1 Executive summary

Overview

1.1 In headline terms, the UK economy has outperformed our March forecast, with GDP expected to grow by 3.0 per cent this year and unemployment already down to 6.0 per cent. But wage and productivity growth have once again disappointed, while national income and spending have outperformed most in those areas that yield least tax revenue.

1.2 For these and other reasons, this year has seen a sharp fall in the amount of tax raised for every pound of measured economic activity. As a result, despite strong economic growth, the budget deficit is expected to fall by only £6.3 billion this year to £91.3 billion, around half the decline we expected in March. That would be the second smallest year-on-year reduction since its peak in 2009-10, despite this being the strongest year for GDP growth.

1.3 GDP has increased more strongly this year than we expected in March, which has led us to increase our forecasts for growth in calendar years 2014 and 2015. But we still expect the quarterly pace of growth to slow into next year – and somewhat more so than in March – as consumer spending moves more into line with income growth. We have also revised down our forecasts for global GDP and trade growth – particularly in the euro area, the UK's largest export market. With unemployment falling more rapidly than we expected, we judge that there is less spare capacity in the economy than we forecast in March and therefore less scope for above-trend growth in the future as this spare capacity is used up. As a result, we have modestly revised down our forecasts for GDP growth in the later years of the forecast to between 2 and 2½ per cent a year, in line with the average of outside forecasts.

1.4 We have also revised our inflation forecast down significantly, due to lower-than-expected outturns in recent data and the effects of lower oil and food prices. We now expect CPI inflation to remain below the Bank of England's 2 per cent target until 2017. Meaningful real wage growth is expected to resume in 2015, although the measure of real earnings in our forecast does not return to its pre-crisis level within the next five years. But that outcome is reliant on the most important uncertainty in our (and most people's) economy forecast: the timing and strength of the long-awaited return to sustained productivity growth.

1.5 Public sector net borrowing is expected to fall by 0.6 per cent of GDP this year, reaching 5.0 per cent – half the peak it reached in 2009-10. Looking further ahead, we expect the deficit to fall each year and – as in March – to reach a small surplus by 2018-19. Comparisons with our March forecast are complicated by methodological changes to the National Accounts that were implemented by the Office for National Statistics – and by other statistical agencies across Europe – over the summer. But on our best estimate of a like-for-like basis, borrowing is expected to be higher in the initial years of the forecast and slightly lower from 2016-17 than we thought in March. This reflects relatively large and broadly offsetting changes in the expected path of receipts and spending. In particular:

- receipts have been revised down by £7.8 billion in 2014-15, rising to £25.3 billion by 2018-19. Lower wage growth has reduced our income tax forecast and a variety of factors have reduced expected receipts from VAT and excise duties. Relative to GDP, tax receipts are expected to recover to their 2013-14 level towards the end of the forecast. This relies on an improvement in productivity boosting earnings growth and income tax receipts, although the Budget 2013 decision to abolish contracting out from National Insurance contributions will also raise the tax-to-GDP ratio significantly in 2016-17; and

- public spending has been revised down by £2.0 billion in 2014-15 and by £7.7 billion in 2015-16, the final years for which the Government has set detailed spending plans. By 2018-19, the downward revision reaches £23.5 billion. This largely reflects lower debt interest payments, due to the fall in market interest rates since March. But the Government has also tightened the implied squeeze on departmental spending on public services from 2016-17 to the end of the forecast and of the next Parliament.

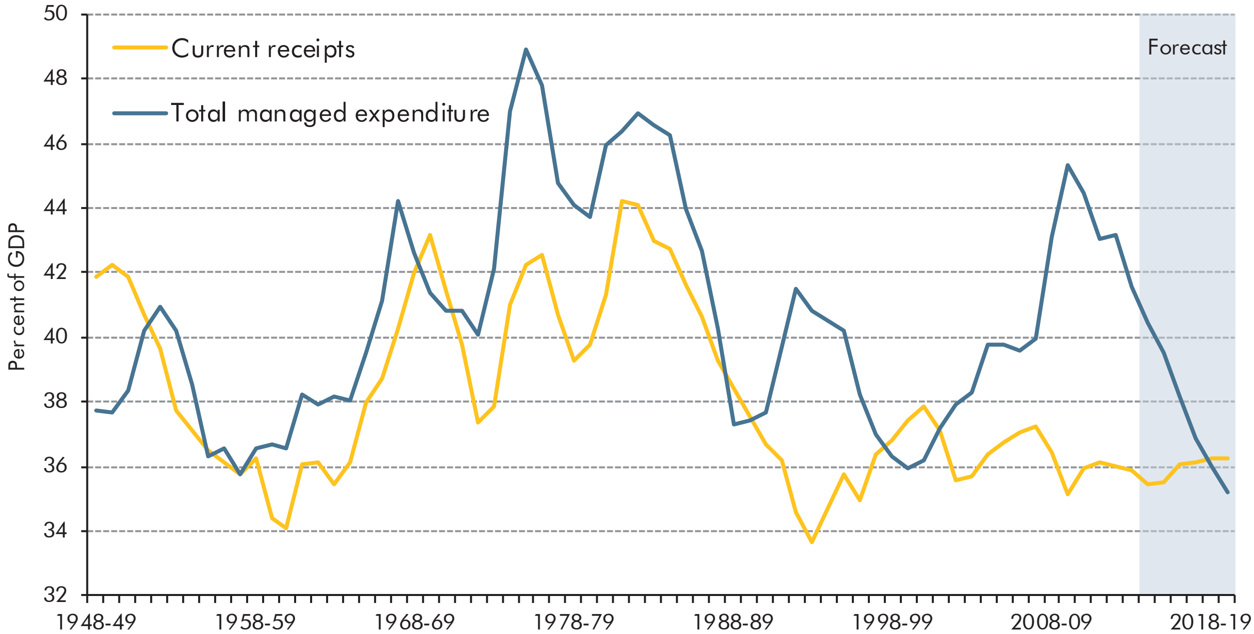
1.6 Autumn Statement 2014 policy measures reduce borrowing by £0.2 billion a year on average between 2014-15 and 2019-20. The giveaways – including the reform of stamp duty land tax and raising the income tax personal allowance – broadly offset the takeaways – particularly from banks (including Financial Conduct Authority fines this year, related to foreign exchange trading) and multinational companies. Additional funding for the NHS from the 2015-16 reserve has also been reflected in our forecast. The largest single-year effect of a Government decision comes via its new assumption for total spending in 2019-20, although this does not appear in the Treasury's table of policy decisions. This implies another cut in current spending by central government departments in that year equivalent to £14.5 billion (compared to holding spending flat as a share of potential GDP).

