1 March 2015 Economic and fiscal outlook – Executive summary

Overview

1.1 In the relatively short period since our last forecast in December, there have been a number of developments affecting prospects for the UK economy and public finances both positively and negatively. These include a further big fall in oil prices, an unexpectedly large increase in net inward migration, further falls in market interest rates, another disappointing quarter for productivity growth, downward revisions to estimates of economic growth in 2014 and downward revisions to the outlook for the world economy. These have had a relatively modest net effect on our forecasts for real GDP growth and the public finances.

1.2 The Coalition Government's policy decisions in this Budget are not expected to have a material impact on the economy. For the public finances, they ensure that net borrowing is lower every year to 2018-19 than in our last forecast, that the new fiscal mandate is met with room to spare in 2017-18, that public spending as a share of GDP no longer falls to a post-war low in 2019-20, and that the debt-to-GDP ratio falls a year earlier in 2015-16.

1.3 The Government has achieved this by tightening the assumed squeeze on total spending through to 2018-19, dropping the cut in spending as a share of GDP it had pencilled in for 2019-20 and announcing the sale of an additional £20 billion in financial assets next year. This leaves a rollercoaster profile for implied public services spending through the next Parliament: a much sharper squeeze on real spending in 2016-17 and 2017-18 than anything seen over the past five years followed by the biggest increase in real spending for a decade in 2019-20. This profile is driven by a medium-term fiscal assumption that the Treasury has confirmed "*represents the Government's agreed position for Budget 2015*" and that was "*discussed by the Quad and agreed by both parties in the Coalition.*" But both parties have said that they would pursue different policies if they were to govern alone.

1.4 Real GDP grew by 0.5 per cent in the final quarter of 2014, slightly weaker than we expected in December. Employment growth was close to forecast, but hours worked were higher than expected. This meant that productivity fell on an hourly basis in the final quarter, falling short of our forecast once again. Unemployment has continued to fall as we expected, reaching 5.7 per cent of the labour force by the end of 2014, while sharply lower oil prices pushed inflation close to zero in January.

1.5 In 2015 and 2016, we expect lower inflation to boost real incomes and consumer spending, leading us to revise up our forecasts for real GDP growth to 2.5 and 2.3 per cent respectively. The upward revision is tempered by the weaker outlook for UK export market growth and the effect of lower oil prices on production and investment in the North Sea.

1.6 Slightly stronger growth means that we expect the remaining spare capacity in the economy to be used up by late 2017, around a year and a half earlier than we forecast in December. Thereafter, we assume that the economy will grow at its sustainable trend rate, which we have revised up slightly to reflect the stronger population and employment growth associated with higher rates of net inward migration.

1.7 We expect CPI inflation to return to the Government's 2 per cent target relatively slowly, partly due to the lagged effects of sterling's recent appreciation. The near-term fall in inflation is expected to boost real wage growth to 1.4 per cent this year – the first year of material growth since the crisis. Real wages rise by 1¾ per cent a year on average in the medium term. As ever, prospects for GDP and real wage growth rely heavily on the timing and strength of the long-awaited return to sustained productivity growth.

1.8 We estimate that public sector net borrowing has fallen to £90.2 billion or 5.0 per cent of GDP this year – down 41 per cent in cash terms and 51 per cent as a share of GDP relative to the post-crisis peak in 2009-10. Looking further ahead, on the basis of the medium-term spending policy assumption provided to us by the Government, we expect borrowing to fall in each year and to reach a small surplus in 2018-19. The Government no longer assumes that it will cut public spending as a share of GDP in 2019-20, reducing the projected surplus in that year to £7.0 billion from £23.1 billion in our December forecast.

1.9 Relative to our December forecast, we have revised public sector net borrowing (PSNB) down by £1.3 billion a year on average between 2015-16 and 2018-19. This reflects:

- a downward revision to receipts, with the largest downgrades for North Sea revenues (due to lower oil prices and production), stamp duty receipts (due to lower property transactions), excise duties (due to lower inflation-related uprating) and interest and dividend receipts (due to lower interest rates and the interest and dividends foregone due to the further asset sales announced in the Budget). Those downward revisions are partly offset by upward revisions to income tax receipts (due to lower inflation-related uprating of thresholds and stronger employment growth from migration);

- a downward revision to annually managed expenditure, including sharply lower debt interest costs (due to lower RPI inflation and interest rates) and lower welfare spending (due to lower uprating in 2016-17); and

- a new Government policy assumption that reduces total public spending in each year from 2016-17 to 2018-19. But this reduction is smaller than the downward revision to annually managed expenditure, which means less of a squeeze on implied day-to-day spending on public services and administration than in December.

1.10 The projected budget surplus in 2019-20 is £16.1 billion lower than in our December forecast. The Government now assumes that total spending will grow in line with nominal

GDP rather than whole economy inflation in that year. Combined with a lower forecast for annually managed expenditure, that means that implied public services spending in 2019-20 has been revised up by £28.5 billion (1.3 per cent of GDP) since December.

1.11 The Budget measures in the Treasury's table of policy decisions are neutral for borrowing on average over the forecast period with 'giveaways' offsetting 'takeaways'. They raise or lower borrowing by less than £1 billion in every year. The biggest takeaway is an increase in the bank levy (raising £4.4 billion over five years), with a variety of other measures raising smaller amounts with often significant uncertainty around their costing. These are balanced by three main giveaways – further increases in the income tax personal allowance (£5.7 billion over five years), tax measures benefiting savers (£3.0 billion) and a subsidy for first-time buyers (£2.2 billion, the take-up of which is also subject to significant uncertainty).

1.12 In contrast to the relatively small net effect of the scorecard measures, the Government has also announced significant asset sales over the coming year. These are sufficiently large for our forecast for public sector net debt to fall as a share of GDP in 2015-16, a year earlier than in our December forecast. The two largest sales relate to NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution (which we assume will raise around £11 billion in 2015-16) and further sales of Lloyds Banking Group shares (which we assume will raise around £9 billion in 2015-16). However, the decision to loosen the squeeze on spending in 2019-20 means that net debt will continue to rise in *cash* terms in that year rather than beginning to fall as it did in our December forecast.

