March 2024 *Economic and fiscal outlook*

Transcript of Presentation by:

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Office for Budget Responsibility

1. Opening slide

- Good afternoon, everyone.

- I'll first take you through our latest forecast for the economy.

- And then turn to what it, and the policies announced by the Chancellor in today's Spring Budget, imply for the public finances.

- Less than three months have passed since our last forecast. And the period in between has been relatively uneventful economically – at least by the tumultuous standards of the early 2020s.

- Nonetheless, there have been some developments in the interim which have had a material impact on our view of the UK's economic and fiscal outlook.

2. Inflation

- First, inflation has come down more quickly than we expected in the Autumn.

- CPI in the final quarter of 2023 was 4.2 per cent, 0.6 percentage points lower than we forecast in November.

- And we now expect it to fall below the Bank of England's 2 per cent target by the second half of this year - helped by falling global energy prices and a cooling domestic labour market.

- Our central forecast then shows inflation remaining just below 2 percent until the final year when we assume the output gap has closed.

- Recent disruptions to global shipping through the Red Sea, associated with the ongoing conflict in the Middle East, pose a significant risk to this more favourable outlook for inflation.

- Its impact in our central forecast is relatively modest, adding just 0.2 percentage points to CPI at its peak in 2025
- But we also consider a scenario in which the current conflict spills over to other parts of the region, interrupting oil and gas exports.
- In this scenario, quarterly inflation spikes back above 7 per cent and real GDP contracts by around 1 per cent at the height of the disruption.

3. Interest rates

- With global and domestic inflationary pressures easing, market participants now expect a sharper fall in interest rates than they did in November
- When we took a print of the market curves in the lead up to the 23rd of January:
    - Bank Rate was expected to fall from its current 15-year high of 5¼ percent to just over 3 per cent by 2026, around ¾ of a percentage point lower than we forecast in November
    - And 10-year gilt yields stood at 3.9 per cent, about ½ a percentage point below their November level
- But interest rate expectations have remained highly volatile since they started rising in the second half of 2022.
- In just the 3 months since our November forecast, medium-term expectations for Bank Rate have been as high as 4.2 per cent and as low as 2.7 per cent.
- In fiscal terms, that is equivalent to an additional £5 billion more or £3 billion less borrowing in the fifth year of our forecast.

4. Migration and participation

- But perhaps the biggest economic development since November has been what we've learnt about the size and composition of the UK population.
- While the ONS continues to face challenges in gathering comprehensive and reliable data, two key releases over the past two months have shed further light on post-pandemic developments in the labour market.

  - The first is the ONS's new net migration data and population projections published in January.

  - The second is the ONS's reweighted Labour Force Survey which came out last month.

- As you can see from the chart on the left, the ONS's latest data showed that annual net migration reached 670,000 in the middle of 2023, 70,000 more than we assumed in our November forecast.

- Informed by the latest ONS projections, and changes in the visa regime announced late last year, we now expect net migration to fall back sharply over the next few years before settling at 315,000 per year in five years' time.

- Compared to our November forecast, this adds an extra 350,000 people to the overall size of the UK population by the fifth year of our forecast.

- But given considerable uncertainty about the level of future migration flows and the impact of recent policy changes, we also explore the economic and fiscal implications of cumulative net migration being 1 million people higher or lower over the next five years.

- The second thing we learned from the ONS over the past three months is that levels of *economic inactivity* among the *resident* population are *also* higher than we previously assumed, and are expected to rise further.

- The latest ONS labour force data from February suggest that the demographic composition of the labour force was more heavily weighted toward groups with lower participation rates.

- And, rather than continuing to decline from its post-pandemic peak, the number of inactive working-age adults has rebounded over the last six months to 9.3 million – 700,000 more than before the pandemic.

- And long-term illness is both the most common, and fastest growing, reason for being outside the labour force, accounting for one-in-three people in this group.

- These worrying trends suggest the overall labour participation rate is likely to continue to fall over the next five years, rather than making a partial recovery as we assumed in November.

- As you can see from the chart on the right, by the end of the forecast period, labour participation is now expected to be 1½ percentage points lower than at its pre-pandemic peak and half a percentage point lower than we forecast in November.

5. Real GDP and real GDP per person

- Turning to what all of this means for our GDP forecast, as you can see from the chart on the left, latest outturn data suggest that the economy has largely stagnated since the pandemic

- And output contracted slightly over the second half of last year, rather than growing by 0.1 per cent as we expected.

- This means the level of real GDP at the start of this year is slightly lower than we anticipated in November.

- But our forecast for economic growth thereafter is largely unchanged. This is because:

    - the positive effect on aggregate GDP of a larger population, lower energy prices, lower interest rates, and a small boost from the measures in the Chancellor's Spring Budget

    - is almost fully offset by the negative effects of lower labour participation, average hours, and productivity - both in outturn and over the forecast.

