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Economic and fiscal outlook

March 2012

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Chairman

EFO coverage and process

- Five year forecasts for the economy and public finances, plus assessment of progress against fiscal targets
- Forecasts closed on March 7 bar impact of measures
- Independent *Budget Responsibility Committee* responsible for assumptions, judgements and conclusions
- BRC helped by OBR staff and drawing on expertise in many Whitehall departments and other bodies
- No political or official pressure to change anything

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Overview

- **Economic outlook**
  - Little change since November
  - Budget measures broadly neutral over the forecast

- **Fiscal outlook**
  - Little underlying change since November
  - But Royal Mail pension transfer has big impact next year

- **Cutting the 50p income tax rate**
  - Looks inexpensive, but revenue forecast also revised down

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GDP growth

% growth p.a.	November EFO	March EFO	*Change*
2011	0.9	0.8	*–0.1*
2012	0.7	0.8	*+0.1*
2013	2.1	2.0	*–0.1*
2014	2.7	2.7	*0*
2015	3.0	3.0	*0*
2016	3.0	3.0	*0*

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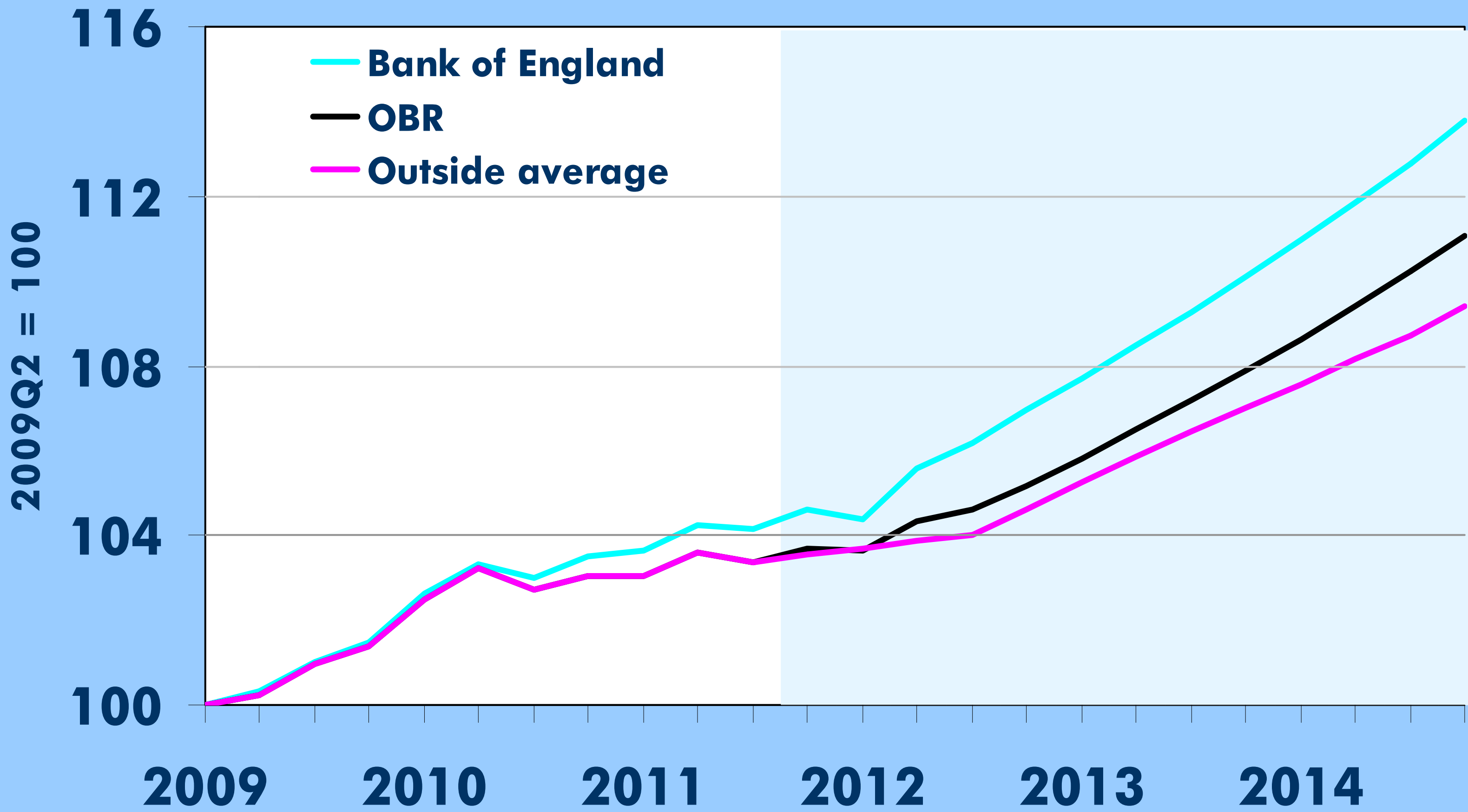
Level of GDP since the trough



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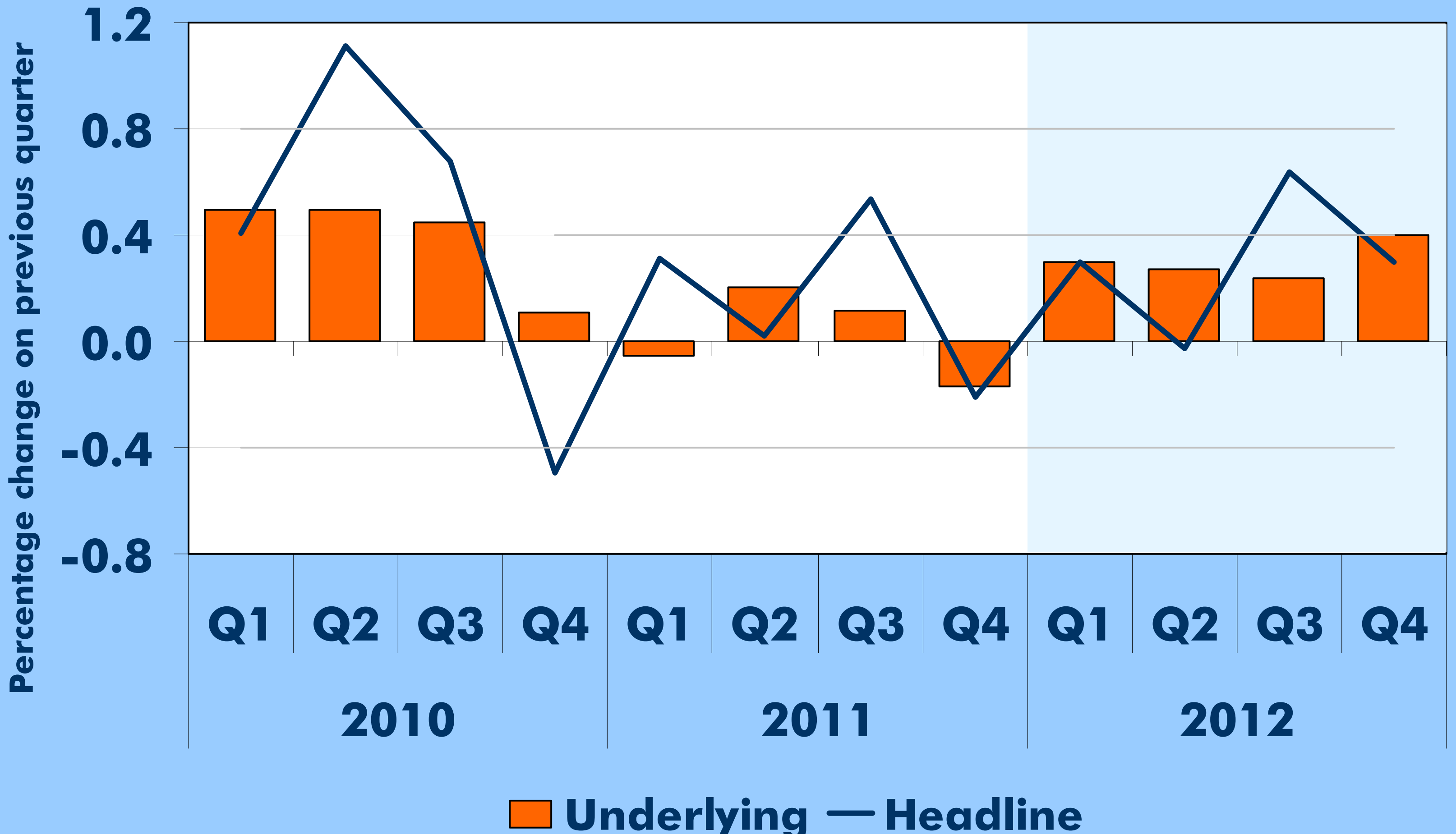
GDP growth per quarter



