

Welsh Government Tax Conference, 23 November 2022

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Introduction

- Good morning and thank you once again for the invitation to do some scene-setting for today's conference.
- It has been another remarkable year for the economy and public finances – and for fiscal policy making in Westminster.
- I am going to take you through the highlights of our latest Economic and fiscal outlook before we open it up to your questions.

Background

- First, a little background for those who have not attended this conference in previous years.
- The OBR is 12 years old now. We are responsible for producing the forecasts that underpin Budgets and, at the Chancellor's request, other fiscal statements. We use those to assess performance against fiscal targets that the Government is responsible for setting.
- And we also analyse fiscal risks and sustainability, trends in welfare spending, the performance of our own forecasts, and prospects for devolved tax revenues.
- One thing we do not do is provide advice – Parliament has stipulated that we are an analytical body, not an advisory one.
- Our work on forecasting Welsh taxes is now well-established too. Tomorrow we will publish the Devolved tax and spending forecasts consistent with last week's UK-wide forecasts. And later next month we will publish our fourth Welsh taxes outlook.
- And let me take this opportunity to thank all those analysts in the Welsh Government that support us in this work with their expertise and dedication. They are a first-rate team.

Energy market developments since March

- Let me now turn to the content of our latest forecast, starting with three key developments that explain most of the changes in the outlook since our last forecast in March.
- The most important economic development since our last forecast has been the deepening of the European energy crisis precipitated by the Russian invasion of Ukraine.

- The further reduction in Russian gas imports, the rush to fill up gas storage before the winter, and the damaging of the Nord Stream 1 pipeline drove wholesale gas prices in Europe to new highs over the summer.
- As shown in the blue line on the right, our economy forecast is conditioned on market expectations for gas prices over the next three years, which we then hold constant in real terms in the final two years of the forecast.
- In our forecast, gas prices are expected to:
 - Reach a peak of around £3.70 a therm in early 2023 – and are roughly double the level in our March forecast over that year.
 - Prices then fall back to around £1.90 a therm by the mid-2020s, which is still four times higher than we were used to before the pandemic.
- The Government’s energy price guarantee limits average household energy bills to £2,500 this winter and £3,000 next winter, insulating households from the even larger increases in energy bills they would have faced. A similar scheme limits the increase in energy costs faced by firms until March.
- But these schemes do not change the price of energy in the medium term so sustained high energy prices reduce the economy’s productive potential over the medium term.

Interest rate developments since March

- As inflationary pressures have built up, market expectations for the rise in the Bank of England’s policy rate (shown on the left) have also risen – from a peak of around 2 per cent in our March forecast (shown in green) to around 5 per cent in the market expectations used in our latest forecast (shown in blue). They have since fallen back a little further.
- And as you can see from the chart on the right, longer-term interest rates on UK government debt have also risen sharply, and are now 2-to-3 times higher than we expected in March.
- The gilt rate curves used in our fiscal forecast (shown in blue) were taken in the first 10 working days of Rishi Sunak’s Prime Ministership starting on 24 October, and see yields peak at just under 4 per cent at the 20-year mark.
- As you can see from the yellow lines, interest rate expectations have come down somewhat since the market convulsions that followed the Growth Plan on 23 September, which saw 20-year yields rise to 4½ per cent the following working day.

- And while some of that late-September spike in yields reflected an increase in the interest rate differential between the UK and other sovereigns, that increase in spreads had all but disappeared by the time we finally closed our fiscal forecast.

