Economic and fiscal outlook

December 2014

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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 make an updated assessment of whether the Government is on course to meet the medium-term fiscal objectives that it has set itself. For the first time, that includes an assessment of spending subject to the Government's new 'welfare cap'. 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, the National Audit Office, local government representatives 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 Chartered Institute of Public Finance and Accountancy and Local Government Association to inform our local authority spending forecasts, as well as 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 September, the Treasury requested that we finalise the Autumn Statement forecast on a 'pre-measures' basis (i.e. before incorporating the effect of new policy announcements) around two weeks ahead of the Autumn Statement 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 March 2014 and with our preliminary judgements on the outlook for the economy. Given the extensive ONS revisions to the National Accounts and public sector finances data over the summer, that was a larger-than-usual task.

- 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 then 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 14 October and our first fiscal forecast, including a provisional judgement on progress towards meeting the fiscal mandate, on 31 October. We provided the Chancellor with these early forecasts and our provisional judgements on compliance with the fiscal mandate and the welfare cap in order to inform his policy choices for the Autumn Statement.

- 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 13 November.

- Meanwhile, we also began to scrutinise the costing of tax and spending measures that were being considered for announcement at the Autumn Statement. The OBR requested a number of changes to the draft costings prepared by HMRC, DWP and other departments. We have certified the final published costings for new Autumn Statement policies as reasonable and central estimates. We have introduced a 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 Autumn Statement 2014 policy costings document.

- 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 20 November, and we met with him and Treasury officials to discuss it on 24 November.

- During the week before publication we produced our final forecast, incorporating the third quarter GDP data released by the ONS on 26 November and 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 on 25 November. These were incorporated into our final economy forecast. On 28 November, we were provided

with details of changes to spending plans in 2015-16 – and the Treasury's assumption for total spending growth from 2016-17 onwards – that would have had an effect on our economy forecast had they been provided in time. This has meant that in this *EFO* unfortunately our economy and fiscal forecasts are not fully consistent.

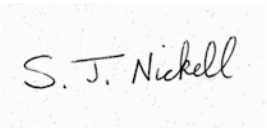
- We provided the Treasury with our final post-measures forecast on 28 November. Our final fiscal forecast included the direct fiscal effects of the full set of Autumn Statement policy decisions, the final version of which was provided to us on 28 November.

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

During the forecasting period, the BRC has 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 headline terms, the UK economy has outperformed our March forecast, with GDP expected to grow by 3.0 per cent this year and unemployment already down to 6.0 per cent. But wage and productivity growth have once again disappointed, while national income and spending have outperformed most in those areas that yield least tax revenue.

1.2 For these and other reasons, this year has seen a sharp fall in the amount of tax raised for every pound of measured economic activity. As a result, despite strong economic growth, the budget deficit is expected to fall by only £6.3 billion this year to £91.3 billion, around half the decline we expected in March. That would be the second smallest year-on-year reduction since its peak in 2009-10, despite this being the strongest year for GDP growth.

1.3 GDP has increased more strongly this year than we expected in March, which has led us to increase our forecasts for growth in calendar years 2014 and 2015. But we still expect the quarterly pace of growth to slow into next year – and somewhat more so than in March – as consumer spending moves more into line with income growth. We have also revised down our forecasts for global GDP and trade growth – particularly in the euro area, the UK's largest export market. With unemployment falling more rapidly than we expected, we judge that there is less spare capacity in the economy than we forecast in March and therefore less scope for above-trend growth in the future as this spare capacity is used up. As a result, we have modestly revised down our forecasts for GDP growth in the later years of the forecast to between 2 and 2½ per cent a year, in line with the average of outside forecasts.

1.4 We have also revised our inflation forecast down significantly, due to lower-than-expected outturns in recent data and the effects of lower oil and food prices. We now expect CPI inflation to remain below the Bank of England's 2 per cent target until 2017. Meaningful real wage growth is expected to resume in 2015, although the measure of real earnings in our forecast does not return to its pre-crisis level within the next five years. But that outcome is reliant on the most important uncertainty in our (and most people's) economy forecast: the timing and strength of the long-awaited return to sustained productivity growth.

1.5 Public sector net borrowing is expected to fall by 0.6 per cent of GDP this year, reaching 5.0 per cent – half the peak it reached in 2009-10. Looking further ahead, we expect the deficit to fall each year and – as in March – to reach a small surplus by 2018-19. Comparisons with our March forecast are complicated by methodological changes to the National Accounts that were implemented by the Office for National Statistics – and by other statistical agencies across Europe – over the summer. But on our best estimate of a like-for-like basis, borrowing is expected to be higher in the initial years of the forecast and slightly

lower from 2016-17 than we thought in March. This reflects relatively large and broadly offsetting changes in the expected path of receipts and spending. In particular:

- receipts have been revised down by £7.8 billion in 2014-15, rising to £25.3 billion by 2018-19. Lower wage growth has reduced our income tax forecast and a variety of factors have reduced expected receipts from VAT and excise duties. Relative to GDP, tax receipts are expected to recover to their 2013-14 level towards the end of the forecast. This relies on an improvement in productivity boosting earnings growth and income tax receipts, although the Budget 2013 decision to abolish contracting out from National Insurance contributions will also raise the tax-to-GDP ratio significantly in 2016-17; and

- public spending has been revised down by £2.0 billion in 2014-15 and by £7.7 billion in 2015-16, the final years for which the Government has set detailed spending plans. By 2018-19, the downward revision reaches £23.5 billion. This largely reflects lower debt interest payments, due to the fall in market interest rates since March. But the Government has also tightened the implied squeeze on departmental spending on public services from 2016-17 to the end of the forecast and of the next Parliament.

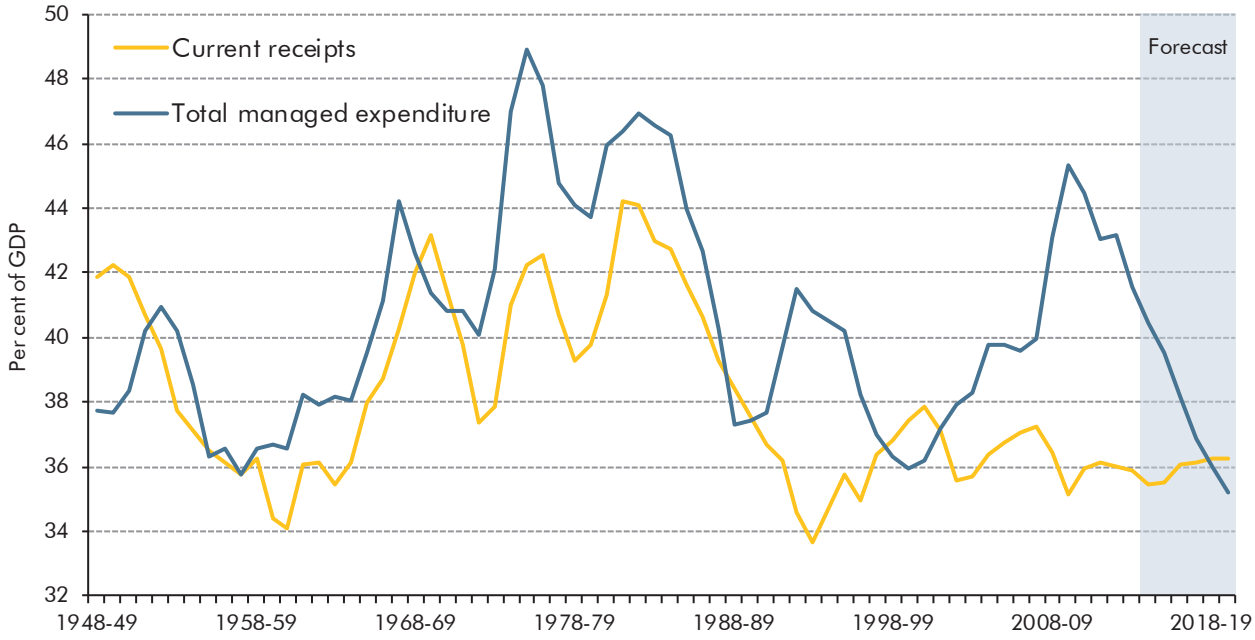
1.6 Autumn Statement 2014 policy measures reduce borrowing by £0.2 billion a year on average between 2014-15 and 2019-20. The giveaways – including the reform of stamp duty land tax and raising the income tax personal allowance – broadly offset the takeaways – particularly from banks (including Financial Conduct Authority fines this year, related to foreign exchange trading) and multinational companies. Additional funding for the NHS from the 2015-16 reserve has also been reflected in our forecast. 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. This implies another cut in current spending by central government departments in that year equivalent to £14.5 billion (compared to holding spending flat as a share of potential GDP).

1.7 On the Government's latest plans and medium-term assumptions, we are now in the fifth year of what is projected to be a 10-year fiscal consolidation. Relative to GDP, the budget deficit has been halved to date, thanks primarily to lower departmental spending (both current and capital) and lower welfare spending. The tax-to-GDP ratio his risen little since 2009-10. Looking forward, the Government's policy assumption for total spending implies that the burden of the remaining consolidation would fall overwhelmingly on the day-to-day running costs of the public services – and more so after this Autumn Statement. Between 2009-10 and 2019-20, spending on public services, administration and grants by central government is projected to fall from 21.2 per cent to 12.6 per cent of GDP and from £5,650 to £3,880 per head in 2014-15 prices. Around 40 per cent of these cuts would have been delivered during this Parliament, with around 60 per cent to come during the next. The implied squeeze on local authority spending is similarly severe.

1.8 As Chart 1.1 illustrates, total public spending is now projected to fall to 35.2 per cent of GDP in 2019-20, taking it below the previous post-war lows reached in 1957-58 and

1999-00 to what would probably be its lowest level in 80 years. Receipts are projected to end the forecast broadly in line with their average share of GDP over the past 20 years.

Chart 1.1: Total public sector spending and receipts



Source: ONS, OBR

1.9 On our central forecast, the Coalition Government is on track to meet its fiscal mandate – to borrow only what it needs to pay for investment, adjusting for the state of the economy, at the end of the five-year forecast – with £50.6 billion to spare. This implies an 80 per cent probability of success given the accuracy of past forecasts. It remains on course to miss its supplementary target, to have net debt falling as a share of GDP in 2015-16. Net debt is forecast to rise by 0.8 per cent of GDP in that year, where it peaks at 81.1 per cent.

1.10 In our first formal assessment, we judge that the Government is on course to keep spending on social security and tax credits (excluding the state pension and those benefits that vary most with the state of the economy) within the permitted margins of the 'welfare cap' it set in the Budget. Ongoing reforms to incapacity and disability benefits are unlikely to save as much money over the next few years as we thought in March, but from 2016-17 the impact is broadly offset by lower expected inflation (which reduces the amount by which most benefits would be uprated) and by another delay to the rollout of universal credit.

1.11 Parliament requires that our forecasts reflect the current policies of the current Government, but those policies could change. The two member parties of the Coalition have already said that they would follow different policies if either was to govern alone after the election. The Conservatives have said they would look to cut welfare spending by more, so that they could cut public services by less. And the Liberal Democrats have said that they would be willing to borrow more to finance capital spending that would increase growth, and also to increase taxes on the relatively well-off. Labour has said that it would "*balance the books and deliver*

a surplus on the current budget and falling national debt in the next Parliament. How fast we can go will depend on the state of the economy and the public finances we inherit."

1.12 In this *Economic and fiscal outlook*, our economy and fiscal forecasts are unfortunately not fully consistent. The inconsistency arises because, after the economy forecast had been closed, the Government allocated £1.2 billion of spending from the reserve to the NHS in 2015-16 and changed its total spending assumption in a way that added around £2 billion a year to spending from 2016-17. These changes were relative to the amounts on which our final economy forecast was based and that had been provided in accordance with the forecast timetable agreed between the Treasury and OBR in September.

1.13 Relative to the size of the economy, the assumed additional spending is modest but not negligible. For example, £2 billion would be equal to 0.6 per cent of government consumption and 0.1 per cent of GDP in 2016-17. Had we been informed of the additional projected spending ahead of our final economy forecast, the main impact would have been on the expenditure composition of GDP. That change in composition would have had small, but again not negligible, implications for our fiscal forecast. But we do not believe it would have been sufficient to change any of the conclusions that we draw about the Government's performance against its fiscal targets or the welfare cap.

Economic developments since our previous forecast

1.14 The UK's National Accounts data have been revised substantially since our March forecast. In addition to the usual annual revisions process, the ONS has implemented the 2010 European System of Accounts (ESA10). The main consequence has been to increase the measured size of the economy. Relative to the data available at the time of our March forecast, nominal GDP in 2013 has been revised up by 6 per cent (around £90 billion).

1.15 The profile and composition of the late 2000s recession and subsequent recovery have also been revised substantially. The recovery now looks stronger, with real GDP regaining its pre-recession peak in the third quarter of 2013, three quarters earlier than in the previous vintage of data. Cumulative growth in real GDP between the 2009 trough and the final quarter of 2013 is now 7.5 per cent, up from 6.3 per cent at the time of our March forecast. And investment now contributes much more to GDP growth since the trough. The level of business investment in the final quarter of 2013 is now around 3 per cent above its pre-crisis peak. The data available in March suggested that it was almost 20 per cent below it.

1.16 GDP growth in 2014 has outperformed our March forecast, growing by 2.4 per cent in the first three quarters of the year against our forecast of 1.9 per cent. Employment growth has also been stronger than expected and the unemployment rate has fallen to 6.0 per cent – 0.8 percentage points lower than we expected. But wage growth failed to pick up as we had forecast, with private sector earnings growth in the year to the third quarter of just 1.0 per cent. Inflation has also been lower than expected, with lower food and oil prices and a stronger exchange rate contributing to the fall in CPI inflation to 1.3 per cent by October 2014. At $79 a barrel in the 10 working days to 21 November, the oil price is around 25 per cent lower than assumed in our March forecast for the final quarter of 2014.

The economic outlook

1.17 With GDP increasing more strongly than we expected in the first three quarters of the year, we now expect growth of 3.0 per cent over the year as a whole, up from 2.7 per cent in March. We still expect the economy to lose momentum through 2015 – and by a little more than we thought in March – thanks to weaker external demand and the expectation that consumer spending growth will slow to rates more in line with growth in people's incomes. But with GDP starting the year higher than we expected, our forecast for GDP growth in 2015 as a whole is 0.1 percentage points higher than in March at 2.4 per cent.

1.18 The unemployment rate has fallen sharply this year. With slack in the labour market being absorbed more quickly, we estimate that the economy was running 0.8 per cent below its sustainable potential in the third quarter, compared to the 1.3 per cent that we expected in March. As in recent forecasts, we judge that the pick-up in growth since early 2013 reflects a cyclical recovery in demand – supported by growing confidence and improving credit conditions – but that it has not been accompanied by an improvement in underlying supply potential. That judgement is supported by weak labour productivity, tighter labour market conditions and a fall in the saving ratio, but challenged by the ongoing weakness in wage growth, with the fall in unemployment not yet pushing pay settlements up significantly.

1.19 Despite stronger growth in 2014 – and a narrower output gap at the start of the forecast – we expect that margin of spare capacity to close very slowly over the forecast period. Indeed, it does not close fully until mid-2019. That reflects a number of judgements:

- we expect both actual and trend productivity growth to pick up relatively slowly to more normal rates. So the 'productivity gap' between them closes very slowly. This is the most important and uncertain judgement in our economy forecast;
- we expect subdued growth in world GDP and world trade – especially in the euro area. Net trade is expected to subtract from GDP growth in every year of the forecast; and
- the Government's fiscal plans imply three successive years of cash reductions in government consumption of goods and services from 2016 onwards, the first since 1948. The corresponding real cuts directly reduce GDP. The economy should be able to adjust to such changes over time, but it is unlikely to be a simple process when monetary policy is already very loose and external demand subdued.

1.20 We have revised our inflation forecast down in the near term, with CPI inflation expected to reach a low of 0.9 per cent in the first quarter of 2015 and not to return to the 2 per cent inflation target until late 2017. That is similar to the Bank of England's latest forecast, published in the November 2014 *Inflation Report*. The RPI inflation forecast has been revised down more than the CPI forecast because lower market interest rates imply that mortgage interest payments will rise more slowly. These feature in the RPI, but not the CPI.

1.21 Lower consumer price inflation and weaker price growth in the government sector – due to the measured effects of additional cash spending cuts – mean that we have revised our nominal GDP growth forecast down by more than real GDP growth.

1.22 We have revised our employment forecast higher due to stronger-than-expected growth so far in 2014. We project employment to rise by 1.0 million between now and the start of 2020, having risen by 1.7 million since the recovery began in 2009. Over the course of the next Parliament, we project that government employment will fall by 1.0 million, compared to the 0.4 million decline that we are likely to have seen over this Parliament. (This reflects a combination of sharper implied cuts in cash spending, plus some pick-up in pay growth.) But over the same period private sector employment is expected to rise by 1.8 million.

