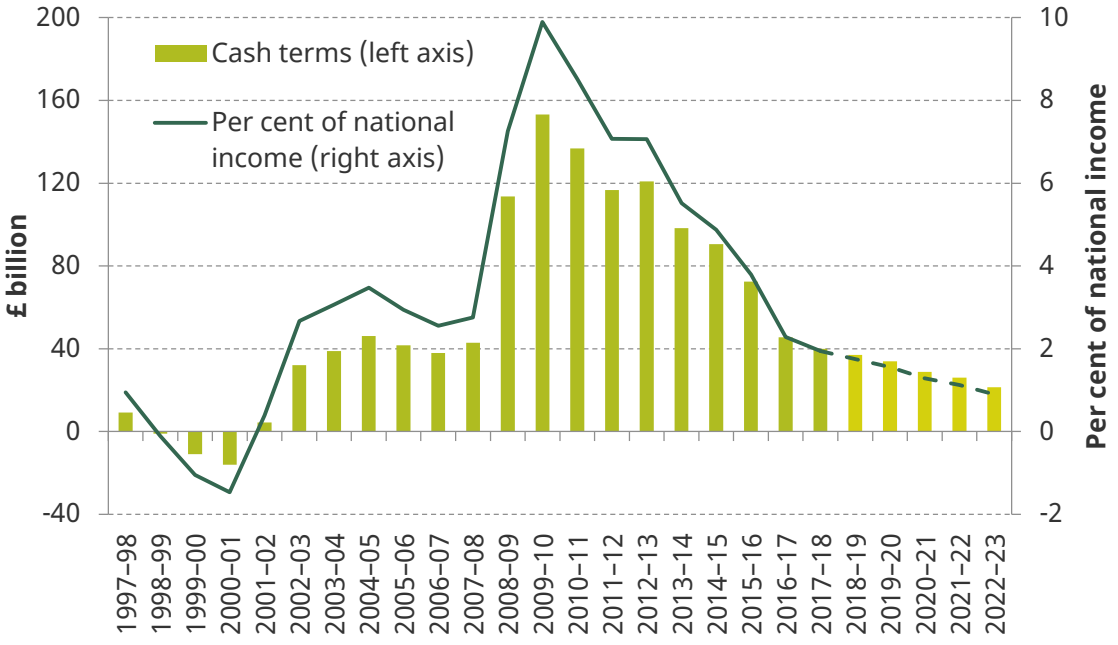
3.1 Introduction

Public sector net borrowing – the difference between how much the government spends and how much it raises in tax and non-tax revenues – has fallen substantially since its peak in 2009–10, when it stood at £153 billion or almost 10% of national income (see Figure 3.1). The latest estimates suggest that in 2017–18 this deficit was £40 billion. At 1.9% of national income, this is less than was borrowed in the years immediately prior to the financial crisis and associated recession and is in line with the average deficits run by UK governments over the 70 years prior to the crisis.

Despite this, the government's stated aim requires that borrowing fall further: its overarching fiscal objective is to eliminate the deficit entirely by the mid 2020s. In recent times, UK governments have never had several successive years of budget surpluses: the last time there were four years in a row without a deficit was the period from 1948 to 1951.

The Office for Budget Responsibility (OBR) forecasts presented alongside the Spring Statement confirm that meeting the objective of eliminating the deficit will be far from easy. These imply that in 2022–23, some 13 years after then-Chancellor George Osborne first began cutting public sector borrowing, there will be a deficit of £21 billion or 0.9% of national income. With none of this deficit deemed to be due to temporary weakness in the economy – and with the ageing of the population projected to place increasing pressure on public spending – this implies further fiscal consolidation, for the next five years and beyond. And as set out in Chapter 4, there are considerable demands for more spending on public services than is implied by the Spring Statement plans: not least for the NHS

Figure 3.1. Public sector net borrowing since 1997–98



Note: Yellow bars and dotted line refer to the OBR's March 2018 forecast.

Source: Office for Budget Responsibility, 'Public finances databank', September 2018, http://obr.uk/data/.

which, on its 70th birthday in June, was promised an additional £20 billion of spending by 2023.[1]

Given that making the necessary spending cuts or tax rises to eliminate the deficit would require short-term pain, one seemingly attractive option might be to abandon any further attempts at such consolidation altogether. However, despite the fact that borrowing is now back to normal levels, and is set to fall further in future years, public sector debt is over 85% of national income (compared with 35% of national income before the financial crisis) and is hardly set to fall over the next few years. This is due to a combination of forecasts for historically weak growth and accounting factors which mean that the stock of debt would rise even if the headline measure of the deficit suggests that 'borrowing' has been eliminated.

In this chapter, we set out the current state of the public finances, the outlook for the future and some of the key risks. We begin by assessing where the public finances stand – taking a detailed look at successive forecasts for borrowing in 2017–18, the latest full fiscal year, and the outlook for borrowing based on data so far this year (Section 3.2). The latest data suggest lower borrowing in both 2017–18 and 2018–19 than forecast by the OBR in March of this year.

Section 3.3 sets this in the broader context of the Spring Statement plans for the next five years for borrowing and debt, and compares these with the government's fiscal targets. It shows that debt is much higher as a share of national income than before the crisis, and highlights what different levels of borrowing and growth would imply for the projected ratio of government debt to national income (GDP) over the longer term. Even with the deficit eliminated, the public sector's debt-to-GDP ratio might be expected to fall only slowly over time.

Section 3.4 looks at how developments since March are likely to affect the medium-term fiscal outlook. These include changes to the underlying economic outlook, interest rates and equity prices. This section also includes estimates of some policy giveaways that previous commitments and practice might suggest are likely to be implemented. Overall (and depending on the extent to which the government continues to announce 'new' policy giveaways such as fuel duty freezes), this suggests that the UK public finances now appear to be in a slightly stronger position than was thought at the time of the inaugural Spring Statement in March. Chancellor Philip Hammond's speech then said this autumn's Budget would set the spending envelope for next year's Spending Review. If it does, a key decision will be the extent to which any loosening of this envelope is financed by fresh tax rises as opposed to increased borrowing.

Any forecast for the public finances is, of course, highly uncertain. But the substantial unknowns surrounding the nature of the UK's exit from the European Union and what effect that will have on the economy mean the forecasts accompanying the Autumn Budget will be more uncertain than most. Section 3.5 describes the extent to which different patterns of economic growth over the next few years – for example, any further deterioration in growth resulting from the UK's decision to leave the European Union – could be expected to affect the deficit and debt over the medium and longer term. These

[1] Source: 'NHS funding: Theresa May unveils £20bn boost', 17 June 2018, https://www.bbc.co.uk/news/health-44495598.

uncertainties dwarf the expected improved outlook for the public finances seen since March.

The impact of any revision to the outlook for growth – either upwards or downwards – on the government's finances would depend on how the Chancellor chooses to react to developments. Recent statements from Mr Hammond suggest an asymmetric approach. Specifically, on the one hand, he has described a desire to cut taxes or increase spending in the face of improvements in the fiscal outlook. But on the other hand, he has also stated a willingness to allow borrowing to increase when the fiscal position deteriorates. By examining how Mr Hammond and his predecessor as Chancellor, George Osborne, have reacted to public finance developments in the past, we quantify this tendency and consider the possible impact on the public finances going forwards. We estimate that continuing to react to fiscal developments in a similar way to which Mr Osborne and Mr Hammond have reacted to fiscal news since 2010 would add a further £11 billion to the deficit in five years' time.

Section 3.6 concludes.

3.2 Where the public finances stand today

One of the key figures in any discussion of the public finances is the size of the deficit. This number – more formally known as public sector net borrowing – represents a measure of the difference between what the government spends and the total amount it receives in tax and non-tax revenues. Reducing the deficit has been a key fiscal aim of successive governments since 2010, when the deficit was almost 10% of national income. In this section, we look at borrowing in the latest fiscal year (2017–18) and consider how forecasts for borrowing in that year have evolved over time. This demonstrates the uncertainty that surrounds any one forecast for the public finances. We then turn to borrowing in the current year, describing the trends observed over the five months from April to August 2018, the impact they have had on the deficit so far this year, and the extent to which they might be likely to continue through to March next year.

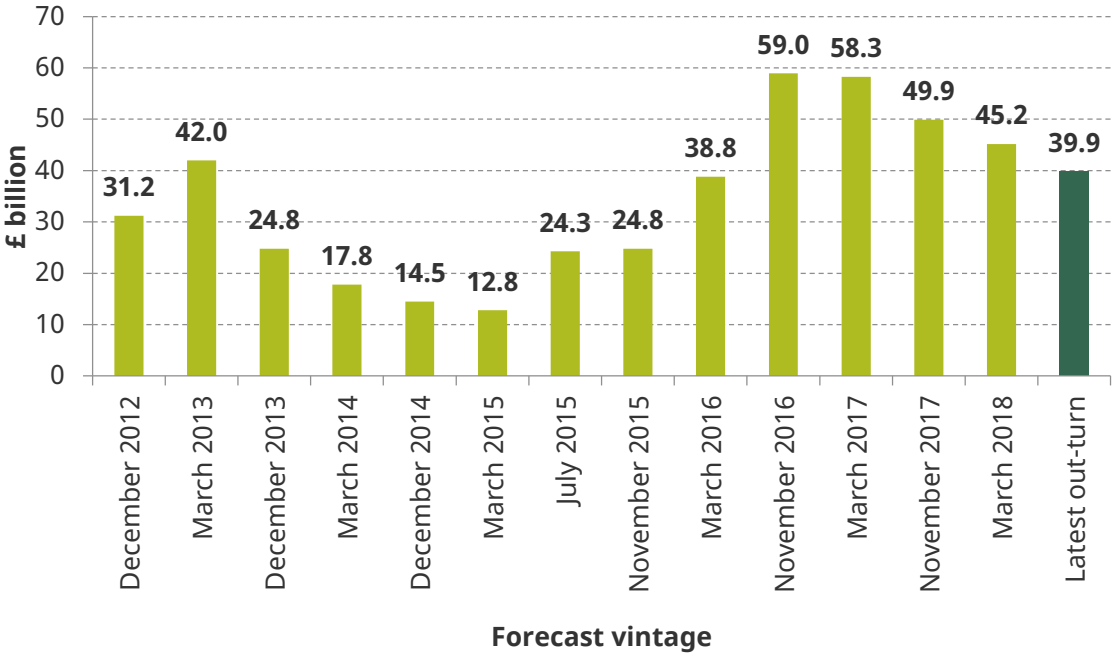
Borrowing in 2017–18

The latest estimate for borrowing in the last full fiscal year (2017–18) is £39.9 billion, or 1.9% of national income. This is much reduced from a high of 9.9% of national income in 2009–10, and the deficit is now back to the long-run average that was run over the 60 years from 1948 to 2007. With public sector net investment in 2017–18 running at £41.2 billion, the current budget deficit (which ignores borrowing that has been used to finance investment spending) is estimated to have been in surplus – albeit by just £1.4 billion – for the first time since 2001–02. In contrast to total borrowing, this surplus on the current budget is smaller than the pre-crisis long-run average seen in the UK.[2]

Borrowing of £39.9 billion is lower than the estimate, made by the OBR and accepted by the Chancellor as the government's own, at the Spring Statement in March. It is also

[2] This is due to investment spending, which in 2017–18 is estimated to have been 2.0% of national income, being below the average of 3.0% of national income invested publicly over the 70 years up to 2016–17. In the 1960s and 1970s, there was much more substantial investment by nationalised industries and by local authorities (in particular on housing). See figure 7 of T. Clark, M. Elsby and S. Love, 'Trends in British public investment', *Fiscal Studies*, 2002, 23, 305–42.

Figure 3.2. The fall, rise and fall of forecast borrowing in 2017–18



Source: Office for Budget Responsibility, 'Historical official forecasts database' and 'Public finances databank', http://obr.uk/data/.

significantly lower than successive OBR forecasts since November 2016. Figure 3.2 shows every OBR forecast for borrowing in 2017–18 since December 2012 (when the first forecast for borrowing in that year was made). In March 2015, just prior to the May 2015 general election, the 2017–18 deficit was forecast to be only £12.8 billion. A combination of a somewhat weaker economic outlook and much policy loosening (as the newly elected Conservative government decided to shy away from its pre-election pledges to cut public spending, for example on social security) meant that a year later the forecast for borrowing in 2017–18 had increased to almost £39 billion.

In November 2016, there was a large downgrade to the economic forecast (and a corresponding increase in the deficit forecast) in the wake of the June 2016 vote to leave the European Union – which Mr Hammond decided not to offset with fresh tax rises or spending cuts. This led to the largest upwards revision to borrowing in 2017–18 between successive forecasts, with the forecast deficit rising by £20.2 billion.

Since then, however, the forecasts for borrowing in 2017–18 have been consistently revised downwards. The estimate at the time of the Spring Statement was £45.2 billion, while the latest estimated out-turn is even lower at £39.9 billion.

In effect, the public finance data are yet to reflect any worsening of the outlook since June 2016 – the latest estimate is that borrowing in 2017–18 was very close to that forecast in March 2016. This is despite the fact that – as set out in Chapter 2 – the economy has grown less quickly than had been forecast prior to the referendum. In particular, between the first quarter of 2016 and the first quarter of 2018, the economy is now estimated to have grown by 1.4 percentage points less in real terms (and a similar amount less in cash terms) than was forecast at the time of the March 2016 Budget (the last pre-referendum

forecast).[3] And in fact, this estimated growth is 0.2 percentage points below that forecast after the referendum in November 2016.

So the economy has performed worse than pre-referendum forecasts expected. And the better-than-expected public finance data are not explained by post-referendum OBR economic forecasts that were too gloomy. Based on its downgrade in economic growth compared with pre-referendum forecasts, we would expect government receipts in 2017–18 to have come in lower. But the March 2016 Budget forecast that government revenues in 2017–18 would total £745.8 billion was borne out almost exactly: the latest estimate is that they came in at £750.8 billion.[4]

What is particularly striking from Figure 3.2 is that borrowing in 2017–18 is now estimated to be over £18 billion (0.9% of national income) lower than was forecast in the March 2017 Budget, just before the start of that financial year. Errors of this size are not unprecedented for Spring forecasts of borrowing in the subsequent financial year, but this is bigger than the 0.7% of national income average absolute error in OBR forecasts at this stage of the year. It is notable that in the eight years to 2017–18, the OBR borrowing forecast from the March just prior to the financial year starting has been an overestimate on six occasions and an underestimate on just two.[5] This is some evidence that it has been consistently too gloomy about the public finances one year out.

In Figure 3.3, we decompose the change in 2017–18 borrowing since the March 2017 Budget forecast into the net effect of new policy measures announced since March 2017, the net effect of classification changes, and the remaining 'underlying' changes (unrelated to policy or classification) which are perhaps best thought of as the true 'forecast error'.

