December 2014 *Economic and Fiscal Outlook* Briefing

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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 of the publication and then we will be very happy to answer your questions. The slides and my speaking notes will be available after we finish.

[SLIDE] Let me start with some 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 the two fiscal targets that it has set itself and – for the first time – against the welfare cap that it set at the time of the Budget.

The views expressed in the EFO are the responsibility of the three members of the Budget Responsibility Committee. But we have relied on the hard work of the OBR's staff and on the help of officials in numerous departments and agencies. Our thanks to them all.

As usual, the forecast went through a number of iterations to reflect new judgements, new data and proposed policy measures. We provided the Chancellor with a final pre-measures forecast on November 20th and then met him to discuss the forecast and the measures on November 24th. We have come under no pressure to change any of our conclusions.

Unfortunately, the economic and fiscal forecasts we present today are not fully consistent. That is because we were notified of the allocation of the additional £1.2 billion from the reserve to the NHS in 2015-16, and a £2 billion increase in the Government's medium term spending assumption, after the date on which we agreed to close the economy forecast. This is regrettable, but the impact would have been modest.

As for the policy changes that appear on the Treasury's decisions table, this Autumn Statement sees the largest number in any fiscal event during this Parliament. As usual we scrutinise these and judge whether the estimated cost or yield looks central and reasonable. For the first time, in this EFO, we now give each Government policy costing an uncertainty rating, from 'low' to 'very high', based on the data, the modelling and behavioural assumptions on which it is based.

[SLIDE] Now let me summarise the main points.

First, the economy.

Real GDP has grown slightly more strongly than we expected so far this year, prompting us to revise up our forecasts for growth in calendar years 2014 and 2015. But we still expect the pace of growth to slow into next year, as consumer spending moves more into line with income growth. Indeed we expect a slightly sharper slowdown than in March, partly reflecting a weaker outlook for the world economy. Over most of the forecast we expect the economy to grow by 2 to 2½ per cent a year.

We have revised our forecast for inflation lower, reflecting recent outturns and lower oil and food prices. We now expect CPI inflation to remain below the Bank of England's 2 per cent target until 2017.

The key uncertainty remains the timing and strength of any sustained recovery in productivity growth, which has been remarkably weak for some years now. We need to see stronger productivity growth to see lasting real earnings growth. But, for the time being, earnings growth continues to surprise on the downside and employment on the upside.

Viewed at a headline level, our forecast looks pretty stable - with real and nominal GDP growth, inflation, unemployment and spare capacity all moving within relatively narrow ranges.

But this masks a significant further change in the composition of national spending, with government consumption assumed to fall sharply as a share of GDP and household spending and business investment increasing as the Bank of England keeps monetary policy relatively loose to sustain private demand. We cannot be sure how smooth such an adjustment would be.

Second, the public finances.

Unfortunately, the task of explaining how the outlook for the public finances has evolved since our March forecast is complicated by the extensive methodological revisions carried out by the ONS over the summer, which implement their review of the public finance statistics and the ESA10 system of national accounts. We set out the impact of these changes as transparently as we can, but this explains why the document and many tables are longer than they normally would be.

The revisions aside, the big picture is as follows. This year we have seen a sharp drop in the amount of tax revenue the government collects for every pound of measured economic activity. As a result, we expect the new measure of the headline budget deficit to fall by only £6.2 billion this year to £91.3 billion, about half the decline we expected in March.

Revenues are lower than in March across the forecast, largely reflecting the impact of weaker earnings growth and a lower effective tax rate on income tax. But spending is also lower across the forecast, reflecting the impact of lower market interest rates on debt interest costs and the Government's decision to tighten and extend the implied squeeze on departmental spending beyond the end of its current firm plans. The policy measures listed in the Treasury's decisions table have little fiscal impact, with 'takeaways' and 'giveaways' broadly offsetting each other.

