<u>March 2014 *Economic and Fiscal Outlook* Briefing</u>

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Good afternoon ladies and gentlemen.

My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our latest *Economic and Fiscal Outlook*.

I am going to take you through some of the highlights of the publication and then we will be very happy to take your questions. The slides and my speaking notes will be available after we finish.

[SLIDE] Let me start with the usual background.

The EFO contains our latest five-year forecasts for the economy and the public finances and an assessment of the Government's progress against the two fiscal targets that it has set itself. All these incorporate the impact of the policy measures the Chancellor announced today, but not the extension of childcare support to all families on Universal Credit, which we were told about too late to include.

The views expressed in the EFO are the responsibility of the three members of the Budget Responsibility Committee. But we have relied enormously on the hard work of the OBR's staff and on the help of officials in numerous departments and agencies. Our thanks to them all.

As usual, the forecast went through a number of iterations to reflect new judgements, new data and proposed policy measures. We provided the Chancellor with a final pre-measures forecast on March 7th and then met him to discuss the forecast and the measures on March 10th. We have come under no pressure to change any of our conclusions.

[SLIDE] Now let me summarise briefly what we are going to cover today.

First, the economic forecast.

The UK economy has continued to recover. Growth was in line with our December forecast in the fourth quarter last year, but revisions to earlier data and other indicators suggest it has slightly more momentum than we expected then. So we have revised our growth forecasts slightly higher for this year and next, although we still expect some slowing in the spring as consumer spending moves more into line with income growth. The upward revision to growth looks largely cyclical rather than a sign of greater underlying potential, so the economy returns to its full potential around a year earlier than we forecast in December.

The key uncertainty in the economy forecast remains the timing and strength of any recovery in productivity growth, which has been remarkably weak by historical standards for some years now. This matters for the sustainability of the recovery, as you need stronger productivity growth to generate lasting real income growth. And it also matters for our assessment of the economy's underlying potential.

Another important uncertainty is the outlook for business investment. Data revisions now suggest a strong pick-up through last year, which is one reason for pushing our growth forecast higher. But we should be cautious: what the ONS giveth, the ONS sometimes taketh away.

Second, the public finances.

Public Sector Net Borrowing - the gap between what the Government spends and raises in revenue – is slightly lower in each year of this forecast than in December and by £24 billion in total. The improved outlook for the economy boosts tax receipts while policy decisions and assumptions slightly reduce cash spending in the next Parliament.

The policy measures listed in the Treasury's Budget scorecard are broadly neutral over the five-year forecast, with giveaways roughly offsetting takeaways. But be aware that some measures are less positive for the public finances in the longer term than over the forecast period.

As in December, it is day-to-day spending on public services and administration that is set to deliver most of the remaining fiscal consolidation through to 2018-19. The various changes to spending policy, spending assumptions and our forecast leave the share of GDP devoted to this little changed since December by the end of the forecast.

On the revenue side, one interesting feature of this forecast is the big proportionate increase in receipts expected from capital taxes, like stamp duty and inheritance tax. They are set to rise to their highest share of GDP for at least 50 years. This largely reflects the way in which the recovery of the housing market is likely to interact with the particular structure of these taxes.

I mentioned a moment ago that the upward revision to economic growth in this forecast looks more cyclical than structural. So the same is true of the improvement in net borrowing. This matters for the Government's performance against its fiscal targets. In this forecast, we estimate that the Government remains on course to *meet* its target of balancing the structural current budget in five years' time, with fractionally less margin for error than in December. And it remains on course to *miss* its target of reducing net debt in 2015-16, but by a slightly smaller margin than in December.

Once you have fully absorbed the public finances data that we are presenting today, you will pleased to hear that the ONS is going to revise them all significantly over the next few months. Most notably, it will increase the measured level of public sector net debt by well over £100 billion, although paradoxically this may make the Government's net debt target a little easier to hit rather than more difficult.

So let me give you some more detail of the economic forecast.

