RF

Resolution Foundation

BRIEFING

Pressing the reset button

The public finance options facing the new Chancellor at the Autumn Statement

Matt Whittaker

October 2016

RF

resolutionfoundation.org   info@resolutionfoundation.org   +44 (0)203 372 2960   @resfoundation

Summary

The first fiscal event for any new Chancellor of the Exchequer is a big deal, setting the tone for what is to follow for years to come. In just four weeks Philip Hammond will get his chance to set out his own stall. The central question he faces is how to respond to a significant expected deterioration in the economic and public finance forecasts, partly but not wholly related to the economic impact of the Brexit vote.

Philip Hammond inherits from George Osborne a fiscal 'mandate' that requires the government to balance the books and deliver an absolute surplus in 2019-20, with a secondary rule requiring the stock of debt relative to the size of the economy to fall in every year up to that point. However, the analysis in this paper raises the prospect of the new Chancellor having to respond to an ***£84 billion deterioration*** *(in 2015-16 prices) in the public finances cumulatively across the five years of the forecast period to 2020-21. This would include:*

- ***£23 billion additional borrowing in 2019-20****, wiping out the £10 billion annual surplus anticipated by the OBR at the March Budget and meaning the mandate's requirement for a surplus in that year would be breached by £13 billion; and*
- ***Rising debt as a proportion of GDP in 2017-18****, breaking the secondary rule by around £10 billion in that year.*

Confronted with such a backdrop, the Chancellor has already indicated the need for a fiscal 'reset'. While this has been over-interpreted as a hint of a radical shift in macro-economic policy, it simply represents recognition of the need to drop his predecessor's fiscal pledges if he is to avoid making significant additional tax rises or spending cuts at a time when the economy will already face increased headwinds.

In this note, we consider the new fiscal rules that the Chancellor might choose to adopt as part of this 'reset' and the headroom that might afford him. We examine two broad ways in which the Chancellor could loosen his fiscal rules:

- ***Softening the target****: switching from the existing overall surplus target to a focus on current budget balance, allowing ongoing borrowing to finance investment; and*
- ***Delaying the target****: maintaining the focus on an overall surplus but meeting it later than 2019-20.*

If the Chancellor softened the target by requiring a ***current budget balance*** *in 2019-20, we believe he could avoid the need for any further tightening. That is, even after accounting for the £23 billion deterioration in the outlook in that year, he would still be on course to deliver a current budget surplus in 2019-20. Indeed, depending on how much of that surplus he wanted to retain as a 'fiscal margin', he could have* ***up to £17 billion in additional fiscal headroom****.*

Such headroom is likely to prove useful given the considerable 'shopping list' of demands the Chancellor faces from within and outside government. These include help for 'just managing' families (by reversing significant planned cuts to the in-work support provided by Universal Credit for instance) and delivering on income tax cut commitments from the Conservative manifesto. An additional £17 billion would more than cover these two asks, with enough left over either to raise day-to-day spending on public services by close to 3 per cent relative to existing plans or to maintain a fiscal margin of just over £8 billion.

The Chancellor has another item on his shopping list in the form of higher public investment, as part of a wider industrial strategy. By focusing on a current budget, he would face very little constraint on his ability to borrow for this purpose. Investment spending would not count towards the borrowing rule, meaning that he would only need to ensure that any additional borrowing didn't breach the supplementary debt rule. By 2019-20 the leeway that approach would provide would be very substantial indeed.

The trade-off of softening his target in this way is a much higher overall deficit of course. Pursuing no more than current budget balance in 2019-20 would leave public sector net borrowing at £30 billion. Combined with the wider public finance deterioration inherited by the Chancellor, this would increase borrowing cumulatively by £145 billion by 2020-21 relative to the March Budget plans. While this approach would still result in falling government debt as a share of GDP in every year after 2017-18, it would mean more than doubling cumulative net borrowing between 2016-17 and 2020-21 on the basis of a significant discretionary loosening. Such an approach would have serious ramifications for how the government's approach to fiscal policy is viewed.

The option to ***delay the overall surplus target*** *is much harder to deliver. Delaying by one year to 2020-21 would require an additional £9 billion of tax rises or spending cuts in that year before making any progress on the shopping list or indeed building a fiscal margin. It would however reduce the cumulative borrowing increase from £84 billion to £75 billion. If the Chancellor instead wished to adopt a delay approach without additional cuts or tax rises, we estimate he might have to wait as long as 2023-24 to meet his target – such a long way off as to be of no credibility benefit and indeed beyond the OBR's forecast horizon.*

For these reasons we believe it is unlikely that the Chancellor will formally retain an overall surplus target (although he may well say one is still desirable at some point). Instead, we expect to see him moving to some form of current budget focus. That may specify balance, or it may specify that just certain types of investment spending sit outside of the fiscal rule. Either way, a focus on current balance would better reflect both the fiscal reality the Chancellor faces and the argument that capital spending should not be treated identically to current spending

Ultimately the path Philip Hammond chooses to follow will depend on the final assessment of the OBR on the extent to which circumstances have changed since the March Budget, the economic merits of different options, and his judgement of the political balance between doing more to support the economy while retaining a reputation for fiscal discipline. Given that the plans he has inherited are set to reduce incomes among the 'just managing' group that has become the focus of the new Prime Minister, it seems certain that he will at the very least look at reprioritising existing tax and welfare programmes. We'll turn to these issues of tax and benefits in two further reports ahead of the Autumn Statement.

The new Chancellor faces both a challenge and an opportunity when he delivers his first fiscal statement

When he stands up to deliver his first fiscal statement at next month's Autumn Statement, Philip Hammond is expected to be speaking against the backdrop of a significant deterioration in the public finances outlook for the coming years. This provides him with both a challenge and an opportunity.

It's challenging because he arrives with a lengthy shopping list. From providing additional support to the 'just managing' group identified by the Prime Minister, to raising public investment and following through on Conservative manifesto pledges for income tax cuts, he has no shortage of demands to satisfy. Being told by the Office for Budget Responsibility (OBR) that he has less money to do it all with is the opposite of good news.

Yet it provides him with an opportunity too. Unlike other Chancellors who plot a public finance path and find themselves blown off course by the winds of economic (and political) circumstance, he starts his journey fully aware that there's a storm brewing and with widely accepted good cause for suggesting that the time is right for a fiscal "reset".[1] Depending on the particular trajectory he chooses to set out – and in particular the new fiscal rules he defines – he could even benefit from additional fiscal headroom.

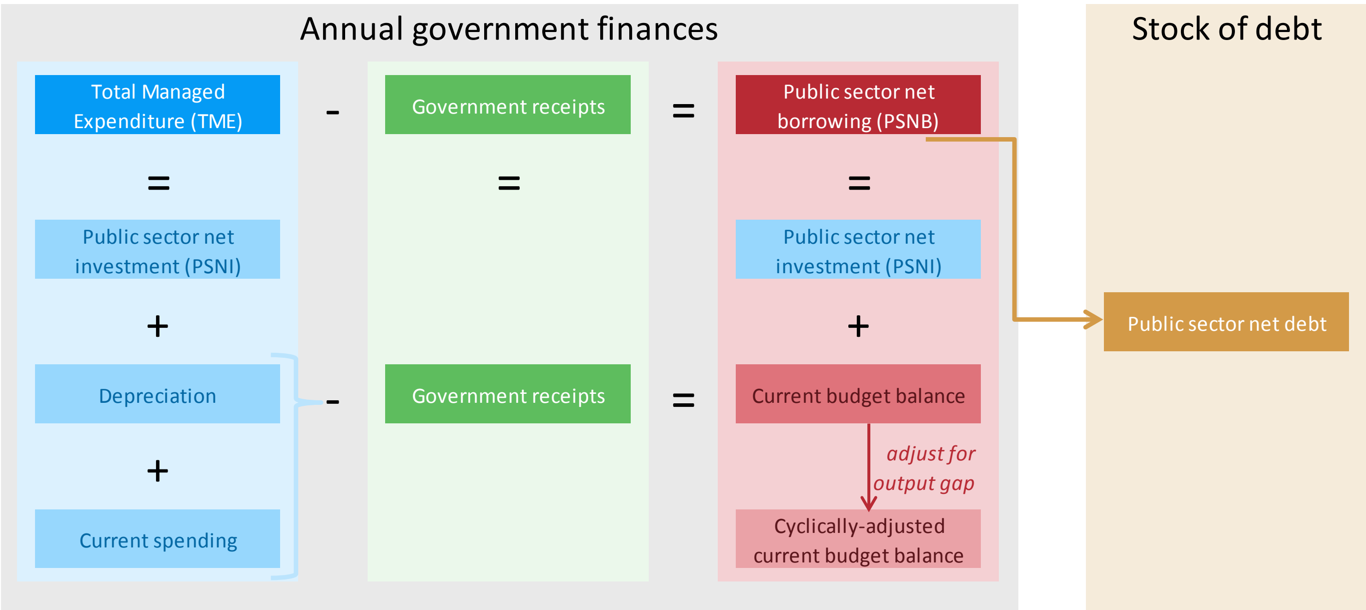
[1] *BBC News*, "Chancellor may 'reset' economic policy in Autumn Statement", 22 July 2016

In this note we consider three things: the potential scale of the fiscal deterioration the OBR will set out on 23 November; the Chancellor's options for response; and the likelihood of his securing the different items on his shopping list. We start with a quick recap of the evolution of fiscal targets – and the government's consistent failure to meet them – over recent years.

