Autumn Statement briefing:

Osborne's New Choice

Key points

- Figures from the Office for Budget Responsibility show that the Government is **planning to go further than its fiscal mandate** to eliminate the structural deficit within five years;
- As of earlier this year, this means it is targeting a surplus on the structural current budget of **£15bn by 2017/18**;
- The Autumn Statement will show us whether the £15bn structural surplus may be **even higher** by 2018/19;
- The reasons for this structural surplus are not clear, but it is likely that the Government is seeking to put money aside to deal with the **long-term challenges of an ageing population**, which look set to drive public spending and debt up again in the 2030s;
- A better way to meet these long-run challenges is to spend the structural surplus on **productivity-enhancing measures**, like investment in skills, research and childcare;
- The Chancellor has a choice to make about how he meets the long-term economic challenges: **more cuts or more investment**.

Introduction

The Chancellor will deliver his fourth Autumn Statement against a backdrop of the strongest economic growth since the middle of 2010. In contrast to last year's Autumn Statement, Mr Osborne will be able to present a positive message about the outlook for the UK economy.

The Autumn Statement will give us revised UK growth forecasts from the Office for Budget Responsibility (OBR). This will enable us to examine what progress has been made towards the Government's fiscal mandate of eliminating the

structural deficit (the part of the budget deficit that remains when the economy has recovered). It will also enable us to explore the implications of the proposed **budget surplus** in more depth.

On spending plans, the Autumn Statement is likely to provide further detail on how the Government will pay for the pledges made by the coalition partners during the party conference season on free school meals and tax breaks for married couples. But, despite the better economic outlook, it is expected that the Chancellor will talk of **continued austerity** throughout the next parliament, a sentiment echoed recently by the Shadow Chancellor. The reason for this approach, as the Chancellor said in his party conference speech, is to "*fix the roof when the sun is shining*".[1] He suggested that this would be achieved exclusively by cuts rather than a mixture of cuts and tax rises.

Even on previous OBR numbers, the Chancellor was planning to go much further than just balancing the books over the course of an economic cycle. Cuts have been penciled in that would lead to a **structural surplus of £15 billion** by 2017-18.

This short briefing examines the impact of the improved economic outlook on the Chancellor's fiscal plans, explores the rationale for targeting a structural surplus and the implications of it.

Perhaps the most persuasive reason for targeting a structural surplus is the long-term challenge for public spending due to an ageing population. What we show in this note though, by reference to the OBR's long-range forecasts, is that this challenge could equally be eased by investing to increase the productivity of our economy. The Chancellor faces a new choice: cuts to put aside money starting in 2017-18 for the future; or investment in productivity-enhancing measures that would set the economy and public finances on a more stable footing.

What will the OBR say about the underlying health of the economy?

The Coalition entered Government in 2010 with a mandate to eliminate the structural deficit over a rolling five-year period. The non-structural, or cyclical, element of the deficit was not part of the target as this is expected to recede as the economy recovers.

[1] George Osborne's speech to the 2013 Conservative Party Conference

However, due to poorer than expected growth, the target date for eliminating the structural deficit was moved forward from 2014/15 to 2016/17, meaning further cuts of over £30 billion[2] in departmental spending were pencilled in for the next parliament.

The Autumn Statement will see the OBR deliver its Economic and Financial Outlook (EFO). In this document the OBR will detail updated growth forecasts and will evaluate whether the current trajectory of public spending will leave the Government on track to fulfil its fiscal mandate to eliminate the structural deficit.

So far, borrowing in 2013 is looking better than was expected back in March and growth has picked up. Some forecasters have predicted significantly lower borrowing over the next five years. But the OBR's judgement on the state of the structural finances will be based on its crucial assessment of whether the growth we have seen recently is due to a faster recovery with the underlying health of the economy unchanged; or whether it also reflects a rise in the economy's productivity.

The former assessment would leave the Chancellor in a similar position; the latter would give more room for spending and less austerity. It is unclear which way the OBR will go. Household consumption and retail sales have been growing consistently over the last few quarters, but this has coincided with a rise in unsecured borrowing by households, suggesting that there is little reason to think that recent growth has reflected better underlying health. Independent forecasters are at odds on what the recent GDP numbers mean for the state of the economy, with little overall change since the last OBR forecast.

But, assuming that the OBR calculates that the underlying state of the economy is unchanged, then the Chancellor will still be looking for the same level of cuts after the next election. The SMF will be publishing a response to the new figures on the day of the Autumn Statement.

[2] In today's prices

What will the Chancellor be talking about in his speech?

