A man for all seasons?

What the Chancellor can expect in the OBR's Spring outlook

Matt Whittaker

March 2018

@MattWhittakerRF @resfoundation

IN THE BLEAK MID~~WINTER~~ Autumn

The OBR's Nov-17 outlook lowered both the government's fiscal headroom and households' living standards prospects

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Heading into the Autumn Budget last November, the OBR had been consistently wrong about the prospect of a return to productivity growth

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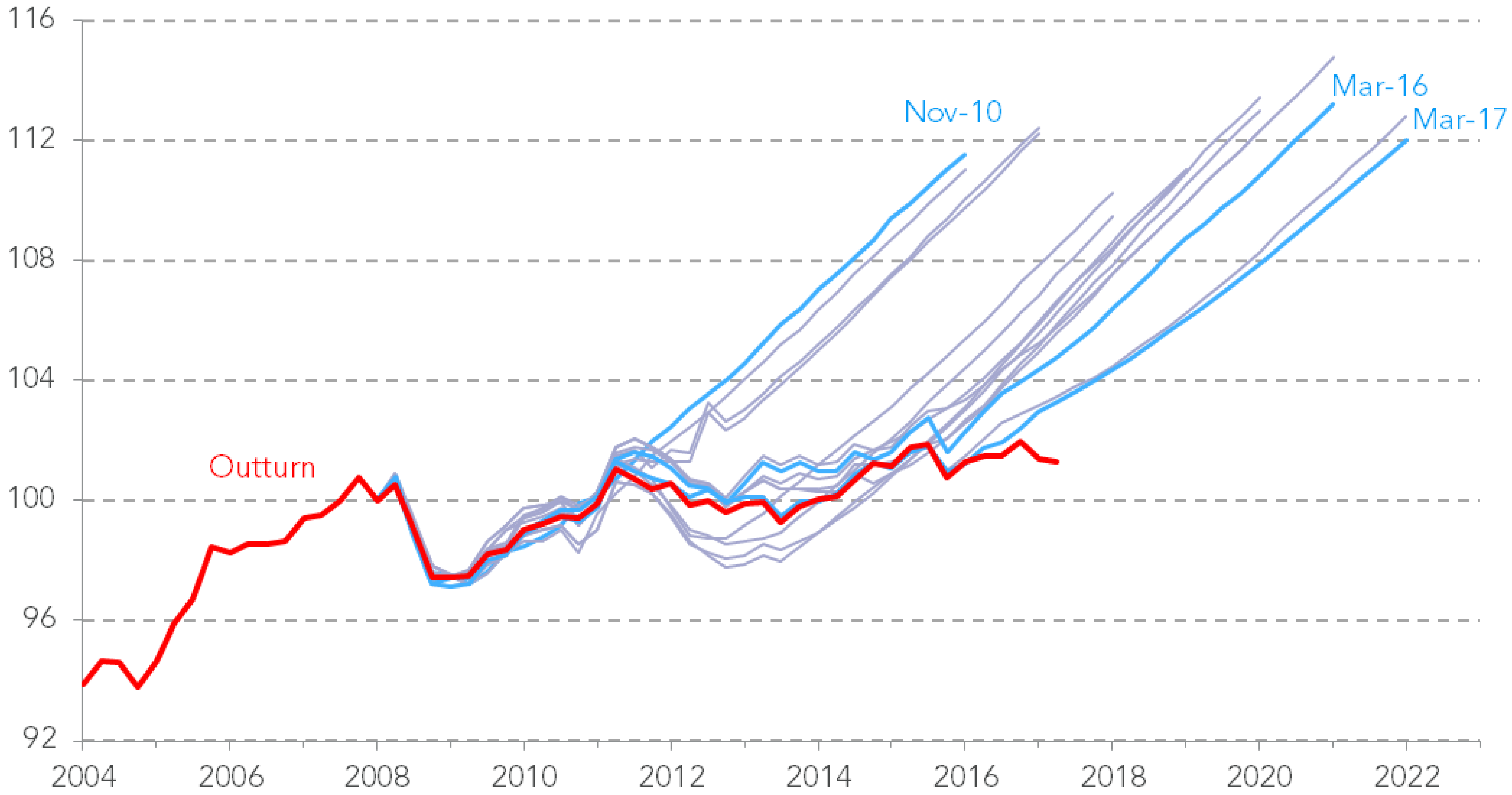
Indices of non-oil GVA per hour: outturn and successive OBR projections
(Q1 2008 = 100)



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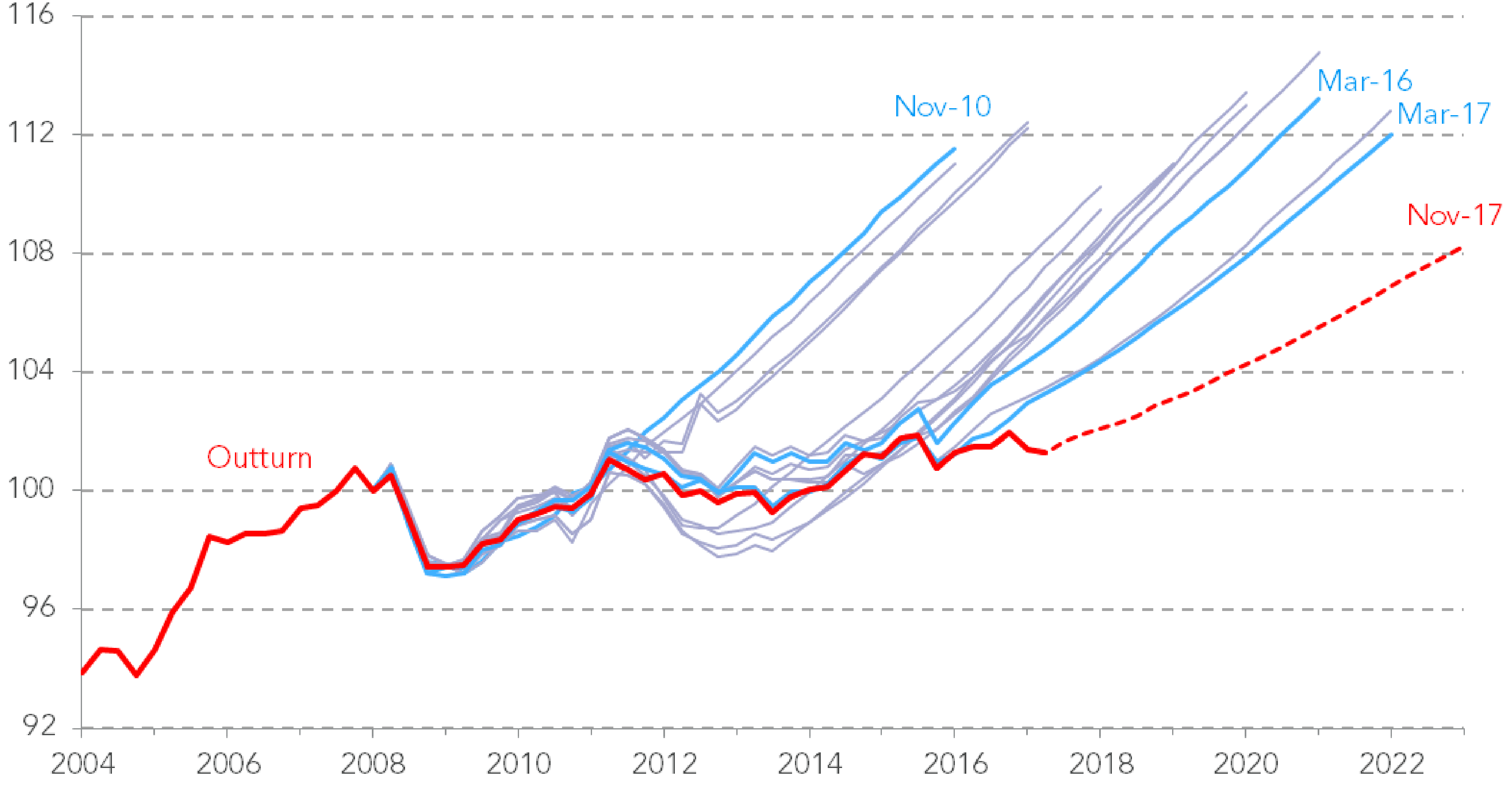
Source: RF analysis of OBR & ONS

So, after a near-decade of stagnation, the OBR chose to significantly revise down its projection for *trend* productivity growth

Indices of non-oil GVA per hour: outturn and successive OBR projections
(Q1 2008 = 100)



Trend productivity growth was revised down from 2.1 per cent before Mar-16 to 1.2 per cent in the Nov-17 outlook. This marked a mid-path between the pre- and post-crisis trends

Output per hour was subsequently forecast to be 4.6 per cent lower in 2022 than previously thought

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Source: RF analysis of OBR & ONS

Lower productivity was partially offset by assumed increases in working hours, but GDP was still projected to be £42bn lower in 2021 than previously thought

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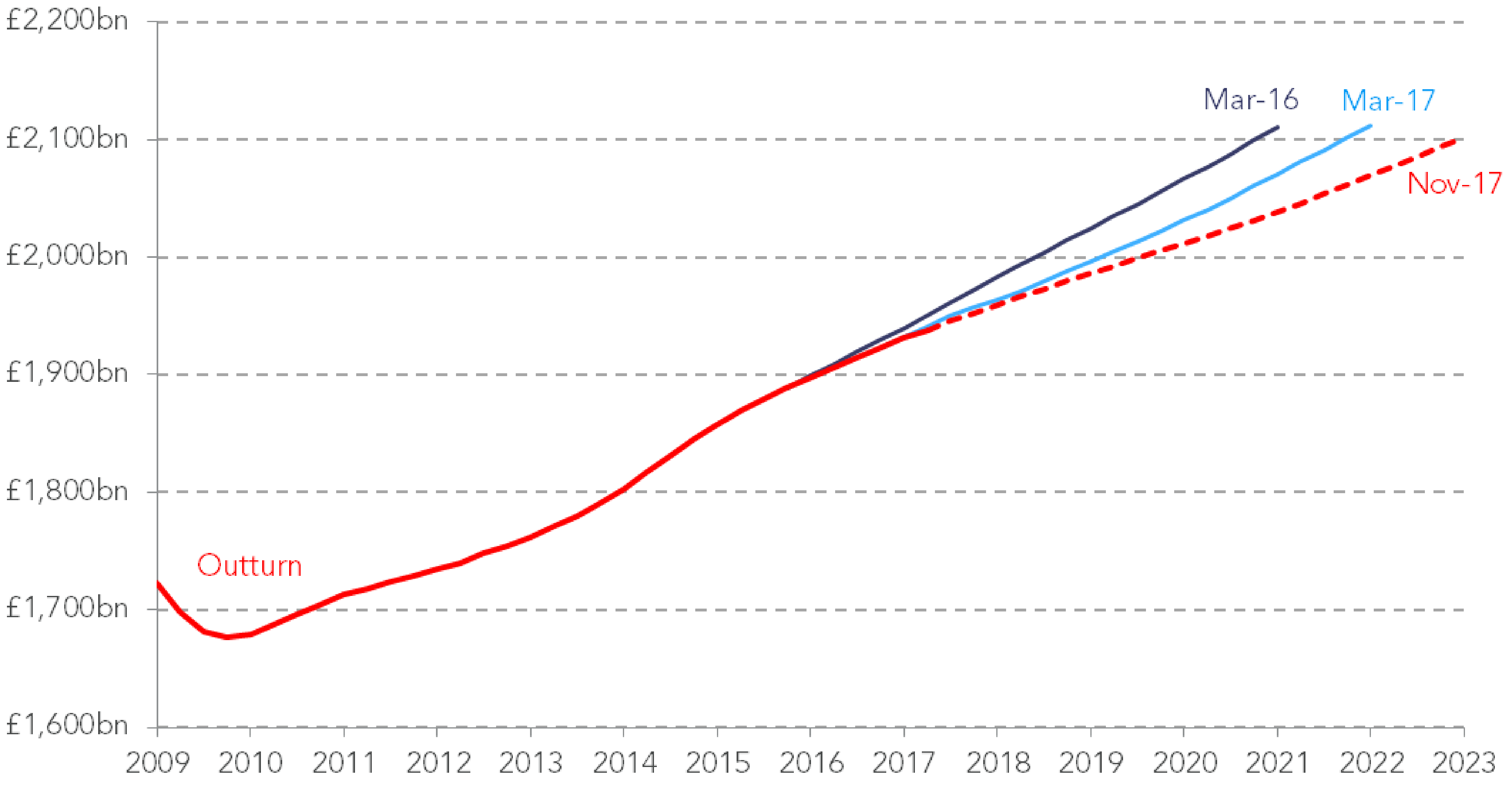
Real-terms GDP: outturn and successive OBR projections (CVM, rolling four-quarter total)