Public finance targets have shifted over recent years, with government regularly having to extend its proposed timetable for balance

In his first Budget, back in Summer 2010, Chancellor Osborne established a new fiscal 'mandate' designed to deal with what he called the "most urgent task facing this country" – namely reducing the annual deficit in the public finances (see Figure 1 for an explanation of the various public finance terms).[2]

Figure 1: The public finances



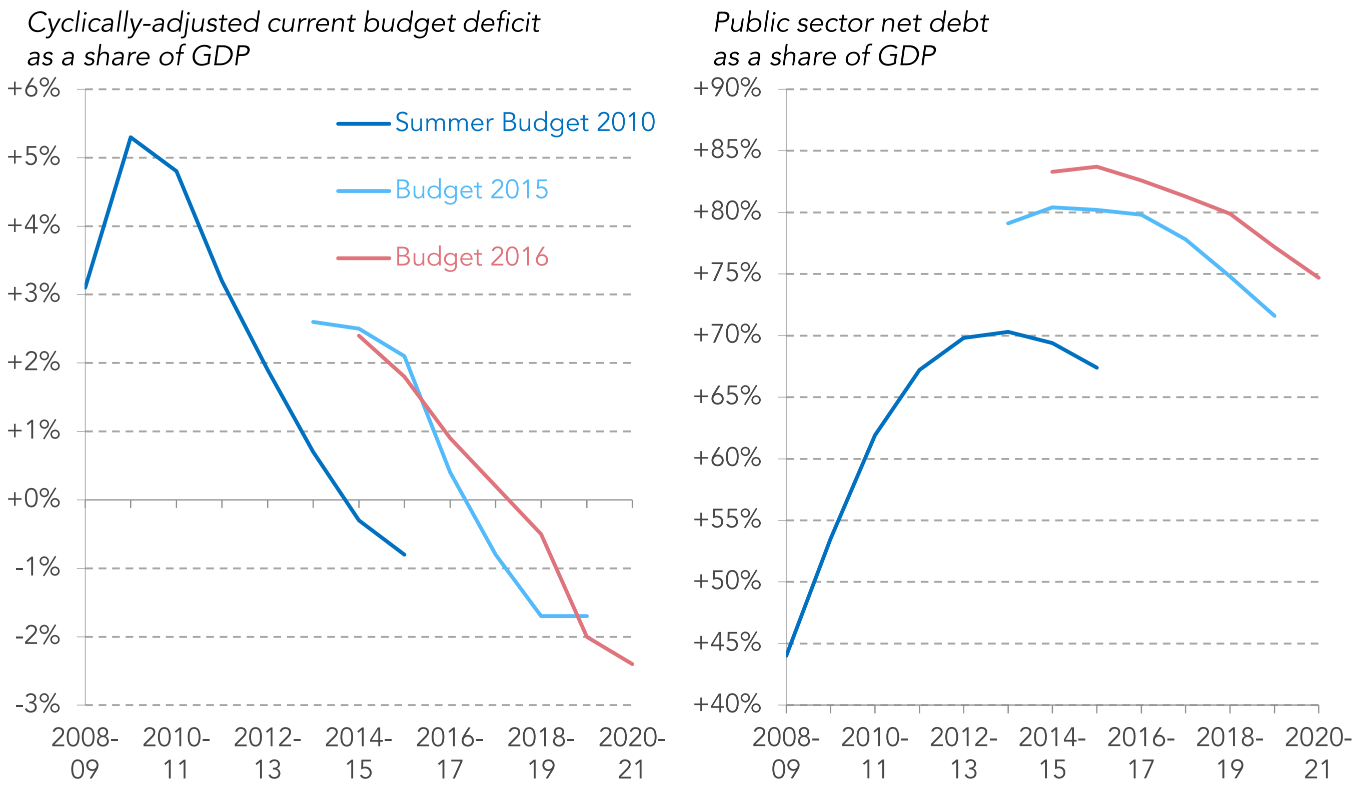
The mandate required the government to achieve cyclically-adjusted (that is, after accounting for any temporary departure from the country's potential level of output) current balance by the end of the rolling, five-year forecast period. Assessing his plans for meeting this mandate, the newly established OBR declared that he was likely to balance the books on this measure one year ahead of schedule, in 2014-15.[3] Likewise, the OBR assessed that the Chancellor would be one year early in meeting his 'supplementary' debt rule – which required the stock of government debt (or public sector net debt (PSND)) to be falling as a share of GDP at a fixed date of 2015-16.

[2] HM Treasury, *Budget 2010*, June 2010

[3] OBR, *Budget Forecast*, June 2010

Yet, as Figure 2 shows, those initial projections for both the deficit and the stock of debt proved wide of the mark – reflecting changes in both economic circumstances and policy. By the time of the 2015 Budget, just before the general election, the cyclically-adjusted current budget was assessed as being set to reach balance in 2017-18 – three years later than originally thought. Debt was judged to start falling as a share of GDP in 2015-16, one year before its updated target of 2016-17 but still one year after the original OBR assessment predicted.

Figure 2: Successive OBR projections for the annual deficit and stock of debt: UK



Source: OBR, *various*

Having dominated politics in the last parliament, the debate on public finances formed one of the key battlegrounds of the 2015 election. With the overall deficit (including spending on investment) captured by the public sector net borrowing (PSNB) figure standing at £95 billion and PSND topping £1.5 trillion in 2014-15, that focus was hardly surprising.

The Conservative party's central pre-election fiscal pledge marked something of a departure from the existing mandate, focusing as it did on delivering an *overall* budget surplus (and indeed, introducing a rule that surplus must be maintained "in normal economic times"). The difference between this overall balance pledge and the current balance[4] focus of the Coalition government amounted to around £37 billion in 2014-15 (with this figure representing total public sector net investment (PSNI)). The Conservative manifesto thus introduced a much tougher overall goal. It also promised to achieve balance by a fixed point (*within* the new parliament, with the expectation being that it would arrive in 2019-20) rather than at the end of a moving five-year horizon.

[4] The output gap was thought to have all but gone by the time of the election and the OBR projected that it would cease to exist part way through the new parliament. As such, the original focus on *cyclically-adjusted* current budget balance would have been indistinguishable from a simple focus on current balance.

This stance set the Conservatives apart from both Labour (who were focused on the current budget balance favoured by the Coalition) and the Liberal Democrats (who said they would exclude some – unspecified – parts of investment spending).

Post-election, Chancellor Osborne updated his *Charter for Budget Responsibility* accordingly.[5] The updated fiscal 'mandate' of 2015 set a specific target for overall surplus by the end of 2019-20. It also set a default target for "a surplus on public sector net borrowing in each subsequent year", in keeping with the manifesto wording this was to be achieved "in normal times".[6] The 'supplementary' debt rule was also updated, such that PSND should be falling as a share of GDP in every year of the parliament.

As Figure 2 showed, the underlying picture on borrowing and debt had shifted again by the time of the last fiscal statement – the March 2016 Budget. Nevertheless, following some fiscal gymnastics, the government was assessed as being on course to meet both its mandate and supplementary target. However, there has been yet more change since then.

Changed economic circumstances are expected to substantially alter the picture on government spending and revenue

Economic forecasts are uncertain at the best of times. Following June's referendum result they come with even larger health warnings. Longer-term, the exact impact of Brexit is impossible to judge – particularly as we don't yet know what form of relationship the UK will have with the rest of the world once it has formally left the EU, nor how any change in the rules on migration might affect GDP growth. Nearer-term too there is much uncertainty, with a clear consensus that the fall-out from the vote is likely to negatively affect the economy over the course of this parliament at least, but little or no consensus on the magnitude that effect might take.

