1 Executive summary

Overview

1.1 The UK economy has slowed this year as households' real incomes and spending have been squeezed by higher inflation. GDP growth has been a little weaker than we expected in March, but once again we have been more surprised by the strength of employment growth and the corresponding weakness of productivity growth. The persistence of weak productivity growth does not bode well for the UK's growth potential in the years ahead.

1.2 That said, the public finances have performed better than expected. The ONS has revised borrowing in 2016-17 sharply lower, relative to its initial estimate and our March forecast. And the deficit has continued to fall in the first half of 2017-18. We have revised borrowing down by £8.4 billion to £49.9 billion for the full year, but this is still slightly up on 2016-17 because timing effects boosted receipts last year and will lower them later this year.

1.3 We have lowered our real GDP forecast in every year. We now expect growth to average 1.4 per cent a year over the next five years, slowing a little over the next two (as public spending cuts and Brexit-related uncertainty weigh on the economy) and picking up modestly thereafter as productivity growth quickens. The main reason for lowering our GDP forecast since March is a significant downward revision to potential productivity growth, reflecting a reassessment of the post-crisis weakness and the hypotheses to explain it.

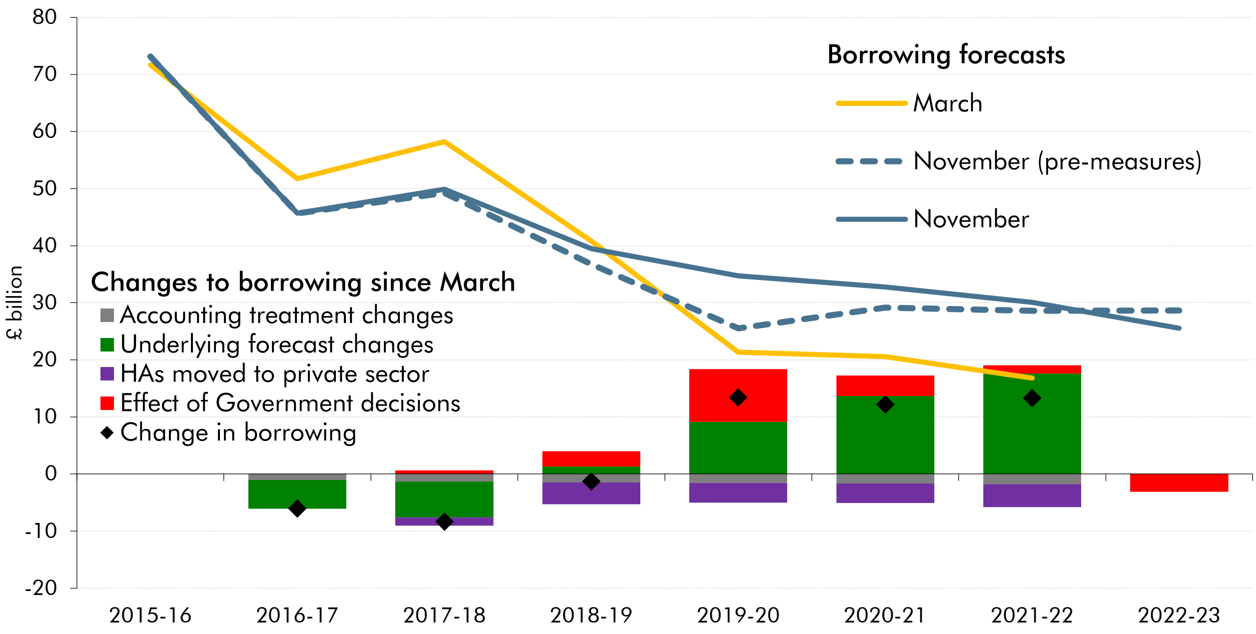
1.4 The combined effects of a better fiscal position now, but weaker prospects looking forward, have led us to revise up our forecast for the budget deficit by increasing amounts over the next five years, even before accounting for the Budget measures. In the Government's fiscal target year of 2020-21, our underlying upward forecast revision of £13.7 billion absorbed roughly half the headroom against the 'fiscal mandate' shown in our March forecast.

1.5 Faced with a weaker outlook for the economy and the public finances, and growing pressures on public services following years of cuts, the Government has chosen to deliver a significant near-term fiscal giveaway. This adds £2.7 billion to borrowing next year and a larger £9.2 billion (0.4 per cent of GDP) in 2019-20. The package includes net tax cuts (to fuel duty, inevitably, and stamp duty for first-time buyers), a significant easing in previously planned cuts to current departmental spending and a boost to capital spending. Together they provide a modest boost to GDP growth in the years we expected it to be weakest. Consistent with the pattern of many past fiscal events, the policy easing is then scaled back in future years, with a small fiscal tightening ultimately pencilled in for 2022-23 in the form of further cuts in public services spending as a share of GDP.

1.6 Despite the deterioration in our underlying forecast, the tax and spending giveaway, and extra lending through Help to Buy, the Government has ensured that net debt still falls fractionally as a share of GDP in 2018-19 and by more beyond. It has achieved this largely by announcing fresh sales of RBS shares and by passing regulations that ease local and central government control over housing associations in England. In response, the Office for National Statistics has announced that it will treat them as private sector entities from the point at which the regulations take effect. This has reduced our borrowing forecast by around £3¾ billion a year and reduced our debt forecast by between £67 and £81 billion. But housing associations' role as providers of a public service means that this accounting change has no material effect on the underlying health and riskiness of the public finances – if the sector faced serious financial difficulties in the future, it seems equally likely that the Government of the day would choose to stand behind it whatever its statistical classification.

1.7 Chart 1.1 shows how the different factors have affected our borrowing forecast since March. Our underlying forecast changes and the Government's fiscal loosening generally push the deficit higher while statistical changes have reduced it more modestly. Absent Budget measures, borrowing would have troughed in 2019-20 and fluctuated thereafter. Once Government decisions are factored in, the deficit declines more smoothly over time.

Chart 1.1: Public sector net borrowing



Source: ONS, OBR

1.8 On this basis, our central forecast implies that the Government's fiscal mandate – for cyclically adjusted borrowing to lie below 2 per cent of GDP in 2020-21 – would be met by a margin of 0.7 per cent of GDP, down by just under half relative to our March forecast. This measure of the deficit falls below 2 per cent in 2018-19. Public sector net debt falls by 3.0 per cent of GDP in 2020-21, meeting the supplementary debt target too. And the subset of spending covered by the welfare cap remains below the stipulated level in 2021-22. A new welfare cap – the fourth to be announced in four years – has been set in this Budget.

Economic developments since our previous forecast

1.9 As expected, real GDP growth has slowed noticeably this year. The fall in the pound that followed the EU referendum has pushed up consumer price inflation and squeezed households' real incomes and spending. But the slowdown started slightly earlier than we expected in March. As a result, the 0.9 per cent increase in real GDP between the end of 2016 and the third quarter of 2017 was 0.2 percentage points weaker than we expected.

1.10 This is a relatively small difference, but the breakdown of that GDP increase between employment and productivity growth has diverged from our forecast more significantly. Employment increased by around 230,000 over the three quarters, more than twice as fast as expected, while average hours worked per person were broadly flat rather than falling as we had expected. As a result, total hours worked rose by 0.7 per cent rather than the 0.1 per cent we had forecast, while output per hour rose by 0.3 per cent rather than 1.1 per cent. This pattern of weaker productivity growth and stronger employment growth than we had been expecting has been a consistent feature of our forecasts for some time.