Fiscal policy developments since March

- In addition to these, largely external, influences, fiscal policy at the UK-level has also been a key source of uncertainty since March.
- The past six months have witnessed a series of dramatic swings in the direction of fiscal policy with five major fiscal statements delivered by three successive Governments.
- This chart illustrates the cumulative effect of those statements on government borrowing over the next five years:
 - Starting with, then Chancellor, Rishi Sunak's 26 May cost-of-living package, which added £9 billion to borrowing in this financial year, with savings in subsequent years from the new energy profits levy.
 - Fast forward to 8 September, and then Prime Minister Liz Truss's original energy price guarantee and equivalent support for businesses added £70 billion to borrowing over the next two years.
 - To this large near-term fiscal loosening, the personal and corporate tax cuts in then Chancellor Kwasi Kwarteng's 23 September Growth Plan would have added £48 billion a year to borrowing over the medium term.
 - But, almost all of these tax cuts were reversed in Chancellor Jeremy Hunt's statement of 17 October, with the main survivor being the ditching of the health and social care levy, which brought the net medium-term loosening down to £21 billion by 2027-28.
 - And finally, last week's Autumn Statement delivered a further package of net tax rises and spending cuts, which reduce borrowing by £62 billion in 2027-28.
 - Taken together, and including their indirect effects via the economy, the net impact of this series of announcements and reversals has been to add over £40 billion to borrowing this year but then take almost £40 billion off borrowing by 2027-28.

Inflation

- Those three big movements in energy markets, interest rates, and government policy since March all have big implications for the economic and fiscal outlook over the next five years.
- Let me start with their implications for inflation.

- We now expect inflation to peak at 11.1 per cent in the fourth quarter of this year, driven by higher global energy and food prices in particular.
- That's 2½ percentage points higher at its peak than we forecast in March, but the peak is 2½ percentage points lower and one quarter earlier than it would have been without the energy price guarantee (as illustrated by the dotted line on the chart).
- Inflation is then expected to fall back sharply over the course of next year and is dragged into negative territory in the middle of the decade as energy prices fall back, before returning to its 2 per cent target by the end of the forecast period.

Living standards

- But in the near term, inflation far outpaces growth in nominal wages, which are expected to grow by 6 per cent this year and 4 per cent next year.
- This drives historically large falls in per person real disposable incomes, which drop by a cumulative 7 per cent over the two years to 2023-24, wiping out the last 8 years of growth.
- This steep fall in living standards happens despite the energy price guarantee and other government support which raise real incomes by 3½ per cent on average this year and next.
- However, for a net energy importer like the UK, the huge increase in global gas prices over the past year represents a terms-of-trade shock that leaves our country as a whole poorer.
- So, while government policy can alter who in the UK pays for these higher energy costs and when, it cannot make them go away.
- Indeed, we expect real incomes in 2027-28 to still be 1 per cent below their pre-pandemic peak of three years ago.

GDP

- This squeeze on real household incomes drags down consumption and has tipped the economy into a recession that we expect to last just over a year.
- Peak to trough, real GDP falls by just over 2 per cent, but it would have fallen half as much again in the absence of government support.
- This fall in output is much shallower than those experienced during the pandemic or 2008 financial crisis, but similar in depth to that seen in the recession of the 1990s.
- Higher energy costs, interest rates, and corporate taxes also reduce business investment over the next few years, with longer-term implications that I'll come back to shortly.

- This weaker outlook, combined with downward revisions to outturn data over the past two years, mean that real GDP doesn't return to its pre-pandemic level until the end of 2024, and remains 3½ per cent lower at the forecast horizon than we expected in March.

Labour market

- Turning to the implications for the labour market, the recession leads to a modest rise in unemployment (seen on the left), which peaks at just under 5 per cent in the third quarter of 2024 before falling back to its structural rate of just above 4 per cent in the medium term.
- More worrying for the long-run health of the economy has been the continued rise in the number of adults not active in the labour force since the start of the pandemic.
- As shown on the right, this means that the overall size of the labour force has shrunk by around 300,000 people since before the pandemic.
- While we assume that some of those currently inactive will eventually re-join the labour force, the prevalence of older people in this group suggests that many never will.
- And the net result is that the overall employment rate of the adult population is around a full percentage point lower by end of the forecast period than on the eve of the pandemic.

