March 2012 *Economic and Fiscal Outlook* Briefing

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Good afternoon ladies and gentlemen.

My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our March 2012 *Economic and Fiscal Outlook*. We are very grateful to the Institute for Government for hosting us once again.

I am going to take you through the highlights of the EFO and then we will be very happy to take your questions. The slides and my speaking notes will be available after we finish.

[SLIDE] A little bit of background first.

The EFO contains our five-year forecasts for the economy and the public finances and an assessment of the Government's progress against the two fiscal targets it has set itself. All these incorporate the impact of the measures announced in the Budget earlier this afternoon.

At the Chancellor's request, we closed the baseline economic and fiscal forecasts on March 7th and the only subsequent changes have been to incorporate the impact of the Budget measures. Some economic data have been published since March 7th, but we do not believe that they would have had a significant impact on the forecast.

The views expressed in the EFO are the responsibility of the three members of the Budget Responsibility Committee – myself, Graham Parker and Steve Nickell. Needless to say we have relied enormously on the work of the OBR's permanent staff and on the expertise of officials in numerous departments and agencies. Our thanks to all of them.

We sent our baseline forecast to the Chancellor on March 7th and met with him to discuss the forecast and policy measures on March 12th. We sent our final post-measures forecast to him on Saturday afternoon. I am

pleased to report that at no point in this process have we come under any political or official pressure to change any of our conclusions.

[SLIDE] Now let me turn to what we are going to cover today.

First, the economic forecast, which is little changed since November. The Budget is broadly neutral in terms of giveaways and takeaways over the forecast horizon, so it has no significant effect on GDP in aggregate. As I will explain in a minute, we have modestly changed our investment and inflation forecasts to reflect particular Budget measures.

Second, the fiscal outlook and progress against the Government's targets. Again, the overall picture is very similar to November. The most eye-catching difference is a big one-off fall in public sector net borrowing next year as the Government brings the Royal Mail's historic pension fund deficit, plus associated assets, into the public sector.

Third, I will spend a little time explaining how we have dealt with the 45p tax rate. The key point here is that although it looks very inexpensive to cut the rate, you also need to look at what is going on in the baseline forecast as we have reassessed the yield from the 50p rate.

So let me start with the economy.

[SLIDE] As you can see, our forecasts for economic growth are very little changed since November.

Growth last year now looks fractionally weaker, but the economy had slightly more momentum coming into this year than we expected. So we have revised our estimate of growth in the first quarter slightly higher and this has nudged up the annual growth rate for 2012 from 0.7 to 0.8 per cent. Growth in 2013 is fractionally lower because we are slightly more pessimistic about export demand. But all these changes are tiny given the uncertainty around the annual rates and the scope for revision of outturn data. As you can see we have made no revisions to our numbers later in the forecast.

[SLIDE] Converting these growth rates into a forecast path for the level of GDP, you can see that we are somewhat more optimistic than the average outside forecast but somewhat more pessimistic than the mean

forecast from the Bank of England's latest Inflation Report – although that in part reflects the fact that they try to adjust for expected revisions to back data. The differences between these lines are dwarfed by the uncertainties around any of them.

[SLIDE] As regards the quarterly profile of headline growth through this year, we — like the Bank – expect a zig-zag pattern as a result of one-off effects from the Diamond Jubilee and the Olympics. But the underlying picture is one in which growth is pretty stable through to the autumn and then picks up towards the end of the year.

Now let me turn to some of the main components of GDP.

[SLIDE] The biggest component of demand in the economy is consumer spending. We have revised up our consumer spending forecasts a little, thanks to pension protection insurance windfalls and stronger asset prices. But overall we continue to see consumer spending acting as a drag on the recovery until wage increases once again start to outpace price increases by a decent margin in 2014.

[SLIDE] Business investment remains an important driver of recovery. Our investment forecasts have been boosted by about 1 per cent by the extra cut in corporation tax announced in the Budget, but overall we have revised the growth rates down a bit. For 2012 this reflects the particularly weak data for the fourth quarter of 2011, although that may well be revised. Towards the end of the forecast it reflects our belief that corporate balance sheets are not quite as strong as official data suggest.

[SLIDE] Looking over the forecast horizon as a whole, we see business investment increasing by around 40 percent over the next five years. This looks plausible when you consider that it rose by 50 per cent in the equivalent period of the last recovery, following a very similar decline during the recession.

