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BRIEFING

Breaking the rules

Analysing the credibility of the Chancellor's commitment to keep to his fiscal rules

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Summary

The Chancellor is shortly to deliver the first spending round (SR) of the post-austerity era. Although he is only setting departmental budgets for 2020-21, this event will mark a turning point in our political and economic debates as it brings to an end almost 10 years of austerity.

The politics of this SR are relatively straightforward. The Chancellor will lay the ground for a potential election by demonstrating that the government has caught up with public opinion and announce that the era of significant public spending restraint is over.

This political approach is also economically sensible. The deficit is at a 17-year low and the cost of government borrowing is at an all-time low. But there are reasons to doubt the economic wisdom of how the government is going about next week's turning on of the spending taps.

Primarily this is because the increase in spending that will be announced by the Chancellor will very likely be inconsistent with the fiscal rules he says he is committed to. He might be able to afford more borrowing, but it's not clear that he can afford, or should choose, to hit the government's economic credibility by knowingly setting policy that is very likely to break the rules he says he wants to stick to.

Deteriorations in the public finances and economic outlook, alongside spending commitments the Prime Minister has already made, lead us to conclude that far from any further headroom to spend, the Treasury is already on course to break the 'fiscal mandate' of borrowing less than 2 per cent of GDP in 2020-21. In addition, with spending commitments building in subsequent years, it's likely that borrowing will only further overshoot this limit in the years after 2020-21.

The economics of announcing such increased spending before it is clear on what basis the UK may leave the EU is also highly questionable. The impact of different Brexit scenarios on the size of our economy should help policy makers decide how much we can spend on public services. The potential for a no-deal Brexit also means that government should be evaluating the impact of additional spending on supporting the economy in a disruptive period. The timing of this SR means neither will be possible.

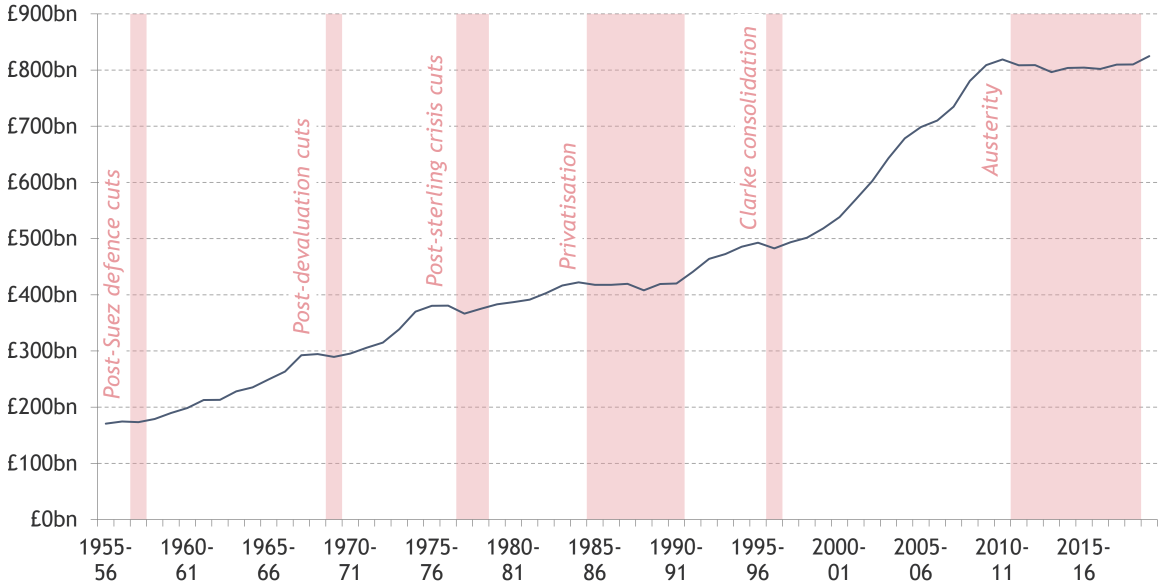
Where does this leave us? It seems likely that the Chancellor will tell us on Wednesday that he will use up most of a £14 billion of headroom for 2020-21 on additional spending, despite knowing that the true size of any headroom is much smaller than this. The additional spending is desirable and might be good politics today, but the way it is being done is not ideal for the government's economic credibility. If we do leave the EU with no-deal in a few weeks' time, that credibility will be more needed than ever.

The spending round marks a turning point in the national debate

On Wednesday the Chancellor will deliver a one year spending round (SR), setting out the detail of departmental budgets for 2020-21. This will be the first big domestic policy statement of this new government. It might not be the long promised three year spending review but it's still a big deal, marking an important turning point in the national political and economic debate. After all the previous commitments to end austerity this will be the moment it actually happens. It will be the first SR since 2007 in which overall departmental spending increases in real terms, something that hasn't taken place in the years of austerity since 2010 as shown in Figure 1 below.