Potential output

- This brings me to our latest estimate of potential output, or the 'supply side' of the economy, which attracted particular attention in the run-up to this forecast.
- Our forecast for the growth in potential output, shown in the middle of this slide, is lower in the near term but unchanged at the end of the forecast compared to March.
- However, as you can see from the chart on the right, the composition of that growth has slightly changed to reflect a number of largely offsetting developments in the drivers of potential growth since March:
 - First, we have revised up our estimate of labour supply growth to reflect continued high levels of immigration since the introduction of the new, post-Brexit, migration regime.
 - Second, we have revised down our estimate of the contribution of capital deepening to reflect the impact of the recession and a higher cost of capital on business investment.
 - And third, we have revised down our estimate of growth in measured productivity to reflect the consequences of higher energy prices.
- All in all, that leaves our assessment of the rate of growth in potential output at the forecast horizon unchanged at 1¾ per cent a year.

- But cumulative growth in potential output over the forecast horizon is lower than in March – by around 1¾ percentage points – due to higher energy prices weighing on productive potential.

Government borrowing

- Let me now turn to the latest fiscal outlook, taking account of the more challenging economic backdrop over the next five years and the net result of the array of fiscal policy announcements over the past six months.
- Having fallen from its post-war peak of 15 per cent of GDP at the height of the pandemic to below 6 per cent of GDP last year, borrowing is set to rise again this year to just over 7 per cent of GDP, before falling back to just over 2 per cent by 2027-28.
- In cash terms, borrowing is nearly £80 billion higher this year and almost £40 billion higher in five years' time than we forecast in March.

Changes in borrowing since March

- To understand what drives this deterioration in the fiscal position, this chart breaks down the increase in cash borrowing into:
 - First, differences arising from underlying forecast changes (shown in shades of blue).
 - Second, changes arising from the net effect of policy decisions (shown in red for spending and yellow for tax changes).
 - And third, the indirect or second-round effects of those policy changes via their impact on the economy and the debt interest paid on new borrowing (shown in purple).
- Starting with the blue, underlying forecast changes add on average £55 billion to borrowing in each of the next five years. Three large changes dominate this: higher interest rates adding to debt servicing costs; higher inflation and inactivity adding to welfare spending; and a weaker economy weighing on receipts.
- Looking at the effect of policy changes:
 - The May and September cost-of-living and energy packages add around £60 billion to spending this year and around £25 billion next year.
 - Cuts in departmental spending plans over the remaining three years save around £30 billion in the final year of the forecast, with three-fifths coming from current budgets and two-fifths coming from capital budgets.

- Tax changes cost money next year but raise money in the final four years, as the revenues lost from scrapping the health and social care levy are more than offset by increases in other taxes with a net yield of £8½ billion in the final year of the forecast.
- Indirect effects reduce borrowing materially in the near term by supporting incomes and lowering inflation, but raise borrowing modestly thereafter due to debt interest costs and fiscal consolidation weighing on economic activity.
- Taken together, these changes leave the level of borrowing around £85 billion higher in the next two years and around £40 billion higher in five years' time.

Tax and spending as a share of GDP

- Where does all of this leave the levels of taxation and expenditure in five years' time?
- The tax burden rises from 33 per cent of GDP before the pandemic in 2019-20 to over 37 per cent of GDP in 2027-28, which is around 1 percentage point higher than we forecast in March and its highest sustained level since just after the Second World War.
- This higher tax burden pays for a larger state whose total expenditure rises from 39 per cent of GDP before the pandemic to 47 per cent of GDP this year, before falling back to 43 per cent in five years' time. This leaves public spending around 3 per cent of GDP larger than we forecast in March, and its highest sustained share of the economy since the late 1970s.
- This increase in the overall size of the state over the medium term is driven by a combination of higher inflation and interest rates, which push up the cost of the Government's inflation-linked welfare commitments and the cost of servicing its higher stock of debt.
- And these increases more than offset the cuts to departmental budgets in the final three years of the forecast, leaving overall government spending higher in cash terms and – more importantly – higher as a share of an economy made smaller by the energy price shock.

