

Office for  
**Budget  
Responsibility**

**Economic and fiscal outlook**

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March 2012

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# Office for Budget Responsibility: Economic and fiscal outlook

Presented to Parliament by  
the Economic Secretary to the Treasury  
by Command of Her Majesty

March 2012

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# Foreword

The Office for Budget Responsibility (OBR) was established in 2010 to provide independent and authoritative analysis of the UK's public finances.

In this *Economic and fiscal outlook (EFO)* we set out forecasts for the period to 2016–17. We also make an updated assessment of whether the Government is on course to meet the medium-term fiscal objectives that it has set itself. The forecasts presented in this document represent the collective view of the three independent members of the OBR's Budget Responsibility Committee (BRC). We take full responsibility for the judgements that underpin them and for the conclusions we have reached.

We have, of course, been hugely supported in this by the full-time staff of the OBR. We are enormously grateful for the hard work, expertise and professionalism that they have brought to the task. Given the highly disaggregated nature of the fiscal forecasts we produce, we have also drawn heavily on the help and expertise of officials across government, including in HM Revenue and Customs, the Department for Work and Pensions, HM Treasury, the Department for Communities and Local Government, the Department for Business, Innovation and Skills, the Department of Energy and Climate Change, the Office for National Statistics, the UK Debt Management Office, the Home Office and the various public sector pension schemes. We are very grateful for their time and patience. We have also had useful exchanges with staff at the Bank of England, the Institute for Fiscal Studies and the National Institute for Economic and Social Research, regarding their recent forecasts, for which again we are very grateful.

The forecast process for this *EFO* has been as follows:

- In January, the Treasury requested that we finalise the Budget forecast on a 'pre-measures' basis (i.e. before incorporating the effect of new policy announcements) around two weeks ahead of the Budget, which is earlier than in previous events, in order to provide the Chancellor with a stable base for his final policy decisions. We agreed to this request and wrote to the Chancellor on 17 January to set out the forecast timetable and the main analytical issues that we would be considering for the forecast. The Chancellor replied to confirm his agreement to the timetable on 30 January.

- We began the forecast process with the preparation by OBR staff of a revised economic forecast, drawing on economic data released since the last published forecast in November 2011 and with our preliminary judgements on the outlook for the economy.
- Using the economic determinants (such as growth, inflation and unemployment) from this forecast, we then commissioned new forecasts from the relevant Government departments for the various tax and spending streams that determine the state of the public finances. We then discussed these in detail with the officials producing them, which allowed us to investigate proposed changes in forecasting methodology and to assess the significance of recent tax and spending outturns. In many cases, the BRC requested changes to methodology and/or the interpretation of recent data.
- We sent our first economic forecast to the Chancellor on 27 January and our first fiscal forecast, including a provisional judgement on progress towards meeting the fiscal mandate, on 3 February. We provided the Chancellor with these early forecasts and provisional judgement on compliance with the fiscal mandate in order to inform his policy choices for the Budget.
- As the forecasting process continued, we identified the key judgements that we would have to make in order to generate our full economic forecast. Where we thought it would be helpful, we commissioned analysis from the relevant experts in the Treasury and consulted outside forecasters to help inform our views. The BRC then agreed the key judgements, allowing the production by OBR staff of a second full economic forecast.
- This provided the basis for a further round of fiscal forecasts. Discussion of these forecasts with HMRC, DWP and the other departments gave us the opportunity to follow up the various requests for further analysis, methodological changes and alternative judgements that we made during the previous round. We provided the second round economic and fiscal forecast to the Chancellor on 23 February.
- Meanwhile, we also began to scrutinise the costing of tax and spending measures that were being considered for announcement at the Budget. The OBR requested a number of changes to the draft costings prepared by HMRC and DWP. We have certified all of the final published costings for new Budget policies as reasonable and central estimates. In the Treasury's Budget 2012 policy costings document we highlight the uncertainties around a number of the costings.
- We then produced a third economy and fiscal forecast which allowed us to take on latest data and to ensure that our judgements on the fiscal forecast

had been incorporated. In line with the agreement in January this was our final pre-measures forecast, and we made no further material changes after this point except to incorporate the direct and indirect effects of new policy measures. We finalised this forecast and sent it to the Chancellor on 7 March, and we met with him and Treasury officials to discuss it on 12 March. The forecast set out in this EFO therefore represents our central view of the economic and fiscal outlook as of 7 March.

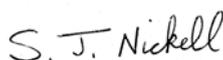
- During the week before publication we produced our final forecast, incorporating the effects of the final package of new policy measures. To this end we were provided with final details of all major policy decisions with a potential impact on the economy forecast on 12 March. We provided the Treasury with our final post-measures economic and fiscal forecast on 17 March. Our final fiscal forecast included the direct fiscal effects of the full set of Budget policy decisions, the final version of which was provided to us on 16 March.
- At the Treasury's written request, and in line with pre-release access arrangements for data releases from the ONS, we provided the Chancellor with a full draft of the *EFO* on 16 March. This allowed the Treasury to prepare the Chancellor's statement and documentation. We provided a full and final copy 24 hours in advance of publication.

During the forecasting period, the BRC has held around 75 scrutiny and challenge meetings with officials from departments, in addition to numerous further meetings at staff level. We have been provided with all the information and analysis that we requested. We have come under no pressure from Ministers, advisers or officials to change any of our conclusions as the forecast has progressed. A full log of our substantive contact with Ministers, their offices and special advisers can be found on our website.

We would be pleased to receive feedback on any aspect of our analysis or the presentation of the analysis. This can be sent to [OBRfeedback@obr.gsi.gov.uk](mailto:OBRfeedback@obr.gsi.gov.uk).



Robert Chote



Steve Nickell



Graham Parker

The Budget Responsibility Committee



# 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

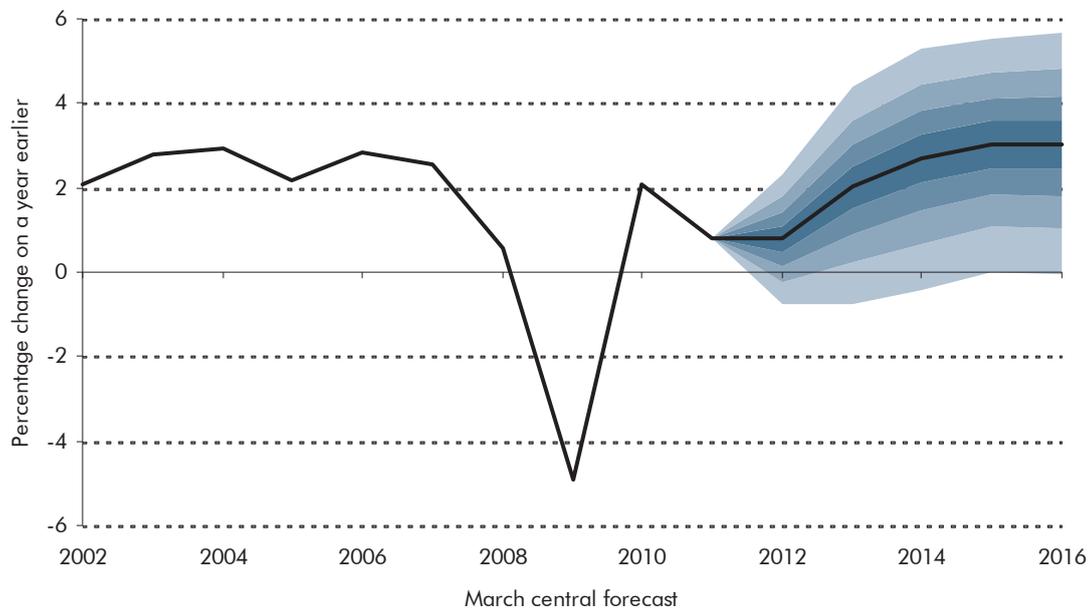


Table 1.1: Economic forecast overview

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast <sup>1</sup>					
	2010	2011	2012	2013	2014	2015	2016
<b>Output at constant market prices</b>							
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
<b>Expenditure components of GDP at constant market prices</b>							
Household consumption <sup>2</sup>	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 <sup>3</sup>	-0.5	1.2	0.4	0.5	0.3	0.2	0.1
<b>Inflation</b>							
CPI	3.3	4.5	2.8	1.9	1.9	2.0	2.0
<b>Labour market</b>							
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Average earnings <sup>4</sup>	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
<b>Changes since November forecast</b>							
<b>Output at constant market prices</b>							
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
<b>Expenditure components of GDP at constant market prices</b>							
Household consumption <sup>2</sup>	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 <sup>3</sup>	0.3	0.1	0.1	-0.1	0.0	0.0	0.0
<b>Inflation</b>							
CPI	0.0	0.0	0.1	-0.2	-0.1	0.0	0.0
<b>Labour market</b>							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Average earnings <sup>4</sup>	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

<sup>1</sup> 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.

<sup>2</sup> Includes households and non-profit institutions serving households.

<sup>3</sup> Contribution to GDP growth, percentage points.

<sup>4</sup> 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
<b>Fiscal mandate and supplementary target</b>								
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 <sup>1</sup>	52.5	60.5	67.3	71.9	75.0	76.3	76.0	74.3
<b>Changes since November forecast</b>								
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 <sup>1</sup>	-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

<sup>1</sup> 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
<i>of which:</i>						
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  $\frac{3}{4}$  per cent of potential GDP narrower, or rather the level of potential output  $\frac{3}{4}$  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.



## 2 Developments since the November 2011 forecast

### Summary

- 2.1 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.
- 2.2 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.
- 2.3 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.
- 2.4 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 – the target year for the Government's fiscal mandate. 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.

## Introduction

2.5 This chapter summarises:

- the main economic and fiscal data developments since our last forecast in November 2011 (from paragraph 2.6);
- recent external forecasts for the UK economy (from paragraph 2.16) and how these have responded to data developments (from paragraph 2.28); and
- the policy measures that have been announced since November and the impact we expect these to have on our forecasts (from paragraph 2.32).

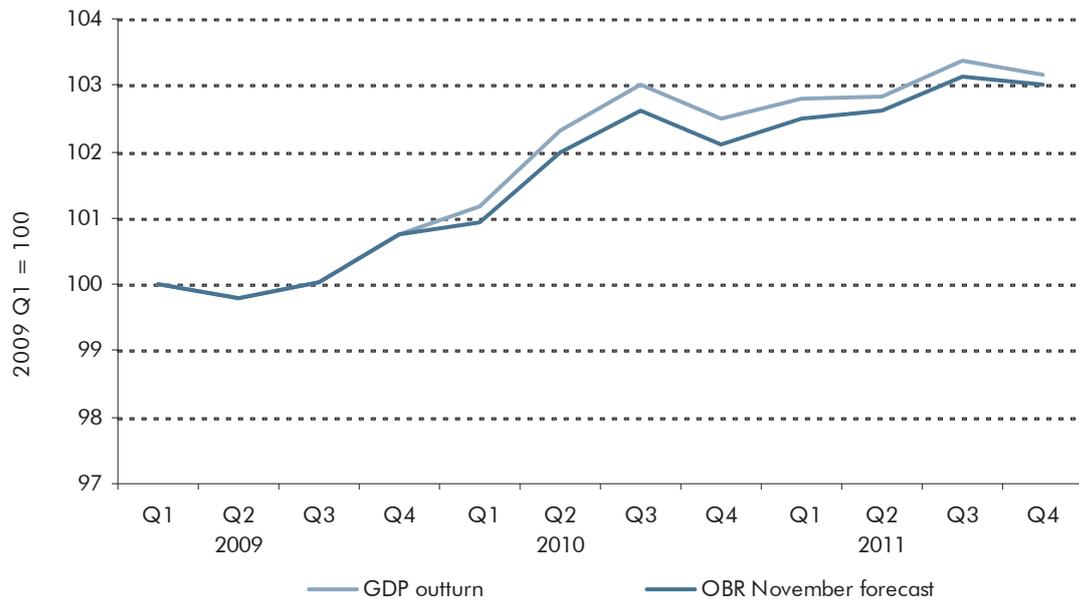
## Economic developments since the November 2011 forecast

2.6 Since our November forecast, the ONS has published *Quarterly National Accounts* for the third quarter of 2011 and the *Preliminary and Second Estimates of GDP* for the final quarter of 2011. The current estimate for GDP growth in the third quarter of 2011 is unchanged from previous estimates at 0.5 per cent. The ONS currently estimates that GDP then fell by 0.2 per cent in the final quarter of 2011, compared to our November forecast of a 0.1 per cent fall.

2.7 These data releases also included revisions to National Accounts data back to the first quarter of 2010. Chart 2.1 shows that these revisions have raised the estimated level of real GDP by around 0.1 per cent, with most of the increase occurring in the first quarter of 2010. As set out further in Box 2.1, annual GDP growth in 2010 has now been revised up significantly from the ONS's initial estimate of 1.4 per cent to the most recent estimate of 2.1 per cent.

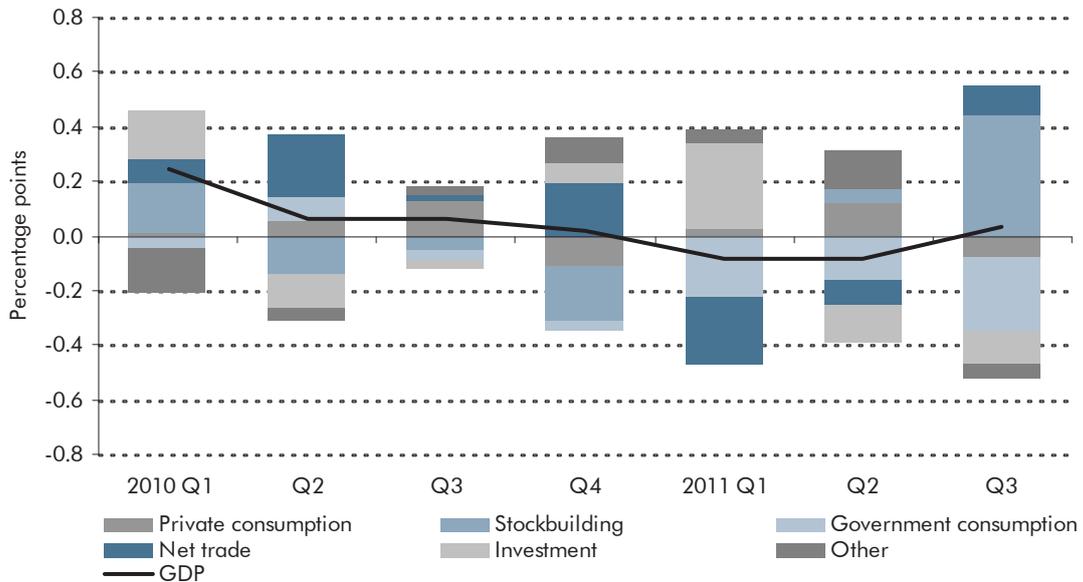
2.8 There have also been revisions to the composition of GDP growth, shown in Chart 2.2. Government consumption made a puzzlingly large contribution to GDP growth in 2011 in our November forecast. But the ONS has now revised government consumption growth down appreciably in both cash and volume terms, reducing its contribution to GDP growth by 0.7 percentage points in the first three quarters of 2011. This has been more than offset by smaller upward revisions spread fairly evenly across the other expenditure components.

Chart 2.1: Level of real GDP



Source: ONS, OBR

Chart 2.2: Revisions to the contribution of expenditure components to GDP growth



Source: ONS

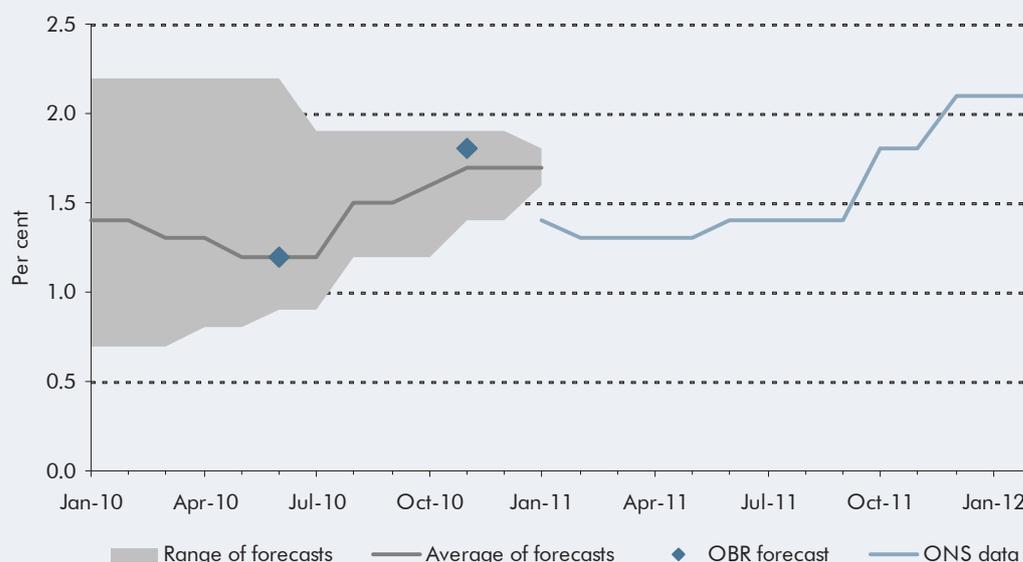
### Box 2.1: Rewriting history: real GDP growth in 2010

We noted in our November *EFO* that National Accounts data are subject to a continuous process of revision and that, over time, the incorporation of new data and improved methodologies have materially changed the profile of GDP growth in the early 1990s. The same applies even to more recent vintages of data.

Chart A shows the range of City, academic and other outside forecasts for real GDP growth in 2010 that were made each month through that year. Not surprisingly, the range of forecasts narrowed as early vintages of quarterly ONS data and more survey data were published. The chart also shows that the OBR's forecast in June 2010 was in line with the average of outside forecasts at that time, at 1.2 per cent, and that we increased our forecast to 1.8 per cent in November 2010, which at the time was slightly above the average outside forecast.

In January 2011, the ONS published its first outturn estimate for growth in 2010. Thanks to the unexpected 0.5 per cent fall in GDP in the fourth quarter, its initial estimate was just 1.4 per cent, lower than all 36 outside forecasts made at that time. But now, following a series of upward revisions, the current ONS estimate for growth in 2010 is 2.1 per cent – higher than every outside forecast made at the end of 2010 and all but two of those made at the start of 2010.

Chart A: Forecasts and outturns for real GDP growth in 2010



Source: ONS, OBR, HM Treasury

- 2.9 In the November *EFO*, we explained that up to the second quarter of 2011 the economy had grown significantly less quickly than we had forecast in June 2010. Our analysis suggested that much of this shortfall could be explained by an external inflation shock, which had not been offset by higher earnings and had instead squeezed real consumer spending. The latest revisions to the National Accounts data are still consistent with this conclusion, although they have made it slightly harder to interpret the path of the economy over this period. Currently the sum of the expenditure components of GDP for the period is less than total GDP growth, meaning there is a statistical discrepancy in the current ONS data, representing around a quarter of the 1.6 per cent GDP growth between the first quarter of 2010 and the second quarter of 2011.
- 2.10 Since the end of 2011, survey evidence has begun to show signs of improvement. For example, the *CIPS Purchasing Managers' Index* indicated a strengthening of activity at the end of 2011 and in the first two months of this year. The Confederation of British Industry (CBI)'s *Industrial Trends Survey* also reported a strengthening in order books in manufacturing, as well as an improvement in export orders in February. The *Gfk Confidence* and the *Nationwide Consumer Confidence* measures have shown some rises in early 2012 but both measures continue to remain below their long-term averages. Retail sales volumes growth rates have picked up at the end of 2011 and have continued to grow in January. After we closed this forecast on 7 March, the ONS published figures for industrial production and construction. The production numbers showed an overall decline in January but a marginal increase in manufacturing output. The construction numbers recorded a sizeable fall in January, but the numbers are not seasonally adjusted, making it difficult to discern the implications for GDP growth.
- 2.11 The labour market has performed broadly in line with our November forecast. The overall level of employment rose to just above 29.1 million in the final quarter of 2011, slightly above the 29.0 million we forecast in November (Chart 2.3). This increase was mainly driven by a rise in part-time employees, in particular 'involuntary' part-time workers who say they would like but cannot find a full-time job. Despite this, average hours worked per week were unchanged in the fourth quarter as the average hours of full-time workers picked up slightly. Taken together with the increase in employment, this implied an increase in total hours worked per week of around 3.7 million on the previous quarter, to 917.4 million. The unemployment rate increased for the third consecutive quarter, but was slightly lower than we expected in the three months to December, at 8.4 per cent.
- 2.12 The claimant count measure of unemployment has performed significantly better than we expected in November. The claimant count stood at just over 1.60 million in January and February, just less than 100,000 lower than our

November forecast for the first quarter of 2012. The level of claimant count unemployment has now been broadly stable since September 2011.

Chart 2.3: LFS employment and November forecast

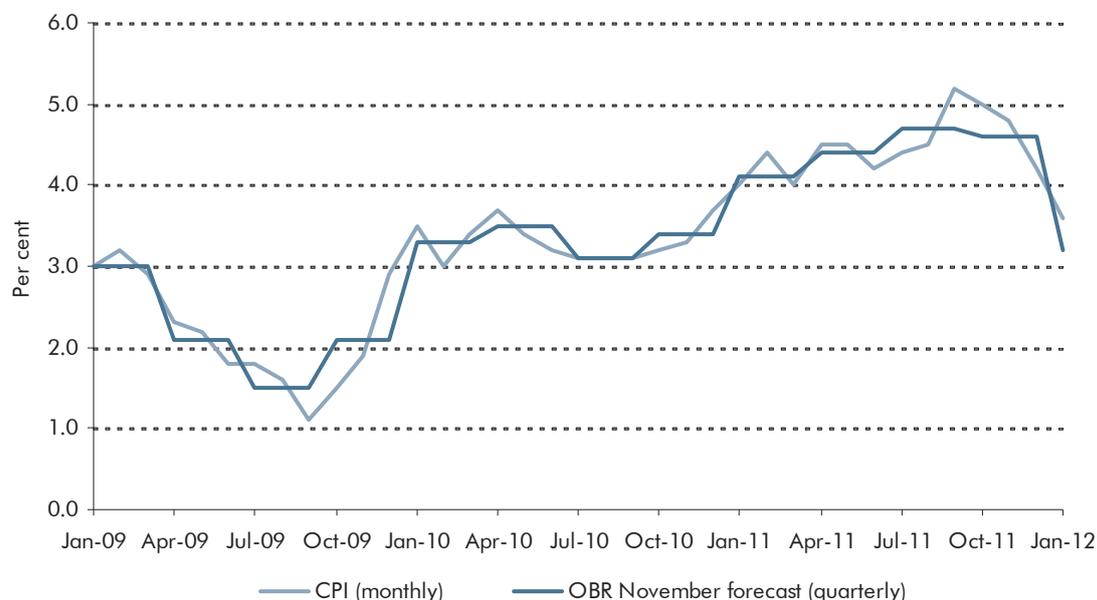


Source: ONS, OBR

2.13 Annual CPI inflation was broadly in line with our November forecast in the final quarter of 2011 (Chart 2.4). Since November, it has continued to fall from its peak of 5.2 per cent in September 2011, as petrol price increases in late 2010 have fallen out of the annual comparison. In January 2012, CPI inflation fell to 3.6 per cent as some of the impact of the previous January’s rise in VAT, a one-off shock to the price level, dropped out of the annual comparison.<sup>1</sup>

<sup>1</sup> Our current forecast takes into account inflation outturns up to and including January 2012.

Chart 2.4: CPI inflation and November forecast



Source: ONS, OBR

- 2.14 At the end of last year the euro area economy performed more weakly than we expected in our November forecast, shrinking by 0.3 per cent in the fourth quarter rather than falling by 0.1 per cent. However, since the turn of the year, the ECB’s long-term refinancing operations seem to have eased immediate tensions in the euro area financial markets significantly. Developments in the US have surprised on the upside with output growth of 0.7 per cent in the last quarter of 2011.
- 2.15 Overall world output growth moderated towards the end of 2011, broadly in line with our November forecast. Some survey evidence points towards a pick up in world activity at the start of the 2012. The JP Morgan *Global Composite PMI*, for example, rose in February to a 12-month high after having dropped to a post-recovery low in October. In line with weak global demand, growth in world trade was relatively flat in the last months of 2011.

## Fiscal data developments since November

- 2.16 The joint Office for National Statistics and HM Treasury statistical bulletin on the public sector finances provides monthly data on central government receipts and expenditure and provisional estimates for the public sector fiscal aggregates. Since our previous forecast, bulletins have been released which cover the public finances over the months from November to February. Total central government receipts growth in these months was lower than our November forecast, mainly reflecting a significant shortfall in self-assessment receipts. Central government

spending growth over this period was also significantly lower than we forecast. These developments and their implications for our latest fiscal forecast are discussed in more detail in Chapter 4.

## Developments in outside forecasts

- 2.17 Many City, academic and other outside organisations forecast the UK economy, using a wide array of techniques and data. A number of publications collate these forecasts and average them.<sup>2</sup> This section sets out some of the movements in the outside forecasts collected since our November forecast.
- 2.18 When interpreting the average of outside forecasts, it is important to bear in mind that different analysts forecast different subsets of variables. This means that the average forecast is not constrained to paint an internally consistent picture, which makes it difficult to compare it with our own forecasts.

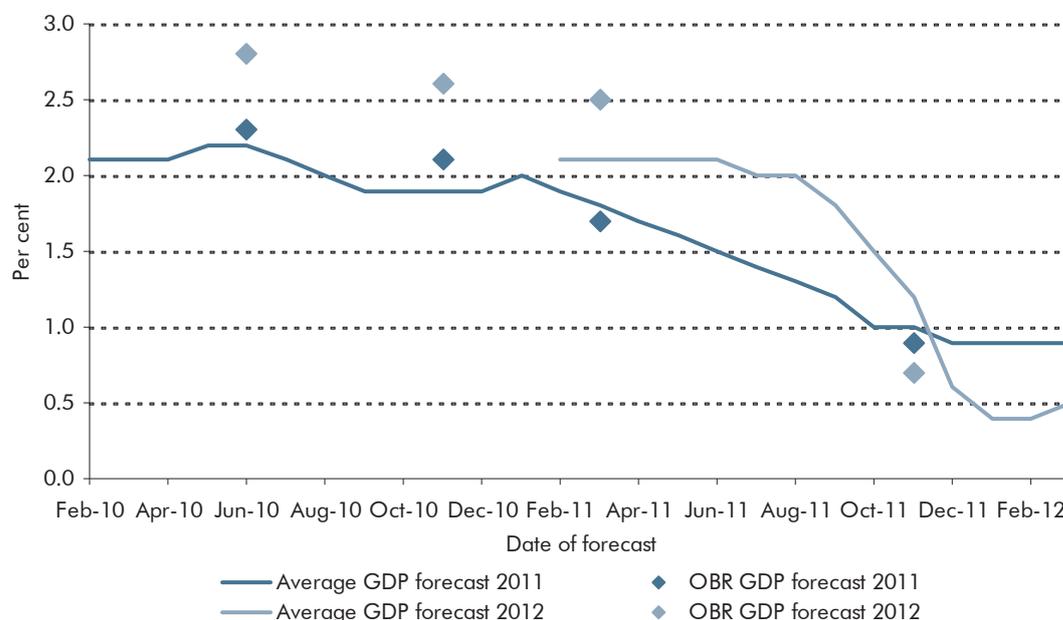
## Growth

- 2.19 As Chart 2.5 shows, our November forecast for GDP growth in 2012, of 0.7 per cent, was below the average of outside forecasts submitted in the three months to November 2011. The average forecast has since fallen sharply and for the three months to March 2012 it is now below our November forecast, at 0.5 per cent. There was a continued deterioration in forecasters' views of the UK economic outlook towards the end of 2011, as the euro area financial crisis intensified and UK economic activity surveys weakened.
- 2.20 The average forecast for private consumption growth in 2012, submitted in the three months to November was 0.6 per cent, declining to 0.4 per cent in the three months to March. Those for fixed investment growth were revised down by 2.7 percentage points, to 0.2 per cent, and the average forecast for the net trade contribution as a percentage of GDP has remain unchanged at 0.4 per cent.

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<sup>2</sup> See HM Treasury, March 2012, *Forecasts for the UK economy: a comparison of independent forecasts*. A full list of contributors is available at the back of the Treasury publication. A number of financial reporting services also monitor these average or consensus figures.

Chart 2.5: Average forecasts for GDP growth in 2011 and 2012



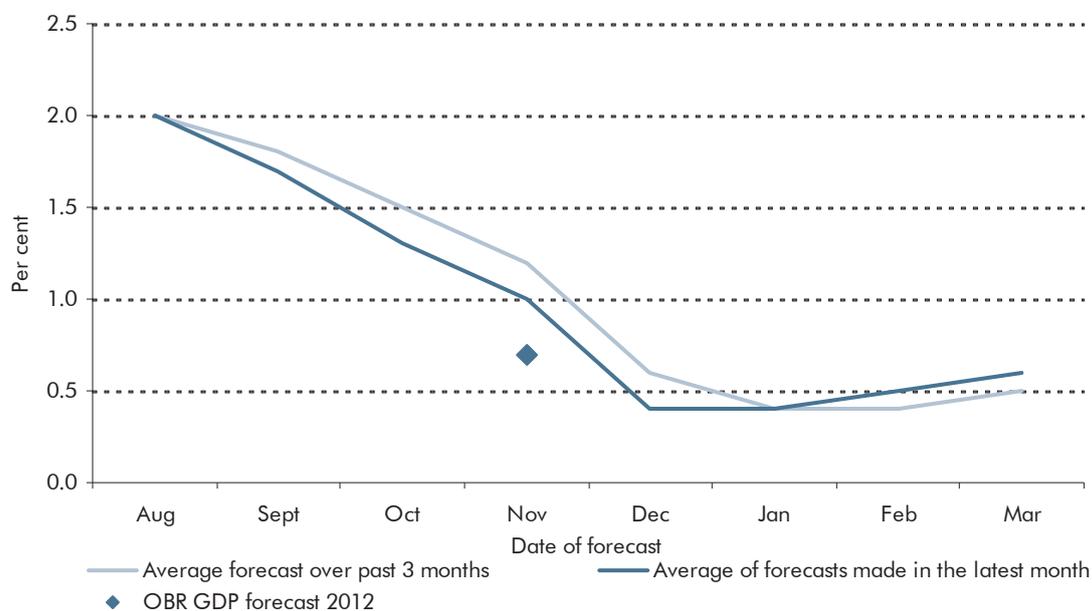
Source: HM Treasury, OBR

2.21 The average of outside forecasts for GDP growth in 2012, submitted in the three months to January and February, remained unchanged at 0.4 per cent, rising slightly to 0.5 per cent in the three months to March. However, Chart 2.6 shows that there has been some upward movement in the forecasts submitted in February and March only, which is likely to reflect the improvement in some survey indicators at the beginning of 2012.

2.22 Looking at the smaller sample of medium-term forecasts,<sup>3</sup> the average forecasts for GDP growth in 2013 and 2014 have fallen since November by 0.4 and 0.2 percentage points respectively. The average forecast for GDP growth in 2015 was 2.4 per cent, down 0.1 percentage points since November. The downward revisions reflect a fall in the expected contribution of domestic demand, although there have also been small downward revisions to the expected contribution of net exports.

<sup>3</sup> See HM Treasury, February 2012, *Forecasts for the UK economy: a comparison of independent forecasts*.

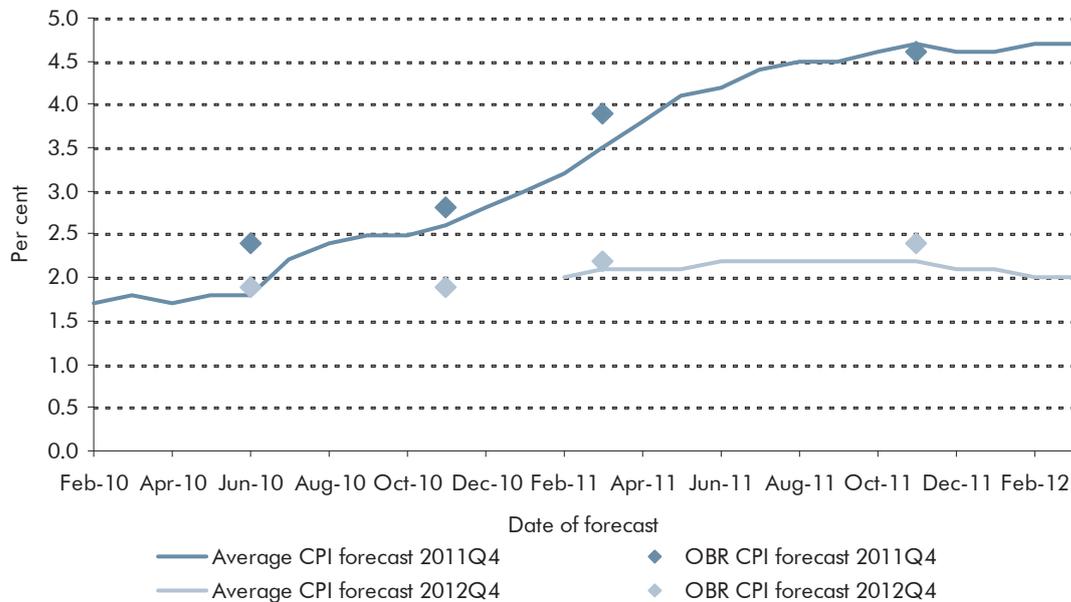
Chart 2.6: Average of new forecasts for GDP growth in 2012



## Inflation

**2.23** The average outside forecast for CPI inflation in the fourth quarter of 2012 has fallen by 0.2 percentage points since November (Chart 2.7). The average forecast for RPI inflation in the final quarter of 2012 has fallen by 0.3 percentage points, to 2.5 per cent. CPI inflation forecasts for the fourth quarter of 2012 vary from 1.3 to 3.0 per cent. This wide range reflects the uncertainty surrounding the inflation outlook in 2012, including prospects for energy and commodity prices.

Chart 2.7: Average forecasts for CPI inflation in the fourth quarter of 2011 and 2012



Source: HM Treasury, OBR

## Labour market

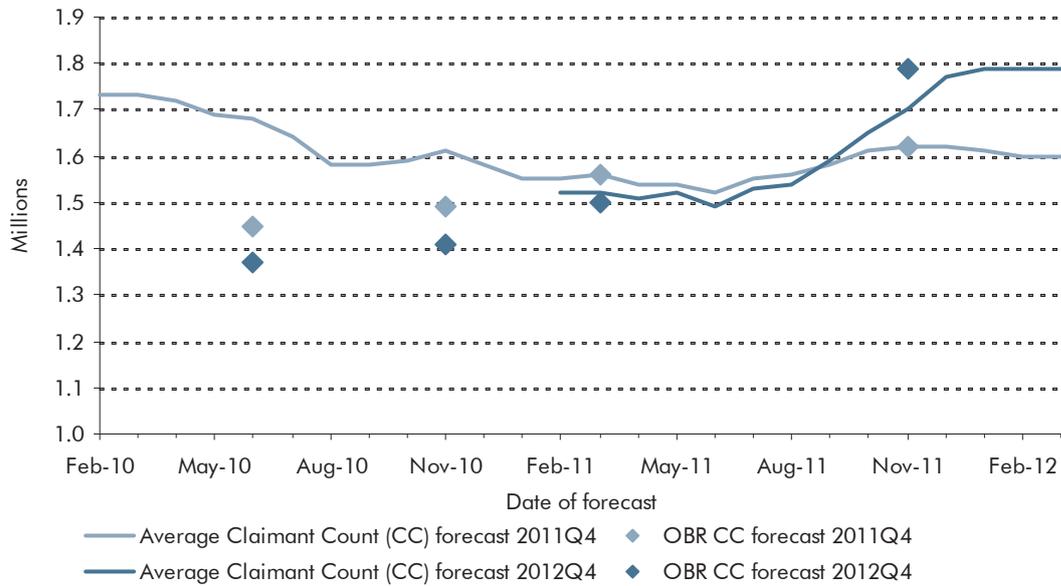
2.24 The average forecast for claimant count unemployment in the fourth quarter of 2012 has generally been rising since June 2011 and has risen by 90,000 since November – it currently stands at 1.8 million (Chart 2.8). The average forecast for employment growth in 2012 fell between November and March by 0.2 percentage points to -0.4 per cent.

2.25 The average forecast for claimant count unemployment in the medium term is measured by the annual average rather than the fourth quarter. This has been revised up in the medium term, with the largest revision in 2015, up by 120,000, from 1.44 million to 1.56 million.

## Public finances

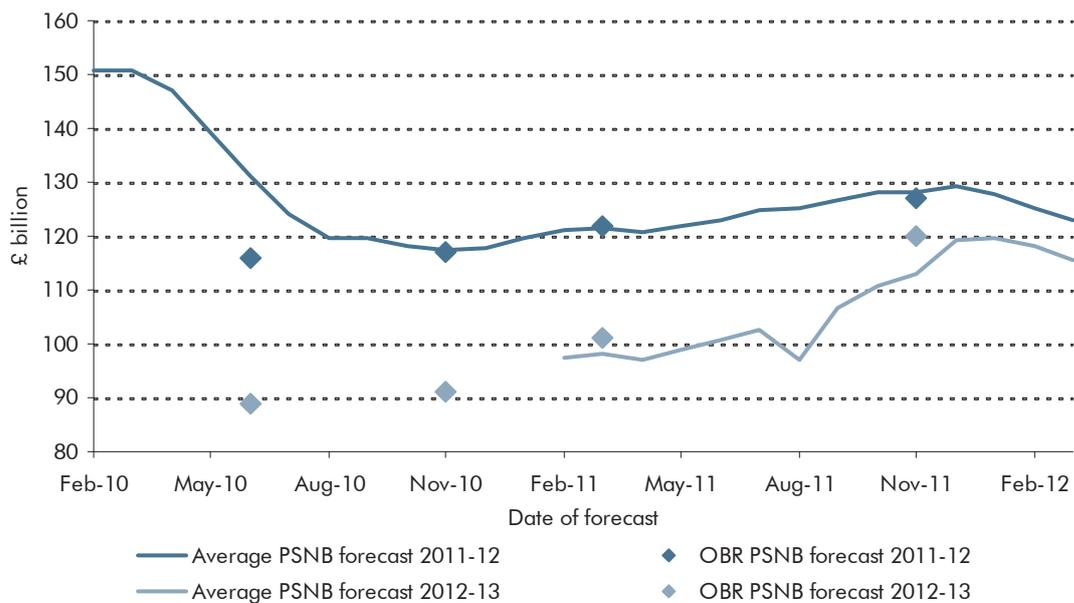
2.26 The average forecast for public sector net borrowing (PSNB) for 2011-12 has declined since November from £128 billion to £123 billion. The average forecast in the three months to March for PSNB in 2012-13 was £115.6 billion, £2.8 billion higher than in the three months to November (Chart 2.9).

Chart 2.8: Average forecast for claimant count in the fourth quarter of 2011 and 2012



Source: HM Treasury, OBR

Chart 2.9: Average forecast for PSNB in 2011-12 and 2012-13

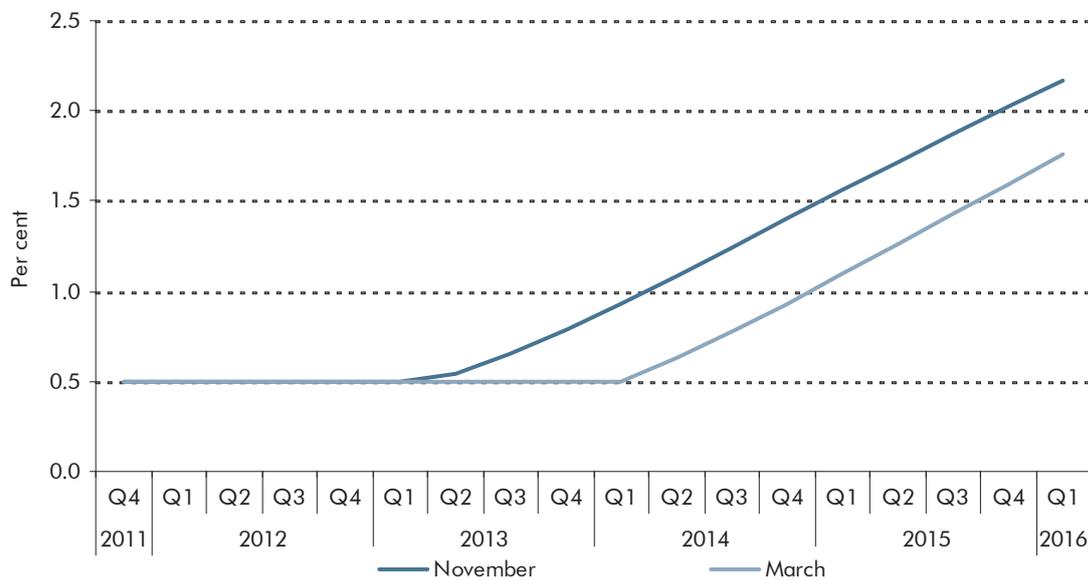


Source: HM Treasury, OBR

## Market expectations of interest rates

2.27 Expectations of interest rates derived from financial market instruments have direct implications for our forecast, as we assume that monetary policy follows the path expected by participants in financial markets. As Chart 2.10 demonstrates, market expectations are now lower than in November from 2013 onwards.

Chart 2.10: Market expectation of three month gilt rates



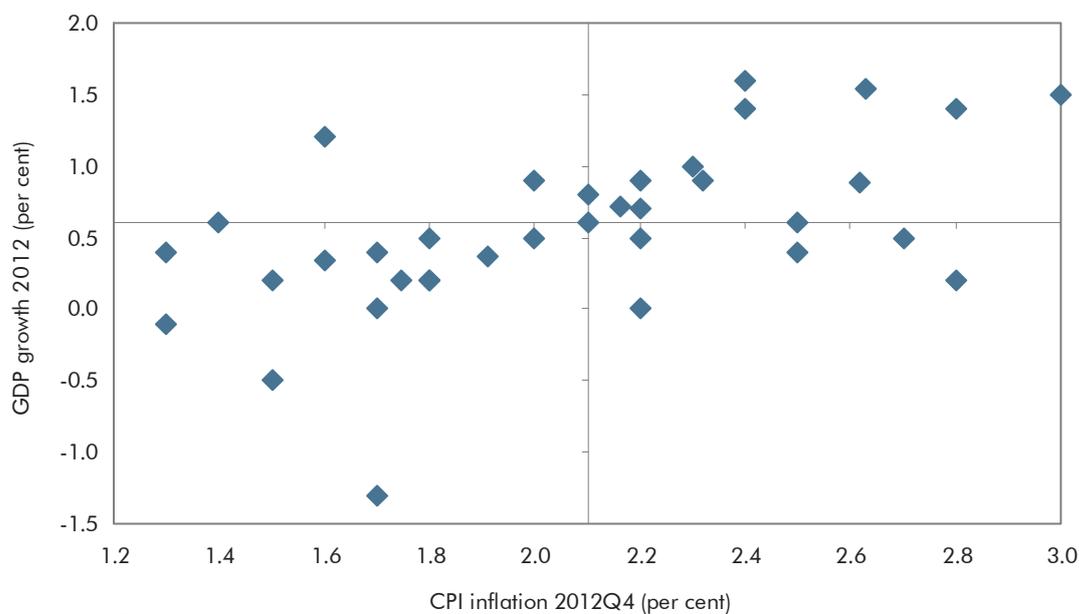
Source: Bank of England

## Forecast dispersion

2.28 Looking at an average of external forecasts facilitates easy comparison, but it does not capture how much consensus there is around those figures. It can therefore be informative to look at the dispersion of forecasts.

2.29 Chart 2.11 illustrates the dispersion of short-term forecasts by plotting current external GDP growth and CPI inflation forecasts for 2012. One explanation for the wide dispersion of forecasts could be different estimates of the current 'output gap', the difference between the economy's actual level of output and its estimated potential level.

Chart 2.11: Distribution of external forecasts for CPI inflation and GDP growth in 2012



Source: HM Treasury

2.30 Forecasters differ not just in their numerical forecasts for key variables, but also in their assessment of important economic and policy trends. Differences of opinion on such trends can help explain the dispersion of external forecasts. A current key topic of debate is the uncertainty surrounding developments in the euro area, and the size of the impact on the outlook for UK trade, credit conditions and confidence. Another key issue is the risk of a further significant increase in oil prices, potentially linked to political tensions in the Gulf region.

2.31 We investigate the potential impact of these differences in view on our fiscal forecasts through the use of scenarios. In Chapter 5 we examine the potential impact on our central economic and fiscal forecasts of:

- the 'OECD stylised downside scenario in the euro area', in which a disorderly sovereign debt restructuring leads to a tightening in credit conditions and significantly lower growth; and
- a 'temporary oil price spike' scenario, in which a temporary shock raises oil prices significantly in the short-term.

## Policy announcements in Budget 2012

- 2.32 The economic and fiscal forecasts that we present in Chapters 3 and 4 reflect recent economic and fiscal developments described in this chapter. But, unlike the external forecasts summarised in the previous section, we are able to take into account the likely impact of policy measures announced in the Chancellor's Budget 2012 Statement.
- 2.33 Consistent with the *Charter for Budget Responsibility*, the OBR only includes an estimate of the impact of a policy in the forecast when a firm announcement has been made that provides sufficient detail to quantify its effect. Accordingly, this forecast incorporates the effects, where significant, of the following policies announced since the November forecast:
- the tax and expenditure measures announced since November and in Budget 2012, as set out in Annex A. We have certified the costings of all these measures as reasonable central estimates. The direct effect on public sector net borrowing (PSNB) of these measures is summarised in Table 4.5 in Chapter 4. Overall, these are broadly neutral fiscally over the forecast period, with a small fiscal tightening of £1.1 billion in 2016-17 – the target year for the Government's fiscal mandate; and
  - a number of measures also have indirect or second round effects on our economy forecast. Our judgements on these potential indirect effects are set out in Box 3.1 in Chapter 3. We have made a small upward revision to our business investment and GDP forecast to reflect the additional reduction in the main rate of corporation tax. We have also adjusted the inflation forecast to reflect the impact of measures on VAT and tobacco. We made no other material adjustments to the economy forecast as a result of Budget policy announcements.
- 2.34 Consistent with the *Charter for Budget Responsibility* the projections do not include the impact of policies for which insufficient detail is available to allow the effects to be quantified. The possible risks to our fiscal forecast from such policies are explained in Chapter 4.



## 3 Economic outlook

### Summary

- 3.1 Our overall assessment of the outlook and risks for the UK economy is broadly unchanged from our November *Economic and fiscal outlook (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.
- 3.2 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.
- 3.3 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.
- 3.4 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.
- 3.5 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.

- 3.6 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.
- 3.7 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.
- 3.8 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.
- 3.9 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.
- 3.10 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.

- 3.11 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.
- 3.12 There is always considerable uncertainty around any economic forecast. Chart 3.1 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 3.1: GDP fan chart

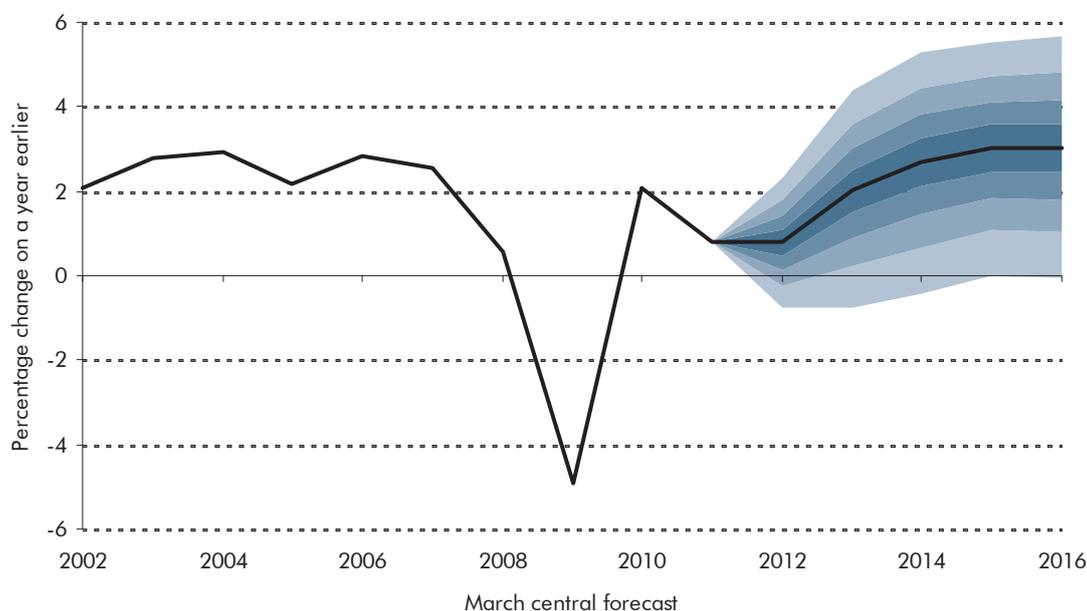


Table 3.1: Summary of central forecast and changes since November

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast <sup>1</sup>					
	2010	2011	2012	2013	2014	2015	2016
<b>Output at constant market prices</b>							
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
<b>Expenditure components of GDP at constant market prices</b>							
Household consumption <sup>2</sup>	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 <sup>3</sup>	-0.5	1.2	0.4	0.5	0.3	0.2	0.1
<b>Inflation</b>							
CPI	3.3	4.5	2.8	1.9	1.9	2.0	2.0
<b>Labour market</b>							
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Average earnings <sup>4</sup>	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
<b>Changes since November forecast</b>							
<b>Output at constant market prices</b>							
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
<b>Expenditure components of GDP at constant market prices</b>							
Household consumption <sup>2</sup>	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 <sup>3</sup>	0.3	0.1	0.1	-0.1	0.0	0.0	0.0
<b>Inflation</b>							
CPI	0.0	0.0	0.1	-0.2	-0.1	0.0	0.0
<b>Labour market</b>							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Average earnings <sup>4</sup>	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

<sup>1</sup> 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.

