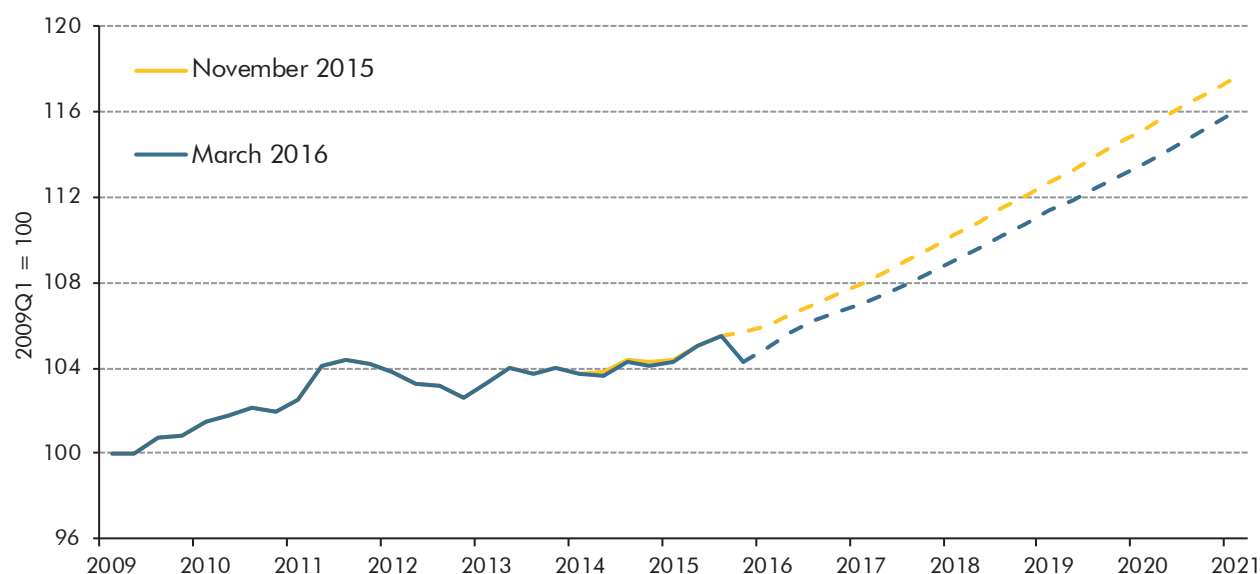


1 Executive summary

Overview

- 1.1 In the short time since our November forecast, economic developments have disappointed and the outlook for the economy and the public finances looks materially weaker.
- 1.2 Global stock markets and commodity prices have fallen, while GDP growth has slowed – especially in value terms. A promising pick-up in productivity through most of last year was almost entirely reversed in the fourth quarter, while growth in average earnings has slowed again. Outside forecasters – including the Bank of England and the OECD – have lowered their growth projections significantly. And financial markets have pushed their forecast of the first rise in interest rates out to 2019 and see a cut as more likely in the near term.
- 1.3 The most significant forecast change we have made since November has been to revise down potential productivity growth. This is the amount of output the economy can produce sustainably per hour worked and is a key driver of its potential size. The data available in November showed a pick-up in productivity growth in mid-2015, consistent with our assumption that the receding financial crisis would exert less of a drag and that trend productivity growth would return to its pre-crisis average rate by the end of the forecast. But more recent data suggest that this was another false dawn. With the period of weak productivity growth post-crisis continuing to lengthen, we have placed more weight on that as a guide to future prospects – although this judgement remains highly uncertain. This in turn has prompted us to revise down our GDP growth forecasts by around 0.3 percentage points a year to an average of 2.1 per cent a year over the rest of the decade.

Chart 1.1: Whole economy productivity: output per hour worked

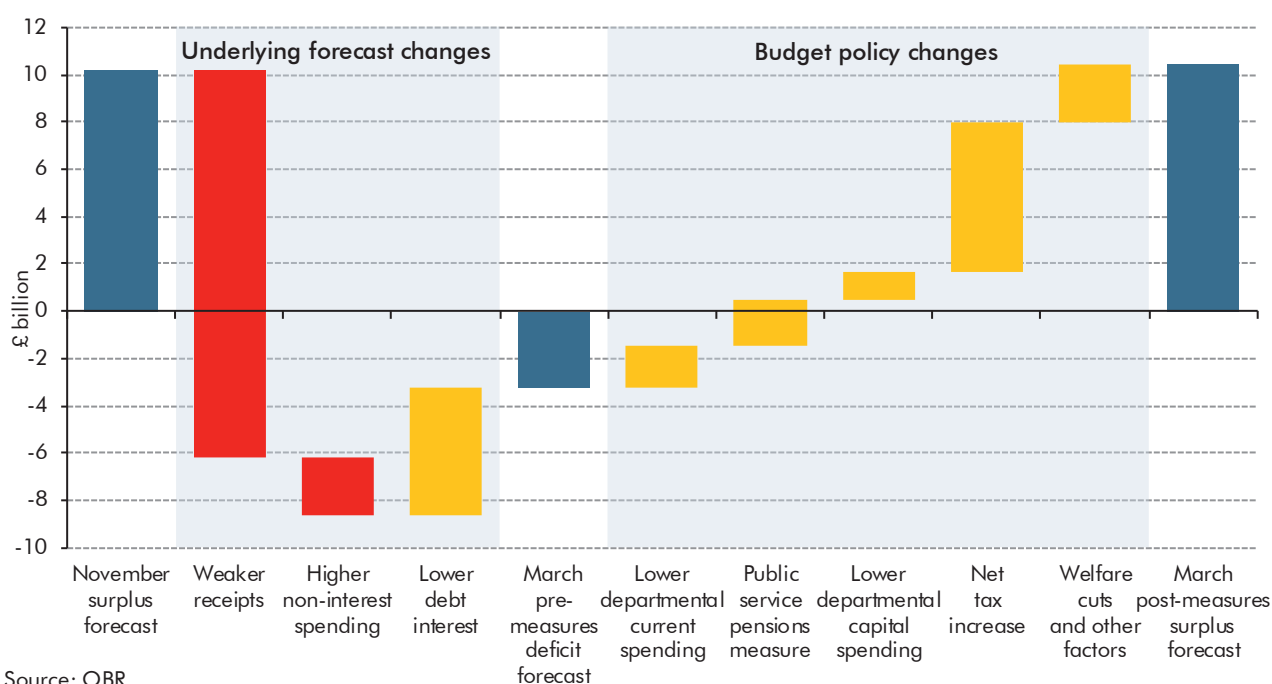


Source: ONS, OBR. Note: Output-per-hour defined as real non-oil gross value added divided by total weekly hours worked.

- 1.4 Lower productivity growth means lower forecasts for labour income and company profits, and thus also for consumer spending and business investment. In aggregate, this reduces tax receipts significantly. We have also revised up our disability benefits spending forecast, as the introduction of the personal independence payment (PIP) is generating much smaller savings than the Government was aiming for. Partly offsetting this upward pressure on borrowing, lower market interest rate expectations once again generate large debt interest savings. But, overall, we have revised up our pre-measures forecasts for the budget deficit by 0.5 per cent of GDP or £11.3 billion a year on average over the forecast period.
- 1.5 The story in the current fiscal year is somewhat different. We have revised our forecast for the deficit in 2015-16 slightly *lower* since November to £72.2 billion. Receipts look slightly weaker than we expected, but we also expect smaller net contributions to the EU, lower borrowing by housing associations and lower tax credits spending. We continue to expect borrowing to fall faster in February and March than over the year to date, although this may not be reflected fully in the initial outturn data due in April.
- 1.6 On the basis of our new pre-Budget-measures forecasts, the Government would have been on course to miss both its legislated fiscal targets – for the budget to be in surplus from 2019-20 and for debt to fall in relation to GDP every year until then. As regards the surplus target, we would have forecast small deficits in both 2019-20 (£3.2 billion) and 2020-21 (£2.0 billion). Given our GDP forecast, these would occur in ‘normal times’ on the Government’s definition and the ‘fiscal mandate’ would therefore be breached. As regards the debt target, we have revised down the cash level of public sector net debt in 2015-16, but the weakness of recent nominal GDP growth – largely reflecting a much wider trade deficit and weaker private sector investment – means that it is now expected to rise as a percentage of GDP, having been expected to fall in November. We expect the ratio of debt to GDP to fall each year thereafter, as the deficit shrinks, just as we did in November.
- 1.7 The Government’s Budget policy measures raise £13.7 billion in 2019-20 and £13.1 billion in 2020-21, broadly offsetting the deterioration in the underlying forecast and putting it back on course to meet the surplus target by £10.4 billion and £11.0 billion respectively in those years – little changed from November. But, given the size and distribution of past forecasting errors, that still puts the probability of meeting the surplus target in 2019-20 only slightly above 50 per cent. The Budget measures make little difference to net debt in 2015-16, so we expect that target still to be missed.
- 1.8 Focusing on the first year of the surplus target in 2019-20, Chart 1.2 shows that our pre-measures forecast for the budget balance has deteriorated by £13.4 billion in that year, with a £5.4 billion fall in debt interest spending more than offset by a £2.4 billion increase in other spending and a £16.3 billion revenue loss. So how has the Government offset this to maintain the £10 billion surplus it was looking for in November? The chart shows it has:

- cut its limit on **departmental current spending** by £2.3 billion (which we estimate would translate into an actual spending cut of £1.8 billion as departments underspend their budgets by less). The Government says that this £2.3 billion gross cut – together with £1.9 billion of new spending commitments in areas such as lengthening the school day, full ‘academisation’ of state schools and improving flood defences – will be funded from a £0.7 billion cut in overseas aid and £3.5 billion of as-yet unidentified cuts to be generated by an ‘efficiency review’ that will report in 2018;
- the Government has also placed an additional £2.0 billion a year squeeze on departments in that year by raising planned **public service pension contributions**, in line with a lower discount rate, but not compensating them for the additional costs they will face. This reduces borrowing by displacing other departmental spending within existing expenditure limits, while reducing net spending on public service pensions;
- cut its limit on **departmental capital spending** by £1.2 billion, largely by bringing £1.6 billion forward from the 2019-20 target year to 2017-18 and 2018-19, which it describes as “accelerating investment plans”. We assume that £0.2 billion of the spending brought forward to 2018-19 will in reality slip back into 2019-20. There are also £0.2 billion of new spending commitments, for example to ease congestion on the M62. With capital spending plans little changed in 2020-21, the very large 17 per cent real terms increase pencilled in for that year in November has now increased to 20 per cent. That had been sufficient in November to ensure that total public spending would remain above its 1990s lows as a share of GDP, but this is the case anyway in this forecast because of lower expected nominal GDP;

Chart 1.2: Changes to public sector net borrowing in 2019-20



Source: OBR

- announced a net **tax increase** of £6.3 billion in 2019-20, although across the forecast as a whole Budget tax measures *reduce* receipts by £0.7 billion a year on average. All but £300 million of this increase reflects the Government's decision to delay the July Budget measure that brings forward the timing of large firms' quarterly corporation tax payments "to give businesses more time to prepare". This also boosts receipts by £3.6 billion in 2020-21 (but not at all thereafter). However, combined with an additional net cut in other (mostly business) taxes taking effect in 2020-21, this gives a much more modest overall net tax increase in that year of £0.8 billion. So the Government needs a much bigger cut in current departmental spending in 2020-21 – £8.1 billion compared to £1.8 billion in 2019-20 – to achieve the surplus it wants. Other tax measures include giveaways (raising the income tax personal allowance and higher rate threshold, cutting capital gains tax rates and freezing fuel duty) and takeaways (more measures to tackle avoidance and increase tax paid by multinational firms). The new soft drinks industry levy raises around £500 million a year over the last three years of the forecast, but by pushing up the retail prices index it has a one-off cost of £1 billion in 2018-19 by increasing the accrued interest on index-linked gilts; and
- cut **welfare spending** by £1.4 billion in 2019-20, largely through a further tightening of the disability benefits system. **Other factors** include a small boost to receipts from easing fiscal tightening over the next two years.

- 1.9 Taking the changes to the pre-measures forecast and the Budget measures into account, our final forecast continues to show borrowing falling each year. In our November forecast the overall pace of fiscal tightening was relatively smooth and diminishing beyond 2017-18. But the uneven path of the giveaways and takeaways in this Budget means that the pace of tightening is now set to pick up slightly over the next three years, then much more sharply in the mandate year of 2019-20, before slowing abruptly again in 2020-21.
- 1.10 Net debt is expected to rise in cash terms every year, but to start falling as a percentage of GDP from 2016-17 onwards. It reaches 74.7 per cent of GDP in 2020-21, which is 3.4 per cent higher than our November forecast. Financial asset sales – which reduce public sector net debt, but generally have little effect on the public sector's net worth – continue to play a significant role in our debt forecast. Proceeds from Lloyds share sales have been pushed back and those from RBS share sales have been revised down significantly due to a lower share price. But the Government is accelerating the sale of mortgage assets that it holds in UK Asset Resolution (mainly those once owned by Bradford and Bingley).
- 1.11 In addition to its fiscal targets, the Government has a 'welfare cap' limiting forecast spending on a subset of social security benefits and tax credits. The cap was set most recently last July, but had already been breached when we made our annual formal assessment at the Autumn Statement. A fresh upward revision to the cost of disability benefits (only partly offset by tighter eligibility criteria announced shortly prior to the Budget) means that our forecast of spending subject to the welfare cap continues to exceed the permitted amount in every year, and by a larger margin than in November. So our Autumn Statement assessment that the welfare cap has been breached still stands.

Economic developments since our previous forecast

- 1.12 Commodity prices, stock markets and bond yields have fallen sharply. The oil price assumption underpinning this forecast is 36 per cent lower in dollar terms than November's and equity prices are almost 8 per cent lower. The interest rate on 10-year government bonds has fallen in many advanced economies. During February it fell to 1.30 per cent in the UK, 1.66 per cent in the US and 0.11 per cent in Germany. In Japan it fell briefly into negative territory, reaching -0.07 per cent on 25 February.
- 1.13 Expectations of tighter monetary policy have also receded further into the future. Based on interest rate swap rates over the 10-day period used in this forecast, the market now believes that Bank Rate is more likely to fall than to rise over the next two years and that it will only reach 1.1 per cent by the end of the forecast period. Bank Rate does not top 0.75 per cent until more than a decade after it was first cut to 0.5 per cent in March 2009.
- 1.14 The path of real GDP growth through 2015 has been revised, with the economy now shown to have lost momentum through the year – despite the boost to onshore activity from the fall in the oil price since late 2014. GDP growth in 2015 as a whole is now estimated at 2.2 per cent, slightly lower than the 2.4 per cent we expected in November. Whole economy prices – as measured by growth in the GDP deflator – have also been much weaker than expected, with the terms of trade and the implied price of the change in inventories falling sharply. As a result, nominal GDP growth in the third and fourth quarters was significantly lower than expected: just 0.4 per cent, against our forecast of 1.8 per cent. Net trade was the main contributing factor, although private investment was also weaker than expected.
- 1.15 With real GDP only growing modestly at the end of the year, but employment and total hours growing strongly, productivity fell sharply. Output per hour fell by 1.2 per cent in the fourth quarter, compared to our November forecast of a 0.2 per cent increase. That fall has reversed almost all the productivity growth seen in the first three quarters of 2015, leaving output per hour in the fourth quarter only 0.2 per cent up on a year earlier. Earnings growth has also weakened. On an annual basis, headline average weekly earnings growth slowed from a recent peak of 3.0 per cent in September to just 1.9 per cent in the latest data.

