

## **March 2020 *Economic and fiscal outlook* launch**

**Robert Chote, Chairman, Office for Budget Responsibility**

[SLIDE] Good afternoon ladies and gentlemen. And welcome to this briefing on the *Economic and fiscal outlook* that we have published today, alongside Chancellor Rishi Sunak's first Budget. This sets out five-year forecasts for the economy and public finances and an assessment of the Government's progress against its fiscal rules. The judgements are those of the OBR's independent Budget Responsibility Committee, but we have benefited hugely from the hard work and expertise not only of our own staff but of officials across a wide range of departments and agencies – to whom we are very grateful.

Needless to say, these are very unusual circumstances in which to be launching an EFO. As normal, the Treasury asked us to close our pre-measures forecasts for the economy and the public finances some weeks ahead of the Budget – in mid-February – to provide them with a stable baseline against which to prepare their policy decisions. When we did so, the coronavirus looked likely to be contained largely within China and to imply only a modestly weaker outlook for world trade and UK export markets. Clearly the position now is very different. In addition to having profound consequences for public health and families' wellbeing, the spread and severity of the virus is now expected to have significant consequences for the economy and the public finances – at least in the near term and asset markets have responded accordingly. This in turn has triggered a policy response – the Bank of England has taken action this morning and the Budget announced a further £12 billion fiscal package to support the economy and protect vulnerable individuals and businesses. These of course came too late to reflect in the figures that we present here.

As a result of all this, the forecasts presented in this EFO can obviously no longer be regarded as central. The downside risks are all too clear, but even if we were starting now – with a blank sheet of paper – their scale and duration would be impossible to quantify with any confidence. But there is still some value in the exercise. As we shall see, the Government has announced a new set of fiscal objectives and the largest giveaway Budget for almost 30 years – for reasons that have nothing to do with coronavirus. Assessing the impact that this might have over the medium term remains worthwhile, even if the near-term outlook is worse and more uncertain than the forecasts assume.

[SLIDE] So let me start with the big fiscal picture.

This chart shows our March 2019 forecast for the budget deficit, which we restated in December to reflect statistical changes – notably an improved accounting treatment for student loans and a corrected treatment of corporation tax. As you can see the deficit was forecast to rise slightly to £47.6 billion this year and then decline steadily to just over £33 billion by 2023-24.

[SLIDE] Our pre-measures, pre-coronavirus forecast was slightly worse, by about £3 billion a year on average. [SLIDE] But most of the action comes from the Budget tax and spending measures and other policy decisions – which by the end of the forecast add almost another £30 billion to the deficit. Over the forecast as a whole, they increase net debt by no less than £125 billion.

[SLIDE] As regards the pre-measures forecast, as far as the economy is concerned we assume that the UK makes a smooth transition to a typical free trade agreement – as we have no way of knowing exactly where the negotiations will end up. As best we can tell, potential output is around 2 per cent smaller now than it would have been in the absence of the referendum vote, largely reflecting lower inward migration and weaker productivity, thanks in particular to depressed business investment. Drawing on several external studies, we assume that the move to an FTA will lower potential productivity and potential GDP by about 4 per cent over the long term – again relative to where it would otherwise have been. We estimate that a third of that can be seen in the data already, a third will come over this five year forecast period and the remaining third thereafter. As time goes by, business investment should pick up as uncertainty recedes and trade frictions and barriers to specialisation will take over as the main factors holding productivity back.

Even before coronavirus came on the scene, world GDP and trade growth were being depressed by trade tensions. And we did make some modest early adjustment for coronavirus, based on the experience of SARS.

In the UK, the outlook for real GDP growth looked somewhat weaker than a year ago. Recent outturn data certainly pointed to a lower calendar year growth rate for 2020 and over the medium term we saw a weaker outlook for productivity growth outweighing better news on labour market participation. So cumulative GDP growth looked weaker overall than a year ago. Consistent with this, financial markets expected lower interest rates than last March.

