



BRIEFING PAPER

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Autumn Statement 2016: Background briefing

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Summary

This briefing sets out the background to the [2016 Autumn Statement](#) which will take place on Wednesday 23 November 2016. The Office for Budget Responsibility (OBR) will publish revised forecasts for the economy and public finances on the same day.

Economic situation

The EU referendum has so far had little effect on overall economic growth. Consumer spending has continued to underpin growth, while business investment has been weak.

Forecasts for growth, however, are less optimistic. The steep fall in the pound following the referendum has increased import prices. This is starting to impact on prices along the supply chain. Economists expect the result to be consumer price inflation rising above 2% by mid-2017, and closer to 3% by end-2017.

Higher inflation would reduce the purchasing power of consumers, potentially leading to slower growth in their spending. This is expected to lead to more modest GDP growth in 2017 despite a potential boost to exports from sterling's decline. Growth forecasts from private sector economists for 2018-2020 have also been lowered since the Budget in March the EU referendum. As a result, we can expect the OBR to lower its growth forecasts as well.

Brexit-related uncertainty and prospects for lower growth led the Bank of England to cut interest rates in August. The Bank has also expanded its quantitative easing programme, whereby it creates new money in order to buy financial assets from financial institutions.

Public finances

In 2015/16 the government had to borrow £76 billion to make up the difference between its spending and income. Despite halving since its 2009/10 peak the UK's borrowing – often referred to as the deficit – remains large relative to other nations.

Since the EU referendum, forecasters have increased their forecasts for government borrowing in response to predictions of lower economic growth. The OBR are expected to do the same.

At over 80% of GDP, public sector net debt – largely the stock of borrowing arising from past deficits – remains relatively high by recent and international standards. The OBR's March 2016 forecast saw the debt-to-GDP ratio falling each year. Forecasts made, by other forecasters, since the EU referendum have cast some doubt over whether the debt-to-GDP ratio will fall in each of the next five years.

New fiscal targets

The Chancellor is set to drop, or amend, at least one of the Government's three targets for the public finances in the Autumn Statement. The target to eliminate borrowing by 2019/20 – in other words, to reach a budget surplus – was abandoned following the EU referendum and is likely to be replaced. The Chancellor may also take the opportunity to change the debt target and welfare cap, both of which have already been breached.

The Chancellor has not said anything definitive on what the new targets might be. However, he has discussed some wider objectives for fiscal policy that the targets may reflect. The Chancellor: still wants to seek a budget surplus in the future; wants to control day-to-day spending and debt; and, may seek to find 'headroom' for a fiscal stimulus if the economy needs one. A fiscal stimulus would see the government increase spending or reduce taxes with the aim of stimulating economic growth.

Infrastructure

Many economists and industry bodies have been calling for the Government to increase spending on infrastructure. These calls are made against the backdrop of historically low government borrowing costs.

Infrastructure looks a likely candidate for additional spending if the Chancellor thinks the economy needs a fiscal stimulus. The Chancellor has indicated that he sees the need for some targeted and time-limited increases in this area of spending.

Other information

The Government is expected to publish the Low Pay Commission's report on the National Minimum Wage on the same day as the Autumn Statement.

The Library will publish an Autumn Statement edition of [economic indicators](#) on 22 November 2016.

The Government has said it will publish a National Shipbuilding Strategy by the Autumn Statement. Further information is available in library briefing paper [The Royal Navy's new frigates and the National Shipbuilding Strategy](#).

The Office for National Statistics will publish [Public Sector Finances for October 2016](#) on 22 November. The Library will summarise the key data in our briefing [Public Finances: Key Economic Indicators](#).

The Library will publish a summary of the Autumn Statement on the evening of 23 November.

Look out for Autumn Statement related blogs on the Library's blog, [Second Reading](#).

1. Economic situation

Summary

Overall economic growth has so far proved to be little affected by the EU referendum. Quarterly GDP growth of 0.5% seen in the three months following the vote was the same as the average recorded since 2012. Consumer spending has continued to underpin growth, while business investment has been weak.

Forecasts for growth, however, are less optimistic. The steep fall in the pound following the referendum – down by 13% since then and 17% compared with a year ago – has increased import prices. This is starting to impact on prices along the supply chain. Economists expect the result to be consumer price inflation rising from its current rate of 0.9% to above 2% by mid-2017, and closer to 3% by end-2017.

Higher inflation would reduce the purchasing power of consumers and, in turn, likely lead to slower growth in their spending. Given that economic growth has been dependent on consumers, this is expected to lead to more modest GDP growth in 2017 (the latest consensus forecast is 1.1%) despite a potential boost to exports from sterling's decline. Growth forecasts from private sector economists for 2018-2020 have also been lowered since the Budget in March and the EU referendum. As a result, we can expect the OBR to lower its growth forecasts as well.

Brexit-related uncertainty and prospects for lower growth led to the Bank of England cutting interest rates from 0.5% to 0.25% in early August. The Bank also expanded its quantitative easing programme, whereby it creates new money in order to buy financial assets from financial institutions, from £375 billion to £445 billion (including £10 billion of corporate debt).

1.1 Recent growth

In the three months following the 23 June vote to leave the European Union, the economy continued to grow in line with its pre-referendum performance. Quarterly GDP growth of 0.5% in Q3 2016¹ was faster than many had expected, particularly when compared with forecasts made in the run-up to the referendum and in its immediate aftermath.²

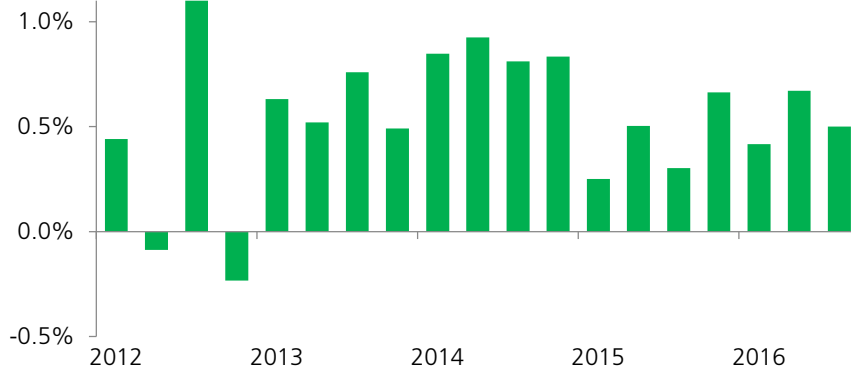
Post-referendum
GDP growth was
0.5% in Q3 2016.

¹ Q3 refers to the third quarter of the year: the three-month period of July-September.

² A [survey of economists](#) by Consensus Economics in September found that the consensus forecast was for a small contraction in Q3 2016 GDP. A [survey by Bloomberg](#) shortly after the referendum found that 71% of economists expected a recession (two successive quarters of negative growth) following Brexit – almost all expected this to be in 2016 or 2017.

Quarterly real GDP growth

% change in real GDP on previous quarter



Source: ONS, series ABMI

Compared with the same quarter a year ago, GDP growth was 2.3% – the largest increase since Q2 2015. Full-year growth in 2016 is now expected to be around 2%, compared with 2.2% in 2015 and 3.1% in 2014.³

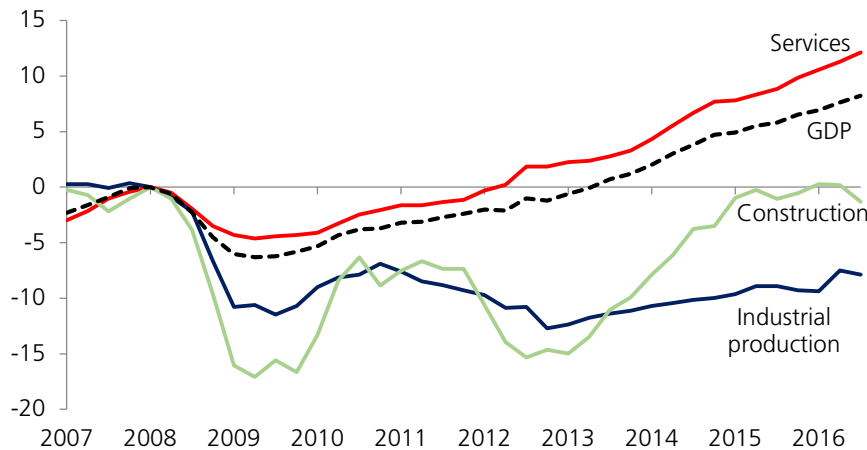
Quarterly growth in Q3 2016 came exclusively from the services sector (which accounts for almost 80% of GDP), with output increasing by 0.8% on the previous quarter. All other sectors of the economy saw their output fall: construction declined by 1.4%; industrial production fell by 0.4% and agriculture was down by 0.4%.

The services sector has been the main impetus behind growth.

This reinforced the trend since the 2008/09 recession of strong growth in the services sector compared with weakness in construction and manufacturing. Output in the services sector is now 12.1% above its pre-recession peak level of early 2008. In contrast, output in the construction sector is 1.3% below its pre-recession level and in industrial production it is 8.2% lower.

Services sector driving GDP growth

% change in sector's output compared with pre-recession peak output in Q1 2008



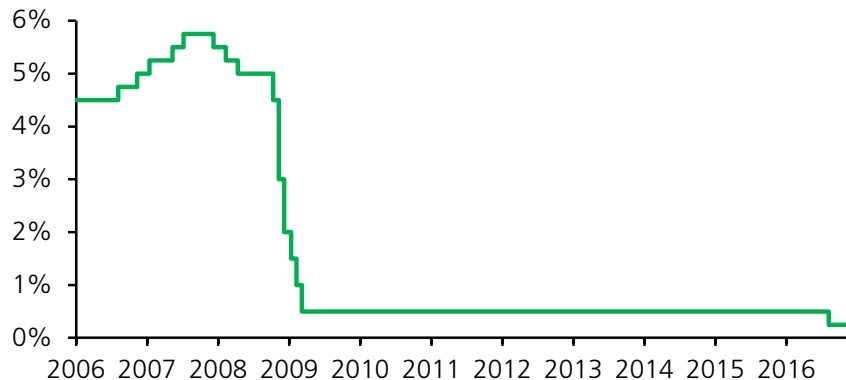
³ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), 16 November 2016

1.2 Interest rates and monetary policy

The Bank of England's Monetary Policy Committee (MPC) cut its main interest rate (the Base Rate) from 0.5% to 0.25% on 4 August 2016, the first change since March 2009. The MPC cited its forecasts (at that time) of a markedly weaker growth outlook in the short to medium term, following the vote to leave the EU, as the reason for loosening monetary policy.

Interest rates were cut to 0.25% following the referendum.

Bank of England base rate, %



As well as cutting interest rates, the MPC agreed a series of other measures designed to boost the economy, including expanding its quantitative easing (QE) programme, whereby the Bank creates new money to buy financial assets from financial institutions, by £70 billion (£60 billion of government debt and £10bn of corporate debt). Planned QE now totals £445 billion (£435 billion of government debt and £10 billion of corporate debt). The MPC also introduced the Term Funding Scheme, designed to ensure banks pass on the interest rate cut by giving them access to cheap loans linked to the amount they lend to firms and households. The scheme is funded from newly-printed money up to a total of £100 billion.⁴

The MPC's efforts to bolster confidence and stimulate demand in the economy have generally been viewed positively, particularly given the uncertainty surrounding the possible implications of Brexit on the economy. Some, though, regard its actions as unnecessary given evidence that growth was, it turned out, healthy over this period.⁵

At its early November meeting, the MPC unanimously agreed to leave policy unchanged. It updated its economic forecasts to show stronger near-term growth but weaker growth over the medium term, and raised its inflation forecasts (compared to its previous forecasts made in August). Growth forecasts are still well down on the MPC's last pre-referendum forecasts from May, however.

