Office for
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Economic and fiscal outlook – November 2015

Government eases public spending squeeze and reverses tax credit cuts, but stronger revenues and lower debt interest boost budget balance

The Government has taken advantage of an improvement in the outlook for tax receipts and debt interest to further loosen the impending squeeze on public services spending, to increase capital spending and to reverse the main tax credit cuts it announced in July, while still delivering a modestly stronger budget balance in most years. As the boost to receipts begins to ebb, the Government increases spending by less and relies more on tax increases to maintain the bottom line improvement.

Today's Spending Review further reduces the squeeze on public services planned for this Parliament, implying real cuts more than a third smaller on average than those delivered over the last Parliament and around two thirds smaller than those pencilled in by the Coalition. But the remaining cuts vary significantly by department.

Together with other measures in the Autumn Statement, the Government has made a net fiscal giveaway of £6.2 billion next year, more than half of which is the cost of reversing the tax credit cut. This outweighs an improvement in the underlying forecast in that year and thereby pushes up the deficit. The giveaway is similar in 2017-18, before declining steadily to £2.2 billion in 2019-20, by which point an £8.0 billion increase in total departmental spending is largely offset by a £7.2 billion net tax increase (mostly the new apprenticeship levy and larger rises in council tax). These giveaways are smaller than the improvements in the underlying forecast in these three years, delivering smaller deficits and then a bigger surplus than in July.

The improvement in the underlying forecast since July (excluding the impact of the decision by the Office for National Statistics (ONS) to reclassify housing associations[1] in England to the public sector) is largely due to an improvement in revenues. This reflects higher expected receipts from income taxes, corporation tax and VAT – some of which result from modelling changes to our NICs and VAT deductions forecasts. But the improvement diminishes towards the end of the forecast as lower growth in wages and salaries weighs on income tax receipts in particular. Spending on debt interest is also lower in all years, reflecting a further fall in market interest rates.

[1] Strictly speaking, it is 'private registered providers' of social housing in England that are being reclassified. These include most housing associations plus some for-profit housing bodies. We refer to housing associations for simplicity.

The Autumn Statement is expected to have a small impact on the economy, boosting growth a little in the short term (because the pace of fiscal tightening has been eased), but weighing on wage growth in the medium term (as employers are assumed to pass most of the cost of the apprenticeship levy onto their employees).

The measures ensure that public sector net debt continues to fall in every year of the forecast as a share of GDP and that the budget reaches a surplus of £10.1 billion in 2019-20 – thereby meeting the Government's fiscal targets. But the Government is set to breach its self-imposed cap on parts of welfare spending, thanks to the reversal of the main July tax credit cuts and slow progress with disability benefit reform.

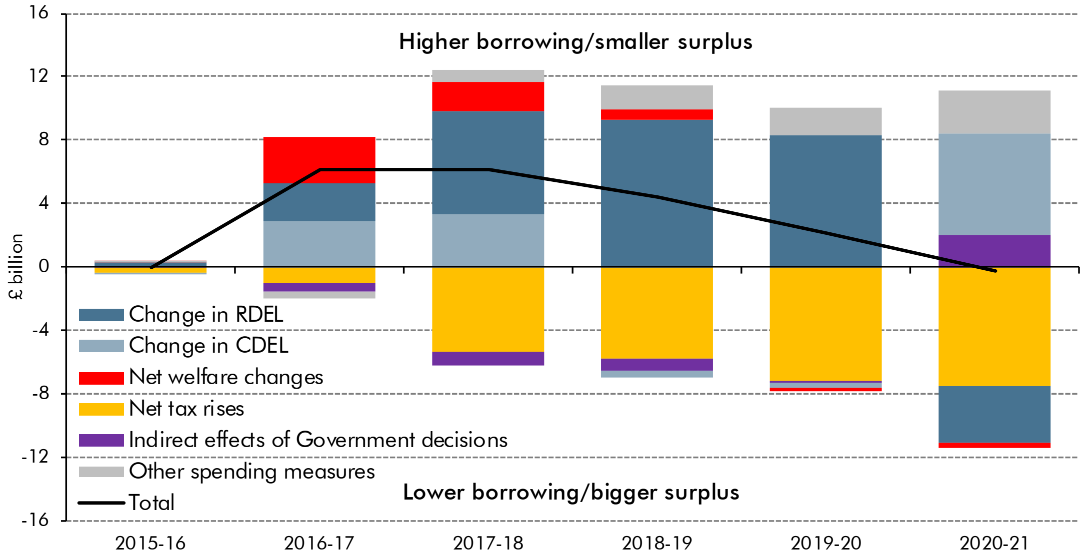
Over the full five years of our forecast, the Government's decisions add a cumulative £18.7 billion to public sector net borrowing (significantly less than the £27.0 billion improvement in the underlying forecast). The 'giveaways' include:

- higher spending within **Resource Departmental Expenditure Limits (RDEL)** – which cover day-to-day central government spending on public services, grants and administration. Taking into account the usual tendency for departments to underspend these limits, we estimate that the Spending Review implies additional spending of £22.9 billion over the five years, relative to the numbers pencilled in in July. RDEL spending is set to fall by an average of 1.1 per cent a year in real terms over this Parliament, compared to 1.6 per cent a year over the last;
- higher spending within **Capital Departmental Expenditure Limits (CDEL)** – which cover central government investment and capital grants. Again taking likely underspending into account, these imply extra spending of £11.9 billion over the five years. The increases average £3.1 billion a year in the next two years, followed by small cuts in the subsequent two years and then a sudden jump of £6.4 billion in 2020-21. The leap in 2020-21 keeps total public spending in that year remains above its late 1990s lows as a share of GDP;
- a £5.0 billion increase in **welfare spending**. Reversing the main tax credit cuts announced in July will cost £9.4 billion over the five years of the forecast, with the annual cost dropping from £3.4 billion in 2016-17 to £0.5 billion in 2020-21. By that latter year, the cost is more than offset by cuts to other benefits, which rise from £0.4 billion in 2016-17 to £0.8 billion in 2020-21;
- **gross tax cuts** that total just £1.7 billion, the largest of which is the latest one-year extension to the doubling of small business rates relief; and
- **other measures that increase spending**, mainly the local government spending that will be financed by making it easier for local authorities to raise council tax.

These giveaways are partly offset over the five-year period by:

- **gross tax increases** that total £28.5 billion. These include the new apprenticeship levy (£11.6 billion), higher council tax (£6.2 billion), and the introduction of higher rates of stamp duty land tax for second homes and buy-to-let purchases (£3.8 billion); and
- small **indirect effects** from the Government's decisions.

Chart 1: The effect of Government decisions on public sector net borrowing



Source: OBR

As we warned might happen in our last *EFO*, the ONS has announced that housing associations will be reclassified from the private to the public sector, with effect from 2008. When implemented, we estimate that this will increase borrowing by £1.4 to £4.6 billion a year and add 3.1 to 3.4 per cent of GDP to public sector net debt.

Compared to our July forecast, adjusted for that classification change, we have revised net borrowing this year down by £0.6 billion to £73.5 billion, as higher-than-expected receipts outweigh higher-than-expected spending on disability benefits and by local authorities. We expect the deficit to shrink faster later in the year.

Borrowing then falls to just under £50 billion in 2016-17 and to less than £5 billion by 2018-19. In 2019-20 the Government is on course for a surplus of £10 billion, matching the headline figure at the July Budget despite a £1½ billion hit from the housing association reclassification. The Government then aims for a surplus of just under £15 billion in 2020-21, slightly larger than in July.

Despite the upward revision to public sector net debt that results from the reclassification of housing associations, we still expect debt to have peaked as a share of GDP in 2014-15 and to fall this year and across the forecast period (although it continues to rise in cash terms). As in July, asset sales make the difference between debt rising and falling as a share of GDP in 2015-16, with £30 billion expected in the financial year as a whole and £24 billion realised to date.

In terms of our economy forecast, since July:

- our GDP growth forecast is unchanged in 2015 at 2.4 per cent. We have then revised growth up a little in 2016 and 2017, reflecting both higher population growth (driven by higher net migration) and the Government's decision to slow the pace of fiscal tightening. Growth is slightly lower in the final year of the forecast, when demographic trends nudge the employment rate lower;

- our estimate of the current output gap – the amount of spare capacity in the economy – is unchanged and we continue to expect it to narrow slowly and to close during 2018. Our inflation forecast is also little changed; and
- we continue to expect employment growth to slow as productivity growth picks up. We have adjusted our earnings growth forecast to take account of the additional costs to employers from auto-enrolment into pensions saving and the newly announced apprenticeship levy.

Notes

1. The Office for Budget Responsibility is the UK's independent fiscal watchdog – responsible for producing forecasts for the economy and the public finances, assessing progress against the Government's fiscal targets, and reporting on long-term fiscal sustainability.
2. All of the documents published by the OBR today are available on our website at: http://budgetresponsibility.org.uk/
3. The OBR will release supplementary information on the *Economic and fiscal outlook* at 11am on 4 December in response to requests received by midday on 2 December. We will release a list of any information to be published at 11am on 3 December.
4. Questions about the *Economic and fiscal outlook* should be sent to OBRpress@obr.gsi.gov.uk.
5. The OBR's release policy can be found on our website at: http://budgetresponsibility.org.uk/transparency/disclosures/