[SLIDE] Real GDP grew by 0.7 per cent in the fourth quarter of 2013, in line with our December forecast. But revisions to earlier data mean that growth over the year as a whole is now estimated at 1.8 per cent – higher than the 1.4 per cent we forecast in December.

Consumer spending remains the key driver of the pick-up in growth last year, financed more from reductions in saving than increases in income. But business investment has now been revised higher, increasing by 8½ per cent in the year to the fourth quarter.

The labour market continues to surprise us, with unemployment lower and employment higher than we expected in the fourth quarter. But wages rose less than we expected and productivity growth remains very weak – output per hour was just 0.2 per cent higher in the second half of the year than in the first.

The housing market continues to accelerate. House prices rose by 5.5 per cent in the fourth quarter and mortgage approvals were 40 per cent higher in January than a year earlier. Housing starts are growing strongly, although shortages of skilled labour and building supplies may act as a brake on construction in the short term.

[SLIDE] The various data revisions and other indicators suggest that the economy has slightly more momentum than we expected in January. So we have revised our growth forecasts slightly higher for this year and next, pushing up the contributions from business investment, private consumption and government consumption.

But we still expect slightly slower growth through most of this year than we have seen in recent quarters. Consumer spending was boosted last year by a 2 percentage point fall in the saving ratio, which we don't think can continue to drop at this rate. So we expect consumer spending to move more in line with income growth, although income growth will in time be boosted by stronger productivity growth.

Towards the end of the forecast, we have revised our growth estimates down a little for 2017 and 2018. This reflects the fact that we expect the spare capacity in the economy to be used up more quickly than in December. Once this has happened, we assume that the Bank of England can keep economic activity in line with potential rather than see it overheating.

Looking over the forecast as a whole, the key drivers of the recovery are consumer spending and private investment. Net trade makes very little contribution and government spending cuts will act as a drag.

[SLIDE] So how does all to this look in terms of numbers?

As you can see we have revised our growth forecast for this year up from 2.4 per cent to 2.7 per cent, in line with the average of outside forecasts. We then have growth falling back to 2.3 per cent in 2015, revised up from 2.2 per cent in December. The fall from this year to next actually reflects the slowing in the quarterly growth path we are seeing this year.

Our growth forecasts for 2017 and 2018 are 2.6 and 2.5 per cent respectively, both revised down from 2.7 per cent as the economy returns to its long run trend path earlier than we forecast in December.

Looking over the forecast horizon as a whole, the level of real GDP is forecast to be 0.3 per cent higher in early 2019 than we forecast in December. Nominal GDP is 0.7 per cent higher at the end, in part because we now assume that rents rise in line with earnings rather than CPI – and this pushes up our forecast for whole economy inflation.

[SLIDE] This slide shows the level of GDP that we expected in December, with the level in 2010 equal to 100. [SLIDE] And this slide shows today's upward revision. [SLIDE] As you can see here, our forecast is very close to the outside average through to 2016, and a little stronger thereafter. But we are somewhat more pessimistic than the Bank of England's latest modal forecast. They have a stronger forecast for consumer spending and business investment growth than we do. They also adjust their forecast for expected revisions to past data, which we don't.

[SLIDE] Following today's upward revisions, our forecast suggests that real GDP will return to its pre-crisis peak in the middle of this year - real GDP has now risen by about 5¼ per cent since the beginning of 2010. But over the same period the population aged 16 and older has increased by 1.4 million and so GDP per head has risen by only 2½ per cent and remains 5½ per cent below its peak. We do not expect GDP per head to regain its pre-crisis peak until early 2017.

[SLIDE] This slide shows our forecasts from December for actual GDP and the potential level that we estimate to be consistent with maintaining stable inflation in the long term. The so-called 'output gap' between the two lines is a measure of spare capacity in the economy.

[SLIDE] This slide shows the forecasts from this EFO. We now believe that the output gap was slightly smaller at the end of last year than we expected in December – 1.7 per cent of GDP to be precise. This is consistent with unemployment – one measure of spare capacity – falling more sharply than we expected at the end of last year. With output therefore slightly closer to its potential, and GDP growth slightly faster this year and next, spare capacity in the economy is now used up in early 2018 – around a year earlier than in December.