Figure 1: This spending round could mark the end of a decade long squeeze on spending

Total managed expenditure, 2018-19 prices: 1955-56 to 2018-19, UK



Notes: Nominal values converted to real terms using GDP deflator.
Source: OBR, *Public Finances Databank*

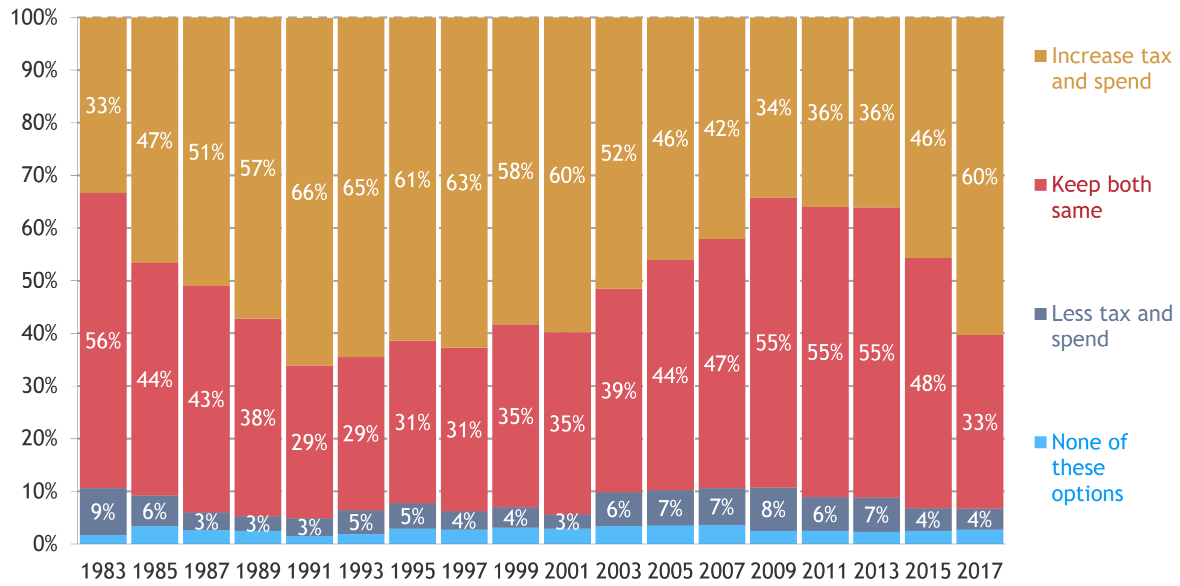
When departmental spending was last rising in real terms the Chancellor was still three years away from being an MP. Along with the majority of his parliamentary colleagues, his life as an MP has been carried out under the backdrop of austerity that has delivered a decade of public service spending restraint of unprecedented duration.

The politics of turning on the spending taps are very straightforward

An imminent election, combined with a widely recognised need in public services and the related austerity fatigue among the public, mean that the politics of turning on the spending taps next week are very straightforward. As Figure 2 shows, 60 per cent of the public now support increases in taxation and public spending – up from closer to 35 per cent around a decade ago. This big shift in public opinion is likely to be reflected in the spending plans announced on Wednesday.

Figure 2: Support for increases in tax and spend is near record highs

Proportion of adults in favour of various options in relation to tax and spend: GB



Source: RF analysis of *Centre for Comparative European Survey Data*; NatCen, *British Social Attitudes Survey*

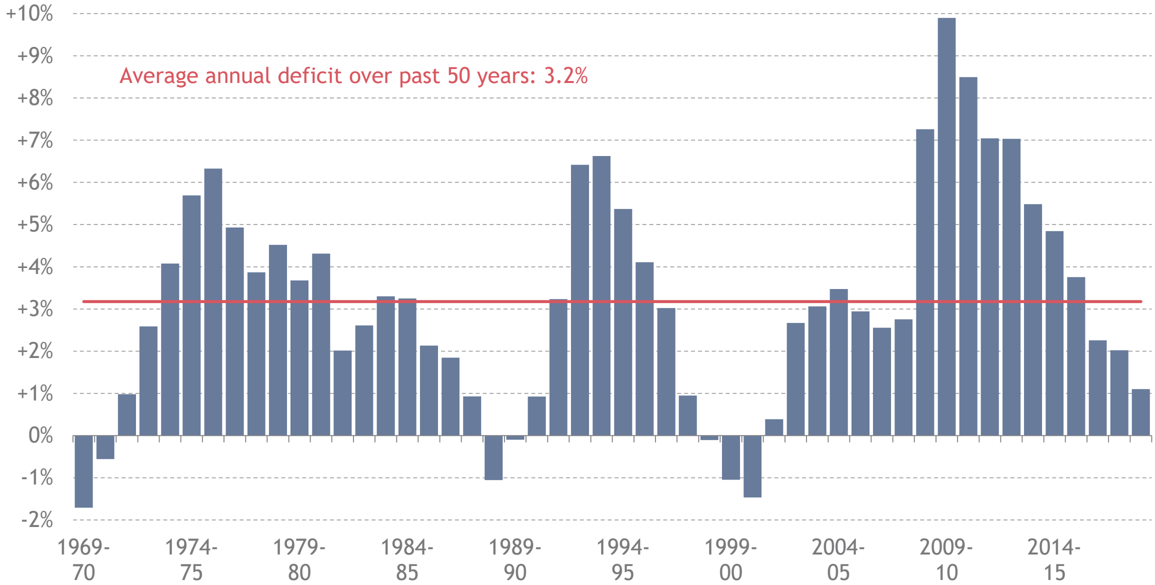
Even before plans to prorogue Parliament raised the political temperature, a new government lacking a secure majority meant that a general election was a distinct possibility and that a policy shift would follow the change in public mood away from support for spending cuts towards favouring spending increases. No Conservative wants to rerun the 2017 election and its arguments on schools and police funding, nor allow Labour a simple austerity/end of austerity dividing line.

