1 Executive summary

Overview

1.1 Our overall assessment of the outlook and risks for the UK economy is broadly unchanged from our November *Economic and fiscal outlook (EFO)*. We still expect the economy to avoid a technical recession with positive growth in the first quarter of 2012, although another fall cannot be ruled out given the volatility of quarterly output estimates. We forecast that GDP will grow by 0.8 per cent this year, the same rate as in 2011. This is an upward revision of 0.1 percentage points relative to our November forecast, reflecting our judgement that the economy carried a little more momentum into the new year than previously anticipated.

1.2 Our medium-term growth forecast is very similar to November. We forecast growth of 2.0 per cent in 2013 (revised down from 2.1 per cent in November), picking up to 2.7 per cent in 2014 and 3.0 per cent in the final two years of the forecast. We still assume that potential output will take until 2014 to return to its long-term average growth rate of around 2.3 per cent a year, as the financial sector and credit conditions take time to normalise. The key risks that we identify to our forecast are the situation in the euro area and a further spike in oil prices.

1.3 Public sector net borrowing (PSNB) is forecast to total £126 billion or 8.3 per cent of GDP this year, £1.1 billion less than we forecast in November. We expect the public sector to spend £6.2 billion less than we forecast in November, but we also expect tax revenues to be £5.1 billion lower than we forecast – primarily due to a £3.6 billion shortfall in self assessment receipts.

1.4 PSNB is then forecast to decline to £21 billion or 1.1 per cent of GDP in 2016-17. The overall decline in PSNB is little changed from our November forecast, with borrowing expected to be just £2.5 billion lower in 2016-17 than we thought in the autumn. Public sector net debt (PSND) is expected to rise from 67.3 per cent of GDP this year to a peak of 76.3 per cent in 2014-15, falling thereafter.

1.5 The fall in PSNB in 2012-13 is much larger than in our November forecast due to the Government's decision to transfer the Royal Mail's historic pension deficit, plus a share of its pension fund's assets, into the public sector. This will lead to a one-off reduction in PSNB of £28 billion (or 1.8 per cent of GDP) in 2012-13, and will reduce PSND by around £23 billion from 2012-13 onwards as pension fund assets are transferred and sold.

1.6 The short-term impact of the Royal Mail transfer appears very favourable for the public finances. But the long-term impact is likely to be negative, as the £37.5 billion estimated present value of the transferred liabilities (the future payments to pensioners) exceeds the £28 billion value of the transferred assets.

1.7 Our public finance forecasts incorporate the expected impact of the tax and spending measures announced in the Budget. The impact of these measures on borrowing is broadly neutral across the forecast period, with net 'giveaways' and 'takeaways' no larger than £2 billion in any year. The impact of measures in the final year of the forecast is to reduce borrowing by £1.1 billion.

1.8 The Chancellor's decision to cut the 50 per cent additional rate of income tax to 45 per cent has an estimated direct cost to the Exchequer of £0.1 billion in 2013-14, excluding the impact of 'reverse forestalling' as people shift taxable income from 2012-13 into 2013-14 to take advantage of the lower rate. The figure is small because the additional rate is now assumed to be close to its revenue-maximising level.

1.9 Analysis of recent tax returns by HMRC suggests that people have taken greater steps to reduce their taxable income in response to the 50 per cent rate than the original costings assumed. We and the Government now assume that the behavioural response is broadly in line with previous estimates made for the Institute for Fiscal Studies' Mirrlees Review, although huge uncertainty surrounds all such estimates. One consequence is that we now assume that the 50 per cent rate would have raised about £2 billion less in 2012-13 than the original costing suggested, after taking account of forestalling. Our baseline forecasts now reflect this shortfall.

