November 2015 *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 third and thankfully our final *Economic and Fiscal Outlook* of this year.

I am going to take you through some of the conclusions and then we will be very happy to answer your questions. The slides and my speaking notes will be available on our website 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 and welfare spending 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.

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 November 9th – a little earlier than usual to accommodate the Spending Review – and then met with him to discuss the forecast and the measures on the 12th.

[SLIDE] Let me start with a brief overview.

The outlook for the economy has not changed a great deal since our last forecast in July. But there have been somewhat bigger changes to the outlook for the public finances.

- First, as we warned might happen back in the summer, the Office for National Statistics has reclassified housing associations as part of the public sector. This will increase net borrowing and net debt back to 2008 when it is implemented in the ONS's outturn data ahead of next year's Budget. In this *EFO*, we have estimated the potential impact of the reclassification in 2014-15 and in each year of our forecast. We have also restated our last forecast in July on the same basis, so that you can make a like-for-like comparison.

- Second, the underlying fiscal position looks somewhat stronger over the medium term than it did in July, before you take into account the Autumn Statement measures. This in part reflects the recent strength of income tax and corporation tax. But it also reflects better modelling of National Insurance Contributions and a correction to the modelling of VAT deductions. But the improvement gets smaller towards the end of the forecast, in part because weaker earnings growth weakens income tax receipts.

The Government's policy decisions – taking the Spending Review and the rest of the Autumn Statement together – amount to a net fiscal loosening that absorbs about two-thirds of the improvement in the underlying forecast. And, like the improvement in the forecast, the fiscal loosening is front-loaded with a £6 billion net giveaway in the near term that tapers away over the remainder of the forecast.

There are four main elements to the policy package:

- First, the Government has lifted and smoothed its plans for public services spending, just as it did in July;

- Second, it is also lifted its plans for capital spending, although in this case it has unsmoothed them rather than smoothing them;

- Third, it has reversed the main tax credits cut that it announced in July. This costs £3.4 billion next year, but only £0.5 billion by 2020-21. By this point the gains to households and costs to the Exchequer are more than offset by other welfare cuts;

- Fourth, the Government has announced a net tax increase that builds to more than £5 billion by the end of the forecast. The apprenticeship levy – a payroll tax that firms can claim back to finance training – is by some distance the largest one.

So what impact do the policy measures have on our forecasts?

- First, in terms of the economy, the fiscal giveaway boosts economic growth slightly next year, although the apprenticeship levy slows earnings growth thereafter.

- Second, the budget balance is stronger in most years than in July, measured like for like, because the forecast improvement is bigger than the fiscal giveaway. But if you include the reclassification of housing associations, the headline budget balance is weaker through to 2017-18, but a bit stronger thereafter.

Our post-measures forecast implies that the Government is on course to meet its fiscal rules. But the tax credit U-turn and slow progress on the reform of disability benefits mean that we expect it to breach its welfare cap through to 2018-19 and only stay within it by a whisker thereafter.

So now let me say a bit more about the pre-measures economy and public finance forecast. I'll then talk about the main elements of the policy package before turning to their impact on the economy, the public finances and the Government's hopes of hitting its targets.

[SLIDE] In terms of the pre-measures economy forecast, the outlook for growth and inflation has not changed enormously since July.

One development has been the release of the ONS's new population projections. These show slightly faster population growth and slightly higher mortality rates among older people. We have used the new projections to model the impact of year-by-year changes in the age structure on employment rates. This boosts employment in the near term and brings it down again later. Combined with a small downward revision to underlying productivity growth, this slightly weakens the outlook for potential and actual GDP by the end of the forecast period.

We have also made some modest changes to the composition of GDP. We expect net trade to be slightly less of a drag than in July, having revised down imports by more than we have revised down exports. This is offset by slightly weaker consumption and investment.

We have made only small changes to the pre-measures inflation forecast. Lower oil prices and a weaker pound offset each other. But we expect that growth in unit labour costs will help to bring inflation back towards target a little more quickly than in July.

Our forecast for house price inflation is little changed, but we have revised transactions down because of the growth in buy-to-let, where the evidence suggests that properties turn over less quickly.

