Office for
Budget Responsibility

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Forecast evaluation report 2017

Deficit falls, but productivity growth disappoints again

Real GDP growth in the period up to mid-2017 was weaker than predicted in both our March 2015 and March 2016 forecasts, but nominal GDP growth – which is the more important driver of the public finances – fell short of our March 2015 forecast by a smaller margin while it actually exceeded our March 2016 forecast.

On a broadly like-for-like basis – abstracting from the effect of classification changes – our March 2015 fiscal forecast was too optimistic while our March 2016 forecast was too pessimistic:

- **Relative to our March 2015 forecast**, borrowing was £10.9 billion higher than expected, with much higher-than-expected spending more than offsetting higher-than-expected receipts. For spending, this was largely the consequence of significant increases in departmental spending announced after the 2015 General Election.

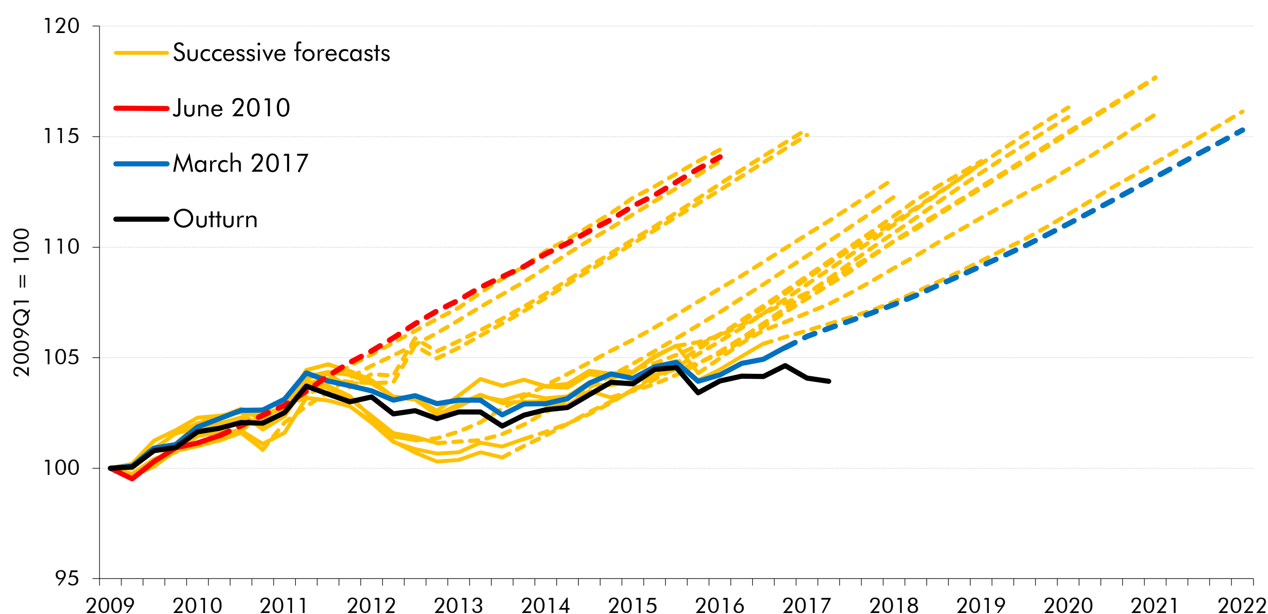
- **Relative to our March 2016 forecast**, borrowing was £2.8 billion lower than expected, more than explained by higher-than-expected receipts. These were boosted by stronger profits and higher employment, which more than offset the effect of weak average earnings growth.

One recurring theme in past reports has been productivity falling short of our forecasts (Chart 1.1) while employment and average hours worked have exceeded them. That pattern is repeated for both forecasts evaluated in this report and, based on revised GDP data and outturns in the first half of 2017, will be repeated again for our March 2017 forecast.

Against this backdrop, we have reviewed the explanations for weak post-crisis productivity growth that have been advanced – including labour hoarding, banking sector impairment, very low interest rates, weak investment – and the international context. Some arguments for the post-crisis weakness being temporary now appear less plausible, while others remain relevant.

Our March 2017 forecast assumed that trend productivity growth would rise slowly to reach 1.8 per cent in 2021. Actual productivity growth averaged 2.1 per cent a year in the pre-crisis period, but has averaged just 0.2 per cent over the past five years. While we continue to believe that there will be some recovery from the very weak productivity performance of recent years, the continued disappointing outturns, together with the likelihood that heightened uncertainty will continue to weigh on investment, means that we anticipate significantly reducing our assumption for potential productivity growth over the next five years in our forthcoming November 2017 *EFO*.

Chart 1.1: Successive OBR productivity forecasts (output per hour)



Note: Solid lines represent the outturn data that underpinned the forecasts at the time (the dashed lines).
Source: ONS, OBR

The weakness of productivity growth has been accompanied by stronger-than-expected employment growth, ongoing falls in unemployment (to 4.3 per cent of the labour force, compared with our March assumption of 5.0 per cent for the equilibrium, or sustainable, rate of unemployment), and average hours rising a little rather than falling as assumed. Strong growth in hours worked, alongside weak earnings growth, suggests that we will also need to revisit our assumptions about potential labour supply. The Bank of England currently estimates that the equilibrium unemployment rate is around 4½ per cent. Given the impact of weak earnings growth on people's incomes, it may also be sensible to assume that the long-term downward trend in hours worked takes longer to reassert itself.

We will be considering all the relevant evidence in detail as we prepare our November forecast. Other things being equal a downward revision to prospective productivity growth would weaken the medium-term outlook for the public finances, while a lower sustainable rate of unemployment and more hours worked would strengthen it. The ONS's downward revisions to last year's budget deficit would also be beneficial, to the extent that they feed through to future years. That said, the downward revision to productivity growth is likely to have the largest quantitative impact.

Notes

1. The OBR is the UK's independent fiscal watchdog. We produce forecasts for the economy and the public finances, assess progress against the Government's fiscal targets, and report on long-term fiscal sustainability.
2. Questions should be sent to OBRpress@obr.gsi.gov.uk or contact Mark Dembowicz on 020 3334 6348.