

Office for  
**Budget  
Responsibility**

## **Economic and fiscal outlook**

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November 2015



# Office for Budget Responsibility: Economic and fiscal outlook

Presented to Parliament by  
the Economic Secretary to the Treasury by  
Command of Her Majesty

November 2015



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# Foreword

The Office for Budget Responsibility (OBR) was established in 2010 to provide independent and authoritative analysis of the UK's public finances.

In this *Economic and fiscal outlook (EFO)* we set out forecasts to 2020-21. We also assess whether the Government is on course to meet the medium-term fiscal objectives that it has set itself, which were approved by Parliament in the October 2015 update to the *Charter for Budget Responsibility*. The forecasts presented in this document represent the collective view of the three independent members of the OBR's Budget Responsibility Committee (BRC). We take full responsibility for the judgements that underpin them and for the conclusions we have reached.

We have, of course, been hugely supported in this by the staff of the OBR. We are enormously grateful for the hard work, expertise and professionalism that they have brought to the task. Given the highly disaggregated nature of the fiscal forecasts we produce, we have also drawn heavily on the work and expertise of officials across government, including in HM Revenue and Customs, the Department for Work and Pensions, HM Treasury, the Department for Communities and Local Government, the Department for Business, Innovation and Skills, the Department of Energy and Climate Change, the Oil and Gas Authority, the Office for National Statistics (ONS), the UK Debt Management Office, the Scottish Government and Scottish Fiscal Commission, the Welsh Government, Transport for London and the various public sector pension schemes. We are very grateful for their time and patience. We have also had useful exchanges with staff at the Bank of England regarding their latest forecast, for which we are very grateful.

The forecast process for this *EFO* has been as follows:

- In September, the Treasury requested that we finalise the Spending Review and Autumn Statement 2015 forecast on a 'pre-scorecard' basis (i.e. before incorporating the effect of new policy announcements that are listed in the Treasury's 'scorecard' table of policy decisions) around two and a half weeks ahead of the Chancellor's statement in order to provide him with a stable base for his final policy decisions. That was slightly earlier than is normally the case, reflecting the greater volume of decisions that needed to be taken in a joint Autumn Statement and Spending Review process.
- We began the forecast process with the preparation by OBR staff of a revised economy forecast, drawing on data released since the last published forecast in July 2015 and with our preliminary judgements on the outlook for the economy.
- Using the economic determinants from this forecast (such as the components of nominal income and spending, unemployment, inflation and interest rates) we then commissioned new forecasts from the relevant government departments for the various tax and spending streams that in aggregate determine the state of the public finances. We discussed these in detail with

the officials producing them, which allowed us to investigate proposed changes in forecasting methodology and to assess the significance of recent tax and spending outturns. In many cases, the BRC requested changes to methodology and/or the interpretation of recent data.

- We sent our first economic forecast to the Chancellor on 6 October and our first fiscal forecast (including a provisional judgement on progress towards meeting the fiscal targets) on 20 October. We provided the Chancellor with these early forecasts in order to inform his policy choices for the Spending Review and Autumn Statement.
- As the forecasting process continued, we identified the key judgements that we would have to make in order to generate our full economy forecast. Where we thought it would be helpful, we commissioned analysis from the relevant experts in the Treasury to help inform our views. The BRC then agreed the key judgements, allowing the production by OBR staff of a second full economy forecast.
- This provided the basis for a further round of fiscal forecasts. Discussion of these forecasts with HMRC, DWP and the other departments gave us the opportunity to follow up the various requests for further analysis, methodological changes and alternative judgements that we made during the previous round. We provided the second round economy and fiscal forecast to the Chancellor on 30 October. On the same day, the ONS announced that it would be reclassifying 'private registered providers' of social housing in England (described for simplicity as 'housing associations' throughout this *EFO*) into the public sector. We therefore began preparation of a forecast for the effect this prospective change would have on our fiscal forecast.
- We then produced a third economy and fiscal forecast, which allowed us to take on latest data and to ensure that our judgements on the fiscal forecast had been incorporated. We finalised this forecast – including our pre-measures forecast of housing associations' effect on borrowing and debt – and sent it to the Chancellor on 9 November, and we met with him and Treasury officials to discuss it on 12 November. Closing the pre-scorecard forecast at this slightly earlier stage than would usually be the case meant that our forecast did not reflect the latest data releases on the labour market (released on 11 November), inflation and house prices (on 17 November) or the full detail of the public sector finances release (on 20 November), though we did have access to some important aspects of the October receipts and spending data via administrative sources.
- Meanwhile, we were also scrutinising the costing of tax and spending measures that were being considered for announcement in the Spending Review and Autumn Statement. The BRC requested a number of changes to the draft costings prepared by HMRC, DWP and other departments. We have endorsed all the tax and annually managed expenditure costings in the scorecard as reasonable and central estimates of the measures themselves. We have continued our fuller discussion and calibration of the uncertainties that surround these policy costings, which is presented in Annex A of this *EFO* and in our annex to the Treasury's *Spending Review and Autumn Statement 2015 policy costings document*.

- During the week before publication we produced our final forecast, incorporating the final package of policy measures and the final spending totals set in the Spending Review. We were provided with final details of major policy decisions with a potential impact on the economy forecast on 13 November. These were incorporated into our final economy forecast.
- At the Treasury's written request, and in line with pre-release access arrangements for data releases from the ONS, we provided the Chancellor with a near-final draft of the *EFO* on 20 November. This allowed the Treasury to prepare the Chancellor's statement and documentation. We also provided a full and final copy 24 hours in advance of publication.

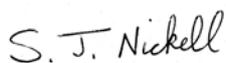
During the forecasting period, the BRC held around 60 scrutiny and challenge meetings with officials from other departments, in addition to numerous further meetings at staff level. We have been provided with all the information and analysis that we requested. We have come under no pressure from Ministers, advisers or officials to change any of our conclusions as the forecast has progressed. A full log of our substantive contact with Ministers, their offices and special advisers can be found on our website.

As a source of additional assurance over how we engage with the Treasury and other departments, our non-executive members Lord Burns and Dame Kate Barker have established a process by which they will review any correspondence that OBR staff feel either breaches the Memorandum of Understanding requirement that it be confined to factual comments only or could be construed as doing so. That review will take place over the next two weeks and any concerns our non-executive members have will be raised with the Treasury's Permanent Secretary or the Treasury Select Committee, if they deem that to be appropriate. This process will be incorporated into the terms of reference of the OBR's Oversight Board and undertaken after each future fiscal event.

We would be pleased to receive feedback on any aspect of our analysis or the presentation of the analysis. This can be sent to [feedback@obr.gsi.gov.uk](mailto:feedback@obr.gsi.gov.uk).



Robert Chote



Sir Stephen Nickell



Graham Parker CBE

The Budget Responsibility Committee



# 1 Executive summary

## Overview

- 1.1 In the first combined Spending Review and Autumn Statement since 2007, the Government has taken advantage of an improvement in the outlook for tax receipts – concentrated in the middle years of this Parliament – 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 on a like-for-like basis. As the boost to receipts begins to ebb, the Government increases departmental spending by less and relies more on tax increases to maintain the bottom line improvement.
- 1.2 The Spending Review sets out firm plans for spending on public services and capital investment by all central government departments through to 2019-20, plus plans for capital spending for all and public services spending for some departments in 2020-21. In aggregate, these further reduce the squeeze on public services spending 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 back in March. But the remaining cuts vary significantly by department.
- 1.3 Taken together with the other measures in the Autumn Statement, the Government has announced 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 a £2.9 billion 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.
- 1.4 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<sup>1</sup> in England to the public sector) is largely due to an improvement in expected 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.

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<sup>1</sup> Strictly speaking, it is “private registered providers” of social housing in England that are being reclassified. These include most housing associations as well as some for-profit housing bodies. We refer to housing associations in most of the text for simplicity.

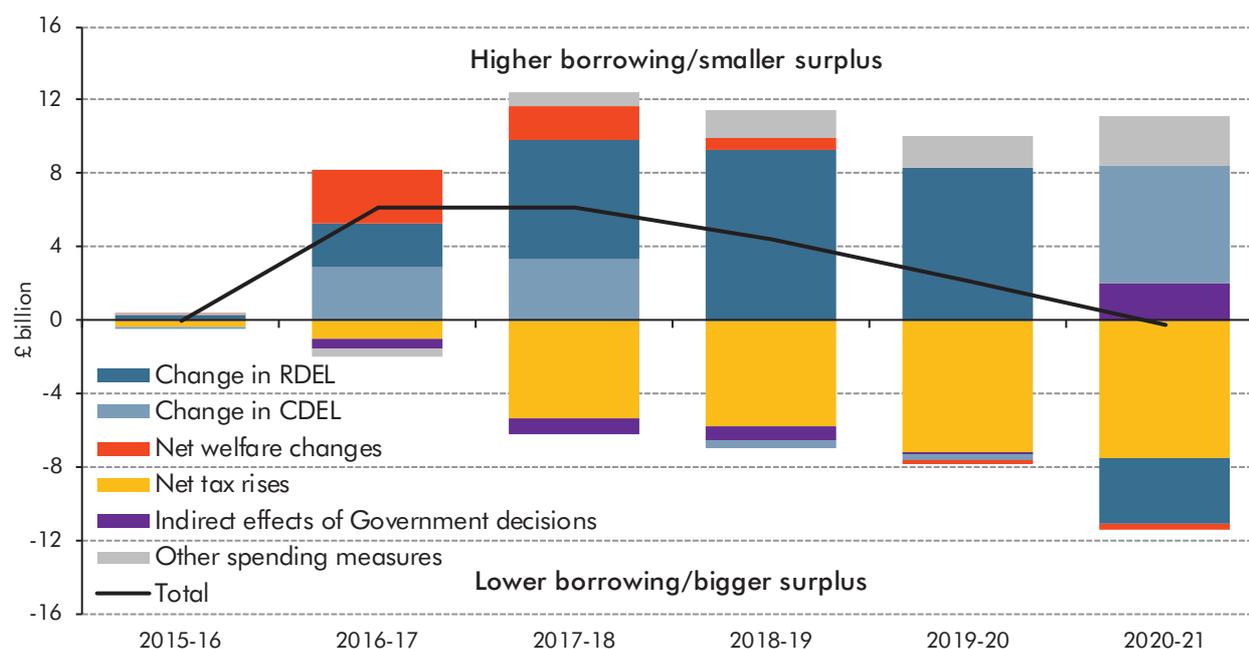
- 1.5 The Autumn Statement policy decisions are expected to have a small impact on the economy, boosting growth a little in the short term (because the pace of fiscal tightening has been eased), but weighing on wage growth in the medium term (as employers are assumed to pass most of the cost of the apprenticeship levy onto their employees).
- 1.6 For the public finances, 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 legislated fiscal targets. However, 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.
- 1.7 Over the full five years of our forecast, from 2016-17 to 2020-21, 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 by the Government in July. That comprises a £26.4 billion increase in the years covered by the detailed Spending Review plans, followed by a £3.6 billion cut pencilled in for 2020-21 (thereby further smoothing the path of public services spending). These higher totals mean that 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 on average over the last Parliament;
  - 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. This gives a cumulative real increase in capital spending of 20 per cent over this Parliament, followed by a further 17 per cent increase in the first year of the next Parliament alone. The leap in 2020-21 is sufficient to ensure that 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 of the tax credit reversal is more than offset by cuts to a variety of 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.

1.8 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. Positive effects include the boost to revenues from the near-term increase in GDP growth, while smaller cuts to central government workforces (from higher RDEL) increase pension contributions and so reduce net spending on public service pensions. Working in the opposite direction, helping some local authorities to raise council tax will push up debt interest costs (via its impact on the Retail Prices Index), while the imposition of the apprenticeship levy will reduce tax revenues by weakening earnings growth.

Chart 1.1: The effect of Government decisions on public sector net borrowing



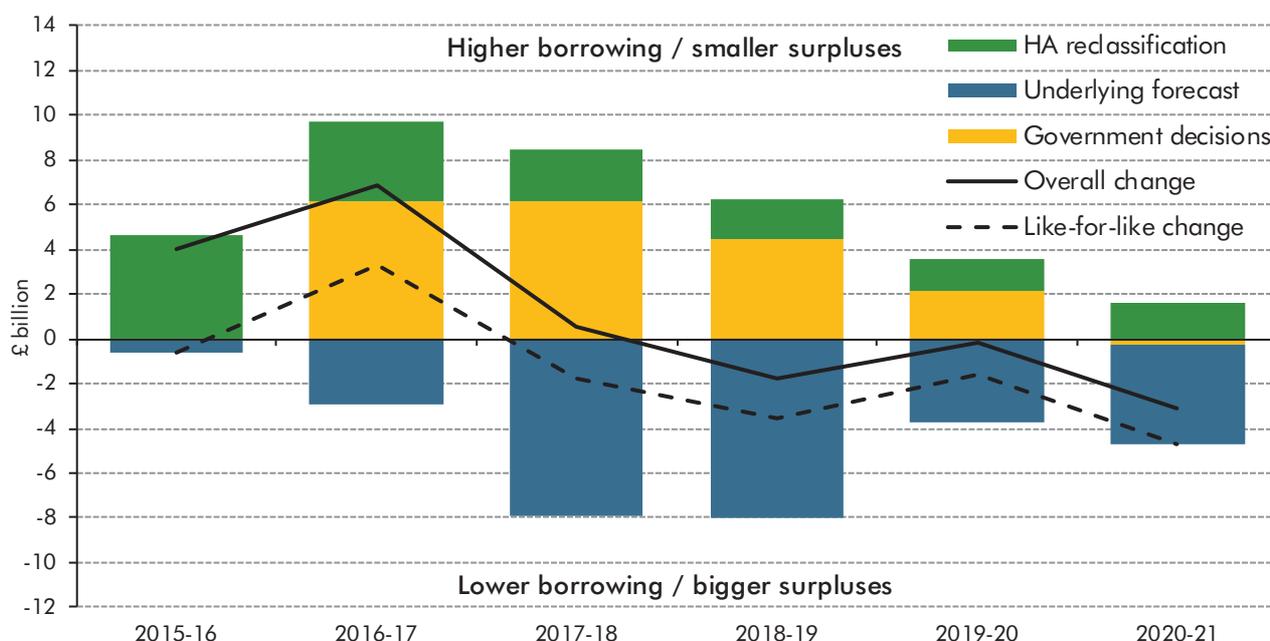
1.9 As we warned might happen in our last *EFO*, the ONS has announced that housing associations will be reclassified from the private to the public sector, with effect from 2008. It intends to implement that decision in the published public finances data sometime before Budget 2016. But we have included estimates of the effect in this forecast, including an outturn for 2014-15. This increases borrowing by between £1.4 and £4.6 billion a year and adds 3.1 to 3.4 per cent of GDP to public sector net debt.

1.10 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 a sharper fall in the deficit over the rest of the year than we have seen to date.

- 1.11 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 both including and excluding the reclassification.
- 1.12 As Chart 1.2 summarises, including the reclassification of housing associations means that the budget balance is weaker in headline terms between 2015-16 and 2017-18, and then stronger thereafter, than in July. On a like-for-like basis it is weaker only in 2016-17 because the policy giveaway is smaller than the forecast improvement in the other years.

Chart 1.2: Contributions to public sector net borrowing changes since July



Source: OBR

- 1.13 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. Financial asset sales typically bring forward cash that would otherwise have been received later (e.g. in mortgage repayments and dividends), so they only reduce net debt temporarily. And when the Government gives away some of the assets, as with Royal Mail shares and the planned retail offering of Lloyds shares early next year, the sale will raise less than the asset is worth and the public sector's net worth is reduced.

#### 1.14 In terms of our economy forecast, since July:

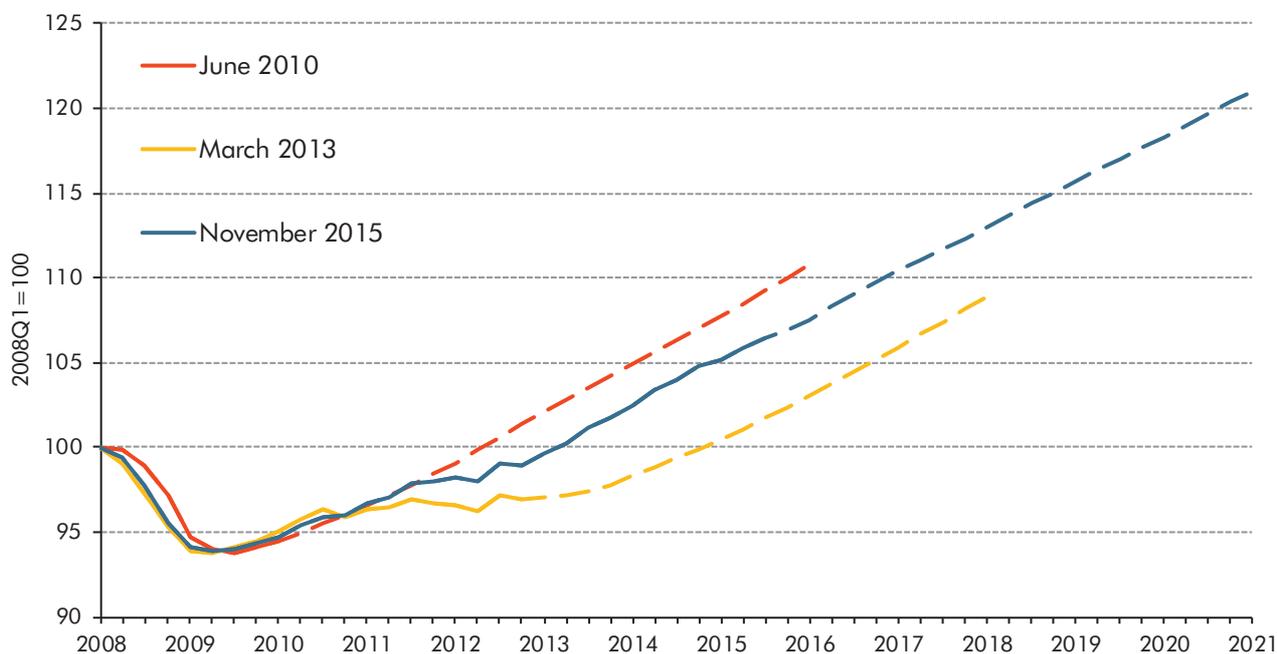
- our GDP growth forecast is unchanged in 2015 at 2.4 per cent. We have then revised growth up a little in 2016 and 2017, reflecting both higher population growth (driven by higher net migration) and the Government's decision to slow the pace of fiscal tightening. Growth is slightly lower in the final year of the forecast, when we now assume that demographic trends will cause the employment rate to edge 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 relative to July; 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. Both are economically equivalent to payroll taxes, the cost of which we assume will be passed largely onto employees.

### **Economic developments since our previous forecast**

1.15 Since our July forecast, the ONS has published the 2015 Blue Book. Methodological and other changes have led to upward revisions to the level of nominal GDP – by 1.1 per cent in the first quarter of 2015. The ONS has also revised real GDP growth down from 1.9 per cent to 1.5 per cent in 2010, but then up by between 0.3 and 0.5 percentage points in each of 2011, 2012 and 2013. Overall, the Blue Book has revised up cumulative GDP growth since the low point of the late 2000s recession from 11.2 to 12.1 per cent.

1.16 As Chart 1.3 shows, this continues the pattern of earlier data revisions in strengthening and smoothing the apparent path of the economic recovery. Relative to the pre-recession peak, real GDP is now estimated to be around 2 per cent higher at the end of 2012 than it looked at the time. And the estimated level of real GDP today is now closer to our optimistic June 2010 forecast than to our pessimistic March 2013 forecast.

Chart 1.3: Selected vintages of ONS real GDP estimates and OBR forecasts



Note: Solid lines indicate ONS data and dotted lines indicate OBR forecasts.  
Source: ONS, OBR

- 1.17** Quarterly GDP growth was slightly stronger than we forecast in the second quarter at 0.7 per cent, but slightly weaker in the third quarter at 0.5 per cent. Our forecast for the composition of growth was subject to bigger errors, thanks largely to extremely volatile trade growth. Net trade contributed 1.4 percentage points to GDP growth in the second quarter, but monthly data suggest that it may have then subtracted around 1 percentage point in the third. As expected, consumer price inflation has fallen to zero. Unemployment has also fallen in line with our July forecast, reaching 5.3 per cent in the third quarter.
- 1.18** GDP growth in advanced economies in the second quarter of 2015 was below our July forecast. The US economy picked up after a weak first quarter, but GDP fell in both Canada and Japan, while growth in the euro area remains weak. Inflation in most major advanced economies is currently close to zero. China's economy continued to slow in the third quarter, with GDP growth at its slowest rate in six years.

## The economic outlook

- 1.19** Since our last forecast, the ONS has updated its population projections. The new projections assume slightly faster population growth (driven by higher net inward migration) and slightly higher mortality rates among older people. We have also fully modelled the effects of the changing age structure of the population on employment rates for this forecast. This suggests that net inward migration of predominantly working-age people will lift the employment rate in the near term, but population ageing will bring it back down in the final years of the forecast. We have also made a small downward revision to underlying productivity growth in the near term, though we continue to expect it to return to historical average rates by the end of the forecast. The net effect of all these changes is a small

downward revision to cumulative potential output growth over the forecast period, in other words the amount of growth the economy can sustain without inflation taking off.

- 1.20 These changes to potential output growth combine with the impact of the Government's policy decisions to explain most of the changes to our real GDP forecast since July. Growth in 2015 is unchanged at 2.4 per cent, but we have revised it higher in 2016 and 2017 by 0.1 percentage points in each year. In 2016, that mainly reflects the Government's decision to ease the pace of fiscal tightening. In 2017, the revisions to underlying potential output growth are more important. We have also revised GDP growth down in 2020 because of the effect of population ageing on the employment rate.
- 1.21 We have also made some changes to the composition of GDP growth. We expect net trade to be a smaller drag than we assumed in July, following downward revisions to imports growth that outweigh the impact of downward revisions to world trade growth on UK exports. The balance of domestic demand has also been affected by the Government's decision to increase departmental current and capital spending in the Spending Review.
- 1.22 We have made only small changes to our inflation forecast. Oil prices have fallen further since July, but sterling has depreciated – with broadly offsetting effects. Unit labour costs place slightly greater upward pressure on inflation in the next couple of years, but policy measures in the Autumn Statement lower CPI inflation slightly in 2017 via lower energy bills. The latter also affects RPI inflation in 2017, but across the forecast it is more than offset by the decision to make it easier for some local authorities to raise council tax. That adds just under 0.1 percentage points a year to RPI inflation, but does not affect CPI inflation.
- 1.23 Employment has grown strongly this year, taking it above 31 million for the first time. But we expect employment growth to slow over the forecast period as productivity growth recovers towards its historical average. Meanwhile, the unemployment rate has fallen to 5.3 per cent and wage growth has picked up. Despite this pick-up, we have revised average earnings growth lower relative to our July forecast. That partly reflects small adjustments to our productivity growth forecast, but also an assumption that the ongoing costs of auto-enrolment and the introduction of an apprenticeship levy will weigh on earnings growth. These are both economically equivalent to payroll taxes, so – consistent with evidence on the incidence of such taxes – we assume that most of the cost will ultimately be borne by employees. Together, auto-enrolment and the new apprenticeship levy reduce cumulative wage growth over the forecast period by 0.7 per cent. This estimate relies on assumptions about how firms respond to such changes, so is subject to considerable uncertainty.
- 1.24 We expect house price inflation to average around 5 per cent a year over the forecast period, leading to a continued rise in the ratio of average house prices to earnings. This forecast is little changed from July. But we have revised down our forecast for property transactions, reflecting recent research suggesting that private landlords tend to hold properties for longer than owner-occupiers. This means that the rising proportion of the housing stock owned by private landlords would be consistent with fewer property transactions in the steady state. We have also assumed that property transactions will be

reduced by the Government's decision to introduce an additional stamp duty land tax charge of 3 per cent on purchases of properties as a second home or as a buy-to-let.

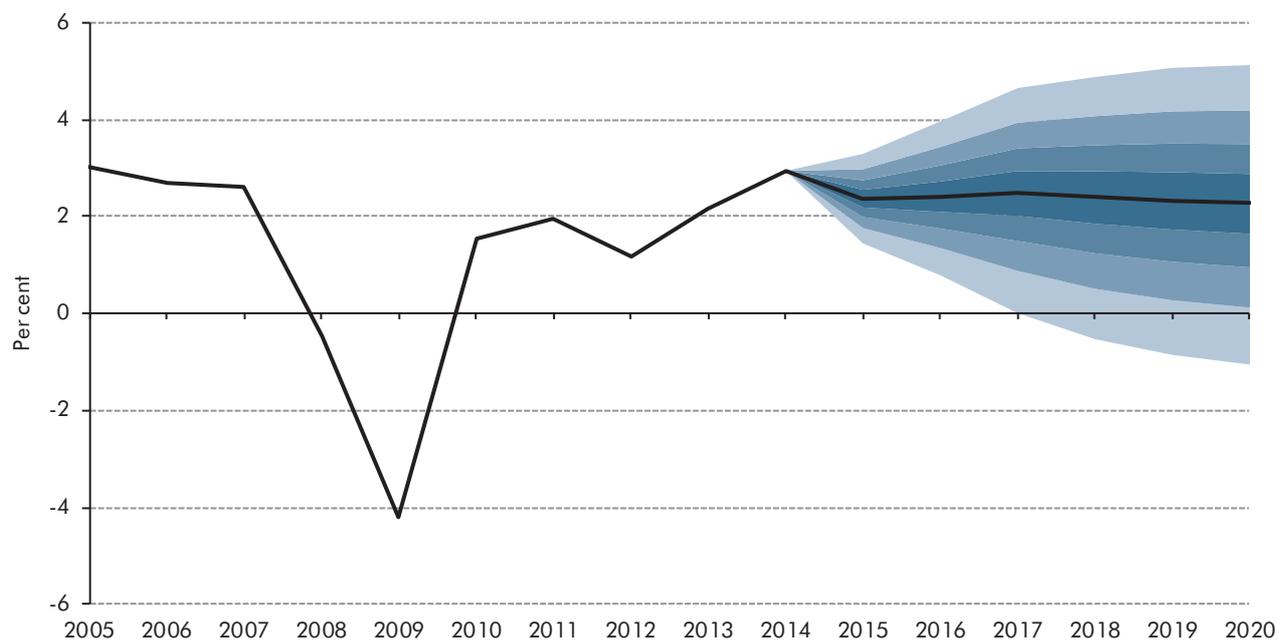
Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2014	2015	2016	2017	2018	2019	2020
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	2.9	2.4	2.4	2.5	2.4	2.3	2.3
GDP levels (2014=100)	100.0	102.4	104.8	107.4	110.0	112.6	115.1
Output gap	-1.0	-0.7	-0.4	-0.1	0.0	0.0	0.0
<b>Expenditure components of GDP</b>							
Household consumption	2.6	2.9	2.6	2.3	2.3	2.1	1.9
General government consumption	1.9	1.7	0.4	0.6	0.5	0.5	1.1
Business investment	4.6	6.1	7.4	7.1	7.0	6.6	4.5
General government investment	7.6	3.0	0.8	0.6	-1.6	1.7	9.2
Net trade <sup>1</sup>	-0.4	0.1	-0.2	-0.1	-0.1	-0.1	-0.1
<b>Inflation</b>							
CPI	1.5	0.1	1.0	1.8	1.9	2.0	2.0
<b>Labour market</b>							
Employment (millions)	30.7	31.1	31.5	31.7	31.9	32.0	32.2
Average earnings	1.5	2.6	3.4	3.7	3.6	3.7	3.9
LFS unemployment (% rate)	6.2	5.5	5.2	5.2	5.3	5.4	5.4
Claimant count (millions)	1.04	0.80	0.77	0.82	0.86	0.87	0.88
<b>Changes since July forecast</b>							
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	-0.1	-0.1	0.1	0.1	0.0	0.0	-0.1
GDP levels (2014=100)	0.0	-0.1	0.0	0.1	0.1	0.1	-0.1
Output gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Expenditure components of GDP</b>							
Household consumption	0.2	-0.1	0.1	0.0	0.0	-0.2	-0.2
General government consumption	0.3	0.5	-0.1	0.3	0.4	0.2	-1.5
Business investment	-3.4	0.1	0.2	0.2	0.4	0.1	-0.2
General government investment	4.2	0.6	0.9	-0.4	-4.0	-0.6	7.2
Net trade <sup>1</sup>	0.3	0.6	0.2	0.1	0.1	0.2	0.1
<b>Inflation</b>							
CPI	0.0	-0.1	-0.1	0.1	0.1	0.1	0.0
<b>Labour market</b>							
Employment (millions)	0.0	-0.1	0.0	0.1	0.2	0.1	0.1
Average earnings	-1.1	0.5	-0.2	-0.2	-0.3	-0.4	-0.4
LFS unemployment (% rate)	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Claimant count (millions)	0.00	0.02	0.04	0.07	0.09	0.09	0.09

<sup>1</sup> Contribution to GDP growth.

**1.25** There is considerable uncertainty around any economic forecast. Chart 1.4 presents our central growth forecast with a fan showing the probability of different outcomes based on past official forecast errors. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands.

Chart 1.4: Real GDP growth fan chart



Source: ONS, OBR

## The fiscal outlook

**1.26** Public sector net borrowing peaked at 10.2 per cent of GDP (£153.5 billion) in 2009-10 as the late 2000s recession and financial crisis dealt the public finances a significant blow. Fiscal consolidation and economic recovery then reduced the deficit to 4.9 per cent of GDP (£90.1 billion) by 2014-15 (excluding the impact of the housing association reclassification described below). Table 1.2 shows that on current policy we expect the deficit to continue falling, and the budget to move into surplus in 2019-20, unchanged from our July forecast.

Table 1.2: Fiscal forecast overview

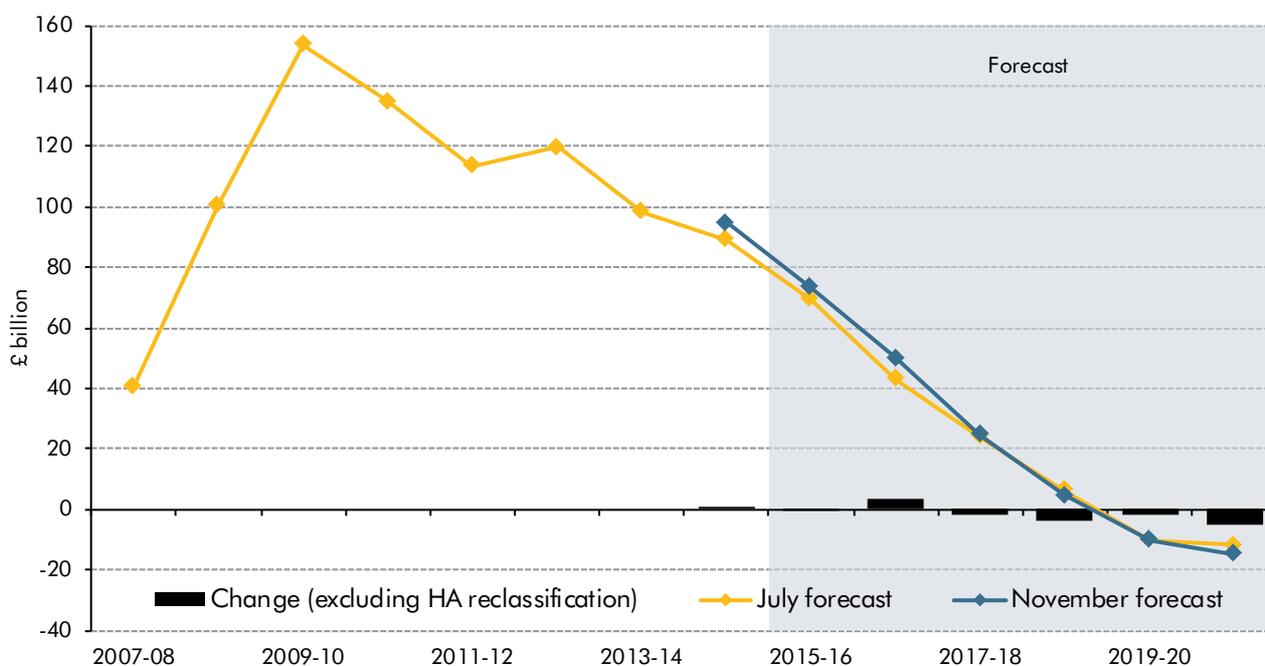
	Per cent of GDP						
	Outturn	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Revenue and spending</b>							
Public sector current receipts	35.8	35.8	36.5	36.9	36.9	36.9	37.1
Total managed expenditure	40.9	39.7	39.1	38.1	37.2	36.5	36.4
<b>Deficit: Fiscal mandate</b>							
Public sector net borrowing	5.2	3.9	2.5	1.2	0.2	-0.5	-0.6
Cyclically adjusted current budget deficit	2.4	1.6	0.5	-0.5	-1.2	-1.9	-2.4
<b>Debt: Supplementary target</b>							
Public sector net debt	83.1	82.5	81.7	79.9	77.3	74.3	71.3
Like-for-like changes since July forecast							
<b>Revenue and spending</b>							
Public sector current receipts	-0.3	-0.4	-0.3	0.0	0.0	-0.1	0.0
Total managed expenditure	-0.3	-0.5	-0.1	-0.1	-0.2	-0.2	-0.2
<b>Deficit: Fiscal mandate</b>							
Public sector net borrowing	0.0	-0.1	0.1	-0.1	-0.2	-0.1	-0.2
Cyclically adjusted current budget deficit	0.0	0.0	0.0	-0.1	-0.1	0.0	-0.5
<b>Debt: Supplementary target</b>							
Public sector net debt	-0.9	-1.2	-0.8	-0.7	-0.7	-0.4	-0.3

## Changes in public sector net borrowing and net debt

- 1.27 Since our last forecast in July, the ONS has announced that it will reclassify housing associations from the private to the public sector, taking effect from 2008. It intends to implement that reclassification in the public finances data before Budget 2016. We always try to forecast the public finances consistent with how the ONS will measure them once it has implemented its classification decisions, so that our forecasts will be consistent with that eventual treatment. We have therefore included estimates of the effect on spending, receipts, borrowing and debt in this forecast (described in detail in Annex B).
- 1.28 To ensure that our latest forecast can be compared with July on a like-for-like basis, we have shown what the July forecast would have looked like had housing associations been included in the public sector then. We have also included an estimate of the effect in 2014-15, so that year-on-year changes in 2015-16 remain meaningful. But we have not adjusted any outturn data for prior years.
- 1.29 We expect borrowing to fall by £21.2 billion in 2015-16, which is a bigger drop than would be implied by extrapolating from the year-on-year change in borrowing in the first seven months of the year. There are a number of factors that we expect to push borrowing down at a faster pace in the rest of 2015-16. These include policy measures boosting self-assessment receipts, the December 2014 reform to stamp duty land tax (which depresses year-on-year comparisons until November 2015) and pressures on departmental spending subject to Treasury controls (including the effect of in-year spending cuts that the Government announced in June). Abstracting from the housing associations reclassification, borrowing has then been revised up in 2016-17, but lower thereafter. Including the

reclassification, the deficit is slightly bigger through to 2017-18 than in July, while the surplus expected in 2019-20 is little changed. The Government then aims to achieve a bigger surplus in 2020-21 than it was on course to do in July.

Chart 1.5: Public sector net borrowing



Note: November forecast for 2014-15 includes our estimate of the effect of housing associations.

Source: ONS, OBR

1.30 Table 1.3 sets out how changes due to the housing association reclassification, our underlying forecast judgements and the Government's policy decisions have affected our forecast for public sector net borrowing. It shows that:

- incorporating **housing associations** would have added £4.6 billion to our July forecast in 2015-16, but diminishing amounts thereafter. The fall in borrowing after 2015-16 reflects the effect on their capital spending of the July Budget measures to force social landlords to reduce rents by 1 per cent a year for four years and to require certain tenants to 'pay to stay' in their accommodation. We assume that the resulting fall in housing associations' rental income will lead to a greater fall in their capital spending, rather than the one-to-one relationship we assumed for our economy forecast in July. This has led to a declining path for housing associations' net borrowing on the basis of Government policy as it stood in July;
- we have revised up our **pre-measures receipts forecast** (which reduces borrowing and therefore shows up as negative figures in the table). Stronger-than-expected income tax and corporation tax receipts this year have boosted all years of the forecast. Improved modelling of national insurance contributions and correcting a systematic overestimate of VAT deductions has also raised receipts. Partly offsetting that, we have revised down stamp duty land tax receipts reflecting a substantial fall in the number of

transactions at very high prices. The net boost to receipts peaks in 2017-18 and then declines as slightly lower nominal GDP growth reduces income taxes in particular;

- our **pre-measures forecast for AME spending** is higher in the near term, but lower in the latter part of the forecast. Welfare spending, particularly on disability benefits, and local authority spending are higher than expected. But debt interest spending is revised down by increasing amounts from 2016-17 onwards, reflecting lower interest rates and an assumed delay to the reversal of quantitative easing;
- the **direct effect of the Government's policy decisions** has been to push borrowing higher between 2016-17 and 2019-20, but to increase the surplus in 2020-21. The Government has chosen to increase departmental current spending across the Spending Review period, but to reduce it in 2020-21. It has also raised departmental capital spending in the first half of the Spending Review period but reduced it slightly in the second half. Then in 2020-21 it has added £6.4 billion to capital spending. Policy measures on the Treasury's 'scorecard' include tax rises in every year, plus welfare giveaways in the near term (reversing July's main cuts to tax credits) that are more than offset by other welfare cuts by the end of the forecast. The Government has also announced that some local authorities will be allowed to raise council tax faster than previously assumed to meet some of the costs of social care and policing. That raises tax and local authority spending, with an almost neutral effect on borrowing; and
- the net **indirect effects** on the public finances of the Government's decisions are small. Positive effects include the boost to revenues from the near-term increase in GDP growth, while smaller cuts to central government workforces (from higher RDEL) increase pension contributions and so reduce net spending on public service pensions. Working in the opposite direction, helping some local authorities to raise council tax will push up debt interest costs (via its impact on the Retail Prices Index), while the imposition of the apprenticeship levy will reduce tax revenues by weakening earnings growth. (Lower earnings growth also reduces the amount by which the triple lock uprates the state pension, thereby reducing spending a little too.)

Table 1.3: Changes to public sector net borrowing since July

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>July forecast</b>	<b>89.2</b>	<b>69.5</b>	<b>43.1</b>	<b>24.3</b>	<b>6.4</b>	<b>-10.0</b>	<b>-11.6</b>
Housing associations reclassification	4.5	4.6	3.5	2.3	1.8	1.4	1.6
<b>July forecast restated to include HAs</b>	<b>93.7</b>	<b>74.1</b>	<b>46.7</b>	<b>26.5</b>	<b>8.2</b>	<b>-8.5</b>	<b>-10.0</b>
<b>Total forecast changes</b>	<b>0.9</b>	<b>-0.5</b>	<b>-2.9</b>	<b>-7.9</b>	<b>-8.0</b>	<b>-3.8</b>	<b>-4.4</b>
of which:							
Receipts	-1.5	-2.5	-4.1	-6.3	-5.4	-2.8	-2.8
AME spending	2.4	2.1	1.4	-1.4	-2.3	-0.8	-1.4
Revisions to DEL spending	0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
<b>November forecast pre-policy decisions</b>	<b>94.7</b>	<b>73.6</b>	<b>43.8</b>	<b>18.6</b>	<b>0.2</b>	<b>-12.3</b>	<b>-14.4</b>
<b>Total effect of Government decisions</b>		<b>-0.1</b>	<b>6.2</b>	<b>6.2</b>	<b>4.4</b>	<b>2.2</b>	<b>-0.3</b>
of which:							
Scorecard receipts measures		-0.3	-0.6	-4.5	-4.6	-5.5	-5.3
Scorecard AME spending measures		0.0	2.6	1.7	0.3	-0.7	-1.1
Non-scorecard measures		0.0	-0.4	0.1	0.5	0.5	1.2
Changes to RDEL spending		0.3	2.3	6.5	9.3	8.3	-3.6
Changes to CDEL spending		-0.1	2.9	3.3	-0.4	-0.3	6.4
Indirect effect of Government decisions		0.0	-0.6	-0.9	-0.7	-0.1	2.0
<b>November forecast</b>	<b>94.7</b>	<b>73.5</b>	<b>49.9</b>	<b>24.8</b>	<b>4.6</b>	<b>-10.1</b>	<b>-14.7</b>
<b>Change on a like-for-like basis</b>	<b>0.9</b>	<b>-0.6</b>	<b>3.3</b>	<b>-1.7</b>	<b>-3.6</b>	<b>-1.6</b>	<b>-4.7</b>
<i>Memo: November forecast excluding housing association reclassification</i>	90.1	68.9	46.8	22.4	2.2	-12.1	-17.6

Note: This table uses the convention that a negative figure means a reduction in PSNB, i.e. an increase in receipts or a reduction in spending will have a negative effect on PSNB.

1.31 We expect public sector net debt (PSND) to have peaked as a percentage of GDP in 2014-15 and to fall in every year of the forecast. Table 1.4 shows how our forecast has changed since July. At that time we highlighted the risk that the Government's decision to force housing associations to cut rents by 1 per cent a year for four years might prompt the ONS to reconsider their classification as private sector entities – and that if they were reclassified to the public sector it would lead to a significant rise in the level of PSND. That has in fact happened, with effect from 2008. We estimate that our July forecast for PSND would have been between 3.1 and 3.4 per cent of GDP higher over the forecast period if housing associations had been classified in the public sector at that time.

1.32 Abstracting from this reclassification, our forecast for PSND has been revised up in cash terms but down as a share of GDP since July. That reflects:

- upward revisions to the level of **nominal GDP** in Blue Book 2015, which lower the debt-to-GDP ratio in every year of the forecast;
- **cumulative borrowing** across the forecast has been revised down slightly, measured on a like-for-like basis. That reflects a downward revision in our pre-measures forecast for borrowing, partly offset by the impact of the Government's policy decisions, which increase spending by more in aggregate than they increase revenue;

- the Bank of England announced in November that it would keep the stock of gilts held in the **Asset Purchase Facility (APF)** at £375 billion until Bank Rate reaches a level from which it can be cut materially. The MPC currently judge this to be around 2 per cent – a level that markets are not pricing in until beyond our five-year horizon.<sup>2</sup> This reduces debt interest spending (and thus borrowing). But it also increases PSND because the nominal (as opposed to the market) value of the gilts the APF holds exceeds the value of the reserves the Bank created to purchase them. (In other words, the Bank pays more for the gilts than they will be worth on redemption.) This effect diminished over time in our previous forecast, as the Bank was assumed to stop buying gilts to replace those that were redeemed from early 2016-17. So the decision to continue doing so for longer adds increasing amounts to PSND, reaching £18 billion by 2020-21. (Netting off the debt interest saving, the total increase in PSND is £12 billion);
- there have been a number of changes to our forecast for **asset sales**. We have revised up the expected proceeds from UKAR sales, with the Granite sale having been completed earlier in the year than we expected and further sales having been announced on top of the natural rundown of UKAR's assets. Conversely, we no longer expect the first student loan book sale to be completed in 2015-16, while the Royal Mail share sale raised less than expected (partly due to a lower share price and partly because the Government chose to give more shares to Royal Mail staff for free). We have also revised down the expected proceeds from the remaining Lloyds share sales, to reflect both the current share price and the Government's intention to give some 'bonus' shares away to retail investors. The Government has also announced that it will sell a further £5.8 billion of RBS shares in 2020-21; and
- **other changes** include a lower adjustment to align our forecasts of the net cash requirement and net borrowing (an effect that is offset within borrowing), as well as small changes to gilt premia.

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<sup>2</sup> See "The MPC's asset purchases as Bank Rate rises", a box in the November 2015 *Inflation Report*.

Table 1.4: Changes to public sector net debt since July

	Per cent of GDP						
	Estimate 2014-15	Forecast					
		2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>July forecast</b>	<b>80.8</b>	<b>80.3</b>	<b>79.1</b>	<b>77.2</b>	<b>74.7</b>	<b>71.5</b>	<b>68.5</b>
Housing association reclassification							
Per cent of GDP	3.2	3.3	3.4	3.3	3.3	3.2	3.1
£ billion	59	64	67	69	71	72	74
<b>July forecast restated to include HAs</b>	<b>84.0</b>	<b>83.6</b>	<b>82.5</b>	<b>80.6</b>	<b>78.0</b>	<b>74.7</b>	<b>71.6</b>
<b>Change</b>	<b>-0.9</b>	<b>-1.2</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-0.7</b>	<b>-0.4</b>	<b>-0.3</b>
of which:							
Change in nominal GDP <sup>1</sup>	-1.0	-1.3	-1.3	-1.3	-1.3	-1.2	-0.9
Change in cash level of net debt	0.0	0.2	0.5	0.6	0.5	0.8	0.6
<b>November forecast</b>	<b>83.1</b>	<b>82.5</b>	<b>81.7</b>	<b>79.9</b>	<b>77.3</b>	<b>74.3</b>	<b>71.3</b>
	£ billion						
July forecast restated to include HAs	1545	1596	1643	1672	1690	1691	1700
November forecast	1546	1599	1652	1685	1702	1708	1715
<b>Change in cash level of net debt</b>	<b>1</b>	<b>4</b>	<b>10</b>	<b>12</b>	<b>12</b>	<b>18</b>	<b>14</b>
of which:							
Borrowing	1	0	4	2	-2	-3	-8
APF gilt valuation effect	0	0	4	8	12	17	18
UKAR and other asset sales	0	4	1	1	0	0	-5
Gilt premia	0	-2	1	-1	-1	0	-1
Lending	0	-1	0	1	1	3	6
CGNCR adjustment	0	1	1	2	2	3	3
Other factors	0	2	-1	0	-1	-2	0

<sup>1</sup> Non-seasonally-adjusted GDP centred end-March.

## The path from deficit to surplus

**1.33** On the basis of the latest ONS estimates, which do not yet include the effect of reclassifying housing associations to the public sector, the budget deficit fell by 5.3 per cent of GDP over the last Parliament. We expect the deficit (including housing associations) to fall by 1.3 per cent of GDP this year and on the basis of our latest forecast – now based on firm spending plans detailed in the Government’s Spending Review – there is a further 4.3 per cent of GDP improvement planned for the rest of this Parliament. That would take the budget into surplus for the first time since 2001-02.

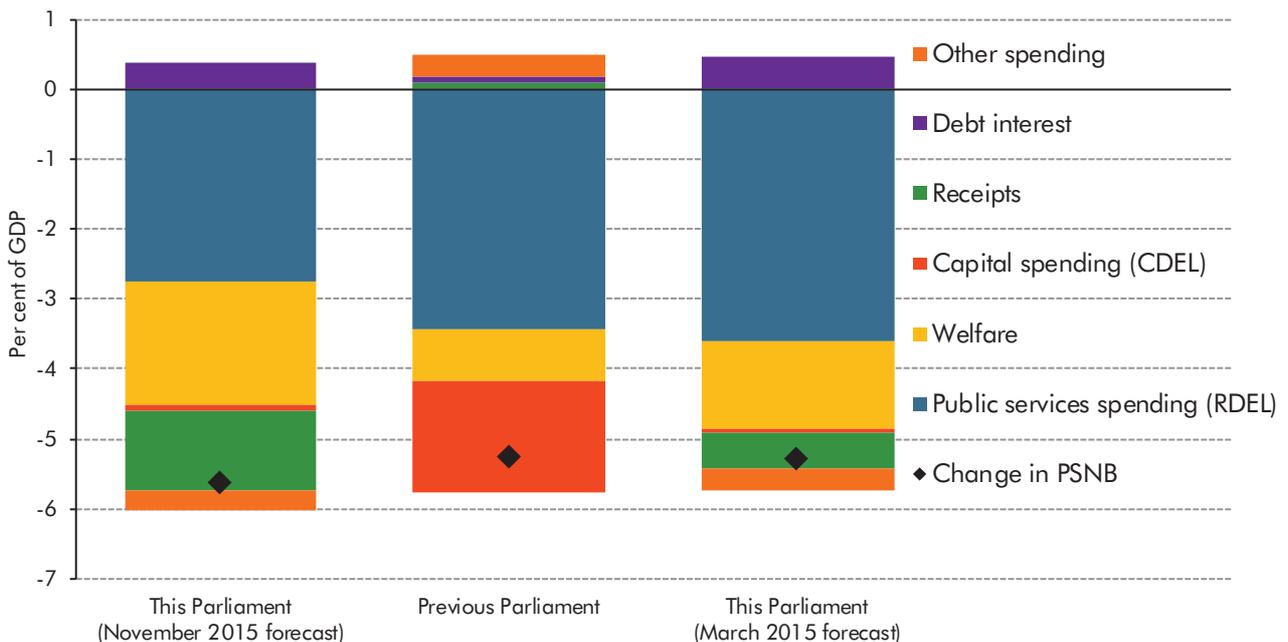
**1.34** As Chart 1.6 shows, the composition of the improvement in the budget balance that the Government plans to deliver over this Parliament (from 2014-15 to 2019-20) differs from that achieved in the last Parliament (from 2009-10 to 2014-15) and from the Coalition’s plans in March. In particular:

- **compared with the last Parliament**, the cuts to public services spending (as a share of GDP) are around a fifth smaller. Capital spending – which contributed to deficit reduction in the last Parliament when it was cut back after the 2009-10 fiscal stimulus – is planned to remain almost flat as a share of GDP in this Parliament. Lower welfare spending is expected to contribute more than twice as much to improving the budget

balance than it did in the last Parliament, while receipts are expected to rise as a share of GDP where they were flat in the last Parliament. That reflects both policy measures and the effects of economic growth interacting with the structure of the tax and benefits systems. Most tax rates and benefit awards move with inflation rather than earnings, so growth in real earnings drags more income into higher tax brackets and reduces the generosity of benefits relative to average earnings in the rest of the economy. In the last Parliament policy measures to increase taxes were offset in their impact on revenues, for example by the impact of weak earnings growth and changes in the distribution of wages on income taxes, and by falling North Sea receipts; and

- compared with the forecast for this Parliament that we prepared for the Coalition’s final Budget in March, the extent to which public services spending will be cut as a share of GDP is around a quarter lower following the increases announced in the July Budget and added to in this Spending Review. Tax rises and welfare spending cuts also contribute a more to the change in the deficit than the Coalition planned in March, while debt interest is set to rise less.

Chart 1.6: Fiscal consolidation over two Parliaments

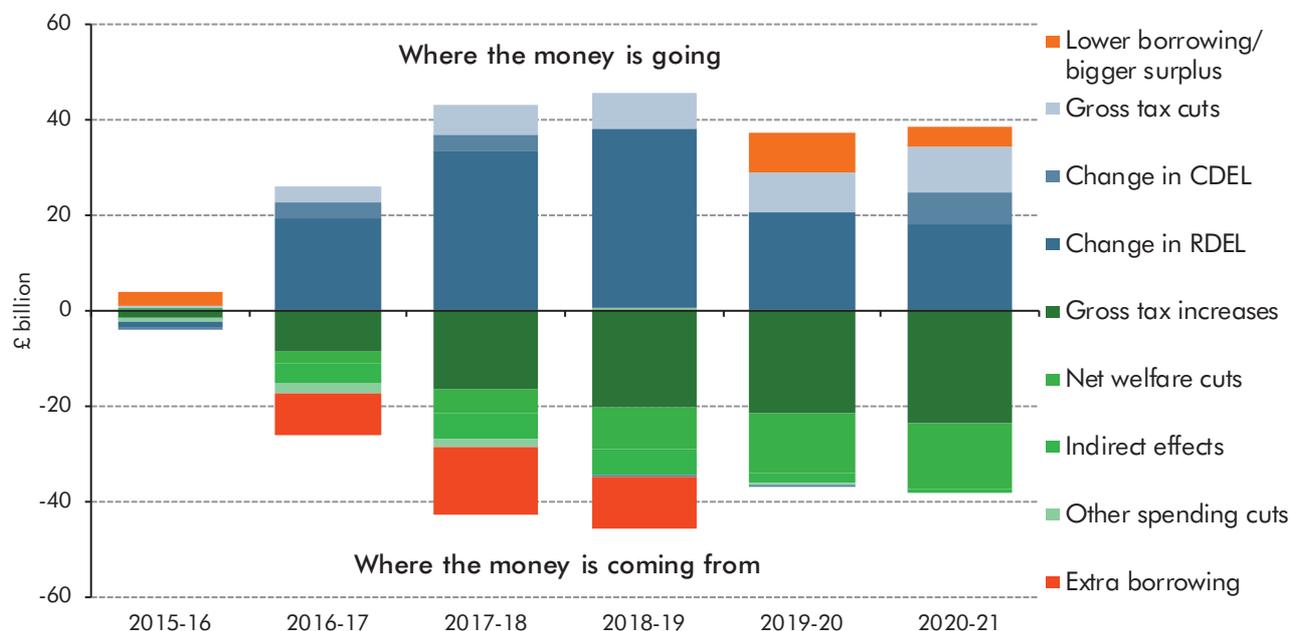


Source: ONS, OBR

1.35 Chart 1.7 summarises the cumulative impact across the forecast of the Government’s policy decisions since March. July’s modest spending cuts and tax increases reduced borrowing a little this year. Over the following three years, welfare cuts and tax increases mount steadily, but they are not large enough to pay for the higher public services spending and tax cuts – hence the need for more borrowing to fill the gap. In the final two years the welfare cuts, tax increases and indirect effects more than pay for the tax cuts and (smaller) additions to public services spending – increasing the then budget surplus. In aggregate over the full five years, the measures in the two statements increase RDEL spending by £129 billion and deliver £36

billion of tax cuts. This is paid for by £91 billion of tax increases, £43 billion of welfare cuts, £19 billion of indirect revenue and spending effects and £21 billion more borrowing.

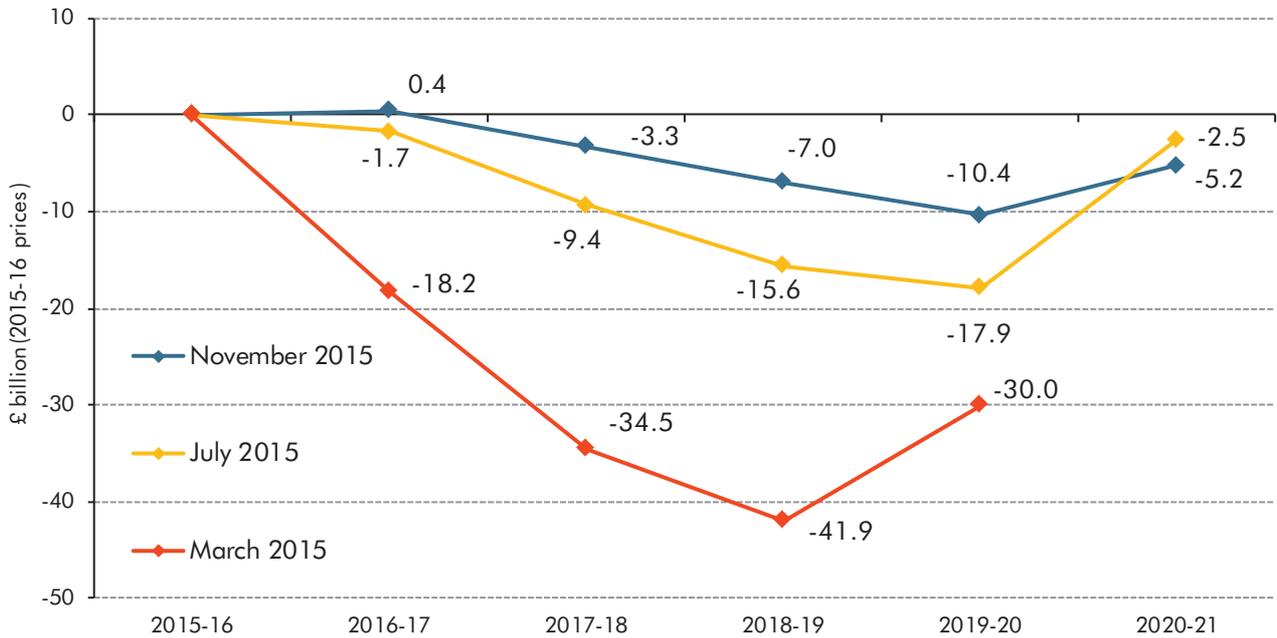
Chart 1.7: The impact of Government policy decisions on the forecast since March



Source: OBR

1.36 As a result of the decisions the Government has taken in July and now, it has lifted and smoothed the path of **current (RDEL) spending**. Taking account of expected underspending against the Government's plans, we expect RDEL spending to be cut by £10.4 billion in real terms by 2019-20. That is around 40 per cent less than the £17.9 billion cut by that year pencilled in by the Government in July and only around a quarter of the £41.9 billion peak cut pencilled in by the Coalition in March (which was to be delivered a year earlier in 2018-19). In contrast to March and July, the Government also no longer assumes that, once the budget has moved into surplus, the real cut to spending will shift significantly into reverse. It is also now expected to fall appreciably less quickly in real terms over this Parliament than the last – by an average of 1.1 per cent a year, compared to 1.6 per cent a year.

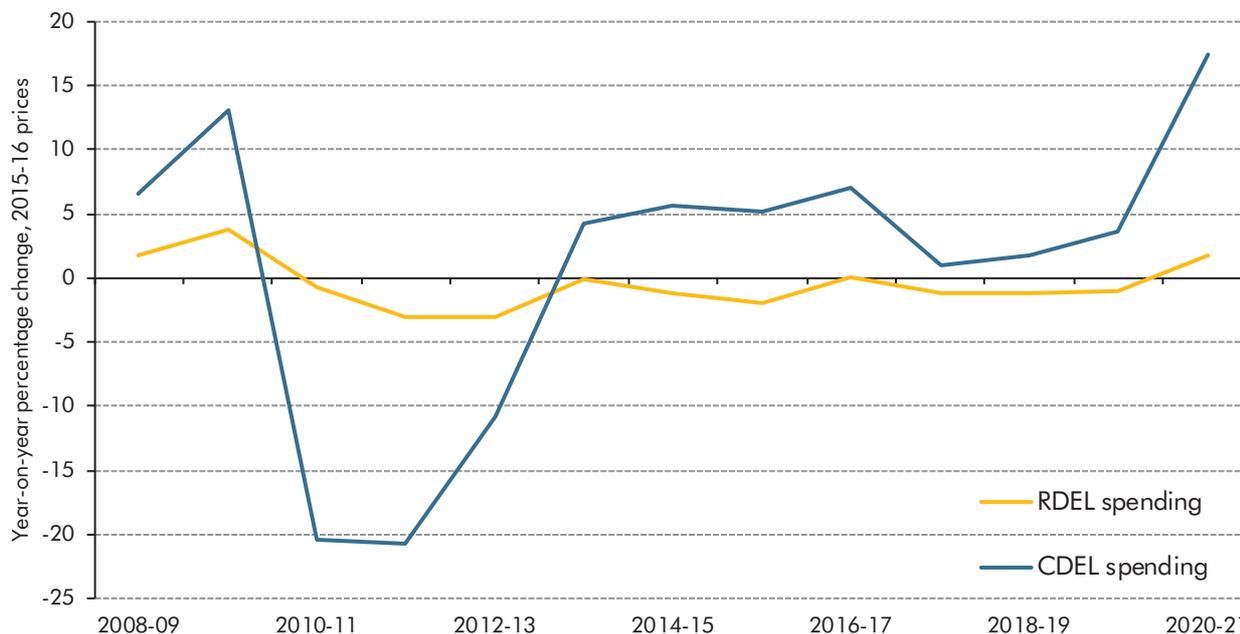
Chart 1.8: Change in real RDEL from 2015-16



Source: OBR

1.37 The Government has also set plans that – again taking account of expected underspending – will see **capital (CDEL) spending** rise by 14 per cent in real terms over the Spending Review period to 2019-20, increasing it slightly as a share of GDP. Then in 2020-21, the Government has told us that its policy assumption is for CDEL plans to rise by 20 per cent in real terms. Even assuming, as we have, that such rapid growth would be accompanied by a greater degree of underspending, CDEL spending would rise by 17 per cent in real terms in that year, faster even than the Labour Government delivered as part of the fiscal stimulus in 2009-10. Large investment projects can affect the path of capital spending from year to year, but it is striking how much more volatile it has been than current spending, both in outturn and in the latest set of Government plans and projections, despite its inherently long-term nature.

Chart 1.9: Real growth in departmental current and capital spending



Note: Both series have been adjusted for the effects of significant discontinuities, details of which are in the supplementary fiscal tables on our website.

Source: HMT, OBR

## Performance against the Government's fiscal targets

1.38 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of hitting its fiscal targets under existing policy. The *Charter* has been updated again since our last forecast, with the latest version approved by Parliament in October (and available on our website). It sets out the targets for borrowing, debt and welfare spending that are assessed in this forecast:

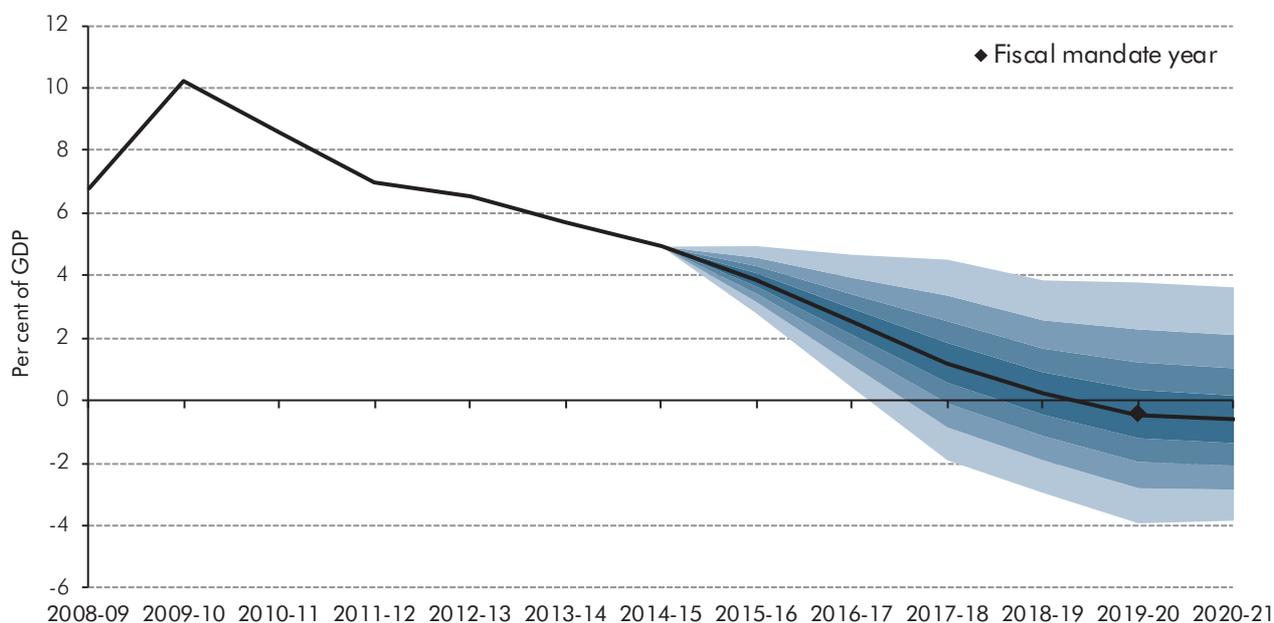
- the **fiscal mandate**, which requires a surplus on public sector net borrowing by the end of 2019-20 and in each subsequent year;
- the **supplementary target**, which requires public sector net debt to fall as a percentage of GDP in each year to 2019-20; and
- the **welfare cap**, a limit on a subset of welfare spending, at cash levels set out by the Treasury for each year to 2020-21 in the July 2015 Budget.

1.39 On our central forecast, we judge that the Government has a greater than 50 per cent chance of meeting the fiscal mandate and supplementary target. We expect the budget to be in surplus by 0.5 per cent of GDP (£10.1 billion) in 2019-20 and public sector net debt to fall by 0.6 per cent of GDP in 2015-16 and by bigger margins in subsequent years.

1.40 All forecasts are subject to significant uncertainty. Chart 1.10 shows our median forecast for public sector net borrowing. Successive pairs of shaded areas around the median forecast represent 20 per cent probability bands. As in Chart 1.4 for our GDP growth forecast, the

bands show the probability of different outcomes if past official errors were a reasonable guide to future forecast errors.

Chart 1.10: Public sector net borrowing fan chart



Source: ONS, OBR

- 1.41 For the purpose of assessing the fiscal mandate, the Government now asks us to assess whether the economy will be in ‘normal times’ after 2019-20, which it has defined as growing by more than 1 per cent on a 4-quarter-on-4-quarter basis. On our central forecast, growth will be above 1 per cent on that metric, but the probability distribution used to generate Chart 1.4 suggests there is a 30 per cent probability of growth falling below the threshold in 2020.
- 1.42 Our central forecast shows that the terms of the welfare cap are set to be breached in three successive years from 2016-17 to 2018-19, with the net effect of policy measures raising welfare cap spending in each of those years, and to well above the 2 per cent forecast margin in 2016-17 and 2017-18. The terms of the cap are set to be observed by very small margins in 2019-20 and 2020-21, with spending above the cap but within the forecast margin and with the net effect of measures in those years reducing spending.
- 1.43 The uncertainties around our central forecast reflect those regarding the outlook for the economy and those regarding the performance of revenues and spending in any given state of the economy. So we test the robustness of our judgement in three ways:
- first, by looking at **past forecast errors**, if our central forecasts are as accurate as official forecasts were in the past, then there is a roughly 55 per cent chance that PSNB will be in balance or surplus in 2019-20 (as the fiscal mandate requires);

- second, by looking at its **sensitivity to varying key features of the economic forecast**. The surplus in 2019-20 could fall to zero due to relatively small differences in the output gap (if it were -0.6 per cent in that year, not zero), potential output (if it were 0.8 per cent lower), whole economy prices (1.1 per cent lower), debt interest spending (due to interest rates 0.9 percentage points higher than market expectations or a 2.2 percentage point upside surprise in RPI inflation), effective tax rates (a 0.5 percentage point lower tax-to-GDP ratio, due to the composition of GDP, distribution of incomes or movements in asset prices), or the delivery of public spending cuts (a quarter less than planned); and
- third, by looking at **alternative economic scenarios**. Since all the Government's fiscal targets are now sensitive to cyclical as well as structural movements in the economy, we have considered three scenarios that involve illustrative cyclical shocks hitting in 2018. The 'positive shock' scenario sees the deficit move to surplus a year earlier than in our central forecast and the debt-to-GDP ratio falling by bigger amounts each year. Welfare cap spending would remain within the forecast margin. The 'growth slowdown' scenario, calibrated to be similar to the slowdown in 2012 where (on the latest data) GDP growth remained just above the 1 per cent 'normal times' threshold defined in the fiscal mandate, would see the deficit persist in 2019-20, so the fiscal mandate would be missed. Debt would continue to fall as a share of GDP in every year and welfare cap spending would remain within the forecast margin during the slowdown. Finally, in the 'negative shock' scenario, which we have calibrated such that real and nominal GDP fall in absolute terms, the fiscal mandate and supplementary debt targets would be missed. Welfare cap spending would be close to the top of the forecast margin, but the increase would be comparatively small since the most cyclical elements of welfare spending are outside the cap. Tax credits spending would be pushed up due to weaker earnings, but much lower inflation would offset much of that effect via lower upratings.



## 2 Developments since the last forecast

2.1 This chapter summarises:

- the main economic and fiscal data developments since our last forecast in July 2015 (from paragraph 2.2); and
- recent external forecasts for the UK economy (from paragraph 2.21).

### Economic developments

#### Data revisions and Blue Book 2015 changes

2.2 Each year, the publication of the Blue Book provides the Office for National Statistics (ONS) with an opportunity to make methodological changes to the National Accounts, on top of the normal quarterly process of incorporating new data into its estimates of GDP growth. Changes this year included:

- how the ONS captures the under-coverage of incomes accruing to small businesses and incomes concealed by businesses and households through tax evasion;
- reclassifications of some transactions, including the sale of 4G spectrum licences, and some entities, including Network Rail; and
- several adjustments to the measurement of gross fixed capital formation, including revisions to the deflator used to capture software prices. These adjustments increased the measured level of real gross fixed capital formation between 1997 and 2014, thereby increasing the level of real GDP.

2.3 One effect of these changes has been to revise up the level of nominal GDP, particularly in more recent years. In the first quarter of 2015, the increase was 1.1 per cent. The Blue Book changes have also revised real GDP growth back to 1983. The most substantial changes have been in recent years, particularly since the late 2000s recession. The path of real GDP growth since 2010 has been smoothed relative to previous estimates. Growth in 2010 was revised down from 1.9 per cent to 1.5 per cent, whereas growth in each of 2011, 2012 and 2013 was revised up by between 0.3 and 0.5 percentage points. As Table 2.1 shows, the effect of these changes has been to raise cumulative GDP growth since the trough in the second quarter of 2009 by 0.9 percentage points. Private consumption and stockbuilding account for the majority of that upward revision.

Table 2.1: Contributions to real GDP growth from 2009Q3 to 2015Q1

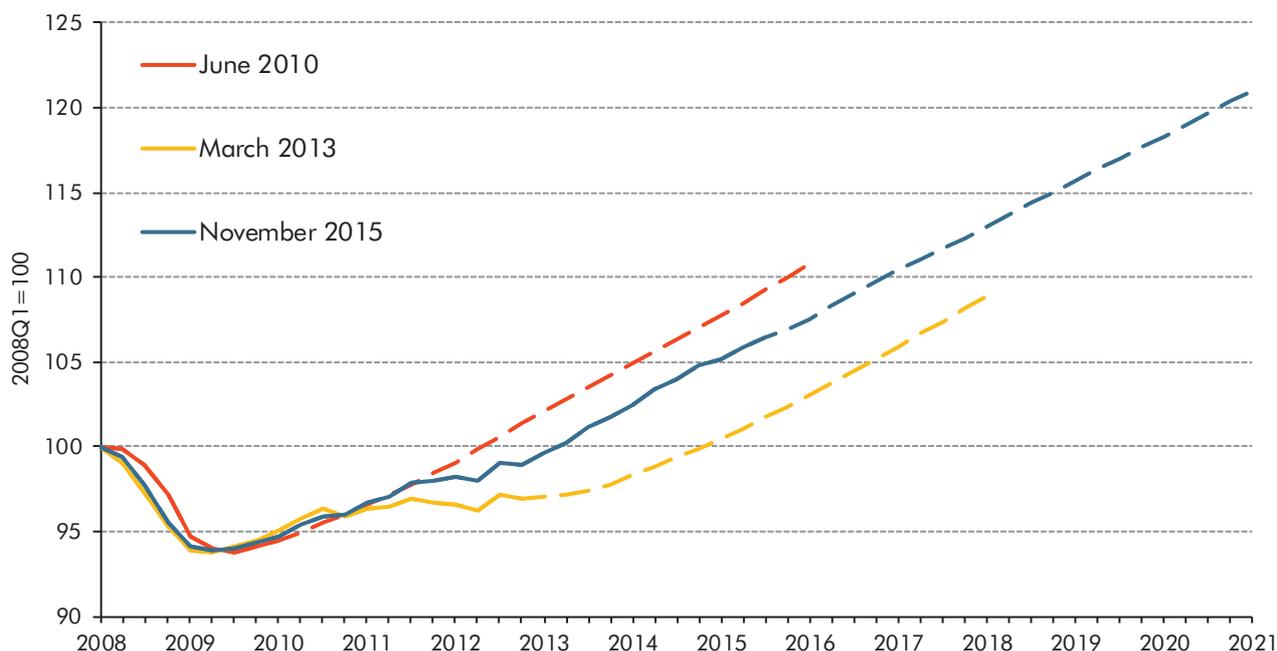
	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
July data	5.7	1.2	-0.1	4.7	-1.5	0.3	11.2
Latest data	6.1	1.4	0.1	4.4	-1.4	0.7	12.1
Difference <sup>1</sup>	0.4	0.1	0.2	-0.2	0.2	0.4	0.9

<sup>1</sup> Difference in unrounded numbers, rounded to one decimal place.

Note: Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is composed of the difference between the estimate of GDP led by the output approach and the expenditure estimate, and the effects of using chain-linked volumes before the base year. The statistical discrepancy is 0.9 and 0.8 percentage points for July and latest data respectively.

2.4 As Chart 2.1 shows, the latest revisions have left the path of real GDP since the low point of the last recession much closer to the path we expected when we made our first forecast in June 2010 than was apparent in previous ONS estimates. For example, relative to the pre-crisis peak the level of real GDP by the end of 2012 is now estimated to be 2.1 per cent higher than was shown in the data available when we produced our March 2013 forecast (which was our most pessimistic economy forecast).

Chart 2.1: Selected vintages of ONS real GDP estimates and OBR forecasts



Note: Solid lines indicate ONS data and dotted lines indicate OBR forecasts.

Source: ONS, OBR

2.5 Revisions to GDP deflator growth have been relatively small, with no more than a 0.2 percentage point change in any year since 2008. The net effect has been to leave cumulative growth of the GDP deflator since the mid-2009 trough in output unchanged, with stronger growth in the private consumption and investment deflators being offset by a smaller improvement in the terms of trade.

Table 2.2: Contributions to GDP deflator growth from 2009Q3 to 2015Q1

	Percentage points						Deflator growth, per cent
	Private consumption	Government consumption	Total investment	Exports	Imports	Stocks	
July data	9.5	0.7	0.4	2.0	-0.8	0.0	12.3
Latest data	10.0	0.8	1.0	2.6	-1.7	0.0	12.3
Difference <sup>1</sup>	0.6	0.1	0.5	0.5	-0.9	0.0	0.0

<sup>1</sup> Difference in unrounded numbers, rounded to one decimal place.

Note: Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is 0.4 and -0.4 percentage points for July and latest data respectively.

2.6 Since the changes to the GDP deflator net to zero over the period since mid-2009, revisions to nominal GDP are driven by those to real GDP. The net effect has been an upward revision to cumulative nominal GDP growth of 1.0 percentage points. The biggest contribution comes from stronger private consumption growth, with smaller positive contributions from government consumption and investment.

Table 2.3: Contributions to nominal GDP growth from 2009Q3 to 2015Q1

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
July data	15.9	2.0	0.1	5.6	-0.1	1.4	24.8
Latest data	16.8	2.2	0.5	5.4	-0.4	1.2	25.8
Difference <sup>1</sup>	0.9	0.2	0.4	-0.2	-0.3	-0.1	1.0

<sup>1</sup> Difference in unrounded numbers, rounded to one decimal place.

Note: Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is -0.1 and 0.1 percentage points for July and latest data respectively.

### Box 2.1: Productivity revisions over the recession and recovery in the UK and US

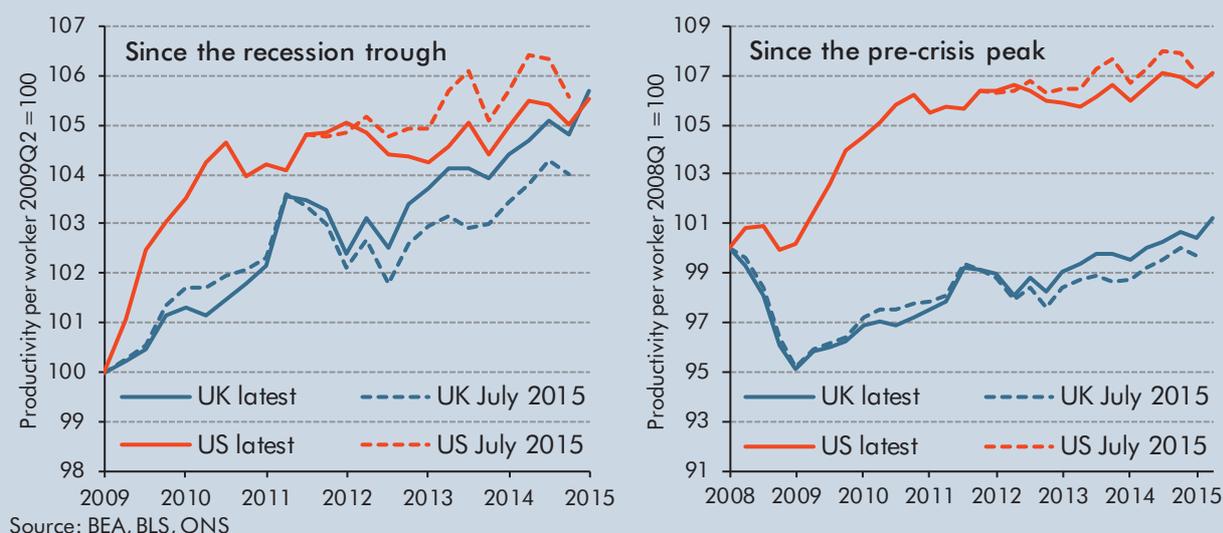
As we always stress, recent estimates of UK GDP growth represent an early draft of economic history that will be revised, often substantially, over time. Such revisions are not unique to the UK – a similar process is carried out by statistical offices around the world.

A recent OECD paper looked at the properties of GDP revisions to assess the accuracy and bias in early estimates.<sup>9</sup> It found that in almost all countries – including the UK – initial estimates have tended to be revised up over time. Compared to other OECD countries, the downward bias in UK early estimates was found to be slightly less than average and not statistically significant. The US stood out as the only country where initial GDP estimates tended to be revised down.

This pattern of revisions has played out in the latest UK and US GDP revisions. As the left-hand panel of Chart A shows, viewed in terms of GDP-per-worker, the vintage of GDP figures available at the time of our July forecast suggested that US productivity growth had been much stronger than the UK's since the beginning of the recovery in mid-2009. Following upward revisions to UK GDP growth and downward revisions to US GDP growth, productivity growth over that period is now estimated to have been similar on average in both countries. Future revisions may change this again.

More significantly, though, the right-hand panel shows that the latest revisions are small relative to the fall in productivity that the UK experienced in the immediate wake of the recession, which was not mirrored in the US (where employment fell more sharply). Looking at the period since the pre-crisis peak, the recent revisions still leave the UK with a substantial productivity shortfall relative to the US and relative to the pre-crisis trend in the UK. As set out in Chapter 3, prospects for productivity growth represent the most important uncertainty in our economy forecast.

Chart A: Current and previous estimates of US and UK productivity growth



<sup>9</sup> Zwijnenburg, J.: *Revision of quarterly GDP in selected OECD countries*, OECD Statistics Brief No.22, July 2015.

## GDP growth since the July 2015 forecast

- 2.7 Since our last forecast, the ONS has published full National Accounts data for the second quarter of 2015 and its preliminary GDP estimate for the third quarter.
- 2.8 GDP growth in the second quarter was 0.1 percentage points stronger than we expected on a quarterly basis, but growth in the year to that quarter was 0.1 percentage points lower than we forecast in July. While headline GDP growth was close to forecast, there were greater differences in its composition. As Table 2.4 shows, net trade was much stronger than forecast, but that was partially offset by much weaker stocks and no contribution from private investment. Quarterly GDP growth of 0.5 per cent in the third quarter was slightly weaker than our July forecast. The expenditure breakdown of that growth is not yet available, but the output breakdown indicates a sharp fall in construction sector activity. (Construction sector data are particularly volatile and prone to revision.)

Table 2.4: Contributions to real GDP growth in 2015Q2

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
July forecast	0.4	0.0	0.0	0.3	0.0	-0.1	0.6
Latest data	0.6	0.1	0.1	0.0	1.4	-1.3	0.7
Difference <sup>1</sup>	0.2	0.1	0.1	-0.3	1.5	-1.2	0.1

<sup>1</sup> Difference in unrounded numbers, rounded to one decimal place.

Note: Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is -0.2 percentage points for the latest data.

- 2.9 Quarterly growth in the GDP deflator in the second quarter of 2015 was 0.6 percentage points higher than we expected, with growth in the terms of trade and the investment deflator explaining much of the surprise. As discussed in Chapter 3, this surprise has fed through to our forecast over the next year.
- 2.10 With growth in both real GDP and the GDP deflator above forecast, nominal GDP growth in the second quarter was significantly higher than expected: up 1.2 per cent on the previous quarter, 0.6 percentage points higher than forecast. This upside surprise was driven almost entirely by net trade. Trade data are also volatile. The latest monthly data suggest that the second quarter strength was largely reversed in the third quarter.

Table 2.5: Contributions to nominal GDP growth in 2015Q2

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
July forecast	0.6	0.0	-0.2	0.6	-0.1	-0.3	0.6
Latest data	0.6	0.0	-0.2	0.3	1.5	-0.9	1.2
Difference <sup>1</sup>	0.0	0.1	0.1	-0.3	1.6	-0.6	0.6

<sup>1</sup> Difference in unrounded numbers, rounded to one decimal place.

Note: Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is -0.2 percentage points for the latest data.

## Conditioning assumptions

2.11 Since we finalised our July forecast, oil prices have fallen significantly below the level that futures prices implied at the time. Our dollar oil price assumption for the fourth quarter of 2015 is down 26.3 per cent from July (Table 2.6). Our conditioning assumption for the sterling effective exchange rate is also lower than in July, reflecting weakness against both the dollar and the euro. Equity prices are assumed to be 7.2 per cent lower than previously expected, while our assumption for mortgage interest rates is unchanged from July.

Table 2.6: Conditioning assumptions in 2015Q4

	Oil price (\$ per barrel)	US\$/£ exchange rate	€/£ exchange rate	ERI exchange rate (index)	Equity prices (FTSE all-share index)	Mortgage interest rates (%) <sup>1</sup>
July forecast	66.6	1.57	1.39	92.6	3765	3.0
Latest assumption	49.1	1.53	1.38	92.2	3494	3.0
Per cent difference	-26.3	-2.5	-1.1	-0.5	-7.2	0.0

<sup>1</sup> Difference is in percentage points.

## Labour market

2.12 Contrary to the pattern in many of our recent forecasts, labour market quantities have underperformed against our July forecast. Employment was around 50,000 lower than expected in the third quarter. Average hours also fell short of our July forecast, which meant that total hours growth over the year was 1.0 percentage points lower than forecast. With the preliminary estimate for year-on-year real GDP growth in line with our July forecast, this implies that annual growth in productivity (per hour) in the third quarter was 1.0 percentage points stronger than expected.

2.13 The shortfall in employment was almost entirely due to inactivity being slightly higher than expected, with the unemployment rate in line with forecast. But the claimant count surprised on the upside, with 30,000 more claimants than expected.

2.14 The labour market data for the third quarter was released after we had closed our pre-measures economy forecast. This means that the labour market figures for the third quarter in our forecast are slightly different to the outturn data. Relative to our forecast, the outturn data show higher employment and lower unemployment, but also lower average hours and so fewer total hours worked, although these differences are small. Wage growth was in line with our expectations.

## Inflation

2.15 CPI inflation for the third quarter of 2015 was in line with our July forecast at zero. Petrol and food price inflation both fell faster than expected, but were offset by high import intensity goods seeing a smaller fall in price than forecast. That might have reflected earlier

sterling appreciation feeding through to consumer prices with a greater lag than we had assumed. Sterling has depreciated in the current quarter.

- 2.16 CPI inflation was -0.1 per cent in October, remaining more than 1 percentage point below the Bank of England's target for the eleventh consecutive month.

## The housing market

- 2.17 Annual house price inflation on the ONS measure was 5.6 per cent in the third quarter, 1.3 percentage points higher than our July forecast. (The third quarter house price data were also released after our forecast had been closed, with prices up faster than the assumption we had made as the basis for this forecast.) The major lenders' house price indices have diverged, with the Halifax index reporting prices are up 9.7 per cent in the year to October while the Nationwide index is up just 3.9 per cent over the same period.
- 2.18 Property transactions also picked up more strongly than expected, rising to 314,000 in the third quarter, around 12,000 higher than we forecast in July. But transactions among high value properties have fallen, with anecdotal evidence suggesting the prime London property market may have been affected more than we had assumed by the higher effective tax rate on transactions under the new system of stamp duty land tax introduced in December 2014.

## The global economy

- 2.19 GDP growth in advanced economies in the second quarter of 2015 was below our July forecast. The US economy picked up after a weak first quarter, but GDP fell in both Canada and Japan and growth in the euro area remains weak. Inflation in most major advanced economies is currently close to zero. China's stock market appears to have stabilised after the falls in the summer, but its economy continued to slow in the third quarter of 2015. GDP was up 6.9 per cent on a year earlier, the slowest rate of growth in six years.

## Fiscal developments

- 2.20 The latest public finances data show public sector net borrowing (PSNB) in the first seven months of 2015-16 was £6.6 billion lower than the same period last year. Our July forecast assumed a fall of £20.6 billion for 2015-16 as a whole. Overall receipts growth has been close to our July forecast. Within that, growth in stamp duty land tax receipts has been lower than our full-year forecast, but that has been offset by growth in PAYE income tax, national insurance contributions and onshore corporation tax. Within the public sector, local authorities' net borrowing is estimated to have increased by £1.4 billion in the first seven months of the year, which contrasts with the £0.7 billion full-year drop we forecast in July. Our latest fiscal forecast is discussed in Chapter 4.