I will put some numbers on the growth and inflation outlook a little later, when we incorporate the impact of the policy measures.

[SLIDE] But before leaving the economy, it is worth pausing on the implications of the ONS's latest Blue Book revisions to the National Accounts. Once again these have made the current recovery look stronger and smoother than earlier vintages of data. Real GDP now appears to be about 2 per cent stronger at the end of 2012 – relative to the pre-crisis peak – than it did at the time. It is striking that the ONS's current estimate of GDP, relative to the peak, is now closer to our optimistic 2010 forecast than to our pessimistic 2013 one.

[SLIDE] Now let me turn to the pre-measures forecast for the public finances.

This table shows public sector net borrowing in each year. [SLIDE] The top line shows the figures we published in July – moving from a deficit of £69.5 billion this year to a surplus of £11.6 billion in 2020-21.

[SLIDE] The first thing to note is the reclassification of housing associations. In essence, the housing association business model involves them borrowing against the capital grants and rent they receive to finance more social housing, while running an operating surplus from their existing properties that is sufficient to cover their interest payments with some margin. The borrowing to expand their housing stock means that they tend to run a deficit in National Accounts terms. As you can see, the deficit is falling over the forecast horizon, in part because of the measure announced in the July budget to force them to cut social sector rents, which lowers their operating surpluses. This means less house building over time and lower deficits. (I will come back to the effect of this policy and more recent ones a little later.)

Incorporating this reclassification, we can now restate our July forecast as though housing associations were already part of the public sector. That allows us to view the impact of the remaining changes in the forecast on a like for like basis.

[SLIDE] Let us start with tax and other government revenue. As you can see, revenues are higher across the forecast, with a peak improvement of around £6 billion in 2017-18. This reflects a number of factors.

First, income tax and corporation taxes have come in stronger than we expected, which pushes through the forecast.

Second, we have made some significant changes to our modelling of VAT deductions and National Insurance Contributions.

The VAT change corrects a problem caused by the long-standing assumption that VAT deductions continue to rise in line with past trends. But when public services spending is being cut – as it is now – this leads to VAT deductions being overestimated and receipts underestimated. Correcting this problem boosts receipts by £3.3 billion by 2020-21.

The NICs modelling change involves aligning the NICs model with HMRC's income tax model. This boosts receipts by £2.8 billion by 2020-21 primarily because the new model assumes that a higher and more plausible proportion of income is taxed above the upper earnings limit.

The problem in both cases stemmed from models that were insufficiently transparent, so difficult to scrutinise. The VAT problem was found after painstaking work ahead of our recent *Forecast Evaluation Report*, in which (as you will all recall) we said we were going to make make this change. The NICs model was on the radar for longer, but building the new model and reconciling differences with the existing forecast was a resource-intensive project.

These two revisions boost revenue by increasing amounts through the forecast. So why does the overall increase in revenue peak in 2017-18?

One reason is that equity markets have fallen since July, which weakens capital gains tax and inheritance tax receipts by increasing amounts over time. Another is the downward revision to housing transactions that I mentioned a moment ago. Taken together, changes in property and equity markets reduce receipts by £3.7 billion by 2020-21.

Another reason for the peak and decline is that growth in wages and salaries is stronger earlier in the forecast than in July, but then weaker later. Employment growth is boosted early on by higher net migration, but is lower later due to demographic pressures.

[SLIDE] The changes in the pre-measures spending forecast are rather smaller, with spending at most £2.6 billion lower than July in 2018-19.

The pre-measures welfare forecast is around £2.4 billion higher by 2020-21, primarily because of the expected cost of disability benefits. New claims for the Personal Independence Payment have been revised up to reflect recent data and we have also assumed that it will take longer for DWP and its contractors to complete the reassessment of Disability Living Allowance claims as people move to PIP.

[SLIDE] As you can see in this chart, slow progress with disability benefits reform has required us to revise up our spending forecasts on a number of occasions, much as we had to do for the reform of incapacity benefits. So considerable uncertainty remains around this forecast.

