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Treasury Committee report on Autumn Budget 2017

I am writing in response to the Committee's report on Autumn Budget 2017, focusing on the specific recommendations relating to the OBR.

Trade intensity and productivity

The OBR has stated that the link between trade intensity and increased productivity is insufficiently well understood to be included in its forecast, and as a result has not included any decline in productivity due to reduced trade intensity in its post Brexit forecast. The Committee is concerned as this conclusion stands in contrast to the assumptions made by the Treasury, Bank of England and the Secretary of State for International Trade, that higher trade intensity leads to higher productivity growth. If trade intensity initially declines as a result of Brexit, as is forecast by the OBR, and does lead to a decline in productivity (as is assumed by the Treasury, the Bank of England and the Secretary of State for International Trade) it would significantly worsen the expected economic and fiscal consequences of leaving the EU, compared to what the OBR forecasts at present. (Paragraph 31)

Our November 2016 *Economic and fiscal outlook* incorporated a provisional estimate of the impact of the referendum vote to leave the European Union. In the absence of a meaningful basis on which to predict the precise outcome of the negotiations, this was based on a series of broad-brush assumptions about the economic and fiscal impact of Brexit that would be consistent with a variety of possible outcomes. As discussed below, when the Government has reached a Withdrawal Agreement that it is prepared to present to Parliament, we will be able to update those assumptions accordingly.

In that November 2016 forecast, we assumed that the vote to leave the EU would lead both to lower trade intensity and to lower trend productivity over our forecast than would otherwise be the case. But we did not calibrate these adjustments on any assumed direct relationship between the two.

Several empirical studies have attempted to establish dynamic relationships of this sort, with greater trade intensity leading to higher productivity growth

as enhanced competition intensifies the pressure to innovate and through the technology transfer that arises from foreign direct investment. But it is not clear how useful these studies are as a quantitative guide to the potential impact of Brexit, especially over our five-year forecast horizon.

For example, much of the empirical evidence on the link between trade openness and productivity is drawn from cross-country growth regressions, where the bulk of the variation in the data comes from what happens in developing countries. Moreover, there are issues around how openness is measured and concerns about 'endogeneity' – the possibility that the measures of openness employed in these studies may be picking up the influence of other factors that drive cross-country productivity growth differences, despite the researchers' best efforts to control for such factors. In addition, it is not clear whether the results would carry across to what may be relatively modest additional trade frictions, when virtually all the evidence relates to increasing openness and very little to reducing it.

Most pertinently, given the concern expressed in the Committee's report that an initial decline in trade intensity could worsen the outlook set out in our current forecast, such dynamic effects onto productivity are likely to take a considerable time to manifest themselves – most likely over decades rather than within the five-year horizon of our *EFO*. Moreover, the lags may be longer still in the Brexit context, since UK-based businesses are unlikely to choose to operate less efficiently simply because openness has declined.

Basing forecasts on current Government policy

The OBR uses the ONS' migration forecasts as its input figure for migration in its economic forecast. These forecasts have been consistently above tens of thousands, which is in contradiction to the Government's stated policy of reducing migration to the tens of thousands. (Paragraph 41)

The OBR is required by Parliament to base its forecasts on current Government policy and not on possible alternative policies. In this context, the Committee's report notes the consistent assumption in our forecasts to date – borne out so far in practice – that that the Government will not succeed in its objective of reducing net inward migration to the tens of thousands (at least over our five-year forecasting horizon).

It is important to remember, however, that when we produce forecasts on the basis of current Government policy, we do so on the basis of those policy instruments that are in the Government's direct control (such as tax rates and spending limits), not the achievement of its policy objectives. Most obviously, it is a Government policy objective to abide by its stated fiscal rules, but it is our job to assess whether the Government's concrete policy *decisions* are consistent with achieving that policy *objective*. We do not assume that they necessarily are.

On the substance of our migration assumption, net inward migration has fallen significantly since the referendum, most probably reflecting weaker 'pull factors' – the lower value of sterling has made it less attractive for

foreigners to work here, while job creation in the rest of the EU has also picked up. This suggests that there is now a greater chance of the Government's aspiration being met than in the past.