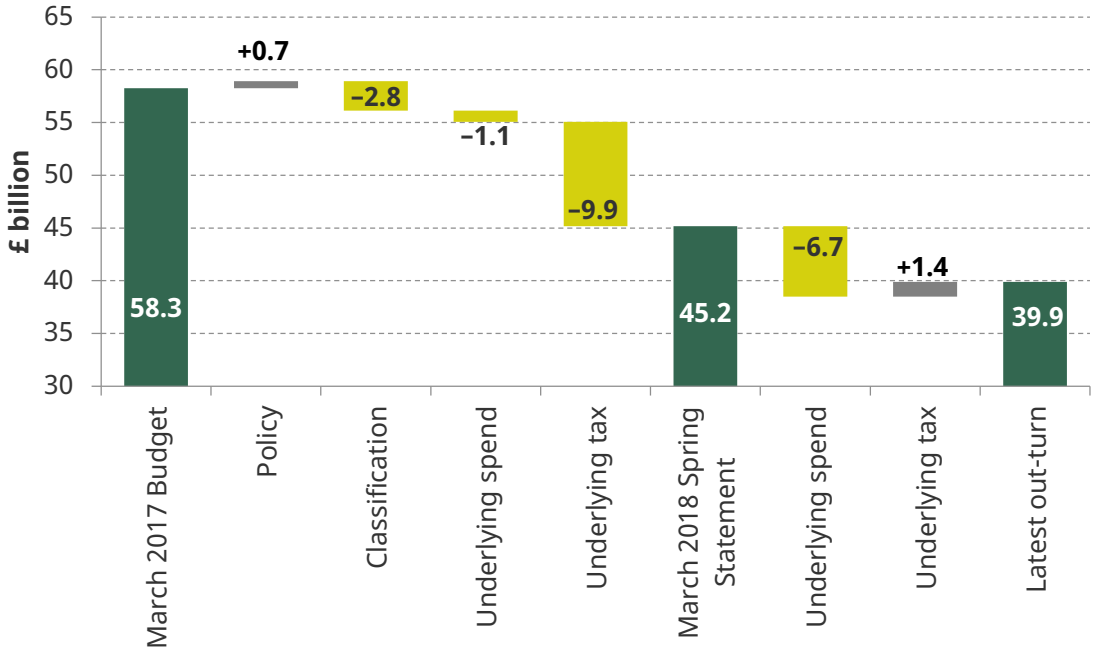
Between March 2017 and March 2018, new policy announcements had a relatively small impact on forecast borrowing, while a small reduction in forecast borrowing – of £2.8 billion – was due to classification changes (mainly the reclassification of English housing associations from the public sector to the private sector). The main driver of the overall reduction in forecast borrowing was an increase in forecast revenues of £9.9 billion ('underlying tax'). This reflected greater receipts across a number of different taxes, including income tax, National Insurance contributions and VAT. A particularly important change was stronger-than-expected self-assessment receipts in January 2018, as the

[3] The economy is estimated to have grown by 3.0% in real terms and 7.1% in cash terms, relative to forecasts of 4.4% real-terms growth and 8.4% nominal growth. The size of the economy in cash terms is particularly important for the public finances (since a larger cash-terms economy would tend to increase cash receipts, while over the period up to March 2020 spending on public services is largely fixed in cash terms by the 2015 Spending Review and the rates of most working-age benefits are frozen in nominal terms).

[4] This increase in receipts relative to forecast is only very partially explained by new measures being announced and implemented since the March 2016 Budget: the net impact of changes over this period is estimated to have boosted receipts in 2017–18 by just £1.6 billion.

[5] The March 2012 forecast for 2012–13 and the March 2014 forecast for 2014–15 both underestimated borrowing. In the other direction, June 2010 (2010–11), March 2011 (2011–12), March 2013 (2013–14), March 2015 (2015–16), March 2016 (2016–17) and March 2017 (2017–18) all forecast greater borrowing than now appears to be the case. For a more detailed evaluation of in-year OBR forecasts – which in fact shows that, after adjusting for classification changes, the forecast from the March just prior to the financial year starting has been an underestimate seven times and an overestimate only once – see J. Taylor and A. Sutton, 'In-year fiscal forecasting and monitoring', Office for Budget Responsibility Working Paper 13, 2018, http://obr.uk/download/working-paper-no-13-year-fiscal-forecasting-monitoring/.

Figure 3.3. Revisions to forecast public sector net borrowing in 2017–18 since March 2017



Note: Yellow bars indicate a reduction in the borrowing forecast while grey bars indicate an increase. Underlying changes are forecasting changes not accounted for by policy or classification changes.

Source: Office for Budget Responsibility, 'Forecast revisions database', 'Historical official forecasts database' and 'Public finances databank', all available from http://obr.uk/data/.

knock-on effects of the April 2016 increase in the rate of dividend tax were weaker than expected.[6] By contrast, there was little revision to forecast spending.

While the reduction in the 2017–18 deficit, relative to forecast, was welcomed by the Chancellor, what matters for the long-run health of the public finances is the extent to which greater tax receipts and lower spending persist into future years. Between March 2017 and March 2018, the OBR revised down forecast borrowing in 2017–18 by £13.1 billion; however, its forecast for borrowing in 2021–22 was revised up by £9.2 billion. Underlying receipts, which in 2017–18 were revised up by £9.9 billion (as shown in Figure 3.3), were revised down by £15.7 billion in 2021–22. This was due to a downgrade in the economic forecast, reflecting a more pessimistic view of productivity growth and thus a smaller economy in the medium term. (By contrast, underlying spending, which in 2017–18 was revised down by £1.1 billion, was revised down by £2.2 billion in 2021–22.)

Since the March 2018 Spring Statement, the Office for National Statistics has released an estimated out-turn for the 2017–18 deficit. This has the 2017–18 deficit even lower than the March 2018 forecast (£39.9 billion rather than £45.2 billion). However, in contrast to the revision seen between March 2017 and March 2018, the improvement in the deficit between the March 2018 estimate and the latest estimated out-turn is entirely due to lower spending. Tax receipts are actually slightly below the forecast level (by £1.4 billion).

[6] The increase in the tax rate on dividend income from April 2016 was announced in the June 2015 Budget. As a result, some high-income individuals brought forward their dividend income from future years into 2015–16, boosting self-assessment receipts in January 2017 but depressing them in subsequent Januaries. Forecasting the scale of these kinds of responses is particularly difficult.

The main reason for lower-than-expected spending is lower local authority (LA) spending. While the OBR expected current spending by LAs to exceed their receipts last year, overall they added to their reserves by spending less on day-to-day expenditure than they received in income.[7] OBR analysis suggests this pattern of LAs adding to their reserves is unlikely to persist in the longer term given the funding pressures on, and statutory obligations of, local authorities.[8]

Overall, this exercise illustrates the difficulty of public finance forecasting, and the likelihood that the true borrowing outcome could be very different from forecast. While it is generally the path of the economy that will affect the public finances in the medium term, in the short term other factors can lead to economic forecasts deteriorating but public finance forecasts improving (and vice versa). We will return to the uncertainty surrounding fiscal forecasts later in the chapter, but first we ask whether this improvement to 2017–18 borrowing seems to be indicative of further improvements in the current fiscal year.

Borrowing so far in 2018–19

Based on past experience, we should not be surprised if the public finances in 2018–19 differ substantially from the forecasts made in the March 2018 Spring Statement (which projected borrowing of £37.1 billion this year). And the public finance data so far this year indeed point to another downwards revision in the forthcoming Budget. Borrowing over the first five months of 2018–19 was 30% lower than the same five months of 2017–18.[9] If this pattern were to persist for the full year, borrowing would be around £28 billion. This would be £9 billion below the OBR forecast of £37.1 billion, and less than 1.5% of national income.

In fact, a significant part of the undershoot in borrowing over the past five months has been driven by lower investment spending and debt interest spending, both of which are likely to increase in the second half of the year to end up close to the OBR forecast for the year as a whole. On the other hand, lower day-to-day departmental spending may be more persistent: this might translate into departments underspending their budgets by perhaps around £1 billion more than the OBR currently assumes this year.

Total receipts from the three main taxes – PAYE income tax, National Insurance contributions and VAT – are all performing more strongly than expected. Because these receipts are collected consistently throughout the year, performance so far is a fairly reliable indicator of stronger-than-forecast full-year performance. If the strength of these revenues persists for the full year, they would contribute to total receipts being around £6 billion higher than forecast. However, weaker-than-anticipated receipts from corporation tax and stamp duty land tax will (if current weakness in receipts persists for the full year) offset this by around £2 billion.

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7 Office for Budget Responsibility, 'Commentary on the public sector finances: August 2018', 2018, http://obr.uk/monthly-public-finances-briefing/.

8 See box 4.4 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/.

9 Source: Office for National Statistics, 'Public sector finances, UK: August 2018', Statistical Bulletin, 2018, https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/august2018.

So based purely on the data so far this year, we might expect borrowing to be around £5 billion lower than forecast by the OBR in March – £1 billion from lower spending and £4 billion from a net improvement in tax receipts. This would leave the deficit at around £32 billion, or 1.5% of national income – below its long-run average and the lowest since the early 2000s.

If, as now seems likely, borrowing in 2018–19 does turn out lower than forecast in the March 2018 Spring Statement, then it would be the seventh occasion out of the nine fiscal years since the OBR began forecasting that the borrowing in the first year of the forecast horizon came out lower than anticipated.

3.3 The government's fiscal objectives and the Spring Statement public finance forecasts

Revenues, spending and public sector net borrowing

The headline deficit this year is set to be the lowest as a share of national income since 2001–02 (when it was just 0.4% of national income), and the same will be true of the current budget deficit (which in 2001–02 was in surplus by 1.1% of national income).

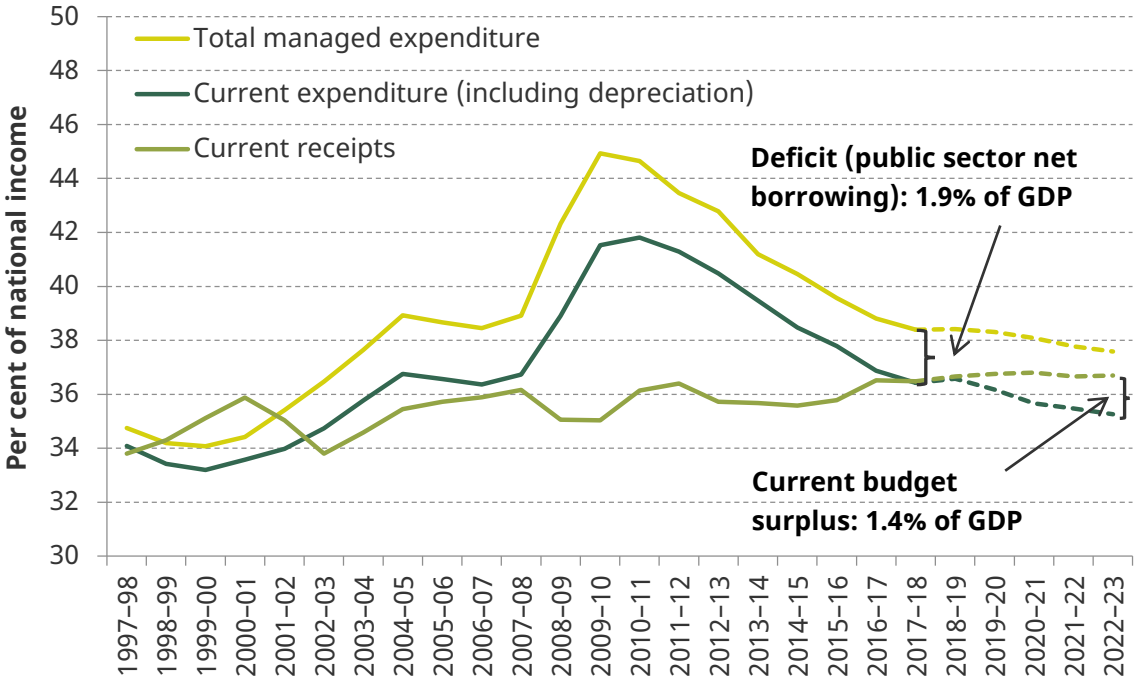
The government is planning further deficit reduction over the next few years. The plans set out in the Spring Statement are for the surplus on the current budget to grow to 1.4% of national income in 2022–23 (as shown in Figures 3.4 and 3.5).[10] This is set to be achieved by a further reduction in day-to-day spending as a share of national income (cutting this to its 2003–04 level as a share of national income) and a further small increase in government receipts as a share of national income (to a level not seen since the 1980s; for a longer-run time series of two potential measures of the tax burden, and a discussion, see Figure 5.1 of Chapter 5 and the surrounding text).

Over the next five years, the headline deficit is forecast to fall more slowly (by 1.0% of national income) than the current budget deficit. This is due to large increases to government investment pencilled in for 2020–21 and 2021–22 (as indicated by the growing gap between 'total managed expenditure', or overall government spending, and 'current (day-to-day) expenditure' in Figure 3.4). This increase in investment spending will boost the assets of the public sector (see Chapter 6) and – if spent well – will help contribute to economic growth.

The 1.0% of national income forecast fall in the deficit from 2017–18 would be sufficient to reduce it to 0.9% of national income in 2022–23 (£21.4 billion in that year). UK government borrowing (as a share of national income) has been lower than that level in only six years out of the last 40.

[10] Here we do not adjust the 2018–19 forecast from the Spring Statement, but graphs do incorporate the latest out-turn for 2017–18 borrowing.

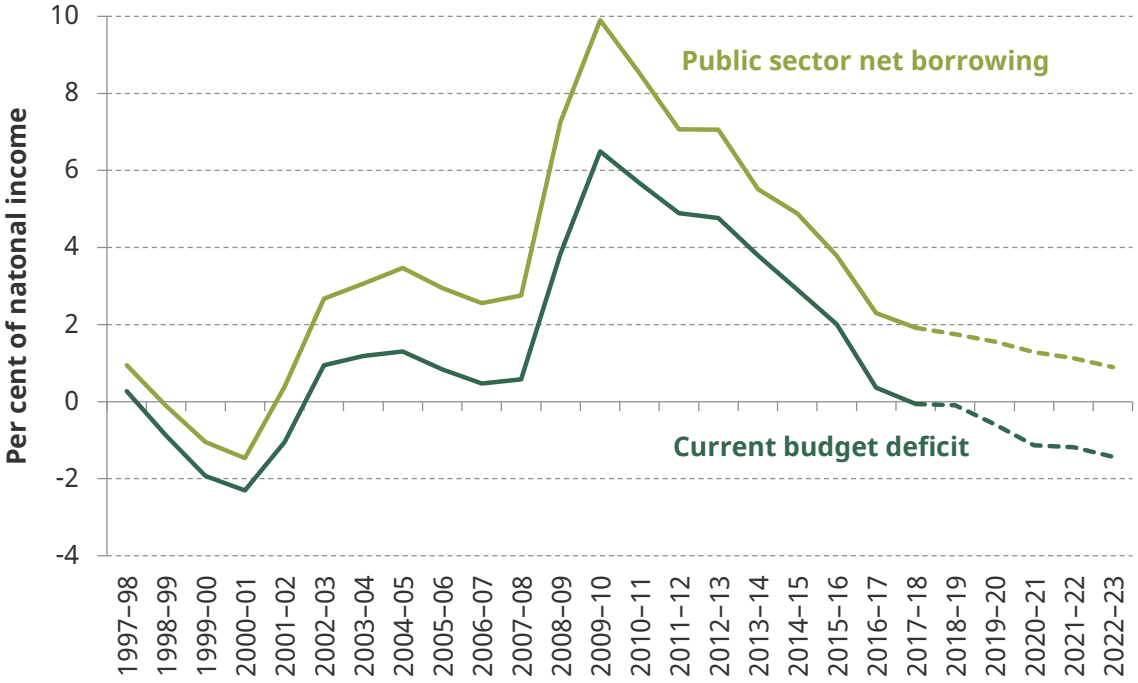
Figure 3.4. Public sector receipts and spending since 1997–98



Note: 'Total managed expenditure' is total government spending. 'Current expenditure' excludes spending on investment, while 'current receipts' encompasses total government revenue (from tax and non-tax sources). Public sector net borrowing is the difference between total managed expenditure and current receipts, while the current deficit is the difference between current expenditure and receipts.