[SLIDE] Local authorities are another source of upward pressure on spending. The latest data suggest that local authority self-financed current spending was £1 billion higher last year than we thought and that the increase has continued into 2015-16. We now assume that local authority spending will be £1.3 billion higher this year than we thought and that councils will add an unusually modest £300 million to their reserves.

But these upward pressures are more than offset elsewhere. The biggest offset comes from debt interest spending, which is expected to be £6.0 billion lower pre-measures by 2020-21 than we thought in July. This primarily reflects a further fall in market interest rates, plus the Bank of England's recent announcement that it will not start to reverse quantitative easing until there is scope to loosen monetary policy meaningfully. They currently interpret this as 2 per cent base rates rather than the 0.75 per cent we assumed in July. This saves money because the Government can continue to finance more of its debt at base rate rather than at gilt rates for longer. Interestingly, while this change helps reduce net borrowing, it simultaneously pushes up net debt by an overall £13 billion by the end of the forecast.

[SLIDE] Add the change in receipts to the change in spending and we have our November pre-measures forecast. As you can see, like for like there has been an improvement peaking at £8 billion a year in 2017-18 and 2018-19, which then roughly halves over the rest of the forecast. As we will see, the Government has taken advantage of this improvement to announce a modest fiscal giveaway without weakening the bottom line.

[SLIDE] But before leaving the pre-measures forecast, let me say a word about the current year: 2015-16. When the ONS published the October public finance data last Friday, there were predictions that borrowing would overshoot the July forecast by £10 billion. That might yet happen, but as you can see we have actually revised our pre-measures forecast down by half a billion on a like for like basis.

We expect the deficit to shrink more quickly over the rest of the year than it has done to date. And there are a number of reasons for this:

- First, policy decisions at previous fiscal events should boost self-assessment receipts in January and February, relative to last year;

- Second, the cost of the stamp duty reforms last December should stop depressing receipts growth from the final quarter;

- Third, the Treasury announced in-year spending cuts in June, most of which are yet to be delivered; and

- Fourth, our forecast includes a number of receipts that the ONS has not yet incorporated into the outturn data.

[SLIDE] So now let us look at the underlying forecast changes alongside the impact of the policy measures.

In this chart the blue bars show the net improvement in the budget balance resulting from the underlying forecast changes that we have just discussed.

[SLIDE] The yellow bars show the overall impact of the policy measures – a net giveaway of £6.2 billion in each of the next two years, falling to a net takeaway of £0.3 billion in 2020-21.

[SLIDE] Add one to the other and we can see that borrowing is higher like-for-like in 2016-17, because the giveaway in that year (mostly the cost of reversing the July tax credit cuts) is bigger than the underlying forecast improvement. In every other year the budget balance is stronger even after the policy giveaway than it was in July.

[SLIDE] Add in the housing association reclassification and the picture is not quite as favourable. The headline balance is weaker over the first half of the forecast and slightly stronger in the second than it was in July.

So now let us look in more detail at the components of the policy package and explain the composition of the yellow bars.

[SLIDE] This chart shows the impact of the various elements of the policy package on net borrowing.

[SLIDE] The biggest is another significant net increase in planned public services spending, on top of that announced in July. The Spending Review has now set out firm plans for current and capital spending for all departments through to 2019-20, plus plans for capital spending for all and public services spending for some departments in 2020-21.

Public services spending – known as RDEL spending in the jargon, as it is spending within Resource Departmental Expenditure Limits – is £22.9 billion higher over the forecast than was implied by the Government's plans in July. This comprises a £26.4 billion increase over the four years of full Spending Review plans, plus a cut of £3.6 billion in 2020-21, which reduces the sudden kick up that was pencilled in for that year.

[SLIDE] Plans for capital investment (CDEL) imply £3 billion more spending in each of the next two years, but small cuts in the following two years, and then a sudden increase of £6.4 billion in 2020-21.

[SLIDE] The next element is welfare spending, which starts as a giveaway of £3 billion next year – as the main tax credit cuts announced in July are reversed – and ends up as a small takeaway of £0.3 billion in 2020-21.