As regards the targets it has set itself, the Government remains on course to achieve the fiscal mandate – to borrow no more than it needs to invest (adjusting for the state of the economy) in five years' time. Indeed it is set to do so with £50 billion to spare.

But we still think it will miss its target of reducing net debt as a share of GDP in 2015-16, although by a slightly smaller margin than in March.

We have also made our first formal assessment of the Government's 'welfare cap'. We judge that spending on this subset of social security benefits and tax credits is likely to remain within its permitted margin through to 2018-19.

With the forecast rolling on another year in this Autumn Statement, we now project a total budget surplus of more than £20 billion in 2019-20, the final year of the next Parliament. This relies on the Government's chosen assumption for the path of total public spending beyond the end of the current spending review in 2015-16. This assumption now takes total public spending to its lowest share of GDP in 80 years. Given the prospective paths of welfare and debt interest costs, this would imply a very tight further squeeze on public services spending.

It is important to emphasise that both Coalition parties – as well as Labour – have said that they would pursue different policies if they were to govern alone. But Parliament has instructed us to base our forecasts on current Government policy - namely that given to us by the Chancellor and signed off by the 'quad' – and not to differentiate between the policies of individual parties. Needless to say, ministers could not claim to be on course to balance the budget and achieve their fiscal mandate with room to spare if they disowned the very policy assumptions that they had provided us with to ensure that this was the case.

So let me give you some more detail of the economic forecast, beginning with the data released since our last forecast.

[SLIDE] Real GDP grew by 2.4 per cent in the first three quarters of 2014, compared to the 1.9 per cent we forecast in March. Consumer spending was the main driver of the increase in GDP over this period, despite weak earnings growth. But the main reason for the positive surprise is stronger growth in government consumption, which is hard to explain and could yet be revised away and replaced by stronger contributions from other components.

[SLIDE] Data revisions since March imply that the entire recovery in real GDP to date has been stronger than the previous data suggested, and that the recession was also shallower. In recent years the most dramatic revisions have been to business investment: last year's Blue Book revised away all the growth between 1998 and 2006, while this year's Blue Book has replaced a flat picture since 2009 with a sharp recovery.

[SLIDE] Most discussion of economic forecasts focuses on real GDP – the volume of goods and services produced in the economy – but it is nominal GDP – the total cash size of the economy – that matters more for the public finances. Nominal GDP grew by 4.4 per cent over the first three quarters of 2014, rather than the 3.2 per cent we forecast in March. But the positive surprise was in those components that deliver least tax revenue: government consumption, net trade and stocks on the spending side, and profits and non-labour income on the income side.

Turning to prices, CPI inflation came in at 1.5 per cent in the third quarter, compared to our March forecast of 1.8 per cent. As in previous forecasts, employment growth has been stronger than we expected, pulling the unemployment rate down to 6 per cent in the third quarter, compared to our forecast of 6.8 per cent. But productivity growth and earnings growth have once again been weaker than we expected.

[SLIDE] So what about the outlook?

As I have just mentioned, growth in real GDP has been stronger than we expected so far in 2014. But we expect the quarterly growth rate to slow into 2015 and 2016 – and somewhat more sharply than we did in March. We expect consumer spending growth to move more into line with relatively subdued income growth, and to rely less on falling saving. And we also expect weaker demand for UK exports, notably from the euro area. The pace of the fiscal consolidation is also assumed to pick up in 2016, as the spending squeeze tightens and as some people with occupational pensions will no longer get the benefit of the National Insurance Contributions contracting out rebate.

[SLIDE] In terms of calendar year rates, stronger quarterly growth so far this year - and the higher implied starting point for next year - have led us to revise our growth forecasts up from 2.7 to 3 per cent for 2014 and from 2.3 to 2.4 per cent for 2015. The rapid fall in unemployment also leads us to believe that there is less spare capacity in the economy now than we thought in March, which limits the scope for above-trend growth in the medium term. So we have revised down our forecasts from 2016 onwards, leaving them broadly in line with outside estimates.

