# <u>March 2018 *Economic and Fiscal Outlook* Briefing</u>

Robert Chote
Chairman
Office for Budget Responsibility

Good afternoon ladies and gentlemen.

My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our latest *Economic and Fiscal Outlook*.

I am going to take you through some of the highlights and then we will be very happy to answer your questions. The slides and my speaking notes will be available on our website after we finish.

[SLIDE] Let me start with the usual background.

The EFO contains our latest five-year forecasts for the economy and the public finances and an assessment of the Government's progress against its fiscal and welfare spending targets.

The views expressed are those of the Budget Responsibility Committee. But, as always, we have relied on the hard work of the OBR's staff and of numerous officials in other departments and agencies.

As usual, the forecast went through several iterations to reflect new judgements and new data. Unusually, we have not had to include any scorecard policy measures – the Chancellor has kept to his word and is saving the policy action for the autumn.

We provided the Chancellor with a near-final forecast on February 28th and met with him and his officials on the same day. We shared a draft of the full document last Wednesday, to give them time to prepare his statement. At no point have we come under pressure to change any conclusions.

[SLIDE] So now let me give a brief overview of the report.

Relatively little time has elapsed since our November forecast and the medium-term outlook for the economy and public finances looks broadly the same.

The economy has slightly more momentum in the near term, thanks to the unexpected strength of the world economy. But there seems little reason to change our view of growth prospects over the medium term.

The budget deficit looks likely to come in almost £5 billion lower than we expected this year at £45.2 billion, an average-sized revision for a March forecast. But the improvement is expected to be smaller in future years.

With much of that modest improvement looking cyclical rather than structural, at least early in the forecast, the Chancellor's margin for error against his fiscal targets is virtually unchanged.

His underlying fiscal objective – of balancing the budget by 2025 – still looks very challenging, although a bit less so than in November.

We have not changed any of our assumptions about the impact of Brexit, but we have been able to quantify the financial settlement or 'divorce bill' that was provisionally agreed last year – and also set out a possible time profile. We estimate that the settlement will total just over £37 billion, in the middle of the range estimated by the Treasury at the time.

[SLIDE] Turning to the detail, let me start with the economy – and with what has been happening to headline GDP growth.

This chart shows the quarterly growth rates through 2016 and 2017 published by the ONS at the time of our November EFO – and our forecast that growth would come in at 0.4 per cent in the fourth quarter of 2017.

[SLIDE] This chart shows the latest picture. Growth was indeed 0.4 per cent in the fourth quarter, but the ONS has revised the data for earlier quarters, most notably upward in the second half of 2016.

[SLIDE] In calendar year terms, this means that headline GDP growth is currently estimated to have slowed from 1.9 per cent in 2016 to 1.7 per cent in 2017, rather than from 1.8 to 1.5 per cent as the outturn data suggested in November.

[SLIDE] Putting the UK performance into international context, this chart shows that the UK economy grew by 1.4 per cent over the latest four quarters, compared to 2 per cent over the preceding four. [SLIDE] In contrast, GDP growth picked up in every other G7 economy, taking us from the top of that particular league table to the bottom.

[SLIDE] Looking at the detail of this growth performance, the forecast judgements that we made back in November 2016 to reflect the referendum vote to leave the EU appear broadly on track:

- We expected net inward migration to slow. Which it has, from 336,000 in the year to June 2016 to 244,000 in the year to September 2017.

- We expected the drop in sterling that followed the vote to raise inflation and squeeze consumers' finances and their contribution to GDP growth. Inflation has indeed risen well above our March 2016 forecast, but consumption has held up a little better than expected as household saving has dropped more sharply.

- We assumed that uncertainty around the Brexit negotiations would weaken business investment. The Bank of England estimates that uncertainty has indeed lowered it by 3 to 4 per cent. Business investment is weaker than we forecast before the referendum, but again has held up better than we expected in the post-vote forecast.

- Finally, we forecast that the fall in sterling would deliver an offsetting boost the economy via a greater contribution from net trade. But this offset has been smaller than we expected, thanks to imports meeting a greater share of domestic demand.

Overall, the referendum vote does seem to have weakened the economy, as we and most other forecasters expected, but not quite as much as we forecast back in November 2016.

