UK economy and the implications for Welsh taxes

Good morning and thank you for the invitation to today's conference. My name is Andy King. I am one of three members of the OBR's Budget Responsibility Committee, where I focus on the fiscal side of our work.

[SLIDE] I've been asked to do some scene-setting for the discussions that will follow, so I'll take you through some background about the OBR, our latest UK-wide and Welsh forecasts, and just a few of the many sources of risks to those forecasts.

If you think of forecasting as mapping out the future path the public finances will take, these risks can be grouped into those that come from not knowing precisely where we start from, and those related to the uncertain pace and direction of travel from here.

The starting point issue is a factor in all forecasts, as data get revised, but is particularly acute for Welsh income tax, where will not have a firm outturn data point for some time yet. The Scottish experience here is instructive.

Growth rate risks come in many different forms. I'll take you through just a few of those we covered in yesterday's *Fiscal risks report*, including the 'no deal' Brexit stress test that you may have heard mentioned here or there over the past 24 hours.

[SLIDE] So first, us. [SLIDE] The OBR was set up almost a decade ago by the UK's Coalition Government, with the objective of taking the politics out of forecasting and to bring much greater transparency to the process.

To that end, we produce forecasts, assess performance against fiscal targets, scrutinise policy measures, report on fiscal sustainability and evaluate our own past forecast performance. We have had tasks added along the way. Forecasting devolved taxes, analysing trends in social security spending, and reporting on fiscal risks.

We have a free hand in all of this, subject to a few statutory limits. First, we must base everything on the current Government's stated policies. Second, we cannot provide policy advice or normative commentary on the merits of different policies, tempting though that can be sometimes.

[SLIDE] The most recent addition to our tasks came this year when we formally took on the role of independent forecaster for the Welsh Government. This builds on the work we already do on Welsh taxes as part of our UK-wide forecasts and the work Bangor University did scrutinising the Welsh Government's forecasts over the past two years.

Two general points I would make about how we intend to approach this role. First, we will be as transparent as possible – about the judgements we make, the risks and uncertainties around them, and the process that sits behind the numbers we publish. Second, we aim to provide central, unbiased forecasts and analysis at all times. What this means is that while it is inevitable that outturns will differ from the central forecasts we publish, the differences should not fall consistently one side or the other.

[SLIDE] So let me turn to our latest forecasts. These were produced in mid-March and are based on broad-brush assumptions about Brexit – leaving at the end of March, as was planned at the time, and moving to a more restrictive trading and migration regime after an implementation period

running to the end of 2020. Those assumptions are not designed to capture any particular Brexit end-point, but instead to reflect a smooth transition to an economic and fiscal outcome that might be considered broadly consistent with a range of possible policy settings.

[SLIDE] Some of the key numbers are presented here. Our real GDP forecast is pretty weak by historical standards, but in the middle of the pack when considered relative to most professional forecasters' views at the moment. We expected the economy to be a little weaker this year than last, then to pick up very modestly over time. Inflation was expected to remain close to target throughout the period.

Bringing those two together, nominal GDP growth – the most important driver of our receipts forecasts – was also expected to pick up slowly but to remain at historically subdued rates. That is reflected in our forecasts for wages and salaries – which drives our income tax forecast – and profits – which drives our corporation tax forecast.

We foresaw weakness in house prices this year – expecting them to fall a little before rebounding. The same was true of property transactions. These drive our forecasts for the various property transactions taxes.

[SLIDE] In terms of the quarterly path of real GDP growth, this is the picture as we saw it in March. The solid line shows the ONS outturns. The dashed line our forecast. [SLIDE] And this is how things look now. Little revision to outturns, but a stronger than expected first quarter. That seems to stem largely from pre-Brexit stockpiling. Some of those stocks were imported, so did not affect GDP. But some were domestically produced and other sectors benefited from the stockpiling – not least the warehousing sector.