1.13 The Coalition updated the *Charter for Budget Responsibility* in December,[1] setting out new medium-term fiscal targets. The fiscal mandate – to borrow only to pay for investment, adjusting for the state of the economy – now applies in the third year of the rolling five-year forecast period, rather than the final year. The supplementary target – for public sector net debt to fall as a share of GDP– now applies in 2016-17, rather than 2015-16.

1.14 On our central forecast, the Government is on track to meet its new fiscal mandate with £16.8 billion to spare. This implies a 65 per cent probability of success given the accuracy of past forecasts. Achieving the mandate with this margin depends heavily on cuts in public spending – particularly on public services and administration – implied by the first two years of the Government's medium-term spending policy assumption. The previous fiscal mandate would have been met with £38.8 billion to spare in 2019-20. Public sector net debt is forecast to peak in 2014-15 and to fall by 0.2 per cent of GDP in 2015-16 and a further 0.5 per cent of GDP in 2016-17, thereby meeting the new supplementary target. The previous target would also have been met – the first time we have forecast debt falling as a share of GDP in 2015-16 since March 2012.

Economic developments since our previous forecast

1.15 The single most important global economic development since our previous forecast has been the further substantial drop in oil prices. From a 2014 peak of $115 a barrel in June,

[1] HM Treasury: *Charter for Budget Responsibility: Autumn Statement 2014 update.*

the price of oil fell to a low of $46 a barrel in January. It has since picked up somewhat, but the assumption underpinning our current forecast remains 17 per cent lower than our December assumption in the medium term. The implications of that drop for our forecast depend in part on the extent to which it has been driven by weaker demand or stronger supply. We consider both factors to have played a part (see Box 2.1).

1.16 Since our December forecast, the ONS has published the *Quarterly National Accounts* for the third quarter of 2014, which included revisions to GDP growth back to the first quarter of 2013. It has also published the second estimate of GDP for the fourth quarter of 2014, which included further revisions to the 2014 data. It now appears that the economy was growing less strongly than previously estimated over the past two years. In addition, real GDP is estimated to have risen 0.5 per cent in the fourth quarter of 2014, slightly below our December forecast of 0.6 per cent. Much weaker private consumption than we expected and flat private investment were partly offset by stronger contributions from net trade and government consumption. Overall, GDP growth in 2014 is estimated at 2.6 per cent, some way below the 3.0 per cent we expected in December.

1.17 Employment growth in the final quarter of 2014 was close to our forecast. The Labour Force Survey measure of the unemployment rate has fallen in line with our forecast, reaching 5.7 per cent, but the claimant count continues to fall faster than expected. While employment growth was close to forecast, hours worked increased more than expected. Taken together with the small downside surprise in GDP growth, that means that hourly productivity was once again weaker than expected, falling by an estimated 0.3 per cent in the final quarter.

1.18 Inflation has dropped more sharply than we expected in December, due in large part to lower oil prices feeding through to petrol and diesel prices. Food prices have also fallen, due to intense supermarket competition as well as the effect of sterling strength and lower commodity prices on import prices. CPI inflation fell to 0.3 per cent in January 2015 and RPI inflation fell to 1.1 per cent. This has had important implications for our fiscal forecast.

The economic outlook

1.19 Despite the economy ending 2014 on a weaker note than we expected – and the International Monetary Fund (IMF) revising down its forecasts for world GDP and trade growth – we have revised up our forecasts for UK GDP growth in 2015 and 2016 to 2.5 and 2.3 per cent respectively. In large part that reflects the boost to real incomes and consumer spending from lower oil prices and lower inflation. With oil prices expected to be 25 per cent lower in 2015 than we assumed in December, we have revised down our CPI inflation forecast for the year as a whole to just 0.2 per cent from 1.2 per cent in December. That helps to boost real incomes in 2015.

1.20 Unemployment fell much as we expected in the fourth quarter, implying that the output gap continued to narrow. But output growth was 0.1 percentage points weaker than forecast. These developments helped to inform our judgement that the economy was running 0.7 per cent below potential in the fourth quarter, a slightly wider output gap than we predicted in

December. With growth stronger in the near term, we expect the gap to close by the end of 2017, around a year and half earlier than in our December forecast.

1.21 We have made a number of adjustments to our estimates of potential output growth since December, in light of recent news. Taken together, they imply that cumulative potential output growth between the third quarter of 2014 and the end of the forecast period will be 0.6 percentage points higher than we assumed in December. This reflects:

- our assumption that net migration flows will follow the levels assumed in the ONS principal population projections, rather than the low migration scenario, given the much higher than assumed flows in recent data. This raises cumulative potential growth by 0.6 percentage points. This largely reflects the effect of stronger adult population growth (+0.5 percentage points), with a further small positive contribution (+0.1 percentage points) via the trend employment rate, as the age structure of inward migrants is assumed to be skewed towards those of working age;

- lower oil prices should encourage additional non-oil business investment and hence the accumulation of capital, due to the lower energy costs of operating buildings, plant and machinery. That would provide a small boost to labour productivity growth of around ¼ percentage points; and

- actual growth in productivity per hour has again been weaker than expected, with a fall in the final quarter of 2014 leading to only a 0.2 per cent rise on the year. We have assumed from this that, absent the oil price boost, productivity growth would have remained subdued for longer than we thought in December, continuing an ongoing pattern from recent forecasts. We have therefore reduced our forecast of implied trend total factor productivity growth by an amount that offsets the effect of lower oil prices on overall labour productivity growth via capital deepening.