In relation to the position of the public finances, it is the OBR's view that matters most. We will not get its verdict until 23 November. We can, however, make use of the medium term economic forecasts which *do* already exist to speculate on the extent to which the picture is likely to have altered when Philip Hammond delivers his first fiscal statement.

Averaging across a number of independent forecasters who have their projections collated by HM Treasury,[7] we find that the economy is now expected to be £60 billion smaller in 2020 than was thought just before the referendum. Likewise, average weekly earnings are estimated to be around £700 a year lower in nominal terms in 2020 than the pre-referendum forecasts suggested. Adding in revisions to CPI inflation increases the real earnings hit to just over £1,050 a year. And fewer people are set to be in work, with the average forecast for unemployment suggesting that around 600,000 more people will be out of work in 2020 than was previously thought.

In terms of how this feeds through to the public finances, we can expect changes in both parts of the deficit equation: that is, in relation to both government spending and government receipts. It is clear that the government can expect lower tax receipts – both corporate and individual – given they are heavily related to changes in nominal GDP. We can also be sure that government social security spending will rise with any increased unemployment (via Job Seekers Allowance for example) or wage growth slowdown (via tax credits, Universal Credit (UC) and other forms of in-work support for example).

[5] HM Treasury, *Charter for Budget Responsibility: Summer Budget 2015 update*, July 2015

[6] The Charter stated that "normal times" would be assumed to apply unless the OBR assessed that the UK faced a "significant negative shock" in the most recent period or during the relevant forecast period. This shock was defined as real GDP growth of less than 1 per cent on a rolling four-quarter on four-quarter basis.

[7] See HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*.

If inflation rises more quickly than previously suggested then the government will gain something of a windfall from its existing plan to freeze the cash value of many working-age benefits (and recipients will find their incomes more tightly squeezed), but this must be offset against an increase in claimant numbers. Government departments too might find existing nominally-fixed departmental spending limits (DEL) stretching less far in the coming years if the GDP deflator rises.

In addition to the welfare costs set out above, we might expect other elements of annually managed expenditure (AME) to rise as a result of these economic changes. The reduction of the Bank of England's base rate and additional asset purchases in August have the potential to lower government borrowing costs. But, while yields on government bonds remain lower than they were pre-referendum, they have risen sharply in recent weeks offsetting some of this boost. Prior to the UK's eventual exit from the EU, the cost of contributing to its budget also looks set to rise. That's because these contributions are denominated in euros, thereby becoming more expensive as the value of the pound has fallen.[8]

Revisions to forecasts point to a £23 billion increase in borrowing relative to Budget 2016 expectations

To assess the impact of all these factors, we focus specifically on seven forecasters who have provided medium-term projections for PSNB before and after the EU referendum.[9] We consider the scale of revisions they report and apply the implied adjustment to the OBR's projections at the time of the March Budget.

In doing so, it's worth noting that not all of the deterioration is likely to reflect 'Brexit effects'. Monthly public finance updates from the ONS suggest that the government had already veered off course before the June referendum, with tax receipts performing particular poorly. Indeed, given that most economic measures are yet to show any fall-out from the vote (Sterling being the obvious exception), it's reasonable to assume that much of the weakening in the latest (September) outturn figures would have existed even in the absence of Brexit.[10]

As Figure 3 shows, PSNB fell by roughly 5 per cent in the first six months of 2016-17 relative to the same period a year earlier.[11] Given that the PSNB trajectory set out by the OBR in March assumed a 27 per cent fall by the end of the financial year, it's likely that next month's update from the OBR was always set to contain bad news for the government.

[8] A similar principle holds in relation to contributions to other international bodies.

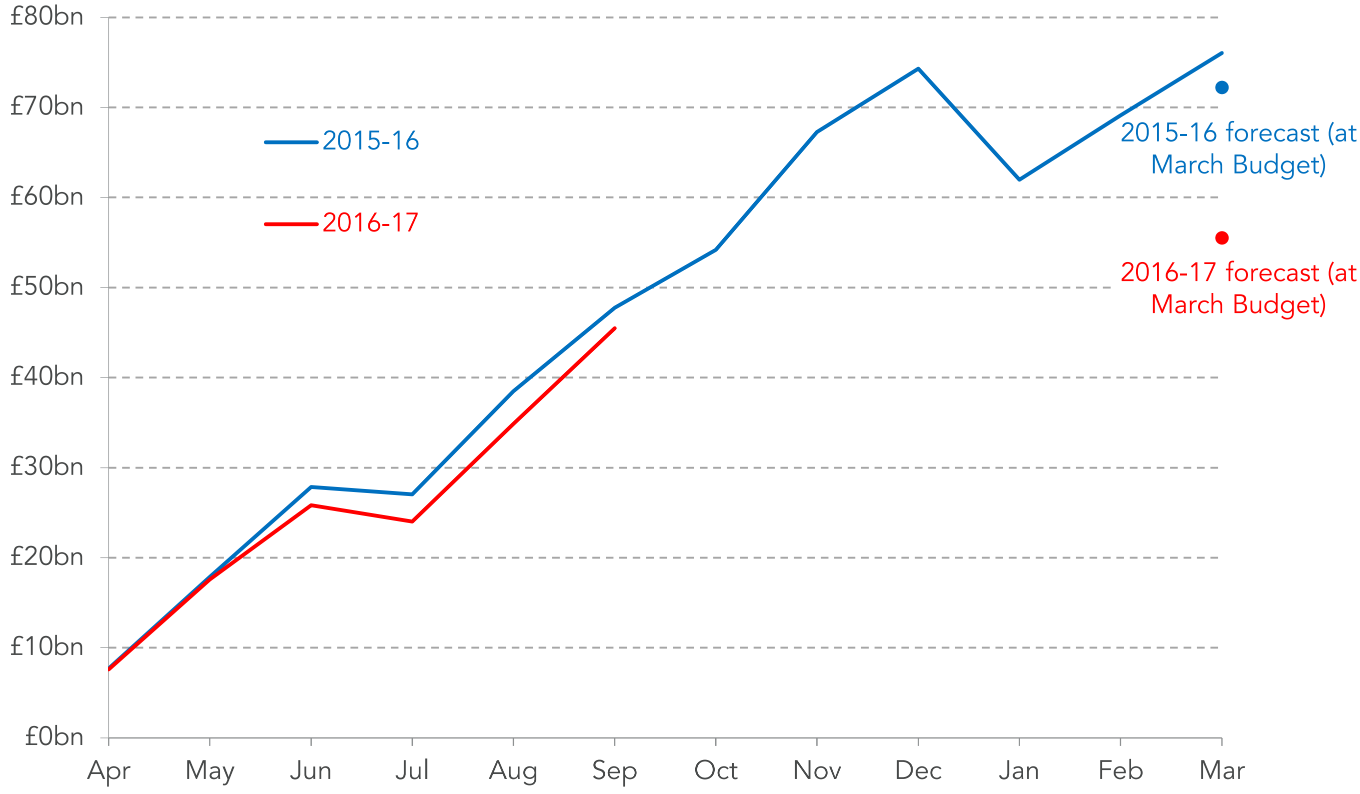
[9] The forecasters are: Citigroup, Commerzbank, ING, Beacon, Experian, NIESR and Oxford Economics and are recorded in HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*. While the publication is updated on a monthly basis, medium-term projections covering the period to 2020 are only published every three months. Our analysis compares forecasts delivered in August 2016 with those presented in May 2016. It is not clear whether or not the post-referendum updates take account of the £170 billion stimulus package announced by the Bank of England at its August meeting. However, consideration of the more timely but shorter-term monthly forecasts provided by these organisations to HM Treasury show little change in projections for 2016 and 2017 between August and October. The next medium-term forecasts – which will account for this intervention and may include additional forecasters – are due in November.

[10] The deterioration will also include the fact that the government has subsequently said it will not implement additional disability benefit cuts that were announced in March 2016. These amounted to £1.3 billion a year in 2019-20.