[SLIDE] We produce our economy forecast in order to generate a fiscal forecast. In terms of the deficit, our March forecast looked like this [SLIDE]. The rise between 2018-19 and 2019-20 reflects things like tax cuts announced by the UK Government in Budget 2018 and the first year of the higher NHS spending settlement. The gentle declines thereafter reflect things like fiscal drag in the tax system and spending growing less quickly than GDP.

[SLIDE] Turning to taxes. Here is our overall UK receipts forecast. [SLIDE] And here it is broken down into the three tax streams we currently forecast for Wales – income tax, property transactions taxes and landfill taxes (which you won't be able to see as they raise very little in relative terms) – and the rest – the largest elements of which are National Insurance contributions, VAT and corporation tax. We don't currently run our business rates and council tax forecasts in the same way as our forecasts for the other three, although we may be able to in the future.

[SLIDE] What did this all imply for the Welsh taxes?

For income tax, our UK forecast provides the starting point, as we forecast Welsh revenue as a share of the UK total. That share has been falling over time. Here [SLIDE] we look at the overall share. The decline is partly down to the population growing more slowly in Wales than in the UK as a whole, and partly due to changes in the income tax system over that time – raising the personal allowance costs proportionally more in Wales; introducing the additional rate raises proportionally less.

We project the share forward by explicitly factoring in relative population growth rates and any forthcoming policy measures that seem likely to have asymmetric effects between Wales and the UK as a whole. This yields a very

gently declining share over the next five years, [SLIDE] and a forecast of income tax liabilities that rises from £2.1 billion in 2018-19 to £2.5 billion by 2023-24.

[SLIDE] We forecast land transaction tax receipts using our UK-wide property price and transactions forecasts and a model operated and maintained for us by the Welsh Government. We expect receipts to rise from £234 million in 2018-19 to £323 million in 2023-24.

Landfill disposals tax is a much smaller source of revenue – and one that is expected to decline over time as more waste is recycled, incinerated or exported, leaving less sent to landfill. Receipts are forecast to fall from £45 million in 2018-19 to £32 million in 2023-24.

So these are our central forecasts, but what about the risks? [SLIDE] Thinking about these in terms of the starting points and the growth rates, on the income tax side there are important risks to both. We do not have an outturn figure yet to start from, so we have to estimate that from other sources. That will be true for another couple of years yet. The Scottish experience, which I'll come to in a moment, suggests the risks here could be significant.

Growth rate risks come from the usual uncertainties around the performance of the economy and wages, but also from uncertainties in policy costings – for example, if income tax rates were to differ between Wales and England, how might taxpayers respond?

It is also worth noting that both LTT and LDT tax bases are concentrated in different ways. A large share of LTT receipts come from Cardiff – especially where commercial property is concerned. And while waste is generated by

everyone, there are only 23 sites, and the volumes going to each are sensitive to developments in local incineration capacity and prospects for waste to be exported.

And then there are operational and compliance risks, which could cause receipts to fluctuate even if we were to get our tax base forecasts spot on. The 'C' flagging process in income tax is an obvious candidate for causing surprises, but the Welsh Revenue Authority's compliance activities are something else that we will need to keep an eye on.

What do these sorts of risks mean for risks to spending power in Wales? [SLIDE] Well things become more complicated here thanks to the fiscal framework and the manner in which the Treasury revises block grant adjustments in light of relative surprises in revenue forecasts and outturns, not absolute ones. On top of this, for years where the Treasury has yet to set detailed spending plans, there is uncertainty over future block grant allocations as well as revenue forecasts and block grant adjustments.

[SLIDE] So what can we learn from recent years' forecasts of Scottish income tax liabilities?

[SLIDE] First, it is possible for the initial year of outturn to differ from forecasts by a large margin. A 6.3 per cent forecast error in respect of a period that ended more than a year ago is big. Much bigger than the error in our UK-wide liabilities forecast. Why was it so large? [SLIDE] This table breaks down what we do and don't know about the difference.