Source: Office for Budget Responsibility, 'Public finances databank', July 2018, http://budgetresponsibility.org.uk/data/.

Figure 3.5. Measures of the public sector deficit since 1997–98



Note and Source: As for Figure 3.4.

Box 3.1. Fiscal targets

The government's fiscal targets

The Charter for Budget Responsibility[a] sets out the government's fiscal targets, against which the OBR assesses compliance. The most recent update is from before the last general election and states that the government has three specific fiscal targets:

- cyclically adjusted public sector net borrowing – that is, headline borrowing adjusted for the estimated impact of the ups-and-downs of the economic cycle – to be less than 2% of national income in 2020–21;
- public sector net debt to be lower as a share of GDP in 2020–21 than in 2019–20;
- spending on 'welfare-in-scope' in 2022–23 to be below the cap set in November 2017, with compliance assessed in the first fiscal event of the next parliament.

There is no perfect fiscal target; there is no one measure that is best suited to guide policy in all time periods and in all circumstances. But there are some obvious issues with each of the targets set out above. There are sensible reasons to attempt to adjust for the economic cycle when looking at borrowing, but what about borrowing caused by other factors that are known to be temporary, such as one-off revenues or spending items? There are good reasons to want debt to fall as a share of national income over the longer term, but how can we be sure that there won't be good reasons why it should be higher in March 2021 than in March 2020? The government should carefully consider how best to respond to unintended increases in social security spending but, rather than wait until the next parliament, why not retain annual assessments as was the case with Mr Osborne's version of this fiscal target?

The Charter also says that the government's overall fiscal objective is 'return the public finances to balance at the earliest possible date in the next Parliament'. An oddity of this is that it links the timing of deficit reduction to the timing of general elections. Given the Charter was legislated in January 2017 – and knowing it was not intended to be a rolling target – it could be interpreted as meaning as soon as possible over the period June 2017 to May 2022 (which is what has turned out to be the 'next parliament') or the period May 2020 to May 2025 (what the Chancellor might have expected at the time to be the 'next parliament' given the Fixed-term Parliaments Act). This lack of clarity means the OBR assesses compliance against both of these timetables.

In fact, it appears that the government is not aiming to eliminate the deficit on either of these timescales. The Conservative party manifesto of 2017 stated that 'We will continue with the fiscal rules announced by the chancellor in the autumn statement last year, which will guide us to a balanced budget by the middle of the next decade';[b] the government's Autumn 2017 Budget used similar language.[c]

A key conclusion from this is that the government should review and update the Charter for Budget Responsibility as this would allow the OBR to assess compliance against the government's actual fiscal objectives.

Labour's 'fiscal credibility rule'

The Labour party has two fiscal rules which it intends to implement in the event of forming a government.[d]

The first is a rolling forward-looking target, which aims to run a current budget deficit of 0 five years out. This was adopted by Mr Osborne as Chancellor in 2010 and by Ed Balls as Shadow Chancellor in 2015. The forward-looking nature of the target has much to commend it (indeed it was recommended in successive IFS Green Budgets prior to 2010[e]), allowing a Chancellor time to respond flexibly to shocks while still returning the deficit to its planned path over the medium term. By targeting a current budget balance, the target would allow for borrowing to fund investment spending – this allows the government to invest more, for example if new opportunities arise or interest rates fall. But on its own it would not place any constraint on public sector net debt.

Labour's second rule requires that the debt-to-GDP ratio is lower at the end of the next parliament than at the beginning. This suffers from the same problem as the government's debt target – depending on circumstances, it may be better for debt to be a greater share of national income at the end of a parliament than at the start. As with the target set out in the Charter for Budget Responsibility, it is also a fiscal target based on the length of a parliament which, to say the least, is odd.

Labour acknowledges one reason why these rules might not be appropriate – they would be suspended if the Monetary Policy Committee of the Bank of England deemed monetary policy to be at its effective lower bound. This is sensible, though there might be other circumstances when it would be better to suspend (or break) the rules rather than keep to them.

Under the plans set out in their 2017 manifesto, Labour would not find it easy to meet their fiscal targets. First, their planned nationalisation programme would add substantially to debt (see Chapter 6), breaching their second target. Even if the additional liabilities acquired from the newly nationalised bodies were ignored (perhaps on the basis that the assets acquired at the same time would generate a flow of substantial revenues), Labour's plan to increase public sector net investment – by an additional £250 billion over 10 years – would require a current budget surplus to be delivered (i.e. their first fiscal rule to be met with room to spare), and maintained, if debt is to fall as a share of national income over time.[f]

[a] HM Treasury, 'Charter for Budget Responsibility: Autumn 2016 update', legislated January 2017, https://www.gov.uk/government/publications/charter-for-budget-responsibility-autumn-2016-update.
[b] Page 14 of the Conservative party's general election manifesto, 2017, https://www.conservatives.com/manifesto.
[c] Paragraph 1.33 of HM Treasury, *Autumn Budget 2017*, https://www.gov.uk/government/publications/autumn-budget-2017-documents.
[d] https://labour.org.uk/manifesto/ and http://labour.org.uk/wp-content/uploads/2017/10/Fiscal-Credibility-Rule.pdf.
[e] See, for example, R. Chote, C. Emmerson and C. Frayne, 'The fiscal policy framework', in R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, https://www.ifs.org.uk/green-budget/2006.
[f] See Labour's general election manifesto, 2017, https://labour.org.uk/manifesto/manifesto-resources/.

End austerity and yet still eliminate the deficit?

The Chancellor has set out three fiscal targets: to keep cyclically adjusted borrowing below 2% of national income in 2020–21; to have debt falling as a share of national income in that same year; and to have spending on 'welfare-in-scope' in 2022–23 below a prescribed cap. These are described in Box 3.1; but a key fact is that, under current forecasts, all are on course to being met.

More challenging is the government's overarching fiscal objective: to eliminate the deficit by the mid 2020s (see Box 3.1 for details of the confusion over the actual timescale for this). Meeting this objective would represent a significant break from the past; the UK government has only run an overall budget surplus seven times in the last 60 years. Keeping the budget in surplus (which would presumably be the intention) would be an even more significant change: the last time an overall budget surplus was delivered for four consecutive years was the period from 1948 to 1951.

At the same time, Prime Minister Theresa May has recently promised an end to austerity: in her speech to the Conservative party conference, she stated: 'A decade after the financial crash, people need to know that the austerity it led to is over and that their hard work has paid off'.[11]

Could a commitment to end austerity be consistent with one to eliminate the deficit by the mid 2020s? This will depend on what is meant by austerity. If 'austerity' is defined as reducing the (cyclically adjusted) deficit then, on these forecasts, ending austerity now is incompatible with the government's overarching fiscal objective. There are good reasons for defining it as such. Reducing the deficit means the government is effectively taking money out of the economy this year relative to last year. As shown in Figure 3.5, despite 13 years of deficit reduction, the Spring Statement forecasts suggest we will still be running a deficit in 2022–23. And if the deficit fell in the years beyond 2022–23 at the same rate as it is forecast to fall on average over the previous four years, we would not eliminate the overall deficit until 2027. So – if these forecasts are correct – meeting the government's overarching fiscal objective requires not just further deficit reduction, over and above that already planned, but a faster pace of deficit reduction too.

But there are other possible definitions of austerity. The spending plans through to 2022–23 imply a continued squeeze on the day-to-day spending budgets of central government departments in the period to be covered by the next Spending Review (see Chapter 4 for more details): spending commitments to the NHS, defence and aid imply that the day-to-day budgets of those departments will increase by £13 billion in real terms between 2019–20 and 2022–23 (see Table 4.2). Over that period, overall day-to-day spending of government departments is set to fall by £2 billion, so that would imply cuts of £15 billion to the day-to-day budgets of unprotected departments over those three years. If 'ending austerity' means no further real cuts to unprotected departments beyond 2019–20 then this would require an additional £15 billion of spending by 2022–23. To meet this level of spending while keeping deficit reduction on course over this period would require tax rises of a similar size (see Chapter 5 for possible tax-raising options).

[11] https://www.telegraph.co.uk/politics/2018/10/03/theresa-mays-conservative-party-conference-speech-full-transcript/.

Of course, even this might not be considered an end to austerity for public spending. Overall day-to-day departmental spending is set to fall by £3 billion in real terms between 2018–19 and 2019–20, with unprotected departments (i.e. those outside of Health & Social Care, Defence and International Development) set to experience real-terms cuts of £4 billion. Furthermore, cuts to working-age benefits are affecting still more families – not least with the final year of the four-year freeze to most working-age benefits scheduled to occur in April 2019. Social security policies already announced, and mostly in place, are set to save a further £7 billion in 2022–23 in today's terms over and above the savings in 2018–19.

In addition, on these forecasts, further fiscal consolidation (in the form of spending restraint or tax rises) would still be required beyond the forecast horizon to eliminate the deficit by the 'middle of the next decade'. On current forecasts, a deficit of 0.9% of national income is forecast to remain in 2022–23. As Table 3.1 shows, eliminating this solely through real cuts to day-to-day department spending (i.e. leaving receipts and other spending unchanged as a share of national income) would require a further cut of £4½ billion in real terms: a £6½ billion cut between 2019–20 and 2025–26. A real cut of this size would see day-to-day departmental spending fall by 1.6% of national income between 2019–20 and 2025–26, equivalent to £34 billion in today's terms. This would come on top of the 0.3% of national income (£7 billion) cut to day-to-day spending as a share of national income next year.

Table 3.1. Potential departmental spending cuts if deficit is to be eliminated in 2025–26

	Spring Statement plans: 2019–20 to 2022–23	**Potential scale of further cuts, 2022–23 to 2025–26**	**Total: 2019–20 to 2025–26**
Real cut to day-to-day DEL (implied by Spring Statement / required to eliminate a 0.9% of national income deficit between 2022–23 and 2025–26)	£2bn	£4½bn	£6½bn
Cut to day-to-day DEL as a % of national income	0.7% of GDP £15bn	0.9% of GDP £19bn	1.6% of GDP £34bn
Memo: Estimated pressure on public spending from an ageing population	*0.2% of GDP* *£4bn*	*0.4% of GDP* *£9bn*	*0.6% of GDP* *£13bn*

Note: The pressures on public spending from an ageing population are projected to be more acute over the five years from October 2020 onwards largely because no increases in the male or female state pension age are legislated for that period, whereas increases are scheduled until October 2020. The first and second rows of the table are not additive: the cut to day-to-day spending as a share of national income by 1.6% of national income in the final column (for example) incorporates the £6½ billion real-terms cut.

Source: Authors' calculations using data from Office for Budget Responsibility, *Fiscal Sustainability Report: July 2018*, http://obr.uk/fsr/fiscal-sustainability-report-july-2018/ and Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012*, http://obr.uk/fsr/fiscal-sustainability-report-july-2012/.

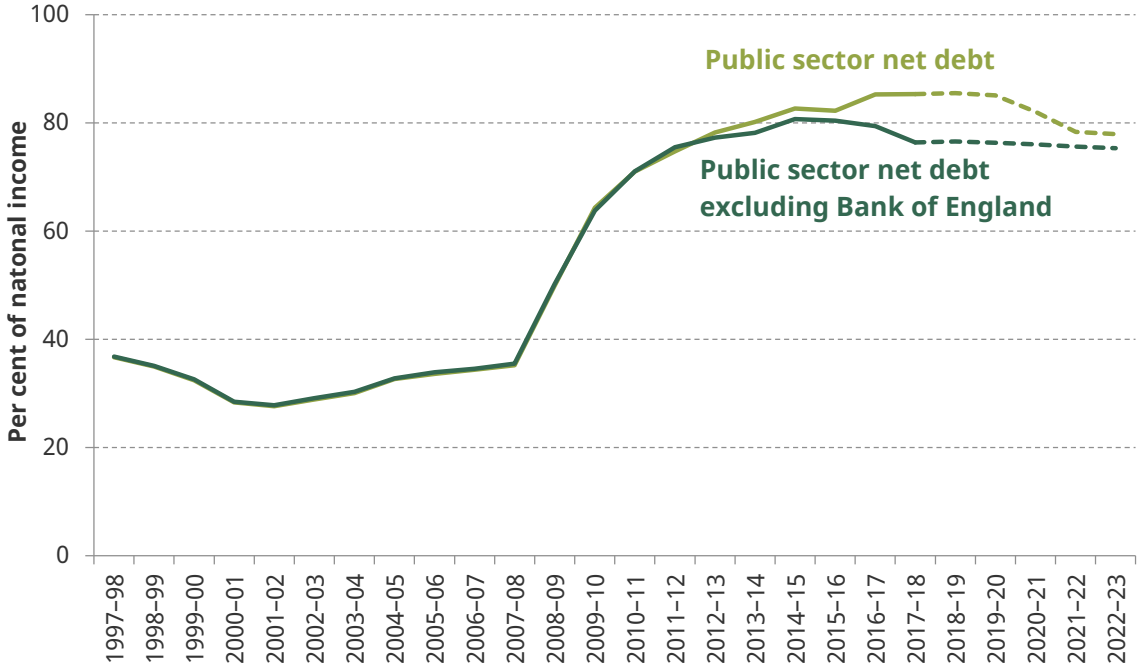
This means that, if 'austerity' is defined as maintaining day-to-day spending on public services as a share of national income at its 2018–19 level, then a substantial increase in the overall tax burden (or, potentially, deep cuts to social security spending) – totalling £41 billion (£34 billion + £7 billion) would be required to 'end austerity' for public services and still be on course to eliminate the deficit by the mid 2020s.

This is happening in the context of an ageing population adding to pressures on public spending. The baby boomers – born around 1950 – are reaching the stage in their lives where they make greater use of NHS and social care services. Furthermore, once the male and female state pension ages have risen to 66 in October 2020, they are not planned to increase again until 2026–27. These ageing pressures, ignoring any other cost pressures, are projected to add 0.4% of national income to public spending between 2022–23 and 2025–26. In today's terms, this is around £9 billion. This is greater than the equivalent pressures between 2019–20 and 2022–23, which have been projected to amount to 0.2% of national income (or around £4 billion). So even if the deficit is reduced to 0.9% of national income in 2022–23, another 0.4% of national income of fiscal tightening would be required just to offset the increase in spending arising from the ageing of the population over the subsequent three years.

Public sector net debt over the next five years

If one were to focus purely on the deficit as a measure of the health of the public finances, one would conclude that things were now 'back to normal' after eight years of consolidation. Public sector net debt – broadly the sum of all government borrowing to date – on the other hand is now around 85% of national income (Figure 3.6). This is more than twice its 2008 level as a share of national income and at its highest level since 1967.

Figure 3.6. Measures of public sector debt since 1997–98



Source: Office for Budget Responsibility, 'Public finances databank', July 2018, http://budgetresponsibility.org.uk/data/; chart 4.14 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/.

