1 Executive summary

Overview

1.1 The new Government has used its first Budget to loosen significantly the impending squeeze on public services spending that had been pencilled in by the Coalition in March. This is being financed by welfare cuts, net tax increases and three years of higher government borrowing. The Government has delayed the expected return to a budget surplus by a year to 2019-20, but is then aiming for a slightly bigger surplus in the medium term.

1.2 The Government's provisional spending assumptions imply that Resource Departmental Expenditure Limits (RDEL) – which cover day-to-day central government spending on public services, grants and administration – would be £83.3 billion higher in total over the current Parliament than the Coalition suggested in March. The Government has also announced tax cuts costing £24.6 billion over the Parliament, primarily cutting corporation tax rates, raising the income tax personal allowance and extending inheritance tax relief for main residences.

1.3 These 'giveaways' are being financed from five main sources:

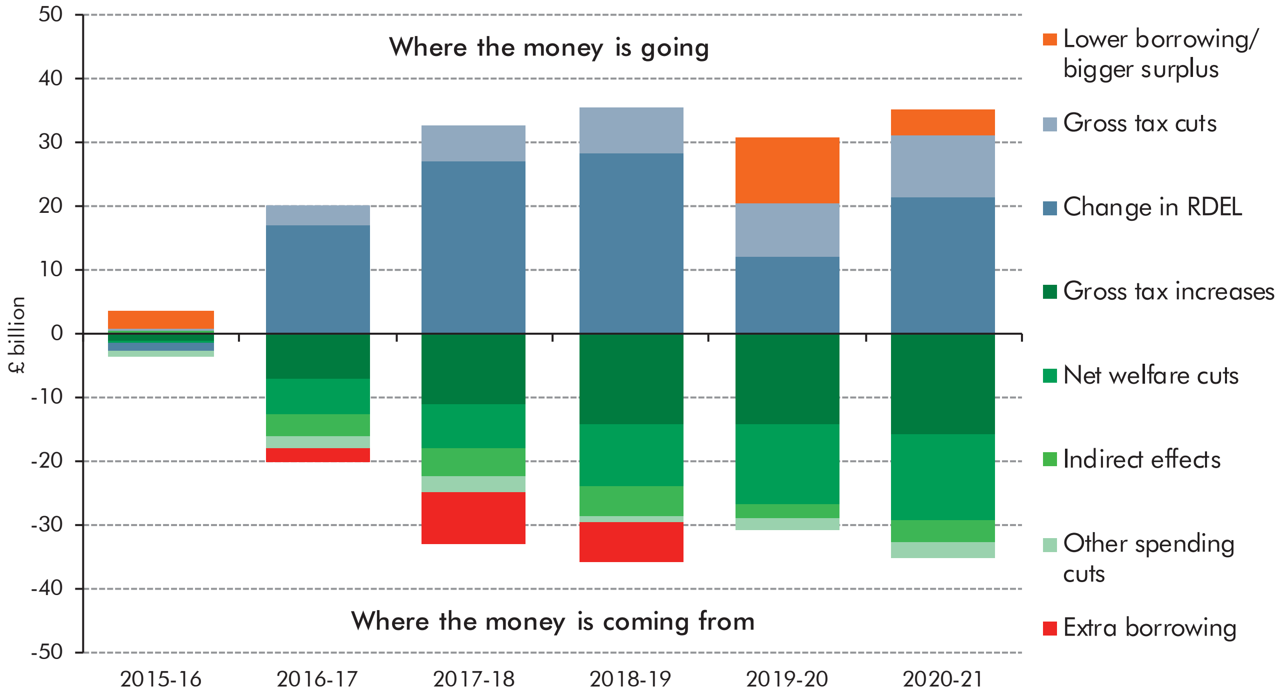
- tax increases raise £47.2 billion over the Parliament, including increases in dividend taxation, insurance premium tax and vehicle excise duty, plus cuts in pensions tax relief, earlier corporation tax payments, and anti-avoidance and evasion measures;
- welfare cuts raise £34.9 billion. These include a four-year freeze in the uprating of most working-age benefits, cuts in the generosity of tax credits and reduced work allowances in universal credit. The Government will also force local authorities and housing associations to cut rents, thereby reducing the cost of housing benefit;
- other spending decisions raise £8.1 billion. These include reductions in departmental capital spending and a cut in funding for the BBC reaching £745 million in 2020-21;
- these various tax and spending decisions have indirect effects that raise a further £14.2 billion. These include the pension contributions that would be paid by additional public sector workers, and higher income tax and NICs receipts; and
- the Budget decisions also imply £3.5 billion of extra borrowing over the Parliament, on top of the £14.6 billion increase implied by our pre-measures forecast. This includes £16.7 billion of additional borrowing between 2016-17 and 2018-19, to help avoid the sharpest cuts in public services spending. Thereafter the Government uses some of the welfare cuts and tax increases to aim for bigger budget surpluses.