[SLIDE] The fall in interest rate expectations (together with lower RPI inflation) lowered debt interest spending by £7.4 billion a year on average. But this is more than offset by weaker tax receipts (thanks to a weaker household incomes and spending) and higher government spending. The latter includes more capital spending by local authorities, higher capital transfers related to student loans, more use of R&D tax credits and greater expected spending on incapacity benefits. Hence the £3 billion average rise in borrowing pre-measures that we saw in the chart.

[SLIDE] So now let me turn to the impact of the policy measures that we have seen since last March – but before the effect of today's £12 billion response to the coronavirus outbreak. There are three main changes we need to reflect:

- First, the Budget package, which builds on the 2020-21 Spending Round last autumn. As we shall see, this includes big increases in current and capital spending plans, partly paid for by net tax increases and the direct Brexit savings that we have included in previous forecasts. But most of the extra spending is financed simply by borrowing more.
- Second, the new migration regime, which is tighter for EU immigrants and marginally less so for non-EU immigrants than what we have now.
- And, third, the plan to increase the National Living Wage to two-thirds of relevant median earnings by October 2024.

[SLIDE] So let us see how these affect borrowing and contribute to the much bigger upward revision to the deficit that we saw in the chart.

[SLIDE] The biggest items are the new and much higher limits on resource and capital spending that will underpin the Government's Comprehensive Spending Review later this year – unless they are further revised. Their direct impact is to increase borrowing by more than £55 billion a year by 2024-25.

[SLIDE] To put this in context, this chart shows successive plans for resource spending – in other words day to day spending on public services, grants and administration – per head of population and adjusted for inflation. It shows that the Conservative governments since 2015 have already significantly reined back the planned cuts inherited from the Coalition and the latest plans would reverse all the cuts since 2010 by 2024-25 – half of them over just two years.

All this is true in aggregate – but of course some parts of the public services will fare better than others.

[SLIDE] Viewed as share of GDP, around a third of the cuts would be reversed.

[SLIDE] Looking at capital spending on the same ‘share of GDP’ measure, you can see that the sharp cuts over the first two years of the Coalition – which were a feature of the previous Labour Government’s Budget in March 2010 – were already being rolled back and would almost have been reversed by the plans on which our last forecast was based a year ago. The new Budget plans will lift capital spending significantly above its 2010 level as a share of GDP.

[SLIDE] It is important to point out that when judging the impact that higher capital spending limits might have on the deficit, we generally assume that departments will not spend fully up to the limits – especially when those limits are being ramped up relatively quickly. As you can see here, capital spending outturns have fallen short of plans in most recent Spending Reviews, except when they have been overtaken by explicit decisions to loosen policy again. In this forecast, we assume that 20 per cent of the increase in capital spending limits that was announced in this Budget does not in fact get spent.

[SLIDE] Returning to the impact of policy changes, [SLIDE] we see that the rise in the spending limits is partly offset by direct savings from Brexit. Our post-referendum forecasts have all assumed that any direct savings from the contributions that the UK makes to the EU Budget, plus any extra proceeds from customs duties, would be recycled into domestic spending. Now that the UK has left the EU – and that spending plans have been set for the next few years – we can remove this ‘DEL in waiting’ from the forecast. This reduces the impact of the new spending plans on borrowing by £4.3 billion next year rising to £14.6 billion in 2024-25 as the divorce bill instalments shrink in size.

[SLIDE] In addition to higher spending, the Budget announced higher taxes. The blue bars show the gross tax increases at the bottom outweighing the gross tax cuts at the top to reduce borrowing by £8.5 billion by 2024-25.

[SLIDE] This table shows the main moving parts. The biggest tax increase is the decision to cancel this year’s planned cut in the main rate of corporation from 19 to 17 per cent that George Osborne announced in his final Budget. Other increases include a reduction in the lifetime capital gains eligible for entrepreneur’s relief and a restriction on use of red diesel relief. The biggest

tax cuts are the increase in the National Insurance threshold, a series of business tax cuts and, that old chestnut, a “one-year” freeze in fuel duty rates.

