1 Executive summary

Overview

1.1 Relatively little time has passed since our November forecast and the outlook for the economy and public finances looks broadly the same. The economy has slightly more momentum in the near term, thanks to the unexpected strength of the world economy, but there seems little reason to change our view of its medium-term growth potential. And while the budget deficit looks likely to come in almost £5 billion lower this year than we expected in November, the explanations for this imply smaller downward revisions for future years. As a result, the Government's headroom against its fiscal targets is virtually unchanged.

1.2 The Chancellor has kept to his word in announcing no new fiscal policy measures in the Spring Statement. The main Government decisions affecting this forecast are his decision to reduce the proportion of debt that will be issued as index-linked gilts, February's local government finance settlement and decisions taken by the Scottish and Welsh Governments since the Chancellor's Autumn Budget in November. These have modest fiscal implications.

1.3 Growth and employment have performed broadly as expected since November and we have made only small revisions to our economy forecast. The latest data show real GDP growth slowing from 1.9 per cent in 2016 to 1.7 per cent in 2017 (and to 1.4 per cent in the year to the fourth quarter of 2017). We expect growth of 1.5 per cent in 2018, slowing a little more in 2019, then picking up modestly over the subsequent three years. At 1.4 per cent a year, the average growth rate over the forecast is unchanged from November.

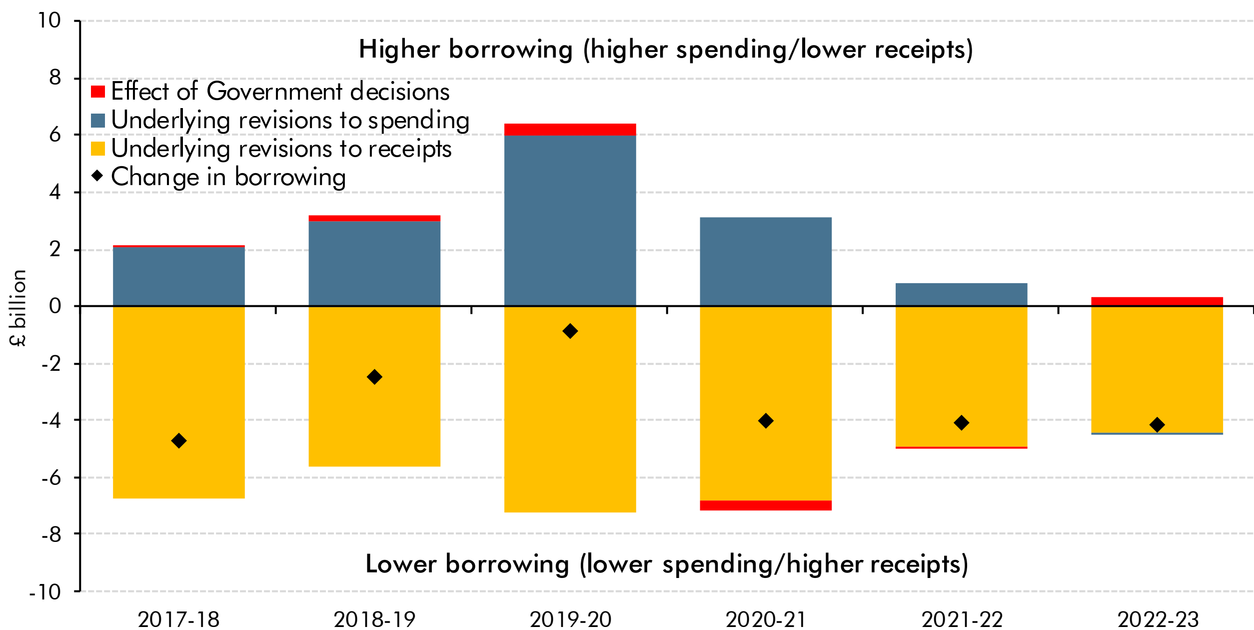
1.4 The vote to leave the European Union appears to have slowed the economy, but by less than we expected immediately after the referendum – thanks in part to the willingness of consumers to maintain spending by reducing their saving. But it is important not to put too much weight on early estimates of economic activity either side of the referendum, not least because the bottom-up measures of GDP growth in the National Accounts differ as to whether growth slowed down, speeded up or remained stable between 2016 and 2017.

1.5 The biggest surprise in the economic data released since November is that productivity growth – measured as output per hour – has been much stronger than expected. But that reflects a much weaker path for average hours worked, rather than stronger output or weaker employment growth. The fall in average hours over the second half of 2017 is the largest since mid-2011 and second largest since the financial crisis. But in 2011 the fall in hours and associated pick-up in productivity growth proved to be erratic and were soon reversed. We assume for now that the same will be true on this occasion.

1.6 We now expect the budget deficit to come in at £45.2 billion this year, £4.7 billion less than we forecast in November and fractionally lower than the latest estimate for 2016-17. Receipts growth in general has been a little stronger than expected, while self-assessment income tax receipts look likely to fall by £0.2 billion rather than the £3.1 billion we assumed in November. The downward revision to the deficit is smaller than you would get simply by extrapolating the data for the year to date, largely because we expect local authorities to underspend their budgets by less than the Office for National Statistics is currently provisionally assuming. Firm outturn data will not be available before September.

1.7 Borrowing is forecast to continue falling from 2018-19 onwards, with the deficit dropping below 2 per cent of GDP next year and below 1 per cent of GDP in the final year of the forecast. The downward revision relative to November diminishes over the next two years, thanks to upward revisions to debt interest and some other spending. Thereafter it is broadly stable at around £4 billion a year. But given the signs of greater cyclical pressure in the economy, we have revised our assumptions about the output gap and the extent to which borrowing is cyclical or structural. We see much of the improvement in borrowing since November as cyclical, with our forecast for the structural deficit little changed on average and improved by just £0.3 billion in the Government's target year of 2020-21.

