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SPENDING ROUND 2019

Thank you for the invitation to appear before the Committee following the Chancellor's statement on *Spending Round 2019*. Given the short notice – and the fact that we do not usually give oral evidence on spending settlements – I thought it might be helpful to explain briefly our role here and how the announcement will be reflected in our public finance forecasts.

Rounds and reviews

As you know, the Government normally sets limits on departmental spending in multi-year 'spending reviews'. Typically, the Government announces separate aggregate limits for resource and capital spending at a Budget or Spring/Autumn Statement and then allocates each of them between departments in a later statement. (This reflects the fact that it can be a herculean task for the government to agree both elements simultaneously, alongside other tax and spending measures, as part of a normal fiscal event.)

So last week's announcement was unusual in two respects: first, it covers only one full fiscal year (2020-21); second, the aggregate limits and departmental allocations have been announced together. The former presumably facilitated the latter. The Government said that in the current unusual circumstances a one-year spending round "gives government departments and the devolved administrations the financial certainty needed to focus on delivering Brexit on 31 October". It says that a full multi-year spending review will follow in 2020.

Why no forecast?

Under the OBR's primary legislation, Parliament requires us to produce two forecasts for the public finances during each financial year and to use them to assess the Government's performance against its fiscal targets. Our secondary legislation specifies that these forecasts should cover a period of at least five years and confirms that they should be based on current stated Government policy (although not necessarily on the assumption that particular policy objectives are achieved). It also states that the Chancellor will determine the date of the forecasts, one of which will generally accompany the Budget.

On this basis, we were not asked to provide a forecast to accompany the spending round – and we would not have expected to be. We will of course include the impact of the announcement in our next forecast (presumably accompanying a Budget later this year). At this point, we will need to know the aggregate departmental spending limits that the Government wishes to pencil or ink in for the years *following* 2020-21, so as to base the forecast on current stated Government policy over the required five-year horizon.

We do not know yet when the Government is going to hold the Budget and/or require a forecast from us. Under our Memorandum of Understanding the Government is supposed to provide us with 10 weeks' notice under normal circumstances. But, clearly, these are not normal circumstances. With significantly less notice, we might need to produce a more 'rough and ready' forecast or – in extremis – not be able to produce one at all.

If the Government wished to hold a Budget before or soon after the date on which the UK is due to leave the EU – and accompany it with a forecast – we would need to know at the beginning of the process whether it intended to design the policy package for a 'deal' or 'no deal' Brexit, to help us decide on what basis we should produce the underlying pre-measures forecast. Given the complexity of the forecast and policy scrutiny processes – and the significant demands we place on officials in other departments and agencies – we cannot produce parallel forecasts on both bases. And 'switching horses' from one to the other would require more time. As last week's announcement demonstrates, there is nothing to stop the Government announcing tax and spending measures without an accompanying forecast. But we would scrutinise and reflect any such measures in the forecast that followed.

The substance

For the public finances, the headlines from the spending round were the total increases of £2.1 billion this year and £11.7 billion next year in resource (i.e. day-to-day) departmental expenditure limits (RDEL) and of £1.7 billion next year in capital departmental expenditure limits (CDEL). These Treasury control aggregates are not the same as the current and capital spending aggregates that we use in our forecasts (primarily because the Treasury treats some government lending as spending for administrative control purposes, but sets its fiscal targets consistent with National Accounts conventions). But we would not expect there to be significant quantitative differences in how last week's spending announcements look on either basis.

