

Office for
**Budget
Responsibility**

Economic and fiscal outlook

March 2015

Cm 9024



Office for Budget Responsibility: Economic and fiscal outlook

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

March 2015

Cm 9024



© Crown copyright 2015

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

This publication is available at www.gov.uk/government/publications

Any enquiries regarding this publication should be sent to us at: obrenquiries@obr.gsi.gov.uk

Print ISBN 9781474116077

Web ISBN 9781474116084

ID 04031511 48002 03/15

Printed on paper containing 75% recycled fibre content minimum

Printed in the UK by the Williams Lea Group on behalf of the Controller of Her Majesty's Stationery Office

Contents

	Foreword.....	1
Chapter 1	Executive summary	
	Overview	5
	Economic developments since our previous forecast	7
	The economic outlook	8
	The fiscal outlook	12
	Performance against the fiscal targets.....	19
Chapter 2	Developments since the last forecast	
	Introduction	23
	Economic developments	23
	Fiscal data developments.....	31
	Developments in outside forecasts.....	31
Chapter 3	Economic outlook	
	Introduction	35
	Potential output and the output gap.....	35
	Key economy forecast assumptions.....	43
	Prospects for real GDP growth	51
	Prospects for inflation	57
	Prospects for nominal GDP growth.....	63
	Prospects for individual sectors of the economy	66
	Risks and uncertainties.....	83
	Comparison with external forecasters	84

Chapter 4	Fiscal outlook	
	Introduction	89
	Economic determinants of the fiscal forecast	90
	Policy announcements, risks and classification changes	96
	Public sector receipts	101
	Public sector expenditure	123
	Loans and other financial transactions.....	158
	The key fiscal aggregates.....	167
	Risks and uncertainties.....	175
	International comparisons.....	176
Chapter 5	Performance against the Government’s fiscal targets	
	Introduction	181
	The Government’s fiscal targets	181
	The implications of our central forecast.....	182
	Recognising uncertainty	192
Annex A	Budget 2015 policy measures	
	Overview	201
	Uncertainty	201
	Indirect effects on the economy	208
	Departmental spending	209
	Total managed expenditure beyond the Spending Review.....	210
Annex B	Fiscal ready reckoners	
	Tax and spending ready reckoners	211
	Index of charts and tables	217

Foreword

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

In this *Economic and fiscal outlook (EFO)* we set out forecasts to 2019-20. We also assess whether the Government is on course to meet the recently updated medium-term fiscal objectives that it has set itself. The forecasts presented in this document represent the collective view of the three independent members of the OBR's Budget Responsibility Committee (BRC). We take full responsibility for the judgements that underpin them and for the conclusions we have reached.

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

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

- In January, the Treasury requested that we finalise the Budget 2015 forecast on a 'pre-measures' basis (i.e. before incorporating the effect of new policy announcements) around two weeks ahead of the Budget in order to provide the Chancellor with a stable base for his final policy decisions.
- We began the forecast process with the preparation by OBR staff of a revised economic forecast, drawing on economic data released since the last published forecast in December 2014 and with our preliminary judgements on the outlook for the economy in light of the sharp fall in oil prices and other developments.
- Using the economic determinants from this forecast (such as the components of nominal income and spending, plus inflation and unemployment), we then commissioned new forecasts from the relevant government departments for the various tax and spending streams that in aggregate determine the state of the public finances. We discussed these in detail with the officials producing them, which allowed us to investigate proposed changes in forecasting methodology and to assess the significance of recent tax and spending outturns. In many cases, the BRC requested changes to methodology and/or the interpretation of recent data.

- We sent our first economic forecast to the Chancellor on 30 January and our first fiscal forecast (including a provisional judgement on progress towards meeting the new fiscal mandate) on 13 February. We provided the Chancellor with these early forecasts and our provisional judgements on compliance with the fiscal mandate in order to inform his policy choices for the Budget.
- As the forecasting process continued, we identified the key judgements that we would have to make in order to generate our full economic forecast. Where we thought it would be helpful, we commissioned analysis from the relevant experts in the Treasury to help inform our views. The BRC then agreed the key judgements, allowing the production by OBR staff of a second full economic forecast.
- This provided the basis for a further round of fiscal forecasts. Discussion of these forecasts with HMRC, DWP and the other departments gave us the opportunity to follow up the various requests for further analysis, methodological changes and alternative judgements that we made during the previous round. We provided the second round economic and fiscal forecast to the Chancellor on 25 February.
- We then produced a third economy and fiscal forecast, which allowed us to take on latest data and to ensure that our judgements on the fiscal forecast had been incorporated. We finalised this forecast and sent it to the Chancellor on 6 March, and we met with him and Treasury officials to discuss it on 9 March.
- Meanwhile, we were also scrutinising the costing of tax and spending measures that were being considered for announcement at the Budget. The OBR requested a number of changes to the draft costings prepared by HMRC, DWP and other departments. The process was particularly difficult for this Budget as we were not given details of costings for a large proportion of significant policy measures until just before our deadlines. We have certified the final published costings for new Budget policies as reasonable and central estimates. We have continued our fuller discussion and calibration of the uncertainties that surround these policy costings, which is presented in Annex A of this *EFO* and in our annex to the Treasury's Budget 2015 policy costings document.
- During the week before publication we produced our final forecast, incorporating the final package of policy measures. We were provided with final details of most major policy decisions with a potential impact on the economy forecast – including the spending assumption to be applied from 2016-17 onwards – on 10 March. These were incorporated into our final economy forecast.
- We provided the Treasury with our final post-measures forecast on 13 March. Our final fiscal forecast included the direct fiscal effects of the full set of Budget policy decisions, the final version of which was provided to us on 13 March.
- At the Treasury's written request, and in line with pre-release access arrangements for data releases from the ONS, we provided the Chancellor with a near final draft of the *EFO* on 13

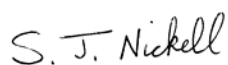
March. This allowed the Treasury to prepare the Chancellor's statement and documentation. We also provided a full and final copy 24 hours in advance of publication.

During the forecasting period, the BRC held more than 50 scrutiny and challenge meetings with officials from other departments, in addition to numerous further meetings at staff level. We have been provided with all the information and analysis that we requested. We have come under no pressure from Ministers, advisers or officials to change any of our conclusions as the forecast has progressed. A full log of our substantive contact with Ministers, their offices and special advisers can be found on our website.

We would be pleased to receive feedback on any aspect of our analysis or the presentation of the analysis. This can be sent to OBRfeedback@obr.gsi.gov.uk.



Robert Chote



Steve Nickell



Graham Parker

The Budget Responsibility Committee

1 Executive summary

Overview

- 1.1 In the relatively short period since our last forecast in December, there have been a number of developments affecting prospects for the UK economy and public finances both positively and negatively. These include a further big fall in oil prices, an unexpectedly large increase in net inward migration, further falls in market interest rates, another disappointing quarter for productivity growth, downward revisions to estimates of economic growth in 2014 and downward revisions to the outlook for the world economy. These have had a relatively modest net effect on our forecasts for real GDP growth and the public finances.
- 1.2 The Coalition Government's policy decisions in this Budget are not expected to have a material impact on the economy. For the public finances, they ensure that net borrowing is lower every year to 2018-19 than in our last forecast, that the new fiscal mandate is met with room to spare in 2017-18, that public spending as a share of GDP no longer falls to a post-war low in 2019-20, and that the debt-to-GDP ratio falls a year earlier in 2015-16.
- 1.3 The Government has achieved this by tightening the assumed squeeze on total spending through to 2018-19, dropping the cut in spending as a share of GDP it had pencilled in for 2019-20 and announcing the sale of an additional £20 billion in financial assets next year. This leaves a rollercoaster profile for implied public services spending through the next Parliament: a much sharper squeeze on real spending in 2016-17 and 2017-18 than anything seen over the past five years followed by the biggest increase in real spending for a decade in 2019-20. This profile is driven by a medium-term fiscal assumption that the Treasury has confirmed "*represents the Government's agreed position for Budget 2015*" and that was "*discussed by the Quad and agreed by both parties in the Coalition.*" But both parties have said that they would pursue different policies if they were to govern alone.
- 1.4 Real GDP grew by 0.5 per cent in the final quarter of 2014, slightly weaker than we expected in December. Employment growth was close to forecast, but hours worked were higher than expected. This meant that productivity fell on an hourly basis in the final quarter, falling short of our forecast once again. Unemployment has continued to fall as we expected, reaching 5.7 per cent of the labour force by the end of 2014, while sharply lower oil prices pushed inflation close to zero in January.
- 1.5 In 2015 and 2016, we expect lower inflation to boost real incomes and consumer spending, leading us to revise up our forecasts for real GDP growth to 2.5 and 2.3 per cent respectively. The upward revision is tempered by the weaker outlook for UK export market growth and the effect of lower oil prices on production and investment in the North Sea.

- 1.6 Slightly stronger growth means that we expect the remaining spare capacity in the economy to be used up by late 2017, around a year and a half earlier than we forecast in December. Thereafter, we assume that the economy will grow at its sustainable trend rate, which we have revised up slightly to reflect the stronger population and employment growth associated with higher rates of net inward migration.
- 1.7 We expect CPI inflation to return to the Government's 2 per cent target relatively slowly, partly due to the lagged effects of sterling's recent appreciation. The near-term fall in inflation is expected to boost real wage growth to 1.4 per cent this year – the first year of material growth since the crisis. Real wages rise by 1¾ per cent a year on average in the medium term. As ever, prospects for GDP and real wage growth rely heavily on the timing and strength of the long-awaited return to sustained productivity growth.
- 1.8 We estimate that public sector net borrowing has fallen to £90.2 billion or 5.0 per cent of GDP this year – down 41 per cent in cash terms and 51 per cent as a share of GDP relative to the post-crisis peak in 2009-10. Looking further ahead, on the basis of the medium-term spending policy assumption provided to us by the Government, we expect borrowing to fall in each year and to reach a small surplus in 2018-19. The Government no longer assumes that it will cut public spending as a share of GDP in 2019-20, reducing the projected surplus in that year to £7.0 billion from £23.1 billion in our December forecast.
- 1.9 Relative to our December forecast, we have revised public sector net borrowing (PSNB) down by £1.3 billion a year on average between 2015-16 and 2018-19. This reflects:
- a downward revision to receipts, with the largest downgrades for North Sea revenues (due to lower oil prices and production), stamp duty receipts (due to lower property transactions), excise duties (due to lower inflation-related uprating) and interest and dividend receipts (due to lower interest rates and the interest and dividends foregone due to the further asset sales announced in the Budget). Those downward revisions are partly offset by upward revisions to income tax receipts (due to lower inflation-related uprating of thresholds and stronger employment growth from migration);
 - a downward revision to annually managed expenditure, including sharply lower debt interest costs (due to lower RPI inflation and interest rates) and lower welfare spending (due to lower uprating in 2016-17); and
 - a new Government policy assumption that reduces total public spending in each year from 2016-17 to 2018-19. But this reduction is smaller than the downward revision to annually managed expenditure, which means less of a squeeze on implied day-to-day spending on public services and administration than in December.
- 1.10 The projected budget surplus in 2019-20 is £16.1 billion lower than in our December forecast. The Government now assumes that total spending will grow in line with nominal GDP rather than whole economy inflation in that year. Combined with a lower forecast for annually managed expenditure, that means that implied public services spending in 2019-20 has been revised up by £28.5 billion (1.3 per cent of GDP) since December.

- 1.11 The Budget measures in the Treasury's table of policy decisions are neutral for borrowing on average over the forecast period with 'giveaways' offsetting 'takeaways'. They raise or lower borrowing by less than £1 billion in every year. The biggest takeaway is an increase in the bank levy (raising £4.4 billion over five years), with a variety of other measures raising smaller amounts with often significant uncertainty around their costing. These are balanced by three main giveaways – further increases in the income tax personal allowance (£5.7 billion over five years), tax measures benefiting savers (£3.0 billion) and a subsidy for first-time buyers (£2.2 billion, the take-up of which is also subject to significant uncertainty).
- 1.12 In contrast to the relatively small net effect of the scorecard measures, the Government has also announced significant asset sales over the coming year. These are sufficiently large for our forecast for public sector net debt to fall as a share of GDP in 2015-16, a year earlier than in our December forecast. The two largest sales relate to NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution (which we assume will raise around £11 billion in 2015-16) and further sales of Lloyds Banking Group shares (which we assume will raise around £9 billion in 2015-16). However, the decision to loosen the squeeze on spending in 2019-20 means that net debt will continue to rise in cash terms in that year rather than beginning to fall as it did in our December forecast.
- 1.13 The Coalition updated the *Charter for Budget Responsibility* in December,¹ setting out new medium-term fiscal targets. The fiscal mandate – to borrow only to pay for investment, adjusting for the state of the economy – now applies in the third year of the rolling five-year forecast period, rather than the final year. The supplementary target – for public sector net debt to fall as a share of GDP – now applies in 2016-17, rather than 2015-16.
- 1.14 On our central forecast, the Government is on track to meet its new fiscal mandate with £16.8 billion to spare. This implies a 65 per cent probability of success given the accuracy of past forecasts. Achieving the mandate with this margin depends heavily on cuts in public spending – particularly on public services and administration – implied by the first two years of the Government's medium-term spending policy assumption. The previous fiscal mandate would have been met with £38.8 billion to spare in 2019-20. Public sector net debt is forecast to peak in 2014-15 and to fall by 0.2 per cent of GDP in 2015-16 and a further 0.5 per cent of GDP in 2016-17, thereby meeting the new supplementary target. The previous target would also have been met – the first time we have forecast debt falling as a share of GDP in 2015-16 since March 2012.

Economic developments since our previous forecast

- 1.15 The single most important global economic development since our previous forecast has been the further substantial drop in oil prices. From a 2014 peak of \$115 a barrel in June, the price of oil fell to a low of \$46 a barrel in January. It has since picked up somewhat, but the assumption underpinning our current forecast remains 17 per cent lower than our December assumption in the medium term. The implications of that drop for our forecast

¹ HM Treasury: *Charter for Budget Responsibility: Autumn Statement 2014 update*.

depend in part on the extent to which it has been driven by weaker demand or stronger supply. We consider both factors to have played a part (see Box 2.1).

- 1.16 Since our December forecast, the ONS has published the *Quarterly National Accounts* for the third quarter of 2014, which included revisions to GDP growth back to the first quarter of 2013. It has also published the second estimate of GDP for the fourth quarter of 2014, which included further revisions to the 2014 data. It now appears that the economy was growing less strongly than previously estimated over the past two years. In addition, real GDP is estimated to have risen 0.5 per cent in the fourth quarter of 2014, slightly below our December forecast of 0.6 per cent. Much weaker private consumption than we expected and flat private investment were partly offset by stronger contributions from net trade and government consumption. Overall, GDP growth in 2014 is estimated at 2.6 per cent, some way below the 3.0 per cent we expected in December.
- 1.17 Employment growth in the final quarter of 2014 was close to our forecast. The Labour Force Survey measure of the unemployment rate has fallen in line with our forecast, reaching 5.7 per cent, but the claimant count continues to fall faster than expected. While employment growth was close to forecast, hours worked increased more than expected. Taken together with the small downside surprise in GDP growth, that means that hourly productivity was once again weaker than expected, falling by an estimated 0.3 per cent in the final quarter.
- 1.18 Inflation has dropped more sharply than we expected in December, due in large part to lower oil prices feeding through to petrol and diesel prices. Food prices have also fallen, due to intense supermarket competition as well as the effect of sterling strength and lower commodity prices on import prices. CPI inflation fell to 0.3 per cent in January 2015 and RPI inflation fell to 1.1 per cent. This has had important implications for our fiscal forecast.

The economic outlook

- 1.19 Despite the economy ending 2014 on a weaker note than we expected – and the International Monetary Fund (IMF) revising down its forecasts for world GDP and trade growth – we have revised up our forecasts for UK GDP growth in 2015 and 2016 to 2.5 and 2.3 per cent respectively. In large part that reflects the boost to real incomes and consumer spending from lower oil prices and lower inflation. With oil prices expected to be 25 per cent lower in 2015 than we assumed in December, we have revised down our CPI inflation forecast for the year as a whole to just 0.2 per cent from 1.2 per cent in December. That helps to boost real incomes in 2015.
- 1.20 Unemployment fell much as we expected in the fourth quarter, implying that the output gap continued to narrow. But output growth was 0.1 percentage points weaker than forecast. These developments helped to inform our judgement that the economy was running 0.7 per cent below potential in the fourth quarter, a slightly wider output gap than we predicted in December. With growth stronger in the near term, we expect the gap to close by the end of 2017, around a year and half earlier than in our December forecast.

- 1.21 We have made a number of adjustments to our estimates of potential output growth since December, in light of recent news. Taken together, they imply that cumulative potential output growth between the third quarter of 2014 and the end of the forecast period will be 0.6 percentage points higher than we assumed in December. This reflects:
- our assumption that net migration flows will follow the levels assumed in the ONS principal population projections, rather than the low migration scenario, given the much higher than assumed flows in recent data. This raises cumulative potential growth by 0.6 percentage points. This largely reflects the effect of stronger adult population growth (+0.5 percentage points), with a further small positive contribution (+0.1 percentage points) via the trend employment rate, as the age structure of inward migrants is assumed to be skewed towards those of working age;
 - lower oil prices should encourage additional non-oil business investment and hence the accumulation of capital, due to the lower energy costs of operating buildings, plant and machinery. That would provide a small boost to labour productivity growth of around $\frac{1}{4}$ percentage points; and
 - actual growth in productivity per hour has again been weaker than expected, with a fall in the final quarter of 2014 leading to only a 0.2 per cent rise on the year. We have assumed from this that, absent the oil price boost, productivity growth would have remained subdued for longer than we thought in December, continuing an ongoing pattern from recent forecasts. We have therefore reduced our forecast of implied trend total factor productivity growth by an amount that offsets the effect of lower oil prices on overall labour productivity growth via capital deepening.
- 1.22 We assess prospects for potential output growth on the non-oil measure of gross value added, excluding North Sea oil and gas output. That distinction is important in considering the revisions to our GDP growth forecast since December. The upward revision to potential output growth means we have revised up cumulative non-oil output growth over the forecast period by 0.6 percentage points. But we have also revised down our forecast for cumulative North Sea production by almost 20 per cent. That means our GDP growth forecast – which comprises non-oil and North Sea output – is only up by 0.4 percentage points.
- 1.23 Overall, we have revised up our GDP forecast in the near term but left it broadly unchanged in the medium term. That is a slightly smaller upward revision than the average external forecast over the past few months. The revision we have made to North Sea production is subject to considerable uncertainty given the big movements in oil prices in recent months and the changes to the tax regime announced in this Budget. Production growth could be significantly higher or lower than we have assumed.
- 1.24 Despite slightly stronger GDP growth and the output gap closing earlier, lower oil prices and a further appreciation of sterling mean have led us to revise our CPI inflation forecast down significantly. We expect inflation to remain below 1½ per cent until the end of 2016 and to return only slowly to the target rate of 2 per cent due to the lagged effects of sterling strength on import prices. Our forecast is slightly lower than the Bank's February 2015

Inflation Report forecast. We have also revised down our estimate of the long-run wedge between RPI and CPI inflation. This has implications for our fiscal forecast given the role of RPI inflation in the cost of servicing index-linked gilts and in uprating excise duties.

Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
Output at constant market prices							
Gross domestic product (GDP)	1.7	2.6	2.5	2.3	2.3	2.3	2.4
GDP levels (2013=100)	100.0	102.6	105.1	107.6	110.1	112.7	115.3
Output gap	-2.2	-1.0	-0.4	-0.2	-0.1	0.0	0.0
Expenditure components of GDP							
Household consumption	1.7	2.0	2.6	2.7	2.5	2.3	2.2
General government consumption	-0.3	1.5	0.8	-0.7	-0.9	-0.2	1.5
Business investment	5.3	6.8	5.1	7.5	6.5	6.4	4.4
General government investment	-8.1	7.3	2.3	1.9	1.6	1.5	2.8
Net trade ¹	0.0	-0.5	-0.1	-0.4	-0.2	-0.2	-0.2
Inflation							
CPI	2.6	1.5	0.2	1.2	1.7	1.9	2.0
Labour market							
Employment (millions)	30.0	30.7	31.1	31.4	31.5	31.7	31.9
Average earnings	1.6	2.2	2.3	3.1	3.7	4.0	4.4
LFS unemployment (% rate)	7.6	6.2	5.3	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.77	0.74	0.76	0.77	0.77
Changes since December forecast							
Output at constant market prices							
Gross domestic product (GDP)	-0.1	-0.5	0.1	0.2	-0.1	0.0	0.0
GDP levels (2013=100)	0.0	-0.4	-0.4	-0.2	-0.3	-0.2	-0.2
Output gap	0.0	0.0	0.1	0.3	0.2	0.1	0.0
Expenditure components of GDP							
Household consumption	0.1	-0.3	-0.2	0.6	0.1	0.0	-0.2
General government consumption	-1.0	0.5	1.2	0.0	0.0	0.1	1.5
Business investment	0.5	-1.0	-3.3	1.2	0.2	0.1	-1.9
General government investment	-0.9	5.2	-1.0	0.3	-0.5	-0.1	0.6
Net trade	0.0	-0.3	0.4	-0.2	-0.1	0.0	0.0
Inflation							
CPI	0.0	-0.1	-0.9	-0.5	-0.3	-0.1	0.0
Labour market							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Average earnings	-0.2	0.4	0.3	0.0	-0.2	0.0	0.5
LFS unemployment (% rate)	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0
Claimant count (millions)	0.00	0.00	-0.08	-0.09	-0.08	-0.08	-0.08

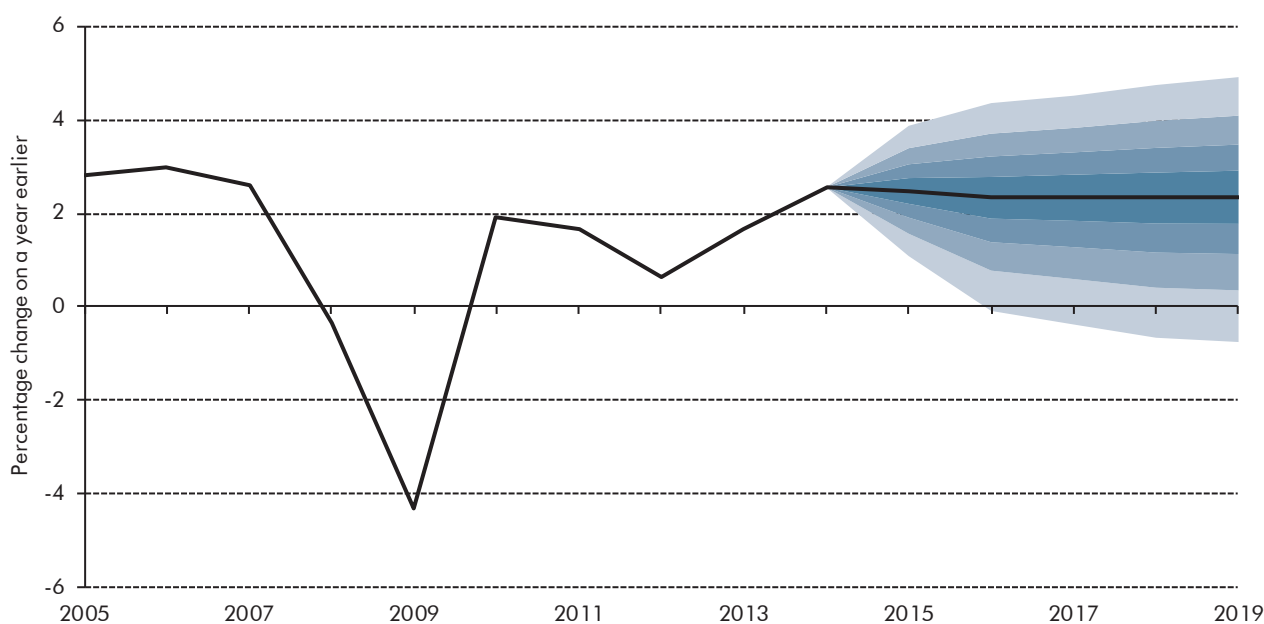
¹ Contribution to GDP growth.

1.25 We have revised employment up by around 0.5 per cent by the end of the forecast period, due almost entirely to the change in our migration assumption. Our unemployment forecast is little changed, reaching a low of 5.1 per cent in the first half of 2016 before rising back to its sustainable medium-term rate later in the forecast. We continue to assume that

productivity growth will pick up slowly to more normal rates, but that remains the most important and uncertain judgement in our forecast. It drives our expectation that real wages (specifically our estimate of the 'real consumption wage') will return to their pre-crisis peak by late 2018 – sooner than we expected in December, thanks in part to the boost to real wages associated with lower oil prices.

- 1.26 We have revised down our near-term forecast of house price inflation, as the latest data suggest that it has slowed more rapidly than we expected in December. Nonetheless, by the end of the forecast house prices are a little higher than in December, thanks to slightly stronger real household income growth. We have made a more significant revision to our forecast for property transactions. The latest data show that transactions have been weaker than expected in recent months, perhaps reflecting a bigger impact on mortgage demand and supply from new Mortgage Market Review regulations. We have also assumed a slightly lower rate of turnover in the housing market in the medium term.
- 1.27 As we noted in December, in many ways our forecast for the economy over the next five years looks very stable – real and nominal GDP growth, unemployment and the output gap fluctuate relatively little. But this continues to conceal some big changes in the structure of the spending, employment and income associated with the remaining years of fiscal consolidation and the extent to which it is delivered through cuts to government spending on public services and administration. At present, that can only be inferred from the Government's overall spending policy assumption. Once detailed departmental plans are set out in a Spending Review, the implications for our forecasts will become clearer.
- 1.28 There is considerable uncertainty around any economic forecast. Chart 1.1 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 1.1: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

1.29 The legislation under which the OBR operates requires us to forecast the public finances and judge progress against the fiscal targets on the basis of agreed Government policy. The Coalition has provided us with policy assumptions, the most important of which is the medium-term public spending assumption – described by the Government as a ‘fiscal assumption’. The Treasury has confirmed that this “represents the Government’s agreed position for Budget 2015” and that it was “discussed by the Quad and agreed by both parties in the Coalition.” But both parties in the Coalition have said that they would pursue different policies if they were to govern alone.

1.30 Public sector net borrowing peaked at 10.2 per cent of GDP (£153.0 billion) in 2009-10 as the late 2000s recession and financial crisis hit the public finances hard. Our latest forecast suggests that by 2014-15 the deficit will have been reduced by 41 per cent in cash terms and by 51 per cent as a share of GDP. Table 1.2 shows that we expect the deficit to continue falling over the next five years, reaching small surpluses in 2018-19 and 2019-20. It also shows that we expect public sector net debt as a share of GDP to peak in 2014-15 and to fall over the forecast period to reach 71.6 per cent in 2019-20.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn 2013-14	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Headline fiscal aggregates							
Public sector net borrowing	5.6	5.0	4.0	2.0	0.6	-0.2	-0.3
Cyclically adjusted net borrowing	4.1	4.2	3.7	1.9	0.6	-0.3	-0.3
Current budget deficit	4.1	3.3	2.4	0.5	-0.8	-1.7	-1.7
Fiscal mandate and supplementary target							
Cyclically adjusted deficit on current budget	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Public sector net debt	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Changes since December forecast							
Headline fiscal aggregates							
Public sector net borrowing	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.7
Cyclically adjusted net borrowing	0.0	0.0	0.1	0.1	0.1	0.0	0.8
Current budget deficit	0.0	0.2	0.2	0.3	0.3	0.3	-0.5
Fiscal mandate and supplementary target							
Cyclically adjusted deficit on current budget	0.0	0.2	0.1	0.1	0.2	0.2	-0.5
Public sector net debt	0.3	0.0	-0.9	-0.9	-1.0	-1.4	-1.2

1.31 Table 1.3 shows how changes in borrowing between our December and March forecasts can be decomposed into underlying forecast changes, including their interaction with the Government's December spending policy assumptions. It also shows the (relatively small) effects the Budget measures shown in the Treasury's policy decisions table and the (much larger) effect of the Government's change to its medium-term spending assumption.

1.32 Relative to our December forecast, we have revised public sector net borrowing (PSNB) down by £1.3 billion a year on average between 2015-16 and 2018-19. This reflects:

- a downward revision to receipts across the forecast period, with the largest downgrades for North Sea revenues (due to lower oil prices and production), stamp duty receipts (due to lower property transactions), excise duties (due to lower inflation-related uprating) and interest and dividend receipts (due to lower interest rates and the interest and dividends foregone due to the further asset sales announced in the Budget). Those downward revisions are partly offset by upward revisions to income tax receipts (due to lower inflation-related uprating of thresholds and stronger employment growth from migration);
- a downward revision to annually managed expenditure, including sharply lower debt interest costs (due to lower RPI inflation and interest rates) and lower welfare spending (due to lower uprating in 2016-17); and
- a new Government policy assumption that reduces total public spending in each year from 2016-17 to 2018-19. But this reduction is smaller than the downward revision to annually managed expenditure, which means less of a squeeze on implied day-to-day spending on public services and administration than in December.

1.33 The projected budget surplus in 2019-20 is £16.1 billion lower than in our December forecast. The Government now assumes that total spending will grow in line with nominal GDP rather than whole economy inflation in that year. Combined with a lower forecast for annually managed expenditure, that means that implied public services spending in 2019-20 has been revised up by £28.5 billion (1.3 per cent of GDP) since December.

1.34 We have assumed that an increase in government spending on its paybill and procurement of this scale would feed through to nominal GDP growth in 2019-20, though not real GDP growth (which is determined by our judgements on potential output). This pushes up receipts, notably income taxes and VAT on public sector procurement. This turnaround in receipts from previous years appears in Table 1.3 as an 'underlying forecast change', but is in effect driven by the change in the spending policy assumption.

Table 1.3: Changes to public sector net borrowing since December

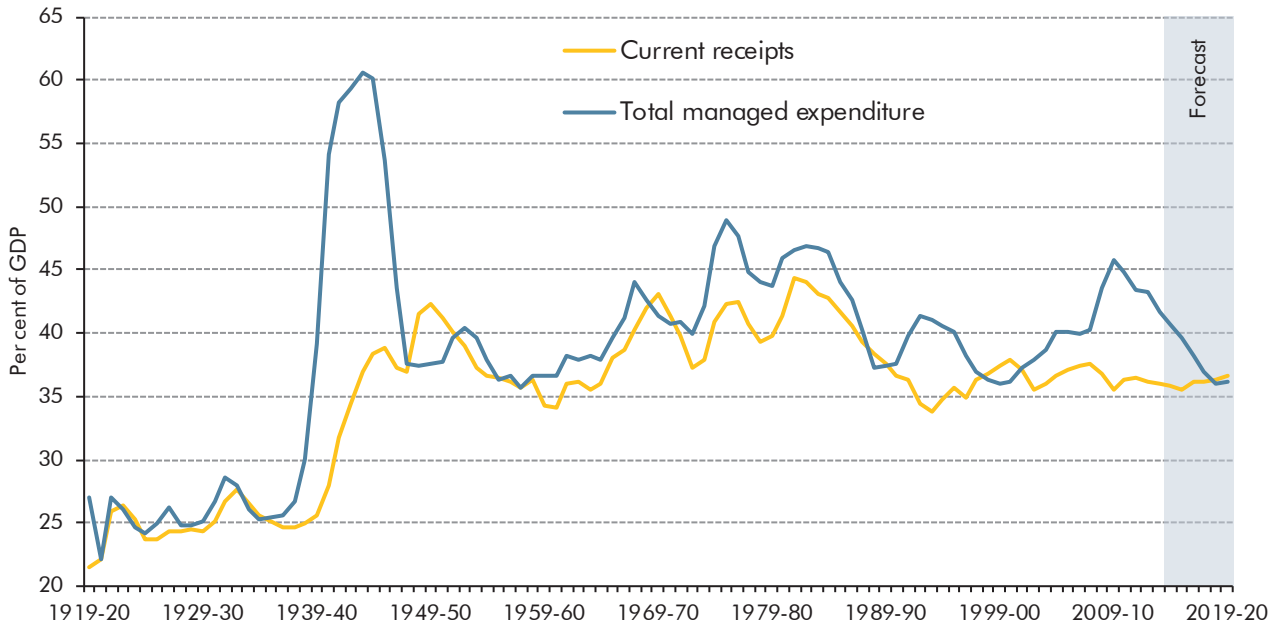
	£billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	91.3	75.9	40.9	14.5	-4.0	-23.1
March forecast	90.2	75.3	39.4	12.8	-5.2	-7.0
Change	-1.1	-0.7	-1.5	-1.8	-1.2	16.1
Underlying OBR forecast changes						
Total	-1.1	0.1	0.5	0.4	-0.1	-4.6
<i>of which:</i>						
Changes in the receipts forecast	-1.1	3.3	4.9	5.8	4.0	-1.9
<i>of which:</i>						
Inflation	0.1	0.7	0.7	0.4	0.8	1.0
Other oil and gas price effects	-0.1	0.7	0.7	1.0	1.1	1.1
Interest rates	0.0	0.3	0.5	0.6	0.5	0.6
Housing market	0.2	1.5	2.1	1.8	0.9	-0.1
Other	-0.5	1.0	1.8	2.8	1.6	-3.4
Classification changes	-0.8	-0.9	-0.9	-0.9	-0.9	-1.0
Changes in the spending forecast	0.0	-3.3				
Effect of applying Autumn Statement spending policy assumptions post 2015-16			-4.4	-5.4	-4.1	-2.8
<i>of which:</i>						
Inflation	-2.2	-4.2	-4.7	-5.6	-6.5	-6.9
Interest rates	-0.3	-1.2	-2.1	-3.0	-3.9	-4.5
Capital spending ¹	1.0	2.0	2.0	2.0	2.3	2.9
Other spending	-0.3	-1.8	-6.5	-5.0	-5.3	-5.0
Classification changes	2.1	2.2	2.2	2.2	2.3	2.3
RDEL	-0.3	-0.4				
Implied RDEL			4.6	4.0	7.0	8.3
Changes due to Government decisions						
Budget policy measures	0.0	-0.7	0.0	-0.2	0.9	0.6
Effect of applying new Budget spending policy assumptions post 2015-16			-1.9	-1.9	-2.0	20.2

¹Excluding classification changes

Note: this table uses the convention that a negative figure means an improvement in PSNB.

- 1.35 Between 2009-10 and 2019-20, the budget balance is forecast to move from a post-war record deficit of 10.2 per cent of GDP to a small surplus of 0.3 per cent – a turnaround of 10.5 per cent of GDP (£172 billion in today’s terms). By 2014-15, around half of that planned reduction – 5.2 per cent of GDP (£79 billion) – will have been completed.
- 1.36 Over the five years to 2019-20, the main factors contributing (positively and negatively) to the removal of the remaining deficit and the move into budget surplus will include:
- relatively small increases in **debt interest** spending (0.4 per cent of GDP) as interest rates are assumed to rise in line with market expectations, which remain well below historical averages by the end of the forecast period;
 - small reductions in **capital spending** (0.1 per cent of GDP);
 - small reductions in **AME spending other than on debt interest and welfare** (0.3 per cent of GDP);
 - a 0.5 per cent of GDP rise in **receipts**. This includes a 0.3 per cent of GDP rise in the tax-to-GDP ratio – the biggest contributors to which are positive fiscal drag in income tax and NICs as sustained productivity and real earnings growth resume and pull more income into higher tax brackets, and the abolition of the NICs contracting out rebate in 2016-17 – and a 0.2 per cent of GDP rise in non-tax revenues, notably interest on the government’s stock of financial assets as interest rates rise;
 - a 1.3 per cent of GDP fall in **welfare spending**, explained largely by lower spending on working-age benefits, due to inflation uprating and lower caseloads for benefits sensitive to the economic cycle. Spending on state pensions is expected to be broadly flat as a share of GDP due to demographic trends and ‘triple lock’ uprating; and
 - a 3.6 per cent of GDP (or £65 billion in today’s terms) cut in **day-to-day spending on public services and administration**, implied by the Government’s firm 2015-16 plans, its medium-term assumptions for total spending and our forecast for AME spending. This is 1.2 per cent of GDP smaller than in our December forecast, but still accounts for around 70 per cent of the improvement in the budget balance over the forecast.
- 1.37 Chart 1.2 shows current receipts and total managed expenditure as a share of GDP since 1919-20 using Bank of England and ONS data. The Government’s decision to assume that spending rises in line with nominal GDP in 2019-20 means that it no longer falls to its lowest share of national income in a full year since before the war, as was the case in our December forecast. Instead, total spending falls to 36.0 per cent of GDP, which is fractionally higher than the previous post-war lows of 35.8 per cent in 1957-58 and 35.9 per cent in 1999-2000. Current receipts as a share of GDP are forecast to remain at similar levels to those seen over the last few decades.

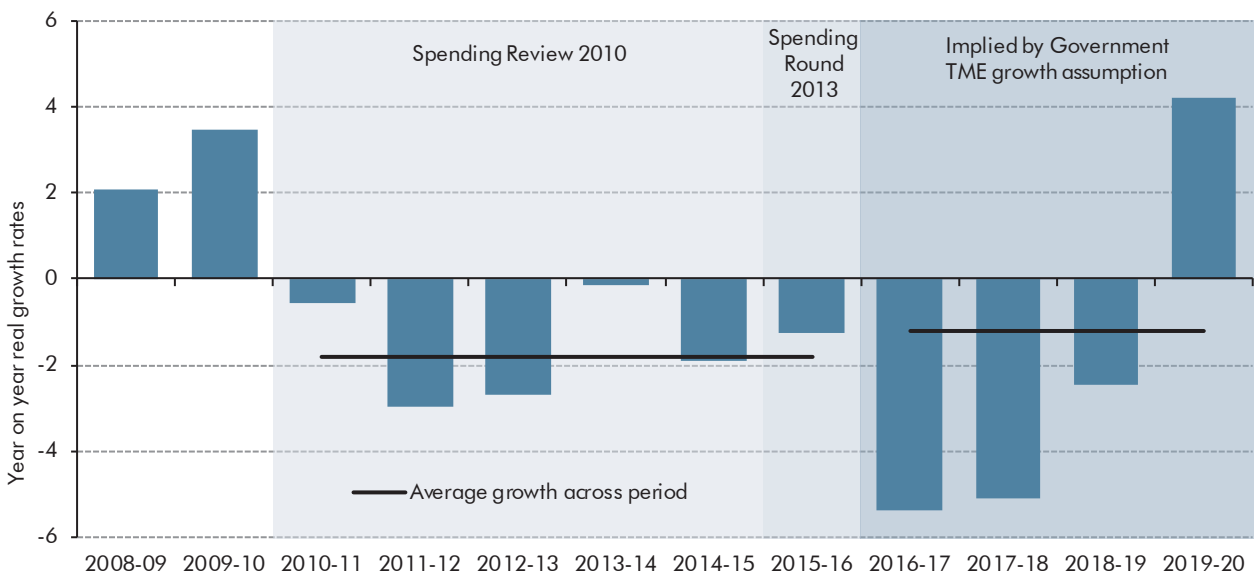
Chart 1.2: Total public sector spending and receipts



Source: Bank of England, ONS, OBR

1.38 Another implication of the Government’s spending policy assumptions is a sharp acceleration in the pace of implied real cuts to day-to-day spending on public services and administration in 2016-17 and 2017-18, followed by a sharp turnaround in 2019-20, as shown in Chart 1.3. As explained below, the implied cuts in 2016-17 and 2017-18 are a key reason why the Government is on course to achieve its new fiscal mandate to balance the cyclically adjusted current budget in 2017-18 with room to spare.

Chart 1.3: Year-on-year growth in real resource DEL spending

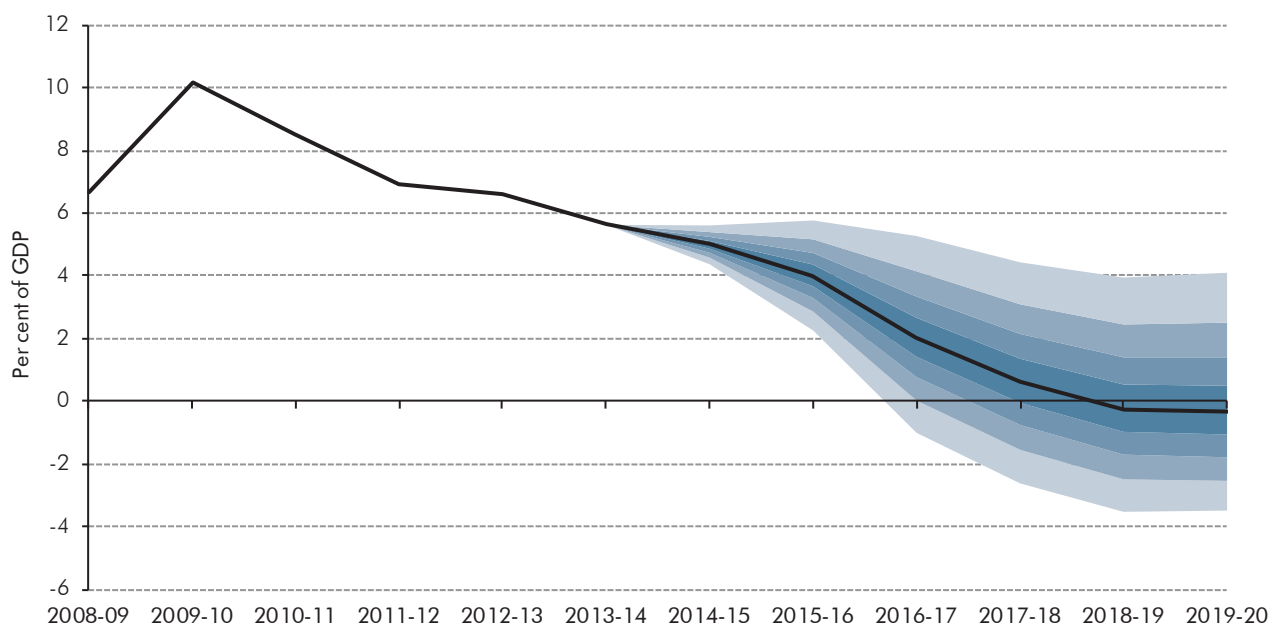


Note: RDEL series excludes major historical switches with AME as well as switches with AME in forecast years. Details are available in the supplementary fiscal tables on our website.
Source: OBR

1.39 The current budget balance, which excludes borrowing to finance net investment spending, is expected to show a deficit of £59.8 billion in 2014-15, down from a peak of £103.8 billion in 2009-10. The current budget moves into surplus in 2017-18 and reaches a surplus of £35.2 billion in 2018-19 and £38.7 billion in 2019-20. Our forecast of the current budget balance between 2015-16 and 2018-19 has improved since December, as lower spending on debt interest and welfare more than offset the increase in spending on public services and administration implied by the Government's latest spending policy assumption. The surplus in 2019-20 has been revised down by £11.3 billion, with the revision more than explained by the change in the Government's spending assumption for that year. With the output gap now estimated to be relatively small and expected to close by late 2017, the cyclically adjusted current budget follows a similar path to the headline current budget and has been revised by similar amounts for similar reasons.

1.40 All forecasts are subject to significant uncertainty. Chart 1.4 shows our median forecast for PSNB, with successive pairs of shaded areas around it representing 20 per cent probability bands. As in Chart 1.1 above, the bands show the probability of different outcomes if past official errors were a reasonable guide to future forecast errors.

Chart 1.4: PSNB fan chart



Source: ONS, OBR

1.41 We forecast that public sector net debt (PSND) will rise as a share of GDP this year, but start to fall from 2015-16 and at an increasingly rapid rate to 71.6 per cent of GDP in 2019-20. Net debt is lower than we forecast in December from 2015-16 onwards, and falls a year earlier than we expected then. Table 1.4 shows that:

- downward revisions to the level of nominal GDP in 2014-15 have increased debt as a share of GDP. That feeds through to the rest of the forecast period, but higher nominal GDP growth later in our forecast unwinds the effect;

- our borrowing forecast – both underlying changes and the effect of Government decisions – have relatively small effects on the level of net debt. The exception is in 2019-20, where the change in the Government's chosen spending policy assumption has increased spending and borrowing relative to our December forecast, reducing the extent to which debt falls as a share of GDP in that year. Indeed, net debt now continues to rise in cash terms in 2019-20 (by £9½ billion), rather than falling modestly as in our December forecast (by £4 billion);
- the Government announcement of two significant asset sales related to the mortgage assets of NRAM plc managed by UK Asset Resolution (UKAR) and its shareholding in Lloyds Banking Group have the largest effect on the debt-to-GDP ratio. Together they are expected to reduce net debt by £20 billion in 2015-16. That means that debt falls as a share of GDP a year earlier than would otherwise have been the case. The bulk of these sales are expected to take place late in the fiscal year. Financial asset sales bring forward cash that would otherwise have been received in future in the shape of mortgage repayments and dividends (around £10 billion over the remainder of the forecast period as a result of the UKAR and Lloyds sales), so they only temporarily reduce the debt-to-GDP ratio;
- UKAR also ran down its assets more quickly in 2014-15 than we had factored into our December forecast. Much of this reflects the sale of an asset that we had assumed would be sold in 2015-16;
- changes in the premia associated with the Debt Management Office issuing gilts at prices above their nominal value have reduced our forecast for net debt slightly further. These premia are particularly associated with index-linked gilts, due to the negative real yield curve that persists over through the forecast period; and
- other factors have reduced net debt further. Downward revisions to student numbers have reduced our forecast of lending on student loans by increasing amounts over time. A debt-neutral classification change relating to subscriptions to multilateral development banks that raises borrowing but reduces financial transactions also affects this line.

Table 1.4: Changes to public sector net debt since December

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
March forecast	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Change	0.3	0.0	-0.9	-0.9	-1.0	-1.4	-1.2
of which:							
Change in nominal GDP ¹	0.3	0.6	0.4	0.6	0.6	0.2	-0.3
Change in cash level of net debt	0.0	-0.5	-1.3	-1.5	-1.6	-1.6	-0.9
	£ billion						
December forecast	1402	1489	1558	1610	1638	1652	1648
March forecast	1402	1479	1533	1580	1606	1617	1627
Change in cash level of net debt	0	-10	-25	-30	-32	-34	-21
of which:							
Borrowing changes	0	-1	-2	-3	-5	-6	10
UK Asset Resolution	0	-3	-8	-7	-5	-3	-1
Lloyds Banking Group share sales	0	-1	-10	-10	-10	-10	-10
Gilt premia	0	-2	0	-2	-3	-3	-5
Other factors	0	-3	-5	-7	-9	-12	-15

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

Performance against the Government's fiscal targets

1.42 In the June 2010 Budget, the Government set itself two medium-term fiscal targets for the current Parliament: the fiscal mandate and a supplementary target. The OBR is required to judge whether the Government has a greater than 50 per cent probability of hitting these under existing policy. In March 2014, the Government updated the *Charter for Budget Responsibility* to include details of how a new 'welfare cap' – set in Budget 2014 – would operate. In December 2014, the Government updated the *Charter* again to set a new fiscal mandate and a new supplementary target.² The welfare cap remained as specified in the March 2014 update.

1.43 The Government's fiscal targets include:

- “a forward-looking aim to achieve cyclically adjusted current balance by the end of the third year of the rolling, 5-year forecast period”. (For the purposes of this forecast, the third year of the forecast period is 2017-18). The previous target had been to achieve balance in the final year of the forecast period (2019-20 in this forecast);
- “an aim for public sector net debt as a percentage of GDP to be falling in 2016-17”. The previous target had been for debt as a share of GDP to be fall at a fixed date of 2015-16; and

² See *Charter for Budget Responsibility: Autumn Statement 2014 update*, which is available on our website.

- *“the cap on welfare spending, at a level set out by the Treasury in the most recently published Budget report, over the rolling 5-year forecast period, to ensure that expenditure on welfare is contained within a predetermined ceiling”.*

1.44 The profile of borrowing and the CACB for 2016-17 and beyond is largely determined by the Government’s policy assumption regarding the path of total public spending. On that basis, we judge that the Government has a greater than 50 per cent chance of meeting the new **fiscal mandate**. The cyclically adjusted current budget (CACB) moves from a deficit of 2.5 per cent of GDP in 2014-15 to a surplus of 0.8 per cent of GDP in the new mandate year of 2017-18. Using cyclical-adjustment coefficients for particular types of receipts and spending, in Chapter 5 we show how this improvement is forecast to come about:

- the CACB is expected to improve by 3.4 per cent of GDP between 2014-15 and 2017-18, with lower spending contributing 3.2 per cent and higher receipts 0.2 per cent;
- in 2015-16, the final year for which the Government has set detailed departmental spending plans, the CACB falls by 0.4 per cent of GDP (£8 billion). Cuts in spending more than account for that change (down by 0.8 per cent of GDP or £15 billion), with a fall in receipts – notably from the North Sea and fuel and excise duties – pushing up the structural deficit by around £7 billion. Within spending, the largest contribution to the change is a structural reduction in departmental spending (£10¾ billion);
- based on the Government’s policy assumption on spending, which implies a path for departmental spending once the rest of our forecast is taken into account, the CACB falls by 1.7 per cent of GDP (£33½ billion) in 2016-17, more than twice the figure in the previous year. Again, by far the largest contribution is the 1.3 per cent of GDP implied cut in spending on day-to-day public services and administration (£25 billion). Other important contributions include the structural rise in receipts from income tax (£5½ billion) and NICs (£6¾ billion). The latter is largely explained by the abolition of the NICs contracting out rebate in 2016-17. Around two thirds of the £5 billion of additional receipts from that measure is expected to come from public sector employers, adding to the pressure on implied departmental budgets; and
- in 2017-18, the CACB again falls significantly, by 1.2 per cent of GDP (£24 billion). Once again, by far the largest contribution to that change is the cut in public services spending implied by the Government’s spending assumption (£24 billion). Receipts are broadly stable as a share of GDP, as an additional year of fiscal drag boosting personal taxes and the effects of further asset price rises on capital taxes are offset by small declines in a number of other receipts.

1.45 The new **supplementary target** requires public sector net debt (PSND) to fall as a share of GDP between 2015-16 and 2016-17, with this year fixed. We expect PSND to fall as a share of GDP in that year, so the Government is on course to meet its new target. Thanks to the significant amount of asset sales announced in the Budget, we now think that the Government is also on course to meet the previous supplementary target for debt to fall as

a share of GDP in 2015-16. This is the first time we have forecast debt falling as a share of GDP in 2015-16 since our March 2012 *Economic and fiscal outlook (EFO)*.

- 1.46 The **welfare cap** was formally defined and initially set by the Government in Budget 2014. The cap was set for the period from 2015-16 to 2018-19 in line with our March 2014 forecast. It was extended to 2019-20 in Autumn Statement 2014, in line with our December 2014 forecast for that year. The Government has set a 2 per cent margin above the cap that can be used to accommodate forecast changes, but not the impact of policy changes.
- 1.47 The OBR has been tasked with assessing the Government's performance against the cap once a year alongside the Autumn Statement. In this *EFO*, we provide an update on performance against the cap without making a formal assessment of whether the Government is meeting its welfare cap commitment. That shows that spending subject to the cap has been revised down in each year of the forecast, thanks largely to the effect of lower inflation on the uprating of most benefits in 2016-17.
- 1.48 There is considerable uncertainty around our central forecast. This reflects uncertainty both about the outlook for the economy and about 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 65 per cent chance that the CACB will be in balance or surplus in 2017-18 (as the new fiscal mandate requires);
 - second, by looking at its sensitivity to varying key features of the economic forecast. The biggest risk to the achievement of the mandate relates to our estimates of future potential output. If potential output is lower than we estimate, implying a positive output gap in the target year, the structural position of the public finances would be worse. If potential output was around 1¼ per cent lower than in our central forecast in 2017-18, then the probability of meeting the mandate would fall to 50 per cent, meaning that it would be as likely as not that the mandate would be missed; and
 - third, by looking at alternative economic scenarios. We have looked at two scenarios in which the oil price jumps back to \$100 a barrel for different reasons: weaker oil supply or stronger global demand. In the supply-driven scenario, inflation rises and real incomes are hit in the short term, lowering GDP growth and leading to a wider output gap. Potential output growth is also slightly lower, due to weaker investment in the capital stock, so that the output gap closes later. In the demand-driven scenario, the same factors affect domestic demand, but the effects are cushioned by stronger export growth. Potential output growth is hit slightly less hard and the output gap closes earlier than in our central forecast. Given the relatively large margins by which the Government's fiscal targets are met in our central forecast, these scenarios would not lead to any of those targets being missed, although with the welfare cap set in nominal terms, higher inflation reduces the headroom against the cap via uprating.

2 Developments since the last forecast

Introduction

2.1 This chapter summarises:

- the main economic and fiscal data developments since our last forecast in December 2014 (from paragraph 2.2); and
- recent external forecasts for the UK economy (from paragraph 2.16).

Economic developments

Data revisions

2.2 Since our December forecast, the ONS has published the *Quarterly National Accounts* (QNA) for the third quarter of 2014, which included revisions to GDP growth back to the first quarter of 2013. It has also published the second estimate of GDP for the fourth quarter of 2014, which included further revisions back to the first quarter of 2014. The overall effect of these revisions is that real GDP is now estimated to have risen by 4.5 per cent between the first quarter of 2013 and the third quarter of 2014, compared to the 5.1 per cent estimated at the time of our December forecast (Table 2.1). The downward revisions were mainly to government consumption and net trade.

Table 2.1: Contributions to real GDP growth from 2013Q1 to 2014Q3

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
December data	2.4	0.7	0.1	1.7	-0.3	0.8	5.1
Latest data	2.3	0.4	0.1	1.6	-0.7	0.8	4.5
Difference ¹	-0.1	-0.3	0.1	-0.1	-0.5	0.0	-0.6

¹ Difference in unrounded numbers, rounded to one decimal place.

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

2.3 Since our December forecast, the whole economy GDP deflator and its components have also been revised. The net effect of these various revisions has been to lower growth in the GDP deflator from 3.9 per cent to 3.3 per cent between the first quarter of 2013 and the third quarter of 2014 (Table 2.2). The downward revision was mainly due to weaker measured government consumption prices and weaker terms of trade.

Table 2.2: Contributions to GDP deflator growth from 2013Q1 to 2014Q3

	Percentage points						Deflator growth, per cent
	Private consumption	Government consumption	Total investment	Exports	Imports	Stocks	
December data	1.9	0.5	0.3	-0.2	0.9	0.0	3.9
Latest data	1.8	0.3	0.3	-0.2	0.6	0.0	3.3
Difference ¹	-0.1	-0.2	0.0	0.0	-0.2	0.0	-0.6

¹ Difference in unrounded numbers, rounded to one decimal place.

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

2.4 Reflecting these revisions to real GDP and GDP deflator growth, nominal GDP growth over the same period was revised down from 9.2 per cent to 8.0 per cent (Table 2.3). A weaker net trade contribution to nominal growth explained more than half of the revision. That reflected an upward revision to import volumes, more than offsetting an upward revision to export volumes.

Table 2.3: Contributions to nominal GDP growth from 2013Q1 to 2014Q3

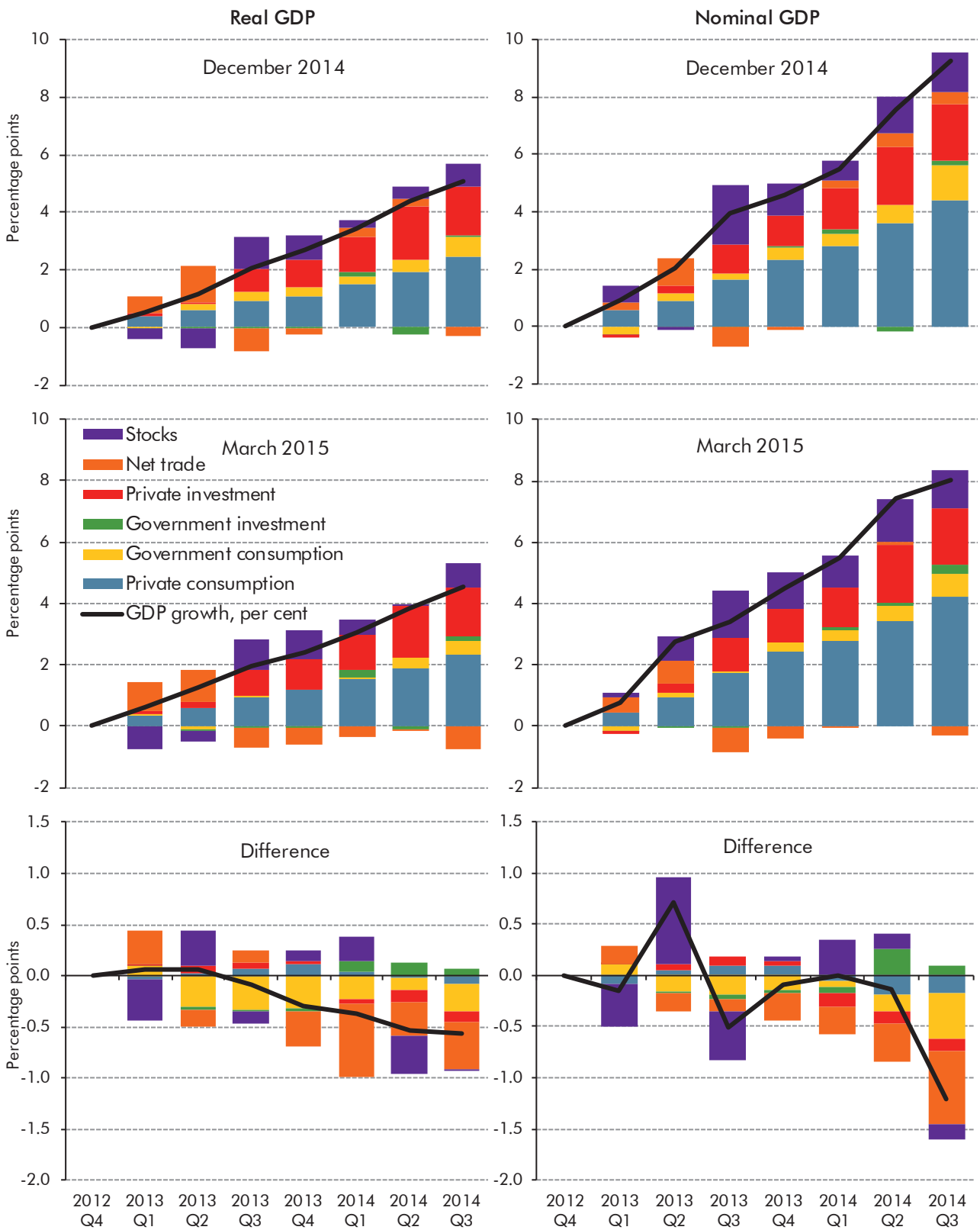
	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
December data	4.4	1.2	0.2	2.0	0.4	1.4	9.2
Latest data	4.2	0.7	0.3	1.9	-0.3	1.2	8.0
Difference ¹	-0.2	-0.4	0.1	-0.1	-0.7	-0.2	-1.2

¹ Difference in unrounded numbers, rounded to one decimal place.

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

2.5 Chart 2.1 shows the contributions to cumulative real and nominal GDP growth over the past two years, and how the ONS estimates have changed since our previous forecast. As well as the overall downward revisions to both real and nominal GDP growth estimates over the period, it shows the relatively large revision to the nominal net trade contribution in the third quarter of 2014, driven largely by revisions to trade prices. Preliminary estimates of trade prices are often revised significantly, posing a challenge to the forecasting process.

Chart 2.1: Cumulative contribution to GDP growth from 2013Q1 to 2014Q3



Source: ONS

GDP growth since the December 2014 forecast

2.6 In the fourth quarter of 2014, real GDP is estimated to have risen by 0.5 per cent, slightly below our December forecast of 0.6 per cent. While overall quarterly GDP growth was close to forecast, the composition, as shown in Table 2.4, was significantly different. Much weaker private consumption and investment than we had anticipated was offset by unexpectedly strong contributions from government consumption and net trade.

Table 2.4: Contributions to real GDP growth in 2014Q4

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
December forecast	0.7	-0.4	0.0	0.6	-0.1	-0.1	0.6
Latest data	0.2	0.0	0.0	0.0	0.6	-0.2	0.5
Difference ¹	-0.4	0.4	0.0	-0.6	0.7	-0.1	-0.1

¹ Difference in unrounded numbers, rounded to one decimal place.

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

2.7 Nominal GDP growth was also weaker than expected in the fourth quarter of 2014 (Table 2.5). In addition to the errors on real GDP described above, this reflected a weaker contribution from the price of inventories more than offsetting stronger private consumption prices.

Table 2.5: Contributions to nominal GDP growth in 2014Q4

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
December forecast	0.8	-0.7	0.0	0.6	-0.1	0.0	0.6
Latest data	0.6	-0.3	0.0	0.0	0.7	-0.6	0.4
Difference ¹	-0.2	0.4	0.0	-0.6	0.8	-0.5	-0.2

¹ Difference in unrounded numbers, rounded to one decimal place.

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

2.8 Full ONS data on the breakdown of GDP growth by detailed income components will not be available for the whole of 2014 until later in March. But the high-level breakdown published so far suggests that, on the income side, the unexpected weakness of nominal GDP growth in 2013 and 2014 has been concentrated in corporate profits and other non-labour income components. On the expenditure side, the weakness has been concentrated in investment and stocks. As labour income and private consumption are the most heavily taxed components of income and expenditure respectively, the composition of the downside surprise in GDP growth since our December forecast has been less damaging for the public finances than could have been the case.

Conditioning assumptions

2.9 Since we finalised our December forecast, oil prices have fallen well below the level that was implied by futures prices at the time. In the first quarter of 2015, outturns and the futures

curve suggest that dollar oil prices will be 31.5 per cent below our December assumption (Table 2.6). Possible reasons for the fall in the oil price are set out in Box 2.1. The oil futures curve (on which we base the first two years of our oil price assumption) is currently upward sloping, with prices expected to increase by 28.3 per cent over the next two years. Our medium-term assumption is around 17 per cent lower than in December. Sterling has continued to appreciate since our December forecast, with a rise against the euro only partially offset by a fall against the US dollar. The sterling effective exchange rate is expected to be 3.5 per cent stronger than our December assumption for the first quarter of 2015. Equity prices and mortgage interest rates are both slightly higher in the first quarter of 2015 than we assumed in December.

Table 2.6: Conditioning assumptions in 2015Q1

	Oil price (\$ per barrel)	US\$/£ exchange rate	euro/£ exchange rate	ERI exchange rate (index)	Equity prices (FTSE all-share index)	Mortgage interest rates (%) ¹
December forecast	81.4	1.57	1.26	86.6	3587	3.1
Latest assumption	55.7	1.53	1.34	89.7	3719	3.2
Per cent difference	-31.5	-2.3	6.5	3.5	3.7	0.1

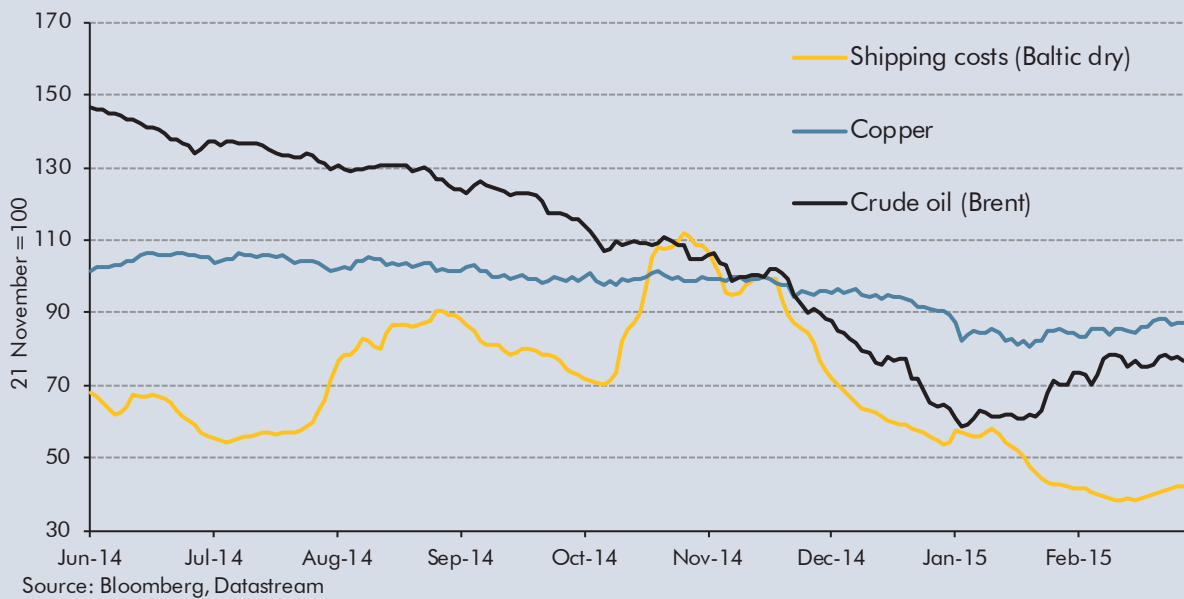
¹ Difference is in percentage points.

Box 2.1: Why have oil prices fallen by so much?

During the second half of 2014, oil prices fell by over 50 per cent from their peak in June 2014 of \$115 a barrel (Chart A). Some of this fall is expected to be reversed over the next two years. As discussed in Chapters 3 and 4, the fall in the oil price has important implications for our economic and fiscal forecasts. To an extent, those implications depend on why exactly it is that the oil price has fallen so far. In particular, negative demand and positive supply shocks will have different effects on our forecasts. This box considers the evidence and external views on that question. Box 3.1 in Chapter 3 reviews estimates of the effect of oil prices on the economy.

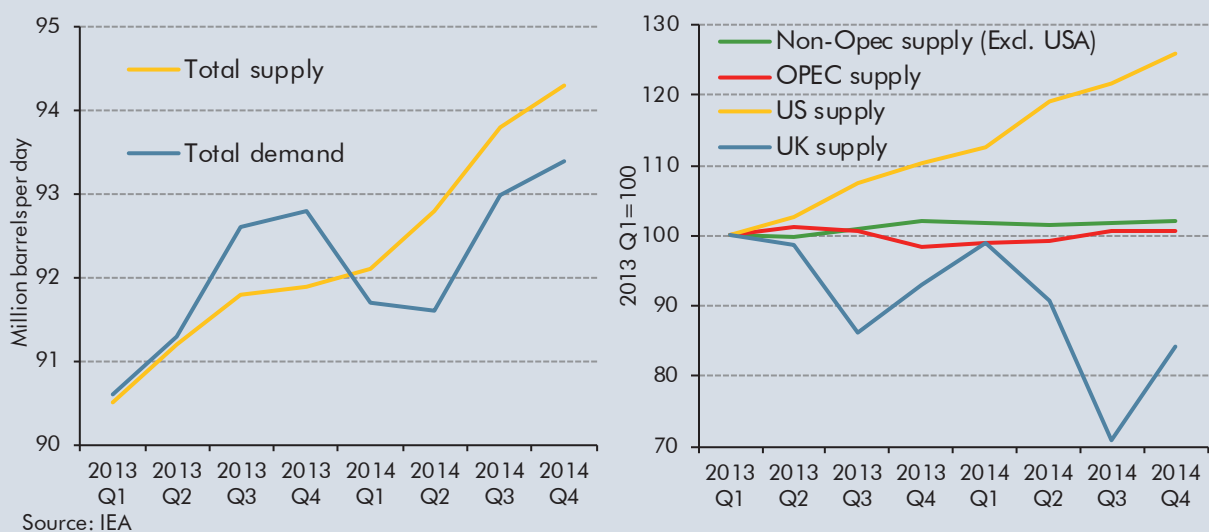
On the demand side, a fall in crude prices may reflect expectations of weaker growth or of a lower oil intensity of GDP. Other primary commodities are generally also sensitive to global demand shocks. So the fact that copper prices have fallen by around 14 per cent since June 2014 – a significant decline, but substantially less than that of the oil price – suggests that weaker demand and greater supply have both played a role. The Baltic dry index, which measures global shipping costs, has fallen 95 per cent since its peak in mid-2008 and around 40 per cent over the same period as the fall in oil, to reach its lowest level since the mid-1980s. Shipping costs are seen as a leading indicator of economic activity, so this also points to some role for weaker demand, although it may also signal greater shipping capacity. The lag between orders and delivery of vessels means the 2013 post-crisis boom in shipping orders is likely to be pushing costs lower.

Chart A: Oil prices relative to copper and shipping prices



On the supply side, over 2014 the International Energy Agency (IEA) estimates that crude oil supply increased by over 2 per cent. Demand for oil is relatively price inelastic, so changes in supply can have large impacts on price. The growth in oil supply was faster than growth in oil demand, leading to an increase in implied stocks (Chart B). Supply has risen in part because of the boom in the US fracking industry. US oil production is up 26 per cent over the past two years. Iraqi supply has hit its highest level in 35 years and, according to the IEA, further capacity coming online in 2015 is likely to boost production further. That has offset lower Libyan oil production. Overall, OPEC supply has remained fairly constant and, in contrast to previous periods of falling prices, OPEC has recently reaffirmed its intention to maintain current production. Indeed, OPEC production has been exceeding its target of 30 million barrels a day.^a These factors also suggest that increased supply has also played a part in the fall in oil prices.

Chart B: Supply and demand for oil



External views on the precise balance of demand and supply factors vary, though most believe that both have played a role. The IMF has concluded that a higher weight should be placed on positive supply factors. It argues that *“the persistence of this supply shift will depend largely on the long run motives of OPEC’s current output strategy.”*^b The IMF has estimated that demand explains only around 20 to 35 per cent of the fall in oil prices.^c The IEA’s view is broadly similar to that of the IMF. It has concluded that rising supply has coincided with demand weakness, which has exacerbated the fall in oil prices. The IEA has argued that *“oil supply remains abundant and that investment cuts will take some time to make more than a relatively small dent on production.”*^a The Bank of England stated in its latest *Inflation Report* that *“Oil supply news is likely to have been the biggest driver of [the] drop in oil prices, although a weakening outlook for world demand is also likely to have played a material role.”*^d Our forecasts are also conditioned on a view that both supply and demand factors have been responsible for the fall in oil prices.

^a See IEA (2015), *January Oil market report*.

^b See IMF (2015), *Impact of oil price decline on the global economy: Special topic to the G-20 surveillance note*.

^c See Arezki and Blanchard (2014), *Seven questions about the recent oil price slump*.

^d See Bank of England (2015), *February 2015 Inflation Report*.

Labour market

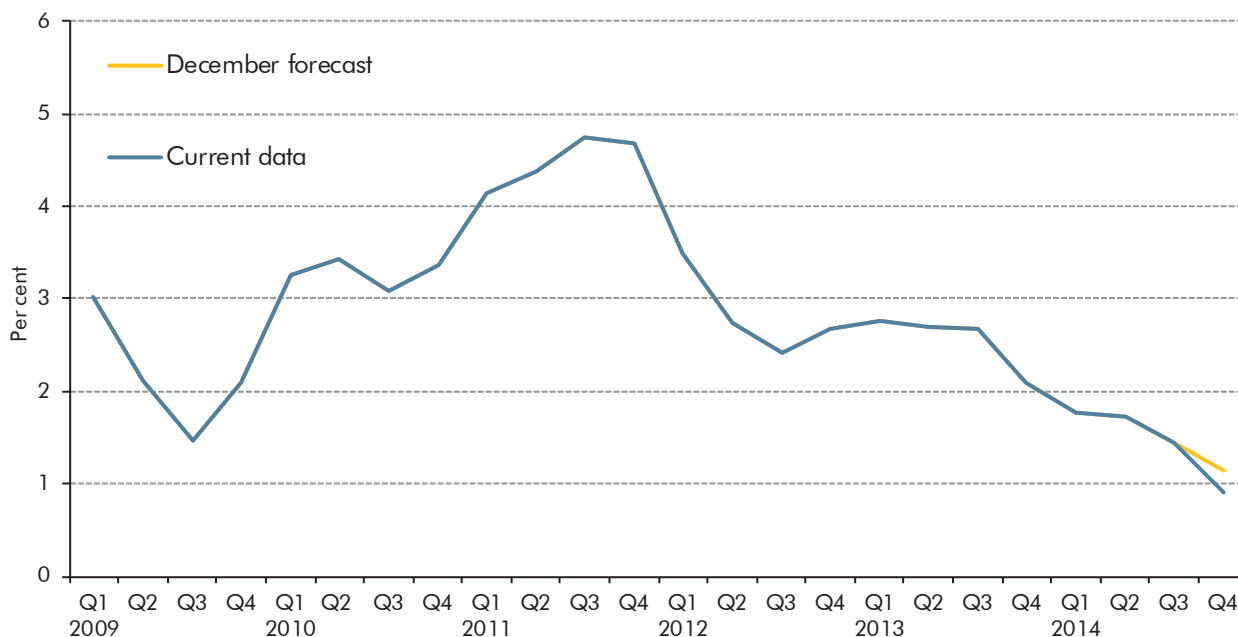
- 2.10 In December, we expected employment to rise by 0.4 per cent between the third and fourth quarters of 2014, slightly more than the actual rise of 0.3 per cent. With real GDP coming in slightly below our forecast in the fourth quarter, growth in productivity per worker was in line with forecast. But an increase in average hours meant that once again productivity per hour was weaker than we expected, falling by 0.3 per cent in the quarter. The LFS unemployment rate has fallen in line with our forecast, reaching 5.7 per cent in the fourth quarter of 2014. Despite LFS unemployment being close to forecast, claimant count unemployment continues to fall faster. The claimant count fell 7.4 per cent in the fourth quarter, compared to a 5.0 per cent fall in LFS unemployment.¹
- 2.11 Despite weak productivity growth, year-on-year growth in average weekly earnings in the private sector was faster than expected in the fourth quarter of 2014, partly due to strong growth in the financial sector.

Inflation

- 2.12 CPI inflation has fallen by more than we expected in December. Inflation was 0.9 per cent in the fourth quarter of 2014, compared to our forecast of 1.1 per cent (Chart 2.2). Food price inflation has continued to fall more quickly than expected, mainly as a result of falling global commodity prices and further escalation of competition in the supermarket sector. Also, there were larger-than-expected falls in petrol and diesel prices as oil prices fell below our December conditioning assumption. Along with the upward surprise in nominal earnings growth, lower inflation means that real earnings have exceeded expectations.

¹ For more information on the divergence between the claimant count and LFS unemployment see Box 8.1 of our 2014 *Welfare trends report*.