1.22 We assess prospects for potential output growth on the non-oil measure of gross value added, excluding North Sea oil and gas output. That distinction is important in considering the revisions to our GDP growth forecast since December. The upward revision to potential output growth means we have revised up cumulative non-oil output growth over the forecast period by 0.6 percentage points. But we have also revised down our forecast for cumulative North Sea production by almost 20 per cent. That means our GDP growth forecast – which comprises non-oil and North Sea output – is only up by 0.4 percentage points.

1.23 Overall, we have revised up our GDP forecast in the near term but left it broadly unchanged in the medium term. That is a slightly smaller upward revision than the average external forecast over the past few months. The revision we have made to North Sea production is subject to considerable uncertainty given the big movements in oil prices in recent months and the changes to the tax regime announced in this Budget. Production growth could be significantly higher or lower than we have assumed.

1.24 Despite slightly stronger GDP growth and the output gap closing earlier, lower oil prices and a further appreciation of sterling mean have led us to revise our CPI inflation forecast down significantly. We expect inflation to remain below 1½ per cent until the end of 2016 and to return only slowly to the target rate of 2 per cent due to the lagged effects of sterling strength on import prices. Our forecast is slightly lower than the Bank's February 2015 *Inflation Report* forecast. We have also revised down our estimate of the long-run wedge between RPI and CPI inflation. This has implications for our fiscal forecast given the role of RPI inflation in the cost of servicing index-linked gilts and in uprating excise duties.

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	2.6	2.5	2.3	2.3	2.3	2.4
GDP levels (2013=100)	100.0	102.6	105.1	107.6	110.1	112.7	115.3
Output gap	-2.2	-1.0	-0.4	-0.2	-0.1	0.0	0.0
Expenditure components of GDP							
Household consumption	1.7	2.0	2.6	2.7	2.5	2.3	2.2
General government consumption	-0.3	1.5	0.8	-0.7	-0.9	-0.2	1.5
Business investment	5.3	6.8	5.1	7.5	6.5	6.4	4.4
General government investment	-8.1	7.3	2.3	1.9	1.6	1.5	2.8
Net trade[1]	0.0	-0.5	-0.1	-0.4	-0.2	-0.2	-0.2
Inflation							
CPI	2.6	1.5	0.2	1.2	1.7	1.9	2.0
Labour market							
Employment (millions)	30.0	30.7	31.1	31.4	31.5	31.7	31.9
Average earnings	1.6	2.2	2.3	3.1	3.7	4.0	4.4
LFS unemployment (% rate)	7.6	6.2	5.3	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.77	0.74	0.76	0.77	0.77
	Changes since December forecast						
Output at constant market prices							
Gross domestic product (GDP)	-0.1	-0.5	0.1	0.2	-0.1	0.0	0.0
GDP levels (2013=100)	0.0	-0.4	-0.4	-0.2	-0.3	-0.2	-0.2
Output gap	0.0	0.0	0.1	0.3	0.2	0.1	0.0
Expenditure components of GDP							
Household consumption	0.1	-0.3	-0.2	0.6	0.1	0.0	-0.2
General government consumption	-1.0	0.5	1.2	0.0	0.0	0.1	1.5
Business investment	0.5	-1.0	-3.3	1.2	0.2	0.1	-1.9
General government investment	-0.9	5.2	-1.0	0.3	-0.5	-0.1	0.6
Net trade	0.0	-0.3	0.4	-0.2	-0.1	0.0	0.0
Inflation							
CPI	0.0	-0.1	-0.9	-0.5	-0.3	-0.1	0.0
Labour market							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Average earnings	-0.2	0.4	0.3	0.0	-0.2	0.0	0.5
LFS unemployment (% rate)	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0
Claimant count (millions)	0.00	0.00	-0.08	-0.09	-0.08	-0.08	-0.08

[1] Contribution to GDP growth.

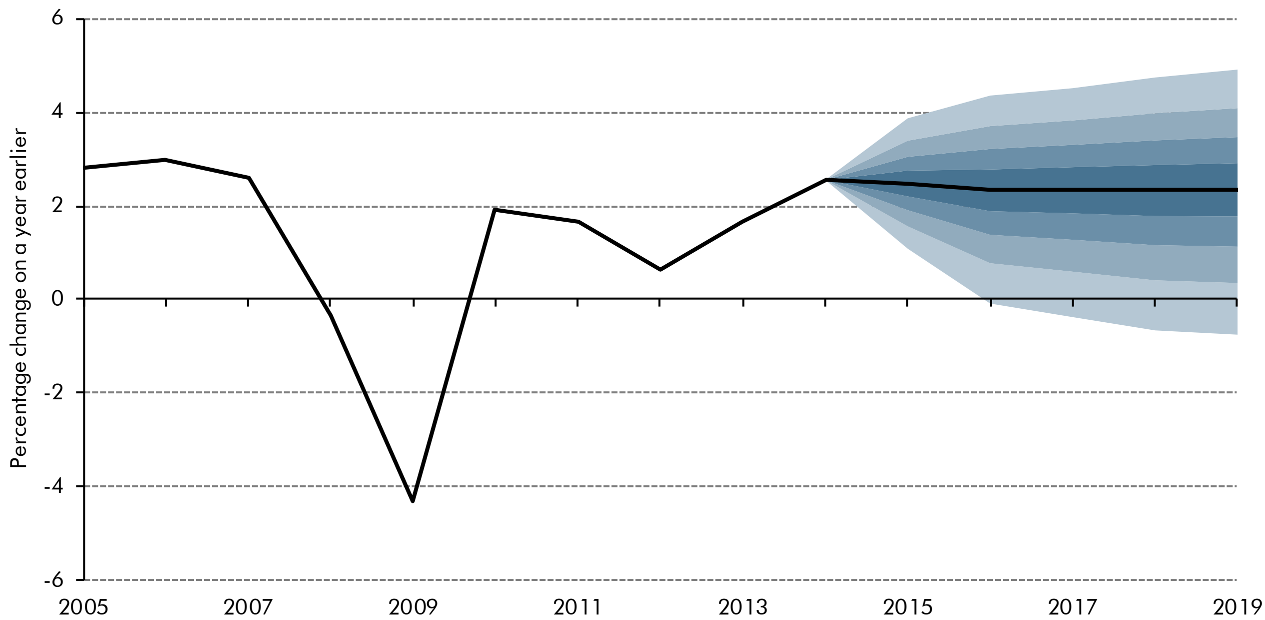
1.25 We have revised employment up by around 0.5 per cent by the end of the forecast period, due almost entirely to the change in our migration assumption. Our unemployment forecast is little changed, reaching a low of 5.1 per cent in the first half of 2016 before rising back to its sustainable medium-term rate later in the forecast. We continue to assume that productivity growth will pick up slowly to more normal rates, but that remains the most important and uncertain judgement in our forecast. It drives our expectation that real wages (specifically our estimate of the 'real consumption wage') will return to their pre-crisis peak by late 2018 – sooner than we expected in December, thanks in part to the boost to real wages associated with lower oil prices.