1.11 The slowdown in UK GDP growth so far this year contrasts with a pick-up in other advanced economies. Real GDP growth averaged 0.3 per cent a quarter in the UK in the first three quarters of 2017, down from 0.5 per cent in the second half of 2016. In the euro area, US, Canada and Japan, quarterly growth so far this year has been stronger than in the second half of 2016 and stronger than in the UK. Sterling's fall has seen inflation pick up more rapidly in the UK than in the other major economies, contributing to weaker real growth.

1.12 Meanwhile, data revisions since our previous forecast have changed some aspects of the National Accounts significantly. In particular, the ONS has revised households' dividend income up hugely, with an offsetting downward revision to retained corporate profits. This now better reflects the rising number of people working as owner-managers of incorporated firms (and taking income as dividends) rather than as employees or unincorporated sole proprietors. This has boosted measured household income and raised the saving ratio, although the latter is still estimated to have fallen sharply in recent years. The ONS has also made significant revisions to the balance of payments, with interest income earned by foreign owners of UK corporate bonds revised up substantially. As a result, the current account deficit is now estimated to have widened to almost 6 per cent of GDP in 2016.

The economic outlook

1.13 Parliament requires us to produce our forecasts on the basis of stated Government policy, but not necessarily assuming that particular policy objectives are achieved. With complex negotiations over the UK's exit from the EU still underway, this is not straightforward.

1.14 The Prime Minister set out further detail of the UK's position in her speech in Florence in September and the Government has published a number of papers on aspects of post-Brexit policy. But there is still no meaningful way to predict the precise end-point of the negotiations upon which to base our forecast. There is also considerable uncertainty about the economic and fiscal implications of different potential outcomes, including the impact of any monetary policy response that might accompany them. So we have retained the same broad-brush assumptions on productivity, trade and migration that underpinned our March forecast (as set out in Chapter 3). These are consistent with a range of possible outcomes.

1.15 The most significant changes to our underlying pre-measures forecast since March relate to the outlook for the economy's supply potential, which determines how much real GDP can grow in total over the next five years consistent with the Bank of England setting monetary policy to achieve its inflation target. Our potential output growth judgement has five elements. Four relate to the total number of hours that can be worked sustainably without putting upward or downward pressure on inflation: the number of adults; the proportion participating in the labour market; the proportion of those that can be sustained in employment; and the average number of hours that they are willing and able to work. The fifth and most important judgement over the medium term is potential growth in productivity – the amount of output that can be produced sustainably from each hour worked.

1.16 We have revised each component of our potential output forecast since March:

- **Population growth**: we use the ONS's 'principal' population projection to underpin our forecast. New projections were published in October, with net inward migration now expected to decline steadily to 165,000 a year by 2023, down from 185,000 by 2021 in the previous projection. More importantly, net inward migration among working-age adults has been revised down more than the total, while mortality rates have been revised up. Together with slightly weaker outturns than we expected, this implies a smaller adult population, reducing potential output in 2021-22 by 0.2 per cent.

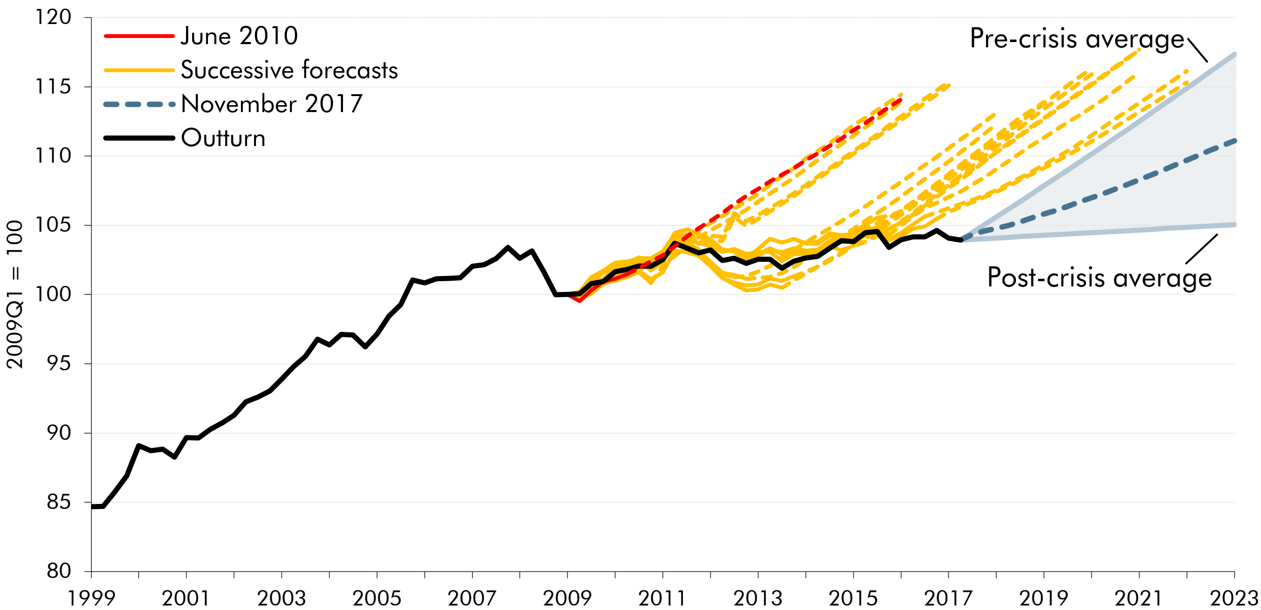
- **Participation rates**: we expect the whole-economy participation rate to decline as the ageing of the population outweighs the upward trend in labour market participation rates at specific older ages. Thanks to the latest population projections and labour market data, the expected decline in the overall participation rate is a little slower than we predicted in March, raising potential output in 2021-22 by 0.2 per cent.

- **Sustainable unemployment**: unemployment has continued to fall without much sign of wage pressures building. This suggests that our March assumption that the economy could sustain unemployment at 5 per cent was too high, so we have revised it down to 4.5 per cent. We still expect it to rise a little over the next few years as the National Living Wage prices some workers out of employment. Relative to March, this raises the level of potential output by 0.5 per cent in all years. This does not affect potential output growth over the forecast, but provides greater scope for actual output growth.

- **Average hours**: average hours worked per person have risen since the financial crisis, but to date we have assumed that the long-run downward trend will reassert itself over the forecast horizon. However, this has not yet happened, probably because workers have been trying to offset some of the impact of weak productivity and earnings growth on their incomes. Given the further downward revision to expected productivity growth in this *EFO*, we now assume a flat path for average hours rather than a 0.2 per cent a year decline. This raises potential output in 2021-22 by 0.9 per cent.