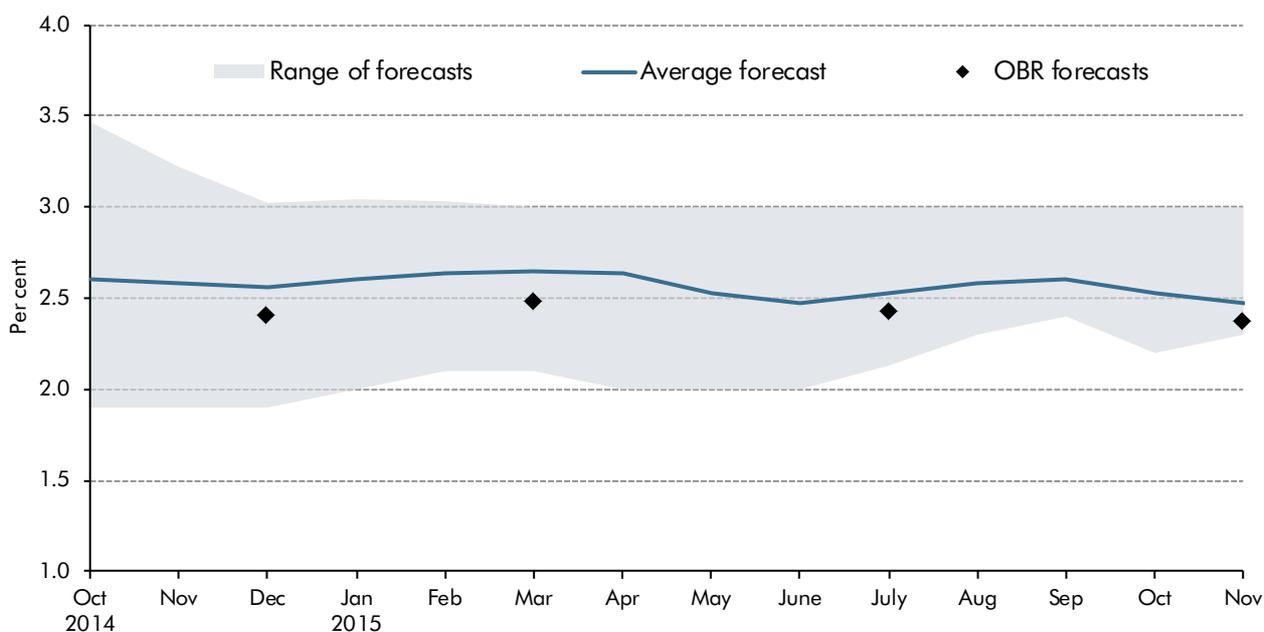
## Developments in outside forecasts

2.21 Many private sector, academic and other outside organisations produce forecasts for the UK economy.<sup>1</sup> This section sets out some of the movements in these forecasts since our July *Economic and fiscal outlook (EFO)*. When interpreting the average of outside forecasts, it is important to bear in mind that different analysts forecast different variables and the average forecast is not constrained to paint an internally consistent picture.

### Real GDP growth

2.22 Outside forecasts for GDP growth in 2015 fell marginally in the months preceding our July forecast (Chart 2.2), and have changed little since. We have revised our 2015 forecast down slightly, to just below the latest independent average. For 2016, the average outside forecast for GDP growth is 2.4 per cent, the same as our current forecast.

Chart 2.2: Forecasts for real GDP growth in 2015



Source: HM Treasury, OBR

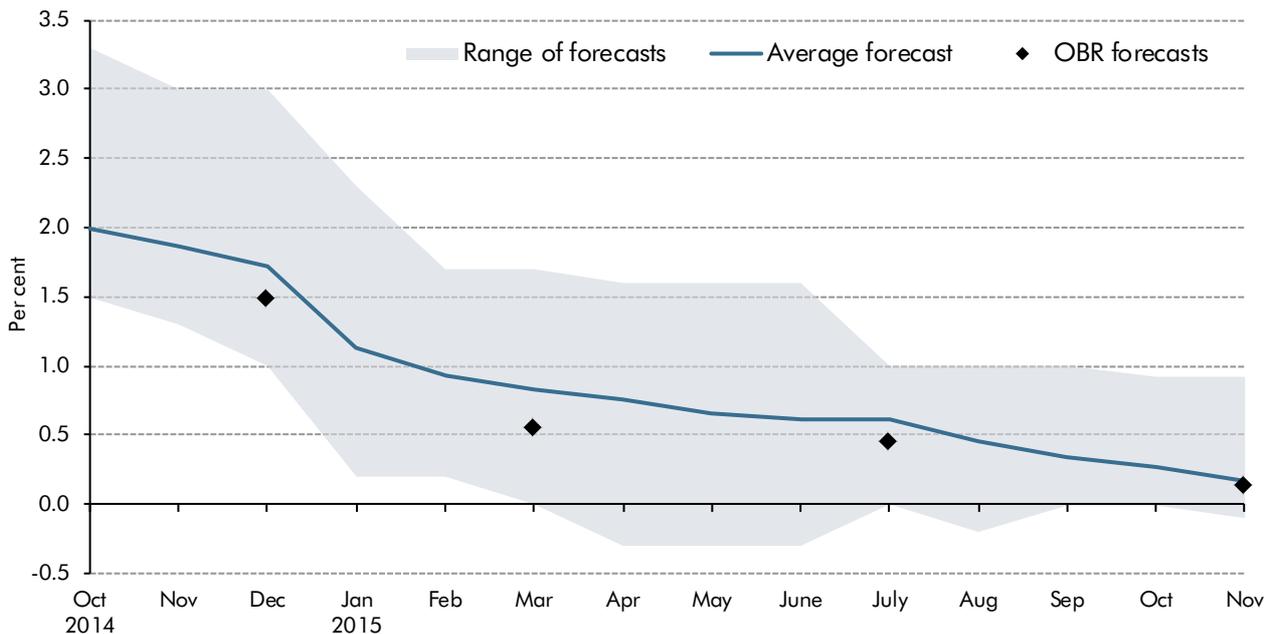
2.23 Looking at the smaller sample of medium-term forecasts, the average forecast for GDP growth in 2017 is unchanged at 2.3 per cent, which is 0.2 percentage points below our current forecast. The average forecasts for 2018 and 2019 have fallen by 0.3 and 0.2 percentage points respectively to 2.2 per cent in both years, 0.2 percentage points lower than our forecast in 2018 and 0.1 percentage points lower in 2019.

<sup>1</sup> See HM Treasury, November 2015, *Forecasts for the UK economy: a comparison of independent forecasts*. A full list of contributors is available at the back of the Treasury publication. A number of financial reporting services also monitor average or consensus figures.

## Inflation

2.24 The average forecast for CPI inflation in the fourth quarter of 2015 has fallen in recent months, mainly reflecting falls in commodity prices. The latest average is 0.2 per cent, slightly above our 0.1 per cent forecast in this *EFO* (Chart 2.3). The average forecast for CPI inflation in the fourth quarter of 2016 is 1.6 per cent, a little higher than our forecast of 1.4 per cent.

Chart 2.3: Forecasts for CPI inflation in 2015Q4



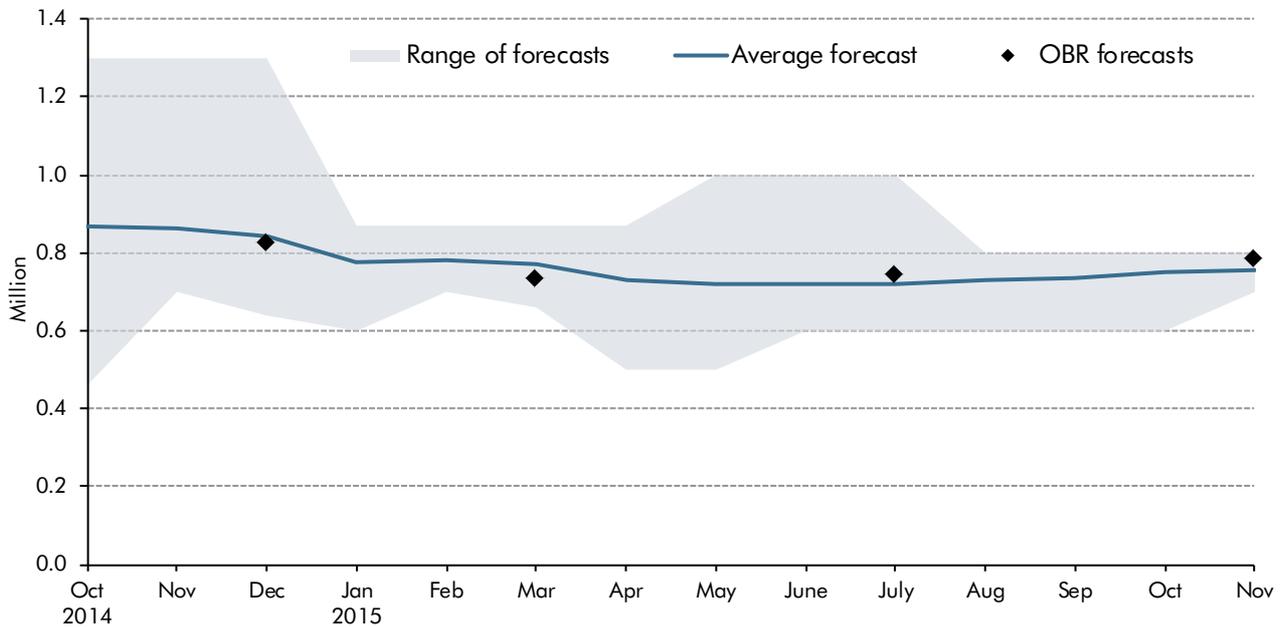
Source: HM Treasury, OBR

## Labour market

2.25 The average forecast for claimant count unemployment<sup>2</sup> in the final quarter of 2015 has risen since our July forecast. It now stands at 0.76 million, 40,000 higher than in July and 20,000 lower than our current forecast (Chart 2.4). The average forecast for employment growth in 2015 is 1.3 per cent, in line with our current forecast. Average earnings growth in 2015 is now expected to be 2.7 per cent, up 0.2 percentage points since July.

<sup>2</sup> Note: The range and average of the October forecasts for the 2015Q4 claimant count has been adjusted to remove an apparent error in the number reported for one of the forecasters.

Chart 2.4: Forecasts for the claimant count in 2015Q4



Source: HM Treasury, OBR

## Public finances

2.26 The average forecasts for PSNB in 2015-16 and 2016-17 have both fallen since our July forecast to £71 billion and £50 billion respectively. Medium-term forecasts now suggest that PSNB will fall to £24 billion by 2018-19, up from the average forecast in July. Some forecasters expect PSNB to be significantly higher in the medium term than we forecast. As well as reflecting differences in views about prospects for the economy, external forecasters may base their judgements on what they consider to be the most likely path of fiscal policy. We are required by Parliament to base our forecasts on the Government’s current policies.

# 3 Economic outlook

## Introduction

3.1 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.2);
- describes the key conditioning assumptions for the forecast, including monetary policy, fiscal policy and the world economy (from paragraph 3.21);
- sets out our short- and medium-term real GDP growth forecasts, as spare capacity is brought back into productive use (from paragraph 3.41) and the associated outlooks for inflation (from paragraph 3.48) and nominal GDP (from paragraph 3.60);
- discusses recent developments and prospects for the household, corporate, government and external sectors of the economy (from paragraph 3.64); and
- outlines risks and uncertainties (from paragraph 3.107) and compares our central forecast to those of selected external organisations (from paragraph 3.109).

## Potential output and the output gap

### The latest estimates of the output gap

3.2 Judgements about the amount of spare capacity in the economy (the ‘output gap’) and the growth rate of potential output provide the foundations of our forecast. Together they determine the scope for growth in GDP in the next five years as activity returns to a level consistent with maintaining stable inflation in the long term. GDP growth is an important driver of trends in the overall budget deficit and the path of public sector debt, the measures on which the Government’s new fiscal targets are based.

3.3 Estimating the size of the output gap also allows us to judge how much of the budget deficit at any given time is cyclical and how much is structural.<sup>1</sup> In other words, how much will disappear automatically, as the recovery boosts revenues and reduces spending, and how much will be left when economic activity has returned to its full potential. This was particularly pertinent to the previous Government’s fiscal target, which was based on a cyclically adjusted measure of borrowing.

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<sup>1</sup> The methodology we use to do so is described in Helgadottir *et al* (2012): *Working Paper No.3: Cyclically adjusting the public finances*.

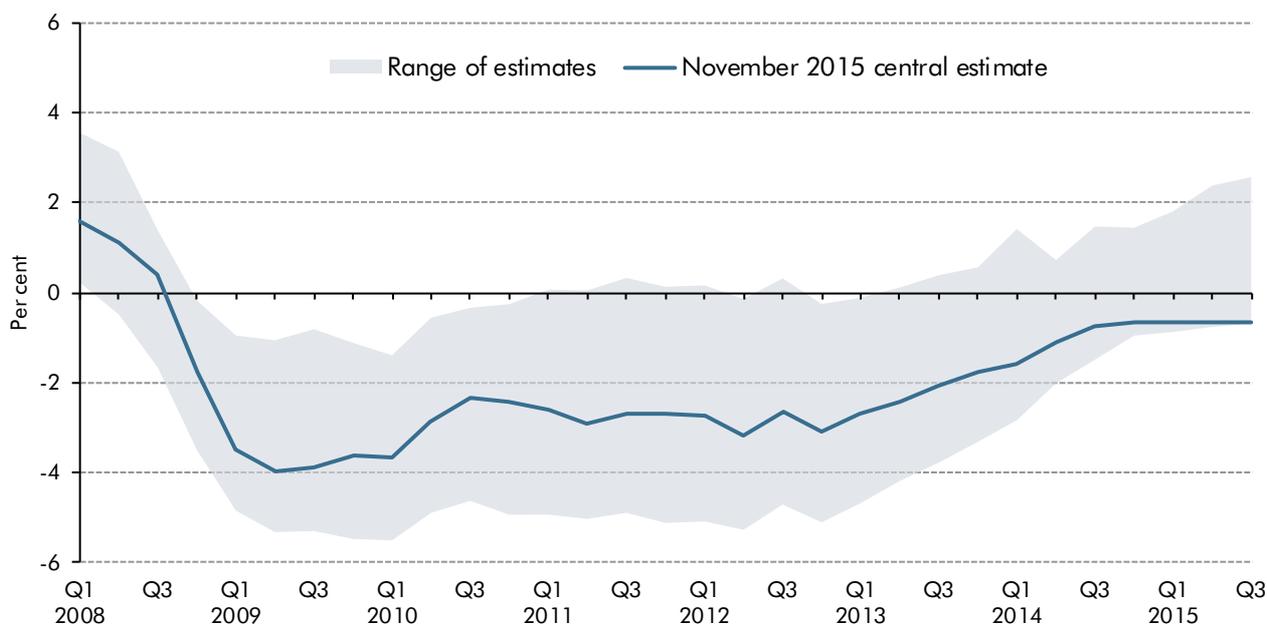
3.4 In this section, we first assess how far from potential the economy is currently operating before considering the pace at which potential output will grow in the future.

### The latest estimates of the output gap

3.5 The first step in our forecast process is to assess how the current level of activity in the economy compares with the potential level consistent with stable inflation in the long term. We cannot measure the supply potential of the economy directly, but various techniques can be used to estimate it indirectly, including cyclical indicators, statistical filters and production functions. In practice, every method has its limitations and no approach entirely avoids the application of judgement. We therefore consider a broad range of evidence when reaching a judgement on spare capacity.

3.6 Chart 3.1 shows a range of estimates of the output gap implied by nine different techniques, as well as our own latest central estimate.<sup>2</sup> Our central estimate is currently at the bottom of this range, which is explained further in paragraph 3.12. All of these estimates showed spare capacity increasing during the course of the late 2000s recession, and their dispersion increased. The swathe remained relatively stable until early 2013 when actual growth picked up. Most estimates have since tightened, but the range remains wide, with estimates varying from -0.7 to +2.6 per cent in the third quarter of 2015. In any event, even the range illustrated here may understate the true degree of uncertainty, as such estimates are likely to change as new data become available and past data are revised.

Chart 3.1: Range of output gap model estimates



Source: OBR

<sup>2</sup> The individual output gap estimates are included in the supplementary economy tables available on our website. The approaches – and the uncertainties associated with them – are discussed in Murray (2014): *Working Paper No.5: Output gap measurement: judgement and uncertainty*.

- 3.7 The cyclical indicator approaches on which we previously placed greatest weight implied that the output gap began to narrow in 2012, even though growth remained relatively weak – less weak according to recent data than was reported at the time. ‘Aggregate composite’ (AC) estimates imply that spare capacity continued to be used up at pace, and that output moved above its sustainable level towards the end of 2013. ‘Principal components analysis’ (PCA) estimates also suggest a significant narrowing of the gap through 2013, but it then remained stable through 2014 before turning positive in 2015.<sup>3</sup>
- 3.8 The AC estimates place a relatively large weight on capacity utilisation indicators, whereas our PCA estimates attach greater importance to indicators of recruitment difficulties. These have been more stable, although there are signs of emerging skill shortages.
- 3.9 Statistical filters that consider output data alone imply that the economy is currently operating above its potential level, but by less than it had been at the end of 2014. Chart 3.3 augments the output data with other information, demonstrating that:
- capacity utilisation indicators also suggest firms are operating at levels associated with overheating;
  - CPI inflation has fallen to below zero, which could in principle suggest more slack in the economy. We do not consider that likely, since the decline in recent months largely reflects lower food and petrol prices, and the effects of past sterling appreciation. The inflation measure that underpins our filters is adjusted for the direct influence of food and oil costs, but in reality only partially so, as these costs also have indirect effects on other prices;
  - the unemployment rate has fallen further in the third quarter of 2015. Complementing output data with a filter-based structural unemployment estimate (informed by changes in real wages and productivity) would suggest that the output gap closed at a steady speed between the end of 2012 and 2014, with the pace declining since. We currently place more weight on measures that incorporate measures of labour market slack; and
  - a production function approach, which applies filters to the individual components of production, would also suggest that the output gap has narrowed more gradually over recent quarters. The amount of slack within the latest quarter is concentrated within total factor productivity in particular.

<sup>3</sup> More details on these methodologies are set out in our *Briefing Paper No.2: Estimating the output gap* and in Pybus (2011): *Working Paper No.1: Estimating the UK’s historical output gap*.

Chart 3.2: Cyclical indicator and filter-based estimates of the output gap

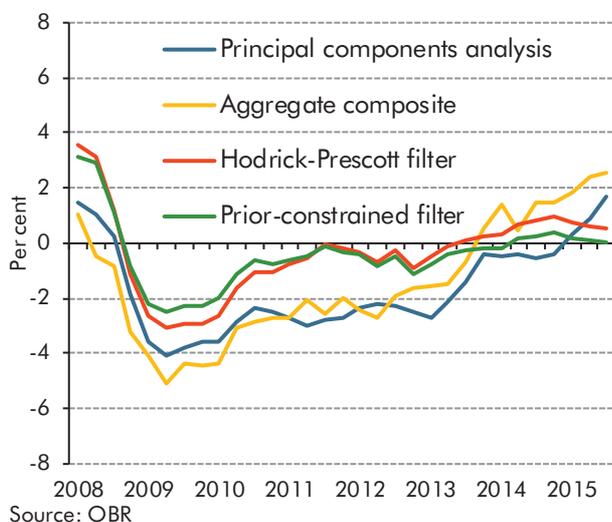
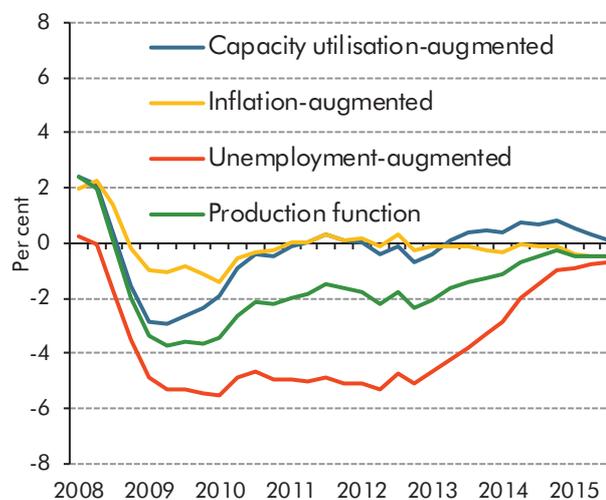


Chart 3.3: Multivariate filter-based estimates of the output gap



3.10 The employment rate fell by 0.2 percentage points in the second quarter of 2015, as both the unemployment and inactivity rates rose. This at least in part appears to reflect a cohort with relatively high employment rates exiting the Labour Force Survey. To the extent that this depressed total hours worked, for a given amount of output growth (which is estimated separately) it will also have exaggerated the rise in hourly productivity, which appears to have risen strongly in the quarter. But overall, output growth (excluding oil and gas) was 0.1 percentage points below forecast.

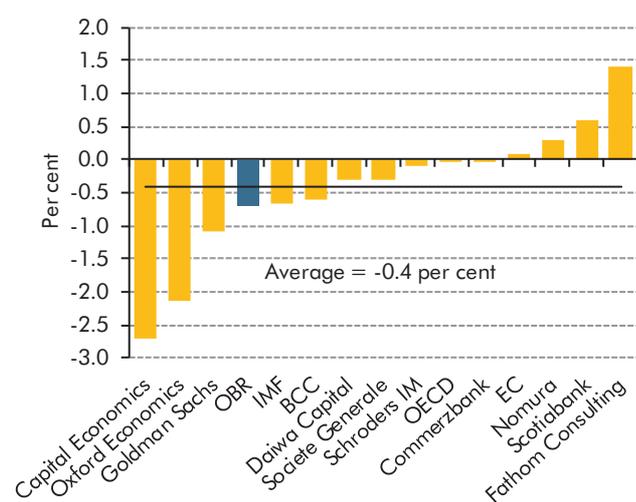
3.11 Output growth was also below our forecast for the third quarter by a similar amount. The employment rate recovered in the third quarter, as both unemployment and inactivity rates fell. But average hours worked also declined, and so total hours worked fell for a second consecutive quarter, although this was partly offset by stronger hourly productivity growth. The labour market data for the third quarter was released after we had closed our economy forecast to changes other than the effects of policy decisions. The actual third quarter data were slightly different from the numbers we assumed for this forecast: employment was slightly stronger and unemployment slightly lower, but average and total hours worked were also lower. If the full third quarter labour market data had been available before we closed our forecast, it would not have made a material difference to our five-year forecasts.

3.12 Considering the balance of evidence, we have judged that the output gap was -0.6 per cent of potential output in the third quarter of this year, unchanged from our July estimate. This is towards the lower end of the broad swathe of estimates illustrated in Chart 3.1, but closer to those to which we attach more weight. Assuming a small negative output gap looks appropriate given the recent evidence that wage growth is now picking up, while broader inflationary pressures remain subdued. We have attributed half of the -0.6 per cent output gap to the employment rate lying below its sustainable rate and the other half to productivity per worker remaining below its potential. The latest labour market data – which were released after we were asked to close our pre-measures forecast – would imply that the

balance is marginally more skewed towards average hours lying below their sustainable level. But these estimates are subject to considerable uncertainty.

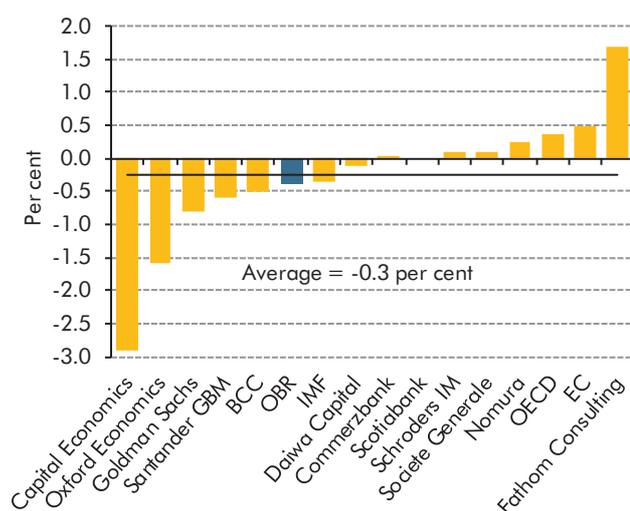
- 3.13 An unchanged estimate of the output gap coupled with weaker actual growth implies that potential output has grown slightly more slowly over recent quarters than we thought in July. But actual output – and therefore also potential output – is subject to revision. If actual output growth is revised up, as has been the case over the recovery since the financial crisis, then potential output would be correspondingly higher.
- 3.14 Charts 3.4 and 3.5 compare our central output gap estimates for 2015 and 2016 to those produced by other forecasters, as set out in the Treasury’s *November Comparison of independent forecasts*. The average estimate is -0.4 per cent in 2015 and -0.3 per cent in 2016, narrower than our forecasts of -0.7 per cent for 2015 and -0.4 per cent for 2016.

Chart 3.4: Estimates of the output gap in 2015



Source: HM Treasury, plus updates where known

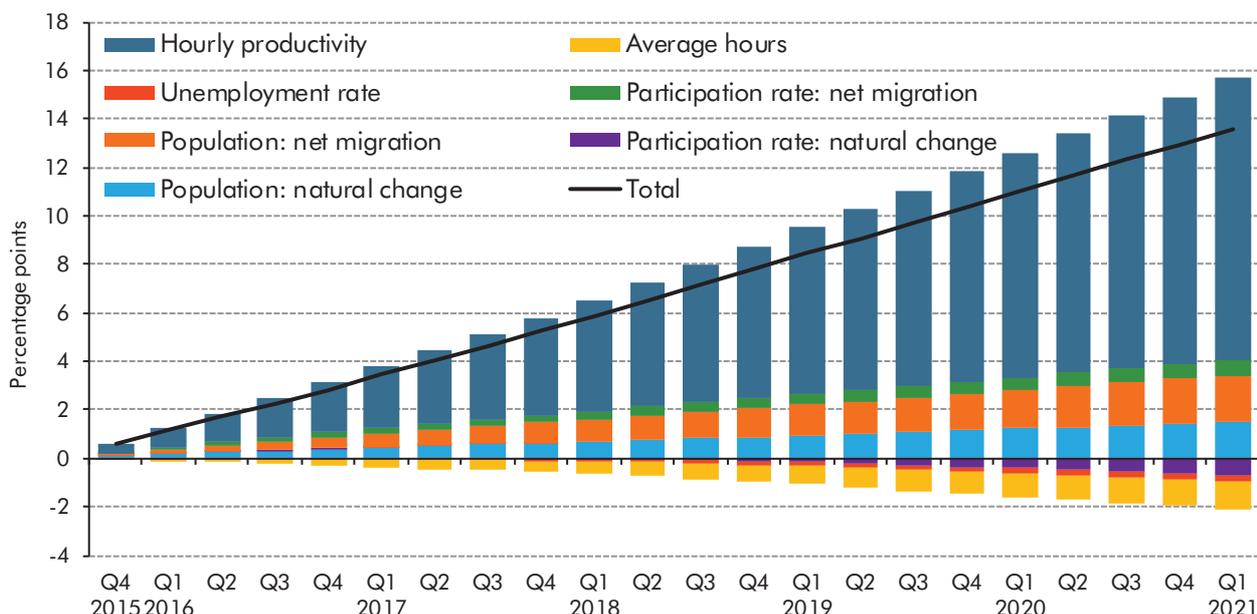
Chart 3.5: Estimates of the output gap in 2016



## The growth of potential output

- 3.15 A small negative output gap implies that actual output can grow slightly above its potential rate over the coming quarters without generating inflationary pressure. But of far greater importance is the path of potential output itself. In July, we forecast a gradual strengthening of potential output growth over the forecast period and that remains our central judgement. But as Chart 3.6 shows, that outcome depends on the most important uncertainty in our (and most people’s) economic forecast: the timing and strength of the long-awaited return to sustained productivity growth. We also expect smaller positive contributions to potential output growth over the next five years from population growth, while average hours worked are expected to trend down over time.

Chart 3.6: Contributions to potential output growth from 2015Q3



Note: We implicitly assume that, conditioned on age and gender, migrants are as likely to be employed as the broader population.  
Source: OBR

3.16 The growth of potential output-per-hour converges towards its historical average over the forecast. That reflects our view that the slow pace of financial system normalisation and the related pace at which resources are reallocated to more productive uses will continue to weigh on the sustainable rate of growth – by diminishing amounts – for some years.

3.17 Although actual productivity growth has picked up in the latest two quarters, some of this has been cyclical or reflects broader temporary factors (such as the sampling variation in the Labour Force Survey discussed above). But since it is difficult to explain the abrupt fall and persistent weakness of productivity in recent years, it is also hard to judge when or if productivity growth will sustainably return to its historical average. We now expect potential output-per-hour to rise slightly more gradually than projected in July, but to still return to historic rates by the middle of 2018.<sup>4</sup>

3.18 We expect that the long-term decline in average hours will reassert itself as productivity recovers and assume that population growth will slow in line with the ONS’s current principal population projections. The 2014-based 16+ population projection is 0.2 per cent higher in 2020 than the 2012-based population projection, mainly due to higher net inward migration. The age structure is also now more skewed towards those of working age, reflecting assumptions on the age profile of inward migrants and more deaths across older age groups. So the effect on employment growth is slightly bigger than simply population growth, taking the overall boost to potential output from the new population projections to 0.3 per cent.

<sup>4</sup> In Chapter 5 of our December 2014 EFO we presented two scenarios that considered the implications of productivity growth remaining stuck at the low levels of recent years and of growth rebounding in line with the strongest UK performance of recent decades.

3.19 To date we have assumed that the participation rate would be broadly flat over the medium term, but we have now modelled the implications of an ageing population and state pension age increases from year to year using the cohort model that informs our long-term projections.<sup>5</sup> This change in methodology has little cumulative effect on potential output across the next five years, but implies that the participation rate rises up to 2018 by small amounts before declining in the following two years as net inward migration slows and the proportion of older people with lower-than-average participation rates increases.

Table 3.1: Potential output growth forecast

	Percentage change on a year earlier, unless otherwise stated					Potential output <sup>3</sup>
	Potential productivity <sup>1</sup>	Potential average hours	Potential employment rate <sup>2</sup>	Potential population <sup>2</sup>	Potential	
2015	1.1	0.0	0.0	0.6	1.8	
2016	1.5	-0.1	0.1	0.7	2.2	
2017	1.8	-0.2	0.1	0.6	2.3	
2018	2.0	-0.2	0.0	0.6	2.4	
2019	2.2	-0.2	-0.1	0.6	2.4	
2020	2.2	-0.2	-0.2	0.6	2.3	
<b>Cumulative growth (per cent) from 2014 to 2020</b>						
July forecast	12.2	-1.0	-0.4	3.6	14.6	
November forecast	11.4	-1.0	-0.1	3.7	14.2	
<b>Change</b>	<b>-0.8</b>	<b>0.0</b>	<b>0.2</b>	<b>0.2</b>	<b>-0.4</b>	

<sup>1</sup> Output per hour.

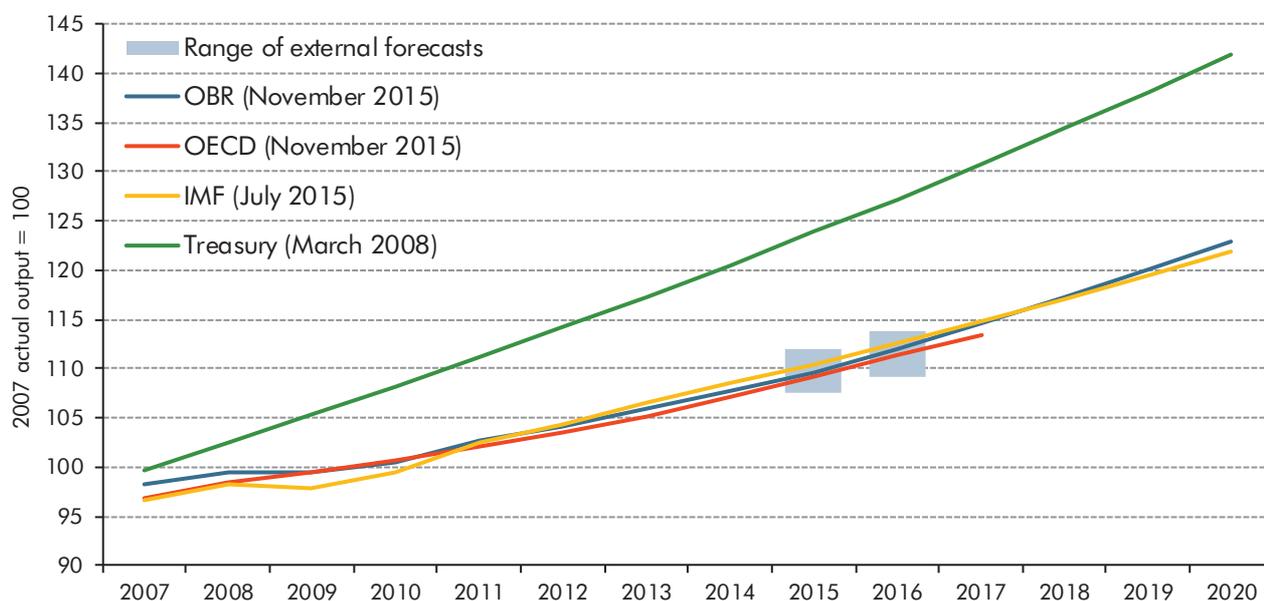
<sup>2</sup> Corresponding to those aged 16 and over.

<sup>3</sup> Components may not sum to total due to rounding.

3.20 Our latest forecast assumes that potential output was around 11.5 per cent lower than an extrapolation of the Budget 2008 forecast by 2015 and that it will be 13.3 per cent below that extrapolation by 2020. Even the most optimistic external assessments of potential output continue to lie well below the pre-crisis trend implied by Budget 2008. The IMF and OECD have made broadly similar judgements to ours about the margin of spare capacity in 2015, but both forecast slower growth in potential output thereafter. The key difference between their forecasts and ours appears to relate to prospects for productivity, with both assuming a slower recovery than we currently project.

<sup>5</sup> Annex A of our July 2014 *Fiscal sustainability report* discusses our longer-term approach to labour market modelling in more detail.

Chart 3.7: Potential output forecasts



Note: IMF forecasts for potential output are inferred by combining GDP and output gap forecasts.

Source: HM Treasury, IMF, OECD, OBR

## Key economy forecast assumptions

**3.21** Our economic forecasts are conditioned on a number of assumptions. We use conditioning assumptions based on market expectations for domestic and international interest rates, the exchange rate, equity prices and oil prices. These market assumptions are all based on the 10-day average to 29 October 2015. Risks to our forecasts are discussed later in the chapter. We also base our forecasts on the Government's fiscal policy stance, including announcements in this Spending Review and Autumn Statement.

## Monetary policy and credit conditions

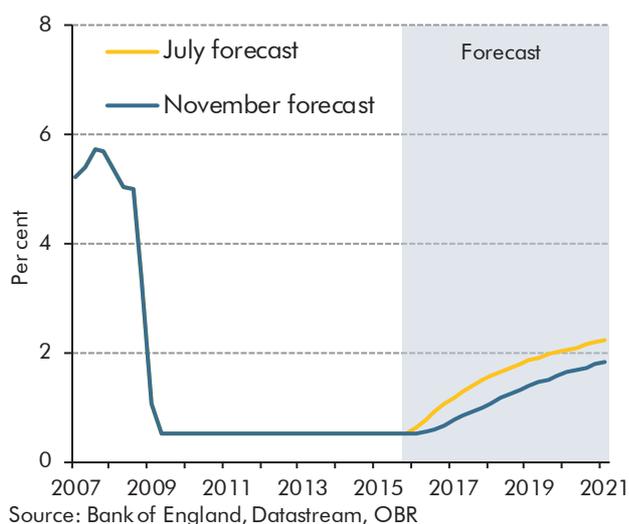
**3.22** Our forecast assumes that the Bank of England will try to bring inflation back to target over its forecast horizon, consistent with the remit the Chancellor has set the Monetary Policy Committee (MPC). In its November 2015 *Inflation Report*, the MPC forecast – on the basis of market interest rate expectations at the time – that CPI inflation would reach 2.06 per cent by the end of 2017 and 2.22 per cent by the end of 2018. In terms of forward guidance on policy it stated that “the MPC judges it appropriate to return inflation to the target in around two years”. Our forecast implies a slower return of inflation to target, the reasons for which are explained in paragraph 3.52.

**3.23** Like the Bank of England, our forecasts are conditioned on interest rates – including Bank Rate and gilt rates – following market expectations over the forecast period. Since our July forecast, medium-term interest rate expectations have fallen (Chart 3.8) so that the first increase in Bank Rate is now not expected until the first quarter of 2017. Bank Rate expectations are 0.4 percentage points lower than in July for the first quarter of 2021,

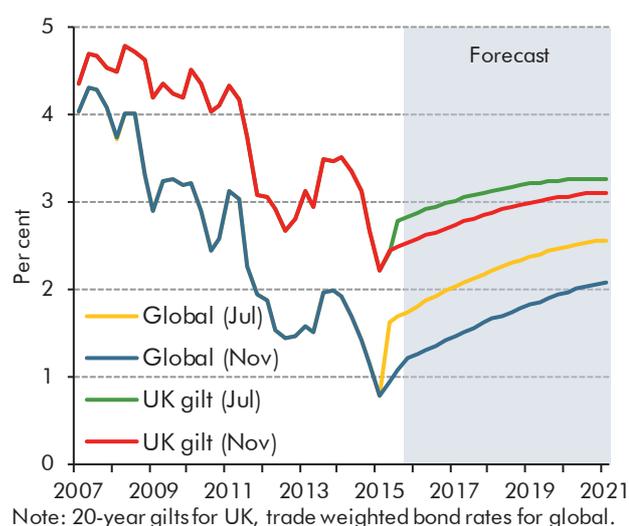
reaching just 1.8 per cent. Gilt rate expectations have also fallen and global bond yields are down more significantly (Chart 3.9).

- 3.24** Domestic financial and credit market conditions continue to ease, with the price of credit generally continuing to fall. While bank funding spreads picked up slightly in the second and third quarters of this year, they remain in line with the levels seen since 2014 and below the elevated spreads observed in the aftermath of the late 2000s recession. We expect the effective mortgage rate to continue falling in the near term due to lagged effects of past falls in funding spreads and as maturing mortgage contracts continue to move onto new lower rates. Mortgage rates then rise slightly over the rest of the forecast period as increases in Bank Rate are more than sufficient to offset narrowing margins. With our assumptions about the evolution of bank funding spreads and mortgage margins little changed since July, the reduction in our forecast for mortgage rates reflects a lower assumed path for Bank Rate.

**Chart 3.8: Bank Rate**



**Chart 3.9: Global bond yields**



- 3.25** Lending to households continues to pick up, mainly as rising house prices affect mortgage lending, although this has been partly offset by a rise in the share of cash transactions. We expect mortgage debt to continue to rise over the forecast period, as the share of cash transactions falls back towards its historical rate and house prices rise faster than incomes, although a lower forecast for property transactions has reduced our forecast for mortgage debt since July. Unsecured lending has risen strongly over the past two years, supported by lending for car purchases, although the rate of growth fell back in the second and third quarters of this year. We expect the ratio of unsecured debt to income to continue to rise, as consumer spending grows faster than disposable income, although we expect the accumulation of unsecured debt to be somewhat slower than we expected in July. Our household debt forecast is discussed in paragraphs 3.79 to 3.82.
- 3.26** Bank lending to non-financial corporates has generally fallen on an annual basis over the past six years, although large companies have been able to raise funds through non-bank sources, such as issuance of bonds. Unlike large companies, small and medium-sized

enterprises (SMEs) do not have access to wholesale markets, so restricted credit availability has hit smaller firms harder. The pace of contraction in net lending to SMEs has eased recently, with net lending growth turning positive in the twelve months to September.

### Fiscal policy and Spending Review and Autumn Statement measures

- 3.27 Fiscal policy has been tightened in every year since 2010-11, when the then Labour Government reversed its temporary crisis-related fiscal stimulus. The Coalition Government increased the pace of discretionary fiscal tightening in the last Parliament. In the July Budget and this Spending Review and Autumn Statement the new Conservative Government has eased the pace and changed the composition of fiscal consolidation. The fiscal multiplier framework that we use to estimate the overall effect of changes in fiscal policy on the economy was explained in Box 3.2 of our July *EFO*. In Box 3.1 below, we describe how our current forecast has been affected by the fiscal and other policy changes announced in this Spending Review and Autumn Statement that we consider sufficiently material to warrant an explicit adjustment to our economy forecast.
- 3.28 There is particular uncertainty about the effect of fiscal tightening on the economy over the coming year. The Coalition Government had for some time planned to tighten fiscal policy significantly in 2016-17, with spending cuts first pencilled in as far back as December 2012 and the rise in national insurance contributions announced in March 2013. Given the lead time involved, we assumed at the time that those announcements would not affect the pace of growth next year as the Bank of England would have plenty of time to offset them through the use of monetary policy. The new Conservative government has decided to ease the pace of fiscal consolidation next year, with the sharp cuts to departmental spending eased in July and again now, and with the Government also reversing the planned tax credit cuts that it announced in July. This loosens fiscal policy relative to the path factored into our previous forecasts and given that this loosening takes place well within the Bank's policy horizon, we have assumed that it will boost GDP growth marginally next year. But there is considerable uncertainty around the implicit assumptions underpinning these adjustments – in particular the extent to which the market-derived Bank Rate forecast has factored in the path of fiscal policy.

#### Box 3.1: The economic effects of policy measures

This box considers the possible effects on the economy of the policy measures announced in this Spending Review and Autumn Statement. More details of each measure are set out in the Treasury's documents. We assess their fiscal implications in Chapter 4 and Annex A.

The Government has eased **the pace of fiscal tightening** in the short term. It has increased spending on public services, capital investment and welfare in 2016-17, financed largely by higher borrowing and small tax increases. Beyond 2016-17 the net tax rise gets bigger while the increase in welfare spending becomes a net cut. The Government has also made a number of changes to the path of capital spending, with an increase in 'Capital Department Expenditure Limits' (CDELs) in 2016-17 and 2017-18, and a significant increase in CDELs in 2020-21.

In order to reflect these changes in our economic forecast, we have applied to them the same ‘multipliers’ we used in our July forecast. They imply a 0.2 percentage point boost to real GDP growth in 2016-17 and a 0.1 percentage points drag in 2017-18 and 2018-19 as the initial boost unwinds. The multipliers are assumed to diminish the further in advance any changes are announced, so differences in the fiscal path in later years, including the significant increase in CDEs in 2020-21, are assumed to have negligible effects on real GDP growth, although they do affect the composition of expenditure in the medium term. The direct effect of changes in RDEL on the GDP deflator – via the government consumption deflator – means that the effects on nominal GDP growth are more persistent. They imply a 0.3 percentage point boost to nominal growth in 2016-17; a negligible effect in 2017-18 and 2018-19; then a drag of 0.1 percentage points in 2019-20 and 0.4 percentage points in 2020-21.

The direct effect of changes to **welfare spending** on overall aggregate demand, including the reversal of the July tax credit cuts, is estimated by applying the relevant multiplier to the total change in spending. But these measures may also affect work incentives and therefore potential labour supply. We did not adjust our July forecast for the package of cuts announced then, as they affected both in-work and out-of-work incomes, so similarly we have not adjusted our labour supply forecasts for the reversal of those cuts. There is a risk that the net effect on labour supply of the cumulative changes announced in July and in this Autumn Statement is not neutral.

The Government has announced the introduction of an **apprenticeship levy** set at 0.5 per cent of employers’ gross pay bill (with an allowance of £3 million), with the resulting funds available to fund apprenticeship training. In the near term we expect the additional cost to employers to be reflected in lower nominal wages and profit margins, with the majority of the incidence assumed to fall on wages by the end of the forecast period. That implies a cumulative reduction in average earnings of around 0.3 per cent by 2020-21. The effect is partly offset by the postponement of planned increases in auto-enrolment pension contributions, which reduces employer costs slightly in 2017-18 and 2018-19.

The Government has announced a number of measures that could affect the **housing market**. This includes higher rates of stamp duty land tax of 3 per cent on purchases of additional properties worth over £40,000 (mainly buy-to-let and second homes). We assume that this will reduce the incentive to purchase second homes and reduce the volume of annual property transactions by around 3 per cent in 2016-17 and around 2 per cent in each subsequent year of the forecast. The Government has also announced changes to grant funding of housebuilding for shared ownership that we expect will affect the activity of housing associations. These are discussed in more detail in Annex B.

The Government has also announced a small number of policies that we expect to have an impact on **inflation**. We expect CPI inflation to be reduced by just under 0.1 percentage points in 2017-18 as a result of replacing the current Energy Companies Obligation (ECO) and by moving to an exemption from the costs of renewables levies for Energy Intensive Industries, but to be unchanged in other years. These policies are likely to have a similar impact on RPI inflation, which is also expected to be affected by the announced increase in council tax referendum thresholds for certain local authorities. The effect of the council tax measures is to raise RPI inflation by just under 0.1 percentage points in each year from 2016-17.

## World economy

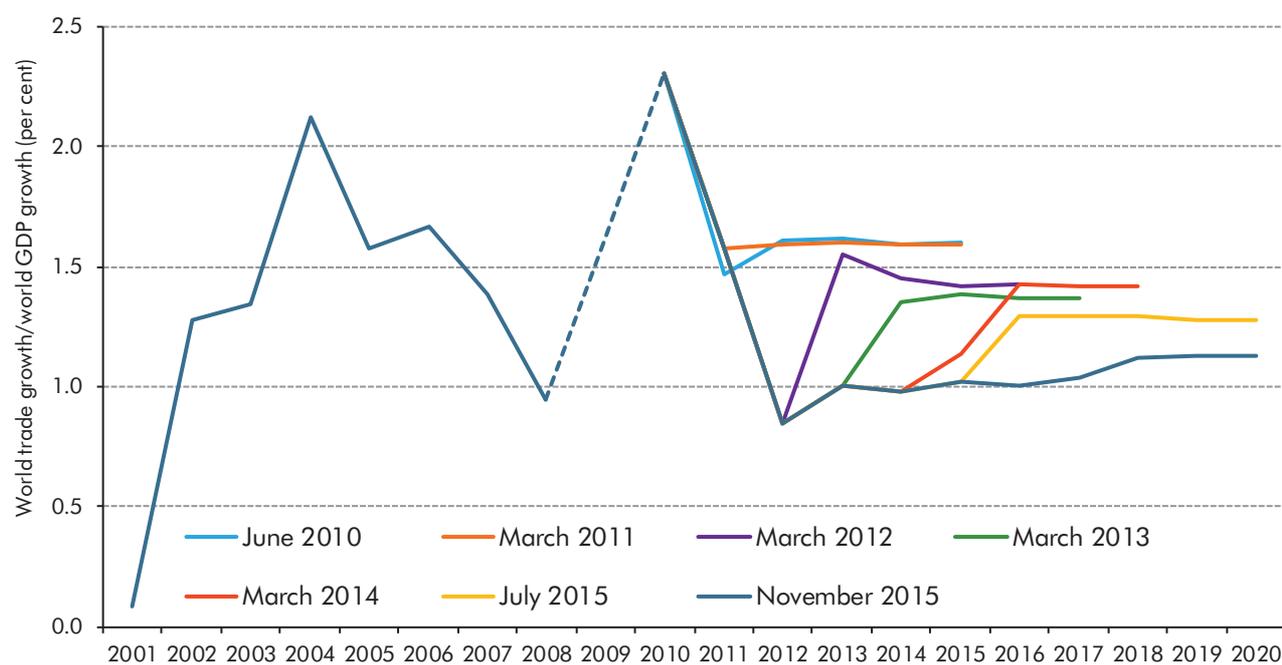
- 3.29 In its latest *World Economic Outlook*, which informs our global forecast, the IMF revised down its forecast for world GDP growth in 2015 and 2016, with the path of world GDP growth little changed from 2017 onwards. We expect world GDP to grow by 3.1 per cent in 2015, down from 3.2 per cent in July. We have also revised down our forecast for world GDP growth in 2016. From 2017 onwards the path of world GDP growth is similar to our July forecast, averaging 3.9 per cent in the four years to 2020.
- 3.30 We forecast euro area GDP growth of 1.5 per cent in 2015, unchanged from our July forecast, and expect growth of 1.6 per cent a year thereafter. In the third quarter of 2015, euro area GDP was up 1.6 per cent on a year earlier, higher than the 1.5 per cent growth in the second quarter. In the year to the third quarter, GDP was up 1.7 per cent in Germany, 1.2 per cent in France and 0.9 per cent in Italy. Spain saw stronger growth of 3.4 per cent. Ireland – an important export market for the UK – reported GDP growth of 7.3 per cent in the year to the second quarter, but that does not appear to have fed through to UK export performance, where the value of goods exports to Ireland were down by around 11 per cent in the first nine months of 2015 compared to a year earlier.
- 3.31 Deflation in the euro area remains a risk to the global and UK outlook. Following five months of positive CPI inflation, euro area inflation fell to -0.1 per cent in September and was only just above zero in October. Core inflation was 1.1 per cent in October, slightly higher than in September. Unemployment fell to 10.8 per cent in September, continuing a path of steady decline. The European Central Bank has commenced quantitative easing under its extended asset purchase programme in order to support the euro area economy in a manner that it deems consistent with its inflation target.
- 3.32 US GDP grew 0.4 per cent in the third quarter of 2015, down from 1.0 per cent growth in the second quarter, with private inventories acting as a drag on growth. Private consumption made a positive contribution to growth in the second and third quarters. Net trade made a positive contribution to GDP growth in the second quarter and a slightly negative contribution in the third quarter, having acted as a significant drag on growth in the first quarter due to temporary port closures resulting from strike action.
- 3.33 GDP growth in China has continued to ease, though it remains high relative to most large economies. In the third quarter, GDP was up 6.9 per cent on a year earlier, the slowest rate of growth in six years. Stock market volatility from earlier in the year appears to have subsided. The value of UK goods exports to China has fallen sharply over the past year: down 35 per cent on a year earlier in the third quarter.

## World trade

- 3.34 The latest global trade data have been weaker than we expected in July, driven by particularly weak trade outturns in emerging markets. We expect world trade to grow by 3.0 per cent in 2015, lower than we forecast in July and lower than the latest IMF WEO forecast.

**3.35** In its latest WEO, the IMF revised down its forecast for world trade growth in each year from 2016 to 2020. We have also revised down our forecast over that period, but have done so by more than the IMF. There has been a consistent pattern of downward revisions to the trade intensity of world GDP growth (i.e. the ratio of world trade growth to world GDP growth) in recent years. We have therefore taken the judgement that trade intensity will not bounce back as quickly or as far as the IMF's latest WEO forecast assumes. This is clearly subject to significant uncertainty as the reasons for the weaker-than-expected trade intensity of recent world growth are not fully understood.<sup>6</sup>

**Chart 3.10: Successive OBR forecasts of trade intensity**



Note: 2009 is not actual outturn data. World trade fell by 10.3 per cent in that year so the implied import intensity of world GDP growth was -369 per cent.

Source: IMF, OBR

**3.36** UK export markets are expected to grow by 4.1 per cent in 2015, higher than our July forecast. While we have revised down world trade growth in 2015, that revision was driven by weaker trade in emerging markets, which have a lower weight in UK export markets. Conversely, the latest data show strong trade in euro area economies, which account for a higher share of UK export markets and more than offset the weaker trade in emerging markets. We have revised down our forecast for growth in UK export markets in each year between 2016 and 2020, reflecting the downward revision to global trade.

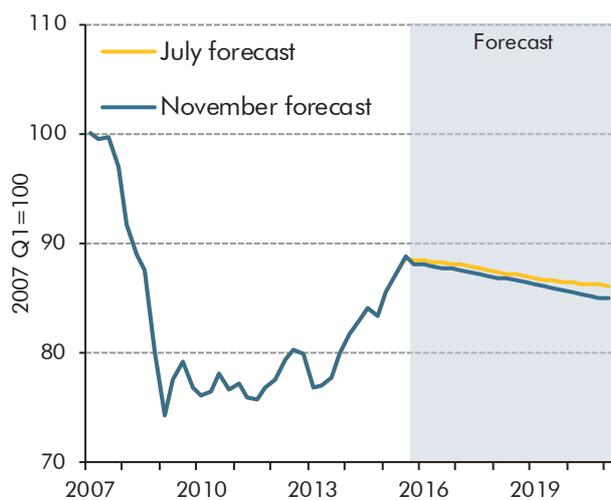
<sup>6</sup> In Box 1.2 of the April 2015 WEO, the IMF analysed the extent to which recent weakness world trade can be explained by cyclical and structural factors. While cyclical factors were found to explain around half of the slowdown in world trade growth, it was assumed that structural factors must also be behind the lower trade intensity of global GDP growth. The analysis suggested that trade intensity may have been affected by a slowing in the international fragmentation of global supply chains. Slower trade liberalisation and narrowing wage differentials were also cited as possible structural factors, but were not explicitly analysed.

## Other conditioning assumptions

3.37 We assume that the exchange rate follows a path implied by the uncovered interest parity condition. Sterling is weaker than in July and is expected to depreciate over the forecast period as the forward UK interest rate curve is above the average of the UK’s major trading partners (Chart 3.11). We assume equity prices rise in line with nominal GDP from their current level. The FTSE all-share index has fallen since July (Chart 3.12).

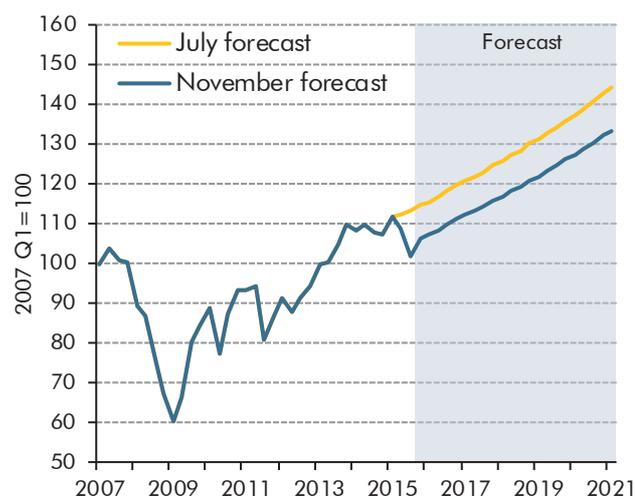
3.38 Since we took the final market assumptions, expectations for the path of Bank Rate increased slightly. Had we taken the 10-day average since the Bank of England published its *Inflation Report*, Bank Rate would be expected to reach 1.9 per cent by the end of the forecast period, compared with 1.8 per cent in our forecast. Oil prices have fallen significantly since our July forecast, with our conditioning assumption for this forecast around a quarter below that in July. They fell slightly further in the two weeks after we closed the market assumptions. Sterling strengthened slightly too. These differences would have had relatively small knock-on effects throughout the forecast period.

Chart 3.11: Sterling effective exchange rate assumption



Source: Bank of England, Bloomberg, Datastream, OBR

Chart 3.12: Equity prices assumption



## Summary

3.39 To summarise, the key assumptions underpinning our central forecast are that:

- monetary policy remains very loose – even more so than assumed in July. It does not begin to tighten until the first quarter of 2017;
- fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past four years. The Government’s decisions in this Spending Review and Autumn Statement ease the pace of fiscal tightening next year, providing a small boost to GDP growth despite the overall fiscal tightening next year remaining significant;

- credit conditions and the financial system continue to normalise gradually; and
- global activity and demand for UK exports pick up steadily over the forecast period, albeit slightly more slowly than expected in July.

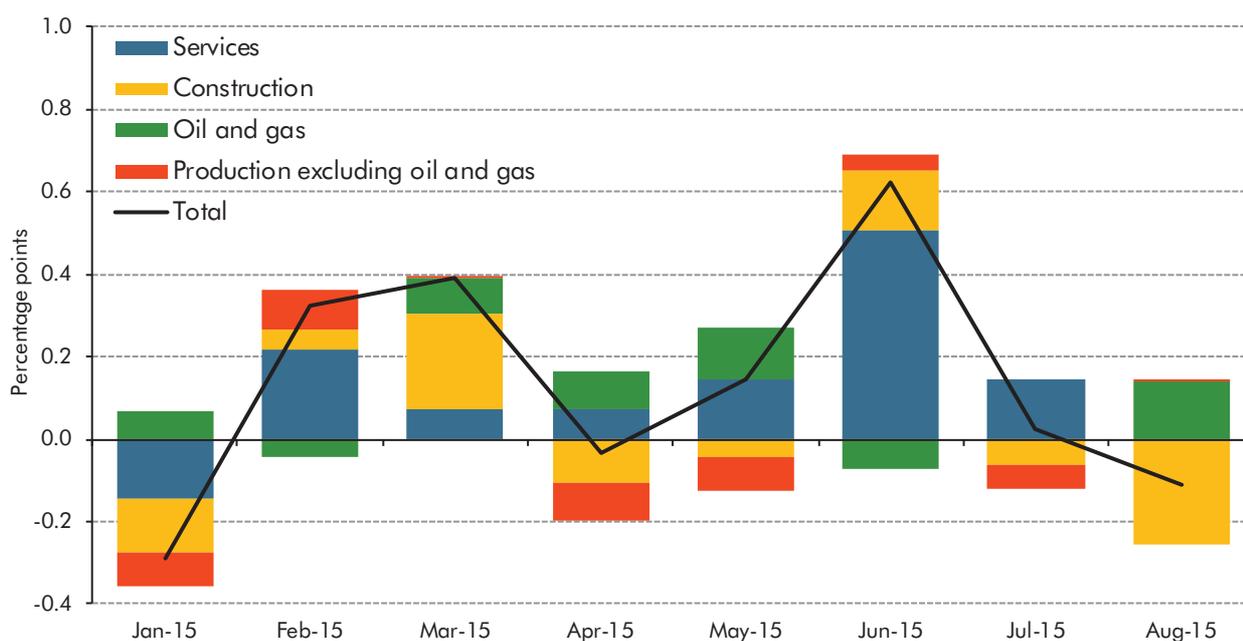
3.40 Risks and uncertainties associated with these assumptions and other facets of the forecast are discussed later in the chapter.

## Prospects for real GDP growth

### The short-term outlook for GDP

3.41 On a monthly basis, Chart 3.13 shows that the services sector made positive contributions to growth in each month between February and July, although there has been some volatility in the size of those contributions. Contributions from the manufacturing, North Sea and construction sectors were more volatile.

Chart 3.13: Contributions to monthly output growth



Source: ONS

3.42 The economy grew by 0.5 per cent in the third quarter of 2015, slightly below our July forecast. The ONS has not yet published estimates of the expenditure split of GDP growth in the third quarter, but monthly trade data suggest that net trade was a significant drag on growth, reversing the strong positive contribution in the second quarter. Survey data for the early part of the fourth quarter showed slightly greater momentum compared with preceding months.

3.43 The fall in the oil price in the second half of 2014 is expected to continue to support real income and consumption for the rest of this year, although we expect the effect to be offset

by the in-year public spending cuts announced in June, with quarterly growth of 0.5 per cent in the final quarter of this year and first quarter of next. Quarterly GDP growth then picks up from the second quarter of 2016, as the effect of in-year spending cuts dissipates and the easing of the pace of fiscal tightening announced in this Spending Review and Autumn Statement supports demand (relative to our July forecast).

Table 3.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2014				2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
November forecast <sup>1</sup>	0.6	0.9	0.6	0.8	0.4	0.7	0.5	0.5	0.5	0.7	0.7	0.6
July forecast <sup>2</sup>	0.9	0.9	0.7	0.8	0.4	0.6	0.6	0.5	0.5	0.7	0.7	0.6
<b>Change<sup>3</sup></b>	<b>-0.3</b>	<b>0.0</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.1</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.1</b>

<sup>1</sup> Forecast from fourth quarter of 2015.

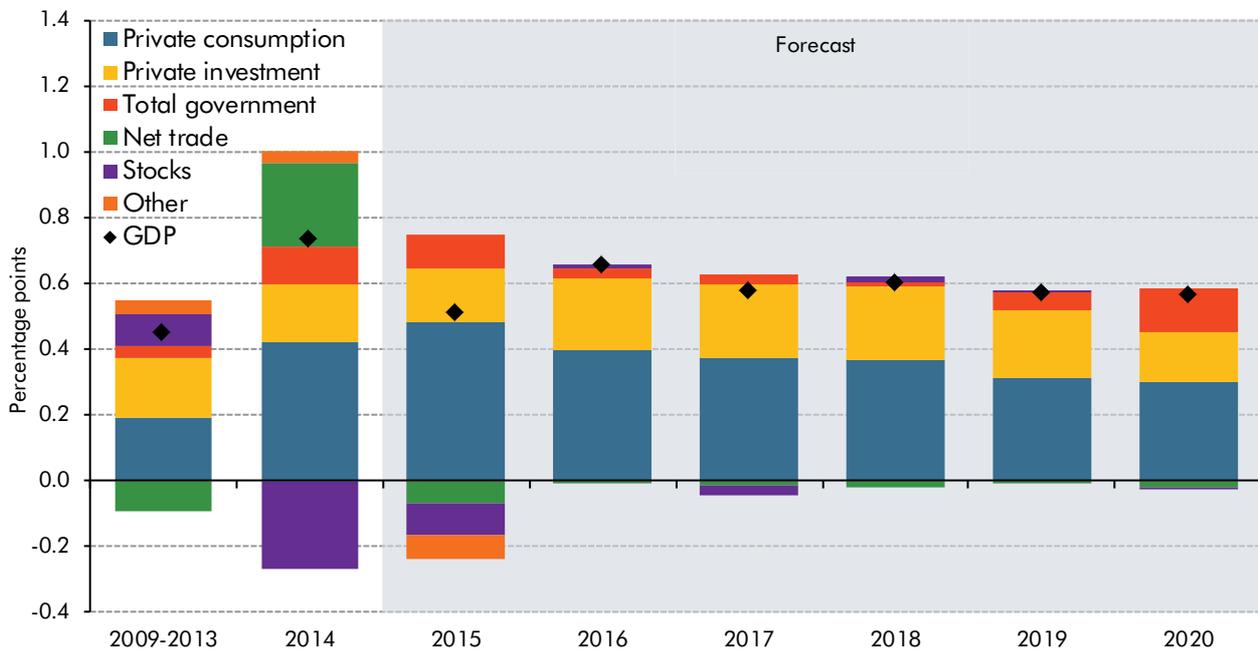
<sup>2</sup> Forecast from second quarter of 2015.

<sup>3</sup> Changes may not sum due to rounding.

## The medium-term outlook

- 3.44** Our forecasts for growth in the medium term are determined by the amount of spare capacity in the economy, and the speed with which we expect it to return to productive use. The prospects for monetary policy, fiscal policy, credit conditions, external demand and financial markets discussed in the previous section all inform that judgement.
- 3.45** Once the near-term effects of fiscal policy changes on quarterly GDP growth have passed, we expect quarterly growth to settle at around 0.6 per cent a quarter, supported by a gradual improvement in productivity growth, with the output gap expected to close gradually over the period to mid-2018. As Chart 3.14 shows, we expect private consumption and investment to account for almost all GDP growth while the fiscal consolidation continues. Then we expect the balance between private and government sources of GDP growth to shift from 2020. Charts 3.15 and 3.16 show these medium-term forecasts in terms of the output gap and the levels of actual and potential output.

Chart 3.14: Contributions to average quarterly GDP growth



Note: 'Other' category includes the statistical discrepancy and the residual between GDP and the expenditure components prior to the base year (2012).

Source: ONS, OBR

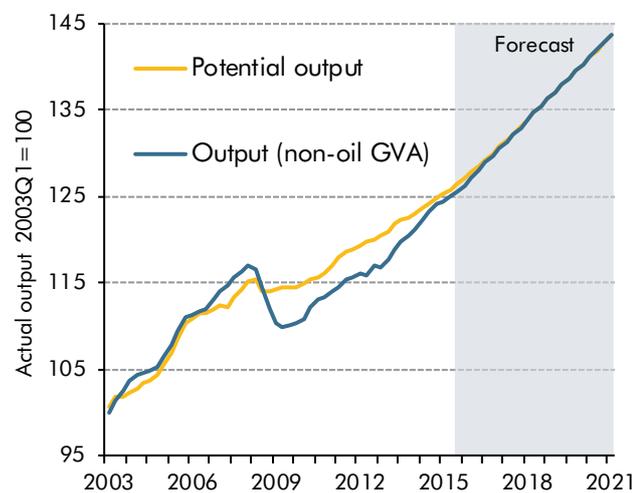
Chart 3.15: The output gap



Note: Output gap estimates on a quarterly basis, based on the latest National Accounts data and expressed as actual output less trend output as a percentage of trend output (non-oil basis).

Source: OBR

Chart 3.16: Projections of actual and potential output



Source: ONS, OBR

3.46 Table 3.3 summarises the expenditure composition of our real GDP forecast. Relative to our July forecast, there is little change to GDP growth in 2015, with larger contributions from government spending and net trade offsetting smaller contributions from stocks, consumption and investment. Thereafter we expect a slightly smaller drag from net trade than we forecast in July, offset by slightly weaker contributions from consumption and

investment. Later sections of this chapter discuss our forecasts for the expenditure components of GDP in more detail.

**Table 3.3: Expenditure contributions to growth**

	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2014	2015	2016	2017	2018	2019	2020
<b>GDP growth (per cent)</b>	<b>2.9</b>	<b>2.4</b>	<b>2.4</b>	<b>2.5</b>	<b>2.4</b>	<b>2.3</b>	<b>2.3</b>
<b>Main contributions</b>							
Private consumption	1.7	1.9	1.7	1.5	1.5	1.3	1.2
Business investment	0.4	0.6	0.7	0.7	0.7	0.7	0.5
Dwellings investment <sup>1</sup>	0.6	0.0	0.2	0.2	0.1	0.1	0.1
Government <sup>2</sup>	0.6	0.4	0.1	0.1	0.0	0.1	0.4
Change in inventories	0.2	-0.9	0.0	0.0	0.0	0.0	0.0
Net trade	-0.4	0.1	-0.2	-0.1	-0.1	-0.1	-0.1

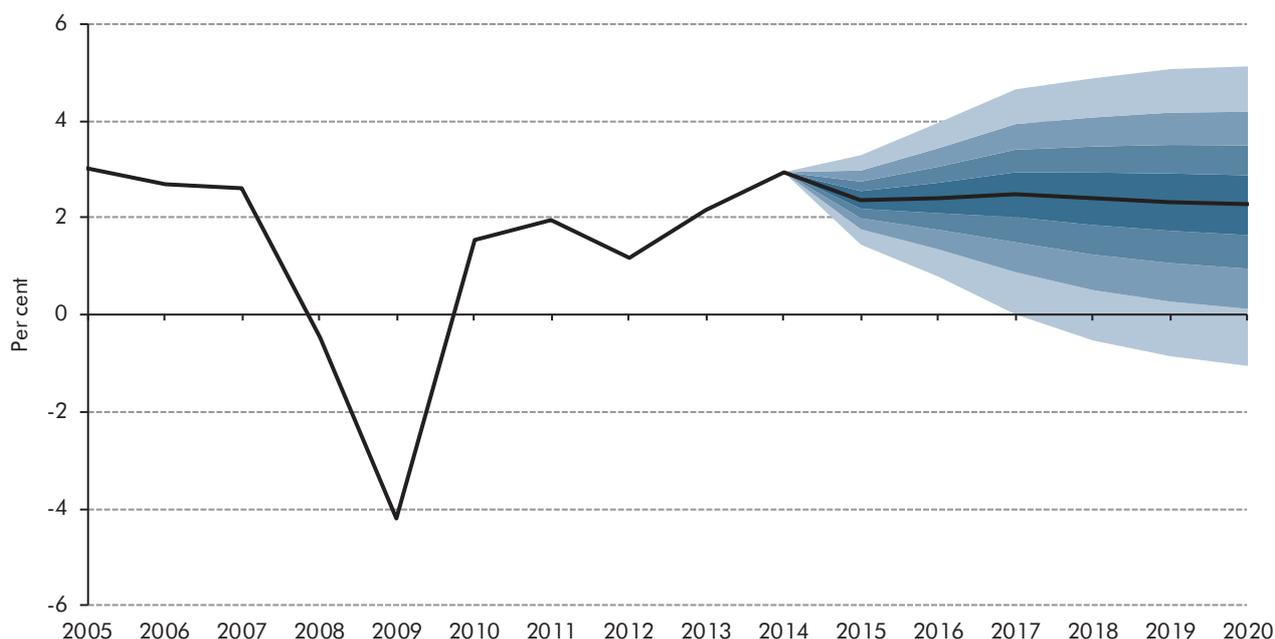
<sup>1</sup> The sum of public corporations and private sector investment in new dwellings, improvements to dwellings and transfer costs.

<sup>2</sup> The sum of government consumption and general government investment.

Note: Components may not sum to total due to rounding and the statistical discrepancy.

**3.47** Our central GDP growth forecast is shown in Chart 3.17. The distribution surrounding it shows the probability of different outcomes based on past forecast accuracy. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. These are based on the historical distribution of official forecast errors. They do not represent a subjective measure of the distribution of risks around the central forecast. Such risks are discussed at the end of the chapter. The Government’s new fiscal mandate requires us to say whether GDP growth has, or is expected to, fall below 1 per cent on a 4-quarter-on-4-quarter basis. This is discussed further in Chapter 5.

**Chart 3.17: Real GDP growth fan chart**



Source: ONS, OBR

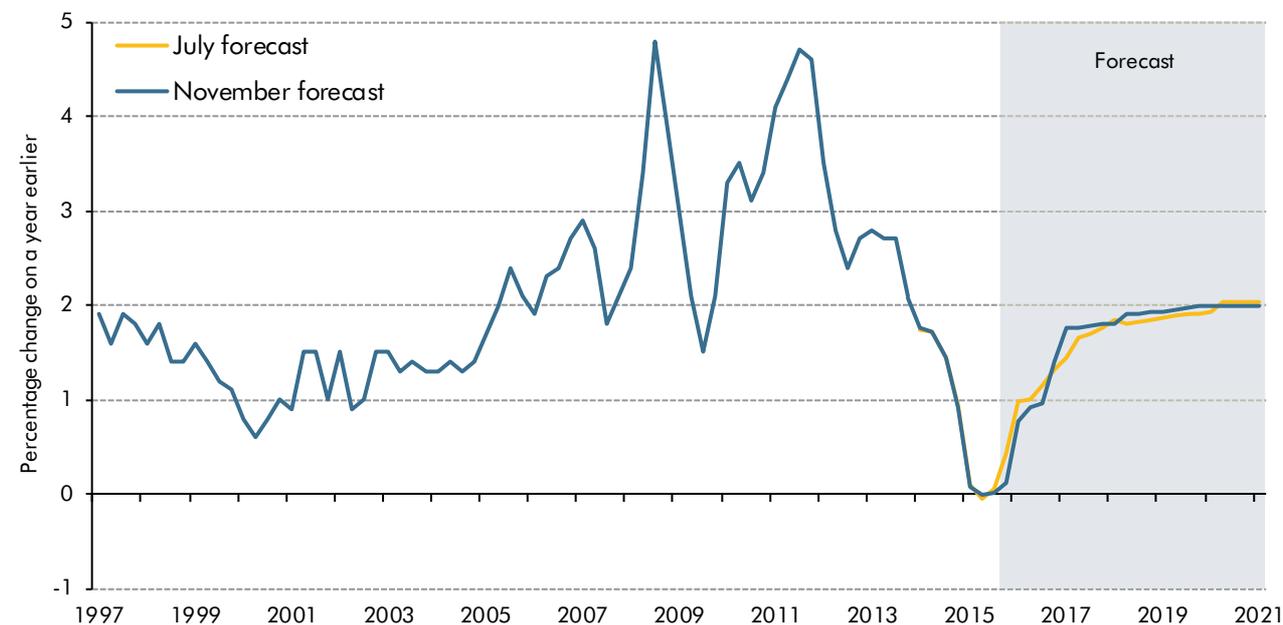
## Prospects for inflation

- 3.48 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation, including the Consumer Prices Index (CPI) and the Retail Prices Index (RPI). The basic measurement approach is the same in both indices, although there are a number of differences in coverage and the methods used to construct them (see Box 3.3 of our March 2015 *EFO* for details). We also forecast the GDP deflator and its components, which are used in generating our nominal GDP forecast.
- 3.49 The CPI and RPI measures of inflation are important because they both affect our fiscal forecast. The Government uses the CPI for the indexation of many tax rates, allowances and thresholds, and for the uprating of benefits and public sector pensions. The RPI is used to calculate interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties. The ONS publishes other inflation measures, but these do not currently affect the public finances, so we do not forecast them.

### CPI inflation

- 3.50 Annual CPI inflation was 0.0 per cent in the third quarter of 2015, in line with our July forecast. The latest monthly reading showed inflation was -0.1 per cent in October. Most of the present shortfall relative to the Bank of England's 2 per cent target can be traced to external factors, including lower oil prices and past appreciation of sterling. Domestic inflationary pressures are more mixed, with unit labour costs starting to rise but profit margins remaining weak.
- 3.51 Inflation is expected to rise slightly in the final quarter of 2015, driven partly by unit labour cost driven rises in the prices of goods and services, and some of last year's petrol price falls dropping out of the annual inflation comparison. It is then forecast to rise more significantly in the first quarter of 2016, with similar factors at work.
- 3.52 The return of inflation to near the Bank of England's 2 per cent target is expected to be a little faster than expected in July, with inflation forecast to reach 1.8 per cent by the second half of 2017. This change in our forecast is almost entirely due to our assumptions about the effect of unit labour costs. As wage growth is forecast to pick up faster than productivity growth over the next few years, firms are expected to pass through some of the associated increase in costs to consumers in higher prices. Inflation is then expected to remain relatively flat for the rest of the forecast, as wages return to rising in line with productivity and we assume that the Bank of England keeps inflation on target when the output gap is closed.
- 3.53 We have made some small adjustments to our CPI forecast for energy policies announced in this Spending Review and Autumn Statement. These policies subtract just under 0.1 per cent from CPI inflation in 2017-18, and have almost no effect on CPI in other years.

Chart 3.18: CPI inflation



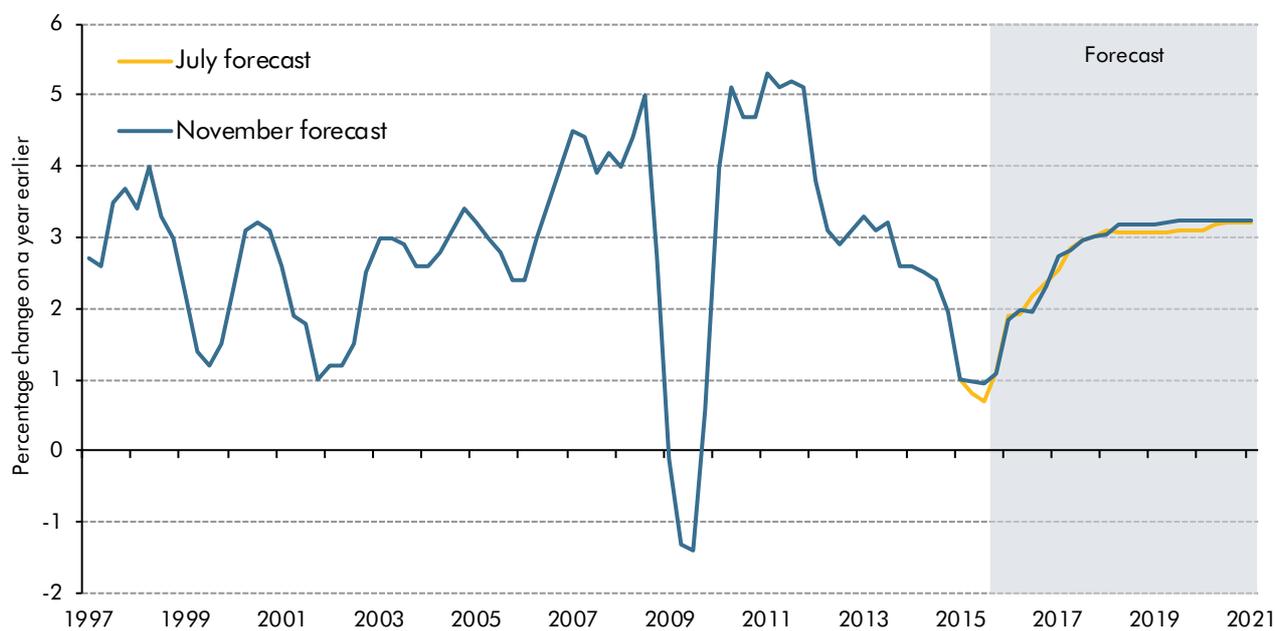
Source: ONS, OBR

## RPI inflation

- 3.54** The calculation of RPI inflation in the UK does not meet international statistical standards,<sup>7</sup> but we continue to forecast it as it remains an input in our fiscal forecasts – notably as a determinant of the interest paid on the large stock of index-linked gilts.
- 3.55** RPI inflation was 1.0 per cent in the third quarter of 2015, 0.3 percentage points higher than our July forecast. We expect RPI inflation to follow a similar path to CPI inflation for the next year and a half, rising to 2.7 per cent by the first quarter of 2017. Growth in mortgage interest payments (MIPs), driven by a rise in the effective mortgage interest rate and the accumulation of mortgage debt, is then expected to increase the wedge between RPI and CPI for several quarters until RPI plateaus in the middle of 2018. Our RPI forecast is little changed since July, as the stronger CPI forecast in the near term is broadly offset by a weaker MIPs path, as lower Bank Rate expectations have fed through to a fall in the expected effective mortgage interest rate.
- 3.56** The RPI profile has also been adjusted for policy measures announced in this Spending Review and Autumn Statement. In addition to the impacts from energy policies discussed above, the RPI profile is affected by the increased flexibility for councils to raise Council Tax, which is included in the RPI but not the CPI basket. The net effect of these policies is to add just under 0.1 percentage points to RPI inflation in each year.

<sup>7</sup> ONS, *Response to the National Statistician's consultation on options for improving the Retail Prices Index*, February 2013.

Chart 3.19: RPI inflation

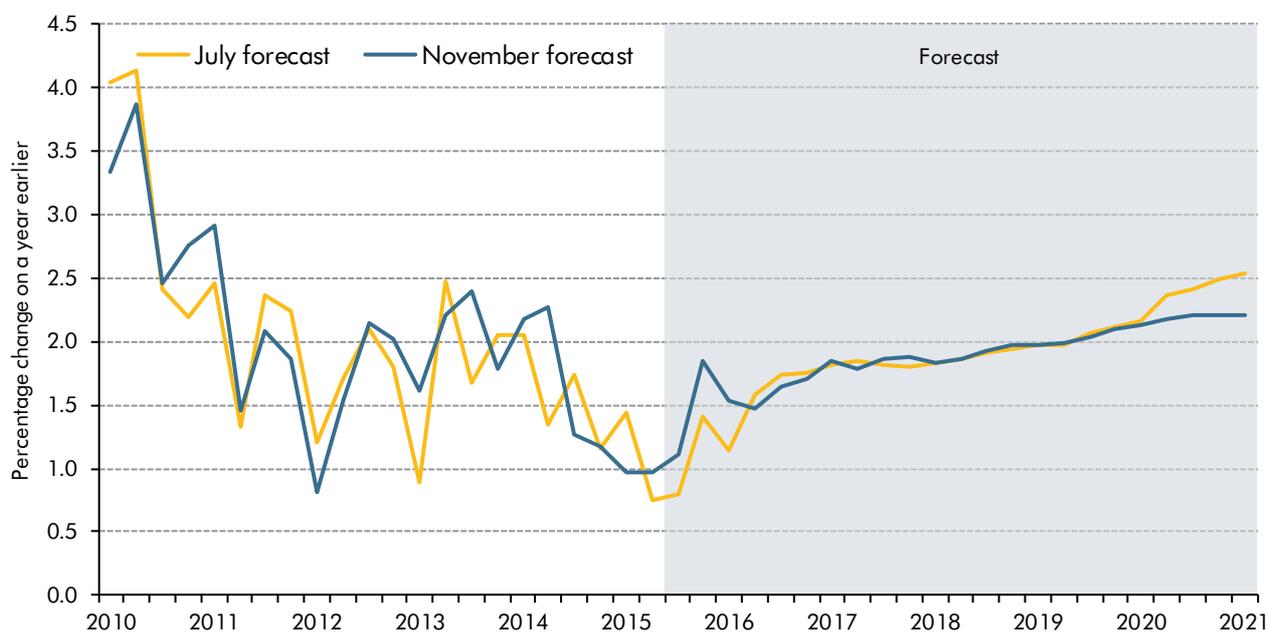


Source: ONS, OBR

## The GDP deflator

- 3.57** GDP deflator growth is the broadest measure of inflation in the domestic economy. It measures changes in prices of the goods and services that make up GDP, including price movements in private and government consumption, investment and the relative price of exports and imports – the terms of trade.
- 3.58** As described in Chapter 2, the latest National Accounts data show that GDP deflator growth in the second quarter of 2015 was above our July forecast. This carries through to a slightly higher near-term path of GDP deflator growth relative to July. In the third quarter of this year we expect a small rise in GDP deflator growth, before a stronger increase in the final quarter due to base effects in the terms of trade.
- 3.59** Growth in the GDP deflator is then forecast to rise slowly across 2016 as increases in private and government consumption deflator growth are tempered by weakness in the terms of trade. GDP deflator growth in 2016 to 2019 is little changed from July, with a weaker profile for the terms of trade offset by stronger growth in the government consumption deflator due to higher departmental spending relative to July feeding through to the measured price of government consumption. In the final year of the forecast we expect the path of GDP deflator growth to continue to rise modestly, contrasting to the sharp pick-up previously anticipated. This is again due to the Government's fiscal plans, which now imply much weaker growth in government consumption in 2020-21.

Chart 3.20: GDP deflator



Source: ONS, OBR

## Prospects for nominal GDP growth

- 3.60** Most public discussion of economic forecasts focuses on real GDP – the volume of goods and services produced in the economy. But the nominal or cash value – and its composition by income and expenditure – is more important in understanding the behaviour of the public finances. Taxes are driven more by nominal than real GDP. So too is the share of GDP devoted to public spending, as a large proportion of that spending is set out in multi-year cash plans (public services, grants and administration, and capital spending) or linked to measures of inflation (benefits, tax credits and interest on index-linked gilts).
- 3.61** Recent data indicate that, on a quarterly basis, nominal GDP grew by 0.8 per cent in the first quarter of 2015 and by 1.2 per cent in the second. Non-oil profit growth remained relatively strong over this period, averaging just over 3 per cent a quarter in the first half of the year, while labour income expanded at a similar pace to nominal GDP. Other elements of income – such as mixed income and household operating surplus, early estimates of which can be subject to large revisions – grew at a slightly weaker pace. On the expenditure side, nominal GDP growth was supported by an improvement in the nominal trade balance and smaller contributions from nominal consumption and investment, offsetting a negative contribution from stocks.
- 3.62** We expect annual nominal GDP growth to fall back from 4.7 per cent in 2014 to 3.6 per cent in 2015, largely reflecting slower quarterly growth of nominal GDP in the second half of 2014 that affects the annual growth rate in 2015. Nominal GDP growth is then expected to pick up steadily from 2016 as CPI inflation moves back towards target and nominal government consumption picks up in 2020, supporting growth of the GDP deflator. We expect nominal GDP to grow by a cumulative 28.9 per cent between the start of 2015 and

the start of 2021 – revised down slightly from the cumulative growth of 29.1 per cent we expected in July.

- 3.63 As the largest expenditure component of GDP, private consumption is expected to be the largest contributor to growth over the forecast period. The relatively slow expected growth of household income means that we expect the share of consumption to remain broadly stable between 2015 and 2020. The share of private investment – both business and residential – in nominal GDP increases from 14.7 to 16.8 per cent over the same period, offsetting a fall in government consumption and investment from 21.7 per cent to 19.4 per cent. Within income, we expect profit margins to recover slightly in the near term, while the share of labour income in nominal GDP is expected to remain broadly stable.

## Prospects for individual sectors of the economy

### The household sector

- 3.64 The household sector is the largest source of income and spending in the economy, with consumer spending making up 65 per cent of nominal GDP by expenditure and household disposable income making up 64 per cent of nominal GDP by income in 2014.