<sup>2</sup> Includes households and non-profit institutions serving households.

<sup>3</sup> Contribution to GDP growth, percentage points.

<sup>4</sup> Wages and salaries divided by employees.

## Introduction

3.13 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.15);
- discusses how quickly economic activity is likely to return to potential (from paragraph 3.28), how monetary policy and credit conditions are assumed to affect this, (from paragraph 3.43) and how the composition of growth is likely to evolve (from paragraph 3.53);
- assesses prospects for inflation (from paragraph 3.85) and the labour market (from paragraph 3.97); and
- compares our central forecast to selected external forecasts (from paragraph 3.105).

3.14 As set out in the Foreword, the Chancellor asked us to finalise our ‘pre-measures’ economic forecast on 7 March in order to provide him with a stable basis on which to take his final Budget policy decisions. The subsequent changes that we made to the forecast were to account for the effects of Budget policy decisions, as set out in Box 3.1. We did not, therefore, take into account any subsequent economic news or data releases, including the ONS releases of the Index of Production and Output in the Construction Industry on 9 March, the Labour Market Statistics of 14 March and the CPI release on 20 March. We do not believe that including the data in these releases would have had a significant impact on the forecast.

## Potential output and the output gap

3.15 The amount of spare capacity in the economy (the ‘output gap’) and the growth rate of potential output are key judgements in our forecast. Together, they determine the scope for actual growth as activity returns to a level consistent with stable inflation in the long term. The size of the output gap also determines how much of the fiscal deficit at any given time is cyclical and how much structural. In other words, how much will disappear automatically, as the recovery boosts revenues and reduces spending, and how much will be left when economic activity has returned to its full potential. The narrower the output gap, the larger the proportion of the deficit that is structural, and the less margin the Government will have against its fiscal mandate, which is set in structural terms.

3.16 In this section we first consider how far below potential the economy is currently operating. We then consider how quickly potential output has grown in the recent past and the speed at which it is likely to grow in the future.

## Latest estimates of the output gap

- 3.17 Our first step in the forecast process is to assess how the current level of activity in the economy compares with the potential level consistent with stable inflation in the long term. We cannot estimate the supply potential of the economy directly, so we use a range of cyclical indicators to estimate the amount of spare capacity in the economy. In reaching a judgement on the size of the output gap, we supplement our own analysis by examining estimates produced by a range of other forecasting organisations using different techniques.
- 3.18 To construct an estimate of the output gap from cyclical indicators, we use two approaches: ‘aggregate composite’ estimates, which weight together business survey indicators; and ‘principal components analysis’, a statistical approach used to combine a range of survey and non-survey indicators.<sup>1</sup>
- 3.19 Our latest estimates of the output gap suggest that the degree of spare capacity remained largely unchanged between the third and fourth quarters of 2011 (Chart 3.2). The aggregate composite estimate of the output gap narrowed slightly in the fourth quarter, reflecting a pick up in a number of the main survey measures of spare capacity. The principal component estimate, which incorporates measures of earnings growth as well as survey information, remained broadly flat as upward movements in survey-based indicators were offset by slowing real wage growth.
- 3.20 On the basis of these cyclical indicators, we judge that there was an output gap of -2.5 per cent in the fourth quarter of 2011, unchanged from the third quarter. This implies marginally less spare capacity in the economy at the end of 2011 than we thought there would be in November. At that time, we expected the output gap to widen to around -2.8 per cent in the fourth quarter of 2011 as forecast output growth fell below our estimate of the economy’s potential growth rate. We estimate the output gap averaged -2.7 per cent for the full year.
- 3.21 Chart 3.3 compares our output gap estimate for the 2011 calendar year to those produced by other forecasters, including all those set out in the Treasury’s *March Comparison of Independent Forecasts* and estimates produced by NIESR, the OECD, the European Commission and the IMF. The average (mean) estimate for 2011 is -2.7 per cent, in line with our central estimate. The difficulties associated with estimating the output gap in real time are well-known and the broad range of estimates presented below (-4 per cent to -0.4 per cent) illustrates the current

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<sup>1</sup> More details are set out in Briefing Paper No.2: *Estimating the output gap*; and Pybus, T. (2011), Working Paper No.1: *Estimating the UK’s historical output gap*.

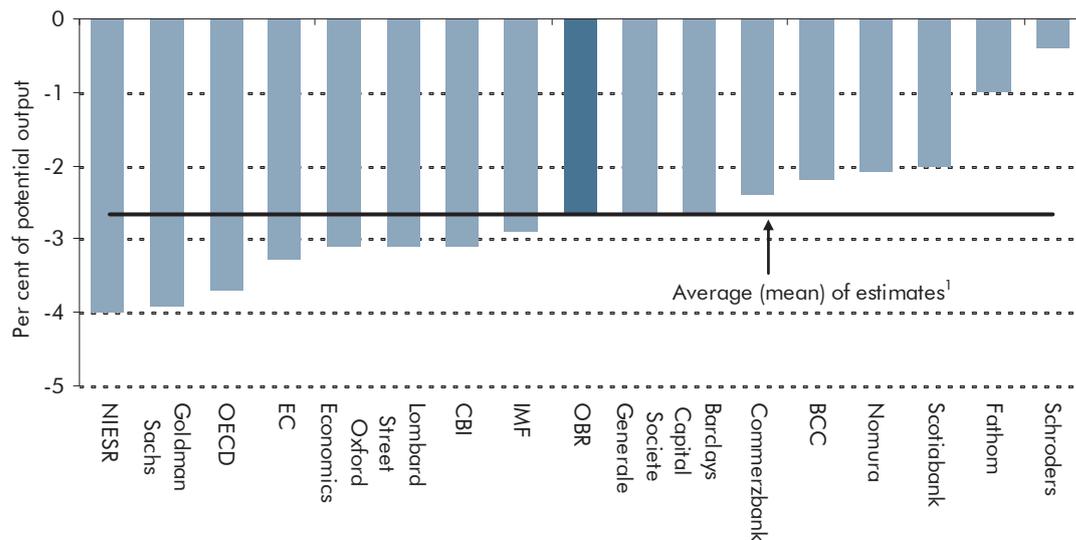
degree of uncertainty. In Chapter 5 we test the sensitivity of our central fiscal forecast to this key judgement.

Chart 3.2: Estimates of the output gap based on cyclical indicators



Source: OBR

Chart 3.3: Estimates of the output gap in 2011



<sup>1</sup>Excludes OBR estimate.

Source: HM Treasury, 2012, *Forecasts for the UK economy: a comparison of independent forecast*, March, plus additions or updates where known. Goldman Sachs estimate refers to the fiscal year 2011-12.

## Decomposing the output gap

3.22 We can decompose our output gap estimate into an output per worker gap (comprising an average hours gap and an output per hour gap), an employment rate gap and a population gap. Of the -2.5 per cent output gap at the end of 2011, we estimate that:

- output per worker is around 0.6 per cent below its estimated trend. This consists of an average hours gap of around 0.2 percentage points and an output per hour gap of 0.4 percentage points;
- around 2.2 percentage points reflects the gap between the employment rate and its estimated potential level. This is consistent with the range of ONS and survey-based indicators that continue to point to spare capacity in the labour market; and
- the gap between the level of the population aged 16+ and its estimated trend reduces the negative output gap by around 0.3 percentage points.

## The growth of potential output

3.23 In November, we reduced our forecasts of potential output growth in the near term, reflecting our assessment that there has been a persistent and significant slowdown in potential output growth following the financial crisis. We judged that it would take until the start of 2014 for potential output growth to return its long-run average of 2.3 per cent. This was consistent with our assumption that credit conditions would start to improve over the course of 2012 and 2013, returning to a stable medium-term position by the start of 2014.

3.24 Data released since November continue to point to sluggish potential output growth. All else equal, our latest assessment of the output gap implies a downward adjustment to the level of potential output of around 0.3 per cent relative to our November forecast. Our estimates of the output gap, taken together with the latest output data, imply that potential output has grown by around 0.8 per cent per annum since the final quarter of 2009. Labour productivity growth has remained weak, with both output per hour and output per worker falling in the final quarter of 2011.

3.25 As we set out in November, quantifying the contributions to the slowdown in potential output growth is difficult. Many of the more easily-quantified channels appear to account for only a part of the slowdown in productivity. One possibility is that the impaired operation of the financial sector has continued to weigh on productivity growth by preventing the reallocation of capital to the most

productive activities. More broadly, evidence suggests that financial crises are often associated with large and persistent output losses.<sup>2</sup>

**3.26** Table 3.2 sets out our potential growth assumptions, which are unchanged from November.<sup>3</sup> Potential output is expected to grow by 0.8 per cent in 2012 and 2.0 per cent in 2013, reverting to a growth rate of 2.3 per cent from 2014 onwards. This remains consistent with our assumption that the financial sector returns to a stable position by 2014. We do not believe there is sufficient evidence, at this stage, to adjust our projection of the long-run potential growth rate. However, our estimates of potential growth do imply a significant and persistent loss of potential output relative to the pre-crisis trend, in line with those of a number of other forecasters (Chart 3.4).<sup>4</sup> Our latest estimates for 2011 imply a potential output loss of around 8 per cent against a continuation of a pre-crisis trend. This shortfall widens to around 11 per cent by 2016 as potential growth remains below the pre-recession average; of this, a small proportion (around 0.5 percentage points) results from the projected demographic slowdown in population growth from 2014.

**Table 3.2: Potential output growth forecasts (annual growth rate, per cent)**

	Potential productivity <sup>1</sup>	Potential average hours	Potential employment rate <sup>2</sup>	Potential population <sup>2</sup>	Potential output
<b>2012<sup>3</sup></b>	0.6	-0.2	-0.3	0.7	<b>0.8</b>
<b>2013</b>	1.6	-0.2	-0.2	0.7	<b>2.0</b>
<b>2014</b>	2.1	-0.2	-0.2	0.5	<b>2.3</b>
<b>2015</b>	2.2	-0.2	-0.2	0.5	<b>2.3</b>
<b>2016</b>	2.2	-0.2	-0.2	0.5	<b>2.3</b>

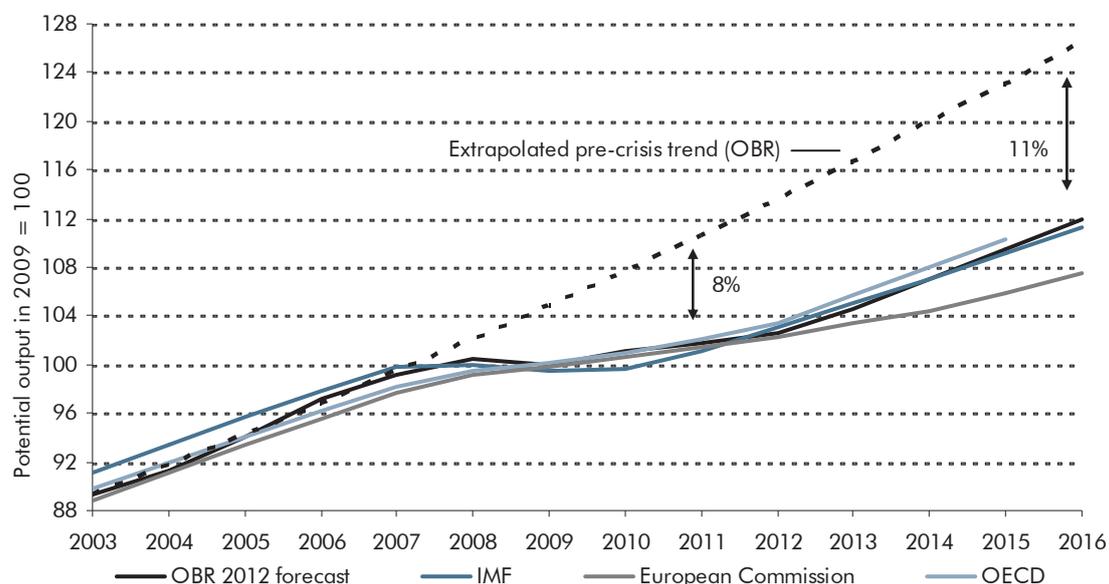
<sup>1</sup> Output per hour.  
<sup>2</sup> Corresponding to those aged 16 and over.

<sup>2</sup> See Box 3.1 of our November 2011 *EFO* for a discussion of the reasons why potential growth might have slowed.

<sup>3</sup> The estimate of potential growth in 2012, set out in Table 3.2, is slightly lower than our November forecast, due to revisions to the level of potential output in 2011. Our forecast of potential growth from the final quarter of 2011 onwards is unchanged from our November forecast.

<sup>4</sup> The Bank of England made a similar assessment in its February 2012 Inflation Report: "Further ahead, underlying productivity growth is projected to move back towards its historical average rate. Nonetheless, the level of productivity is projected to remain significantly below a continuation of its pre-recession trend throughout the forecast period."

Chart 3.4: Projections of potential output<sup>5,6</sup>



Source: OBR; IMF *World Economic Outlook*, September 2011; European Commission *European Economic Forecast*, Autumn 2011; OECD *Economic Outlook No.90*, November 2011.

3.27 Our assumptions for the supply of labour remain unchanged from our November forecast. Our projection of population growth is based on average inward net migration of 140,000 per annum, in line with the long-term assumption underpinning the ONS’ low migration variant population projection. Similarly, our assumption about the long-term Non-Accelerating Inflation Rate of Unemployment (NAIRU) is unchanged, at 5.35 per cent, discussed further in the labour market section of this chapter.

## The pace of the recovery

3.28 In this section we set out the expected path of GDP growth over the forecast period. We first consider the short-term outlook using information from recent economic data and forward-looking surveys. We then consider the rate at which GDP will grow over the medium term as spare capacity is taken up and economic activity approaches the potential level identified in the previous section.

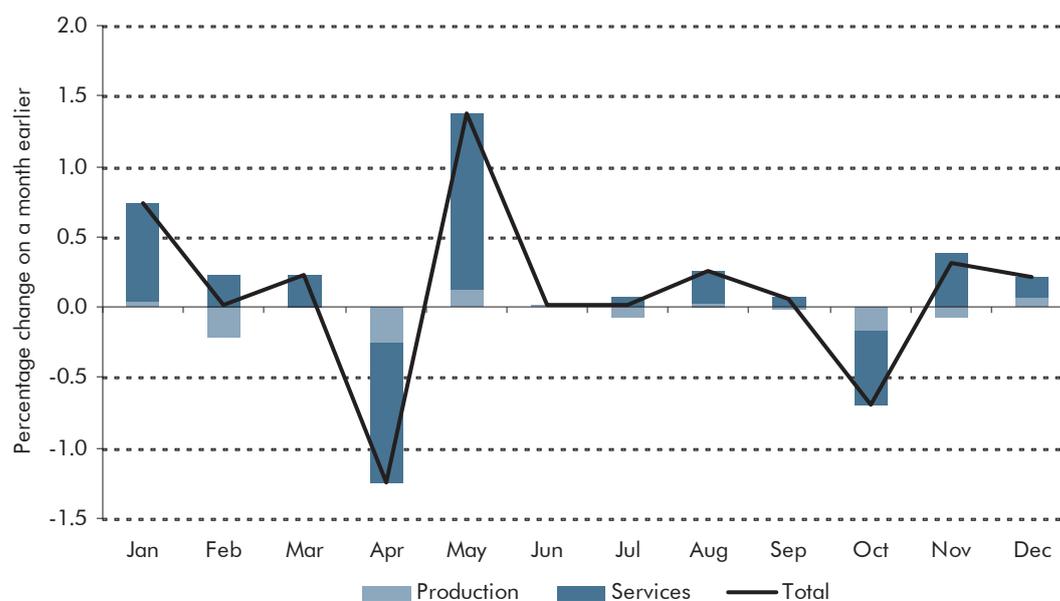
<sup>5</sup> Extrapolated pre-crisis trend shows level of potential output derived by projecting forward average rate of potential growth between the first quarter of 2003 and the first quarter of 2008 (2.7 per cent), as implied by the latest principal components estimates of the output gap.

<sup>6</sup> The OECD estimate is constructed using projections of potential output to 2012 and linearly interpolating to the level in 2015 implied by the OECD’s long-term baseline scenario.

## The short-term outlook

**3.29** Downward pressure on real incomes from elevated inflation weighed heavily on the recovery in 2011. And, in the second half of the year, the intensification of the euro area crisis led to tighter credit conditions and increases in the cost of borrowing for firms and households. The economy contracted by 0.2 per cent in the final quarter of the year, marginally more than we forecast in November. Chart 3.5 shows that this was driven by a particularly weak October for the services sector. Growth in services recovered in November and December but did not fully offset the weakness in October. However, the monthly profile of growth through the quarter implies the economy is carrying some momentum into 2012.

Chart 3.5: Monthly output growth in 2012<sup>7</sup>



Source: ONS, OBR

**3.30** As we set out in Chapter 2, since the beginning of 2012 a range of survey evidence on economic activity in the UK has begun to show signs of improvement. Inflation has fallen sharply in recent months, in line with expectations, which should gradually reduce the squeeze on real incomes and consumption over 2012. The ECB's recent operations also seem to have eased short-term pressures in euro area financial markets (see Box 3.2), which should increase confidence.

<sup>7</sup> This measure excludes construction output, which is not available on a seasonally-adjusted basis

- 3.31 We expect positive growth in the first quarter of 2012 of 0.3 per cent, which is slightly above our forecast of 0.1 per cent in November. This revision also raises our forecast for 2012 annual growth marginally to 0.8 per cent, from 0.7 per cent in November.

Table 3.3: The quarterly GDP profile

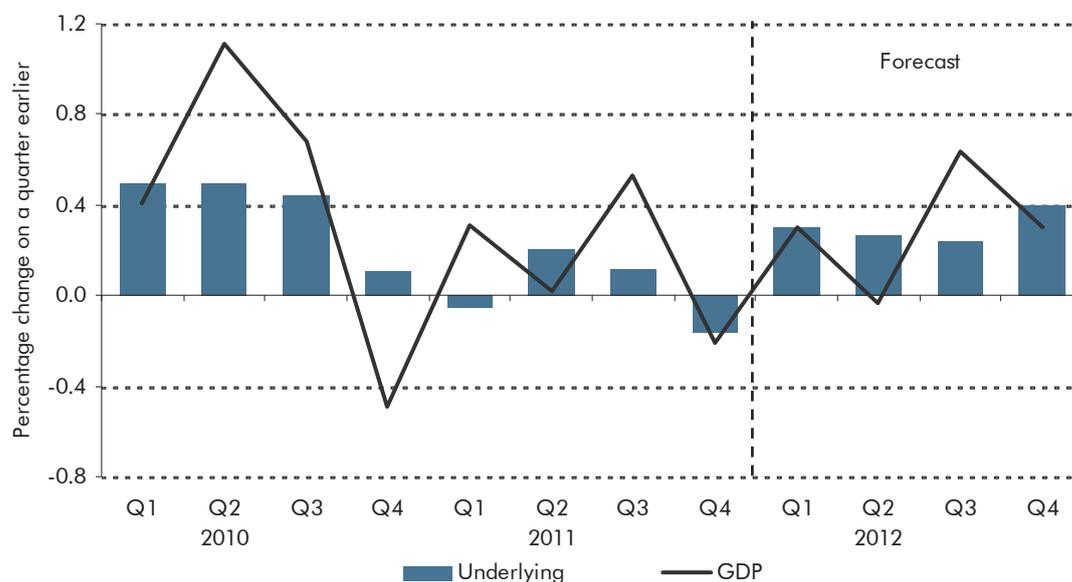
	Percentage change on previous quarter											
	2010				2011				2012			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<b>March forecast<sup>1</sup></b>	0.4	1.1	0.7	-0.5	0.3	0.0	0.5	-0.2	0.3	0.0	0.6	0.3
<b>November forecast<sup>2</sup></b>	0.2	1.1	0.6	-0.5	0.4	0.1	0.5	-0.1	0.1	0.1	0.6	0.3
<i>Change</i>	0.2	0.1	0.1	0.0	-0.1	-0.1	0.0	-0.1	0.2	-0.1	0.0	0.0

<sup>1</sup> Forecast from first quarter of 2012.

<sup>2</sup> Forecast from fourth quarter of 2011.

- 3.32 Chart 3.6 shows that we expect a recovery in underlying growth momentum over the year but measured GDP growth to be broadly flat in the first half of 2012. This partly reflects distortions to the path of actual growth through the year from one-off influences.
- 3.33 As in our November forecast, we expect the additional bank holiday in June, marking the Queen's Diamond Jubilee, to have a similar effect to the royal wedding in 2011 – weakening headline growth in the second quarter and strengthening it in the third. Since our November forecast, revisions to monthly output data by the ONS imply that the royal wedding effect was larger than previously thought, so we have revised up the expected size of the Diamond Jubilee effect. However the effect is still likely to be smaller than last year's, which was probably exacerbated by the proximity of the royal wedding to Easter (increasing the number of staff who chose to take holidays) and the additional supply chain disruption from the earthquake and tsunami in Japan.

Chart 3.6: Underlying and headline growth in GDP



Source: ONS, OBR

**3.34** GDP growth may also be affected by the Olympic Games. The associated ticket sales, worth approximately 0.1 per cent of GDP, will boost GDP growth in the third quarter of 2012 and reduce it by the same amount in the final quarter.<sup>8</sup> The size and even the direction of the other effects associated with the games are far less certain. The games may lead some workers to take more annual leave over the period in which they take place, which could redistribute output from the third quarter to earlier or later in the year. It is also unclear whether the Olympics will generate an increase in net tourism or whether some visits will be delayed or cancelled in order to avoid the crowds and associated travel disruption. Given the uncertainties and the relatively small size of any possible effects, we assume that, apart from the ticket sales effects, the Olympics will not have a material effect on the quarterly path of GDP. This is consistent with a number of studies which suggest that the overall economic impact is likely to be small.<sup>9</sup>

<sup>8</sup> Although ticket sales took place in the second quarter of 2011, the ONS decided to delay their appearance in retail sales data until the Olympics take place in 2012, which is the point of consumption. A more detailed explanation is available on the ONS website.

<sup>9</sup> Blake, (2005) 'The economic impact of the London 2012 Olympics' estimates the Olympics could provide a small boost to GDP. Visa, (2011) 'A golden opportunity' estimates that the games will have a net positive effect on spending in the third quarter of 2012. However, the estimates are negligible in terms of aggregate consumption.

### Box 3.1: The economic effects of policy measures

This box considers the possible effects on the economy of policy measures announced in Budget 2012. More details of each measure are set out in the Treasury's Budget document and our assessment of the fiscal implications can be found in Chapter 4.

The Government has announced policy measures that are expected to have a broadly neutral fiscal impact overall and, in aggregate, they have had limited effect on our economic forecast. The main effect is from the reduction in the main rate of **corporation tax**, which we estimate will reduce the cost of capital faced by firms and increase the level of business investment by 1 per cent over the forecast period. This judgement is the same as was reached by the interim OBR with regards to the cut to the corporation tax rate in the June 2010 Budget. Given that output is below potential across the forecast period, we assume no offset from monetary policy, leading to a very small increase in the level of GDP of 0.1 per cent by the end of the forecast period.

We have adjusted our inflation forecast for measures that directly influence the price level, including the increase in **tobacco duty** and the **widening of the VAT base**. We have estimated that this will lead to a small upward effect of 0.1 percentage points on the annual rate of CPI and RPI inflation in 2012-13. This is a permanent effect on the price level but a temporary effect on inflation.

There are a number of measures that increase real household disposable income, for example the raising of the **personal allowance**, the tapering of **child benefits** and the reduction in the additional rate of **income tax**. However, a number of other measures are likely to reduce real disposable income, including the changes to **age related allowances** and the **widening of the VAT base**. The net effect on real household disposable income is likely to be small and the effect on consumption will depend on differences between the marginal propensities to consume of the winners and losers.

Some of the measures announced in Budget 2012 could also have an effect on labour supply. Higher personal allowances may make it more attractive for those out of work to enter the labour market. The impact on those in work is less clear. For example, higher real incomes may lead some individuals to reduce their hours worked. Similarly, the reduction in the additional rate of income could affect the net inflow of high income workers from overseas, although the size and timing of such effects are highly uncertain. Some workers may have seen the additional rate as temporary which could limit the migration impact of the reduction. Given these uncertainties, we judge there is insufficient evidence, at present, to adjust our labour supply assumptions.

In its Autumn Statement, the Government announced a credit easing initiative aimed at reducing the cost of borrowing for small and medium-sized firms (SMEs). The largest part of that initiative is the **National Loan Guarantee Scheme** (NLGS). Under this scheme, the Government will guarantee up to £20 billion of new debt issued by participating banks against default, lowering its price. In exchange, the banks will pay the Government a fee. Banks are required to pass on the whole benefit they receive

from lower funding costs to SMEs. The economic impact of the scheme will depend on the reduction in funding costs achieved and the amount of net additional lending that it leads to.

Since November, the Government has announced some further details on the design of the scheme, including the participating banks and the size of the first tranche, and it has received State aid approval from the European Commission. Under current funding market conditions, the Government guarantee on the first tranche should lead to lower funding costs and some additional net lending. The scale of the initial tranche is not large enough to have a material impact on our aggregate business investment forecast, but within this it should provide a boost to SME lending.

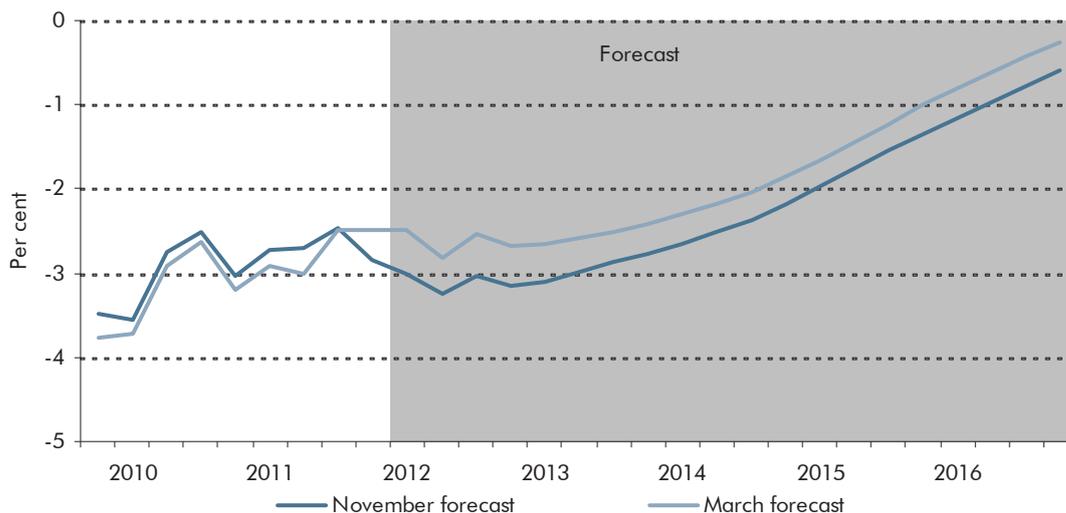
The benefits associated with further tranches are less certain. The value of the Government guarantee would fall if conditions in funding markets improve, which is the case in our central forecast. In such circumstances the extent to which the further tranches would lead to lower funding costs and net additional lending is uncertain. However, the initiative would help to protect SMEs against higher borrowing spreads, should funding costs stay higher for longer than we expect.

## The medium-term outlook

- 3.35 Our forecasts for medium-term growth are determined by our view of the amount of spare capacity in the economy, and the speed with which it seems likely to be absorbed. The judgements surrounding the effect of monetary policy and credit conditions, which underpin this growth forecast, are set out in the next section.
- 3.36 We expect momentum to build gradually in 2012 and 2013, but it is not until 2014 that the recovery really gathers pace and the output gap starts to close (Chart 3.7). We forecast that year-on-year GDP growth will be the same in 2012 as in 2011, as the positive influence of falling inflation is offset by the effect of uncertainty over the euro area outlook and tighter credit conditions feeding through to the wider economy.
- 3.37 We then forecast that growth will pick up steadily as tensions in financial markets ease and the banking sector returns to normal operation. By 2014 we expect productivity growth to return to its historical average rate and incomes to grow strongly enough to outstrip inflation by a significant margin. This should provide support to household consumption and so GDP growth rises from 2.7 per cent to reach 3.0 per cent in the final two years of the forecast.
- 3.38 As in November, our central forecast is for the recovery to be much weaker than those which followed the recessions of the 1980s and 1990s. This reflects the expected slow easing of tight credit conditions, relatively high rates of externally-

driven inflation, the weak outlook for the euro area and the continued influence of the fiscal consolidation.

Chart 3.7: The output gap



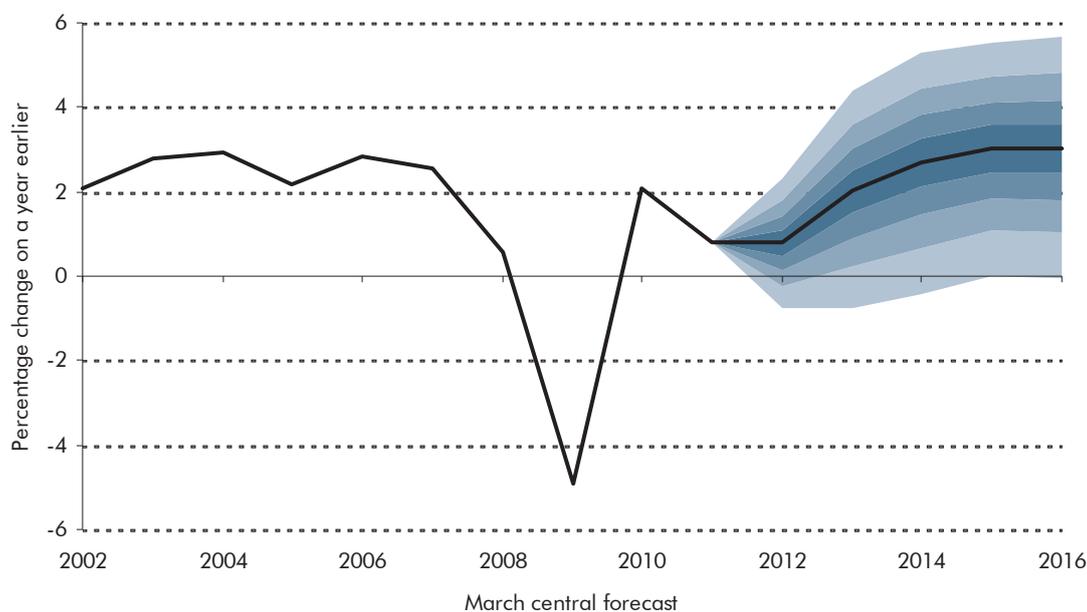
Output gap estimates on a quarterly basis, based on the latest National Accounts data and expressed as actual output less trend output as a percentage of trend output (non-oil basis).

Source: OBR

3.39 Our central growth forecast is shown in Chart 3.8. The distribution surrounding it shows the probability of different outcomes if you expected our forecasts to be as accurate as official forecasts have been in the past. The solid black line shows our median forecast, with the 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 between 2011 and 2012, based on past forecasting errors.

3.40 The probability bands are based on the distribution of official forecast errors since 1987. They do not represent a subjective measure of the distribution of risks around the central forecast. It suffices to say that although we believe that the chances of growth being above or below our central forecast are broadly equal, the risk of a disorderly outcome in the euro area means that a much weaker outcome is more likely than a much stronger one.

Chart 3.8: GDP fan chart

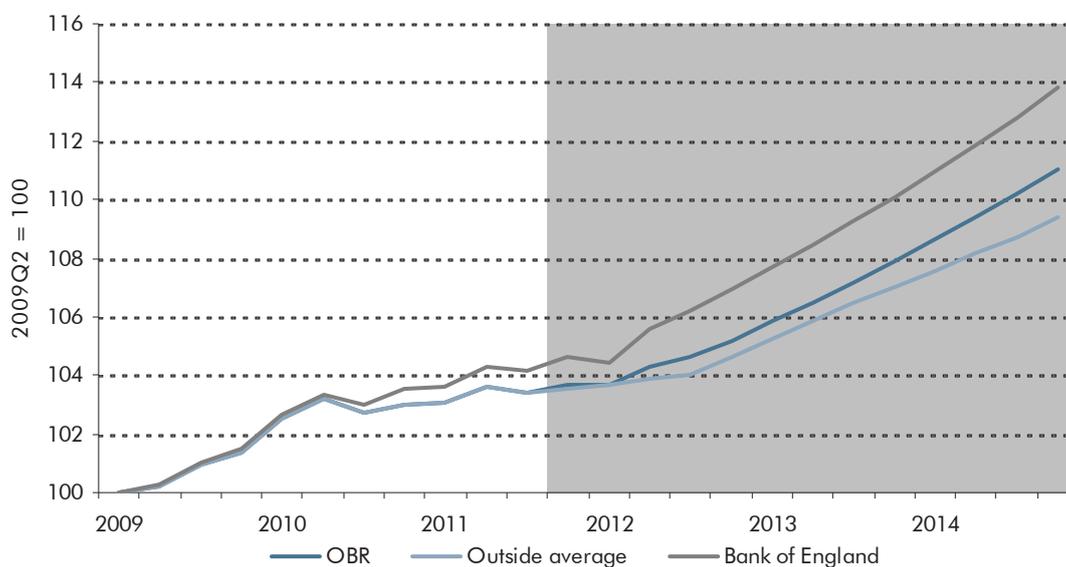


Source: ONS, OBR

- 3.41 Chart 3.9 plots our central forecast for the next three years against the Bank of England's mean February *Inflation Report* forecast and the forecast implied by the average of outside forecasts.
- 3.42 Our forecast for growth this year is a little weaker than the Bank of England's forecast and a little stronger than the outside average. In later years our forecast slightly outpaces the outside average, while growth picks up more strongly in the Bank of England's forecast. By the start of 2015, the Bank of England's median forecast for the level of GDP is around 2½ per cent higher than our central forecast, although around a quarter of this difference is attributable to its 'backcast'.<sup>10</sup> It should be emphasised that the differences between these point forecasts are dwarfed by the uncertainties around each of them – as the fan charts in this *EFO* and in the Bank of England's *Inflation Report* make clear.

<sup>10</sup> This reflects its expectation that the level of GDP over the recent past will be revised up, whereas we make no assumption about the likely scale or direction of future revisions.

Chart 3.9: Forecasts of the level of GDP



Source: ONS, OBR, Bank of England, HM Treasury, 2012, Forecast for the UK economy: a comparison of independent forecasts, March

## Monetary policy

- 3.43** An important anchoring assumption in our forecast is that monetary policy succeeds in bringing inflation back to target over the forecast horizon. Coupled with a view that domestic price pressures (well-represented by the output gap) are the most important driver of inflation in the medium term, this implies that monetary policy will act to close the output gap over time by stimulating or softening aggregate demand.<sup>11</sup>
- 3.44** In February, the Bank of England's Monetary Policy Committee voted to expand its quantitative easing program by £50 billion, taking its overall size to £325 billion. This move was widely anticipated and there appears to have been little reaction from gilt yields on the day it was announced. So it is likely that this looser monetary stance was already priced-in. Chart 2.10 shows that, relative to November, policy rates are now expected to be around 50 basis points lower by the end of the forecast period. This has implications for our fiscal forecast, which we discuss in Chapter 4. Whether the second and third rounds of quantitative easing will provide as much support to the real economy as the first remains a risk to our central forecast.

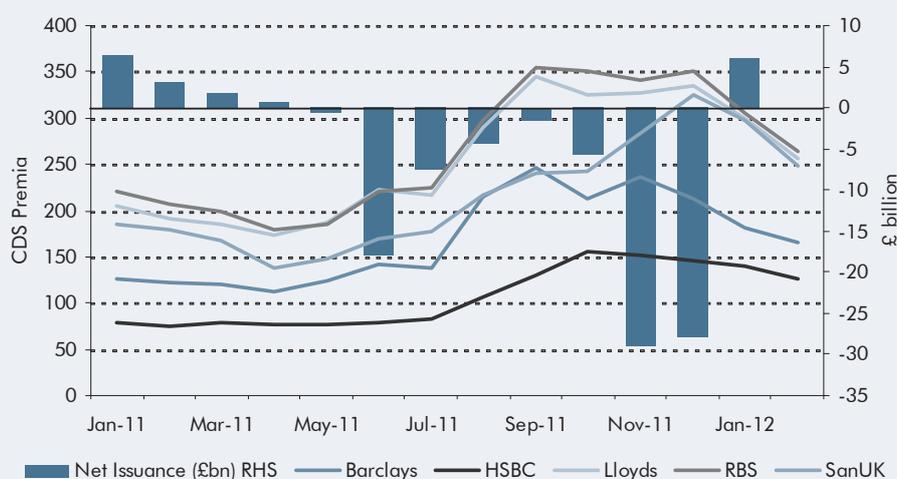
<sup>11</sup> See OBR Briefing paper No.3: *Forecasting the economy* for more on how we incorporate the effects of monetary policy in our forecast, available on our website.

### Box 3.2: Central bank operations and the credit outlook

Since our November forecast, central banks launched two significant new market operations designed to ease pressures in the financial markets. On November 30 2011 the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the US Federal Reserve and the Swiss National Bank announced a program providing liquidity support to the global financial system. The action was designed to make it easier and less costly for banks to fund themselves in US dollars, addressing a shortage experienced by many euro area banks. The announcement appears to have had a positive impact on funding markets in both the euro area and the UK.

However, funding conditions in the euro area remained tight and on December 8 2011 the ECB announced that it would offer unlimited 3 year loans to euro area banks at its main interest rate of 1 per cent. This longer-term refinancing operation (LTRO) seems to have significantly eased pressures in the euro area financial sector and removed the immediate risk of large-scale bank failures.

Chart A: 5-year CDS premia and net capital issuance by UK banks



Source: Datastream, Bank of England

The reduction in credit risk that followed the LTRO encouraged banks to lend to one another and led to a further fall in the cost of borrowing. Chart A shows that the UK's largest lenders, some of which participated in the LTRO, have experienced significant reductions in the cost of borrowing, as measured by their credit default swap (CDS) premia. Chart A also shows that, in January 2012, banks issued more capital than they redeemed for the first time since April 2011.

The LTRO has materially improved the credit outlook for the UK economy but CDS premia remain elevated relative to the first half of 2011 and we continue to expect lending spreads over bank rate to businesses and households to rise over the coming year. Chart 3.10 shows the adjustments we have made to our forecast of CDS premia since November.

## Credit conditions

- 3.45 Since November, credit conditions have tightened a little for both households and firms. This was expected in our previous forecast, reflecting the elevated cost of funding faced by banks in the latter half of 2011, as the euro area crisis intensified. Most lending spreads over gilt rates rose in December and January, while net lending to households was subdued and negative to businesses.
- 3.46 Since the start of 2012, funding conditions faced by UK banks have improved (see Box 3.2) and, in January, net capital issuance by UK banks was positive for the first time in nine months. However, despite recent improvements, the cost of funding remains significantly higher than during the first half of 2011.
- 3.47 Developments in the euro area remain a key downside risk to our central forecast. We described the channels through which an escalation of the sovereign debt crisis might affect the UK economy in our November *EFO*. A disorderly default of one or more sovereign borrowers, leading to deteriorating credit conditions, could have rapid and significant effects on the functioning of the UK banking sector. There are numerous ways in which the downside risks to the euro area might evolve, but for illustration we set out the possible economic and fiscal implications of the OECD's November stylised downside scenario in Chapter 5.

## Credit supply

- 3.48 Lenders surveyed by the Bank of England at the end of 2011 expected lending rate spreads over bank rate to businesses of all sizes to increase in the first quarter of 2012.<sup>12</sup> However, that survey may have been too late to reflect the expected impact of the LTRO. In February, Bank of England Agents reported tightening credit conditions for both large and small companies.<sup>13</sup> The January ECB credit conditions survey reports similar results with banks expecting to tighten credit standards further in the first quarter of 2011.<sup>14</sup>
- 3.49 Chart 3.10 shows that we expect funding costs experienced by banks to follow a similar path over 2012 to that presented in our November *EFO*, but from a lower starting position. This reflects our assumption that the situation in the euro area will improve further, before the financial sector gradually returns to normal operation over the next couple of years.

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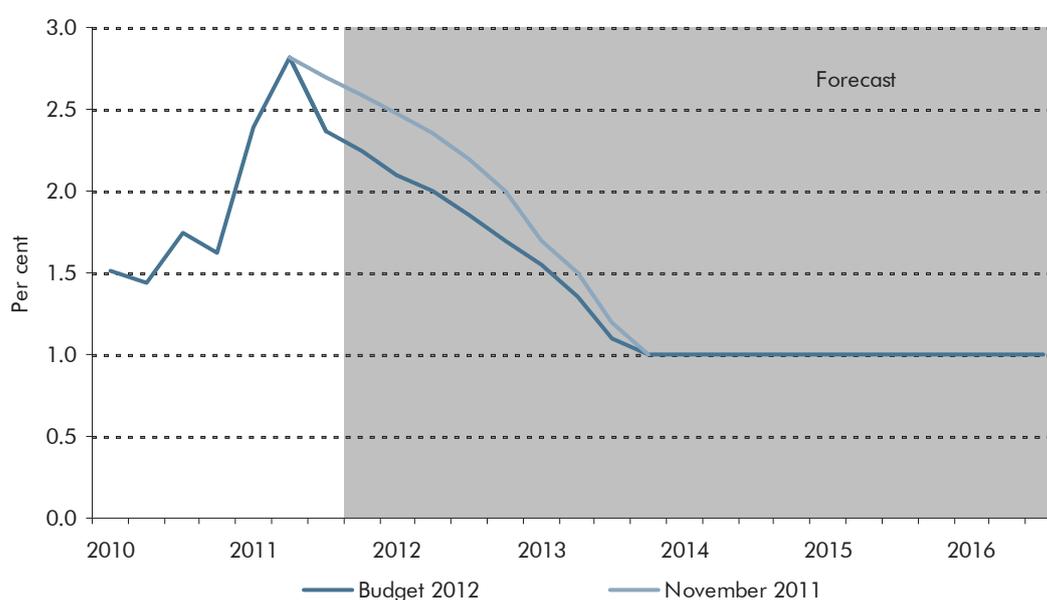
<sup>12</sup> Bank of England, 2012, *Trends in lending*, January

<sup>13</sup> Bank of England, 2012, *Agents' summary of business conditions*, February

<sup>14</sup> European Central Bank, 2012, *The euro area bank lending survey*, January

3.50 We do not expect the price or availability of credit to return to pre-crisis levels but to stabilise at a tighter position, reflecting the effects of changed regulatory policy and the mispricing of risk in the run up to the crisis. We assume that credit spreads faced by households and firms follow this path with a lag, implying tighter conditions to come in early 2012 followed by a gradual improvement thereafter.

Chart 3.10: Forecasts of credit default swap premia<sup>15</sup>



Source: Datastream, OBR

## Credit demand

### Households

3.51 Mortgage lending remains weak with the annual growth of net lending at around 1 per cent at the start of the year. Lenders reported weakening demand at the end of the year while indicating that availability had increased. This trend was expected to continue this quarter.<sup>16</sup> Annual growth in unsecured lending to households was negative in January at -0.8 per cent. Lenders say this reflects weak demand rather than lower availability of credit.

<sup>15</sup> The aggregate credit default swap premium is the average of the five major UK banks' 5-year senior CDS spreads, weighted by their share of lending in the UK mortgage market.

<sup>16</sup> Bank of England, 2012, *Trends in Lending*, January

## Corporations

- 3.52 Bank lending to private non-financial companies (PNFC's), especially small and medium-sized enterprises (SMEs), continue to be weak with the annual growth rate in November at -2.1 per cent for all businesses and -6.1 per cent for SMEs. Lenders reported especially weak demand from SMEs at the end of 2011, citing reduced business confidence.

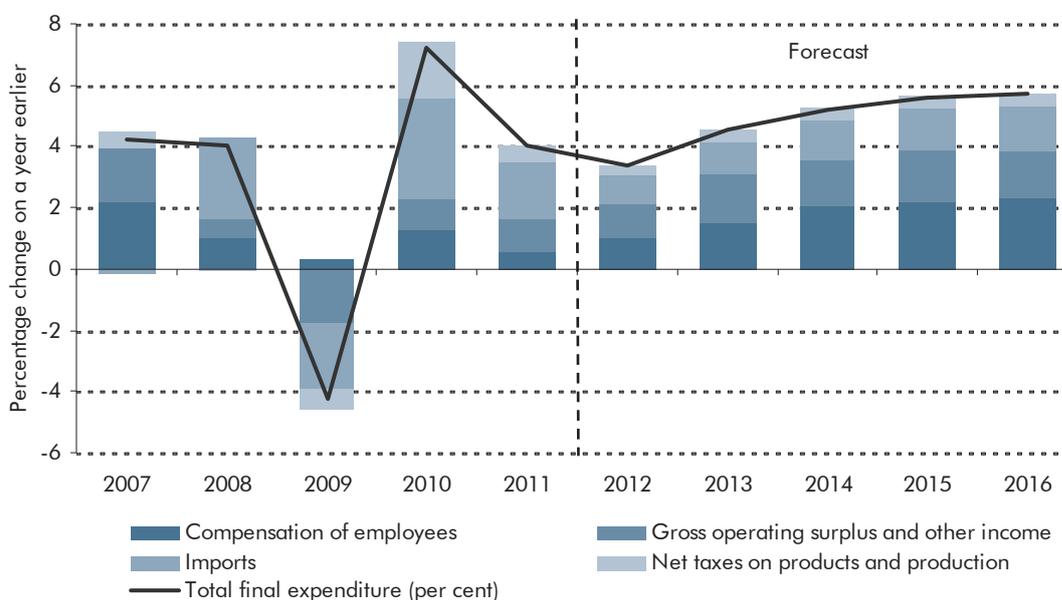
## The composition of GDP

- 3.53 Our forecast for the level of GDP in the medium term is a key driver of our assessment of the outlook for the public finances. But the composition of GDP is also important. This section discusses the broad outlook for the income and expenditure measures of GDP, and our forecasts of the expenditure components in more detail.

## Income

- 3.54 For a given profile of nominal GDP, the outlook for the public finances will vary with the relative contribution of different types of income flow. This is mainly because the Government receives more revenue from every pound of labour income than from every pound of profits.
- 3.55 Chart 3.11 shows the pattern of income flows associated with our forecast for total final expenditure – the total of domestic spending plus overseas spending on UK exports. Growth in this measure of nominal spending is expected to fall back slightly this year before picking up over the forecast period. The chart shows that the pattern of income flows associated with nominal spending has shifted in recent years. Relatively little of the strong rebound in nominal spending in 2010 translated into compensation of employees or corporate profits. In contrast, although we forecast nominal spending growth will fall back a little in 2012, the share of income flowing to UK households and firms is expected to pick up this year and in subsequent years.