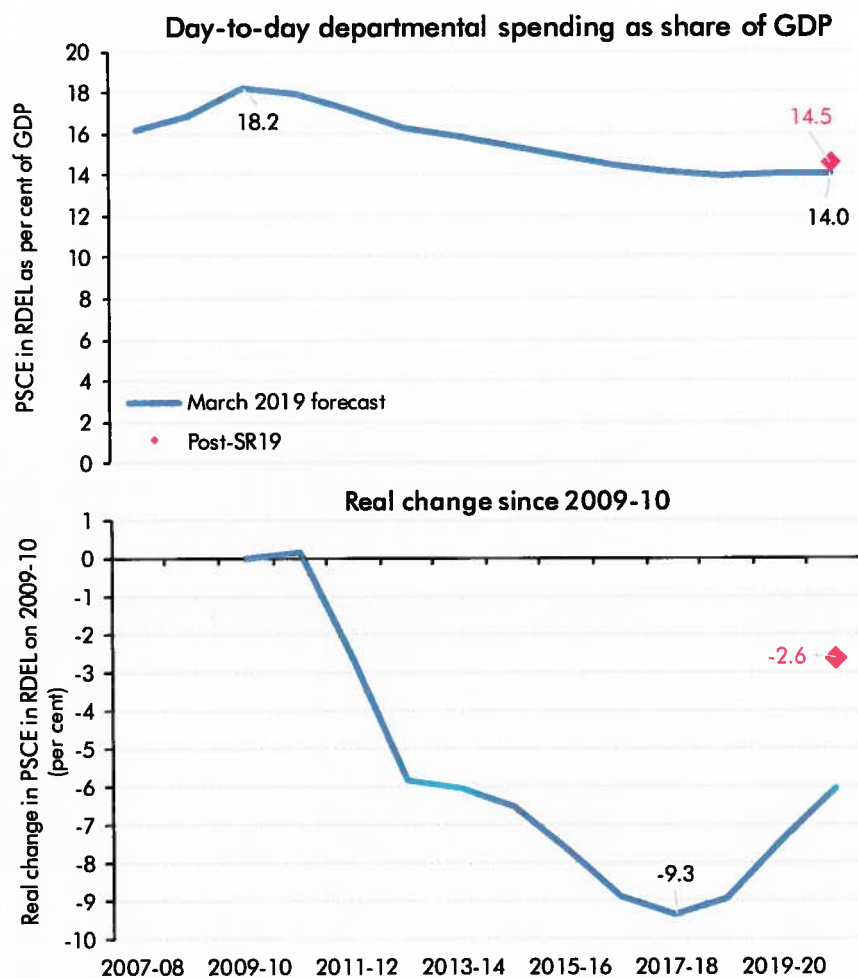
Ignoring that distinction for simplicity – and based on the outturns, plans and forecasts for inflation and nominal GDP in our most recent March 2019 *Economic and fiscal outlook* – the new plans imply real increases in resource DELs of 2.3 per cent in 2019-20 and 4.5 per cent in 2020-21,¹ which correspond to increases of 0.1 per cent and 0.5 per cent of GDP respectively.

As the charts below illustrate, on this basis the aggregate increase in spending now planned over these two years would reverse around two-thirds of the 9.3 per cent peak-to-trough decline in real terms between 2009-10 and 2017-18, but only around one eighth of the decline as a share of GDP from 18.2 to 14.0 per cent of GDP between 2009-10 and 2018-19. It would also remain below its pre-crisis share. (About half the reversal in real terms reflects the spending

¹ This corresponds to the Treasury's published real terms growth rate of 4.1 per cent. The difference arises because we apply the SR announcements on additional RDEL ex spending to our forecasts of *actual* spending on PSCE in RDEL, whereas the Treasury applies it to *plans* for RDEL ex. The Treasury has reflected our RDEL underspend assumptions in its Resource AME figures.

round, while the remainder was already in the March baseline – thanks primarily to the additional NHS spending announced in June 2018.) These comparisons exclude the £5.5 billion cost of higher employer pension contributions in 2020-21, which in effect just shifts some of the gross cost of those pensions to DEL budgets from annually managed expenditure (AME).

Chart 1: Resource departmental expenditure limits



The generosity of the spending round – and the comparison with the previous decade – varies significantly by department, but our remit means we focus on the aggregate figures that determine the impact on the public finances.

In passing, it is worth noting that the £0.5 billion adult social care precept that the Government said that it was considering would count as additional council tax revenue and locally financed spending. So it would not increase borrowing one-for-one in the way that additional DEL spending would.

Meeting the rules?

The Chancellor said in his statement that “with the extra spending we are still meeting the current fiscal rules”. And the accompanying Treasury document stated that “this spending round has been delivered within the current fiscal rules”, but it acknowledged in a footnote that this judgement is “based on the OBR’s March 2019 forecast” rather than a new contemporaneous assessment.