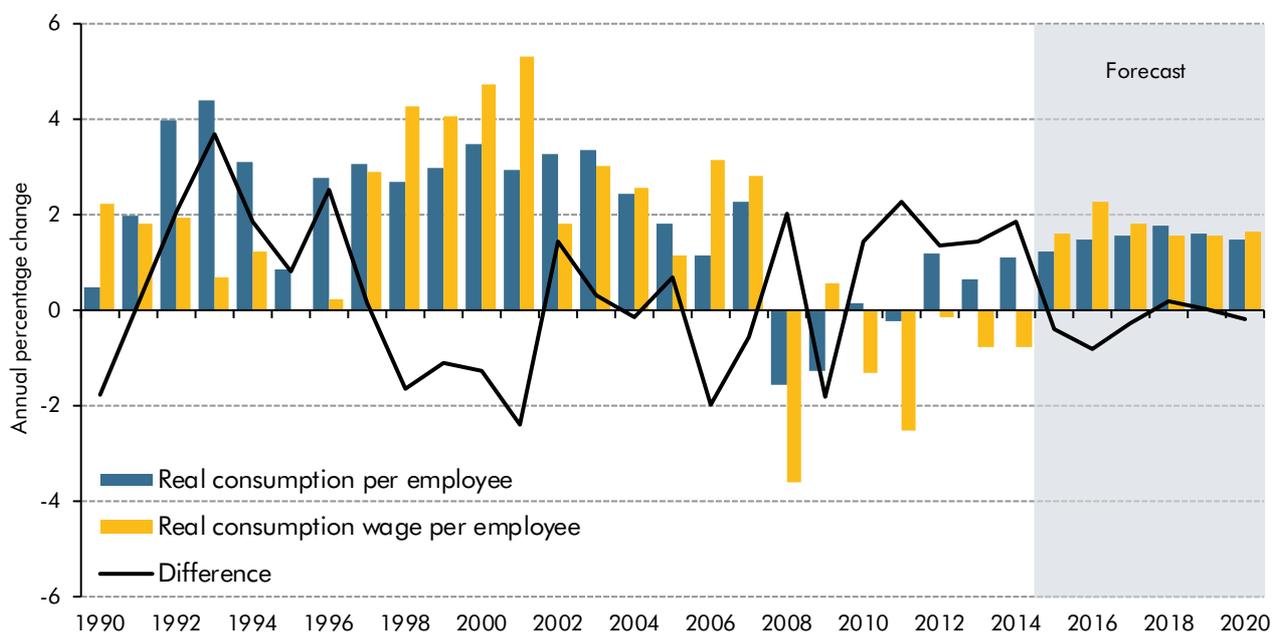
#### Real consumer spending

- 3.65 The latest data show that consumption growth was 2.6 per cent in real terms in 2014, slightly higher than was estimated in July. Our near-term forecast for consumption is little changed from July, but revisions to the profile of private consumption in recent quarters mean that we now forecast consumption growth of 2.9 per cent in 2015 as a whole, slightly below our July forecast. We assume that real consumption will grow broadly in line with real wages over the forecast period, having risen faster than real wages in each year since 2010 (Chart 3.21).<sup>8</sup>

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<sup>8</sup> While consumption growth is expected to be broadly in line with labour income growth, it is expected to be stronger than household disposable income growth, as shown in Chart 3.24. This is because labour income includes employer pension contributions, which are expected to grow relatively strongly over the forecast period but which have a neutral effect on household disposable income.

Chart 3.21: Real consumption wage and real consumption



Source: ONS, OBR

### The labour market and household income

- 3.66** The unemployment rate increased in the second quarter of 2015, but more than reversed that rise in the third quarter, reaching 5.3 per cent. The latest labour market data were not available at the time that we closed our economy forecast (to changes other than policy decisions). The current unemployment figure is slightly lower than we had pencilled in for this forecast. It is in line with our July forecast.
- 3.67** We forecast the unemployment rate to decline slowly to 5.1 per cent by the end of 2016, as productivity growth picks up, allowing firms to expand output more through their existing workforce rather than through recruitment. The headline unemployment rate is then forecast to rise back to 5.4 per cent in the medium term as an increasing 'National Living Wage' puts upward pressure on structural unemployment (see Box 3.2). We now expect the claimant count to rise relative to the broader measure of unemployment, as the lone parent obligation, which moves parents off income support and typically onto jobseeker's allowance in the first instance, is extended to lone parents of 3-year olds.
- 3.68** The participation rate is expected to rise modestly over the next three years – in part due to net inward migration that is focused among people of working age – and then to fall back to its current level as the population ages. The 1.1 million rise in employment over the forecast period can therefore be explained entirely by additional population growth, which has been marginally revised up in light of the ONS's latest projections.
- 3.69** The measure of average earnings growth that we forecast – based on the National Accounts – has been revised down in 2014, bringing it closer to the headline average weekly earnings (AWE) measure. The National Accounts use AWE data, until administrative tax data become available, so in principle the two should be consistent, but the aggregation process

and other factors have in the past led to material differences. Underlying average earnings in the year to date has been broadly in line with our expectations in July, but the forecast for 2015 has been revised up relative to the lower 2014 baseline.

- 3.70 We have reduced average earnings growth in each subsequent year. This is consistent with slower (but still rising) productivity growth over the next few years, although we continue to expect real average earnings to rise by slightly more than productivity per worker over this period. Over the medium term, the downward revision to our forecast reflects a judgement that the additional costs created for firms and workers by the Government's introduction of the apprenticeship levy and ongoing auto-enrolment into workplace pensions – both of which are economically equivalent to payroll taxes – will largely be borne through lower wages. The Government's decision to postpone planned increases in auto-enrolment pension contributions in this Spending Review and Autumn Statement delays the effects, but we still expect these factors to reduce earnings by 0.7 per cent over the forecast period. Lower whole economy inflation also translates into slower nominal earnings growth in the final year of our forecast.

### Box 3.2: The effects of the National Living Wage

In July, the Government announced the 'National Living Wage' (NLW) for workers aged 25 and above, with a target of it reaching 60 per cent of median hourly earnings for that group by 2020. (This is distinct from the higher voluntary 'living wage' set each year by the Living Wage Foundation.) We were unable to discuss the modelling of the policy with stakeholders, including the Low Pay Commission (LPC), at the time. Following these conversations, our basic modelling approach, detailed in Annex B of the July *EFO*, is unchanged.

But our forecast for the wider economy – in which the NLW will operate – has been revised. As we project median earnings forward from April 2014, our projection for the NLW is dependent upon both outturns and our forecast of hourly wages. Although our forecast for cumulative hourly earnings growth to the end of 2020 has been revised down by 2.1 percentage points, the National Accounts data for wage growth since the second quarter of 2014 has been revised up. The net effect is to reduce our projection for the NLW in 2020 slightly, from £9.35 to £9.30. The path up to that point will be determined by the Government based on advice from the LPC, but we need to assume a path for the NLW to inform our fiscal forecast. That path is shown in Table A. It assumes that the NLW rises in a straight line to reach 60 per cent of the median in 2020.

Table A: Illustrative paths of the NMW and the NLW<sup>a</sup>

	£ per hour					
	2015	2016	2017	2018	2019	2020
National Minimum Wage	6.70	6.95	7.20	7.50	7.80	8.10
National Living Wage	-	7.20	7.65	8.20	8.70	9.30

<sup>a</sup> The NMW has been set for 2015 and the NLW for 2016, but all other figures are OBR assumptions consistent with the rest of our economy forecast.

We use the Annual Survey of Hours and Earnings (ASHE) microdata to estimate the static effects of the policy. Absent any indirect effects, we estimate a total increase in wages and salaries of £3¼ billion in 2020 and a £3¾ billion increase in the broader compensation of employees.

Around  $\frac{3}{4}$  million employees otherwise earning the National Minimum Wage (NMW) would on average see an increase in weekly pay of £28. Around 2 million people moving from above the NMW to at least the NLW would gain £15 a week on average. Finally, we have assumed that there will be a wage 'spillover' for employees earning up to the 25<sup>th</sup> percentile of the wage distribution, affecting  $3\frac{1}{4}$  million people, but by a much lower £4 per week on average. The average increase across these three groups is around £11 a week. But these figures ignore how firms choose to respond.

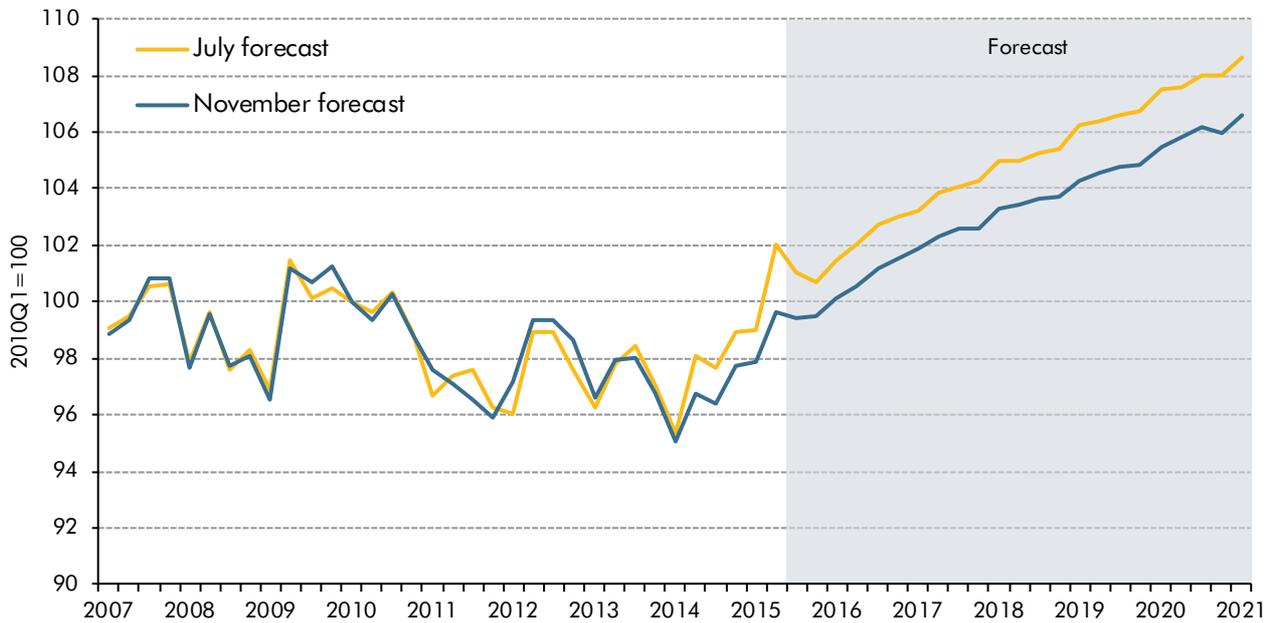
To model firms' response to the policy we move to a top-down macro analysis, rather than distinguishing between different industries or other groupings.<sup>b</sup> We use the proportional increase in total costs together with a demand elasticity to calculate the reduction in total hours worked, which is shared between lower employment and lower average hours. This results in the average increase in weekly earnings for those affected falling to around £6 a week. Within that, unemployment would be around 60,000 higher than in the absence of the NLW. That could result from firms firing members of their existing workforce or reducing hiring so that the workforce adjustment happens during the normal turnover of employees. As the policy increases unit costs for firms, we assume that they pass some of those costs through to consumers in higher prices, as well as see a fall in their profits.

There are significant uncertainties in our assumptions that were detailed in our July *EFO*. One key uncertainty is how the distribution of hourly wages will evolve over the next five years. New ASHE data for 2015 have been released since we closed our economy forecast, giving an updated picture of the wage distribution. The static wage effect – and therefore the associated reduction in employment and average hours – appears to be slightly larger with the new distribution than with the 2014 distribution used in our modelling. We will take the new data into account in our next forecast.

<sup>b</sup> Some industries, particularly accommodation and food services, and residential care, will see bigger increases in costs than others. Moreover, relatively small businesses and very large companies are likely to be disproportionately affected. The effects will also differ across different regions and localities.

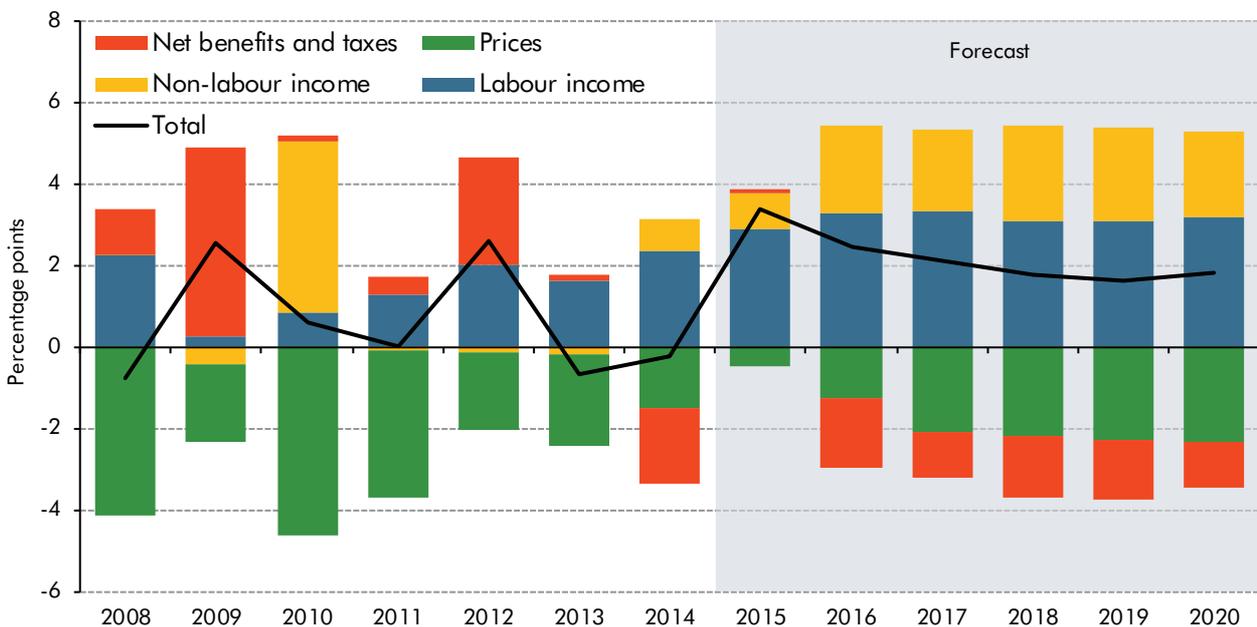
- 3.71 Real household disposable income growth has picked up sharply in calendar year 2015. We forecast growth of 3.4 per cent, due to both lower inflation and rising income growth – although this year-on-year comparison is somewhat distorted by 'base effects' reflecting the uneven path of quarterly household income over the recent past. The contribution from net taxes and benefits is expected to turn positive in 2015, largely reflecting the latest ONS outturns from the first half of the year. These can be volatile on a quarterly basis. We expect this component to act as a drag on household income in future years as growth in taxes on income and employee social contributions outpaces the growth of social benefits. We expect real household disposable income growth to settle at just under 2 per cent a year over the medium term, as underlying income growth stabilises and inflation returns to target.

Chart 3.22: Real household disposable income per capita



Source: OBR

Chart 3.23: Contributions to real household income growth

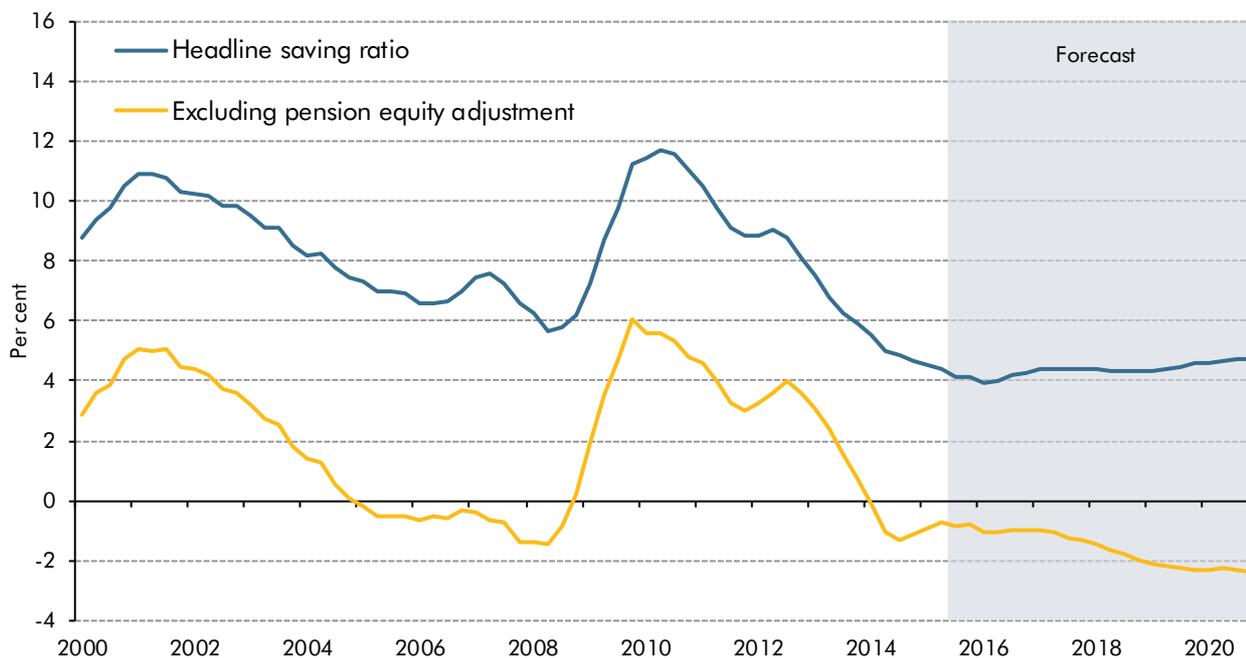


Source: ONS, OBR

### The saving ratio

3.72 Since our July forecast the ONS has revised down the level of the saving ratio in 2014 and the start of 2015, largely reflecting downward revisions to household income growth. The latest data show it continuing to fall steadily in 2013 and 2014 as consumption outpaced the relatively weak growth of household disposable income (Chart 3.24).

Chart 3.24: The household saving ratio



Note: Both series show four-quarter moving averages. The estimate of the saving ratio excluding the pension equity adjustment is calculated as household disposable income less consumption, as a proportion of household disposable income.

Source: ONS, OBR

**3.73** The downward revisions to recent data mean that we now expect the saving ratio to be lower throughout the forecast period than in July. We expect consumption to grow more quickly than household disposable income, but the effect on the household saving ratio is more than offset by an expected rise in measured pension saving. This implies a gradual rise in the headline saving ratio over the forecast period. The expected rise in pension saving reflects both rising gilt yields – which are used by the ONS in the calculation of imputed pension saving – and the effect of auto-enrolment on employer and employee pension contributions as coverage expands and minimum contribution rates increase.

### The housing market and dwellings investment

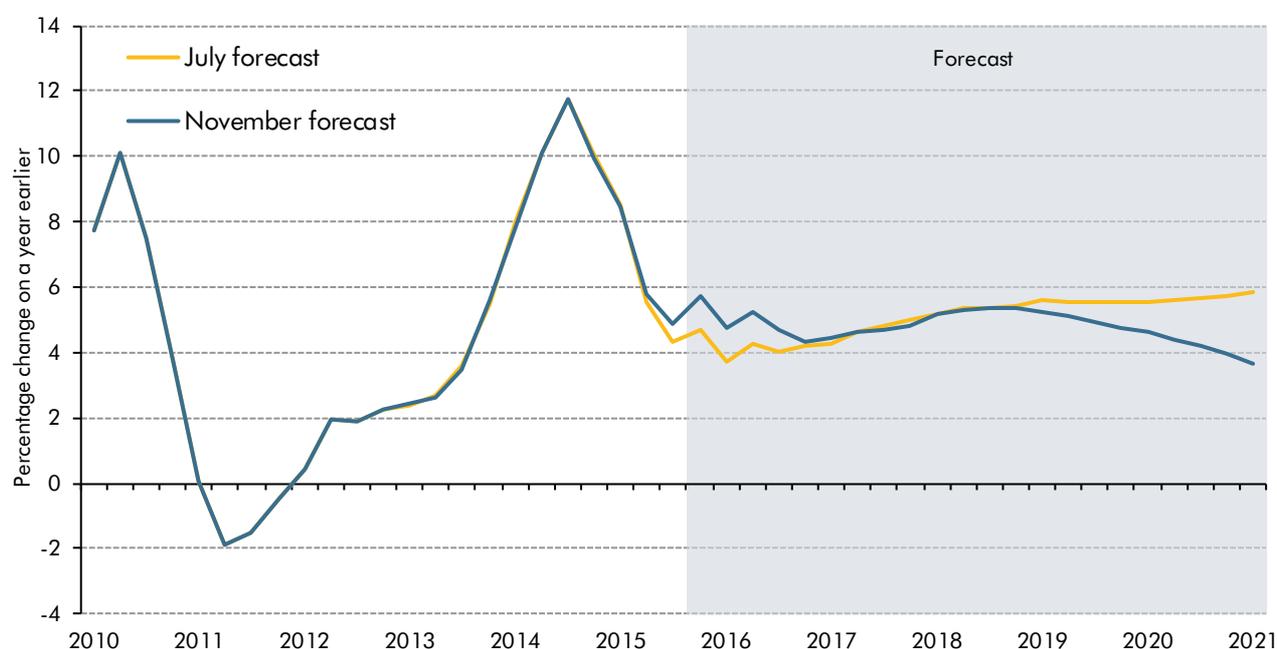
**3.74** House price inflation has continued to ease, with year-on-year growth in the third quarter of 2015 at 5.6 per cent, down from a recent peak of 11.7 per cent in the third quarter of 2014 (Chart 3.25). There is considerable uncertainty about near-term prospects for house price inflation. The major lenders' house price indices have diverged, with the Halifax index reporting prices are up 9.7 per cent in the year to October while the Nationwide index is up just 3.9 per cent over the same period. Survey indicators from the Royal Institution of Chartered Surveyors have generally picked up. We closed the forecast before the September ONS data were available, but it would not have materially affected our forecast.

**3.75** Beyond the near term, we use a house price model to inform our forecast.<sup>9</sup> Currently, this suggests that there is a significant amount of credit rationing in the mortgage market. Financial institutions are extending less secured debt than the model suggests households

<sup>9</sup> For more information on our house price model see Auterson (2014): *Working paper No. 6: Forecasting house prices*.

would like based on fundamental drivers of mortgage demand. We continue to assume this implied mortgage rationing eases relatively slowly, persisting at the end of the forecast period. This is consistent with changes to the regulatory environment, ongoing repair to bank balance sheets and changes to lenders' behaviour brought about by the Mortgage Market Review. Over the forecast period, we expect house price inflation to persist at rates somewhat above earnings growth, consistent with historical trends in the UK. Revisions to the profile across the forecast since July have been relatively small, with the level of house prices in the first quarter of 2021 2.1 per cent lower than in July. House prices are expected to rise by 28.4 per cent by the first quarter of 2021. Relative to their pre-crisis peaks in 2007, real house prices at the end of the forecast are expected to be 11.2 per cent higher and the ratio of house prices to average earnings 10.5 per cent higher.

Chart 3.25: House price inflation forecast



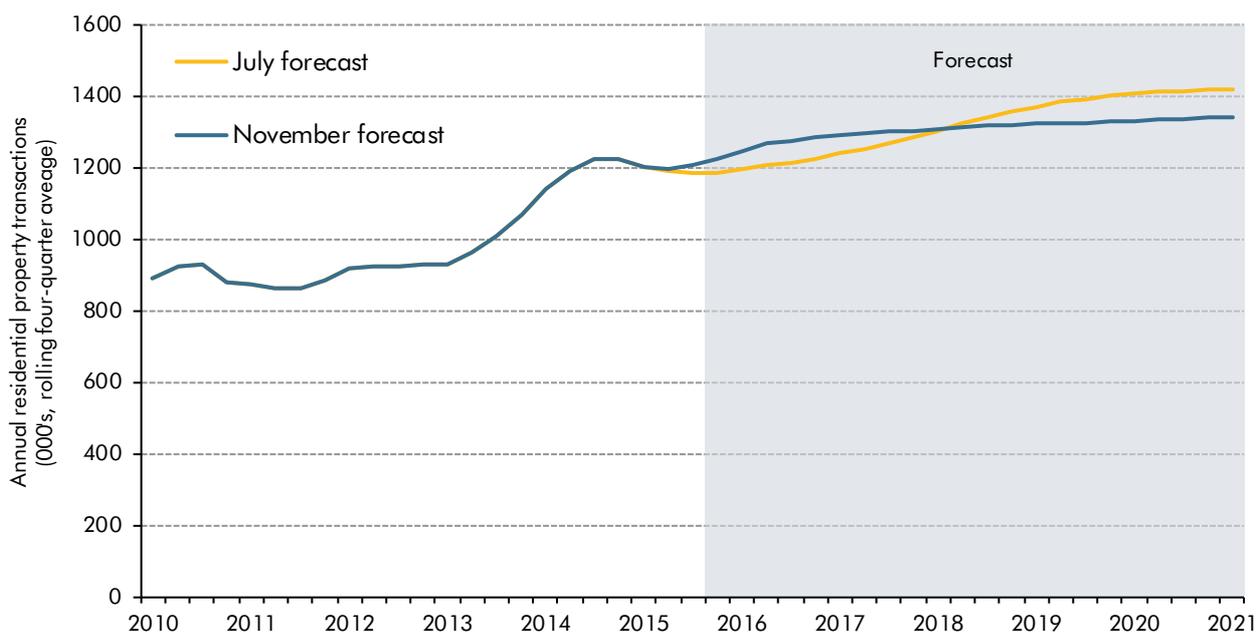
Source: ONS, OBR

**3.76** We have revised down our forecast for residential property transactions since July (Chart 3.26). The proportion of privately renting households rose from 10 per cent in 2000 to 19 per cent in 2014. Over the same period, the number of owner-occupier households fell from 71 per cent to 63 per cent. Within that, the reduction in mortgaged households (as opposed to those owning outright) was even greater – down from 42 to 31 per cent. This trend affects the number of property transactions as recent research suggests private buy-to-let landlords re-sell their properties at about half the rate of owner-occupiers.<sup>10</sup> Taken together, these two factors suggest our previous assumption – that the volume of transactions will return towards its historical average as a percentage of the housing stock over the forecast period – was optimistic. We now assume that the growth in private renting will continue and therefore reduce the number of residential property transactions. The level of transactions in the first quarter of 2021 is 6 per cent lower than in our July forecast.

<sup>10</sup> Bracke, P. (2015), How much do investors pay for houses? *Bank of England Staff Working Paper*, No. 549.

3.77 The Government has introduced higher rates of stamp duty land tax on purchases of additional properties (mainly buy-to-let and second homes) of 3 per cent, which is expected to reduce the number of residential property transactions. It comes on top of two measures announced in July – the reduction in the rate of allowable mortgage interest relief and the removal of the wear and tear allowance. These policy changes add to the uncertainty around our house price and transactions forecasts.

Chart 3.26: Residential property transactions forecast

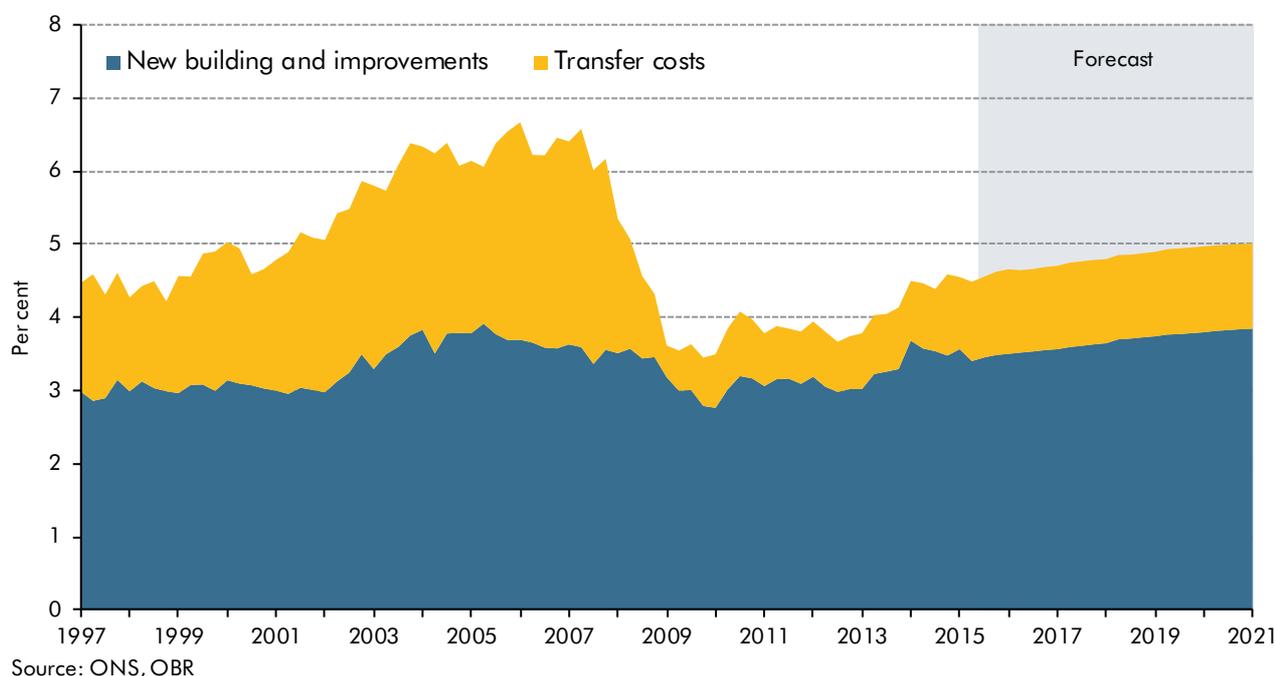


Source: ONS, OBR

3.78 The latest National Accounts data contained significant revisions to residential investment growth in recent quarters. It is now thought to have grown by 7.4 per cent in the first quarter of 2014, but quarterly growth rates have been revised down in each subsequent quarter. Those revisions mean that residential investment growth is little changed in 2014 as a whole, but we now expect 0.3 per cent growth in 2015, down significantly from the 6.3 per cent growth we forecast in July. Our forecast for 2016 is unchanged, but it has been revised down in each year from 2017 onwards, in line with the revisions to our property transactions forecast. We have also revised up our estimate of the negative impact that the July Budget measure reducing social sector rents will have on housebuilding by housing associations, although changes to grant funding offset some of this revision (see Annex B).<sup>11</sup> Total private residential investment is expected to remain below its pre-crisis peak as a share of GDP throughout the forecast period (Chart 3.27).

<sup>11</sup> In the UK Economic Accounts, housing associations remain classified to the private sector and as such any investment they undertake is classified as private residential investment. Consistent with this, we have not attempted to reflect the reclassification in our economy forecast, given the difficulties of doing so and the longer timetable associated with implementing reclassifications in the National Accounts.

Chart 3.27: Residential investment as a share of nominal GDP



### Net lending and the balance sheet

3.79 Our forecast for the household balance sheet is built up from a number of components:

- the accumulation of household assets (such as deposits), pension and insurance assets, equity and other assets;
- the accumulation of liabilities, which are decomposed into mortgages secured on dwellings and unsecured debt; and
- these are constrained to be consistent with our forecast for households' net lending position, which determines the rate at which households acquire assets relative to liabilities (their 'net' asset accumulation). All else equal, a positive net lending position implies that households will accumulate more assets than liabilities and vice versa.

3.80 Since July, we have reviewed all aspects of our household balance sheet forecast methodology and have made a number of changes:

- recent data suggest that households' acquisition of insurance assets has been negative. Consistent with this, we have moved to a disaggregated approach to forecasting pension and insurance assets and have revised down our forecast for acquisition of insurance assets. The accumulation of pension assets remains linked to our forecasts of pension saving. This has reduced household asset accumulation, all else equal;
- we have changed our methodology for forecasting unsecured debt. Our previous forecasts were based on a top-down approach where the accumulation of unsecured

debt was projected forward on the basis of households' net lending position, ensuring consistency between the stock and flow positions of households' financial accounts. We have moved to a bottom-up approach, where the accumulation of unsecured debt is projected based on its relationship with a number of other variables in our economic forecast, including consumption, unemployment and property transactions; and

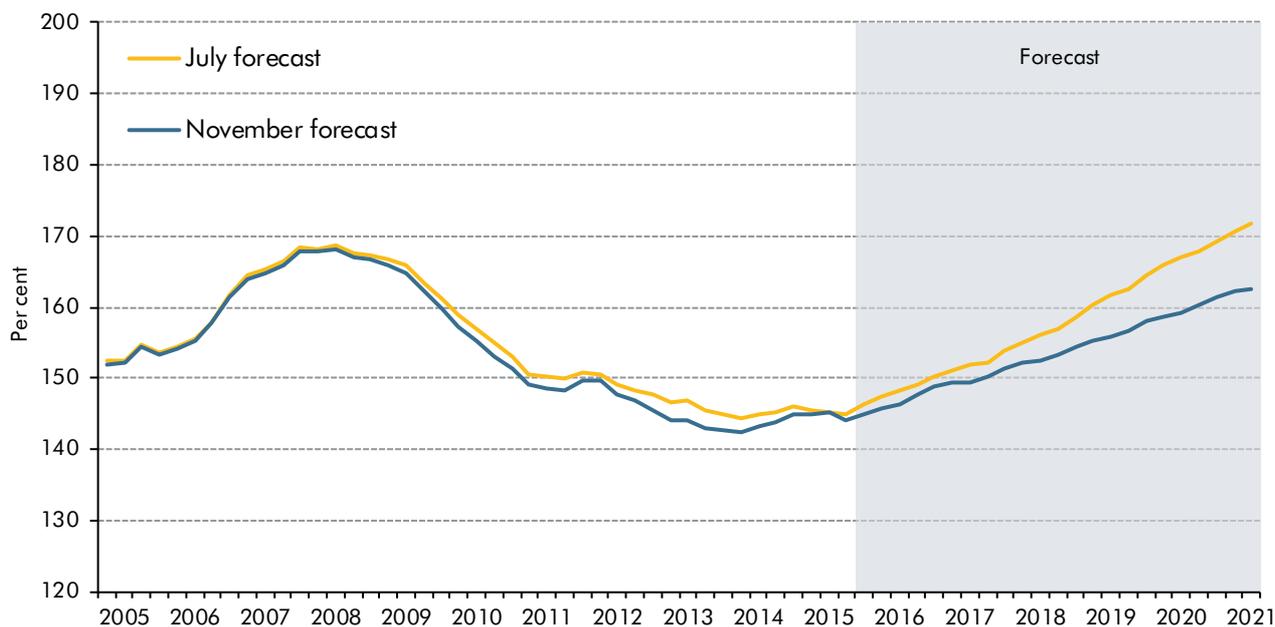
- given the need to constrain the balance sheet forecast to be consistent with households' net lending position, our forecast for 'other' assets is now constructed using a top-down approach linked to our forecasts for household net lending and all other elements of the balance sheet. Having reviewed the relative data quality of different elements of the household balance sheet, we think it more appropriate to use this element as the residual to ensure consistency between the stock and flow positions of households' financial accounts.

**3.81** These changes have lowered our forecasts for households' accumulation of both assets and liabilities relative to July. The weaker household net lending position since July – largely reflecting the lower starting point for household saving – means that the downward revision to asset accumulation is larger than that to liabilities. So, while we have revised down our forecast for gross household debt, we have also revised down our forecast for household net worth. The latter remains broadly stable relative to household disposable income over the forecast period rather than rising slowly as in our July forecast.

**3.82** We now expect gross household debt to reach 163 per cent of household disposable income by the end of the forecast period, revised down from an expected 172 per cent in our July forecast:

- in cash terms, gross debt is expected to be £145 billion lower by the start of 2021 than we expected in July. Of this, around £11 billion reflects lower than expected household debt in the second quarter of 2015;
- around £38 billion is accounted for by less accumulation of secured debt, consistent with a lower expected path for property transactions (see paragraph 3.76);
- our forecast for the accumulation of unsecured debt has been revised down by £96 billion; and
- household disposable income at the start of 2021 is expected to be around ½ per cent lower than our July forecast.

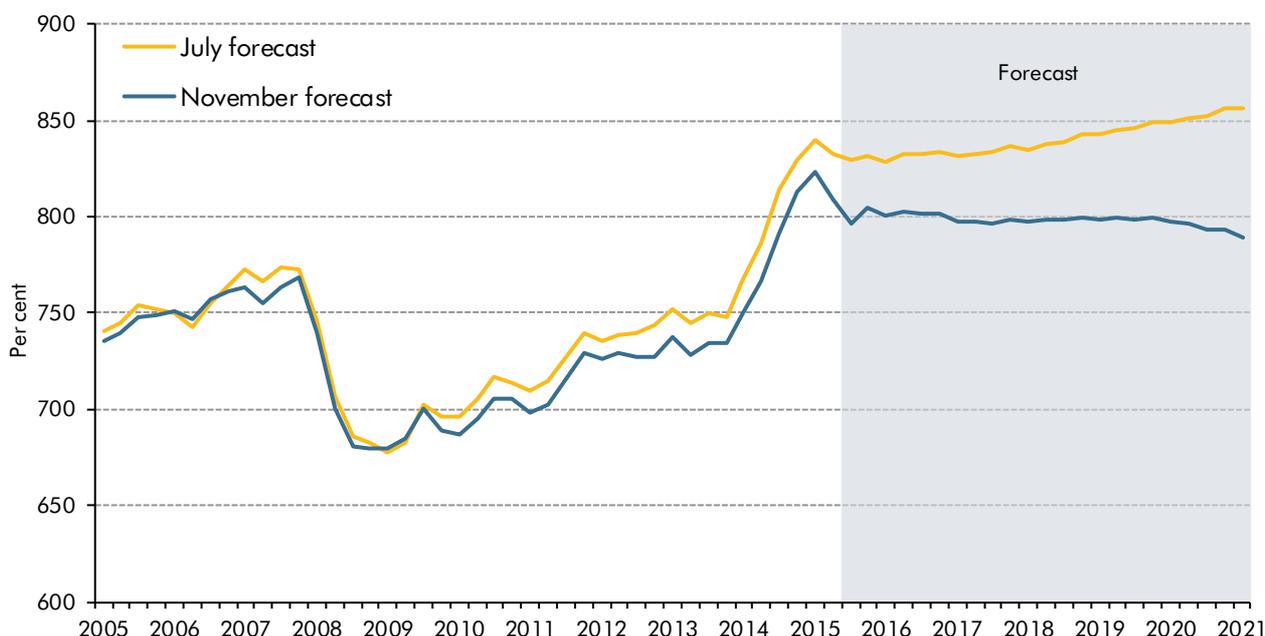
Chart 3.28: Household gross debt to income



Source: ONS, OBR

**3.83** Chart 3.29 shows our forecast of household net worth, which includes housing equity as well as the financial assets and liabilities described above. The ratio of net worth to income increased between 2010 and 2015, particularly over the past two years. That reflected the rising value of housing assets and households' ongoing accumulation of financial assets, relative to financial liabilities. While rising house prices mean that we expect the value of the housing stock to continue to rise at a similar pace over the next five years, we expect a slower accumulation of financial assets relative to liabilities than over the past five years – in turn reflecting households' weaker net lending position.

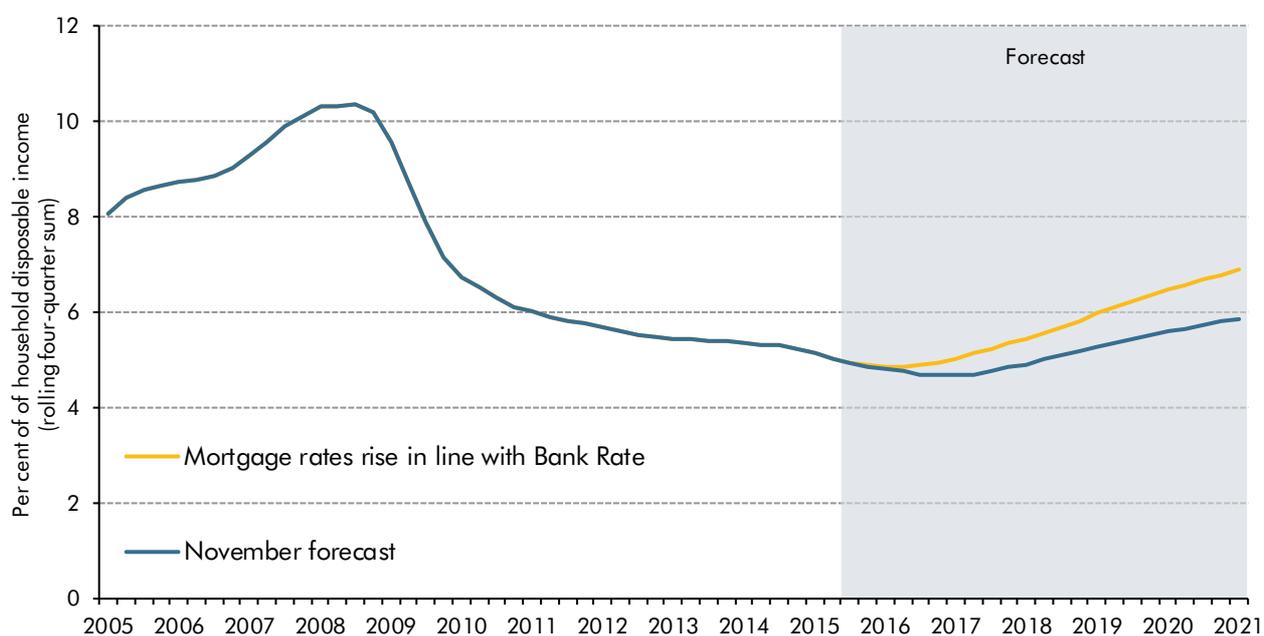
Chart 3.29: Household net worth relative to household income



Source: ONS, OBR

3.84 While we expect the stock of secured debt to increase over the forecast period, household debt servicing costs are expected to remain low relative to household income (Chart 3.30), as mortgage rates are expected to remain at historically low levels. The relatively low path of mortgage rates reflects the lagged effects of past falls in funding spreads, the low level of Bank Rate and our assumption that the margin on mortgages will narrow over the forecast period. If margins remained steady, so that mortgage rates increased at the same pace as Bank Rate, debt servicing costs would be somewhat higher than our central assumption, although as a share of income they would remain well below pre-crisis levels.

Chart 3.30: Household debt servicing costs



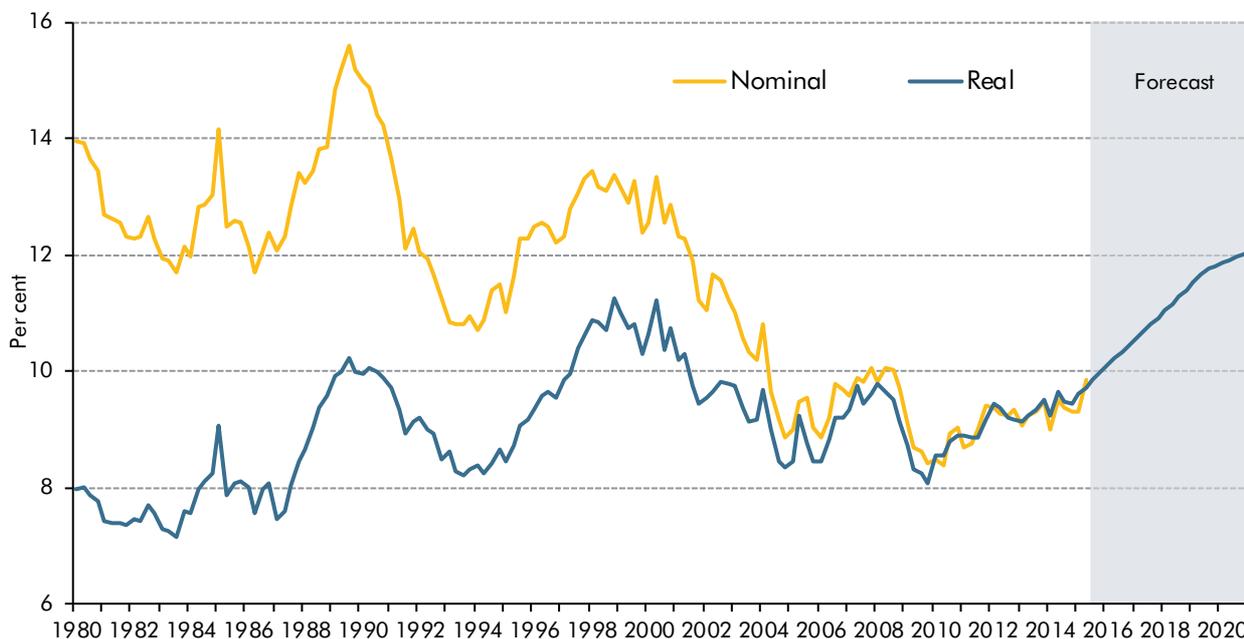
Source: ONS, OBR

## The corporate sector

### Business investment and stockbuilding

- 3.85** Business investment grew by 4.6 per cent in 2014, significantly less than was estimated in July. Business investment grew relatively strongly in the first two quarters of 2015 and we expect it to grow by 6.1 per cent in 2015 as a whole, slightly higher than our July forecast.
- 3.86** The Bank of England's *Agents' Summary* reports investment intentions consistent with modest growth over the coming year. We expect business investment to continue to grow relatively strongly and have revised up our forecast in each year between 2016 and 2019, but have revised it down slightly in 2020. As usual, the latest ONS data are subject to potentially large revisions, so our forecast is subject to considerable uncertainty.
- 3.87** As Chart 3.31 shows, our forecast implies that real business investment will rise as a share of GDP, as typically occurs during the later stages of a recovery. It also shows how the nominal share has tended to fall relative to the real share because investment goods price inflation has tended to be lower than whole economy inflation.

Chart 3.31: Business investment as a share of GDP



Source: ONS, OBR

**3.88** The latest ONS data indicate that stocks acted as a drag on GDP growth in the second quarter of 2015. We expect inventories to make a positive contribution in the third quarter, largely offsetting an expected negative contribution from net trade, but to make a negative contribution to GDP growth in 2015 as a whole. We assume the contribution from stocks will be neutral from 2016 onwards.

### Corporate profits

**3.89** Following recent revisions, non-oil profits are now estimated to have grown strongly over the past two years, increasing by just over 10 per cent in both 2013 and 2014. As the output gap continues to close, we expect non-oil profits to continue to rise slightly more quickly than nominal GDP in the short term, growing by just over 6 per cent in 2015 and by around 4½ per cent in 2016. In subsequent years we expect the growth of corporate profits to settle at rates just below the growth rate of nominal GDP, as the increasing costs associated with auto-enrolment and the Government's introduction of an apprenticeship levy are expected to be borne partly by lower profit margins.

### The government sector

**3.90** Total public spending amounted to 40.9 per cent of GDP in 2014-15.<sup>12</sup> But not all government spending contributes directly to GDP. Spending on welfare payments and debt interest, for example, merely transfers income from some individuals to others. The government sector contributes directly to GDP via consumption of goods and services, and investment. These together accounted for 22.2 per cent of GDP in 2014-15.

<sup>12</sup> Total managed expenditure (TME).

## Real government consumption

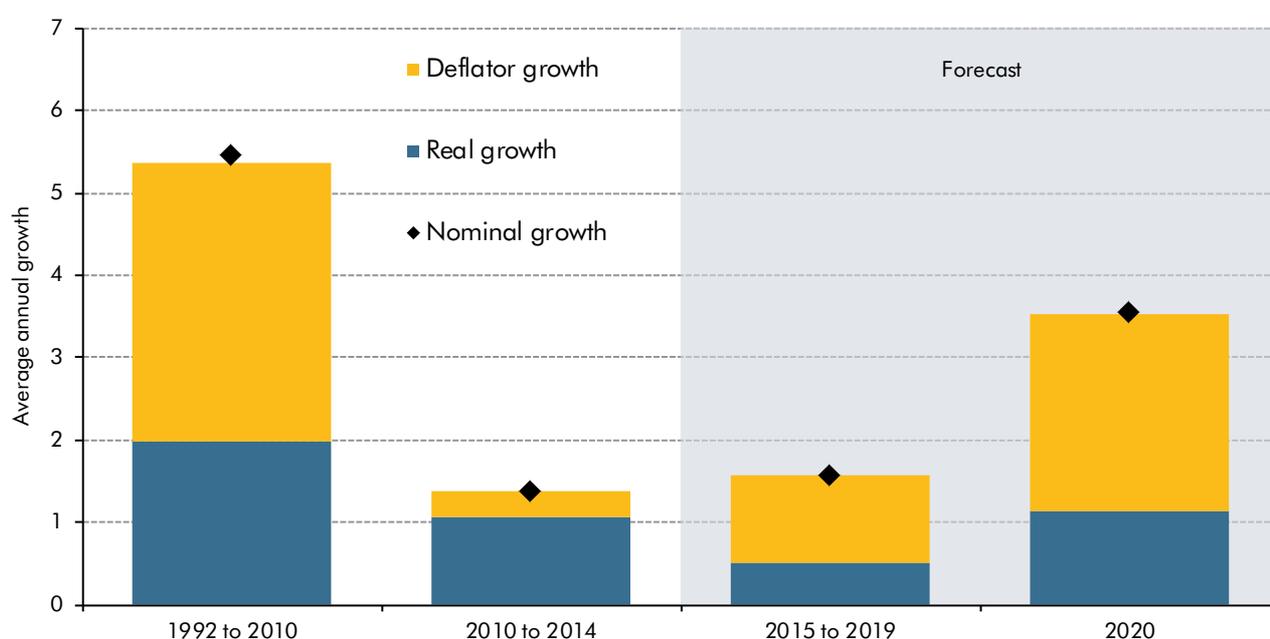
3.91 Real government consumption grew by 0.4 per cent in the second quarter of 2015 and we expect it to grow by 1.7 per cent in 2015 as a whole, faster than we forecast in July. Our forecast for government consumption growth has been revised down slightly in 2016, but revised up slightly between 2017 and 2019, reflecting the Government's decisions on the pace and composition of fiscal consolidation and the plans set out in the Spending Review. Government consumption is forecast to rise less strongly in 2020 than we forecast in July.

## Nominal government consumption

3.92 Growth in the implied price of government consumption – the ratio of nominal spending to real government consumption – has been subdued as cash spending growth has slowed (Chart 3.32). This largely reflects the way real government consumption is measured, as described in Box 3.2 of our July *EFO*.

3.93 The government consumption deflator is expected to fall by 1.4 per cent in 2015 as a whole. This is a larger fall than we forecast in July, reflecting stronger growth in real government consumption. Government consumption deflator growth is slightly lower in 2016, is higher between 2017 and 2019, and is lower in 2020, compared with our July forecast. These revisions are also driven by the Government's decisions on the pace and composition of fiscal consolidation.

Chart 3.32: General government consumption

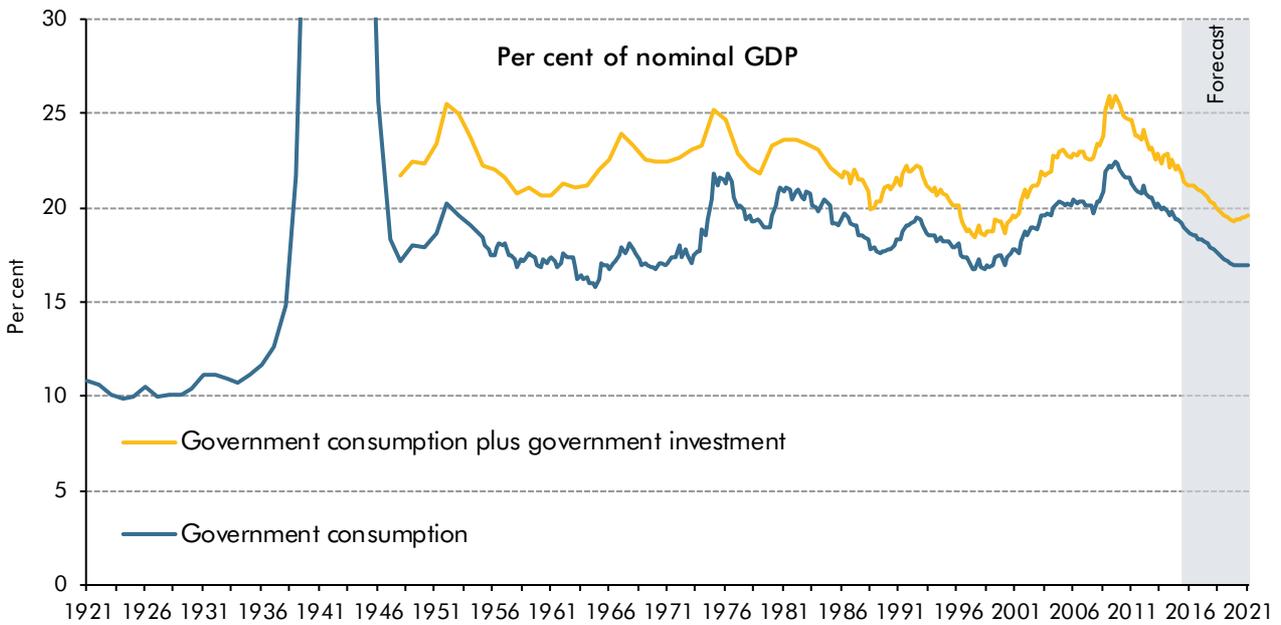


Source: ONS, OBR

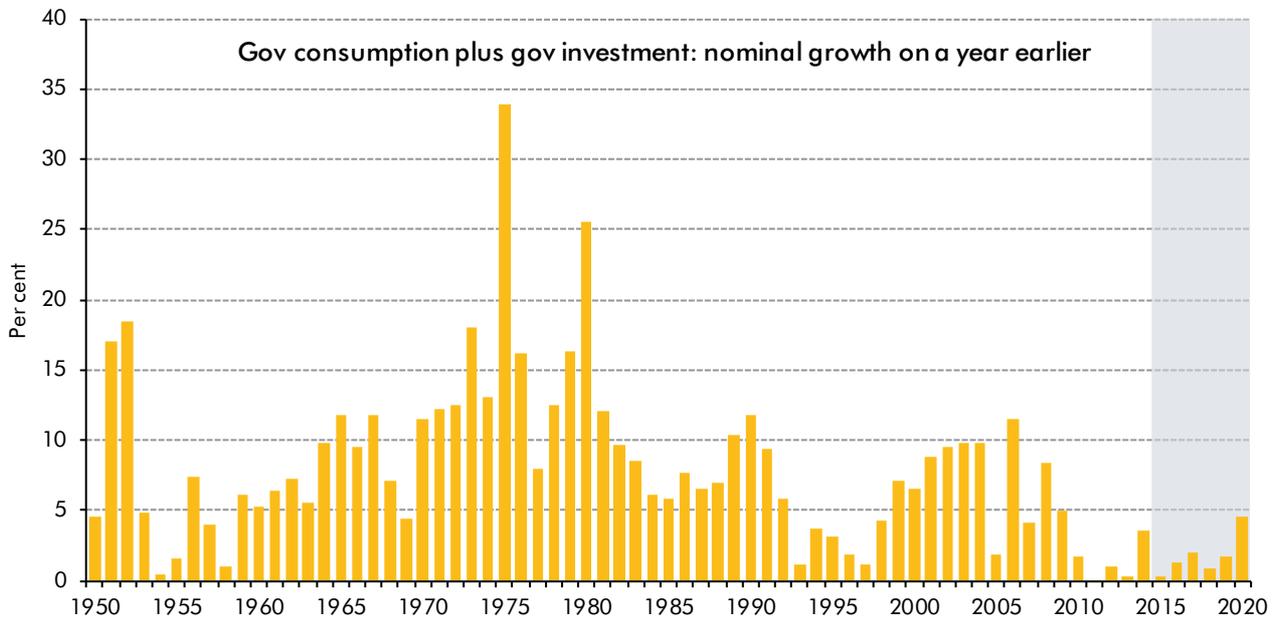
3.94 The Government's updated fiscal plans imply that nominal government consumption will grow by 2.0 per cent a year on average over the forecast period, unchanged from our July forecast. This implies that nominal government consumption will fall from 19.0 per cent of GDP in 2015 to 17.0 per cent of GDP in 2020, slightly higher than in July. In our July

forecast, government consumption fell as a percentage of GDP up to 2019, before rising in 2020. While the Government’s updated fiscal plans imply a smoother path for government consumption over the forecast period, government investment is now forecast to rise strongly in 2020 (Chart 3.33).

Chart 3.33: Government consumption and government investment



Note: Government consumption as a share of GDP is estimated to have peaked at 54.0 per cent of GDP in 1944.



Note: Government consumption plus government investment on a National Accounts basis.

Source: ONS, OBR

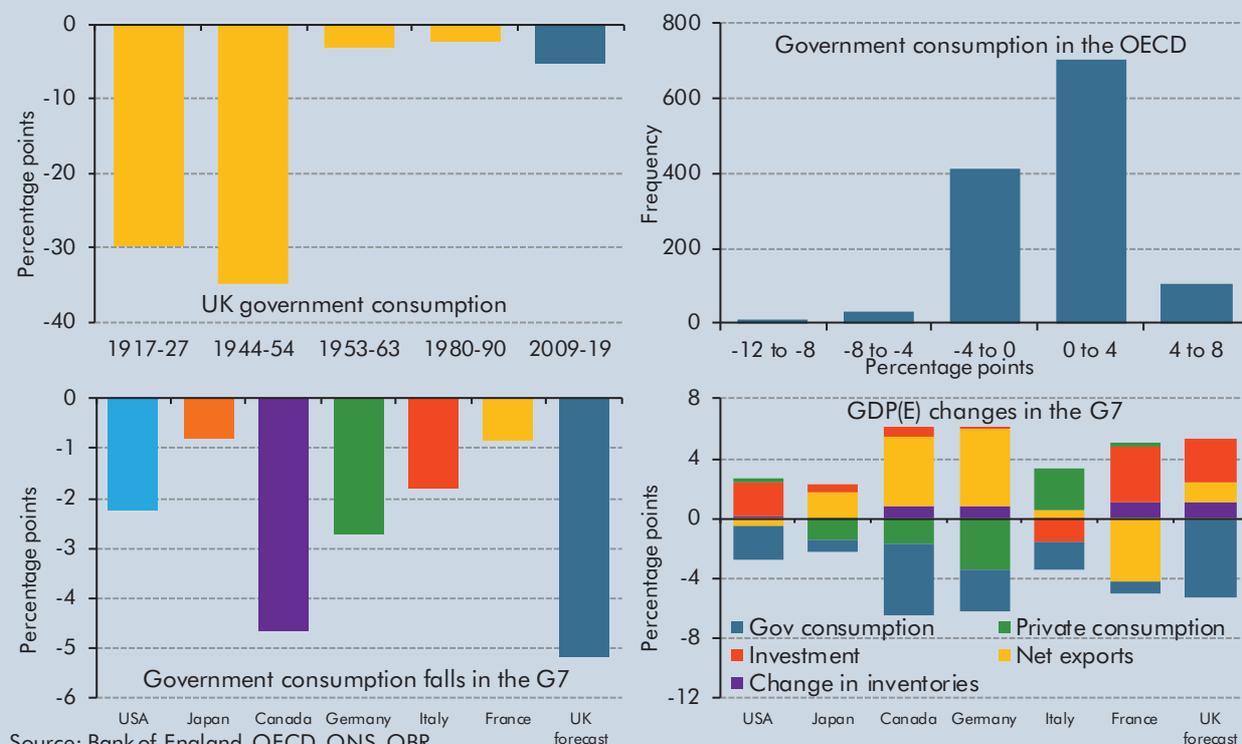
### Box 3.3: Government consumption as a share of GDP

The new Government has significantly reduced the cuts to departmental budgets that had been pencilled in by the Coalition when it left office earlier this year. But government consumption – the closest equivalent measure in the National Accounts – is still set to fall by 5.2 per cent of GDP between its peak in 2009 and 2019.

Barring the periods of demobilisation in the wake of the first and second world wars, this would be the biggest ten-year reduction in the past century (top left panel of Chart A). It would also be the biggest ten-year fall seen in any G7 country in the past half century, according to OECD data dating back to 1960. That dataset contains 38 occasions where a country has recorded falls in government consumption of more than 4 per cent of GDP over a ten-year period, which represents just 3 per cent of the total sample (top right panel).

When government consumption falls as a share of GDP, other components of nominal spending must rise by definition. For example, in the UK between 1953 and 1963 and then between 1980 and 1990, investment increased substantially as a share of GDP as government consumption was reduced. The bottom panels of Chart A show the biggest falls in government consumption in the G7 countries over this period, alongside our forecast for the UK, and the changes in other spending categories during those episodes. Of those six largest falls in government consumption, three have seen net exports provide the main offset, in two cases it was investment and in one it was private consumption. In our forecast, investment provides the largest offset.

Chart A: Historical and international comparisons of government consumption<sup>a</sup>



<sup>a</sup> The international comparisons charts in the bottom panels compare the largest recorded falls in government consumption across G7 countries. In the US, this refers to the period 1971-1981, for Japan it is 1980-1990, for Canada it is 1992-2002, for Germany it is 1981-1991, for Italy it is 1990-2000 and for France it is 1997-2007. These periods are compared with the forecast fall in UK government consumption between 2009 and 2019.

## General government employment

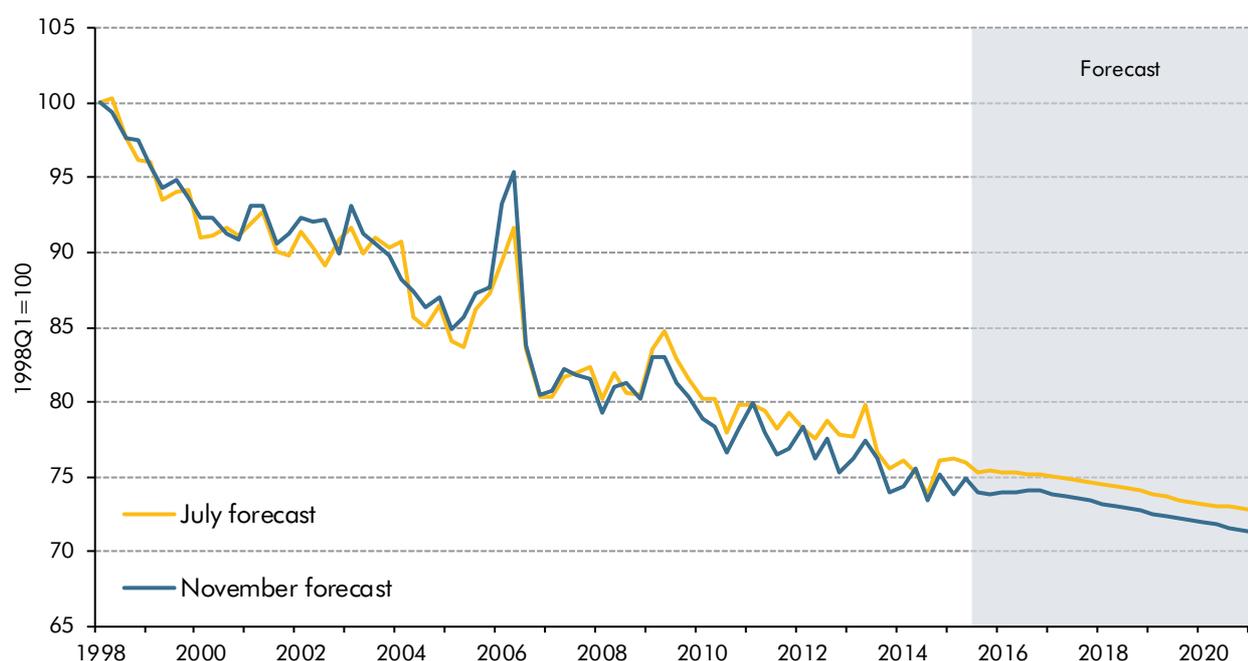
- 3.95 In the absence of specific workforce plans, we project general government employment based on some simple and transparent assumptions. We begin by assuming that the total paybill will grow in line with a measure of current government spending. We also separately forecast government sector wage growth, taking into account recent data, stated government policy (such as limits on pay growth), historic rates of pay drift and whole economy earnings growth over the medium term. We then combine total and average pay growth to derive a projection of general government employment.
- 3.96 Slow growth in cash spending and low annual wage growth imply that general government employment will fall by 0.1 million between the first quarter of 2015 and the first quarter of 2020, leading to a total fall from early 2011 of 0.4 million. This is 0.3 million smaller than projected in July, following increases to spending plans and the Government's decision to limit public sector pay awards to 1 per cent a year over the period (which was announced in the July Budget, but not included in our figures as the Government did not inform us of that decision until after our forecast had been closed). We expect the fall to be more than offset by a rise in market sector employment, with general government employment broadly flat in the final year of the forecast period and market sector employment continuing to rise.

## The external sector

### Export and import volumes

- 3.97 The latest National Accounts data revised up exports growth in 2014 relative to estimates at the time of our July forecast. But downward revisions to quarterly trade growth at the end of 2014 and weaker outturn data in early 2015 mean that we forecast exports growth of 3.4 per cent in 2015 as a whole, slightly weaker than in July. Our forecast for exports has been revised down in each year from 2016 onwards, reflecting a downward revision to UK export markets that stems largely from our judgement that the trade intensity of world GDP growth will remain weaker for longer than assumed in July (see paragraph 3.35). The declining path for the UK export market share is similar to our July forecast.

Chart 3.34: UK export market share



Note: UK export share defined as exports divided by UK export markets, where exports series have been adjusted to account for the effect of VAT Missing Trader Intra Community (MTIC) fraud.

Source: OECD, ONS, OBR

### Box 3.4: The under-performance of nominal exports of goods and services

At Budget 2012, the Government stated its aspiration to increase the value of exports to £1 trillion in 2020. That required export growth of £506 billion over nine years, whereas extending our March 2012 *EFO* forecast would have implied growth of £352 billion over the same period.<sup>a</sup>

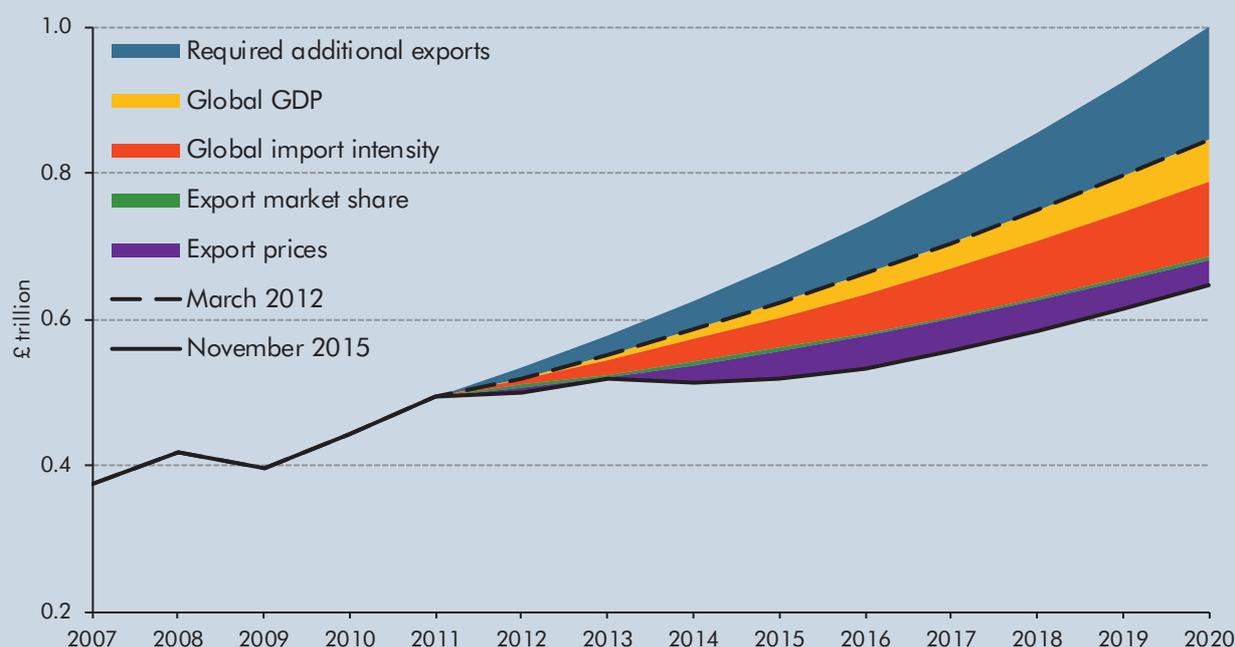
Export growth can be decomposed into a combination of four components. Real GDP growth in the UK's export markets and the import intensity of that growth will together determine the size of UK export markets. The UK share of demand in those export markets will determine the volume of exports, then finally the price of exports will determine their nominal value.

Based on our extended March 2012 forecast, GDP growth in UK export markets was expected to contribute £174 billion to growth in UK exports between 2011 and 2020. Rising import intensity of that GDP growth was expected to contribute a further £164 billion, so the total contribution from growth in UK export markets was £338 billion. The UK's export market share was expected to decline between 2011 and 2020, which was expected to subtract £31 billion from UK exports. Beyond these three real components, growth in the export deflator was expected to contribute a further £44 billion to nominal exports growth between 2011 and 2020.

The Government has limited control over any of these drivers of export growth, but it could be assumed that the ambition reflected a desire to increase export market share relative to the path consistent with the March 2012 forecast (for example, the Government increased funding for UKTI and export finance). The UK's export market share would have had to increase by 10.8 per cent from its 2011 level to meet the Government's export aspiration. In our March 2012 *EFO*, we forecast that it would fall by 6.3 per cent over that period.

We now forecast the cash value of total exports of goods and services will reach £647 billion in 2020, 23 per cent lower than our extended March 2012 forecast and 35 per cent lower than the Government’s aspiration. Since March 2012, we have revised down our forecast for GDP growth in UK export markets, which reduces nominal exports by £58 billion. Lower import intensity of that growth reduces exports by a further £102 billion. The UK’s export market share has fallen a little more than expected in our March 2012 forecast, subtracting a further £5 billion. Weaker growth in the export deflator subtracts a further £34 billion from exports in 2020. Overall, nominal exports are forecast to be £199 billion lower in 2020 than the extension of our March 2012 forecast and £353 billion short of the £1 trillion ambition.

Chart B: Nominal exports compared with our March 2012 forecast



Source: OBR

IMF GDP forecasts can be used to determine which geographic regions are expected to contribute to export growth up to 2020. Between 2011 and 2015, the latest WEO reports lower GDP growth in UK export markets than was forecast in the September 2011 WEO – the latest available at the time of our March 2012 EFO – with growth lower than expected in the US, euro area and China. Between 2015 and 2020, the latest WEO also forecasts lower growth than would be implied by an extension of the September 2011 WEO forecast.<sup>b</sup> Lower GDP forecasts for the US and China both contribute to this downward revision.

The IMF’s forecasts for the import intensity of GDP can be weighted to give an estimate of import intensity in specific markets to which the UK exports. Between 2011 and 2015, import intensity increased more strongly than was forecast in the September 2011 WEO, with the euro area accounting for almost all that increase. Between 2015 and 2020, import intensity is now expected to increase less than would be implied by an extension of the September 2011 WEO forecast, with import intensity expected to rise less strongly in the US, euro area, Japan, Australia and New Zealand. Import intensity is forecast to fall in China, having previously been expected rise strongly, although China’s weight in UK export markets is only 3.6 per cent.

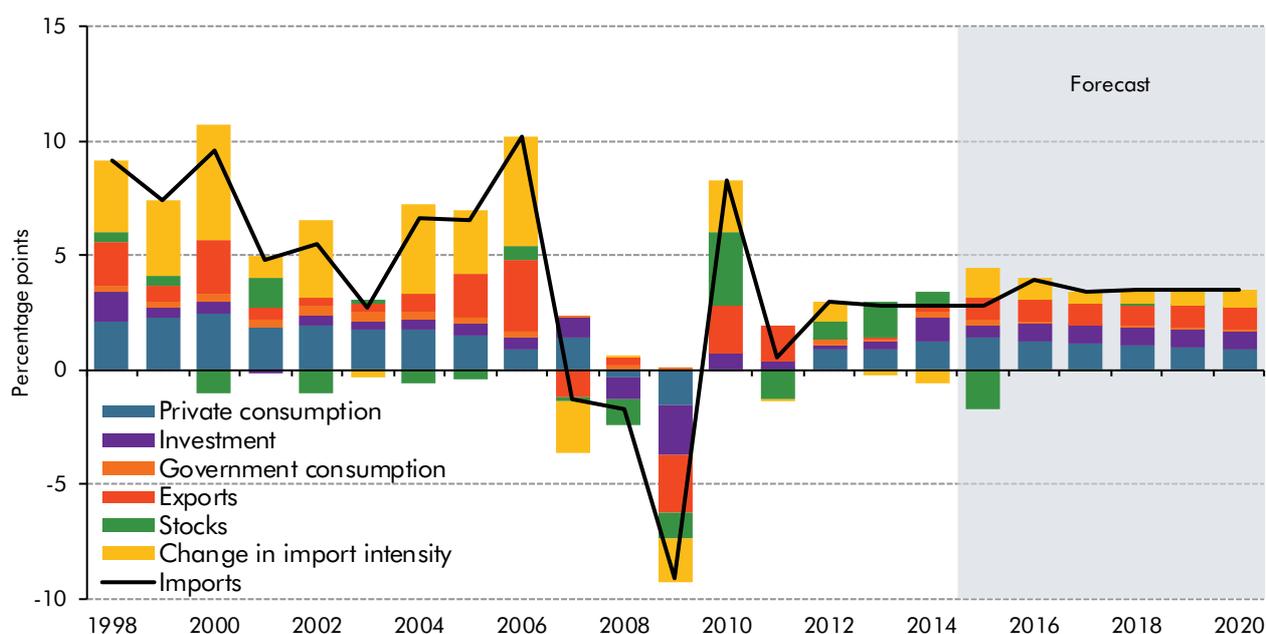
To meet the Government's aspiration the UK's export market share now would need to rise by around 50 per cent over the next five years, compared to a 3.3 per cent fall in our latest forecast.

<sup>a</sup> Using growth rates from the March 2012 EFO forecast applied to the latest data until 2016, the final year of that forecast. For the years 2017 to 2020, variables are assumed to grow at 2016 rates. All figures exclude the estimated effect of MTIC fraud.

<sup>b</sup> For the years 2017 to 2020, variables are again assumed to grow at 2016 rates.

- 3.98 Imports growth in 2014 has been revised up too. It has also been erratic. It was revised down in the first quarter of 2015 and imports fell sharply in the second quarter of 2015, with latest monthly data suggesting that they will rise strongly in the third quarter. We forecast imports growth of 2.8 per cent in 2015 as a whole, below our July forecast.
- 3.99 Our forecast for UK imports is determined by the outlook for import-weighted domestic demand and a trend rise in the import intensity of that demand. From 2016 onwards, we have revised down our forecast for imports growth in each year, based on a judgement that import intensity will rise more slowly than in our July forecast. The rationale for this change is the same as that underpinning our updated judgement on prospects for the trade intensity of world GDP growth. As Chart 3.35 shows, the contribution of rising import intensity to imports growth averaged 3.0 percentage points between 1998 and 2006, but import intensity subtracted 0.2 percentage points from imports growth on average between 2007 and 2014. Our forecast assumes an average contribution of 0.8 percentage points between 2015 and 2020. In its latest WEO, the IMF also revised down its forecast for UK imports growth between 2017 and 2019.

Chart 3.35: Contributions to import-weighted domestic demand and imports growth

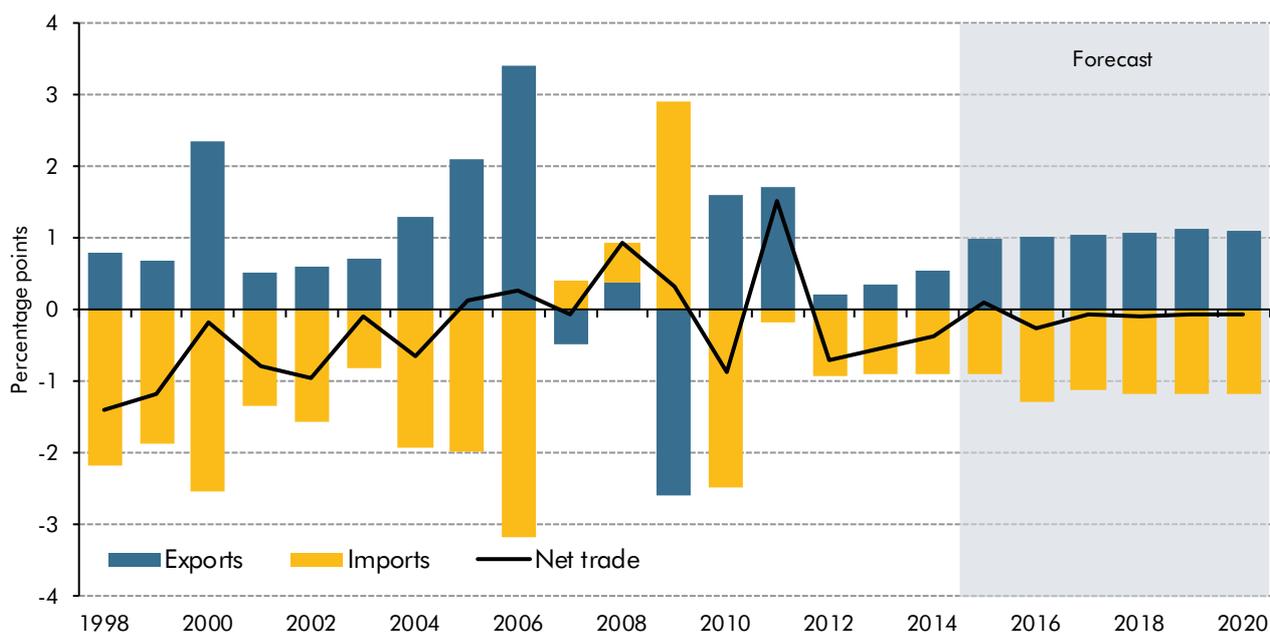


Source: ONS, OBR

- 3.100 Net trade is expected to make a positive contribution to GDP growth in 2015, having been expected to make a negative contribution at the time of our July forecast. This change

reflects the downward revision to imports growth.<sup>13</sup> We then expect net trade to subtract 0.2 percentage points from GDP growth in 2016, and to subtract 0.1 percentage points a year from 2017 onwards. In each of these years, we expect net trade to act as less of a drag on GDP growth than in our July forecast. Our net trade forecast reflects the weakness of export market growth, a gradual decline in export market share and a gradual increase in the ratio of imports to import-weighted domestic demand.

Chart 3.36: Net trade contribution to real GDP



Source: ONS, OBR

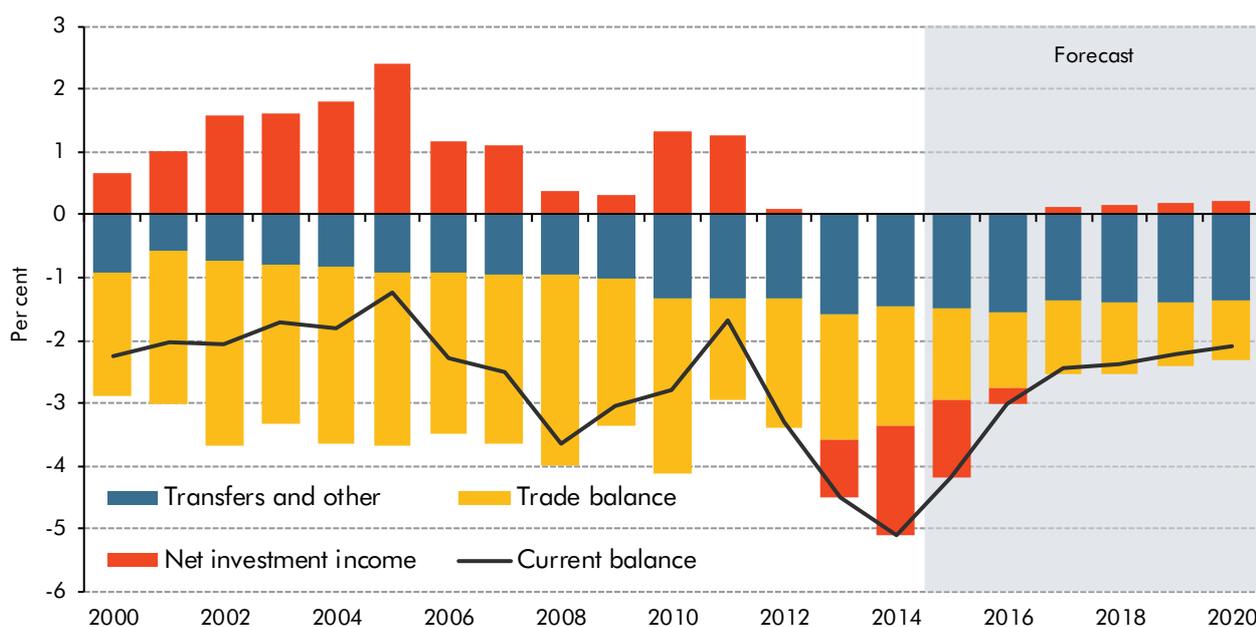
### The current account balance

- 3.101** Recent revisions have meant that the recent widening of the current account deficit no longer looks as severe as it did in earlier estimates, with the deficit standing at 5.1 per cent of GDP in 2014, revised from a previous estimate of 5.9 per cent. Nevertheless the current account deficit remains large by historical standards: the deficit in 2014 remains the largest in peacetime since at least 1830, based on the Bank of England's historical dataset.
- 3.102** While the UK has operated a trade deficit for a number of years, much of the additional deterioration in the current account in recent years is attributable to a weaker income balance. In the decade prior to 2012, the income balance averaged a surplus of just over 1 per cent of GDP; in 2013 the income balance moved into a deficit of 0.9 per cent of GDP; it widened to 1.8 per cent of GDP in 2014, as the UK's net rate of return deteriorated. While recent quarterly data show tentative evidence of a narrowing in the income deficit in the first half of 2015, it remains to be seen how persistent this improvement will be, given that early estimates of the income account can be subject to significant revision.

<sup>13</sup> The ONS has identified an issue that results in a divergence between the implied trade deflators and the underlying trade price indices. This may lead to future revisions to recent trade data in volume terms. We have not adjusted our forecast to anticipate these revisions. More details on this issue are available on the ONS website.

3.103 Our forecast for the income account remains conditioned on the assumption that the deterioration in the net rate of return is partly temporary, consistent with weaker growth prospects in the euro area and the possible effects of large cross-border fines and compensation paid by UK firms abroad (although this is not verifiable from published data). As a consequence we expect the income account to improve gradually over the forecast period, although we do not expect a return to pre-crisis surplus levels.

Chart 3.37: Current account balance as a share of GDP



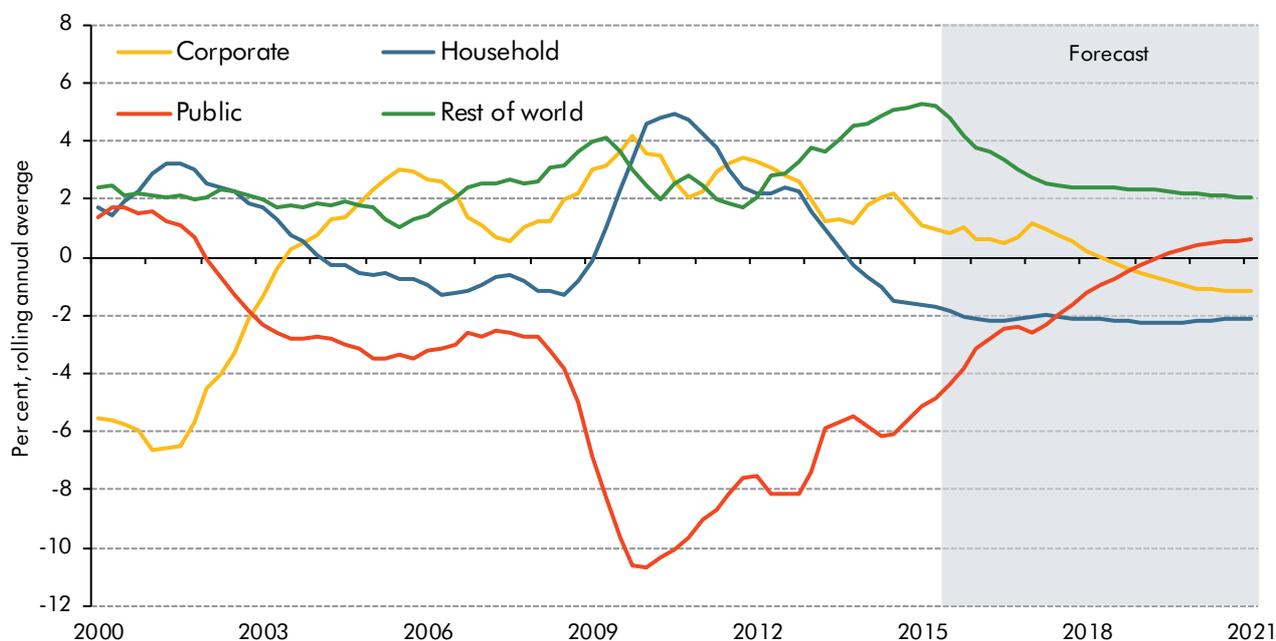
Source: ONS, OBR

## Sectoral net lending

- 3.104 In the National Accounts framework that we use for our economic forecast, the income and expenditure of the different sectors imply a path for each sector's net lending or borrowing from others. By identity, these must sum to zero – for each borrower, there must be a lender. In 2015 we estimate that the public and household sectors are in deficit, the corporate sector close to balance and the rest of the world in surplus (Chart 3.38).
- 3.105 As detailed in Chapter 4, on current Government policy we expect the public sector deficit to narrow, moving into surplus by the end of the forecast period. This is largely offset by a narrowing of the rest of the world surplus (i.e. a narrowing of the current account deficit) and a widening of the corporate deficit. Recent data revisions have increased the size of the household deficit in 2014 and we expect little change in the household net position over the forecast period, with gradual increases in household saving offset by ongoing growth of household investment.
- 3.106 Available historical data suggest that this persistent and relatively large household deficit would be unprecedented. This may be consistent with the unprecedented scale of the ongoing fiscal consolidation and market expectations for monetary policy to remain

extremely accommodative over the next five years, but it also illustrates how the adjustment to fiscal consolidation assumed in our central forecast is subject to considerable uncertainty.