Chart 2.2: CPI inflation



Source: ONS, OBR

The housing market

2.13 Annual house price inflation slowed by more than we expected in December, reaching 10.0 per cent in the year to the fourth quarter of 2014 against our forecast of 10.8 per cent. Mortgage approvals, property transactions and the RICS housing market survey also suggest that the housing market is slowing by more than we factored into our December forecast. Part of this surprise has been related to new Mortgage Market Review requirements on lenders, which appear to have had a larger and more persistent effect than we expected.

The global economy

2.14 Growth in emerging markets has slowed more than we expected in December. Growth in China unexpectedly slowed to 7.4 per cent in 2014, while the Russian economy has been hit hard by sanctions and falls in energy prices. Activity in advanced economies has been more mixed, with growth in the euro area and Japan continuing to disappoint, while growth in the US has rebounded rapidly from a weather-related fall in GDP at the start of the year. Inflation has continued to drop around the world, partly as the result of falls in global energy prices. The euro area has experienced three months of prices falling on a year-on-year basis. In response to this, and to falling medium-term inflation expectations, the European Central Bank has announced a €60 billion a month quantitative easing programme that is planned to last at least until September 2016.

Fiscal data developments

2.15 The latest ONS public finances data show public sector net borrowing in the ten months to January 2015 was £6.0 billion lower than the same period last year. Our December forecast assumed a fall of just over £6 billion for the 2014-15 year as a whole. Both spending and receipts growth have been reasonably in line with our December forecast in the year to date. We expected receipts growth to be end-loaded in 2014-15, because of factors affecting self-assessment receipts from income tax and capital gains tax, both of which are paid in January and February. The profile of inflation was also expected to reduce debt interest costs associated with index-linked gilts in the final months of the year. Our latest fiscal forecast is discussed in Chapter 4.

Developments in outside forecasts

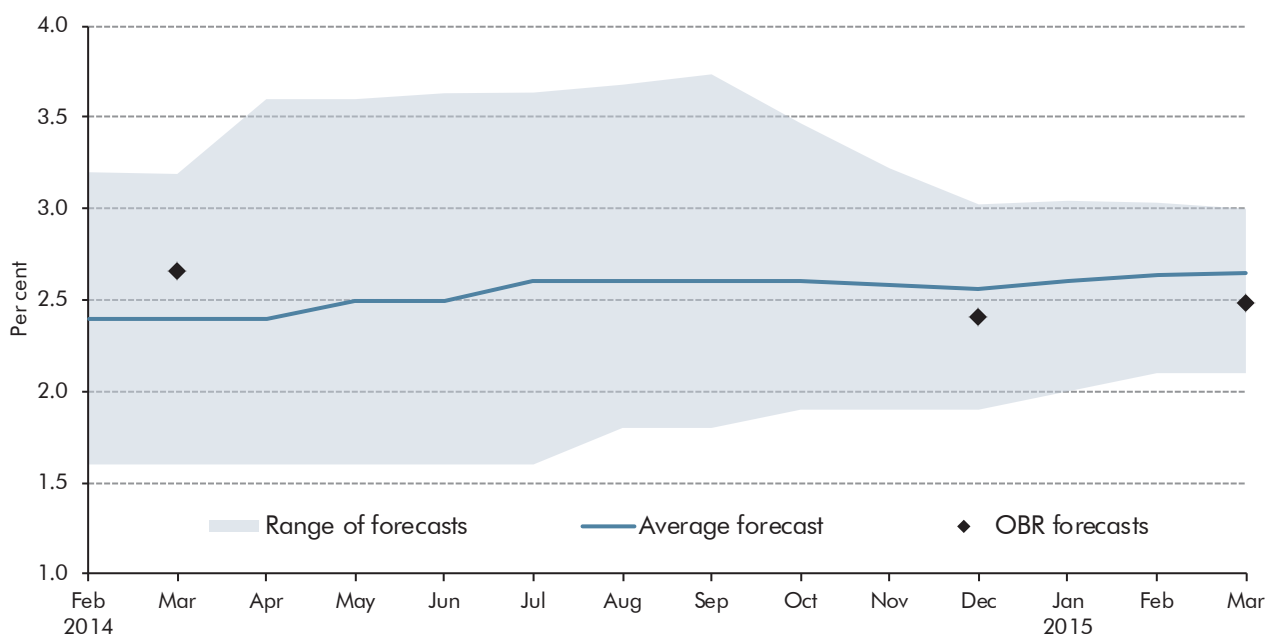
2.16 Many private sector, academic and other outside organisations produce forecasts for the UK economy.² This section sets out some of the movements in these forecasts since our December *Economic and fiscal outlook (EFO)*. When interpreting the average of outside forecasts, it is important to bear in mind that different analysts forecast different variables and the average forecast is not constrained to paint an internally consistent picture.

Real GDP growth

2.17 Outside forecasts for GDP growth in 2015 were fairly steady in the months preceding our December forecast (Chart 2.3). Since then, expectations have risen, which probably reflects an expected boost to real consumer spending from lower inflation, in turn due to the recent sharp fall in oil prices. The average forecast in March was 0.2 percentage points above our 2.5 per cent forecast. For 2016, the average outside forecast for GDP growth has decreased from 2.4 per cent at the time of our December forecast to currently be in line with our March forecast of 2.3 per cent.

² See HM Treasury, March 2015, *Forecasts for the UK economy: a comparison of independent forecasts*. A full list of contributors is available at the back of the Treasury publication. A number of financial reporting services also monitor average or consensus figures.

Chart 2.3: Forecasts for real GDP growth in 2015



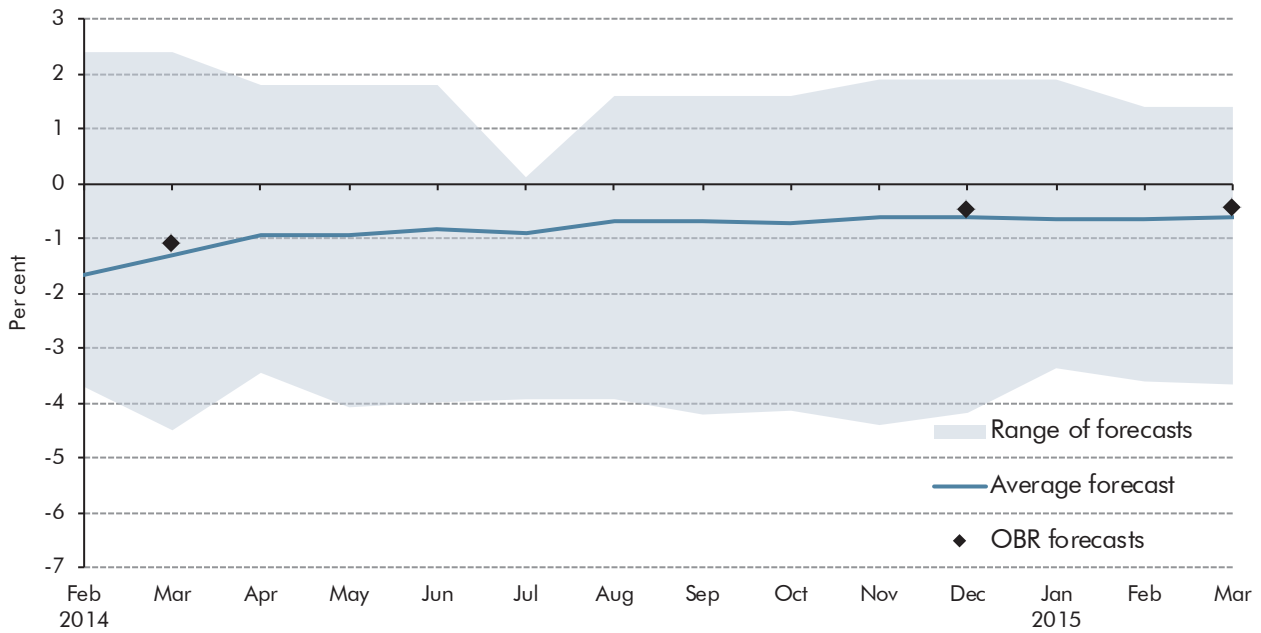
Source: HM Treasury, OBR

2.18 Looking at the smaller sample of medium-term forecasts compiled in February, the average forecast for GDP growth in 2017 has increased by 0.2 percentage points to 2.5 per cent and the average forecast for 2018 has increased by 0.1 percentage point to 2.4 per cent since December. These are slightly above our forecasts for GDP growth of 2.3 per cent in 2017 and 2018.

Output gap

2.19 The average estimate for the output gap in 2015 has remained fairly stable in recent months at close to -0.7 per cent (Chart 2.4). The latest estimate is -0.6 per cent, slightly wider than our estimate of -0.4 per cent for the year as a whole. Output gap forecasts vary much more than GDP growth forecasts because of the greater uncertainty surrounding the evolution of potential output, which cannot be directly observed or measured.

Chart 2.4: Forecasts for the output gap in 2015

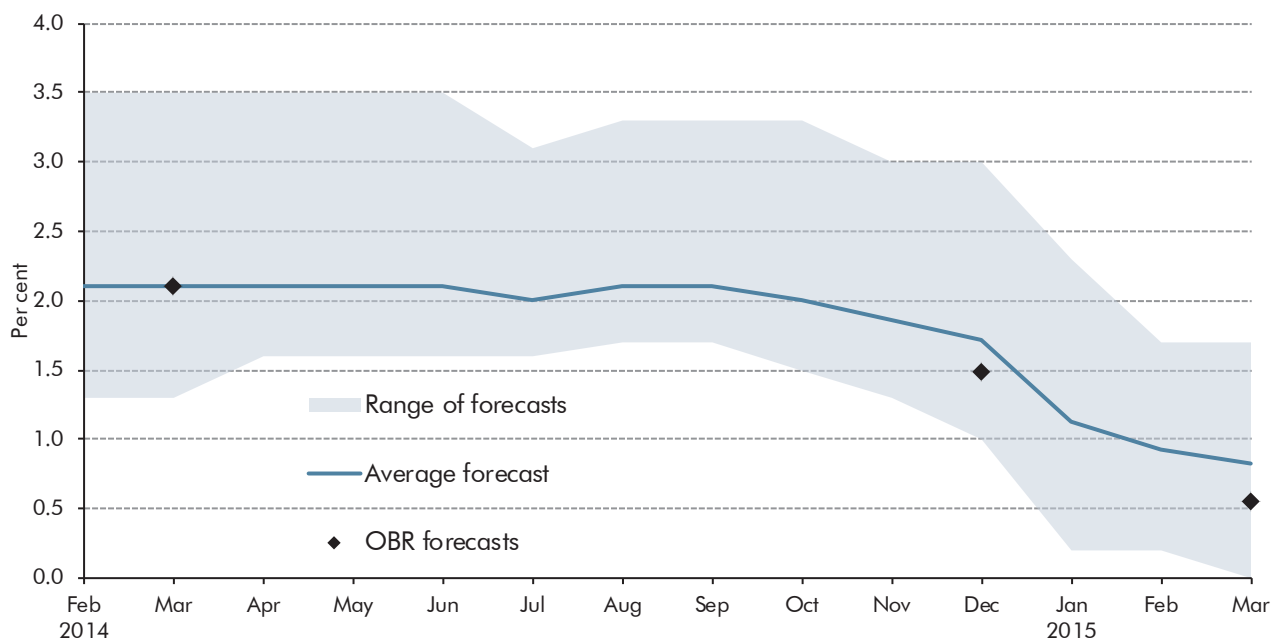


Source: HM Treasury, OBR

Inflation

2.20 The average forecast for CPI inflation in the fourth quarter of 2015 has fallen significantly in recent months, mainly reflecting falls in commodity prices and the further appreciation of sterling. The March average was 0.8 per cent, slightly above our 0.6 per cent forecast in this *EFO* (Chart 2.5). The average forecast for CPI inflation in the fourth quarter of 2016 is 1.9 per cent, which is higher than our forecast of 1.4 per cent.

Chart 2.5: Forecasts for CPI inflation in the fourth quarter of 2015

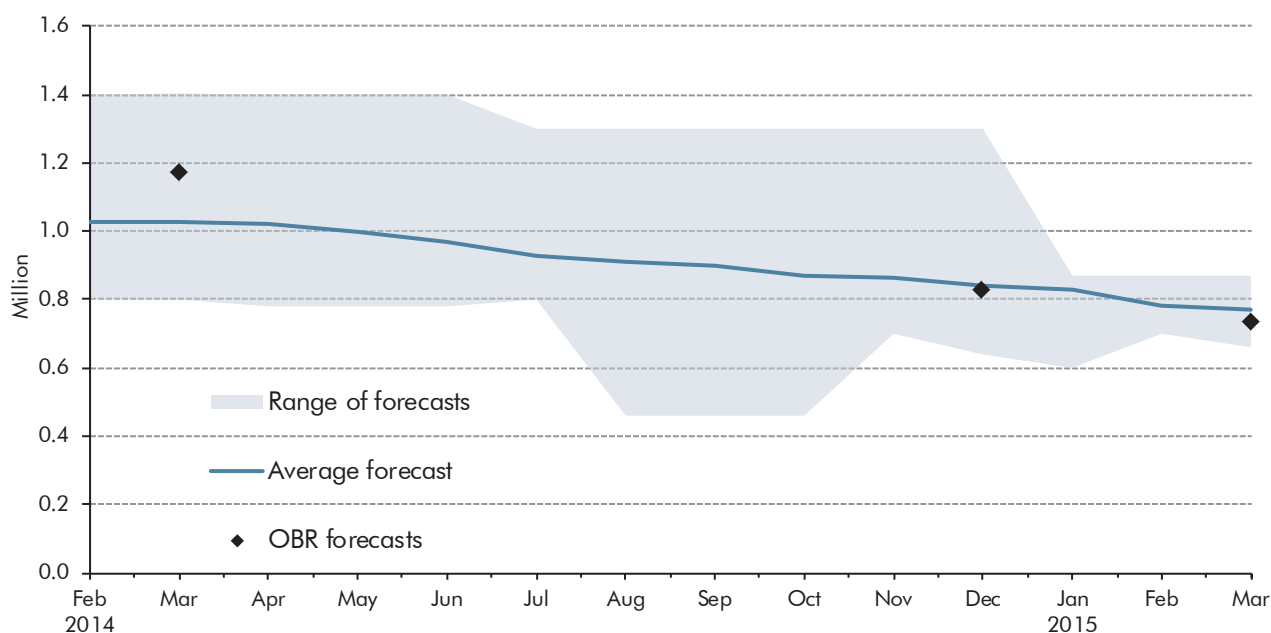


Source: HM Treasury, OBR

Labour market

2.21 The average forecast for claimant count unemployment in the final quarter of 2015 has fallen since our December forecast. It currently stands at 0.77 million, which is 70,000 lower than in December, but 40,000 higher than our current forecast (Chart 2.6). The average forecast for employment growth in 2015 is currently 1.2 per cent, slightly below our forecast of 1.4 per cent. Average earnings growth in 2015 is now expected to be 2.5 per cent, up from 2.4 per cent in December.

Chart 2.6: Forecasts for the claimant count in the fourth quarter of 2015



Source: HM Treasury, OBR

Public finances

2.22 The average forecasts for public sector net borrowing (PSNB) in 2015-16 and 2016-17 have both fallen since our December forecast. Medium-term forecasts, compiled in February, suggest PSNB will fall by £15 billion a year on average thereafter. Some forecasters expect PSNB to be significantly higher in the medium term than we forecast. As well as reflecting differences in views about prospects for the economy, external forecasters may base their judgements on what they consider to be the most likely path of fiscal policy. We are required by Parliament to base our forecasts on the current Government's current policies.

3 Economic outlook

Introduction

3.1 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.2);
- describes the key conditioning assumptions for the forecast, including monetary policy, fiscal policy, credit conditions and the world economy (from paragraph 3.21);
- sets out our short- and medium-term real GDP growth forecasts, as spare capacity is brought back into productive use (from paragraph 3.41) and the associated outlooks for inflation (from paragraph 3.54) and nominal GDP (from paragraph 3.69);
- discusses recent developments and prospects for the household, corporate, government and external sectors of the economy (from paragraph 3.74); and
- outlines risks and uncertainties (from paragraph 3.111) and compares our central forecast to those of selected external organisations (from paragraph 3.113).

Potential output and the output gap

3.2 Judgements about the amount of spare capacity in the economy (the ‘output gap’) and the growth rate of potential output provide the foundations for our forecast. Together they determine the scope for growth in GDP as activity returns to a level consistent with maintaining stable inflation in the long term.

3.3 Estimating the size of the output gap allows us to judge how much of the budget deficit at any given time is cyclical and how much is structural.¹ In other words, how much will disappear automatically, as the recovery boosts revenues and reduces spending, and how much will be left when economic activity has returned to its full potential. The narrower the output gap, the larger the proportion of the deficit that is structural, and the less margin the Government will have against its fiscal mandate, which is set in structural terms.

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

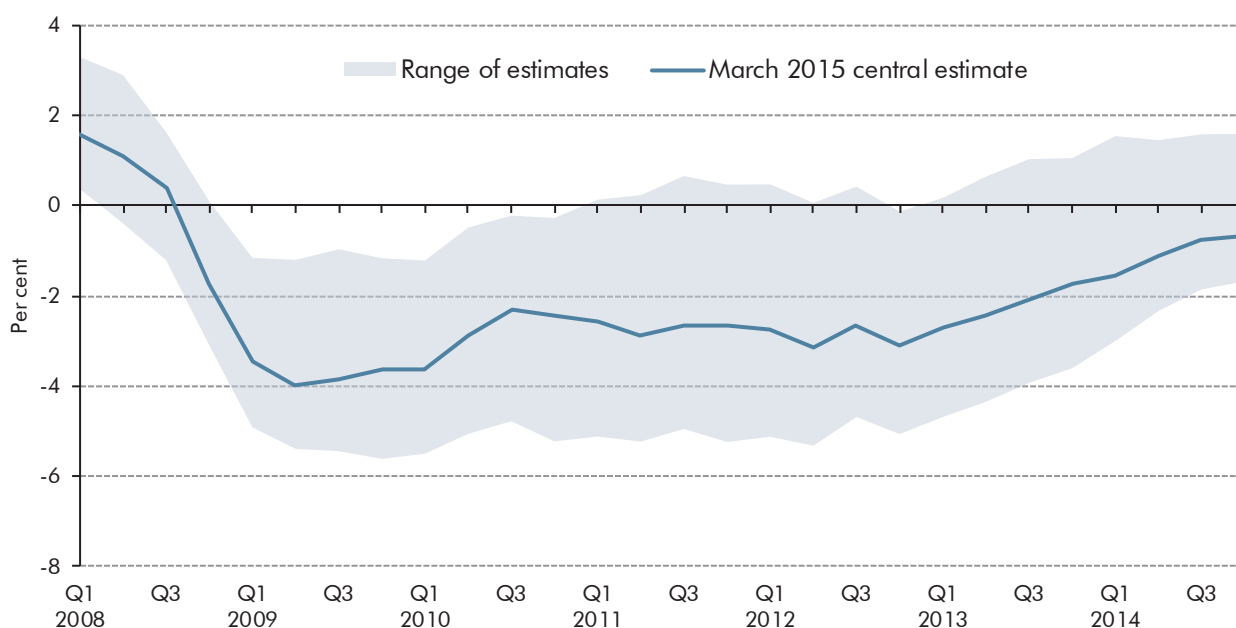
¹ The methodology we use to do so is described in Helgadottir *et al* (2012): *Working Paper No.3: Cyclically adjusting the public finances*.

The latest estimates of the output gap

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

3.6 Chart 3.1 shows a range of estimates of the output gap implied by nine different techniques, as well as our own latest central estimates.² All of these estimates showed spare capacity increasing during the course of the late 2000s recession, and the range between them increased. The swathe remained relatively stable until early 2013 when actual growth picked up. Most estimates have since narrowed, but the range remains wide. In the fourth quarter of 2014, the estimates vary from -1.7 to +1.6 per cent. But even this range may understate the degree of uncertainty, as such estimates are likely to change as new data become available and past data are revised.

Chart 3.1: Range of output gap model estimates



Source: OBR

3.7 The cyclical indicators approaches that we previously placed greatest emphasis upon implied that the output gap began to narrow in 2012, even though growth remained relatively weak. 'Aggregate composite' (AC) estimates imply that spare capacity continued to be used up at pace, and that output moved above its sustainable level towards the end of

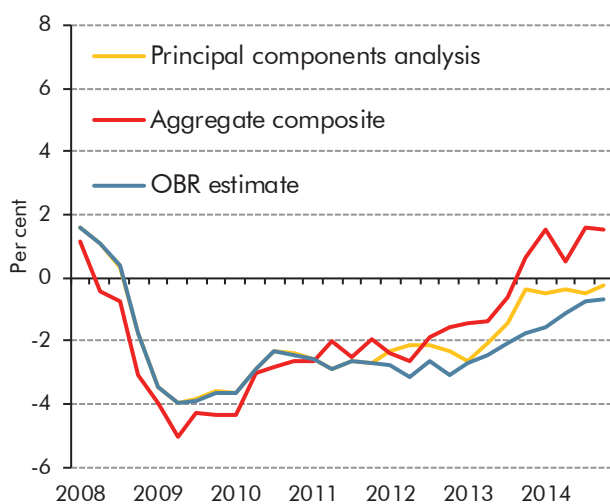
² The individual output gap estimates are included in the supplementary economy tables available on our website. The approaches – and the uncertainties associated with them – are discussed in Murray (2014): *Working Paper No.5: Output gap measurement: judgement and uncertainty*.

2013. 'Principal components analysis' (PCA) estimates also suggest a significant narrowing of the gap through 2013, but with the gap remaining stable, and slightly negative, through 2014.³

3.8 Chart 3.3 shows the disaggregated PCA series underlying the headline indicator. The PCA model varies the weights on the various indicators such that more weight is placed on those that move together and less on those that appear to be outliers. The AC weights are imposed using sector and income shares. It appears that:

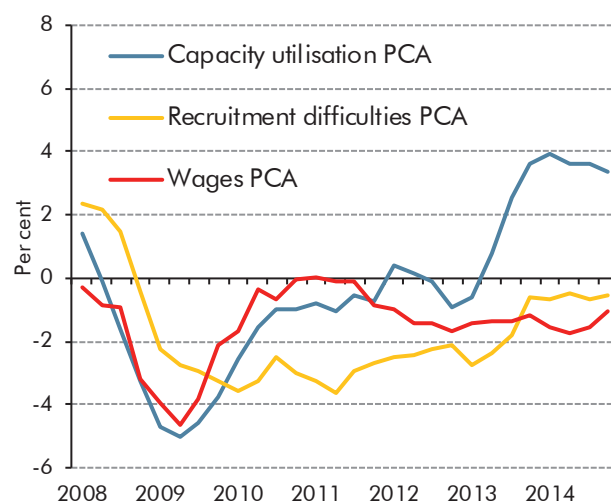
- PCA estimates are increasingly downplaying capacity utilisation indicators that suggest firms are operating at levels associated with significant overheating. These retain a higher weight in our AC estimates, based on the profit share of GDP;
- firms experienced greater recruitment difficulties through 2013, but the aggregate position has remained reasonably stable since – although there are signs of emerging skill shortages in some areas. Our PCA estimates currently place a high weight on recruitment difficulties indicators and so follow a similar path; and
- growth in the real product wage remains low, mainly reflecting the ongoing weakness of productivity growth. We judge that this has been a largely structural phenomenon, rather than indicating scope for further catch-up growth.

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



Source: OBR

Chart 3.3: Principal component subsets



3.9 CPI inflation was lower than expected in December, which could in principle suggest more slack in the economy. But we do not consider that likely, since the decline in recent months largely reflects lower food and petrol prices, and the effects of sterling appreciation. The unemployment rate has continued to drop at a steady pace, falling to 5.7 per cent in the

³ More details are set out in our *Briefing Paper No.2: Estimating the output gap* and in Pybus (2011): *Working Paper No.1: Estimating the UK's historical output gap*.

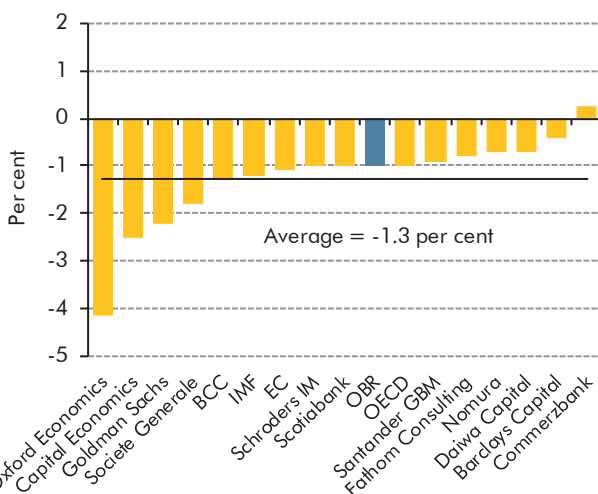
final quarter of 2014, in line with our December forecast. But, contrary to our expectations, the participation rate has also fallen, as has hourly productivity.

3.10 Considering the balance of evidence, we now judge that the output gap was 0.1 percentage point wider in the fourth quarter of 2014 than we forecast in December, at -0.7 per cent of potential output. This is in line with GDP growth also being 0.1 percentage point lower than forecast in the fourth quarter.

3.11 Of that -0.7 per cent output gap, we attribute -0.3 percentage points to the unemployment rate lying above its sustainable rate and a further -0.2 percentage points to the activity rate lying below its potential. Average hours worked exhibit a declining trend over the long term, but have risen since mid-2011. This may reflect unexpectedly weak income growth and negative wealth shocks for many households, leading them to increase their labour market input. Much of the shock to incomes is expected to be permanent, in which case it is unlikely that average hours will resume their long-term decline quickly. We therefore assume that trend average hours have been flat since the start of the recession, which still implies a positive average hours gap of 1.5 percentage points. This is offset by output-per-hour currently lying 1.6 percentage points below our estimate of its potential (i.e. cyclical weakness in actual productivity on top of the large structural shortfall that built up during and since the late 2000s financial crisis).

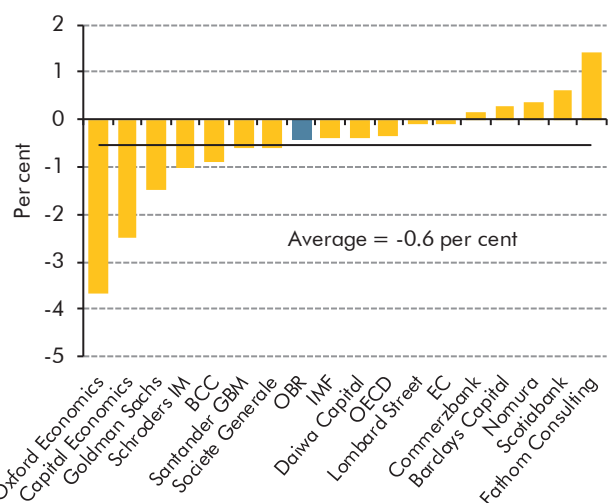
3.12 Charts 3.4 and 3.5 compare our central output gap estimates for 2014 and 2015 to those produced by other forecasters, as set out in the Treasury’s February and March *Comparison of independent forecasts*. The average estimate is -1.3 per cent in 2014 and -0.6 per cent in 2015, only slightly wider than our central estimates of -1.0 per cent for 2014 and -0.5 per cent for 2015. However, due to the skew of the distribution, the median estimates are closer still, at -1.1 per cent and -0.4 per cent for 2014 and 2015 respectively.

Chart 3.4: Estimates of the output gap in 2014



Source: HM Treasury, plus updates where known

Chart 3.5: Estimates of the output gap in 2015



The growth of potential output

- 3.13 In our December *EFO*, we forecast a gradual strengthening of potential output growth over the forecast period and that remains our central judgement. But that outcome depends on the most important uncertainty in our (and most people's) economic forecast: the timing and strength of the long-awaited return to sustained productivity growth. The effects of significantly lower oil prices on potential output add a new source of uncertainty in this forecast, as do the relatively large shifts in net migration seen in recent quarters.
- 3.14 The growth of potential productivity per hour remains below its historical average throughout the forecast. That reflects our view that the slow pace of financial system normalisation and the related pace at which resources are reallocated to more productive uses will continue to weigh on the sustainable rate of growth – by diminishing amounts – for some years. But since it is difficult to explain the abrupt fall and persistent weakness of productivity in recent years, it is also hard to judge when or if productivity growth will return to its historical average.⁴
- 3.15 Actual hourly productivity growth has again been weaker than expected, with a fall in the final quarter of 2014 and a rise of only 0.2 per cent on the year. This suggests productivity growth might remain subdued for longer. But, looking ahead, lower oil prices should encourage additional non-oil business investment and hence the accumulation of capital, which would provide a small boost to productivity growth of around ¼ per cent (Box 3.1). We consider the downside news over the recent past and the potential upside from lower oil prices to be broadly offsetting, leading to an unchanged forecast for potential productivity growth.
- 3.16 We continue to expect population growth to slow and the potential employment rate to drift down over the medium term as the population ages. (This downward drift is due to the proportion of older people with lower-than-average employment rates increasing, which outweighs the effect of age-specific employment rates at older ages rising.) But we have made some changes to the population and employment rate assumptions underpinning our potential output growth forecast.
- 3.17 Net migration in the year to September 2014 rose to 298,000, up from 210,000 in the year to September 2013. Our previous forecasts have been underpinned by the assumption in the ONS low migration population projections that net migration will move towards 105,000 a year by mid-2019. A reduction over time seems consistent with the international environment and with the Government's declared efforts to reduce it. But in light of recent evidence, it no longer seems central to assume it will decline so steeply. So we now assume that net migration flows will tend towards 165,000 in the long term, consistent with the ONS principal population projections. Relative to our December forecast, this raises potential output growth by 0.5 per cent over the forecast period via 16+ population growth.

⁴ In Chapter 5 of our December 2014 *Economic and fiscal outlook* we presented two scenarios that considered the implications of productivity growth remaining stuck at the low levels of recent years and of growth rebounding in line with the strongest UK performance of recent decades.

3.18 The age structure of inward migrants is skewed towards those of working age (see Chart 4.1 in Chapter 4), which implies that the effects on employment will be slightly bigger than on population growth. We have assumed that, conditional on age and gender, migrants are as likely as the broader population to be employed. Relative to our December forecast, this raises potential output by a further 0.1 per cent, which means that potential output growth has been revised up 0.6 per cent in total by the end of the forecast period. Output per worker is not affected by these changes, although GDP per capita is raised fractionally due to the higher employment rate.

Table 3.1: Potential output growth forecast

	Annual growth rate (per cent)				
	Potential productivity ¹	Potential average hours	Potential employment rate ²	Potential population ²	Potential output ³
2015	1.4	0.0	0.0	0.6	2.0
2016	1.7	-0.1	0.0	0.6	2.2
2017	1.9	-0.2	0.0	0.6	2.3
2018	2.0	-0.2	0.0	0.5	2.4
2019	2.1	-0.2	0.0	0.6	2.5
2015-2019 average					
December forecast	1.8	-0.1	-0.1	0.5	2.2
March forecast	1.8	-0.1	0.0	0.6	2.3
Change	0.0	0.0	0.0	0.1	0.1

¹ Output per hour.

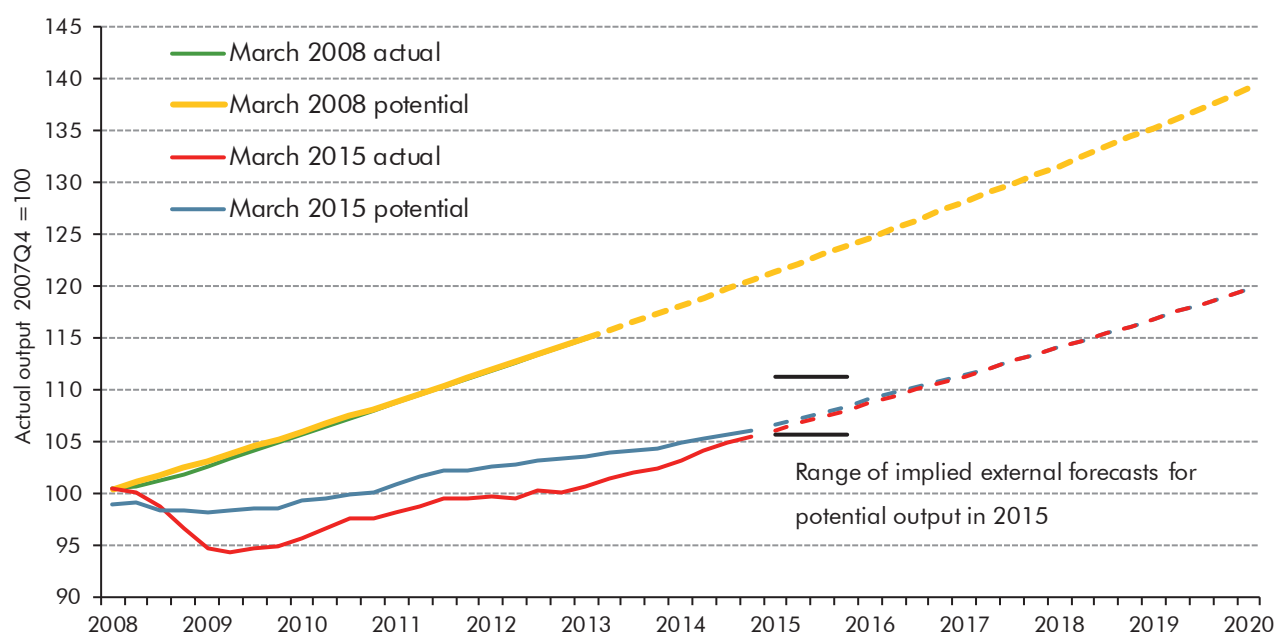
² Corresponding to those aged 16 and over.

³ Components may not sum to total due to rounding.

3.19 Our latest forecast assumes that potential output was almost 11 per cent lower than an extrapolation of the Budget 2008 forecast by 2013-14 and that it will be almost 14 per cent below that extrapolation by 2019-20. This is little changed since December. Outturn estimates of actual output growth have been revised down for 2014, which implies an equal downward revision to potential output given that we assume that the output gap is essentially unchanged over that period. But this downward revision is offset over the forecast period by our assumption of higher net migration.

3.20 Even the most optimistic external assessments of potential output continue to lie well below the pre-crisis trend implied by Budget 2008. The range presented in the chart illustrates some of the uncertainty surrounding this crucial judgement – we test the sensitivity of the Government's fiscal mandate to it in Chapter 5.

Chart 3.6: Potential output forecasts



Source: HM Treasury, ONS, OBR

Box 3.1: Oil prices and the economy

Since our December forecast, sterling oil prices have fallen significantly. We now expect the sterling oil price to average £36 a barrel in the first quarter of this year – around 30 per cent lower than the level implied by our December forecast. By the end of the forecast period, sterling oil prices are 17 per cent lower in this forecast than was the case in December. There are a number of channels by which this decline is likely to affect prospects for GDP growth in the UK:

- the fall in consumer prices will increase households' real income, which is likely to feed through to higher real consumption;
- lower energy-related production costs and stronger domestic demand may support business investment and capital accumulation;
- UK trade tends to be more heavily weighted to oil importers than to oil exporters, so a boost to real consumption in those economies may support demand for UK exports; and
- lower oil prices make the North Sea less profitable, which is likely to reduce production, exports and investment by oil and gas extraction companies.

As a net oil importer, a fall in the oil price would be expected to have a positive net effect on UK GDP. A number of factors will affect the size of this boost. For example, a temporary oil price change would be expected to have a smaller effect than a permanent change because its effects would also be expected to be temporary. The response of the economy will also depend on the extent to which the oil price change reflects the influence of supply or demand: if lower oil prices primarily reflect weaker world demand, then an associated reduction in UK export growth may partially offset any improvement in real incomes. Disentangling the role of supply and demand in the recent decline in the oil price is difficult, although most analysis points to a role for both

factors. See Box 2.1 for further discussion.

Empirical studies point to a wide range of possible effects of oil price changes on UK GDP:

- using data since 1984, Blanchard and Gali (2007)^a find that an increase in oil prices of 10 per cent reduces UK output by around 0.5 per cent;
- simulations produced by the National Institute for Economic and Social Research (NIESR) suggest that a permanent reduction in the oil price of \$20 a barrel – a reduction of around 20 per cent relative to NIESR’s baseline – could lead to a permanent increase in the level of UK GDP of around 0.5 per cent.^b A temporary shock would have a much more modest effect, increasing GDP growth by 0.1 percentage points in the near term, but reducing GDP growth after two years as interest rates are assumed to rise in response to the increase in the oil price to previous levels;
- recent simulations by the Bank of England^c using COMPASS (the Bank’s central forecasting model), indicate that a 10 per cent fall in oil prices could raise the level of GDP by around 0.1 per cent after two years, with the increase in demand mainly resulting from higher real wages;
- Millard and Shakir (2013)^d find that the effect of an oil price shock on UK GDP depends both on the source of the shock and the time period over which the effect is estimated. Based on the period from 1976 to 2011, a 10 per cent increase in the oil price that is entirely driven by weaker supply would be expected to reduce GDP by 0.12 per cent, while a world-demand driven increase in the oil price of the same magnitude would be expected to increase UK GDP by around 0.03 per cent. The size of the GDP effect is even smaller when estimated over a more recent sample period; and
- in 2010, the interim OBR set out an assessment of the effect of oil price fluctuations on the economy and public finances.^e A permanent 20 per cent increase in the real oil price was assumed to reduce GDP by around ½ per cent, although this estimate did not incorporate any offsetting effect on North Sea output, and was based on the assumption that any effect of oil prices on potential output would occur relatively quickly. We expect the fall in the oil price to provide a small boost to productivity growth of around ¼ per cent. This is smaller than was assumed in the interim OBR study, and reflects an assumption that any effect on potential output from stronger capital accumulation will build relatively slowly. For this forecast we have also incorporated the effect of lower oil prices on North Sea production, which is expected to reduce GDP by 0.3 per cent by the end of the forecast period, part of which we expect to be offset by measures announced in the Budget (see Box 3.2).

^a Blanchard, O and Gali, J, *The Macroeconomic Effects of Oil Price Shocks: Why are the 2000s so different from the 1970s?*, NBER Working Paper No. 13368, NBER, September 2007.

^b Kirby, S and Meaning, J, *Oil Prices and Economic Activity*, National Institute Economic Review, February 2015.

^c Bank of England, *Inflation Report*, February 2015.

^d Millard, S and Shakir, T, *Oil shocks and the UK economy: the changing nature of shocks and impact over time*, Bank of England Working Paper No. 476, August 2013.

^e Office for Budget Responsibility, *An Assessment of the Effect of Oil Price Fluctuations on the Public Finances*, September 2010.

Key economy forecast assumptions

Monetary and macro-prudential policy

- 3.21 Our forecast assumes that the Bank of England will try to bring inflation back to target over its forecast horizon, consistent with the Monetary Policy Committee (MPC) remit set by the Chancellor. In its February 2015 *Inflation Report*, the MPC forecast – on the basis of market interest rate expectations at the time – that CPI inflation would reach 1.96 per cent by the beginning of 2017 and 2.15 per cent by early 2018. In terms of forward guidance on policy, the MPC's expectation was that *“conditional on interest rates following the path currently implied by market yields, it was likely that slack in the economy would be absorbed and inflation would return to the 2 per cent target within two years”*.
- 3.22 Since our December forecast, there have been no new announcements on macro-prudential policy, but the Bank of England has published its December *Financial Stability Report (FSR)*. That contained an update on progress towards previously announced recommendations and the results of recent commercial bank stress tests. The Bank argued that there had been sufficient progress on the four recommendations made in their June *FSR* (see paragraph 3.22 of our December 2014 *EFO*). The stress tests concluded that *“no system-wide, macro-prudential actions on bank capital are needed given the results of those tests, the capital plans agreed by banks with the PRA Board, and given that the banking system is on the transition path to meet higher standards of loss absorbing capacity.”*

Fiscal policy and Budget measures

- 3.23 Applying the multipliers we have used in previous forecasts to the latest estimates of the size and composition of the fiscal consolidation produced by the Institute for Fiscal Studies would suggest that it had reduced the level of GDP by around 1.5 per cent in 2013-14. They implied a positive impact on GDP growth of 0.3 per cent in 2014-15, as the effects of previous tightening fade a little faster than new tightening bears down on GDP. Needless to say, there is huge uncertainty around the size of fiscal multipliers and their speed of decay.
- 3.24 As set out in Box 3.2, the net effect on GDP of measures announced in Budget 2015 is expected to be small.

Box 3.2: The economic effects of policy measures

This box considers the possible effects on the economy of the policy measures announced in Budget 2015. More details of each measure are set out in the Treasury's Budget document. Our assessment of their fiscal implications can be found in Chapter 4 and Annex A.

The Government has announced a number of **policy measures** taking effect between 2015-16 and 2019-20 that are expected to have a broadly neutral fiscal impact overall, with 'giveaways' offsetting 'takeaways' over this period. Using the same multipliers that the interim OBR used in June 2010, these measures are expected to have a negligible effect on annual GDP growth and have no effect on our GDP forecast. Given the relatively small size of these measures, using

larger multipliers would not change this conclusion.

The Government has revised its assumption for the **growth of total managed expenditure (TME)** between 2016-17 and 2019-20, which has a material effect in 2019-20. TME is now assumed to grow in line with nominal GDP in that year, rather than being held flat in real terms. Within total spending, the change in the assumption implies a significant upward revision to the path of nominal government consumption in 2019, which is now forecast to grow by 5.0 per cent in that year, rather than falling 0.7 per cent in our December forecast. As a result, government consumption is now expected to remain broadly flat as a share of GDP between 2018 and 2019, rather than continuing to decline. At that time horizon, we have assumed this change affects the composition of real GDP rather than the level, as monetary policy is assumed to determine the overall amount of spending in the economy. But we have assumed that this adds around 0.6 percentage points to growth in the GDP deflator and nominal GDP in that year via its effect on the government consumption deflator.

The Government has announced a number of **measures that will directly affect inflation**. This includes a 2 per cent reduction in duty on most beer, cider and spirits and freezing duty on wine, relative to previously assumed increases in line with RPI in April, and the cancellation of the planned increase in fuel duty in September 2015 (in line with RPI inflation). These changes are expected to reduce CPI inflation by less than 0.1 percentage points in 2015 and 2016.

The Government has announced a package of policies affecting the **North Sea oil and gas sector**, including the introduction of a new investment allowance, a reduction in the supplementary charge on profits from 30 per cent to 20 per cent, and a 15 per cent reduction in petroleum revenue tax. All else equal, these measures would be expected to reduce the cost of capital associated with investment in the sector and therefore have a positive effect on capital expenditure and production, partially offsetting the negative effect of lower oil prices on the profitability of oil and gas extraction. We have assumed that these measures increase the level of oil production by 2019 by around 15 per cent, equivalent to around 0.1 per cent of GDP. This partly offsets the effect of the significant decline in the oil price since December, which in the absence of these policy changes we assume would have reduced the level of North Sea production by around 30 per cent. In Chapter 4 we provide greater detail on these pre- and post-measures assumptions that underpin our North Sea revenues forecast.

The Government has also introduced a scheme aimed at **first-time house buyers**. The scheme offers a bonus for first-time buyers saving for a deposit, equivalent to 25 per cent of the balance in the account, with a limit on the monthly deposit of £200 and a maximum Government bonus of £3,000. To the extent that this supports prospective first-time owner-occupiers relative to those looking to buy-to-let, then it is possible that the measure will lead to a change in the composition of transactions towards first-time buyers, although the effect on aggregate property transactions is unclear. In supporting overall demand for housing, it is also possible that the policy will add to house price growth, although given the scale of the scheme we would expect any effect to be negligible. We have therefore not adjusted our forecasts for housing transactions and house prices for this measure.

The Government has announced a number of measures relating to **household saving**. These include a tax-free allowance for savings income from April 2016 of £1,000 for basic-rate

taxpayers and £500 for higher-rate taxpayers; a change to ISA rules that allows savers to withdraw and replenish funds in cash ISAs up to the annual limit; an extension to the 'pensioner' bonds offered by National Savings and Investments; and measures that increase the flexibility with which annuity holders can sell their annuities for a cash lump sum. The net effect of these measures on aggregate spending and saving is highly uncertain. It is possible, for example, that the tax-free allowance will encourage households to change the composition of their saving assets. While a tax-free allowance will also provide an income boost to savers, the amount for most households will be small, suggesting a limited effect on aggregate consumption.

By increasing the flexibility with which individuals can sell an annuity, it is assumed that this will encourage a secondary market in annuities. If the creation of such a market is successful, it is possible that households' funds will be redirected from the assets backing annuities into other assets. As with the pensions flexibility measures introduced in Budget 2014, it is possible that some people may temporarily increase pension saving. Alternatively, lump sums could be used to finance consumption, although such effects are likely to be small. As we consider the principal effect of these measures will be on the composition of household assets, rather than aggregate flow of saving or spending, we have not adjusted our forecast for these measures. The uncertainties associated with them are particularly large.

The Government has introduced measures specific to the **financial sector**, most significantly an increase in the bank levy from 0.156 per cent to 0.21 percent. These measures will have a negative effect on retained earnings, which may affect banks' ability to meet capital requirements. To the extent that banks are capital constrained, the measures could affect the supply of credit and thereby GDP growth. However, we do not judge that such effects would be significant, given the scale of the changes and that the banking sector as a whole appears to be relatively well capitalised,⁹ suggesting that material deleveraging would be unlikely. The changes are likely to have a small effect on the share prices of affected financial institutions by reducing the expected future flow of post-tax income.

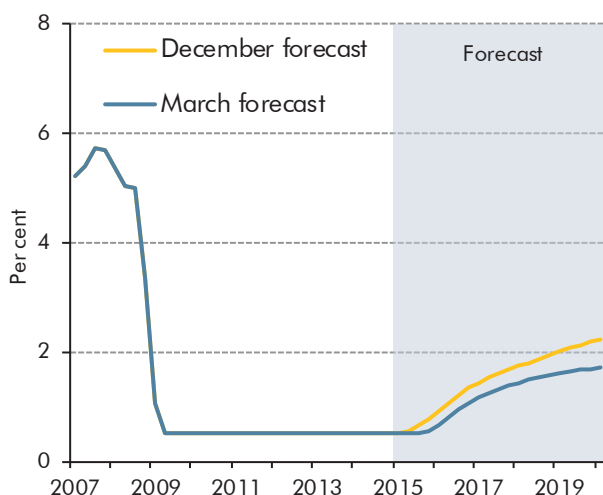
⁹ In response to the Bank of England's 2014 stress-test exercise for the UK banking system, the Financial Policy Committee agreed that "the system should be sufficiently capitalised to ensure that banks were able to maintain the supply of lending in the face of adverse shocks". See Bank of England, *Record of the Financial Policy Committee meetings, 8 and 15 December 2014*, December 2014.

Credit conditions

3.25 Domestic financial and credit market conditions continue to ease, with the price of credit generally continuing to fall and volumes picking up. Bank funding spreads have continued to fall back towards pre-crisis levels and we assume that this relatively benign environment for bank funding will be sustained across the forecast period. We base our interest rate forecasts on market expectations for Bank Rate, gilt rates and commercial bank liability rates as published by the Bank of England. Since our December forecast, interest rate expectations have fallen significantly (Chart 3.7). The first increase in Bank Rate is now expected in mid-2016 rather than late 2015. Bank Rate expectations are 0.5 percentage points lower than in December for the first quarter of 2020, only reaching 1.7 per cent by the end of our forecast period. Gilt rate expectations have fallen in line with lower Bank Rate

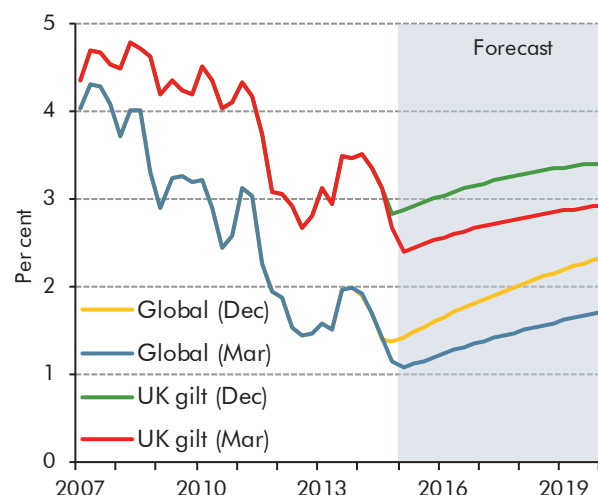
expectations. Movements in UK bond yields have largely matched those in other global bond markets (Chart 3.8).

Chart 3.7: Bank Rate expectations



Source: Bank of England, Thomson Reuters Datastream, OBR

Chart 3.8: Global bond rates



Note: 20-year gilts for UK, trade weighted bond rates for global

- 3.26 New mortgage rates have fallen significantly since mid-2012, but the effective interest rate paid on the stock of all UK mortgages has fallen by less. This is because the amount of new lending is much smaller than the stock, and terms on existing mortgages are revised only when contracts expire (typically every two to three years). For the same reason, the combination of gradually maturing mortgage contracts, competitive pressure on margins and the lagged effect of previous falls in new mortgage rates means that we expect effective mortgage rates to fall further in the near term and then to rise only slightly over the forecast period as increases in Bank Rate are offset by narrowing margins (Chart 3.9).
- 3.27 We have not changed our assumption for the evolution of bank funding spreads since December, so our forecast for bank funding costs is lower than December due to lower Bank Rate expectations. Offsetting these lower funding costs, we have assumed that lenders' margins will be higher over the forecast period than we assumed in December, leaving mortgage rates little changed by the end of the forecast period (Chart 3.10). Previously, we had assumed that margins, which have been elevated in recent years, would return towards their pre-crisis average as Bank Rate rises, normalising around the end of 2017. With market expectations implying later and more gradual Bank Rate rises, we have assumed that margins will normalise at a later date.

Chart 3.9: Mortgage rate forecast

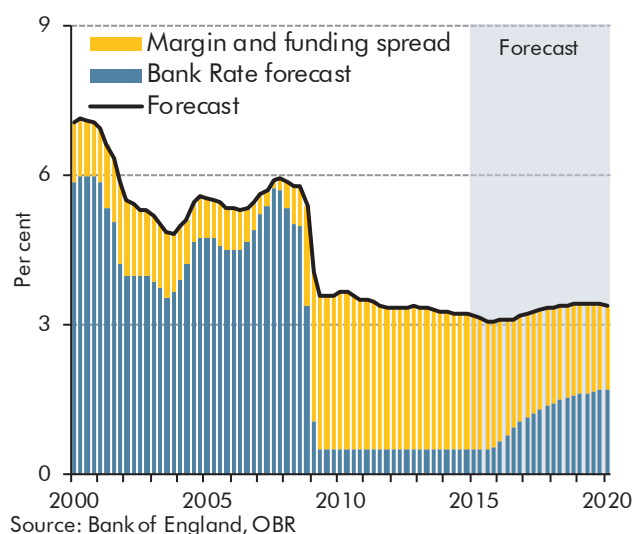
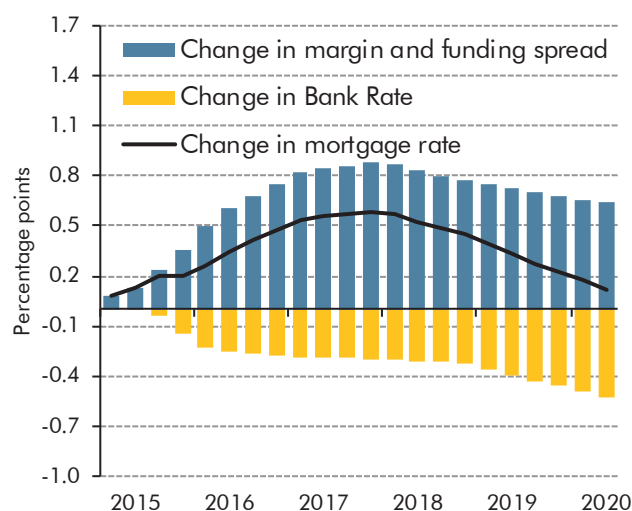


Chart 3.10: Change in mortgage rate forecast since December



3.28 Lending to households continues to pick up, mainly as rising house prices lead to more secured mortgage lending, which makes up the majority of household debt. However, secured debt has not risen as much as house price and transaction growth would imply, as the share of cash transactions has increased. We expect growth in mortgage debt to continue rising over the forecast period, as the share of cash transactions falls back, house prices continue to rise and transactions increase back towards their pre-crisis turnover rate. Strong growth in car purchases has contributed to the growth of unsecured lending, which in the fourth quarter of 2014 increased at the fastest rate since 2006.⁵

3.29 Bank lending to non-financial companies continues to fall. Large companies continue to choose non-bank sources of funds as favourable wholesale market conditions have encouraged strong net issuance of bonds. Lending to SMEs continues to fall year-on-year, although the rate of decline has eased slightly in the past few months.

World economy

3.30 World GDP is estimated to have increased by 3.3 per cent in 2014, in line with our December forecast. We now expect world GDP to grow by 3.5 per cent in 2015, down from 3.8 per cent in December. The revision is in spite of an overall boost to global GDP from lower oil prices and reflects weaker outturn data in emerging and oil-exporting countries.

3.31 The euro area economy has remained weak. In the fourth quarter of 2014, GDP was 0.9 per cent up on a year earlier. GDP was up 1.5 per cent on a year earlier in Germany and 0.2 per cent in France, but down 0.5 per cent in Italy. Spain saw stronger growth of 2.0 per cent in the year to the fourth quarter. Euro area GDP is estimated to have increased 0.9 per cent in 2014 as a whole and we forecast 1.2 per cent growth in 2015, slightly below our

⁵ Car leasing arrangements, which are becoming a more popular way of purchasing cars, are classified as unsecured lending.

December forecast. We have made further small downward revisions across the rest of the forecast.

- 3.32 Deflation in the euro area remains a risk to the global and UK outlook. Euro area CPI inflation was -0.3 per cent in February, its third consecutive negative reading. Euro area core inflation in February was 0.6 per cent, the same as in January. Since January 2013, inflation has fallen well below the European Central Bank's inflation target of below but close to 2 per cent and a number of euro area countries are experiencing deflation. In response to this and declining medium-term inflation expectations, the European Central Bank announced that it would undertake a programme of quantitative easing. Unemployment in the euro area was 11.2 per cent in January, having fallen slightly in each month since October. Weaker growth, lower inflation and monetary policy easing have helped to push the euro to a seven-year low in relation to sterling and a 12-year low against the dollar. Our latest conditioning assumption for the first quarter of 2015 shows the euro down 8.4 per cent against the US dollar and 6.5 per cent against sterling in the period since our December forecast.
- 3.33 In our December *EFO*, we identified euro area rebalancing as a risk to the UK economic outlook. Since then, elections in Greece and subsequent negotiations over the country's debt obligations have brought these issues into focus once again. Our central forecast assumes that these issues are resolved without causing undue instability. Greece accounts for only 0.6 per cent of UK exports, so the direct channel of risk is limited, but any spillover to the wider euro area could be damaging, as witnessed between 2010 and 2012.
- 3.34 Data available at the time of our December forecast showed that US GDP increased by 1.0 per cent in the third quarter of 2014. That estimate has since been revised up to 1.2 per cent. Outturn data for the fourth quarter of 2014 showed growth of 0.5 per cent, leaving US GDP up 2.4 per cent in 2014 as a whole. The IMF's latest forecast suggests the rate of US GDP growth will pick up further in 2015 to 3.6 per cent.

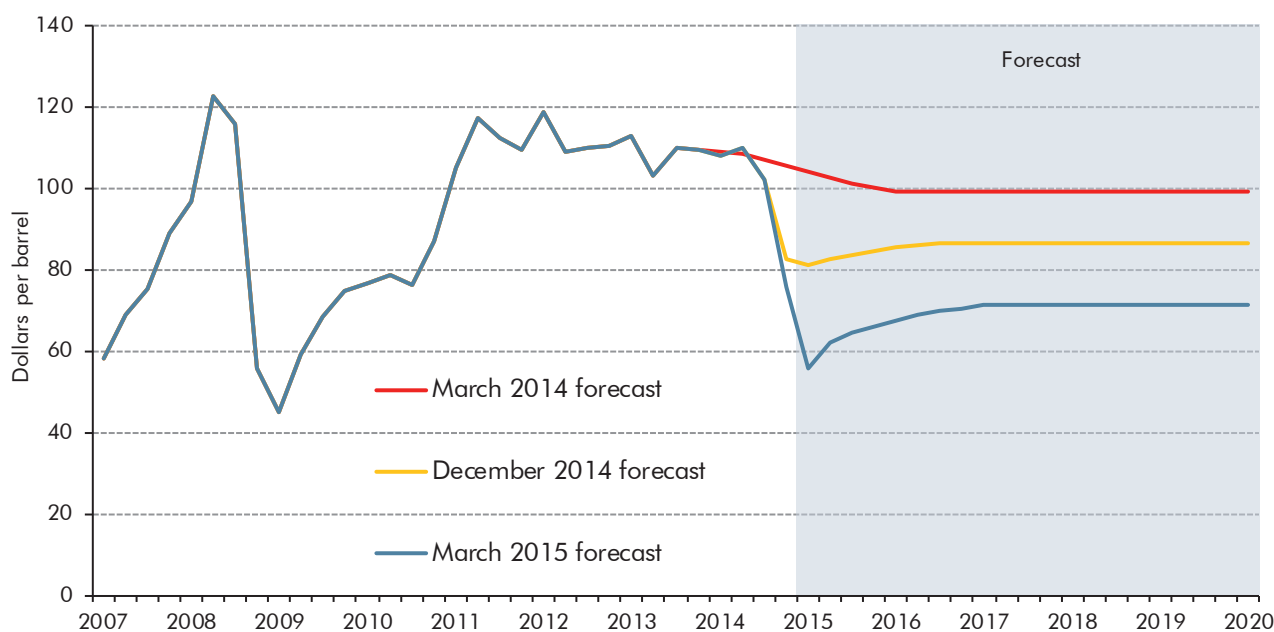
World trade

- 3.35 We expect world trade to grow by 4.0 per cent in 2015. This is slower than we forecast in December, partly reflecting weaker outturn data for the second half of 2014. World trade has also been revised down in each year of the forecast period and by a greater amount than world GDP. That is consistent with the IMF's downward revisions to world GDP and world trade growth in its January 2015 *World economic outlook update*, in particular reflecting lower expected growth in emerging markets.
- 3.36 UK export markets are expected to grow by 3.7 per cent in 2015. This is below our December forecast, but the change is smaller than the downward revision to overall world trade, which was driven by weaker growth in emerging markets that account for a smaller share of UK exports.

Oil prices

3.37 The most significant change since December to the market-derived assumptions we use in our forecasts relates to oil prices. In the 10 days to 26 February (the period we take for our conditioning assumptions), oil prices averaged \$58, which was 27 per cent lower than in our December forecast (Chart 3.11). The fall since our March 2014 forecast has been 47 per cent. By the end of the forecast period, the differences are slightly smaller at 17 per cent lower than the December forecast and 28 per cent lower than the March 2014 forecast. This reflects the change from a downward sloping futures curve in March 2014 to a modestly upward sloping curve in December and a more steeply upward sloping curve now. (We only use the first two years of the futures curve in our forecast, holding prices flat thereafter.)⁶ The drivers of the fall in oil prices are discussed in Box 2.1, while Box 3.1 summarises the channels along which lower prices might affect the economy.

Chart 3.11: Oil price assumption



Source: IMF, Thomson Reuters Datastream, OBR

Other conditioning assumptions

3.38 We use market-derived conditioning assumptions for our exchange rate and equity price forecasts. We assume that the exchange rate follows the path implied by the uncovered interest parity condition. In February 2015, the sterling effective exchange rate rose to its highest level since 2008. By the first quarter of 2015 we expect it to have moved 3.5 per cent higher than our December conditioning assumption due to the appreciation of sterling against the euro (Chart 3.12). The exchange rate is expected to depreciate over the forecast period as the forward UK interest rate curve is above the average of the UK's major trading partners. We assume equity prices rise in line with nominal GDP from their current level.

⁶ See paragraph 3.49 of our December 2013 *Economic and fiscal outlook* for an explanation of this methodology.

The FTSE all-share index has risen above the December conditioning assumption, reaching an all-time high in February 2015 (Chart 3.13).

Chart 3.12: Sterling effective exchange rate assumption

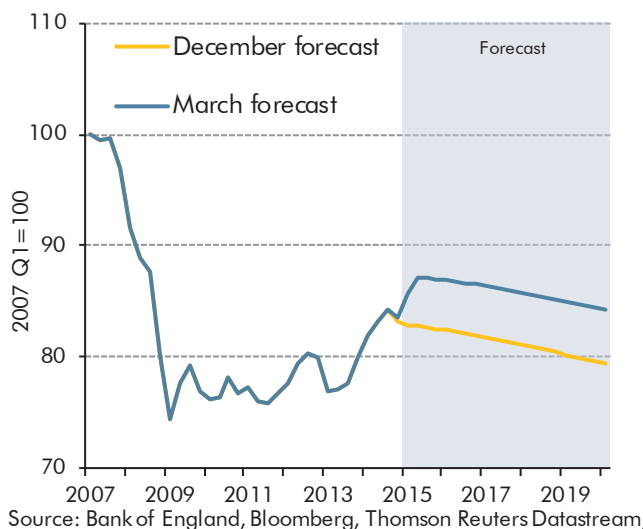
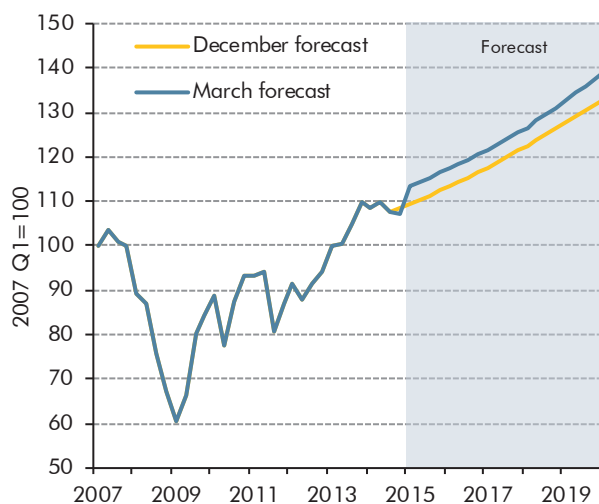


Chart 3.13: Equity prices assumption



Summary

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

- monetary policy remains very loose and does not begin to tighten until mid-2016;
- fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past four years;
- the measures announced in the Budget have a negligible overall impact on demand and a very small effect on CPI inflation;
- credit conditions and the financial system continue to normalise gradually;
- global activity and demand for UK exports pick up steadily, albeit slightly more slowly in the near term than expected in December; and
- financial markets are stable and oil prices rise slightly after recent falls.

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

Prospects for real GDP growth

3.41 In this section, we set out the expected path of GDP growth over the forecast period. We first consider the short-term outlook, based on recent economic data and forward-looking surveys. We then consider the rate at which GDP will grow over the medium term as spare capacity is put to productive use and the relatively small negative output gap closes.

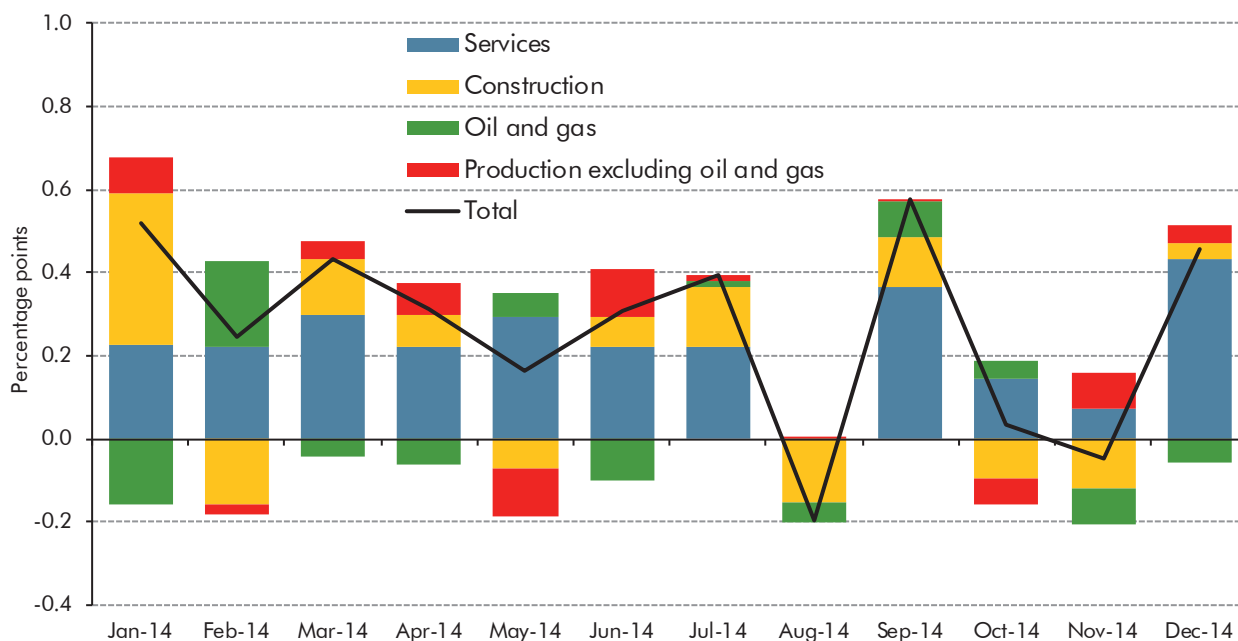
The short-term outlook for GDP

3.42 The economy grew by 0.5 per cent in the fourth quarter of 2014, slightly below the 0.6 per cent we forecast in December. *Quarterly National Accounts* data released after our December forecast contained downward revisions to GDP back to the start of 2013. As a result of this and the second estimate of fourth quarter GDP, the ONS now estimates that GDP increased by 2.6 per cent in 2014, below the 3.0 per cent we expected in December.

3.43 On a monthly basis, Chart 3.14 shows steady contributions to growth from the services sector in the second half of 2014. Contributions from the construction and production sectors were more volatile. The *Markit/CIPS Purchasing Managers' Index (PMI)* for February showed strong growth in the manufacturing and construction sectors. The services sector eased slightly in February, following a strong reading in January.

3.44 The latest survey indicators point to continued momentum into 2015, and we expect GDP growth to pick up to 0.7 per cent in the first quarter. We then forecast growth of 0.6 per cent in each of the remaining quarters of 2015, up slightly from our December forecast of 0.5 per cent a quarter over this period. This reflects a similar judgement to December that momentum would ease over the year, but incorporates an upward revision to growth due to lower oil prices boosting real household consumption. These changes leave GDP growth in 2015 as a whole at 2.5 per cent, slightly above our December forecast.

Chart 3.14: Contributions to monthly output growth in 2014



Source: ONS

Table 3.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2014				2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
March forecast ¹	0.7	0.8	0.7	0.5	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
December forecast ²	0.7	0.9	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Change³	-0.1	-0.2	0.0	-0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0

¹ Forecast from first quarter of 2015.² Forecast from fourth quarter of 2014.³ Changes may not sum due to rounding.

The medium-term outlook

3.45 Our forecasts for growth in the medium term are determined by the amount of spare capacity in the economy, and the speed with which we expect it to return to productive use. The prospects for monetary policy, fiscal policy, credit conditions, external demand and financial markets discussed in the previous section all inform that judgement.

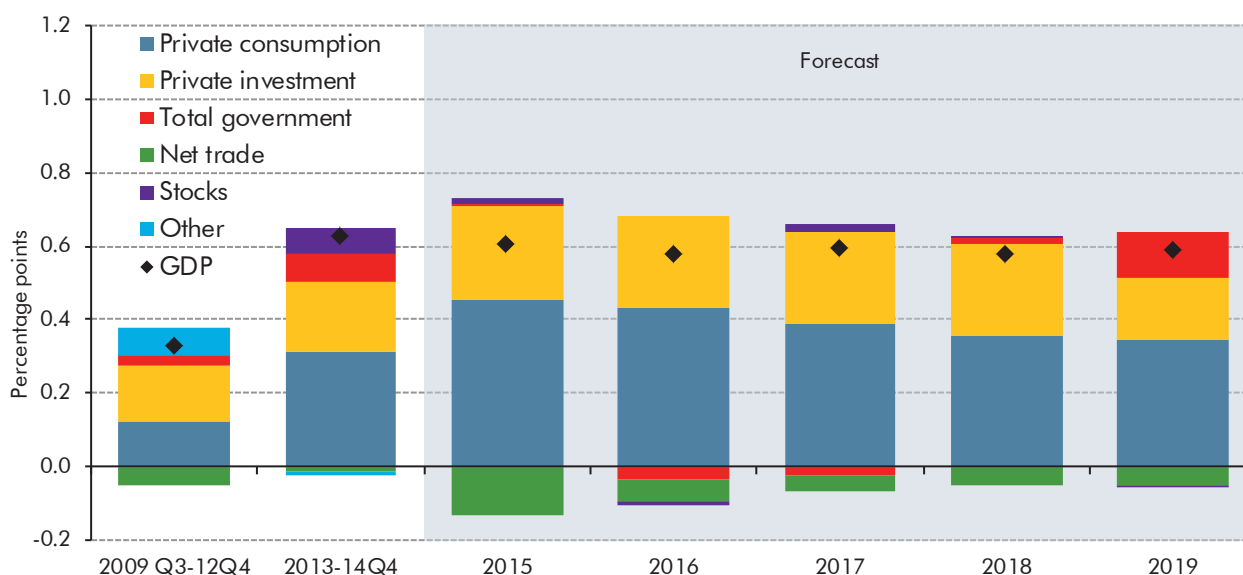
3.46 Recent ONS data revisions mean that the pick-up in GDP growth through 2014 now appears somewhat weaker than previously thought. Nevertheless the general picture of a significant pick-up in activity in 2013 and 2014 remains intact. GDP growth has averaged 0.6 per cent a quarter since the start of 2013, compared to just 0.3 per cent between the end of the recession and the end of 2012. Much of the increase in growth is attributable to a pick-up in consumer spending, as well as stronger investment growth, although investment is estimated to have fallen in the second half of 2014.

3.47 As set out in Box 3.1, the significant decline in the oil price since December is likely to affect economic activity in a number of ways: boosting real household incomes and thereby consumer spending and, to a lesser extent, encouraging business investment, but weighing on North Sea production and investment. Taken together we expect the fall in the oil price since December to increase GDP growth by around 0.4 percentage points across 2015 and 2016, with the largest effect likely to be observed over the second half of 2015 and first half of 2016. This more than offsets the effect on net trade of a further deterioration in the outlook for the UK's export markets. We have revised up our forecast for GDP growth in 2015 and 2016 by 0.1 and 0.2 percentage points respectively.

3.48 After 2016, the effect of lower oil prices on real income growth dissipates as the oil price is assumed to stabilise. Growth is instead supported by our assumption that productivity growth picks up towards its historical average rate. We therefore forecast the quarterly growth rate to remain at around 0.6 per cent from mid-2016. Lower oil prices are assumed to have a persistent effect on North Sea production in the medium term, implying a cumulative reduction in GDP of around 0.2 per cent by 2019 due to a 20 per cent downward revision to oil and gas production relative to our December forecast.

3.49 Overall, our forecast for cumulative real GDP growth between the third quarter of 2014 and the start of 2020 is slightly stronger than our December forecast (13.7 per cent versus 13.3 per cent). This reflects slightly stronger average growth of potential output, in turn reflecting the upward revision to assumed net inward migration (see paragraphs 3.17 to 3.18).

Chart 3.15: Contributions to average quarterly GDP growth



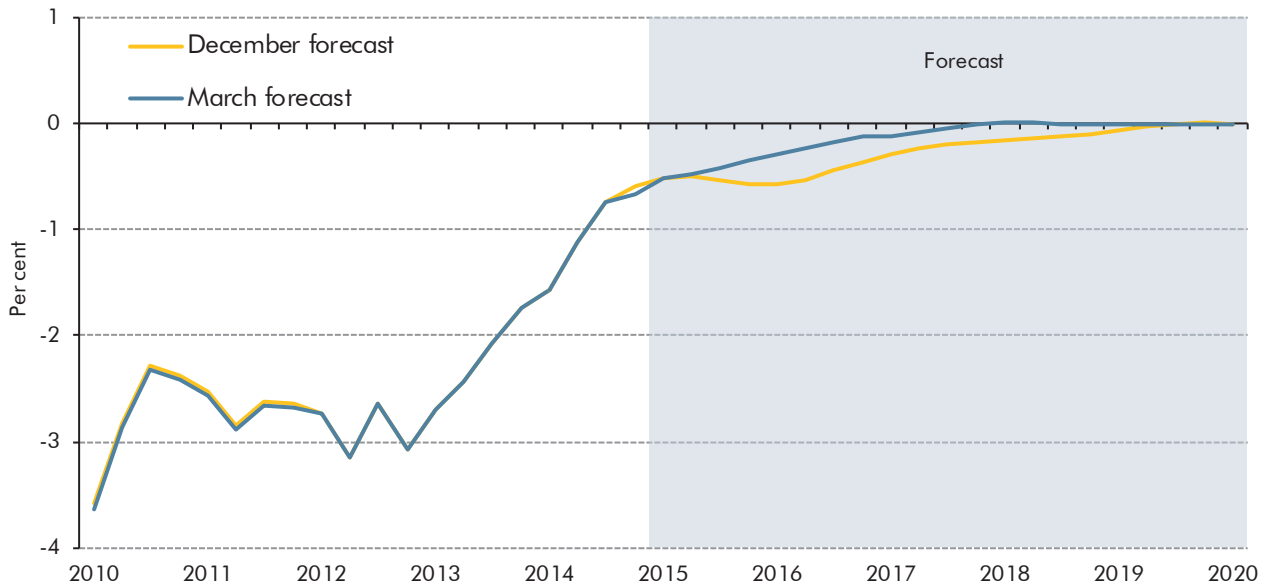
Note: 'Other' category includes the statistical discrepancy and the residual between GDP and the expenditure components prior to the base year (2011).