1.10 The Government's fiscal mandate requires it to balance the cyclically-adjusted current budget (CACB) at the end of a rolling, five-year period, now 2016-17. The supplementary target requires public sector net debt to fall as a share of GDP between 2014-15 and 2015-16. Including Budget policy measures, our central forecast suggests that the Government has a greater than 50 per cent probability of meeting both these targets. The CACB is expected to be in surplus by £9 billion or 0.5 per cent of GDP in 2016-17, while PSND is expected to fall by 0.3 per cent of GDP in 2015-16. These margins for error are essentially unchanged since the November forecast and are little affected by the Budget measures.

1.11 There is huge uncertainty around all public finance projections, especially over this time horizon. We stress-test the Government's chances of achieving the targets using sensitivity and scenario analysis. A significant risk to achieving the mandate is that potential output turns out to be lower at the end of the forecast than we currently assume.

Developments since the November 2011 forecast

1.12 Recent economic developments in the UK have been broadly in line with our November 2011 forecast. GDP is currently estimated to have fallen by 0.2 per cent in the fourth quarter of 2011, fractionally more than the fall of 0.1 per cent we forecast in November. Meanwhile survey indicators point to renewed growth in the first quarter of 2012, as we expected in November. The labour market has also performed much as expected, with the unemployment rate increasing in the final quarter of 2011 to 8.4 per cent. CPI inflation has continued to fall from its peak of 5.2 per cent in September 2011, reaching 3.6 per cent in January 2012.

1.13 Activity in the euro area economy was weaker than we had forecast in November at the end of last year. However, since the turn of the year, the European Central Bank's (ECB) long-term refinancing operations seem to have eased immediate tensions in the euro area financial markets significantly.

1.14 Our November forecast for 0.7 per cent GDP growth in 2012 was lower than the average independent forecast at the time, of 1.2 per cent. The average forecast has since declined to 0.5 per cent, reflecting the intensification of the euro area financial crisis and the weakening of UK economic activity surveys at the end of last year. However, independent forecasts for growth in 2012 began to pick up in February and March, presumably reflecting the recent signs of improvement in business and consumer surveys.

1.15 Our forecast in this *EFO* includes the impact of the policy announcements set out by the Chancellor in his 2012 Budget. These are broadly neutral over the forecast period, with a small fiscal tightening of £1.1 billion in 2016-17. We have made a small upward revision to our business investment and GDP forecast to reflect the reduction in the main rate of corporation tax. We have also adjusted the inflation forecast to reflect the measures on VAT and tobacco.

The economic outlook

1.16 Our overall assessment of the outlook and risks for the UK economy is broadly unchanged from our November *EFO*. As expected, GDP growth fell marginally in the final quarter of 2011. But the monthly profile of output through the quarter and recent survey indicators point to improving short-term momentum. So we still expect the economy to avoid a technical recession, with positive growth in the first quarter of 2012.

1.17 On the assumptions that the euro area continues to struggle through its current difficulties and that the elevated rate of inflation continues to fall back, we expect the economy to gain momentum this year. However, measured GDP is likely to be broadly flat over the first half of the year. This partly reflects temporary influences on its quarterly growth path, such as the additional bank holiday in June, associated with the Diamond Jubilee.

1.18 We forecast that GDP will grow by around 0.8 per cent this year, the same rate as in 2011. We expect the beneficial effects of falling inflation to be offset by uncertainty over the euro area and tighter credit conditions feeding through to the wider economy. This is an upward revision of 0.1 percentage points relative to our November forecast, reflecting our judgement that the economy carried a little more momentum into the new year than previously anticipated.

1.19 Business and consumer surveys, and other cyclical indicators, suggest the economy was operating around 2.5 per cent below its potential level in the final quarter of 2011. This is close to the average of the current estimates of outside forecasters and implies marginally less spare capacity than we expected in our November *EFO*, despite weaker actual growth. This in turn suggests that potential output has grown slightly less quickly than forecast in November.

1.20 Taking this and data revisions into account, it remains our central judgement that potential output has grown at a little less than one percent per annum, on average, since the recession ended. Therefore, as in November, our forecast is for the path of potential output growth to pick up gradually over the next two years to its long term average rate of 2.3 per cent, as the financial sector and credit conditions normalise.