1.26 We have revised down our near-term forecast of house price inflation, as the latest data suggest that it has slowed more rapidly than we expected in December. Nonetheless, by the end of the forecast house prices are a little higher than in December, thanks to slightly stronger real household income growth. We have made a more significant revision to our forecast for property transactions. The latest data show that transactions have been weaker than expected in recent months, perhaps reflecting a bigger impact on mortgage demand and supply from new Mortgage Market Review regulations. We have also assumed a slightly lower rate of turnover in the housing market in the medium term.

1.27 As we noted in December, in many ways our forecast for the economy over the next five years looks very stable – real and nominal GDP growth, unemployment and the output gap fluctuate relatively little. But this continues to conceal some big changes in the structure of the spending, employment and income associated with the remaining years of fiscal consolidation and the extent to which it is delivered through cuts to government spending on public services and administration. At present, that can only be inferred from the Government's overall spending policy assumption. Once detailed departmental plans are set out in a Spending Review, the implications for our forecasts will become clearer.

1.28 There is considerable uncertainty around any economic forecast. Chart 1.1 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 1.1: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

1.29 The legislation under which the OBR operates requires us to forecast the public finances and judge progress against the fiscal targets on the basis of agreed Government policy. The Coalition has provided us with policy assumptions, the most important of which is the medium-term public spending assumption – described by the Government as a 'fiscal assumption'. The Treasury has confirmed that this "*represents the Government's agreed position for Budget 2015*" and that it was "*discussed by the Quad and agreed by both parties in the Coalition.*" But both parties in the Coalition have said that they would pursue different policies if they were to govern alone.

1.30 Public sector net borrowing peaked at 10.2 per cent of GDP (£153.0 billion) in 2009-10 as the late 2000s recession and financial crisis hit the public finances hard. Our latest forecast suggests that by 2014-15 the deficit will have been reduced by 41 per cent in cash terms and by 51 per cent as a share of GDP. Table 1.2 shows that we expect the deficit to continue falling over the next five years, reaching small surpluses in 2018-19 and 2019-20. It also shows that we expect public sector net debt as a share of GDP to peak in 2014-15 and to fall over the forecast period to reach 71.6 per cent in 2019-20.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Headline fiscal aggregates							
Public sector net borrowing	5.6	5.0	4.0	2.0	0.6	-0.2	-0.3
Cyclically adjusted net borrowing	4.1	4.2	3.7	1.9	0.6	-0.3	-0.3
Current budget deficit	4.1	3.3	2.4	0.5	-0.8	-1.7	-1.7
Fiscal mandate and supplementary target							
Cyclically adjusted deficit on current budget	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Public sector net debt	79.1	80.4	80.2	79.8	77.8	74.8	71.6
	Changes since December forecast						
Headline fiscal aggregates							
Public sector net borrowing	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.7
Cyclically adjusted net borrowing	0.0	0.0	0.1	0.1	0.1	0.0	0.8
Current budget deficit	0.0	0.2	0.2	0.3	0.3	0.3	-0.5
Fiscal mandate and supplementary target							
Cyclically adjusted deficit on current budget	0.0	0.2	0.1	0.1	0.2	0.2	-0.5
Public sector net debt	0.3	0.0	-0.9	-0.9	-1.0	-1.4	-1.2

1.31 Table 1.3 shows how changes in borrowing between our December and March forecasts can be decomposed into underlying forecast changes, including their interaction with the Government's December spending policy assumptions. It also shows the (relatively small) effects the Budget measures shown in the Treasury's policy decisions table and the (much larger) effect of the Government's change to its medium-term spending assumption.

1.32 Relative to our December forecast, we have revised public sector net borrowing (PSNB) down by £1.3 billion a year on average between 2015-16 and 2018-19. This reflects:

- a downward revision to receipts across the forecast period, with the largest downgrades for North Sea revenues (due to lower oil prices and production), stamp duty receipts (due to lower property transactions), excise duties (due to lower inflation-related uprating) and interest and dividend receipts (due to lower interest rates and the interest and dividends foregone due to the further asset sales announced in the Budget). Those downward revisions are partly offset by upward revisions to income tax receipts (due to lower inflation-related uprating of thresholds and stronger employment growth from migration);

- a downward revision to annually managed expenditure, including sharply lower debt interest costs (due to lower RPI inflation and interest rates) and lower welfare spending (due to lower uprating in 2016-17); and

- a new Government policy assumption that reduces total public spending in each year from 2016-17 to 2018-19. But this reduction is smaller than the downward revision to annually managed expenditure, which means less of a squeeze on implied day-to-day spending on public services and administration than in December.

1.33 The projected budget surplus in 2019-20 is £16.1 billion lower than in our December forecast. The Government now assumes that total spending will grow in line with nominal GDP rather than whole economy inflation in that year. Combined with a lower forecast for annually managed expenditure, that means that implied public services spending in 2019-20 has been revised up by £28.5 billion (1.3 per cent of GDP) since December.