[SLIDE] This slide shows the level of real GDP that we expected in March, with the level in 2011 equal to 100. [SLIDE] And this slide shows today's revision – upwards at the start to reflect recent data, but slightly slower growth thereafter. [SLIDE] As you can see here, our forecast is broadly in line with the outside average, but somewhat weaker than the Bank of England's. The Bank has a stronger forecast for business investment than we do and it also adjusts its forecast for expected revisions to past data.

[SLIDE] This slide shows our forecasts from March for actual GDP and the potential level that we estimate to be consistent with maintaining stable inflation in the long term. The so-called 'output gap' between the two lines is a measure of spare capacity in the economy.

[SLIDE] This slide shows the forecasts from this EFO. We now believe that the output gap was slightly smaller in the third quarter than we expected in March – around 0.8 per cent of potential, rather than 1.3 per cent. But we expect the gap to close more slowly than in March.

That it doesn't close more quickly reflects a number of headwinds to growth: relatively slow growth in productivity and real incomes, a pick-up in the pace of fiscal tightening, the gradual return to health for the financial system, on-going weakness in UK export markets, and limits to what monetary policy can do to boost demand in these circumstances.

[SLIDE] With a smaller output gap, you might expect less downward pressure on inflation from spare capacity. But we expect inflation to fall to a low of 0.9 per cent early next year. This reflects lower food price inflation, lower petrol and diesel prices, lower-than-expected unit labour costs, and the impact of a stronger pound on import prices. We expect inflation to remain below the 2 per cent target until late 2017.

[SLIDE] In compositional terms, consumer spending remains the biggest contributor to growth over the forecast, followed by business investment. Government spending is broadly neutral in its impact, while net trade is a slight drag. In cash terms, we expect nominal GDP to grow by almost 24 per cent in total, a little less than in March.

[SLIDE] I mentioned earlier that data revisions now show a much bigger pick-up in business investment over the recovery to date than was apparent in March. As a result, we have concluded that there is less scope for further rapid growth in the future. [SLIDE] That said, our latest forecast shows an on-going recovery in business investment broadly in line with those seen during the 1980s and 1990s.

[SLIDE] Needless to say, there are many risks and uncertainties around any forecast for the economy, with knock-on implications for the fiscal outlook. We highlight a number in the report:

- the possibility of further instability in the euro area;

- the danger of volatility as investors anticipate the unwinding of exceptionally loose global monetary policy;

- geopolitical developments and the possible spread of disease;

- the impact on people's behaviour of the on-going deficit in household finances and the implied rise in household debt (although much of this reflects a stronger housing market);

- and the need to adjust the mix of spending and employment in as government consumption continues to fall as a share of GDP.

Given recent experience, perhaps the biggest risk is that we have to wait even longer for a sustained pick-up in productivity and real earnings growth. We assume that both begin to recover through next year, but – even on our current projections – the real consumption wage would still not have regained its 2007 peak by the end of the forecast. The outlook for productivity and earnings growth is central to the outlook for living standards and for the fiscal position. And we show the impact of high and low productivity growth scenarios in the document.

So now let me now turn to the public finances, and begin with a few important points of background.

[SLIDE] First, let me remind you again that the fiscal forecast and the economy forecast in this EFO are not fully consistent, because we were notified of extra spending after we closed the economy forecast. The fiscal forecast incorporates the direct impact of those late decisions, but not the knock-on effects of running them through the economy forecast as well. But this would have been unlikely to change the figures much.

Second, comparisons between this forecast and our March forecast are complicated by the methodological revisions to the public finance aggregates implemented by the ONS over the summer. I will explain this briefly and then focus on the best available like-for-like comparison.

Third, the fiscal outlook depends crucially on the assumptions that you make about the level and composition of public spending beyond 2015-16, the last year for which the Government has firm and detailed plans. The Government has provided us with a very detailed policy assumption, but both members of the Coalition say that in practice they would like to do something different if they were left to their own devices.