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Household consumption

% growth p.a.	2011	2012	2013	2014	2015	2016
New forecast	**-0.8**	**0.5**	**1.3**	**2.3**	**3.0**	**3.0**
Change from Nov	*+0.2*	*+0.4*	*+0.1*	*+0.1*	*+0.3*	*+0.1*
Memo: GDP	**0.8**	**0.8**	**2.0**	**2.7**	**3.0**	**3.0**

- **Consumption growth revised up slightly since November, thanks in part to PPI payouts and stronger asset prices**
- **But continues to drag on the recovery until growth in real wages resumes in earnest in 2014**

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Business investment

% growth p.a.	2011	2012	2013	2014	2015	2016
New forecast	**0.2**	**0.7**	**6.4**	**8.9**	**10.2**	**10.1**
Change from Nov	*+0.9*	*-6.9*	*-2.5*	*-0.5*	*-2.4*	*-2.3*
Memo: GDP	**0.8**	**0.8**	**2.0**	**2.7**	**3.0**	**3.0**

- **Key driver of recovery – rises as a share of GDP**
- **Boosted slightly by Budget corporation tax cut**
- **But revised down since November thanks to weak 2011Q4 data and assessment of corporate cash position**
- **Forecast recovery weaker than in the 1990s**

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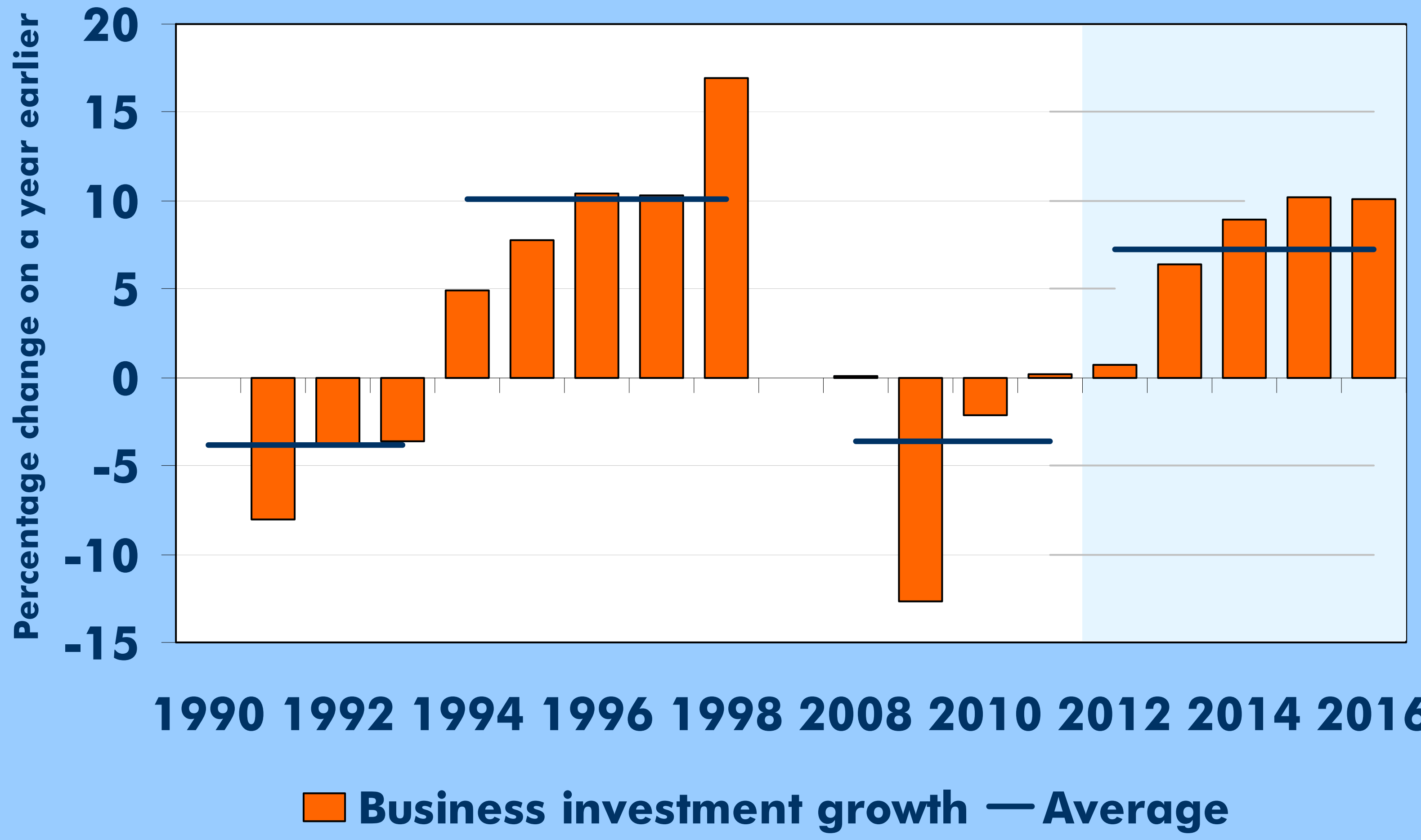
Business investment: now & 90s



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Other components of demand

- Housing investment
  - To revive as housing market returns to normal
- Government spending and investment
  - Slightly bigger contribution to growth than in November
  - Because cuts showing up more in prices than output
- Net trade
  - Positive but diminishing contribution
  - Slightly weaker than November thanks to export markets

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Labour market

- Little change to ILO (un)employment since November. Unemployment to rise from 8.4% to peak at 8.7% later this year

- But claimant count unemployment revised down

- Government employment projected to fall by 730,000 from Q1 2011 to 2017
- 20,000 more than in November

- Outweighed by 1.7m rise in market sector employment

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Inflation

- Inflation revised down slightly since November
- CPI inflation slightly below target in 2013 and 2014
- VAT and excise duties measures: very small upward effect
- Risk from oil prices

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Potential output I

- Business surveys and earnings growth suggest little change in spare capacity in Q4 despite weak GDP growth

- Economy assumed to be running 2.5% below full potential in Q4 and 2.7% below potential for 2011 as a whole