1.34 We have assumed that an increase in government spending on its paybill and procurement of this scale would feed through to nominal GDP growth in 2019-20, though not real GDP growth (which is determined by our judgements on potential output). This pushes up receipts, notably income taxes and VAT on public sector procurement. This turnaround in receipts from previous years appears in Table 1.3 as an 'underlying forecast change', but is in effect driven by the change in the spending policy assumption.

Table 1.3: Changes to public sector net borrowing since December

	£billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	91.3	75.9	40.9	14.5	-4.0	-23.1
March forecast	90.2	75.3	39.4	12.8	-5.2	-7.0
Change	**-1.1**	**-0.7**	**-1.5**	**-1.8**	**-1.2**	**16.1**
Underlying OBR forecast changes						
Total	**-1.1**	**0.1**	**0.5**	**0.4**	**-0.1**	**-4.6**
of which:						
Changes in the receipts forecast	**-1.1**	**3.3**	**4.9**	**5.8**	**4.0**	**-1.9**
of which:						
Inflation	0.1	0.7	0.7	0.4	0.8	1.0
Other oil and gas price effects	-0.1	0.7	0.7	1.0	1.1	1.1
Interest rates	0.0	0.3	0.5	0.6	0.5	0.6
Housing market	0.2	1.5	2.1	1.8	0.9	-0.1
Other	-0.5	1.0	1.8	2.8	1.6	-3.4
Classification changes	-0.8	-0.9	-0.9	-0.9	-0.9	-1.0
Changes in the spending forecast	**0.0**	**-3.3**				
Effect of applying Autumn Statement spending policy assumptions post 2015-16			**-4.4**	**-5.4**	**-4.1**	**-2.8**
of which:						
Inflation	-2.2	-4.2	-4.7	-5.6	-6.5	-6.9
Interest rates	-0.3	-1.2	-2.1	-3.0	-3.9	-4.5
Capital spending[1]	1.0	2.0	2.0	2.0	2.3	2.9
Other spending	-0.3	-1.8	-6.5	-5.0	-5.3	-5.0
Classification changes	2.1	2.2	2.2	2.2	2.3	2.3
RDEL	-0.3	-0.4				
Implied RDEL			4.6	4.0	7.0	8.3
Changes due to Government decisions						
Budget policy measures	0.0	-0.7	0.0	-0.2	0.9	0.6
Effect of applying new Budget spending policy assumptions post 2015-16			-1.9	-1.9	-2.0	20.2

[1]Excluding classification changes

Note: this table uses the convention that a negative figure means an improvement in PSNB.

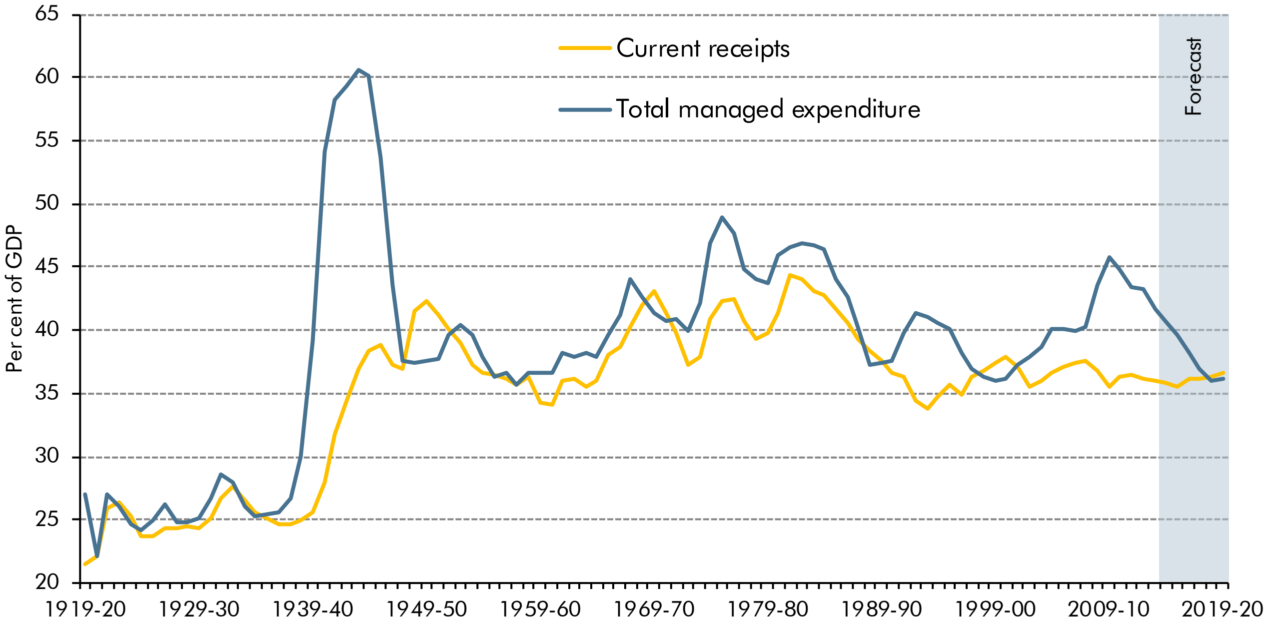
1.35 Between 2009-10 and 2019-20, the budget balance is forecast to move from a post-war record deficit of 10.2 per cent of GDP to a small surplus of 0.3 per cent – a turnaround of 10.5 per cent of GDP (£172 billion in today's terms). By 2014-15, around half of that planned reduction – 5.2 per cent of GDP (£79 billion) – will have been completed.