Source: ONS, OBR

3.50 Our estimate of the output gap at the end of 2014 is little changed from our December forecast. The boost to GDP growth from the lower oil price means that we now expect the output gap to be somewhat narrower from 2015, with output returning to its potential level

by the final quarter of 2017, around a year and a half earlier than we expected in December. That it does not close more quickly reflects a number of headwinds to growth over the medium term, including a pick-up in the pace of fiscal tightening, the slow return to health of the financial system, ongoing weakness in UK export markets and limits to what monetary policy can do to stimulate demand in these circumstances.

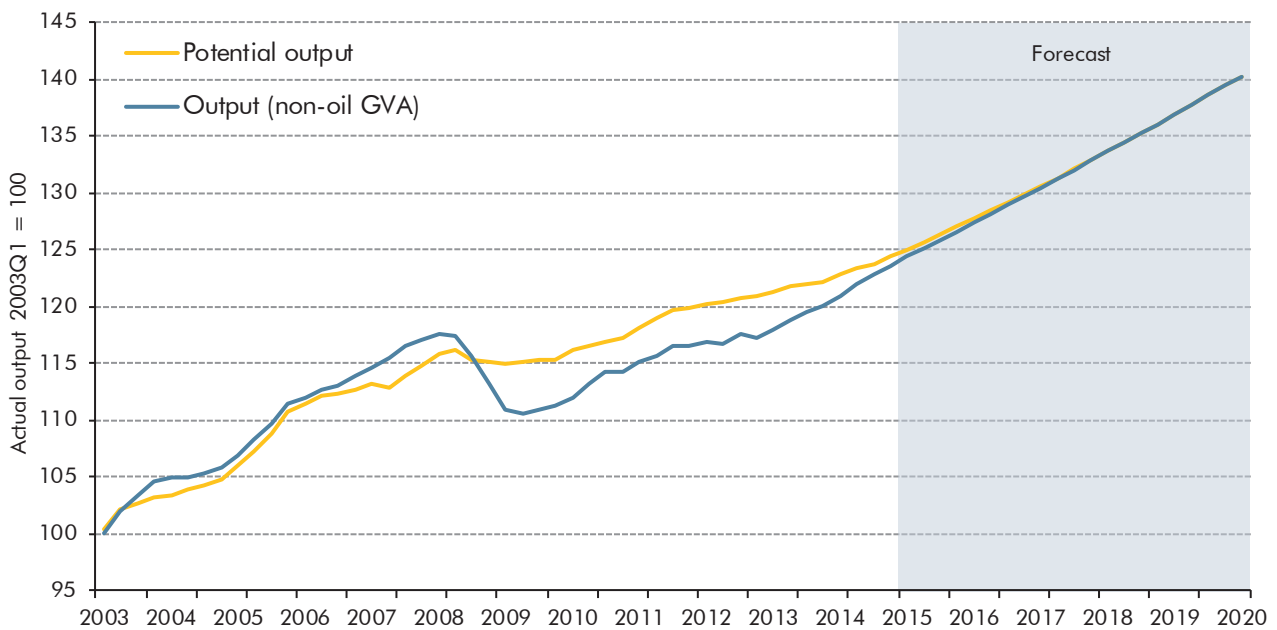
Chart 3.16: The output gap



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

Source: OBR

Chart 3.17: Projections of actual and potential output



Source: ONS, OBR

3.51 Table 3.3 summarises the expenditure composition of our real GDP forecast. Relative to December, we expect stronger consumption growth in the near term, as the fall in the oil price boosts real incomes. We also expect somewhat stronger government consumption. Our forecast for cumulative investment growth is somewhat weaker, reflecting a downward revision to the outlook for both business (particularly North Sea) and residential investment. Later sections of this chapter discuss the expenditure components of GDP in more detail.

Table 3.3: Expenditure contributions to growth

	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
GDP growth (per cent)	1.7	2.6	2.5	2.3	2.3	2.3	2.4
Main contributions							
Private consumption	1.1	1.3	1.6	1.8	1.6	1.5	1.4
Business investment	0.5	0.7	0.5	0.8	0.7	0.8	0.5
Dwellings investment ¹	0.2	0.3	0.1	0.2	0.2	0.3	0.2
Government ²	-0.3	0.5	0.2	-0.1	-0.1	0.0	0.3
Change in inventories	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Net trade	0.0	-0.5	-0.1	-0.4	-0.2	-0.2	-0.2

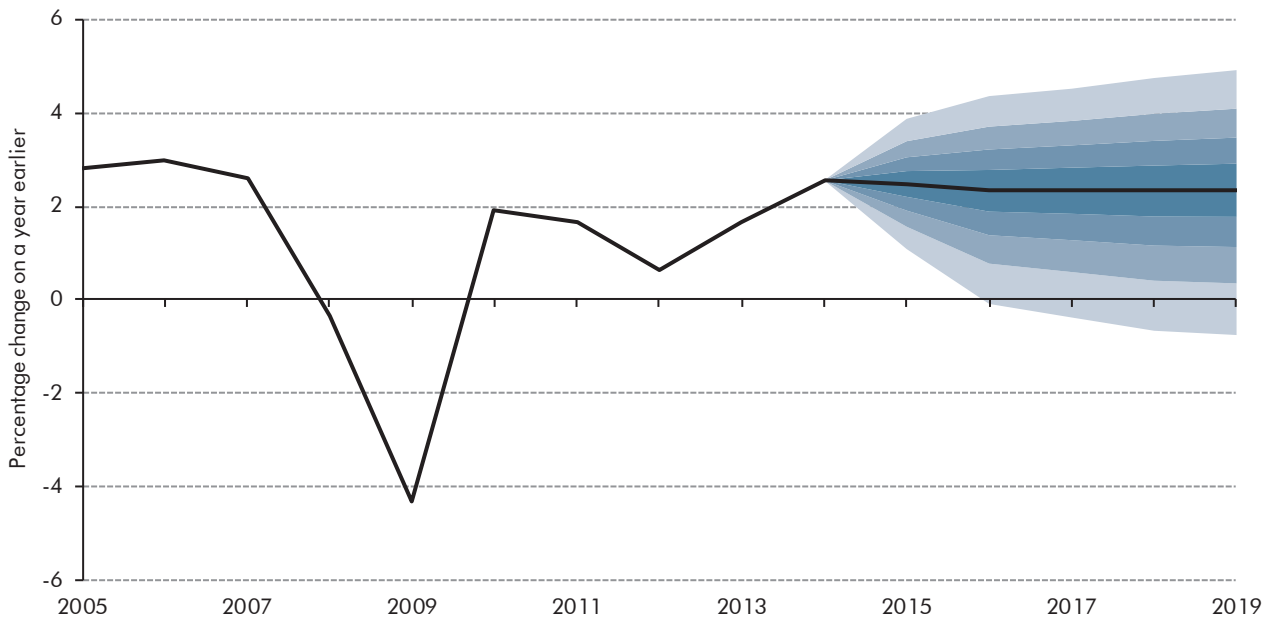
¹ The sum of public corporations and private sector investment in new dwellings, improvements to dwellings and transfer costs.

² The sum of government consumption and general government investment.

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

3.52 Our central GDP growth forecast is shown in Chart 3.18. The distribution surrounding it shows the probability of different outcomes based on past forecast accuracy. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. These are based on the distribution of official forecast errors since 1987. They do not represent a subjective measure of the distribution of risks around the central forecast. Such risks are discussed at the end of the chapter.

Chart 3.18: Real GDP growth fan chart

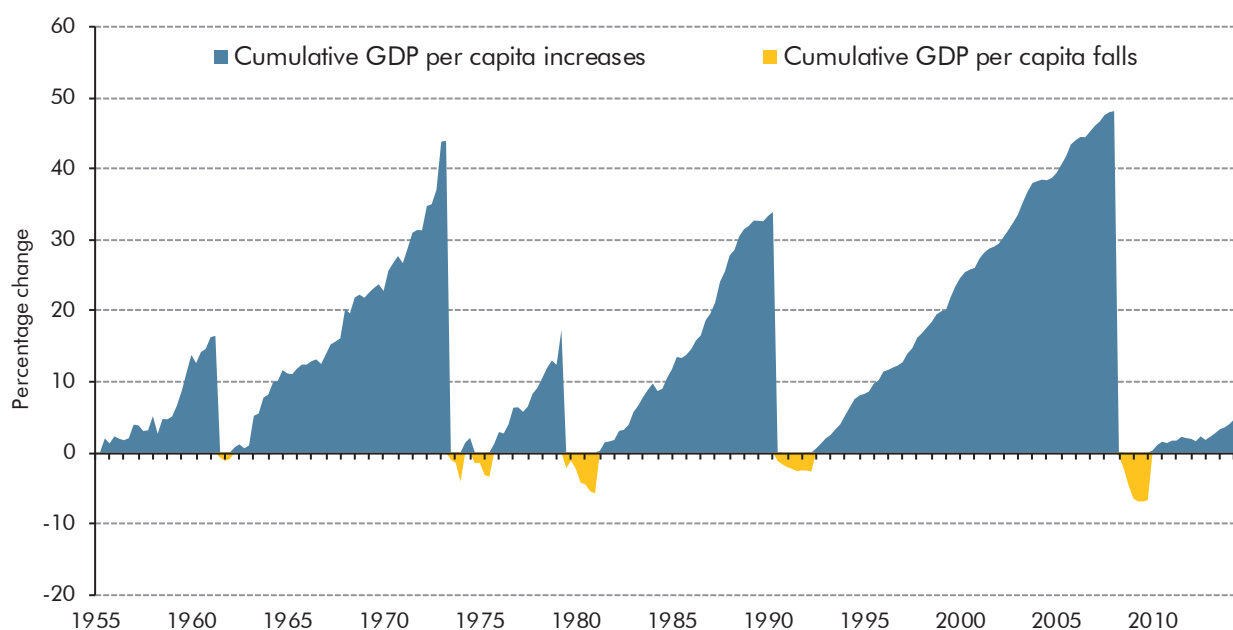


Source: ONS, OBR

3.53 The latest data imply that by the end of 2014, GDP per capita will have risen by 5.6 per cent since its trough in mid-2009, having grown at an average rate of just 1.0 per cent a year over that period. As Chart 3.19 shows, significant falls in GDP per capita like that experienced in the late 2000s recession are historically rare and typically short-lived compared with periods of expansion. The pace of expansion since the 2009 trough is notably subdued relative to the other post-war expansions shown in the chart.⁷

⁷ Expansion periods are defined as continuing until GDP per capita falls cumulatively by more than 1 per cent over two consecutive quarters, triggering the start of a contraction period. Conversely, contraction periods are defined as continuing until cumulative GDP per capita growth is higher than 1 per cent over two consecutive quarters, triggering the start of an expansion period.

Chart 3.19: Cumulative growth in real GDP per capita



Source: ONS, OBR

Prospects for inflation

3.54 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation, including the Consumer Prices Index (CPI) and the Retail Prices Index (RPI). The basic measurement approach is the same in both indices, although there are a number of differences in coverage and the methods used to construct them (see Box 3.3 for more details). We also forecast the GDP deflator and its components, which are used in generating our nominal GDP forecast.

3.55 The CPI and RPI measures of inflation are important because they each affect our fiscal forecast. The Government uses the CPI for the indexation of many tax rates, allowances and thresholds, and for the uprating of benefits and public sector pensions. The RPI is used to calculate interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties. The GDP deflator, among other items, feeds into the Government's policy assumption for total public spending growth. The ONS publishes other inflation measures, but these do not currently affect the public finances, so we do not forecast them.

CPI inflation

3.56 CPI inflation was 0.9 per cent in the fourth quarter of 2014, below our December forecast of 1.1 per cent. The lower-than-expected outturn is explained by food and fuel prices.

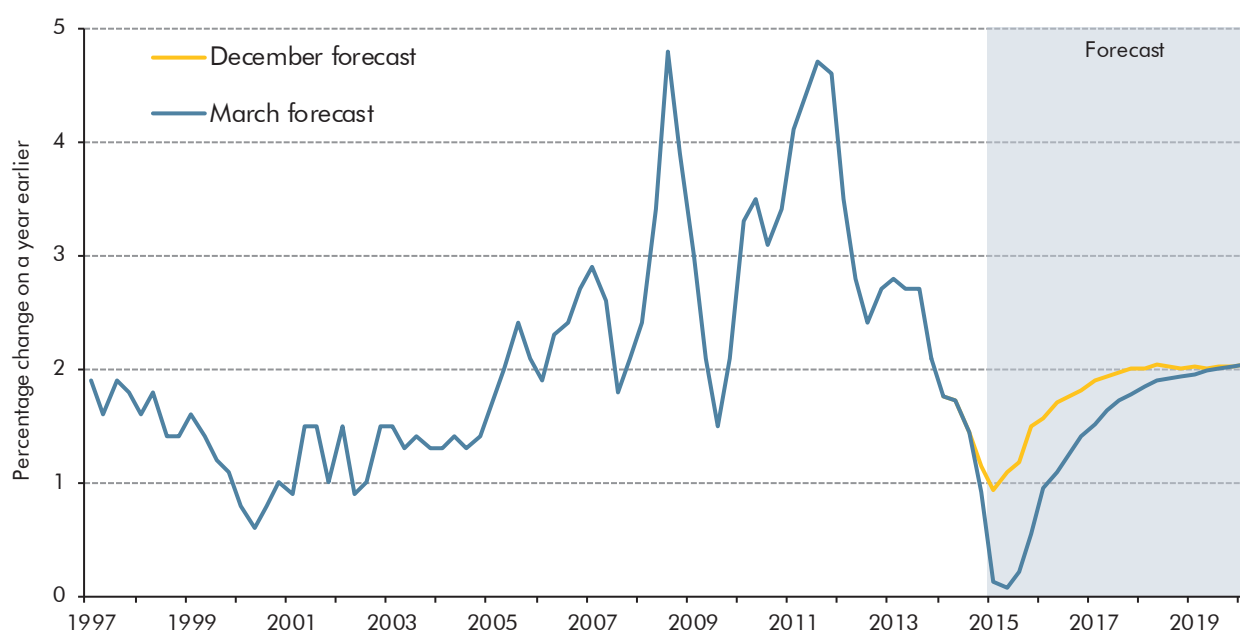
3.57 The most important development since December has been the further sharp fall in oil prices. The assumption for sterling oil prices underpinning our current forecast is 30 per cent lower in the first quarter of 2015 and 17 per cent lower in the medium term than in

December. This reduction has its greatest impact on inflation directly through fuel prices, with the transmission almost immediate. Fuel prices make up 3.4 per cent of the CPI, although a significant proportion of this reflects fuel duty, which is fixed in pence per litre so does not vary with oil prices. Part of the fuel price also represents other costs and margins for fuel retailers. Taking all this into account, the fall in oil prices is expected to subtract 0.3 percentage points from CPI inflation in 2015 through its direct impact on fuel prices. Some of this impact will be unwound later, as the oil futures curve is upward sloping.

- 3.58 Oil prices can also have indirect impacts on inflation through their role as a cost of production for firms – e.g. fuel costs affecting airfares, transport costs affecting the whole supply chain and lower production costs affecting global food commodity prices and subsequently retail food prices. We expect these indirect impacts to take longer to flow through to the CPI and eventually take a further 0.1 percentage points off inflation.
- 3.59 Wholesale gas prices have also fallen, with the average futures curve over the next two years 11 per cent lower than assumed in December. In response to these falls, the ‘big six’ energy firms have announced cuts to retail gas prices ranging from 1.3 to 5.1 per cent. Wholesale costs are thought to make up slightly less than half of utility prices, but energy companies buy wholesale energy up to two years in advance which means that changes in wholesale prices can take time to feed through to retail prices.⁸ The announcements from energy firms take a further 0.1 percentage points off inflation in our forecast. We assume that utility prices will rise more slowly than assumed in December, as the lagged effects of lower wholesale prices partly offset increases in other costs of production.
- 3.60 Other inflation developments have included:
- more downward pressure on food prices, resulting from further falls in global commodity prices and intensification of competition in the food retail sector; and
 - sterling appreciating further, which lowers the cost of import-intensive goods.
- 3.61 The sum of these developments means that we have significantly lowered our forecast for CPI inflation in the near term (Chart 3.20). Inflation is expected to trough at 0.1 per cent in the first half of 2015 (although it may well be negative in some months). It is expected to rise in the second half of 2015, as oil prices are assumed to rise and as spare capacity is used up. The CPI inflation profile jumps up at the start of 2016 as the peak impact of the recent fall in energy prices drops out of the year-on-year calculation.
- 3.62 Inflation is then forecast to return to the 2 per cent target slowly as the effects of the recent sterling appreciation and the indirect effects of the recent falls in commodity prices feed through with lags. The Bank of England is expected to look through the effects of these external influences and inflation is forecast to return to its 2 per cent target during 2019, when these effects have worked their way through.

⁸ OFGEM, *Charts: Outlook for costs that make up energy bills*, February 2015.

Chart 3.20: CPI inflation



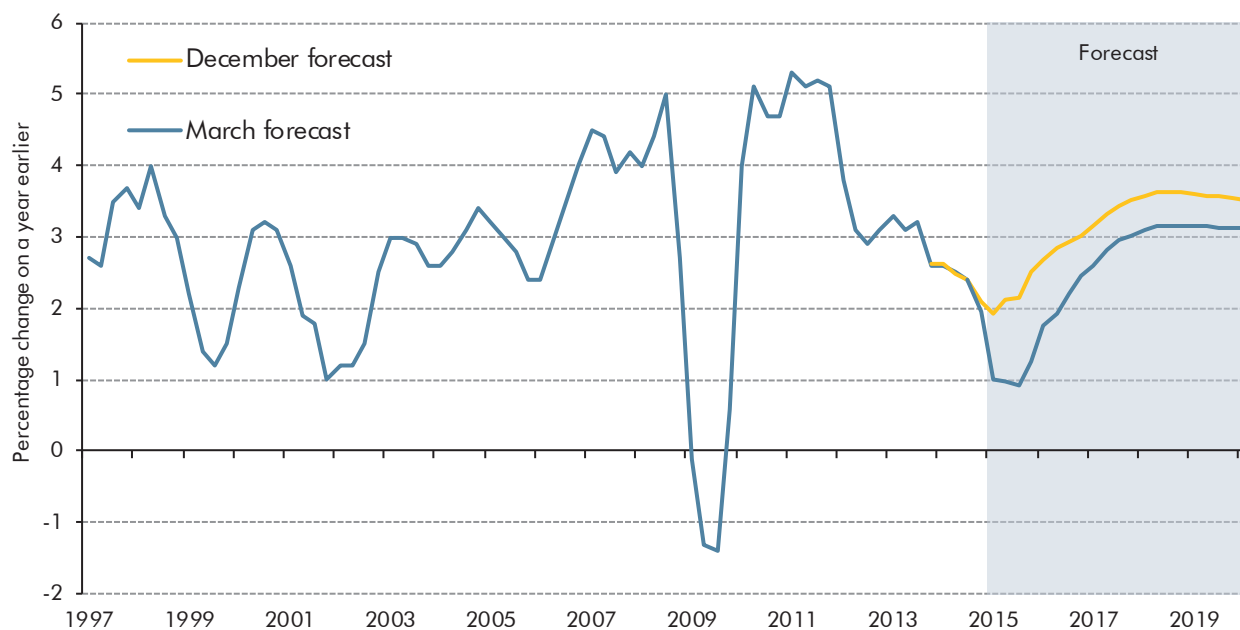
Source: ONS, OBR

RPI inflation

- 3.63** The calculation of RPI inflation in the UK does not meet international statistical standards,⁹ but we continue to forecast RPI as it remains an input in our fiscal forecasts.
- 3.64** RPI inflation was 2.0 per cent in the fourth quarter of 2014, close to our December forecast of 2.1 per cent. The items contributing to the negative CPI surprise were partly offset by higher-than-expected mortgage interest payments (MIPs) inflation, which are not included in the CPI.
- 3.65** In the near term, we expect RPI inflation to fall back for the same reasons as CPI inflation. It is forecast to average 1.0 per cent in the first half of 2015, 1.0 percentage points lower than expected in December. Over 2015, RPI inflation rises in line with CPI inflation before an increase in MIPs pushes RPI inflation slightly above 3 per cent. The rise in MIPs is driven by an increase in mortgage debt as housing market turnover increases back towards its pre-crisis average. Compared to our December forecast, RPI inflation is lower over the whole forecast period, partly because we have lowered our assumption for the long-run wedge between RPI and CPI inflation (Box 3.3).

⁹ ONS, *Response to the National Statistician's consultation on options for improving the Retail Prices Index*, February 2013.

Chart 3.21: RPI inflation



Source: ONS, OBR

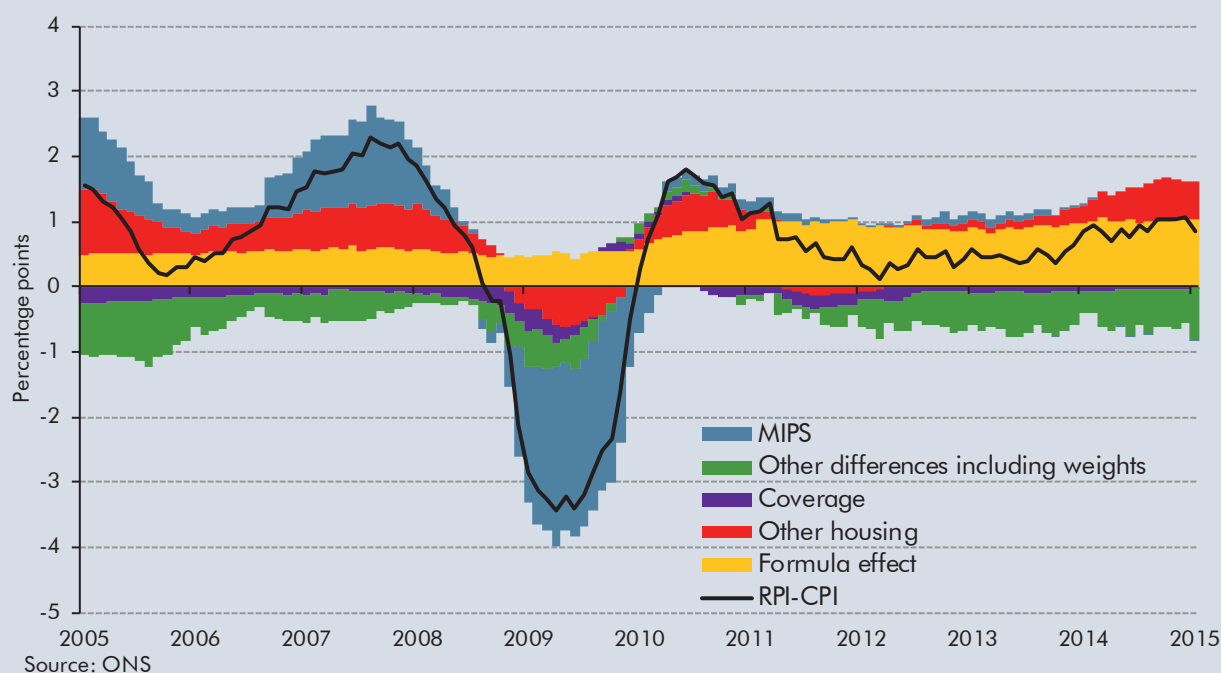
Box 3.3: Revised assumption for the long-run wedge between RPI and CPI inflation

RPI inflation differs from CPI inflation for a number of reasons. The ONS decomposes the wedge between the two measures into the following categories:

- the formula effect – the RPI uses a combination of the ‘Dutot’ and ‘Carli’ methods of aggregating prices at the most basic level, while the CPI uses a combination of the Dutot and ‘Jevons’ methods. Jevons is a geometric averaging technique, Dutot is an internationally accepted arithmetic average, but Carli is an arithmetic average that does not meet international standards since it tends to inject spurious inflation into the index. Since the RPI uses Carli it generally overstates inflation;
- housing – the RPI includes a number of housing components that the CPI does not, including depreciation, council tax and mortgage interest payments;
- other differences in coverage – certain items are included in one index but not the other, for example the CPI includes overseas student tuition fees but the RPI does not and the RPI contains vehicle excise duty but the CPI does not; and
- other differences including weights – different data sources and population bases mean other components have different weights.

Chart A illustrates how these different factors have contributed to the wedge between RPI and CPI inflation since 2005, when the ONS switched to its preferred methodology for measuring the wedge, with some factors fluctuating significantly while others have been reasonably constant.

Chart A: Contributions to the RPI-CPI inflation wedge



The OBR first published an estimate of the long-run wedge between RPI and CPI inflation in a 2011 working paper.^a Since then, the ONS has begun producing RPIJ, which recalculates the RPI by replacing the Carli averaging method with Jevons. We have also had more time to assess the impact of the 2010 change in the calculation of clothing prices, which has increased the size of the formula effect.^b On the basis of the latest evidence, we have revised down our estimate of the long-run wedge between RPI and CPI inflation.

Table A sets out the estimated components of the wedge from our 2011 working paper and our updated estimates, as well as comparing them to the averages since 2005 (when the ONS moved to the preferred methodology for measuring the wedge) and since 2010 (when the ONS changed the collection of clothing prices). It shows that:

- we have kept the **formula effect** unchanged at 0.9 percentage points, in line with the average since 2010, when the method of collecting clothing prices was changed;
- we have slightly lowered our estimate of the **housing effect**. We still expect mortgage interest payments and housing depreciation to grow in line with average earnings, but we have reduced our long-run average earnings projection from 4.7 to 4.4 per cent. We now expect council tax to grow in line with CPI inflation of 2 per cent, as in our fiscal forecast, compared to the 3 per cent assumption in 2011, which was based on the historical average growth rate;
- we still expect **other differences in coverage** to contribute nothing to the wedge in steady state; and
- we have revised down the contribution of **other differences including weights** from zero (as assumed in our 2011 paper) to -0.4 percentage points. The ONS calculates this series as a residual so it will pick up differences in weights other than housing as well as any

interactions between categories. Since 2010, when the method of collecting clothing prices was changed, this component has averaged a -0.4 percentage point contribution to the wedge. This is despite a bottom-up estimate of the difference in weights at the item level (the approach that underpinned our 2011 estimate), suggesting an effect of zero. We believe that part of this difference represents interactions between categories, in particular between the formula and weights effects. This is demonstrated by the gap between RPI and RPIJ (the formula effect using RPI weights), which has averaged 0.6 percentage points since 2010, whereas the published ONS formula effect (the formula effect calculated using CPI weights) remains around 0.9 percentage points. We assume that the average contribution from this category since 2010 will persist.

Summing the contributions gives our new estimate of the long-run wedge between RPI and CPI inflation of 1.0 percentage points. This is lower than our 2011 estimate of 1.4 percentage points. It is also lower than the Bank of England's estimate of 1.3 percentage points. But it is in line with what market participants told the Bank was built into the price of inflation breakevens.^c

Table A: Long-run assumption for the RPI-CPI inflation wedge

	Percentage points contributions, unless otherwise stated				Total
	Formula effect	Housing	Coverage	Weights	
Bank of England	0.9	0.6	-0.1 ¹	-0.1 ¹	1.3
2005-current average	0.7	0.3	-0.1	-0.4	0.5
2010-current average	0.9	0.3	-0.1	-0.4	0.7
2011 Working paper	0.9	0.5	0.0	0.0	1.4
New value	0.9	0.5	0.0	-0.4	1.0
Change	0.0	-0.1	0.0	-0.4	-0.4

¹The Bank of England assumes a combined coverage and weights contribution of -0.2 percentage points. We have split this evenly between the two categories.

Note: Components may not sum to total due to rounding.

^a Miller (2011) *Working Paper No. 2: The long-run difference between RPI and CPI inflation*.

^b More information can be found in the ONS information note, *CPI and RPI: the increased impact of the formula effect in 2010*, January 2011.

^c For more detail see page 34 of the Bank of England's *Inflation Report*, February 2014: 'The long-run RPI-CPI wedge'.

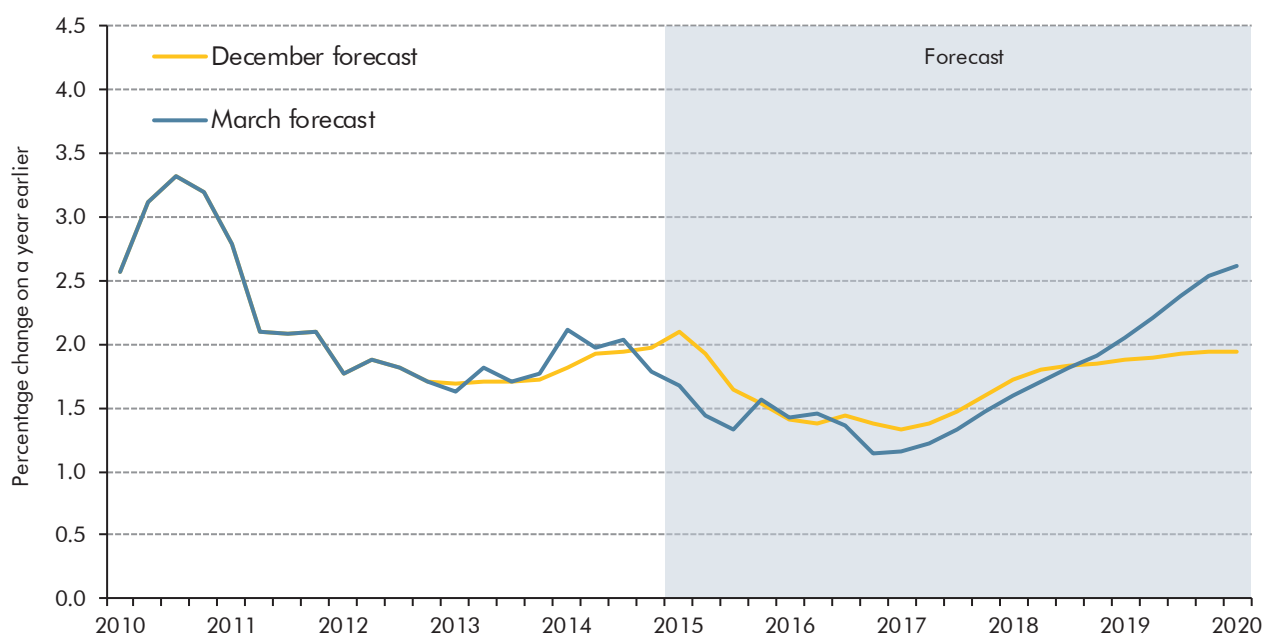
The GDP deflator

- 3.66** GDP deflator growth is the broadest measure of inflation in the domestic economy. It measures changes in prices of the goods and services that make up GDP, including price movements in private and government consumption, investment and the relative price of exports and imports – the terms of trade. The GDP deflator plays an important role in our fiscal forecast through its role in the Government's chosen public spending assumption, described in Chapter 4.
- 3.67** Our forecast for the GDP deflator has been revised down in the near term as lower private consumption and housing investment prices are only partly offset by a stronger terms of trade (Chart 3.22). The lower consumption deflator is due to revisions to our CPI forecast while lower housing investment prices reflect lower house price growth. The stronger terms of trade partly reflects the fact that the UK is a net importer of oil, the price of which has

fallen significantly. (The oil trade balance moved from surplus to deficit in 2003.) The net impact of the fall in oil prices on the GDP deflator is small as most of the consumption price impact comes from imported products, leaving only a fall in the price of exported oil to affect the GDP deflator. An alternative way to think about this is that the GDP deflator only reflects the price of goods and services produced in the UK and the share of oil production in UK GDP is fairly small, hence the small fall resulting from lower oil prices.

- 3.68 Medium-term GDP deflator growth is then stronger than our December forecast, thanks to higher growth in the price of government consumption, reflecting a smaller squeeze on such spending implied by the Government's medium-term spending assumption, particularly at the end of the forecast period. Higher growth in housing investment prices, reflecting stronger house price growth, also contributes.

Chart 3.22: GDP deflator



Source: ONS, OBR

Prospects for nominal GDP growth

- 3.69 Most public discussion of economic forecasts focuses on real GDP – the volume of goods and services produced in the economy. But the nominal or cash value of GDP – and its composition by income and expenditure – is more important in understanding the behaviour of the public finances. Taxes are driven more by nominal than real GDP. So too is the share of GDP devoted to public spending, as a large proportion of that spending is set out in multi-year cash plans (public services and administration) or linked to measures of inflation (benefits, tax credits and interest on index-linked gilts).
- 3.70 The latest ONS data indicate that nominal GDP grew by 4.4 per cent in 2014, weaker than the 5.0 per cent we expected in December. Most of this difference reflects ONS revisions to the first three quarters of 2014, which implied a somewhat weaker path for nominal

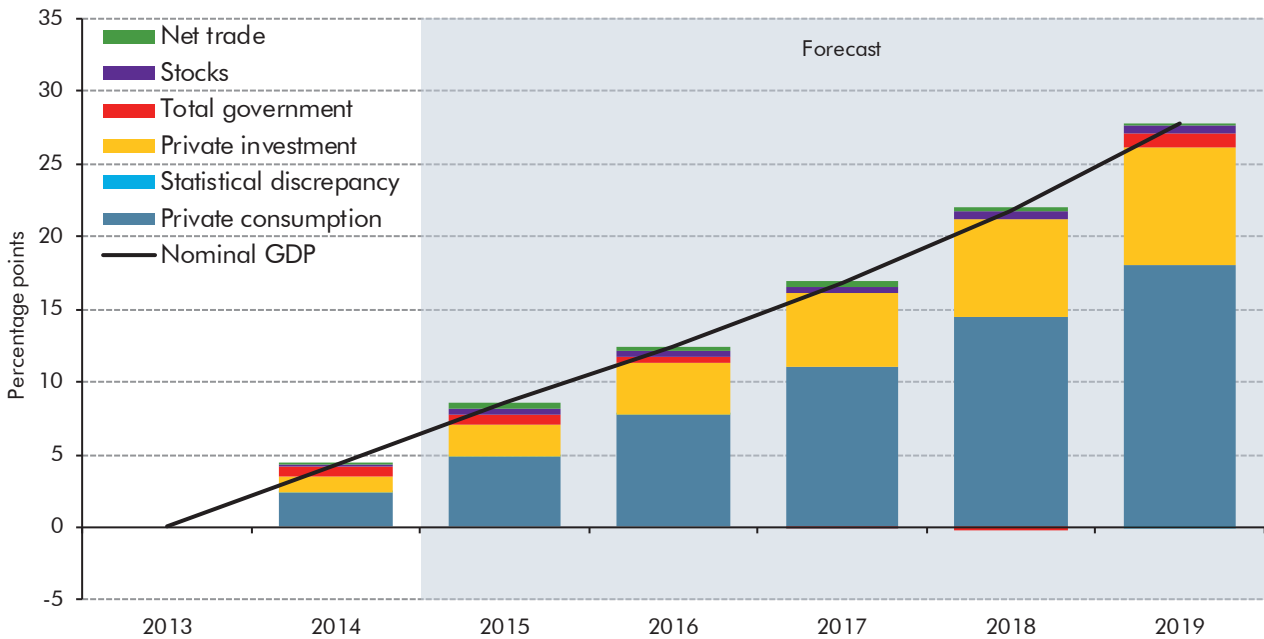
government spending and private consumption, and a stronger path for imports than earlier estimates (see Chapter 2). The latest estimates indicate nominal GDP growth of 0.4 per cent in the fourth quarter, around 0.2 percentage points weaker than we expected in December. The high-level breakdown published so far suggests that the additional weakness of nominal GDP growth in the fourth quarter has been concentrated in stocks and investment on the expenditure side, and profits on the income side.

3.71 We forecast that nominal GDP will grow by 4.1 per cent in 2015, falling back to 3.5 per cent in 2016 as calendar-year real GDP growth slows. We then expect growth of 3.8 per cent in 2017, picking up to 5.0 per cent by 2019 as temporary downward influences – notably the effect of fiscal consolidation on government consumption prices – ease. Overall, cumulative nominal GDP growth between the third quarter of 2014 and the start of 2020 is 1.9 percentage points higher than in our December forecast (25.5 per cent versus 23.6 per cent). Around 0.4 percentage points of this reflects an upward revision to our forecast of real GDP growth, with cumulative growth in the GDP deflator accounting for the rest.

Expenditure

3.72 Chart 3.23 sets out our forecast for cumulative nominal GDP growth by expenditure component. As the largest component of demand, private consumption is expected to be the biggest contributor over the forecast period. However, given the relatively slow growth of disposable incomes, we expect the share of consumption in nominal GDP to remain broadly stable over the forecast period. Private investment is expected to make a growing contribution to nominal GDP growth, as is typical during a recovery, with its share of nominal GDP increasing from just under 15 per cent in 2014 to just over 17 per cent in 2019. This offsets a fall in the contribution of government consumption and investment, which drops from around 22 per cent of nominal GDP in 2014 to just over 18 per cent by 2019. Prospects for individual sectors are set out in more detail later in this chapter.

Chart 3.23: Contributions to cumulative nominal GDP growth: expenditure

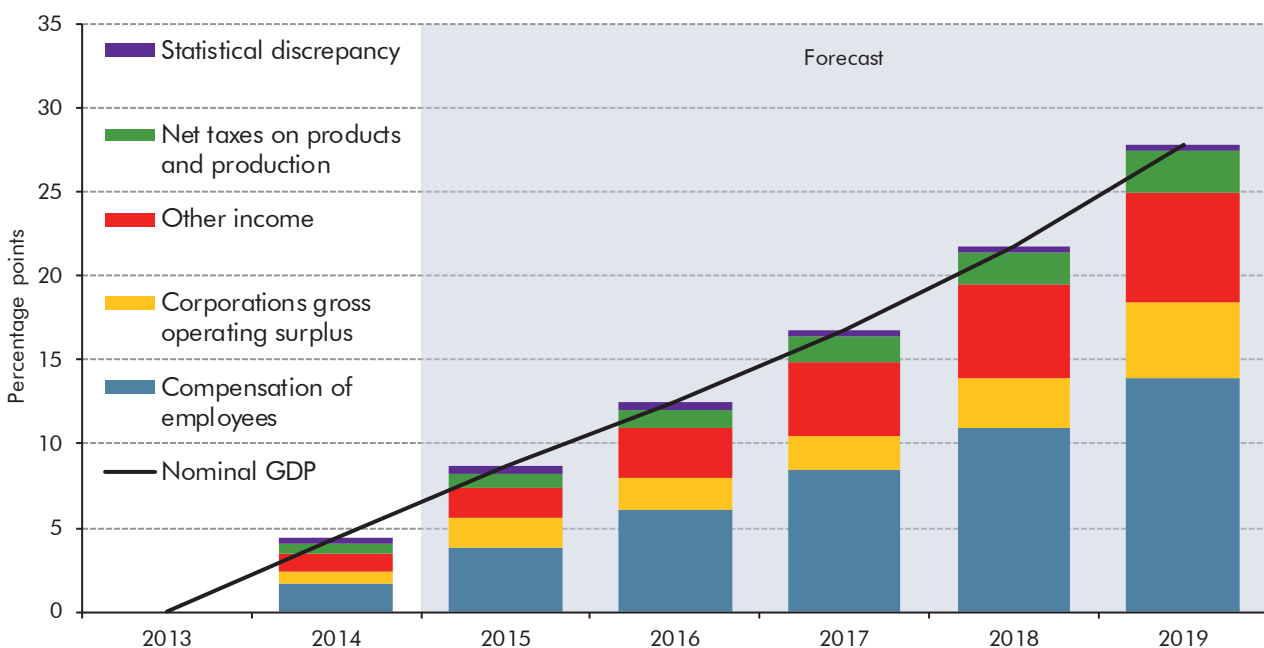


Source: ONS, OBR

Income

3.73 Chart 3.24 shows the contribution of different sources of income to cumulative growth in nominal GDP between 2014 and 2019. As the output gap closes, we expect profit margins to recover, with profit growth slightly outpacing nominal GDP growth in the near term. With real earnings forecast to grow in line with productivity, the share of labour income in nominal GDP is expected to remain broadly stable from 2015.

Chart 3.24: Contributions to cumulative nominal GDP growth: income



Source: ONS, OBR

Prospects for individual sectors of the economy

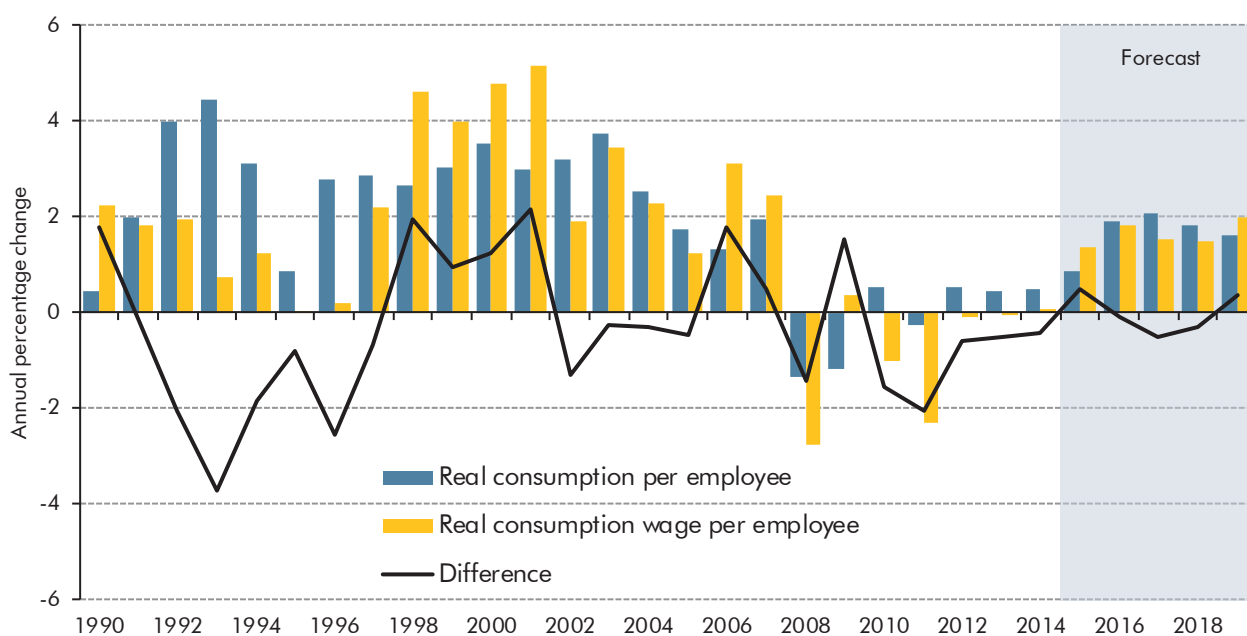
The household sector

3.74 The household sector is the largest source of income and spending in the economy, with consumer spending making up 65 per cent of nominal GDP by expenditure and household disposable income making up 66 per cent of nominal GDP by income in 2013.

Real consumer spending

3.75 Consumption growth slowed to 0.3 per cent in the final quarter of 2014, which implies that it grew by a cumulative 2.0 per cent in real terms through 2014 (Chart 3.25). This was despite little growth in real wages. The real consumption wage per employee is estimated to have been broadly flat in 2014, slightly stronger than we expected in December.

Chart 3.25: Real consumption wage and real consumption



Source: ONS,OBR

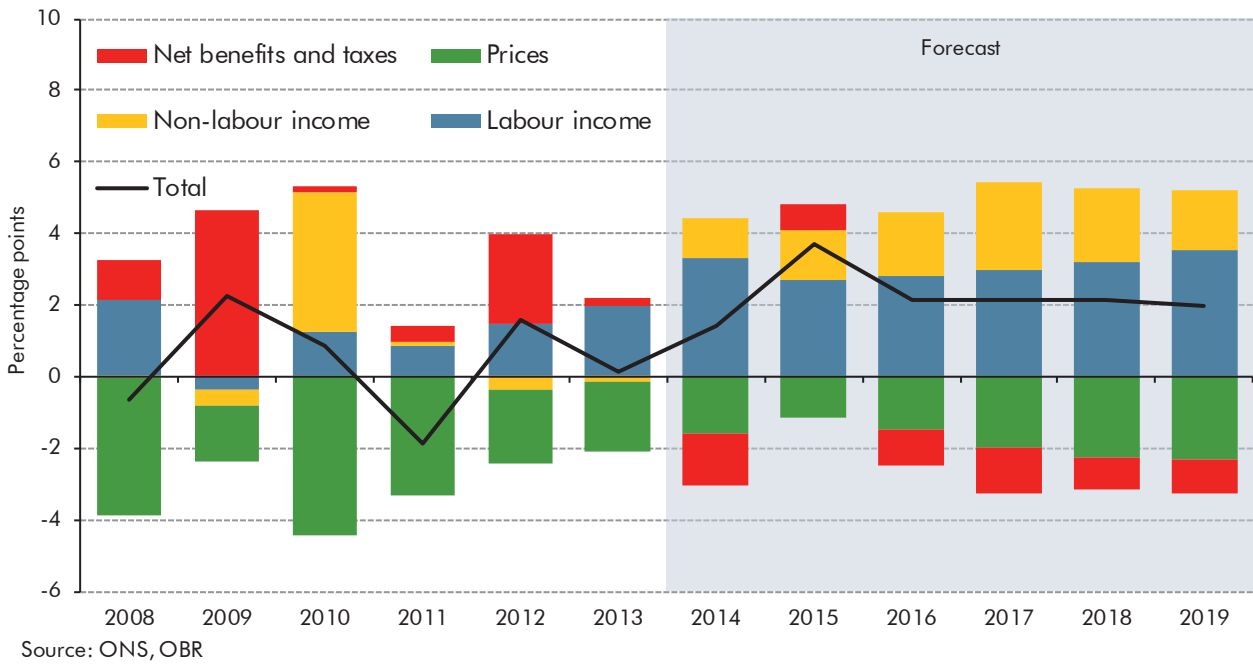
The labour market and household income

3.76 The unemployment rate has fallen steadily over recent quarters, reaching 5.7 per cent in the final quarter of 2014. We expect the rate of decline to ease over coming quarters as GDP growth slows and productivity growth picks up, allowing firms to expand output through their existing workforce rather than through recruitment. But the recovery in productivity per worker is likely to be gradual, and we expect sufficient momentum in the labour market for the unemployment rate to drop below its equilibrium level from mid-2015. A small gap is expected to remain until the start of 2018, as productivity growth takes time to fill the slack. The broad picture is similar to our December forecast, but we now forecast that, within productivity per worker, average hours will be somewhat firmer over the near term and hourly productivity growth slightly weaker.

- 3.77 The Labour Force Survey (LFS) measure of unemployment has fallen in line with our recent expectations, but the claimant count has fallen further relative to both the LFS measure and our December forecast. This mainly reflects a drop in the rate of inflows, although a rise in the rate of outflows has also played a role. The disproportionate decline in the claimant count could be due to some features of the benefit system, including a tightening of the JSA sanctions regime relative to other benefits and tax credits. But it is difficult to isolate the importance of such factors against more general labour market developments.¹⁰ We expect the claimant count to fall even further relative to the LFS measure, but that both measures will be broadly stable from the beginning of 2016.
- 3.78 The National Accounts measure of wages and salaries is currently stronger than would be implied by multiplying employee numbers in the LFS by the average weekly earnings (AWE) measure of earnings. This means that the measure of average earnings growth we forecast – based on the National Accounts – has been stronger than the headline AWE measure, rising by an estimated 2.2 per cent in 2014, relative to 1.2 per cent growth in the AWE. The National Accounts uses AWE data (until administrative tax data become available), so in principle the two should be consistent and we expect this gap to unwind in 2015. But one consequence is that our forecast measure is essentially flat across the two years, masking some underlying momentum in earnings.
- 3.79 We expect real earnings growth to rise in the near term as inflation continues to fall and nominal earnings pick up, and over the medium term as productivity growth returns to more normal levels. This implies that the real consumption wage will not rise above its pre-crisis peak in the third quarter of 2007 until the end of 2018.
- 3.80 Over the forecast period, we expect labour income to be the largest contributor to growth in real household disposable income, although to a lesser extent than in the pre-crisis period given weaker productivity growth. We also expect non-labour income growth to pick up, helped by a cyclical recovery in corporate profits supporting dividend income. Lower inflation over the near term will also support real income growth. The result is real household disposable income growth of 3.7 per cent in 2015, and around 2 per cent thereafter, as inflation returns to target and productivity growth picks up.

¹⁰ See Box 8.1 of our 2014 *Welfare trends report* for a fuller discussion.

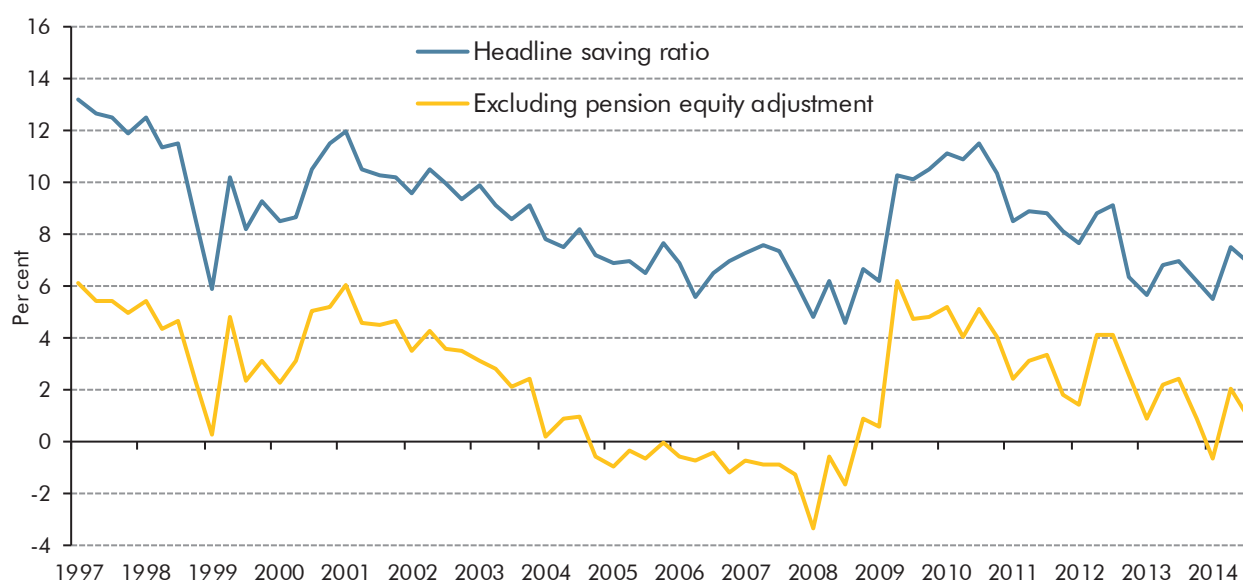
Chart 3.26: Contributions to real household income growth



The saving ratio

3.81 The headline saving ratio fell back sharply between 2012 and 2013, supporting a pick-up in household consumption despite ongoing weakness in household income growth. Since then, the household saving ratio has stabilised, averaging around 6½ per cent in 2013 and 2014. Nominal household consumption has continued to grow more strongly than household disposable income (with the former growing by around 6½ per cent and the latter by just over 5 per cent between the final quarter of 2012 and the third quarter of 2014), but this has been offset by an increase in measured pension saving. If the adjustment for pension saving is excluded, then the saving ratio continued to decline in 2013 and 2014 (Chart 3.27).

Chart 3.27: The household saving ratio



Note: Estimate of the saving ratio excluding the pension equity adjustment calculated as household disposable income less consumption, as a proportion of household disposable income.

Source: ONS, OBR

3.82 With real household disposable income expected to outstrip real consumption over the near term, we expect the saving ratio to pick up slightly in 2015. Thereafter we expect it to remain broadly stable, with consumption growing in line with household incomes. The starting level of the saving ratio is higher than in our December forecast, reflecting the strength of pension saving in the latest data. But from 2015 this is partly offset by a weaker outlook for the *growth* of pension saving, which reflects the direct effect of the fall in gilt yields on investment income.¹¹

The housing market and dwellings investment

3.83 House price inflation has eased more quickly than we expected in December, with year-on-year growth of 10.0 per cent in the fourth quarter of 2014, 0.8 percentage points lower than expected (Chart 3.28). Housing market indicators suggest price growth will continue to slow in coming quarters, so we have lowered our near-term house price forecast. But the fundamental factors that drive our house price model thereafter suggest stronger price growth than in December, which has fed through to a higher medium-term forecast.¹²

3.84 Relative to our December forecast, there is additional upward pressure on prices from the demand fundamentals with little change in expectations for supply. The additional housing demand mainly comes from stronger real income per household, partly as a result of the recent falls in energy prices, with a partial offset from higher mortgage interest rates over most of the forecast period. The level of house prices in the first quarter of 2020 is 3.9 per cent higher than in our December forecast. Overall, house prices are expected to rise by

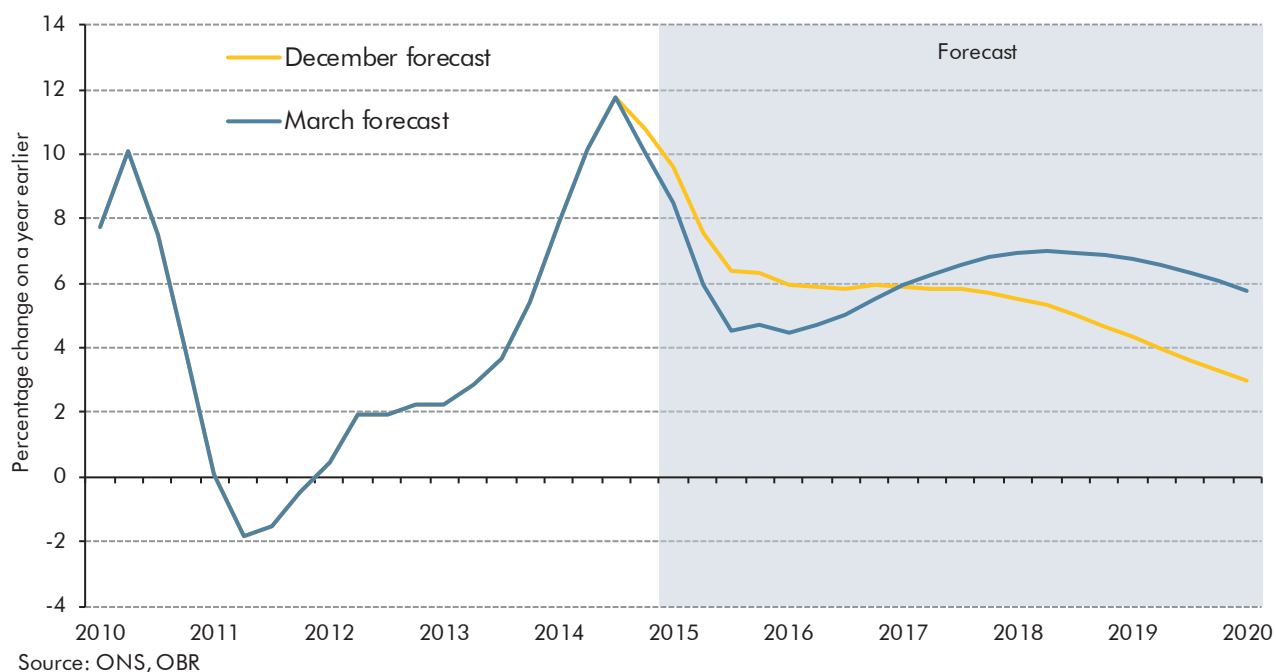
¹¹ Following changes to the treatment of pension saving in Blue Book 2014, investment income is now calculated as opening pension liabilities multiplied by the yield on 15 year gilts. See ONS, *Changes to National Accounts: The Impact of the Changes to the Treatment of Pensions in the National Accounts*, September 2014.

¹² For more information on our house price model see Auterson (2014): *Working paper No. 6: Forecasting house prices*.

35.5 per cent by the first quarter of 2020. Relative to their pre-crisis peaks in 2007, real house prices at the end of the forecast are expected to be 14.4 per cent higher and the ratio of house prices to average earnings 11.2 per cent higher.

3.85 There is a risk that the greater flexibility over people’s access to their pension assets, announced in Budget 2014 and due to come into effect in April 2015, could affect the housing market. As we explained in Box 3.1 of the December 2014 *EFO*, we have not adjusted our forecast as we assume that there will be offsetting effects from the flows associated with this policy change, but the effects are highly uncertain and, in reality, are unlikely to net off precisely.

Chart 3.28: House price inflation forecast



3.86 We have revised down our near-term residential property transactions forecast again as the latest data have been below our December forecast and mortgage approvals remain subdued. Among other factors, it appears that the Mortgage Market Review regulations on lending have had a larger and more persistent effect than we had assumed. We have also revised down our medium-term transaction forecasts. We assume that the volume of transactions returns towards its historical average as a percentage of the housing stock over the forecast period. Previously the period over which we took the average was 1991 to 2007. We have now excluded the period from 2004 to 2007 – the height of the pre-crisis boom – as a guide to medium-term turnover rates. This has reduced the turnover rate we use to anchor our medium-term forecast (Chart 3.29).

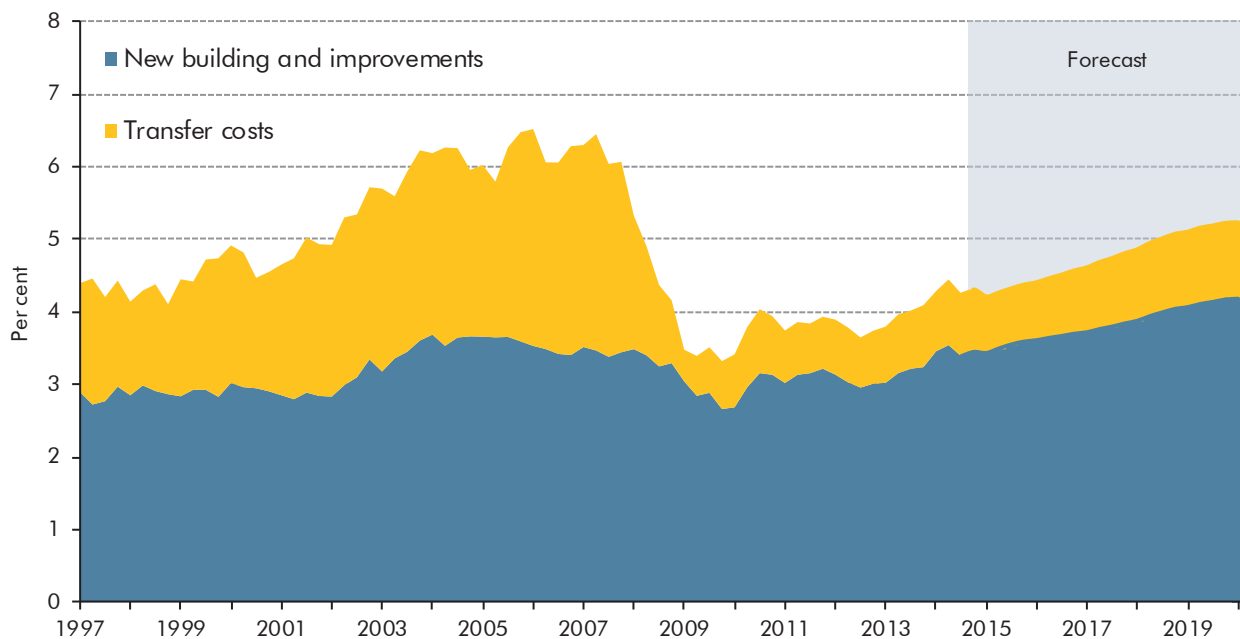
Chart 3.29: Quarterly residential property turnover rate



Source: ONS, OBR

3.87 In line with our forecasts for house prices and property transactions, we expect relatively strong growth in residential investment over the forecast period. Near-term growth in housebuilding is encouraged by recent strong growth in house prices, while medium-term strength is motivated by housing market turnover returning towards its historical average. But, despite relatively strong rates of growth in the forecast, total private residential investment as a share of GDP is expected to remain below its pre-crisis peak throughout the forecast period (Chart 3.30).

Chart 3.30: Residential investment as a share of nominal GDP

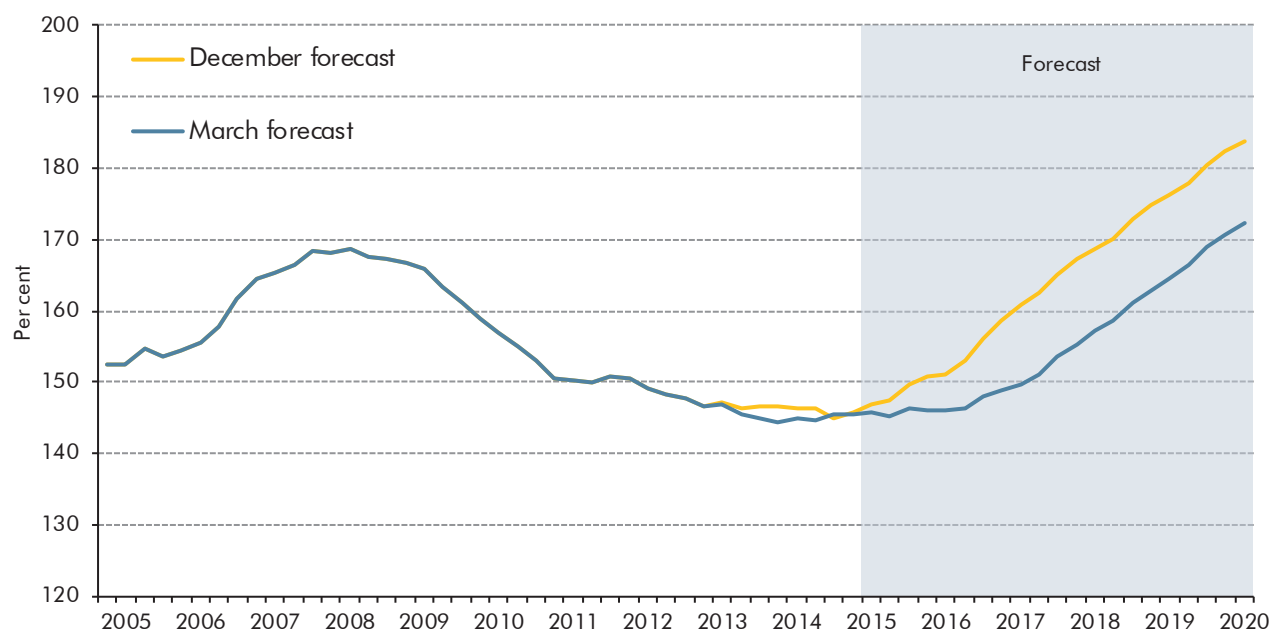


Source: ONS, OBR

Net lending and the balance sheet

- 3.88 The saving ratio is expected to fall back slightly between 2015 and 2019. Taken together with strong growth in household investment, this will push households' overall net lending position – total income less total spending – into deficit. In an accounting sense, this, together with a gradual improvement in the current account and a decline in corporate net lending, provides the offset to the Government's fiscal consolidation (Chart 3.39).
- 3.89 With household net lending negative and relatively strong house price growth driving mortgage borrowing, the ratio of households' gross debt to income is projected to rise again from 2015, having fallen steadily since 2008 (Chart 3.31). Of the 27 percentage point increase in the ratio over the forecast period, around 16 percentage points reflect an increase in secured debt. The remainder reflects higher unsecured debt relative to income, which in turn reflects the deterioration in households' net balance to an historically large deficit over the forecast period.
- 3.90 The gross household debt to income ratio has been revised down since our December forecast. This reflects a number of factors:
- in cash terms, the level of gross debt is expected to be £144 billion lower by the start of 2020 than we forecast in December, of which £14 billion reflects a lower starting point;
 - around £47 billion of this reflects a lower path for secured debt – which in turn reflects lower growth in property transactions;
 - around £83 billion reflects less accumulation of unsecured debt – as we have revised down household investment and consumption. We have also factored in an ongoing reduction in households' outstanding unsecured debt through write-offs, which had not been incorporated in our previous forecasts; and
 - the level of household disposable income at the end of the forecast is expected to be around 1 per cent higher than expected in our December forecast.

Chart 3.31: Household gross debt to income



Source: ONS, OBR

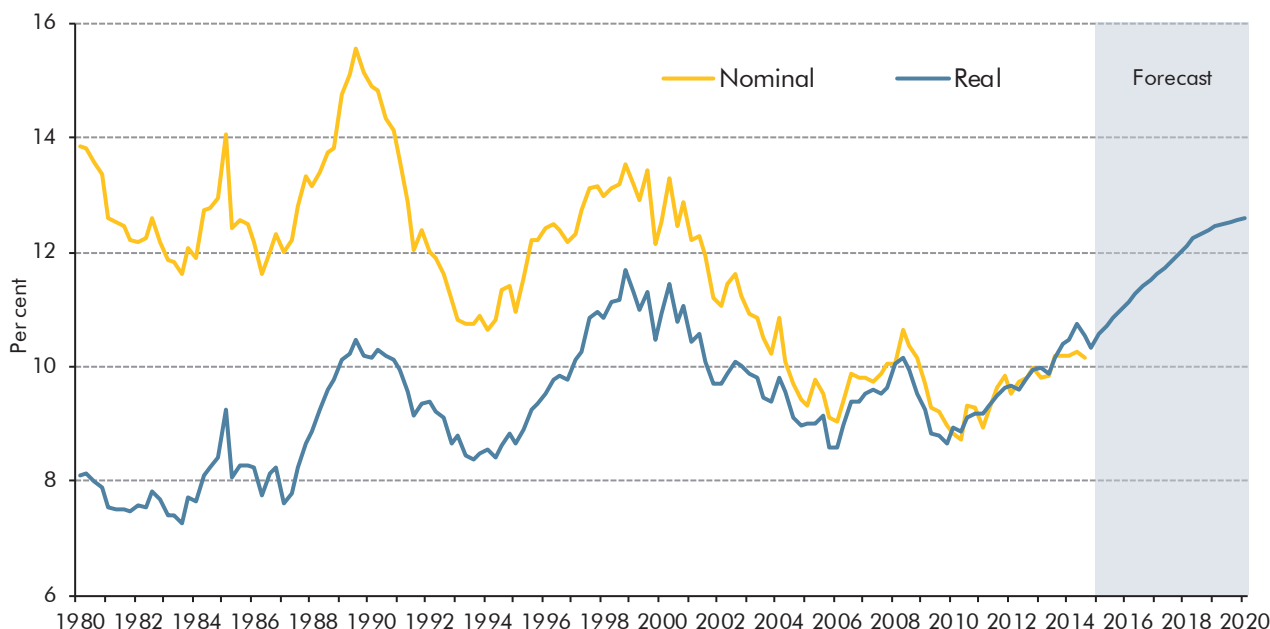
The corporate sector

Business investment and stockbuilding

- 3.91** The latest data show that business investment fell by 1.4 per cent in the fourth quarter of 2014 after a 1.2 per cent fall in the third quarter. Despite that, business investment is estimated to have increased by 6.8 per cent in 2014 as a whole. We expect business investment to continue to grow relatively strongly in 2015, albeit at a slower rate than we forecast in December. Business investment growth has been revised up between 2016 and 2018, but is lower in 2019 than we forecast in December.
- 3.92** The weight of activity in the North Sea in whole economy investment is much higher (above 7 per cent) than its weight in GDP (less than 2 per cent), in part due to the unusually high North Sea investment of recent years. We therefore expect the boost to onshore investment from lower energy costs to be more than offset by the direct effect of lower investment in the North Sea. (Prospects for investment in the North Sea are covered in more detail in Chapter 4.) As usual, the latest ONS data are subject to potentially large revisions, so our forecast is subject to considerable uncertainty. The Bank of England's *Agents' Summary* reports investment intentions consistent with modest growth over the next twelve months, although investment intentions have eased since our December forecast.
- 3.93** As Chart 3.32 shows, our forecast implies real business investment rising as a share of GDP, as typically occurs during the later stages of a recovery. It also shows how the nominal share has tended to fall relative to the real share because investment goods price inflation has tended to be lower than whole economy inflation.

3.94 The latest ONS data indicate that stocks contributed 0.2 percentage points to GDP growth in 2014. We expect inventories to make a contribution to GDP growth of 0.1 percentage points in 2015 and assume they will be neutral from 2016.

Chart 3.32: Business investment as a share of GDP



Source: ONS, OBR

Corporate profits

3.95 Non-oil, non-financial company profits are forecast to grow more quickly than GDP in 2014 and 2015 as the output gap continues to narrow. Relative to our December forecast, we have revised down profit growth in 2015, in line with the downward revision to our forecast of nominal GDP growth and latest outturns. From 2016 we expect profits to grow broadly in line with nominal GDP.

The government sector

3.96 Total public spending amounted to 41.7 per cent of GDP in 2013-14.¹³ But not all government spending contributes directly to GDP. Spending on welfare payments and debt interest, for example, merely transfers income from some individuals to others. The government sector contributes directly to GDP via consumption of goods and services, and investment. These together accounted for 22.4 per cent of GDP in 2013-14.

Real government consumption

3.97 Real government consumption is estimated to have grown by 1.5 per cent in 2014, compared with estimated growth of 1.1 per cent at the time of our December forecast, and is forecast to grow by 0.8 per cent in 2015, having been forecast to fall in our December forecast. Our government consumption forecast is similar to December between 2016 and

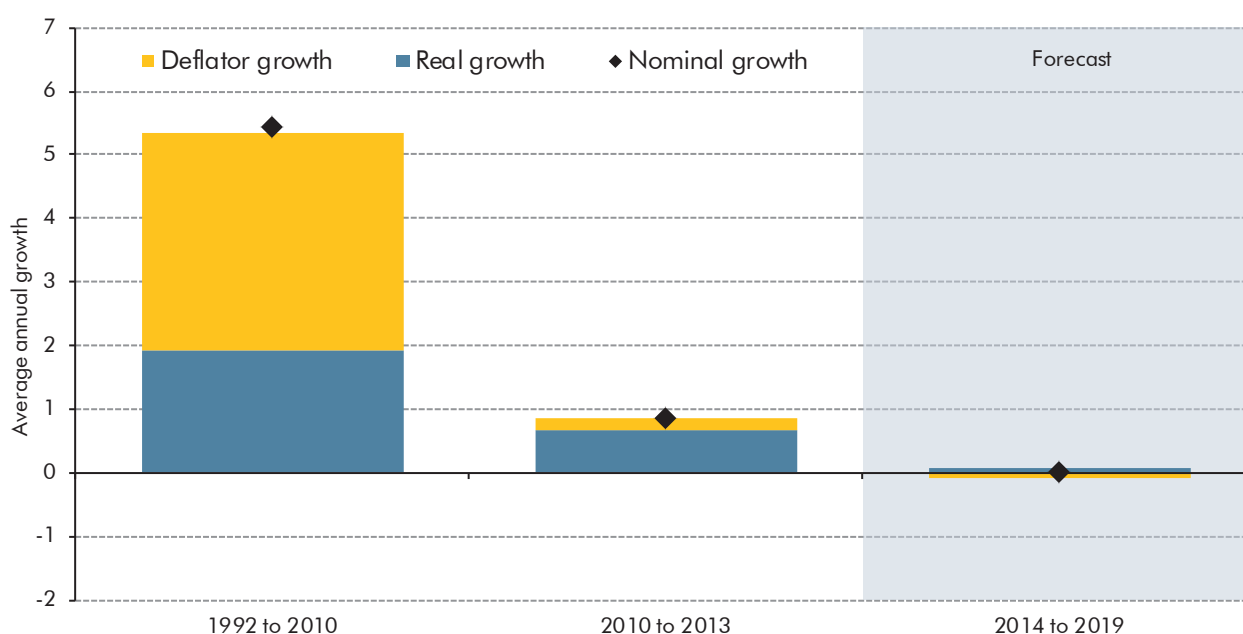
¹³ Total managed expenditure (TME).

2018, but has been revised up significantly in 2019, reflecting the Government's decision to change the assumption it applies to total spending in that year.

Nominal government consumption

3.98 Growth in the implied price of government consumption – the ratio of nominal spending to real government consumption – has been subdued as cash spending growth has slowed. The government consumption deflator is not expected to fall to the same extent as in our December forecast (Chart 3.33). The upward revision in 2019 is especially large, with the Government having decided to change its total spending assumption in that year, so that the government consumption deflator rises by 3.5 per cent in 2019. It was flat in December. This change adds around 0.6 percentage points to growth in the GDP deflator and nominal GDP in that year.

