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Resolution Foundation
BRIEFING

Super, smashing, great?

Spring Statement response

March 2019

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

Summary

Last night parliamentarians channelled their inner Noel Edmonds as they debated deal or no deal. But earlier in the day the Chancellor brought back memories of the late, great Jim Bowen of Bullseye fame in his Spring Statement: setting out just what MP's "could've won" – or might still win – if they would only back a Brexit deal. We've got the cash and the good times can roll – so long as we don't stuff up Brexit – was the Chancellor's unsubtle message to his colleagues and country.

At first glance, that positive public finance picture is hard to square with what feels like a pretty gloomy economy right now. Indeed, the Office for Budget Responsibility (OBR) downgraded its growth forecast for 2019 from 1.6 per cent to 1.2 per cent – leaving us with the slowest annual growth since the end of financial crisis-inspired downturn. And this comes on top of an already sluggish period for growth: Britain's economy is now forecast to be around £50 billion smaller at the start of 2021 than it was expected to be just ahead of the 2016 EU referendum.

Fortunately for the Chancellor, the OBR had better news on the public finances. This year we're expected to borrow just 1.1 per cent of GDP – the lowest for 17 years. And over the full six years of its forecast, the OBR presented the Chancellor with a £37 billion windfall – one that he chose to bank all but £7 billion of (for now). So what explains this combination of weak growth but strong public finances?

For one, we're paying more income tax than expected. That reflects good news on employment and earnings – with average annual pay now expected to be £570 a year higher in 2023 than was projected back in October (though the forecast remains £1,400 down on the level the OBR expected to be reached in its final pre-referendum *Outlook* and we're still on course to complete a 16-year period of lost pay growth). But increased tax receipts also reflect the fact that higher earners have done particularly well. The OBR revealed that the top 0.1 per cent of employees enjoyed annual pay growth of 5.9 per cent last year, compared to an average of 3.7 per cent. Good news for the Chancellor; bad news for those wanting a more equal society.

The other squaring of the circle comes via a reduction in the debt interest paid by the government. That's partly a reflection of lower-than-expected RPI inflation in the near-term, but further out it's driven by lower market interest rate expectations. Somewhat ironically those expectations flow in part from the growing shadow of a 'no deal' Brexit on market sentiment. The Chancellor is keen to reap the rewards of the 'deal dividend', but on this occasion the uncertainty around Brexit has actually helped him.

But while the Chancellor has pocketed the latest OBR windfall for now, he declared himself ready to change course in the coming years to finally draw a line under a decade of austerity. He offered his colleagues the opportunity to fire the starting gun on a Spending Review process that would cover the three years from 2020-21 to 2022-23, and would

be defined not by discussions about what to cut, but instead by a debate about how best to share fiscal headroom between "increased spending on public services, capital investment in Britain's future prosperity and keeping taxes low, while always continuing to keep our debt falling".

But how much can he realistically do? Quite a lot. Relative to his fiscal 'mandate' – which requires him to bring the structural deficit below 2 per cent of GDP by 2020-21 – he now has projected headroom of £26.6 billion, up from £15.4 billion at October's Budget. That's the fourth highest level of headroom either he or his predecessor George Osborne have enjoyed relative to their chosen mandate. And it is set to rise to £34.9 billion by the final year of his proposed Spending Review period in 2022-23.

Such headroom represents more than enough to end austerity defined in a number of different ways. Ensuring that all currently unprotected departments (i.e. not the NHS, defence or international aid, which already have protections in place) had their budgets protected in real, per capita terms would require him to unleash just £3.4 billion of his headroom in 2022-23. More in keeping with the spirit of ending austerity, maintaining spending on the unprotected departments as a share of GDP would cost him £8.8 billion. Yet even this would leave existing cuts in place: by 2022-23, the Department for Transport budget would still be down 76 per cent on its 2009-10 level and Housing and Communities would be 55 per cent lower.

And it is worth noting that spending more without any tax rises would move the Chancellor even further away from his ultimate fiscal objective of running a budget surplus – something he is already on course to miss. He has significant fiscal room for manoeuvre, but tough choices remain.

While the Chancellor held out the prospect of ending austerity for public services on the back of strong earnings growth for high earners, he has allowed it to continue for low and middle income households. Overall tax and benefit changes being introduced this April will take £100 from families in the bottom fifth of the income distribution – driven by the ongoing benefit freeze – and give £280 to those in the top fifth. When people ask why child poverty is going up, this is the answer.

So, while all eyes are on Brexit, yesterday's Spring Statement gave an insight into where politics is heading when – if – we move beyond the current impasse.

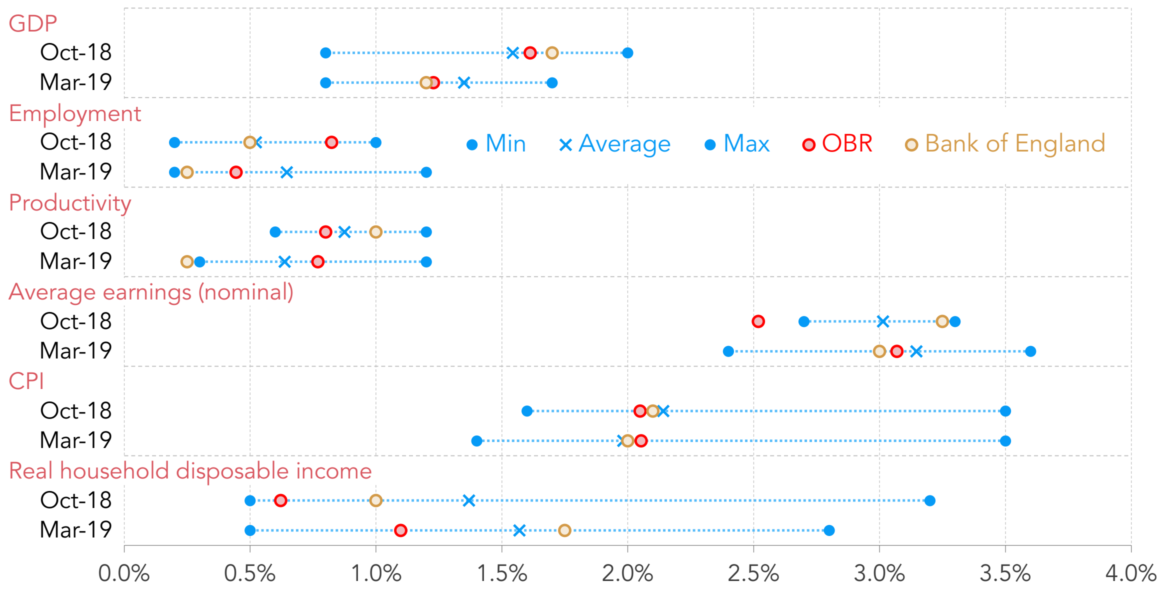
Lots of difficult times will still lie ahead – not least with sluggish growth here and around most of the world. But the good news on the public finances means a corner could then be turned on austerity for our public services. By that point hopefully all the main parties will recognise that ending austerity has to mean ending it for the living standards of low and middle income families as well. Then maybe, even if times remain tough and choices hard, we can reasonably talk about hitting the bullseye.

The near-term outlook for UK growth has weakened, but the medium-term picture is broadly unchanged

In line with what we've seen in official outturn data and heard from several forecasters over recent months, the OBR painted a relatively gloomy picture of the UK's near-term economic growth prospects yesterday. As Figure 1 shows, it followed the lead of the Bank of England and others by downgrading its forecast for GDP growth in 2019 from the 1.6 per cent it had projected at October's Budget, to just 1.2 per cent – a growth level that would be the slowest recorded in any calendar year since 2009.[1]

Figure 1: The OBR has downgraded its growth projection for 2019 slightly, but upgraded its forecast for earnings growth

Projected growth rates in 2019



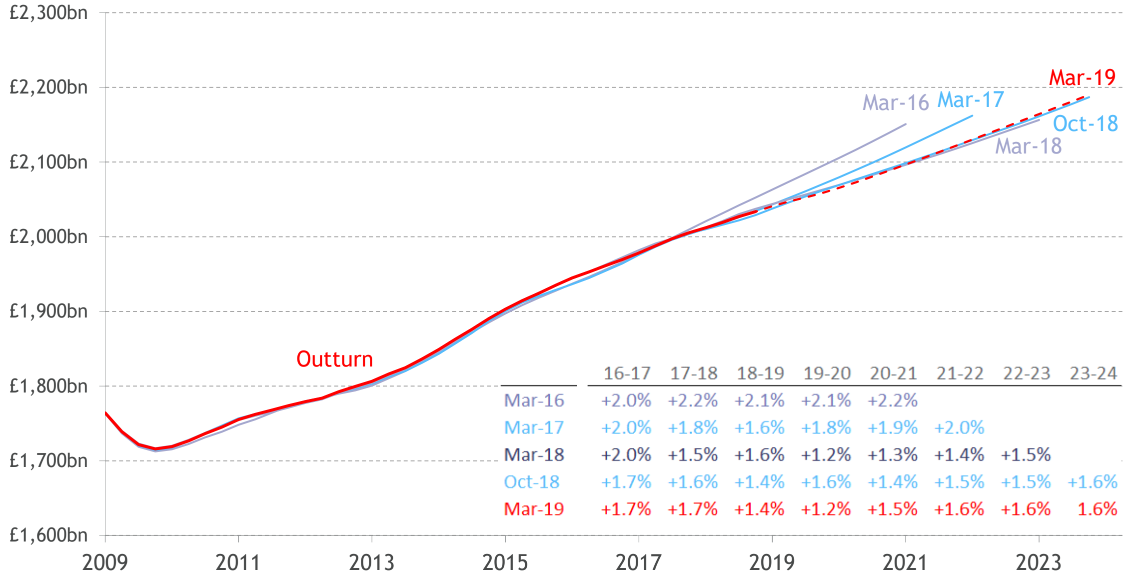
Notes: Bank of England data cover Nov-18 and Feb-19. Min, max and average drawn from those forecasters included in the HMT *Independent Forecasts* publication in both the Oct-18 and Feb-19 editions. CPI forecasts cover Q4 2019.
Source: HMT, *Forecasts for the UK economy: a comparison of independent forecasts*, OBR, *Economic and Fiscal Outlook* and *Bank of England, Inflation Report.*

However, the OBR doesn't expect this GDP downgrade to be sustained through its projection period. Figure 2 shows that the OBR expects real-terms GDP to be very little changed from its October forecast once we look across the entirety of its forecast horizon. Growth is projected to pick-up relative to the October forecast after 2019-20, before returning to the same level (1.6 per cent) as previously projected by 2023-24. By the end of the period, the forecast *level* of GDP is almost entirely unchanged.

[1] See J Smith, *Counting the cost*, Resolution Foundation, February 2019.

Figure 2: The OBR has downgraded its growth projection for 2019 slightly, but overall the forecast for GDP is little changed

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



	16-17	17-18	18-19	19-20	20-21	21-22	22-23	23-24
Mar-16	+2.0%	+2.2%	+2.1%	+2.1%	+2.2%			
Mar-17	+2.0%	+1.8%	+1.6%	+1.8%	+1.9%	+2.0%		
Mar-18	+2.0%	+1.5%	+1.6%	+1.2%	+1.3%	+1.4%	+1.5%	
Oct-18	+1.7%	+1.6%	+1.4%	+1.6%	+1.4%	+1.5%	+1.5%	+1.6%
Mar-19	+1.7%	+1.7%	+1.4%	+1.2%	+1.5%	+1.6%	+1.6%	1.6%

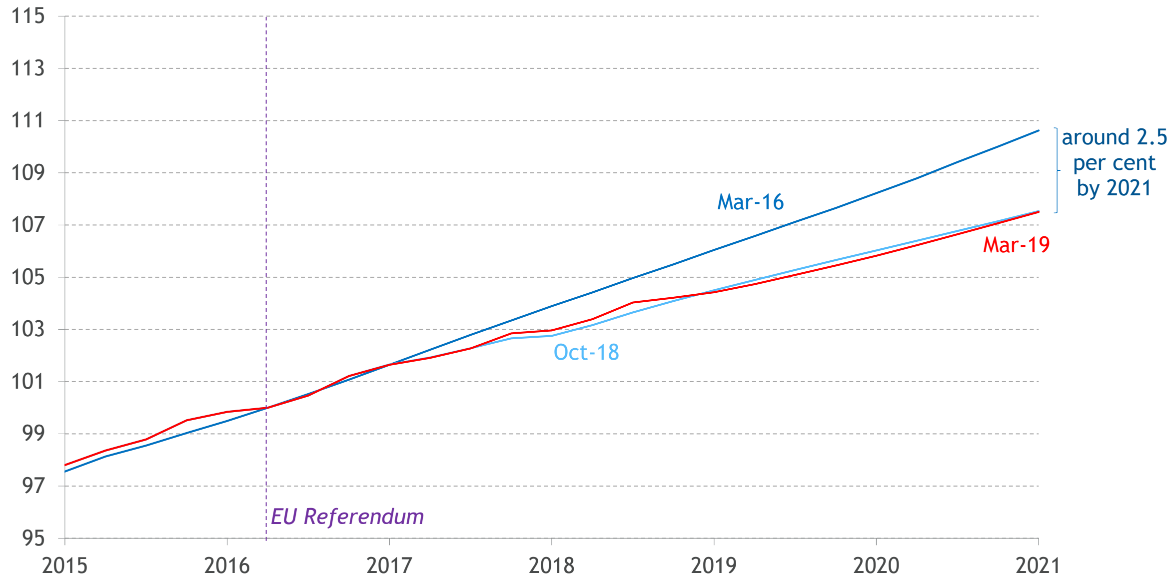
Sources: OBR, *Economic and Fiscal Outlook*, various.