⁴ Bank of England, [Monetary policy summary](#), 3 November 2016

⁵ For example, City AM, "[As recession fears fade following strong services PMIs, was the Bank of England wrong to cut interest rates post-Brexit?](#)", 5 September 2016

Bank of England forecasts for real GDP growth, 2016-19

Annual % change in real GDP

	2016	2017	2018	2019
May 2016 forecast	2.0	2.3	2.3	..
August 2016 forecast	2.0	0.8	1.8	..
November 2016 forecast	2.2	1.4	1.5	1.6
<i>%-point change from May to Nov</i>	<i>+0.2</i>	<i>-0.9</i>	<i>-0.8</i>	..
<i>%-point change from Aug to Nov</i>	<i>+0.2</i>	<i>+0.6</i>	<i>-0.3</i>	..

Note: Difference between projections may not equal the change figure due to rounding
The May and August Inflation Reports did not contain a 2019 GDP forecast

Source: Bank of England, Inflation Report, May 2016, Aug 2016 and Nov 2016

The MPC provided guidance that although inflation is forecast to rise above its 2% target (see section below) it will leave rates unchanged as it expects the sterling-related boost to inflation to prove temporary. However, it did warn that “there are limits to the extent to which above-target inflation can be tolerated” if, for example, inflation expectations started to rise.⁶ For the time being though, the MPC is keeping its options open, noting pithily that “monetary policy can respond, in either direction, to changes to the economic outlook”.⁷

1.3 Exchange rates and inflation

As of 15 November 2016, the pound has fallen by 13% against a basket of the UK’s main trading partners’ currencies since the EU referendum, and by 17% compared with a year ago (see chart below).⁸ Against the US dollar, sterling is 16% lower than at the time of the referendum, while against the euro it is down by 11%.

The decline in the pound makes it more expensive for those in the UK to purchase imported goods and services that are denominated in foreign currencies.

The pound has fallen by 13% since the referendum, raising import prices.

⁶ Bank of England, [Monetary policy summary](#), 3 November 2016

⁷ Bank of England, [Monetary policy summary](#), 3 November 2016

⁸ This is the Sterling Exchange Rate Index measuring sterling’s value against a ‘basket’ of currencies, ‘trade-weighted’ (based on currencies’ relative importance in UK trade). [Data](#) are from the Bank of England

UK£ exchange rate index against main trading partners

Index, where 23 June 2016 = 100; daily values from 1 Sep '15 to 15 Nov '16



Source: Bank of England

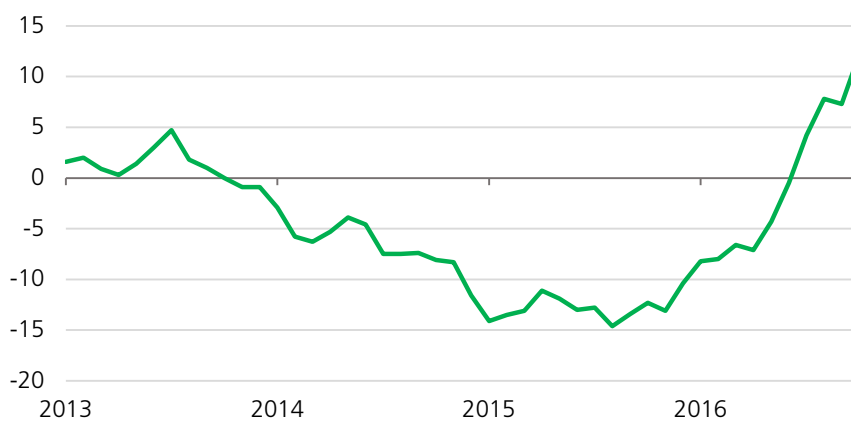
Fall in the pound feeding through into higher producer prices

The fall in the pound has already led to producer input prices rising in recent months. This reflects prices of materials and fuels bought by UK manufacturers for processing. In October producer input prices were 12.2% higher than a year ago, up from 7.3% in September. Imported items (including oil) accounted for most of this: 10.5%-points of the 12.2% increase.

This is unsurprising, given that most commodities (including oil) are traded on world markets and priced in dollars. Therefore a fall in the pound leads to higher imported commodity prices in sterling. Of course, changes in the price of the commodities themselves are also important.

Producer input prices rising sharply

Annual % change, monthly data



Source: ONS, UK producer price inflation

Price pressures in the next stage of the supply chain are also increasing, though not by as much. Producer output prices – the prices that UK manufacturers charge for their goods – went up by 2.1% in October compared with a year ago, up from 1.3% in September. As the Office for National Statistics noted, this “would suggest higher input costs are feeding into the output prices of manufacturing goods”.⁹

Not all of the higher import costs will be passed on to consumers.

⁹ ONS, [UK producer price inflation: Oct 2016](#), 15 November 2016

Producers may not pass on all of these higher costs to other companies further up the production chain. What they do will depend on the company's other costs (wages for example), as well as its ability and desire to pass these costs on. Similarly, retailers may not pass on the full cost on to consumers, accepting lower profit margins to preserve market share.

In addition, the full impact of higher import prices will not be immediate as some firms will have agreed contracts to pay a fixed price for their imports; only when those contracts expire and new contracts are negotiated will the full impact be felt. Businesses may also protect against short-term movements in the exchange rate by hedging their exposure to such changes via financial products.

Consumer prices have not yet felt the impact, but are expected to

Consumer prices have risen in recent months, with the CPI measure 0.9% higher in October compared with a year ago, slightly down from 1.0% in September but up from 0.5% in June. This increase is mostly a result of higher energy prices – due to sterling's fall and rising dollar oil prices – and also the statistical effects of the previous year's oil price decline dropping out of the annual calculation.¹⁰

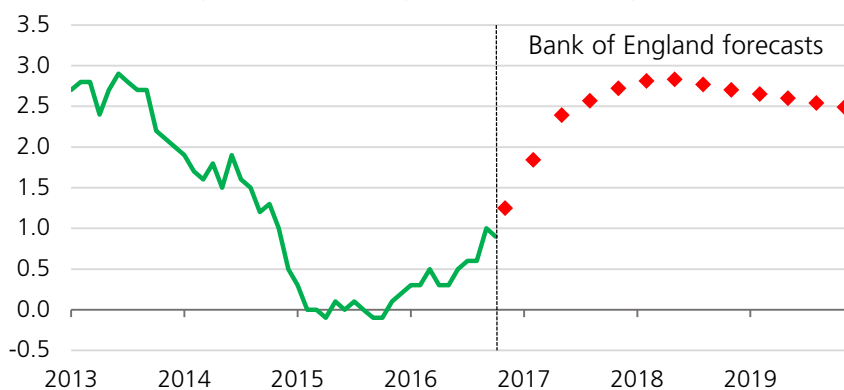
Looking ahead, economists expect rising producer prices to feed through into higher consumer price inflation. In a recent survey, the average forecast of economists was for annual CPI inflation to rise to 2.7% in the final quarter of 2017.¹¹

The Bank of England expects it to take several years for higher import costs to be fully passed through to consumer prices. It forecasts CPI inflation to rise to 2.4% in Q2 2017 and peak at 2.8% in the first half of 2018, before easing to 2.5% by the end of 2019.¹²

Consumer price inflation expected to rise above 2% in 2017.

Consumer price inflation expected to rise

Annual % change in CPI, monthly data and quarterly forecasts



Source: ONS, series D7G7 and Bank of England projections from November 2016 Inflation report: mode forecasts based on market interest rate expectations and other policy as announced

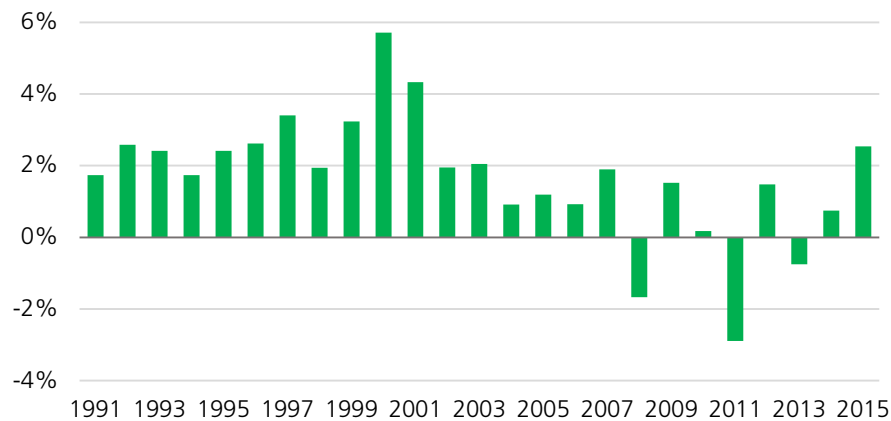
¹⁰ The “base effect” – a year ago oil prices were ‘low’ and lower than the previous year, reducing the overall inflation rate; they are now higher compared with the ‘low’ price of a year ago, raising the overall inflation rate.
¹¹ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), 16 November 2016
¹² Bank of England, *Inflation Report: November 2016*, [current fan chart data](#)

1.4 Consumers

Low inflation since the end of 2014 has underpinned strong growth in real (inflation-adjusted) incomes, despite modest increases in average earnings. In 2015, real household disposable income per head grew by 2.5% – the most since 2001. This supported consumer spending growth of 2.6% in 2015, and was the most important element contributing to overall GDP growth of 2.2%. The first half of 2016 also saw robust consumer spending growth of 2.9% compared with the year before.

Real (inflation-adjusted) household disposable income per head

Annual % change



Source: ONS, series IHYZ

Consumers appear to have made little change to their spending patterns following the EU referendum. While we don't yet have official data on overall consumer spending post-referendum, many indicators point to continued robust expenditure growth:

- retail sales growth has been strong, up 5.9% in volume terms in the 3 months to October 2016 compared with the year before;¹³
- new car registrations have increased;¹⁴
- the housing market has been resilient, with prices rising by nearly 8% in Q3 2016 compared with a year earlier;¹⁵
- consumer confidence is upbeat, after an initial drop following the referendum.¹⁶

Consumer spending remains strong.

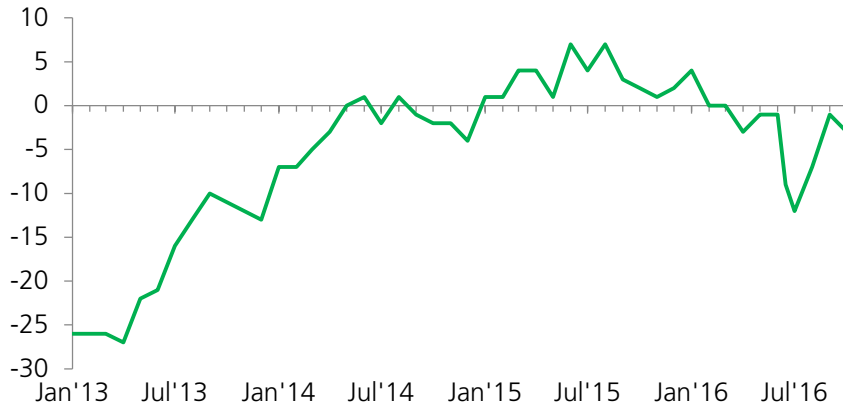
¹³ ONS, [Retail sales in Great Britain: Oct 2016](#), 20 October 2016

¹⁴ SMMT, [Car registrations data](#)

¹⁵ ONS, [House Price Index: Sept 2016](#), 15 November 2016

¹⁶ GfK for European Commission, [Consumer confidence index](#), 28 October 2016

Consumer confidence recovers from post-referendum fall
 % balance expecting improvement/deterioration



Source: GfK for European Commission, Consumer Confidence

Summarising the data in early November, Bank of England Governor Mark Carney said consumers were “appearing to entirely look through Brexit-related uncertainties”.¹⁷ However, the outlook for consumer spending – which accounts for over 60% of GDP – is more uncertain.