The economic outlook

- 1.16 Real economy indicators around the world have not been as weak as financial markets, so we have made only relatively small downward revisions to our forecasts for world GDP and world trade growth, with knock-on implications for the UK's export markets. But risks to the global outlook remain significant, with slower growth in China, shifting prospects for oil supply and the outlook for US monetary policy among the sources of uncertainty.
- 1.17 The most significant change we have made to our domestic forecast since November has been to revise down our estimate of potential productivity growth, which in turn reduces the sustainable level of GDP and our forecast for GDP growth over the next five years. As we have stressed for some time, the outlook for productivity growth is both the most important and the most uncertain judgement in most economic forecasts. In November, the pick-up in

productivity growth in mid-2015 seemed consistent with our long-held assumption that the post-crisis drag on productivity growth would ease as the financial system returned to full health and that it would be back at its pre-crisis historic average rate of 2.2 per cent by the end of the forecast period. That pick-up appears to have been another false dawn. As a result, we have revised down our estimate of potential productivity growth so that it remains somewhat below its pre-crisis average at the end of the forecast at 2.0 per cent.

- 1.18 In reaching a view on the outlook for productivity growth over the medium and longer term, all forecasters – whatever methodology they use – in effect have to decide how much weight to place on the recent period of very weak productivity performance and how much on the earlier period of stronger performance. As the period of weak performance lengthens, it seems sensible to place slightly more weight on that as a guide to the future, although this judgement is of course highly uncertain and has to be revisited in each forecast we make.
- 1.19 The downward revisions we have made to our potential productivity growth forecasts over the last five years are not unique to the UK. Since 2010 we have reduced our forecast for potential productivity growth between 2010 and 2020 from 22 to 14½ per cent. Over the same period the Congressional Budget Office has reduced its forecast for potential productivity growth in the US from 24½ to 15½ per cent. But the hit to potential GDP growth has been smaller in the UK, largely because the participation rate has held up, despite an ageing population. In the US, it has fallen significantly.
- 1.20 We estimate that the UK economy was running about 0.3 per cent below potential in the final quarter of 2015, narrower than the 0.7 per cent we expected in November. Taken together with lower potential output growth, that has led us to revise down real GDP growth across the forecast period. We now expect growth to average 2.1 per cent a year over the next five years, down from 2.4 per cent in November. The Bank of England and the OECD have also significantly revised down their growth forecasts since November. This is consistent with the receding market expectations of a Bank Rate increase.
- 1.21 We have made smaller changes to our pre-measures inflation forecast, with the effect of lower oil prices on petrol prices and weaker sterling on import-intensive items working in opposite directions. The new soft drinks industry levy announced in the Budget is expected to push CPI inflation above the Bank's 2 per cent target briefly when introduced in 2018-19.
- 1.22 With nominal GDP growth having disappointed expectations much more than real GDP growth in the second half of 2015, we have made more substantial revisions to that forecast. Nominal GDP matters more than real GDP when forecasting the public finances. Tax receipts in particular are sensitive to the cash value of labour income, corporate profits and consumer spending. We have revised cumulative growth in nominal GDP between 2015-16 and 2020-21 down to 21.7 per cent from 23.8 per cent in November.
- 1.23 In terms of the individual sectors of the economy:
- **household sector:** real consumption growth has been revised down in 2016. But with nominal consumption growing more strongly than household income in the final

quarter of 2015, our saving ratio forecast has been revised down significantly. Early estimates of the saving ratio are often subject to considerable revisions, but this appears consistent with the further pick-up in consumer credit growth reported in the latest Bank of England data. The household financial deficit is close to 3 per cent of GDP across the forecast. This is unprecedented in available historical data, although arguably consistent with the latest market expectations of Bank Rate barely topping 1 per cent by 2020 and significant fiscal tightening continuing over that period;

- **corporate sector:** real business investment fell in the final quarter of 2015. This gives a lower start to the current year and has therefore prompted a significant downward revision to annual business investment growth in 2016. At 2.6 per cent, it is 4.9 percentage points weaker than our November forecast. Business investment data are also prone to revision, so it is not clear how much should be read into the weakness of the latest data. It predates the bout of global market volatility since January and any additional uncertainty associated with the EU referendum campaigns; and
- **external sector:** the net trade contribution to GDP growth was weaker than expected in 2015 and we have revised it down in 2016 too. Combined with the sharp fall in the terms of trade, this has led to a substantial revision to the trade deficit, which is wider by around £24 billion a year on average. As a result we expect the current account deficit to average 3.7 per cent of GDP over the next five years rather than the 2.4 per cent we forecast in November. This is the counterpart to the wider household deficit.

1.24 Employment has grown strongly, rising 0.5 million in the year to the final quarter of 2015. We expect employment growth to slow over the coming year, as the unemployment rate falls slightly further from its current 5.1 per cent and then rises towards our estimate of its sustainable rate, and as productivity growth is assumed to pick up.

1.25 We have made relatively small revisions to our housing market forecasts. House price inflation was higher than expected in late 2015, pushing up our near-term forecast. But a lower household income forecast – reflecting weaker productivity growth – has lowered our medium-term forecast. Property transactions have been close to forecast, so we have not made significant revisions. Some uncertainty remains over the effects of the pre-announced April 2016 increase in stamp duty charged on purchases of second homes.

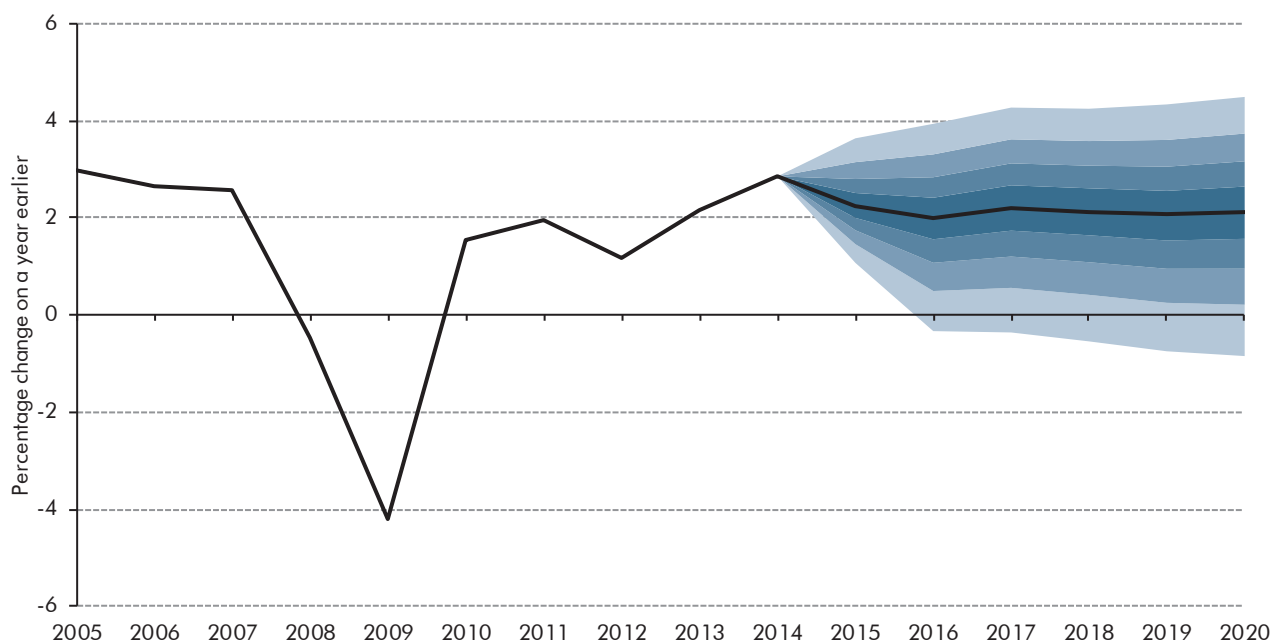
Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn		Forecast				
	2014	2015	2016	2017	2018	2019	2020
Output at constant market prices							
Gross domestic product (GDP)	2.9	2.2	2.0	2.2	2.1	2.1	2.1
GDP levels (2014=100)	100.0	102.2	104.3	106.6	108.9	111.1	113.5
Output gap	-1.0	-0.3	-0.2	0.0	0.0	0.0	0.0
Expenditure components of real GDP							
Household consumption	2.5	2.9	2.4	2.2	2.1	2.0	1.9
General government consumption	2.5	1.7	0.2	0.6	0.5	0.2	0.7
Business investment	4.7	4.7	2.6	6.1	5.8	5.5	4.4
General government investment	5.8	2.2	0.2	1.9	-0.3	-0.2	6.5
Net trade ¹	-0.4	-0.5	-0.4	-0.1	-0.1	-0.1	-0.1
Inflation							
CPI	1.5	0.0	0.7	1.6	2.0	2.1	2.0
Labour market							
Employment (millions)	30.7	31.2	31.6	31.7	31.9	32.0	32.1
Average earnings	1.4	2.3	2.6	3.6	3.5	3.4	3.6
LFS unemployment (rate, per cent)	6.2	5.4	5.0	5.0	5.2	5.3	5.3
Claimant count (millions)	1.04	0.80	0.75	0.78	0.84	0.86	0.87
Changes since November forecast							
Output at constant market prices							
Gross domestic product (GDP)	-0.1	-0.1	-0.4	-0.3	-0.3	-0.3	-0.2
GDP levels (2014=100)	0.0	-0.1	-0.5	-0.8	-1.0	-1.3	-1.5
Output gap	0.0	0.4	0.2	0.2	0.0	0.0	0.0
Expenditure components of real GDP							
Household consumption	-0.2	0.0	-0.2	-0.1	-0.2	0.0	0.1
General government consumption	0.6	0.0	-0.3	0.0	0.1	-0.3	-0.4
Business investment	0.1	-1.3	-4.9	-1.0	-1.2	-1.1	-0.1
General government investment	-1.8	-0.8	-0.6	1.3	1.3	-1.9	-2.7
Net trade ¹	-0.1	-0.6	-0.2	-0.1	0.0	0.0	0.0
Inflation							
CPI	0.0	0.0	-0.3	-0.2	0.1	0.1	0.0
Labour market							
Employment (millions)	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Average earnings	-0.1	-0.3	-0.7	-0.1	-0.1	-0.3	-0.3
LFS unemployment (rate, per cent)	0.0	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1
Claimant count (millions)	0.00	0.00	-0.03	-0.03	-0.02	-0.01	-0.01