Before going any further, it is useful to define various related terms: borrowing, deficit and structural deficit.

Total **borrowing** is made up of borrowing to finance capital investment and borrowing to finance current spending. The **deficit** on the current budget refers to current spending only. The **structural deficit** is the part of the deficit that won't disappear as the economy recovers is calculated based on estimates of the **output gap,** which is the amount of spare capacity in the economy.

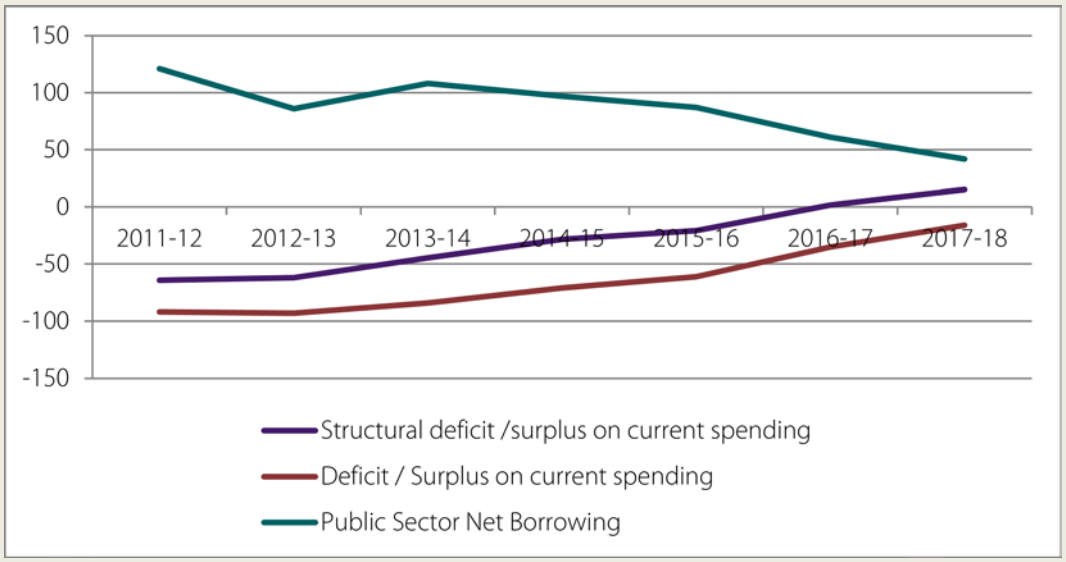
The Coalition Government came into power in 2010 with a plan to repair the public finances: its central mandate to achieve this goal was to eliminate the structural deficit within a rolling five year period. So the fiscal mandate only refers to the *structural deficit*. There is good reason for this, as this focuses attention on spending that won't disappear as the economy recovers.

A structural approach means spending more in a downturn and less in an upturn with the overall effect of balancing the budget over the course of an economic cycle. The structural deficit therefore provides an indication of the medium-term health of the finances.

But in past Autumn Statement and Budget speeches, the Chancellor has often referred to the deficit and borrowing. Neither of these are in the actual mandate, and although they are related, often paint a slightly different picture of the public sector finances. For example, in the last OBR forecast the headline deficit was consistently larger than the structural deficit as it was assumed that the economy would still be below trend throughout the five-year period. It was forecast that in 2017-18 we would no longer have a structural deficit – we would have a structural surplus, as shown in the graph below.

In the first Spending Review speech in 2010, George Osborne referred to the structural deficit or the structural current budget three times. But in his last Spending Review speech in June, he did not refer to it at all – and spoke only about the deficit. But the structural deficit is what matters if we want to know the level of cuts that need to be made.

Chart: The state of the public finances (OBR's last assessment)