Having said all this, we are still dealing with the very early drafts of economic history. And it is important not to put too much weight on what are still early indicators of economic activity either side of the Brexit vote.

[SLIDE] One reason to be cautious is that different measures of economic growth in the National Accounts are painting very different pictures of what has been going on over the last two years.

As we saw a moment ago, the headline measure of GDP shows growth weakening from 1.9 to 1.7 per cent between 2016 and 2017. [SLIDE] But, as you can see here, alternative measures in the National Accounts – which feed into the headline measure – disagree amongst themselves as to whether growth picked up, slowed down or remained stable over those two years. So we should not be surprised to see the headline figures revised in coming quarters as these estimates are further reconciled.

As some of you may remember, the biggest economic judgement that we made back in our November forecast was to assume that potential productivity growth would be weaker over the forecast than we had previously assumed, reflecting the sustained weakness that we have seen in actual productivity growth since the financial crisis and the fact that this appears to be a global rather than purely domestic phenomenon.

[SLIDE] So what has happened over the past two quarters, for which we now have data? As we have seen, growth in headline GDP was slightly stronger than expected, thanks to the ONS's upward revision in quarter three. [SLIDE] Meanwhile employment grew slightly less than expected, which means that productivity growth measured as output per worker was a little stronger than we forecast, but not significantly so.

[SLIDE] Much more noticeable is that the ONS's estimate of the average hours that each worker works per week dropped by 1 per cent in the second half of 2017, the biggest decline since the middle of 2011. This means that total hours worked also fell and that productivity measured as output per hour grew much more strongly than we forecast in November.

If this could be sustained, the outlook for GDP growth over the medium-term would be a lot rosier. But for the time being it looks more likely that the drop in average hours reflects statistical sampling errors rather than a real world development. The same was true of the fall in mid-2011.

[SLIDE] So for the time being we assume that the recent fall in hours will be reversed and that the medium-term outlook for productivity growth and for potential GDP growth remains broadly in line with our November forecast. Needless to say, we will come back to this in the autumn.

[SLIDE] So, with little change to the economy's underlying growth potential, what are the prospects for actual GDP growth looking forward?

To answer this question, we first need to assess whether activity in the economy is running above or below the level that can be sustained without upward or downward pressure on inflation. That determines whether actual GDP will grow more or less than potential GDP.

We use a variety of techniques to estimate this so-called 'output gap' and have concluded that the economy was 0.3 per cent above potential in the fourth quarter – a little more than we judged in November. This seems consistent with the latest surveys of capacity and recruitment difficulties, and with tentative signs of wage settlements picking up. There is of course huge uncertainty around this number, and we investigate the implications of a larger positive output gap in our scenario analysis in Chapter 5.

[SLIDE] Thanks to the unexpected strength of the world economy, we have revised our forecast for quarter-on-quarter GDP growth a little higher in the near term. But with our assessment of medium-term growth potential unchanged, and a more positive starting output gap, this slightly stronger growth in the near term is followed by slightly weaker growth later on.

[SLIDE] We can see the same pattern in year-on-year growth, comparing November and [SLIDE] today. Upward revisions to the outturn estimates for 2016 and 2017, and a small upward revision to 1.5 per cent for 2018, followed by small downward revisions in 2021 and 2022. Growth averages 1.4 per cent a year over the forecast, unchanged from November.

[SLIDE] The differences between the November and March forecasts are of course dwarfed by the uncertainty around either implied by the size and distribution of past forecast errors.

In terms of composition, we expect household consumption growth to fall back into line with income growth, business investment to remain subdued, government spending cuts to weigh on growth over the next couple of years, and net trade to be neutral from 2020 onwards.

[SLIDE] With the outlook for growth little changed, the outlook for CPI inflation is also much the same as in November, with the revisions again dwarfed by the uncertainty around either forecast.

[SLIDE] So how does the growth outlook stack up over the forecast as a whole – and how does this map onto the different elements of income and spending that matter most for tax receipts?

As this table shows, real GDP is expected to rise by 7 per cent between 2017-18 and 2022-23, little changed from November. Add in whole economy inflation and nominal GDP rises 16.3 per cent – barely changed at all from November. Aggregate growth in wages and salaries and company profits is a bit stronger, but growth in nominal consumer spending and real business investment is a bit weaker.