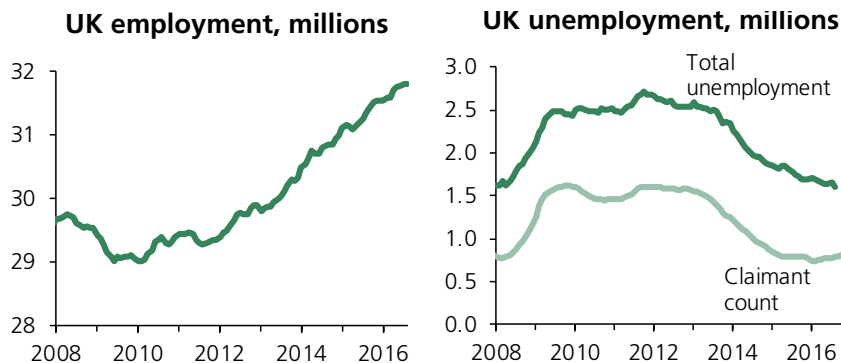
The anticipated rise in inflation is expected to reduce the purchasing power of consumers, with growth in real (inflation-adjusted) incomes slowing in 2017. This, in turn, is expected to lead to consumer spending being reined in: the latest average forecast is for a 1.1% increase in 2017, compared with 2.7% in 2016.¹⁸

1.5 Labour market

Employment and unemployment

Employment in the UK is at a record high in 2016: 31.8 million people were in work in the three months July-September. The employment rate among people aged 16-64 was 74.5%, compared with 73.0% in early 2008 before the economic downturn.¹⁹

1.6 million people were unemployed and the unemployment rate was 4.8%, the lowest rate since mid-2005.



Source: ONS *UK Labour Market, November 2016*

¹⁷ Mark Carney, [Inflation report press conference: Opening remarks by the Governor](#), Bank of England, 3 November 2016

¹⁸ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), 16 November 2016

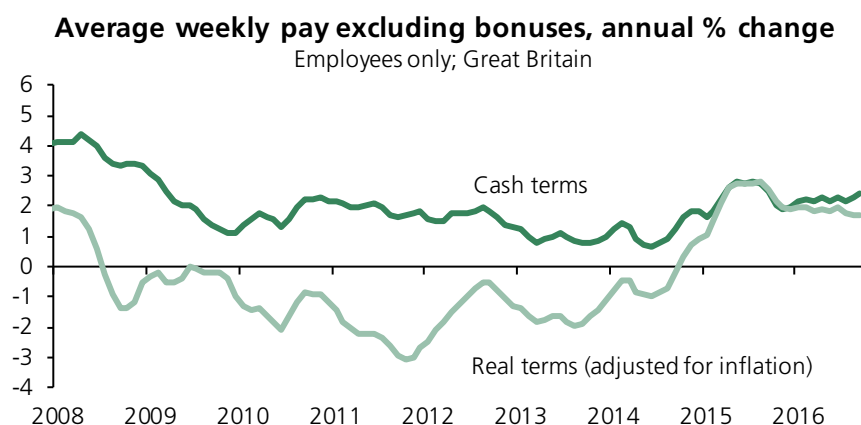
¹⁹ Employment and unemployment data from ONS [UK Labour Market, November 2016](#)

Employment has grown strongly since 2012 but data for recent months signal the pace of growth is slowing. The number of people in work in July-September 2016 was 49,000 higher than in the previous quarter, while the employment rate held steady. Although figures suggest that unemployment fell over the last quarter (by 37,000), the number of people claiming unemployment benefits has been rising gradually since early 2016.

Earnings

Average weekly earnings have been increasing in real terms since late 2014 (i.e. increasing more quickly than prices, partly thanks to price inflation being very low), after a sustained real terms fall over the previous six years.

Excluding bonuses, average weekly pay increased by 1.7% in real terms in the year to July-September 2016. This is weaker than the rate of growth seen before the economic downturn: on average, between 2001 and 2007 average weekly pay excluding bonuses grew by 2.3% per year in real terms.²⁰



Note: three month average. Source: ONS *UK Labour Market, November 2016*

Although the *average* level of pay may not be growing as quickly as before the downturn, the introduction of the National Living Wage in April 2016, set at an initial rate of £7.20 an hour for employees aged 25 and over, led to a sharp rise in pay among the lowest earning employees. 5% of full-time employees earned less than £279 per week in April 2016, up from £263 in 2015 – an increase of 6.2% (not adjusted for inflation). By comparison, pay at the middle of the earnings distribution for full-time employees (i.e. the median value) went up by a more modest 2.2% over the same period.²¹

The Government is expected to publish the Low Pay Commission's report recommending the value of the National Minimum Wage for different age groups (including the National Living Wage) from April 2017 on the same day as the Autumn Statement, 23 November.

²⁰ ONS Average Weekly Earning series (series codes KAI9 and A2FA)

²¹ ONS, [Annual Survey of Hours and Earnings, 2016](#), Figure 5

1.6 Business investment

In contrast to consumers, businesses appear to be more circumspect in their reaction to the referendum outcome. While official data on business investment for the period after the referendum is not yet available, surveys point to weakening investment intentions among firms, continuing a trend seen since the beginning of the year.²²

The business investment outlook has deteriorated.

Official business investment data was already weak prior to the referendum (possibly due to uncertainty related to it), declining by 0.8% in the first half of 2016 compared with a year earlier. This compares to growth of 5.0% in 2015. As a result, forecasts for business investment in 2016 and 2017 have been lowered.²³

1.7 Trade and current account

The UK's current account balance – the trade balance plus the balance of income and transfers moving into and out of the UK – has deteriorated in recent years. In 2015, the current account deficit was £100 billion, equivalent to 5.4% of GDP. This is the highest annual figure since records began in 1948. The current account deficit with the EU was £109 billion in 2015 while the UK ran a surplus of £9 billion with non-EU countries.

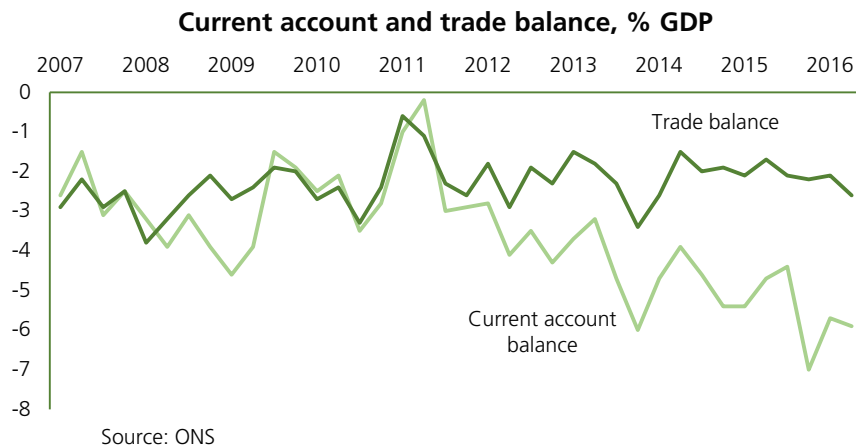
The main reason for the rise in the deficit is not the trade deficit (the difference between exports and imports) which was a relatively modest 2.1% of GDP in 2015. More important is the worsening primary balance that measures flows of profits, dividends and interest between the UK and abroad. The primary balance was in surplus every year between 2000 and 2011, peaking at 2.4% of GDP in 2005. It went into deficit in 2012 and the deficit was 2.0% of GDP in 2015. There has been some improvement in recent quarters with the primary account deficit falling from 3.2% of GDP in Q4, 2015 to 2.1% in Q2, 2016. The average independent forecast is for the current account deficit to be £106.8 billion in 2016 falling to £80.9 billion in 2017.²⁴ These are both higher than the OBR's March 2016 forecast of a deficit of £80.3 billion in 2016 and £75.1 billion in 2017.²⁵

²² Bank of England, [Inflation Report, November 2016](#), p13, p16 and chart 2.5

²³ For example, EY ITEM Club, [Autumn forecast](#), October 2016 and ICAEW, [UK Economic forecast Q3 2016](#) among others

²⁴ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), November 2016

²⁵ OBR, [Economic and fiscal outlook](#), March 2016, Table 3.5



The pound has depreciated significantly since the EU referendum. In the past, depreciations have boosted exports by making them more competitive (and imports less competitive). It is too early to say whether the recent fall in sterling’s value has had this effect. There is also uncertainty over how large any effect might be. The Bank of England has commented that “net trade – exports less imports – will be sensitive to how companies anticipate and respond to possible future changes in the United Kingdom’s trading arrangements.”²⁶

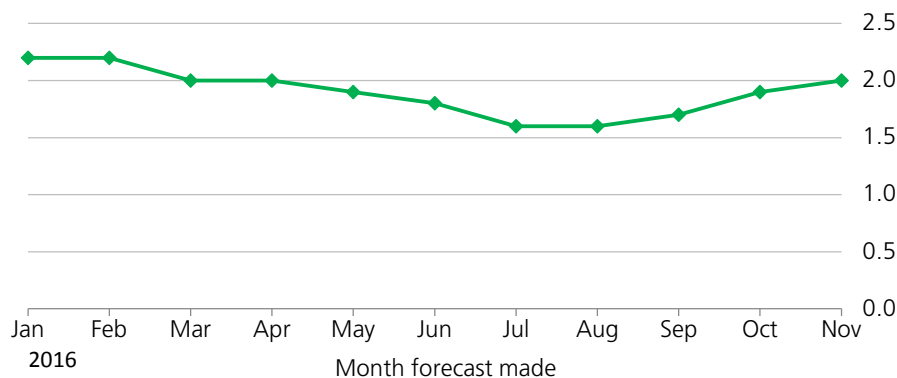
The lower pound may help to boost demand for exports.

1.8 Growth outlook

The economy’s resilience following the EU referendum, with GDP growth in Q3 2016 in line with its recent performance, is expected to result in full-year GDP growth in 2016 of 2.0% (based on the latest average of economic forecasts).²⁷ Consumer spending has been the main impetus behind growth this year, given weakness in investment and net trade (exports minus imports).

2016 GDP growth forecasts have risen in recent months

Consensus forecast for full-year 2016 GDP growth (%)



Source: HM Treasury survey of independent forecasts

In 2017 the outlook is less favourable. As noted earlier, the fall in the pound is expected to lead to higher inflation. This is expected to result in consumers’ purchasing power being eroded and, in turn, consumer

²⁶ Bank of England, [Inflation Report](#), November 2016, p21

²⁷ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), November 2016

spending growth slowing. The investment outlook is also uncertain and unlikely to provide a boost to growth next year.

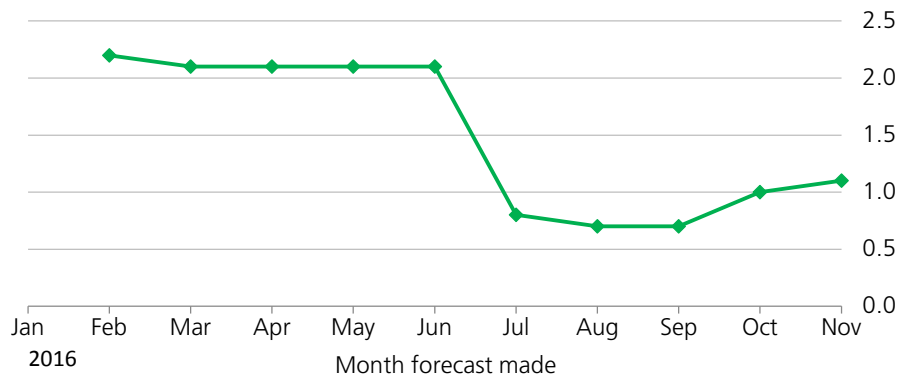
Sterling’s decline, however, could help to boost exports, with the price of UK products now cheaper internationally. In addition, higher import prices are likely to result in weaker demand for imports. The combination of these two factors could lead to net exports contributing to GDP growth in 2017.

The latest average 2017 GDP growth forecast of 1.1% is lower than before the referendum.