[SLIDE] Thanks largely to policy measures and real earnings growth pulling more income into higher tax brackets, tax revenues rise as a share of GDP over the forecast. [SLIDE] National Accounts taxes reach their highest share of GDP since 1969-70 and total receipts their highest since 1984-85.

[SLIDE] Taking only the direct effect of all these measures into account, the increase in the budget deficit would reach more than £36 billion by the end of the forecast. But this is partly offset by their [SLIDE] indirect effect, via the economy. The fiscal giveaway gives a temporary cyclical boost to GDP growth as well as pushing whole economy prices permanently higher. Higher incomes also increase house prices in the near term. This boosts tax receipts.

Over the longer term we might expect the increase in public sector investment – especially in areas like transport infrastructure – to boost potential GDP. Indeed, if the increase in general government investment announced in this Budget were to be sustained indefinitely – which history admittedly suggests is unlikely – then this could increase the potential size of the economy by around 2½ per cent. But little of this would show up within our five-year forecast.

In addition to its economic impact, higher resource spending is also partially self-financing (at least in the short term) because around one-tenth of the money comes back to the Exchequer in higher pension contributions.

Taken together, these two effects reduce the deficit by £7 billion by 2024-25.

Two other policy changes have much smaller and, by coincidence, largely offsetting indirect effects on the deficit – namely the new migration regime and the planned increase in the National Living Wage.

[SLIDE] The new points-based migration criteria that the Government will introduce in 2021 are more restrictive for EU migrants and marginally less so for non-EU migrants than what we have now. We expect this to reduce net inward migration overall, particularly for low-wage and therefore mostly low productivity workers.

As a result, we now base our forecasts on the ONS’s zero net EU migration population projections rather than their ‘principal projection’ (even though we

would not actually expect precisely zero net migration from the EU). This puts net inward migration in 2024-25 at 129,000, instead of 190,000. A smaller population and a slightly lower participation rate reduce employment by 0.4 per cent by 2024-25, but average productivity across the smaller workforce is 0.1 per cent higher. This leaves real GDP 0.3 per cent lower, but real GDP per head little affected – as the effects on the participation rate and productivity broadly offset each other. Lower tax receipts outweigh lower welfare payments to leave borrowing a negligible £1 billion higher five years from now.

One caveat here, delivering the new regime on time looks very challenging.

[SLIDE] Turning to the living wage, increasing the target to two-thirds of relevant median earnings will raise it to a level above that in most other countries. This makes the potential impact harder to judge.

[SLIDE] But we have assumed that in addition to directly increasing the wages of people below the new path for the NLW, the impact will spill over to people with wages up to 40 per cent higher than that. We estimate that this will reduce total hours worked by 0.3 per cent, including a modest rise in unemployment of around 50,000, and lower real GDP by 0.1 per cent by 2024-25. The expected change in the wage distribution shown here boosts income tax receipts, but squeezes tax on profits. Welfare spending is little affected, with means-tested bits lower, but the triple lock pushing state pensions higher. In aggregate, borrowing is a little over £1 billion lower five years ahead.

[SLIDE] So where do these effects leave our post-measures economy forecast? Bear in mind, once again, that – like the pre-measures forecast upon which it is based – the post-measures forecast does not reflect the recent news on the spread of coronavirus (or the policy response from the Bank and the Treasury) and thus looks too optimistic in the near term at least.

This chart shows our GDP growth forecast from a year ago [SLIDE] and the new pre-measures forecast – slightly weaker over the next five years, especially in 2020. [SLIDE] Add the impact of the policy measures and you can see that the fiscal loosening gives the economy a bit of a sugar-rush in 2021, but the other policy changes leave growth slightly weaker on average over the full five years.

[SLIDE] Turning to prices, we see that CPI inflation has been lower over the past year than we had forecast. And we expect it to remain lower for much of the next five years, in part because of less rapid increases in energy prices.

Excise duty freezes help push inflation a little lower this year, but the fiscal expansion pushes it back up to target earlier than our pre-measures forecast and at a similar point to where we forecast a year ago.