[11] ONS, *Public Sector Finances: Sept 2016*, 21 October 2016

Figure 3: Outturn and forecasts for borrowing: UK

Cumulative public sector net borrowing (nominal)



Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of ONS, *Public Sector Finances: Sept 2016*

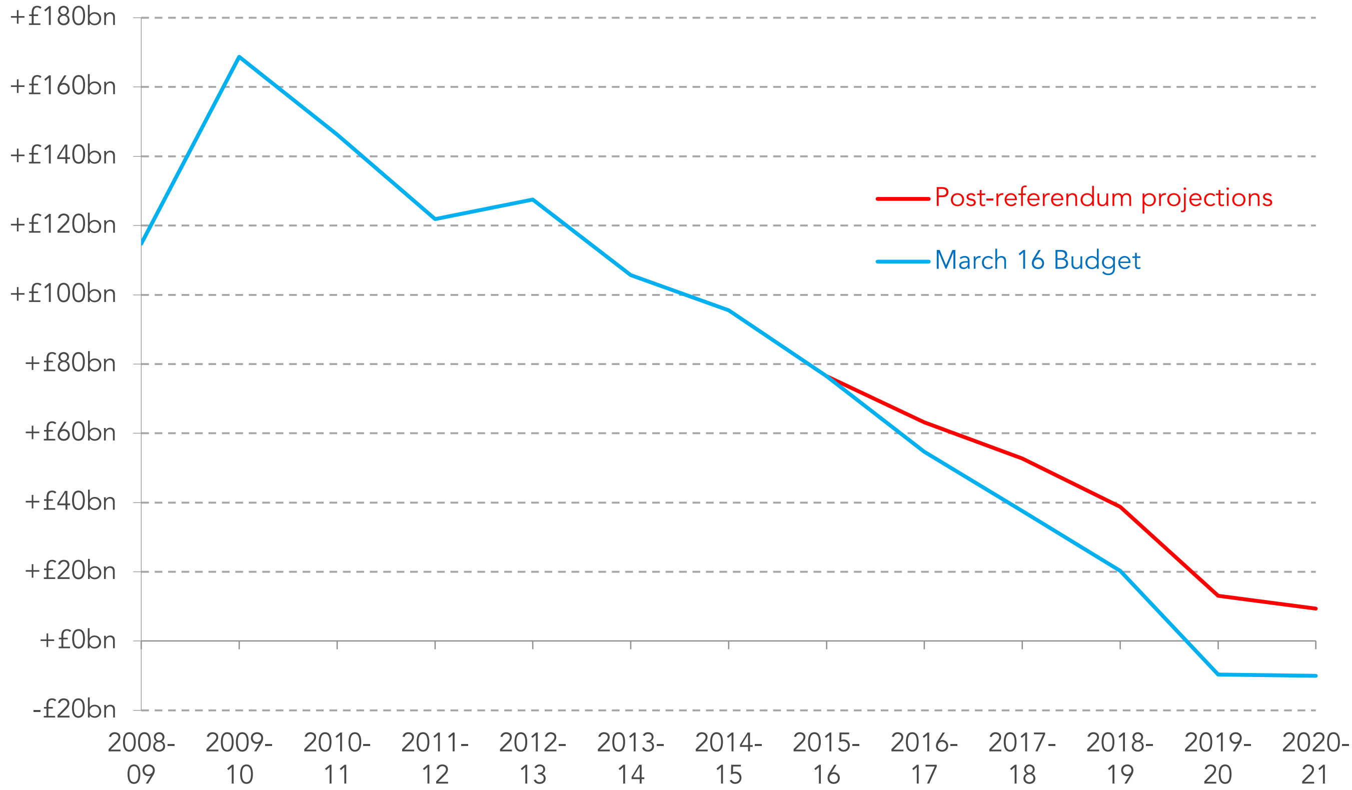
Taking a simple arithmetic approach, the outturn for the first six months of 2016-17 suggests that PSNB will miss the OBR's projection by around £15 billion. The OBR has pointed out that there are reasons why the figure might not come in as large as this – with some expectation of back-loading in tax receipts. Nevertheless, the OBR has concluded that it is "very unlikely" that its March forecast will now be met.[12]

As Figure 4 shows, the OBR had previously projected an overall surplus of £10 billion in both 2019-20 and 2020-21 (in 2015-16 prices). Under the adjustments we apply, the government now appears on course to record deficits of £13 billion in 2019-20 and £9 billion in 2020-21. The combination of in-year changes and potential 'Brexit effects' is therefore assumed to generate a £23 billion annual deterioration in the public finances by 2019-20.

[12] OBR, *Commentary on the Public Sector Finances release: September 2016*, 21 October 2016

Figure 4: Actual and projected annual net borrowing before and after the EU referendum: UK

Public sector net borrowing, 2015-16 prices



Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

Table 1 details the figures for each year in turn. It also shows the cumulative effect of this deterioration on borrowing, indicating that the government is set to borrow an additional £84 billion in total over the course of the parliament in the absence of any policy change, coming close to doubling the overall level of borrowing over that five year period.

Table 1: PSNB projections before and after the EU referendum: UK

2015-16 prices	*2016-17*	*2017-18*	*2018-19*	*2019-20*	*2020-21*	*Cumulative*
Budget 2016	£55bn	£38bn	£20bn	-£10bn	-£10bn	£93bn
Updated for latest independent forecasts	£63bn	£53bn	£39bn	£13bn	£9bn	£177bn
Difference	*£8bn*	*£15bn*	*£18bn*	*£23bn*	*£19bn*	*£84bn*

Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

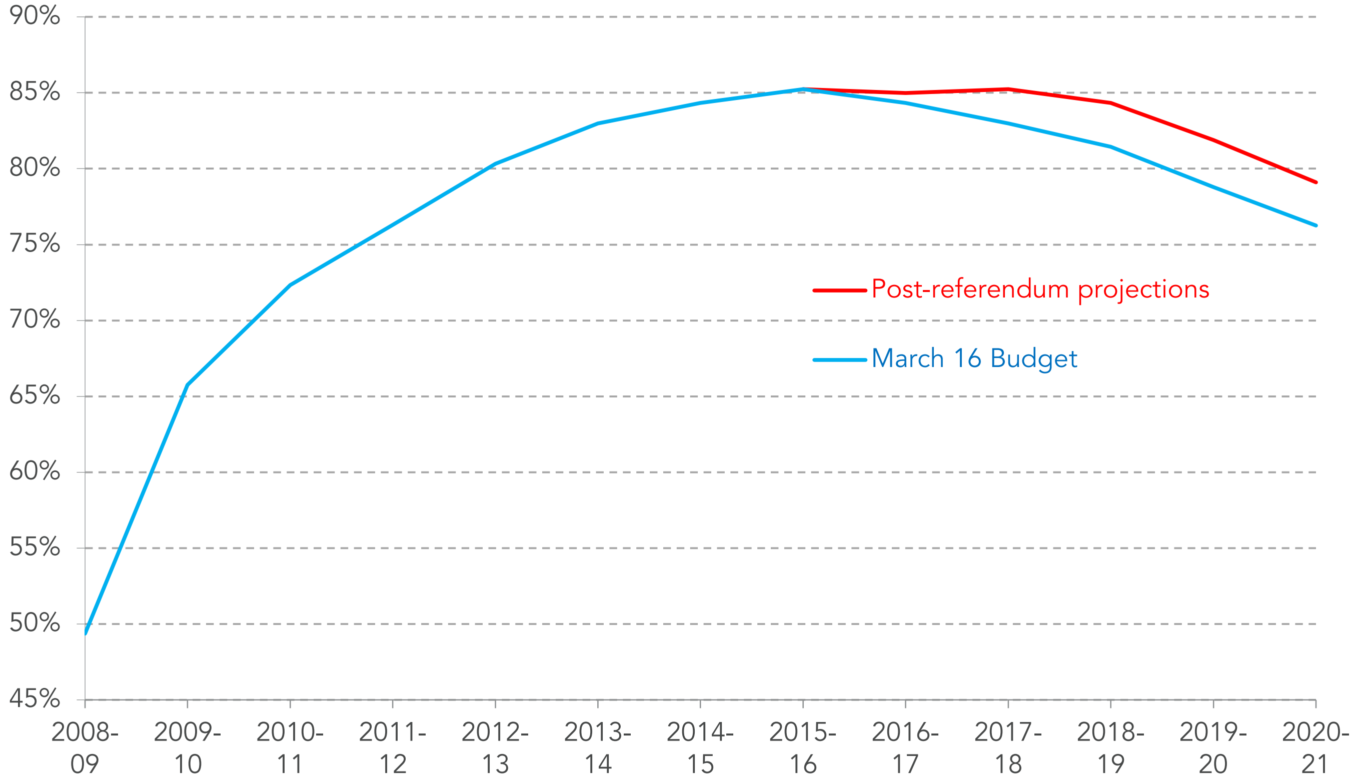
The supplementary debt rule may also be about to be breached

The post-referendum trajectory for PSNB that we are left with has implications for the supplementary debt rule too. At the March Budget, the OBR assessed that PSND as a share of GDP would fall slowly in the first half of the parliament; from 85.2 per cent in 2015-16 to 84.3 per cent in 2016-17 and 83 per cent in 2017-18. It was then expected to fall more swiftly, reaching 76.3 per cent in 2020-21.