[SLIDE] Looking briefly at other components of demand:

- housing investment is forecast to revive as activity in the housing market returns towards normal;

- government consumption and investment looks slightly less negative for growth, as the Coalition's spending cuts are showing up more in prices than output than we originally assumed; and

- net trade makes a positive but diminishing contribution to growth, with a slightly weaker forecast than in November thanks to weaker export demand.

[SLIDE] Turning to the labour market, little change to our growth forecasts means little change to our forecasts for ILO employment and unemployment. We see the unemployment rate rising from its current 8.4% to peak at around 8.7% at the end of this year.

We have though revised down our forecasts for claimant account unemployment, especially in the mid years of the forecast. This reflects recent data, plus a change in the way that policies affecting the number of people on Jobseekers' Allowance are incorporated into the forecast.

Our fiscal forecasts imply a small reduction in the amount of money available to pay for public sector workers since November, although they are also likely to be slightly cheaper. The net result is that we now expect general government employment to fall by 730,000 between the beginning of 2011 and the beginning of 2017, 20,000 more than in November. As in November, this is outweighed by a 1.7 million expected increase in market sector employment.

[SLIDE] Our CPI inflation forecast has been revised down a bit since November. We now expect CPI inflation to fall slightly below the Government's 2 per cent target in 2013 and 2014 before returning to it thereafter. The Budget announcements on VAT and excise duties have a very small upward effect on the inflation rate in 2012 and 2013. We do note in the report that oil prices pose a risk to the inflation forecast and indeed to the broader economic forecast given recent increases.

[SLIDE] Assessing the potential level of economic activity – in other words the amount of goods and services that the economy could produce while keeping inflation stable – is a key judgement in all our forecasts. It determines how much growth the economy can sustain and how much of the budget deficit is structural rather than a temporary consequence of the state of the economic cycle. This depends on the

difference between actual output and potential output. This so-called 'output gap' is a measure of spare capacity in the economy.

Recent business surveys and labour market data suggest there was little change in the amount of spare capacity in the fourth quarter despite the fall in GDP. We estimate that the economy was running about 2.5 per cent below full capacity in the fourth quarter, a slightly smaller output gap than we anticipated in November. We estimate that the output gap was around 2.7 per cent for 2011 as a whole, [SLIDE] bang in line with the average of outside forecasters' estimates.

[SLIDE] Potential output has been growing relatively slowly since the recession ended, and this has been reflected in weak productivity growth. As in November, we assume that potential output growth will return to its long-run rate of about 2.3 per cent a year over the next couple of years as financial and credit conditions normalise.

[SLIDE] Our forecasts for the level of potential output over the forecast horizon are broadly in line with those of the OECD and the IMF and slightly more optimistic than those of the European Commission. They all imply a permanent loss of potential relative to the pre-crisis trend. It is this apparent permanent loss of potential that helps explain the structural deterioration in the public finances that has accompanied the financial crisis and the recession, and the consequent need for fiscal consolidation.

So let me turn now to the public finances.

[SLIDE] We have revised down our forecast for public sector net borrowing this year by just over £1 billion to £126 billion. Government departments look likely to spend about £6 billion less than originally planned and £5.5 billion less than we anticipated in November. This under-spending led a number of outside forecasters to predict that we would make a bigger downward revision. The reason we have not is that tax receipts also look likely to come in about £5 billion lower than we forecast in November, notably from the self-assessment returns just in. That helps explain why this morning's public sector finances release for February was so much worse than market expectations.

[SLIDE] Looking further ahead, public sector net borrowing is expected to decline at roughly the same rate that it has done over the last couple of years to around £21 billion or 1.1 per cent of GDP by 2016-17. Our deficit forecasts are all slightly smaller than they were in November, with the exception of next year's deficit which is much smaller. This reflects the decision to transfer the Royal Mail's historic pension deficit and associated assets into the public sector.

[SLIDE] As we foreshadowed in November' EFO, this will have three main effects:

- First, there will be a one-off cut in net borrowing of £28 billion in 2012-13 as the assets, worth this amount, are transferred:

- Second, there will be a reduction in public sector net debt of around £18 billion next year rising to £23 billion in 2013-14 and beyond as the assets are sold; and

- Third, the Government will have to find between £1.3 billion and £1.6 billion a year to pay the pensions of the retirees affected.