[SLIDE] In addition to their effect on GDP growth in aggregate, the policy measures also affect the composition of GDP. This chart shows the cumulative change in real GDP between the pre- and post-measures forecasts. As you can see, GDP increases slightly less overall than a year ago – thanks mostly to lower inward migration. [SLIDE] And the increases in planned government spending crowd out [SLIDE] consumer spending, private investment and net trade in roughly equal measure.

[SLIDE] We can see this crowding out in the labour market too. We expect whole economy employment to rise by 520,000 over the next five years rather than 720,000 pre-measures, thanks largely to less migration. And we expect general government employment to account for 490,000 of this increase, rather than 350,000 pre-measures. That would reverse the entire fall in general government employment that we have seen since 2010.

[SLIDE] Turning back to the Budget policy package, how does it look in historical context? This slide shows some of the largest fiscal giveaways and takeaways of the last 30 years, as shares of GDP.

As you can see, this is the biggest sustained giveaway since Norman Lamont's ill-fated pre-election Budget in March 1992 (when official forecasts did not extend very far). In fact this had to be reversed within months, after sterling left the European exchange rate mechanism in September that year.

The fiscal stimulus implemented in response to the financial crisis – in November 2008 and March 2009 – was larger than this Budget to begin with, but soon moved to the promise of a large fiscal consolidation to reflect the weaker outlook for potential GDP and reduce the structural budget deficit.

The closest comparator looks like Gordon Brown's 2000 Budget, when the Labour Government turned on the spending taps after initially sticking to the cuts it had inherited from the Conservatives in 1997. They did so in the expectation that tax receipts would remain strong, but they were dented by the bursting of the dotcom bubble and they never rebounded as strongly as Labour hoped.

[SLIDE] This Budget can also be seen as part of a broader shift in fiscal approach between the Coalition years and what has followed. As you can see here, the measures announced by Conservative governments since 2015 (especially in the wake of the EU referendum) would reverse about a third of the consolidation undertaken by the Coalition, measured by the impact of policy measures as a share of GDP.

[SLIDE] As well as looking at the impact of policy decisions on the deficit, we can also look at public sector net debt. [SLIDE] This chart shows that by the end of the forecast the direct effect of the Budget measures is to increase net debt by just under £150 billion, thanks to higher cumulative borrowing. [SLIDE] Asset sale delays and cancellations increase it by a further £12 billion, mostly because the Government has decided not to continue selling student loan debt now that this no longer flatters the public finances under the improved accounting treatment. [SLIDE] The indirect effects of the policy measures reduce borrowing, as we have seen, and thus they lower net debt by £36 billion at the end of the forecast. So the overall impact is to raise net debt by £125 billion or 4.6 per cent of GDP.

[SLIDE] This is sufficient to take the total above £2 trillion for the first time.

[SLIDE] It is more meaningful though to look at net debt as a share of GDP. [SLIDE] And we can also look at other balance sheets measures that remove the short-term effects of the Bank of England's Term Funding Scheme or which include a wider range of assets and liabilities. As you can see, both net debt measures broadly stabilise at around 75 per cent of GDP rather than falling as they did last March. Public sector net financial liabilities do fall slightly as assets not included in net debt (such as student loans and those of funded pension schemes) rise in value. But even PSNFL remains far above its pre-crisis levels.

[SLIDE] So how would the Government perform against its fiscal rules if the public finances were to evolve in line with these forecasts?

The current formal targets are those that Parliament approved in the latest Charter for Budget Responsibility in January 2017. But the Chancellor wrote to us ahead of the Budget to say that his decisions would instead be guided by the looser rules set out in the Conservative manifesto and confirmed in the Queen's Speech. These will be reviewed again ahead of the next Budget, which suggests that may not offer a good guide to future policy decisions.

[SLIDE] Of the targets still in legislation, the Government is now on course to miss two of them: the fiscal mandate and the fiscal objective.