[SLIDE] Tax measures on the scorecard reduce borrowing in each year, and by £5.3 billion by 2020-21.

[SLIDE] Measures that the Treasury has chosen not to include on its scorecard modestly reduce borrowing next year and modestly increase it thereafter. This is the result of changes to grant funding of housing associations, which have knock-on implications for the amounts they are assumed to borrow for housebuilding. The size of this effect is uncertain.

The Government has also announced that it will allow some local authorities to raise council tax faster to meet some of the costs of adult social care and policing. That doesn't affect borrowing – higher council tax finances higher local authority spending. But it is a policy decision that affects our forecast. And it is also uncertain – the Government is not setting higher council tax rates, but allowing local authorities to choose to raise them faster.

[SLIDE] Add in some small indirect effects and other measures and we see the pattern we saw in the chart a moment ago – [SLIDE] a £6 billion net loosening in the near term that tapers away over the remainder of the forecast.

Let's look at a couple of the components in more detail.

[SLIDE] First, the plans for public services spending. This chart shows how in July the Government lifted and smoothed the path of public services spending that it had inherited from the Coalition's March Budget, while still leaving in place a sharp rebound in 2020-21 once the fiscal consolidation is complete.

[SLIDE] Today's Spending Review further increases spending over this Parliament and moderates the increase in 2020-21.

[SLIDE] As a result the real cut in public services spending over the coming five years now peaks at just over £10 billion in 2019-20, compared to almost £18 billion in July and almost £42 billion (a year earlier) back in March. The plans now imply an average real cut of 1.1 per cent a year over this Parliament, down from 1.6 per cent a year over the last.

[SLIDE] That said, the squeeze varies significantly from department to department, as this chart of spending as a share of GDP shows. Health, defence, education and international development are relatively protected, leaving other departments to shoulder the biggest cuts.

[SLIDE] So public services spending is on much less of a rollercoaster than in March and on a less bumpy ride even than in July. Interestingly, the path of capital spending – both in outturn and in the current plans – is a lot less smooth. The 17 per cent real increase pencilled in for 2020-21 would be larger than the increase seen under Labour's fiscal stimulus programme during the financial crisis. But it is also is sufficient to keep total spending above the level recorded in 2000-01.

[SLIDE] Turning briefly to tax measures, the July Budget announced a net tax increase rising to £6.5 billion by 2020-21, comprising gross tax increases of £15.9 billion partly offset by gross tax cuts to £9.4 billion.

[SLIDE] The net tax increase in today's package is only slightly smaller than in July , but interestingly there is much less give-and-take. There are very few tax cuts at all in this package and they add up to just £0.3 billion in 2020-21. Indeed this is the smallest set of gross tax cuts in any Budget or Autumn Statement since March 2008.

[SLIDE] By far the largest tax measure on the scorecard is the apprenticeship levy. The next biggest is the increase in stamp duty rates for buy-to-let and second homes. This is expected to raise almost a billion pounds a year by the end of the forecast, although we note in Annex A that this costing is highly uncertain because there is no current requirement to declare whether a transaction involves a second property (which makes it hard to estimate the tax base) and because the behavioural response is hard to predict.

Two other tax measures worthy of note are the reduction in the capital gains tax payment window for residential property and bringing forward payments of SDLT. Like the corporation tax payment date measure in July, these deliver a one-off boost to receipts that is neither repeated nor reversed in future years. If receipts from these taxes were recorded in accrual terms the yield would to all intents and purposes be zero.

[SLIDE] Turning to welfare, the big measure is of course the decision to reverse the main tax credit cuts announced in the July Budget. This costs £3.4 billion next year, falling to £0.5 billion in 2020-21 as more of the people who would be receiving tax credits move onto universal credit. So this decision reverses almost 80 per cent of the July welfare savings next year, but only 8 per cent by the last year of the Parliament.

By the end of the forecast, the giveaway is also more than offset by other measures including a new funding mechanism for temporary accommodation and limits on the social sector rate of housing benefit. In earlier years there are also savings from the Government's decision to further delay the roll-out of universal credit.

