

1 Executive summary

Overview

- 1.1 In the first combined Spending Review and Autumn Statement since 2007, the Government has taken advantage of an improvement in the outlook for tax receipts – concentrated in the middle years of this Parliament – to further loosen the impending squeeze on public services spending, to increase capital spending and to reverse the main tax credit cuts it announced in July, while still delivering a modestly stronger budget balance in most years on a like-for-like basis. As the boost to receipts begins to ebb, the Government increases departmental spending by less and relies more on tax increases to maintain the bottom line improvement.
- 1.2 The Spending Review sets out firm plans for spending on public services and capital investment by all central government departments through to 2019-20, plus plans for capital spending for all and public services spending for some departments in 2020-21. In aggregate, these further reduce the squeeze on public services spending planned for this Parliament, implying real cuts more than a third smaller on average than those delivered over the last Parliament and around two thirds smaller than those pencilled in by the Coalition back in March. But the remaining cuts vary significantly by department.
- 1.3 Taken together with the other measures in the Autumn Statement, the Government has announced a net fiscal giveaway of £6.2 billion next year, more than half of which is the cost of reversing the tax credit cut. This outweighs a £2.9 billion improvement in the underlying forecast in that year and thereby pushes up the deficit. The giveaway is similar in 2017-18, before declining steadily to £2.2 billion in 2019-20, by which point an £8.0 billion increase in total departmental spending is largely offset by a £7.2 billion net tax increase (mostly the new apprenticeship levy and larger rises in council tax). These giveaways are smaller than the improvements in the underlying forecast in these three years, delivering smaller deficits and then a bigger surplus than in July.
- 1.4 The improvement in the underlying forecast since July (excluding the impact of the decision by the Office for National Statistics (ONS) to reclassify housing associations¹ in England to the public sector) is largely due to an improvement in expected revenues. This reflects higher expected receipts from income taxes, corporation tax and VAT – some of which result from modelling changes to our NICs and VAT deductions forecasts. But the improvement diminishes towards the end of the forecast as lower growth in wages and salaries weighs on income tax receipts in particular. Spending on debt interest is also lower in all years, reflecting a further fall in market interest rates.

¹ Strictly speaking, it is “private registered providers” of social housing in England that are being reclassified. These include most housing associations as well as some for-profit housing bodies. We refer to housing associations in most of the text for simplicity.