[SLIDE] The fiscal mandate requires cyclically adjusted public sector net borrowing to lie below 2 per cent of GDP in 2020-21. [SLIDE] In our original March 2019 forecast this was on course to be met with around £26 billion to spare, but the statistical restatement in December reduced this to £7.6 billion. [SLIDE] On the pre-measures forecast for this Budget, the margin was smaller again at £5.3 billion. [SLIDE] But this has been more than exhausted by the fiscal giveaway and the target ends up being breached by £9.2 billion or 0.4 per cent of GDP.

[SLIDE] The Government's legislated fiscal objective – which had been downplayed even before the election – is to balance the budget by the mid-2020s. As this chart shows, just 18 months ago – in our October 2018 pre-measures forecast – the Government was on course to achieve this ahead of schedule in 2023-24. But it is now aiming to run a deficit of around 2 per cent of GDP into the medium term.

[SLIDE] Why the turnaround – from a potential surplus of £3.5 billion in 2023-24 to a deficit of £60 billion? The Government's policy choices have made most of the difference – adding £50 billion to the deficit. The statistical improvements have also contributed, while underlying forecast revisions have provided a modest offset.

[SLIDE] So what of the Government's new targets, announced in December, described in the Budget somewhat impermanently as the “rules in paragraph 1.34”, and already up for review?

In addition to the reset welfare spending cap, there are three new targets for the public finances:

- To keep the current budget balance (which excludes borrowing to finance net investment spending) in surplus three years ahead.
- To ensure that public sector net investment does not exceed 3 per cent of GDP on average over the forecast period. This puts a ceiling on total borrowing.

- And to ensure that the debt-to-GDP ratio is falling if the ratio of debt interest to revenue exceeds 6 per cent over a sustained period.

Not surprisingly, the Government has set policy in the Budget to meet them all.

[SLIDE] Starting with the first of these, you can see that the current budget had returned to surplus in 2018-19, the deficit having peaked at over 7 per cent of GDP in 2009-10. [SLIDE] Our pre-measures forecast shows the balance continuing to improve, albeit more slowly than over the past decade. [SLIDE] Add on the Budget and other policy measures and you can see that it remains in surplus – but with less margin for error. The rule is met in 2022-23 with £11.7 billion to spare.

[SLIDE] Turning to the maximum investment rule, we can see here that the Government's spending plans would deliver public sector net investment averaging 2.9 per cent of GDP over the five years of the forecast, thereby meeting the rule. As the chart shows, this is a relatively high level of investment by past standards, at least back to the 1970s when we had more nationalised industries and public sector house building. Ironically, if the Government were to succeed in spending right up to the departmental limits that it proposes for the Spending Review, the rule would soon be breached.

[SLIDE] There are of course different elements within public sector net investment. Net fixed capital formation – which is what most people would think of as capital spending, namely the building or purchasing of fixed assets for the public sector like roads and buildings – only accounts for a little under half the total. The remainder consists largely of capital grants, some of which finance fixed assets in the private sector (such as social housing), but others do not – for example the upfront recognition of student loan write-offs.

[SLIDE] The third target – or trigger – is to take action to reduce the debt-to-GDP ratio if net interest payments exceed 6 per cent of non-interest revenues for a sustained period. This chart shows that this ratio is expected to drop from 3.8 per cent in 2019-20 to 2.9 per cent in 2024-25, so the trigger is not pulled. As you can see, the ratio exceeded 6 per cent consistently up to 1991, reflecting high borrowing costs and – initially – the still high post-war debt burden. But it has exceeded 6 per cent only twice over the past decade, thanks to spikes in RPI inflation in 2010-11 and 11-12.

The Conservative manifesto said that pursuing the new fiscal rules “means that debt would be lower at the end of the Parliament” (at least as a share of GDP). And, as we saw a moment ago, that is forecast to be the case, but only because of the repayment of Term Funding Scheme loans.

It is worth noting that the new rules would not in themselves guarantee that the debt-to-GDP ratio falls in normal times. Its path depends not just on borrowing, but also on financial transactions and the growth of nominal GDP. The new rules put an effective ceiling on public sector net borrowing of 3 per cent of GDP, but over the medium term the deficit would need to be closer to 2.5 per cent even to keep the ratio falling very slowly.