¹ Contribution to GDP growth.

1.26 There is considerable uncertainty around any economic forecast. Chart 1.3 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 1.3: Real GDP growth fan chart



Source: ONS, OBR

- 1.27 Risks to our central forecast include greater volatility in financial and commodity markets, slower growth in China, the possibility of a significant fall in the exchange rate and the impact of the upcoming EU referendum on business and consumer confidence and the behaviour of asset and financial markets. We have made no assessment of the potential long-term impact of 'Brexit' on the economy and the public finances, as Parliament requires us to base our forecasts on current Government policy and not to consider alternatives.

The fiscal outlook

- 1.28 Public sector net borrowing peaked at 10.3 per cent of GDP (£154.7 billion) in 2009-10 as the late 2000s recession and financial crisis dealt the public finances a significant blow.¹ Fiscal consolidation and economic recovery then reduced the deficit to 5.0 per cent of GDP (£91.9 billion) by 2014-15. We estimate that the deficit will fall by a further £19.7 billion in 2015-16 to £72.2 billion – a similar fall to the one we predicted in November.
- 1.29 Table 1.2 shows that on current policy – including the decisions announced in this Budget – we expect the deficit to continue falling, and the budget to move into surplus in 2019-20, as we did in November.

¹ In our November forecast, we anticipated the effect of the ONS announcement that private registered providers of social housing in England – including most housing associations and some for-profit housing bodies – would be reclassified to the public sector. The ONS has now implemented that decision in the official statistics, so all figures presented here are on a consistent basis, including the latest estimate of housing associations' effect on public sector borrowing and debt and our updated forecasts.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Revenue and spending							
Public sector current receipts	35.7	36.3	36.9	36.9	37.0	37.5	37.4
Total managed expenditure	40.8	40.2	39.7	38.8	38.0	37.0	36.9
Deficit: Fiscal mandate (current and previous)							
Public sector net borrowing	5.0	3.8	2.9	1.9	1.0	-0.5	-0.5
Cyclically adjusted current budget deficit	2.4	1.8	0.9	0.2	-0.5	-2.0	-2.4
Debt: Supplementary target							
Public sector net debt	83.3	83.7	82.6	81.3	79.9	77.2	74.7
Changes since November forecast							
Revenue and spending							
Public sector current receipts	0.0	0.5	0.3	0.0	0.1	0.6	0.3
Total managed expenditure	-0.2	0.5	0.7	0.7	0.9	0.5	0.4
Deficit: Fiscal mandate (current and previous)							
Public sector net borrowing	-0.2	0.0	0.3	0.7	0.8	0.0	0.1
Cyclically adjusted current budget deficit	0.0	0.2	0.4	0.7	0.7	-0.1	0.0
Debt: Supplementary target							
Public sector net debt	0.2	1.3	0.9	1.4	2.6	2.9	3.4

Changes in public sector net borrowing and net debt

Expected borrowing in 2015-16

- 1.30 We expect borrowing to fall to £72.2 billion this year, down £19.7 billion or 21.4 per cent from 2014-15. That is a bigger drop than would be implied by the data for the first 10 months of the year, which showed borrowing down £10.6 billion or 13.7 per cent on 2014-15. So it is not surprising that outside analysts tend to have higher forecasts.
- 1.31 We have revised down our receipts forecast since November (although it still implies stronger year-on-year growth in the final two months of the year than in the first ten). But this has been more than offset by downward revisions to spending.
- 1.32 As ever, it is important to stress the uncertainty that remains around in-year borrowing, even at this late stage in the year. It is also important to remember that we are forecasting the level at which the budget deficit will settle when all the relevant data have been gathered over the coming months. History suggests that this will not be the level initially reported by the ONS when it publishes its first estimate next month. This will necessarily be based on provisional data that will be revised as final outturn data become available.
- 1.33 The main factors that are likely to explain the difference between our latest forecast for borrowing in 2015-16 and the gloomier outside expectations include:
- we expect stronger growth in **income tax and NICs receipts**, reflecting indications from HMRC administrative data for February. The Government's **marriage tax allowance** is also costing less than expected, thanks to IT problems for many people trying to claim

it, and a combination of lack of awareness and possibly a reluctance among other potential recipients to attract the attention of HMRC. That more than offsets the lower yield from the introduction of **Class 3A voluntary NICs**, where lack of awareness has also led to much lower take-up than expected;

- we expect **stamp duty land tax** to rise by 16.5 per cent in the year to February and March combined, up from 0.3 per cent year-to-date, due largely to the timing of the 2014 reform. That pick-up remains despite a £0.5 billion downward revision to our forecast since November. We also expect **stamp duty on shares** to be boosted by a large payment made in February as a result of a recent corporate takeover;
- **VAT** is also expected to be stronger over the remaining two months, reflecting February administrative data. We also forecast stronger receipts from **environmental levies** (where we are investigating differences between DECC and ONS estimates) and **alcohol duties** (where we expect timing effects associated with cuts in duty rates last year not to be repeated);
- a £0.7 billion downward revision to **housing associations'** net borrowing, informed by the £1.0 billion lower-than-expected ONS estimate for their borrowing in 2014-15. The latest public finances data for 2015-16 are based on our November 2015 housing associations forecast, so our new forecast will be reflected in the official data until the ONS can replace it with firm data from housing associations; and
- we have revised down spending on **EU contributions** in 2015-16 by £1.2 billion, largely due to a lower-than-expected demand from the European Commission for a contribution in March.