1.23 We expect the unemployment rate to continue falling over the coming year and a half – though at a slower pace than we have seen so far this year – and to reach a trough of 5.2 per cent in mid-2016. That would be slightly below our estimate of its long-term sustainable rate, so we then expect it to rise a little thereafter.

1.24 We have revised our forecast for house price inflation in 2014 from 8.5 per cent to 10.2 per cent, reflecting bigger-than-expected price rises since March. House price inflation reached 12.1 per cent in the year to September 2014, but we expect the rate to ease from the fourth quarter. By contrast, growth in property transactions has been much weaker than we expected since March and we have revised our forecast for 2014 as a whole down from 25 per cent to around 15 per cent. The stamp duty land tax reform announced at the Autumn Statement is expected to increase the overall volume of property transactions as the costs associated with the vast majority of transactions will be slightly cheaper as a result.

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	3.0	2.4	2.2	2.4	2.3	2.3
GDP levels (2013=100)	100.0	103.0	105.5	107.8	110.4	112.9	115.5
Output gap	-2.2	-1.0	-0.5	-0.5	-0.2	-0.1	0.0
Expenditure components of GDP							
Household consumption	1.6	2.3	2.8	2.2	2.4	2.3	2.4
General government consumption	0.7	1.1	-0.4	-0.8	-0.9	-0.3	0.0
Business investment	4.8	7.7	8.4	6.3	6.3	6.3	6.3
General government investment	-7.3	2.1	3.3	1.6	2.2	1.6	2.3
Net trade[1]	0.0	-0.2	-0.5	-0.1	-0.1	-0.1	-0.2
Inflation							
CPI	2.6	1.5	1.2	1.7	2.0	2.0	2.0
Labour market							
Employment (millions)	30.0	30.7	31.2	31.4	31.5	31.6	31.7
Average earnings	1.8	1.8	2.0	3.1	3.9	3.9	3.8
LFS unemployment (% rate)	7.6	6.2	5.4	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.84	0.83	0.84	0.85	0.86
	Changes since March forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.0	0.3	0.1	-0.4	-0.2	-0.1	-
GDP levels (2013=100)	0.0	0.3	0.3	0.0	-0.3	-0.4	-
Output gap	0.0	0.4	0.6	0.3	0.1	-0.1	-
Expenditure components of GDP							-
Household consumption	-0.7	0.2	1.0	-0.3	-0.2	0.0	-
General government consumption	-0.2	-0.1	0.1	0.5	0.9	0.6	-
Business investment	6.0	-0.2	-0.8	-1.7	-2.4	-1.3	-
General government investment	-0.9	-8.6	2.3	-0.6	1.3	2.1	-
Net trade	-0.1	0.0	-0.6	-0.1	-0.1	-0.1	-
Inflation							-
CPI	0.0	-0.3	-0.8	-0.3	0.0	0.0	-
Labour market							-
Employment (millions)	0.1	0.4	0.5	0.5	0.3	0.2	-
Average earnings	0.3	-0.7	-1.2	-0.5	0.1	0.1	-
LFS unemployment (% rate)	0.0	-0.6	-1.2	-0.9	-0.4	0.0	-
Claimant count (millions)	0.00	-0.16	-0.29	-0.23	-0.14	-0.09	-

[1] Contribution to GDP growth.

1.25 In many ways our forecast for the economy over the next five years looks very stable – real and nominal GDP growth, inflation, unemployment and the output gap fluctuate relatively little from 2015 onwards. But this conceals some big changes in the structure of spending and income associated with another five years of fiscal consolidation – and, in particular, with the fact that on current policy assumptions so much of it is delivered through cuts to day-to-day spending on public services that would directly reduce GDP. They imply that:

- government consumption of goods and services falls to its lowest share of GDP since at least 1948 – when comparable National Accounts data begins – and since 1938 using a historical dataset compiled by the Bank of England (Chart 3.36). This change can also be seen in the near 20 per cent fall in government employment over the forecast period that is implied by the Government's spending assumptions;

- we assume that monetary policy will be able to support demand to achieve the inflation target and that the economy will be sufficiently flexible that the private sector can absorb the labour shed by the public sector. This implies that the negative effect of the fiscal tightening on GDP should be temporary, not permanent. It also means that private domestic spending will rise as a share of GDP. In particular, we assume that business and residential investment will rise faster than profits and household income respectively, while consumer spending will grow broadly in line with household income. These assumptions in turn imply a sharp rise in the real share of GDP accounted for by business investment (Chart 3.34) and a rising household debt to income ratio (Chart 3.31) – thanks also to house prices rising faster than incomes; and

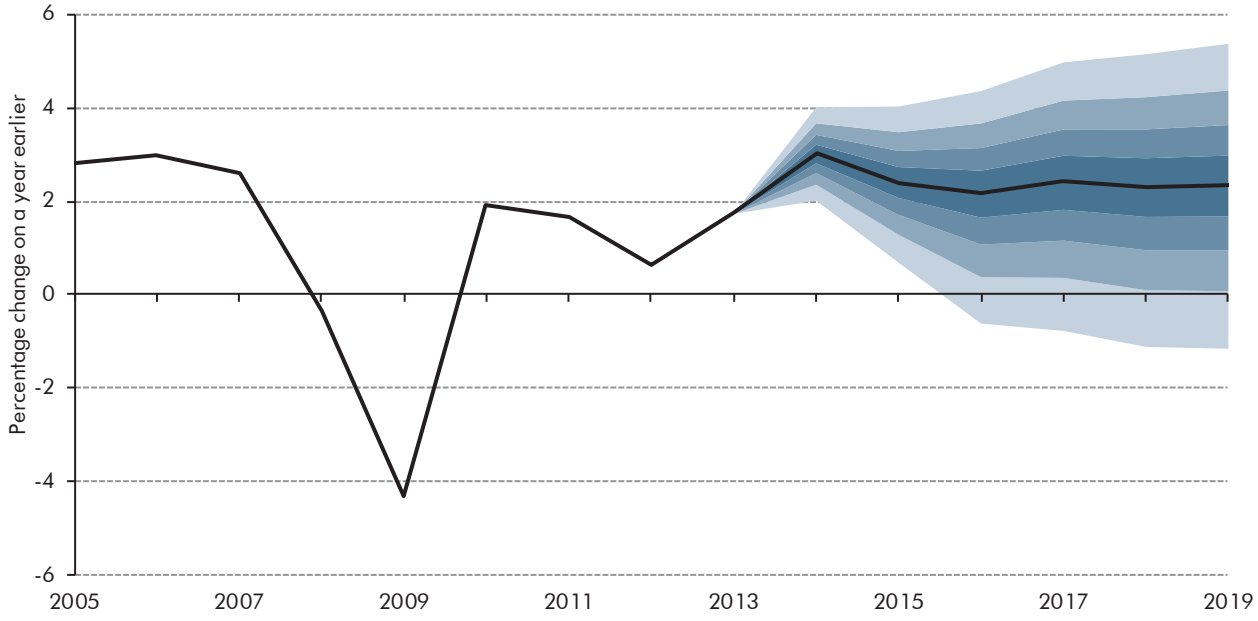
- we assume that the UK will partially arrest the decline in export market share that was a feature of the pre-crisis decade, which means the contribution of net trade to GDP growth will be less negative than would otherwise be the case (Chart 3.37 and Box 3.3). This assumption is consistent with the recovery of productivity growth boosting export competitiveness and with a slowing in the pace at which emerging markets take market share away from mature economies like the UK.

1.26 While these assumptions are mutually consistent – private spending would be expected to rise as a share of GDP when the share of household income and corporate profits derived from government pay and procurement falls – they do illustrate the challenge facing the UK economy in adjusting to the further fiscal tightening that the Government is assuming.

1.27 As ever, the key judgement underpinning our forecast is about the return of sustained productivity growth. This is necessary to finance private spending and to allow domestic producers to compete in export markets and with foreign producers in the domestic market. In Chapter 5, we explore two alternative productivity growth scenarios – a downside scenario based on a continuation of recent history and an upside scenario based on a return to the rates seen in the early 1980s. These illustrate the very different economic and fiscal outcomes that would result from significantly different productivity performance.

1.28 There is considerable uncertainty around any economic forecast. Chart 1.2 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 1.2: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

1.29 The public finances data have been revised substantially since our March forecast, following the ONS review of these statistics (the 'PSF review') and the implementation of the ESA10 guidelines for the National Accounts. This means there are a number of steps in the explanation of the changes in our fiscal forecasts since March.

1.30 Table 1.2 shows how the changes can be decomposed into:

- changes relating to ESA10 and the PSF review;
- changes due to underlying forecast changes, including their interaction with the Government's policy assumption for total managed expenditure beyond 2015-16 (the 'TME assumption') that applied in March; and
- changes resulting from Government decisions, which include the effect of the policies listed in the Treasury's table of policy decisions, plus the effect of changing the March TME assumption that applied from 2016-17 to 2018-19 and applying the new assumption to spending in 2019-20, now that the forecast has rolled on a year.

1.31 Changes in our borrowing forecast since March can therefore be explained as follows:

- in March, we focused on an underlying measure of PSNB that excluded the effects of transfers between the Exchequer and the Asset Purchase Facility (APF) related to quantitative easing, which as treated at the time had been uneven from year to year.

The first panel of the table moves from this starting point to the ONS headline measure of PSNB at the time, including those APF transfers;

- the second panel shows changes since March that relate to the implementation of ESA10 and the PSF review by the ONS. This allows us to restate our March forecast on an ESA10 basis, as best we can, to facilitate like-for-like comparisons. The main changes are that spending and receipts are higher in every year by amounts that are broadly offsetting. The inclusion of Network Rail in the public sector adds to borrowing in every year, while the change in the treatment of APF flows reduces borrowing by an amount that rises each year. Other effects are largely offsetting, so that overall borrowing is higher in the near term and lower in the medium term;

- the third panel shows the underlying forecast changes since March. Overall, these changes have led to higher borrowing across the forecast period due to:

    - a large and increasing downward revision to receipts, notably income tax. This raises borrowing by £7.8 billion in 2014-15, rising to £25.3 billion in 2018-19;

    - a largely offsetting downward revision to 'annually managed expenditure' (AME) – in particular lower debt interest costs, due to lower interest rates and our revised assumption that gilts held by the APF will not be actively sold during the forecast period. This reduces borrowing by £1.3 billion in 2014-15, rising to £19.2 billion in 2018-19; and

    - the effect of all the revisions to our forecasts of public spending and the GDP deflator on the TME assumption that the Government used in March 2014. These imply reductions in 'departmental expenditure limits' (DEL) from 2016-17 to 2018-19 – the implied envelopes for central government spending on public services, grants and capital investment – of £5.8 billion a year on average.

- the final panel shows the effect on borrowing of the decisions the Government has taken in this Autumn Statement. These are split between:

    - the estimated effect of policy measures that are included in the Treasury's table of policy decisions, which on average reduce borrowing by £0.2 billion a year over the forecast period to 2019-20; and

    - the effect on TME – and thus on the implied envelope for DEL spending – of the Government's decision to change the TME assumption for the years beyond 2015-16. Between 2016-17 and 2018-19, that reduces borrowing by an average of £1.2 billion a year.

Table 1.2: Changes to public sector net borrowing since March

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March 2014 underlying PSNB (ESA95)	**107.8**	**95.5**	**75.2**	**44.5**	**16.5**	**-4.8**	
APF effect	12.2	11.6	6.9	2.9	-1.3	-3.7	
March 2014 headline PSNB (ESA95)	**95.6**	**83.9**	**68.3**	**41.5**	**17.8**	**-1.1**	
Changes due to implementation of ESA10 and the ONS PSF review							
Total	**3.6**	**2.5**	**0.0**	**-0.1**	**-2.0**	**-2.5**	
Of which:							
Receipts	-0.9	-4.7	-9.8	-13.9	-15.9	-16.8	
AME spending	*4.5*	*7.3*	*9.8*	*13.8*	*13.9*	*14.2*	
March 2014 headline PSNB (ESA10)	**99.3**	**86.4**	**68.3**	**41.5**	**15.8**	**-3.7**	
Forecast changes and consequences for implied government spending							
Forecast changes since March 2014	**-1.7**	**5.8**	**6.6**	**-0.1**	**0.8**	**1.8**	
Of which:							
Receipts forecast	-1.6	7.8	14.3	18.9	22.7	25.3	
Spending forecast	-0.1	-2.0	-7.7	-19.0	-21.9	-23.5	
Of which:							
AME	*-2.5*	*-1.3*	*-9.3*	*-11.9*	*-15.9*	*-19.2*	
DEL plans	*2.4*	*-0.7*	*1.6*				
Changes to implied total DEL from applying Budget 2014 spending policy assumptions post 2015-16				*-7.1*	*-6.0*	*-4.3*	
December 2014 before effects of Government decisions	**97.5**	**92.1**	**74.9**	**41.3**	**16.6**	**-1.9**	**-6.5**
Changes due to Government decisions							
Autumn Statement policy measures	0.0	-0.9	1.0	-0.1	-0.4	-0.5	-0.4
Effect of applying new Autumn Statement spending policy assumptions post 2015-16[1]				-0.4	-1.6	-1.7	-16.2
December 2014 headline PSNB (ESA10)	**97.5**	**91.3**	**75.9**	**40.9**	**14.5**	**-4.0**	**-23.1**
Change since March on a like-for-like basis	**-1.7**	**4.9**	**7.7**	**-0.6**	**-1.3**	**-0.3**	
Memo: December 2014 implied on ESA95	*101.2*	*93.8*	*76.0*	*40.8*	*12.6*	*-6.6*	

[1]The additional tightening in 2019-20 of £14.5 billion is relative to a baseline that assumes current spending by departments would otherwise have remained constant as a share of potential GDP.

1.32 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 the largest surplus since 2000-01 – a turnaround of 11.2 per cent of GDP (£205 billion in today's terms). By 2014-15, around 46 per cent of that planned reduction – 5.2 per cent of GDP (£94 billion) – will have been completed. As Chart 1.3 shows, the sources of deficit reduction during the first five years of the consolidation differ in their relative importance from those implied by the Government plans and medium-term assumptions that underpin our forecast for the second five years.

1.33 Between 2009-10 and 2014-15, the main factors contributing (positively and negatively) to the reduction in public sector net borrowing have included:

- a relatively small increase in **debt interest spending** (0.2 per cent of GDP). The impact of much higher cash debt has been offset by lower government borrowing costs. This

reflects lower gilt yields, plus the effect of financing some debt at Bank Rate (via quantitative easing) rather than selling gilts;

- an even smaller increase in **other AME spending** (less than 0.1 per cent), mainly higher net public service pension costs (via lower contributions from a shrinking workforce);

- little change from **receipts** (also less than 0.1 per cent). Tax increases (notably the main rate of VAT) have more than offset tax cuts (notably corporation tax and fuel duty rates and increases in the income tax personal allowance) over this period. But falling effective tax rates, associated with subdued productivity and real incomes, have absorbed the remaining net tax increase and have left receipts little changed overall;

- larger contributions from cuts in **welfare spending** (0.7 per cent of GDP) and **capital spending** (1.4 per cent), with welfare spending falling steadily as a share of GDP while investment cuts were concentrated in the early years of the recovery; and

- around two thirds of the deficit reduction has come from cuts in **day-to-day spending on public services and administration** (3.5 per cent of GDP), with the cuts to-date concentrated in unprotected departments outside health, schools and overseas aid.