1.7 On the Government's latest plans and medium-term assumptions, we are now in the fifth year of what is projected to be a 10-year fiscal consolidation. Relative to GDP, the budget deficit has been halved to date, thanks primarily to lower departmental spending (both current and capital) and lower welfare spending. The tax-to-GDP ratio his risen little since 2009-10. Looking forward, the Government's policy assumption for total spending implies that the burden of the remaining consolidation would fall overwhelmingly on the day-to-day running costs of the public services – and more so after this Autumn Statement. Between 2009-10 and 2019-20, spending on public services, administration and grants by central government is projected to fall from 21.2 per cent to 12.6 per cent of GDP and from £5,650 to £3,880 per head in 2014-15 prices. Around 40 per cent of these cuts would have been delivered during this Parliament, with around 60 per cent to come during the next. The implied squeeze on local authority spending is similarly severe.

1.8 As Chart 1.1 illustrates, total public spending is now projected to fall to 35.2 per cent of GDP in 2019-20, taking it below the previous post-war lows reached in 1957-58 and

1999-00 to what would probably be its lowest level in 80 years. Receipts are projected to end the forecast broadly in line with their average share of GDP over the past 20 years.

Chart 1.1: Total public sector spending and receipts



Source: ONS, OBR

1.9 On our central forecast, the Coalition Government is on track to meet its fiscal mandate – to borrow only what it needs to pay for investment, adjusting for the state of the economy, at the end of the five-year forecast – with £50.6 billion to spare. This implies an 80 per cent probability of success given the accuracy of past forecasts. It remains on course to miss its supplementary target, to have net debt falling as a share of GDP in 2015-16. Net debt is forecast to rise by 0.8 per cent of GDP in that year, where it peaks at 81.1 per cent.

1.10 In our first formal assessment, we judge that the Government is on course to keep spending on social security and tax credits (excluding the state pension and those benefits that vary most with the state of the economy) within the permitted margins of the 'welfare cap' it set in the Budget. Ongoing reforms to incapacity and disability benefits are unlikely to save as much money over the next few years as we thought in March, but from 2016-17 the impact is broadly offset by lower expected inflation (which reduces the amount by which most benefits would be uprated) and by another delay to the rollout of universal credit.

1.11 Parliament requires that our forecasts reflect the current policies of the current Government, but those policies could change. The two member parties of the Coalition have already said that they would follow different policies if either was to govern alone after the election. The Conservatives have said they would look to cut welfare spending by more, so that they could cut public services by less. And the Liberal Democrats have said that they would be willing to borrow more to finance capital spending that would increase growth, and also to increase taxes on the relatively well-off. Labour has said that it would "*balance the books and deliver* *a surplus on the current budget and falling national debt in the next Parliament. How fast we can go will depend on the state of the economy and the public finances we inherit."*

1.12 In this *Economic and fiscal outlook*, our economy and fiscal forecasts are unfortunately not fully consistent. The inconsistency arises because, after the economy forecast had been closed, the Government allocated £1.2 billion of spending from the reserve to the NHS in 2015-16 and changed its total spending assumption in a way that added around £2 billion a year to spending from 2016-17. These changes were relative to the amounts on which our final economy forecast was based and that had been provided in accordance with the forecast timetable agreed between the Treasury and OBR in September.

1.13 Relative to the size of the economy, the assumed additional spending is modest but not negligible. For example, £2 billion would be equal to 0.6 per cent of government consumption and 0.1 per cent of GDP in 2016-17. Had we been informed of the additional projected spending ahead of our final economy forecast, the main impact would have been on the expenditure composition of GDP. That change in composition would have had small, but again not negligible, implications for our fiscal forecast. But we do not believe it would have been sufficient to change any of the conclusions that we draw about the Government's performance against its fiscal targets or the welfare cap.

Economic developments since our previous forecast

1.14 The UK's National Accounts data have been revised substantially since our March forecast. In addition to the usual annual revisions process, the ONS has implemented the 2010 European System of Accounts (ESA10). The main consequence has been to increase the measured size of the economy. Relative to the data available at the time of our March forecast, nominal GDP in 2013 has been revised up by 6 per cent (around £90 billion).

1.15 The profile and composition of the late 2000s recession and subsequent recovery have also been revised substantially. The recovery now looks stronger, with real GDP regaining its pre-recession peak in the third quarter of 2013, three quarters earlier than in the previous vintage of data. Cumulative growth in real GDP between the 2009 trough and the final quarter of 2013 is now 7.5 per cent, up from 6.3 per cent at the time of our March forecast. And investment now contributes much more to GDP growth since the trough. The level of business investment in the final quarter of 2013 is now around 3 per cent above its pre-crisis peak. The data available in March suggested that it was almost 20 per cent below it.

