Welfare trends and Forecast evaluation reports – December 2019
Robert Chote, Chairman, Office for Budget Responsibility

Good morning ladies and gentlemen.

[SLIDE] My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this merry yuletide briefing, in which I am going to summarise our annual Welfare Trends and Forecast Evaluation Reports.

These would normally come out in October, but have been delayed – and also significantly shortened – because of the early, then later, then ultimately abandoned Budget forecast that we and our contributors across Whitehall had to work on through the autumn. Both are an opportunity to look back at past forecasts and compare the predictions with what subsequently happened and to draw lessons for us, the Government and public finance watchers.

In the Welfare Trends Report we look back two elections to the Conservatives' 2015 manifesto proposal to deliver £12 billion of welfare cuts within two years, should they be returned to govern alone. We ask whether this was achieved – spoiler: it wasn't – and look at what actually happened instead.

In the Forecast Evaluation Report we look back to the economy and public finance forecasts that we published either side of the EU referendum in 2016 and assess how well our initial judgements on the likely impact of the vote have stood the test of time. It turns out that our post-referendum forecast for the economy has proved surprisingly accurate, while the public finances outperformed expectations – although not for referendum-related reasons.

Finally, I will briefly summarise the restatement of our most recent March public finance forecast for subsequent statistical changes, which we published on Monday. This will be the baseline for our next forecast, to accompany the spring Budget. After a succession of fiscal events in which the forecast and policy scrutiny process has been disrupted – quite understandably – by various stages of the Brexit negotiations and the associated parliamentary debates, it is in everyone's interest that we return to a proper Budget process – with a robust, sufficient and adhered-to timetable that allows for proper scrutiny and incorporation of a significant package of policy measures.

[SLIDE] So let me pluck the first satsuma out of the stocking and start with the Welfare Trends Report. Cast your minds back an aeon to the 2015 general election campaign, in which the Conservatives said that if they won they would continue with deficit reduction – and that in doing so they would aim to achieve £12 billion of welfare cuts by 2017-18. They did of course win that election and the July 2015 Budget duly contained a significant cuts package, but on a less ambitious timetable than in the manifesto. Specifically, it aimed for £12.5 billion of welfare savings by 2019-20, of which £9.7 billion were to be delivered by 2018-19. That is the latest year for which we have outturn data and against which we can now therefore assess what actually happened.

There were three main elements in the cuts package that we estimated would deliver about 60 per cent of the total savings:

- First, a four-year cash freeze in working age benefits, tax credits and Local Housing Allowances;

- Second, cuts in the income thresholds in tax credits and work allowances in universal credit. These are the levels of income at which support begins to be tapered away; and

- Third, an increase in the rate at which tax credits are tapered away above the income threshold from 41 to 48 per cent.

The Government banked the expected savings in its self-imposed 'welfare cap', lowering the ceiling on the spending in scope by 13 per cent in 2019-20.

[SLIDE] So how did the measures announced in the 2015 Budget affect the outlook for welfare spending? And by 'welfare spending', we are referring here only to spending on social security benefits and tax credits, not to broader measures of the spending on the welfare state.

This chart shows our pre-measures forecast for welfare spending in the July 2015 Budget. [SLIDE] And here is the post-measures forecast, which was £9.7 billion lower in 2018-19 as I mentioned a second ago. [SLIDE] Finally, we can see what has actually happened, according the latest outturn data. Welfare spending has overshot that forecast, by a total of £3.5 billion in 2018-19.

[SLIDE] So to what extent did the fate of the July 2015 cuts package contribute to this spending overshoot?

This chart shows the total sum that the cuts package was designed to save, broken down into the three major components I mentioned a moment ago, plus all the other measures. As you can see, by 2019-20 the benefit freeze was supposed to save £3.9 billion, the income threshold and work allowance cuts £3.3 billion and the increase in the taper rate £0.3 billion. Other measures were to save £4.9 billion, giving £12.5 billion in total. (The savings from most of the measures rise over time, but those from the taper rate decline because it was not matched by equivalent changes to the universal credit taper rate.)

