October 2024 *Economic and fiscal outlook*

Transcript of Presentation by:

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Office for **Budget Responsibility**

1. The Budget in context

- Thanks, Laura. Good afternoon, everyone.

- Against a largely unchanged economic and fiscal backdrop since our last forecast in March, this Budget delivers one of the largest increases in spending, tax, and borrowing of any single fiscal event in history.

- In the 14 years since the OBR was established, it was only:

  - George Osborne's first Budget after the 2010 General Election;

  - And Rishi Sunak's mid-pandemic economic update in July 2020;

- That rival this Budget in terms of the overall change in the stance of fiscal policy.

- I'll first take you through how the Budget's spending and tax policies reshape the public finances over the next five years.

- I'll then talk about their impact on the demand and supply sides of the economy.

- And I'll conclude with what this all means for the Government's prospects of meeting its new fiscal rules and the risks around them.

2. Public spending as a share of GDP

- Let me start with public spending, which is the biggest moving part in this Budget.

- Relative to the plans of the previous Government, this Chancellor has added around £70 billion per year to public spending over the next five years.

- As a result, the size of the state settles at 44 per cent of GDP by the end of the decade.

- This is around 5 percentage points higher than it was before the pandemic and around 2 percentage points higher than the level implied by the previous Government's spending plans.

- The increase in spending reflects both:

  - the funding of some undisclosed spending pressures which existed at time of the March Budget and have subsequently come to light;

  - and the cost of new policy decisions taken by this Government.

3. Current and capital spending

- Looking at the composition of this increase in spending:

  - about two-thirds goes on current spending, which raises its annual real growth over the forecast period from 1 to 1.5 per cent per year;

  - the other third goes on capital spending and keeps public investment broadly flat at around 2½ per cent of GDP over the next five years, rather than dropping to the 1.7 per cent assumed in the previous Government's plans.

- Some of the increase in spending in the early years includes additional payments for the infected blood and Post Office Horizon compensation schemes.

- But most of the increase over the five years is added to the departmental expenditure plans set by the previous Government with:

  - departmental current spending £23 billion higher in this year and £49 billion higher by 2028-29;

  - and departmental capital spending largely unchanged this year but £24 billion higher by 2028-29.

4. Departmental spending in 2024-25 and 2025-26

- The Budget also provides some more detail about the breakdown of this spending between departments after:

  - topping up day-to-day departmental spending in *this* financial year by £23 billion;

- and setting new departmental expenditure limits, or DELs, for 2025-26.

- As you can see from this chart of real growth in resource DEL budgets over the next two years:

  - most major departments now see significant real growth in their budgets this year;

  - but growth slows significantly going into next year, with growth in NHS spending falling from 4.7 per cent this year to 3.3 per cent next year and defence spending slowing from over 3 per cent this year to almost no real growth next year;

  - and some departments, including the Home Office, experience significant real cuts in spending in both years.

5. Departmental spending from 2026-27 onwards

- We will need to wait until the full, multi-year Spending Review next year to understand what the Budget means for the composition of departmental spending over the remainder of the Parliament.

- In the meantime, this chart compares:

  - the growth in the overall resource DEL envelope that the Government has set for this exercise – which rises by around 1.3 per cent per year in real terms from 2026-27 onwards;

  - with the additional expenditure required to meet the long-term spending commitments that this Government has already made in the areas like heath, defence, and overseas aid.

- Subtracting these existing commitments from the overall envelope leaves real spending on all other departments falling by 1.1 per cent a year in real terms in the final four years of our forecast.

- And, this assumes the Government makes no progress over the next five years toward its aspirations of raising defence spending to 2.5 per cent of GDP or returning overseas aid to 0.7 per cent.

- Meeting these aspirations would mean unprotected departments see their budgets fall by 3.5 per cent in real terms in the years beyond 2025-26.

6. Tax policy measures

- Turning to how this additional spending is funded, just over half is paid for by an increase in taxes, which raises around £36 billion a year in extra revenue over the next five years:

    - Most of that increase in taxes comes from an increase in employer National Insurance contributions, which raises about £800 a year per employee and £24 billion a year in total.

    - Another £6 billion comes from increases in capital gains tax, inheritance tax, and other taxes on assets.

    - Another £4 billion comes from various HMRC compliance measures.

    - And the remaining £2 billion comes from a range of smaller measures, including the levying of VAT on private schools.

7. Taxes as a share of GDP

- Together these measures increase the overall tax take to 38 per cent of GDP by the end of the decade, its highest level on record and 5 percentage points higher than before the pandemic.

- While the NICs rise is collected from the employer, we assume that around three-quarters of the cost is eventually passed on to employees through lower real wages.

- With employers paying the remaining quarter via lower profits.

8. Change in government borrowing since March

- The remaining half of the increase in spending is funded through higher government borrowing in each year of the forecast.