1.34 Between 2014-15 and 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 further increases in **debt interest** spending (0.7 per cent of GDP) as interest rates are assumed to rise in line with market expectations;

- small reductions in **other AME spending** (0.3 per cent of GDP) and **capital spending** (0.1 per cent). Net public service pensions costs continue to rise as a share of GDP;

- a 0.8 per cent of GDP rise in **receipts**. This includes a 0.5 per cent of GDP rise in the tax-to-GDP ratio – largely due to 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 a 0.3 per cent of GDP rise in non-tax revenues, notably interest on the government's stock of financial assets as interest rates rise;

- a 0.9 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 economy 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

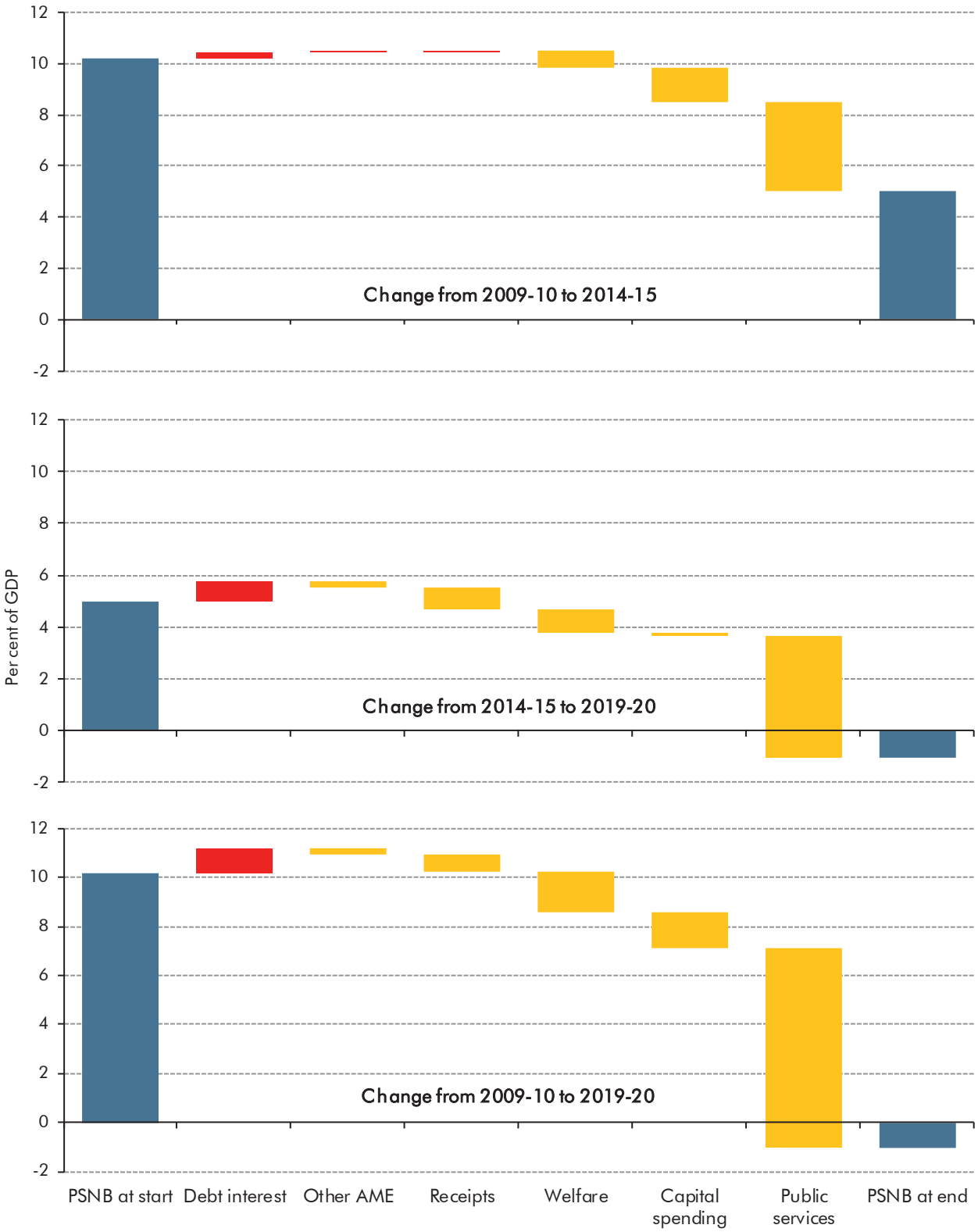
- around 80 per cent of the remaining change in the budget balance (4.7 per cent of GDP or £86 billion in today's terms) comes from the cuts in **day-to-day spending on public services and administration** implied by the Government's firm 2015-16 plans, its assumption for total spending thereafter and our forecast for AME spending.

1.35 Over the full decade, based on the Government's policies and policy assumptions, the 11.2 per cent of GDP change in the budget balance would be composed of:

- a 10.5 per cent of GDP reduction in spending – over 90 per cent of the total. Current spending on public services would make up the bulk of that change – 8.2 per cent of GDP – of which around 40 per cent will have taken place by 2014-15. Capital spending would account for 1.5 per cent of GDP of the fall, almost all of which will already have taken place by 2014-15; and

- a 0.7 per cent of GDP rise in receipts – less than 10 per cent of the total. The rise in income tax and NICs receipts as a share of GDP between 2014-15 and 2019-20 in our latest forecast more than explains this rise.

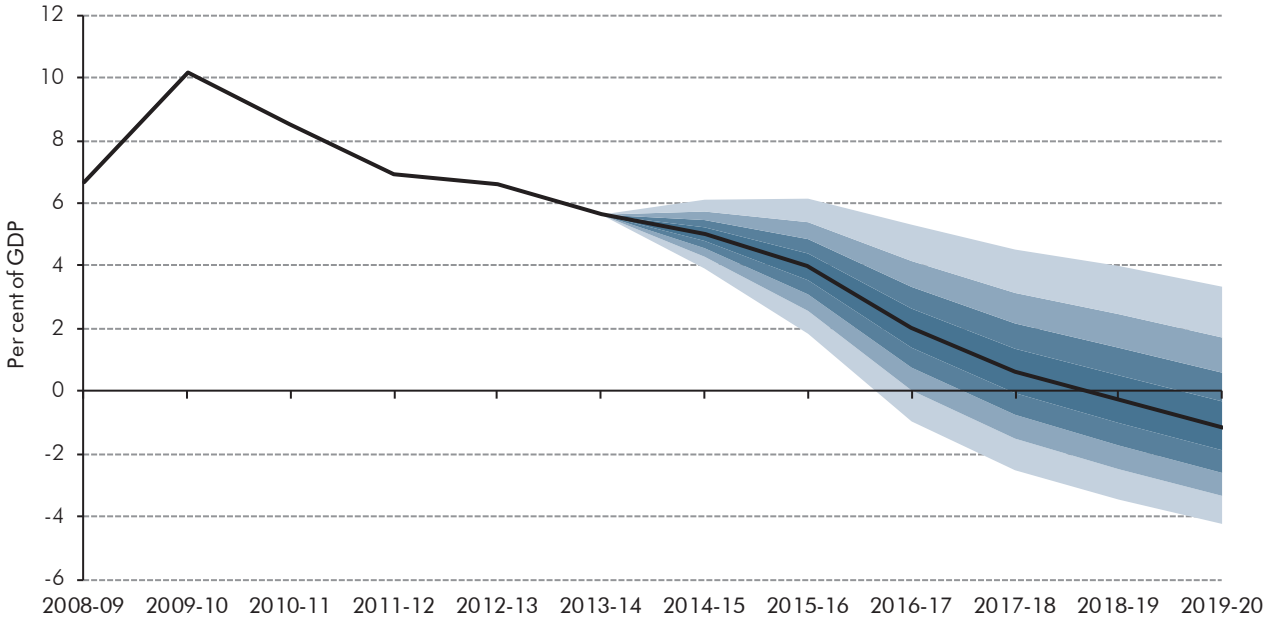
Chart 1.3: Sources of deficit reduction



Source: ONS, OBR. Note: Figures adjusted for negtive tax credits and reforms to council tax benefit and business rates.

1.36 All fiscal forecasts are subject to significant uncertainty. Chart 1.4 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 just over 50 and 60 per cent in 2018-19 and 2019-20 respectively.

Chart 1.4: PSNB fan chart



Source: ONS, OBR

1.37 We forecast that public sector net debt (PSND) will rise as a share of GDP this year and next, peaking at 81.1 per cent of GDP in 2015-16, before then falling at an increasingly rapid rate to 72.8 per cent of GDP in 2019-20. Net debt rises more slowly and then falls more quickly than forecast in March, but the level is higher throughout. The changes reflect:

- ESA10 and PSF review changes, including bringing Network Rail and the APF inside the public sector boundary, have raised the starting level of debt. These changes are partly offset by upward revisions to nominal GDP relating to the implementation of ESA10 and other National Accounts revisions since March;
- our borrowing forecast increases net debt in the near term, but reduces it in the medium term, as weaker receipts are offset by larger spending cuts; and
- other changes generally reduce net debt further, in particular the fact that falls in gilt yields since March imply that gilts will be sold at a greater premium relative to their nominal value over the forecast period, and also that the cash requirement will be lower than implied by borrowing this year and next.

Table 1.3: Changes to public sector net debt since March

	Outturn	Per cent of GDP Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March forecast	74.5	77.3	78.7	78.3	76.5	74.2	
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
Change	**4.3**	**3.1**	**2.4**	**2.4**	**2.2**	**2.0**	
of which:							
Change in nominal GDP[1]	-3.8	-4.2	-3.8	-3.2	-2.9	-2.8	
Change in cash level of net debt	8.1	7.2	6.2	5.7	5.2	4.8	
				£ billion			
March forecast	1258	1355	1439	1497	1530	1548	
December forecast	1402	1489	1558	1610	1638	1652	1648
Change in cash level of net debt	**144**	**134**	**119**	**113**	**107**	**104**	
of which:							
ESA10 and PSF review	129	133	135	137	135	134	
Other changes in net borrowing	-2	3	11	10	9	8	
Gilt premia	1	-6	-22	-29	-34	-36	
Other	16	5	-5	-5	-3	-3	

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

Performance against the fiscal targets

1.38 In the June 2010 Budget, the Coalition Government set itself a medium-term fiscal mandate and a supplementary target, namely:

- to balance the cyclically-adjusted current budget (CACB) by the end of a rolling, five-year period, which is now 2019-20; and
- to see public sector net debt (PSND) falling as a share of GDP in 2015-16.

1.39 We judge that the Government has a greater than 50 per cent chance of meeting the **fiscal mandate**. The CACB is forecast to be in surplus by 2.3 per cent of GDP (£50.6 billion) in 2019-20, the first surplus in excess of 2 per cent that we have forecast in a mandate year.

1.40 The **supplementary target** requires public sector net debt (PSND) to fall as a share of GDP between 2014-15 and 2015-16, with this target year fixed. We expect that PSND will continue to rise as a share of GDP in that year, so the Government is on course to miss its supplementary target. This has been the case in each of our forecasts since December 2012. PSND is expected to peak as a share of GDP in 2015-16, falling in 2016-17 and then by larger amounts each year.

1.41 The Government set a '**welfare cap**' in Budget 2014, covering spending on social security and tax credits excluding the state pension and benefits closely linked to the ups and downs of the economy. The cap was set in line with our March forecast, but has subsequently been increased by around £0.3 billion a year thanks to a classification change. So it now rises from £119.7 billion in 2015-16 to £127.0 billion in 2018-19. At the outset, the

Government set a 2 per cent margin above the cap that can be used to accommodate forecast changes but not the impact of policy changes.

1.42 We have concluded that ongoing reforms to incapacity and disability benefits are likely to save less money over the next few years than we had forecast in March. But from 2016-17 onwards, this is largely offset by the downward revision to our inflation forecast (which reduces the amount by which most benefits would be uprated) and by a further delay to the rollout of universal credit (which is treated as a policy change). The net result is that our current forecast for spending is £0.9 billion higher than the cap in 2015-16 and £0.1 billion in 2016-17. It is then £0.8 billion lower in 2017-18 and £0.1 billion lower in 2018-19. The net effect of policy measures in these years is to reduce spending, so the excess over the cap in 2015-16 and 2016-17 is due to forecast revisions not policy changes, and it is within the permitted forecast margin. On the basis of our central forecast, our assessment is therefore that the Government is on track to meet the welfare cap commitment.

1.43 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 80 per cent probability that the CACB will be in balance or surplus in 2019-20 (as the mandate requires). As the CACB is expected to move into surplus in 2017-18 in our central forecast, there is a more than 50 per cent probability of that occurring;

- 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 1 per cent lower than in our central forecast in 2019-20, the probability of meeting the mandate would fall to 70 per cent. The level of potential output would need to be over 3¼ per cent lower in 2019-20 than in our central forecast to make it more likely than not that the mandate would be missed; and

- third, by looking at alternative economic scenarios. We have looked at two scenarios in which the productive potential of the economy grows by significantly more or less than in our central forecast. In the downside scenario, the disappointing productivity growth of recent years continues. In the upside scenario, productivity grows at rates witnessed in the UK in the early 1980s. In both scenarios, we assume that the differences are structural, so that inflation and the output gap are unchanged from our central forecast. In the downside scenario, the deficit would fall more gradually over the forecast period, which would mean that the fiscal mandate would be missed and that debt would rise in every year. Real wages in 2019 would remain 7 per cent below their pre-crisis peak. In the upside scenario, the fiscal mandate would be met by a very large margin and the welfare cap would still be observed. Net debt would also fall as a share of GDP in 2015-16, so the supplementary target would be met. But even in

this upside scenario, productivity by the end of the forecast period would have recovered less than half of the ground lost since the crisis relative to its pre-crisis trend.

2 Developments since the last forecast

Introduction

2.1 This chapter summarises:

- the main economic and fiscal data developments since our last forecast in March 2014 (from paragraph 2.2); and
- recent external forecasts for the UK economy (from paragraph 2.25).

Economic developments

Data revisions – Blue Book 2014

2.2 Since our March forecast, the Office for National Statistics (ONS) has published *Blue Book 2014*. Each year, the publication of the Blue Book provides the ONS with an opportunity to make methodological changes to the National Accounts and incorporate extra data. This year the ONS – in common with other national statistical agencies across Europe – has also aligned the National Accounts to the latest international guidance, as set out in the European System of Accounts 2010 (ESA10). The combination of these factors has resulted in unusually large revisions to historical data. The last time a Blue Book included revisions of such scope was in 1998, with the move to the European System of Accounts 1995 (ESA95).

2.3 As a result of the shift to ESA10:

- research and development (R&D) is now classified as investment (which contributes to GDP) rather than intermediate consumption (a cost of doing business, which does not). This has raised the level of GDP, but has not greatly affected its growth profile; and
- the treatment of pension liabilities has changed. This affects particular sectors in significant ways, but the effects are largely offsetting in their overall impact on GDP. Most importantly, defined benefit household pension saving is now determined by the change in promised future pension benefits from pension schemes, rather than the actual contributions paid into those scheme. This raises the measured saving ratio as households' incomes are notionally higher, but consumption is unaffected.

2.4 The other significant revisions since March – not related to ESA10 – have been:[1]

[1] These non-ESA10 revisions are related to the large historic adjustment to the UK's contributions to the EU (see Chapter 4).

- the inclusion of economic activity related to illegal drugs and prostitution in the National Accounts, which raised the level of GDP without much effect on the profile;
- the use of new data sources and methods for estimating the output of 'non-profit institutions serving households', raising both the level and growth of GDP;
- changes to the method for deflating inventories; and
- for investment, reverting to the pre-Blue Book 2013 method of supply-use balancing and revising some of the industry classifications. This has raised the average growth rate and reduced the quarterly volatility of measured investment in recent years.

2.5 The revisions have been taken back to the beginning of the National Accounts in 1948. Nominal GDP has been revised higher on average over this period. Relative to the data available at the time of our March forecast, annual nominal GDP in 2013 is now estimated to be 6 per cent higher (around £90 billion).

