March 2017 *Economic and Fiscal Outlook* Briefing

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Good afternoon ladies and gentlemen.

My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to this briefing on our latest *Economic and Fiscal Outlook*.

I am going to take you through some of the highlights and then we will be very happy to answer your questions. The slides and my speaking notes will be available on our website after we finish.

[SLIDE] Let me start with the usual background.

The EFO contains our latest five-year forecasts for the economy and the public finances and an assessment of the Government's progress against its fiscal and welfare spending targets.

The views expressed are the responsibility of the independent Budget Responsibility Committee, to which I am delighted to welcome Professor Sir Charlie Bean for his first EFO. As always, we have relied on the hard work of the OBR's staff and officials in other departments and agencies.

As usual, the forecast went through a number of iterations to reflect new judgements, new data and proposed policy measures. We provided the Chancellor with our final pre-scorecard forecast on February 24th.

We have come under no pressure to change any of our conclusions and we have been provided with all the information we requested.

[SLIDE] So now let me turn to a brief overview of the report.

The changes to our economy forecast are relatively modest. The ONS's initial estimate of real GDP growth for 2016 was slightly weaker than we anticipated in November, but with momentum building through the year rather than slowing. The recent strength largely reflects consumer spending, which grew much more strongly than incomes through last year. But we expect GDP growth to slow through this year as higher inflation squeezes household budgets and as the saving ratio stabilises. The strong start to the year should be sufficient to deliver 2 per cent growth for 2017 as a whole, with small downward revisions in later years as the economy will have less spare capacity to use up. Cumulative growth over the whole forecast is little changed.

Turning to the public finances, public sector net borrowing is expected to be a lot lower this year than we thought in November, but revisions to later years are much smaller. The £16.4 billion downward revision this year is so big that the deficit actually rises between 2016-17 and 2017-18, taking it back roughly to the level we forecast in November. The deficit then remains close to the trajectory we set out in the autumn.

This pattern reflects a variety of one-off factors and timing effects that flatter this year's numbers at the expense of next year's. These include changes to the timing of EU contribution requests, evidence of greater income shifting to beat higher dividend taxation, more under-spending by government departments this year, and a £3 billion fiscal giveaway next year from the Budget measures. In a familiar pattern, the Budget starts with a small fiscal giveaway in the early years of the forecast, before moving to a small promised takeaway towards the end.

All this leaves the Government on course to achieve its target for structural borrowing in 2020-21 with fractionally less room for manoeuvre than it had in November. It is also on course to achieve its targets for public sector net debt and welfare spending, with slightly more room for manoeuvre. In contrast, the Government is not yet on course to achieve its 'fiscal objective' to balance the budget as early as possible in the next Parliament – the deficit is still 0.7 per cent of GDP in 2021-22, with spending pressures from ageing and healthcare costs likely to push it up in the absence of offsetting policy decisions.

So let me turn to our forecast for the economy in a little more detail.

[SLIDE] Back in November, the outturn data available from the ONS suggested that the economy had slowed between the second and third quarters of 2016 and we assumed that it would continue to slow in the fourth quarter, giving 2 per cent growth for the year as a whole.

[SLIDE] Since November, the ONS has revised growth down in the first two quarters of last year, but up in the third. And it came in slightly stronger still in the fourth quarter. This means that growth over the year as a whole was weaker than we thought in November at 1.8 per cent, but it ended the year with greater momentum.

[SLIDE] The recent strength of the economy is largely down to the consumer. Real consumer spending grew by 3.2 per cent in the year to the fourth quarter, while we estimate that incomes were flat.

[SLIDE] This implies a sharp fall in household saving. Excluding pensions saving (some of which is imputed in the official measure), the saving ratio fell from 2.8 per cent in the final quarter of 2015 to 0.6 per cent in the third quarter of 2016 – and we think it turned negative in the fourth quarter for the first time since mid-2008. This pace of decline cannot continue indefinitely and we don't assume that it does.

[SLIDE] Looking ahead, we expect GDP growth to remain firm at 0.6 per cent in the first quarter of this year, although the latest PMI data – published after we closed the forecast – might point to a lower number. We then expect growth to slow to 0.3 per cent a quarter as higher inflation – largely the result of the fall in the pound over the past year – squeezes real incomes and real consumer spending, and as the saving ratio stops falling. The growth rate then picks up through 2018 as business investment begins to recover and as the squeeze from higher inflation loosens. Net trade boosts the economy in 2017 and 2018 – thanks to the lower pound and the slowdown in the domestic economy – before becoming a drag on GDP in later years.