1.16 GDP growth in 2014 has outperformed our March forecast, growing by 2.4 per cent in the first three quarters of the year against our forecast of 1.9 per cent. Employment growth has also been stronger than expected and the unemployment rate has fallen to 6.0 per cent – 0.8 percentage points lower than we expected. But wage growth failed to pick up as we had forecast, with private sector earnings growth in the year to the third quarter of just 1.0 per cent. Inflation has also been lower than expected, with lower food and oil prices and a stronger exchange rate contributing to the fall in CPI inflation to 1.3 per cent by October 2014. At $79 a barrel in the 10 working days to 21 November, the oil price is around 25 per cent lower than assumed in our March forecast for the final quarter of 2014.

The economic outlook

1.17 With GDP increasing more strongly than we expected in the first three quarters of the year, we now expect growth of 3.0 per cent over the year as a whole, up from 2.7 per cent in March. We still expect the economy to lose momentum through 2015 – and by a little more than we thought in March – thanks to weaker external demand and the expectation that consumer spending growth will slow to rates more in line with growth in people's incomes. But with GDP starting the year higher than we expected, our forecast for GDP growth in 2015 as a whole is 0.1 percentage points higher than in March at 2.4 per cent.

1.18 The unemployment rate has fallen sharply this year. With slack in the labour market being absorbed more quickly, we estimate that the economy was running 0.8 per cent below its sustainable potential in the third quarter, compared to the 1.3 per cent that we expected in March. As in recent forecasts, we judge that the pick-up in growth since early 2013 reflects a cyclical recovery in demand – supported by growing confidence and improving credit conditions – but that it has not been accompanied by an improvement in underlying supply potential. That judgement is supported by weak labour productivity, tighter labour market conditions and a fall in the saving ratio, but challenged by the ongoing weakness in wage growth, with the fall in unemployment not yet pushing pay settlements up significantly.

1.19 Despite stronger growth in 2014 – and a narrower output gap at the start of the forecast – we expect that margin of spare capacity to close very slowly over the forecast period. Indeed, it does not close fully until mid-2019. That reflects a number of judgements:

- we expect both actual and trend productivity growth to pick up relatively slowly to more normal rates. So the 'productivity gap' between them closes very slowly. This is the most important and uncertain judgement in our economy forecast;
- we expect subdued growth in world GDP and world trade – especially in the euro area. Net trade is expected to subtract from GDP growth in every year of the forecast; and
- the Government's fiscal plans imply three successive years of cash reductions in government consumption of goods and services from 2016 onwards, the first since 1948. The corresponding real cuts directly reduce GDP. The economy should be able to adjust to such changes over time, but it is unlikely to be a simple process when monetary policy is already very loose and external demand subdued.

1.20 We have revised our inflation forecast down in the near term, with CPI inflation expected to reach a low of 0.9 per cent in the first quarter of 2015 and not to return to the 2 per cent inflation target until late 2017. That is similar to the Bank of England's latest forecast, published in the November 2014 *Inflation Report*. The RPI inflation forecast has been revised down more than the CPI forecast because lower market interest rates imply that mortgage interest payments will rise more slowly. These feature in the RPI, but not the CPI.

1.21 Lower consumer price inflation and weaker price growth in the government sector – due to the measured effects of additional cash spending cuts – mean that we have revised our nominal GDP growth forecast down by more than real GDP growth.

1.22 We have revised our employment forecast higher due to stronger-than-expected growth so far in 2014. We project employment to rise by 1.0 million between now and the start of 2020, having risen by 1.7 million since the recovery began in 2009. Over the course of the next Parliament, we project that government employment will fall by 1.0 million, compared to the 0.4 million decline that we are likely to have seen over this Parliament. (This reflects a combination of sharper implied cuts in cash spending, plus some pick-up in pay growth.) But over the same period private sector employment is expected to rise by 1.8 million.

1.23 We expect the unemployment rate to continue falling over the coming year and a half – though at a slower pace than we have seen so far this year – and to reach a trough of 5.2 per cent in mid-2016. That would be slightly below our estimate of its long-term sustainable rate, so we then expect it to rise a little thereafter.

1.24 We have revised our forecast for house price inflation in 2014 from 8.5 per cent to 10.2 per cent, reflecting bigger-than-expected price rises since March. House price inflation reached 12.1 per cent in the year to September 2014, but we expect the rate to ease from the fourth quarter. By contrast, growth in property transactions has been much weaker than we expected since March and we have revised our forecast for 2014 as a whole down from 25 per cent to around 15 per cent. The stamp duty land tax reform announced at the Autumn Statement is expected to increase the overall volume of property transactions as the costs associated with the vast majority of transactions will be slightly cheaper as a result.

Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
Output at constant market prices							
Gross domestic product (GDP)	1.7	3.0	2.4	2.2	2.4	2.3	2.3
GDP levels (2013=100)	100.0	103.0	105.5	107.8	110.4	112.9	115.5
Output gap	-2.2	-1.0	-0.5	-0.5	-0.2	-0.1	0.0
Expenditure components of GDP							
Household consumption	1.6	2.3	2.8	2.2	2.4	2.3	2.4
General government consumption	0.7	1.1	-0.4	-0.8	-0.9	-0.3	0.0
Business investment	4.8	7.7	8.4	6.3	6.3	6.3	6.3
General government investment	-7.3	2.1	3.3	1.6	2.2	1.6	2.3
Net trade[1]	0.0	-0.2	-0.5	-0.1	-0.1	-0.1	-0.2
Inflation							
CPI	2.6	1.5	1.2	1.7	2.0	2.0	2.0
Labour market							
Employment (millions)	30.0	30.7	31.2	31.4	31.5	31.6	31.7
Average earnings	1.8	1.8	2.0	3.1	3.9	3.9	3.8
LFS unemployment (% rate)	7.6	6.2	5.4	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.84	0.83	0.84	0.85	0.86
	Changes since March forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.0	0.3	0.1	-0.4	-0.2	-0.1	-
GDP levels (2013=100)	0.0	0.3	0.3	0.0	-0.3	-0.4	-
Output gap	0.0	0.4	0.6	0.3	0.1	-0.1	-
Expenditure components of GDP							-
Household consumption	-0.7	0.2	1.0	-0.3	-0.2	0.0	-
General government consumption	-0.2	-0.1	0.1	0.5	0.9	0.6	-
Business investment	6.0	-0.2	-0.8	-1.7	-2.4	-1.3	-
General government investment	-0.9	-8.6	2.3	-0.6	1.3	2.1	-
Net trade	-0.1	0.0	-0.6	-0.1	-0.1	-0.1	-
Inflation							-
CPI	0.0	-0.3	-0.8	-0.3	0.0	0.0	-
Labour market							-
Employment (millions)	0.1	0.4	0.5	0.5	0.3	0.2	-
Average earnings	0.3	-0.7	-1.2	-0.5	0.1	0.1	-
LFS unemployment (% rate)	0.0	-0.6	-1.2	-0.9	-0.4	0.0	-
Claimant count (millions)	0.00	-0.16	-0.29	-0.23	-0.14	-0.09	-