Forecasts for GDP growth in 2017 were downgraded sharply following the EU referendum (see chart below). They have since improved somewhat in light of more upbeat recent economic data, but still remain well below pre-referendum expectations. Of course, forecasts are prone to change particularly in uncertain times such as these.

2017 GDP growth forecasts fell sharply after the referendum

Consensus forecast for full-year 2017 GDP growth (%)



Source: HM Treasury survey of independent forecasts

Against this backdrop of projected weaker growth, there are indications that the Government may announce policies in the Autumn Statement to boost economic activity. Additional spending on infrastructure has been mentioned, with the Chancellor noting that road and rail investments could be targets for investment (see [section 4](#)).²⁸ In addition, the Government has signalled that existing fiscal targets should be more flexible, providing scope for additional investment (see [section 3](#)).²⁹

There is potential for a limited Government stimulus programme.

Nevertheless, any potential stimulus may be constrained by the impact of lower growth forecasts on the public finances, with government borrowing already at high levels historically. As such, any stimulus is unlikely to be large. For more on infrastructure and the potential for fiscal stimulus see [section 4](#).

²⁸ For example, in the Chancellor’s [Conference Speech](#), and to the [Lords Economic Affairs Committee](#)

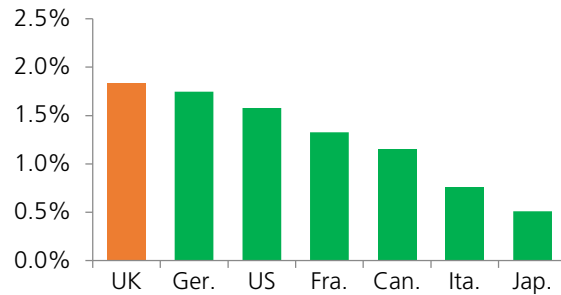
²⁹ Telegraph, [Hammond warns of Britain’s economy heading for post-Brexit rollercoaster](#), 3 October 2016

Box 1.1: International comparisons of GDP growth

Based on the most recent IMF forecasts, made in October, the UK is expected to have the highest GDP growth rate among G7 economies in 2016 at 1.8%, slightly higher than Germany at 1.7% and the US at 1.6%. In 2017, the UK's forecast growth rate of 1.1% is above only Japan and Italy.³⁰

2016 GDP growth (%) in G7 countries

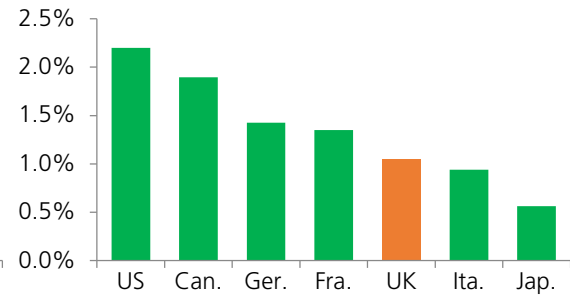
IMF forecasts from October 2016



Source: IMF, World Economic Outlook, Oct'16

2017 GDP growth (%) in G7 countries

IMF forecasts from October 2016



Source: IMF, World Economic Outlook, Oct'16

1.9 Productivity and longer-term outlook

Productivity – how much is produced for a given input (such as an hour's work) – is directly linked to living standards, with a country's ability to improve its standard of living over time almost entirely dependent on productivity growth.

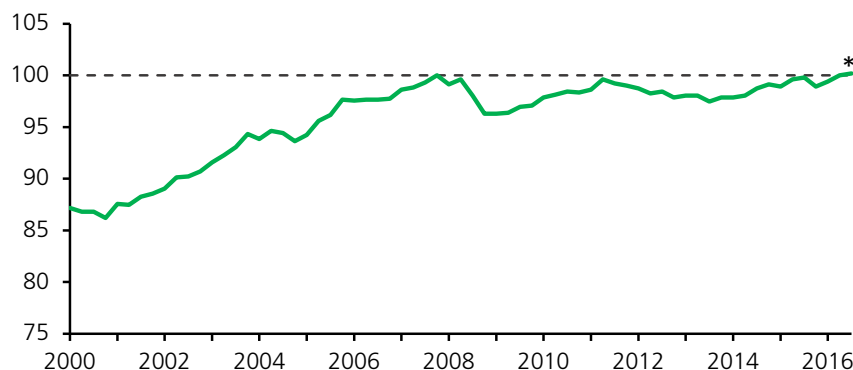
Productivity is also crucial in determining the long-term growth rates of an economy. In other words, stronger productivity growth leads to stronger GDP growth. This, in turn, increases tax revenues and lowers government budget deficits. Of course, lower productivity growth results in the opposite: lower GDP growth and higher budget deficits.

Productivity – as measured by output per worker – was growing at its historical average rate of around 2% per year in the decade prior to the 2008/2009 recession. Since then it has stagnated. The level of labour productivity in Q3 2016 was only a little higher than it was nearly nine years earlier in Q4 2007 (the pre-recession peak level).

The lack of productivity growth remains a key concern.

Productivity (GDP per hour) has stagnated since 2007

Index where Q4 2007 level = 100 (quarterly data)



Source: ONS; * Q3 2016 figure is based on 'flash' preliminary estimate of GDP per hour

³⁰ IMF, [World Economic Outlook database](#), October 2016

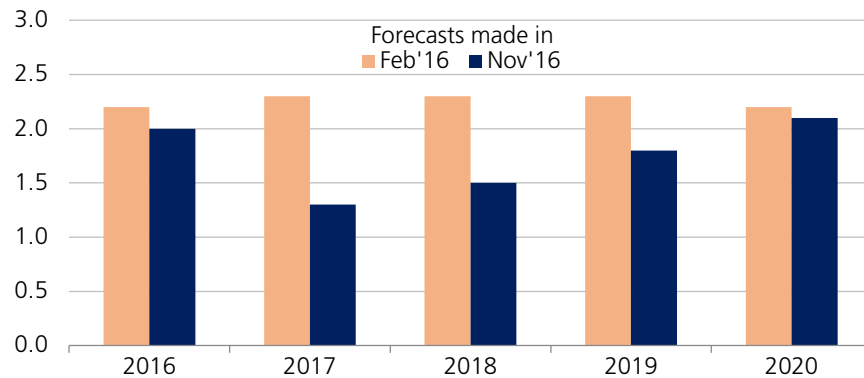
We don't have a firm understanding as to why this has happened and whether this is the 'new normal'. Most economists expect productivity growth to improve back towards its historic trend, but if it doesn't, the implications for the economy, public finances and future living standards could be severe.³¹

Even with productivity growth expected to improve, the outlook for growth in the next few years is weaker than at the time of the Budget in March, the last time the OBR published forecasts. The chart below shows the average GDP growth forecast of independent economists for each year up to 2020.³² Forecasts are noticeably lower now compared with those made in February, the last survey prior to the Budget. This likely results from the perceived additional uncertainty surrounding Brexit weighing on economic growth expectations.

Growth forecasts up to 2020 are lower now than at the time of the March Budget.

GDP growth forecasts up to 2020 lower than at time of Budget

Consensus forecast for annual GDP growth (%) in each year



Source: HM Treasury survey of independent forecasts

Box 1.2: Forecasting the post-Brexit economy

The Office for Budget Responsibility will add an additional year to its forecasts, taking the forecast period up to 2021/22. This will – assuming that Article 50 is triggered before April 2017 and the UK exits within two years – take the forecast period well into a future where the UK is no longer a member of the European Union.

The models the OBR uses to produce its economic forecasts are underpinned by a range of important judgements and assumptions. Making these assumptions is difficult at the most 'normal' of times, but they are much more difficult to make for a future in which it isn't clear what form the UK's exit from the EU will take.

While it would be foolhardy to try and guess what the OBR will assume for the UK after Brexit, there are things we can say about what the OBR's forecasts can and cannot do:

- Legislation requires that the OBR's forecasts only reflect Government policy. As such, when the Government sets out 'ambitions' or 'intentions' the OBR asks the Treasury to confirm whether they represent firm policy. If there is no firm policy the OBR note the ambition or intention as a source of risk to the forecast.
- Legislation requires that the OBR's forecasts do not consider any policies that are alternatives to the Government's policies. This was why the OBR made no assessment of the potential impact of Brexit before the EU referendum.

These obligations suggest that we should expect one forecast that represents the Government's firm policies – including on Brexit – with anything that isn't firm policy being noted as a source of risk.

³¹ For more on productivity see the Library Briefing, [Productivity in the UK](#)

³² HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), February 2016 and November 2016

2. Public finances and the welfare cap

Summary

Government borrowing: the budget deficit

In 2015/16 the government had to borrow £76 billion to make up the difference between its spending and income. Despite halving since its 2009/10 peak the UK's borrowing – often referred to as the budget deficit – remains large relative to other nations.

In its last forecast before the EU referendum, the Office for Budget Responsibility (OBR) – the UK's fiscal watchdog – forecast that borrowing would fall in each year before a surplus was reached in 2019/20. Forecasts published since the EU referendum, by other forecasters, suggest borrowing will fall more slowly than the OBR had thought.

The Chancellor is set to change the Government's target for borrowing in the Autumn Statement. He has said that it wouldn't be sensible to pursue the target of reaching a budget surplus in 2019/20 given the uncertainty the economy faces following the EU referendum result. See [section 3](#) for more on this.

Government debt

At over 80% of GDP, public sector net debt – largely the stock of borrowing arising from past deficits – remains relatively high by recent and international standards. Forecasts made since the EU referendum have cast some doubt over whether the debt-to-GDP ratio will fall in each of the next five years. In March 2016 the OBR forecast that the debt-to-GDP ratio would fall each year.

Welfare cap

The welfare cap sets a limit on the amount that can be spent on certain benefits. It excludes Jobseeker's Allowance and the state pension. The OBR will assess performance against the cap alongside the Autumn Statement. In its last formal assessment – at Autumn Statement 2015 – the OBR said that the cap would be breached in three of the following five years.

2.1 The deficit: public sector net borrowing

Borrowing has halved since its recent peak

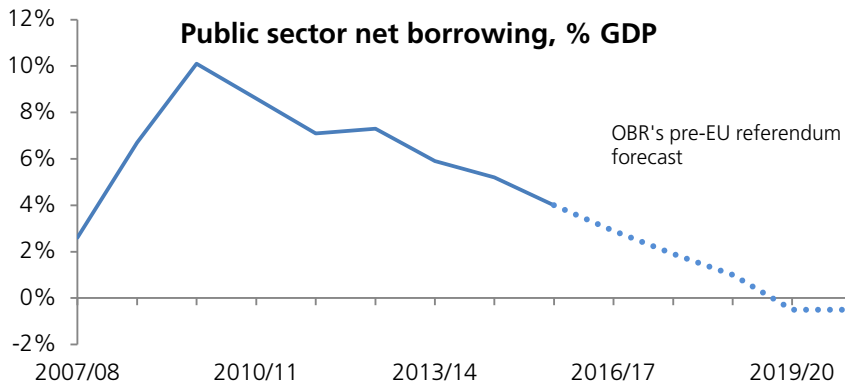
When the government spends more than it receives in tax and other revenues it needs to borrow to cover the difference. This borrowing is known as 'public sector net borrowing', but is often referred to as the deficit.

Borrowing has fallen considerably since the high levels it reached during the financial crisis. Borrowing has more than halved since its peak of £155 billion in 2009/10, falling to £76 billion in 2015/16; this level of borrowing is equivalent to 4.0% of GDP.³³

Before the EU referendum in March 2016, the OBR forecast that borrowing would fall each year before reaching a surplus in 2019/20.

Public sector net borrowing, often referred to as the deficit, was £76 billion in 2015/16, equivalent to 4.0% of GDP.

³³ These figures are in nominal terms. Borrowing as a share of GDP is shown in the chart. All public sector figures exclude public sector banks.