[SLIDE] With a smaller output gap, you might expect less downward pressure on inflation from spare capacity. But that effect is offset by the continued rise in sterling, which pushes down import costs. Inflation is slightly lower than we expected in December in the near term, reflecting an unexpectedly sharp fall in food price inflation.

[SLIDE] I mentioned earlier that data revisions showing greater momentum in business investment were one reason for the upward revision to our growth forecast. But it is important to remember how volatile business investment is and by how much estimates of it are revised. Here you can see the estimates published by the ONS in late 2011, [SLIDE] then late 2012, [SLIDE] then late 2013 and [SLIDE] finally the current data. So while the latest news on business investment is encouraging, we should remember that history might well be revised again.

So now let me turn to the public finances.

[SLIDE] As in our last two forecasts, our ability to compare the public finances from one year to another - and from one forecast to another - has been complicated by transfers related to the Royal Mail's pension assets and the Bank of England's Asset Purchase Facility. To keep things as simple as possible, I'm going to focus on an underlying measure of public sector net borrowing that excludes these two effects. As I mentioned earlier, the ONS will be revising the public finances data significantly over the coming months to reflect methodological and classification changes. I'll say a bit more about that shortly.

[SLIDE] On the current definition, our new estimate for the underlying deficit this year is £107.8 billion, £3.4 billion lower than we forecast in December and £7 billion lower than the latest outturn estimate for 2012-13. We have revised spending down by £2.3 billion, most of which reflects the impact of lower inflation on debt interest costs and lower capital spending by public corporations. On the revenue side, upward revisions to our forecasts for stamp duty, corporation tax and income tax and national insurance contributions reduce borrowing by around £2 billion. These and other revenue increases are partially offset by a £1.4 billion shortfall in our North Sea and capital gains tax forecasts.

[SLIDE] Looking over the forecast horizon as a whole, you can see that net borrowing is slightly lower in each year than in December – although the downward revision is very small next year thanks to higher social security spending and contributions to the European Union.

[SLIDE] Before looking at the policy measures in the Budget, you can see that higher receipts reduce borrowing in each year of the forecast. The biggest upward revisions are to VAT, corporation tax and stamp duty land tax reflecting a stronger outlook for nominal consumer spending, company profits and the housing market. We have revised spending slightly higher next year, partly because more people are expected to be claiming Employment and Support Allowance and Personal Independence Payments. But spending is lower in 2016-17 and 2017-18, mostly because the Government has changed its policy assumption for total spending beyond 2015-16.

[SLIDE] Turning to the policy measures in the Treasury's Budget scorecard, we find a net tax cut totalling £5½ billion across the forecast, slightly more than offset by a £5¾ billion cut in spending – mostly in the period beyond 2015-16 for which there are not yet detailed plans. The net impact in each year of the forecast is pretty modest.

Looking at this table, one obvious question to ask is why the overall improvement in the deficit is smaller in 2018-19 than in the previous two years. The first reason is slower growth in employment and GDP in that and the previous year, and that is because we expect the output gap to close earlier. And second, the Treasury has once again told us to assume that spending rises in line with whole economy inflation in 2018-19, and we have revised that higher since December.

[SLIDE] The scorecard may be pretty neutral in its impact on the public finances – and we also assume that it has little impact on the economy – but some of the measures would have a rather different impact on the public finances beyond our five-year forecasting horizon than during it:

- the pensions withdrawals measure brings forward income tax receipts, but has a small net cost in the long term;

- the voluntary national insurance contributions measure increases NICs receipts in the short term but raises future state pension spending;

- the extension of the annual investment allowance increases the amount of tax relief that can be claimed until December 2015, but reduces it thereafter, and;

- the acceleration of tax payments related to anti-avoidance schemes brings forward receipts from future years.

[SLIDE] As this chart shows, these four measures taken together improve the public finances by an average of £1.2 billion a year during the five years of our forecast, but the improvement falls to an average of just £0.2 billion on average over the subsequent 15 years.