The cut in borrowing and debt mean that the transfer looks highly beneficial for the government's finances over our forecast horizon. But this is not true over the longer term as the value of the assets it will receive is about £10 billion smaller than the expected present value of the pension payments it will eventually have to make.

[SLIDE] Looking at the detail of the public finance forecasts, neither the receipts forecast nor the expenditure forecast have changed much since November at the end of our forecast horizon in 2016-17.

On the receipts side the net change is tiny, with gains from higher profits, less use of capital allowances, higher VAT receipts and higher share prices offset by weaker self-assessment receipts and the impact of lower oil production and a weaker property market.

On the expenditure side we have revised down total spending by £2.4 billion at the end of the forecast. Lower interest rates push down debt interest costs. There are Budget measures, such as the reduction in the

Afghanistan special reserve. And the Government has also announced a cap on the potential costs of Universal Credit.

[SLIDE] So where does all this leave us with respect to the Government's two fiscal targets? The fiscal mandate requires the Government to set policy so as to have a better than 50 per cent chance of balance or surplus on the cyclically adjusted current balance at the end of the rolling five-year horizon. This means raising enough revenue to pay for all non-investment spending, adjusting for the state of the economic cycle.

In November we estimated that the Government was on course to achieve the fiscal mandate with about £9 billion or half a percent of GDP to spare. The fact that the output gap is slightly smaller throughout this forecast than in November means that more of the deficit now looks structural. This removes 0.2 percentage points of the Government's margin for error. But this is almost entirely offset by other forecasting changes. Once you also take into account the very small improvement in the current budget balance delivered by the Budget measures, this leaves the margin for error against the mandate essentially unchanged since November.

[SLIDE] Needless to say, there is huge uncertainty around such projections – as there is around all our economic and fiscal forecasts. We can draw a flamethrower of uncertainty around our central forecast, showing the probability of different outcomes based on past official forecasting errors, and this suggests that the Government has about a 60 per cent chance of meeting the mandate on current policies – unchanged since November.

[SLIDE] The supplementary target requires the ratio of public sector net debt to GDP to be falling in 2015-16. If we compare our November and March forecasts, we can see that the transfer of Royal Mail pension fund assets has lowered the expected debt level right across the forecast. But it has not affected the change in the debt ratio from 2014-15 to 2015-16, which remains 0.3 percent of GDP – so there is still some margin for error there too, and the same amount as in November.

[SLIDE] Now let me say a little about the way we have dealt with the cut in the 50p additional rate of income tax on incomes above £150,000.

One of our tasks is to judge whether we believe that the Government's costing of the rate cut is "reasonable and central". It is not our job to say whether it is a good idea or whether it is better than any alternatives. The costing in the Budget has been informed by HMRC's detailed analysis of 2010-11 self assessment tax returns, most of which were returned early this year. HMRC have published this analysis alongside the Budget.

This study also casts light on how much the 50p rate is likely to have raised in 2010-11 and how much we might expect it to raise if the Government left it in place. We need to check that our baseline forecast is consistent with any new information here, as early OBR forecasts implicitly inherited the final pre-implementation costing of the 50p rate from the March 2010 Budget.

[SLIDE] That Budget costing suggested that the 50p rate would raise about £2.7 billion in 2012-13. Roughly 300,000 people would have been expected to pay an additional £7.5 billion of tax if none of them had changed their behaviour. But the costing assumed that roughly £4.9 billion of this would never materialise because people **would** change their behaviour. They might reduce the amount of labour they supply, for example by working less, retiring early or leaving the country. Or they might engage in more tax planning, avoidance and evasion.

This is a pretty big behavioural response and it assumed that the Government would lose about two-thirds of the static revenue. But some of you may recall that, when I was at the IFS, Mike Brewer and other colleagues produced an estimate suggesting that the behavioural response was if anything likely to be even bigger and the amount of revenue raised even smaller. But we all emphasised at the time how uncertain all such estimates are.

[SLIDE] So what do we learn from the HMRC analysis?

One of the most striking findings is that people affected by the tax rate seem to have shifted at least £16 billion of income into 2009-10 from future years in order to avoid the 50p rate. This forestalling behaviour might include closed company directors deciding to bring forward

planned dividend payments. This only goes to show how much high income individuals' behaviour can respond to tax changes.