Reassessing the impact of the vote to leave

In its Economic and Fiscal Outlook November 2016, the OBR forecast that the impact of leaving the EU would increase Government borrowing by £58 billion over the forecast period. It has not since revisited this assessment. However, as 2018 progresses, the Committee judges that the ability to revise the November 2016 forecast is likely to be possible and the Committee recommends the OBR does so at the earliest possible opportunity. (Paragraph 41)

In our November 2016 *EFO*, we set out as transparently as possible those elements of the economy and fiscal forecast revisions that were related to the referendum vote and those that were not. This was possible because little time had passed since the referendum and it was therefore reasonable to assign certain elements of our forecast diagnostics into each category. The fiscal effect was estimated to be stable at around £15 billion a year from 2018-19 to 2020-21.

In our subsequent *EFO* in March 2017 we explained that "*We have not attempted to update the breakdown of our forecast revisions relative to an illustrative 'no referendum' scenario that we published in our November EFO. Over time, maintaining a meaningful counterfactual would be increasingly challenging – for example, how much of the movements in financial markets since November should be ascribed to participants reassessing the effects of Brexit and how much to other factors? The uncertainties to which such a counterfactual was subject would only increase.*" Another year on, this remains true, and not just in respect of financial market prices. It is equally a matter for debate how household and business spending have been affected by the vote.

Even if we were able to develop an economic and market counterfactual for the referendum going the other way, generating the associated fiscal counterfactual would be a lengthy and resource intensive process for the OBR and supporting departments, on the scale of that required for our annual *Forecast evaluation reports*.

It is also important to remember that the November 2016 analysis was an attempt to quantify the likely impact of the vote to leave, with Brexit itself assumed not to occur until half way though the forecast. So rerunning this analysis – even if it was possible to do so in a meaningful way – would be an attempt to answer the question 'What if we had never voted to leave?' rather than 'What if we change our minds now?' This might provide ammunition for Remainers and Leavers to refight old battles, but it would do little to clarify the outlook looking forward from our present position.

Transitional arrangements after Brexit

The OBR has stated that it still has no meaningful basis to judge the UK's final relationship with the EU, on which it can condition its forecast for the economy and the public finances. However, the absence in its forecasts of a step change in trade intensity at the point that the UK is expected to leave the EU (in March 2019) is consistent with a scenario where transitional arrangements are negotiated. The forecasts are not consistent with a reversion to WTO rules in March 2019, which would be likely to lead to a substantial negative trade shock from Q2 2019 onwards. (Paragraph 42)

Our trade forecasts assume that the net effect of Brexit will be to reduce the trade intensity of the UK economy. This can be seen in the assumptions underpinning our November *EFO*. Import intensity (the ratio of imports to import-weighted domestic demand) has risen steadily for several decades and by around 1 per cent a year on average since 2008. We assume it will fall by around 1 per cent a year from 2019 until beyond our five-year forecast horizon. The UK's export market share (the ratio of UK exports to UK-weighted world imports) has declined steadily for several decades and by just under 1 per cent a year since 2008. We assume the rate of decline will pick up to around 3½ per cent a year from 2019 until beyond the horizon.

These assumptions were calibrated by averaging the results of three major external studies published before the referendum.[1] In that sense, they are consistent with a range of possible outcomes. As we discussed when we gave evidence to you in November, our assumptions would not be consistent with a disorderly exit to WTO rules – 'crashing out'. But while they do assume a smooth adjustment to post-Brexit trading arrangements – in common with the Bank of England's latest projections – they are not predicated on a multi-year transition or implementation period coming into force after 29 March 2019, as the decline in trade intensity begins immediately.

Basing a forecast on the full Withdrawal Agreement

Parliament will need to be fully informed about the size and the direction of these economic and fiscal impacts before it comes to vote on the legislation giving effect to the withdrawal agreement. The independent OBR is best placed to provide this information. It should publish an economic outlook that incorporates the terms of the Withdrawal Agreement prior to Parliament's consideration of the planned Withdrawal Agreement and Implementation Bill. If the next scheduled forecasts, due to be published around November 2018, come either too early to incorporate the terms of the Withdrawal Agreement, or too late for Parliament's consideration of the Bill, the OBR should prepare a special forecast. The legislation setting out the OBR's statutory responsibilities requires

[1] Specifically, we took the average estimated effect from studies by NIESR (*The long-term economic impact of leaving the EU*, National Institute Economic Review no. 236, May 2016), the OECD (*The economic consequences of Brexit: A taxing decision*, OECD policy paper no. 16, April 2016) and LSE/CEP (*The consequences of Brexit for UK trade and living standards*, March 2016). These represented a subset of the many studies that were presented before the referendum.