[SLIDE] Now let me say a little bit more about the measures affecting housing associations, both in this Autumn Statement and in July.

As I have already mentioned, the ONS has now decided to bring housing associations into the public sector. And their business model implies an addition to net borrowing and net debt because they borrow against their grant and rental income to finance new housing. Public sector net worth – a broader measure of the balance sheet – would actually be stronger because it would also include the value of their housing stock.

The reclassification story is complicated by the fact that there were significant policy measures affecting housing associations in both July and today. In July the Government forced them to cut social rents by 1 per cent a year for four years. This reduced their income, partially offset by requiring them to charge market rents to higher earners.

In today's statement the Government has significantly altered the funding of housing associations. Capital grants have been cut in 2016-17 and 2017-18 and then raised in later years – especially in 2020-21. The composition has also changed, with less money for the social renting sector and the majority now targeted at supporting shared ownership.

So let us look at the potential impact of these changes.

[SLIDE] Imagine that we reran our July forecast, including housing associations in the public sector, but not including the July Budget policy measures. We would have predicted then that the reclassification would add £4.8 billion to net borrowing in 2020-21 and increase net debt by 3.7 per cent of GDP. We would have expected housing associations to build around 220,000 houses over the five year forecast.

The July measures reduce housing associations' income and operating surpluses and thus encourage them to build around 80,000 fewer houses over the forecast. (This is a lot bigger than the simple assumption we made in July for our economy forecast that residential investment would fall one-for-one with lower income, reducing house building by 14,000. The bigger figure reflects the gearing in the housing association business model, which we now forecast explicitly.

Today's measures push things back in the other direction. Capital grants are higher overall than in July, but with the increase back-loaded. Gearing means more borrowing and a larger addition to net debt, but also more housebuilding – 46,000 more over the forecast than would have seen on the basis of the July measures, but still 34,000 lower than in the absence of both packages. As we point out in Annex B of the *EFO*, there is enormous uncertainty around these various estimates and particularly around the impact of the November measures, which are pushing housing associations towards a different business model. How far they are willing to be pushed remains to be seen.

[SLIDE] In terms of the profile of housing association house building you can see from this chart that the November measures still produce a decline over the next couple of years, but with a recovery thereafter. Housebuilding is lower over the Parliament as a whole than it would have been in the absence of both the July and November measures, but it is higher per year just beyond it.

[SLIDE] Now let me turn to another set of policy measures that are significant for the public finances – the sale of financial assets.

As you will recall from July, the Government was relying on a big spike in asset sales this year to get public sector net debt falling as a share of GDP a year earlier than it otherwise would. In later years the reduction in borrowing would have been sufficient to keep debt falling on its own.

[SLIDE] The profile of asset sales has changed somewhat in this forecast thanks to: a delay in the sale of the student loan book, lower expected proceeds from Lloyds Bank shares (because the share price has fallen and the Government wants to give some of the shares away), slightly lower realised proceeds from the sale of Royal Mail shares, and a last-minute decision to sell more RBS shares in 2020-21.

Taking all this together, we now expect asset sales worth £30 billion this year (£24 billion of which has already been delivered), a further £41 billion over the rest of the Parliament, plus an additional £8 billion in 2020-21. It is important to remember that when the Government sells financial assets for roughly the value of the future income stream they would generate this does not materially affect public sector net worth even if it reduces the headline measure of net debt.

So having set out the key details of today's policy package, let me return to their impact on our forecasts and on the Government's chances of meeting its various targets.

[SLIDE] In terms of the economy, the near term fiscal giveaway boosts GDP growth a little next year, weakening it thereafter as the boost to output diminishes.

The apprenticeship levy behaves like a payroll tax, so we assume that the costs are passed on into lower profits and – primarily – lower wages. This reduces earnings growth later in the forecast. Bear in mind that this comes on top of the higher minimum wage and auto-enrolment into pension saving, which also increase business costs.

Finally, higher stamp duty for second homes and buy-to-let reduces property transactions and the various policy measures on energy and council tax have small effects on different measures of inflation.

[SLIDE] But in term of numbers, the big picture is not very different to July. GDP growth is broadly stable at or a little under 2½ per cent a year.