[SLIDE] Needless to say, and as we always emphasise, the outlook for the public finances is inevitably uncertain. Leaving aside the unusual current situation, and looking purely at past forecast performance, this chart shows that the Government has around a 60 per cent chance of meeting its new rules, compared to around 70 per cent when the last ones were put in place. So the Government has given itself less margin for error than last time.

[SLIDE] As always, the EFO discusses a large number of risks and uncertainties that lie around our central forecasts and around the Government’s chances of hitting its targets. But for now, of course, coronavirus is by far the most immediate and important. In addition to its expected impact on public health, it is likely to have significant consequences for the economy and the public finances – at least in the near term if less so further out.

With lots of people potentially sick – or limiting their movements to avoid becoming so – the virus is likely to depress both demand for goods and services and the ability of businesses at home and abroad to supply them. This will reduce tax receipts and the government will need to spend more in areas like health. One potential offset is that the virus may make it even harder for the Government to get its planned capital spending increases under way.

It is impossible to predict the scale or duration of the economic and fiscal disruption with any confidence, but it should be temporary unless it inflicts lasting damage on the economy’s supply capacity – as the financial crisis did. We might therefore expect the coronavirus shock to further ratchet up the level of public sector net debt, as borrowing rises temporarily, but hopefully it should not increase the structural budget deficit long term.

As regards the specific measures that the Chancellor has announced today, the Treasury has put a figure of £12 billion on the package, but there is obviously a lot of uncertainty around that. There is £5 billion for the NHS, which will be added to if necessary. There are measures to limit as far as possible the effect on household incomes – partly at the expense of Government and partly at the expense of employers. Then there are measures to absorb or offset some of those costs for business and to make sure that temporary cashflow problems don't cause otherwise healthy companies to fail. The cost of support to households and businesses will of course largely depend on how many people are affected by the outbreak, which we simply can't know at present.

[SLIDE] To conclude, let me look beyond coronavirus for a minute to the big fiscal judgement that the Government was making in this Budget before it came along. In the immediate aftermath of the financial crisis, the Coalition government focused on reducing the large structural budget deficit that emerged in the crisis, a process that would in time stabilise the debt-to-GDP ratio and begin to bring it down. By late 2016 Philip Hammond, as Chancellor, was easing up on austerity, but said that he still wanted to return the Budget to balance and bring the debt-to-GDP ratio down.

The new Government is taking a different approach, in some ways resembling that of the Labour Government in the years running up to the crisis. It is trying to keep the current budget in modest surplus, but to ramp up investment spending. In doing so it is content to run a significant budget deficit in normal times and to stabilise the debt-to-GDP ratio rather than reduce it.

The case for doing so rests on the fact that is far cheaper for governments to borrow now than it was in the mid-2000s, and financial market expectations suggest that this will remain the case for the foreseeable future. So the ratio of debt interest to GDP remains low even if the ratio of the debt stock to GDP is relatively high.

The risk of course is that financial conditions do not remain benign and that borrowing costs rise because of risk premia rather than a stronger outlook for economic growth. The debt-to-GDP ratio is twice as high as it was pre-crisis, the Government has much more index-linked debt, and the Bank of England's asset purchases have shortened the effective maturity of the debt stock.

[SLIDE] Note that even though we expect the budget deficit to be lower over the next five years than it was pre-crisis, as a share of GDP, [SLIDE] the amount of money that the government has to raise from the gilts market and other

sources is significantly higher at around £150 billion pounds a year. [SLIDE] This is because it has to roll over maturing debt – in effect refinancing the consequences of the financial crisis – at the same time as it finances this new borrowing.

The bottom line is that the current approach looks sustainable over the medium term on current forecasts for growth and borrowing costs. But the public finances are much more vulnerable to inflation and interest rate surprises than they were.

Thank you – we would be happy to take your questions.