Source: ONS, OBR

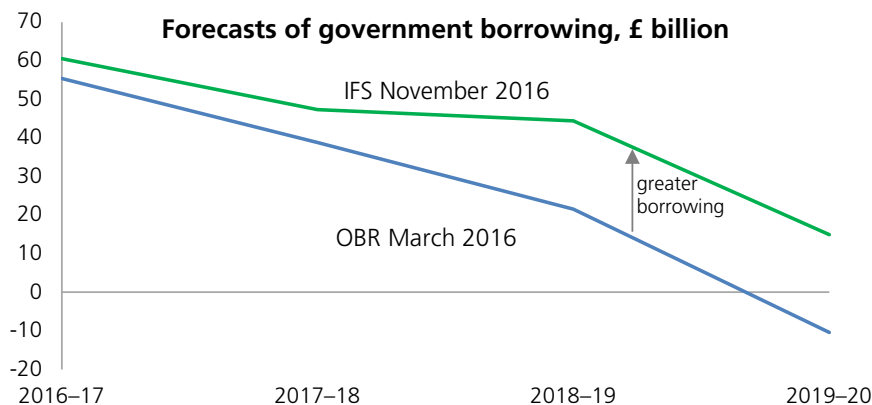
Recent forecasts suggest that borrowing may fall more slowly than the OBR forecast

Forecasts made since the EU referendum, by the likes of the Institute for Fiscal Studies (IFS) – an economic think tank – have suggested that borrowing may fall more slowly than the OBR forecast in March 2016.

Forecasters have, following the EU referendum, reassessed the outlook for the UK economy with the majority expecting economic growth to be lower in the coming years (see [section 1.8](#)). Lower economic growth and other changes to the economy are expected to slow the rate at which borrowing will fall.³⁴

Borrowing forecasts have increased since the EU referendum, relative to the OBR's March 2016 forecasts.

The IFS have forecast higher borrowing than in the OBR's March forecast in all years up to 2019/20. They estimate borrowing in 2019/20 of £15 billion; a deterioration of £25 billion compared with the £10 billion surplus forecast by the OBR.



The Resolution Foundation – a think tank – forecast a level of borrowing similar to the IFS in 2019/20.³⁵

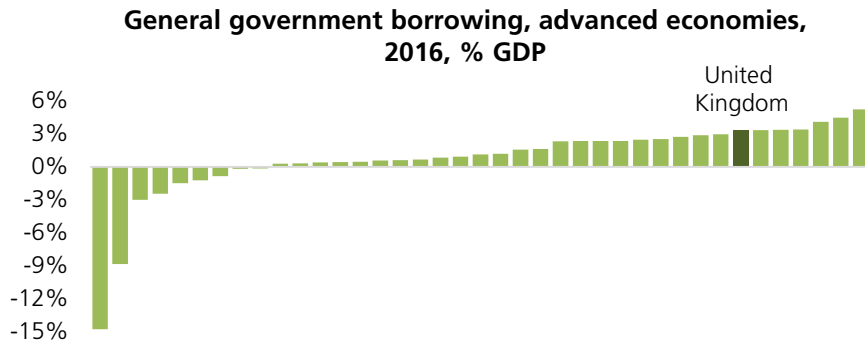
³⁴ HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, October 2016

³⁵ Any reference in this section to the IFS or the Resolution Foundation refers to these publications: IFS, *Winter is Coming: The outlook for the public finances in the 2016 Autumn Statement*, November 2016; Resolution Foundation, *Pressing the reset button: The public finance options facing the new Chancellor at the Autumn Statement*, October 2016

UK borrowing remains relatively high by international standards

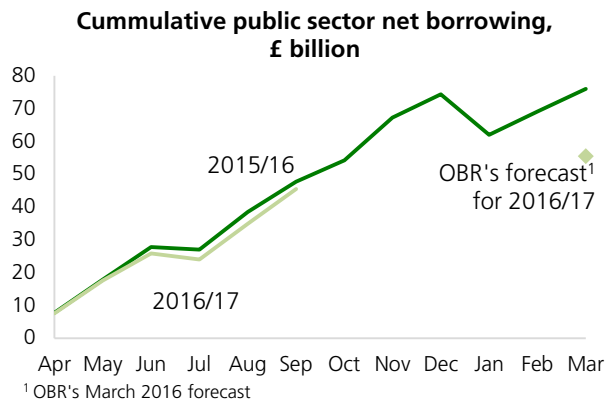
Despite decreases in recent years, the UK's borrowing remains relatively high by international standards. The IMF – who use a slightly different measure of governments' net borrowing – forecast that UK government borrowing will be 3.3% of GDP in 2016, higher than the European Union average of 2.1% or the average for advanced economies of 3% of GDP.³⁶

UK's government borrowing remains relatively high by international standards.



Box 2.1: Borrowing is falling more slowly in 2016/17 than the OBR forecast

Provisional data on borrowing has been published for the first 6 months of 2016/17.³⁷ The data shows that borrowing in the current financial year has not been falling as quickly as the OBR had expected.



For the OBR's forecast for 2016/17 to be met borrowing needs to fall by £20.5 billion compared with 2015/16. However, borrowing in the first half of 2016/17 is only £2.3 billion lower than during the same period of 2015/16.

This data has led the OBR to say that their forecast for 2016/17 is "very unlikely to be met".³⁸ Slower than forecast growth in tax receipts – particularly for PAYE³⁹ income tax, NICs⁴⁰ and Stamp Duty Land Tax – has been identified as the main contributory factor.

The Institute for Fiscal Studies estimates that borrowing may be around £5 billion higher in 2016/17 than the OBR forecast in March 2016. The median amongst forecasters surveyed by the Treasury is for over £10 billion of additional borrowing in 2016/17 compared with the OBR's forecast.⁴¹ The OBR's forecast was for £55.5 billion of borrowing in 2016/17.

The Office for National Statistics will publish [Public Sector Finances for October 2016](#) on 22 November. The Library will summarise the key data in our briefing [Public Finances: Key Economic Indicators](#).

³⁶ IMF. [World Economic Outlook Database](#), October 2016

³⁷ ONS. [Public sector finances: Sept 2016](#), 21 October 2016

³⁸ OBR. [Commentary on the Public Sector Finances release: September 2016](#), 21 October 2016

³⁹ Pay-as-you-earn

⁴⁰ National Insurance contributions

⁴¹ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts, November 2016, Table 3](#)

The Government is no longer targeting a surplus in 2019/20

In the Summer Budget 2015 the Government introduced a target for borrowing to reach a surplus in 2019/20. Following the EU referendum result, the previous Chancellor – George Osborne MP – said that the Government would no longer be pursuing this target.⁴² His successor, Philip Hammond MP, confirmed this once in post.⁴³

The current Chancellor said that it wouldn't be sensible to aim for a surplus in 2019/20 given the uncertainty the economy faces following the EU referendum result.⁴⁴ Further details are set to be announced in the Autumn Statement (see [section 3](#) for more on the fiscal targets).

The Chancellor is set to announce new borrowing targets in the Autumn Statement. See [section 3](#) for more.

2.2 Other ways to assess government borrowing

Government borrowing can be assessed using measures other than public sector net borrowing. For instance, the current budget deficit considers the government's day-to-day spending alongside its income, while structural borrowing looks at the persistent element of borrowing that is unrelated to the economic cycle.

The current budget deficit

The current budget deficit is the difference between government current spending – day-to-day spending on running public services, grants and administration – and revenues. It doesn't include investment spending and therefore is said to measure the degree to which taxpayers meet the cost of paying for the services provided to them.

The current budget deficit was £43 billion in 2015/16, equivalent to 2.3% of GDP. It has fallen by close to three-fifths since its post-financial crisis peak of £103 billion in 2009/10.

The current budget deficit was £43 billion in 2015/16, equivalent to 2.3% of GDP.

In March 2016 the OBR forecast that a surplus would be reached on the current budget in 2018/19. In a forecast made since the EU referendum, the IFS suggest 2019/20 is the more probable year for the current budget to reach surplus.

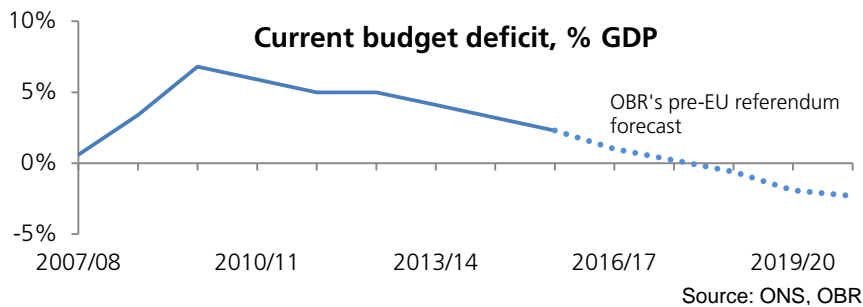
Opposition parties have proposed targets for the public finances that focus on the current budget, rather than public sector net borrowing.⁴⁵ Focusing on the current budget would allow borrowing for investment purposes.

⁴² 'Osborne abandons 2020 budget surplus target', *BBC*, 1 July 2016; [HC Deb. 4 July 2016:c622](#)

⁴³ [Philip Hammond's speech to 2016 Conservative Party Conference](#), 3 October 2016

⁴⁴ Treasury Committee *The work of the Chancellor of the Exchequer*, 19 October 2016, HC 777, [Q94](#)

⁴⁵ [HC Deb. 20 July 2016:c904-905](#); [Liberal Democrats: 2015 Manifesto](#); SNP, [What do the SNP propose as an alternative to austerity?](#)



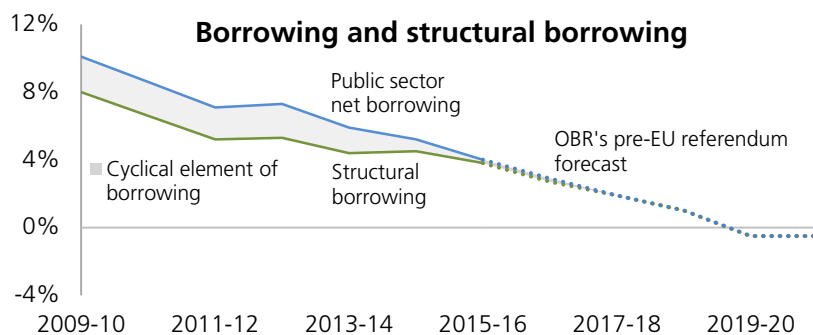
Structural borrowing

Structural borrowing is the level of borrowing we would expect to remain if the economy was running at a normal, sustainable level of employment and activity. Structural elements are the underlying or persistent part of government borrowing, which are unrelated to the economic cycle.

The OBR never know what the economy's normal level is, so they estimate it through the output gap (see Box 2.1). The OBR estimated the output gap to be 0.3% of GDP in 2015/16; that is, the economy was thought to be running 0.3% below normal capacity.

As the economy was thought to be running slightly below capacity in 2015/16, the OBR judged the structural deficit to be a little lower than overall borrowing. The remaining part of overall borrowing was thought to be cyclical – related to the economic cycle – which should disappear as the economy returns to a normal level of activity.

Structural borrowing – the underlying element of government borrowing – is estimated to have been 3.8% of GDP in 2015/16.



Box 2.1: The output gap

The difference between the actual level of economic output and what could be achieved if the economy was operating at full potential is known as the 'output gap'.

A negative output gap suggests that the economy is operating below its potential level and has idle resources. A positive output gap suggests that the economy is operating above potential or overheating.

A big problem for policymakers is that the level of potential output cannot be directly measured and consequently neither can the output gap. Therefore economists must estimate what the output gap is.

The OBR estimates that the output gap was close to -4% of GDP in 2009/10 and is currently around -0.3% of GDP.