Chart 3.11: Income counterparts to growth in total final expenditure



Source: ONS, OBR

## Expenditure

**3.56** Table 3.4 shows our forecast for the contribution of expenditure components to real GDP growth. Our private consumption growth forecast implies that consumer spending will continue to fall as a share of GDP, before stabilising in later years. Business investment and net trade are expected to contribute a large proportion of forecast GDP growth. These trends are driven by the sustained depreciation of the real exchange rate and the ongoing fiscal consolidation, which releases resources for private sector investment. Our forecast for these expenditure components is discussed in more detail in the following sections.

Table 3.4: Expenditure contributions to growth

	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2010	2011	2012	2013	2014	2015	2016
<b>GDP growth, per cent</b>	2.1	0.8	0.8	2.0	2.7	3.0	3.0
<b>Main contributions</b>							
Private consumption	0.8	-0.5	0.3	0.8	1.5	1.9	1.9
Business investment	-0.2	0.0	0.1	0.5	0.8	0.9	1.0
Dwellings investment <sup>2</sup>	0.4	0.1	0.0	0.5	0.6	0.5	0.5
Government <sup>3</sup>	0.5	-0.3	0.0	-0.3	-0.5	-0.6	-0.6
Change in inventories	1.3	-0.1	-0.1	0.0	0.0	0.0	0.0
Net trade	-0.5	1.2	0.4	0.5	0.3	0.2	0.1

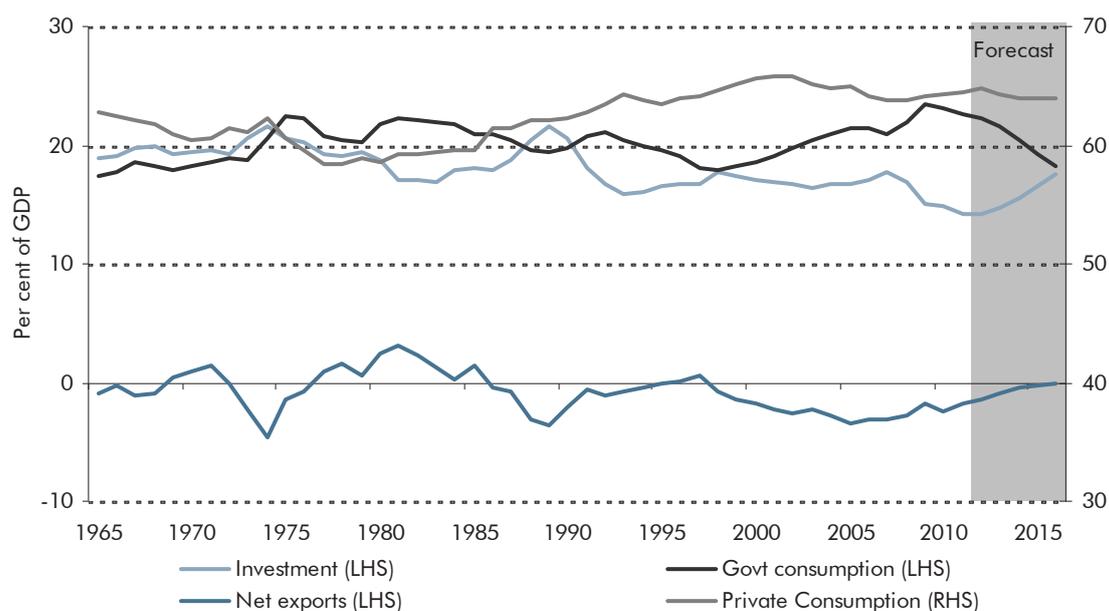
<sup>1</sup> Components may not sum to total due to rounding and the statistical discrepancy.

<sup>2</sup> The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.

<sup>3</sup> The sum of government consumption and general government investment.

3.57 Chart 3.12 provides a longer-run historical context for our forecast. The effect of the recession in 2008 can be seen most clearly in the shares of investment, which fell sharply as firms cut back in the face of huge uncertainty and financing problems, and government consumption, which rose as spending plans were maintained. A similar pattern can be seen around the recessions of the early 1980s and 1990s. The share of private consumption was reasonably stable prior to the recession and actually fell back slightly through the last decade.

Chart 3.12: Long run nominal expenditure shares of GDP

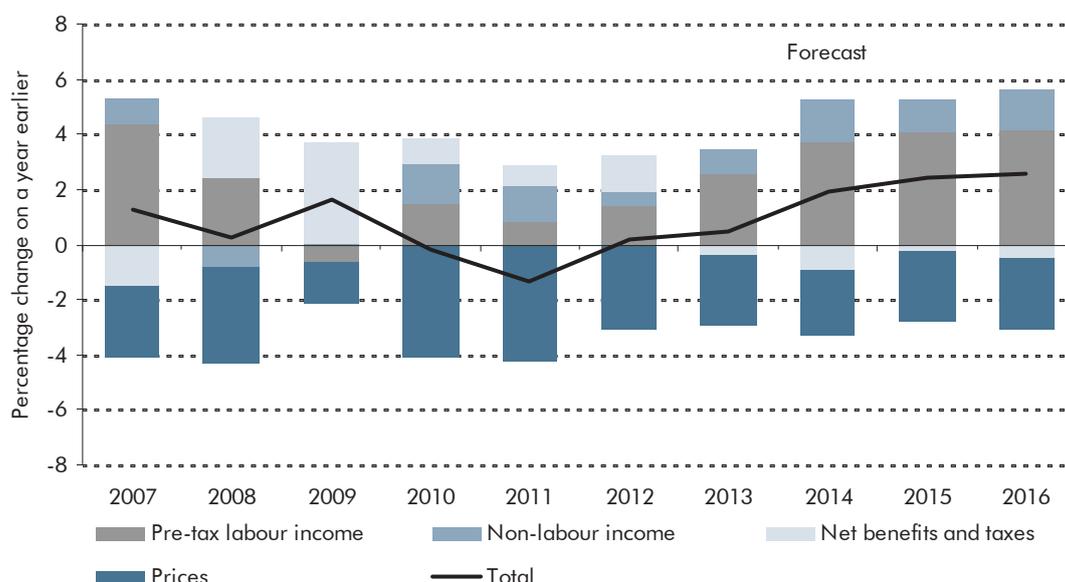


## Components of domestic demand

### Consumer spending

3.58 Nominal household disposable income and consumer spending grew by around 3 per cent in 2011. But prices rose by over 4 per cent, leading to a fall in real consumption over the year. The influences keeping inflation high are dissipating, with annual Consumer Prices Index inflation falling significantly in January. Absent further shocks, we expect the quarter-on-quarter rate of inflation to be relatively stable in 2012 providing the platform for modest real consumption growth of 0.5 per cent.

Chart 3.13: Contributions to real household disposable income growth



Source: ONS, OBR

3.59 We expect real household disposable income growth to be subdued in both 2012 and 2013. Compared to our November forecast, we have revised income growth in these two years mainly due to the effects of payment protection insurance (PPI) fee repayments. It seems likely that the majority of these repayments will be made in 2012 and will provide some short-term support to household consumption growth.

3.60 In the medium term, we have made a slight upward revision to our forecast as households' net financial wealth is now expected to be a little higher than we thought back in November. This is due to developments in asset markets, and equity markets in particular, which have been more favourable than we had assumed in November. The influence of households' balance sheets position on their consumption plans is discussed in more detail in Box 3.3.

### Box 3.3: Will household deleveraging act as a drag on growth?

In the build-up to the financial crisis, household debt grew faster than incomes, mainly because increasing numbers of households took out mortgages and those mortgages were increasingly large. Yet households' financial and physical assets grew faster still so household net worth rose.

As a measure of leverage, gearing of debt to household income does not lend itself well to international comparisons and is an imperfect gauge of debt sustainability. For example, varying degrees of owner-occupation can lead to differences in debt to income ratios between countries, while a borrower who collateralises borrowing with an asset is less risky than one who does not and is likely to experience lower borrowing costs.

Chart A: Household debt to equity ratio



Source: ONS, OBR

Chart A presents a measure of leverage for the UK and the US that takes account of the asset side of the balance sheet. It is a debt to equity ratio, which tells us the proportion of households' assets which are financed by borrowing. The chart shows that this measure of leverage was relatively stable in the years preceding the crisis in both countries. This is largely because households, in aggregate, were borrowing to finance the purchase of assets, on which they received a return, rather than to consume goods and services. As the financial crisis began, asset prices fell and so debt accounted for a higher share of assets.

Some outside commentators have concluded from debt-to-income ratios that household deleveraging has further to run in the UK than in the US. However, when assets are taken into account, US households have seen leverage fall more slowly than in the UK as the value of housing assets there has recovered less quickly.

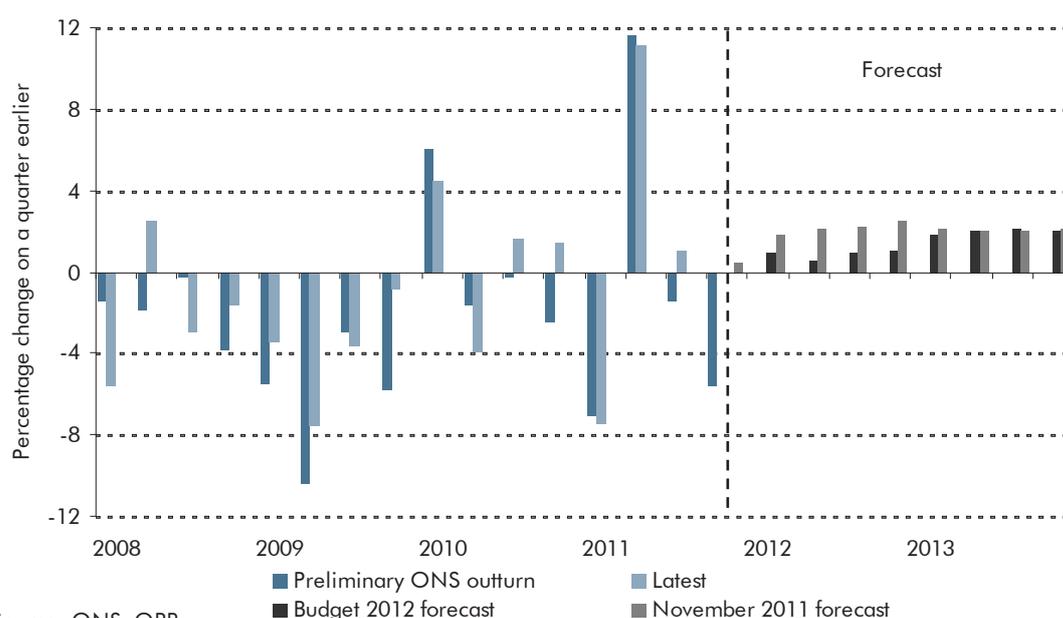
We do not expect household sector deleveraging to drag significantly on GDP growth, mainly because most consumers do not depend on credit to finance their spending and they have already made much of the required adjustment to their lower expected income.<sup>a</sup> Our expectation that GDP growth will be weaker than previous recoveries is based more on our expectation of weak income growth. If banks shrink their loan portfolios this could lead to a slower recovery in the housing market and weaker residential investment, but this type of expenditure accounts for a relatively small share of GDP.

<sup>a</sup> See, Weale, 'From retailers' paradise to shoppers' strike: what lies behind the weakness in consumption?' February, 2012.

## Business investment

3.61 Chart 3.14 shows the ONS preliminary estimates of quarterly growth in business investment alongside the latest estimate; it also shows our current and November forecasts. The majority of the downward revision to our forecast for calendar year business investment growth in 2012 is attributable to the weakness of the outturn for the fourth quarter. However, in recent years there has been a statistically significant tendency for initial estimates of business investment to be revised up, and we might expect the current estimate to be subject to a similar upward revision over time.

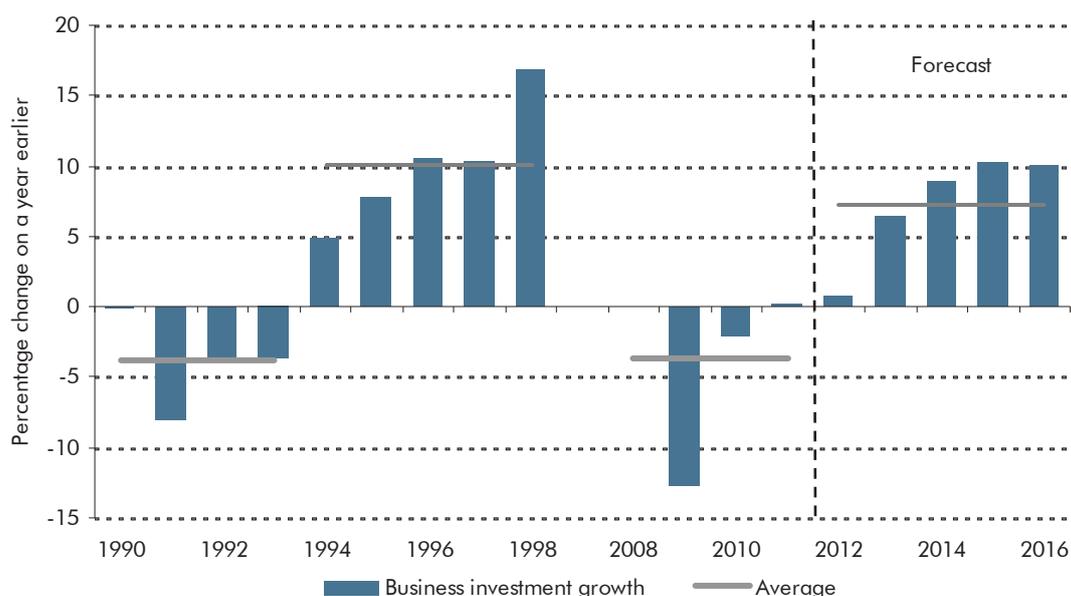
Chart 3.14: Revisions to outturn data and forecasts for quarterly business investment growth



Source: ONS, OBR

- 3.62 Nevertheless, current investment conditions remain challenging and firms' investment intentions weakened across a range of business surveys in the final quarter of last year. We therefore expect only moderate growth in business investment this year as the heightened uncertainty from the ongoing euro area difficulties limits firms' investment plans to capital replacement rather than expansionary projects.
- 3.63 We continue to expect strong medium-term investment growth rates, repeating the pattern of the 1990s recovery. The 14 per cent fall in business investment since 2008 almost exactly matches the 15 per cent fall in business investment in the first four years of the 1990s recession. In the subsequent five years, business investment grew by over 50 per cent. The recovery in our current forecast is smaller at 40 per cent, as shown in Chart 3.15.

Chart 3.15: Business investment compared to the 1990s



Source: ONS, OBR

- 3.64 We have revised down our medium-term forecast for business investment compared to November, though we still expect strong annual growth of around 10 per cent in the final two years of the forecast. As we highlighted in Box 3.5 of our November EFO, the official data may have overstated the strength of corporate assets in the run-up to the financial crisis. Further assessment of this suggests that firms' cash balances may not be able to support as much investment as we previously thought. Set against this, we expect a boost to the level of business investment of 1 per cent over the forecast period from the corporation tax rate cut announced in the Budget.

3.65 In November, the Government published the National Infrastructure Plan 2011, alongside its Autumn Statement. It included an aim to deliver around £30 billion of new long-term investment projects. This included the aim of encouraging around £20 billion of private investment from pension funds. This is still under discussion and subject to significant uncertainties, so is not included in our forecast. Over the forecast period, £5 billion of additional Government investment, announced in the Autumn Statement, was included in our November forecast. No additional projects have been announced in the Budget. We have therefore not made any further adjustments to our investment forecast to reflect the plan.

### Residential investment

3.66 The outlook for residential investment growth mirrors the prospects for property transactions and the housing market, discussed in more detail in Box 3.4. The level of residential investment halved in just eight quarters during the recession, and has yet to make up much of this ground. After a further year of subdued activity in both prices and transactions, we expect the UK housing market to start moving back to more normal levels of activity from 2013. Despite averaging annual growth of over 10 per cent a year from 2013 to 2016, the forecast increase is from a very low starting base, and we expect residential investment to remain below its pre-recession peak in 2017.

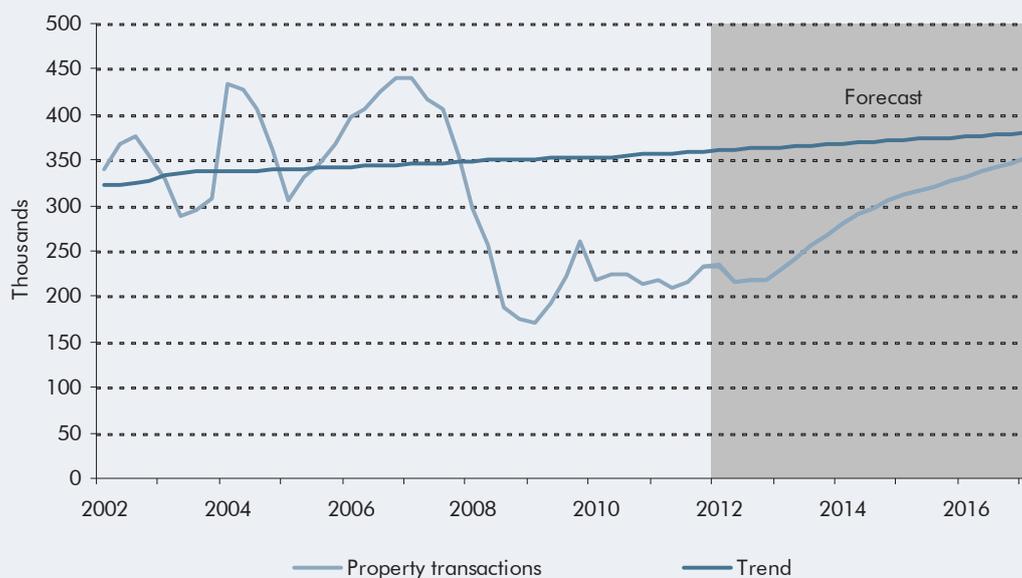
### Box 3.4: Turnover in the housing market

Residential property transactions fell sharply in 2008 as the availability of mortgage finance fell. Lenders' risk appetite was reduced, as funding conditions deteriorated, resulting in stricter credit standards. This led to a sharp fall in purchases by first-time buyers, who are now typically asked to raise a 25 per cent deposit, compared to 10 per cent before the crisis.<sup>o</sup> Turnover has recovered a little from its trough in 2009, but remains well below its long-run trend, as shown on Chart A.

There has been a pick-up in residential property transactions and mortgage approvals in the past few months, probably driven by the upcoming expiry of the stamp duty exemption for first-time buyers in March 2012. We, therefore, expect transactions to fall back again in the short term, before recovering slowly from 2013 onwards as credit conditions ease.

Our medium-term projection of property transactions are conditioned on a return toward the long-run average rate of turnover in the housing market – which implies owner-occupiers move once every 19 years. The depressed current level of transactions is consistent with owner-occupiers moving only once every 30 years. We are forecasting a relatively slow return to the long-run average, which is not quite complete by the end of the forecast period. By this time, and despite strong growth rates, the level of property transactions is still around 20 per cent below the pre-crisis peak.

Chart A: Property transactions



Source: HMRC, OBR

<sup>o</sup> CML, 2010, *Affordability and first-time buyers*, Housing Finance Issue 01 2010

## Stock building

3.67 In November we assumed that the demand weakness around the turn of the year would lead to a short involuntary stock build-up. This looks to have been justified, so far, as the pace of stock accumulation initially rose then decelerated in to the fourth quarter of 2011. Survey measures of stock adequacy are currently not far from their long-run averages and we do not expect any further significant contributions to growth from this component in our forecast.

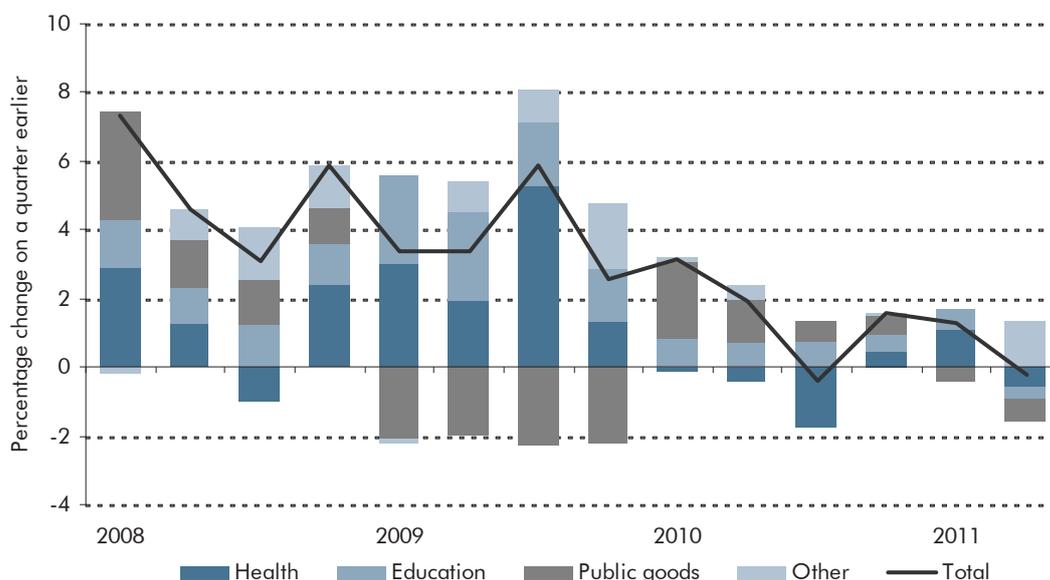
## Government

3.68 Government consumption looks to have made a positive contribution to growth in 2011 and is currently estimated to have grown by a little over 1 per cent in real terms in the final quarter of the year. We now expect government consumption growth to turn negative in the second quarter of 2012, but its ongoing growth to date has been a persistent upward surprise relative to our forecasts. The latest National Accounts release revised down government consumption growth throughout 2011, making the profile appear more plausible against the backdrop of real terms departmental budget cuts in 2011-12.

3.69 Nevertheless, the positive contributions from this component are still surprising. Comparing the current vintage of data to the interim OBR's June 2010 forecast reveals that, in cash terms, government spending on goods and services has been almost exactly in line with forecast. However, growth in the price of government consumption has been weaker than forecast, and weaker than whole economy inflation. This has resulted in stronger real government consumption growth than was anticipated by the interim OBR and in our previous forecasts.

3.70 The weakness in prices is likely largely to reflect the way in which government consumption is measured: the majority is based on direct output measures (e.g. the number of hospital operations, or school pupils) rather than by deflating a nominal measure with a price index. Therefore if nominal spending growth falls, but the direct output measures are little changed, measured inflation will fall. Chart 3.16 demonstrates this effect: the fall in government consumption inflation, since 2010, is largely a result of a fall in the contributions from the health and education sectors, in which output is primarily directly measured.

Chart 3.16: Contributions to general government consumption inflation



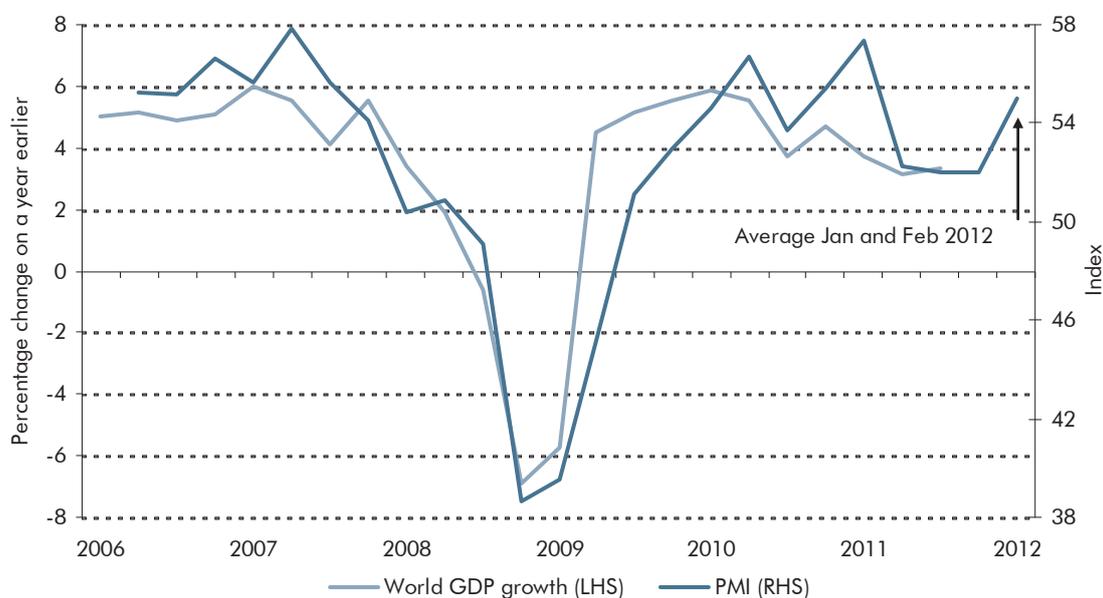
Source: ONS, OBR

3.71 This effect has been larger than we allowed for in earlier forecasts, so we have revised down our forecast for government consumption inflation throughout the forecast period. This reduces the drag on growth from this component in the forecast. However the cumulative negative effect on GDP over the period 2011 to 2016 remains broadly unchanged at around 2 percentage points.

## World economy

3.72 World output growth slowed towards the end of 2011. But recent survey evidence points to a pick up in global activity at the start of 2012. For example, the JP Morgan *Global PMI Composite Index* rose in February to a 12 month high, as shown in Chart 3.17. Mainly as a result of the weaker euro area data toward the end of 2011, we have revised down our world output growth forecasts by 0.2 percentage points in 2012 and 0.3 percentage points in 2013.

Chart 3.17: World GDP growth and PMI indicator



Source: IMF and JP Morgan

- 3.73** The euro area remains a major risk to our forecast. The ECB's recent long-term refinancing operations, discussed further in Box 3.2, have significantly reduced immediate pressures in euro area financial markets, but the underlying situation remains very fragile. Indeed there is now more evidence of a feed through from the sovereign debt crisis to the real economy. Output in the euro area fell in the last quarter of 2011 by more than we expected in November. As a result, outside forecasters revised down their projections of euro area GDP growth in 2012 by an average of 0.7 percentage points between November and February.<sup>17</sup>
- 3.74** We have revised down our forecast for euro area growth in 2012 by 0.8 percentage points to -0.3 per cent. This largely reflects a downgrade to growth in some of the periphery countries, in particular Spain and Italy. We still expect euro area growth to pick up in the second half of 2012, but at a slower rate than previously anticipated, partly reflecting the impact of additional fiscal tightening announced since November. Consequently, we have also revised down our growth forecast for 2013 by 0.4 percentage points to 1.1 per cent. In Chapter 5 we consider the possible implications for the UK's public finances of the stylised downside scenario published by the OECD in November.

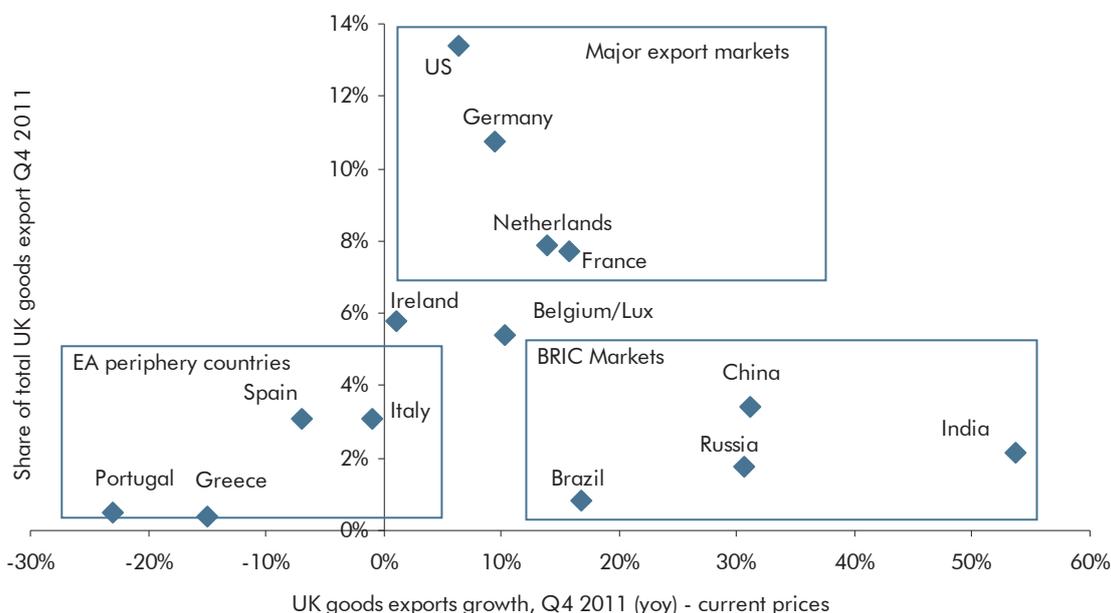
<sup>17</sup> Consensus Economics, 2011, *Consensus Forecasts: World Economic Activity*, October. Consensus Economics, 2012, *Consensus Forecast: World Economic Activity*, February.

- 3.75 Developments in the US have been more positive. Output grew faster than we expected in the final quarter of 2011 and recent survey data are consistent with stronger growth in the first quarter of 2012. Employment data in recent months have been consistent with a steady recovery in the labour market, leading us to revise up our forecast for GDP growth in 2012.
- 3.76 Consistent with our November forecast, output growth for most emerging economies slowed at the end of 2011 with weaker global demand affecting exports. A tighter monetary policy stance, responding to inflationary pressures, has also softened domestic demand. We expect growth to moderate further in 2012, consistent with the weaker outlook for the advanced economies, before picking up again in 2013, albeit at a slightly slower pace than we expected in November. In emerging economies, there remains considerable scope for looser monetary policy if the advanced economies should weaken further.

## World trade

- 3.77 World trade was relatively flat in the last months of 2011, slightly weaker than we expected in November but consistent with softer demand. We have revised down our world trade forecast, in line with our global output forecast, and now expect trade to grow by 4.1 per cent in 2012 and 6.4 per cent in 2013 before picking up to 6.9 per cent in 2014.
- 3.78 Our forecast for UK export market growth is 0.1 percentage points lower in 2012 and 0.6 percentage points lower in 2013 than in our November forecast. We have revised down demand for UK exports by less than world trade. This is primarily because the euro area countries that have seen their growth prospects revised down the most, such as Italy and Spain, account for a relatively small share of UK exports. Chart 3.19 shows that periphery euro area economies account for a small and falling share of UK exports, while the euro area economies to which we export most are fairing better. Faster growing economies, such as the Brazil, Russia, India and China (BRICs) group, account for a small but rising proportion of UK exports.

Chart 3.18: UK export markets



Source: ONS

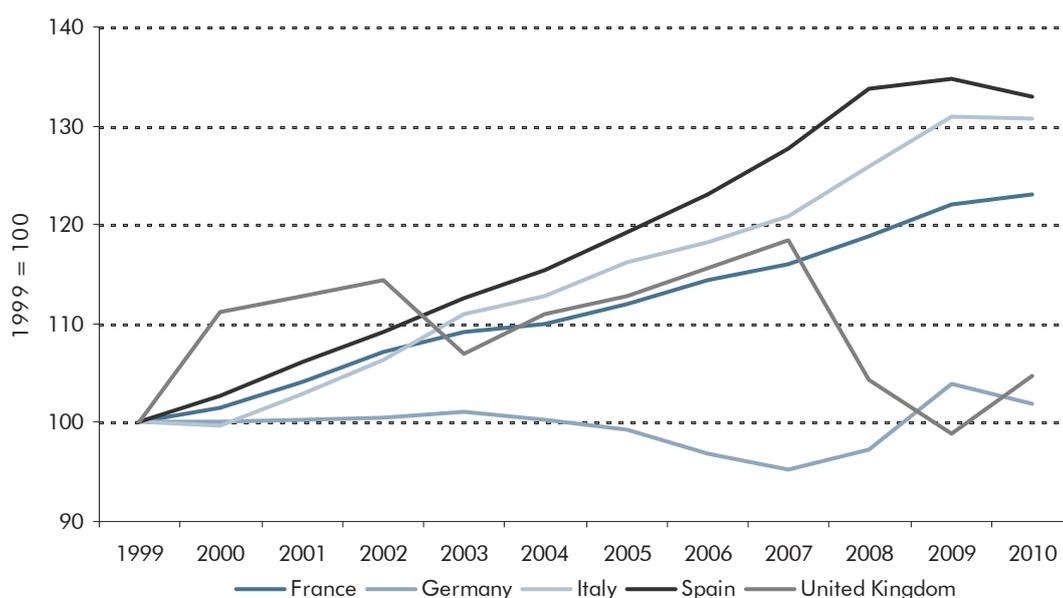
## Exports

- 3.79** It is difficult to judge the current degree of momentum in UK export growth. At first sight the strength of UK goods exports, which grew by almost 4 per cent in the final quarter of last year, is somewhat surprising given the deterioration in euro area growth prospects in the second half of last year. However, short-run movements in trade data can be erratic (and are prone to large revisions) so it is difficult to draw firm conclusions at this stage. Surveys of export orders also pointed to a continued easing in growth prospects in the second half of 2011.
- 3.80** There is some early evidence of a divergence in the outlook for EU and non-EU trade. The Deloitte CFO survey for the fourth quarter of 2011 indicated that foreign-facing firms appear less pessimistic than domestic-facing firms, recording higher risk appetite and a more expansionary outlook. More recently, the CBI services sector survey for the first quarter of 2012 reported that the value of business with EU markets declined over the past three months with a further decline expected, but the value of business with non-EU firms has increased. These survey readings are supported by the ONS monthly trade release for January which showed that while core goods exports to the EU have fallen 2.9

per cent since last August, core exports to non-EU destinations have increased by 13.3 per cent.<sup>18</sup>

3.81 We also expect UK exports to continue to be supported by the sustained real sterling depreciation that began in 2007. The importance of the real exchange rate depreciation, and the resulting boost to the UK’s external competitiveness, can be seen in Chart 3.19, which shows the relative unit labour costs of the UK and the larger euro area countries, measured in euros. After tracking the rise in relative unit labour costs in France, Italy and Spain in the first half of the last decade, the depreciation of sterling in 2008 resulted in falling UK unit labour costs, towards those in Germany. This has underpinned the 2½ percentage point contribution of net exports to UK growth since 2007.

Chart 3.19: Relative unit labour costs



Source: OECD, Bank of England, OBR

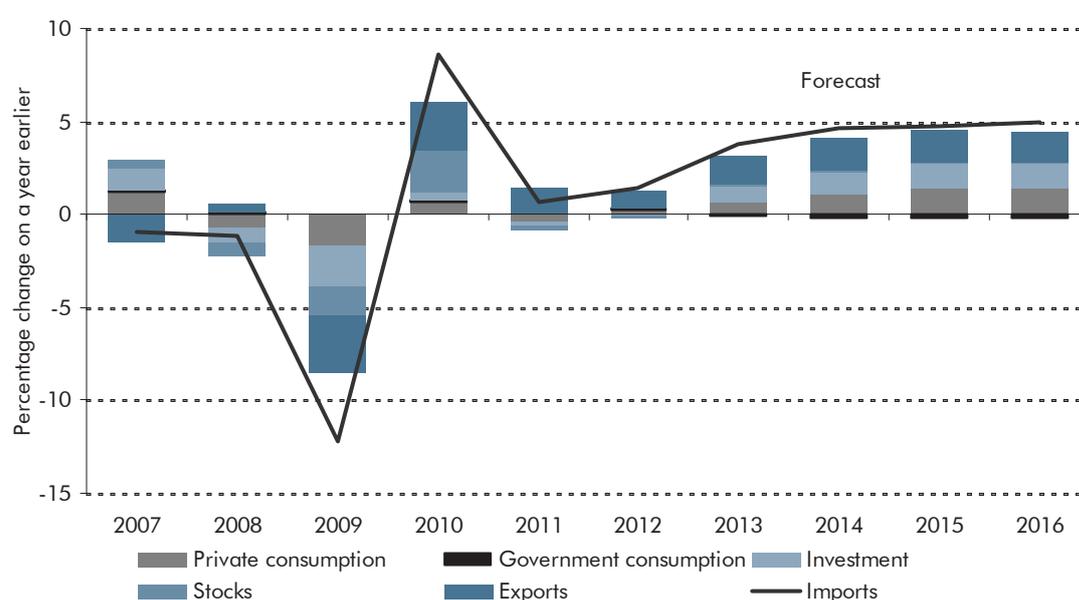
## Imports

3.82 Our forecast for import growth is little changed from November. In the medium term our forecast is driven by the outlook for relative prices and domestic demand, weighted by the relative import intensity of the components of domestic demand. Chart 3.20 shows these individual contributions to our domestic demand and import growth forecast. The very high import intensity of

<sup>18</sup> Excluding oil and erratics

stockbuilding, which was a major contribution to the decline in GDP in the recession, goes some way to explain the very large fall and rebound in import growth in 2009 and 2010. Similarly, the sizeable negative contribution of government consumption to overall GDP growth in our forecast has only limited implications for import growth, given its relatively low import intensity.

Chart 3.20: Contributions to import-weighted domestic demand growth and UK import growth



Source: ONS, OBR

## Net trade

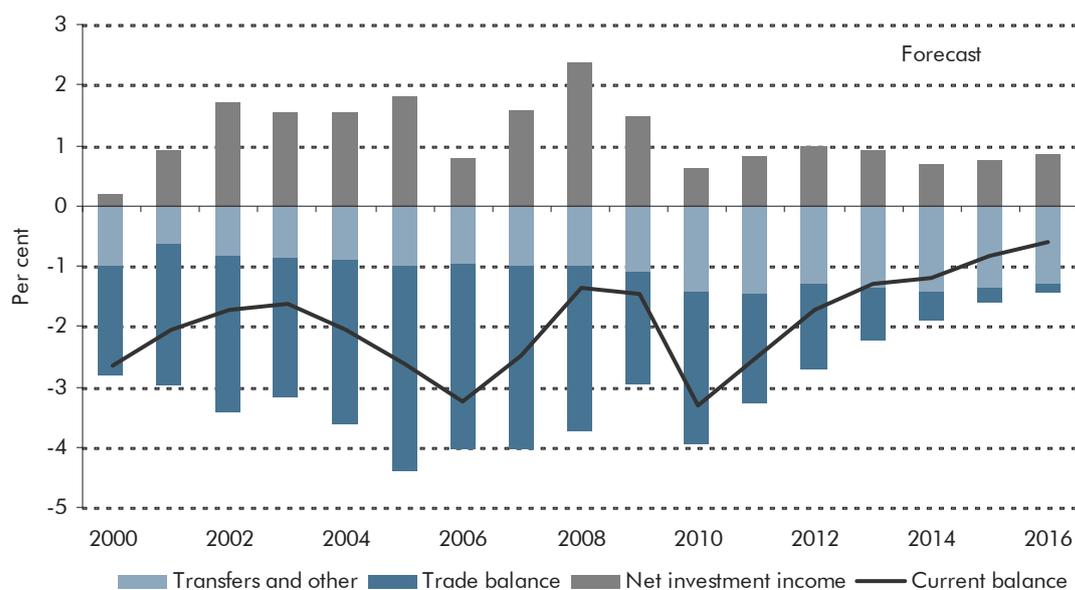
3.83 With the outlook for domestic demand growth unchanged in our forecast, the revisions to headline GDP growth in 2012 and 2013 are attributable to small changes in the net trade contribution. The upward revision to the contribution in 2012 is more than accounted for by the large positive contribution in the final quarter of 2011. The contribution from net trade has been revised down modestly in every quarter of 2012 and 2013, relative to our November forecast, reflecting the downward revision to expected growth in UK export markets. We continue to expect the 25 per cent depreciation of sterling in 2007 to lead to a total net trade contribution to GDP growth of around 4 percentage points, with around two-thirds of this effect having already occurred.

## Balance of payments

3.84 The steady narrowing of the trade deficit is forecast gradually to reduce the size of the UK's current account deficit, which falls to around  $\frac{1}{2}$  per cent of GDP by 2016. The narrowing of the trade balance is partially offset by a slight increase in

transfers and we do not expect net investment income, as a share of GDP, to return to pre-crisis levels.

Chart 3.21: Current account balance as a share of GDP



Source: ONS, OBR

## Inflation and the GDP deflator

3.85 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation, including the Consumer Prices Index (CPI) and the Retail Prices Index (RPI) measures. The basic approach to the measurement of inflation using these indices is the same, although there are a number of differences due to coverage, the representative population covered by the indices, and the methods used to construct them.<sup>19</sup>

3.86 The RPI and CPI measures of inflation are important because they have different effects on our fiscal forecast. The Government uses CPI for the indexation of most tax rates, allowances and thresholds and the uprating of benefits and public sector pensions. The RPI is used for calculating interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties.

<sup>19</sup> For more details on the differences between the RPI and CPI, see OBR Working paper No. 2, *The long-run difference between RPI and CPI inflation*, available on our website.

## CPI inflation

- 3.87 Annual CPI inflation was broadly in line with our November forecast in the final quarter of 2011. Since November, it has continued to fall from its peak of 5.2 per cent in September 2011, as petrol price increases in late 2010 have fallen out of the annual comparison. In January 2012, CPI inflation fell to 3.6 per cent as some of the impact of the previous January's rise in VAT, a one-off shock to the price level, dropped out of the annual comparison.<sup>20</sup>
- 3.88 The size and timing of the impact that the increase in VAT had on CPI inflation (and therefore the consequences of it falling out of the annual comparison) depend on how much of the increase was passed on to consumers and when. This is uncertain, but we continue to assume that around 75 per cent of the VAT rise was passed through to consumer prices by the end of the first quarter of 2011.<sup>21</sup> This is likely to have added around 1 percentage point to CPI inflation in 2011, which falls out of the annual comparison in early 2012.
- 3.89 The substantial retail gas and electricity price rises, which occurred towards the end of 2011, will continue to contribute to CPI inflation through 2012 and only partly be offset by the smaller reductions in prices announced in early 2012. We expect the contribution to inflation from utility prices to fall in the latter part of 2012, as the 2011 price rises drop out of the annual calculation.
- 3.90 Our forecast assumes that oil prices move in line with the prices implied by futures markets, using the average of the 10 days to 27 February 2012. Since November, oil prices have risen amid tensions in the Gulf region and heightened concerns about future oil supply. The futures market suggests that oil prices will remain higher throughout the forecast period than we assumed in November, but that they will fall back more quickly than expected previously to \$95 per barrel in 2016. Prospects for oil prices remain a significant uncertainty and the possibility of a further temporary spike in prices represents a risk to our forecast, the possible impact of which we assess in Chapter 5.
- 3.91 We expect the upward pressure on inflation from higher energy and commodity prices to fade and weaker prospects for global demand growth to put further downward pressure on import prices relative to our November forecast. The disinflationary impact of spare capacity in the domestic economy will weigh on inflation in the medium term. Therefore, we expect CPI inflation to remain close

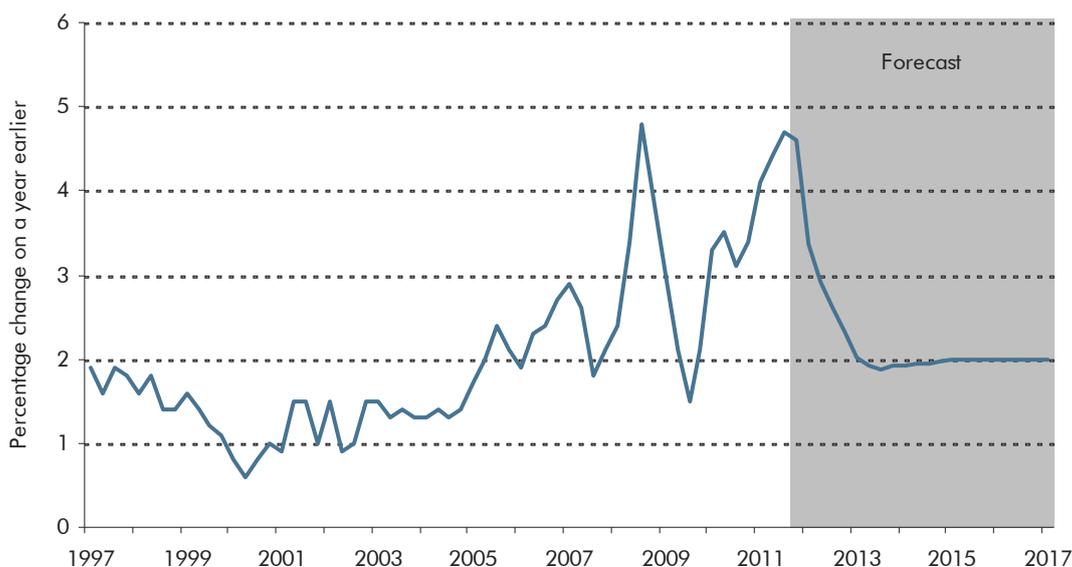
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<sup>20</sup> Our forecast takes into account inflation outturns up to and including January 2012.

<sup>21</sup> The ONS has calculated an estimate for the impact of the VAT increase on CPI inflation for January 2011 only, which suggests that the rise in VAT increased the annual rate of CPI inflation by 0.76 percentage points. For more details see: ONS, 2011, Information note, *Impact of the VAT increase on the CPI*.

to, but slightly below, 2 per cent in 2013, returning to target by the beginning of 2015 (Chart 3.22).

Chart 3.22: CPI inflation forecast



Source: ONS, OBR

3.92 Policy announcements made by the Government have also been incorporated in our inflation forecast. The increase in the number of goods subject to the standard rate of VAT will have a small, but temporary, upward effect on the annual rate of CPI and RPI inflation in 2012-13, with a permanent effect on the level of prices. The one-off increase in tobacco duty rates, by 5 per cent above the RPI in 2012-13 also has a small upward effect on the annual rate of CPI and RPI inflation in 2012-13, relative to the baseline of pre-announced policy. Taken together these measures are estimated to add around 0.1 percentage points to the annual rate of CPI and RPI inflation in 2012-13. However, there are a number of uncertainties around this estimate. In particular, the extent to which items that are affected by the VAT measure feature in the baskets of goods used to construct the CPI and RPI.

### RPI inflation

3.93 RPI inflation is expected to follow a similar path to CPI inflation, but this measure of inflation also includes mortgage interest payments (MIPs) and housing depreciation. We assume that house prices rise in line with the median outside

forecast of Communities and Local Government (CLG) house prices.<sup>22</sup> House prices have been slightly higher in the final quarter of 2011 than we assumed in November. Despite this, the median forecast suggests weaker house price inflation in the fourth quarters of 2012 and 2013 than we expected in November. From 2015, we expect house price inflation to rise broadly in line with the long-term average rate of earnings growth.

- 3.94 We have revised down our forecast for UK banks' funding costs in the near term. Relative to November, our forecast for the contribution of MIPs to RPI inflation is, therefore, lower in the near term but slightly higher at the end of the forecast period reflecting movements in the yield curve.

## The GDP deflator

- 3.95 GDP deflator growth is a broad measure of general inflation in the domestic economy. It measures the changes in the overall level of prices for goods and services that make up GDP, including price movements in consumption, government spending, investment and trade.
- 3.96 We have revised down our near-term forecast for the GDP deflator as a result of weaker-than-expected data in the fourth quarter of 2011 and revisions to its quarterly path since 2010. Since November, the outlook for global demand growth has weakened, contributing to weaker import price inflation over the next few years. All else equal, this judgement has an upward effect on the terms of trade – the ratio of export to import prices – but a downward effect on the consumption deflator. The recent volatility of ONS estimates of the price of government consumption also injects uncertainty into the outlook for the GDP deflator and we now expect this component to rise more slowly over the forecast period (for more details see paragraphs 3.68 to 3.71). In aggregate, we expect GDP deflator growth to remain broadly in line with our November forecast in the medium term.

## The labour market

### Employment, unemployment and inactivity

- 3.97 As set out in Chapter 2, the labour market has performed broadly in line with our November forecast. In line with the similar outlook for output growth, our forecast for the level of ILO unemployment (Chart 3.23) is broadly unchanged from our November projection. We expect ILO unemployment to rise gradually over the remainder of the year as output growth remains below the economy's potential

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<sup>22</sup> See HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, March, 2012.

growth rate. The unemployment rate is forecast to peak at 8.7 per cent at the end of this year, corresponding to a peak unemployment level of 2.8 million. We then expect it to fall back from the start of 2013 as output growth picks up.

**3.98** We have revised down our projection of the claimant count. The claimant count is now expected to peak at around 1.67 million (Chart 3.23), compared to the peak of 1.8 million we expected in November. Of the revision to the peak level of the claimant count, around 70,000 is attributable to better than expected outturns since November. The remaining reduction is largely accounted for by a methodological change to the way in which the impacts of policies affecting the number of people on Jobseeker’s Allowance are incorporated into the forecast, rather than a change in the effectiveness of policy in moving individuals between benefits.