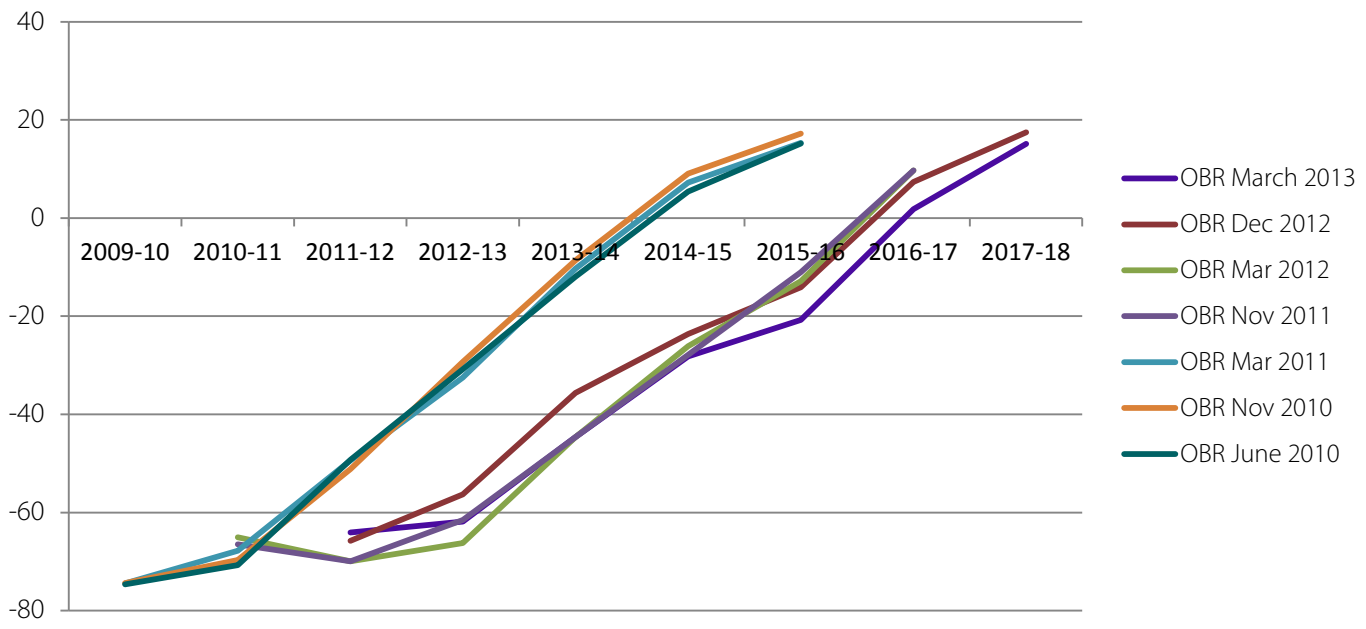


Source: OBR Economic and Fiscal Outlook, March 2013

Targeting a Budget Surplus

As Chart 1 below shows, the figures behind the Government's fiscal plans have always revealed that the Government would not stop at simply eliminating the structural deficit, but that it would instead go further, taking the structural current budget into surplus after five years.

Chart 1: Structural deficit / surplus on current spending (£bn)



That the Government is targeting a surplus was made more explicit at this year's party conferences, with the Chancellor stating that "*Our goal is to achieve a surplus in the next Parliament.*"[3]

While the Liberal Democrats are reported to have said that they will not sign up to this tough new fiscal mandate[4] , in his speech the Chief Secretary to the Treasury hinted that austerity would continue even once the structural deficit has been eliminated. He said: "*It will be another five years shaped by the necessity of fiscal restraint.*"

[3] http://www.politics.co.uk/comment-analysis/2013/09/30/george-osborne-s-conference-speech-in-full

The March OBR figures show that the Government is targeting a structural surplus on current spending of £15bn by 2017/18. Targeting a structural surplus means aiming for more cuts than are needed simply to balance the books over the course of an economic cycle. On 5th December, we will find out whether the Government is planning to go even further.

Why target a surplus?

Although the concept of a structural surplus on the current budget can seem a slippery one, exploring the rationale for it goes to the heart of the debate about austerity. Is the only purpose of austerity to balance the books, or is it an economic choice that regards cutting spending as the best way of achieving future prosperity?

While we do know that the size of the structural current budget surplus is set to be £15bn by 2017/18 on the OBR's forecast back in March, we know very little about the Government's rationale for targeting it, or indeed whether this is the limit of austerity or if there is even more to come.

Indeed different members of the Coalition have each hinted at different reasons. George Osborne in his speech to the 2013 party conference billed it as "*insurance for the difficult times ahead*", David Cameron said it was because another banking crisis could "*tip us over the edge*"[5], and Danny Alexander made clear that the "*pressures of an ageing and growing population will have to be paid for*".

There are three main reasons we have identified that a Government may wish to target a structural surplus:

Caution: In practice, calculating the structural deficit requires an estimate of the output gap. But the output gap is notoriously hard to estimate: the latest estimates of the output gap in 2013 by independent forecasters range from -0.8% to -6.5% of GDP.[6] To put this in perspective, the OBR calculated that just a 1 percentage point change in the estimate of the output gap would change the size of the structural deficit or surplus in 2017-18 by £13-15 billion.

A way to mitigate against this uncertainty is to target a structural surplus on current spending which could be used to cover the reality that this part of the deficit is higher than previously thought.