- This chart decomposes the change in the level of borrowing compared to our March forecast into:

    - The relatively small changes to our pre-measures forecast, which are shown in green. These add £21 billion to borrowing this year, mostly due to higher debt interest costs, and reduce borrowing by small amounts in the years thereafter.

- The Chancellor's decision in this Budget to raise the level of current and capital spending, shown in shades of blue, adds £47 and £25 billion respectively in the final year of the forecast.

- The tax rises in this Budget, shown in yellow, raise about £42 billion by 2029-30.

- Taken together, these Budget measures, and their indirect effects on the economy, leave the level of borrowing, shown in the black diamonds, around £28 billion a year higher over the next five years.

9. Borrowing as a share of GDP

- Turning to the implications of these changes for the path of total government borrowing as a share of the economy.

- The net fiscal loosening in this Budget slows the pace of fiscal consolidation relative to the previous Government's plans.

- Borrowing is now flat at 4.5 per cent of GDP this year and then falls back gradually to 2.1 per cent of GDP by the final year of the forecast.

- Compared with our March forecast, borrowing is on average around 1 per cent of GDP higher in every year.

- The Budget also shifts the composition of the fiscal consolidation:

    - away from cutting spending as a share of GDP, which accounted for two-thirds of the previous Government's deficit-reduction plan;

    - and toward increases in taxes, which account for two-thirds of this Government's plans for reducing the deficit over the next five years.

10. Debt as a share of GDP

- The additional £180 billion in borrowing over the forecast means that net debt ends up around 3 per cent of GDP higher than in March and stays broadly flat as a share of the economy in the coming years.

- Net debt excluding the Bank of England, the previous Government's fiscal target, now rises as a share of GDP in every year, from 89 per cent last year to 96 per cent by the end of the decade.

- The interest costs on this debt are also higher and are now forecast to exceed £100 billion in each of the next five years.

11. Fiscal policy impact on GDP

- Turning to what impact this fiscal loosening has on our economic forecast, this chart splits the impact of the fiscal policy changes in this Budget into:

    - their impacts on the demand side of the economy, shown in blue;

    - and their impacts on the supply side of the economy, shown in other colours.

- As you can see from the blue bars, the net fiscal loosening provides a temporary boost to demand, which raises the level of GDP by slightly over ½ a per cent at its peak impact next year.

- The impact then tapers to zero as monetary policy and associated changes in wages and prices are assumed to crowd out some private spending and bring GDP back into line with potential output by the end of our forecast.

- The policies in this Budget also have lasting impacts, both positive and negative, on the supply side of the economy over our five-year forecast period:

    - Starting from the green bars, the increase in public investment in this Budget boosts the level of potential output by a bit more than 0.1 per cent.

    - Weighing against this is the increase in employer NICs, shown in yellow, which we assume reduces employment by around 50,000 and potential output by around 0.1 per cent.

    - And, finally, the increase in the public sector's use of resources, in an economy close to its potential level of output, leads to the crowding out of some business investment, shown in the purple bars, reducing output by around 0.2 per cent.

- As you can see from the black diamonds on this chart, the net effect of all of these changes is to leave the level of GDP higher in the near term but broadly unchanged in the medium term.

- However, were the Government to sustain the higher level of investment assumed in this forecast in the period beyond our five-year horizon, then the net effect of

government policy would turn positive in the early 2030s as the lagged impact of a larger public capital stock feeds through to potential output.

12. GDP growth and output gap

- Looking at the path of GDP relative to our March forecast:
    - We expect the economy to grow faster in the near term, at 1.1 per cent this year and 2 per cent in 2025, supported by stronger outturn data and the net fiscal stimulus in this Budget which, as you can see from the chart on the right, pushes GDP about ½ a per cent above its potential level.
    - But growth falls back in the final three years of the forecast to around 1½ per cent, slightly below its estimated potential rate, as the positive output gap closes.

13. Inflation

- Inflation is also higher in the near term than we forecast in March, rising to a quarterly peak of 2.7 per cent in the middle of next year.
- Higher inflation reflects a combination of:
    - more persistent growth in nominal earnings;
    - the inflationary impact of the fiscal loosening;
    - the rise in employer costs from the NICs measure being passed onto prices;
    - and the net impact of several other Budget tax changes on the prices of specific consumer goods and services.
- Inflation then gradually returns back to its 2 per cent target by the forecast horizon as these effects fade and the positive output gap closes.

14. Interest rates

- Bank Rate expectations are also about ½ a percentage point higher in the near term and a ¼ percentage point higher in the medium term than in our March forecast. This reflects:

- higher market expectations for Bank Rate at the time we closed our pre-measures forecast in September;

- and the fiscal loosening in this Budget, not all of which would have been anticipated at that time.

15. The Government's new fiscal rules

- Let me conclude with what this forecast means for the Government's new fiscal rules and performance against them.

- Alongside this Budget, the Chancellor has announced two new fiscal rules:

  - The first one is to for the current budget, or the difference between day-to-day spending and revenue, to be in surplus.