Chart 3.38: Sectoral net lending



Source: ONS, OBR

## Risks and uncertainties

**3.107** As always, we emphasise the uncertainties that lie around our central forecast for the economy, and the implications that these can have for the public finances (see Chapter 5). There are some risks and uncertainties common to all forecasts: conditioning assumptions may prove inaccurate; shocks may prove asymmetric (illustrated in the scenarios in Chapter 5 of this *EFO*); and previously stable relationships that have described the functioning of the economy may change.

**3.108** In addition, prevailing economic circumstances suggest some specific risks to the forecast. In this *EFO*, we would highlight:

- recent survey data suggest that the slowdown in the Chinese economy could be sharper than is currently expected. Although direct trade with China accounts for only 3.6 per cent of UK exports, China's contribution to world GDP and trade growth is significant. While some slowdown from previous high growth rates would be expected as the economy rebalances towards consumption, the importance of China to the global economy and its increasing integration in global financial markets means there is a risk that lower growth in China could have wider implications;
- possible global financial market instability that could be associated with expected monetary policy tightening in the US has been cited by the IMF and OECD in their recent *WEO* and *Economic outlook* publications;

- if productivity fails to recover as predicted but wage growth continues to accelerate, the MPC could be forced to raise interest rates more quickly, which could in turn have a negative impact on consumer spending and housing investment. Alternatively, lower productivity growth could mean that wage growth falls short of our forecast. (Another way of expressing this risk would be to note that our implied estimate of current potential output is towards the top of the range of measures we look at and that our estimate of potential output growth over the coming few years is higher than those made by the major international forecasting organisations);
- the pace of fiscal tightening in the UK is set to pick up again from next year. There is uncertainty over the extent to which it will affect GDP growth or – because it was pre-announced by many years – it has been factored into the market interest rates that underpin our forecasts and will therefore have been offset by monetary policy being looser than would otherwise have been the case;
- our forecast assumes that the decline in public sector net borrowing is offset by a widening corporate deficit and a modest improvement in the current account, but there are other ways in which sectoral balances might adjust. Some commentators see a risk that sterling could depreciate significantly, leading to a greater narrowing of the current account deficit but a reduction in household incomes via the associated shock to the terms of trade. Another alternative would be that the household saving ratio continues to decline as it did in 2013 and 2014, implying a widening household deficit and a further deterioration in the household balance sheet; and
- even in our central forecast, the ratio of households' gross debt to income rises significantly over the forecast. That seems consistent with supportive monetary policy and other interventions, but it could pose risks to the recovery over the longer term.

## Comparison with external forecasters

**3.109** In this section, we compare our latest projections with those of selected outside forecasters. The differences between our forecast and those of external forecasters are generally small compared with the uncertainty that surrounds any one of them.

**3.110** In its November *Economic review*, the National Institute for Economic and Social Research (NIESR) forecast GDP growth of 2.4 per cent in 2015, in line with our central forecast. NIESR's forecast for GDP growth is slightly below ours in 2016 and is slightly above our forecast from 2017 onwards. In 2017, NIESR forecast stronger investment growth and from 2018 onwards, NIESR forecast that net exports will make a positive contribution to GDP growth. The IMF's latest forecast is weaker than ours from 2016 onwards, which, given a similar output gap profile, implies the IMF's estimate of UK potential output growth is below ours. The OECD forecast is in line with ours in 2015 and 2016, but is slightly below ours in 2017 due to lower consumption growth. The European Commission forecast for GDP growth is slightly higher than ours in 2015, due to higher investment growth. The Commission's forecast for 2016 is in line with ours, but is lower than ours in 2017, due to lower expected growth in government consumption and a negative stocks contribution.

Table 3.4: Comparison with external forecasters

	Per cent					
	2014	2015	2016	2017	2018	2019
<b>OBR (November 2015)</b>						
GDP growth	2.9	2.4	2.4	2.5	2.4	2.3
CPI inflation	1.5	0.1	1.0	1.8	1.9	2.0
Output gap	-1.0	-0.7	-0.4	-0.1	0.0	0.0
<b>OECD (November 2015)</b>						
GDP growth	2.9	2.4	2.4	2.3		
CPI inflation	1.5	0.1	1.5	2.0		
Output gap	-0.5	0.0	0.4	0.8		
<b>Bank of England (November 2015)<sup>1,2</sup></b>						
GDP growth (mode)		2.7	2.5	2.7	2.6	
CPI inflation (mode) <sup>3</sup>		0.1	1.2	2.1	2.2	
<b>European Commission (November 2015)</b>						
GDP growth	2.9	2.5	2.4	2.2		
CPI inflation	1.5	0.1	1.5	1.7		
Output gap	-0.7	0.1	0.5	0.8		
<b>NIESR (November 2015)<sup>1</sup></b>						
GDP growth	2.9	2.4	2.3	2.6	2.6	2.5
CPI inflation	1.4	0.1	1.1	1.8	2.2	2.0
<b>Oxford Economics (October 2015)</b>						
GDP growth	2.9	2.5	2.6	2.5	2.3	2.3
CPI inflation	1.5	0.1	1.2	1.7	1.8	1.8
Output gap	-2.8	-2.2	-1.6	-1.3	-1.1	-1.1
<b>IMF (October 2015)</b>						
GDP growth	3.0	2.5	2.2	2.2	2.2	2.2
CPI inflation	1.5	0.1	1.5	2.0	2.0	2.0
Output gap	-1.4	-0.7	-0.4	-0.2	-0.1	0.0

<sup>1</sup> Output gap not published.

<sup>2</sup> Forecast based on market interest rates and the Bank of England's 'backcast' for GDP growth.

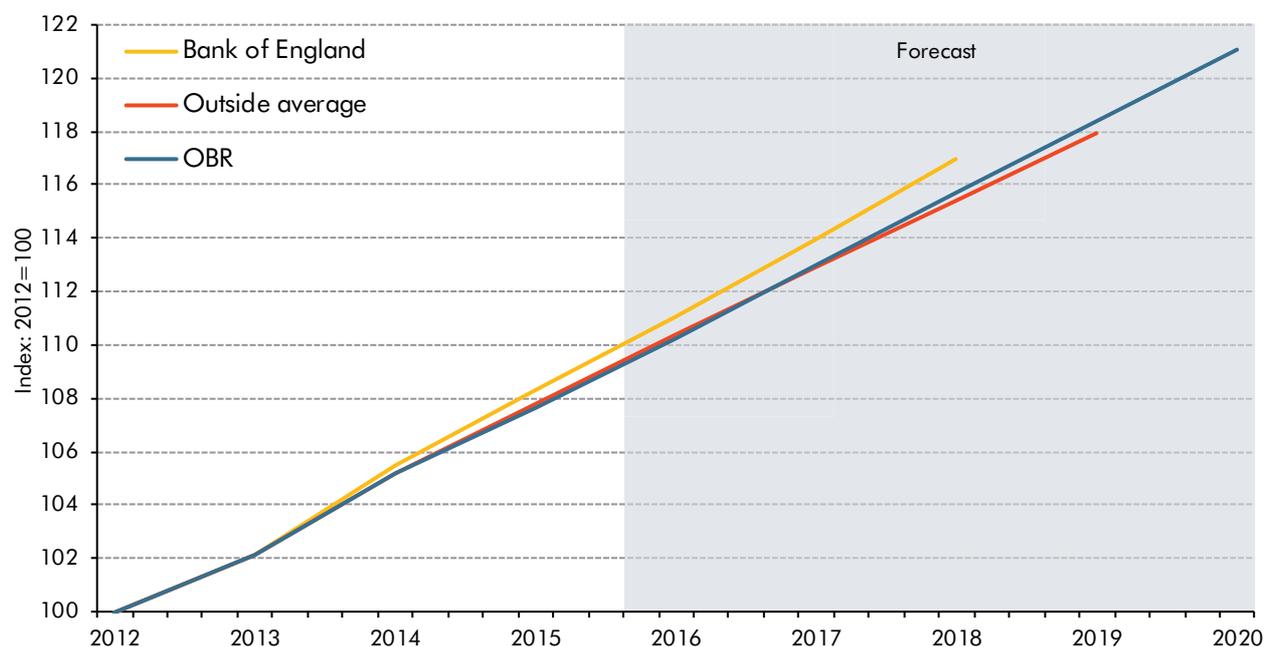
<sup>3</sup> Fourth quarter year-on-year growth rate.

## Comparison with the Bank of England's *Inflation Report* forecast

3.111 Alongside its November 2015 *Inflation Report*, the Bank of England published additional information about its forecast against which we can compare our own (see Table 3.5). This included the Bank staff's forecasts for the expenditure composition of GDP, consistent with the MPC's central forecasts of GDP, CPI inflation and the unemployment rate.

3.112 The MPC's modal forecast for GDP growth is 2.7 per cent in 2015. This is higher than our forecast, largely because the Bank anticipates upward revisions to outturn GDP data. The Bank's modal forecast is also higher than ours between 2016 and 2018. Table 3.5 shows that it expects stronger consumption and business investment growth in each of these years, but lower productivity growth. The Bank's forecast for GDP is 0.9 per cent higher than ours in 2017, compared to a 1.1 per cent gap at the time of our last forecast in July.

Chart 3.39: Comparison of forecasts for the level of GDP projections



Source: Bank of England, HM Treasury, ONS, OBR

Table 3.5: Comparison with the Bank of England's illustrative projections

	Per cent			
	2015 <sup>1</sup>	2016	2017	2018
<b>Bank of England November <i>Inflation Report</i> forecast</b>				
Household consumption	3	3	3	2¾
Business investment	5½	7½	8¾	7¾
Housing investment <sup>2,3</sup>	¼	4½	5¾	4¾
Exports	3¾	2½	1¾	2½
Imports	3	3¾	3¼	3¼
Employment <sup>4</sup>	1½	1	1	¾
Productivity <sup>5</sup>	1¼	1	1½	1¾
Average weekly earnings <sup>3,4</sup>	2½	3¾	4	4¼
<b>Difference from OBR forecast</b>				
Household consumption	0.1	0.4	0.7	0.4
Business investment	-0.6	0.1	1.6	0.8
Exports	0.4	-0.9	-1.8	-1.1
Imports	0.2	-0.2	-0.1	-0.2
Employment <sup>4</sup>	0.3	-0.1	0.4	0.2
Productivity <sup>5</sup>	0.2	-0.5	-0.4	-0.4

<sup>1</sup> 2015 estimates contain a combination of data and projections.<sup>2</sup> Whole economy measure. Includes transfer costs of non-produced assets.<sup>3</sup> We have not shown a comparison for housing investment and average weekly earnings as the definitions of these variables differ and are therefore not directly comparable.<sup>4</sup> Four-quarter growth rate in Q4.<sup>5</sup> Output per hour.

Table 3.6: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2014	2015	2016	2017	2018	2019	2020
<b>UK economy</b>							
Gross domestic product (GDP)	2.9	2.4	2.4	2.5	2.4	2.3	2.3
GDP level (2014=100)	100.0	102.4	104.8	107.4	110.0	112.6	115.1
Nominal GDP	4.7	3.6	4.0	4.4	4.3	4.4	4.5
Output gap (per cent of potential output)	-1.0	-0.7	-0.4	-0.1	0.0	0.0	0.0
<b>Expenditure components of GDP</b>							
Domestic demand	3.2	2.3	2.6	2.5	2.4	2.3	2.3
Household consumption <sup>1</sup>	2.6	2.9	2.6	2.3	2.3	2.1	1.9
General government consumption	1.9	1.7	0.4	0.6	0.5	0.5	1.1
Fixed investment	7.5	4.1	5.4	5.1	4.7	5.0	4.7
Business	4.6	6.1	7.4	7.1	7.0	6.6	4.5
General government <sup>2</sup>	7.6	3.0	0.8	0.6	-1.6	1.7	9.2
Private dwellings <sup>2</sup>	14.2	0.3	3.8	3.4	3.1	3.1	3.0
Change in inventories <sup>3</sup>	0.2	-0.9	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	1.8	3.4	3.4	3.5	3.6	3.6	3.6
Imports of goods and services	2.8	2.8	3.9	3.4	3.5	3.5	3.5
<b>Balance of payments current account</b>							
Per cent of GDP	-5.1	-4.2	-3.0	-2.4	-2.4	-2.2	-2.1
<b>Inflation</b>							
CPI	1.5	0.1	1.0	1.8	1.9	2.0	2.0
RPI	2.4	1.0	2.0	2.9	3.2	3.2	3.2
GDP deflator at market prices	1.7	1.2	1.6	1.8	1.9	2.0	2.2
<b>Labour market</b>							
Employment (millions)	30.7	31.1	31.5	31.7	31.9	32.0	32.2
Productivity per hour	0.3	1.1	1.5	1.9	2.2	2.2	2.2
Wages and salaries	3.1	4.4	4.5	4.5	4.2	4.1	4.3
Average earnings <sup>4</sup>	1.5	2.6	3.4	3.7	3.6	3.7	3.9
LFS unemployment (% rate)	6.2	5.5	5.2	5.2	5.3	5.4	5.4
Claimant count (millions)	1.04	0.80	0.77	0.82	0.86	0.87	0.88
<b>Household sector</b>							
Real household disposable income	-0.2	3.4	2.5	2.1	1.7	1.6	1.8
Saving ratio (level, per cent)	4.9	4.1	4.2	4.4	4.4	4.5	4.7
House prices	9.9	6.2	4.8	4.7	5.3	5.0	4.3
<b>World economy</b>							
World GDP at purchasing power parity	3.4	3.1	3.5	3.8	3.9	3.9	3.9
Euro area GDP	0.9	1.5	1.6	1.6	1.6	1.6	1.6
World trade in goods and services	3.3	3.0	3.5	3.9	4.3	4.4	4.4
UK export markets <sup>5</sup>	3.8	4.1	3.6	4.1	4.5	4.5	4.5

<sup>1</sup> Includes households and non-profit institutions serving households.

<sup>2</sup> Includes transfer costs of non-produced assets.

<sup>3</sup> Contribution to GDP growth, percentage points.

<sup>4</sup> Wages and salaries divided by employees.

<sup>5</sup> Other countries' imports of goods and services weighted according to the importance of those countries in the UK's total exports.

Table 3.7: Detailed summary of changes to the forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2014	2015	2016	2017	2018	2019	2020
<b>UK economy</b>							
Gross domestic product (GDP)	-0.1	-0.1	0.1	0.1	0.0	0.0	-0.1
GDP level (2014=100) <sup>1</sup>	0.0	-0.1	0.0	0.1	0.1	0.1	-0.1
Nominal GDP	0.1	0.1	0.1	0.1	0.0	0.0	-0.3
Output gap (per cent of potential output)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Expenditure components of GDP</b>							
Domestic demand	-0.2	-0.6	0.0	0.0	-0.1	-0.2	-0.2
Household consumption <sup>2</sup>	0.2	-0.1	0.1	0.0	0.0	-0.2	-0.2
General government consumption	0.3	0.5	-0.1	0.3	0.4	0.2	-1.5
Fixed investment	-1.1	-1.5	-0.2	-0.4	-0.7	-0.4	0.7
Business	-3.4	0.1	0.2	0.2	0.4	0.1	-0.2
General government <sup>3</sup>	4.2	0.6	0.9	-0.4	-4.0	-0.6	7.2
Private dwellings <sup>3</sup>	1.0	-6.0	-1.0	-1.0	-0.9	-0.8	-0.3
Change in inventories <sup>4</sup>	0.0	-0.7	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	1.4	-0.4	-0.4	-0.7	-0.5	-0.3	-0.3
Imports of goods and services	0.4	-2.3	-0.7	-0.9	-0.8	-0.7	-0.7
<b>Balance of payments current account</b>							
Per cent of GDP	0.8	0.8	0.9	0.7	0.7	0.7	0.7
<b>Inflation</b>							
CPI	0.0	-0.1	-0.1	0.1	0.1	0.1	0.0
RPI	0.0	0.1	-0.1	0.0	0.1	0.1	0.1
GDP deflator at market prices	0.1	0.1	0.0	0.0	0.0	0.0	-0.2
<b>Labour market</b>							
Employment (millions)	0.0	-0.1	0.0	0.1	0.2	0.1	0.1
Productivity per hour	-0.1	0.2	-0.2	-0.5	-0.2	0.0	0.0
Wages and salaries	-1.1	0.2	0.0	0.2	-0.1	-0.4	-0.6
Average earnings <sup>5</sup>	-1.1	0.5	-0.2	-0.2	-0.3	-0.4	-0.4
LFS unemployment (% rate)	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Claimant count (millions)	0.00	0.02	0.04	0.07	0.09	0.09	0.09
<b>Household sector</b>							
Real household disposable income	-1.0	-0.5	0.2	0.0	-0.1	-0.2	0.0
Saving ratio (level, per cent)	-1.2	-2.4	-2.9	-3.0	-3.1	-3.0	-2.8
House prices	-0.1	0.4	0.7	0.0	0.0	-0.6	-1.3
<b>World economy</b>							
World GDP at purchasing power parity	0.0	-0.1	-0.2	-0.1	0.0	0.0	0.0
Euro area GDP	0.0	0.1	-0.1	0.0	0.0	0.0	0.0
World trade in goods and services	0.1	-1.2	-1.3	-1.0	-0.6	-0.6	-0.6
UK export markets <sup>6</sup>	0.4	0.9	-0.9	-0.7	-0.4	-0.4	-0.4

<sup>1</sup> Per cent change since July.<sup>2</sup> Includes households and non-profit institutions serving households.<sup>3</sup> Includes transfer costs of non-produced assets.<sup>4</sup> Contribution to GDP growth, percentage points.<sup>5</sup> Wages and salaries divided by employees.<sup>6</sup> Other countries' imports of goods and services weighted according to the importance of those countries in the UK's total exports.



# 4 Fiscal outlook

## Introduction

4.1 This chapter:

- sets out the key economic and market determinants that drive the fiscal forecast (from paragraph 4.3);
- explains the effects of new policies announced in this Spending Review and Autumn Statement – and since the July Budget – on the fiscal forecast (from paragraph 4.7);
- describes the outlook for public sector receipts, including a tax-by-tax analysis explaining how the forecasts have changed since July (from paragraph 4.19);
- describes the outlook for public sector expenditure, focusing on spending covered by departmental expenditure limits and the components of annually managed expenditure, including those subject to the Government’s welfare cap (from paragraph 4.68);
- describes the outlook for government lending to the private sector and other financial transactions, including asset sales (from paragraph 4.124);
- describes the outlook for the key fiscal aggregates: headline and structural measures of public sector net borrowing and the current budget, and public sector net debt (from paragraph 4.146);
- looks back and forward to tell the story of how the budget will have moved from a post-war record deficit in 2009-10 to planned surplus by 2019-20 (from paragraph 4.159);
- summarises risks and uncertainties (paragraph 4.189); and
- provides a comparison with forecasts from international organisations (from paragraph 4.190).

4.2 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in the supplementary tables on our website. The medium-term forecasts for the public finances in this chapter start from outturn 2014-15 data.<sup>1</sup> We then present an in-year

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<sup>1</sup> Outturn data for 2014-15 are consistent with the *Public Sector Finances October 2015 Statistical Bulletin* (released in November) published by the ONS and HM Treasury.

estimate for 2015-16 that makes use of published Office for National Statistics (ONS) outturn data for April to September and some administrative receipts data for October, followed by forecasts for 2016-17 to 2020-21. As in previous *Economic and fiscal outlooks* (EFOs), this fiscal forecast:

- represents our central view of the path of the public finances, conditioned on the current policies and policy assumptions of the Government. On that basis, we believe that the outturns – which will be affected by any errors in our forecast assumptions or future Government policy changes – are as likely to be above the forecast as below it;
- is based on announced Government policy on the indexation of rates, thresholds and allowances for taxes and benefits, and incorporates certified costings for all new policy measures announced by the Chancellor in the Spending Review and Autumn Statement; and
- focuses on official ‘headline’ fiscal aggregates that exclude public sector banks. We have included our estimates of the effect on these headline fiscal aggregates of the ONS decision to reclassify housing associations from the private to the public sector. The ONS has said that it aims to implement this decision in the official public finances data early in 2016, ahead of Budget 2016.<sup>2</sup>

## Economic determinants of the fiscal forecast

4.3 Our fiscal forecasts are based on the economic forecasts presented in Chapter 3. Most economic forecasts focus on the outlook for real GDP, but it is nominal GDP that matters most when forecasting the public finances. Forecasts of tax receipts are particularly dependent on the profile and composition of economic activity. On the income side, labour income is generally taxed more heavily than company profits. On the expenditure side, consumer spending is subject to VAT and other indirect taxes while business investment attracts capital allowances that reduce corporation tax receipts in the short term. And while around half of public sector expenditure is set out in multi-year plans, large elements (such as social security and debt interest payments) are linked to developments in the economy – notably inflation, market interest rates and the labour market.

4.4 Table 4.1 sets out some of the key economic determinants of the fiscal forecast and Table 4.2 shows how these have changed since our July forecast. Detailed descriptions of these forecasts and changes are provided in Chapter 3. In summary:

- the ONS has published updated **population projections** that have modestly increased our forecasts of employment (described in paragraphs 3.15 to 3.20). Changes to the projected population age structure, which are also relevant to our fiscal forecast, are described below;

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<sup>2</sup> ONS, *Classification announcement: ‘Private registered providers’ of social housing in England*, 30 October 2015. See Annex B for a full discussion of our estimate of the effects of this reclassification on our fiscal forecasts.

- **nominal GDP** is forecast to grow by 4.3 per cent a year on average between 2015-16 and 2020-21. Compared with July, growth is slightly stronger in 2015-16, little changed over the next few years, but weaker in 2020-21 (reflecting changes to both real GDP growth and the GDP deflator in that year);
- on the expenditure side of GDP, **nominal consumer spending** is forecast to grow by 4.1 per cent a year on average between 2015 and 2020, down marginally from our July forecast;
- on the income side of GDP, **wages and salaries** growth is slightly higher over the first few years of the forecast but lower thereafter, with the cumulative growth over the period a little lower than in July. Within that, employment growth has been revised up, while average earnings growth is down by the end of the forecast. Non-oil, non-financial **profits** grow by 4.6 per cent a year on average, up from 4.3 per cent in July;
- the CPI measure of **inflation** is slightly higher in the medium term than in July, reaching 1.8 per cent by the second half of 2017. RPI inflation is also slightly higher in the final years of the forecast. We continue to expect RPI inflation to be higher than CPI inflation throughout the forecast period because of differences in the ONS approach to constructing the two measures;
- **house price inflation** has been revised down over the forecast period. **Residential property transactions** have been revised down significantly across the forecast period (see paragraphs 3.76 and 3.77 for an explanation of these changes);
- **commercial property prices** have been rising strongly, which has pushed up our near-term forecast. We assume that **commercial property transactions** in 2015-16 will increase in line with the growth seen over the first half of this year, and then in line with real GDP thereafter;
- market-derived assumptions for **equity prices**, **interest rates** and the **oil price** reflect average prices in the 10 days to 29 October. Equity and oil prices have been revised down since July in line with recent outturns;
- our **oil and gas production** forecasts are informed by the central projections published by the Department of Energy and Climate Change (DECC). We have revised our 2015 production forecast up slightly, reflecting stronger growth so far this year; and
- the **output gap** – which we use to estimate the structural health of the public finances – is largely unchanged from our July forecast. It is expected to average -0.7 per cent in 2015-16 and to close in 2018-19.

Table 4.1: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>GDP and its components</b>							
Real GDP	2.9	2.2	2.5	2.4	2.4	2.3	2.3
Nominal GDP <sup>1</sup>	4.2	4.0	4.0	4.3	4.5	4.4	4.5
Nominal GDP (£ billion) <sup>1,2</sup>	1829	1903	1980	2065	2157	2251	2353
Nominal GDP (centred end-March £bn) <sup>1,3</sup>	1860	1939	2022	2109	2203	2301	2405
Wages and salaries <sup>4</sup>	3.4	4.2	4.7	4.4	4.2	4.1	4.4
Non-oil PNFC profits <sup>4,5</sup>	10.3	6.3	4.6	3.8	4.1	4.3	4.6
Non-oil PNFC net taxable income <sup>4,5</sup>	9.9	4.5	2.7	1.4	1.8	2.1	4.1
Consumer spending <sup>4,5</sup>	4.2	3.4	3.9	4.4	4.5	4.3	4.2
<b>Prices and earnings</b>							
GDP deflator	1.4	1.4	1.7	1.8	1.9	2.1	2.2
RPI (September) <sup>6</sup>	2.3	0.8	2.0	3.0	3.2	3.2	3.2
CPI (September) <sup>6</sup>	1.2	-0.1	1.0	1.8	1.9	2.0	2.0
Average earnings <sup>7</sup>	1.5	2.9	3.5	3.7	3.7	3.7	4.0
'Triple-lock' guarantee (September)	2.5	2.9	3.2	3.7	3.6	3.7	3.9
<b>Key fiscal determinants</b>							
Claimant count (millions)	0.95	0.79	0.77	0.84	0.87	0.88	0.88
Employment (millions)	30.9	31.2	31.6	31.8	31.9	32.1	32.2
VAT gap (per cent)	10.4	11.1	10.9	10.9	10.7	10.5	10.3
Output gap (per cent of potential output)	-0.8	-0.7	-0.3	-0.1	0.0	0.0	0.0
<b>Financial and property sectors</b>							
Equity prices (FTSE All-Share index)	3580	3480	3622	3777	3943	4117	4303
HMRC financial sector profits <sup>1,5,8</sup>	4.4	3.6	4.1	4.4	4.5	4.4	4.4
Financial sector net taxable income <sup>1,5</sup>	0.8	-3.1	1.3	4.3	5.0	2.7	3.6
Residential property prices <sup>9</sup>	10.0	5.3	4.7	4.8	5.3	4.9	4.1
Residential property transactions (000s) <sup>10</sup>	1202	1258	1249	1277	1291	1300	1310
Commercial property prices <sup>10</sup>	17.6	7.4	3.1	1.8	1.9	2.1	2.1
Commercial property transactions <sup>10</sup>	8.6	3.7	2.4	2.5	2.5	2.3	2.3
Volume of stampable share transactions	-8.6	0.0	0.0	0.0	0.0	0.0	0.0
<b>Oil and gas</b>							
Oil prices (\$ per barrel) <sup>5</sup>	98.9	53.8	53.6	58.1	58.8	58.8	58.8
Oil prices (£ per barrel) <sup>5</sup>	60.0	35.1	34.8	37.7	38.1	38.0	37.9
Gas prices (p/therm) <sup>5</sup>	50.2	43.0	39.1	40.1	40.1	40.1	40.1
Oil production (million tonnes) <sup>5</sup>	40.0	41.2	37.9	36.0	34.2	32.5	30.9
Gas production (billion therms) <sup>5</sup>	13.0	13.4	12.4	11.8	11.2	10.6	10.1
<b>Interest rates and exchange rates</b>							
Market short-term interest rates (%) <sup>11</sup>	0.6	0.6	0.8	1.2	1.5	1.8	2.0
Market gilt rates (%) <sup>12</sup>	2.3	2.0	2.1	2.3	2.5	2.6	2.8
Euro/Sterling exchange rate (€/£)	1.28	1.38	1.37	1.36	1.34	1.32	1.31

<sup>1</sup> Not seasonally adjusted.<sup>2</sup> Denominator for receipts, spending and deficit forecasts as a per cent of GDP.<sup>3</sup> Denominator for net debt as a per cent of GDP.<sup>4</sup> Nominal. <sup>5</sup> Calendar year.<sup>6</sup> Q3 forecast used as a proxy for September.<sup>7</sup> Wages and salaries divided by employees.<sup>8</sup> HMRC Gross Case 1 trading profits.<sup>9</sup> Outturn data from ONS House Price Index.<sup>10</sup> Outturn data from HMRC information on stamp duty land tax.<sup>11</sup> 3-month sterling interbank rate (LIBOR).<sup>12</sup> Weighted average interest rate on conventional gilts.

Table 4.2: Changes in the determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>GDP and its components</b>							
Real GDP	-0.1	0.0	0.1	0.0	0.0	-0.1	-0.2
Nominal GDP <sup>1</sup>	-0.2	0.5	-0.1	0.0	0.0	-0.1	-0.4
Nominal GDP (£ billion) <sup>1,2</sup>	21	30	30	32	35	34	27
Nominal GDP (centred end-March £bn) <sup>1,3</sup>	21	31	31	33	35	37	29
Wages and salaries <sup>4</sup>	-1.3	0.2	0.3	0.1	-0.1	-0.5	-0.6
Non-oil PNFC profits <sup>4,5</sup>	1.3	1.6	0.7	-0.2	0.2	0.1	-0.2
Non-oil PNFC net taxable income <sup>4,5</sup>	2.0	2.4	1.4	0.3	0.6	0.4	-0.2
Consumer spending <sup>4,5</sup>	0.2	-0.4	-0.1	0.1	0.0	-0.2	-0.2
<b>Prices and earnings</b>							
GDP deflator	0.0	0.3	-0.1	0.0	0.0	0.0	-0.3
RPI (September) <sup>6</sup>	0.0	0.1	-0.2	0.0	0.1	0.1	0.0
CPI (September) <sup>6</sup>	0.0	-0.1	-0.2	0.1	0.1	0.1	0.0
Average earnings <sup>7</sup>	-1.2	0.5	-0.1	-0.2	-0.3	-0.4	-0.4
'Triple-lock' guarantee (September)	0.0	0.1	-0.1	-0.2	-0.3	-0.4	-0.4
<b>Key fiscal determinants</b>							
Claimant count (millions)	0.00	0.03	0.04	0.09	0.09	0.09	0.09
Employment (millions)	0.0	-0.1	0.0	0.1	0.2	0.1	0.1
VAT gap (per cent)	1.0	1.8	1.6	1.6	1.3	1.1	1.0
Output gap (per cent of potential output)	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
<b>Financial and property sectors</b>							
Equity prices (FTSE All-Share index)	0	-261	-276	-286	-298	-314	-347
HMRC financial sector profits <sup>1,5,8</sup>	-0.1	0.1	0.0	0.1	0.0	0.0	-0.6
Financial sector net taxable income <sup>1,5</sup>	2.3	0.3	-0.3	1.5	-0.1	-4.4	-7.8
Residential property prices <sup>9</sup>	0.0	0.7	0.5	-0.1	-0.1	-0.7	-1.6
Residential property transactions (000s) <sup>10</sup>	-3	49	-5	-42	-97	-124	-127
Commercial property prices <sup>10</sup>	-3.8	0.8	0.2	0.1	0.0	-0.1	-0.4
Commercial property transactions <sup>10</sup>	0.0	-2.4	-0.1	0.1	0.1	-0.1	-0.2
Volume of stampable share transactions	-13.0	0.8	0.8	0.8	0.8	0.8	0.8
<b>Oil and gas</b>							
Oil prices (\$ per barrel) <sup>5</sup>	0.0	-8.2	-15.1	-12.6	-12.0	-12.0	-12.0
Oil prices (£ per barrel) <sup>5</sup>	0.0	-4.9	-8.8	-7.1	-6.5	-6.3	-6.1
Gas prices (p/therm) <sup>5</sup>	0.0	-2.5	-7.2	-7.6	-7.6	-7.6	-7.6
Oil production (million tonnes) <sup>5</sup>	0.3	2.9	1.2	1.1	0.8	1.6	1.5
Gas production (billion therms) <sup>5</sup>	-0.1	0.8	0.5	0.4	0.3	0.3	0.3
<b>Interest rates and exchange rates</b>							
Market short-term interest rates <sup>11</sup>	0.0	-0.1	-0.4	-0.5	-0.5	-0.4	-0.4
Market gilt rates <sup>12</sup>	0.0	-0.3	-0.4	-0.4	-0.4	-0.4	-0.3
Euro/Sterling exchange rate (€/£)	0.00	-0.01	-0.02	-0.02	-0.02	-0.02	-0.02

<sup>1</sup> Not seasonally adjusted.<sup>2</sup> Denominator for receipts, spending and deficit forecasts as a per cent of GDP.<sup>3</sup> Denominator for net debt as a per cent of GDP.<sup>4</sup> Nominal. <sup>5</sup> Calendar year.<sup>6</sup> Q3 forecast used as a proxy for September.<sup>7</sup> Wages and salaries divided by employees.<sup>8</sup> HMRC Gross Case 1 trading profits.<sup>9</sup> Outturn data from ONS House Price Index.<sup>10</sup> Outturn data from HMRC information on stamp duty land tax.<sup>11</sup> 3-month sterling interbank rate (LIBOR).<sup>12</sup> Weighted average interest rate on conventional gilts.

4.5 Chart 4.1 shows how the latest 2014-based ONS UK population projections, published in October 2015, compare with the previous 2012-based projections that underpinned our July forecast. The main drivers of changes in the different age groups during our 5-year forecast period include:

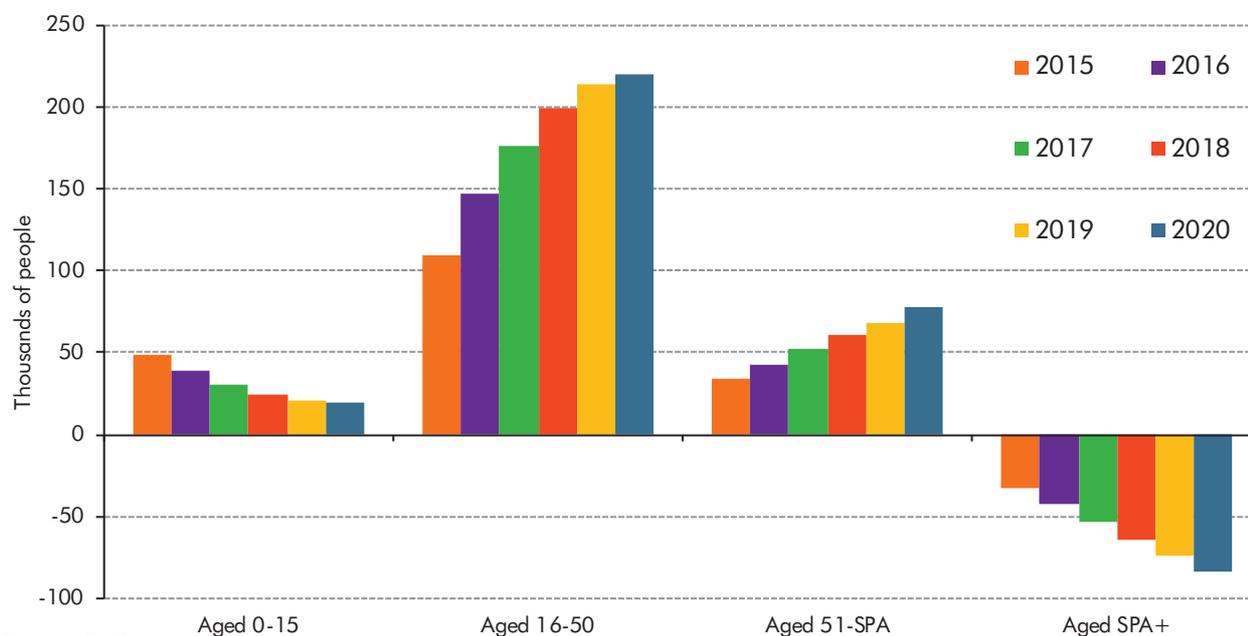
- for **children aged 0-15**: an upward revision that diminishes over time. That reflects higher net inward migration, partly offset by lower fertility in recent outturn data;
- for **younger adults aged 16-50**: an upward revision that increases in size over the next five years, reflecting higher net inward migration. By 2020, the population in this age group is 0.7 per cent bigger than assumed in the previous population projections;
- for **older working-age adults aged 51 to the state pension age (SPA)**: also an upward revision, but resulting more from the cohort effects of upward revisions to younger age groups as net migration at these ages has not been revised significantly; and
- for **pensioners** aged above the SPA: a downward revision due to higher mortality, especially for the over 80s. That is consistent with recent data showing more deaths than had been assumed in the previous population projections. The population in this age group is 0.7 per cent lower than previously assumed by 2020.

4.6 In broad terms, based on the representative age profiles that we use to drive the long-term projections in our *Fiscal sustainability reports*, these changes would put upward pressure on education, health and welfare (e.g. child benefit and tax credits) spending for children and downward pressure on health, welfare (e.g. state pension) and long-term care spending for the elderly. They would also lead to higher receipts from people of working age. In policy terms, higher mortality at older ages might also affect the Government's decisions about when the SPA will rise in future.<sup>3</sup> And there will, of course, be other changes that will affect our next long-term projections, including the allocation of departmental spending in this Spending Review, which increases the share of spending on health relative to the assumptions in our most recent long-term projections.

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<sup>3</sup> For more detail on the Government's announcement on how changes in projected longevity might affect such decisions, see 'The core principle underpinning future State Pension age rises: DWP background note', Department for Work and Pensions, December 2013.

Chart 4.1: The effect on the population age structure of moving to the latest ONS population projections



Source: ONS

## Policy announcements, risks and classification changes

4.7 The Government publishes estimates of the direct impact on the public finances of tax and selected spending policy decisions in its 'scorecard', after detailed discussions with the OBR. It also makes changes to departmental spending limits that are generally not shown on that scorecard – these changes were large in July and have been again in this Spending Review. If we were to disagree with any of the final scorecard numbers they chose, we would use our own estimates in our forecast. We are also responsible for assessing any indirect effects of policy measures on the economic forecast.<sup>4</sup> These are discussed in Box 3.1 in Chapter 3. We note as risks to the fiscal forecast any significant policy commitments that are not quantifiable, as well as any potential statistical classification changes.

### Direct effect of new policy announcements on the public finances

4.8 In Annex A, we reproduce the Treasury's scorecard of the direct effect on PSNB of policy decisions in this Spending Review and Autumn Statement or announced since the July Budget. Annex A also includes our formal assessment of the degree of uncertainty associated with each costing that we have certified.

4.9 Table 4.3 summarises the Treasury's policy scorecard and the changes since our last forecast to the Government's plans for spending subject to departmental expenditure limits (DELs). These encompass spending on public services, grants, administration and capital investment. The table excludes the effects of reclassifications, to show changes on a like-for-

<sup>4</sup> In March 2014, we published a briefing paper on our approach to scrutinising and certifying policy costings, and how they are fed into our forecasts, which is available on our website: *Briefing paper No 6: Policy costings and our forecast*.

like basis. A positive figure means an improvement in PSNB, i.e. higher receipts or lower expenditure. (We produce a detailed breakdown in a supplementary fiscal table on our website, showing how each policy measure is allocated to different categories of tax and spending.)

4.10 Table 4.3 also shows the effect on our forecasts for receipts and AME spending of policy decisions that have not been shown – either fully or in part – on the Treasury scorecard. These include:

- the decision to help some local authorities to raise council tax more quickly to meet some of the costs associated with adult social care and policing. That decision raises receipts and local authority self-financed expenditure (LASFE). It is very nearly neutral for borrowing; and
- the AME spending effect of housing associations' estimated response to changes in grant funding announced in the Spending Review and the new limits imposed on social sector rents (as explained in Annex B).

Table 4.3: Summary of the effect of Government decisions on the budget balance

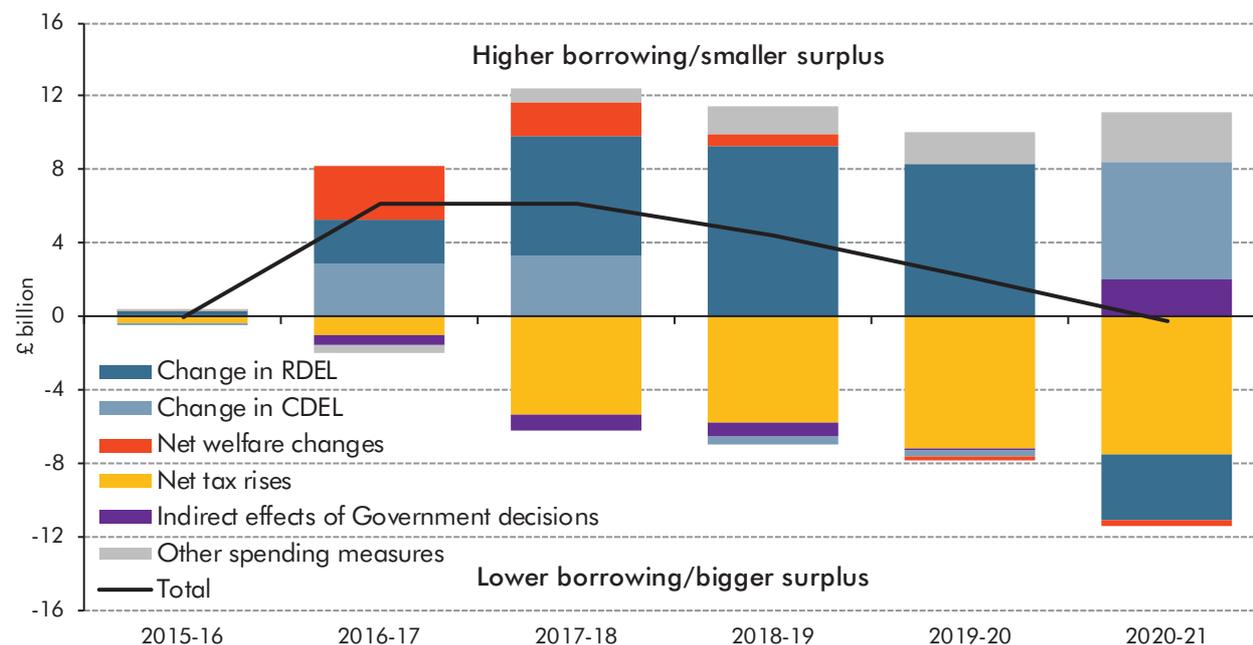
	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Total effect of scorecard measures</b>	<b>0.3</b>	<b>-2.0</b>	<b>2.8</b>	<b>4.3</b>	<b>6.2</b>	<b>6.4</b>
<b>Effects of scorecard receipts measures</b>	<b>0.3</b>	<b>0.6</b>	<b>4.5</b>	<b>4.6</b>	<b>5.5</b>	<b>5.3</b>
of which:						
Apprenticeship levy	0.0	0.0	2.7	2.8	3.0	3.1
Stamp duty land tax	0.0	0.7	0.9	0.9	1.0	1.1
Income tax and NICs	0.0	0.4	0.8	0.8	0.4	0.6
Capital gains tax	0.0	0.0	-0.1	-0.1	0.8	0.1
Onshore corporation tax	0.3	0.1	0.2	0.1	0.1	0.1
Business rates	0.0	-0.6	0.0	0.0	0.0	0.0
Other	0.0	0.1	0.0	0.0	0.2	0.3
<b>Effects of scorecard AME measures</b>	<b>0.0</b>	<b>-2.6</b>	<b>-1.7</b>	<b>-0.3</b>	<b>0.7</b>	<b>1.1</b>
of which:						
Current AME	0.0	-2.6	-1.7	-0.3	0.7	1.1
of which:						
Welfare	0.0	-3.0	-1.9	-0.6	0.2	0.3
Other	0.0	0.4	0.2	0.3	0.5	0.8
<b>Total effect of non-scorecard measures</b>	<b>0.0</b>	<b>0.4</b>	<b>-0.1</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-1.2</b>
<b>Effects of non-scorecard receipts measures</b>	<b>0.0</b>	<b>0.4</b>	<b>0.8</b>	<b>1.2</b>	<b>1.7</b>	<b>2.2</b>
of which:						
Council tax	0.0	0.4	0.8	1.2	1.7	2.2
<b>Effects of non-scorecard AME measures</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.9</b>	<b>-1.8</b>	<b>-2.2</b>	<b>-3.4</b>
of which:						
Council tax-financed local spending	0.0	-0.4	-0.8	-1.2	-1.6	-2.1
Housing associations' spending	0.0	0.4	-0.1	-0.6	-0.6	-1.3
	<b>Summary of changes</b>					
<b>Total effect of Government decisions</b>	<b>0.1</b>	<b>-6.2</b>	<b>-6.2</b>	<b>-4.4</b>	<b>-2.2</b>	<b>0.3</b>
of which:						
Receipts and AME scorecard measures	0.3	-2.0	2.8	4.3	6.2	6.4
Receipts and AME non-scorecard measures	0.0	0.4	-0.1	-0.5	-0.5	-1.2
RDEL changes	-0.3	-2.3	-6.5	-9.3	-8.3	3.6
CDEL changes	0.1	-2.9	-3.3	0.4	0.3	-6.4
Indirect effect of Government decisions	0.0	0.6	0.9	0.7	0.1	-2.0
<b>Financial transactions<sup>1</sup></b>	<b>0.0</b>	<b>-0.2</b>	<b>-0.5</b>	<b>-1.0</b>	<b>-1.5</b>	<b>4.0</b>
<i>Memo: gross tax increases</i>	0.3	1.6	5.5	6.1	7.5	7.8
<i>Memo: gross tax cuts</i>	0.0	-0.6	-0.2	-0.3	-0.3	-0.3

<sup>1</sup> Affects PSNCR, not PSNB.

Note: The full Treasury scorecard can be found in Annex A. This table uses the Treasury scorecard convention that a positive figure means an improvement in the PSNB, PSNCR and PSND.

4.11 Chart 4.2 summarises the impact of Government decisions on PSNB across the forecast. It shows that the Government has eased the pace of fiscal tightening in the near term, with the biggest additions to borrowing coming in 2016-17 and 2017-18 due to higher spending by departments and on tax credits. Thereafter, the additions to borrowing diminish each year. In 2020-21, the Government's decisions change the composition of spending – raising departmental capital budgets, but reducing resource budgets and welfare spending – and increase taxes.

Chart 4.2: The effect of Government decisions on public sector net borrowing



Source: OBR

4.12 The legislation that underpins our role requires that our forecasts only reflect Government policy. As such, when the Government sets out ‘ambitions’ or ‘intentions’ where the status as firm policy is unclear, we ask the Treasury for confirmation of whether they represent firm policy that should be reflected in our forecast. Where they are not yet firm policy, we note them as a source of risk to our central forecast. For this forecast, there are a number that we need to note:

- the ambition to increase the personal allowance to £12,500 (discussed in paragraph 4.25 of our July *EFO*);
- the ambition to raise the higher rate threshold for income tax to £50,000 by the end of this Parliament;
- the intention to localise all business rates and to provide some additional discretion to local authorities in setting business rates, while also shifting some new spending responsibilities to local authorities;
- the intention to expand right-to-buy to tenants of housing associations; and
- the outcomes of the consultations on feed-in-tariffs and the renewables obligation, which have yet to be decided.

## Contingent liabilities

4.13 We have asked the Treasury to identify any changes to future contingent liabilities as a result of policy announcements since July. Two announcements appear relevant:

- in September the Chancellor announced a new government guarantee, to be provided by Infrastructure UK, for a new nuclear power station planned for **Hinkley Point C**.<sup>5</sup> It was announced that the initial guarantee is set to be worth up to £2 billion. Any contingent liability associated with this announcement will only occur once the deal has been signed and guaranteed debt has been issued. That has not yet taken place;
- the Treasury's scorecard of policy measures includes the creation of '**Flood Re**', an entity that provides reinsurance to insurers covering losses associated with flooding. Use of this scheme would create contingent liabilities that could crystallise if claims on insurers were large enough. 'Pool Re' – a similar entity providing reinsurance for insurers covering losses associated with acts of terrorism – is currently reported in the Treasury's departmental accounts as an unquantifiable contingent liability. The Treasury has advised us that stop-loss cover to contain potential costs from Flood Re's reinsurance products limits any contingent liability that would be reported in the Department for Environment, Food and Rural Affairs' accounts.

## Classification changes

- 4.14 In this forecast, we have anticipated the effect on receipts, spending, borrowing and debt of the ONS decision to reclassify 'private registered providers' of social housing in England – which include most housing associations and some for-profit bodies – from the private sector to the public corporations sector. Annex B outlines this change in full. Box 4.1 set outs the approach that we take when the ONS has announced classification decisions, but has not yet implemented them in the public finances data.

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<sup>5</sup> See '£2 billion support for Hinkley Point', HM Treasury, 21 September 2015.

### Box 4.1: Anticipating the implementation of ONS classification decisions

We always try to forecast the public finances consistent with how the ONS will measure them once it has implemented its classification decisions, so that our forecasts will be consistent with that eventual treatment. Our forecasts therefore include various items that anticipate future revisions or classification changes that the ONS has announced, but is yet to implement.

In this forecast, as well as the effect of the reclassification of housing associations, we include the following items that are not yet in the ONS outturn data:

- some environmental levies, including **feed-in tariffs** (a subsidy for renewable and low-carbon energy generation) and the **warm homes discount** (an electricity bill discount scheme). Including these items is neutral for borrowing, as they are classified as imputed tax and spending and therefore add equal amounts to both (rising to £2.6 billion in 2020-21). The ONS is awaiting further guidance from Eurostat on their treatment; and
- **new items announced in the October and November Public Sector Finances releases**, which the ONS is planning to include over the coming months. These include lighthouse dues, British Transport Police service agreements and other small items of receipts and negative spending. (This is related to work that the ONS, the Treasury and we have been undertaking to resolve previously unexplained differences between accrued and cash measures of borrowing, discussed in Box 4.3 of our July *EFO*.)

In its October Public Sector Finances release, the ONS announced that it will start to include two items that we have previously included in our forecasts:

- **community infrastructure levy**: a levy on property developers that has been included as a central government tax on production; and
- **heavy goods vehicle road user levy**: a charge that started in April 2014 and has been included as a central government tax on production. We have adjusted our vehicle excise duty forecast to align with this treatment.

Details of the items included in our forecast that do not yet appear in outturn data are shown in a supplementary fiscal table on our website.

## Financial sector interventions

4.15 The Government undertook a number of interventions in the financial sector as a result of the crisis and recession of the late 2000s. In each *EFO* we provide an update on the estimated net effect of those interventions on the public finances. Table 4.4 summarises the position as at the end of September 2015. It therefore pre-dates the £13 billion sale of UK Asset Resolution assets announced on 13 November.

4.16 In total, £134 billion has been disbursed by the Treasury to date since the crisis. By the end of September, principal repayments on loans, proceeds from share sales and redemptions of preference shares amounted to £50 billion, up from the £41 billion reported in our last *EFO*. The additional income mainly relates to around £6 billion of Lloyds shares sold

through the trading plan and £2 billion for the sale of RBS shares. In total, the Treasury also received a further £20 billion in other fees and interest, so the net cash position stood at around a £64 billion shortfall.

- 4.17 As of the end of September, the Treasury was owed £36 billion (largely the value of loans outstanding). The value of the shares it still retained in Lloyds and RBS had fallen to £34 billion as their share prices fell and some shares were sold, while its holdings in B&B and NRAM plc had an equity book value close to £8 billion.
- 4.18 If the Treasury was to receive all loan payments in full, and sold its remaining shares at their end-September 2015 values, it would realise an overall cash surplus of £13.3 billion. But that excludes the costs to the Treasury of financing these interventions. If all interventions were financed through debt, the Treasury estimates that additional debt interest costs would have amounted to £23.6 billion by the end of September 2015, implying an overall cost of £10.3 billion to the Government. This is £3.2 billion larger than estimated in the July *EFO*, largely reflecting additional debt interest and the lower RBS share price.

Table 4.4: Gross and net cash flows of financial sector interventions

	£ billion						
	Cash outlays	Principal repayments	Other fees received <sup>1</sup>	Outstanding payments	Market value <sup>2</sup>	Implied balance	Change since July <i>EFO</i> <sup>3</sup>
Lloyds	-20.5	15.6	3.0	0.0	6.2	4.2	-0.1
RBS	-45.8	2.6	4.1	1.2	27.4	-10.4	-2.2
UK Asset Resolution <sup>4</sup>	-41.3	21.9	3.9	18.5	7.6	10.6	0.7
FSCS <sup>5</sup>	-20.9	5.1	2.3	15.8	-	2.3	0.0
Other interventions	-5.3	4.4	0.1	0.9	-	0.1	0.0
Credit Guarantee Scheme	-	-	4.3	-	-	4.3	0.0
Special Liquidity Scheme	-	-	2.3	-	-	2.3	0.0
<b>Pre-financing total</b>	<b>-133.8</b>	<b>49.6</b>	<b>20.0</b>	<b>36.3</b>	<b>41.3</b>	<b>13.3</b>	<b>-1.6</b>
<b>Exchequer financing</b>						<b>-23.6</b>	<b>-1.6</b>
<b>Total</b>						<b>-10.3</b>	<b>-3.2</b>

<sup>1</sup> Fees relating to the asset protection scheme and contingent capital facility are included within the Lloyds and RBS figures.

<sup>2</sup> Lloyds and RBS figures are based on average share prices in the 10 working days to 30 September 2015. UKAR is book value of equity derived from its Interim Financial Report for the 6 months to 30 September 2015.

<sup>3</sup> July *EFO* figures were consistent with 31 March 2015 data.

<sup>4</sup> Holdings in Bradford & Bingley and Northern Rock Asset Management plc are now managed by UK Asset Resolution.

<sup>5</sup> Financial services compensation scheme.

## Public sector receipts

- 4.19 Table 4.5 summarises our receipts forecast. The tax-to-GDP ratio is expected to rise slightly in 2015-16 and then more significantly in 2016-17 (due in part to the abolition of the NICs contracting out rebate). The ratio is then forecast to remain close to 34 per cent of GDP in the remaining years of the forecast. Non-tax receipts – in particular interest and dividend receipts – are also expected to rise over the forecast period, so that total receipts rise by 1.3 per cent of GDP between 2014-15 and 2020-21. The contribution of receipts to the overall path of PSNB from deficit to surplus is discussed later in this chapter.

Table 4.5: Major receipts as a per cent of GDP

	Per cent of GDP						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Income tax and NICs	15.0	15.1	15.9	15.9	16.1	16.3	16.4
Value added tax	6.1	6.1	6.1	6.1	6.0	6.0	6.0
Onshore corporation tax	2.2	2.3	2.2	2.4	2.2	2.0	2.0
Fuel duties	1.5	1.4	1.4	1.4	1.3	1.3	1.3
Business rates	1.5	1.5	1.4	1.4	1.4	1.4	1.4
Council tax	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Excise duties	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Capital taxes	1.3	1.3	1.4	1.5	1.5	1.6	1.6
UK oil and gas receipts	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.9	3.0	3.0	3.2	3.2	3.1	3.1
<b>National Accounts taxes</b>	<b>33.0</b>	<b>33.1</b>	<b>33.9</b>	<b>34.2</b>	<b>34.2</b>	<b>34.2</b>	<b>34.2</b>
Interest and dividend receipts	0.3	0.3	0.3	0.4	0.4	0.5	0.6
Other receipts	2.4	2.4	2.3	2.3	2.3	2.3	2.3
<b>Current receipts</b>	<b>35.8</b>	<b>35.8</b>	<b>36.5</b>	<b>36.9</b>	<b>36.9</b>	<b>36.9</b>	<b>37.1</b>

### Detailed current receipts forecast

4.20 Our detailed receipts forecasts and changes since July are presented in Tables 4.6 and 4.7. Further detailed breakdowns of other taxes and non-tax revenues are available in supplementary fiscal tables on our website. Our forecasts for Scottish and Welsh devolved taxes are discussed in more detail in *Devolved tax forecasts*, also available on our website.

Table 4.6: Current receipts

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Income tax (gross of tax credits) <sup>1</sup>	163.7	171.8	186.9	195.1	208.2	219.8	233.5
of which: Pay as you earn	140.0	147.2	156.9	167.9	177.8	187.0	198.1
Self assessment	23.6	24.9	31.4	29.1	32.6	35.0	37.4
National insurance contributions	110.3	114.6	127.0	133.2	139.3	146.0	153.4
Value added tax	111.2	115.6	120.1	124.9	130.2	135.9	142.3
Corporation tax <sup>2</sup>	43.0	44.3	44.8	49.8	47.9	45.3	46.6
of which: Onshore	40.9	43.4	44.2	49.2	47.4	44.9	46.1
Offshore	2.1	0.9	0.6	0.6	0.5	0.4	0.5
Petroleum revenue tax	0.1	-0.7	-0.5	-0.4	-0.3	-0.2	-0.1
Fuel duties	27.2	27.4	27.5	28.0	28.5	29.1	29.7
Business rates	27.3	27.8	28.2	29.1	30.2	31.4	32.4
Council tax	27.9	28.7	29.8	30.9	32.1	33.4	34.8
VAT refunds	13.7	14.1	14.5	14.7	14.6	14.9	15.6
Capital gains tax	5.6	6.4	6.7	7.3	7.9	9.5	9.4
Inheritance tax	3.8	4.4	4.6	4.8	4.9	5.2	5.6
Stamp duty land tax <sup>3</sup>	10.9	11.2	12.9	14.3	15.4	16.6	17.8
Stamp taxes on shares	2.9	2.9	3.1	3.2	3.3	3.5	3.7
Tobacco duties	9.3	9.2	9.1	9.1	9.2	9.4	9.5
Spirits duties	3.0	3.3	3.3	3.5	3.6	3.8	3.9
Wine duties	3.8	4.0	4.1	4.4	4.7	5.0	5.3
Beer and cider duties	3.7	3.6	3.5	3.7	3.7	3.8	3.8
Air passenger duty	3.2	3.1	3.2	3.3	3.5	3.7	3.8
Insurance premium tax	3.0	3.5	4.6	4.7	4.8	4.9	5.0
Climate change levy	1.6	2.1	2.5	2.4	2.3	2.2	2.0
Other HMRC taxes <sup>4</sup>	6.6	6.9	6.9	6.9	7.1	7.4	7.7
Vehicle excise duties	5.9	5.4	5.3	5.5	5.7	5.9	6.1
Bank levy	2.8	3.5	2.9	2.7	2.5	2.4	2.2
Bank surcharge	0.0	0.0	1.0	1.6	1.6	1.3	1.4
Apprenticeship levy	0.0	0.0	0.0	2.7	2.8	3.0	3.1
Licence fee receipts	3.1	3.1	3.1	3.2	3.2	3.3	3.3
Environmental levies	3.6	6.2	7.3	8.5	10.3	12.2	13.1
EU ETS auction receipts	0.6	0.5	0.5	0.6	0.6	0.6	0.6
Scottish taxes <sup>5</sup>	0.0	0.5	0.6	0.7	0.7	0.8	0.9
Diverted profits tax	0.0	0.0	0.3	0.4	0.3	0.4	0.4
Other taxes	6.3	7.4	7.4	7.9	8.2	8.5	8.8
<b>National Accounts taxes</b>	<b>603.9</b>	<b>630.9</b>	<b>671.2</b>	<b>706.6</b>	<b>737.6</b>	<b>768.8</b>	<b>805.5</b>
Less own resources contribution to EU	-3.0	-3.1	-3.2	-3.1	-3.1	-3.2	-3.5
Interest and dividends	6.0	6.2	6.3	8.1	9.7	11.5	13.2
Gross operating surplus	44.5	45.7	47.2	49.0	50.4	52.0	54.6
Other receipts	3.1	2.5	1.9	2.0	2.0	2.0	2.1
<b>Current receipts</b>	<b>654.3</b>	<b>682.2</b>	<b>723.4</b>	<b>762.7</b>	<b>796.5</b>	<b>831.1</b>	<b>871.9</b>
Memo: UK oil and gas revenues <sup>6</sup>	2.2	0.1	0.1	0.1	0.1	0.2	0.3

<sup>1</sup> Includes PAYE, self assessment, tax on savings income and other minor components.

<sup>2</sup> National Accounts measure, gross of reduced liability tax credits.

<sup>3</sup> Forecast for SDLT is for England, Wales and Northern Ireland from 2015-16.

<sup>4</sup> Consists of landfill tax (ex Scotland from 2015-16), aggregates levy, betting and gaming duties and customs duties.

<sup>5</sup> Consists of Scottish LBTT and landfill tax but not the Scottish rate of income tax or aggregates levy.

<sup>6</sup> Consists of offshore corporation tax and petroleum revenue tax.

Table 4.7: Change to current receipts since July

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Income tax (gross of tax credits) <sup>1</sup>	0.0	1.6	2.1	2.5	2.4	-0.1	-1.1
<i>of which: Pay as you earn</i>	0.0	2.0	1.8	2.5	2.9	0.5	-0.8
<i>Self assessment</i>	0.0	-0.4	0.2	-0.1	-0.5	-0.5	-0.3
National insurance contributions	0.0	-0.2	1.2	2.0	1.9	1.8	1.8
Value added tax	-0.1	-0.3	0.8	1.8	2.4	3.0	3.2
Corporation tax <sup>2</sup>	0.1	1.1	1.4	2.1	2.0	1.6	1.7
<i>of which: Onshore</i>	0.1	0.9	1.4	2.0	2.0	1.6	1.7
<i>Offshore</i>	0.0	0.2	0.0	0.1	0.0	0.0	0.1
Petroleum revenue tax	0.0	-0.8	-0.4	-0.5	-0.4	-0.3	-0.3
Fuel duties	0.0	0.3	0.2	0.2	0.2	0.3	0.3
Business rates	0.0	-0.2	-0.8	-0.3	-0.3	-0.4	-0.5
Council tax	0.0	0.3	0.8	1.3	1.8	2.2	2.7
VAT refunds	-0.1	0.5	0.7	0.9	1.0	1.1	0.9
Capital gains tax	0.0	0.0	-0.8	-1.0	-1.2	-0.5	-1.5
Inheritance tax	0.0	0.2	0.0	0.0	0.0	0.0	-0.1
Stamp duty land tax <sup>3</sup>	0.0	-0.3	0.4	0.3	-0.2	-0.6	-1.1
Stamp taxes on shares	0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.4
Tobacco duties	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Spirits duties	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Wine duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Beer and cider duties	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Air passenger duty	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance premium tax	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Climate change levy	0.0	-0.2	0.1	0.1	0.1	0.1	0.1
Other HMRC taxes <sup>4</sup>	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Vehicle excise duties	0.0	-0.2	-0.2	-0.2	-0.2	-0.1	-0.2
Bank levy	0.0	-0.2	-0.1	-0.1	0.0	0.0	0.0
Bank surcharge	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Apprenticeship levy	0.0	0.0	0.0	2.7	2.8	3.0	3.1
Licence fee receipts	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Environmental levies	0.0	0.1	0.0	0.2	0.1	-0.1	-0.4
EU ETS auction receipts	0.2	0.2	0.1	0.2	0.2	0.1	0.0
Scottish taxes <sup>5</sup>	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2
Diverted profits tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	0.2	0.2	0.3	0.8	0.8	0.9	1.0
<b>National Accounts taxes</b>	<b>0.3</b>	<b>2.0</b>	<b>6.0</b>	<b>13.0</b>	<b>13.2</b>	<b>11.5</b>	<b>9.2</b>
Less own resources contribution to EU	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest and dividends	0.1	0.4	-0.3	-0.4	-0.5	-0.3	0.7
Gross operating surplus	7.6	6.5	6.1	6.0	5.5	5.2	5.5
Other receipts	0.0	0.5	0.4	0.4	0.4	0.4	0.4
<b>Current receipts</b>	<b>8.0</b>	<b>9.4</b>	<b>12.2</b>	<b>18.9</b>	<b>18.6</b>	<b>16.8</b>	<b>15.8</b>
<i>Memo: UK oil and gas revenues<sup>6</sup></i>	<i>0.0</i>	<i>-0.5</i>	<i>-0.4</i>	<i>-0.4</i>	<i>-0.4</i>	<i>-0.3</i>	<i>-0.2</i>

<sup>1</sup> Includes PAYE, self assessment, tax on savings income and other minor components.

<sup>2</sup> National Accounts measure, gross of reduced liability tax credits.

<sup>3</sup> Forecast for SDLT is for England, Wales and Northern Ireland from 2015-16.

<sup>4</sup> Consists of landfill tax (ex Scotland from 2015-16), aggregates levy, betting and gaming duties and customs duties.

<sup>5</sup> Consists of Scottish LBTT and landfill tax but not the Scottish rate of income tax or aggregates levy.

<sup>6</sup> Consists of offshore corporation tax and petroleum revenue tax.

## Changes in the receipts forecast since July

- 4.21 The reclassification of housing associations to the public sector has increased public sector receipts by the value of housing associations' gross operating surpluses and interest receipts (see Annex B). We show forecast and policy changes in this *EFO* relative to a restated July forecast that includes our estimates of those housing association receipts on the basis of policy as set out in July.
- 4.22 On that like-for-like basis, we have revised up our receipts forecast by a total of £53.2 billion between 2015-16 and 2020-21. As Table 4.8 shows, the main upward revisions are explained by:
- **PAYE income tax and national insurance contributions (NICs)**, where modelling changes (discussed in Box 4.2) and strong outturn receipts have raised the forecast despite lower average earnings growth towards the end of the forecast;
  - **VAT** receipts, which have been boosted by a correction to the modelling of VAT deductions (again discussed further in Box 4.2);
  - **corporation tax**, where strong outturn receipts and stronger industrial and commercial profits increase the forecast; and
  - the effect of **Government decisions** in this Spending Review and Autumn Statement, where scorecard measures increase receipts by £20.9 billion in total, decisions that are not shown on the Treasury's scorecard (in relation to council tax) increase receipts by £6.2 billion and the indirect effects of Government decisions increase receipts by £2.1 billion.
- 4.23 These upward revisions are partly offset by a downward revision to stamp duty land tax (SDLT) receipts, reflecting a weaker forecast for residential property transactions and lower receipts so far this year, in part due to a substantial fall in the number of transactions at very high prices (which account for a tiny fraction of all transactions, but a big share of tax receipts). Lower equity prices have reduced our forecasts for receipts from capital gains tax, stamp duty on shares and inheritance tax.

Table 4.8: Sources of change to the receipts forecast since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>July forecast</b>	<b>672.8</b>	<b>711.2</b>	<b>743.7</b>	<b>777.9</b>	<b>814.4</b>	<b>856.1</b>
<b>Housing association reclassification</b>	<b>6.5</b>	<b>6.4</b>	<b>6.6</b>	<b>6.3</b>	<b>6.2</b>	<b>6.5</b>
<b>July forecast restated to include HAs</b>	<b>679.4</b>	<b>717.6</b>	<b>750.3</b>	<b>784.3</b>	<b>820.5</b>	<b>862.6</b>
<b>November forecast</b>	<b>682.2</b>	<b>723.4</b>	<b>762.7</b>	<b>796.5</b>	<b>831.1</b>	<b>871.9</b>
<b>Change on a like-for-like basis</b>	<b>2.8</b>	<b>5.8</b>	<b>12.4</b>	<b>12.3</b>	<b>10.6</b>	<b>9.3</b>
	<b>Underlying OBR forecast changes</b>					
<b>Total change to underlying forecast</b>	<b>2.5</b>	<b>4.1</b>	<b>6.3</b>	<b>5.4</b>	<b>2.8</b>	<b>2.8</b>
<i>of which:</i>						
<b>Income and expenditure</b>	<b>1.2</b>	<b>1.5</b>	<b>2.0</b>	<b>1.2</b>	<b>-0.6</b>	<b>-2.1</b>
Average earnings	1.4	1.3	0.7	-0.6	-1.9	-2.8
Employee numbers	-0.4	0.1	0.9	1.3	1.0	0.4
Non-financial company profits	0.3	0.7	1.0	0.9	1.1	1.2
Consumer expenditure	-0.4	-0.5	-0.4	-0.3	-0.5	-0.5
Investment	0.2	0.0	0.0	0.1	0.0	0.0
Other	0.1	0.0	-0.2	-0.3	-0.3	-0.4
<b>North Sea</b>	<b>-0.1</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.2</b>	<b>-0.4</b>
Oil and gas prices	-0.4	-0.5	-0.5	-0.6	-0.6	-0.6
Production and expenditure	0.3	0.1	0.2	0.2	0.4	0.2
<b>Property markets</b>	<b>0.2</b>	<b>0.4</b>	<b>0.1</b>	<b>-0.4</b>	<b>-1.0</b>	<b>-1.6</b>
<b>Market-derived assumptions</b>	<b>-0.6</b>	<b>-1.8</b>	<b>-2.1</b>	<b>-2.2</b>	<b>-2.2</b>	<b>-2.3</b>
Equity prices	-0.4	-1.6	-1.8	-1.9	-2.0	-2.1
Interest rates	-0.1	-0.2	-0.3	-0.3	-0.3	-0.2
<b>Prices</b>	<b>0.1</b>	<b>0.2</b>	<b>0.7</b>	<b>0.7</b>	<b>0.6</b>	<b>0.2</b>
<b>Other economic determinants</b>	<b>0.1</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.2</b>	<b>0.0</b>
<b>Other assumptions</b>	<b>1.7</b>	<b>4.2</b>	<b>6.0</b>	<b>6.5</b>	<b>6.4</b>	<b>9.0</b>
IT and NICs receipts and modelling	-0.2	0.6	0.8	0.9	0.3	1.0
New NICs model	0.4	0.4	0.6	1.1	1.7	2.8
Corporation tax receipts and modelling	0.6	1.1	1.3	1.2	0.6	0.6
Other VAT modelling	-0.4	-0.1	-0.1	-0.4	-0.4	-0.5
VAT deductions modelling	0.4	1.0	1.6	2.3	2.9	3.3
VAT refunds modelling	0.5	0.8	0.8	0.8	0.8	0.9
Other judgements and modelling	0.3	0.4	1.1	0.7	0.4	0.8
	<b>Effect of Government decisions</b>					
<b>Total effect of Government decisions</b>	<b>0.3</b>	<b>1.7</b>	<b>6.1</b>	<b>6.8</b>	<b>7.8</b>	<b>6.5</b>
<i>of which:</i>						
Scorecard measures	0.3	0.6	4.5	4.6	5.5	5.3
Non-scorecard measures	0.0	0.4	0.8	1.2	1.7	2.2
Indirect effects	0.0	0.8	0.7	1.0	0.6	-1.0

## Box 4.2: Updates to fiscal forecasting models

Our October 2015 *Forecast evaluation report* set out our approach for assessing and scrutinising the wide range of forecasting models we use to produce our detailed bottom-up fiscal forecasts. We judge the performance of these models against a number of criteria, including:

- **accuracy** – how well does the model match outturns?;
- **plausibility** – how well do the model outputs align with theory and experience?;
- **transparency** – how easily can the model outputs be understood and scrutinised?; and
- **effectiveness** – how well does the model capture the tax or benefit system?

In line with these criteria, we have reviewed the HMRC modelling of two of our largest receipts items and have made the changes described below.

**VAT deductions** are an adjustment made to the HMRC VTTL (VAT theoretical tax liability) model to remove items that are not scored as net VAT receipts by the ONS. In 2014, around 64 per cent of these deductions reflected current VAT refunds to central government. The forecast for these deductions was previously projected in line with past trends. But, thanks to the public spending cuts implemented in recent years, deductions relating to the government sector have not risen as quickly as past trends would have suggested, so we have been over-forecasting deductions (and thus under-forecasting net VAT receipts). This error has built up as the fiscal consolidation has continued. The model was insufficiently transparent to pick it up sooner.

To correct this error, we have adjusted these government deductions to grow in line with our forecasts for government spending. This correction has boosted VAT receipts by around £0.4 billion in 2015-16, rising to £3.3 billion in 2020-21.

**Class 1 national insurance contributions (NIC1)** have previously been forecast by HMRC using a model originally created by the Government Actuary's Department (GAD). This model also lacked transparency, making it challenging to scrutinise forecast outputs effectively. To improve consistency across income taxes, we have now aligned the Class 1 NICs forecast model with that used by HMRC to forecast PAYE receipts for us. The new model features the latest ONS data on the income distribution and allows for changes in this over time. This switch has boosted the NIC1 forecast by £2.8 billion by 2020-21, of which £2.6 billion comes from employer NIC1 contributions.

Moving to this HMRC model has increased the transparency of the forecast, giving us more scope to scrutinise and implement key judgements, in particular regarding the average marginal tax rates that drive the receipts forecast. The £2.8 billion upward revision reflects a £3.3 billion boost from assuming that a higher (and more plausible) proportion of income is taxed above the upper earnings limit, partly offset by a £0.5 billion loss from assuming that a lower proportion of income is taxed between the primary threshold and the upper earnings limit.

We will continue to work with the relevant specialists in forecasting departments to improve our fiscal forecasting models in line with these criteria. We are grateful for the commitment, expertise and professionalism consistently shown by the analysts that work on these forecast models for us, often at times when Government calls on their time are significant.

## Receipts in 2015-16

- 4.24 In preparing this forecast, we had access to full ONS receipts data up to September 2015 and much of the administrative receipts data consistent with the ONS estimates for October 2015. Central government receipts in October were down by £1.0 billion on a year previously, largely reflecting the timing and size of transfers from the Asset Purchase Facility. Abstracting from these transfers (which are neutral for PSNB), receipts growth was weaker in October than our July full-year forecast, primarily due to corporation tax.
- 4.25 Table 4.9 looks at receipts growth in the first six months of 2015-16. It shows that we expect overall growth in National Accounts taxes in the second half of 2015-16 to be similar to that in the first. Growth in the first half was driven particularly by PAYE, NICs and onshore corporation tax (CT). We expect onshore CT to be weaker in the second half of 2015-16, in part because of the end-loading of receipts from the financial and life assurance sectors last year. Growth in inheritance tax is also expected to be lower in the rest of the year, reflecting slower house price inflation and that the first half of the year was boosted by some very high-value estates.
- 4.26 Growth in self-assessment (SA) income tax and stamp duties is expected to pick up in the second half of the year. SA receipts are expected to be boosted by various policy measures, which together add around £1½ billion to receipts in 2015-16 relative to last year (and are described in paragraph 4.31). The year-on-year comparison for stamp duty should benefit from higher annual growth in residential transactions and that the comparison from December onwards will be against the new 'slice' system for residential properties.

Table 4.9: Receipts in 2015-16

	£ billion			Percentage change on 2014-15		
	Outturn	Forecast		Outturn	Forecast	
	Apr-Sep	Oct-Mar	Full year	Apr-Sep	Oct-Mar	Full year
Income tax and NICs	132.1	154.4	286.4	4.4	4.7	4.6
of which:						
PAYE and NICs	125.0	136.8	261.8	4.6	4.6	4.6
Self assessment	8.1	16.8	24.9	2.4	7.0	5.5
Value added tax	56.7	58.9	115.6	4.3	3.6	4.0
Corporation tax	20.3	24.0	44.3	7.9	-0.8	3.0
Petroleum revenue tax	-0.2	-0.5	-0.7			
Fuel duties	13.9	13.5	27.4	1.4	0.3	0.9
Capital gains tax	0.0	6.4	6.4		15.7	15.6
Inheritance tax	2.4	2.0	4.4	20.4	7.1	13.9
Stamp duties	7.2	7.4	14.5	-2.2	14.3	5.5
Tobacco duties	4.1	5.1	9.2	2.4	-2.8	-0.6
Alcohol duties	5.2	5.6	10.8	2.8	4.7	3.8
Business rates	14.0	13.8	27.8	1.3	2.7	2.1
Council tax	14.5	14.2	28.7	3.6	2.0	2.8
Other <sup>1</sup>	26.8	26.8	53.5	4.4	7.7	6.1
<b>National Accounts taxes</b>	<b>296.8</b>	<b>331.7</b>	<b>628.4</b>	<b>4.0</b>	<b>4.1</b>	<b>4.1</b>

<sup>1</sup> Forecast data has been adjusted to exclude feed-in-tariffs, the warm home discount and other items which were excluded in the October ONS Public Sector Finances release. Further detail on these items can be found in our fiscal supplementary tables.

## Tax-by-tax analysis

### Income tax and NICs

- 4.27 Receipts of income tax and NICs are expected to be £1.4 billion higher in 2015-16 than we forecast in July. This is more than explained by an upward revision to PAYE and NIC receipts on employment income of £1.7 billion. Stronger-than-expected earnings growth is likely to be a key driver of the additional receipts, with receipts particularly strong in the business services and financial sector.
- 4.28 Compared with our July forecast, income tax and NICs receipts are between £3 billion and £4½ billion a year higher in 2016-17, 2017-18 and 2018-19, although by the end of the forecast receipts are just £0.7 billion higher. After stronger-than-expected earnings growth in 2015-16, we have revised down our forecast of earnings growth in each subsequent year. The downward revisions in part reflect the additional costs created for firms and workers from the introduction of a new apprenticeship levy and ongoing auto-enrolment into workplace pensions. We expect these costs to be borne largely through lower wages. By 2020-21, we expect lower average earnings growth to take £4.0 billion off the forecast. A new NICs model, explained in more detail in Box 4.2, has added around £2.8 billion to the forecast by 2020-21, mainly due to a higher forecast for employer NICs.
- 4.29 Receipts of income tax and NICs are expected to rise by 0.8 per cent of GDP in 2016-17, more than explaining the rise in the overall receipts-to-GDP ratio in that year. Of that increase, NICs receipts account for around half. This mainly reflects the Budget 2013 policy decision to abolish the NICs contracting-out rebate from April 2016. This is expected to raise NICs receipts by £5.1 billion (0.3 per cent of GDP) in 2016-17, with around 50 per cent of the extra burden falling on public sector employers in additional employer NICs. PAYE receipts in 2015-16 have been boosted by the pension flexibility reforms. Pension withdrawals have been slightly higher than expected so far this year and we assume a yield of around £0.9 billion from these withdrawals over the whole of 2015-16, around £0.2 billion higher than previously assumed. Estimates of pension withdrawals and the extent to which the reforms also lead to higher pension contributions (and higher tax relief) remain subject to significant uncertainty. We have not revised our forecast for future years.
- 4.30 The July Budget delayed the implementation of the related March 2015 measure on secondary annuities to 2017. The Government did not inform us of that decision and so we have only now been able to include the effect of the delay in the forecast. It reduces receipts by around £0.5 billion in 2016-17, but increases them in 2018-19 as the effect has simply been pushed forward a year. We still consider this costing to be subject to very high uncertainty, with the range of possible outcomes around the central estimate including the possibility that a secondary market does not develop and no receipts are generated.
- 4.31 Self-assessment (SA) income tax is assumed to rise by 5.5 per cent in 2015-16. For the first seven months of 2015-16, SA receipts have risen 2.1 per cent on a year earlier but receipts to date almost entirely reflect payments on account based on the last year's tax. SA receipts should be boosted in 2015-16 by previously announced measures on partnership income

(adding around £1 billion to receipts) and accelerated payments (adding £0.6 billion relative to 2014-15). In the latter, taxpayers have to pay disputed tax much earlier if HMRC wins a legal case. The effect from the partnerships measure is only expected when taxpayers pay the balancing payment on their 2014-15 liabilities in January 2016. Receipts in 2015-16 should also be boosted by the strong growth in self-employment in 2014 and rising profits should boost dividend and partnership income.

4.32 SA receipts are then expected to rise by £6.5 billion in 2016-17 (0.3 per cent of GDP), with forestalling ahead of the rise in dividend tax adding £2.7 billion to receipts. This estimate is informed by the 2010-11 introduction of the 50p additional rate of income tax for incomes over £150,000. We also expect 2016-17 to be the peak year for yield from accelerated payments. The unwinding of the forestalling in 2017-18 and 2018-19 will depress receipts in those years, but between 2015-16 and 2020-21 we nonetheless expect SA receipts to rise by 50 per cent, almost double the 28 per cent growth in public sector current receipts as a whole. In addition to the rise in dividend tax, a number of other measures announced in the July Budget – including the changes in non-domicile rules, HMRC compliance measures and restrictions on residential landlords' deductions from taxable income – are all expected to boost receipts. The savings tax reforms announced in March mean that much of the remaining liabilities on savings income will now be collected through SA, while the measures that encourage small businesses to pay their taxes digitally are expected to raise a further £0.3 billion by the end of the forecast period.

Table 4.10: Key changes to the income tax and NICs forecast since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	285.1	310.6	323.8	343.2	364.1	386.2
November forecast	286.4	313.9	328.3	347.5	365.8	386.8
<b>Change</b>	<b>1.4</b>	<b>3.3</b>	<b>4.5</b>	<b>4.3</b>	<b>1.7</b>	<b>0.7</b>
	Underlying OBR forecast changes					
<b>Total</b>	<b>1.4</b>	<b>2.6</b>	<b>3.3</b>	<b>2.9</b>	<b>1.2</b>	<b>1.2</b>
<i>(by economic determinant)</i>						
Average earnings	1.4	1.3	0.7	-0.6	-1.9	-2.8
Employee numbers	-0.4	0.1	0.9	1.3	1.0	0.4
Inflation	0.0	0.0	0.2	-0.1	-0.2	-0.3
SA determinants	0.3	0.1	0.0	0.1	0.0	-0.1
Other economic determinants	0.0	0.1	0.1	0.2	0.2	0.2
<i>(by other category)</i>						
Outturn IT and NICs receipts	0.3	0.6	0.8	0.9	1.0	1.1
Outturn SA receipts	-0.2	-0.1	-0.2	-0.3	-0.3	-0.3
Revisions to costings	-0.2	0.2	0.5	0.6	0.0	0.4
New NICs model	0.4	0.4	0.6	1.1	1.7	2.8
Other modelling and receipts changes	-0.1	-0.1	-0.4	-0.3	-0.5	-0.2
	Changes due to Government decisions					
<b>Scorecard measures</b>	<b>0.0</b>	<b>0.4</b>	<b>0.8</b>	<b>0.8</b>	<b>0.4</b>	<b>0.6</b>
<b>Indirect effects of Government decisions</b>	<b>-0.1</b>	<b>0.4</b>	<b>0.4</b>	<b>0.6</b>	<b>0.1</b>	<b>-1.1</b>

## VAT

- 4.33** Accrued VAT receipts have risen 3.8 per cent so far in 2015-16 and are expected to increase at a similar rate over the financial year as a whole. This is lower than the 4.4 per cent rise in 2014-15. A key factor is weaker nominal consumer spending growth (which accounts for over two-thirds of the tax base) reflecting the sharp drop in inflation. Based on receipts so far this year, we have assumed a rise in the VAT gap in 2015-16. This is the difference between the theoretical level of VAT payments and actual amounts received by HMRC. This judgment is subject to considerable uncertainty.
- 4.34** Compared with our July forecast, we expect accrued VAT receipts to be £0.3 billion lower in 2015-16, much of which can be explained by lower growth in nominal consumer spending. VAT receipts are then higher throughout the rest of the forecast, with receipts up £3.2 billion relative to July by 2020-21. Modelling changes to VAT deductions, explained in Box 4.2, more than account for this upward revision. We have also incorporated an adjustment for a change in the way that the Department for Education (DfE) pays for land, buildings and construction services for its free schools programme. This adds £0.3 billion to VAT receipts by 2020-21. The Treasury has advised us that the associated increase in spending by DfE has been reflected in its Spending Review DEL settlement.