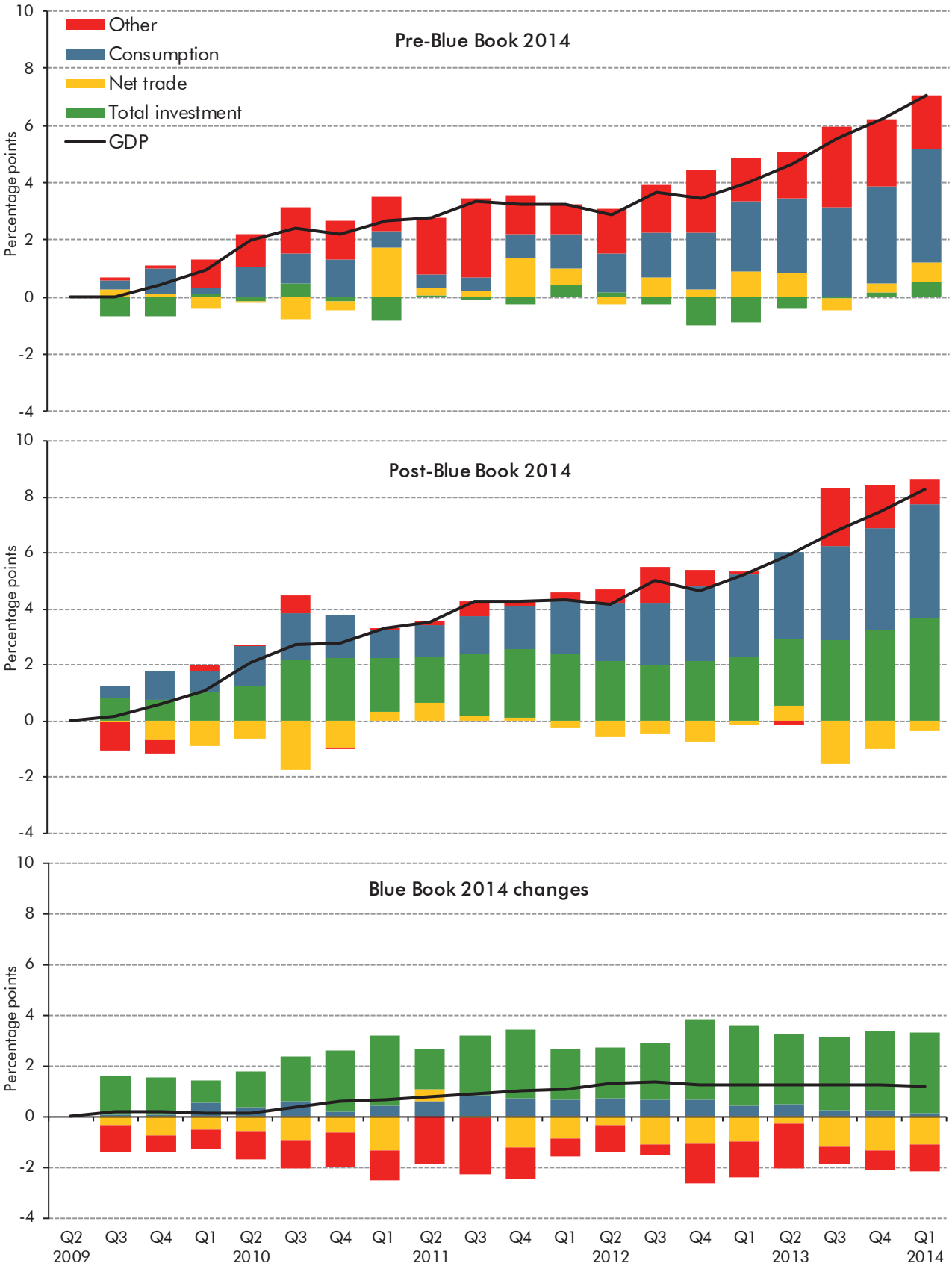
2.6 In terms of recent history, the revisions have reduced the depth of the late 2000s recession and increased the pace of the subsequent recovery. Real GDP growth in 2007 was revised down from 3.4 to 2.6 per cent, while the falls in GDP in 2008 and 2009 are now smaller, with revisions of 0.4 and 0.9 percentage points respectively. As a result, the peak-to-trough fall between the first quarter of 2008 and the second quarter of 2009 has been revised from 7.2 per cent at the time of our March forecast to 6.0 per cent on the latest data.

2.7 The estimated recovery in GDP is now stronger, with the pre-recession peak being surpassed in the third quarter of 2013, three quarters earlier than in the previous vintage of data. Cumulative growth in real GDP between the 2009 trough and the final quarter of 2013 is now 7.5 per cent, up from 6.3 per cent at the time of our March forecast.

2.8 The composition of the recovery has also been revised significantly (Chart 2.1). Investment now contributes much more to GDP growth since the second quarter of 2009. Indeed, it almost matches the contribution of private consumption over that period, despite being much smaller as a share of GDP (Table 2.1). Stronger growth in investment over the period was driven by a change in how the ONS compiles investment at the industry level.[2] The upward revision to investment growth has been partly offset by downward revisions to the contributions from net trade and other components, which include government consumption, stocks and the statistical discrepancy.

[2] For more detail, see: *Changes to National Accounts: gross fixed capital formation and business investment – impact of ESA10 changes on volume measures*, ONS, June 2014.

Chart 2.1: Cumulative contribution to real GDP growth since the trough



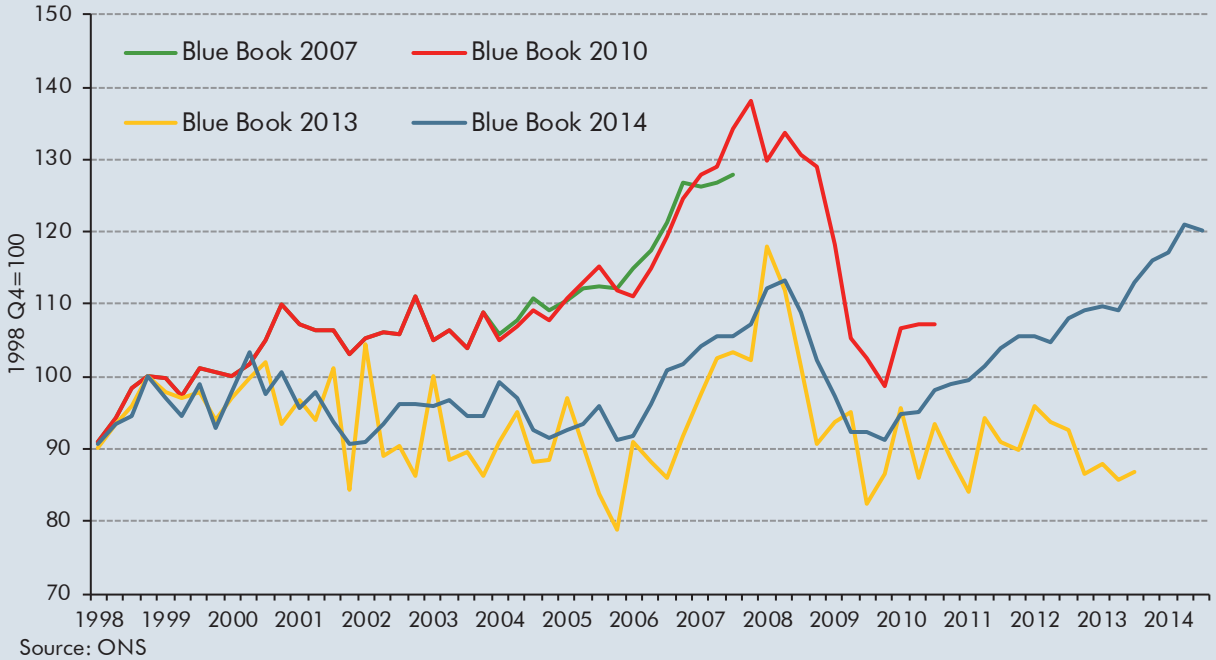
Box 2.1: Historical revisions to business investment

In recent years, the recent and historical path of business investment has been subject to significant revisions. The implications of these recent revisions for our forecast are described in Chapter 3. Chart A shows that business investment since 1999 has been rewritten many times:

- in the 2007 vintage of ONS Blue Book data, business investment in the eight years to the end of 2006 was estimated to have increased by 26.8 per cent. At the time, that average annual growth rate of 3.0 per cent was considered puzzlingly weak for a period of apparent strength and stability in the wider UK economy;[a]
- by the 2010 Blue Book, produced around the time the OBR was established, business investment growth over that period had been revised down slightly to 24.7 per cent;
- by the 2013 Blue Book, on which our last forecast was based, business investment growth over that period had been revised away entirely, with the level at the end of 2006 estimated to have been 8.3 per cent below that at the end of 1998. The path of business investment was also much more uneven from quarter to quarter; and
- in the 2014 Blue Book, business investment is smoother again and now shows some growth over the pre-crisis period. But at 1.6 per cent over eight years, the average is just 0.2 per cent a year during a period when GDP growth averaged 3.0 per cent.

Future revisions may rewrite this history again, but the measured investment rate in the UK is likely to remain relatively low. We considered this issue from an international perspective in Box 3.6 of our March 2014 *Economic and fiscal outlook*.

Chart A: Successive vintages of real business investment estimates



Source: ONS

[a] For example, see Gieve, Q4 2006, Bank of England Quarterly Bulletin: *The puzzle of UK business investment.*

Table 2.1: Contributions to real GDP growth from 2009Q3 to 2014Q1

	Percentage points				GDP growth, per cent
	Private consumption	Total investment	Net trade	Other	
Pre-Blue Book data	3.9	0.5	0.7	1.9	7.1
Latest data	4.1	3.7	-0.4	0.9	8.3
Difference[1]	0.1	3.2	-1.1	-1.1	1.2

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

Note: Contributions to GDP based on ONS estimates. Components may not sum to total due to rounding.

2.9 Offsetting the upward revision to real GDP growth is a downward revision to whole economy inflation (Table 2.2). The GDP deflator now grows by 10.5 per cent rather than the 11.7 per cent estimated at the time of our March forecast. The main contribution to the downward revision was from private consumption, thanks largely to a change in the data source for measuring rents.[3] The contribution from investment to the growth in the deflator has also been revised down.

Table 2.2: Contributions to GDP deflator growth from 2009Q3 to 2014Q1

	Percentage points				GDP growth, per cent
	Private consumption	Total investment	Net trade	Other	
March data	10.2	1.1	-0.1	0.5	11.7
Latest data	9.0	0.5	0.3	0.7	10.5
Difference[1]	-1.1	-0.6	0.3	0.2	-1.2

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

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

2.10 The offsetting revisions to real GDP growth and deflator growth mean there have not been significant revisions to nominal GDP growth (Table 2.3). The composition of nominal GDP growth has been revised somewhat, with a stronger contribution from investment and a weaker contribution from private consumption. All else equal, that implies that the composition of expenditure was less favourable for the public finances as private consumption is taxed more heavily than investment, much of which is tax deductible.

Table 2.3: Contributions to nominal GDP growth from 2009Q3 to 2014Q1

	Percentage points				GDP growth, per cent
	Private consumption	Total investment	Net trade	Other	
March data	15.1	1.9	0.0	2.5	19.5
Latest data	12.7	4.5	-0.1	2.4	19.6
Difference[1]	-2.3	2.6	-0.1	-0.2	0.1

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

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

[3] For more information, see: *Changes to National Accounts: Revisions to household expenditure on rentals to align with the Consumer Price Index with Housing*, ONS, September 2014.

GDP growth since the March 2014 forecast

2.11 Real GDP growth has been somewhat stronger than we expected in March. Over the first three quarters of 2014, GDP grew by 2.4 per cent compared to our forecast of 1.9 per cent (Table 2.4). The unexpected strength came from faster growth in government consumption and a less negative contribution from stocks. In recent forecasts, we have consistently over-predicted investment growth, so the revisions described above and the fact that it grew broadly in line with forecast this year suggest that the expected pick-up is occurring. Private investment is now estimated to have increased by 32.5 per cent between the second quarter of 2009 and the third quarter of 2014, compared to the 10.1 per cent implied by our March forecast and the outturn data available at the time. But future data revisions could change this picture again.

Table 2.4: Contributions to real GDP growth from 2014Q1 to 2014Q3

	Percentage points						
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	GDP growth, per cent
March forecast	1.2	0.0	0.1	0.8	0.1	-0.3	1.9
Latest data	1.3	0.4	0.1	0.7	0.0	-0.1	2.4
Difference[1]	0.2	0.4	0.0	-0.1	-0.1	0.2	0.5

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

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

2.12 The unexpected strength in real GDP relative to our March forecast over the past three quarters was exceeded by the positive surprise in nominal GDP (Table 2.5), with the GDP deflator also increasing by more than in our forecast. The errors in our forecasts for the government consumption and private investment contributions to real and nominal GDP growth were in line, as the deflators came in close to forecast. Private consumption actually contributed less to nominal GDP growth than we expected, thanks to lower than expected consumer prices (described below). Nominal net trade and the contribution from stocks were stronger than expected, as prices contributed more than we had anticipated.

Table 2.5: Contributions to nominal GDP growth from 2014Q1 to 2014Q3

	Percentage points						
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	GDP growth, per cent
March forecast	2.2	0.2	0.0	0.9	0.1	-0.2	3.2
Latest data	2.0	0.7	0.1	0.9	0.5	0.2	4.4
Difference[1]	-0.2	0.5	0.1	0.0	0.4	0.4	1.2

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

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

2.13 Full ONS data on the breakdown of GDP growth by income will not be available for the first three quarters of 2014 until later in December. But the high-level breakdown published so far suggests that on the income side the unexpected strength of nominal GDP growth has been concentrated in corporate profits and other non-labour income components. As

labour income and private consumption are the most heavily taxed components of income and expenditure respectively, the composition of GDP growth since our March forecast has been less favourable than expected for the public finances.

Business surveys

2.14 Most survey evidence suggests that relatively strong GDP growth will continue in coming quarters, although at a slightly slower rate than so far this year. The composite CIPS *Purchasing Managers' Index* (PMI) has eased slightly in recent months, although at 55.8 in October it remains above its long-run average. The services PMI has fallen from 58.4 in February to 56.2 in October, explaining much of the recent fall in the composite index. The manufacturing index has also fallen, while the construction index has been more volatile.

2.15 The *GfK Consumer Confidence* measure has stayed relatively flat in recent months, at a level above its long-run average, which suggests continued solid growth in private consumption. The Bank of England *Agents' Summary* reports a small further increase in investment intentions since our March forecast. Manufacturing activity has eased back in the last few months after rising earlier in the year. Construction output and retail sales volumes have fluctuated but are currently estimated to be at a similar level to earlier in the year. The Confederation of British Industry's (CBI) quarterly *Industrial Trends Survey* reported that growth in manufacturing output and new orders for the current and next quarter are expected to be similar to that at the time of our March forecast and are above their long-run averages. The CBI's *Distributive Trades Survey* has reported an easing in retail sales volume growth in recent months. In the fourth quarter of 2014, the CBI's *Services Sector Survey* showed business optimism continued to ease from earlier in the year, although it still reports a rise in business volumes for the current and next quarters.

Conditioning assumptions

2.16 Since we finalised our March forecast, oil prices have fallen considerably more than was implied by futures prices at the time. By the third quarter of 2014, the oil price was 4.6 per cent below our March assumption (Table 2.6). It had fallen a further 22.5 per cent by the 10 days to 21 November 2014 – the average that underpins our current forecast – and even further since. Oil prices have fallen due to a combination of weaker demand (mainly from China and Europe) and stronger supply (from Libya and Russia), as well as US demand being met increasingly by domestic shale oil. Sterling continued to appreciate after our March forecast, before recently falling back. Overall, it was 2.2 per cent stronger than our March assumption for the third quarter of 2014. The appreciation has been greater against the euro, partly as a result of improving relative growth and interest rate prospects (see Box 2.2 for discussion of the UK's performance relative to other advanced economies). Equity prices are lower and mortgage interest rates higher than we assumed in March.

Table 2.6: Conditioning assumptions in 2014Q3

	Oil price ($ per barrel)	US$/£ exchange rate	euro/£ exchange rate	ERI exchange rate (index)	Equity prices (FTSE all-share index)	Mortgage interest rates (%)[1]
OBR March forecast	107.0	1.66	1.22	86.1	3730	3.0
Latest data	102.1	1.67	1.26	88.0	3534	3.2
Per cent difference	-4.6	0.3	3.4	2.2	-5.3	0.2

[1] Difference is in percentage points.

Labour market

2.17 Employment growth has continued to out-perform our forecasts. The ONS has also revised the historic level of employment higher in the Labour Force Survey (LFS), after the 2011 Census found a larger-than-expected population. This has little impact on employment or unemployment rates because it increases both the numerator and denominator in these calculations. Employment was revised up by 142,000 in the fourth quarter of 2013 (Chart 2.2).

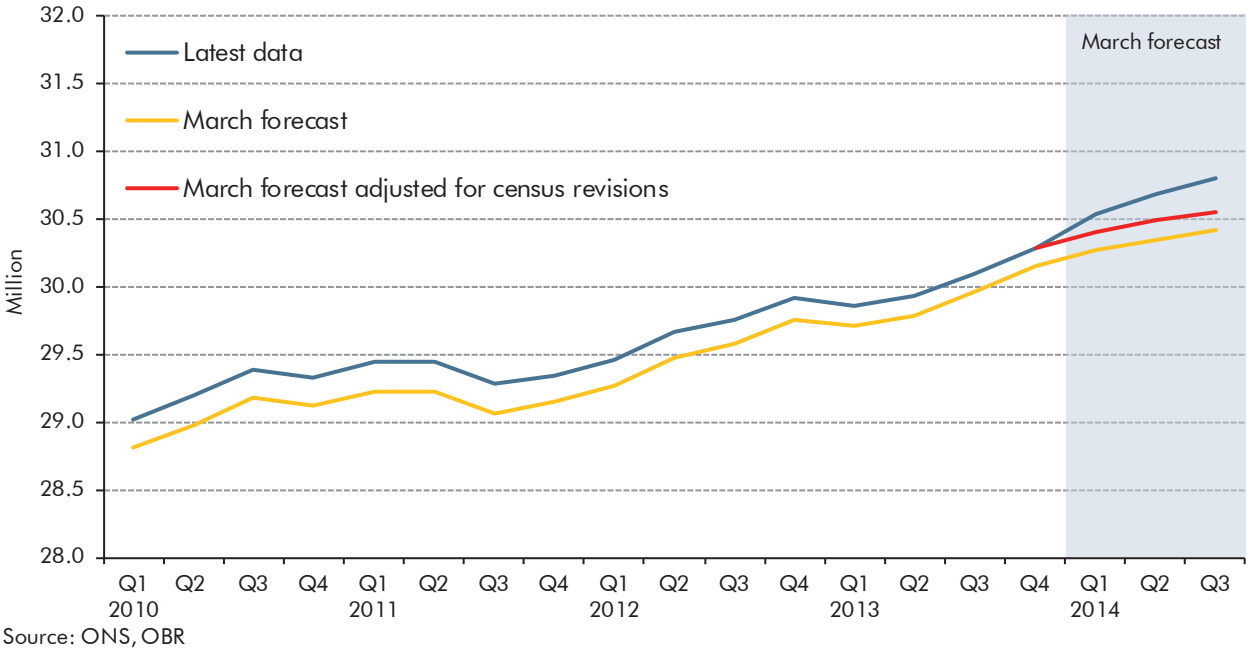
2.18 In March, we expected employment to rise by 265,000 (0.9 per cent) between the fourth quarter of 2013 and the third quarter of 2014, but in fact it has increased by 505,000 (1.7 per cent). This was bigger than the positive surprise in real GDP relative to our forecast, which means that productivity growth has continued to be weaker than we expected.