The Chancellor can afford to borrow more for spending

The politics are very straightforward but the economics are less so – despite first appearances. Spending more now is certainly doable with the deficit at a 17-year low, as Figure 3 shows. The deficit is lower now than it has been in all but 12 of the past 50 years, and is three times smaller than the average level of the deficit (3.2 per cent) over the same time period.

Figure 3: The deficit is at a 17-year low

Overall deficit (public sector net borrowing) as a share of GDP: 1969-70 to 2018-19, UK

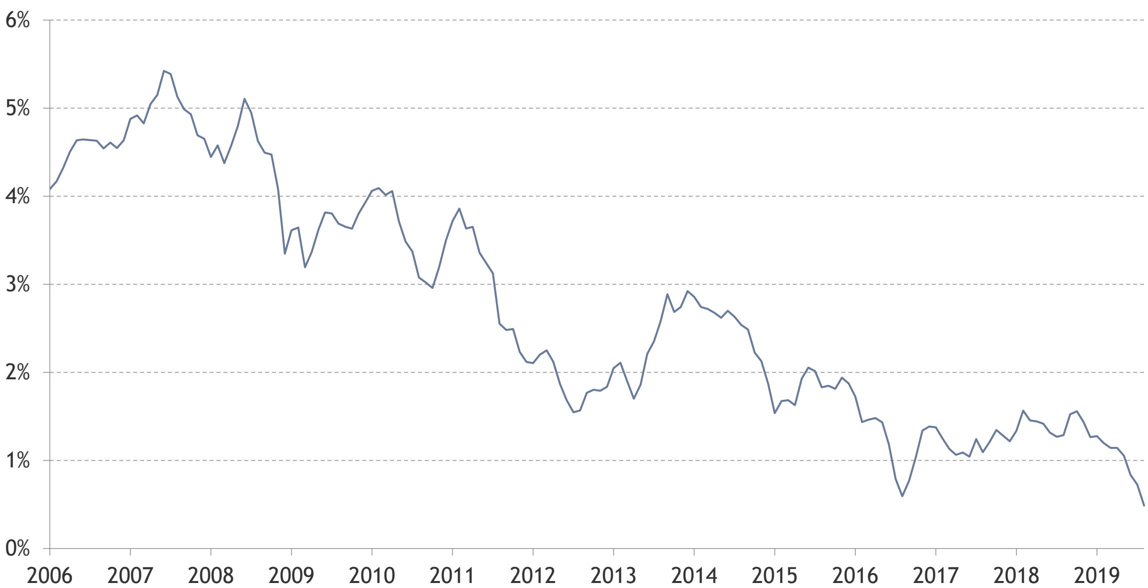


Source: OBR, *Public Finances Databank*

Not only is the deficit low, but the cost of borrowing is too. In fact, as can be seen from Figure 4, it has been on a downward trajectory for over a decade, having fallen sharply again recently to just 0.5 per cent for a 10 year gilt.

Figure 4: Borrowing costs are at record lows

Average monthly 10-year gilt yield: Jan-2006 to Aug-2019, UK



Source: UK Debt Management Office, Bloomberg

But the government's commitment to meeting its fiscal rules isn't very credible

So there is no imminent substantive fiscal constraint on a government wanting to borrow modest amounts more for public service spending. However, there are reasons to doubt the economic wisdom of how the government is going about next week's turning on of the spending taps. First, it is increasingly unlikely that the increase in spending is consistent with the fiscal rules the new Chancellor says he is committed to. He might be able to afford more borrowing, but it's not clear that he can afford to hit the government's economic credibility in already unstable times by saying he is committed to fiscal rules while setting policy that is very likely to break them. Secondly, while the planned timing of this spending round does appear sensible on the basis of an imminent election, it appears less so on the basis that we are still weeks away from knowing what form of Brexit we are heading for.