Nov-17 projections implied some 150,000 more people being in employment at the start of 2022 than was forecast at the Mar-17 Budget. Total hours worked in 2021 were set to rise by 1.7 per cent relative to the earlier projection

But despite working harder, the productivity downgrade dominated, resulting in lower GDP than previously assumed

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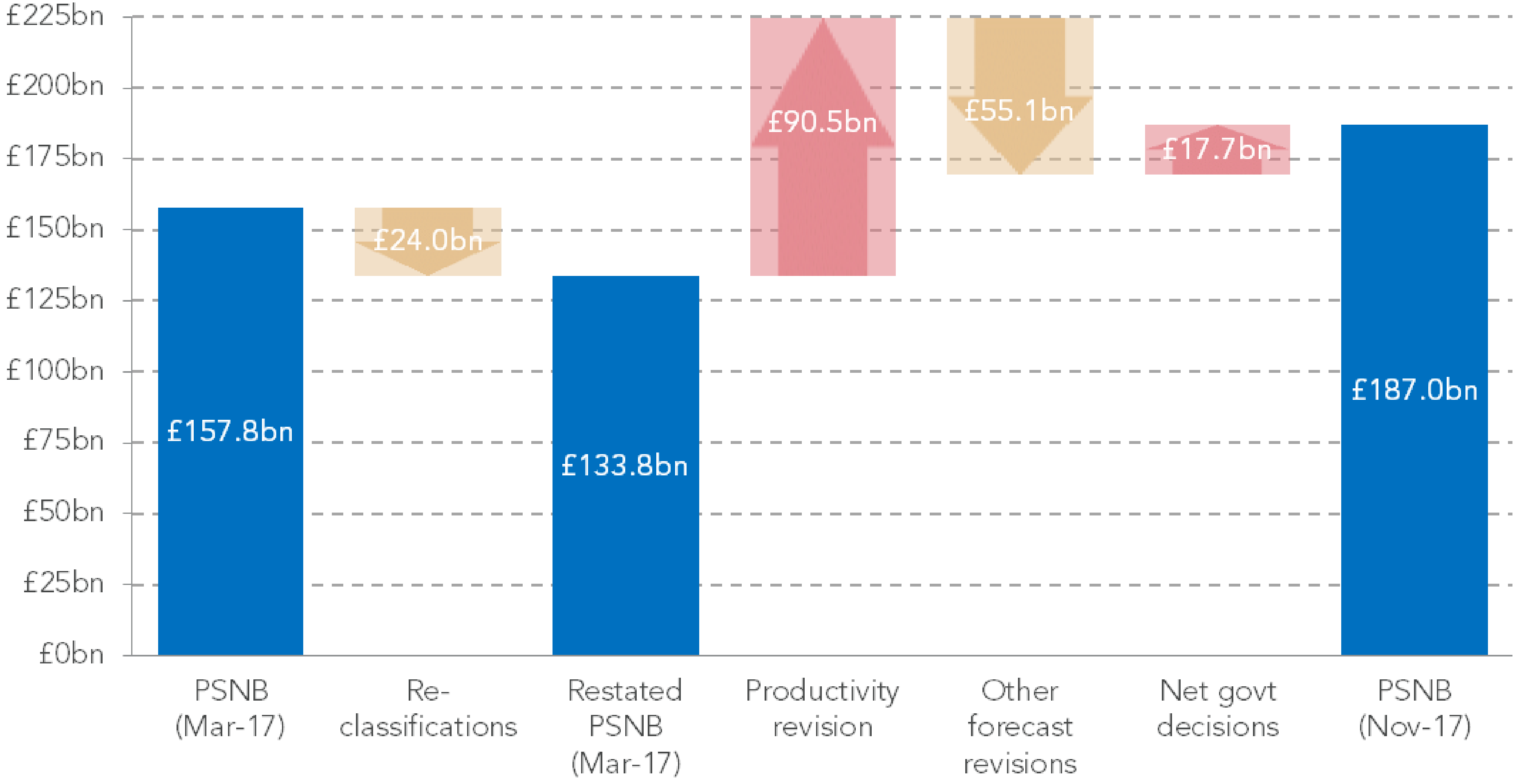
Source: RF analysis of OBR & ONS

The productivity revision raised the cumulative (2017-18 to 2021-22) borrowing forecast by £91bn, but other factors lowered the overall increase to £29bn

Changes between Mar-17 and Nov-17 to OBR's cumulative PSNB projection for 2017-18 to 2021-22



Reclassifications included moving English housing associations into the private sector (with no real effect on the overall fiscal picture)

Forecast revisions other than in relation to productivity growth (e.g. on average hours) lowered the net borrowing projection

The net policy giveaway included net tax cuts, easing in planned DEL cuts and a capital spending increase

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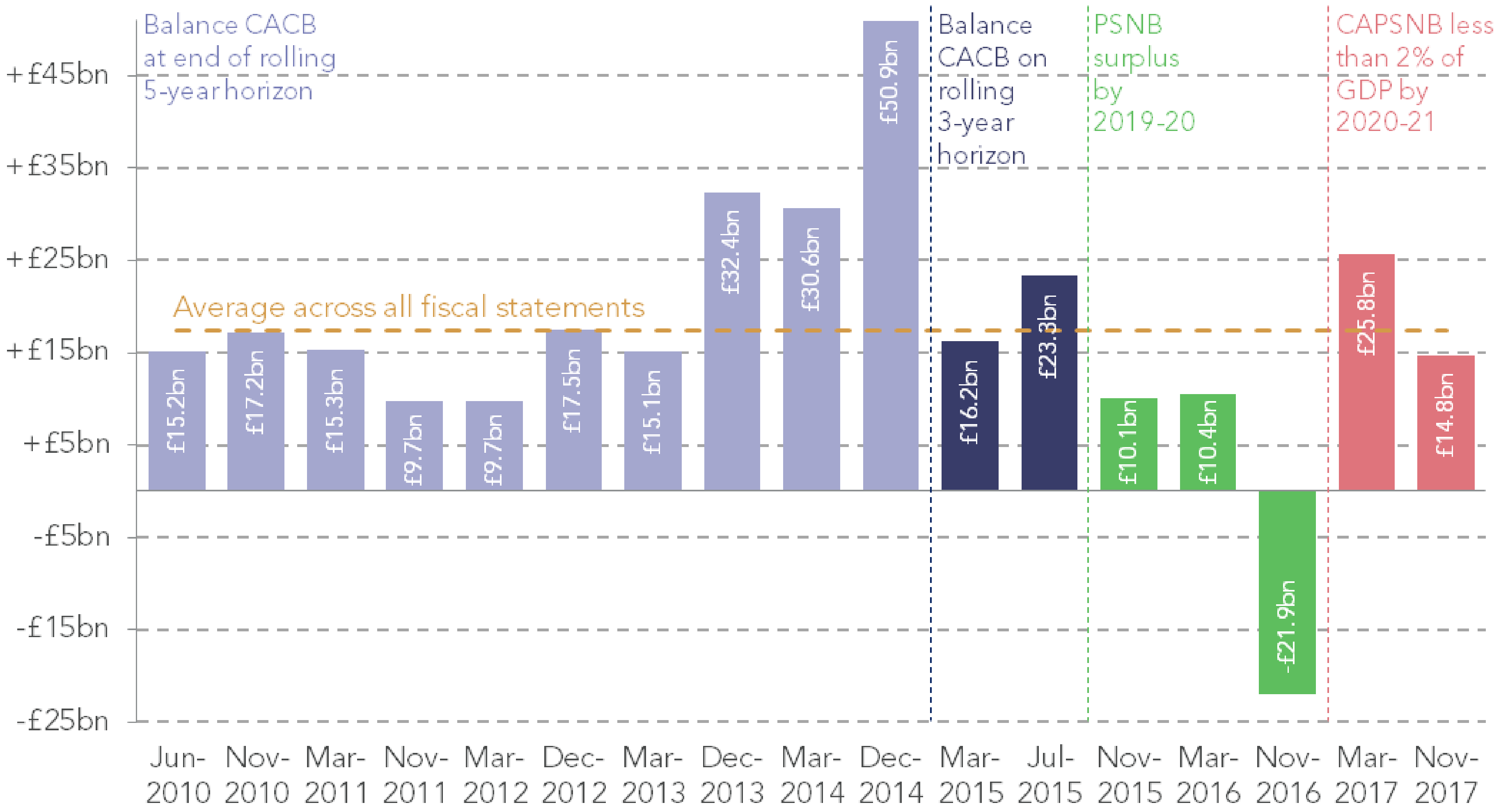
Source: RF analysis of OBR

These revisions lowered the Chancellor's headroom in 2020-21 from £26bn to £15bn

Forecast headroom against fiscal mandate in successive OBR *Economic and Fiscal Outlook* publications



Notes: CACB = cyclically adjusted current budget; PSNB = public sector net borrowing; CAPSNB = cyclically adjusted public sector net borrowing