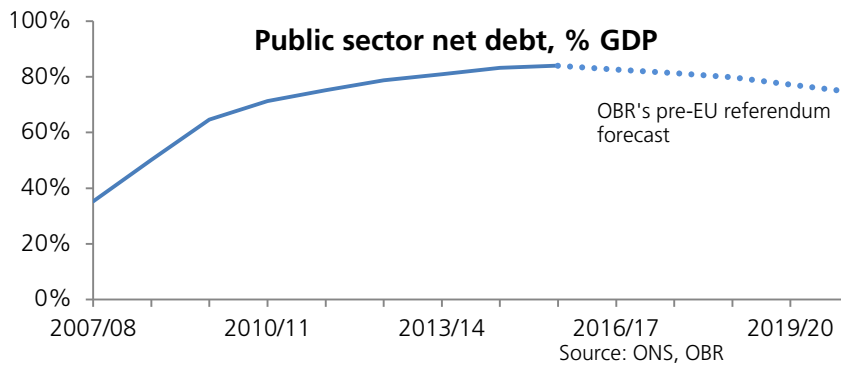
2.3 Public sector net debt

Public sector net debt is the overall level of government indebtedness, built up over many years. Broadly speaking it is the stock of borrowing arising from past deficits.

Before the financial crisis, public sector net debt was around 36-37% of GDP. As a result of the crisis, debt increased sharply and was close to 84% of GDP at the end of 2015/16, a debt to GDP ratio not seen since the mid to late 1960s.⁴⁶

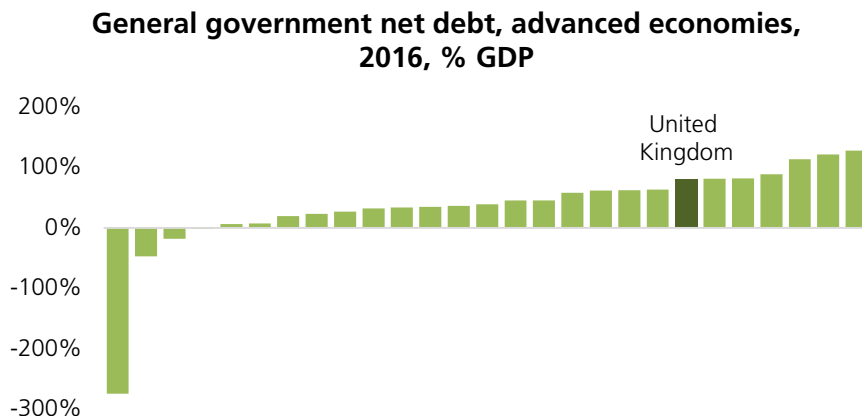
In March 2016 the OBR forecast that the UK's debt to GDP ratio would fall in 2016/17, and continue to fall over the following four years of its forecast. Forecasts made since the EU referendum by the IFS, Resolution Foundation and the economists at the National Institute of Economic and Social Research⁴⁷ suggest that this may not be the case.

Public sector net debt – broadly speaking the stock of borrowing from past deficits – was 84.0% of GDP at the end of 2015/16.



By international standards the UK's net debt is relatively high. The IMF – who produce data using a slightly different measure of debt – forecast that the UK's general government net debt in 2016 will be 80% of GDP. The IMF forecast that the UK's net debt will be higher than the EU average of 66% and higher than the average amongst advanced economies of 72% of GDP.⁴⁸

The UK's government net debt is relatively high by international standards.



⁴⁶ OBR. [Public finances databank](#), October 2016

⁴⁷ National Institute Economic Review No. 238 November 2016, *Prospects for the UK economy*, Table A8

⁴⁸ IMF. [World Economic Outlook Database](#), October 2016

2.4 The welfare cap

The welfare cap was introduced in Budget 2014 and sets a limit on the amount that can be spent on certain benefits, including tax credits, incapacity benefit and most housing benefit. It excludes Jobseeker's Allowance and the state pension.⁴⁹

The cap covers each year of the forecast period – currently 2016/17 to 2020/21 – and is set according to the OBR's forecast for welfare spending in scope. The OBR will report alongside the Autumn Statement 2016 on whether the cap has been met or exceeded in each of these years.

At the time of Autumn Statement 2015, the OBR assessed that relevant welfare spending would breach the cap in three of the following five years, following the cancellation of changes to tax credits that had been proposed in the Summer Budget 2015.⁵⁰ The cap was comprehensively breached – by around £2 billion a year – in 2016/17 and the following two years. The Government's response to this was to 'justify' the breach to Parliament, rather than take action to remedy the situation,⁵¹ which led the Institute for Fiscal Studies to question the efficacy of the cap.⁵²

The Government announced in the 2016 Budget that its intention is for the cap to be met by the end of the Parliament according to the OBR's assessment that will accompany the Autumn Statement 2016.⁵³

The OBR's forecasts for the 2016 Budget (see below) showed the cap being breached in all years of the forecast period. This didn't represent a formal assessment. The OBR is only required to assess the Government's performance against the cap formally at each Autumn Statement.

The OBR will assess performance against the welfare cap alongside the Autumn Statement.

In its last formal assessment the OBR said that the cap would be breached in three of the following five years.

The welfare cap 2016/17 to 2020/21

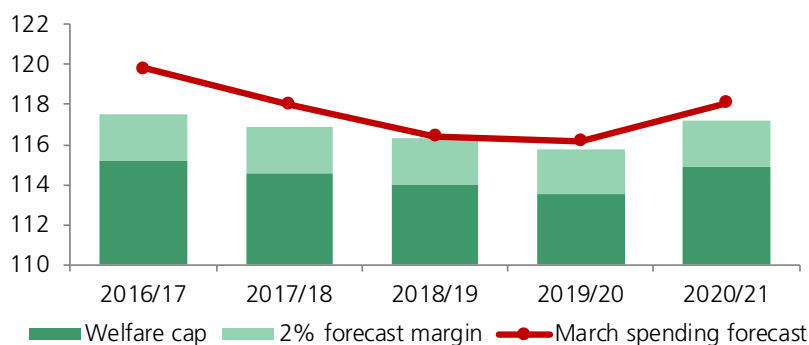
£billion

	2016/17	2017/18	2018/19	2019/20	2020/21
Welfare cap	115.2	114.6	114.0	113.5	114.9

Sources: HM Treasury, Budget 2016, March 2016, Table 1.5, p27

OBR, Economic and Fiscal Outlook March 2016, Table 5.3

Note: the 2% margin above the cap allows for forecast fluctuations each year



⁴⁹ HM Treasury, *Budget 2014*, March 2014, para 1.76, p26

⁵⁰ OBR, *Economic and Fiscal Outlook*, November 2015, pp 192,193

⁵¹ [HC Deb. 16 December 2015:c1633-1650](#)

⁵² IFS, *2016 Green Budget*, February 2016, p74

⁵³ HM Treasury, *Budget 2016*, March 2016, para 1.70, p26

3. Revising the fiscal targets

Summary

The Government has three targets for the public finances – often referred to as fiscal targets. The targets are designed to guide decisions affecting the public finances. The Chancellor is set to drop, or amend, at least one of the fiscal targets in the Autumn Statement.

The target for borrowing had been for a budget surplus to be reached in 2019/20. Following the EU referendum result the Government will no longer be pursuing this target. The Chancellor, Phillip Hammond MP, says that following the target is no longer sensible given the uncertainty the economy faces following the EU referendum result.

The Chancellor has not said anything definitive on what the new targets might be. However, he has discussed some wider objectives for fiscal policy that the targets might reflect. The Chancellor: still wants to seek a budget surplus in the future; wants to control day-to-day spending and debt; and may seek to find ‘headroom’ for a fiscal stimulus if the economy needs one. A fiscal stimulus would see the government increase spending or reduce taxes with the aim of stimulating economic growth.

The Chancellor may also take the opportunity to reassess the other fiscal targets – for debt and welfare spending – in the Autumn Statement. Both targets were being breached in the OBR’s latest assessments.

3.1 Background

Both the Coalition Government and Conservative Government have operated targets for the public finances – often referred to as fiscal targets. The targets are designed to guide decisions affecting the public finances.

The targets have been changed at various points.⁵⁴ The current target for borrowing, introduced by the Conservative Government in the 2015 Summer Budget, requires a budget surplus to be reached in 2019/20 (see Box 3.1). This ‘interim fiscal mandate’ would have the government spending less than it receives from taxes and other revenues in 2019/20, thus eliminating the deficit.

Following the EU referendum vote, the previous Chancellor, George Osborne MP, said that the Government would no longer be pursuing the 2019/20 surplus target.⁵⁵ The current Chancellor, Philip Hammond MP, and the Prime Minister have since confirmed this;⁵⁶ although both have said that they are not abandoning the intention to move to surplus in the future.

The Government isn’t going to aim to reach budget surplus in 2019/20.

⁵⁴ See Annex 1 of Library briefing [Office for Budget Responsibility and the Charter for Budget Responsibility](#) for details of previous fiscal rules. [Table 5.1](#) in the aforementioned IFS report covers targets from previous administrations.

⁵⁵ ‘Osborne abandons 2020 budget surplus target’, *BBC*, 1 July 2016; [HC Deb. 4 July 2016:c622](#)

⁵⁶ House of Lords Economic Affairs Committee, [Chancellor of the Exchequer Oral Evidence](#), 8 September 2016; [HC Deb 20 July 2016:c818-819](#)

The current Chancellor has said that it is more sensible to change the target rather than “squeezing a slowing economy to deliver a fiscal surplus target”.⁵⁷

Dropping the 2019/20 budget surplus target has not proved particularly controversial. There was doubt that the target was achievable, and ending the inflexible target to give the government greater flexibility to deal with a changing economy has been welcomed.⁵⁸

The Chancellor is set to announce details of new fiscal targets at the Autumn Statement. New targets for borrowing seem likely. The Chancellor may also take the opportunity to reassess the Government’s other fiscal targets – the debt and welfare targets – both of which were being breached in the OBR’s latest assessments.

The Chancellor is set to unveil a new target for borrowing in the Autumn Statement.

He may also revisit the Government’s other fiscal targets.

Box 3.1: The Government’s fiscal targets

The fiscal targets that were introduced in the 2015 Summer Budget are shown below. These targets are included in the [Charter for Budget Responsibility](#); if the Government wishes to change the targets this Charter will have to be revised.

See [section 2](#) for more on the public finances.

The fiscal mandate

The Government’s interim fiscal mandate is for public sector net borrowing to be in surplus by 2019/20. A surplus will be achieved if government spending is less than the taxes and receipts it receives. Once a surplus has been reached the target is for a surplus to be achieved in every year when the economy is in ‘normal times’.

Supplementary debt target

Until 2019/20 the fiscal mandate will be supplemented with a target for the public sector net debt-to-GDP ratio to fall each year.

Normal times

The above targets will apply unless the OBR assess that there has been a significant negative shock. If annual real growth in the UK economy is less than 1% the OBR will judge there to have been a significant negative shock, and the economy will be out of normal times.

If the OBR judges that a negative shock has occurred, or will occur over the forecast period, the fiscal targets will be suspended. The Treasury must then set out a plan to return the budget to surplus including temporary fiscal targets. The plan must be approved by a vote in the House of Commons.

Cap on welfare

The welfare cap sets a limit on the amount that can be spent on certain benefits including tax credits, incapacity benefit and most housing benefit. It excludes Job Seekers Allowance, Universal Credit and the state pension. The level of the cap is set by the Treasury for each year of the five years that the OBR produces forecasts for – often referred to as the forecast period.

The OBR’s latest judgement

Twice a year – alongside the Budget and Autumn Statement – the OBR judges whether the Government is more likely than not to meet the fiscal mandate and supplementary debt target. In March 2016, the OBR judged the Government to be on course to meet the fiscal mandate, but not the supplementary debt target. The debt target was not met as the OBR expected the debt-to-GDP ratio to increase between 2014/15 and 2015/16.

