October 2018 *Economic and Fiscal Outlook* video briefing

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Hello. My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this video briefing on our October 2018 *Economic and Fiscal Outlook*, which accompanies Philip Hammond's Autumn Budget.

[SLIDE] Let me start with some background to the document.

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 various fiscal and welfare spending targets.

The views expressed are those of the independent Budget Responsibility Committee. But, as always, we have relied on the hard work of the OBR's staff and of numerous officials in other departments and agencies.

As usual, the forecast went through several iterations to reflect new judgements, new data a policy measures. We provided the Chancellor with a final pre-measures forecast on October the 15th and I met him on the same day. We provided a final version of our document on Sunday the 28th.

I am pleased to say that we have come under no pressure to change any of our conclusions. But this has been an unusually challenging forecast, with repeated failures to stick to the timetable we agreed with the Treasury. This means that there is a regrettable (but thankfully small) inconsistency between our economy and public finance forecasts. And we have not been able to certify the costing of the Government's package of changes to universal credit as central and reasonable on the basis of the information we were provided. We will be seeking assurance from the Treasury that these problems are not repeated at future fiscal events.

[SLIDE] So now let me turn to a brief overview of the report.

The underlying outlook for the public finances has improved since our last forecast in March. The Office for National Statistics has revised down its estimate of last year's budget deficit and so far this year borrowing has been dropping more quickly than expected. So the starting point for the forecast is stronger than in March. As a result, before taking account of the policy measures announced in the Budget, we have revised down our forecast for public sector borrowing this year by around £12 billion.

In addition, we are also more optimistic about economic growth over the next five years. This is because recent outturn data suggest that that the economy can sustain lower rates of unemployment than we thought and because we think labour market participation is likely to be higher.

A stronger outlook for economic growth means a stronger outlook for tax revenues. So our £12 billion downward revision to the pre-measures budget deficit this year rises to £18 billion by 2022-23. This the largest favourable forecast revision we have made since December 2013, as a share of GDP, but only the sixth largest revision we have made in either direction since 2010. It is about average size for an autumn forecast.

On its own, this improvement in the underlying outlook would have put the Government on course to achieve its so-called 'fiscal objective' of balancing the budget by 2025. But most of it had already been swallowed by the Prime Minister's announcement of extra money for the NHS back in June, for which the funding has been confirmed in the Budget. The other Budget measures have the familiar Augustinian pattern of a further giveaway in the near term that the Government promises to rein back over the longer term. The net result is that the overall budget deficit at the end of the forecast is little changed since the spring statement in March.

The Budget package has been fine-tuned to ensure that the Chancellor has exactly the same wriggle room against his 'fiscal mandate' as he had in March. (This requires the structural budget deficit to lie below 2 per cent of GDP in 2020-21.) But by the end of the forecast the deficit is still around £20 billion, with just two years remaining to eliminate it by 2025.

The forecast is based on the same broad assumptions regarding the impact of the Brexit that we have made in our other forecasts since the referendum. In the near term it is important to remember that we assume a relative smooth exit from the EU next March. A disorderly one could have a severe short-term impact on the economy and the public finances.

[SLIDE] So let me take you through this story in a little more detail.

Let's begin with last year's budget deficit. With 11 months of provisional data available to us, we forecast back in March that the public sector would borrow £45.2 billion during 2017-18. The ONS's initial outturn, published a month later, was £42.6 billion. And, consistent with the pattern of recent years, it has subsequently revised it down further to £39.8 billion. So the public finances had been doing better over the previous 12 months than the available data suggested when we made our March forecast.

[SLIDE] Despite that revision, the budget deficit has fallen more sharply between the first half of last year and the first half of this year than we forecast in March. As you can see here, the cumulative deficit over the year to date is 35 per cent lower than same period last year. That is almost twice the 18 per cent decline for the full year that we expected in March.

[SLIDE] The revisions to last year's deficit and the further improvement that we have seen over the past six months have lowered our forecast for borrowing this year by £11.9 billion (after restating the March forecast for some small classification changes to give a like-for-like comparison). As this table shows, all four major tax streams are outperforming expectations. And, unusually, the revision to debt interest is pushing in the same direction, thanks in part to lower RPI inflation than expected. Welfare spending is coming in lower, thanks in part to lower unemployment but also recent data on tax credits and disability benefits. And local authorities are also putting more money into their reserves rather than spending it.