On the first issue, while the Chancellor clearly takes a more relaxed view of the public finances than his predecessor he has still kept a commitment to the existing fiscal rules, writing recently in The Telegraph that:

> *"I can confirm that next week's Spending Round will be delivered within the current fiscal rules."*
>
> Sajid Javid MP, 27 August 2019[1]

However, this commitment is very unlikely to be kept if he announces a substantial increase in spending next week, let alone if very significant promises to cut taxes are delivered upon in the future.

The fiscal rule that matters here is that the government should keep structural borrowing below 2 per cent of GDP in 2020-21 – the 'fiscal mandate'. On the most recent Office for Budget Responsibility (OBR) forecast back in March, the Treasury had £27 billion headroom against this rule. This isn't, as is sometimes implied, a pot of money that's being kept to one side for a rainy day but instead the amount *extra* the government could choose to borrow in 2020-21 without breaking the rule. That headroom has subsequently been reduced to £14 billion by the Office for National Statistics' decision to count the cost of issuing student loans that are unlikely to be repaid within government borrowing.

The Chancellor is arguing that he can therefore spend up to £14 billion more next week while claiming to operate within the fiscal rules. This is wrong because the world has changed in material ways since the OBR made that forecast back in March. So why has the £14 billion headroom disappeared?

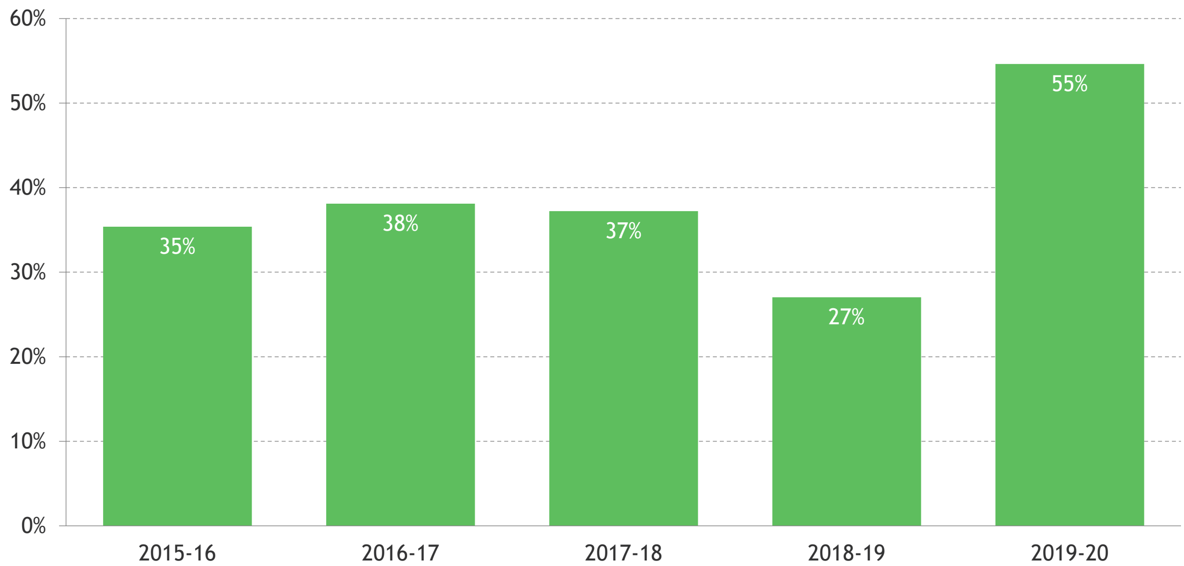
[1] S Javid, 'Next week's Spending Round will clear desks to let us focus on Brexit', *The Telegraph*, 27 August 2019

Spending is increasing faster than anticipated already, with knock-on effects for borrowing next year

The public finances are already deteriorating because the spending taps in practice were turned on before Boris Johnson entered Downing Street, and higher spending this year implies higher spending – and borrowing – next year too. The OBR was already forecasting that borrowing this year would be higher in 2019-20 (£29.2 billion) than in 2018-19 (£22.8 billion), but the four months of data we already have from this financial year suggest that borrowing may well come in higher than that. Public sector net borrowing (PSNB) is already at 55 per cent of the forecasted amount for the whole year, notably higher than has been the case at this point in the year in any of the past four years as Figure 5 shows.

Figure 5: Borrowing is running well ahead of where we'd expect it to be at this point in the year

Public sector net borrowing in first four months of financial year as share of most recent OBR forecast for full year: UK



Source: RF analysis of OBR, *Economic and Fiscal Outlook*, various

This extra borrowing is not being driven by the falling revenues or higher benefit spending that slower economic growth might deliver, but instead by faster-than-anticipated growth in directly controlled public spending - particularly by government departments. Spending has grown twice as fast as the OBR expected it would so far this year. The OBR has pointed out that if this fast pace of growth continued throughout 2019-20, then central government spending (excluding grants to local authorities) would be a massive £19.4 billion higher than forecast in March.[2] Most of the increase in total spending is a result of increasing spending on public services, which is up by 8.1 per cent so far this year (compared to a forecast of 5.9 per cent for the whole year). If this trend continues, then public service spending will overshoot the OBR's forecast for 2019-20 by £8.8 billion.