[SLIDE]And we still expect inflation to kick up over the coming year as favourable base effects drop out. We expect it to rise slightly more quickly than in July thanks to greater pressure from unit labour costs.

[SLIDE] As we have already discussed, the outlook for net borrowing is affected first by the reclassification of housing associations, with only modest changes on a like for like basis as the front-loaded improvement in the underlying forecast is largely offset by a front-loaded fiscal loosening. The deficit has roughly halved since its post-crisis peak with roughly half the fiscal consolidation still to come.

[SLIDE] Turning to public sector net debt: the reclassification of housing associations pushes up the level in each year of the forecast. But, on a like for like basis, net debt is slightly lower as a share of GDP in each year than in July. That is because nominal GDP has been revised higher by the ONS, so a given cash debt corresponds to a lower ratio.

The cash value of net debt is actually higher in each year of the forecast than in July, even like for like. The changes to net borrowing push debt up a little over the next couple of years, but then down by £8 billion by 2020-21. But this is offset by the Bank of England's decision to delay the reversal of QE, which pushes net debt up by £18 billion by 2020-21.

[SLIDE] The paths of net borrowing and net debt mean that the Government is on course to achieve its fiscal targets. The fiscal mandate requires a budget surplus in 2019-20 and we forecast one of £10 billion. The supplementary target requires the debt-to-GDP ratio to fall in each year to 2019-20. We forecast that it will achieve this by 0.6 per cent of GDP this year (thanks to asset sales), rising to 3 per cent by 2019-20.

[SLIDE] The Government has been less fortunate with its welfare cap, which sets a ceiling on social security and tax credit spending (other than on state pensions and those benefits linked most closely to the economic cycle). The Government set the cap in line with our last forecast for this spending in July – locking in the effect of all the cuts announced in the Summer Budget. It also set a 2 per cent margin that can be used to accommodate forecast changes but not policy giveaways.

This table shows the welfare cap and the changes in our forecasts since July. As I mentioned earlier, we revised up our pre-measures forecast for welfare spending, primarily to reflect slow progress on disability benefit reform. This has been exacerbated by the Government's decision to reverse its main tax credit cuts from July, although the cost of this diminishes over time and is eventually offset by other welfare cuts.

[SLIDE] The net result is that the cap is breached. Taking each year in turn, it is breached in 2016-17 and 2017-18, as the upward revision to spending has more than exhausted the forecast margin. [SLIDE] It is also breached in 2018-19, with spending remaining within the forecast margin but higher than the cap baseline as a result of policy measures. [SLIDE] The cap is then adhered in 2019-20 and 2020-21, although with almost all of the forecast margin used up.

In much of what I have had to say today, it is clear that this Autumn Statement is in effect the second half of a two-stage event, alongside the Budget in July. So, to conclude, it is worth taking a step back and looking at the overall picture, combining the two events.

[SLIDE] This chart does that, showing where the money is coming from and where it is going, relative to the plans left in place by the Coalition in March. In aggregate, over the full five years, the two statements increase public services spending by £128 billion, capital spending by £12 billion and deliver £36 billion of tax cuts. This is paid for by £92 billion of tax increases, £43 billion of welfare cuts, £17 billion of indirect revenue and spending effects and £19 billion more borrowing.

July's spending cuts and tax increases reduce borrowing a little this year. Over the following three years welfare cuts and tax increases mount steadily, but not sufficiently to pay for the extra public services and capital spending and tax cuts – so the Government also has to borrow more. In the final two years, the welfare cuts, tax increases and indirect effects are large enough to pay for the tax cuts and what is by then a smaller increase in public services spending. That is sufficient to increase the projected budget surplus as we go into the next Parliament.

[SLIDE] All this means that the composition of the fiscal consolidation will be noticeably different over this Parliament, compared both to the last Parliament and to the Coalition's plans back in March. There will less reliance on public services cuts and more reliance on revenue increases and welfare cuts, relative to both.

[SLIDE] On that note, let me leave you with a list of some of the key points and we will be happy to take your questions.