Looking forward over the rest of the forecast, the outlook for the budget deficit depends importantly on the pace of economic growth. [SLIDE] This chart shows how the economy has grown in recent quarters. Real GDP increased by just 0.5 per cent in the first half of 2018, more slowly than we expected in March and the slowest rate over such a period since the second half of 2011. As a result, we have revised real GDP growth for 2018 as a whole down from 1.5 to 1.3 per cent. But the slowdown partly reflects the temporary impact of the severe weather last winter.

[SLIDE] Looking ahead we think the economy has greater growth potential than we thought in March. This chart shows that the level of potential GDP – the level consistent with stable inflation – is 0.7 per cent higher at the end of the forecast than we thought in March.

The increase reflects the fact that we have reduced our estimate of the sustainable rate of unemployment from 4½ per cent of the labour force to 4 per cent, because the continued fall in the jobless total still hasn't prompted a significant pick-up in wage growth. We also assume that labour market participation will be higher than we forecast in March, reflecting new data on participation by age that we incorporated into our *Fiscal sustainability report* back in July. These positive factors are offset by a lower assumption for potential average hours worked per week.

[SLIDE] Turning from potential growth to actual growth, this chart shows our forecasts for year-on-year growth in March. [SLIDE] And this is the forecast that we would have published today if there were no measures in the Budget, taking into account our judgement that the economy is currently running slightly above potential at the moment. You can see, there is slightly more momentum through the forecast than in March. [SLIDE] And the same is true if we look at growth in nominal GDP – the cash value of the economy – which also takes into account whole economy inflation. This is the measure that matters most for tax receipts, as most taxes are levied on components of nominal income or spending.

[SLIDE] So what does all this mean for the outlook for the public finances? This chart shows the change since March in our underlying forecast for public sector net borrowing, before taking account of the impact of the Budget measures. The diamonds show the total change, which – as I mentioned a moment ago – moves from an improvement of around £12 billion this year to one of around £18 billion by 2022-23.

Where does this improvement come from? [SLIDE] The biggest factor is the unexpected strength of tax revenues this year, which reduces the deficit by £6 to £7 billion a year. This pushes through the forecast because we assume that the rise in the tax-to-GDP ratio this year is structural and/or that nominal GDP growth is being understated. [SLIDE] Our downward revision to the sustainable rate of unemployment contributes another £3 billion or so, as employment is higher across the forecast, boosting receipts from taxes on household income and spending. [SLIDE] Debt interest contributes £2 billion, reflecting the fact that lower borrowing means a lower debt stock. [SLIDE] Other factors push in both directions, but higher oil production and smaller litigation payouts from challenges to HMRC both also help push the deficit lower in aggregate.

[SLIDE} And how does this change the picture from March? This slide shows our forecast for net borrowing back then, falling steadily over the next few years to reach a deficit of little over £20 billion by 2022-23. [SLIDE] This line incorporates the favourable revisions I have just described, plus some small classification changes and ONS corrections. It shows that if the Chancellor had sat on his hands in the Budget, he would be on course to deliver a small surplus of £3.5 billion by 2023-24.

But the Chancellor hasn't sat on his hands – he has delivered the largest discretionary fiscal giveaway since the creation of the OBR. [SLIDE] As you can see, this means that while the deficit remains significantly lower than expected this year, there is very little improvement from March in the later years of the forecast. The windfall has been spent rather than saved.

[SLIDE] So how do the Budget measures affect the borrowing forecast?

[SLIDE] By far the largest impact comes from the NHS spending settlement announced back in June. The direct cost rises from £7.4 billion in 2019-20 to £27.6 billion in 2023-24. [SLIDE] The other Budget measures add up to a further giveaway of £5.7 billion next year, but this diminishes over time.

The direct effect of the extra health spending and other giveaways on the deficit is partly offset by the temporary boost they deliver to real GDP growth and the permanent impact they have on the whole economy price level and nominal GDP. This boosts tax revenues, but the higher price level also means that a given cash sum spent on public services stretches less far in terms of the quality and quantity of output it can deliver. So the boost to public spending is partially self-financing and partially self-defeating.

[SLIDE] We can see here that the indirect effect of the Budget measures reduces borrowing by £1.8 billion next year, rising to £4.2 billion in 2023-24. [SLIDE] To simplify matters, we can allocate them proportionately to the health and non-health elements of the package. (On this basis the non-health measures deliver a very small net tightening in 2023-24.)