[2] Office for Budget Responsibility, *Commentary on the Public Sector Finances: July 2019*, August 2019

It's important to note that there is a lot of uncertainty here. We only have data for one-third of this financial year, which means both that the public spending data we have is particularly uncertain (relying on departments' estimates not actual spending) and that we don't know how much of the fast growth in spending we've seen so far this year will continue into the rest of the year. Further uncertainty comes from the extent to which it will feed through to higher spending in 2020-21. The Treasury could regain tighter control of departmental spending, or the numbers we've seen so far this year might turn out to be innaccurate, but it would seem rather optimistic to act on the basis that we are not currently on course for higher-than-expected borrowing. Even if we very cautiously assume the situation improves and the growth in government spending in the remaining two-thirds 2019-20 actually comes in as forecast by the OBR back in March, £5 billion of the Chancellor's headroom would be used up.

The economic outlook has worsened since the OBR's March forecast

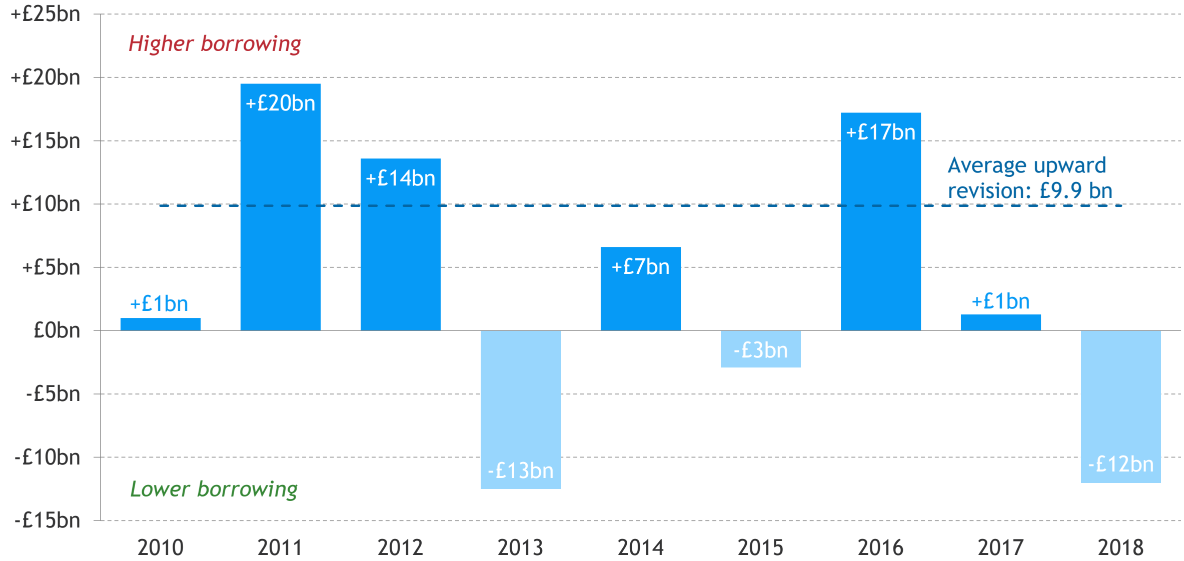
A weaker-than-expected economy is the second reason why the Chancellor's headroom has shrunk. This isn't just about Brexit-related uncertainty – a generalised global growth slowdown is underway, which will have an impact on borrowing. To help think about what that might mean if the OBR had to produce a new forecast today, we can turn to the more regular Bank of England forecasts. Their August forecast for GDP in 2020-21 was 0.4 per cent lower than the forecast in May. The exact mechanisms through which this feeds through into borrowing are complex, with some good news mixed into the picture such as the recent fall in government's cost of new borrowing mentioned above. But taking all that together, a reasonable rule of thumb that has been used by the OBR is that borrowing rises by about half the reduction of GDP. This means that the 0.4 per cent deterioration would translate into an additional £5 billion (0.2 per cent of GDP) of borrowing for the Chancellor to contend with next year.[3]

It's worth noting here that the OBR isn't scared of making big revisions to it's borrowing forecasts. Some years Chancellors get lucky and enjoy windfalls as Mr Hammond did in October 2018. However, as Figure 6 shows, in most autumn fiscal events since 2010 PSNB has been revised up. The average upward revision at an autumn fiscal event for the following financial year is £9.9 billion.