[1] Contribution to GDP growth.

1.25 In many ways our forecast for the economy over the next five years looks very stable – real and nominal GDP growth, inflation, unemployment and the output gap fluctuate relatively little from 2015 onwards. But this conceals some big changes in the structure of spending and income associated with another five years of fiscal consolidation – and, in particular, with the fact that on current policy assumptions so much of it is delivered through cuts to day-to-day spending on public services that would directly reduce GDP. They imply that:

- government consumption of goods and services falls to its lowest share of GDP since at least 1948 – when comparable National Accounts data begins – and since 1938 using a historical dataset compiled by the Bank of England (Chart 3.36). This change can also be seen in the near 20 per cent fall in government employment over the forecast period that is implied by the Government's spending assumptions;

- we assume that monetary policy will be able to support demand to achieve the inflation target and that the economy will be sufficiently flexible that the private sector can absorb the labour shed by the public sector. This implies that the negative effect of the fiscal tightening on GDP should be temporary, not permanent. It also means that private domestic spending will rise as a share of GDP. In particular, we assume that business and residential investment will rise faster than profits and household income respectively, while consumer spending will grow broadly in line with household income. These assumptions in turn imply a sharp rise in the real share of GDP accounted for by business investment (Chart 3.34) and a rising household debt to income ratio (Chart 3.31) – thanks also to house prices rising faster than incomes; and

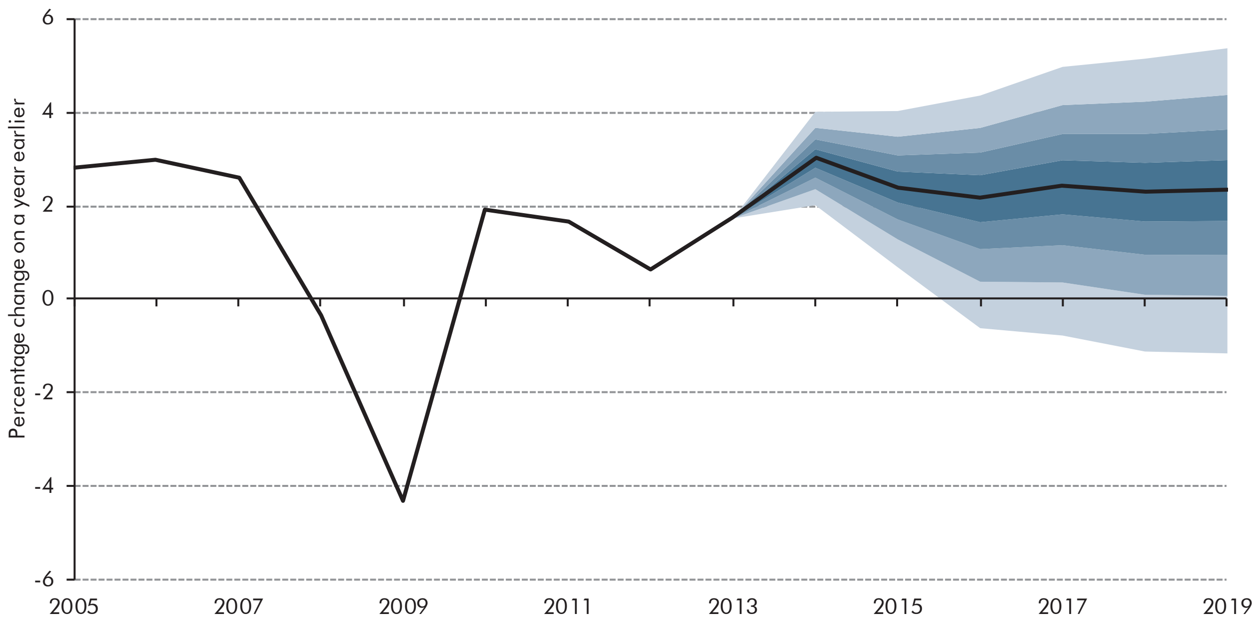
- we assume that the UK will partially arrest the decline in export market share that was a feature of the pre-crisis decade, which means the contribution of net trade to GDP growth will be less negative than would otherwise be the case (Chart 3.37 and Box 3.3). This assumption is consistent with the recovery of productivity growth boosting export competitiveness and with a slowing in the pace at which emerging markets take market share away from mature economies like the UK.

1.26 While these assumptions are mutually consistent – private spending would be expected to rise as a share of GDP when the share of household income and corporate profits derived from government pay and procurement falls – they do illustrate the challenge facing the UK economy in adjusting to the further fiscal tightening that the Government is assuming.

1.27 As ever, the key judgement underpinning our forecast is about the return of sustained productivity growth. This is necessary to finance private spending and to allow domestic producers to compete in export markets and with foreign producers in the domestic market. In Chapter 5, we explore two alternative productivity growth scenarios – a downside scenario based on a continuation of recent history and an upside scenario based on a return to the rates seen in the early 1980s. These illustrate the very different economic and fiscal outcomes that would result from significantly different productivity performance.

