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# Opening remarks to the Scottish Parliament Finance Committee[1] UK Spending Review evidence session, Edinburgh, January 6 2016

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Good morning Convener.

Thank you for the invitation. It is a pleasure to be here as always.

The last time I joined you to discuss the economic and fiscal outlook was, perhaps fittingly, April Fool's Day last year, following the Coalition government's final Budget. Since then we have produced two further forecasts, the first alongside the post-election Budget in July and the second alongside the Autumn Statement in November.

To all intents and purposes these were two halves of the same fiscal event. The Conservatives have used them to depart significantly from the provisional tax and spending plans that they agreed with the Liberal Democrats in Coalition last March, setting out their own preferred strategy for the rest of this Parliament and slightly beyond.

So in talking about our latest forecast, it may be helpful to focus on what has and hasn't changed since March, rather than July, thereby comparing the current position to the inheritance from the Coalition.

The first point to make is that neither the underlying forecast for the economy nor that for the public finances has changed a great deal. Almost all the action has been in the policy decisions taken and the make-up of the remainder of the post-crisis fiscal consolidation.

Take the economy. Back in March last year we were predicting that the economy was close to full capacity, that it would grow by between 2 and 2½ per cent a year over the next five years and that CPI inflation would return

[1] This original script may differ slightly from the delivered version.

relatively slowly to its 2 per cent target. We made the same predictions in November – and they are broadly in line with the average views of other forecasters.
These are our central forecasts. Reality will be less smooth, of course, but we think that any fluctuations are as likely to be above as below. Most of the key uncertainties around the forecast in March are still there today: When will we see a return to sustained robust growth in productivity and wages? How will the economy rebalance in response to continued fiscal consolidation? And how will the UK be affected by global events: tighter monetary policy in the US, slower growth in China and developments in Europe?

In part reflecting the recent stability of the economic forecast, the changes in our public finances forecast over the past year have also been relatively small compared to those we made in earlier years.

Following the Autumn Statement, lots of people latched onto the £27 billion that we had apparently found down the back of the sofa over the next five years. The biggest contributors to this aggregate improvement in the budget balance were a fall in the Government's prospective debt interest payments, the recent strength of some tax receipts and changes to the way we forecast VAT and National Insurance Contributions. These were partly offset by the impact of lower share prices, plus judgements we made on the outlook for property transactions and spending on disability benefits.

Unfortunately £27 billion is not as much as it sounds. Over five years it corresponds to an average downward revision to the budget deficit of one quarter of one per cent of GDP. This is pretty small beer in an economy where the public sector is spending around 40 per cent of GDP and raising about 36 per cent of GDP in revenue - and where the average error forecasting the budget deficit just over the rest of the fiscal year at an Autumn Statement is around ½ per cent of GDP.

Add in the changes to our forecast in July – which went in the opposite direction - and we have an even smaller underlying net improvement since March of closer to £10 billion cumulatively over the next five years or just one tenth of one per cent of GDP, again excluding the impact of policy measures.

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By way of comparison, the underlying changes we have made to our budget deficit forecasts between previous March Budgets and Autumn Statements were deteriorations of around 1½ per cent of GDP in 2011 and 1¼ per cent in 2012, an improvement of ¾ per cent in 2013 and a deterioration of ¼ per cent in 2014. The lesson is that what the sofa gives, the sofa can easily take away. And the sums lost or gained have often been much larger than they were last November.

So, confronted by these modest changes to our underlying economic and fiscal forecasts, what policy judgements has the Chancellor made, taking the Budget and Autumn Statement together?

His key decision has been to reshape the remainder of the fiscal consolidation to rely less on cuts in public services and more on tax increases and welfare cuts than the Coalition's March plans implied.

The tax increases and welfare cuts build up gradually - and less quickly than the Chancellor said he would aim for ahead of the election. So he has also decided to borrow more over the next three years to help reduce the severest squeeze on public services spending during the middle years of this Parliament. Then he aims for a slightly bigger budget surplus in the medium term as the mounting tax increases and welfare cuts eventually outweigh what are by then smaller increases in public services spending.

Helped by the modest improvement in our underlying forecast, this leaves the Chancellor on course to achieve his new target of delivering a budget surplus in 2019-20 (and beyond) with a margin of around £10 billion in that year. Past forecast errors suggest that this implies a roughly 55 per cent chance of delivering a surplus in that year on current policy, so by no means a done deal.

For public services, the two-stage loosening of the belt in July and November means that the Government is now looking for a real cut of around £10 billion a year by 2019-20 rather than the £42 billion a year by 2018-19 pencilled in by the Coalition. This corresponds to a real cut averaging 1.1 per cent a year, compared to 1.6 per cent in the last Parliament. But this is still quite a challenge. A lot of low hanging fruit has already been plucked and the cuts are much bigger than this average figure in 'unprotected' areas - especially with

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defence and the police joining the NHS, schools and overseas aid as areas that the Government has chosen to squeeze less hard.

Turning to welfare, the Government announced a significant package of cuts in benefits and tax credits in July, the proceeds of which the Chancellor banked when setting his ‘welfare cap’ – a self-imposed cash ceiling on forecast welfare spending outside state pensions and payments linked closely to the ups and downs of the economic cycle.
But by November this cap had already been breached, thanks in large part to slower-than-expected progress on disability benefit reform and the Chancellor’s decision to reverse the major tax credit cuts he announced in July. This is costly in the near term, but less towards the end of the forecast as by then most of the individuals affected are expected to have moved onto the new Universal Credit. The generosity of UC was also reduced significantly in July, but those cuts were not reversed in November.

To conclude, looking at the evolution of our forecasts since the end of the Coalition, the underlying economic and fiscal picture is little changed. We expect the economy to grow steadily, but more slowly than is typical in economic recoveries. And we expect the budget to move into modest surplus on current policies over the next five years, having now more than halved from its post-war peak.

But uncertainties abound in the underlying forecast, not least the outlook for productivity and real wage growth and its implications for tax revenues. And our forecasts are also based on current policies, while other forecasters might expect those policies to change. Some will look at the public services cuts that remain and ask if they can be delivered. And some will look at the projected savings from welfare, but worry about the Government’s ability to deliver reforms logistically and cuts politically. And if they expect disappointment on either of those fronts, or from the underlying forecast, some may expect the Government to opt for more tax increases or to think again about its goal of sustained budget surpluses. Fortunately, these musings lie beyond our remit.