All this leaves calendar year growth in real GDP noticeably higher this year than in November at 2 per cent, but correspondingly lower in subsequent years as the economy will have less spare capacity to use up. Cumulative growth over the forecast as a whole is fractionally weaker than in November, because we think that the economy is probably already running slightly above potential.

[SLIDE] Turning this into pictures, this slide shows the pattern of quarterly growth in our forecast last March, [SLIDE] then in November, [SLIDE] and now in this forecast. As you can see, the expected slowdown is shallower but more protracted than in November. This picture also highlights how volatile and prone to revision the GDP data are, which reminds us not to read too much into the precise quarterly pattern set out at any given time. Revisions will continue for many years.

[SLIDE] Viewed as annual changes, here you can see the downward revision to growth last year, the upward revision this year, and the small downward revisions to subsequent years. Calendar year growth troughs at 1.6 per cent in 2018, picking up slowly thereafter as trend productivity growth gradually returns towards its historical average. This remains a very important but highly uncertain judgement. I should note here that we have not changed any of our policy assumptions regarding Brexit or its impact, which leaves potential growth unchanged since November.

[SLIDE] The future is of course uncertain, not least because we cannot predict how smooth the Brexit negotiations will be or their eventual outcome. This chart shows a probability distribution around our central forecast for GDP growth based purely on past forecast performance. There is a 20 per cent probability that we end up in the inner band, a 40 per cent probability in the next, and so on. [SLIDE] You can see that the difference between our November forecast and this forecast is very small compared to the uncertainty around either.

[SLIDE] So how does our GDP forecast compare to others?

This chart shows our forecast for the level of GDP over the next five years, compared to 2012, and [SLIDE] compares it to those of the Bank of England and the average of outside forecasters. You can see that we are somewhat more optimistic than the outside average, but a little less so in the near term than the Bank. As usual, this is explained in part by the fact that the Bank attempts to predict future revisions to past GDP data – and it generally assumes that they will push them up.

[SLIDE] I mentioned a moment ago that we expect the economy to slow through this year largely because higher inflation will squeeze household budgets. This chart shows our forecasts for CPI inflation in November and now. The peak is slightly higher and slightly earlier than in November at 2.7 per cent in the fourth quarter, reflecting recent announcements on household energy bills and the prospect of higher insurance premiums due to the change in the personal injury discount rate. Inflation is a little lower thereafter, partly reflecting the recent appreciation in the pound and evidence that the soft drinks industry levy may not push prices up as much as we had thought.

[SLIDE] This chart shows the same comparison for RPI inflation, which affects debt interest spending via the cost of servicing index-linked gilts. The spike in inflation this year is somewhat bigger for RPI than for CPI, because the impact of the insurance premium increase is four times greater. This is because motor insurance premiums have a weight based on gross spending in the RPI, but net of payouts in the CPI. Reflecting this, RPI inflation peaks at 4.1 per cent, also in the fourth quarter.

[SLIDE] So what does all this mean for the public finances? This slide shows the elements of our GDP forecast that are most important for our fiscal forecast. [SLIDE] As I mentioned a moment ago, our forecast for cumulative growth in potential GDP over the forecast is the same as in November, but actual GDP growth is slightly weaker because we start with the economy presumed to be slightly above potential.

Real GDP measures the volume of goods and services produced in the economy, but it is [SLIDE] nominal GDP – the cash value of these flows – that matters more for the public finances. Most taxes are levied on some part of nominal incomes or spending. We are expecting rather less growth in nominal GDP over the forecast than in November, largely because of weaker whole economy inflation. [SLIDE] Its composition is also somewhat less favourable for receipts, with cumulative growth in wages, company profits and consumer spending all revised down.

[SLIDE] So now let me turn to the public finances themselves.

This chart shows our November forecast for public sector net borrowing in billions of pounds [SLIDE] and our new forecast today. [SLIDE] As you can see, borrowing is £16.4 billion lower this year than we forecast in November at £51.7 billion. The revisions in subsequent years are much smaller, less than £1 billion a year in each year bar 2018-19.