2.19 The LFS unemployment rate has also fallen more rapidly than we expected, reaching 6.0 per cent in the third quarter of 2014 compared to our March forecast of 6.8 per cent. The error on claimant count unemployment was even larger. We expected the claimant count to fall by 7 per cent between the fourth quarter of 2013 and the third quarter of 2014, in line with the expected 6 per cent fall in the number of LFS unemployed. In the event, the claimant count fell by 23 per cent, compared to a 17 per cent fall in the LFS unemployed.[4]

2.20 While employment has surprised on the upside, private sector earnings growth has once again surprised on the downside. Average weekly earnings in the private sector in the year to the third quarter grew by just 1.1 per cent, compared with our forecast of 2.4 per cent. This negative surprise is more than would be implied by our productivity forecast error.

[4] 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: LFS employment



Source: ONS, OBR

Inflation

2.21 CPI inflation has fallen by more than we expected in March. Inflation was 0.4 percentage points below forecast in the third quarter of 2014 (Chart 2.3). Food price inflation has continued to fall more quickly than expected, as domestic production has put more downward pressure on seasonal food price inflation and as falling global commodity prices have fed through to non-seasonal food prices. Also, there were larger-than-expected falls in petrol and diesel prices as oil prices fell below our March conditioning assumption. The trade-weighted exchange rate has also been stronger than assumed, putting downward pressure on items with a high import component, including food prices.

Chart 2.3: CPI inflation

Source: ONS, OBR

The housing market

2.22 House price inflation increased by more than we expected in March, reaching 11.7 per cent in the year to the third quarter of 2014 against our forecast of 9.2 per cent. By contrast, property transactions in the third quarter of 2014 were 33,000 lower than our March forecast of 338,000. Part of this surprise has been related to the new Mortgage Market Review requirements on lenders, which appear to have had a larger and more persistent effect than we expected. Recent indicators, including the RICS housing market survey and timelier private sector measures of house prices, suggest house price inflation is slowing.

The global economy

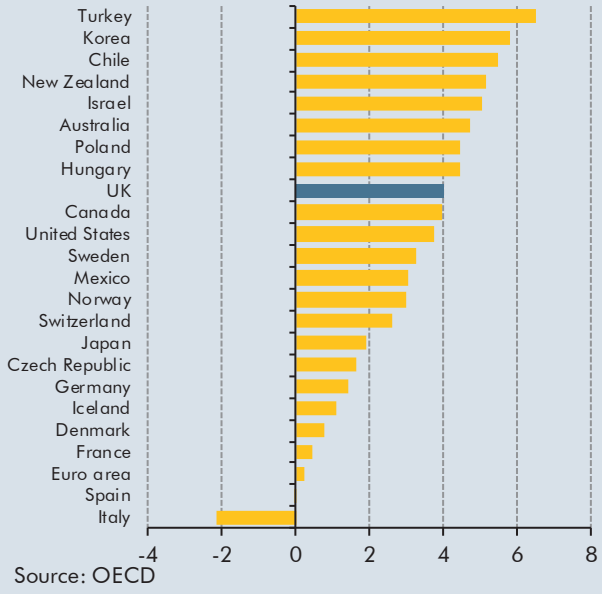
2.23 GDP growth in advanced economies continues to recover, but has been somewhat weaker than expected. There is also still significant variation between countries. Growth in the US, euro area and Japan has been weaker than expected in the year to the third quarter. Euro area growth has remained very weak and CPI inflation has continued to fall, reaching a low of 0.3 per cent in November 2014. The European Central Bank has announced that it intends to expand its balance sheet from the current level of around €2 trillion to about €3 trillion, through the purchase of asset-backed securities. By contrast, the US Federal Reserve has completed the tapering of its asset purchases, so is no longer adding further monetary stimulus to the US economy. Growth in emerging markets has slowed recently, with geopolitical tensions weighing on some regions. Concerns about global growth prospects have contributed to falls in commodity prices and European equity prices in recent months.

Box 2.2: Comparing the UK's recession and recovery after Blue Book revisions

Over the past two years, growth in the UK has outpaced all other members of the G7, but has been below that of some other members of the OECD group of advanced economies (Chart B). It is worth putting this recent pick-up into the context of the latest estimates of the path of GDP over the late 2000s recession and subsequent recovery. The UK is not the only country to have made significant revisions to its GDP estimates. Other EU economies have made revisions following their own implementation of ESA10 and other advanced economies have implemented similar changes resulting from the adoption of the System of National Accounts 2008.

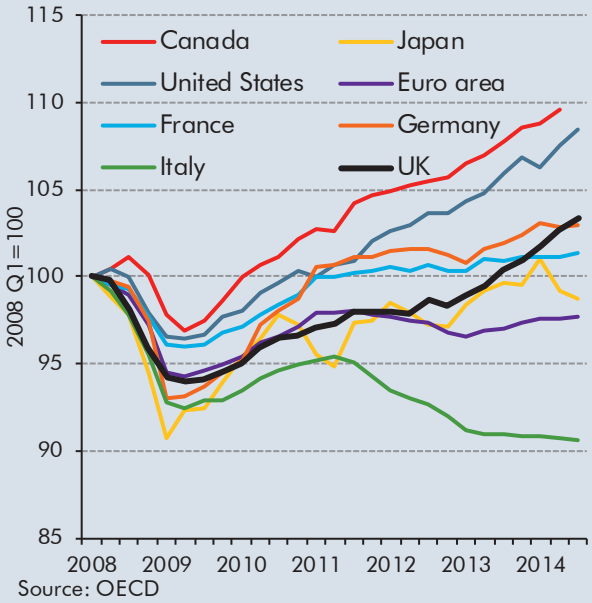
Following the onset of the financial crisis, the UK experienced a relatively sharp contraction of 6.0 per cent, which was similar to the euro area as a whole. Of the G7 economies, Germany, Italy and Japan experienced deeper recessions, with milder recessions in France, the US and Canada (Chart C). The UK recovery was initially subdued, only keeping pace with Japan and the euro area as a whole, while growth in Germany, the US and Canada was significantly stronger. However, over the past two years UK growth has gathered pace. As a result, relative to the pre-crisis peak, the UK now lags behind only the US and Canada within the G7.

Chart B: OECD GDP growth 2012Q3-2014Q2 (per cent)



Source: OECD

Chart C: G7 real GDP since 2008Q1

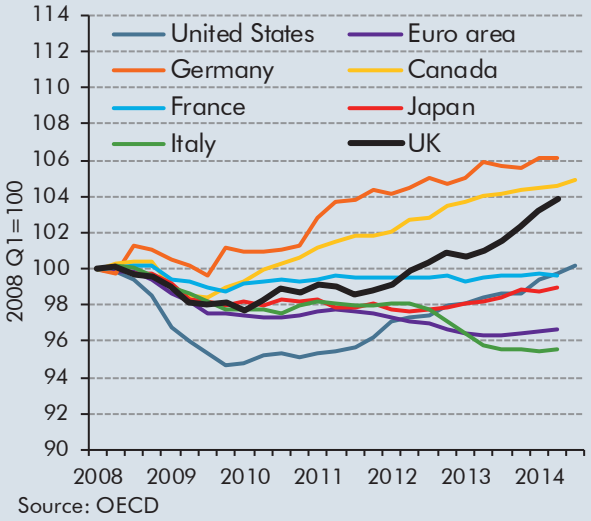


Source: OECD

Relative to the recovery in GDP, employment growth since the crisis has been strong in the UK. Employment is now around 4 per cent higher than in the first quarter of 2008. Canada and Germany are the only G7 economies with employment further above its 2008 level (Chart D). The flip side is that productivity growth has been very weak, with only Italy further below its pre-crisis level than the UK (Chart E). Both Germany and Japan experienced a greater peak-to-trough fall in productivity, but have since recovered more of that loss. Meanwhile productivity in the UK has stagnated and is currently 3 per cent lower than in the first quarter of 2008. This highlights that the recent weakness in UK productivity growth is not only a puzzle relative to past UK performance, but also a puzzle relative to the performance of other major advanced

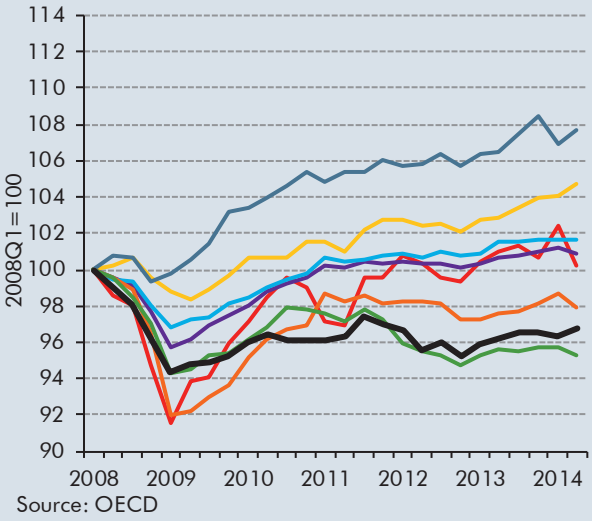
economies. Judging when productivity growth in the UK will pick up is the biggest uncertainty in our economy forecast. Productivity growth is an essential ingredient of sustainable GDP growth and higher real wages, which in turn underpin our fiscal forecast.

Chart D: G7 employment since 2008Q1



Source: OECD

Chart E: G7 productivity (output per worker) since 2008Q1



Source: OECD

Fiscal data developments

2.24 The latest ONS public finances data show public sector net borrowing (on the new ESA10 basis) in the first seven months of 2014-15 has been £3.7 billion higher than in the same period last year, contrasting with the full-year fall expected in our March forecast. Spending growth has been broadly in line with our March forecast, but receipts growth has been weaker than expected. We expected receipts growth to be end-loaded in 2014-15, because of the shifting of liabilities due to the reduction in the additional rate of income tax to 45p. However, factors such as weaker-than-expected wage growth, lower-than-expected residential property transactions and lower oil and gas revenues have reduced receipts growth relative to our March forecast. These developments and their implications for our latest fiscal forecast are discussed in more detail in Chapter 4.

Developments in outside forecasts

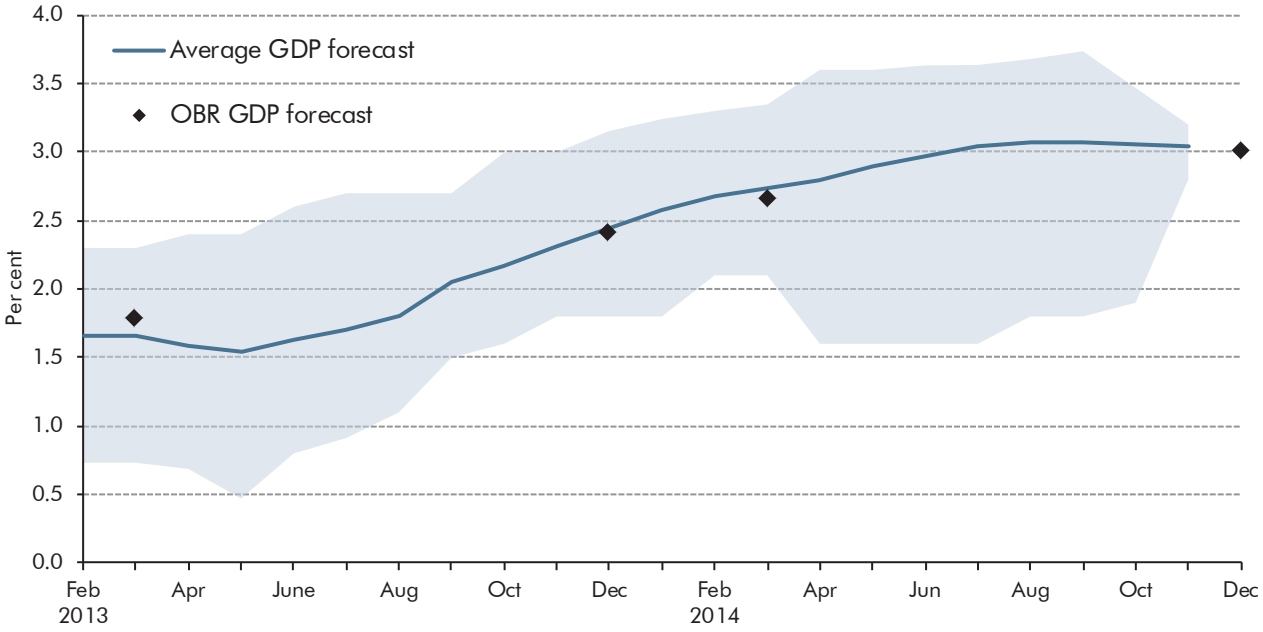
2.25 Many private sector, academic and other outside organisations produce forecasts for the UK economy.[5] This section sets out some of the movements in these forecasts since our March *Economic and fiscal outlook (EFO)*. When interpreting the average of outside forecasts, it is important to bear in mind that different analysts forecast different variables and the average forecast is not constrained to paint an internally consistent picture.

[5] See HM Treasury, November 2014, *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.

Real GDP growth

2.26 Outside forecasts for real GDP growth in 2014 were increasing in the run-up to our March forecast, reflecting momentum in GDP data in 2013, strength in survey measures of activity and confidence, and easing credit conditions. Our forecast of 2.7 per cent was in line with the average of outside forecasts at that time (Chart 2.4). Forecasts have been revised up since then, with the November average at 3.0 per cent for 2014, the same as our forecast in this *EFO*. The average forecast for 2015 is 2.6 per cent, slightly higher than our current forecast.

Chart 2.4: Forecasts for real GDP growth in 2014



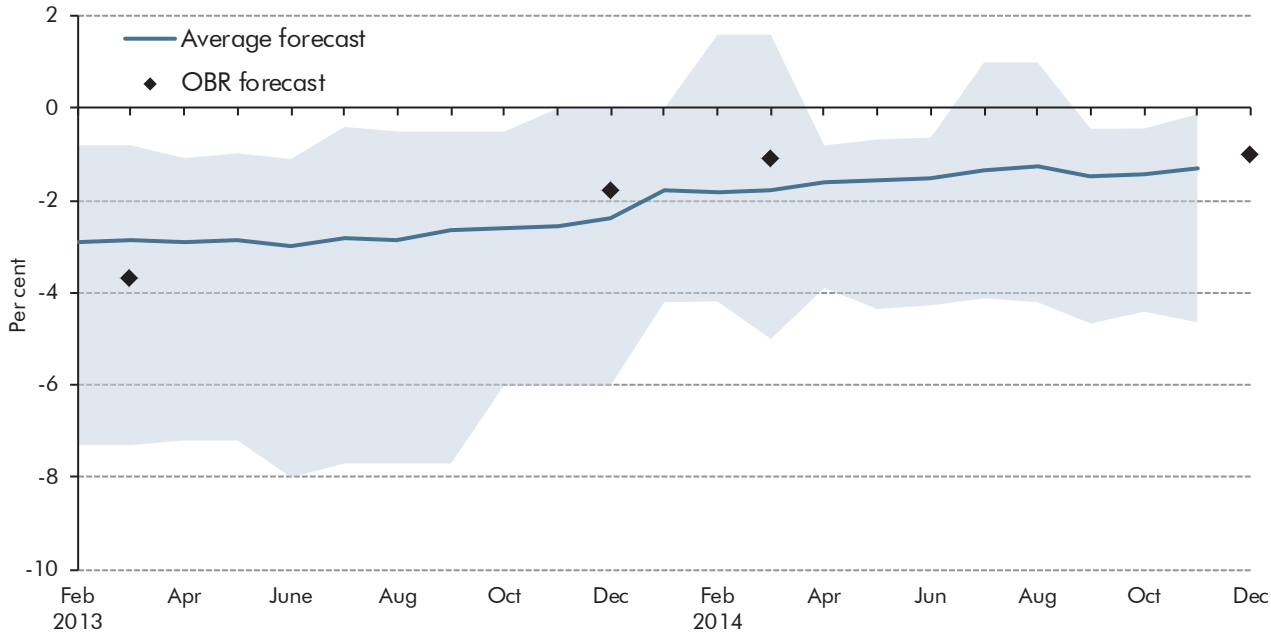
Source: HM Treasury, OBR

2.27 Looking at the smaller sample of medium-term forecasts, the average forecast for GDP growth in 2016 has stayed the same, while 2017 and 2018 have fallen by 0.1 percentage points since March. The forecasts are now 2.4, 2.3 and 2.3 per cent respectively. These are very similar to our current central forecasts of 2.2, 2.4 and 2.3 per cent respectively.