Regrettably, our forecasts do not include the costs of the Government's announcement yesterday that it will extend childcare support to all families on Universal Credit, and not just those paying income tax. We were only notified of this announcement on Monday evening, well after the EFO had been sent to the printers and almost a week after the deadline for us to be notified of new policies.

The Government claims that the cost of this measure will be around £200 million a year. It would have been much better for this costing to have been subjected to proper scrutiny and to be included in our forecasts, along with every other policy measure that affects the public finances. To say that the cost to the Exchequer will be offset later by some as-yet-unidentified changes to Universal Credit is no excuse. We will look at this measure, and any accompanying measures, very closely in the run-up to the Autumn Statement.

For those of you interested in the way in which we scrutinise policy costings and include them in our forecasts, we have published a detailed briefing note on the subject today which you can find on the website.

[SLIDE] So let's have a quick look at the big picture of the public finances. This chart shows total receipts and total spending as a share of GDP, with the Royal Mail and APF transfers removed. The gap between them is underlying public sector net borrowing. As in December, we expect the budget to reach balance in 2018-19, with the deficit having shrunk from its post war peak of 11.0 per cent in 2009-10. Tax receipts return broadly to their pre-crisis level while spending falls sufficiently both to reverse the increase seen during the recession and to remove the budget deficit that we were running prior to the crisis.

[SLIDE] This chart shows how the deficit is being eliminated. The total improvement is a little over 11 per cent of GDP, but with debt interest increasing by almost 2 per cent of GDP, the gross improvement is even bigger than that. Higher tax receipts deliver about 20 per cent of the net improvement, most of which has already happened thanks to the increases in the standard rate of VAT. Spending delivers about 80 per cent of the improvement, with most of the contribution from cuts in capital spending now banked – the Government wants to hold this broadly constant as a share of GDP. By far the largest contribution, especially in terms of what still needs to be done – is what appears here as 'PSCE in RDEL', which is in effect day-to-day spending on public services and administration. This falls by almost 8 per cent of GDP.

[SLIDE] This slide shows this category of spending divided between those areas that the Government is currently protecting in relative terms – the NHS, schools and overseas aid – and the rest. Detailed plans have been set out until 2015-16, with the aggregate figure for subsequent years falling out as a residual given the Government's policy assumption for overall spending and our forecasts for annually managed spending. As you can see, the squeeze has some way still to go – with the end point little changed since December at just over 14 per cent of GDP.

[SLIDE] Turning to the revenue side of the forecast, I mentioned earlier that receipts from capital taxes are expected to grow particularly strongly. This chart shows the receipts from stamp duty, inheritance taxes and capital gains tax rising to their highest share of GDP at least since the early 1970s and probably for at least 50 years. In cash terms capital tax receipts are expected to total £36 billion in 2018-19, up from £16 billion last year. This reflects the interaction between expected movements in asset markets and the particular structure of these taxes.

[SLIDE] As this chart shows, over the coming five years we expect both house prices and housing transactions to increase significantly more quickly than money GDP. And we assume that share prices rise in line with money GDP.

[SLIDE] Stamp duty land tax is very strongly geared to changes in house prices because of its slab structure – the fact that at each threshold at which the tax rate changes the higher tax rate is applied to the whole transaction and not just the portion that lies above the previous threshold. So with the tax rate rising from 1 per cent to 3 per cent at a threshold of £250,000 the tax bill rises from £2,500 for a transaction of exactly that amount to £7,500 for a transaction just £1 higher.

[SLIDE] Stamp duty receipts rise sharply through our forecast in part because we expect the average house price to move above the £250,000 threshold this year – and to be 28 per cent above it by 2018-19. [SLIDE] As a result the average effective tax rate on property transactions will rise from around 2½ per cent this year to over 3 per cent in 2018-19.

[SLIDE] Inheritance tax does not have a slab structure, but we are still expecting to see the average effective tax rate rising significantly because the nil rate and transferable nil rate bands are being frozen in cash terms until 2017-18, while share prices and house prices are expected to rise significantly.