Chart 1.1: Public sector net borrowing revisions since November



Source: ONS, OBR

1.8 On this basis, our central forecast implies that the Government's fiscal mandate – for cyclically adjusted borrowing to lie below 2 per cent of GDP in 2020-21 – would be met by a margin of 0.7 per cent of GDP, unchanged from our November forecast. Public sector net debt falls by 3.0 per cent of GDP in 2020-21, meeting the supplementary debt target – again by the same margin as in our November forecast. And the subset of spending covered by the welfare cap remains below the stipulated level in 2022-23.

1.9 Our forecasts continue to be based on broad-brush assumptions about the economy and public finances after the UK's exit from the EU, pending a meaningful basis upon which to predict the precise end-point of the Brexit negotiations. One area where sufficient clarity is now available to be more specific relates to the financial settlement – the 'divorce bill' – that the UK will pay after leaving the EU on 29 March 2019. The December 2017 joint report by the UK and EU negotiators detailed the components of this settlement. The Treasury estimated at the time that it would amount to £35 billion to £39 billion. Using assumptions consistent with our central economic and fiscal forecasts, we estimate the settlement would cost £37.1 billion, with around 75 per cent falling due within our five-year forecast period.

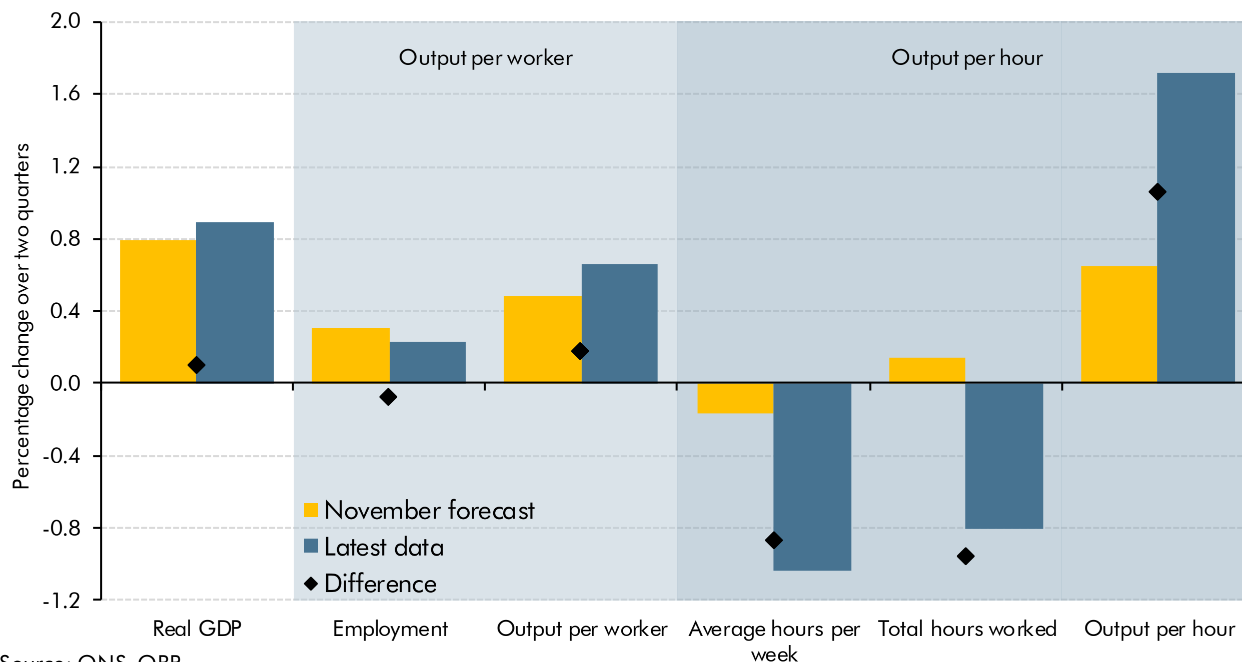
Economic developments since our previous forecast

1.10 With less than four months having passed since our previous forecast, relatively little news has accumulated to affect our economy forecast. Real GDP growth in the third quarter of 2017 was revised up by 0.1 percentage points, while growth in the fourth quarter was as expected. Employment growth was weaker than expected in the third quarter, but then slightly stronger in the fourth quarter. Overall, productivity growth on an output per worker basis was 0.2 percentage points stronger than expected in the second half of 2017.

1.11 The largest surprise relative to our November forecast has been in average hours worked, which are reported to have fallen more sharply in the second half of 2017 (by 1.0 per cent) than at any point since mid-2011 – showing the second steepest six-month fall since the financial crisis and far weaker than our forecast of a 0.2 per cent drop. With employment growth relatively stable, this has meant a similarly sharp drop in total hours worked and a sharp rise in productivity on an output per hour basis – the sharpest six-month rise since mid-2011. But it is worth noting that output per hour fell in the first half of 2017, and so in aggregate it rose by just 1.0 per cent in the year to the fourth quarter of 2017.

1.12 Chart 1.2 shows the surprises relative to our November forecast through the second half of 2017. In terms of real GDP growth, employment and output per worker they are small. But in terms of hours worked and output per hour they are large. Compared with the experience since mid-2011, the fall in average hours and the rise in average hourly productivity were both unusually large, yet real GDP growth was just a touch weaker than average. Hours data can be erratic, so the sharp drop in average hours recorded in the second half of 2017 may well reflect statistical sampling errors rather than developments in the real world. After a similarly sharp fall in mid-2011, measured average hours rebounded sharply and hourly productivity fell. We have assumed that a similar pattern will be seen in early 2018.