1.28 There is considerable uncertainty around any economic forecast. Chart 1.2 presents our central growth forecast with a fan showing the probability of different outcomes based on past official forecast errors. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands.

Chart 1.2: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

1.29 The public finances data have been revised substantially since our March forecast, following the ONS review of these statistics (the 'PSF review') and the implementation of the ESA10 guidelines for the National Accounts. This means there are a number of steps in the explanation of the changes in our fiscal forecasts since March.

1.30 Table 1.2 shows how the changes can be decomposed into:

- changes relating to ESA10 and the PSF review;
- changes due to underlying forecast changes, including their interaction with the Government's policy assumption for total managed expenditure beyond 2015-16 (the 'TME assumption') that applied in March; and
- changes resulting from Government decisions, which include the effect of the policies listed in the Treasury's table of policy decisions, plus the effect of changing the March TME assumption that applied from 2016-17 to 2018-19 and applying the new assumption to spending in 2019-20, now that the forecast has rolled on a year.

1.31 Changes in our borrowing forecast since March can therefore be explained as follows:

- in March, we focused on an underlying measure of PSNB that excluded the effects of transfers between the Exchequer and the Asset Purchase Facility (APF) related to quantitative easing, which as treated at the time had been uneven from year to year.

The first panel of the table moves from this starting point to the ONS headline measure of PSNB at the time, including those APF transfers;

- the second panel shows changes since March that relate to the implementation of ESA10 and the PSF review by the ONS. This allows us to restate our March forecast on an ESA10 basis, as best we can, to facilitate like-for-like comparisons. The main changes are that spending and receipts are higher in every year by amounts that are broadly offsetting. The inclusion of Network Rail in the public sector adds to borrowing in every year, while the change in the treatment of APF flows reduces borrowing by an amount that rises each year. Other effects are largely offsetting, so that overall borrowing is higher in the near term and lower in the medium term;

- the third panel shows the underlying forecast changes since March. Overall, these changes have led to higher borrowing across the forecast period due to:

  - a large and increasing downward revision to receipts, notably income tax. This raises borrowing by £7.8 billion in 2014-15, rising to £25.3 billion in 2018-19;

  - a largely offsetting downward revision to 'annually managed expenditure' (AME) – in particular lower debt interest costs, due to lower interest rates and our revised assumption that gilts held by the APF will not be actively sold during the forecast period. This reduces borrowing by £1.3 billion in 2014-15, rising to £19.2 billion in 2018-19; and

  - the effect of all the revisions to our forecasts of public spending and the GDP deflator on the TME assumption that the Government used in March 2014. These imply reductions in 'departmental expenditure limits' (DEL) from 2016-17 to 2018-19 – the implied envelopes for central government spending on public services, grants and capital investment – of £5.8 billion a year on average.

- the final panel shows the effect on borrowing of the decisions the Government has taken in this Autumn Statement. These are split between:

  - the estimated effect of policy measures that are included in the Treasury's table of policy decisions, which on average reduce borrowing by £0.2 billion a year over the forecast period to 2019-20; and

  - the effect on TME – and thus on the implied envelope for DEL spending – of the Government's decision to change the TME assumption for the years beyond 2015-16. Between 2016-17 and 2018-19, that reduces borrowing by an average of £1.2 billion a year.

Table 1.2: Changes to public sector net borrowing since March

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March 2014 underlying PSNB (ESA95)	**107.8**	**95.5**	**75.2**	**44.5**	**16.5**	**-4.8**	
APF effect	12.2	11.6	6.9	2.9	-1.3	-3.7	
March 2014 headline PSNB (ESA95)	**95.6**	**83.9**	**68.3**	**41.5**	**17.8**	**-1.1**	
Changes due to implementation of ESA10 and the ONS PSF review							
Total	**3.6**	**2.5**	**0.0**	**-0.1**	**-2.0**	**-2.5**	
Of which:							
Receipts	-0.9	-4.7	-9.8	-13.9	-15.9	-16.8	
AME spending	*4.5*	*7.3*	*9.8*	*13.8*	*13.9*	*14.2*	
March 2014 headline PSNB (ESA10)	99.3	86.4	68.3	41.5	15.8	-3.7	
Forecast changes and consequences for implied government spending							
Forecast changes since March 2014	**-1.7**	**5.8**	**6.6**	**-0.1**	**0.8**	**1.8**	
Of which:							
Receipts forecast	-1.6	7.8	14.3	18.9	22.7	25.3	
Spending forecast	-0.1	-2.0	-7.7	-19.0	-21.9	-23.5	
Of which:							
AME	*-2.5*	*-1.3*	*-9.3*	*-11.9*	*-15.9*	*-19.2*	
DEL plans	*2.4*	*-0.7*	*1.6*				
Changes to implied total DEL from applying Budget 2014 spending policy assumptions post 2015-16				*-7.1*	*-6.0*	*-4.3*	
December 2014 before effects of Government decisions	**97.5**	**92.1**	**74.9**	**41.3**	**16.6**	**-1.9**	**-6.5**
Changes due to Government decisions							
Autumn Statement policy measures	0.0	-0.9	1.0	-0.1	-0.4	-0.5	-0.4
Effect of applying new Autumn Statement spending policy assumptions post 2015-16[1]				-0.4	-1.6	-1.7	-16.2
December 2014 headline PSNB (ESA10)	**97.5**	**91.3**	**75.9**	**40.9**	**14.5**	**-4.0**	**-23.1**
Change since March on a like-for-like basis	**-1.7**	**4.9**	**7.7**	**-0.6**	**-1.3**	**-0.3**	
Memo: December 2014 implied on ESA95	*101.2*	*93.8*	*76.0*	*40.8*	*12.6*	*-6.6*	

[1]The additional tightening in 2019-20 of £14.5 billion is relative to a baseline that assumes current spending by departments would otherwise have remained constant as a share of potential GDP.