Debt has been higher before: during the Second World War it grew to a peak of just over 250% of national income, and it remained above 100% of national income for the 80 years from 1779 to 1858 and the 47 years from 1916 to 1962.[12] But outside of World Wars the increase in debt as a share of national income experienced over the last decade is unprecedented in modern times.

While the headline measure of debt is due to fall as a share of national income between 2019–20 and 2021–22, this is in fact driven by the effect of Bank of England loans made to private sector banks. When the loans were offered to banks in 2016–17 and 2017–18, this measure of debt rose: the liabilities incurred by the public sector to make the loans added to debt, but the assets that were acquired did not reduce it (since public sector net debt is only net of short-term financial assets, which did not include these loans). There will be a corresponding fall in public sector net debt when the loans are repaid, which is due to occur in 2020 and 2021. This will help the Chancellor meet his target of ensuring public sector net debt (as a share of national income) is lower in March 2021 than in March 2020. However, as Figure 3.6 shows, stripping out the effect of the Bank of England, debt is forecast to fall by only 1.2% of national income between 2018–19 and 2022–23. It would not take much by way of lower-than-forecast growth or higher-than-forecast deficits for it not to fall at all: for example, if growth in 2020–21 were just 0.2ppt lower than forecast, then this would be expected to wipe out the 0.3% of national income fall in public sector net debt (excluding the effect of the Bank of England) forecast between March 2020 and March 2021.[13]

It is unusual that the burden of government debt is set to fall so slowly when the deficit is forecast to be so small. In 2022–23, the deficit is forecast to be only 0.9% of national income, but the debt-to-GDP ratio is set to fall by just 0.3% of national income. In 1990–91, when the deficit was also 0.9% of national income, public sector net debt fell by 1.4% of national income. There are two factors driving this slow fall in the debt-to-GDP ratio: growth is forecast to be extremely sluggish and the headline statistic of public sector net borrowing does not fully capture all of the increase in debt each year. Between them, these mean that if public sector net borrowing in 2022–23 were 1.2% of national income (i.e. just 0.3% of national income, or £6 billion in today's terms, larger than currently forecast) – easily low enough to be consistent with falling debt in the past – debt would not fall between March 2022 and March 2023.

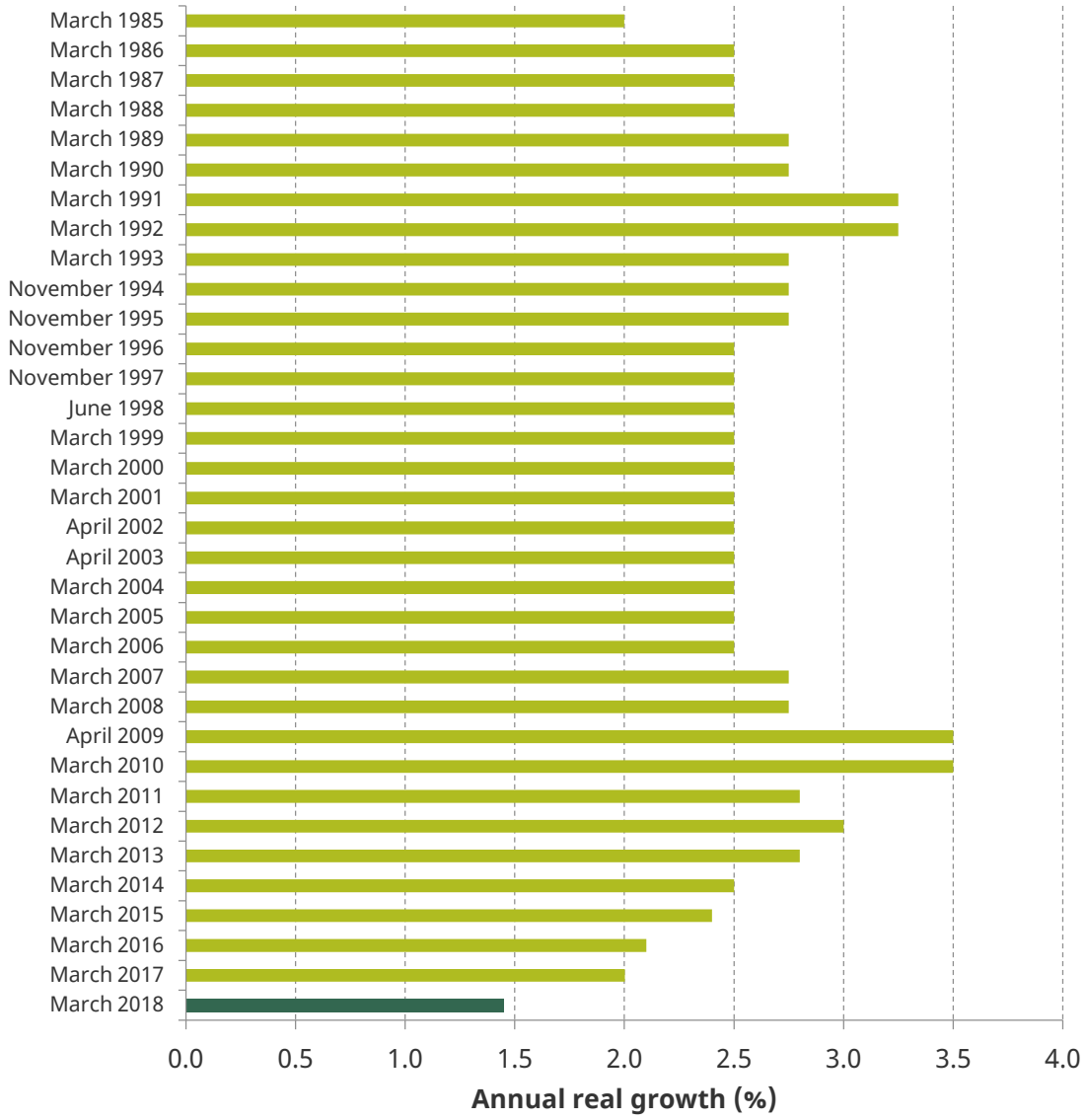
Very weak growth forecast for the next five years

Faster economic growth would, all else equal, reduce the UK's debt as a share of national income. However, cumulative real GDP growth in the five years from 2017 to 2022 is forecast to average only 1.5% per year, with no faster growth in sight even at the end of this period. This is significantly slower medium-term growth than has typically been forecast. Figure 3.7 shows the final year-of-forecast GDP growth rate for medium-term forecasts since the mid 1980s. The March 2018 forecast is more pessimistic than previous forecasts by some distance: it was a substantial downgrade on that made 12 months earlier, which itself was the most pessimistic Spring forecast for final year-of-forecast growth since March 1985.

[12] Source: Bank of England, 'A millennium of macroeconomic data', version 3.1, August 2018, https://www.bankofengland.co.uk/statistics/research-datasets.

[13] Source: Authors' calculations based on table 5.5 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/.

Figure 3.7. Final year-of-forecast real growth forecasts since 1985



Note: One forecast per calendar year is shown. This is the Spring forecast unless the Autumn forecast covers a longer time horizon.

Source: Office for Budget Responsibility, 'Historical forecasts database', http://obr.uk/data/.

If, rather than growing in line with the OBR forecast, the economy grew in line with the average in the 50 years to 2008 (2.7% per year), just the 'denominator effect' of higher national income (i.e. ignoring the fact that faster growth would also deliver greater tax receipts) would mean debt would be 73.8% of national income in 2022–23 (rather than 77.9%). That would almost quadruple the projected fall in the debt-to-GDP ratio (ignoring the impact of Bank of England loans) between now and then, even if the government borrowed exactly as much as it is planning to now. Put another way, if the economy were to grow at its long-run average, the government could borrow an extra £27 billion a year for the next four years (£107 billion in total) and still have the same debt-to-GDP ratio in 2022–23 as is currently forecast. Sluggish growth is thus playing an important role in slowing the rate at which the debt ratio is set to fall over the next few years.

Public finance treatment of student loans[14]

Weak forecast growth is an important determinant of why historically low levels of public sector net borrowing are not translating into the debt-to-GDP ratio declining quickly. Another important factor is a mismatch between public sector net borrowing and the annual increase in the cash value of debt. Much of this is driven by the treatment of student loans in the public finances. New loans to students in 2022–23 are forecast to total £22.0 billion. These loans are income-contingent (the repayments due depend on the graduate's earnings), and are written off entirely 30 years after graduation. Based on earnings projections, only around half of the principal being loaned out is expected to be repaid. So these loans come with a considerable taxpayer subsidy.[15]

Despite this, at the point when loans are taken out by students, they do not add at all to public sector net borrowing. Furthermore, as loans accrue interest over time – at a high rate of up to RPI plus 3 percentage points for high-income graduates – the amount of money owed to the government rises, which in turn reduces public sector net borrowing (since the interest owed is scored as a non-tax receipt of government). But the majority of interest is expected never actually to be paid to the government: interest on the loans only begins to be paid off after principal is paid off in full, and many loan recipients will never pay any accrued interest. This accrued interest is rising quickly over time to substantial levels: while it reduced public sector net borrowing by £3.2 billion in 2017–18, it is forecast to reduce the deficit by £7.5 billion in 2022–23.

Because the stock of student loan debt increases over time, the impact of this accrued interest is set to increase further, reducing the deficit by 0.7% of national income (£15 billion in today's terms) by 2035. The fact that loans are not fully repaid would only be reflected in government borrowing when the loans are written off (in over 30 years' time). Overall, the borrowing numbers will continue to be flattered by this treatment of student loans over the longer term – and in perpetuity as long as the current student loans system remains in place.

In many ways, the treatment of student loans for the headline measure of debt is the reverse of the treatment for borrowing. Student loans only affect public sector net debt when cash transfers are made – either from the government to students or from graduates to the government. As a result, debt increases by the full value of the loan in the year it is made (even though the government has acquired a financial asset with some considerable value), and is only reduced in future years as repayments are made. Debt is not affected by loan write-offs or the accrual of interest on the loans.

In 2022–23, when the outstanding stock of student debt will have reached £190 billion,[16] new student loans are forecast to *increase* public sector net debt by £19.1 billion

[14] The analysis in this section ignores a further twist which occurs if the student loan book is sold by the government. If that happens, public sector net debt is reduced by the amount the loan book is sold for. But since the sale would count as a financial asset, it would not affect public sector net borrowing. As a result, remarkably, the subsidy to students would not increase borrowing at any point in time – in other words, student loans would flatter the headline deficit measure indefinitely, with write-offs never affecting borrowing.

[15] Source: Chapter 5 of C. Belfield, C. Farquharson and L. Sibieta, *2018 Annual Report on Education Spending in England*, IFS Report R150, 2018, https://www.ifs.org.uk/publications/13306.

[16] Supplementary table 2.1 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2018*, http://obr.uk/fsr/fiscal-sustainability-report-july-2018/.

(£22.0 billion of new loans, net of £2.9 billion of loan repayments) but to *reduce* public sector net borrowing by £7.5 billion (due to the accruing interest on the student loan book). Neither of these numbers reflects the true economic cost of the student loan system in that year. The borrowing treatment fails to recognise that a substantial loan has been made that is not expected to be repaid in full and therefore effectively represents a subsidy to students of around £10 billion.[17] However, the debt treatment fails to recognise that the government is effectively purchasing an asset – the expected future stream of student loan repayments – which, while equal to far less than the full value of the loan, still has considerable value (worth around £12 billion on the £22.0 billion of loans made in 2022–23). Debt will more fully reflect the true economic impact in future years as repayments increase.

This rather odd accounting treatment of student loans results from the fact that they are treated as a financial asset, and that the Office for National Statistics (ONS) follows international guidance on how this should be done. The ONS is working with international organisations to change the accounting guidance for these types of assets,[18] and has been supported by a recent OBR working paper laying out alternative accounting guidelines.[19] However, while the current system remains in place, the borrowing numbers will continue to flatter the public finances in this respect, while the debt figures will be excessively gloomy. Specifically, a more reasonable treatment would count about half of student loans as borrowing – adding around £10 billion a year (0.5% of national income) to this measure – and around half of the outstanding liability as an asset likely to be repaid – which would take around 4% of national income off the measure of debt in 2022–23.[20]

Public sector net debt over the longer term

One reason to be concerned about debt at high levels (currently 85% of GDP) is that it may leave the UK with limited fiscal space to deal with unexpected adverse economic events in the future. All else equal, a lower level of debt would mean that the government could allow debt to rise by more without being at risk of exhausting its fiscal space. In 2009, the then-Labour government allowed the deficit to rise in the face of a weakening economic situation, both through the 'automatic stabilisers' (such as greater spending on benefits for those not in paid work and on in-work tax credits) and through an active fiscal stimulus package – a combination of discretionary tax cuts and spending increases aimed at helping limit the length and depth of the recession. As we have shown, the deficit has only now been returned to pre-crisis levels. Public sector net debt has increased by 50% of national income since 2008 and we might worry about whether the option to allow it to rise by a similar (or even greater) amount should another substantial adverse shock hit is still available.

Obviously we don't know when the next significant downturn will hit. The OBR's inaugural Fiscal Risks Report – published in July 2017 – judged that, based on past experience 'the

[17] 46.8% of £22.0 billion. Source: Chapter 5 of C. Belfield, C. Farquharson and L. Sibieta, *2018 Annual Report on Education Spending in England*, IFS Report R150, 2018, https://www.ifs.org.uk/publications/13306.

[18] See https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/lookingaheaddevelopmentsinpublicsectorfinancestatistics/2018#treatment-of-student-loans.

[19] J. Ebdon and R. Waite, 'Student loans and fiscal illusions', Office for Budget Responsibility Working Paper 12, 2018, http://cdn.obr.uk/WorkingPaperNo12.pdf.

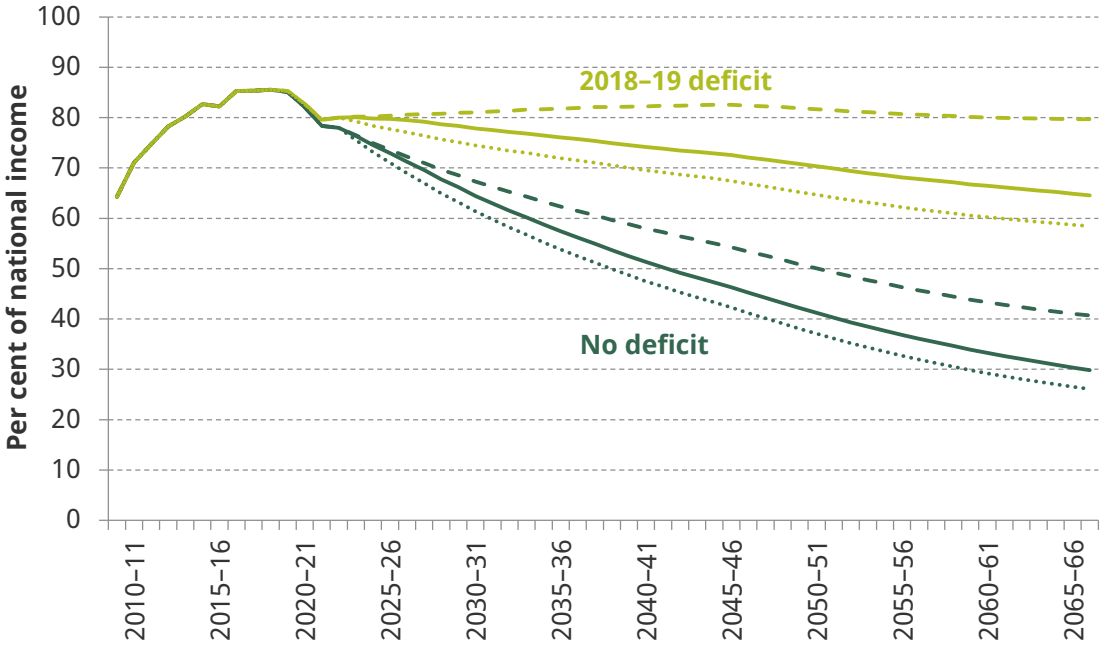
[20] Source: Supplementary table 2.1 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2018*, http://obr.uk/fsr/fiscal-sustainability-report-july-2018/.

chance of a recession in any five-year period is around one in two' and 'one might expect the UK to experience a financial crisis roughly every 20 years', although, of course, the next recession and financial crisis may not (and hopefully will not) be as large as the most recent one.