Chart 1.2: Real GDP, labour input and productivity: 2017Q2 to 2017Q4



Source: ONS, OBR

1.13 Since our November forecast, the Office for National Statistics has published its first complete estimates for GDP growth in calendar year 2017. The headline measure shows growth slowing slightly from 1.9 per cent in 2016 to 1.7 per cent in 2017. But it is worth noting that the various alternative measures of GDP in the National Accounts that the headline measure draws upon are painting divergent pictures of whether growth slowed or quickened last year. Growth slowed from 2.4 to 1.9 per cent for the output measure and from 1.6 to 1.4 per cent for income, but rose from 1.2 to 1.9 per cent for expenditure. The headline measure of output at basic prices suggests growth was flat at 1.7 per cent.

The economic outlook

1.14 Parliament requires us to produce our forecasts on the basis of stated Government policy, but not necessarily assuming that particular policy objectives are achieved. With complex negotiations over the UK's exit from the EU still underway, this is not straightforward.

1.15 The UK Government and the European Commission have both published further documents and delivered speeches that set out their respective positions and frame the continuing negotiations. But there is still no meaningful way for us to predict the precise end-point of the negotiations upon which to base our forecast. There is also considerable uncertainty about the economic and fiscal implications of different potential outcomes, including the impact of any monetary policy response that might accompany them. So we have retained the same broad-brush assumptions on productivity, trade and migration that underpinned our previous post-referendum forecasts (as set out in Chapter 3). These are consistent with a range of possible outcomes, albeit smooth rather than disorderly ones.

1.16 With real GDP and employment performing broadly as expected since our November forecast, and the sharp movements in average hours and hourly productivity assumed to be erratic ones that will be reversed, we have made only small revisions to our economy forecast. Our assumptions about potential output growth are unchanged.

1.17 The main news since November has been the continued strengthening of advanced economies around the world. Growth picked up in most in 2017 – from 1.5 per cent in 2016 to 2.3 per cent in the United States and from 1.8 to 2.5 per cent in the euro area. This stronger global demand will have boosted UK output, although GDP growth still slowed from 1.9 to 1.7 per cent. The International Monetary Fund's January forecast update included upward revisions to 2018 and 2019 GDP growth in the United States, the euro area, Japan and Canada, which has led us to raise our forecast for UK export market growth. The contribution of net trade to UK GDP growth is higher in both years.

1.18 Despite this global tailwind, we still expect UK GDP growth to continue to ease – to 1.5 per cent in 2018 and 1.3 per cent in 2019, before picking up slowly over the remaining years of the forecast. This reflects our revised assumption that the economy is operating a little above its potential – reflecting signals from a variety of business surveys and early indications of pay settlements growth in 2018 – and the expectations of monetary policy tightening priced into financial markets, upon which our forecast is predicated.

1.19 By expenditure component, we assume: that household consumption growth will come more into line with income growth, allowing the saving ratio to stabilise; that business investment growth will remain subdued; and that net trade will be neutral for growth from 2020 onwards. Domestic demand growth is expected to pick up slowly from 2020 onwards, supported by a modest recovery in trend productivity growth.

1.20 CPI inflation reached 3.1 per cent in November 2017, which we expect to have been its local peak. We assume that the unwinding of last year's sterling-driven rise in import prices will bring inflation down to around 2 per cent relatively quickly and that it will remain close to that level. But higher oil and food prices mean that inflation is a little higher this year than we forecast in November. Thereafter it is little changed, as the effects of slightly more cyclical momentum in the economy and higher wage growth have been offset by a stronger pound and market expectations of higher interest rates and a sharper fall in oil prices.

1.21 We continue to expect employment growth to slow over the next five years from the strong rates seen in much of the post-crisis period. This reflects our view that unemployment is currently just below its sustainable rate and that the ageing of the population will place downward pressure on the overall participation rate.

1.22 We expect wage growth to pick up in the short term, partly on the basis of early indications of stronger growth in pay settlements in 2018. But real earnings growth over the next five years is expected to remain subdued, averaging just 0.7 per cent a year. Growth in real household disposable income per person is expected to average only 0.4 per cent a year.