[SLIDE] So what explains these changes? [SLIDE] There are three main elements:

- [SLIDE] First, as we flagged back in November, the Office for National Statistics has changed the way that it records corporate tax receipts in the public finances. It now scores them closer to the date at which companies earn their profits rather than when they pay their tax. This raises recorded receipts in most years, but with an uneven pattern reflecting the timing of future cuts in corporation tax that have already been announced.

- [SLIDE] Second, we have the changes in our underlying forecast for the budget deficit – a big downward revision this year, smaller downward revisions over the following three years and then very small upward revisions in 2020-21 and 2021-22.

- [SLIDE] And third, the impact of the policy decisions in this Budget, not all of which are included on the Treasury's published scorecard. These add up to a £3.1 billion giveaway this year, which shrinks and then becomes a small net fiscal tightening in 2020-21 and 2021-22, a familiar pattern from past fiscal events.

[SLIDE] Let me look at the changes in the underlying forecast in more detail and then I will turn to the Budget policy decisions.

[SLIDE] Measured on a like for like basis, we have revised the deficit down by £13.4 billion this year, £7½ billion of which is an upward revision to receipts and £6 billion a downward revision to spending.

[SLIDE] Receipts are higher in the first three years of the forecast, then lower in the last two. [SLIDE] Breaking that down, we can see that corporation tax receipts are higher right across the forecast. This reflects stronger receipts this year than we had expected, some of which we push into later years. But the increase diminishes over time, because we have revised profits growth lower towards the end of the forecast.

[SLIDE] Capital gains tax receipts are also higher across the forecast, reflecting very strong payments this January and February. Receipts are up 23 per cent this year (despite a fall in the FTSE All-Share Index in the year to which the payments relate). And this follows even stronger increases of 27 and 42 per cent in the previous two years.

[SLIDE] PAYE income tax and NICs receipts have come in stronger than expected since November, which pushes through into future years. But this is more than offset later in the forecast by weaker earnings growth.

[SLIDE] Self-assessment income tax is weaker over the forecast, but with the underlying picture distorted by forestalling ahead of the increase in dividend taxation in April 2016. The Government announced this change ahead of time, giving owner-directors in particular an opportunity to bring forward dividend payments into 2015-16 to beat the tax rise. We factored that in to previous forecasts, but apparently not enough.

As far as we can tell from HMRC's analysis of individual tax returns, taxpayers shifted more than £10 billion of dividend payments into 2015-16 from future years. This boosts receipts this year by about £4 billion, but will lower them in future years by £4.8 billion – thereby saving taxpayers and costing the Exchequer around £800 million in the process. HMRC's analysis suggests that more than £100 million of this saving benefited just 100 wealthy individuals who, on average, withdrew around £30 million worth of dividends each from their companies.

[SLIDE] Turning to spending, our forecast is £6 billion lower this year than in November, with an uneven pattern of much smaller revisions in subsequent years.

[SLIDE] Departmental spending is more than £2 billion lower this year than expected in November, based on the latest evidence from the Treasury and Whitehall departments. In contrast, local authorities' self-financed current spending ('current LASFE' in the table) is higher this year and across the forecast than in November, with evidence suggesting that councils are having to dip deeper into their reserves.

[SLIDE] Welfare spending is lower across all years of the forecast. In the near term this reflects the continuing – and still somewhat puzzling – weakness of tax credit spending. In later years it reflects bigger expected savings from universal credit and lower pension spending.

[SLIDE] Debt interest spending is higher in most years than in November. This reflects higher gilt yields, higher expectations for Bank Rate and higher RPI inflation, the last partly the result of policy decisions.

[SLIDE] The profile of the UK's contributions to the European Union also looks very different this year and next than we thought in November, because the Commission has asked member countries for only three months' worth of their 2017 contributions in the first quarter of the year, rather than the five months' worth that it normally asks for. The Commission doesn't feel the need to front-load contributions as much this year because it is underspending on some major programmes.

This makes no difference to most countries' accounts, but because the UK government has an April to March financial year it takes £1.8 billion of spending out of 2016-17 and puts it into 2017-18.

[SLIDE] Looking across the five-year horizon as a whole, our forecast for the budget deficit is fractionally lower on average than in November. As you can see, this is one of the smaller revisions we have made since 2010 – and would remain so even if you included the current year.

[SLIDE] So, why has the overall revision to the deficit forecast for this year been so big relative to outside expectations? And what information has become available since November to justify it?

