3 – Outlook for the public finances and options for the Autumn Statement

Key points

- In our main scenario we project that public borrowing will, in the absence of policy changes, be persistently higher than the OBR forecast back in March before the Brexit vote.
- In particular, we project a continuing budget deficit of around £67 billion this year, falling to around £18 billion in 2019/20 on unchanged policies rather than a £10 billion budget surplus in that year. In total, we project a cumulative public borrowing overshoot of over £100 billion by 2020/21 compared to the OBR's March forecasts.
- This would, however, still leave the Chancellor with a current budget surplus (excluding net investment) in 2019/20 and it seems likely that he will want to add to planned public investment in priority areas such as housing, transport infrastructure and NHS capital budgets in his Autumn Statement.
- Assuming an additional £20 billion (c. 1% of GDP) of net public investment spread over the period between 2017/18 and 2019/20, we estimate that the public debt to GDP ratio would still be on a downward trend from 2018/19 onwards, as well as retaining a current budget surplus of around £16 billion in 2019/20. This would meet a revised, more flexible set of fiscal rules more similar to those initially adopted by George Osborne in 2010, as opposed to his later more ambitious budget surplus target.
- While the Chancellor may boost public investment, he does not have the money for large net tax cuts and is likely to continue to bear down on non-investment spending by both central and local government.

Introduction

Back in March, the then Chancellor, George Osborne, looked on course to eliminate the budget deficit before the end of the current Parliament, based on projections by the Office for Budget Responsibility (OBR) that assumed a vote to remain in the EU. Since then, however, not only has the deficit not fallen as fast as hoped during the first half of 2016/17, but the Brexit vote has dampened growth projections for the next few years as discussed in Section 2 above.

The new Chancellor, Philip Hammond, has already said that he would 'reset' fiscal policy in the light of the Brexit vote, deferring the date by which he would seek to balance the books. He has also expressed his intention to boost public investment at a time when gilt yields are near record lows (despite some recent increases). But few details of these revised plans have been announced ahead of his Autumn Statement on 23 November.

In this article we present updated post-Brexit economic and public finance projections to 2020/21 and consider the Chancellor's options in the light of this revised outlook. The discussion is structured as follows:

Section 3.1	Describes our main scenario projections for the public finances after the Brexit vote and compares these with previous OBR forecasts
Section 3.2	Consider how the new Chancellor might amend his predecessor's fiscal rules
Section 3.3	Considers the scope for additional public investment within such a revised set of fiscal rules
Section 3.4	Discusses other high level options for the Chancellor in the Autumn Statement
Section 3.5	Summarises and draws conclusions from the analysis.

3.1 - Outlook for the public finances after the Brexit vote

Budget deficit estimates for 2016/17

Latest estimates indicate a budget deficit outcome of around £76 billion in 2015/16, just over 4% of GDP. Back in March, the OBR was estimating this would fall to £55.5 billion in 2016/17 and then improve relatively rapidly to an overall budget surplus of around £10 billion by 2019/20. This assumed continued real public spending cuts over this period and some net tax rises.

Even before the EU referendum, this pace of deficit reduction looked ambitious, and the latest data for the first six months of 2016/17 show the deficit for that period only £2.3 billion lower than in the same period in 2015/16. This is even before there has been time for any noticeable effect of the Brexit vote to feed through to tax revenues, given that the economy held up relatively well in the third quarter of the year. Projecting the latest data forward suggests a full year budget deficit of around £67 billion (3.4% of GDP) in 2016/17, which would be around £11.5 billion higher than the OBR forecast in March.

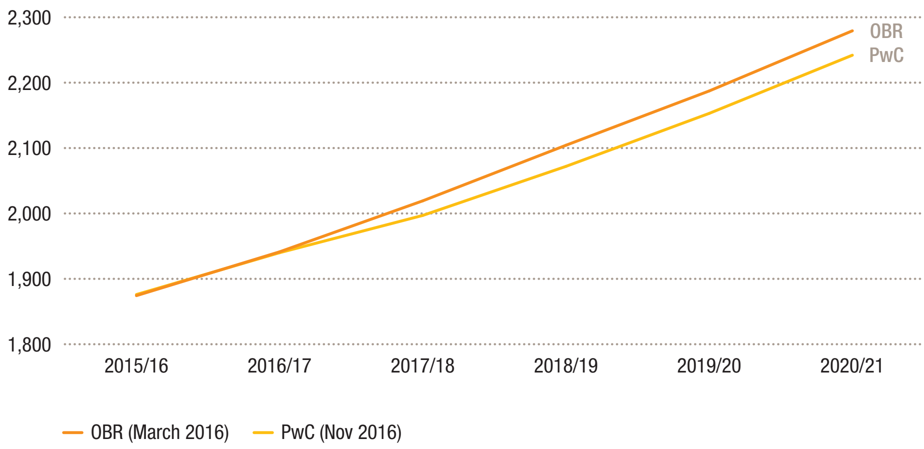
In itself this would not be a disaster and there is still considerable uncertainty around the full year outturn given that we are only half way through the fiscal year and self-assessment receipts are expected[1] to be relatively strong in January and February 2017. But the bigger question is what will happen to the public finances in the medium term.