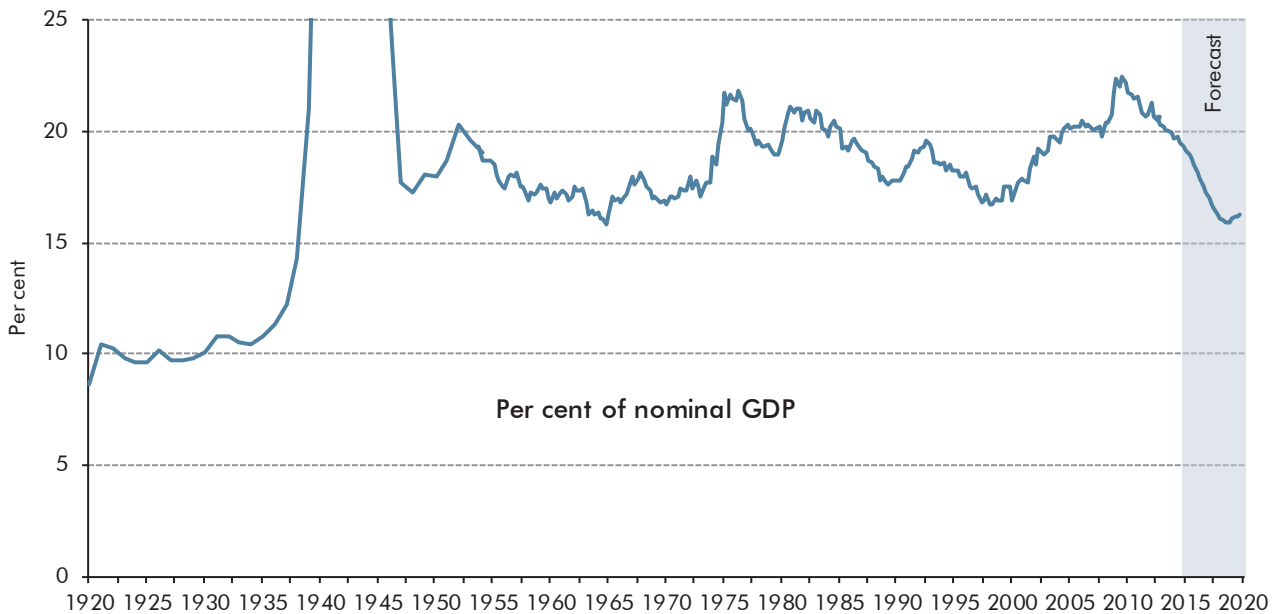
Chart 3.33: Government consumption



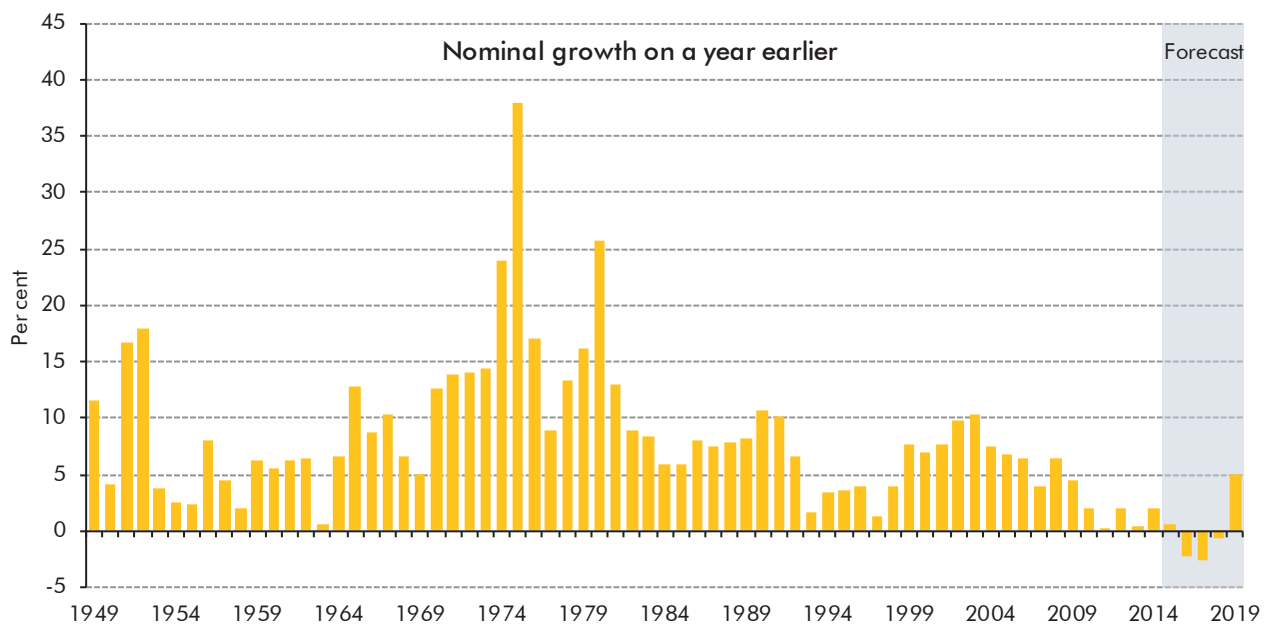
Source: ONS, OBR

3.99 Relative to the size of the economy, nominal government consumption is forecast to fall from 19.7 per cent of GDP in 2014 to 16.1 per cent of GDP by 2019. This is less of a fall than we forecast in December, but would still leave government consumption as a share of GDP equal to its level in 1964 and would be the joint lowest level in consistent National Accounts data going back to 1948. On a quarterly basis, government consumption falls to 15.9 per cent of GDP at the end of 2018. This is marginally above its previous low of 15.8 per cent, again in 1964. Chart 3.34 also shows pre-war estimates taken from the Bank of England's historical dataset.

Chart 3.34: Government consumption of goods and services



Note: Government consumption as a share of GDP is estimated to have peaked at 52.2 per cent of GDP in 1944.



Note: Government consumption on a National Accounts basis, excluding Network Rail
Source: ONS, OBR

General government employment

3.100 In the absence of specific workforce plans, we project general government employment based on some simple and transparent assumptions. We begin by taking our forecasts of government spending on total pay – the paybill, which we proxy using a measure of current government expenditure. We then combine these top-down numbers with our forecasts of government wage growth to derive paybill per head. From this we derive a projection of general government employment – headcount. In reaching a judgement on general government wage growth, we take into account stated government policy (such as pay freezes), historical rates of pay drift and recent data. Reflecting the uncertain timing of

employment cuts and wage changes, we simply assume that the profile of government employment will match the profile of government consumption, which largely comprises pay and procurement costs.

3.101 Applying the Government's latest medium-term spending assumptions to our fiscal forecast implies an unusual year-to-year profile for government employment. Overall, our government consumption forecast implies that general government employment will fall by 0.8 million by the first quarter of 2019, making a total fall from early 2011 of 1.1 million, before rising by 150,000 in the final year of the forecast period. This represents an overall 20 per cent fall in headcount, consistent with departmental and local authorities' cash spending remaining broadly flat, and modest annual wage growth. Again, we expect the fall to be more than offset by a 1.7 million rise in market sector employment, making a rise in total employment of 1.1 million by the start of 2020.¹⁴ Even more than usual, we would emphasise the stylised nature of the assumptions underpinning these numbers, which imply sharp falls in general government employment in 2016-17 and 2017-18 but also a rise in 2019-20. If, when detailed spending plans are set by a future Government, any of the simplifying assumptions described above did not hold (as will inevitably be the case) the scale and profile of these reductions would be expected to change.

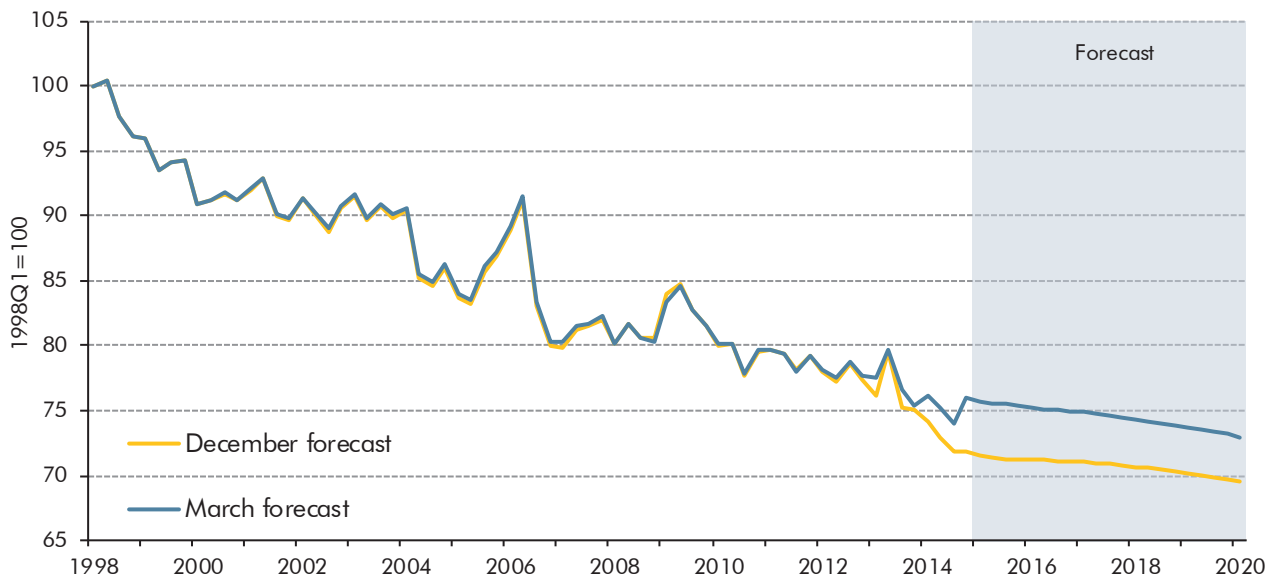
The external sector

Export and import volumes

3.102 The latest ONS data contained upward revisions to export growth in 2014 relative to our December forecast. Strong growth in exports in the fourth quarter of 2014 also means that our forecast for exports has been revised up substantially in 2015. Given that we have lowered our forecast for growth in UK export markets in 2015, this implies a higher export market share (Chart 3.35). Lower expected growth in UK export markets is expected to feed through to lower growth in exports from 2016 onwards, which means that the declining path for the UK export market share is similar to our December forecast.

¹⁴ These estimates exclude a classification change introduced in the second quarter of 2012, which moved around 196,000 employees from the public to the private sector. Further details about the assumptions for public sector wages and employment can be found in the supplementary economy tables available on our website.

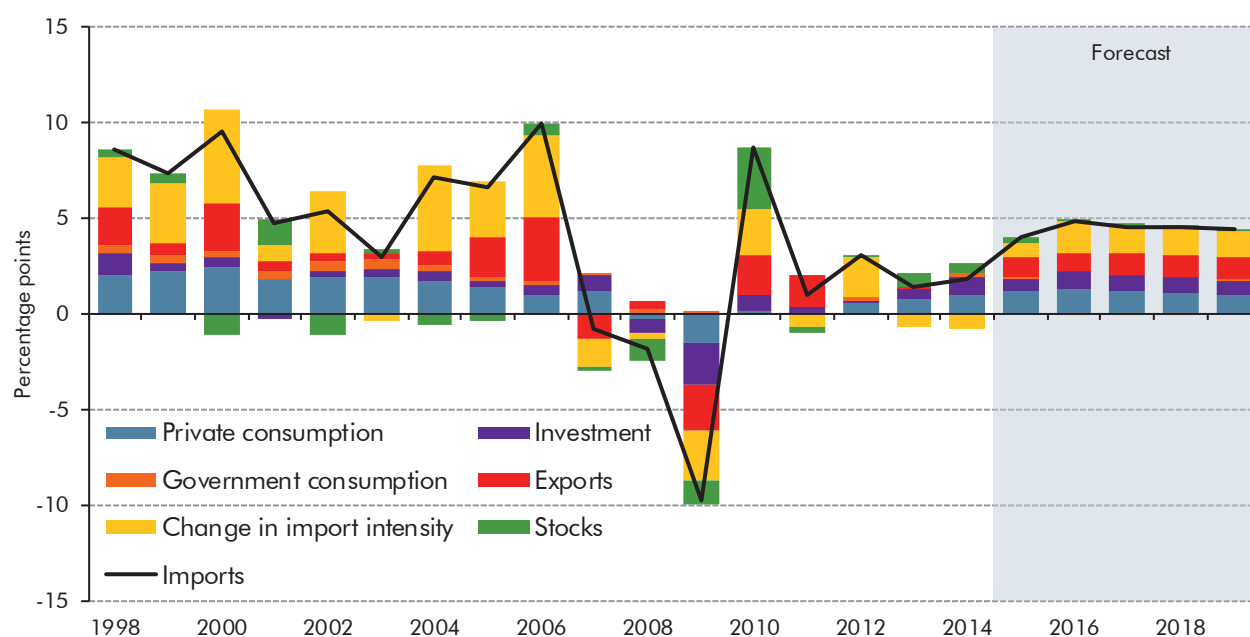
Chart 3.35: UK export market share



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

- 3.103 Outturn data show that imports grew strongly in the fourth quarter of 2014. Revisions to outturn data also suggests that imports growth was stronger over the first three quarters of 2014 than was estimated at the time of our December forecast.
- 3.104 Our forecast for imports is determined by the outlook for import-weighted domestic demand and a trend rise in the import intensity of that demand. Import-weighted domestic demand has been revised up in 2015, due largely to the boost to real consumer spending from lower oil prices and the data-driven revision to exports growth (which are import intensive).

Chart 3.36: Contributions to import-weighted domestic demand and import growth

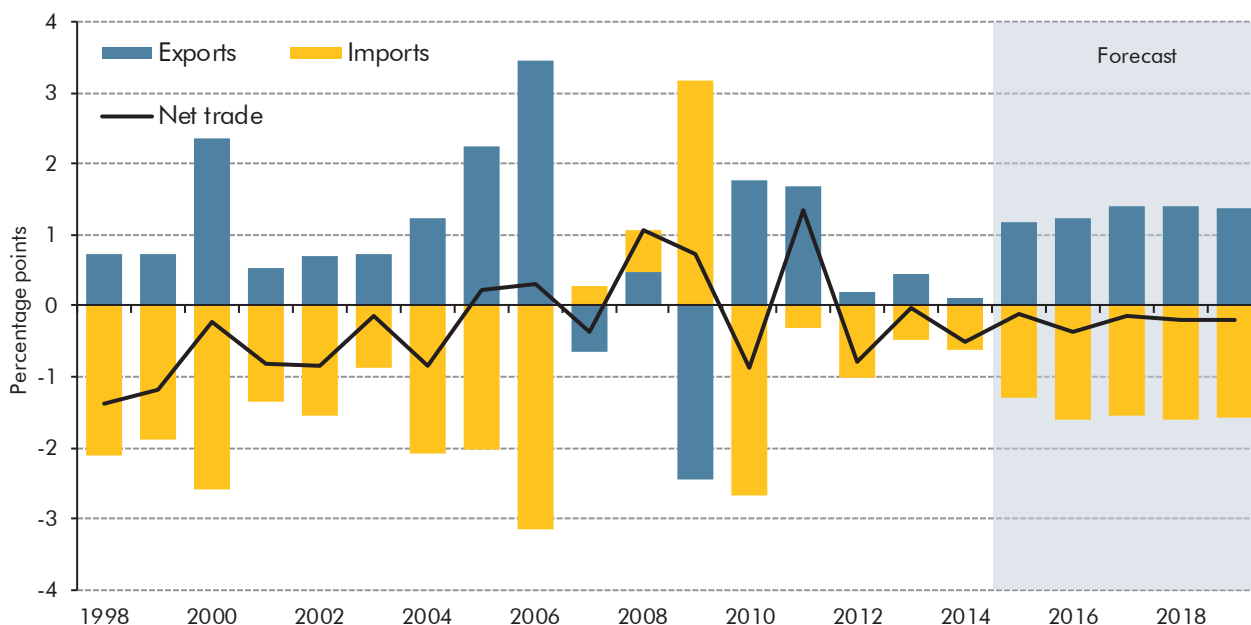


Source: ONS, OBR

The terms of trade and the trade balance

- 3.105** Since our December forecast, the terms of trade have been revised up slightly in 2014 due to stronger export prices more than offsetting higher import prices. The fall in the oil price boosts the terms of trade slightly in 2015, but it is broadly unchanged thereafter. Compared with our December forecast, we have revised up our forecast for exports growth in 2015, whereas our forecast for imports growth is little changed. Net trade is therefore expected to make a smaller negative contribution to GDP growth in 2015. Thereafter, net trade is expected to make a small negative contribution to annual GDP growth in each year, reflecting the weakness of export market growth, a gradual decline in export market share and a gradual increase in the ratio of imports to import-weighted domestic demand.
- 3.106** Our trade forecast includes estimates of oil imports and oil exports that are produced in a relatively mechanistic way. In volume terms, oil exports are determined by oil production and the share of North Sea output that is exported, while oil imports are derived from an assumption about the oil intensity of domestic activity and the proportion of North Sea production that is consumed domestically. These volumes are inflated to nominal exports and imports using our oil price assumption. Based on these assumptions, trade in oil subtracts 0.3 percentage points from GDP growth in 2015. This means that the trade deficit widens in 2015, subtracting 0.1 percentage points from GDP growth. Details are available in the supplementary economy tables on our website.

Chart 3.37: Net trade contribution to real GDP



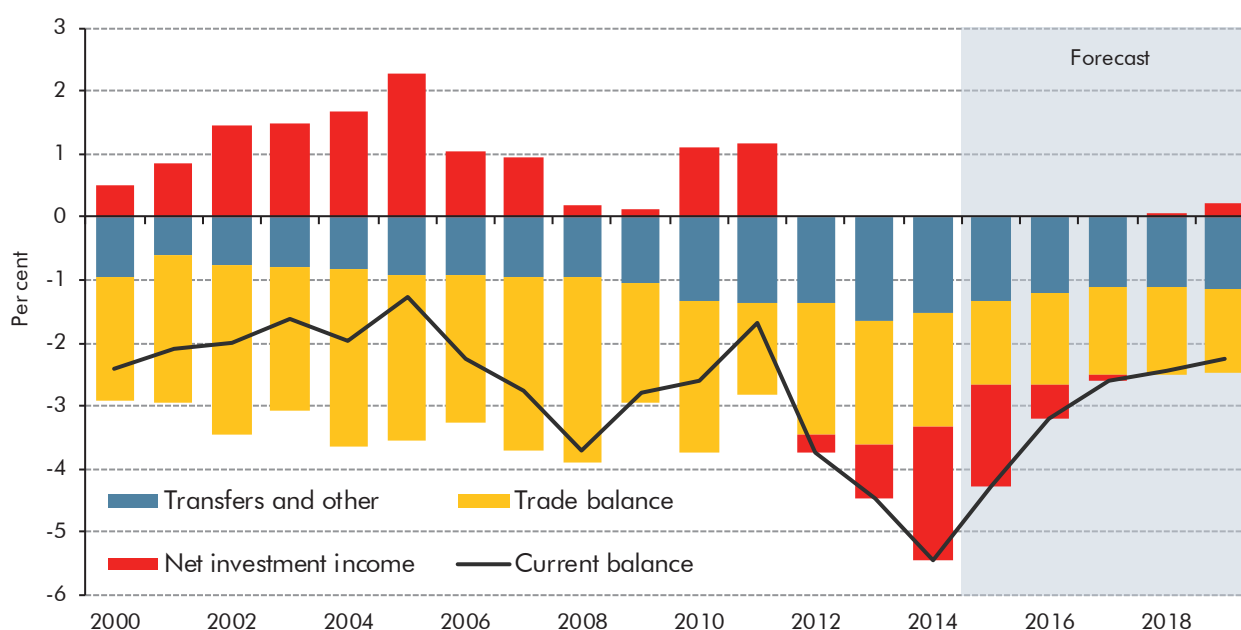
Source: ONS, OBR

The current account balance

3.107 The current account deficit remains wide by historical standards. It increased to around 6 per cent of GDP in the third quarter of 2014, the second largest quarterly deficit in National Accounts data stretching back to 1955. While this in part reflects the ongoing weakness in net trade, much of the recent deterioration reflects a significant worsening of the income balance: the income account deficit widened to 2.7 per cent of GDP in the third quarter of 2014, compared to an average *surplus* of around 1 per cent in the pre-crisis decade. The main source of the deterioration has been weaker rates of return on the UK's assets relative to its liabilities. Box 3.4 discusses recent developments in investment income in more detail.

3.108 We continue to expect the income account to improve gradually over the forecast period. But relative to our December forecast, we now expect a much slower return to typical net rates of return, consistent with the downward revision to our near-term forecast for global growth and movements in global interest rate expectations. The income account forecast remains subject to significant uncertainty, and is based on the assumption that relative rates of return have been temporarily depressed and will normalise as global growth gathers momentum. This has led us to revise our forecast of the current account deficit wider over the forecast period relative to December – by an average of around $\frac{1}{2}$ per cent of GDP between 2014 and 2019.

Chart 3.38: Current account balance as a share of GDP



Source: ONS, OBR

Box 3.4: Recent movements in the income balance

We expect the current account deficit in 2014 as a whole to have been 5.4 per cent of GDP. This would be the largest peace-time deficit since at least 1830, based on the Bank of England's historical dataset.^a

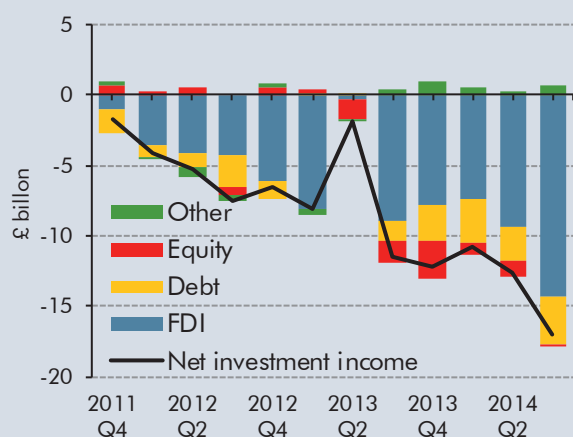
Much of the widening of the deficit in recent years reflects a significant deterioration in the net income earned on cross-border investment. Net investment income – the income earned on the UK's overseas investments, minus the income earned by overseas investors on their UK investments – averaged a surplus of 1.2 per cent of GDP between 2000 and 2008. Since mid-2011, the income balance has deteriorated from a 2.2 per cent of GDP surplus to a 2.7 per cent deficit in the third quarter of 2014.

In assessing changes in the income balance it is useful to decompose net investment income into its four components: net income on foreign direct investment (FDI); net income on debt securities; net income on equity; and net income on other assets. Chart B shows that the deterioration in the net investment income balance since 2011 is largely attributable to the deterioration in net income earned on FDI, with a smaller negative contribution from net income earned on debt securities.

Changes in the net income earned on investments can reflect changes in the stocks of those investments or changes in the net rate of return on them. Since the end of 2011, the stock of FDI assets has fallen while the stock of liabilities has continued to rise. All else equal this will have served to reduce net FDI income. In addition, the net rate of return on FDI has fallen sharply in recent quarters and remains well below pre-crisis levels (Chart C): between 2000 and 2007, the net rate of return on FDI averaged 1.9 percentage points; this compares to an average of 1.6 percentage points since 2012 and 1.2 percentage points so far in 2014.

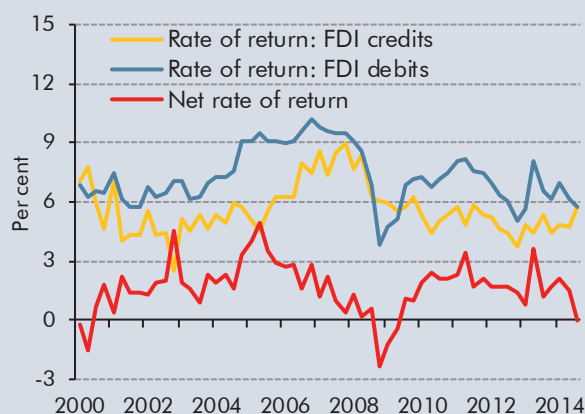
Analysing why the income balance has deteriorated so sharply is complicated both by the volatility of the series and by revisions to early estimates. One possibility is that relatively weak growth in the UK's trading partners – most notably the euro area – has depressed returns on the UK's overseas foreign direct investments relative to overseas foreign direct investment in the UK. Regional analysis of income flows suggests that a large part of the deterioration in FDI earnings can be attributed to lower earnings in Europe – most notably in the information and communications sector.^b While not verifiable in the published data, it seems likely that the very large cross-border fines and compensation paid by BP and some large banks (to the United States in particular) will also have depressed measured rates of return on those sectors' overseas assets. The deterioration in net income on debt securities may reflect changes in the composition of the debt held by UK residents or issued by UK companies.^c

Chart B: Change in net investment income since 2011



Note: Change in the level of net investment income relative to its average level in 2011
Source: ONS, OBR

Chart C: Rates of return on foreign direct investment



Note: Annualised earnings as a proportion of the stock of FDI assets/liabilities

^a Bank of England, *Three centuries of data on the UK economy*, 2010.

^b ONS, *Economic Review*, February 2015.

^c Bank of England, *Inflation Report*, May 2014.

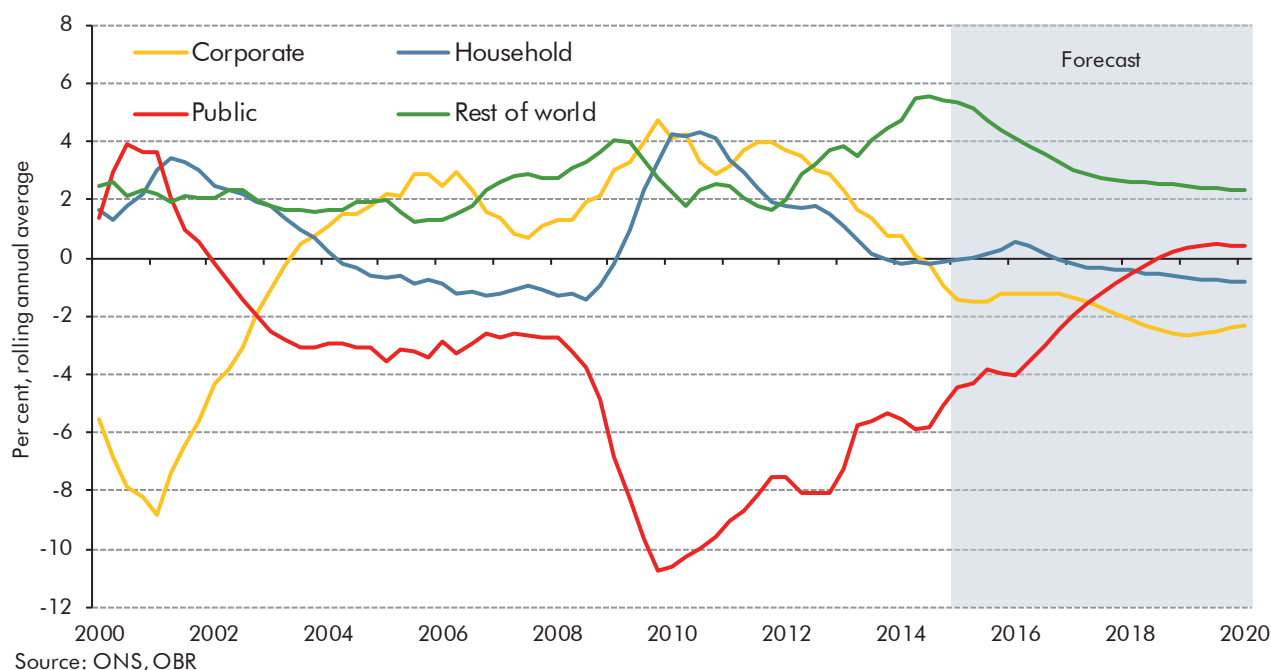
Sectoral net lending

3.109 In the National Accounts framework that we use for our economic forecast, the income and expenditure of the different sectors imply paths for each sector's net lending or borrowing from others. By identity, these must sum to zero – for each borrower, there must be a lender. In 2014, we estimate the public sector to be in deficit, households and companies close to balance, and the rest of the world to be in surplus (Chart 3.39).

3.110 By the end of the forecast period, we expect the public sector's balance to have moved into surplus as the fiscal consolidation continues (see Chapter 4). The household sector provides part of the offsetting change, with household net lending moving from a deficit of -0.1 per cent of GDP in 2014 to a larger deficit of -0.8 per cent of GDP in 2019. The gradual narrowing of the current account deficit over the forecast period means that the external sector also plays a role in offsetting the fiscal consolidation, while the rising share of

business investment in GDP means that corporate sector net lending is also expected to decline over the forecast period.

Chart 3.39: Sectoral net lending



Risks and uncertainties

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

3.112 In addition, prevailing economic circumstances suggest some specific risks to the forecast. In this *EFO*, we consider the following to be among the key risks:

- further instability in euro area economies and banking systems remains a key risk. Recent developments in Greece have once again highlighted concerns about the sustainability of the public finances in the region – particularly in an environment of very low inflation and weak medium-term growth prospects, with a number of euro area countries yet to complete the adjustment toward sustainable growth and competitiveness;
- geopolitical tensions continue to pose risks through trade linkages and financial exposures to affected countries;
- while the UK's main export markets are weighted heavily towards oil-importing countries, the significant fall in the oil price may have adverse implications for the

outlook if deteriorating prospects for oil producers have significant spillover effects via trade or financial markets;

- domestically, productivity and real wages remain weak and the pick-up we forecast from 2015 is a key judgement. If productivity fails to pick up as predicted, consumer spending and housing investment could falter as the resources to sustain them would be lacking;
- we expect some significant changes in the composition of expenditure associated with the fiscal consolidation and, in particular, with the fact that on current policy so much of that consolidation is delivered through cuts to day-to-day spending on public services that will directly reduce GDP. The scale and speed of the adjustments this switch in spending implies may also represent a risk to the economy evolving in line with our central forecast; and
- strong growth of residential investment and ongoing growth in house prices and property transactions leave households' gross debt to income ratio rising back towards its pre-crisis peak by the forecast horizon. That seems consistent with supportive monetary policy and other interventions (such as Help to Buy and further support for first-time buyers announced in this Budget), but it could pose risks to the sustainability of the recovery over the medium term.

Comparison with external forecasters

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

3.114 In its February *Economic Review*, the National Institute for Economic and Social Research (NIESR) forecasts GDP growth of 2.9 per cent in 2015, higher than our central forecast. Much of the difference is attributable to NIESR expecting both stronger consumption and investment growth in 2015. The European Commission expects growth of 2.6 per cent in 2015, slightly above our central forecast. The Commission forecasts weaker government consumption growth in 2015, but this is more than offset by stronger forecasts for both private consumption and investment. Global oil prices have fluctuated significantly in the period during which these forecasts were produced. These changes and their assumed impacts on the real economy – both directly via North Sea production and indirectly via changes in real incomes and business input costs – are likely to have been a key reason for differences between the reported forecasts.

Table 3.4: Comparison with external forecasts

	Per cent					
	2013	2014	2015	2016	2017	2018
OBR (March 2015)						
GDP growth	1.7	2.6	2.5	2.3	2.3	2.3
CPI inflation	2.6	1.5	0.2	1.2	1.7	1.9
Output gap	-2.2	-1.0	-0.4	-0.2	-0.1	0.0
IMF (October 2014)¹						
GDP growth	1.7	3.2	2.7	2.4	2.4	2.4
CPI inflation	2.6	1.6	1.8	2.0	2.0	2.0
Output gap	-2.7	-1.2	-0.4	-0.3	-0.1	0.0
OECD (November 2014)						
GDP growth	1.7	3.0	2.7	2.5		
CPI inflation	2.6	1.6	1.8	2.1		
Output gap	-1.4	-0.3	0.1	0.0		
European Commission (February 2015)						
GDP growth	1.7	2.6	2.6	2.4		
CPI inflation	2.6	1.5	1.0	1.6		
Output gap	-2.4	-1.1	-0.1	0.6		
NIESR (February 2015)²						
GDP growth	1.7	2.6	2.9	2.3	2.3	2.5
CPI inflation	2.6	1.4	0.6	1.6	2.1	2.0
Oxford Economics (February 2015)						
GDP growth	1.7	2.6	2.8	2.7	2.7	2.5
CPI inflation	2.6	1.5	-0.1	1.8	1.9	1.9
Output gap	-4.1	-4.3	-3.7	-3.4	-3.2	-3.1
Bank of England (February 2015)^{2,3}						
GDP growth (mode) ⁴		3.1	2.9	2.9	2.7	
CPI inflation (mode)		0.9	0.5	1.8	2.1	

¹The IMF updated its short-term forecasts in the January 2015 *World economic outlook* update. For the UK, it revised GDP growth down to 2.6 per cent in 2014 reflecting latest data, but left its forecasts for 2015 and 2016 at 2.7 per cent and 2.4 per cent.

²Output gap not published.

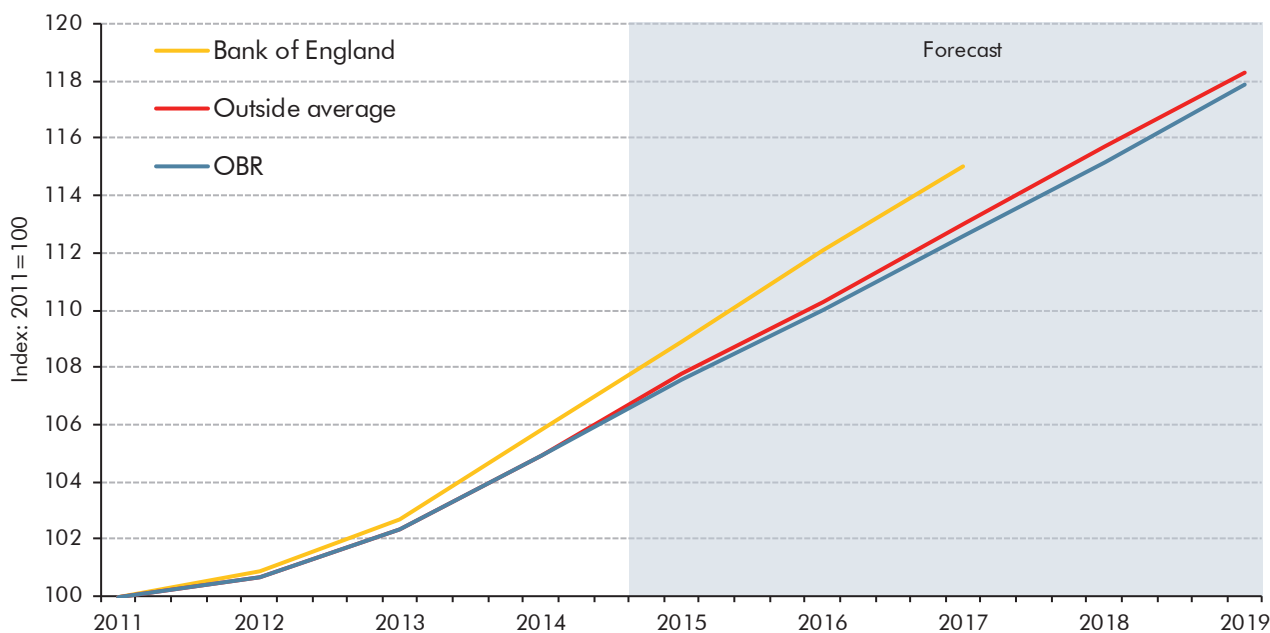
³Forecast based on market interest rates and the Bank of England's 'backcast' for GDP growth.

⁴Fourth quarter year-on-year growth rate.

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

- 3.115** Alongside its February 2015 *Inflation Report*, the Bank of England published additional information about its projections against which we can compare our own (see Table 3.5). This included information on the Bank staff's forecast for the expenditure composition of GDP, consistent with the MPC's central forecasts of GDP, CPI inflation and the LFS unemployment rate.
- 3.116** The table shows that the Bank's modal expectation for household consumption growth and business investment growth are somewhat stronger than our forecast in 2015 and 2016, helping to explain the Bank's stronger GDP growth forecast relative to our central forecast.

Chart 3.40: Comparison of forecasts for the level of GDP



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

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

	Per cent			
	2014 ¹	2015	2016	2017
Bank of England February Inflation Report forecast				
Household consumption	2¼	3¾	3½	2½
Business investment	7	6¼	8½	9
Housing investment ^{2,3}	11¼	2	6¼	5¾
Exports	-¾	3¼	5½	4½
Imports	¾	2	6¼	5
Employment ⁴	2	1½	1	¾
Average weekly earnings ^{3,4}	1¾	3½	4	4
Difference from OBR forecast				
Household consumption	0.2	1.2	0.8	0.0
Business investment	0.2	1.1	1.0	2.5
Exports	-1.1	-0.7	1.5	0.0
Imports	-1.1	-2.0	1.5	0.4
Employment ⁴	0.0	0.3	0.4	0.3

¹ 2014 estimates contain a combination of data and projections.² Whole economy measure. Includes transfer costs of non-produced assets.³ We have not shown a comparison for housing investment and average weekly earnings as the definitions of these variables differ and are therefore not directly comparable.⁴ Four-quarter growth rate in Q4.

Table 3.6: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
UK economy							
Gross domestic product (GDP)	1.7	2.6	2.5	2.3	2.3	2.3	2.4
GDP level (2013=100)	100.0	102.6	105.1	107.6	110.1	112.7	115.3
Nominal GDP	3.5	4.4	4.1	3.5	3.8	4.3	5.0
Output gap (per cent of potential output)	-2.2	-1.0	-0.4	-0.2	-0.1	0.0	0.0
Expenditure components of GDP							
Domestic demand	1.8	2.9	2.6	2.6	2.4	2.5	2.5
Household consumption ¹	1.7	2.0	2.6	2.7	2.5	2.3	2.2
General government consumption	-0.3	1.5	0.8	-0.7	-0.9	-0.2	1.5
Fixed investment	3.4	6.8	4.3	6.2	5.6	5.7	4.4
Business	5.3	6.8	5.1	7.5	6.5	6.4	4.4
General government ²	-8.1	7.3	2.3	1.9	1.6	1.5	2.8
Private dwellings ²	6.2	6.6	3.5	5.4	5.5	6.2	5.2
Change in inventories ³	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Exports of goods and services	1.5	0.4	3.9	4.0	4.5	4.4	4.3
Imports of goods and services	1.4	1.8	4.0	4.8	4.6	4.6	4.4
Balance of payments current account							
Per cent of GDP	-4.5	-5.4	-4.3	-3.2	-2.6	-2.4	-2.3
Inflation							
CPI	2.6	1.5	0.2	1.2	1.7	1.9	2.0
RPI	3.0	2.4	1.0	2.1	2.8	3.1	3.1
GDP deflator at market prices	1.8	1.8	1.6	1.1	1.5	1.9	2.5
Labour market							
Employment (millions)	30.0	30.7	31.1	31.4	31.5	31.7	31.9
Productivity per hour	-0.1	0.1	0.9	2.1	2.5	2.5	2.4
Wages and salaries	2.9	3.8	4.0	3.9	4.1	4.5	4.9
Average earnings ⁴	1.6	2.2	2.3	3.1	3.7	4.0	4.4
LFS unemployment (% rate)	7.6	6.2	5.3	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.77	0.74	0.76	0.77	0.77
Household sector							
Real household disposable income	0.1	1.4	3.7	2.1	2.2	2.1	2.0
Saving ratio (level, per cent)	6.4	6.7	7.4	7.3	7.2	7.2	7.2
House prices	3.5	10.0	5.9	4.9	6.4	6.9	6.4
World economy							
World GDP at purchasing power parity	3.3	3.3	3.5	3.6	3.9	4.0	4.0
Euro area GDP	-0.4	0.9	1.2	1.4	1.6	1.6	1.6
World trade in goods and services	3.4	3.1	4.0	4.9	5.3	5.4	5.4
UK export markets ⁵	2.5	3.1	3.7	4.7	5.1	5.2	5.2

¹ Includes households and non-profit institutions serving households.

² Includes transfer costs of non-produced assets.

³ Contribution to GDP growth, percentage points.

⁴ Wages and salaries divided by employees.

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

Table 3.7: Detailed summary of changes to the forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
UK economy							
Gross domestic product (GDP)	-0.1	-0.5	0.1	0.2	-0.1	0.0	0.0
GDP level (2013=100) ¹	0.0	-0.4	-0.4	-0.2	-0.3	-0.2	-0.2
Nominal GDP	0.0	-0.7	0.1	-0.1	-0.2	0.1	0.6
Output gap (per cent of potential output)	0.0	0.0	0.1	0.3	0.2	0.1	0.0
Expenditure components of GDP							
Domestic demand	-0.2	-0.3	-0.3	0.4	0.0	0.1	0.0
Household consumption ²	0.1	-0.3	-0.2	0.6	0.1	0.0	-0.2
General government consumption	-1.0	0.5	1.2	0.0	0.0	0.1	1.5
Fixed investment	0.2	-1.3	-4.0	0.3	0.0	0.6	-0.4
Business	0.5	-1.0	-3.3	1.2	0.2	0.1	-1.9
General government ³	-0.9	5.2	-1.0	0.3	-0.5	-0.1	0.6
Private dwellings ³	0.2	-6.4	-7.5	-1.6	-0.1	2.2	2.8
Change in inventories ⁴	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Exports of goods and services	0.9	1.9	1.5	-0.7	-0.4	-0.3	-0.1
Imports of goods and services	0.9	2.7	0.0	0.1	-0.2	-0.2	-0.1
Balance of payments current account							
Per cent of GDP	-0.2	-0.8	-0.8	-0.3	-0.1	-0.2	-0.3
Inflation							
CPI	0.0	-0.1	-0.9	-0.5	-0.3	-0.1	0.0
RPI	0.0	0.0	-1.1	-0.8	-0.5	-0.5	-0.4
GDP deflator at market prices	0.0	-0.2	0.0	-0.2	-0.1	0.1	0.6
Labour market							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Productivity per hour	-0.1	-0.4	-0.4	0.2	0.1	0.2	0.0
Wages and salaries	-0.2	0.4	0.3	0.1	-0.1	0.2	0.7
Average earnings ⁵	-0.2	0.4	0.3	0.0	-0.2	0.0	0.5
LFS unemployment (% rate)	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0
Claimant count (millions)	0.00	0.00	-0.08	-0.09	-0.08	-0.08	-0.08
Household sector							
Real household disposable income	0.4	-0.8	1.8	0.4	0.4	0.1	-0.1
Saving ratio (level, per cent)	0.0	0.1	2.0	1.8	2.1	2.3	2.4
House prices	0.0	-0.2	-1.5	-1.0	0.6	1.8	2.6
World economy							
World GDP at purchasing power parity	0.0	0.1	-0.3	-0.4	-0.1	0.0	0.0
Euro area GDP	0.0	0.1	0.0	-0.2	-0.1	0.0	0.0
World trade in goods and services	0.3	-0.7	-1.1	-0.5	-0.3	-0.2	-0.2
UK export markets ⁶	0.2	-0.6	-0.6	-0.3	-0.2	-0.1	0.0

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

4 Fiscal outlook

Introduction

4.1 This chapter:

- sets out the key economic and market determinants that drive the fiscal forecast (from paragraph 4.3);
- explains the effects of reclassifications and new policies announced in this Budget and since the Autumn Statement on the fiscal forecast (from paragraph 4.22);
- describes the outlook for public sector receipts, including a tax-by-tax analysis explaining how the forecasts have changed since December (from paragraph 4.32);
- describes the outlook for public sector expenditure, focusing on departmental expenditure limits and the components of annually managed expenditure including those subject to the Government's welfare cap (from paragraph 4.95);
- describes the outlook for government lending to the private sector and other financial transactions, including asset sales (from paragraph 4.153);
- describes the outlook for the key fiscal aggregates: public sector net borrowing, the current budget, the cyclically adjusted current budget and public sector net debt (from paragraph 4.179);
- summarises risks and uncertainties (paragraph 4.192); and
- provides a comparison with forecasts from international organisations (from paragraph 4.193).

4.2 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in the supplementary tables available on our website. The medium-term forecasts for the public finances in this chapter consist of an in-year estimate for 2014-15, which makes use of published ONS outturn data for April to January,¹ some preliminary data on tax receipts in February, and then forecasts to 2019-20. As in previous *Economic and fiscal outlooks (EFOs)*, this fiscal forecast:

¹ Outturn data are consistent with the *Public Sector Finances January 2015 Statistical Bulletin* (released in February) published by the Office for National Statistics and HM Treasury.

- represents our central view of the path of the public finances, conditioned on the policies and policy assumptions of the Coalition Government. On that basis, we believe that the outturns would be as likely to be above the forecast as below it;
- is based on announced Government policy on the indexation of rates, thresholds and allowances for taxes and benefits, and incorporates the impact of certified costings for all new policy measures announced by the Chancellor in the Budget; and
- focuses on official 'headline' fiscal aggregates that exclude public sector banks. The Government's recently updated fiscal mandate and supplementary target are defined in terms of these measures.

Economic determinants of the fiscal forecast

4.3 Our fiscal forecasts are based on the economic forecasts presented in Chapter 3. Forecasts of tax receipts are particularly dependent on the profile and composition of economic activity. And while around half of public sector expenditure is set out in multi-year plans, large elements (such as social security and debt interest payments) are linked to developments in the economy – notably inflation, market interest rates and the labour market. Table 4.1 sets out some of the key economic determinants of the fiscal forecast and Table 4.2 shows how these have changed since our forecast in December. In Annex B, we present ready reckoners for the fiscal effects of changes in some of these determinants.

GDP and the output gap

4.4 Most economic forecasts focus on the outlook for real GDP, but it is nominal GDP that matters most when forecasting the public finances. Relative to our December forecast, cumulative nominal GDP growth between 2014-15 and 2019-20 has been revised up by 1.0 percentage points. The biggest revision is in 2019-20, reflecting stronger growth in government consumption due to a change in the Government's spending assumption.

4.5 The structural, or cyclically adjusted, component of net borrowing and the current budget is estimated using the output gap. A negative output gap implies that the economy is operating below capacity, providing scope for tax receipts to increase and spending to fall as a share of GDP as the economy returns to its potential level. Our latest estimate of the output gap is slightly narrower on average across the forecast period than in December, largely reflecting the boost to demand in the near term from lower oil prices. We estimate that the output gap was -0.7 per cent of GDP in the final quarter of 2014, and that it will close slowly by late 2017.

Income and expenditure components of GDP

4.6 The composition of nominal GDP growth is particularly important. On the income side, labour income is generally taxed more heavily than company profits. On the expenditure side, consumer spending is subject to VAT and other indirect taxes while business investment attracts capital allowances that reduce corporation tax receipts in the short term.

- 4.7 The largest source of labour income is wages and salaries, which are determined by employment and earnings. Wages and salaries growth is slightly higher than in our December forecast. This includes a slightly lower forecast of earnings growth in 2016-17 and 2017-18, with stronger growth thereafter. We have revised up employment growth from 2016-17 onwards due to faster population growth. That reflects our decision to base this forecast on the ONS principal population projections rather than the low migration variant that underpinned our December forecast.
- 4.8 Nominal consumer spending growth is expected to be lower in most years compared to our December forecast, reflecting lower inflation throughout most of the forecast period.
- 4.9 Non-oil, non-financial company profits are expected to grow slightly more slowly in 2015 than we expected in December, partly reflecting recent outturn data. Financial sector profits are forecast to grow more slowly than non-financial sector profits due to both ongoing conduct fines and pressures from regulation throughout the forecast period.

Inflation

- 4.10 The CPI measure of inflation is used to index many tax rates, allowances and thresholds, and to uprate benefits and public sector pensions. Our forecast for CPI inflation has been revised down significantly since December, primarily reflecting the implications of sterling oil prices being 30 per cent lower in the first quarter of 2015 than assumed in December. CPI inflation returns to the Bank of England's 2 per cent target by early 2019.
- 4.11 RPI inflation determines the interest paid on index-linked gilts and is used to revalorise excise duties and uprate business rates. Near-term RPI inflation has also been revised down since December due to lower oil prices. We have also changed our assumption for the long-term wedge between RPI and CPI inflation, which has lowered our medium-term RPI inflation forecast by 0.4 percentage points. This change is explained in Box 3.3. RPI inflation is expected to fall to a low of 0.9 per cent in the third quarter of 2015, before an increase in mortgage interest payments (MIPs) inflation pushes it up relative to CPI inflation.
- 4.12 The basic state pension (BSP) is uprated in April each year in line with the 'triple-lock' guarantee that it will increase by the highest of average earnings growth, CPI inflation in the previous September and 2.5 per cent. As a result, the BSP was once again uprated by the minimum 2.5 per cent in 2015-16. Our forecast now implies that it will be uprated by this minimum again in 2016-17, which would be the fifth successive year since the triple-lock was announced that the BSP had increased faster than average earnings, with a cumulative difference over that period of 8.2 per cent. On our current forecast, uprating will be in line with average earnings growth from 2017-18 onwards.²

² Earnings growth as defined for the purposes of benefit uprating – that is, AWE earnings growth in the three months to July of the preceding year. For our forecast, we use whole economy wages and salaries (as defined in the National Accounts) divided by LFS employment (excluding self-employed) in Q2 as a proxy for AWE earnings growth.

Table 4.1: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
GDP and its components							
Real GDP	2.1	2.6	2.4	2.3	2.4	2.3	2.4
Nominal GDP ¹	4.0	4.5	3.8	3.5	4.0	4.4	5.0
Nominal GDP (£ billion) ^{1,2}	1731	1809	1878	1943	2022	2111	2218
Nominal GDP (centred end-March £bn) ^{1,3}	1773	1840	1910	1981	2064	2163	2272
Wages and salaries ⁴	2.8	4.1	3.8	3.8	4.3	4.5	5.0
Non-oil PNFC profits ^{4,5}	2.6	6.8	6.0	3.5	3.8	4.3	5.0
Non-oil PNFC net taxable income ^{4,5}	-1.0	5.6	4.6	1.1	1.0	1.9	3.1
Consumer spending ^{4,5}	3.6	3.6	3.7	4.2	4.5	4.6	4.5
Prices and earnings							
GDP deflator	2.1	1.7	1.4	1.2	1.6	2.1	2.6
RPI (September)	3.2	2.3	0.9	2.2	3.0	3.2	3.1
CPI (September)	2.7	1.2	0.2	1.2	1.7	1.9	2.0
Average earnings ⁶	1.6	2.3	2.3	3.1	3.8	4.0	4.4
Triple-lock' guarantee	2.7	2.5	2.5	3.1	3.6	3.9	4.4
Key fiscal determinants							
Claimant count (millions)	1.33	0.95	0.75	0.74	0.76	0.77	0.78
Employment (millions)	30.2	30.8	31.2	31.4	31.6	31.7	31.9
VAT gap (per cent)	10.8	10.0	9.9	9.9	9.9	9.9	9.9
Output gap (per cent of potential output)	-2.0	-0.8	-0.4	-0.2	0.0	0.0	0.0
Financial and property sectors							
Equity prices (FTSE All-Share index)	3475	3594	3803	3937	4094	4275	4491
HMRC financial sector profits ^{1,5,7}	4.0	4.5	3.8	3.5	4.0	4.4	5.0
Financial sector net taxable income ^{1,5}	4.4	-2.1	-8.7	3.5	4.2	3.8	3.9
Residential property prices ⁸	5.0	10.1	4.9	5.3	6.7	6.9	6.2
Residential property transactions (000s) ⁹	1140	1195	1129	1211	1308	1386	1425
Commercial property prices ⁹	17.3	17.9	1.0	1.0	1.8	3.0	4.5
Commercial property transactions ⁹	8.4	9.0	6.7	2.7	2.7	2.6	2.8
Volume of stampable share transactions	13.6	4.4	-0.8	-0.8	-0.8	-0.8	-0.8
Oil and gas							
Oil prices (\$ per barrel) ⁵	108.8	98.9	62.1	69.2	71.4	71.4	71.4
Oil prices (£ per barrel) ⁵	69.6	60.0	40.3	44.9	46.1	45.9	45.7
Gas prices (p/therm) ⁵	66.9	50.2	47.8	50.3	50.3	50.3	50.3
Oil production (million tonnes) ⁵	40.6	39.7	38.3	36.7	34.9	33.4	30.9
Gas production (billion therms) ⁵	12.8	13.1	12.6	11.9	11.4	10.9	10.3
Interest rates and exchange rates							
Market short-term interest rates (%) ¹⁰	0.5	0.6	0.7	1.2	1.6	1.8	1.9
Market gilt rates (%) ¹¹	2.5	2.3	2.1	2.3	2.4	2.5	2.6
Euro/Sterling exchange rate (€/£)	1.19	1.27	1.37	1.36	1.34	1.33	1.31

¹ Not seasonally adjusted.

² Denominator for receipts, spending and deficit forecasts as a per cent of GDP.

³ Denominator for net debt as a per cent of GDP.

⁴ Nominal.

⁵ Calendar year.

⁶ Wages and salaries divided by employees.

⁷ HMRC Gross Case 1 trading profits.

⁸ Outturn data from ONS House Price Index.

⁹ Outturn data from HMRC information on stamp duty land tax.

¹⁰ 3-month sterling interbank rate (LIBOR).

¹¹ Weighted average interest rate on conventional gilts.

Table 4.2: Changes in the determinants of the fiscal forecast since December

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
GDP and its components							
Real GDP	-0.2	-0.4	0.2	0.1	0.0	0.0	0.0
Nominal GDP ¹	-0.2	-0.6	0.1	-0.1	-0.1	0.2	0.7
Nominal GDP (£ billion) ^{1,2}	-2	-13	-10	-13	-16	-13	2
Nominal GDP (centred end-March £bn) ^{1,3}	-6	-13	-10	-15	-15	-6	9
Wages and salaries ⁴	-0.1	0.5	0.3	0.0	-0.1	0.3	0.8
Non-oil PNFC profits ^{4,5}	-2.4	-0.8	-1.1	0.0	-0.2	0.1	0.7
Non-oil PNFC net taxable income ^{4,5}	-3.8	-0.8	-0.2	0.4	-0.1	0.4	1.2
Consumer spending ^{4,5}	0.1	-0.4	-0.6	0.1	-0.2	-0.1	-0.2
Prices and earnings							
GDP deflator	0.3	-0.4	0.0	-0.2	-0.1	0.2	0.7
RPI (September)	0.0	0.0	-1.2	-0.7	-0.5	-0.5	-0.4
CPI (September)	0.0	0.0	-1.0	-0.6	-0.3	-0.1	0.0
Average earnings ⁶	-0.1	0.5	0.2	-0.2	-0.1	0.1	0.6
'Triple-lock' guarantee (September)	0.0	0.0	0.0	0.1	-0.2	-0.1	0.5
Key fiscal determinants							
Claimant count (millions)	0.00	-0.01	-0.09	-0.09	-0.08	-0.08	-0.08
Employment (millions)	0.0	0.0	0.0	0.0	0.1	0.1	0.2
VAT gap (per cent)	0.5	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Output gap (per cent of potential output)	0.0	0.0	0.2	0.2	0.2	0.1	0.0
Financial and property sectors							
Equity prices (FTSE All-Share index)	0	23	131	132	131	145	183
HMRC financial sector profits ^{1,5,7}	2.6	2.3	0.0	-0.2	-0.1	0.4	0.7
Financial sector net taxable income ^{1,5}	1.5	2.9	-2.6	0.2	0.5	0.5	3.0
Residential property prices ⁸	0.0	-0.5	-1.6	-0.6	0.9	2.1	2.7
Residential property transactions (000s) ⁹	0	-20	-164	-174	-131	-88	-78
Commercial property prices ⁹	0.0	6.5	0.2	-0.3	-0.9	0.9	1.8
Commercial property transactions ⁹	0.0	4.9	6.2	0.7	-0.2	0.1	0.2
Volume of stampable share transactions	0.0	3.2	2.4	-0.2	-0.2	-0.2	-0.2
Oil and gas							
Oil prices (\$ per barrel) ⁵	0.0	-1.6	-21.0	-16.8	-15.1	-15.1	-15.1
Oil prices (£ per barrel) ⁵	0.0	-0.9	-12.8	-10.2	-9.2	-9.2	-11.1
Gas prices (p/therm) ⁵	0.0	0.0	-6.8	-6.5	-6.5	-6.5	-6.5
Oil production (million tonnes) ⁵	0.0	0.5	-0.9	-2.5	-4.3	-5.8	-6.3
Gas production (billion therms) ⁵	0.0	0.3	-0.1	-0.8	-1.3	-1.8	-1.8
Interest rates and exchange rates							
Market short-term interest rates ¹⁰	0.0	0.0	-0.2	-0.3	-0.3	-0.3	-0.5
Market gilt rates ¹¹	0.0	-0.2	-0.4	-0.4	-0.5	-0.5	-0.5
Euro/Sterling exchange rate (€/£)	0.00	0.02	0.11	0.12	0.12	0.11	0.12

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

Property market

- 4.13 The residential property market is a key driver of receipts from stamp duty land tax (and the land and buildings transaction tax in Scotland) and inheritance tax. House price growth in the last quarter of 2014 was weaker than expected, and we expect that to persist over the next two years relative to our December forecast. House price growth is stronger in the second half of the forecast reflecting stronger growth of real income per household. House prices rise faster than earnings for most of the forecast period thanks to the lagged effect of past falls in mortgage interest rates and the fact that household income growth has historically had a more than one-for-one impact on house prices.
- 4.14 Residential property transactions have been lower than expected in recent months, with growth in 2014-15 expected to be 4.9 per cent, below our December forecast of 6.6 per cent. Property transactions are now expected to fall by 5.5 per cent in 2015-16, reflecting the weakness of mortgage approvals in recent months. We have also revised down our medium-term assumption for turnover in the housing market. As a result, property transactions are 6.7 per cent lower on average in the final three years of the forecast than in December. This revision is explained more fully in Chapter 3.
- 4.15 Commercial property prices increased strongly in the third quarter of 2014. Average prices are now expected to rise by 18 per cent in 2014-15 and the volume of transactions by 9 per cent. Our forecast for price growth is similar to December, while our forecast for transactions growth is higher in 2015-16.

Oil and gas sector

- 4.16 We assume that for the next two years dollar oil prices move in line with the average of the futures curve over the 10 working days to 26 February, and then remain at that level. Since our December forecast, oil prices have fallen significantly (see Box 2.1). We use the same method to project gas prices, which are also lower.
- 4.17 Our oil and gas production forecasts are informed by the central projection published by the Department of Energy and Climate Change (DECC). The projections for oil and gas production are significantly lower than our December forecast, as reductions in the oil price mean that some new fields and projects will no longer be profitable. The effect of lower oil prices on investment is expected to be greater than the effect on production. Compared to December, we expect much lower levels of capital and operating expenditure. Lower oil and gas prices will have reduced the net present value of potential capital projects as well as reducing upward pressures on operating costs.
- 4.18 Given the material effects on investment and production in the North Sea that the policy changes announced in the Budget are expected to encourage, we have presented our pre- and post-measures forecasts in full later in the chapter. These are shown in Table 4.11.

Equity markets

- 4.19 Equity prices are a significant determinant of capital gains tax, inheritance tax and stamp duty on shares. Equity prices are assumed to rise from their current level in line with our forecast for nominal GDP. As equity prices in the 10 working days to 26 February were above our December assumption – and that is locked in by our forecast assumption – they remain higher across the forecast period.

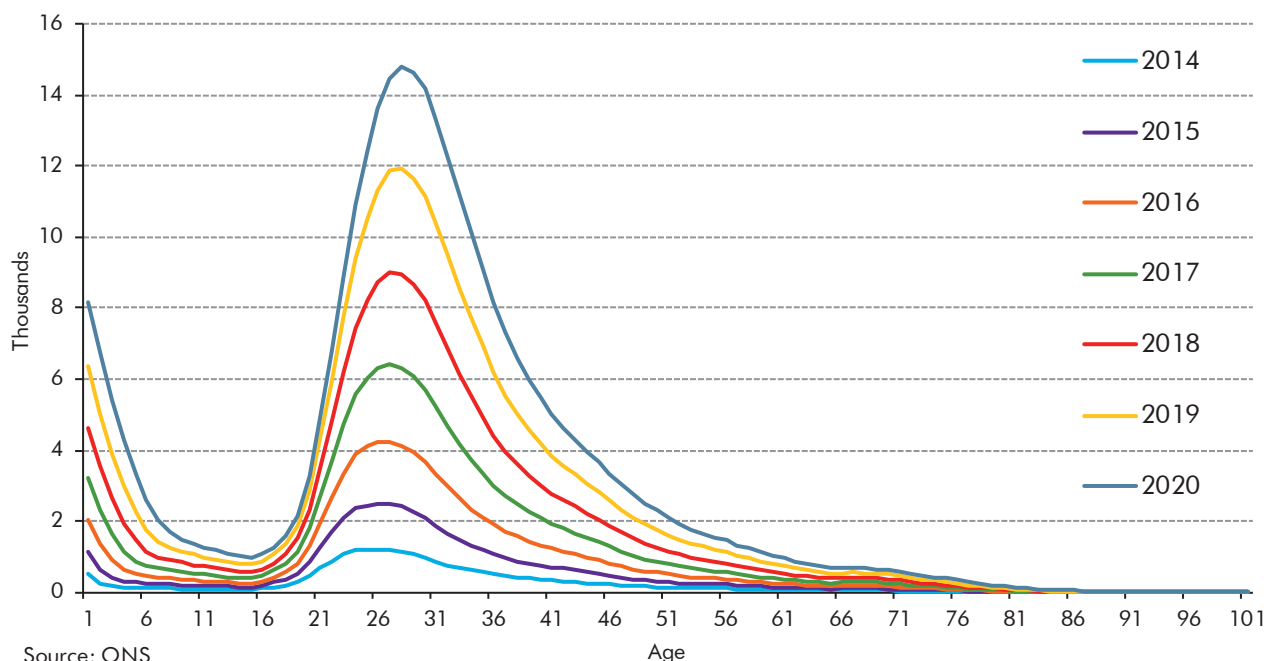
Interest rates

- 4.20 We use the 3-month sterling interbank rate as a benchmark for our short-term interest rate determinant. Our forecast reflects average forward rates for the 10 working days to 26 February. The futures curve implies that rates will be lower in all years of the forecast than in December, reflecting changes in monetary policy expectations. We assume that gilt yields move in line with market expectations based on average forward rates over the same 10-day period. These are also lower across the forecast period than we assumed in December.

Population

- 4.21 As described in Chapter 3, we have moved from the ONS ‘low migration’ population projections to the ‘principal’ projections to underpin this forecast. As well as the effects on potential output growth set out in Chapter 3, a key driver of the fiscal implications of this change for our forecast is the age structure of the addition to the population it implies. As Chart 4.1 shows, the assumed age structure is skewed heavily towards those of working age, and less towards children, while very few are assumed to be above the state pension age. By the end of the forecast period, the total population is nearly 320,000 higher than previously assumed, a 0.5 per cent increase. Within that increase, 84 per cent is assumed to be among people of working age (16 to 64 years old); by comparison 62 per cent of the population underpinning our December forecast were of working age.

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



Source: ONS

Policy announcements, risks and classification changes

4.22 The Government publishes estimates of the direct impact of tax and spending policy decisions on the public finances in its policy decisions table, after detailed discussions with the OBR. If we were to disagree with any of the final numbers they chose, we would use our own estimates in our forecast. We are also responsible for assessing any indirect effects of policy measures on the economic forecast.³ These are discussed in Box 3.2 in Chapter 3. We note as risks to the fiscal forecast any significant policy commitments that are not quantifiable, as well as any potential statistical classification changes.

Direct effect of new policy announcements on the public finances

4.23 In Annex A, we reproduce the Treasury's table of the direct effect on PSNB of policy decisions in the Budget or announced since the Autumn Statement. We have endorsed all of the tax and annually managed expenditure costings in the table as reasonable and central estimates of the measures themselves. Annex A also includes a formal assessment of the degree of uncertainty associated with each costing that we have certified.

4.24 Table 4.3 summarises the Treasury's Budget policy decisions table. A positive figure means an improvement in PSNB, i.e. higher receipts or lower expenditure. We produce a detailed breakdown in a supplementary fiscal table on our website, showing how each policy measure is allocated to different categories of tax and spending.

³ In March 2014, we published a briefing paper on our approach to scrutinising and certifying policy costings, and how they are fed into our forecasts, which is available on our website: *Briefing paper No 6: Policy costings and our forecast*.

- 4.25 By far the largest single-year effect of a Government decision comes via its new assumption for total spending in 2019-20, although this does not appear in the Treasury's table of policy decisions. The Government has decided that total spending should grow in line with nominal GDP in that year, rather than being held flat in real terms. This implies a substantial increase in current departmental spending on public services and administration in that year, which on our estimate is equivalent to £20.2 billion.
- 4.26 The Budget measures in the Treasury's table of policy decisions are neutral for borrowing on average over the forecast period with 'giveaways' offsetting 'takeaways'. They raise or lower borrowing by less than £1 billion in every year. The biggest takeaway is an increase in the bank levy (raising £4.4 billion over five years), with a variety of other measures raising smaller amounts with often significant uncertainty around their costing. These are balanced by three main giveaways – further increases in the income tax personal allowance (£5.7 billion over five years), tax measures benefiting savers (£3.0 billion) and a subsidy for first-time buyers (£2.2 billion, the take-up of which is also subject to significant uncertainty).
- 4.27 There are some Budget measures that might be expected to have different costs in the longer term than over the five-year period of our medium-term forecast:
- sales of annuities in a secondary market would raise income tax receipts in the short term, but at the expense of future receipts. The profile would be similar to that expected for the Budget 2014 pensions flexibility measure (see Chart 4.1 of our March 2014 *EFO*);
 - the tax foregone on savings income through introducing a tax-free allowance on savings income would be greater if – as we assume in our long-term projections – interest rates eventually normalise at higher rates than is implied by market expectations over the next five years; and
 - the cost of the package of oil and gas tax measures would be greater in the long term if a higher proportion of North Sea companies were tax-paying, as might be expected. (Currently, a large proportion of companies have either past trading losses or tax deductible expenditure sufficient to offset the tax liability from current profits).
- 4.28 In contrast to the relatively small net effect of the scorecard measures, the Government has also announced significant asset sales over the coming year. The two largest sales relate to NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution and further sales of Lloyds Banking Group shares. This allows net debt to fall as a share of GDP a year earlier than in December – but at the cost of future revenue.

Table 4.3: Summary of the effect of Government decisions

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Effects of receipts measures	0.5	0.0	0.2	-0.9	-0.6
<i>of which:</i>					
Income tax and NICs	0.1	-0.7	-0.6	-1.6	-1.5
Onshore corporation tax	0.2	0.5	0.5	0.4	0.3
UK oil and gas	-0.2	-0.4	-0.3	-0.3	-0.1
Fuel duty	-0.1	-0.2	-0.2	-0.2	-0.3
Alcohol duty	-0.2	-0.2	-0.2	-0.2	-0.2
Bank levy	0.7	0.9	0.9	0.9	0.9
Other	0.0	0.2	0.2	0.1	0.1
Effects of expenditure measures¹	0.3	0.0	0.0	0.0	0.0
<i>of which:</i>					
Current DEL	-0.5	0.1	0.1	0.0	0.0
Current AME	-0.1	-0.1	-0.1	0.0	0.0
<i>of which:</i>					
Welfare	0.0	0.0	0.0	0.1	0.1
Company and other tax credits	0.0	0.0	-0.1	-0.1	-0.1
Central government gross debt interest	-0.1	-0.1	-0.1	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Capital DEL	0.4	0.2	0.4	0.6	0.8
Capital AME	0.5	-0.2	-0.4	-0.6	-0.8
Total direct effect of Budget policy measures on PSNB	0.7	0.0	0.2	-0.9	-0.6
Effect of applying new Budget spending policy assumptions post 2015-16		1.9	1.9	2.0	-20.2
Financial transactions ²	8.5	0.0	0.0	0.0	0.0

¹ Expenditure categories are equivalent to PSCE in RDEL, PSCE in AME, PSGI in CDEL and PSGI in AME in Table 4.20.
² Affects PSNCR, not PSNB.
Note: this table uses the Treasury scorecard convention that a positive figure means an improvement in the PSNB, PSNCR and PSND.

Contingent liabilities

4.29 We have asked the Treasury to identify any changes to future contingent liabilities as a result of new policy announcements since December. The Government has made one such announcement in this Budget: a bonus of up to £3,000 for first-time buyers saving for a deposit, which appears in the Treasury's table of policy decisions. During the period when prospective first-time buyers are saving, the potential future bonus payments will represent a contingent liability to the public sector. The scale of this contingent liability is subject to significant uncertainty. Indeed, in Annex A, we have identified the assumptions about take-up of this support as a source of uncertainty in the policy costing itself.

Classification changes

4.30 Our forecast incorporates all the classification changes recently made by the ONS. We have also anticipated changes it has signalled it will make in March and later this year.⁴ We have included these changes in our forecasts for 2014-15 onwards. Outturn data will become consistent with our forecast once the ONS has completed them. They include:

- **multilateral development banks:** subscriptions to multilateral development banks that offer primarily concessionary loans (for example the World Bank's International Development Association) will be classified as capital transfers (spending) rather than equity injections (financial transactions). This adds £1.4 billion to capital spending and borrowing from 2014-15 onwards, but has no effect on net debt;
- **depreciation of the road network:** will be calculated over a life of 55 years rather than 75 years, to harmonise with other EU member states. This adds £1.1 billion to current spending from 2014-15 onwards (with an offsetting effect on gross operating surpluses on the receipts side to leave the effect neutral for borrowing);
- **Network Rail:** changes to the modelling of Network Rail depreciation reduce current spending by £0.5 billion in 2014-15 and £0.4 billion thereafter, with an offsetting effect on gross operating surpluses on the receipts side to leave the effect neutral for borrowing;
- **Air Travel Organiser's Licensing (ATOL) protection contributions:** will be included in receipts as a tax on production, having not previously been recorded in the public finances data. This adds £0.1 billion to current receipts from 2014-15 and reduces the current deficit and borrowing accordingly; and
- **new vehicle registration fee:** the fee that is paid when a motor vehicle is registered and taxed for the first time will be netted off in receipts as a tax on production rather than treated as negative expenditure. This change is neutral for borrowing, increasing current spending and current receipts by £0.1 to £0.2 billion from 2014-15 onwards.

Financial sector interventions

4.31 The Government undertook a number of interventions in the financial sector as a result of the crisis and recession of the late 2000s. Box 4.1 provides an update on the fiscal impact of these past interventions.

⁴ See 'Recent events and methodological changes' in the ONS *Public Sector Finances January 2015 Statistical Bulletin* (released in February).

Box 4.1: Fiscal impact of the financial interventions

This box provides an update on crisis-related interventions in the financial system, in particular:

- equity injections into Royal Bank of Scotland (RBS), Lloyds and the nationalisation of Northern Rock plc;
- holdings in Bradford & Bingley (B&B) and NRAM plc, now managed by UK Asset Resolution (UKAR);
- loans through the financial services compensation scheme (FSCS) and various wholesale and depositor guarantees; and
- other support, through the asset protection scheme, special liquidity scheme, credit guarantee scheme and a contingent capital facility – all now closed.

Table A summarises the position as at the end of February 2015.^a Since then, the Government has sold further shares in Lloyds and has announced an intention to sell more. It has also announced plans to sell NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution (UKAR). These are discussed later in the chapter.

In total, £134 billion has been disbursed by the Treasury to date since the crisis. By the end of February, principal repayments on loans, proceeds from share sales and redemptions of preference shares amounted to £39 billion, up from the £35 billion reported in our last *EFO*. The additional repayments mainly relate to the loan to UKAR (Northern Rock, NRAM plc and B&B working capital facility) and the recovery of the claim on Landsbanki estate (which operated its UK branch as Icesave) for depositors in the UK. In total, the Treasury also received a further £17 billion, mainly from fees. So the net cash position stood at around a £77 billion shortfall.

By the end of February, the Treasury was owed £37 billion – largely the value of loans outstanding – and held shares in Lloyds and RBS – valued at £49 billion – and holdings in B&B and NRAM plc.

If the Treasury was to receive all loan payments in full, and sold the shares at their latest values, it would realise an overall cash surplus of £9 billion. But these figures exclude the costs to the Treasury of financing these interventions, and any offsetting interest and dividend receipts. If all interventions were financed through debt, the Treasury estimate that additional debt interest costs would have amounted to £22 billion to date. The Treasury has also received around £5 billion of interest over the same period.

Table A: Cost of financial interventions

	£ billion					
	Cash disbursed	Principal repayments	Other fees received ¹	Outstanding payments	Market value ²	Implied balance
Lloyds	20.5	8.2	2.7	0.1	13.3	3.8
RBS	45.8	0.5	4.5	1.2	35.7	-3.9
UK Asset Resolution	41.3	21.2	3.7	19.1	-	2.7
FSCS	20.9	5.1	-	15.8	-	0.0
Other institutions	5.3	4.3	-	1.0	-	0.0
Credit Guarantee Scheme	-	-	4.3	-	-	4.3
Special Liquidity Scheme	-	-	2.3	-	-	2.3
Total	133.8	39.4	17.4	37.2	49.0	9.2

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

² Based on average share prices over the 10 working days to 26 February 2015.

^a The Lloyds figures show the position at 23 February, when the Government announced the sale of the first £500 million of shares that had been sold under the current trading plan.

Public sector receipts

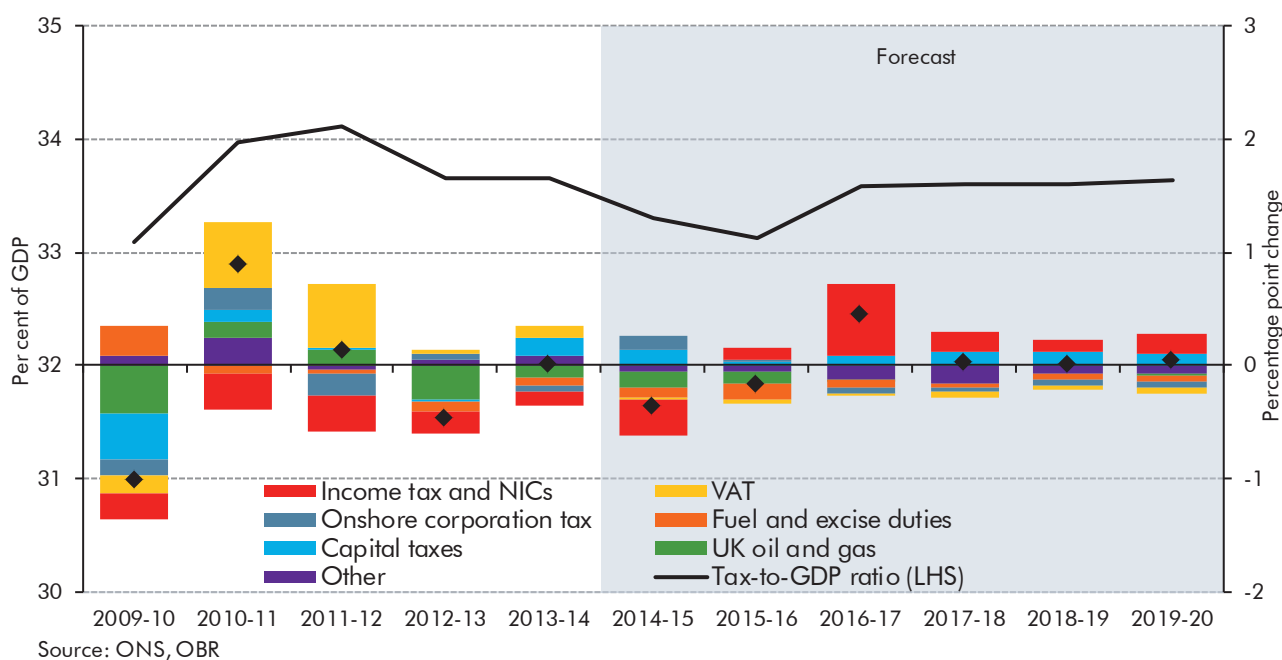
4.32 Table 4.4 summarises our receipts forecast. We expect taxes to have fallen by 0.5 per cent of GDP between 2013-14 and 2015-16, but then to return to just below their 2013-14 level by the end of the forecast period (due in part to the abolition of the NICs contracting out rebate in 2016-17). This would be only 0.5 percentage points higher than in 2009-10, when the budget deficit was at its peak. Non-tax receipts – in particular interest and dividend receipts – are also expected to rise over the forecast period, so that total receipts rise by 0.2 per cent of GDP between 2013-14 and 2019-20.