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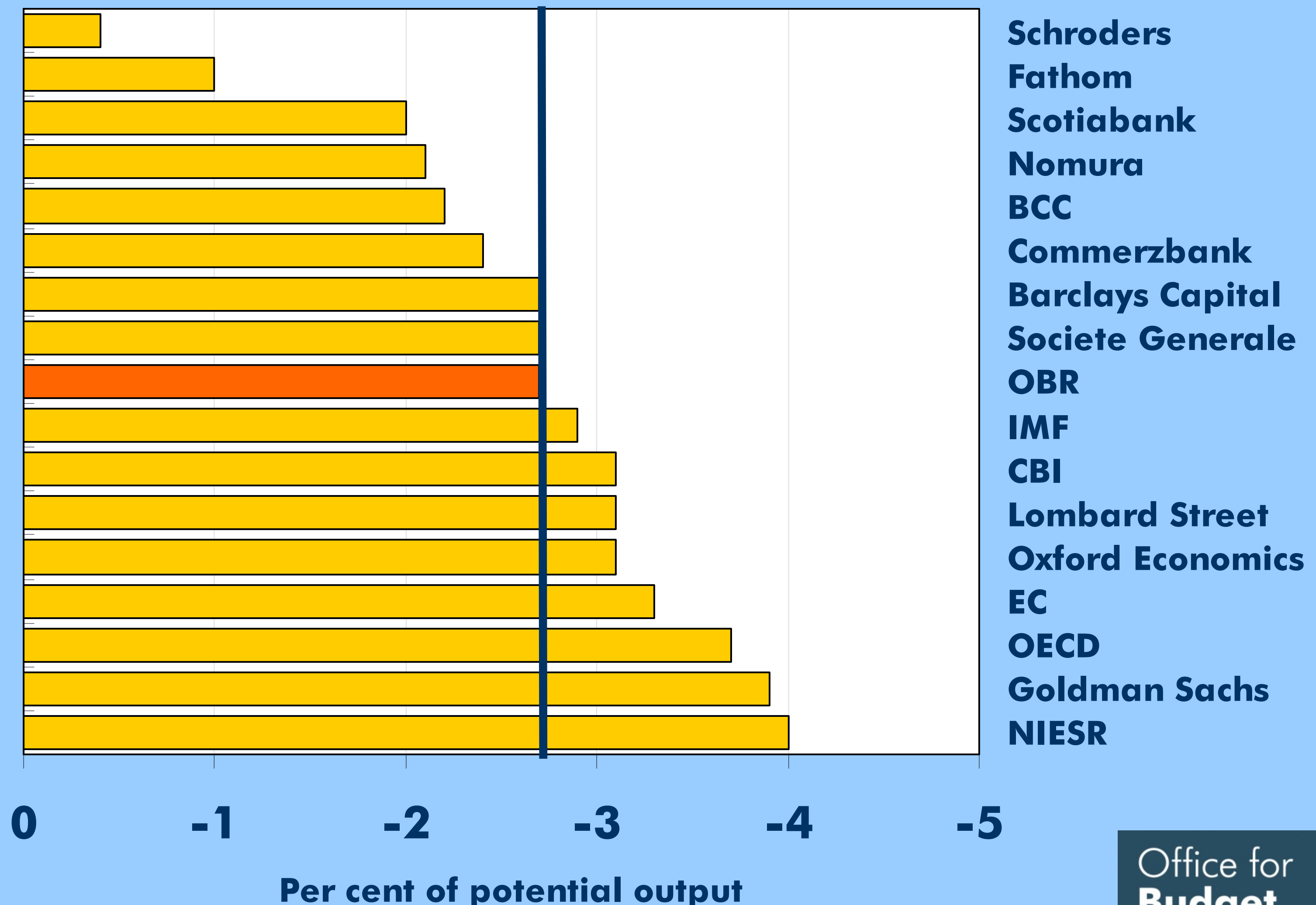
Output gap in 2011



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Potential output II

- Growth in potential GDP assumed to recover to long-run average over next two years – as in November

- Potential GDP in line with OECD and IMF estimates over the course of the forecast and somewhat higher than European Commission

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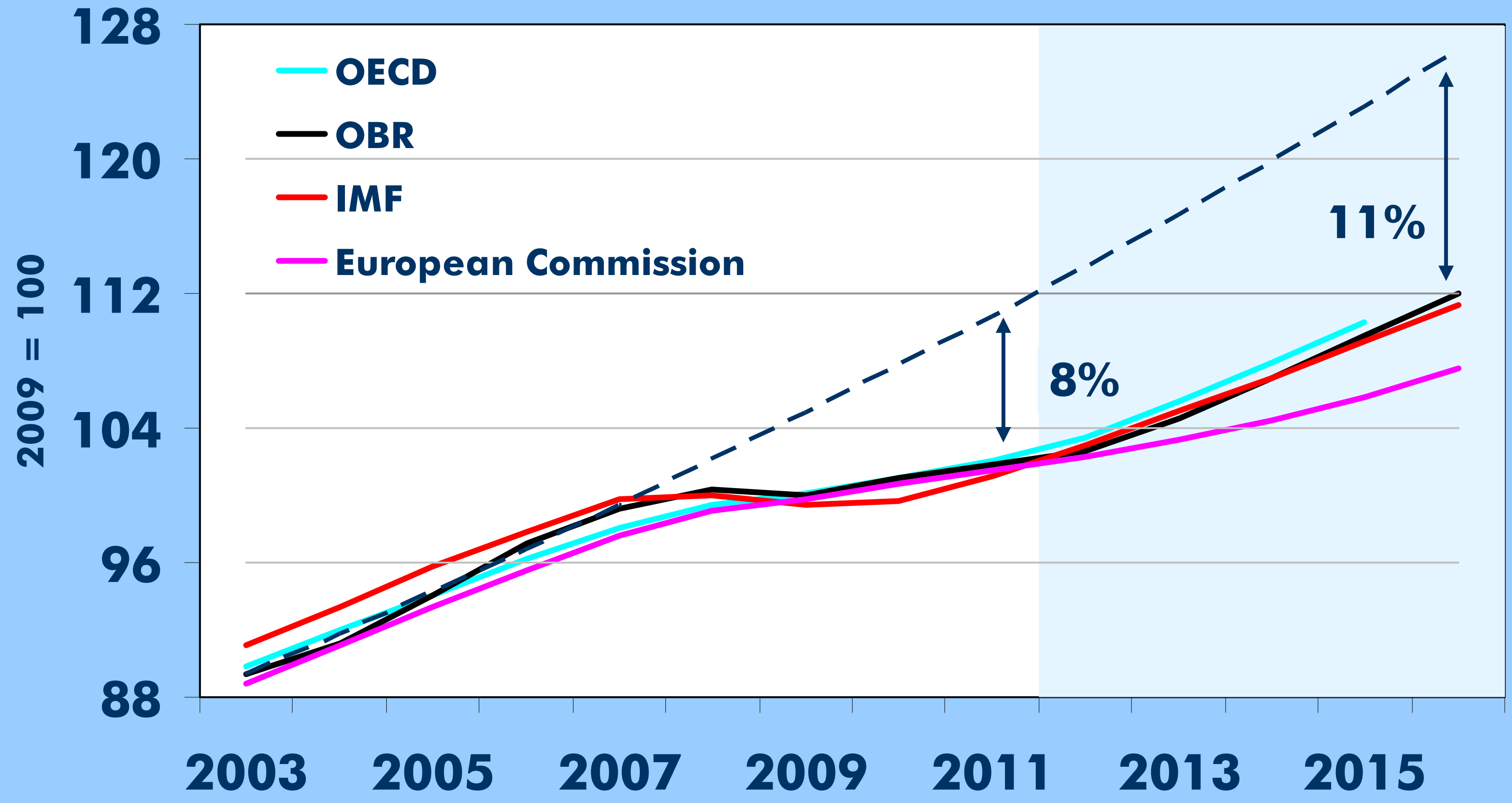
Potential output forecasts



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The public finances in 2011-12

- **Public sector net borrowing (PSNB) forecast at £126bn this year – down £1.1bn since November**

- **Government departments expected to underspend by £6bn against plans and by £5.5bn against November forecast**

- **But tax revenues also expected to come in £5bn below November forecast – mostly recent weakness in self-assessment receipts**