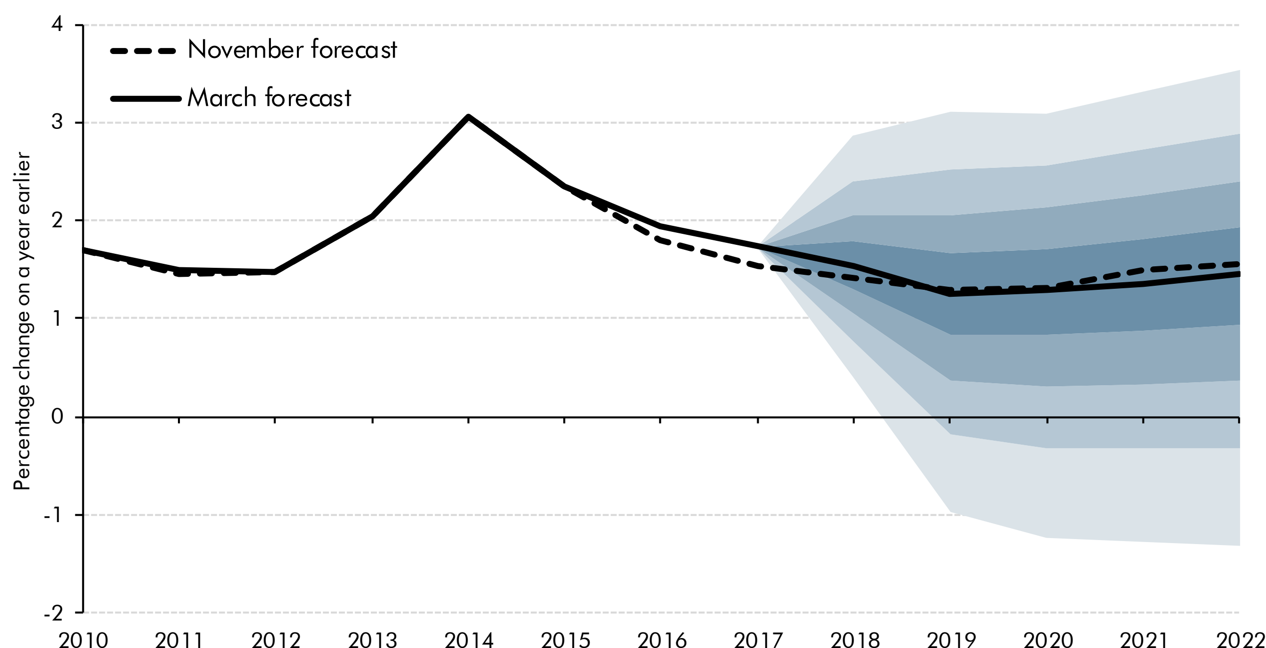
Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2016	2017	2018	2019	2020	2021	2022
Output at constant market prices							
Gross domestic product (GDP)	1.9	1.7	1.5	1.3	1.3	1.4	1.5
GDP per capita	1.1	1.1	0.9	0.7	0.7	0.8	0.9
GDP levels (2016=100)	100.0	101.7	103.3	104.6	105.9	107.4	108.9
Output gap	-0.1	0.1	0.3	0.1	0.0	0.0	0.0
Expenditure components of real GDP							
Household consumption	2.9	1.7	0.9	0.9	1.1	1.4	1.5
General government consumption	0.8	0.3	1.1	0.9	0.6	0.9	1.1
Business investment	-0.5	2.2	1.7	2.0	2.3	2.4	2.5
General government investment	1.3	3.5	2.1	2.1	6.1	1.0	1.2
Net trade[1]	-0.8	0.3	0.5	0.3	0.0	0.0	0.0
Inflation							
CPI	0.7	2.7	2.4	1.8	1.9	2.0	2.0
Labour market							
Employment (millions)	31.7	32.1	32.2	32.4	32.5	32.6	32.7
Average earnings	2.7	2.6	2.7	2.4	2.5	2.8	3.0
LFS unemployment (rate, per cent)	4.9	4.4	4.4	4.5	4.6	4.6	4.6
	Changes since November forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.1	0.2	0.1	0.0	0.0	-0.1	-0.1
GDP per capita	0.1	0.2	0.1	0.0	0.0	-0.1	-0.1
GDP levels (2016=100)	0.0	0.2	0.3	0.3	0.3	0.1	0.0
Output gap	0.1	0.3	0.3	0.3	0.2	0.1	0.0
Expenditure components of real GDP							
Household consumption	0.2	0.2	0.1	-0.3	-0.1	-0.1	-0.2
General government consumption	-0.2	0.0	0.2	0.2	0.1	-0.1	0.1
Business investment	-0.1	-0.3	-0.6	-0.3	-0.2	0.0	0.1
General government investment	-0.2	1.1	0.7	-0.2	-0.2	0.0	0.3
Net trade[1]	0.2	-0.1	0.2	0.2	0.1	0.0	0.0
Inflation							
CPI	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Average earnings	-0.1	0.3	0.4	0.1	-0.1	-0.3	-0.1
LFS unemployment (rate, per cent)	0.0	0.0	0.1	0.1	0.0	0.0	0.0

[1] Contribution to GDP growth.

1.23 The future is, of course, uncertain and no central forecast will be fulfilled in its entirety. One way of illustrating the uncertainty around our GDP growth forecast is shown in Chart 1.3. This presents our central forecast together with a fan showing the probability of different outcomes based on past errors on official forecasts. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. These are not subjective judgements about the extent of uncertainty, which for the reasons discussed above are greater than usual at present.

Chart 1.3: Real GDP fan chart



Source: ONS, OBR

The fiscal outlook

1.24 Public sector net borrowing has fallen from its post-crisis peak of 9.9 per cent of GDP (£153.0 billion) in 2009-10 to an estimated 2.2 per cent of GDP (£45.2 billion) this year, a smaller deficit than we forecast in November. With the economy judged to be operating fractionally above its potential level, we estimate that the structural deficit (which excludes the effects of the economic cycle) is currently just above the headline deficit at 2.3 per cent of GDP. On both measures, the deficit is expected to fall steadily over the next five years. Public sector net debt is expected to peak relative to GDP this year, to edge down by 0.1 per cent of GDP in 2018-19 and then to fall more noticeably thereafter.

1.25 Table 1.2 shows that on current policy – including our broad-brush assumptions regarding the UK's exit from the EU – we expect the deficit to move below 2 per cent of GDP next year and then to fall slowly over the four years to 2022-23. Our central forecast is for a structural deficit of 1.3 per cent of GDP in 2020-21, below the 2 per cent of GDP ceiling set in the Chancellor's 'fiscal mandate'.