Nevertheless, while little is changed relative to October in the OBR's medium-term growth outlook, the bigger picture is one of an economy that is projected to be very much smaller in the coming years than it was forecast to be ahead of the EU referendum of 2016. Figure 3 makes this clear, comparing the October 2018 and March 2019 projections for real-terms GDP with the one prevailing in March 2016. It shows that the economy is now projected to be around 2.5 per cent smaller at the start of 2021 than was previously forecast – around £50 billion in annual GDP terms.

Brexit is not the only factor at play in this story. The OBR's near-term gloom also flows from evidence of a wider slowdown in global growth. This has been particularly marked in the euro area, where a number of countries – particularly Germany and Italy – recorded sharp growth slowdowns towards the end of 2018. As a result, the UK shifted from the bottom of the G7 growth league at the start of 2018 to the middle of the pack by the end of the year. Yet there is little comfort in moving up the rankings during a race to the bottom. The softening of global growth has implications for UK exports, with the OBR marking down its forecast for external demand.

Figure 3: The economy is now expected to be around £50bn a year smaller by 2021 than forecast before the 2016 referendum.

Index of real GDP (2016 Q2 = 100)



Source: OBR, *Economic and Fiscal Outlook*, various.

Notwithstanding this broad-based headwind, Brexit-related uncertainty remains a significant UK-specific challenge. And it is one that is very likely larger than the OBR projections allow for, at least in the near-term. Yesterday's *Outlook* retained the same broad-brush assumptions the OBR has been using since the referendum, as set out in Box 1.

i Box 1: OBR Brexit assumptions

The OBR has been clear about the modelling challenges posed by Brexit, bringing as it does an unknown endpoint and policy that evolves in real time. Following the referendum result, it established broad-brush assumptions and judgements which have continued to underpin its central case ever since. These assumptions are listed on the OBR website, and include:

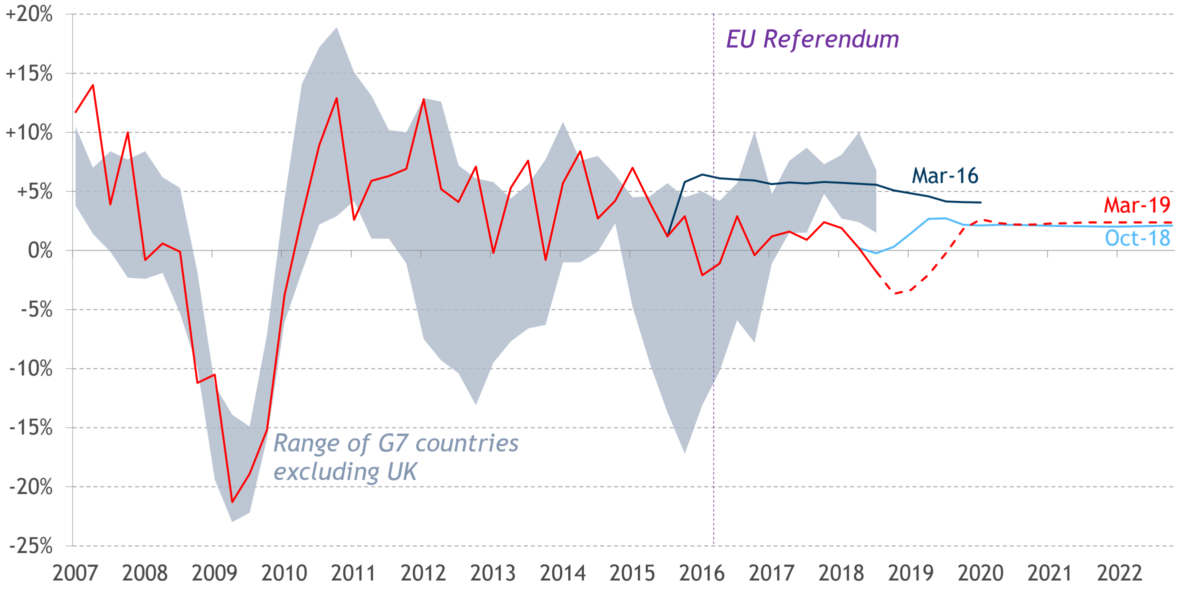
- The UK leaves the EU in March 2019.
- The negotiation of new trading arrangements with the EU and others slows import and export growth over a 10-year period.
- The UK adopts a tighter migration regime following departure from the EU than that currently in place, but not sufficiently restrictive to reduce net inward migration to the desired 'tens of thousands'.
- Any reduction in expenditure transfers to EU institutions – after factoring in the cost of the financial settlement – would be recycled fully into extra spending. This assumption is fiscally neutral.

Crucially, these assumptions include the expectation that the UK secures an orderly exit from the EU on 29 March, meaning Brexit-related uncertainty is expected to dissipate over the medium-term. This assumption increasingly looks likely to be undermined. Whether or not the UK achieves a smooth Brexit, it almost certainly will not happen this month. As such, all of the projections set out by the OBR yesterday need to be taken with a larger dose of salt than usual.

The likely extension of the Article 50 period has direct implications for the OBR's projections for business investment. Figure 4 shows how the UK has shifted over the period since the EU referendum from having a level of investment growth near the top of the G7 to one that is some way below the spread recorded across the other G7 members. And the UK's comparative performance has significantly worsened over the past 12 months as uncertainty has increased and business confidence has waned. Indeed, business investment is now projected to fall for a second successive calendar year in 2019, marking out its weakest performance since the financial crisis.

Figure 4: The UK's post-referendum stagnation in business investment contrasts with growth across the G7

Year-on-year growth in business investment in the UK and the G7 excluding the UK



Notes: Chained-volume measure. The business investment measures are not directly comparable across countries. Instead the shaded area includes series similar to the UK one, derived from other countries' National Accounts. These include private sector business investment for Italy; business investment minus residential structures for Canada; non-residential private investment for Japan and the US; and non-government investment minus dwellings investment for France and Germany.
Source: Bank of England, *Inflation Report*, February 2019, Chart 2.4.

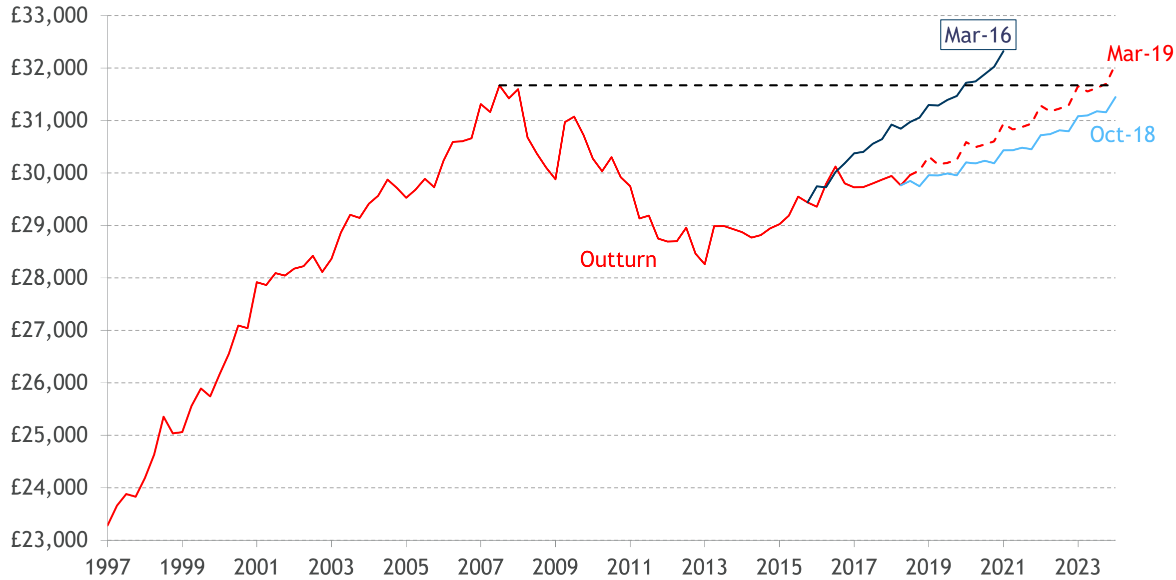
Over the medium term, the OBR expects business investment growth to pick back up, reflecting an assumed fading of the headwinds associated with Brexit uncertainty. But if this uncertainty persists for a longer period than the OBR had supposed, then we might expect investment performance to remain weak for longer. And the longer the uncertainty remains in place, the more probable it becomes that today's investment weakness reflects a permanent cancelling of business plans rather than just a temporary postponement.

The pay and income outlooks have both improved, though the bigger picture remains one of subdued growth

Despite the downgrade to the 2019 growth projection, Figure 1 also showed a marked pickup in expected earnings and incomes growth. Figure 5 compares the latest forecast – after adjusting for the new inflation projections – with those in place at other recent fiscal events. It shows average earnings are now expected to be around £570 a year higher at the start of 2023 than had been forecast in October.

Figure 5: The recovery in real-terms annual pay is stronger than at Autumn Budget 2018

Average annual employee earnings, CPI-adjusted: outturn and successive OBR projections (2018-19 prices)



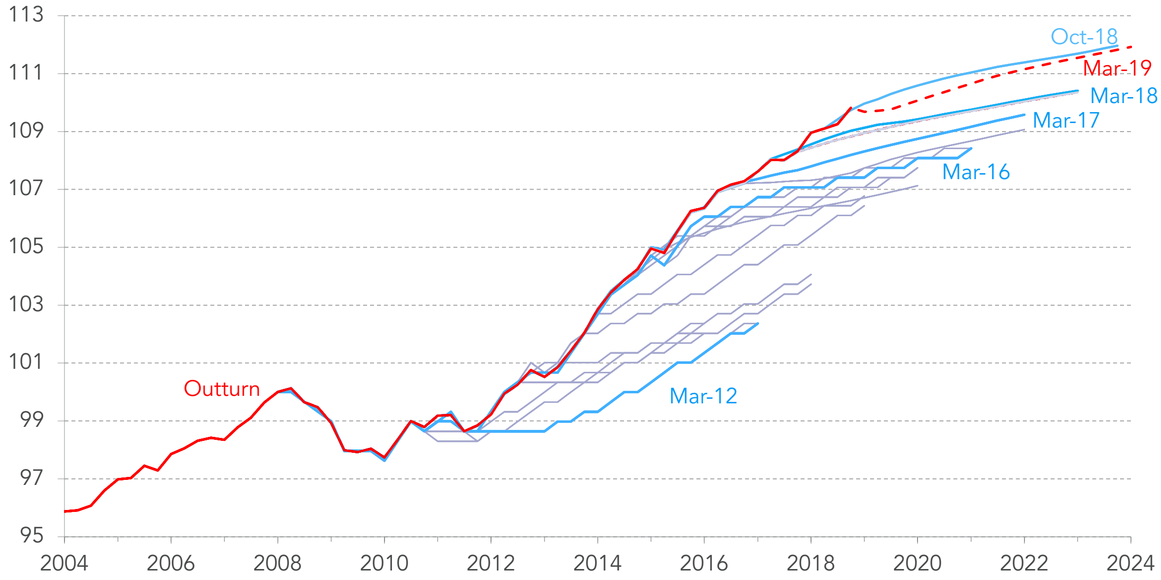
Source: OBR, *Economic and Fiscal Outlook*, various.