- **Productivity growth**: the largest change we have made to our economy forecast in this *EFO* has been to revise down trend or potential productivity growth, as foreshadowed in our *Forecast evaluation report* in October. As the remarkable period of post-crisis weakness extends – and as various explanations pointing to a temporary slowdown become less compelling – it seems sensible to place more weight on recent trends as a guide to the next few years. But huge uncertainty remains around the diagnosis for recent weakness and the prognosis for the future. We have assumed that productivity growth will pick up a little, but remain significantly lower than its pre-crisis trend rate throughout the next five years. On average, we have revised trend productivity growth down by 0.7 percentage points a year. It now rises from 0.9 per cent this year to 1.2 per cent in 2022. This reduces potential output in 2021-22 by 3.0 per cent. The ONS estimates that output per hour is currently 21 per cent below an extrapolation of its pre-crisis trend. By the beginning of 2023 we expect this to have risen to 27 per cent.

Chart 1.2: Productivity growth (output per hour) – forecasts and outturns

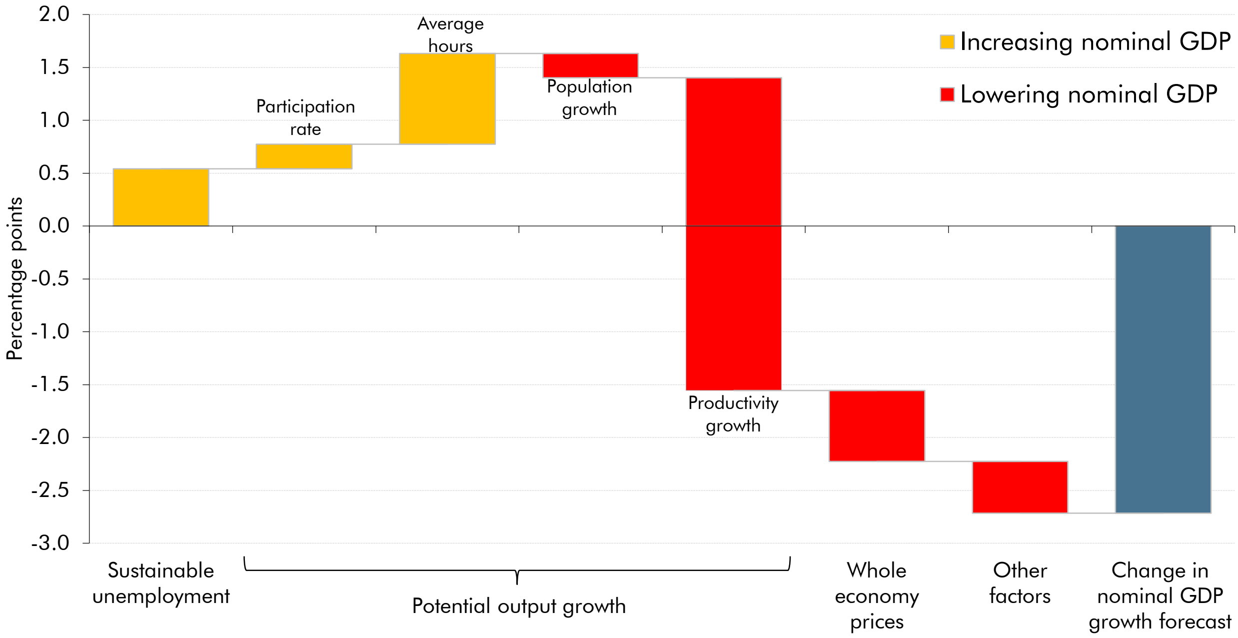


Note: Solid lines represent the outturn data that underpinned the forecast.
Source: ONS, OBR

1.17 The net effect of these revisions is to reduce the estimated level of potential output in 2021-22 by 2.1 per cent compared to our March forecast. Growth in potential still picks up over the forecast – from 1.3 per cent in 2018 to 1.5 per cent in 2022 – but the average rate through to 2021 is now just 1.4 per cent a year, down 0.5 percentage points since March.

1.18 Increasing the current level of potential output, but reducing the rate at which it grows thereafter, leads us to revise down our forecast for *actual* GDP growth by 0.4 percentage points a year relative to March. We now expect real GDP to grow by 5.7 per cent between 2017-18 and 2021-22 – down from 7.5 per cent in March. Whole economy inflation is also expected to be weaker than we thought in March, largely because we changed our modelling of import prices to make it more consistent with our forecast for consumer prices. Taking the two sets of judgements together, GDP in nominal or cash terms is expected to grow by 12.6 per cent by 2021-22, down from 15.3 per cent in March. This implies slower growth in all the major sources of tax revenue. (The breakdown of this 2.7 percentage point downward revision to nominal GDP growth is illustrated in Chart 1.3.)

Chart 1.3: Sources of revision to nominal GDP growth from 2017-18 to 2021-22



Source: OBR

1.19 Looking at the year-by-year profile, we expect real GDP growth to slow from 1.5 per cent this year to 1.4 per cent in 2018 and 1.3 per cent in 2019, as public spending cuts intensify and Brexit-related uncertainty continues to bear down on activity. The gentle improvement in underlying productivity growth and a small cyclical boost as spare capacity is brought back into use are expected to deliver slightly higher GDP growth in 2021 and 2022. The short-term fiscal loosening announced in this Budget boosts growth by 0.1 percentage points in 2018 and 2019, but its withdrawal then reduces it by the same amounts in the following two years. The uncertainty around the central projection is clearly very large.

1.20 We expect CPI inflation to peak in the current quarter and then fall back to – and for a while slightly below – the Government's 2 per cent target over the subsequent year and a half, easing the squeeze on households' finances. Interest rates are expected to rise slowly, with markets expecting Bank Rate to reach 1¼ per cent in five years' time, implying only three further quarter-point rises following the one announced earlier this month by the Monetary Policy Committee. House price inflation is expected to average just over 3 per cent a year.

1.21 The unemployment rate has fallen by 0.5 percentage points over the past year, despite real GDP growth slowing. We expect the rate to trough at 4.3 per cent of the labour force – its current rate – in the second half of this year, and then to edge up as GDP growth slows a little further and the National Living Wage prices some workers out of employment. Relative to our March forecast, we have revised unemployment down in every year. But we have also revised earnings growth down in line with the weaker outlook for productivity. We now expect it to pick up slowly from 2.3 per cent this year to 3.1 per cent by 2022. Real earnings growth is forecast to average just 0.6 per cent a year in the six years to 2022.