[SLIDE] Add the two and that the overall impact of the measures is to increase borrowing by £1.1 billion this year and £10.9 billion next year, rising to £23.2 billion in 2023-24. As we saw, towards the end of the forecast this broadly offsets the underlying forecast improvement.

[SLIDE] But what exactly is going on in the non-health package – the new measures that have been announced in this Budget?

[SLIDE] The giveaways include a series of tax cuts, including an above-inflation rise in the income tax personal allowance and higher rate threshold, and the traditional one-year freeze in fuel duties.

[SLIDE] They include an increase in public services spending outside health in most years.

[SLIDE] And they include other spenindg changes, notably a package of measures that increases the generosity of universal credit. I mentioned earlier that we have not been able to certify the cost of these as central and reasonable, but there is no a priori reason to expect a bias in either direction so we put in the estimates given to us by the Treasury in for now and will revisit them in the next forecast.

[SLIDE] The takeaways in the Budget package include some gross tax rises, including a new tax on large digital businesses, a tightening of the tax rules for people who work though their own companies and a reversal of the 2016 decision to abolish Class 2 National Insurance Contributions for the self-employed.

[SLIDE] The Budget also cuts planned capital spending from 2020-21, a measure that is not on the Treasury's published scorecard of policy measures.

[SLIDE] Add in the indirect effects I mentioned a moment ago and [SLIDE] we have a total giveaway of £5.3 billion next year that becomes a tiny £0.2 billion takeaway by 2023-24 – a familiar pattern from past fiscal events.

As we have seen, in terms of pounds given away, the Budget package is dominated by public spending decisions rather tax ones. These decisions are provisional – plans for the next few years will not be inked in until the forthcoming Spending Review, presumably next year. But how have they affected the outlook for spending over the medium term?

[SLIDE] There are many metrics for public spending, but we focus here on spending per head adjusted for inflation – and on how that changes cumulatively compared to a 2015-16 baseline.

[SLIDE] This chart shows the cumulative changes in resource departmental spending – day to day central government spending on public services, grants and administration. The change since March is obvious. Rather than falling almost 6 per cent from its 2015-16 level by 2022-23, spending is now planned to rise on this basis by around 2 per cent.

[SLIDE] This chart shows how the latest plans differ between health spending and other spending. (The figures are not directly comparable because these are the proposed Treasury limits, rather than what is actually likely to be spent, but the broad pattern would be the same. You can see that health spending rises steadily to a total increase of around 20 per cent., Non-health spending is broadly flat from now on, but that leaves in place the 10 per cent cuts implemented in the last couple of years.

[SLIDE] Turning to capital spending, the plans in place in March included a sharp jump in 2020-21 that we did not expect to be fully delivered. The cuts announced in the Budget leave a smoother pattern, but one in which capital spending continues to rise in real per capita terms.

[SLIDE] I mentioned a moment ago that the Budget contains a package of measures affecting universal credit, which is gradually absorbing most benefits and tax credits paid to working age people. This includes the measures that were announced by the DWP in June. The package:

- Reverses some of the cut in work allowances that the Government announced in its summer 2015 budget. This increases the amount that claimants can earn before their awards are tapered way.

- It reverses and relaxes and number of other features of UC. Housing support will no longer be withheld from those aged 18 to 21, all self-employed claimants will have a 12-month grace period before being subject to the minimum income floor and surplus earnings rules will be relaxed in 2019-10. (The last of these mirrors the increase in income disregards in tax credits in the mid-2000s when the practical implications of the new system became apparent.)

- And the package eases the transition from the legacy system to UC. For example, claimants moving from jobseeker's allowance, income support and the employment and support allowance which get two week's extra legacy benefit income at the start of a new UC claim.

The costs of these measures is partly offset by yet again delaying the roll-out of managed migration, and the associated cost of transitional protection for those who would lose from the move. The Government's estimate of the net cost – which we have not been able to certify – rises from £700 million next year to £2.1 billion by 2023-24.

[SLIDE] You can see here how the roll-out has been delayed to date [SLIDE] and the impact of the latest changes in the budget. The caseload is now planned to rise much less steeply over the next few years.
[SLIDE] This chart shows the cost of UC relative to the cost of the legacy system it is replacing and how that has changed over successive forecasts. You can see that up to March 2015 – the final Budget under the coalition – UC was designed to cost more than the legacy system, although some of generosity in the original vision had been whittled away. But under the new Government UC was seen as a potential source of savings and in November 2015 it was looking to cut spending by £3 billion.