The new projections bring forward the point at which average earnings are expected to return to their pre-crisis peak. Where previously this crossover wasn't expected to arrive until the end of 2024, it is now projected to come in 2023. While this is clearly good news, it remains the case that workers are set to have faced a 16-year period of lost growth on pay. And it also remains the case that annual pay is projected to remain someway below the level forecast ahead of the EU referendum: by the start of 2021 employees are expected to be earning £1,400 a year less than had been projected in March 2016.

Slightly offsetting the better picture on pay, the OBR's employment projections are somewhat weaker than in October. This change is small and reflects the slightly weaker outlook for growth in the near term, coupled with historically high employment rates. The latter means that further increases in employment growth, even in the face of stronger GDP growth, are likely to be limited.

Figure 6: Employment growth is a little weaker

Indices of number of people in employment, 16+: outturn and successive OBR projections (Q1 2008 = 100)

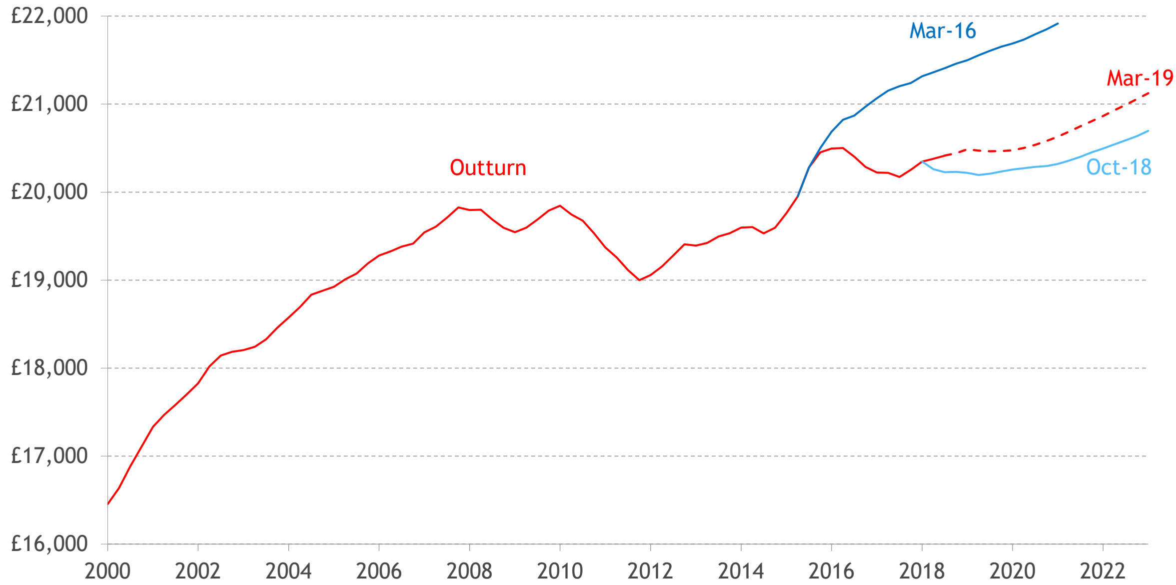


Source: OBR, *Economic and Fiscal Outlook*, various.

Nevertheless, the stronger pay growth projections trump the weaker employment ones, providing a welcome improvement in the outlook for household incomes. In this instance the outlook is also affected by past revisions to income growth. In particular, the starting level for real household incomes is around 1 per cent higher than in October's *Outlook*. Figure 7 shows that real household disposable income per capita stood at £20,415 in Q3 2018 and is expected to rise by £215 by the start of 2021.

Figure 7: Household incomes are stronger than in October, but growth remains subdued

Annualised real household disposable income per capita: outturn and successive OBR projections (CVM)



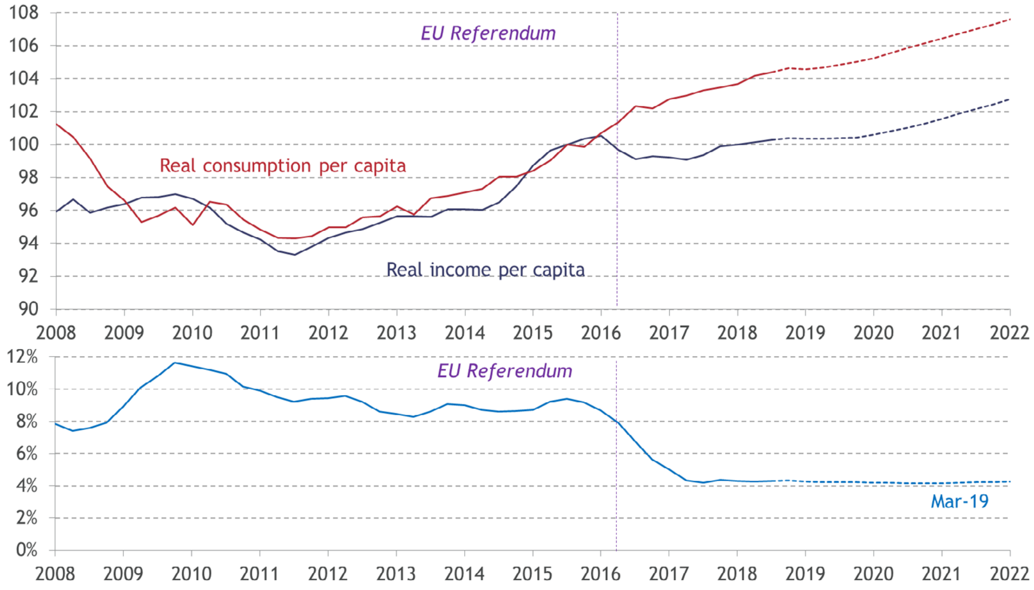
Source: OBR, *Economic and Fiscal Outlook*, various.

Once again though, the bigger picture is one of subdued growth and an outlook that remains weaker than the one set out ahead of the EU referendum. At the time of the March 2016 *Outlook*, average per person income was expected to be £21,915 in Q1 2021. Despite the revisions in the back data, that remains around £1,300 higher than the latest projection suggests.

A key uncertainty for the OBR's forecast is the extent to which any future income growth feeds through into consumption growth or into increased saving. In direct contrast to businesses, consumers have remained relatively immune to Brexit-related uncertainty over recent months. Figure 8 shows how consumption growth has consistently outpaced income growth in the period since the EU referendum, resulting in a marked drop in the savings ratio.

Figure 8: Household consumption growth has consistently outpaced income growth since the EU referendum announcement

Indices of annualised real income and real consumption per capita, 2015 Q3 = 100 and household saving ratio: UK



Source: ONS, *National Accounts*, time series NRJR, ABJR, HAYO, EBAQ & DGD8.

Going forward, the OBR expects household spending growth to remain resilient, weakening in the near-term but subsequently growing in strength alongside the medium-term pick-up in incomes. The savings ratio is expected to remain broadly flat, at its current low level. The OBR's forecast is therefore predicated on households remaining confident and putting off the point at which they bring their spending back in line with their incomes.

Clearly if households were to become more pessimistic about prospects for their finances, a rise in household saving would lead to a weaker outlook for the economy. As with the outlook for business investment, the prospect of such pessimism and associated precautionary saving might be looming larger given recent developments in parliament.

Despite relatively little change in the economic outlook, the public finance projections have undergone another upgrade

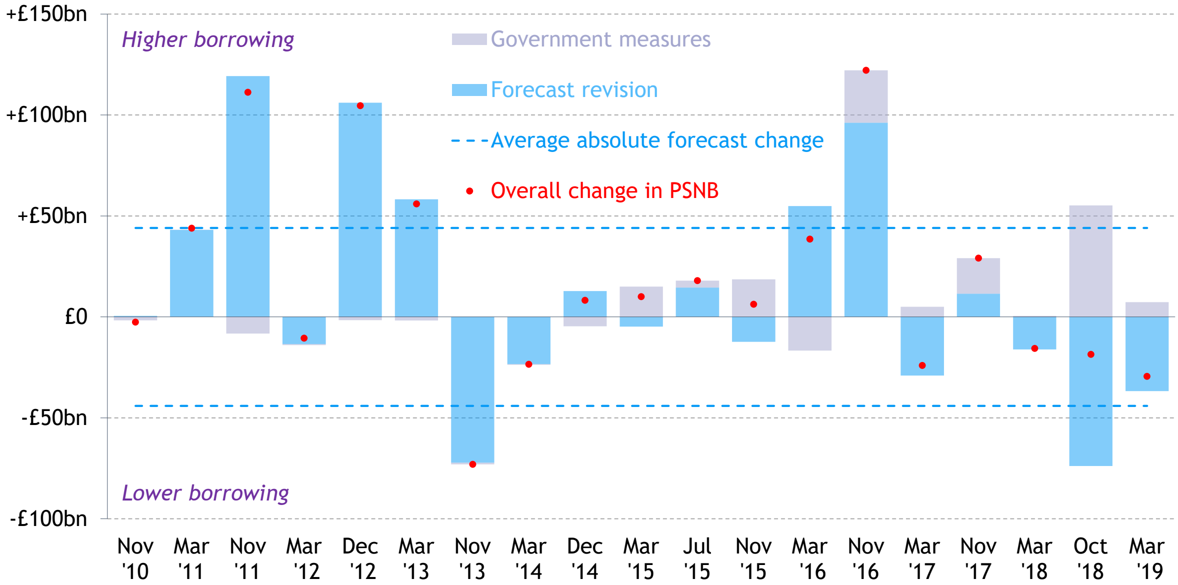
Back at October's Budget, the OBR handed the Chancellor a £74 billion fiscal windfall.[2] This was driven in the near-term by an acknowledgement of stronger-than-expected tax receipts and lower-than-expected spending on welfare and debt interest in the first half of 2018-19. Over the medium term, the OBR's upgrade reflected its belief that the economy had greater growth potential than previously assumed (shown by a reduction in its estimate of the sustainable rate of unemployment and an increase in its estimate of labour market participation).

[2] M Whittaker, How to spend it: Autumn 2018 Budget response, Resolution Foundation, October 2018

In its latest *Outlook* the OBR has reaffirmed this upgrade, and gone further still. While not as substantial as the October revision, its new projections provide the Chancellor with a further £36.7 billion windfall over the six years from 2018-19 to 2023-24. Unlike the Budget, the Chancellor has this time chosen to bank most of this windfall, spending just £7.3 billion of it. As Figure 9 shows then, these movements result in a cumulative reduction in public sector net borrowing (PSNB) of £29.5 billion.

Figure 9: On a cumulative basis, the Chancellor has been handed a new fiscal windfall of £37 billion

Change in cumulative PSNB over forecast horizon in successive OBR statements (nominal)

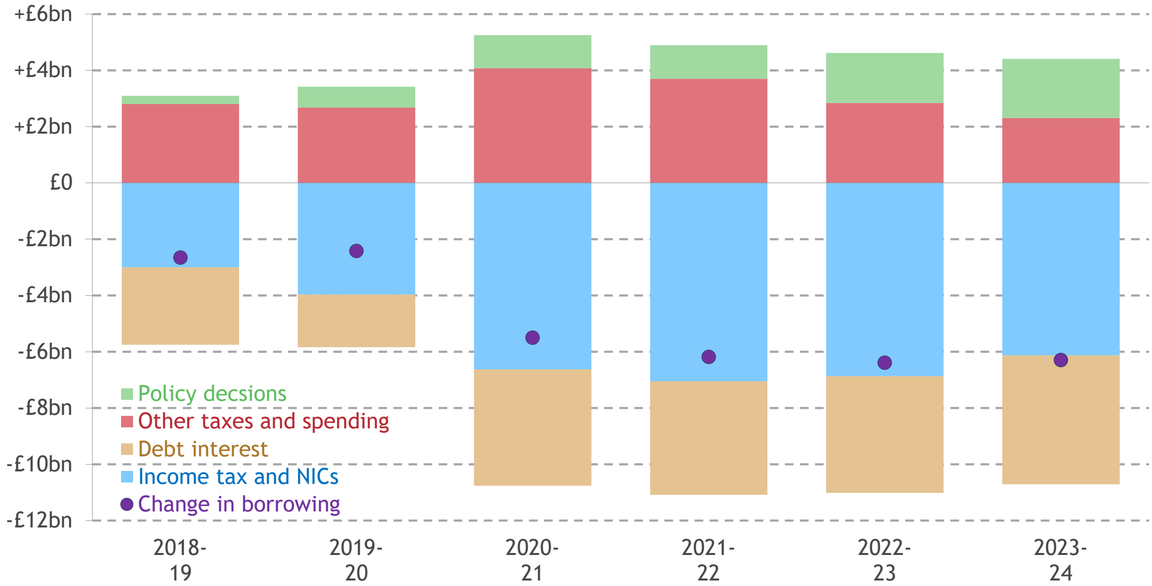


Notes: Cumulative PSNB calculated over the maximum forecast window provided by the OBR. For this Outlook this is 2018-19 to 2023-24.
Source: OBR, *Economic and Fiscal Outlook*, various.