**Table 4.11: Key changes to the VAT forecast since July**

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	115.9	119.2	123.1	127.9	132.9	139.2
November forecast	115.6	120.1	124.9	130.2	135.9	142.3
<b>Change</b>	<b>-0.3</b>	<b>0.8</b>	<b>1.8</b>	<b>2.4</b>	<b>3.0</b>	<b>3.2</b>
	Underlying OBR forecast changes					
<b>Total</b>	<b>-0.3</b>	<b>0.6</b>	<b>1.6</b>	<b>2.2</b>	<b>2.7</b>	<b>3.2</b>
<i>of which:</i>						
Household spending	-0.3	-0.6	-0.5	-0.3	-0.5	-0.4
Standard rated share	0.0	0.3	0.5	0.5	0.5	0.5
VAT deductions modelling	0.4	1.0	1.6	2.3	2.9	3.3
DfE free schools adjustment	0.0	0.0	0.1	0.1	0.2	0.3
Other determinants and modelling	-0.4	-0.1	-0.1	-0.4	-0.4	-0.5
	Changes due to Government decisions					
<b>Scorecard measures</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.2</b>	<b>0.3</b>
<b>Indirect effects of Government decisions</b>	<b>0.0</b>	<b>0.2</b>	<b>0.2</b>	<b>0.1</b>	<b>0.1</b>	<b>-0.3</b>

## Onshore corporation tax

- 4.35** Receipts of onshore corporation tax (CT) have risen 9.7 per cent in the first seven months of 2015-16. We expect slower growth of 6.1 per cent for the year as a whole. Growth in receipts has been strongest in the financial sector and in instalment payments from larger industrial and commercial companies. Higher instalment payments suggest strong profit growth has more than compensated for the further cut in the main rate of corporation tax to 20 per cent, while the Autumn Statement 2014 measure to limit the use of trading losses by the financial sector is likely to have driven higher receipts from the financial sector. In

contrast, CT from smaller industrial and commercial companies is expected to fall in 2015-16, reflecting the increase in the annual investment allowance to £500,000 until December 2015. (It is then set to drop to £200,000 and remain at that level.)

- 4.36 Over the remainder of 2015-16, we expect onshore CT receipts to be only marginally up on a year earlier. Receipts to date have been boosted by strong instalment payments in April that largely related to previous years' liabilities. Receipts from firms in the financial and life assurance sectors were also particularly end-loaded during 2014-15. This base effect will worsen year-on-year comparisons over the rest of the financial year.
- 4.37 Compared with July, our onshore CT forecast is up £0.9 billion in 2015-16 and by between £1 billion and £2 billion a year thereafter. Higher receipts in 2015-16 are pushed through into future years, while a stronger forecast for growth in industrial and commercial company profits adds over £1 billion to the forecast by 2020-21.
- 4.38 The profile of onshore CT receipts over the forecast period – peaking in 2017-18, then falling for two years – largely reflects the measures announced in the July Budget. In particular, the decision to bring the CT payment date for larger companies forward by four months from April 2017 raises receipts by around £4 billion in 2017-18 and by around £3 billion in 2018-19. Receipts are being brought forward from later years, providing a one-off boost that is not subsequently reversed. Further cuts in the main rate of corporation tax to 19 per cent in April 2017 and to 18 per cent in April 2020 will reduce receipts.

Table 4.12: Key changes to the onshore corporation tax forecast since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	42.5	42.8	47.2	45.4	43.4	44.5
November forecast	43.4	44.2	49.2	47.4	44.9	46.1
<b>Change</b>	<b>0.9</b>	<b>1.4</b>	<b>2.0</b>	<b>2.0</b>	<b>1.6</b>	<b>1.7</b>
	Underlying OBR forecast changes					
<b>Total</b>	<b>0.6</b>	<b>1.2</b>	<b>1.9</b>	<b>1.9</b>	<b>1.5</b>	<b>1.6</b>
<i>of which:</i>						
Industrial and commercial company profits	0.3	0.7	1.0	0.9	1.1	1.2
Industrial and commercial company investment	0.0	0.0	0.0	-0.1	-0.1	-0.1
Other economic determinants	-0.3	-0.5	-0.3	-0.2	-0.1	0.0
Latest receipts data	0.8	1.3	1.1	1.1	1.0	1.5
Modelling and costings updates	-0.2	-0.3	0.2	0.1	-0.5	-0.9
	Changes due to Government decisions					
<b>Scorecard measures</b>	<b>0.3</b>	<b>0.1</b>	<b>0.2</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>
<b>Indirect effects of Government decisions</b>	<b>0.0</b>	<b>0.1</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.1</b>

## UK oil and gas revenues

- 4.39 Our forecast for UK oil and gas revenues is just £130 million in 2015-16, down from £2.2 billion in 2014-15 and receipts of just under £11 billion four years earlier. Receipts of petroleum revenue tax (PRT) in the first seven months of 2015-16 were minus £222 million

as PRT repayments more than offset PRT payments. High levels of PRT repayments relate both to lower oil prices, higher decommissioning costs and the carry back of losses to reclaim previously paid tax. We expect high PRT repayments to continue through 2015-16.

- 4.40 Compared to July, our forecast for oil and gas revenues is lower in all years. Lower oil and gas prices more than explain the downward revision. Oil prices are projected using futures prices for the first two years and then held flat in nominal terms. This leaves them \$8 a barrel lower in 2015 and \$12 a barrel lower in the medium term than in our July forecast. Gas prices are expected to be 2.5p a therm lower in 2015 and then between 7p and 8p a therm lower over the rest of the forecast. In light of lower prices, we have assumed that capital and operating expenditure drop by more than was assumed in July. Higher-than-expected oil and gas production in 2015 is partly pushed through to future years.
- 4.41 Our central forecast is that oil and gas revenues remain very low throughout the forecast. This remains subject to significant uncertainty, including about the extent to which the much lower oil and gas prices will affect production and expenditure and how much the new investment allowance and cut to the supplementary charge and PRT rates announced in March 2015 will provide an offset by boosting post-tax returns on oil and gas extraction.

### Stamp duties

- 4.42 Stamp duty land tax (SDLT) from residential property has been weaker than expected so far in 2015-16. We have revised receipts down by £0.3 billion from our July forecast. Growth in overall residential transactions and house prices in recent months have been a little higher than we assumed in July, with the weakness concentrated at the top-end of the housing market. In particular, SDLT receipts are weaker because transactions among properties worth at least £2 million have fallen. While the 10 per cent year-on-year drop in the first half of 2015-16 represents only around 350 fewer transactions, each transaction pays a very large amount of SDLT. Assuming an average transaction price in this bracket of £4 million would imply a £140 million drop in receipts.
- 4.43 Compared with July, we have revised our pre-measures residential SDLT forecast down by over £2 billion by 2020-21. This revision reflects a combination of pushing the 2015-16 receipts weakness through the forecast, allowing for an additional downward effect from expensive properties and a lower forecast for overall residential transactions. In contrast, we have revised our commercial SDLT forecast up since July to allow for greater buoyancy in the effective tax rate, given rising prices and thresholds fixed in cash terms. These changes are partly offset by the policy measure of a 3 per cent SDLT surcharge on second homes and buy-to-let properties, which adds around £0.9 billion to the forecast by 2020-21.
- 4.44 We have reduced our forecast for stamp duty on shares by £0.3 billion a year on average, largely reflecting a downward revision to equity prices.

Table 4.13: Key changes to the SDLT forecast since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	11.5	12.6	13.9	15.7	17.3	18.9
November forecast	11.2	12.9	14.3	15.4	16.6	17.8
<b>Change</b>	<b>-0.3</b>	<b>0.4</b>	<b>0.3</b>	<b>-0.2</b>	<b>-0.6</b>	<b>-1.1</b>
	Underlying OBR forecast changes					
<b>Total</b>	<b>-0.4</b>	<b>-0.3</b>	<b>-0.6</b>	<b>-1.2</b>	<b>-1.7</b>	<b>-2.1</b>
of which:						
House prices	0.1	0.2	0.2	0.2	0.1	-0.3
Residential property transactions	0.2	0.2	-0.1	-0.5	-0.8	-0.9
Commercial property market	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2
Commercial property modelling	0.4	0.4	0.5	0.5	0.6	0.7
Modelling and receipts outturns	-1.0	-0.9	-1.1	-1.2	-1.3	-1.4
	Changes due to Government decisions					
<b>Scorecard measures</b>	<b>0.0</b>	<b>0.7</b>	<b>0.9</b>	<b>0.9</b>	<b>1.0</b>	<b>1.1</b>

### Taxes on capital

- 4.45 Capital gains tax (CGT) is currently paid in the final quarter of the financial year after the year in which the gains from the sale of an asset are realised. So CGT receipts in 2015-16 will reflect asset disposals in 2014-15. We expect growth in CGT receipts of around 16 per cent in 2015-16, as receipts will be boosted by the 10 per cent rise in house prices during 2014-15. CGT is payable on disposals of non-principal residences.
- 4.46 CGT is highly geared to changes in equity prices and this is the key driver of the rise in receipts over the forecast period. Around three-quarters of chargeable gains are related to financial assets and CGT is charged only on the gain rather than the disposal price. Following recent market falls, the path of equity prices is around 7 to 8 per cent lower than in our July forecast. This takes around £1.5 billion off the forecast by 2020-21.
- 4.47 The overall effect from the measures announced in the July Budget and this Autumn Statement is to boost CGT receipts in each year, but particularly in 2019-20. The July Budget saw measures to tackle avoidance by private equity and hedge funds and changes to non-domicile status. This Autumn Statement has announced that from 2019-20, CGT on residential property would be due 30 days after the disposal rather than between 10 and 21 months after the sale. This brings forward around £0.9 billion of CGT receipts into that year. As with the July Budget measure to bring forward CT payment dates, this represents a one-off increase in receipts that is neither repeated nor reversed in later years.
- 4.48 Receipts from inheritance tax (IHT) are expected to rise by almost 14 per cent in 2015-16 and have been revised up by £0.2 billion from our estimate in July. Given the lags before IHT is paid, the strong housing market in 2014 is likely to be a key factor driving recent growth. Housing accounts for around 50 per cent of the value of estates notified for probate. A higher number of deaths last winter and some exceptionally high-value estates

have also boosted receipts this year. From 2016-17 onwards, lower equity prices mean that IHT receipts are similar to our July forecast.

## Fuel duties

- 4.49 Compared with July, we have revised fuel duty receipts up by £0.3 billion in 2015-16. Fuel duty is now expected to rise by around 1 per cent from last year. With duty rates frozen, this reflects a small rise in fuel clearances. These had fallen in every year between 2007-08 and 2012-13, reflecting improvements in fuel efficiency and the effects of the late 2000s downturn on mileage. With fuel duty charged on a pence per litre basis, the drop in pump prices since late 2014 is expected to raise the demand for fuel and boost fuel duty receipts. The lower oil price path throughout the forecast therefore adds around £0.2 billion a year to receipts.
- 4.50 The Government has told us that its policy is to uprate duty rates in line with RPI inflation each year from April 2016 onwards. This more than explains the £2.3 billion rise in receipts between 2015-16 and 2020-21 and helps offset the effect of further improvements in fuel efficiency. This uprating assumption could be considered a source of policy risk to the forecast, given repeated decisions to cancel planned duty rises in recent years.

## Alcohol and tobacco duties

- 4.51 Alcohol duty is expected to rise from £10.8 billion in 2015-16 to £13.0 billion in 2020-21. Receipts from wine and spirits are expected to increase by £1.3 billion and £0.6 billion respectively. But we expect a rise of just £0.2 billion over the same period in receipts from beer and cider. We assume that the downward trend in beer clearances continues through the forecast. Our forecast for alcohol duties is little changed since July. Receipts are higher by between £0.1 and £0.2 billion a year reflecting stronger receipts so far this year.
- 4.52 Tobacco receipts are expected to rise only slightly, from £9.2 billion in 2015-16 to £9.5 billion in 2020-21, despite RPI plus 2 per cent rises in duty each year. This is largely offset by the downward trend in cigarette clearances, thanks in part to the recent above-RPI increases in duty, changing attitudes to smoking, policies (such as the display ban) and the growing popularity of e-cigarettes. Our forecast is little changed since July. Receipts are £0.1 billion a year higher reflecting stronger receipts so far this year.

## Other taxes

- 4.53 **Business rates** receipts are calculated by multiplying the rateable value of non-domestic property by the multiplier (which is uprated in line with RPI inflation). The announcement in this Autumn Statement that the doubling of the small business rate relief would be extended for a further year is the main change to our forecast since July. The Government has extended the doubling of small business rates relief policy for another year at a cost of £0.6 billion. It has stated that Government policy is to extend it for only one year, so our forecast is based on the relief halving from 2017-18. This may represent another source of policy risk to the forecast, since the relief has been extended by one year every year since 2011.

- 4.54 Our business rates forecast is subject to some further policy-related uncertainty following the Government's announcement of its intention to localise all business rates and to provide some additional discretion to local authorities in setting business rates. However, the Government has told us that this intention does not yet constitute Government policy, so we have not reflected it in this forecast.
- 4.55 Receipts from **council tax** are expected to be around £2.7 billion higher in 2020-21 than in our July forecast. Around £2.2 billion of this reflects the Autumn Statement announcements on council tax. Upper tier local authorities in England will have an additional 2 per cent flexibility from 2016-17 onwards to allow them to increase council tax by up to 4 per cent a year. Some Police and Crime Commissioners will also have more flexibility to raise their element of council tax. These changes are explained in more detail in the expenditure section of this chapter. Changes in council tax receipts are offset within the locally financed expenditure forecast and are therefore neutral for borrowing.
- 4.56 **Environmental levies** include levy-funded spending policies such as the renewables obligation and contracts for difference, feed-in tariffs, the carbon reduction commitment, capacity markets and the warm homes discount. It does not include other DECC schemes that affect energy bills such as the energy company obligation. Our forecast shows environmental levies are expected to rise from £6.2 billion in 2015-16 to £13.1 billion in 2020-21. The steep rise in the forecast mainly reflects the expected rise in electricity generation from renewable sources.
- 4.57 Our forecasts do not include the outcomes of the consultations on feed-in tariffs or the renewables obligation that have yet to be decided. Relative to July, our forecast is a little higher in the near term. Spending on feed-in-tariffs is around £0.2 billion higher throughout the forecast mainly reflecting an increase in projects getting pre-accreditation before it was removed at the end of September. Developers were able to pre-accredit projects ahead of building and the start of electricity generation, allowing them to lock in more generous tariff levels.
- 4.58 **Insurance premium tax** receipts are expected to rise by around 20 per cent in 2015-16 and around 30 per cent in 2016-17, reflecting the July Budget measure to increase the standard rate of IPT to 9.5 per cent. Compared to July, our forecast is higher by £0.1 billion by 2020-21, reflecting updated modelling of the demand for insurance premiums. We have reduced IPT receipts by around £50 million a year on average to allow for an expected drop in motor insurance premiums from reforms designed to reduce the cost of certain forms of road traffic personal injury claims.
- 4.59 **Air passenger duty** receipts are expected to rise from £3.1 billion in 2015-16 to £3.8 billion in 2020-21. This reflects duty rate rises and growth in passenger numbers. Our forecast is little changed since July.
- 4.60 **Vehicle excise duty (VED)** is levied annually on road vehicles and is expected to rise from £5.4 billion in 2015-16 to £6.1 billion in 2020-21, reflecting the uprating of duties in line with RPI inflation and measures announced in the July budget. Relative to July, we have

revised our forecast down by £0.2 billion a year to ensure consistency with the ONS treatment of the HGV road user levy (which is captured elsewhere in our receipts forecast). Abstracting from this adjustment, our forecast is little changed.

- 4.61 Receipts from the **climate change levy (CCL)** are expected to rise from £1.6 billion in 2014-15 to £2.1 billion in 2015-16 reflecting the big rise in carbon price support rates for the carbon price floor element of CCL. We have revised CCL receipts down by £0.2 billion in 2015-16 since July, reflecting updated information on the July Budget measure to remove the CCL exemption from energy generated from renewable sources. We now expect that more exemption certificates will be used this year, so cash receipts from the measure will only start to score from 2016-17 onwards.
- 4.62 **Bank levy** receipts are expected to fall from £3.5 billion in 2015-16 to £2.2 billion in 2020-21. This mainly reflects the graduated cuts in the bank levy rate from 0.21 per cent to 0.1 per cent by 2021 announced in the July Budget. Our forecast has been revised down by £0.1 billion a year since July, reflecting weaker than expected receipts growth so far this year that is pushed through to subsequent years.
- 4.63 **VAT refunds** to central and local government are neutral for borrowing, as they are offset within spending. The forecast for VAT refunds largely reflects the path of government procurement and investment. VAT refunds to local authorities have risen much more strongly so far this year than would be implied by our forecast for local authority spending. We assume that growth in local authority refunds will be slower over the rest of the year, but that the implied increase in the effective tax rate will be sustained over the forecast. The changes since July also reflect changes to the profile of DEL totals set out in the Spending Review.
- 4.64 Our forecast for **BBC licence fee** receipts has been revised down by around £0.1 billion a year from 2016-17 onwards, reflecting a small decrease in our assumption of the proportion of households that are licence fee payers, informed by BBC estimates.

### Other receipts

- 4.65 **Interest and dividend** receipts include interest income on the government's stock of financial assets, which includes student loans and holdings related to financial sector interventions. The reclassification of housing associations to the public sector (see Annex B) has added £0.2 billion a year to the forecast. Abstracting from that classification change, our pre-measures forecast for interest and dividend receipts is on average lower than in July. That largely reflects lower interest rates and lower earnings on the UK's foreign exchange reserves.
- 4.66 The accrued interest on student loans is expected to increase rapidly over the forecast period from £1.9 billion in 2015-16 to £6.5 billion by 2020-21, reflecting the rise in the stock of loans. The further changes to student funding announced in the Autumn Statement are expected to boost accrued interest by £0.4 billion by 2020-21.

4.67 Our forecast for **gross operating surplus (GOS)** comprises general government depreciation and public corporations' gross operation surplus (PCGOS). The reclassification of housing associations has a big effect on this line of our receipts forecast, adding £6.2 billion a year on average over the forecast period. Abstracting from this, changes reflect recent revisions to outturn and that we have switched the classification of the Housing Revenue Account component of the July 'pay-to-stay' social housing measure from GOS to a tax on production.

## Public sector expenditure

### Definitions and approach

4.68 This section explains our central forecast for public sector expenditure, which is based on the National Accounts aggregates for public sector current expenditure (PSCE), public sector gross investment (PSGI) and total managed expenditure (TME), which is the sum of PSCE and PSGI. In our forecast, we combine these National Accounts aggregates with the two administrative aggregates used by the Treasury to manage public spending:

- **departmental expenditure limits (DELs)**<sup>6</sup> – mostly covering spending on public services, grants, administration and capital investment, which can be planned over extended periods. Our fiscal forecast therefore shows PSCE in resource DEL and PSGI in capital DEL. We typically assume (in line with historical experience) that departments will underspend the limits that the Treasury sets for them, so – unless otherwise stated – when we refer to PSCE in RDEL and PSGI in CDEL (or RDEL and CDEL for simplicity) we are referring to the net amount that we assume is actually spent; and
- **annually managed expenditure (AME)** – categories of spending less amenable to multi-year planning, such as social security spending and debt interest. Again, our fiscal forecast shows PSCE in current AME and PSGI in capital AME.

### Summary of the expenditure forecast

4.69 Table 4.14 summarises our latest forecast for public spending. TME is expressed as a share of GDP, but not all of TME contributes directly to GDP – benefit payments, debt interest and other cash transfers merely transfer income from some individuals to others. The table also shows how TME is split between DEL spending and AME, and the main components of each.

4.70 The table shows that TME is expected to fall by 3.2 per cent of GDP over the four years of the latest Spending Review period up to 2019-20, but then to stabilise in 2020-21. The drivers of this decline are described at the end of this chapter where we discuss the path from deficit to surplus over the previous and current Parliaments.

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<sup>6</sup> Our presentation of expenditure only shows those components of RDEL, CDEL and AME that are included in the fiscal aggregates of PSCE and PSGI. For budgeting purposes, the Treasury also includes other components in DEL and AME such as non-cash items and financial transactions, which are discussed later in this chapter.

Table 4.14: TME split between DEL and AME

	Per cent of GDP						
	Estimate	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
TME	40.9	39.7	39.1	38.1	37.2	36.5	36.4
of which:							
TME in DEL <sup>1</sup>	19.4	18.5	18.2	17.6	17.0	16.6	16.8
of which:							
PSCE in RDEL	17.4	16.6	16.2	15.7	15.1	14.6	14.5
PSGI in CDEL	2.0	1.9	2.0	1.9	1.9	2.0	2.2
TME in AME <sup>1</sup>	21.5	21.2	20.9	20.5	20.1	19.9	19.7
of which:							
Welfare spending	11.7	11.4	11.0	10.6	10.3	10.0	9.7
Debt interest net of APF	1.8	1.8	2.0	2.1	2.2	2.2	2.1
Locally-financed current expenditure	2.0	2.1	2.0	2.1	2.1	2.1	2.1
Net public service pension payments	0.7	0.6	0.6	0.6	0.7	0.7	0.7
Other PSCE in AME	3.3	3.3	3.3	3.3	3.3	3.4	3.4
PSGI in AME	2.1	2.0	1.9	1.8	1.6	1.6	1.6

<sup>1</sup> In relation to table 4.15, TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME, and TME in AME is defined as PSCE in AME plus PSGI in AME minus single use military equipment (SUME).

4.71 Tables 4.15 and 4.16 detail our latest spending forecast and the changes since July. One significant source of change is the effect on our forecast of the ONS decision to reclassify housing associations into the public sector. Annex B details our estimates of housing associations on TME, which average £9.0 billion a year between 2015-16 and 2020-21, on the basis of policy as set out in July. This change affects public corporations' capital expenditure and public corporations' debt interest.

Table 4.15: Total managed expenditure

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Public sector current expenditure (PSCE)</b>							
<b>PSCE in RDEL</b>	317.6	315.4	321.1	323.2	325.5	328.6	341.5
<b>PSCE in AME</b>	355.7	366.9	374.9	387.5	400.0	413.4	425.5
<i>of which:</i>							
Welfare spending	213.9	217.2	217.8	219.8	221.5	224.1	229.4
<i>of which:</i>							
<i>Inside welfare cap</i>	119.3	120.9	119.2	117.7	115.9	115.3	117.1
<i>Outside welfare cap</i>	94.7	96.3	98.6	102.0	105.6	108.8	112.3
Company and other tax credits	2.1	2.4	2.6	2.7	2.8	2.8	2.9
Net public service pension payments	12.3	11.4	11.5	12.7	14.3	15.7	16.7
National lottery current grants	1.4	1.4	1.4	1.4	1.5	1.5	1.5
BBC current expenditure	3.8	3.8	3.8	3.8	3.7	3.6	3.7
Network Rail other current expenditure <sup>1</sup>	1.1	0.8	0.7	0.4	-0.1	-0.1	-0.1
Other PSCE items in departmental AME	1.0	1.2	1.0	1.0	0.9	0.9	0.9
Expenditure transfers to EU institutions	10.4	11.7	10.7	9.7	10.9	11.4	11.7
Locally financed current expenditure	36.2	39.8	40.3	43.4	45.6	48.0	49.9
Central government gross debt interest	45.2	46.5	51.0	54.2	55.7	57.3	56.6
Reductions in debt interest due to APF	-12.4	-11.7	-11.5	-10.6	-9.3	-8.3	-7.6
Public corporations debt interest	2.5	3.2	3.3	3.6	3.8	4.0	4.2
<i>of which: housing associations</i>	2.7	2.9	3.0	3.2	3.4	3.6	3.7
General government depreciation	28.5	29.6	31.2	32.8	34.4	36.0	37.8
Current VAT refunds	11.5	11.9	12.1	12.2	12.3	12.4	12.8
R&D expenditure	-7.2	-7.4	-7.6	-7.6	-7.7	-7.7	-8.0
Single use military expenditure	0.3	0.2	0.2	0.2	0.2	0.3	0.3
Environmental levies	3.2	5.9	7.3	8.8	10.6	12.7	13.8
Local authority imputed pensions	1.8	1.8	1.9	2.1	2.2	2.3	2.4
Other National Accounts adjustments	0.1	-2.9	-3.0	-3.1	-3.2	-3.3	-3.5
<b>Total public sector current expenditure</b>	<b>673.3</b>	<b>682.3</b>	<b>696.0</b>	<b>710.7</b>	<b>725.5</b>	<b>742.0</b>	<b>767.0</b>
<b>Public sector gross investment (PSGI)</b>							
<b>PSGI in CDEL</b>	37.3	35.8	39.0	40.1	41.6	44.0	52.8
<b>PSGI in AME</b>	38.4	37.6	38.4	36.6	34.1	35.0	37.4
<i>of which:</i>							
National lottery capital grants	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Network Rail capital expenditure	6.2	6.8	7.4	5.6	4.3	5.0	5.3
Other PSGI items in departmental AME	0.2	0.2	1.4	1.8	2.5	2.9	3.2
Locally financed capital expenditure	6.9	6.5	7.1	7.5	5.9	6.2	6.1
Public corporations capital expenditure	16.0	15.7	14.4	13.6	12.9	12.1	13.5
<i>of which: housing associations</i>	8.3	8.2	6.5	5.7	5.3	4.5	5.7
R&D expenditure	7.2	7.4	7.6	7.6	7.7	7.7	8.0
Other National Accounts adjustments	1.5	0.3	0.1	0.0	0.3	0.5	0.7
<b>Total public sector gross investment</b>	<b>75.7</b>	<b>73.4</b>	<b>77.4</b>	<b>76.7</b>	<b>75.7</b>	<b>79.0</b>	<b>90.2</b>
Less public sector depreciation	-38.5	-39.8	-41.6	-43.4	-45.0	-46.8	-48.9
<b>Public sector net investment</b>	<b>37.2</b>	<b>33.6</b>	<b>35.8</b>	<b>33.4</b>	<b>30.6</b>	<b>32.2</b>	<b>41.3</b>
<b>Total managed expenditure</b>	<b>749.0</b>	<b>755.7</b>	<b>773.3</b>	<b>787.5</b>	<b>801.2</b>	<b>821.0</b>	<b>857.2</b>

<sup>1</sup> Other than debt interest and depreciation, which are included in totals shown separately in this table.

Table 4.16: Changes to total managed expenditure since July

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Public sector current expenditure (PSCE)</b>							
PSCE in RDEL	0.2	0.3	2.3	6.5	9.3	8.3	-3.6
PSCE in AME	4.5	6.7	7.9	5.9	4.8	5.3	5.8
<i>of which:</i>							
Welfare spending	-0.3	0.3	4.0	3.3	2.1	1.9	2.0
<i>of which:</i>							
<i>Inside welfare cap</i>	0.1	0.4	4.0	3.1	1.9	1.8	2.1
<i>Outside welfare cap</i>	-0.5	-0.1	0.0	0.2	0.2	0.1	-0.1
Company and other tax credits	0.1	0.2	0.2	0.2	0.3	0.2	0.3
Net public service pension payments	0.1	0.2	0.0	-0.2	-0.3	-0.3	0.5
National lottery current grants	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
BBC current expenditure	-0.1	-0.1	0.0	-0.1	-0.1	0.0	0.2
Network Rail other current expenditure <sup>1</sup>	-0.1	-0.5	-0.1	0.0	0.0	0.0	0.0
Other PSCE items in departmental AME	-0.2	0.0	-0.1	-0.1	-0.2	-0.2	-0.2
Expenditure transfers to EU institutions	-0.1	0.4	0.4	0.2	0.1	0.1	0.0
Locally financed current expenditure	1.0	1.3	0.1	1.3	1.9	2.9	3.5
Central government gross debt interest	-0.2	-0.2	-0.1	-1.7	-1.6	-1.2	-1.9
Reductions in debt interest due to APF	0.0	0.3	-1.2	-2.3	-2.7	-3.0	-3.2
Public corporations debt interest	2.8	2.9	3.0	3.2	3.4	3.6	3.7
<i>of which: housing associations</i>	2.7	2.9	3.0	3.2	3.4	3.6	3.7
General government depreciation	1.2	0.1	0.2	0.3	0.2	0.1	0.1
Current VAT refunds	0.0	0.4	0.5	0.8	0.9	1.0	0.6
R&D expenditure	0.4	0.7	0.7	0.5	0.5	0.5	0.8
Single use military expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Environmental levies	0.0	0.2	0.0	0.2	-0.1	-0.5	-1.1
Local authority imputed pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other National Accounts adjustments	0.0	0.3	0.3	0.3	0.3	0.3	0.3
<b>Total public sector current expenditure</b>	<b>4.7</b>	<b>7.1</b>	<b>10.2</b>	<b>12.4</b>	<b>14.1</b>	<b>13.5</b>	<b>2.2</b>
<b>Public sector gross investment (PSGI)</b>							
PSGI in CDEL	-0.1	-0.2	2.8	3.1	-0.6	-0.5	6.2
PSGI in AME	8.9	6.6	6.0	4.0	3.4	3.6	4.3
<i>of which:</i>							
National lottery capital grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Network Rail capital expenditure	0.2	-0.1	1.0	-0.4	-0.5	0.0	0.0
Other PSGI items in departmental AME	-0.2	-0.1	0.1	0.1	0.3	0.2	-0.1
Locally financed capital expenditure	-1.0	-0.4	-0.7	-0.7	-0.7	-0.3	-0.4
Public corporations capital expenditure	7.5	8.3	6.7	5.9	5.2	4.6	5.8
<i>of which: housing associations</i>	8.3	8.2	6.5	5.7	5.3	4.5	5.7
R&D expenditure	-0.4	-0.7	-0.7	-0.5	-0.5	-0.5	-0.8
Other National Accounts adjustments	2.8	-0.3	-0.4	-0.4	-0.5	-0.4	-0.2
<b>Total public sector gross investment</b>	<b>8.8</b>	<b>6.3</b>	<b>8.8</b>	<b>7.1</b>	<b>2.8</b>	<b>3.1</b>	<b>10.5</b>
Less public sector depreciation	-2.4	-1.4	-1.5	-1.5	-1.4	-1.3	-1.3
<b>Public sector net investment</b>	<b>6.4</b>	<b>5.0</b>	<b>7.3</b>	<b>5.6</b>	<b>1.4</b>	<b>1.8</b>	<b>9.2</b>
<b>Total managed expenditure</b>	<b>13.5</b>	<b>13.4</b>	<b>19.0</b>	<b>19.5</b>	<b>16.9</b>	<b>16.6</b>	<b>12.7</b>

<sup>1</sup> Other than debt interest and depreciation, which are included in totals shown separately in this table.

4.72 Table 4.17 summarises the sources of changes to our forecast since July. Our estimates of the effect of housing associations on TME, consistent with the July policy setting, are shown as a classification change. Abstracting from that change, the table shows that changes since July reflect:

- **economy-driven changes** have had a relatively small impact on our forecast, with effects largely offsetting;
- **debt interest** spending has been revised down significantly, due to lower market interest rates and the effect on our forecast of the Bank of England's announcement that it would keep the stock of gilts held in the Asset Purchase Facility at £375 billion until Bank Rate reaches a level from which it can be cut materially. The MPC currently judge this to be around 2 per cent – a level that markets are not pricing in until beyond our five-year horizon;
- our **pre-measures welfare spending** forecast has been revised up significantly, with a variety of factors pushing up spending on disability benefits in particular;
- the **direct effect of Government decisions** on AME and DEL spending push total spending higher, especially in the middle years of the forecast. The Government has directly added an average of £10.2 billion to total spending in the years from 2016-17 to 2019-20, with the biggest increase £12.4 billion in 2017-18. It has then changed the composition of spending in 2020-21, by reducing RDEL spending and AME, but adding £6.4 billion to CDEL spending relative to the July forecast. Spending has also been increased by the Government's decision to help some local authorities to increase council tax at a faster pace to fund some of the cost of adult social care and policing. And changes to grant funding for housing associations are expected to increase capital spending as they are assumed to leverage these grants; and
- the **indirect effect of Government decisions** increases spending on average over the forecast. This mostly reflects higher debt interest costs as a result of two changes: the direct effects of Government decisions increase borrowing and lending, which increases the financing requirement, while higher council tax pushes up the Retail Prices Index and the cost of serving index-linked gilts. This is partly offset by lower net public service pension costs in all years other than 2020-21, due to smaller falls in the workforce making contributions to the schemes as current departmental spending is boosted up to 2019-20, but then a bigger fall as spending is cut in 2020-21.

Table 4.17: Sources of changes to the spending forecast since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	742.3	754.3	768.0	784.3	804.4	844.5
Housing association reclassification	11.2	9.9	8.8	8.2	7.6	8.1
July forecast restated to include HAs	753.5	764.2	776.8	792.5	812.0	852.6
November forecast	755.7	773.3	787.5	801.2	821.0	857.2
<b>Change on a like-for-like basis</b>	<b>2.2</b>	<b>9.1</b>	<b>10.6</b>	<b>8.7</b>	<b>9.0</b>	<b>4.6</b>
	Forecast changes					
Forecast changes since July	2.0	1.2	-1.6	-2.6	-1.0	-1.6
<i>of which:</i>						
Economic determinants	-0.4	0.5	0.4	0.8	1.0	0.2
<i>of which:</i>						
Inflation	-0.3	0.3	-0.2	0.1	0.5	0.0
Unemployment	0.1	0.2	0.6	0.6	0.6	0.6
Population projections	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other determinants	0.0	0.1	0.2	0.1	0.0	-0.3
Market assumptions: interest rates	-0.6	-2.2	-3.6	-4.0	-3.6	-3.7
Other assumptions and changes	3.0	2.9	1.6	0.6	1.6	1.9
<i>of which:</i>						
Other welfare changes	0.4	0.8	0.9	0.8	1.5	2.2
Locally financed current expenditure forecast changes	1.3	0.0	0.5	0.7	1.2	1.4
Other debt interest forecast changes	1.0	0.2	-0.5	-1.3	-1.9	-2.2
Public sector pensions forecast changes	0.2	0.1	0.3	0.4	0.3	0.3
Expenditure transfers to EU institutions	0.4	0.3	0.1	0.0	0.0	-0.1
Network Rail current and capital spending	-0.6	0.9	-0.4	-0.5	0.0	0.0
Other	0.3	0.5	0.8	0.4	0.6	0.3
	Effect of Government decisions					
Total effect of Government decisions	0.2	7.9	12.2	11.3	10.0	6.2
<i>of which:</i>						
AME scorecard measures	0.0	2.6	1.7	0.3	-0.7	-1.1
Non-scorecard measures	0.0	0.0	0.9	1.8	2.2	3.4
<i>of which:</i>						
Council tax-financed local spending	0.0	0.4	0.8	1.2	1.6	2.1
Housing associations' spending	0.0	-0.4	0.1	0.6	0.6	1.3
RDEL changes <sup>1</sup>	0.3	2.3	6.5	9.3	8.3	-3.6
CDEL changes <sup>1</sup>	-0.1	2.9	3.3	-0.4	-0.3	6.4
Indirect effects of Government decisions	0.0	0.2	-0.2	0.3	0.5	1.0

<sup>1</sup> Excludes changes to DELs that are forecast (classification) changes.

## Expenditure in 2015-16

4.73 Abstracting from the reclassification of housing associations, our total spending forecast for 2015-16 is £2.2 billion higher than in July. Table 4.16 shows that the largest element of this is a £1.3 billion increase in locally financed current expenditure. This reflects the latest in-year spending outturn data collected from local authorities by the Department for Communities and Local Government (though this is often subject to significant revision).

4.74 Monthly outturn information is only available for central government spending. And, when we finalised this forecast, it was only available up to September. Table 4.18 compares the growth in spending over the first six months of 2015-16 with our full-year forecasts and what that implies for the remainder of the year. For debt interest payments, higher growth in the rest of the year largely reflects the path of monthly RPI inflation, which affects accrued interest payments on index-linked gilts. For the remaining current spending lines, differences between first and second half growth rates are relatively small. Other current spending, which covers current spending by departments, will be affected by the in-year spending cuts the new Government announced in June. The monthly profile of capital payments often changes significantly from year-to-year and outturns are prone to large revisions. The bigger differences in year-to-date growth relative to the full-year forecasts for capital spending reflect such profile changes.

Table 4.18: Central government expenditure in 2015-16

	Spending in 2015-16 (£ billion)			Percentage change on 2014-15		
	Outturn	Forecast <sup>1</sup>		Outturn	Forecast <sup>1</sup>	
	Apr-Sept	Oct-Mar	Full Year	Apr-Sept	Oct-Mar	Full Year
<b>Total current expenditure</b>	<b>329.2</b>	<b>325.8</b>	<b>655.0</b>	<b>0.7</b>	<b>0.8</b>	<b>0.8</b>
<i>of which:</i>						
Net social benefits	101.7	102.8	204.4	1.0	1.8	1.4
Debt interest	24.5	21.9	46.5	-1.3	7.9	2.9
Current grants to local authorities	62.5	54.5	117.0	-3.8	-5.4	-4.5
Other current spending	140.5	146.6	287.2	3.0	1.6	2.3
<b>Total (gross) capital spending</b>	<b>23.5</b>	<b>29.6</b>	<b>53.2</b>	<b>3.6</b>	<b>-3.5</b>	<b>-0.5</b>
<i>of which:</i>						
Capital grants to local authorities	6.4	5.8	12.2	5.6	-4.4	0.6
Other capital spending	17.2	23.8	41.0	2.9	-3.3	-0.8
<b>Total central government expenditure in TME</b>	<b>352.8</b>	<b>355.4</b>	<b>708.2</b>	<b>0.9</b>	<b>0.5</b>	<b>0.7</b>

<sup>1</sup> Forecast data has been adjusted to be consistent with the latest National Accounts definition of central government spending.

Differences between our forecast and what is currently included in outturn by the ONS is detailed in the fiscal supplementary tables on our website.

## Spending within departmental expenditure limits (DELs)

### DEL spending in 2015-16

4.75 Our latest forecast for DEL spending in 2015-16 is consistent with the latest information published in Public Expenditure Statistical Analyses (PESA) 2015. Each year, new PESA data typically require us to make changes to our forecasts for PSCE in RDEL and PSGI in CDEL, not least because departments often change the allocation of spending within their RDEL and CDEL limits between items that are included in the fiscal aggregates of PSCE and PSGI and items that are not.

4.76 Table 4.19 shows our latest forecasts for RDEL and CDEL spending in 2015-16, and the changes since July. As we have not changed the amounts by which we expect departments to underspend the limits that have been set for them by the Treasury, there are no changes

of forecast judgement since July. Instead, the table splits changes since July into those resulting from classification changes and those that reflect Government decisions.

4.77 The two classification changes affecting DEL spending in 2015-16 (and therefore in all forecast years) are as follows:

- PSCE in RDEL has increased because we have removed fees received from Network Rail under the 'financial indemnity mechanism'. These receipts and the corresponding Network Rail payment have been removed because they are transfers within central government that are not therefore included in the National Accounts; and
- further classification changes to include some receipts as negative spending. These are items that we have found were not previously recorded in spending or receipts, but which were affecting the cash measures of borrowing. This is one result of the work done by the ONS and Treasury on the reconciliation of accrued and cash measures of borrowing (described in Box 4.3 of our July EFO). As this work is ongoing, further small revisions of this type are likely to be necessary in future forecasts.

4.78 The changes due to Government decisions include:

- changes to departments' detailed spending plans within their RDEL and CDEL limits reported in PESA 2015; and
- policy measures included on the scorecard, which consist of a small increase in CDEL (less than £0.1 billion) to reflect the Government's latest decision to gift shares to Royal Mail employees.

Table 4.19: Changes to DEL in 2015-16 since July

	£ billion	
	PSCE in RDEL	PSGI in CDEL
	Forecast	Forecast
	2015-16	2015-16
July forecast	315.1	36.1
November forecast	315.4	35.8
<b>Change</b>	<b>0.3</b>	<b>-0.2</b>
<i>of which:</i>		
<b>Classification changes</b>	<b>0.0</b>	<b>-0.2</b>
<i>of which:</i>		
Remove Network Rail 'financial indemnity mechanism' fees	0.3	-
Receipts reclassified from non-fiscal to fiscal DEL	-0.3	-0.2
<b>Effect of Government decisions</b>	<b>0.3</b>	<b>-0.1</b>
<i>of which:</i>		
Other changes to PESA plans	0.3	-0.1
Policy changes on Treasury scorecard	0.0	0.0

## DEL spending from 2016-17 onwards

- 4.79 Table 4.20 shows our forecasts for PSCE in RDEL and PSGI in CDEL spending from 2016-17 onwards. These numbers are based on the latest DEL plans that have been set in this Spending Review, adjusted for assumptions regarding underspending against those plans, plus the Government's assumed totals for 2020-21, again adjusted for underspending. These lie beyond the horizon for the full detailed plans in the Spending Review.
- 4.80 Table 4.20 shows the formal DEL totals that the Government has set to 2019-20, the amounts by which we expect these limits to be underspent and the amount of spending that we therefore actually expect to take place. Similarly, we show the provisional DEL total that the Government has asked us to assume for 2020-21, the amount of underspending we would expect against that total and the amount we therefore assume would be spent.
- 4.81 The underspend assumption for CDEL in 2020-21 is much larger than the underspends we assume in the Spending Review years, due to the much faster rise in spending that the Government is assuming in that year – experience cautions that actual spending falls further short of plans when the Government attempts to ramp up capital spending quickly.
- 4.82 We treat the like-for-like changes in RDEL and CDEL as policy changes, alongside other tax and spending measures, in explaining how our spending and borrowing forecasts have moved relative to previous forecasts. These policy changes, adjusted for the classification changes described above, are set out in Table 4.20. It shows that the Government has:
- raised expected RDEL spending in each year of the Spending Review, with the biggest increases in 2018-19 and 2019-20. But the Government has smoothed the growth of RDEL spending in 2020-21 relative to the sharp pick-up it had pencilled in in July. That has reduced RDEL spending by £3.6 billion in 2020-21 relative to July; and
  - raised expected CDEL spending in the next two years by £3.1 billion a year on average, but cut it slightly in the final two years of the Spending Review period. It has then assumed it will deliver a sharp increase in CDEL spending in the year immediately after the Spending Review, thus *unsmoothing* the path of CDEL growth relative to July.

Table 4.20: RDEL and CDEL spending and changes since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>PSCE in RDEL</b>						
<b>July forecast</b>						
Actual spending	315.1	318.8	316.7	316.2	320.3	345.1
<b>November forecast</b>						
Limits	316.4	322.1	324.2	327.0	330.1	343.0
Assumed underspend <sup>1</sup>	-1.0	-1.0	-1.0	-1.5	-1.5	-1.5
Actual spending	315.4	321.1	323.2	325.5	328.6	341.5
<b>Change</b>	<b>0.3</b>	<b>2.3</b>	<b>6.5</b>	<b>9.3</b>	<b>8.3</b>	<b>-3.6</b>
<i>of which:</i>						
Classification changes	0.0	0.0	0.0	0.0	0.0	-0.1
Effect of Government decisions	0.3	2.3	6.5	9.3	8.3	-3.6
<b>PSGI in CDEL</b>						
<b>July forecast</b>						
Actual spending	36.1	36.2	37.0	42.2	44.5	46.6
<b>November forecast</b>						
Limits	37.8	41.0	42.1	44.1	46.5	56.8
Assumed underspend <sup>1</sup>	-2.0	-2.0	-2.0	-2.5	-2.5	-4.0
Actual spending	35.8	39.0	40.1	41.6	44.0	52.8
<b>Change</b>	<b>-0.2</b>	<b>2.8</b>	<b>3.1</b>	<b>-0.6</b>	<b>-0.5</b>	<b>6.2</b>
<i>of which:</i>						
Classification changes	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Effect of Government decisions	-0.1	2.9	3.3	-0.4	-0.3	6.4
<b>Per cent of GDP</b>						
<b>PSCE in RDEL (actual spending)</b>						
July forecast	16.8	16.4	15.6	14.9	14.5	14.8
November forecast	16.6	16.2	15.7	15.1	14.6	14.5
<b>Change</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.1</b>	<b>-0.3</b>
<b>PSGI in CDEL (actual spending)</b>						
July forecast	1.9	1.9	1.8	2.0	2.0	2.0
November forecast	1.9	2.0	1.9	1.9	2.0	2.2
<b>Change</b>	<b>0.0</b>	<b>0.1</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.2</b>

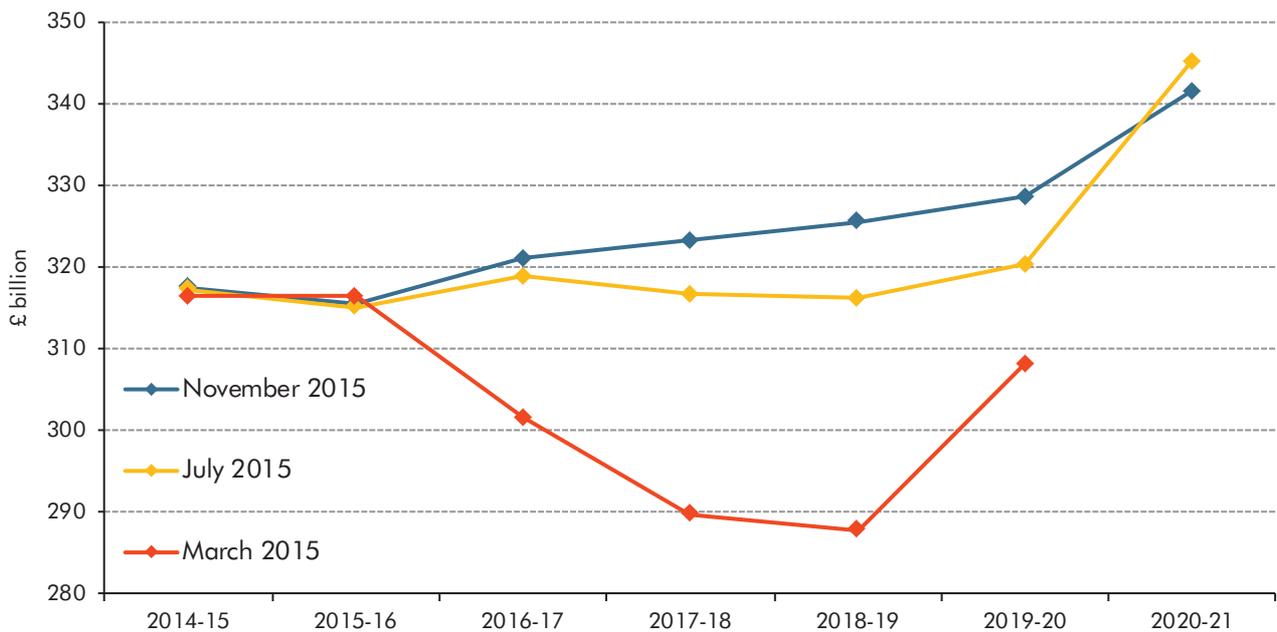
<sup>1</sup> Underspends are measured against initial plans at the start of each year (for example, as set out in PESA), and are net of amounts carried forward from previous years under Budget Exchange.

## The path of resource DEL spending over the Parliament

**4.83** The RDEL limits that the Government has set out in the Spending Review are significantly different from those it asked us to assume in July and even more so than the levels that the Coalition asked us to assume in March and at earlier fiscal events. Chart 4.3 shows how the sharp cuts up to 2018-19 assumed in March were smoothed out in July and that spending has now been increased further as detailed plans are set. In aggregate over the Parliament – from 2015-16 to 2019-20 – RDEL spending (net of our assumed underspends) has been increased by £26.7 billion or 1.7 per cent relative to July and by £110.0 billion or 7.3 per cent relative to March. The Government also now assumes that it will increase RDEL spending by £12.9 billion or 3.9 per cent between 2019-20 and 2020-21, down from the

£24.8 billion or 7.7 per cent that it assumed in July, thereby smoothing the profile beyond the Spending Review period too.

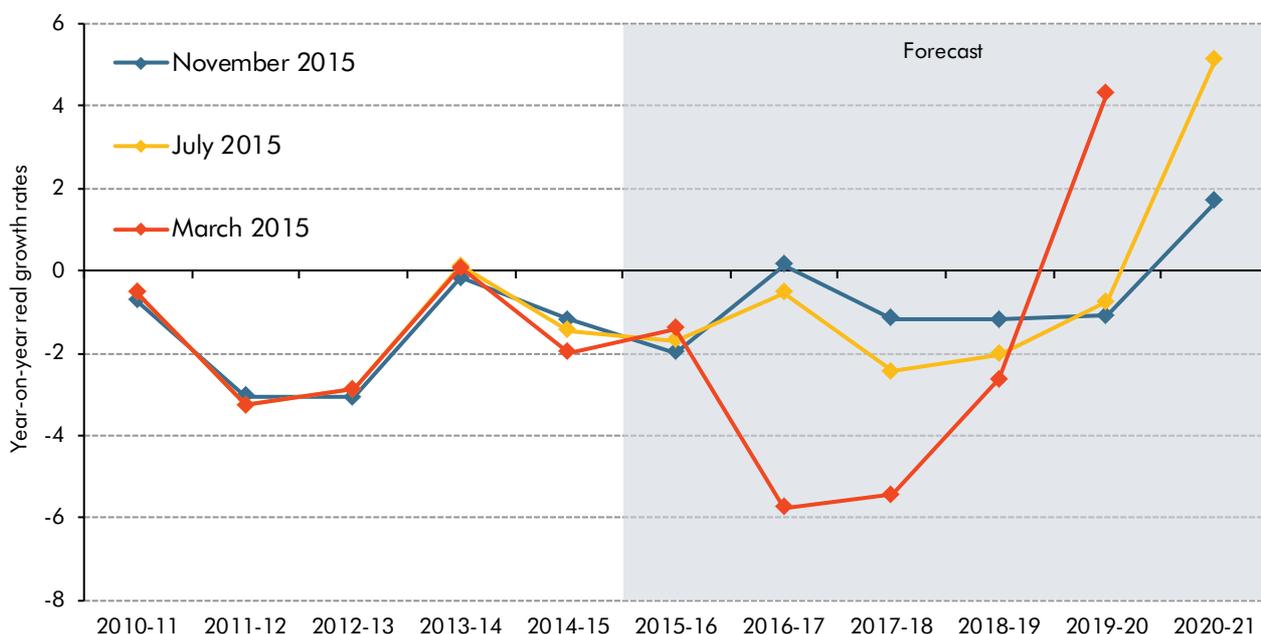
Chart 4.3: Resource DEL spending in cash terms



Source: OBR

4.84 By further lifting and smoothing the path of RDEL in cash terms, prospective real changes in RDEL are much less uneven than the ‘rollercoaster’ path set out in March and smoother even than the path set out in July. RDEL spending is also now expected to fall appreciably less quickly in real terms over this Parliament than the last – by an average of 1.1 per cent a year, compared to 1.6 per cent per cent a year. At the time of the July Budget, the average real fall over this Parliament implied by the Government’s plans was 1.5 per cent.

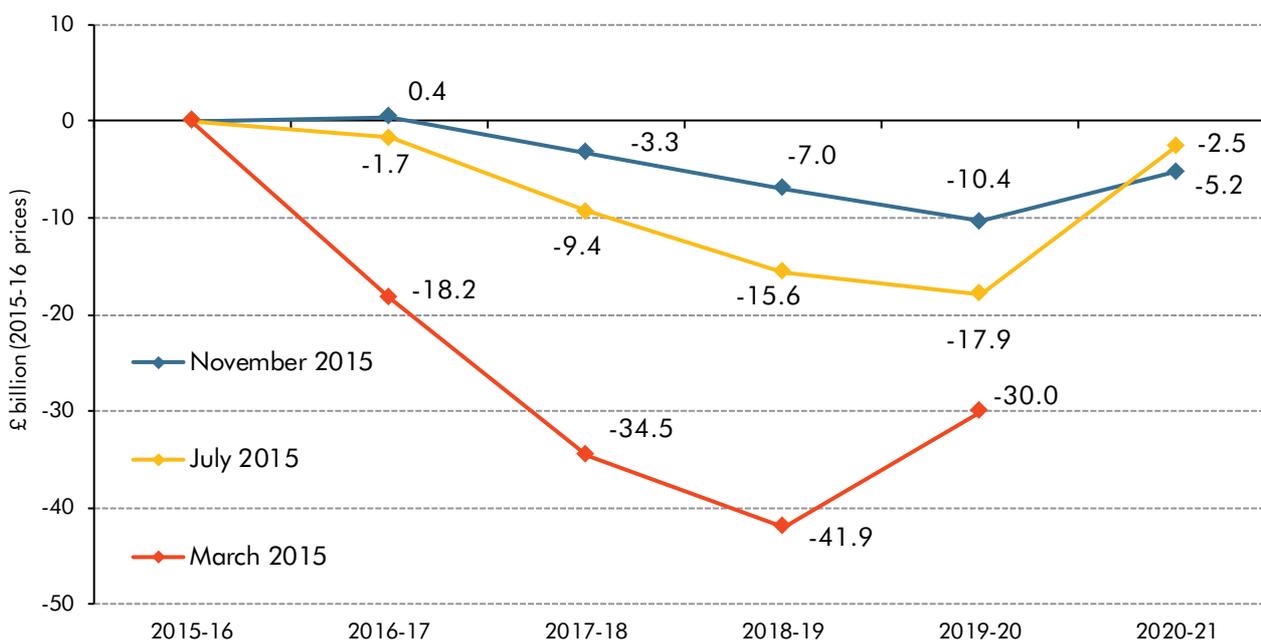
Chart 4.4: Year-on-year real growth in resource DEL spending



Note: RDEL series excludes major historical switches with AME. Details are in the supplementary fiscal tables on our website.  
Source: OBR

4.85 Relative to our estimate of the level of spending in 2015-16, these numbers mean that the real cuts in public services spending set out in the Spending Review now reach a peak of £10.4 billion in 2019-20. That is around two-fifths less than the £17.9 billion cut by that year pencilled in by the Government in July and around a quarter of the £41.9 billion peak cut pencilled in by the Coalition in March (which was to be delivered a year earlier in 2018-19). In contrast to March and July, the Government also no longer assumes that once the budget has moved into surplus the real cut to spending will shift significantly into reverse.

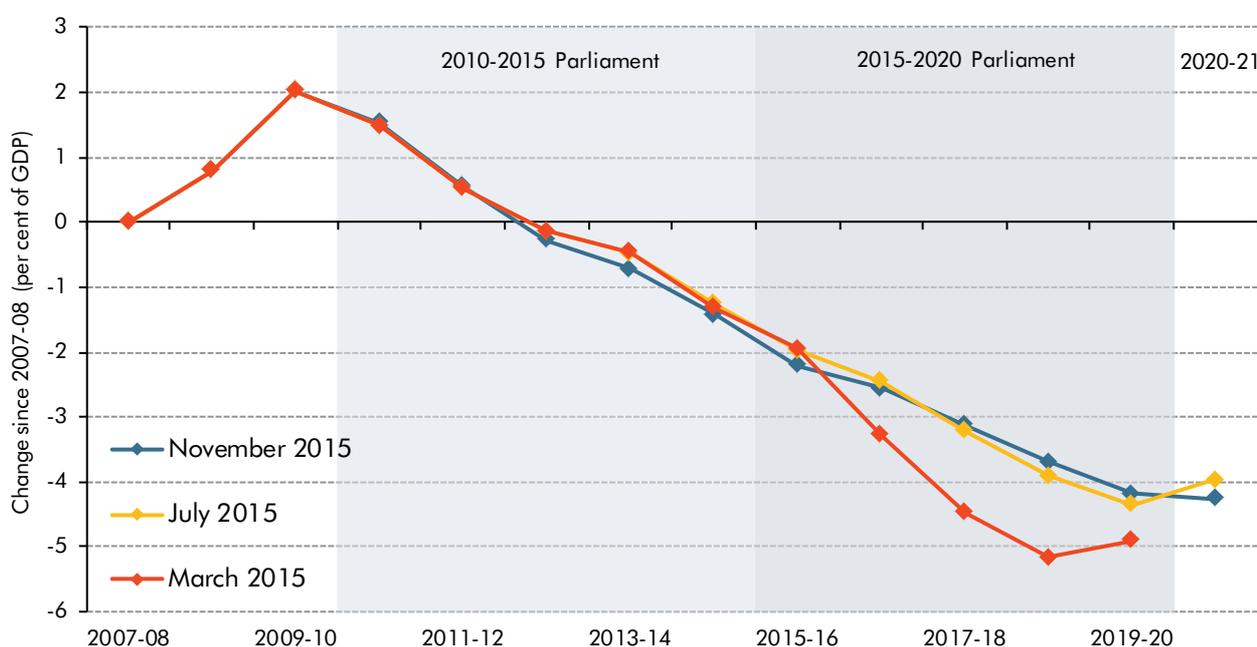
Chart 4.5: Change in real RDEL from 2015-16



Source: OBR

4.86 With the prospective pace of real cuts having been reduced again, Chart 4.6 shows that cuts to RDEL spending as a share of GDP are now expected to be slightly shallower in this Parliament than the last. Between the peak in 2009-10 and the final year of this Parliament in 2019-20, RDEL spending is expected to have been reduced by 6.2 per cent of GDP (£118 billion in terms of nominal GDP in 2015-16) – with 3.4 per cent of GDP delivered in the last Parliament and 2.8 per cent of GDP still to be delivered in this one. As we discuss in Chapter 3, government consumption of goods and services – the closest equivalent of RDEL spending in the National Accounts – is forecast to reach a 22-year low of 17.0 per cent of GDP in 2020-21.

Chart 4.6: Resource DEL as a share of GDP in successive Parliaments



Note: RDEL series excludes major historical switches with AME. Details are in the supplementary fiscal tables on our website. Source: OBR

### Annually managed expenditure (AME)

4.87 Table 4.15 sets out our latest central projection of AME spending to 2020-21, based on the economic forecast described in Chapter 3, the latest estimates of agreed policy commitments and the measures announced in this Spending Review and Autumn Statement.

#### Welfare cap and other welfare spending

4.88 Total welfare spending in our forecast refers to AME spending on social security and tax credits – a subset of which is subject to the Government’s ‘welfare cap’ (around 56 per cent in 2015-16). We have been tasked with assessing the Government’s performance against the cap at each Autumn Statement. Our formal assessment is set out in Chapter 5.

4.89 Table 4.21 shows that total welfare spending is forecast to increase by 5.6 per cent over the forecast period, from £217.2 billion in 2015-16 to £229.4 billion in 2020-21. Over that period, spending on items subject to the cap (predominantly working-age welfare spending)

is projected to fall by 3.2 per cent. By contrast, spending on items outside the cap (largely state pensions) is expected to rise by 16.6 per cent.

4.90 Relative to the size of the economy, welfare spending is forecast to fall by 1.7 per cent of GDP between 2015-16 and 2020-21 to its lowest share of GDP in 30 years, with spending inside the welfare cap falling by 1.4 per cent of GDP and spending outside the welfare cap falling by 0.3 per cent of GDP. The role played by welfare spending in the Government's plans to deliver a budget surplus by 2019-20 is discussed later in this chapter.

Table 4.21: Welfare spending forecast overview

	Outturn		Forecast				
	2014-15	2015-16	Welfare cap period				
			2016-17	2017-18	2018-19	2019-20	2020-21
<b>£ billion</b>							
Total welfare spending	213.9	217.2	217.8	219.8	221.5	224.1	229.4
of which:							
Inside welfare cap	119.3	120.9	119.2	117.7	115.9	115.3	117.1
Outside welfare cap	94.7	96.3	98.6	102.0	105.6	108.8	112.3
<b>Per cent of GDP</b>							
Total welfare spending	11.7	11.4	11.0	10.6	10.3	10.0	9.7
of which:							
Inside welfare cap	6.5	6.4	6.0	5.7	5.4	5.1	5.0
Outside welfare cap	5.2	5.1	5.0	4.9	4.9	4.8	4.8

4.91 Table 4.22 sets out our detailed welfare spending forecasts for 2015-16 to 2020-21 on a pre-scorecard basis, plus the total effect on welfare spending of the Government's policy decisions announced in this Spending Review and Autumn Statement. A detailed post-measures forecast for each line is available in a supplementary fiscal table on our website.

Table 4.22: Welfare spending

	£ billion						
	Outturn		Forecast				
	2014-15	2015-16	Welfare cap period				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Welfare cap</b>							
DWP social security	74.5	76.6	76.3	75.6	75.2	75.6	77.0
of which:							
Housing benefit (not on JSA) <sup>1</sup>	21.4	22.1	22.3	21.9	21.7	21.5	21.8
Disability living allowance and personal independence payments	15.4	16.2	16.1	15.9	15.8	16.2	16.7
Incapacity benefits <sup>2</sup>	14.1	15.0	14.6	14.4	14.3	14.4	14.7
Attendance allowance	5.4	5.5	5.5	5.6	5.8	5.9	6.0
Pension credit	6.6	6.1	5.9	5.7	5.5	5.5	5.5
Carer's allowance	2.3	2.5	2.6	2.7	2.8	2.9	3.0
Statutory maternity pay	2.3	2.3	2.4	2.5	2.5	2.6	2.7
Income support (non-incapacity)	2.6	2.4	2.3	2.1	1.9	1.9	2.0
Winter fuel payments	2.1	2.1	2.1	2.0	2.0	2.0	2.0
Universal credit <sup>3</sup>	0.0	0.0	0.0	0.4	0.6	0.3	0.2
Other DWP in welfare cap	2.3	2.4	2.4	2.4	2.4	2.4	2.4
Personal tax credits	29.7	29.1	24.6	24.2	24.0	23.5	23.7
Child benefit	11.6	11.7	11.7	11.6	11.6	11.6	11.8
Tax free childcare	0.0	0.0	0.1	0.7	0.8	0.9	1.0
NI social security in welfare cap	3.4	3.4	3.4	3.5	3.5	3.6	3.7
Paternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Autumn Statement measures	0.0	0.0	3.0	1.9	0.7	-0.1	-0.3
<b>Total welfare cap</b>	<b>119.3</b>	<b>120.9</b>	<b>119.2</b>	<b>117.7</b>	<b>115.9</b>	<b>115.3</b>	<b>117.1</b>
<b>Welfare spending outside the welfare cap</b>							
DWP social security	92.0	93.9	96.2	99.5	103.0	106.1	109.5
of which:							
State pension	86.5	89.3	91.8	94.8	98.1	101.1	104.4
Jobseeker's allowance	3.1	2.3	2.6	2.8	2.9	2.9	3.0
Housing benefit (on JSA)	2.4	1.8	1.8	2.0	2.0	2.1	2.1
Universal credit <sup>3</sup>	0.1	0.5					
NI social security outside welfare cap	2.2	2.4	2.4	2.5	2.6	2.7	2.8
War pensions <sup>4</sup>	0.8						
Autumn Statement measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total welfare outside the welfare cap</b>	<b>94.7</b>	<b>96.3</b>	<b>98.6</b>	<b>102.0</b>	<b>105.6</b>	<b>108.8</b>	<b>112.3</b>
<b>Total welfare<sup>5</sup></b>	<b>213.9</b>	<b>217.2</b>	<b>217.8</b>	<b>219.8</b>	<b>221.5</b>	<b>224.1</b>	<b>229.4</b>
<i>Memo: welfare cap as proportion of total welfare</i>	55.7	55.7	54.7	53.6	52.3	51.4	51.0

<sup>1</sup> Housing benefit (not on jobseeker's allowance) is made up of a number of claimant groups. The main claimant groups are pensioners, those on incapacity benefits, lone parents, and housing benefit only claimants.

<sup>2</sup> Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

<sup>3</sup> Universal credit actual spending for 2014-15 and 2015-16. Spending from 2016-17 onwards represents universal credit additional costs not already included against other benefits (i.e. UC payments that do not exist under current benefit structure).

<sup>4</sup> Transferred to departmental expenditure limits.

<sup>5</sup> Total welfare outturn in 2014-15 is sourced from OSCAR, consistent with PESA 2014. The OSCAR data do not split welfare spending inside and outside the welfare cap, so this split has been estimated based on departments' return. For 2014-15 only, the components reflect departments' own outturns which may not be on a consistent basis to OSCAR.

4.92 Table 4.23 sets out the changes in our welfare spending forecast since July, splitting them between changes that flow from our updated economy forecast, changes that result from other movements in the pre-measures forecast and, finally, changes due to policies announced in the Autumn Statement. It shows that we have revised up spending by £2.3 billion a year on average between 2015-16 and 2020-21.

4.93 The sources of the upward revision are different across years. In summary:

- spending has been revised up by £0.3 billion in 2015-16, with a caseload-driven increase in spending on disability benefits more than explaining the rise. The claimant count has also fallen less quickly than we expected, pushing up spending on jobseeker's allowance relative to our July forecast. Partly offsetting those factors, a higher number of deaths has reduced spending on state pensions;
- we have revised up our pre-measures forecast for spending subject to the welfare cap by increasing amounts from 2016-17 to 2020-21. The biggest change has been to disability benefits, including higher numbers of new claims to disability living allowance (DLA) and personal independence payment (PIP) and a slower pace of reassessments as cases are migrated from DLA to PIP. We have also revised up spending on incapacity benefits, assuming that 38 per cent of claims will be in the more expensive support group of employment and support allowance (ESA) in steady state (up from 30 per cent in our July forecast). New ONS population projections assume higher numbers of children, pushing up spending on tax credits and child benefit. Our forecast of the marginal cost of universal credit is based on a new assumption for the pace of rollout, which we have once again deemed necessary to push back. The changes to disability benefits spending and the universal credit rollout assumption are explained more fully below, while Box 4.3 details various reallocations and revisions to July's welfare policy costings;
- changes to spending outside the welfare cap have been small, with downward revisions to state pensions (from higher mortality at older ages in the new population projections and slightly lower triple-lock uprating reflecting our latest earnings growth forecast) offsetting upward revisions to jobseeker's allowance (reflecting the higher outturns this year knocking through to the forecast); and
- the Government's policy decisions raise spending in the short term but reduce it by the end of the forecast. The near-term increase reflects the decision to reverse the main July Budget cuts to tax credits, which adds £3.4 billion to spending in 2016-17 alone. A variety of cuts to other benefits save increasing amounts over time and more than offsets the changes to tax credits by 2019-20.

Table 4.23: Key changes to welfare spending since July

	£ billion						
	Outturn	Forecast					
		Welfare cap period					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Welfare spending inside the welfare cap</b>							
July forecast	119.1	120.6	115.2	114.6	114.0	113.5	114.9
November forecast	119.3	120.9	119.2	117.7	115.9	115.3	117.1
<b>Change</b>	<b>0.1</b>	<b>0.4</b>	<b>4.0</b>	<b>3.1</b>	<b>1.9</b>	<b>1.8</b>	<b>2.1</b>
<i>of which:</i>							
<b>Economic determinants</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.3</b>	<b>0.6</b>	<b>0.9</b>	<b>1.1</b>
CPI inflation	0.0	0.0	0.0	-0.1	-0.1	0.0	0.0
Population projections	0.1	0.1	0.2	0.3	0.4	0.5	0.6
Other	0.0	0.0	0.0	0.1	0.2	0.3	0.4
<b>Estimating/modelling changes</b>	<b>0.0</b>	<b>0.4</b>	<b>0.8</b>	<b>1.1</b>	<b>1.0</b>	<b>1.2</b>	<b>1.4</b>
Disability benefits <sup>1</sup>	0.0	0.5	1.0	1.4	1.2	1.3	1.5
Incapacity benefits <sup>2</sup>	0.0	0.2	0.0	0.1	0.4	0.5	0.7
Housing benefit	0.0	0.0	0.1	0.1	0.1	0.2	0.2
Universal credit	0.0	0.0	0.0	-0.1	-0.3	-0.4	-0.5
Income support (non-incapacity)	0.0	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4
Personal tax credits	-0.1	-0.4	-0.3	-0.5	-0.5	-0.5	-0.5
Other	0.1	0.2	0.2	0.3	0.4	0.4	0.5
<b>Classification changes</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.4</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.5</b>
<b>Recostings</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.1</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>
<b>Autumn Statement measures</b>	<b>0.0</b>	<b>0.0</b>	<b>3.0</b>	<b>1.9</b>	<b>0.7</b>	<b>-0.1</b>	<b>-0.3</b>
<b>Welfare spending outside the welfare cap</b>							
July forecast	95.1	96.4	98.6	101.8	105.4	108.7	112.4
November forecast	94.7	96.3	98.6	102.0	105.6	108.8	112.3
<b>Change</b>	<b>-0.5</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.2</b>	<b>0.2</b>	<b>0.1</b>	<b>-0.1</b>
<i>of which:</i>							
<b>Economic determinants</b>	<b>0.0</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.4</b>	<b>-0.8</b>
CPI inflation	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Claimant count unemployment	0.0	0.1	0.2	0.6	0.6	0.6	0.6
Triple lock	0.0	0.0	0.1	0.0	-0.1	-0.4	-0.7
Population projections	0.0	-0.2	-0.3	-0.4	-0.5	-0.6	-0.7
<b>Estimating/modelling changes</b>	<b>0.0</b>	<b>0.1</b>	<b>0.1</b>	<b>-0.3</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.3</b>
<b>Classification changes</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.4</b>	<b>0.5</b>	<b>0.5</b>	<b>0.5</b>
<b>Other</b>	<b>-0.5</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Autumn Statement measures</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Total welfare spending</b>							
July forecast	214.3	216.9	213.8	216.5	219.4	222.2	227.3
November forecast	213.9	217.2	217.8	219.8	221.5	224.1	229.4
<b>Change</b>	<b>-0.3</b>	<b>0.3</b>	<b>4.0</b>	<b>3.3</b>	<b>2.1</b>	<b>1.9</b>	<b>2.0</b>
<i>of which:</i>							
Economic determinants	0.1	-0.1	0.2	0.5	0.5	0.5	0.3
Estimating/modelling changes	0.0	0.5	0.8	0.8	0.8	1.2	1.7
Other	-0.4	-0.1	0.0	0.1	0.1	0.3	0.4
Autumn Statement measures	0.0	0.0	3.0	1.9	0.6	-0.2	-0.3

<sup>1</sup> Disability benefits refers to disability living allowance and personal independence payment.

<sup>2</sup> Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

<sup>3</sup> Total welfare outturn in 2014-15 is sourced from OSCAR, consistent with PESA 2014. The OSCAR data do not split welfare spending inside and outside the welfare cap, so this split has been estimated based on departments' return. For 2014-15 only, the components reflect departments' own outturns which may not be on a consistent basis to OSCAR.

4.94 The upward revisions to our **disability benefits** forecast (covering DLA and PIP, but not attendance allowance) have been material, peaking at £1.5 billion (9.9 per cent) in 2020-21. Table 4.24 shows that the main sources of that upward revision have been:

- updated assumptions about the DLA caseload. That includes assuming higher inflows and average awards, but lower claim success rates, among the DLA children caseload, as well as lowering both the rate at which working-age DLA claims migrate to PIP and natural exits from DLA (which had been over-optimistic). In the near term, the number of pensioners migrated to PIP is higher, reducing spending on DLA, but this is gradually offset by lower assumptions for mortality rates specific to pensioner DLA claims;
- new claims to PIP have been revised up to reflect recent data. This has affected inflows, average awards and exit rates among the new claims caseload; and
- in response to the latest evidence from DWP, we have revised our assumption about how long it will take DWP and its contractors to complete the reassessment of DLA cases during the managed migration to PIP. We have reduced assumed volumes of reassessments in 2016-17 by around 35,000 a month (around 45 per cent lower). That means that PIP reassessments will not be completed until 2018-19, a year later than assumed in our July forecast. Because of the savings expected to arise from reassessments, this change raises spending between 2016-17 and 2018-19.

Table 4.24: Key changes in disability benefits spending since July

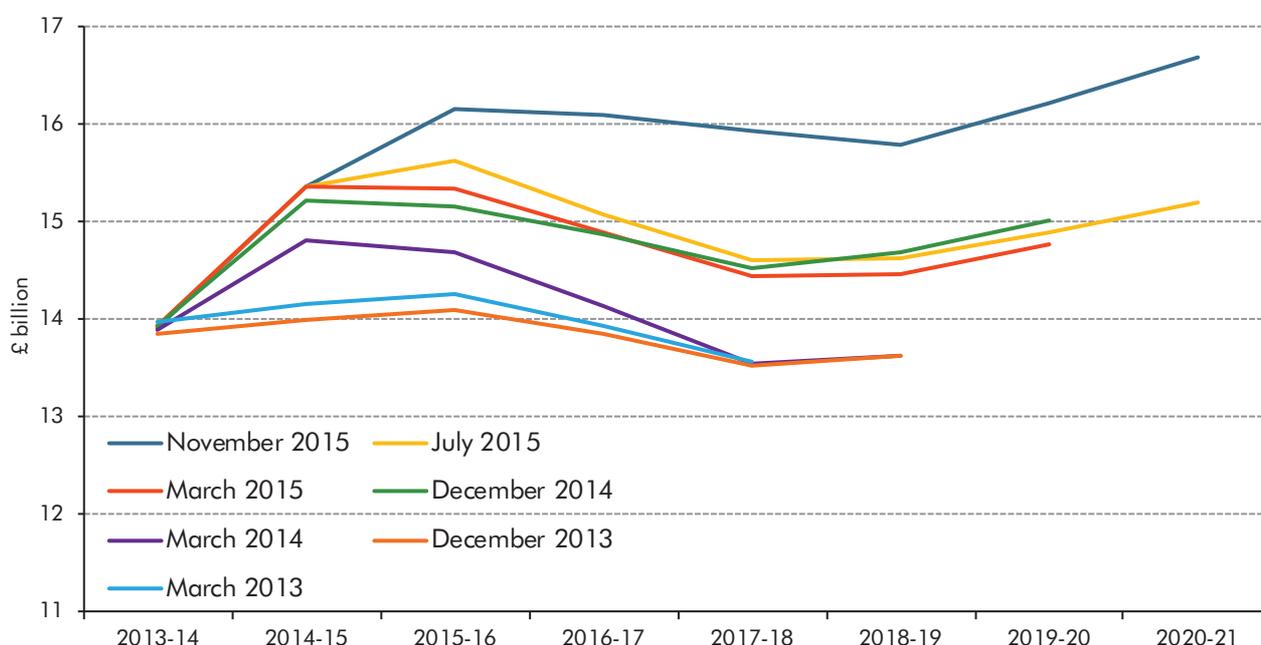
	£ billion					
	Forecast					
	Welfare cap period					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	15.6	15.1	14.6	14.6	14.9	15.2
November forecast	16.2	16.1	15.9	15.8	16.2	16.7
<b>Change</b>	<b>0.5</b>	<b>1.0</b>	<b>1.3</b>	<b>1.2</b>	<b>1.3</b>	<b>1.5</b>
<i>of which:</i>						
DLA caseload	0.2	0.4	0.2	0.1	0.2	0.3
PIP new claims	0.2	0.2	0.4	0.8	0.9	1.0
PIP reassessments	0.1	0.4	0.8	0.3	0.2	0.2
Other	0.1	0.0	0.0	0.0	0.0	0.0

4.95 It is a concern to us that the revisions to our spending forecasts on DLA and PIP echo the pattern of revisions to our forecasts of spending on incapacity benefit and ESA during the reform of the incapacity benefits system.<sup>7</sup> Chart 4.7 shows how spending has been revised up over successive forecasts. Considerable uncertainty remains, given the assumed savings associated with reassessments during the migration to PIP. Based on the results of a small-scale trial of 900 DLA cases that opted in to the PIP assessment, our forecast assumes that

<sup>7</sup> For more on the pattern of revisions to spending on incapacity benefits, see Chapter 4 of our 2014 *Welfare trends report* and Chapter 2 of our 2015 *Welfare trends report*.

only 74 per cent of DLA claims reassessed would be successful in a PIP award.<sup>8</sup> So with around 1½ million claims assumed to be reassessed through managed migration, that implies that by 2018-19 just under 400,000 managed migration claims will not receive a PIP award, reducing spending by around £1.8 billion in that year. With managed reassessments yet to commence, the only evidence we have to test the success rate assumption is from natural reassessments. These have been running close to the 74 per cent assumption, but these cases may differ from the larger number of managed reassessment cases due to take place over the next three years. Our forecast will therefore remain sensitive to any changes to this assumption as new evidence becomes available, as well as to the assumptions we have made about the pace at which reassessments will take place.

Chart 4.7: Successive forecasts for spending on disability benefits



Source: DWP, OBR

4.96 Our July forecast of spending associated with the marginal cost of **universal credit** (UC), relative to the legacy benefit and tax credit systems, was based on the rollout assumption described in Box 4.8 of our December 2014 *EFO*. We have revised that assumption again in this forecast – the latest in a series of revisions, as shown in Chart 4.8. The revision between December 2014 and July 2015 was due to the welfare spending cuts announced in the July Budget, which reduced the overall caseload. The latest revision reflects two sources of change:

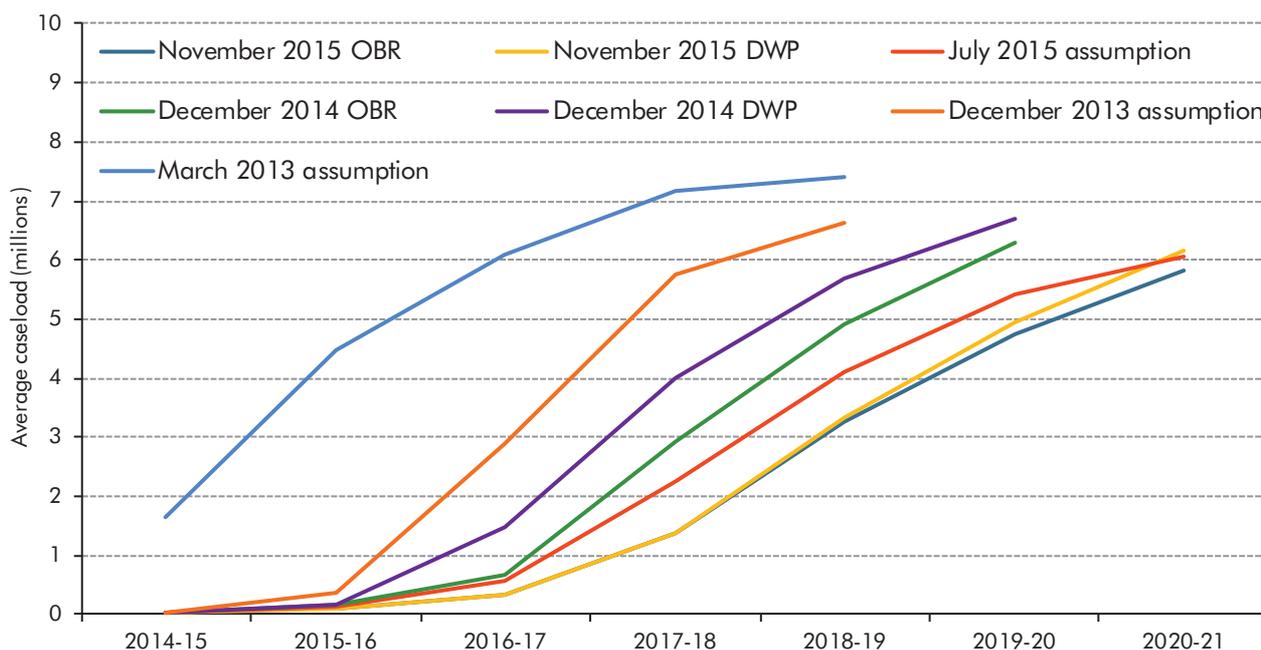
- DWP has decided to slow the pace of natural migration – pushing the end of what it calls the ‘transition period’ back another six months (broadly in line with the delay factored into our forecasts since December 2014). This reduces the marginal cost of UC between 2016-17 and 2018-19 by reducing the caseload. The latest DWP plan

<sup>8</sup> ‘Personal Independence Payment: second draft of assessment criteria. An explanatory note to support the second draft of the assessment regulations’, DWP (November 2011)

also adds the managed migration of tax credits and ESA claims into 2020-21 (previously they were not assumed to take place within our forecast horizon). That increases costs in 2020-21 since these cases receive transitional protection. The impact of these changes to DWP's plans is shown on the Treasury's scorecard since we have judged this to have been a policy decision for the purposes of the welfare cap; and

- we have added our own forecast judgement of a further six-month delay to the managed migration phase of the UC rollout. As usual, we have considered evidence from DWP and the latest assessment of UC rollout by the Major Projects Authority. While this indicates greater confidence in the 'transition phase' rollout plan, considerable uncertainty remains over the 'managed migration' phase. And of course the transition phase rollout schedule has just been pushed back six months, just a year after the previous delay. Our assumption of a further delay reduces the marginal cost of UC in our forecast as cases are migrated later. In particular, this pushes some of the transitional protection costs associated with the tax credits and ESA claimants beyond the forecast horizon. We consider this a forecasting change for the purposes of the welfare cap.

Chart 4.8: Successive revisions to the universal credit rollout assumption



Source: DWP, OBR

### Box 4.3: Impact of the Summer Budget 2015 welfare package

An unusually large number of welfare measures announced in the July Budget affected spending across multiple benefits with many interactions. We certified all but one of those measures. While incorporating the changes into our latest forecast, we have identified a number of interactions between benefits that were not estimated correctly. This reflects the challenge of estimating interactions between HMRC tax credits and DWP benefits in the run-up to a fiscal event, where the Treasury's policy costings process does not permit us to call on the expertise of officials across both departments on all measures that might be subject to interactions. We have also made a large, but neutral, reallocation of spending between tax credits and universal credit (UC) to bring the treatment of the July measures into line with the approach in our baseline forecast.

#### Reclassification of three tax credits measures

In our July forecast, we took the scorecard costings of the tax credit and UC measures (Tables A and B, line b) and added them to our pre-measures forecast (line a) to reach a post-measures forecast (line c). These costings took a bottom-up approach, whereby the effect on tax credits spending declined over time and the effect on UC increased over time as the UC caseload is assumed to rise (consistent with how the transition to UC will operate in practice). But because DWP is currently unable to produce a full bottom-up forecast of spending on UC and legacy benefits, this is not consistent with our forecast, which is based on adding the marginal cost of UC to a forecast of the legacy tax credits and benefit system.

Correcting this means that the measures are now added into the forecast as though the legacy tax credit system continues indefinitely and only the *marginal* costs/savings are included in the UC forecast (line d). This results in a further fall in tax credit spending over the forecast period and an equal and offsetting increase to the marginal cost of UC. The net effect on spending is zero. The measures announced in this Autumn Statement, which reverse the main July tax credit cuts, have been costed on a consistent basis with the forecast and are shown in line g of Tables A and B.

Table A: Tax credits: reallocations and recostings

	£ billion				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
July 2015 pre-measures forecast (a)	29.9	30.5	31.3	31.8	32.5
July 2015 scorecard measures (b)	-4.6	-4.2	-4.0	-4.3	-4.4
July 2015 post-measures forecast (a + b) = (c)	25.3	26.3	27.3	27.5	28.2
Reallocations of summer budget measures (d)	-0.4	-2.0	-3.4	-4.3	-4.9
Recostings of summer budget measures (e)	-0.1	0.0	0.0	0.1	0.1
July 2015 post-measures forecast restated (c + d + e)	24.8	24.4	23.8	23.3	23.3
Nov 2015 pre-measures forecast (f)	24.6	24.2	24.0	23.5	23.7
Nov 2015 scorecard measures (g)	4.2	4.3	4.2	4.1	4.2
Nov 2015 post-measures forecast (h)	28.8	28.5	28.1	27.6	28.0

Table B: Marginal cost of universal credit: reallocations and recostings

	£ billion				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
July 2015 pre-measures forecast (a)	0.0	0.1	0.4	0.4	0.4
July 2015 scorecard measures (b)	-0.1	-1.0	-2.1	-3.1	-3.5
July 2015 post-measures forecast (a + b) = (c)	-0.2	-0.9	-1.7	-2.7	-3.1
Reallocations of summer budget measures (d)	0.4	2.0	3.4	4.4	4.9
Recostings of summer budget measures (e)	0.0	0.0	0.1	0.1	0.1
July 2015 post-measures forecast restated (c + d + e)	0.3	1.1	1.8	1.8	2.0
Nov 2015 pre-measures forecast (f)	0.0	0.4	0.6	0.3	0.2
Nov 2015 scorecard measures (g)	-0.2	-1.0	-2.3	-3.2	-3.6
Nov 2015 post-measures forecast (h)	-0.2	-0.6	-1.8	-2.9	-3.4

### Interaction between housing benefit and the July tax credit measures

Housing benefit entitlement is based on gross income including any tax credits received. This means that cuts to tax credits will increase the amount of housing benefit families receive. This effect was incorrectly allocated to tax credits – and was also underestimated – in the July costings. Correcting this has reduced tax credits spending and, by a more than offsetting amount, increased spending on housing benefit (Table C).

### Reclassification of the extension to the 'lone parent obligation' policy costing

The lone parent obligation costing has also been revised to be consistent with the 'legacy benefits plus marginal cost of UC' approach in the forecast. That results in spending being moved from UC to tax credits, housing benefit, ESA and jobseeker's allowance. The net effect on total welfare spending is zero, but £0.5 billion is now outside the welfare cap.