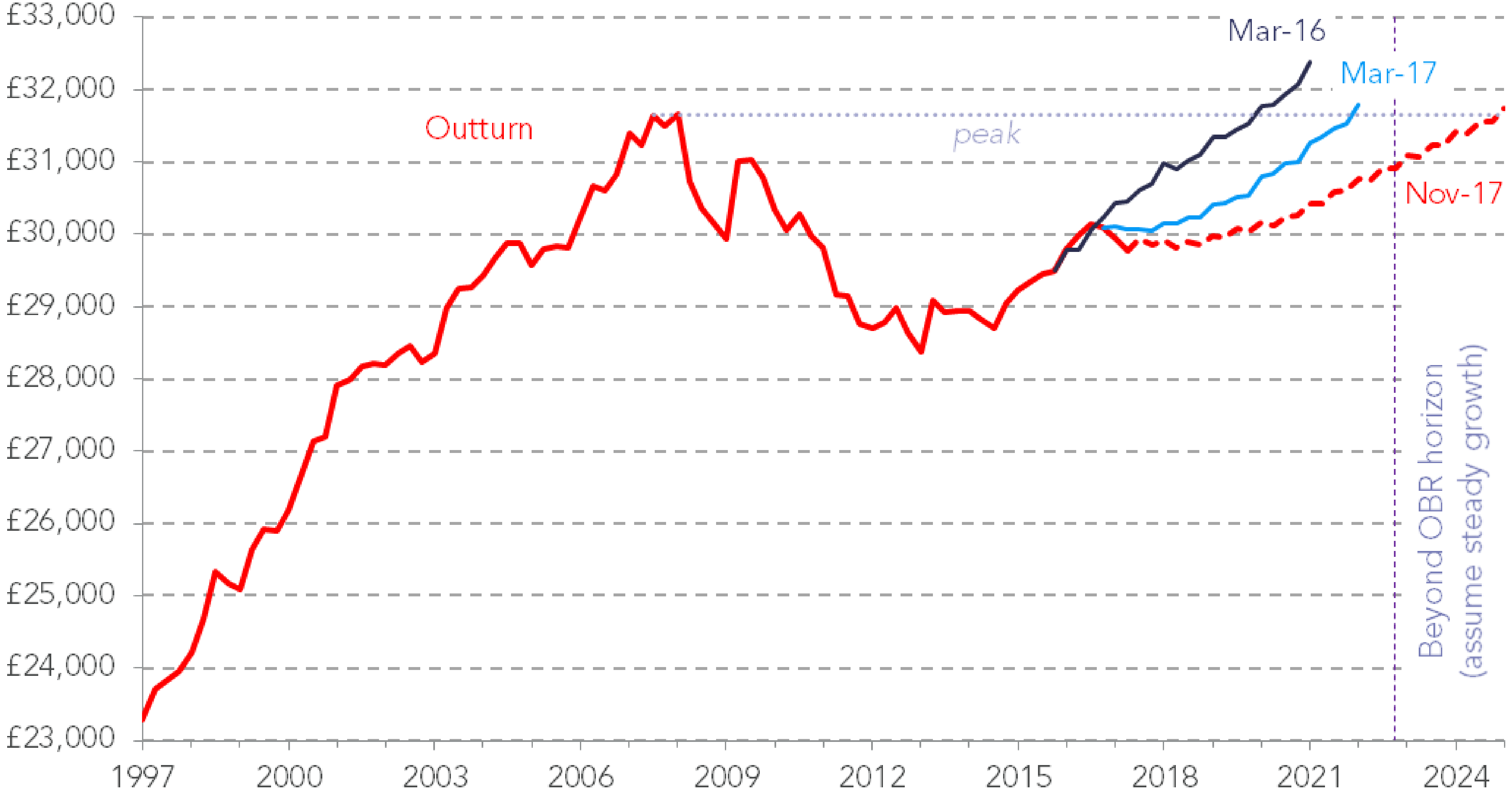
Source: RF analysis of OBR

The fiscal mandate requires the government to lower public cyclically-adjusted public sector net borrowing below 2 per cent of GDP by 2020-21, while the Treasury's broader 'objective for fiscal policy' is:

"to return the public finances to balance at the earliest possible date in the next Parliament"

The downward revisions in productivity growth fed into a slower pay recovery too, with a return to the pre-crisis peak not due until 2025

Average annual employee earnings, CPI-adjusted: outturn and successive OBR projections (Q4 2016 prices)



Average annual earnings were forecast to be £1,000 lower in 2022 than projected in Mar-17

A straight extrapolation of real-terms growth in the final four quarters of the forecast implied the pre-crisis peak wouldn't be restored until the start of 2025

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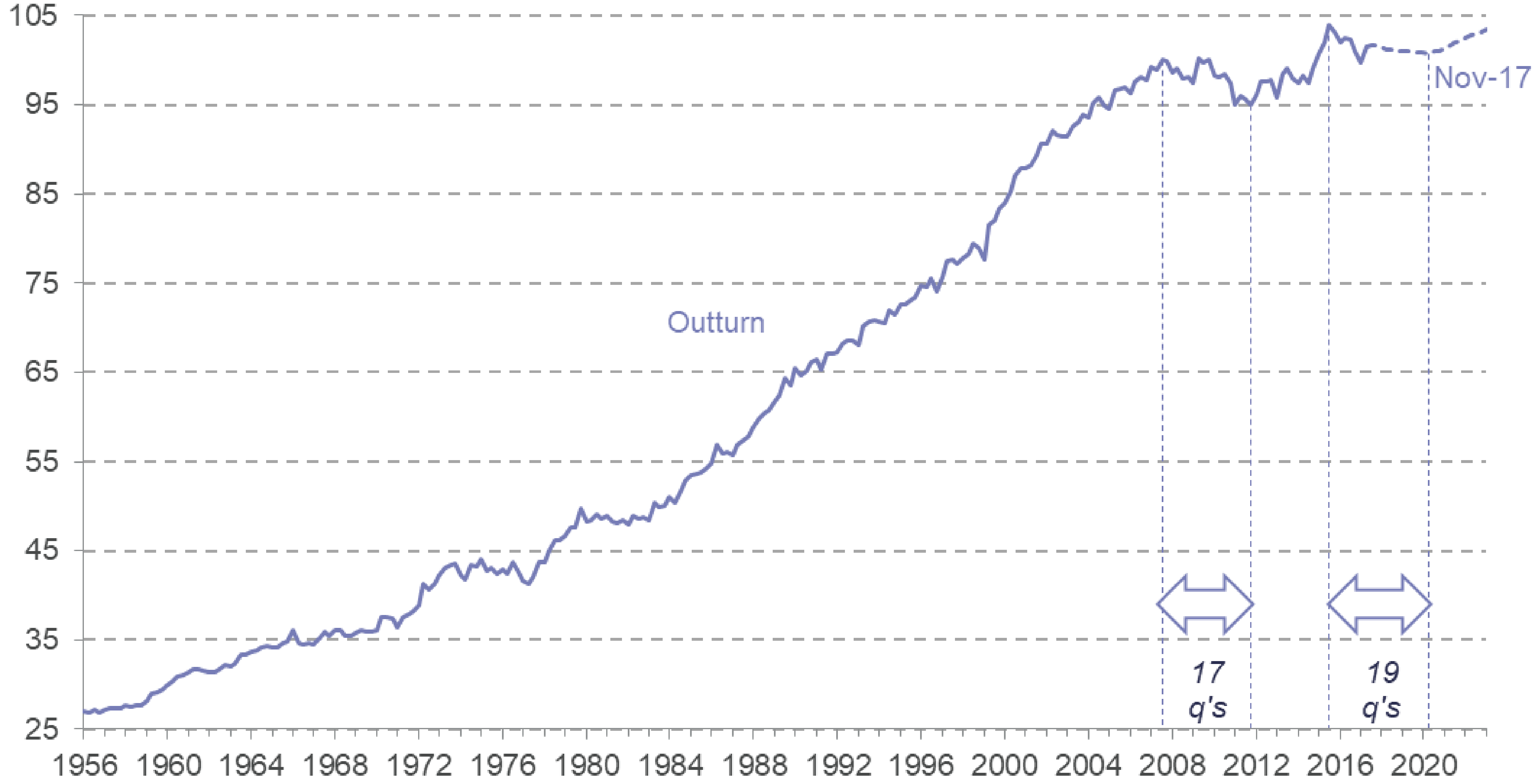
Source: RF analysis of OBR & ONS

And broader income growth was projected to undergo a longer squeeze than the one felt immediately after the financial crisis

Annualised real household disposable income per capita: outturn and successive OBR projections (CVM, Q1 2008 = 100)



Disposable income per person fell across 17 quarters between Q3 2007 and Q4 2011; but the OBR's outlook suggested that the current squeeze – which started after Q3 2015 – is set to last 19 quarters (until Q2 2020)

Source: RF analysis of OBR & ONS

HOPE SPRINGS

Better recent performance on productivity, pay and borrowing could bring some cheer for the Chancellor in next week's outlook

Recent GDP and productivity outturns have been revised up since Nov-17, and performance in the second half of 2017 was better than projected

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Year-on-year growth in selected economic metrics: OBR Nov-17 projections vs latest ONS outturns

	GDP (real-terms)		*GDP per capita (real-terms)*		*Productivity (real non-oil output/hour)*	
	Nov-17 OBR	Latest ONS	Nov-17 OBR	Latest ONS	Nov-17 OBR	Latest ONS
2016Q1	1.9%	1.9%	1.1%	1.1%	0.1%	0.2%
2016Q2	1.8%	1.8%	1.0%	1.0%	-0.3%	-0.3%
2016Q3	1.8%	2.0%	1.0%	1.2%	-0.4%	-0.2%
2016Q4	1.6%	2.0%	0.9%	1.2%	1.2%	1.5%
2017Q1	1.8%	2.0%	1.1%	1.3%	0.1%	0.4%
2017Q2	1.5%	1.8%	0.9%	1.2%	-0.2%	0.1%
2017Q3	1.5%	1.8%	0.9%	1.1%	0.2%	0.9%
2017Q4	1.3%	1.4%	0.7%	0.8%	0.0%	1.0%

GDP, GDP per capita and productivity growth have all been revised up since the Nov-17 outlook

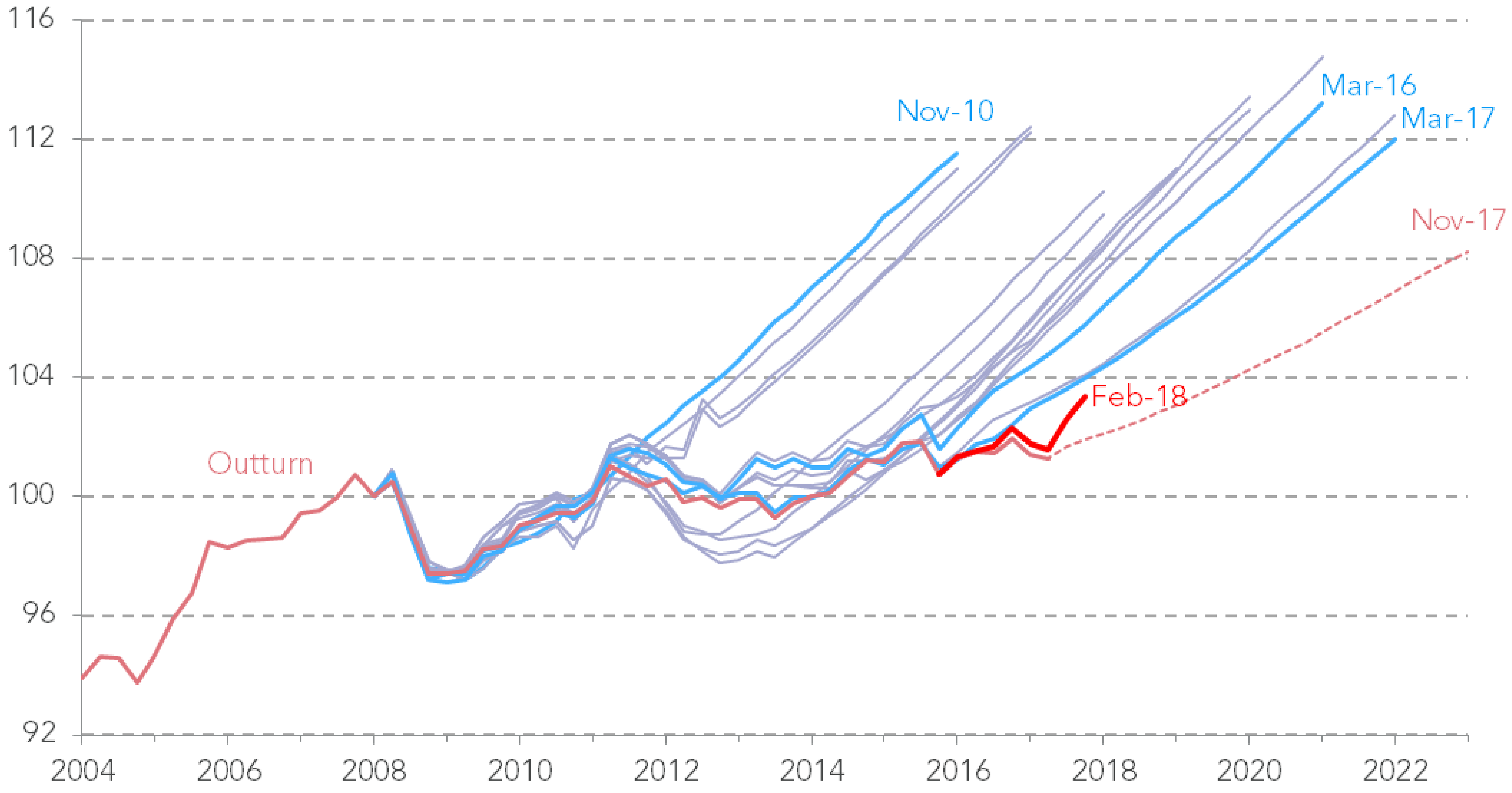
GDP growth in 2017 has come in at 1.7 per cent, rather than the 1.5 per cent projected by the OBR

