Global Counsel

Brexit reckoning, the OBR and the budget

Blog post by Chief Economist Gregor Irwin, 21 February 2020

Britain's new chancellor of the exchequer, Rishi Sunak, will give his first budget on March 11th, less than four weeks after he was appointed, following the unexpected resignation of Sajid Javid. All budgets are important, but this one more than most, as Sunak must demonstrate that he is delivering on the commitment made by the Conservatives in the 2019 election to "level up" growth and economic opportunities across the UK.

That's costly. Sunak is expected to announce a big boost to infrastructure spending. But his job will be made harder by two connected factors. One is that he does not have much space to increase day-to-day spending without changing or breaching the government's fiscal rules. The other is that the independent forecast underpinning the budget might be about to lay out the fiscal cost of the government's signature policy, Brexit, for the first time, which could further constrain him. Most commentary on the budget has focused on the former issue; but the latter may turn out to be as or more important, politically and economically.

Explaining this requires a small detour on how these forecasts are prepared, and by who. Since 2010, the UK has had an independent fiscal watchdog, called the Office of Budget Responsibility. The OBR is required by legislation to provide detailed five-year forecasts for the economy and public finances twice each year, including at budget time. Under that legislation the forecasts must be based on current government policy, but the OBR is not obliged to assume that policy objectives will be met. Since 2010 the OBR has developed a strong reputation for independence and the quality of its analysis. It is probably fair to say that its forecasting record is not that bad either.

But how has the OBR handled Brexit in its forecasts until now? This can be summed up in one word – conservatively – with a small "c". And that is for justifiable reasons. One is uncertainty about the UK government's policy and exactly what Brexit means. The other is uncertainty about the impact of the policy, given that Brexit amounts to an experiment in the de-liberalisation of trade, for which there are few good data points, at least not for a wealthy, advanced economy, such as the UK.

As a result, the OBR has, until now, hedged its position. You must go back to March 2019 for the most recent full forecast by the OBR. That was when Theresa May was prime minister and, somewhat heroically, the OBR assumed the UK would leave the EU at the end of the month with the withdrawal agreement negotiated by May but rejected three times by the British parliament.

The immediate implication of that assumption was continuity, under a transition period running until the end of 2020. Beyond that, the OBR assumed extra trade frictions would arise over an extended period as trade barriers impede the "exploitation of comparative advantage". And the OBR assumed lower net inward migration, as the UK introduces a tighter migration regime, but with net inward migration "remaining above" tens of thousands.

At that time, the OBR also set out future forecast issues concerning Brexit. It committed to adjusting its Brexit assumptions appropriately when more "substantive detail" is available on both the future trade regime with the EU and immigration policy.

That time is surely now. The UK government has just published proposals for a points-based immigration system, which will, according to the Home Office, reduce EU migration by 70%. That will have consequences for labour supply, growth and the fiscal position. Some of the effects will be felt relatively soon.

The UK and the EU are also setting out negotiating mandates for the agreement on the future relationship. The new UK government is adamant this must enter into force at the end of this year. The relationship, assuming it can be agreed, will be a more distant one than Theresa May anticipated a year ago, when she was still seeking a “frictionless” relationship for trade in goods.

Both these developments imply a sharper adjustment to growth – and to the fiscal position – than the OBR has been forecasting until now. And they will be amplified if, as the OBR has assumed in previous analysis, they also mean lower business investment than is currently forecast.

None of this changes the uncertainty about the impact of the policy changes and that may still give the OBR reasons to be cautious. But when the policies change, so must the forecast. And that might make this budget even more awkward for the new chancellor.