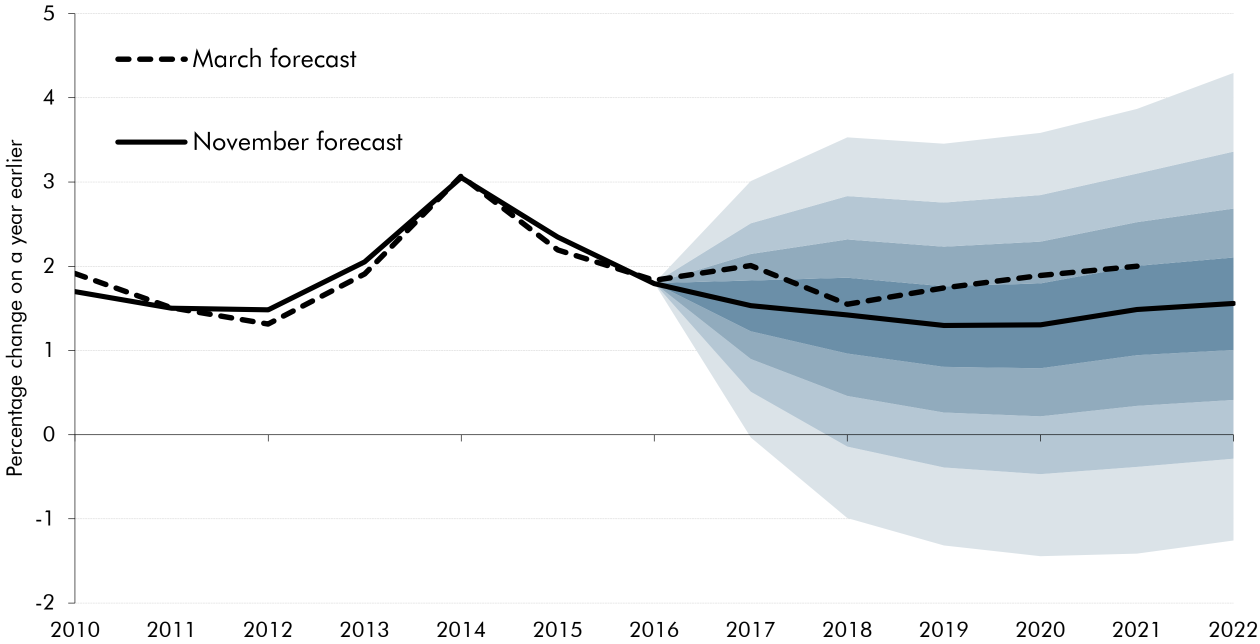
Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2016	2017	2018	2019	2020	2021	2022
Output at constant market prices							
Gross domestic product (GDP)	1.8	1.5	1.4	1.3	1.3	1.5	1.6
GDP per capita	1.0	0.9	0.8	0.7	0.7	0.9	1.0
GDP levels (2016=100)	100.0	101.5	103.0	104.3	105.7	107.2	108.9
Output gap	-0.2	-0.2	-0.1	-0.2	-0.2	-0.1	0.0
Expenditure components of real GDP							
Household consumption	2.8	1.5	0.8	1.2	1.2	1.5	1.6
General government consumption	1.1	0.3	1.0	0.7	0.5	1.0	1.0
Business investment	-0.4	2.5	2.3	2.3	2.4	2.4	2.4
General government investment	1.5	2.4	1.4	2.3	6.2	1.1	0.9
Net trade[1]	-0.9	0.4	0.2	0.0	0.0	0.0	0.0
Inflation							
CPI	0.7	2.7	2.4	1.9	2.0	2.0	2.0
Labour market							
Employment (millions)	31.7	32.1	32.3	32.4	32.5	32.6	32.7
Average earnings	2.8	2.3	2.3	2.3	2.6	3.0	3.1
LFS unemployment (rate, per cent)	4.9	4.4	4.3	4.4	4.6	4.6	4.6
	Changes since March forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.0	-0.5	-0.1	-0.4	-0.6	-0.5	
GDP per capita	-0.1	-0.4	-0.1	-0.4	-0.5	-0.4	
GDP levels (2016=100)	0.0	-0.5	-0.6	-1.0	-1.6	-2.1	
Output gap	-0.2	-0.4	0.0	-0.1	-0.1	-0.1	
Expenditure components of real GDP							
Household consumption	-0.2	-0.3	-0.1	-0.5	-0.5	-0.4	
General government consumption	0.2	-0.8	0.3	0.3	-0.4	-0.3	
Business investment	1.1	2.5	-1.4	-1.9	-1.4	-1.2	
General government investment	0.1	2.3	0.2	0.2	0.2	-2.7	
Net trade[1]	-0.6	0.1	-0.1	0.0	0.0	0.1	
Inflation							
CPI	0.0	0.3	0.0	-0.1	0.0	0.0	
Labour market							
Employment (millions)	0.0	0.2	0.2	0.2	0.2	0.2	
Average earnings	0.6	-0.3	-0.4	-0.6	-0.8	-0.6	
LFS unemployment (rate, per cent)	0.0	-0.5	-0.8	-0.7	-0.6	-0.5	

[1] Contribution to GDP growth.

1.22 The future is, of course, uncertain and no central forecast will be fulfilled in every respect. One way of illustrating the uncertainty around our GDP growth forecast is shown in Chart 1.4. This presents our central forecast together with a fan showing the probability of different outcomes based on past errors on official forecasts. 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 not subjective judgements about the extent of uncertainty, which for the reasons discussed above are greater than usual at present. The chart shows that the change in our central growth forecast since March, though material, is small relative to the uncertainty around either forecast implied by past forecast performance.

Chart 1.4: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

1.23 Public sector net borrowing has fallen from its post-crisis peak of 9.9 per cent of GDP (£152.5 billion) in 2009-10 to 2.3 per cent of GDP (£45.7 billion) in 2016-17, a smaller deficit than we forecast in March. With little spare capacity in the economy, we judge that the 2016-17 structural deficit (which excludes the effects of the economic cycle) was close to the headline deficit at 2.2 per cent of GDP. On both measures, the deficit is expected to rise fractionally in 2017-18 before falling steadily thereafter.

1.24 Table 1.2 shows that on current policy – including the decisions announced in this Budget and our assumptions regarding the UK's exit from the EU – we expect the deficit to move below 2 per cent of GDP next year and to fall slowly over the four years to 2022-23. Our central forecast is for a structural deficit of 1.3 per cent of GDP in 2020-21, below the 2 per cent of GDP ceiling set in the Chancellor's 'fiscal mandate'.

Table 1.2: Fiscal forecast overview

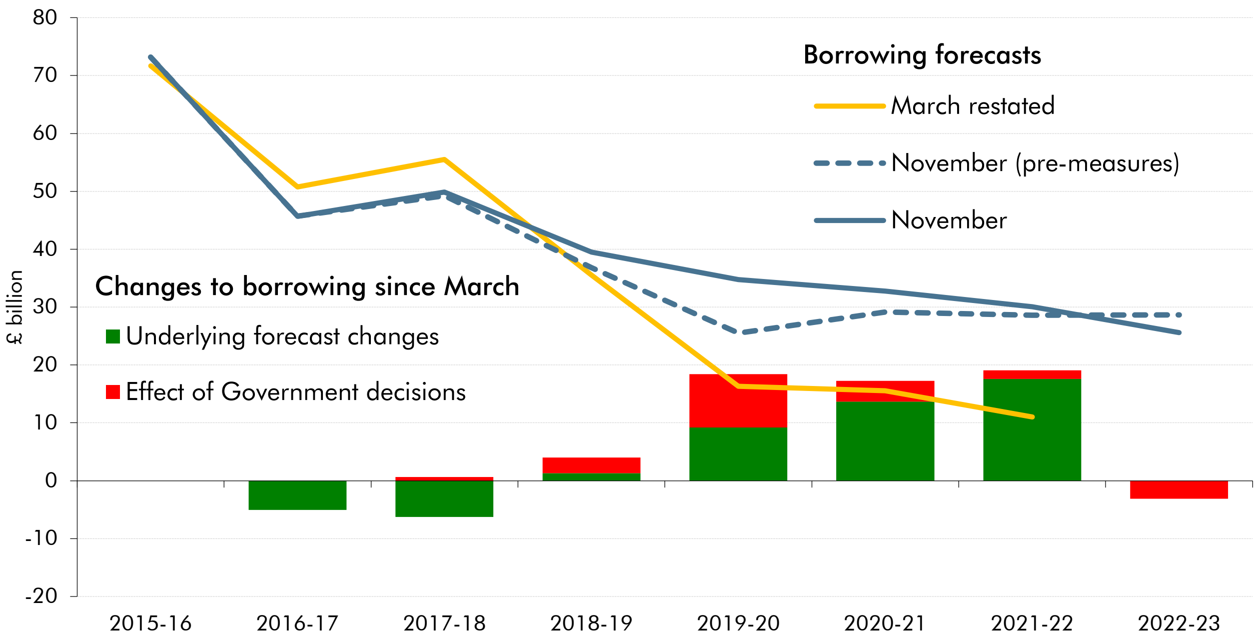
	Per cent of GDP						
	Outturn	Forecast					
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Revenue and spending							
Public sector current receipts	36.7	36.5	36.6	36.7	36.7	36.6	36.7
Total managed expenditure	39.0	38.9	38.5	38.3	38.2	37.9	37.7
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	2.2	2.3	1.8	1.5	1.3	1.2	1.1
Public sector net borrowing	2.3	2.4	1.9	1.6	1.5	1.3	1.1
Cyclically adjusted current budget deficit	0.2	0.3	0.0	-0.5	-1.1	-1.1	-1.3
Debt: Supplementary target							
Public sector net debt	85.8	86.5	86.4	86.1	83.1	79.3	79.1
	£ billion						
Revenue and spending							
Public sector current receipts	726.7	745.4	769.8	792.0	817.2	841.6	871.3
Total managed expenditure	772.4	795.3	809.3	826.7	849.9	871.7	896.8
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	43.0	48.0	37.9	32.3	29.7	28.1	25.0
Public sector net borrowing	45.7	49.9	39.5	34.7	32.8	30.1	25.6
Cyclically adjusted current budget deficit	4.3	6.2	0.0	-11.8	-24.0	-25.4	-29.9
Debt: Supplementary target							
Public sector net debt	1727	1791	1840	1885	1879	1853	1909

