<u>July 2015 *Economic and Fiscal Outlook* Briefing</u>

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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 first *Economic and Fiscal Outlook* of the new Parliament.

I am going to take you through some of the key themes of the report 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 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 targets.

The views expressed are the responsibility 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-scorecard forecast on June 25th – well before the Greek referendum, of course – and then met with him to discuss the forecast and the measures on June 29th.

[SLIDE] Let me start with a brief overview.

Our pre-measures forecasts for the economy and the public finances have changed only modestly since March. Most of the action today comes from policy decisions announced by the Chancellor this afternoon. Relative to the plans set out in the Coalition's swansong

Budget, there are big giveaways in the form of higher public services spending and tax cuts. These are paid for primarily by increases in other taxes and by cuts in welfare and some other spending. But the takeaways take time to pay for the giveaways, so the Government also has to borrow more in the short term although it can then run bigger surpluses in the longer term.

Given the importance of the Budget policy measures in this EFO, I am going to talk about them first, before turning to their impact on our forecasts. Then we will look at what the forecasts imply for the Government's performance against its fiscal rules.

[SLIDE] So let us start by putting some numbers and pictures on the policy story I have just told. This chart will show where the money is coming from and where it is going to as a result of the various categories of Budget measure – and of course the two have to balance.

[SLIDE] The Chancellor's single biggest decision in this Budget has been to increase the provisional plans for public services spending over the current Parliament by more than £83 billion in total, compared to the Coalition's plans in March. The biggest increases are in the middle years, where the Coalition had pencilled in particularly sharp cuts.

[SLIDE] In addition to this extra spending, the Chancellor has also announced a series of tax cuts that will cost more than £24 billion over the same five years. These build in size as the Parliament progresses.

These two giveaways are financed from a number of sources:

[SLIDE] First, a package of tax increases that will raise £47 billion. So the tax increases are roughly twice the size of the tax cuts in aggregate.

[SLIDE] Second, a package of welfare cuts that will save £35 billion. Like the tax measures, these build in size as the Parliament progresses.

[SLIDE] Third, cuts in other spending, notably central government capital spending and funding for the BBC. These will raise £8 billion, and;

[SLIDE] Fourth, these giveaways and takeaways have indirect effects that we estimate will raise a further £14 billion. By far the largest of these relate to the decision to increase departmental spending. For example, higher public services spending means more public sector workers which means bigger contributions to public service pension schemes.

As you can see, these four sources are not sufficient on their own to cover the cost of the extra public services spending and tax cuts over the next three years, [SLIDE] so the Government is also borrowing more. One consequence is that the budget is now still in deficit in 2018-19.

However, by the end of the Parliament the takeaways exceed the giveaways and the Chancellor can use [SLIDE] some of the proceeds of his tax increases and welfare cuts to aim for bigger budget surpluses.

So let us look at some of the elements of the package in more detail.

First, the announcements on public services spending. Strictly speaking we are talking here about Resource Departmental Expenditure Limits, or RDEL for short. This encompasses central government spending on public services, grants and administration. Roughly half of this is spent on public sector pay and the other half on procurement.

[SLIDE] As you see in this chart, the Coalition had pencilled in a sharp fall in RDEL spending over the next three years – almost £30 billion in cash terms by 2017-18 – with spending increasing again once the budget was back in surplus. Now RDEL is broadly flat for the next four years.

[SLIDE] As this chart shows, the small rise in cash spending on public services now pencilled in for next year is in marked contrast to the assumptions underpinning previous forecasts – especially the last two forecasts, in which the Coalition intensified the implied squeeze on RDEL after the introduction of the new ESA10 system for National Accounts pushed up the measured level of annually managed spending.

[SLIDE] This means that the forthcoming departmental Spending Review looks a lot less challenging than it did in March – although just as challenging as the 2010 Spending Review was at the beginning of the last Parliament. Compared to the detailed plans already in place for 2015-16, the Government will have to deliver additional real cuts reaching £17.9 billion by 2019-20, rather than £41.9 billion by 2018-19. So: less than half the squeeze with an extra year to deliver it.

[SLIDE] Look at the changes in real spending from year to year, and you can see that we have moved from a very big cut followed by a very sharp rebound to more modest ups and downs from year to year – much less like a rollercoaster, but still a bit of a bumpy ride.

Public services spending falls by 1.5 per cent a year on average over the Parliament as a whole, down slightly from the 1.6 per cent a year delivered over the last Parliament. And in no year are the prospective cuts as steep as they were in 2011-12 and 2012-13.