Subsequent policy changes have whittled those savings away and [SLIDE] under our pre-measures forecast UC would have cost slightly more than the legacy system – at least for as long as transitional protection had to be paid. The measures announced in the Budget mean that UC now costs more than the legacy system and by rising amounts over time. Having marched to the bottom of the hill, we have marched to the top again.

[SLIDE] So now let me turn to the Government's fiscal and spending targets and how the combination of our underlying forecast revisions and the Budget measures affect the Government's chances of hitting them.

The slide gives a summary. The Government remains on course to meet both its fiscal mandate for the structural budget deficit and its supplementary target to reduce the debt-to-GDP ratio. And it also remains on course to stay within its welfare spending cap. In the absence of any Budget measures, the Government would have also been on course to achieve its overall fiscal objective of balancing the budget by 2025, although this lies beyond the end of our formal forecasting horizon. But the Government has spent the fiscal windfall rather than saving it – indeed it had already spent it months before it knew it was coming.

[SLIDE] Looking at the targets individually, the fiscal mandate requires the Government to bring the structural budget deficit below 2 per cent of GDP by 2020-21. The structural deficit is the one you would see if activity in the economy was running at its potential level, consistent with stable inflation. With the output gap – between actual output and potential – currently very small, the structural deficit is little different from the actual deficit and that remains true across the forecast.

This chart shows the path of the structural budget deficit from our March forecast – and the 2 per cent ceiling. By 2020-21 the deficit was forecast to fall to 1.3 per cent of GDP, thanks to further planned cuts in day-to-day public public spending as a share of GDP. That left headroom against the target of 0.7 per cent of GDP.

[SLIDE] Our pre-measures forecast revisions would have lowered the structural deficit to 0.9 per cent of GDP in the target year and increased the margin to 1.1 per cent. But the Budget giveaway unwinds that improvement and puts the structural deficit back where it started. Such is the Treasury's scorecard artistry that (with a little bit of effort) they have ensured that the Chancellor has exactly the same margin against the mandate as he had in March – to the nearest £0.1 billion.

[SLIDE] Given the precision of this fine-tuning, it is worth recalling the uncertainty that lies around our central forecast, based on the accuracy of past ones. On that basis, the Government's current room for manoeuvre translates into a roughly 65 per cent probability of achieving the mandate on current policy.

[SLIDE] Turning to the supplementary fiscal target, this requires public sector net debt to fall as a share of GDP in 2020-21. In our March forecast net debt peaked at 85.6 per cent of GDP in 2017-18 and fell by 3.0 per cent of GDP in the target year. [SLIDE] In this forecast the peak is slightly lower at 85.2 per cent in 2016-17 and drops by 3.2 per cent in the target year. The ending of the Bank of England's Term Funding Scheme (or TFS) contributes 2.3 percentage points of that.

Net debt falls to 75.0 per cent of GDP by the 2022-23, down from 77.9 per cent in March. The improvement reflects higher nominal GDP, slightly lower cumulative borrowing over the forecast and further planned sales of RBS shares and student loans. In the absence of the Budget giveaway, debt would have been nearer 70 per cent of GDP.

[SLIDE] Turning very briefly to the welfare cap, this has been restated again at this fiscal event. Spending remains substantially below the cap and pathway in every year of the forecast, so that the cap is adhered to comfortably – with our without the permitted margin. In the absence of the Budget measures – particularly the increase in the generosity of universal credit – it would have been met even more comfortably.

[SLIDE] The Government describes the fiscal mandate and the supplementary debt target as 'interim targets'. Its formal 'fiscal objective' is to bring the public finances to balance as soon as possible in the next Parliament. When the target was set, this would have been 2025-26 at the latest.

This lies beyond our five-year forecast horizon, so we cannot judge the prospects definitively. But in the absence of the discretionary fiscal giveaway announced in the Budget, we estimate that the Government would be running a small budget surplus by 2023-24, thanks to the favourable revisions to our underlying forecast. With fiscal drag pushing the deficit down and spending pressures pushing it up in the subsequent two years, I think we would have concluded that the Government was on course to stay in surplus to the target year.

But, as we have heard, the government has spent the fiscal windfall – mostly on health. So rather than a surplus in 2023-24, we forecast a deficit of around £20 billion – little changed from the previous year. With only two year remaining to the target year, the Government does not seem to be on course to meet the objective.