Departmental spending

- This slide looks in more detail at the implications of those reductions in departmental spending beyond the current Spending Review period ending in 2024-25.
- At the time of our March forecast, the total envelope for departmental resource expenditure was expected to grow by 2½ per cent in real terms from the middle of the decade.
- This resource envelope was sufficient to allow the Government to meet an array of medium-term spending commitments and pressures including:

- growing health spending by 3.1 per cent a year in real terms – continuing the underlying growth rate in the current Spending Review period;
 - growing defence and overseas aid spending in line with GDP;
 - and holding core schools spending per pupil constant in real terms.
- And this would have left sufficient resources for the budgets of all other government departments to rise by 2.8 per cent a year in real terms in the next SR period.
 - The removal of £18 billion from the resource envelope by 2027-28 in the Autumn Statement means that total spending now only grows by 1 per cent a year in real terms over the next Spending Review period.
 - Meeting the pressures and commitments in health, defence, aid and schools within this smaller envelope would now imply a real-terms cut of 0.7 per cent a year in this remaining spending.
 - While significant, cuts on this scale are smaller than those planned in the 2010 and 2015 Spending Reviews, which planned real cuts of 5 and 3 per cent for such unprotected departments.
 - But one needs to bear in mind that it is the same group of departments that have borne the brunt of successive real cuts over more than a decade.
 - And that the base from which the next squeeze will apply in 2024-25 has already been squeezed by the decision not to reopen cash limits set in the October 2021 Spending Review to compensate many of these departments for much higher inflation in the meantime.
 - So while we consider the revised path of public spending beyond the current SR years to be plausible, it is not without risks, which we spell out in the EFO.

Government debt

- Turning to what this implies for the stock of debt, compared with our March forecast headline debt is higher as a share of the economy in every year, and by 17 per cent of GDP in the final year.
- Including the net debt of the Bank of England, it rises from 97 per cent of GDP last year to a peak of 107 per cent in 2023-24, its highest level in six decades, and then falls over the remaining four years of the forecast. But this path is somewhat distorted by the repayment of around £150 billion of loans issued under the Bank's Term Funding Scheme.

- Excluding the Bank, underlying debt rises from 84 per cent of GDP last year to a peak of 98 per cent of GDP in 2025-26, and then falls modestly in the final two years of the forecast.

Debt interest

- This higher stock of debt, coupled with much higher interest rates, means that the share of public revenue being consumed by interest payments has risen dramatically since March.
- We expect debt interest costs to rise from under 5 per cent of revenues in 2019-20 to 8½ per cent by 2027-28, having spiked to a post-war high of 12 per cent this year.
- It is not only the scale, but also the speed, with which higher interest rates and inflation have pushed up debt servicing costs that is striking – and that speaks to the risks they pose.
- As we have set out in successive reports on fiscal risks, three developments in recent years have greatly increased the sensitivity of the public finances to changes in borrowing costs since the start of the century:
 - The first is the increase in the debt stock itself, which has almost quadrupled from 28 per cent of GDP in 2000-01 to 102 per cent by 2022-23.
 - The second is the associated rise in inflation-linked debt, which has also almost quadrupled from 6 to 22 per cent of GDP, and for which any inflation surprises directly increase the stock of debt rather than erode its real value.
 - And the third is the shortening in the effective maturity of that debt as a result of the quantitative easing operations of the Bank of England. This has reduced the median maturity of the debt of the consolidated public sector from 7 years in 2008, before QE began, to less than 2 years now.
- The combined effect of all of these changes has been to leave the public finances much more exposed to interest rate and inflation movements than before.
- To illustrate this in today's money, every 1 percentage point rise in short-term interest rates now adds £13 billion to debt interest costs the following year rather than just £2 billion if we had the same debt level and structure as in the year 2000.

Fiscal rules

- The heightened sensitivity of the public finances to higher inflation and interest rates more than explains why the Government has missed both of its currently legislated fiscal rules.