[SLIDE] We have now gone back to re-cost the welfare cuts package – making some simplifying assumptions – and the picture looks like this. The benefits freeze now saves slightly more than we thought at the time, but the savings from the threshold and allowance cuts and the increase in the taper rate essentially disappear.

[SLIDE] Compare the original costing with the re-costing and you can see that across the five years we estimate that the package raises consistently about £4 billion a year less than planned. So why the difference?

The main reason is subsequent policy decisions – notably the fact that the Government swiftly abandoned both the cut in the tax credit income threshold and the increase in the taper rate in the face of a political outcry. But it did not immediately reverse the equivalent cuts in universal credit, which meant that for the first time UC was set to save money relative to the system it replaced. More recently, the Government has reversed most of the effects of the UC cuts by raising work allowances and reducing the taper rate again, so we are now back in a position where UC is expected to cost more.

The benefit and tax credit freeze raised more than we expected because inflation – to which benefit levels would otherwise have been linked – exceeded our forecast. But the effect was partly offset because the incomes of the tax credit population rose more rapidly than incomes overall, reducing the number of cases affected by the freeze.

[SLIDE] Returning to the overall forecasts and outturns, there were other factors – pushing in both directions – that help explain the £3.5 billion welfare spending overshoot last year. Among the most important:

- Disability benefit spending overshot our forecast by £4 billion, primarily because the PIP roll-out failed to save money as originally expected. (We discussed this in detail in our last Welfare Trends Report.)

- Lower earnings growth raised spending on means-tested benefits, but reduced the cost of the state pension triple lock.

- Higher income growth among tax credits recipients reduced spending.

- And unexpectedly high mortality rates resulted in fewer claims for the state pension and other pensioner benefits.

[SLIDE] Looking back at the July 2015 forecast and cuts package teaches us a few useful lessons should we be confronted by a similar situation again. Let me mention three of them:

- First, squeezing average awards (for example through the benefits freeze) has proved a more reliable source of welfare savings than complex structural reforms, like those to disability benefits.

- Second, the size of the state pension bill means that even small variations in its determinants can have a big cash impact.

- And, third, the policy measures that end up being reversed, delayed or watered down have largely been those that generate cash losers from one year to the next rather than an extended real squeeze. This was true of the 2016-17 tax credit cuts – which were swiftly dropped – as well as some measures affecting housing benefit and UC. (There are elements of UC that still generate such effects as people move onto it from the legacy system – even though UC is now more generous overall.)

[SLIDE] Now let me turn to the second satsuma – the Forecast Evaluation Report. As I mentioned a moment ago, here we assess the performance of our March and November 2016 forecasts, those either side of the EU referendum.

In common with almost all forecasters, we downgraded the outlook for both the economy and the public finances to reflect the impact of the vote. As we shall see, our post-referendum forecast for the economy now looks remarkably accurate, while the public finances performed better. Why was that? The main reason is that the public finances were in better shape ahead of the referendum than the outturn data suggested at the time.

[SLIDE] So why did we (and others) downgrade our economy forecast?

We assumed that the fall in the pound that followed the vote would raise import prices and inflation, squeezing real incomes and real consumer spending, but that there would be only a modest improvement in net trade. We assumed that uncertainty regarding the future trade, customs and migration regimes would depress business investment. We expected weaker net inward migration, partly reflecting that fact that the UK would be a less attractive destination for overseas migrants. These together would mean a weaker outlook for productivity growth, and for actual and potential GDP.

[SLIDE] So, three years on, is that what actually happened?

This chart shows our pre- and post-referendum forecasts for real GDP, with a 1.4 per cent downgrade by the third quarter of this year. [SLIDE] And here are the latest outturn data. As you can see, the economy held up better than we expected over the first few quarters after the vote, but since then has underperformed. The level of real GDP is now 2.2 per cent below our pre-referendum forecast and 0.8 per cent below our post-referendum one.