[SLIDE] But the task is still a considerable one, as you can see from this chart of the cumulative change in public services spending since before the crisis, as a share of GDP. The peak to trough decline is now 6.4 per cent of GDP – with 3.3 per cent delivered in the last Parliament and 3.1 per cent to be delivered in this one. Public services spending still ends up well below its pre-crisis level, at its lowest share of GDP since 1964-65 on the basis of the best comparable long-run data.

One consequence of pencilling in higher public services spending is that we project a smaller fall in general government employment than we did in March. On its own we estimate that the increase in spending would reduce the likely reduction in general government employment between now and the first quarter of 2020 from 600,000 to 400,000. We were only told this morning about the Government's plan to hold public sector pay awards to 1 per cent a year for another four years. We estimate that this would further reduce the cut in general government employment to around 200,000 – although it remains to be seen what consequences this would have for retention and recruitment.

[SLIDE] So now let's turn from public services spending to the tax measures. As I mentioned a moment ago, the Budget announces packages of tax cuts and tax increases that both increase as the Parliament progresses, but with a net tax increase in aggregate.

[SLIDE] This table shows the total size of the tax cuts rising to £9.4 billion by 2020-21. The largest giveaways are the cuts in the corporation tax main rate, the increase in the income tax personal allowance, and the inheritance tax cut for main residences.

[SLIDE] The total size of the tax increases rises to £15.9 billion by 2020-21. The biggest revenue raisers by the end of the forecast are higher dividend taxation, insurance premium tax and vehicle excise duty, plus the further restriction of pensions tax relief. But hidden in the middle of the parliament is a significant one-off increase in corporation tax payments as large firms are required to pay up earlier. In effect, they will be required to make five quarterly instalments in the year of transition to the new timetable.

[SLIDE] The Chancellor said in his March Budget speech that he wanted to raise £5 billion by 2017-18 from measures to tackle, and I quote, "tax avoidance, evasion and aggressive tax planning". In the event the measures in this Budget raise £1.3 billion in that year from what the Treasury calls, and I quote again, "total imbalances in the tax system, avoidance and tax planning, and evasion and compliance". The revenue raised from these measures rises to almost £5 billion by 2019-20. The biggest revenue raisers are the decision to apply the climate change levy to energy generated from renewable sources and greater HMRC compliance activity.

[SLIDE] A number of these anti-avoidance and anti-evasion measures require additional resources for HMRC and in deciding whether to certify them as "reasonable and central", we have looked not just at the resources each measure would require but also at whether HMRC is adequately resourced to achieve the levels of compliance implicit in our baseline forecast.

To that end the Treasury has set out the commitment shown here to provide more than £1 billion a year to finance HMRC's baseline compliance activity, with some assumption of productivity improvements over time. It has also announced additions to HMRC's current and capital budgets to help deliver the additional Budget revenues. We will be keeping this under scrutiny in future forecasts.

[SLIDE] Now let me turn to the welfare cuts. Like the tax measures, these mount steadily over time and raise £13.3 billion on our definition by 2020-21. The Chancellor said in his March Budget speech that he wanted to deliver £12 billion of welfare cuts by 2017-18, but on his and our definition the measures in this Budget do not do so until 2019-20.

The biggest savings come from a four-year freeze in the uprating of working age benefits, cuts in the generosity of tax credits and reduced work allowances in universal credit. The Government will also force local authorities and housing associations to cut rents, reducing the cost of housing benefit. This measure could end up costing the public finances more than it saves if – because of the degree of control the Government has chosen to exercise over them – the Office for National Statistics were to decide to reclassify housing associations as public sector bodies.

[SLIDE] Most of the welfare savings come from reducing the generosity of particular payments, rather than by reducing the number of people who receive them – although that plays its part as well. As you can see here, most benefits have increased in generosity relative to the weak performance of average earnings over the course of the crisis and its aftermath. But they are now set to fall steadily. The obvious exception is the basic state pension, where the increase in relative generosity since the financial crisis is being locked in rather than reversed. Taking all the welfare measures into account, we now forecast that spending on social security and tax credits will drop below 10 per cent of GDP by the end of the forecast, for the first time in 30 years.

[SLIDE] Slightly more than half the Government's spending on social security and tax credits is now subject to its 'welfare cap'. This excludes spending on the state pension and those benefits on which spending moves most closely with the ups and downs of the economy. The vast bulk of the welfare savings announced in this Budget reduce spending within the cap, not least because the state pension has not been touched. By 2019-20 we forecast that spending would undershoot the March welfare cap by £16 billion. The Chancellor has decided to lock these savings in and align the cap with our new forecasts.