Changes in public sector net borrowing

1.25 Public sector net borrowing is expected to rise by £4.2 billion year-on-year in 2017-18 to £49.9 billion (2.4 per cent of GDP). It then falls both in cash terms and as a share of GDP in each subsequent year. The rise this year is largely due to timing effects that boosted receipts at the end of 2016-17 and should depress them at the end of 2017-18. The reclassification of English housing associations reduces PSNB from 2017-18 onwards as their own-account borrowing will now be recorded within the private sector.

1.26 As Chart 1.5 shows, borrowing is lower in 2017-18 but higher in each subsequent year relative to our March forecast restated on a comparable basis to our latest forecast – namely by excluding English housing associations from the public sector throughout and incorporating the various other ONS classification and methodological changes. On a pre-measures basis, borrowing would have troughed in 2019-20 and fluctuated in a narrow range thereafter. Thanks to the familiar pattern of Budget measures increasing borrowing in the near term but promising to reduce it by the end of the forecast, our post-measures forecast shows a smoother downward path for borrowing over the next five years.

Chart 1.5: Public sector net borrowing on a consistent definition



Source: ONS, OBR

1.27 Table 1.3 breaks down the changes in our borrowing forecast since March. First, it restates our March forecast consistent with current and prospective classification and methodological changes affecting the public finances data. Second, it breaks down our underlying forecast revisions into those due to recent public finances data and those that flow from our updated economy forecast and other factors. And third, it summarises the effect of Government decisions on borrowing, including those reported on the Treasury's Budget scorecard and other decisions that the Treasury chooses not to present that way.

ONS classification and methodological changes

1.28 Two sources of change to the public finances data since March have affected our forecast. Restating our March forecast to be consistent with these changes involves:

- **Removing English housing associations' own-account borrowing** from the point at which the reclassification takes effect. This results in a £1.4 billion downward revision in 2017-18 – a part-year effect – and average reductions of £3.7 billion a year from 2018-19 onwards. Central and local government grants to housing associations now count against public borrowing rather than being transfers within the public sector.

- **Factoring in Blue Book 2017 and other methodological and classification changes** that were reflected in the ONS's September public finances release. This reduces borrowing by £1.5 billion a year on average across the forecast period, largely due to changes to imputed pensions spending associated with various funded pension schemes.

Underlying forecast revisions

1.29 On a like-for-like basis, and before factoring in the effect of Government decisions, the revision to our borrowing forecast since March can be thought of in two parts. Recent data point to lower borrowing this year than we expected in March, which provides a more favourable starting point for the forecast. But the downward revision to our economy forecast provides a progressively less favourable path for borrowing thereafter.

1.30 As regards the recent data, borrowing in 2016-17 is now estimated to have been lower than our March forecast – by £6.1 billion in total and by £5.0 billion on a like-for-like basis. Borrowing in the first half of 2017-18 has also been lower than would be consistent with our March forecast. We still expect borrowing to rise this year, relative to 2016-17, but we have revised it down by £5.6 billion on a like-for-like basis.

1.31 The downward revision to borrowing in 2017-18 reflects:

- **PAYE income tax and NICs receipts** having been revised up by £1.9 billion. Receipts were £2.1 billion higher than expected last year, reflecting stronger-than-expected bonuses in the financial and business services sectors at the end of 2016-17. We have not changed our assumptions about bonus growth, so this feeds through to a higher level of bonuses this year and throughout the forecast.

- **Departmental spending** having been revised down by £3.2 billion in 2017-18. This largely reflects greater-than-expected underspending against departments' plans. But one year's underspending does not necessarily provide a guide to what will happen in the next. We have not made large changes to our assumptions for 2018-19 onwards.

- **Other receipts** having been revised up by £1.3 billion. This largely reflects a higher 2016-17 starting point, including for VAT, excise duties and interest and dividend receipts. Around £1 billion of the 2016-17 income tax surplus reflected a one-off income tax accounting charge so has not affected future years.

- **Various annually managed expenditure lines** – including state pensions and tax credits in welfare spending, and EU contributions and tax litigation payments – having been revised down by £4.7 billion in total. The welfare spending effects are assumed to persist, but the EU and tax litigation revisions are largely timing effects.

1.32 Partly offsetting those factors, we have raised our 2017-18 forecast for self-financed spending by **local authorities** by £5.0 billion. Spending was £2.9 billion higher than expected in 2016-17, largely due to greater-than-expected use of prudential borrowing. We have assumed that this is repeated this year and that local authorities also draw down more heavily on reserves to finance current spending. These effects diminish thereafter.

1.33 Taken together, we have assumed that the majority of the downside borrowing surprise in 2017-18 will persist, reducing our deficit forecast from 2018-19 onwards.