Public finance outlook to 2020/21

The primary driver of tax revenues is economic growth in nominal (i.e. cash) terms. Extending forward our main scenario for UK GDP growth and inflation in Section 2 above to 2020/21, we can see that nominal GDP in 2020/21 might be around £40 billion, or just under 2%, lower than the OBR forecast back in March (see Figure 3.1). This reflects the expected medium term drag on real GDP growth from the Brexit vote, offset in part by higher inflation[2].

Of course, nominal GDP is not the only driver of the public finances. There could be some offsetting influences from lower government bond yields, so reducing interest costs for future gilt issues, and the fact that the major drag on growth is expected to come from reduced business investment more than from lower consumer spending. The latter is more 'tax rich' (at least in the short to medium term), since it is a key driver of VAT and other indirect tax revenues, whereas lower business investment also implies lower deductible capital allowances for corporate tax purposes.

Figure 3.1 – Our latest nominal GDP projections vs OBR pre-Brexit forecasts (£bn)



Source: ONS, OBR, PwC

1 Based on analysis of the latest public finance data by the OBR here: http://budgetresponsibility.org.uk/docs/dlm_uploads/October-2016-Commentary-on-the-Public-Sector-Finances.pdf
2 Note, however, that the relevant inflation measure here is the Gross Domestic Product (GDP) deflator, which will tend to be less sensitive to import price rises than other inflation measures such as the CPI or RPI.

Stock markets have also risen since the Brexit vote, which will boost tax revenues from stamp duty and financial sector incomes and profits, although any Brexit-related dampening of the UK property market would have an offsetting negative impact on stamp duty revenues from that source. There will also be a net saving of around £6 billion of net annual contributions to the EU budget from 2019/20 onwards.

Allowing for these various factors, our latest projections for key public finance aggregates are summarised in Table 3.1, which also shows the OBR's March 2016 central forecasts for comparison. We find that:

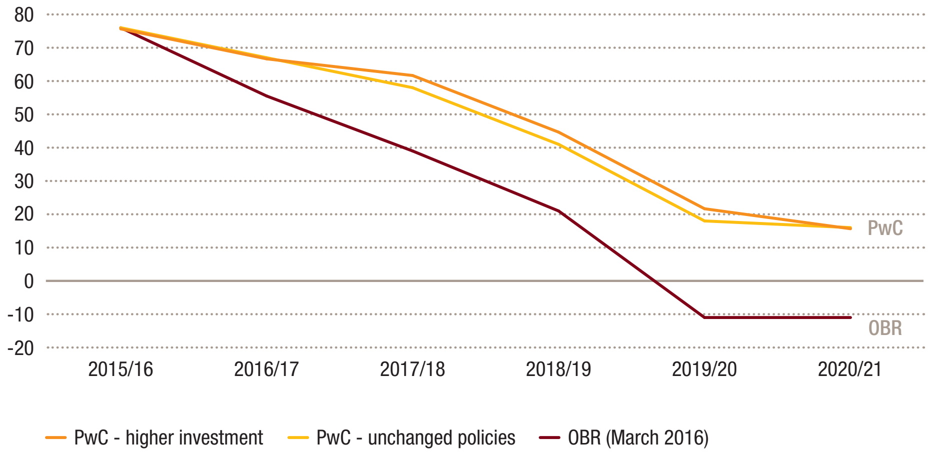
- public borrowing looks to be on track to overshoot the OBR forecast by more than £10 billion this year, coming in at around £67 billion (3.4% of GDP) in our main scenario;
- by 2019/20 and 2020/21, the projected public borrowing overshoot rises to around £25-30 billion (see Figure 3.2), with a budget deficit of just under 1% of GDP by the end of the period compared to a budget surplus of 0.5% of GDP as projected by the OBR in March;
- cumulatively, the public borrowing overshoot is projected to be around £106 billion over the five year period to 2020/21 (with unchanged tax and spending policies); and
- this implies a public sector net debt to GDP ratio that peaks at just under 85% of GDP next year and then declines only gradually to around 81% of GDP by March 2021, as compared to an OBR forecast that the debt ratio would be down to around 75% of GDP by that time; nonetheless, the debt ratio would still be on a downward path from 2018/19 onwards based on our projections.