[SLIDE] In addition to tax increases and welfare cuts, the Government is also cutting other spending. The biggest reduction is to departmental capital spending, about £1.6 billion a year on average.

The Government has also announced a cut in funding to the BBC that will rise to around £785 million in 2020-21, by no longer reimbursing it for the requirement to provide free TV licences for the over 75s.

[SLIDE] We assume that some of the impact on BBC spending will be absorbed by a reduction in its reserves, but we still expect to see its spending fall by almost 20 per cent in real terms between 2015-16 and 2020-21, compared to just 0.8 per cent for total public services spending. (We will of course update this judgement in our next forecast when we see how the BBC plans to respond.) The BBC's spending has been declining slightly in real terms in recent years, with a jump in 2014-15 when it took on the running costs of the World Service.

Now let me turn from tax and spending decisions to two other significant Budget policy announcements: on asset sales and the National Living Wage.

[SLIDE] The Government is now planning to sell financial assets worth £32 billion this year, which reduces public sector net debt straightaway but forfeits the flow of income that these assets would generate in the future. The Government has already said that it wants to sell the remainder of its Lloyds shares within a year and today it has announced plans to sell three-quarters of its stake in RBS during the current Parliament. We assume that this will raise £2 billion this year and around £6 billion a year over the rest of the Parliament. The Government also plans to sell its remaining stake in Royal Mail and its holding in King's Cross Central Partnership. As we shall see later, it is only because of these asset sales that public sector net debt is forecast to fall as a share of GDP this year.

[SLIDE] Turning to the living wage, the Government has announced that it will place a premium on top of the national minimum wage – or perhaps we should now say the notional minimum wage – for people aged 25 and above. This will rise to 60 per cent of the median earnings of the group affected by 2020, or £9.35 an hour on our central forecast.

This will increase the effective minimum wage by 13 per cent for the affected group. In the absence of any adjustment to hours or employment, we estimate that ¾ of a million people would move from the minimum wage to the living wage, 2 million people from above the minimum wage to the living wage and 3¼ million people already earning above the living wage and up to the 25th percentile of the earnings distribution would see some further increase through spillover effects.

[SLIDE] This chart shows how this would affect the earnings distribution.

[SLIDE] Comparing the national living wage to average full-time median earnings – not just the earnings of those affected – we would move from having a minimum wage in the middle of the OECD league table to having one closer to the top, but still some way below countries like France.

[SLIDE] In the absence of any changes to jobs and hours, this would increase the country's total wage bill by £4 billion a year. But in line with academic estimates of the elasticity of labour demand, we assume that this would in fact reduce total hours worked by about 0.4 per cent – 4 million hours a week. We assume that this would split equally between reduced average hours and 60,000 fewer people in employment.

Those losing their jobs or reducing their hours are likely to be less productive than the average worker, so we expect this to reduce potential output by only 0.1 per cent with average productivity therefore increased through a 'batting average' effect. Profits would fall by 0.3 per cent and prices would rise by 0.1 per cent. The impact on the fiscal position would be very modest – perhaps a gain of £200 million a year – negligible in the context of a £2 trillion economy. The Exchequer would gain from lower tax credits spending and higher national insurance receipts and VAT revenues, but lose from higher spending on pensions and out of work benefits and from a loss of corporation tax revenues. Needless to say, the assumptions underpinning these estimates are highly uncertain and we explore how sensitive the numbers are in the EFO.

[SLIDE] Of course the National Living Wage is not the only Budget policy with effects relevant to our economic forecast.

We reflect the overall composition of the Budget in our economic forecast via the use of 'fiscal multipliers'. The in-year spending cuts announced in June and the additional public services spending announced today push real GDP growth down slightly in 2015-16 and then up slightly in 2016-17. The effects on nominal GDP are larger and more persistent than those on real GDP.

We assume that the welfare package has no net impact on labour supply, as the cuts in out-of-work and in-work benefits have broadly offsetting effects.

The forced cut in social sector rents will reduce the income of local authorities and housing associations and we assume that this will reduce the number of houses they will build across the forecast period by about 14,000.

The corporation tax measures on balance reduce the cost of capital for firms and we assume that this will boost the level of business investment by about 0.6 per cent.

The social rents measures, the national living wage and the various tax measures have a variety of effects on inflation that are ultimately modest but mean in aggregate that we assume that inflation returns to target slightly more slowly than we did in March.

So where does this leave our forecasts?