Chart 3.23: Unemployment levels



Source: ONS

**3.99** Between the start of 2011 and the start of 2017, we expect total employment to increase by around 1 million. This comprises an expected rise in market sector employment of around 1.7 million, partly offset by a reduction in general government employment of around 730,000. Box 3.5 sets out more details of our latest general government employment projection.

### Box 3.5: General government employment

Our projection of general government employment (GGE) is built up from projections of the growth of total government paybill and paybill per head. We use these projections to estimate the total decline in GGE over the forecast horizon and then make a stylized assumption that employment falls at a constant rate to that end-point from the latest outturn data. We have taken the same approach here as we did in our November EFO.

Our latest projection takes on board expenditure projections and new data on average earnings and workforce reductions to date in 2011-12:

- In November we projected a 710,000 fall in general government employment between the start of 2011 and the start of 2017.
- Our latest forecast suggests that there will be slightly less departmental spending and therefore less money available to pay government employees at the start of 2017 than we thought in November. Other things being equal, this would reduce GGE by a further 30,000 in 2017 relative to our projection in November.
- This revision is partially offset by the fact that government employees are expected to be slightly cheaper in 2017 than we thought in November. The latest data suggest that average earnings have grown by only around 1.4 per cent a year so far in 2011-12, compared to an estimate of 1.6 per cent at the time of our November forecast. So we have revised down our estimate of paybill per head growth this year from 2 to 1.8 per cent. Other things being equal, the resulting downward revision to the expected level of paybill per head in 2017 would increase GGE by around 10,000;<sup>a</sup>
- The net effect of these two changes is that we have increased the projected fall in GGE between the start of 2011 and the start of 2017 to around 730,000. The latest outturn data imply that GGE fell at an average rate of just over 80,000 per quarter between the first and third quarters of 2011, which implies an average fall of just under 30,000 per quarter over the remainder of the period. This is consistent with anecdotal evidence that many public sector employers are attempting to frontload employment reductions.

<sup>a</sup> More details of our assumptions for the growth of paybill and paybill per head, as well as general government employment projections by year, can be found in the supplementary tables accompanying this EFO, available on our website.

- 3.100 There is little evidence of a significant structural deterioration in the labour market since our November forecast. The incidence of long-term unemployment fell back slightly in the fourth quarter of 2011, and remains low relative to previous recessions. Youth unemployment remains elevated. The unemployment rate among those aged 18-24 has risen by around 8 percentage points since the start of 2008, compared to an increase in the aggregate rate of just over 3 percentage points. This may pose an upside risk to the structural unemployment rate if high youth unemployment leads to long-term labour market detachment. Set against this, some of the increase in the 18-24 unemployment rate is attributable to a reduction in labour market activity as more individuals have entered higher education, which may have some offsetting positive effect on long-term labour market prospects.
- 3.101 While the impact of higher youth unemployment on long-term labour market prospects remains uncertain, we do not judge there to be sufficient evidence at this stage to adjust our estimate of the long-term Non-Accelerating Inflation Rate of Unemployment (NAIRU). Our forecast of unemployment is therefore conditioned on a long-term NAIRU of 5.35 per cent, unchanged from our November forecast.

## Earnings

- 3.102 Average earnings growth remains weak. Average weekly earnings (AWE) in the private sector grew by 2.2 per cent in the year to the final quarter of 2011, slightly lower than the rate recorded in the third quarter. Annual growth in whole economy wages and salaries per employee picked up from less than 1 per cent in the second quarter to 2.4 per cent in the third, although this measure of earnings growth is particularly volatile.
- 3.103 Key determinants of the prospects for average earnings growth include the growth rate of productivity, the extent of labour market slack and the degree of real wage resistance to changes in price inflation. With our projection for employment and output growth broadly similar to our November forecast, and the latest data continuing to point to subdued real wage growth, we have maintained a broadly unchanged forecast for nominal earnings growth. Whole economy nominal wages are expected to grow by around 2½ per cent this year, rising gradually over the course of 2013 as productivity growth picks up and spare capacity in the labour market starts to be taken up. With price inflation continuing to remain elevated over the near term, annual real wage growth is

expected to remain close to zero on average in 2012, picking up gradually from the first half of 2013 and settling at around 2 per cent by 2015.<sup>23</sup>

- 3.104 Recent data indicate that total wages and salaries, a key determinant of tax receipts from labour income, were just under ½ per cent higher in the year to the third quarter of 2011 than we expected in November. With a broadly unchanged outlook for the growth of average earnings and employment, this implies a small upward adjustment to wages and salaries relative to our November forecast, with the level of wages and salaries around £5 billion higher by 2016-17.

## Comparison with external forecasts

- 3.105 In this section, we compare our latest projections with those of key outside forecasters. Different assumptions about how the euro area crisis will evolve and how the economy will be affected, which are hard to assess quantitatively, probably explain much of the difference between forecasts at the current time. Estimates of the current degree of spare capacity and the potential growth rate of the economy also differ widely. The degree to which the economy will shift away from consumption towards investment and net exports is a further area of debate. In what follows, we compare selected outside forecasts to our own.
- 3.106 In its January *World Economic Outlook Update*, the International Monetary Fund (IMF) forecast that GDP growth in 2012 would be 0.2 percentage points weaker than in our central forecast. The forecast was produced before recent improvements in near-term indicators and credit conditions, which could explain some of the difference. The January update does not include a medium-term forecast, but the *October World Economic Outlook* contained a slightly weaker growth forecast than our own in 2014-2016. The IMF forecast is for lower inflation in 2012 which could reflect its larger output gap forecast.
- 3.107 In its January *Economic Review*, the National Institute for Economic and Social Research (NIESR) presented a weaker growth forecast in 2012 than us, slightly stronger in 2013-2014, but weaker again in 2015-2016. NIESR expects investment growth to be substantially lower than we project this year, which explains most of the difference in the headline GDP forecast for 2012. This could be related to expectations of tighter credit conditions, which have eased somewhat since the publication of its forecast. NIESR has a weaker forecast for potential output growth, implying less scope for medium-term growth. NIESR forecasts lower inflation throughout the forecast period, presumably due to its wider output gap forecast.

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<sup>23</sup> Whole economy wages and salaries per employee, deflated by the GDP deflator.

- 3.108 In its February *Interim Forecast*, the European Commission expected GDP growth in 2012 to be slightly weaker than we project, at 0.6 per cent. The *Interim Forecast* did not include a detailed expenditure breakdown so it is difficult to assess where the difference lies. The Commission is expecting inflation in 2012 to be 2.7 per cent, in line with our forecast. The Commission's forecast for growth in 2013, from its *Autumn Economic Forecast*, is 0.5 percentage points below ours. This reflects weaker forecast domestic demand, but a stronger contribution from net trade.
- 3.109 In its November *Economic Outlook*, the OECD presented a more downbeat view of the economy with significantly weaker investment and government consumption growth than we forecast. Inflation in 2013 is expected to be lower than we anticipate, probably reflecting a larger output gap projection.
- 3.110 Comparison with the Monetary Policy Committee's economic forecast is not straightforward because the Bank of England only publishes point estimates for two variables, CPI inflation and GDP growth. We have a weaker output growth profile, especially in 2012 and 2013. The MPC's median forecast for annual CPI inflation is below our central forecast in 2012 to 2014.

Table 3.5: Comparison of external forecasts

	Per cent					
	2011	2012	2013	2014	2015	2016
<b>OBR (March 2011)</b>						
GDP growth	0.8	0.8	2.0	2.7	3.0	3.0
CPI inflation	4.5	2.8	1.9	1.9	2.0	2.0
Output gap	-2.7	-2.6	-2.5	-2.1	-1.3	-0.5
<b>IMF (January 2012<sup>1</sup>)</b>						
GDP growth	0.9	0.6	2.0	2.6	2.7	2.7
CPI inflation	4.5	2.5	2.0	2.0	2.0	2.0
Output gap	-2.9	-3.2	-2.8	-2.1	-1.5	-0.8
<b>OECD (November 2011)</b>						
GDP growth	0.9	0.5	1.8			
CPI inflation	4.4	2.7	1.3			
Output gap	-3.7	-4.4	-4.1			
<b>EC (February 2012<sup>2</sup>)</b>						
GDP growth	0.9	0.6	1.5			
CPI inflation	4.5	2.7	2.0			
Output gap	-3.3	-3.6	-3.1			
<b>NIESR (January 2011)</b>						
GDP growth	0.9	-0.1	2.3	2.8	2.5	2.4
CPI inflation	4.5	2.2	1.4	1.6	1.7	1.8
Output gap <sup>3</sup>		-4				
<b>Bank of England (February 2011)</b>						
GDP growth (median) <sup>4</sup>	1.2	1.3	2.8	3.1		
CPI inflation (median) <sup>4</sup>	4.5	2.7	1.7	1.8		

<sup>1</sup>Forecasts for GDP growth in 2014-16, CPI inflation and the output gap are taken from September 2011 *World economic outlook*.

<sup>2</sup>Forecast for 2013 and the output gap is taken from the November 2011 *Autumn Economic Forecast*.

<sup>3</sup>Output gap not published.

<sup>4</sup>Median forecast based on market interest rates and the Bank of England's 'backcast' for GDP growth.

Table 3.6: Detailed summary of central forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2010	2011	2012	2013	2014	2015	2016
<b>World economy</b>							
World GDP at purchasing power parity	5.1	3.8	3.3	4.1	4.7	4.8	4.9
Euro Area GDP	1.8	1.5	-0.3	1.1	1.6	1.7	1.7
World trade in goods and services	12.4	6.3	4.1	6.4	6.9	6.9	7.0
UK export markets <sup>1</sup>	12.1	6.2	3.6	6.1	6.3	6.2	6.3
<b>UK economy</b>							
Gross domestic product (GDP)	2.1	0.8	0.8	2.0	2.7	3.0	3.0
<b>Expenditure components of GDP</b>							
Domestic demand	2.9	-0.8	0.3	1.5	2.4	2.8	2.9
Household consumption <sup>2</sup>	1.2	-0.8	0.5	1.3	2.3	3.0	3.0
General government consumption	1.5	0.3	0.5	-1.1	-2.1	-2.8	-2.7
Fixed investment	3.1	-1.7	-0.3	6.2	8.6	8.9	8.7
Business	-2.1	0.2	0.7	6.4	8.9	10.2	10.1
General government <sup>3</sup>	7.8	-13.0	-5.0	-3.6	0.1	0.4	-1.4
Private dwellings <sup>3</sup>	13.3	2.4	0.2	10.5	11.6	9.9	9.7
Change in inventories <sup>4</sup>	1.3	-0.1	-0.1	0.0	0.0	0.0	0.0
Exports of goods and services	7.4	4.8	2.9	5.3	5.7	5.5	5.3
Imports of goods and services	8.6	0.6	1.4	3.8	4.6	4.8	4.9
<b>Balance of payments current account</b>							
£ billion	-49	-38	-27	-21	-20	-15	-11
Per cent of GDP	-3.3	-2.5	-1.7	-1.3	-1.2	-0.8	-0.6
<b>Inflation</b>							
CPI	3.3	4.5	2.8	1.9	1.9	2.0	2.0
RPI	4.6	5.2	3.2	2.3	2.5	3.6	4.0
Terms of trade <sup>5</sup>	-0.6	-1.5	-0.2	0.2	0.2	0.0	-0.1
GDP deflator at market prices	2.9	2.3	2.5	2.5	2.5	2.5	2.5
<b>Labour market</b>							
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Wages and salaries	2.2	1.5	2.0	3.5	5.1	5.5	5.6
Average earnings <sup>6</sup>	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
<b>Household sector</b>							
Real household disposable income	-0.2	-1.4	0.2	0.5	1.9	2.4	2.5
Saving ratio (level, per cent)	7.2	6.3	6.6	5.9	5.6	5.2	5.0
House prices	7.2	-0.7	-0.4	0.1	2.5	4.5	4.5
<b>Nominal indicators</b>							
Nominal GDP	5.0	3.1	3.3	4.6	5.3	5.6	5.6
Non-oil PNFC profits <sup>7</sup>	-1.0	11.9	4.7	6.9	9.6	9.4	9.2

<sup>1</sup> Other countries' imports of goods and services weighted according to the importance of those countries in the UK's total exports

<sup>2</sup> Includes households and non-profit institutions serving households

<sup>3</sup> Includes transfer costs of non-produced assets

<sup>4</sup> Contribution to GDP growth, percentage points

<sup>5</sup> Ratio of export to import prices

<sup>6</sup> Wages and salaries divided by employees

<sup>7</sup> Private non-oil non-financial corporations' gross trading profits

Table 3.7: Detailed summary of changes to forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2010	2011	2012	2013	2014	2015	2016
<b>World economy</b>							
World GDP at purchasing power parity	0.0	0.0	-0.2	-0.3	0.0	0.0	0.0
Euro Area GDP	0.1	-0.1	-0.8	-0.5	-0.3	-0.1	0.0
World trade in goods and services	0.2	-0.3	-0.8	-0.7	-0.3	-0.1	-0.1
UK export markets <sup>1</sup>	0.5	0.1	-0.1	-0.6	0.0	0.3	0.4
<b>UK economy</b>							
Gross domestic product (GDP)	0.3	-0.1	0.1	-0.1	0.0	0.0	0.0
<b>Expenditure components of GDP</b>							
Domestic demand	0.2	-0.3	0.0	0.1	0.0	0.0	0.0
Household consumption <sup>2</sup>	0.1	0.2	0.4	0.1	0.1	0.3	0.1
General government consumption	0.0	-2.0	0.7	0.5	0.2	0.4	0.8
Fixed investment	0.5	0.4	-3.8	-1.2	0.0	-1.1	-0.9
Business	-2.9	0.9	-6.9	-2.5	-0.5	-2.4	-2.3
General government <sup>3</sup>	5.0	-6.2	4.4	0.6	0.2	1.4	0.9
Private dwellings <sup>3</sup>	6.9	4.0	-2.4	0.6	1.1	0.9	2.2
Change in inventories <sup>4</sup>	0.0	-0.1	0.2	0.1	-0.1	0.0	0.0
Exports of goods and services	1.2	0.8	-0.1	-0.4	0.1	0.1	0.2
Imports of goods and services	0.1	0.6	-0.4	0.0	0.2	0.2	0.2
<b>Balance of payments current account</b>							
£ billion	-12	-7	9	4	3	7	10
Per cent of GDP	-0.8	-0.4	0.6	0.2	0.1	0.4	0.5
<b>Inflation</b>							
CPI	0.0	0.0	0.1	-0.2	-0.1	0.0	0.0
RPI	0.0	0.0	-0.1	-0.6	-0.5	0.1	0.1
Terms of trade <sup>5</sup>	-0.4	0.0	0.4	0.3	0.4	0.2	0.0
GDP deflator at market prices	0.0	-0.2	-0.3	0.0	0.0	0.0	0.0
<b>Labour market</b>							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Wages and salaries	0.3	0.1	0.2	0.0	0.0	0.0	0.0
Average earnings <sup>6</sup>	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
<b>Household sector</b>							
Real household disposable income	-0.3	1.0	0.5	-0.4	-0.1	-0.1	0.1
Saving ratio (level, per cent)	-0.4	-0.4	0.1	-0.3	-0.4	-0.7	-0.7
House prices	0.0	0.1	-0.2	-1.8	-1.8	0.0	0.0
<b>Nominal indicators</b>							
Nominal GDP	0.4	-0.3	-0.2	0.0	-0.1	0.0	0.0
Non-oil PNFC profits <sup>7</sup>	-2.4	4.3	1.3	0.6	0.2	0.0	-0.1

<sup>1</sup> Other countries' imports of goods and services weighted according to the importance of those countries in the UK's total exports

<sup>2</sup> Includes households and non-profit institutions serving households

<sup>3</sup> Includes transfer costs of non-produced assets, which were excluded in previous forecasts

<sup>4</sup> Contribution to GDP growth, percentage points

<sup>5</sup> Ratio of export to import prices

<sup>6</sup> Wages and salaries divided by employees

<sup>7</sup> Private non-oil non-financial corporations' gross trading profits



## 4 Fiscal outlook

### Summary

- 4.1 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.
- 4.2 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.
- 4.3 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.
- 4.4 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.
- 4.5 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.

Table 4.1: 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
<b>Fiscal mandate and supplementary target</b>								
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 <sup>1</sup>	52.5	60.5	67.3	71.9	75.0	76.3	76.0	74.3
<b>Changes since November forecast</b>								
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 <sup>1</sup>	-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

<sup>1</sup> Debt at end March; GDP centred on end March.

- 4.6 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).
- 4.7 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.
- 4.8 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.

- 4.9 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.
- 4.10 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.

**Table 4.2: Changes to public sector net borrowing since November forecast**

	Per cent of GDP					
	Outturn 2011-12	2012-13	2013-14	Forecast 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
<i>of which:</i>						
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

- 4.11 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 in the next chapter we outline how our forecasts for the public sector finances would be expected to change under different economic scenarios.

## Introduction

- 4.12 This chapter sets out our medium term forecasts for the public finances. These consist of an in-year estimate for 2011-12, that makes use of provisional ONS outturn data for April to January and some preliminary outturn data for February<sup>1</sup>, and then forecasts to 2016-17. As set out in the Foreword the

<sup>1</sup> Outturn data is consistent with the Public Sector Finances January 2012 statistical bulletin published by the Office for National Statistics. We have also used HMRC administrative data on central government receipts in February to inform our forecast.

Chancellor asked us to finalise our ‘pre-measures’ fiscal forecast on 7 March in order to provide him with a stable basis on which to take his final Budget policy decisions. The only subsequent material changes that we made to the forecast were to account for the effects of Budget policy decisions.

### 4.13 As in previous EFOs, this fiscal forecast:

- represents our central view for the path of the public finances. We believe that the outturns are as likely to be above the forecast as below it. We illustrate the uncertainties that are inherent in any fiscal forecast by using fan charts, sensitivity analysis and alternative economic scenarios;
- is based on the forecast of the economy set out in Chapter 3. Public sector receipts and certain elements of expenditure are closely linked to the performance of the economy;
- is based on announced Government policy on the indexation of rates, thresholds and allowances for taxes and benefits;
- incorporates the impact of certified costings for all new policy measures announced by the Chancellor in his Budget Statement;
- includes cyclically-adjusted versions of the key fiscal aggregates, which adjust for the effect of the economic cycle on the public finances. We currently use the Treasury’s approach to cyclical adjustment along with our own estimates of output gaps over the forecast period;<sup>2</sup> and
- focuses on fiscal aggregates that exclude the temporary effects of interventions in the financial sector.<sup>3</sup> The Government’s fiscal mandate and supplementary target are defined in terms of these measures.

### 4.14 We have set out our approach to the fiscal forecast in a briefing paper *Forecasting the public finances* available on our website. This explains in detail how we work with government departments to assemble a bottom-up forecast of the UK public finances. We produce separate forecasts for individual categories of receipts, spending and financial transactions, and our briefing paper outlines

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<sup>2</sup> HM Treasury, 2008, *Public sector finances and the cycle: Treasury Economic Working Paper No. 5*. The cyclical adjustment coefficients we use are based on the relationship between past fiscal aggregates and the Treasury’s estimates of past output gaps. In November we published Working Paper No.1: *Estimates of the UK output gap* which explores methods of estimating a historical output gap series. This will enable us to reassess the size of the cyclical adjustment coefficients.

<sup>3</sup> Office for National Statistics, 2010, *Public sector finances excluding financial sector interventions*.

how each is constructed, the key economic determinants used, and the judgements that need to be taken. All judgements and assumptions have been agreed by the OBR's Budget Responsibility Committee (BRC) which takes full responsibility for the final forecast.

4.15 The outline for this chapter is as follows:

- the key economic and market determinants that drive the fiscal forecast to 2016-17 (paragraphs 4.17 to 4.37);
- the effect of new policy announced in this Budget on the fiscal forecast (paragraphs 4.38 to 4.45);
- the outlook for public sector receipts, including a tax by tax analysis explaining how the forecasts have changed since November (paragraphs 4.46 to 4.93);
- the outlook for public sector expenditure, focussing in particular on the components of annually managed expenditure (paragraphs 4.94 to 4.152);
- the outlook for government lending to the private sector and other financial transactions (paragraphs 4.153 to 4.169);
- the outlook for key fiscal aggregates, including public sector net borrowing, the cyclically-adjusted current budget balance and public sector net debt (paragraphs 4.170 to 4.185); and
- a comparison with external forecasts (paragraphs 4.186 to 4.192).

4.16 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in the supplementary tables available on our website.

## Economic determinants of the fiscal forecast

4.17 Our forecasts for the public sector finances are closely linked to our economic forecasts. Tax receipts, in particular, depend on the evolution of individual tax bases that are in turn largely determined by the strength and composition of economic activity. And even though about half of public expenditure is set out in fixed multi-year plans, the remainder (notably social security and debt interest payments) are linked to developments in the economy. Table 4.3 presents some of the key economic determinants of the fiscal forecast and Table 4.4 shows how these have changed since our previous forecast in November.

## GDP and the output gap

- 4.18 While most economic forecasts focus on the outlook for real (i.e. inflation-adjusted) GDP, nominal GDP is more important for the public finances forecast. In this forecast the expected level of nominal GDP is marginally lower than November, which mainly reflects a downward revision to the GDP deflator in 2012.
- 4.19 The size of the output gap determines the 'structural' or cyclically-adjusted component of the deficit. A more negative output gap implies that more of the deficit will disappear automatically as the economy recovers, pushing up revenues and reducing spending. We estimate that the output gap in Q4 2011 was -2.5 per cent of potential non-oil GVA, and will close to -0.4 per cent by 2016-17. The estimate of the output gap at the end of 2011 is slightly narrower than in November.

## Income and expenditure

- 4.20 The composition of nominal GDP is also very important for the fiscal forecast. For example, labour income is generally taxed at higher effective rates than company profits. On the expenditure side, additional household consumption leads to extra indirect tax receipts, while the initial effect of stronger investment would be to reduce corporation tax receipts as companies claim higher capital allowances.
- 4.21 **Labour income**, particularly wages and salaries, is a key determinant for income tax and NICs. We forecast that wages and salaries growth will remain weak over the next year, but then pick up in line with real activity and falling unemployment. By 2016-17, the level of wages and salaries is slightly higher than in the November *EFO* reflecting higher than expected growth in the third quarter of 2011. Our forecast shows a small decline in the labour share of income from 75.6 per cent in 2010-11 to 74.7 per cent in 2016-17, which other things equal would imply a slight fall in the share of tax receipts to GDP.
- 4.22 Our forecasts for **company profits**, which largely determine corporation tax receipts, show different paths for the non-financial and financial sectors. Non-financial sector profits are expected to pick up strongly in the second half of the forecast period, as the economy recovers. We expect growth in financial sector profits to recover in the next couple of years, but to be constrained in the medium term by regulatory changes, such as the reforms proposed by the Independent Commission on Banking. This assumption is unchanged from our November forecast.
- 4.23 We now also publish forecasts of **net taxable income** for industrial and commercial companies and the financial sector. This is produced by adjusting

our company profit forecast for estimates of other sources of corporate income as well as deductions relating to losses, allowances and reliefs. It is then used by HMRC to forecast corporation tax receipts. For industrial and commercial companies, net taxable income grows faster than profits in 2011-12 as group reliefs arising from the recession end, but growth is slower than profits in the later years of the forecast due to losses carried forward and growth in capital allowances. For the financial sector net taxable income grows faster than profits from 2013-14 as increases in interest rates lead to higher interest income.

- 4.24 **Nominal consumer spending**, which drives VAT and other indirect tax receipts, is also expected to pick up as the economic recovery becomes stronger. However, we expect the share of household consumption in GDP to fall over the forecast period, partly due to a strong rebound in **business investment**. This effect is slightly weaker than in our November forecast, as we have revised down business investment growth and marginally revised up consumption growth, as explained in Chapter 3.

## Inflation

- 4.25 **CPI inflation** is used to index most tax rates, allowances and thresholds and to uprate benefits and public sector pensions. Our forecast of CPI inflation is slightly lower than in November, falling marginally below the Bank of England target of 2 per cent in 2013-14 and 2014-15, mainly reflecting weaker import prices.
- 4.26 **RPI inflation** determines the interest paid on index-linked gilts and is used to revalorise excise duties. RPI inflation is significantly lower in the medium term than in our November forecast due to the impact of lower interest rates on mortgage interest payments and weaker import prices.
- 4.27 The **GDP deflator** is an important determinant for our forecast of total managed expenditure. Revisions to 2011 data mean that the level of the GDP deflator is slightly lower in the short term compared to our previous forecast, but annual growth in the medium term is broadly unchanged.

## Equity markets

- 4.28 **Equity prices** are an important determinant of capital gains tax, inheritance tax and stamp duty receipts. They also affect receipts from self assessment income tax and financial corporations. Equity prices are assumed to rise from their present level in line with nominal GDP. The present level is determined by the average of the closing price of the FTSE All-Share index over the ten working days ending 27 February 2012. The higher starting point means that equity prices are stronger throughout the forecast period than in November.

Table 4.3: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>GDP and its components</b>							
Real GDP	2.2	0.5	1.0	2.3	2.8	3.1	3.0
Nominal GDP (£ billion) <sup>1</sup>	1478	1521	1576	1652	1740	1839	1941
Nominal GDP <sup>1</sup>	5.1	2.9	3.6	4.8	5.3	5.7	5.6
Nominal GDP (centred end-March)	3.4	3.3	4.3	5.1	5.5	5.7	5.4
Wages and salaries <sup>2</sup>	1.5	1.7	2.1	4.1	5.2	5.6	5.6
Non-oil PNFC profits <sup>2,3</sup>	-1.0	11.9	4.7	6.9	9.6	9.4	9.2
Non-oil PNFC net taxable income <sup>2,3</sup>	5.1	15.0	6.8	7.2	7.3	6.8	6.5
Consumer spending <sup>2,3</sup>	5.4	3.2	3.8	3.9	4.8	5.6	5.6
<b>Prices and earnings</b>							
GDP deflator	2.7	2.2	2.7	2.5	2.5	2.5	2.5
RPI (September)	4.6	5.6	3.0	2.3	2.6	3.7	4.0
CPI (September)	3.1	5.2	2.6	1.9	1.9	2.0	2.0
Whole economy earnings growth	0.9	2.1	2.4	3.5	4.4	4.5	4.6
<b>Key fiscal determinants</b>							
Claimant count (millions) <sup>4</sup>	1.47	1.58	1.66	1.61	1.49	1.31	1.16
Employment (millions)	29.1	29.1	29.1	29.3	29.5	29.8	30.1
VAT gap (per cent)	10.1	9.7	9.3	9.3	9.3	9.3	9.3
<i>Financial and property sectors</i>							
Equity prices (FTSE All-share index)	2885	2917	3138	3290	3465	3662	3866
HMRC financial sector profits <sup>1,3,5</sup>	4.0	-10.0	3.7	6.8	5.4	4.0	3.4
Financial sector net taxable income <sup>1,3</sup>	11.6	-6.0	2.4	8.2	7.1	7.0	6.5
Residential property prices <sup>6</sup>	5.3	-0.7	-0.6	0.5	3.3	4.5	4.5
Residential property transactions	-1.7	1.5	-1.5	18.8	15.6	7.4	6.2
Commercial property prices <sup>7</sup>	0.1	2.9	0.9	4.5	5.5	5.1	4.1
Commercial property transactions <sup>7</sup>	8.5	-3.3	-0.8	1.8	4.7	5.9	5.9
Volume of share transactions	-13.0	-16.0	2.4	2.3	2.8	3.1	3.0
<i>Oil and gas</i>							
Oil prices (\$ per barrel) <sup>3</sup>	80	111	118	112	105	99	95
Oil prices (£ per barrel) <sup>3</sup>	52.0	69.2	74.4	70.2	65.9	62.5	60.0
Gas prices (p/therm)	43.4	60.6	63.4	63.5	59.6	56.1	53.6
Oil production (million tonnes) <sup>3,8</sup>	63.0	51.9	48.3	47.7	47.2	46.6	44.7
Gas production (billion therms) <sup>3,8</sup>	20.6	16.1	16.1	15.9	15.6	15.6	14.9
<i>Interest rates and exchange rates</i>							
Market short-term interest rates (per cent) <sup>9</sup>	0.7	1.0	1.0	0.8	1.0	1.7	2.3
Market gilt rates (per cent) <sup>10</sup>	2.8	2.2	2.3	2.8	3.2	3.5	3.8
Euro/Sterling exchange rate	1.18	1.16	1.18	1.18	1.18	1.17	1.17

<sup>1</sup> Not seasonally adjusted<sup>2</sup> Nominal<sup>3</sup> Calendar year<sup>4</sup> UK seasonally-adjusted claimant count<sup>5</sup> HMRC Gross Case 1 trading profits<sup>6</sup> Outturn data from Communities and Local Government (CLG) property prices index<sup>7</sup> Outturn data from HMRC information on stamp duty land tax<sup>8</sup> DECC forecasts from 2012 available at [www.og.decc.gov.uk](http://www.og.decc.gov.uk)<sup>9</sup> 3-month sterling interbank rate (LIBOR)<sup>10</sup> Weighted average interest rate on conventional gilts

Table 4.4: Changes to determinants since the November forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>GDP and its components</b>							
Real GDP	0.3	-0.1	0.1	-0.1	0.0	0.0	0.0
Nominal GDP (£ billion) <sup>1</sup>	1	0	-1	-2	-3	-3	-4
Nominal GDP <sup>1</sup>	-0.3	-0.1	-0.1	-0.1	-0.1	0.1	0.0
Nominal GDP (centred end-March)	-0.7	-0.1	0.0	-0.1	0.0	0.1	-0.2
Wages and salaries <sup>2</sup>	0.2	0.1	0.1	0.0	0.0	0.0	0.0
Non-oil PNFC profits <sup>2,3</sup>	-2.5	4.3	1.3	0.7	0.2	0.0	-0.1
Non-oil PNFC net taxable income <sup>2,3</sup>	-1.1	4.8	1.4	1.6	0.7	0.5	0.0
Consumer spending <sup>2,3</sup>	0.5	-0.2	0.6	0.1	0.0	0.3	0.1
<b>Prices and earnings</b>							
GDP deflator	-0.1	-0.4	0.0	0.0	0.0	0.0	0.0
RPI (September)	0.0	0.0	-0.1	-0.6	-0.5	0.1	0.1
CPI (September)	-0.1	0.0	0.1	-0.2	-0.1	0.0	0.0
Whole economy earnings growth	0.3	0.4	0.3	0.0	0.0	0.0	0.1
<b>Key fiscal determinants</b>							
Claimant count (millions) <sup>4</sup>	0.00	-0.02	-0.12	-0.14	-0.14	-0.08	-0.03
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
VAT gap (per cent)	0.4	-0.1	-0.5	-0.4	-0.5	-0.5	-0.5
<i>Financial and property sectors</i>							
Equity prices (FTSE All-share index)	0	67	234	243	254	270	284
HMRC financial sector profits <sup>1,3,5</sup>	0.0	0.0	-0.4	0.0	0.1	0.1	0.0
Financial sector net taxable income <sup>1,3</sup>	-0.2	2.9	-1.5	-1.4	-2.2	-1.2	-0.6
Residential property prices <sup>6</sup>	0.0	0.2	-0.5	-2.2	-1.1	0.0	0.0
Residential property transactions	0.1	4.5	-3.0	-1.9	0.0	0.0	0.0
Commercial property prices <sup>7</sup>	0.0	-1.8	-0.2	0.9	0.1	-0.8	-1.3
Commercial property transactions <sup>7</sup>	0.0	1.4	-4.5	-1.9	-1.0	-0.5	-0.3
Volume of share transactions	-4.2	-8.3	0.5	-0.1	0.0	0.0	0.0
<i>Oil and gas</i>							
Oil prices (\$ per barrel) <sup>3</sup>	0	0	13	11	8	5	4
Oil prices (£ per barrel) <sup>3</sup>	0.0	0.9	9.9	8.4	6.8	5.4	4.2
Gas prices (p/therm)	0.0	0.7	3.0	2.4	-1.0	-2.5	-3.7
Oil production (million tonnes) <sup>3,8</sup>	0.0	-1.4	-5.0	-3.5	-2.3	-1.0	-1.3
Gas production (billion therms) <sup>3,8</sup>	0.0	0.0	-0.7	-0.2	0.1	0.7	0.5
<i>Interest rates and exchange rates</i>							
Market short-term interest rates (per cent) <sup>9</sup>	0.0	0.1	0.1	-0.2	-0.5	-0.4	-0.4
Market gilt rates (per cent) <sup>10</sup>	0.0	-0.1	-0.3	-0.1	0.0	0.1	0.2
Euro/Sterling exchange rate	0.00	0.03	0.05	0.04	0.04	0.03	0.03

<sup>1</sup> Not seasonally adjusted<sup>2</sup> Nominal<sup>3</sup> Calendar year<sup>4</sup> UK seasonally-adjusted claimant count<sup>5</sup> HMRC Gross Case 1 trading profits<sup>6</sup> Outturn data from Communities and Local Government (CLG) property prices index<sup>7</sup> Outturn data from HMRC information on stamp duty land tax<sup>8</sup> DECC forecasts available at [www.og.decc.gov.uk](http://www.og.decc.gov.uk)<sup>9</sup> 3-month sterling interbank rate (LIBOR)<sup>10</sup> Weighted average interest rate on conventional gilts

- 4.29 The **volume of share transactions** is an important determinant of receipts from stamp duty levied on those transactions. We expect these to increase from their present level in line with real GDP growth. The volume of share transactions is significantly lower than in November. This reflects lower outturn data on the number of transactions reported to HMRC for stamp duty which we expect to persist through the forecast period.

## Property market

- 4.30 The residential property market is a key driver of receipts from stamp duty land tax and inheritance tax. **Residential property prices** in 2012 and 2013 are assumed to grow in line with the median of independent forecasts, which is currently lower than the November forecast. House prices are then expected to rise in line with average earnings.
- 4.31 We expect **residential property transactions** to grow strongly in 2013 when credit restrictions start to ease and housing transactions move towards a level consistent with the historical average duration of home ownership. Compared to the November forecast we are now expecting volumes to be higher in 2011-12, reflecting a temporary pick up related to the end of the stamp duty exemption for first-time buyers in March 2012, before returning to a level similar to that in the November forecast. More detail on this forecast is provided in Box 3.4 in Chapter 3.
- 4.32 Our forecast of **commercial property prices** is sluggish through 2012 before picking up more strongly as the economic recovery gathers pace. **Commercial property transactions** are also expected to be weak in the near term. The recovery in volumes is slower than for residential property, reflecting the current high incidence of forbearance on loans to the real estate sector, and that we expect developer activity to be more concentrated in the residential sector. Our outlook for the commercial property sector is weaker than in November.

## Oil and gas sector

- 4.33 **Oil prices** are assumed to move in line with the prices implied by futures markets. For our forecast we take an average of the futures curve over the ten working days ending 27 February 2012. Oil prices are higher than in our November forecast, but on the basis of the futures curve are still expected to fall in the second half of the forecast period.
- 4.34 **Gas prices** have historically followed the trend in oil prices, but they decoupled in the early part of 2009 due to a number of supply side pressures affecting global oil production. In this forecast we expect gas prices to follow the same trend as oil

prices but with a six month lag. This means that gas prices are higher than our November forecast up to 2013-14 but lower thereafter.

- 4.35 Our forecasts for **oil and gas production** uses the central projection published by DECC.<sup>4</sup> In 2011 oil and gas production fell by 18 per cent and 22 per cent respectively, but this annual drop is judged to be a one-off occurrence rather than a worsening trend. Production levels are now expected to be significantly lower in the near term than in our November forecast, but the lower trend decline in production sees this shortfall gradually diminish by the end of the forecast period.

### Interest rates

- 4.36 **Short-term interest rates** are defined as the 3 month sterling interbank rate (LIBOR). Our forecast uses the average forward rates for the ten working days ending 27 February 2012. At that point the futures curve had fallen by an average of 27 basis points compared to November.
- 4.37 Our forecast assumes **gilt rates** move in line with market expectations based on the average of the rates prevailing over the ten days up to and including 27 February 2012. Relative to our November assumptions, gilt rates are lower in the near term, but then marginally higher towards the end of the forecast period.

## Effects of new policy announcements and policy risks

- 4.38 The Government publishes estimates of the direct impact of tax and spending policy decisions on the public finances in its 'scorecard' table. The OBR provides independent scrutiny and certification of these costings and explains if it agrees with them. If we disagree, we use our own costings in our forecast. We are also responsible for assessing any indirect effects of policy measures on the economic forecast. These are discussed in Box 3.1 in Chapter 3. The OBR also notes any significant policy commitments that are not quantifiable at the current time as fiscal risks.

### Direct effect of new policy announcements on the public finances

- 4.39 Annex A reproduces the Treasury's table of the direct effect on PSNB of policy decisions in Budget 2012 or announced since the Autumn Statement in November 2011. The OBR has endorsed all of the tax and AME expenditure costings in the Treasury's table as being reasonable central estimates. As we explain in more detail in our annex to the Treasury's *Budget 2012 policy costings*

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<sup>4</sup> [http://og.decc.gov.uk/en/olgs/cms/data\\_maps/field\\_data/field\\_data.aspx#](http://og.decc.gov.uk/en/olgs/cms/data_maps/field_data/field_data.aspx#)

document, a number of these costings are highly uncertain, in particular the announcements on the additional rate, the cap on income tax reliefs, stamp duty land tax avoidance, controlled foreign companies, machine games duty and right to buy: paying-down housing debt.

Table 4.5: Summary of the impact of policy measures

	£ billion				
	2012-13	2013-14	Forecast 2014-15	2015-16	2016-17
Effect of receipts measures <sup>1</sup>	-1.8	-0.8	1.2	-0.9	0.0
of which:					
Income tax and NICs	-2.4	-2.3	-0.5	-2.3	-1.4
Onshore corporation tax	0.4	0.3	0.1	-0.4	-0.5
Stamp duty	0.2	0.3	0.3	0.4	0.4
Bank levy	0.0	0.4	0.5	0.5	0.5
UK oil and gas revenues	-0.2	0.2	0.5	0.4	0.3
Other	0.2	0.3	0.4	0.6	0.6
Effect of expenditure measures <sup>2</sup>	-0.1	-0.2	0.8	1.0	1.2
of which:					
Current DEL	-0.1	0.4	0.9	1.0	1.1
Current AME	-0.1	-0.7	-0.8	-0.7	-0.7
Capital DEL	0.0	0.1	0.5	0.4	0.4
Capital AME	0.0	0.1	0.2	0.3	0.3
<b>Total direct effect of policy measures on PSNB</b>	<b>-1.9</b>	<b>-1.0</b>	<b>2.0</b>	<b>0.1</b>	<b>1.1</b>
<b>Total direct effect of policy measures on current balance</b>	<b>-2.0</b>	<b>-1.2</b>	<b>1.3</b>	<b>-0.6</b>	<b>0.4</b>
Financial transactions	-0.2	-0.2	0.0	0.0	0.0
of which:					
Business Finance Partnership	-0.1	-0.1	0.0	0.0	0.0
Get Britain Building	-0.1	-0.1	0.0	0.0	0.0
Memo: Effect of the transfer of the Royal Mail's historic pension deficit					
Public sector net borrowing	28.0	0.0	0.0	0.0	0.0
Public sector net debt	18.4	22.9	22.9	22.9	22.9

<sup>1</sup> Includes forestalling impacts from Budget 2012 measures

<sup>2</sup> Expenditure categories are equivalent to PSCE in RDEL, PSCE in AME, PSGI in CDEL and PSGI in AME in Table 4.17

Note: This uses the Treasury scorecard convention that a positive figure means an improvement in the PSNB, CGNCR and PSND

**4.40** The top section of Table 4.5 summarises the Treasury's policy costings table. This table follows the Treasury convention that a positive figure means an improvement in PSNB, i.e. higher receipts or lower expenditure. The Budget measures are broadly neutral in their impact on the public finances across the forecast horizon, with 'giveaways' and 'takeaways' largely offsetting each other. In 2016-17, the current fiscal mandate year, the measures reduce borrowing by £1.1 billion and improve the current budget balance by £0.4 billion. The policy measures lead to changes to both expenditure and receipts. Where significant the

effects are discussed in the tax and expenditure sections of this chapter. The key changes are:

- the measures result in lower receipts in the short term but the impact is neutral by 2016-17. The largest changes are to income tax and NICs receipts as a result of the measures on the personal allowance, additional rate and age-related allowances. Table 4.5 includes the impact of the Treasury's estimate of 'reverse forestalling' ahead of the reduction in the additional rate of income tax in 2014-15. The cost of the reduction in the additional rate is discussed in more detail in Box 4.2; and
- the measures result in a reduction in expenditure of £1.2 billion by 2016-17. There are a number of different expenditure measures, the largest being the changes to Child Benefit which increases AME expenditure, and the reduction in the special reserve for Afghanistan which decreases DEL expenditure.

4.41 Table 4.5 also shows the impact of two small measures which are classified as financial transactions and so do not affect PSNB but do affect the Central Government Net Cash Requirement (CGNCR) and PSND.

4.42 The impact of the Government's decision in June 2011 to take on the Royal Mail's historic pension deficit with effect from April 2012 is explained in detail in Box 4.1. The final timing and details of this transfer were still uncertain at the time of the November *EFO*, so at that time we explained the potential impact as a fiscal risk rather than including it in our central forecast. The Government has now laid in Parliament the statutory instruments which will facilitate the transfer and so we are now including the effects in our central fiscal forecast.

#### Box 4.1: Implications of transferring the historic deficit of Royal Mail's pension fund to the public sector

The Government is currently legislating to take on Royal Mail's historic pension deficit with effect from April 2012. It intends to take over the pension liabilities accrued up to March 2012 and a share of the pension fund's assets, leaving behind a fully funded pension scheme. The Treasury estimates the value of the assets being transferred at around £28 billion, with the present value of the liabilities transferring at around £37.5 billion. The liabilities will crystallise over time in the form of payments to pensioners.

The ONS decide on the treatment in the National Accounts of public sector transactions. The advice we have received from the Treasury is that the initial transfer of assets will be treated as a capital grant from the private to the public sector. The liabilities will be treated as a contingent liability which will not affect the National Accounts but will feature in the Whole of Government Accounts.

The Government has announced its intention to cancel the gilt holdings during 2012-13 and sell the majority of the non-gilt assets within the first two years, although less liquid assets such as property and private equity will take longer to realise. We therefore assume that all non-gilt liquid assets are sold in 2012-13 and 2013-14, but make no assumption for the less liquid assets. Although it remains dependent on the final amount and breakdown of the assets and liabilities transferred, the Treasury's latest estimates, included in our forecast, are that:

- PSNB will be reduced in 2012-13 by the total value of the assets transferred, which is around £28 billion;
- the central government net cash requirement (CGNCR) and PSND will immediately be reduced by around £4.5 billion, reflecting the cash portion of the assets transferred. They will fall by a further £9 billion over 2012-13 and 2013-14 as the non-gilt liquid assets are sold. The transfer of gilts held by the fund will reduce PSND by over £9 billion in 2012-13, equal to the uplifted nominal value of the debt. (The market value of the debt is estimated to be over £11 billion, but the uplifted nominal value, which is the amount that affects PSND, is closer to £9 billion). The subsequent cancellation of gilts will have no further impact on the fiscal aggregates. In total, as a result of these elements, PSND will be reduced by £23 billion from 2013-14 onwards;
- pension payments will raise public sector expenditure and PSNB over time, by between £1.3 and £1.6 billion in each year of the forecast period; and
- income from the assets retained will raise receipts by around £0.5 billion per year, while debt interest costs will fall by up to £1 billion each year.

The overall impact of these flows would be to raise PSNB by up to £0.3 billion per year in the medium term, but the Government has chosen to offset the forecast net cost over the current Spending Review period through a reduction in DEL reserves, leaving no overall impact on PSNB over these years. Table A sets out the various effects of the transfer on the public finances including this offset. The current budget and the cyclically-adjusted current budget are unaffected.

The immediate impact on the public finances would appear to be significantly beneficial. However, the value of the liabilities exceeds the current present value of the assets resulting in a real cost to the Government over the lifetime of the pension scheme.

Table A: Impact on the public sector finances of the Royal Mail transfer

	£ billion				
	2012-13	2013-14	2014-15	2015-16 <sup>1</sup>	2016-17 <sup>1</sup>
Receipts	0.6	0.5	0.5	0.4	0.4
Current expenditure	0.6	0.5	0.5	0.4	0.4
o/w: Pension payments	1.3	1.4	1.4	1.5	1.6
Debt interest	-0.5	-0.6	-0.8	-0.9	-0.9
DEL reserves <sup>1</sup>	-0.2	-0.2	-0.2	-0.2	-0.3
Net investment	-28.0	0.0	0.0	0.0	0.0
Public sector net borrowing	-28.0	0.0	0.0	0.0	0.0
Current budget	0.0	0.0	0.0	0.0	0.0
Public sector net cash requirement	-9.0	-4.5	0.0	0.0	0.0
Public sector net debt	-18.4	-22.9	-22.9	-22.9	-22.9
Memo: PSNB including transfer	92	98	75	52	21
Memo: PSNB excluding transfer	120	98	75	52	21

<sup>1</sup> The allocation of DELs beyond the current Spending Review period is yet to be determined. Beyond 2014-15, the table assumes the net cost continues to be offset through a cut in DEL reserves. In practice, we apply the Government's stated policy assumption for total spending in 2015-16 and 2016-17. By 2016-17, PSNB is up to £0.1 billion higher under our central forecast than illustrated in the table.

## Currently unquantifiable policy commitments

4.43 Consistent with the *Charter for Budget Responsibility*, our projections do not include the impact of policies where there is insufficient detail or certainty of implementation to quantify the impact and allocate it to particular years. Where significant, these are noted as fiscal risks:

- the **UK-Switzerland tax deal** announced in August 2011, which is not included in the central projection as it is subject to ratification by the Swiss Parliament and a possible referendum. HMRC and Ministers have stated that the yield from this policy is in the range of £4 to £7 billion. We have not certified this costing. Our initial discussions with HMRC suggested

significant uncertainties and we currently judge that the yield is likely to be towards the lower end of the range. We will consider the available evidence further for the final costing;

- new EU rules which come into force in 2015 will mean that **VAT is charged at the customer location** rather than the supplier location, as at present. There are a number of uncertainties around the potential revenue raised but we will look to include an estimate in our next *EFO*; and
- we only include the impact of **asset sales** in our medium-term forecasts once sufficiently firm details are available of the nature, size and timing of the transactions for the effects to be quantified with reasonable accuracy. At this Budget the Government has made a commitment to sell the non-gilt liquid assets acquired as part of the transfer of the Royal Mail pension scheme to the public sector over the next two years. As we have reasonable estimates of the value of these we include these sales in our central forecast. No other substantive announcements have been made since the November *EFO* that would allow us to quantify the effects of other proposed sales, such as spectrum, with reasonable accuracy.

4.44 There are both upside and downside risks to the forecast from these policies. The tax-related risks could potentially increase receipts. Certain financial asset sales would reduce PSND initially, but the impact on net borrowing would depend on the future income flows associated with the assets. At current market prices, as set out in Box 4.3, the sale of the public sector banks would lead to a significant loss to the taxpayer.

4.45 In previous *EFOs* we have identified the Coalition Agreement's long-term objective to raise the personal allowance to £10,000 as a specific fiscal risk, on the grounds that additional policy action would be required to achieve it within our forecast horizon. Following the Budget announcement of an additional £1,100 increase in the allowance to £9,205 in 2013-14, the conventional assumption that the allowance will thereafter be uprated in line with inflation would on our current forecast take it to £9,675 in 2015-16 and £10,035 in 2016-17. These figures would change if our inflation forecast changes in future *EFOs* and the Government could, of course, make further policy announcements to reach £10,000 more quickly or slowly.

## Public sector receipts

4.46 Our central forecasts for current receipts are set out in Table 4.6, which shows the main streams of receipts as a per cent of GDP, and Table 4.7, which provides a detailed breakdown of the forecast by individual taxes and other types of receipts. Table 4.8 shows how the forecast has changed since November.

4.47 Total public sector current receipts as a share of GDP are expected to increase slightly between 2011-12 and 2016-17. However, this largely reflects an increase in non-tax receipts, specifically interest and dividend receipts, which grow more quickly as interest rates increase from their current low levels. The share of National Accounts taxes in GDP is expected to rise slightly between 2011-12 and 2014-15 but then fall back to the 2011-12 level by 2016-17 reflecting offsetting contributions from different taxes.