Table C: Other reallocations and recostings

	£ billion				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Reallocation of HB interaction with Summer tax credit changes</b>					
Personal tax credits	-0.2	-0.2	-0.3	-0.3	-0.4
Housing benefit	0.2	0.3	0.3	0.3	0.5
<b>Reallocation of lone parent obligation savings</b>					
Employment support allowance		0.0	0.0	0.0	0.0
Housing benefits		0.1	0.2	0.3	0.3
Income support		-0.1	-0.1	0.0	0.0
Universal credit		-0.4	-0.7	-0.7	-0.8
Personal tax credits		0.2	0.3	0.3	0.3
Jobseeker's allowance		0.2	0.2	0.2	0.2
<b>Recostings of summer budget measures</b>					
Housing benefits	0.0	0.0	0.1	0.1	0.1
NI social security	0.0	0.1	0.1	0.2	0.2

## Public service pensions

- 4.97 The public service pensions forecast covers net expenditure on benefits paid less employer and employee contributions received. It includes central government pay-as-you-go schemes and locally administered police and firefighters' schemes.<sup>9</sup> A breakdown of spending and income for the major schemes covered by our forecast is included in the supplementary fiscal tables on our website.
- 4.98 Changes in net expenditure since July mainly reflect changes to the profile of RDEL spending described earlier in the chapter. These changes have knock-on effects to our forecasts for contributions received by different schemes because we link the workforce assumptions in our public service pensions receipts forecast directly to departmental budgets. In our July forecast, when the allocation of RDEL had not been specified by the Government, we assumed that paybill and workforce growth for all schemes moved in line with overall RDEL. Now that RDEL has been allocated across departments, we can refine that assumption. In this forecast, we model announced budget protections affecting the NHS and teachers' workforces and the associated squeeze on other departmental budgets.<sup>10</sup>
- 4.99 Taken together, the Government's decision to increase RDEL in most years relative to July and to allocate a rising share of it to the NHS and schools has had the following effects:
- higher RDEL spending, particularly between 2017-18 and 2019-20, raises receipts by £0.3 to £0.5 billion. The Government has also now told us that RDEL will grow much less strongly in 2020-21 than it did in July, which reduces our pension receipts forecast for that year by £0.2 billion; and
  - allocating more of RDEL to spending that affects particular workforces further increases receipts by between £0.1 and £0.2 billion a year relative to those protections not having been factored into the receipts forecast. The protections cause an increase in receipts as the two protected budgets make up a large proportion of the total workforce covered by the forecast.
- 4.100 Table 4.25 details the changes to our public service pensions forecast since July:
- we have revised expenditure up slightly. This reflects small and largely offsetting movements, due to CPI inflation and other small changes to scheme forecasts;
  - most changes on the receipts side reflect the indirect effects of the Government's decisions about the level and composition of RDEL spending described above; and
  - that effect is partly offset by the reduction in paybill per head growth resulting from the 1 per cent public sector pay policy that was announced in July, but which was not

<sup>9</sup> The police and firefighters' pension schemes are administered at a local level, but pensions in payment are funded from AME, along with other public service pension schemes. They are therefore included in our pensions forecast.

<sup>10</sup> The only scheme where workforce assumptions are not linked to implied departmental budgets is the armed forces pension scheme, where workforce assumptions reflect the profile laid out by firm Future Force 2020 plans, rather than the growth in the year-on-year profile of defence RDEL expenditure.

included in our July forecast because the Government did not inform us. That reduces armed forces pension scheme (AFPS) receipts only.<sup>11</sup> Downward revisions to pensionable paybills for the principal civil service and teachers' schemes in 2015-16 also feed through to the rest of the forecast, reducing receipts in later years.

**4.101** As in July, our public service pensions forecast has not been adjusted for the recent ruling in the GAD-Milne court case, which will lead to compensation payments associated with past underpayment in the firefighters' and police pension schemes. In accordance with National Accounts guidance, these payments will be treated as capital AME. No new information has arisen to suggest that the estimated costs used in July should be revised.

**Table 4.25: Key changes to public service pensions since July**

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Net public service pensions</b>						
July forecast	11.1	11.5	12.9	14.5	16.0	16.1
November forecast	11.4	11.5	12.7	14.3	15.7	16.7
<b>Change</b>	<b>0.2</b>	<b>0.0</b>	<b>-0.2</b>	<b>-0.3</b>	<b>-0.3</b>	<b>0.5</b>
<b>Expenditure</b>						
July forecast	39.3	40.0	41.6	43.4	45.3	47.2
November forecast	39.4	40.0	41.5	43.4	45.2	47.2
<b>Change</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.0</b>
<b>Income</b>						
July forecast	-28.2	-28.5	-28.6	-28.8	-29.3	-31.1
November forecast	-28.1	-28.5	-28.8	-29.1	-29.5	-30.5
<b>Change</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.2</b>	<b>-0.3</b>	<b>-0.3</b>	<b>0.5</b>
<i>of which:</i>						
AFPS paybill assumption	0.1	0.1	0.1	0.2	0.2	0.2
Other paybill outturns	0.0	0.1	0.1	0.1	0.1	0.2
Other forecast changes	0.0	0.0	0.0	0.0	0.0	0.0
Indirect effects of Government RDEL decisions	0.0	-0.1	-0.4	-0.7	-0.6	0.2

## EU contributions

**4.102** We have made small upward revisions to our forecast for expenditure transfers to EU institutions across the forecast period. The main news since July has come from the European Commission's Draft Amending Budgets (DAB) 7 and 8, alongside updated economic determinants. Spending has been revised up by £0.4 billion in 2015-16, with the revisions diminishing steadily across years and the forecast unchanged in 2020-21.

**4.103** Table 4.26 decomposes the sources of change in our forecast since July. It shows that:

- we have revised up our assumptions for the EU budget implementation rate from 2016 onwards. For 2016, that reflects the latest information that was available on EU

<sup>11</sup> As we take AFPS workforce assumptions, the total paybill growth for this scheme is equal to paybill per head growth plus workforce growth. As a result, the 1 per cent policy results in lower paybill rather than a higher workforce within a given paybill.

budget negotiations when our forecast was closed – which was before the 16 November ECOFIN meeting had taken place. The European Commission and European Council proposals both implied a higher implementation rate than our July assumption, which we have factored into this forecast. (The initial 2016 budget agreed at the November ECOFIN was slightly higher than our assumption for implemented expenditure in that year, but outturns can vary significantly from initial budgets, so that does not necessarily imply spending would have been revised up further if that information had been available before our forecast was closed.) Given our higher assumptions for implementation rates in 2015 and 2016, we have also revised up our assumptions from 2017 onwards;<sup>12</sup>

- reported EU miscellaneous revenue for 2015 in DAB8 (mostly fines and penalties received from private companies that have breached EU competition rules) was lower than we had assumed. At €3.0 billion, it was below the 3-year average of €4.6 billion on which our July forecast was based. Less income from this source increases UK contributions, adding £0.2 billion to spending in 2015-16 and £0.1 billion a year thereafter because, given the volatility of this revenue stream, we continue to use a 3-year rolling average as the basis for our forecast;
- changes to the UK GNI and VAT bases and anticipated adjustments have been small relative to the revisions in some of our recent forecasts. This reflects small downward revisions to the UK VAT base but small upward revisions to the GNI base, leading to slightly higher contributions in the short term that, because the UK's share in EU VAT bases is the ultimate driver of UK contributions, are partly offset one year later via the rebate. It is important to note that these elements of our forecast are sensitive to relative movements in new and revised data across all EU Member States, which represent a source of significant uncertainty; and
- the effect of other factors, including the effect of sterling having depreciated against the euro, has generally been small.

Table 4.26: Key changes to expenditure transfers to EU institutions since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast	11.3	10.4	9.5	10.8	11.3	11.7
November forecast	11.7	10.7	9.7	10.9	11.4	11.7
<b>Change</b>	<b>0.4</b>	<b>0.4</b>	<b>0.2</b>	<b>0.1</b>	<b>0.1</b>	<b>0.0</b>
<i>of which:</i>						
Changes to assumed budget implementation rates	0.0	0.2	0.1	0.1	0.1	0.2
EU miscellaneous revenue estimate	0.2	0.1	0.1	0.1	0.1	0.1
GNI and VAT bases and anticipated adjustments <sup>1</sup>	0.0	0.1	0.0	-0.1	-0.1	-0.2
Exchange rate and other	0.1	-0.1	0.0	-0.1	-0.1	-0.1

<sup>1</sup> Adjustments to UK GNI and VAT payments in respect of 2014 will be made in December 2015. Adjustments in respect of 2015 will be made during 2016, using the ACOR bases that will be agreed in May 2016. Adjustments to the UK rebate follow a year after the GNI adjustments.

<sup>12</sup> Detailed assumptions on this and other aspects of the forecast are presented in the fiscal supplementary tables on our website.

## Locally financed current expenditure

- 4.104 We forecast local authority spending by forecasting the sources of income that local authorities use to finance their spending and then the extent to which spending will be higher or lower than income, through additions to or withdrawals from their reserves. Our forecast therefore encompasses spending financed by grants from central government, which are mostly in DEL, and local authority self-financed expenditure (LASFE) in AME.
- 4.105 Producing a local authority spending forecast has been more challenging than usual because we needed to complete our forecast before the Government had completed its Spending Review. We were therefore not able to produce a forecast that factored in any knock-on effects from changes in grants from central government. Indeed, the full extent of those changes will not be fully clear for some time because some smaller elements of grant funding – for example, from the Department for Education and the Department for Transport – will be determined on the basis of departments’ own Spending Review settlements, and their own subsequent budgets and departmental plans.
- 4.106 We have also had to consider the uncertainty for local authorities associated with the Government’s announced intention “to make significant reforms to the way in which local government is funded” – including full retention of business rates – and that this funding “will come with new responsibilities to ensure the reforms are fiscally neutral”.<sup>13</sup> The Treasury has confirmed that these intentions do not yet constitute ‘government policy’ and that we should therefore forecast LASFE on the basis of the present system of 50 per cent business rates retention. The Treasury has also informed us that the changes in grants in the Spending Review are intended to lead to one-for-one changes in local authority spending, and are not related to the intended reforms to business rates and new local authority responsibilities. It is these future reforms that the Government intends to be fiscally neutral.
- 4.107 Our forecast for current LASFE is largely driven by our forecasts for council tax and business rates. In 2015-16, council tax increases in England average 1.1 per cent, with 57 per cent of councils having frozen their tax levels and taken up the council tax freeze grant. But we have revised up our estimate of council tax revenues in light of new data on the council tax base, which has increased our forecast for council tax in 2015-16 by £0.3 billion, and our forecast in subsequent years by £0.4 billion. Council tax increases are currently frozen in Scotland. From 2016-17 onwards, our pre-measures forecast assumes that council tax levels in England and Scotland will rise in line with CPI inflation. The changes in our CPI assumptions have increased our forecast of council tax by a further £0.1 billion from 2017-18 onwards. Council tax has risen at faster rates in Wales since 2011-12, so we assume that Welsh council tax will increase in line with a three-year historical average.
- 4.108 Our forecast for retained business rates in England in current LASFE is linked to our forecast for overall business rates, as discussed above. The pre-measures forecast for retained business rates is little changed from July, except in 2016-17 where we have revised it down

<sup>13</sup> Department for Communities and Local Government, Written Ministerial Statement on ‘Business rates reform’, 12 October 2015.

by £0.3 billion to reflect the known shortfall in collection in earlier years. This will affect the LASFE figure in that year.

4.109 Data published since our July forecast point to higher local authority current spending than we expected then. Provisional outturn data for 2014-15 suggest current LASFE was £1.0 billion higher than we had estimated in July. Quarterly outturn information is currently only available for English authorities in the first quarter of 2015-16. This indicates that higher spending has continued into 2015-16, although it is worth stressing that quarterly local authority data can be revised substantially over time.

4.110 Table 4.27 summarises the main changes to our current LASFE forecast. It shows that:

- we have assumed that spending in 2015-16 will be £1.3 billion higher than forecast in July, reflecting the latest outturns. For local authority net current expenditure in England, this implies that spending will be around £4 billion below their budgets, compared to an average £3 billion shortfall over the previous three years. Given our forecasts for local authority income, that implies only £0.3 billion will be added to reserves by English authorities this year, down from £1.0 billion last year, an average of £2.5 billion a year between 2011-12 and 2013-14, and our July forecast of £0.8 billion;
- we have, however, assumed that the uncertainties associated with the Spending Review changes to funding and other Government reform intentions will prompt local authorities to reduce spending and to add greater amounts to reserves again from next year. We assume that they will increase their reserves by £2.4 billion in total between 2016-17 and 2018-19, which is higher in each year than this year's figure and also higher than the £0.9 billion over that period that we assumed in July;
- we have also reduced our assumptions for the amounts that English local authorities set aside for the repayment of principal, which in turn increases the remaining finance available for current spending. This reflects the lower growth in these amounts set aside over the last four years. The drivers of this trend are not clear, so we will investigate the issue further ahead of our next forecast. For now we have assumed that the amounts set aside remain flat over the forecast period, which increases our forecast of current LASFE by £0.5 billion a year on average; and
- spending has been increased by the Government's policy decision to allow some local authorities to increase council tax at a faster pace to fund some of the cost of adult social care and policing. The scorecard measures on business rates also reduce spending financed by retained business rates in 2016-17.

4.111 Full details of our latest local authority current and capital spending forecasts are available in the supplementary fiscal tables on our website. Given the issues set out above about changes to grant funding and future reforms to local government funding, and the extra uncertainty arising from only having one quarter's outturn data for 2015-16, we would place even more emphasis than normal on the uncertainty around these forecasts.

Table 4.27: Key changes to locally financed expenditure and public corporations expenditure since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Locally financed current expenditure</b>						
July forecast	38.5	40.2	42.1	43.7	45.1	46.4
November forecast	39.8	40.3	43.4	45.6	48.0	49.9
<b>Change</b>	<b>1.3</b>	<b>0.1</b>	<b>1.3</b>	<b>1.9</b>	<b>2.9</b>	<b>3.5</b>
<i>of which:</i>						
Council tax	0.3	0.4	0.5	0.5	0.5	0.6
Net use of current reserves	0.5	-0.6	-0.5	-0.4	0.0	0.0
Provision for debt repayment	0.3	0.4	0.5	0.6	0.7	0.8
Other items that finance current spending	0.3	-0.2	0.1	0.0	0.0	0.1
Effects of Government decisions	0.0	0.1	0.8	1.2	1.6	2.1
<i>of which:</i>						
Council tax-financed local spending	0.0	0.4	0.8	1.2	1.6	2.1
Scorecard measures	0.0	-0.3	0.0	0.0	0.0	0.0
<b>Locally financed and public corporations capital expenditure</b>						
July forecast						
As published in July	14.4	15.4	15.9	14.2	14.1	14.2
Housing association reclassification	8.2	6.9	5.6	4.7	4.0	4.4
July forecast restated to include housing associations	22.6	22.4	21.6	18.9	18.0	18.6
November forecast	22.2	21.4	21.1	18.8	18.3	19.6
<b>Change</b>	<b>-0.4</b>	<b>-0.9</b>	<b>-0.5</b>	<b>-0.2</b>	<b>0.2</b>	<b>1.0</b>
<i>of which:</i>						
Other public corporations' capital expenditure <sup>1</sup>	-0.1	0.0	-0.1	-0.3	-0.2	-0.1
Capital spending from prudential borrowing	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1
Other capital spending	-0.1	-0.3	-0.3	-0.3	0.1	0.0
Effects of Government decisions:						
Housing associations' spending: affordable housing measure	0.0	-0.4	0.1	0.6	0.6	1.2

<sup>1</sup> Change to the forecast for public corporations capital spending, excluding housing associations and local authorities' Housing Revenue Accounts.

## Locally financed and public corporations capital expenditure

4.112 Our latest forecasts for locally financed capital expenditure (capital LASFE) and public corporations capital spending are shown in Table 4.27 above. Capital LASFE is measured net of asset sales. It is also measured net of capital spending by local authorities' Housing Revenue Accounts (HRAs) and the Transport for London (TfL) subsidiaries that are treated as public corporations in the National Accounts.<sup>14</sup> We switch these items out of capital LASFE and include them in our forecast for public corporations net capital expenditure to ensure our forecast is consistent with the National Accounts.

<sup>14</sup> These TfL transport subsidiaries trade under the company name 'Transport Trading Ltd' (TTL). The ONS currently classifies all the TTL subsidiaries as public corporations apart from Crossrail, which is classified as part of the local authority sector. However, the ONS announced last year that it will be reclassifying several of the other TTL subsidiaries to the local authority sector. We would expect that these reclassifications will have a neutral effect on the public sector finances and we will wait until the ONS implements those reclassifications in the outturn data before we reflect them in our forecast.

- 4.113 Our forecast for public corporations' capital spending now includes housing associations' capital spending (the forecast of which is described in Annex B). That classification change has led to a significant increase in public corporations' capital spending in all years of the forecast period. HRAs and TfL's public corporation subsidiaries account for most of the remaining spending in this category. All these forecasts of capital spending are net of asset sales, forecasts for which are shown in the supplementary fiscal tables on our website.
- 4.114 Table 4.27 groups our forecasts for capital LASFE and public corporations' capital spending together to show the overall effect of the revisions. The main changes – abstracting from the reclassification of housing associations – reflect:
- revisions to our forecasts of other public corporations' capital expenditure, including small downward revisions related to TfL;
  - small reductions in our forecast for capital spending financed by prudential borrowing, mainly reflecting the latest movements in outturn in 2014-15; and
  - small reductions in other capital LASFE and public corporations' capital spending, flowing from revisions to our forecasts for local authorities' sales of capital assets, the timing adjustment we apply to TfL capital spending, and capital spending financed by the community infrastructure levy.

### Central government debt interest

- 4.115 Central government debt interest payments (net of the effect of the Bank of England's Asset Purchase Facility (APF) holdings of gilts) are forecast by applying interest rates to the stocks of different liabilities. These interest rates are derived from financial market expectations and our inflation forecast (for index-linked gilts).<sup>15</sup>
- 4.116 Table 4.28 shows that debt interest payments (net of the APF) are significantly lower than in July, with the size of the downward revision getting larger in each year of the forecast. There have been significant changes to both elements of the forecast – the gross debt interest paid by central government (including that paid to the APF) and the amount that is netted off because the APF is part of the public sector. The table therefore shows the sources of changes to both elements. These include the effect of:
- **market expectations of Bank Rate and gilt yields** have fallen. That reduces spending by rising amounts over the forecast period as lower gilt yields reduce gross debt interest payments and lower Bank Rate reduces the cost of financing the Bank of England reserves created to fund the APF's gilt purchases;
  - the Bank of England announced in the November *Inflation Report* that the **stock of gilts in the APF** will be kept at £375 billion until Bank Rate reaches a level from which it can be cut materially. The MPC currently judge this to be around 2 per cent, which, on the

<sup>15</sup> Our forecasting approach was explained in Box 4.4 of our March 2015 *EFO*. We publish a supplementary fiscal table on our website that presents the different stocks, flows and effective interest rates that make up our debt interest forecast.

market expectations underpinning our forecast, is currently beyond our forecast horizon. We previously assumed that the redemptions would start to reduce the stock of gilts held in the APF once Bank Rate had started rising (early 2016-17 in our July forecast). Aligning our forecast assumption with the Bank's latest announcement means that the APF's gilt holdings remain larger for longer and the debt interest saving associated with effectively financing debt held in the APF at Bank Rate remains higher for longer. That reduces debt interest spending by rising amounts over the forecast period, reaching £2.1 billion in 2020-21;

- **lower RPI inflation** has reduced debt interest costs on index linked gilts in 2015-16, but RPI inflation has been revised up by small amounts on average over the rest of the forecast, which increases debt interest in most subsequent years;
- **other small changes to our pre-measures forecast** associated with the financing requirement, latest outturn data and other factors; and
- the **indirect effects of the policy measures** announced in the Spending Review and Autumn Statement increase debt interest spending in every year. There are two main drivers of that change: higher borrowing and higher lending have pushed up the financing requirement and the decision to allow council tax to rise faster has increased the cost of financing index-linked gilts via its effect on the Retail Prices Index.

Table 4.28: Key changes to central government debt interest since July

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast (net of APF)	34.6	40.8	47.7	50.7	53.2	54.3
November forecast (net of APF)	34.7	39.5	43.7	46.4	49.0	49.1
<b>Change</b>	<b>0.1</b>	<b>-1.4</b>	<b>-4.0</b>	<b>-4.3</b>	<b>-4.2</b>	<b>-5.2</b>
July forecast (gross of APF)	46.7	51.1	55.9	57.2	58.5	58.6
November forecast (gross of APF)	46.5	51.0	54.2	55.7	57.3	56.6
<b>Change</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.2</b>	<b>-1.9</b>
<i>of which:</i>						
Interest rates	-0.5	-1.0	-2.0	-2.5	-2.4	-2.7
Inflation	-0.3	0.3	0.0	0.3	0.5	-0.1
Financing	0.0	0.0	-0.3	-0.5	-0.5	-0.4
Other factors (including outturn)	0.5	0.3	0.4	0.5	0.4	0.5
Indirect effects of Government decisions	0.0	0.3	0.1	0.7	0.8	0.8
<b>Changes from the Asset Purchase Facility</b>						
July forecast	-12.1	-10.3	-8.3	-6.5	-5.3	-4.3
November forecast	-11.7	-11.5	-10.6	-9.3	-8.3	-7.6
<b>Change</b>	<b>0.3</b>	<b>-1.2</b>	<b>-2.3</b>	<b>-2.7</b>	<b>-3.0</b>	<b>-3.2</b>
<i>of which:</i>						
Interest rates	-0.1	-1.2	-1.6	-1.5	-1.2	-1.0
Profile of APF drawdown	0.0	0.0	-0.5	-1.1	-1.7	-2.1
Other factors (including outturn)	0.5	0.0	-0.2	-0.2	-0.1	-0.1

## Other AME spending

- 4.117 Our forecast of **BBC** spending includes the Government's decision progressively to stop compensating the BBC for the licence fee revenue forgone by requiring it to provide free TV licences for those aged 75 and over. We certified the Government's costing of this policy change in July and it is now reflected in our pre-measures BBC spending forecast. The licence fee is a tax in the National Accounts, so free TV licences are in effect a tax relief and do not affect spending. DWP currently compensates the BBC for that forgone revenue, so that BBC income is unaffected. As the current arrangement is an intra-public sector transfer, spending and borrowing are also unaffected. However, BBC current spending under the new scenario now declines at a similar rate to that at which the grant is removed, with the removal phased in between 2018-19 and 2019-20, before the grant is withdrawn entirely in 2020-21. Spending is £0.2 billion higher in the final year of the forecast than in July due to an increase in pension deficit payments, as agreed with the BBC's pension trustees. (The forecast now reflects the actual repayment profile, whereas previous forecasts included an estimate based on the level of historical payments.) We have also reduced our licence fee forecast slightly relative to July (as discussed in the receipts section above), which feeds through to slightly lower current spending.
- 4.118 Our RDEL forecast includes spending on **research & development (R&D)**, but this is classified in the National Accounts as capital spending. In order to move this spending from current to capital in our forecast, current AME includes a negative R&D accounting adjustment and capital AME includes an offsetting positive entry for that R&D spending. Our latest forecast includes revisions to 2015-16 that reflect updated departmental plans data, in line with PESA 2015.<sup>16</sup> Spending from 2016-17 onwards is assumed to grow in line with RDEL, so reflects the changes the Government has made to RDEL totals in the Spending Review.
- 4.119 **Other PSCE in departmental AME** is little changed over the forecast period. The movements in **other PSGI items in departmental AME** are largely explained by a change in the profile of assumed HMRC tax litigation costs. An additional £0.1 billion and £0.2 billion of spending in 2015-16 and 2016-17 respectively is attributable to the bonus shares element that will be part of the forthcoming Lloyds retail share offering (see paragraph 4.133). This will be treated as a capital grant. The spending in these categories is detailed in the supplementary fiscal tables on our website.
- 4.120 **Environmental levies** include spending on DECC levy-funded policies such as the renewables obligation, feed-in tariffs and warm homes discount. Most are neutral for borrowing as they are directly offset by receipts. These forecasts are explained in the receipts section. The renewable heat incentive (RHI) is a spending-only policy. The Spending Review sets out RHI budgets from 2016-17 to 2020-21 and will introduce budget caps in each year. Compared with July, spending on RHI is forecast to be £0.7 billion lower by 2020-21.
- 4.121 **VAT refunds** expenditure is neutral for borrowing, as it is directly offset within receipts. The upward revisions to the forecast are explained in the receipts section above.

<sup>16</sup> See HM Treasury, July 2015, *Public Expenditure Statistical Analyses 2015*.

- 4.122 Our forecast for **Network Rail** spending has been revised by only small amounts, with current spending down by an average of £0.1 billion a year and capital spending unchanged, on average, over the forecast period. We have treated the Network Rail AME forecast in much the same way as we would a departmental expenditure limit, as this seems to be consistent with how Network Rail's spending is controlled by the Government. The Treasury has treated the July forecast as the baseline, and has then used the space created by some small downward revisions in our pre-measures forecast (due mainly to correcting some items that were revealed to be double-counted) to increase Network Rail's spending over the forecast period. We did not feel that this treatment of the changes since July would be misleading for users of our forecasts, so we have shown all changes since July as forecast changes.
- 4.123 The AME forecast includes other **National Accounts adjustments**, which are included in the definitions for PSCE and PSGI. Movements in these adjustments over the forecast period typically consist of numerous changes that are small and largely offsetting. On current spending, we have been able to resolve most of the issues flagged in our 2015 *Forecast evaluation report*, so changes since July are relatively small. On capital, changes in 2015-16 and over the rest of the forecast period mainly reflect two adjustments to local authority spending: an updated (higher) forecast for local authority financial transactions, which we remove because these are not included in PSGI, and our latest (higher) forecast for an adjustment to reflect ONS outturn data for local authorities' receipts of capital grants from the private sector. The substantial change to total capital National Accounts adjustments in 2014-15 is attributable to the fact that the residual adjustment between our estimated sum of the detailed components of spending and latest outturns for PSGI published by the ONS has diminished substantially since our July *EFO* (which reported provisional outturn figures). At the time, this reflected the extent to which different sources of estimated outturns were still being revised and picked up by the ONS with different timings. This gap has now narrowed, as expected, in line with the publication of more definitive outturn sources. Further details of our forecasts for all the other National Accounts adjustments are included in the supplementary tables on our website. Explanations and the background to National Accounts adjustments are given in Annex D to PESA 2015.

## Loans and other financial transactions

- 4.124 Public sector net borrowing (PSNB) is the difference between total public sector receipts and expenditure each year, measured on an accrued basis. But the public sector's fiscal position also depends on the flow of financial transactions, such as loans and repayments between government and the private sector, and the sale of financial assets to the private sector. These do not directly affect PSNB, but they do lead to changes in the Government's cash flow position and stock of debt.
- 4.125 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.<sup>17</sup> It drives our forecast of public sector net debt (PSND), which is largely a cash measure. Estimating the PSNCR also allows us to estimate the central

<sup>17</sup> Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the public sector banks.

government net cash requirement (CGNCR), which in turn largely determines the Government's financing requirement – the amount it needs to raise from instruments including treasury bills, gilt issues and NS&I products.

4.126 Differences between the PSNCR and PSNB can be split into the following categories:

- **loans and repayments:** loans that the public sector makes to the private sector do not directly affect PSNB, but the cash flows affect the PSNCR;
- **transactions in other financial assets:** the public sector may buy or sell financial assets, such as corporate bonds or equities. When it sells an asset for cash the initial transaction does not affect PSNB, whereas the cash received will reduce the PSNCR. But both PSNB and the PSNCR will be higher in future years if the government foregoes an income stream that flowed from the asset sold;
- **accruals adjustments:** PSNB is an accruals measure of borrowing in which, where possible, spending and receipts are attributed to the year of the activity to which they relate. In contrast, PSNCR is a cash measure in which spending and receipts are attributed to the year in which the cash flow takes place. These timing differences need to be adjusted for;
- **UK Asset Resolution:** we separately identify transactions relating to UKAR holdings, including asset sales and the natural rundown of loan books that the Government acquired during the late 2000s financial crisis; and
- other factors affecting the **central government net cash requirement:** these include Network Rail and some other adjustments that do not fall into the categories above.

Table 4.29: Reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Public sector net borrowing</b>	<b>73.5</b>	<b>49.9</b>	<b>24.8</b>	<b>4.6</b>	<b>-10.1</b>	<b>-14.7</b>
<b>Loans and repayments</b>	<b>16.0</b>	<b>18.3</b>	<b>20.2</b>	<b>20.4</b>	<b>22.4</b>	<b>22.9</b>
<i>of which:</i>						
Student loans <sup>1,2</sup>	11.2	12.8	14.8	16.9	18.7	19.6
Ireland	0.0	0.0	0.0	-0.4	0.0	0.0
Other lending	4.8	6.3	6.1	4.9	4.7	4.3
Allowance for shortfall	0.0	-0.8	-0.8	-1.0	-1.0	-1.0
<b>Transactions in financial assets</b>	<b>-17.3</b>	<b>-9.8</b>	<b>-8.4</b>	<b>-8.3</b>	<b>-8.2</b>	<b>-8.2</b>
<i>of which:</i>						
Student loan book	0.0	-2.3	-2.3	-2.3	-2.3	-2.3
Royal Mail pension asset disposal	-0.5	-0.5	-0.4	-0.3	-0.1	-0.1
Lloyds Banking Group share sales	-12.1	0.0	0.0	0.0	0.0	0.0
Royal Bank of Scotland share sales	-2.1	-5.8	-5.8	-5.8	-5.8	-5.8
Other	-2.6	-1.2	0.0	0.0	0.0	0.0
<b>Accruals adjustments</b>	<b>7.2</b>	<b>7.4</b>	<b>2.1</b>	<b>-2.7</b>	<b>-2.6</b>	<b>7.1</b>
<i>of which:</i>						
Student loan interest <sup>1,2</sup>	1.9	2.2	3.2	4.3	5.4	6.5
PAYE income tax and NICs	1.7	1.6	2.0	1.9	1.9	2.2
Indirect taxes	1.8	1.1	0.9	1.0	1.0	0.9
Other receipts	2.4	2.3	2.5	2.6	2.6	2.7
Index-linked gilts <sup>3</sup>	-5.2	-0.5	-8.3	-13.7	-14.0	-5.4
Conventional gilts	3.5	3.5	4.6	4.1	3.6	3.4
Other expenditure	1.1	-2.7	-2.7	-2.8	-3.0	-3.2
<b>Other factors</b>	<b>-18.5</b>	<b>-6.1</b>	<b>-5.4</b>	<b>-5.2</b>	<b>-4.4</b>	<b>-2.0</b>
<i>of which:</i>						
UKAR alignment	-17.9	-5.5	-5.1	-5.1	-4.5	-2.0
Network Rail	0.6	0.6	0.8	1.0	1.2	1.1
Alignment adjustment	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
<b>Public sector net cash requirement</b>	<b>61.0</b>	<b>59.8</b>	<b>33.2</b>	<b>8.7</b>	<b>-2.9</b>	<b>5.1</b>

<sup>1</sup> The table shows the net flow of student loans and repayments. This can be split out as follows:

Cash spending on new loans	13.3	15.4	17.6	19.8	21.5	22.9
Cash repayments	2.2	2.6	2.8	2.9	2.8	3.3

<sup>2</sup> Cash payments of interest on student loans are included within 'Loans and repayments' as we cannot easily separate them from repayments of principal. To prevent double counting the 'Student loan interest' timing effect therefore simply removes accrued interest.

<sup>3</sup> This reconciliation to the net cash requirement does not affect public sector net debt.

Table 4.30: Changes in the reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Public sector net borrowing</b>	<b>4.0</b>	<b>6.8</b>	<b>0.5</b>	<b>-1.7</b>	<b>-0.2</b>	<b>-3.1</b>
<b>Loans and repayments</b>	<b>-0.8</b>	<b>0.2</b>	<b>1.0</b>	<b>1.1</b>	<b>2.7</b>	<b>6.0</b>
<i>of which:</i>						
Student loans <sup>1,2</sup>	0.0	-0.1	0.1	0.5	1.4	2.7
Ireland	0.0	0.0	0.0	0.0	0.0	0.0
Other lending	-1.7	1.0	1.6	1.6	2.2	4.2
Allowance for shortfall	1.0	-0.8	-0.8	-1.0	-1.0	-1.0
<b>Transactions in financial assets</b>	<b>3.1</b>	<b>-1.2</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>-8.1</b>
<i>of which:</i>						
Student loan book	2.3	0.0	0.0	0.0	0.0	-2.3
Royal Mail pension asset disposal	0.0	0.0	0.0	0.0	0.0	0.0
Lloyds Banking Group share sales	0.8	0.0	0.0	0.0	0.0	0.0
Royal Bank of Scotland share sales	-0.1	0.0	0.0	0.0	0.0	-5.8
Other	0.1	-1.2	0.0	0.0	0.0	0.0
<b>Accruals adjustments</b>	<b>2.3</b>	<b>-1.2</b>	<b>0.3</b>	<b>-0.4</b>	<b>-0.6</b>	<b>0.8</b>
<i>of which:</i>						
Student loan interest <sup>1,2</sup>	0.2	-0.2	0.0	0.0	0.1	1.0
PAYE income tax and NICs	0.2	-0.7	-0.1	0.0	-0.2	-0.2
Indirect taxes	0.1	0.2	0.2	0.0	-0.1	-0.2
Other receipts	0.3	0.1	0.2	0.2	0.3	0.3
Index-linked gilts <sup>3</sup>	0.2	-0.4	0.2	-0.3	-0.6	0.1
Conventional gilts	0.2	0.3	0.2	0.2	0.3	0.3
Other expenditure	1.0	-0.6	-0.4	-0.4	-0.5	-0.5
<b>Other factors</b>	<b>1.6</b>	<b>-0.5</b>	<b>-0.2</b>	<b>-0.6</b>	<b>-0.3</b>	<b>2.0</b>
<i>of which:</i>						
UKAR alignment	0.8	-1.3	-1.3	-1.8	-1.6	0.8
Network Rail	0.3	0.3	0.5	0.6	0.8	0.6
Alignment adjustment	0.6	0.6	0.6	0.6	0.6	0.6
<b>Public sector net cash requirement</b>	<b>10.3</b>	<b>4.1</b>	<b>1.6</b>	<b>-1.6</b>	<b>1.6</b>	<b>-2.4</b>

<sup>1</sup> The table shows the net flow of student loans and repayments. This can be split out as

Cash spending on new loans	-0.1	0.1	0.4	1.1	1.8	3.7
Cash repayments	-0.1	0.2	0.3	0.6	0.3	0.9

<sup>2</sup> Cash payments of interest on student loans are included within 'Loans and repayments' as we cannot easily separate them from repayments of principal. To prevent double counting the 'Student loan interest' timing effect therefore simply removes accrued interest.

<sup>3</sup> This reconciliation to the net cash requirement does not affect public sector net debt.

## Loans and repayments

### Student loans

4.127 Net lending by the public sector to the private sector, in particular for student loans, raises the net cash requirement relative to net borrowing in each year of our forecast. The recent student loan reforms have increased the size of the upfront loans, with repayments being made over a longer period. In our 2015 *Fiscal sustainability report*, on the policy settings that were current at the time, we estimated that student loans would increase PSND by 8.8 per cent of GDP by the late 2030s before falling to 8.0 per cent of GDP in 2064-65.

4.128 The Government has announced several further changes to higher education funding and student support in this Autumn Statement. These include:

- **freezing the repayment threshold** at £21,000 for five years from 2016-17 to 2020-21 for post-2012 student loans. This is expected to increase repayments by £0.4 billion by 2020-21. Over the long term, it will both lead to some students fully repaying their loans earlier and increase the proportion of loans repaid before outstanding balances are written off after 30 years, shifting part of the cost of these loans from the Exchequer to the individuals that received the loans;
- **converting maintenance grants for students in certain health-related courses into loans.** Over a 5-year horizon, this will increase outlays by amounts that rise to around £1.2 billion in 2020-21. But it has no effect on repayments within the forecast period. Over the long term, it will shift part of the cost of funding these students from the Exchequer to the individuals that previously received grants and must now repay loans. As with other student loans, some proportion will not be repaid before the point at which they are written off and will therefore remain a cost to the Exchequer; and
- **other changes that expand the number of students eligible for loans** from government. These increase the amount of lending to individuals involved in further education, part-time higher education, postgraduate study and certain types of retraining. Over a 5-year horizon, they increase outlays by amounts that rise to around £1.0 billion by 2020-21 and have a much smaller effect on repayments. Over the long term, by expanding the number of individuals receiving loans, they will add to public sector net debt to the extent that the loans are not fully repaid.

4.129 These policy changes are not expected to affect full-time undergraduate student numbers, so our forecast for those numbers has been revised only slightly since July. Reflecting the new ONS population projections that were published in October, it has been revised up a little from 2017-18 onwards.<sup>18</sup> The revision reaches 3,000 in 2020-21. Overall, this means that we expect student numbers to rise by around 40,000 (11 per cent) between 2014-15 (before the student numbers cap was removed) and 2020-21. As well as the general uncertainties around the assumptions underpinning this forecast, one specific risk relates to the strong growth in EU-domiciled entrants in recent years, which may not be captured effectively in our current forecast methodology.

4.130 Reflecting these small changes in student numbers and the larger effects of new policy measures, we have revised up our forecast for student loan outlays. The change in 2020-21 also reflects a correction for student loans and repayments related to Scotland, Wales and Northern Ireland that had been omitted in that year.<sup>19</sup> Beyond the effect of the Government's decision to freeze the repayment threshold for post-2012 loans, and the

<sup>18</sup> The methodology we use to produce our student numbers forecast was described in a supplementary release to the July 2015 *EFO* available on our website. It has three main inputs: ONS population projections at relevant ages, application rates and acceptance rates. Our forecast for student numbers is presented in the supplementary fiscal tables available on our website.

<sup>19</sup> See the supplementary 'Student loans forecast' release on the July 2015 *EFO* page of our website.

delay in selling the student loan book (discussed below) our student loan repayments forecast is little changed since July.

### Other lending

- 4.131 Other lending covers a range of other Government schemes. In order to inform our estimate for the current year, we ask the Government to provide us with an estimate of the planned lending by each institution or scheme. In light of new information provided by the Treasury, we have revised down expected lending this year by a number of schemes, including the British Business Bank, Green Investment Bank and some housing schemes (though not Help to Buy, where lending has been close to forecast this year).
- 4.132 For 2016-17 onwards, our latest forecast has been constructed in a similar way to the departmental spending forecasts described earlier in the chapter. The Treasury has set limits for lending within departmental capital budgets, against which, reflecting the tendency for new schemes to take longer than originally planned to deliver the amount targeted and existing schemes lending below their plans, we have assumed a margin of 'under-lending' in each year. We have not yet been able to scrutinise the details of the new plans for lending schemes set out in this Spending Review so for this *EFO* Tables 4.29 and 4.30 do not split out the major lending schemes. We would expect to need to revise our under-lending assumptions in the future as further information becomes available.

### Transactions in other financial assets

- 4.133 We only include the impact of financial asset sales and purchases in our forecasts once firm details are available that allow the effects to be quantified with reasonable accuracy and allocated to a specific year. There are now a number of asset sales that meet these criteria, the scale of which is illustrated in Chart 4.9. These include:
- in Autumn Statement 2013, the Government announced its plan to sell part of the **student loan book**, which it expected would raise around £12 billion over five years from 2015-16. This plan was reiterated in the July Budget.<sup>20</sup> Since July, the Treasury has informed us that its policy commitment remains unchanged, but that it will not now be able to complete the first sale until 2016-17. We believe that this represents a central assumption, but the delay has highlighted that it remains uncertain. Selling the loan book reprofiles the flow of receipts, with more recorded upfront as sales proceeds, and less in future years, as future loan repayments will flow to the private sector rather than the Exchequer. As in July, we have made a neutral assumption that sales will be evenly spread across the five years, though now starting in 2016-17. The total sale proceeds over five years have been revised down by £0.8 billion since July because delaying the sales means that more of the outstanding loans will have been repaid before the sales take place. The sales are now expected to reduce the flow of repayments to the Exchequer by around £1.5 billion by 2020-21;

<sup>20</sup> In March, we explained that there had been some changes in the form of the expected sale that implied that a larger quantity of loans would need to be sold to meet the Government's £12 billion central estimate for the proceeds from the sale.

- our forecast in July included the Government's planned sales of £12.9 billion of **Lloyds Banking Group** shares in 2015-16. This was consistent with the Chancellor's announcement in June that the Government would "return Lloyds to the private sector over the coming year". We have revised down the amount we expect the Government to receive from the sale in 2015-16 by £0.8 billion to £12.1 billion reflecting the fall in the Lloyds share price since July and the Government's decision to give away some bonus shares in the retail offering planned for later this financial year;
- the Government's sales of **Royal Mail** shares this year have raised about £0.1 billion less than we expected in July. That reflected a lower share price when the final sale was completed in October, and the Government's decision to give more shares away alongside the sale;
- the Government's commitment to sell over £25 billion of **Royal Bank of Scotland (RBS)** shares over the course of this Parliament. The Government sold the first tranche of RBS shares for £2.1 billion in August and we have assumed that it will raise £5.8 billion a year for four years to achieve its £25 billion commitment by 2019-20. We have also assumed that the Government will receive the remaining payment from RBS of about £1.2 billion in 2016-17 to retire the dividend access share (DAS), completing the transaction that was agreed in 2014. The Government has also announced that it will sell a further £5.8 billion of RBS shares in 2020-21. We were informed of this new policy well after the mutually agreed deadlines for us to scrutinise and certify the Government's estimate as reasonable and central. In such instances, we decide whether or not to include the Government's estimate in our forecast uncertified. As this was not a complex policy, we have included it in our forecast; and
- the active sale of **UK Asset Resolution's** assets, in addition to the natural rundown of the loan book. These are discussed in the UKAR section below.

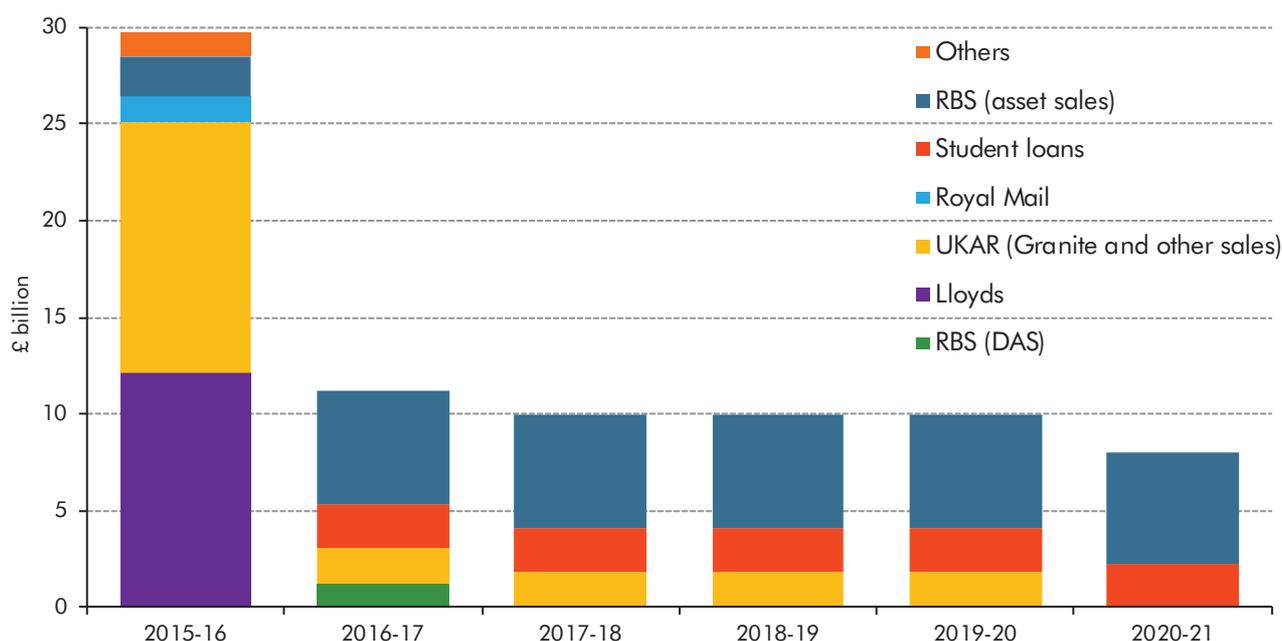
4.134 The Government added about £45 million to public spending by gifting Royal Mail shares to staff when selling its remaining stake (a cost shown on the Treasury's scorecard of policy measures). It has announced that there will be a gift element to the Lloyds retail share offering – allocating bonus shares to small investors – that, together with an assumption that shares will be sold at a small discount to the prevailing market price, we estimate will add £100 million to public spending this year and £180 million in 2016-17 (costs that are not shown on the Treasury's scorecard). In contrast, the Treasury has confirmed to us that it has not assumed any gift element in the current policy for RBS sales. Any change to that position in the future could affect our forecasts for public spending.

4.135 Chart 4.9 shows that the expected proceeds from major asset sales over the forecast amount to £30 billion in 2015-16, a further £41 billion over the remainder of this Parliament to 2019-20, and £6 billion in 2020-21, the first year of the next Parliament. We expect the Government to receive about £2 billion less in 2015-16 than we thought in July as a result of the postponed student loans sale and lower share prices affecting the Lloyds and Royal Mail share sales. However, we forecast that the Government will receive about

£9 billion more over the rest of the Parliament as a result of additional UKAR sales and the DAS payment.

4.136 So far in 2015-16, major asset sales have totalled £24 billion, with the largest contributions coming from UKAR’s sale of the Granite securitisation vehicle and other assets, and the ongoing sales of Lloyds shares. Around £6 billion of proceeds are expected in the remaining months of this year, in large part the remaining Lloyds share sales.

Chart 4.9: Expected proceeds from major asset sales



Source: HMT, OBR

## Accruals adjustments

4.137 To move from PSNB to PSNCR, it is necessary to adjust for the expected impact of timing differences between cash flows and accruals. For example, if receipts are forecast to rise over time, the cash received each year will generally be lower than the accrued receipts.

4.138 A large component of the receipts timing adjustment relates to the interest on student loans. This is included in the accrued measure of public sector current receipts as soon as the loan is issued, but cash repayments are not received until the point at which former students earn sufficient income. Higher loan outlays associated with policies announced in this Autumn Statement have increased accrued interest receipts by £0.4 billion by the end of the forecast, which also affects the accruals adjustment. The forecast has also been affected by changes to our RPI inflation forecast and other factors. For 2020-21, we have corrected the forecast to include student interest payments related to Scotland, Wales and Northern Ireland that were omitted in July.

4.139 Similar timing adjustments are made for expenditure. The largest is for the timing of payments on index-linked gilts. This is very sensitive to RPI inflation, as well as to the profile

of redemptions, which is uneven from year to year. Positive RPI inflation raises the amount the government will have to pay on index-linked gilts when they are redeemed. This commitment is recognised in PSNB as debt interest payments each year, but the actual cash payments do not occur until redemption of the gilt, which may be many years in the future. Since July, the small downward revision to RPI inflation in 2015-16 has further reduced accrued debt interest, with a largely offsetting change in the accruals adjustment. RPI inflation is then up slightly in later years translating into a higher accruals adjustment than in July.

- 4.140 Since our last forecast, HMRC has made significant interim payments in relation to tax litigation cases. These payments do not necessarily affect accrued spending immediately. The interim payments are recorded in the public finances as financial transactions, while any associated spending will only be recorded when the relevant court proceedings have been finalised. We have therefore included an accruals adjustment associated with all tax litigation payments so far in 2015-16 equal to £1.4 billion.

## UK Asset Resolution

- 4.141 The rundown of UKAR's Bradford & Bingley and NRAM plc (B&B and NRAM) loan books directly reduces the net cash requirement, in addition to those loans generating net interest that also reduces net borrowing. As well as this rundown, our July forecast assumed that £11.9 billion would be raised in 2015-16 by the sale of the Granite securitisation vehicle and some related assets. The Government announced in November that it has agreed the sale of these assets for £13 billion. The difference between this amount and our July forecast is largely explained by the sale happening earlier than we had assumed, so the underlying assets had not run down as much as expected. The Government also announced that the assets were sold at a small premium to the book value, which was not factored into our July forecast.
- 4.142 The Government has announced in this Autumn Statement that UKAR will undertake further asset sales totalling £7.5 billion over the course of this Parliament to 2019-20. We consider the information that the Government has provided to us in relation to this announcement is sufficiently firm to allow the effect to be included in our forecast. We have assumed that the proceeds will be equally spread over the period.

## Central government net cash requirement

- 4.143 The central government net cash requirement (CGNCR) is the main determinant of government's net financing requirement. Table 4.31 reconciles CGNCR with PSNCR and Table 4.32 sets out the changes in this reconciliation since July. The CGNCR is derived by adding or removing transactions associated with local authorities and public corporations to the PSNCR.
- 4.144 Cash flows are usually more volatile than the underlying accrued position of the public finances, and reconciling borrowing and estimating the net cash requirement has recently proved difficult. The net cash requirement has come in lower than the bottom-up receipts,

expenditure and financial transactions forecasts we use to project it would suggest. In Box 4.3 of our July *EFO* we discussed a number of changes we had made to our forecast as we explored the reasons for this discrepancy. After those changes, we retained a £2.0 billion a year 'alignment adjustment' for factors that we expected to persist. Since July, the Treasury and ONS have carried out further work on reconciling PSNB and PSNCR. This has uncovered a number of relatively small receipts lines that were affecting PSNCR but not PSNB. They amount to around £0.6 billion a year and have now been added to our receipts and spending forecasts (some score as negative spending). We have therefore subtracted £0.6 billion a year from the alignment adjustment we make between the PSNB and PSNCR forecasts.

4.145 The classification of B&B and NRAM plc and Network Rail in the central government sector means that the CGNCR is no longer simply a measure of the cash required by the Exchequer to fund its operations, which forms the basis for the Government's net financing requirement.<sup>21</sup> This has three effects:

- the banks' own cash requirements are included in the headline CGNCR. Running down the banks' loan books (including through asset sales) reduces the CGNCR by almost £18 billion in 2015-16, falling to around £2 billion by 2020-21, but this does not directly affect the Exchequer (this forecast is shown towards the bottom of Table 4.29);
- interactions between the Exchequer and these bodies net off within the headline measure. The banks' loan repayments to the Exchequer vary from around £2 billion to £7 billion a year; and
- the Treasury will finance Network Rail's new and maturing debt in future, for which Network Rail will pay a fee. Refinancing needs are projected at £3 billion in 2015-16 but decline over time.

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<sup>21</sup> The Government is publishing a revised financing remit for 2015-16 alongside the Spending Review and Autumn Statement. The OBR provides the Government with the forecast of the CGNCR for this purpose, but plays no further role in the derivation of the net financing requirement.

Table 4.31: Reconciliation of PSNCR and CGNCR

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Public sector net cash requirement (NCR)</b>	<b>61</b>	<b>60</b>	<b>33</b>	<b>9</b>	<b>-3</b>	<b>5</b>
<i>of which:</i>						
Local authorities and public corporations NCR	2	2	1	-1	-2	0
Central government (CG) NCR own account	59	58	33	9	-1	6
CGNCR own account	59	58	33	9	-1	6
Net lending within the public sector	2	1	1	1	1	1
<b>CG net cash requirement</b>	<b>61</b>	<b>60</b>	<b>34</b>	<b>11</b>	<b>1</b>	<b>7</b>
B&B and NRAM adjustment	11	2	-3	1	1	1
Network Rail adjustment	3	2	1	1	-1	0
<b>CGNCR ex. B&amp;B, NRAM and Network Rail</b>	<b>75</b>	<b>64</b>	<b>32</b>	<b>13</b>	<b>1</b>	<b>7</b>

Table 4.32: Changes in the reconciliation of PSNCR and CGNCR

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Public sector net cash requirement (NCR)</b>	<b>10</b>	<b>4</b>	<b>2</b>	<b>-2</b>	<b>2</b>	<b>-2</b>
<i>of which:</i>						
Local authorities and public corporations NCR	4	1	1	1	1	2
Central government (CG) NCR own account	6	3	1	-2	1	-4
CGNCR own account	6	3	1	-2	1	-4
Net lending within the public sector	0	0	0	0	0	0
<b>CG net cash requirement</b>	<b>6</b>	<b>3</b>	<b>1</b>	<b>-2</b>	<b>1</b>	<b>-4</b>
B&B and NRAM adjustment	0	0	0	0	0	0
Network Rail adjustment	0	0	0	0	0	0
<b>CGNCR ex. B&amp;B, NRAM and Network Rail</b>	<b>4</b>	<b>4</b>	<b>-2</b>	<b>-1</b>	<b>2</b>	<b>-3</b>

## Key fiscal aggregates

4.146 Our central forecast for the key fiscal aggregates incorporates the forecast for receipts, expenditure and financial transactions set out earlier in this chapter. In this section we explain the changes in five key fiscal aggregates:

- **public sector net borrowing:** the difference between total public sector receipts and expenditure on an accrued basis each year. As the widest measure of borrowing, PSNB is a key indicator of the fiscal position. We focus on it when explaining the reasons for changes since the previous forecast. It is also now the target measure for the Government's fiscal mandate;
- **cyclically adjusted net borrowing:** public sector net borrowing adjusted to reflect the estimated impact of fluctuations in the economic cycle. It represents an estimate of underlying or 'structural' net borrowing, in other words borrowing we would expect to see if the output gap was zero;

- the **current budget**: the difference between public sector current expenditure and receipts each year. In effect, this is public sector net borrowing excluding borrowing to finance investment;
- the **cyclically adjusted current budget**: the current budget adjusted to reflect the estimated impact of fluctuations in the economic cycle. It was the target measure for the Coalition Government's fiscal mandate in the last Parliament; and
- **public sector net debt**: a stock measure of the public sector's net liability position defined as its gross liabilities minus its liquid assets. In broad terms, it is the stock equivalent of public sector net borrowing, measured on a cash basis rather than an accrued basis. It is used for the Government's supplementary fiscal target (and was also targeted by the Coalition Government in the last Parliament).

### Public sector net borrowing

- 4.147 Since our last forecast in July, the ONS has announced that it will reclassify housing associations from the private to the public sector, taking effect from 2008. It intends to implement that reclassification in the public finances data before Budget 2016. We always try to forecast the public finances consistent with how the ONS will measure them once it has implemented its classification decisions, so that our forecasts will be consistent with that eventual treatment. We have therefore included estimates of the effect on spending, receipts, borrowing and debt in this forecast (described in detail in Annex B).
- 4.148 We expect borrowing to fall by £21.2 billion in 2015-16 (22.4 per cent on a year earlier). That is a bigger drop than would be implied by the public finances data for the first seven months of the year, which showed borrowing down £6.6 billion (10.9 per cent on the same period in 2014-15). There are a number of factors that we expect to push borrowing down at a faster pace in the rest of 2015-16, including policy measures affecting self-assessment receipts, the effect of shifting to a 'slice' system of SDLT in December 2014 (which depresses year-on-year comparisons until November 2015) and pressures on departmental spending subject to Treasury controls (including the effect of in-year spending cuts that the Government announced in June and the usual changes in spending profiles from year-to-year). We also include a number of receipts that are not currently included in outturn data, but that we expect to be in future (as described in Box 4.1).
- 4.149 So that changes in our latest forecast can be compared with July on a like-for-like basis, we have shown what our July forecast would have looked like if housing associations had been included in the public sector then. We have included an estimate of the effect in 2014-15 so that year-on-year changes in 2015-16 remain meaningful, but we have not adjusted any outturn data for prior years.
- 4.150 Table 4.33 sets out how changes due to the housing association reclassification, our underlying forecast judgements and the Government's policy decisions have affected our forecast for public sector net borrowing. It shows that:

- we estimate that **housing associations** would have added £4.6 billion to our July forecast in 2015-16, but diminishing amounts thereafter. The fall in borrowing after 2015-16 reflects the effect on their capital spending of the July Budget measures to force social landlords to reduce rents by 1 per cent a year for four years and to require certain tenants to 'pay to stay' in their accommodation. We assume that the resulting fall in housing associations' rental income will lead to a greater fall in their capital spending, rather than the one-to-one relationship we assumed for our economy forecast in July. This has led to a declining path for housing associations' net borrowing on the basis of Government policy as it stood in July;
- we have revised up our **pre-measures receipts forecast** (which reduces borrowing and therefore shows up as negative figures in the table). Stronger-than-expected income tax and corporation tax receipts this year have boosted all years of the forecast. Improved modelling of national insurance contributions and correcting a systematic overestimate of VAT deductions has also raised receipts. Partly offsetting that, we have revised down stamp duty land tax receipts reflecting a substantial fall in the number of transactions at very high prices. The net boost to receipts peaks in 2017-18 and then declines as slightly lower nominal GDP growth reduces income taxes in particular;
- our **pre-measures forecast for AME spending** is higher in the near term, but lower in the latter part of the forecast. Welfare spending, particularly on disability benefits, and local authority spending are higher than expected. But debt interest spending is revised down by increasing amounts from 2016-17 onwards, reflecting lower interest rates and an assumed delay to the reversal of quantitative easing;
- the **direct effect of the Government's policy decisions** has been to push borrowing higher between 2016-17 and 2019-20, but to increase the surplus in 2020-21. The Government has chosen to increase departmental current spending across the Spending Review period, but to reduce it in 2020-21. It has also raised departmental capital spending in the first half of the Spending Review period but reduced it slightly in the second half. Then in 2020-21 it has added £6.4 billion to capital spending. Policy measures on the Treasury's 'scorecard' include tax rises in every year, plus welfare giveaways in the near term (reversing July's main cuts to tax credits) that are more than offset by other welfare cuts by the end of the forecast. The Government has also announced that some local authorities will be allowed to raise council tax faster than previously assumed to meet some of the costs of social care and policing. That raises tax and local authority spending, with an almost neutral effect on borrowing; and
- the net **indirect effects** on the public finances of the Government's decisions are small. Positive effects include the boost to revenues from the near-term increase in GDP growth, while smaller cuts to central government workforces (from higher RDEL) increase pension contributions and so reduce net spending on public service pensions. Working in the opposite direction, helping some local authorities to raise council tax will push up debt interest costs (via its impact on the Retail Prices Index), while the imposition of the apprenticeship levy will reduce tax revenues by weakening earnings

growth. (Lower earnings growth also reduces the amount by which the triple lock updates the state pension, thereby reducing spending a little too.)

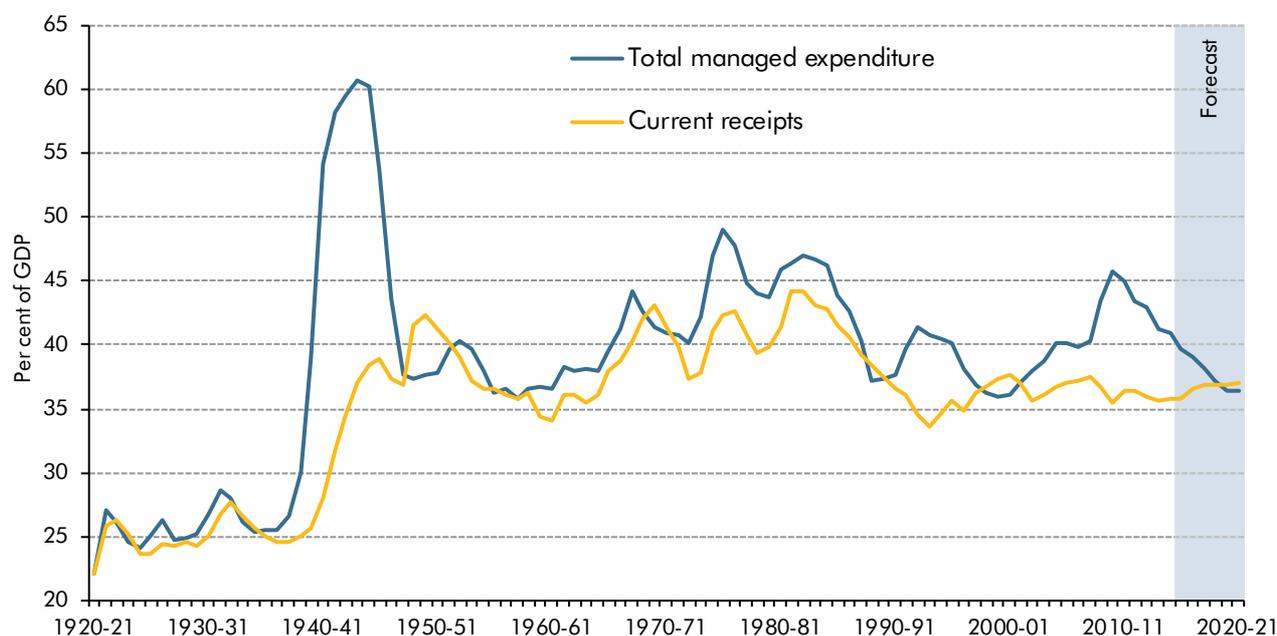
Table 4.33: Public sector net borrowing since July

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>July forecast</b>	<b>89.2</b>	<b>69.5</b>	<b>43.1</b>	<b>24.3</b>	<b>6.4</b>	<b>-10.0</b>	<b>-11.6</b>
Housing associations reclassification	4.5	4.6	3.5	2.3	1.8	1.4	1.6
<b>July forecast restated to include HAs</b>	<b>93.7</b>	<b>74.1</b>	<b>46.7</b>	<b>26.5</b>	<b>8.2</b>	<b>-8.5</b>	<b>-10.0</b>
<b>Total forecast changes</b>	<b>0.9</b>	<b>-0.5</b>	<b>-2.9</b>	<b>-7.9</b>	<b>-8.0</b>	<b>-3.8</b>	<b>-4.4</b>
<i>of which:</i>							
Receipts	-1.5	-2.5	-4.1	-6.3	-5.4	-2.8	-2.8
AME spending	2.4	2.1	1.4	-1.4	-2.3	-0.8	-1.4
Revisions to DEL spending	0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
<b>November forecast pre-policy decisions</b>	<b>94.7</b>	<b>73.6</b>	<b>43.8</b>	<b>18.6</b>	<b>0.2</b>	<b>-12.3</b>	<b>-14.4</b>
<b>Total effect of Government decisions</b>		<b>-0.1</b>	<b>6.2</b>	<b>6.2</b>	<b>4.4</b>	<b>2.2</b>	<b>-0.3</b>
<i>of which:</i>							
Scorecard receipts measures		-0.3	-0.6	-4.5	-4.6	-5.5	-5.3
Scorecard AME spending measures		0.0	2.6	1.7	0.3	-0.7	-1.1
Non-scorecard measures		0.0	-0.4	0.1	0.5	0.5	1.2
Changes to RDEL spending		0.3	2.3	6.5	9.3	8.3	-3.6
Changes to CDEL spending		-0.1	2.9	3.3	-0.4	-0.3	6.4
Indirect effect of Government decisions		0.0	-0.6	-0.9	-0.7	-0.1	2.0
<b>November forecast</b>	<b>94.7</b>	<b>73.5</b>	<b>49.9</b>	<b>24.8</b>	<b>4.6</b>	<b>-10.1</b>	<b>-14.7</b>
<b>Change on a like-for-like basis</b>	<b>0.9</b>	<b>-0.6</b>	<b>3.3</b>	<b>-1.7</b>	<b>-3.6</b>	<b>-1.6</b>	<b>-4.7</b>
<i>Memo: November forecast excluding housing association reclassification</i>	<i>90.1</i>	<i>68.9</i>	<i>46.8</i>	<i>22.4</i>	<i>2.2</i>	<i>-12.1</i>	<i>-17.6</i>

Note: This table uses the convention that a negative figure means a reduction in PSNB, i.e. an increase in receipts or a reduction in spending will have a negative effect on PSNB.

4.151 Chart 4.10 shows current receipts and total managed expenditure as a share of GDP since 1919-20 using Bank of England and ONS data. Our forecast includes the effect of including housing associations in the public sector – which raises both spending and receipts – but we have not adjusted any historical data to reflect the prospective ONS revisions back to 2008, when this is included in their outturn data. Total spending falls to 36.4 per cent of GDP, which is the lowest since 2000-01. Current receipts as a share of GDP are forecast to remain at similar levels to those seen over the last few decades.

Chart 4.10: Total public sector spending and receipts



Source: Bank of England, ONS, OBR

### Cyclically adjusted net borrowing (the structural fiscal position)

- 4.152 Our estimate of the margin of spare capacity in the economy is small in 2015-16 at just 0.7 per cent of potential output and we expect this 'output gap' to close in 2018-19. So the path of structural borrowing is similar to that of headline borrowing described above.
- 4.153 The year-on-year change in the structural budget deficit – public sector net borrowing adjusted for the size of the output gap – is a common measure of the pace of fiscal consolidation. It has drawbacks when estimates of potential output change significantly, but is more useful when, as currently appears the case, potential output growth is more stable. On this metric, the pace of fiscal tightening averages 1.0 per cent of GDP a year over the next four years, slightly more than the 0.9 per cent of GDP a year we forecast in July.

### Current budget

- 4.154 The inclusion of housing associations in the public sector improves the current budget, because their gross operating surplus lifts receipts by more than their interest payments raise current spending (see Annex B). Their capital spending net of depreciation adds to public sector net investment.
- 4.155 The current budget balance, which excludes borrowing to finance net investment spending, is estimated to have been in deficit by £59.7 billion in 2014-15 (excluding the current surplus of housing associations), down from a peak of £104.6 billion in 2009-10. Our latest forecast, including the effect of housing associations, shows the current budget moving into surplus in 2017-18 and the surplus increasing thereafter to reach £56.0 billion in 2020-21.

## Cyclically adjusted current budget

4.156 We expect the cyclically adjusted current budget (CACB), including our estimate of the effect of housing associations, to move from a deficit of 1.6 per cent of GDP in 2015-16 to a surplus in 2017-18. The surplus rises to 2.4 per cent of GDP in 2020-21. The CACB balance is weaker between 2016-17 and 2018-19, reflecting the Government's decision to slow the pace of fiscal consolidation. The surplus is then slightly bigger in 2019-20. The output gap is assumed to close in 2018-19, so by the end of the forecast period our estimate of the CACB is equal to the headline current balance at £56.0 billion.

## Public sector net debt

4.157 We expect public sector net debt (PSND) to have peaked as a percentage of GDP in 2014-15 and to fall in every year of the forecast to reach 71.3 per cent of GDP in 2020-21. Table 4.34 shows how our forecast has changed since July. At that time we highlighted the risk that the Government's decision to force housing associations to cut rents by 1 per cent a year for four years might prompt the ONS to reconsider their classification as private sector entities – and that if they were reclassified to the public sector it would lead to a significant rise in the level of PSND. That has in fact happened, with effect from 2008. We estimate that our July forecast for PSND would have been between 3.1 and 3.4 per cent of GDP higher over the forecast period if housing associations had been classified in the public sector at that time.

4.158 Abstracting from the housing associations reclassification, our forecast for PSND has been revised down since July. That reflects:

- upward revisions to the level of **nominal GDP** in Blue Book 2015, which lower the debt-to-GDP ratio in every year of the forecast;
- **cumulative borrowing** across the forecast has been revised down slightly, measured on a like-for-like basis. That reflects a downward revision in our pre-measures forecast for borrowing, partly offset by the impact of the Government's policy decisions, which increase spending by more in aggregate than they increase revenue;
- the Bank of England announced in November that it would keep the stock of gilts held in the **Asset Purchase Facility (APF)** at £375 billion until Bank Rate reaches a level from which it can be cut materially. The MPC currently judge this to be around 2 per cent – a level that markets are not pricing in until beyond our five-year horizon.<sup>22</sup> This reduces debt interest spending (and thus borrowing). But it also increases PSND because the nominal (as opposed to the market) value of the gilts the APF holds exceeds the value of the reserves the Bank created to purchase them. (In other words, the Bank pays more for the gilts than they will be worth on redemption.) This effect diminished over time in our previous forecast, as the Bank was assumed to stop buying gilts to replace those that were redeemed from early 2016-17. So the decision to

<sup>22</sup> See "The MPC's asset purchases as Bank Rate rises", a box in the November 2015 *Inflation Report*.

continue doing so for longer adds increasing amounts to PSND, reaching £18 billion by 2020-21. (Netting off the debt interest saving, the total increase in PSND is £12 billion;

- there have been a number of changes to our forecast for **asset sales**. We have revised up the expected proceeds from UKAR sales, with the Granite sale having been completed earlier in the year than we expected and further sales having been announced on top of the natural rundown of UKAR's assets. Conversely, we no longer expect the first student loan book sale to be completed in 2015-16, while the Royal Mail share sale raised less than expected (partly due to a lower share price and partly because the Government chose to give more shares to Royal Mail staff for free). We have also revised down the expected proceeds from the remaining Lloyds share sales, to reflect both the current share price and the Government's intention to give some 'bonus' shares away to retail investors. The Government has also announced that it will sell a further £5.8 billion of RBS shares in 2020-21; and
- **other changes** include a lower adjustment to align our forecasts of the net cash requirement and net borrowing (an effect that is offset within borrowing), as well as small changes to gilt premia.

Table 4.34: Changes in public sector net debt since July

	Per cent of GDP						
	Estimate	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
<b>July forecast</b>	<b>80.8</b>	<b>80.3</b>	<b>79.1</b>	<b>77.2</b>	<b>74.7</b>	<b>71.5</b>	<b>68.5</b>
Housing association reclassification							
Per cent of GDP	3.2	3.3	3.4	3.3	3.3	3.2	3.1
£ billion	59	64	67	69	71	72	74
<b>July forecast restated to include HAs</b>	<b>84.0</b>	<b>83.6</b>	<b>82.5</b>	<b>80.6</b>	<b>78.0</b>	<b>74.7</b>	<b>71.6</b>
<b>Change</b>	<b>-0.9</b>	<b>-1.2</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-0.7</b>	<b>-0.4</b>	<b>-0.3</b>
of which:							
Change in nominal GDP <sup>1</sup>	-1.0	-1.3	-1.3	-1.3	-1.3	-1.2	-0.9
Change in cash level of net debt	0.0	0.2	0.5	0.6	0.5	0.8	0.6
<b>November forecast</b>	<b>83.1</b>	<b>82.5</b>	<b>81.7</b>	<b>79.9</b>	<b>77.3</b>	<b>74.3</b>	<b>71.3</b>
	£ billion						
July forecast restated to include HAs	1545	1596	1643	1672	1690	1691	1700
November forecast	1546	1599	1652	1685	1702	1708	1715
<b>Change in cash level of net debt</b>	<b>1</b>	<b>4</b>	<b>10</b>	<b>12</b>	<b>12</b>	<b>18</b>	<b>14</b>
of which:							
Borrowing	1	0	4	2	-2	-3	-8
APF gilt valuation effect	0	0	4	8	12	17	18
UKAR and other asset sales	0	4	1	1	0	0	-5
Gilt premia	0	-2	1	-1	-1	0	-1
Lending	0	-1	0	1	1	3	6
CGNCR adjustment	0	1	1	2	2	3	3
Other factors	0	2	-1	0	-1	-2	0

<sup>1</sup> Non-seasonally-adjusted GDP centred end-March.

Table 4.35: Fiscal aggregates

	Per cent of GDP						
	Estimate 2014-15	Forecast					
		2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Receipts and expenditure</b>							
Public sector current receipts (a)	35.8	35.8	36.5	36.9	36.9	36.9	37.1
Total managed expenditure (b)	40.9	39.7	39.1	38.1	37.2	36.5	36.4
<i>of which:</i>							
Public sector current expenditure (c)	36.8	35.9	35.2	34.4	33.6	33.0	32.6
Public sector net investment (d)	2.0	1.8	1.8	1.6	1.4	1.4	1.8
Depreciation (e)	2.1	2.1	2.1	2.1	2.1	2.1	2.1
<b>Deficit</b>							
Current budget deficit (c+e-a)	3.1	2.1	0.7	-0.4	-1.2	-1.9	-2.4
Cyclically-adjusted deficit on current budget	2.4	1.6	0.5	-0.5	-1.2	-1.9	-2.4
Cyclically-adjusted net borrowing	4.4	3.4	2.3	1.1	0.2	-0.5	-0.6
Primary balance	-3.5	-2.2	-0.6	0.7	1.7	2.3	2.4
Cyclically-adjusted primary balance	-2.7	-1.7	-0.4	0.8	1.7	2.3	2.4
<b>Fiscal mandate and supplementary target</b>							
Public sector net borrowing (b-a)	5.2	3.9	2.5	1.2	0.2	-0.5	-0.6
Public sector net debt <sup>1</sup>	83.1	82.5	81.7	79.9	77.3	74.3	71.3
<b>Financing</b>							
Central government net cash requirement	4.6	3.2	3.0	1.6	0.5	0.0	0.3
Public sector net cash requirement	4.0	3.2	3.0	1.6	0.4	-0.1	0.2
<b>Stability and Growth Pact</b>							
Treaty deficit <sup>2</sup>	5.1	3.9	2.5	1.3	0.3	-0.3	-0.6
Cyclically-adjusted Treaty deficit	4.3	3.5	2.3	1.2	0.3	-0.3	-0.6
Treaty debt ratio <sup>3</sup>	87.5	87.1	86.5	84.8	82.2	79.2	76.0
£ billion							
Public sector net borrowing	94.7	73.5	49.9	24.8	4.6	-10.1	-14.7
Current budget deficit	57.4	39.9	14.2	-8.6	-26.0	-42.3	-56.0
Cyclically-adjusted net borrowing	80.2	64.2	44.7	22.8	4.2	-10.2	-14.7
Cyclically-adjusted deficit on current budget	43.0	30.6	8.9	-10.6	-26.4	-42.4	-56.0
Public sector net debt	1546	1599	1652	1685	1702	1708	1715
<i>Memo: Output gap (per cent of GDP)</i>	-0.8	-0.7	-0.3	-0.1	0.0	0.0	0.0

<sup>1</sup> Debt at end March; GDP centred on end March.

<sup>2</sup> General government net borrowing on a Maastricht basis.

<sup>3</sup> General government gross debt on a Maastricht basis.

## The path from deficit to surplus

**4.159** In the wake of the last recession and financial crisis, public sector net borrowing (PSNB) peaked in 2009-10 at £153.5 billion (10.2 per cent of GDP). Over the subsequent five-year Parliament, the Coalition Government completed the reversal of the previous Labour Government's fiscal stimulus and then embarked on a programme of fiscal consolidation.

**4.160** The spending cuts and tax increases that it implemented were larger and more rapid than Labour had planned, but the deficit nonetheless fell more slowly than expected. By 2014-

15, net borrowing had fallen to £90.1 billion (4.9 per cent of GDP), some £52.7 billion (2.8 per cent of GDP) higher than we forecast at the time of the Coalition's first Budget.<sup>23</sup>

4.161 The new Conservative Government's fiscal plans, set out in preliminary form in its Summer Budget in July and now revised and detailed in this Spending Review and Autumn Statement, aim to deliver a surplus of £10.1 billion in 2019-20 (0.5 per cent of GDP) and to maintain a surplus thereafter. In this section, we compare the deficit reduction seen over the previous Parliament with that planned over this Parliament. We show that the planned composition is different.

## Deficit reduction under the Coalition

4.162 Between 2009-10 and 2014-15, net borrowing fell by 5.3 per cent of GDP, slightly more than halving from its peak. (The ONS has not yet published historical data including housing associations in the public sector, so we have based this analysis on current definitions.) The factors contributing (positively and negatively) to the fall in the deficit were:

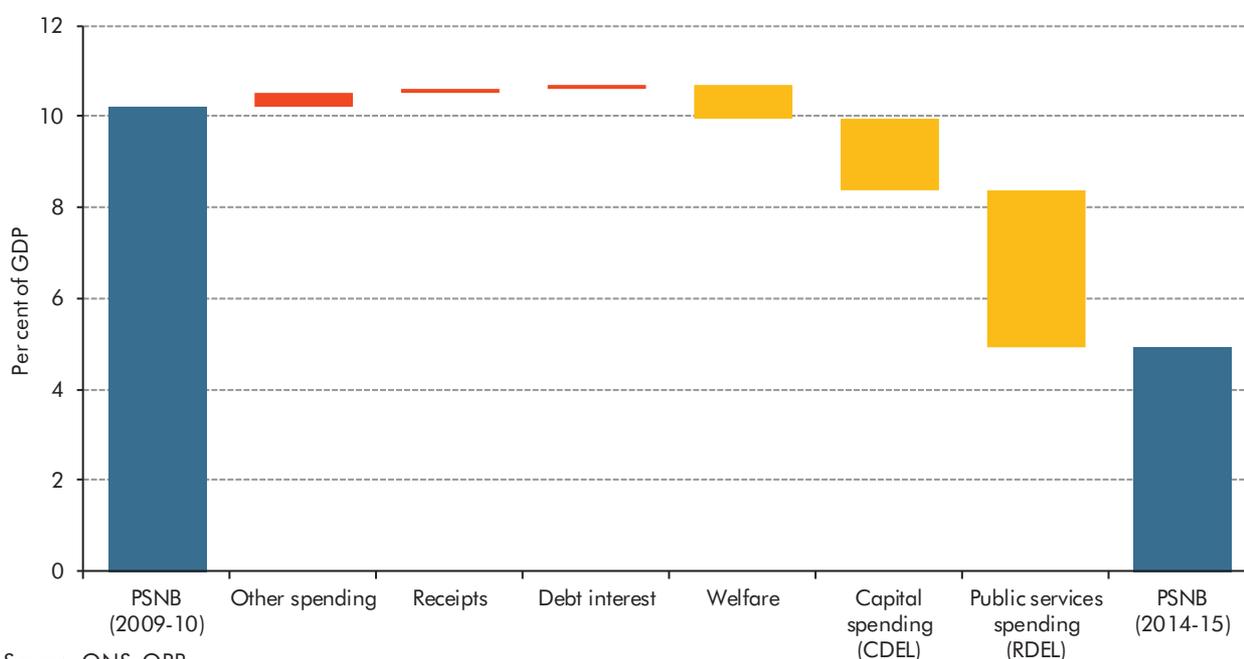
- a relatively small increase in **other AME spending** (0.3 per cent of GDP), mainly due to higher net public service pension costs (via lower contributions from a shrinking workforce and demographic pressures stemming from more people – who are, on average, living and thus claiming a pension for longer – having hit retirement age);
- an even smaller increase in central government **debt interest** spending (0.1 per cent of GDP). The impact of much higher cash debt was offset by lower government borrowing costs. That reflected lower gilt yields, plus the impact of quantitative easing, which in effect allows the Government to finance some of its debt at Bank Rate, which was just 0.5 per cent throughout the last Parliament;
- little change in **receipts** (0.1 per cent of GDP). Tax increases (notably the increases in the main rate of VAT in January 2010 and January 2011) raised receipts by 2.4 per cent of GDP. This more than offset tax cuts (notably corporation tax, fuel duties and increases in the income tax personal allowance) worth 2.0 per cent of GDP. The resulting net tax increase from policy measures was not large enough to offset the impact of weak earnings growth, associated with subdued productivity, leaving the ratio of receipts to GDP little changed overall;
- lower **welfare spending** (0.7 per cent of GDP). This reflected a number of factors working in both directions. Policy measures reduced spending on working-age benefits and tax credits (including switching uprating from RPI to CPI inflation) but increased spending on state pensions due to the triple lock. However, because CPI inflation outstripped earnings growth, even working-age welfare spending was pushed up as a share of GDP. By contrast, caseloads generally increased less quickly than overall population growth, reflecting tax credits policy measures and economic recovery

<sup>23</sup> We discussed the sources of that 2014-15 PSNB forecast error in our 2015 *Forecast evaluation report*, available on our website.

reducing spending on jobseeker’s allowance. Those effects reduced welfare spending as a share of GDP;

- cuts in **capital spending** (1.6 per cent of GDP). These were concentrated in the early years of the Parliament, where the cuts the Coalition delivered were largely in line with the plans pencilled into the outgoing Labour Government’s March 2010 Budget; and
- around two thirds of the deficit reduction has come from cuts in **day-to-day spending on public services and administration** (3.4 per cent of GDP), with the cuts concentrated in unprotected areas outside the NHS, schools and overseas aid.

Chart 4.11: Sources of deficit reduction from 2009-10 to 2014-15



4.163 We now look in greater detail at some of these components, beginning with the change in receipts (primarily taxes) as a share of GDP, then turning to welfare spending and spending on public services and capital investment.

### Tax receipts

4.164 Receipts as a share of GDP were broadly flat over the last Parliament, falling slightly from 33.1 to 33.0 per cent of GDP. This was driven entirely by tax receipts – the ratio of non-tax receipts to GDP was flat over this period. Focusing on tax receipts, movements in the tax-to-GDP ratio arise from two sources:

- changes in the composition of GDP can lead to specific tax bases growing more or less quickly than the economy as a whole; and
- the effective tax rate paid on each tax base can change due to policy or other factors.

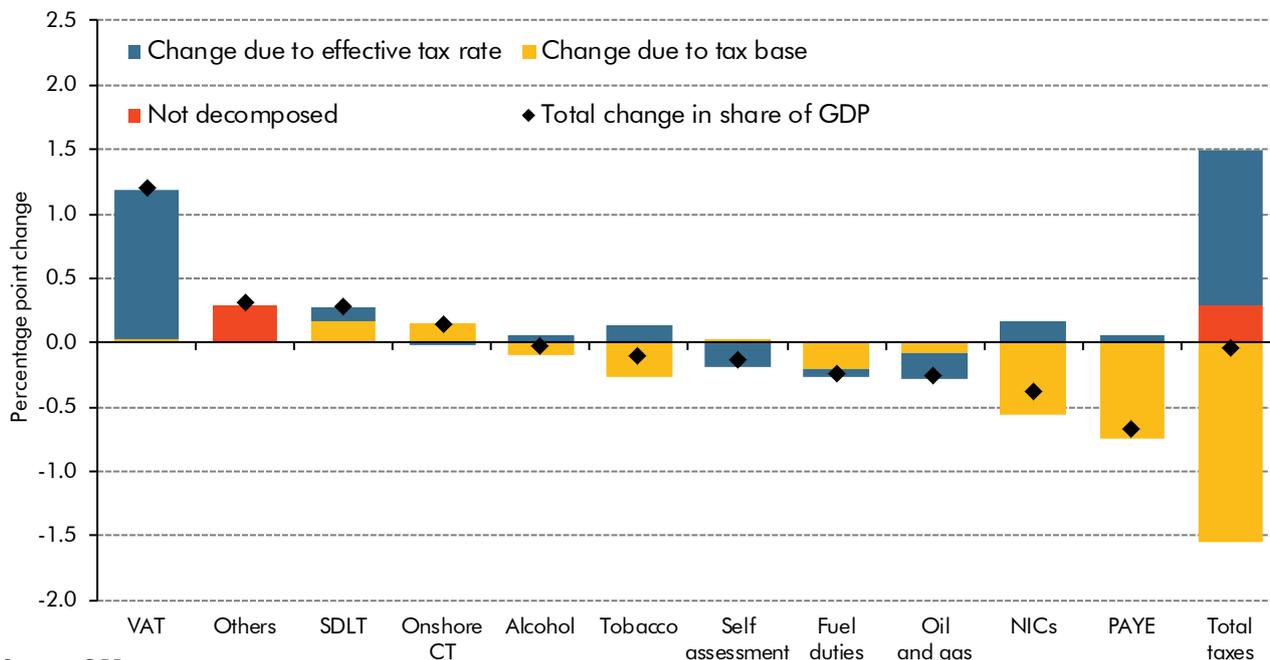
4.165 Chart 4.12 shows that the main sources of the small fall in the tax-to-GDP between 2009-10 and 2014-15 were:

- a 1.2 per cent of GDP fall in **income tax and NICs** receipts. This reflected weak growth in the tax base as average earnings rose by only 6.3 per cent over the period – much more slowly than the 14.6 per cent rise in consumer prices. This was partly offset by a rise in the effective tax rate, reflecting a greater share of receipts coming from higher earners (despite policy measures – in particular increases to the personal allowance – that would on their own have reduced the effective tax rate);
- a 0.4 per cent of GDP fall in **excise duties**. This was explained by declining tax bases, due to falling alcohol, tobacco and fuel consumption. Tobacco and alcohol duty escalators partly offset that, although freezes in headline fuel duty rates contributed to the fall in receipts as a share of GDP; and
- a 0.3 per cent of GDP fall in **oil and gas revenues**. Receipts were reduced by lower production (tax base) and higher tax-deductible expenditure (effective tax rate).

4.166 Largely offsetting these falls were increases from:

- a 1.2 per cent of GDP rise in **VAT** receipts. This was driven almost entirely by the rise in the effective tax rate. That reflected the rise in the main rate of VAT back to 17½ per cent in January 2010 and further to 20 per cent in January 2011, as well as a modest fall in the VAT gap over the period. That was partly offset by a fall in the share of consumer spending on goods and services subject to the standard rate of VAT;
- a 0.3 per cent of GDP rise in **SDLT** receipts. This was driven both by an increase in the tax base (due to the pick-up in house prices and transactions) and an increase in the effective tax rate (due to fiscal drag, as a greater proportion of residential transactions was dragged into higher tax brackets);
- a 0.3 per cent of GDP rise in **other taxes**. This included strong growth in capital gains tax, environmental levies and the introduction of the bank levy in 2011-12; and
- a 0.1 per cent of GDP rise in **onshore corporation tax** receipts. This was driven entirely by an increase in the tax base. That reflected strong growth in commercial and industrial company profits from the depressed level they reached in the recession.