[SLIDE] That's it for the targets, but before I conclude I should explain briefly how the budget measures have affected our final economy forecasts. As I noted in my introduction, the Treasury changed its mind about some elements of the Budget package after we had closed the economy forecast. The giveaway was slightly smaller than originally intended. We have tried to capture the impact of this in our fiscal forecast, but this means that there is a small inconsistency between the economy forecast and the final fiscal package. But we don't think that it would have moved our real GDP growth forecasts by as much as 0.1 percentage points in any year.

[SLIDE] Starting with those, this chart shows our March forecast and today's pre-measures forecast. [SLIDE] Move to the post-measures forecast and you can see that the impact of the Budget giveaway is relatively modest. The peak impact is in 2019, when we expect growth of 1.6 per cent, up from 1.3 per cent in March. The Budget package boosts growth early in the forecast but lowers it slightly thereafter as potential GDP is unaffected.

[SLIDE] The impact of the measures is slightly more obvious when looking at nominal GDP, because the spending permanently increases the whole economy price level as well as temporarily boosting real GDP growth. Nominal GDP growth is relatively stable at around 3 ½ per cent a year over most of the forecast, up from March.

[SLIDE] The Budget measures have a relatively significant impact on the composition of GDP, in particular reflecting the increases in health spending. Nominal government consumption is now higher at the end of the forecast than at the beginning, the first time we have projected such a rise. The latest data suggest that business investment has held up less well since the EU referendum than previously suggested, but we still expect it to rise slightly over the forecast as a share of GDP. Household consumption grows more strongly in the near term than in March, but in line with household income thereafter. The saving ratio excluding pension contributions is very slightly negative through the forecast and unsecured debt rises as a share of GDP, but this does not mean that we are relying on an unsustainable debt-fueled increase in consumption to drive growth. The saving ratio is broadly flat and only a small part of unsecured debt is made up by consumer credit, with a small and growing share accounted for by student loans.

[SLIDE] Consumer price inflation is slightly higher across the forecast than in March, thanks in part to higher oil prices and a weaker pound, although Ofgem's cap on energy tariffs lowers inflation in 2019. The Budget freeze in fuel duty and some alcohol duties also lowers inflation, but the overall fiscal loosening keeps it fractionally above target.

[SLIDE] As I mentioned earlier on, we have lowered our estimate of the sustainable rate of unemployment from 4 ½ to 4 per cent of the labour force. As you see here, we expect unemployment to drop to around 3.7 per cent in the near term before rising gradually back towards that level.

[SLIDE] Our estimate of the sustainable rate of unemployment rises very gradually over time, reflecting the planned increase in the national living wage to 60 per cent of median earnings by 2020. Alongside the Budget, the Government dropped a hint that it might seek to increases this to two-thirds of median earnings, the OECD's definition of low pay.

This is not firm policy, so we have not included it in our central forecast.

But it would increase the living wage to a level without much precedent in other countries. We estimate that it would affect a quarter of the labour force directly and another quarter indirectly. The rise in the minimum wage to date has had little apparent impact on employment, as one would expect, but an increase to two-thirds of median earnings might well price more people out of jobs. In today's terms, we estimate that it might reduce employment by 140,000 and hours worked by those in work by an equivalent amount. Together this might reduce real GDP by 0.2 per cent. The Government will consult on the idea.

[SLIDE] So now let me conclude.

This has been a Budget with some significant moving parts. The outlook for the public finances has improved since March, but history tells us the positive forecast surprises can be followed by negative ones. Nonetheless, the Government has spent the fiscal windfall – funding its earlier promises on the NHS and delivering a further near-term giveaway. Rather than making further progress towards its formal objective of a balanced budget, it has been content to meet its near-term targets with the same room for manoeuvre that it had in March.

Our forecast is based on the same broad-brush assumptions about the impact of Brexit that we have made in our other post-referendum forecasts to date. We explained in a recent discussion paper how we would revisit these when firm details are agreed on our future relationship with the EU – a process that could extend well beyond the forthcoming Withdrawal Agreement. In the near term, it is important to remember that this forecast assumes a relatively smooth departure from the EU in March next year. A disorderly one could have severe short-term implications for the economy, the exchange rate, asset prices and the public finances. The sale of the impact would be very hard to predict with confidence, given the lack of precedent.