As Figure 5 shows, the projections for higher annual deficits set out in Figure 4 mean that the stock of debt is now set to fall more gradually. Indeed PSND is shown to fall very marginally in 2016-17, to 85 per cent of GDP, before *rising* back to its 2015-16 level of 85.2 per cent in 2017-18 because of slower GDP growth alongside increased borrowing. If this were to happen, the supplementary debt rule would be broken by £10 billion in that year. Debt as a share of GDP does fall thereafter though, highlighting the fact that it is possible to run an annual deficit and still bring down the stock of debt relative to the size of the economy.

Figure 5: Actual and projected stock of debt before and after the EU referendum: UK

Public sector net debt as a share of GDP



Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

Before turning to what these new projections might mean for the Chancellor's options at the Autumn Statement, it is worth re-emphasising just how uncertain the borrowing and debt assessments are. Looking across the seven forecasters used in our analysis, the PSNB revisions for 2019-20 ranged from a £2 billion *improvement* in the deficit to a £55 billion deterioration. Our £23 billion figure can be considered no more than illustrative of the potential scale of additional challenge facing the new Chancellor.

Faced with this deterioration, the new Chancellor must set new targets

Whatever the precise details of the figures handed to him by the OBR on 23 November, the key question is "how will the Chancellor react"?

Any attempt to stick to the existing fiscal rules would involve fiscal tightening of £10 billion in 2017-18 – in order to comply with the debt rule – and £13 billion in 2019-20 to stick to the main mandate. However, that's an option he's ruled out. Speaking at the Conservative party conference he said (emphasis added):

> *The deficit remains unsustainable. And the decision to leave the EU has introduced new fiscal uncertainty... The British people elected us on a promise to restore fiscal discipline. And that is exactly what we are going to do. But we will do it in a pragmatic way that reflects the new circumstances we face.*
>
> *The fiscal policies that George Osborne set out were the right ones for that time. But when times change, we must change with them. So we will* ***no longer target a surplus at the end of this Parliament****.*

But just what form of fiscal 'reset' does he have in mind? The rest of his speech provided limited clues:

> *But make no mistake.* ***The task of fiscal consolidation must continue****. And it must happen within the context of a* ***clear, credible fiscal framework that will control day-to-day public spending****, deliver value for money and get Britain back living within our means.*
>
> *At the Autumn Statement in November I will set out our plan to deliver long-term fiscal sustainability while responding to the consequences of short-term uncertainty and recognising the* ***need for investment*** *to build an economy that works for everyone.* [13]

It's reasonable to assume from this statement that the Chancellor will continue to target a reduction in debt as a share of GDP – that is, he is likely to stick to some form of supplementary debt rule. But in terms of his overall fiscal target, there appear to be two broad options open to him:

- ***Softening the target:*** *switching from the existing overall surplus target to a focus on current budget balance, allowing ongoing borrowing to finance investment; and*
- ***Delaying the target:*** *maintaining the focus on an overall surplus but meeting it later than 2019-20.*

Softening the target would actually open up some additional fiscal headroom. That's because, even though the expected deterioration in the outlook removes the prospect of *overall* surplus by 2019-20, the government would still be on course to record a *current* budget surplus of roughly £17 billion. The Chancellor could therefore make further discretionary increases in borrowing up to this amount and still achieve balance. In addition, because investment spending would no longer be included in the fiscal target, he would be free to increase this element of expenditure more significantly still. The only limit here would be the debt rule (where borrowing for investment *is* included).

This is of course a particularly loose interpretation of the current budget rule. The Chancellor could instead target a modest surplus to provide headroom against future shocks. For example, just as George Osborne hoped to go beyond overall budget balance by 2019-20 and instead deliver a £10 billion *surplus*, so Philip Hammond might choose to focus on a £10 billion current budget surplus. Such an approach would of course reduce any fiscal headroom generated by softening the target accordingly.

The alternative of delaying the existing target looks more difficult. For it to be relevant in the current parliament, the Chancellor would need to delay by no more than one year. This would require roughly £9 billion of fiscal tightening in the last year of the parliament – and any attempt

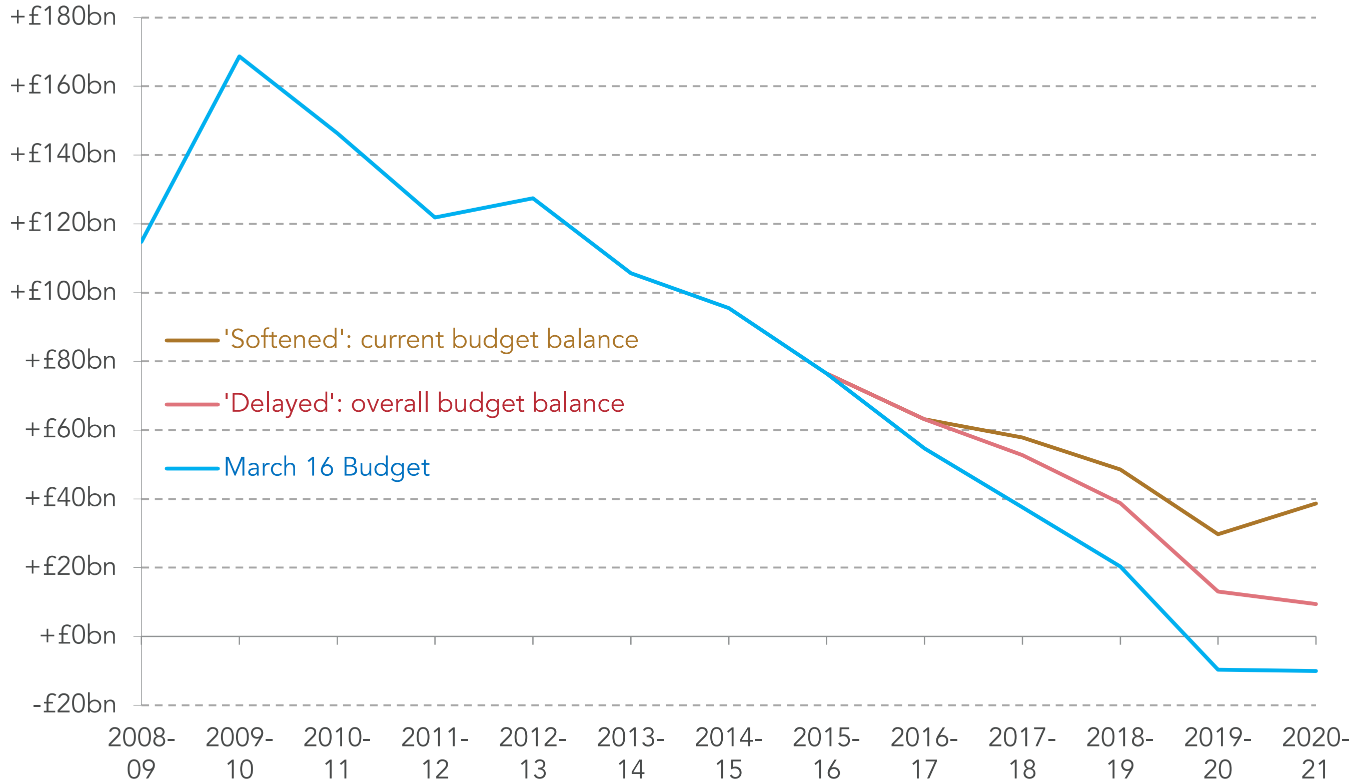
[13] P Hammond, "An economy that works for everyone", *Speech to Conservative Party Conference*, 3 October 2016

to maintain a £10 billion fiscal margin would mean even higher tax increases or spending cuts. Avoiding any additional tightening would mean pushing the overall budget target into the next parliament. Assuming that government receipts and expenditure continued to grow at the same annual rate as projected for 2020-21, our estimate is that the former would outweigh the latter (that is, the budget would be in surplus) by 2023-24.