[SLIDE] One consequence is that proportion of deaths resulting in estates large enough to be liable to IHT is forecast to double over the next five years from just under one in 20 to just under one in 10.

[SLIDE] I mentioned earlier that our forecast assumes that the small positive surprise to economic growth since our last forecast is cyclical rather than structural, reducing the amount of spare capacity in the economy rather than raising our estimate of potential output. Correspondingly, the small cuts in our forecasts for borrowing since December are also mostly cyclical rather than structural: they reduce the headline deficit but not the structural deficit, the borrowing that will still be left when the economy has recovered back to its potential.

This chart shows our forecasts for the total deficit and for the structural deficit in December. [SLIDE] And this chart shows the latest forecasts – the total deficit falls noticeably towards the end, but the structural deficit barely moves. This is important for the Government's fiscal mandate, which is defined in structural terms – although none of the movements are very big.

So now let me turn to the Government's fiscal targets.

[SLIDE] The fiscal mandate requires the Government to have the cyclically adjusted current budget in balance or surplus five years ahead, which in this forecast, as in December's, is 2018-19. That means raising enough money to pay for non-investment spending, adjusting for the impact of any remaining spare capacity in the economy.

Our central forecast shows the cyclically adjusted current budget in surplus by 1.5 per cent of GDP in 2018-19, which means we think the Government does have a better than 50 per cent chance of meeting the mandate on current policy. It has fractionally less margin for error than in December, with the Government's decision to tighten its spending assumption for the years beyond 2015-16 almost offsetting other changes in the forecast – which in effect mean that receipts are slightly weaker than you would expect given the way we adjust for the cycle.

[SLIDE] As always, there is significant uncertainty around the central forecast. The flamethrower of uncertainty shows the probability of different outcomes based on past official forecasting errors. It suggests that there is a roughly 75 per cent chance of meeting the mandate in 2018-19, down a little from roughly 80 per cent in December.

[SLIDE] Now let me turn to the supplementary target, which requires net debt to be falling as a share of GDP in 2015-16. As you can see here, the ratio of net debt to GDP is slightly lower throughout the forecast than in December, partly reflecting lower borrowing and partly reflecting higher nominal GDP.

[SLIDE] As the table shows, we now expect net debt to rise by 1.5 per cent of GDP in 2015-16 and to fall by 0.5 per cent in 2016-17. So the Government remains on course to breach the supplementary target, but by a slightly smaller margin than we forecast in December.

[SLIDE] These revisions to net debt since our December forecast will be dwarfed by revisions to the public finances data that are due to be announced by the ONS between now and our next forecast in the autumn. These reflect the ONS's review of its public finance statistics and the requirements of the new ESA10 system of National Accounts. It is important to emphasise that these are changes in the way in which the public finances are measured, not changes in the underlying activity that is being measured.

The most obvious consequence will be a big increase in the measured value of public sector net debt. There are three main reasons for this:

- First, the bank shares bought by the Government during the financial crisis will no longer count as liquid assets, and be netted off gross debt;

- Second, the Asset Purchase Facility will be brought into the net debt boundary, and;

- Third, Network Rail will be moved into the public sector.

On the basis of the information we have available to us at the moment, we estimate that these changes will raise the measured value of net debt by around £140 billion next year, falling to £125 billion by 2018-19.

The impact of these and other revisions on the budget deficit will be less dramatic. We estimate that net borrowing excluding the APF will be £3.6 billion higher next year, falling to £1.9 billion higher by 2018-19, as a result of the revisions.

[SLIDE] This line shows our current forecast for net debt as a share of GDP. [SLIDE] And this one shows our best guess at the direct impact of the public finance revisions, assuming that nominal GDP is unchanged. But the ESA10 changes are also expected to result in an upward revision to nominal GDP of between 2½ and 5 per cent. [SLIDE] Taking that on board as well would move the debt-to-GDP ratio somewhere into this range. For the time being all these estimates are provisional and we will have more concrete numbers for you at our next forecast in the autumn.

Well that is all we have for you today. We would be happy to take your questions.