1 Executive summary

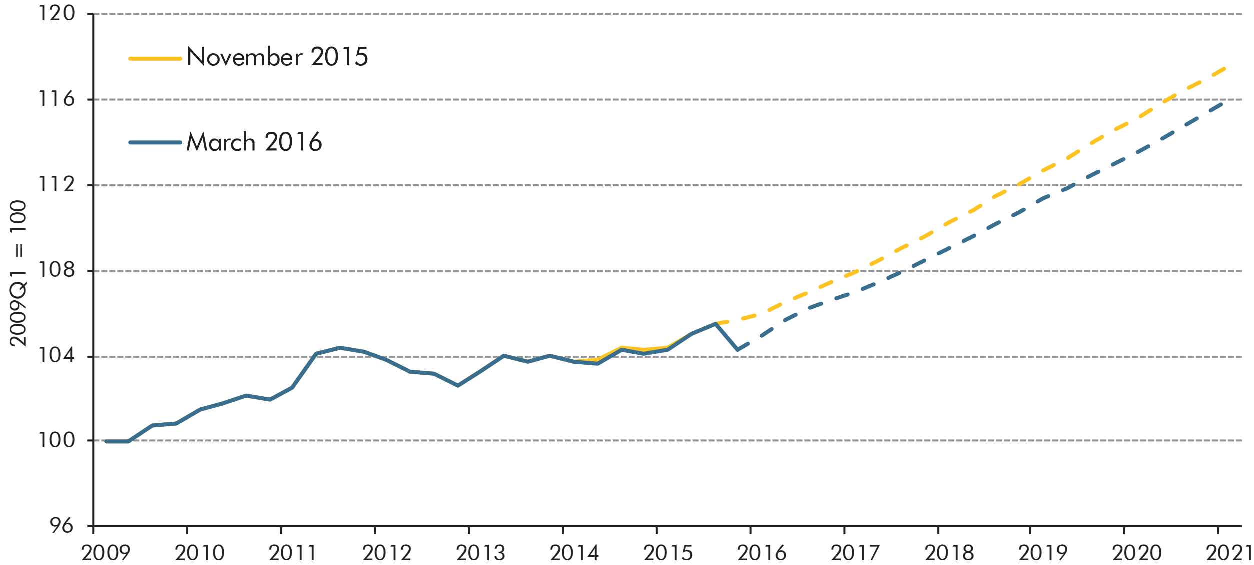
Overview

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.

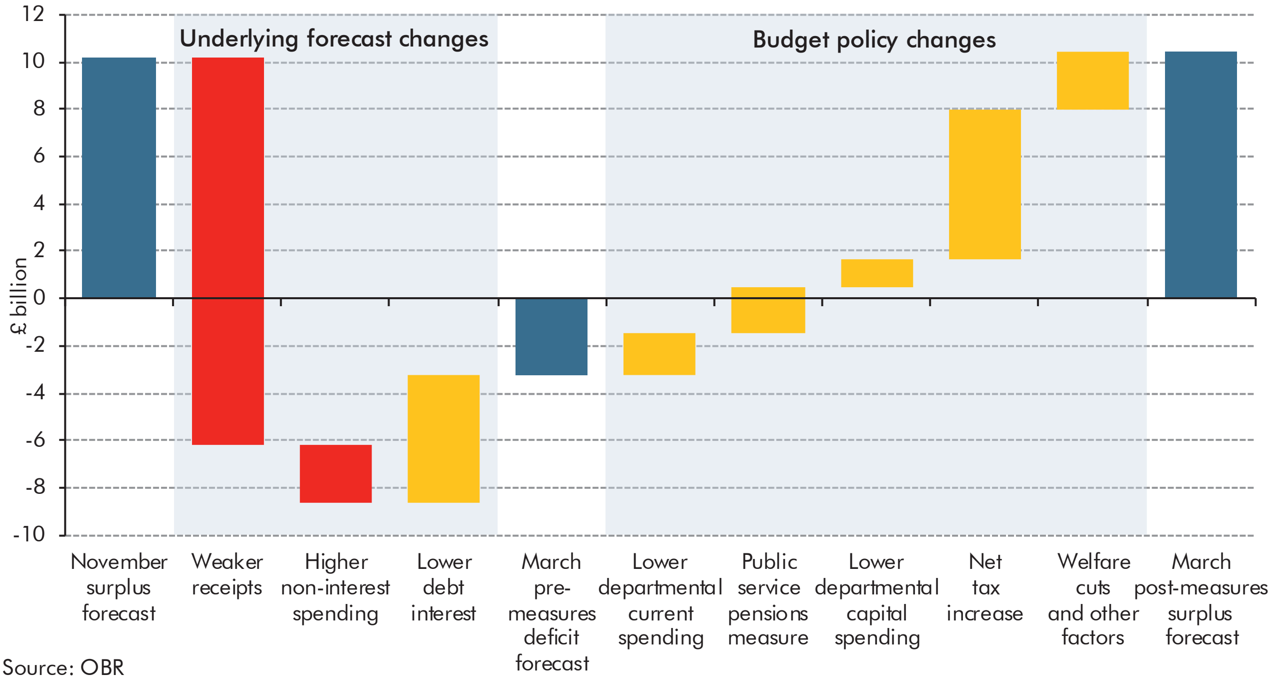
1.8 Focusing on the first year of the surplus target in 2019-20, Chart 1.2 shows that our pre-measures forecast for the budget balance has deteriorated by £13.4 billion in that year, with a £5.4 billion fall in debt interest spending more than offset by a £2.4 billion increase in other spending and a £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 shows 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.