Figure 6 sets out the potential trajectories for borrowing implied by the outside-edge interpretations of these two approaches to the fiscal target. The 'delayed' overall balance line is identical to the 'post-referendum projections' line shown in Figure 4, reflecting the fact that the Chancellor wouldn't need to take any additional action if he was prepared to wait until 2023-24. The 'softened' current budget balance line represents the approach of achieving no more than balance (i.e. no fiscal margin) in 2019-20 and 2020-21. In practice then, the two rules would be consistent with some trajectory falling between the red and gold lines.[14]

Figure 6: Actual and projected annual deficit under alternative fiscal scenarios: UK

Public sector net borrowing, 2015-16 prices



Notes: The 'softened' scenario targets current budget balance in 2019-20 and is based on the assumed deterioration in the public finances detailed in Figure 4. The 'delayed' line targets overall budget balance in the middle of the next parliament and is identical to the 'post-referendum projections' line set out in Figure 4.

Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

[14] Given the speculative nature of this exercise and the relatively short timeframe over which we are assessing the implications of these different approaches, we take no account of any potential dynamic effects – such as higher growth associated with increased investment spending or larger debt interest costs associated with running a bigger deficit. The results we present are intended to be no more than illustrative of the scale of difference in potential outcomes emanating from different fiscal approaches in the coming years.

Table 2 provides a bit more detail, showing the extent to which PSNB would deviate from the post-referendum baseline under different interpretations of the two alternative approaches to the fiscal rules. It shows for example that the version of the 'softened' target that just delivers a current balance in 2019-20 would mean a choice to borrow an additional £61 billion over the course of the parliament. Coming on top of our existing £84 billion deterioration estimate, this would add up to £145 billion of additional borrowing relative to the March Budget projections.

Table 2: PSNB projections under alternative fiscal scenarios: UK

2015-16 prices	2016-17	2017-18	2018-19	2019-20	2020-21	Cumulative
Baseline						
Budget 2016 projections	£55bn	£38bn	£20bn	-£10bn	-£10bn	£93bn
Post-referendum baseline	£63bn	£53bn	£39bn	£13bn	£9bn	£177bn
Difference from Budget 2016	*£8bn*	*£15bn*	*£18bn*	*£23bn*	*£19bn*	*£84bn*
Softened target						
Current balance 2019-20	£63bn	£58bn	£49bn	£30bn	£39bn	£238bn
Difference from baseline	*£0bn*	*£5bn*	*£10bn*	*£17bn*	*£29bn*	*£61bn*
Current surplus 2019-20	£63bn	£56bn	£44bn	£20bn	£29bn	£212bn
Difference from baseline	*£0bn*	*£3bn*	*£5bn*	*£7bn*	*£19bn*	*£35bn*
Delayed target						
Overall balance 2020-21	£63bn	£53bn	£39bn	£13bn	£0bn	£168bn
Difference from baseline	*£0bn*	*£0bn*	*£0bn*	*£0bn*	*-£9bn*	*-£9bn*
Overall balance 2023-24	£63bn	£53bn	£39bn	£13bn	£9bn	£177bn
Difference from baseline	*£0bn*	*£0bn*	*£0bn*	*£0bn*	*£0bn*	*£0bn*

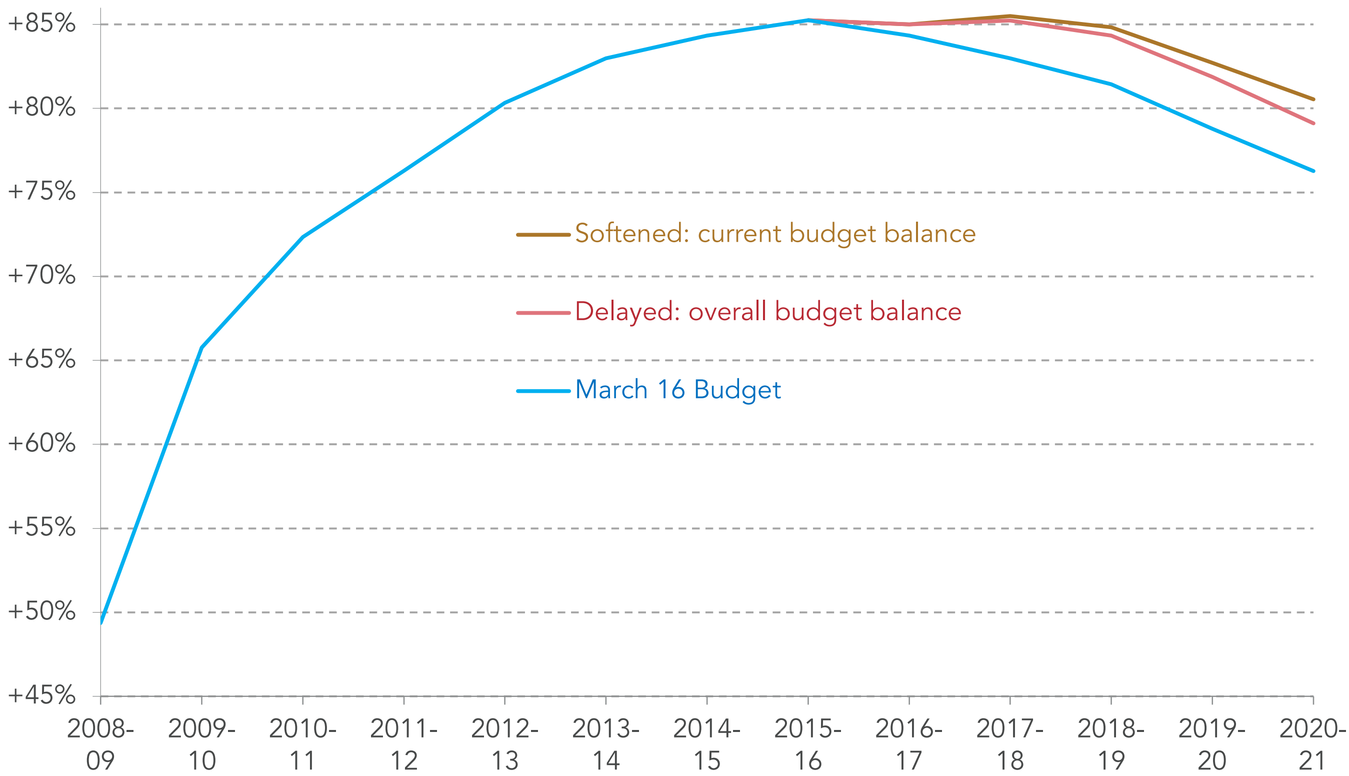
Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

Targeting a £10 billion current budget surplus instead means the Chancellor would choose to borrow £35 billion more than the post-referendum baseline (and therefore £119 billion more than the Budget baseline) instead. Either of these options *would mean more than doubling cumulative net borrowing between 2016-17 and 2020-21 compared to the OBR's March 2016 forecast, and doing so on the basis of a significant discretionary loosening. Such an approach would have serious ramifications for how the government's approach to fiscal policy is viewed.*

The scale (and pace) of any increases in borrowing beyond the post-referendum baseline also affect the trajectory for national debt. As noted above, our assumption is that the post-referendum revisions to the PSND forecasts result in it rising very slightly as a share of GDP in 2017-18. Figure 7 shows how the profile for debt differs if we instead adopt the current balance rule in 2019-20. As before, the 'delayed' overall balance line is identical to the 'post-referendum projections' line shown in Figure 5. And once more, the space between this red line and the gold 'softened' current budget balance line shows the range of potential PSND paths the Chancellor might choose to plot.

Figure 7: Actual and projected stock of debt under alternative fiscal scenarios: UK

Public sector net debt as a share of GDP



Notes: See notes to Figure 6

Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

What's noticeable is that, despite the current budget balance target appearing to be significantly looser on the face of it, the difference between the debt trajectories in the two scenarios is relatively minor. By 2020-21 the debt-to-GDP ratio stands at 80.5 per cent following the current budget balance, just 1.4 percentage points higher than in the delayed overall budget approach. This finding highlights the fact that it is possible to target a current balance on an annual basis while still lowering the overall debt burden over time, assuming no increase in investment spending.

