November 2023 *Economic and fiscal outlook*

Transcript of Presentation by:

Richard Hughes, Chair, Office for Budget Responsibility

Office for Budget Responsibility

1. Opening slide

- Thanks, Steve.

- 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 Autumn Statement, imply for the public finances.

- As many have already noted, there have been significant changes to the economic and fiscal outlook since our last forecast back in March of this year.

- These are driven by three key economic developments in the interim.

2. GDP

- First, the revisions to historical GDP data and recent outturns suggest that the economy has proven to be more resilient to the twin shocks of the pandemic and the energy crisis than we believed back in March.

- As you can see from the gap between the yellow and blue lines on this chart, ONS revisions and outturn data since March suggest that

    - output recovered more fully from the pandemic in 2021 and weathered the 2022 energy crisis better than we expected

    - and the level of output currently stands 2 per cent above its pre-pandemic level, rather than remaining 1 per cent below as we thought in March

- However, from this higher starting point, we now expect the economy to grow more slowly over the forecast period at around 1.6 per cent a year – which is around ½ a percentage point less over the next four years than we forecast in March.

- This slower pace of output growth reflects a combination of:

    - more of the recovery from the economic shock of the pandemic now having happened in the past;

    - higher interest rates weighing on household and corporate finances;

    - and a revised assessment of the impact of demographic and technological changes on the effective supply of labour and capital in the economy.

- As you can see from the right of this chart, the net result of these changes leaves the level of real output in medium term only ½ a per cent higher than in our March forecast.

3. Inflation

- A second key development over the last 9 months is that inflation has turned out to be both more persistent and more domestically driven than we had anticipated

- While inflation has more than halved from its 40-year peak of 11 per cent at the end of last year, as you can see from this chart, it was still more than a percentage point higher in the third quarter of this year than we projected in March

- And we now expect inflation to be higher over the remainder of the forecast - taking a further year to reach the Bank of England's 2 per cent target and staying relatively close to that level in the years after that.

4. Composition of inflation

- We also expect the composition of inflation to be driven less by external and more by domestic factors.

- As you can see from the chart on the left, wholesale gas prices, which were the source of much of the increase in inflation in 2022, have fallen more quickly than we anticipated over the course of this year - and are expected to remain below our March forecast over the next 5 years

- By contrast, as you can see from the chart on the right, the nominal earnings of UK workers have grown more quickly in recent months than we anticipated and are forecast to be 4 per cent higher by 2027-28 than in our March forecast

- As you will see later in this presentation, this more persistent and more domestically driven inflation has important implications for the underlying fiscal outlook.

5. Interest rates

- A third key economic development since the Spring has been the further rise in UK and global interest rates.

- From their historic lows in the midst of the pandemic:

    - As you can see from the chart on the left, markets now expect Bank Rate to peak at just over 5 per cent, more than 1 percentage point higher than at the time of our March forecast

    - And as you can see in the chart on the right, yields on UK government debt are also over 1 percentage point higher across the curve, and have now also reached 5 per cent at some long-dated maturities for the first time since 2002

- For a government with stock of debt approaching £3 trillion pounds, this rise in the expected cost of servicing those liabilities also has significant fiscal implications

6. Changes in public borrowing since March

- Turning to what these 3 key changes in the economic outlook imply for the public finances relative to our March forecast:

    - Higher and more domestically fuelled inflation – and in particular the interplay between higher nominal earnings and frozen tax thresholds – raises nominal tax receipts and reduces underlying borrowing by around £60 billion in 2027-28

    - But higher inflation and earnings also push up the cost of inflation-linked welfare benefits and the triple-locked state pension by around £20 billion

    - And higher inflation and interest rates add £15 billion to the cost of serving the government's debts

    - But because the Chancellor leaves departmental and other spending largely unchanged in cash terms despite higher inflation…

    - …these changes in the economic outlook deliver a £27 billion net fiscal windfall by the fifth year of our forecast

    - And the Chancellor chose to spend virtually all of this windfall on the policy measures he announced in his Autumn Statement

    - So after accounting for the cost of these measures and their effect on the economy, this leaves total borrowing over the next five years almost completely unchanged relative to our March forecast

7. Autumn Statement policy package

- Looking in more detail at the Autumn Statement policy package, the Chancellor spends most of this £27 billion on two big tax cuts:

- First, a 2p cut in employee National Insurance Contributions and a 1p cut in the rate for the self-employed.

    - These deliver a £343 average increase in take-home pay to 29 million workers, at an average annual cost of £10 billion.

    - We also expect to it deliver a modest boost to work incentives, raising employment by 28,000 people.

    - But as it also raises the hours worked by those already in employment, delivering a total increase in hours worked across the economy of 94,000 in full-time equivalent terms.

- Second, the Chancellor's Autumn Statement makes up-front tax write-offs for business investment permanent, rather than allowing them to expire in March 2026.

    - This costs around £9 billion a year and boosts total investment by £14 billion over our five-year forecast period - and even more beyond that.

- He also announces a further package of welfare reforms aimed at boosting the labour supply - this time targeting those on health-related benefits.