Outturn productivity growth of 0.6 per cent compares with an OBR expectation of zero growth

Notes: Red font = downgrade; green font = upgrade.
Source: RF analysis of OBR & ONS

At precisely the point the OBR lowered its projection for productivity growth, the UK recorded its strongest two quarters for six years

Indices of non-oil GVA per hour: outturn and successive OBR projections
(Q1 2008 = 100)



Source: RF analysis of OBR & ONS

Quarter-on-quarter growth of 1 per cent and 0.7 per cent (in non-oil GVA per hour) in Q3 and Q4 represents the best performance since Q2 2011 (1.2%), and compares with a pre-2008 quarterly average of 0.6 per cent

2017 pay growth has also been revised up since Nov-17, though the picture for 2016 is more mixed (and wages have still been falling in real-terms)

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Year-on-year growth in pay: OBR Nov-17 projections vs latest ONS outturns

	Average weekly earnings (nominal)		*Average weekly earnings (CPI-adjusted)*		*Average hourly earnings (nominal)*		*Average hourly earnings (CPI-adjusted)*	
	Nov-17 OBR	Latest ONS	Nov-17 OBR	Latest ONS	Nov-17 OBR	Latest ONS	Nov-17 OBR	Latest ONS
2016Q1	2.2%	2.2%	1.9%	1.9%	2.2%	2.2%	1.8%	1.9%
2016Q2	2.5%	2.4%	2.2%	2.1%	2.7%	2.8%	2.4%	2.4%
2016Q3	3.2%	3.1%	2.5%	2.2%	2.7%	2.4%	2.0%	1.6%
2016Q4	3.3%	3.2%	2.0%	1.9%	3.8%	3.8%	2.6%	2.6%
2017Q1	2.7%	3.1%	0.6%	0.9%	2.4%	2.8%	0.2%	0.6%
2017Q2	2.0%	2.5%	-0.7%	-0.2%	1.4%	1.9%	-1.3%	-0.9%
2017Q3	2.1%	2.3%	-0.7%	-0.5%	1.7%	2.3%	-1.0%	-0.5%
2017Q4	2.2%	2.5%	-0.8%	-0.5%	2.0%	3.2%	-1.0%	0.1%

Nominal weekly pay growth was revised down for 2016 (from 2.8 per cent to 2.7 per cent) and up for 2017 (from 2.3 per cent to 2.6 per cent)

In real-terms, the latest outturns suggest weekly pay fell by 0.1 per cent over the course of 2017 – a less tight squeeze than the one previously projected by the OBR (-0.4 per cent)

Notes: Red font = downgrade; green font = upgrade.
Source: RF analysis of OBR & ONS

But monthly data provides clear evidence of a recent acceleration in nominal weekly pay growth in the private sector

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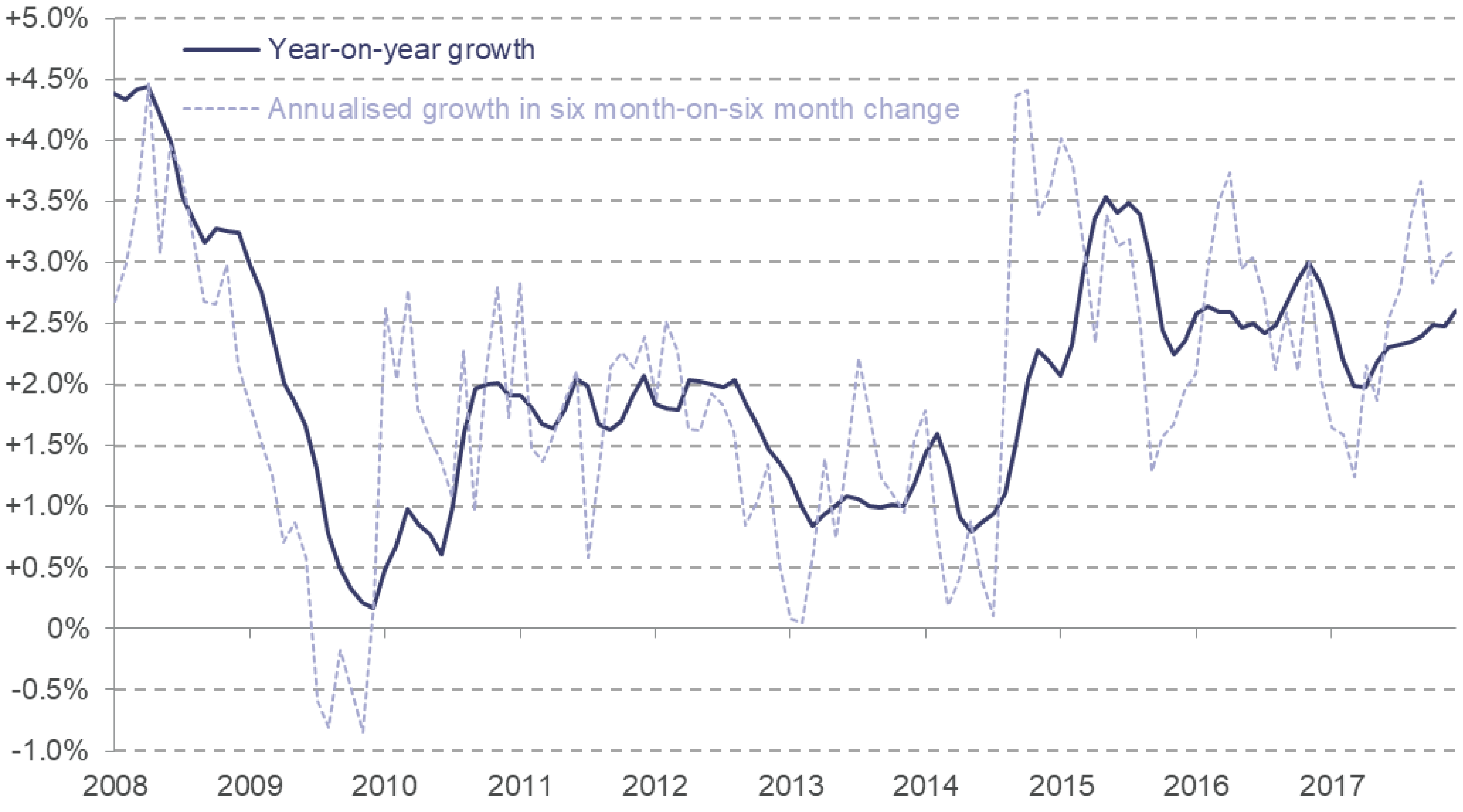
Growth in regular (excluding bonuses) private sector weekly pay: nominal



While pay is still falling in real-terms, nominal growth has picked up from its post-EU referendum low. The shorter-term six month-on-six month measure has increased especially sharply, reaching 3.1 per cent in the private sector (and 2.9 per cent across the whole economy)

The Bank of England has reported that private sector pay settlements are expected to reach 3.1 per cent in 2018, up from 2.6 per cent in 2017 and the highest recorded since 2008

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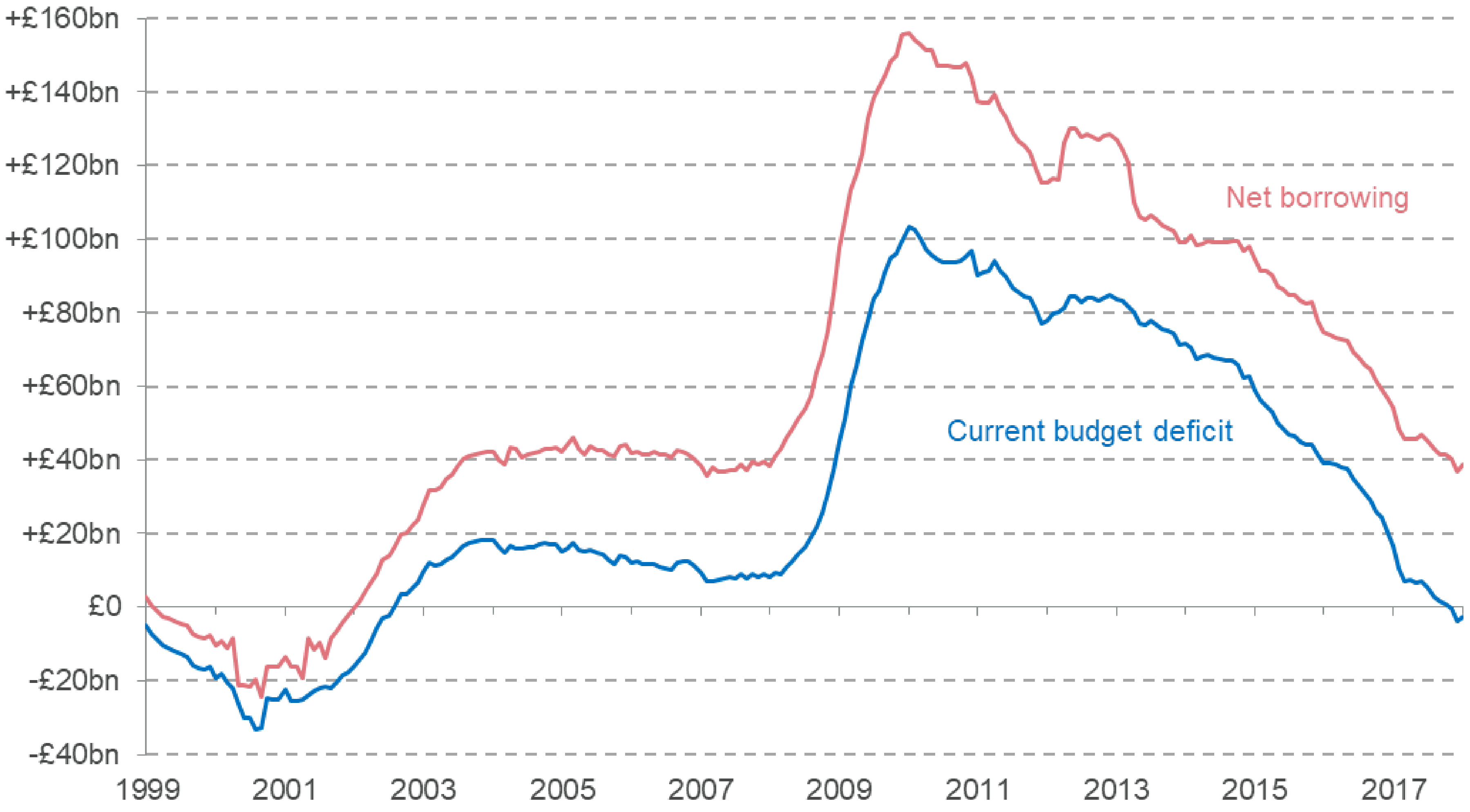
Source: RF analysis of ONS