This table shows the main contributors, most of which we have touched on already. One interesting point to note is that when we produced our forecast back in November, the ONS estimated that the deficit over the first six months of the year was £45.5 billion. Since then it has revised that figure down by almost £10 billion. So it is not just that the public finances have improved late in the financial year, but also that the position in the first half the year was better than it looked at the time.

That said, the most important new information that has become available since November includes: the strength of corporation tax, income tax and capital gains tax in the revenue-rich early months of the calendar year; the European Commission's decision on member contributions; the impact of the corporate tax accounting change, and; the new evidence on departmental spending from the latest forecasts that departments sent to the Treasury in February.

[SLIDE] So now let us turn from the change in the underlying forecast to the impact of the Budget policy decisions. As we saw earlier, this moves from a £3.1 billion giveaway in 2017-18 to a half billion takeaway in

2021-22. [SLIDE] Here is that total change again [SLIDE], and this is how it breaks down between [SLIDE] the measures that the Chancellor has chosen to include on the Treasury's published scorecard (which sum to zero or thereabouts across the five years), [SLIDE] the measures that do not appear on the scorecard (which are a net fiscal loosening) and [SLIDE] our estimates of their indirect effects (which are generally small).

[SLIDE] So let us look at some of the biggest measures, beginning with those on the scorecard. It is worth saying at this point that this was a relatively small Budget, with fewer separately identified measures on the scorecard than in any other fiscal event that the OBR has scrutinised. But, as you know, the Chancellor has decided to move the Budget to the autumn and make that the main fiscal event of the year.

[SLIDE] The biggest tax changes were the reduction in the recently introduced dividend tax allowance, which raises around £900 million a year, and the increase in National Insurance Contributions on self-employment profits, which raises about half a billion a year.

[SLIDE] These more than pay for a business rates relief package (a little over £200 million next year) and extra social care funding (which averages £800 million a year over the next three years). The other scorecard measures amount to a modest giveaway in all years.

[SLIDE] The biggest policy developments off the scorecard follow the Ministry of Justice's decision to reduce the personal injury discount rate, which will significantly increase the size of cash settlement payments.

The Chancellor has set aside about £1.2 billion a year to meet the cost to the NHS and other parts of the public sector. The decision is also expected to cost insurers about £2 billion a year, which will push up premiums. This increases revenue from insurance premium tax, but raises debt interest spending by pushing up RPI inflation. The overall effect is to increase borrowing by £1.8 billion this year and around £1 billion each year thereafter.

[SLIDE] Smaller in its effect is the Government's decision to increase probate fees to between £300 and £20,000, depending on the size of the estate. This will raise around £300 million. Probate fees are currently treated as negative spending and this increase had already been taken into account in the Ministry of Justice's spending settlement.

Once the change is implemented, the Treasury expects the Office for National Statistics to classify probate fees as a tax because the fee is not in proportion to the cost of the service. That will simply convert some negative spending into positive tax receipts. The only net impact on the public finances comes via a small loss of inheritance tax as we assume people will take steps to avoid stepping up a band in the fee structure.

[SLIDE] Taking the ONS accounting change, the underlying forecast changes and the impact of Budget policy measures into account, public sector net borrowing is now expected to rise from £51.7 billion this year to £58.3 billion in 2017-18, rather than falling from £68.2 billion to £59.0 billion as we thought in November. This is the first increase since 2012-13, when the Royal Mail's historic pension fund deficit moved into the public sector. But the level of the deficit in 2017-18 is still fractionally lower than we forecast it would be in November.

[SLIDE] This table shows the main factors behind the turnaround from a £9.2 billion fall in the deficit next year to a £6.5 billion rise. We have seen most of them already. [SLIDE] The biggest factors include the change in the timing of EU contributions, the impact of greater dividend forestalling, the Budget giveaway and the cost of higher inflation next year. [SLIDE] One offsetting factor is that we expect nominal GDP growth to be a little stronger than we did in November, which on its own would improve the deficit by almost £3 billion between this year and next.

[SLIDE] So what does the outlook for the public finances that we have set out in the *EFO* imply for the Government's performance against the various fiscal goals that it has set itself?

As we shall see, the Government remains on course to achieve its fiscal mandate for structural borrowing, to achieve its supplementary target for net debt and to stay within its cap on welfare spending. But it is not yet on course to achieve its so-called 'fiscal objective' – to balance the public finances at the earliest possible date in the next Parliament.