1.21 Our medium-term growth forecast is very similar to the one we presented in November. We forecast growth of 2.0 per cent in 2013 (revised down from 2.1 per cent in November), picking up to 2.7 per cent in 2014 and reaching 3.0 per cent in the final two years of the forecast. Economic activity remains around 0.5 per cent below potential in the final year of the forecast, partly reflecting the limitations of what monetary policy can do to encourage the uptake of spare capacity.

1.22 The situation in the euro area remains a major risk to our forecast. Our central forecast assumes that the euro area finds a way through its current problems and that policymakers eventually find a solution that delivers sovereign debt sustainability and the normal operation of the financial sector. Since our last forecast, the ECB's long-term refinancing operations have eased immediate pressures in financial markets. However, the underlying situation remains fragile and will take time to resolve. The likelihood of a more disorderly event and the way in which it might play out is very uncertain. But to provide an illustration of the implications for the UK public finances, we estimate the possible effects of the OECD's stylised downside scenario published in November.

1.23 We expect consumption to begin to offer some support to the recovery in the second half of the year, but we continue to expect net trade and business investment to drive medium-term growth, increasing their shares of UK output throughout the forecast. Relative to our November *EFO*, we have made a further downward revision to business investment, as we believe that non-financial companies' balance sheets may be weaker than official statistics suggest. Set against this, we expect a boost to the level of business investment of 1 per cent from the corporation tax rate cut announced in the Budget. In our forecast, the overall downward revision to business investment is partly offset by a smaller drag on GDP growth from real government consumption, the price of which we now expect to rise less quickly.

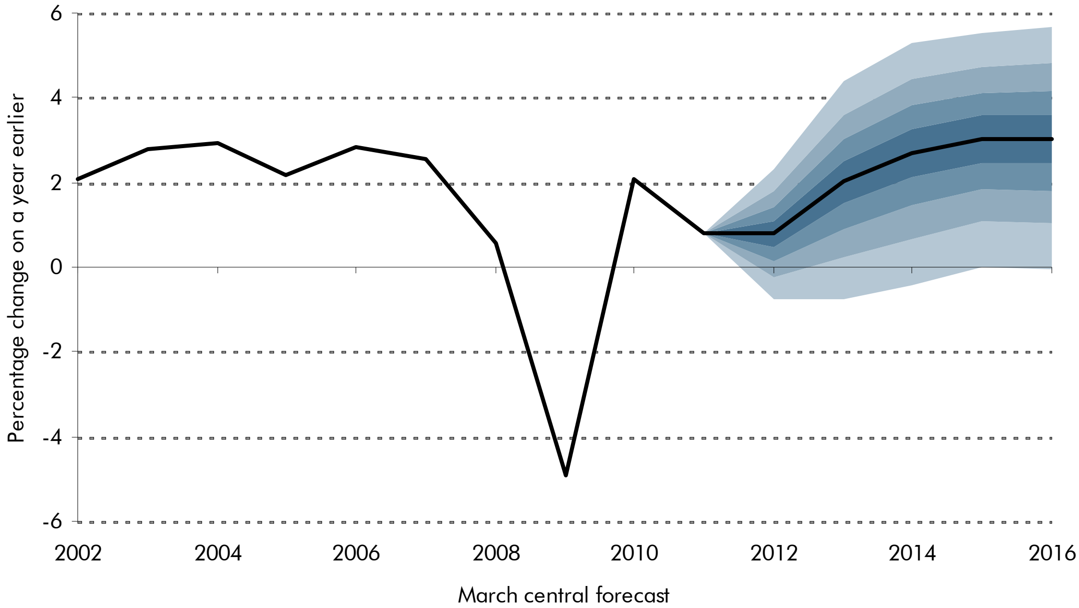
1.24 We expect real household disposable income growth to be weak in both 2012 and 2013. Payment Protection Insurance repayments to households are likely to offer a little support this year but less in the next. It is not until 2014 that income growth outstrips inflation by a significant margin and the share of household consumption in GDP stabilises.