And government borrowing is returning to pre-crisis levels, with the current budget deficit eliminated for the first time since 2002

Public sector net borrowing and current budget deficit: rolling 12-month total, nominal



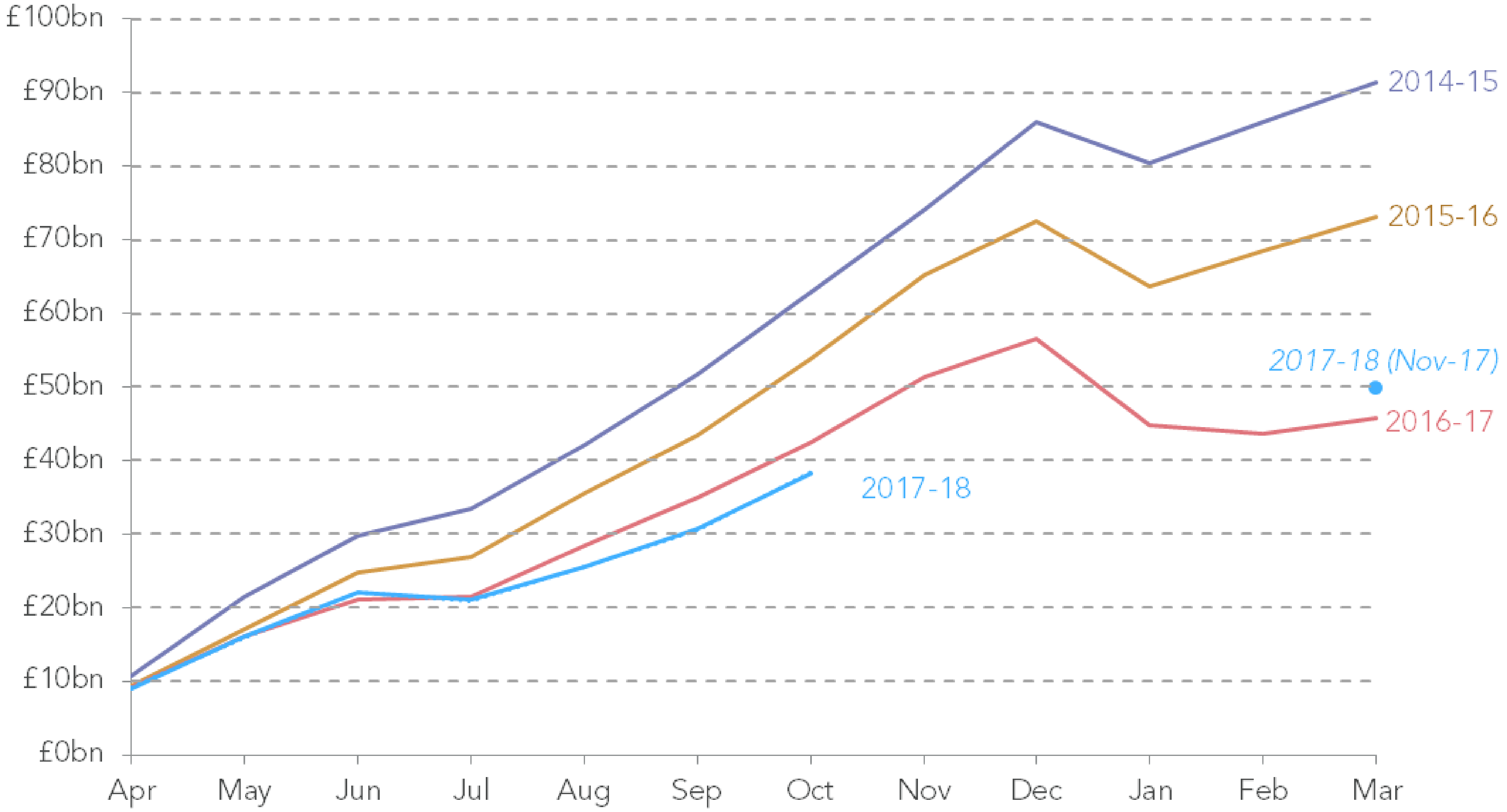
Source: RF analysis of ONS

The current budget deficit covers day-to-day spending, whereas overall net borrowing includes capital expenditure

The 2010 fiscal mandate set out by the coalition government required the current budget to be on course to reach balance at the end of a rolling five-year horizon

The expectation had been that the 2017-18 deficit would reach £49.9bn, up from £45.7bn in 2016-17

Cumulative Public Sector Net Borrowing: outturn and forecast: nominal, ex. public sector banks



Despite year-to-date borrowing in 2017-18 being down 10 per cent at the time of the Nov-17 outlook, the OBR still assessed that it would end the financial year 9 per cent *up* on the 2016-17 figure

Underpinning this assessment was an expectation that the annual reduction in borrowing associated with the arrival of self-assessment and CGT receipts in Jan/Feb would be more muted than in 2016-17 (following the bringing forward of dividend payments into 2015-16 to avoid the Apr-16 tax rise)

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Source: RF analysis of OBR & ONS

But it is on course to come in somewhere between £7bn and £11bn lower than the Nov-17 projection, thanks to strong receipts

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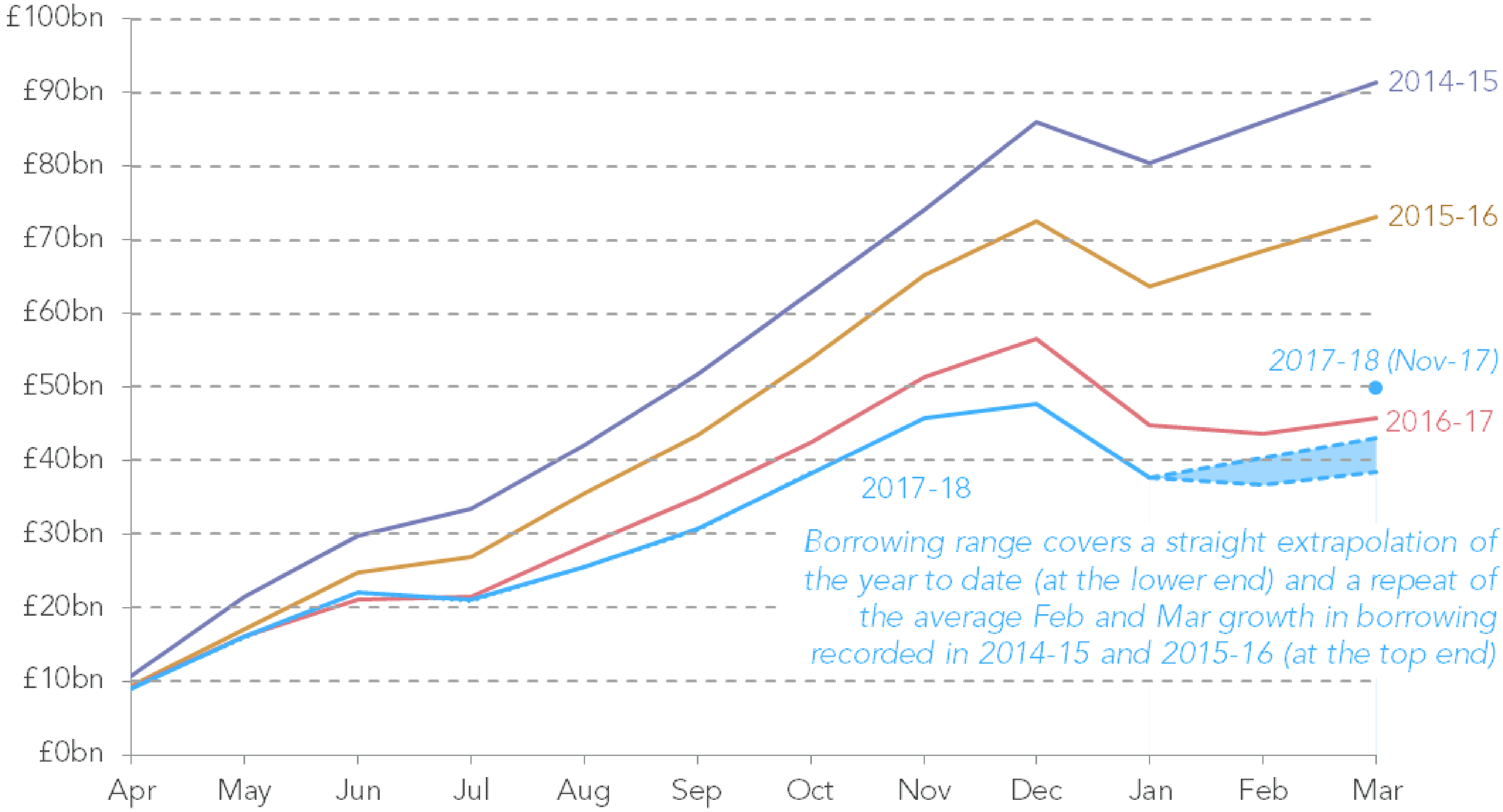
Cumulative Public Sector Net Borrowing: outturn and forecast: nominal, ex. public sector banks



The Jan-18 self-assessment receipts were stronger than expected, causing the OBR to state that: "*It now looks clear that borrowing in 2017-18 will undershoot our November forecast by a significant margin. But the full-year deficit is still unlikely to fall as sharply from last year's figure as a simple extrapolation of the year to date would suggest*"

Past experience would suggest the final financial year total could be between £7bn and £11bn lower than previously projected

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Source: RF analysis of OBR & ONS

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A False ~~HOPE~~ SPRING~~S~~?