- Set by then Chancellor Sunak last October, they included targets to get underlying debt falling as a share of GDP and balance the current budget three years into the forecast – 2025-26 in this forecast.
- These legislated targets are set to be missed by £11 billion and £9 billion.
- But as he deals with the fiscal consequences of this energy shock, the current Chancellor proposed a new set of fiscal targets in his Autumn Statement:
 - The first rule is to ensure that underlying debt is falling after five years rather than three. In the absence of new policy measures, he was on course to miss that target by £29 billion. With them he has met it with £9 billion to spare.
 - The second rule is to bring overall borrowing below 3 per cent of GDP by the end of the forecast. Pre-measures borrowing was set to be 3.7 per cent of GDP. Post measures, it is 2.4 per cent, meaning this target is met with £19 billion to spare.

Risks to the outlook

- But the margins by which the new targets are met are historically small, and the risks around our forecast right now are large.
- The outlook would be considerably brighter were a rapid end to Russia's war in Ukraine to stabilise European energy markets, reducing pressure on inflation and interest rates. That also could spur investment and productivity growth over the medium term, and get debt falling faster.
- But should the Ukraine war last longer and high energy prices and inflation persist, there are several downside risks to worry about:
 - Energy-related support to households and businesses, much like the furlough scheme during the pandemic, could prove difficult to withdraw as their deadlines draw closer.
 - Other supposedly one-off measures, such as the temporary business rates relief for the retail and leisure sectors and the Household Support Fund, are now heading into their fourth years at a cost of over £3 billion next year.
 - Inflation is putting pressures on departmental spending. £8½ billion has been found in this Autumn Statement to top up the health, social care and schools budgets in 2024-25, but other departments face a reduction in their real-terms spending power of between £5 and £15 billion depending on your choice of inflation index.

- And next April's planned super-indexation in fuel duty is assumed to bring in £6 billion in revenue next year in our forecast, but would require a rate increase of 23 per cent.

Implications for Welsh taxes

- What does this all mean for the devolved Welsh tax revenues?
- For the largest of these, income tax, revenues are down modestly in the near term and more materially in the medium term. That is very largely down to the UK-wide consequences of the energy crisis – tempered somewhat by higher-than-expected wage growth in the near term, which has lifted revenues, and by a higher share of UK-wide revenues being assumed to accrue to Wales in the medium term, reflecting the latest ONS population projections.
- For the land transaction tax, revenues are down sharply. This reflects bad news for property markets – especially residential markets – as a consequence of rising mortgage interest rates and the downturn in household incomes. We expect house prices to fall 9 per cent peak to trough over the next year or so and for property transactions to drop more sharply through the recession before recovering. Raising the LTT threshold from £180,000 to £225,000 from last month has a much more modest effect on revenues of around £10 million a year.
- And for landfill disposals tax, revenues are up modestly throughout reflecting an upside surprise in the latest data that we have assumed will persist.

Conclusion

- So let me step back again to summarise the big picture. Rising energy prices, inflation, and interest rates have delivered another blow to a UK economy that had not quite regained its pre-pandemic level, and tipped it into a recession we expect to last just over a year.
- Inflation is expected to peak at 11 per cent this year, but would have peaked 2½ percentage points higher without the energy price guarantee.
- Despite the government spending more than £100 billion over the next two years to cushion the resulting financial squeeze on households and businesses, we expect a record 7 per cent fall in living standards over the next two years.
- These, largely global, forces are also putting the government finances under considerable strain and would have seen underlying debt on an ever-rising trajectory in the absence of further policy action.

- To bring growth in debt under control within five years, the Chancellor announced £30 billion in tax rises and £30 billion in spending cuts in the Autumn Statement.
- But this still leaves the stock of government debt £400 billion higher in five years' time than we forecast back in March.
- And the more than doubling of interest rates in the meantime pushes the share of government resources consumed by the cost of servicing that debt to its highest level in a generation.
- This leaves the UK's public finances more sensitive to movements in interest rates than they have been for decades.
- Even small rises in interest rates would be sufficient to put debt back on an ever-rising path. But equally small falls would generate more headroom against fiscal targets and allow this or future Chancellors more room for manoeuvre in the years ahead.
- And with that I'll say thank you again, and will stop sharing the slides and open things up for any questions.