1.36 Over the five years to 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 increases in **debt interest** spending (0.4 per cent of GDP) as interest rates are assumed to rise in line with market expectations, which remain well below historical averages by the end of the forecast period;
- small reductions in **capital spending** (0.1 per cent of GDP);
- small reductions in **AME spending other than on debt interest and welfare** (0.3 per cent of GDP);
- a 0.5 per cent of GDP rise in **receipts**. This includes a 0.3 per cent of GDP rise in the tax-to-GDP ratio – the biggest contributors to which are 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 the abolition of the NICs contracting out rebate in 2016-17 – and a 0.2 per cent of GDP rise in non-tax revenues, notably interest on the government's stock of financial assets as interest rates rise;
- a 1.3 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 economic 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
- a 3.6 per cent of GDP (or £65 billion in today's terms) cut in **day-to-day spending on public services and administration**, implied by the Government's firm 2015-16 plans, its medium-term assumptions for total spending and our forecast for AME spending. This is 1.2 per cent of GDP smaller than in our December forecast, but still accounts for around 70 per cent of the improvement in the budget balance over the forecast.

1.37 Chart 1.2 shows current receipts and total managed expenditure as a share of GDP since 1919-20 using Bank of England and ONS data. The Government's decision to assume that spending rises in line with nominal GDP in 2019-20 means that it no longer falls to its lowest share of national income in a full year since before the war, as was the case in our December forecast. Instead, total spending falls to 36.0 per cent of GDP, which is fractionally higher than the previous post-war lows of 35.8 per cent in 1957-58 and 35.9 per cent in 1999-2000. Current receipts as a share of GDP are forecast to remain at similar levels to those seen over the last few decades.

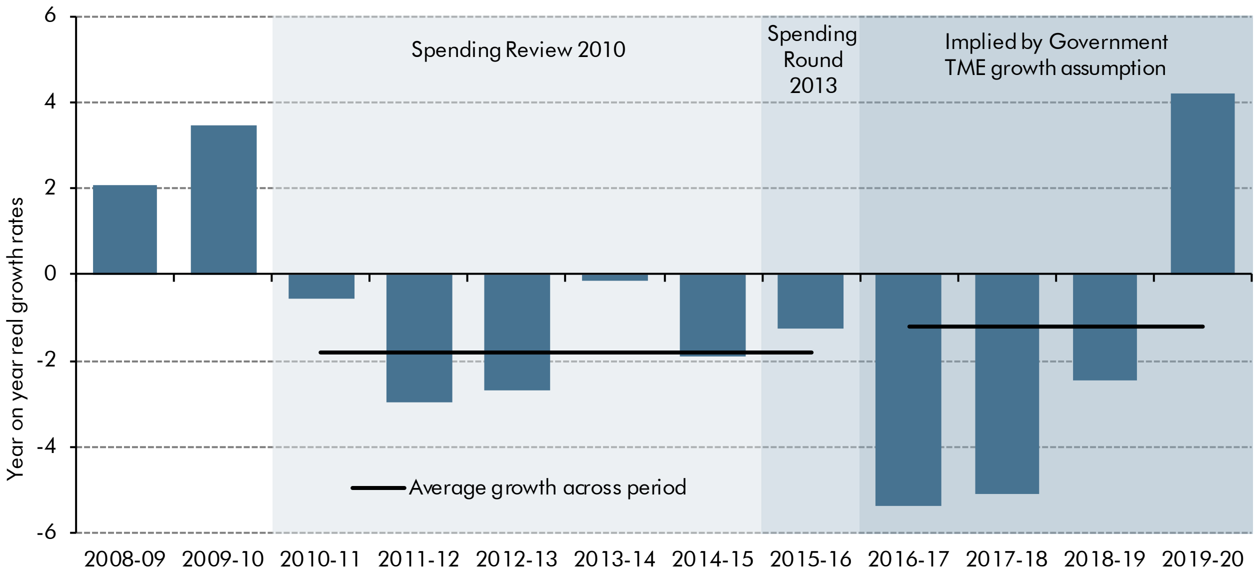
Chart 1.2: Total public sector spending and receipts



Source: Bank of England, ONS, OBR

1.38 Another implication of the Government's spending policy assumptions is a sharp acceleration in the pace of implied real cuts to day-to-day spending on public services and administration in 2016-17 and 2017-18, followed by a sharp turnaround in 2019-20, as shown in Chart 1.3. As explained below, the implied cuts in 2016-17 and 2017-18 are a key reason why the Government is on course to achieve its new fiscal mandate to balance the cyclically adjusted current budget in 2017-18 with room to spare.