[3] Office for Budget Responsibility, Briefing paper No. 4: How we present uncertainty, June 2012

Figure 6: The OBR has made big upward revisions to borrowing before

Revisions to public sector net borrowing forecasts for next financial year at autumn fiscal events, nominal: UK



Notes: Year shown is the year of autumn fiscal event for which revisions to forecast for borrowing in the subsequent financial year were published.
Source: RF analysis of OBR, *Economic and Fiscal Outlook*, various

Taking stock: even without making any new spending commitments, a realistic assessment of the current state of the Chancellor's headroom would conclude that it is closer to £4 billion than £14 billion because of changes in the fiscal and economic backdrop.

The more realistic £4 billion headroom within the Chancellor's fiscal mandate is likely to have already been used up

The Prime Minister (PM) has already made significant spending commitments ahead of the forthcoming spending round that use up all of this £4 billion headroom. Taken together, promises over the summer for extra spending on police, schools, hospitals and prisons could amount to almost £6 billion of extra spending and borrowing in 2020-21.

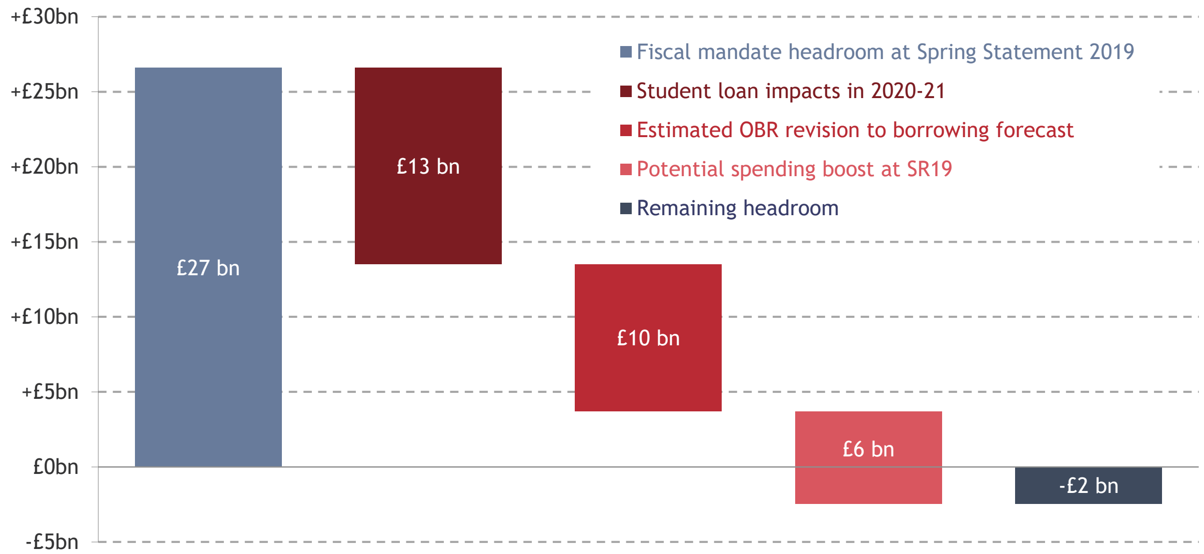
This figure is drawn from our estimates, based on a mixture of formal government announcements, statements by the PM or other government ministers, and by briefings associated with policy commitments made by the PM during the Conservative leadership election campaign. Where commitments to additional funding by some later date than 2020-21 have been made we have assumed (unless there is evidence to the contrary) that spending will increase in a straight line from its existing baseline. We assume that the additional cost of the PM's commitment on schools (restoring per-pupil funding to its 2015 levels) and police (recruiting an additional 20,000 police officers) will add £4 billion to spending in 2020-21. The government has also announced an additional £1 billion for hospital upgrades (to be shared between this year and next) and £850m further

NHS capital funding to be shared over five years. Finally, we add in an amount for the delivery of 13,500 extra prison places by the mid-2020s, which the Justice Secretary has said will cost "up to £2.5 billion" of "new" spending. We add the appropriate Barnett consequentials to all of our estimates.

These estimates suggest that the fiscal mandate could be breached by £2 billion (see Figure 7) even if no further spending rises are announced next week. But they almost certainly will be, with an overall increase potentially right up to the headroom of £14 billion that existed prior to fiscal and economic developments since March. And this is all before the very significant tax cuts pledged during the Conservative leadership campaign or more recently briefed as being planned. Such cuts to income tax, national insurance, corporation tax and fuel duty could run into the tens of billions.