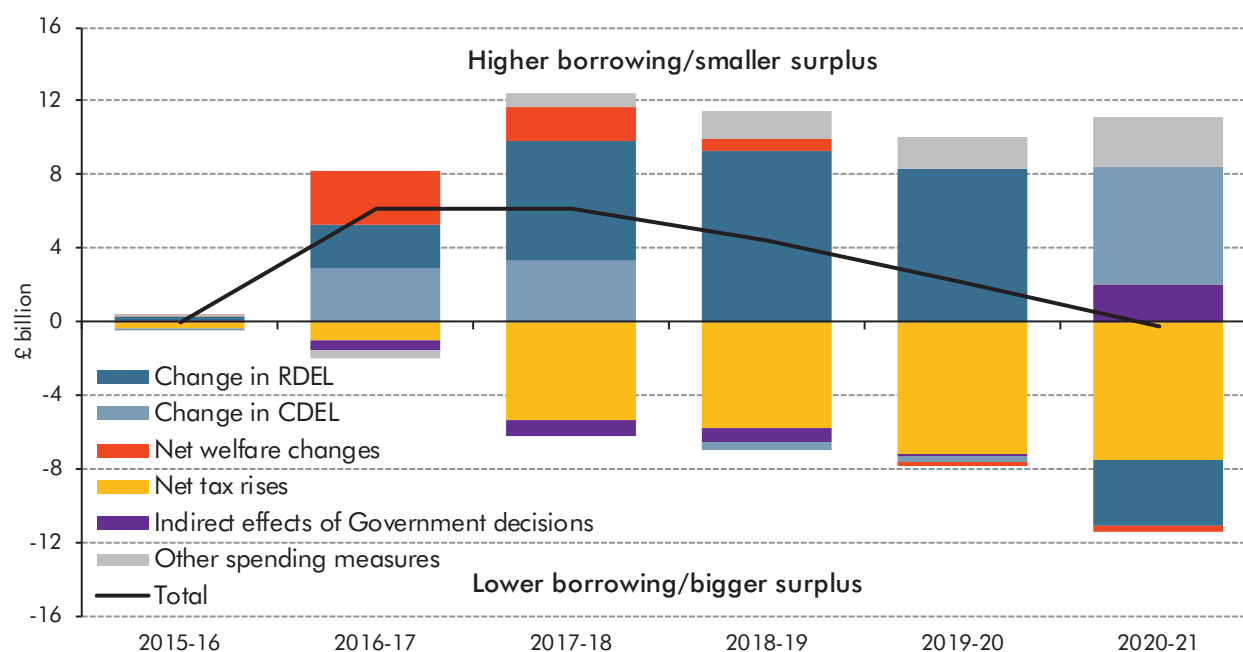
- 1.5 The Autumn Statement policy decisions are expected to have a small impact on the economy, boosting growth a little in the short term (because the pace of fiscal tightening has been eased), but weighing on wage growth in the medium term (as employers are assumed to pass most of the cost of the apprenticeship levy onto their employees).
- 1.6 For the public finances, the measures ensure that public sector net debt continues to fall in every year of the forecast as a share of GDP and that the budget reaches a surplus of £10.1 billion in 2019-20 – thereby meeting the Government’s legislated fiscal targets. However, the Government is set to breach its self-imposed cap on parts of welfare spending, thanks to the reversal of the main July tax credit cuts and slow progress with disability benefit reform.
- 1.7 Over the full five years of our forecast, from 2016-17 to 2020-21, the Government’s decisions add a cumulative £18.7 billion to public sector net borrowing (significantly less than the £27.0 billion improvement in the underlying forecast). The ‘giveaways’ include:
- higher spending within **Resource Departmental Expenditure Limits (RDEL)** – which cover day-to-day central government spending on public services, grants and administration. Taking into account the usual tendency for departments to underspend these limits, we estimate that the Spending Review implies additional spending of £22.9 billion over the five years, relative to the numbers pencilled in by the Government in July. That comprises a £26.4 billion increase in the years covered by the detailed Spending Review plans, followed by a £3.6 billion cut pencilled in for 2020-21 (thereby further smoothing the path of public services spending). These higher totals mean that RDEL spending is set to fall by an average of 1.1 per cent a year in real terms over this Parliament, compared to 1.6 per cent a year on average over the last Parliament;
 - higher spending within **Capital Departmental Expenditure Limits (CDEL)** – which cover central government investment and capital grants. Again taking likely underspending into account, these imply extra spending of £11.9 billion over the five years. The increases average £3.1 billion a year in the next two years, followed by small cuts in the subsequent two years and then a sudden jump of £6.4 billion in 2020-21. This gives a cumulative real increase in capital spending of 20 per cent over this Parliament, followed by a further 17 per cent increase in the first year of the next Parliament alone. The leap in 2020-21 is sufficient to ensure that total public spending in that year remains above its late 1990s lows as a share of GDP;
 - a £5.0 billion increase in **welfare spending**. Reversing the main tax credit cuts announced in July will cost £9.4 billion over the five years of the forecast, with the annual cost dropping from £3.4 billion in 2016-17 to £0.5 billion in 2020-21. By that latter year, the cost of the tax credit reversal is more than offset by cuts to a variety of other benefits, which rise from £0.4 billion in 2016-17 to £0.8 billion in 2020-21;
 - **gross tax cuts** that total just £1.7 billion, the largest of which is the latest one-year extension to the doubling of small business rates relief; and

- **other measures that increase spending**, mainly the local government spending that will be financed by making it easier for local authorities to raise council tax.

1.8 These giveaways are partly offset over the five-year period by:

- **gross tax increases** that total £28.5 billion. These include the new apprenticeship levy (£11.6 billion), higher council tax (£6.2 billion), and the introduction of higher rates of stamp duty land tax for second homes and buy-to-let purchases (£3.8 billion); and
- small **indirect effects** from the Government's decisions. Positive effects include the boost to revenues from the near-term increase in GDP growth, while smaller cuts to central government workforces (from higher RDEL) increase pension contributions and so reduce net spending on public service pensions. Working in the opposite direction, helping some local authorities to raise council tax will push up debt interest costs (via its impact on the Retail Prices Index), while the imposition of the apprenticeship levy will reduce tax revenues by weakening earnings growth.