The HMRC analysis also suggest that underlying behavioural response I talked about a moment ago has been bigger than the original costings suggested – around or even greater still than the IFS estimate. Judging the scale of these effects is enormously difficult with just a short period of data to go on, but the Government has chosen to cut the rate now and we and they therefore need to make some judgement to come up with a costing and to ensure that we have the right baseline forecast.

The Government has chosen to assume that the underlying behavioural response is broadly in line with the IFS estimate rather than that used in the original costing. This implies that the introduction of the 50p rate would have resulted in a bigger fall in taxable income and less revenue than the original costings assumed. We discussed the choice of behavioural response at length with HMRC and the Treasury and we believe that this is a reasonable and central judgement given the evidence available.

[SLIDE] Having made that judgement, the first thing we have to do is to ensure that our baseline pre-measures forecast recognises the likelihood that the 50p rate would raise less than originally assumed. Given the tax rate we are starting from – and the expected strength of the behavioural response – we can work out how much it would raise or cost to move the additional rate up or down from 50p. And you can draw what is called a 'Laffer curve' to link all the answers together.

[SLIDE] The Laffer curve that you end up with implies that it would cost around £700 million in 2013-14 to cut the 50p rate right back to 40p.

[SLIDE] This suggests that the earliest OBR forecasts overestimated the revenues from the 50p rate in that year by about £2bn.

Alternatively, you can ask what would happen if you started at 40p and moved up to 50p. Annoyingly, if you use the same mathematical calculation – called the taxable income elasticity – to summarise the behavioural effect, but start from a different tax rate, you end up with a slightly different Laffer curve. That would show you raising around £1.2-1.3 billion from the 50p rate, as shown in this year's IFS Green Budget.

That would imply that the revenue from the 50p rate had been overestimated by around £1.5 billion. We have used the former method in the EFO so as to tell a consistent story about costing future rate changes, but in practice the difference would come out in the wash as revenue outturns were incorporated in future forecasts.

We now need to take the overestimate of the 50p yield out of our baseline forecast before costing the cut to 45p. But, in fact, this has already happened to a significant degree. PAYE receipts came in weaker than we expected through 2010-11 and into 2011-12 and we revised earlier OBR forecasts accordingly. But at the time we didn't have the evidence to attribute these downward revisions to the 50p rate. The new HMRC analysis also suggests that our previous adjustments for forestalling were far too low, so we have now incorporated better estimates of their level and timing.

[SLIDE] So now let us turn to the costing of the move to 45p. [SLIDE] As you can see, the cost is tiny at between £50 and £100 million because we are simply strolling across the summit of the Laffer curve. The behavioural response we have assumed implies that the revenue maximising additional rate would be around 48p, so moving from just above it to just below it would have very little revenue effect. As we saw a moment ago, moving to 40p would be proportionately more expensive at £700 million because the Laffer curve gets steeper as the tax rate moves further below 48p.

[SILDE] If the Government had stuck with the original, smaller, behavioural response assumption – and the Laffer curve which that implies – the cut from 50p to 45p would have been cost at around £800 million [SLIDE] and from 50p to 40p at £2.1 billion. (All these figures depend on exactly which year you are looking at.)

[SLIDE] As I noted earlier, we believe that the new behavioural response assumption – and the costings that it implies – are reasonable and central given the evidence available. Taken in isolation, the range of estimates in the HMRC study might point to an even bigger behavioural response and to an even lower revenue maximising rate. In that world cutting the rate to 45p might well raise revenue rather than reducing it.

We don’t believe that it would have sensible to make such an assumption at this stage, as it would place too much weight on not even a full year’s data showing the 50p rate in action. One might also expect the behavioural response to this rate cut to be weaker than it was to the increase, given that they are so close together in time and that some of the behavioural responses would be expensive to reverse swiftly.

But it is important once again to emphasise the huge uncertainties that surround all such estimates. At the end of the day, we have to make a choice, even though the evidence is bound to change again in the future.

It is also important to remember that, even if we could estimate it with complete confidence, the behavioural response is not a mathematical constant like pi or e. It in part reflects policy choices about the structure of the tax system and the potential that creates for avoidance.

Thanks very much. We now have a little time for questions.