1.34 As regards borrowing beyond 2017-18, underlying forecast revisions mean it falls by £23.8 billion less between 2017-18 and 2021-22 than on our restated March forecast, leaving an upward revision of £17.6 billion in 2021-22. The change in 2021-22 reflects our new judgement regarding the path of potential output. In particular:

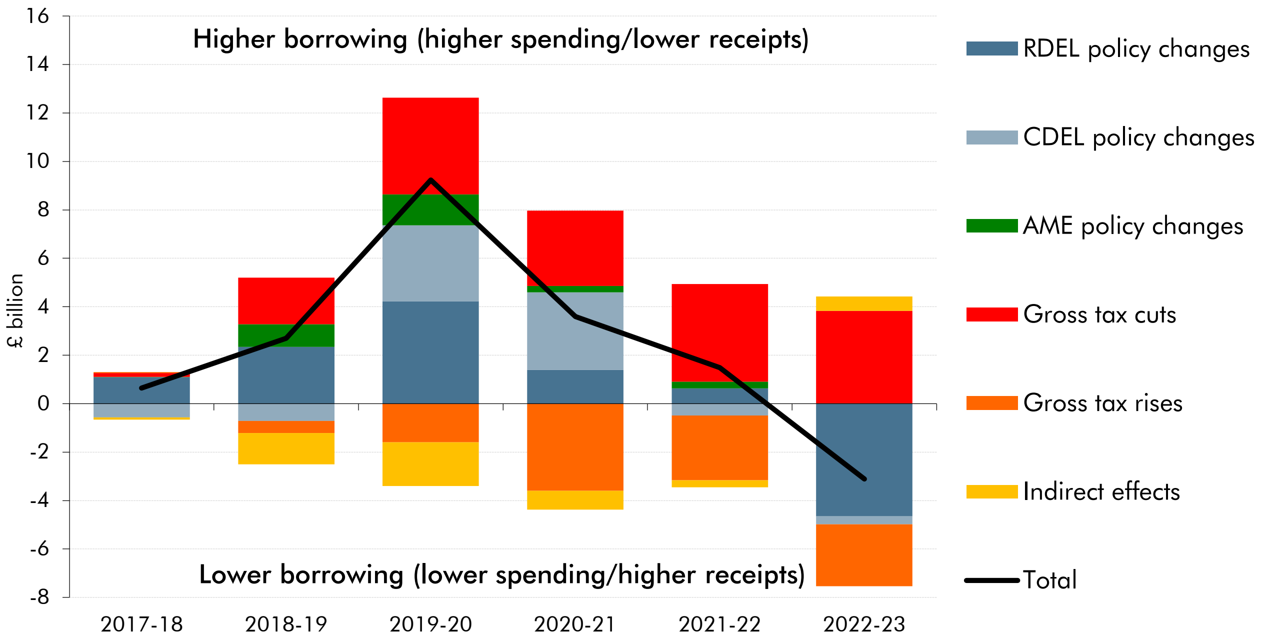
- We have revised **productivity growth** down by 0.6 percentage points a year on average in the four years to 2021-22. This depresses growth in GDP and in the major tax bases, raising borrowing by £25.8 billion.
- Partly offsetting that, we have revised up **average hours worked**, assuming a flat rather than a declining trend. This raises GDP growth, reducing borrowing by £7.4 billion.
- We have revised down our estimate of the **sustainable unemployment rate**, which implies greater scope for GDP growth. This reduces borrowing by £3.3 billion.
- The new **ONS population projections** assume slower growth in the working-age population (depressing the tax base), but also higher mortality at older ages (reducing spending on pensioner benefits). The net effect of these changes raises borrowing by £0.7 billion. These effects are set out in more detail in Box 4.1.

1.35 Other changes that flow from our revised economy forecast reduce borrowing in the short term but are largely offsetting by the end of the forecast. In the near term, they reflect the strength of growth in tax bases despite much weaker productivity growth than expected this year. Most significantly, growth in wages and salaries has actually been revised up by 0.5 percentage points in 2017-18, thanks to stronger-than-expected employment growth and a jump in the labour share as earnings have held up relative to productivity, squeezing profit margins in the process. Lower RPI inflation also reduces accrued interest on index-linked gilts. The largest fiscal forecast judgements relate to welfare spending, where we have revised up disability benefits and revised down expected savings from universal credit.

Government decisions

1.36 Budget measures and other Government decisions increase borrowing in all but the final year of our forecast. In the near term, net tax giveaways and a significant easing in the pace of spending cuts add £2.7 billion to borrowing in 2018-19 and a larger £9.2 billion in 2019-20 (0.4 per cent of GDP). In 2020-21 and 2021-22 the extent of the fiscal easing diminishes, while in 2022-23 the Government has pencilled in a cut in departmental resource spending as a share of GDP. The profile of these policy decisions means that while our pre-measures borrowing forecast troughs in 2019-20 and is uneven thereafter, our post-measures forecast shows borrowing falling relatively smoothly over the forecast period.

Chart 1.6: The effect of Government decisions on borrowing



Source: OBR

1.37 The key features of the Budget policy package include:

- **Higher departmental resource spending**: a temporary boost to the NHS and for Brexit preparations eases the pace of cuts previously planned for the next two years. The Government has also scaled back the ambition of its 2019-20 'efficiency review'.

- **Higher departmental capital spending**: NHS capital spending and various housing schemes have been expanded. The largest increases are in 2019-20 and 2020-21.

- **Net tax giveaways**: two large tax giveaways – the inevitable one-year freeze in fuel duty rates plus the introduction of a permanent stamp duty relief for first-time buyers of properties worth less than £500,000 – and a number of smaller ones are only partly offset by a raft of new anti-avoidance and evasion measures (focused on additional resources for HMRC) and freezing indexation allowance in the corporation tax regime (raising the effective tax rate companies actually pay relative to the headline rate).

- **Promised fiscal tightening in 2022-23**: the Government has pencilled in departmental spending totals for 2022-23 that would allow capital spending rise broadly in line with GDP, but hold current spending flat in real terms – thereby cutting it as a share of GDP and by 0.5 per cent in real per capita terms.

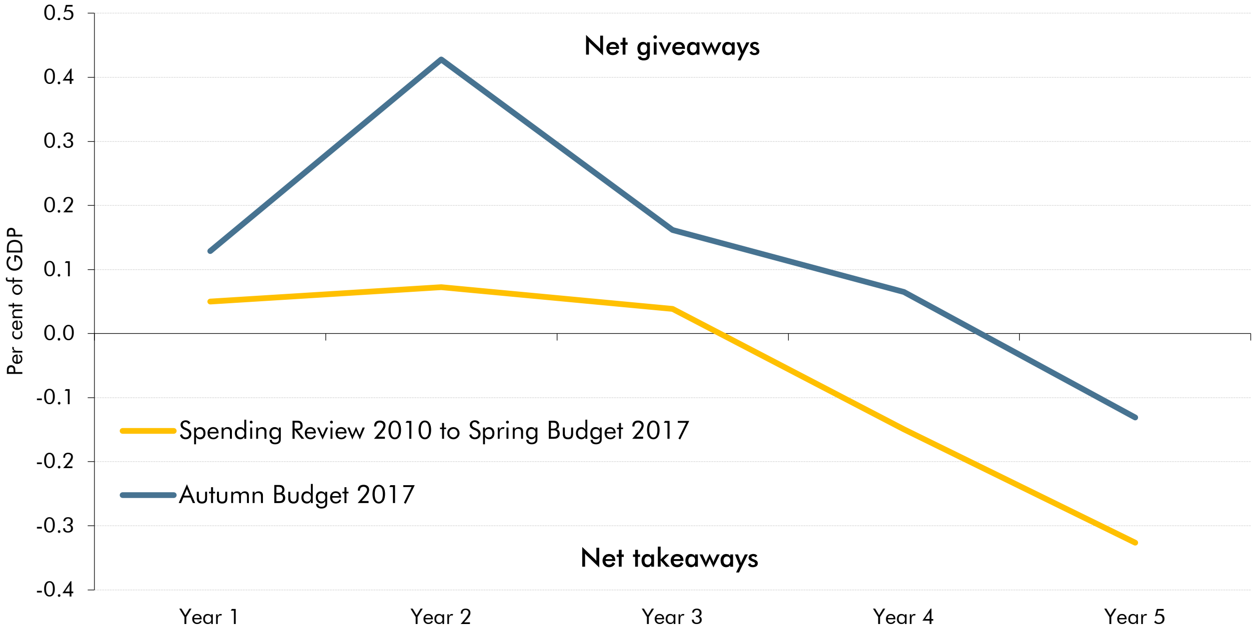
Table 1.3: Changes to public sector net borrowing since March