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Public sector net borrowing

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Cash (£bn)	**126**	**92**	**98**	**75**	**52**	**21**
Change from Nov	*-1.1*	*-28*	*-2*	*-4*	*-1*	*-2*
Memo: % GDP	**8.3**	**5.8**	**5.9**	**4.3**	**2.8**	**1.1**

- **Very small deficit-reducing revisions since November**
- **Only big change is in 2012-13: Royal Mail pension transfer**

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Royal Mail pension transfer

- Government taking Royal Mail's historic pension deficit – plus associated pension fund assets – onto public sector balance sheet on April 1

- Impact:
  - £28bn one-off cut in PSNB in 2012-13
  - £23bn cut in net debt from 2013-14 as assets sold
  - £1.3-1.6bn increase in annual pension spending

- Looks favourable short-term, but not long-term
  - Present value of assets = £28bn
  - Present value of liabilities = £37.5bn

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Receipts and spending

- **Little net change in either receipts or spending at the end of our forecast horizon**

- **Receipts revised up £0.1bn in 2016-17**
  - **Downward revisions from self assessment shortfall, lower oil production and weaker property market**
  - **Upward revisions from higher profits, lower investment, higher VAT and higher share prices**

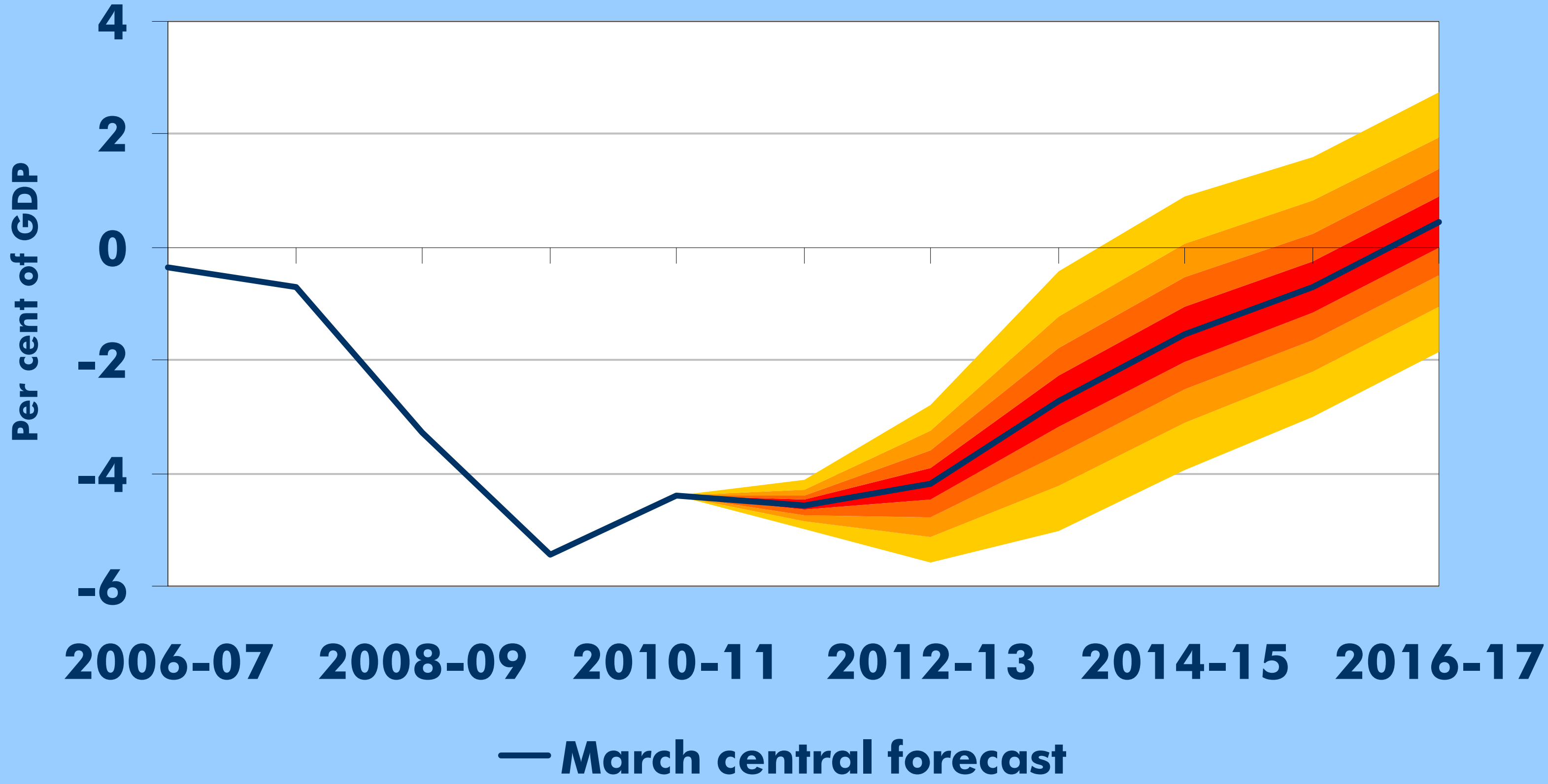
- **Spending revised down by £2.4 in 2016-17**
  - **Lower interest rates**
  - **Afghanistan special reserve reduction**
  - **Cap on potential costs of Universal Credit**

The fiscal mandate

- **Balance or surplus in the cyclically adjusted current budget balance 5 years ahead – currently 2016-17**

CACB in 2016-17	Cash	% GDP
November forecast	**9.4**	**0.5**
Change in output gap		-0.2
Other forecast changes		+0.2
Budget measures		+0.0
March forecast	**8.7**	**0.5**

Uncertainty and the mandate



- Implies 60% chance of success

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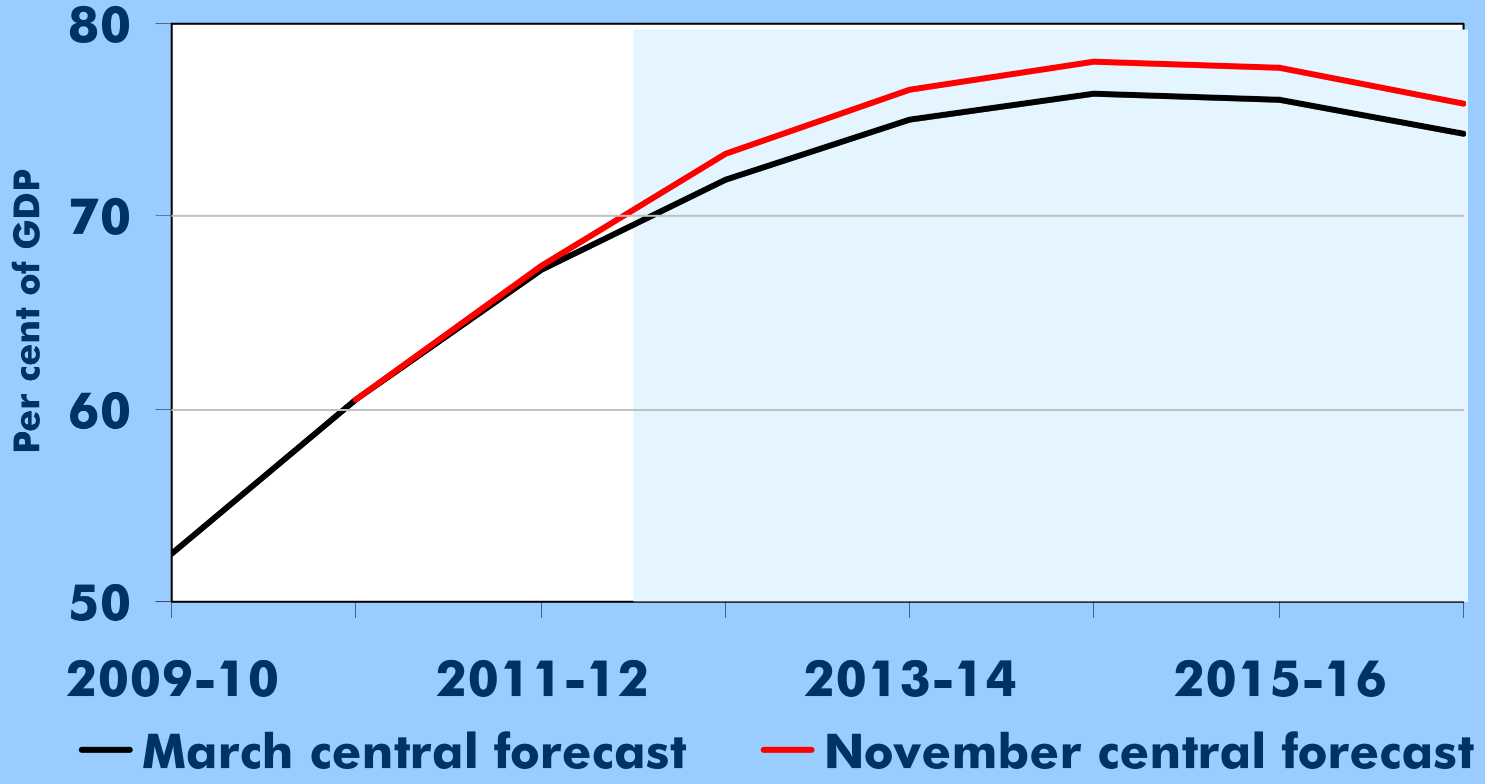
The supplementary target