Our March 2018 forecast for 2016-17 forecast was based on the 2015-16 edition of HMRC's Survey of Personal Incomes. We projected that forward and adjusted it for known relative population growth rates to get a Scottish

share of 7.08 per cent. Outturn was 6.68 per cent. Of the 0.4 percentage point difference, 0.2 percentage points was down to our projection method missing things that the 2016-17 Survey of Personal Incomes recorded. Another 0.05 percentage points was down to the postcode-basis of identifying Scottish taxpayers generating a higher share than the 'S'-code basis that underpins the outturn. That leaves 0.15 percentage points unexplained – over £250 million in revenue terms.

This large error for 2016-17 illustrates what is possible when there is no actual outturn data on which to base a forecast. [SLIDE] Here we compare our most recent forecast for the share in 2017-18 with the outturn data HMRC published yesterday. As you can see, the error is much smaller. This illustrates a more normal forecast error, where you are reasonably confident about the starting point but need to make uncertain judgements about growth from there.

Next I'll turn to some broader sources of risk to receipts growth [SLIDE] drawn from the *Fiscal risks report* we published yesterday. [SLIDE] Over the medium term, perhaps the most important risk to receipts growth derives from uncertain prospects for the economy's growth potential. There are also risks from cyclical shocks and from many other pressures that can affect the tax take from a given amount of economic activity. We also highlighted policy risks, which feel quite prominent right now. The balanced budget 'fiscal objective' is being downplayed. The leadership candidates have both set out potentially expensive shopping lists of policies they would implement if they win. And of course we still don't know what form Brexit is going to take.

[SLIDE] This chart illustrates the medium-term growth risk. Productivity growth has been remarkably weak since the crisis. We expect it to recover somewhat over the next five years, but to remain weak by historical standards. We see the risks lying to both sides of this. The recent past could persist; the more distant past, which prevailed for much longer, could reassert itself. Small changes to our assumptions here can have quite large ones for receipts once they have built up over a period of years.

[SLIDE] This picture shows the latest monthly and quarterly GDP data. Based on the April and May GDP data, and the PMI surveys for June, it looks like the economy flat-lined at best. So is the UK economy already in recession? I think most people think probably not – it's more likely to be payback from first quarter stockpiling – but the risk is there. The Resolution Foundation put the probability of recession at 40 per cent.

What about some revenue-specific risks? [SLIDE] Here we have HMRC's estimate of the UK-wide tax gap. It has generally been falling over time, but ticked up in the past couple of years. From a forecast perspective, the risk here is that it changes, since we typically assume it will remain constant at its most recent level. And we tend to do that implicitly rather than explicitly, because we forecast growth from outturn receipts – and those receipts reflect the latest tax gap before HMRC has time to put a number on it.

I would expect movements in the tax gap to be a greater risk at the UK level than for the Welsh taxes, because such a large proportion of revenue comes from non-savings, non-dividend income tax – and such a large proportion of that is collected via PAYE, where the tax gap is very small indeed.

[SLIDE] This slide shows the trend towards self-employment and incorporations at the UK level. Much of the growth in self-employment has been associated with growth in single-director companies. This will at least in part reflect the lower overall tax burden incurred from working that way. This trend lowers income tax and NICs receipts, while raising corporation tax results – and it lowers receipts overall because of the different rates.

HMRC looked into whether trends in incorporations on this metric differed in Wales relative to the UK as a whole, but they don't seem to.

[SLIDE] Finally, let me take you through the main findings from our fiscal stress test. With both remaining candidates for Number 10 explicitly countenancing the possibility of a 'no-deal' Brexit on October 31st, we decided to look at the fiscal implications of the less severe of the two 'no-deal, no-transition' scenarios set out by the IMF in its April *World economic outlook*. This scenario is not necessarily the most likely outcome and it is relatively benign compared to some (for example, assuming no major short-term border disruptions). A more disruptive outcome, closer to the Bank of England scenario we used for our stress test two years ago, would have more severe consequences. Nonetheless it is useful for thinking about some of the channels through which a no deal Brexit might affect the public finances – and to illustrate the extent to which even a relatively benign 'no deal' scenario might knock the public finances off course.