So what does all this mean for the public finances? The short answer is that relatively small changes to the economy forecast and no scorecard policy measures mean relatively small changes to the fiscal forecast.

[SLIDE] This chart shows our November forecast for public sector net borrowing [SLIDE] and our new forecast today. [SLIDE] Borrowing is now expected to be £4.7 billion lower this year than we expected in November at £45.2 billion. We have also revised the deficit down in each subsequent year, but by smaller amounts. So the average revision is only £3.4 billion.

[SLIDE] So where have these revisions come from?

- [SLIDE] As you can see here, they are dominated by upward revisions to receipts, which peak at a little over £7 billion a year in 2019-20.

- [SLIDE] These are partly offset by upward revisions to spending, which peak at £6 billion a year, also in 2019-20.

- [SLIDE] And finally, there is the very modest impact of Government policy decisions since November.

With no 'scorecard' of tax and spending measures in the Spring Statement, the Government decisions we are talking about here are the February local government settlement, the tax and spending measures included in the Welsh and Scottish Government budgets, and the Chancellor's decision in the debt financing remit to reduce the proportion of debt that will be issued as index-linked gilts. None has a significant fiscal impact.

[SLIDE] So now let's look at the underlying forecast revisions in a bit more detail and begin with the upward revision to receipts.

[SLIDE] First, and most noticeable since November, is an upward revision to self-assessment income tax receipts. These came in £2.9 billion higher than we forecast in November, but we don't expect much of that good news to push through into future years.

That is for two main reasons:

- First, about a third of the positive self-assessment surprise reflects the fact that forestalling of the April 2016 dividend tax increase appears to be unwinding more slowly than we anticipated. We estimate that taxpayers shifted more than £13 billion of dividend income into 2015-16 to beat the tax increase, but HMRC's latest analysis of individual tax returns suggests that only around 60 per cent of this was unwound in 2016-17, rather than the 80 per cent we had assumed. So there is more still to come.

- Second, much of the rest of the self-assessment surprise reflected payments on account for 2017-18 liabilities, which are boosted mechanically by higher-than-expected payments on 2016-17 liabilities. This boosts receipts in 2017-18, but at the expense of 2018-19. So there is little boost to future years.

[SLIDE] Other income tax and NICS receipts are coming in £2.8 billion higher than expected in November. Receipts growth has been particularly rapid in the business services sector and repayments have also been lower than expected. Next year, these receipts are further boosted by the cyclical pick-up in earnings growth. This effect fades slowly in later years.

[SLIDE] Onshore corporation tax receipts are almost £2 billion higher this year than expected, but much of this reflects liabilities from previous accounting periods. So it doesn't make a rising contribution to receipts over time.

[SLIDE] Heading in the other direction, capital gains tax receipts are coming in around £1 billion lower than expected this year. Together with the impact of lower equity prices, this pushes through the forecast and builds up in size to reduce receipts by £2.3 billion in the final year.

[SLIDE] Turning to public spending, this has been revised up by £2 billion this year and by an average of £2.5 billion a year over the forecast.

[SLIDE] The first contributor is higher debt interest spending. This is thanks to higher RPI inflation in the near term, which increases accrued interest on index-linked gilts, and to higher interest rates later in the forecast.

Market participants expect the Bank to raise interest rates a little further and faster than they did in November.

[SLIDE] The second contributor is higher local authority spending. This reflects a higher forecast for council tax receipts and greater assumed use of reserves to deal with spending pressures.

[SLIDE] Third, departmental spending is a bit higher than expected this year – not because the Government has increased spending limits, but because we expect departments to underspend them by a smaller margin.

[SLIDE] Fourth, growth in welfare spending has been revised lower. Tax credit spending has fallen short of our forecasts repeatedly in recent EFOs, suggesting that the incomes of tax credit recipients are growing more quickly – rather than more slowly – than those of the rest of the population. Adjusting for this lowers welfare spending by progressively larger amounts, reaching nearly £2 billion a year by the end of the forecast. The effect is offset in the near term by the expected cost of implementing a recent High Court judgement in respect of personal independence payments.