[SLIDE] So let us start with the impact of ESA10 and the other methodological revisions. Our goal here is to move from the measure of public sector net borrowing that we highlighted in March to an equivalent measure defined on the new basis, so we can then see the impact of other forecast and policy changes on a like-for-like basis.

The key changes are shown in this table. We start with the underlying measure of the deficit that we focused on in March and then add back the flows of money between the Exchequer and the Bank of England's Asset Purchase Facility to get to the ONS's March headline measure. The revisions then make spending and receipts higher in every year of the forecast, by roughly offsetting amounts. The inclusion of Network Rail adds to borrowing in every year, while a change in the treatment of the APF reduces it by rising amounts. Together with other, smaller, changes, this worsens the budget balance by £3.6 billion last year and improves it by £2.5 billion by 2018-19. That leaves you with the budget balance figures on the bottom line, which I will use as the baseline from here on.

[SLIDE] So what has happened this year? On the new statistical basis, we started with a predicted budget deficit of £86.4 billion in our March forecast. We now estimate that receipts from income tax and NICs will be £4.5 billion lower than we expected this year, reflecting the weakness of earnings growth and the fact that employment growth has been skewed toward relatively low-earners. Growth in self-employment also appears to have been skewed to relatively low earners (which affects tax receipts with a one-year lag). Meanwhile, weaker housing transactions have hit stamp duty and lower oil and gas prices have reduced North Sea receipts. Interest and dividend receipts have also been weaker.

[SLIDE] An important theme in our receipts forecasts, shown in this chart, is that they are lower than we expected not simply because the cash size of the economy is smaller than expected – indeed the opposite is the case. But, first, the composition of nominal income and spending has been less revenue-rich. And, second, the effective tax rates applied to particular tax bases have fallen in a number of cases – notably for income tax.

[SLIDE] On the spending side, debt interest payments have been revised down by £5 billion since March, thanks to lower inflation and market interest rates. In contrast, welfare spending is up by £1 billion and other spending by £2½ billion.

Turning to the impact of what the Treasury chooses to define as policy measures, the recent fines for rigging foreign exchange markets reduce the deficit by just over £1.1 billion this year, while the reforms to stamp duty cost almost £400 million. Taking other measures into account, the net effect of new policy measures since March is to reduce the deficit by £0.9 billion. So this leaves us with a headline deficit of £91.3 billion, about £5 billion higher than we forecast in March on a comparable basis.

[SLIDE] So now let's look over the full forecast horizon, and focus on the underlying changes before the impact of any policy decisions.

Receipts have been revised down across the forecast and by £25 billion by 2018-19. Income tax and National Insurance account for about £15 billion of this, reflecting weaker earnings growth and the unexpectedly low effective tax rate this year. Interest and dividend receipts are down by £2.3 billion, reflecting lower market interest rates. And VAT is down by £2 billion, thanks to lower consumer expenditure.

Annually managed spending is also lower across the forecast, and by £19.2 billion by 2018-19. Central government debt interest accounts for £14 billion of this, reflecting lower market interest rates and revisions to the estimated stock of debt. And welfare spending is down by over £2 billion, mostly reflecting the impact of lower expected unemployment and inflation. Given the various forecasting changes since March, the medium term spending rule in place at the last Budget would also have reduced implied departmental spending by a further £4.3 billion.

Pulling all this together, we see a modest underlying deterioration in the pre-measures forecast that by 2018-19 knocks £1.8 billion off the £3.7 billion surplus that we would have predicted in March.

[SLIDE] Turning to the measures in the Treasury's policy decisions table, you can see here that the biggest giveaways are the stamp duty reforms, the higher personal allowance, the extra money for GP services and – next year – the extension of the small firms' business rates relief. The biggest 'takeaways' are the measures that restrict the past losses banks can set off against their tax bills, that try to prevent multinational companies shifting profits and that increase employers' public service pension contributions (this squeezes public spending further in the areas affected rather than directly reducing people's incomes).