4.48 Receipts are expected to increase as a proportion of GDP for:

- income tax and NICs, reflecting policy changes and the effects of ‘fiscal drag’ in the later years of the forecast – once earnings start to rise faster than tax thresholds and allowances, people will find more of their income taxed at higher rates; and
- capital taxes, due mainly to increases in equity prices and residential property transactions;

4.49 Receipts are expected to fall as a proportion of GDP for:

- oil and gas revenues due to a trend decline in production and continued high levels of capital and operating expenditure that offset tax liabilities;
- fuel duties, reflecting improvements in vehicle efficiency, and because duty rates are revalorised in line with RPI which grows at a slower rate than nominal GDP;
- VAT due to a slight fall in the household consumption share of GDP and a strong contraction in government procurement spending; and
- business rates, council tax and excise duties where annual increases in tax rates are generally lower than the growth rate in nominal GDP.

Table 4.6: Major taxes as a percentage of GDP

	Per cent of GDP						
	Outturn 2010-11	2011-12	2012-13	Forecast			
				2013-14	2014-15	2015-16	2016-17
Income tax and NICs	17.0	16.7	16.5	16.7	17.1	17.2	17.4
Value added tax	5.8	6.4	6.5	6.4	6.4	6.3	6.3
Onshore corporation tax	2.4	2.2	2.3	2.3	2.2	2.2	2.3
UK oil and gas receipts	0.6	0.7	0.6	0.5	0.5	0.3	0.3
Fuel duties	1.8	1.8	1.7	1.7	1.7	1.6	1.6
Business rates	1.6	1.6	1.7	1.7	1.7	1.6	1.6
Council tax	1.7	1.7	1.7	1.7	1.7	1.6	1.6
Excise duties	1.3	1.3	1.3	1.3	1.2	1.2	1.2
Capital taxes	1.0	1.1	1.0	1.1	1.2	1.3	1.3
Other taxes	2.5	2.6	2.8	2.8	2.8	2.7	2.6
<b>National Accounts taxes</b>	<b>35.8</b>	<b>36.2</b>	<b>36.1</b>	<b>36.3</b>	<b>36.4</b>	<b>36.1</b>	<b>36.2</b>
Gross operating surplus	1.7	1.5	1.5	1.5	1.5	1.5	1.5
Other receipts	-0.2	-0.2	-0.1	-0.1	0.0	0.1	0.2
<b>Current receipts</b>	<b>37.3</b>	<b>37.5</b>	<b>37.5</b>	<b>37.7</b>	<b>37.8</b>	<b>37.6</b>	<b>37.9</b>

Table 4.7: Current receipts

	£ billion						
	Outturn 2010-11	2011-12	2012-13	Forecast			
				2013-14	2014-15	2015-16	2016-17
Income tax (gross of tax credits) <sup>1</sup>	153.3	152.6	154.8	165.0	179.4	190.5	205.3
<i>of which: Pay as you earn</i>	130.1	131.7	132.6	141.1	150.0	162.1	174.1
<i>Self assessment</i>	22.1	20.1	22.3	22.9	28.5	27.7	30.2
Tax credits (negative income tax)	-5.6	-4.7	-4.2	-4.2	-4.3	-4.2	-4.2
National insurance contributions	97.7	102.0	105.6	111.3	117.4	124.9	133.0
Value added tax	86.3	98.0	102.0	106.1	111.1	116.2	121.4
Corporation tax <sup>2</sup>	43.0	43.4	44.8	44.8	45.8	46.1	49.4
<i>of which: Onshore</i>	35.7	34.0	36.8	37.3	38.9	41.3	44.9
<i>Offshore</i>	7.3	9.4	8.0	7.5	6.8	4.9	4.5
Corporation tax credits <sup>3</sup>	-0.9	-0.9	-0.9	-1.0	-0.9	-0.8	-0.8
Petroleum revenue tax	1.5	1.8	1.6	1.5	1.4	1.1	0.8
Fuel duties	27.3	26.9	27.3	28.1	28.9	30.1	31.3
Business rates	23.6	24.5	26.2	27.9	28.8	29.1	30.8
Council tax	25.7	26.0	26.3	27.9	29.0	30.1	31.4
VAT refunds	13.3	14.3	14.8	14.7	14.4	14.0	13.8
Capital gains tax	3.6	4.2	3.8	4.9	5.6	6.5	7.5
Inheritance tax	2.7	2.9	3.0	3.1	3.2	3.3	3.5
Stamp duty land tax	6.0	6.1	6.4	7.4	8.7	9.9	11.1
Stamp taxes on shares	3.0	2.8	3.0	3.2	3.5	3.8	4.1
Tobacco duties	9.1	9.5	9.8	9.8	9.9	10.1	10.4
Spirits duties	2.7	2.8	3.0	3.1	3.2	3.4	3.6
Wine duties	3.1	3.4	3.7	3.9	4.2	4.6	5.0
Beer and cider duties	3.7	3.8	3.9	3.9	3.9	4.0	4.1
Air passenger duty	2.2	2.7	2.9	3.0	3.3	3.5	3.9
Insurance premium tax	2.5	3.0	2.9	3.0	3.1	3.1	3.2
Climate Change Levy	0.7	0.7	0.8	1.4	1.8	2.0	2.2
Other HMRC taxes <sup>4</sup>	5.9	6.1	6.2	6.8	7.2	7.6	7.9
Vehicle excise duties	5.8	5.8	5.9	5.8	5.8	5.8	5.8
Temporary bank payroll tax	3.5	0.0	0.0	0.0	0.0	0.0	0.0
Bank levy	0.0	1.8	2.2	2.7	2.8	2.8	2.8
Licence fee receipts	3.1	3.1	3.1	3.2	3.2	3.2	3.2
Environmental levies	0.5	1.7	2.3	2.7	3.3	3.7	4.2
EU ETS Auction Receipts	0.0	0.3	0.7	1.5	1.6	1.7	1.7
Other taxes	5.9	6.1	7.0	7.2	7.5	7.5	7.4
<b>National Accounts taxes</b>	<b>528.9</b>	<b>550.6</b>	<b>568.8</b>	<b>598.8</b>	<b>633.0</b>	<b>663.6</b>	<b>703.6</b>
<i>Less own resources contribution to</i>							
EU budget	-5.3	-5.2	-5.3	-5.7	-6.0	-6.2	-6.5
Interest and dividends	2.4	2.8	4.6	5.0	6.1	8.3	10.8
Gross operating surplus	25.2	23.2	24.4	25.3	26.3	27.3	28.4
Other receipts	-0.4	-0.9	-0.9	-0.9	-1.0	-1.0	-1.0
<b>Current receipts</b>	<b>550.8</b>	<b>570.4</b>	<b>591.5</b>	<b>622.5</b>	<b>658.4</b>	<b>692.0</b>	<b>735.3</b>
<i>Memo:</i>							
UK oil and gas revenues <sup>5</sup>	8.8	11.2	9.6	9.0	8.3	6.0	5.3

<sup>1</sup> Income tax includes PAYE and Self Assessment and also includes tax on savings income and other minor components.

<sup>2</sup> National Accounts measure, gross of enhanced and payable tax credits

<sup>3</sup> Includes enhanced company tax credits

<sup>4</sup> Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

<sup>5</sup> Consists of offshore corporation tax and petroleum revenue tax.

Note: Table is on accruals basis in line with national accounts definitions.

Table 2.8 in the supplementary table presents receipts on a cash basis.

Table 4.8: Changes to current receipts since November forecast

	£ billion						
	Outturn	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Income tax (gross of tax credits) <sup>1</sup>	0.1	-2.8	-5.0	-5.3	-2.3	-4.3	-3.0
of which: Pay as you earn	-0.4	-0.3	-1.9	-1.6	-2.7	-1.8	-1.8
Self assessment	0.0	-3.6	-3.5	-3.8	0.2	-2.7	-1.5
Tax credits (negative income tax)	0.0	0.1	0.1	0.1	0.0	0.1	0.0
National insurance contributions	0.0	-0.4	-0.6	0.7	0.4	0.5	0.6
Value added tax	0.0	0.9	1.8	2.0	2.2	2.5	2.8
Corporation tax <sup>2</sup>	0.0	-0.7	1.2	1.8	1.9	1.2	0.8
of which: Onshore	0.0	-0.7	1.9	2.1	2.3	2.4	2.5
Offshore	0.0	0.0	-0.7	-0.3	-0.4	-1.2	-1.8
Corporation tax credits <sup>3</sup>	0.0	0.0	0.0	0.0	0.1	0.2	0.3
Petroleum revenue tax	0.0	0.0	-0.1	0.0	-0.1	-0.1	-0.3
Fuel duties	0.0	-0.1	0.0	-0.3	-0.5	-0.6	-0.6
Business rates	0.0	0.0	-0.1	-0.1	-0.3	-0.4	-0.4
Council tax	0.0	0.1	0.2	0.3	0.3	0.3	0.4
VAT refunds	0.0	0.2	0.3	0.2	0.1	0.1	0.2
Capital gains tax	0.0	-0.4	-0.3	0.4	0.4	0.4	0.5
Inheritance tax	0.0	0.0	0.1	0.1	0.0	0.0	0.0
Stamp duty land tax	0.0	0.1	0.0	-0.1	-0.3	-0.3	-0.4
Stamp taxes on shares	0.0	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Tobacco duties	0.0	0.0	-0.1	-0.2	-0.2	-0.2	-0.2
Spirits duties	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Wine duties	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Beer and cider duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Air passenger duty	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Insurance premium tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Climate Change levy	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.3
Other HMRC taxes <sup>4</sup>	0.0	0.0	-0.2	0.1	0.2	0.4	0.4
Vehicle excise duties	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Temporary bank payroll tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bank levy	0.0	-0.3	-0.5	0.0	0.0	0.0	-0.1
Licence fee receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Environmental levies	0.0	0.0	0.3	0.1	0.4	0.5	0.6
EU ETS Auction Receipts	0.0	0.0	0.0	-0.3	-0.3	-0.3	-0.3
Other taxes	-0.1	-0.3	0.3	0.3	0.1	0.0	0.0
<b>National Accounts taxes</b>	<b>0.0</b>	<b>-3.5</b>	<b>-2.5</b>	<b>-0.2</b>	<b>2.5</b>	<b>0.0</b>	<b>1.2</b>
Less own resources contribution to EU budget	0.0	0.1	0.3	0.3	0.2	0.2	0.2
Interest and dividends	0.0	-0.3	0.4	-0.1	-0.7	-0.8	-0.5
Gross operating surplus	0.1	-1.3	-1.1	-1.1	-1.1	-1.0	-1.0
Other receipts	-0.7	-0.1	0.0	0.0	0.1	0.1	0.2
<b>Current receipts</b>	<b>-0.6</b>	<b>-5.1</b>	<b>-2.8</b>	<b>-1.1</b>	<b>1.0</b>	<b>-1.5</b>	<b>0.1</b>
Memo:							
UK oil and gas revenues <sup>5</sup>	0.0	0.0	-0.9	-0.3	-0.4	-1.3	-2.0

<sup>1</sup> Income tax includes PAYE and Self Assessment receipts, and also includes tax on savings income and other minor

<sup>2</sup> National Accounts measure, gross of enhanced and payable tax credits

<sup>3</sup> Includes enhanced company tax credits

<sup>4</sup> Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

<sup>5</sup> Consists of offshore corporation tax and petroleum revenue tax.

## Changes in the receipts forecast since November

4.50 Current receipts are expected to be £5.1 billion lower than the November forecast in 2011-12, but are £0.1 billion higher by 2016-17. Table 4.9 shows the key drivers of this, split by changes due to economic factors, market determinants and other factors. In the next section we explain these changes in more detail on a tax by tax basis.

4.51 The biggest downward revisions to our receipts forecast since November are:

- the £3.6 billion shortfall in self assessment receipts in 2011-12, which is largely due to higher-than-expected forestalling ahead of the introduction of the 50 per cent income tax rate. Much of this weakness persists through the forecast period. This is discussed further in Box 4.2;
- lower UK oil and gas revenues, reflecting lower projections of oil and gas production and higher capital and operating expenditure; and
- lower stamp duty land tax and inheritance tax receipts, reflecting a weaker outlook for the residential and commercial property markets.

4.52 In the medium term, these downward revisions are largely offset by:

- slightly stronger growth in labour income, and higher company profits combined with lower company investment, which increase our medium-term forecasts of income tax, NICs and onshore corporation tax;
- higher VAT receipts, due to the effect of higher-than-expected receipts this year and an increase in the share of household consumption spent on standard rated goods; and
- the effect of higher equity prices on capital taxes.

Table 4.9: Change to the receipts forecast compared to November

	£ billion					
	2011-12	2012-13	Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
November forecast	575.5	594.4	623.6	657.4	693.5	735.2
March forecast	570.4	591.5	622.5	658.4	692.0	735.3
<b>Total Change in Receipts</b>	<b>-5.1</b>	<b>-2.8</b>	<b>-1.1</b>	<b>1.0</b>	<b>-1.5</b>	<b>0.1</b>
<i>of which:</i>						
<b>Income and expenditure</b>	<b>-2.8</b>	<b>-1.4</b>	<b>0.5</b>	<b>1.3</b>	<b>1.1</b>	<b>2.2</b>
Wages and salaries	0.7	1.3	1.4	1.4	1.6	1.8
Self assessment income and receipts	-3.6	-3.5	-2.3	-2.0	-2.7	-2.0
Non-financial company profits	0.1	0.6	1.0	1.2	1.3	1.2
Non-financial company investment	0.0	0.2	0.4	0.7	0.9	1.2
<b>North Sea</b>	<b>0.1</b>	<b>-1.2</b>	<b>-0.9</b>	<b>-1.3</b>	<b>-1.6</b>	<b>-2.2</b>
Production and expenditure	0.0	-3.5	-2.6	-2.4	-2.5	-2.7
Oil and gas prices	0.1	2.2	1.7	1.1	0.9	0.5
<b>Market assumptions</b>	<b>-0.1</b>	<b>0.0</b>	<b>-0.2</b>	<b>-1.0</b>	<b>-1.1</b>	<b>-0.9</b>
Commercial property market	0.0	-0.1	-0.2	-0.2	-0.2	-0.3
Residential property market	0.1	0.1	-0.3	-0.5	-0.6	-0.7
Equity prices	0.0	0.6	1.2	1.3	1.5	1.6
Volume of share transactions	-0.1	-0.4	-0.5	-0.5	-0.6	-0.6
Interest rates	-0.2	-0.1	-0.5	-1.1	-1.1	-1.0
<b>RPI inflation</b>	<b>0.0</b>	<b>-0.2</b>	<b>-0.4</b>	<b>-0.3</b>	<b>0.1</b>	<b>0.3</b>
Income tax and NICs	0.0	-0.1	0.1	0.6	1.2	1.2
Duty and business rates	0.0	-0.2	-0.5	-0.9	-1.1	-0.9
<b>Other assumptions</b>	<b>-0.7</b>	<b>0.7</b>	<b>0.8</b>	<b>0.9</b>	<b>0.9</b>	<b>0.9</b>
VAT outturn receipts	1.4	1.0	1.0	1.0	1.1	1.1
VAT standard rated share	0.5	0.7	0.8	0.9	0.8	0.6
Corporation tax repayments	-1.3	0.2	0.1	0.1	0.0	0.0
Public sector gross operating surplus	-1.3	-1.1	-1.1	-1.1	-1.0	-0.9
<b>Budget measures</b>	<b>0.0</b>	<b>-1.8</b>	<b>-0.8</b>	<b>1.2</b>	<b>-0.9</b>	<b>0.0</b>

## Tax by tax analysis

### Income tax and NICs

4.53 Our estimate for receipts from income tax and NICs is £3.2 billion lower in 2011-12 than in the November *EFO*. This is more than accounted for by self assessment income tax receipts, which are £3.6 billion lower for 2011-12 than in our November forecast. As discussed further in Box 4.2, a key driver of this shortfall is lower-than-expected revenue from the 50 per cent additional rate of income tax introduced in April 2010. PAYE income tax and NICs are also down £0.6 billion in 2011-12 from our previous forecast. Receipts from other smaller elements of income tax are £1.1 billion higher than forecast in November.<sup>5</sup>

<sup>5</sup> The smaller elements of income tax include company income tax, the tax deduction scheme for interest (TDSI) and unallocated receipts which are estimated at £0.6 billion for 2011-12.

- 4.54 PAYE and NICs receipts are strongly driven by our forecast for wages and salaries.<sup>6</sup> As Chart 4.1 shows, these have only grown weakly in 2011-12 because of broadly flat employment levels and weak average earnings growth. The £1000 rise in the personal allowance in 2011-12 announced in Budget 2010 and sharply lower bonuses in the financial sector have also reduced growth in 2011-12. These effects were partially offset by PAYE forestalling being less negative in 2011-12 than in 2010-11, and by the one percentage point increases in the rates of employee and employer NICs.
- 4.55 Financial sector bonuses are expected to be 30 per cent lower in 2011-12 than in the previous year – larger than the 20 per cent fall we had assumed in November. Because the majority of bonuses are usually paid in February and March, with HMRC receiving related tax and NICs payments in March and April, this estimate is still particularly uncertain. It is also difficult to predict the impact of deferred bonus schemes and any possible substitution of bonus for base pay. However, a stronger fall in financial sector bonus payments is broadly consistent with announced changes in bonus pools to date.
- 4.56 As Chart 4.1 shows, weak growth in PAYE and NICs receipts will persist into 2012-13 with wage and salary growth remaining subdued. The above-inflation increase in the personal allowance for 2012-13 announced at Budget 2011 will also constrain receipts. As explained in Box 4.2, receipts in 2012-13 will also be reduced by ‘reverse forestalling’ of the cut in the additional rate of income tax to 45 per cent in 2013-14, as some taxpayers shift taxable income from 2012-13 into 2013-14 to be taxed at the lower rate.
- 4.57 Although the further increase in the personal allowance announced in this Budget reduces receipts from 2013-14 onwards, growth in PAYE and NICs receipts then picks up gradually over the rest of the forecast and is the main driver for the rise in the income tax and NICs to GDP ratio from 2013-14 onwards. With growth in the economy strengthening, wage and salary growth accelerates. After 2013-14, the forecast assumes that tax thresholds and allowances are uprated with RPI inflation. With earnings growing faster than inflation, fiscal drag adds about 0.15 per cent of GDP a year to the tax to GDP ratio.
- 4.58 The final payments of 2010-11 self assessment (SA) liabilities were due at the end of January 2012. These included, for the first time, the direct effects on SA of the 50 per cent tax rate for incomes over £150,000. The effect of this is discussed in detail in Box 4.2. SA income tax receipts are estimated to have fallen by

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<sup>6</sup> Almost all of NICs receipts are Class 1 NICs which is collected through the PAYE system. Combined PAYE income tax and Class 1 NICs typically account for over 90 per cent of total income tax and NICs receipts.

around 9 per cent in 2011-12 from the previous year and were £3.6 billion below the November forecast. The shortfall reflects a number of factors:

- reduced underlying revenue from the 50 per cent rate. Over £1 billion of the shortfall in SA receipts each year can be explained by lower-than-expected yield from the 50 per cent additional rate. The lower-than-expected PAYE receipts from the measure would have been picked up in previous EFOs;
- forestalling ahead of the introduction of the 50 per cent additional rate was also greater than previously assumed. This meant that around £2¼ billion of the weakness in SA receipts in 2011-12 relative to November reflected greater unwinding of this forestalling than previously assumed; and
- economic determinants driving the SA forecast were weaker than expected. In particular, recent ONS outturns and our forecast for self employment income were lower than previously assumed. This lowers SA receipts throughout the forecast, although it is partly offset by modelling changes in the latter years of the forecast.

4.59 The main effect from policy measures on SA receipts is from ‘reverse forestalling’ ahead of the reduction in the additional rate. This lowers tax liabilities in 2012-13 (paid in 2013-14) and raises tax liabilities in 2013-14 (paid in 2014-15).

Table 4.10: Key changes to self assessment revenues since the November forecast

	£ billion					
	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
November forecast	23.8	25.8	26.7	28.3	30.4	31.7
March forecast	20.1	22.3	22.9	28.5	27.7	30.2
<b>Change</b>	<b>-3.6</b>	<b>-3.5</b>	<b>-3.8</b>	<b>0.2</b>	<b>-2.7</b>	<b>-1.5</b>
<i>of which: (by source)</i>						
Overestimate of 50 per cent yield	-1.4	-1.1	-1.1	-1.0	-1.3	-1.2
Forestalling ahead of introduction of 50 per cent	-2.2	-0.4	-1.0	0.3	0.0	0.0
Other (economic determinants, modelling)	0.0	-2.0	-0.2	-1.4	-1.4	-0.8
Measures (excluding reverse forestalling of SA ahead of 45 per cent rate)	0.0	0.0	-0.1	0.5	0.3	0.5
Reverse forestalling of SA ahead of 45 per cent rate	0.0	0.0	-1.4	1.7	-0.4	0.0

Chart 4.1: Contributions to growth in total income tax and NICs



Source: ONS, OBR

### Box 4.2: The additional rate of income tax

The previous Government announced in Budget 2009 that it would tax incomes above £150,000 at 50 per cent from April 2010. The Chancellor has now announced that this 'additional rate' will be cut to 45 per cent from April 2013.

The Government's decision requires us to judge whether its costing of this measure in the Budget is reasonable and central, and hence whether this or an alternative costing should be incorporated in our forecast. For consistency, we have also re-examined our baseline tax receipts forecast, as the final pre-implementation costing of the 50 per cent rate in the March 2010 Budget was implicitly carried forward into subsequent OBR forecasts.

#### The costing of the 50 per cent rate

The March 2010 Budget estimated that the 50 per cent rate would raise an additional £2.6 billion of tax in 2012-13 on a liabilities basis (updated to £2.7 billion in the June 2010 Budget forecast). It assumed that the 300,000 individuals likely to be affected would be liable to an extra £7.5 billion in tax in the absence of any change in behaviour, but that £4.9 billion of this would never materialise as they took steps to reduce their taxable income. These steps might include labour supply responses (e.g. working less, taking a lower paid job, retiring early, or leaving the country) or greater recourse to tax planning, avoidance and evasion. The increase in the tax rate might also affect the willingness of high earning individuals based abroad to move to the UK and pay tax here.

Estimating the size of such behavioural responses is very difficult, especially for high-income individuals who are likely to be more willing and able to alter their working lives and financial arrangements in response to tax changes than the bulk of the population. The overall size of the behavioural response can be captured by estimating the Taxable Income Elasticity (TIE), the overall responsiveness of total taxable incomes to changes in marginal tax rates. The March 2010 costing used a TIE of 0.35, implying that the introduction of the 50 per cent rate would cut the total taxable income of the affected taxpayers by 5.9 per cent.

The most relevant alternative estimate at the time was produced by Mike Brewer, Emmanuel Saez and Andrew Shephard, for the Mirrlees Review at the Institute for Fiscal Studies in 2008.<sup>7</sup> Based on responses to marginal rate cuts in the 1960s, 1970s and 1980s, they estimated that the TIE for the highest income 1 per cent of the UK population was around 0.46, implying that the introduction of the 50 per cent rate would reduce taxable income by 7.7 per cent. This would reduce the expected yield from the 50 per cent rate, although the authors have consistently emphasised the uncertainties around their number and all such estimates.

<sup>7</sup> *Means testing and tax rates on earnings*, Institute for Fiscal Studies, available at [www.ifs.org.uk/mirrleesreview/press\\_docs/rates.pdf](http://www.ifs.org.uk/mirrleesreview/press_docs/rates.pdf)

HMRC have now undertaken the first *ex post* analysis of the 50 per cent yield, based on 2010-11 self-assessment tax returns. One striking finding is that high-income individuals appear to have shifted at least £16 billion of income that would have been taxed in future years into 2009-10 so that it would be taxed at 40 per cent rather than 50 per cent. This has a one-off cost to the Exchequer of around £1 billion. The scale of forestalling, which was not factored into the March 2010 Budget costing at all, illustrates how willing and able high-income individuals are to adjust their behaviour in response to changes in tax rates.

Using a methodology broadly consistent with that of Brewer et al, and adjusting for forestalling, the HMRC study also suggests that the underlying behavioural response to the 50 per cent rate has been more powerful than the March 2010 Budget costing suggested. It points to a TIE around or above the Brewer et al level and significantly higher than 0.35.

In its costing of the move to a 45 per cent rate, the Government has assumed a TIE of 0.45 – broadly in line with the Brewer et al estimate. We believe that this is a reasonable and central estimate, both for the costing and for our underlying forecast. Taken at face value the HMRC study might suggest an even higher TIE, but this would risk placing too much weight on a single year's outturn evidence – especially given the complications from disentangling the forestalling effect. There is also reason to believe that the behavioural response to the cut in the tax rate may be smaller than to the increase, because of the costs involved in swiftly reversing expensive decisions on retirement, migration, tax planning and evasion. But it is very important to emphasise the significant uncertainties around all such estimates.

### **Implications for our baseline revenue forecasts**

In addition to costing the rate cut, we need to re-examine our baseline pre-measures forecast to ensure that it reflects the latest evidence on the scale of forestalling and the strength of the behavioural response to the 50 per cent rate. Table A shows how these elements, plus the impact of the rate cut, have contributed to changes in our income tax forecast since the 50 per cent rate came in.

As regards forestalling, we conclude from the HMRC study that the shifting of income into 2009-10 probably increased tax liabilities in that year by around £6.1 billion, and would reduce them by £5.0 billion in 2010-11, £1.4 billion in 2011-12 and £0.6 billion in 2012-13. The scale of this behaviour in 2010-11 helps explain why self-assessment receipts have been so much weaker in January and February this year than we assumed in our November forecast.

Turning to the underlying impact of the 50 per cent rate, excluding the impact of forestalling, the HMRC analysis now suggests that it would raise £0.6 billion on a liabilities basis in 2012-13 rather than the £2.7 billion implied by the June 2010 Budget. (Based on the current estimated cost of cutting the rate back to 40 per cent.

Re-estimating the cost of increasing the rate from 40 per cent to 50 per cent with the same TIE would give a higher figure). The amount of income subject to the 50 per cent rate is only slightly lower than that estimated in the June 2010 Budget and so this change in the costing very largely reflects the assumption of a stronger behavioural effect and a TIE of 0.45.

An added complication comes from the need to adjust these estimates on to a National Accounts basis. Budget policy costings and our forecast are both prepared on a National Accounts basis, which allocates most income tax receipts to years on an accruals basis (i.e. when the liability arises), but which allocates self-assessment receipts on a cash basis (i.e. when the money reaches HMRC). Most self assessment receipts come in nine months after the end of the tax year in which the liability was incurred. On a National Accounts basis the underlying costing of the 50 per cent rate in 2012-13 falls from £2.6 billion in the June 2010 Budget to £0.6 billion (again based on the current estimated cost of cutting the rate back to 40 per cent).

The lower expected yield from the 50 per cent rate has already manifested itself to some extent in lower-than-expected PAYE receipts during 2010-11, which would have been picked up (but not attributed to this explanation) in earlier *EFOs*. The HMRC analysis implies that we can now attribute £2 billion of the decline in our National Accounts receipts forecasts for 2012-13 since the 50 per cent rate was introduced to a reduction in the assumed underlying tax liabilities from the 50 per cent rate and £0.5 billion to forestalling.

The original Budget costings of the 50 per cent rate may also overstate the additional revenue generated because the labour supply response will affect disposable income, consumer spending and indirect tax revenues. There may also be similar effects in response to the reduction in the additional rate. We have not made any adjustment to our economic forecast for such effects. As Box 3.1 in Chapter 3 explains there are a number of measures in the Budget that could increase real household disposable income and consumption but also a number of measures that could reduce them, and we judge that the overall net effect is likely to be small.

### **The costing of the move to 45 per cent**

Turning to the costing of the move to 45 per cent, measured against our baseline that reflects the new information on the 50 per cent yield, we have endorsed as reasonable and central the Government's estimate that the underlying cost would be around £0.1 billion in 2013-14, based on an assumed TIE of 0.45. The figure is as low as this because a TIE of 0.45 implies that the revenue-maximising additional tax rate is around 48 per cent. Moving from just above to just below this rate would therefore have very little revenue impact. Moving the additional rate back to 40 per cent would take it further below the revenue maximising rate and would thus be more expensive at roughly an additional £600 million. But for the reasons set out above we would again emphasise the huge uncertainties here.

The Government has decided to implement the move to 45 per cent from April 2013.

As we have seen, this will create an incentive to shift income between years to take advantage of the lower tax rate. The Budget costing and our forecast assume that around £6.25 billion of income will be shifted from 2012-13 into 2013-14 and that there will be a further small boost to taxable income in 2013-14 thanks to the underlying behavioural effect. This would reduce tax liabilities by £3.4 billion in 2012-13 and increase them by £3.3 billion in 2013-14, at a one-off cost to the Exchequer in the range of £100-200 million, though this is again uncertain.

**Table A: Impact on income tax forecast of cut in additional rate plus re-costing of original additional rate**

	£ billion						
	Outturn			Forecast			
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Liabilities Basis</b>							
Underlying Impact of 50p rate:							
Original costing, OBR estimate June 2010 (TIE=0.35)	0.0	2.5	2.5	2.7	2.9	3.2	3.5
Current costing <sup>1</sup>	0.0	0.7	0.6	0.6	0.7	0.7	0.8
<b>Difference</b>	<b>0.0</b>	<b>-1.8</b>	<b>-1.9</b>	<b>-2.1</b>	<b>-2.2</b>	<b>-2.5</b>	<b>-2.7</b>
Forestalling ahead of introduction of 50p rate <sup>2</sup>							
	6.1	-5.0	-1.4	-0.6	0.0	0.0	0.0
Underlying impact of move to 45p rate							
Reverse forestalling of 45p rate <sup>2</sup>	0.0	0.0	0.0	-3.4	3.3	0.0	0.0
<b>Total Effect</b>	<b>6.1</b>	<b>-6.8</b>	<b>-3.3</b>	<b>-6.1</b>	<b>1.0</b>	<b>-2.6</b>	<b>-2.8</b>
<b>National Accounts Basis</b>							
Underlying Impact of 50p rate:							
Original Costing, OBR estimate June 2010 (TIE=0.35)	0.0	1.3	2.9	2.6	2.8	2.9	3.2
Current costing <sup>1</sup>	0.0	0.5	0.7	0.6	0.6	0.8	0.7
<b>Difference</b>	<b>0.0</b>	<b>-0.8</b>	<b>-2.2</b>	<b>-2.0</b>	<b>-2.2</b>	<b>-2.1</b>	<b>-2.5</b>
Forestalling ahead of introduction of 50p rate <sup>2</sup>							
	4.4	-1.5	-2.9	-0.5	-0.6	0.2	0.0
Underlying impact of move to 45p rate							
Reverse forestalling of 45p rate <sup>2</sup>	0.0	0.0	0.0	-2.4	0.9	1.7	-0.4
<b>Total Effect</b>	<b>4.4</b>	<b>-2.3</b>	<b>-5.1</b>	<b>-4.9</b>	<b>-1.9</b>	<b>-0.2</b>	<b>-3.0</b>
<sup>1</sup> Based on the current estimated cost of a reduction in the rate from 50 per cent to 40 per cent.							
<sup>2</sup> Includes behaviour on forestalled income.							

## Conclusion

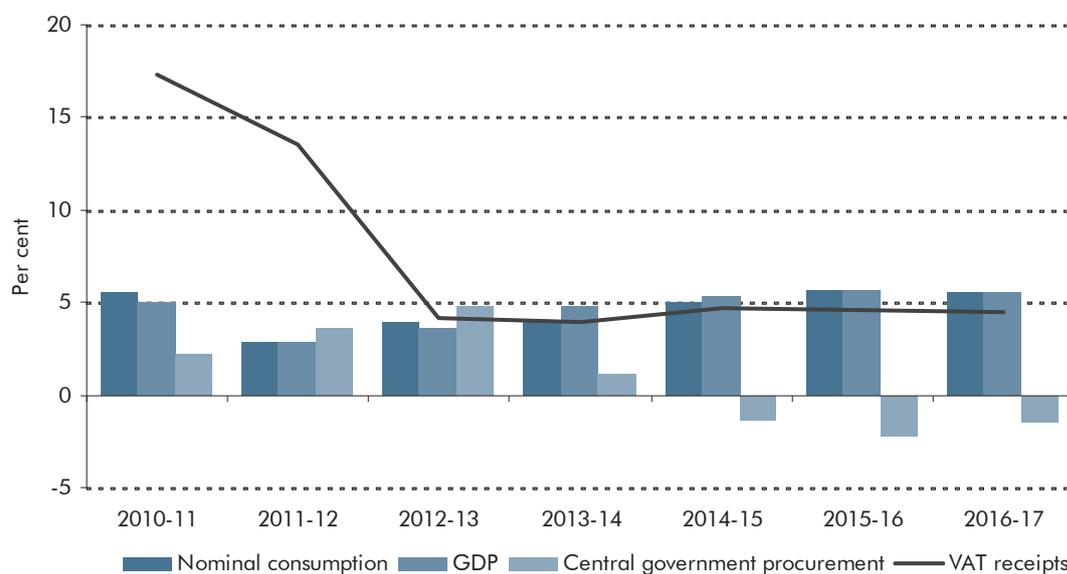
The assumption that the behavioural response to the 50 per cent rate is more powerful than the original costings assumed means that the cut to 45 per cent appears less expensive than it would have done under the original assumptions. Indeed at £0.1 billion it appears very inexpensive because 45 and 50 per cent are very close and either side of the implied revenue-maximising additional rate. But it is important to remember that the reassessment of the 50 per cent yield has a much bigger impact on the revenue forecast than the direct cost of the cut in the rate

to 45 per cent. We now believe that overstatement of the original yield accounts for around a £2.5 billion reduction in our underlying National Accounts income tax forecasts by the end of the forecast horizon. A weaker behavioural response and a lower TIE would make the cut in the rate to 45 per cent more expensive and would reduce the downward impact on the baseline revenue forecast.

### Value added tax

- 4.60 The increase in the standard rate of VAT rate to 20 per cent means that, despite weak nominal household consumption, VAT receipts in 2011-12 have increased by 13.5 per cent on 2010-11. Growth has also been boosted by lower litigation payments relating to the Fleming and *Condé Nast* cases than in the previous year and a lower forecast of the VAT gap – the difference between the theoretical level of VAT payments and the actual receipts received by HMRC.
- 4.61 From 2012-13 we expect growth in VAT receipts to be relatively subdued. As Chart 4.2 illustrates, this is primarily because we expect nominal household consumption to grow at a slightly lower rate than nominal GDP. Weaker growth in VAT receipts in the second half of the forecast period is also driven by a fall in government procurement in line with the Government's spending plans. As a result of these two factors, our forecast shows VAT receipts declining as a share of GDP between 2012-13 and 2016-17.
- 4.62 The VAT gap is a key determinant of the VAT forecast and VAT debt is an important component of it – that is VAT that should have been paid to HMRC but which has not yet been paid. VAT debt increased significantly between 2007-08 and 2008-09 as the economy worsened. In 2009-10 the VAT gap fell from 13 per cent to 10.6 per cent, with a fifth of the decline attributed to the reduction in debt. Our forecast is for the gap to fall to 9.7 per cent this year and to 9.3 per cent the year after as debt falls, boosting receipts. The VAT gap is then projected forward at this rate to the end of the forecast period.
- 4.63 VAT receipts have been revised up since November by £0.9 billion in 2011-12 rising to £2.8 billion in 2016-17. This reflects stronger receipts this year that are expected to persist through the forecast period and an increase in the share of household consumption spent on VAT-eligible goods and services (the 'standard rated share' (SRS)). The rise in the SRS is partly because interest rates are lower in this forecast than in November, which reduces the proportion of household spending accounted for by mortgage interest payments.

Chart 4.2: Key determinants of the VAT forecast



Source: ONS, OBR

Table 4.11: Key changes to VAT revenues since November forecast

	£ billion					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
November forecast	97.1	100.2	104.1	108.8	113.6	118.6
March forecast	98.0	102.0	106.1	111.1	116.2	121.4
<b>Change</b>	<b>0.9</b>	<b>1.8</b>	<b>2.0</b>	<b>2.2</b>	<b>2.5</b>	<b>2.8</b>
<i>of which:</i>						
Outturn VAT receipts	1.4	1.0	1.0	1.0	1.1	1.1
VAT debt	0.0	0.2	0.2	0.2	0.2	0.2
SRS of household consumption	0.5	0.7	0.8	0.9	0.8	0.6
Household spending	-0.3	0.2	0.3	0.3	0.5	0.6
Other spending	-1.0	-0.3	-0.2	-0.2	-0.1	0.1
Other	0.3	0.0	0.0	0.0	0.0	0.0
Budget measures	0.0	0.1	-0.1	0.0	0.0	0.0

### Onshore corporation tax

4.64 Onshore corporation tax receipts are expected to be broadly flat as a share of GDP throughout the forecast period. This is despite our forecast for a recovery in non-financial profits growth, particularly towards the end of the forecast period. Partly this is due to measures – the staggered reduction in the main rate of corporation tax to 22 per cent by 2014-15 and other measures, such as the Patent Box. In addition we expect companies to continue to bring forward losses built-up in the recession to offset against future profits, particularly in the financial sector. The recovery in business investment assumed in our forecast will also increase capital allowance claims against taxable profits and dampen receipts.

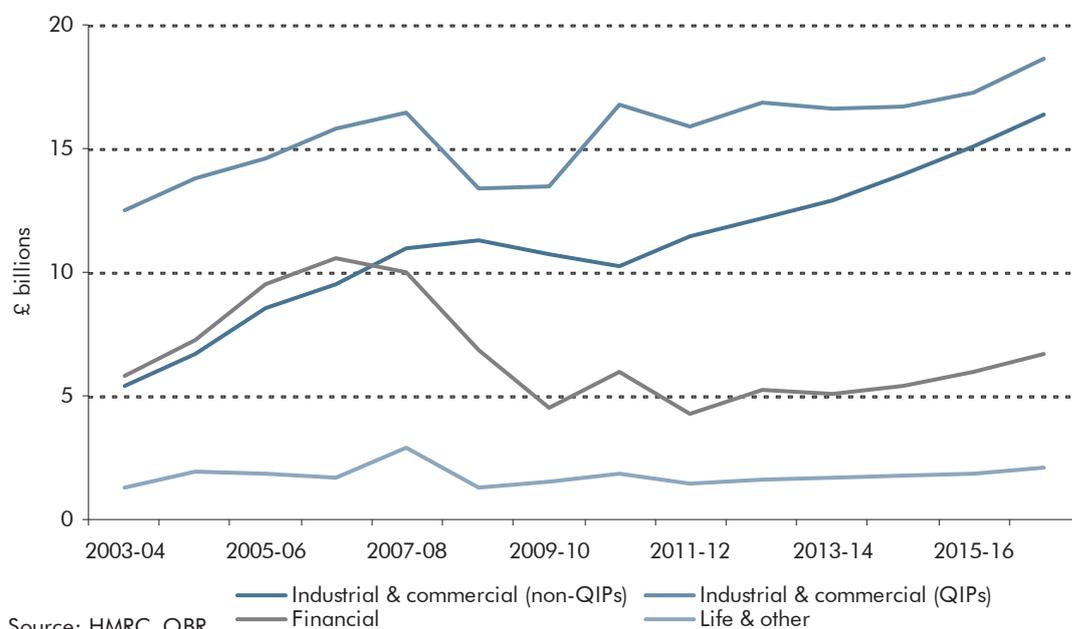
This results in slower growth of net taxable income relative to profits for industrial and commercial companies.

- 4.65 Chart 4.3 shows our forecasts of corporation tax receipts for each of the main sectors. Industrial and commercial companies are split into firms that pay corporation tax in quarterly instalment payments (QIP) and those that do not (non-QIP). Non-QIP payers tend to be smaller companies that pay the small profits rate rather than the main rate of corporation tax. The small profits rate remains unchanged at 20 per cent through the forecast period while the main rate falls from 26 per cent to 22 per cent. This is a key factor driving the difference in our forecast for receipts growth between these sectors.
- 4.66 Receipts from the financial sector have fallen sharply this year in line with the decline in financial sector profits. Despite forecasting an increase in financial sector profits from 2012-13 onwards, policy measures and the continued use of losses to offset liabilities are expected to depress receipts. This means that financial sector corporation tax is forecast to yield less than two-thirds of its 2006-07 peak revenue by the end of the forecast period in 2016-17.
- 4.67 Our forecast for overall corporation tax receipts in 2011-12 is £0.7 billion lower than in November. This is more than accounted for by repayments relating to liabilities from earlier years totalling £1.3 billion. Payments relating to current year liabilities were a little stronger than in the November forecast. A lower level of repayments in 2012-13 is a key reason for growth of around 8 per cent in receipts in the next financial year. By 2016-17 our forecast is £2.5 billion higher than in November, which is primarily due to an increase in our forecast of non-financial profit growth and a lower forecast for business investment growth.

Table 4.12: Key changes to onshore Corporation Tax revenues since November forecast

	£ billion					
	2011-12	2012-13	Forecast			
			2013-14	2014-15	2015-16	2016-17
November forecast	34.7	34.9	35.3	36.7	38.9	42.3
March forecast	34.0	36.8	37.3	38.9	41.3	44.9
<b>Change</b>	<b>-0.7</b>	<b>1.9</b>	<b>2.1</b>	<b>2.3</b>	<b>2.4</b>	<b>2.5</b>
<i>of which:</i>						
Non-financial company profits	0.1	0.6	1.0	1.2	1.3	1.2
Investment	0.0	0.2	0.4	0.7	0.9	1.2
Other income and asset prices	0.0	-0.1	-0.2	-0.4	-0.5	-0.6
Outturn corporation tax receipts	0.6	0.3	0.3	0.3	0.4	0.4
Repayments	-1.3	0.2	0.1	0.1	0.0	0.0
Modelling updates	0.1	0.3	0.2	0.3	0.6	0.7
Budget measures	0.0	0.4	0.3	0.1	-0.4	-0.5

Chart 4.3: Components of the onshore Corporation Tax forecast



## UK oil and gas revenues

- 4.68** UK oil and gas revenues are nearly 30 per cent higher in 2011-12 than in 2010-11, due both to oil prices in 2011 being \$30 a barrel higher than in 2010 and to the increase in the supplementary charge announced in Budget 2011. These effects have been partly offset by the 18 per cent decline in oil and gas production seen in 2011 and a sharp rise in capital expenditure.
- 4.69** Relative to our November forecast, oil prices (which we assume to move in line with futures prices) are expected to be around \$13 a barrel higher in 2012 and \$4 a barrel higher in 2016. Despite this, we have revised down our forecast for oil and gas revenues in each year from 2012-13. This primarily reflects DECC's latest projections of UK oil and gas production and recent industry data on capital, exploration and operating expenditure plans. The new data suggests that capital investment will increase by 90 per cent between 2010 and 2012, and remain higher than previously assumed throughout the forecast period. With 100 per cent first year capital allowances, higher investment significantly reduces expected tax revenues.
- 4.70** We expect oil and gas revenues to fall in each year of the forecast, with revenues in 2016-17 less than half those collected in 2011-12. The fall in 2012-13 primarily reflects lower oil production and higher capital expenditure. Thereafter, the decline in revenues reflects the continued fall in production, high expenditure plans and the decline in oil futures prices.

Table 4.13: Key changes to oil and gas revenues since November forecast

	£ billion					
	2011-12	2012-13	Forecast			
			2013-14	2014-15	2015-16	2016-17
November forecast	11.1	10.5	9.4	8.7	7.2	7.3
March forecast	11.2	9.6	9.0	8.3	6.0	5.3
<b>Change</b>	<b>0.0</b>	<b>-0.9</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-1.3</b>	<b>-2.0</b>
<i>of which:</i>						
Oil and gas production	0.0	-1.7	-1.1	-0.8	-0.2	-0.3
Expenditure	0.1	-1.7	-1.6	-1.6	-2.3	-2.4
Sterling oil price	0.1	2.2	1.8	1.4	1.2	0.8
Gas price	0.0	0.2	0.1	-0.1	-0.2	-0.3
Other	-0.1	0.4	0.2	0.3	-0.2	-0.2
Budget measures	0.0	-0.2	0.2	0.5	0.4	0.3

### Fuel duties

- 4.71 Our forecast for fuel duties is driven by the duty rate and the demand for fuel. The duty rate assumption reflects the announcements in the Autumn Statement that the 3 pence per litre rise in duty due in January 2012 would be deferred to August 2012 and that the 2 pence per litre rise due in August 2012 would be cancelled. Thereafter duty rates are assumed to grow in line with RPI inflation.
- 4.72 We expect fuel duty receipts to fall as a share of GDP in the medium term, largely due to subdued demand. Duty-paid road fuel consumption has fallen in each year since its peak in 2007-08, reflecting the downturn in economic activity, the effect on the demand for fuel from higher pump prices and the improvement in the fuel efficiency of the vehicle stock. A further gradual improvement in fuel efficiency is assumed over the forecast period, in order to meet EU targets on new car CO<sub>2</sub> emissions. Road fuel consumption is expected to level off in the second half of the forecast period due to the strengthening economy, resulting in faster growth in fuel duty receipts in this period.
- 4.73 Compared to the November *EFO*, our forecast is around £0.1 billion lower in 2011-12 with the shortfall rising to £0.6 billion by 2016-17. This reflects weaker-than-expected receipts this year which are expected to persist through the forecast period, a lower path for RPI inflation and a stronger sterling oil price which acts to reduce the demand for fuel.

### Taxes on capital

- 4.74 **Capital gains tax (CGT)** receipts have typically been very volatile and difficult to forecast because they are driven by volatile asset prices and individual decisions to sell assets. There have been extra complications in recent years because of a number of changes to the tax regime. Around two-thirds of CGT chargeable gains are on financial assets and so the forecast is strongly determined by equity

prices. The pick up in equity prices we are forecasting from 2012-13 onwards drives strong growth in CGT receipts in this period.

- 4.75 Our forecast now includes an updated judgement that the effect of forestalling ahead of the mid-year increase in CGT rates in June 2010, and a consequent reduction in the level of asset disposals after June 2010, was higher than we had estimated in the November *EFO*. As a result, the CGT forecast is £0.4 billion lower in 2011-12 than in November. The effect of the lower 2010-11 base reduces receipts for 2012-13 and later years but is progressively outweighed by our higher path of equity prices so by 2016-17 our forecast is £0.5 billion higher than in November.
- 4.76 **Inheritance tax** receipts are determined by the value of estates. These are predominantly driven by residential property prices, and to a lesser extent by equity prices and the stock of household deposits. Strong receipts growth in 2011-12 partly reflects the strong rise in house prices in the previous year, but our forecast for flat house prices between 2011-12 and 2013-14 constrains receipts in the near term. Stronger receipts growth in the final two years of the forecast is mainly due to the expected recovery in the housing and equity markets. Fiscal drag resulting from the freeze in the inheritance tax threshold until 2014-15 followed by CPI uprating also contributes to stronger expected growth in receipts in these years. Overall changes since the previous forecast are small as the effect of higher equity prices is offset by lower house prices.

### Stamp duties

- 4.77 **Stamp duty land tax (SDLT)** receipts are expected to grow only modestly in 2012-13. Both residential and commercial property markets are expected to remain weak in 2012-13. Thereafter, SDLT receipts are expected to grow strongly over the forecast period, with receipts growth in excess of 10 per cent each year. This mainly reflects the expected recovery in property markets as credit conditions begin to normalise and economic growth increases. In particular, residential property transactions are expected to recover towards a level consistent with the average historical duration of home ownership, as set out in Box 3.4.
- 4.78 Compared with November, SDLT receipts are lower in each year from 2012-13 onwards. The positive impact of the new Budget 2012 measures on SDLT receipts is more than offset by the effect of lower forecasts for residential prices and commercial property volumes.
- 4.79 Our updated forecast for **stamp duty on shares** is weaker in all years than in November. Higher equity prices have a positive effect increasing the forecast by up to £0.5 billion in 2016-17. But this is more than offset by the lower path for the volume of share transactions which reduces the forecast by up to £0.6 billion in that year.