1.4 On the basis of these provisional plans, the forthcoming Spending Review would be a lot less challenging than it appeared in March. The Government would have to identify further real cuts in public services spending rising to a peak of £17.9 billion in 2019-20, rather than £41.9 billion in 2018-19. Thereafter spending is assumed to rise again in real terms. Public services spending would fall by an average of 1.5 per cent a year in real terms over this Parliament as a whole, slightly less than the 1.6 per cent a year cuts over the last.

1.5 We now forecast that public sector net borrowing will total £69.5 billion this year, down £5.8 billion since March thanks to stronger-than-expected revenues, the spending cuts announced in June, the rise in insurance premium tax and a delay to the introduction of tax-free childcare. The deficit then declines more slowly than in March, moving into surplus by £10.0 billion in 2019-20, increasing to £11.6 billion in the following year.

1.6 Chart 1.1 summarises the impact of the Budget policy decisions across the forecast. Modest spending cuts and tax increases reduce borrowing a little this year. Over the following three years the welfare cuts and tax increases mount steadily, but they are not large enough to pay for the higher public services spending and tax cuts – hence the need for more borrowing to fill the gap. In the final two years the welfare cuts, tax increases and indirect effects more than pay for the tax cuts and (smaller) additions to public services spending – increasing the then budget surplus. In 2020-21, the Budget raises £13.3 billion from welfare cuts, £15.9 billion from tax increases and £6.1 billion from lower departmental capital spending, other measures and indirect effects. This pays for £21.6 billion more public services spending, £9.4 billion of tax cuts and a £4.3 billion bigger budget surplus.

Chart 1.1: The impact of Budget policy decisions over the forecast



Source: OBR

1.7 The Chancellor said in his March Budget speech that he wanted to raise £12 billion from welfare cuts and £5 billion from anti-avoidance and evasion measures by 2017-18. As defined in the Treasury's scorecard of policy measures, this Budget raises £7.0 billion from welfare cuts and £2.4 billion from 'avoidance and tax planning, evasion and compliance, and imbalances in the tax system'. These rise to £12.1 billion and £5.0 billion in 2019-20.

1.8 The Budget policy measures take place against the backdrop of an underlying economic and fiscal forecast that has changed relatively little since our last forecast in March. We have not adjusted our economy forecast for the potentially disruptive events in Greece that were still unfolding when we closed the pre-measures forecast on 25 June.

1.9 In terms of our economy forecast, since March:

- we have revised GDP growth in 2015 down to 2.4 per cent, reflecting the weaker-than-expected start to the year and a small drag from the in-year public spending cuts announced in June. Growth is unchanged since March in 2016, as we assume that the effect of the in-year cuts will be back-loaded, offsetting the slower cuts in 2016-17. Growth is then up a little in 2017, reflecting the slower pace of fiscal tightening;

- we have made small upward revisions to unemployment and downward revisions to hours worked in the final years of the forecast. That reflects higher labour costs from the introduction of the National Living Wage. We assume that this would raise the effective minimum wage for those aged 25 and above by over 13 per cent by 2020;

- the negative output gap is estimated to be slightly wider at the start of 2015, and is expected to close slightly later, in mid-2018; and

- our inflation forecast is little changed, remaining very low for the rest of the year, then rising in 2016 and returning slowly to the 2 per cent target over the forecast period.

1.10 Excluding the impact of policy measures, our forecasts for public sector net borrowing are up a little since March. Receipts are stronger, by an average of £3.9 billion a year across the forecast, but our forecast for annually managed expenditure is up by £6.3 billion a year. That includes the effect of higher interest rates on debt interest payments, higher spending associated with environmental levies and a methodological change that raised our net public sector pensions forecast.

1.11 In addition to the sales of Lloyds shares and mortgage assets held by UK Asset Resolution that were announced in March, the Government has now said that it will sell some of its RBS shares, its remaining stake in Royal Mail and its shares in King's Cross Central Partnership this year. Together with the initial tranche of sales of the pre-2012 student loan book, these asset sales should reduce public sector net debt by £32 billion in 2015-16. The Government has also announced plans to sell three-quarters of its shares in RBS over the Parliament, which we assume will raise around £6 billion a year from 2016-17 to 2019-20. Financial asset sales typically bring forward cash that would otherwise have been received later in mortgage repayments and dividends, so they only reduce net debt temporarily.

1.12 The Government has proposed two new fiscal targets in this Budget: to achieve a surplus on public sector net borrowing in 2019-20 (and then every year in 'normal times') and for public sector net debt to fall as a share of GDP every year up to 2019-20. Our central forecast is consistent with it meeting those targets, as well as those still in force from the previous Coalition government, namely: the fiscal mandate (to balance the cyclically adjusted current budget in the third year of the forecast period) and the supplementary target (for debt to fall as a share of GDP in the fixed year of 2016-17).