[SLIDE] The remaining revisions to the forecast have their biggest impact in 2019-20. The increase in spending in that year reflects the reprofiling of expected tax litigation costs and contributions to the EU.

[SLIDE] The revisions that we have made across the forecast as a whole are relatively small. Receipts have been revised up by 0.7 per cent and spending up by 0.3 per cent. As is often the case, when receipts are revised up because the economy is doing better, part of the gain is offset by higher debt interest spending, because market rates move higher.

As this chart shows, the net effect of the forecast revisions this time has been to reduce the budget deficit by 0.14 per cent of GDP on average over the last five years of the forecast. This is less than half the average revision for a March forecast. The revision in the current year is 0.24 per cent of GDP, which is in line with the average revision for a March forecast.

[SLIDE] Some commentators may be surprised that the downward revision to the deficit this year isn't bigger. As this chart shows, borrowing during the first 10 months of the financial year is 16 per cent lower than it was last year. If you simply applied that percentage fall over the year a whole, you would expect a deficit of £38.4 billion, £6.7 billion lower than we have penciled in.

Why the difference?

- First, we suspect that local authorities are underspending their budgets by less than the ONS is currently assuming in its outturn data for the year to date. But we won't know for sure until full outturn data are published in September.

- Second, we expect non-PAYE income tax receipts to be £2.1 billion lower in February and March than they were last year. That reflects a timing effect and a year-on-year fall in self-assessment receipts.

- Third, we expect transfers to the EU to be £800 million higher in February and March than last year, largely because the Commission's request for payment is more front-loaded in calendar year 2018 than it was in 2017. This means more of it is paid in 2017-18.

[SLIDE] So now let us turn to the Government's various targets.

As this slide summarises, the forecast we publish today suggests that the Government is on course to meet both its fiscal mandate for the structural budget deficit and its supplementary target to reduce the debt-to-GDP ratio. It is also on course to stay within its welfare spending cap.

But the Government does not yet appear to be on course to achieve its overall fiscal objective of balancing the budget by 2025, although this lies beyond our formal forecasting horizon.

[SLIDE] The fiscal mandate requires the Government to bring the structural budget deficit below 2 per cent of GDP by 2020-21. The structural deficit is the one you would see if activity in the economy was running at its potential level, consistent with stable inflation. With the output gap currently very small, and expected to remain so, the structural deficit is much the same as the actual deficit looking over the forecast years.

This chart shows the path of the structural budget deficit from our November forecast – and the 2 per cent ceiling. By 2020-21 the deficit was forecast to fall to 1.3 per cent of GDP, thanks to the further planned cuts in day-to-day public spending as a share of GDP that the Government has pencilled in. That left headroom against the target of 0.7 per cent of GDP.

[SLIDE] Add on today's forecast and there is very little difference. The Government's room for manoeuvre remains 0.7 per cent of GDP and has increased by just £600 million in cash terms to £15.4 billion.

[SLIDE] This reflects the fact that almost all the downward revision we have made to the budget deficit in the target year is assumed to be cyclical rather than structural, reflecting the greater – but temporary – short-term momentum in the economy. There is a bigger structural improvement later in the forecast, because the Government has stuck with the same cash spending assumptions despite our upward revision to the level of nominal GDP from higher whole-economy inflation.

[SLIDE] Given the uncertainty around our forecast for the structural deficit implied by past forecast errors, the Government's current room for manoeuvre translates into a roughly 65 per cent probability of achieving the mandate on current policy – little changed from November.

[SLIDE] Those of you with long memories will recall that the Coalition Government's fiscal mandate was to balance the structural current budget balance, which excludes borrowing to finance net investment spending.

Over the past 12 months, the current budget has recorded a small surplus, but we estimate that once full local authority outturn data are available there will still be a deficit of £1.6 billion for the current fiscal year – although this is well within the margin for error. [SLIDE] On our central forecast the structural balance remains marginally in deficit next year as well, although once again the margins are very small compared to typical forecast errors.

[SLIDE] Turning to the supplementary fiscal target, this requires public sector net debt to fall as a share of GDP in 2020-21. In our November forecast net debt peaked at 86.5 per cent of GDP this year and fell by 3.0 per cent of GDP in the target year.