the OBR to publish a minimum of two forecasts a year, but does not set an upper limit. (Paragraph 44)

Once a Withdrawal Agreement with the EU has been reached and published, we will be able to incorporate it into our subsequent forecasts. (Note that we will not need to wait until Parliament has passed the associated legislation, just as we incorporate Budget measures into our forecasts before passage of the corresponding Finance Act.) We would, of course, explain the impact of the Agreement as transparently as possible, relative to the Brexit assumptions in our previous forecast. But we could not present the impact relative to a counterfactual in which Parliament rejected the agreement, as that would represent the evaluation of an alternative policy (and potentially an incompletely specified one) and would thus contravene the Budget Responsibility and National Audit Act.

The Government will presumably take the parliamentary timetable for consideration of the Agreement into account when deciding the dates of the Autumn Budget and Spring Statement. It would not be practical to produce an additional forecast between the two, not least because this would require several weeks of detailed input from many analysts across HMRC, DWP and other departments, as well as the OBR.

The EU financial settlement

Members of the Government have repeatedly stated that the OBR has included the UK's financial settlement with the EU within its November 2017 forecast. This is not supported by the OBR's Outlook. The OBR has assumed that the UK's contributions to the EU budget are 'recycled' into domestic spending after March 2019, but it makes no judgement about the purpose to which these funds are deployed. The impact of the financial settlement on the public finances will depend on its size and the schedule of payments, neither of which are known at this point. It will also depend on the purposes to which the settlement is deployed. Until the final payments and scheduling are agreed, the Government cannot assume there will be additional money available for domestic spending. (Paragraph 75)

As the Committee's report notes, since the referendum we have made the fiscally neutral assumption that expenditure transfers to the EU will cease at the end of 2018-19, but will be replaced by unspecified domestic spending equal to the transfers that we would have made if the UK remained a member of the EU. As we noted in Annex B of our November 2017 *EFO*, there are many uncertainties over the composition of this substitute spending. We noted that the Government might decide to continue to contribute to the EU budget for some purposes, that it was likely to make payments under the financial settlement, and that it might replace EU spending in the UK on areas such as agriculture and science, and on overseas aid.

Since our previous forecast, the European Commission and the UK Government have issued their joint report on progress during phase one of the Article 50 negotiations. You have asked the National Audit Office to

consider the Treasury's estimate of the cost of the financial settlement outlined in the joint report. We will present our own estimate consistent with the assumptions in our central forecast in our March 2018 *EFO*. This will allow us to show the extent to which a financial settlement on these terms would leave additional money available for domestic spending, within the envelope implied by our current fiscally neutral assumption.

Stamp duty land tax relief for first-time buyers

The changes to Stamp Duty Land Tax (SDLT) in the Budget helps first-time buyers by reducing the sum of money needed to save to purchase a house. However, the OBR forecasts that just 3,500 additional first-time buyers over the forecast period will enter the market as a result of the policy change, at a cost of £3.2 billion. There needs to be a step change to helping first-time buyers purchase a home. (Paragraph 93)

The OBR forecasts that a permanent reduction in SDLT in isolation will increase the affected first-time buyer house prices by double the reduction in SDLT. The previous 'Stamp Duty Holiday', which was in operation from March 2010 to March 2012, was found by HMRC not to have increased affordability, and to have resulted in an increase in the number of first-time buyers of "between zero and two per cent". (Paragraph 94)

Let me take this opportunity to provide some further explanation of the assumptions that were incorporated into our November forecast:

- **House prices**: we assumed that the first-time buyer relief would increase house prices by 0.3 per cent. This refers to the average across all properties. The effect on first-time buyer purchases would be higher. As noted in the *EFO*, we assumed a 2-for-1 effect on prices from the SDLT saving – e.g. at £200,000 the SDLT saving is 0.75 per cent (£1,500) so the price increase would be 1.5 per cent (£3,000). This is a central estimate around which there is much uncertainty.
- **Additionality**: The 3,500 additional first-time buyers referred to in the *EFO* is a 'per year' figure across the five years of the forecast. It would be reasonable to assume that this effect would persist at about that level beyond the forecast period. This is our central estimate of the number of first-time buyer purchases that would not otherwise have taken place. Again, it is subject to uncertainty.

I have copied this letter to Richard Hughes, Director of Fiscal Group at the Treasury.

Robert Chote

Chairman