[SLIDE] Real GDP growth was weaker than we expected at the beginning of the year, but we assume that this does not persist. Indeed, our new forecast for real GDP growth is remarkably stable at around 2.4 per cent a year, with the rates slightly higher in 2017 and 2018 than in March, reflecting the size and composition of the net fiscal loosening over the early part of the forecast. We assume that the policy announcements have relatively less effect later in the forecast as by then the Bank of England will be able to offset their impact with monetary policy.

[SLIDE] CPI inflation remains well below target for the moment, thanks largely to lower oil prices. We assume that it will pick up sharply in 2016 and then return slowly to the target thereafter.

Needless to say, recent developments in Greece cast additional uncertainty over the economic outlook. Events were still unfolding when we closed the pre-measures forecast on June 25th, so we have made no specific adjustments for them here. In its July Financial Stability Report, the Bank of England noted that neither UK banks nor their counterparties have a large direct exposure to Greece, although exposures to the wider group of peripheral Eurozone economies are more significant. Needless the say, if the current drama was to damage confidence and investment across the Eurozone, then the UK would be affected. History suggests that the nature, scale and speed of contagion from financial crises like that affecting Greece are very hard to predict.

[SLIDE] So now let us see how the Budget policy decisions and the changes in our underlying fiscal forecast since March affect the outlook for public sector net borrowing. This table decomposes the differences between our March and July forecasts for budget deficits and surpluses.

[SLIDE] Looking first at the pre-measures picture, we see that receipts are higher across the forecast than in March. This reflects the recent strength of income tax and national insurance receipts, an upward revision to environmental levies and a methodological change that converts the expected costs of tax litigation cases from negative tax to capital grants in line with National Accounts guidelines.

Spending is also higher across the forecast, thanks in part to the same increase in environmental levies and change in treatment for tax litigation costs. A further methodological change has increased our estimates of net public service pension costs. Debt interest payments are also higher, reflecting higher market interest rates.

Taken together the forecast changes are relatively modest, increasing the underlying deficit by about £7 billion by the end of the forecast.

[SLIDE] The impact of the policy decisions is also relatively modest, pushing borrowing up to £8 billion higher in the middle of the parliament – to help alleviate the squeeze on public services spending – and then increasing the budget surplus in 2019-20 and 2020-21.

[SLIDE] Take the forecast and policy changes together and the deficit is about £6 billion lower this year than we forecast in March at £69.5 billion. This reflects stronger revenues, in-year spending cuts, higher insurance premium tax and a delay to the introduction of tax-free childcare – thanks to a legal challenge.

The deficit is then somewhat larger in the middle years of the Parliament, by around £11 to 12 billion. The budget balance then moves into surplus in 2019-20 – a year later than in March – but the surplus in that year is slightly larger than in March as by then the Budget takeaways modestly outweigh the giveaways.

The surplus rises only slightly in the final year of the forecast, as the Government has pencilled in an increase in public services spending as a share of GDP in that year – the first for a decade. This offsets the impact of fiscal drag in lifting the average tax rate and inflation uprating in reducing the welfare bill as a share of GDP.

[SLIDE] You can see the expected path of public sector net borrowing here, with borrowing lower this year than in March, but a slower improvement thereafter, and a slightly bigger surplus in 2019-20.

[SLIDE] With only a small margin of spare capacity remaining in the economy, we assume that most of the change in public sector net borrowing over the forecast is structural rather than a consequence of the economic cycle. The change in the cyclically adjusted budget deficit from year to year is sometimes used as a measure of the additional fiscal consolidation taking place. This method has its flaws, but is a reasonable approximation when the path of potential output is relatively stable.

If we compare the year-on-year changes in the structural deficit forecast now and in March, we can see that the path of the consolidation looks much more even. It still picks up in 2016-17, but to nothing like the degree that it was assumed to do in March. This reflects the strength of revenues and the in-year cuts this year, plus the Government's decision to increase borrowing next year to ease the pace of the spending cuts.

As well as changing the pace of the consolidation, the Budget measures also imply a change in its composition – as we have seen.

[SLIDE] This chart shows how we expected the Government to move from a deficit of 4 per cent of GDP in 2015-16 to a surplus of 0.3 per cent of GDP in 2019-20 in our March forecast. Rising debt interest costs and a small increase in capital spending meant that this required a gross improvement of 4.9 per cent of GDP, 3 percentage points of which was to be delivered via cuts in public services spending, with smaller contributions from rising revenues and falling welfare costs.