1.25 Our labour market forecast is very similar to the projection we presented in November. We expect the ILO unemployment rate to rise from its current level of 8.4 per cent to 8.7 per cent over the coming year, as euro area concerns and tighter credit cause continued cyclical weakness. By 2016, we expect it to fall back to around 6.3 per cent. Our projection for the claimant count is lower than November, reflecting better than expected data and methodological changes in the way in which policies affecting the number of people on Jobseeker's Allowance are incorporated into the forecast.

1.26 The annual rate of Consumer Prices Index inflation fell sharply in January as the VAT rise last year fell out of the annual comparison. We expect inflation to continue falling as the upward pressures from energy and commodity prices fade and spare capacity weighs on prices. Higher or lower externally-generated inflation remains a risk to our central forecast. We explore this in our 'temporary oil price spike scenario', in which a temporary shock to oil prices leads to prolonged cyclical weakness in the economy.

1.27 There is always considerable uncertainty around any economic forecast. Chart 1.1 presents our central growth forecast with a fan chart showing the probability of different outcomes based purely on past official forecasting errors. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 10 per cent probability bands. It suggests that there is a roughly one-in-four chance that the economy will shrink in 2012, judging from past forecasting errors.

Chart 1.1: GDP fan chart



Source: ONS, OBR

Table 1.1: Economic forecast overview

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast[1]					
	2010	2011	2012	2013	2014	2015	2016
Output at constant market prices							
Gross domestic product (GDP)	2.1	0.8	0.8	2.0	2.7	3.0	3.0
GDP Level (2010 =100)	100	100.8	101.6	103.6	106.4	109.7	113.0
Expenditure components of GDP at constant market prices							
Household consumption[2]	1.2	-0.8	0.5	1.3	2.3	3.0	3.0
Business investment	-2.1	0.2	0.7	6.4	8.9	10.2	10.1
General government consumption	1.5	0.3	0.5	-1.1	-2.1	-2.8	-2.7
General government investment	7.8	-13.0	-5.0	-3.6	0.1	0.4	-1.4
Net trade[3]	-0.5	1.2	0.4	0.5	0.3	0.2	0.1
Inflation							
CPI	3.3	4.5	2.8	1.9	1.9	2.0	2.0
Labour market							
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Average earnings[4]	2.4	1.2	2.6	3.1	4.3	4.5	4.5
ILO unemployment (% rate)	7.9	8.1	8.7	8.6	8.0	7.2	6.3
Claimant count (millions)	1.50	1.53	1.65	1.64	1.52	1.35	1.19
Output gap	-3.1	-2.7	-2.6	-2.5	-2.1	-1.3	-0.5
	Changes since November forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.3	-0.1	0.1	-0.1	0.0	0.0	0.0
GDP Level	0.3	0.2	0.3	0.3	0.2	0.2	0.2
Expenditure components of GDP at constant market prices							
Household consumption[2]	0.1	0.2	0.4	0.1	0.1	0.3	0.1
Business investment	-2.9	0.9	-6.9	-2.5	-0.5	-2.4	-2.3
General government consumption	0.0	-2.0	0.7	0.5	0.2	0.4	0.8
General government investment	5.0	-6.2	4.4	0.6	0.2	1.4	0.9
Net trade[3]	0.3	0.1	0.1	-0.1	0.0	0.0	0.0
Inflation							
CPI	0.0	0.0	0.1	-0.2	-0.1	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Average earnings[4]	0.3	0.3	0.5	0.0	0.0	0.0	0.1
ILO unemployment (% rate)	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Claimant count (thousands)	0	-6	-97	-136	-146	-100	-39
Output gap	-0.1	0.0	0.5	0.4	0.3	0.3	0.3

[1] The forecast is consistent with the second estimate of GDP data for the fourth quarter of 2011, released by the Office for National Statistics on 24th February 2012.

[2] Includes households and non-profit institutions serving households.

[3] Contribution to GDP growth, percentage points.