Output gap

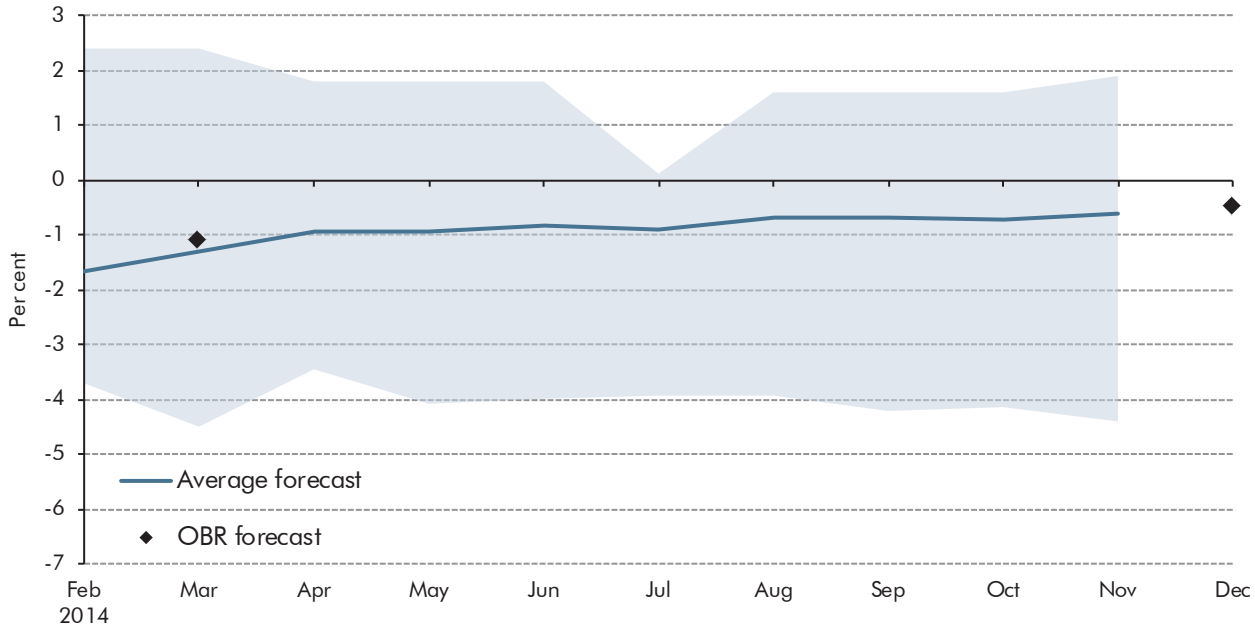
2.28 The average estimate for the output gap in 2014 has narrowed since March (Chart 2.5). The latest is -1.3 per cent, slightly wider than our estimate of -1.0 per cent for the year as a whole. Over the same period, the average forecast for 2015 has narrowed from -1.3 per cent to -0.6 per cent, fractionally wider than our central forecast of -0.5 per cent (Chart 2.6). Output gap forecasts vary much more than GDP growth forecasts.

Chart 2.5: Forecasts for the output gap in 2014



Source: HM Treasury, OBR

Chart 2.6: Forecasts for the output gap in 2015

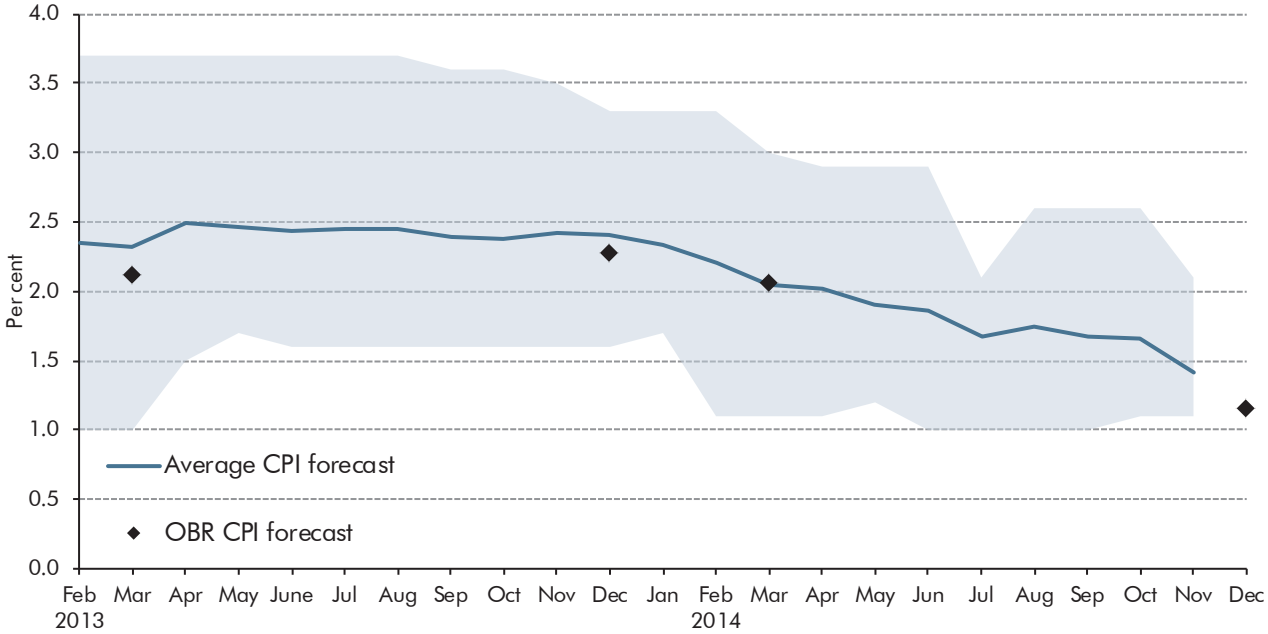


Source: HM Treasury, OBR

Inflation

2.29 The average forecast for CPI inflation in the fourth quarter of 2014 at the time of our March forecast was 2.0 per cent. This has fallen to 1.4 per cent, slightly above our forecast in this *EFO*, reflecting lower recent outturns (Chart 2.7). The average forecast for CPI inflation in the fourth quarter of 2015 is 1.9 per cent, which is higher than our 1.5 per cent.

Chart 2.7: Forecasts for CPI inflation in the fourth quarter of 2014

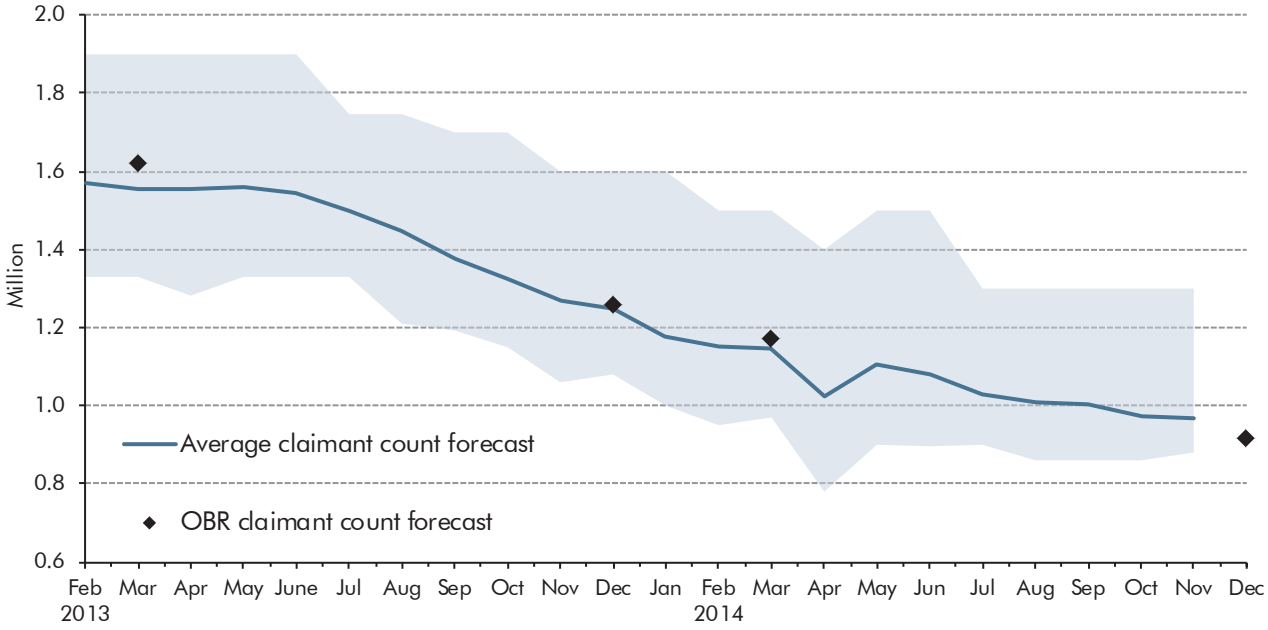


Source: HM Treasury, OBR

Labour market

2.30 The average forecast for claimant count unemployment in the final quarter of 2014 has fallen since our March forecast. It currently stands at 1.0 million, which is 0.1 million lower than in March, but 0.1 million higher than our current forecast (Chart 2.8). The average forecast for employment growth in 2014 has risen from 1.6 per cent in March to 2.4 per cent. Average earnings in 2014 are now expected to rise by 1.2 per cent, compared to 2.3 per cent in March, reflecting the unexpected weakness of earnings growth so far this year.

Chart 2.8: Forecasts for the claimant count in the fourth quarter of 2014



Source: HM Treasury, OBR

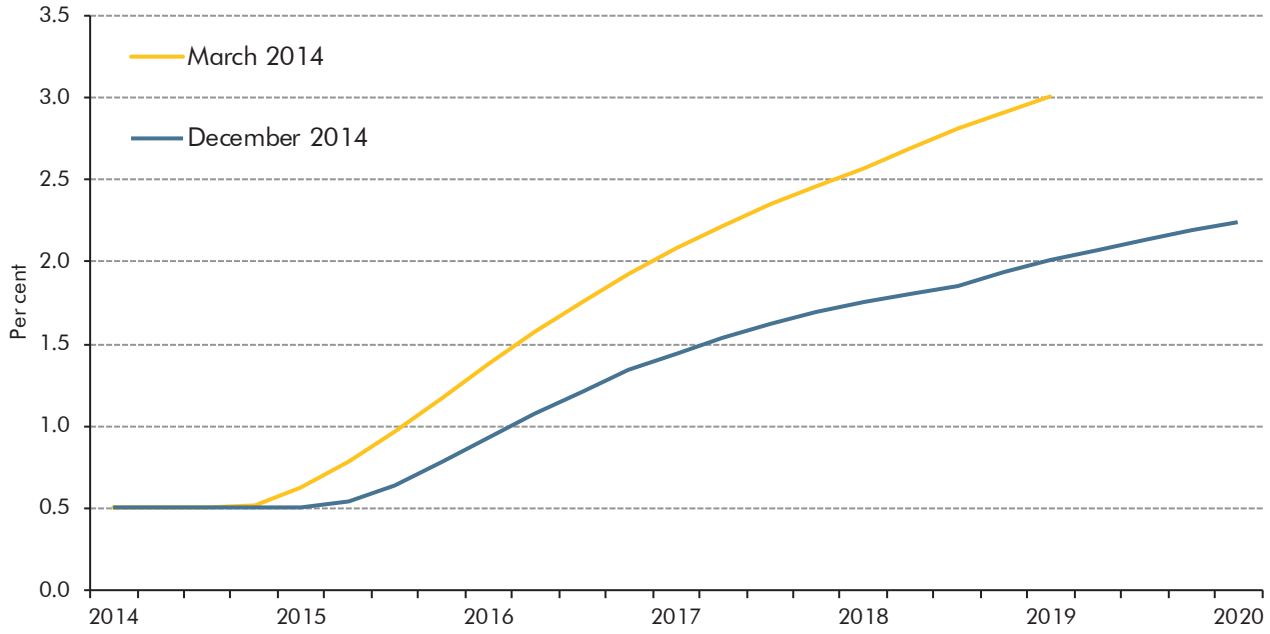
Public finances

2.31 The average forecasts for public sector net borrowing (PSNB) in 2014-15 and 2015-16 have both risen. Medium-term forecasts, compiled in November, suggest PSNB will fall by £18 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.

Market expectations of interest rates

2.32 Expectations of interest rates derived from financial market instruments have direct implications for our forecast, as we assume that monetary policy follows the path implied by financial markets. Relative to expectations in March, markets expect Bank Rate to rise later and by significantly less over the next five years. The first quarter in which a rise in Bank Rate to 0.75 per cent is fully priced in is the fourth quarter of 2015, two quarters later than at the time of the March *EFO*. Bank Rate is now expected to reach 2.0 per cent in the first quarter of 2019, two years later than in March.

Chart 2.9: Market expectation for Bank Rate



Source: Bank of England, OBR

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 3.5);
- 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 3.47) and the associated outlooks for inflation (from paragraph 3.57) 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 3.75); and
- outlines risks and uncertainties (from paragraph 3.121) and compares our central forecast to those of selected external organisations (from paragraph 3.123).

3.2 As described in Chapter 2, the Office for National Statistics (ONS) – in common with statistical agencies across Europe – made significant revisions to National Accounts data over the summer, which included aligning the National Accounts to the latest international guidance, as set out in the European System of Accounts 2010 (ESA10). As a result, our forecast changes since March reflect not just surprises in the data since then, but also the extensive rewriting of history in the latest National Accounts.

3.3 In this *Economic and fiscal outlook (EFO)*, our economy and fiscal forecasts are unfortunately not fully consistent. The inconsistency arises because, after the economy forecast had closed, the Government allocated £1.2 billion of spending from the reserve to the NHS in 2015-16 and changed its total spending assumption for subsequent years in a way that added around £2 billion a year to spending from 2016-17. These changes were relative to the amounts on which our final economy forecast was based and that had been provided in accordance with the forecast timetable agreed between the Treasury and OBR in September.

3.4 Relative to the size of the economy, the amounts of additional spending are small but not negligible. For example, £2 billion would be equal to 0.6 per cent of government consumption and 0.1 per cent of GDP in 2016-17. Had we been informed of this ahead of our final economy forecast, the main impact would have been on the expenditure

composition of GDP. That would have had small, but again not negligible, implications for our fiscal forecast.

Potential output and the output gap

3.5 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 actual growth in GDP as activity returns to a level consistent with maintaining stable inflation in the long term.

3.6 Estimating the size of the output gap allows us to estimate how much of the budget deficit at any given time is cyclical and how much is structural. 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.