Table 3.1: Comparison of PwC and OBR public finance projections (unchanged policies)

	2016/17	2017/18	2018/19	2019/20	2020/21
PwC main scenario (Nov-16)					
Real GDP growth (%)	1.9	1.1	1.6	2.0	2.1
Public sector net borrowing (£bn)	67	58	41	18	16
Public sector net borrowing (% GDP)	3.4	2.9	2.0	0.9	0.7
Current budget deficit (% GDP)	1.7	1.1	0.4	-0.6	-1.2
Cyclically adjusted budget deficit (% GDP)	1.5	0.6	-0.3	-1.3	-1.8
Public sector net debt (% GDP)	84.3	84.5	84.1	82.6	81.2
OBR forecast (Mar-16)					
Real GDP growth (%)	2.0	2.2	2.1	2.1	2.1
Public sector net borrowing (£bn)	56	39	21	-11	-11
Public sector net borrowing (% GDP)	2.9	1.9	1.0	-0.5	-0.5
Current budget deficit (% GDP)	1.0	0.2	-0.6	-1.9	-2.3
Cyclically adjusted budget deficit (% GDP)	0.9	0.2	-0.6	-1.9	-2.3
Public sector net debt (% GDP)	82.6	81.3	79.9	77.2	74.7

Source: OBR central forecast (March 2016), PwC main scenario with unchanged tax and spending policies (November 2016)

Figure 3.2 – Alternative public borrowing projections vs OBR's pre-Brexit forecasts (£bn)



Source: ONS, OBR, PwC

3.2 - Possible revisions to fiscal rules

The government's fiscal rules have gone through a number of evolutions over the past twenty years, as summarised in Table 3.2.

The new Chancellor, Philip Hammond, has indicated that he will relax George Osborne's fiscal rules, specifically the objective of eliminating the overall budget deficit by 2019/20. There are various options here, but we think that a plausible approach may be to revert to something similar to George Osborne's initial fiscal rules from 2010-14, with an interim aim to:

- eliminate the current budget deficit[3] (excluding net public investment) by 2019/20; and
- establish a clear downward trend in the public sector net debt to GDP ratio by 2019/20.

Both of these targets would be achieved based on our projections in Table 3.1 for unchanged tax and spending policies. The aim of an overall balanced budget could be left for the longer term since achieving this is likely to require going beyond the OBR's normal forecast horizon and would also take us beyond the next scheduled General Election in May 2020.

A question then arises as to how far these targets would allow the new Chancellor scope to relax fiscal policy at least temporarily in order to support the economy over the next few years as the UK negotiates its exit from the EU. Mr Hammond has, in particular, suggested that increased public investment in areas like housing and transport infrastructure could be a focus of any such fiscal relaxation, given these are also desirable from a longer term supply side perspective. So how much room for manoeuvre might the Chancellor have here?

Table 3.2: Evolution of the government's fiscal rules since 1997

Chancellor	Deficit target	Debt target	Assessed by:
Gordon Brown (1997-2007)	Current budget in balance or surplus on average across economic cycle (backward looking)	Public sector net debt to GDP ratio not higher than 40%	HM Treasury
Alastair Darling (2007-2010)	Initially the same fiscal rules as above, but suspended after the global financial crisis		HM Treasury
George Osborne (2010-2014)	Cyclically adjusted budget surplus by end of rolling 4 year forecast period	Public sector net debt to GDP ratio starts falling again no later than March 2015	OBR
George Osborne (2015-2016)	Overall budget surplus by 2019/20	Declining trend in public sector net debt to GDP ratio	OBR

Source: HM Treasury

3 In his initial rules, George Osborne focused on the cyclically-adjusted current budget deficit, which would be slightly easier to eliminate by 2019/20. But this is not critical to our analysis and we suspect Philip Hammond may prefer the conceptually simpler and somewhat tougher target of eliminating the actual current budget deficit, without getting into the complexities of cyclical adjustment methodology (even though this is now delegated to the OBR).