Figure 10 shows how this £29.5 billion windfall builds over the course of the forecast period, with a £2.7 billion public finance improvement in 2018-19 evolving into a £6.3 billion improvement by 2023-24. The chart also shows what is driving the improvement; upward revisions in income tax and NICs receipts, and downward revisions in debt interest costs more than offset the effects of changes in other taxes and spending, and the government's policy decisions. Taking the period as a whole, lower debt interest projections amount to £21.5 billion and higher income tax and NICs revenue projections amount to £33.7 billion.

Figure 10: Higher income tax receipts and lower debt interest projections have reduced the borrowing forecast

Change in PSNB over forecast horizon compared with October 2018 (nominal)



Source: OBR, *Economic and Fiscal Outlook*, March 2019.

The former is driven by lower-than-forecast near-term RPI inflation and by lower market expectations for interest rates over the projection period. While this provides the Chancellor with good news, it is worth noting that it is in part associated with the ongoing shadow of 'no deal' on market sentiments. As such, any future 'deal dividend' he hopes to secure once a Brexit deal is in place could be at least partly offset by a rise in interest rate expectations and therefore higher future debt interest costs.

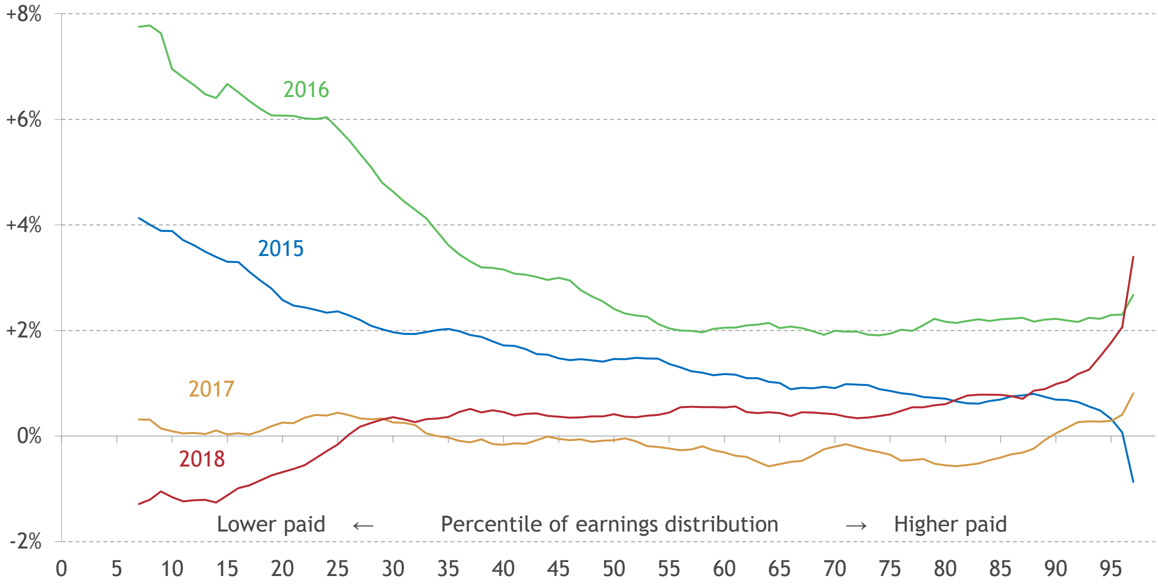
The OBR puts the strength in income tax and NICs revenues down to higher-than-expected employment growth over the past 12 months and, more markedly, stronger-than-expected earnings growth in the years ahead. It is also based on data which shows that earnings growth at the very top of the employee earnings distribution is stronger than previously thought. Real-time information data shows that total pay grew by an annualised 5.9 per cent for the top 0.1 per cent of the earnings distribution between April and September 2018, compared to a year-on-year rise of 3.7 per cent for the rest of the distribution.[3] Such 'top-heavy' earnings growth has a pronounced impact on income tax receipts because higher earners face higher marginal tax rates.

Figure 11 tells a similar story. It shows that 2018 was the first year in which weekly pay increased at a notably faster rate at the top of the earnings distribution than the bottom. While weekly pay fell for the bottom fifth of earners, weekly earnings were up by an average of 2.4 per cent for the top 5 per cent. Given this growth in earnings inequality, the Chancellor's announcement that Professor Arindrajit Dube will be conducting a review for HM Treasury of international evidence on minimum wages in order to inform an "ambitious" new remit for the Low Pay Commission beyond 2020 is especially welcome.

[3] OBR, *Economic and Fiscal Outlook*, March 2019, para 4.25

Figure 11: Earnings inequality increased in 2018

Annual change in average real (CPIH-adjusted) weekly pay by percentile



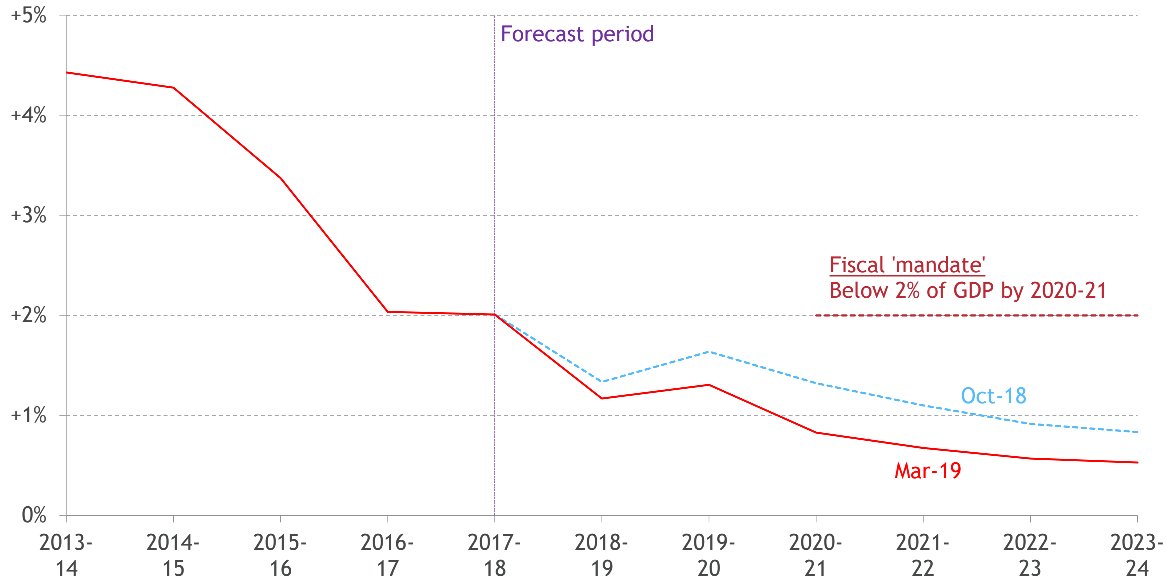
Source: RF analysis of Office for National Statistics. (2018). *Annual Survey of Hours and Earnings*, 1997-2018: Secure Access. [data collection]. 13th Edition. UK Data Service. SN: 6689, http://doi.org/10.5255/UKDA-SN-6689-12.

Both better-than-expected tax receipts and lower debt interest are treated by the OBR as structural improvements to the fiscal position. Cyclically-adjusted net borrowing – the measure that forms the basis of the Chancellor's fiscal 'mandate' (whereby it must be below 2 per cent of GDP by 2020-21) – has thus been revised down by more than PSNB.

As Figure 12 shows, the Chancellor's headroom against his 'mandate' in 2020-21 is, accordingly, set to rise from 0.7 per cent of GDP (£15.4 billion) to 1.2 per cent (£26.6 billion). Relative to maintaining the de minimis mandate position of holding structural borrowing at 2 per cent of GDP beyond 2020-21, that headroom is then forecast to rise to 1.4 per cent of GDP (£34.9 billion) in 2022-23 and 1.5 per cent of GDP (£37.2 billion) by 2023-24.

Figure 12: The Chancellor's headroom against his fiscal 'mandate' is 0.5 percentage points higher than in October

Cyclically-adjusted public sector net borrowing as a share of GDP

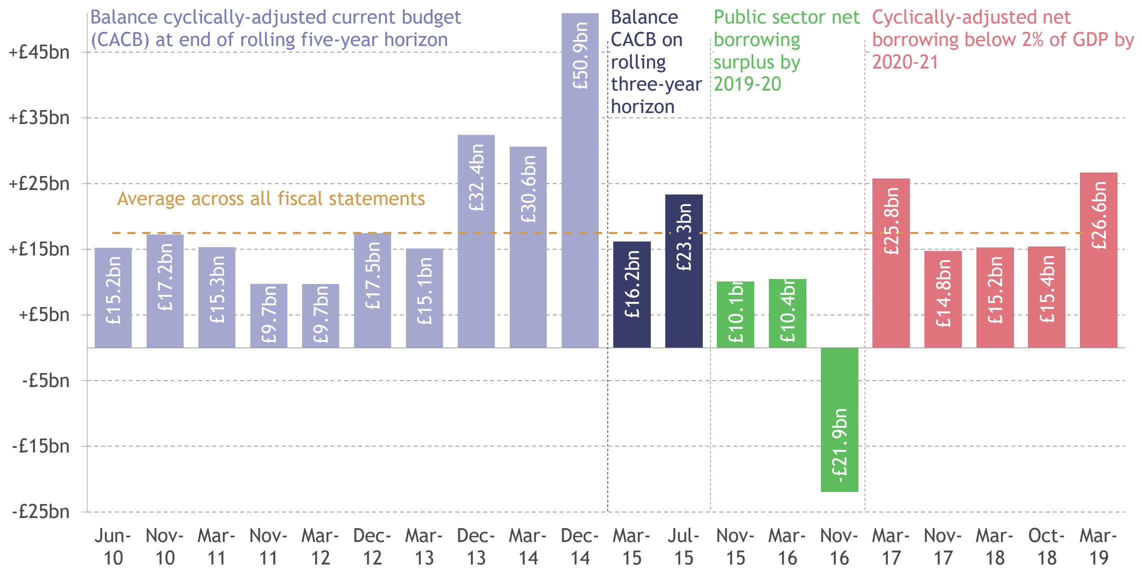


Source: OBR, *Economic and Fiscal Outlook*, various.

This is a very sizeable increase in headroom relative to the October Budget position. And, as Figure 13 shows, the 2020-21 figure is high by historical standards – with the average across all previous fiscal events since 2010 standing at £17.5 billion. The scale is such that the Chancellor could even afford to absorb the impact of impending changes to the treatment of student loans (see Box 2) while still maintaining a level of headroom not much lower than the average over the last decade.

Figure 13: The currently projected headroom of £26.6 billion is well above the historical average

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



Source: OBR, *Economic and Fiscal Outlook*, various.