Chart 4.12: Sources of changes to the tax-to-GDP ratio (2009-10 to 2014-15)



Source: OBR

## Welfare spending

4.167 Welfare spending contributed to deficit reduction over the last Parliament, falling from 12.4 per cent of GDP in 2009-10 to 11.7 per cent in 2014-15. Movements in welfare spending as a share of GDP can be decomposed into two main sources:

- changes in the caseload as a share of the population; and
- changes in the average award relative to average incomes.

4.168 Chart 4.13 shows that the main factors pushing welfare spending down as a share of GDP between 2009-10 and 2014-15 were:

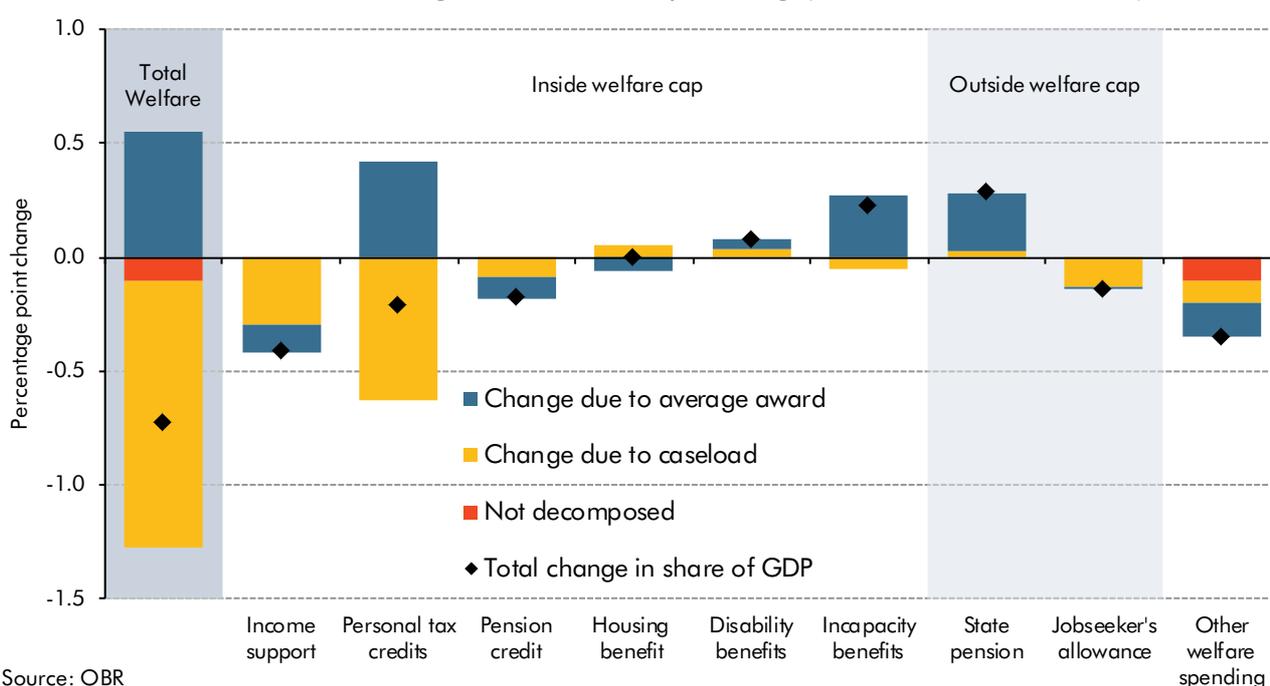
- a 0.4 per cent of GDP fall in spending on **income support (IS)**, as the caseload shifted first to jobseeker's allowance under the lone parent obligation, and second, to ESA as the incapacity element of IS was withdrawn;
- a 0.2 per cent of GDP fall in spending on **tax credits**, as policy-driven reductions cut the caseload by around a quarter (in particular removing eligibility from higher income families and increasing the taper rate), which more than offset the effect of relatively generous discretionary uprating, particularly to the child element of child tax credit;
- a 0.2 per cent of GDP fall in spending on **pension credit**, reflecting caseloads falling as eligibility was linked to the rising female state pension age. Average awards were broadly flat in nominal terms, so fell relative to average incomes; and

- smaller falls in spending on **jobseeker's allowance and associated housing benefit** (as economic recovery reduced the caseload) and **child benefit** (largely due to policy effects, freezing the average award and removing eligibility from higher income families).

4.169 These downward pressures were partly offset by:

- a 0.3 per cent of GDP rise in **state pension spending**. This was entirely driven by average awards rising in line with the Government's triple lock on uprating, which meant state pensions rising faster than GDP per person;
- a 0.2 per cent of GDP rise in spending on **incapacity benefits**. Inflation pushed up average awards relative to earnings, while the savings that were expected to flow from the migration of the caseload to the new employment and support allowance failed to materialise; and
- smaller rises in spending on **disability benefits** (as inflation pushed up average awards) and **housing benefit** (where the in-work caseload increased due to weak earnings growth and a rising share of households living in privately rented accommodation).

Chart 4.13: Sources of changes to welfare spending (2009-10 to 2014-15)



Source: OBR

## Public services spending

4.170 Our forecasts for central government spending on public services, grants and administration are based on the resource departmental expenditure limits (RDEL) set by the Government and our assumptions about any underspending relative to those limits. As such, with the exception of changes to our underspending assumptions or classification changes, any movement in public services spending can be considered a policy change.

4.171 There are different counterfactuals against which such changes could be compared – for example, holding spending flat in real terms or flat as a share of GDP. In this section, we have used the methodology that we apply in our long-term projections, which defines unchanged policy as age- and gender-specific spending per person being held flat as a share of GDP. Under this definition, unchanged policy accommodates upward pressure on some types of spending, notably healthcare, from demographic trends.

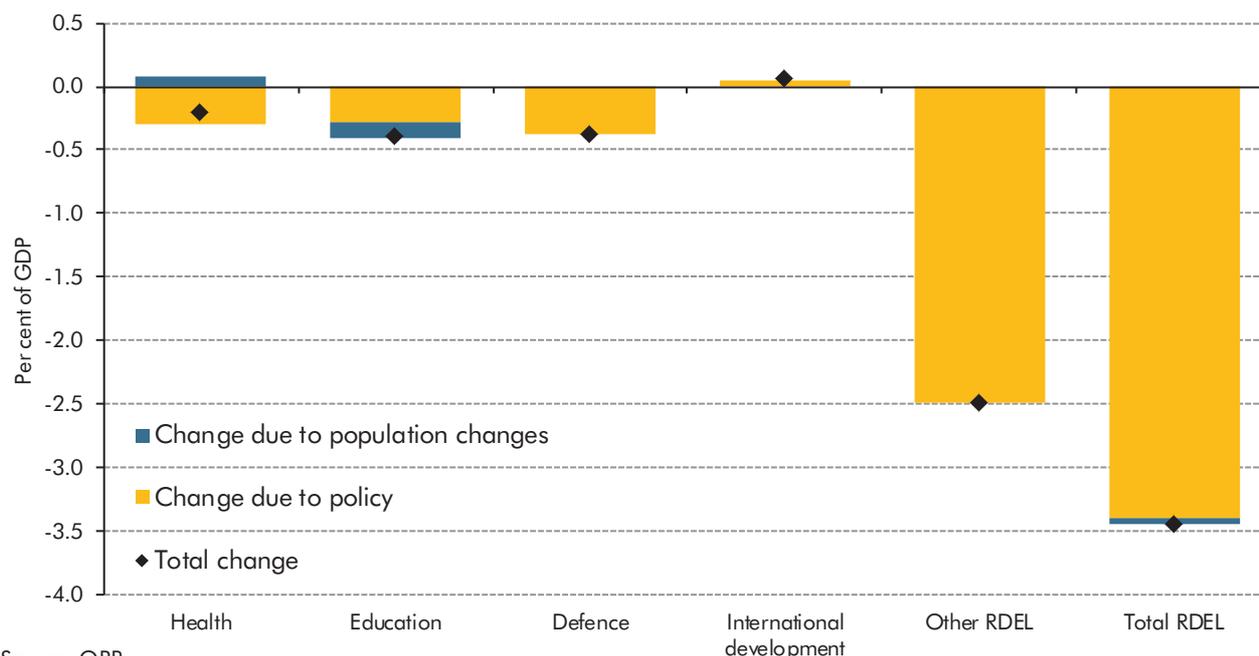
4.172 Using this age-related counterfactual, we can decompose the movements in RDEL spending as a share of GDP into two main sources:

- spending changes arising from changes in age composition of the population; and
- policy and other changes that alter the level of spending relative to that demographically driven counterfactual.

4.173 Demographic pressures on spending over the last Parliament were relatively small. They would have added around 0.1 per cent of GDP to health spending if age-specific spending per person had been held constant as a share of GDP, but would have subtracted around 0.1 per cent of GDP from education spending as the school-age population grew more slowly than the population as a whole. We have adjusted outturn RDEL spending totals to remove the effect of switches between DEL and AME, so virtually all the 3.4 per cent of GDP fall in RDEL spending can therefore be considered policy changes. Chart 4.14 shows that:

- **health** spending fell by 0.2 per cent of GDP in total and by 0.3 per cent of GDP relative to a demographically driven counterfactual. It was up by 6.4 per cent in real terms (adjusted for whole economy inflation);
- **education** spending (a broader definition than the ‘schools’ spending that was protected in the last Parliament and continues to be protected in this Spending Review) fell by 0.4 per cent of GDP in total but by 0.3 per cent of GDP relative to the demographically driven counterfactual. It was down by 3.3 per cent in real terms;
- current spending on **defence** fell by 0.4 per cent of GDP. It was down by 12.7 per cent in real terms;
- current spending on **international development** was up fractionally as a per cent of GDP as a result of the Coalition’s policy of increasing total spending on official development assistance (ODA) to 0.7 per cent of national income. It increased by 26.5 per cent in real terms; and
- **other RDEL** spending fell by 2.5 per cent of GDP or 19.7 per cent in real terms. The departmental resource budgets that were cut most sharply included the Department for Communities and Local Government and the Department for Transport.

Chart 4.14: Sources of changes to RDEL spending (2009-10 to 2014-15)



Source: OBR

### Capital spending

4.174 Central government capital spending (covered by capital departmental expenditure limits (CDEL)) rose by 0.8 per cent of GDP between 2007-08 and 2009-10, to help support the economy during the recession. In its March 2010 Budget, the Labour Government then pencilled in cuts to CDEL spending that amounted to 1.8 per cent of GDP by 2014-15. In the event, the Coalition cut CDEL spending by a slightly smaller 1.6 per cent of GDP. Two government departments, the Department for Education and the Communities part of the DCLG, accounted for around two thirds of the cuts to CDEL spending over this period.

### The planned path to surplus in 2019-20

4.175 We expect public sector net borrowing to fall by 1.3 per cent of GDP this year, to stand at 3.9 per cent of GDP in 2015-16 as a whole. (For the rest of this section, our analysis includes our estimates of the effect of the housing association reclassification that are described in Annex B.) The sources of deficit reduction this year include:

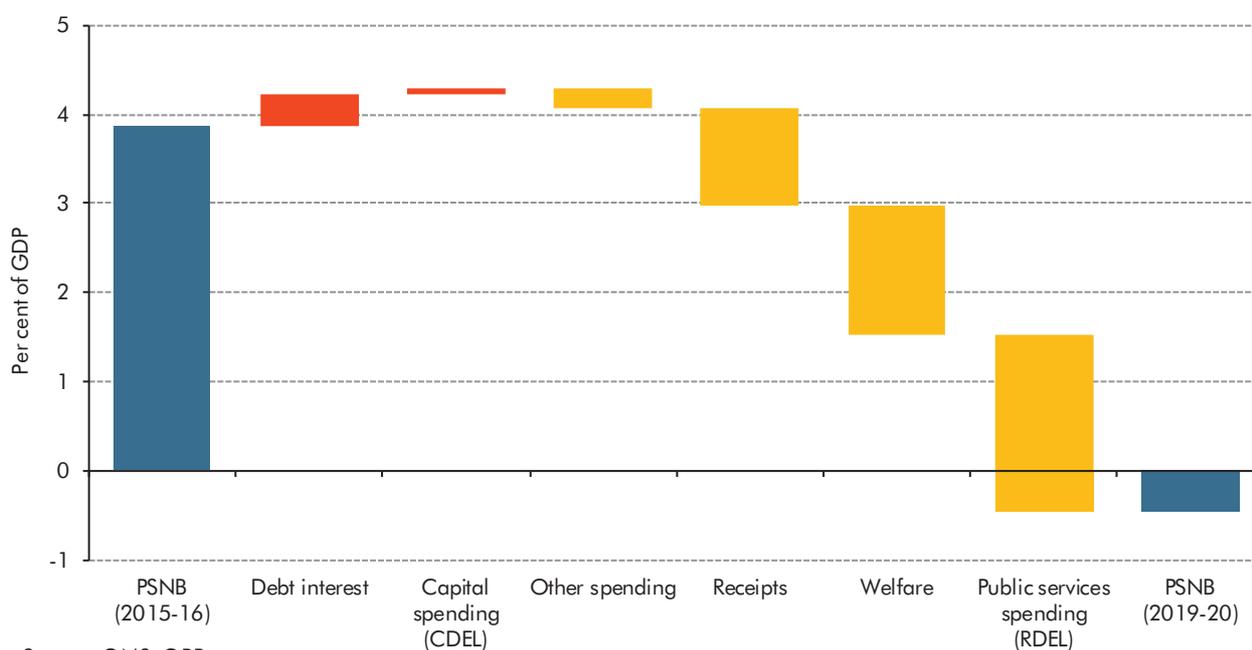
- a 0.8 per cent of GDP fall in **day-to-day spending on public services, grants and administration** (RDEL), which we expect to fall by 0.7 per cent in cash terms this year;
- a 0.3 per cent of GDP fall in **welfare spending** reflecting falls in state pension and pension credit caseloads and a fall in the tax credit average awards and a 0.2 per cent of GDP fall in **capital spending**;
- a 0.1 per cent of GDP rise in **receipts**, in part reflecting stronger growth in income tax and NICs receipts; and

- **debt interest spending** and **other AME** spending are expected to be flat as a share of GDP this year.

4.176 Chart 4.15 shows how, on the basis of our latest forecast, the Government intends to remove the remaining deficit and deliver a headline budget surplus of 0.5 per cent of GDP in 2019-20. About half the planned reduction is delivered by the RDEL cuts that have been detailed in the Spending Review. The remaining half is explained by increases in receipts and cuts to welfare spending. The main (negative and positive) contributions are:

- **debt interest** spending (net of the savings associated with financing some debt through the Bank of England's Asset Purchase Facility (APF)) is forecast to rise by 0.4 per cent of GDP. This is despite interest rates remaining well below historical averages and our updated assumption that the Government will still be financing around a fifth of its debt at Bank Rate through the APF in 2019-20. That is because market expectations point to interest rates rising more quickly (in year-on-year terms) than GDP growth, while we expect RPI inflation to push up the cost of servicing index-linked gilts. That more than offsets the effect of debt falling as a share of GDP in every year of the forecast;
- a small increase in **departmental capital spending** (0.1 per cent of GDP);
- small reductions in **other AME spending** excluding spending on debt interest and welfare (less than 0.2 per cent of GDP);
- a 1.1 per cent of GDP rise in **receipts**. This is largely due to income tax and NICs receipts rising by 1.2 per cent of GDP, which in turn reflects the resumption of fiscal drag, the abolition of the NICs contracting out rebate in 2016-17 and the effect from other policy measures. This is partly offset by smaller falls across other taxes;
- a 1.5 per cent of GDP fall in **welfare spending**. This mostly reflects average awards rising more slowly than earnings, partly due to policies announced in July and despite the changes announced in this Autumn Statement. Spending subject to the welfare cap accounts for 1.2 per cent of GDP of the fall, while spending outside the cap falls by just 0.2 per cent of GDP. Spending on state pensions, which are outside the welfare cap, continues to be uprated with the triple-lock, so – unlike most working-age benefits – average state pension awards do not fall relative to earnings and state pension spending only falls slightly as a share of GDP (as explained below); and
- cuts in **day-to-day spending on public services, grants and administration**, reflecting RDEL totals for 2016-17 onwards that have been detailed in the Spending Review, contributes 2.0 per cent of GDP to the movement from deficit to surplus – the largest share at 46 per cent of the total. This represents a smaller contribution to the overall change than was the case in July (2.4 per cent) and a much smaller contribution than had been implied in the Coalition Government's last Budget in March (3.6 per cent).

Chart 4.15: Sources of deficit reduction from 2015-16 to 2019-20



4.177 The three biggest sources of change over the next four years are receipts, welfare spending and departmental RDEL budgets. These changes are explored in more detail in the following sections.

### Tax receipts

4.178 Using the same approach described above, Chart 4.16 shows that the main sources of the 1.0 per cent of GDP rise in tax receipts between 2015-16 and 2019-20 are:

- a 1.0 per cent of GDP rise in **PAYE income tax and NICs** receipts. This is driven almost entirely by a rise in the effective tax rate. Most of this is explained by the return of fiscal drag, as productivity and real earnings growth are assumed to pick up, dragging more income into higher tax brackets. The Budget 2013 policy decision to abolish the NICs contracting out rebate from April 2016 is expected to raise NICs receipts by around £5 billion in 2016-17 (0.3 per cent of GDP), with around half representing a cost to public sector employers;
- a 0.2 per cent of GDP rise in **self-assessment (SA) receipts**. This reflects both the measures announced in the July Budget and at earlier Budgets and Autumn Statements, as well as a recovery in receipts from savings income as interest rates are assumed to rise;
- a 0.2 per cent of GDP rise in **stamp duty land tax (SDLT)** receipts (including its counterpart in Scotland, the land and buildings transactions tax or LBTT). This reflects both the tax base and the effective tax rate. Growth in the tax base reflects rising house prices and property transactions. With SDLT thresholds in the new 'slice' system still

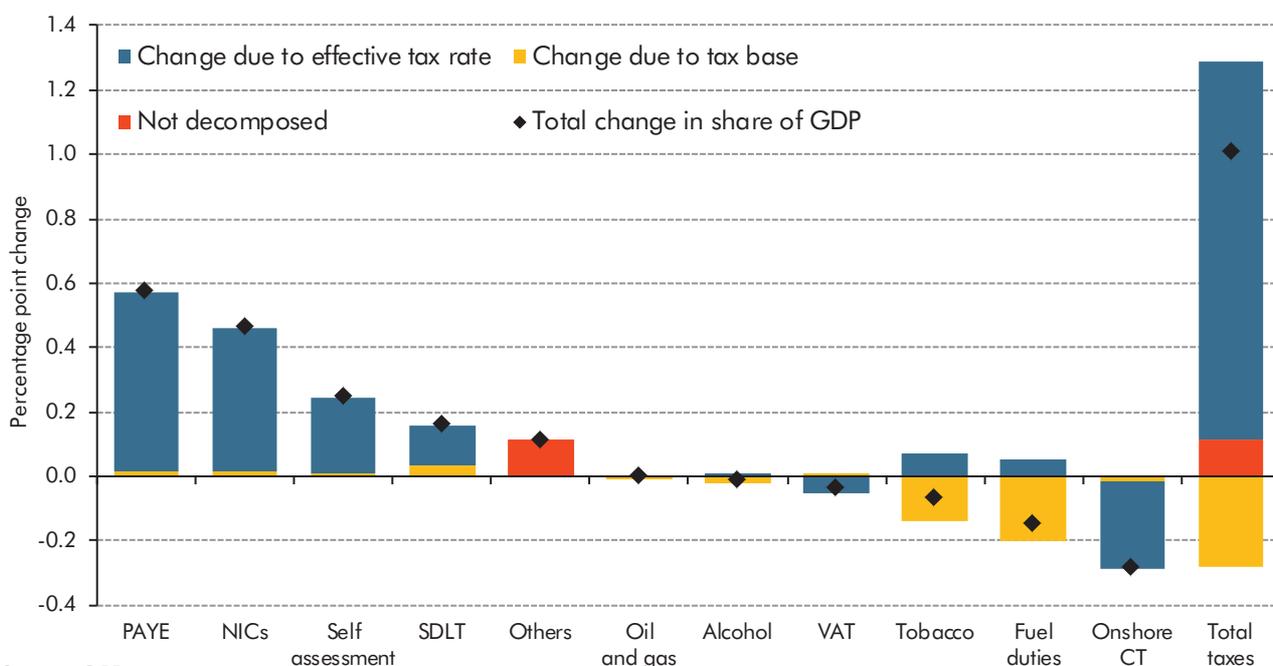
fixed in cash terms over the forecast period, rising house prices drag a greater proportion of the value of residential transactions into higher tax brackets; and

- a small rise in a number of taxes that we have not decomposed into tax base and effective tax rate movements. For example, the **apprenticeship levy** will increase receipts by 0.1 per cent of GDP in 2019-20.

4.179 Partly offsetting these rises are:

- a 0.3 per cent of GDP fall in **onshore corporation tax** receipts. This is driven by a cut in the main corporation tax rate to 19 per cent by 2019-20 and further falls in the effective tax rate as strong growth in investment increases the use of capital allowances and as the financial sector sets past losses against future liabilities. The Government is cutting the main corporation tax rate to 18 per cent in 2020-21;
- a 0.2 per cent of GDP fall in **excise duties**. This is explained by declining tax bases, due to trends in alcohol and tobacco consumption and rising fuel efficiency. These falls are only partly offset by assumed rises in duty rates, raising the effective tax rate; and
- a less than 0.1 per cent of GDP fall in **VAT** receipts. With VAT rates unchanged and consumption expected to grow broadly in line with GDP, it is assumed that increases in the share of household spending devoted to mortgage interest payments – which are zero-rated – will reduce the effective tax rate.

Chart 4.16: Sources of changes in the tax-to-GDP ratio (2015-16 to 2019-20)

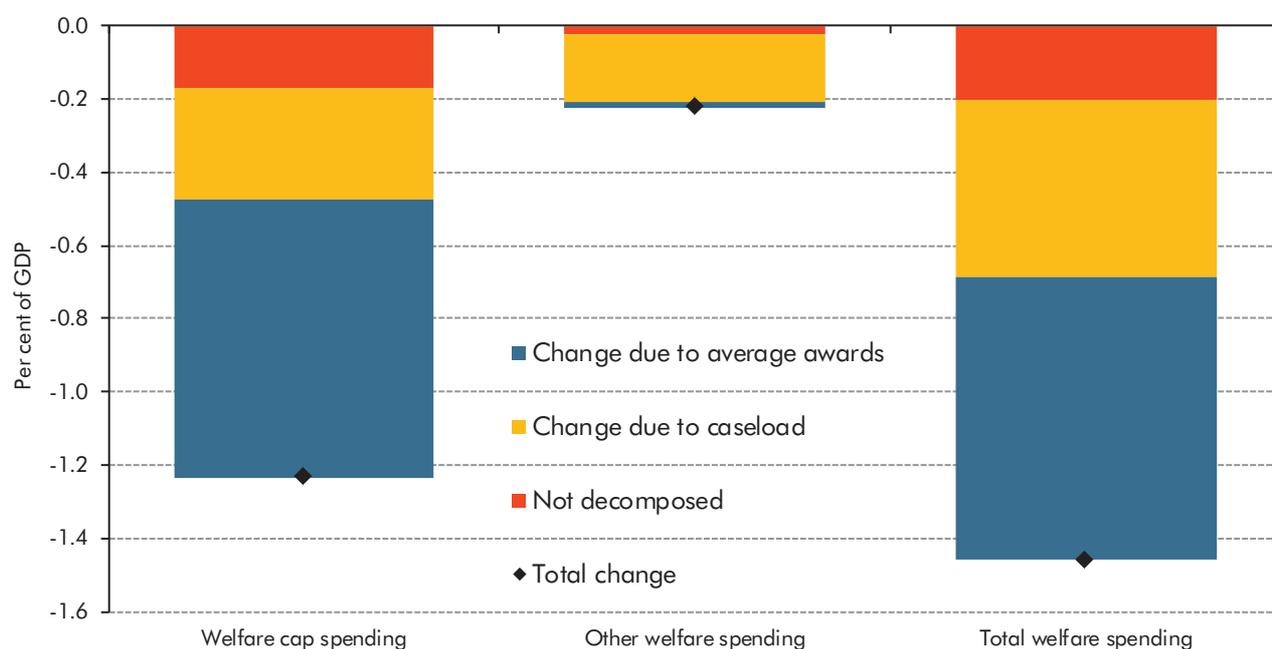


Source: OBR

## Welfare spending

4.180 Chart 4.17 shows that of the 1.5 per cent of GDP fall in welfare spending that we expect between 2015-16 and 2019-20, around a third can be explained by trends in caseloads and around half by trends in average awards. The overwhelming majority of the reduction in spending (85 per cent) occurs on items that are subject to the Government's welfare cap. Lower welfare cap spending is driven by falls in relative average awards and caseloads, while the smaller fall in spending on items outside the cap is driven almost entirely by the caseload falling as a share of the total population.

Chart 4.17: Sources of changes to welfare spending (2015-16 to 2019-20)



Source: OBR

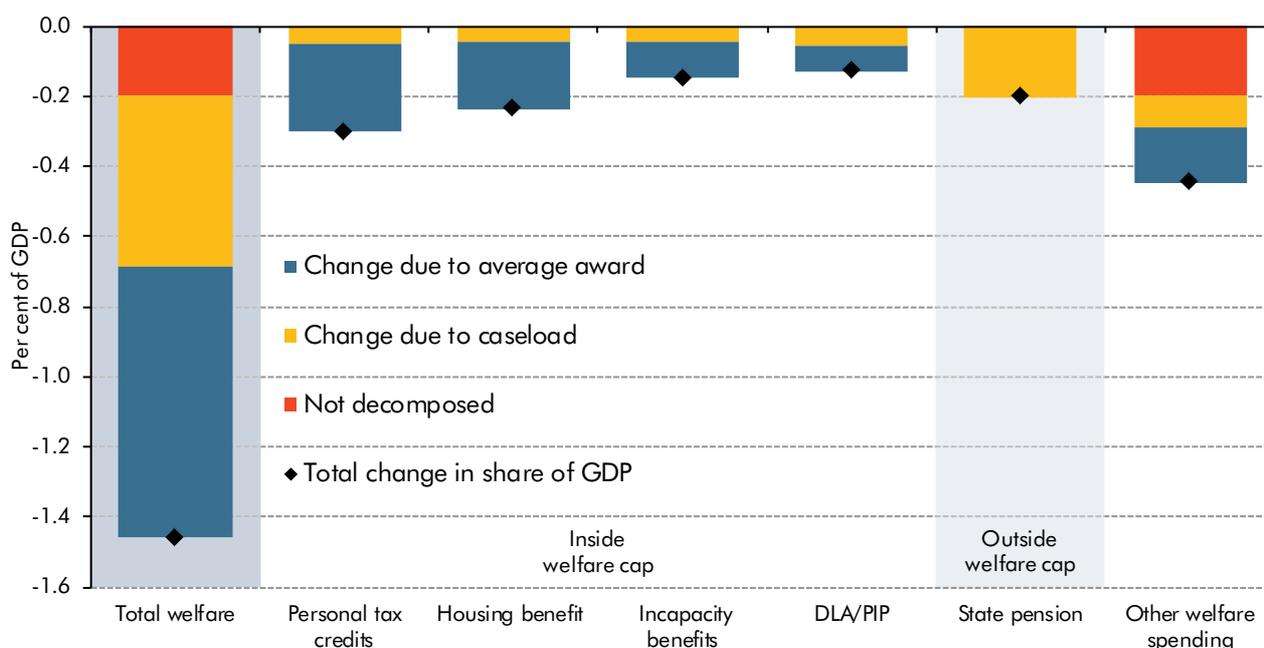
4.181 Chart 4.18 splits the 1.5 per cent of GDP fall in welfare spending into its main components. These include:

- a fall in spending on **tax credits** (0.3 per cent of GDP). Most of this is due to the reduction in average awards and a small proportion due to expected falls in caseload numbers. The freeze in the uprating of tax credits between 2016-17 and 2019-20 means that average awards fall significantly relative to average earnings, reducing spending on tax credits as a share of GDP. Had the July 2015 Budget package of tax credits measures (including reducing the income threshold and increasing the taper rate) not been undone in this Autumn Statement there would have been much greater cuts to both average awards and caseloads in earlier years;
- a 0.2 per cent of GDP fall in spending on **housing benefit** (inside the cap). This is almost entirely driven by a reduction in average awards relative to average earnings, which largely reflects the freeze in working-age benefit uprating and the July 2015 Budget measure forcing social housing landlords to reduce rents by 1 per cent a year

over four years. November measures (capping housing benefit in social housing and limiting temporary absence to 4 weeks) make additional cuts to average awards;

- lower spending on **disability benefits** (0.1 per cent of GDP), due largely to the assumed drop in the caseload associated with migrating claims from DLA to PIP. And lower spending on **incapacity benefits** (0.1 per cent of GDP), largely due to average awards rising more slowly than average earnings. Awards outside the ‘support group’ for ESA have been frozen for four years, like most working-age benefits; and
- a 0.2 per cent of GDP fall in spending on the **state pension**. This is driven entirely by the caseload rising more slowly than the total population as the state pension age rises. In contrast to working-age benefits, the basic state pension award is expected to rise in line with earnings due to the triple lock on uprating, so average awards are not expected to affect state pension spending as a share of GDP.

Chart 4.18: Sources of changes to welfare spending (2015-16 to 2019-20)



Source: OBR

### Public services spending

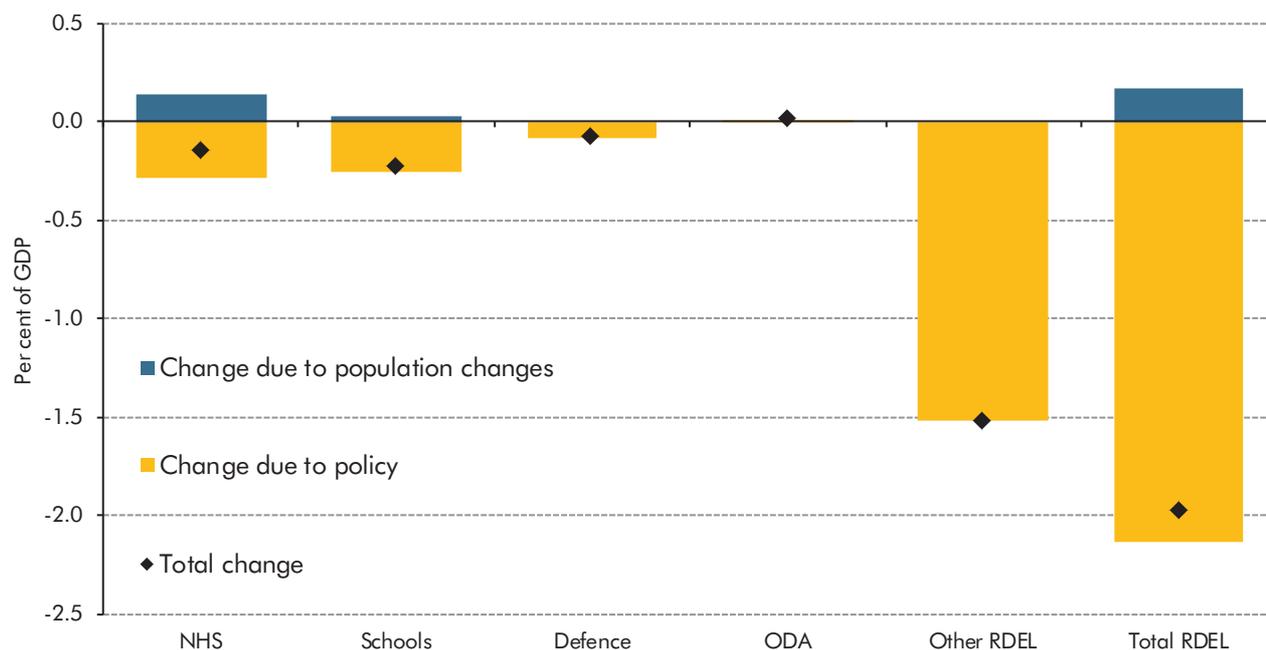
4.182 Using the same approach as set out above – setting a counterfactual for public services spending being driven by demographic trends and otherwise fixed as a share of GDP – the Government has set out plans for departmental current spending over the next four years that represent significant cuts. That said, the cuts are significantly smaller than those pencilled in by the current Government in July and by the Coalition in March.

4.183 The full detail of the Spending Review was still being finalised when our *EFO* was completed, so the following section is based on the firm RDEL totals that had been set for inclusion in our forecast and on information about the main protections to the NHS, schools, defence and overseas aid that the Government has already announced. Together,

it is estimated that the protected areas accounted for 56 per cent of RDEL plans in 2015-16. The figures used below should therefore be sufficiently precise for analysing broad changes in spending as a share of GDP.

- 4.184 Chart 4.19 shows how RDEL spending is set to fall by 2.0 per cent of GDP between 2015-16 and 2019-20. Absent other changes, demographic trends would push spending up by 0.2 per cent of GDP, so the Government's policy choices reduce it relative to that counterfactual by 2.2 per cent of GDP. In today's terms, relative to nominal GDP in 2015-16, that would be equivalent to £40.7 billion. One way in which the Government is planning to reduce RDEL spending as a share of GDP is by holding public sector pay rises to 1 per cent a year for four years, which means that other things equal the public sector paybill would rise more slowly than GDP.
- 4.185 Taking each of the protected areas and the unprotected remainder in turn, it shows that:
- spending on the **NHS** would increase by around 0.1 per cent of GDP (£2.6 billion in today's terms) over that period if age-specific spending was held constant as a share of GDP, because of the pressures associated with an ageing population. In fact, the Government plans to reduce NHS spending by around 0.2 per cent of GDP (£2.9 billion in today's terms) relative to 2015-16 and therefore by around 0.3 per cent of GDP (£5.5 billion in today's terms) relative to a demographically driven counterfactual;
  - spending on **schools** would increase very slightly due to demographic trends. In fact, the Government plans to reduce spending on schools by slightly over 0.2 per cent of GDP (£4.3 billion in today's terms). That is consistent with the terms by which it is protected: flat in cash terms per pupil, so falling in real terms per pupil;
  - spending on **defence** and **official development assistance** are not assumed to be affected by demographic trends in the UK. The Government has committed to meeting the NATO target of spending 2 per cent of GDP on defence and has legislated to protect aid spending as a share of national income. The precise way in which these commitments relate to spending within departmental expenditure limits is not straightforward, but the effect is assumed to leave spending on these items flat as a share of GDP; and
  - spending on **unprotected departments, including grants to local government** are also not assumed to be affected by demographic trends, so the counterfactual against which we compare the Government's plans is spending flat as a share of GDP. In fact, the Government plans to cut spending in these unprotected areas by 1.5 per cent of GDP (£28.9 billion in today's terms). Despite accounting for only 44 per cent of RDEL plans in 2015-16, these areas are set to account for around 75 per cent of total cuts to RDEL as a share of GDP.

Chart 4.19: Sources of changes to RDEL as a share of GDP (2015-16 to 2019-20)



Source: OBR

## Prospects for 2020-21

4.186 Beyond the period for which detailed spending plans are being set, we expect the surplus to rise by 0.2 per cent of GDP in 2020-21. That change is driven by:

- a 0.2 per cent of GDP fall in **welfare** spending. Government policy on uprating means that average awards rise more slowly than average incomes;
- a 0.1 per cent of GDP rise in **receipts**, reflecting further fiscal drag from income tax and NICs receipts. This is partly offset by a further cut in the main CT rate to 18 per cent in that year. Abstracting from this, we assume that most tax bases grow in line with GDP;
- a 0.1 per cent of GDP fall in **day-to-day spending on public services, grants and administration** spending, reflecting the Government's chosen policy assumption; and
- a 0.1 per cent of GDP fall in **debt interest** spending, reflecting the stock of debt falling as a share of GDP in that year.

4.187 These are partly offset by:

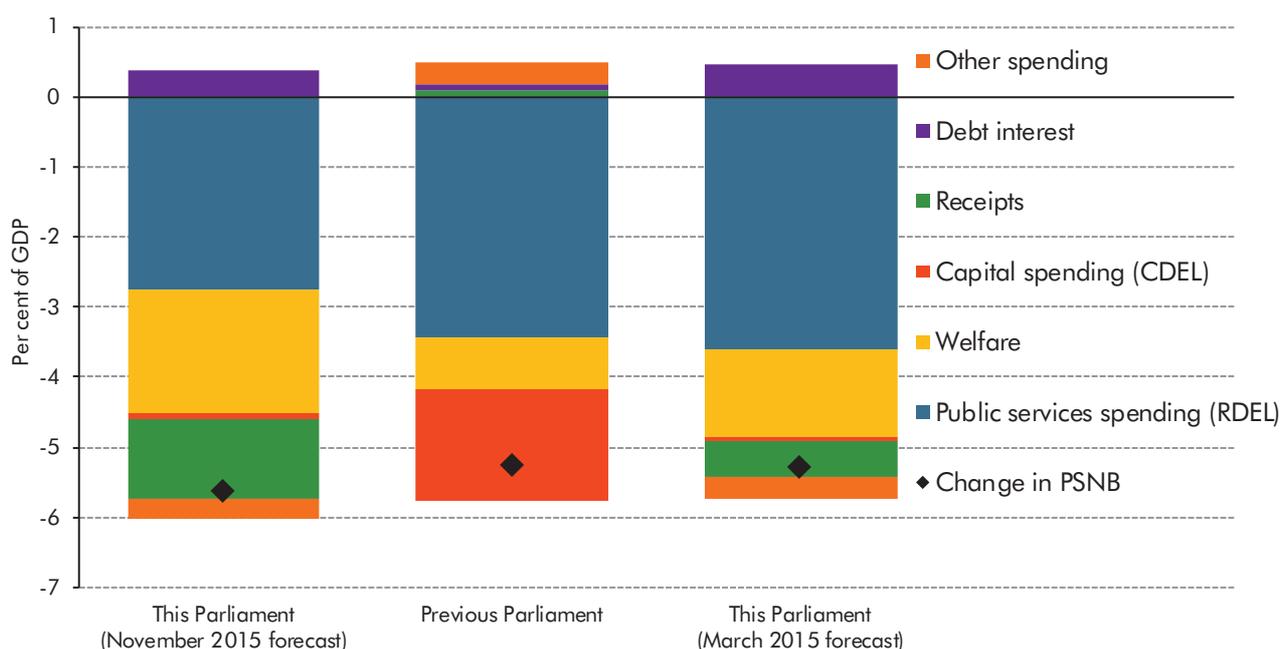
- a rise of 0.3 per cent of GDP in **departmental capital spending (CDEL)** reflecting the Government's chosen policy assumption. Other AME spending also rises by 0.1 per cent of GDP in that year, mostly reflecting an increase in public corporations' capital expenditure, which is driven by higher investment by housing associations.

## Summary

4.188 As Chart 4.20 shows, the composition of the improvement in the budget balance that the Government plans to deliver over this Parliament (from 2014-15 to 2019-20) differ from that achieved in the last Parliament (from 2009-10 to 2014-15) and from the Coalition's plans in March. In particular:

- **compared with the last Parliament**, the cuts to public services spending (as a share of GDP) are around a fifth smaller. Capital spending – which contributed to deficit reduction in the last Parliament when it was cut back after the 2009-10 fiscal stimulus – is planned to remain almost flat as a share of GDP in this Parliament. Lower welfare spending is expected to contribute more than twice as much to improving the budget balance than it did in the last Parliament, while receipts are expected to rise as a share of GDP where they were flat in the last Parliament. That reflects both policy measures and the effects of economic growth interacting with the structure of the tax and benefits systems. Most tax rates and benefit awards move with inflation rather than earnings, so growth in real earnings drags more income into higher tax brackets and reduces the generosity of benefits relative to average earnings in the rest of the economy. In the last Parliament policy measures to increase taxes were offset in their impact on revenues, for example by the impact of weak earnings growth and changes in the distribution of wages on income taxes and by falling North Sea receipts; and
- **compared with the forecast for this Parliament that we prepared for the Coalition's final Budget in March**, the extent to which public services spending will be cut as a share of GDP is around a quarter lower following the increases announced in the July Budget and added to in this Spending Review. Tax rises and welfare spending cuts also contribute a more to the change in the deficit than the Coalition planned in March, while debt interest is set to rise less.

Chart 4.20: Fiscal consolidation over two Parliaments



Source: ONS, OBR

## Risks and uncertainties

4.189 As always, we emphasise the uncertainties that lie around our central fiscal forecast. We expose our judgements to different sensitivities and scenarios in Chapter 5. While there are some risks and uncertainties common to all forecasts, in this *EFO* we have highlighted:

- global and domestic risks associated with the economy, including the outlook for productivity growth in the UK and the implications of lower growth in China (paragraph 3.107);
- uncertainties associated with the delivery of reforms to the welfare system, particularly in relation to disability benefits (from paragraph 4.94) and universal credit (from paragraph 4.96);
- the implications for the public sector finances of the ONS decision to reclassify housing associations from the private sector to the public sector. This includes uncertainties surrounding the outlook for HAs' housebuilding, operating costs and accumulation of debt, as well as their response to policy changes announced in July and in this Spending Review (Annex B);
- ongoing uncertainties around the large financial asset sales that are planned to take place over this Parliament ( from paragraph 4.133); and
- the Government has set out a number of ambitions or intentions that have not yet been confirmed as firm policy decisions, but which remain a source of risk to the forecast (paragraph 4.12).

## International comparisons

4.190 International organisations, such as the European Commission and the International Monetary Fund (IMF), produce forecasts of deficit and debt levels of different countries on a comparable basis. These are based on general government debt and borrowing and are presented on a calendar year basis. To facilitate comparisons, Tables 4.37 and 4.38 present our UK forecasts on a basis that is comparable with that used by these international organisations. (The reclassification of housing associations into the public corporations sector will not affect these general government measures of debt and borrowing.) With both modelling and reporting of much tax and expenditure done primarily on a financial year basis, the calendar year forecasts are illustrative and have been derived by simply weighting the financial year forecasts.

Table 4.36: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty deficit <sup>1</sup>			Treaty debt <sup>2</sup>		
	2015	2016	2017	2015	2016	2017
UK (November)	4.2	2.9	1.6	87.4	86.8	85.2
UK (EC)	4.4	3.0	1.9	88.3	88.0	86.9
Germany	-0.9	-0.5	-0.4	71.4	68.5	65.6
France	3.8	3.4	3.3	96.5	97.1	97.4
Italy	2.6	2.3	1.6	133.0	132.2	130.0
Spain	4.7	3.6	2.6	100.8	101.3	100.4
Euro area	2.0	1.8	1.5	94.0	92.9	91.3

<sup>1</sup> General government net borrowing.

<sup>2</sup> General government gross debt.

Source: European Commission, *European Economic Forecast Autumn 2015*, OBR

Table 4.37: Comparison with IMF forecasts

	Per cent of GDP					
	General government net borrowing			General government net debt		
	2015	2016	2020	2015	2016	2020
UK (November)	4.2	2.9	-0.5	78.9	78.3	68.8
UK (IMF)	4.2	2.8	-0.1	80.3	79.5	69.3
Germany	-0.5	-0.3	-1.0	48.4	46.4	38.1
France	3.8	3.4	0.7	89.4	90.3	85.4
Italy	2.7	2.0	0.2	113.5	112.8	104.8
Japan	5.9	4.5	4.1	126.0	128.1	132.1
U.S	3.8	3.6	4.2	79.9	80.7	81.2

Source: IMF, *World Economic Outlook*, October 2015, OBR



# 5 Performance against the Government's fiscal targets

## Introduction

5.1 This chapter:

- sets out the Government's medium-term fiscal targets (from paragraph 5.2);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.7); and
- assesses how robust these judgements are to the uncertainties inherent in any fiscal forecast, by looking at past forecast errors, sensitivity to key parameters of the forecast and alternative economic scenarios (from paragraph 5.29).

## The Government's fiscal targets

5.2 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of hitting its fiscal targets under current policy. The latest version of the *Charter* (approved by Parliament in October 2015 and available on our website) sets out two targets that are formally in place for this forecast:

- the Government's fiscal mandate requires a surplus on **public sector net borrowing** by the end of 2019-20 and in each subsequent year; and
- it is supplemented by a target for **public sector net debt** to fall as a percentage of GDP in each year to 2019-20 (after which it would continue to do so if the mandate is met).

5.3 The *Charter* states that *"These targets apply unless and until the Office for Budget Responsibility (OBR) assess, as part of their economic and fiscal forecast, that there is a significant negative shock to the UK. A significant negative shock is defined as real GDP growth of less than 1% on a rolling 4 quarter-on-4 quarter basis."* We will make this assessment alongside our forecasts, at the same time as we carry out our assessment of performance against the fiscal targets.

5.4 This fiscal mandate replaces the previous target of achieving cyclically adjusted current balance by the end of the third year of the forecast period. The new supplementary target requires public sector net debt as a percentage of GDP to be falling in each year rather than at a fixed date in 2016-17 as previously.

5.5 The fiscal mandate is further supplemented by:

- a cap on a subset of **welfare spending**, at cash levels set out by the Treasury for each year from 2016-17 to 2020-21 in the July 2015 Budget.

5.6 In this chapter, we assess the Government's performance against the current targets and provide an update on how our central forecast compares with the requirements of the targets that preceded them. On our central forecast, the Government is on course to meet its new fiscal mandate and supplementary target – and would have met the previous versions of those targets – but it is set to breach the terms of the welfare cap.

## The implications of our central forecast

5.7 Table 5.1 shows our central forecasts for the fiscal aggregates relevant to the current and previous fiscal targets: public sector net borrowing (PSNB); public sector net debt (PSND); spending subject to the welfare cap; and the cyclically adjusted current budget deficit (CACB). These forecasts are described in detail in Chapter 4. They include our estimates of the effect of the ONS reclassification of housing associations to the public sector, which are described in Annex B. They are median forecasts, so we believe it is equally likely that outturns will come in above them as below them.

Table 5.1: Fiscal aggregates relevant to the Government's fiscal targets

	Per cent of GDP						
	Estimate	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
<b>Fiscal mandate: Public sector net borrowing</b>							
July forecast restated	5.2	4.0	2.4	1.3	0.4	-0.4	-0.4
November forecast	5.2	3.9	2.5	1.2	0.2	-0.5	-0.6
<b>Supplementary target: Public sector net debt</b>							
July forecast restated	84.0	83.6	82.5	80.6	78.0	74.7	71.6
November forecast	83.1	82.5	81.7	79.9	77.3	74.3	71.3
<b>Spending subject to the welfare cap (£ billion)</b>							
July forecast	119.1	120.6	115.2	114.6	114.0	113.5	114.9
November forecast	119.3	120.9	119.2	117.7	115.9	115.3	117.1
<b>Previous fiscal mandate: Cyclically adjusted current budget deficit</b>							
July forecast restated	2.3	1.6	0.4	-0.4	-1.2	-1.9	-1.9
November forecast	2.4	1.6	0.5	-0.5	-1.2	-1.9	-2.4

## The new fiscal mandate

5.8 The Government's new fiscal mandate requires it to achieve an overall budget surplus (in other words, that PSNB must be negative) in 2019-20. Our latest central forecast shows a surplus of £10.1 billion or 0.5 per cent of GDP in that year, which means we judge that the Government is more likely than not to meet its new target on existing policy.

5.9 The margin by which it is expected to meet this target is little changed from July. As Table 4.33 in Chapter 4 shows, that small change reflects the net effect of bigger, but largely

offsetting, changes to our receipts and spending forecasts, including the effects of policies announced in the Spending Review and Autumn Statement.

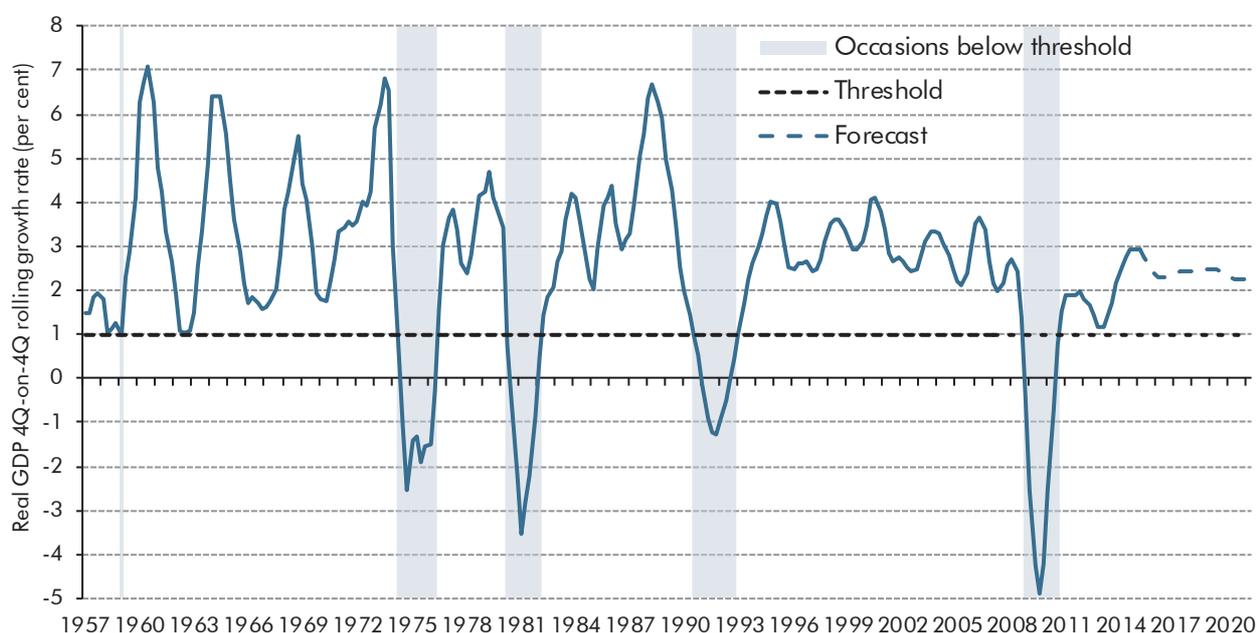
- 5.10 The path from this year's estimated deficit of £73.5 billion or 3.9 per cent of GDP to that surplus is described from paragraph 4.159 in Chapter 4. Around half the change in PSNB as a share of GDP over the next four years is accounted for by cutting day-to-day spending on public services, with the majority of that focused on 'unprotected' departments.
- 5.11 The fiscal mandate then requires a headline budget surplus in all subsequent years, subject to the economy not being hit by a negative shock. This is ambitious relative to the fiscal performance of past governments. The public sector has run a surplus in only five of the last 40 years – and in four of those years that was only because economic activity was running above its sustainable level (at least with the benefit of hindsight). Our central forecast of a structural budget surplus of 0.6 per cent of GDP in 2020-21 would be the largest in at least 40 years – topping the 0.4 per cent achieved in 2000-01.

### The negative shock threshold

- 5.12 Beyond 2019-20, the Government's fiscal targets only apply if we confirm that the UK economy is not expected to experience a 'negative shock' that the Government has defined to be real GDP growth of less than 1 per cent on a rolling 4 quarter-on-4 quarter basis.
- 5.13 As described in Chapter 3, we expect the economy to be growing at a rate consistent with its underlying potential in the final year of the forecast period, so we are not forecasting a negative shock on the Government's definition after 2019-20. But, based on past official forecast errors (as used in the fan charts we present in our *EFOs*), our central forecast nonetheless implies that there is around a 30 per cent chance that GDP growth will be below 1 per cent in 2020-21.
- 5.14 Chart 5.1 presents GDP growth over the past six decades on the measure used in the negative shock threshold. The rolling four quarter metric is relatively smooth, since in any given quarter only one of the eight quarters in the calculation is new. The chart shows that there have been 36 quarters (in four distinct episodes) since 1957 in which this measure was below the 1 per cent threshold. In 14 of those quarters, not only was rolling 4-quarter growth below 1 per cent, but the economy was also in recession (defined as a fall in quarterly GDP that was part of a period of consecutive falls of two or more quarters). In two of the four distinct episodes, GDP fell on a quarterly basis two or three quarters before the 1 per cent negative shock threshold was reached – these were the recessions that resulted largely from external shocks: the oil shock in the mid-1970s and the global financial crisis in 2008. In the other two episodes, the threshold was triggered either at the same time or within one quarter of GDP falling on a quarterly basis – these were the recessions that are associated more with domestic macroeconomic policy being tightened to reduce domestic inflation in the early 1980s and early 1990s.
- 5.15 It is worth noting that Chart 5.1 presents GDP growth according to the latest vintage of GDP data. But, as we describe in many of our reports, the ONS frequently rewrites economic

history when it revises GDP estimates in light of new data or changes in methodology. Revisions to National Accounts data on the path of real GDP during the recessions that started in 1990 and 2008 have been sizable. The recession of the early 1990s now appears shorter, shallower and followed by a stronger economic recovery than was the case in early estimates of GDP data, while the recovery from the last recession also looks stronger than initially estimated. The 2012 slowdown is also less severe than initially estimated, with growth no longer falling below 1 per cent on the negative threshold metric. But these factors would not affect our assessment of negative shocks as the *Charter* sets out that once a shock has been triggered that will remain the case “regardless of future data revisions”.

Chart 5.1: Episodes of ‘normal’ and ‘non-normal’ times since 1957



Source: ONS, OBR

## The previous fiscal mandate

5.16 As in our July forecast, the Government’s previous goal to achieve cyclically adjusted current balance by the third year of the forecast period (2017-18 in this forecast) would be met in this forecast. In fact, the margin by which we estimate that the mandate would have been met in that year has increased slightly to 0.5 per cent of GDP in this forecast. The CACB surplus is also expected to be higher from 2018-19 onwards than we forecast in July. It peaks at 2.4 per cent of GDP or £56.0 billion in 2020-21. That would be the largest CACB surplus forecast in any year of any forecast – topping the 2.3 per cent of GDP or £50.6 billion in the final year of our December 2014 forecast.

## The new supplementary target

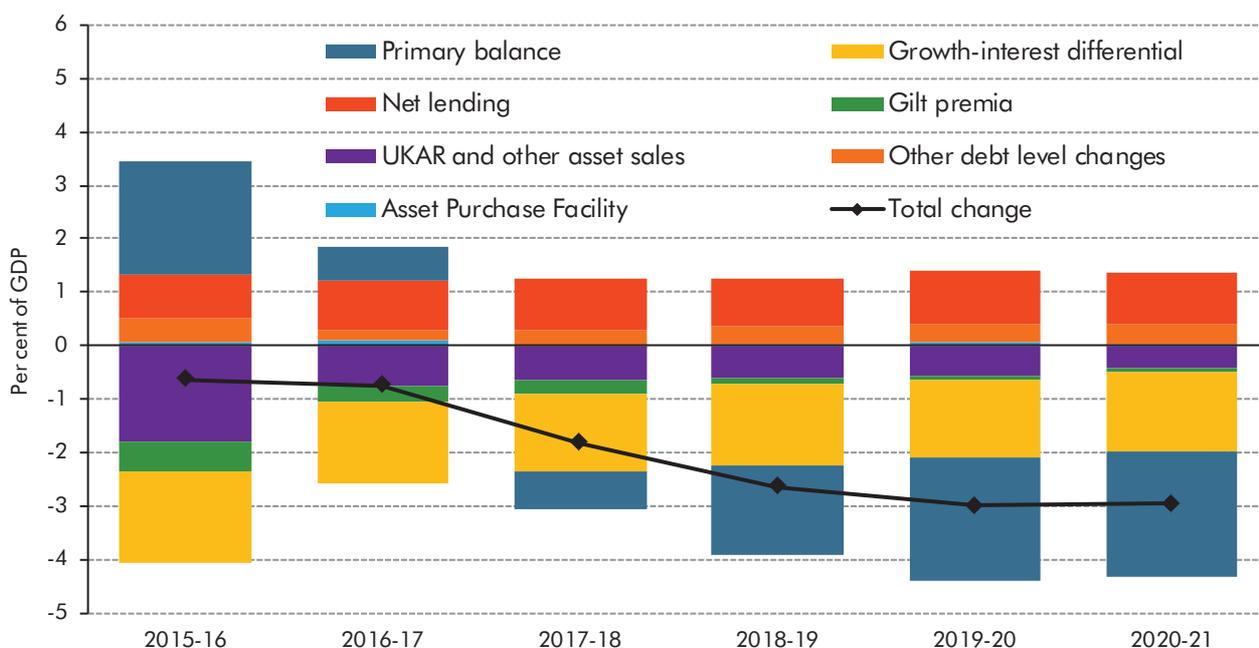
5.17 The new supplementary target requires public sector net debt (PSND) to fall as a share of GDP in every year to 2019-20. The *old* supplementary target required PSND to fall as a share of GDP between 2015-16 and 2016-17, with that year fixed. As in July, we expect

PSND to fall as a share of GDP in every year of the forecast, so that the Government is on course to meet both the new and the old supplementary targets in our central forecast.

- 5.18 As in July, debt would still be rising as a share of GDP in 2015-16 if it were not for significant sales of financial assets (most of which have already taken place in the first eight months of the year). This is because the primary budget deficit (the difference between non-interest receipts and spending) and net lending to the private sector (mostly student loans) are putting upward pressure on the debt-to-GDP ratio this year, outweighing the fact that nominal GDP growth is higher than the effective interest rate on the government's debt. In subsequent years the impact of net lending to the private sector and the differential between the growth rate and the interest rate are broadly stable, while the primary balance improves sufficiently to keep the ratio falling without the need for further significant asset sales.
- 5.19 More specifically, Chart 5.2 decomposes year-on-year changes in the debt-to-GDP ratio over the forecast period. It shows that:
- changes in the year-on-year profile typically reflect changes in the **primary balance**. But the debt-to-GDP ratio falls in 2015-16 and 2016-17 despite the primary balance being in deficit by 2.1 and 0.6 per cent of GDP in these years;
  - significant **financial asset sales** more than offset the effect of the primary deficit to reduce the debt-to-GDP ratio in 2015-16. Our latest estimates of these sales are described from paragraph 4.133 in detail in Chapter 4. Beyond 2015-16, further sales of RBS shares also affect the year-on-year profile of PSND. (Financial asset sales typically bring forward cash that would otherwise have been received in future revenues, in the shape of mortgage repayments and dividends, so they only temporarily reduce the debt-to-GDP ratio. In broad terms, financial asset sales leave the public sector's net worth unchanged. When the Government gives away some of the assets that it is disposing of, as with the disposal of Royal Mail shares and the planned retail offering of Lloyds shares early next year, the sale raises less than the asset is worth and the public sector's net worth is reduced);
  - the fact that **nominal GDP growth exceeds expected interest rates** would, all else equal, be sufficient for debt to fall by 1.7 per cent of GDP in 2015-16 and by 1.5 per cent of GDP in 2020-21. This differential is an extremely important component of public sector debt dynamics, especially over longer timeframes. In our *Fiscal sustainability reports*, we analyse the impact of different assumptions on our results;
  - **net lending to the private sector** – mainly student loans, but also through schemes like Help to Buy – increases net debt in every year (but, as a financial transaction, it does not directly affect measures of the deficit);
  - **issuing debt at a premium to its nominal value** reduces net debt over the forecast period. But this is ultimately only temporary and will unwind over the long term; and

- **other** changes, mainly relating to the Asset Purchase Facility (APF) and timing effects, are relatively small. Accrued receipts exceed cash receipts over the medium term, partly because some receipts are collected with a lag (including interest on student loans, where the lag can be many years).

Chart 5.2: Year-on-year changes to the debt-to-GDP ratio



Source: OBR

5.20 While our forecast continues to show net debt falling as a share of GDP each year from 2015-16 onwards, the pace of decline has changed relative to our July forecast. Table 5.2 decomposes changes in the profile of net debt since July. It shows that:

- in 2015-16, debt falls further as a share of GDP than it did in July. That is more than explained by stronger growth in the denominator in the debt-to-GDP calculation. But much of that may be a statistical artefact – the public finances data use non-seasonally adjusted nominal GDP as the denominator, so an unusual pattern of seasonal factors has fed through to deliver a beneficial effect to the year-on-year change in the debt ratio. Asset sales contribute less to the fall than we expected in July, as higher proceeds from the sale of the Granite securitisation vehicle are more than offset by lower expected proceeds from remaining Lloyds share sales and the first student loan book sale being pushed back to 2016-17;
- higher borrowing slows the pace at which debt falls in 2016-17, but it helps the ratio to fall faster thereafter. The additional sale of RBS shares in 2020-21 and a higher surplus in 2020-21 push PSND down faster than our July forecast in that year;
- our revised assumption that the APF's gilt holdings will remain at £375 billion throughout our five-year forecast horizon, consistent with the Bank of England's November announcement, reduce the pace at which PSND falls relative to July. The

APF gilt holdings add to PSND because the nominal (as opposed to market) value of the gilts the APF holds exceeds the value of the reserves the Bank created to finance their purchase. In July, that effect was assumed to reduce over the forecast period as the Bank stopped replacing gilts that were redeemed, so the new assumption pushes up the profile in most years relative to July;

- beyond 2015-16, asset sales contribute slightly more to the downward path of debt-to-GDP, thanks to the inclusion of active asset sales by UKAR on top of the natural rundown of assets that was assumed in July and the additional RBS sale in 2020-21;
- government lending to the private sector slows the pace at which debt falls from 2017-18 onwards. That reflects higher departmental lending totals set out in the Spending Review and a variety of policy measures that increase student loans outlays; and
- changes to gilt premia and other factors are relatively small and mostly offsetting.

Table 5.2: Changes in the profile of net debt since July

	Per cent of GDP					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July forecast restated	-0.4	-1.1	-2.0	-2.6	-3.3	-3.1
November forecast	-0.6	-0.7	-1.8	-2.6	-3.0	-3.0
<b>Change</b>	<b>-0.2</b>	<b>0.4</b>	<b>0.1</b>	<b>0.0</b>	<b>0.3</b>	<b>0.2</b>
<i>of which:</i>						
Nominal GDP <sup>1</sup>	-0.4	0.1	0.0	0.0	0.1	0.3
Borrowing	0.0	0.2	-0.1	-0.2	-0.1	-0.2
APF	0.0	0.2	0.2	0.1	0.2	0.0
UKAR and asset sales	0.2	-0.1	-0.1	-0.1	-0.1	-0.3
Lending	0.0	0.0	0.1	0.1	0.1	0.2
Gilt premia	-0.1	0.1	0.0	0.0	0.0	0.0
Other factors	0.1	0.0	0.0	0.0	0.0	0.1

<sup>1</sup>GDP is centred end-March.

## The welfare cap

5.21 The welfare cap was initially set in line with our March 2014 forecast for the items of spending that are subject to it. As required under the *Charter*, the welfare cap was reset for this Parliament at the July 2015 Budget, where the Government chose to set it at our post-measures forecast. This locked in a reduction in the level of the cap that reached £16.3 billion by 2019-20. The Government sets a 2 per cent forecast margin above the cap, which can be used if our forecast judgements push up spending, but cannot be used to accommodate policy measures that increase spending. We are required to assess the Government's performance against the cap formally at each Autumn Statement, and did so for the first time in our December 2014 *EFO*. In this *EFO*, we carry out our second formal assessment – this time against the welfare cap as reset in July.

## Forecasting changes

5.22 The welfare cap includes a 2 per cent margin that permits spending to be higher than the cap for forecasting reasons, but not for policy reasons. We therefore need to track the sources of changes to our welfare cap spending forecast in order to assess performance against it. As discussed in Chapter 4, since July we have revised up spending on disability and incapacity benefits. In addition, the latest ONS population projections imply a smaller fall in the number of births than we had previously assumed, pushing up spending on tax credits and child benefit. These changes – most notably the rise in spending on disability benefits resulting from the slower pace of PIP reassessments – mean that forecasting changes exceed the 2 per cent forecast margin in 2020-21.

## Policy changes

5.23 The Government has announced a number of policy measures in the Autumn Statement that increase spending subject to the welfare cap in the near term, but reduce it by the end of the forecast. The near-term giveaway reflects the decision to reverse the main July Budget cuts to tax credits, while a range of smaller policy measures save increasing amounts over time. Taken together, the Autumn Statement welfare cap spending measures become a small net takeaway by 2019-20. The biggest changes to spending include:

- the reversal of the two main tax credit measures announced in July, thereby returning the taper rate to 41 per cent and resetting the income threshold at £6,420. This increases spending by £3.4 billion in 2016-17 and £1.9 billion a year on average from 2016-17 to 2020-21;
- cuts to the support provided through housing benefit: these include capping payments in the social rented sector and abolishing the management fee currently paid to local authorities for housing benefit tenants in temporary accommodation. The latter measure reduces welfare cap spending, but only by shifting that cost to within the grants provided via central government DELs. In total, housing benefit spending is £0.4 billion a year lower on average from 2017-18 to 2020-21; and
- other smaller changes include linking the minimum income floor in universal credit to the National Living Wage rather than the National Minimum Wage and the Government's latest decision to slow the rollout of universal credit, which both reduce spending. The decision to migrate the remaining tax credits and employment support allowance cases to universal credit in 2020-21 increases costs in that year.

## Performance against the welfare cap

5.24 Based on the forecasting and policy changes described above, Table 5.4 shows our forecast for spending subject to the welfare cap in each year to 2020-21. Taking each year in turn, our assessment of performance against the terms of the cap is that:

- it is set to be **breached in 2016-17**: spending will be £4.0 billion higher than the cap, with the policy changes explaining the majority of the higher spending;

- it is set to be **breached in 2017-18**: spending will be £3.1 billion higher than the cap, again largely due to the effects of policy changes;
- it is set to be **breached in 2018-19**: spending will be £1.9 billion higher than the cap. That is within the forecast margin, but some of the higher spending reflects the net giveaway in that year due to policy measures, thereby breaching the requirement that the margin can only be used for forecast-driven changes to spending;
- it is set to be **observed in 2019-20**: spending will be £1.8 billion higher than the cap, which is £0.5 billion below the 2 per cent forecast margin. The effect of Autumn Statement measures in that year reduce spending by £0.1 billion. That is less than the amount that has been shifted from welfare cap AME to DEL spending via the change in how local authorities will be funded for management of temporary accommodation. (Paragraph 3.30 of the Charter states that *"The Treasury will not be required to seek approval for fiscally neutral classification changes such as changes from Annually Managed Expenditure to fixed Departmental Expenditure Limits as certified by the OBR. The level of the cap will be adjusted to reflect any such classification changes."* The Government has made the case that this shift will allow and encourage local authorities to spend the money in different ways and that it is therefore a policy change leading to changes in behaviour rather than a reclassification); and
- it is set to be **observed in 2020-21**: spending will be £2.1 billion higher than the cap, which uses up nearly all the 2 per cent forecast margin. Absent the effect of scorecard measures, spending would have been above the forecast margin too thanks to higher spending on disability benefits in particular. Spending would also have been above the forecast margin absent the shift of spending from AME to DEL described above.

Table 5.3: Performance against the welfare cap

	£ billion					
	Forecast					
	Welfare cap period					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Welfare cap (July)		115.2	114.6	114.0	113.5	114.9
2 per cent forecast margin (July)		2.3	2.3	2.3	2.3	2.3
July forecast	120.6	115.2	114.6	114.0	113.5	114.9
November forecast	120.9	119.2	117.7	115.9	115.3	117.1
<b>Change</b>	<b>0.4</b>	<b>4.0</b>	<b>3.1</b>	<b>1.9</b>	<b>1.8</b>	<b>2.1</b>
of which:						
Forecast changes	0.4	1.0	1.2	1.3	1.9	2.4
Scorecard measures	0.0	3.0	1.9	0.7	-0.1	-0.3
Reversing July tax credits measures		3.4	2.9	1.7	0.9	0.5
Other Autumn Statement measures		-0.4	-1.0	-1.1	-1.0	-0.8
Indirect effects of Government decisions	0.0	0.0	-0.1	-0.1	0.0	0.0
<b>November forecast relative to:</b>						
July welfare cap		+4.0	+3.1	+1.9	+1.8	+2.1
July welfare cap + forecast margin		+1.7	+0.8	-0.4	-0.5	-0.2

## Risks to performance against the welfare cap

- 5.25 Developments in the economy – notably the labour and housing markets – pose important risks to our welfare spending forecast. Typically, inflation would also be an important source of risk because the welfare cap is set in cash terms and changes in inflation typically feed through to spending via uprating. But the four-year uprating freeze on the majority of spending subject to the cap means that, for most of the forecast period, welfare cap spending will be relatively insensitive to changes in inflation.
- 5.26 We highlighted other key sources of uncertainty – and therefore risks to the forecast – in our 2015 *Welfare trends report*. These in particular related to reforms to incapacity and disability benefits, and the rollout of universal credit. These include the effect on caseloads and average awards as the systems are changed, as existing caseloads are migrated from old to new benefits, and as savings are assumed to flow from the associated reassessment processes. In this forecast, we have revised up spending on disability benefits due to a slower pace of reassessments and moved our forecast for the timetable of universal credit back once more. We will continue to monitor the evidence, but these are still obviously areas of concern as, despite repeated and sometimes large revisions, it is not yet clear whether we have reached a point where the risks to our forecast are balanced.
- 5.27 We also discussed how estimates of the impacts of previously announced policy measures have changed over time. This highlighted that:
- errors in our economic forecasts can be significant sources of error in costings themselves. This was particularly relevant to the major uprating policy measures in the last Parliament: the triple lock on state pension uprating; switching from RPI to CPI inflation uprating for most benefits and tax credits; and later limiting the uprating of most working-age benefits to 1 per cent for three years; and
  - costings associated with structural changes to the welfare system are subject to even greater uncertainty. This is reflected in the changes to our estimates of the switch from incapacity benefit to employment support allowance, from disability living allowance to the personal independence payment, the rollout of universal credit, and the introduction of the high-income child benefit charge.
- 5.28 The lessons learnt in this area have been applied to the estimated savings from the measures announced in the July Budget and this Autumn Statement. The largest measures yet to come into effect have been simpler changes to rates and/or withdrawal rates rather than the large structural changes to the system in the last Parliament. In that sense, these large items pose lower risks to the welfare cap than those introduced in the June 2010 Budget, for example. But the estimated savings remain sensitive to the economic forecasts on which they are based, in particular the inflation and earnings growth assumptions.

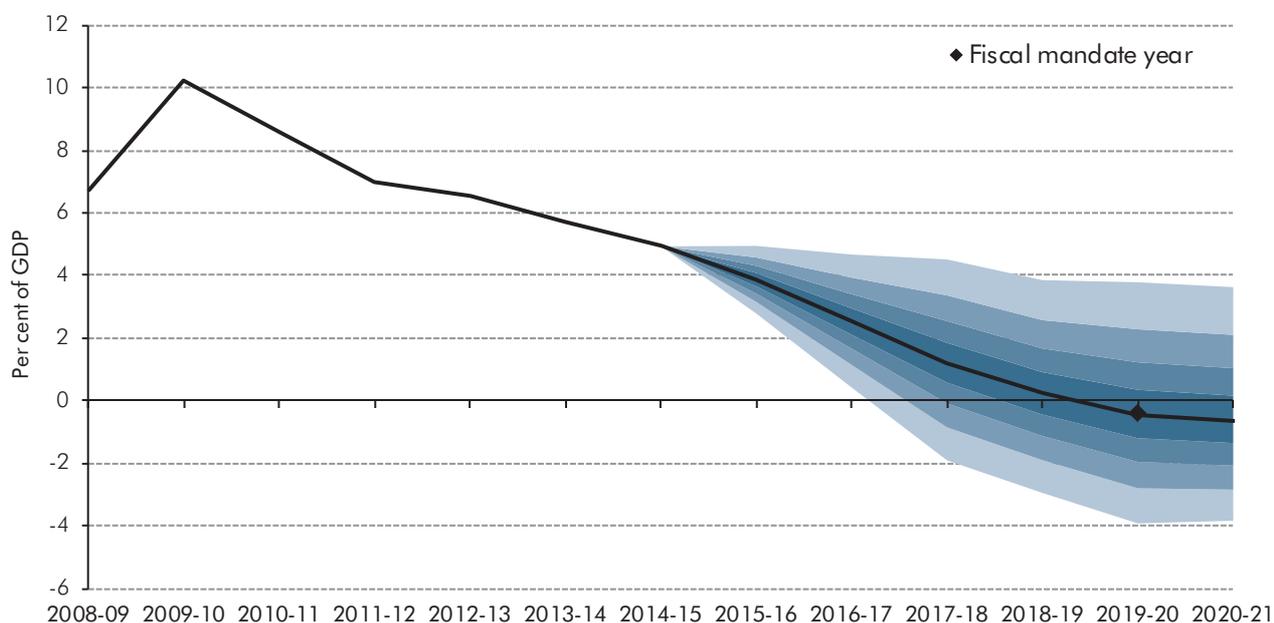
## Recognising uncertainty

- 5.29 Past experience and common sense suggest that there are significant upside and downside risks to our central forecasts for the public finances. These reflect uncertainty both about the outlook for the economy and about the level of receipts and spending in any given state of the economy. The size and composition of the remaining fiscal consolidation – and its impact on national income and spending – create additional uncertainty.
- 5.30 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet its fiscal targets – current and proposed. We do this in three ways:
- by looking at the evidence from past forecast errors;
  - by seeing how our central forecast would change if we altered some of the key judgements and assumptions that underpin it; and
  - by looking at alternative economic scenarios.

### Past performance

- 5.31 One relatively simple way to illustrate the uncertainty around our central forecast is to consider the accuracy of previous official public finance forecasts. This can be done using fan charts like that we presented for GDP growth in Chapter 3. The fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that forecast errors in the past offered a reasonable guide to likely forecast errors in the future.
- 5.32 Chart 5.3 shows our central forecast for PSNB on the same basis. Again, a direct reading of the chart would imply that the probability that PSNB will reach balance rises from 30 per cent in 2017-18 to 45 per cent in 2018-19, then to 55 per cent in 2019-20 and 60 per cent in 2020-21. The Government therefore has a small margin against its fiscal mandate.

Chart 5.3: Public sector net borrowing fan chart



Source: ONS, OBR

5.33 Unfortunately, we cannot estimate the probability of achieving the supplementary targets as we do not have the joint distribution that would allow us to apply the same technique. But our central forecast shows the debt-to-GDP ratio falling in each year of the forecast, meeting the supplementary target in both its current and previous form. We also do not have a long enough disaggregated series of past welfare spending forecasts to produce a fan chart for the welfare cap projections.

### Sensitivity analysis

5.34 It is very difficult to produce a full subjective probability distribution for the Government's target fiscal variables because they are affected by a huge variety of economic and non-economic determinants, many of which are correlated with each other. However, to recognise the uncertainty in our forecast we can go further than using evidence from past forecast errors by quantifying roughly how sensitive our central forecast is to changes in certain key economic parameters.

5.35 In thinking about the evolution of the public finances over the medium term, there are several parameters that have a particularly important bearing on the forecast. In this section we focus in particular on:

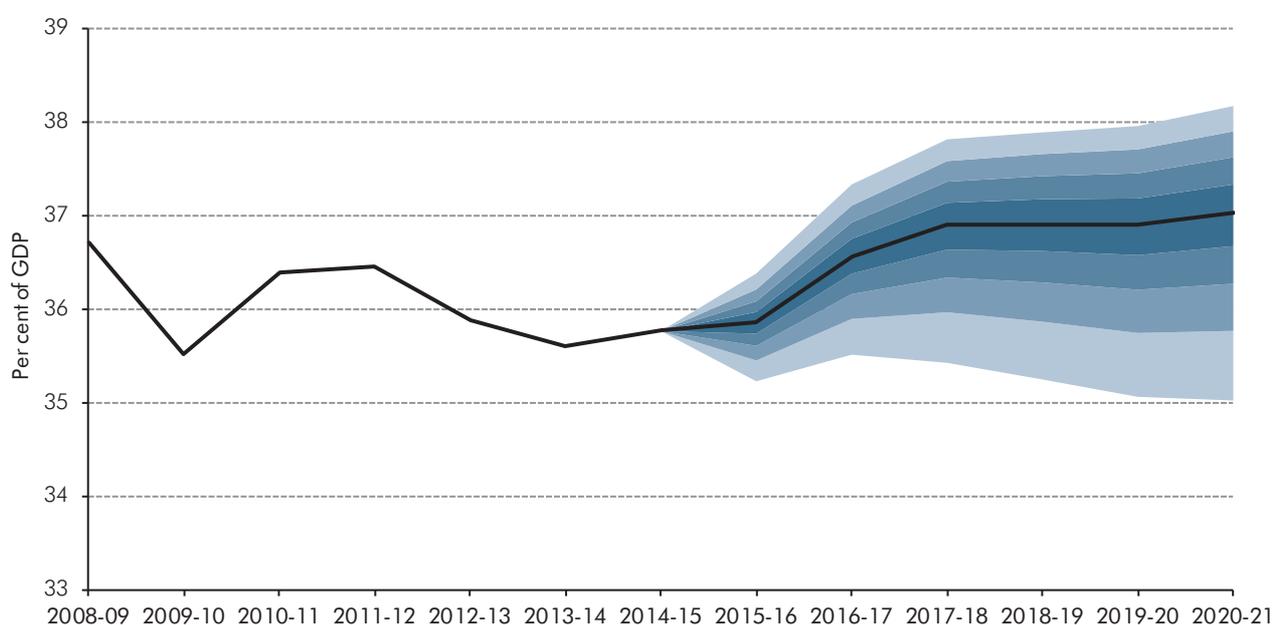
- the sensitivity of the fiscal mandate headline surplus measure to changes to the level of GDP, inflation, interest rates and effective tax rates; and
- the sensitivity of the supplementary debt target to differences in the level of debt or the growth rate of the economy, which both affect how debt changes from year-to-year as a share of GDP.

## The fiscal mandate

- 5.36 We have already shown that, on the basis of past forecast errors, there is around a 45 per cent probability that the budget will be in deficit rather than surplus in 2019-20. There are many reasons why we could see such an outcome. For example, economic developments could be less favourable than we forecast or we could be wrong about prospects for receipts or spending for a given state of the economy. And while our forecasts are conditioned on current Government policy, that may also evolve over time.
- 5.37 In Annex B of our March 2015 *EFO*, we presented a range of ready-reckoners that show how the public finances could be affected by changes in selected economic determinants of our fiscal forecast. It is important to stress that these were stylised quantifications that reflect the typical impact of changes in variables on receipts and spending. They are subject to significant uncertainty. But with those caveats in mind, we can use these ready-reckoners to calibrate a number of possible negative surprises relative to our central forecast that would be sufficient to push the budget from surplus to deficit in 2019-20. Where possible, we assess the probability of such a surprise on the basis of past forecast errors.
- 5.38 This analysis suggests that the 0.5 per cent of GDP surplus in 2019-20 could fall to zero if:
- there was a **negative output gap** of 0.6 per cent or **potential output** was 0.8 per cent lower. Swings in the output gap have a larger effect since we assume that these also drive changes in asset prices, which have geared effects on receipts;
  - **whole economy prices** rise by 1.1 per cent less than expected. This is important because receipts are linked to nominal tax bases and thus rise and fall (slightly more than proportionately) with prices. However, much of spending is fixed in nominal terms in Spending Reviews or relatively insensitive to prices (e.g. much of debt interest on conventional gilts is based on the stock that has already been accumulated, on which interest rates are fixed);
  - higher **interest rates** pushed up debt interest spending. If interest rates were 0.9 percentage points above market expectations by 2019-20, this would be sufficient to add 0.5 per cent of GDP to spending on debt interest. Such an effect would not happen in isolation – for example, a boost to interest receipts on the government's stock of financial assets would partly offset higher debt interest.
  - the **effective tax rate** – as measured by the tax-to-GDP ratio – was 0.5 per cent of GDP lower than in our central forecast. This could be because the composition of GDP was less tax rich than expected, or asset markets underperformed our assumptions, or the income distribution was skewed towards people with lower effective tax rates. Chart 5.4 presents a fan chart for receipts as a share of GDP using a similar methodology to that used in the CACB and PSNB fan charts above. It suggests there is a 35 per cent chance that receipts could be 0.5 per cent of GDP lower than forecast;

- planned **spending cuts** – which reduce RDEL by 2.0 per cent of GDP between 2015-16 and 2019-20 in our forecast – fell short by around a quarter; and
- a jump in **RPI inflation** could increase accrued interest on index-linked gilts. Taken in isolation, if RPI inflation was 2.2 percentage points higher than expected in 2019-20, that alone would add 0.5 per cent of GDP to debt interest costs. Based on past forecasts errors, there would be around a 10 per cent probability of that happening. Of course, such a shock to inflation would be likely to have other material effects on the public finances.

Chart 5.4: Receipts fan chart



Source: ONS, OBR

### The supplementary debt target

5.39 The supplementary debt target is focused on year-on-year changes in the debt-to-GDP ratio. Table 5.4 shows how our central forecast for a 3.0 per cent of GDP fall in PSND in 2019-20 would be affected by two sources of sensitivity: differences in the level of debt in the preceding year and by differences in growth in 2019-20. We use cyclical adjustment coefficients to estimate the effect of GDP growth shocks on borrowing, but do not vary interest rates, so that differences in the assumed GDP growth rate result in changes to the interest rate-growth rate differential. On that basis, the table shows that:

- in most cases, the extent to which debt falls in 2019-20 is inversely related to the level of debt in the preceding year. That counter-intuitive result is due to the low level of interest rates assumed in our central forecast and these sensitivities, which means that the effect of GDP growth on the denominator in the debt-to-GDP ratio is greater than the effect of interest rates on changes in the cash level of debt (via debt interest spending). The higher the starting level of debt, the more the denominator effect outweighs the interest rate effect. It is only the bigger negative growth shocks that see

the growth rate fall close to the interest rate. When they are similar (which would be the case if growth was around 2 percentage points lower), the two effects cancel out. When the growth rate is lower than the interest rate, the extent to which debt falls is positively related to the level of debt in the preceding year; and

- as expected, negative shocks to GDP growth reduce the extent by which debt falls as a share of GDP and positive shocks increase it. The year-on-year change in the debt-to-GDP ratio is more sensitive than the deficit to GDP shocks, because it is affected both by the deficit channel (which drives the accumulation of debt in that year) but also the denominator channel (which means the previous year's cash debt is divided by a different level of nominal GDP).