Forecast for borrowing from 2016-17 onwards

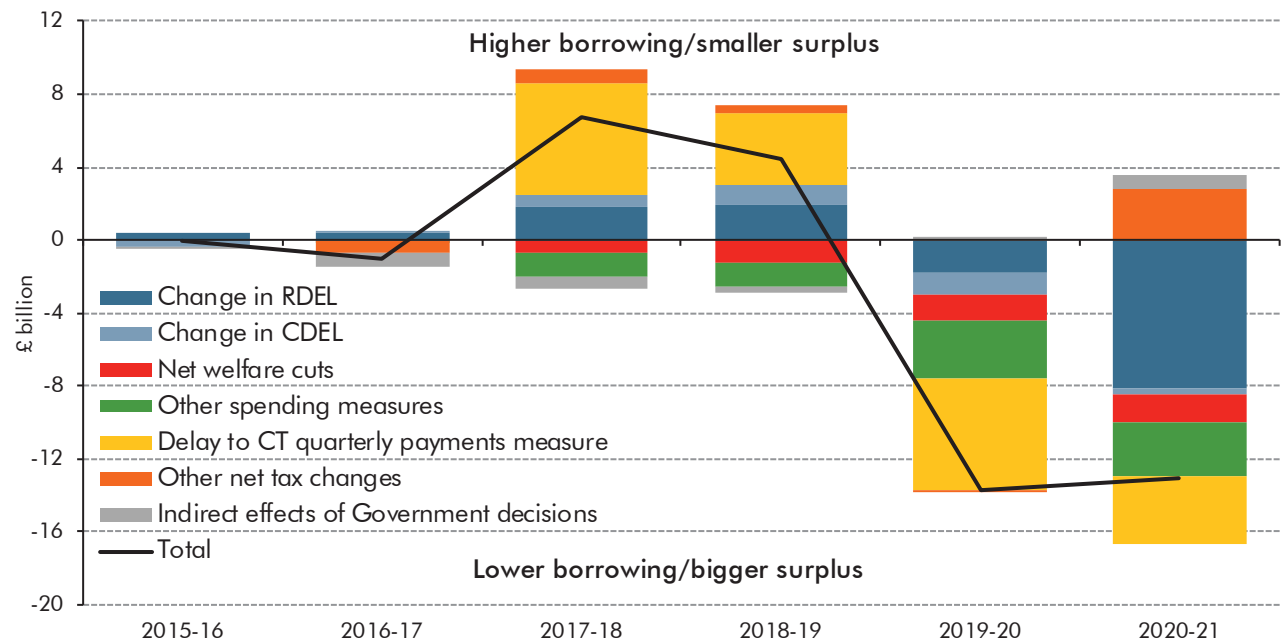
1.34 Table 1.3 shows how changes to our underlying forecast judgements and the Government's policy decisions (shown in Chart 1.4) have affected our forecast for borrowing:

- we have revised down our **pre-measures receipts forecast** significantly (which increases borrowing and therefore shows up as positive figures in the table). Weaker productivity growth implies weaker nominal GDP growth and this reduces growth in all the main tax bases (wages and salaries, consumer spending and corporate profits). Lower share prices have also reduced receipts from capital taxes, while lower market expectations of interest rates have reduced interest and dividend receipts. Updated modelling of stamp duty land tax has also contributed to the downward revision;
- lower market expectations of Bank Rate and gilt yields, plus downward revisions to our RPI inflation forecast, have prompted a further large downward revision to **debt interest spending**, net of the saving associated with financing part of the debt at Bank Rate through the Asset Purchase Facility (APF). This is the third time in our last four forecasts that changes in market expectations have led to a large downward revision to debt interest spending (as set out in Box 4.4 in Chapter 4). Higher interest rates clearly pose

an upside risk to our spending forecast, although recent experience shows that even at very low interest rates it is possible for them to fall further;

- our **pre-measures forecast for other AME spending** is higher every year. Welfare spending has been revised up, thanks largely to higher-than-expected caseloads and average awards as disabled people are migrated from disability living allowance to the new personal independence payment. Spending by local authorities and public corporations has also been revised up. We have made smaller downward revisions to spending on state pensions, tax credits and public service pensions;
- the **direct effect of the Government’s policy decisions** has been to increase the deficit in 2017-18 and 2018-19 by £6 billion a year on average, but then to improve the budget balance by an average of £14 billion in 2019-20 and 2020-21. The contrast is dominated by the Government’s decision to delay the July Budget measure that brings forward the timing of large firms’ quarterly corporation tax payments. This shifts roughly £10 billion of receipts from 2017-18 and 2018-19 back to the surplus target years of 2019-20 and 2020-21; and
- the net **indirect effects** on the public finances of the Government’s decisions have been relatively small. In most years, they reflect the knock-on effects of how the Government has altered the pace of fiscal tightening. In 2018-19, the effect on RPI inflation of introducing the new soft drinks industry levy has added around £1 billion to accrued interest payments on index-linked gilts.

Chart 1.4: The effect of Government decisions on public sector net borrowing



Source: OBR

Table 1.3: Changes to public sector net borrowing since November

	£ billion						
	Outturn	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
November forecast	94.7	73.5	49.9	24.8	4.6	-10.1	-14.7
Total forecast changes	-2.8	-1.3	6.6	7.2	12.3	13.4	16.7
<i>of which:</i>							
Receipts	-0.5	0.4	8.2	10.5	14.0	16.3	19.5
Debt interest spending	0.0	-0.6	-3.9	-4.9	-4.8	-5.4	-5.2
Non-interest AME spending	-2.3	-1.5	1.8	1.1	2.7	2.0	2.0
Revisions to DEL spending	0.0	0.5	0.5	0.5	0.5	0.5	0.5
March forecast pre-policy decisions	91.9	72.2	56.5	32.0	17.0	3.2	2.0
Total effect of Government decisions		-0.1	-1.0	6.7	4.5	-13.7	-13.1
<i>of which:</i>							
Scorecard receipts measures		0.0	-0.6	7.0	4.3	-6.3	-0.8
Scorecard AME spending measures		0.0	-0.1	-2.1	-2.6	-4.6	-4.5
Changes to RDEL spending		0.4	0.3	1.8	1.9	-1.8	-8.1
Changes to CDEL spending		-0.4	0.1	0.7	1.1	-1.2	-0.4
Indirect effect of Government decisions		-0.1	-0.7	-0.6	-0.3	0.2	0.7
March forecast post-policy decisions	91.9	72.2	55.5	38.8	21.4	-10.4	-11.0
Overall change since November	-2.8	-1.3	5.5	14.0	16.8	-0.3	3.7

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.

1.35 In November we forecast that public sector net debt (PSND) would fall as a share of GDP in 2015-16 and in each subsequent year of the forecast. But despite revising down the cash level of net debt this year, we now expect it to rise as a share of GDP in 2015-16 before declining from 2016-17 onwards. This reflects revisions to our nominal GDP forecast.

1.36 PSND is now forecast to come in at 83.7 per cent of GDP this year, falling to 74.7 per cent of GDP in 2020-21. Table 1.4 shows that we have revised up the debt-to-GDP ratio by increasing amounts across the forecast period since November. That is because:

- lower **nominal GDP growth** in the near term has raised the debt-to-GDP ratio significantly. In particular, the sharp slowdown in the year to the final quarter of 2015 – up just 1.9 per cent, compared with the 3.9 per cent we forecast in November – has fed through to the denominator for the 2015-16 debt-to-GDP ratio calculation. This has pushed the ratio up significantly compared to 2014-15. From 2016-17 onwards, smaller downward revisions to our nominal GDP growth forecast, due to a lower estimate of underlying productivity growth, push the ratio up a little further;
- **cumulative borrowing** across the forecast has been revised up significantly. As described above, that reflects a large upward revision to our pre-policy-measures forecast, partly offset by the impact of the Government’s policy decisions;