Table 4.4: Major receipts as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
		2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax and NICs	15.3	15.0	15.1	15.7	15.9	16.0	16.2
Value added tax	6.1	6.1	6.1	6.1	6.0	6.0	5.9
Onshore corporation tax	2.1	2.2	2.3	2.2	2.2	2.1	2.1
UK oil and gas receipts	0.3	0.1	0.0	0.0	0.0	0.0	0.0
Fuel duties	1.6	1.5	1.4	1.4	1.4	1.3	1.3
Business rates	1.5	1.5	1.5	1.5	1.5	1.5	1.4
Council tax	1.6	1.5	1.5	1.5	1.5	1.4	1.4
Excise duties	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Capital taxes	1.1	1.3	1.3	1.4	1.5	1.7	1.8
Other taxes	2.8	2.8	2.8	2.7	2.6	2.6	2.6
National Accounts taxes	33.7	33.3	33.1	33.6	33.6	33.6	33.6
Interest and dividend receipts	0.3	0.4	0.4	0.4	0.5	0.5	0.5
Other receipts	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Current receipts	36.1	35.8	35.5	36.1	36.2	36.2	36.3

4.33 Chart 4.2 shows how the tax-to-GDP ratio has changed in recent years, broken down by tax stream. As a result of weak real earnings growth and the effect of policy measures, income tax and NICs receipts have fallen as a share of GDP in every year since 2009-10, having the largest negative effect on the total tax-to-GDP ratio over this period. Oil and gas receipts, fuel and excise duties have all fallen as a share of GDP over this period. Partially offsetting these falls are VAT receipts, which have risen by 1.2 per cent of GDP, driven by the VAT rate rises in January 2010 and January 2011.

Chart 4.2: Changes in the tax-to-GDP ratio



Sources of changes in the tax-to-GDP ratio

4.34 Movements in the tax-to-GDP ratio can stem from two sources:

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

4.35 We have used this approach to identify the main drivers of the fall in the tax-to-GDP ratio in 2014-15 and the relatively slow rise over the remainder of the forecast period.

Change in the tax-to-GDP ratio in 2014-15

4.36 Chart 4.3 shows that the main sources of the 0.4 percentage point fall in the tax-to-GDP ratio are:

- a 0.4 per cent of GDP fall in PAYE and NICs receipts, explained in roughly equal measure by the tax base – wages and salaries – rising less quickly than GDP and by a

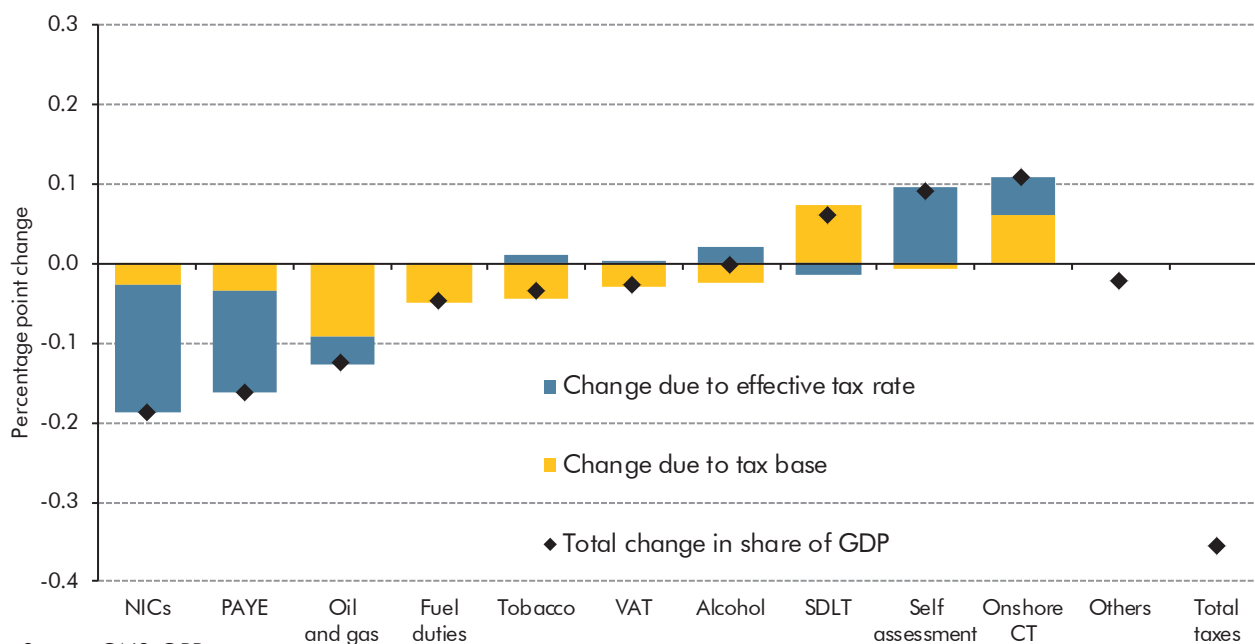
drop in the effective tax rate paid. The effective tax rate will have been reduced by the increase in the income tax personal allowance to £10,000. It is also likely to have been affected by changes in the composition of employment – lower paid age groups and lower paid occupations and industries have seen stronger growth in employment;

- a 0.1 per cent of GDP fall in oil and gas receipts, due to lower oil and gas prices and higher expenditure reducing taxable profits. (The steep fall in oil prices in late 2014 will mostly feed through into lower 2015-16 receipts); and
- a 0.1 per cent of GDP fall in excise duties, with receipts from fuel duty, tobacco duties and alcohol duties all falling as a share of GDP. The main source of the decline has been the tax base, which is either falling in absolute terms (tobacco) or is rising more slowly than GDP (alcohol and fuel).

4.37 Partly offsetting these falls are:

- a 0.1 per cent of GDP rise in self-assessment (SA) income tax receipts, due to the effects of income shifting prompted by the reduction in the additional rate of income tax to 45p in April 2013, which affected receipts with a lag;
- a 0.1 per cent of GDP rise in onshore corporation tax receipts, driven by growth in receipts from all sectors, partly reflecting strong profit growth; and
- a 0.1 per cent rise in stamp duty land tax (SDLT) receipts, reflecting strong growth in the tax base due to growth in house prices and property transactions over the past year. A slight reduction in the effective tax rate partially offsets this, mostly driven by the reforms to stamp duty announced in Autumn Statement 2014.

Chart 4.3: Sources of changes in the tax-to-GDP ratio (2013-14 to 2014-15)



Change in the tax-to-GDP ratio over the forecast period

4.38 Chart 4.4 shows that the main sources of the expected 0.3 percentage point rise in the tax-to-GDP ratio over the forecast period are:

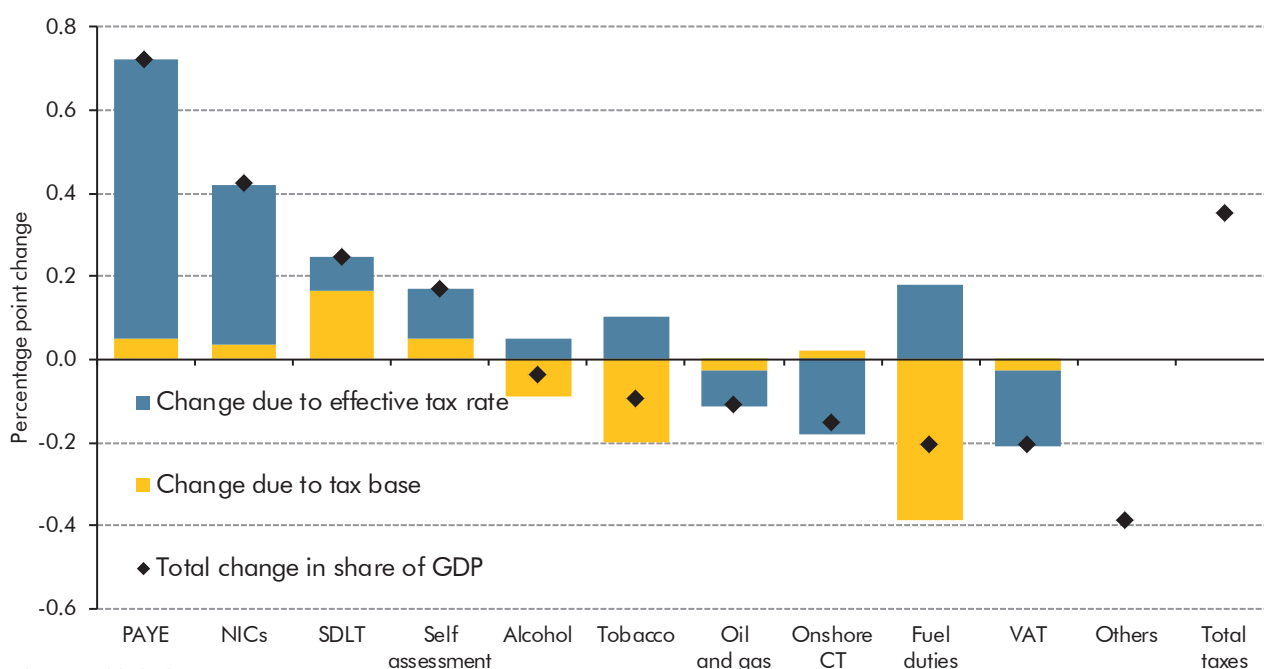
- a 1.1 per cent of GDP rise in PAYE and NICs receipts, driven almost entirely by a rise in the effective tax rate. The majority of this is explained by the return of fiscal drag, as productivity and real earnings growth are assumed to pick up, dragging more income into higher tax brackets. Around 0.3 per cent of GDP is accounted for by the Budget 2013 policy decision to abolish the NICs contracting out rebate, which is expected to raise NICs receipts by around £5 billion in 2016-17;
- a 0.2 per cent of GDP rise in SDLT receipts, reflecting both the tax base and the effective tax rate. Growth in the tax base reflects the growth in prices and transactions over the forecast period. With SDLT thresholds in the new 'slice' system still fixed in cash terms over the forecast period, rising house prices drag a greater proportion of the value of residential transactions into higher tax brackets; and
- a 0.2 per cent of GDP rise in SA receipts, again driven by the effective tax rate.

4.39 Partly offsetting these rises are:

- a 0.3 per cent of GDP fall in excise duties. This is explained by declining tax bases, due to falling tobacco consumption and increasing fuel efficiency, which are only partly offset by assumed rises in duty rates raising the effective tax rate. The planned September 2015 rise in fuel duty was cancelled in the Budget;

- a 0.2 per cent of GDP fall in onshore corporation tax receipts, driven entirely by a falling effective tax rate as strong growth in investment increases use of capital allowances and as the financial sector sets past losses against future liabilities;
- a 0.2 per cent of GDP fall in VAT receipts, as assumed increases in the share of household finances devoted to mortgage interest payments – which are zero-rated – make up a rising share of consumer spending, reducing the effective tax rate; and
- a 0.1 per cent of GDP fall in oil and gas receipts. The decline in the tax base is driven by lower oil and gas prices as well as a fall in the volume of production. The effective tax rate also falls over the forecast period. The policy measures announced in the Budget are assumed to raise production, but to reduce the effective tax rate further.

Chart 4.4: Sources of changes in the tax-to-GDP ratio (2014-15 to 2019-20)



Source: ONS, OBR

Detailed current receipts forecast

4.40 Tables 4.5 and 4.6 present our detailed receipts forecasts.

Table 4.5: Current receipts

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Income tax (gross of tax credits) ¹	157.7	162.6	170.5	182.0	192.7	202.8	216.5
of which: Pay as you earn	135.5	138.6	143.9	153.6	163.7	173.5	185.9
Self assessment	20.9	23.4	26.2	29.3	30.3	31.1	32.4
National insurance contributions	107.3	108.7	113.2	123.9	129.2	135.4	142.7
Value added tax	106.5	110.8	114.3	117.7	121.4	125.9	131.1
Corporation tax ²	40.3	42.4	43.0	43.6	44.6	45.6	46.6
of which: Onshore	36.7	40.3	42.3	42.9	44.0	44.8	46.0
Offshore	3.6	2.1	0.7	0.7	0.7	0.8	0.7
Corporation tax credits ³	-1.0	-0.9	-0.9	-0.9	-1.0	-1.0	-1.0
Petroleum revenue tax	1.1	0.5	0.0	-0.1	0.0	0.0	0.0
Fuel duties	26.9	27.2	27.0	27.2	27.6	28.2	28.8
Business rates	26.8	27.3	28.0	29.0	29.5	30.7	32.0
Council tax	27.5	27.9	28.3	28.8	29.5	30.2	31.1
VAT refunds	13.8	13.9	13.9	13.2	12.7	12.7	13.4
Capital gains tax	3.9	5.7	6.5	7.3	8.0	8.8	9.8
Inheritance tax	3.4	3.8	4.2	4.6	5.1	5.7	6.4
Stamp duty land tax ⁴	9.4	10.9	10.4	11.8	13.8	16.0	18.0
Stamp taxes on shares	3.1	3.0	3.3	3.4	3.5	3.6	3.9
Tobacco duties	9.6	9.4	9.1	9.0	9.1	9.2	9.3
Spirits duties	2.9	3.2	3.2	3.3	3.5	3.6	3.7
Wine duties	3.7	3.9	3.9	4.1	4.4	4.6	4.9
Beer and cider duties	3.7	3.7	3.4	3.4	3.6	3.6	3.6
Air passenger duty	3.0	3.2	3.1	3.2	3.4	3.5	3.7
Insurance premium tax	3.0	3.0	3.0	3.1	3.1	3.2	3.2
Climate change levy	1.2	1.7	2.0	2.0	1.8	1.7	1.6
Other HMRC taxes ⁵	6.5	6.5	6.8	6.6	6.9	7.1	7.3
Vehicle excise duties	6.1	6.1	5.8	5.6	5.5	5.3	5.1
Bank levy	2.3	2.8	3.6	3.8	3.7	3.7	3.7
Licence fee receipts	3.1	3.1	3.1	3.1	3.1	3.2	3.3
Environmental levies	3.1	4.8	5.9	6.8	7.3	8.7	9.4
EU ETS auction receipts	0.4	0.3	0.3	0.3	0.4	0.4	0.6
Scottish taxes ⁶	0.0	0.0	0.5	0.6	0.7	0.8	0.9
Diverted profits tax	0.0	0.0	0.0	0.3	0.4	0.3	0.4
Other taxes	7.3	7.2	6.5	6.1	6.0	5.9	6.0
National Accounts taxes	582.6	602.4	622.1	652.7	679.4	709.5	746.2
Less own resources contribution to EU	-2.9	-2.9	-2.6	-2.2	-2.3	-2.4	-2.6
Interest and dividends	5.9	6.4	6.7	7.5	9.2	10.7	11.9
Gross operating surplus	36.7	38.2	39.6	41.4	43.2	45.1	47.2
Other receipts	1.8	2.9	1.5	1.5	1.6	1.6	1.6
Current receipts	624.1	646.9	667.4	700.9	731.2	764.5	804.3
Memo: UK oil and gas revenues ⁷	4.7	2.6	0.7	0.6	0.7	0.8	0.7

¹ Includes PAYE, self assessment, tax on savings income and other minor components.

² National Accounts measure, gross of reduced liability tax credits. ³ Includes reduced liability company tax credits.

⁴ Forecast for SDLT is for England, Wales and Northern Ireland from 2015-16.

⁵ Consists of landfill tax (ex Scotland from 2015-16), aggregates levy, betting and gaming duties and customs duties.

⁶ Consists of Scottish LBTT and landfill tax but not the Scottish rate of income tax or aggregates levy.

⁷ Consists of offshore corporation tax and petroleum revenue tax.

Table 4.6: Change to current receipts forecast since December

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Income tax (gross of tax credits) ¹	0.0	-0.4	-0.2	1.0	1.2	0.7	2.6
<i>of which: Pay as you earn</i>	0.0	0.8	1.1	2.4	2.4	2.2	4.1
<i>Self assessment</i>	0.0	-1.2	-1.5	-0.7	-0.5	-0.8	-0.9
National insurance contributions	0.0	-0.2	0.2	1.0	1.0	1.3	2.5
Value added tax	0.0	0.7	0.2	0.1	-0.2	0.1	1.0
Corporation tax ²	0.0	0.7	-0.2	0.1	0.4	0.3	1.0
<i>of which: Onshore</i>	0.0	1.0	0.8	1.2	1.4	1.6	2.1
<i>Offshore</i>	0.0	-0.2	-1.0	-1.1	-1.0	-1.3	-1.0
Corporation tax credits ³	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Petroleum revenue tax	0.0	0.0	-0.5	-0.7	-1.0	-1.0	-1.0
Fuel duties	0.0	0.2	0.0	-0.5	-0.7	-0.9	-1.0
Business rates	0.0	0.2	0.4	-0.2	-0.4	-0.5	-0.7
Council tax	0.2	0.0	0.0	-0.2	-0.3	-0.4	-0.4
VAT refunds	0.0	0.0	0.1	0.1	-0.2	0.1	0.8
Capital gains tax	0.0	0.5	0.7	0.8	0.9	1.1	1.5
Inheritance tax	0.0	0.0	0.0	0.0	-0.1	-0.1	0.1
Stamp duty land tax ⁴	0.0	-0.6	-1.7	-2.0	-1.8	-1.4	-0.7
Stamp taxes on shares	0.0	0.1	0.4	0.4	0.4	0.4	0.5
Tobacco duties	0.0	0.3	0.1	0.0	0.0	0.0	0.0
Spirits duties	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Wine duties	0.0	0.0	-0.2	-0.3	-0.4	-0.5	-0.7
Beer and cider duties	0.0	0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Air passenger duty	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1
Insurance premium tax	0.0	-0.2	-0.3	-0.4	-0.4	-0.5	-0.5
Climate change levy	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Other HMRC taxes ⁵	0.0	-0.1	-0.1	-0.3	-0.3	-0.3	-0.4
Vehicle excise duties	0.0	-0.1	-0.3	-0.3	-0.4	-0.4	-0.4
Bank levy	0.0	0.0	0.7	1.0	0.9	0.9	0.9
Licence fee receipts	0.0	0.0	-0.1	-0.1	-0.2	-0.2	-0.2
Environmental levies	-0.1	0.0	0.2	-0.2	-0.3	0.2	0.3
EU ETS auction receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Scottish taxes ⁶	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0
Diverted profits tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	2.5	0.5	0.1	0.2	0.2	0.1	0.2
National Accounts taxes	2.6	1.9	-0.8	-1.2	-2.0	-1.4	4.9
Less own resources contribution to EU	0.0	0.1	0.2	0.3	0.3	0.4	0.4
Interest and dividends	0.1	0.1	-1.0	-2.4	-2.4	-2.4	-2.8
Gross operating surplus	-1.2	-1.0	-1.4	-1.5	-1.5	-1.4	-1.2
Other receipts	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Current receipts	1.8	1.1	-2.9	-4.9	-5.5	-4.9	1.3
<i>Memo: UK oil and gas revenues⁷</i>	0.0	-0.2	-1.5	-1.8	-2.0	-2.3	-2.0

¹ Includes PAYE, self assessment, tax on savings income and other minor components.

² National Accounts measure, gross of reduced liability tax credits. ³ Includes reduced liability company tax credits.

⁴ Forecast for SDLT is for England, Wales and Northern Ireland from 2015-16.

⁵ Consists of landfill tax (ex Scotland from 2015-16), aggregates levy, betting and gaming duties and customs duties.

⁶ Consists of Scottish LBTT and landfill tax but not the Scottish rate of income tax or aggregates levy.

⁷ Consists of offshore corporation tax and petroleum revenue tax.

Changes in the receipts forecast since December

4.41 Receipts in 2014-15 are expected to be higher than we forecast in December. That reflects stronger-than-expected receipts from onshore corporation tax, PAYE income tax and VAT. Overall SA receipts were around £0.6 billion lower than our December forecast with the provisional head of duty split suggesting that SA income tax was £1.2 billion lower than forecast, SA NIC was £0.1 billion higher and CGT receipts were £0.5 billion higher.

4.42 But our forecast for receipts has then been revised down between 2015-16 and 2018-19. As Table 4.7 shows, the key reasons for the weaker receipts forecast are:

- lower RPI inflation, which reduces excise, fuel duty and business rates, as well as interest receipts from student loans;
- SDLT, where a lower path for residential property transactions and a revised forecasting methodology (required due to the SDLT reforms announced in Autumn Statement 2014) reduce receipts;
- lower interest rates reduce income on the government's stock of financial assets, while large asset sales planned for 2015-16 – including mortgage-related assets held by UKAR and Lloyds Banking Group shares – lead to reductions in future interest and dividend receipts;
- UK oil and gas revenues, where much lower oil and gas prices, as well as a lower production forecast, reduce receipts. Policy measures announced in the Budget reduce receipts further, despite being assumed to boost production by raising the post-tax return from oil and gas extraction; and
- lower gross operating surplus (GOS), where lower outturn depreciation and lower public corporation GOS feed through into a weaker forecast. These more than offset upward revisions from classification changes.

4.43 These factors are somewhat offset by stronger PAYE and NICs receipts. Lower CPI inflation feeds through to a slower rise in tax thresholds. Since we assume that lower CPI inflation boosts real incomes – i.e. nominal income growth has not been revised down – that means more income is dragged into higher tax brackets. Higher outturn VAT, PAYE and onshore corporation tax receipts also boost receipts over the forecast.

Table 4.7: Sources of changes to the receipts forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	645.8	670.3	705.8	736.7	769.3	803.0
March forecast	646.9	667.4	700.9	731.2	764.5	804.3
Change	1.1	-2.9	-4.9	-5.5	-4.9	1.3
Underlying OBR forecast changes						
Total	1.1	-3.3	-4.9	-5.8	-4.0	1.9
<i>of which:</i>						
Income and expenditure	0.9	0.7	0.9	0.5	1.7	5.5
Average earnings	1.1	1.8	1.3	0.8	1.3	3.9
Employee numbers	0.6	0.8	1.2	1.4	2.0	2.5
Non-financial company profits	0.0	-0.3	-0.6	-0.6	-0.7	-0.6
Consumer expenditure	-0.2	-0.6	-0.6	-0.7	-0.8	-1.3
Investment	0.0	-0.1	0.4	0.4	0.5	0.4
Other	-0.4	-0.9	-0.8	-0.8	-0.6	0.5
North Sea	0.0	-0.9	-0.8	-1.1	-1.2	-1.1
Production	0.1	-0.2	-0.5	-1.1	-1.6	-1.6
Oil and gas prices	-0.2	-1.3	-1.0	-0.9	-1.0	-0.9
Expenditure	0.1	0.6	0.8	1.0	1.5	1.4
Market assumptions	0.1	-0.9	-1.2	-1.0	0.1	1.2
Residential property market	-0.2	-1.5	-2.1	-1.8	-0.9	0.1
Commercial property market	0.2	0.5	0.5	0.5	0.6	0.6
Equity prices	0.1	0.4	0.9	0.9	0.9	1.1
Interest rates	0.0	-0.3	-0.5	-0.6	-0.5	-0.6
Prices	-0.1	-0.7	-0.7	-0.4	-0.8	-1.0
Other economic determinants	0.1	0.3	0.1	-0.1	-0.1	-0.1
Other assumptions	0.0	-1.9	-3.3	-3.7	-3.7	-2.7
IT and NICs receipts and modelling	-0.9	-0.8	0.2	0.0	-0.5	-0.8
SA receipts	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9
CGT receipts and modelling	0.5	0.6	0.6	0.7	0.8	1.0
Corporation tax receipts and modelling	1.0	0.5	0.6	0.8	0.9	1.2
VAT receipts	1.0	1.1	1.1	1.1	1.2	1.5
North Sea receipts and modelling	-0.2	-0.4	-0.6	-0.6	-0.9	-0.8
Interest and dividend receipts and modelling	0.1	-0.8	-1.7	-1.9	-1.8	-2.0
Stamp duty land tax judgement	-0.6	-0.8	-0.9	-1.0	-1.4	-1.5
Non classification GOS changes	-1.6	-2.0	-2.2	-2.2	-2.2	-1.9
VAT refunds	0.0	0.1	0.1	-0.2	0.1	0.8
Classification changes	0.8	0.9	0.9	0.9	0.9	1.0
Other judgements and modelling	0.9	0.8	-0.3	-0.5	0.1	-0.1
Changes due to Government decisions						
Budget measures	0.0	0.5	0.0	0.2	-0.9	-0.6

Tax-by-tax analysis of changes since December

Income tax and NICs

4.44 Receipts of income tax and NICs are expected to be £0.6 billion down on our December forecast in 2014-15. We have revised PAYE and NICs up £0.6 billion, but self-assessment

income tax (SA) down by £1.2 billion. SA receipts remain lower in each year of the forecast, but over time this is more than offset by upward revisions to PAYE and NICs receipts and lower income tax repayments, giving a £5.1 billion net improvement by 2019-20.

- 4.45 PAYE and NICs receipts have been stronger than expected since our December forecast, reflecting receipts from the business services sector and from financial sector firms in non-bonus months. But in the light of initial receipts from bonuses, and recent announcements about major banks' bonus pools, we are now assuming a 10 per cent fall in financial sector bonuses in 2014-15. Some of the drop in financial sector bonuses may reflect the fact that financial firms have paid their employees higher base salaries or role-based allowances. With most bonuses paid in February and March (and received by HMRC in March and April), this judgement on bonuses remains uncertain.
- 4.46 Lower CPI inflation feeds through into slower growth in allowances and thresholds (which are usually uprated in line with inflation). With our nominal earnings growth forecast little changed over much of the forecast, this drags income into higher tax brackets, increasing the effective tax rate and boosting receipts by £2.1 billion by the end of the forecast period. Higher employment relative to our December forecast also pushes up PAYE and NICs receipts. This is due largely to stronger population growth, reflecting recent evidence on net migration. We have assumed that the effective tax rate is broadly flat in 2015-16. However, we expect PAYE and NICs receipts to rise as a share of GDP from 2016-17 onwards. This reflects a rising effective tax rate, due to the abolition of the NICs contracting out rebate in that year and the return of positive fiscal drag. Increasing the personal allowance further to £10,800 in 2016-17 and £11,000 in 2017-18 will reduce receipts growth in those years.
- 4.47 The balancing payment on 2013-14 SA liabilities was due by the end of January 2015. SA income tax receipts were £1.2 billion lower than forecast in December, but still around 12 per cent higher in 2014-15 than a year earlier. The £1.2 billion shortfall pushes through to future years. An initial analysis of SA returns suggests that income shifting related to the reduction in the additional rate of income tax to 45p boosted receipts to roughly the extent we expected. Some individuals deferred income from 2012-13 into 2013-14 to take advantage of the lower tax rate. Strong growth was recorded in both dividend and partnership income for those with incomes over £150,000. As in recent years, SA income growth for those at the lower end of the income distribution was weak. Relative to our forecast, the shortfalls for those below the additional rate threshold appear to have been in self-employment and savings income.
- 4.48 We expect further growth in SA receipts in 2015-16, despite the one-off boost to 2014-15 from income shifting. This in part reflects around £2¾ billion from previous Budget and Autumn Statement measures. The two largest measures boosting receipts in 2015-16 are those on partnerships and accelerated payments in follower avoidance cases. In the latter, taxpayers will have to pay disputed tax much earlier if HMRC wins a legal test case. As with all anti-avoidance measures, the yield from these measures is subject to considerable uncertainty (see Box 4.2 in our December 2014 *EFO*). The Government has extended the accelerated payments measure again in this Budget.

- 4.49 With the final payment on 2014-15 SA liabilities paid in 2015-16, we also expect SA receipts to be boosted by recent strong growth in self-employment, while rising profits are likely to boost dividend and partnership income. The number of people in self-employment increased by 6.8 per cent in 2014 as a whole. The limited amount of information on self-employment incomes suggests that growth continues to be concentrated at the lower end of the income distribution.
- 4.50 Prior to the Budget announcement of a £1,000 allowance for basic rate taxpayers' savings income from 2016-17 and a £500 allowance for higher rate taxpayers, tax on savings interest earned through a bank or building society was deducted through the TDSI (tax deduction scheme for interest) mechanism. Higher and additional rate taxpayers would pay any additional liabilities through SA or PAYE coding adjustments. As part of the policy, TDSI will be switched off, with liabilities from savings income above the allowance paid through SA or PAYE. On a pre-measures basis, receipts from TDSI were expected to be between £1.6 billion and £1.9 billion a year between 2016-17 and 2019-20. With extra receipts related to savings income now expected through SA and PAYE, the overall cost of the measure – including the effect of greater flexibility in the use of ISAs – is £1.0 billion in 2016-17 diminishing to £0.8 billion by 2019-20.

Table 4.8: Key changes to the income tax and NICs forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	271.9	283.6	303.9	319.7	336.2	354.1
March forecast	271.3	283.7	305.8	321.9	338.2	359.2
Change	-0.6	0.1	2.0	2.2	1.9	5.1
<i>of which:</i>						
<i>(by economic determinant)</i>						
Average earnings	1.1	1.8	1.3	0.8	1.3	3.9
Employee numbers	0.6	0.8	1.2	1.4	2.0	2.5
Inflation	-0.1	-0.2	1.0	1.6	1.8	2.1
SA determinants	-0.2	-0.3	0.0	0.0	0.0	-0.1
Other economic determinants	0.0	-0.2	-0.1	-0.1	0.0	-0.2
<i>(by other category)</i>						
Outturn PAYE and NICs receipts	-0.6	-0.7	-0.8	-0.9	-0.9	-1.1
Outturn SA receipts	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9
Other modelling and receipts changes	-0.3	-0.1	1.1	0.9	0.4	0.4
Budget measures	0.0	0.1	-0.7	-0.6	-1.6	-1.5

VAT

- 4.51 Accrued VAT receipts are expected to increase by 4.0 per cent in 2014-15. This is a little higher than the 3.6 per cent growth in nominal consumer spending, which accounts for over two-thirds of the tax base. Compared to our December forecast, accrued VAT receipts in 2014-15 are expected to be up £0.7 billion. Given that growth in receipts is stronger than growth in the theoretical level of VAT payments, the estimated VAT gap – the difference between the theoretical level of VAT payments and actual receipts received by HMRC – will have fallen slightly in 2014-15. We assume that the VAT gap remains constant thereafter.

- 4.52 By 2019-20, accrued VAT receipts are expected to be £1.0 billion higher than in our December forecast, thanks mainly to higher outturn receipts in 2014-15 being pushed through to future years, and a higher standard rated share of spending. Lower nominal household spending partly offsets this, reducing receipts by £1.3 billion by 2019-20.
- 4.53 We have revised up the share of consumer spending subject to the standard rate of VAT since December, mainly reflecting a higher estimated share in 2014. This reflects strong growth in spending on durable goods, notably on new cars. We expect this share to be flat in 2015, helped by continued strong growth in spending on durables. The recent fall in oil prices will partly offset this effect, as consumers spend less on road fuels which are generally standard-rated (road fuels are price inelastic, so a fall in the price leads to a proportionately smaller increase in volumes consumed, meaning the value of road fuels consumed falls). As in previous forecasts, the standard rated share is then expected to fall, as spending on mortgage payments is assumed to rise.

Table 4.9: Key changes to the VAT forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	110.1	114.1	117.7	121.6	125.7	130.2
March forecast	110.8	114.3	117.7	121.4	125.9	131.1
Change	0.7	0.2	0.1	-0.2	0.1	1.0
<i>of which:</i>						
Household spending	-0.2	-0.6	-0.6	-0.7	-0.8	-1.3
Latest receipts	1.0	1.1	1.1	1.1	1.2	1.5
Oil price effect on standard rated share	0.0	-0.1	-0.1	-0.1	-0.1	-0.2
Other standard rated share effects	0.0	0.3	0.1	-0.1	0.0	0.3
Other spending	-0.1	-0.4	-0.5	-0.5	-0.2	0.5
Budget measures	0.0	0.0	0.1	0.1	0.1	0.1

Onshore corporation tax

- 4.54 We have revised our forecast for onshore corporation tax receipts up by £1.0 billion in 2014-15, in light of stronger-than-expected payments on 2014 profits from the financial sector and on 2013 profits from smaller industrial and commercial firms. Receipts in 2014-15 are expected to be up around 10 per cent on a year earlier, despite the 2 percentage point cut in the main rate to 21 per cent that came into effect from April 2014. This seems to reflect increasing profitability of financial sector and life assurance firms.
- 4.55 Compared to December, onshore corporation tax receipts are expected to be higher throughout the forecast, with higher outturn receipts in 2014-15 being the main driver. Lower projections of industrial and commercial profits in most years have a negative effect on receipts, partly offset by a downward revision to our business investment forecast.
- 4.56 Growth in receipts from onshore corporation tax is expected to slow in 2015-16 and beyond. This reflects the further cut in the main rate of corporation tax to 20 per cent from April 2015 and the increase in the annual investment allowance to £500,000 until

December 2015. The latter measure has a large negative effect on receipts in 2015-16. Growth in receipts over the remainder of the forecast is also reduced by strong growth in investment, which increases the use of capital allowances, and by the continued high level of trading losses being carried forward and used against taxable profits in the financial sector. Despite the Autumn Statement 2014 measure to limit the use of trading losses by the banking sector (and measures announced in this Budget), corporation tax from the financial sector is still expected to be more than £4 billion lower than its pre-crisis peak in 2019-20.

4.57 Our December forecast included the receipts associated with the Autumn Statement diverted profits measure in onshore corporation tax receipts. In fact, the diverted profits tax is a separate stream of receipts, so we have removed it from the corporation tax forecast. The amount expected from the diverted profits tax has not changed since December (see Tables 4.5 and 4.6).

Table 4.10: Key changes to the onshore corporation tax forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast ¹	39.4	41.5	41.7	42.6	43.2	43.9
March forecast	40.3	42.3	42.9	44.0	44.8	46.0
Change	1.0	0.8	1.2	1.4	1.6	2.1
<i>of which:</i>						
Industrial and commercial company profits	0.0	-0.3	-0.6	-0.6	-0.7	-0.6
Industrial and commercial company investment	0.0	0.1	0.3	0.4	0.5	0.5
Other economic determinants	0.0	0.2	0.4	0.4	0.5	0.6
Latest receipts data	0.5	0.9	0.7	0.7	0.7	0.8
Modelling updates	0.5	-0.4	-0.1	0.0	0.2	0.4
Budget measures	0.0	0.2	0.5	0.5	0.4	0.3

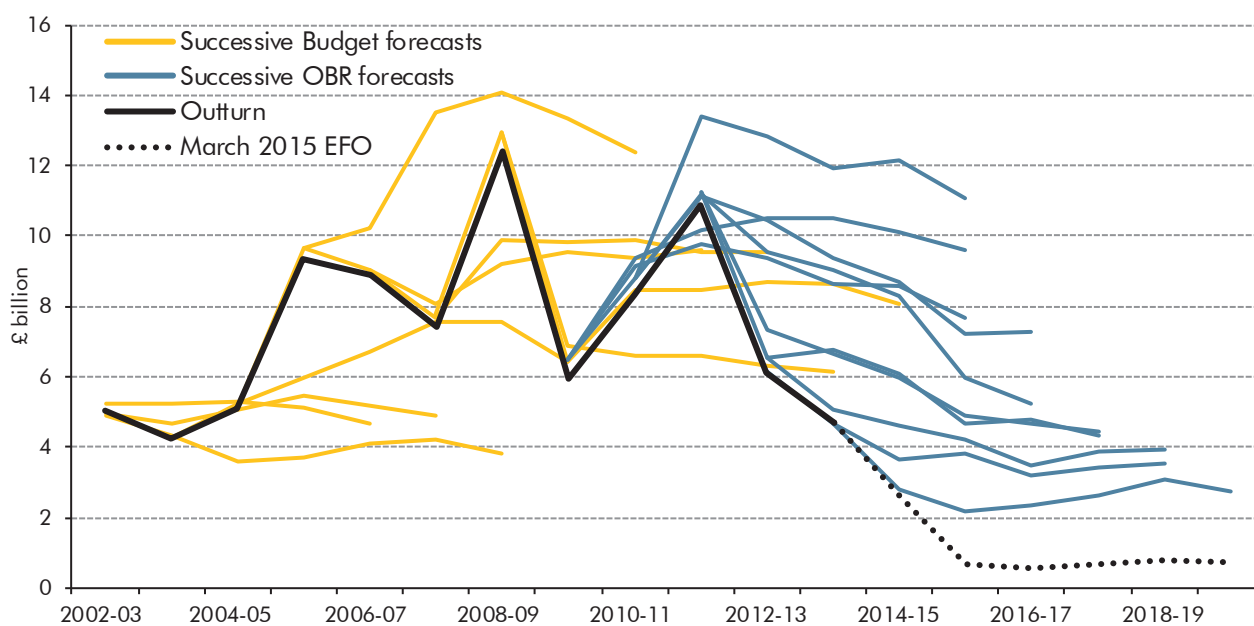
¹ December forecast has been adjusted to remove diverted profits tax.

UK oil and gas revenues

4.58 UK oil and gas revenues are expected to have fallen by 44 per cent between 2013-14 and 2014-15 to £2.6 billion. This compares with receipts of just under £11 billion three years earlier. The sharp fall in 2014-15 reflects the weakness in wholesale gas prices throughout 2014 (down 16p a therm from 2013) and the more recent sharp fall in oil prices (although they still averaged \$99 a barrel in 2014). The drop in receipts in 2014-15 also reflects the continued rise in operating and capital expenditure in the industry. In particular, capital expenditure rose by over 60 per cent between 2011 and 2014, due to several large projects and strong cost pressures. With 100 per cent first-year allowances available to oil and gas firms, higher investment leads to an immediate reduction in receipts.

4.59 Chart 4.5 shows the path of oil and gas receipts since 2002-03 and successive official forecasts that have been published over that period. That chart highlights the volatility of the revenue stream itself and the associated forecast errors.

Chart 4.5: Oil and gas receipts: outturns and forecasts



Source: HMRC, HM Treasury, OBR

- 4.60 We use oil and gas futures to project prices for 2015 and 2016 and then hold them flat. At \$62 a barrel in 2015, oil prices are expected to be \$21 lower than in our December forecast and \$40 lower than our March 2014 forecast. The projections for 2018 are \$15 and \$28 a barrel lower respectively. This has reduced our revenues forecast. In the absence of policy measures, it would be lower by around £1 billion a year.
- 4.61 Lower oil prices are likely to have marked effects on prospects for North Sea production and expenditure. In our December forecast, we expected capital expenditure to drop as several large projects were completed and lower oil prices reduced the likelihood of new projects coming on stream. In the absence of policy measures in this Budget, we would expect an even steeper drop as further falls in oil prices would have made it less likely that investment projects would pass hurdle rates. Incremental projects would also be expected to be cancelled and exploration and appraisal spending to be cut back quickly. The industry has already started to reduce operating expenditure.
- 4.62 These factors would also lead to a much lower production profile than we assumed in December, when oil and gas production was expected to be flat for much of the period, restarting its long-term decline in 2019. In the absence of policy measures, we would have revised down our forecasts for oil and gas production in 2019 by 27 per cent and 23 per cent respectively (Table 4.11).
- 4.63 Relative to December, our pre-measures forecast for revenues would be lower by £1 billion to £2 billion a year. By 2019-20, lower oil and gas prices would take £0.9 billion off the forecast, while the lower path for oil and gas production would reduce receipts by a further £1.6 billion. Partly offsetting that, lower expenditure would raise receipts by £1.4 billion.

- 4.64 One further source of change in our pre-measures forecast is a modelling correction. The large changes to our North Sea prices, production and revenue forecasts – and the policy measures announced in this Budget – required even greater scrutiny of the outputs of the oil and gas model. That required a number of corrections and updates to the model that have reduced the forecast by an average of £0.6 billion a year from 2015-16.
- 4.65 The policy measures announced in the Budget to introduce a new investment allowance, cut the supplementary charge (SC) from 30 per cent to 20 per cent and a 15 per cent cut in the rate of petroleum revenue tax (PRT), reduce receipts by a further £0.3 billion a year on average. The costing of these measures involved a relatively simple static effect of changing rates, but a highly uncertain set of judgements about the effect on capital expenditure and production, which offset some of the pre-behavioural cost.
- 4.66 The investment allowance will provide companies with an allowance of 62.5 per cent of capital investment to offset against profits subject to the SC. The allowance replaces existing field allowances and can be offset against profits (chargeable to the SC) arising from all operations in which companies are involved, not just the project or field from which the allowance is generated. The SC and PRT cuts also raise the post-tax returns on oil and gas extraction. In reaching a judgement on the extent to which these measures would lead to increased production and investment, we considered both bottom-up evidence of the possible impact on representative project profit-to-investment ratios and top-down evidence of the impact of the policy change relative to the oil price falls already witnessed.
- 4.67 The judgements we have made are subject to considerable uncertainty, as it is not possible to know the precise hurdle rates or cost and price assumptions that firms will make, or the speed with which any new investment will deliver additional production. With those caveats in mind, Table 4.11 presents our pre- and post-measures forecasts of production and expenditure. We have assumed for our central forecast that the policy measures will boost oil production by 14 per cent, capital expenditure by 23 per cent and operating expenditure by 6 per cent. Different assumptions would not be unreasonable and – as illustrated clearly in Chart 4.5 – it is likely that outcomes will be different to our forecasts. But we do consider the risks to be both to the upside and the downside.

Table 4.11: Oil and gas production and expenditure forecasts

	£ billion (unless otherwise stated)					
	2014	2015	2016	2017	2018	2019
	Pre-measures					
Oil production (million tonnes)	39.7	38.1	35.9	33.0	30.8	27.1
Gas production (billion therms)	13.1	12.5	11.5	10.8	10.1	9.3
Capital expenditure	14.8	10.5	8.0	6.0	5.0	4.0
Decommissioning expenditure	1.0	1.4	2.0	2.0	2.0	2.0
Exploration and appraisal expenditure	1.1	0.8	0.5	0.5	0.5	0.5
Operating expenditure	9.6	9.0	8.5	8.0	7.5	7.0
	Post-measures					
Oil production (million tonnes)	39.7	38.3	36.7	34.9	33.4	30.9
Gas production (billion therms)	13.1	12.6	11.9	11.4	10.9	10.3
Capital expenditure	14.8	10.8	8.3	6.6	5.9	4.9
Decommissioning expenditure	1.0	1.4	2.0	2.0	2.0	2.0
Exploration and appraisal expenditure	1.1	0.8	0.8	0.8	0.8	0.8
Operating expenditure	9.6	9.0	8.6	8.2	7.8	7.4

4.68 Overall, oil and gas receipts are set to fall to less than 0.05 per cent of GDP in 2015-16, the lowest share since 1975-76. Oil and gas receipts remain below 0.1 per cent of GDP throughout the forecast period.

Table 4.12: Key changes to the oil and gas revenues forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	2.8	2.2	2.4	2.6	3.1	2.7
March forecast	2.6	0.7	0.6	0.7	0.8	0.7
Change	-0.2	-1.5	-1.8	-2.0	-2.3	-2.0
<i>of which:</i>						
Pre-measures forecast changes	-0.2	-1.3	-1.4	-1.7	-2.0	-1.9
<i>of which:</i>						
Sterling oil prices	-0.2	-1.1	-0.8	-0.7	-0.7	-0.6
Gas prices	0.0	-0.2	-0.2	-0.2	-0.3	-0.3
Production	0.1	-0.2	-0.5	-1.1	-1.6	-1.6
Expenditure	0.1	0.6	0.8	1.0	1.5	1.4
Modelling and outturn receipts	-0.2	-0.4	-0.6	-0.6	-0.9	-0.8
Budget measures	0.0	-0.2	-0.4	-0.3	-0.3	-0.1
<i>of which:</i>						
Static effect	0.0	-0.2	-0.4	-0.4	-0.4	-0.3
Behavioural effect	0.0	0.0	0.0	0.1	0.1	0.3

Stamp duties

4.69 Stamp duty land tax (SDLT) is forecast to increase from £10.9 billion in 2014-15 (including Scottish SDLT receipts) to £18.0 billion in 2019-20 (excluding Scottish land and buildings transaction tax (LBTT) receipts). Compared to December, the forecast is lower by £0.6 billion in 2014-15 and by between £0.7 billion and £2.0 billion over the forecast period.

4.70 Residential property transactions are expected to be lower throughout the forecast period than previously assumed. Lower outturns since December and the subdued level of mortgage approvals reduce our near-term forecast, while we have revised down our assumption for the long-run trend level for transactions. This takes up to £1.2 billion a year off the SDLT forecast. Receipts have been lower in 2014-15 than would be implied by changes in prices and transactions – i.e. the effective tax rate appears to have fallen. This may reflect the slowdown in the London housing market in recent months. The weakness in 2014-15 receipts has been pushed through the forecast. We have also had to make some modelling changes due to the change from a ‘slab’ system to a ‘slice’ system announced in Autumn Statement 2014 (see Box 4.5 of our December 2014 *EFO*). The combined effect is to take over £1 billion a year off the forecast from 2017-18 onwards.

4.71 With SDLT being switched off in Scotland from April 2015, we expect SDLT receipts to fall in 2015-16. If receipts from Scotland’s LBTT were included, overall receipts would be flat between 2014-15 and 2015-16. The effects of lower residential property transactions in 2015-16 and Autumn Statement reforms to stamp duty – which reduce SDLT for around 98 per cent of purchasers – offset those from further house price growth and a stronger commercial property market. Thereafter, we expect strong growth as residential property transactions pick up towards their long-run trend and higher house prices raise the effective tax rate on transactions.

Table 4.13: Key changes to the SDLT forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	11.5	12.1	13.9	15.6	17.4	18.7
March forecast	10.9	10.4	11.8	13.8	16.0	18.0
Change	-0.6	-1.7	-2.0	-1.8	-1.4	-0.7
<i>of which:</i>						
House prices	-0.1	-0.3	-0.5	-0.4	0.1	0.7
Residential property transactions	-0.1	-1.1	-1.2	-1.0	-0.7	-0.6
Commercial property	0.2	0.5	0.5	0.5	0.6	0.6
Modelling and receipts outturns	-0.6	-0.8	-0.9	-1.0	-1.4	-1.5

4.72 The Scottish Government announced provisional rates for LBTT in its October 2014 Draft Budget and we included it for the first time in our December forecast. The Scottish Government then changed those rates in January. Our LBTT forecast is lower compared with December, reflecting the change in LBTT rates and a lower residential property transactions forecast for the UK as a whole. A fuller explanation can be found in our *Devolved taxes forecast* published alongside this *EFO*.

Taxes on capital

4.73 Capital gains tax (CGT) is paid via SA in the final quarter of the financial year after the year in which the gains from the sale of an asset are realised. So CGT receipts in 2014-15 reflect asset disposals in 2013-14. CGT receipts have risen from £3.9 billion in 2013-14 to £5.7 billion in 2014-15, boosted by the 13 per cent rise in equity prices in the previous year.

CGT is highly geared to changes in equity prices, since around three-quarters of chargeable gains are related to financial assets and CGT is only charged on the gain rather than the disposal price. CGT has also benefited from the recovery in the housing market in 2013-14, as CGT is payable on disposals of non-principal residences.

- 4.74 Compared to our December forecast, CGT receipts have been revised up in all years. That reflects higher than expected receipts in 2014-15 (up 45 per cent on a year earlier, even stronger than the 31 per cent we forecast in December). This higher starting point for the forecast builds to larger upward revisions in later years. A higher path for equity prices is partly offset by lower residential property transactions over the forecast period. By 2019-20, CGT receipts are expected to be £1.5 billion higher than in our December forecast.
- 4.75 Inheritance tax receipts are expected to rise by an average of around 11 per cent a year between 2014-15 and 2019-20. This reflects our forecast for strong growth in house prices and the stock of household cash deposits, as well as the effect of the nil-rate band being frozen until April 2018. This is consistent with the proportion of estates being subject to inheritance tax rising from an estimated 6.4 per cent in 2014-15 to 11.6 per cent in 2019-20.⁵ Compared to December, our forecast for inheritance tax is slightly lower in each year from 2016-17 to 2018-19 reflecting lower house prices and lower household holdings of cash and deposits.

Fuel duties

- 4.76 The volume of fuel clearances is on a long-term downward trend, reflecting the increasing fuel efficiency of motor vehicles. Total clearances fell 9 per cent in the decade to 2013-14, with lower petrol clearances more than offsetting a rise in diesel clearances.
- 4.77 While fuel duty is expected to be £0.2 billion higher in 2014-15 than assumed in our December forecast, we expect receipts to be £1.0 billion lower by 2019-20. The reduction in our RPI inflation forecast since December is expected to reduce fuel duty revenues by £0.5 to £1.0 billion a year between 2016-17 and 2019-20, as duty rates are assumed to be uprated by smaller amounts. As shown in Box 4.2, this uprating assumption could be considered a source of policy risk to the forecast given repeated decisions to cancel planned duty rises. Fuel duty has been frozen once again in this Budget. Lower pump prices resulting from the drop in oil prices are expected to boost the demand for fuel and to raise receipts by between £0.2 and £0.3 billion a year, relative to our December forecast.

Alcohol and tobacco duties

- 4.78 Alcohol duty is expected to increase from £10.7 billion to £12.2 billion between 2014-15 and 2019-20. Within this total, receipts from wine and spirits are expected to increase by £1.0 billion and £0.6 billion respectively, while beer and cider duties are expected to fall by £0.1 billion. We have revised down the expected growth in wine receipts over the forecast period. This reflects smaller duty rises, resulting from lower RPI inflation and measures, and a reassessment of wine consumption. After strong growth in wine clearances in the previous

⁵ The forecasts underpinning these proportions are available in the supplementary fiscal tables on our website.

decade, clearances in the past few years have been broadly flat. We now assume that wine consumption will grow in line with overall consumer spending over the forecast period.

- 4.79 Tobacco duties are expected to fall by £0.2 billion to £9.4 billion in 2014-15, despite the RPI plus 2 per cent rise in duty in March 2014. Cigarette clearances have trended down, thanks in part to the recent above-RPI increases in duty, changing attitudes to smoking, policies (such as the display ban) and the growing popularity of e-cigarettes. This fall also reflects the recent trend towards cheaper cigarettes, which were only a very small proportion of the market in 2008, but have since grown significantly. Because part of the duty on cigarettes depends on the final price, a lower average price reduces receipts. We expect receipts from tobacco duty to fall by a further £0.1 billion between 2014-15 and 2019-20. Rates are planned to increase by 2 per cent above RPI inflation in each year of the forecast, but this is offset by the downward trend in cigarette clearances.
- 4.80 The recently announced requirement for tobacco to be sold in plain packaging represents a source of uncertainty to our forecast. We have not made a specific adjustment for this, due to uncertainty around the timing of its introduction given likely legal challenges.

Box 4.2: The indexation of excise and environmental duties in our forecast

Our forecasts for excise and environmental duties assume that rates are indexed in line with default parameters. These parameters are set by the Government and detailed at each Budget in the Treasury's *Policy costings document*. The assumptions represent a source of economy and policy-related uncertainties in our forecast. In this box, we look back at how a selection of duty rates have moved over the last Parliament relative to the default uprating assumptions assumed in the OBR's first forecast in June 2010.

Table B sets out the level of selected duties at the June 2010 Budget, the default indexation parameters underpinning that forecast, what the rates would have been today in the absence of Government policy (abstracting from differences between actual inflation and our forecasts) and the actual level of rates now.

The table shows that several duties (fuel, alcohol, aggregates levy) have been reduced relative to the default uprating assumptions underpinning the June 2010 forecast. One source of potential difference between actual rates now and the level that would have been assumed had they been uprated in line with default assumptions is errors in our inflation forecasts. For example, relative to the June 2010 forecast, the level of the Retail Prices Index by the end of 2014 was 0.6 per cent lower than we forecast.

But a major source of difference has been policy changes at various Budgets and Autumn Statements that have delayed, frozen or cut rates. The main fuel duty rate has been cut once and frozen four times over this Parliament – and has been again in this Budget – leaving the rate around 20 per cent lower than it would have been if default uprating had proceeded in line with the June 2010 forecast and 19 per cent lower than if it had followed actual RPI inflation. This contrasts with the Budget 2011 fair fuel stabiliser measure, which proposed to raise fuel duty by RPI plus 1 per cent in the event of oil prices reaching \$75 a barrel (later specified in regulations

as £45 a barrel). The oil price is now £38 a barrel, but the fair fuel stabiliser was abolished in Autumn Statement 2014 (when the oil price stood at £50 a barrel).

The biggest exception to this is the specific duty on cigarettes, which has risen much faster than we would otherwise have assumed. In part that reflects the Budget 2011 policy measures that raised the specific duty by around £36 per thousand cigarettes, while at the same time cutting the ad valorem rate from 24 per cent to 16.5 per cent of the retail price. The main rates for vehicle excise duty (VED), air passenger duty (APD) and the climate change levy (CCL) have risen in line with the default indexation parameters.

Table B: Indexation parameters

Tax head	Level at June Budget 2010	Default indexation parameter at June Budget 2010	Level if no Government policy since June Budget 2010	Level at Budget 2015	Difference (per cent)	Default indexation parameter at Budget 2015	2014-15 receipts (£ billion)
Fuel duty ¹	57.19	RPI + 1ppl escalator until 14-15, RPI thereafter	72.48	57.95	-20.0	Freeze in 15-16, RPI thereafter	27.2
Tobacco duty ²	119.0	RPI + 2% until 14-15, RPI thereafter	148.8	189.5	27.4	RPI+2%	9.4
VED ³	155.0	RPI (rounded to £5)	180.0	180.0	0.0	RPI (rounded to £5)	6.1
Beer duty ⁴	17.3	RPI + 2% until 14-15, RPI thereafter	21.6	18.4	-15.0	-2% in 15-16, RPI thereafter	3.3
Wine duty ⁵	225.0	RPI + 2% until 14-15, RPI thereafter	281.3	273.3	-2.8	Freeze in 15-16, RPI thereafter	3.9
Spirit duty ⁶	23.8	RPI + 2% until 14-15, RPI thereafter	29.8	27.7	-7.1	-2% in 15-16, RPI thereafter	3.2
Cider duty ⁷	33.5	RPI + 2% until 14-15, RPI thereafter	41.8	38.9	-7.1	-2% in 15-16, RPI thereafter	0.3
APD ⁸	11.0	RPI (rounded to £1)	12.0	13.0	8.3	RPI (rounded to £1)	3.2
Climate change levy ⁹	0.47	RPI	0.55	0.55	0.0	RPI	1.7
Landfill tax ¹⁰	48.0	£8 per tonne until 14-15, RPI thereafter	80.8	82.6	2.3	RPI	1.1
Aggregates levy ¹¹	2.0	RPI	2.3	2.0	-13.8	Freeze in 15-16, RPI thereafter	0.3

¹ Main rate (pence per litre)

² Cigarette specific duty (£ per 1000 sticks)

³ Band G (£ per vehicle)

⁴ Main rate (£ per 1% ABV per hectolitre)

⁵ Main rate (£ per hectolitre of product)

⁶ £ per litre of pure alcohol

⁷ Main rate (£ per hectolitres of product)

⁸ Band A (£ per ticket)

⁹ Electricity rate (pence per gross kWh)

¹⁰ Standard rate (£ per tonne)

¹¹ Standard rate (£ per tonne)

Other taxes

- 4.81 **Business rates** have been revised up in 2015-16 and then down in each year from 2016-17, compared with December. The upward revision in 2015-16 reflects information from local authorities on the yield expected from business rates in that year. The subsequent downward revisions reflect lower RPI inflation. Business rates are calculated by multiplying the rateable value of non-domestic property by the multiplier (which is updated in line with RPI inflation).
- 4.82 We have also revised down our expectation of the cost of the business rates discount to small shops, pubs, cafes and restaurants. Information from local authorities suggests a cost of less than £300 million in 2015-16 rather than the £500 million originally scored in the 2013 and 2014 Autumn Statements. The lower cost reflects fewer eligible properties and a lower take-up rate than originally assumed. In the past, we have also had to reduce our initial estimates of the cost of other business rates reliefs, such as those for enterprise zones.
- 4.83 Receipts from **council tax** are expected to be slightly lower than in our December forecast. These changes are explained in more detail in the expenditure section of this chapter. Changes in council tax receipts are offset within the locally-financed expenditure forecast, and are therefore neutral for net borrowing.
- 4.84 **Air passenger duty (APD)** receipts are expected to rise from £3.2 billion in 2014-15 to £3.7 billion in 2019-20. This reflects duty rate rises and growth in passenger numbers. Our forecast is slightly lower than in December, as lower RPI inflation means duty rates are updated by smaller amounts.
- 4.85 **Vehicle excise duty** is levied annually on road vehicles and is based on the carbon emissions produced by different types of vehicles. Revenues are expected to fall over the forecast period, as increases in fuel efficiency reduce the average duty rate paid. Our forecast is slightly lower than in December, reflecting lower RPI inflation.
- 4.86 **Environmental levies** include levy-funded spending policies such as the renewables obligation and contracts for difference, feed-in tariffs and the warm homes discount. We have also included the DECC capacity markets scheme in the forecast for the first time. The underlying downward revision to our forecast for 2016-17 since December reflects lower RPI inflation, but the forecast is higher overall in the final two years of the forecast due to the capacity markets scheme.
- 4.87 **Environmental taxes** include the aggregates levy, climate change levy (including the carbon price floor), landfill tax and the EU emissions trading scheme (EU ETS). Landfill tax receipts have been revised down by around £0.2 billion in the latter years of the forecast period, reflecting a lower proportion of waste being sent to landfill. Other taxes are broadly unchanged since December.
- 4.88 **Bank levy** receipts are expected to rise from £2.8 billion in 2014-15 to £3.7 billion by 2019-20. This entirely reflects the Budget announcement that the bank levy rate would rise

to 0.21 per cent from April 2015. Excluding this measure, bank levy receipts were expected to remain close to their 2014-15 level throughout the forecast.

- 4.89 Receipts in 2014-15 have come in as expected a year ago. This is in contrast to previous years when receipts have disappointed. The tax base – specific types of bank liabilities – was initially over-estimated and then fell away more quickly than expected. The levy was then repeatedly raised to offset the loss of receipts from a smaller tax base. Our recent forecasts have incorporated a further near-term shrinkage in banks' balance sheets. In the current forecast, the tax base is assumed to continue to fall until 2017 and is then held flat for the remainder of the forecast. Given that the Budget announcement is for a sizeable rise in the bank levy rate, we have allowed for a larger behavioural response to the policy change. Banks may restructure their funding arrangements, while foreign banks may locate less activity in the UK.
- 4.90 **VAT refunds** to central and local government are neutral for borrowing, as they are offset within spending. The forecast for VAT refunds largely reflects the path of government procurement and investment. VAT refunds are therefore forecast to fall by an average of 2.2 per cent a year between 2015-16 and 2018-19, but to rise by 6.0 per cent in 2019-20 reflecting the path of government procurement implied by the Government's latest spending assumption for that year.
- 4.91 We include a provision for **tax litigation losses** in our receipts forecast. Once cases are settled – and their effects in particular years can be quantified – they are incorporated into the public finances. The magnitude and timing of losses is difficult to forecast as it depends on the nature of the legal judgement and the Government's response. We have kept our provision for future litigation losses over the whole forecast period at £5.6 billion, in line with the provision included in the 2013-14 HMRC Trust Statement.

Other receipts

- 4.92 **Interest and dividend** receipts capture the interest income on the government's stock of financial assets, which includes student loans and holdings related to financial sector interventions due to the late 2000s financial crisis. Lower interest rates through the forecast both in the UK and abroad reduce receipts compared with our December forecast. Lower inflation reduces interest income from student loans, while a lower Bank Rate assumption reduces interest income on some older student loans.
- 4.93 Two significant sources of revision to our forecast since December relate to the asset sales described later in this chapter. The Government has announced sales of mortgage-related assets held by UK Asset Resolution (UKAR) and of shares in Lloyds Banking Group. These sales generate cash for the Government, but reduce future income due to the mortgage interest and Lloyds dividends foregone. (We included a forecast for Lloyds dividends for the first time in our December forecast.) Together, the effect on interest and dividend receipts on our forecast is over £1 billion a year on average from 2016-17 onwards.

Table 4.14: Key changes to the interest and dividends forecast since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	6.3	7.7	10.0	11.6	13.1	14.8
March forecast	6.4	6.7	7.5	9.2	10.7	11.9
Change	0.1	-1.0	-2.4	-2.4	-2.4	-2.8
<i>of which:</i>						
Interest rates	0.0	-0.2	-0.3	-0.3	-0.3	-0.4
Earnings on foreign exchange reserves	-0.1	-0.3	-0.3	-0.3	-0.3	-0.5
Interest on student loans (RPI effect)	0.0	0.0	-0.4	-0.3	-0.3	-0.4
Interest on student loans (other effects)	0.0	-0.2	-0.1	-0.4	-0.4	-0.5
UKAR (including effect of sales)	0.0	-0.1	-0.9	-0.8	-0.7	-0.6
Lloyds dividends (including effect of sales)	0.0	-0.3	-0.7	-0.6	-0.6	-0.6
Other	0.2	0.1	0.2	0.3	0.2	0.1

4.94 Our forecast for **gross operating surplus (GOS)** comprises general government depreciation and public corporations' gross operating surplus. Classification changes to depreciation have increased GOS by an average of around £0.9 billion a year, as explained above. More than offsetting that, we have reduced our underlying forecast for GOS by around £2.1 billion a year reflecting the latest outturn data.

Public sector expenditure

4.95 This section explains our central projections for public sector expenditure, which are based on the National Accounts aggregates for public sector current expenditure (PSCE), public sector gross investment (PSGI), and total managed expenditure (TME), which is the sum of PSCE and PSGI. The Treasury plans public spending using two administrative aggregates:

- departmental expenditure limits (DELs)⁶ – mostly spending on public services and administration, which can be planned some years in advance. Our forecast is based on the Government's latest plans for resource and capital DELs to 2015-16, plus our view of the extent to which departments might underspend against these limits; and
- annually managed expenditure (AME) – categories of spending less amenable to multi-year planning, such as social security spending and debt interest. We forecast these out to 2019-20, based on determinants derived from our economic forecast.

4.96 For the years 2014-15 and 2015-16, our projections are constructed using the latest plans for PSCE in RDEL and PSGI in CDEL,⁷ plus our forecast for departments' underspending against those plans. To this, we add our detailed forecast for AME spending.

⁶ Our presentation of expenditure only shows those components of RDEL, CDEL and AME that are included in the fiscal aggregates of PSCE and PSGI. For budgeting purposes, the Treasury also includes other components in DEL and AME such as non-cash items.

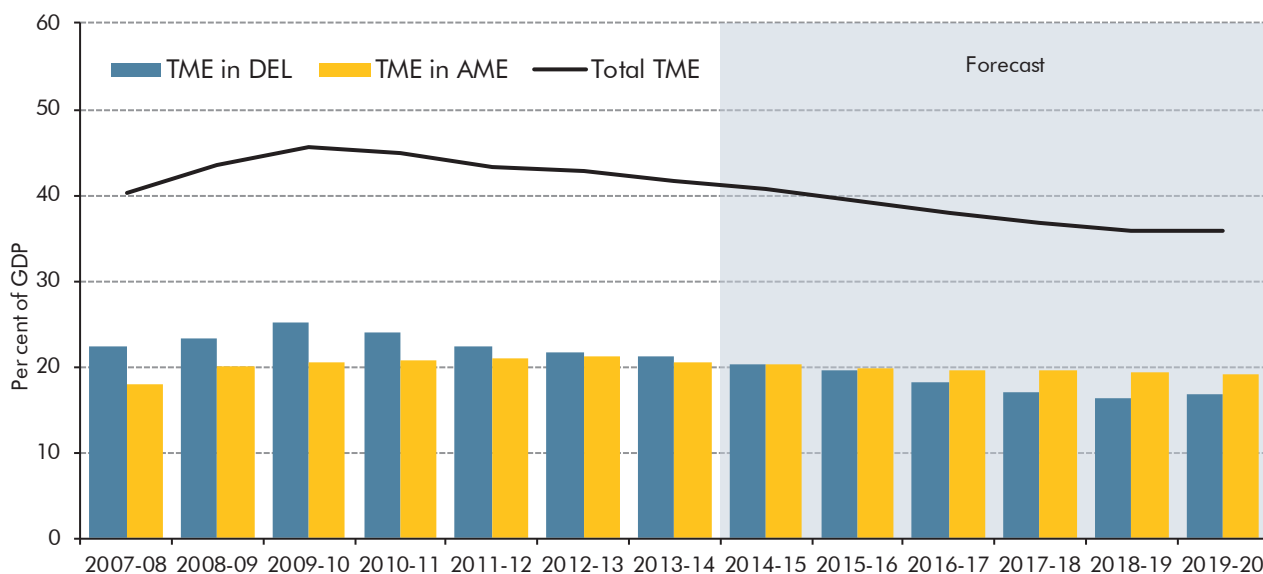
⁷ Our forecasts for PSCE in RDEL and PSGI in CDEL are consistent with the Government's plans for RDEL and CDEL presented in the Budget. A reconciliation between the Treasury's DEL figures and ours is published in the supplementary fiscal tables on our website.

4.97 Beyond 2015-16, the Government has not set out detailed spending plans. Instead, our projections for total spending from 2016-17 to 2019-20 are based on the Government’s policy assumptions for TME that are set out in paragraph 4.103. We produce a bottom-up forecast of AME for these years, which is subtracted from the level of TME that results from the Government’s policy assumptions to derive implied resource and capital DELs. This approach means that changes in AME spending beyond 2015-16 – e.g. debt interest or social security – result in offsetting changes in implied DELs.

4.98 Chart 4.6 shows TME as a share of GDP from 2007-08 to the end of the forecast period, and how TME is split between DEL and AME. Spending increased sharply as a share of GDP during the late-2000s recession, reaching a peak of 45.7 per cent of GDP in 2009-10. With DELs fixed in cash terms through to 2010-11 in the 2007 Comprehensive Spending Review, this mainly reflected the large shortfall in nominal GDP in 2008-09 and 2009-10 relative to forecast. AME spending on social security and debt interest also increased over this period.⁸

4.99 From its peak in 2009-10, we estimate TME reached 40.7 per cent of GDP in 2014-15 and will fall to 39.6 per cent in 2015-16, the final year of detailed spending plans. The Government’s TME assumptions imply that spending will fall considerably further as a share of GDP, to 36.0 per cent of GDP in 2018-19 and 2019-20.

Chart 4.6: DEL and AME components of TME



Note: Series adjusted to remove discontinuities. DEL and AME series exclude major historical switches. Forecast figures exclude future classification changes not yet reflected in outturn. Details are available in the supplementary fiscal tables on our website.
Source: ONS, OBR

⁸ For a detailed discussion of the public finances during this period, see Riley and Chote (2014): *Working Paper No.7: Crisis and consolidation in the public finances*.

Summary of the expenditure forecast

4.100 Table 4.15 summarises our latest forecast for public expenditure. TME is expressed as a share of GDP, but not all of TME contributes directly to GDP, as benefit payments, debt interest and other cash transfers merely shift income from some individuals to others.

Table 4.15: Expenditure as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Total managed expenditure	41.7	40.7	39.6	38.1	36.8	36.0	36.0
<i>of which:</i>							
Public sector current expenditure	38.1	37.0	35.9	34.5	33.3	32.5	32.5
Public sector gross investment	3.5	3.7	3.6	3.6	3.5	3.5	3.5
Total public sector expenditure that contributes directly to GDP ¹	23.2	22.6	21.8	20.7	19.5	18.8	19.0
<i>of which:</i>							
General government consumption	20.2	19.6	18.9	17.8	16.7	16.0	16.2
General government gross fixed capital formation	2.6	2.6	2.5	2.5	2.4	2.4	2.4
Public corporations gross fixed capital formation	0.4	0.4	0.4	0.4	0.4	0.4	0.3

¹GDP at market prices.

4.101 Table 4.16 shows how TME is split between DEL and AME, and the main components of AME. AME is forecast to be relatively flat as a share of GDP over the forecast period. Welfare spending is forecast to fall gradually as a share of GDP as working-age benefits are uprated by less than earnings growth and as some caseloads fall as a share of the population. Debt interest payments have been revised down significantly due to lower interest rates and lower cash borrowing, including due to the effects of further asset sales. The Government's spending policy assumptions imply DEL spending will fall as a share of total spending in each year until 2018-19, but rise in 2019-20. As described in Box 4.6 of our December 2014 *EFO*, this aspect of our forecast is subject to particular uncertainties relating to future policy decisions of future governments.

Table 4.16: TME split between DEL and AME

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
TME in DEL ¹	20.6	19.8	19.1	17.7	16.5	15.9	16.2
TME in AME	21.1	20.9	20.5	20.4	20.3	20.1	19.8
of which:							
Welfare spending	12.1	11.9	11.6	11.3	11.1	10.9	10.6
Debt interest net of APF	2.1	1.9	1.8	2.1	2.3	2.3	2.3
Locally-financed current expenditure	1.9	2.0	2.0	2.1	2.1	2.1	2.0
Other PSCE in AME	3.7	3.8	3.7	3.6	3.5	3.6	3.6
PSGI in AME	1.3	1.4	1.4	1.4	1.3	1.3	1.2

¹ In relation to table 4.20, TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME, and TME in AME is defined as PSCE in AME plus PSGI in AME minus single use military equipment (SUME).

The Government's spending policy assumptions

4.102 For the years beyond those covered by detailed spending plans, our forecasts for spending are based on the Government's policy assumptions for growth in total spending. The precise terms of these assumptions tend to change at each Budget and Autumn Statement.⁹

4.103 The Government's policy assumptions for the growth of TME between 2016-17 and 2019-20 at Budget 2015 are as follows:

- for 2016-17 and 2017-18:** TME should fall in real terms at the same rate as over the 2010-11 to 2014-15 period covered by Spending Review 2010. For 2010-11, the relevant measure of TME should exclude underspending against plans and the in-year spending reductions announced in the June 2010 Budget, include an estimate of the retrospective effect of our decision to anticipate the future ONS revisions to the measurement of depreciation for Network Rail and the life-length of roads, but not include the retrospective effect of our decision to anticipate the future ONS reclassification of UK subscriptions to multilateral development banks. For 2014-15, the measure of TME should exclude our measure of DEL shortfalls, include our changes to the depreciation forecast that anticipate ONS revisions mentioned above, exclude the changes to our forecast for the ONS's reclassification of UK subscriptions to multilateral development banks, exclude the net effect of the historical adjustment to the UK's GNI-based contribution to the EU, and also exclude the expected adjustment in respect of its VAT contributions to the EU in December 2014. This fall in real terms should then be applied to our pre-measures forecast of TME in 2015-16, which should also exclude our forecast for DEL underspending, exclude the reclassification of UK subscriptions to multilateral development banks, exclude the additional rebate in respect of the historical adjustment to the UK's GNI-based contribution to the EU, exclude the adjustments included in our latest forecast that would accrue in December 2015 in respect of UK GNI and VAT-based contributions to the EU in 2014-15, but

⁹ Alongside this EFO, we have published a full set of the TME growth assumptions that have applied to post-Spending Review periods in each of the forecasts that we have produced since March 2011.

include the adjustment included in our latest forecast for the expected revisions to the UK's 2015-16 GNI contributions when these are revised in May 2015. The effects of previous budget measures are also taken into account, to ensure that they have the same effect on future years as they did in each previous fiscal event. Within TME, PSGI should be held flat in real terms from a level in 2015-16 that includes our allowance for shortfall and includes the reclassification of UK subscriptions to multilateral development banks;

- **for 2018-19:** TME should be held flat in real terms, and within TME, PSGI should grow in line with nominal GDP. The results should be calculated to ensure that previous budget measures have the same effect as announced in the relevant fiscal event; and
- **for 2019-20:** both TME and PSGI within TME should be grown in line with nominal GDP. Again, the results should be calculated to ensure that previous budget measures have the same effect as announced in the relevant fiscal event.

4.104 Since December 2012, the spending assumption has been described in the Treasury's Budget and Autumn Statement documents as a 'fiscal assumption' rather than a spending assumption, with those documents noting that tax rather than spending could deliver some of the consolidation implied by the assumption. For this Budget, we have sought and received specific assurances from the Treasury that the latest assumption described above represents the Coalition Government's agreed position for Budget 2015, and that it has been discussed by the 'Quad' and agreed by both parties in the Coalition.

4.105 The complex formulation of the assumption means that changes in the implied cash paths of PCSE in RDEL and PSGI in CDEL from forecast to forecast reflect a number of factors, including:

- changes in our spending forecast in the base year for the growth assumption;
- changes in the definition of spending used to calculate the assumption;
- changes in our GDP deflator forecast, which feed through to changes in the amount of cash spending needed to achieve the assumed real growth rates, and our nominal GDP forecast;
- Government decisions shown in the Treasury's table of policy decisions and changes in its spending assumptions; and
- changes in our forecast for AME after 2015-16.

4.106 Table 4.17 sets out the changes since December to the cash values of TME implied by the latest policy assumption. It shows that:

- using the previous formulation of the spending assumptions that was Government policy in December, the £3.0 billion reduction in the forecast for TME in 2015-16 –

largely from lower debt interest payments – would have reduced TME by an average of £4.2 billion a year over the four years from 2016-17 to 2019-20. (The effect of the GDP deflator on spending in 2019-20 is complicated by the effect of the new spending assumption on the GDP deflator. We have shown the effect here assuming the revision to the GDP deflator in 2019-20 absent the change in the spending assumption would have been proportionate to the revision in 2018-19);

- within this overall change to TME, the further large falls in AME spending – again, largely from lower debt interest payments, but also from lower welfare spending – would have meant that, over the four-year period from 2016-17 to 2019-20, DEL spending would on average have been £9.5 billion a year higher than in our December forecast; but
- the change to the spending assumptions in this Budget have reduced implied RDEL spending by around £2 billion a year from 2016-17 to 2018-19, and then increased RDEL spending by just over £20 billion in 2019-20.

Table 4.17: Changes to TME from 2015-16 since December

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	746.2	746.7	751.3	765.3	779.9
March forecast	742.6	740.3	743.9	759.2	797.3
Change	-3.6	-6.4	-7.3	-6.1	17.4
Underlying OBR forecast changes					
Forecast changes since December	-3.3				
Effect of applying Autumn Statement spending policy assumptions post 2015-16		-4.4	-5.4	-4.1	-2.8
<i>of which:</i>					
GDP deflator	-	-0.9	-1.4	-0.1	1.3
AME	-4.3	-11.7	-13.3	-14.2	-14.4
DEL plans	1.0	-	-	-	-
Changes to implied DEL	-	8.1	9.3	10.1	10.3
Changes due to Government decisions					
Budget policy measures	-0.3	0.0	0.0	0.0	0.0
Effect of applying new Budget spending policy assumptions post 2015-16	-	-1.9	-1.9	-2.0	20.2

4.107 Table 4.18 sets out real growth rates and shares of GDP for different spending aggregates, determined by the spending policy assumptions set out above and our forecast of AME spending. It illustrates the extent to which real terms cuts to spending from 2010-11 onwards are concentrated in departmental spending – particularly day-to-day spending on public services (PSCE in RDEL) – and the large fall in spending as a share of GDP that results. The changes the Government has made to the spending assumptions for 2019-20 mean that this multi-year squeeze on public services spending is now forecast to end in 2018-19, with implied PSCE in RDEL rising slightly as a share of GDP in 2019-20. These forecasts are subject to considerable policy-related uncertainty.