[SLIDE] Turn to the new forecast, and we can see how the picture has changed. Focus on the yellow bars to the right. The overall gross improvement over these four years is much the same as in March, but revenue increases and welfare cuts now shoulder more of the burden while the contribution from cuts in public services spending has fallen from 3 per cent of GDP to 2.4 per cent.

[SLIDES] Look at the big picture for receipts and spending and we now see them coming into balance at around 36½ per cent of GDP. Public spending at the end of the forecast would be at its lowest level since 2000-01, when Gordon Brown overachieved the spending cuts that he had inherited from Kenneth Clarke. And receipts would still be in the narrow range in which they have fluctuated since the late 1980s.

[SLIDE] If we move now from the flows of spending, receipts and the deficit to the stock of public sector debt, we can see that the outlook is little changed since March. Very roughly speaking, higher levels of borrowing add to the debt, relative to March, while more ambitious plans for asset sales subtract from it – at least over the forecast horizon that we are looking at. By 2020-21, we forecast that the debt ratio will be down to 68.5 per cent of GDP, having reversed about a quarter of the increase we will have seen between the outbreak of the crisis and debt's peak last year. In cash terms the stock of debt continues to rise.

[SLIDE] So why is debt falling as a share of GDP?

This chart shows that the debt ratio is being pulled higher every year by net government lending to the private sector, notably in student loans. And it is being pulled lower every year because the interest rate the government is paying on the debt is lower than the growth rate of the economy. In 2015-16, we are still running a large primary budget deficit. So debt is only falling this year because of the large volume of financial asset sales. But in subsequent years the primary balance improves sufficiently for the debt ratio to fall even with a much smaller flow of asset sales.

[SLIDE] Finally let me turn to the Government's formal fiscal targets – the two that remain in force under the current Charter for Budget Responsibility and the two that the Chancellor wishes to replace them with following a vote in the House of Commons.

As you can see, on our central forecasts he meets all of them with room to spare.

The current fiscal mandate requires the cyclically adjusted current budget balance to be in surplus three years ahead, a horizon that has moved forward a year to 2018-19 since our March forecast. The Government is on course to meet it with 1.1 per cent of GDP to spare, which implies a 70 per cent chance of success given past forecast accuracy. The Government is actually still on course to deliver a surplus in the previous year, but with a much smaller margin for error than the Chancellor was happy with in March thanks to the fiscal loosening.

The current supplementary target requires net debt to fall as a share of GDP in 2016-17. As we saw a moment ago he is on course to achieve this, with 1.1 per cent of GDP to spare, even without the benefit of the substantial asset sales necessary to ensure that it falls this year. Indeed the debt to GDP ratio falls in every year of the forecast, thereby satisfying the Chancellor's proposed new supplementary target as well.

The proposed fiscal mandate requires the Government to run a budget surplus in 2019-20 and to stay in surplus thereafter unless or until there is a 'significant negative shock' to the economy. Our forecast shows the Government on course to meet this initial target with 0.4 per cent of GDP to spare, implying a 55 per cent chance of meeting it on past forecasting performance.

[SLIDE] The Government's ability to deliver budget surpluses further into the future will depend in part on how it deals with the challenges of an ageing population, which will put upward pressure on spending on health, long-term care and the state pension. In our Fiscal sustainability report in June we projected that on unchanged policy this would see the budget surplus at the end of our March EFO forecast return to a deficit by the mid-2020s.

[SLIDE] In applying the new fiscal mandate, the government has defined the 'significant negative shock' that would make deficits permissible again as a period in which real GDP growth falls below 1 per cent on a rolling four quarter on four quarter basis. As this chart shows there have been six separate occasions since 1957 in which this has been the case and on four of them this involved a full blown recession with GDP falling for at least two quarters. The main exception was the recent slowdown in 2012, which breached the threshold without a full recession. The lower the trend rate of economic growth, looking ahead, the more often the threshold is likely to be triggered.

[SLIDE] So let me conclude.

This is the most significant package of measures in any fiscal event at least since the so-called 'emergency budget' of June 2010. That Budget increased the size and speed of the consolidation. Then, as the last Parliament progressed, further years were added to the consolidation and, each time, this implied less space for spending on public services. In contrast, this Budget slows the remaining consolidation and makes it less reliant on cuts in public services, although those cuts are still significant.

It is important to remember that our forecasts are conditioned on whatever current government policy is at the time. Some outside forecasters have been more pessimistic about the medium-term outlook for the public finances than we have precisely because they thought that policy would change. It will be interesting to see if they regard the rebalancing of the consolidation in this Budget away from cuts in public services spending – and towards tax increases and welfare cuts – as enhancing the credibility and deliverability of the fiscal policy stance.