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[4] *Billions more to be cut from welfare cash before 2020 in Tory pledge for budget surplus,* The Independent, 30 September 2013

[5] *David Cameron: It's responsible to target budget surplus*, BBC, 1 October 2013

[6] *Forecasts for the UK economy: a comparison of independent forecasts*, HM Treasury, November 2013

Efficiency: Cuts to public spending are an opportunity to transform and reform services, making them more efficient and better at delivering value for money. Continued cuts to welfare may also be part of a wider strategy to improve the incentives for taking up work or to force increased self-reliance.

Long-run fiscal challenges: the OBR's long-term projection for the UK economy shows that although the debt-to-GDP ratio is set to fall from 2017-18 and throughout the 2020s, long-term trends such as the ageing population will drive public spending and debt up again in the 2030s. So targeting a larger structural surplus on current spending could be intended to reduce debt and put aside public money for the future.

Are cuts the best way to manage long-run fiscal challenges?

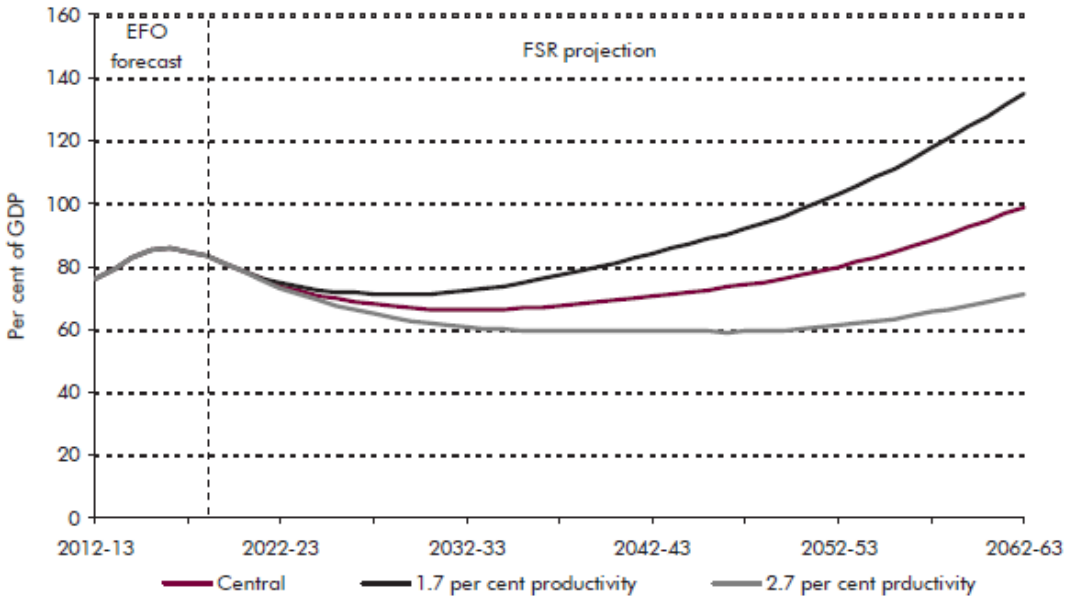
According to the OBR's fiscal sustainability work, changes in productivity can have a major impact upon the public spending of the future, as the chart below shows. While on the central case, debt as a proportion of GDP begins to rise again in the mid-2030s, if the UK was to achieve higher productivity growth than the central case, debt would remain lower.

The challenge for the UK at the moment is that productivity growth is sluggish. After actually falling for a year, it was running at only 0.5% as of 2013 Q2. Even before the crisis, in 2006, productivity only grew by 1.8%.[7] And recent evidence from the OECD, for example, confirms long-standing weaknesses in skills and education.[8] Without a very significant improvement in productivity, public sector debt will start rising even earlier than the 2030s and will be above 100% of GDP by the middle of the century.