[SLIDE] Let's start with the fiscal mandate.

This requires the Government to bring the structural budget deficit below 2 per cent of GDP by 2020-21. The structural deficit is the one you would see if activity in the economy remained at its potential level, consistent with stable inflation. In this forecast, the economy remains very close to potential throughout the five year horizon, so the path of the structural deficit is very close to the path of the headline deficit.

This chart shows the path of the structural deficit from our November forecast – and the 2 per cent ceiling specified in the fiscal mandate. By 2020-21 it reaches 0.8 per cent of GDP, implying headroom against the target of 1.2 per cent of GDP. [SLIDE] Now let's add the structural deficit from this forecast and – as you can see – there is very little difference.

The structural deficit is 0.9 per cent of GDP in 2020-21. Strictly speaking this implies less room for manoeuvre. But an unrounded difference of less than 0.05 per cent of GDP at that time horizon is completely dwarfed by the uncertainty around the forecast.

[SLIDE] We can show that uncertainty using another fan chart based on past forecast performance. And, on this basis, our central forecast implies a 65 per cent chance of achieving the mandate on current policy.

[SLIDE] The Government's supplementary target for public sector net debt requires it to fall as a share of GDP in 2020-21. In our November forecast net debt peaked at just over 90 per cent of GDP next year, and fell by 3.2 per cent of GDP in the target year. [SLIDE] In this forecast the peak next year is slightly lower – thanks primarily to lower borrowing – and the decline is a larger 3.9 per cent of GDP in the target year. So the target is achieved with slightly more room for manoeuvre than in November. That said, more than half the decline in the ratio in the target year reflects the repayment of loans issued under the Bank of England's Term Funding Scheme at the end of their four-year term.

[SLIDE] Turning to the welfare cap, this requires spending on benefits and tax credits (excluding the state pension and payments closely linked to the ups and downs of the economic cycle) to lie below a specified cash limit in 2021-22. [SLIDE] The cap was set in line with our November 2016 forecast, plus a 3 per cent margin. Assessment of spending against the cap also has to strip out the impact of changes in inflation since it was set, on a methodology chosen by the Government.

Spending within the welfare cap has been revised down fractionally since November in most years of the forecast. Tax credit spending continues to be weak and we expect slightly bigger savings from universal credit in the longer term. [SLIDE] Making the Government's requested adjustment for inflation, spending is now expected to be £4.5 billion below the cap plus margin in 2021-22, up from £3.8 billion in November – again a very small difference at that time horizon.

[SLIDE] In the Budget document, the Government describes the fiscal mandate and the supplementary debt target as 'interim targets'. Its stated 'fiscal objective' is to bring the public finances to balance at the earliest possible date in the next Parliament.

Most of the next Parliament lies beyond our five-year forecast horizon, so we cannot judge its prospects definitively. But it does look unlikely that the Government would achieve this on current policy settings.

To begin with, our central forecast has the Government still running a deficit of 0.7 per cent of GDP in 2021-22, the first or second year of the next Parliament, depending on how you define it.

Uprating tax allowances and benefit payments in line with inflation rather than earnings could cut the deficit by about another 1 per cent of GDP by 2025-26, which would get the Government into surplus. But this would push the average tax rate up further and reduce working age welfare payments by about another 10 per cent relative to earnings.

Even if the Government did do this, the effect might well be unwound if it felt it had to accommodate upward pressure on spending from the ageing of the population and other cost pressures in the health service, which we discussed in our latest *Fiscal sustainability report*.

To be confident that the Government is on course to achieve the fiscal objective, we will need to know more about how it plans to address these challenges.

[SLIDE] So, finally, let me conclude with a brief summary.

The changes to our economy forecast since November have been relatively modest. The economy ended 2016 with greater momentum than we expected, thanks to the great British consumer, but the outlook over the medium term is little changed.

As regards the public finances, public sector net borrowing looks likely to come in a lot lower than we expected this year, but primarily due to timing effects and one-off factors.

As with the economy, the path of the public finances over the medium term has changed little since November. The Budget measures are also modest in their impact, with a small fiscal loosening in the near term and a small promised tightening in a few years' time.

The Government remains on course to achieve what it calls its 'interim' fiscal targets, and with room to spare. But it does not look as though it is on course to achieve what it calls its 'fiscal objective' – to balance the budget as early as possible in the next Parliament.

And, with that, we are happy to take your questions.