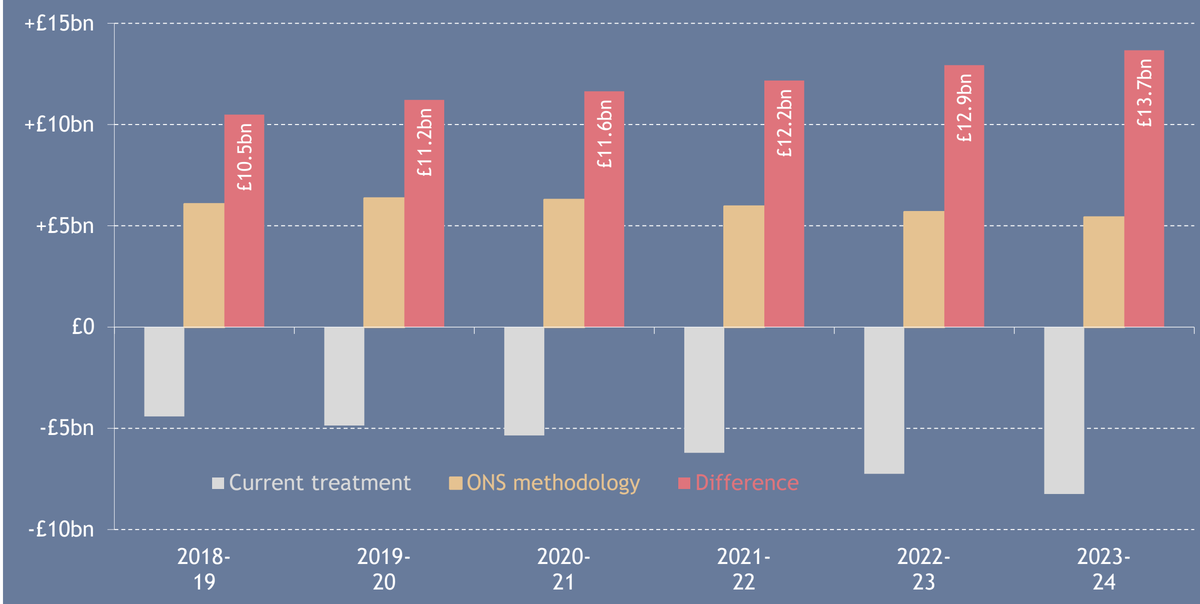
i Box 2: A new approach to accounting for student loans will raise borrowing in the years ahead

Back in October, the OBR outlined some of the problems with the way in which student loans are accounted for in the National Accounts. In particular it pointed out that the current approach does not recognise the large subsidy involved in the system where current projections suggest that only 38 per cent of the total principal and interest charged to students will be repaid.

Since then, the Office for National Statistics (ONS) has set out a new accounting treatment whereby loans are considered to be part grant (which will go unpaid) and part loan. The new approach has no effect on the actual cost to government of the student loans policy, but it does have a significant impact on the way in which that cost is recorded. Most importantly, it will increase PSNB in the short-run compared to the current approach (in which student loans flatter borrowing figures initially but then sharply increase them when losses are realised at the end of the loans term some decades in the future).

The OBR has signalled that it plans to adopt this new approach once the ONS changes the way it treats student loans in the National Accounts, but that the implementation of the new treatment is too uncertain to include in its formal forecasts just yet. For now, it has provided an illustration of what the impact might be, which we replicate in Figure 14. It shows that the new loan treatment could raise PSNB by £10.5 billion in 2018-19, rising to an additional £13.7 billion in 2023-24. The Chancellor's headroom against his fiscal mandate would therefore drop to £15 billion in 2020-21, and £23.5 billion in 2023-24. The ONS plans to publish provisional estimates of its new accounting approach in June 2019 and then implement it in September 2019.[4]

Figure 14: The new accounting approach to student loans could raise PSNB by £13.7 billion in 2023-24



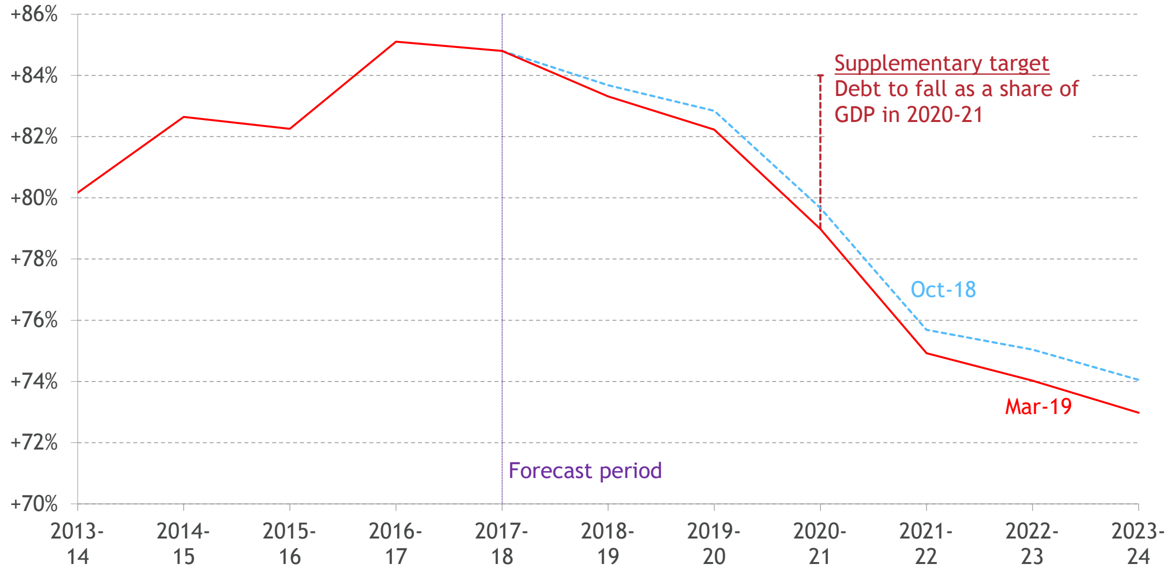
Source: OBR, Economic and Fiscal Outlook, various

In terms of government *debt*, Figure 15 shows a slight improvement from the October forecast. Debt-to-GDP is now expected to have peaked in 2016-17, with a modest reduction in 2017-18 and sharper falls in subsequent years. By 2020-21, the ratio is set to have fallen to 79 per cent. This represents a drop of 3.2 percentage points of GDP relative to 2019-20, meaning the Chancellor remains on target to meet his supplementary debt rule (for the debt-to-GDP ratio to fall in 2020-21).

[4] See M Whittaker, *Hitting the books: student loans and the public finance*, December 2018 for more discussion of this issue.

Figure 15: Public sector net debt is forecast to fall to 73 per cent by 2023-24

Public sector net debt as a share of GDP



Source: OBR, *Economic and Fiscal Outlook*, various.

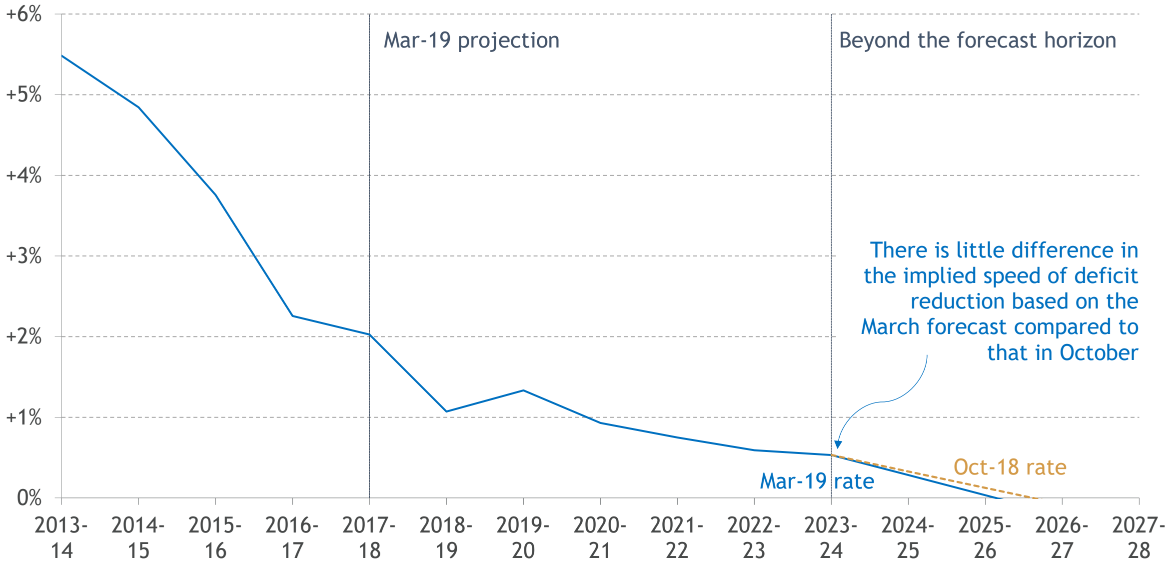
It is worth noting that the unwinding of the Bank of England's *Term Funding Scheme* continues to account for the majority (2.2 percentage points) of this drop. And the overall pace of debt reduction remains slow, at around 1.1 per cent of GDP per year. Even by 2023-24, when debt is projected to have fallen to 73 per cent of GDP – its lowest level since 2010-11 – the ratio will remain more than twice that recorded in 2007-08 (35.2 per cent).

Against the backdrop of significant fiscal headroom but heightened economic uncertainty, the Chancellor set out the option of a conditional Spending Review designed to 'end austerity'

Despite yesterday's further marked improvement in the public finances outlook, the Chancellor remains unlikely to meet his broader fiscal 'objective' of balancing the public finances by 2025-26. Figure 16 set out two simple extrapolations of the pace of deficit reduction currently planned for the years after 2023-24. One is based on the average annual reduction in the deficit between 2017-18 and 2023-24 as estimated in October 2018, the other on the average annual reduction implied by yesterday's forecast. Both would result in the deficit being eliminated only by 2026-27, albeit marginally faster based on the latest projections.

Figure 16: Maintaining the current pace of deficit reduction would result in surplus being achieved in 2026-27

Public sector net borrowing as a share of GDP: UK



Notes: Extrapolations produced by applying the average annual percentage point reduction in the deficit between 2017-18 and 2023-24 in the October forecast (gold line) and yesterdays' forecast (blue line) in the years after 2023-24.
Source: RF analysis of OBR, *Public Finances Databank*.

However, the Chancellor made it clear yesterday that he is prepared to make use of at least some of the headroom he enjoys in order to increase public service funding, implying that he has entirely abandoned achieving his fiscal objective in preference for delivering on his promise of 'ending austerity'.

He announced a conditional Spending Review – saying that the process would begin only once a Brexit deal had been secured. The Review is set to cover the three years from 2020-21 to 2022-23, with the process beginning ahead of the summer recess and concluding alongside the Autumn 2019 Budget.

He made reference once again to his desire to secure a Brexit 'deal dividend', comprising two elements: an economic boost "from recovery in business confidence and investment"; and a "fiscal boost from a reduction in the minimum necessary level of fiscal headroom once the risk of a 'no-deal' exit is removed". And he declared that once that dividend arrived, the nation would have a choice of how much to make use of:

> *And how we would share it between increased spending on public services, capital investment in Britain's future prosperity and keeping taxes low, while always continuing to keep our debt falling.*[5]

There are question marks over how real the economic element of the deal dividend is – not least given the discussion above about the effect the removal of the no-deal shadow

[5] P Hammond, *Spring Statement 2019: Philip Hammond's speech*, HM Treasury, 13 March 2019

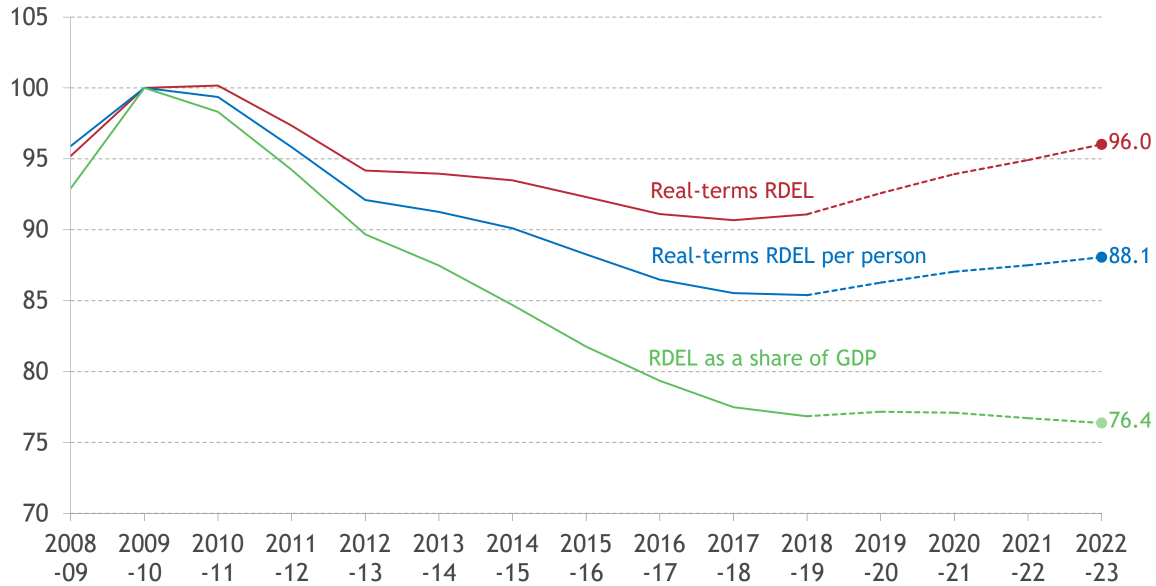
might have on interest rate expectations and therefore projections for debt interest – but the message about his willingness to make use of his fiscal headroom was nonetheless clear.