3.3 - How much scope might the Chancellor have for higher public investment?

To investigate this issue we have considered a potential increase in public investment, relative to previous plans from the March 2016 Budget, of £20 billion (c.1% of GDP). We assume this would be spread evenly over the three year period from 2017/18 to 2019/20 (i.e. around £6-7 billion extra per annum), so it is relatively modest in macroeconomic terms.

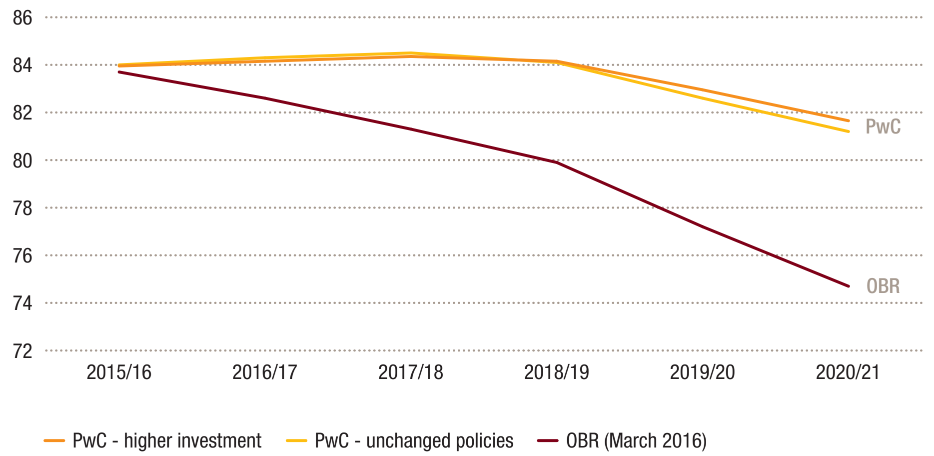
This temporary stimulus programme would aim to bolster the economy and offset a potential dampening of private sector investment during a period when uncertainty around the outcome of the UK-EU negotiations and the immediate aftermath of actual UK exit from the EU would be at a maximum. It would also cover the period up to the next General Election in May 2020, beyond which the current government cannot make firm spending commitments.

We model the impact of this based on an assumed first year fiscal multiplier of 1, so that GDP rises in line with the increase in public investment relative to previous plans. Tax receipts also rise, but by less than the increase in public investment spending since they are only around 36% of GDP. So there is some net increase in the budget deficit (see Figure 3.2), but not by the full amount of the increase in public investment. The current budget deficit actually falls slightly due to the boost to tax revenues from the temporary rise in GDP. Since the increased in investment is time-limited, however, there is no material effect on tax revenues or GDP after 2019/20[4].

In the medium to long run, the main fiscal effect of public investment would be an increase in the total public debt stock to finance this additional spending. However, as shown in Figure 3.3, we estimate that this effect would be relatively small, with the net public debt to GDP ratio in March 2021 being just 0.5% of GDP higher than without this extra investment and still on a clear downward path from 2018/19 onwards.

Our conclusion from this modelling exercise is that a public investment increase of this relatively modest scale – i.e. £20 billion in total over 3 years – would remain consistent with the suggested revised fiscal rules we discuss above and would not put longer term fiscal sustainability under threat.

Figure 3.3 – Alternative public sector net debt to GDP ratio projections vs OBR's pre-Brexit forecasts (%)



Source: ONS, OBR, PwC

4 In practice, we might expect some boost to GDP in the long run from a larger public sector capital stock, but these effects would be relatively small in macroeconomic terms over the period to 2020, so we do not consider them here.

Indeed a larger programme of additional investment might be considered, but the Chancellor may not wish to go too far in his first major fiscal statement, bearing in mind that gilt yields have risen somewhat since their mid-August lows. While still very low by historical standards, this does suggest some nervousness in international bond markets about gilts, which is linked to the weakness of the pound since the Brexit vote.

So it may be prudent for the Chancellor to proceed with caution here – if the markets react well to a measured rise in public investment of this kind, then he would retain the option of going further later if the economy (and particularly private investment) weakened more than expected during the next few years.