### Alcohol and tobacco duties

- 4.80 Total revenues from **alcohol duties** is expected to increase from £10 billion in 2011-12 to around £12.6 billion by the end of the forecast period, which is broadly unchanged from November. This primarily reflects the pre-announced duty rises of 2 per cent above RPI inflation in each year to 2014-15 and the rise by RPI in 2015-16 and 2016-17.
- 4.81 **Tobacco duty** receipts are expected to increase in each year of the forecast, due to the Budget announcement of duty rises on tobacco products of 5 per cent above RPI inflation in 2012-13, followed by the pre-announced duty rises of 2 per cent above RPI inflation in each year to 2014-15, and the rise in RPI in 2015-16 and 2016-17. This offsets the downward trend in cigarette consumption over the forecast period. The forecast is lower than our November forecast as the higher duty rates for 2012-13 are more than offset by the lower path of RPI and stronger exchange rate against the Euro which is expected to encourage more cross-border shopping.

### Other taxes

- 4.82 Our **business rates** forecast incorporates the announcements in the Autumn Statement of the extension of the small business rate relief (SBBR) holiday to 2012-13 and the introduction of a deferral scheme in 2012-13. These announcements lead to slower than otherwise growth in receipts in 2012-13 and then faster growth in receipts in 2013-14 when the SBBR holiday ends and businesses make their deferred payments. The forecast has been revised down slightly since November due to lower RPI inflation.
- 4.83 The **council tax** forecast for 2012-13 assumes a 0.3 per cent overall rise in council tax bills in 2012-13, based on information gathered from councils by CIPFA. Thereafter, the forecast reverts to a stylised assumption that English council tax rises by the average of the three most recent years of council tax rises prior to the freezes. Changes to council tax are broadly offset by changes to locally financed expenditure, so are largely fiscally neutral.
- 4.84 **VAT refunds** to central and local government are fiscally neutral as receipts are offset within AME. VAT refunds increased in 2011-12, reflecting the rise in the standard rate of VAT. Refunds decline from 2013-14 onwards reflecting the fall in government procurement and investment implied by the Government's spending plans. Our forecast is higher in every year than in November due to higher outturn data for central government VAT refunds.
- 4.85 **Air passenger duty (APD)** is driven primarily by forecasts for passenger numbers and planned duty rate rises. Our forecast is broadly unchanged from November. Revenue is expected to rise sharply in 2012-13, primarily because duty rates will

rise by both the current year's planned revalorisation and the deferred rate rise from 2011-12.

- 4.86 Our forecast for **vehicle excise duty (VED)** receipts is broadly flat at around £5.8 billion each year, and is marginally lower than our November forecast in later years. The forecast partly reflects EU regulations on new car CO<sub>2</sub> emissions which are expected to cause a gradual shift in the stock of road vehicles to lower VED bands over time.
- 4.87 The combined receipts from four environmental taxes – **climate change levy (CCL)**, **aggregates levy**, **landfill tax** and the **Emissions Trading Scheme (ETS)** – are expected to increase from £2.4 billion in 2011-12 to £5.9 billion in 2016-17. This rise primarily reflects the introduction of the carbon price floor in 2013-14 and the start of Phase III of ETS in 2013, which will auction a higher number of allowances. Changes since the November forecast result in combined receipts falling by up to £0.5 billion in 2013-14 due to a lower forecast of carbon emissions.
- 4.88 **Environmental levies** include receipts from DECC levy-funded spending policies such as the Renewables Obligation (RO), Feed-in tariffs, Warm Homes Discount and receipts from the Carbon Reduction Commitment. These see strong growth through the forecast largely due to the expected rise in electricity generation from renewables and a higher-than-expected uptake of payments under the feed-in-tariffs scheme. Since the November *EFO* we have made large upward revisions to our forecast of feed-in tariffs to reflect this stronger uptake. However, this effect is fiscally neutral since it is balanced by higher spending within AME.
- 4.89 We have revised down the **bank levy** forecast since November in light of latest receipts data and information about likely full-year liabilities. Banks pay the levy on their balance sheets and we now expect growth in bank balance sheets to be further constrained by regulations such as Basel III and the proposals from the Independent Commission on Banking. The rise in the bank levy rate announced in Budget 2012 largely offsets these downward revisions from 2013-14 onwards.
- 4.90 Once **tax litigation** cases have been finally settled, and their effects in particular years can be quantified to a reasonable degree, they are allowed for in our forecasts of the taxes concerned. However, there are several outstanding cases which have not reached this stage, but which could have an impact over the forecasting period. The receipts forecast includes an assumption that repayments relating to future tax litigation losses across all taxes will amount to £3.8 billion in total between 2012-13 and 2016-17, unchanged from our November *EFO*.
- 4.91 The magnitude and timing of actual losses is difficult to forecast as it depends on the legal process and final judgement. Even when a case is lost the impact on

receipts depends on the nature of the judgement and the response from Government. Some cases represent an upside risk for Government.

### Other receipts

- 4.92 **Interest and dividend** receipts capture the interest income on the stock of financial assets held by the Government. These are expected to rise sharply over the forecast period from £2.8 billion in 2011-12 to £10.8 billion in 2016-17. The key drivers of the forecast are short-term market interest rates which are expected to be around 40 basis points higher by the end of the forecast period, as well as higher interest on student loans, following reforms. Relative to the November forecast, interest and dividend receipts are £0.4 billion higher in 2012-13, which is more than accounted for by the transfer of Royal Mail pension fund assets to the public sector. However, the lower path of market interest rates means that total interest and dividend receipts are over £0.5 billion lower in each year from 2014-15.
- 4.93 The **gross operating surplus** is over £1 billion lower in each year of the forecast horizon. However, this mainly reflects two changes that are both neutral for net borrowing as a whole. The gross operating surplus includes depreciation, which is lower, as well as an imputed central government subsidy to local authorities' Housing Revenue Accounts (HRA). This imputed subsidy is offset in spending, as discussed in paragraph 4.151.

## Public sector expenditure

- 4.94 This section details our central projections for public sector expenditure. The projections cover the whole public sector, and are based on the National Accounts aggregate Total Managed Expenditure (TME). TME is split into two fiscal aggregates: public sector current expenditure (PSCE) and public sector gross investment (PSGI). PSCE is the current spending component of the surplus on the current budget. TME is the spending component of net borrowing.
- 4.95 For budgeting and public spending control purposes, the Treasury splits TME into departmental expenditure limits (DEL) and annually managed expenditure (AME).<sup>8</sup> DEL spending is fixed for each Government department within multi-year cash spending limits which are set at each Spending Review. AME spending is not

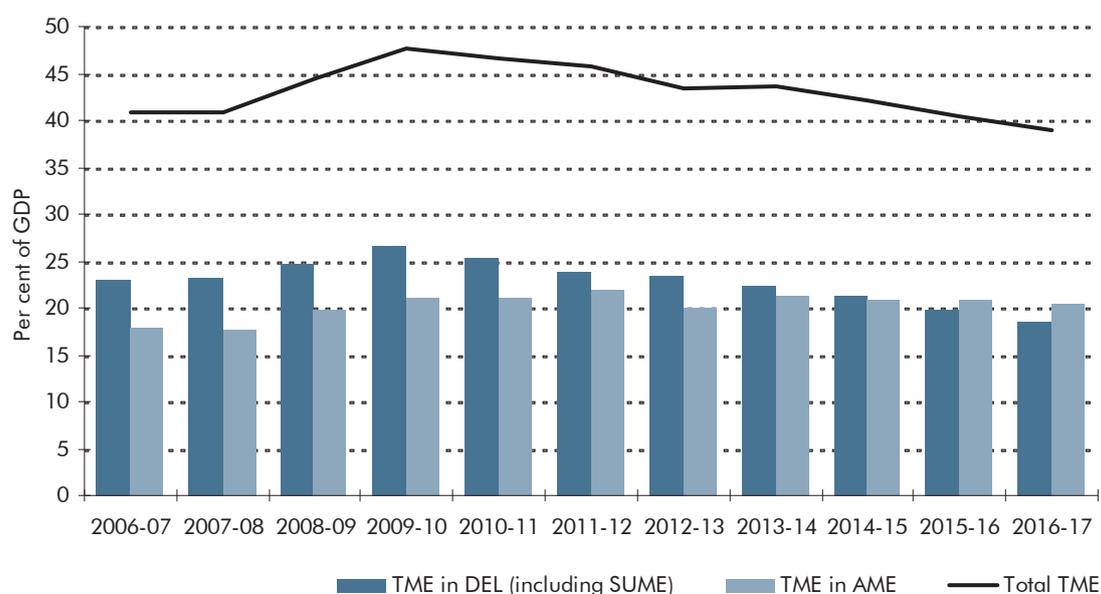
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<sup>8</sup> Our presentation of expenditure only includes those components of RDEL and CDEL that are included in the fiscal aggregates of PSCE and PSGI and therefore affect our projections of public sector borrowing and debt. For budgeting purposes HM Treasury includes some other components in DEL such as non-cash items. A reconciliation between HM Treasury's DEL figures and ours is published in the supplementary fiscal tables on our website.

set within similar fixed limits, because it is affected by economic determinants and is therefore considered to be demand-led and more volatile. It mainly consists of transfer payments, such as social security, and other volatile items such as the Government's debt interest payments.

- 4.96 Chart 4.4 shows the trends in TME, DEL and AME as a per cent of GDP since 2006-07. As a share of GDP, TME rose sharply through the recession to reach a peak of 48 per cent of GDP in 2009-10. With much of departmental spending fixed in cash terms through to 2010-11 in the 2007 Comprehensive Spending Review this was primarily the result of the sharp fall in nominal GDP in 2008-09 and 2009-10.

Chart 4.4: DEL and AME components of TME



Source: ONS, OBR

## Summary of the expenditure forecast

- 4.97 Table 4.14 summarises our forecast for public expenditure as a percentage of GDP. TME is expressed as a share of the economy, but not all of TME contributes directly to the calculation of GDP as it comprises benefit payments, debt interest and other cash transfers rather than the production or consumption of goods and services.
- 4.98 TME is forecast to fall to 39 per cent of GDP by 2016-17, mostly because of the cuts in DEL spending set out as part of the Government's fiscal consolidation plan. AME is also forecast to fall as a share of GDP by 2016-17, but less sharply than DEL. Within AME, social security payments are forecast to fall as a share of

GDP as the economy recovers, while debt interest payment rise due to high levels of borrowing. From 2015-16, total AME spending is expected to exceed DEL spending.<sup>9</sup>

Table 4.14: Expenditure as a percentage of GDP

	Per cent of GDP						
	Outturn		Forecast				
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Total managed expenditure	46.5	45.8	43.4	43.6	42.2	40.5	39.0
<i>of which:</i>							
Public sector current expenditure	42.6	42.6	42.2	40.8	39.4	37.9	36.5
<i>of which:</i>							
PSCE in RDEL <sup>1</sup>	22.1	21.2	20.8	20.0	18.9	17.6	16.5
PSCE in AME	20.5	21.3	21.4	20.8	20.6	20.4	20.0
<i>of which:</i>							
Social security <sup>1</sup>	11.4	11.5	11.5	11.1	10.7	10.5	10.3
Debt interest	2.9	3.1	2.8	2.8	3.1	3.2	3.3
Other	6.2	6.7	7.0	6.9	6.8	6.6	6.4
Public sector gross investment	4.0	3.2	1.2	2.8	2.7	2.5	2.5
<i>of which:</i>							
PSGI in CDEL	2.9	2.3	2.3	2.1	2.0	1.9	1.8
PSGI in AME	1.0	0.9	-1.1	0.8	0.7	0.7	0.7
<b>Total public sector expenditure that contributes to GDP <sup>2</sup></b>	<b>25.7</b>	<b>25.0</b>	<b>24.5</b>	<b>23.5</b>	<b>22.3</b>	<b>20.9</b>	<b>19.9</b>
<i>of which:</i>							
General government consumption	22.8	22.5	22.1	21.3	20.2	19.0	18.0
General government gross fixed capital formation	2.4	2.0	1.9	1.8	1.8	1.6	1.6
Public corporations gross fixed capital formation	0.5	0.5	0.4	0.4	0.3	0.3	0.3

<sup>1</sup> Social security includes the additional costs of universal credit in 2015-16 and 2016-17, which were previously contained within PSCE in RDEL.

<sup>2</sup> GDP at market prices

4.99 Table 4.15 shows changes to TME and its components in real terms. TME falls by an annual average of 0.8 per cent per year in real terms over the Spending Review period from 2010-11 to 2014-15.

<sup>9</sup> Total AME and DEL spending are measured as TME in AME and TME in DEL. The detailed definitions for these aggregates are explained in a footnote to Table 4.15.

Table 4.15: Expenditure growth rates

	Spending review years 2011-12 to 2014-15				Forecast 2011-12 to 2016-17	
	Total change (%)	Average change (%)	change in 2015-16	change in 2016-17	Total change (%)	
<b>Real terms</b>						
<b>Total managed expenditure</b>	<b>-3.2</b>	<b>-0.8</b>	<b>-1.0</b>	<b>-0.8</b>	<b>-5.0</b>	
<i>of which:</i>						
PSCE	-1.0	-0.3	-0.9	-0.9	-2.8	
PSGI	-27.0	-7.6	-3.5	0.0	-29.6	
TME in AME <sup>1</sup>	5.9	1.4	2.2	1.2	9.5	
TME in DEL <sup>1</sup>	-10.9	-2.8	-4.2	-3.0	-17.1	
<i>of which:</i>						
PSCE in RDEL	-8.7	-2.2	-4.1	-3.3	-15.3	
PSGI in CDEL	-27.0	-7.6	-5.0	-0.3	-30.9	
<b>Percentage of GDP</b>						
<b>Total managed expenditure</b>	<b>-4.4</b>	<b>-1.1</b>	<b>-1.7</b>	<b>-1.5</b>	<b>-7.6</b>	
<i>of which:</i>						
PSCE	-3.1	-0.8	-1.5	-1.4	-6.1	
PSGI	-1.3	-0.3	-0.2	-0.1	-1.5	
TME in AME <sup>1</sup>	-0.2	0.0	-0.2	-0.4	-0.7	
TME in DEL <sup>1</sup>	-4.2	-1.1	-1.5	-1.1	-6.8	
<i>of which:</i>						
PSCE in RDEL	-3.2	-0.8	-1.3	-1.1	-5.6	
PSGI in CDEL	-0.9	-0.2	-0.2	-0.1	-1.2	

<sup>1</sup> In relation to table 4.17, TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME, and TME in AME is defined as PSCE in AME plus PSGI in AME minus SUME. SUME is single use military equipment and is explained in more detail in paragraph 4.148.

## Expenditure projections in 2015-16 and 2016-17

4.100 After the current Spending Review period, our spending projections for 2015-16 and 2016-17 are driven by the Government's stated policy assumption, which is unchanged from the Autumn Statement: *TME falls at the same average real rate as the Spending Review period (now 0.8 per cent per year in real terms) and PSGI is flat in real terms, calculated on the basis of a baseline which excludes the additional investment expenditure in 2014-15 announced in the Autumn Statement.*

4.101 Table 4.15 shows that as a result of these assumptions, against a baseline that includes all spending in 2014-15:

- in 2015-16, TME now declines in real terms by 1 per cent, PSGI declines by 3.5 per cent and PSCE declines by 0.9 per cent; and

- in 2016-17, TME now declines in real terms by 0.8 per cent, PSGI is flat and PSCE declines by 0.9 per cent.

4.102 On the basis of current policy, we expect total AME to rise by 2.2 per cent in 2015-16 and 1.2 per cent in 2016-17 in real terms. For these years, implied projections for our definitions of RDEL and CDEL can be derived by subtracting the forecast for AME from the forecasts for total PSCE and total PSGI. Our latest forecasts for AME in 2015-16 and 2016-17 include an estimate of the additional costs of Universal Credit, which have previously been contained within RDEL. This is explained further in paragraph 4.116 below. Taking this into account:

- implied PSCE in RDEL falls in real terms by 4.1 per cent in 2015-16, and by 3.3 per cent in 2016-17. In the November forecast the equivalent fall in PSCE in RDEL, excluding Universal Credit, was a fall of 4.0 per cent in 2015-16, and 3.1 per cent in 2016-17; and
- implied PSGI in CDEL falls in real terms by 5.0 per cent in 2015-16, and by 0.3 per cent in 2016-17. In the November forecast the equivalent fall was 1.8 per cent in 2015-16, and a rise of 1.5 per cent in 2016-17.

### Summary of changes to the expenditure forecast since November

4.103 Table 4.16 shows the main reasons for the changes in our forecast of public sector expenditure since November. The main drivers are:

- changes to the economic determinants. In particular, a lower RPI inflation forecast cuts debt interest payments, and lower claimant count unemployment cuts social security payments;
- the latest assumptions on short-term interest and gilts rates, based on recent market expectations, reduce the forecast for Government debt interest payments;
- we now expect Government departments to underspend in 2011-12 by a total of £6 billion, compared to our assumption in November of £0.5 billion. This is explained fully in the DEL section below;
- the forecast now includes the Government's agreement to take on Royal Mail's historic pension deficit from April 2012. The spending implications of this are explained fully in Box 4.1; and
- the effect of policies announced in the March Budget, which are summarised in Table 4.5 and set out in full in Annex A.

4.104 Tables 4.17 and 4.18 show the detailed spending forecasts and the changes in these forecasts since the November *EFO*. These are explained in more detail in the subsequent sections.

Table 4.16: Summary of changes to total expenditure since the November forecast

	£ billion					
	2011-12	2012-13	Forecast			
	2013-14	2014-15	2015-16	2016-17		
November forecast	702.6	714.5	723.1	736.4	746.6	758.7
March forecast	696.4	683.4	720.0	733.5	744.0	756.3
<b>Change</b>	<b>-6.2</b>	<b>-31.1</b>	<b>-3.1</b>	<b>-2.9</b>	<b>-2.7</b>	<b>-2.4</b>
<i>of which:</i>						
<b>Economic determinants</b>	<b>-0.1</b>	<b>-1.3</b>	<b>-2.6</b>	<b>-1.6</b>	<b>-0.5</b>	<b>-0.1</b>
Inflation	0.0	-0.6	-2.0	-0.9	-0.2	-0.1
Unemployment	-0.1	-0.7	-0.8	-0.9	-0.5	-0.1
State pension uprating	0.0	0.0	0.2	0.2	0.2	0.3
Average earnings	0.0	-0.1	0.0	0.0	-0.1	-0.1
<b>Market assumptions</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.9</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-0.9</b>
Gilt rates	0.0	-0.3	-0.6	-0.7	-0.7	-0.6
Short rates	0.0	0.0	-0.2	-0.5	-0.4	-0.4
<b>Other assumptions/changes</b>	<b>-6.1</b>	<b>-29.6</b>	<b>0.3</b>	<b>0.6</b>	<b>0.0</b>	<b>-0.2</b>
Allowance for shortfall	-5.5	0.0	0.0	0.0	0.0	0.0
Royal Mail	0.0	-27.4	0.5	0.5	0.4	0.5
CGNCR impact on debt interest	0.0	-0.1	-0.2	-0.2	-0.4	-0.6
TfL and HRA capital spending <sup>1</sup>	-0.2	0.2	0.2	0.3	1.4	2.1
Other <sup>2</sup>	-0.4	-2.3	-0.2	0.1	-1.6	-2.1
<b>Budget measures</b>	<b>0.0</b>	<b>0.1</b>	<b>0.2</b>	<b>-0.8</b>	<b>-1.0</b>	<b>-1.2</b>

<sup>1</sup> Changes to our forecasts for capital spending related to the Housing Revenue Account and also to Transport for London subsidiaries, explained in more detail in para 4.136.

<sup>2</sup> 2012-13 includes a one off capital receipt from the Special Liquidity Scheme, which is explained in more detail in paragraph 4.146. The significant decreases in 2015-16 and 2016-17 are largely decreases in PSCE in RDEL and PSGI in CDEL.

Table 4.17: Total managed expenditure

	£ billion						
	Outturn		Forecast				
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Public sector current expenditure (PSCE)</b>							
<b>PSCE in RDEL<sup>1,3</sup></b>	<b>326.3</b>	<b>322.9</b>	<b>328.1</b>	<b>330.3</b>	<b>328.6</b>	<b>323.0</b>	<b>320.2</b>
<b>PSCE in Annually Managed Expenditure</b>	<b>302.9</b>	<b>324.4</b>	<b>336.6</b>	<b>343.3</b>	<b>357.9</b>	<b>374.5</b>	<b>388.4</b>
<i>of which:</i>							
Social security benefits <sup>2,3</sup>	168.6	174.7	181.8	182.6	185.7	193.1	199.3
Tax credits <sup>2</sup>	25.3	26.9	27.4	27.9	28.5	29.1	29.7
Net public service pension payments	5.6	8.4	11.6	12.2	13.2	14.3	15.4
<i>of which:</i> CG unfunded pension schemes	4.5	7.0	10.0	10.6	11.5	12.5	13.5
LG police and fire pension schemes	1.1	1.4	1.6	1.6	1.7	1.8	1.9
National lottery current grants	0.8	0.9	0.9	0.9	0.9	1.0	1.1
BBC domestic services current expenditure	3.4	3.7	3.5	3.4	3.7	3.6	3.7
Fees associated with financial interventions	-2.4	-2.0	-0.7	-0.3	-0.2	0.0	0.0
Other PSCE items in departmental AME	0.3	0.2	1.0	0.6	0.5	0.5	0.5
Expenditure transfers to EU institutions	6.8	6.2	5.8	6.9	7.8	7.1	6.2
Locally-financed current expenditure	22.4	26.1	26.7	28.1	29.2	30.1	31.1
Central government gross debt interest	42.8	47.4	44.8	46.1	53.2	59.7	64.0
Depreciation	15.2	16.1	16.9	17.6	18.3	19.0	19.8
Current VAT refunds	11.2	12.0	12.6	12.7	12.5	12.0	11.7
Single use military expenditure	5.4	5.5	5.8	5.7	5.2	5.0	5.1
Environmental levies	0.6	1.0	1.6	2.0	2.5	3.0	3.7
Other National Accounts adjustments	-3.0	-2.7	-3.2	-3.2	-3.1	-2.9	-3.0
<b>Total public sector current expenditure</b>	<b>629.2</b>	<b>647.3</b>	<b>664.6</b>	<b>673.6</b>	<b>686.4</b>	<b>697.5</b>	<b>708.6</b>
<b>Public sector gross investment (PSGI)</b>							
<b>PSGI in CDEL</b>	<b>43.6</b>	<b>35.0</b>	<b>35.7</b>	<b>33.9</b>	<b>35.1</b>	<b>34.1</b>	<b>34.9</b>
<b>PSGI in Annually Managed Expenditure</b>	<b>14.9</b>	<b>14.1</b>	<b>-16.9</b>	<b>12.6</b>	<b>11.9</b>	<b>12.4</b>	<b>12.8</b>
<i>of which:</i>							
National lottery capital grants	0.4	0.5	0.6	0.6	0.6	0.6	0.6
Other PSGI items in departmental AME	0.5	-7.8	-30.2	0.4	0.4	0.4	0.4
Locally-financed capital expenditure <sup>4</sup>	5.4	13.6	5.3	4.9	4.8	5.2	5.6
Public corporations capital expenditure	8.1	7.1	7.0	6.4	6.0	5.9	5.8
Other National Accounts adjustments <sup>4</sup>	0.5	0.7	0.4	0.3	0.2	0.2	0.3
<b>Total public sector gross investment</b>	<b>58.4</b>	<b>49.1</b>	<b>18.8</b>	<b>46.4</b>	<b>47.0</b>	<b>46.5</b>	<b>47.7</b>
Less depreciation	-20.3	-21.2	-22.2	-23.1	-23.9	-24.8	-25.6
<b>Public sector net investment</b>	<b>38.1</b>	<b>27.8</b>	<b>-3.4</b>	<b>23.4</b>	<b>23.1</b>	<b>21.8</b>	<b>22.1</b>
<b>Total managed expenditure</b>	<b>687.6</b>	<b>696.4</b>	<b>683.4</b>	<b>720.0</b>	<b>733.5</b>	<b>744.0</b>	<b>756.3</b>

<sup>1</sup> Implied DEL numbers for 2015-16 and 2016-17. Calculated as the difference between PSCE and Resource AME in the case of Resource DEL, and between PSGI and Capital AME in the case of capital DEL.

<sup>2</sup> For 2010-11 to 2014-15, child allowances in income support and jobseeker's allowance have been included in tax credits and excluded from social security benefits.

<sup>3</sup> Social security includes the additional costs of universal credit in 2015-16 and 2016-17, which were previously contained within PSCE in RDEL.

<sup>4</sup> Includes an adjustment to remove capital spending by TfL subsidiaries that are classified as PCs in the National Accounts. This adjustment was previously contained in other national accounts adjustments.

Table 4.18: Changes to total managed expenditure since November forecast

	£ billion						
	Outturn	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Public sector current expenditure (PSCE)</b>							
<b>PSCE in RDEL<sup>1,3</sup></b>	<b>0.0</b>	<b>-3.8</b>	<b>-0.1</b>	<b>-0.6</b>	<b>-1.1</b>	<b>-3.1</b>	<b>-4.9</b>
<b>PSCE in Annually Managed Expenditure</b>	<b>-0.3</b>	<b>-1.3</b>	<b>-1.9</b>	<b>-3.5</b>	<b>-2.7</b>	<b>-0.4</b>	<b>1.7</b>
<i>of which:</i>							
Social security benefits <sup>2,3</sup>	0.1	-0.3	-1.0	-1.0	-1.8	0.0	1.0
Tax credits <sup>2</sup>	0.1	-0.1	-0.4	-0.5	-0.3	-0.5	-0.6
Net public service pension payments	0.0	0.0	1.7	1.7	1.6	1.7	1.9
<i>of which: CG unfunded pension schemes</i>	0.0	0.0	1.6	1.7	1.5	1.5	1.6
<i>LG police and fire pension schemes</i>	0.0	0.0	0.0	0.0	0.1	0.2	0.3
National lottery current grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BBC domestic services current expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fees associated with financial interventions	0.1	0.2	0.0	0.0	0.0	0.0	0.0
Other PSCE items in departmental AME	0.0	-0.4	0.2	0.1	0.0	0.0	0.0
Expenditure transfers to EU institutions	0.0	0.7	-0.8	-0.1	0.0	0.1	0.1
Locally-financed current expenditure	0.0	-0.1	-0.1	0.0	0.1	0.1	0.5
Central government gross debt interest	0.0	-0.2	-2.3	-4.3	-2.9	-2.0	-1.5
Depreciation	0.0	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1
Current VAT refunds	0.0	0.2	0.3	0.1	0.1	0.0	0.0
Single use military expenditure	0.0	-0.9	0.0	0.0	0.0	-0.4	-0.5
Environmental levies	0.0	0.0	0.2	0.3	0.3	0.4	0.4
Other National Accounts adjustments	-0.5	-0.3	0.6	0.5	0.5	0.5	0.4
<b>Total public sector current expenditure</b>	<b>-0.3</b>	<b>-5.1</b>	<b>-2.0</b>	<b>-4.1</b>	<b>-3.8</b>	<b>-3.5</b>	<b>-3.3</b>
<b>Public sector gross investment (PSGI)</b>							
<b>PSGI in CDEL</b>	<b>-0.3</b>	<b>-1.8</b>	<b>0.0</b>	<b>-0.1</b>	<b>-0.5</b>	<b>-1.7</b>	<b>-2.4</b>
<b>PSGI in Annually Managed Expenditure</b>	<b>-0.2</b>	<b>0.7</b>	<b>-29.1</b>	<b>1.2</b>	<b>1.3</b>	<b>2.5</b>	<b>3.3</b>
<i>of which:</i>							
National lottery capital grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other PSGI items in departmental AME	0.0	0.5	-30.3	0.0	0.0	0.0	0.0
Locally-financed capital expenditure <sup>4</sup>	0.5	1.2	1.9	2.2	2.6	3.8	4.5
Public corporations capital expenditure	0.1	-1.3	-1.0	-1.5	-1.8	-1.9	-2.0
Other National Accounts adjustments <sup>4</sup>	-0.9	0.3	0.3	0.5	0.6	0.7	0.8
<b>Total public sector gross investment</b>	<b>-0.6</b>	<b>-1.1</b>	<b>-29.1</b>	<b>1.1</b>	<b>0.8</b>	<b>0.9</b>	<b>0.9</b>
Less depreciation	0.0	0.3	0.4	0.5	0.5	0.5	0.5
<b>Public sector net investment</b>	<b>-0.5</b>	<b>-0.8</b>	<b>-28.7</b>	<b>1.5</b>	<b>1.3</b>	<b>1.3</b>	<b>1.4</b>
<b>Total managed expenditure</b>	<b>-0.8</b>	<b>-6.2</b>	<b>-31.1</b>	<b>-3.1</b>	<b>-2.9</b>	<b>-2.7</b>	<b>-2.4</b>

<sup>1</sup> Implied DEL numbers for 2015-16 and 2016-17. Calculated as the difference between Resource AME and PSCE in the case of Resource DEL, and between Capital AME and PSGI in the case of capital DEL.

<sup>2</sup> For 2010-11 to 2014-15, child allowances in income support and jobseeker's allowance have been included in tax credits and excluded from social security benefits.

<sup>3</sup> Social security includes the additional costs of universal credit in 2015-16 and 2016-17, which were previously contained within PSCE in RDEL. The impact of this is shown in Table 4.20 - the social security diagnostic table.

<sup>4</sup> The November forecast base has been restated so that locally financed capital expenditure includes the removal of the capital spending of TfL's PC subsidiaries, previously removed in the other national accounts adjustments.

## Expenditure in 2011-12

- 4.105 Our forecast for TME in 2011-12 is £6.2 billion lower than in the November *EFO*, primarily reflecting larger-than-expected underspends by central government departments, discussed below. Our forecast for AME in 2011-12 is around £0.7 billion lower than in November across capital and current AME.
- 4.106 Most of the change in 2011-12 is concentrated in the central government sector. Overall, compared to November we have reduced our forecasts by £6.0 billion for central government spending and £1.6 billion for public corporations spending, and increased local government spending by £1.5 billion. Detailed sectoral breakdowns of our forecasts are shown in the supplementary fiscal tables on our website.

## Departmental expenditure limits (DELs)

- 4.107 Our latest forecasts for resource and capital departmental expenditure are shown in Table 4.17. For 2012-13 to 2014-15, these reflect departments' own spending plans published in *Public Expenditure Statistical Analyses (PESA) 2011*, updated to include changes announced by the Government in the Autumn Statement and the Budget, as shown in Table 4.5.<sup>10</sup>
- 4.108 We explained in the November *EFO* that there were particular uncertainties around our estimate of departmental expenditure in 2011-12, because it was the first year of the Treasury's new system of inter-year spending flexibility, known as the Budget Exchange system.
- 4.109 Under this system, departments are only allowed to transfer underspends against their DEL plans from one year to the next if they declare and surrender those underspends to the Treasury before the end of the year. Any further underspends against those final plans cannot be carried forward, unlike the system that operated up until 2010-11. Budget Exchange might therefore be expected to encourage departments to provide an accurate estimate of likely underspends before the cut-off point, and to minimise further underspends thereafter.
- 4.110 In our November forecast, following discussions with the Treasury, we assumed that the Treasury would use Budget Exchange this year to redistribute declared underspends to other spending areas, and we judged that Budget Exchange would act to limit the overall underspend against plans. However, as shown in

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<sup>10</sup> We publish a further table in the supplementary fiscal tables on our website, which shows how the *PESA* plans for total RDEL and total CDEL split into the figures for PSCE in RDEL and PSGI in CDEL which we have included in our forecast, and the other components that are not included in TME.

Table 4.19, after this redistribution the net impact of the Budget Exchange system was still a reduction against plans of £1.1 billion in departmental resource expenditure. This included some transfers to capital expenditure, so this was partly offset by an increase in departmental capital expenditure against plans of £0.2 billion.

4.111 The latest departmental expenditure data<sup>11</sup> suggests that, despite the incentives to minimise underspends that we thought Budget Exchange would create, departments are forecasting significantly larger underspends than we allowed for in November. Table 4.19 below shows that:

- the departmental forecasts suggest a further underspend of £1.9 billion on both resource and capital expenditure; and
- as departments typically underestimate final underspends at this point of the year, we have decided to assume an additional shortfall of £1 billion on resource and £0.3 billion on capital on top of those forecasts.

4.112 Overall for 2011-12, Table 4.19 shows that we now assume that departments will underspend against the PESA plans by £4 billion for resource expenditure and £2 billion for capital expenditure. This reduces our forecast of total spending in 2011-12 by £5.5 billion compared with the November *EFO*, where we assumed shortfalls against plans would be only £250 million for both resource and capital.

4.113 Given the mounting pressures on most departmental budgets under the 2010 Spending Review plans, we are not currently assuming that the 2011-12 underspends will be repeated in future years. From 2012-13 onwards, Budget Exchange will increase some departments spending plans as they bring forward underspends from the previous year. It is also possible that some of this year's underspending may reflect departments' frontloading their Spending Review budget cuts. This might be consistent with the higher-than-expected general government employment reductions seen this year, as discussed in Box 3.5 in Chapter 3. We will keep our judgement on DEL underspends for future years under review.

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<sup>11</sup> The latest departmental data available when we finalised our forecast included departments estimates of outturn to January and their full year forecasts made in early February.

Table 4.19: Components of shortfall against DEL plans in 2011-12

	PSCE in RDEL	PSGI in CDEL
<b>PESA plans at start of year</b> <sup>1</sup>	<b>326.9</b>	<b>37.0</b>
OBR assumption of shortfall against PESA plans	-4.0	-2.0
of which:		
Revisions to plans at Supplementary Estimates (including changes under Budget Exchange system)	-1.1	0.2
Shortfall against revised plans in departments' forecast outturn <sup>2</sup>	-1.9	-1.9
OBR estimate of allowance for further shortfall	-1.0	-0.3
<b>OBR forecast in March EFO</b>	<b>322.9</b>	<b>35.0</b>

<sup>1</sup> The derivation of these numbers from PESA plans is shown in the supplementary tables on our website.  
<sup>2</sup> Reflects departments estimates of forecast outturn in February 2012.

## Annually managed expenditure

4.114 Table 4.17 sets out our latest central projections of AME spending to 2016-17, based on our economic forecast, the latest estimates of agreed policy commitments, and the effect of measures announced in the Budget.

### Social security

4.115 Table 4.14 shows that expenditure on social security as a share of GDP is forecast to fall from 11.4 per cent to 10.3 per cent over the forecast period, as the economy recovers and unemployment falls, and fiscal consolidation through savings in social security take effect. Compared to our November forecast, social security spending is expected to be around £1.8 billion lower in 2014-15. In 2015-16 the difference with November is eliminated, and in 2016-17 our forecast is now £1 billion higher, because in this forecast we now include a provisional estimate of the additional costs of universal credit in these years.

4.116 There are a number of uncertainties around the final policy parameters and operational design of universal credit, and at this point we have not been able to produce a robust estimate of the additional costs. We are therefore using the provisional estimates of £1.8 billion in 2015-16 and £3.1 billion in 2016-17, that we first published in our July 2011 *Fiscal Sustainability Report*. In 2016-17, we have adjusted this down to £2.5 billion as the Government has stated in the Budget that final decisions on policy design will ensure that additional costs are capped at this level. We will work with DWP to produce a final estimate of the additional costs for our Autumn 2012 forecast, by which point more of the policy parameters and operational details should have been finalised. The costs of universal credit before 2015-16 are being met from within DWP's DEL settlement.

4.117 Table 4.20 shows the other main factors contributing to the change in social security since our November forecast, including Budget measures on child benefit

and amendments to the Welfare Reform Bill. Detailed forecasts for the main components of social security are included in the supplementary fiscal tables available on our website.

Table 4.20: Key changes to social security since November forecast

	£ billion					
	2011-12	2012-13	Forecast			
	2013-14	2014-15	2015-16	2016-17		
November forecast	175.0	182.8	183.6	187.6	193.1	198.3
March forecast	174.7	181.8	182.6	185.7	193.1	199.3
<b>Change</b> <sup>1</sup>	<b>-0.3</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-1.8</b>	<b>0.0</b>	<b>1.0</b>
<i>of which:</i>						
CPI	0.0	0.0	0.1	-0.1	-0.2	-0.2
Claimant count unemployment	-0.1	-0.7	-0.8	-0.9	-0.5	-0.1
State pension uprating	0.0	0.0	0.2	0.2	0.2	0.3
State pension modelling	0.0	-0.1	-0.2	-0.3	-0.4	-0.5
ESA modelling	0.0	-0.2	-0.4	-0.4	-0.4	-0.4
Housing benefit modelling	-0.1	-0.3	-0.4	-0.4	-0.4	-0.4
Universal Credit	0.0	0.0	0.0	0.0	1.8	2.5
Budget measures <sup>2</sup>	0.0	0.1	0.7	0.6	0.5	0.5
Other	-0.1	0.1	-0.1	-0.6	-0.6	-0.6

<sup>1</sup> For 2011-12 to 2014-15, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

<sup>2</sup> March Budget measures include the introduction of a child benefit taper and amendments to the Welfare Reform Bill.

4.118 The reduction in claimant count unemployment since November decreases benefit payments by nearly £1 billion in 2014-15. This falls to only £0.1 billion in 2016-17 as the reduction in claimant count unemployment shrinks. Our forecast of CPI in 2013-14 and 2014-15 is slightly lower than in November, which cuts social security spending by around £0.2 billion each year.

4.119 The forecast of state pension costs is lower by around £0.5 billion by 2016-17 compared with the November forecast as a result of various improvements to the modelling. Around half the change is as a result of improvements to the measurement of new claimants and the modelling of the forthcoming changes to state pension age. The forecast of the number of deaths is also higher.

4.120 Employment and Support Allowance (ESA) spending is lower by around £0.4 billion each year as a result of recent data. These include an increase in the assumption for the 'fit for work' rate from 25 per cent to 32 per cent and a reduction in the rate of switching between JSA and ESA. The housing benefit forecast is also lower by around £0.4 billion each year, because new data have led us to reduce the expected growth in the JSA, IB and in-work claimant groups.

## Tax credits

- 4.121 Tax credits expenditure falls as a share of GDP over the forecast period, largely due to the decision to up-rate the main elements by CPI inflation in the medium term. Compared to our November forecast, expenditure on tax credits is around £0.6 billion lower by 2016-17 due to small changes to the economic determinants – CPI inflation and average earnings – and revised assumptions on the childcare element. Table 4.21 includes company tax credits as well as both the negative tax and AME spending items for child and working tax credits.<sup>12</sup>
- 4.122 Both the number and average value of childcare claims has fallen over the past year, and we assume that the lower expenditure that this leads to persists through the forecast. Spending on households that will continue to be entitled to tax credits following reforms in 2012-13 has also been slightly lower than expected, and we assume this persists in future years.

Table 4.21: Key changes to tax credits since November forecast

	£ billion					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
November forecast	31.8	32.1	32.7	33.1	33.9	34.5
March forecast	31.6	31.6	32.1	32.7	33.3	33.9
<b>Change</b> <sup>1, 2</sup>	<b>-0.1</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.4</b>	<b>-0.6</b>	<b>-0.6</b>
<i>of which:</i>						
CPI	0.0	0.0	0.0	-0.1	-0.1	-0.1
Average earnings growth	0.0	-0.1	-0.1	-0.1	-0.1	-0.2
Childcare assumptions	-0.2	-0.2	-0.3	-0.3	-0.3	-0.4
Budget measures <sup>3</sup>	0.0	0.0	0.0	0.2	0.2	0.2
Other	0.1	-0.2	-0.2	-0.1	-0.2	-0.1

<sup>1</sup> This table shows changes to total tax credits. Tax credits are split between current receipts (shown in table 4.7) and AME current spending (shown in table 4.17), and the changes are split as follows:

Changes to tax credits treated as AME spending	-0.1	-0.4	-0.5	-0.3	-0.5	-0.6
Changes to tax credits treated as negative tax	-0.1	-0.1	-0.1	0.0	-0.1	0.0

<sup>2</sup> For 2011-12 to 2014-15, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

<sup>3</sup> March Budget measures include changes to R&D tax credits.

## Public service pensions

- 4.123 The net public service pensions expenditure forecast is prepared on a National Accounts basis and measures benefits paid less employer and employee

<sup>12</sup> The breakdown between household and company tax credits is shown in the supplementary tables on our website, whilst the negative tax element is in Table 4.7 and the AME portion is shown in Table 4.17.

contributions received. It includes central government pay-as-you go public service pension schemes and the locally administered police and fire-fighters' pension schemes.<sup>13</sup> It excludes the funded Local Government Pension Scheme, but for the first time includes payments to Royal Mail pensioners in respect of their service prior to the transfer date, discussed further in Box 4.1. A breakdown for the major schemes covered is included in the supplementary tables on our website. Table 4.22 shows the main changes since the November *EFO*.

**Table 4.22: Key changes to net public service pension payments since the November forecast**

	£ billion					
	2011-12	2012-13	Forecast			
			2013-14	2014-15	2015-16	2016-17
<b>Net public service pensions</b>						
November forecast	8.4	9.9	10.5	11.6	12.5	13.5
March forecast	8.4	11.6	12.2	13.2	14.3	15.4
<b>Change</b>	<b>0.0</b>	<b>1.7</b>	<b>1.7</b>	<b>1.6</b>	<b>1.7</b>	<b>1.9</b>
<b>Expenditure</b>						
November forecast	31.7	34.0	35.9	37.6	39.2	41.0
March forecast	31.7	35.9	37.7	39.2	41.0	43.0
<b>Change</b>	<b>0.0</b>	<b>1.9</b>	<b>1.8</b>	<b>1.7</b>	<b>1.8</b>	<b>2.0</b>
<i>of which:</i>						
Royal Mail	0.0	1.3	1.4	1.4	1.5	1.6
Other	0.0	0.6	0.4	0.2	0.3	0.4
<b>Income</b>						
November forecast	-23.3	-24.1	-25.4	-26.0	-26.6	-27.4
March forecast	-23.4	-24.3	-25.5	-26.1	-26.7	-27.5
<b>Change</b>	<b>0.0</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>

**4.124** The gross expenditure forecast rises steadily across the forecast period as the age profile of each scheme's membership changes and people live longer. The most significant change since November is the provisional estimate of payments to the Royal Mail pension scheme which adds around £1.5 billion each year from 2012-13. We have not yet had time to quality assure these estimates and we will review them fully for the Autumn forecast.

**4.125** The income of each pension scheme is almost entirely made up of employer and employee pension contributions, and is largely driven by changes in the

<sup>13</sup> The police and firefighters' pension schemes are administered at a local level, however pensions in payment are funded from AME in the same way as other public service pension schemes so they are included in the pensions forecast.

pensionable paybill. Table 4.22 shows that the income side of the pensions forecast is largely unchanged since November.

4.126 The forecast does not include any consequences of the potential reforms included in HM Treasury's recent paper *Public Service Pensions: good pensions that last*, as much of the scheme-by-scheme detail is still to be agreed. In any case it is likely that there would be minimal impact on the forecast over this short a time horizon. We will examine the impact of the recent reforms over a fifty-year horizon in our *Fiscal sustainability report* on 12 July.

### EU contributions

4.127 The main components of the AME expenditure transfers to EU institutions are the UK's gross national income (GNI) contribution, minus the UK's abatement. The forecast for the GNI-based contribution depends mainly on the level of the agreed EU Budget and the relative GNI of each member state. The UK abatement is affected by the UK's share of EU VAT and the UK's share of EU receipts.<sup>14</sup>

4.128 The medium-term forecast is largely unchanged since November. In the short term there is a switch of approximately £0.6 billion of spending from 2012-13 to 2011-12, as a result of significantly higher budget draw-forward than expected. We assume this maximum draw-forward will be repeated in the first quarter of 2013, which also leads to a switch of approximately £0.2 billion from 2013-14 to 2012-13.<sup>15</sup>

4.129 Changes to the sterling-euro exchange rate lead to a decrease in 2012-13 of around £0.4 billion and around £0.3 billion in the later years of the forecast. This is largely offset in the later years by revisions to EU GNI growth assumptions, which are updated to reflect the Commissions latest estimates.

### Locally financed expenditure

4.130 Locally financed expenditure consists mainly of local authority self-financed expenditure (LASFE) – local expenditure that is not funded by grants from central government – and Scottish Government spending financed by business rates.

4.131 The outturn for current LASFE in 2010-11 was significantly lower than we expected for reasons that were explained in our *October 2011 Forecast*

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<sup>14</sup> A further supplementary fiscal table on our website provides further details of UK transactions with the EU, including how all these various contributions score in the National Accounts and in this forecast.

<sup>15</sup> The maximum draw-forward in 2012-13 is less than the draw-forward in 2011-12 because the November forecast already assumed a higher draw-forward in 2012-13 than 2011-12.

*Evaluation Report.* As a result we have reviewed our forecast methodology and are working with the ONS to resolve some measurement differences that this has revealed.<sup>16</sup> We are also making use of the new in-year quarterly data returns on local authority spending, which are published by the Department for Communities and Local Government (DCLG).<sup>17</sup> For this forecast we have been able to use data covering the first three quarters of 2011-12.

4.132 The main explanation for the forecast error in 2010-11 was that authorities overall added to reserves by around £1.6 billion rather than drawing them down by £0.6 billion as we had expected. For 2011-12, as in our November forecast, we assume that authorities will start to draw down reserves given the increased pressures on their budgets under the 2010 Spending Review settlement. This is the main factor driving the forecast increase in total current LASFE of £3.7 billion between 2010-11 and 2011-12. Overall, the forecast for current LASFE in 2011-12 is broadly unchanged from November and is consistent with the latest available data both in departments' forecast outturns of their grants to local authorities, and in DCLG's new in-year quarterly data.<sup>18</sup>

4.133 The main component of current LASFE is expenditure financed by council tax receipts. The forecast for 2012-13 reflects the latest WGLA estimate of an average increase in council tax in Wales of 2.1 per cent, and the latest CIPFA report of an expected overall increase in England of 0.3 per cent. For 2013-14 onwards, our forecasts continue to assume that English council tax increases revert to the average over the three years prior to the recent freezes. Council tax increases in Scotland are assumed to be frozen to the end of the current Scottish Parliament. These assumptions are neutral for the overall fiscal aggregates as they are also applied to the council tax projections in our receipts forecast.

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<sup>16</sup> This work has found an apparent inconsistency between our forecasts and ONS outturn due to different treatments of local authorities' net spending on fire and police pensions (shown in Table 4.17). We are working further with ONS to resolve this apparent difference which may explain at least £1 billion of the 2010-11 forecast error but in the meantime we have not changed the treatment of these payments in our forecasts. Following this work we are also now able to publish full breakdowns of our forecasts for local authority current and capital spending, in the supplementary fiscal tables published on our website.

<sup>17</sup> Local authority quarterly revenue outturn (QRO) in England published at: [www.communities.gov.uk/localgovernment/localgovernmentfinance/quarterlyrevenue/](http://www.communities.gov.uk/localgovernment/localgovernmentfinance/quarterlyrevenue/)

<sup>18</sup> We assume that in 2011-12 local authorities will spend some £0.7 billion more than their budgets, excluding an adjustment that we have also included of -£1.8 billion in order to avoid double-counting spending on new Academies. Schools that apply to become Academies are reclassified from local authority to central government spending in the National Accounts, but the point at which the change has been made is not immediately clear in data returns sent to DCLG.

### Capital LASFE and public corporations capital expenditure

- 4.134 Capital LASFE in 2011-12 includes the large, one-off, net capital transfer by local authorities to central government arising from the reforms to the Housing Revenue Account (HRA). This net capital transfer is scheduled to happen at the end of March 2012, and is now estimated to be £8.1 billion.<sup>19</sup> The payment of this net capital transfer is neutral for overall public sector capital expenditure as it is exactly offset by the central government receipt that appears in Table 4.17 in 'Other PSGI items in departmental AME'.
- 4.135 Since our November forecast there have been changes to our forecasts for the capital spending related to HRA and also to Transport for London (TfL) subsidiaries.<sup>20</sup> Because these bodies span the local authority and public corporations subsectors in the National Accounts, Table 4.23 shows how these changes have affected both these sectors taken together.
- 4.136 Our latest assessment is that the reforms to the HRA announced in the 2010 Spending Review are likely to increase local authority capital spending on housing by an additional £0.5 to £0.9 billion, although these estimates are highly uncertain.
- 4.137 In the November *EFO* we used publically available information on TfL's capital spending plans in our forecast. In this forecast we have used more detailed information supplied by TfL which has enabled us to reflect better the expected timing of capital spending. This reduces our forecasts up to 2014-15, which covers the period of the current TfL Business Plan. Although TfL cannot yet provide this information beyond 2014-15 we have assumed that timing effects will unwind and this spending will increase in 2015-16 and 2016-17 in the final stages of construction of Crossrail.