[4] Wages and salaries divided by employees.

The fiscal outlook

1.28 Public sector net borrowing (PSNB) is forecast to total £126 billion or 8.3 per cent of GDP this year, £1.1 billion less than we forecast in November. We expect the public sector to spend £6.2 billion less than we forecast in November, but we also expect tax revenues to be £5.1 billion lower than we forecast – primarily due to a £3.6 billion shortfall in self assessment receipts.

1.29 PSNB has now fallen by 2.8 per cent of GDP since its post-war peak in 2009-10. Our central forecast shows it falling at roughly the same rate on average over the next five years, reaching £21 billion or 1.1 per cent of GDP in 2016-17.

1.30 The overall decline in PSNB is little changed from November 2011, with borrowing forecast to be just £2.5 billion (or 0.1 per cent of GDP) lower in 2016-17 than we previously expected. But the fall in PSNB next year is much bigger than in November due to the Government's decision to transfer the Royal Mail's historic pension deficit, plus a share of its pension fund's assets, into the public sector. This will lead to a one-off reduction in PSNB of £28 billion (or 1.8 per cent of GDP) in 2012-13.

1.31 Public sector net debt (PSND) is expected to rise from 67.3 per cent of GDP this year to a peak of 76.3 per cent in 2014-15, falling thereafter. The expected peak is about 1.7 per cent of GDP lower than we forecast in November, largely reflecting the fact that the Royal Mail transfer will reduce PSND by around £23 billion from 2012-13 onwards as pension fund assets are transferred and sold.

1.32 The short-term impact of the Royal Mail transfer appears very favourable for the public finances. But the long-term impact is likely to be negative, as the £37.5 billion estimated present value of the transferred liabilities (the future payments to pensioners) exceeds the £28 billion value of the transferred assets.

1.33 Our public finance forecasts incorporate the expected impact of the tax and spending measures announced by the Chancellor in the Budget. The impact of these measures on borrowing is broadly neutral across the forecast period, with net 'giveaways' and 'takeaways' no larger than £2 billion in any year. The impact of measures in the final year of the forecast is to reduce borrowing by £1.1 billion (or 0.1 per cent of GDP).

1.34 The Chancellor's decision to cut the 50 per cent additional rate of income tax to 45 per cent has an estimated direct cost to the Exchequer of £0.1 billion, excluding the impact of 'reverse forestalling' as people shift taxable income from 2012-13 into 2013-14 to take advantage of the lower rate. The figure is small because the additional rate is now assumed to be close to its revenue-maximising level.

Table 1.2: Fiscal forecast overview

	Per cent of GDP							
	Outturn		Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Public sector net borrowing	11.1	9.3	8.3	5.8	5.9	4.3	2.8	1.1
Cyclically-adjusted net borrowing	8.9	7.0	6.4	4.0	4.1	2.9	1.9	0.7
Surplus on current budget	-7.7	-6.7	-6.5	-6.0	-4.5	-3.0	-1.6	0.1
Fiscal mandate and supplementary target								
Cyclically-adjusted surplus on current budget	-5.5	-4.4	-4.6	-4.2	-2.7	-1.5	-0.7	0.5
Public sector net debt[1]	52.5	60.5	67.3	71.9	75.0	76.3	76.0	74.3
	Changes since November forecast							
Public sector net borrowing	0.0	0.0	-0.1	-1.8	-0.1	-0.2	-0.1	-0.1
Cyclically-adjusted net borrowing	-0.1	-0.1	0.0	-1.5	0.2	0.0	0.2	0.1
Surplus on current budget	0.0	0.0	0.0	0.0	0.2	0.3	0.1	0.2
Cyclically-adjusted surplus on current budget	0.1	0.1	0.0	-0.3	-0.1	0.1	-0.1	0.0
Public sector net debt[1]	-0.3	0.0	-0.2	-1.4	-1.5	-1.7	-1.6	-1.5
Memo: PSNB excluding Royal Mail transfer	*11.1*	*9.3*	*8.3*	*7.6*	*5.9*	*4.3*	*2.8*	*1.1*

[1] Debt at end March; GDP centred on end March.