Despite better news, significant challenges remain in relation to both public finances and living standards

If the OBR follows the pattern set by the Bank of England and other forecasters, it will upgrade the near-term picture but do little to change the medium-term outlook facing the Chancellor

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Successive Bank of England *Inflation Report* projections and assumptions

	UK GDP (4-quarter average)		*Productivity (real GDP/hour)*		*Average weekly earnings (nominal)*	
	Nov-17	Feb-17	Nov-17	Feb-17	Nov-17	Feb-17
2017	1.6	1.7	¼	½	2¼	2½
2018	1.6	1.8	1¼	1¼	3	3
2019	1.7	1.7	1½	1¼	3¼	3¼
2020	1.7	1.7	1¼	1	3¼	3½

Despite the uptick in productivity growth in the second half of 2017, the Bank left its Feb-18 projection for *structural* productivity growth broadly unchanged

It revised down its medium-term productivity growth projection in the Feb-18 report on the assumption that there is less spare capacity in the economy than it previously thought – reducing the opportunity for 'above-trend' productivity growth

Notes: Red font = downgrade; green font = upgrade.
Source: RF analysis of Bank of England, Inflation Report

And UK growth prospects look less impressive when set against global trends: the UK is bottom of the G7 growth league (having been top in mid-2016)

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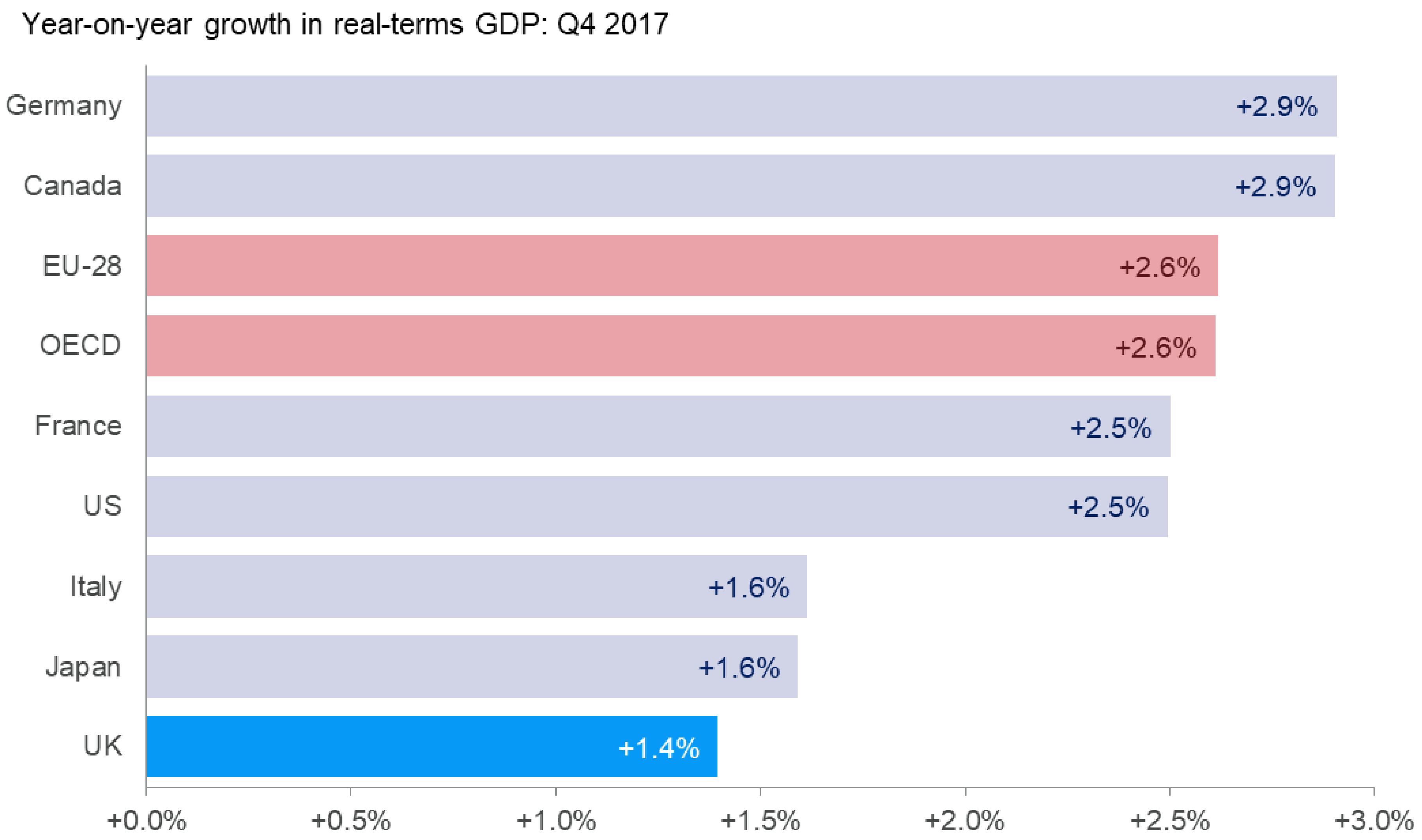

In its latest *World Economic Outlook*, the IMF revised up its 2019 growth projections by 0.4 percentage points across advanced economies (to 2.2 per cent)

But the UK growth projection was revised *down* by 0.1 percentage points (to 1.5 per cent)

Source: RF analysis of OECD

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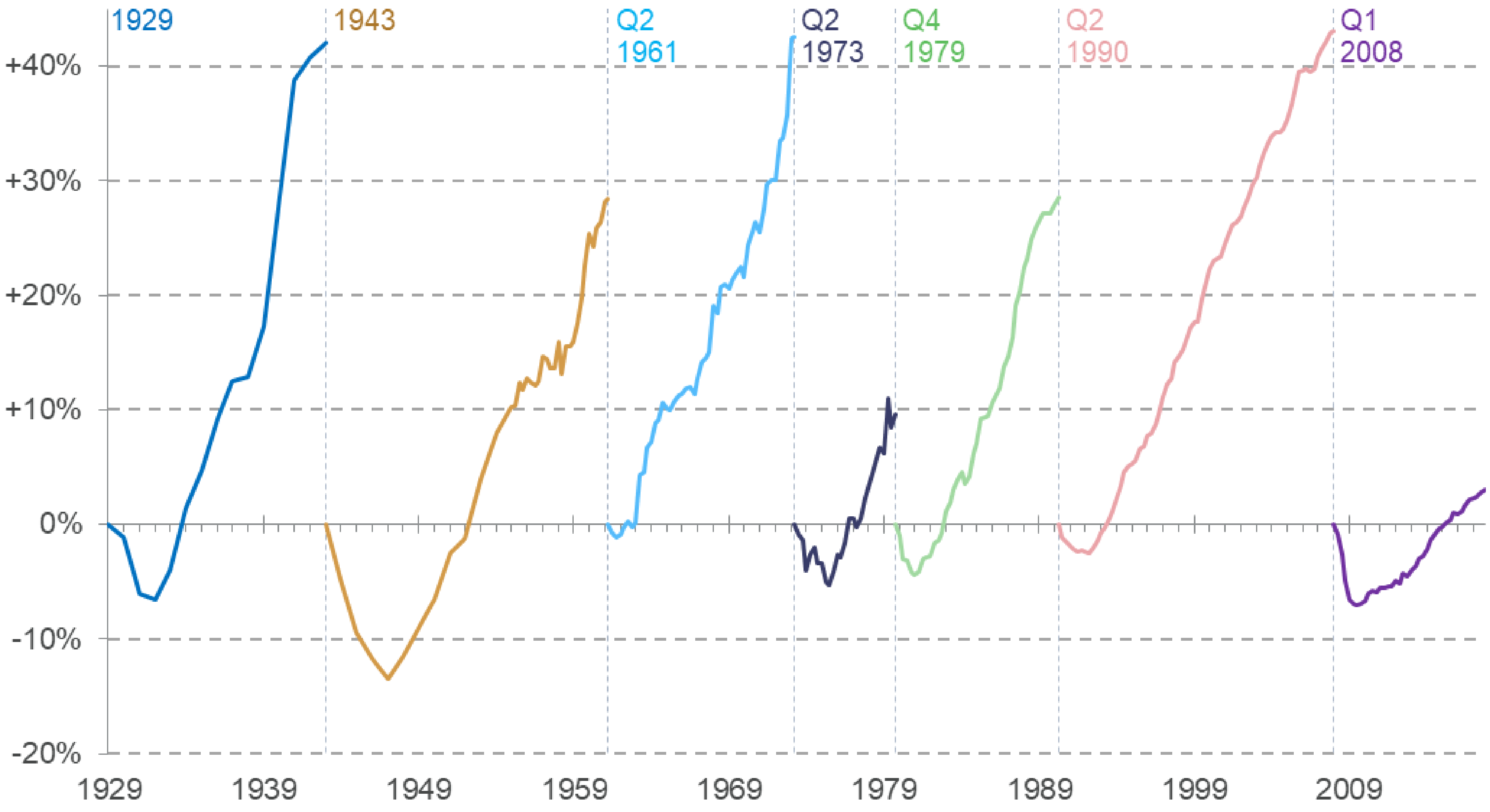
Longer term, the picture on UK GDP per capita remains one of incredibly slow recovery

Cumulative growth in real-terms GDP per capita over successive economic cycles: UK



9½ years after the pre-crisis peak in output per person, the UK's GDP per capita is up just 3 per cent

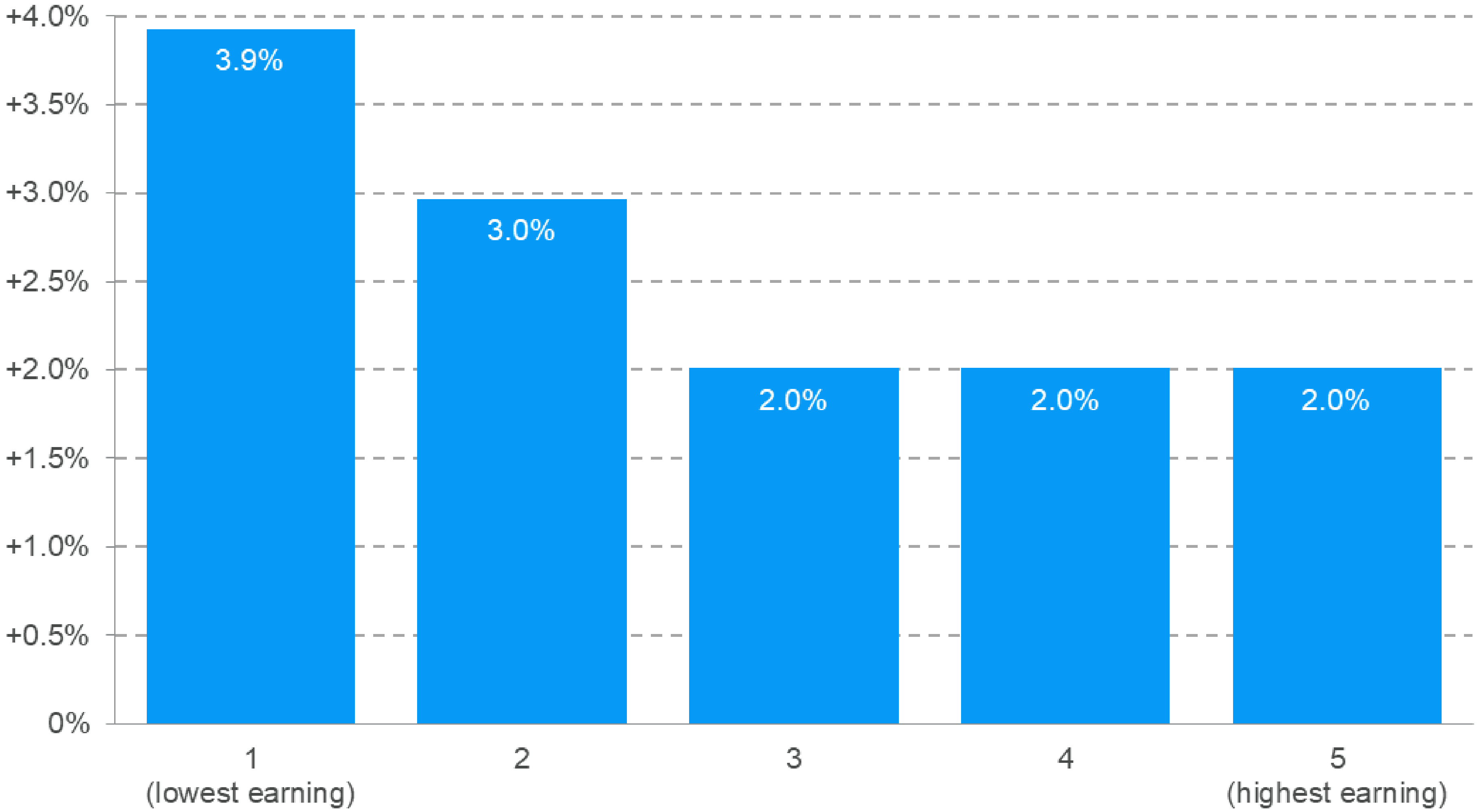
At the same stage of the recovery from the 1920 crash, GDP per capita was up roughly 15 per cent