Figure 3.8 sets out what different levels of the deficit would imply for the path of debt going forwards. The solid lines take the OBR's central estimates of the UK's growth rate (which averages 2.1% a year over the next 50 years, compared with 2.7% a year over the 50 years to 2008).[21] The dashed lines take a more pessimistic scenario where the weak growth forecast for 2022–23 (of just 1.45%) is assumed to persist over the longer term, while the dotted lines present an optimistic scenario in which the economy grows at 2.7% per year, in line with the long-run pre-crisis average. In all scenarios, we assume that borrowing outside that counted against public sector net borrowing remains unchanged as a share of national income.

The different coloured lines denote different paths for public sector net borrowing. The light green lines show what would happen were the deficit to fall to 1.8% of national income this year and then remain at this level thereafter. The dark green lines show what

Figure 3.8. Paths for debt under alternative assumptions for the deficit and economic growth



Note: The solid lines take GDP projections from the OBR's July 2018 Fiscal Sustainability Report. The dashed lines assume instead that the real growth rate in 2022–23 in the Spring Statement forecast (1.45%) persists in the longer term, while the dotted lines assume a real growth rate of 2.7% per year (the long-run pre-crisis average) after 2022–23. '2018–19 deficit' assumes the deficit remains at 1.8% of national income from 2018–19 onwards. 'No deficit' assumes that from 2023–24 onwards the deficit is 0. The figure takes non-PSNB effects on debt from the January 2017 Fiscal Sustainability Report. Principally, this reflects the impact of student loans.

Source: Authors' calculations using Office for Budget Responsibility, *Fiscal Sustainability Report: January 2017* and *Fiscal Sustainability Report: July 2018*, http://obr.uk/fsr/fiscal-sustainability-report-july-2018/.

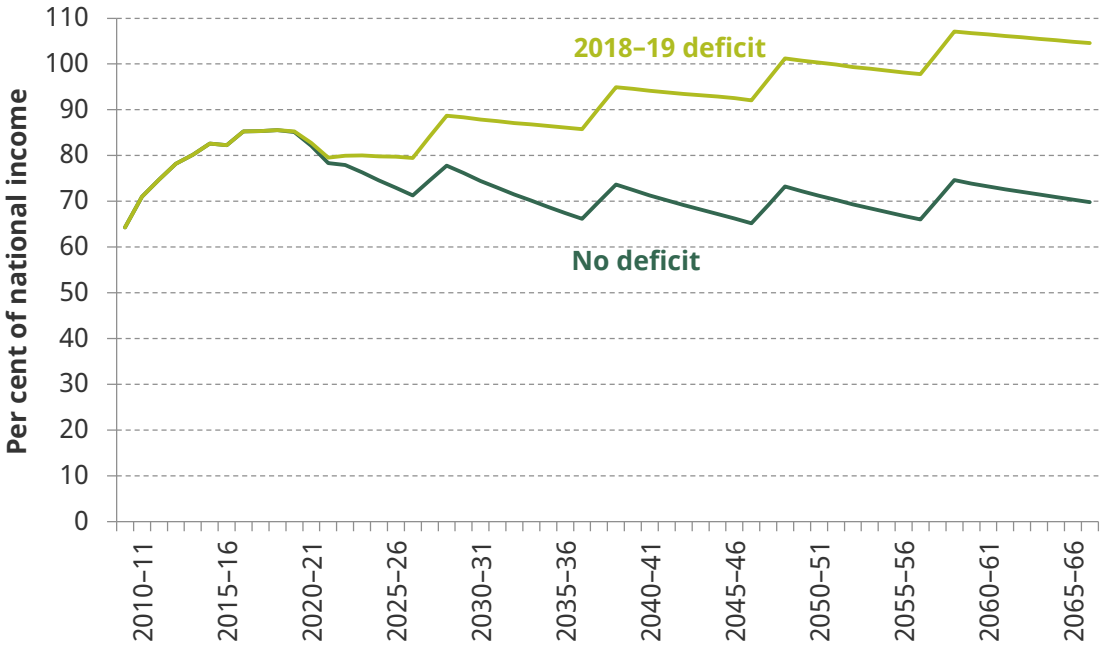
[21] We also take the OBR's long-run assumptions for interest rates and economy-wide inflation.

would happen were the deficit to be eliminated in 2022–23 and no deficit (or surplus) to be run thereafter.

Maintaining a deficit of 1.8% of national income would see public sector net debt fall slowly as a share of national income over time. However, even by 2040, it would still be above 70% of national income under the OBR's central growth forecast, only just below 70% of national income under the high growth scenario, and would remain virtually flat under the more pessimistic growth forecast in Figure 3.8. Eliminating the deficit entirely would see public sector net debt fall faster, such that it would be just above 50% of national income under the OBR's central growth forecast and just below 60% of national income under the more pessimistic growth forecast in 2040.

Of course, growth will not be smooth, as suggested in Figure 3.8. To illustrate the possible impact of recessions on the profile for public sector net debt, Figure 3.9 takes the two different profiles of the deficit from Figure 3.8 and assumes that in non-recession years the economy grows in line with the OBR's central forecast for growth (as with the solid lines in Figure 3.8). But now we assume that a recession strikes in 10 years' time (i.e. 20 years since the last recession), with another occurring every 10 years thereafter. Specifically, we assume that the debt-to-GDP ratio increases by 10 percentage points over two years when we experience a recession – this is somewhat lower than the impact of the 1990s recession on debt, much lower than the impact of the 2000s recession on debt, but more severe than the effects of the 1960s, 1970s and 1980s recessions.

Figure 3.9. Paths for debt under alternative assumptions for the deficit, with recessions every decade



Note: As for Figure 3.8. Every 10 years, we assume a recession event occurs and the debt-to-GDP ratio increases by 5% of national income per year for two years relative to the pre-recession path. This gap is then maintained thereafter.

Source: As for Figure 3.8.

Every recession will be different, and recessions will not arise at regular 10-year intervals. However, this provides an illustration of the sensitivity of the long-run public finances to future economic shocks. In some respects, it may be too pessimistic – for example, because it assumes growth in 'normal times' is no higher than the OBR central scenario, despite there being periods of lower growth (so this is 'bust' without the 'boom'). However, as the OBR suggests in its Fiscal Risks Report, 'unexpected downturns tend to surprise more on the downside than unexpectedly strong upswings surprise on the upside',[22] which provides a rationale for why economic booms do not generate a symmetric reduction in net debt compared with recessions. The impact of the recessions assumed in Figure 3.9 may also be too conservative because, while the recessions of the 1960s and 1970s were associated with higher inflation (which put downwards pressure on the debt-to-GDP ratio), more recent recessions have tended to be in low-inflation environments, with more adverse public finance consequences.

Taking this scenario, Figure 3.9 shows that even under the scenario where the deficit is eliminated, debt would remain above 60% of national income throughout the next 50 years. Furthermore, maintaining the deficit at its 2018–19 level over the longer term (what might be deemed to be an immediate and permanent end to austerity) might not be sustainable: while debt would fall as a share of national income between recessions, it would ratchet up by more each time a recession hit. Indeed, for debt to be stable under this scenario, with a recession every decade, we would require growth (in the years outside of recessions) to be more than 1ppt per year higher than projected by the OBR: i.e. to average 3.1% a year, considerably greater than the 2.7% a year seen over the 50 years to 2008.

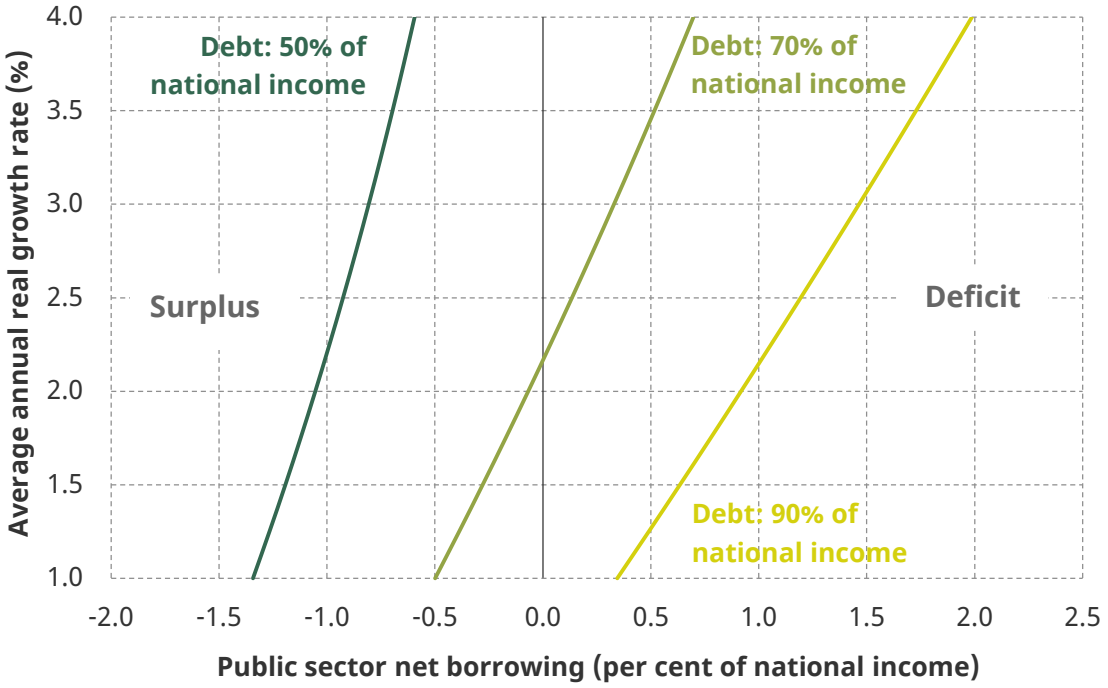
This analysis explains the Chancellor's keenness to reduce the deficit further. Of course, even if one accepts it in full, it doesn't mean that borrowing reductions necessarily need to be made immediately. In particular, if one believed that there was (or was about to be) a large amount of spare capacity in the economy, there would be a case for delaying this consolidation.

Indeed an important caveat is that, thus far, we have assumed that fiscal policy and the underlying rate of growth are unrelated. In practice, there are many ways in which fiscal policy will affect the supply side of the economy – which is what matters for long-term economic performance. For example, a fiscal tightening might lead to unemployment, which in turn eroded skills, making it harder for individuals to return to the labour market. A fiscal tightening achieved by increasing the corporation tax rate might translate into lower private sector investment, and thus lower growth. On the other hand, higher public sector investment would be expected to increase growth.

For a given level of public sector net borrowing, and for a given target for future public sector net debt, it is possible to calculate the level of growth required for the target to be met. Conversely, for a given level of growth, and for a given target for future public sector net debt, it is possible to calculate the level of public sector net borrowing that needs to be maintained. Figure 3.10 presents this trade-off, again assuming that recessions hit at regular 10-year intervals as in Figure 3.9. As before, we assume that borrowing outside that counted against public sector net borrowing remains unchanged.

[22] Paragraph 3.42 of Office for Budget Responsibility *Fiscal Risks Report: July 2017*, http://cdn.obr.uk/July_2017_Fiscal_risks.pdf.

Figure 3.10. Combinations of long-run growth rates and deficit levels that achieve different debt-to-GDP ratios in 2066–67 (assuming recessions at 10-year intervals)



Note: Assumes recessions have the same effects on debt as in Figure 3.9 and that they occur at 10-year intervals. Assumes that growth and deficit are held at stated level in all non-recession years. As in Figure 3.8, this takes the non-PSNB effects on debt from the January 2017 Fiscal Sustainability Report. Principally, this reflects the impact of student loans.

Source: As for Figure 3.8.

If (outside of recessions) growth were to average just 1.5% a year going forwards, then a budget surplus of 1.2% of national income would need to be maintained for the debt-to-GDP ratio in 2066–67 to be projected to be 50%. Were growth to instead average 3.0% a year, the required budget surplus would fall to 0.8% of national income. If the objective was only to stabilise the projected debt-to-GDP ratio at around its current 90% level, then growth of 3.0% a year would allow a deficit of 1.5% of national income to be maintained, while growth of 1.5% a year would instead be consistent with running a deficit of 0.6% of national income.

The Labour 2017 general election manifesto planned extra investment to the tune of £250 billion over 10 years[23] – roughly equal to an extra 1% of national income per year. It also announced sizeable tax rises that were intended to cover a proposed significant increase in day-to-day spending. The most expensive spending increase was the proposed abolition of tuition fees and, with them, the associated student loans. As well as being a substantial giveaway to students, this would also reduce – and eventually eliminate – the 'fiscal illusion' arising from the treatment in the public finances of student loans for tuition fees, and thus much of the non-borrowing additions to debt going forwards.[24] (In addition, Labour propose nationalisation of Royal Mail and publicly owned companies operating in rail, energy and water industries – which would also push up debt substantially. In what

[23] https://labour.org.uk/manifesto/manifesto-resources/.

[24] In effect, this would mean that a deficit of 1.9% of national income in this scenario is 'tighter' than a 1.9% of national income deficit when student loans are subject to their current treatment.

follows, we abstract from that effect. See Box 3.1 and, in particular, Chapter 6 for a discussion.)

If we assume that under Labour's plans the current budget surplus were maintained at its forecast 2022–23 level as a share of national income and capital spending were increased by 1% of national income, this would imply public sector net borrowing of 1.9% of national income (but with, in the long run, perhaps around 1% of national income less borrowing not scored in public sector net borrowing). On the OBR's current growth forecasts, and given the stylised impact of recessions assumed in Figure 3.9, this would imply that over the longer term debt would be projected to be around the same share of national income as it is today (roughly speaking it would be around halfway between the two lines presented in Figure 3.9).

Of course, the OBR's current growth forecasts might be affected by Labour's proposed policies. Labour's significant increase in infrastructure spending would, if spent well, increase the productive capacity of the UK economy. This would help push debt as a share of national income on a projected downwards path. However, Labour's other policies – such as increased rate of corporation tax, increased labour market regulations and four additional bank holidays – would have the opposite effect.

Taking the longer-term view does suggest that, given current debt levels, forecast growth and the current government's desire to borrow in ways that do not affect the headline deficit, a long-term fiscal objective that targeted a lower deficit than the current 1.8% of national income would be appropriate. Labour's policies would involve greater public sector net borrowing and, unless their overall package of policies led to the OBR revising up its forecast of long-run growth, could be expected to leave debt being projected to be around its current share of national income over the longer term. (The cost of financing any nationalisations – plus the substantial liabilities of the organisations brought under state control – would also push debt up further.)