Table 1.2: Fiscal forecast overview

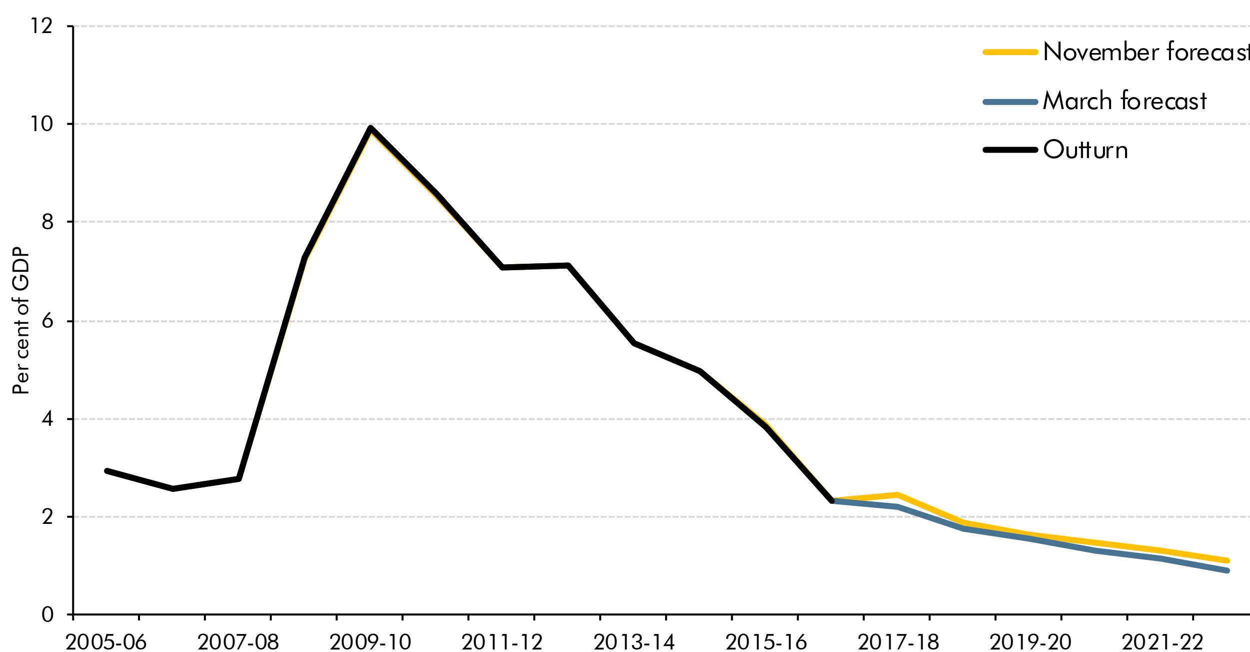
	Per cent of GDP						
	Outturn	Forecast					
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Revenue and spending							
Public sector current receipts	36.6	36.6	36.7	36.8	36.8	36.7	36.7
Total managed expenditure	38.9	38.8	38.4	38.3	38.1	37.8	37.6
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	2.3	2.3	1.9	1.6	1.3	1.1	0.9
Public sector net borrowing	2.3	2.2	1.8	1.6	1.3	1.1	0.9
Cyclically adjusted current budget deficit	0.3	0.2	0.1	-0.5	-1.1	-1.2	-1.4
Debt: Supplementary target							
Public sector net debt	85.3	85.6	85.5	85.1	82.1	78.3	77.9
	£ billion						
Revenue and spending							
Public sector current receipts	726.5	752.2	775.8	800.1	824.9	847.5	876.6
Total managed expenditure	772.2	797.4	812.9	834.0	853.6	873.4	898.0
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	45.0	46.7	40.2	35.8	29.5	26.1	21.4
Public sector net borrowing	45.8	45.2	37.1	33.9	28.7	26.0	21.4
Cyclically adjusted current budget deficit	6.2	3.2	1.3	-10.7	-24.7	-27.2	-34.2
Debt: Supplementary target							
Public sector net debt	1727	1783	1835	1880	1868	1841	1893

Changes in public sector net borrowing

1.26 We expect borrowing in 2017-18 to be £4.7 billion lower than we forecast in November – and £10.3 billion lower than we forecast in March 2017 (on a like-for-like basis). The revision since November reflects the better-than-expected performance of tax receipts in recent months, most notably self-assessment income tax receipts received in January.

1.27 The downward revision to PSNB in 2017-18 now means that borrowing falls fractionally on a year earlier, by 0.1 per cent of GDP (£0.6 billion). The deficit falls more quickly in 2018-19, by 0.4 per cent of GDP (£8.1 billion), as total spending rises by only 1.9 per cent in cash terms. As Chart 1.4 shows, net borrowing then falls steadily by 0.2 per cent of GDP a year on average from 2019-20 onwards to reach 0.9 per cent of GDP in 2022-23.

Chart 1.4: Public sector net borrowing



Source: ONS, OBR

1.28 Table 1.3 breaks down the changes in our borrowing forecast since November. First, it breaks down our underlying forecast revisions into drivers from key tax and spending streams. Second, it summarises the effect of Government decisions on borrowing – including those taken by the Scottish and Welsh Governments since November.

Expected borrowing in 2017-18

1.29 Our forecast for PSNB in 2017-18 is down by £4.7 billion, reflecting a £6.8 billion upward revision to receipts partly offset by a £2.0 billion upward revision to spending.

1.30 The unexpected strength in tax receipts since November partly reflects stronger nominal GDP growth in 2017-18, revised up from 3.1 to 3.4 per cent. This boosts growth in the major tax bases. For example, growth in wages and salaries has been revised up from 3.3 to 3.6 per cent. Reflecting this and other factors, the main receipts revisions are:

- A £2.9 billion upward revision to **self-assessment (SA) income tax** receipts. Based on provisional analysis from HMRC, around a third reflects slower-than-expected unwinding of dividend forestalling, which boosts 2017-18 at the expense of future years. Much of the rest reflects payments on account for 2017-18 liabilities, which are boosted mechanically by higher-than-expected payments on 2016-17 liabilities. This boosts 2017-18 receipts at the expense of those in 2018-19, when balancing payments on 2017-18 liabilities will be due. Taken together, this means that only a small part of the upward revision since November boosts receipts in future years.

- A £2.8 billion upward revision to **other income tax and NICs** receipts. Modest upward revisions to labour income growth will have contributed to this strength, but the recent growth in PAYE cash receipts has been stronger than these changes alone would

predict. Receipts growth has been particularly rapid in the business services sector. Repayments have also been lower than expected, boosting receipts.

- **Onshore corporation tax** receipts have again exceeded our expectations. We have raised our forecast for receipts this year by £1.9 billion, reflecting strong growth in January cash payments by large companies. Financial sector companies have reported rapid profit growth over the past year, contributing to strength in receipts. But much of this overall receipts strength relates to liabilities from previous accounting periods, so does not form part of the base from which we project receipts in future years.

1.31 Higher spending and weaker CGT receipts partly offset the broad-based receipts strength. CGT receipts in 2017-18 were down 7 per cent on a year earlier, but are still nearly twice their level of four years ago. Preliminary analysis of CGT returns did not suggest any one-off explanations for the weakness, so it has been pushed through the forecast. The largest contributor to higher spending than we assumed in November is local authorities, where we expect greater drawdowns from reserves than previously assumed.

