Institute for Fiscal Studies

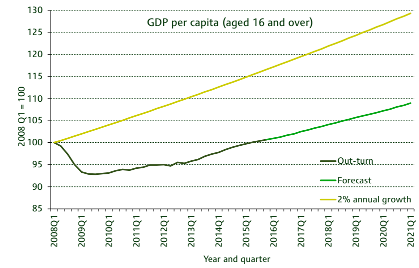
Household incomes, Brexit and the Autumn Statement: Winter is Coming

Paul Johnson

9 November 2016

ESRC ECONOMIC & SOCIAL RESEARCH COUNCIL

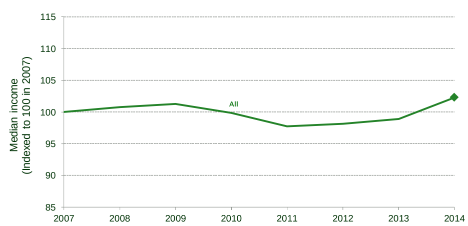
Pre-referendum forecast: GDP per capita only just back to pre-crisis levels



Source: Office for Budget Responsibility (2016).

Institute for Fiscal Studies

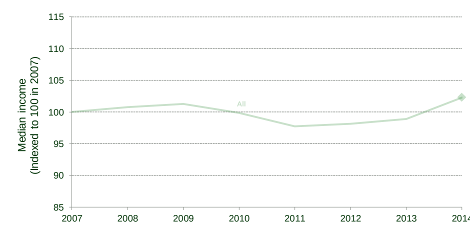
Median income by age



Source: Figure 2.6 of *Living Standards, Poverty and Inequality: 2016*

Institute for Fiscal Studies

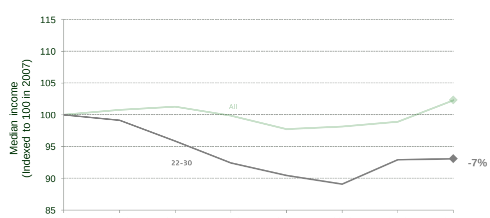
Median income by age



Source: Figure 2.6 of *Living Standards, Poverty and Inequality: 2016*

Institute for Fiscal Studies

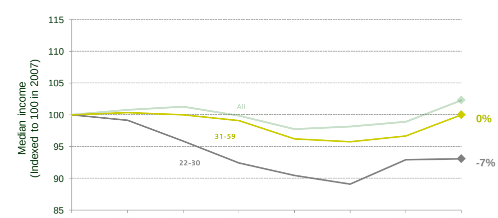
Median income by age



Source: Figure 2.6 of *Living Standards, Poverty and Inequality: 2016*

Institute for Fiscal Studies

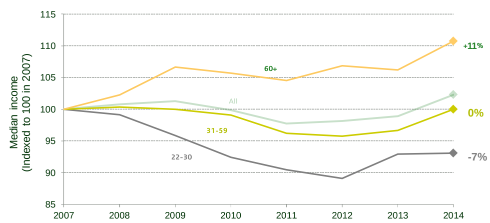
Median income by age



Source: Figure 2.6 of *Living Standards, Poverty and Inequality: 2016*

Institute for Fiscal Studies

Median income by age



Source: Figure 2.6 of *Living Standards, Poverty and Inequality: 2016*

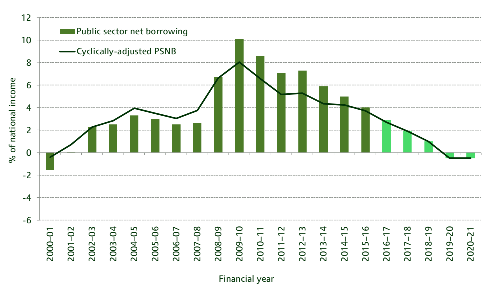
Institute for Fiscal Studies

So we go into next few years

- After several years of very poor growth
- With interest rates as low as they can go
  - After a record period at record low levels
- With a dreadful productivity record
- With incomes doing very badly by historic standards
- And as a result a budget deficit which remains substantial

Institute for Fiscal Studies

Pre-referendum forecast: deficit reduced from peak, but some way off being eliminated



Source: Office for Budget Responsibility (2016).