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

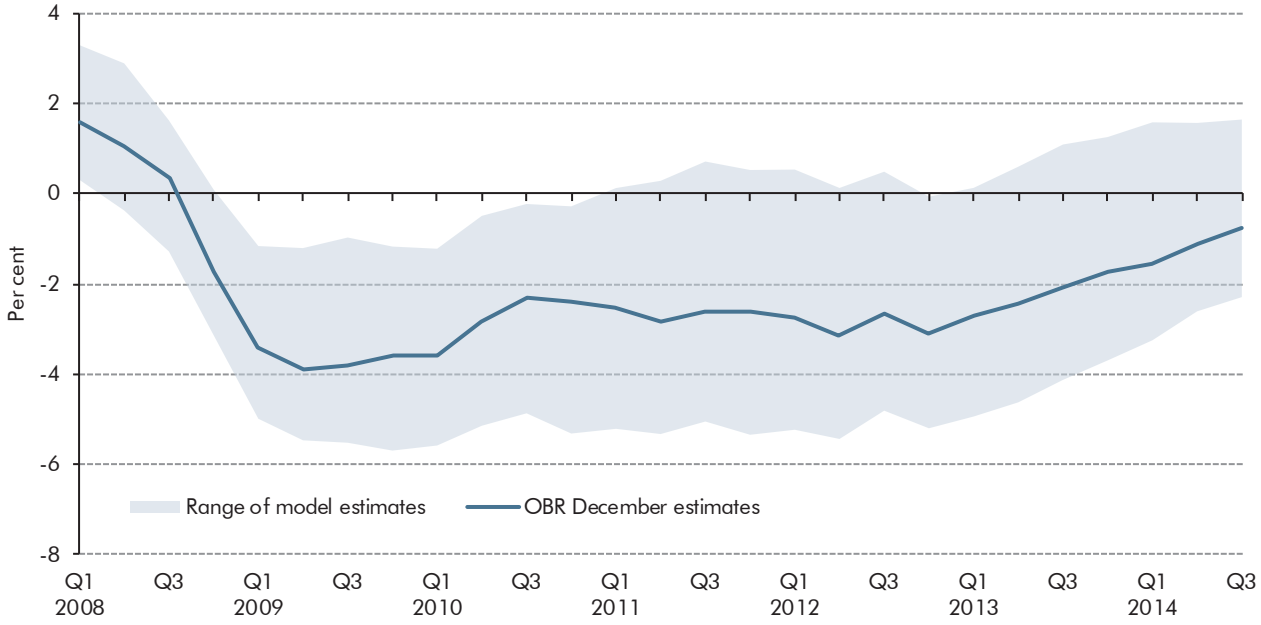
The latest estimates of the output gap

3.8 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 avoids the application of judgement entirely. We therefore consider a broader set of evidence when reaching a judgement on spare capacity.

3.9 Chart 3.1 shows a range of estimates implied by nine of these techniques, as well as our own latest estimates.[1] All of these estimates fell during the course of the recession, and the range widened. The swathe remained relatively stable until early 2013 as actual growth picked up. Most estimates have since narrowed, but the range remains wide, varying from -2.3 to +1.6 per cent for the third quarter of 2014. 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.

[1] 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*.

Chart 3.1: Range of output gap model estimates



Source: OBR

3.10 Our standard cyclical indicators approach implied that the output gap began to narrow in 2012, even though growth remained relatively weak. Our '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 2013. Our 'principal components analysis' (PCA) estimates also suggest a significant narrowing of the gap through 2013, but that the gap has remained stable, and slightly negative, through 2014.[2]

3.11 Chart 3.3 shows the disaggregated PCA series underlying the headline indicator. The PCA weights the various indicators such that more weight is attached to those that display greater commonality and less weight is placed on those that appear to be outliers. The AC weights are determined by sector and income shares and are hence fixed. It appears that:

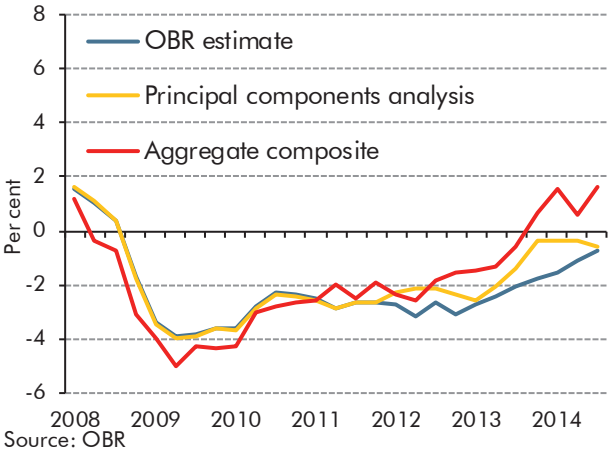
- PCA estimates are increasingly downplaying capacity utilisation indicators that suggest firms are operating at levels associated with overheating. These indicators retain a higher weight in our AC estimates;

- firms experienced additional recruitment difficulties through 2013, but the situation has remained reasonably stable since. Our March 2014 *EFO* highlighted the possibility that some of the tightening during 2013 may have reflected the fact that hiring was gathering pace, making it temporarily more difficult for firms to find staff. The flat picture since, despite further falls in unemployment, is consistent with some of the earlier tightening being temporary. Our PCA estimates are currently placing a high weight on recruitment difficulties indicators and so follow a similar path; and

[2] 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*.

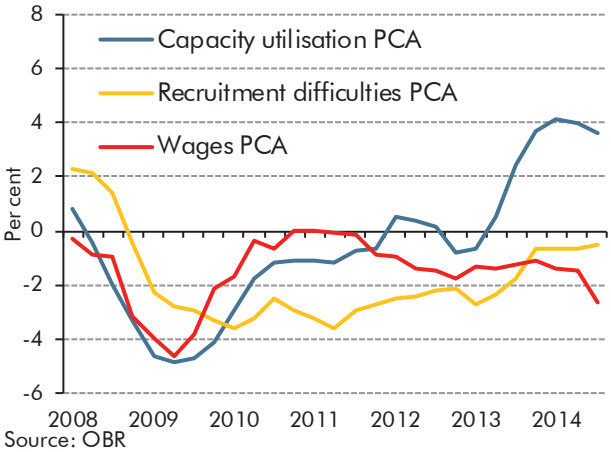
- real wage growth remains weak, mainly reflecting the ongoing weakness of productivity growth. We judge that this has been a largely structural phenomenon, rather than indicative of scope for further catch-up growth.

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



Source: OBR

Chart 3.3: Principal component subsets



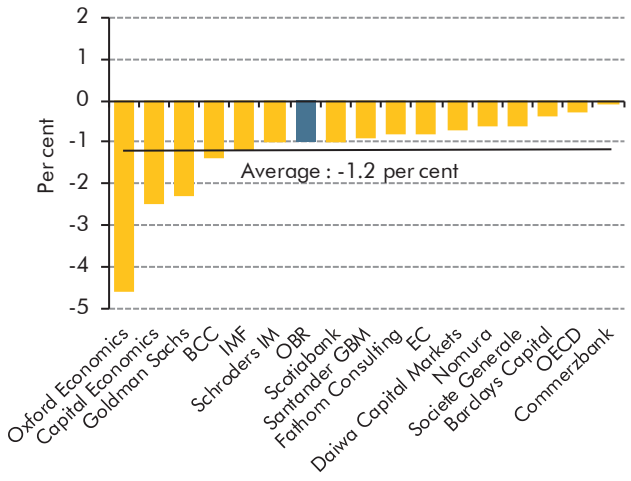
Source: OBR

3.12 Since March, both the unemployment rate and CPI inflation have been lower than expected. Lower inflation could be consistent with there being more slack in the economy, but the decline in recent months appears to be explained more by lower food and commodity prices, and sterling appreciation, than by emerging spare capacity. Pointing to less capacity, the unemployment rate has continued to drop at a steady pace in recent quarters, falling to 6.0 per cent in the third quarter of 2014 relative to our March forecast of 6.8 per cent. That said, the participation rate has fallen slightly over recent quarters, and – although gradually picking up – productivity growth has again been lower than forecast.

3.13 Considering the balance of evidence, we now judge that the output gap was around 0.6 percentage points narrower in the third quarter of 2014 than we forecast in our March *EFO*, at -0.8 per cent of potential output. This is consistent with unemployment 0.8 percentage points lower than forecast, partially offset by a little more scope for further rises in participation and productivity. In the case of productivity, that scope is fractionally less than the shortfall since our last forecast, implying a small hit to potential output.

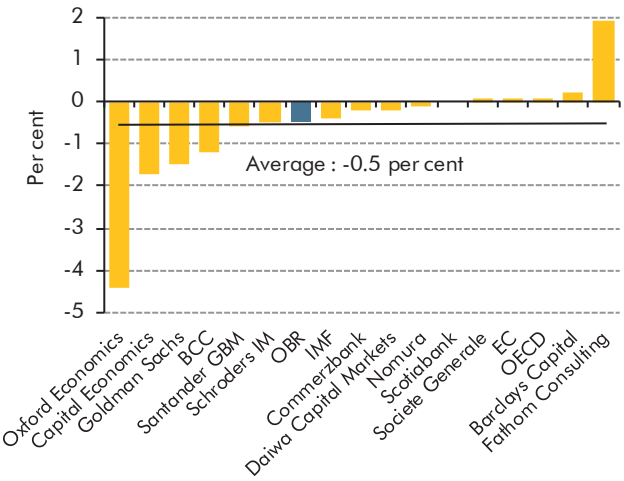
3.14 Charts 3.4 and 3.5 compare our central estimates for 2014 and 2015 to those produced by other forecasters, as set out in the Treasury's November *Comparison of independent forecasts,* with updates where known. The average estimate is -1.2 per cent in 2014 and -0.5 per cent in 2015, slightly wider than our central estimate of -1.0 per cent for 2014 and in line with our forecast for 2015. However, due to the skew of the distribution, the median estimates are marginally narrower than ours, at -0.5 per cent and -0.2 per cent 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



Source: HM Treasury, plus updates where known.

3.15 Of the -0.8 per cent output gap we estimate for the third quarter of 2014, we attribute -0.6 percentage points to the unemployment rate being above its sustainable rate and -0.1 percentage points to the activity rate lying below its potential. Average hours worked have been on a long-term declining trend, 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. So we now assume that trend average hours have been flat since the start of the recession. This still implies an average hours gap of +1.0 percentage points, suggesting that some of the recent rise will be temporary. This is largely offset by output-per-hour falling 0.9 percentage points below its potential (i.e. cyclical weakness in actual productivity on top of the large structural shortfall since the financial crisis).

The growth of potential output

3.16 In our March *EFO*, we forecast a gradual strengthening of potential output growth over the forecast period and that remains our central judgement. The growth of potential productivity per hour remains below its historical average throughout the forecast, reflecting 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 for some years.

3.17 With actual productivity again weaker than expected, we now judge that this recovery in trend productivity will be more gradual. 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. In Chapter 5, we consider the possible fiscal implications of productivity growth remaining persistently weak (or recovering very strongly) over the next five years.

3.18 We expect relatively weak productivity growth in the near term to be partly offset by trend average hours worked remaining flatter for longer, consistent with below-average productivity growth weighing on income growth. We assume that the downward trend will reassert itself from the middle of 2016, as annualised hourly productivity growth picks up to around 2 per cent. The net effect is a very small reduction in trend output, with potential output growth between the end of 2013 and the beginning of 2019 revised down by around 0.2 percentage points since our March forecast.

Table 3.1: Potential output growth forecast (annual growth rate, per cent)

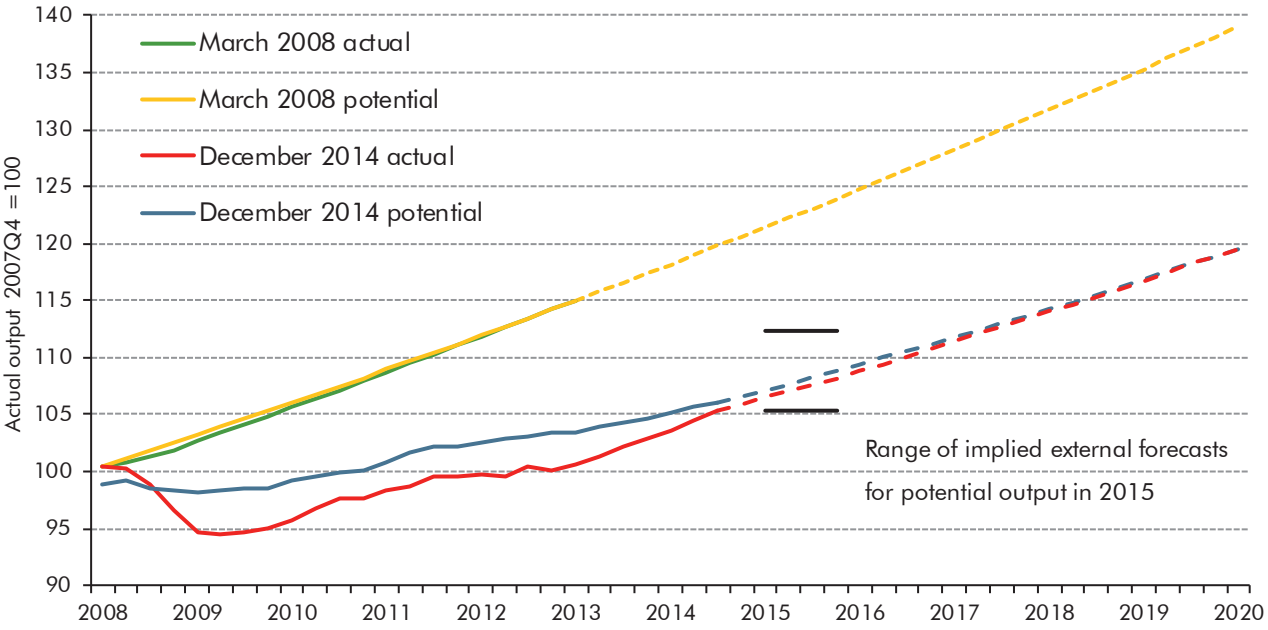
	Potential productivity[1]	Potential average hours	Potential employment rate[2]	Potential population[2]	**Potential output[3]**
2014	1.0	0.0	0.1	0.7	1.7
2015	1.4	0.0	0.0	0.6	2.0
2016	1.7	-0.1	-0.1	0.6	2.1
2017	1.9	-0.2	-0.1	0.5	2.2
2018	2.0	-0.2	-0.1	0.5	2.2
2019	2.1	-0.2	-0.1	0.4	2.3

[1] Output per hour.
[2] Corresponding to those aged 16 and over.
[3] Components may not sum to total due to rounding.

3.19 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. As set out in our October 2014 *Forecast evaluation report (FER)*, the potential size of the labour force appears larger than we projected in June 2010. A small fraction of this is explained by a bigger population, as net inward migration has been higher than assumed, but it mainly reflects higher participation rates.

3.20 Our latest forecast assumes that potential GDP was over 10½ per cent lower than an extrapolation of the Budget 2008 forecast by 2013-14 and that it will be 14 per cent below that extrapolation by 2019-20. These numbers are a little smaller than implied in March, following upward revisions to actual output during the recession and initial stages of the recovery. Our judgement about the output gap is unchanged over that period, implying equal upward revisions to potential. Even the most optimistic external assessments 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

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 November 2014 *Inflation Report*, the MPC forecast – on the basis of market interest rate expectations – that CPI inflation would reach 1.8 per cent by the end of 2016 and 2.0 per cent by the end of 2017. In terms of forward guidance on policy, the MPC's expectation was that *"given the likely persistence of the headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so only gradually and to remain below average historical levels for some time to come."*

3.22 Since our March forecast there have been developments in macro-prudential policy that aim to complement monetary policy. In its June 2014 *Financial Stability Report*, the Financial Policy Committee (FPC) recommended that mortgage lenders should apply a stress test to see whether households could cope with a 3 percentage point increase in Bank Rate within the first 5 years of their mortgage. The FPC also recommended that mortgage lenders should limit mortgages with a loan-to-income ratio above 4.5 to only 15 per cent of new mortgages. These recommendations were not expected to have an immediate impact, but would act as insurance against any significant loosening in lending standards. Subsequent statements by the FPC recommended that the Treasury provide them with new powers over the setting of loan-to-value and loan-to-income ratios for bank lending as well as setting maximum leverage ratios for major financial institutions.

3.23 The Treasury and the Bank of England have also modified and extended the Funding for Lending Scheme. Box 3.1 sets out further details.

Fiscal policy and Autumn Statement measures

3.24 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 imply 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.

3.25 As set out in Box 3.1, the net effect on GDP of measures announced in Autumn Statement 2014 is expected to be small.

Box 3.1: The economic effects of policy measures

This box considers the possible effects on the economy of the policy measures announced in Autumn Statement 2014. More details of each measure are set out in the Treasury's Autumn Statement document. Our assessment of the fiscal implications can be found in Chapter 4.

The Government has announced a number of measures taking effect between 2014-15 and 2019-20 that are expected to have a 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 immediate reforms to **stamp duty land tax** announced in the Autumn Statement are likely to have significant effects on the UK housing market, complicated by the subsequent further change to rates and thresholds in Scotland that has already been announced by the Scottish Government (subject to approval by the Scottish Parliament) to take effect in April next year. The main effect is likely to be distributional – house prices and transactions will be lifted at lower prices (where the effective tax rate has been reduced) and will be depressed at higher prices (where the effective tax rate has been increased). These effects are reflected in the costing of the measure (described in Box 4.5) rather than via our economy forecast.