- Change in PSND in 2015-16 stays at -0.3% GDP

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The additional rate: our task

- OBR has to judge if HMG costing of cut to 45p "reasonable and central" (not if it is a good idea)
- Costing informed by HMRC analysis of 50p yield
- OBR forecasts inherited last Government's costing of 50p rate from March 2010 Budget forecast
- So also need to check that any reassessment of what the 50p rate would have raised is properly reflected in our baseline pre-measures forecast

The original 50p costing

- March 2010 Budget estimated that 50p rate would raise £2.7bn in 2012-13

- 300,000 people would pay £7.5bn more if they did not change their behaviour

- But £4.9bn would never materialise because of:
  - People working less, retiring early or leaving the country
  - More tax planning, avoidance and evasion

- 2008 study for IFS suggested bigger behavioural response and less revenue

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New HMRC analysis

- Based on 2010-11 self-assessment returns
- Suggests people shifted at least £16bn of income into 2009-10 from future years to avoid 50p
  - e.g directors bringing forward dividend payments
- Also suggests bigger <u>underlying</u> behavioural response than the original costings – at or above level suggested by IFS study
- Costing and forecast now assume behavioural response broadly in line with IFS study

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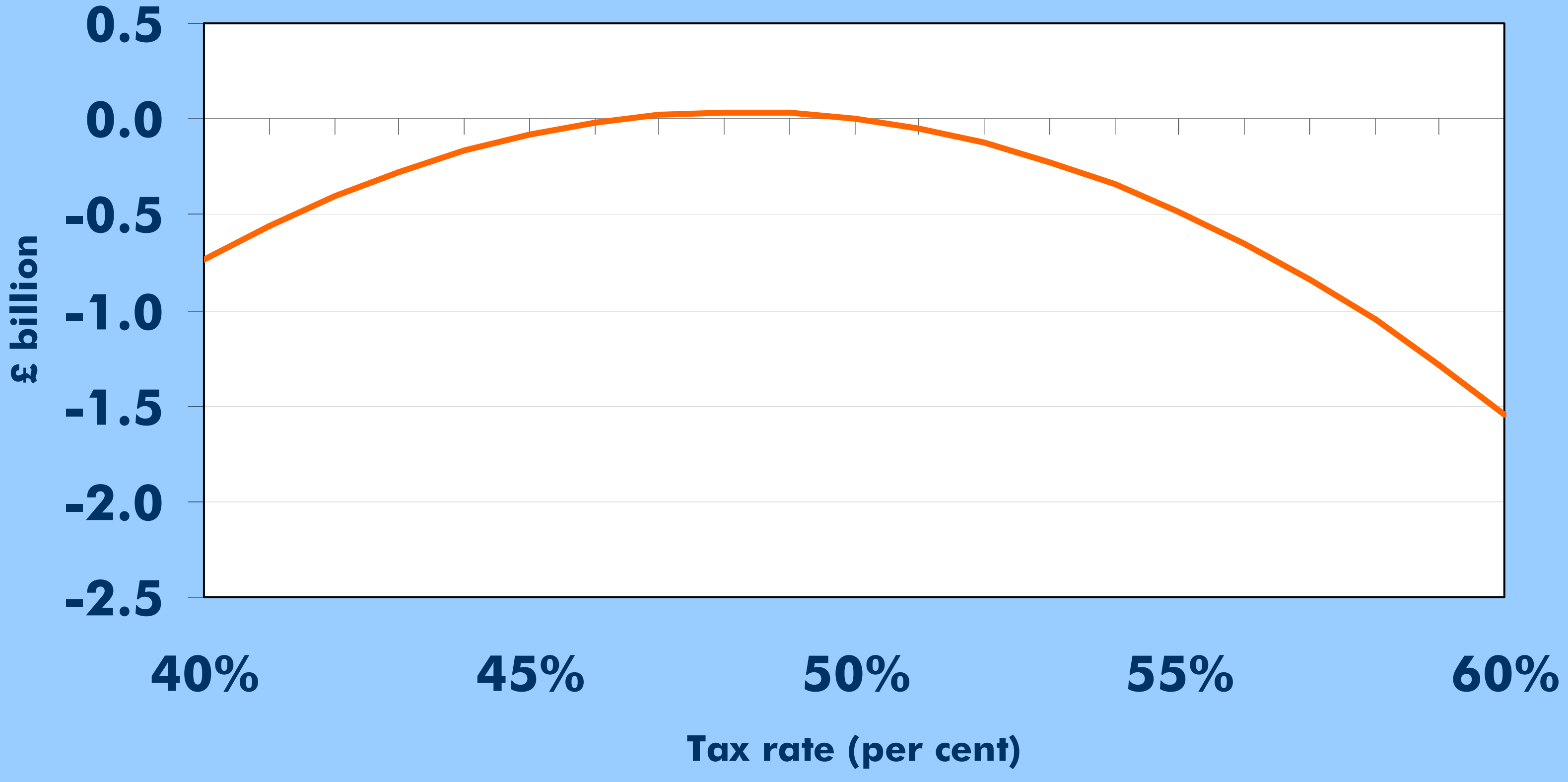
Moving from 50p: costs and gains