We think this extra public investment should be focused on supply side priorities such as housebuilding and repairs and maintenance to roads and railways that can proceed relatively quickly, rather than longer term megaprojects that would not have the same supportive impact on the economy over the next few years. This could be linked to the wider aim of boosting productivity growth through better infrastructure, including in the North and Midlands regions of England, which we would expect to be a key focus of the government's new industrial strategy[5].

Some increase in capital spending budgets may also help ease the pressure on NHS finances at present. As argued by the NHS Confederation recently[6], this could be focused on additional one-off investment in buildings and equipment to help achieve the objectives of Sustainability and Transformation Plans (STPs).

3.4 - Other high level policy options for the Autumn Statement

It is beyond the scope of this article to look in detail at all the other possible options for the Chancellor. As we have argued previously[7], there are several possible areas of tax policy reform that merit attention (e.g. as regards greater integration of income tax and national insurance, VAT and a more general measure to make the tax system simpler and more efficient). However, such reforms typically create both winners and losers and the Chancellor has limited funds at his disposal now to compensate the losers.

We may therefore get consultations on future tax reforms, including next steps on fiscal devolution, rather than immediate action, which would be deferred to the 2017 Budget or later. This would also be desirable from the perspective of allowing businesses and individuals both a say in the process and time to prepare for any changes that may be enacted in future. The Chancellor is also likely to talk more about the Making Tax Digital initiative[8], which envisages HMRC moving to a fully digital tax system by 2020 in order to boost both cost efficiency and ease of use for taxpayers.

On the spending side, overall real current (i.e. non-investment) spending growth is likely to remain relatively subdued over the next few years, broadly in line with George Osborne's previous plans. There may be some reallocation of funds to reflect the priorities of the new government, including settlements for new departments – DExEU and DIT – although the latter would mostly involve reallocations of money and staff rather than requiring large additional expenditures in macroeconomic terms. There will also be a renewed emphasis on efficiency improvements, including greater use of digital technology across the public sector, which has great potential as discussed in our recent report on 'Gov Tech'[9].

But, as with tax, the Chancellor has limited room for manoeuvre on current spending if he is to meet our suggested revised target to eliminate the current budget deficit by 2019/20. Although our central projections (see Table 3.1) suggest that he could meet this target with a margin of around 0.6% of GDP, this is considerably smaller than the uncertainty surrounding any such forward projections, particularly at present in the aftermath of the Brexit vote.

5 Although we would note that key elements in this, such as boosting skills, will require more than just capital spending.
6 See the NHS Confederation submission to HM Treasury here: http://www.nhsconfed.org/resources/2016/10/autumn-statement-2016-nhs-confederation-representation
7 See our 'Paying for Tomorrow' website for more details of these ideas, which spring from discussions with business people, a citizens' jury and students, as well as PwC tax experts: http://www.pwc.co.uk/issues/futuretax.html
8 As set out here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/484668/making-tax-digital.pdf
9 You can find further details of this report here: http://www.pwc.co.uk/govtech.html

3.5 - Summary and conclusions

The Chancellor has said that he intends to reset fiscal policy plans in the aftermath of the Brexit vote, but he clearly faces some constraints in doing so as we estimate that there may be a cumulative public borrowing overshoot of over £100 billion over the next five years based on unchanged tax and spending policies.

However, this fiscal outlook would still see the overall deficit declining to below 1% of GDP by the end of the Parliament, and we think this should still meet a plausible revised set of fiscal rules based on eliminating the current budget deficit by 2019/20 and getting the public sector net debt to GDP ratio back on a clear downward path by that time.

Indeed, we see room for the Chancellor to continue to meet these rules even if he decided to raise public sector investment by a cumulative £20 billion over the next three years (i.e. around £6-7 billion per year), helping to offset potential weakness in private sector investment during the uncertainties of the UK-EU negotiations over Brexit. By focusing on short term projects aimed at achieving long term supply side objectives to boost housebuilding and transport infrastructure reliability, we believe the Chancellor could craft a credible package for the Autumn Statement that would not unsettle the financial markets.

The Chancellor would need to exercise some caution on the scale of such extra investment, however, and also maintain a tight grip on non-investment spending. Any tax cuts are likely to need to be broadly balanced by tax rises. Resetting fiscal policy needs to be seen to be consistent with maintaining longer term prudence in managing the public finances.

The Design Group 31267 (11/16)