1.32 Between 2009-10 and 2019-20, the budget balance is forecast to move from a post-war record deficit of 10.2 per cent of GDP to the largest surplus since 2000-01 – a turnaround of 11.2 per cent of GDP (£205 billion in today's terms). By 2014-15, around 46 per cent of that planned reduction – 5.2 per cent of GDP (£94 billion) – will have been completed. As Chart 1.3 shows, the sources of deficit reduction during the first five years of the consolidation differ in their relative importance from those implied by the Government plans and medium-term assumptions that underpin our forecast for the second five years.

1.33 Between 2009-10 and 2014-15, the main factors contributing (positively and negatively) to the reduction in public sector net borrowing have included:

- a relatively small increase in **debt interest spending** (0.2 per cent of GDP). The impact of much higher cash debt has been offset by lower government borrowing costs. This reflects lower gilt yields, plus the effect of financing some debt at Bank Rate (via quantitative easing) rather than selling gilts;

- an even smaller increase in **other AME spending** (less than 0.1 per cent), mainly higher net public service pension costs (via lower contributions from a shrinking workforce);
- little change from **receipts** (also less than 0.1 per cent). Tax increases (notably the main rate of VAT) have more than offset tax cuts (notably corporation tax and fuel duty rates and increases in the income tax personal allowance) over this period. But falling effective tax rates, associated with subdued productivity and real incomes, have absorbed the remaining net tax increase and have left receipts little changed overall;
- larger contributions from cuts in **welfare spending** (0.7 per cent of GDP) and **capital spending** (1.4 per cent), with welfare spending falling steadily as a share of GDP while investment cuts were concentrated in the early years of the recovery; and
- around two thirds of the deficit reduction has come from cuts in **day-to-day spending on public services and administration** (3.5 per cent of GDP), with the cuts to-date concentrated in unprotected departments outside health, schools and overseas aid.

1.34 Between 2014-15 and 2019-20, the main factors contributing (positively and negatively) to the removal of the remaining deficit and the move into budget surplus will include:

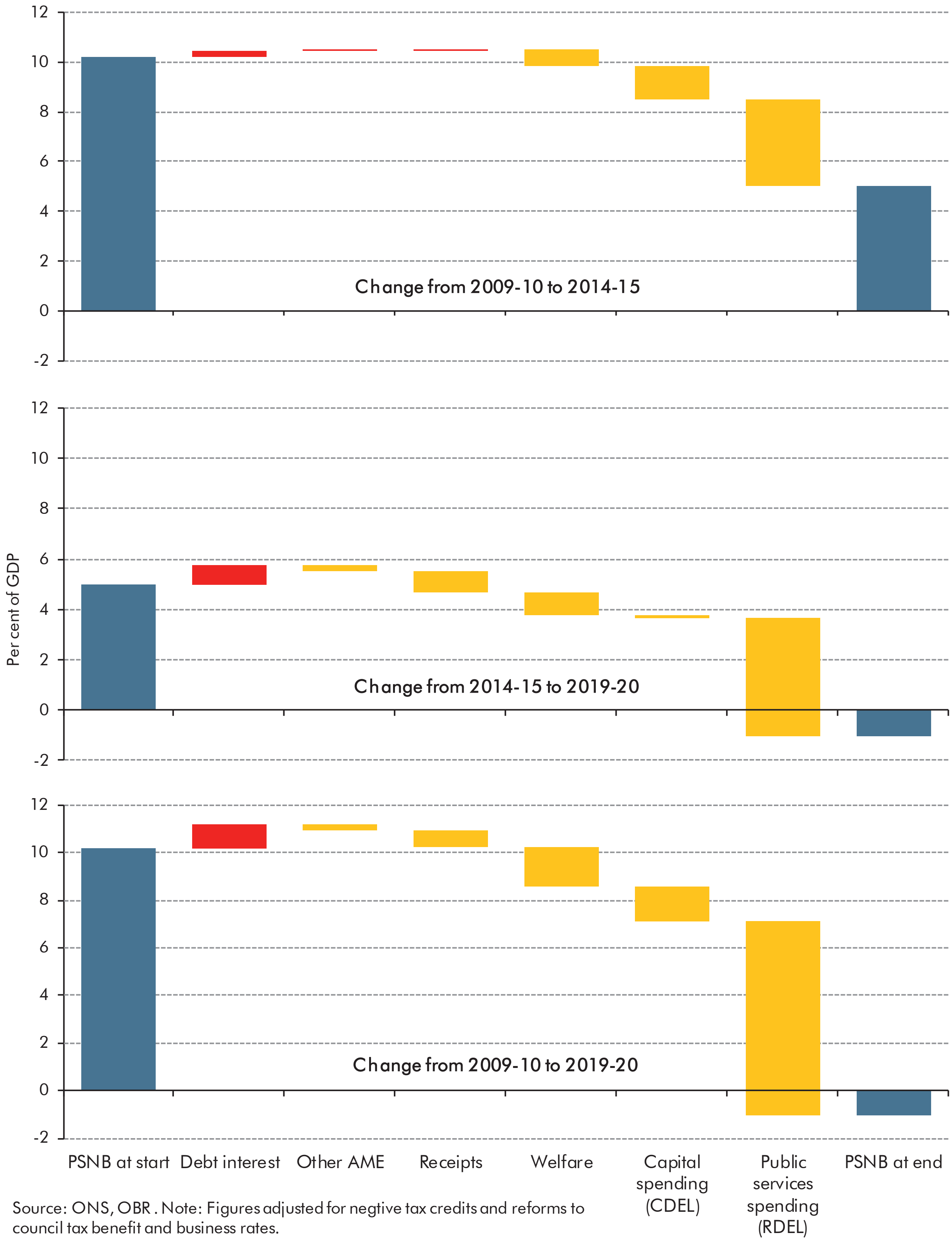
- relatively small further increases in **debt interest** spending (0.7 per cent of GDP) as interest rates are assumed to rise in line with market expectations;
- small reductions in **other AME spending** (0.3 per cent of GDP) and **capital spending** (0.1 per cent). Net public service pensions costs continue to rise as a share of GDP;
- a 0.8 per cent of GDP rise in **receipts**. This includes a 0.5 per cent of GDP rise in the tax-to-GDP ratio – largely due to positive fiscal drag in income tax and NICs as sustained productivity and real earnings growth resume and pull more income into higher tax brackets – and a 0.3 per cent of GDP rise in non-tax revenues, notably interest on the government's stock of financial assets as interest rates rise;
- a 0.9 per cent of GDP fall in **welfare** spending, explained largely by lower spending on working-age benefits, due to inflation uprating and lower caseloads for benefits sensitive to the economy cycle. Spending on state pensions is expected to be broadly flat as a share of GDP due to demographic trends and 'triple lock' uprating; and
- around 80 per cent of the remaining change in the budget balance (4.7 per cent of GDP or £86 billion in today's terms) comes from the cuts in **day-to-day spending on public services and administration** implied by the Government's firm 2015-16 plans, its assumption for total spending thereafter and our forecast for AME spending.