Two other measures that noticeably affect the profile of the scorecard are the foreign exchange fines I mentioned a moment ago and the further delay to the rollout of universal credit, which saves money up to 2017-18 and costs money thereafter. [SLIDE] This chart shows how the planned rollout of universal credit has been pushed further and further into the future in successive Government plans. Given this history and the recent assessment of the Major Projects Authority, we have assumed a further six-month delay relative to the latest plans.

[SLIDE] If we look at the net impact of all the policy scorecard measures, they add up to a very small net tightening in most years. [SLIDE] More important in quantitative terms, the Government has altered and extended the assumption that it makes about the total level of public spending beyond the current spending review. [SLIDE] The Government tweaks this assumption from forecast to forecast to achieve the outcome it wants and the current version is shown here. It is as simple as it is elegant and I shall leave you to study it at your leisure. [SLIDE] Suffice to say, it implies a slightly tighter squeeze on departmental spending than in March, reaching £1.7 billion through to 2018-19 and 2019-20, plus a further £14.5 billion additional cut in the final year of the forecast, relative to holding it constant as a share of potential GDP.

[SLIDE] Taking both explicit and implicit policy changes into account we are left with the deficit forecast here – little changed since March in the later years of the forecast.

[SLIDE] So where does this leave the big picture?

This chart shows total receipts and total spending as a share of GDP. The gap between them is public sector net borrowing. The budget deficit peaked at 10.2 per cent of GDP in 2009-10. We expect it to have more than halved to 5 per cent of GDP this year, before moving into surplus in 2018-19, as in March. The forecast horizon has rolled forward to 2019-20 in this Autumn Statement. And thanks to the Government assuming that it would hold total public spending constant in real terms in that year, we estimate that it would drop to 35.2 per cent of GDP.

[SLIDE] Extend the same chart backwards and we can see that this would take the spending share below the previous post-war lows in 1957-58 and 1999-2000 and probably to its lowest share in 80 years. This would deliver a budget surplus of £23 billion or 1 per cent of GDP in 2019-20.

[SLIDE] This chart shows how the deficit is being eliminated over the full 10 years of the fiscal consolidation:

- The total improvement between 2009-10 and 2019-20 is a little over 11 per cent of GDP, but with debt interest increasing by about 1 per cent of GDP, the necessary gross improvement is even bigger than that.

- Higher tax receipts only deliver 0.7 per cent of GDP. The vast bulk of the tax increases implemented to date – notably the higher standard rate of VAT – have paid for other tax cuts or have been absorbed by underlying revenue weakness. The expected increase in receipts from now on comes largely from income tax, as real earnings growth resumes, and from interest on financial assets, as interest rates rise.

- Welfare spending delivers about 1.6 per cent of GDP, mostly through lower spending on working age benefits, as the basic state pension is protected by the 'triple lock'.

- Capital spending – CDEL - is being cut by 1.5 per cent of GDP, almost all of which has already happened.

- By far the largest contribution – around 8.2 per cent of GDP – comes from cuts in resource departmental expenditure limits, namely central government spending on public services and administration, including grants to local government. About 40 per cent of this cut in 'RDEL' will have been delivered during the current Parliament, with about 60 per cent to come through the next – based on the firm plans for 2015-16 and the policy assumption provided to us by the Government for later years.

[SLIDE] This slide shows this measure of public services spending over time, divided between those areas that the Government is protecting in relative terms in the current spending review – the NHS, schools and overseas aid – and the rest. The total envelope falls from 21.2 per cent of GDP in 2009-10 to 17.4 per cent this year and to an implied 12.6 per cent in 2019-20. Real spending per head falls from £5,650 in 2009-10 to £4,910 this year and to an implied £3,880 in 2019-20, all in 2014-15 prices. If the current protections were maintained through the next Parliament, spending by unprotected departments would reach £1,290 per head in 2019-20, down almost 60 per cent on a decade earlier.