3.4 Revisions to the March outlook

The previous section considered the longer-run public finances, and how debt would evolve over the longer term under different realisations of growth or borrowing. However, a key part of the Chancellor's Budget announcement will be focused on how the economic and public finance outlook has changed since the March Spring Statement and how he has chosen to respond to this.

There are two broad sources of revisions to public finance forecasts. First, the public finance outlook will change – not least as the economic forecast changes. Second, changes to tax or spending policy will also affect the outlook for government borrowing.

In Section 3.2, we noted that the public finance data for 2018–19 point towards a downwards revision to 2018–19 borrowing of around £5 billion. Here we consider other ways in which the outlook may differ from March – both in terms of changes to the economy and in terms of likely policy changes – and we focus on the five-year period to 2022–23.

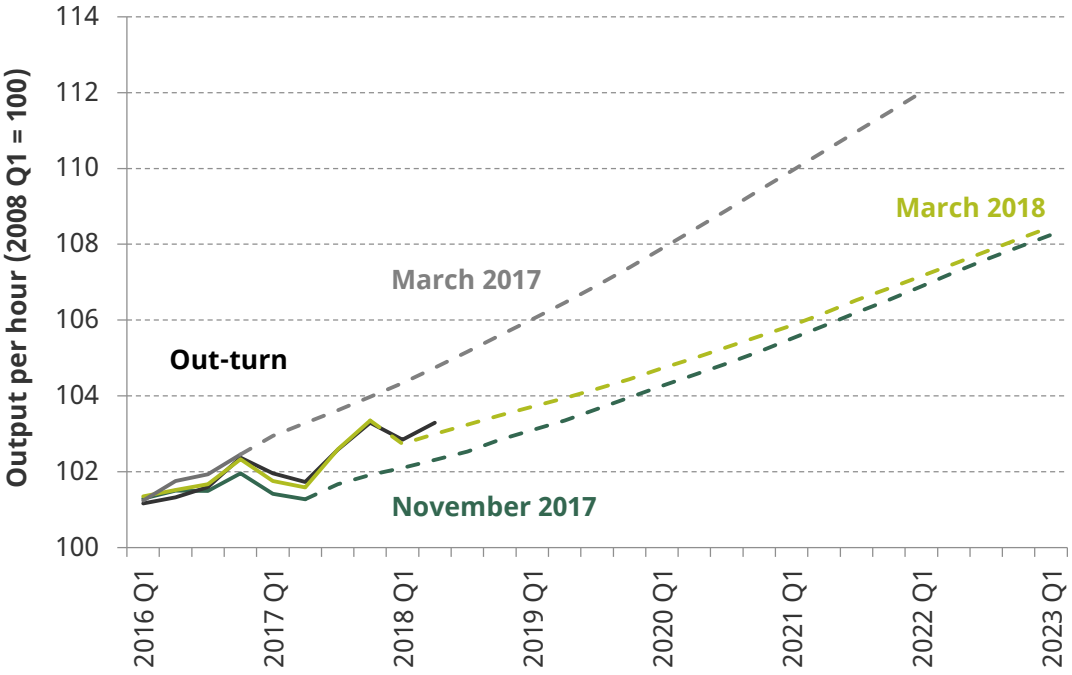
The economy

Economic growth is the most important determinant of the public finances. The OBR forecasts sluggish growth over the next five years, driven by its view that productivity growth will be slow – a view it has held since November 2017, when it revised downwards significantly its outlook for productivity growth. Previously, it had persistently predicted a return to pre-recession trends, which had repeatedly failed to materialise.

Successive OBR forecasts for productivity growth are shown in Figure 3.11. Between March and November 2017, the OBR revised its assumed annual productivity growth rate down from 1.6% to 1.0%. While a substantial downgrade, this forecast still assumed that productivity growth would exceed recent performance, which has averaged just 0.5% per year since 2010. Between November 2017 and March 2018, the out-turn data were revised and provided a rosier view of the UK's most recent productivity performance. However, this did not lead the OBR to revise its medium-term view of productivity, and data since then have been slightly above, but close to, the revised March 2018 forecast.

The OBR is more pessimistic than most other economic forecasters about future growth prospects. A natural comparator is the Bank of England – the other independent public sector forecaster. Figure 3.12 shows that the Bank downgraded its forecast for economic growth slightly between February and August 2018. However, it continues to anticipate higher growth than the OBR in the medium term – the Bank is forecasting growth of 1.7% in 2021 (the last year of its forecast), compared with the OBR's 1.4% in that year. This puts

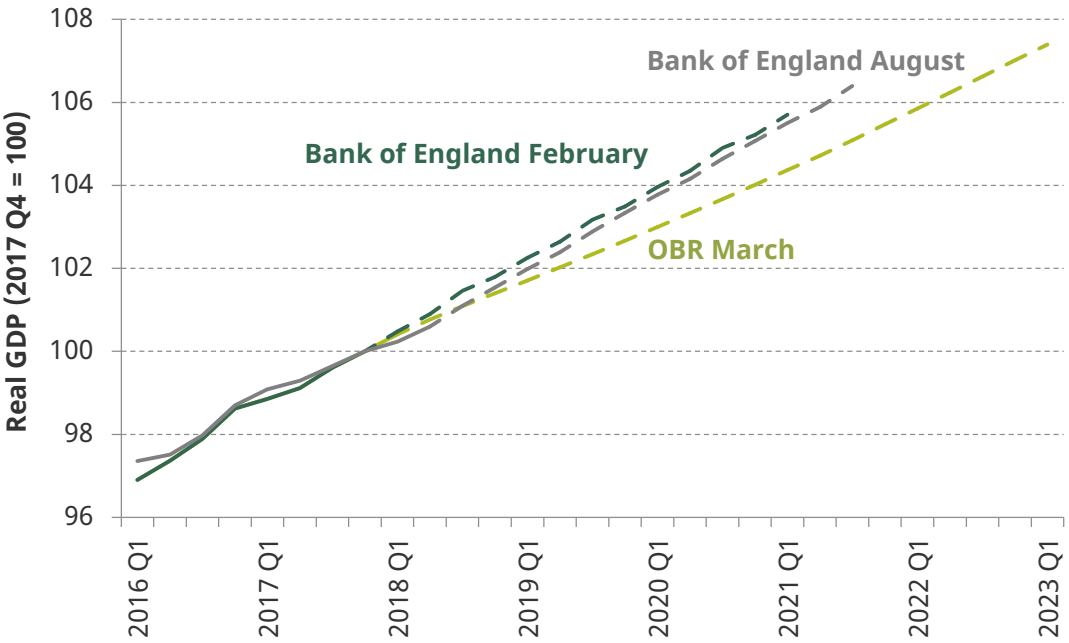
Figure 3.11. Successive OBR forecasts for productivity



Note: Output per hour calculated as non-oil gross value added at market prices (ONS series KLS2) divided by total number of hours worked (ONS series YBUS). All series indexed to 2008 Q1 as this was the last pre-recession quarter.

Source: Office for National Statistics; Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2017*, http://obr.uk/efo/economic-fiscal-outlook-november-2017/; Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/.

Figure 3.12. Real GDP forecasts: Office for Budget Responsibility and Bank of England, 2018



Note: Bank of England forecasts are modal GDP growth forecasts based on market expectations for interest rates.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/; Bank of England, *Inflation Report: February 2018*, https://www.bankofengland.co.uk/inflation-report/2018/february-2018; Bank of England, *Inflation Report: August 2018*, https://www.bankofengland.co.uk/inflation-report/2018/august-2018; and authors' calculations.

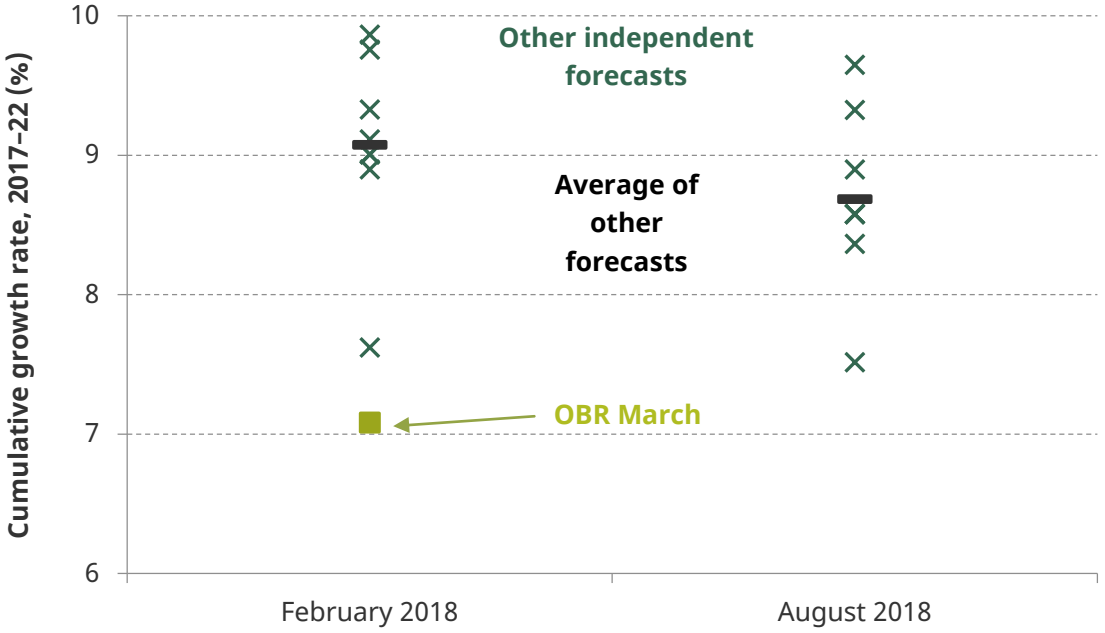
UK economic policy in a situation where the public finance forecasts are based on a more pessimistic outlook for the economy than the forecasts produced by those setting monetary policy.

A similar picture emerges when looking at forecasters surveyed by HM Treasury (Figure 3.13). Medium-term growth forecasts are, on average, lower in August than they were in February, but the OBR Spring Statement forecast remains more pessimistic about medium-term growth prospects than any of the other independent forecasters considered. The average of independent forecasters implies a growth rate in 2022 of 1.9% as opposed to an OBR forecast of 1.5%. The latest forecast from Citi – as set out in Chapter 2 – is one example of this, with growth in 2022 forecast to be 1.9%.

Despite being an outlier in terms of its forecasts, there seems little reason to think the OBR will significantly change its forecasts this Autumn, not least because productivity data since March are broadly in line with its latest forecast.

Nonetheless, it is informative to consider how different the public finance outlook might be if the OBR adopted a growth forecast in line with other independent forecasters. The Bank of England's economic forecast provides a natural alternative 'central outlook' for the public finances. Adopting the Bank's forecast through to 2020–21, and then assuming growth in line with the average of independent forecasters thereafter, would mean an economy in 2022–23 that is 1.9% larger than forecast by the OBR. As a result, we would

Figure 3.13. Independent forecasts for cumulative real GDP growth, 2017–22



Note: Includes all forecasters for whom a new five year growth forecast was provided in February and August: Beacon, Citigroup, Commerzbank, EY ITEM, Kern Consulting, Natwest, NIESR and Oxford Economics.

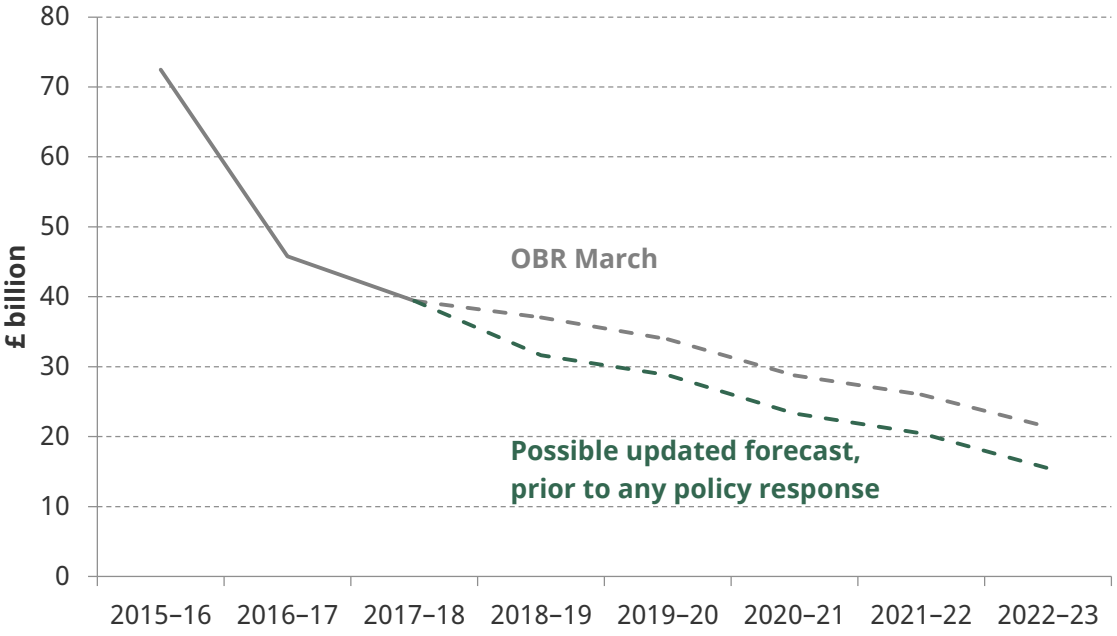
Source: Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/; HM Treasury, *Forecasts for the UK Economy: August 2018*, https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-august-2018.

expect borrowing to be around £23 billion (0.9% of national income) lower. A downwards revision to forecast borrowing of this magnitude would put the government on course to eliminate the deficit entirely in that year, allowing the Chancellor to meet his fiscal objective of eliminating the deficit by the middle of the next decade.

Other economic factors impact the public finances independently of any change to economic growth. Since March, there have been modest changes to the outlook for interest rates and the stock market, both of which slightly improve the outlook for the deficit and will automatically be reflected in the OBR's new forecast.

Changes to market expectations of the base rate, set by the Bank of England's Monetary Policy Committee, also affect the OBR's public finance forecasts. The headline deficit is currently flattered by the Bank of England's programme of quantitative easing. Under this programme, £435 billion of gilts have been purchased by the Bank of England through its Asset Purchase Facility (APF), which is almost a quarter of the £1.8 trillion of outstanding public sector net debt in March 2018. The interest rate scored against this borrowing is equal to the Bank of England's base rate – currently 0.75%. This is very low, depressing debt interest payments. If those gilts were instead held by the private sector, debt interest spending would be more than £13 billion higher in 2018–19 and more than £6 billion higher in 2022–23 (the forecast reduction in debt interest spending diminishes as the base rate is assumed to increase in line with market expectations, bringing it closer to the interest rate that would have been paid had those gilts been held in the private sector).

Figure 3.14. A new central outlook for public sector net borrowing



Note: Forecast prior to any policy response takes into account stronger-than-expected tax receipts so far this year and revised paths for the stock market and the base rate.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/.

In the short term, this also means the public finance forecasts will vary with changes in the forecast for the base rate. Medium-term market expectations over the base rate have fallen slightly since March, which will lower recorded borrowing by reducing the debt interest scored against the gilts held by the APF.