[SLIDE] You can see the cumulative forecast error here. [SLIDE] A consistent feature throughout is that hours worked have been stronger than predicted while productivity – output per hour – has been weaker. This 'productivity puzzle' has of course bedevilled most forecasts since the financial crisis. Indeed, it remains a feature if you look back at our more recent ones, despite having taken the axe to our productivity growth forecast two years ago.

[SLIDE] Looking at the composition of real GDP growth, consumer spending has held up better than we expected – especially during the early part of the period. A year ago, the ONS outturn data suggested that this was largely because consumers had borrowed more and saved less, but recent ONS revisions now suggest that income growth was stronger than we thought. Beware though: forthcoming revisions will change this picture again.

Government spending has also made a bigger contribution to GDP growth than we thought three years ago, but that is largely because of the increase in spending (mostly on the NHS) that was announced in the 2018 Budget.

On the downside, net trade has contributed even less to growth than we expected, but the biggest disappointment has been business investment, which appears to have been even more depressed by uncertainty around the form and timing of Brexit than we had anticipated. [SLIDE] As you can see here, business investment has barely contributed at all to growth over the period and has actually fallen in five of the last eight quarters. (That said, one should always be cautious of these data, as they are liable to significant revisions.)

[SLIDE] So far I have focused on real GDP and its components, which is what most people focus on when they assess the performance of the economy.

For the purposes of producing a forecast for the public finances, it is actually nominal GDP (or GDP in cash terms) that matters more. That is because most taxes are levied on cash quantities and a large part of public spending is managed through cash plans. This chart shows our pre- and post-referendum forecasts for nominal GDP [SLIDE] and the latest outturns.

Over the period as a whole we were bang on the nose with an 11.5 per cent increase, which reflects the fact that whole economy inflation has been slightly stronger than we expected and real GDP growth slightly weaker. Like real GDP, nominal GDP held up better than expected to begin with but then weakened.

[SLIDE] So now let me turn to the public finances.

Comparing forecast and outturn is less straightforward here than for the economy. To allow a meaningful like-for-like comparison we typically restate our earlier forecasts in FERs to make them consistent with current statistical treatment. On this occasion we have also adjusted the outturn to reflect similar changes since March, which have been unusually big.

[SLIDE] If we look at the unadjusted numbers, we see the same picture as we saw for the economy. The outturn budget deficit for 2018-19 is broadly in line with the more pessimistic forecast that we made in November 2016, taking into account the referendum vote.

[SLIDE] But if we adjust both forecast and outturn for statistical consistency, the true picture is different. Last year's budget deficit is now much closer to our March 2016 forecast, implying that our November forecast was too gloomy – despite the fact that our economy forecast was pretty good.

Why is that?

[SLIDE] This chart shows that our March forecast underestimated borrowing by just £4.4 billion on a like-for-like basis, with receipts underestimated by £14.3 billion and spending by £18.7 billion.

In both cases our in-year forecast for 2015-16 was pretty accurate, which is what you would expect given that the financial year was almost over. But we underestimated both receipts and spending growth over the subsequent three years. The unexpected strength of receipts growth was dominated by onshore corporation tax, while the spending overshoot reflected current and capital spending by both central and local government.

[SLIDE] In the November forecast, by contrast, we overestimated borrowing by £20.3 billion, with receipts underestimated by £26.3 billion and spending by just £6.0 billion. The overall error is more than explained by the fact that our in-year forecast for 2016-17 was too pessimistic. This reflected several factors, among them that the outturn data were subsequently revised substantially. Growth in receipts and spending over the next two years was closer to forecast, consistent with the relatively accurate forecast for the economy, though we still underestimated both of them.

[SLIDE] As usual, we try to draw lessons from the Forecast Evaluation Report. And in this one, we highlight a number of issues that we have been working on or need to look at, among them: the difficulty of predicting the size and speed of household responses to real income shocks, the importance of the composition of labour income, the unexpectedly limited use of corporation tax deductions and reliefs, and the unexpected strength of local authority borrowing to finance capital expenditure (where information is limited).