Figure 7: A realistic assessment is that no headroom within the current fiscal rule remains

Estimated changes to fiscal mandate 'headroom' since March 2019, 2020-21 prices: 2020-21, UK



Notes: Headroom calculated as the difference between cyclically adjusted net borrowing in 2020-21 and 2 per cent of GDP in 2020-21.
Source: RF analysis of OBR, *Economic and Fiscal Outlook*, March 2019

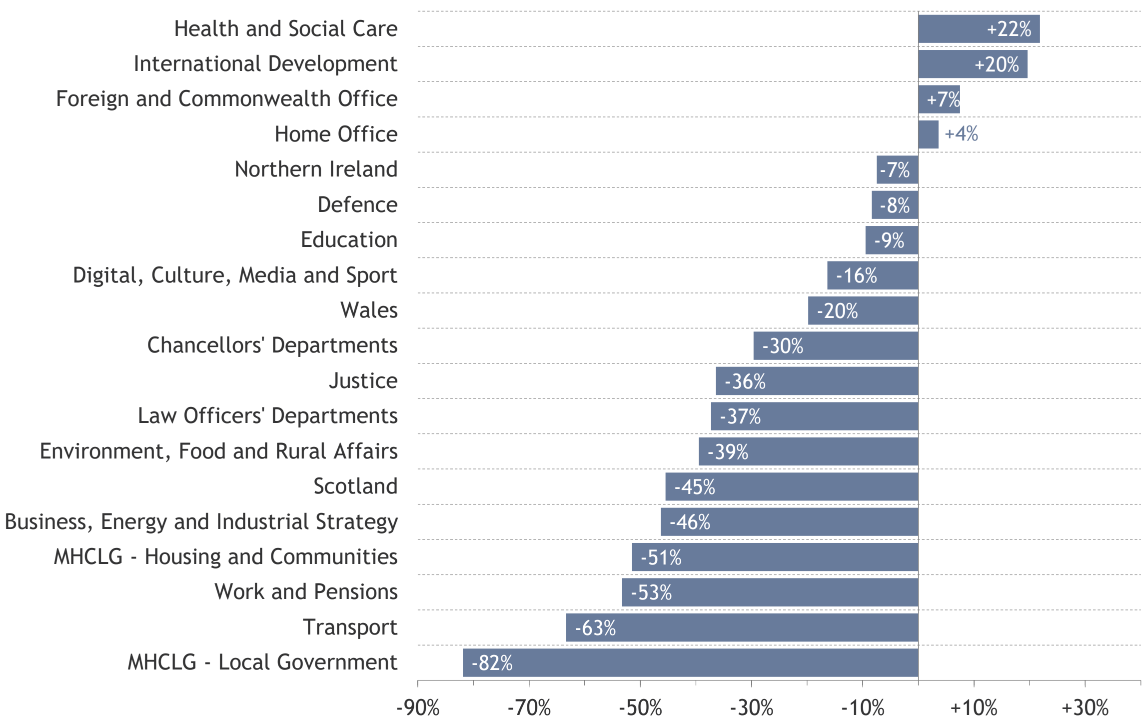
There is a strong case for increasing spending, but not for undermining credibility

None of the above represents anything like official forecasts, but they are reasonable estimates based on the latest readings of the UK economy and public finances of the kind that the Treasury routinely undertakes internally. Next week, Treasury ministers will say that on the basis of the most recent OBR forecasts the spending plans they annouce are consistent with their fiscal rules. Such a statement is true in letter but not in spirit – and it is certainly not credible. In addition, with spending commitments building in subsequent years, it's likely that borrowing will only further overshoot this limit in the years after 2020-21.

There are strong grounds for increasing spending. 'Ending austerity' is socially desirable and economically achievable. Unprotected Whitehall departments and local government have shrunk considerably since 2010, bearing the brunt of public spending cuts. For example, as shown in Figure 8, Ministry of Justice spending has fallen by over a third in real per-capita terms since 2010 and spending on the day-to-day Transport departmental budget is down by almost two-thirds.

Figure 8: Ending austerity next year is by no means the same as reversing the cuts to departmental budgets since 2010

Cumulative real-terms change in per-capita RDEL between 2007-08 and 2019-20: UK



Notes: Figures are adjusted as far as possible to account for machinery of government changes. GDP deflator used to convert cash changes to real terms changes.
Source: RF analysis of HMT, PESA, various

Preventing any further cuts to unprotected departments given the spending commitments the PM and Chancellor have already made is also relatively inexpensive. Allowing unprotected departmental budgets to grow in line with the growth in the economy would require Mr Javid to borrow a small amount more, less than £1 billion, in 2020-21. Reversing the cuts of the last decade would clearly be a much bigger, and much more expensive, undertaking.

But whatever your view about the desirability of extra spending, it's clearly undesirable for the Treasury to be announcing plans next week that are inconsistent with the fiscal rules they say they remain committed to. Avoiding doing so would also have been relatively straightforward if the government had simply adjusted their fiscal rules to take into account the statistical but not economically meaningful ONS reclassification of student loans. The whole point of having fiscal rules is to increase government economic credibility – but saying you are committed to them while acting otherwise has the opposite effect.