Institute for Fiscal Studies

A lot more "austerity" was planned

- A budget tightening of 3% of national income implied a lot more "austerity"
  - Further cuts in working age benefits
  - Very slow growth in NHS spending
  - Real cuts in "unprotected" areas
- And debt would still be around 80% of national income

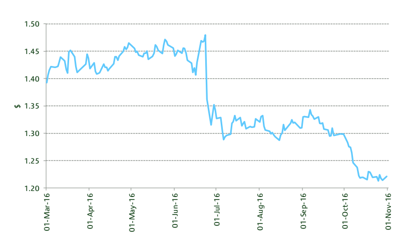
Institute for Fiscal Studies

Brexit will make things worse

- Short run effect has been on the exchange rate

Institute for Fiscal Studies

The collapse in the exchange rate



Institute for Fiscal Studies

Brexit will make things worse

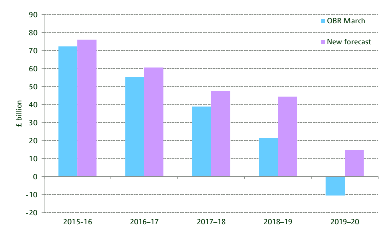
- Short run effect has been on the exchange rate
  - Which will result in higher prices
- The next big concern is about investment
  - No data yet but increased uncertainty likely to reduce investment, especially FDI
- Even so Bank of England thinks national income will be 2.1% lower by 2019 than it would have been
  - Average of independent forecasters have GDP 2.8% lower

Forecasts for cumulative growth to 2020

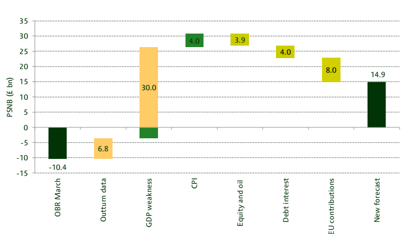
Brexit will make things worse

- Short run effect has been on the exchange rate
  - Which will result in higher prices
- The next big concern is about investment
  - No data yet but increased uncertainty likely to reduce investment, especially FDI
- Even so Bank of England thinks national income will be 2.1% lower by 2019 than it would have been
  - Average of independent forecasters have GDP 2.8% lower
- Which means borrowing will be higher

Our borrowing forecast relative to March OBR



Of which these are the components



All based on current policy

- All announced spending cuts occur
  - Including “efficiencies” announced in the Budget for 2019-20
  - And big cuts to working age benefits
- No additional money for NHS, social care etc
- Does not include cost of increasing income tax personal allowance

Real effects of Brexit come in longer run

- It looks likely we will leave both the single market and the customs union
  - Raising both tariffs and "non tariff barriers
- So trade costs will rise, impact depending on
  - Nature of trade deal / membership of single market
  - Importance of "dynamic" effects especially of reduced FDI reducing investment and productivity
- Nearly half our trade is with the EU
  - No other trade agreement could make up for barriers within EU
- Wide variety of long run estimates
  - Ranging from small GDP losses to losses of 8% or more

So where now for fiscal policy?

- Surplus target for 2019-20 seems to have been abandoned
  - Despite being legislated only last year
- But that need not mean the "end of austerity"
- My Hammond might in fact decide to extend austerity
  - at its current pace that might get us to surplus a year or two later
- Or he might decide on something else entirely
  - allowing borrowing to finance investment spending
  - Focussing on a debt to GDP ratio
  - Revert to Osborne's initial rule of targeting forecast surplus 5 years out
- Uncertainty over economic developments is pervasive

Short run stimulus is possible

- Very difficult judgment given uncertainty
  - would add to borrowing, but borrowing cheap
- *Only* a response to short run economic cost
  - If potential output falls, in the end fiscal policy will need to be tightened
- Any stimulus package should be **T**argeted, **T**imely and **T**emporary
- Could push back fiscal tightening and/or announce new measures:
  - one-off boost to public sector investment spending
  - temporary cut to the main rate of VAT
  - a time-limited tax break to encourage companies to invest
  - a stamp duty holiday to stimulate housing transactions
- Versions of all these measures were implemented by Alistair Darling

And things get even harder in next 30 years

- Population ageing will increase what we need to spend on state pensions and health
- Pension spending rises between 1 and 3% of national income, depending on:
  - Whether triple lock continues
  - Whether pension age rises with longevity
- Health spending rises between 2 and 5% of national income depending on:
  - How productivity in NHS rises
- A *minimum* 5% of national income increase overall

Conclusions

- Incomes for all have been squeezed
  - Young have done especially badly
- Substantial further fiscal tightening planned as of March
- With no policy change borrowing in 2019-20 likely to be £25bn more than planned
- In the Autumn Statement the new Chancellor will need to decide
  - what level of borrowing to aim for in the longer-term, and how quickly to try to get there: further austerity beyond 2019–20 likely
  - whether to announce temporary fiscal easing to boost UK economy
- In the context of, perhaps unprecedented, levels of uncertainty over the path of the economy
  - And long run challenges from both Brexit and ageing

Institute for Fiscal Studies

Household incomes, Brexit and the Autumn Statement: Winter is Coming

Paul Johnson

9 November 2016