    - And we estimate that they will help get around 50,000 more people into employment over the next 5 years.

8. Tax burden

- The two big cuts to personal and corporate taxes in this Autumn Statement reduce the overall tax burden by around ½ a per cent of GDP

- But the tax burden still rises in every year of the forecast to a post-war high of almost 38 per cent of GDP.

- This 4½ percentage point forecast rise in the post-pandemic tax burden is due to a combination of:

    - Increases in tax rates, like the rise in the headline rate of corporation tax from 19 to 25 percent;

    - And higher forecast inflation and frozen personal tax thresholds dragging more people into higher tax bands.

- Indeed, freezing virtually all allowances and thresholds in the personal tax system between 2022 and 2028:

    - raises an estimated £45 billion in additional revenue compared to indexing to inflation

    - and creates nearly 4 million more basic rate, 3 million more higher rate, and 400,000 more additional rate taxpayers over the next 5 years

9. Public services spending

- And it is worth dwelling for a moment on something the Chancellor didn't announce in his Autumn Statement – which is any major change to departmental spending plans despite significantly higher inflation.

- Departmental expenditure limits (or DELs) account for around 40 per cent of public spending and are allocated out between departments in periodic Spending Reviews

- The current Spending Review period comes to an end in 2024-25, and the next review is not scheduled until after the next General 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 for the period beyond March of 2025.

- Their decision in this Autumn Statement to add just £5 billion a year in cash terms to departmental budgets – despite significantly higher inflation - means that the real spending power of these budgets is eroded by around £19 billion relative to our March forecast, as you can see from the chart on the right.

- The eagle eyed amongst you will recognise that is roughly equal to the amount that the Chancellor spent on the two big tax cuts in this fiscal event.

- Had he sought to preserve the real spending power of public services in the face of higher inflation over the next five years, that would have left him relatively little to spend on other measures in this fiscal event.

10. Government borrowing

- The Chancellor's decision to spend virtually all of the fiscal improvement in this forecast means that the overall path of borrowing as a share of GDP is largely unchanged relative to March

- From a post-war high of 15 per cent of GDP during the pandemic, borrowing falls to a 4½ per cent of GDP this year and then steadily over the next 5 years 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

11. Government debt (ex Bank of England)

- An 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 peaks at 93.2 per cent of GDP in 2026-27 and then falls in the last two years of the forecast to 92.8 per cent of GDP

- He even has slightly more headroom against his debt falling target at £13 billion compared to the £6½ billion of headroom he had back in March

- But all of this improvement comes from the rolling nature of the rule giving him a further year to meet it, rather than from any substantive improvement in the fiscal position

- Had the target continued to apply in 2027-28, rather than 2028-29, he would have only just scraped by with £1.6 billion of headroom

12. Headroom against fiscal rules

- But even £13 billion pounds remains a modest amount compared to margins set aside by previous Chancellors against their fiscal rules - which averaged just under £30 billion since 2010.

- And it's important to bear in mind that very few of these rules were ever actually met.

13. Risks to the outlook

- And one needs to judge the adequacy of that modest amount of fiscal headroom against the array of potential risks to the fiscal outlook

- On the economy side, it would only take…

    - interest rates to be another ½ a percentage point higher

    - annual GDP growth to be 0.1 percentage points lower

    - or health-related inactivity to continue rising in line with recent trends

- …to wipe out of this headroom entirely.

- On the fiscal side, key risks come from the array of stated government policies whose implementation is subject to question

    - The most doubtful of these is the stated intention of delivering an RPI-plus-5p indexation of fuel duty next year and RPI indexation after that. Freezing fuel duty at is current rate instead - as every Government has done since 2011 - would knock £6 billion of the Chancellor's headroom

    - Sticking to the Government's stated Departmental spending plans has become more difficult in the face of more persistent inflation and new long-term commitments such as the NHS workforce plan. Just preserving the real spending power that Departments had in March would require an additional £19 billion by 2027-28. And this is 1/3rd less than the £30 billion that Chancellors have added to spending totals in the run-up the last two Spending Reviews.

- Finally, our fiscal forecasts assume that all of the main personal tax allowances and thresholds remain frozen for the next 5 years and the tax burden continues rising to a post-war high. Were the tax take to be held at its current level, this would cost an additional £45 billion in 2028-29.

14. Summary

- In summary, the economy has proven to be more resilient to the shocks of the pandemic and the energy crisis, but we now expect it to grow more slowly over the next 5 years

- We also expect inflation to be more persistent and domestically-fuelled, which means that interest rates are expected to remain higher to bring price rises under control

- Higher inflation has pushed up tax receipts but also welfare benefits while higher interest rates have also pushed up the cost of servicing the government's debts

- But thanks to his decision to leave departmental spending plans largely unchanged in cash terms, our latest forecast gives the Chancellor a net fiscal windfall of £27 billion in five years' time

- He spends virtually all of this on two big tax personal and business tax cuts and a smaller package of welfare reforms which provide a modest boost to the supply potential of the economy

- But thanks to the deadline for his debt target rolling onto another year, he actually increases his headroom against that target from £6½ billion to £13 billion.