1.35 Over the full decade, based on the Government's policies and policy assumptions, the 11.2 per cent of GDP change in the budget balance would be composed of:

- a 10.5 per cent of GDP reduction in spending – over 90 per cent of the total. Current spending on public services would make up the bulk of that change – 8.2 per cent of GDP – of which around 40 per cent will have taken place by 2014-15. Capital spending would account for 1.5 per cent of GDP of the fall, almost all of which will already have taken place by 2014-15; and

- a 0.7 per cent of GDP rise in receipts – less than 10 per cent of the total. The rise in income tax and NICs receipts as a share of GDP between 2014-15 and 2019-20 in our latest forecast more than explains this rise.

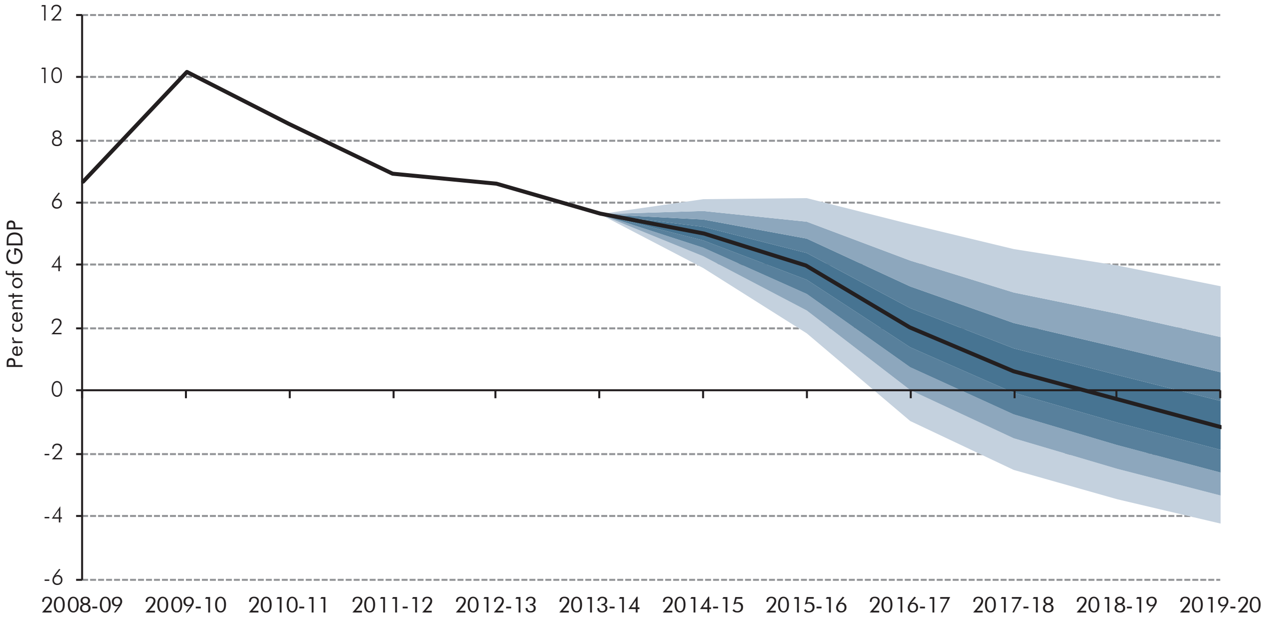
Chart 1.3: Sources of deficit reduction



Source: ONS, OBR . Note: Figures adjusted for negtive tax credits and reforms to council tax benefit and business rates.

1.36 All fiscal forecasts are subject to significant uncertainty. Chart 1.4 shows our central forecast for PSNB with successive pairs of shaded areas around it. These represent 20 per cent probability bands, based on the pattern of past official forecast errors. (As with our GDP forecast, the central forecast is judged to be a median forecast, with equal probability that outcomes will be above or below the forecast.) On this basis, the probability that PSNB will reach balance rises from 20 per cent in 2016-17, to 40 per cent in 2017-18, and to just over 50 and 60 per cent in 2018-19 and 2019-20 respectively.