For now, the Chancellor's spending profile remains largely unchanged from October. He opted to spend just £7.3 billion of the £36.7 billion fiscal windfall given to him by the OBR, with no major changes to any spending programmes. Part of the increase reflected a maintenance of previous real-terms public services spending plans – including yet more money for the NHS – in the face of a higher GDP deflator. Much of the remainder was accounted for by policy changes relating to Universal Credit (UC) and disability benefits. The question he faces ahead of the Spending Review then is what it would take to 'end austerity'.

Back in October, we referred to the Chancellor's "significant easing" of austerity, but we were clear that he had not ended it.[6] Following yesterday's modest spending changes, this remains the case. As Figure 17 shows, real-terms day-to-day spending (resource departmental expenditure limits, or RDEL) are projected to rise steadily over the OBR's forecast horizon on current, pre-Spending Review, plans. Much of this is driven by the new NHS settlement, but non-health RDEL spending is also already set to rise by an average of 1.2 per cent a year between 2019-20 and 2023-24.

Figure 17: Day-to-day departmental spending is forecast to increase steadily in the coming years

Indices of real-terms resource departmental expenditure limits, 2009-10 = 100 (GDP-deflator): UK



Notes: From 2019-20 the RDEL totals are reduced to remove the effect of extra payments made to departments to compensate them for an increase in employer pension contribution costs (with a partially offsetting saving in AME). See OBR, *Economic and Fiscal Outlook*, October 2018, Table A.1 for more detail of the costs.
Source: OBR, *Economic and Fiscal Outlook* and ONS, GDP deflator, time series L8GG.

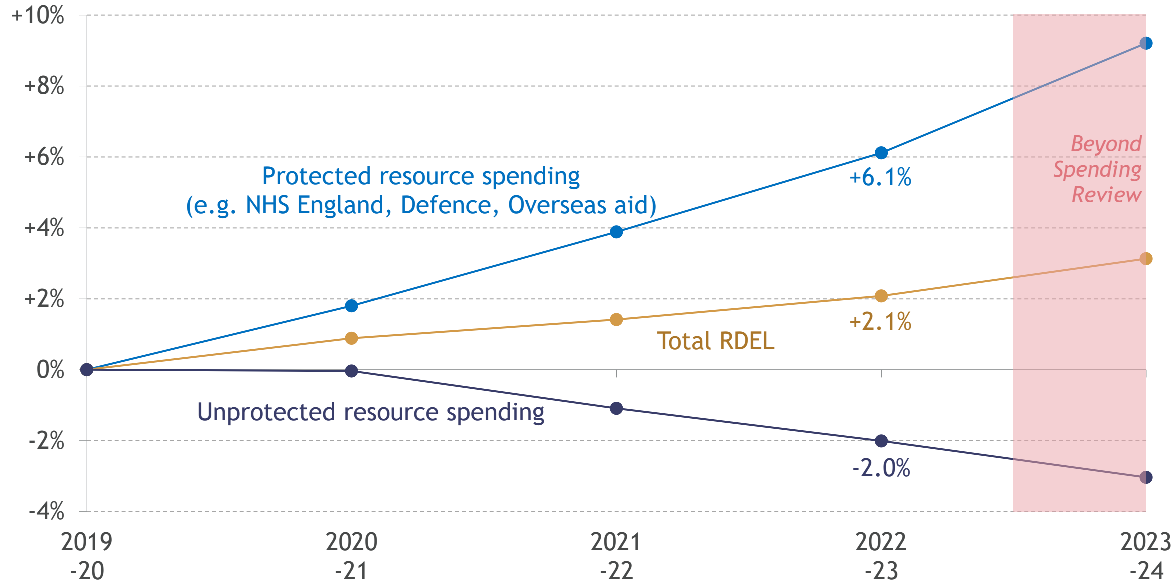
[6] M Whittaker, *How to spend it: Autumn 2018 Budget response*, Resolution Foundation, October 2018

While the current plans provide for increases in real-terms spending per person, they show RDEL continuing to fall as a share of GDP – albeit much more slightly than has been the case in recent years. And on all three measures shown in Figure 17, spending is still set to be lower at the end of the Spending Review period (2022-23) than in 2009-10. Overall, even with the new plans in place, we remain only part way through a pause in real-terms public spending growth that is unprecedented in modern times.

Moreover, the very large resources being directed towards health at the Budget, along with continued protection for defence, intelligence and aid spending means that other departments continue to face further cuts under the pre-Spending Review plans. Figure 18 makes the point, showing how planned increases in real-terms per capita RDEL spending are set to be split between the 'protected' and 'unprotected' departments between 2019-20 and the end of the OBR's forecast period.

Figure 18: On current plans, austerity is set to remain in place for unprotected departments

Cumulative real-terms change in RDEL per person from 2019-20 (GDP deflator): UK



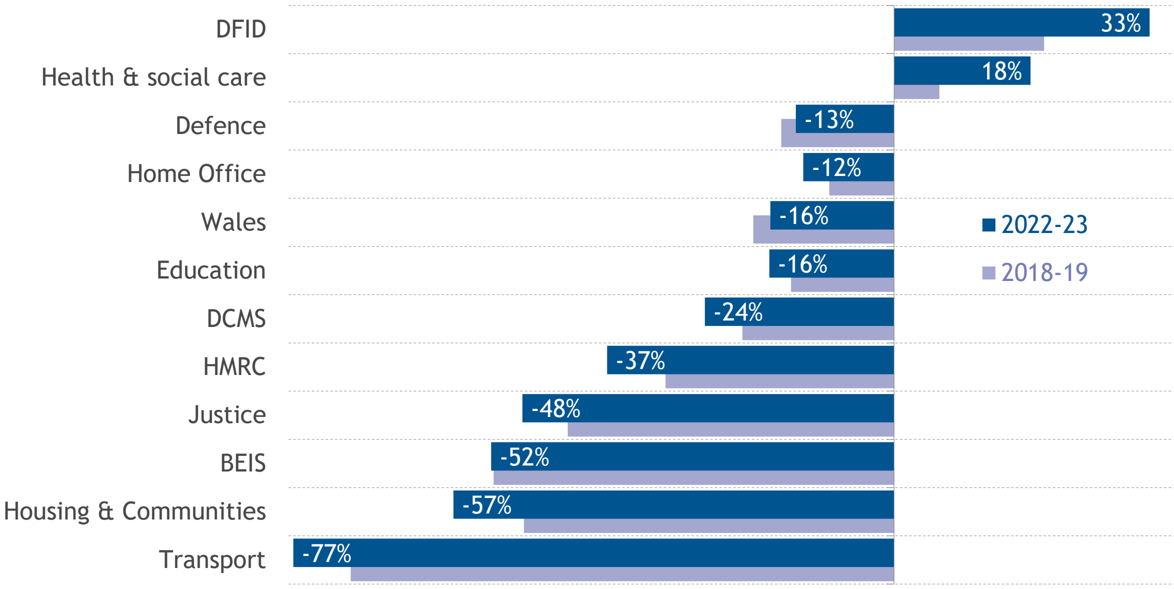
Notes: See notes to Figure 17.
Source: HMT, *PESA 2018*; OBR, *Economic and Fiscal Outlook*; HMT, *Budget 2018*; ONS, GDP deflator, time series L8GG; and RF analysis.

By 2022-23, the last year included in the Chancellor's proposed Spending Review period, an overall provisional 2.1 per cent increase in RDEL per capita between 2019-20 and 2022-23 equates to a 6.1 per cent increase for protected areas of spending and a further 2 per cent cut for unprotected departments on average.

And even within this overall tightening for the unprotected departments, we can expect some budgets to be squeezed harder than others. Figure 19 shows how per capita RDEL budgets across selected departments have already changed in the period since 2009-10. As of 2018-19, real-terms per capita resource spending in the Department for Transport has been cut by 70 per cent, and the Business, Energy and Industrial Strategy (BEIS) budget has been reduced by 52 per cent.

Figure 19: The distribution of austerity has been very unevenly felt across government departments

Real change in departmental resource budgets (RDEL per person, GDP deflator) relative to 2009-10: UK



Source: HMT, *PESA 2018*; OBR, *Economic and Fiscal Outlook*; HMT, *Budget 2018*; ONS, GDP deflator, time series L8GG; and RF analysis.

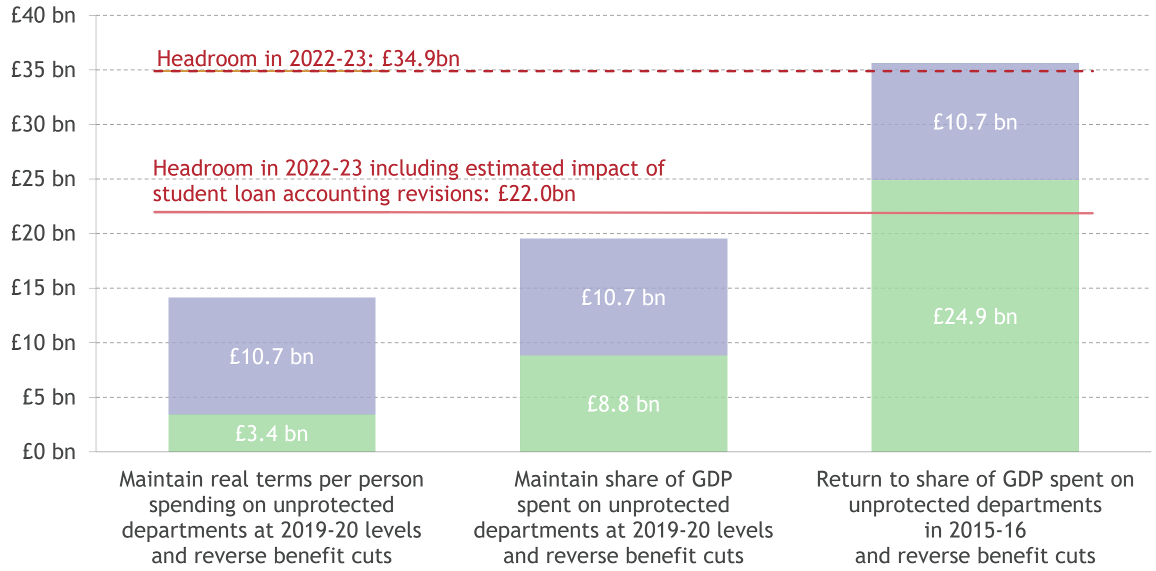
Taking 2019-20 budgets as planned and assuming the cuts to unprotected departments implied by the current overall RDEL spending profile for the years after this are shared equally across departments, the chart also shows where the different departments might expect to find themselves by the end of the Spending Review period if no further spending increase was forthcoming. Increases of one-third (33 per cent) in the Department for International Development and almost one-fifth (18 per cent) in Health and Social Care stand in direct contrast to assumed cuts of over half for BEIS (52 per cent), Housing and Communities (57 per cent) and Transport (77 per cent).

Assuming that a Brexit deal is eventually agreed upon, the Chancellor will be looking to return to the despatch box in the summer to set out how he plans to alter this picture. But how much he would need to spend to be able to truly declare an 'end to austerity'?

Figure 20 sets out a number of illustrative options. It shows the Chancellor's headroom in 2022-23 (both with and without the estimated reduction from the change in accounting for student loans), alongside differing potential spending commitments.

Figure 20: Ending austerity is possible within the Chancellor's current headroom

Headroom against the fiscal mandate in 2022-23 (nominal terms) and policies that might make use of it



Source: RF modelling using HMT, *PESA 2018*; OBR, *Economic and Fiscal Outlook*; HMT, *Budget 2018*; ONS, GDP deflator, time series L8GG.