Deciding how much you have to spend, and how you spend it, before you know what Brexit you're delivering is also sub-optimal

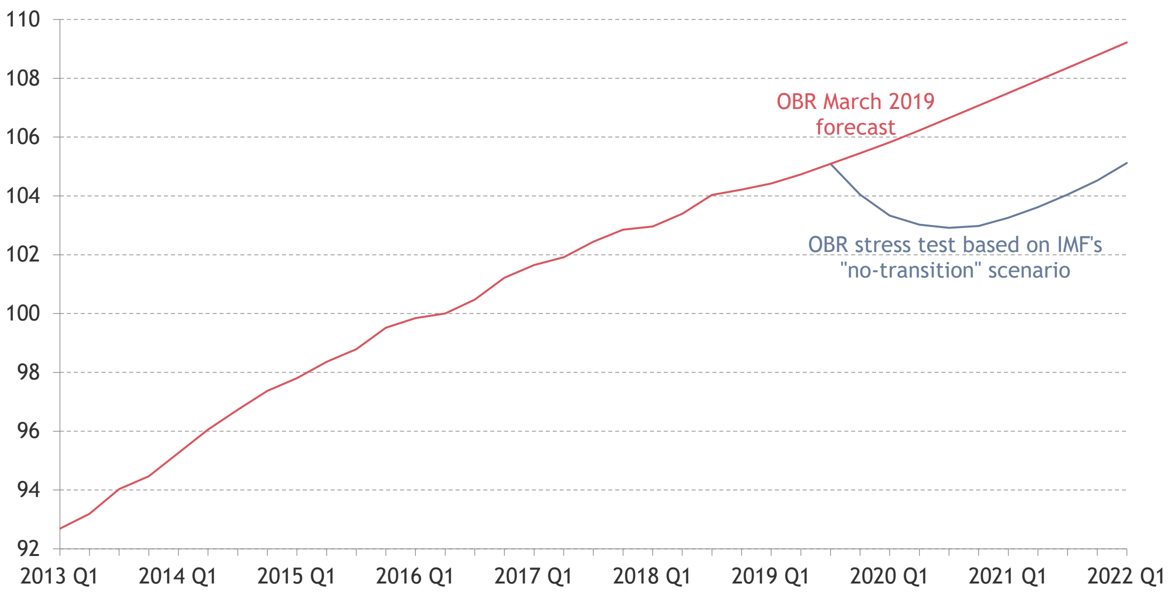
How much a government chooses to spend should depend on fiscal rules they are genuinely committed to, but also on the heavily related assessment of the size of the economy that is likely to be funding such spending. For any given level of taxation, how much you can sustainably spend on our collective consumption of public services is based on our economic performance as a nation.

Crucially, however, the discussion above assumes, as the OBR did in March, a smooth and orderly Brexit. In reality, the form of Brexit the government will seek to deliver in just two months' time is far from clear. We have not carried out any forecasts of the impact of different Brexit scenarios, but every serious organisation that has done so has found a significant variation in the size of our economy over the next five years depending on whether we are engaged in a deal or no-deal scenario. Even those at the modest end are far from negligible. Figure 9 (overleaf) shows the 4 per cent difference in the size of our economy between the OBR's March forecast and its assessment of what might happen if the IMF's "no-transition" Brexit scenario comes to pass. Knowing which of those two lines we are likely to be on should be an important input to your view on how much we can spend on our public services.

What Brexit we are heading towards should also determine what money is spent on, not just how much gets spent. A no-deal scenario will demand a much wider activist response from government to reduce, but not eliminate, the impact on the economy. This would involve alleviating the impact of supply hits and mitigating any fall in demand with spending increases, tax cuts and support to firms facing difficulties. In a future paper we will return to the detailed considerations that should guide such interventions, but what is very clear is that they should be chosen on the basis of the economic and social objectives of softening the impact of a no-deal Brexit.

Figure 9: The range of outcomes for GDP in the near future is larger than normal

Path of real GDP as forecasted in March 2019 & under a no-deal scenario (2016 Q1=100): UK



Source: OBR, *Fiscal Risks Report*, July 2019

Note this is not the same thing as saying, as some have, that money shouldn't be spent now because it will make it impossible to spend more in the event of a no-deal Brexit. In such a scenario fiscal rules and other constraints would rightly be jettisoned. It is instead saying that decisions about the size of public service spending in the long run are based in significant part on the size of your economy. A country that is actively planning on a no-deal Brexit outcome should be considering very carefully the economic impact of spending increases to prioritise their role in supporting the economy in difficult times. The timing of the coming spending round ahead of clarity on Brexit means that neither can be sensibly done. For this reason, setting any departmental budgets for 2020-21 before we know our place in the world on 1 November is unwise.

Conclusion

Where does this leave us? Public services need more funding, and the UK can clearly afford to borrow more to meet some of those needs. But that big picture should not entirely cloud worries about how the government goes about providing such funding. It seems likely that the Chancellor will tell us on Wednesday that he will use up most of a claimed £14 billion of headroom within current fiscal rules for additional spending. But any reasonable assessment concludes that the true size of any headroom is much smaller than this – and may well not exist at all any longer. This approach might be good politics today, but it's bad for the government's economic credibility. Such an approach a few weeks before we are due to leave the EU, when economic credibility may be more valuable than ever and different spending decisions may well be needed, is doubly unwise.

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