Targeting a current budget balance could open up options on welfare and tax

As noted above, the Chancellor approaches the Autumn Statement with something of a shopping list in his hand. The new Prime Minister's focus on 'just managing' families provides an especial challenge.[15]

The tax and benefit plans inherited by the new Chancellor are set to make things *harder* for this particular group over the coming years, meaning that he is under some pressure to change these plans. Our estimate at the March Budget suggested that cuts in working age benefits would lower incomes among the bottom 30 per cent of the population by more than 3 per cent in 2020-21, with only very modest offset from income tax cuts and the arrival of the National Living Wage. In contrast, this same suite of policies was expected to *raise* incomes in the top half of the distribution.[16]

[15] "Statement from the new Prime Minister Theresa May", 13 July 2016

[16] M Whittaker, *Budget 2016 response*, March 2016

And, as mentioned earlier, higher inflation related to the falling value of the pound and slower wage growth than previously anticipated mean that the squeeze on the 'just managing' is now likely to get tighter in the absence of any change in policy.[17]

The Chancellor also faces the cost of meeting existing Conservative promises. The 2015 election manifesto included high profile pledges to increase the personal allowance (the point at which people start paying income tax) to £12,500 by the end of the parliament and to raise the point at which the higher rate of 40 per cent becomes payable to £50,000.[18]

By Budget 2016, George Osborne had set out plans for raising the personal allowance to £11,500 and lifting the higher rate threshold to £45,000 in 2017-18. Higher post-referendum inflation means that the cost of delivering both the existing and remaining aspects of this policy is likely to be lower than expected (with the inflation-linked default thresholds now rising more quickly). Nevertheless, based on a simple HMRC ready reckoner we still estimate that finishing the job by the end of the parliament would cost a little over £2 billion.[19]

Higher inflation related to the falling value of the pound and slower wage growth than previously anticipated mean that the squeeze on the 'just managing' is now likely to get tighter in the absence of any change in policy

There will of course be other priorities too – including in relation to public services. By way of context, it's worth considering just how much of this shopping list the Chancellor might be able to afford were he to switch to a current budget focus and so establish an additional £17 billion of fiscal headroom in 2019-20. To do so, we can establish a 'fiscal frontier' showing the spectrum of options between two extremes in which the full £17 billion is either used as a fiscal margin (that is, the Chancellor targets a £17 billion current budget surplus) or is allocated to tax and spending programmes (that is, the Chancellor targets no more than current budget balance). Such a 'frontier' is depicted in Figure 8.

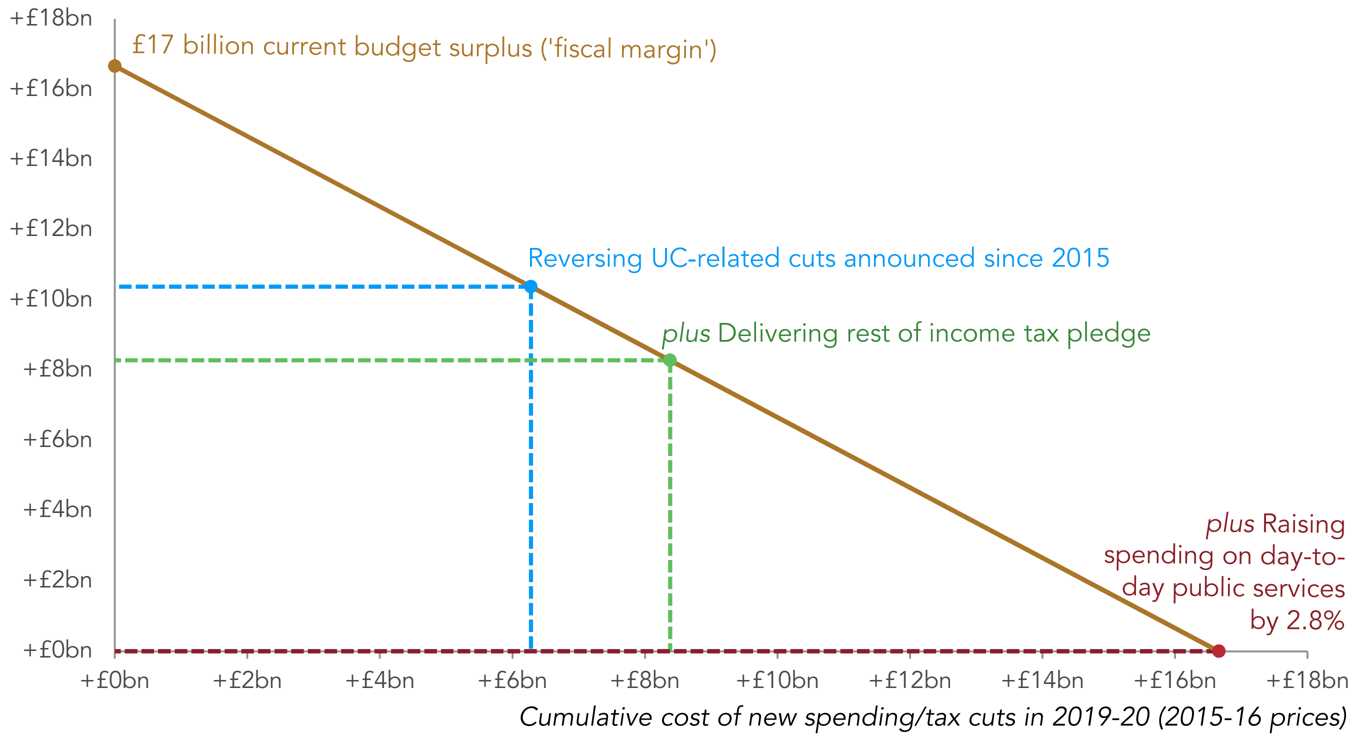
[17] We'll update our projection of the distributional impact of existing tax and benefit policies in a forthcoming pre-Autumn Statement paper.

[18] *The Conservative Party Manifesto 2015*, Conservative party, 2015

[19] As with welfare, we'll update this tax figure in a second forthcoming pre-Autumn Statement paper.

Figure 8: The 'fiscal frontier' under a current budget balance scenario

Current budget surplus in 2019-20 (2015-16 prices)



Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016; and OBR, *Policy Measures Database*

Purely for illustrative purposes, we consider three potential options the Chancellor might use any headroom for. First, by way of exploring one form of support for 'just managing' families, we consider the cost of **reversing UC cuts** announced since the 2015 general election (those already introduced and those still to come). These include the nominal freeze on the value of UC awards (which are due to bite harder than initially thought as inflation rises) the introduction of two-child limits and reductions in disregards and work allowances. In total, reversing or not implementing all of these changes amounts to just over £6 billion (in 2015-16 prices).

Adding in the cost of delivering on the **manifesto pledges on income tax** would take total spend up to just over £8 billion. That would leave roughly a further £8 billion of remaining headroom, sufficient to simultaneously increase **day-to-day spending on public services** in 2019-20 by 2.8 per cent relative to existing plans.

Low borrowing costs, a need to boost productivity and the opportunity provided by fiscal 'reset' mean the Chancellor could consider a significant increase in investment

Crucially, the nature of a current budget balance target means that the Chancellor could open up even more fiscal space on the other item on his shopping list – higher public investment as part of a wider industrial strategy – without breaching any new rule.

The government has already announced new plans for a £3 billion 'Home Building Fund' designed to provide more than 25,000 new homes in this parliament and 200,000 more in the longer-term.[20] But it is probably the Chancellor himself who has been clearest on the need to raise investment spending. Speaking at the Conservative conference he said:

> *Our stock of public infrastructure – like our roads, railways and flood defences – languishes near the bottom of the developed-countries' league table after decades of under-investment.*
>
> *And our businesses, too, are not investing enough. All of this must change to build an economy that works for everyone. We need to close that gap with **careful, targeted public investment in high value infrastructure**. And encouragement of more private investment in British businesses.*[21]

Calls for more government funds to be diverted into investment are understandable. Increased investment can boost UK productivity – which is too low and has stagnated in recent years – and there are numerous obvious candidates for infrastructure spending. At the same time, historically low cost of government borrowing means that investing in large scale projects that boost future growth appear especially cost efficient at the moment.