[SLIDE] In this forecast the peak is slightly lower at 85.6 per cent of GDP, thanks to the downward revision to the budget deficit, less use of the Bank of England's Term Funding Scheme (or TFS) and the upward revision to nominal GDP. But the decline in the target year is unchanged since

November at 3.0 per cent of GDP.

[SLIDE] As this chart shows, four-fifths of that decline in the debt-to-GDP ratio in the target year reflects the repayment of the four-year TFS loans. The remainder reflects low borrowing costs (relative to the rate of economic growth), asset sales and a small primary budget surplus, partly offset by the continuing growth of student loan debt.

[SLIDE] Balance sheet measures that exclude the Bank of England from net debt, or that widen the range of assets and liabilities taken into account, suggest that net liabilities are already past their peak as a share of GDP.

[SLIDE] Turning very briefly to the welfare cap, this requires spending on benefits and tax credits (excluding the state pension and payments linked to the economic cycle) to lie below a specified cash limit. The cap was set in line with our November 2017 forecast, plus a 3 per cent margin. It has since been restated for a small classification change. When assessing performance against it, changes in inflation are taken into account.

Spending within the welfare cap has been revised down by £1.5 billion in the target year since November, largely reflecting another downward revision to tax credit spending. As mentioned earlier, this reflects the fact that the incomes of tax credit recipients now seem to be rising more quickly rather than less quickly than those of the rest of the population. Having adjusted for this, spending is now expected to be £5.4 billion below the cap plus margin in 2022-23, so the target looks likely to be adhered to.

[SLIDE] The Government describes the fiscal mandate and the supplementary target as ‘interim targets’. Its ‘fiscal objective’ is to bring the public finances to balance as soon as possible in the next Parliament. When the target was set, this would have been 2025-26 at the latest.

This lies beyond our five-year forecast horizon, so we cannot judge the prospects definitively. But it does look unlikely that the Government would achieve this on current policy settings, although it looks slightly less of a stretch than it did back in November.

To begin with, our central forecast ends with the Government still running an overall deficit of 0.9 per cent of GDP in 2022-23, down from 1.1 per cent in November.

If the deficit was to continue falling at the average rate expected beyond the Spending Review, then it would not disappear until 2027-28 (2030-31 in November). And over this period there is likely to be upward pressure on spending from the ageing of the population and other cost pressures in the health service, as discussed in our *Fiscal sustainability reports*.

[SLIDE] That's it for the targets, but before I conclude let me summarise the assessment we have made of the Brexit withdrawal settlement that was provisionally agreed by the UK and EU late last year, which you can find in Annex B. This has not affected any of the forecast numbers that I have discussed so far.

As you know, Parliament requires us to base our forecasts on current government policy, but not on the achievement of particular policy objectives. With the Brexit negotiations still ongoing, this is not straightforward.

In the absence of a meaningful basis on which to predict the outcome of the negotiations – and of any agreements that may be reached with non-EU countries – we made a series of broad-brush assumptions about the Brexit process and the channels through which it might affect the economy and public finances in our first forecast after the referendum in November 2016. We will be able to update these at a future fiscal event, once the Government has an agreement with the EU that it is ready to publish and present to Parliament.

As regards the direct financial flows between the UK and EU institutions, we have so far made the fiscally neutral assumption that any reduction in our direct contributions to the EU will be recycled into other spending rather than used to bring the budget deficit down more quickly. That spending might include the divorce bill, the replacement of particular streams of EU funding or money for other domestic priorities.

We are still sticking with that approach. But rather than flipping a switch and turning all EU contributions into domestic spending at a particular point in the forecast, we now have enough information from last year's agreement to set out the likely size and time profile of the withdrawal settlement within that overall envelope. And we are grateful to the National Audit Office for their help in scrutinizing the inputs into this judgement that we have both been given by the Treasury.

[SLIDE] The withdrawal settlement has three main elements:

- Continued contributions as though we were a member of the EU up to the end of 2020;

- The UK share of any outstanding commitments at the end of 2020;

- And any other actual and contingent liabilities, net of corresponding assets.

Let me deal with each of these in turn.

The contributions through to 2020 drop straight out of our forecast for EU contributions as part of annually managed expenditure. However, we do need to make an assumption about how front-loaded the Commission's request for payment will be in 2019. This doesn't affect the total amount of money that will end up going to Brussels, but it does affect how much is counted as part of the withdrawal settlement.