- the depreciation of the pound has increased the sterling value of the UK's **foreign currency reserves**, as measured in the PSND calculation.² In reality, the reserves are largely hedged against currency movements to reduce the Exchequer's exposure to currency risk, but Eurostat's *Manual on government deficit and debt* stipulates that derivative instruments must not be counted in EDP measures of debt (even though they are counted in the full National Accounts). The ONS follows this Eurostat guidance for its PSND calculations. The result is that the sharp drop in the pound this year has raised the sterling value of the official reserves, which net off PSND. The effect was worth £6.3 billion in January alone and we estimate it will subtract £10 billion from PSND by the end of the year. This is a feature of the PSND calculation rather than a true reflection of the public sector's net worth;
- the pace at which **UK Asset Resolution's assets** are sold or rundown has increased, reducing PSND. UKAR's mortgage book has been running down slightly faster than expected as its customers take advantage of lower mortgage rates currently offered by other lenders. UKAR is then planning a further large sale of mortgage assets – following last year's £13 billion sale of the Granite securitisation and other assets. That brings forward around £17½ billion of sales into 2016-17 and 2017-18, while reducing the amount of mortgages that would otherwise have run down naturally later in the forecast period. Taken together, the reduction in PSND relative to our last forecast peaks in 2017-18 then declines in subsequent years;
- lower proceeds from **other financial asset sales** across the forecast period. Sales of the Government's remaining stake in Lloyds have been pushed back from 2015-16 to 2016-17, with proceeds also lower due to the fall in the share price since November. (The Government still plans to give some shares away to retail investors, so while this sale reduces PSND it would worsen a broader measure of public sector net worth.) More significantly, the expected proceeds from RBS share sales between 2016-17 and 2020-21 have fallen by 26 per cent to £21.5 billion, more than explained by the sharp fall in the share price;
- **APF balance sheet effects** have been revised up slightly, due to the difference between the amount the Bank pays for the gilts held in the APF and their nominal value at redemption. Lower market expectations of gilt yields mean that when the APF replaces gilts that reach their redemption date the new gilts will be purchased at a greater premium to the nominal values at which they are valued for PSND. As a result, over the coming five years we expect that the APF will need to purchase gilts with a market value of £138½ billion to replace gilts of the same value that are redeemed, but that the nominal value of those gilts will be £115½ billion compared with the redeemed gilts' nominal value of £124½ billion. That £9 billion difference by 2020-21 is around £4 billion higher than assumed in November; and

² The ONS has introduced a new table in its public sector finances bulletin that details how to reconcile changes in the central government net cash requirement and changes in central government net debt, of which these effects on the foreign exchange reserves are one element. Thanks to this greater transparency, we will be able to forecast its elements directly rather than treating it as an unexplained residual in the PSND calculation.

- movements in expected **gilt premia** push PSND down in every year of the forecast, while **other factors** are generally smaller and partly offsetting.

Table 1.4: Changes to public sector net debt since November

	Per cent of GDP						
	Outturn	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
November forecast	83.1	82.5	81.7	79.9	77.3	74.3	71.3
March forecast	83.3	83.7	82.6	81.3	79.9	77.2	74.7
Change	0.2	1.3	0.9	1.4	2.6	2.9	3.4
of which:							
Change in nominal GDP ¹	0.2	1.7	1.6	1.8	2.0	2.2	2.3
Change in cash level of net debt	0.1	-0.5	-0.7	-0.4	0.6	0.7	1.1
	£ billion						
November forecast	1546	1599	1652	1685	1702	1708	1715
March forecast	1547	1591	1638	1677	1715	1725	1740
Change in cash level of net debt	1	-9	-14	-8	14	16	25
of which:							
Pre-measures borrowing	0	-1	5	13	25	38	55
Policy effects on borrowing	0	0	-1	6	10	-4	-17
Foreign currency reserves	0	-10	-10	-10	-10	-11	-11
UKAR asset sales and rundown	0	-1	-9	-18	-14	-11	-10
Other financial asset sales	0	4	2	2	3	3	9
Gilt premia	0	-2	-4	-4	-6	-6	-7
APF balance sheet effects	0	0	1	1	2	3	4
Other factors	1	1	3	3	4	3	2

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

The pace of fiscal consolidation

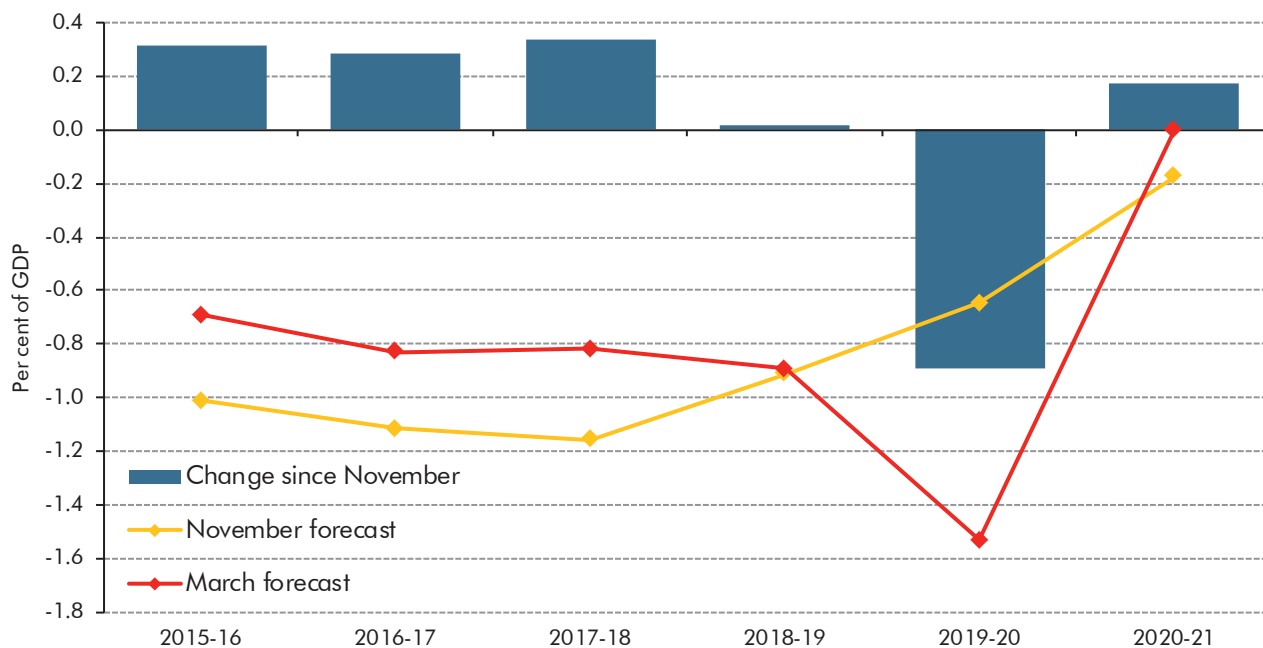
1.37 Our estimate of the margin of spare capacity in the economy is small in 2015-16 at just 0.3 per cent of potential output – slightly narrower than we estimated in November – and we expect the output gap to be very close to zero from 2016-17 onwards. This means that more of the deficit in 2015-16 is considered structural than was the case in November, but the path of structural borrowing is similar to that of headline borrowing described above.

1.38 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 potential output growth is more stable. Chart 1.5 shows that:

- **in November's Spending Review and Autumn Statement**, the Government set a path for the structural deficit that saw the pace of tightening pick up slightly in 2016-17 and 2017-18 and then diminish year by year as the budget moved into surplus; but
- **in this Budget**, thanks to tax and spending policy changes that have uneven effects on borrowing across the forecast, the Government has charted a course that sees the pace of tightening pick up gradually up to 2018-19, then dramatically in 2019-20 (the

year in which its surplus target first applies), before slowing abruptly in 2020-21. The 1.5 per cent of GDP tightening of the structural fiscal position in 2019-20 would be the sharpest since 2010-11.

Chart 1.5: Year-on-year changes in cyclically adjusted net borrowing



Source: OBR

Fiscal forecast revisions over the past six years

1.39 Following our last forecast in November, much attention focused on the fact that we had reduced our pre-measures forecast for the budget deficit by an aggregate £27 billion over five years, or about £5.4 billion a year or ¼ per cent of GDP on average. In this *EFO* we have increased our pre-measures forecast by £11.3 billion a year or 0.5 per cent of GDP, giving an aggregate increase of £56 billion over the five years. Table 1.5 shows the main sources of those revisions. In both cases, there were factors pushing in both directions. On the spending side, debt interest spending was revised down in both while welfare cap spending was revised up in both. The main difference between them is the receipts forecast. In November it was revised up, thanks largely to various changes to modelling judgements – which are still in place in this forecast. But our latest forecast has been hit by the productivity-driven downward revision to the major tax bases.