	£ billion						
	Outturn	Forecast					
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
March forecast	**51.7**	**58.3**	**40.8**	**21.4**	**20.6**	**16.8**	
Reclassification of English HAs		*-1.4*	*-3.9*	*-3.5*	*-3.4*	*-4.1*	
Other ONS changes	*-1.0*	*-1.3*	*-1.4*	*-1.5*	*-1.6*	*-1.7*	
March forecast restated	**50.7**	**55.5**	**35.5**	**16.3**	**15.5**	**11.0**	
November forecast	**45.7**	**49.9**	**39.5**	**34.7**	**32.8**	**30.1**	**25.6**
Like-for-like difference	-5.0	-5.6	4.0	18.4	17.3	19.1	
Underlying forecast revisions	**-5.0**	**-6.3**	**1.3**	**9.2**	**13.7**	**17.6**	
of which:							
Latest data	-5.0	-6.3	-4.1	-5.7	-6.1	-6.6	
Productivity revision		9.0	14.6	18.3	22.8	25.8	
Average hours revision		-2.5	-4.1	-5.1	-6.3	-7.4	
Sustainable unemployment revision		-0.7	-1.6	-2.1	-2.7	-3.3	
Population projection changes		0.1	0.2	0.4	0.5	0.7	
Other economy forecast changes		-5.9	-3.4	-1.0	1.2	2.9	
Fiscal modelling and other factors		0.0	-0.3	4.3	4.3	5.4	
Total effect of Government decisions		**0.7**	**2.7**	**9.2**	**3.6**	**1.5**	**-3.1**
of which:							
Scorecard receipts measures		0.1	1.4	2.3	-0.6	1.3	1.1
Scorecard AME measures		0.0	0.2	1.4	0.4	0.4	0.1
Total RDEL policy changes[1]		1.1	2.3	4.2	1.4	0.6	-4.7
Total CDEL policy changes[1]		-0.6	-0.7	3.1	3.2	-0.5	-0.3
Non-scorecard receipts and AME measures		0.1	0.8	0.0	0.0	0.0	0.1
Indirect effects		-0.1	-1.3	-1.8	-0.8	-0.3	0.6
Memo: November pre-measures forecast	*45.7*	*49.2*	*36.8*	*25.5*	*29.2*	*28.6*	*28.7*
Overall change since March	*-6.1*	*-8.4*	*-1.3*	*13.4*	*12.2*	*13.3*	

[1] The change in 2022-23 is relative to a baseline that assumes DEL would otherwise have remained constant as a share of GDP.
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.

1.38 Governments often announce Budget policy packages that deliver a net giveaway in the near term but promise a net takeaway in the longer term. This Budget has followed suit. Chart 1.7 shows how it compares to the average across all fiscal events since the 2010 Spending Review. The profile of loosening followed by tightening across the forecast period is the same, but with policy looser every year this time than the average. This 'Augustinian' profile is also reflected in the fact that fiscal policy was tightened for 2018-19 in the Autumn Statements of 2013 and 2014, but has been loosened at every subsequent fiscal event.

Chart 1.7: The average effect of Government decisions on borrowing



Source: OBR

Changes to public sector net debt

1.39 In March we expected public sector net debt (PSND) to peak at 88.8 per cent of GDP in 2017-18. We continue to expect it to peak this year, but at a lower 86.5 per cent of GDP. Most importantly, this reflects the reclassification of English housing associations to the private sector, which reduces PSND by 3.2 per cent of GDP. Partly offsetting that, we now expect the Bank of England's Term Funding Scheme (TFS) to lend £130 billion to banks by the end of February, up from the £90 billion we assumed in March. That adds 1.9 per cent of GDP to PSND at the end of 2017-18 relative to our March forecast.

1.40 We expect the debt-to-GDP ratio to fall by 0.1 percentage points between 2017-18 and 2018-19 – but only 0.03 percentage points on an unrounded basis. That reflects the precise calibration of Budget measures affecting borrowing, lending and asset sales, and the further increase in the TFS indemnity announced ahead of the Budget. Thereafter debt continues to fall as a share of GDP, with the largest falls in 2020-21 and 2021-22 due to the repayment of TFS loans at their 4-year term and the associated drop in Bank of England liabilities.

1.41 Beyond the effects of housing associations and TFS loans, the changes in our debt-to-GDP ratio forecast are driven by revisions to the path of GDP and our pre-measures fiscal forecast plus Government decisions announced in this Budget and since March. These are decomposed in Table 1.4, which shows that:

- **Nominal GDP** is higher in the near term, but lower from the middle of the forecast reflecting a weaker outlook for productivity growth and whole economy prices. That reduces the debt-to-GDP ratio in 2017-18, but raises it from 2019-20 onwards.

- Changes to our **pre-measures borrowing forecast** reduce debt up to 2019-20, thanks to the lower-than-expected outturn in 2016-17 and downward revision to 2017-18. But they increase it in the final two years as the cumulative effect of higher borrowing from 2018-19 onwards eventually offsets the more favourable starting point.

- Delayed **UKAR asset sales** increase debt in 2017-18, but with the sales moved into 2018-19 reduce debt in that year. As this delay was due to issues encountered in the sales process, we treat this as a forecast rather than a policy change. The Government has also announced plans to sell all UKAR's mortgage assets, which puts further downward pressure on debt. This is treated as a policy change.

- The effect of **gilt premia** has been revised down due to a slightly higher real yield curve reducing the extent of expected premia in future index-linked gilt auctions.

- A **variety of smaller forecast revisions** have generally reduced PSND. For example, exchange movements increase the value of the unhedged currency reserves in the near term, reducing net debt, but that then dissipates over the forecast.

- **Government decisions** push debt higher in all years and by increasing amounts. In terms of decisions affecting both borrowing and debt, the Government has announced a significant spending increase and smaller net tax giveaways. The cumulative effect adds £18 billion to debt by 2021-22. In terms of public sector lending, which affects net debt directly, the latest expansion of the Help to Buy equity loan scheme and other smaller measures, rolled forward in line with the Treasury's CDEL totals beyond the Spending Review period, add another £19 billion to debt by 2021-22. But the Government has partly offset this by announcing plans to sell RBS shares and to accelerate UKAR asset sales, cutting net debt by £20 billion.