Table 1.3: Changes to public sector net borrowing since November forecast

	Per cent of GDP					
	Outturn	Forecast				
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
PSNB November	8.4	7.6	6.0	4.5	2.9	1.2
PSNB March	8.3	5.8	5.9	4.3	2.8	1.1
Change	-0.1	-1.8	-0.1	-0.2	-0.1	-0.1
of which:						
Forecast changes	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1
Policy measures	*0.0*	0.1	0.1	-0.1	0.0	-0.1
Royal Mail	*0.0*	-1.8	0.0	0.0	0.0	0.0

1.35 Analysis of recent tax returns by HMRC suggests that people have taken greater steps to reduce their taxable income in response to the 50 per cent rate than the original costings assumed. We and the Government now assume that the behavioural response is broadly in line with previous estimates made for the Institute for Fiscal Studies' Mirrlees Review, although huge uncertainty surrounds all such estimates. One consequence is that we now assume that the 50 per cent rate would have raised about £2 billion less in 2012-13 than the original costing suggested, after taking account of forestalling. Our baseline forecasts now reflect this shortfall.

1.36 The downward revision to estimated receipts from the additional rate is only one of a number of revisions to our revenue forecasts. We have also made a significant downward revision to our forecast for UK oil and gas revenues, due to lower expected production and higher capital expenditure. Offsetting this are a number of upward revisions, including to the VAT and onshore corporation tax forecasts. By 2016-17 our receipts forecast is virtually unchanged from November, and the Budget measures are neutral for receipts.

1.37 On the spending side, the substantial underspend by government departments this year is not expected to persist into future years as the 2010 Spending Review settlement becomes more constraining – but we will keep this under review. We have revised down our forecasts for social security and debt interest payments, but these have been partly offset by higher forecasts for capital expenditure by local government and public corporations. By the final year of the forecast, our spending forecast is £2.4 billion lower than in November, of which £1.2 billion reflects the direct fiscal effect of Budget spending policy measures.

1.38 All fiscal forecasts are subject to significant uncertainties. We show this by using fan charts to present a range of probabilities around our central forecast and we outline how our forecasts for the public sector finances would be expected to change under different economic scenarios.

Performance against the Government's fiscal targets

1.39 In the June 2010 Budget the Coalition Government set itself a medium-term fiscal mandate and a supplementary target:

- to balance the cyclically-adjusted current budget (CACB) by the end of a rolling, five-year period, which is now 2016-17; and
- to see public sector net debt (PSND) falling as a share of GDP in 2015-16.

1.40 Our latest forecasts suggest that the Government has a greater than 50 per cent chance of hitting both targets. The margin for error against the fiscal mandate would have been very slightly smaller than in November in the absence of any Budget measures, but is unchanged when they are included. The margin for error against the supplementary target is unchanged, both including and excluding the impact of Budget measures.

1.41 There is considerable uncertainty around our central forecast, as there is around all fiscal forecasts. This reflects uncertainty both about the outlook for the economy and about the performance of revenues and spending for any given state of the economy. Given these uncertainties we probe the robustness of our central 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 60 per cent probability that the CACB will be in balance or surplus in 2016-17 (as the mandate requires) and a roughly 40 per cent chance a year earlier;
- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest risk to the achievement of the mandate is that we again need to revise down our estimates of future potential output. If the output gap was around ¾ per cent of potential GDP narrower, or rather the level of potential output ¾ per cent lower, then in our central forecast the Government would no longer be on course to balance the cyclically-adjusted current budget in 2016-17; and
- third, by looking at alternative economic scenarios. We examine the implications of two illustrative scenarios: first, the OECD's downside scenario in the euro area, which it published in November; and second, a scenario where a temporary shock raises oil prices in the short term. The first significantly reduces the Government's chances of meeting its fiscal targets, and the second also reduces the chances, but to a much lesser extent.