Receipts of taxes such as capital gains tax and stamp duty on share transactions will rise and fall with equity prices. The stock market has performed more strongly than expected since March – this will be reflected in the OBR's forecast and will lead to higher receipts from these taxes in the medium term. Combined, updated paths for the base rate and equity markets could reduce forecast borrowing by around £1½ billion in 2022–23.

Combining information on receipts so far this year and the evolution of the economy, we can arrive at a new 'central outlook' for the public finances absent any changes to policy relative to that assumed at the time of the Spring Statement. This is shown, alongside the OBR's March forecast, in Figure 3.14.

This updated scenario assumes that stronger-than-expected tax receipts so far this year (which suggest receipts could be £4 billion higher than forecast) reflect a permanent improvement to the public finances and therefore persist throughout the forecast period, but that the £1 billion lower spending this year is a one-off 2018–19 effect. Combined with the lower borrowing implied by revised paths for equity markets and the base rate, these underlying factors combine to reduce forecast borrowing in 2022–23 by £6 billion.

Policy changes

This revised outlook does not take into account ways in which policy might depart from the path assumed in the Spring Statement. But policy changes are likely. Under the OBR's remit, it cannot take these likely policy changes into account in its central forecast; however, they can have a substantial impact on the public finances.

For one thing, the Chancellor has said that he will announce the total spending envelope for the next Spending Review in the Budget. As Chapter 4 describes, it is likely that this will involve more spending than is currently pencilled in given that those plans would involve real cuts averaging more than 3% a year across the unprotected departmental budgets (i.e. outside the NHS, defence and aid).

There could also be tax cuts in some areas.

Rates of fuel duties have remained frozen in cash terms since April 2011, despite being due to rise by at least RPI inflation every year. In the Autumn 2017 Budget, the OBR described the announcement of another freeze as 'traditional' and 'inevitable'.[25] Despite this, the OBR has no choice but to produce a forecast that continues to assume that fuel duties will increase in line with RPI each April. In her speech to the Conservative party conference, the Prime Minister announced that rates of fuel duties would again be frozen in April 2019. This will reduce revenues by £0.8 billion in 2019–20. If fuel duties remain frozen in cash terms for the foreseeable future, revenues would be reduced by a further £2½ billion (i.e. on top of the £0.8 billion reduction in 2018–19) in 2022–23.

The Conservative party 2017 general election manifesto retained a long-standing commitment to increase the personal allowance to £12,500 and the higher-rate threshold to £50,000 by April 2020. Higher-than-anticipated inflation since the commitment was originally made in the 2015 general election manifesto means that meeting this policy is now only expected to cost £1.1 billion, but this is a £1.1 billion increase in borrowing not currently factored into the OBR forecasts.

If both of these tax cuts (freezing rates of fuel duties and raising income tax thresholds) happened, they would use up two-thirds of the possible £6 billion underlying improvement in 2022–23 suggested above and illustrated in Figure 3.14. But it is perhaps more likely that announcements of increases in income tax allowances and freezes to fuel duty rates beyond April 2019 will be left for subsequent Budgets. In any case, any significant loosening of the spending plans (for example, if austerity is to be ended for public services) would, unless accompanied by fresh tax rises, lead to the borrowing forecast for 2022–23 being higher on 29 October than it was back in the Spring.

3.5 Risks surrounding the central outlook

Strong public finance data so far this year mean that a downwards revision of £6 billion in forecast borrowing for 2022–23 (before taking into account any policy changes) seems plausible. This would constitute only a modest revision to the central outlook given the amount of uncertainty surrounding the public finances. Indeed, past forecasting

[25] Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2017*, http://obr.uk/efo/economic-fiscal-outlook-november-2017/.

performance would suggest that there is around a one-in-three chance that the budget will be in surplus in 2022–23. But there is a similar chance that the UK would instead run a deficit of over 2% of national income (around £50 billion), higher than the current level.

In fact, the Budget forecast this year will be even more uncertain than would be suggested by previous forecast errors. We neither know what form Brexit will take nor can we say with any certainty how big the economic hit will be from leaving the EU. This is a set of risks that come on top of the 'usual' economic uncertainties.

Another source of risk surrounds how Chancellors use policy to respond to changes in the fiscal forecasts. For example, if they tend to respond to changes in the fiscal outlook with offsetting policy measures – by implementing giveaways such as spending rises or tax cuts in response to fiscal improvements and takeaways in response to fiscal deteriorations – then the outlook for the deficit would be more certain. But if Chancellors tend to respond differently to forecast improvements and forecast deteriorations, then this would have implications for the likely central path of the deficit over time.

This section first illustrates the sensitivity of the public finances to different types of economic shock – the main source of public finance uncertainty. It then looks at how policy has tended to respond to fiscal forecast revisions since 2010 and evaluates what this might mean for government borrowing and Chancellors' fiscal targets.

Economic shocks

There are upside and downside risks to growth. On the upside, productivity growth could return to pre-crisis trends. On the downside, growth may be hit by a disorderly Brexit. Rather than consider the public finance implications of precise alternative economic scenarios – of which there are many possible candidates – here we instead illustrate the sensitivity of the medium-term public finances to different types of unexpected negative economic events. In each case, the reverse would apply were a favourable economic shock to occur.

Broadly, adverse changes to the path of the economy can be of three types, each with different implications for the public finances. Table 3.2 provides illustrations of how each of these types of change might be expected to increase short-, medium- and longer-term borrowing (the primary deficit, which is public sector net borrowing excluding debt interest receipts and spending) and debt (assuming that the borrowing increases are not offset).[26]

- First, the impact may be purely temporary – the economy underperforms to a greater extent for a period of time, but its underlying potential is unaffected. Economic growth would be slower in the short term, but would then speed up at some later date such that the economy returned to its previous path. Borrowing would be higher in the short

[26] It is important to note that these numbers are illustrative, and the public finance impact of a change to the path of the economy will depend on the composition of growth. In particular, if sectors of the economy, or activities within the economy, that are more heavily (lightly) taxed are more adversely affected by a given shock, the effect on borrowing may be larger (smaller). For the impact on borrowing, we present the effect on the primary deficit – this can be thought of as the amount of extra fiscal consolidation that would be necessary to return the deficit to its previous path should such a shock hit. The impact on debt, on the other hand, reflects the increase in the debt-to-GDP ratio if none of the borrowing increase were offset (and therefore allows for increased debt to push up debt interest spending).

term (2019–20), but no higher in the medium term, while debt would be slightly higher due to the earlier additional borrowing.

- Second, the adjustment may be one-off but permanent. As in the case of a temporary shock, growth would slow in the short term. However, rather than growth subsequently being greater, the growth rate would return to its pre-crisis level and the 'lost output' would never be regained. In this case, borrowing would be higher in the short and medium terms, and the impact on debt would grow over time.

- Finally, the adjustment may be to the rate of growth itself. The economy would evolve along a new, lower growth path. Unlike the other two types of adjustment above, the gap between the new growth path and the previous trend would continue to grow over time. This only leads to a modest increase in short-term borrowing, but a growing impact as national income diverges further from its previous path. While in 2022–23 the impacts of a permanent 1% hit to national income and a 0.25ppt fall in the growth rate on borrowing are the same, the impact of a lower growth rate on both borrowing and debt in 2034–35 is much larger.

In practice, these three types of changes are not mutually exclusive, and most adverse economic shocks combine these different features. For example, the OBR noted in its most recent Fiscal Risks Report that it is rare that cyclical slowdowns do not also have some permanent impact on borrowing – several years after recessions, potential output is normally lower than implied by the pre-recession trend.[27] Economic performance since the financial crisis and associated recession reflects both a large permanent reduction to GDP relative to trend and a reduction in the growth rate, such that the gap between actual GDP and the pre-crisis trend continues to grow.

Table 3.2. Increase in borrowing and debt under different adverse economic shocks

Change relative to forecast	Increase in 2019–20		Increase in 2022–23		Increase in 2034–35	
	Primary deficit	Debt (% GDP)	Primary deficit	Debt (%GDP)	Primary deficit	Debt (%GDP)
Temporary 1% fall in GDP in 2019–20 and 2020–21	£11bn	1.4%	£0	1.1%	£0	0.6%
Permanent 1% fall in GDP	£11bn	1.4%	£11bn	2.9%	£8bn	5.9%
Permanent 0.25ppt fall in annual GDP growth rate	£3bn	0.4%	£11bn	2.2%	£33bn	12.7%

Note: Assumes that a 1% smaller economy leads to a 0.5% of national income increase in borrowing (primary balance) during the forecast period, and 0.4% of national income thereafter. The precise impact of these changes is uncertain. The OBR assumes a 1% cyclical fall in national income leads to a 0.7% of national income increase in the deficit, but the reduction in the forecast path of the economy in November 2016, and resulting change in borrowing, implied a 1% fall in national income only led to a 0.35% of national income increase in the deficit. Primary balance changes all presented in 2018–19 terms.

[27] Page 54 of Office for Budget Responsibility, *Fiscal Risks Report: July 2017*, http://obr.uk/frr/fiscal-risk-report-july-2017/.

The impact of Brexit on the public finances

In light of this discussion of economic shocks, how might we assess the possible impact of Brexit on the public finances? There are two main ways in which the public finances are affected by Brexit – the direct effect of a change to flows between the UK and the EU (set out in Box 3.2) and indirect effects through the impact on the economy.

Box 3.2. Financial flows between the UK and the EU

The OBR forecasts

In its Spring Statement forecast, the OBR maintained its 'fiscally neutral' assumption that any money that the UK would have sent to Brussels over the forecast period would be recycled and spent elsewhere. The OBR has also forecast a path for likely 'divorce payments' in the medium term based on the agreement between the government and the EU in December 2017.

Chapter 4 sets out these flows for the final year of the forecast, 2022–23. These suggest that, after making payments to the EU and replacing spending that would otherwise have been done by the EU in the UK, there would be less than £1 billion remaining to reduce the deficit or to spend elsewhere.

In the longer term, the divorce payments are forecast to become smaller, which would allow the government to replace spending that would have occurred in the UK and have money left over (an amount equal to the UK's net contribution of around £9 billion) to spend elsewhere or reduce the deficit, though of course this ignores any impact of Brexit on tax receipts or on public service pressures.

Flows under different Brexit deals

The government has indicated that, should it fail to reach a deal with the EU, it might not pay these 'divorce payments'.[a] In that case, the direct fiscal benefits could be enjoyed more quickly. However, the detrimental consequences for the economy would almost certainly more than outweigh this public finance benefit.

Alternatively, the UK could choose to continue to make contributions to the EU budget. It may wish, for example, to participate in certain EU-wide schemes such as the EU's spending on overseas aid (see Chapter 8 for a discussion). Additionally, part of the UK's contribution pertains to tariff revenues that the UK collects on the EU's behalf – depending on the customs arrangement that is reached, a transfer of tariff revenues from the UK to the EU may continue. This would mean a smaller direct benefit to the public finances from leaving the EU, but one that is likely to come alongside a smaller adverse hit to the UK economy and therefore stronger public finances overall.

[a] Source: 'Dominic Raab: Britain will refuse to pay £39 billion divorce bill to Brussels if the EU fails to agree trade deal', *The Telegraph*, 21 July 2018, https://www.telegraph.co.uk/politics/2018/07/21/dominic-raab-britainwill-refuse-pay-39-billion-divorce-bill/.

Source: Annex B and supplementary fiscal table 2.26 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2018*, http://obr.uk/efo/economic-fiscal-outlook-march-2018/.

The UK's exit from the EU could conceivably lead to all three types of economic shock considered above. A sudden departure on 29 March 2019 (in the event of failing to reach a deal), with little time for firms and individuals to prepare, would cause a hit to the economy. A protracted period without an effective trade agreement and with associated uncertainty would almost certainly result in slower growth over time.

Estimates from the Centre for Economic Performance (CEP), NIESR and HM Treasury suggest the long-run effect could be to reduce the size of the economy by between 2.6% and 7.8% relative to what it would otherwise have been.[28] The current OBR forecasts implicitly assume that the UK's vote to leave the European Union will mean an economy that is 2% smaller than it would otherwise have been. This was the initial assessment in November 2016, the first post-referendum forecast – an assessment that has not been updated since.[29] Importantly, this assessment is predicated on a relatively smooth exit, and the OBR's long-term projections assume that the economy's long-term growth rate is unaffected. Other studies suggest that even such a smooth Brexit would mean that, overall, the UK is a less open economy and the result would likely be a permanently lower trend growth rate.[30] As illustrated in Table 3.2, small changes in the trend rate of growth have big effects on the public finances over time.

The OBR's assumed one-off hit to national income of 2% as a result of Brexit resulted in it attributing a £15 billion increase in borrowing in 2020–21 to Brexit. Even if it is right about the relatively modest effect on the economy that it assumes as a result of Brexit, this may understate the long-run public finance impact. A large predicted fall in investment actually increases tax receipts in the short term (as investment costs are deducted from corporate profits for corporation tax purposes), but would be expected to affect medium-term receipts as lower investment fed into lower profits and wages.

While there is considerable uncertainty over the precise impact of Brexit, economic analyses generally find that scenarios where the UK is in a closer relationship with the EU would be expected to have smaller negative impacts on the economy. For example, NIESR, CEP and HM Treasury have all predicted much larger negative effects under a scenario in which the UK trades on World Trade Organisation (WTO) terms with the EU than if the UK were to remain inside the European Economic Area (EEA).

Importantly, this means that a scenario that provides a greater direct benefit to the public finances (due to smaller net contributions to Brussels) would in all likelihood be worse for the public finances overall (due to more adverse economic effects). A no-deal Brexit in which the UK did not make planned 'divorce payments' would most likely lead to a worse long-term public finance outcome than a scenario in which the UK remained in the Single Market and continued to make some financial contributions to the EU budget, even if the latter scenario implied only slightly higher growth in the medium term.

[28] For a survey, see D. Mackie, 'Brexit: wealth effects much larger than income effects', JP Morgan Research Note, 28 April 2016.

[29] Source: Annex B of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, http://obr.uk/efo/economic-and-fiscal-outlook-november-2016/.

[30] See S. Dhingra, G. Ottaviano, T. Sampson and J. van Reenen, 'The consequences of Brexit for UK trade and living standards', Centre for Economic Performance (CEP), Brexit Analysis 2, 2016, http://cep.lse.ac.uk/pubs/download/brexit02.pdf.

Policy responses to changes in the underlying public finances

Public finance forecasts are revised. It matters how Chancellors respond to these revisions. If they respond symmetrically to improvements and deteriorations – for example, by always using policy to offset any underlying change in the deficit, or by always allowing the deficit to rise and fall as the economy improves and worsens – there would be no systematic effect on the path of the deficit. And where their response is to offset the underlying change, the amount of uncertainty over the actual path of the deficit would, in the medium term, be reduced.

However, if Chancellors tend to spend windfall gains, but allow the deficit to increase when the forecast deteriorates, this will lead to systematic increases in the deficit relative to forecast over time.