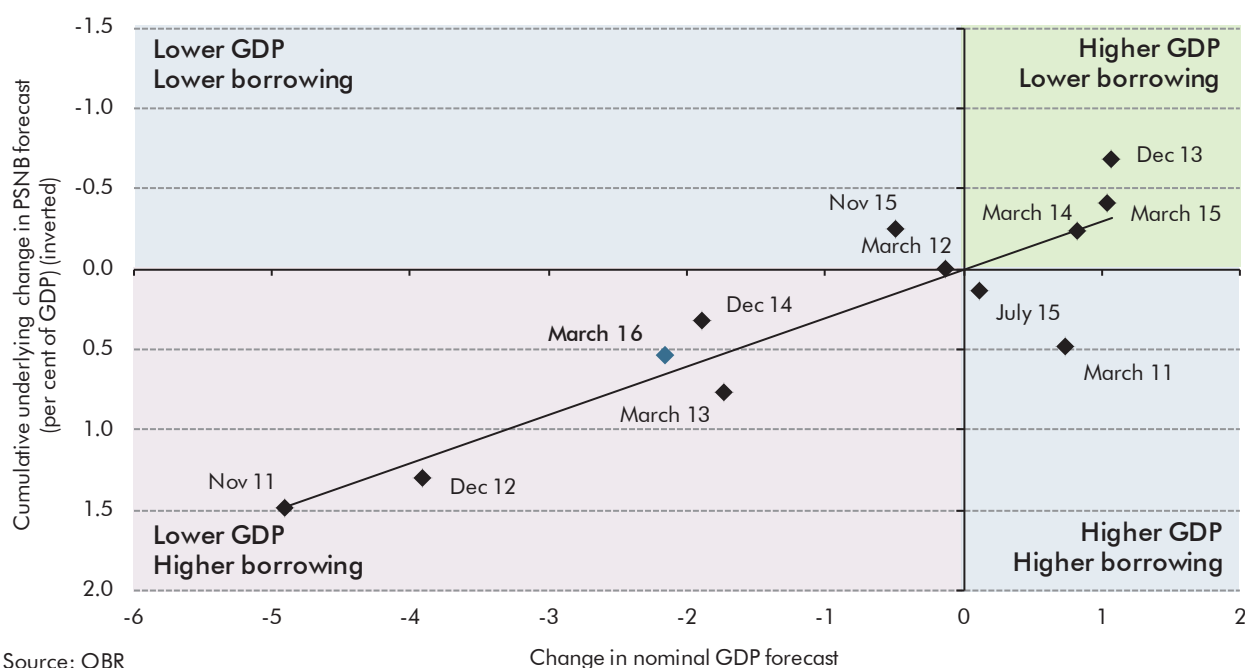
Table 1.5: Underlying fiscal forecast revisions in November 2015 and March 2016

	Forecast						Per cent of GDP
	£ billion						
	2016-17	2017-18	2018-19	2019-20	2020-21	Total	
Change in PSNB forecast: November 2015	-2.9	-7.9	-8.0	-3.8	-4.4	-27.0	-0.2
<i>of which:</i>							
Debt interest spending and updated APF redemption profile	-1.7	-4.1	-5.0	-5.0	-6.0	-21.8	-0.2
VAT deductions modelling	-1.0	-1.6	-2.3	-2.9	-3.3	-11.1	-0.1
Company profits and CT receipts	-1.8	-2.3	-2.1	-1.7	-1.8	-9.7	-0.1
Other receipts judgements and modelling	-1.2	-2.0	-1.4	-1.4	-1.8	-7.9	-0.1
New NICs model	-0.4	-0.6	-1.1	-1.7	-2.8	-6.6	-0.1
Lower interest rates effect on receipts	0.2	0.3	0.3	0.3	0.2	1.3	0.0
Other forecast changes	-0.3	-1.8	-1.2	2.6	4.3	3.6	0.0
Welfare cap spending	1.0	1.2	1.2	1.9	2.4	7.7	0.1
SDLT related judgements	0.7	1.1	1.7	2.2	2.4	8.1	0.1
Lower equity prices effect on receipts	1.6	1.8	1.9	2.0	2.1	9.4	0.1
Change in PSNB forecast: March 2016	6.6	7.2	12.3	13.4	16.7	56.3	0.5
<i>of which:</i>							
Debt interest spending	-3.9	-4.9	-4.8	-5.4	-5.2	-24.2	-0.2
Other forecast changes	2.3	-1.1	1.0	0.2	1.2	3.6	0.0
Lower interest rates effect on receipts	0.3	0.6	0.9	1.1	1.1	4.1	0.0
Local authorities and public corporations spending	0.8	1.3	1.2	1.1	1.1	5.5	0.1
Welfare cap spending	-0.5	0.6	1.1	2.0	2.4	5.7	0.1
Lower equity prices effect on receipts	0.8	1.8	1.9	2.1	2.3	8.8	0.1
Lower nominal GDP reduces tax base growth	6.8	8.8	11.0	12.3	13.8	52.8	0.5

1.40 How do these compare with revisions at past *EFOs*? In Annex B we review all the revisions we have made since the first full OBR forecast was published in June 2010. This shows that the revision in this forecast is in line with the average in absolute size, although it is relatively large for a March forecast (when revisions are typically smaller because less time has passed since the previous forecast). Notwithstanding the attention it received at the time, the November revision was only the ninth largest of thirteen. Since 2010, we have revised borrowing up on nine occasions and down on four, with the biggest revisions upward in November 2011, December 2012 and March 2013.

1.41 The analysis also confirms how important changes in nominal GDP are for our fiscal forecast, whether they reflect revised assumptions about potential output (as in November 2011 and this forecast), the output gap (in December 2012 and December 2013) or whole economy inflation (in December 2012 and December 2014). As Chart 1.6 shows, there is a close correlation between our economy and fiscal forecast revisions – when we revise down prospective GDP growth, we tend to revise up our borrowing forecast, and vice versa. But we have produced three forecasts in which the revisions to borrowing and nominal GDP have moved in the same direction rather than in opposite directions.

Chart 1.6: Underlying fiscal forecast and overall nominal GDP revisions since 2010



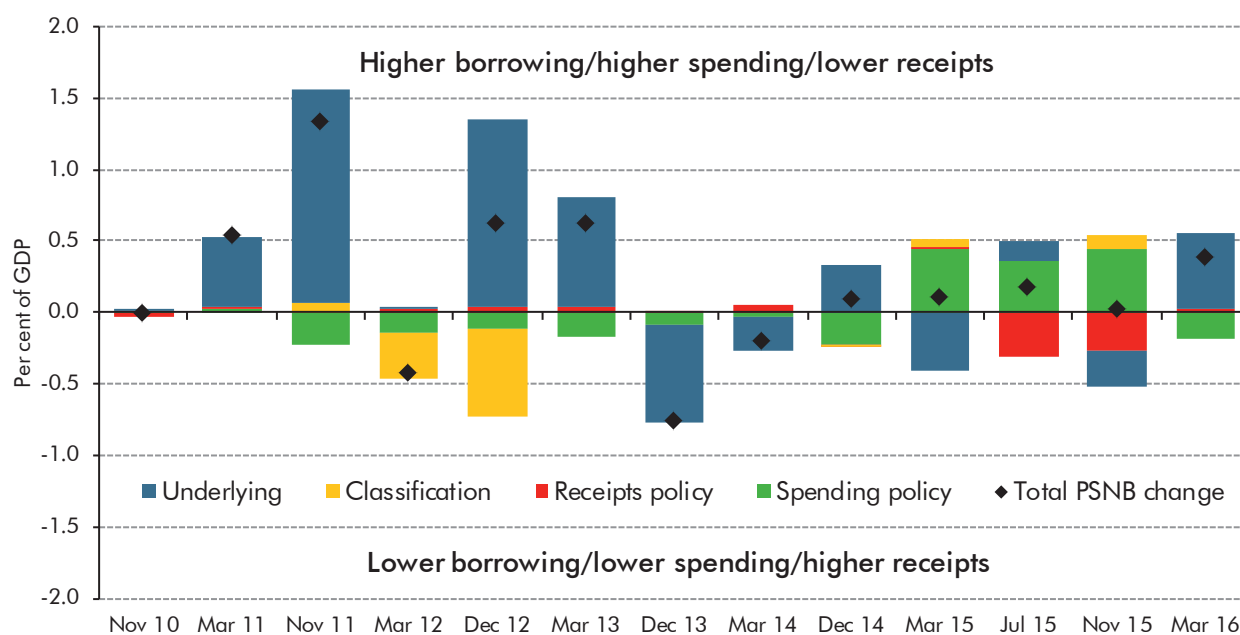
1.42 Classification changes and our underlying forecast revisions provide the Government with the baseline fiscal forecasts against which it takes its policy decisions. On some occasions, the Government has chosen to offset the underlying revisions – e.g. in November 2011, when it announced additional public spending cuts to offset an upward revision to our underlying deficit forecast and thereby ensure that one of its fiscal targets would not be missed. On other occasions it has accommodated the revisions – e.g. in December 2012, when we forecast that the Government was on course to miss its target for net debt, but it chose not to take policy measures that would have been sufficient to get back on track.