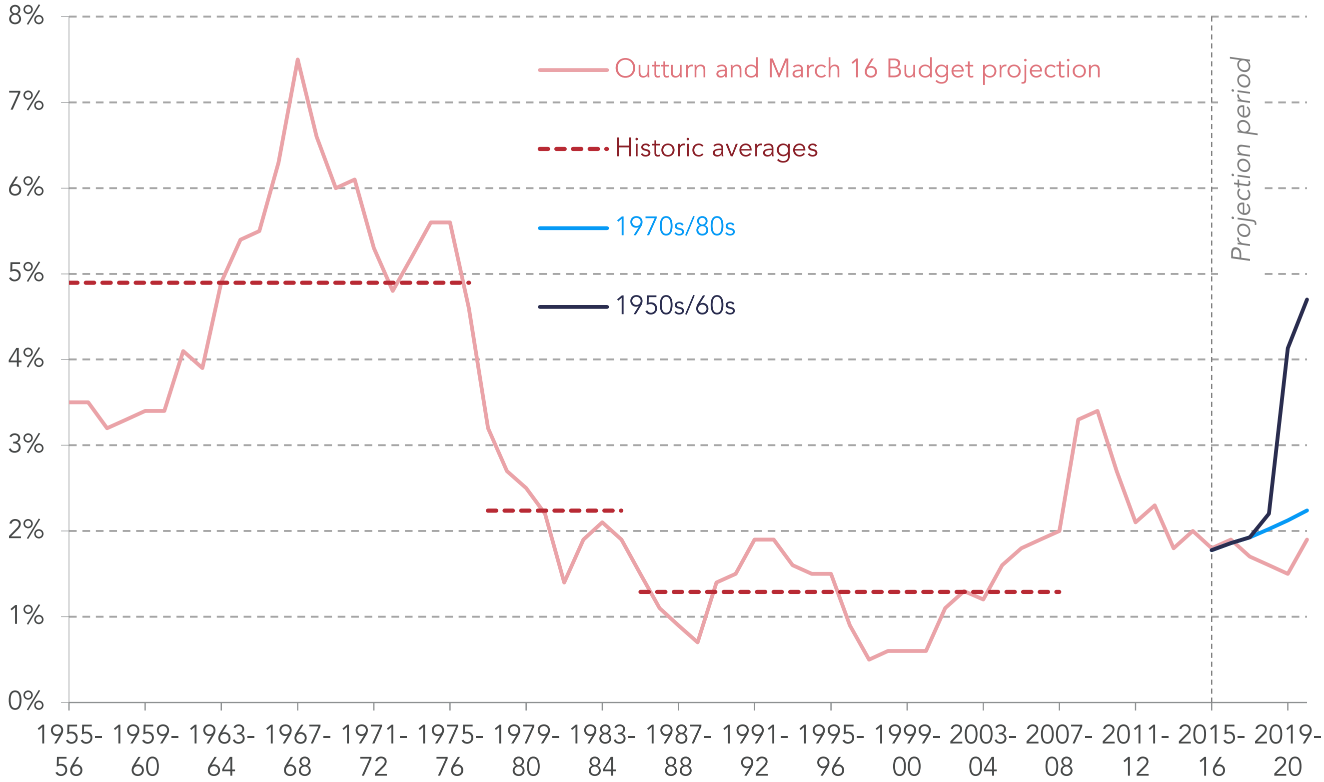
But what is the right level of investment? As Figure 9 shows, PSNI as a share of GDP averaged 1.3 per cent between 1985-86 and 2007-08, and fell as low as 0.5 per cent in 1997-98. That's in contrast to an average of 4.9 per cent between the mid-1950s and mid-1970s. It picked up a little after the financial crisis, with the Labour government bringing forward capital projects as part of its stimulus package (and as GDP fell). But it is projected to fall over much of this parliament, before jumping to 1.9 per cent in 2020-21.

[20] "Sajid Javid and Philip Hammond: Let's get Britain building", government press release, 4 October 2016

[21] P Hammond, "An economy that works for everyone", *Speech to Conservative Party Conference*, 3 October 2016

Figure 9: Investment outturns and projections under alternative approaches: UK

Public sector net investment as a share of GDP



Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2016; and RF analysis of HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2016 & August 2016

The sharp decline in investment from the mid-1970s was largely a product of reduced spending by local authorities on public housing. The scale of the drop is probably a little overstated because the recorded investment is net of the capital raised by local authorities from sales of council houses. Nevertheless, the change in focus was dramatic. The next marked drop in investment relative to GDP came in the mid- to late-1980s, and reflected reductions by public corporations – most obviously in relation to large scale privatisations.

In theory, the fact that much of the fall in public investment can be explained by an increasing emphasis on the private sector – in relation to housing and to formerly nationalised institutions – should mean that it isn't a cause for worry. However, private investment hasn't sufficiently offset this decline in public investment, meaning that overall investment levels in the country are lower than they were. With business investment projected to fall sharply in the coming months due to the uncertainty provoked by the referendum result, there certainly appears to be space for the government to step up its investment.

Figure 9 also shows the level of PSNI consistent with returning to the 2.2 per cent of GDP average that prevailed in the late-1970s and early-1980s. This represents an increase of two-thirds on the average investment recorded in the two decades before the financial crisis and marks an increase in PSNI relative to the 2020-21 post-referendum baseline of just under £7 billion (or 17 per cent). By way of context, note that the government expects to spend £4.8 billion in 2020-21 on HS2.[22]

Taking the cumulative increase over the course of the parliament, the trajectory we set out would result in an additional £31 billion of investment. It would of course also raise cumulative

[22] HM Treasury, *National Infrastructure Pipeline*, Spring 2016

borrowing by the same amount. That is while this borrowing wouldn't affect the target for current budget balance, it would raise overall borrowing as measured by PSNB.

At some point, raising borrowing to fund investment would come up against the supplementary debt rule: PSNB would rise to a level where debt started increasing relative to GDP even as the current budget remained in balance. However, while this limit bites to some degree in the near-term, but the end of the parliament it offers very substantial leeway.

To illustrate how much, the final line in Figure 9 details the hypothetical (and highly unlikely) approach of returning investment relative to GDP to the levels that prevailed in the 1950s and 1960s. Returning all the way to the 4.9 per cent average would marginally breach the debt rule, but it *is* possible to raise PSNI to 4.7 per cent of GDP by 2020-21, thereby increasing investment by some £57 billion (in 2015-16 prices) relative to existing plans. In cumulative terms, it would provide £120 billion more investment over the course of the parliament. Once again however, even though the debt rule wouldn't be breached, the Chancellor would need to accept this same level of cumulative increase in borrowing over the period. This analysis highlights the degree to which with a current balance fiscal rule it is market forces and the availability of good investment projects that are likely to restrain borrowing for investment spending rather than fiscal rules per se.

Despite the obvious challenge posed by fiscal deterioration, the Chancellor has economic and political room for manoeuvre

Much like the economic fall-out from the Brexit vote, the Chancellor's plans for the Autumn Statement remain very uncertain at this stage. We know that he intends to depart from the fiscal 'mandate' of his predecessor, removing the target for an overall budget surplus at any point in this parliament. Given that post-referendum projections suggest that changed economic circumstances alone are set to increase government borrowing by £23 billion in 2019-20 – leaving a deficit of roughly £13 billion in the absence of any further tightening – that is a sensible approach, allowing the automatic stabilisers to operate and cushion the impact on growth of the economic headwinds Philip Hammond has himself said we are likely to face.

There has been wider speculation too that the Autumn Statement might mark a shifting of the balance of economic support by introducing a more active fiscal stance. Some have read a wider shift in macro policy into the Chancellor's promise of a fiscal 'reset' and the recognition in the Prime Minister's conference speech that exceptional monetary policy loosening had brought with it unwelcome distributional effects.[23] Such interpretations look set to be wide of the mark, not least because any real intention to actively provide a discretionary fiscal stimulus would have led to action during the summer rather than five months after the referendum result.

What is clear however, despite the significant deterioration in the public finances, is that the Chancellor has decisions to make regarding both the fiscal target he wishes to set and how he balances the need to demonstrate ongoing fiscal discipline with the wish to chart a new direction for the government. The Treasury can set fiscal targets that provide room to both support 'just managing families' and deliver on the renewed focus on investment spending, but it can only do so at the price of significantly higher borrowing.

Beyond these big macro policy choices the new Chancellor faces a range of specific policy choices. In two further notes ahead of the Autumn Statement, we will consider the specific options he faces on tax and on welfare.

[23] T May, "The good that Government can do", *Speech to Conservative Party Conference*, 5 October 2016

Resolution Foundation

Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- *undertaking research and economic analysis to understand the challenges facing people on a low to middle income;*
- *developing practical and effective policy proposals; and*
- *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

For more information on this report, contact:

Matt Whittaker
Chief Economist
matthew.whittaker@resolutionfoundation.org
020 3372 2958