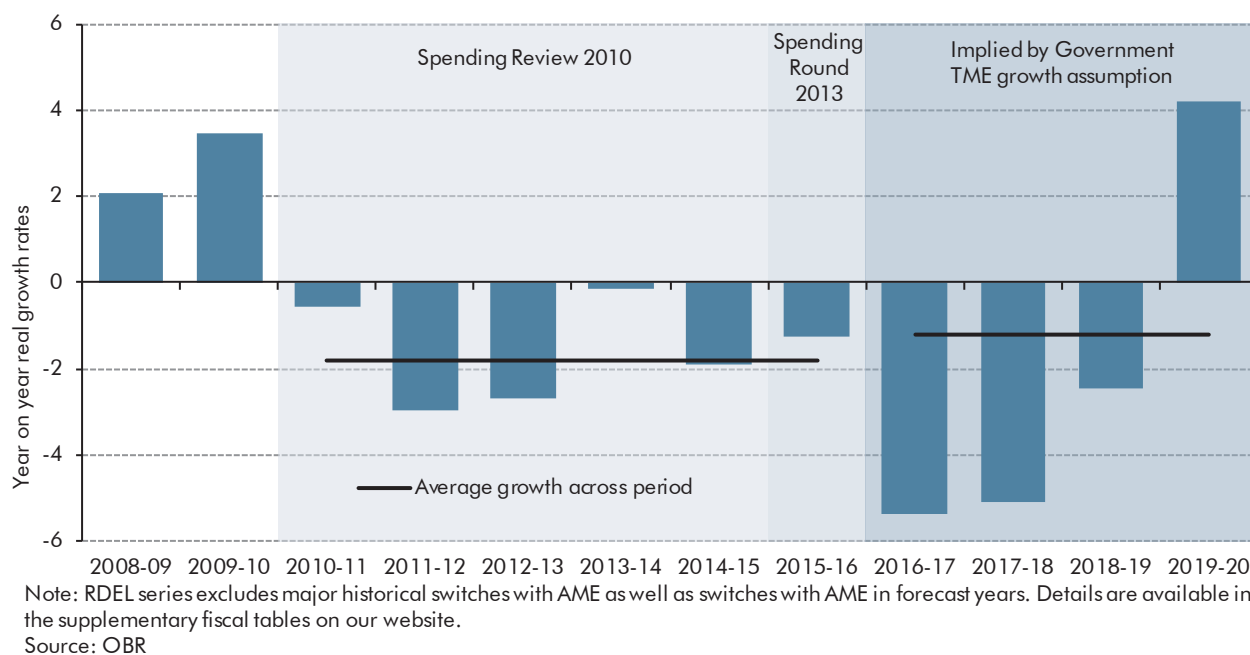
Table 4.18: Spending: real growth rates and as a per cent of GDP

	Real terms growth rate ¹ (per cent)						Total change between 2010-11 and 2019-20 ¹
	2010 Spending Review (2010-11 to 2014-15) ¹	2013 Spending Round	Post Spending Review years				
	Average annual change	Change in 2015-16	Change in 2016-17	Change in 2017-18	Change in 2018-19	Change in 2019-20	
TME	-0.8	-0.7	-1.5	-1.1	0.0	2.3	-4.0
<i>of which:</i>							
PSCE	-0.5	-0.7	-1.7	-1.2	-0.2	2.3	-3.3
PSGI	-3.6	-0.6	0.4	0.0	2.3	2.2	-10.0
TME in AME	1.4	0.1	1.9	2.0	1.2	0.8	12.2
TME in DEL	-2.8	-1.5	-5.1	-4.6	-1.5	4.3	-18.3
<i>of which:</i>							
PSCE in RDEL	-2.4	-1.4	-5.8	-5.4	-2.6	4.3	-19.1
PSGI in CDEL	-5.7	-1.8	-0.1	1.3	5.9	4.3	-13.2
	Per cent of GDP						
TME	-1.0	-1.2	-1.5	-1.3	-0.8	0.0	-9.0
<i>of which:</i>							
PSCE	-0.8	-1.1	-1.4	-1.2	-0.8	0.0	-7.8
PSGI	-0.2	-0.1	-0.1	-0.1	0.0	0.0	-1.2
TME in AME	-0.1	-0.4	-0.1	-0.1	-0.2	-0.3	-1.4
TME in DEL	-1.0	-0.7	-1.4	-1.2	-0.6	0.3	-7.6
<i>of which:</i>							
PSCE in RDEL	-0.8	-0.6	-1.3	-1.2	-0.7	0.3	-6.7
PSGI in CDEL	-0.2	-0.1	-0.1	0.0	0.1	0.0	-0.9

¹ Growth rates are calculated against figures for 2010-11 which have been adjusted to include an estimate for the ONS prospective revisions and classification changes which have been anticipated in this forecast. These include the changes for the UK subscriptions to multilateral development banks, the changes to depreciation and the revision to reclassify certain DVLA fees from negative spending to current receipts.

4.108 One implication of the Government's spending policy assumptions is a sharp acceleration in the pace of implied real cuts to day-to-day spending on public services and administration in 2016-17 and 2017-18, followed by a sharp turnaround in 2019-20, as shown in Chart 4.7. As we explain in Chapter 5, the implied cuts in 2016-17 and 2017-18 are a key reason why the Government is on course to achieve its new fiscal mandate to balance the cyclically adjusted current budget in 2017-18 with room to spare.

Chart 4.7: Year-on-year real growth in resource DEL



Summary of changes to the expenditure forecast since December

4.109 Tables 4.20 and 4.21 detail our latest spending forecast and the changes since December. Table 4.19 summarises the sources of those changes. It shows that:

- the largest economy-driven changes to our spending forecast are due to lower inflation and lower interest rates. Lower inflation reduces spending on debt interest (on index-linked gilts) and on welfare and net public sector pensions spending (due to uprating);
- a lower central government net cash requirement – in part reflecting the asset sales described later in this chapter – further reduces spending on debt interest;
- the net effect of all these changes on implied DELs, before the further change in the Government’s spending policy assumptions, is an increase of £8 billion in 2016-17, rising to £10 billion in 2019-20; and
- the Government’s change to its spending assumptions reduces spending between 2016-17 and 2018-19, but increases it substantially in 2019-20.

Table 4.19: Sources of changes to the spending forecast since December

	Forecast					
	£ billion					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	737.1	746.2	746.7	751.3	765.3	779.9
March forecast	737.1	742.6	740.3	743.9	759.2	797.3
Changes	0.0	-3.6	-6.4	-7.3	-6.1	17.4
Underlying OBR forecast changes						
Forecast changes since December	0.0	-3.3	-4.4	-5.4	-4.1	-2.8
<i>of which:</i>						
Economic determinants	-2.2	-4.7	-6.0	-7.6	-7.4	-6.5
Inflation	-2.2	-4.2	-4.7	-5.6	-6.5	-6.9
Unemployment	0.0	-0.4	-0.3	-0.3	-0.3	-0.3
GDP deflator			-0.9	-1.4	-0.1	1.3
Other determinants	0.0	0.0	-0.2	-0.3	-0.5	-0.7
Market assumptions	-0.3	-1.2	-2.1	-3.0	-3.9	-4.5
Gilt rates	0.0	-0.5	-1.2	-1.8	-2.3	-2.7
Short rates	-0.3	-0.7	-0.9	-1.2	-1.6	-1.8
Other assumptions and changes	2.5	2.6	3.7	5.2	7.1	8.2
Changes to DEL underspend assumptions	-1.0	0.0	-	-	-	-
CDEL classification changes ¹	1.4	1.4	-	-	-	-
Other changes to implied DELs	-	-	8.1	9.3	10.1	10.3
Social security modelling changes ²	-0.5	-1.0	-1.1	-1.2	-1.3	-1.6
Non-economic pension costs	0.6	0.7	0.1	0.2	0.2	0.2
Non-exchange rate EU changes	0.1	1.3	-1.9	0.3	0.3	0.3
Other debt interest changes	0.2	-1.4	-2.0	-2.1	-1.9	-1.7
Locally-financed current expenditure	0.7	0.4	0.4	0.3	0.0	0.0
Locally-financed and public corporations capital expenditure	1.2	1.0	0.6	-0.3	0.0	-0.1
Other	-0.3	0.3	-0.6	-1.3	-0.2	0.8
Changes due to Government decisions						
Budget policy measures	0.0	-0.3	0.0	0.0	0.0	0.0
Effect of applying new Budget spending policy assumptions post 2015-16	-	-	-1.9	-1.9	-2.0	20.2

¹ Subscriptions to multilateral development banks. For 2016-17 onwards the effects of these changes are included in the changes to implied DELs.

² Includes the transfer of war pensions from AME to DEL.

Table 4.20: Total managed expenditure

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector current expenditure (PSCE)							
PSCE in RDEL¹	317.5	316.5	316.4	301.6	289.7	287.9	308.2
PSCE in AME²	342.8	352.8	357.9	369.3	383.7	397.7	411.9
<i>of which:</i>							
Welfare spending ²	209.4	214.5	216.9	219.5	223.6	229.3	235.1
<i>of which:</i>							
Inside welfare cap ²	116.1	119.4	120.6	121.0	121.8	124.0	126.5
Outside welfare cap	93.3	95.1	96.3	98.5	101.8	105.2	108.6
Company and other tax credits	1.6	2.1	2.3	2.5	2.7	2.8	2.9
Net public service pension payments	10.9	12.5	11.1	11.2	11.9	12.7	13.8
National lottery current grants	1.2	1.4	1.3	1.3	1.4	1.4	1.4
BBC domestic services current expenditure	3.2	3.9	3.9	3.8	3.7	3.8	3.9
Network Rail other current expenditure ³	0.4	0.9	1.0	0.7	0.4	-0.2	-0.3
Other PSCE items in departmental AME	1.4	1.2	1.1	1.1	1.2	1.2	1.2
Expenditure transfers to EU institutions	11.1	11.0	11.2	9.4	9.5	10.5	11.0
Locally-financed current expenditure	33.2	35.8	37.6	40.0	41.9	43.6	45.0
Central government debt interest, net of APF	36.1	33.6	33.7	40.4	46.5	49.0	51.1
<i>of which:</i>							
Central government gross debt interest	48.7	45.7	46.0	50.7	55.2	56.3	57.4
Reductions in debt interest due to APF	-12.6	-12.1	-12.3	-10.4	-8.7	-7.2	-6.2
Depreciation	26.9	28.6	29.9	31.2	32.7	34.3	36.0
Current VAT refunds	11.6	11.8	11.8	10.9	10.5	10.5	11.1
R&D expenditure	-7.1	-7.8	-8.2	-8.5	-8.8	-9.2	-9.6
Single use military expenditure	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Environmental levies	3.6	4.4	5.6	6.7	7.6	9.3	10.3
Local authority imputed pensions	1.9	1.9	2.0	2.1	2.2	2.3	2.4
Other National Accounts adjustments	-2.9	-3.2	-3.4	-3.5	-3.5	-3.6	-3.7
Total public sector current expenditure	660.3	669.3	674.3	670.9	673.4	685.6	720.1
Public sector gross investment (PSGI)							
PSGI in CDEL¹	38.4	42.1	42.0	42.4	43.6	47.2	50.5
PSGI in AME	22.8	25.7	26.4	27.0	26.9	26.5	26.8
<i>of which:</i>							
National lottery capital grants	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Network Rail capital expenditure	3.1	2.2	2.4	1.5	1.4	1.8	1.4
Other PSGI items in departmental AME	-0.5	0.6	-0.1	0.4	0.6	0.8	1.0
Locally-financed capital expenditure	7.0	7.1	7.0	8.1	7.7	6.1	6.1
Public corporations capital expenditure	7.2	7.8	7.9	7.7	7.8	7.7	7.6
R&D expenditure	7.1	7.8	8.2	8.5	8.8	9.2	9.6
Other National Accounts adjustments	-1.6	-0.2	0.6	0.3	0.0	0.4	0.6
Total public sector gross investment	61.2	67.8	68.3	69.4	70.5	73.6	77.2
Less depreciation	-35.4	-37.4	-38.8	-40.2	-41.9	-43.7	-45.5
Public sector net investment	25.8	30.4	29.5	29.2	28.6	30.0	31.8
Total managed expenditure	721.5	737.1	742.6	740.3	743.9	759.2	797.3

¹ Implied DEL numbers for 2016-17 to 2019-20. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

² 2013-14 outturn figures now include the negative tax credit element of tax credit spending, in line with ESA10 changes. This element was excluded for 2013-14 outturn at Autumn Statement 2014 as the change had not yet been made by the ONS.

³ Other than debt interest and depreciation, which are included in totals shown separately in this table.

Table 4.21: Changes to total managed expenditure since December

	£ billion						
	Outturn 2013-14	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector current expenditure (PSCE)							
PSCE in RDEL ¹	0.0	-0.3	0.1	2.6	1.9	5.0	28.5
PSCE in AME ²	1.8	-2.1	-6.2	-12.4	-12.5	-14.7	-15.4
of which:							
Welfare spending ²	2.7	-0.5	-1.4	-3.0	-3.9	-4.9	-5.6
of which:							
Inside welfare cap ²	2.6	-0.3	-0.1	-1.4	-2.2	-2.8	-3.2
Outside welfare cap	0.1	-0.2	-1.4	-1.6	-1.7	-2.1	-2.3
Company and other tax credits	-0.2	0.0	-0.1	0.1	0.1	0.2	0.3
Net public service pension payments	0.0	0.6	0.7	-0.2	-0.3	-0.5	-0.5
National lottery current grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BBC domestic services current expenditure	0.0	-0.1	0.2	-0.1	-0.2	-0.2	-0.2
Network Rail other current expenditure ³	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other PSCE items in departmental AME	0.0	0.2	0.1	0.0	0.1	0.1	0.1
Expenditure transfers to EU institutions	-0.1	0.1	1.3	-2.0	-0.1	-0.1	-0.1
Locally-financed current expenditure	-0.6	0.7	0.4	0.4	0.3	0.0	0.0
Central government debt interest, net of APF	0.0	-2.3	-6.7	-7.0	-7.5	-8.5	-9.0
of which:							
Central government gross debt interest	0.0	-2.4	-5.9	-5.5	-6.1	-7.1	-7.4
Reductions in debt interest due to APF	0.0	0.1	-0.8	-1.5	-1.4	-1.4	-1.6
Depreciation	-0.7	-0.3	-0.4	-0.6	-0.6	-0.5	-0.5
Current VAT refunds	0.0	0.0	0.0	0.0	-0.1	0.1	0.8
R&D expenditure	0.0	-0.3	-0.4	-0.2	-0.5	-0.9	-1.3
Single use military expenditure	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Environmental levies	0.0	0.0	0.0	-0.1	0.0	0.3	0.4
Local authority imputed pensions	0.0	0.1	0.1	0.1	0.1	0.1	0.2
Other National Accounts adjustments	0.9	-0.3	0.0	0.0	0.0	0.0	0.0
Total public sector current expenditure	1.8	-2.4	-6.1	-9.8	-10.7	-9.7	13.1
Public sector gross investment (PSGI)							
PSGI in CDEL ¹	0.0	0.7	1.0	2.4	3.5	2.4	2.4
PSGI in AME	-0.2	1.7	1.6	1.0	-0.2	1.2	1.9
of which:							
National lottery capital grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Network Rail capital expenditure	0.0	0.4	0.7	0.0	0.0	0.0	0.0
Other PSGI items in departmental AME	0.0	0.2	-0.4	0.3	0.4	0.6	0.8
Locally-financed capital expenditure	0.6	1.0	1.1	0.7	-0.4	-0.3	-0.2
Public corporations capital expenditure	-0.2	0.2	-0.2	0.0	0.1	0.3	0.1
R&D expenditure	0.0	0.3	0.4	0.2	0.5	0.9	1.3
Other National Accounts adjustments	-0.5	-0.5	-0.1	-0.1	-0.7	-0.3	-0.2
Total public sector gross investment	-0.2	2.4	2.6	3.4	3.4	3.6	4.3
Less depreciation	0.7	0.3	0.4	0.6	0.6	0.6	0.5
Public sector net investment	0.5	2.7	3.0	4.0	4.0	4.2	4.8
Total managed expenditure	1.6	0.0	-3.6	-6.4	-7.3	-6.1	17.4

¹ Implied DEL numbers for 2016-17 to 2019-20. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

² 2013-14 outturn figures now include the negative tax credit element of tax credit spending in line with ESA10 changes. This element was excluded for 2013-14 outturn at Autumn Statement 2014 as the change had not yet been enforced.

³ Other than debt interest and depreciation, which are included in totals shown separately in this table.

Expenditure in 2014-15

- 4.110 Compared to our December forecast, TME in 2014-15 is unchanged. Within that, PSCE is down by £2.4 billion and PSGI up by an offsetting amount. The reduction in PSCE is mostly due to lower RPI inflation reducing debt interest costs. An increase in current LASFE spending is mostly offset by a reduction in welfare spending. The increase in PSGI mainly reflects higher capital LASFE spending, stemming largely from an increase in spending financed by prudential borrowing and an increase in Network Rail capital spending. Detailed sectoral breakdowns of our forecasts are shown in the supplementary fiscal tables on our website.
- 4.111 Monthly outturn information is only available for central government spending. The February release of the monthly Public Sector Finances statistics showed that central government current expenditure in the first ten months of 2014-15 was 1.4 per cent higher than the same period last year. That compares with the 0.6 per cent increase that we are now forecasting for 2014-15 as a whole. One reason for the further slowing in the rate of growth implied in our forecast is that the monthly profile of debt interest spending will reflect the lower rates of RPI inflation expected in the final two months of 2014-15. The outturn data for the year to date are also prone to large revisions.

Departmental expenditure limits (DELs)

- 4.112 Table 4.22 shows our latest forecasts for PSCE in RDEL and PSGI in CDEL, and the changes since December. For 2014-15, the changes reflect departments' latest 'forecast outturns', which were sent to the Treasury in February, plus our assumptions regarding further underspending in the final outturns.
- 4.113 For 2014-15 and 2015-16, PSGI in CDEL has been increased to reflect the ONS decision to reclassify the UK's subscriptions to multilateral development banks as capital grants (explained in the section on classification changes above). This increases our measure of PSGI in CDEL by £1.4 billion in both years.¹⁰
- 4.114 For 2015-16, PSCE in RDEL also reflects some offsetting switches, and some small further changes to plans, that are described below. For 2016-17 onwards, where detailed plans have not yet been set, our forecasts for implied PSCE in RDEL and PSGI in CDEL have been derived from the policy assumptions described above.

¹⁰ PSGI in CDEL will also be increased by a similar amount in 2013-14, but this change is not shown in this *EFO* because it will not be reflected in the ONS outturn statistics for the Public Sector Finances (PSF statistical bulletin) until March, after this *EFO* is published. The ONS has announced that these subscriptions will be reclassified in two stages. The subscriptions to the International Development Association arm of the World Bank will be reclassified in the March PSF bulletin. Subscriptions to the remaining multilateral development banks will be reclassified in due course.

Table 4.22: Key changes to DEL since December

	£ billion					
	Forecast		Implied DEL ¹			
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
PSCE in RDEL						
December forecast	316.8	316.3	299.0	287.9	282.9	279.7
March forecast	316.5	316.4	301.6	289.7	287.9	308.2
Change	-0.3	0.1	2.6	1.9	5.0	28.5
<i>of which:</i>						
Changes to underspend assumptions ¹	-0.3	0.0	-	-	-	-
Switches between DEL and AME	0.0	-0.1	-	-	-	-
Recosting of change to Armed Forces Pension Scheme employer contributions (Autumn Statement 2014 policy change)	-	-0.3	-	-	-	-
Other changes to DEL plans	0.0	0.0	-	-	-	-
Changes in economic determinants used in the spending assumptions	-	-	-0.7	-1.2	0.0	0.9
Other changes to implied RDEL ²	-	-	5.4	5.2	7.0	7.4
Effect of applying new Budget spending policy assumptions post 2015-16	-	-	-1.9	-1.9	-2.0	20.2
Budget measures	0.0	0.5	-0.1	-0.1	0.0	0.0
PSGI in CDEL						
December forecast	41.4	41.0	40.0	40.1	44.8	48.0
March forecast	42.1	42.0	42.4	43.6	47.2	50.5
Change	0.7	1.0	2.4	3.5	2.4	2.4
<i>of which:</i>						
Changes to underspend assumptions	-0.7	0.0	-	-	-	-
Subscriptions to multilateral development banks (ONS classification change)	1.4	1.4	-	-	-	-
Other changes to DEL plans	0.0	0.0	-	-	-	-
Changes in economic determinants used in the spending assumptions	-	-	-0.1	-0.2	-0.1	0.4
Other changes to implied CDEL ²	-	-	2.8	4.1	3.1	2.8
Budget measures	0.0	-0.4	-0.2	-0.4	-0.6	-0.8
Total TME in DEL³						
December forecast	358.5	357.5	339.2	328.2	327.9	328.0
March forecast	358.9	358.6	344.3	333.6	335.3	358.9
Change	0.5	1.1	5.0	5.4	7.4	30.9
¹ Other latest forecasts for underspends are as follows:						
	Latest underspends in this forecast		Previous underspends in our December forecast			
	2014-15	2015-16		2014-15	2015-16	
PSCE in RDEL	-2.3	-0.6	PSCE in RDEL	-2.0	-0.6	
PSGI in CDEL	-1.2	-0.5	PSGI in CDEL	-0.5	-0.5	
TME in DEL	-3.5	-1.1	TME in DEL	-2.5	-1.1	
² Other changes to implied RDEL are calculated as changes to total PSCE less changes to PSCE in AME less the effects of changes in economic determinants used in applying the spending assumptions, less changes from Budget measures and the effects of applying the changes in the new Budget spending assumptions. Other changes to implied CDEL are calculated similarly.						
³ Total TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus the small amount of SUME that is included in PSCE in AME. Under ESA10, most SUME is now classified as capital spending and is included within PSGI in CDEL. However a small amount of SUME is still classified as PSCE and is included within PSCE in AME. The latest figures for SUME are as follows:						
SUME (treated as PSCE under ESA10)	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	0.3	0.2	0.2	0.2	0.2	0.2
March forecast	0.3	0.2	0.2	0.2	0.2	0.2

DEL plans in 2014-15 and 2015-16

4.115 In 2014-15 and 2015-16, the years covered by detailed spending plans, the main change to our forecast is the classification change to PSGI in CDEL described above. Other smaller changes include:

- an upward revision to our assumption for underspends in 2014-15 (described below);
- a smaller increase in PSCE in RDEL to finance higher employer contributions to the Armed Forces Pension Scheme included as a policy change in Autumn Statement 2014. We now estimate that this will increase pension contributions by £0.3 billion less than we assumed in December, which increases our net pension payment forecast by £0.3 billion, and reduces PSCE in RDEL by the same amount (since most of the increase was covered by additional RDEL);
- various offsetting changes and switches that are neutral for TME in 2015-16, and are described in Box 4.3; and
- the Budget measures covered in Annex A.

4.116 Tables 4.9 and 4.10 show the details of our latest underspend assumptions against DEL plans in 2014-15 and 2015-16. The underspends are measured against the plans set out in the 2014 *Public Expenditure Statistical Analyses (PESA)* publication. Each year departments carry forward some specific underspends that they have surrendered under the Treasury's Budget Exchange system, and the PESA plans assume that the additional amounts carried forward will be offset by further underspends and surrenders at the end of the year. Our underspends are measured against the net PESA plans, which already include these assumed new underspends. The tables show the gross underspends, as well as the net reduction against PESA plans.¹¹

4.117 Relative to our December forecast, our underspend assumption for 2014-15 benefits from knowing departments' final spending plans, as set out in the Supplementary Estimates that were published in February, and the 'forecast outturns' that were returned to the Treasury in February. These forecast outturns tend to be cautious, in that departments' spending falls away further by the end of the year. Our latest estimates of 2014-15 underspends assumes a similar fall away as in 2013-14 (Table 4.23). In total, our forecast now assumes a £3.5 billion net underspend compared to PESA plans, up from £2.5 billion in December.

4.118 In 2015-16, we assume that total net underspends will be £1.1 billion, unchanged from December. As we explained in our December *EFO*, we expect underspends to be lower in 2015-16 than in recent years because of expected pressures on budgets, and because some of the reserve has already been allocated to the NHS.¹² Since our December forecast,

¹¹ The 2014 PESA plans also include our forecast of net underspend against those plans from our March 2014 *EFO*. Our measure of net underspend is measured against the PESA plans excluding our previous forecast of underspends.

¹² See paragraph 4.109 of the December *EFO*, which explained why we reduced our forecast of DEL underspend by £2 billion in 2015-16.

and following the 2014-15 Supplementary Estimates, we now know the final amounts of Budget Exchange being carried forward into 2015-16. This allows us to calculate the implied gross underspending shown in Table 4.24. The implied gross underspend for PSCE in RDEL is materially smaller than in 2013-14 and 2014-15, and these judgements on underspends are subject to considerable uncertainty.

Table 4.23: DEL shortfalls against PESA plans for 2014-15

	£ billion					
	PSCE in RDEL		PSGI in CDEL		TME in DEL ¹	
	Outturn	Forecast	Outturn	Forecast	Outturn	Forecast
	13-14	14-15	13-14	14-15	13-14	14-15
Budget Exchange carried forward	1.6	2.2	0.6	1.0	2.3	3.2
Gross underspend against PESA plans	-4.5	-4.5	-1.0	-2.2	-6.8	-6.7
<i>of which:</i>						
Supplementary Estimates (final plans)	-2.2	-1.6	-0.1	-0.8	-3.5	-2.4
Shortfall against final plans in departments' forecast outturn in February	-1.5	-1.9	-0.7	-1.1	-2.7	-3.0
OBR estimate of further shortfall	-0.8	-0.9	-0.2	-0.3	-0.7	-1.3
Net underspend against PESA plans²	-2.9	-2.3	-0.4	-1.2	-4.6	-3.5

¹ TME in DEL includes SUME.

² Total underspend against final PESA plans, net of increases in spending from Budget Exchange carried forward from earlier years.

Table 4.24: DEL shortfalls against PESA plans for 2015-16

	£ billion		
	Forecast		
	PSCE in RDEL	PSGI in CDEL	TME in DEL ¹
	2015-16	2015-16	2015-16
Budget Exchange carried forward	0.5	1.2	1.8
Gross underspend against PESA plans	-1.1	-1.7	-2.9
Net underspend against PESA plans²	-0.6	-0.5	-1.1

¹ TME in DEL includes SUME.

² Total underspend against final PESA plans, net of increases in spending from Budget Exchange carried forward from earlier years.

Box 4.3: Switches between DEL and AME and other devolution changes to DELs

In this forecast, there have been two switches between RDEL and AME that apply from 2015-16 onwards. Within AME, these changes reduce welfare spending and increase local authorities' self-financed current spending (current LASFE), giving a small increase overall that is mirrored by a small net reduction in RDEL. Specifically, as shown in Table A:

- war pensions will be switched out of Ministry of Defence AME into Ministry of Defence RDEL; and
- business rates in Wales will be switched out of the Welsh Assembly DEL into (non-departmental) current LASFE. In effect, they will be treated as finance raised and spent in Wales rather than as central government funding distributed from Whitehall.

Table C: DEL and AME switches for war pensions and Welsh business rates

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Changes to PSCE in AME:					
Current LASFE: devolution of Welsh business rates	0.9	0.9	1.0	1.0	1.0
Welfare spending outside the welfare cap: war pensions	-0.8	-0.8	-0.8	-0.7	-0.7
	DEL plans	Implied DELs			
Changes to PSCE in RDEL:					
Devolution of Welsh business rates	-0.9	-0.9	-1.0	-1.0	-1.0
War pensions	0.8	0.8	0.8	0.7	0.7

DEL plans for 2015-16 have also been updated to reflect the DEL spending financed by Scottish taxes and borrowing in the DELs for Scotland. Specifically:

- within PSCE in RDEL, RDEL has been increased by £0.5 billion, for the spending financed by the Scottish devolved taxes for land and building transactions and landfill; and
- this is offset within PSCE in RDEL by a reduction in the Scottish block grant of £0.5 billion.

PSGI in CDEL already includes £0.3 billion of capital spending that is expected to be financed by Scottish borrowing. This was included in CDEL plans in PESA 2014.

Implied DELs from 2016-17 to 2019-20

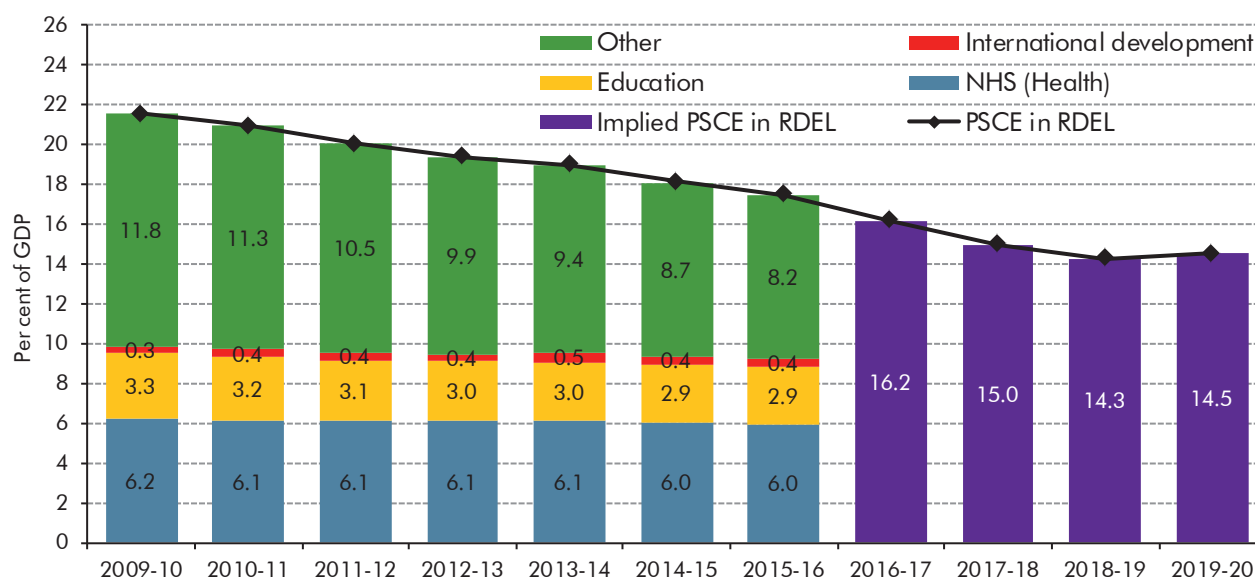
4.119 From 2016-17 onwards, DELs are inferred from the Government's spending policy assumptions and our AME forecast. Changes since December therefore reflect interaction between those assumptions and other changes to the forecast. Between 2016-17 and 2019-20, the main changes to implied DELs reflect:

- an overall reduction of £3.3 billion in our forecast for TME in 2015-16 (before measures) has been taken forward by the spending assumption, reducing overall TME by an average £4.2 billion a year, even before taking the latest change in the spending assumptions into account;
- within this £3.3 billion reduction in 2015-16, our forecast for capital spending has increased by £3.5 billion, which increases PSGI and PSGI in CDEL by £3 to £3½ billion a year. Since total spending is constrained by the overall spending assumption, this then reduces current spending, which is lower by just under £8 billion a year on average over the next four years;
- there is an even larger reduction in debt interest payments and social security spending, reflecting lower interest rates and inflation;
- the net effect of all these changes on implied RDEL, before the further change in the Government's spending policy assumptions, is an increase of over £5 billion a year, rising to £7.4 billion in 2019-20; and

- the Government's decision to change its spending policy assumptions reduces implied RDEL by £2 billion a year on average over the next three years, reducing the extent to which implied RDEL is revised up from 2016-17 to 2018-19. But the much bigger change to the spending assumption for 2019-20 increases implied RDEL by £20 billion, meaning an overall increase relative to December of £28.5 billion.

4.120 Chart 4.8 shows the trend in PSCE in RDEL as a proportion of GDP – the proportion of national income devoted to day-to-day spending on public services and administration. For the years where the Government has set plans, the chart shows the share of spending where the Government has further stated objectives, such as the commitment to maintain total health spending in real terms or to spending 0.7 per cent of gross national income on Official Development Assistance (some of which is capital, so not shown here). The largest departmental budgets included in the 'other' category in Chart 4.8 are the Ministry of Defence and the Department of Business, Innovation and Skills. Beyond the years for which plans have been set, we simply show the path of PSCE in RDEL implied by the total spending assumption and our forecast for PSCE in AME. Implied RDEL rises slightly as a share of GDP in 2019-20 because the Government's spending assumption holds TME and CDEL constant as shares of GDP while AME falls as a share of GDP largely because working-age benefits are uprated by less than earnings growth and some caseloads fall as a share of the population.

Chart 4.8: Resource DEL and implied resource DEL relative to GDP



Note: RDEL series excludes major historical switches with AME as well as switches with AME in forecast years. Details are available in the supplementary fiscal tables on our website. Source: HM Treasury Public Expenditure Statistical Analyses, July 2014; HM Treasury supplementary estimates, February 2015; OBR

Annually managed expenditure (AME)

4.121 Table 4.20 sets out our latest central projection of AME spending to 2019-20, based on the economic forecast described in Chapter 3, the latest estimates of agreed policy commitments and the measures announced in Budget 2015.

Welfare cap and other welfare spending

4.122 Total welfare spending in our forecast refers to AME spending on social security and personal tax credits, a subset of which is subject to the Government's welfare cap. Table 4.25 summarises our forecasts for welfare spending over the next five years. It shows that, in nominal terms, welfare spending is forecast to rise by 9.6 per cent from £214.5 billion in 2014-15 to £235.1 billion in 2019-20. Within this total, spending on items inside the cap increases by 6.0 per cent while spending on items outside the cap increases by 14.1 per cent (as spending on state pensions is expected to rise by 17.1 per cent). Relative to the size of the economy, welfare spending is forecast to fall by 1.3 per cent of GDP between 2014-15 and 2019-20, with spending inside the welfare cap falling by 0.9 per cent of GDP and spending outside the welfare cap falling more slowly by 0.4 per cent of GDP.

Table 4.25: Welfare spending forecast overview

	Outturn		Forecast				
	2013-14	2014-15	Welfare cap period				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
£ billion							
Total welfare spending ^{1,2}	209.4	214.5	216.9	219.5	223.6	229.3	235.1
of which:							
Inside welfare cap ^{1,2}	116.1	119.4	120.6	121.0	121.8	124.0	126.5
Outside welfare cap ²	93.3	95.1	96.3	98.5	101.8	105.2	108.6
Per cent of GDP							
Total welfare spending	12.1	11.9	11.6	11.3	11.1	10.9	10.6
of which:							
Inside welfare cap	6.7	6.6	6.4	6.2	6.0	5.9	5.7
Outside welfare cap	5.4	5.3	5.1	5.1	5.0	5.0	4.9

¹ 2013-14 outturn figures now include the negative tax credit element of tax credit spending, in line with ESA10 changes. This element was excluded for 2013-14 outturn at Autumn Statement 2014 as the change had not yet been made by the ONS.

² Total welfare outturn inside and outside of the welfare cap in 2013-14 is sourced from OSCAR, consistent with PESA 2014.

4.123 For spending that is subject to the welfare cap, the projected fall of 0.9 per cent of GDP over the next five years is driven by:

- spending on **tax credits** falling by 0.2 per cent of GDP. Average awards grow more slowly than GDP per person as a result of previously announced measures (uprating capped at 1 per cent in 2015-16) and operational changes targeting debt and error and fraud, while caseloads are relatively flat, reflecting falling unemployment and a pick-up in average earnings;
- spending on **disability benefits** falling by 0.2 per cent of GDP. Caseloads are set to fall as eligibility is reassessed when cases are migrated from the existing disability living allowance to the new personal independence payment;
- smaller falls in spending on **housing benefit** (0.1 per cent of GDP) and **incapacity benefits** (0.1 per cent of GDP). Spending on housing benefit falls as average awards grow more slowly than GDP per person. Spending on incapacity benefits falls mainly

because the clearance of the backlog of work capability assessments (under the new contractor, Maximus) is expected to reduce the overall caseload relative to the adult population; and

- falls in spending on a number of other benefits, including pension credit (in part due to the rise in the state pension age) and child benefit (due to uprating by less than earnings growth and a rise in the number of families opting out of payment as a result of the 'high income child benefit charge').

4.124 Spending outside the welfare cap is expected to fall by 0.4 per cent of GDP. This reflects:

- spending on **state pensions** falling by 0.2 per cent of GDP. Upward pressure from an ageing population is more than offset by the raising of the state pension age. The 'triple lock' means that from 2017-18 average awards rise broadly in line with earnings; and
- spending on the unemployed – comprising **jobseeker's allowance and housing benefit paid to jobseekers** – falls by 0.1 per cent of GDP. Caseloads fall a little and average awards rise more slowly than earnings.

Table 4.26: Welfare spending

	£ billion						
	Outturn		Forecast				
	2013-14	2014-15	Welfare cap period				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare cap							
DWP social security	71.7	74.6	75.7	75.3	75.2	76.1	77.6
of which:							
Incapacity benefits	13.5	14.1	14.7	14.7	14.5	14.6	15.0
Statutory maternity pay	2.2	2.2	2.3	2.3	2.4	2.4	2.5
Income support (non-incapacity)	2.6	2.5	2.6	2.6	2.6	2.7	2.8
Pension credit	7.0	6.6	6.2	5.8	5.6	5.4	5.3
Winter fuel payments	2.1	2.1	2.1	2.1	2.0	2.0	2.0
Disability living allowance and personal independence payments	13.9	15.4	15.3	14.9	14.4	14.5	14.8
Attendance allowance	5.4	5.4	5.5	5.6	5.7	5.8	6.0
Carer's allowance	2.1	2.3	2.5	2.5	2.6	2.8	2.9
Universal credit ¹	0.0	0.0	0.0	-0.1	0.1	0.3	0.3
Housing benefit (not on JSA) ²	20.5	21.5	22.2	22.5	22.8	23.2	23.6
Other DWP in welfare cap	2.3	2.4	2.4	2.4	2.4	2.4	2.4
Personal tax credits	29.7	29.7	29.5	29.8	30.5	31.6	32.3
Tax free childcare	-	-	0.3	0.7	0.8	0.9	0.9
Child benefit	11.4	11.6	11.7	11.6	11.7	11.9	12.0
NI social security in welfare cap	3.2	3.4	3.4	3.4	3.5	3.5	3.6
Paternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Budget measures	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1
Total welfare cap^{3,4}	116.1	119.4	120.6	121.0	121.8	124.0	126.5
Welfare spending outside the welfare cap							
DWP social security	90.8	92.0	93.9	96.1	99.3	102.6	105.8
of which:							
Jobseeker's allowance	4.3	3.1	2.4	2.4	2.5	2.5	2.6
State pension	83.1	86.5	89.8	92.0	95.0	98.2	101.3
Housing benefit (on JSA)	3.2	2.4	1.8	1.7	1.8	1.9	1.9
Discretionary housing payments ⁵	0.2	-	-	-	-	-	-
Universal credit ¹	0.0	0.1	-	-	-	-	-
NI social security outside welfare cap	2.2	2.3	2.4	2.4	2.5	2.6	2.7
War pensions ⁶	0.9	0.8	-	-	-	-	-
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total welfare outside the welfare cap⁴	93.3	95.1	96.3	98.5	101.8	105.2	108.6
Total welfare^{3,4}	209.4	214.5	216.9	219.5	223.6	229.3	235.1
<i>Memo: welfare cap as proportion of total welfare</i>	55.5	55.6	55.6	55.1	54.5	54.1	53.8

¹ Universal credit actual spending for 2013-14 and 2014-15. Spending from 2015-16 onwards represents universal credit additional costs not already included against other benefits (i.e. UC payments that do not exist under current benefit structure).

² Housing benefit (not on jobseeker's allowance) is made up of a number of claimant groups. The main claimant groups are pensioners, those on incapacity benefits, lone parents, and housing benefit only claimants.

³ 2013-14 outturn figures now include the negative tax credit element of tax credit spending, in line with ESA10 changes. This element was excluded for 2013-14 outturn at Autumn Statement 2014 as the change had not yet been made by the ONS.

⁴ Total welfare outturn inside and outside of the welfare cap in 2013-14 is sourced from OSCAR, consistent with PESA 2014. For 2013-14 only, the components reflect departments' own outturns, which may not be on a consistent basis to OSCAR. For this year the components may not sum to the total for this reason.

⁵ Transferred to DEL in 2014-15.

⁶ Transferred to DEL from 2015-16.

4.125 Table 4.27 shows the changes in welfare spending since our December forecast. We have made downward revisions of £3.8 billion a year on average between 2015-16 and 2019-20, with greater downward revisions from 2016-17. Revisions are of a similar size inside and outside the welfare cap.

4.126 Table 4.28 sets out the main drivers of these revisions. Within the welfare cap:

- lower CPI inflation (due largely to lower oil prices) is the biggest source of revisions. This reflects two effects. First, lower inflation means slower uprating of most benefits¹³ from 2016-17 onwards, reducing spending by £1.6 billion a year on average between 2016-17 and 2019-20. Second, lower inflation feeds through to a lower forecast for rents and therefore spending on housing benefit. This reduces spending by a further £0.4 billion a year on average;
- lower projected fertility rates reduce spending on tax credits, child benefit, tax-free childcare and maternity benefits by increasing amounts from 2014-15 onwards. This change is informed by evidence of lower than expected fertility rates in 2013;
- reductions in the savings associated with tax credits operational measures increase spending by £0.2 billion a year between 2015-16 and 2019-20; and
- projected spending on incapacity benefits, disability living allowance (DLA) and personal independence payment (PIP) is up by £0.2 billion a year on average between 2014-15 and 2019-20. Higher spending on incapacity benefits primarily reflects higher numbers of cases being assigned to the support group, while higher spending on DLA and PIP reflects higher than expected outturns so far in 2014-15.

4.127 For welfare spending that is not subject to the cap, Table 4.28 shows that:

- the Government's spending-neutral decision to transfer war pensions to DEL from 2015-16 reduces welfare spending by £0.8 billion a year;
- lower CPI inflation also feeds through to lower uprating of the state second pension, jobseeker's allowance and associated housing benefit payments. This lowers spending by £0.5 billion a year on average between 2016-17 and 2019-20;
- lower claimant count unemployment reduces spending on jobseeker's allowance and associated housing benefit payments by £0.5 billion a year on average between 2014-15 and 2019-20. Roughly half is due to our lower claimant count forecast and half due to lower outturn data for the housing benefit JSA caseload;
- higher-than-expected mortality rates reduce spending on state pensions by an average of £0.1 billion a year between 2015-16 and 2019-20; and

¹³ Uprating for many benefits is capped at 1 per cent until 2015-16, reverting to CPI uprating thereafter.

- the 'triple lock' means that lower inflation does less to reduce the cost of state pensions than it does to reduce spending subject to the cap.

Table 4.27: Key changes to welfare since December

	£ billion						
	Outturn	Forecast					
		Welfare cap period					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare cap							
DWP social security	-0.1	0.1	0.2	-0.4	-0.8	-1.1	-1.2
<i>of which:</i>							
Incapacity benefits	0.0	0.1	0.2	0.0	-0.1	-0.2	-0.2
Statutory maternity pay ¹	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Income support (non-incapacity)	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Pension credit	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Winter fuel payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Disability living allowance and personal independence payments	0.0	0.1	0.2	0.0	-0.1	-0.2	-0.3
Attendance allowance	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Carer's allowance	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Universal credit ²	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Housing benefit (not on JSA)	0.0	0.0	-0.1	-0.3	-0.4	-0.5	-0.5
Other DWP in welfare cap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Personal tax credits	0.0	-0.4	-0.4	-0.8	-1.2	-1.3	-1.4
Tax free childcare	-	-	0.0	0.0	0.0	0.0	0.0
Child benefit	0.0	0.0	0.0	-0.2	-0.4	-0.5	-0.6
NI social security in welfare cap	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Paternity pay	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Budget measures	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1
Total welfare cap^{3,4}	2.6	-0.3	-0.1	-1.4	-2.2	-2.8	-3.2
Welfare spending outside the welfare cap							
DWP social security	0.0	-0.1	-0.5	-0.8	-0.9	-1.3	-1.6
<i>of which:</i>							
Jobseeker's allowance	0.0	0.0	-0.1	-0.2	-0.2	-0.2	-0.3
State pension	0.0	0.0	-0.1	-0.3	-0.5	-0.8	-1.1
Housing benefit (on JSA)	0.0	-0.1	-0.4	-0.3	-0.3	-0.3	-0.3
Discretionary housing payments ⁵	0.0	-	-	-	-	-	-
Universal credit ²	0.0	0.0	-	-	-	-	-
NI social security outside welfare cap	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
War pensions ⁶	0.0	0.0	-0.8	-0.8	-0.8	-0.8	-0.7
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total welfare outside the welfare cap⁴	0.1	-0.2	-1.4	-1.6	-1.7	-2.1	-2.3
Total welfare^{3,4}	2.7	-0.5	-1.4	-3.0	-3.9	-4.9	-5.6

¹ The decrease in welfare spending in 2013-14 represents a change in the latest available outturn data for statutory maternity pay.

² Universal credit actual spending for 2013-14 and 2014-15. Spending from 2015-16 onwards represents universal credit additional costs not already included against other benefits (i.e. UC payments that do not exist under current benefit structure).

³ 2013-14 outturn figures now include the negative tax credit element of tax credit spending, in line with ESA10 changes. This element was excluded for 2013-14 outturn at Autumn Statement 2014 as the change had not yet been made by the ONS.

⁴ Total welfare outturn inside and outside of the welfare cap in 2013-14 is sourced from OSCAR, consistent with PESA 2014. For 2013-14 only, the components reflect departments' own outturns, which may not be on a consistent basis to OSCAR. For this year the

⁵ Transferred to DEL in 2014-15.

⁶ Transferred to DEL from 2015-16.

Table 4.28: Sources of changes in welfare spending since December

	£ billion					
	Forecast					
	Welfare cap period					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare spending inside the welfare cap						
December forecast	119.6	120.7	122.4	124.0	126.8	129.8
March forecast	119.4	120.6	121.0	121.8	124.0	126.5
Changes since December	-0.3	-0.1	-1.4	-2.2	-2.8	-3.2
<i>of which:</i>						
Economic determinants	0.0	-0.1	-1.2	-2.0	-2.5	-2.7
CPI inflation	0.0	0.0	-1.1	-2.0	-2.4	-2.6
Other	0.0	-0.1	-0.1	0.0	0.0	-0.1
Estimating and modelling changes	-0.3	-0.1	-0.2	-0.2	-0.3	-0.4
Fertility assumption	-0.2	-0.3	-0.4	-0.6	-0.7	-0.8
Tax credits recostings	0.0	0.2	0.2	0.2	0.1	0.1
Incapacity benefits and disability benefits ¹	0.2	0.4	0.3	0.2	0.2	0.1
Other	-0.4	-0.3	-0.2	0.0	0.1	0.1
Other	0.0	0.0	0.0	0.1	0.0	0.0
Budget measures	0.0	0.0	0.0	0.0	-0.1	-0.1
Welfare spending outside the welfare cap						
December forecast	95.3	97.7	100.1	103.5	107.3	110.9
March forecast	95.1	96.3	98.5	101.8	105.2	108.6
Changes since December	-0.2	-1.4	-1.6	-1.7	-2.1	-2.3
<i>of which:</i>						
Economic determinants	0.0	-0.4	-0.7	-0.7	-1.0	-1.1
CPI inflation	0.0	0.0	-0.3	-0.5	-0.6	-0.7
Claimant count unemployment	0.0	-0.4	-0.3	-0.3	-0.3	-0.3
Other	0.0	0.0	0.0	0.1	-0.1	-0.2
Estimating and modelling changes	-0.2	-0.1	-0.1	-0.2	-0.3	-0.5
State pension mortality assumption	0.0	-0.1	-0.1	-0.1	-0.2	-0.2
Housing benefit (on JSA)	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Other	0.0	0.2	0.2	0.2	0.1	0.0
Transfer of war pensions to DEL²	0.0	-0.8	-0.8	-0.8	-0.8	-0.7
Other	0.0	0.0	0.0	0.0	0.0	0.0
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0
Total welfare spending						
December forecast	215.0	218.3	222.5	227.5	234.1	240.7
March forecast	214.5	216.9	219.5	223.6	229.3	235.1
Changes since December	-0.5	-1.4	-3.0	-3.9	-4.9	-5.6
<i>of which:</i>						
Economic determinants	0.0	-0.5	-1.9	-2.8	-3.5	-3.8
Estimating and modelling changes	-0.5	-0.2	-0.3	-0.4	-0.6	-0.9
Transfer of war pensions to DEL²	0.0	-0.8	-0.8	-0.8	-0.8	-0.7
Other	0.0	0.0	0.0	0.0	0.0	0.0
Budget measures	0.0	0.0	0.0	0.0	-0.1	-0.1

¹ Disability benefits refers to disability living allowance and personal independence payment.

² Transferred to DEL from 2015-16.

Public service pensions

- 4.128 The public service pensions forecast covers net expenditure on benefits paid less employer and employee contributions received. It includes central government pay-as-you-go schemes and locally-administered police and firefighters' schemes.¹⁴
- 4.129 Gross expenditure is expected to rise steadily in cash terms over the forecast period, as demographic trends increase the age profile of each scheme's membership. But it remains broadly flat as a share of GDP. The income of each scheme is made up of employer and employee contributions, which are determined by the pensionable paybill and the respective contribution rates. Contribution rates are determined by actuarial valuations of each of the individual schemes. A breakdown of spending and income for the major schemes covered by our forecast is included in the supplementary fiscal tables on our website.
- 4.130 Gross expenditure is up on our December forecast in 2014-15 and 2015-16, largely due to higher NHS scheme spending. In 2014-15, this is attributable to an increase in lump sums (due to average values rising) and to a rise in transfers out that also affects 2015-16. (The increase in NHS employees transferring out of the public sector scheme may be linked to forthcoming legislation related to the Budget 2014 pensions flexibility measures, which will prohibit transfers from unfunded defined benefit schemes into defined contribution schemes. While the legislation comes into effect from April 2015, some applications are expected to be processed in 2015-16. This effect was not fully captured in the costings of these measures for this particular scheme.) From 2016-17 onwards, the downward revision to our CPI inflation forecast reduces uprating and therefore lowers spending.
- 4.131 On the basis of near-final scheme valuations, Autumn Statement 2014 announced changes to employer contribution rates for the armed forces, firefighters, the judiciary, the Scottish NHS and teachers, and Northern Ireland NHS, teachers, civil service and police. These changes have been reflected in this forecast and take effect in 2015-16.
- 4.132 We have made two broadly offsetting changes to our receipts forecast:
- we have corrected the methodology applied in December to estimate the impact of the new, higher armed forces pension scheme (AFPS) employer contribution rate, and have updated the forecast to reflect the final rate.¹⁵ These changes have reduced expected receipts from 2015-16 onwards; and
 - a revised assumption about the impact on paybills of the pressure on spending associated with abolishing the NICs contracting out rebate in 2016-17, in line with an

¹⁴ The police and firefighters' pension schemes are administered at a local level, but pensions in payment are funded from AME, along with other public service pension schemes. They are therefore included in our pensions forecast.

¹⁵ As discussed in the DEL plans section above, since the fiscal impact of the AFPS employer contribution rate is limited to £100 million via an appropriate DEL increase, a downward adjustment has been made to 2015-16 DEL in respect of this new estimate.

update to the estimate of the central government impact. This indicates less paybill pressure, which increases pension receipts relative to the December forecast.¹⁶

Table 4.29: Key changes to public service pensions since December

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Net public service pensions							
December forecast	10.9	11.8	10.4	11.4	12.2	13.2	14.3
March forecast	10.9	12.5	11.1	11.2	11.9	12.7	13.8
Change	0.0	0.6	0.7	-0.2	-0.3	-0.5	-0.5
Expenditure							
December forecast	36.1	37.8	38.8	40.2	41.9	43.7	45.6
March forecast	36.1	38.4	39.3	40.1	41.6	43.3	45.2
Change	0.0	0.6	0.5	-0.1	-0.2	-0.4	-0.4
<i>of which:</i>							
CPI inflation	0.0	0.0	0.0	-0.3	-0.5	-0.7	-0.7
Increase in NHS expenditure	0.0	0.4	0.3	0.0	0.0	0.0	0.0
Other	0.0	0.2	0.3	0.2	0.3	0.3	0.3
Income							
December forecast	-25.1	-26.0	-28.4	-28.8	-29.6	-30.5	-31.4
March forecast	-25.1	-25.9	-28.2	-28.8	-29.7	-30.6	-31.5
Change	0.0	0.0	0.1	-0.1	-0.1	-0.1	-0.1
<i>of which:</i>							
Correction for overestimate of AFPS pensions receipts in Autumn Statement measure	0.0	0.0	0.3	0.3	0.3	0.3	0.3
Change in central government contracting out estimate	0.0	0.0	0.0	-0.2	-0.2	-0.2	-0.2
Other	0.0	0.0	-0.2	-0.1	-0.2	-0.2	-0.2

EU contributions

4.133 In our December 2014 *EFO*, we provided a step-by-step explanation of our forecast for the UK's contributions to the EU. That included an explanation of how the large one-off adjustment to the UK's historic GNI contributions announced in October 2014 was expected to affect the public finances in 2014-15 and 2015-16. The additional information provided on the assumptions underpinning our forecasts is now available in an expanded supplementary fiscal table available on our website.

4.134 Our understanding of how the historic adjustment will affect the public finances – based on Eurostat advice to the ONS – has changed slightly since December. The adjustment still amounts to a net payment of £1.7 billion before the UK abatement and £0.9 billion after it. The £1.7 billion net payment consists of a gross payment of £2.9 billion, partly offset by a refund of £1.2 billion. Both of these transactions were included in the public finance statistics in December 2014 on an accruals basis, increasing public sector net borrowing –

¹⁶ Our latest estimates of the overall effect of the abolition of contracting out on public service pension receipts is shown in the supplementary fiscal table on our website that shows the breakdown of our forecast for each pension scheme.

the accruals measure of the deficit – in 2014-15, as expected. The associated cashflows were all expected to take place in 2015-16, increasing the public sector net cash requirement and net debt. However £0.5 billion of the £1.2 billion refund has been received in February 2015, so that the accrued impact on borrowing and the cash impact on the net cash requirement are different by £2.2 billion in 2014-15. This will unwind in 2015-16, when the £2.9 billion payment will be made, and the remaining £0.7 billion refund will be received. The associated £0.8 billion abatement is expected to affect both public sector net borrowing and the cash requirement in 2015-16.

4.135 We have made further changes to our forecast since December, which over the forecast period average a downward revision of £0.2 billion, but include a substantial upward revision in 2015-16 and a larger downward revision in 2016-17. The main sources of changes have been:

- the sterling/euro exchange rate on 31 December 2014 – which determines the rate at which UK contributions during 2015 will be converted – was stronger than factored into our December forecast, reducing spending in 2015-16 by £0.1 billion. The exchange rate assumption underpinning future years of the forecast (described in Chapter 3) is also stronger than in December, reducing spending in later years of the forecast. Together these effects reduce spending by £0.5 billion a year by 2019-20;
- anticipated future GNI-related adjustments increase spending in 2015-16 and reduce spending in 2016-17. This reflects separate judgements related to 2014 and 2015. For 2014, we expect the UK's GNI level to be higher than assumed at the May 2014 meeting of the Advisory Committee on Own Resources (ACOR). For 2015, we also expect the May 2015 ACOR meeting to set bases that assume a higher UK share of EU GNI. Together, these mean we have revised up our estimate of GNI adjustments paid in 2015-16 from £0.2 billion to £1.4 billion and revised our estimate of associated rebates and other repayments in 2016-17, so we now expect to receive a repayment of £1.4 billion, compared with a payment of £0.8 billion assumed in our December forecast. As ever, these assumptions are associated with great uncertainty; and
- smaller changes to anticipated future VAT base adjustments, which are in part related to the switch of Europe's National Accounts from the ESA95 to ESA10 accounting framework. The latest Eurostat estimates of 2013 final consumption expenditure on both bases suggest that the UK's VAT share will be higher on an ESA10 basis. That has increased our forecast by £0.2 billion a year on average. This remains an estimate at this stage, as the first estimates of all member states' ESA10 VAT bases will not be made until the May 2015 ACOR meeting.

4.136 Future revisions associated with GNI reservations or other factors remain a source of significant uncertainty around our EU contributions forecast. The ONS has announced that it will delay the publication of this summer's Blue Book until 30 September in order to carry out the quality assurance necessary to meet with confidence a Eurostat stipulation that

remaining GNI reservations must be addressed by 22 September.¹⁷ We do not have firm information on which to assess whether the net effect of addressing remaining reservations in the UK and other EU member states would lead to upward or downward adjustments to the UK's contributions to the EU, so we have not adjusted our forecast at this stage. But it is clear that the possibility of such adjustments poses risks to our forecast.

Table 4.30: Key changes to EU contributions since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	11.0	9.9	11.5	9.6	10.7	11.2
March forecast	11.0	11.2	9.4	9.5	10.5	11.0
Change	0.1	1.3	-2.0	-0.1	-0.1	-0.1
<i>of which:</i>						
Change in exchange rate	0.0	0.1	-0.1	-0.4	-0.4	-0.5
Revisions to adjustments for UK GNI contributions for 2014 and 2015, net of refunds and associated rebate ¹	0.0	1.2	-2.1	0.0	0.0	0.0
Revisions to adjustments for UK VAT contributions for 2014 and 2015 ²	0.1	0.2	0.3	0.2	0.2	0.2
Other	0.0	-0.2	-0.1	0.0	0.1	0.1

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

² These adjustments mainly affect the UK rebate

Locally financed current expenditure

- 4.137 We forecast local authority spending by forecasting the sources of income that local authorities use to finance their spending and then the extent to which spending will be higher or lower than income, thereby adding to or subtracting from their reserves. Our forecast therefore encompasses spending financed by grants from central government, which are mostly in DEL, and local authority self-financed expenditure (LASFE) in AME.
- 4.138 Our forecast for current LASFE is largely driven by our forecasts for council tax and business rates. The forecast profile for council tax is reduced in 2014-15 and 2015-16 by the availability of council tax freeze grant in England, which runs until 2015-16. This has meant average council tax increases of 0.9 per cent in 2014-15, as 60 per cent of local authorities have frozen their tax levels and taken up the council tax freeze grant. In 2015-16, we expect a similar rise. After 2015-16, we assume that council tax in England, Scotland and Wales will rise in line with CPI inflation.¹⁸ These assumptions are little changed from December, but our forecasts for spending financed by council tax in LASFE have fallen by £1.2 billion over the period from 2016-17 to 2019-20, due to our lower CPI inflation forecast.

¹⁷ See *Blue and Pink Books 2015 statement*, Office for National Statistics, 26 February 2015.

¹⁸ These council tax increases are assumed to apply in conjunction with an increase in the council tax base, which averages 0.9 per cent a year in England over the forecast period. This is measured net of discounts, including localised council tax reduction schemes. Further details of our council tax assumptions are available in a supplementary fiscal table on our website.

- 4.139 For English local authorities, current LASFE contains the 50 per cent of business rates that are now retained directly by local authorities. For Scottish and Welsh local authorities, reflecting the arrangements for devolution, business rates are treated as locally raised central government support. Current LASFE contains all of the spending financed by business rates. (The latest forecasts for business rates are discussed in paragraph 4.81 in the receipts section.) Council tax and retained business rate assumptions are broadly neutral for the current budget deficit and borrowing – other than some minor timing differences – as they increase receipts and spending equally.
- 4.140 In our December 2014 *EFO*, we described in detail the information sources we use and the judgements we make when settling on a central assumption for the extent to which local authorities will add to reserves over the next five years. These additions to reserves reduce their current spending. For 2014-15 we have revised our forecast to reflect the latest quarterly spending information collected by DCLG. We now assume that English local authorities will underspend their budgets for current expenditure on services by £2.7 billion and will therefore add only £1 billion to their net reserves rather than the £1.5 billion that we assumed in December. Our recent forecasts have assumed that English local authorities' will add to their reserves by decreasing amounts until 2018-19, and that they will be flat thereafter. Given the latest information on reduced net additions in 2014-15, we have reduced our assumptions of net additions by £0.6 to £0.2 billion over the next three years, which increases current LASFE spending.
- 4.141 Table 4.31 summarises the main changes to our forecast for current LASFE. This has been increased by about £1 billion from 2015-16 because of the switch of devolved business rates in Wales from RDEL to current LASFE. This is discussed in Box 4.3 above. Excluding this switch, current LASFE is £0.5 billion lower in 2015-16 with the reduction increasing to £1 billion by 2019-20. In 2015-16 and 2016-17, this spending falls mainly because of an increase in capital expenditure financed from the revenue account (CERA). The increased CERA forecast switches more local authority spending out of current spending and into capital spending. This reflects new information on Transport for London (TfL) plans that is discussed below. The remaining reductions out to 2019-20 are accounted for by lower council tax and business rates, reflecting lower inflation.

Table 4.31: Key changes to locally financed expenditure and public corporations capital expenditure since December

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Locally-financed current expenditure						
December forecast	35.0	37.2	39.5	41.6	43.5	45.0
March forecast	35.8	37.6	40.0	41.9	43.6	45.0
Change	0.7	0.4	0.4	0.3	0.0	0.0
<i>of which:</i>						
Net use of current reserves	0.5	0.5	0.6	0.2	0.0	0.0
Capital expenditure from revenue account	0.4	-1.0	-0.5	0.0	0.1	0.2
Council tax	0.0	0.0	-0.2	-0.3	-0.3	-0.4
Retained business rates	0.0	0.3	-0.1	-0.2	-0.2	-0.3
Interest receipts	0.0	-0.1	-0.1	-0.1	-0.1	-0.2
Business rates in Scotland	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Devolved business rates in Wales	-	0.9	0.9	1.0	1.0	1.0
Other	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Locally-financed capital expenditure, and public corporations capital expenditure						
December forecast	13.7	13.9	15.2	15.9	13.8	13.7
March forecast	14.9	14.8	15.8	15.5	13.8	13.7
Change	1.2	1.0	0.6	-0.3	0.0	-0.1
<i>of which:</i>						
Capital expenditure from revenue account	-0.4	1.0	0.5	0.0	-0.1	-0.2
Capital spending financed by prudential borrowing	0.7	0.3	0.2	-0.1	-0.2	-0.1
OBR timing adjustment for Crossrail	0.1	-0.3	0.2	-0.3	0.2	0.0
Capital spending of TfL PC subsidiaries ¹	0.4	-0.4	-0.3	0.1	0.3	0.5
Capital spending financed by use of capital receipts	0.3	0.1	0.0	-0.1	-0.1	0.0
Asset sales	0.1	0.2	0.2	0.1	0.0	-0.1
Other	0.0	-0.1	-0.1	-0.1	-0.1	-0.1

¹ This reflects the net change to the adjustment that reduces capital LASFE to remove TfL financing for its PC subsidiaries capital spending, and the forecast for these TfL PC subsidiaries capital spending.

Locally financed and public corporations capital expenditure

4.142 Our latest forecasts for locally financed capital expenditure (capital LASFE) and public corporations capital spending are shown in Table 4.31. Capital LASFE is measured net of asset sales. It is also measured net of capital spending by local authorities' Housing Revenue Accounts (HRAs) and the TfL subsidiaries that are treated as public corporations in the National Accounts.¹⁹ We switch these items out of capital LASFE and include them in our forecast for public corporations net capital expenditure to ensure our forecast is consistent with the National Accounts.

¹⁹ These TfL transport subsidiaries trade under the company name 'Transport Trading Ltd' (TTL). The ONS currently classifies all of the TTL subsidiaries as public corporations apart from Crossrail, which is classified as part of the local authority sector. However, the ONS announced last year that it will be reclassifying several of the other TTL subsidiaries to the local authority sector. We would expect that these reclassifications will have a neutral effect on the public sector finances and we will wait until the ONS implements those reclassifications in the outturn data before we reflect them in our forecast.

- 4.143 Our forecast for local authorities' capital spending in England remains fairly stable over the forecast period, and continues to assume that spending is boosted by an additional £2½ billion from capital reserves over the period from 2015-16 to 2018-19, related to the closing stages of Crossrail construction. Capital LASFE declines by the end of the forecast period because we assume declining levels of spending financed by prudential borrowing and CERA, while asset sales are projected to rise. Further details are shown in supplementary fiscal tables available on our website.²⁰
- 4.144 The forecast for public corporations' capital spending is largely driven by the forecasts of capital spending by HRAs, net of asset sales, and TfL's public corporation subsidiaries.
- 4.145 Table 4.31 groups our forecasts for capital LASFE and public corporations' capital spending together to show the overall impact of the revisions. There are three main changes:
- we have incorporated new information supplied by TfL, consistent with their latest published business plan. This has a large impact on our forecast for CERA, since TfL transactions currently account for almost half of all CERA in England. As a result we have revised down our forecast for CERA by £0.4 billion in 2014-15 and increased it by £1 billion in 2015-16 and by £½ billion in 2016-17. The latest TfL information has also changed the profile of our forecast of their capital spending, including the amounts we assume are financed from capital LASFE;
 - we have revised up our forecast for local authority capital spending in England in 2014-15 by £0.2 billion in order to reflect the latest in-year quarterly capital spending information collected by DCLG. This suggests that English local authorities will underspend their net capital budgets by a net total of £6.7 billion. Given the reduction that we expect on CERA from TfL's latest forecast above, we have assumed that the £0.2 billion increase in local authority capital spending is reflected in greater use of prudential borrowing and use of capital receipts, which also changes the profile of the capital spending from these resources later in the forecast period; and
 - we have revised our forecast for sales of capital assets to reflect our latest economic assumptions for prices and volumes of property transactions, and information from DCLG on HRA sales under the Right to Buy programme.

²⁰ Welsh local authorities are expected to buy themselves out of the HRA subsidy system in early April 2015. The transactions associated with this buyout have not been included in this forecast because, at the stage when we finalised our pre-measures forecast in early March, it was not completely certain yet that the buyout would happen. This does not materially affect our forecast because the transactions would be contained within the public sector and would be neutral for the fiscal aggregates. Assuming the buyout goes ahead, this will involve Welsh local authorities taking £0.9 billion additional loans from the PWLB, which they would pay to central government to buy out their HRA subsidy obligations. The payment would boost capital LASFE by £0.9 billion in 2015-16, which would be offset by £0.9 billion of receipts of capital grants that would be included in other PSGI in AME. Welsh local authorities currently pay £0.1 billion negative subsidies to central government, which reduce public corporations gross operating surplus (PCGOS) in our current receipts forecast, and reduce other PSCE items in AME in our spending forecast. Assuming the buyout goes ahead, these negative subsidies would stop being paid, and PCGOS and TME would both increase by £0.1 billion, with no effect on the current deficit or borrowing.

Central government debt interest

- 4.146** Central government debt interest payments (net of the effect of the Bank of England's Asset Purchase Facility (APF) holdings of gilts) are expected to be broadly stable as a share of GDP in 2015-16, but then to increase as interest rates, inflation and the stock of debt rise. But these determinants of the debt interest bill are now expected to rise more gradually than in December, so our forecast is more than £6 billion lower in 2015-16, rising to £9.0 billion lower by 2019-20. This follows large downward revisions in the December forecast itself, also due mainly to changes in determinants. On a comparable basis, our forecast for debt interest payments in 2018-19 has been revised down by £26.3 billion since our March 2014 *EFO*. In order to facilitate understanding of these significant changes, Box 4.4 describes how our forecast is built up from its key components.
- 4.147** Table 4.32 shows changes in central government debt interest since December. Lower RPI inflation feeds through immediately to accrued debt interest payments, but changes in interest rates take longer to affect debt servicing costs. We have revised down our RPI inflation forecast in each year, reducing debt interest payments by nearly £3 billion in most years, although the amount is larger at £4.2 billion in 2015-16. (Box 3.3 in Chapter 3 explains one source of change to our RPI inflation forecast, where we have revised down our estimate of the steady-state difference between RPI and CPI inflation.) Lower interest rates reduce spending by increasing amounts each year, rising to over £6 billion by 2019-20. These underlying interest rate assumptions are all drawn from financial market prices, as calculated and published by the Bank of England. Other changes, including the extension of pensioner bonds, updating stocks data and taking into account UKAR's latest plans, are small and broadly offsetting over the forecast period.

Table 4.32: Key changes to central government debt interest since December

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	36.1	35.9	40.4	47.3	54.0	57.5	60.1
March forecast	36.1	33.6	33.7	40.4	46.5	49.0	51.1
Change	0.0	-2.3	-6.7	-7.0	-7.5	-8.5	-9.0
<i>of which:</i>							
Interest rates	0.0	-0.3	-2.0	-3.6	-4.4	-5.3	-6.1
<i>of which:</i>							
APF net flows	0.0	0.0	-0.8	-1.5	-1.4	-1.4	-1.6
Other gilt rates	0.0	0.0	-0.5	-1.2	-1.8	-2.3	-2.7
Other short-term rates	0.0	-0.3	-0.7	-0.9	-1.2	-1.6	-1.8
Inflation	0.0	-2.2	-4.2	-2.9	-2.5	-2.7	-2.8
Financing	0.0	0.0	-0.2	-0.5	-0.4	-0.4	-0.3
Other	0.0	0.2	-0.4	-0.1	-0.3	-0.1	0.2
Budget measures	0.0	0.0	0.1	0.1	0.1	0.0	0.0

Box 4.4: Forecasting debt interest spending

Given the large changes in our recent debt interest forecasts – and the added complexity that debt interest is now expressed net of the effect of gilts held by the Bank of England Asset Purchase Facility (APF) associated with past quantitative easing – this box describes how we produce the debt interest forecast and illustrates some of the sensitivities to which it is subject.

We start with an estimate of the stock of different types of debt on which government must pay some form of debt service. These include:

- conventional gilts (net of the amount held by the APF);
- index-linked gilts;
- the liabilities of the APF; and
- other financing products (such as NS&I).

We forecast changes to these stocks by adding the net cash requirement each year to the total stock of debt, projecting redemptions of gilts and other liabilities, and making assumptions about the composition of gross financing each year to cover the cash deficit and redemptions.

Spending on debt interest is then determined by the effective interest rate paid on the stock of each type of debt. Table D shows the amount of stock outstanding, the debt interest payments and the effective interest rates for different types of debt. There are different drivers of our forecasts for these effective interest rates, most of which are derived from financial market prices:

- debt servicing on conventional gilts is distinguished between debt interest on conventional gilts for new and existing debt. Payments on the existing stock of conventional gilts are fixed for the lifetime of those gilts. Payments on new conventional gilts reflect current and future market conditions, as summarised in the weighted average conventional yield curve and the level of new borrowing. The stock of old conventionals declines over the forecast period due to redemptions, whereas the stock of new conventionals rises due to new gross issuance. The effective interest rate on conventional gilts is projected to be broadly flat over the forecast period, reflecting two offsetting factors: refinancing old debt at the lower prevailing rates pushes down debt interest costs; but financing new debt becomes relatively more expensive over time;
- index-linked gilts (ILGs) differ from conventionals in that the coupon payments and principal are adjusted in line with the RPI. The debt interest accrued each month therefore reflects a fixed component – the real interest rate set when gilts are sold – and a variable component – inflation. Most of the payment relates to the inflation component. Indeed real rates are currently projected to be negative over the forecast period, which means the effective rate on new index-linked gilts would continue to be less than the rate of RPI inflation;
- the APF receives coupon income on the gilts it holds and pays Bank Rate on its loan from the Bank of England. (The Bank charges the same rate on the reserves it has created to finance the loan to the APF.) The coupon payments cancel out within the public sector, so this debt is in effect financed at Bank Rate. We assume that gilts held by the APF will not

be sold actively during the forecast period, and will only be run down through redemptions once Bank Rate begins to rise;

- the government also finances other short-term debt (mainly Treasury bills) and issues savings products through NS&I. We use short-term market interest rates to project forward payments on Treasury bills, and these also inform our forecasts for payments on most NS&I products ('pensioner' bonds are a notable exception); and
- our central government debt interest forecast includes interest payments made by UK Asset Resolution (UKAR) and Network Rail, which are both classified within the central government sector, as well as other smaller payments, such as interest on finance leases.

Table D: Total outstanding stocks, debt interest payments and effective interest rates over the forecast period

	£ billion (stock and debt interest), per cent (interest rates and RPI)				
	2015-16	2016-17	2017-18	2018-19	2019-20
Conventional gilts					
Stock (net of APF holdings)	643	715	779	802	854
Debt interest (net)	19.6	21.7	24.3	25.8	26.8
Effective interest rate	3.1	3.0	3.1	3.2	3.1
Gross effective interest rate	3.1	3.0	3.0	3.0	3.0
Gross interest rate on existing stock	3.5	3.5	3.6	3.7	3.8
Gross interest rate on new stock	1.7	1.8	2.0	2.1	2.1
Index-linked gilts					
Stock	303	331	361	370	393
Debt interest	9.4	13.0	15.7	16.7	17.8
Effective interest rate	3.1	3.9	4.4	4.5	4.5
Real effective interest rate	2.2	1.7	1.4	1.4	1.4
RPI inflation	0.9	2.2	3.0	3.2	3.1
NS&I					
Stock	134	136	138	140	142
Debt interest	2.0	2.6	3.1	3.1	3.0
Effective interest rate	1.5	1.9	2.2	2.2	2.1
APF					
Stock	375	349	318	293	258
Debt interest	2.1	3.6	4.6	4.9	4.8
Effective interest rate	0.6	1.0	1.5	1.7	1.9
Short-term debt					
Stock	102	103	103	104	105
Debt interest	0.7	1.2	1.6	1.8	2.0
Effective interest rate	0.7	1.2	1.6	1.8	1.9
Total identified stock	1557	1634	1699	1710	1751
Debt interest	33.1	40.9	47.8	50.5	52.4
Effective interest rate	2.1	2.5	2.8	3.0	3.0

Note: The effective interest rate is calculated as debt interest payments over the year divided by total outstanding stocks at the end of the year.

