1 March 2015 Economic and fiscal outlook – Overview

1.1 In the relatively short period since our last forecast in December, there have been a number of developments affecting prospects for the UK economy and public finances both positively and negatively. These include a further big fall in oil prices, an unexpectedly large increase in net inward migration, further falls in market interest rates, another disappointing quarter for productivity growth, downward revisions to estimates of economic growth in 2014 and downward revisions to the outlook for the world economy. These have had a relatively modest net effect on our forecasts for real GDP growth and the public finances.

1.2 The Coalition Government's policy decisions in this Budget are not expected to have a material impact on the economy. For the public finances, they ensure that net borrowing is lower every year to 2018-19 than in our last forecast, that the new fiscal mandate is met with room to spare in 2017-18, that public spending as a share of GDP no longer falls to a post-war low in 2019-20, and that the debt-to-GDP ratio falls a year earlier in 2015-16.

1.3 The Government has achieved this by tightening the assumed squeeze on total spending through to 2018-19, dropping the cut in spending as a share of GDP it had pencilled in for 2019-20 and announcing the sale of an additional £20 billion in financial assets next year. This leaves a rollercoaster profile for implied public services spending through the next Parliament: a much sharper squeeze on real spending in 2016-17 and 2017-18 than anything seen over the past five years followed by the biggest increase in real spending for a decade in 2019-20. This profile is driven by a medium-term fiscal assumption that the Treasury has confirmed "*represents the Government's agreed position for Budget 2015*" and that was "*discussed by the Quad and agreed by both parties in the Coalition.*" But both parties have said that they would pursue different policies if they were to govern alone.

1.4 Real GDP grew by 0.5 per cent in the final quarter of 2014, slightly weaker than we expected in December. Employment growth was close to forecast, but hours worked were higher than expected. This meant that productivity fell on an hourly basis in the final quarter, falling short of our forecast once again. Unemployment has continued to fall as we expected, reaching 5.7 per cent of the labour force by the end of 2014, while sharply lower oil prices pushed inflation close to zero in January.

1.5 In 2015 and 2016, we expect lower inflation to boost real incomes and consumer spending, leading us to revise up our forecasts for real GDP growth to 2.5 and 2.3 per cent respectively. The upward revision is tempered by the weaker outlook for UK export market growth and the effect of lower oil prices on production and investment in the North Sea.

1.6 Slightly stronger growth means that we expect the remaining spare capacity in the economy to be used up by late 2017, around a year and a half earlier than we forecast in December. Thereafter, we assume that the economy will grow at its sustainable trend rate, which we have revised up slightly to reflect the stronger population and employment growth associated with higher rates of net inward migration.

1.7 We expect CPI inflation to return to the Government's 2 per cent target relatively slowly, partly due to the lagged effects of sterling's recent appreciation. The near-term fall in inflation is expected to boost real wage growth to 1.4 per cent this year – the first year of material growth since the crisis. Real wages rise by 1¾ per cent a year on average in the medium term. As ever, prospects for GDP and real wage growth rely heavily on the timing and strength of the long-awaited return to sustained productivity growth.

1.8 We estimate that public sector net borrowing has fallen to £90.2 billion or 5.0 per cent of GDP this year – down 41 per cent in cash terms and 51 per cent as a share of GDP relative to the post-crisis peak in 2009-10. Looking further ahead, on the basis of the medium-term spending policy assumption provided to us by the Government, we expect borrowing to fall in each year and to reach a small surplus in 2018-19. The Government no longer assumes that it will cut public spending as a share of GDP in 2019-20, reducing the projected surplus in that year to £7.0 billion from £23.1 billion in our December forecast.

1.9 Relative to our December forecast, we have revised public sector net borrowing (PSNB) down by £1.3 billion a year on average between 2015-16 and 2018-19. This reflects:

- a downward revision to receipts, with the largest downgrades for North Sea revenues (due to lower oil prices and production), stamp duty receipts (due to lower property transactions), excise duties (due to lower inflation-related uprating) and interest and dividend receipts (due to lower interest rates and the interest and dividends foregone due to the further asset sales announced in the Budget). Those downward revisions are partly offset by upward revisions to income tax receipts (due to lower inflation-related uprating of thresholds and stronger employment growth from migration);

- a downward revision to annually managed expenditure, including sharply lower debt interest costs (due to lower RPI inflation and interest rates) and lower welfare spending (due to lower uprating in 2016-17); and

- a new Government policy assumption that reduces total public spending in each year from 2016-17 to 2018-19. But this reduction is smaller than the downward revision to annually managed expenditure, which means less of a squeeze on implied day-to-day spending on public services and administration than in December.

1.10 The projected budget surplus in 2019-20 is £16.1 billion lower than in our December forecast. The Government now assumes that total spending will grow in line with nominal GDP rather than whole economy inflation in that year. Combined with a lower forecast for annually managed expenditure, that means that implied public services spending in 2019-20 has been revised up by £28.5 billion (1.3 per cent of GDP) since December.

1.11 The Budget measures in the Treasury's table of policy decisions are neutral for borrowing on average over the forecast period with 'giveaways' offsetting 'takeaways'. They raise or lower borrowing by less than £1 billion in every year. The biggest takeaway is an increase in the bank levy (raising £4.4 billion over five years), with a variety of other measures raising smaller amounts with often significant uncertainty around their costing. These are balanced by three main giveaways – further increases in the income tax personal allowance (£5.7 billion over five years), tax measures benefiting savers (£3.0 billion) and a subsidy for first-time buyers (£2.2 billion, the take-up of which is also subject to significant uncertainty).

1.12 In contrast to the relatively small net effect of the scorecard measures, the Government has also announced significant asset sales over the coming year. These are sufficiently large for our forecast for public sector net debt to fall as a share of GDP in 2015-16, a year earlier than in our December forecast. The two largest sales relate to NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution (which we assume will raise around £11 billion in 2015-16) and further sales of Lloyds Banking Group shares (which we assume will raise around £9 billion in 2015-16). However, the decision to loosen the squeeze on spending in 2019-20 means that net debt will continue to rise in *cash* terms in that year rather than beginning to fall as it did in our December forecast.

1.13 The Coalition updated the *Charter for Budget Responsibility* in December,[1] setting out new medium-term fiscal targets. The fiscal mandate – to borrow only to pay for investment, adjusting for the state of the economy – now applies in the third year of the rolling five-year forecast period, rather than the final year. The supplementary target – for public sector net debt to fall as a share of GDP– now applies in 2016-17, rather than 2015-16.

1.14 On our central forecast, the Government is on track to meet its new fiscal mandate with £16.8 billion to spare. This implies a 65 per cent probability of success given the accuracy of past forecasts. Achieving the mandate with this margin depends heavily on cuts in public spending – particularly on public services and administration – implied by the first two years of the Government's medium-term spending policy assumption. The previous fiscal mandate would have been met with £38.8 billion to spare in 2019-20. Public sector net debt is forecast to peak in 2014-15 and to fall by 0.2 per cent of GDP in 2015-16 and a further 0.5 per cent of GDP in 2016-17, thereby meeting the new supplementary target. The previous target would also have been met – the first time we have forecast debt falling as a share of GDP in 2015-16 since March 2012.

[1] HM Treasury: *Charter for Budget Responsibility: Autumn Statement 2014 update.*