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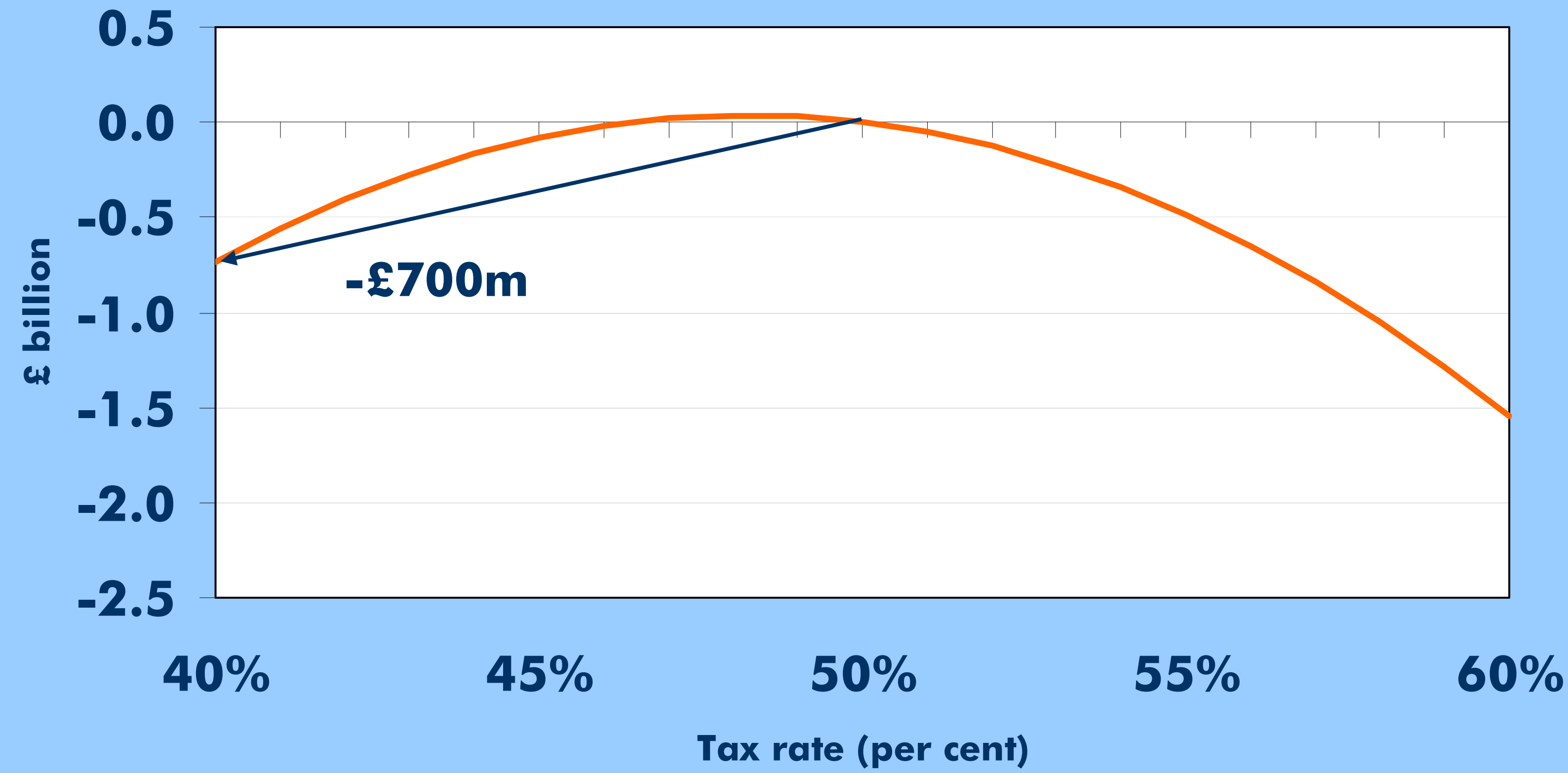

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Implications: baseline forecast

- Need to ensure baseline forecast reflects scale of forestalling and stronger behavioural response
- New study suggests 50p rate would have raised £1.5-2bn less than original costing
- Need to take the difference out of the forecast, but some of it will have shown up already in weak 2010-11 PAYE receipts and previous forecasts

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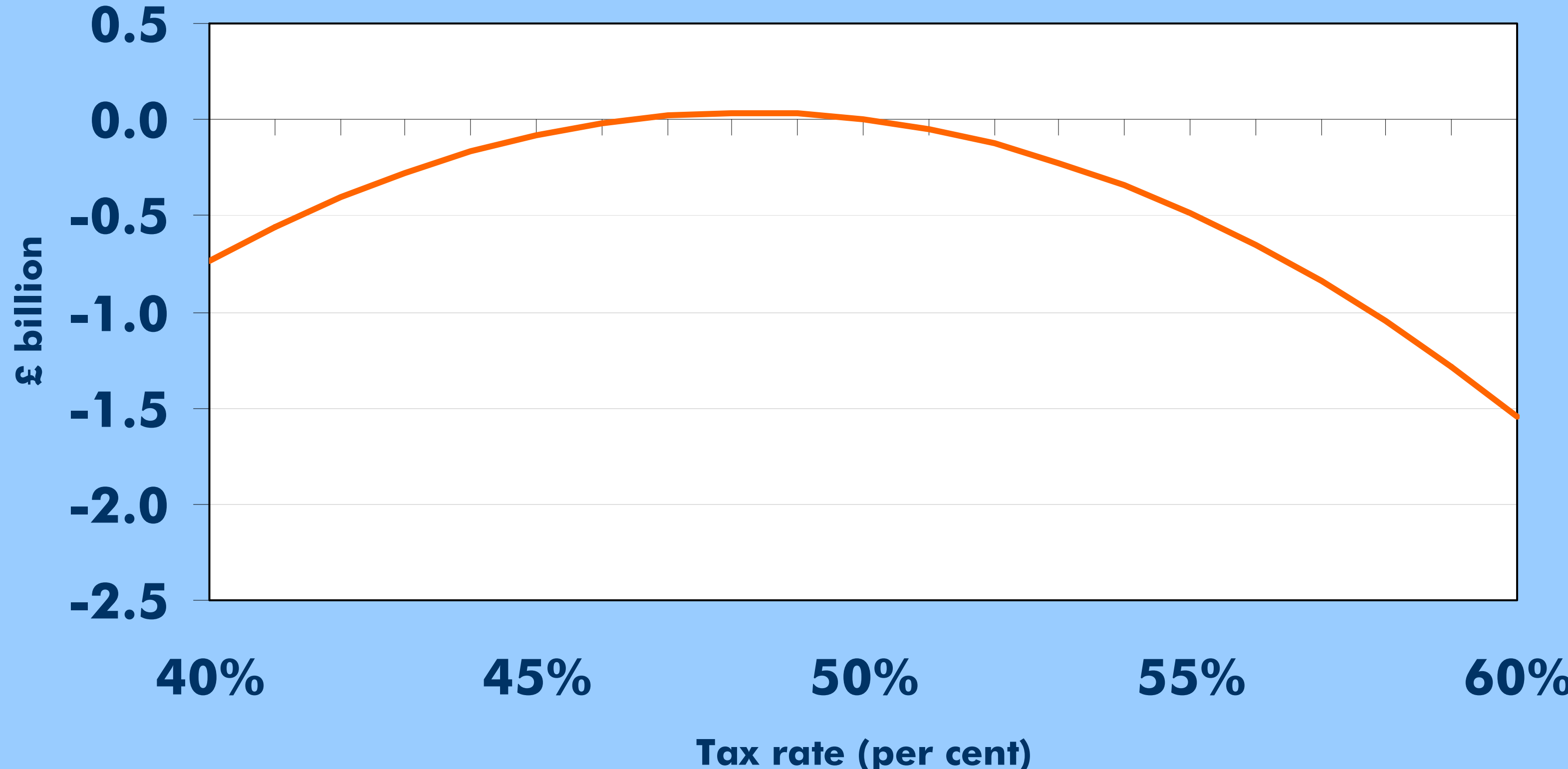
Moving from 50p: costs and gains