Chart 1.3: Year-on-year growth in real resource DEL spending

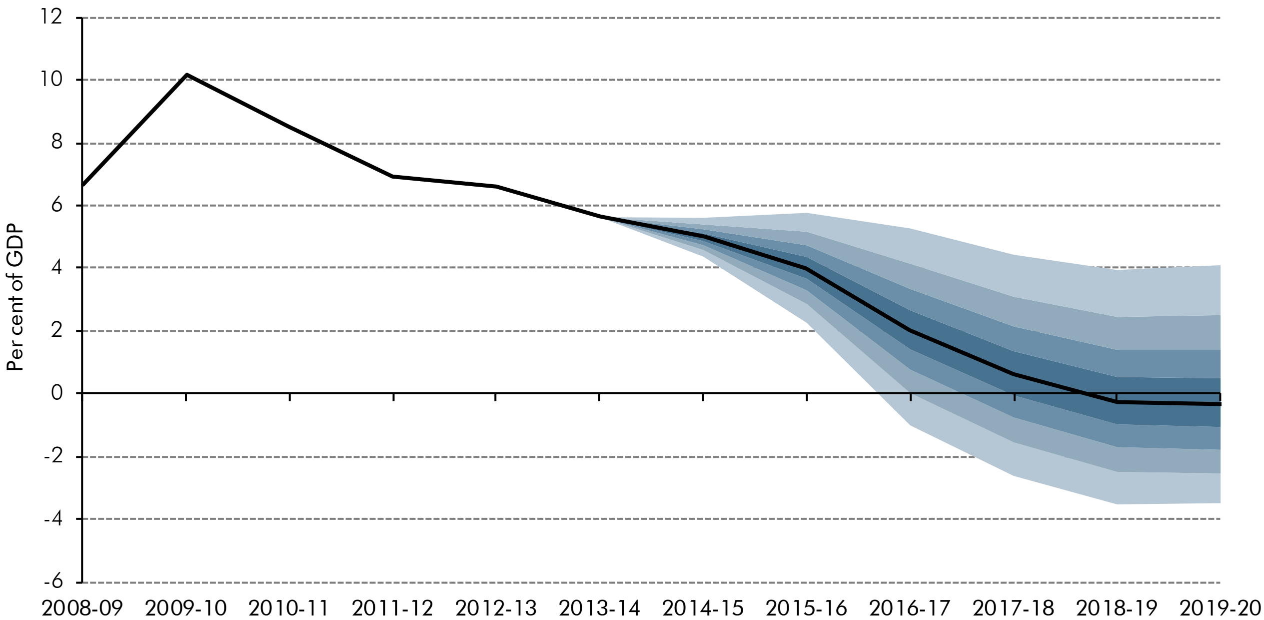


Note: RDEL series excludes major historical switches with AME as well as switches with AME in forecast years. Details are available in the supplementary fiscal tables on our website.
Source: OBR

1.39 The current budget balance, which excludes borrowing to finance net investment spending, is expected to show a deficit of £59.8 billion in 2014-15, down from a peak of £103.8 billion in 2009-10. The current budget moves into surplus in 2017-18 and reaches a surplus of £35.2 billion in 2018-19 and £38.7 billion in 2019-20. Our forecast of the current budget balance between 2015-16 and 2018-19 has improved since December, as lower spending on debt interest and welfare more than offset the increase in spending on public services and administration implied by the Government's latest spending policy assumption. The surplus in 2019-20 has been revised down by £11.3 billion, with the revision more than explained by the change in the Government's spending assumption for that year. With the output gap now estimated to be relatively small and expected to close by late 2017, the cyclically adjusted current budget follows a similar path to the headline current budget and has been revised by similar amounts for similar reasons.

1.40 All forecasts are subject to significant uncertainty. Chart 1.4 shows our median forecast for PSNB, with successive pairs of shaded areas around it representing 20 per cent probability bands. As in Chart 1.1 above, the bands show the probability of different outcomes if past official errors were a reasonable guide to future forecast errors.

Chart 1.4: PSNB fan chart



Source: ONS, OBR

1.41 We forecast that public sector net debt (PSND) will rise as a share of GDP this year, but start to fall from 2015-16 and at an increasingly rapid rate to 71.6 per cent of GDP in 2019-20. Net debt is lower than we forecast in December from 2015-16 onwards, and falls a year earlier than we expected then. Table 1.4 shows that:

- downward revisions to the level of nominal GDP in 2014-15 have increased debt as a share of GDP. That feeds through to the rest of the forecast period, but higher nominal GDP growth later in our forecast unwinds the effect;

- our borrowing forecast – both underlying changes and the effect of Government decisions – have relatively small effects of the level of net debt. The exception is in 2019-20, where the change in the Government's chosen spending policy assumption has increased spending and borrowing relative to our December forecast, reducing the extent to which debt falls as a share of GDP in that year. Indeed, net debt now continues to rise in *cash* terms in 2019-20 (by £9½ billion), rather than falling modestly as in our December forecast (by £4 billion);

- the Government announcement of two significant asset sales related to the mortgage assets of NRAM plc managed by UK Asset Resolution (UKAR) and its shareholding in Lloyds Banking Group have the largest effect on the debt-to-GDP ratio. Together they are expected to reduce net debt by £20 billion in 2015-16. That means that debt falls as a share of GDP a year earlier than would otherwise have been the case. The bulk of these sales are expected to take place late in the fiscal year. Financial asset sales bring forward cash that would otherwise have been received in future in the shape of mortgage repayments and dividends (around £10 billion over the remainder of the forecast period as a result of the UKAR and Lloyds sales), so they only temporarily reduce the debt-to-GDP ratio;

- UKAR also ran down its assets more quickly in 2014-15 than we had factored into our December forecast. Much of this reflects the sale of an asset that we had assumed would be sold in 2015-16;

- changes in the premia associated with the Debt Management Office issuing gilts at prices above their nominal value have reduced our forecast for net debt slightly further. These premia are particularly associated with index-linked gilts, due to the negative real yield curve that persists over through the forecast period; and

- other factors have reduced net debt further. Downward revisions to student numbers have reduced our forecast of lending on student loans by increasing amounts over time. A debt-neutral classification change relating to subscriptions to multilateral development banks that raises borrowing but reduces financial transactions also affects this line.

Table 1.4: Changes to public sector net debt since December

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
March forecast	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Change	**0.3**	**0.0**	**-0.9**	**-0.9**	**-1.0**	**-1.4**	**-1.2**
of which:							
Change in nominal GDP[1]	0.3	0.6	0.4	0.6	0.6	0.2	-0.3
Change in cash level of net debt	0.0	-0.5	-1.3	-1.5	-1.6	-1.6	-0.9
	£ billion						
December forecast	1402	1489	1558	1610	1638	1652	1648
March forecast	1402	1479	1533	1580	1606	1617	1627
Change in cash level of net debt	**0**	**-10**	**-25**	**-30**	**-32**	**-34**	**-21**
of which:							
Borrowing changes	0	-1	-2	-3	-5	-6	10
UK Asset Resolution	0	-3	-8	-7	-5	-3	-1
Lloyds Banking Group share sales	0	-1	-10	-10	-10	-10	-10
Gilt premia	0	-2	0	-2	-3	-3	-5
Other factors	0	-3	-5	-7	-9	-12	-15

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

Performance against the Government's fiscal targets

1.42 In the June 2010 Budget, the Government set itself two medium-term fiscal targets for the current Parliament: the fiscal mandate and a supplementary target. The OBR is required to judge whether the Government has a greater than 50 per cent probability of hitting these under existing policy. In March 2014, the Government updated the *Charter for Budget Responsibility* to include details of how a new 'welfare cap' – set in Budget 2014 – would operate. In December 2014, the Government updated the *Charter* again to set a new fiscal mandate and a new supplementary target.[2] The welfare cap remained as specified in the March 2014 update.