On our central forecast, this element of the financial settlement amounts to €8.1 billion in 2019 and €10.4 billion in 2020.

The second and largest element of the settlement is our share of the so-called RAL (or 'reste a liquider'). These are the commitments made during the current EU Multiannual Financial Framework that won't have been paid by the time it ends in 2020.

We estimate the total RAL by taking the European Commission's latest estimate from 2016 and adjusting it to reflect recent under-spending of EU budgets and expected commitments and decommitments. This gives a total RAL for the EU as a whole of €256.4 billion.

We estimate the UK's share of this to be 12.4 per cent, based on our expected share of total contributions between 2014 and 2020. This implies a gross payment of €31.7 billion, but we then need to deduct an estimate of the receipts we will receive, which we base on our actual shares in 2015 and 2016. That leaves a net payment of €20.2 billion. The timing of this payment has not yet been agreed, but we have assumed it is paid out on a declining path over eight years, in line with the previous MFF profile.

Finally, there are payments related to the EU's assets and liabilities, where again we assume the UK has a 12.4 per cent share. This is a much smaller sum than the previous two elements – just €2.7 billion in aggregate – and the payments stretch out over a much longer time period.

[SLIDE] As you can see here, the one liability is our share of the pension payments for former EU staff (in blue). The largest asset is the repayment of our paid-in capital at the European Investment Bank (in yellow). There are then a series of other, much smaller, assets.

[SLIDE] Add all of this together and this is what you get. A total settlement estimated at €41.4 billion or £37.1 billion at the exchange rates assumed in our forecast. This estimate is almost exactly in the middle of the £35 to £39 billion range presented by the Treasury in December. But it remains uncertain and could be affected by exchange rate movements, relative growth performance between the UK and the EU, the eventual size of the RAL and agreements on when payments should be made.

[SLIDE] To see how this meshes with the rest of the EFO, this chart shows our forecast for the UK's contributions to the EU if we remained a member throughout. [SLIDE] These bars show our actual contributions while we remain a member. [SLIDE] And these bars show the early years of the withdrawal payments.

The fiscally neutral assumption in our forecast that the payments we would have made if we had decided to remain a member will be recycled into other spending means that the amounts shown in [SLIDE] these bars are left over for other spending – and they would get bigger the further you push the forecast horizon, as the RAL payments decline and stop.

As you will be aware, the Government has made a number of statements about other spending that it might need or wish to undertake after we leave the EU, covering areas like farm support, the Shared Prosperity Fund, overseas aid, science and education and participation in EU regulatory agencies. Spending in these areas in the most recent years for which we have outturn data is about £7 billion a year.

We asked the Treasury if any of this should be incorporated in our forecast as firm policy commitments, but they said that final decisions would have to await the next Spending Review. Bear in mind that if and when some of this spending is confirmed in a spending review, some of it – particularly in relation to structural funds – would probably be covered by receipts from the EU in the early years of the RAL.

It is important to emphasise again that we have been talking here purely about the direct financial flows between the UK and the EU. Brexit also has indirect effects on the public finances, via its impact on the economy, and we estimated in November 2016 that the vote to leave would increase borrowing by about £15 billion a year by 2020-21. It is impossible to recalculate this number now in an equally robust way, but it does seem likely that the indirect hit will be bigger than the direct gain, especially once some of the replacement spending is taken into account.

[SLIDE] Finally, let me conclude.

The economy and the public finances have both performed somewhat better in the last few months than we expected in November. But the medium-term outlook and the Chancellor's room for manoeuvre against his fiscal targets are very little changed. The budget deficit has been reduced well below the levels it reached during the financial crisis and some measures of public sector debt are already falling as a share of GDP.

But, as always, we would emphasise the risks and uncertainties that lie around all such projections. Remember that 10 years ago, in the final pre-crisis Budget of March 2008, the Treasury predicted that the economy would grow by 4 per cent over the following two years and only one out of 34 outside economists surveyed by the Treasury thought that it would shrink in either year. The latest outturn data estimate that it in fact shrank by almost 5 per cent.

On that cautionary note, we are happy to take your questions.