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<sup>19</sup> This estimate has been revised down by £0.4 billion since the November forecast, but it now reflects the final capital transfers for each local authority that are published on the DCLG website at: <http://www.communities.gov.uk/publications/housing/selffinancingdeterminations>

<sup>20</sup> ONS currently classify all of TfL subsidiaries as public corporations, with the exception of Crossrail and Rail for London, which are classified as part of the local government sector. We expect the ONS to include revisions in the 2012 *Blue Book* to ensure that the capital expenditure included for these bodies follows these classifications, which is not currently the case.

Table 4.23: Key changes to local authority self financed capital expenditure and public corporations capital expenditure since the November forecast

	£ billion					
	2011-12	2012-13	Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
November forecast for capital LASFE	12.5	3.4	2.7	2.2	1.5	1.2
November forecast for PC capital spending	8.3	8.0	8.0	7.8	7.8	7.7
March forecast for capital LASFE	13.6	5.3	4.9	4.8	5.2	5.6
March forecast for PC capital spending	7.1	7.0	6.4	6.0	5.9	5.8
<b>Total change</b>	<b>-0.1</b>	<b>0.9</b>	<b>0.7</b>	<b>0.8</b>	<b>1.8</b>	<b>2.5</b>
<i>of which:</i>						
HRA capital spending as a result of HRA reform	0.0	0.5	0.6	0.7	0.8	0.9
TfL subsidiaries capital spending	-0.2	-0.3	-0.4	-0.4	0.6	1.1
Change in capital transfers for HRA reform	-0.4	0.0	0.0	0.0	0.0	0.0
Local authority capital spending financed by unsupported borrowing	0.2	0.4	0.3	0.3	0.3	0.3
Local authority asset sales (receipts netted off capital LASFE)	0.2	0.3	0.3	0.3	0.3	0.4
Budget measures <sup>1</sup>	0.0	0.0	-0.1	-0.2	-0.3	-0.3
Other	0.1	0.0	0.0	0.0	0.0	0.0

<sup>1</sup> March Budget measures include Right to buy: paying down housing debt, tax increment financing, and a measure on PWLB lending.

4.138 The changes to public corporations capital expenditure also include the estimated savings in net capital expenditure as a result of the Right to Buy policy measure. This policy is expected to increase property sales. These lead to increased capital receipts, which are netted off public corporations capital expenditure. The additional receipts are partially offset by additional capital spending to replace the additional properties sold with new affordable rented housing. The level of increased sales arising from the higher Right to Buy discounts is particularly uncertain.

4.139 Other changes to capital LASFE include an increase in the forecast for spending financed by unsupported borrowing, and reductions in the forecast for receipts from assets sales. These changes reflect DCLG recent releases on local authorities' quarterly in-year capital spending, and capital budgets in 2012-13.

## Debt interest

4.140 Central government debt interest payments fall as a share of GDP in 2012-13 and 2013-14 reflecting lower RPI inflation, which reduces the uplift on index-linked gilts, and existing debt being refinanced at current lower interest rates. Payments then rise as a share of GDP over the remainder of the forecast period,

reflecting expected increases in interest rates and RPI inflation, and the rising stock of debt.

4.141 As discussed in Box 4.1, the transfer of Royal Mail pension scheme assets reduces debt interest costs by up to £1 billion per year compared to our November forecast. Lower market interest rates compared to November also reduce payments by over £1 billion by the end of the forecast period. Revisions to our RPI forecast lower spending by over £2 billion in 2013-14, but increase it in the final two years.

4.142 Since November the ONS has announced its intention to revise its methodology for converting cash payments to accruals. Applying this new methodology increases the forecast of debt interest payments. Other changes include lower spending on National Savings & Investment interest, as well as incorporating recent outturns and the financing remit for 2012-13.

4.143 A breakdown of the debt interest forecast by financing component is shown in the supplementary fiscal tables on our website, including a distinction between debt interest on conventional gilts for new and existing debt. Payments on the existing stock of conventional gilts are fixed for the lifetime of those gilts. With a long average maturity for UK conventional gilts, around half of the payments relate to static debt interest costs on existing conventional gilts. We also include a separate ready-reckoner table showing the approximate effect on debt interest of movements in interest rates, RPI inflation and the CGNCR.

Table 4.24: Key changes to debt interest since November forecast

	£ billion					
	2011-12	2012-13	Forecast			
			2013-14	2014-15	2015-16	2016-17
November forecast	47.6	47.1	50.5	56.1	61.7	65.5
March forecast	47.4	44.8	46.1	53.2	59.7	64.0
<b>Change</b>	<b>-0.2</b>	<b>-2.3</b>	<b>-4.3</b>	<b>-2.9</b>	<b>-2.0</b>	<b>-1.5</b>
<i>of which:</i>						
Royal Mail	0.0	-0.5	-0.6	-0.8	-0.9	-0.9
Other CGNCR	0.0	-0.1	-0.2	-0.2	-0.4	-0.6
Gilt rates	0.0	-0.3	-0.6	-0.7	-0.7	-0.6
Short rates	0.0	0.0	-0.2	-0.5	-0.4	-0.4
Inflation	0.0	-0.6	-2.1	-0.7	0.2	0.3
Accruals methodology	0.3	0.3	0.8	0.6	0.4	0.5
Other	-0.5	-1.2	-1.3	-0.5	-0.2	0.2

### Fees associated with the financial interventions

4.144 Estimates of transactions related to interventions to stabilise the financial sector are included in the fiscal projections where they can be quantified with

reasonable certainty. So the projections include estimates of fee income from the Asset Protection Scheme (APS), the Credit Guarantee Scheme (CGS) and the Contingent Capital Commitment, which score as negative AME, as well as those other interest and loan repayments that can be forecast. The projections do not include estimates of components that cannot be quantified at the current time, such as: the sale of shares in Royal Bank of Scotland and Lloyds Banking Group; or any potential loss payouts on the schemes. There have been very small revisions since the November forecast.

### Other AME spending

- 4.145 Our forecast of **other PSCE items in departmental AME** since November is lower by £0.4 billion in 2011-12, which is largely offset by small increases in other years of the forecast. This is mainly because of delays to Equitable Life payments.<sup>21</sup>
- 4.146 Our forecast of **other PSGI items in departmental AME** has decreased by £30.3 billion in 2012-13 since the November forecast. This is mostly because of the one-off transfer of Royal Mail pension scheme assets to Government, which are valued at £28 billion (see Box 4.1). 2012-13 also includes a £2.3 billion capital receipt following the closure of the Special Liquidity Scheme. This relates to fees received by the Bank of England, which will be transferred to central government in early 2012-13. The £0.5 billion increase in 2011-12 mainly reflects a £0.4 billion decrease in the value of the expected receipt for central government from the net capital transfers associated with the reform of council house financing announced in the Spending Review.<sup>22</sup>
- 4.147 Expenditure from **National Lottery** grants and expenditure by the **BBC** over the forecast period are unchanged compared with our November forecast.
- 4.148 Table 4.17 shows a separate entry in PSCE in AME for **single-use military expenditure**. This expenditure is treated as capital DEL in the control framework, but is classified as current expenditure in the National Accounts. To align with National Accounts we therefore remove this from CDEL and include it as a separate addition to PSCE within current AME expenditure. The reduction of £0.9 billion in 2011-12 since our November forecast reflects the latest available departmental spending information.

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<sup>21</sup> A full breakdown of other PSCE items in departmental AME are shown in the OBR supplementary tables published on our website.

<sup>22</sup> A full breakdown of other PSGI items in departmental AME are shown in the OBR supplementary tables published on our website.

4.149 **Environmental levies** include spending on DECC levy-funded policies such as the Renewables Obligation, Feed-In Tariffs and Warm Homes Discount. Most of these are fiscally-neutral as they are balanced by receipts, and the forecasts are explained in the receipts section. The Renewable Heat Incentive (RHI) policy is not balanced by receipts. Since November, the forecast of the RHI has been reduced to £0.6 billion in 2016-17 as a result of a delay to the scheme launch and new energy price assumptions.

### Accounting adjustments

4.150 The AME forecast includes forecasts for the further adjustments that are included in the National Accounts definitions for PSCE and PSGI. Further details and data for these National Accounts adjustments are provided in the supplementary fiscal tables on our website, which now also show the changes in the underlying detailed adjustments compared to our November forecast. Explanations and the background to all of the National Accounts adjustments are also given in Annex D to *PESA 2011*.

4.151 Table 4.18 shows that the forecasts for the current accounting adjustments have reduced by £0.3 billion in 2011-12 and increased by around £½ billion from 2012-13 onwards. The largest change is to the imputed subsidy for the equity injection into the HRA. The latest outturn information shows that this adjustment is expected to fall from £1 billion in 2010-11 to £0.2 billion in 2011-12, and our forecast assumes that, with the reforms to the HRA account, this adjustment will disappear from 2012-13 onwards. Compared to November, this change reduces PSCE by £1.3 billion in 2011-12, and by £0.8 billion from 2012-13 onwards. However this is fiscally neutral, since the imputed subsidy is also included in public corporations' gross operating surplus (PCGOS), our forecast of which has therefore fallen by an equal and offsetting amount.

4.152 Our forecasts for the capital accounting adjustments have increased by £0.3 to £0.8 billion over the forecast period, with the main change being a reduction in the forecast adjustment to remove local authorities' net financial transactions. The outturn for capital accounting adjustments in 2010-11 has reduced by almost £1 billion mainly because ONS have now revised their outturns to reflect later CLG outturn data.

## Loans and other financial transactions

4.153 Public sector net borrowing (PSNB) is the difference between total public sector receipts and expenditure each year measured on an accrued basis. As we show in Table 4.25, and as we explain in greater detail in the next section, we forecast that PSNB will fall from £126 billion in 2011-12 to £21 billion in 2016-17.

4.154 But the public sector's fiscal position also depends on the flow of financial transactions, which are mainly loans and repayments between Government and the private sector. Generally these do not directly affect PSNB, but they do lead to changes in the Government's cash flow position and stock of debt.<sup>23</sup>

4.155 The public sector net cash requirement (PSNCR)<sup>24</sup> is the widest measure of the public sector's cash flow position in each year. It drives the forecast of public sector net debt (PSND), which is largely a cash measure. Estimating the PSNCR also allows us to estimate the central government net cash requirement (CGNCR), which in turn largely determines the Government's net financing requirement – the amount it needs to raise from treasury bills, gilt issues and National Savings.

4.156 Differences between the PSNCR and PSNB can be split into the following categories:

- **Loans and repayments:** loans that the public sector make to the private sector and that it expects to be repaid do not directly affect PSNB, but the associated cash flow does affect the PSNCR;
- **Cash flow timing effects:** PSNB is an accruals measure of the budget deficit in which, where possible, spending and receipts are attributed to the year that they relate to. In contrast PSNCR is a cash measure in which spending and receipts are attributed to the year in which the associated cash flow takes place. To generate a PSNCR forecast we therefore adjust the PSNB forecast for any differences in the timing of accruals and cash flows. For example, VAT is generally not received by HMRC until up to 3 months after the consumer spending occurs, at which point the cash flow will affect the PSNCR. But in PSNB the receipts are accrued back and counted as is they

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<sup>23</sup> PSNB can also be seen as the change in the Government's net liability position each year. If the Government spends more than it receives in tax in any year then it must borrow the difference, so increasing its net liabilities. Financial transactions do not affect PSNB as they generally leave the Government's net liability position unchanged. For example, when the Government makes a loan it receives an equal and offsetting asset (i.e. a claim on the borrower) in exchange for the cash advanced.

<sup>24</sup> Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the temporary effects of financial sector interventions.

had been received months earlier, because that is the period in which the associated spending on VATable goods took place;

- **Transactions in company securities:** the public sector may buy or sell company securities, such as corporate bonds or equities. As a consequence it will gain or lose an asset and so the transaction does not affect PSNB, but the associated cash flow will affect PSNCR; and
- **Other:** this category includes one-off financial transactions that do not fall into the categories above and some other adjustments.

4.157 Table 4.25 shows the steps required to move from PSNB to the PSNCR while Table 4.26 highlights the changes since our November *EFO*.

### Loans and repayments

4.158 PSNCR is higher than PSNB in each year of our forecast, which largely reflects net lending by the Government to the private sector, in particular for student loans. The recent student loan reforms have increased the size of upfront loans, with repayments being made over a more prolonged period. In our July 2011 *Fiscal sustainability report* we showed that on current policy settings we might expect the difference between new loans and repayments to peak around 2030 and then fall away.

4.159 The student loans forecast is little changed since November. For the English scheme, we assume that the initial average loan per student for tuition fees will be £7,000, with the average maintenance loan of another £3,300. In line with recent announcements, we assume the maximum amounts will be frozen in 2013-14, and then rise with RPIX inflation thereafter. We have also increased our forecast for Scottish loans, to reflect the latest funding proposals there.

4.160 Other loans include lending through the Green Investment Bank and the Department for International Development's (DfID) contributions to multilateral development banks, as well as loans to Ireland and a range of other schemes. The forecast also allows for bank repayments of loans provided as part of the previous Government's financial sector interventions. As discussed further below, these were incorrectly netted out of our November PSNCR forecast.

Table 4.25: Reconciliation of PSNB and PSNCR

	£ billion						
	Outturn 2010-11	2011-12	2012-13	Forecast			
				2013-14	2014-15	2015-16	2016-17
<b>Public sector net borrowing</b>	<b>136.8</b>	<b>126</b>	<b>92</b>	<b>98</b>	<b>75</b>	<b>52</b>	<b>21</b>
Loans and repayments	4.9	8.6	9.4	9.8	6.7	7.1	8.1
<i>of which:</i>							
Student loans <sup>2,3</sup>	4.9	5.0	5.8	7.4	8.6	9.3	9.4
Financial sector interventions	-2.3	-0.3	-1.4	-2.2	-4.2	-4.1	-3.2
DfID	1.0	1.2	1.0	1.1	1.2	1.1	1.1
Ireland	0.0	1.2	1.6	0.8	0.0	0.0	0.0
Green Investment Bank	0.0	0.0	0.8	1.0	0.0	0.0	0.0
Business Finance Partnership	0.0	0.0	0.3	0.5	0.4	0.1	0.0
Get Britain Building scheme	0.0	0.0	0.4	0.3	-0.1	-0.1	-0.1
Other	1.3	1.6	0.9	0.9	0.8	0.8	0.8
Cash flow timing effects	-7.1	-3.0	0.3	7.1	-3.6	-6.3	3.6
<i>of which:</i>							
Student loan interest <sup>3</sup>	0.3	0.7	0.8	1.1	1.7	2.7	4.1
PAYE income tax and NICs	0.8	1.2	3.0	1.6	1.6	2.2	2.2
Indirect taxes	3.0	0.3	1.2	1.3	1.1	1.1	1.2
Other receipts	-0.6	1.3	-0.2	0.4	0.4	0.4	0.4
Index-linked gilts	-9.6	-4.9	-7.3	0.4	-10.5	-14.2	-5.9
Conventional gilts	2.0	2.0	2.1	1.3	1.1	0.9	0.7
Other expenditure	-3.1	-3.8	0.7	1.1	1.0	0.6	0.8
Transactions in company securities	-0.9	-0.7	-4.6	-4.5	0.0	0.0	0.0
<i>of which:</i>							
Northern Rock plc	0.0	-0.7	-0.1	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	-4.5	-4.5	0.0	0.0	0.0
Other	5.1	1.3	23.8	0.3	0.3	0.3	0.3
<i>of which:</i> Royal Mail transfer	0.0	0.0	23.5	0.0	0.0	0.0	0.0
<b>Public sector net cash requirement</b>	<b>138.9</b>	<b>132</b>	<b>121</b>	<b>110</b>	<b>78</b>	<b>53</b>	<b>33</b>

<sup>1</sup> A breakdown based on ONS classifications is available on our website.

<sup>2</sup> The table shows the net flow of student loans and repayments. This can be split out as follows:

Cash spending on new loans	6.3	6.7	7.8	9.7	11.2	12.3	12.9
Cash repayments	1.3	1.7	2.0	2.3	2.6	3.0	3.5

<sup>3</sup> Cash payments of interest on student loans are included within 'Loans and repayments' as we cannot easily separate them from repayments of principal. To prevent double counting the 'Student loan interest' timing effect therefore simply removes accrued interest.

Table 4.26: Changes in the reconciliation of PSNB and PSNCR since November forecast

	£ billion						
	Outturn 2010-11	2011-12	2012-13	Forecast 2013-14 2014-15 2015-16 2016-17			
<b>Public sector net borrowing</b>	<b>-0.2</b>	<b>-1</b>	<b>-28</b>	<b>-2</b>	<b>-4</b>	<b>-1</b>	<b>-2</b>
Loans and repayments	-2.3	0.8	-0.9	-1.5	-3.8	-3.8	-2.8
<i>of which:</i>							
Student loans <sup>1,2</sup>	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Financial sector interventions	-2.3	-0.3	-1.4	-2.2	-4.2	-4.1	-3.2
DfID	0.0	0.3	0.0	0.1	0.1	0.1	0.1
Ireland	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Green Investment Bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Business Finance Partnership	0.0	0.0	0.1	0.1	0.0	0.0	0.0
Get Britain Building scheme	0.0	0.0	0.1	0.1	0.0	0.0	0.0
Other	0.0	0.8	0.1	0.3	0.2	0.2	0.2
Cash flow timing effects	-3.4	-4.2	0.9	2.4	-0.4	-1.6	-2.1
<i>of which:</i>							
Student loan interest <sup>2</sup>	0.0	0.0	0.0	-0.1	-0.3	-0.3	-0.1
PAYE income tax and NICs	0.0	-0.9	-0.1	0.1	-0.4	-0.1	-0.3
Indirect taxes	0.1	0.3	0.1	0.3	0.1	0.1	0.1
Other receipts	-1.1	0.1	-0.1	0.0	0.0	0.0	0.0
Index-linked gilts	-1.6	0.7	0.7	2.0	0.1	-1.2	-1.8
Conventional gilts	0.0	-0.1	0.3	-0.3	-0.1	0.0	-0.1
Other expenditure	-0.8	-4.5	0.0	0.4	0.3	-0.1	0.1
Transactions in company securities	0.0	0.0	-4.5	-4.5	0.0	0.0	0.0
<i>of which:</i>							
Northern Rock plc	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	-4.5	-4.5	0.0	0.0	0.0
Other	5.9	1.0	23.5	0.0	0.0	0.0	0.0
<i>of which:</i> Royal Mail transfer	0.0	0.0	23.5	0.0	0.0	0.0	0.0
<b>Public sector net cash requirement</b>	<b>0.0</b>	<b>-4</b>	<b>-9</b>	<b>-6</b>	<b>-8</b>	<b>-7</b>	<b>-7</b>

<sup>1</sup> The table shows the net flow of student loans and repayments. This can be split out as follows:

Cash spending on new loans	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Cash repayments	0.0	0.0	0.0	0.0	0.0	0.0	0.0

<sup>2</sup> Cash payments of interest on student loans are included within 'Loans and repayments' as we cannot easily separate them from repayments of principal. To prevent double counting the 'Student loan interest' timing effect therefore simply removes accrued interest.

## Cash flow timing effects

4.161 As discussed above, to move from PSNB to PSNCR it is necessary to make an adjustment for the likely impact of timing differences between cash flows and accruals. If receipts are forecast to rise over time, the cash received in any given year will generally be lower than the accrued tax receipts, and the difference

increases over time. Excluding interest payments, this timing effect increases from around £2.5 billion in 2011-12 to around £4 billion in 2016-17.

- 4.162 A large component of the receipts timing adjustment relates to the interest on student loans. This is notionally included in the accrued measure of public sector current receipts as soon as the loan is issued. However, cash repayments are not actually received until the point at which students earn sufficient income. The relevant interest rates are marginally lower than assumed in November, but interest that is owed still rises from less than £1 billion in 2012-13 to over £4 billion in 2016-17. The notionally accrued interest is removed via a receipts timing adjustment. Cash interest receipts are included within 'loans and repayments' as we cannot easily separate them from repayments of principal.
- 4.163 Similar timing adjustments are made for expenditure. The largest adjustment is for the timing of payments on index-linked gilts. These adjustments are very sensitive to RPI inflation, as well as to the profile of redemptions, which is not smooth. Positive RPI inflation raises the amount the Government is committed to pay on index-linked gilts, and this commitment is recognised in PSNB each year, but the actual cash payments will not occur until redemption of the gilt which may be many years in the future. There are also lags due to the timing of cash payments through the year, which also affect conventional gilts.
- 4.164 The revisions in Table 4.26 for expenditure timing effects from 2012-13 mainly relate to gilts and reflect our revised RPI inflation forecast, as well as the ONS' revised methodology for moving between cash and accruals.
- 4.165 Timing effects relating to other elements of cash spending are much more difficult to forecast. We typically therefore assume that the adjustment over the forecast period is equal to the historical average. However, cash spending in the year to date has been significantly weaker than would otherwise be expected and we have revised down this component by over £4 billion for 2011-12.

### Transactions in company securities

- 4.166 Consistent with the *Charter for Budget Responsibility*, and our wider approach to policy announcements, we only include the impact of financial asset sales or purchases once firm details are available that allow the effects to be quantified with reasonable accuracy. As discussed in Box 4.1, the Government intends over the next two years to sell the non-gilt liquid assets that it will receive alongside the transfer of Royal Mail's historic pension liabilities. We assume it will sell £9 billion of bonds and equities over 2012-13 and 2013-14. But we do not assume any further asset sales beyond these.

### Other factors

4.167 The transfer of the Royal Mail pension fund assets reduces PSNB by £28 billion in 2012-13. However, only £4.5 billion is liquid cash that reduces PSNCR, so the transfer reduces net borrowing by £23.5 billion more than it reduces PSNCR.

### Central government net cash requirement

4.168 The other important cash measure is the central government net cash requirement (CGNCR). This measures the cash required by central government to fund its operations, and forms the basis for the Government's net financing requirement.<sup>25</sup> Table 4.27 shows how it relates to PSNCR and Table 4.28 sets out the changes in this relationship since the November forecast. The CGNCR is derived by adding and removing transactions that are associated with local authorities and public corporations from the PSNCR.

4.169 Changes in the CGNCR forecast broadly follow changes to our PSNCR forecast. We expect the cash requirement of local authorities and public corporations to be close to neutral from 2012-13. For local authorities, we have revised up our forecast of spending. Our November forecast for public corporations incorrectly included bank loan repayments to central government, which artificially increased their requirement for cash and therefore the public sector as a whole. But there was no error in the PSND forecast because of this, as such transactions are excluded (see Table 4.32).

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<sup>25</sup> The Government is publishing a financing remit for 2012-13 alongside the Budget. The OBR provides the Government with the forecast of the CGNCR for this purpose, but plays no further role in the derivation of the net financing requirement.

Table 4.27: Reconciliation of PSNCR and CGNCR

	£ billion						
	Outturn 2010-11	2011-12	2012-13	Forecast			
				2013-14	2014-15	2015-16	2016-17
<b>Public sector net cash requirement</b>	<b>138.9</b>	<b>132</b>	<b>121</b>	<b>110</b>	<b>78</b>	<b>53</b>	<b>33</b>
of which:							
Local authorities and public corporations NCR	1.2	12	2	0	-1	-1	-2
Central government NCR own account	137.7	120	119	110	79	54	35
CGNCR own account	137.7	120	119	110	79	54	35
Net lending within the public sector	1.9	10	2	2	2	2	2
<b>Central government net cash requirement</b>	<b>139.7</b>	<b>130</b>	<b>121</b>	<b>112</b>	<b>81</b>	<b>56</b>	<b>37</b>

Table 4.28: Changes in the reconciliation of PSNCR and CGNCR since November forecast

	£ billion						
	Outturn 2010-11	2011-12	2012-13	Forecast			
				2013-14	2014-15	2015-16	2016-17
<b>Public sector net cash requirement</b>	<b>0.0</b>	<b>-4</b>	<b>-9</b>	<b>-6</b>	<b>-8</b>	<b>-7</b>	<b>-7</b>
of which:							
Local authorities and public corporations NCR	0.0	1	0	-1	-4	-1	-1
Central government NCR own account	0.0	-5	-9	-5	-4	-6	-7
CGNCR own account	0.0	-5	-9	-5	-4	-6	-7
Net lending within the public sector	0.0	0	0	0	0	0	0
<b>Central government net cash requirement</b>	<b>0.0</b>	<b>-5</b>	<b>-9</b>	<b>-5</b>	<b>-4</b>	<b>-6</b>	<b>-7</b>

### Box 4.3: Fiscal impact of the financial interventions

We have certified the Treasury's approach for calculating the net cost or benefit to the taxpayer of the interventions to stabilise the financial sector. In particular, these are:

- equity injections into RBS, Lloyds and Northern Rock plc;
- the Asset Protection Scheme;
- bank financing support through the Special Liquidity Scheme (SLS) and Credit Guarantee Scheme (CGS);
- loans to Bradford & Bingley (B&B), Northern Rock Asset Management (NRAM), and the Financial Services Compensation Scheme (FSCS); and
- various wholesale and depositor guarantees.

The overall cost or benefit is highly uncertain and will depend in large part on the eventual sale price for the Government's shareholdings in RBS and LBG, which it is not possible to predict with any confidence. The Treasury's approach therefore uses market prices to value these shares. On the basis of the latest volume weighted average market prices this implies a loss of £25.6 billion on these investments, relative to an implied loss of £30.6 billion reported in the November *EFO*.

The Treasury then uses the Asset Protection Agency's central projection of a net benefit to the taxpayer from the Asset Protection Scheme of £5 billion, including fee income.

Given the large original exposures, the Treasury have not in the past included income from the SLS or CGS. However, exposure to these schemes has diminished substantially. The SLS has now closed, with fee income of £2.5 billion and no reported losses. By January, there was £47.1 billion of outstanding debt guaranteed by the CGS, from a peak of under £140 billion in 2009. This debt will mature by the end of 2012 and associated fees received to date amount to £4 billion.

UK Financial Investments (UKFI) has published estimates for the repayment of the B&B and NRAM loans. The Government provided £62 billion of funding and, over time, the cash returns are expected to be between £94 billion and 96 billion. However, the outstanding cash returns will be received over the next 10-15 years and on a net present value basis will be relatively small in the context of the original funding provided to both banks. Therefore, the Treasury continue to assume that the cost of these and other interventions will not materially affect the aggregate cost or benefit.

Overall, their approach implies an estimated direct loss to the taxpayer of £14.3 billion. This contrasts to the November estimate of a loss of £25.6 billion, since when RBS' and Lloyds' equity values have increased (£5 billion) and other interventions have been quantified (£6 billion).

If all interventions were financed through debt, the Treasury estimate that additional debt interest costs would have totalled £12.5 billion over the 43 months to date.

## The key fiscal aggregates

4.170 Our central forecast for the key fiscal aggregates is presented in Table 4.29. These reflect the forecasts we have set out for receipts, expenditure and financial transactions earlier in this chapter. In this section we explain the changes in four key fiscal aggregates:

- **public sector net borrowing:** the difference between total public sector receipts and expenditure on an accrued basis each year. As the widest measure of borrowing it is a key indicator of the fiscal position and useful for illustrating the reasons for changes since the previous forecast;
- the **surplus on the current budget:** the difference between public sector current expenditure and receipts each year. In other words this is public sector net borrowing excluding borrowing to finance investment;
- the **cyclically-adjusted current budget:** the surplus on the current budget adjusted to remove the estimated effect of the economic cycle. It represents an estimate of the underlying or ‘structural’ surplus on the current budget, in other words the surplus we would see if the output gap was zero. It is used as the target measure for the Government’s fiscal mandate; and
- **public sector net debt:** a stock measure of the public sector’s net liability position i.e. its liabilities minus its liquid assets. It is broadly the stock equivalent of public sector net borrowing, but measured on a cash rather than an accrued basis. It is also the fiscal measure used for the Government’s supplementary fiscal target.

Table 4.29: Fiscal aggregates

	Per cent of GDP						
	Outturn		Forecast				
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Receipts and expenditure</b>							
Public sector current receipts (a)	37.3	37.5	37.5	37.7	37.8	37.6	37.9
Total managed expenditure (b)	46.5	45.8	43.4	43.6	42.2	40.5	39.0
of which:							
Public sector current expenditure (c)	42.6	42.6	42.2	40.8	39.4	37.9	36.5
Public sector net investment (d)	2.6	1.8	-0.2	1.4	1.3	1.2	1.1
Depreciation (e)	1.4	1.4	1.4	1.4	1.4	1.3	1.3
<b>Deficit</b>							
Public sector net borrowing (b-a)	9.3	8.3	5.8	5.9	4.3	2.8	1.1
Surplus on current budget (a-c-e)	-6.7	-6.5	-6.0	-4.5	-3.0	-1.6	0.1
Cyclically-adjusted net borrowing	7.0	6.4	4.0	4.1	2.9	1.9	0.7
Primary balance	-6.5	-5.3	-3.2	-3.3	-1.5	0.0	1.7
Cyclically-adjusted primary balance	-4.2	-3.4	-1.3	-1.6	-0.1	1.0	2.1
<b>Fiscal mandate and supplementary target</b>							
Cyclically-adjusted surplus on current budget	-4.4	-4.6	-4.2	-2.7	-1.5	-0.7	0.5
Public sector net debt <sup>1</sup>	60.5	67.3	71.9	75.0	76.3	76.0	74.3
<b>Financing</b>							
Central government net cash requirement	9.5	8.5	7.7	6.8	4.7	3.1	1.9
Public sector net cash requirement	9.4	8.7	7.7	6.7	4.5	2.9	1.7
<b>Stability and Growth Pact</b>							
Treaty deficit <sup>3</sup>	9.4	8.3	5.9	6.0	4.4	2.9	1.2
Cyclically-adjusted Treaty deficit <sup>2</sup>	7.1	6.4	4.0	4.2	3.0	2.0	0.8
Treaty debt ratio <sup>3</sup>	76.4	84.0	89.0	91.9	92.7	91.4	88.6
<b>£ billion</b>							
Surplus on current budget	-98.7	-98	-95	-74	-52	-30	1
Net investment	38.1	28	-3	23	23	22	22
Public sector net borrowing	136.8	126	92	98	75	52	21
Central government net cash requirement	139.7	130	121	112	81	56	37
Public sector net debt	905.3	1039	1159	1272	1365	1437	1479
<i>Memo: PSNB excluding Royal Mail transfer</i>	136.8	126	120	98	75	52	21
<i>Memo: Cyclically-adjusted PSNB excluding Royal Mail transfer</i>	7.0	6.4	5.7	4.1	2.9	1.9	0.7
<i>Memo: Output gap (per cent of GDP)</i>	-2.9	-2.6	-2.7	-2.4	-1.9	-1.1	-0.4

<sup>1</sup> Debt at end March; GDP centred on end March<sup>2</sup> General government net borrowing on a Maastricht basis<sup>3</sup> General government gross debt on a Maastricht basis

## Public sector net borrowing

### Public sector net borrowing in 2011-12

4.171 Our new forecast for PSNB in 2011-12 is £126 billion or 8.3 per cent of GDP. This is £1.1 billion below the estimate we made in the November *EFO*. This reflects a reduction in our receipts forecast that is more than offset by a reduction in our expenditure forecast. As discussed in earlier sections:

- we expect around £5.1 billion less receipts than we forecast in November. This is largely the result of the £3.6 billion shortfall in self assessment receipts; and
- we expect £6.2 billion less expenditure than we forecast in November, thanks largely to central government departments under-spending against plans by more than expected. At this point, given the pressures on most departmental budgets under the 2010 Spending Review plans, we do not expect the 2011-12 under-spend to be repeated in future years. But we will keep this judgement under review in future *EFOs*.

4.172 Even at this late stage of the year there are a number of risks to our in-year estimate of PSNB. In recent years, local authority expenditure has been revised very significantly after the end of the year as fuller data becomes available. Total receipts are also often revised after the end of the year. This is because the ONS report on an accrued basis for a number of taxes. For example, PAYE income tax receipts received in April are accrued back to the 2011-12 financial year, as are VAT receipts received over April, May and June. A particular uncertainty at the current time is the level of PAYE receipts associated with financial sector bonuses, the bulk of which are paid out in February, March and April.

### Public sector net borrowing from 2012-13

4.173 Table 4.29 shows that we expect PSNB to decline from 8.3 per cent of GDP this year to 1.1 per cent in 2016-17. As shown in Chart 4.5, the decline in PSNB over the forecast period is mainly driven by a fall in spending as a share of GDP due to the Government's fiscal consolidation.

4.174 The most significant change to the path of borrowing since November is the impact of the transfer of the Royal Mail pension scheme to the public sector in 2012-13. The timing and final details of this transfer were still uncertain at the time of the November *EFO*, so at that time we explained the potential impact as a fiscal risk rather including it in our central forecast. As explained in detail in Box 4.1, the transfer of the scheme assets leads to a one-off reduction in PSNB in 2012-13 of £28 billion, while the overall effect on borrowing after 2012-13 is neutral.

4.175 Including this transfer, PSNB is now expected to fall to £92 billion or 5.8 per cent of GDP in 2012-13, and then to rise slightly to £98 billion or 5.9 per cent of GDP in 2013-14. Excluding the impact of the transfer PSNB is £120 billion or 7.6 per cent of GDP in 2012-13 and declines in a smooth path across the forecast period.

4.176 After 2012-13 the profile of PSNB is very similar to our November forecast, with a difference of only £2.5 billion by 2016-17. In the context of the uncertainty around any fiscal forecast this is an extremely small difference. As shown in Table 4.31, the policy decisions taken in this Budget are broadly neutral for borrowing over the forecast period. There have been a number of forecasting changes in both tax and expenditure, which are discussed in the earlier sections of this chapter. However, as Table 4.31 shows, these have been broadly offsetting at the aggregate level, leaving overall borrowing broadly unchanged.

Table 4.30: Components of net borrowing

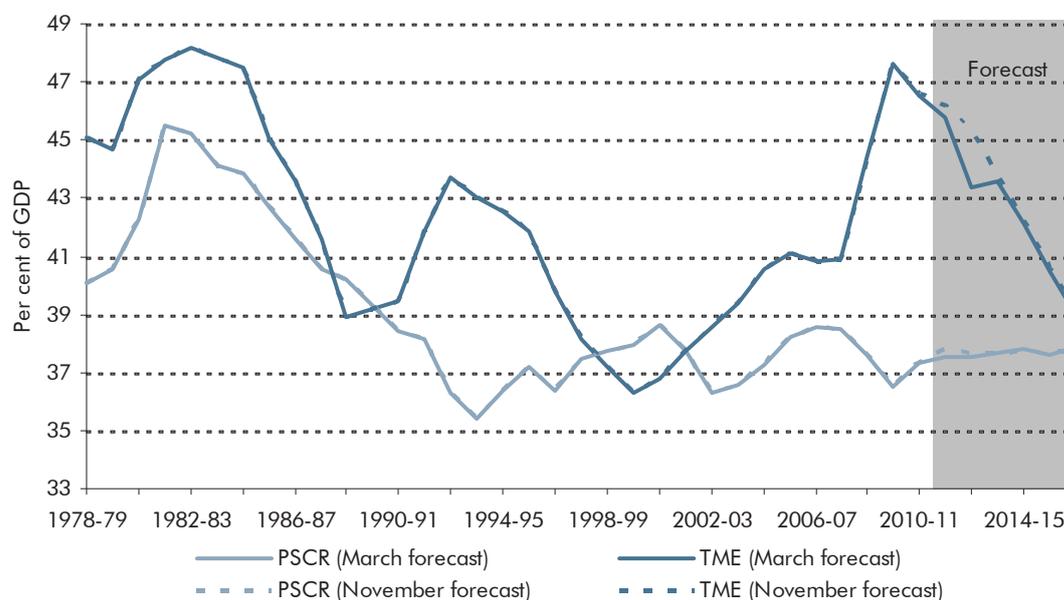
	£ billion						
	Outturn			Forecast			
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Current budget</b>							
Current receipts	550.8	570	592	623	658	692	735
Current expenditure	629.2	647	665	674	686	697	709
Depreciation	20.3	21	22	23	24	25	26
<b>Surplus on current budget</b>	<b>-98.7</b>	<b>-98</b>	<b>-95</b>	<b>-74</b>	<b>-52</b>	<b>-30</b>	<b>1</b>
<b>Capital budget</b>							
Gross investment <sup>1</sup>	58.4	49	19	46	47	47	48
Less Depreciation	-20.3	-21	-22	-23	-24	-25	-26
<b>Net investment</b>	<b>38.1</b>	<b>28</b>	<b>-3</b>	<b>23</b>	<b>23</b>	<b>22</b>	<b>22</b>
<b>Net borrowing</b>	<b>136.8</b>	<b>126</b>	<b>92</b>	<b>98</b>	<b>75</b>	<b>52</b>	<b>21</b>

<sup>1</sup> Net of asset sales

Table 4.31: 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
<b>Change</b>	<b>-0.1</b>	<b>-1.8</b>	<b>-0.1</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.1</b>
<i>of which:</i>						
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

Chart 4.5: Total public sector spending and receipts



Source: ONS, OBR

4.177 All fiscal forecasts are subject to significant uncertainties. One way of illustrating this is by looking at the errors made in previous official forecasts of the public finances. The solid black line in Chart 4.6 shows our median (central) forecast for PSNB with each shaded area representing a 10 per cent probability band. These are calculated on the basis that errors in past official forecasts offer a reasonable guide to errors in the future.

4.178 Since the November *EFO* we have changed our methodology for constructing this fan chart which is explained in Box 4.4. This change in methodology has no implications for our assessment of the probability of the Government meeting its fiscal mandate.

## Current budget

4.179 The current budget is forecast to move from a deficit of £98 billion or 6.5 per cent of GDP in 2011-12 to a surplus of £1 billion or 0.1 per cent of GDP in 2016-17. The improvement is less sharp than for the PSNB as it excludes the reduction in capital spending over the period.

4.180 Compared to our November forecast, there is a relatively small improvement in the current budget over the forecast period. In 2016-17, the current budget has improved by £3.8 billion compared to November. This is because we are forecasting slightly lower current expenditure over the forecast period than in November, while current receipts are broadly unchanged. The transfer of the

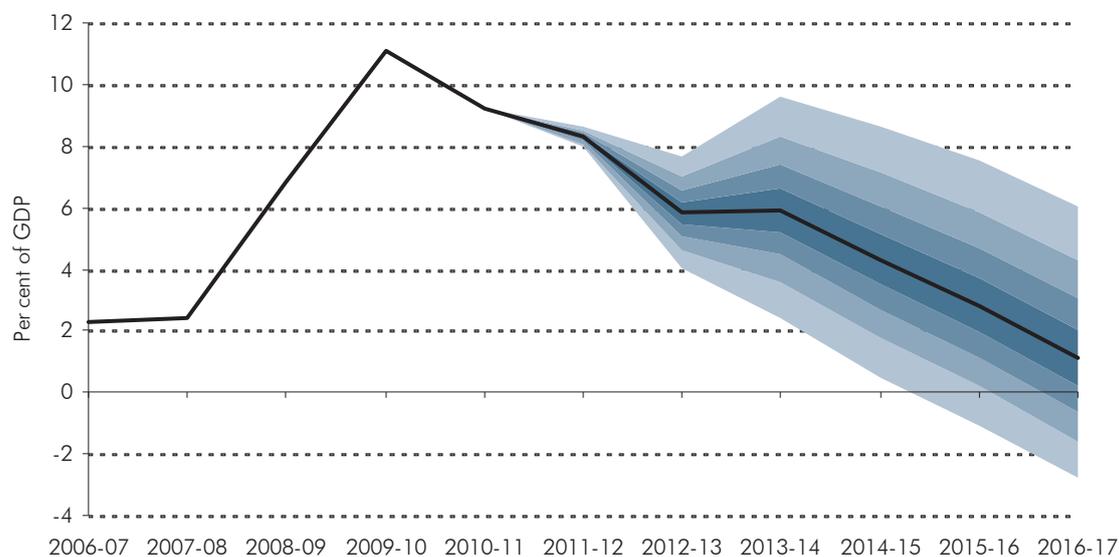
Royal Mail pension scheme assets in 2012-13 does not affect the current budget as it is classified as negative capital expenditure.

### Cyclically-adjusted current budget

4.181 The cyclically-adjusted current budget (CACB) is the current budget adjusted to remove the estimated effect of the economic cycle. It therefore represents an estimate of the 'structural' current deficit. It is used as the target measure for the deficit on the Government's fiscal mandate. Our latest forecast is for a CACB deficit of 4.6 per cent of GDP in 2011-12, improving to a surplus of 0.5 per cent of GDP in 2016-17, which is unchanged from the November forecast.

4.182 The CACB is broadly unchanged from November across the forecast period. The small improvement in the headline current budget, discussed above, is offset by the slightly narrower output gap in this forecast, explained in Chapter 3. Further discussion of the change to the CACB in 2016-17 is provided in Chapter 5.

Chart 4.6: Public sector net borrowing fan chart



Source: ONS, OBR

— March central forecast

### Box 4.4: PSNB fan charts

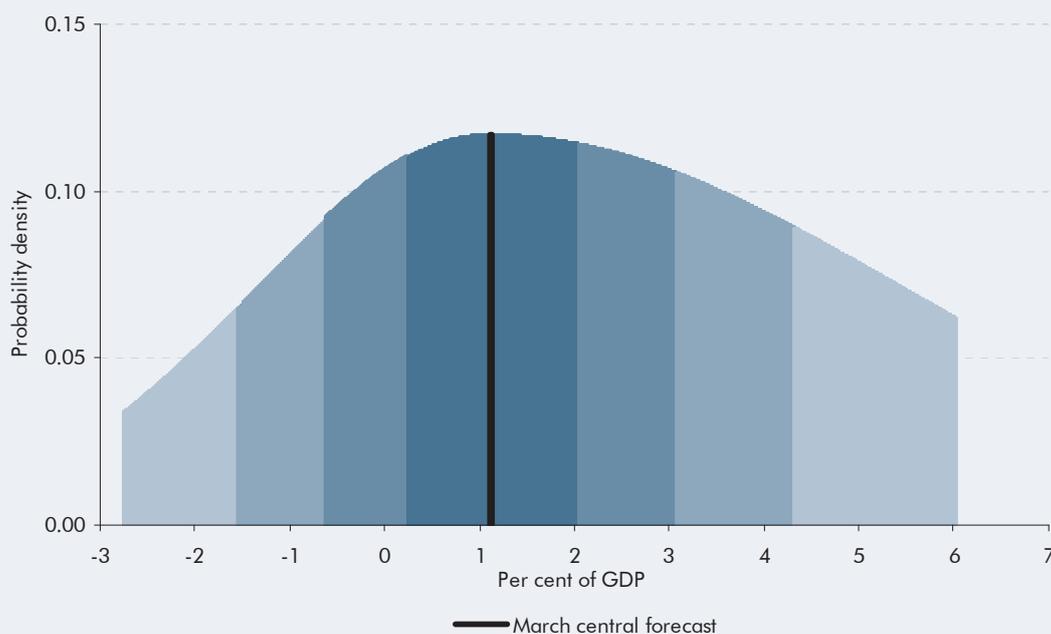
One way of illustrating the uncertainty around the public finances forecast is by using fan charts based on the errors made in previous official forecasts. The fan charts do not represent our assessment of specific risks to the central forecast. Instead, they show the degree of uncertainty that someone might expect if they believed, rightly or wrongly, that errors in the past offered a reasonable guide to future errors.

In previous *EFOs* we have assumed a symmetrical distribution of past errors around the central forecast when constructing the PSNB fan chart. However, our fan chart of errors on the GDP forecast, shown in Chapter 3, has always assumed that past errors on the GDP forecast have been skewed to the downside.

Given the close link between borrowing and the economy one might therefore also expect errors to PSNB to also be skewed towards more negative outcomes (higher borrowing). To ensure consistency between the two charts, we have now decided to use the GDP fan chart to determine directly the shape of the PSNB fan chart. We do this by using a ready reckoner of the sensitivity of PSNB to changes in GDP and will present further details of this methodology in a forthcoming briefing paper, which discusses our approach to recognising uncertainty more generally.

The result can be seen in Chart 4.6, which suggests that the likelihood of making large errors due to under-forecasting PSNB is greater than generating large errors due to over-forecasting borrowing. This is perhaps clearer in Chart A, which illustrates the uncertainty over borrowing in the final year of the forecast period.

Chart A: Probability projections for PSNB in 2016-17



This change does not affect our judgement whether the Government has a greater than 50 per cent probability of meeting its targets. This is determined simply by asking whether our central (or median) forecast of the cyclically-adjusted current budget (CACB) is in balance five years ahead, and whether public sector net debt is falling in 2015-16.

We use a CACB fan chart, as shown in Chart 5.2, to assess the margin between the Government meeting and missing its fiscal mandate. GDP growth and PSNB errors will largely relate to errors in forecasting the cyclical position of the economy. As the CACB should not move with the economic cycle, we would not expect the same pattern of errors to be repeated for the CACB. We therefore continue to assume that risks around the median CACB forecast are distributed symmetrically.

## Net debt

- 4.183 The Government's supplementary fiscal target is for PSND to be falling as a share of GDP at a fixed date of 2015-16. In our latest forecast, PSND rises from 67.3 per cent in 2011-12 to 76.3 per cent of GDP in 2014-15 before falling back to 76.0 per cent of GDP in 2015-16 and then to 74.3 per cent of GDP in 2016-17.
- 4.184 Compared to our November *EFO*, PSND is now expected to be lower from 2012-13 onwards by around 1.5 per cent of GDP. This is primarily the result of the one-off impact of the transfer of the Royal Mail pension fund assets in 2012-13, which as set out in Box 4.1 reduces PSND in that year by £22.9 billion or 1.5 per cent of GDP.
- 4.185 The majority of PFI assets and the associated liabilities are currently held off the public sector balance sheet. The additional liabilities not included in public sector net debt were equivalent to £33 billion or around 2.3 per cent of GDP at the end of March 2010. The Government has announced its intention to reform PFI, and it is not yet clear what the outcome will be, so we cannot project a specific path for this in the future. But, assuming that the additional liability remained fixed at its March 2010 level, net debt would be 2.3 per cent higher as a share of GDP in each year and the peak would be 78.6 per cent in 2014-15.