Table 5.4: Illustrative debt target sensitivities in 2019-20

		Year on year change in the PSND-to-GDP ratio in 2019-20					
		Difference in GDP growth in 2019-20 (percentage points)					
		-3	-2	-1	0	+1	+2
Difference in the level of PSND in 2018-19 (per cent of GDP)	-20	1.1	-0.1	-1.4	-2.6	-3.9	-5.1
	-10	1.2	-0.1	-1.5	-2.8	-4.1	-5.5
	+0	1.3	-0.1	-1.6	-3.0	-4.4	-5.8
	+10	1.4	-0.1	-1.7	-3.2	-4.7	-6.2
	+20	1.5	-0.1	-1.8	-3.4	-5.0	-6.6

## Scenario analysis

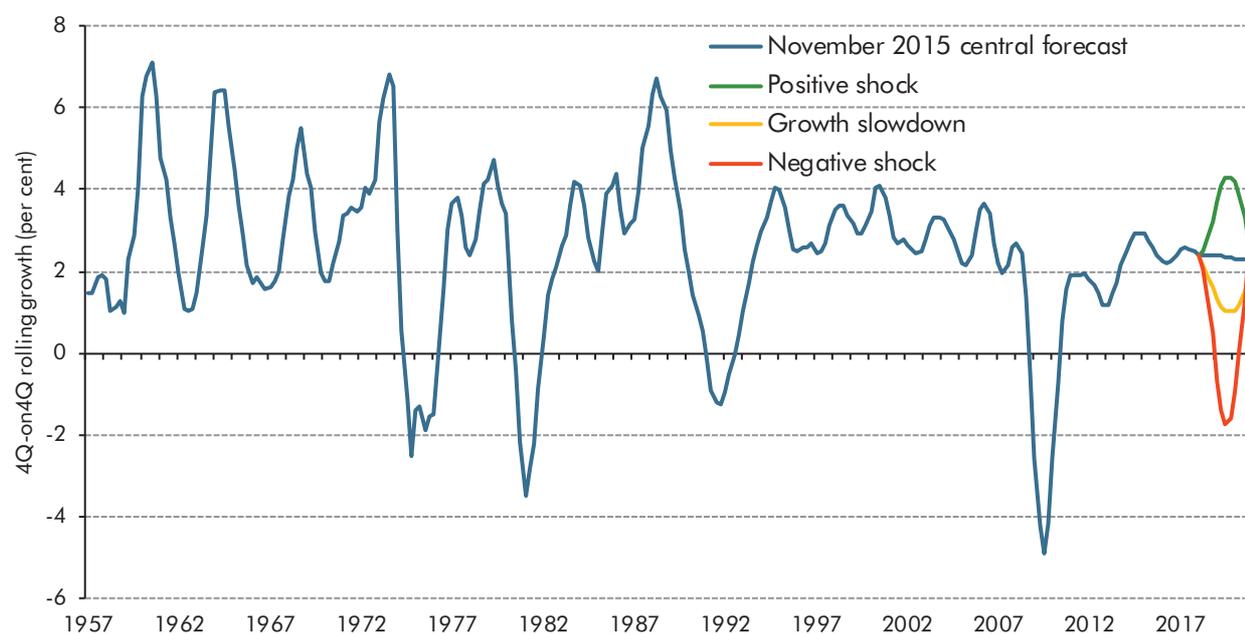
- 5.40 The sensitivity analysis discussed above focuses on individual factors and therefore offers only a limited assessment of potential uncertainty. In this section, we set out the fiscal implications of illustrative alternative economic scenarios, designed to test how dependent our conclusions are on key judgements that are subject to debate in the forecasting community. We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from the central forecast and we do not attempt to attach particular probabilities to them occurring.
- 5.41 The Government's new fiscal mandate is set in terms of headline PSNB. That means that unlike the previous fiscal mandate that targeted a structural measure of borrowing, performance against it will be affected by cyclical swings in the economy that have a temporary effect on the public finances. The supplementary debt target and welfare cap are also sensitive to cyclical developments, although the welfare cap excludes spending on those items that are most closely linked to the ups and downs of the economic cycle.
- 5.42 Given this importance of cyclical factors for all the Government's fiscal targets, we have considered the effects of three different cyclical shocks hitting the economy in 2018. That would be two years before the fiscal mandate requires the Government to be running a headline surplus. The economy scenarios are all purely cyclical – we have not adjusted the potential output assumptions underlying our central forecast. As shown in Chart 5.5, we have modelled:

- a **'positive shock' scenario**, which we have calibrated by looking at historical fluctuations in the output gap and using our small model of the UK economy to reflect how monetary policy under the inflation targeting framework would offset such a shock.<sup>1</sup> It results in real GDP growth rising to more than 4 per cent in 2019-20 (the fiscal mandate year) and the output gap rising above +3 per cent in that year. Because we assume that the shock hits then monetary policy responds, inflation would rise above target before the effects of monetary policy kicked in. House prices are assumed to rise too. Tighter monetary policy would imply Bank Rate rising above 5 per cent by the end of the forecast period, which would feed through to higher gilt yields across the yield curve;
- a **'growth slowdown' scenario**, which we have calibrated to follow a path similar to the slowdown experienced in 2012 as the intensification of the euro area crisis delivered a shock to confidence and credit conditions in the UK. GDP growth slows, but remains positive and just above the 1 per cent 'normal times' threshold that the Government has defined in the *Charter*. A negative output gap would open up, reaching more than 2 per cent in 2019-20. Inflation would be lower than in our central forecast. The monetary policy response implied by our small model would be equivalent to Bank Rate falling below -0.5 per cent by the end of the forecast period, with knock-on effects on gilt yields; and
- a **'negative shock' scenario**, which we have calibrated by looking at historical fluctuations in real GDP growth and the output gap. As we are modelling a shock hitting when our central forecast has the economy on trend, calibrating the shock solely via historical fluctuations in the output gap (where peak to trough movements tend to be from positive to negative) would give implausible results. The shock we have modelled therefore sees GDP fall by  $2\frac{3}{4}$  per cent in the year and a half after the shock hits. A large negative output gap would open up, reaching 6 per cent in 2019-20. CPI inflation would turn negative and house prices would fall. Nominal GDP would also fall in 2019-20 (as it did in 2009-10, after the financial crisis struck). Our small model would imply a monetary policy response that took Bank Rate well below zero. For the economy element of the scenario, we have assumed the Bank delivers the monetary support consistent with the model but have not made any assumptions about how that would happen. To ready reckon the fiscal effects of this scenario, we have assumed Bank Rate does not fall below 0.5 per cent and gilt yields are not pushed lower by quantitative easing or other factors.

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<sup>1</sup> See *Working Paper No.4: A small model of the UK economy*, Murray (2012), available on our website for a description of the type of modelling we undertake. The parameters in this model have been updated to reflect latest data.

Chart 5.5: Real GDP growth: central forecast and illustrative scenarios



Source: ONS, OBR

5.43 Taking these scenarios in turn, Table 5.5 sets out the implications of each for the Government's fiscal targets:

- under the **'positive shock' scenario**, the budget balance improves more quickly than in our central forecast, moving into surplus a year earlier than the fiscal mandate requires. Debt would continue to fall in every year, by bigger margins than in our central forecast. Welfare cap spending would remain within the forecast margin above the cap in the last two years of the forecast, as higher earnings growth reduces spending on tax credits, but higher inflation pushes up cash spending on benefits and tax credits via uprating in 2020-21 (after the 4-year freeze has ended);
- under the **'growth slowdown' scenario**, the budget would remain in deficit in 2019-20, thereby missing the fiscal mandate surplus target. The extent of the higher borrowing would not be sufficient to place debt on a rising path as a share of GDP, so the supplementary debt target would still be met. Welfare cap spending would be higher, but would remain within the forecast margin, as lower earnings raise tax credits spending but lower inflation reduces most benefits via uprating in 2020-21; and
- under the **'negative shock' scenario**, the budget would remain in deficit every year with the extent of the increase sufficient for debt to rise as a share of GDP in each year after the shock had hit. With nominal GDP falling, the deficit would be pushed up by weaker receipts, but also because departmental spending has been fixed in cash terms in this Spending Review. That denominator effect was one of the biggest causes of the deficit rising to 10.2 per cent of GDP in 2009-10.<sup>2</sup> Despite higher borrowing adding to

<sup>2</sup> For a discussion of what caused the deficit to balloon during the late 2000s recession and financial crisis, see *Working Paper No.7: Crisis and consolidation in the public finances*, Riley and Chote (2014).

debt interest, lower RPI inflation and lower gilt rates would reduce it by more. And we have not modelled any effects on the public finances from any unconventional monetary policy easing that would be implied by the economy scenario. Welfare cap spending would be higher still and close to the limit of the forecast margin, as the substantial increase in spending on tax credits was offset by the effect of much lower inflation on uprating.

Table 5.5: Key economic and fiscal aggregates under alternative scenarios

	Per cent (unless otherwise stated)					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
<b>Central forecast</b>						
<b>Economic assumptions</b>						
GDP growth	2.2	2.5	2.4	2.4	2.4	2.4
<b>Fiscal outcome (per cent of GDP)</b>						
Welfare cap margin (per cent)		3.4	2.7	1.7	1.6	1.9
Public sector net borrowing	3.9	2.5	1.2	0.2	-0.5	-0.6
Cyclically adjusted current deficit	1.6	0.5	-0.5	-1.2	-1.9	-2.4
Public sector net debt	82.5	81.7	79.9	77.3	74.3	71.3
<b>Positive shock scenario</b>						
<b>Economic assumptions</b>						
GDP growth	2.2	2.5	2.4	3.7	4.2	1.7
<b>Fiscal outcome (per cent of GDP)</b>						
Welfare cap margin (per cent)		3.4	2.6	1.5	1.1	1.3
Public sector net borrowing	3.9	2.5	1.2	-0.3	-1.7	-2.1
Cyclically adjusted current deficit	1.6	0.5	-0.5	-1.1	-1.2	-1.8
Public sector net debt	82.5	81.7	79.9	75.8	69.9	65.1
<b>Growth slowdown scenario</b>						
<b>Economic assumptions</b>						
GDP growth	2.2	2.5	2.3	1.3	1.0	2.8
<b>Fiscal outcome (per cent of GDP)</b>						
Welfare cap margin (per cent)		3.4	2.7	1.9	2.0	2.2
Public sector net borrowing	3.9	2.5	1.2	0.6	0.6	0.6
Cyclically adjusted current deficit	1.6	0.5	-0.5	-1.4	-2.3	-2.6
Public sector net debt	82.5	81.7	80.0	78.6	78.0	76.5
<b>Negative shock scenario</b>						
<b>Economic assumptions</b>						
GDP growth	2.2	2.5	2.4	-0.7	-0.9	4.2
<b>Fiscal outcome (per cent of GDP)</b>						
Welfare cap margin (per cent)		3.4	2.9	2.1	2.4	2.4
Public sector net borrowing	3.9	2.5	1.2	1.5	2.7	2.8
Cyclically adjusted current deficit	1.6	0.5	-0.5	-1.5	-2.4	-2.5
Public sector net debt	82.5	81.7	79.9	81.0	84.7	85.3

# A Spending Review and Autumn Statement 2015 policy measures

## Overview

- A.1 Our *Economic and fiscal outlook (EFO)* forecasts incorporate the expected impact of the policy decisions announced in each Budget and Autumn Statement. In the run-up to each statement, the Government provides us with draft estimates of the cost or gain from each policy measure it is considering. We discuss these with the relevant experts and then suggest amendments if necessary. This is an iterative process where individual measures can go through several stages of scrutiny. After this process is complete, the Government chooses which measures to implement and which costings to include in its scorecard. We choose whether to certify the costings as 'reasonable and central', and whether to include them – or alternative costings of our own – in our forecast.
- A.2 In this forecast, we have certified all the costings of tax and annually managed expenditure (AME) measures that appear in the Government's main policy decisions scorecard as reasonable and central. But we were unable to certify the financial transaction costing for the 2020-21 sale of £5.8 billion of RBS shares. This measure was submitted more than three days after the mutually agreed deadline for us to be informed of new policies, on the day that we finalised our fiscal forecast. We have included the Treasury's estimate in our forecast as an uncertified costing because of its relatively simple nature – on the assumptions underpinning our central forecast, the Government would still own a sufficient number of RBS shares to raise £5.8 billion in 2020-21.
- A.3 In July, we were unable to certify one element of the welfare savings package – removing the first child premium in universal credit for new claims. In that instance too, we included the Treasury's estimate of its fiscal impact in our forecast. We have now been provided with the information necessary to assure ourselves that the costing is reasonable and central, so have included the same amount in this forecast.
- A.4 Table A.1 reproduces the Treasury's scorecard, with further details set out in Chapter 4 and in the Treasury's *Spending Review and Autumn Statement policy costings document*, which summarises the methodologies used to produce each costing and provides some information on the main areas of uncertainty within each.
- A.5 The costings process worked more efficiently alongside this forecast, with a smaller proportion of policy measures being submitted just before our deadlines than had been the case in March and July.

## Policy decisions not on the Treasury scorecard

A.6 In this *EFO* we have shown the effect on our forecasts for receipts and AME spending of policy decisions that have not been fully included in the Treasury scorecard. These include:

- the decision to help some local authorities to raise council tax more quickly to meet some of the costs associated with adult social care and policing. That decision raises receipts and local authority self-financed expenditure (LASFE). It is very nearly neutral for borrowing; and
- the AME spending effect of housing associations' estimated response to changes in grant funding announced in the Spending Review and the new limits imposed on social sector rents (explained in Annex B).

## Uncertainty

A.7 In order to be transparent about the potential risks to our forecasts, we assign each certified costing a subjective uncertainty rating, shown in Table A.1. These ratings range from 'low' to 'very high'. In order to determine the ratings, we have assessed the uncertainty arising from each of three sources: the data underpinning the costing; the complexity of the modelling required; and the possible behavioural response to the policy change. We take into account the relative importance of each source of uncertainty for each costing. The full breakdown that underpins each rating is available on our website. It is important to emphasise that, where we see a costing as particularly uncertain, we see risks lying to both sides of what we nonetheless judge to be a reasonable and central estimate.

Table A.1: Treasury scorecard of policy decisions and OBR assessment of the uncertainty of costings

		Head	£ million					Uncertainty	
			2015-16	2016-17	2017-18	2018-19	2019-20		2020-21
<b>Business, growth and skills</b>									
1	Apprenticeship Levy (funding employer apprenticeship scheme)	Tax	0	0	+2,730	+2,845	+2,970	+3,095	Medium
2	Business Rates: small business relief extension <sup>2</sup>	Tax	0	-700	+40	+15	0	0	Medium-low
3	Enterprise Zones	Tax	0	*	-10	-15	-15	-5	Medium-high
4	Royal Mail share scheme	Spend	-45	0	0	0	0	0	N/A
<b>Property and housing</b>									
5	Stamp Duty Land Tax: higher rates on additional properties	Spend	+30	+625	+700	+760	+825	+880	High
6	Stamp Duty Land Tax: bringing forward payments	Spend	0	0	+110	+10	+10	+10	Medium
7	Capital Gains Tax: reduce payment window for residential property	Tax	0	0	0	0	+930	+230	Medium
8	Temporary accommodation: impact of new funding mechanism <sup>3</sup>	Spend	0	0	+225	+235	+245	+260	Medium
<b>Energy, environment and transport</b>									
9	Renewable Heat Incentive: capping costs and improving value for money	Spend	0	+30	+100	+245	+460	+690	Medium-low
10	Landfill Communities Fund: reform	Tax	0	+20	+20	+20	+20	+20	Low
11	Flood Re: levy and premiums income	Spend	-10	+75	+65	+70	+70	+65	Medium
12	Company Car Tax: retain the diesel supplement until 2021	Tax	0	+280	+275	+275	+265	+265	Medium
13	Insurance Premium Tax: reform to motor insurance claims rules	Tax	0	0	-35	-45	-55	-55	Medium-high
<b>Avoidance, evasion and tax planning</b>									
14	Stamp Duty Reserve Tax: options abuse	Tax	0	+35	+40	+40	+40	+45	High
15	Venture capital schemes: restrictions on use	Tax	+15	+95	+95	+95	+90	+95	Medium-high
16	Capital allowances and leasing: reducing avoidance	Tax	+5	+25	+40	+30	+20	+20	High
17	Corporation Tax: disposals of intangible fixed assets to related parties	Tax	+15	+45	+70	+35	+30	+25	High
18	Company distributions: preventing avoidance	Tax	0	*	+35	+20	+15	+10	High
19	General Anti-Abuse Rule: penalties	Tax	*	+10	+20	+25	+5	+5	High

Table A.1 continued: Treasury scorecard of policy decisions and OBR assessment of the uncertainty of costings

<b>Modernising the tax and benefit system</b>									
20	Making Tax Digital: reducing errors through record keeping	Tax	0	0	*	+10	+300	+610	High
21	Corporation Tax: special rate on restitution payments	Tax	+270	+55	+55	+75	+100	+115	Medium-high
22	Fraud, error and debt: DWP and HMRC changes	Tax	0	+85	+135	+105	+135	+145	Medium
<b>Welfare</b>									
23	Tax credits: maintain taper and income threshold	Spend	0	-3,385	-2,875	-1,735	-910	-465	Medium-low
24	Universal Credit: updated delivery schedule	Spend	0	+60	+250	+225	+70	-215	Medium-high
25	Universal Credit: uprate Minimum Income Floor with National Living Wage	Spend	0	*	+10	+55	+120	+180	Medium
26	Housing Benefit: limit social sector rates to the equivalent private sector rate	Spend	0	0	0	+120	+170	+225	Medium-high
27	Housing Benefit and Pension Credit: limit temporary absence	Spend	0	+25	+20	+15	+10	+10	High
28	Childcare: revised eligibility criteria	Spend	0	+10	+70	+90	+110	+125	Medium-high
<b>Pensions and pensioners</b>									
29	Pensions automatic enrolment: align with start of tax year	Tax	0	0	+390	+450	-10	-10	Medium-high
30	Pension Credit Savings Credit: freeze	Spend	0	+135	+130	+125	+125	+120	Medium
31	Social care reforms: updated implementation date	Spend	0	+105	+110	+100	+75	-75	Low
<b>TOTAL POLICY DECISIONS</b>			<b>+280</b>	<b>-1,965</b>	<b>+2,815</b>	<b>+4,295</b>	<b>+6,220</b>	<b>+6,420</b>	
<i>Of which: welfare cap policy decisions</i>			<i>-5</i>	<i>-2,970</i>	<i>-1,920</i>	<i>-670</i>	<i>+140</i>	<i>+290</i>	
<b>Total tax policy decisions</b>			<b>+335</b>	<b>+585</b>	<b>+4,545</b>	<b>+4,620</b>	<b>+5,520</b>	<b>+5,335</b>	
<i>Of which: Apprenticeship Levy</i>			<i>0</i>	<i>0</i>	<i>+2,730</i>	<i>+2,845</i>	<i>+2,970</i>	<i>+3,095</i>	
<b>MEMO: SPENDING REVIEW: TOTAL REAL-TERM SAVINGS IN RDEL<sup>4</sup></b>			<b>0</b>	<b>+300</b>	<b>+4,100</b>	<b>+8,100</b>	<b>+11,900</b>		

\* Negligible

<sup>1</sup> Costings reflect the OBR's latest economic and fiscal determinants.

<sup>2</sup> Costing includes the impact on local government grants which have been incorporated in departmental settlements.

<sup>3</sup> This reflects the reduction in Annually Managed Expenditure from this measure. Funding for managing temporary accommodation will be included within DCLG Communities DEL; See Chapter 3 of HM Treasury's document for further detail.

<sup>4</sup> RDEL savings calculated compared to a counterfactual in which RDEL excluding depreciation grows in line with whole economy inflation from its 2015-16 level (excluding the OBR's Allowance for Shortfall).

A.8 Table A.2 shows the detailed criteria and applies them to a sample policy measure from this Spending Review and Autumn Statement: 'Pensions automatic enrolment: align with start of tax year'. It is expected to raise around £400 million in both 2017-18 and 2018-19. We have judged that the most important source of uncertainty in the costing is modelling, followed by data and behaviour. The modelling is based on an assumption of a steady-state opt-out rate of around 28 per cent of employees enrolled automatically on a workplace pension, with a gradual build-up from the current 10 per cent as contribution rates rise over the next few years. These opt-out rates were already in our baseline forecast. DWP has estimated that there will be a lower opt-out rate due to the lower contributions, but this is assessed against an unverifiable counterfactual leading us to consider it to be a 'high' source of uncertainty. The data used come from an internal DWP survey of employers, a long-standing survey on hours and earnings from the ONS, and a cross-departmental register of businesses providing workplace pensions. While not as certain as administrative data, the costing does use high quality external data. We consider this to be a 'medium' source of uncertainty. The behavioural response is a considerable factor in the costing, but it is informed by outturn data and we considered sensitivity analysis that provided further reassurance. We judge this to be a 'medium' source of uncertainty. Taking all these judgments into account, we gave the costing an overall uncertainty rating of 'medium-high'.

Table A.2: Example of assigning uncertainty rating criteria: ‘Pensions automatic enrolment: align with start of tax year’

Rating	Modelling	Data	Behaviour
Very high	Significant modelling challenges	Very little data	No information on potential behaviour
	Multiple stages and/or high sensitivity on a range of unverifiable assumptions	Poor quality	
High	Significant modelling challenges	Little data	Behaviour is volatile or very dependent on factors outside the tax/benefit system
	Multiple stages and/or high sensitivity on a range of unverifiable assumptions	Much of it poor quality	
Medium-high	Some modelling challenges	Basic data	Significant policy for which behaviour is hard to predict
	Difficulty in generating an up-to-date baseline and sensitivity to particular underlying assumptions	May be from external sources Assumptions cannot be readily checked	
Medium	Some modelling challenges	Incomplete data	Considerable behavioural changes or dependent on factors outside the system
	Difficulty in generating an up-to-date baseline	High quality external sources Verifiable assumptions	
Medium-low	Straightforward modelling Few sensitive assumptions required	High quality data	Behaviour fairly predictable
Low	Straightforward modelling of new parameters for existing policy with few or no sensitive assumptions	High quality data	Well established, stable and predictable behaviour
Importance	High	Medium	Low
Overall	Medium-high		

A.9 Using the approach set out in Table A.2, we have judged eight measures in the Treasury’s scorecard to have ‘high’ uncertainty around the central costing. One financial transaction was judged to have ‘very high’ uncertainty. These scorecard measures represent 26 per cent of those in the Autumn Statement by number and 14 per cent by absolute value (in other words ignoring whether they are expected to raise or cost money for the Exchequer). In net terms, they are expected to raise the Exchequer £5.3 billion in total over the forecast period. The measures are:

- Further Education: expansion of tuition fee loans:** This measure receives a ‘very high’ uncertainty rating. It expands advanced learning loans to cover level 3 and 4 courses for young learners (aged 19 to 23) and level 5 and 6 courses for all learners. This costing rests entirely on an estimate of behavioural change, as there is no pre-behavioural impact of making these loans available. This is the source of uncertainty in the costing. Given the lack of data on the demand for public funding for these courses

- there is currently no public funding available for standalone level 5 and 6 qualifications – and difficulties in estimating the additionality in take-up due to the measure, the estimated cost of this measure is highly dependent on judgement-based assumptions;
- **Stamp Duty Land Tax: higher rates on additional property:** This measure receives a ‘high’ uncertainty rating. From April 2016 stamp duty land tax (SDLT) rates on additional residential properties – primarily buy-to-let and second homes – will be 3 per cent higher. There are two main sources of uncertainty in the costing: the tax base and the behavioural response. Uncertainty regarding the tax base arises from the fact that at present there is no requirement to declare whether a transaction is being made as a second dwelling. As such, the number of transactions that will be liable for these higher rates in future years has had to be estimated using other sources and a number of assumptions. While there are relatively high quality data for buy-to-let purchases, data on second homes is much poorer, with estimation being based on council tax and census information. There are a number of possible behavioural effects and each adds uncertainty. For example, the measure requires purchasers to declare that the dwelling they are acquiring will not be their primary residence – i.e. effectively to opt in to the higher SDLT charge. There are also uncertainties about the extent to which the higher rates will reduce the number of property transactions and whether they could have a material effect on house prices;
- **Stamp Duty Reserve Tax: options abuse:** This measure receives a ‘high’ uncertainty rating. It is an anti-avoidance measure to restrict the use of ‘deep in the money’ options, a financial instrument used to reduce artificially the taxable consideration of transactions in shares. There is considerable uncertainty over how much of the current use of such options is legitimate and how much is largely for avoidance purposes, which creates uncertainty over the tax base. The use of these options at the moment suggests that this population is actively changing behaviour in response to the tax system. Any measure targeting such a population is inherently uncertain;
- **Making Tax Digital: reducing errors through record keeping:** This package receives a ‘high’ uncertainty rating. It is an HMRC initiative to interact digitally with small businesses across income tax, corporation tax and VAT, working with the private sector to introduce software that will design out record-keeping errors in taxpayers’ returns. There are uncertainties in the behavioural response and operational delivery. In terms of behaviour, the uncertainty relates to the extent to which the software will prevent errors by taxpayers; in terms of deliverability, the uncertainty relates to whether HMRC can deliver this challenging project in time for the benefits to be realised as scored. Reflecting lessons learnt from previous costings (as described later in this annex), we paid particular attention to the degree of contingency built into the delivery plan before certifying the costing as central;
- **Company distributions: preventing avoidance:** This package is intended to tackle the use of voluntary liquidation as a tax planning tool, and receives a ‘high’ uncertainty rating. This package introduces two new sets of rules that mean that voluntary

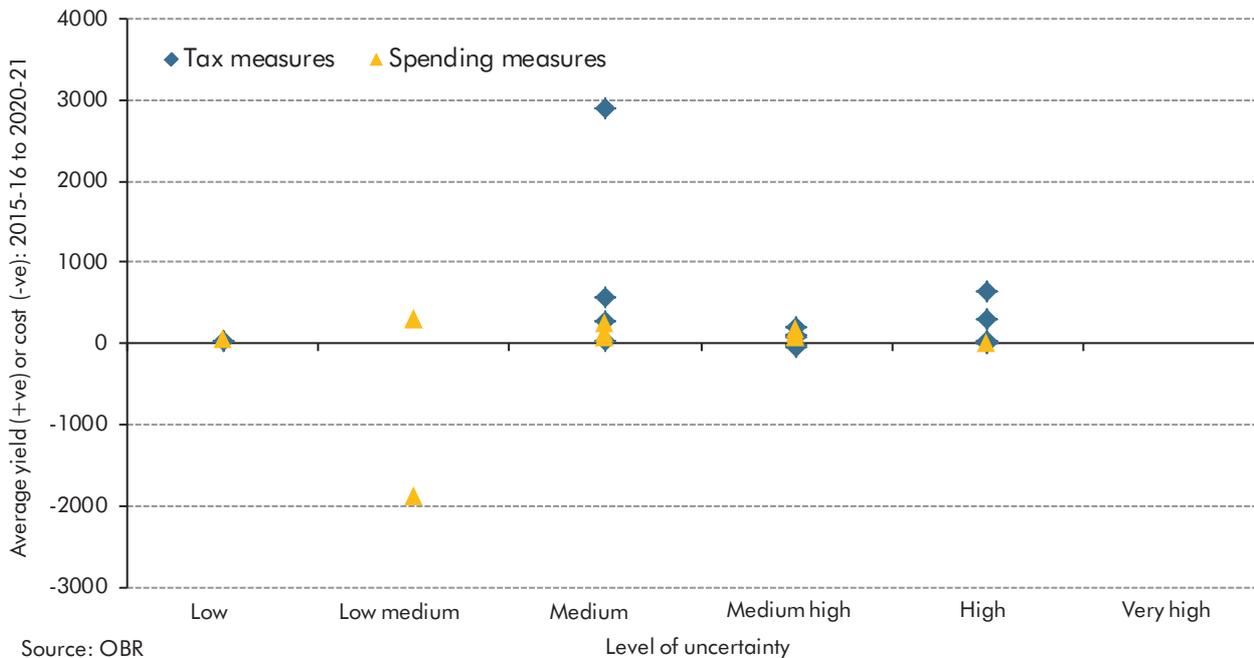
liquidation of companies that are then re-opened by the same controlling shareholders will result in an income tax liability rather than a capital gains tax liability, increasing the effective tax rate paid. The tax base has a high degree of uncertainty in this package, as the estimate relies on intelligence obtained by HMRC on whether the rule would have applied in previous cases. As a result, there is a very wide range of plausible estimates. The final costing is also reduced to account for the tax planning behaviour of the population using these tools, as they are already actively changing their behaviour in response to the tax system;

- **Capital allowances and leasing: reducing avoidance:** This measure receives a 'high' uncertainty rating. It intends to tackle schemes that resulted in either artificially low disposal values for capital allowances purposes or tax-deductible sale-and-lease-back arrangements. The tax base estimate is derived from a relatively low number of cases, which creates uncertainty: it is very sensitive to small changes in the number of future cases. There is also uncertainty over the behavioural effect, as with all measures targeting taxpayers who are already actively responding to the tax system by changing their behaviour;
- **Corporation Tax: disposals of intangible fixed assets to related parties:** This measure receives a 'high' uncertainty rating. It amends the related party rules in effect in the corporation tax regime for transfers of intangible assets to make clear that partnerships will be treated as part of a group. The uncertainty in this measure comes from the tax base and the behavioural response. The tax base is estimated from a small number of existing cases with little evidence on which to base the number of new cases that will arise from year to year. In terms of behavioural response, the main uncertainty relates once again to the measure targeting taxpayers that are already responding to the tax system by changing their behaviour;
- **General Anti-Abuse Rule: penalties:** This measure receives a 'high' uncertainty rating. It introduces a penalty for tax cases caught by the GAAR, set at 60 per cent of the tax affected. The uncertainty comes from a number of sources in this costing: the tax base is the number of cases expected to be caught by the GAAR, of which there are as yet none. It is also formed from activity hidden within avoidance schemes. The behavioural effect is based on GAAR penalties acting as a deterrent on top of the existing deterrence from the GAAR, which itself is uncertain. As we have seen with the original GAAR measure, it can take a long time for any receipts benefit to materialise – yet another source of uncertainty;
- **Housing Benefit and Pension Credit: limit temporary absence:** This package receives a 'high' uncertainty rating. It reduces the maximum temporary absence from the UK of housing benefit and pension credit claimants to four weeks before they lose their entitlement. There are two main sources of uncertainty in this costing. First, the number of people on these benefits currently travelling abroad for periods between four weeks (the new limit) and thirteen weeks (the current limit), which affects the pre-behavioural estimate. Second, the extent to which the lower limit will change behaviour, the estimate for which relies on judgement in the absence of available evidence.

A.10 We have judged 21 scorecard measures to have between ‘medium-low’ and ‘medium-high’ uncertainty around the central costing, with a further two having ‘low’ uncertainty. That means that 68 per cent of the Autumn Statement scorecard measures have been placed in the medium range (85 per cent by absolute value) and 6 per cent have been rated as low (just 1 per cent by absolute value).

A.11 Chart A.1 plots these uncertainty ratings relative to the amount each policy measure is expected to raise or cost. One feature of the distribution of measures by uncertainty is that the spending measures are typically assigned lower uncertainty ratings, while the tax raising measures are typically assigned higher uncertainty ratings than the tax cuts. This is particularly true for the measures that aim to raise money from companies and from high income and wealth individuals that are already actively planning their affairs to reduce their tax liabilities.

Chart A.1: OBR assessment of the uncertainty of scorecard costings



### Longer-term uncertainties

A.12 For most policy costings, the five-year scorecard period is sufficient to give a representative view of the long-term cost or yield of a policy change. Typically, that effect is either zero – because the policy has only a short-term impact that has passed by the end of the scorecard period – or it would be reasonable to expect it to rise broadly in line with nominal growth in the economy. In this Spending Review and Autumn Statement, the final year effect of most scorecard measures are representative of the longer-term scorecard yield.

A.13 There are two measures bringing forward payment of tax liabilities, in capital gains tax (CGT) and stamp duty land tax (SDLT). These are measures that change only the timing of tax payments and not the overall level of tax liability or the underlying economic activity being taxed:

- **Capital Gains Tax: reduce payment window for residential property:** This measure changes the payment method for CGT due on residential property disposals. Currently CGT on property disposals is paid through self-assessment, which is paid more than a year in arrears. From April 2019 onwards, taxpayers will instead have to pay within 30 days of a transaction taking place. This measure therefore boosts CGT receipts in 2019-20 and 2020-21. This is a one-off boost to receipts that is neither repeated nor reversed in future years. If CGT receipts were recorded in the public finances data in accruals terms – aligned with the timing of the economic activity that gave rise to the tax liability – rather than cash terms – when the tax is paid – our baseline forecast would change and the yield from this measure would be effectively zero; and
- **Stamp Duty Land Tax: bringing forward payments:** This measure reduces the window during which SDLT liabilities can be paid without penalty from 30 days to 14 days, alongside a consultation on other changes to the SDLT payment and filing process. This will come into force in 2017-18. This is a timing effect that will provide a one-off boost to receipts in 2017-18 but does not change the total level of liabilities. As with the CGT measure, if SDLT receipts were recorded in the public finances data in accruals rather than cash terms, our baseline forecast would change and the yield from this measure would be effectively zero.

A.14 The package of new student loans measures announced in this Autumn Statement will also have effects over the long term. These are discussed in the Chapter 4 section on loans and other financial transactions.

## Small measures

A.15 The BRC has agreed a set of conditions that, if met, allow OBR staff to put an individual policy measure through a streamlined scrutiny process. These conditions are:

- The expected cost or yield does not exceed £40 million in any year;
- There is a good degree of certainty over the tax base;
- It is analytically straightforward;
- There is a limited, well-defined behavioural response; and
- It is not a contentious measure.

A.16 A good example of a small measure announced in this Spending Review and Autumn Statement is the **reform of the landfill communities fund**, which is a simple reduction in value of the fund, with the direct consequence of reducing the value of tax credits that landfill operators can claim for contributions made to environmental bodies. This costing fulfilled all five criteria of the small measures process. Its yield is around £20 million a year, and the data are of high quality for the whole of the tax base, as it comes from the scheme's regulator. The modelling is a straightforward mechanical reduction in value and

allowable deductions. The behavioural adjustment is very small and based on historical take-up rates. It is not considered to be a contentious measure.

- A.17 By definition, any costings that meet all these conditions will have a maximum uncertainty rating of 'medium'.

## Evaluation of HMRC anti-avoidance measures

- A.18 The Treasury Select Committee's report on the Autumn Statement 2013 recommended that *"the OBR should do all it can to report on whether yields [from anti-avoidance measures] were attained as originally costed."* We did so first in Box 4.2 of our December 2014 EFO. We have repeated the exercise this year looking at more recently introduced measures and those measures for which there is new information. In total, 39 announced measures from the past five years have been evaluated.
- A.19 The revenue impact of anti-avoidance measures tends to be particularly uncertain as they often target a specific subset of taxpayers who are already actively changing their behaviour in response to the tax system. Typically these measures are assigned one of our higher uncertainty rankings as both data quality and behavioural response tend to be uncertain. That is clear again in the uncertainty ratings assigned in this Autumn Statement.
- A.20 Due to the difficulty and resource requirements of producing formal counterfactual evaluations, we again draw on evidence from HMRC's monitoring of receipts, operational intelligence and re-costing of previous measures for most of the evaluations.

## Total receipts compared to original costing

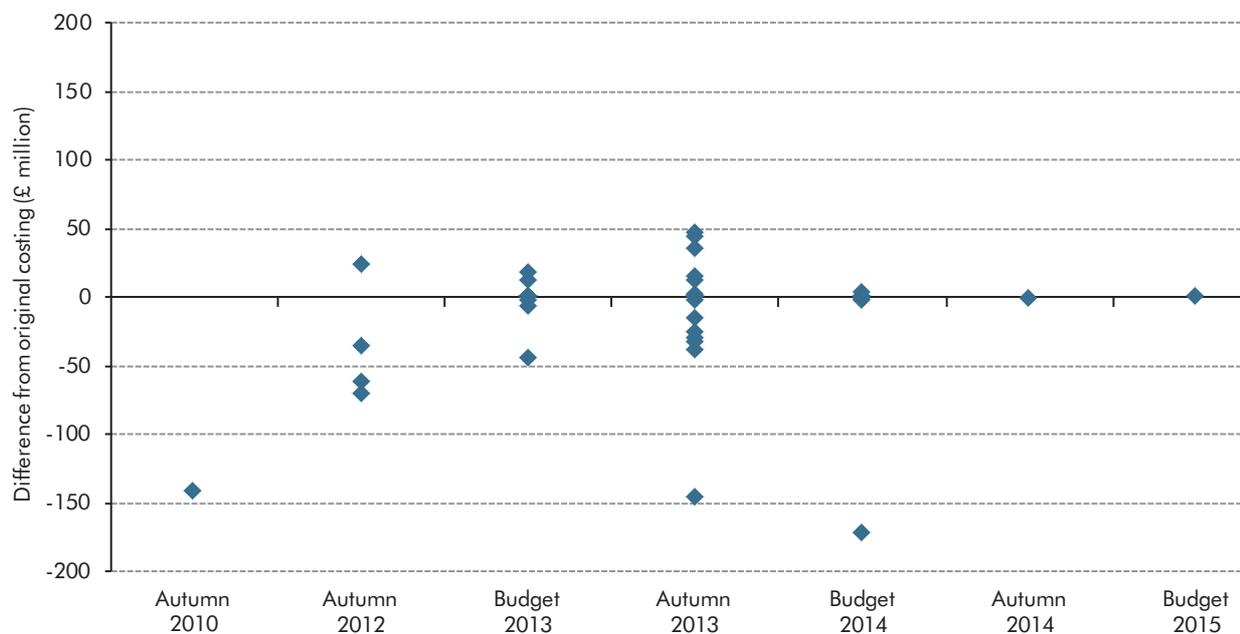
- A.21 Last December's evaluation suggested there was no systematic bias across the costings: the large shortfall from the UK-Swiss tax agreement meant that the total yield from the measures considered was below expectations, but across other measures there were both upside and downside surprises.
- A.22 Chart A.2 presents the results from the current evaluation. For each measure we plot the difference between the average yield each year from the original costing and the current estimate. The chart shows that most measures are within £50 million of the original estimate either way, but that there have been five measures where the average yield is lower by more than £50 million a year. No measures have significantly outperformed the original costing.
- A.23 Measures that changed the most since the original costing include:
- **Using real-time PAYE information to inform tax credits calculations:** This Spending Review 2010 measure sought to use HMRC's real-time PAYE information (RTI) system to lower overpayment of tax credits through a reduction in error and fraud. Initially the total estimated savings from 2014-15 onwards were in the region of £350 million a year, but these have now been lowered to around £200 million. This level is expected to continue in future years. The reduction is mainly due to a lower number of cases

affected by RTI, partly as a result of reductions in income error and fraud prior to 2014-15. This offsets the large increase in tax credits payments since 2010;

- **Tax repatriation from Jersey, Guernsey and the Isle of Man:** In our previous evaluation exercise, we noted that the Budget 2013 measure announcing the disclosure facility with the crown dependencies was not expected to yield benefits as quickly as expected in the original costing. New information indicates that overall revenue from the measure is also expected to be lower than anticipated by an average of around £50 million a year, a reduction of around 20 per cent from the original estimate. The final yield from this measure remains highly uncertain and will depend on whether there is a surge in taxpayers registering for the disclosure facility ahead of its closure at the end of the year;
- **Onshore employment intermediaries:** This Autumn Statement 2013 measure strengthened legislation to tackle the use of intermediaries facilitating false self-employment. It also introduced a new quarterly reporting obligation on intermediary businesses engaging with workers outside of PAYE. Yield from this measure is expected to have been £0.3 billion lower in both 2014-15 and 2015-16 than the original costing. The reporting obligation was delayed until 2015-16 and we expect yield to be at or above the original costing from 2016-17 as compliance activity in light of this reporting picks up;
- **Accelerated payments:** Since Budget 2013, HMRC has been issuing accelerated payments notices, which bring in revenue more quickly by demanding payment upfront in avoidance cases. A review of the measures shows that they have so far brought forward more revenue than originally estimated. However, since these measures mostly change the timing of revenue coming into the Exchequer, this means that they are now expected to result in lower revenue than anticipated in future years. The re-profiling of the yield from this measure has been incorporated into the fiscal forecast;
- **General anti-abuse rule (GAAR):** Announced at Budget 2013, the estimate of future yield from the GAAR remains highly uncertain due to the fact that no referrals have yet been made to it, and so its effectiveness in practice remains to be tested. It is now expected to raise around 25 per cent more revenue than originally estimated. The main reason for this difference is that the GAAR is now expected to have a more prolonged deterrent effect on tax avoiders. The GAAR advisory panel's opinions were originally intended to apply to avoidance schemes rather than on a case-by-case basis, which was not possible under the original legislation. The Government is now introducing legislation to apply the panel's opinions at scheme level; and
- **HMRC compliance:** Since 2010, HMRC has introduced a number of measures targeting fraud detection and debt collection. We looked at 14 debt collection measures announced and implemented since then, which shows that there have been both under- and over-estimates. Two large measures, however, have resulted in

significantly lower benefits than originally anticipated: ‘real-time information’ (described above) and ‘error and fraud additional capacity’ (discussed below).

Chart A.2: Differences between original and revised estimates of average revenue per year from anti-avoidance measures



Source: HMRC, OBR

**A.24** The Government has announced further anti-avoidance and compliance measures in recent Budgets and Autumn Statements. For many of these policies, the yield is only expected in the forecast period and we will evaluate them once they have come into effect. For example, much of the yield from the Budget 2013 and Autumn Statement 2013 policies on partnership income is only expected from January 2016.

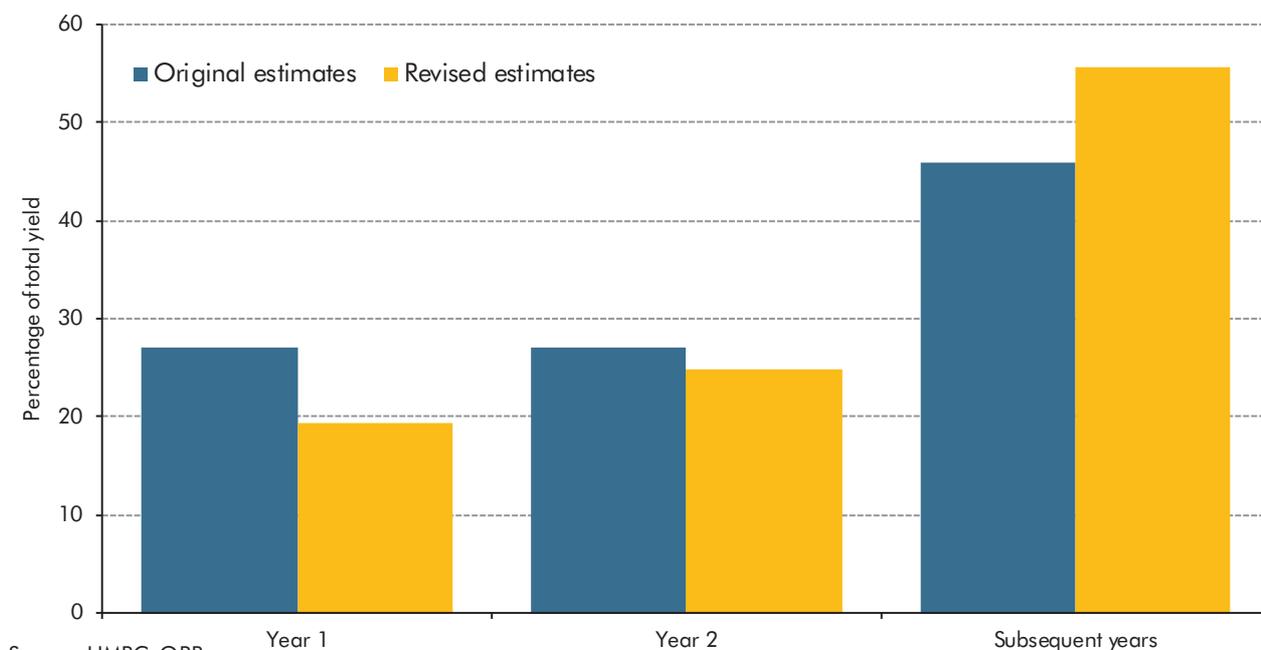
**A.25** In the July 2015 *EFO*, we discussed the Government’s announcement of a package of measures designed to increase the level and quality of compliance activity carried out by HMRC. At that time, we sought assurances from the Treasury regarding the funding of these measures, and we also scrutinised evidence from HMRC’s performance over the last Parliament. We noted that these measures were subject to considerable uncertainty. That remains the case, but having completed this evaluation of anti-avoidance measures and reviewed the assumptions used in the costings of those measures as part of the forecast process, we remain satisfied that the estimates of the yield from the measures published in July remain reasonable and central.

### Timing of receipts compared to original costing

**A.26** Last December’s evaluation also noted that “a key lesson from this exercise relates to the profile of expected yield. Anti-avoidance measures – like many new government activities – can take longer than expected to start delivering results. This includes measures that rely on new processes, staff or external contractors.” Chart A.3 covers the 39 measures in the current evaluation as well as 19 from last year’s evaluation. Across all measures, the

original costings estimated 54 per cent of the total yield would be generated in the first two years. On the revised estimates that has fallen to 44 per cent. The yield pushed into later years represents an important source of uncertainty in our fiscal forecast.

Chart A.3: Difference between timing of yield between original costing and current estimate



Source: HMRC, OBR

A.27 The yield from the majority of measures is reasonably close to the original estimate, but there are somewhat more under-performing than over-performing measures. A number of these policies remain at a relatively early stage so it is not possible to make a definitive statement about their overall effectiveness. As shown in Chart A.3 we are currently expecting some of these measures to bring in yield in future years, though this is uncertain. We will continue to evaluate the performance of these measures and apply any lessons in our scrutiny of future policy costings.

## Assessing the delivery of past measures

A.28 In order to certify costings as central, we need to estimate when – as well as by how much – measures will affect the public finances. A number of the Government’s announced policy measures were subject to uncertainty over the timing of delivery; a number were subsequently delayed. These included:

- universal credit** has been substantively delayed on at least three separate occasions in the past three years. Chart 4.8 in Chapter 4 shows that relative to our first formal inclusion of spending on universal credit in our December 2012 forecast, the rollout schedule is now around three years later than expected. In 2016-17 we now expect 330,000 claimants on universal credit rather than the 6.1 million expected in our forecast three years ago. This has typically lowered our spending forecasts because it postpones the costs associated with those that stand to gain from universal credit and

also those that stand to receive transitional protection payments because they would lose from universal credit. These delays have knock-on impacts on all the forecasts and scorecard measures associated with the legacy benefits that will be replaced by universal credit;

- the reform of **disability living allowance** (DLA) moving working-age claimants to **personal independence payments** (PIP) was originally due to cut spending by a quarter through the reassessment of DLA claimants. DWP's external contractors have so far struggled to meet required volumes and outcomes. This means that the timetable for the reassessments has been extended from two to three years (as set out in Chapter 4);
- the Budget 2013 measure following the **recommendations of the Dilnot Commission** on social care was initially due to be implemented in April 2016, at a cost of around £1 billion a year. In July 2015, it was announced that the implementation of these reforms would be delayed until April 2020;
- the introduction of **tax free childcare** has been delayed by 18 months following a legal challenge to the Government's procurement process. This pushed annual spending of around £0.9 billion into future years;
- **error and fraud additional capacity** sought to bring in private sector support for HMRC tax credits compliance activity. It was part of the Autumn Statement 2013 measure 'tax credits: improving collection and administration'. This measure has been subject to a number of issues: the start date was initially pushed back from April to September 2014; it was then further delayed due to problems with the suppliers' IT; and when it did come into operation in 2014-15, the number of cases worked proved only around a quarter of those expected. Overall savings from this measure are now around £700 million lower than expected over the contract;
- **cross-award recovery from tax credits debt** formed part of the Autumn Statement 2012 measure 'tax credits: error and fraud'. It aimed to recover recipients' previous tax credits debt from their current awards. The measure has been subject to a number of problems: initially limitations in the IT system meant that not all debts originally in scope of the policy could be included; then during the early stages of implementation, less debt than expected was able to come within scope due to difficulties transferring debts within HMRC; and HMRC's systems were unable to recover cross-award debts as rapidly as anticipated. Overall savings from this measure are now around £200 million lower than expected;
- **recovery of any tax credit debt from any tax credit award**: this was announced in July 2015 and is already subject to delay. It was due to be implemented from early November 2015, but problems encountered by HMRC's IT suppliers mean it has been delayed by a minimum of four weeks. We were informed of this delay too late to incorporate it into this forecast, but the £60 million benefit expected this year is now unlikely. We will return to the costing in our next forecast;

- **outsourcing to debt collection agencies:** another measure targeting tax credit debts. Collections were expected to begin in 2013-14, but were delayed until 2014-15. As a result, the benefits were only £60 million – a third lower than originally expected;
- in Budget 2015 the Government announced the **help-to-buy ISA** for first-time buyers of residential properties. This was due to be operative from 1 October 2015 but is currently subject to a three-month delay due to operational challenges;
- the July Budget this year announced a one-year delay in the implementation of the March 2015 measure on **secondary annuities**. We discuss the effect of this measure on our income tax forecast in Chapter 4;
- in Autumn Statement 2013, the Government announced its plan to sell part of the **student loan book**, which it expected would raise around £12 billion over five years from 2015-16. The Treasury has informed us that its policy commitment on the student loan book sale remains unchanged, but that it will not now be able to complete the first sale until 2016-17. The effects of this delay are also discussed in Chapter 4;
- the **gambling place of consumption tax reform** was announced in Budget 2012. It was expected to raise around £250 million a year and to be implemented from December 2014. Issues with the implementation of the IT system required for delivery of the new tax regime, the first accounting period was extended and no yield was received until the beginning of 2015-16; and
- in Budget 2014, the Government announced a £525 million **builders' finance fund** to provide developers of sites of up to 250 homes access to finance. A number of projects were shortlisted by the Homes and Communities Agency in September 2014, but as of October 2015, only two projects had received funds; ten schemes have signed contracts but have yet to draw down funds.

## Departmental spending

- A.29 We do not scrutinise the costings of policies that reallocate spending within departmental expenditure limits (DELs), since the total cost or yield is wholly determined by a Government policy decision. Neither do we typically scrutinise the DEL implications of measures that affect current receipts or AME spending, as those are also wholly determined by Government policy decisions. Instead, we include the overall DEL envelopes for current and capital spending in our forecasts, plus judgments on the extent to which we expect those to be over- or underspent in aggregate. DEL totals were set in the Spending Review and we have assumed underspending relative to those totals across the forecast.
- A.30 In the July Budget, we asked the Treasury to provide assurance that the announced package of HMRC and DWP operational measures would receive the necessary funding. For this forecast, we checked again that these had been fully funded.

**A.31** For this Autumn Statement, we have sought assurance from the Treasury on the funding of the measure on temporary accommodation. This is part of a reform to the funding of temporary accommodation provided by local authorities, in which the management fee will no longer be funded from DWP AME (a saving that is shown on the Treasury scorecard) but will instead be funded through grants to local authorities (reflected in DCLG DEL). The Treasury has provided assurance that this will be fully funded. The increase in DEL from this measure is captured in the Spending Review settlement and therefore within our forecast. This switch from AME to DEL moved spending from within the Government's self-imposed welfare cap to outside it.

## Indirect effects on the economy

**A.32** This Spending Review and Autumn Statement contains a number of policy changes that we have judged to be sufficiently large to justify adjustments to our central economic forecast. These include:

- the Government has eased the pace of fiscal tightening in the short term, increasing 2016-17 spending on public services, capital investment and welfare. We now expect GDP growth to be 0.2 percentage points higher in that year, and then lower in subsequent periods as the initial boost to the level of output diminishes;
- the additional costs to employers following the introduction of an apprenticeship levy are expected to initially reduce nominal wages and profit margins, with the majority of the incidence assumed to fall on wages by the end of the forecast period. This is temporarily offset by the postponement of planned increases in auto-enrolment pension contributions, which reduces employer costs slightly in 2017-18 and 2018-19;
- the higher rates of stamp duty land tax on buy-to-let properties and second homes reduces the incentive to purchase them, which we assume will reduce the number of property transactions each year; and
- changes to energy policy are expected to have a small one-off effect on CPI inflation in 2017-18. Faster rises in council tax are expected to have a more persistent effect on RPI inflation, equivalent to just under 0.1 percentage points each year from 2016-17.



# B Housing associations: reclassification and forecast

## Introduction

- B.1** The Office for National Statistics (ONS) announced in October that it would reclassify ‘private registered providers’ of social housing in England – which includes most housing associations and some for-profit bodies – from the private sector to the public corporations (PC) sector.<sup>1</sup> In this forecast, we have anticipated the effect that this will have on the official measures of public sector net borrowing and debt. These entities (which we refer to simply as ‘housing associations’ (HAs) by way of shorthand) have also been the focus of significant policy changes announced in July and again in this Spending Review and Autumn Statement. So we use this annex to set out the assumptions that we have made to forecast how the public finances will be affected by this reclassification.
- B.2** In order to forecast these effects, we have drawn on the expertise of officials in the ONS, the Department of Communities and Local Government (CLG), the Treasury and the Homes and Communities Agency (HCA), for which we are very grateful. All judgements in the forecast were made by the Budget Responsibility Committee (BRC). Those judgements are, of course, subject to significant uncertainty.
- B.3** The ONS has published provisional estimates of the effects of this reclassification on both net borrowing and net debt. Our forecasts are consistent with those estimates, but we have needed to model this bottom-up, making assumptions on individual components of receipts and spending. Past experience – for example with UK Asset Resolution and the public finances treatment of the Asset Purchase Facility – suggests it is quite possible that the assumptions that we have made will not align with the final treatment of HAs in the ONS public finances data. Our forecasts always start from published outturn data, so this represents a source of possible future revisions to the forecasts we set out in this annex.
- B.4** One issue to note is that the Government has said that it plans to deregulate HAs through the Housing Bill that is currently passing through Parliament and that it aims to return HAs to being classified in the private sector. If in future the ONS decides that these measures justify such a reclassification, we will reflect that change in our forecasts. But the possible extension of ‘right-to-buy’ to HAs’ tenants could complicate any decision.

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<sup>1</sup> See ‘Classification announcement: “Private registered providers” of social housing in England’, ONS, 30 October 2015.

## How will HAs' financial activities affect the public finances?

- B.5 HAs will be included in the public sector as public corporations (PCs). This means that a number of lines of our forecast will be affected. These include:
- **PC gross operating surplus:** HAs' rental and other income (including that received from government via housing benefit), net of non-interest running costs, will add to public sector current receipts;
  - **PC interest receipts:** HAs receive a flow of interest on their financial assets, which contributes to public sector current receipts;
  - **PC interest payments:** HAs' debt interest spending will raise public sector current expenditure; and
  - **PC capital expenditure:** HAs' investment in housebuilding and major repairs, net of asset sales, will raise public sector gross investment. Capital grants from government that are used to fund this investment will now net off within the public sector boundary. Write-offs on rental payments are also treated as capital spending.
- B.6 Together these lines will determine the effect of HAs on public sector net borrowing (PSNB). HAs' stock of liabilities will also add to public sector net debt (PSND), for which we need to forecast:
- **PC gross debt:** HAs' total outstanding loans and other liabilities will add to PSND. The extent to which this addition will rise or fall in each year of the forecast period will largely be driven by HAs' net borrowing; and
  - **PC liquid financial assets:** HAs' holdings of cash and deposits will net off PSND.
- B.7 We also need to forecast **PC depreciation**, which does not affect borrowing or debt, but is used to calculate how HAs' gross investment is split between net investment and the effect of depreciation on the current budget deficit.
- B.8 The rest of the annex will discuss how these individual lines have been forecast and the assumptions we have made about the effect of policy measures on them.

## Estimating the effect on PSNB and PSND in outturn

- B.9 Our forecasts include the impact of HAs in every year of the forecast period. In order to show the profile of changes between 2014-15 and 2015-16 on a consistent basis, we have also included estimates of the effects of including HAs in 2014-15.
- B.10 The HCA collates financial statement data across HAs and reports on them in its 'Global Accounts'. These are consistent with commercial accounting standards, but individual HAs

may interpret them in slightly different ways. These standards differ in certain respects from the National Accounting standards that determine how PSNB and PSND are calculated.

- B.11** The latest set of Global Accounts cover the year ending March 2014.<sup>2</sup> Using these data, the ONS has provisionally estimated that the reclassification will add around £3 billion to PSNB and around £55 billion to PSND in 2013-14. The ONS has provided initial estimates for 2014-15 of £4.5 billion (0.2 per cent of GDP) of additional borrowing and £59 billion (3.2 per cent of GDP) of debt.<sup>3</sup> These initial estimates will be subject to change when the reclassification is fully implemented and – as with all official data – beyond that too as new information becomes available or methodologies are updated.
- B.12** We have needed to make assumptions about the individual receipts and spending effects consistent with the ONS’s estimates for PSNB. Our estimates for 2014-15 have been projected from the 2013-14 Global Accounts baseline using the same methodology that we have applied over the forecast period, which we discuss below. These estimates were produced by OBR staff and approved by the BRC for the purposes of this forecast and will be replaced with official ONS outturn data when they are published.<sup>4</sup>
- B.13** It is also worth noting that HAs have significant housing assets on their balance sheets. As these assets are not liquid, they do not net off PSND and affect performance against the fiscal targets. But they would affect the broadest measure of the public sector’s balance sheet: public sector net worth. According to the 2014 Global Accounts, the gross book value of HAs’ housing properties in March 2014 was £132.7 billion (7.1 per cent of GDP).

## Our approach to forecasting HAs

- B.14** The reclassification affects over 1,500 bodies. Our forecasts project the aggregated numbers in the Global Accounts (which capture the larger bodies), rather than attempting to break this down. Within that total, some HAs will have different starting points and business models to each other. This is one source of uncertainty for our forecast.
- B.15** The basic premise underpinning our projections is that HAs leverage grants and cash surpluses through borrowing to invest in dwellings, subject to an interest cover constraint that their operating surpluses must more than adequately cover their interest expenses. Rental income is largely constrained by either policy and/or market conditions, and although there is some flexibility in expenses, the main room for discretion is assumed to be the choice as to how far to leverage income (by taking on more debt) to build or purchase more dwellings. The implications are twofold: the extra dwellings lead to a proportionate increase in operating surpluses, while the additional debt increases interest costs.
- B.16** In some cases the interest cover constraint may be formal, in the shape of debt covenants, but we only model the aggregate picture. This means that there is no fixed binding

<sup>2</sup> See ‘2014 Global Accounts of Housing Providers’, Homes and Communities Agency, March 2015.

<sup>3</sup> See the ONS public sector finances bulletin for October 2015, published on 20 November 2015.

<sup>4</sup> In all tables in this *EFO* that include HAs in 2014-15 we refer to the relevant numbers as an ‘Estimate’ not an ‘Outturn’ to clarify that they are not ONS outturn data.

constraint, so there is some margin for HAs to aim for lower (higher) cover than we have assumed in our forecasts, by leveraging up income by more (less), leading to higher (lower) borrowing than we have modelled. This is the key source of uncertainty in the judgements that drive our forecasts. Incomes and expenses are also uncertain, and errors in forecasting these will be amplified through leveraging in the framework that we have used.

**B.17** Our forecasts are all the more uncertain as they span a period of significant announced – and prospective – policy changes:

- the decision in the July Budget to cut social rents by 1 per cent a year for four years from 2016-17 will reduce HAs' income from social lettings. This loss of income will only be partly offset by the 'pay-to-stay' measure, which requires HAs to charge market rents to higher earners;
- this Spending Review includes an increase in central government grants over the period to 2020-21. Grants are now back-loaded, with cuts in 2016-17 and 2017-18 offset by increases in subsequent years – particularly 2020-21. The composition has also changed, with: fewer grants earmarked for the social rented sector; new grants for what the Government calls 'build-to-rent' (which allows HAs to charge higher rents, with the expectation that dwellings will be sold at a later date beyond our current forecast horizon); and a bigger expansion of grants for dwellings to be sold via shared-ownership, with fewer restrictions than at present. The shared-ownership grants will also be made available to the private sector. Capping rents for new tenants in the social rented sector at local housing allowance (LHA) rates will also lead to a small reductions in HAs' rental income; and
- the Government has said that it plans to deregulate HAs through the Housing Bill that is currently passing through Parliament. But we have not been provided with any detail as to how these plans will be implemented, and so have not modelled their potential effects. The Conservative manifesto also included a commitment to extend right-to-buy to HAs' tenants, but the Treasury has confirmed that this is not yet firm Government policy so we have not factored it into this forecast. We are likely to need to return to these issues in future forecasts.

**B.18** The following section sets out a baseline forecast, before adding the July Budget measures and then the measures announced in the Spending Review and Autumn Statement. But first we discuss the underlying assumptions.

### HAs' dwellings stock

**B.19** To forecast HAs' stock of dwellings we start from a CLG estimate of HAs' total dwellings stock, which was 2.64 million in 2013-14. We have estimated growth in 2014-15 using CLG's estimate of HAs' housing completions, which were up around 20 per cent on a year earlier. From 2015-16 onwards, our forecast for additions to the dwellings stock is driven by the capital expenditure forecast described below and by an assumption for the average cost per dwelling.

- B.20 For simplicity, in our baseline forecast we have assumed only a small flow of sales and no other reductions to the housing stock, so the net increase in dwellings is equal to the gross increase. But dwellings developed under the shared-ownership scheme will be sold in part, which will reduce the proportion of the stock that represents HAs' assets.

## Gross operating surplus

- B.21 We estimate that HAs' gross operating surplus (GOS) was £6.3 billion in 2014-15, which comprised rental and other income of £14.1 billion less operating costs of £7.8 billion. Around two-thirds of HAs' rental income is estimated to be made up of housing benefit paid by DWP on behalf of eligible tenants.
- B.22 **Rental income** has been grown in line with net additions to the dwellings stock (as described above) and average rents. Rents will differ by the type of dwelling. The average rents assumption applied to the stock of social rented housing is consistent with our forecast for housing benefit for the social rented sector, falling by 0.8 per cent a year for four years from 2016-17. This is slightly less than the announced 1 per cent cuts, as we assume, for example, that rents below the maximum are moved closer to that level as dwellings are re-let to new tenants. We previously assumed that social sector rents would rise by 1 per cent above CPI inflation (and continue to assume that in 2020-21).
- B.23 Rents on build-to-rent and shared-ownership dwellings are not subject to the same constraints. We assume that rents under these schemes are 15 per cent higher than social rents in 2014-15. This is broadly consistent with the mark-up of rents on current shared-ownership lettings against social lettings. These rents are then forecast to rise by 0.5 per cent above RPI inflation each year, in line with current HCA rules. Shared-ownership rent is scaled proportionately with the share of the property HAs own.
- B.24 **Operating costs** have been grown in line with the retained dwellings stock (the gross stock less the share bought by tenants) and the broadest measure of prices in our economy forecast, the GDP deflator. This implicitly assumes that costs fall proportionately as HAs dwellings shares are sold. Some operating costs are unlikely to change by as much – for example, rent collection costs are not greatly affected by the value of rents collected – but some other activities may be scaled back by more, or potentially cancelled.

## Interest costs

- B.25 HAs spent an estimated £2.7 billion on **interest expenses** in 2014-15. HAs tend to issue long-term debt at fixed interest rates, so much of the debt interest costs over the forecast period have already been determined. But some existing debt will mature, and HAs will also need to pay interest on the new debt they accumulate over time. We do not have a profile for the redemptions of HAs' debt over the next five years, so have assumed that the current stock matures at a fixed rate each year. The interest rate charged on both new and refinanced debt is assumed to be 150 basis points above gilt rates. This spread above gilt rates is within the range that large providers can currently access through bond markets, but above the range that they were financing at prior to the July Budget.

## Capital expenditure

- B.26** HAs spent an estimated £2.0 billion on capital repairs in 2014-15, with a further £7.5 billion of additional capital spending. HAs are also estimated to have generated up to £0.2 billion of asset sales, which net off gross capital spending in the public finances. The housebuilding and asset sales estimates are subject to greater uncertainty than other lines of the forecast that can be related more easily to lines in the Global Accounts.
- B.27** **Capital repairs** are projected to rise with the retained dwellings stock. Both the costs of repairs per dwelling and the construction of new dwellings are driven by a simple average of our forecasts for house price growth and CPI inflation, as a proxy for whole economy construction costs growth.
- B.28** We assume a small amount of **asset sales** in the baseline forecast, but the vast majority relates to the expansion of the shared-ownership scheme. Our central forecast assumes that tenants initially purchase 40 per cent of the property, which is valued at around 95 per cent of the average house price for first-time buyers. Both figures are comparable to evidence under the current shared-ownership scheme, but the programme will be opened up to a wider pool of people, so these figures may change as the scheme expands. We make the simplifying assumption that tenants do not buy additional shares of the properties they part-own within the forecast period. Just under half the sales are assumed to take place in the same period that construction begins, reflecting, for example, the time taken to exchange contracts and that construction started late in one year will run into the next.
- B.29** Our forecast for **additional capital spending** completes the forecast and determines the number of dwellings acquired. Given how we have linked most other components of the forecast to the number of dwellings, capital spending also indirectly drives the rest of the forecast. Extra capital spending can be financed through asset sales, cash operating surpluses, capital grants from central government, and debt financing. We assume that asset sales are reinvested pound-for-pound, but that cash surpluses and grants are leveraged. The degree of leveraging is constrained by the amount of interest cover.
- B.30** Asset sales and cash surpluses are both the result of other parts of our modelling. Capital grants for social dwellings are tied to particular developments. If these are sold or moved out of the regulated sector, then the HA is liable to pay back the grant to central government, although in fact it is usually allowed to be reinvested.
- B.31** Shared-ownership grants will not be subject to the same constraints, and so proceeds from sales under that scheme will be fully retained. But the amount of shared-ownership grants that HAs will receive is uncertain as they will compete with the private sector for access to this funding. We assume that 90 per cent of funding is directed towards HAs, a little less than their share of funding to date. But conditions attached to the funding are being relaxed (for example there will be fewer constraints on the types of tenants that can be targeted), and the scale will be much larger. Both factors can be expected to make the scheme more desirable to new entrants.

## Other receipts and spending

- B.32** HAs also receive a number of smaller receipts streams, including **current grants** and **interest receipts**, both of which are estimated to have been around £0.2 billion in 2014-15. We assume that current grants are unchanged in each year and that interest receipts move with changes in interest rates (we assume cash balances are flat). This implies that interest receipts are also essentially flat.
- B.33** **Write-offs** on rental payments are linked to total rental income, consistent with assuming that the rate of write-offs is fixed over time. **Depreciation** per dwelling is assumed to rise with whole economy prices.

## The effects on our fiscal forecast

### July 2015 pre-measures forecast

- B.34** Our baseline forecast assumes that, in the absence of the measures announced in July and subsequently, surpluses and capital grants (targeted at the social sector) would have been leveraged at a steady rate across time. Given our other underlying assumptions, this implies reasonably stable capital spending and net borrowing in each year. The degree of interest cover also declines over time. This path for interest cover has been used to inform our forecasts once measures are taken into account.

Table B.1: HAs' effects on the public finances: July 2015 pre-measures

	£ billion, unless otherwise stated						
	Estimate 2014-15	Forecast					
		2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Current receipts (a)	6.4	6.5	6.7	6.9	7.3	7.7	8.1
Current spending (b)	2.7	2.9	3.0	3.3	3.7	4.0	4.2
Depreciation (c)	1.5	1.5	1.6	1.7	1.7	1.8	1.8
Capital spending (d)	8.3	8.8	8.7	8.5	8.4	8.5	8.7
of which: additional capital	7.5	7.9	7.7	7.3	7.2	7.2	7.3
<b>Current deficit (b+c-a)</b>	<b>-2.3</b>	<b>-2.1</b>	<b>-2.0</b>	<b>-2.0</b>	<b>-1.9</b>	<b>-2.0</b>	<b>-2.0</b>
<b>Net borrowing (b+d-a)</b>	<b>4.5</b>	<b>5.2</b>	<b>5.1</b>	<b>4.8</b>	<b>4.7</b>	<b>4.7</b>	<b>4.8</b>
<b>Net debt</b>	<b>59</b>	<b>64</b>	<b>69</b>	<b>74</b>	<b>79</b>	<b>83</b>	<b>88</b>
<b>Net debt as a share of GDP</b>	<b>3.2</b>	<b>3.4</b>	<b>3.5</b>	<b>3.6</b>	<b>3.6</b>	<b>3.7</b>	<b>3.7</b>
<i>Memo items:</i>							
Annual change in the dwellings stock (net of any shares sold) ('000s)	45	47	45	42	40	39	39
Interest cover (GOS/interest costs)	2.26	2.19	2.14	2.03	1.94	1.90	1.87

### July post-measures forecast

- B.35** The July Budget announced a 4-year period of cuts in social sector rents. With HAs outside the public sector boundary, this led to a reduction in PSNB through lower housing benefit spending. At the time, we noted that if HAs were included in the public sector – as they now are – that the measure would instead lead to higher PSNB through lower rental payments by

HA tenants (changes in housing benefit payments would net-off within the public sector, but not any rent paid directly by tenants to HAs).

- B.36** It remains the case that the rental income effect is larger than the housing benefit effect, but changes to rental income will also have indirect effects on HAs' activities. Although the 'pay-to-stay' measure supports HAs' income, its effect is much smaller than the changes to social rents. Lower current and future income reduces the incentive to invest. And since interest costs are relatively fixed, all else equal, interest cover falls. The main way HAs could cushion themselves from this would be by reducing the amount of new debt taken on by reducing capital spending. This amplifies the negative effects of the original cuts on investment, which in turn leads to a further small reduction in income because it reduces the stock of dwellings from which rental income is generated.
- B.37** Allowing for this – but assuming that interest cover is still lower than it otherwise would be – we now estimate that the July Budget measures reduce borrowing in each year, and by around £3 billion a year in the medium term. This is more than explained through lower net investment, so the current budget deficit is worsened.

**Table B.2: HAs' effects on the public finances: July 2015 post-measures**

	£ billion, unless otherwise stated						
	Estimate	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Current receipts (a)	6.4	6.5	6.4	6.6	6.3	6.2	6.5
Current spending (b)	2.7	2.9	3.0	3.2	3.4	3.6	3.7
Depreciation (c)	1.5	1.5	1.6	1.6	1.7	1.7	1.8
Capital spending (d)	8.3	8.2	6.9	5.6	4.7	4.0	4.4
of which: additional capital	7.5	7.3	5.9	4.6	3.6	2.9	3.3
<b>Current deficit (b+c-a)</b>	<b>-2.3</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.7</b>	<b>-1.2</b>	<b>-0.8</b>	<b>-1.0</b>
<b>Net borrowing (b+d-a)</b>	<b>4.5</b>	<b>4.6</b>	<b>3.5</b>	<b>2.3</b>	<b>1.8</b>	<b>1.4</b>	<b>1.6</b>
<b>Net debt</b>	<b>59</b>	<b>64</b>	<b>67</b>	<b>69</b>	<b>71</b>	<b>72</b>	<b>74</b>
<b>Net debt as a share of GDP</b>	<b>3.2</b>	<b>3.3</b>	<b>3.4</b>	<b>3.3</b>	<b>3.3</b>	<b>3.2</b>	<b>3.1</b>
<i>Memo items:</i>							
<i>Annual change in the dwellings stock (net of any shares sold) ('000s)</i>	45	44	35	26	20	16	18
<i>Interest cover (GOS/interest costs)</i>	2.26	2.19	2.07	1.98	1.80	1.67	1.71

Table B.3: The estimated effects of the July measures on HAs

	£ billion, unless otherwise stated						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Current receipts (a)	0.0	0.0	-0.3	-0.4	-0.9	-1.5	-1.6
Current spending (b)	0.0	0.0	0.0	-0.1	-0.2	-0.4	-0.5
Depreciation (c)	0.0	0.0	0.0	0.0	0.0	0.0	-0.1
Capital spending (d)	0.0	-0.6	-1.8	-2.8	-3.6	-4.5	-4.3
of which: additional capital	0.0	-0.6	-1.7	-2.8	-3.5	-4.3	-4.1
<b>Current deficit (b+c-a)</b>	<b>0.0</b>	<b>0.0</b>	<b>0.2</b>	<b>0.3</b>	<b>0.7</b>	<b>1.1</b>	<b>1.0</b>
<b>Net borrowing (b+d-a)</b>	<b>0.0</b>	<b>-0.6</b>	<b>-1.5</b>	<b>-2.6</b>	<b>-2.9</b>	<b>-3.3</b>	<b>-3.2</b>
<b>Net debt</b>	<b>0</b>	<b>-1</b>	<b>-2</b>	<b>-5</b>	<b>-8</b>	<b>-11</b>	<b>-14</b>
<b>Net debt as a share of GDP</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.1</b>	<b>-0.2</b>	<b>-0.4</b>	<b>-0.5</b>	<b>-0.6</b>
<i>Memo items:</i>							
Annual change in the dwellings stock (net of any shares sold) ('000s)	0	-3	-10	-15	-19	-23	-21
Interest cover (GOS/interest costs)	0.00	0.00	-0.07	-0.05	-0.15	-0.23	-0.16

## November 2015 forecast

**B.38** Our November forecast uses the same approach, but factors in the effects of Government decisions in the Spending Review and Autumn Statement. The biggest change results from Spending Review decisions on the size and composition of capital grants available to HAs. They have been cut in 2016-17 and 2017-18, then raised in later years. Grants are higher over our forecast period as a whole, but this is mainly due to the increase in 2020-21 (which is beyond the current Spending Review period). The composition now differs, with less earmarked for the social sector, and the majority now targeted at shared-ownership, with smaller grants for 'build-to-rent'.

Table B.4: Central government capital grants to HAs

	£ million					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
July (social sector only)	960	960	960	960	960	960
November <sup>1</sup>	960	690	590	1,100	1,190	1,700
of which:						
Social sector	960	600	400	130	130	130
Shared-ownership <sup>2</sup>	0	90	160	910	990	1,510
Build-to-Rent	0	0	30	60	60	50
<i>Memo: total shared-ownership grants</i>	<i>0</i>	<i>100</i>	<i>180</i>	<i>1,020</i>	<i>1,100</i>	<i>1,680</i>

<sup>1</sup> Components may not sum to total due to rounding.

<sup>2</sup> This is the assumption underpinning our forecasts, and is consistent with 90 per cent of the total being received by HAs.

**B.39** Capital grants are expected to be leveraged to finance investment, so revisions to net borrowing follow a similar path to the revisions to grants. Since the features of each of the schemes differ, changing the composition of grants has generated further variations.

- B.40** As rents under build-to-rent and shared-ownership will be higher than in the social sector, and the costs of running these properties are unlikely to be significantly different, these schemes are expected to yield a higher return to HAs. The additional headroom above interest expenses is assumed to lead to some additional leveraging, leaving the interest cover unchanged. The effects on total income are relatively small, since the vast majority of the stock of HA dwellings will still be within the social sector.
- B.41** Shared-ownership brings forward income that HAs would otherwise have received as a stream of future rents. Although this may reduce uncertainty over the eventual return (as some has been received up-front), it does not necessarily imply a change in overall profitability over the lifetime of the asset. But by yielding cash earlier, it allows HAs to re-invest the proceeds or to reduce debt.
- B.42** We assume that proceeds are fully re-invested, with half going into additional shared-ownership dwellings and the remainder in social dwellings, supporting investment in that sector given the cuts in related capital grants. In essence, spending is recycled, leading to higher gross investment, but little change in net investment (i.e. net of the partial asset sales through shared-ownership) or net borrowing.
- B.43** The decision to cap rents for new tenants in the social rented sector at private sector LHA rates will also lead to lower HA income. Similar to the decision in July to cut social rents, this is expected to reduce net borrowing as investment falls by more than the reduction in rent. But the effects are on a much smaller scale.

**Table B.5: HAs' effects on the public finances: November 2015 post-measures**

	£ billion, unless otherwise stated							
	Estimate	Forecast						
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	
Current receipts (a)	6.4	6.5	6.4	6.5	6.3	6.2	6.5	
Current spending (b)	2.7	2.9	3.0	3.2	3.4	3.6	3.7	
Depreciation (c)	1.5	1.5	1.6	1.6	1.7	1.7	1.8	
Capital spending (d)	8.3	8.2	6.5	5.7	5.3	4.5	5.7	
of which: additional capital	7.5	7.3	5.3	4.6	5.4	5.9	8.3	
<b>Current deficit (b+c-a)</b>	<b>-2.3</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.7</b>	<b>-1.2</b>	<b>-0.8</b>	<b>-1.0</b>	
<b>Net borrowing (b+d-a)</b>	<b>4.5</b>	<b>4.6</b>	<b>3.1</b>	<b>2.4</b>	<b>2.4</b>	<b>2.0</b>	<b>2.9</b>	
<b>Net debt</b>	<b>59</b>	<b>64</b>	<b>67</b>	<b>69</b>	<b>71</b>	<b>73</b>	<b>76</b>	
<b>Net debt as a share of GDP</b>	<b>3.2</b>	<b>3.3</b>	<b>3.3</b>	<b>3.3</b>	<b>3.2</b>	<b>3.2</b>	<b>3.2</b>	
<i>Memo items:</i>								
<i>Annual change in the dwellings stock (net of any shares sold) ('000s)</i>	45	44	31	25	27	24	35	
<i>Interest cover (GOS/interest costs)</i>	2.26	2.19	2.07	1.99	1.80	1.67	1.71	

Table B.6: The estimated effects of the November measures on HAs

	£ billion, unless otherwise stated						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Current receipts (a)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current spending (b)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Depreciation (c)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital spending (d)	0.0	0.0	-0.4	0.1	0.6	0.6	1.2
of which: additional capital	0.0	0.0	-0.6	0.0	1.8	3.0	5.0
<b>Current deficit (b+c-a)</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Net borrowing (b+d-a)</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.4</b>	<b>0.1</b>	<b>0.6</b>	<b>0.6</b>	<b>1.2</b>
<b>Net debt</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>1</b>	<b>2</b>
<b>Net debt as a share of GDP</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.1</b>
<i>Memo items:</i>							
Annual change in the dwellings stock (net of any shares sold) ('000s)	0	0	-4	-1	6	9	17
Interest cover (GOS/interest costs)	0.00	0.00	0.00	0.01	0.00	-0.01	-0.01

Table B.7: HAs' effects on the public finances: latest forecasts in detail

	£ billion, unless otherwise stated						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Current receipts	6.4	6.5	6.4	6.5	6.3	6.2	6.5
of which:							
Rental and other income (GOS)	14.1	14.5	14.6	15.0	15.0	15.1	15.8
Operating costs (GOS)	-7.8	-8.1	-8.4	-8.6	-8.9	-9.1	-9.4
Interest receipts	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Interest costs (current spending)	2.7	2.9	3.0	3.2	3.4	3.6	3.7
Depreciation	1.5	1.5	1.6	1.6	1.7	1.7	1.8
Capital spending	8.3	8.2	6.5	5.7	5.3	4.5	5.7
of which:							
Capital repairs	2.0	2.0	2.1	2.1	2.2	2.2	2.3
Asset sales	-0.2	-0.2	-0.3	-0.5	-1.3	-2.5	-3.4
Additional capital	7.5	7.3	5.3	4.6	5.4	5.9	8.3
Capital grants	-1.1	-1.0	-0.7	-0.6	-1.1	-1.2	-1.7
Write-offs <sup>1</sup>	0.1	0.1	0.1	0.1	0.1	0.1	0.1

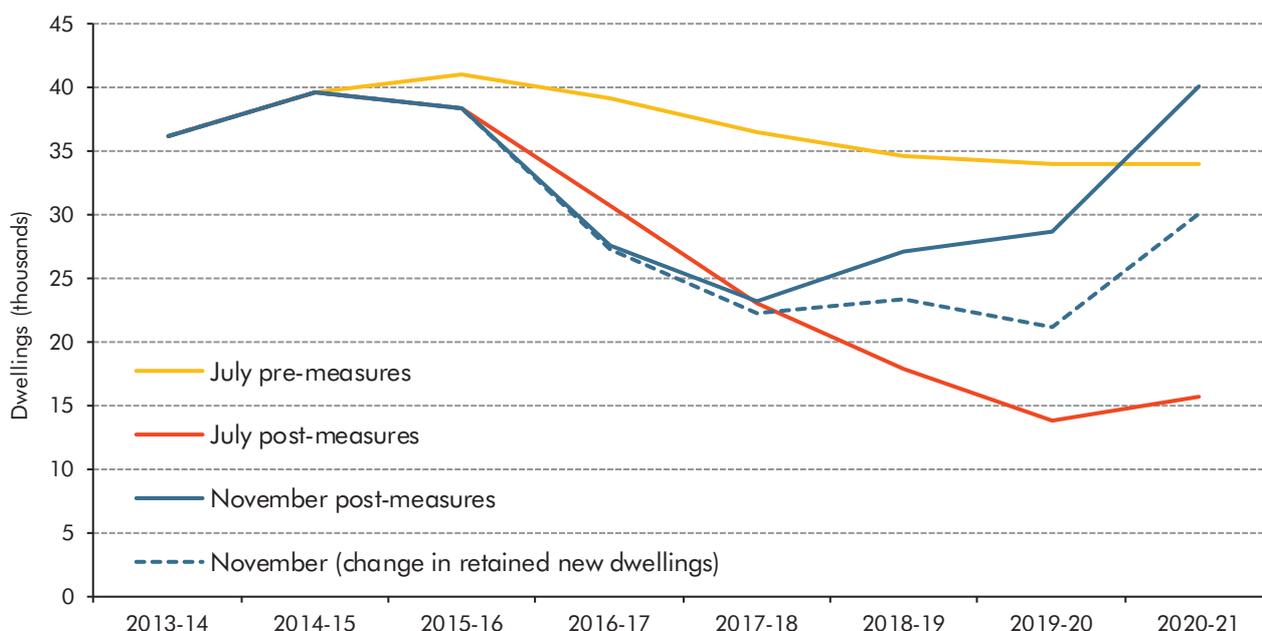
<sup>1</sup> Write-offs do not involve cash, so do not affect public sector net debt.

## The effects on dwellings

B.44 HAs can expand their stock of dwellings through new builds or acquisitions. We assume the split between the two is unchanged from 2013-14. Assuming that the costs are comparable, this split does not matter for the purposes of our fiscal forecast. But the number of new dwellings directly contributes to GDP through residential investment. So changes to HAs' new builds will potentially affect our economy forecast – although only to the extent that HAs develop properties that would not otherwise be built within our forecast horizon.

- B.45** With net investment spending stable in our baseline forecast, rising construction costs lead to a marginal slowdown in the accumulation of dwellings. At the time, our July economy forecast assumed a flat baseline, and that HAs’ investment in dwellings would fall proportionately to the change in social sector rents, suggesting 14,000 fewer dwellings would be built over the forecast period. Our latest estimates, which take into account the relative sizes of rents and capital spending (which alone suggests a disproportionate effect on investment), and, more importantly, the role of leveraging (discussed above) are significantly larger. We now estimate that the July measures alone would have cut the number of HAs new builds over the forecast period from 220,000 to 140,000 – a reduction of 80,000.
- B.46** Taking into account the Spending Review and Autumn Statement measures, we now expect lower grants to lead to even fewer new builds in 2016-17. Our forecast for 2017-18 is then unchanged, with new builds rising in each year thereafter, given the increases in grants and the expected re-investment of sales proceeds from shared-ownership.
- B.47** Over the forecast period as whole, we now expect 185,000 new builds, 46,000 more than we would have seen in the absence of the November measures, but still 34,000 lower than we would have seen in the absence of both the July and November measures. (The number of net new properties retained in the HA sector is 23,000 higher than in the absence of the November measures but 57,000 lower than it would have been before the July measures.) By 2020-21 the number of new builds a year rises above our July pre-measures baseline, at which point it is roughly in line with our estimate for the number in 2014-15.

Chart B.1: HAs’ new builds



Source: CLG, OBR

- B.48** Only liquid assets are netted off within public sector net debt, but HAs also hold significant long-term assets, in the form of their stock of dwellings. The book value of the stock

currently exceeds HAs' net debt, and if the stock were to rise with average houses prices, then the gap would increase over time, with the value of dwellings rising above £200 billion by 2020-21. This simple illustration takes into account the slower accumulation of dwellings in our post-measures forecasts, but not the effect of lower rents on their value to HAs, so is likely to be an overestimate.

- B.49** Although it does not capture revaluation effects, an alternative way to view the net worth of HAs over time is to consider how the current budget balance evolves. The HA current budget is in surplus by around £2 billion a year in our baseline forecast, suggesting that their net worth would have risen by that amount each year. But this halves by the end of our forecast period once we take the July Budget measures into account. The effects of the Spending Review measures on the current budget balance are very small.

## Uncertainties and sensitivity analysis

- B.50** There are many uncertainties surrounding our first forecast for HAs, not least given the possible behavioural responses of many entities, large and small, to the policy changes announced in July and now in the Spending Review, plus the further changes in prospect. Although we were able to discuss the potential effects of the July measures and our basic modelling approach with the HCA, we were unfortunately not able to test with them the modelling of these latest measures. In particular, the shared-ownership model differs from HAs' current operating model, and it is not clear how actively it will be pursued. There is also considerable uncertainty about how HAs will respond to the further policy changes that the Government plans.
- B.51** Table B.2 shows the effects of varying key assumptions on PSNB, the current budget and gross housebuilding:
- HAs might, in aggregate, take on more or less debt for a given amount of income than we have assumed. We currently assume that interest cover acts as a constraint, but HAs might be willing to operate with lower cover if they anticipate it to be only temporary. Taking on more debt would lead to both higher borrowing and housebuilding, and, due to higher debt interest costs, a smaller current budget surplus;
  - holding the leverage ratio fixed, but assuming that rent growth is stronger, would also lead to higher borrowing and investment, but with an improvement in the current budget balance, consistent with a better underlying position. Higher operating costs would work in the opposite direction. Higher construction costs would mainly show through fewer dwellings being built, with little change in the deficit over the near term; and
  - higher proceeds from shared-ownership sales, either due to stronger house price growth or a bigger share being sold up-front, would also affect dwellings growth since we assume that sales proceeds are fully re-invested. Assuming only partial reinvestment would lead to significantly lower net borrowing, as the asset sales still net-off gross investment, but also lower housebuilding.

Table B.8: Sensitivity analyses for 2020-21

	£ billion		New dwellings (000's)
	Public sector net borrowing	Current budget deficit	
Central forecast	2.9	-1.0	46
Leverage ratio is up by 1	4.3	-0.7	52
Rent/cost growth is 1 ppt. higher			
Rent	3.9	-1.8	57
Operating costs	2.2	-0.4	39
Construction costs	2.7	-1.0	41
Asset sales			
House price growth is 1 ppt. higher	2.9	-1.0	47
Half the property is sold up-front	2.8	-1.0	50
Half the proceeds are re-invested	1.4	-1.1	38

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