[7] Whole economy output per worker, ONS Labour Productivity Statistical Bulletin, Q2 2013, September 2013

[8] *Better Life Index*, OECD, November 2013

Chart 2: Public sector net debt under different assumptions about productivity growth



Source: OBR

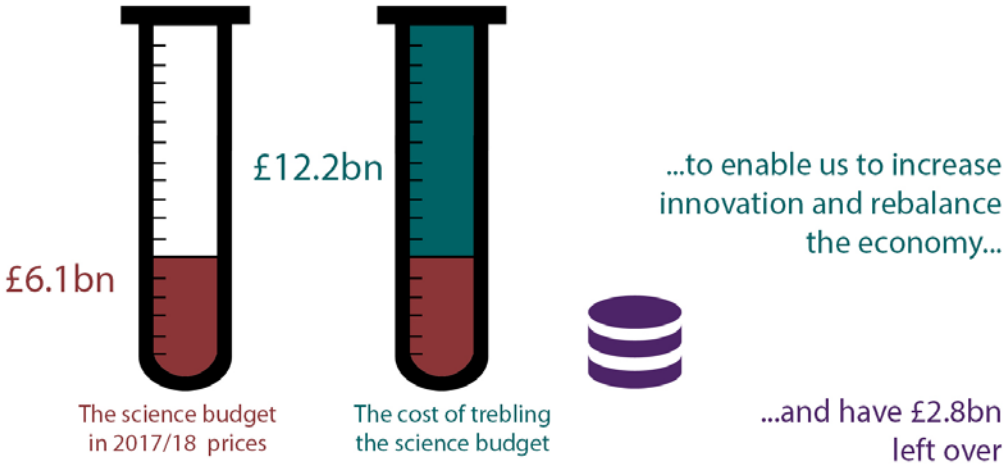
Policy and spending choices can shape the future of productivity growth and help the UK to do better than the central case scenario that the OBR has forecast. Rather than making further spending cuts through to 2017-18, it may be possible to invest more in skills, higher education, research and infrastructure and drive up future productivity. If that strategy was well designed and executed, then it may be possible to keep future debt down to 60% of GDP until well into the second half of the century. Cutting now might cost us in the future.

However, even if the path ahead is to target a structural surplus rather than spend more to boost our productivity, there is debate to be had about how any structural surplus might be achieved. The Chancellor's party conference speech suggested that – if re-elected – the Conservative Party would focus on achieving the structural surplus through spending cuts alone rather than using tax rises as well. This would put further pressure on unprotected areas of public spending and perhaps make the ring fences around health and education impossible to maintain. This would mean cuts to healthcare going beyond the £34bn of savings, as we have previously identified[9], that the NHS already has to find to live within a protected 'flat real' budget.

[9] *SMF briefing: Spending Review 2013*, Social Market Foundation ,June 2013

What could the Government do with £15bn per year?

Spend three times as much on science...



Baseline science research budget based on plans for 2015-16, as announced in HM Treasury, *Investing in Britain's Future*, June 2013

or...

Provide universal free childcare...

Estimated cost of universal childcare based on IPPR, *Making the Case for Universal Childcare*, December 2011

or…

Baseline overall adult skills and FE budget based on 2013/14 levels, as set out in BIS, Skills Funding Agency, Skills Funding Statement 2012-15, December 2012

Another way to spend the structural surplus, especially for a Conservative Chancellor, would be to bring in a series of tax cuts to enhance the competitiveness of the economy and increase investment in the UK. Some Conservative MPs are already urging this course of action[10].

What will the Autumn Statement tell us about the budget surplus?

The OBR's verdict on the nation's finances at the Autumn Statement will give us more information to help assess the Government's rationale for the structural surplus. While the last OBR figures suggested that the intended structural surplus is £15bn by 2017/18, we do not know if the Government intends to keep making savings at the current rate or if they will stop once this target has been hit. The Autumn Statement will show what the projected surplus will look like into 2018/19, giving us an indication of the Government's plans, and will give us any updates since March.

[10] *Cut benefits cap to £20,000, say Tories*, Daily Mail, 19 November 2013

If we see targeting of an even higher structural surplus well into 2018/19 we might surmise that the Government intends to keep adding to the surplus throughout the lifetime of the parliament. But even if it continues to target the same level as has previously been set out, there are still questions to be answered around how the Government envisages tackling our long-term fiscal challenges and what the alternatives are.

Conclusion

Our analysis has shown that the Government is planning to go further than its fiscal mandate to eliminate the structural deficit within five years. By targeting a structural surplus of £15bn by 2017/18 it is clear that austerity will continue well into the next parliament.

There may be good reasons to seek to put aside public money for the future. The challenges posed by an ageing population are immense and almost certainly mean more public debt in decades to come. However, public spending cuts are not the only way to manage this. Investment in areas such as skills and infrastructure could significantly increase the long-run productivity of the UK economy.

Whatever the rationale for the Government's fiscal plans, the case for a surplus should therefore be weighed up against the opportunity cost of investment in increased productivity. We need an open and honest debate about whether or not more austerity is the best way to manage the challenges ahead. Osborne has a new choice to make: cuts or investment. We suggest he opts for the latter.