Table 1.4: Changes to public sector net debt since March

	Per cent of GDP					
	Outturn	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
March forecast	**86.6**	**88.8**	**88.5**	**86.9**	**83.0**	**79.8**
Reclassification of English HAs		*-3.2*	*-3.3*	*-3.4*	*-3.4*	*-3.4*
March forecast restated	**86.6**	**85.5**	**85.2**	**83.5**	**79.6**	**76.4**
November forecast	**85.8**	**86.5**	**86.4**	**86.1**	**83.1**	**79.3**
Like-for-like difference	-0.8	0.9	1.2	2.6	3.5	2.9
of which:						
Change in nominal GDP[1]	-0.6	-0.5	0.0	0.7	1.2	1.6
Change in cash level of net debt	-0.2	1.4	1.2	1.9	2.3	1.3
	£ billion					
Total underlying forecast revisions	**-3**	**26**	**20**	**26**	**36**	**13**
of which:						
Bank of England schemes	5	40	40	40	37	0
Borrowing (pre-measures)	-6	-14	-14	-6	6	22
Gilt premia	0	-3	-1	-1	-1	-2
Lending	0	-1	-2	-2	-3	-4
UKAR	0	5	0	-1	0	0
Others	-2	-1	-3	-4	-2	-3
Total effect of Government decisions		**3**	**5**	**14**	**17**	**17**
of which:						
Affecting borrowing and debt		1	3	13	16	18
Affecting only debt		2	2	2	1	0
Memo: Impact of reclassification of English HAs		*-67.0*	*-70.7*	*-74.1*	*-77.4*	*-81.4*

[1] Non-seasonally adjusted GDP centred end-March.

1.42 One risk posed by focusing on any particular fiscal aggregate is the temptation to set policy so that it has an effect on the chosen metric even if that is not a good guide to the effect on the underlying health of the public finances. The IMF describes such disparities as 'fiscal illusions'. PSND is susceptible to such illusions because it includes only a limited range of liabilities and an even smaller range of assets. This makes financial asset sales superficially attractive as they reduce a liability that 'scores' by reducing an asset that does not.

1.43 In this forecast PSND and the alternative debt metrics that we consider have all been distorted by the reclassification of English housing associations from the public to the private sector, since they use the same distinction between the public and private sectors. This followed the passage of new regulations of which the Government stated: "*The only reason these regulations have been introduced is to seek ONS to reclassify housing associations to the private sector. In preparing [them], we have ensured that these only go as far as we have to, to reclassify housing associations.*"[1] It is hard to argue that the change in statistical treatment reduces the *de facto* exposure of the Government to these organisations, were they to fall into financial difficulty, nor does it alter their use as vehicles to deliver the Government's social housing policies.

[1] House of Lords Secondary Legislation Scrutiny Committee, 6th Report of Session 2017-19, October 2017.

Performance against the Government's fiscal targets

1.44 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of achieving its fiscal targets under existing policy. The *Charter* has been updated a number of times in recent years as the Government has revised its fiscal targets. The latest version was approved by Parliament in January 2017.

1.45 The *Charter* states that the Government's objective for fiscal policy is to "*return the public finances to balance at the earliest possible date in the next Parliament*". At the time, this was expected to be the period from 2020 to 2025. Given the early General Election in 2017, it could now be interpreted as the period from 2017 to 2022. We consider it on both bases.

1.46 The *Charter* also sets out targets for borrowing, debt and welfare spending that require:

- The **structural deficit** (cyclically adjusted public sector net borrowing) to lie below 2 per cent of GDP by 2020-21.
- **Public sector net debt** to fall as a percentage of GDP in 2020-21.
- Welfare spending (excluding the state pension and payments closely linked to the economic cycle) to be below a **welfare cap** that was set for 2021-22, in line with our November 2016 forecast for that year. The Government set a 3 per cent margin for error above the cap, so the effective cap on spending is higher. It has also set out a methodology by which the effect of changes in our inflation forecast relative to November 2016 must be stripped out of the formal assessment of performance against the cap. That assessment must be made at the start of each Parliament, so following the early General Election we assess performance formally in this *EFO*.

1.47 Our central forecast implies that all three of these targets are on course to be met:

- **Fiscal mandate**: the structural deficit declines slowly from 2.3 per cent of GDP in 2017-18 to 1.3 per cent in 2020-21, thanks largely to current departmental spending being cut as a share of GDP (albeit by less than was planned in March). This means that the Government meets its target with a margin of 0.7 per cent of GDP. But this is 0.5 per cent of GDP smaller than we estimated in March – so the Government has lost slightly less than half its future room for manoeuvre, but with slightly less time left for things to go awry. This is despite the 0.2 per cent of GDP reduction in borrowing due to the Government's success in persuading the ONS to reclassify English housing associations out of the public sector. On a like-for-like basis, including the effect of other ONS revisions to the public finances data since March, the margin is 0.7 per cent of GDP smaller than it was in our previous forecast – losing half its future room for manoeuvre. This reflects a 0.5 per cent of GDP deterioration in our underlying forecast for the structural deficit and a 0.2 per cent of GDP fiscal loosening.
- **Supplementary target**: public sector net debt falls by 3.0 per cent of GDP in 2020-21, down from 3.9 per cent in March due largely to the higher deficit forecast for that

year. The repayment of loans issued under the Bank's Term Funding Scheme at the end of their four-year term contributes 2.4 per cent of GDP to the year-on-year fall. The policy changes in the Budget and since March have little impact on the change in debt in that year. The same is true of the reclassification of housing associations.

- **Welfare cap**: the relevant welfare spending is forecast to be £1.0 billion higher than the cap in 2021-22 but £2.5 billion below the cap-plus-margin once the small adjustment for changes in our inflation forecast since November 2016 has been applied. On that basis, our formal assessment is that the terms of the cap are met. The policy changes in the Budget and since March have little material impact.

1.48 Achieving the broader balanced budget fiscal objective, interpreted as applying to 2025-26, looks challenging (although this lies beyond our formal forecasting horizon). In particular, it is a period in which population ageing will continue to exert upward pressure on spending, and more so than in recent years when the State Pension age has been rising. Interpreted as applying to 2022-23, the objective would be missed. That year lies within our forecast horizon, at which point we forecast a headline budget deficit of 1.1 per cent of GDP.

1.49 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. We assess the robustness of our judgements 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 65 per cent chance that the structural deficit would be below 2 per cent of GDP in 2020-21.

- Second, by looking at the **sensitivity of the deficit to key features of the economy forecast**. The 0.7 per cent of GDP margin relative to the 2 per cent structural deficit ceiling would fall to zero if potential output were 1.3 per cent lower, if the effective tax rate were 0.7 per cent of GDP lower for structural reasons, or if the planned spending cuts – which reduce RDEL by 0.7 per cent of GDP between 2017-18 and 2020-21 – were not implemented.

- Third, by looking at **alternative economic scenarios**. We have considered the implications of two different paths for trend productivity growth – one in which it reverts to the average rate of 2.1 per cent a year that prevailed over the 35 years before the crisis and another in which it continues at its post-crisis average rate of just 0.2 per cent a year. As in our central forecast, we have assumed that the trend in average hours worked is inversely linked to productivity growth, so it is higher in the weak productivity scenario and lower in the strong one. We have assumed that the divergence from our central forecast of GDP in each scenario is concentrated in business investment and that house prices are geared to changes in household income. These scenarios have the expected fiscal consequences, with the deficit and debt higher in the weak productivity scenario and lower in the strong one. In terms of the fiscal targets, in the weak productivity scenario the fiscal mandate would be missed by 0.1 per cent of GDP but the supplementary debt target would still be met.