1.43 The Government's fiscal targets include:

- *"a forward-looking aim to achieve cyclically adjusted current balance by the end of the third year of the rolling, 5-year forecast period"*. (For the purposes of this forecast, the third year of the forecast period is 2017-18). The previous target had been to achieve balance in the final year of the forecast period (2019-20 in this forecast);
- *"an aim for public sector net debt as a percentage of GDP to be falling in 2016-17"*. The previous target had been for debt as a share of GDP to be fall at a fixed date of 2015-16; and

[2] See *Charter for Budget Responsibility: Autumn Statement 2014 update*, which is available on our website.

- *"the cap on welfare spending, at a level set out by the Treasury in the most recently published Budget report, over the rolling 5-year forecast period, to ensure that expenditure on welfare is contained within a predetermined ceiling"*.

1.44 The profile of borrowing and the CACB for 2016-17 and beyond is largely determined by the Government's policy assumption regarding the path of total public spending. On that basis, we judge that the Government has a greater than 50 per cent chance of meeting the new **fiscal mandate**. The cyclically adjusted current budget (CACB) moves from a deficit of 2.5 per cent of GDP in 2014-15 to a surplus of 0.8 per cent of GDP in the new mandate year of 2017-18. Using cyclical-adjustment coefficients for particular types of receipts and spending, in Chapter 5 we show how this improvement is forecast to come about:

- the CACB is expected to improve by 3.4 per cent of GDP between 2014-15 and 2017-18, with lower spending contributing 3.2 per cent and higher receipts 0.2 per cent;

- in 2015-16, the final year for which the Government has set detailed departmental spending plans, the CACB falls by 0.4 per cent of GDP (£8 billion). Cuts in spending more than account for that change (down by 0.8 per cent of GDP or £15 billion), with a fall in receipts – notably from the North Sea and fuel and excise duties – pushing up the structural deficit by around £7 billion. Within spending, the largest contribution to the change is a structural reduction in departmental spending (£10¾ billion);

- based on the Government's policy assumption on spending, which implies a path for departmental spending once the rest of our forecast is taken into account, the CACB falls by 1.7 per cent of GDP (£33½ billion) in 2016-17, more than twice the figure in the previous year. Again, by far the largest contribution is the 1.3 per cent of GDP implied cut in spending on day-to-day public services and administration (£25 billion). Other important contributions include the structural rise in receipts from income tax (£5½ billion) and NICs (£6¾ billion). The latter is largely explained by the abolition of the NICs contracting out rebate in 2016-17. Around two thirds of the £5 billion of additional receipts from that measure is expected to come from public sector employers, adding to the pressure on implied departmental budgets; and

- in 2017-18, the CACB again falls significantly, by 1.2 per cent of GDP (£24 billion). Once again, by far the largest contribution to that change is the cut in public services spending implied by the Government's spending assumption (£24 billion). Receipts are broadly stable as a share of GDP, as an additional year of fiscal drag boosting personal taxes and the effects of further asset price rises on capital taxes are offset by small declines in a number of other receipts.

1.45 The new **supplementary target** requires public sector net debt (PSND) to fall as a share of GDP between 2015-16 and 2016-17, with this year fixed. We expect PSND to fall as a share of GDP in that year, so the Government is on course to meet its new target. Thanks to the significant amount of asset sales announced in the Budget, we now think that the Government is also on course to meet the previous supplementary target for debt to fall as a share of GDP in 2015-16. This is the first time we have forecast debt falling as a share of GDP in 2015-16 since our March 2012 *Economic and fiscal outlook (EFO)*.

1.46 The **welfare cap** was formally defined and initially set by the Government in Budget 2014. The cap was set for the period from 2015-16 to 2018-19 in line with our March 2014 forecast. It was extended to 2019-20 in Autumn Statement 2014, in line with our December 2014 forecast for that year. The Government has set a 2 per cent margin above the cap that can be used to accommodate forecast changes, but not the impact of policy changes.

1.47 The OBR has been tasked with assessing the Government's performance against the cap once a year alongside the Autumn Statement. In this *EFO*, we provide an update on performance against the cap without making a formal assessment of whether the Government is meeting its welfare cap commitment. That shows that spending subject to the cap has been revised down in each year of the forecast, thanks largely to the effect of lower inflation on the uprating of most benefits in 2016-17.

1.48 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 65 per cent chance that the CACB will be in balance or surplus in 2017-18 (as the new fiscal mandate requires);

- 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 around 1¼ per cent lower than in our central forecast in 2017-18, then the probability of meeting the mandate would fall to 50 per cent, meaning that it would be as likely as not that the mandate would be missed; and

- third, by looking at alternative economic scenarios. We have looked at two scenarios in which the oil price jumps back to $100 a barrel for different reasons: weaker oil supply or stronger global demand. In the supply-driven scenario, inflation rises and real incomes are hit in the short term, lowering GDP growth and leading to a wider output gap. Potential output growth is also slightly lower, due to weaker investment in the capital stock, so that the output gap closes later. In the demand-driven scenario, the same factors affect domestic demand, but the effects are cushioned by stronger export growth. Potential output growth is hit slightly less hard and the output gap closes earlier than in our central forecast. Given the relatively large margins by which the Government's fiscal targets are met in our central forecast, these scenarios would not lead to any of those targets being missed, although with the welfare cap set in nominal terms, higher inflation reduces the headroom against the cap via uprating.