[SLIDE] This chart shows a similar ongoing squeeze in spending by local authorities, reflecting the declining size of central government grants. We don't know how the further cuts would be allocated between central government and local authorities. So this simply assumes that grants to local authorities are cut at the same rate as implied DEL.

Given the scale of the squeeze on public services implied by the Government's policy assumption, a number of commentators have asked whether it is sensible for us to assume that this could be delivered in our central forecast. We understand the argument, but we do not feel that it would be appropriate for us to assume, ex ante, that this could not be done. After all, to date the Government has kept departmental spending comfortably below the Treasury's limits and local authorities are in aggregate still adding to their financial reserves rather than running them down. There would be no robust basis on which we could claim that the plans become undeliverable at any particular point.

So now let me turn to the Government's fiscal targets.

[SLIDE] The fiscal mandate requires the Government to have the cyclically adjusted current budget in balance or surplus five years ahead, which in this forecast is 2019-20. That means raising enough money to pay for non-investment spending, adjusting for the impact of any remaining spare capacity in the economy.

Our central forecast shows the cyclically adjusted current budget in surplus by 2.3 per cent of GDP in 2019-20. So we judge that the Government does have a better than 50 per cent chance of meeting the mandate on current policy. This is a slightly larger margin for error than it would have had based on our March forecast, as the extra borrowing implied by the weaker outlook for receipts and the data revisions is offset by lower debt interest costs and the extra year of implied spending cuts. The cyclically adjusted surplus in 2018-19, the previous mandate year, is unchanged since March at 1.5 per cent of GDP.

[SLIDE] As always, there is significant uncertainty around the central forecast. The flamethrower of uncertainty shows the probability of different outcomes based on past official forecasting errors. It suggests that there is a roughly 80 per cent chance of meeting the mandate in 2019-20, up from 75 per cent for 2018-19 in our March forecast.

[SLIDE] Now let me turn to the supplementary target, which requires net debt to be falling as a share of GDP in 2015-16. As you can see here, the ratio of net debt to GDP is higher throughout the forecast than in March, largely thanks to the data and methodological revisions implemented over the summer – which we foreshadowed in our March EFO.

[SLIDE] As the table shows, we now expect net debt to rise by 0.8 per cent of GDP in 2015-16 and to fall by 0.5 per cent in 2016-17. So the Government remains on course to breach the supplementary target, but by a slightly smaller margin than we forecast in March. The nominal GDP revisions and the Autumn Statement measures worsen the position somewhat, but this is more than offset by the impact of falling gilt yields, which suggest that the Debt Management Office will issue gilts at a greater premium over their nominal value than in March.

One other milestone for our debt forecast. This is the first EFO in which we forecast that public sector net debt will begin to fall in cash terms – from £1652 billion in 2018-19 to just £1648 billion a year later.

[SLIDE] Finally let me turn to the welfare cap. The Government announced in March that it wished to cap spending on social security and tax credits, excluding the state pension and those benefits most sensitive to the ups and downs of the economy. The welfare cap has been set in line with our March forecast, adjusted for a subsequent classification change. The restated level is shown in the top line here. The Government has also set a 2 per cent margin above the cap, which can be used to accommodate forecast changes but not policy changes.

Forecasting changes have pushed up the level of expected spending between 2015-16 and 2017-18 and have reduced it slightly thereafter. We have concluded that current reforms to incapacity and disability benefits are likely to save less money than we had expected in March, but this is largely offset in later years by lower expected inflation. This reduces the amount by which most benefits would be uprated.

Autumn Statement policy measures reduce spending in the middle years, notably the delay to universal credit that I mentioned earlier. The bottom line is that we expect spending to be slightly above the cap in 2015-16 and 2016-17 – but within the permitted margin for forecasting changes – and slightly below it thereafter. So we judge that the Government is on course to meet its stated commitment.

With that, we are happy to take your questions.