We have also set out some priorities for the next set of reviews of our fiscal forecasting models, among them exploiting administrative data sources more effectively, achieving better alignment with ONS accounting treatments and improving the transparency and plausibility of some forecasting models.

[SLIDE] Satsumas consumed, it's now time for a treat: the chocolate coin that is the new baseline for our next public finance forecast, which will accompany the Budget at some point next spring. As you know – and as we have set out in painful detail in the Forewords to our recent EFOs – the Brexit negotiations and associated parliamentary timetable have played understandable (but nonetheless regrettable) havoc with the forecast and policy scrutiny process at most of the fiscal events that we have gone through since the referendum.

This needs to change. The OBR was created to ensure that fiscal policy is underpinned by a robust assessment of the outlook for the economy and the public finances – and the uncertainty that lies around it – plus forensic scrutiny of the tax, spending and other fiscal policy decisions that governments take. We can only deliver this to the standard that Parliament and the public have the right to expect if we can agree an adequate and robust timetable for the forecast process with the Government that they then adhere to. After a series of events at which the Treasury has legitimately been able to plead "exceptional circumstances" – and now that we have a Government with a clear majority – we need to rebuild the foundations of proper process.

This is particularly important for the next forecast, given the long gap since the last one, the significant policy changes that have already been announced (with more presumably to follow) and a new set of fiscal rules to police.

Of course, one consequence of the cancellation of the Budget last November is that the spring forecast will be our first of this financial year. And, as you may know, the Budget Responsibility and National Audit Act requires us to publish two forecasts during each financial year. Even if it was practical, no useful purpose would be served by publishing two forecasts in quick succession with no significant developments or policy changes between them. So we are talking to the Treasury about how best to square this circle – whether there could be a legislative solution to this legislative problem or whether there is a way we could tick the legal box without wasting your and a lot of other people's time. In deciding how to proceed, we obviously hope to discuss any proposal with the Treasury Committee to ensure that Parliament is content that we are addressing this hopefully unique situation in a sensible way.

In terms of the forthcoming forecast itself, our starting point will be the restated public finance forecast that we published earlier this week. This takes the final post-measures forecast that we published in March and restates it for a series of statistical and methodological changes and corrections that have been announced and implemented in outturn since then. It does not attempt to capture any real-world changes in the economy or the public finances.

As we explained on Monday, the main change is the new treatment of student loans – in which those loans that are not expected to be repaid are treated as grants. Others are related to funded public sector pension schemes, public sector depreciation, corporation tax receipts, the Lifetime ISA and the treatment of environmental levies. Taken together, these push up the forecast for net borrowing, but push down the forecast for net debt. This looks odd, but the latter reflects the fact that the gilts held by funded pension schemes now net off the debt stock – they are now central government liabilities to another part of the public sector. However, the liabilities of those schemes do not add to the debt stock as they are not 'debt liabilities'.

[SLIDE] This chart shows our March forecast for public sector net borrowing, with the budget deficit falling from £29.3 billion this year to £13.5 billion in 2023-24. [SLIDE] The restatement increases the deficit forecast by roughly £20 billion each year, so that borrowing now still exceeds £30 billion in 2023-24.

[SLIDE] If we look at the same comparison for the current budget deficit – which excludes borrowing for capital spending – the impact is slightly smaller. (And it is dominated by the revisions to depreciation rather than student loans.) The current budget is still in surplus through the forecast, but by a smaller margin.

[SLIDE] As you know, the Conservatives said during the election campaign that they would ensure that the current budget remained in surplus three years ahead – in 2022-23 – after any giveaways in the Budget. The restated forecast gives them a total of £18.6 billion to play with in that year, although current spending plans in 2020-21 have already been raised by £11.7 billion last autumn.

On that note, the stocking is empty and we would be happy to take any questions you may have.