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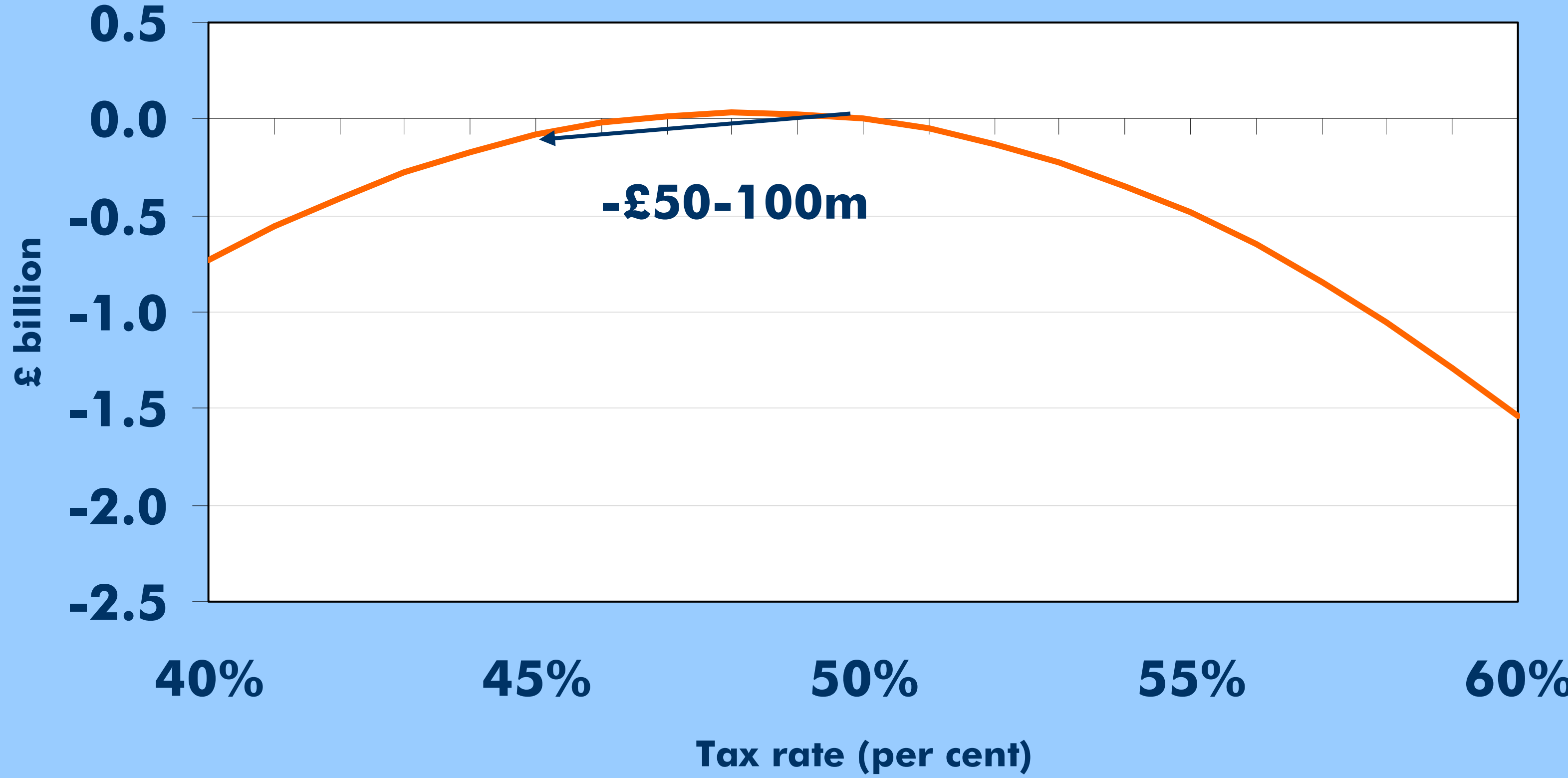

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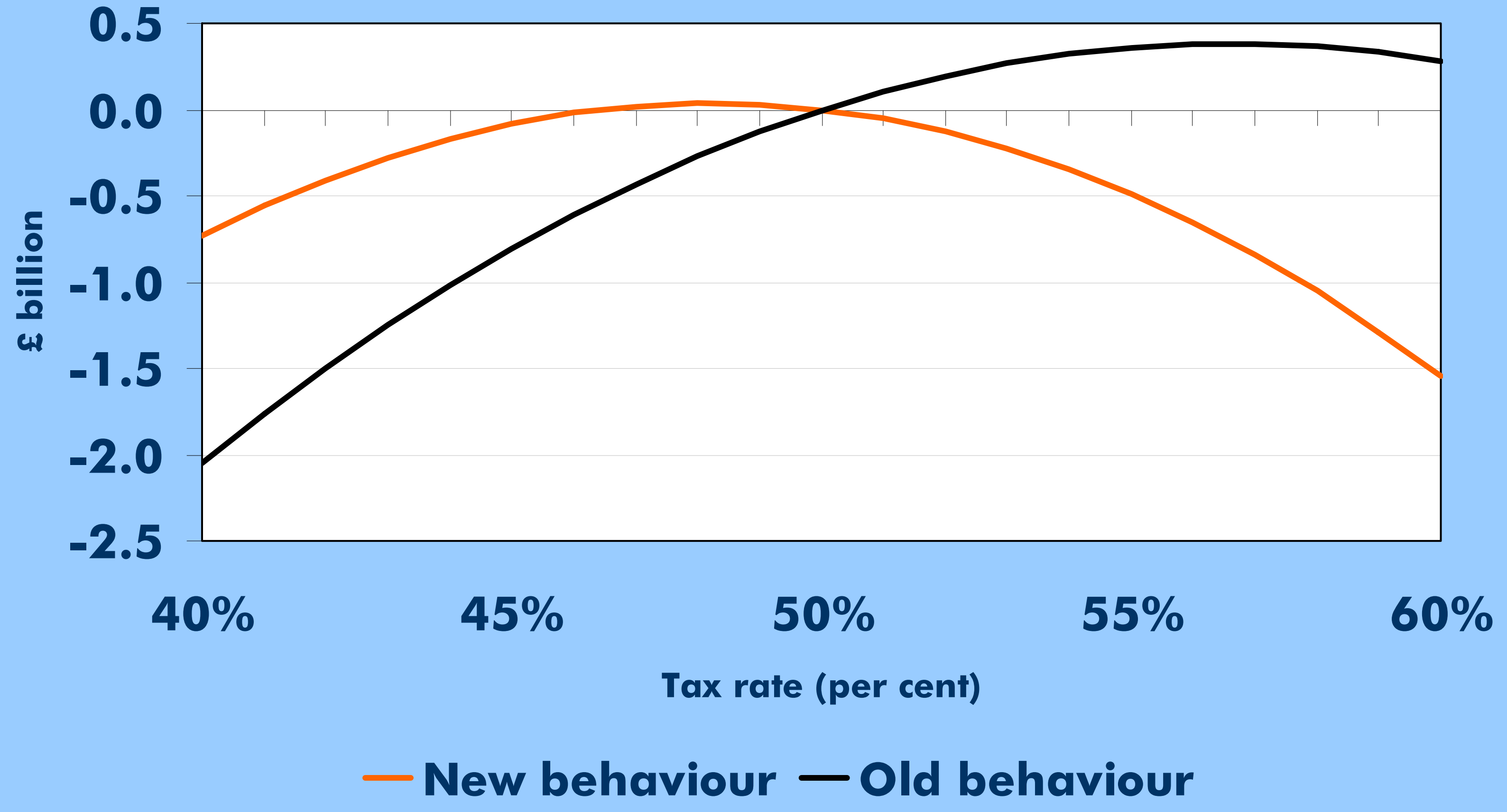