In making these assertions, the Treasury was referring to the *fiscal mandate*, which requires cyclically-adjusted public sector net borrowing (the 'structural deficit') to lie below 2 per cent of GDP in 2020-21, and the *supplementary target*, which requires net debt to fall as a share of GDP in 2020-21:

- In March we forecast that the structural budget deficit would be 0.8 per cent of GDP in 2020-21, giving headroom against the **fiscal mandate** of £26.6 billion. As of March, we estimated that the new treatment of student loans by the Office for National Statistics would increase the measured deficit by £11.6 billion in 2020-21, leaving headroom of £15.0 billion, all else equal. The spending round would increase the deficit by £13.4 billion in 2020-21, ignoring any indirect effects, leaving headroom of £1.6 billion. (The ONS's new treatment of student loan *sales*, which had not been finalised in March, would push borrowing higher, potentially eliminating this remaining headroom.)
- In March we forecast that public sector net debt would fall by 3.2 per cent of GDP in 2020-21 and by 1.0 per cent of GDP excluding repayments under the Term Funding Scheme, satisfying the **supplementary target**. As a cash measure of the balance sheet, net debt is unaffected by the new student loan treatment. The additional spending announced last week would reduce the year-on-year fall in net debt by around 0.6 per cent of GDP in 2020-21, leaving the target met with room to spare.

Whether the Government will be on course to satisfy the fiscal mandate when we make a new forecast remains to be seen:

- The **pre-measures forecast** of the structural deficit in 2020-21 will need to reflect the latest outturn data for the public finances through 2019-20 – where over the year to date the deficit has been rising more quickly than we forecast for the year as a whole – and any changes in our judgements regarding growth in spending and revenue between this year to next as a result of either economic or non-economic developments. The structural deficit forecast would also be determined in part by our estimate of the 'output gap', which will require a fresh assessment of spare capacity in firms and the labour market. Any increase in borrowing reflecting greater spare capacity would not reduce the headroom against the mandate.
- To complete the **post-measures forecast**, we would also need to judge whether the increase in departmental spending plans announced last week is likely to translate one-for-one into an increase in actual spending and therefore higher borrowing. History suggests that when governments announce relatively abrupt increases in planned spending it often proves hard to get all the money out of the door (especially for capital spending). We would also need to estimate the indirect effect of the extra spending on borrowing via its impact on the economy. But as the spending is unlikely to affect economic potential, this is likely to be more important for the cyclical deficit than for the structural one.

In the event of a disruptive 'no deal' Brexit, calculating the output gap and the structural budget deficit over the next couple of years will become even more difficult and, arguably, not particularly meaningful. The concept is based on the idea that potential output usually moves relatively smoothly over time while actual output cycles around it. But we and other economists assume

that a disruptive exit would involve short-term shocks to both demand and supply, so that it would become very hard to apportion the resulting budget deficit between structural and cyclical components with any confidence.

Whether or not the fiscal mandate is met next year, we noted in our *Fiscal risks report* in July that with a fixed target date just one year ahead it “does not provide an anchor for medium term tax and spending decisions”. The spending round statement and accompanying document made no mention of the Government’s legislated *fiscal objective* – to balance the headline budget deficit by the mid-2020s. We have concluded in our forecasts to date that the government is not yet on course to meet this objective and the additional spending announced last week makes that even less likely.

The Chancellor said in his statement that the Government would review the fiscal framework ahead of the Budget later this year. Given that we do not know yet whether we are heading for a ‘deal’ or ‘no deal’ Brexit – and bearing in mind the uncertainties that lie around the fiscal outlook in either event, but especially in the event of a disruptive exit – the Government will have to decide at what point it would be possible to set out fresh quantitative targets for the public finances to which it could credibly commit. In the meantime, as we noted in the *Fiscal risks report*, “all the signs point to a fiscal loosening and less ambitious objectives for the management of the public finances”.

I hope this is helpful and we look forward to seeing you this afternoon.

A handwritten signature in black ink that reads "Best regards, Robert." The signature is written in a cursive, flowing style.

Robert Chote
Chairman