Forecasts for borrowing from 2018-19 onwards

1.32 The underlying downward revision to PSNB from 2018-19 onwards averages £3.2 billion a year. This reflects an upward revision to receipts that averages £5.8 billion (0.7 per cent), partly offset by an upward revision to spending that averages £2.6 billion (0.3 per cent).

1.33 On the receipts side, relatively little of the higher 2017-18 starting point is assumed to persist, as most of the unexpected strength in SA income tax and onshore corporation tax appears to reflect timing changes rather than genuinely higher underlying liabilities. But we have also assumed slightly higher receipts growth in the near term, which means that receipts have still been revised up significantly in 2018-19. We have then revised receipts growth down toward the end of the forecast. These changes reflect:

- A modest **cyclical boost to GDP growth** and slightly stronger earnings growth in the near-term feed through to growth in most tax bases. This effect unwinds by the end of the forecast as the positive output gap closes. The short-term boost via average earnings growth is the largest positive determinant change, reflecting the latest indications that pay settlements growth may pick up in 2018.

- Higher **interest rates** boost interest and dividend receipts across the forecast. (This only partly offsets the increase in debt interest spending due to higher interest rates.)

- The combined effect of lower **equity prices** and the **shortfall in 2017-18 capital gains tax receipts** has reduced receipts by £2.5 billion. That reflects the gearing of capital gains to equity price rises, which means that both factors generate progressively larger negative effects over the forecast.

1.34 On the spending side, the upward revision peaks in 2019-20 at £6.0 billion, but then falls to a £0.1 billion downward revision by 2022-23. The main drivers of that profile reflect:

- **Local authority self-financed current expenditure** has been revised up in every year. This mostly reflects a higher council tax forecast (which boosts receipts too), as well as an increase in – and a different profile for – the assumed use of reserves.

- **Debt interest spending** has been revised up in most years, with the upward revision peaking in 2020-21. Higher RPI inflation increases accrued spending on index-linked gilts in the near term, while higher interest rates increase spending later in the forecast. But lower borrowing and debt offsets some of the effect from higher interest rates.

- Growth in **welfare spending** – particularly on tax credits – has been revised down. This has a progressively larger effect over the forecast. Tax credits spending has repeatedly fallen short of our forecasts. This suggests that relative income growth in the tax credits population has been stronger than had previously been the case. Adjusting for this across the forecast reduces spending by nearly £2 billion in 2022-23.

1.35 The relatively large upward revision to 'other spending' in 2019-20 in part reflects reprofiling of the expected cost of tax litigation losses on the basis of updated HMRC information. Assuming a flat profile from 2019-20 rather than a steadily rising one raises spending in 2019-20 by £1.1 billion, but reduces it by £0.7 billion a year on average in subsequent years. Other spending has also risen in 2019-20 because payments to the EU in calendar year 2019 are expected to be less front-loaded than looked likely in November.

Government decisions

1.36 The Chancellor has kept to his word in announcing no new fiscal policy measures in the Spring Statement. The main Government decisions affecting this forecast are his decision to reduce the proportion of debt that will be issued as index-linked gilts, February's local government finance settlement and decisions taken by the Scottish and Welsh Governments since the Chancellor's Autumn Budget in November. These effects are detailed in Annex A.

Table 1.3: Changes in public sector net borrowing since November

	£ billion						
	Outturn	Forecast					
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
November forecast	45.7	49.9	39.5	34.7	32.8	30.1	25.6
March forecast	45.8	45.2	37.1	33.9	28.7	26.0	21.4
Change	**0.1**	**-4.7**	**-2.4**	**-0.8**	**-4.0**	**-4.1**	**-4.2**
Underlying revisions to receipts	**0.2**	**-6.8**	**-5.6**	**-7.2**	**-6.8**	**-4.9**	**-4.4**
of which:							
Self-assessment IT receipts	0.0	-2.9	-0.5	-1.0	-0.9	-1.3	-1.1
Other IT and NICs receipts	-0.1	-2.8	-5.2	-5.1	-4.7	-3.6	-4.5
Onshore CT receipts	1.1	-1.9	-1.1	-1.9	-1.3	-1.2	-1.1
CGT receipts	0.0	1.0	1.1	1.9	1.7	1.9	2.3
Other receipts	-0.8	-0.2	0.0	-1.1	-1.7	-0.7	0.0
Underlying revisions to spending	**-0.2**	**2.0**	**3.0**	**6.0**	**3.1**	**0.8**	**-0.1**
of which:							
Debt interest spending	0.0	-0.1	1.7	1.9	2.4	2.3	1.9
Local authority current spending[1]	-0.2	1.1	1.6	1.6	1.2	1.0	1.0
Departmental spending (DEL)	0.3	1.2	-0.5	-0.5	0.0	0.0	0.0
Welfare spending	0.0	-0.4	-0.1	0.4	-0.1	-0.6	-1.2
Other spending	-0.2	0.3	0.2	2.6	-0.3	-1.8	-1.7
Effect of UK Government decisions		0.0	0.2	0.4	-0.1	0.2	0.5
Effect of devolved administration decisions		0.0	0.1	0.0	-0.2	-0.2	-0.2
Memo: March pre-measures forecast	*45.8*	*45.2*	*36.9*	*33.5*	*29.1*	*26.0*	*21.1*

[1] Self-financed local authority current expenditure (LASFE).
Note: This table uses the convention that a negative figure means a reduction in PSNB, i.e. an increase in receipts or a reduction in spending will have a negative effect on PSNB.

Changes to public sector net debt

1.37 In addition to the profile of public sector borrowing and lending to the private sector, public sector net debt (PSND) has been affected by two large factors over the past couple of years. The Bank of England's August 2016 monetary policy package will raise it by around 7.1 per cent of GDP by the end of 2017-18, but the November 2017 reclassification of English housing associations to the private sector has reduced it by 3.2 per cent of GDP.