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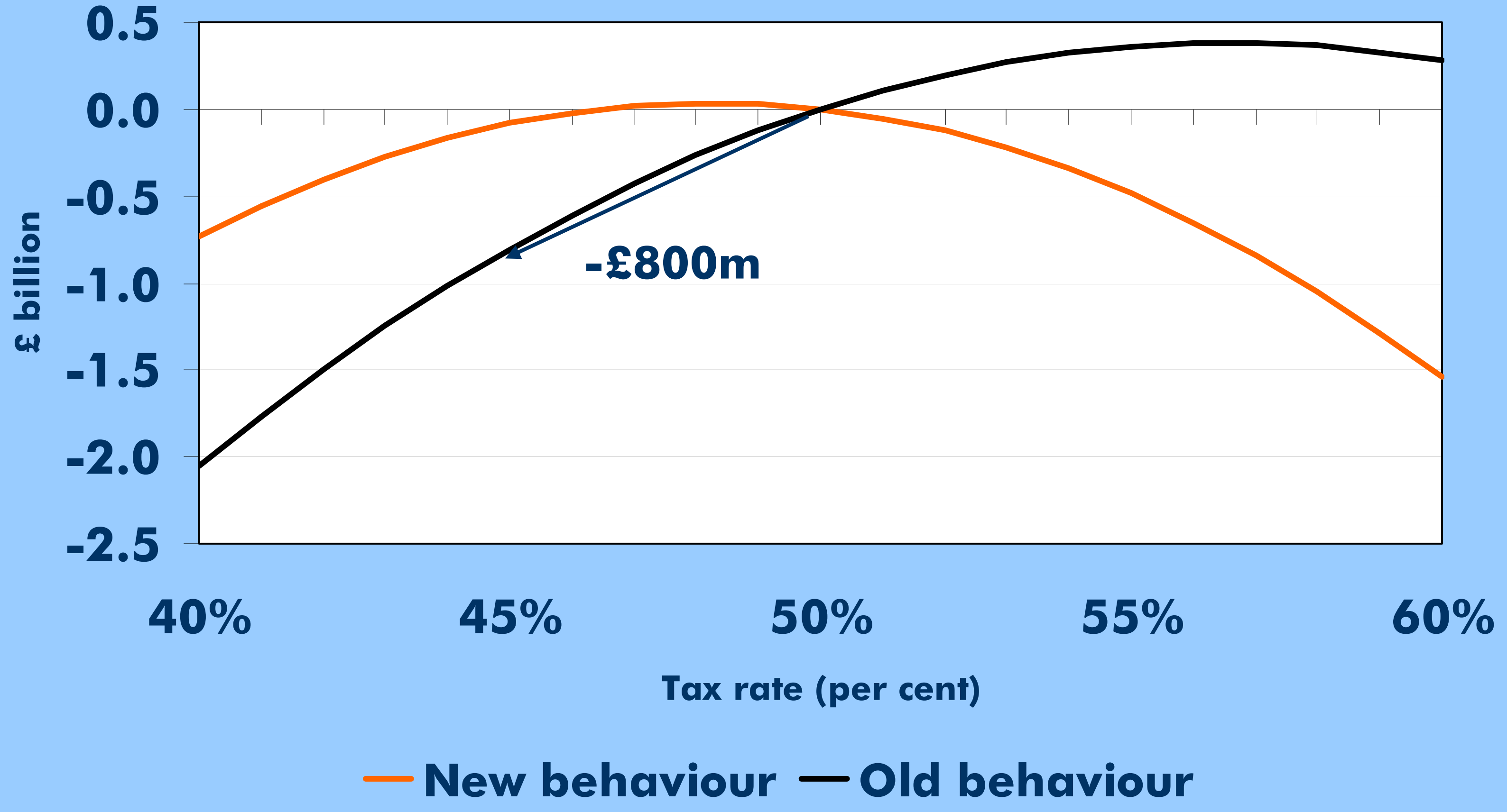

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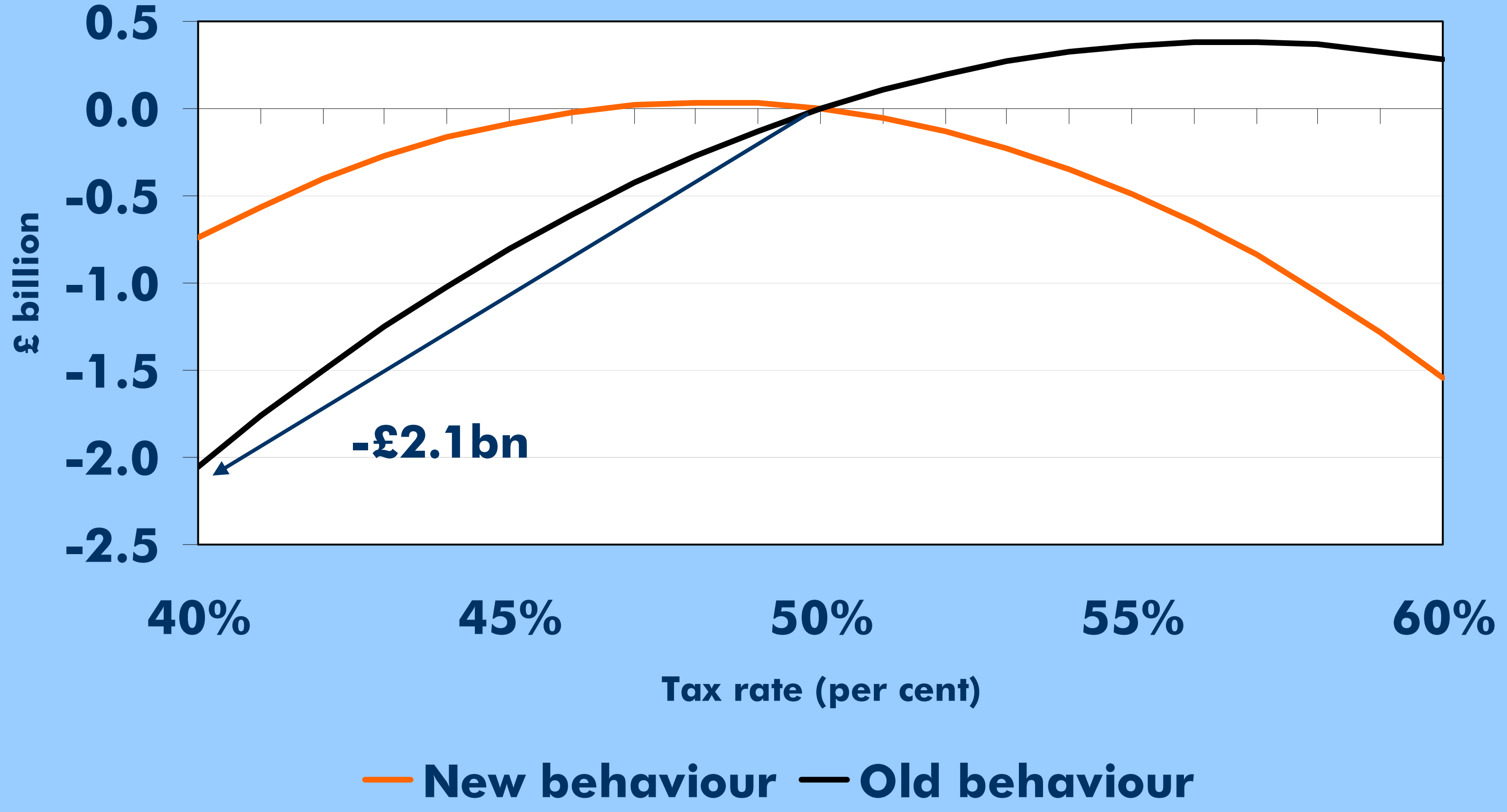

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Implications: costings

	50p to 45p	50p to 40p
New behaviour	-£50-100m	-£700m
Old behaviour	-£800m	-£2.1bn

- New behavioural response looks reasonable and central
- HMRC study might point to even bigger response, but data limited and potential asymmetry
- Huge uncertainty around all such estimates and evidence likely to evolve further
- Behaviour not fixed – affected by policy choices

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