⁵⁷ Treasury Committee, *Oral evidence: The work of the Chancellor of the Exchequer*, 19 October 2016, HC 777, [q94](#)

⁵⁸ IFS, *post-Budget 2016 introductory remarks*, 17 March 2016 [‘Businesses welcome Hammond’s plans to ditch budget surplus targets’](#), *The Telegraph*, 3 October 2016; [‘George Osborne scraps 2020 budget surplus plan’](#), *The Guardian*, 1 July 2016; [‘Rethinking the public finances - Plan B’](#), *The Economist*, 8 October 2016; IFS Newspaper Article, [If Hammond hits reset, it won’t mean Osborne got it wrong](#), 26 July 2016

The welfare cap is assessed at the Autumn Statement. At Autumn Statement 2015, the OBR reported that the Government had breached the welfare cap. In its March 2016 forecast, the OBR said that forecast spending remains above the welfare cap and the breach would still hold.

Further information on the current and previous fiscal rules can be found in the Library Briefing Paper [The Office for Budget Responsibility and Charter for Budget Responsibility](#).⁵⁹

3.2 Changing the fiscal targets

The fiscal targets are set out in the Charter for Budget Responsibility (the Charter).⁶⁰ If the Government wishes to change any of the current targets it must lay an updated Charter before Parliament, which must then be approved by a vote of the House of Commons. It seems likely that this is the approach the Chancellor will take to replace the 2019/20 budget surplus target, and that the Government will publish a revised Charter alongside the Autumn Statement.

An alternative approach does exist, but this approach only becomes available if the OBR forecasts economic growth to be sufficiently low.^{61,62} The fiscal targets can be replaced if the OBR forecasts there has been a significant negative shock. As Box 3.1 explains, a significant negative shock is deemed to have happened if the OBR forecasts that annual economic growth will be less than 1% in real terms at any point over the next five years.⁶³ If the OBR makes such an assessment the Chancellor can review the targets. Any changes made to the targets must still be approved by a vote in the House of Commons.

The fiscal targets are set out in the Charter for Budget Responsibility.

Revisions to the Charter must be approved by a vote of the House of Commons.

3.3 What has the Chancellor said about new fiscal targets?

The Chancellor hasn't laid out any specifics for the new fiscal targets – the detail will come in the Autumn Statement.

While nothing specific about the new targets has been announced, the Chancellor has discussed some wider objectives for fiscal policy that the targets may reflect.

Taken overall, the Chancellor's comments, summarised below, suggest that the new targets may focus on the current budget, but include a longer-term desire to return to surplus.⁶⁴ They may also be more flexible, not focusing on a particular date, but always looking to a rolling period in the future. This was the sort of target that the Coalition

⁵⁹ [The Office for Budget Responsibility and Charter for Budget Responsibility](#), Commons Library Briefing Paper, SN05657, 6 November 2015

⁶⁰ HM Treasury. [The Charter for Budget Responsibility: autumn 2015 update](#)

⁶¹ Of course, the Government could also amend or repeal primary legislation to bring to an end the Charter for Budget Responsibility and the targets contained in it. The relevant Act is the [Budget Responsibility and National Audit Act 2011](#).

⁶² This approach is only available for the fiscal mandate and supplementary debt target.

⁶³ A significant negative shock is also deemed to have happened if its real terms economic growth was less than 1% in the most recent 4 quarter period or is occurring at the time when the OBR is making the assessment.

⁶⁴ Resolution Foundation, [Pressing the reset button: The public finances options facing the new Chancellor at the Autumn Statement](#), October 2016

Government used for borrowing, which was recently praised by Paul Johnson, Director of the Institute for Fiscal Studies (IFS).^{65,66}

Controlling public sector debt is a concern for the Chancellor, so there may also continue to be a target specifically focused on the debt-to-GDP ratio.

Reaching a surplus in the future and controlling debt

The Chancellor is not abandoning the aim to reach a budget surplus at some point, but 2019/20 will no longer be the target date.⁶⁷ The government will therefore still be working to reduce the deficit: "The task of fiscal consolidation must continue."⁶⁸

The Chancellor believes that debt needs to be controlled:

"I suggest that the level of public sector net debt as a ratio of GDP that we are at at the moment we are getting quite close to a level that might make a difference to the willingness of markets to lend to us, so I do not think we should be cavalier about the levels of debt".⁶⁹

Room for fiscal stimulus and flexibility

The Chancellor has said that a new fiscal rule could allow 'headroom' to deliver a fiscal stimulus, if the economy needed one. That is, the Chancellor has suggested that a rule could be designed that would allow for increased public spending or reduced taxes if the economy required such a stimulus.⁷⁰ The Chancellor has suggested that this flexibility could be built into a new rule whether the headroom is required immediately or not.⁷¹

Controlling day-to-day public spending, but allowing for investment

The Chancellor wants to control the government's day-to-day, or current, spending.⁷² He has also suggested that if fiscal stimulus is required it should focus on investment that delivers a short-term stimulus and long-term benefits for productivity. A new rule, according to the Chancellor, should allow for "high value economic infrastructure investment."⁷³ See [section 4](#) for more on infrastructure.

⁶⁵ The Coalition Government started with a target for the cyclically-adjusted current budget to be in surplus 5 years out. This then got shortened to 3 years out.

⁶⁶ P Johnson, "[Rip it up and start again: flexibility is key to writing the fiscal rulebook](#)", *The Times*, 15 November 2016

⁶⁷ Treasury Committee, *Oral evidence: The work of the Chancellor of the Exchequer*, 19 October 2016, HC 777, [q94](#)

⁶⁸ [Philip Hammond's speech to 2016 Conservative Party Conference](#), 3 October 2016; Treasury Committee, *Oral evidence: The work of the Chancellor of the Exchequer*, 19 October 2016, HC 777, [q102](#)

⁶⁹ House of Lords Economic Affairs Committee, [One-off evidence session with the Chancellor of the Exchequer](#), 8 September 2016

⁷⁰ House of Lords Economic Affairs Committee, [One-off evidence session with the Chancellor of the Exchequer](#), 8 September 2016

⁷¹ ['Hammond seeks fiscal headroom to react to any Brexit fallout'](#), *FT*, 2 November 2016

⁷² [Philip Hammond's speech to 2016 Conservative Party Conference](#), 3 October 2016; BBC Radio 4, Today Programme, 3 October 2016

⁷³ ['Chancellor says there will be no infrastructure 'splurge''](#), *FT*, 7 October 2016

4. Infrastructure

Summary

The run up to the Autumn Statement has seen calls from economists and industry bodies for increased government spending on infrastructure. The Chancellor has indicated that he sees the need for some targeted and time limited increases in this sort of spending.

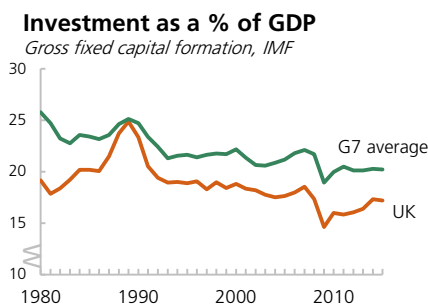
The motivation for this is partly the historically low cost of government borrowing (despite recent rises) and the fact that GDP growth forecasts have been cut recently, particularly for 2017. Infrastructure spending is seen as an important part of a potential 'fiscal stimulus' to boost GDP growth in the medium term. A fiscal stimulus would see the government increase spending or reduce taxes with the aim of stimulating economic growth.

Areas of infrastructure that could see increased investment include house building, road and rail improvements and flood defences.

The Chancellor has stated that the UK needs more "careful, targeted public investment in high value infrastructure"⁷⁴ and this option has been widely discussed ahead of the Autumn Statement. Why has this possibility been raised and what has been suggested?

4.1 Why increase infrastructure spending?

The World Economic Forum ranks the UK 9th out of 144 countries in terms of infrastructure quality, behind France and Germany (7th and 8th), but ahead of the US (11th).⁷⁵



Total investment spending in the UK, however, is below the level seen in other developed economies. The UK invested 17% of GDP in 2015, compared with 22% in France, 20% in the US and 19% in Germany. The G7 average was 20%.⁷⁶

Box 4.1: A fiscal stimulus?

Increasing spending or cutting taxes to boost economic growth is known as a 'fiscal stimulus'. The idea has attracted considerable attention in the run up to the Autumn Statement.

In 2008 and 2009 the then Labour Government introduced a fiscal stimulus in response to the financial crisis. This stimulus cut VAT, introduced new infrastructure spending and brought forward already planned investment.

⁷⁴ Phillip Hammond, [Speech to Conservative Party Conference](#), 3 October 2016

⁷⁵ World Economic Forum, [Global Competitiveness Index 2016/17, 2nd Pillar](#)

⁷⁶ International Monetary Fund database, [Total Investment: Gross Fixed Capital Formation](#), Downloaded November 2016

The economic outlook is materially better now compared with in 2008, but GDP forecasts have been reduced quite sharply in recent months, particularly for 2017.⁷⁷ Options for boosting growth in the medium term are therefore being widely discussed.

Oxford Economics estimate that increasing infrastructure spending by 1% of GDP in 2017/18 and 2018/19 would increase economic growth by up to 1.2% points more than cutting taxes, and by up to 0.4% points more than increasing other spending by the same amount.⁷⁸

The UK Government spent £33 billion or 1.8% of GDP on infrastructure in 2015/16.⁷⁹ Increasing this figure by 1% of GDP is probably beyond the scale of any increase to be announced in the Autumn Statement, but the comparatively greater impact of infrastructure spending on growth means some increase in this area is possible.

Increased investment in infrastructure also appears attractive at the moment because of the relatively low cost of government borrowing. Despite recent increases, 10 year government bond yields are still well below the level seen before the financial crisis or even a couple of years ago. Government bond yields indicate the rate the government can expect to pay on new borrowing. If the Government were to accept the arguments for increasing infrastructure spending, doing so now would incur lower borrowing costs than in previous eras.⁸⁰

Government borrowing costs are relatively low.

The Government has also signalled that it will alter the 'fiscal targets' which guide the Government's decisions affecting spending and taxes. The revised targets may introduce extra scope for increases in infrastructure investment (see [section 3](#) for more on the fiscal targets).

The Financial Times notes that Government officials are looking into the possibility of new "infrastructure bonds" which be used to help fund infrastructure spending. The bonds are seen as one way that the Government might try to mitigate the impact that leaving the EU would have on the UK's access to loans from the European Investment Bank (see Box 4.2).⁸¹

⁷⁷ HM Treasury, [Forecasts for the UK economy: a comparison of independent forecasts](#), October 2016

⁷⁸ Oxford Economics, *UK economic outlook: the UK votes to leave the EU, what happens next?* September 2016. Cited in Telegraph, [Big spender: new Chancellor Philip Hammond could splurge on construction](#), 18 September 2016

⁷⁹ ONS, [Public Sector Net Investment series: JW2Z](#)

⁸⁰ Financial Times, [UK sovereign bond yields close to pre-Brexit levels](#), 10 November 2016

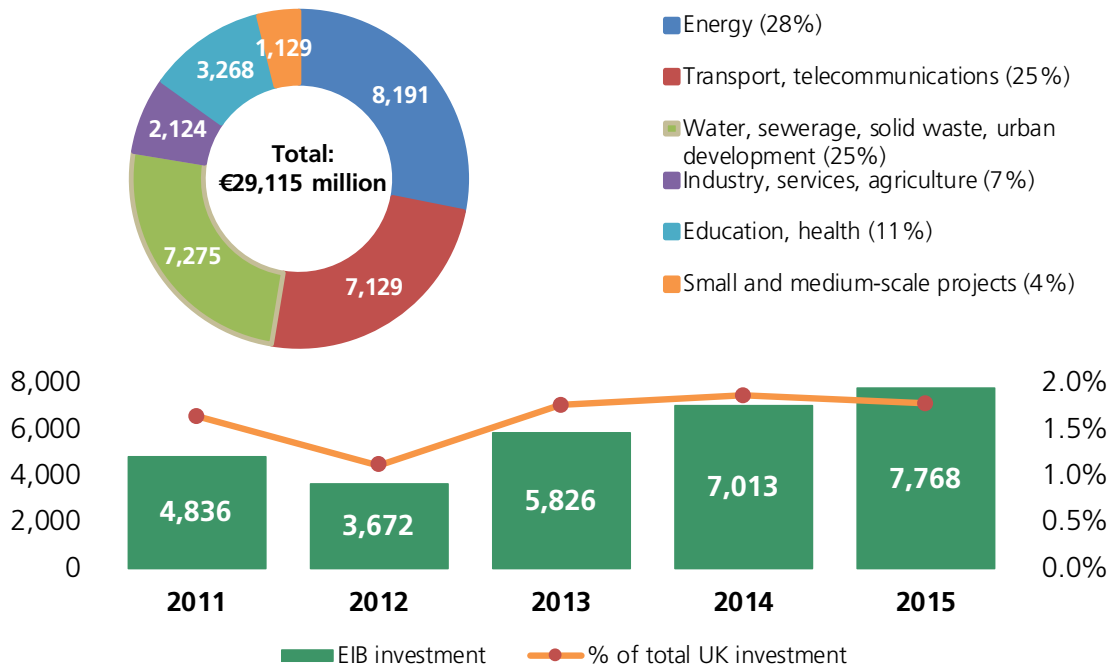
⁸¹ Financial Times, [UK drawing up plans for infrastructure bonds for large projects](#), 14 November 2016