  - The second is to get its net financial liabilities, or the difference between its financial liabilities and its financial assets, falling as a share of GDP.

- Both targets currently fall due in 2029-30.

- The first of these rules is familiar to seasoned fiscal policy watchers and has featured in 6 of the 10 fiscal frameworks that the UK has had since 1997.

- The second is an innovation in the UK and a relative novelty internationally.

- As we describe in an annex to the *EFO*, public sector net financial liabilities, known as PSNFL, includes a wider range of liabilities and assets beyond just the debt and liquid financial assets captured in the previous net debt measure:

  - the additional financial liabilities are primarily those of *funded* public pension schemes;

  - and the *financial* assets include loans and equities issued or purchased by public bodies.

- Targeting PSNFL enables the Government to borrow to invest in these *financial* instruments without changing the level or trajectory of the measure – something which was not true of the old debt target which just recognised the borrowing.

- However, it is important to stress that *physical* assets remain outside the measure, meaning that borrowing to invest directly in things like roads, railways, schools, and hospitals would still push the level of PSNFL upward.

16. Performance against the fiscal rules

- As you can see from the chart on the left, the Budget leaves the Government on course to meet its first fiscal rule two years early in 2027-28.

- This leaves the Chancellor £10 billion worth of headroom against her target to balance the current budget by 2029-30.

- As you can see from the chart on the right, the Government is also on course to get net financial liabilities falling two years early.

- This leaves the Chancellor with £16 billion of headroom against this measure in the target year.

- However, had the Chancellor retained her predecessor's main fiscal rule of getting debt excluding the Bank of England falling in the fifth year of the forecast, she would have missed this by around £6 billion.

17. Fiscal headroom in historic context

- Even the £10 billion in headroom the Chancellor retains against her new fiscal rules is small by historical standards.

- As this chart shows, it's around a third of the £28 billion average headroom that previous Chancellors held against their rules.

- And she has chosen to make things harder for herself by allowing the target to roll toward her for the next two years until it becomes the third year of the forecast.

18. Risks to the fiscal outlook

- But against any measure and over any horizon, the level of headroom the Chancellor has against her fiscal targets remains a small fraction of the risks around the economic and fiscal outlook.

- This Budget crystalises a number of significant fiscal policy risks which we have highlighted over successive forecasts including:

  - By making explicit provision for compensating the victims of the infected blood and Post Office Horizon inquiries at a total cost of £14 billion over the forecast.

  - This Budget also ends the practice of pre-committing a large share of the Treasury's resource DEL reserve well before the start of the financial year.

  - And it fills in some of the details around the composition of departmental spending next year and adds significant sums to the envelope for the forthcoming Spending Review exercise covering the remainder of the Parliament.

- But against this, the Chancellor's Budget also:

  - Continues to incorporate a number of policy assumptions that few of her predecessors implemented, including indexation of fuel duty which, if not delivered, would reduce her headroom by nearly £5 billion.

  - It also makes no evident progress toward meeting the Government's stated ambitions of raising defence spending to 2.5 per cent of GDP or overseas aid to 0.7 per cent of GNI, which would cost a combined £24 billion.

  - This sets the Government up for a challenging Spending Review next year, given the overall envelope for departmental spending is set to *fall* as a share of GDP from 2026-27 onwards.

- And the Chancellor's new fiscal rule targeting the financial balance sheet creates strong incentives to move public investment into financial vehicles such as loans and equity injections which, if not carefully monitored, could create risks in future.

- And all of these fiscal policy risks are a fraction of the risks to the economic outlook.

- In the final year of our forecast, the headroom against the Government's fiscal targets would be wiped out by:

  - a 0.3 percentage point rise in interest rates;

  - a 1.1 percentage point rise in RPI inflation;

  - or just 0.7 percentage points less economic growth in the final year of our forecast.

19. Summary

- In summary, the Chancellor's first budget delivers large, sustained increases in spending, tax, and borrowing.

- It increases spending by 2 per cent of GDP by the end of the decade in an attempt to prevent real cuts in some departments' current budgets and stop public investment from falling as a share of GDP.

- Just over half of this is funded by a 1 per cent of GDP increase in taxes on employment and assets and from a raft of compliance measures.

- The other half is funded by increasing borrowing by around 1 per cent of GDP in each of the next five years, which slows the pace of fiscal consolidation relative to the previous Government's plans.

- The net fiscal loosening delivers a temporary boost to GDP, with growth reaching 2 per cent in 2025, but leaves the level of output broadly unchanged at our five-year forecast horizon.

- To make room for this extra borrowing, the Government has announced new fiscal rules, but maintained the practice of setting aside very small margins against them.

- And potential claims on those margins are numerous, with:

  - interest rates on the Government's large and rising debt stock remaining highly volatile;

  - the steady rise in the tax burden over the next five years relying on a range of uncertain tax changes;

  - and a multi-year departmental spending review not set to conclude until sometime next year.