- So by the end, the overall level of GDP is just 0.1 per cent higher than we forecast in November

- But as you can see from the chart on the right, GDP per person continues to fall to a trough of 1¼ per cent below its pre-pandemic peak in the middle of this year and ends the forecast almost a full percentage point lower than we expected in November.

- And varying the level of net migration over this period by 200,000 per year has a meaningful effect on the level of aggregate GDP, but makes much less difference to GDP per person.

6. Changes in public borrowing since November

- Turning to what these economic developments imply for the public finances relative to our November forecast:

- Lower Bank Rate and gilt yields reduce debt interest costs (shown in dark blue) by around £14 billion per year over the forecast
- And lower inflation reduces welfare costs (shown in light blue) by a few billion pounds a year
- But it also reduces nominal earnings, and therefore tax receipts, (shown in yellow) by amounts rising to £15 billion by 2028-29
- The net effect of these changes in our pre-measures forecast (shown by the white diamonds) is to deliver the Chancellor a modest fiscal windfall of around £10 billion a year over the next two years, but leave total borrowing largely unchanged by the final year
- In his Spring Budget, the Chancellor announced a front-loaded package of tax cuts and spending increases (shown in green) which cost around £10 billion a year over the next two years, but whose cost is partly recouped by tax rises by the end of our forecast
- After accounting for the cost of these measures, and their effect on the economy, this leaves post-measures borrowing (shown by the black diamonds) around £4 billion higher in 2028-29 than we forecast in November

7. Spring Budget policy package

- Looking in more detail at the Spring Budget policy package, the Chancellor spends a total of around £40 billion over the five-year forecast period.
- The single largest element is a further 2p cut in national insurance contributions at a cost of £10 billion a year.
- There is also the traditional one-year freeze in fuel duty costing a further £3 billion in 2024-25.
- But the Budget also introduces new taxes on vaping and carbon imports, and a new tax regime for non-doms which, together with other anti-avoidance measures, raise a total of £7 billion of extra revenue by 2028-29
- The only major spending item is £900 million a year to be invested in pump-priming efficiency savings in the NHS and other public services over the next Spending Review period.

8. Taxation

- The further net tax cuts announced in this Budget help to reduce the overall tax-to-GDP ratio by around half a percentage point relative to our November forecast

- But it is still set to rise over the next five years to close to a post-war high of just over 37 per cent of GDP.

- About one-third of the 4 percentage point increase in the post-pandemic tax take is due to the decision to keep the main personal tax allowances and thresholds frozen, in the face of high inflation since 2022.

- This drags growing numbers of people into higher tax bands, creating

    - over 3 million more taxpayers, with

    - over 2 million more higher rate, and

    - over half a million more additional rate taxpayers by 2028

9. Labour supply impact of policy measures

- The NICs cuts and other measures in this Budget also provide a further boost to the labour supply, on top of the other reforms announced in the last two fiscal events.

- As you can see from this table, we estimate that the 4p worth of NICs cuts announced over the past 3 months will boost the effective supply of labour by around 200,000 over the next five years

- Other reforms to pensions, benefits, and childcare add a further 100,000 to the labour supply

- But the increase in marginal tax rates for those dragged into higher tax bands is also likely to have a negative effect on work incentives, which we quantify for the first time in this EFO.

- We estimate that freezing, rather than indexing, the allowances and thresholds in the personal tax system since 2022 is likely to have reduced total hours worked by the equivalent of 130,000 FTE by 2028-29 – with just over half of this effect having already been realised and a bit under half still to come

- And, as you can see from the bottom line of this table, the net effect of all of these decisions on the labour supply is to boost it by just under 200,000

- Which is an important contribution to tackling one of the UK's biggest supply side challenges. But it's also equivalent to just over a quarter of the rise in in working-age inactivity we've seen since the pandemic.

10. Public services spending

- Turning to public spending, apart from the temporary injection of capital into the NHS, the Chancellor has, once again, left the path of Departmental Expenditure Limits (or DELs) largely unchanged in this Budget.

- DELs account for just over 40 per cent of public spending and are allocated out between departments in periodic Spending Reviews

- The last Spending Review was conducted in October 2021 and set multi-year budgets for each department in nominal-terms up to 2024-25

- And the Treasury has announced today that it won't be conducting another Spending Review until after the next election.

- As you can see from the chart on the left, this means that 4 out of the 5 years of our forecast for this large proportion of spending are not based on any detailed departmental plans from the Government

- Instead, the Treasury simply provides us with an assumed level of total current and capital spending on public services for the period beyond March of next year.