Following the last two recessions (1980 and 1990), output per person had grown by 27 per cent and 21 per cent respectively

Source: RF analysis of ONS

In terms of living standards, a further increase in the National Living Wage will provide a boost for some workers in the coming year

Projected year-on-year growth in nominal hourly pay in the private sector, by earnings quintile: 2018-19

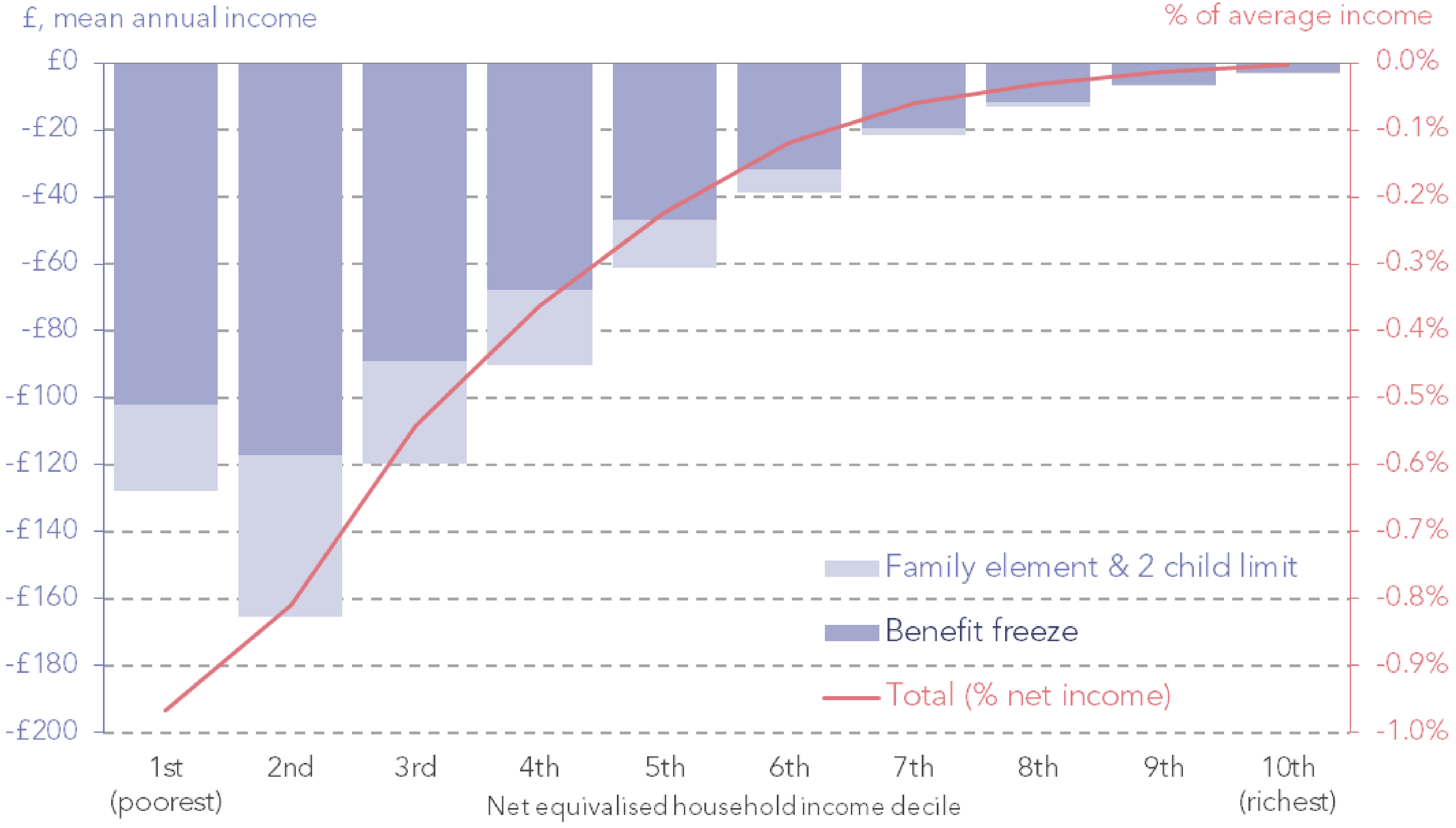


Over 1.5 million workers are in line for 4.4 per cent pay rise when the National Living Wage increases to £7.83 on 1 April. That contrasts with average (Nov-17) OBR-projected growth in hourly pay in 2018-19 of 2.3 per cent

Source: RF analysis of OBR

But pre-announced policy changes are set to lower incomes for many households from April onwards

Impact of benefit measures taking effect from April 2018 on disposable income



11 million working age families are set to feel the effect of the benefits freeze from 9 April 2018, with a couple with two children set to lose £315 on average

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Source: RF analysis using the IPPR taxben model

Notes: estimates take account of the freeze to most working-age benefits in April 2018, removal of family element for new claims throughout 2018-19 and limiting of support to two children for families newly effected in 2018-19. Mean income changes are expressed in cash terms for 2018-19.

And departmental spending pressures continue to bite – with per capita spending on day-to-day services set to remain largely unchanged in 2018-19

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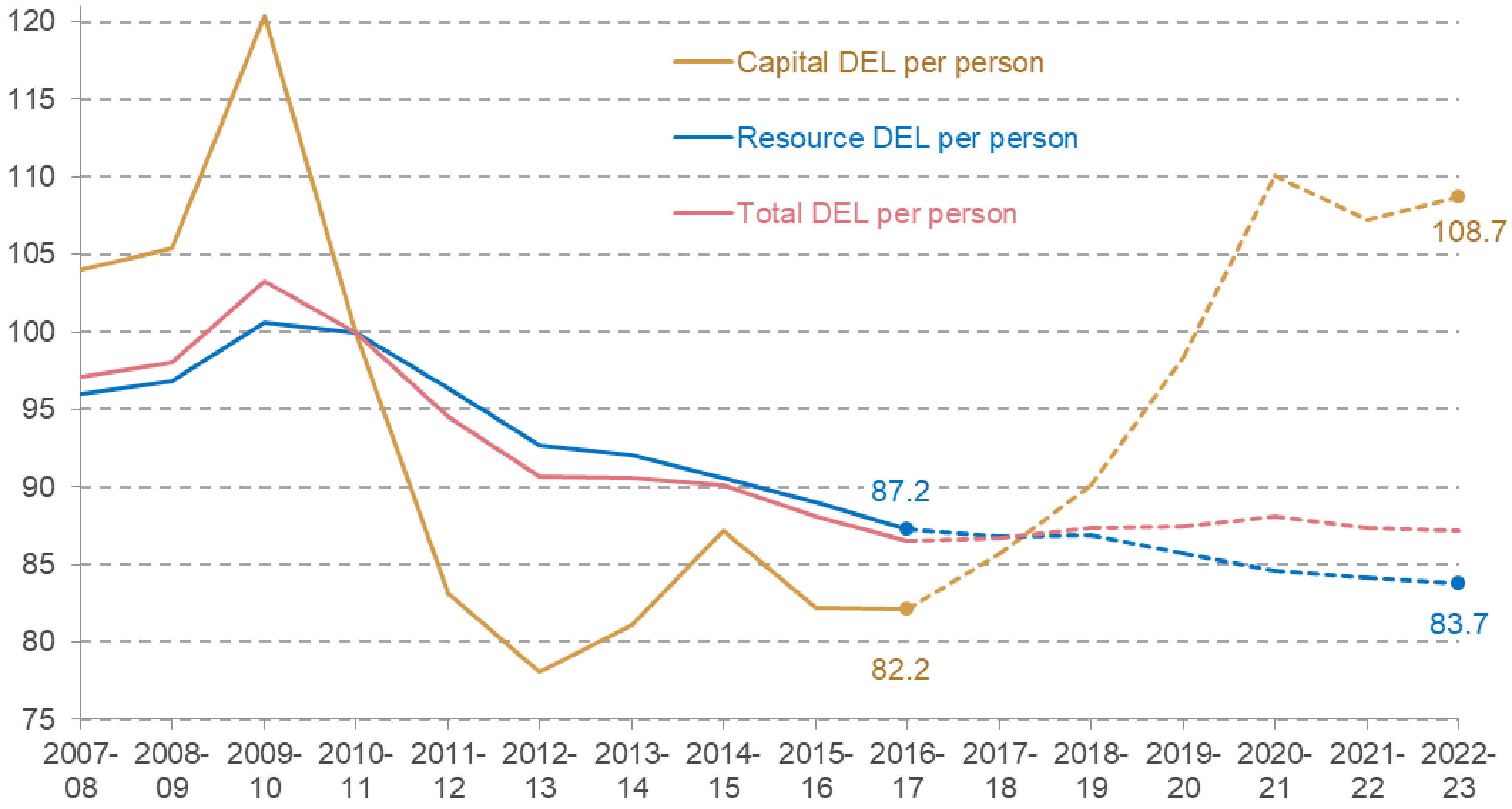
Indices of real-terms departmental expenditure limits: 2010-11 = 100 (GDP-deflator)



Capital expenditure is set to rise rapidly in the coming years – returning to pre-crisis levels

But day-to-day departmental spending will fall further after 2018-19, standing 16 per cent lower in 2022-23 than it was in 2010-11

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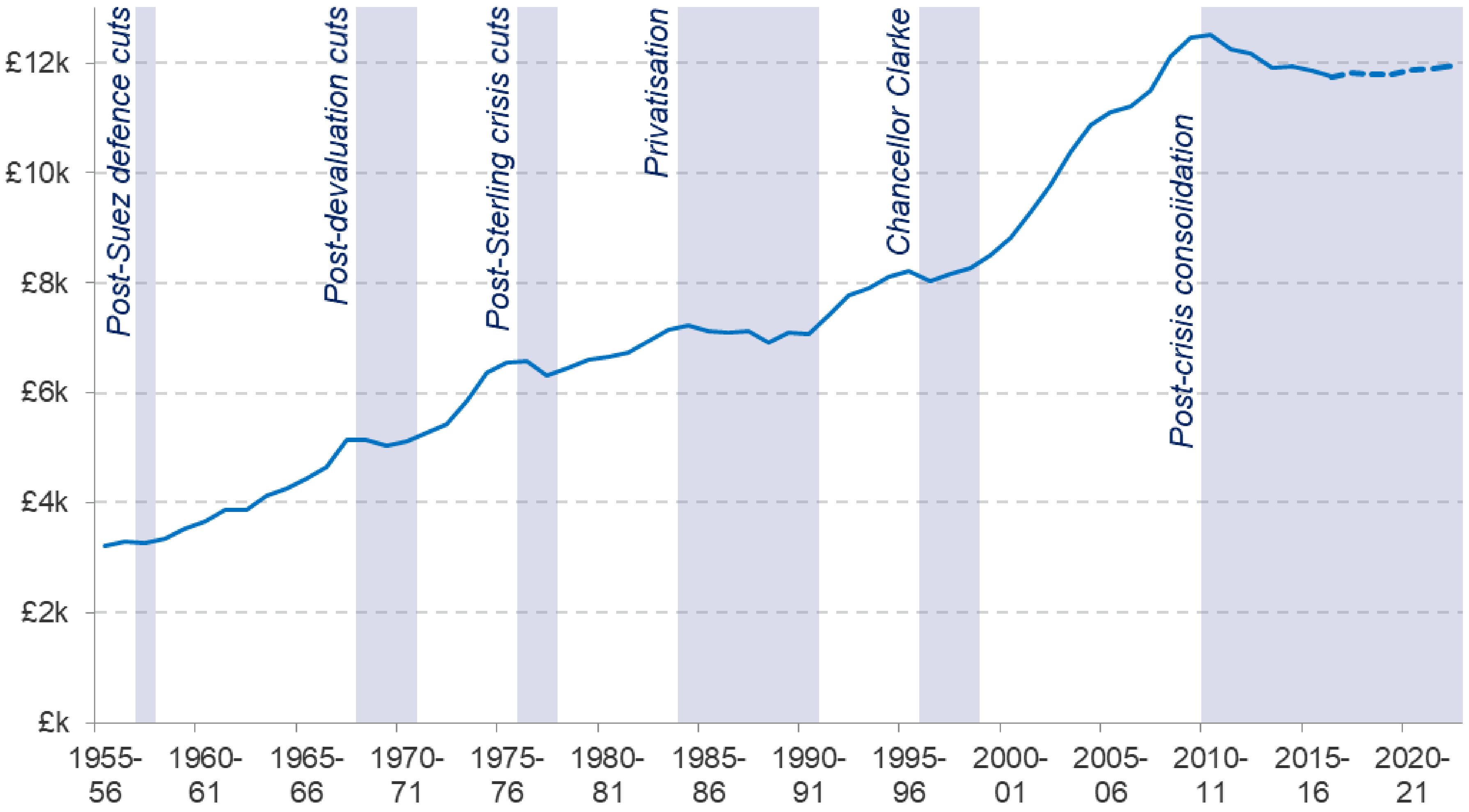
Source: RF analysis of OBR