It shows that increasing overall RDEL spending sufficiently to allow day-to-day budgets in the unprotected departments to be held constant in real-terms per person (alongside following through on planned increases in protected spending) across the Spending Review period would cost £3.4 billion in 2022-23 in nominal terms (the real terms increase, in 2018-19 prices, is closer to £3 billion). If the Chancellor wished instead to raise spending on unprotected departments in line with economic growth – maintaining RDEL spending in these departments as a share of GDP throughout the Spending Review period – he would have to allocate £8.8 billion more in nominal terms to unprotected departments in 2022-23.

Both of these options sit well within the headroom currently available to him in 2022-23 (even after accounting for the new treatment of student loans), and would still leave him able to meet his simultaneous desire to lower government debt. However, as we discuss below, any claim of an 'end to austerity' is likely to ring hollow for those lower income households that have faced, and are continuing to face, sizeable cuts in benefits. By way of illustration, we consider here what it would take to reverse all of the post-2015 general election benefit cuts that are expected to be in place by 2022-23 – a figure that comes to £10.7 billion. While clearly harder, the Chancellor would still be in a position to deliver this and increased public service spending within his projected headroom.

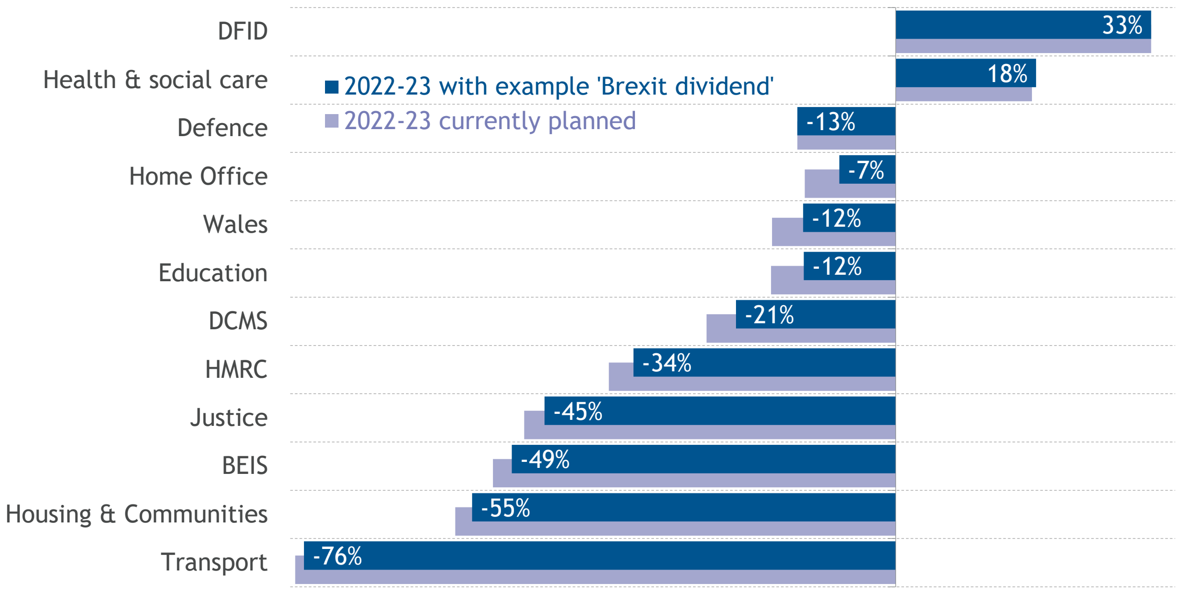
Taking a more ambitious approach, Figure 20 also shows that spending on unprotected departments would need to increase by £24.9 billion if the Chancellor wished to use the Spending Review to return the amount spent on unprotected departments to the same share of GDP as in 2015-16, before he and Theresa May took on their current roles at the top of government. This would push spending beyond the headroom post-student finance accounting revisions, and would leave much less room for reversal of the benefit cuts. It would also make it much harder for the Chancellor to keep paying down debt.

This example is indicative, though, of the extent to which defining 'ending austerity' relative to past spending is significantly more expensive than a definition that just seeks to avoid further cuts. Going even further, restoring day-to-day spending in unprotected departments to its 2007-08 level would require an additional £54 billion to be allocated to these departments.

We can see this too if we adjust the departmental breakdowns shown in Figure 19 in line with the second option for 'ending austerity' presented in Figure 20. Even if spending in unprotected departments is maintained at the same share of GDP as in 2019-20 over the coming Spending Review, at a cost of £8.8 billion, the budget reductions faced by many departments since 2009-10 remain substantial. This is shown in Figure 21, which compares the size of day-to-day departmental spending cuts with and without an example Brexit 'deal dividend' of £8.8 billion. The scale of cuts to unprotected departments since 2009-10 is only slightly reduced in this scenario.[7]

Figure 21: Even if austerity is 'ended', the scale of cuts since 2010 will remain large

Real change in departmental resource budgets (RDEL per person, GDP deflator) relative to 2009-10: UK



Source: HMT, *PESA 2018*; OBR, *Economic and Fiscal Outlook*; HMT, *Budget 2018*; ONS, GDP deflator, time series L8GG; and RF analysis.

[7] The variation in reduction is accounted for by differences in plans for changes in departmental spending between the current fiscal year and 2019-20.

Despite the promise of spending to come, the Chancellor did nothing yesterday to end the austerity faced by many lower income households

While the possibility of lifting spending plans for public services and investment in the coming months will be rightly welcomed by many, yesterday's Statement was conspicuous for its failure to do anything to ease the squeeze faced by millions of lower income households in the here and now.

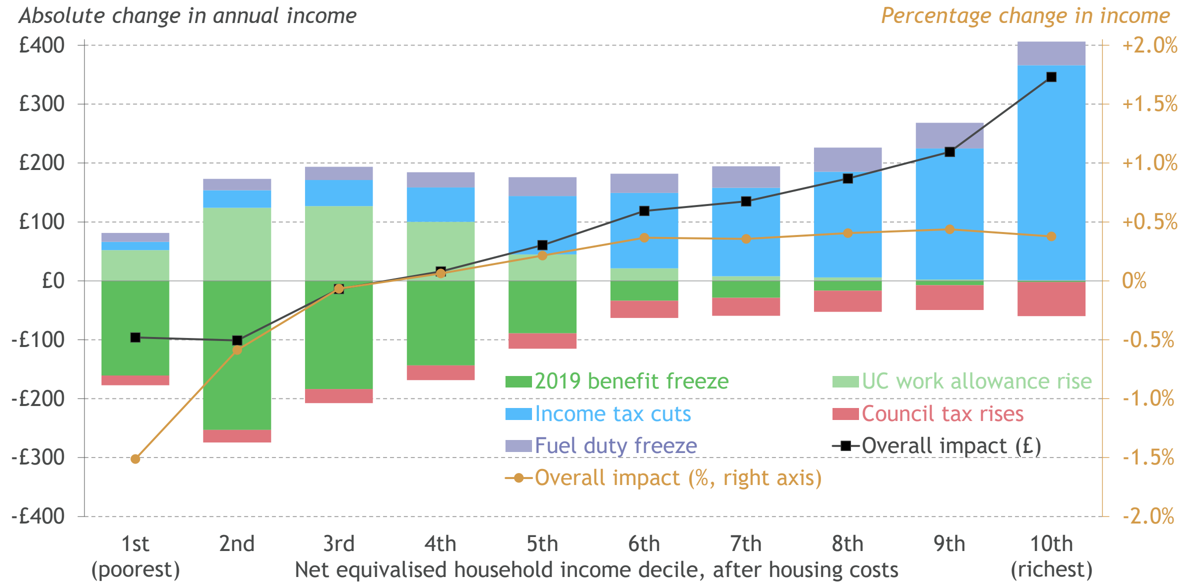
Most glaringly, the Chancellor failed to take the opportunity to cancel the final year of the four year benefit freeze which begins next month. This final freeze is set to cost couples with children in the bottom fifth of the income distribution almost £400 on average (and some even more) over the course of 2019-20, saving the Exchequer £1.8 billion.

Over the full four years, the policy is expected to save the government £4.7 billion in 2019-20. On average, this policy will leave couples with children in the bottom fifth of the income distribution nearly £900 poorer in 2019-20 than they otherwise would have been, with the poorest single parents losing almost £700.

Figure 22 sets out the effect of the final year of the benefit freeze, alongside the impact of several other policies that kick-in from next month. Council tax is rising rapidly, with the OBR assuming an increase in typical bills in 2019 of 4.1 per cent in England, 4.3 per cent in Scotland and 4.2 per cent in Wales. Other policies will pull in the opposite direction, however. Savings from the fuel duty freeze, relative to the previously planned duty escalator, will largely offset the council tax rises for instance. Increases in the main income tax thresholds – to £12,500 and £50,000 – will provide a tax cut in 2019-20 of £73 for basic rate taxpayers and £327 for higher rate ones. The final policy modelled in Figure 22 relates to the increase scheduled for the work allowances provided in Universal Credit (UC), a move that will be more targeted on lower income households but which in large part simply represents a partial reversal of previously planned cuts (not shown).

Figure 22: Income tax cuts, council tax rises and the final year of the benefit freeze combine to produce a highly regressive picture across households in the coming financial year

Change in disposable household income as a result of recent tax and benefit policy changes, 2019-20



Notes: Assumes partial take-up and partial roll-out of UC. UC work allowance rise is a partial reversal of earlier cuts (not shown). Income tax cuts include related NICs changes.
Source: RF analysis using the IPPR tax-benefit model with modifications. Fuel duty distributional impact uses ONS, *Effects of taxes and benefits on UK household income*.

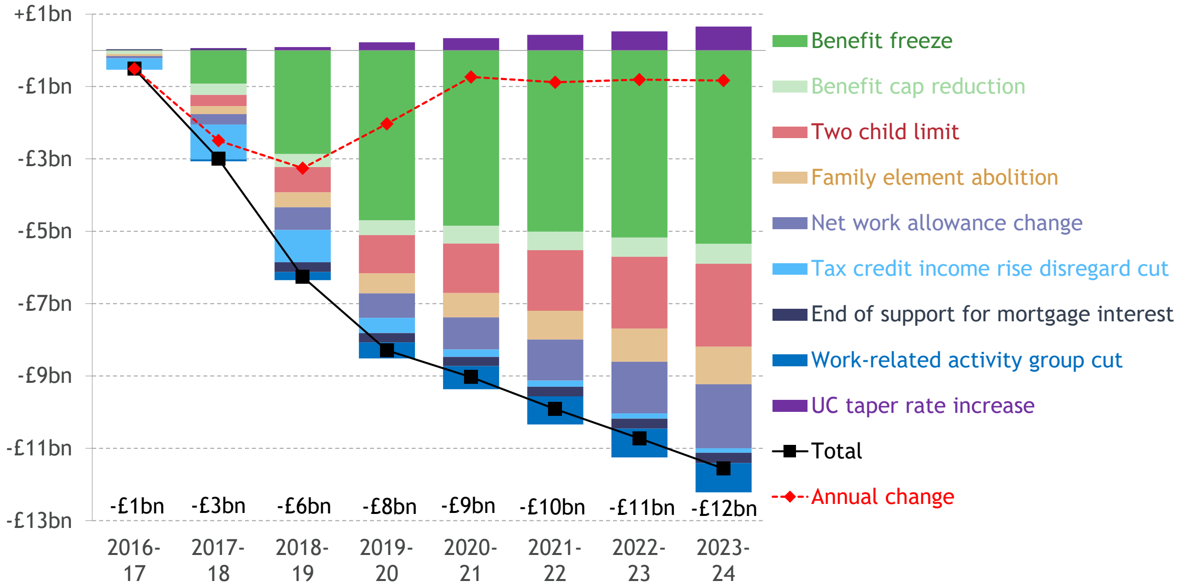
Taken together, these five policies boost 2019-20 incomes by an average of £280 for households in the top fifth of the income distribution, but reduce them by £100 those in bottom fifth.

From this perspective, looking at the full package of benefit cuts that are in train further emphasises that austerity is far from ended. Even with some significant new spending announcements over the last few years, the package of benefit cuts announced in July 2015 is still set to reduce household incomes by around £12 billion in 2023-24.[8] And only £6 billion of this had been rolled out by 2018-19, leaving around half still to come. As noted above, a significant chunk will be delivered imminently via the 2019 benefit freeze. But other policies such as the two child limit, family element abolition, work-related activity group cut and UC-specific cuts are set to affect considerably more people over the coming years than they have already.