Chart 1.4: PSNB fan chart



Source: ONS, OBR

1.37 We forecast that public sector net debt (PSND) will rise as a share of GDP this year and next, peaking at 81.1 per cent of GDP in 2015-16, before then falling at an increasingly rapid rate to 72.8 per cent of GDP in 2019-20. Net debt rises more slowly and then falls more quickly than forecast in March, but the level is higher throughout. The changes reflect:

- ESA10 and PSF review changes, including bringing Network Rail and the APF inside the public sector boundary, have raised the starting level of debt. These changes are partly offset by upward revisions to nominal GDP relating to the implementation of ESA10 and other National Accounts revisions since March;
- our borrowing forecast increases net debt in the near term, but reduces it in the medium term, as weaker receipts are offset by larger spending cuts; and
- other changes generally reduce net debt further, in particular the fact that falls in gilt yields since March imply that gilts will be sold at a greater premium relative to their nominal value over the forecast period, and also that the cash requirement will be lower than implied by borrowing this year and next.

Table 1.3: Changes to public sector net debt since March

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	
March forecast	74.5	77.3	78.7	78.3	76.5	74.2	
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
Change	**4.3**	**3.1**	**2.4**	**2.4**	**2.2**	**2.0**	
of which:							
Change in nominal GDP[1]	-3.8	-4.2	-3.8	-3.2	-2.9	-2.8	
Change in cash level of net debt	8.1	7.2	6.2	5.7	5.2	4.8	
March forecast	1258	1355	1439	1497	1530	1548	
December forecast	1402	1489	1558	1610	1638	1652	1648
Change in cash level of net debt	**144**	**134**	**119**	**113**	**107**	**104**	
of which:							
ESA10 and PSF review	129	133	135	137	135	134	
Other changes in net borrowing	-2	3	11	10	9	8	
Gilt premia	1	-6	-22	-29	-34	-36	
Other	16	5	-5	-5	-3	-3	

[1] Non-seasonally-adjusted GDP centred end-March.

Performance against the fiscal targets

1.38 In the June 2010 Budget, the Coalition Government set itself a medium-term fiscal mandate and a supplementary target, namely:

- to balance the cyclically-adjusted current budget (CACB) by the end of a rolling, five-year period, which is now 2019-20; and
- to see public sector net debt (PSND) falling as a share of GDP in 2015-16.

1.39 We judge that the Government has a greater than 50 per cent chance of meeting the **fiscal mandate**. The CACB is forecast to be in surplus by 2.3 per cent of GDP (£50.6 billion) in 2019-20, the first surplus in excess of 2 per cent that we have forecast in a mandate year.

1.40 The **supplementary target** requires public sector net debt (PSND) to fall as a share of GDP between 2014-15 and 2015-16, with this target year fixed. We expect that PSND will continue to rise as a share of GDP in that year, so the Government is on course to miss its supplementary target. This has been the case in each of our forecasts since December 2012. PSND is expected to peak as a share of GDP in 2015-16, falling in 2016-17 and then by larger amounts each year.

1.41 The Government set a '**welfare cap**' in Budget 2014, covering spending on social security and tax credits excluding the state pension and benefits closely linked to the ups and downs of the economy. The cap was set in line with our March forecast, but has subsequently been increased by around £0.3 billion a year thanks to a classification change. So it now rises from £119.7 billion in 2015-16 to £127.0 billion in 2018-19. At the outset, the

Government set a 2 per cent margin above the cap that can be used to accommodate forecast changes but not the impact of policy changes.

1.42 We have concluded that ongoing reforms to incapacity and disability benefits are likely to save less money over the next few years than we had forecast in March. But from 2016-17 onwards, this is largely offset by the downward revision to our inflation forecast (which reduces the amount by which most benefits would be uprated) and by a further delay to the rollout of universal credit (which is treated as a policy change). The net result is that our current forecast for spending is £0.9 billion higher than the cap in 2015-16 and £0.1 billion in 2016-17. It is then £0.8 billion lower in 2017-18 and £0.1 billion lower in 2018-19. The net effect of policy measures in these years is to reduce spending, so the excess over the cap in 2015-16 and 2016-17 is due to forecast revisions not policy changes, and it is within the permitted forecast margin. On the basis of our central forecast, our assessment is therefore that the Government is on track to meet the welfare cap commitment.

1.43 There is considerable uncertainty around our central forecast. This reflects uncertainty both about the outlook for the economy and about the performance of revenues and spending in any given state of the economy. So we test the robustness of our judgement in three ways:

- first, by looking at past forecast errors. If our central forecasts are as accurate as official forecasts were in the past, then there is a roughly 80 per cent probability that the CACB will be in balance or surplus in 2019-20 (as the mandate requires). As the CACB is expected to move into surplus in 2017-18 in our central forecast, there is a more than 50 per cent probability of that occurring;

- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest risk to the achievement of the mandate relates to our estimates of future potential output. If potential output is lower than we estimate, implying a positive output gap in the target year, the structural position of the public finances would be worse. If potential output was 1 per cent lower than in our central forecast in 2019-20, the probability of meeting the mandate would fall to 70 per cent. The level of potential output would need to be over 3¼ per cent lower in 2019-20 than in our central forecast to make it more likely than not that the mandate would be missed; and

- third, by looking at alternative economic scenarios. We have looked at two scenarios in which the productive potential of the economy grows by significantly more or less than in our central forecast. In the downside scenario, the disappointing productivity growth of recent years continues. In the upside scenario, productivity grows at rates witnessed in the UK in the early 1980s. In both scenarios, we assume that the differences are structural, so that inflation and the output gap are unchanged from our central forecast. In the downside scenario, the deficit would fall more gradually over the forecast period, which would mean that the fiscal mandate would be missed and that debt would rise in every year. Real wages in 2019 would remain 7 per cent below their pre-crisis peak. In the upside scenario, the fiscal mandate would be met by a very large margin and the welfare cap would still be observed. Net debt would also fall as a share of GDP in 2015-16, so the supplementary target would be met. But even in this upside scenario, productivity by the end of the forecast period would have recovered less than half of the ground lost since the crisis relative to its pre-crisis trend.