Box 4.2: Brexit, infrastructure spending and the European Investment Bank (EIB)

Founded under the Treaty of Rome of 1957, the European Investment Bank (EIB) is directed and managed by EU member states and it is tasked with contributing to the “balanced and steady development of the internal market in the interest of the Union”.⁸² The charts below highlight the key sectors for EIB lending in the UK as well as the increase in lending commitments over recent years (more than doubling between 2012 and 2015).⁸³

EIB lending in the UK, 2011 to 2015

€ millions



Brian Unwin, a British former President of the EIB, has pointed out the role of the EIB in various large scale infrastructure projects, including the Channel tunnel (of which the EIB was the leading financier), the second Severn crossing, the Jubilee Line extension to the London Underground network, the Heathrow Express and London to Dover fast rail links. Mr Unwin believes that:

“There is no alternative multilateral institution with the EIB’s lending capacity and expertise in infrastructure investment, and proposals to establish a UK equivalent have come to nothing.”⁸⁴

Reports suggest that the Government may be considering a number of proposals on how to fill a gap in infrastructure investment left by the EIB. These include the possibility of the Treasury issuing “infrastructure bonds” or the launch of a UK investment bank.⁸⁵

Could the EIB still lend to the UK after Brexit?

EIB lending outside the EU is governed by a series of mandates from the European Union in support of EU development and cooperation policies in partner countries. As a result, any continued lending to the United Kingdom would have to be unanimously agreed by the EIB’s board of governors (the finance ministers).

⁸² [Article 309 of the Lisbon Treaty](#)

⁸³ EIB, [The EIB in the United Kingdom](#) (accessed on 14 November 2016)

⁸⁴ Financial Times, [“Brexit Britain will miss cheap EU funds for infrastructure”](#) (11 August 2016)

⁸⁵ Financial Times, [“UK drawing up plans for infrastructure bonds for large projects”](#) (14 November 2016)

4.2 What infrastructure spending has been suggested?

The Chancellor has commented that

If there is a need...to deliver a fiscal stimulus...it has to be well designed; it has to be limited in duration and quick in delivering effect...⁸⁶

This implies that although the Autumn Statement may make reference to large-scale projects (such as the third runway at Heathrow, the Hinkley Point C nuclear power station and HS2), any new infrastructure spending announcements are likely to be smaller in scale and 'shovel ready', or as the Chancellor has characterised them, "modest, rapidly deliverable investments..."⁸⁷

The Government also announced measures to build more houses in early October, including a £3 billion Home Building Fund which aims to "build more than 25,000 new homes this Parliament and up to 200,000 in the longer term."⁸⁸

The Chancellor has repeatedly mentioned road and rail improvements as potential targets for investment.⁸⁹ Given the flood damage in early 2016, flood defences are another likely candidate for improvement.

The Government's [Infrastructure Pipeline](#) features a number of other smaller projects which are due to begin work in 2018/19 or later which could potentially be brought forward. These include station upgrades across the country, a river crossing in London and motorway expansion in the North East of England.⁹⁰

⁸⁶ House of Lords Economic Affairs Select committee, [Oral evidence from Rt. Hon. Philip Hammond MP](#), 8 September 2016

⁸⁷ *Ibid*

⁸⁸ Department for Communities and Local Government, [Press Release: Let's get Britain building](#), 4 October 2016

⁸⁹ For example, in the Chancellor's [Conference Speech](#), and to the [Lords Economic Affairs Committee](#)

⁹⁰ HM Treasury, [National Infrastructure Pipeline Spring 2016](#), April 2016

Appendix 1: Sources of further information

Library's Brexit briefings

The Library has produced a range of briefings. The briefings, and other relevant parliamentary material, are pulled together in our [EU referendum hub](#).

Section 6 of [Productivity in the UK](#) looks at the channels through which Brexit can affect future productivity – and growth – prospects.

HM Treasury

[Budget 2016](#)

[Autumn Statement and Spending Review 2015](#)

[Summer Budget 2015](#)

[Budget 2015](#)

Office for Budget Responsibility

[Economic and fiscal outlook, March 2016](#)

[Economic and fiscal outlook, November 2015](#)

[Monthly commentary on the public finances](#)

[Public finance databank](#)

Institute for Fiscal Studies

[Post-Budget Briefing 2016](#)

[Post-Spending Review and Autumn Statement Briefing 2015](#)

[Post-Summer Budget Briefing 2015](#)

[Green Budget 2016](#)

[Commentary on the September 2016 public finances](#)

House of Commons Library

[Economic indicators](#) (an edition will be published on 22 November 2016)

House of Lords Library

[2016 Budget: Overview and Reactions](#)

House of Commons Treasury Select Committee

[Inquiry into Budget 2016](#)

[Inquiry into Spending Review and Autumn Statement 2015](#)

[Inquiry into Summer Budget 2015](#)

[Inquiry into Budget 2015](#)

[Report on Autumn Statement 2014](#)

Appendix 2: Economic and public finance data 1979-2021

Economic data, 1979-2020

	Real GDP growth %	Inflation RPI %	Inflation CPI %	ILO Unemployment Q4, %
1979	3.7%	13.4%	..	5.5%
1980	-2.0%	18.0%	..	8.0%
1981	-0.8%	11.9%	..	10.2%
1982	2.0%	8.6%	..	11.1%
1983	4.2%	4.6%	..	11.7%
1984	2.3%	5.0%	..	11.6%
1985	4.2%	6.1%	..	11.3%
1986	3.2%	3.4%	..	11.3%
1987	5.4%	4.2%	..	9.7%
1988	5.8%	4.9%	..	8.0%
1989	2.6%	7.8%	5.2%	7.0%
1990	0.7%	9.5%	7.0%	7.5%
1991	-1.1%	5.9%	7.5%	9.5%
1992	0.4%	3.7%	4.3%	10.4%
1993	2.5%	1.6%	2.5%	10.3%
1994	3.9%	2.4%	2.0%	9.0%
1995	2.5%	3.5%	2.6%	8.3%
1996	2.5%	2.4%	2.5%	7.8%
1997	3.1%	3.1%	1.8%	6.5%
1998	3.2%	3.4%	1.6%	6.1%
1999	3.3%	1.5%	1.3%	5.8%
2000	3.7%	3.0%	0.8%	5.2%
2001	2.7%	1.8%	1.2%	5.2%
2002	2.4%	1.7%	1.3%	5.1%
2003	3.5%	2.9%	1.4%	4.9%
2004	2.5%	3.0%	1.3%	4.7%
2005	3.0%	2.8%	2.1%	5.1%
2006	2.5%	3.2%	2.3%	5.5%
2007	2.6%	4.3%	2.3%	5.2%
2008	-0.6%	4.0%	3.6%	6.4%
2009	-4.3%	-0.5%	2.2%	7.8%
2010	1.9%	4.6%	3.3%	7.9%
2011	1.5%	5.2%	4.5%	8.4%
2012	1.3%	3.2%	2.8%	7.8%
2013	1.9%	3.0%	2.6%	7.2%
2014	3.1%	2.4%	1.5%	5.7%
2015	2.2%	1.0%	0.0%	5.1%
2016	2.0%	1.7%	0.7%	4.9%
2017	2.2%	2.4%	1.6%	5.1%
2018	2.1%	3.2%	2.0%	5.2%
2019	2.1%	3.2%	2.1%	5.3%
2020	2.1%	3.2%	2.0%	5.4%

Sources: ONS (series, IHYP, CZBH, D7G7, MGSX)

OBR, Economic and fiscal outlook, March 2016, Table 3.8, and Economy Supplementary Tables 1.6 & 1.7

Public finance data 1979-80 to 2020-21

	Public sector net borrowing		Structural	Public sector net debt	
	£ billion	% GDP	deficit % GDP	£ billion	% GDP
1979/80	8.5	3.7%	4.0%	98.2	45.0%
1980/81	11.5	4.3%	2.9%	113.8	45.6%
1981/82	6.0	2.0%	-0.1%	125.2	45.3%
1982/83	8.5	2.6%	0.6%	132.5	43.9%
1983/84	11.8	3.3%	2.0%	143.6	43.6%
1984/85	12.5	3.3%	2.8%	157.0	44.3%
1985/86	9.0	2.1%	2.1%	162.5	41.7%
1986/87	8.4	1.9%	2.0%	167.8	40.1%
1987/88	4.7	0.9%	2.1%	167.4	35.6%
1988/89	-6.0	-1.1%	1.0%	153.7	29.3%
1989/90	-0.6	-0.1%	1.3%	151.9	26.2%
1990/91	6.2	0.9%	0.7%	151.1	24.2%
1991/92	23.0	3.3%	1.9%	165.8	25.2%
1992/93	47.1	6.5%	4.8%	201.9	29.0%
1993/94	51.6	6.7%	5.4%	249.8	33.9%
1994/95	43.8	5.4%	4.6%	290.0	37.5%
1995/96	35.3	4.2%	2.9%	322.1	39.2%
1996/97	27.7	3.1%	2.7%	347.0	37.3%
1997/98	5.9	0.6%	1.8%	358.6	37.1%
1998/99	-4.4	-0.4%	0.9%	357.8	35.3%
1999/00	-14.4	-1.4%	0.0%	349.3	32.7%
2000/01	-17.2	-1.6%	-0.4%	316.7	28.5%
2001/02	0.5	0.0%	0.7%	323.1	27.9%
2002/03	26.7	2.2%	2.3%	356.2	29.1%
2003/04	31.5	2.5%	2.8%	391.0	30.3%
2004/05	43.6	3.3%	3.9%	446.5	32.9%
2005/06	41.1	2.9%	3.5%	487.2	33.9%
2006/07	36.6	2.5%	3.0%	523.6	34.6%
2007/08	40.5	2.6%	3.7%	554.4	35.3%
2008/09	104.0	6.7%	6.6%	763.8	50.2%
2009/10	154.9	10.1%	8.0%	1,006.9	64.6%
2010/11	136.8	8.6%	6.6%	1,151.7	71.3%
2011/12	115.5	7.1%	5.2%	1,246.6	75.2%
2012/13	123.4	7.3%	5.3%	1,357.5	78.8%
2013/14	104.0	5.9%	4.4%	1,460.1	80.9%
2014/15	96.3	5.2%	4.4%	1,548.5	83.3%
2015/16	76.0	4.0%	3.8%	1,602.8	84.0%
2016/17	55.5	2.9%	2.7%	1,638.4	82.6%
2017/18	38.8	1.9%	1.9%	1,676.9	81.3%
2018/19	21.4	1.0%	1.0%	1,715.3	79.9%
2019/20	-10.4	-0.5%	-0.5%	1,724.8	77.2%
2020/21	-11.0	-0.5%	-0.5%	1,739.9	74.7%

Source: OBR, ONS

Note: figures exclude public sector banks

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