1.38 In November we expected PSND to peak at 86.5 per cent of GDP in 2017-18. We continue to expect it to peak this year, but at a lower 85.6 per cent of GDP. This reflects the £4.7 billion downward revision to PSNB in 2017-18 and a £5 billion reduction in the forecast size of the Bank of England's Term Funding Scheme (TFS).

1.39 We expect the debt-to-GDP ratio to fall by 0.1 percentage points between 2017-18 and 2018-19 – only 0.05 per cent on an unrounded basis. Thereafter debt continues to fall as a share of GDP, with the largest falls in 2020-21and 2021-22 due to the repayment of TFS loans at their 4-year term and the associated drop in Bank of England liabilities.

1.40 In addition to the changes to the TFS discussed above, the changes in our PSND forecast reflect changes to the path of GDP and to our fiscal forecast. As Table 1.4 shows:

- **Nominal GDP** is higher in all years, reflecting stronger near-term real GDP growth and a revised profile for the terms of trade (with the size of the revision diminishing as the small positive output gap closes). This reduces the debt-to-GDP ratio in all years.
- Downward revisions to our **borrowing forecast** reduce debt in all years, and by increasing amounts as the cumulative effect builds up.
- The effect of **gilt premia** has been revised down due to a slightly higher yield curve, lower issuance and the Chancellor's decision to reduce the proportion of index-linked gilts. These all reduce expected premia in future index-linked gilt auctions.
- A **variety of smaller changes** have increased PSND up to 2020-21 and reduced it thereafter. Lower foreign exchange reserves from stronger sterling pushes up debt but by the end of the forecast this is more than offset by decreased forecasts for loans.

Table 1.4: Changes in public sector net debt since November

	Per cent of GDP						
	Outturn	Forecast					
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
November forecast	85.8	86.5	86.4	86.1	83.1	79.3	79.1
March forecast	85.3	85.6	85.5	85.1	82.1	78.3	77.9
Change	**-0.5**	**-0.9**	**-0.9**	**-1.0**	**-1.0**	**-1.0**	**-1.1**
of which:							
Change in nominal GDP[1]	-0.5	-0.5	-0.7	-0.8	-0.5	-0.4	-0.4
Change in cash level of net debt	0.0	-0.4	-0.2	-0.2	-0.5	-0.5	-0.7
	£ billion						
Total underlying forecast revisions		**-7.8**	**-4.7**	**-5.3**	**-11.2**	**-12.4**	**-16.9**
of which:							
Borrowing		-4.7	-7.2	-8.0	-12.0	-16.1	-20.3
Bank of England schemes		-5.0	-5.0	-5.0	-5.0	0.0	0.0
Gilt premia		1.1	4.6	5.8	5.7	5.7	5.6
Lending to the private sector		-0.4	-0.7	-2.7	-4.0	-4.9	-5.6
Foreign exchange reserves		2.1	3.4	3.5	3.6	3.7	3.8
Other factors		-0.9	0.0	1.1	0.5	-0.7	-0.4

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

EU financial settlement

1.41 On 8 December 2017, the EU and the UK Government published a joint report on phase one of negotiations under Article 50.[1] One of the areas the report discussed was the financial settlement – the 'divorce bill'. This provides sufficient information for us to estimate the prospective cost of a financial settlement on those terms and incorporate it into our central forecast. We continue to make the fiscally neutral assumption that any reductions in transfers to the EU after factoring in this settlement are recycled into other spending.

[1] *Joint report on progress during phase 1 of negotiations under Article 50 TEU on the UK's orderly withdrawal from the EU*, Department for Exiting the European Union, 8 December 2017.

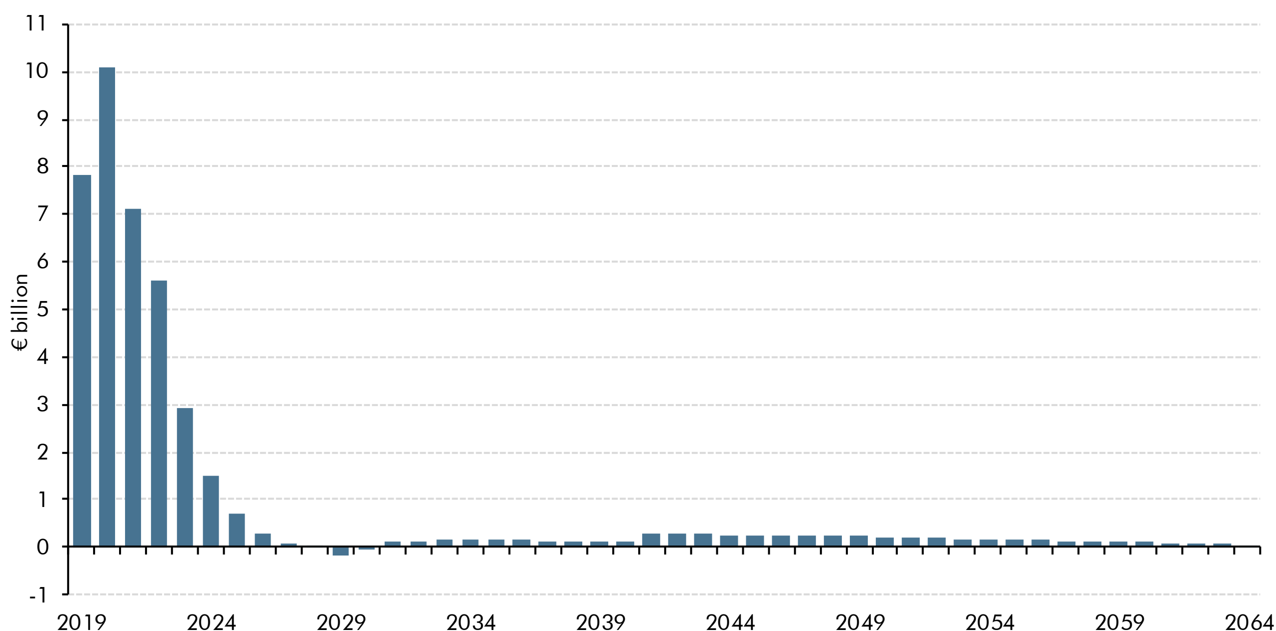
1.42 The settlement comes in three broad parts. Just under half reflects the UK continuing to make payments as though we were still a Member State during the current Multiannual Financial Framework (MFF) that ends in December 2020. Around half is due to meeting our share of outstanding payments at the end of the current MFF (known as the '*reste à liquider*' or RAL), which is expected to cost diminishing amounts over the subsequent eight years. The remaining small fraction reflects pension liabilities less assets returned to the UK, such as our capital subscription at the European Investment Bank. Receipts and payments associated with these other elements of the settlement could extend for many years, although the precise modalities for meeting them have yet to be agreed.