Table 4.32: Key changes to net debt since November forecast

	£ billion						
	Outturn			Forecast			
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
November forecast	905	1044	1182	1300	1397	1470	1515
March forecast	905	1039	1159	1272	1365	1437	1479
<b>Change</b>	<b>0</b>	<b>-5</b>	<b>-23</b>	<b>-28</b>	<b>-32</b>	<b>-34</b>	<b>-36</b>
<i>of which:</i>							
Cumulative change in net borrowing	-0.2	-1	-30	-32	-36	-37	-39
Cumulative change in financial transactions	0.2	-2	17	13	9	4	-1
Other	0.0	-1	-10	-10	-6	0	5
	Per cent of GDP						
November forecast	60.5	67.5	73.3	76.6	78.0	77.7	75.8
March forecast	60.5	67.3	71.9	75.0	76.3	76.0	74.3
<b>Change</b>	<b>0.0</b>	<b>-0.2</b>	<b>-1.4</b>	<b>-1.5</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.5</b>
<i>of which:</i>							
Change in net debt (£ billion)	0.0	-0.3	-1.4	-1.7	-1.8	-1.8	-1.8
Change in nominal GDP	0.0	0.1	0.1	0.1	0.1	0.1	0.3

Table 4.33: Changes to the fiscal forecast

	£ billion						
	Outturn		Forecast				
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Surplus on current budget</b>							
June 2010 forecast	-110.2	-88	-65	-40	-17	0	
November 2011 forecast	-98.4	-99	-95	-78	-57	-33	-3
Change	-0.3	0	0	4	5	3	4
March 2012 forecast	-98.7	-98	-95	-74	-52	-30	1
<b>Net investment</b>							
June 2010 forecast	38.9	27	24	20	21	21	
November 2011 forecast	38.6	29	25	22	22	20	21
Change	-0.5	-1	-29	2	1	1	1
March 2012 forecast	38.1	28	-3	23	23	22	22
<b>Net borrowing</b>							
June 2010 forecast	149.1	116	89	60	37	20	
November 2011 forecast	137.1	127	120	100	79	53	24
Change	-0.2	-1	-28	-2	-4	-1	-2
March 2012 forecast	136.8	126	92	98	75	52	21
Per cent of GDP							
<b>Net borrowing</b>							
June 2010 forecast	10.1	7.5	5.5	3.5	2.1	1.1	
November 2011 forecast	9.3	8.4	7.6	6.0	4.5	2.9	1.2
Change	0.0	-0.1	-1.8	-0.1	-0.2	-0.1	-0.1
March 2012 forecast	9.3	8.3	5.8	5.9	4.3	2.8	1.1
<b>Cyclically-adjusted surplus on current budget</b>							
June 2010 forecast	-4.8	-3.2	-1.9	-0.7	0.3	0.8	
November 2011 forecast	-4.5	-4.6	-3.9	-2.7	-1.6	-0.6	0.5
Change	0.1	0.0	-0.3	-0.1	0.1	-0.1	0.0
March 2012 forecast	-4.4	-4.6	-4.2	-2.7	-1.5	-0.7	0.5
<b>Cyclically-adjusted net borrowing</b>							
June 2010 forecast	7.4	5.0	3.4	1.8	0.8	0.3	
November 2011 forecast	7.1	6.4	5.5	4.0	2.8	1.7	0.6
Change	-0.1	0.0	-1.5	0.2	0.0	0.2	0.1
March 2012 forecast	7.0	6.4	4.0	4.1	2.9	1.9	0.7
<b>Net debt<sup>1</sup></b>							
June 2010 forecast	61.9	67.2	69.8	70.3	69.4	67.4	
November 2011 forecast	60.5	67.5	73.3	76.6	78.0	77.7	75.8
Change	0.0	-0.2	-1.4	-1.5	-1.7	-1.6	-1.5
March 2012 forecast	60.5	67.3	71.9	75.0	76.3	76.0	74.3

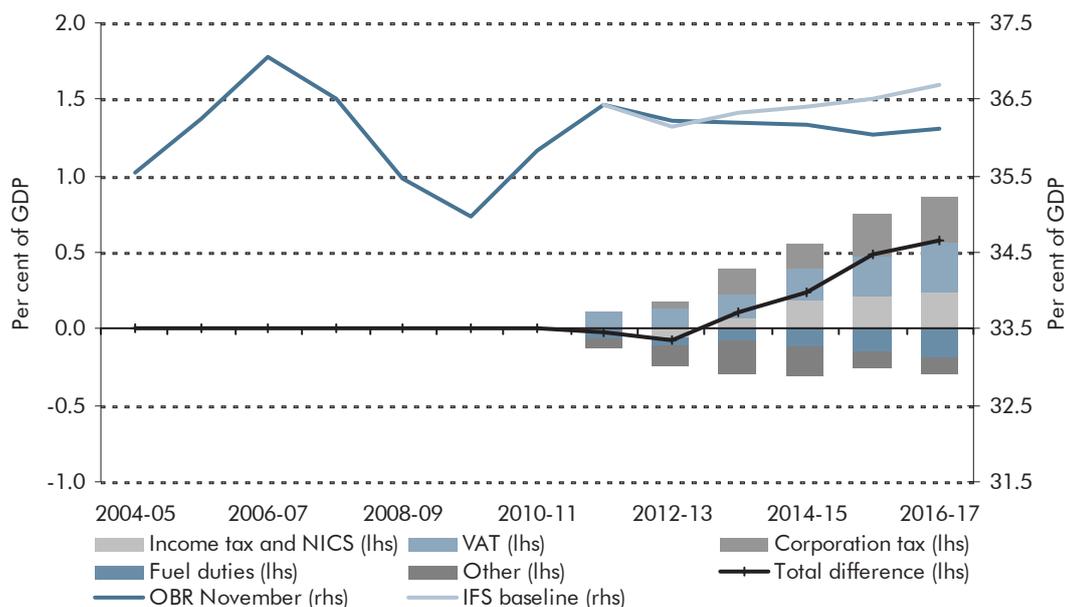
<sup>1</sup> Debt at end March; GDP centred on end March.

## Comparison with external forecasts

- 4.186 The latest average of independent forecasts for public sector net borrowing (PSNB) was £123 billion for 2011-12 and falls to £66.1 billion for 2015-16. Many external forecasters expect PSNB in 2011-12 to be below our forecast, primarily because of the low government spending growth seen in monthly public finance releases since November. However, as described previously we expect this to be largely offset by weak growth in receipts. There is a considerable range to the independent forecasts for 2015-16 from a low of £30.0 billion to a high of £94.7 billion.
- 4.187 The Institute for Fiscal Studies (IFS) is the only body other than the OBR to produce a detailed bottom up forecast for the UK public finances. The Green Budget, published in February 2012, shows their forecasts for the next five years.
- 4.188 The IFS baseline forecast assumed that the economy evolves largely as the OBR forecast in our November EFO. This predicts that PSNB in 2011-12 will be £2.9 billion lower than our November forecast due to lower current spending of £3.3 billion which is slightly offset by lower receipts of £0.4 billion. In 2016-17 the IFS baseline forecast for PSNB is £11.2 billion lower than the November EFO. The difference is largely due to stronger expected growth in tax revenues.
- 4.189 Chart 4.7 shows how the share of tax in national income evolves in the IFS baseline and our November forecast. The IFS baseline forecast assumed a gradual increase in tax as share of national income between 2012-13 and 2016-17, while in our forecast the share remains broadly flat. As a result the tax share is 0.6 percentage points higher in the IFS baseline, equivalent to around £11 billion in tax receipts. The IFS used the economic determinants from our November forecast in their baseline scenario. So these differences are generally likely to be driven by different assumptions on the elasticity of revenues to the determinants and the estimated effects of policy measures. Chart 4.7 shows that the key differences are:
- a stronger recovery in income tax and NICs receipts in the IFS forecast, which is likely to be driven by a higher assumed elasticity of receipts to labour income;
  - a stronger rise in VAT receipts which again is likely to be driven by a stronger assumed elasticity between VAT and nominal consumption than in our forecast;
  - stronger growth in onshore corporation taxes as corporate profits rise. We expect receipts growth to be dampened by the ongoing use of losses built-up in the recession to offset liabilities; and

- a weaker forecast for fuel duties. This could be because our forecast assumes that falling fuel sales will flatten off when the economy begins to grow more robustly.

Chart 4.7: IFS baseline and November EFO forecasts of the tax-to-GDP ratio



Source: IFS, OBR

4.190 Using the IFS Oxford Economics central scenario for the economy makes relatively little difference to the baseline estimates as weaker growth than forecast by the OBR is partly offset by a higher oil price and greater North Sea oil and gas production. Both the IFS baseline forecast and the Oxford Economics central forecast expect the Government to meet the fiscal mandate and supplementary target by greater margins than we forecast in November and also in our latest forecast. The differences between the forecasts though are small given the inherent uncertainties in any fiscal forecast.

Table 4.34: Comparisons with external forecasts of key fiscal aggregates

	£ billion					
	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Public sector net borrowing</b>						
OBR November	127	120	100	79	53	24
IFS February baseline	124	121	98	75	44	12
IFS February Oxford Economics central	123	123	101	76	43	11
Average of independent forecasters	123	116	102	87	66	
OBR March	126	92	98	75	52	21
<b>Per cent of GDP</b>						
<b>Cyclically-adjusted surplus on current budget</b>						
OBR November	-4.6	-3.9	-2.7	-1.6	-0.6	0.5
IFS February baseline	-4.3	-4.0	-2.6	-1.3	-0.1	1.1
IFS February Oxford Economics central	-4.1	-4.0	-2.9	-1.8	-0.5	0.9
OBR March	-4.6	-4.2	-2.7	-1.5	-0.7	0.5
<b>Public sector net debt</b>						
OBR November	67.5	73.3	76.6	78.0	77.7	75.8
IFS February baseline	67.4	73.3	76.6	77.8	77.1	74.7
IFS February Oxford Economics central	67.5	74.4	78.4	79.9	79.5	77.3
OBR March	67.3	71.9	75.0	76.3	76.0	74.3

## International comparisons

- 4.191 International organisations such as the European Commission, the IMF and the OECD all provide comparisons of deficit and debt levels between countries. These are on a general government basis and also on a calendar year basis. To facilitate international comparisons, Tables 4.35 and 4.36 provide UK forecasts on comparable definitions and on a calendar year basis. With both modelling and reporting of much tax and spend done primarily on a financial year basis only, the calendar year forecasts are illustrative and have been generated simply by weighting the financial year forecasts appropriately.
- 4.192 Table 4.35 compares our March forecasts for Treaty deficit and debt against the latest forecasts from the European Commission, made in the Autumn. While the 2011 Treaty deficit outturn of 8.3 per cent of GDP was below the Commission forecast for that year, the UK's Treaty deficit remains high relative to the main European countries. The UK's Treaty debt to GDP ratio in 2013 is expected to be in line with the euro area average. Prior to the economic downturn, the UK's Treaty debt ratio was over 20 per cent of GDP below the euro area average. Table 4.36 compares our forecasts with the latest IMF projections. This shows that UK government borrowing by 2016 is expected to be close to several other main European countries and well below the projected deficits of Japan and the U.S.

Table 4.35: Comparisons with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit			Treaty Debt		
	2011	2012	2013	2011	2012	2013
UK (March EFO)	8.3	6.6	6.0	82.1	87.9	91.3
UK (EC)	9.4	7.8	5.8	84.0	88.8	91.3
Germany	1.3	1.0	0.7	81.7	81.2	79.9
France	5.8	5.3	5.1	85.4	89.2	91.7
Italy	4.0	2.3	1.2	120.5	120.5	118.7
Spain	6.6	5.9	5.3	69.6	73.8	78.0
Euro area	4.1	3.4	3.0	88.0	90.4	90.9

Table 4.36: Comparisons with IMF forecasts

	Per cent of GDP					
	General Government Net Borrowing			General Government Net Debt		
	2011	2012	2016	2011	2012	2016
UK (March EFO)	8.3	6.6	1.7	74.1	80.2	83.5
UK (IMF)	8.6	7.8	1.7	72.9	76.9	72.5
Germany	1.1	0.7	-0.4	57.2	57.0	55.3
France	5.7	4.8	1.4	81.0	83.5	81.9
Italy	3.9	2.8	1.1	100.4	100.7	94.8
Japan	10.1	10.2	7.3	130.6	139.0	166.9
U.S.	9.5	8.0	6.0	72.6	78.4	88.7

Forecasts for GGNB for 2011 and 2012 from IMF's Fiscal Monitor (January 2012). All other forecasts from World Economic Outlook (September 2011)

# 5 Performance against the Government's fiscal targets

## Summary

- 5.1 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.
- 5.2 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.
- 5.3 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  $\frac{3}{4}$  per cent of potential GDP narrower, or rather the level of potential output  $\frac{3}{4}$  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.

## Introduction

5.4 This chapter:

- sets out the Government's medium-term fiscal targets (from paragraph 5.5);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast for the public finances (from paragraph 5.8); and
- assesses how robust this judgement is to the uncertainties inherent in any fiscal forecast, by looking at: past forecast errors; sensitivity to key parameters of the forecast; and alternative economic scenarios (from paragraph 5.12).

## The fiscal mandate and the supplementary target

5.5 In the June 2010 Budget, the Government set itself two medium-term fiscal targets for the current Parliament: the fiscal mandate and a supplementary target. The OBR is required to judge whether the Government has a greater than 50 per cent probability of hitting these targets under existing policy.

5.6 The *Charter for Budget Responsibility* defines the fiscal mandate as "a forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period". This means that total public sector receipts need to at least equal total public sector spending (minus spending on net investment) in five years time, after adjusting for the impact on receipts and spending of any remaining spare capacity in the economy. For the purposes of this forecast, as in our last forecast at the time of the Autumn Statement, the five-year horizon ends in 2016-17. For our autumn 2012 *EFO*, the horizon will roll forward to 2017-18.

5.7 The *Charter* says that the supplementary target requires "public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring the public finances are restored to a sustainable path." The target refers to the measure of

public sector net debt (PSND) that excludes the temporary effects of financial interventions.

## The implications of our central forecast

5.8 Table 5.1 shows our central forecasts for the cyclically-adjusted current budget (CACB) and PSND in each year to 2016-17, as set out in Chapter 4. These are median forecasts, which means that we believe it is equally likely that the eventual outturns will come in above them as below them.

Table 5.1: Performance against the Government's fiscal targets

	Per cent of GDP						
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Cyclically-adjusted current budget</b>							
November 2011 forecast	-4.5	-4.6	-3.9	-2.7	-1.6	-0.6	0.5
March 2012 forecast							
excluding measures <sup>1</sup>	-4.4	-4.6	-4.1	-2.7	-1.6	-0.7	0.4
March 2012 forecast	-4.4	-4.6	-4.2	-2.7	-1.5	-0.7	0.5
<b>Public sector net debt</b>							
November 2011 forecast	60.5	67.5	73.3	76.6	78.0	77.7	75.8
November 2011 forecast							
plus RM announcements <sup>2</sup>	60.5	67.5	72.1	75.2	76.7	76.4	74.6
March 2012 forecast							
excluding measures <sup>1</sup>	60.5	67.3	71.8	74.8	76.3	76.0	74.3
March 2012 forecast	60.5	67.3	71.9	75.0	76.3	76.0	74.3

<sup>1</sup> These remove the direct effect of measures announced in the 2012 Budget. No account is therefore taken of the effect of measures on debt interest payments, nor any indirect effects via their impact on the economic forecast.

<sup>2</sup> This includes the effects of the transfer of Royal Mail's historic pension deficit and subsequent asset sales (see Box 4.1).

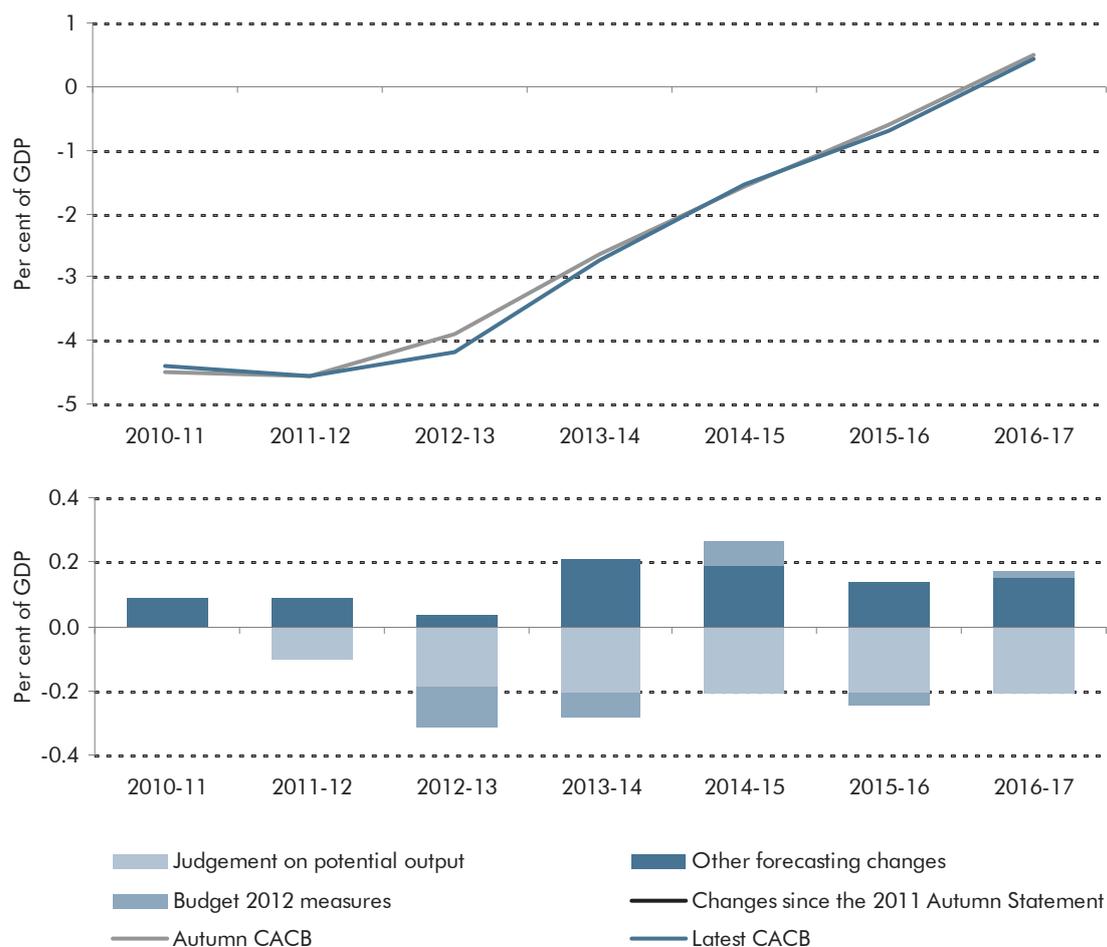
5.9 Table 5.1 shows that in the absence of any Budget policy measures our central forecast would show the CACB in surplus by 0.4 per cent of GDP in 2016-17, marginally lower than our November forecast. The Budget measures very slightly increase the expected surplus, so that overall our forecast for the CACB in 2016-17 remains unchanged from November at 0.5 per cent of GDP. This means that there remains a greater than a 50 per cent chance of the Government achieving balance on this measure in that year and as a result it is on course to achieve the mandate.

5.10 Chart 5.1 decomposes the changes in our forecasts of the CACB since November. In the context of the large degree of uncertainty that surrounds all fiscal forecasts, the changes since the autumn are all very small. The decomposition shows that:

## Performance against the Government's fiscal targets

- our downward revision to potential output at the beginning of the forecast period has worsened the CACB by around 0.2 per cent of GDP from 2012-13;
- other forecasting changes to receipts and spending have a close to offsetting effect, improving the CACB by between 0.1 and 0.2 per cent of GDP from 2013-14; and
- measures announced in the Budget are broadly neutral overall, with a small net addition to the surplus in 2016-17 of £0.4 billion (less than 0.1 per cent of GDP).

Chart 5.1: Revisions to the cyclically-adjusted current budget balance since November 2011



Source: OBR

- 5.11 The supplementary target requires PSND to fall between 2014-15 and 2015-16, and this target year remains fixed. We have revised down PSND in each year of the forecast period, mainly reflecting the transfer of assets from the Royal Mail pension fund into the public sector. But this transfer has no differential effect in either 2014-15 or 2015-16 and so does not affect the likelihood of the Government meeting its supplementary target. As Table 5.1 shows, in the absence of Budget tax and spending measures we would have expected PSND to drop by 0.3 per cent of GDP in 2015-16, in line with our forecast in the autumn. The Budget measures have a broadly neutral impact across 2014-15 and 2015-16 and therefore do not affect this forecast.

## Recognising uncertainty

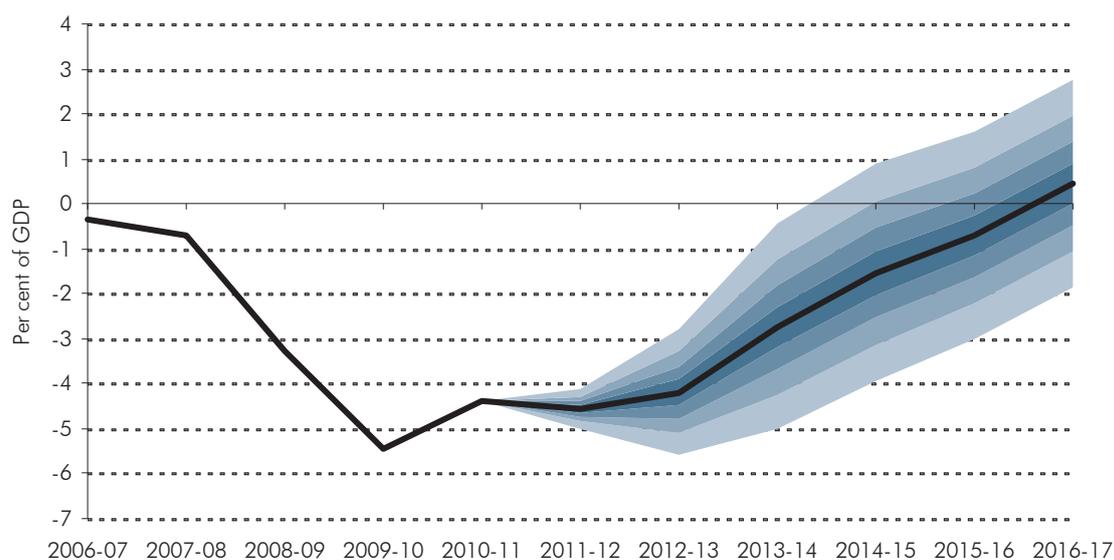
- 5.12 Past experience and common sense suggest there are significant upside and downside risks to our central forecasts for the public finances. These reflect uncertainty both about the outlook for the economy and about the level of receipts and spending that the Government would record in any given state of the economy.
- 5.13 Given these uncertainties, it is important to stress-test our judgement that the Government is on course to meet the mandate in 2016-17 and the supplementary target in 2015-16. We do this in three ways:
- by looking at the lessons from past forecast errors;
  - by seeing how our central forecast would change if we altered some of the key judgements that underpin it; and
  - by looking at alternative economic scenarios.

## Past performance

- 5.14 One relatively simple way to illustrate the uncertainty around our central forecast is to draw lessons from the accuracy of previous official public finance forecasts. This can be illustrated through the use of fan charts like those we presented for GDP growth in Chapter 3 and public sector net borrowing (PSNB) in Chapter 4. These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that errors in the past offered a reasonable guide to errors in the future.
- 5.15 In this spirit, Chart 5.2 shows the probability distribution around our central forecast for the CACB, based on past official forecasting errors (which usually tend to be dominated by errors in the fiscal forecast rather than the underlying

economic forecast). The solid black line shows the median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands. This implies that, based on current policy, there would be an 80 per cent probability of the outturn lying within the shaded bands.

Chart 5.2: Cyclically-adjusted current budget fan chart



Source: OBR

— March central forecast

5.16 We can see from the chart that, given past forecasting performance, the margin between the Government meeting and missing its fiscal mandate is dwarfed by the uncertainty that surrounds the public finance forecast over that time horizon. A direct reading of the chart would imply that the Government currently has a roughly 60 per cent probability of achieving a surplus on the CACB in 2016-17 and thereby meeting the mandate. The probability of achieving a cyclically-adjusted surplus a year earlier in 2015-16 is lower at around 40 per cent. These probabilities are broadly unchanged since our November forecast.

5.17 Unfortunately, one cannot estimate the probability of achieving the supplementary target, given that we do not have a joint distribution that would allow us to apply the same technique. That said our central median forecast shows PSND falling as a percentage of GDP in 2015-16, and by the same amount as in November.

### Sensitivity analysis

5.18 It is very difficult to produce a full subjective probability distribution for the Government's target fiscal variables because they are affected by a huge variety of economic and non-economic determinants. However, to recognise the

uncertainty in our forecast we can go further than using the lessons of past forecasting errors, by quantifying roughly how sensitive our central forecast is to certain key economic parameters.

- 5.19 In thinking about the evolution of the public finances over the medium term, there are several parameters that have a particularly important bearing on the forecast. In this section we focus on four:
- the level of potential output, captured by the size of the output gap;
  - the speed with which the output gap closes (i.e. the pace of the recovery);
  - the interest rates that the Government has to pay on its debt; and
  - possible errors on our cyclical adjustment coefficients.
- 5.20 Our central forecast is based on a judgement that the economy was running around 2½ per cent below potential in the fourth quarter of 2011, that the output gap will widen through 2012, and that there will be above-trend GDP growth thereafter.
- 5.21 The output gap appears to have remained unchanged between the third and fourth quarters of 2011, despite actual growth being slightly negative. We are expecting the potential growth rate of the economy to remain weak over the coming quarters and return gradually to its long-run average.
- 5.22 Our assumptions and forecasts for the level of economic potential and headline growth imply that the negative output gap will close in 2017-18. But neither the level of potential, nor the pace of recovery, are possible to estimate with confidence, not least because the former is not a variable that we can observe directly in the economic data. So what if the medium-term level of potential was higher or lower than our central estimate, and what if the output gap closed earlier or later than our central estimates?
- 5.23 Tables 5.2 and 5.3 present illustrative estimates of the impact on:
- the level of the cyclically-adjusted current budget balance in 2016-17; and
  - the change in PSND between 2014-15 and 2015-16.
- 5.24 For practical reasons, we have not undertaken complete forecast runs for each variant, but have instead used ready-reckoners and simplifying assumptions to generate illustrative estimates. We assume that a lower or higher level of potential is reflected in our starting output gap, rather than errors in forecasting

trend growth rates further forward. Adjusting the mix between the two does not alter the results.

- 5.25 The cyclical adjustment ready-reckoner assumes that a 1 per cent change in GDP will result in a 0.7 per cent of GDP change in PSNB and the current surplus after two years. The actual change in the public finances would depend on many other factors, including the composition of growth, inflation and labour market response. We assume that these follow the same path as in past economic cycles. While we recognise the limitations of these ready-reckoners, applying them yields the results shown in the tables below.

Table 5.2: Cyclically-adjusted current balance in 2016-17

Per cent of GDP	Output gap closes				
	2013-14	2015-16	2017-18	2019-20	2021-22
<b>-0.5</b>	-1.0	-1.0	-1.0	-1.0	-1.0
<b>-1.5</b>	-0.3	-0.3	-0.3	-0.3	-0.3
<b>-2.5</b>	0.4	0.5	0.5	0.4	0.4
<b>-3.5</b>	1.2	1.2	1.2	1.2	1.2
<b>-4.5</b>	1.9	2.0	1.9	1.9	1.9

Table 5.3: Change in PSND between 2014-15 and 2015-16

Per cent of GDP	Output gap closes				
	2013-14	2015-16	2017-18	2019-20	2021-22
<b>-0.5</b>	0.9	0.7	0.9	1.0	1.3
<b>-1.5</b>	0.2	0.0	0.3	0.5	0.8
<b>-2.5</b>	-0.4	-0.9	-0.3	0.2	0.6
<b>-3.5</b>	-1.0	-1.5	-0.8	-0.2	0.0
<b>-4.5</b>	-1.7	-2.2	-1.3	-0.6	-0.2

- 5.26 Table 5.2 shows that the level of potential output has a strong effect on the size of the cyclically-adjusted current budget balance in 2016-17. The lower potential output is, and therefore the smaller the output gap, the larger the proportion of the deficit that is structural (and therefore impervious to economic recovery) and the less margin the Government has against its fiscal mandate. Conversely if potential is higher, less of the deficit is structural and the Government has more margin against its mandate.
- 5.27 Closing the output gap at a different pace will result in a change in cyclical borrowing, but has little effect on the structural balance. For example, closing the output gap more slowly will result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.

- 5.28 Roughly speaking, the output gap would have to be about  $\frac{3}{4}$  per cent of potential output narrower than our central estimate (or rather the level of potential output would need to be  $\frac{3}{4}$  per cent lower in 2016-17 than in our central forecast) to make it more likely than not that the mandate would be missed. As we saw in Chapter 3, projections of potential output vary considerably, and this is well within the margins of uncertainty.
- 5.29 Table 5.3 shows that the Government would miss its supplementary target if the output gap was narrower than in our central forecast, or closed fractionally later. The former would imply more structural borrowing, whereas the latter would suggest further cyclical borrowing. In both cases PSNB would be higher as a per cent of GDP in 2015-16, leading PSND to continue to rise.
- 5.30 A third potential source of departure from our central forecast is variation in the interest rates that the Government has to pay on future borrowing and some existing debt. As set out in Chapter 4 our central forecast assumes that gilt rates for future borrowing move in line with market expectations. But what if the central forecast of gilt rates were to suffer a shock? We examine the implications of a negative shock of 50 basis points, making debt cheaper, and increases of 50, 100 and 150 basis points, making debt more expensive. We assume the shock occurs in 2012-13 and does not affect any other part of the forecast, including exchange rates and shorter-term interest rates. Table 5.4 shows the level of the CACB in 2016-17 and the change in PSND between 2014-15 and 2015-16 under these variants, constructed using a ready-reckoner.

Table 5.4: Fiscal target variables under different gilt rate assumptions

Per cent of GDP	Change in gilt rate (bps)				
	-50	0	50	100	150
<b>Cyclically-adjusted current budget balance in 2016-17</b>	0.6	0.5	0.3	0.1	-0.1
<b>Change in public sector net debt between 2014-15 and 2015-16</b>	-0.4	-0.3	-0.1	0.0	0.2

- 5.31 Table 5.4 shows that these illustrative shocks to gilt rates have a relatively small impact on the chances of meeting the mandate and supplementary target. This is because an increase in rates only applies to new debt issuance, and the UK has a relatively long average debt maturity for conventional gilts, and because new issuance is projected to fall as borrowing declines. Therefore over a short horizon, such as our five-year forecasting period, the impact of a shock to the average nominal rate on gilts is relatively small.

- 5.32 All else equal, a sustained shock of 150 basis points would make it more likely than not that the Government would miss both its fiscal targets. However, if short-term interest rates moved in line with gilt rates, there would be a direct offsetting impact on the public finances through an increase in interest receipts and tax on corporate and household savings. In the November 2011 *EFO* we showed that potentially this could offset around 60 per cent of the direct impact on debt interest payments, though this would depend on the precise change in interest rates at different maturities.
- 5.33 Our last sensitivity analysis concerns the uncertainty around our cyclical adjustment coefficients. Cyclical adjustment attempts to remove the effect of the economic cycle from forecasts of the public finances. This is done by adjusting a given fiscal aggregate, such as PSNB, for the size of the output gap in the current and previous years, using cyclical adjustment coefficients.<sup>1</sup> We use the Treasury's approach to cyclical adjustment, presented in *Public finances and the cycle*.<sup>2</sup> The coefficients are therefore 0.2 for the previous year's output gap, and 0.5 for the current year's gap.
- 5.34 The coefficients are derived by analysing the past relationship between the output gap and the fiscal position. They are highly uncertain for a number of reasons:
- the output gap is not directly observable, so there is no historical 'fact' from which to estimate the coefficients;
  - the number of observations on which to base coefficient estimates is limited;
  - the fiscal position is affected by events that do not necessarily move in line with the cycle, such as one-off fiscal policy adjustments and movements in commodity and asset prices; and
  - insofar as the current economic cycle differs from the average cycle, the relationship between the public finances and the output gap over the course of that cycle will not be captured in the coefficients.
- 5.35 We published a working paper in the autumn exploring methods of estimating an historical output gap series.<sup>3</sup> This will enable us to reassess the size of the cyclical

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<sup>1</sup> For example, the cyclically-adjusted current budget is calculated as:  $CACB_t = CB_t - \alpha \cdot (OG_{t-1}) - \beta \cdot (OG_t)$ , where  $OG$  is the output gap in a given fiscal year  $t$ ,  $\alpha$  and  $\beta$  are cyclical adjustment coefficients, and the current budget is expressed as a percentage of GDP.

<sup>2</sup> HM Treasury, 2008, Treasury Economic Working Paper No.5: *Public finances and the cycle*.

<sup>3</sup> OBR, 2011, Working Paper No. 1: *Estimates of the UK output gap*.

adjustment coefficients. In the meantime, however, it is useful to consider how sensitive our central forecast is to variations in the coefficients.

- 5.36 If the coefficient on the current year's output gap was 0.4, rather than the Treasury's estimate of 0.5, the cyclically-adjusted current budget would be 0.04 per cent of GDP lower in 2016-17. If the coefficient on the previous year's output gap was also 0.1 rather than 0.2, the cyclically-adjusted current budget would be 0.15 per cent of GDP lower in 2016-17. Equally, higher coefficients would result in a smaller deficit or larger surplus on the current budget and lower net borrowing, on a cyclically-adjusted basis.
- 5.37 This analysis should be seen in the context of the uncertainty surrounding the size of the coefficients. The Treasury's 2008 paper included a comparison with alternative estimates, looking at the European Central Bank's (ECB) coefficient of 0.65 and the OECD figure of 0.45. Compared with the Treasury's estimate, the lower ECB and OECD coefficients would imply reductions in the cyclically-adjusted current budget in 2016-17 of 0.17 and 0.24 per cent of GDP respectively.<sup>4</sup> Using these coefficients the fiscal mandate would still be met, but with less margin for error than in our central forecast.

## Scenario analysis

- 5.38 The variants discussed above focus on a narrow set of factors and therefore only offer a partial assessment of potential uncertainty. In this section we set out the fiscal implications of two broader illustrative alternative economic scenarios, designed to test how dependent our conclusions are on key judgements that are subject to debate in the forecasting community. We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from the central forecast and we do not attempt to attach particular probabilities to their occurrence. They are:
- the 'OECD stylised downside scenario in the euro area', in which a disorderly sovereign debt restructuring leads to a tightening in credit conditions and significantly lower growth; and
  - a 'temporary oil price spike' scenario, in which a temporary shock raises oil prices significantly in the short term.

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<sup>4</sup> These estimated effects assume that the ECB and OECD coefficients apply to the current year's output gap, so the coefficient on the previous year's output gap is zero.

### Scenario one: OECD stylised downside scenario in the euro area

- 5.39 Our central forecast is predicated on the euro area continuing to find a way through its recent difficulties, with the effects on economic activity slowly unwinding over time. Although financial conditions appear to have eased since the autumn, there remains the risk of a more prolonged period of improvement or a disorderly outcome.
- 5.40 Here we consider the fiscal implications of the OECD's stylised downside scenario, presented in its November *Economic Outlook*, of a disorderly sovereign debt restructuring in the euro area. The OECD did not assume any additional risk premia associated with non-euro area government debt, and so the effects on the UK economy come primarily through the impaired functioning of the banking sector. The key features of the OECD's scenario are that:
- credit conditions, bond spreads and equity prices move in line with developments over the second half of 2007 to early 2009. But policy interest rates are unchanged;
  - tighter financial conditions and heightened uncertainty lead to a reduction in growth in OECD countries of 2 percentage points in 2012, and a further 3 percentage points in 2013; and
  - the additional weakness is largely cyclical, with the output gap widening significantly. Inflation is lower as a result, with consumer prices across OECD countries falling by over 2 percentage points in 2013.
- 5.41 The OECD's scenario does not extend past 2013. To extend it we simply assume that the recovery in growth that we expect under our central forecast is delayed beyond 2013. Consistent with our central forecast, the potential growth rate of the economy also remains slower for longer, with a gradual return to its long-run average over the remainder of the forecast period. Table 5.5 summarises the key implications of this scenario compared to our central forecast, and more specifically:
- the wider output gap bears down on inflation, with the CPI inflation rate remaining below target;
  - weak nominal GDP growth leads to significantly lower tax receipts, due to lower consumption, labour income and company profits. Taxes on assets are significantly weaker, due to lower equity prices and housing transactions;
  - unemployment-related spending rises, but lower inflation dampens benefits upratings and debt interest payments on index-linked gilts. Departmental

spending, which is fixed in nominal terms over the current Spending Review period, increases as a share of national income. Growth in spending beyond the Spending Review period rises more slowly, as it is linked to general economy inflation; and

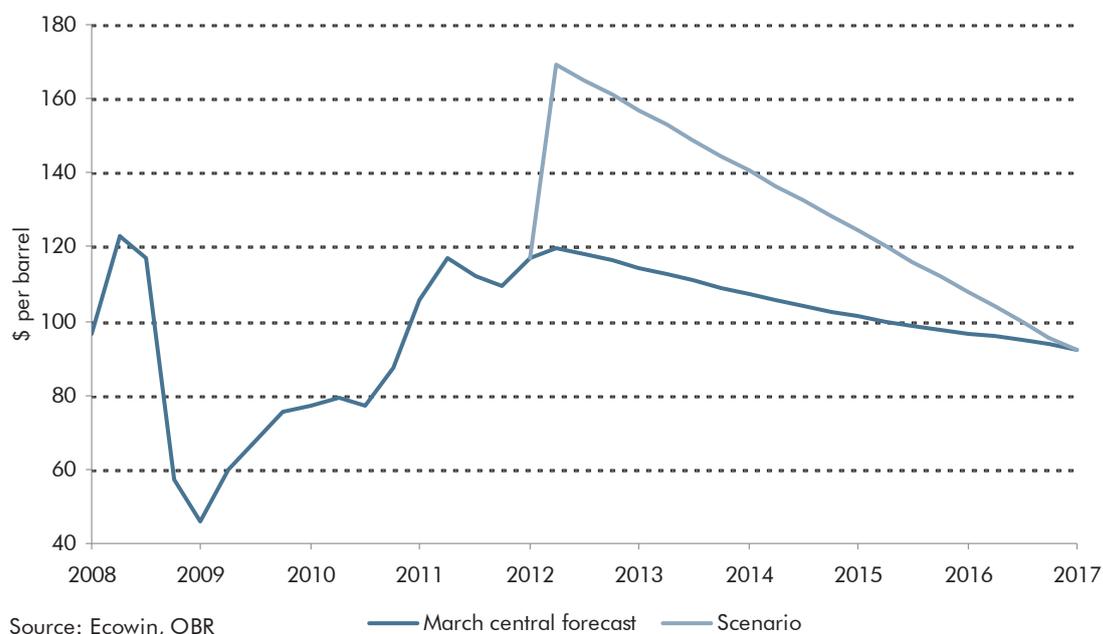
- much of the additional borrowing compared to our central forecast is cyclical, but nevertheless, because of our assumption of slower potential growth, the CACB is no longer in surplus in 2016-17; and
- higher borrowing (both structural and cyclical) leads to public sector net debt rising significantly over the forecast period. Therefore under this scenario, absent further policy announcements, the Government would fail to meet either its fiscal mandate or supplementary target.

#### Scenario two: Temporary oil price spike

5.42 Our central forecast assumes that oil prices move in line with the latest futures curve. Currently this assumes that prices will fall from the current level of around \$120 per barrel to around \$95 dollars per barrel by 2017. However, many analysts have identified further increases in the oil price as a risk, potentially due to increased political tension in the Gulf region. This scenario considers the implications of such an oil price shock by assuming:

- an immediate \$50 shock to the oil price, with prices then gradually returning towards the same level in 2017 as in our central forecast. The respective paths are illustrated in Chart 5.3. The path of prices in our scenario differs from the oil price shock seen in late 2010 when prices rose sharply and then remained at the new elevated level;
- the shock leads to a fall in output with a lag of around two quarters. We assume this fall is cyclical with no effect on the potential level of output; and
- there is a rise in consumer prices which is offset by a deterioration in the terms of trade, as the price of imports rises by more than the price of exports.

Chart 5.3: Brent crude oil price



5.43 The key implications, compared to our central forecast, are as follows:

- consumer inflation rises significantly in the short term, but is below-target in following years, as the price level converges with our central forecast;
- GDP growth is 0.3 per cent in 2012-13, compared to 1 per cent in our central forecast. Because we assume this is a cyclical change, the lost output is made up in the medium term as the effects of the shock dissipate;
- the direct effect on tax receipts is positive, as higher UK oil and gas revenues more than offset a reduction in fuel duty. VAT receipts also rise, as spending on fuel (subject to the standard rate of VAT) displaces spending on other items that are either zero-rated or subject to a reduced rate of VAT. But these effects are gradually outweighed by weaker economic activity;
- spending is higher under this scenario, as the inflation shock immediately increases debt interest on index-linked gilts, and the uprating of benefits a year later. Some of the additional spending is persistent, as the triple lock on state pensions leads to permanently higher pension payments; and
- the net effect on the public finances of this temporary shock is reasonably small. The margins against both the fiscal mandate and supplementary target are lower than in our central forecast, but the Government would remain on course to achieve both its targets. However, these margins would diminish if the oil price remained higher for longer.

5.44 Table 5.5 summarises the economic assumptions we have made, as well as the fiscal consequences of these alternative scenarios.

Table 5.5: Key economic and fiscal aggregates under alternative scenarios

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
<b>Central forecast</b>						
<b>Economic assumptions</b>						
GDP (percentage change)	0.5	1.0	2.3	2.8	3.1	3.0
CPI inflation (Q3)	4.7	2.6	1.9	1.9	2.0	2.0
ILO unemployment (% rate)	8.3	8.7	8.5	7.9	7.0	6.1
Output gap	-2.6	-2.7	-2.4	-1.9	-1.1	-0.4
<b>Fiscal impact (per cent of GDP)</b>						
Public sector net borrowing	8.3	5.8	5.9	4.3	2.8	1.1
CACB	-4.6	-4.2	-2.7	-1.5	-0.7	0.5
Public sector net debt	67.3	71.9	75.0	76.3	76.0	74.3
<b>OECD stylised downside scenario in the euro area</b>						
<b>Economic assumptions</b>						
GDP (percentage change)	0.5	-1.9	-0.2	2.3	2.8	3.0
CPI inflation (Q3)	4.7	2.4	-0.6	0.0	0.7	0.8
ILO unemployment (% rate)	8.3	9.8	10.7	10.5	9.8	9.0
Output gap	-2.6	-5.1	-6.0	-5.1	-4.4	-3.7
<b>Fiscal impact (per cent of GDP)</b>						
Public sector net borrowing	8.3	7.5	8.8	7.6	6.3	4.6
CACB	-4.6	-4.7	-3.4	-2.5	-1.9	-0.7
Public sector net debt	67.3	75.6	83.7	88.9	92.2	93.5
<b>Temporary oil price spike</b>						
<b>Economic assumptions</b>						
GDP (percentage change)	0.5	0.3	2.3	3.0	3.3	3.2
CPI inflation (Q3)	4.7	4.4	1.5	1.6	1.6	1.5
ILO unemployment (% rate)	8.3	9.0	8.7	8.1	7.1	6.2
Output gap	-2.6	-3.3	-3.1	-2.4	-1.4	-0.4
<b>Fiscal impact (per cent of GDP)</b>						
Public sector net borrowing	8.3	6.0	6.1	4.5	3.1	1.3
CACB	-4.6	-4.1	-2.5	-1.4	-0.8	0.2
Public sector net debt	67.3	72.5	75.9	77.2	76.9	75.2



# A Budget 2012 policy measures

- A.1 The *Economic and fiscal outlook* incorporates the Government's costings for policy decisions in Budget 2012 or announced since the Autumn Statement. The OBR has certified all of the tax and AME measures as being reasonable central estimates. This Annex reproduces HM Treasury's table of policy measures. Chapter 4 of this report and the OBR's annex in the Treasury's Budget 2012 policy costings document sets out further details.

Table A.1: HM Treasury table of Budget 2012 policy decisions

	Head	£million					
		2012-13	2013-14	2014-15	2015-16	2016-17	
<b>Personal and Property tax</b>							
1	Personal allowance: increase by £1,100 in 2013-14, with a proportion passed to higher rate tax payers	Tax	0	-3,320	-3,450	-3,510	-3,580
2	Child Benefit: threshold at £50,000 and taper to £60,000	Spend	-185	-690	-630	-	-
3	Income tax: reduce additional rate to 45p in 2013-14	Tax	0	-50	-100	-100	-110
4	Income tax: cap on unlimited tax reliefs <sup>2</sup>	Tax	0	*	+490	+240	+300
5	Stamp Duty Land Tax: avoidance on residential property and associated CGT changes	Tax	*	+65	+65	+65	+75
6	Stamp Duty Land Tax: 7% on residential properties over £2million	Tax	+150	+180	+225	+260	+300
<b>Growth and Enterprise</b>							
7	Corporation tax: decrease main rate to 24% in 2012-13, 23% in 2013-14, 22% from 2014-15	Tax	-405	-730	-820	-880	-920
8	Bank Levy	Tax	+10	+420	+455	+455	+455
9	North Sea oil and gas: decommissioning	Tax	-115	+245	+385	+340	+290
10	North Sea oil and gas: securing new fields and other measures	Tax	-45	-90	+65	+30	+30
11	Capital allowances: enterprise zones (Yorkshire and Humber, Scotland, London and Wales)	Tax	*	-5	-20	-15	*
12	R&D tax credits: above the line	Spend	0	+5	-205	-	-
13	Video games and animation: tax relief <sup>3</sup>	Spend	0	-15	-35	-	-
14	Enterprise Management Incentive	Tax	*	-5	-10	-20	-25
<b>Environment</b>							
15	Climate change levy: levy exemption certificates removal	Tax	0	+110	+125	+145	+165
16	Carbon price floor: combined heat and power relief and other changes	Tax	0	-45	-90	-115	-145
17	Aggregates levy: freeze	Tax	-15	-10	-10	-10	-10
18	Landfill communities fund: freeze	Tax	0	+5	+5	+10	+10
19	Capital allowances: energy and water efficient technologies	Tax	+5	+20	+15	+10	+5
20	Company car tax	Tax	0	0	+120	+375	+350
21	Capital allowances: company cars	Tax	0	+25	+115	+185	+250
22	Fuel benefit charge	Tax	+5	+10	+10	+5	+5
<b>Duties</b>							
23	Tobacco duty: RPI +5% from 21 March 2012	Tax	+70	+50	+50	+45	+45
24	Gambling: place of consumption	Tax	-15	-20	+55	+240	+270
25	Vehicle Excise Duty: freeze rates for Heavy Goods Vehicles in 2012-13	Tax	-10	-10	-10	-10	-10
<b>Simplification</b>							
26	Age-related allowances: freeze amount and restrict to existing recipients from 6 April 2013	Tax	0	+360	+670	+1,010	+1,250
27	VAT: correcting anomalies	Tax	+50	+115	+125	+145	+160
28	VAT: closing loopholes	Tax	+75	+155	+165	+170	+190

<b>Avoidance and administration</b>							
29	Capital allowances: avoidance	Tax	+25	+45	+45	+45	+45
30	Settlor-interested trusts: avoidance	Tax	0	+15	+10	+10	+10
31	IHT: spouse relief	Tax	0	*	-5	-5	-5
<b>Other spending measures</b>							
32	Working tax credits: extend exemptions for carers allowance	Spend	-5	-5	-5	-	-
33	DWP fraud and error initiatives	Spend	-140	-105	-80	-	-
34	Armed forces: housing, council tax relief and Families Welfare Grant	Spend	-5	-105	-5	-	-
35	Local Authorities: Tax Increment Financing	Spend	0	-20	-20	-	-
36	Aerodynamics centre	Spend	-25	-35	0	-	-
37	Science capital investment fund for universities	Spend	0	-25	0	-	-
38	Public works loan board	Spend	+5	+15	+25	-	-
39	Smaller cities broadband	Spend	0	-50	0	-	-
40	Right to Buy: paying down housing debt	Spend	+55	+115	+175	-	-
<b>Changes to spending forecasts</b>							
41	Special Reserve	Spend	+100	+800	+1,500	-	-
42	Consequential changes to current spending	Spend				+255	+450
43	Consequential changes to capital spending	Spend				+705	+725
<b>Previously announced measures</b>							
44	Corporation tax: confirmation of announced Controlled Foreign Company rules	Tax	+210	+365	+320	+150	+35
45	Capital allowances: feed in tariffs and renewable heat incentive	Tax	+20	+45	+60	+80	+100
46	Debt buybacks: avoidance	Tax	+395	+210	+55	0	0
47	Transfer of assets	Tax	0	*	*	*	-5
48	Pensions: delay to auto-enrolment	Tax	0	0	+5	+35	+340
49	Insurance tax: Solvency II	Tax	0	+55	+30	-65	+30
50	Insurance tax: stop loss and quota share	Tax	+170	+250	+260	+110	+25
51	Insurance tax: Claims Equalisation Reserves	Tax	0	*	+85	+90	+80
52	Capital allowances: fixtures mandatory pooling	Tax	*	+15	+20	+30	+35
53	Life assurance premium relief	Tax	0	0	0	+5	+5
54	Stamp Duty Land Tax: area based reliefs	Tax	0	+30	+40	+40	+40
55	Welfare Reform Bill: amendments	Spend	+90	-80	-20	-	-
56	Support for free advice services	Spend	0	-20	-20	-	-
<b>TOTAL POLICY DECISIONS</b>			<b>+470</b>	<b>-1,710</b>	<b>+235</b>	<b>+460</b>	<b>+1,140</b>
<b>Forestalling impact of additional rate reduction and cap on unlimited tax reliefs</b>			<b>-2,400</b>	<b>+760</b>	<b>+1,750</b>	<b>-370</b>	<b>0</b>
<b>TOTAL FISCAL IMPACT OF POLICY DECISIONS</b>			<b>-1,930</b>	<b>-950</b>	<b>+1,985</b>	<b>+90</b>	<b>+1,140</b>

\* Negligible.

- Spending measures do not affect borrowing in 2015-16 and 2016-17 as they fall within the Total Managed Expenditure assumption.

<sup>1</sup> Costings reflect the OBR's latest economic and fiscal determinants.

<sup>2</sup> The effect on tax liabilities underlying the exchequer receipts is £0 in 2012/13, £350m in 2013/14, £270m in 2014/15, £290m in 2015/16 and £310m in 2016/17. There is a lag between the tax liability arising and the tax revenue being collected via self assessment

<sup>3</sup> Tax reliefs for creative industries total £40 million by 2015/16







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