[SLIDE] This chart shows the path of real GDP under the Brexit stress test, compared to that in our March *EFO* forecast. This path is based directly on the IMF scenario, with the start date of Brexit pushed back to the fourth quarter. But the Fund publishes only a limited amount of information on the composition of the downturn and associated economic and market

developments, so we have had to fill in some blanks ourselves. So the Fund should not be held responsible for our conclusions.

The big picture is that heightened uncertainty and declining confidence deter investment. Higher trade barriers with the EU weigh on domestic and foreign demand, while the pound and other asset prices fall sharply. These factors combine to push the economy into recession. The economy and asset prices then recover somewhat over time.

[SLIDE] This chart decomposes the hit to nominal GDP from the stress test into lower potential GDP, a wider output gap and higher whole economy inflation. (Because nominal GDP is more important than real GDP in determining the path of the public finances.) Higher trade barriers lower potential productivity and lower inward migration reduces labour force growth. As a result, potential GDP is lower and accounts for most of the loss of nominal GDP at the five-year horizon. The imposition of tariffs and the fall in sterling push inflation higher, but the MPC is assumed to look through this and cut Bank Rate to support demand and eventually bring output back towards potential.

[SLIDE] The consequences for the public finances are that borrowing is around £30 billion a year greater under the stress test than in our March forecast and net debt is about 12 per cent of GDP higher at the five-year horizon – and it rises rather than falls relative to GDP over the next three years. The main contributing factors are as follows:

- Income tax and national insurance are hit by the cyclical downturn, raising borrowing by about £16½ billion a year from 2020-21.

- Capital tax receipts fall sharply, thanks to lower house prices, equity prices and property transactions. This raises borrowing by around £10 billion a year.

- Conversely debt interest spending benefits more from lower interest rates and RPI inflation than it suffers from higher borrowing, so it lowers the deficit by £6 billion in 2021-22 but by less thereafter.

- Customs duties raise more than in March and now count as UK tax receipts, lowering borrowing by around £10 billion a year from 2021-22.

- We assume, as we do in our baseline forecast, that reduced budget contributions to the EU are recycled into domestic spending. Subsumed within this is the cost of the divorce settlement, whatever form that might take in a 'no deal' scenario.

Needless to say there is huge uncertainty around estimates of this sort and the impact of a 'no deal' Brexit will depend on the behaviour of governments, businesses and consumers abroad as well as here. As we discuss at the end of Chapter 10 of the *FRR*, there are a number of economic risks and other risks to tax receipts that could lead to a more adverse outcome than in the stress test.

And it is important to remember that this scenario is relative to our March forecast. Economic and fiscal developments over the past three years already incorporate some impact of the referendum vote, although you cannot isolate that easily from other surprises we have seen relative to our pre-referendum forecasts. And the impact of Brexit would also continue to make itself felt well beyond the five-year horizon, according to the IMF's and

most other studies. So these numbers should not be taken as the total fiscal impact of Brexit.

[SLIDE] So let's bring this back to Welsh tax receipts and the risks to which our forecasts of them are subject.

[SLIDE] I'll leave you with three thoughts.

- First, we aim to produce central forecasts, but outturns will inevitably differ. That might be due to uncertainty about the starting point – a particular issue for income tax – or to how receipts will grow from here.
- Second, the political and policy context feels unusually uncertain – the Brexit end-state is still unknown and medium-term fiscal objectives may be changing.
- And third, the implications of all this for spending power here in Wales depend crucially on whether spending plans have been set. Once set, the fiscal framework insulates you from lots of revenue risks. But before that, which of course is currently the case for most of the next five years, UK-level spending policy represents a bigger source of uncertainty.