Indeed, Mr Hammond's statements at fiscal events imply that he is likely to view improvements and deteriorations differently. In the Spring Statement, he said:

> And if, in the Autumn, the public finances continue to reflect the improvements that today's report hints at. Then, in accordance with our balanced approach, and using the flexibility provided by the fiscal rules. I would have capacity to enable further increases in public spending and investment in the years ahead.[31]

Yet in the Autumn Budget last November, citing the same 'balanced approach', the Chancellor responded to a deterioration in the forecast by saying:

> I reaffirm our pledge of fiscal responsibility and our commitment to the fiscal rules I set out last Autumn. But now I choose to use some of the headroom I established then. So that as well as reducing debt, we can also invest in Britain's future. Support our key public services. Keep taxes low. And provide a little help to families and businesses under pressure.[32]

In one instance, the Chancellor is promising to spend the windfall should the public finances improve, loosening policy in response to a better forecast. Yet in response to a worse forecast in the second instance, Mr Hammond advocates allowing the deficit to rise without offsetting it with policy measures. This is exactly the type of asymmetric behaviour that would lead to a ratchet effect, with the deficit rising over time: improvements in the forecast feed through into lower taxes and higher spending, but deteriorations in the forecast are not offset by equivalent tax increases or spending cuts.

In this section, we look for evidence of asymmetric behaviour by Chancellors since 2010 (Mr Hammond and his predecessor Mr Osborne) and evaluate the possible impact of such behaviour on the likely path of borrowing going forward.

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[31] Philip Hammond's Spring Statement speech, March 2018, https://www.gov.uk/government/speeches/spring-statement-2018-philip-hammonds-speech.

[32] Philip Hammond's Autumn Budget speech, November 2017, https://www.gov.uk/government/speeches/autumn-budget-2017-philip-hammonds-speech.

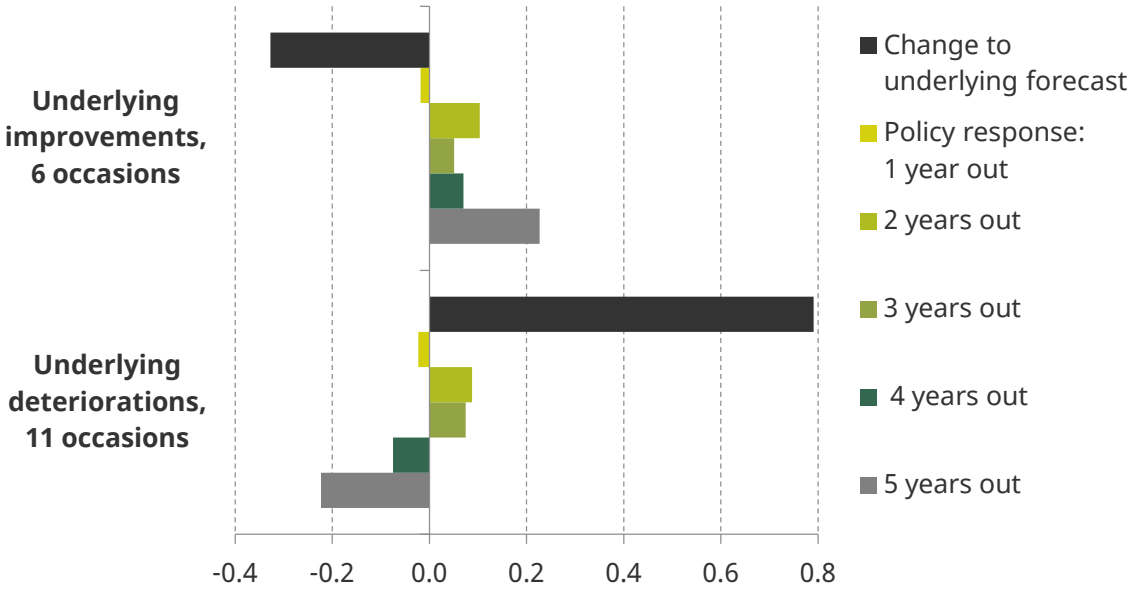
Forecast changes since 2010

It is possible to divide changes in successive deficit forecasts between changes resulting from policy and other 'underlying changes' unrelated to policy decisions.[33] Underlying borrowing changes between successive forecasts are often large – the average absolute change in (underlying) forecast for the final year of the forecast (five years after the fiscal event) is 0.6% of national income, or £13 billion in today's terms. Since 2010, public finance changes have been more likely to be deteriorations than improvements (focusing on the final year of the forecast horizon, there have been 11 forecast deteriorations and only six improvements). The average size of deteriorations has also been larger than the average size of improvements.

Figure 3.15 shows how policy has responded to these forecast changes, splitting the fiscal events into 'improvements' and 'deteriorations' based on the underlying change in the final-year borrowing forecast. The government may respond with measures that reduce the deficit or increase it. The figure shows the following:

- In the short term – two and three years out – on average the net effect of policy has been a small giveaway (i.e. increasing the deficit). This is true regardless of whether the forecast has improved or worsened, or whether the net effect of policy in the medium term is a giveaway or a takeaway.

Figure 3.15. Average policy response to changes in the underlying forecast



Note: Positive (negative) values represent a deterioration (improvement) in the forecast, i.e. an increase (decrease) in public sector net borrowing.

Source: Office for Budget Responsibility, 'Forecast revisions database', http://obr.uk/data/; authors' calculations.

[33] We disregard classification changes in this analysis.

- In the medium term, on average policy has partially offset underlying changes to the forecast. In periods when the underlying forecast has improved, policy has on average been loosened in the medium term (i.e. acted to increase the deficit), while forecast deteriorations have been met with fiscal tightening (i.e. action to reduce the deficit).

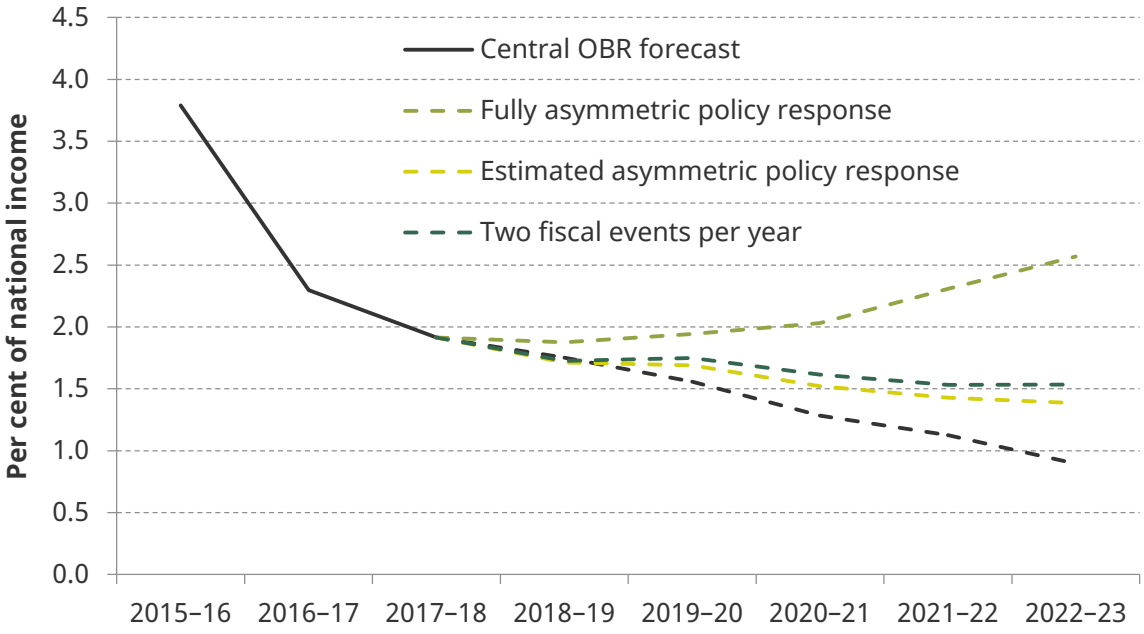
- However, the response to forecast improvements and deteriorations is not symmetric. On average, two-thirds of the total value of windfall forecast improvements in the final year of the forecast has been offset with extra spending or tax cuts, while only around one-quarter of the total value of fiscal deteriorations is counteracted by fiscal tightening.

Implications for borrowing

If a higher proportion of windfalls are spent than deteriorations are offset, on average we can expect borrowing forecasts to increase rather than fall over time.

Figure 3.16 shows the OBR central forecast from the March 2018 Spring Statement, and alternative central scenarios based on different policy responses. Forecast changes are assumed to be equally likely to improve and worsen the forecast, and so the OBR central forecast is also equivalent to a 'no policy change' central scenario and a 'symmetric policy change' central scenario, in which improvements and deteriorations are treated in the same way on average.

Figure 3.16. Central borrowing forecast under different policy assumptions



Note: Policy response series are based on 100,000 simulations of forecast errors and subsequent policy responses. 'Full asymmetric policy response' assumes that any underlying reduction in the deficit is reversed by spending increases or tax cuts, while there is no policy response to a deterioration in the forecast. 'Estimated asymmetric response' takes values of policy response based on Figure 3.15 for underlying improvements and deteriorations respectively.

Source: Authors' calculations using Office for Budget Responsibility, 'Forecast revisions database', http://obr.uk/data/.

The extreme case would be that any windfall from a forecast improvement is fully spent while deteriorations are not offset at all. This is the 'fully asymmetric policy response' scenario in Figure 3.16, and such behaviour would put the public finances on an unsustainable course over the longer term. Effectively, this would mean that the deficit could never fall below the forecast level (as any improvement is spent), while any negative shock would feed through into higher borrowing. If that were to happen, the central expectation would be that borrowing would be over £50 billion (2.5% of national income) in today's terms in 2022–23.

In practice, we do not find that Chancellors' responses to improvements and deteriorations have been anywhere near so extreme. The 'estimated asymmetric policy response' scenario assumes that policy responds to upgrades and downgrades in the way it has on average since 2010 (shown in Figure 3.15).[34] Even this behaviour would lead to a substantial increase in the expected path of the deficit such that by 2022–23 it would be 0.5% of national income (£10 billion in today's terms) higher than currently forecast. This suggests that treating public finance improvements and deteriorations differently can have a substantial impact on the path of the deficit, and is a genuine risk to the Chancellor's plans, and his fiscal targets, going forward.

Since changes in fiscal forecasts result in asymmetric behaviour by Chancellors, the frequency of fiscal events matters for policy outcomes. Having more fiscal events would mean more revisions to forecasts that would then, in turn, induce a policy change. Alternatively, having fewer fiscal events would provide more opportunity for the impact of different developments in the public finances between successive forecasts to offset each other rather than induce a policy response. So one further implication of this analysis is that the Chancellor's move from two fiscal events per year to one will have been (on average) a deficit-reducing measure. The 'two fiscal events per year' scenario in Figure 3.16 assumes the same policy responsiveness as the 'estimated asymmetric policy response' scenario, but instead allows the Chancellor to adjust policy twice a year rather than once.[35] Because policy responds differently to improvements and deteriorations, on average this reduces the deficit (albeit by a modest 0.15% of national income in 2022–23, or £3 billion in today's terms). This is perhaps a further reason, on top of a number of others,[36] why the Chancellor should be encouraged to persist with one fiscal event per year, something that his predecessors have failed to do.

3.6 Conclusion

While borrowing has now returned to pre-crisis levels, the impact of the Great Recession is still evident in national debt, which as a share of national income is 50 percentage points higher than it was in 2007–08. Given the benefits of a lower debt-to-GDP ratio, sluggish

[34] Specifically, in order to quantify the possible impacts of this asymmetric treatment, we simulate series of forecast-to-forecast underlying revisions based on the distribution of such revisions since 2010. As we now have only one fiscal event per year where policy will be announced, we look at autumn-to-autumn changes in the underlying forecast since 2010. We model alternative policy responses to these shocks, allowing for improvements and deteriorations to be treated differently.

[35] In this scenario, shocks have a narrower distribution, reflecting the distribution of past forecast-to-forecast shocks rather than 12-month shocks.

[36] See recent joint work by researchers at the Chartered Institute of Taxation, Institute for Fiscal Studies and Institute for Government, *Better Budgets: Making Tax Policy Better*, https://www.instituteforgovernment.org.uk/publications/better-budgets-making-tax-policy-better.

growth prospects and the 'fiscal illusion' from the accounting treatment of student loans in public sector net borrowing, there are good reasons for the government to target a lower borrowing level than the current 1.8% of national income over the longer term (though not necessarily immediately). This is especially the case when considering potential future downturns and the fact that recessions tend to be associated with sharp increases in debt as a share of national income.

On the other hand, reducing the deficit back to normal levels from a peak of 10% of national income has required an eight-year period of substantial fiscal consolidation since 2010. An ageing society is set to place increasing upwards pressures on public spending for the foreseeable future (and in particular over the few years after October 2020). All of this makes delivering the fiscal plans set out in the Spring Statement – which include continued large implied real-terms cuts to the day-to-day spending for 'unprotected' areas – extremely difficult.

Meeting the overarching fiscal objective of eliminating the deficit entirely by the mid 2020s looks very challenging: it requires not just an extension of fiscal consolidation, over and above that already planned through to 2022–23, but an acceleration of the pace of fiscal consolidation.

The Chancellor has said that, at the Budget, he will set out the total spending envelope for a 2019 Spending Review. It would not be a surprise if this loosened policy relative to the path assumed for government spending in the Spring Statement, especially given commitments made by the Prime Minister on NHS funding in the summer, and her conference speech statement celebrating the apparent end of austerity. The Chancellor might find it difficult to fund any such increase entirely through tax rises given political constraints (and government revenues are already at their highest level relative to the size of the economy since the mid 1980s). This suggests that policy measures might be likely to represent a net giveaway in the Budget on 29 October.

One factor that may be in the Chancellor's favour is that the public finance data so far this year point towards an improvement in the underlying (i.e. pre-policy-measures) forecast. Forecast borrowing in 2022–23 could be £6 billion lower than forecast in the Spring Statement, which might provide the Chancellor with welcome fiscal wiggle room. Such an improvement could allow him to loosen, at least partly, the spending squeeze without needing to deliver tax rises, while keeping the deficit on a path similar to the one set out in the Spring Statement.

However, an improvement of £6 billion is a modest revision relative to the amount of uncertainty surrounding public finance forecasts, and that is especially true of this forecast. Given uncertainties surrounding the nature of the post-Brexit deal, and the knock-on effect of that deal onto the economy and the public finances, it is reasonable to expect large revisions to the forecasts over the next few years. While it may seem innocuous for the Chancellor to increase spending if the underlying forecast improves, it is a threat to fiscal sustainability if Chancellors are systematically more willing to spend windfall gains than to tighten policy in response to deteriorations in the forecast.

This asymmetric treatment of forecast improvements and deteriorations is strongly suggested by the Chancellor's statements to the House of Commons and we find evidence of this approach in his and his predecessor's behaviour since 2010. It is true that

uncertainty can go both ways – forecasts could improve as well as worsen over the next five years. But the asymmetric response of policy means the risks are skewed – when things get better, this is only partly reflected in the deficit, while deteriorations pass through more fully into borrowing.

This may provide a further reason to be sceptical that the government's target of eliminating the deficit by the mid 2020s will be met, on top of the challenges of delivering further consolidation measures. Based on past forecast errors, there is an almost one-in-three chance that the deficit will be eliminated by 2022–23 without further policy action being required. But this fails to take into account the fact that much of any public finance windfall might be used to finance giveaways (either through spending increases or tax cuts). The history of fiscal rules and targets in the UK since 1997 is one of rules being broken and targets being missed. If the Chancellor and his successors continue to respond asymmetrically to good and bad public finance news, then it is more likely than not that the government's overarching fiscal objective will go the same way.