The large revisions in recent forecasts illustrate the sensitivity of debt interest payments to changes in market interest rates, inflation and borrowing. Alongside each *EFO*, we publish a

table of debt interest ready reckoners on our website that quantify these sensitivities. Table E contains the ready reckoners consistent with this forecast. It shows that:

- the effect of a persistent increase in conventional gilt rates would only gradually build over time, as higher rates only apply to new debt issuance, and UK conventional gilts have a relatively long average maturity;
- higher short-term rates would quickly lead to higher debt interest costs, through the APF holdings and as short-term debt rolls over;
- an increase in RPI inflation would also have an immediate impact, as it increases accrued payments on both old and new index-linked debt. The table shows the consequences of a succession of shocks to annual inflation, with the higher impact over time mainly reflecting a rising stock of gilts; and
- assuming interest rates were to remain unchanged, an increase in the central government net cash requirement would have a more modest effect over the forecast period.

Table E: Debt interest ready reckoners

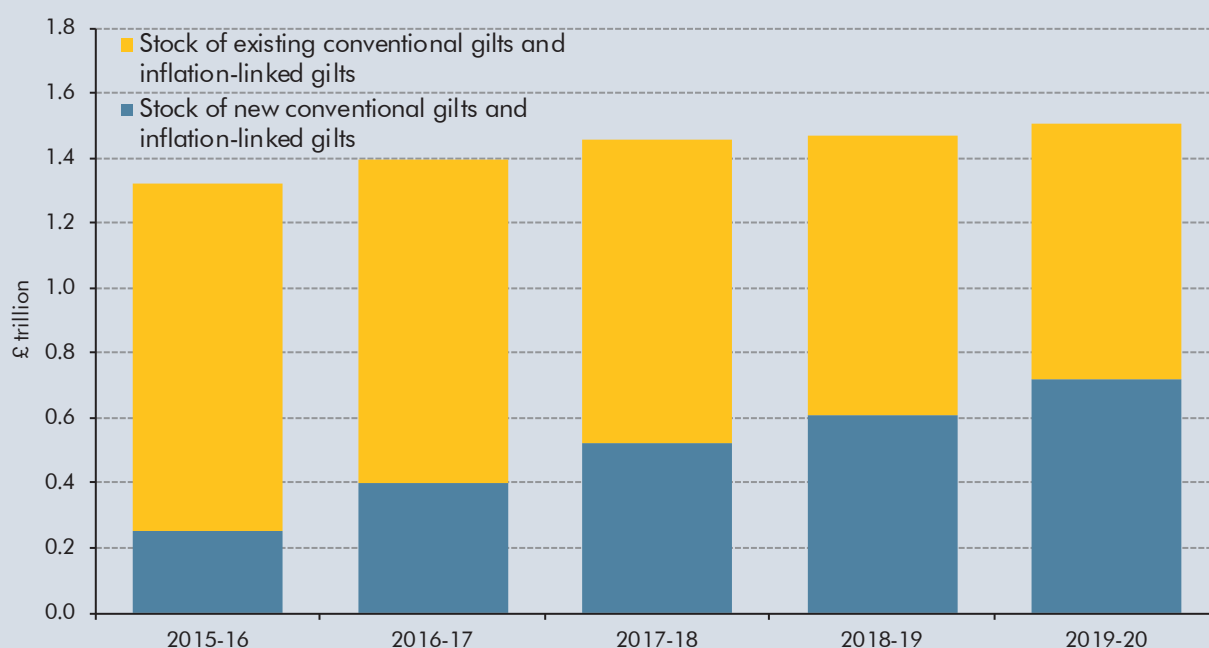
	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
1 per cent increase in gilt rates	0.5	1.6	2.6	3.4	4.2
1 per cent increase in short rate	4.7	4.6	4.4	4.1	3.8
1 per cent increase in inflation	3.6	3.9	4.7	5.2	5.9
£5bn increase in CGNCR	0.0	0.2	0.3	0.4	0.5

Note: all increases are assumed to take effect at the beginning of 2015-16 and continue throughout the forecast.

The structure of the UK's debt and the effect of the APF gilt holdings also have some important implications for our forecast:

- a relatively long average maturity of existing debt means that changes in interest rates only gradually affect our medium-term forecast. More than half of the projected gilts at the end of the forecast period have already been issued (see chart A);
- the assumed skew of future debt issuance also has a bearing on our forecast, as longer-term debt tends to be relatively more expensive to finance, reflecting term premia, and conventional and index-linked gilts attract different rates; and
- the APF currently holds around a quarter of outstanding gilts. As a result, the debt interest forecast is less sensitive to changes in gilt rates than would otherwise be the case, but more sensitive to changes in Bank Rate. An additional uncertainty is also created as to how and when the APF will be run down, as the effective rate will eventually revert back to gilt rates, rather than the typically lower Bank Rate.

Chart A: Outstanding stocks of conventional and index-linked gilts



Source: OBR

Other AME spending

- 4.148 Our forecast of **BBC** spending is down for most years. Some expenditure earmarked for 2014-15 has been pushed back into 2015-16, with a new, higher estimate for digital investment costs explaining most of the 2015-16 increase above and beyond that timing adjustment. Thereafter, income is down in line with expected reductions in the number of households who consume live content and thus require a television licence. Spending is assumed to fall in line with this income change.
- 4.149 Our forecast for PSCE in RDEL includes spending on **research & development (R&D)** which, under the European System of Accounts 2010, is classified in the National Accounts as capital spending. Our forecast for current AME spending therefore includes an accounting adjustment that removes this spending, and our forecast for capital AME spending includes an offsetting entry that includes this spending. Our latest forecast includes revisions to 2014-15 and 2015-16 that reflect the latest information on departments' forecast outturn and plans data that are held on the Treasury's public spending database. We have fed these changes through to the remainder of the forecast period.
- 4.150 **Other PSCE in departmental AME** is little changed over the forecast period. **Other PSGI items in departmental AME** increase in 2014-15 and 2015-16 are mostly attributable to BBC capital spending, now including assets under construction. The 2014-15 increase is also partly explained by Bradford & Bingley and NRAM plc capital spending. The spending in these categories is detailed in the supplementary tables available on our website.

- 4.151 **Environmental levies** include spending on DECC levy-funded policies such as the renewables obligation, feed-in tariffs and warm homes discount. Most are neutral for borrowing as they are directly offset by receipts. The DECC capacity markets scheme discussed in the receipts section has also been included, raising 2018-19 and 2019-20, although this scheme is also neutral for borrowing. The forecasts are explained in the receipts section.
- 4.152 The AME forecast includes forecasts for the further adjustments that are included in the National Accounts definitions for PSCE and PSGI. Movements in the **National Accounts adjustments** forecasts typically consist of numerous small, offsetting changes. Within the current accounting adjustments, the change in the outturn for 2013-14 reflects movement in residual adjustments, while the change in 2014-15 is largely explained by a reduction in the forecast for local authorities' debt interest payments to the Public Works Loan Board. Our current LASFE forecast covers local authorities' spending on all their debt interest payments, and the payments that are netted off within the public sector are therefore removed as an accounting adjustment. Within the capital accounting adjustments, the changes in the outturn for 2013-14 reflect movement in residual adjustments, and the change over the forecast period reflects our latest forecast for the local authority financial transactions, which we remove because these are not included in PSGI. Further details of accounting adjustment breakdowns are included in the supplementary tables on our website, with the local authority debt interest change also detailed in the local authority current expenditure supplementary table. Explanations and the background to National Accounts adjustments are given in Annex D to PESA 2014.²¹

Loans and other financial transactions

- 4.153 Public sector net borrowing (PSNB) is the difference between total public sector receipts and expenditure each year measured on an accrued basis. But the public sector's fiscal position also depends on the flow of financial transactions, which are mainly loans and repayments between government and the private sector. These do not directly affect PSNB, but they do lead to changes in the Government's cash flow position and stock of debt.
- 4.154 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.²² It drives our forecast of public sector net debt (PSND), which is largely a cash measure. Estimating the PSNCR also allows us to estimate the central government net cash requirement (CGNCR), which in turn largely determines the Government's financing requirement – the amount it needs to raise from treasury bills, gilt issues and NS&I products.
- 4.155 Differences between the PSNCR and PSNB can be split into the following categories:
- **loans and repayments:** loans that the public sector makes to the private sector do not directly affect PSNB, but the cash flows affect the PSNCR;

²¹ See HM Treasury, July 2014, *Public Expenditure Statistical Analyses 2014*.

²² Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the public sector banks.

- **transactions in other financial assets:** the public sector may buy or sell financial assets, such as corporate bonds or equities. When it sells an asset for cash the initial transaction does not affect PSNB, whereas the cash received will reduce the PSNCR. But both PSNB and the PSNCR will be higher in future years if the government foregoes an income stream that flowed from the asset sold;
- **accruals adjustments:** PSNB is an accruals measure of borrowing in which, where possible, spending and receipts are attributed to the year of the activity that they relate to. In contrast, PSNCR is a cash measure in which spending and receipts are attributed to the year in which the cash flow takes place; and
- **other factors:** we separately identify transactions relating to UKAR holdings and Network Rail, as well as including some other adjustments that do not fall into the categories above.

4.156 Net lending to the private sector, in particular for student loans, raises the net cash requirement relative to net borrowing in each year of our forecast. Table 4.33 shows the steps from PSNB to PSNCR and Table 4.34 shows the changes since our December forecast.

Table 4.33: Reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net borrowing	90.2	75.3	39.4	12.8	-5.2	-7.0
Loans and repayments	13.7	16.8	17.2	17.4	16.7	17.0
<i>of which:</i>						
Student loans ^{1,2}	9.8	11.2	12.2	13.0	13.7	13.9
DfID	0.4	0.2	0.1	0.1	0.1	0.1
Green Investment Bank	0.2	0.4	0.2	0.0	0.0	0.0
British Business Bank	0.2	0.5	0.2	0.3	-0.1	-0.1
Help to Buy equity loans	1.4	1.5	1.3	1.3	1.2	1.1
UK Export Financing	0.0	0.3	0.5	0.5	0.4	0.3
Ireland	0.0	0.0	0.0	0.0	-0.4	0.0
Other	1.8	3.8	2.8	2.2	1.8	1.6
Allowance for shortfall	-0.1	-1.0	0.0	0.0	0.0	0.0
Transactions in financial assets	-2.0	-12.7	-2.8	-2.7	-2.6	-2.4
<i>of which:</i>						
Student loan book	0.0	-2.3	-2.3	-2.3	-2.3	-2.3
Royal Mail pension asset disposal	-1.0	-0.5	-0.5	-0.4	-0.3	-0.1
Lloyd's Banking Group share sales	-1.0	-9.0	0.0	0.0	0.0	0.0
Other	0.0	-0.9	0.0	0.0	0.0	0.0
Accruals adjustments	1.5	4.6	10.2	3.7	-0.6	0.2
<i>of which:</i>						
Student loan interest ^{1,2}	1.5	2.0	2.5	3.3	4.2	5.0
PAYE income tax and NICs	1.2	0.3	2.2	1.9	2.0	2.4
Indirect taxes	0.6	0.7	0.6	0.8	1.0	1.2
Other receipts	2.8	2.7	2.8	2.8	2.9	2.9
Index-linked gilts ⁴	-4.6	-5.7	-0.5	-9.1	-14.3	-14.6
Conventional gilts	2.9	3.7	4.0	5.3	5.0	4.8
Other expenditure	-2.9	1.0	-1.3	-1.4	-1.4	-1.5
Other factors	-18.4	-20.6	-5.1	-3.1	-2.7	-2.4
<i>of which:</i>						
UKAR alignment	-8.0	-15.3	-5.7	-3.7	-3.2	-2.8
Network Rail	0.3	0.4	0.3	0.4	0.2	0.1
Alignment adjustment	-11.0	-6.0	0.0	0.0	0.0	0.0
Public sector net cash requirement	85.0	63.5	59.0	28.1	5.6	5.4

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

Cash spending on new loans	9.8	11.2	12.2	13.0	13.7	13.9
Cash repayments	12.1	13.7	14.8	15.5	16.0	16.5

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

⁴ This reconciliation to the net cash requirement does not affect public sector net debt.

Table 4.34: Changes in the reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net borrowing	-1.1	-0.7	-1.5	-1.8	-1.2	16.1
Loans and repayments	-1.6	-0.8	-1.7	-2.1	-2.3	-2.6
<i>of which:</i>						
Student loans ^{1,2}	-0.5	-0.4	-0.8	-1.1	-1.2	-1.5
DfID	-1.5	-1.4	-1.4	-1.4	-1.4	-1.4
Green Investment Bank	-0.1	-0.4	0.2	0.0	0.0	0.0
British Business Bank	-0.1	0.0	0.0	0.3	0.0	0.0
Help to Buy equity loans	0.1	0.2	0.0	0.0	-0.1	-0.1
UK Export Financing	0.0	0.0	0.0	0.0	0.0	0.0
Ireland	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.3	1.3	0.3	0.1	0.3	0.4
Allowance for shortfall	0.2	0.0	0.0	0.0	0.0	0.0
Transactions in financial assets	-1.0	-9.9	0.0	0.0	0.0	0.0
<i>of which:</i>						
Student loan book	0.0	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	0.0	0.0	0.0	0.0
Lloyd's Banking Group share sales	-1.0	-9.0	0.0	0.0	0.0	0.0
Other	0.0	-0.9	0.0	0.0	0.0	0.0
Accruals adjustments	2.7	3.7	2.2	3.0	3.3	3.5
<i>of which:</i>						
Student loan interest ^{1,2}	0.0	-0.2	-0.5	-0.6	-0.7	-0.9
PAYE income tax and NICs	0.6	-0.8	0.1	0.1	0.1	0.5
Indirect taxes	-0.1	0.2	0.0	0.1	0.3	0.3
Other receipts	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Index-linked gilts ³	2.2	3.9	2.4	2.5	3.2	3.0
Conventional gilts	0.2	0.4	0.4	1.0	0.6	0.8
Other expenditure	-0.2	0.3	-0.1	-0.1	-0.1	-0.1
Other factors	-3.9	-5.1	0.9	2.4	1.9	1.7
<i>of which:</i>						
UKAR alignment	-2.9	-5.1	0.9	2.4	1.9	1.7
Network Rail	0.0	0.0	0.0	0.0	0.0	0.0
Alignment adjustment	-1.0	0.0	0.0	0.0	0.0	0.0
Public sector net cash requirement	-5.0	-12.7	0.0	1.6	1.7	18.7

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

Cash spending on new loans	-0.5	-0.4	-0.8	-1.1	-1.2	-1.5
Cash repayments	-0.3	-0.3	-0.7	-1.0	-1.3	-1.5

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

³ This reconciliation to the net cash requirement does not affect public sector net debt.

Loans and repayments

4.157 Student loan reforms in recent years have increased the size of the upfront loans, with repayments being made over a longer period. In our 2014 *Fiscal sustainability report (FSR)*,

we estimated that on current policy settings student loans would increase public sector net debt by a maximum of 9.8 per cent of GDP around the mid-2030s and by less thereafter.

- 4.158 Student numbers in England were expected to rise this year following the removal of the higher education numbers cap, but have done so by considerably less than expected. The latest data on student numbers and applications indicate a more gradual rise than in the original estimate of the cost of this policy change. We originally assumed that student numbers would rise relatively quickly as excess demand was catered for, but there have only been around 10,000 new entrants this year and applications for next year suggest a similar rise in 2015-16. We therefore assume that student numbers will rise by a further 10,000 in 2016-17, to 375,000, but remain broadly stable thereafter. This would still represent a steadily rising proportion of 18-19 year olds. (The ONS population projections that underpin our forecasts show around a 10 per cent decline in the number of 18 year olds in the population between 2015 and 2020.) The forecast also takes account of new postgraduate loans, the introduction of which was announced in Autumn Statement 2014.
- 4.159 Other loans include a range of other Government schemes as well as loans to Ireland. As discussed above, the ONS announced in February that it intended to reclassify the UK's subscriptions to multilateral development banks that lend at concessionary interest rates from financial transactions to capital grants. Relative to the December forecast, this increases capital expenditure by around £1.4 billion a year and reduces financial transactions by a corresponding amount.
- 4.160 In order to inform our forecast, we ask the Government to provide us with an estimate of the planned lending by each institution or scheme. Following downward revisions to lending by many of these other schemes in our December forecast, the changes in this forecast have been relatively small. The most notable is a small upward revision to lending under Help to Buy equity loans. In our December forecast, reflecting the tendency for new schemes to take longer than originally planned to deliver the amounts targeted – and existing schemes lending below their plans – we introduced an allowance for additional shortfalls this year and next. We have made only a small adjustment to these judgements since December. In particular, we have reduced the additional shortfall for 2014-15 to £0.1 billion, but left unchanged our assumption on the additional shortfall of £1 billion for 2015-16.

Transactions in other financial assets

- 4.161 We only include the impact of financial asset sales or purchases in our forecasts once firm details are available that allow the effects to be quantified with reasonable accuracy and allocated to a specific year.
- 4.162 At Autumn Statement 2013, the Government announced the intention to sell part of the student loan book, which it expected would raise around £12 billion over five years from 2015-16. This intention was reiterated in Autumn Statement 2014 and has been again in this Budget. The Government has informed us that the sale in 2015-16 remains its firm intention, but that there have been changes in the form of the expected sale relative to that which underpinned our previous forecast assumptions. While the preparations for the sale

are still at an early stage and significant uncertainties remain, one implication is that it is likely that a larger quantity of loans would need to be sold to meet the Government's £12 billion central estimate for the proceeds from the sale. The Government has confirmed to us that it intends to proceed on that basis. We have therefore kept the £12 billion over five years in our latest forecast, but have revised up the extent to which future repayments and interest paid to the Exchequer will be reduced. Other things equal, these changes reduce repayments by around £¼ billion on top of the almost £1¼ billion by 2019-20 that had already been factored into our forecast.

4.163 The Government has also announced a further £9 billion of sales of its shares in Lloyds Banking Group, which we have assumed will reduce the net cash requirement by that amount in 2015-16. We assume that these sales will be made through a continuation of the trading plan that was announced in December and has so far seen the sale of £1 billion of the Government's stake in Lloyds, and through further institutional placings. In order to estimate the knock-on effect of these sales for our forecast of interest and dividend receipts – which include an estimate of dividends on Lloyds shares – we have assumed that on average the sales will take place at a small discount relative to the current share price, in part to reflect the likely impact on bank share prices of the tax policy measures (raising the bank levy and limiting tax deductibility of compensation payments to customers) announced in this Budget. We have reduced our forecast for dividend receipts by around £½ billion a year from 2016-17 onwards.

4.164 We have also included two smaller transactions in this forecast:

- the proceeds of the sale of the Government's remaining interest in Eurostar for just under £0.8 billion. The cash is expected to be received in early 2015-16;²³ and
- a preliminary estimate of the proceeds of the sale for the 2.3 and 3.4 GHz spectrum that is also expected to take place in 2015-16.²⁴ At an estimated £0.1 billion, we assume that this sale will be much smaller than the 3G and 4G spectrum sales that took place in 2000-01 and 2012-13. We have estimated the provisional figures in this forecast by taking the centre of the range of reserve prices indicated by OFCOM (between £50 million and £70 million) and raising it by the average ratio of the final proceeds to the reserve price in the 4G auction.

Accruals adjustments

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

²³ See www.gov.uk: *UK Government reaches agreement on the sale of its entire interest in Eurostar for £757.1 million*, 4 March 2015.

²⁴ See OFCOM: *Public Sector Spectrum Release (PSSR) Award of the 2.3 GHz and 3.4GHz bands*, 23 January 2015.

- 4.166 A large component of the receipts timing adjustment relates to the interest on student loans. This is included in the accrued measure of public sector current receipts as soon as the loan is issued. However, cash repayments are not received until the point at which former students earn sufficient income. This part of the forecast is lower than in December, reflecting the effects of lower Bank Rate and RPI inflation on the interest rate applied to these loans, and that more loans are sold through the asset sale described above.
- 4.167 Similar timing adjustments are made for expenditure. The largest is for the timing of payments on index-linked gilts. This is very sensitive to RPI inflation, as well as to the profile of redemptions, which is uneven from year to year. Positive RPI inflation raises the amount government will have to pay on index-linked gilts when they are redeemed. This commitment is recognised in PSNB each year, but the actual cash payments do not occur until redemption of the gilt, which may be many years in the future. In comparison to our December forecast, a further downward revision to RPI inflation – including to our assumption of the steady-state difference between RPI and CPI inflation – has reduced accrued debt interest, with a largely offsetting change in the accruals adjustment. There are also lags due to the timing of cash payments through the year and from auction price effects. For gilts sold at a premium, the cash payments to cover coupons will be larger than the amounts accrued in debt interest. Lower gilt rates since December have increased the projected premia on gilt sales.

Other factors

- 4.168 The rundown of the Bradford & Bingley and NRAM plc (B&B and NRAM) loan books directly reduces the net cash requirement, a small part of which also reduces net borrowing. The largest change since December is the inclusion of the expected sale of NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution (UKAR), announced by the Chancellor in the Budget. We have assumed that this sale raises around £11 billion in 2015-16, reducing the CGNCR by that amount. (This is consistent with a further run-off of around £2 billion in Granite assets before the sale is completed.) There are a number of important uncertainties around the form and timing of this sale. We have assumed that there will be sufficient private sector demand for Granite that the sale will be successful, that UKAR will sell at a price consistent with its book value at the time of the sale, and that the sale will be completed by March 2016. It is possible that UKAR will decide to sell different assets, or that if Granite is sold that the price or timing will be different to our central forecast.
- 4.169 There will be knock-on effects from foregone mortgage repayments associated with the Granite sale. These reduce interest receipts (affecting both PSNB and the CGNCR) and principal repayments (affecting only the CGNCR). In total, these knock-on effects are assumed to raise the CGNCR by an average of £2 billion, on a declining path, over the forecast period.
- 4.170 We have also revised financial transactions in 2014-15 to reflect the £2.7 billion 'Project Slate' sale of assets by UKAR in October 2014. The asset sales had been pencilled in for

2015-16 in previous forecasts, but should have been updated in our December forecast to occur in 2014-15.

- 4.171 We also include a small amount of financial transactions associated with Network Rail, which are unchanged since December.
- 4.172 Cash flows are invariably more volatile than the underlying accrued position of the public finances and reconciling borrowing and estimating the net cash requirement has recently proved difficult. The net cash requirement has come in lower than the bottom-up receipts, expenditure and financial transactions forecasts we use to project it would suggest.
- 4.173 We have again asked the Treasury to supply estimates consistent with its central data on projected departmental outlays and our forecasts for other spending and receipts. These indicate that the cash requirement will be significantly lower this year and somewhat lower next year than our previous approach would suggest. For 2014-15, we have aligned our forecasts to the new methodology, reducing the cash requirement by £11 billion, which is £1 billion more than assumed in December. For 2015-16, we have left our assumption for this gap at £6 billion. Firm spending plans have yet to be set beyond 2015-16, so we cannot do the same for later years.
- 4.174 We should expect there to be some discrepancy between the accrued and cash borrowing estimates each year – since neither the public sector finance statistics nor our forecasts will capture the size and timing of every government transaction perfectly – but the gap has been both large and persistent in recent years. Its persistence implies incomplete coverage somewhere in the data or forecast, rather than the timing effects that would typically be expected to open up and unwind differences from year to year.
- 4.175 We have not been able to reconcile these differences fully, which makes our assumptions for 2016-17 onwards subject to greater uncertainty. In the absence of strong evidence to suggest that further adjustments are required at this stage, we have not included any in 2016-17 and beyond. But we will continue to review this part of the forecast.
- 4.176 ONS efforts to publish greater detail on the reconciliation of accrued and cash borrowing measures may help to resolve some of this issue in time. But for now this remains a significant source of uncertainty in our forecast for the profile of PSND and (as we discuss in Chapter 5) our assessment of the Government's performance against the supplementary debt target when the margin by which debt rises or falls is small.

Central government net cash requirement

- 4.177 The central government net cash requirement (CGNCR) is important because it is the main determinant of Government's net financing requirement. Table 4.35 shows how CGNCR relates to PSNCR and Table 4.36 sets out the changes in this relationship since December. The CGNCR is derived by adding or removing transactions associated with local authorities and public corporations to the PSNCR. We expect local authorities and public corporations to be net lenders over the forecast period.

4.178 Including B&B and NRAM plc and Network Rail in the central government sector means that the CGNCR is no longer simply a measure of the cash required by the Exchequer to fund its operations, which forms the basis for the Government's net financing requirement.²⁵ This has two effects:

- the banks' and Network Rail's own cash requirements are now included in the headline CGNCR. Running down the banks' loan books reduces CGNCR by around £3 billion to £9 billion a year (excluding the Granite sale), but these do not directly affect the Exchequer;
- interactions between the Exchequer and these bodies net off within the headline measure. The banks' loan repayments to the Exchequer vary from around £2 billion to £7 billion a year; and
- the Treasury provides grants to Network Rail and will also finance its new and maturing debt in future, for which Network Rail will pay a fee. Grants are projected to be relatively stable, at just over £4 billion, and refinancing needs are up to £3 billion a year, with fees rising over time.

Table 4.35: Reconciliation of PSNCR and CGNCR

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net cash requirement (NCR)	85	63	59	28	6	5
<i>of which:</i>						
Local authorities and public corporations NCR	-2	-4	0	-2	-3	-5
Central government (CG) NCR own account	87	67	59	30	9	10
CGNCR own account	87	67	59	30	9	10
Net lending within the public sector	1	2	2	2	2	2
CG net cash requirement	88	69	61	32	11	12
B&B and NRAM adjustment	2	4	5	2	2	2
Network Rail adjustment	6	7	6	5	4	3
CGNCR ex. B&B, NRAM and Network Rail	96	79	72	38	17	17

²⁵ The Government is publishing a revised financing remit for 2014-15 alongside the Budget. The OBR provides the Government with the forecast of the CGNCR for this purpose, but plays no further role in the derivation of the net financing requirement.

Table 4.36: Changes in the reconciliation of PSNCR and CGNCR

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net cash requirement (NCR)	-5	-13	0	2	2	19
<i>of which:</i>						
Local authorities and public corporations NCR	3	2	2	0	1	0
Central government (CG) NCR own account	-8	-15	-2	1	1	19
CGNCR own account	-8	-15	-2	1	1	19
Net lending within the public sector	0	0	0	0	0	0
CG net cash requirement	-8	-15	-2	1	1	19
B&B and NRAM adjustment	2	-2	0	-1	-1	0
Network Rail adjustment	0	0	0	0	0	0
CGNCR ex. B&B, NRAM and Network Rail	-6	-16	-1	0	0	18

The key fiscal aggregates

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

- **public sector net borrowing:** the difference between total public sector receipts and expenditure on an accrued basis each year. As the widest measure of borrowing, PSNB is a key indicator of the fiscal position and is useful for illustrating the reasons for changes since the previous forecast;
- the **current budget:** the difference between public sector current expenditure and receipts each year. In effect, this is public sector net borrowing excluding borrowing to finance investment;
- the **cyclically adjusted current budget:** the current budget adjusted to reflect the estimated impact of fluctuations in the economic cycle. It represents an estimate of the underlying or 'structural' current budget, in other words the current budget balance we would see if the output gap was zero. It is used as the target measure for the Government's fiscal mandate; and
- **public sector net debt:** a stock measure of the public sector's net liability position defined as its gross liabilities minus its liquid assets. In broad terms, it is the stock equivalent of public sector net borrowing, measured on a cash basis rather than an accrued basis. It is used for the Government's supplementary fiscal aim.

Public sector net borrowing

4.180 Public sector net borrowing (PSNB) is forecast to be £90.2 billion in 2014-15, a decline of £7.2 billion on the previous year. Excluding the effects of some forthcoming classification changes that the ONS plans to implement this year, borrowing would be down £8.5 billion

on a like-for-like basis. Borrowing falls in each year of the forecast, but by varying amounts. In 2016-17 and 2017-18, the falls are particularly large at £35.9 billion and £26.6 billion. The budget moves into a surplus of £5.2 billion in 2018-19, which then widens slightly to £7.0 billion in 2019-20.

4.181 Table 4.37 shows how changes in borrowing between our December and March forecasts can be decomposed into underlying forecast changes, including their interaction with the Government's December spending policy assumptions. It also shows the (relatively small) effects of the Budget measures shown in the Treasury's policy decisions table and the (much larger) effect of the Government's change to its chosen medium-term spending assumption.

4.182 Relative to our December forecast, we have revised PSNB down by £1.3 billion a year on average between 2015-16 and 2018-19. This reflects:

- a downward revision to receipts across the forecast period, with the largest downgrades for North Sea revenues (due to lower oil prices and production), stamp duty receipts (due to lower property transactions), excise duties (due to lower inflation-related uprating) and interest and dividend receipts (due to lower interest rates and the receipts foregone due to the further asset sales announced in the Budget). Public sector gross operating surplus has also been revised down (due to outturn data and an ONS reclassification change that we have anticipated in this forecast). Those downward revisions are partly offset by upward revisions to income tax receipts (due to lower inflation-related uprating and stronger employment growth from migration);
- a downward revision to annually managed expenditure, including sharply lower debt interest costs (due to lower RPI inflation and interest rates) and lower welfare spending (due to lower uprating from 2016-17); and
- a new Government policy assumption that reduces total public spending in each year from 2016-17 to 2018-19. But this reduction is smaller than the downward revision to annually managed expenditure, which means less of a squeeze on implied day-to-day spending on public services and administration than in December.

4.183 The projected budget surplus in 2019-20 is £16.1 billion lower than in our December forecast. The Government now assumes that total spending will grow in line with nominal GDP rather than whole economy inflation in that year. Combined with a lower forecast for annually managed expenditure, that means that implied public services spending in 2019-20 has been revised up by £28.5 billion (1.3 per cent of GDP) since December.

4.184 We have assumed that an increase in government spending on its paybill and procurement of this scale would feed through to nominal GDP growth in 2019-20, though not real GDP growth (which is determined by our judgements on potential output). This pushes up receipts, notably income taxes and VAT on public sector procurement. This turnaround in receipts from previous years appears in Table 4.37 as an 'underlying forecast change', but is in effect driven by the change in the spending policy assumption.

Table 4.37: Public sector net borrowing

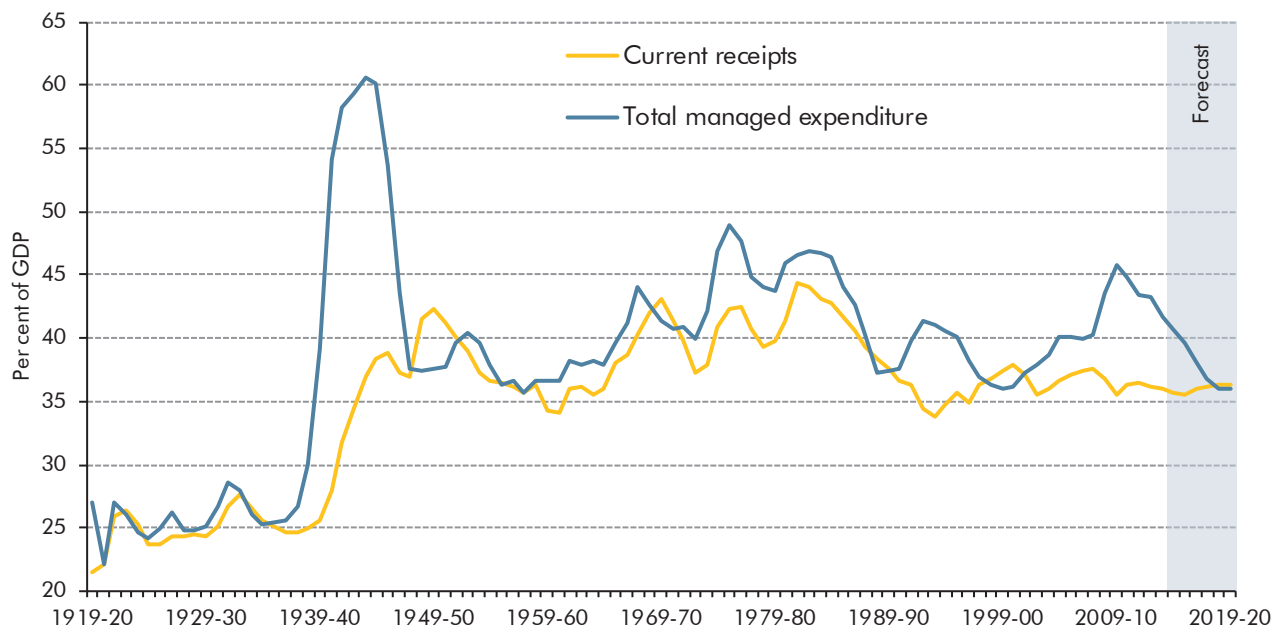
	£billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	91.3	75.9	40.9	14.5	-4.0	-23.1
March forecast	90.2	75.3	39.4	12.8	-5.2	-7.0
Change	-1.1	-0.7	-1.5	-1.8	-1.2	16.1
Underlying OBR forecast changes						
Total	-1.1	0.1	0.5	0.4	-0.1	-4.6
<i>of which:</i>						
Changes in the receipts forecast	-1.1	3.3	4.9	5.8	4.0	-1.9
<i>of which:</i>						
Inflation	0.1	0.7	0.7	0.4	0.8	1.0
Other oil and gas price effects	-0.1	0.7	0.7	1.0	1.1	1.1
Interest rates	0.0	0.3	0.5	0.6	0.5	0.6
Housing market	0.2	1.5	2.1	1.8	0.9	-0.1
Other	-0.5	1.0	1.8	2.8	1.6	-3.4
Classification changes	-0.8	-0.9	-0.9	-0.9	-0.9	-1.0
Changes in the spending forecast	0.0	-3.3				
Effect of applying Autumn Statement spending policy assumptions post 2015-16			-4.4	-5.4	-4.1	-2.8
<i>of which:</i>						
Inflation	-2.2	-4.2	-4.7	-5.6	-6.5	-6.9
Interest rates	-0.3	-1.2	-2.1	-3.0	-3.9	-4.5
Capital spending ¹	1.0	2.0	2.0	2.0	2.3	2.9
Other spending	-0.3	-1.8	-6.5	-5.0	-5.3	-5.0
Classification changes	2.1	2.2	2.2	2.2	2.3	2.3
RDEL	-0.3	-0.4				
Implied RDEL			4.6	4.0	7.0	8.3
Changes due to Government decisions						
Budget policy measures	0.0	-0.7	0.0	-0.2	0.9	0.6
Effect of applying new Budget spending policy assumptions post 2015-16			-1.9	-1.9	-2.0	20.2

¹Excluding classification changes

Note: this table uses the convention that a negative figure means an improvement in PSNB.

4.185 Chart 4.9 shows current receipts and total managed expenditure as a share of GDP since 1919-20 using Bank of England and ONS data. The Government's decision to assume that spending rises in line with nominal GDP in 2019-20 means that it no longer falls to its lowest share of national income in a full year since before the war, as was the case in our December forecast. Instead, total spending falls to 36.0 per cent of GDP, which is fractionally higher than the previous post-war lows of 35.8 per cent in 1957-58 and 35.9 per cent in 1999-2000. Current receipts as a share of GDP are forecast to remain at similar levels to those seen over the last few decades.

Chart 4.9: Total public sector spending and receipts



Source: Bank of England, ONS, OBR

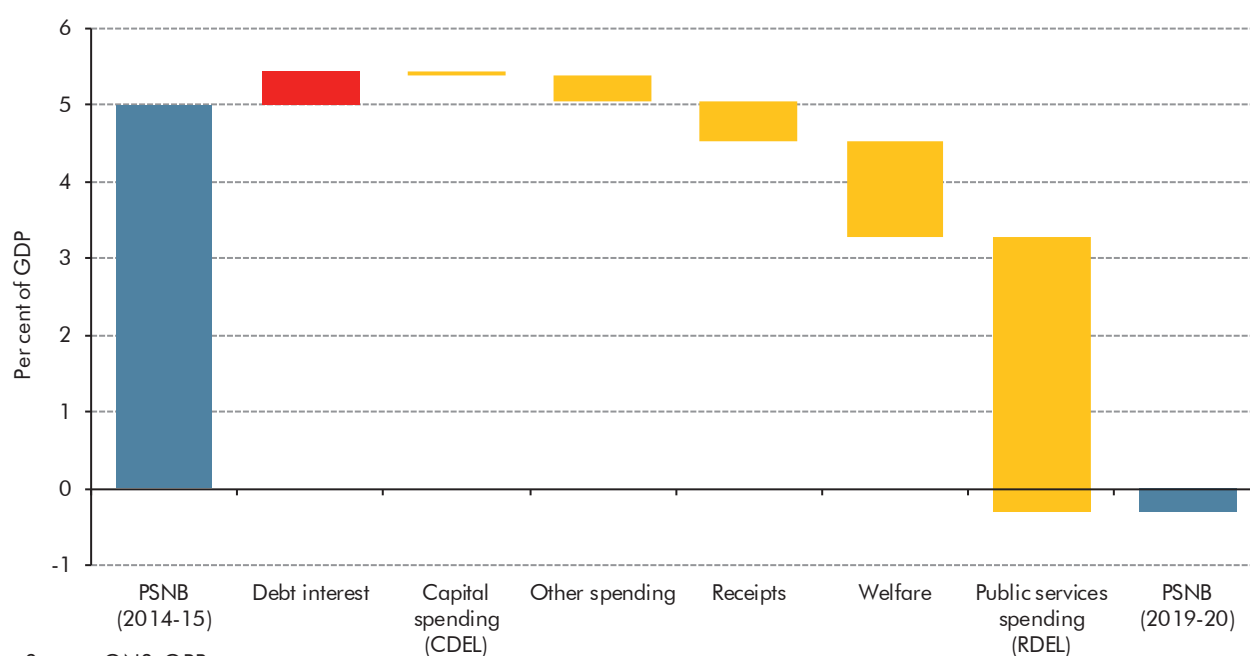
4.186 Between 2009-10 and 2019-20, the budget balance is forecast to move from a post-war record deficit of 10.2 per cent of GDP to a small surplus of 0.3 per cent – a turnaround of 10.5 per cent of GDP (£190 billion in today’s terms). By 2014-15, around half of that planned reduction – 5.2 per cent of GDP (£94 billion) – will have been completed.

4.187 Over the five years of our forecast period up to 2019-20, the main factors contributing (negatively and positively) to the removal of the remaining deficit and the move into budget surplus will include (Chart 4.10):

- relatively small increases in **debt interest** spending (0.4 per cent of GDP) as interest rates are assumed to rise in line with market expectations, which remain well below historical averages by the end of the forecast period;
- small reductions in **capital spending** (0.1 per cent of GDP);
- small reductions in **AME spending other than on debt interest and welfare** (0.3 per cent of GDP);
- a 0.5 per cent of GDP rise in **receipts**. This includes a 0.3 per cent of GDP rise in the tax-to-GDP ratio – the biggest contributors to which are positive fiscal drag in income tax and NICs as sustained productivity and real earnings growth resume and pull more income into higher tax brackets, and the abolition of the NICs contracting out rebate in 2016-17 – and a 0.2 per cent of GDP rise in non-tax revenues, notably interest on the government’s stock of financial assets as interest rates rise;

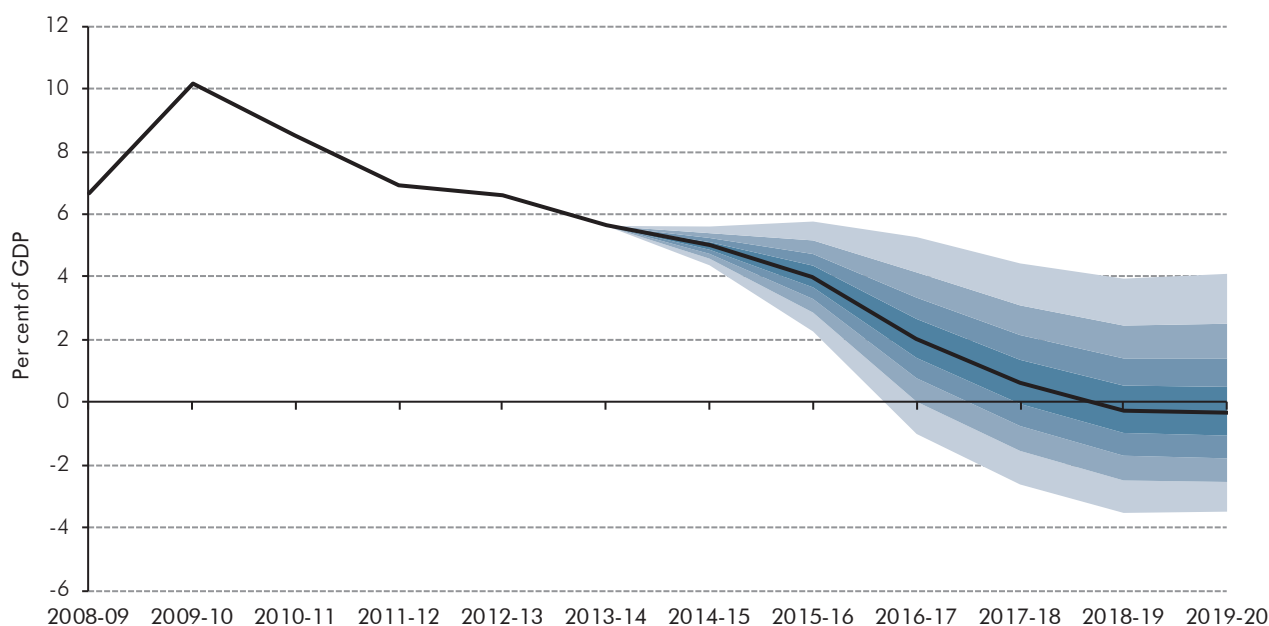
- a 1.3 per cent of GDP fall in **welfare spending**, explained largely by lower spending on working-age benefits, due to inflation uprating and lower caseloads for benefits sensitive to the economic cycle. Spending on state pensions is expected to be broadly flat as a share of GDP due to demographic trends and 'triple lock' uprating; and
- a 3.6 per cent of GDP (or £65 billion in today's terms) cut in **day-to-day spending on public services and administration**, implied by the Government's firm 2015-16 plans, its medium-term assumptions for total spending and our forecast for AME spending. This is 1.2 per cent of GDP smaller than in our December forecast, but still accounts for around 70 per cent of the improvement in the budget balance over the forecast.

Chart 4.10: Sources of deficit reduction



4.188 All fiscal forecasts are subject to significant uncertainty. Chart 4.11 shows our central forecast for PSNB with successive pairs of shaded areas around it. These represent 20 per cent probability bands, based on the pattern of past official forecast errors. (As with our GDP forecast, the central forecast is judged to be a median forecast, with equal probability that outcomes will be above or below the forecast.) On this basis, the probability that PSNB will reach balance rises from 20 per cent in 2016-17, to 40 per cent in 2017-18, and to around 55 per cent in 2018-19 and 2019-20.

Chart 4.11: PSNB fan chart



Source: ONS, OBR

Current budget

4.189 The current budget balance, which excludes borrowing to finance net investment spending, is expected to show a deficit of £59.8 billion in 2014-15, down from a peak of £103.8 billion in 2009-10. The current budget moves into surplus in 2017-18 and reaches a surplus of £35.2 billion in 2018-19 and £38.7 billion in 2019-20. The current budget balance between 2015-16 and 2018-19 has improved since December, as lower spending on debt interest and welfare more than offset the increase in spending on public services and administration implied by the Government's latest spending policy assumption. The surplus in 2019-20 has been revised down by £11.3 billion, with the revision more than explained by the change in the Government's spending assumption for that year.

Cyclically adjusted current budget

4.190 The cyclically adjusted current budget (CACB) moves from a deficit of 2.5 per cent of GDP in 2014-15 to a surplus of 1.7 per cent of GDP in 2019-20, with the balance moving into surplus in 2017-18. The CACB balance has improved by 0.2 per cent of GDP on average between 2014-15 and 2018-19, but the CACB surplus has been revised down by 0.5 per cent in 2019-20. The CACB is discussed further in Chapter 5.

Public sector net debt

4.191 We forecast that public sector net debt (PSND) will rise as a share of GDP this year, but start to fall from 2015-16 and at an increasingly rapid rate to 71.6 per cent of GDP in 2019-20. Net debt is lower than we forecast in December from 2015-16 onwards, and falls a year earlier than we expected then. Table 4.38 shows that:

- downward revisions to the level of nominal GDP in 2014-15 have increased debt as a share of GDP. That feeds through to the rest of the forecast period, but higher nominal GDP growth later in our forecast unwinds the effect;
- our borrowing forecast – both underlying changes and the effect of Government decisions – have relatively small effects on the level of net debt. The exception is in 2019-20, where the change in the Government's spending policy assumption has increased spending and borrowing relative to our December forecast, reducing the extent to which debt falls as a share of GDP in that year. Indeed, net debt now continues to rise in cash terms in 2019-20 (by £9½ billion), rather than falling modestly as in our December forecast (by £4 billion);
- the Government announcement of two significant asset sales related to the mortgage assets of NRAM plc managed by UK Asset Resolution (UKAR) and its shareholding in Lloyds Banking Group have the largest effect on the debt-to-GDP ratio. Together, they are expected to reduce net debt by £20 billion in 2015-16. That means that debt falls as a share of GDP a year earlier than would otherwise have been the case. The bulk of these sales are expected to take place late in the fiscal year. Financial asset sales bring forward cash that would otherwise have been received in future in the shape of mortgage repayments and dividends (around £10 billion over the remainder of the forecast period as a result of the UKAR and Lloyds sales), so they only temporarily reduce the debt-to-GDP ratio;
- UKAR also ran down its assets more quickly in 2014-15 than we had factored into our December forecast. Much of this reflects the sale of an asset that we had assumed would be sold in 2015-16;
- changes in the premia associated with the Debt Management Office issuing gilts at prices above their nominal value have reduced our forecast for net debt slightly further. These premia are particularly associated with index-linked gilts, due to the negative real yield curve that persists over through the forecast period; and
- other factors reduce net debt further. Downward revisions to student numbers have reduced our forecast of lending on student loans by increasing amounts over time. But most of the 'other factors' line of Table 4.38 relates to the reclassification of subscriptions to multilateral development banks. This has a neutral effect on net debt, as it increases borrowing but reduces net lending by around £1.4 billion a year.

Table 4.38: Changes to public sector net debt since December

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
March forecast	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Change	0.3	0.0	-0.9	-0.9	-1.0	-1.4	-1.2
<i>of which:</i>							
Change in nominal GDP ¹	0.3	0.6	0.4	0.6	0.6	0.2	-0.3
Change in cash level of net debt	0.0	-0.5	-1.3	-1.5	-1.6	-1.6	-0.9
	£ billion						
December forecast	1402	1489	1558	1610	1638	1652	1648
March forecast	1402	1479	1533	1580	1606	1617	1627
Change in cash level of net debt	0	-10	-25	-30	-32	-34	-21
<i>of which:</i>							
Borrowing changes	0	-1	-2	-3	-5	-6	10
UK Asset Resolution	0	-3	-8	-7	-5	-3	-1
Lloyds Banking Group share sales	0	-1	-10	-10	-10	-10	-10
Gilt premia	0	-2	0	-2	-3	-3	-5
Other factors	0	-3	-5	-7	-9	-12	-15

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

Table 4.39: Fiscal aggregates

	Per cent of GDP						
	Outturn 2013-14	Forecast					
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Receipts and expenditure							
Public sector current receipts (a)	36.1	35.8	35.5	36.1	36.2	36.2	36.3
Total managed expenditure (b)	41.7	40.7	39.6	38.1	36.8	36.0	36.0
of which:							
Public sector current expenditure (c)	38.1	37.0	35.9	34.5	33.3	32.5	32.5
Public sector net investment (d)	1.5	1.7	1.6	1.5	1.4	1.4	1.4
Depreciation (e)	2.0	2.1	2.1	2.1	2.1	2.1	2.1
Deficit							
Public sector net borrowing (b-a)	5.6	5.0	4.0	2.0	0.6	-0.2	-0.3
Current budget deficit (c+e-a)	4.1	3.3	2.4	0.5	-0.8	-1.7	-1.7
Cyclically-adjusted net borrowing	4.1	4.2	3.7	1.9	0.6	-0.3	-0.3
Primary balance	-3.8	-3.4	-2.5	-0.3	1.3	2.1	2.1
Cyclically-adjusted primary balance	-2.3	-2.7	-2.2	-0.1	1.3	2.1	2.1
Fiscal mandate and supplementary target							
Cyclically-adjusted deficit on current budget	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Public sector net debt ¹	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Financing							
Central government net cash requirement	4.5	4.9	3.7	3.1	1.6	0.5	0.5
Public sector net cash requirement	3.7	4.7	3.4	3.0	1.4	0.3	0.2
Stability and Growth Pact							
Treaty deficit ²	5.8	5.2	4.3	2.2	0.8	0.0	-0.1
Cyclically-adjusted Treaty deficit	4.2	4.4	4.0	2.0	0.8	0.0	-0.1
Treaty debt ratio ³	87.9	88.4	89.7	89.7	88.2	85.7	82.8
£ billion							
Public sector net borrowing	97.3	90.2	75.3	39.4	12.8	-5.2	-7.0
Current budget deficit	71.6	59.8	45.7	10.2	-15.8	-35.2	-38.7
Cyclically-adjusted net borrowing	70.4	76.2	68.8	36.3	11.8	-5.4	-7.0
Cyclically-adjusted deficit on current budget	44.6	45.8	39.3	7.1	-16.8	-35.3	-38.8
Public sector net debt	1402	1479	1533	1580	1606	1617	1627
Memo: Output gap (per cent of GDP)	-2.0	-0.8	-0.4	-0.2	0.0	0.0	0.0

¹ Debt at end March; GDP centred on end March.

² General government net borrowing on a Maastricht basis.

³ General government gross debt on a Maastricht basis.

Risks and uncertainties

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

- global and domestic risks associated with the economy (paragraph 3.111);
- prospects for North Sea revenue related to policy changes announced in the Budget and oil prices, and their effects on production and capital expenditure in the industry (paragraphs 4.58 to 4.68);

- policy related uncertainties, including the path of public spending associated with the Government's medium-term spending assumption (paragraphs 4.102 to 4.108) and the indexation of excise duties (Box 4.3);
- the significant uncertainties associated with forecasting the UK's payments to EU institutions (paragraphs 4.133 to 4.136);
- uncertainties surrounding the scale and timing of three large asset sales planned to take place (or begin) in 2015-16: the pre-Browne student loan book, an NRAM mortgage securitisation vehicle and the Government's shareholding in Lloyds Banking Group (paragraphs 4.161 to 4.164); and
- a number of policy costings that have been incorporated into our forecast (Annex A).

International comparisons

4.193 International organisations, such as the European Commission and the International Monetary Fund (IMF), produce forecasts of deficit and debt levels of different countries on a comparable basis. These are based on general government debt and borrowing and are presented on a calendar year basis. To facilitate comparisons, Tables 4.40 and 4.41 present our UK forecasts on a comparable basis. With both modelling and reporting of much tax and expenditure done primarily on a financial year basis, the calendar year forecasts are illustrative and have been derived by weighting the financial year forecasts.

Table 4.40: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit ¹			Treaty Debt ²		
	2014	2015	2016	2014	2015	2016
UK (March EFO)	5.6	4.5	2.7	89.6	89.3	89.7
UK (EC)	5.4	4.6	3.6	88.7	90.1	91.0
Germany	-0.4	-0.2	-0.2	74.2	71.9	68.9
France	4.3	4.1	4.1	95.3	97.1	98.2
Italy	3.0	2.6	2.0	131.9	133.0	131.9
Spain	5.6	4.5	3.7	98.3	101.5	102.5
Euro area	2.6	2.2	1.9	94.3	94.4	93.2

¹ General government net borrowing.

² General government gross debt.

Source: European Commission, European Economic Winter 2015; OBR

Table 4.41: Comparison with IMF forecasts

	Per cent of GDP					
	General government net borrowing			General government net debt		
	2014	2015	2019	2014	2015	2019
UK (March EFO)	5.6	4.5	-0.1	81.7	81.1	75.4
UK (IMF)	5.3	4.1	0.2	83.9	85.0	76.8
Germany	-0.3	-0.2	-0.4	53.9	51.6	42.0
France	4.4	4.3	1.0	88.1	90.6	88.8
Italy	3.0	2.3	0.4	114.3	114.0	105.0
Japan	7.1	5.8	4.7	137.8	140.0	140.7
U.S	5.5	4.3	4.0	80.8	80.9	80.8

Source: OBR, IMF, World Economic Outlook, October 2014

Box 4.5: Deficit reduction – international comparisons

The UK budget deficit increased to a post-war high after the financial crisis and recession of the late 2000s. This box uses the European Commission's recent *Winter economic forecast* to compare the main sources of deficit reduction in the UK and a selection of other major advanced economies on common definitions.

In the UK, general government net borrowing almost quadrupled from 2007 to reach a post-war high of 10.8 per cent of GDP in 2009, the drivers of which we discussed in *Working Paper No.7: Crisis and consolidation in the public finances*. Since then, borrowing on this measure has fallen by 5.3 per cent of GDP, due entirely to expenditure falling as a share of GDP. Despite real GDP growth, a narrowing output gap, very strong employment growth and net tax-raising policy measures, government revenues have been broadly flat as a share of GDP.

Chart B shows how changes in spending and revenue have contributed to falls in general government net borrowing as a share of GDP between 2009 and 2014 in six major economies:

- in the US, borrowing peaked at almost 13 per cent of GDP in 2009, the largest deficit in the G7. Lower spending and strong growth in revenues have contributed in broadly equal terms to reducing borrowing to around 5 per cent of GDP in 2014;
- borrowing in Japan has only declined slightly over this period. It remains at around 8 to 9 per cent of GDP, largely because spending has grown faster than national income – in part driven by a rapidly ageing population. Revenue growth has more than offset that rise in spending, including through an increase in the headline VAT rate to 8 per cent;
- France has also seen spending rise as a share of GDP, but overall borrowing has fallen – and has remained lower than in the UK, US and Japan – as revenues have risen by 4 per cent of GDP in the five years to 2014;
- in Italy, government borrowing was lower than in most other G7 countries in 2009, at just over 5 per cent of GDP, although net general government debt was over 100 per cent of GDP. Since 2009, borrowing has fallen by just over 2 per cent of GDP, reflecting both lower spending and higher revenues; and
- borrowing in Germany was the lowest in the G7 in 2009, at just 3 per cent of GDP. It increased to around 4 per cent in 2010, reflecting lower revenues, but then fell close to balance in 2012. In 2014, Germany was the only G7 country estimated to have run a budget surplus, at around half a per cent of GDP. Lower spending explains the majority of the move from deficit to surplus over the past five years.

So the UK began the period with the second highest deficit (after the US) and ended with the second highest (after Japan), despite the second largest fall among these countries. The contribution of lower spending to that fall was the largest among these countries. The UK was the only country where the deficit has not been reduced by having revenue growing faster than national income. That revenue weakness has come despite employment growth in the UK over the past five years having been the fastest among these countries. It largely reflects weakness in income taxes, due to policy measures and disappointing productivity and earnings growth.

Chart B: Sources of deficit reduction: an international comparison



Source: European Commission

Note: red bars indicate upward effect on borrowing, yellow bars indicate downward effect

5 Performance against the Government's fiscal targets

Introduction

5.1 This chapter:

- sets out the Government's updated medium-term fiscal targets (from paragraph 5.2);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.5); and
- assesses how robust these judgements are to the uncertainties inherent in any fiscal forecast, by looking at past forecast errors, sensitivity to key parameters of the forecast and alternative economic scenarios (from paragraph 5.20).

The Government's fiscal targets

5.2 In the June 2010 Budget, the Government set itself two medium-term fiscal targets for the current Parliament: the fiscal mandate and a supplementary target. The OBR is required to judge whether the Government has a greater than 50 per cent probability of hitting these targets under existing policy. In March 2014, the Government updated the *Charter for Budget Responsibility* to include details of how a new 'welfare cap' – set in Budget 2014 – would operate. In December 2014, the Government updated the *Charter* again to set a new fiscal mandate and a new supplementary target for debt-to-GDP.¹

5.3 The Government fiscal targets assessed in this chapter are:

- *"a forward-looking aim to achieve cyclically adjusted current balance by the end of the third year of the rolling, 5-year forecast period".²* (For the purposes of this forecast, the third year of the forecast period is 2017-18.) The previous target had been to achieve balance in the final year of the forecast period, which would have been 2019-20 in this forecast;
- *"an aim for public sector net debt as a percentage of GDP to be falling in 2016-17".* The previous target had been for debt as a share of GDP to fall at a fixed date of 2015-16; and

¹ See *Charter for Budget Responsibility: Autumn Statement 2014 update*, which is available on our website.

² In its inquiry on Autumn Statement 2014, the Treasury Select Committee questioned the Chancellor about the change of wording from "target" to "aim" in the new Charter. In its report on that inquiry, the Committee noted that "the Chancellor argued that 'I do not think there is a substantive difference'".

- “the cap on welfare spending, at a level set out by the Treasury in the most recently published Budget report, over the rolling 5-year forecast period, to ensure that expenditure on welfare is contained within a predetermined ceiling”.

5.4 The welfare cap was formally defined and initially set by the Government in Budget 2014. The cap was set for the period from 2015-16 to 2018-19 in line with our March 2014 forecast. It was extended to 2019-20 in Autumn Statement 2014, in line with our December 2014 forecast for that year. The Government has set a 2 per cent margin above the cap that can be used to accommodate forecast changes, but not the impact of policy changes. The OBR has been tasked with assessing the Government's performance against the cap once a year alongside the Autumn Statement. In this *Economic and fiscal outlook*, we therefore provide an update on performance against the cap without formally assessing whether the Government is meeting its welfare cap commitment.

The implications of our central forecast

5.5 Table 5.1 shows our central forecasts for the cyclically adjusted current budget deficit (CACB), public sector net debt (PSND), and the welfare cap, as described in detail in Chapter 4. These are median forecasts, so we believe it is equally likely that outturns will come in above them as below them.

Table 5.1: Performance against the Government's fiscal targets

	Per cent of GDP						
	Outturn	Forecast					
		2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Cyclically adjusted current budget deficit							
December forecast	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
March forecast	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Public sector net debt							
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
March forecast	79.1	80.4	80.2	79.8	77.8	74.8	71.6
£ billion							
Spending within the welfare cap							
December forecast	113.5	119.6	120.7	122.4	124.0	126.8	129.8
March forecast	116.1	119.4	120.6	121.0	121.8	124.0	126.5

Fiscal mandate

5.6 Table 5.1 shows that our central forecast is for the CACB to be in surplus by 0.8 per cent of GDP in 2017-18. This means that there is a greater than 50 per cent chance of the Government achieving its new fiscal mandate. The surplus rises to 1.7 per cent of GDP by 2019-20. This means that the previous fiscal mandate would still have been met by a significant margin, although by less than in our December forecast.

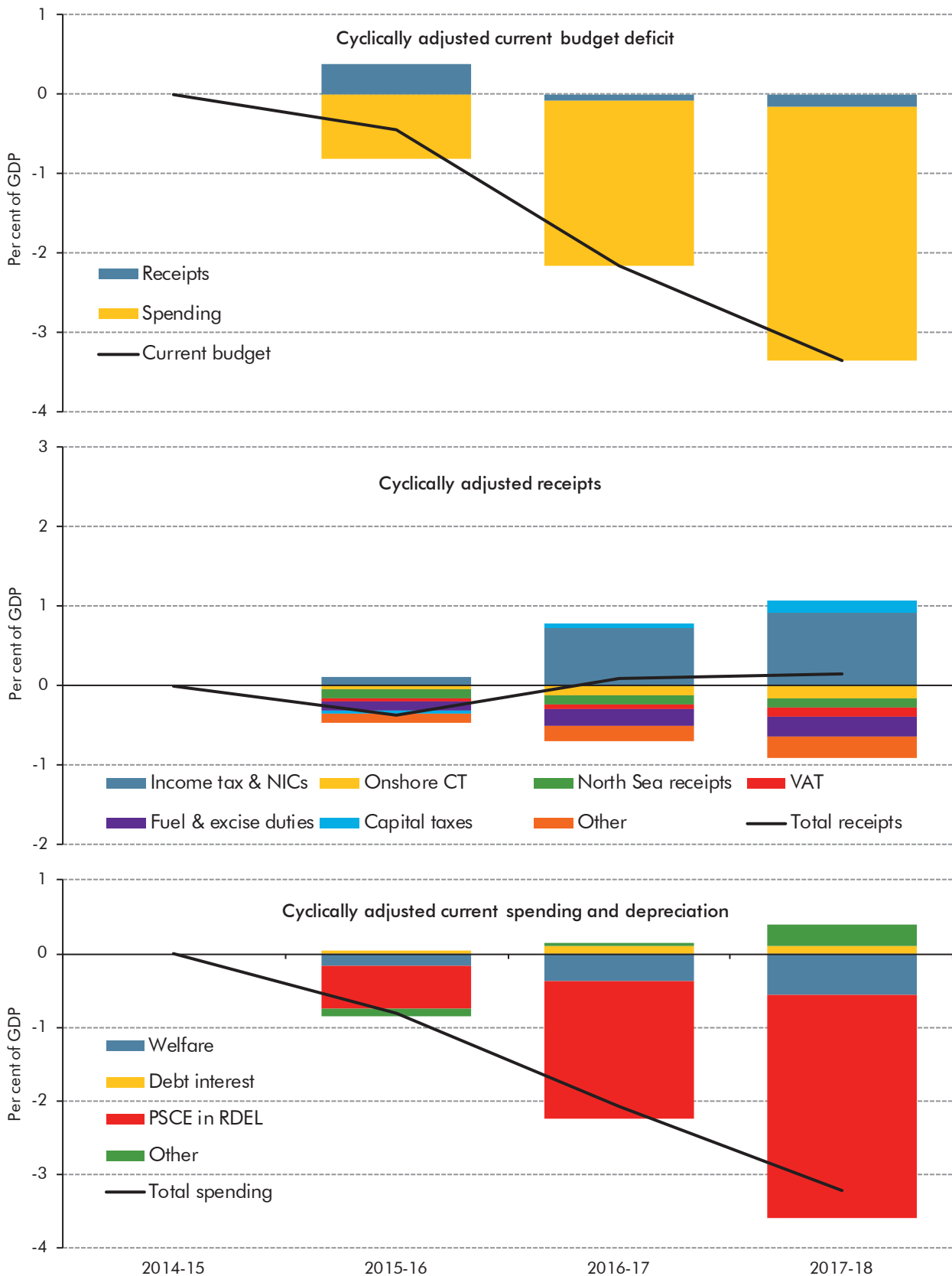
5.7 We estimate that the output gap was just -0.7 per cent of GDP at the end of 2014 and that it will narrow slowly over the next few years, closing in late 2017. The path of the structural deficit therefore closely matches changes in the headline deficit.

5.8 The CACB moves from a deficit of 2.5 per cent of GDP in 2014-15 to a surplus of 0.8 per cent of GDP in the new mandate year of 2017-18. Chart 5.1 uses cyclical-adjustment coefficients for particular types of receipts and spending³ to show how this comes about:

- the CACB is expected to improve by 3.4 per cent of GDP between 2014-15 and 2017-18, with lower spending contributing 3.2 per cent and higher receipts 0.2 per cent;
- in 2015-16, the final year for which the Government has set detailed departmental spending plans, the CACB falls by 0.4 per cent of GDP (£8 billion). Cuts in spending more than account for that change (down by 0.8 per cent of GDP or £15 billion), with a fall in receipts – notably from the North Sea and fuel and excise duties – pushing up the structural deficit by around £7 billion. Within spending, the largest contribution to the change is a structural reduction in departmental spending (£10¾ billion);
- based on the Government's policy assumption on spending, which implies a path for departmental spending once the rest of our forecast is taken into account, the CACB falls by 1.7 per cent of GDP (£33½ billion) in 2016-17, more than twice the figure in the previous year. Again, by far the largest contribution is the 1.3 per cent of GDP implied cut in spending on day-to-day public services and administration (£25 billion). Other important contributions include the structural rise in receipts from income tax (£5½ billion) and NICs (£6¾ billion). The latter is largely explained by the abolition of the NICs contracting out rebate in 2016-17. Around two thirds of the £5 billion of additional receipts from that measure is expected to come from public sector employers, adding to the pressure on implied departmental budgets; and
- in 2017-18, the CACB again falls significantly, by 1.2 per cent of GDP (£24 billion). Once again, by far the largest contribution to that change is the cut in public services spending implied by the Government's spending assumption (£24 billion). Receipts are broadly stable as a share of GDP, as an additional year of fiscal drag boosting personal taxes and the effects of further asset price rises on capital taxes are offset by small declines in a number of other receipts.

³ Further details can be found in Helgadóttir *et al* (2012), *Working Paper No.4: Cyclically adjusting the public finances*.

Chart 5.1: Year-on-year changes to the cyclically adjusted current budget from 2014-15 to 2017-18



Source: OBR

5.9 Table 5.2 decomposes the changes in our forecast of the CACB since December. On the basis of the new fiscal mandate year of 2017-18, it shows that:

- we expect a slightly larger surplus on the CACB in 2017-18 than in December;
- cyclically adjusted receipts were stronger than expected in 2014-15, reflecting a number of relatively small in-year changes to our forecast. But that improvement does not persist – in later years our structural receipts forecast is unchanged;
- debt interest and welfare spending have been revised down significantly since December, due in large part to lower inflation and interest rates. That is reflected as a structural reduction in spending. But part of that reduction is offset by higher departmental spending, as the Government's chosen spending assumption means that some of the lower debt interest and welfare spending eases the squeeze on implied departmental budgets rather than improving the CACB; and
- Budget measures appearing in the Treasury's policy decisions table are broadly neutral in 2017-18.

5.10 For the previous target year of 2019-20, Table 5.2 shows that we have revised our forecast of the CACB surplus down by 0.5 per cent of GDP to 1.7 per cent. While lower debt interest and welfare spending continue to reduce structural spending relative to our December forecast, the Government's decision to change its spending assumption for 2019-20 – so that total spending grows in line with nominal GDP rather than remaining flat in real terms – raises spending relative to December. That additional 0.9 per cent of GDP increase in implied day-to-day spending on public services and administration (over and above the additional 0.4 per cent of GDP implied by applying the previous spending assumption to our latest forecast) means that the surplus on the CACB is now expected to be flat as a share of GDP.

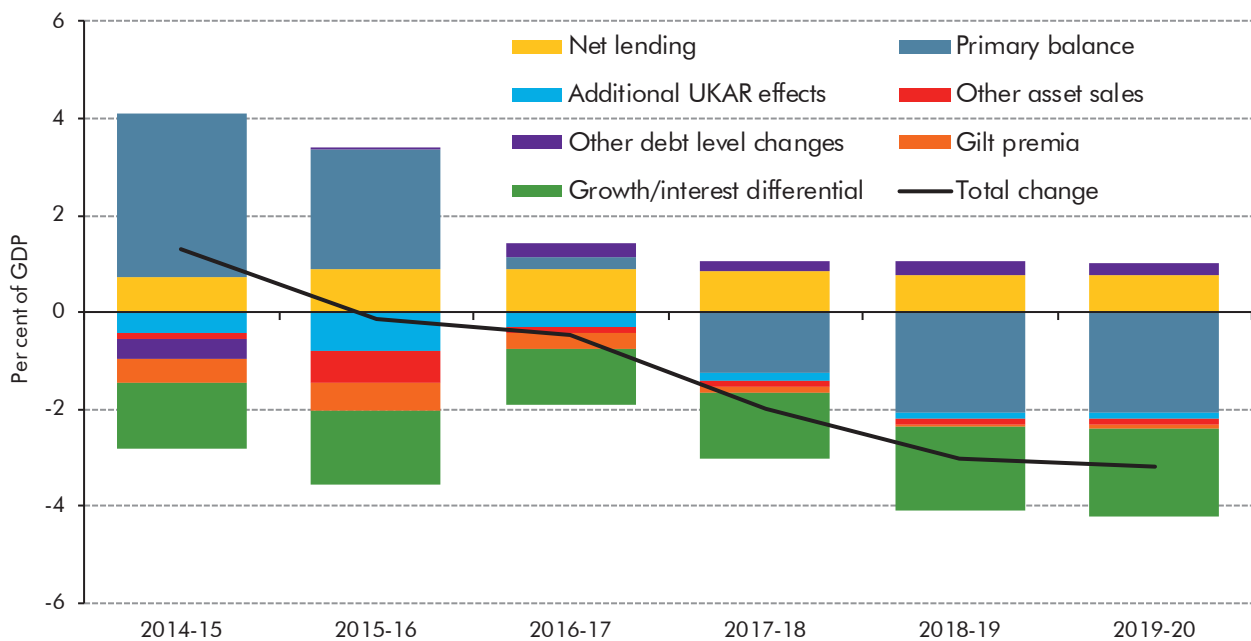
Table 5.2: Changes to the cyclically adjusted current budget deficit since December

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
March forecast	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Change	0.0	-0.2	-0.1	-0.1	-0.2	-0.2	0.5
<i>of which:</i>							
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other receipts	0.0	-0.3	0.0	0.1	0.0	0.0	0.0
Other non-departmental spending	0.0	0.0	-0.2	-0.5	-0.4	-0.6	-0.7
Other departmental spending	0.0	0.1	0.1	0.3	0.2	0.3	1.3
<i>of which:</i>							
Before new spending assumption	0.0	0.1	0.1	0.4	0.3	0.4	0.4
Baseline spending assumption	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.9

Supplementary target

- 5.11 The new supplementary target requires public sector net debt (PSND) to fall as a share of GDP between 2015-16 and 2016-17, with that year fixed. As in December, we expect that PSND will fall as a share of GDP in that year, so that the Government is on course to meet its supplementary target. But just three months after having dropped it as the supplementary target, we now believe that the Government is back on course to have debt falling as a share of GDP in 2015-16, thanks in large part to its plans to sell more financial assets. The bulk of these sales are expected to take place late in the fiscal year.
- 5.12 Chart 5.2 decomposes year-on-year changes in the debt-to-GDP ratio over the forecast period. It shows that:
- the Government's announcement of two large asset sales – £11 billion of assets of NRAM plc held by UK Asset Resolution (UKAR) and a further £9 billion of its shareholding in Lloyds Banking Group – are key factors explaining the year-on-year drop in the debt-to-GDP ratio in 2015-16. These are explained further below;
 - changes in the year-on-year profile of the debt-to-GDP ratio typically reflect changes in the primary balance (the difference between non-interest receipts and spending). But the debt-to-GDP ratio falls in both 2015-16 and 2016-17 despite the primary balance being in deficit by 2.5 per cent of GDP and 0.3 per cent of GDP in those years;
 - the fact that nominal GDP growth exceeds expected interest rates would, all else equal, be sufficient for debt to fall by over 1 per cent of GDP in every year, and by 1.8 per cent of GDP in 2019-20. This differential is an extremely important component of public sector debt dynamics, especially over longer timeframes. In our annual *Fiscal sustainability reports*, we analyse the impact of different assumptions on our results;
 - net lending to the private sector – mainly student loans – increases net debt in every year (but, as a financial transaction, it does not directly affect measures of the deficit);
 - issuing debt at a premium to its nominal value reduces net debt over the forecast period. But this is ultimately only temporary and will unwind over the long term; and
 - other changes, mainly the Asset Purchase Facility and timing effects, are relatively small. Accrued receipts exceed cash receipts over the medium term, partly because some receipts are collected with a lag (including interest on student loans, where the lag can be many years).

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



Source: OBR

5.13 Relative to our December forecast, we now expect PSND to rise more gradually this year and to start falling a year earlier in 2015-16. Table 5.3 decomposes changes in the profile of net debt as a share of GDP since December. It shows that:

- changes in the profile of nominal GDP growth have added or subtracted small amounts to year-on-year changes in the debt-to-GDP ratio across the forecast period, slightly reducing the ratio in 2015-16 relative to 2014-15, but slightly raising it in 2016-17 relative to 2015-16. This reflects the profile of revisions to our real GDP forecast. Stronger nominal GDP growth also reduces the ratio in the final two years of the forecast period;
- Budget policy measures that affect net borrowing – and other underlying changes to our borrowing forecast – have small effects on the profile of net debt. The exception is in 2019-20, where the Government's change to its spending policy assumption has increased spending and borrowing relative to our December forecast, reducing the extent to which debt falls as a share of GDP in that year. Indeed, net debt now continues to rise in cash terms in 2019-20 (by £9½ billion), rather than falling modestly as in our December forecast (by £4 billion);
- by far the most significant changes to the profile of net debt relate to 2015-16, where the Government has announced two significant asset sales of £11 billion of NRAM plc assets held by UKAR and a further £9 billion of its shareholding in Lloyds Banking Group. Together, they are expected to reduce net debt by £20 billion in 2015-16. That means that debt falls as a share of GDP a year earlier than would otherwise have been the case. The bulk of these sales are expected to take place late in the fiscal year. Financial asset sales bring forward cash that would otherwise have been received in

future in the shape of mortgage repayments and dividends (around £10 billion over the remainder of the forecast period as a result of the UKAR and Lloyds sales), so they only temporarily reduce the debt-to-GDP ratio. In broad terms, they leave the public sector's net worth unchanged;

- UKAR also ran down its assets more quickly in 2014-15 than we had factored into our December forecast. Because that simply brought the effect on debt forward by a year, it reduces the change in the debt-to-GDP ratio by 0.2 per cent of GDP in 2014-15 and increases it by the same margin in 2015-16;
- changes in the premia associated with the Debt Management Office issuing gilts at prices above their nominal value lead to small changes in the year-on-year profile of net debt. These premia are particularly associated with index-linked gilts, due to the negative real yield curve that persists throughout the forecast period; and
- other changes are relatively small. The reclassification of subscriptions to multilateral development banks reduces net lending in each year, but has a neutral effect on net debt as it increases net borrowing instead.