1.43 Chart 1.7 illustrates the effect of all factors contributing to revisions in our fiscal forecasts since 2010. It shows that:

- **when our underlying forecast revisions have worsened the outlook** for the public finances, the Government has tended to respond by using policy to offset part of those changes over the forecast period. When presented with our largest upward revisions to expected borrowing in November 2011 and December 2012, the Coalition decided to add more years to the fiscal consolidation, with the policy tightening assumed to be borne almost entirely by lower departmental spending;
- **when our underlying forecast revisions have improved the outlook** for the public finances, the Government has responded either by banking the improvement (as in December 2013) or by reducing the squeeze on spending that had been pencilled in at previous fiscal events (as in March and November 2015); and
- **spending cuts pencilled in during the last Parliament were later reversed.** In the seven forecasts between November 2011 and December 2014, the Coalition's policy

decisions involved cutting spending every time and a net tax giveaway in all but two. At the next three forecasts, the Coalition and then the new Conservative Government reversed much of that planned squeeze on spending in the run-up to setting detailed plans in last November's Spending Review.

Chart 1.7: Changes in our post-measures fiscal forecasts since 2010



Source: OBR

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 hitting its fiscal targets under existing policy. The Charter has been updated a number of times in recent years, with the latest version approved by Parliament in October 2015 (and available on our website). It sets out the targets for borrowing, debt and welfare spending that are assessed in this forecast:

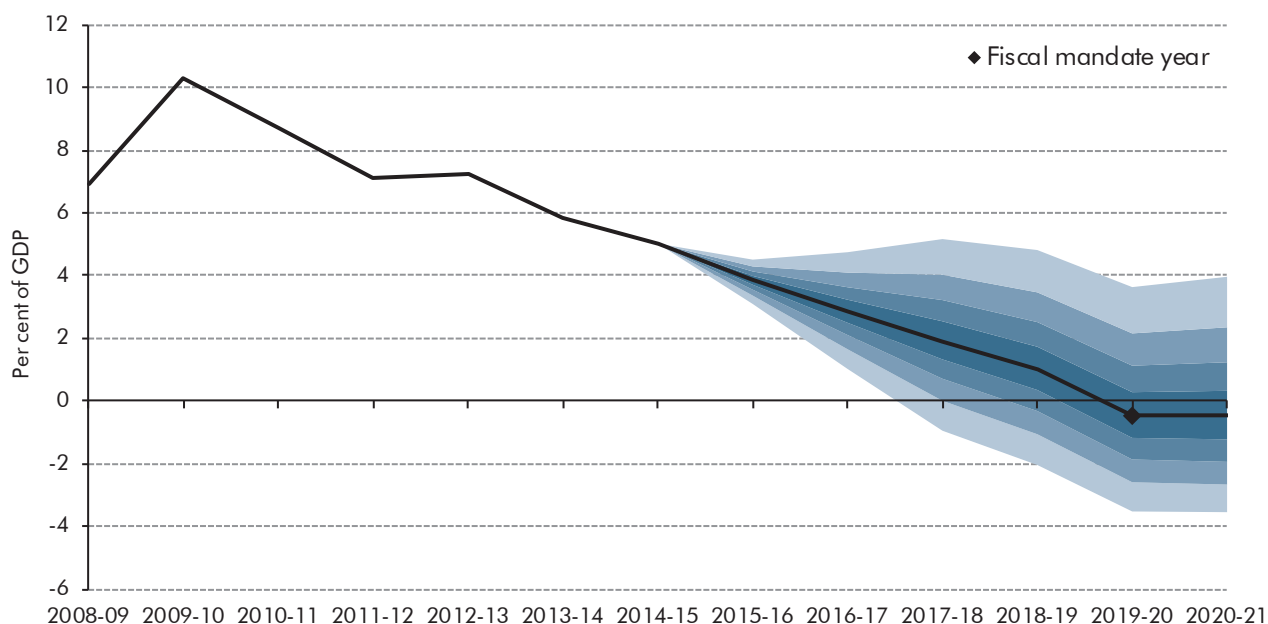
- the **fiscal mandate**, which requires a surplus on public sector net borrowing by the end of 2019-20 and in each subsequent year;
- the **supplementary target**, which requires public sector net debt to fall as a percentage of GDP in each year to 2019-20; and
- the **welfare cap**, a limit on a subset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

1.45 In the absence of any policy measures in this Budget, the Government would have been on course for small deficits in 2019-20 (£3.2 billion) and 2020-21 (£2.0 billion), breaching the fiscal mandate. But the Government's Budget policy decisions raise £13.7 billion in 2019-20 and £13.1 billion in 2020-21, offsetting the deterioration in the underlying forecast and

putting it back on course to meet the surplus target by £10.4 billion and £11.0 billion respectively. We therefore judge that the Government is more likely than not to meet its target on existing policy, but with a margin that is small in comparison with the uncertainty that surrounds our fiscal forecast at that horizon.

- 1.46 In November, we expected debt to fall as a share of GDP in every year of the forecast, so that in our central forecast the Government was on course to meet its supplementary target. We now expect the debt-to-GDP ratio to rise between 2014-15 and 2015-16, thereby missing the target. But we still expect it to fall in each year thereafter.
- 1.47 In our central forecast spending subject to the welfare cap remains above the cap in all years. It is also above the 2 per cent forecast margin in all years. On this basis, our Autumn Statement assessment that the cap has been breached still holds.
- 1.48 All forecasts are subject to significant uncertainty. Chart 1.8 shows our median forecast for public sector net borrowing with successive pairs of shaded areas around that median forecast representing 20 per cent probability bands. As in Chart 1.3 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 1.8: Public sector net borrowing fan chart



Source: ONS, OBR

- 1.49 In judging adherence to 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. But the probability distribution used to generate Chart 1.3 suggests there is a 35 per cent probability of growth falling below the threshold in 2020.

1.50 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 economy forecast**. The surplus in 2019-20 could fall to zero due to relatively small differences in the output gap (if it were -0.7 per cent in that year, not zero), potential output (if it were 1.0 per cent lower), whole economy prices (1.2 per cent lower), debt interest spending (due to interest rates 1.2 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**. We have considered the implications of higher or lower net inward migration, using a similar framework to that which underpins our demographically driven long-term fiscal projections. In these scenarios, higher/lower migration leads to a higher/lower population and employment rate (because net inward migration is concentrated among people of working age). We do not assume any change in average productivity per worker. The effect on the public finances is driven by population size (e.g. higher numbers of taxpayers or benefit recipients) and age structure (e.g. those of working-age pay more tax and do not receive child benefit or state pensions). Since the Government has set departmental spending plans in cash terms, we do not assume that changes in population size lead to changes in departmental spending. We use the ONS 'high' and 'low' migration population projection variants, where net migration is assumed to fall from over 320,000 over the past year to 265,000 by 2021 in the high scenario and 105,000 in the low scenario, and also its 'natural change' variant where net migration is zero. In these scenarios, the surplus in 2019-20 would be higher under the high migration scenario and lower, but still positive, in the low migration scenario. In the natural change scenario the budget would be close to balance in 2019-20 and 2020-21.