Chart 1.1: The effect of Government decisions on public sector net borrowing



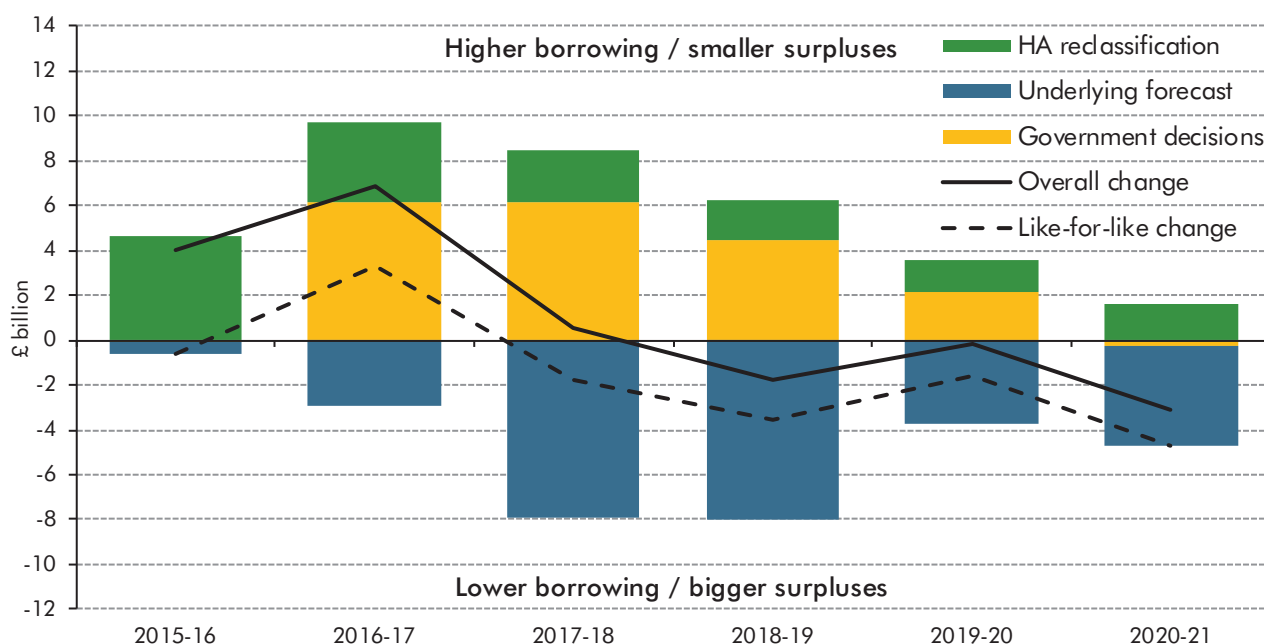
1.9 As we warned might happen in our last *EFO*, the ONS has announced that housing associations will be reclassified from the private to the public sector, with effect from 2008. It intends to implement that decision in the published public finances data sometime before Budget 2016. But we have included estimates of the effect in this forecast, including an outturn for 2014-15. This increases borrowing by between £1.4 and £4.6 billion a year and adds 3.1 to 3.4 per cent of GDP to public sector net debt.

1.10 Compared to our July forecast, adjusted for that classification change, we have revised net borrowing this year down by £0.6 billion to £73.5 billion, as higher-than-expected receipts

outweigh higher-than-expected spending on disability benefits and by local authorities. We expect a sharper fall in the deficit over the rest of the year than we have seen to date.

- 1.11 Borrowing then falls to just under £50 billion in 2016-17 and to less than £5 billion by 2018-19. In 2019-20 the Government is on course for a surplus of £10 billion, matching the headline figure at the July Budget despite a £1½ billion hit from the housing association reclassification. The Government then aims for a surplus of just under £15 billion in 2020-21, slightly larger than in July both including and excluding the reclassification.
- 1.12 As Chart 1.2 summarises, including the reclassification of housing associations means that the budget balance is weaker in headline terms between 2015-16 and 2017-18, and then stronger thereafter, than in July. On a like-for-like basis it is weaker only in 2016-17 because the policy giveaway is smaller than the forecast improvement in the other years.

Chart 1.2: Contributions to public sector net borrowing changes since July



Source: OBR

- 1.13 Despite the upward revision to public sector net debt that results from the reclassification of housing associations, we still expect debt to have peaked as a share of GDP in 2014-15 and to fall this year and across the forecast period (although it continues to rise in cash terms). As in July, asset sales make the difference between debt rising and falling as a share of GDP in 2015-16, with £30 billion expected in the financial year as a whole and £24 billion realised to date. Financial asset sales typically bring forward cash that would otherwise have been received later (e.g. in mortgage repayments and dividends), so they only reduce net debt temporarily. And when the Government gives away some of the assets, as with Royal Mail shares and the planned retail offering of Lloyds shares early next year, the sale will raise less than the asset is worth and the public sector's net worth is reduced.

1.14 In terms of our economy forecast, since July:

- our GDP growth forecast is unchanged in 2015 at 2.4 per cent. We have then revised growth up a little in 2016 and 2017, reflecting both higher population growth (driven by higher net migration) and the Government's decision to slow the pace of fiscal tightening. Growth is slightly lower in the final year of the forecast, when we now assume that demographic trends will cause the employment rate to edge lower;
- our estimate of the current output gap – the amount of spare capacity in the economy – is unchanged and we continue to expect it to narrow slowly and to close during 2018. Our inflation forecast is also little changed relative to July; and
- we continue to expect employment growth to slow as productivity growth picks up. We have adjusted our earnings growth forecast to take account of the additional costs to employers from auto-enrolment into pensions saving and the newly announced apprenticeship levy. Both are economically equivalent to payroll taxes, the cost of which we assume will be passed largely onto employees.