[8] This excludes savings in benefit spending from the 2015 policy of reducing social rents by 1 per cent a year, as this does not directly affect household incomes.

Figure 23: Around half of the 2015 package of benefit cuts is still to come

Impact of welfare changes since the 2015 election, in each year (nominal)

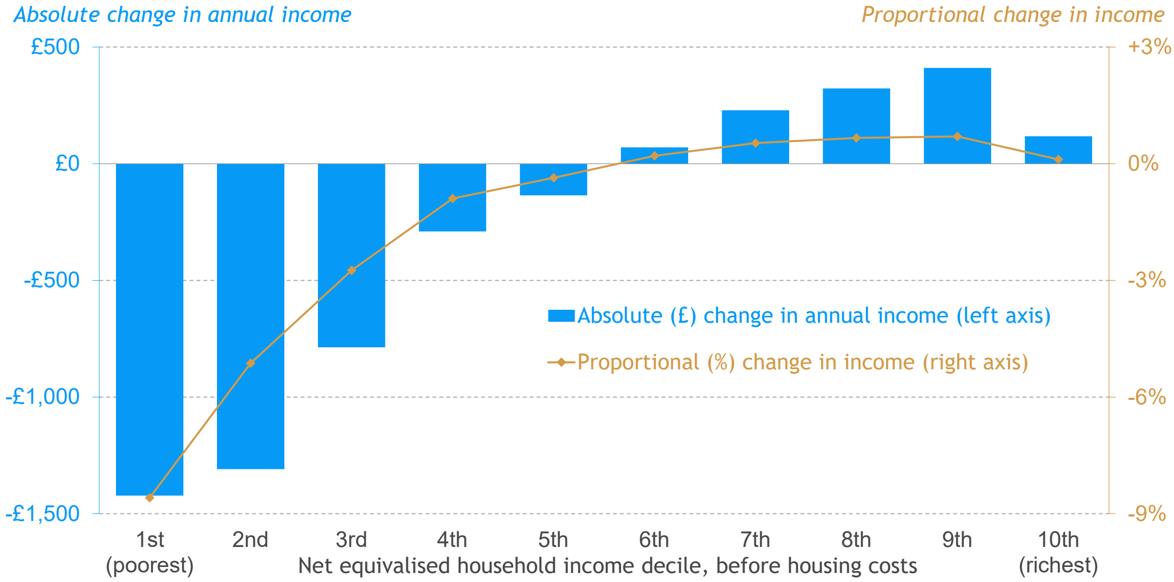


Source: OBR, *Policy measures database*, with broad adjustments for UC delays, policy roll-outs and bespoke modelling.

Figure 24 confirms that, once fully rolled out, the overall effect of government tax and benefit policies put into place since May 2015 is expected to be strongly regressive. Compared to policies that would otherwise have been in place in 2023-24, the poorest fifth of households are expected to be an average of £1,400 a year worse off. In contrast, the richest fifth are forecast to receive an average gain of £300 a year.

Figure 24: The overall impact of tax and benefit policy since the 2015 election is strongly regressive

Distributional impact of tax and benefit policies announced since March 2015: 2023-24, before housing costs (2019-20 prices)

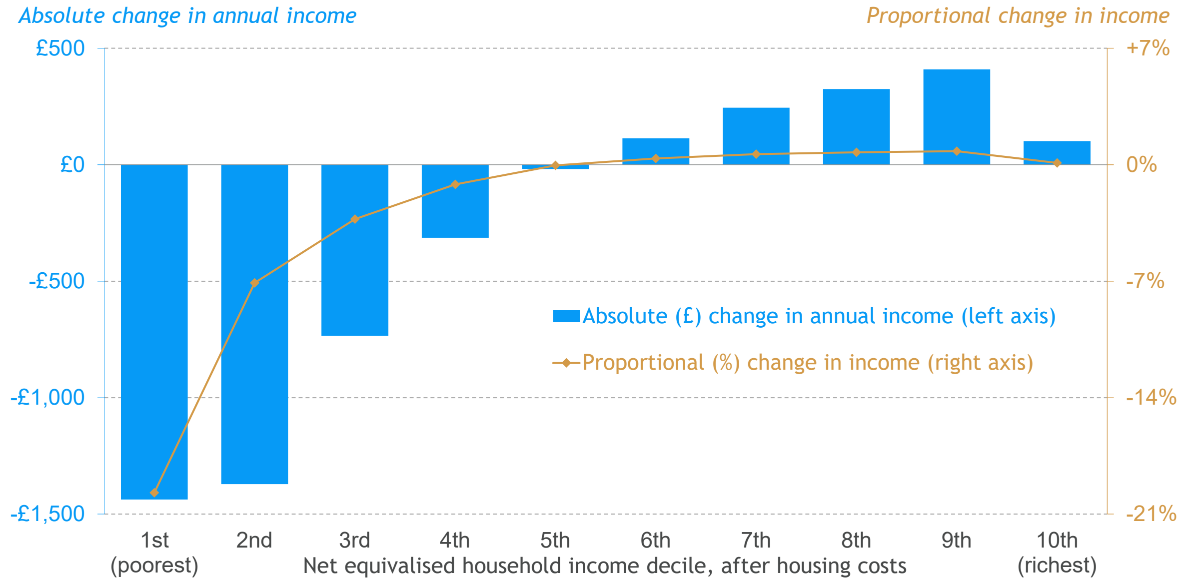


Notes: Includes announced income tax cuts, additional hours of free childcare, removal of family element, alcohol & fuel duty freeze, limiting support to two children, work allowance cuts, pension tax relief cut, Class 2 NICs abolition & re-instatement, benefit freeze, reducing UC taper to 63%, abolition of six-week wait, HB run-on, further UC transitional measures & £1,000 work allowance boost. Uses partial benefit take-up, partial UC roll-out & partial roll-out of measures affecting new claims/births.
Source: RF analysis using the IPPR tax-benefit model with modifications.

These losses for poorer households are even larger as a share of disposable incomes after housing costs (and also ordering households on this basis), as Figure 25 shows. Losses of roughly one-fifth of disposable income among those in the bottom fifth of the income distribution are huge, but arguably better reflect the lived impact of policy changes than do the before housing cost results.

Figure 25: When measuring incomes after housing costs, the scale of losses for poorer households is even more striking

Distributional impact of tax and benefit policies announced since March 2015: 2023-24, after housing costs (2019-20 prices)



Notes: Includes announced income tax cuts, additional hours of free childcare, removal of family element, alcohol & fuel duty freeze, limiting support to two children, work allowance cuts, pension tax relief cut, Class 2 NICs abolition & re-instatement, benefit freeze, reducing UC taper to 63%, abolition of six-week wait, HB run-on, further UC transitional measures & £1,000 work allowance boost. Uses partial benefit take-up, partial UC roll-out & partial roll-out of measures affecting new claims/births.
Source: RF analysis using the IPPR tax-benefit model with modifications.

To illustrate how recent changes to policy and to economic forecasts will play out in the real world, in Table 1 we outline their impact on the household incomes of ten example families. The first column of numbers shows the 2019-20 income each household is projected to have, based on their assumed circumstances and in light of the latest OBR forecasts. The next three columns show the impact of recent economic and policy changes on this forecast.

- Column two isolates the effect of the changes made in the new OBR economic forecast relative to their October 2018 figures. A small increase in the earnings forecast leads to a small upward shift in family incomes but the overall change since the Autumn Budget is small.
- Column three holds the economic projections constant and looks instead at the impact of all the policy changes made since the 2015 general election. Tax cuts have supported net household earnings, but their generally regressive nature has meant that the biggest boosts to earnings have been felt by higher-income families like Family 10. Cuts to the generosity of the benefits system announced in 2015 have been partly reversed, particularly at the 2018 Autumn Budget, but they continue to have a strong negative impact on low and middle income working households.
- Finally, column four focuses specifically on the impact of the largest policies due to come into force in April 2019: the continued benefit freeze and cuts in income tax. It highlights the extent to which households with low-paid workers and children are set to be hit the hardest.

Table 1: Case studies show how the economic forecast for 2019-20 has changed little, and that benefit policy continues to weigh on poorer families' living standards

Net household incomes (before housing costs)	Income forecast for 2019-20 (with Mar-19 OBR figures)	Impact on forecast… of Mar-19 OBR economic forecast update	of policy changes since March 2015	of 2019 benefit freeze and tax cuts
1. Single (no children), full time, self-employed, low earning works 37.5 hours per week and earns equivalent of NMW per hour	£12,580	+£0	+£180	+£30
2. Single (no children), full time, earning wage floor works 37.5 hours per week at NLW, rents privately at 30th pctile	£12,820	-£10	+£180	+£10
3. Single (1 child), part time, earning wage floor works 20 hours per week at NLW	£14,830	+£0	-£400	-£230
4. Single (1 child), full time, low earning, renting works 37.5 hours per week at p25 wage, rents social housing at average rents	£17,620	+£0	-£380	-£180
5. Couple (2 children), full time single earner on wage floor main earner works 37.5 hours per week at NLW	£21,930	+£0	-£330	-£220
6. Couple (2 children), low earning/wage floor, renting main earner works 37.5 hours per week at p25 wage, second earner works 20 hours per week at NLW, rents privately at 30th pctile	£26,570	+£0	-£1,180	-£370
7. Couple (3 children), low earning/wage floor, renting main earner works 37.5 hours per week at p25 wage, second earner works 20 hours per week at NLW, rents privately at 30th pctile	£29,950	-£10	-£1,510	-£470
8. Couple (no children), low/mid earning both work 37.5 hours per week, main earner at median wage, second earner at p25 wage	£28,950	+£40	+£180	+£10
9. Couple (2 children), low/mid earning both work 37.5 hours per week, main earner at median wage, second earner at p25 wage	£37,120	+£50	+£250	+£40
10. Couple (no children), high earning both work 37.5 hours per week at p90 wage	£81,160	+£80	+£1,270	+£590

Notes: Figures relate to modelled hypothetical outcomes in 2019-20 on the assumption that the families receiving in-work benefits are in the legacy benefits system. Impacts cover the effects of direct tax and benefit changes, the introduction of the National Living Wage and new childcare support but assume no behavioural changes or dynamic effects. The two-child limit and family element abolition are assumed not to apply. Wage floors (NMW and NLW) reflect OBR projections. Figures are rounded to nearest £10. Inflation and earnings projections are taken from OBR forecasts.
Source: RF analysis using RF microsimulation model.

Given these policy impacts, it is perhaps unsurprising that we have previously projected significant increases in poverty for children and parents over the rest of this parliament,[9] likely to record highs, and nothing in this Spring Statement has materially changed that outlook.

[9] A Corlett, *The Living Standards Outlook 2019*, Resolution Foundation, February 2019

Conclusion

As we speculated ahead of the Spring Statement,[10] yesterday's event provided little in the way of answers. We had new OBR forecasts, with yet another fiscal windfall for the Exchequer – but the fact that they were predicated on an increasingly questionable assumption of an orderly Brexit on 29 March meant they were at risk of being out of date before the Chancellor even stood up. We were also offered the prospect of a Spending Review later this year that would provide significant new funding for government departments and an opportunity to 'end austerity' – but the understandably conditional nature of this offer meant we got nothing on just how much extra spending we're talking about, nor what areas of expenditure the government wants to prioritise in the coming years.

Instead, the Statement and the associated OBR *Outlook* shone a brighter light on the big questions facing the UK economy as it approaches Brexit. Questions about how businesses, consumers and government will shift their behaviour in the coming months in the light of ongoing uncertainty.

Will business confidence, and with it investment, return? Or will the prospect of a protracted period of negotiations mean that postponed investment turns into cancelled investment? And will consumers carry on spending regardless, as the OBR's projections assume? Or will their confidence falter, depriving the economy of a key element of growth? And just how will government marry up its desire to end austerity and lower the level of government debt? Spending increases look to be on the way, but who will benefit?

It's part of the nature of UK politics right now to throw up more questions than answers. But, as with so much else that's going on, we must hope that we obtain more clarity over the coming weeks and months.

[10] M Whittaker, *Spring Forward or Fall Back? The questions facing the UK economy ahead of the Spring Statement 2019*, 4 March 2019

Resolution Foundation

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- 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:

Matthew Whittaker, Deputy Director
matthew.whittaker@resolutionfoundation.org
0203 372 2958

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