- As you can see from the chart on the right, the real per person spending power of these plans and assumptions has been steadily eroded over the past three years

    - Starting with the blue line, this shows you what the Government's public spending plans implied, in terms of real spending per person, when they were first set out in October of 2021 – around £8,200 per person by 2026-27

    - As shown in the yellow line, these plans were then topped up in *cash* terms in subsequent fiscal events

    - But the last three years has also seen much higher *inflation* than anticipated, for which budgets were not fully adjusted. This reduced the *real* spending power of these plans by around 6 per cent, as shown in the green line.

    - And finally, the last three years has also seen higher levels of net *migration* and population growth. As shown in the purple line, this reduces real spending *per person* by a further 2 per cent to just under £7,600 by 2026-27

- So the net result is that real departmental spending per person is now expected to be around £600 lower in 2026-27 than was implied when the Government first set out its plans in October of 2021.

- And real per person spending on public services no longer grows over the next five years in our central forecast.

11. Government borrowing

- The Chancellor's decision to spend all of the underlying fiscal improvement in our forecast on net tax cuts in this Budget means that the overall path of borrowing as a share of GDP is largely unchanged relative to our November forecast

- From a post-war high of 15 per cent of GDP during the pandemic, borrowing falls to 4 per cent of GDP this year, and then steadily to around 1 per cent of GDP by 2028-29

- Were this path to be delivered, it would mean borrowing falls to its lowest level as a share of GDP since the start of the century

12. Government debt (ex Bank of England)

- The unchanged path of borrowing means the Chancellor remains on track to meet his fiscal target of getting debt to fall as a share of GDP in five years' time

- Underlying debt rises from 89 per cent of GDP this year to peak at 93.2 per cent in 2027-28, and then falls slightly to 92.9 per cent in the target year of 2028-29

- Headroom against his debt falling target is around £9 billion. This is £4 billion less than he had back in November, mostly due to the cost of the policies announced in the Budget.

13. Headroom against fiscal rules

- £9 billion may sound like a lot of money, but, as you can see from this chart, it's

    - a third of the average margin of £26 billion set aside by all Chancellors against their respective fiscal rules since 2010.

  - and it's the second smallest such margin, after Jeremy Hunt's Budget from this time last year.

14. Risks to the outlook

- And it is useful to weigh the adequacy of that very modest amount of fiscal headroom against the array of potential risks to the fiscal outlook.

- Based on historic forecast errors, we estimate there is only a 54 per cent chance that the main fiscal rule will be met, which means there is a 46 per cent chance that it won't be.

- In the final year of our *economy* forecast, it would only take…

  - labour participation to be another 0.2 percentage points *lower*

  - interest rates on government debt to be 0.3 percentage points *higher*

  - or nominal GDP growth to be 0.3 percentage points *lower*

- … to wipe out of this headroom entirely.

- On the fiscal side, key risks come from stated government policies, on both the tax and spending side, whose implementation is subject to question

  - The most doubtful of these is the Government's stated intention of delivering an RPI-plus-5p indexation of fuel duty next year and RPI indexation after that. Freezing fuel duty at its current rate instead - as every government has done since 2011 - would knock £4½ billion off the Chancellor's headroom.

  - Our fiscal forecast also assumes that all the main personal tax allowances and thresholds are frozen for an unprecedented 6 years, with each year of the freeze delivering an additional £7 billion in revenue relative to indexation.

  - Given higher inflation and net migration since they were first set out, the Government's stated departmental spending plans now entail no real increase in per person spending on public services over the next five years.

  - But, beyond March of next year, the Government has not set out any detailed plans for how such spending restraint would be delivered - while also meeting its commitments to grow spending on several major services including health, defence, and overseas aid in line with or faster than real GDP.

15. Summary

- In summary, while GDP growth has disappointed since our last forecast, we expect a steeper fall in inflation and interest rates to support a stronger recovery in output this year and next.

- And while we now expect higher population growth over the medium-term, we also expect a smaller proportion of people to be active in the labour force.

- The net result is an underlying economic and fiscal forecast which looks very similar to the one we presented 3 months ago

- And that forecast requires some difficult choices if you want to stop debt from rising as a share of national income, which the Chancellor says he does

- In this Budget, he has delivered a second 2p cut to the headline rate of national insurance.

- But he has also confirmed a wider set of decisions which keep the overall tax take rising to its highest level in over 70 years.

- And, by leaving departmental expenditure plans largely unchanged in the face of higher inflation and population growth, he has also chosen no real growth in spending per person on public services over the next five years.

- These choices are just about enough to deliver the remaining 3 per cent of GDP reduction in borrowing needed to get debt falling in a world of relatively slow growth and much higher interest rates

- But the outlook remains highly uncertain.

- And the £9 billion of headroom the Chancellor has left himself against his main fiscal target is a tiny fraction of the risks surrounding this or any other five-year forecast.