Table 5.3: Changes in the profile of net debt since December

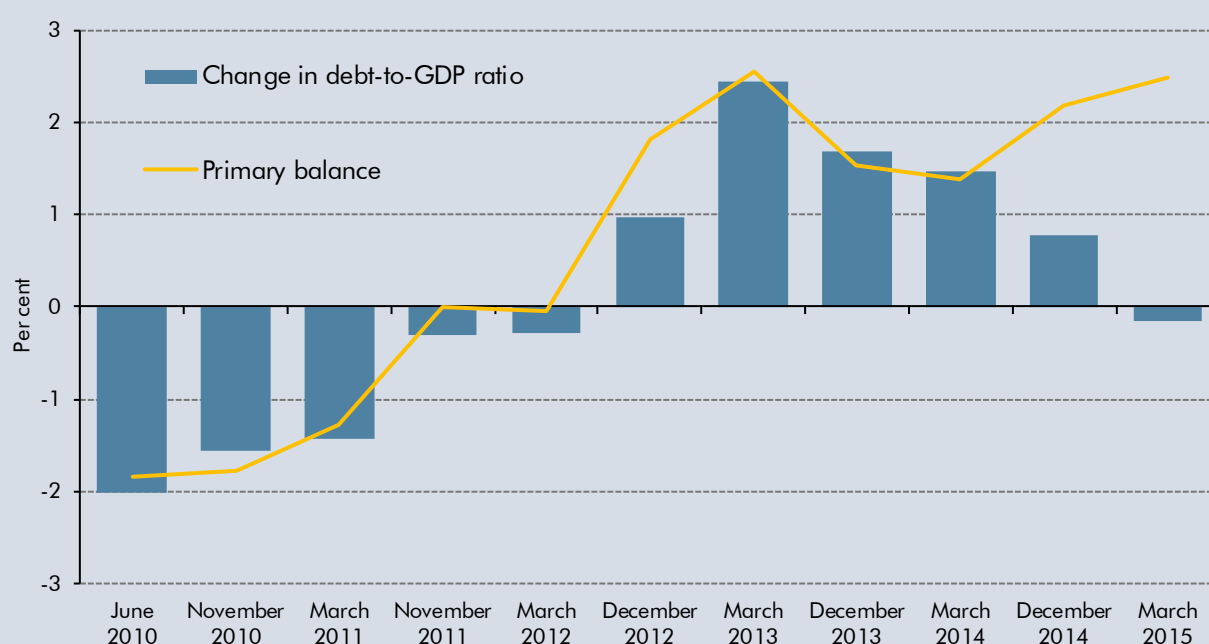
	Change on a year earlier (per cent of GDP)					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
December forecast	1.6	0.8	-0.5	-1.9	-2.6	-3.3
March forecast	1.3	-0.2	-0.5	-2.0	-3.0	-3.2
Change	-0.2	-0.9	0.0	-0.1	-0.4	0.1
<i>of which:</i>						
Nominal GDP ¹	0.3	-0.1	0.2	0.0	-0.4	-0.5
Net borrowing changes	-0.1	0.0	-0.1	-0.1	0.0	0.7
Other UKAR effects	-0.2	-0.3	0.1	0.1	0.1	0.1
Lloyds Banking Group share sales	-0.1	-0.5	0.0	0.0	0.0	0.0
Gilt premia	-0.1	0.1	-0.1	0.0	0.0	-0.1
Other factors	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1

¹GDP is centred end-March

Box 5.1: Changes in our forecast for the debt profile in 2015-16

In the first OBR forecast of this Parliament in June 2010, the debt-to-GDP ratio was forecast to fall by 2.0 per cent in 2015-16, comfortably meeting the supplementary target the Coalition Government set in its first Budget. As Chart A shows, over time that margin was reduced until in our December 2012 forecast we expected debt to rise by 1.0 per cent of GDP in 2015-16. The amount by which debt was expected to increase in 2015-16 peaked at 2.4 per cent of GDP in our March 2013 forecast. Since then, the gap has declined. And we now expect the debt-to-GDP ratio to fall in 2015-16, by the small margin of 0.2 per cent.

Chart A: Successive forecasts for the change in the debt-to-GDP ratio and primary balance in 2015-16



Source: OBR

Chart A also shows that between June 2010 and March 2013 (and continuing up to March 2014), projected changes in the debt-to-GDP ratio in 2015-16 could largely be explained by our forecast of the primary balance. That has not been the case in our two most recent forecasts.

What has happened since March 2013 so that the debt-to-GDP ratio is now expected to fall?

Table A uses the same decomposition of changes in the debt ratio as in Chart 5.2. It shows that:

- our forecast of the primary balance in 2015-16 has changed little since March 2013. The precise revision has been just 0.1 per cent of GDP, although this reflects an improvement up to March 2014 and then a reversal;
- the difference between interest rates and GDP growth in 2015-16 is more favourable in our latest forecast than it was in March 2013. Our nominal GDP growth forecast is 0.5 percentage points lower, but implied interest rates are 1.1 percentage points lower. The net effect is an additional 0.4 per cent of GDP reduction in the debt ratio; and

- the main factors helping to reduce the debt ratio in 2015-16 by more than expected in March 2013 do not reduce borrowing:
 - running down UK Asset Resolution's loan book, including through the sale of mortgage assets, reduces the ratio by another 0.5 per cent of GDP;
 - other subsequently announced asset sales – notably Government shareholdings in Lloyds Banking Group – subtract 0.7 per cent of GDP from debt in 2015-16;
 - gilts are now expected to be sold at a significant premium, which reduces the debt-to-GDP ratio by a further 0.7 per cent of GDP; and
 - the net cash requirement has been lower than would be expected given our borrowing forecast in recent years, and we expect this to continue in 2015-16. This reduces the debt-to-GDP ratio by 0.3 per cent of GDP.

Table A: Sources of changes in the debt-to-GDP ratio in 2015-16

	Per cent of GDP		
	March 2013	March 2015	Change
Total	2.4	-0.2	-2.6
of which:			
Primary balance	2.6	2.5	-0.1
Growth-interest differential	-1.1	-1.5	-0.4
Additional UKAR effects	-0.3	-0.8	-0.5
Other asset sales	0.0	-0.7	-0.7
Gilt premia	0.1	-0.6	-0.7
Net lending	0.8	0.9	0.1
Other debt level changes	0.4	0.0	-0.3

Welfare cap

- 5.14 The welfare cap was initially set in line with our March 2014 forecast for the items of spending that lie within it. We are required to assess the Government's performance against the cap formally at each Autumn Statement, and did so for the first time in our December 2014 *EFO*. In this *EFO*, we provide an update on performance against the cap, but will not make a formal assessment until the next Autumn Statement.
- 5.15 Given the distinction between forecasting assumptions and discretionary policy changes in the assessment of the cap, the classification of movements in the forecast is crucial to our assessment. Some changes are obviously forecasting changes (for example, the implications of our latest economy forecast) while others are clearly policy changes (appearing in the Treasury's table of policy decisions at each Budget or Autumn Statement). But there are grey areas, notably operational changes resulting from Ministerial decisions or responses to legal challenges. These require careful consideration.

5.16 Table 5.4 shows our forecast for spending subject to the welfare cap in each year to 2019-20, as described in Chapter 4. Our latest forecast for such spending is higher than the welfare cap in 2015-16. It is then lower than the cap between 2016-17 and 2019-20. The margin by which our forecast exceeds the cap in 2015-16 is 0.7 per cent. This is the result of forecasting changes (rather than policy changes) and lies within the 2 per cent margin allowed for such changes. The net effect of policy measures in later years is very small.

Table 5.4: Performance against the welfare cap

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare cap	119.7	122.3	124.8	127.0	129.8
2 per cent forecast margin	2.4	2.4	2.5	2.5	2.6
December forecast	120.7	122.4	124.0	126.8	129.8
March forecast	120.6	121.0	121.8	124.0	126.5
Change	-0.1	-1.4	-2.2	-2.8	-3.2
<i>of which:</i>					
Forecasting changes	-0.1	-1.3	-2.2	-2.7	-3.2
Economic determinants	-0.1	-1.2	-2.0	-2.5	-2.7
CPI inflation	0.0	-1.1	-2.0	-2.4	-2.6
Other	-0.1	-0.1	0.0	0.0	-0.1
Estimating and modelling changes	-0.1	-0.2	-0.2	-0.3	-0.4
Fertility assumption	-0.3	-0.4	-0.6	-0.7	-0.8
Tax credits recastings	0.2	0.2	0.2	0.1	0.1
Incapacity benefits	0.2	0.1	0.1	0.1	0.1
DLA and PIP ¹	0.2	0.2	0.1	0.1	0.0
Other	-0.3	-0.2	0.0	0.1	0.1
Other changes	0.0	0.0	0.1	0.0	0.0
Budget policy measures	0.0	0.0	0.0	-0.1	-0.1
Difference between March forecast and welfare cap	0.8	-1.3	-3.0	-2.9	-3.2

¹ Disability living allowance and personal independence payment.

Forecasting changes

5.17 Our forecasting changes since December have led to downward revisions to welfare spending subject to the cap of £0.1 billion in 2015-16 and an average of £2.4 billion a year from 2016-17 to 2019-20. Table 5.4 shows that:

- the single largest downward revision is due to lower CPI inflation (thanks largely to lower oil prices). This feeds through to the uprating of most benefits from 2016-17 onwards and a lower forecast for rents that reduces spending on housing benefit;
- lower projected fertility rates reduce spending on tax credits, child benefit, tax-free childcare and maternity benefits by increasing amounts between 2014-15 and 2019-20. This reflects lower than assumed fertility rates in 2013;
- we have revised down the savings associated with tax credits operational measures. These increase spending by £0.2 billion a year between 2015-16 and 2019-20; and

- estimating changes to incapacity benefits, disability living allowance (DLA) and personal independence payment (PIP) increase spending for these benefits by £0.2 billion a year on average between 2014-15 and 2019-20. For DLA and PIP, this reflects higher than expected outturn so far in 2014-15 feeding through to the forecast. For incapacity benefits, this primarily reflects higher than expected numbers of cases being assigned to the support group.

Policy changes

- 5.18 The Government has announced policy measures in the Budget that are estimated to reduce spending subject to the cap by very small amounts.

Risks to performance against the welfare cap

- 5.19 Developments in the economy – notably inflation and the labour and housing markets – pose important risks to our welfare spending forecast. We highlighted a number of broader risks to the forecast in our *October 2014 Welfare trends report*, including operational risks during a period of significant reforms. In particular, we have noted a history of optimism bias relating to reforms to incapacity benefits, disability benefits and universal credit. In this forecast, we have identified some similar – though smaller – issues in respect of operational tax credits measures. In addition, an ongoing legal case means that there is some uncertainty over the tax-free childcare policy, but at present we do not have firm evidence on which to assume a change in spending in our forecast. We will be applying the lessons from these developments when we come to certifying the Government's estimates of the fiscal impact of any future welfare reforms.

Recognising uncertainty

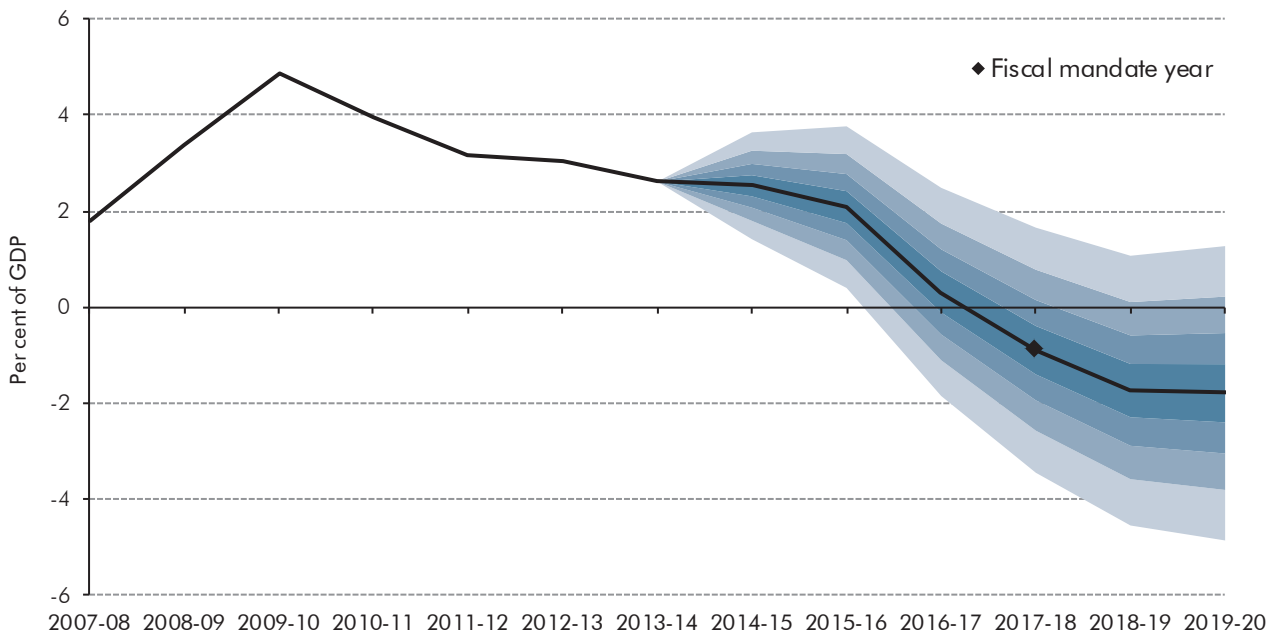
- 5.20 Past experience and common sense suggest that there are significant upside and downside risks to our central forecasts for the public finances. These reflect uncertainty both about the outlook for the economy and about the level of receipts and spending in any given state of the economy. There are significant uncertainties about economic forecasts when historically large changes in the composition of national income and spending – due to the size and composition of the remaining fiscal consolidation – are in prospect.
- 5.21 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet the new fiscal mandate in 2017-18 and the new supplementary target in 2016-17, and also to maintain welfare spending within the cap plus margin.
- 5.22 We do this in three ways:
- by looking at the evidence from past forecast errors;
 - by seeing how our central forecast would change if we altered some of the key judgements and assumptions that underpin it; and
 - by looking at alternative economic scenarios.

Past performance

5.23 One relatively simple way to illustrate the uncertainty around our central forecast is to consider the accuracy of previous official public finance forecasts. This can be done using fan charts like those we presented for GDP growth in Chapter 3 and public sector net borrowing (PSNB) in Chapter 4. These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that forecast errors in the past offered a reasonable guide to likely forecast errors in the future.

5.24 In this spirit, Chart 5.3 shows the probability distribution around our central forecast for the CACB deficit, based on past official forecast errors. The solid black line shows the median forecast, with the successive pairs of lighter shaded areas around it representing 20 per cent probability bands. This implies that, based on current policy, there would be an 80 per cent probability of the outturn lying within the shaded bands.

Chart 5.3: Cyclically adjusted current budget deficit fan chart



Source: OBR

5.25 A direct reading of the chart would imply that the Government currently has a roughly 65 per cent probability of achieving a surplus on the CACB in 2017-18 and thereby meeting the mandate. The probability of achieving a surplus rises from 40 per cent in 2016-17 to 75 per cent by 2019-20.

5.26 Unfortunately, we cannot estimate the probability of achieving the supplementary target as we do not have the joint distribution that would allow us to apply the same technique. But our central forecast shows the debt-to-GDP ratio falling in 2016-17. We also do not have a long enough disaggregated series of past welfare spending forecasts to produce a fan chart for the welfare cap projections.

Sensitivity analysis

- 5.27 It is very difficult to produce a full subjective probability distribution for the Government's target fiscal variables because they are affected by a huge variety of economic and non-economic determinants, many of which are correlated with each other. However, to recognise the uncertainty in our forecast we can go further than using evidence from past forecast errors by quantifying roughly how sensitive our central forecast is to changes in certain key economic parameters.
- 5.28 In thinking about the evolution of the public finances over the medium term, there are several parameters that have a particularly important bearing on the forecast. In this section we focus on two in particular:
- the level of potential output; and
 - the speed at which the output gap closes (i.e. the pace of economic growth).
- 5.29 Our central forecast is based on a judgement that the economy was running 0.7 per cent below potential in the final quarter of 2014, and that the output gap will close slowly over the forecast period, reaching zero by late 2017. But neither the level of potential output nor the pace of recovery are possible to estimate with confidence, not least because the former is not something that can be observed directly in economic data. So what if the medium-term level of potential was higher or lower than our central estimate, and what if the output gap closed earlier or later?
- 5.30 Tables 5.5 and 5.6 present illustrative estimates of the impact on:
- the level of the CACB deficit in 2017-18; and
 - the change in PSND as a share of GDP between 2015-16 and 2016-17.
- 5.31 For practical reasons, we have not undertaken complete forecast runs for each variant, but have instead used ready-reckoners and simplifying assumptions to generate illustrative estimates. We assume that a lower or higher level of potential is reflected in our starting output gap, rather than errors in forecasting trend growth over the forecast period.
- 5.32 The cyclical adjustment ready-reckoner assumes that a 1 per cent change in GDP will result in a 0.7 per cent of GDP change in PSNB and the current budget after two years. The actual change in the public finances would depend on many other factors, including the composition of growth, inflation and the labour market response. While we recognise the limitations of this top-down approach, applying these ready-reckoners yields the results shown in the tables below.
- 5.33 Table 5.5 shows that the level of potential output has a big effect on the size of the CACB deficit in 2017-18. The lower potential output is – and therefore the smaller the negative output gap or larger the positive output gap – the larger the proportion of the deficit that is

structural and the less margin the Government has against its fiscal mandate. Conversely, if potential output is higher, less of the deficit is structural and the Government has a greater margin against its mandate.

- 5.34 Closing the output gap at a different pace would typically result in a change in cyclical borrowing, but would have little effect on the structural balance. For example, closing the output gap more slowly would result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.
- 5.35 In broad terms, the level of potential output would need to be around 1¼ per cent lower in 2017-18 than in our central forecast to make it more likely than not that the mandate would be missed.

Table 5.5: Cyclically adjusted current budget deficit in 2017-18

		Per cent of GDP		
		Output gap closes		
		2015-16	2017-18	2019-20
Level of potential output	-2	0.6	0.6	0.6
in 2019-20 relative to	-1	-0.1	-0.1	-0.1
central forecast	0	-0.8	-0.8	-0.8
(per cent)	1	-1.6	-1.5	-1.5
	2	-2.3	-2.3	-2.3

- 5.36 Table 5.6 shows that the Government would continue to meet its supplementary target unless the output gap was materially smaller than in our central forecast, which would imply more structural borrowing.

Table 5.6: Change in public sector net debt between 2015-16 and 2016-17

		Per cent of GDP		
		Output gap closes		
		2015-16	2017-18	2019-20
Level of potential output	-2	1.1	0.8	0.4
in 2019-20 relative to	-1	0.3	0.2	0.1
central forecast	0	-0.5	-0.5	-0.4
(per cent)	1	-1.3	-1.1	-0.8
	2	-2.1	-1.7	-1.2

- 5.37 In previous *EFOs*, we have also quantified the risks to the fiscal mandate and supplementary target of shocks to the interest rates that the Government has to pay on its debt and possible errors in our cyclical adjustment coefficients. We have not quantified those sensitivities again, but would note that:

- since the UK has a relatively long average debt maturity, new issuance forms a relatively small proportion of the stock each year. Moreover, new issuance is projected to fall as borrowing declines. Therefore over our five-year forecast period, the impact of a shock to the average nominal interest rate on gilts is relatively small. Box 4.4 in

Chapter 4 discusses our debt interest forecast in greater detail and provides a ready-reckoner of the effect on borrowing of different gilt rate assumptions; and

- cyclical adjustment attempts to look through the effect of the economic cycle on the public finances. This is achieved by adjusting a given fiscal aggregate, such as the current budget, for the size of the output gap in the current and previous years, using coefficients to estimate a cyclically adjusted aggregate, such as the CACB. These coefficients are highly uncertain, as the output gap is not directly observable, so there is no historical 'fact' from which to estimate the coefficients. In addition, the fiscal position is affected by events that do not necessarily move in line with the cycle, such as one-off fiscal policy adjustments and movements in commodity and asset prices. And insofar as the current economic cycle differs from the average cycle, the relationship between the public finances and the output gap over the course of that cycle will not be captured in the coefficients. However, our current forecast of a very small negative output gap in 2016-17 and 2017-18, implies that using different coefficients would have very little impact on the estimated CACB in 2017-18.

5.38 Annex B presents some illustrative ready-reckoners of the effect on welfare spending of different changes in some of the main economic determinants. In particular, inflation surprises represent a key risk to the welfare cap, as inflation errors would broadly translate into one-for-one errors in many benefits and tax credits through their effect on uprating. Since the welfare cap was introduced, we have revised our inflation forecast down significantly, due largely to lower oil prices, with the expected effect of reducing spending subject to the cap. This has more than offset upward revisions to some other parts of the forecast. As we aim to produce central forecasts, there should be an equal possibility that future inflation surprises will be to the upside or the downside of our current forecast.

Scenario analysis

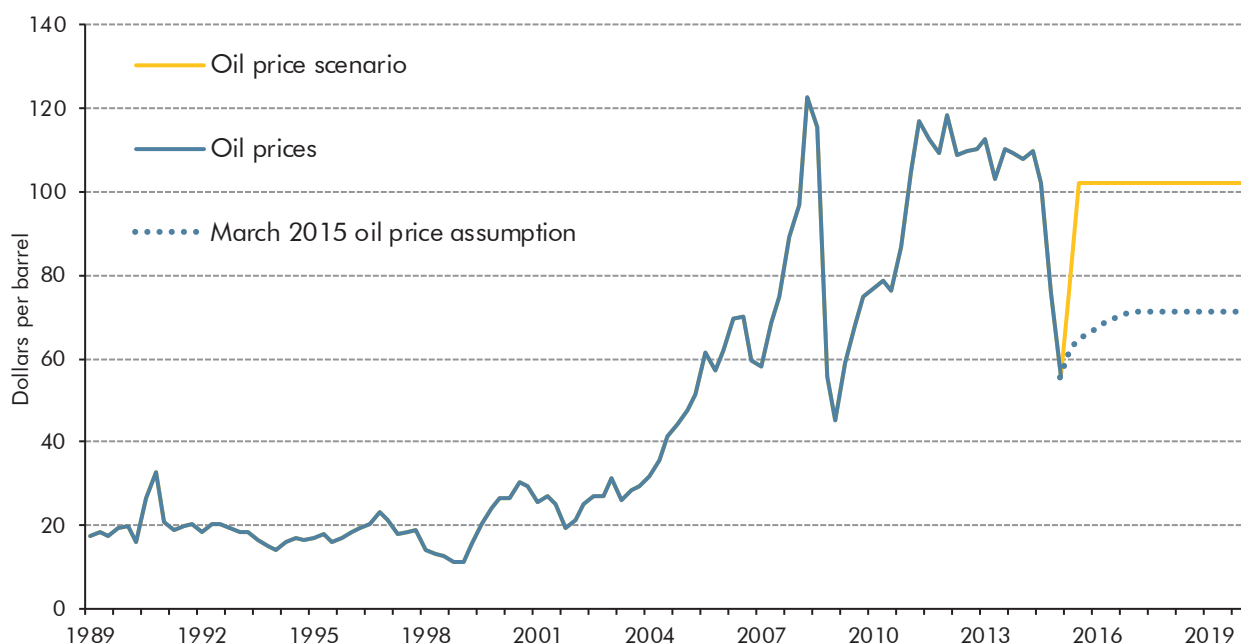
5.39 The sensitivity analysis discussed above focuses on individual factors and therefore only offers a partial assessment of potential uncertainty. In this section, we set out the fiscal implications of two illustrative alternative economic scenarios, designed to test how dependent our conclusions are on key judgements that are subject to debate in the forecasting community. We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from the central forecast and we do not attempt to attach particular probabilities to them occurring.

5.40 One of the most important developments affecting the public finances since our December forecast has been the further fall in oil prices. Over recent years – and indeed past decades – large and unanticipated movements in oil prices have been a relatively frequent occurrence (Chart 5.4). As discussed in previous chapters, the implications of oil price movements for the public finances depend crucially on the underlying drivers of those changes. We therefore consider two scenarios which assess the potential impact of movements in the oil price similar to those that have been witnessed in the past. Under both scenarios the oil price snaps back to around \$100 a barrel (the two-year ahead futures

curve fluctuated around this level between late-2011 and mid-2014), but for different reasons. Specifically, we consider:

- a supply-driven shock, in which a drop in the global supply of oil leads to oil prices rising to around \$100 a barrel within two quarters; and
- a demand-driven shock, where oil prices rise in exactly the same way, but due to stronger global GDP growth that feeds through to greater demand for oil.

Chart 5.4: Oil price scenario in the context of historical oil price volatility



Source: Thomson Datastream, OBR

Supply-driven increase in oil prices

5.41 In this scenario, we consider the implications of an exogenous shock to oil supply where the key assumptions and implications are that:

- higher oil prices feed through to fuel prices, leading to an immediate fall in real household consumption. Other effects on demand broadly cancel out. The shock increases firms' production costs, which gradually reduces non-oil business investment, and the combination of lower consumption and investment reduces import growth. Higher oil prices also encourage additional North Sea investment and production;
- the reduction in non-oil investment feeds through to slower capital accumulation and hence marginally lower labour productivity growth. Overall, the output gap widens initially as a result of lower consumption and narrows at a similar pace as in our central forecasts, implying it closes around a year later;
- most of the higher consumer price inflation reflects an import price shock, and so the implications for whole economy inflation are much smaller. CPI inflation is however

slightly lower in mid-2016 than in our central forecast, as the oil price remains flat rather than following the upward-sloping path underpinning our central forecast. The wider negative output gap also depresses inflation slightly;

- higher oil prices have a number of direct effects on receipts, which are on balance positive. Lower fuel duty is offset by higher oil and gas receipts and VAT receipts – the latter rising as spending on fuel (which is subject to the standard rate of VAT) displaces spending on other items that are either zero-rated or subject to a reduced rate of VAT. The effect on oil and gas receipts is smaller than when we have considered the sensitivity of receipts to oil prices in the past (such as in our March 2012 *EFO*). And the direct positive effect is more than outweighed by the indirect effect through its negative implications for GDP. The effects of inflation measures on receipts are broadly offsetting;
- spending is also higher in each year. The inflation shock immediately increases debt interest on index-linked gilts, and both higher unemployment and inflation increase welfare spending. The unemployment effects are small and soon unwind, but the inflation effects are more persistent. As benefits and tax credits are uprated with a lag, this only increases spending from 2016-17 onwards. But spending from that point and beyond is determined by the Government's spending assumption. This essentially pushes through the higher spending in 2015-16 into future years. But the debt interest shock is largely a one-off, and so additional departmental spending is assumed to fill the gap; and
- the combination of marginally lower receipts and higher spending result in higher borrowing and debt in each year, and debt is flat as a share of GDP in 2015-16. The underlying structural position is a little weaker in 2017-18 and beyond, due both to lower potential output and the persistence of higher spending. And the higher uprating of tax credits and benefits leads to permanently higher welfare spending. These all serve to reduce the Government's margins against its three fiscal targets, but it would remain on course to meet all three.

Demand-driven increase in oil prices

5.42 In this scenario, we assess the implications of a demand driven shock, where oil prices rise due to stronger global GDP growth that feeds through to greater demand for oil. The key assumptions and implication of this scenario are that:

- higher oil prices affect the outlook through the same channels as under our supply-driven scenario. The immediate increase in inflation reduces real household consumption and, over time, the level of non-oil business investment and so capital accumulation. But it encourages additional North Sea production;
- stronger global growth however boosts exports, which means the initial impact on GDP growth is smaller than in the supply-driven scenario. The increase in export demand is also assumed to be persistent, which encourages business investment. So

although the output gap is initially wider than in our central forecast, it closes sooner. This has a small additional upward effect on inflation;

- the direct effects of higher oil prices on receipts (a net positive) are also invariant to whether the shock is supply or demand driven. But the negative effects on the wider economy are soon offset by stronger export demand. Although real GDP ends the period in a similar position, the higher domestic price level also boosts cash receipts;
- higher inflation increases debt interest payments in 2015-16 and welfare costs a year later. Again, the debt interest effects knock through into higher cash spending in later years due to the Government's spending assumption, in effect showing up as higher departmental spending. But total spending is marginally lower as a share of GDP over the medium term; and
- the overall fiscal picture is slightly better than in our central forecast. The Government would have a little more headroom against its fiscal mandate and supplementary aim, although the margin against the welfare cap would be somewhat smaller.

5.43 Table 5.7 summarises the economic assumptions we have made, as well as the fiscal consequences of these alternative scenarios. It shows that either scenario would have only modest effects over the medium term, with the supply-driven scenario slightly worse than our central outlook and the demand-driven scenario marginally better. But in either case the Government would continue to meet its three fiscal targets.

Table 5.7: Key economic and fiscal aggregates under alternative scenarios

	Per cent (unless otherwise stated)				
	2015-16	2016-17	2017-18	2018-19	2019-20
Central forecast					
Economic assumptions					
GDP growth	2.4	2.3	2.4	2.3	2.4
CPI inflation (Q3)	0.2	1.2	1.7	1.9	2.0
Output gap	-0.4	-0.2	0.0	0.0	0.0
Fiscal outcome (per cent of GDP)					
Welfare cap margin (per cent)	0.7	-1.1	-2.4	-2.3	-2.5
Public sector net borrowing	4.0	2.0	0.6	-0.2	-0.3
Cyclically adjusted current budget	2.1	0.4	-0.8	-1.7	-1.7
Public sector net debt	80.2	79.8	77.8	74.8	71.6
Supply-driven oil shock scenario					
Economic assumptions					
GDP growth	2.2	2.1	2.5	2.4	2.4
CPI inflation (Q3)	0.8	1.3	1.6	1.8	1.9
Output gap	-0.6	-0.6	-0.3	-0.1	0.0
Fiscal outcome (per cent of GDP)					
Welfare cap margin (per cent)	0.7	-0.5	-1.8	-1.8	-2.1
Public sector net borrowing	4.1	2.3	0.9	0.0	0.0
Cyclically adjusted current budget	2.1	0.4	-0.7	-1.5	-1.5
Public sector net debt	80.4	80.4	78.8	76.2	73.4
Demand-driven oil shock scenario					
Economic assumptions					
GDP growth	2.4	2.4	2.3	2.3	2.3
CPI inflation (Q3)	0.8	1.4	1.8	1.9	2.0
Output gap	-0.4	-0.1	0.0	0.0	0.0
Fiscal outcome (per cent of GDP)					
Welfare cap margin (per cent)	0.7	-0.5	-1.7	-1.6	-1.8
Public sector net borrowing	4.1	2.0	0.5	-0.4	-0.5
Cyclically adjusted current budget	2.1	0.3	-0.9	-1.8	-1.9
Public sector net debt	80.2	79.6	77.3	74.0	70.6

A Budget 2015 policy measures

Overview

- A.1 Our *Economic and fiscal outlook (EFO)* forecasts incorporate the expected impact of the policy decisions announced in each Budget and Autumn Statement on the public finances. In the run-up to each statement, the Government provides us with draft estimates of the cost or gain from each measure it is considering. We discuss these with the relevant experts and then suggest amendments if necessary. This is an iterative process where individual measures can go through several stages of scrutiny. After this process is complete, the Government chooses which measures to implement and which costings to include in its table of policy decisions. We choose whether to certify the costings as ‘reasonable and central’, and whether to include them – or alternative costings – in our forecast.
- A.2 In this Budget, we have certified all the costings of tax and annually managed expenditure (AME) measures that appear in the Government’s policy decisions table as reasonable and central. Table A.1 reproduces HM Treasury’s table of policy decisions, with further details set out in Chapter 4 and in the Treasury’s *Budget 2015 policy costings document*, which summarises the methodologies used to produce each costing and provides some information on the main areas of uncertainty within each.
- A.3 The policy costings scrutiny process was particularly difficult for this Budget as we were not given details of costings for a large proportion of significant policy measures until just before our deadlines.

Uncertainty

- A.4 At past Budgets and Autumn Statements, we have used our annex in the Treasury’s policy costings document to highlight costings that were particularly uncertain. In our December 2014 *EFO*, we introduced a more systematic and transparent assessment of the uncertainty around each costing, building on an approach developed by the Australian Parliamentary Budget Office. It is important to stress that all the costings remain central estimates and that any uncertainty lies on both sides: the measures could raise or cost more or less than expected.
- A.5 Under our new approach, we assign each certified costing a subjective uncertainty rating, which is shown alongside the relevant costing in Table A.1. These ratings range from ‘low’ to ‘very high’. In order to determine the ratings, we have assessed the uncertainty arising from each of three sources: the data underpinning the costing; the complexity of the modelling required; and the possible behavioural response to the policy change. We take

into account the relative importance of each source of uncertainty for each costing. The full breakdown that underpins each rating is available on our website.

Table A.1: HM Treasury table of Budget policy decisions and OBR assessment of the uncertainty of costings

	Head	£ million					Uncertainty	
		2015-16	2016-17	2017-18	2018-19	2019-20		
Personal tax								
1	Personal Allowance: increase to £10,800 in 2016-17 and to £11,000 in 2017-18 with full gains to higher rate taxpayers	Tax	0	-960	-1,480	-1,585	-1,680	Medium
Savings and pensions								
2	Savings tax: allowance and ISA flexibility	Tax	-15	-1,030	-565	-640	-765	Medium-high
3	Help to Buy: ISA	Spend	-45	-230	-415	-640	-835	Very high
4	Annuities: secondary market	Tax	0	+535	+540	-130	-120	Very high
5	NS&I bonds for people aged 65 and over: extension	Spend	-80	-	-	-	-	Medium-high
6	Pensions guidance: extending availability	Spend	-20	-	-	-	-	N/A
7	Pensions: lifetime allowance to £1m from 2016-17, and index with inflation from 2018-19	Tax	+60	+300	+420	+550	+590	Medium-high
Duties								
8	Fuel Duty: cancel September 2015 RPI increase	Tax	-140	-240	-245	-250	-250	Medium-low
9	Alcohol Duty: 1p off a pint of beer and 2% off cider duty	Tax	-85	-80	-85	-85	-85	Medium-low
10	Alcohol Duty: reduce spirits duty by 2%, and freeze wine duty	Tax	-100	-95	-100	-100	-105	Medium-low
Investment and growth								
11	Oil and gas: investment allowance and 10% cut to Supplementary Charge	Tax	-230	-270	-190	-200	-75	Very high
12	Oil and gas: 15% cut to Petroleum Revenue Tax	Tax	0	-125	-115	-85	-10	Very high
13	Oil and gas: support for seismic surveys	Spend	-20	-	-	-	-	N/A
14	Energy intensive industries: bring forward compensation for Feed-in Tariffs	Spend	-25	-	-	-	-	N/A
15	Exports and investment: UKTI China and trade missions	Spend	-15	-	-	-	-	N/A
16	Regional growth	Spend	-15	-	-	-	-	N/A
17	Creative industries: extend support	Spend	-5	-	-	-	-	Medium-high
18	Support for technological innovation	Spend	-20	-	-	-	-	N/A
19	Telecommunications	Spend	-15	-	-	-	-	N/A
20	Venture capital schemes: qualifying criteria	Tax	0	-5	-5	-15	-10	Medium
21	Enterprise Zones	Tax	*	*	-5	-5	-5	Low
22	Financial transactions adjustment ¹	Spend	+490	-	-	-	-	N/A

Fairness, evasion and avoidance								
23	Bank Levy: increase to 0.21%	Tax	+685	+925	+925	+920	+920	Medium
24	Corporation Tax: bank compensation payments	Tax	+150	+260	+225	+180	+150	High
25	Evasion: Common Reporting Standard	Tax	-5	+90	+270	+75	+130	Very high
26	Employment intermediaries: travel and subsistence (umbrella companies)	Tax	0	+155	+175	+160	+145	Medium-high
27	VAT: foreign branches	Tax	+25	+95	+90	+85	+90	Medium-high
28	Corporation Tax: contrived loss arrangements	Tax	+95	+170	+170	+150	+130	High
29	Capital Gains Tax: contrived ownership arrangements	Tax	*	+45	+45	+45	+45	High
30	Tobacco: enforcement	Tax	0	+5	+10	+10	+10	Medium-high
31	Accelerated Payments: extension	Tax	0	+290	+175	+70	+20	Medium-high
32	Total fiscal impact of welfare cap measures ²	Spend	-50	-	-	-	-	Medium
Health, education and security								
33	Mental health	Spend	-305	-315	-325	-310	-310	N/A
34	Health innovation	Spend	-10	-	-	-	-	N/A
35	Counter-terrorism and security	Spend	-25	-	-	-	-	N/A
36	Free school meals: small schools	Spend	-20	-	-	-	-	N/A
Transport and environment								
37	Company car taxation: 3 ppt increase in 2019-20	Tax	0	0	0	0	+340	Medium-high
38	Heavy Goods Vehicles: freeze VED and the Road User Levy	Tax	*	*	*	-5	-5	Low
39	Aggregates Levy: freeze in 2015-16	Tax	-5	-5	-5	-5	-5	Low
40	Capital allowances: energy and water efficient technologies	Tax	0	+5	+15	+10	+10	Medium-low
41	Income Tax: extending farmers' profits averaging period to 5 years	Tax	0	-10	-30	-30	-30	Medium
Previously announced								
42	Stamp Duty Land Tax: property funds	Tax	-10	-15	-10	-5	-5	Medium-high
43	Guarantees income	Spend	+500	-	-	-	-	Low
TOTAL POLICY DECISIONS			+745	+45	+230	-885	-570	
Total spending policy decisions			+295	0	0	0	0	
Total tax policy decisions			+450	+45	+230	-885	-570	

* Negligible

Note: Costings reflect the OBR's latest economic and fiscal determinants.

Note: Only spending numbers which directly affect borrowing in 2016-17, 2017-18, 2018-19 and 2019-20 are shown. All other spending measures do not affect borrowing as they fall within the Total Managed Expenditure assumption in those years.

¹ This is a neutral reclassification from PSGI to Financial Transactions. See Table 2.2 for offsetting adjustment.

² Total fiscal impact of welfare policy decisions, including DWP DEL funding. See Budget 2015: policy costings for further detail on policy decisions, and Budget 2015, Chapter 1 for an update on spending within the welfare cap.

A.6 Table A.2 shows the detailed criteria and applies them to a sample policy measure from this Budget: 'Fuel duty: cancel September 2015 RPI increase'. This is estimated to cost around £250 million a year on average over the forecast period. For this policy we have judged that the most important source of uncertainty will be modelling, followed by data, with the

least important being behaviour. The data used to estimate this measure are high quality HMRC administrative data on fuel clearances, so we consider this to be a 'low' source of uncertainty. The likely behavioural response is well documented in external academic papers and in HMRC research: lower post-tax fuel prices would be expected to increase consumption. But this has only a relatively small impact on the costing, so we deem this a 'medium-low' source of uncertainty. The modelling is based on reliable HMRC forecasting models. So we regard this as a 'low' source of uncertainty. Taking all these judgements into account, we have assigned the costing an overall uncertainty rating of 'medium-low'.

Table A.2: Example of assigning uncertainty rating criteria: 'Fuel duty: cancel September 2015 RPI increase'

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

A.7 In this Budget, we have judged eight measures in the policy decisions table to have ‘high’ or ‘very high’ uncertainty around the central costing. These represent 25 per cent of the measures in the Budget by number and 27 per cent by absolute value (in other words ignoring whether they are expected to raise or cost money for the Exchequer). In net terms, they are expected to raise the Exchequer £7.2 billion in total over the forecast period. The reasons we consider the fiscal effects of these measures to be particularly uncertain include:

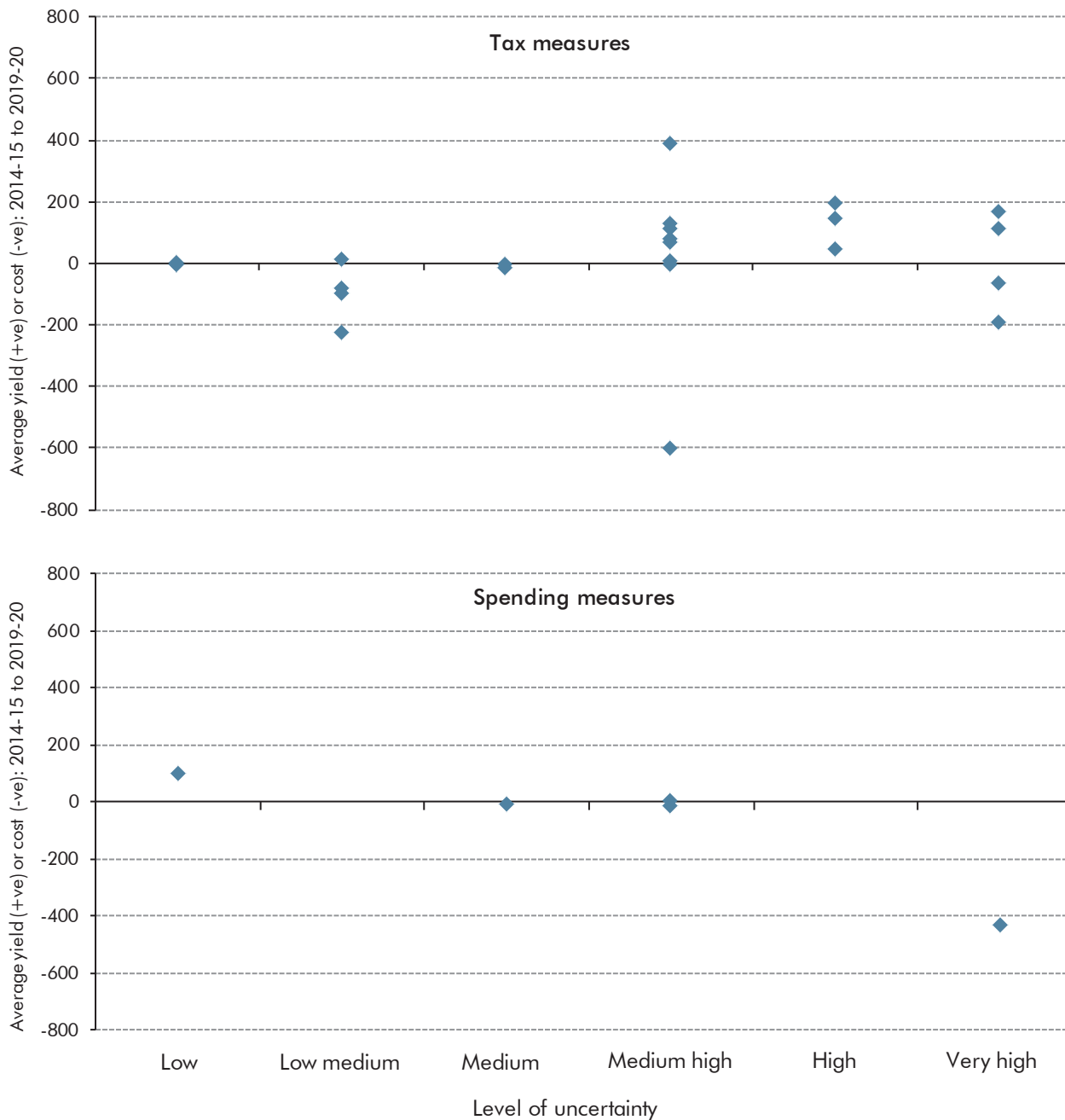
- **annuities: secondary market:** This costing receives a ‘very high’ uncertainty rating. The measure will allow current annuity holders to sell their annuity for a lump sum, which will attract an upfront tax charge. The yield over the forecast period – and the resulting costs in the longer term – depends on two forms of take-up: annuity holders wishing to sell their income stream and prospective buyers wishing to purchase that flow of income for an upfront cash sum. These assumptions come together via a highly uncertain assumption about the discount buyers are likely to apply given the likely informational asymmetries in the transaction and the lack of such a market at present. Any estimates on how potential buyers will view the risk associated with this product and set their preferred discounts are particularly uncertain. This measure is also unusual in the sense that it is not impossible that potential buyers will view this as a risk that cannot be priced, in which case no secondary market would develop and the effect of the policy would be nil. There is also uncertainty about how sales of annuities will affect benefit payments, especially in respect of the effect of DWP’s ‘deprivation of capital’ rules and the Government’s consultation, which asks if annuities should be sold by those receiving means-tested benefits;
- **oil and gas: investment allowance and 10 per cent cut to supplementary charge and 15 per cent cut to petroleum revenue tax:** This comprises two measures that we have considered together as they collectively alter the post-tax returns from oil and gas extraction. The measures receive a ‘very high’ uncertainty rating. They are expected to encourage investment and production in the North Sea, offsetting some of the effect of the fall in oil prices over the past year. The post-behavioural cost is based on uncertain assumptions about the investment and production response of oil and gas companies – a key source of uncertainty in our offshore corporation tax receipts and PRT forecasts more generally. We estimate that these measures will increase production by around 15 per cent compared to the pre-measures baseline. If the production response is stronger or weaker than expected – or the oil price moves substantially again – then the cost of these measures and their wider impact on the economy could significantly differ. There are also data uncertainties, since the precise cost of the measures will depend on the specific effects at individual field and company level. The modelling is also complex and important for the costing;
- **evasion: common reporting standard:** This costing receives a ‘very high’ uncertainty rating. The common reporting standard is designed to facilitate information sharing on non-residents’ financial interests in a given jurisdiction with other signatory jurisdictions where they are resident. The measure aims to capture the effect of the UK’s adoption of this standard and the HMRC operational response. There is considerable uncertainty around both the data and behavioural response in this costing. There is little

information available to HMRC on the level of assets held abroad that will be captured by the new standard. There is also considerable uncertainty about how individuals will respond to HMRC compliance interventions, be they targeted or more general. As ever, predicting the behaviour of individuals who are already actively changing behaviour in response to the tax system is particularly challenging;

- **Help to Buy: ISA:** This costing receives a ‘very high’ uncertainty rating. The Help to Buy: ISA will involve the Government offering financial support to first-time buyers who contribute to a special account. There is considerable uncertainty around the behavioural impact – in particular the take-up within the target population;
- **corporation tax: bank compensation payments:** This costing receives a ‘high’ uncertainty rating. The measure prevents banks from obtaining tax deductions for costs in respect of compensation to customers in relation to the provision of financial services – for example, the large payouts in recent years related to payment protection insurance mis-selling. The costing relies on projecting a particularly uncertain tax base: the future misconduct provisions and compensation payments made by banks. The overall yield is very sensitive to the assumed path of such payments over the forecast period. It is also sensitive to an element of our corporation tax forecast that is itself highly uncertain: the point at which major banks have exhausted stocks of accumulated losses and return to taxpaying status;
- **corporation tax: contrived loss arrangements:** This costing receives a ‘high’ uncertainty rating. This measure will prevent the use of contrived arrangements to access ‘trapped’ losses and create versatile in-year relief. The main uncertainty in this costing is with the tax base. It was constructed based on HMRC operational intelligence on the level of non-trading losses, but no data were available to estimate the level of trading losses using these arrangements, so uncertain assumptions had to be made; and
- **capital gains tax: contrived ownership arrangements:** This costing receives a ‘high’ uncertainty rating. These measures aim to limit use of entrepreneur’s relief to reduce CGT liabilities. HMRC does not hold detailed administrative data on the use of the specific arrangements that are to be limited. Again, this required the tax base to be generated using uncertain assumptions on the level of use of such schemes. The behavioural response of affected taxpayers to these measures is also very uncertain.

A.8 We have judged 20 measures to have ‘low-medium’ or ‘high-medium’ uncertainty around the central costing, with a further four costings having ‘low’ uncertainty. That means that 63 per cent of the Budget measures have been placed in the medium range (71 per cent by absolute value) and 13 per cent have been rated as low uncertainty (just 2 per cent by absolute value). Chart A.1 plots these uncertainty ratings relative to the amount each policy measure is expected to raise or cost.

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



Longer-term uncertainties

- A.9** For most policy costings, the five-year period covered by the Treasury's policy decisions table is sufficient to give a representative view of the long-term cost or yield of a policy change. Typically, that effect is either zero – because the policy has only a short-term impact that has passed by the end of the forecast period – or it would be reasonable to expect it to rise broadly in line with nominal growth of the economy.
- A.10** There are some measures in this Budget that might be expected to have different costs in the longer term than over the five-year period of our medium-term forecast:

- sales of annuities in a secondary market would raise income tax receipts in the short term, but at the expense of future receipts. The profile would be similar to that expected for the Budget 2014 pensions flexibility measure (see Chart 4.1 of our March 2014 *EFO*);
- the tax foregone on savings income through introducing a tax-free allowance on savings income would be greater if – as we assume in our long-term projections – interest rates eventually normalise at higher rates than is implied by market expectations over the next five years; and
- the cost of the oil and gas tax measures would be greater in the long term if a higher proportion of North Sea companies were tax-paying, as might be expected. (Currently, a large proportion of companies have either past trading losses or tax deductible expenditure sufficient to offset the tax liability from current profits).

Small measures

A.11 The BRC has agreed a set of conditions that, if met, allow OBR staff to put an individual policy measure through a streamlined scrutiny process. These conditions are:

- the expected cost or yield does not exceed £40 million in any year (this has been increased from £25 million following review of the process);
- there is a good degree of certainty over the tax base;
- it is analytically straightforward;
- there is a limited, well-defined behavioural response; and
- it is not a contentious measure.

A.12 A good example of a small measure announced at Budget 2015 is the ‘capital allowances: energy and water efficient technologies’, updates the list of technologies and products covered by the first-year allowance scheme for energy-saving and environmentally beneficial technologies. This costing was based on DECC and DEFRA estimates on the change to qualifying sales due to the policy. The modelling involves simple assumptions about the proportion of the enhanced capital allowances that will be claimed. No behavioural adjustment was made.

A.13 By definition, any costings that meet all of these conditions will have a maximum uncertainty rating of ‘medium’.

Indirect effects on the economy

A.14 The Government has announced a number of measures taking effect between 2015-16 and 2019-20 that are expected to have a broadly neutral fiscal impact overall, with ‘giveaways’

offsetting 'takeaways' over this period. Further details of the judgements we have taken about indirect effects of policy changes on the economy are provided in Box 3.2.

- A.15 The Government has announced a package of policies affecting the North Sea oil and gas sector, including the introduction of a new investment allowance, a 10 per cent reduction in the supplementary charge on profits and a 15 per cent reduction in petroleum revenue tax. All else equal, these measures would be expected to reduce the cost of capital associated with investment in the sector and therefore have a positive effect on capital expenditure and production, partially offsetting the negative effect of lower oil prices on the profitability of oil and gas extraction. We have assumed that these measures increase the level of oil production by 2019 by around 15 per cent, equivalent to around 0.1 per cent of GDP. This partly offsets the effect of the significant decline in the oil price since December, which in the absence of these policy changes we assume would have reduced the level of North Sea production by around 30 per cent. In Chapter 4 we provide greater detail on these pre- and post-measures assumptions that underpin our North Sea revenues forecast.
- A.16 The Government has announced a number of measures that will directly affect inflation. This includes a 2 per cent reduction in duty on most beer, cider and spirits and freezing duty on wine, relative to previously assumed increases in line with RPI in April, and the cancellation of the planned increase in fuel duty in September 2015 (in line with RPI inflation). These changes are expected to reduce CPI inflation by less than 0.1 percentage points in 2015 and 2016.
- A.17 We have not adjusted our economy forecast in light of the support for first-time buyers, savings tax reform and annuities flexibility announced in the Budget or our updated assessment of the effect of the changes announced in Budget 2014. The effect on the economy of the pensions and annuities flexibility measures is considered to be subject to particularly significant uncertainty.

Departmental spending

- A.18 We do not scrutinise the costings of policies that reallocate spending within departmental expenditure limits (DELs), since the total cost or yield is wholly determined by a Government policy decision. Neither do we scrutinise the DEL implications of measures that affect current receipts or AME spending, where those are also wholly determined by Government policy decisions. Instead we include the overall DEL envelopes for current and capital spending in our forecast, plus judgements on the extent to which we expect those be over- or underspent in aggregate. In this forecast, we judge – in line with historical experience and our recent forecasts – that they will be modestly underspent in 2014-15 and 2015-16.
- A.19 There are measures announced at this Budget that rely on extra HMRC operational capacity in order to be implemented as intended. These include 'accelerated payments: extension' and 'evasion: common reporting standard'. We sought and received assurances from the Treasury that such activities will be funded. We will be monitoring this commitment ahead of future fiscal events.

A.20 The Treasury's policy decisions table also contains a 'financial transactions adjustment', which reclassifies £0.5 billion of DEL from 'fiscal' spending (which affects borrowing and debt) to 'non-fiscal' financial transactions spending (which only affects debt). This measure therefore reduces borrowing by £0.5 billion, but has no effect on debt. Excluding its effect on borrowing would not have changed any of the conclusions we have reached in this forecast.

Total managed expenditure beyond the Spending Review

A.21 Beyond the years for which the Government has set detailed spending plans, our forecasts are based on the Government's chosen assumption for the growth in total managed expenditure (TME). While the effect of changes in this assumption do not typically appear in the Treasury's table of policy decisions, they can lead to substantial changes in the implied envelopes for current and capital spending in our forecast. In this forecast, that has particularly been true in 2019-20, where spending is significantly higher than would have been the case if this policy assumption had not been changed. Further details of the effect of these changes are described in Chapter 4 of the *EFO*.

B Fiscal ready reckoners

Tax and spending ready reckoners

B.1 In this annex, we set out a range of individual tax and spending ‘ready reckoners’ that show how the public finances could be affected by changes in selected economic determinants of our fiscal forecasts.

B.2 Ready reckoners are stylised quantifications that reflect the typical impact of changes in economic variables on receipts and spending. The estimates are specific to this forecast and we would expect them to become outdated over time, as the economy and public finances, and the policy setting, continue to evolve. For example, the big drop in North Sea oil production in recent years – and the associated drop in North Sea revenues – has altered the way changes in oil prices affect the UK public finances. The ready reckoners presented here do not cover every determinant that feeds into the fiscal forecasting models.

B.3 Ready reckoners are subject to uncertainty because they are based on models that draw on historical relationships or simulations of policy settings. Another source of uncertainty relates to revenue streams that are concentrated on a relatively small number of taxpayers. Such concentration could lead to volatility that may not be captured by a ready reckoner. For example:

- **stamp duty land tax (SDLT):** in 2013-14, just 4,000 residential property transactions of over £2 million contributed 17 per cent of SDLT receipts. As a result of the reforms announced by the Government in Autumn Statement 2014, this share could rise to close to 30 per cent. This means that just a few hundred more or fewer transactions at the top end of the property market could have a significant impact on receipts; and
- **income tax:** in 2012-13 (the last year of published data) around 56 per cent of income tax revenues came from the top 10 per cent of taxpayers, up from around 50 per cent in the early 2000s. This share has been rising over time due to changes in the distribution of income and, in recent years, income tax allowances and thresholds.

B.4 Table B.1 sets out the effect of a 1 per cent increase in selected determinants on each tax or spending stream. It shows:

- **GDP growth effects on borrowing:** we use cyclical adjustment coefficients¹ that estimate the sensitivity of borrowing to the size of the output gap. This suggests that if growth was 1 per cent stronger than expected, borrowing would be 0.5 per cent of GDP lower in the first year and 0.7 per cent of GDP lower after two years;

¹ See Helgadottir et al (2012): *Working Paper No.3: Cyclically adjusting the public finances* for further details.

- **inflation effects on receipts:** the impact of changes in inflation on cash receipts depends on the extent to which inflation feeds through into higher nominal tax bases, in particular wages. Assuming that average earnings growth is unchanged, higher inflation would reduce income tax and NICs receipts (higher thresholds – which are uprated in line with inflation – mean that less income is taxed at higher rates), increase excise receipts (as duty rates are indexed to a higher level) and increase business rates receipts (which are also uprated in line with inflation), as well as interest on student loans (where the interest charged is based on inflation);
- **inflation effects on spending:** the direct effect on spending would be to raise benefits, tax credits and public service pensions (uprated by CPI inflation) with a one-year lag. Higher RPI inflation would also lead to a larger increase in debt interest payments relating to index-linked gilts;
- **GDP deflator effect on the Government's spending policy assumptions:** the Government's chosen policy assumption for the growth of total managed expenditure (TME) between 2016-17 and 2019-20 is specified in real terms between 2016-17 and 2018-19, then to grow in line with nominal GDP in 2019-20. Therefore, any increase in GDP deflator growth over that period would raise TME in cash terms;
- **interest rate effects on receipts:** an increase in deposit rates would increase income tax on savings income, which will now be mainly received through self-assessment the following year. There is a smaller net effect on corporation tax, as businesses would pay additional tax on their interest income, but also deduct greater amounts from their tax payments as interest costs are tax deductible. Central government and local authorities would also receive additional income on their reserves and holdings of financial assets;
- **interest rate effects on spending:** higher interest rates increase central government debt interest costs. The effect on spending is complicated slightly at present by the fact that a considerable amount of gilts are held in the Bank of England's Asset Purchase Facility (a consequence of past quantitative easing), which affects the measure of debt interest that we forecast. Box 4.4 describes our forecast and sensitivities in more detail;
- **nominal consumption effect on receipts:** around 70 per cent of VAT receipts are derived from household consumption, and these move largely one-for-one with changes in nominal consumer spending. Changes in the composition of consumption are also important, as different types of spending attract different VAT rates;
- **other types of expenditure effects on receipts:** changes in other types of spending generally have smaller impacts on receipts. Higher nominal business investment would directly reduce corporation tax payments as capital allowances rise. Real GDP is also used as a proxy for total demand in forecasting models for fuel duties and air passenger duty, where receipts are affected by both business and household spending;

- **labour income effects on receipts:** Income tax and NICs comprise 42 per cent of total receipts, so changes in labour income have a relatively large impact on total receipts. Staggered income tax and NICs thresholds mean that receipts rise (and fall) proportionately more than changes in labour income. Increases in self-employment income also feed through into receipts, but with a longer time lag given the self-assessment system which requires taxpayers to file returns by the January after the financial year;
- **company profits effects on receipts:** Holding deductions constant, corporation tax liabilities are geared to changes in income. For some companies, stronger-than-expected profits would bring forward the point at which they would again be liable to pay corporation tax, rather than immediately raising their payments. This is particularly the case for some financial companies, so our central forecast is currently less sensitive to changes in financial company profits than it would have been in the past;
- **average earnings effect on receipts:** Income tax receipts are more geared towards earnings than employment, given staggered income tax thresholds. This distinction is smaller for national insurance contributions, as a lower employee NICs rate is applied to earnings above the upper earnings limit. In comparison, there is a one-for-one relationship with employment and tax on employment income;
- **average earnings effect on spending:** The 'triple lock' on uprating guarantees that the basic state pension rises by the highest of 2.5 per cent, CPI inflation or average earnings growth. Assuming that average earnings growth was the highest, a 1 per cent increase in earnings growth would increase pension spending by around £0.8 billion. Pension credit is also uprated in line with average earnings. Partially offsetting these, an increase in earnings would also reduce spending on income-related benefits and tax credits, as the entitlement to these tapers away as incomes rise;
- **unemployment effect on spending:** An increase in the claimant count leads to a one-for-one increase in spending on jobseekers' allowance and directly-related benefits. On average, higher unemployment also marginally increases tax credits expenditure, even though entitlement to working tax credits is withdrawn;
- **property prices effect on receipts:** Property prices have a direct and geared effect on stamp duty land tax (SDLT) receipts, since the tax rate is based on the value of the property, with relatively more expensive property transactions subject to higher rates. Property prices also affect the value of assets subject to inheritance tax and capital gains tax, but this has a much smaller effect on total receipts;
- **property transactions effect on receipts:** Turnover in the housing stock is a key determinant for SDLT receipts, where the relationship is assumed to be proportionate, and it also affects disposals subject to capital gains tax;
- **equity price effects on receipts:** stamp duty on shares, capital gains tax and inheritance tax are all directly affected by changes in equity prices. In particular,

capital gains tax is very sensitive to equity price changes, as the tax is only due on the profit on sale of the asset, and not its overall value. The return on financial investments is also a key determinant of the life assurance sector's corporation tax liabilities; and

- **oil prices on receipts:** the profits of UK oil and gas companies – and therefore their tax liabilities – are directly affected by changes in the oil price. Receipts will also be affected by the level of production and expenditure, which will themselves be influenced by the oil price, although the simple ready reckoner presented below assumes these are maintained at existing levels. Higher oil prices also reduce the demand for fuel and therefore fuel duty, which is charged on the number of litres consumed. Demand for fuel is relatively inelastic. Price movements will also change VAT receipts, if spending on fuel (subject to the standard rate of VAT) displaces spending on other items that are either zero-rated or subject to a reduced rate of VAT.

Table B.1: Ready reckoners

Determinant	Direct impact on tax/spend stream of 1 per cent increase, unless otherwise stated ^{1,2}	Affected receipts or spending categories
GDP	0.5% of GDP in the first year, rising to 0.7% of GDP after two years	Public sector net borrowing
Inflation		
GDP deflator	-0.4% of GDP	Total spending
RPI (positive revenue effects)	£½ billion in first year, rising to £1 billion	Indirect taxes, business rates, student loan interest
CPI (negative revenue effects) ³	-£1¼ billion, with a one year lag	IT and NICs
RPI/CPI⁴ (Total revenue effect)	In year: £½ billion, -£¼ billion thereafter	
CPI (positive spending effects)	£1¾ billion with a one year lag	Benefits, tax credits, public sector pensions
RPI (positive spending effects)	£3½ billion, rising to £6 billion	Debt interest
RPI/CPI⁴ (Total spending effect)	In year: £3½ billion, rising to £7 billion	
Interest rates (1 ppt)		
Gilt rates	£½ billion in first year, rising to £4 billion	Debt interest
Short rates	£4½ billion	Debt interest
Savings rates	£1¼ billion with a one year lag	Self-assessment
Interest on govt. assets	£1½ billion	Interest receipts
Nominal GDP expenditure		
Consumption	£¾ billion	VAT
Consumption SRS (1 ppt) ⁵	£1½ billion	VAT
Other VAT tax bases	£0.4 billion	VAT
Business investment	-£50 million	Corporation tax
Real GDP	£100 to £200 million	Fuel duty, APD
GDP income		
Wages & salaries	£3 billion rising to £3¾ billion	PAYE income tax & NICs
Self employment income	£¼ billion, with a one year lag	Self-assessment
PNFC trading profits	£0.2 billion in first year, rising to £0.4 billion	Indust. & comm. CT
Financial profits	£50 million	Financial sector CT
Labour market		
Average earnings	£3¾ billion rising to £4½ billion	PAYE & NICs
	£¾ billion	Benefits and tax credits
Employment	£2½ billion rising to £3 billion	PAYE & NICs
Unemployment (0.1m)	£0.5 billion	Benefits
Assets		
House prices	£180 to £360 million	Capital taxes
Property transactions	£100 to £170 million	Capital taxes
Equity prices	£100 to £200 million	Capital taxes
Oil prices (£10 a barrel)	£¾ billion	Oil and gas revenues
	-£¼ billion	Fuel duty

¹These are ballpark figures that are specific to the March 2015 EFO forecast. The actual effects will differ over time, as policy and our forecast continue to evolve

²A positive figure represents an increase in the tax or spending stream.

³Assuming that average earnings growth is unchanged

⁴Impact of a 1% increase in the price level.

⁵Standard rated share; share of nominal household consumer spending subject to the standard rate of VAT.

B.5 Table B.2 presents illustrative ready reckoners of the effect on welfare spending of different changes in some of the main economic determinants. It shows that:

- a 1 per cent change in the **CPI inflation** level in September 2015, affecting uprating in 2016-17, would raise spending in 2016-17 by around £1.3 billion. This comes primarily through higher uprating on the state second pension and disability-related benefits, and higher rents for housing benefit;
- a 5 per cent increase in the **claimant count** would raise spending on jobseeker's allowance and associated housing benefit – which are both outside the welfare cap – by around £0.3 billion;
- a 1 per cent rise in housing benefit **eligible rents** – affecting both the social and private rented sectors – would increase spending on housing benefit by around £0.3 billion; and
- a 1 per cent rise in the number of **children** would add around £0.1 billion to child benefit spending. A 1 per cent rise in the number of **pensioners** would – assuming they had the same entitlements as current pensioners – add £1.2 billion to spending, mostly from higher spending on state pensions that are outside the welfare cap.

Table B.2: Welfare ready reckoners

	Impact on spending in 2015-16 unless otherwise stated (£ billion)
Change in 2015-16 (unless otherwise stated)	
Inflation¹	
1 per cent change in CPI level affecting 2016-17 (uprating of CPI for most benefits)	£1.3 billion
Labour market	
5 per cent increase in claimant count ²	£0.2 billion
Housing market	
1 per cent increase in housing benefit eligible rents affecting 2016-17 ³	£0.3 billion
Demographics	
1 per cent increase in child benefit caseload	£0.1 billion
1 per cent increase rise in pensioner caseloads ⁴	£1.2 billion

¹ Impact of an increase in the preceding September that affects uprating in the following fiscal year.

² Impact on jobseeker's allowance and passported housing benefit.

³ Impact on housing benefit only.

⁴ Impact on all benefits for which pensioner caseloads are available.

Index of charts and tables

Chapter 1 Executive Summary

Table 1.1: Overview of the economy forecast	10
Chart 1.1: Real GDP growth fan chart.....	12
Table 1.2: Fiscal forecast overview	13
Table 1.3: Changes to public sector net borrowing since December.....	14
Chart 1.2: Total public sector spending and receipts	16
Chart 1.3: Year-on-year growth in real resource DEL spending	16
Chart 1.4: PSNB fan chart	17
Table 1.4: Changes to public sector net debt since December	19

Chapter 2 Developments since the last forecast

Table 2.1: Cumulative contribution to GDP growth from 2013Q1 to 2014Q3.....	23
Table 2.2: Contributions to GDP deflator growth from 2013Q1 to 2014Q3.....	24
Table 2.3: Contributions to nominal GDP growth from 2013Q1 to 2014Q3	24
Chart 2.1: Contributions to real GDP growth from 2013Q1 to 2014Q3	25
Table 2.4: Contributions to real GDP growth in 2014Q4	26
Table 2.5: Contributions to nominal GDP growth in 2014Q4	26
Table 2.6: Conditioning assumptions in 2015Q1	27
Chart 2.A: Oil prices relative to copper and shipping prices	28
Chart 2.B: Supply and demand for oil	28
Chart 2.2: CPI inflation	30
Chart 2.3: Forecasts for real GDP growth in 2015	32
Chart 2.4: Forecasts for the output gap in 2015	33
Chart 2.5: Forecasts for CPI inflation in the fourth quarter of 2015.....	33
Chart 2.6: Forecasts for the claimant count in the fourth quarter of 2015.....	34

Chapter 3 Economic outlook

Chart 3.1: Range of output gap model estimates	36
Chart 3.2: Cyclical indicator-based estimates of the output gap.....	37
Chart 3.3: Principal component subsets.....	37

Chart 3.4: Estimates of the output gap in 2014	38
Chart 3.5: Estimates of the output gap in 2015	38
Table 3.1: Potential output growth forecast	40
Chart 3.6: Potential output forecasts.....	41
Chart 3.7: Bank rate expectations	46
Chart 3.8: Global bond rates	46
Chart 3.9: Mortgage rate forecast.....	47
Chart 3.10: Change in mortgage rate forecast since December.....	47
Chart 3.11: Oil price assumption.....	49
Chart 3.12: Sterling effective exchange rate assumption.....	50
Chart 3.13: Equity prices assumption	50
Chart 3.14: Contributions to monthly output growth in 2014.....	52
Table 3.2: The quarterly GDP profile.....	52
Chart 3.15: Contributions to average quarterly GDP growth.....	53
Chart 3.16: The output gap.....	54
Chart 3.17: Projections of actual and potential output.....	54
Table 3.3: Expenditure contributions to growth	55
Chart 3.18: Real GDP growth fan chart.....	56
Chart 3.19: Cumulative growth in real GDP per capita	57
Chart 3.20: CPI inflation	59
Chart 3.21: RPI inflation	60
Chart 3.A: Contributions to the RPI-CPI wedge.....	61
Table 3.A: Long-run assumption for the RPI-CPI wedge.....	62
Chart 3.22: GDP deflator	63
Chart 3.23: Contributions to cumulative nominal GDP growth: expenditure	65
Chart 3.24: Contributions to cumulative nominal GDP growth: income.....	65
Chart 3.25: Real consumption wage and real consumption.....	66
Chart 3.26: Contributions to real household income growth.....	68
Chart 3.27: The household saving ratio	69
Chart 3.28: House price inflation forecast	70
Chart 3.29: Quarterly residential property turnover rate.....	71
Chart 3.30: Residential investment as a share of nominal GDP.....	71
Chart 3.31: Household gross debt to income.....	73
Chart 3.32: Business investment as a share of GDP	74

Chart 3.33: Government consumption	75
Chart 3.34: Government consumption of goods and services	76
Chart 3.35: UK export market share	78
Chart 3.36: Contributions to import-weighted domestic demand and import growth.....	79
Chart 3.37: Net trade contribution to GDP	80
Chart 3.38: Current account balance as a share of GDP.....	81
Chart 3.B: Change in net investment income since 2011	82
Chart 3.C: Rates of return on foreign direct investment	82
Chart 3.39: Sectoral net lending	83
Table 3.4: Comparison with external forecasts.....	85
Chart 3.40: Comparison of forecasts for the level of GDP	86
Table 3.5: Bank of England’s illustrative projections	86
Table 3.6: Detailed summary of forecast	87
Table 3.7: Detailed summary of changes to the forecast.....	88

Chapter 4 Fiscal outlook

Table 4.1: Determinants of the fiscal forecast	92
Table 4.2: Changes in determinants of the fiscal forecast since December	93
Chart 4.1: The effect on the population age structure of moving to the ONS principal population projections.....	96
Table 4.3: Summary of the effect of Government decisions.....	98
Table 4.A: Fiscal impact of financial interventions	101
Table 4.4: Major receipts as a per cent of GDP.....	101
Chart 4.2: Changes in the tax-to-GDP ratio.....	102
Chart 4.3: Sources of changes in the tax-to-GDP ratio (2013-14 to 2014-15)	104
Chart 4.4: Sources of changes in the tax-to-GDP ratio (2014-15 to 2019-20)	105
Table 4.5: Current receipts	106
Table 4.6: Change to current receipts since December	107
Table 4.7: Sources of changes to the receipts forecast since December	109
Table 4.8: Key changes to the income tax and NICs forecast since December	111
Table 4.9: Key changes to the VAT forecast since December	112
Table 4.10: Key changes to the onshore corporation tax forecast since December	113
Chart 4.5: Oil and gas receipts: outturns and forecasts	114
Table 4.11: Oil and gas production and expenditure forecasts	116
Table 4.12: Key changes to the oil and gas revenues forecast since December	116

Table 4.13: Key changes to the SDLT forecast since December	117
Table 4.B: Indexation parameters.....	120
Table 4.14: Key changes to the interest and dividends forecast since December	123
Chart 4.6: DEL and AME components of TME.....	124
Table 4.15: Expenditure as a per cent of GDP	125
Table 4.16: TME split between DEL and AME.....	126
Table 4.17: Changes to TME from 2015-16 since December	128
Table 4.18: Spending: real growth rates and as a per cent of GDP.....	129
Chart 4.7: Year-on-year real growth in resource DEL.....	130
Table 4.19: Sources of changes to the spending forecast since December.....	131
Table 4.20: Total managed expenditure.....	132
Table 4.21: Changes to total managed expenditure since December	133
Table 4.22: Key changes to DEL since December.....	135
Table 4.23: DEL shortfalls against PESA plans for 2014-15	137
Table 4.24: DEL shortfalls against PESA plans for 2015-16	137
Table 4.C: DEL and AME switches for war pensions and Welsh business rates	138
Chart 4.8: Resource DEL and implied resource DEL relative to GDP.....	139
Table 4.25: Welfare spending forecast overview	140
Table 4.26: Welfare spending.....	142
Table 4.27: Key changes to welfare since December.....	144
Table 4.28: Sources of changes in welfare spending since December	145
Table 4.29: Key changes to public service pensions since December.....	147
Table 4.30: Key changes to EU contributions since December.....	149
Table 4.31: Key changes to locally financed expenditure and public corporations capital expenditure since December.....	151
Table 4.32: Key changes to central government debt interest since December	153
Table 4.D: Total outstanding stocks, debt interest payments and effective interest rates over the forecast period.....	155
Table 4.E: Debt interest ready reckoners.....	156
Chart 4.A: Chart A: Outstanding stocks of conventional and index-linked gilts	157
Table 4.33: Reconciliation of PSNB and PSNCR	160
Table 4.34: Changes in the reconciliation of PSNB and PSNCR	161
Table 4.35: Reconciliation of PSNCR and CGNCR.....	166
Table 4.36: Changes in the reconciliation of PSNCR and CGNCR	167
Table 4.37: Public sector net borrowing.....	169

Chart 4.9: Total public sector spending and receipts	170
Chart 4.10: Sources of deficit reduction.....	171
Chart 4.11: PSNB fan chart	172
Table 4.38: Changes to public sector net debt since December	174
Table 4.39: Fiscal aggregates	175
Table 4.40: Comparison with the European commission forecast.....	176
Table 4.41: Comparison with IMF forecast	177
Chart 4.B: Sources of deficit reduction: an international comparison.....	179
Chapter 5 Performance against the Government’s fiscal targets	
Table 5.1: Performance against the Government’s fiscal targets	182
Chart 5.1: Year-on-year changes to the cyclically adjusted current budget from 2014-15 to 2017-18	184
Table 5.2: Changes to the cyclically adjusted current budget deficit since December	185
Chart 5.2: Year-on-year changes to the debt-to-GDP ratio.....	187
Table 5.3: Changes in the profile of net debt since December	188
Chart 5.A: Successive forecasts for the change in the debt-to-GDP ratio and primary balance in 2015-16.....	189
Table 5.A: Sources of changes in the debt-to-GDP ratio in 2015-16	190
Table 5.4: Performance against the welfare cap	191
Chart 5.3: Cyclically adjusted current budget deficit fan chart.....	193
Table 5.5: Cyclically adjusted current budget deficit in 2017-18	195
Table 5.6: Change in public sector net debt between 2015-16 and 2016-17	195
Chart 5.4: Oil price scenario in the context of historical oil price volatility.....	197
Table 5.7: Key economic and fiscal aggregates under alternative scenarios.....	200
Annex A Budget 2015 policy measures	
Table A.1: HM Treasury table of Budget policy decisions and OBR assessment of the uncertainty of costings	202
Table A.2: Example of assigning uncertainty rating criteria: ‘Fuel duty – cancel September 2015 RPI increase’.....	204
Chart A.1: OBR assessment of the uncertainty of costings.....	207
Annex B Fiscal ready reckoners	
Table B.1: Ready reckoners.....	215
Table B.2: Welfare ready reckoners.....	216

ISBN 978-1-4741-1607-7



9 781474 116077