1.43 Based on the assumptions set out in Annex B, we estimate the total size of the financial settlement to be £37.1 billion (€41.4 billion). This is within the range of estimates that the Treasury presented following the joint report's publication.

Table 1.5: EU financial settlement components and assumed payment periods

	Payment period	Amount	
		€ billion	£ billion
Total	**2019-2064**	**41.4**	**37.1**
of which:			
UK participation in EU annual budgets to 2020	2019-2020	18.5	16.4
Reste à liquider	2021-2028	20.2	18.2
Other net liabilities	2019-2064	2.7	2.5

Chart 1.5: Assumed annual path of EU financial settlement payments



Source: OBR

Performance against the Government's fiscal targets

1.44 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of achieving its fiscal targets under existing policy. The *Charter* has been updated several times in recent years as the Government has revised its fiscal targets. The latest version was approved by Parliament in January 2017.

1.45 The *Charter* states that the Government's objective for fiscal policy is to "*return the public finances to balance at the earliest possible date in the next Parliament*". At the time, this was expected to be the period from 2020 to 2025. Given the early General Election in 2017, it could now be interpreted as the period from 2017 to 2022. We consider it on both bases.

1.46 The *Charter* also sets out targets for borrowing, debt and welfare spending that require:

- The **structural deficit** (cyclically adjusted public sector net borrowing) to lie below 2 per cent of GDP by 2020-21.
- **Public sector net debt** to fall as a percentage of GDP in 2020-21.
- Welfare spending (excluding the state pension and payments closely linked to the economic cycle) to be below a **welfare cap** that has been set for 2022-23. The Government set a 3 per cent margin for error above the cap, so the effective cap on spending is higher. It has also set out a methodology by which the effect of changes in our inflation forecast relative to November 2017 must be stripped out when assessing performance against the cap.

1.47 Our central forecast implies that all three targets are on course to be met:

- **Fiscal mandate**: the structural deficit declines slowly from 2.3 per cent of GDP in 2017-18 to 1.3 per cent in 2020-21, thanks largely to current departmental spending being cut as a share of GDP. This means that the Government meets its target with a margin of 0.7 per cent of GDP, unchanged from our November forecast.
- **Supplementary target**: public sector net debt falls by 3.0 per cent of GDP in 2020-21, also unchanged from our November forecast. The repayment of loans issued under the Bank's Term Funding Scheme at the end of their four-year term contributes 2.4 per cent of GDP to the year-on-year fall.
- **Welfare cap**: the relevant welfare spending is forecast to be £1.5 billion lower than the cap in 2022-23 and £5.4 billion below the cap-plus-margin once the small adjustment for changes in our inflation forecast since November has been applied. On that basis, the terms of the cap are met. (The Treasury has increased the cap by £0.1 billion to reflect a reclassification of welfare spending from outside to inside the cap.)

1.48 Achieving the broader fiscal objective of a balanced budget, interpreted as applying to 2025-26, looks challenging (although it lies beyond our formal forecasting horizon). In

particular, this is a period in which population ageing will continue to exert upward pressure on spending, and more so than in recent years when the State Pension age has been rising. Interpreted as applying to 2022-23, the objective would be missed. That year lies within our forecast horizon, at which point we forecast a headline deficit of 0.9 per cent of GDP.

1.49 The uncertainties around our central forecast reflect those regarding the outlook for the economy and those regarding the performance of revenues and spending in any given state of the economy. We assess the robustness of our judgements 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 structural deficit would be below 2 per cent of GDP in 2020-21.

- Second, by looking at the **sensitivity of the deficit to key features of the economy forecast**. The 0.7 per cent of GDP margin relative to the 2 per cent structural deficit ceiling would fall to zero if potential output were 1.4 per cent lower, if the effective tax rate were 0.7 per cent of GDP lower for structural reasons, or if the planned spending cuts – which reduce RDEL by 0.7 per cent of GDP between 2017-18 and 2020-21 – were not implemented.

- Third, by looking at **alternative economic scenarios**. We have considered the implications of two scenarios that generate higher inflation and interest rates – one for relatively benign reasons (stronger global demand, albeit temporarily so) and the other for more malign reasons (domestic supply potential being lower than we currently assume). In the stronger global demand scenario, UK GDP growth is buoyed in the short term, but weaker in the medium term as tighter monetary policy brings output back to trend. In the weak domestic supply scenario there is no short-term cyclical boost, so output growth is weaker throughout. In both scenarios, higher inflation and interest rates raise debt interest spending significantly. In the benign scenario this is offset by higher receipts, leaving borrowing lower from 2020-21 onwards. But in the malign scenario it is not, so borrowing is higher throughout. All three fiscal targets would be met in the stronger global demand scenario, although the margin against the mandate would be smaller because the improvement in headline borrowing is more than accounted for by cyclical factors. The fiscal mandate would be missed in the weak domestic supply scenario, while the debt target would only be met thanks to the repayment of TFS loans as they mature in 2020-21.