Given this backdrop, and the fact that the deficit is back in more 'normal' territory, there is a strong case for the Chancellor to spend some money

Real-terms government spending per person: 2016-17 terms (GDP deflator)

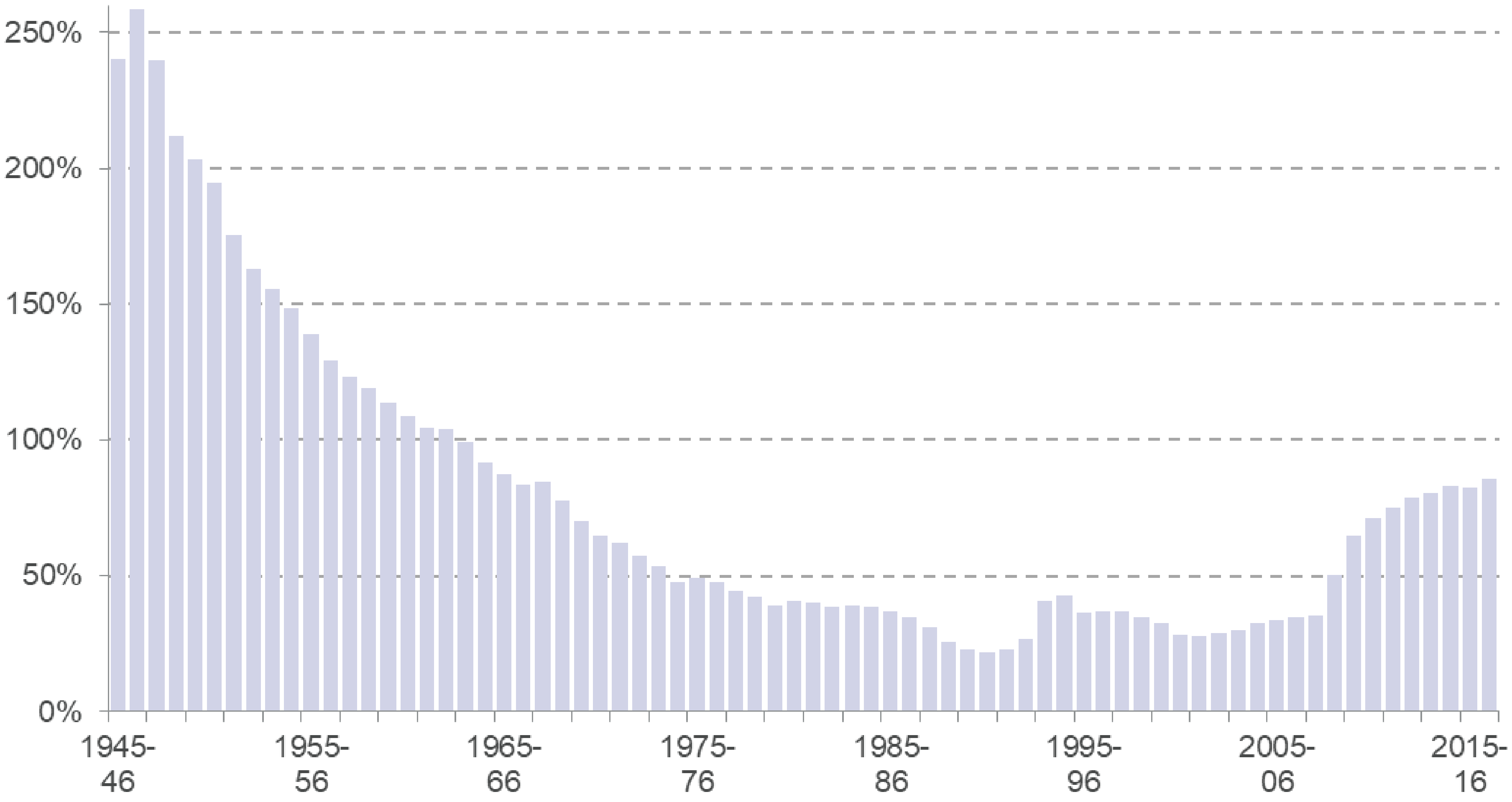


On current spending plans, the UK appears to be only part way through an unprecedentedly long pause in the growth of government spending per person

Source: RF analysis of OBR

But he will feel constrained by the fact that debt remains elevated relative to pre-crisis levels

Public sector net debt as a share of GDP



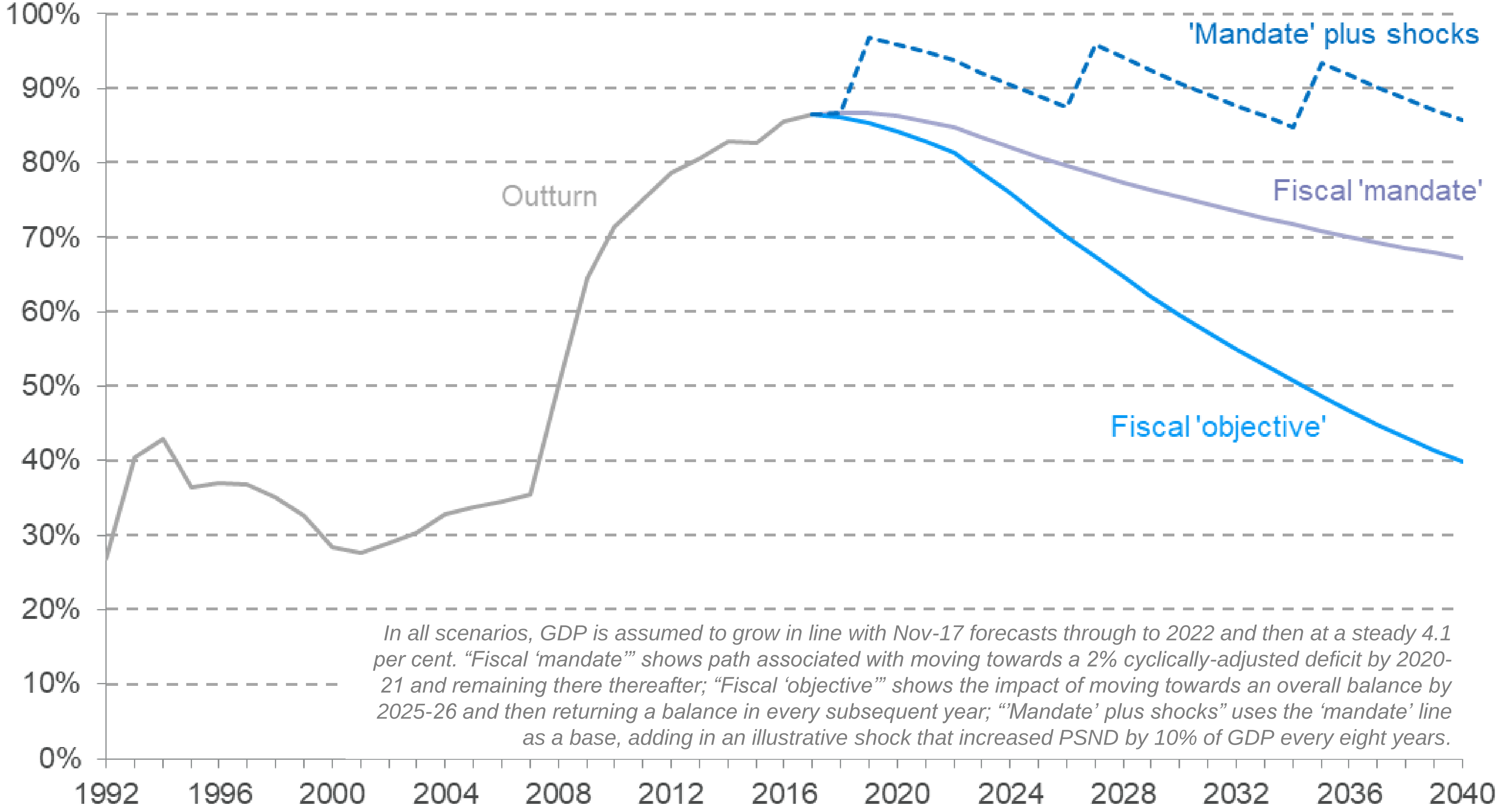
PSND was estimated to have been £1.7 trillion in 2016-17. That's equivalent to 85.6 per cent of GDP; the highest level since 1965-66

It picked up to 87.2 per cent of GDP in Oct-17, but fell back to 84.1 per cent in Jan-18

Source: RF analysis of OBR

And vulnerable to what might happen to public finances when the next crisis hits

Public sector net debt as a share of GDP: outturn and projections under different scenarios



It is possible to run an overall budget deficit each year (as per the current fiscal mandate) and still lower the debt to GDP ratio, but that inevitably slows the pace relative to the government's fiscal 'objective' of overall balance

The introduction of illustrative, but plausible, future 'shocks' further slows the pace of debt reduction

Source: RF modelling

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Some conclusions for the Chancellor

Conclusions

- On a number of measures, the economic outlook has brightened a little since the 'bloodbath' of the Autumn Budget, meaning the Chancellor is likely to receive some good news on the deficit at next week's Spring Statement

- But if the OBR follows the same path as the Bank of England and other forecasters, it is likely to confine its upgrades to the near-term. And we know that the living standards outlook will certainly be clouded by tax and benefit policy changes coming into effect in April – especially in the bottom half of the income distribution

- Increased headroom on the public finances provides more space for some fiscal loosening in the near-term. But, easing pressures on public finances and working-age welfare over the longer-term would likely need to come alongside an increase in revenues. This is especially the case given the fiscal pressures associated with an ageing population

A man for all seasons?

What the Chancellor can expect in the OBR's Spring outlook

Matt Whittaker

March 2018

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