We have, however, increased the overall volume of property transactions by an eventual 1.1 per cent to reflect the fact that the volume-weighted effective tax rate has been reduced – i.e. that the costs associated with the vast majority of transactions will be slightly cheaper, more than offsetting the small number where they will be significantly more expensive. As property transactions contribute directly to the measure of residential investment in GDP, we have also adjusted our residential investment forecast upwards by an eventual 0.2 per cent. We assume that this affects the composition of GDP rather than the overall size of the economy, since we have not assumed that the policy change raises whole economy productivity. It is possible that the greater efficiency associated with a marginal 'slice' transaction tax, relative to the previous 'slab' structure, could positively affect productivity by increasing labour mobility. But evidence on

this effect is limited and highly uncertain. For example, research by the London School of Economics in 2012 found that while higher rates of stamp duty reduce households' propensity to move, the adverse effect was confined to short-distance and non-job related moves – an impact less likely to have direct implications for GDP.[a]

We have not adjusted our economy forecast in light of the further changes to the **rules governing people's access to their pension assets** announced in the Autumn Statement, or our updated assessment of the effect of the changes announced in Budget 2014. But it is worth reiterating that the effects of the large financial flows that are likely to result from the changes are highly uncertain. These include flows out of pension assets for some people incentivised by the reduction in the tax charge and the removal of the effective requirement to annuitise. These could flow into other financial and real (e.g. housing) assets or immediate spending. Alternatively, there may be flows into pension assets for some people incentivised by the more flexible access to that tax-efficient saving in the future. These could reduce amounts that would have otherwise flowed into other financial and real assets, or spending if those people saved more to increase their post-tax returns from this saving. We have assumed that the effects will be offsetting. But this reflects the lack of any strong evidence to assume that one effect will be larger than the other. In reality, the effects are very unlikely to net off precisely.

The Treasury and the Bank of England have announced that the **Funding for Lending Scheme** will be extended for a further year and that the incentive structure of the scheme will be focused entirely on lending to SMEs. We would expect this to reduce the cost of borrowing for SMEs at the margin. Since SMEs make up a relatively small proportion of total business investment – and given the uncertainty around our forecast – we have not made a specific adjustment to the forecast for this change. But it should support the strong growth in investment we expect in 2015.

[a] Hilber and Lyytikäinen (2012): *SERC discussion paper 115: The effect of the UK stamp duty land tax on household mobility*.

Credit conditions

3.26 Domestic financial and credit market conditions continue to improve, with the price of credit generally continuing to fall and volumes rising. Somewhat better prospects for the euro area financial system, the strengthening of the UK economy and the availability of the FLS have all helped to lower perceived risks to UK banks' balance sheets and contain funding costs.[3] We assume that the current, relatively benign, environment for bank funding will be sustained across the forecast period.

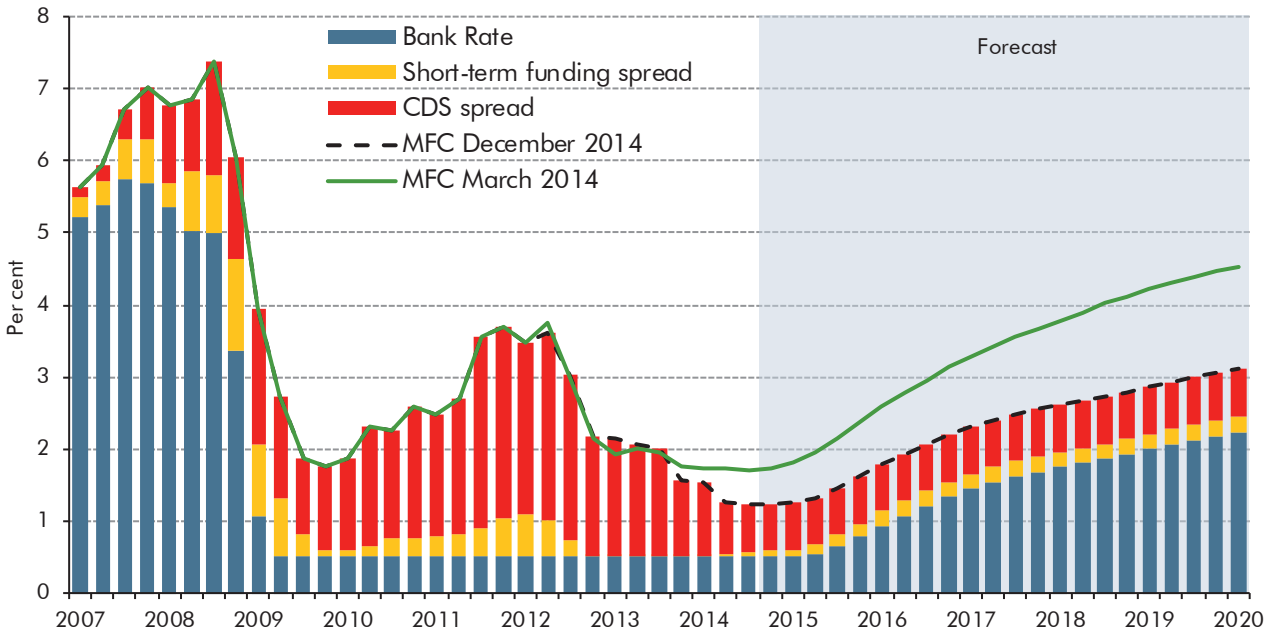
The price of credit

3.27 We expect banks' variable-rate funding costs (the benchmark for new variable-rate mortgages) to rise in late-2015, when markets expect the first Bank Rate rise (Chart 3.7). Costs then rise gradually, consistent with a gradual normalisation of monetary policy. Relative to our March forecast, lower Bank Rate expectations (Chart 3.8) and a reduced

[3] For example, see: Bank of England, *Systemic Risk Survey*, 2014H1. This shows that the perceived probability of a high impact event in the UK financial system has fallen to its lowest level since the survey began in 2008.

assumption for medium-term funding spreads mean that there has been a significant fall in our forecast for funding costs.

Chart 3.7: Banks' marginal funding costs

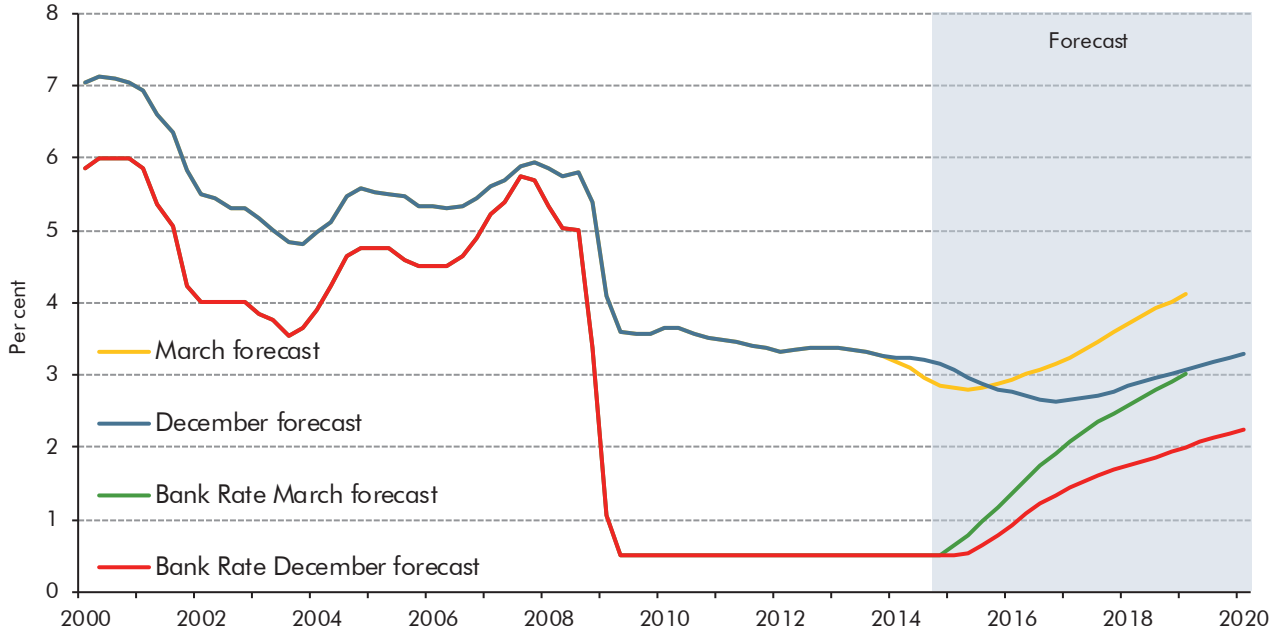


Source: Bank of England, Thomson Reuters Datastream, OBR

3.28 Although new mortgage rates have fallen significantly since mid-2012, 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 (usually 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 more slowly than Bank Rate over the forecast period (Chart 3.8).

3.29 In the third quarter of 2014, the average mortgage rate was 3.2 per cent versus our March forecast of 3.0 per cent, as banks' implied margins unexpectedly increased. In the near term, we expect margins to fall back towards more normal levels, putting downward pressure on mortgage rates. Thereafter a rise in marginal funding costs puts upwards pressure on average mortgage rates as Bank Rate rises. Mortgage rates are lower in the medium term than in March, in line with lower Bank Rate expectations and funding costs.

Chart 3.8: Average mortgage rate



Source: Bank of England, OBR

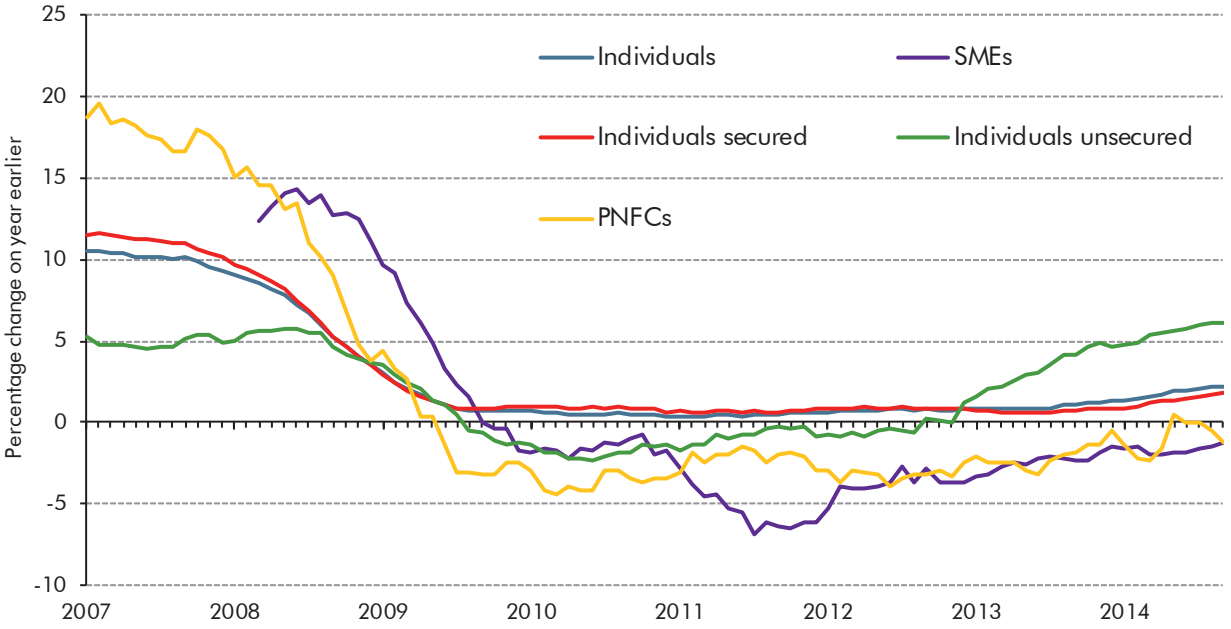
3.30 Interest rates on business loans vary much more than mortgage rates because companies have a wider range of characteristics relevant to lending decisions than households. In aggregate, businesses appear to have benefitted much less from the improvement in bank funding conditions than households. Loan interest rates for small businesses (SMEs) appear to have fallen slightly in recent months. Overall, we expect the spread of corporate loan rates over reference rates to narrow over the forecast, as profitability and perceptions of creditworthiness improve.

The flow of credit

3.31 Household borrowing continues to pick up, mainly as rising house prices lead to more secured lending. We expect mortgage debt to continue rising over the forecast period, as house prices continue to rise and transactions increase back towards their pre-crisis turnover rate. Strong growth in car purchases has contributed to a recent rise in unsecured lending, which in the third quarter of 2014 increased faster than in 2007 and 2008.

3.32 Bank lending to non-financial companies continues to fall, although at a slower rate (Chart 3.9). Large companies continue to choose non-bank sources of funds as favourable wholesale market conditions have encouraged strong net issuance of bonds. Recent improvements in loan spreads, fees and the availability of bank credit, and further expected improvements, suggest stronger demand for and supply of loans to companies in 2015.

Chart 3.9: Net lending to the wider economy



Source: Bank of England. SMEs data combines two separate series.

House prices

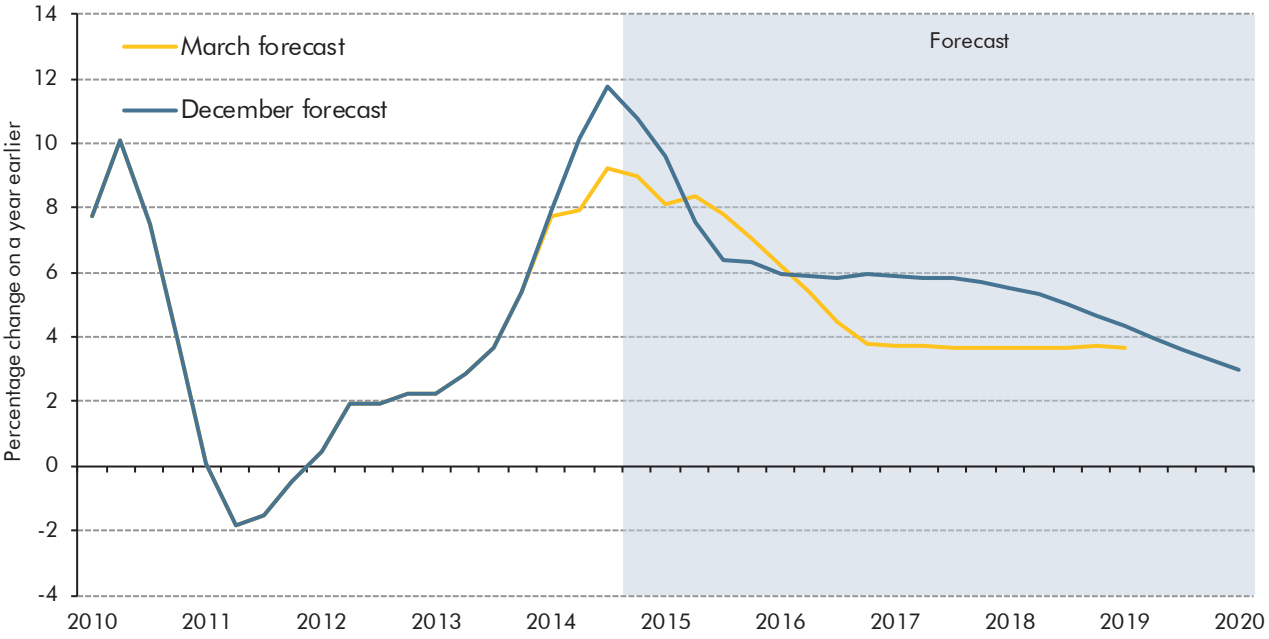
3.33 House prices have continued to accelerate since our March forecast, with year-on-year growth reaching 11.7 per cent in the third quarter of 2014, compared to our March forecast of 9.2 per cent (Chart 3.10). Housing market indicators suggest this will be the peak in annual house price growth and our forecast has it slowing from the fourth quarter.

3.34 We have changed our method for forecasting house prices slightly since March. We still base our quarter-ahead forecasts on contemporaneous housing market indicators and those for the subsequent two years on our house price model. However, rather than then converging on average earnings growth, we now base the entire medium-term forecast on the house price model. This means that our house price forecasts are more closely tied to expectations of the fundamental drivers of house prices and any near-term deviations can be unwound over the entire forecast period. Relative to our March forecast, there is additional pressure from the demand fundamentals with little change in supply. The additional fundamental housing demand mainly comes from a lower discount rate, as mortgage interest rates are expected to be lower over the forecast period.[4]

3.35 We therefore expect stronger house price growth than we forecast in March. The level of house prices in the first quarter of 2019 is 5.9 per cent higher than our March forecast. In total, house prices are expected to rise by 31.4 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 would be 8.8 per cent higher and the ratio of house prices to average earnings 9.5 per cent higher.

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

Chart 3.10: House price inflation forecast



Source: ONS, OBR

World economy

3.36 World GDP grew by 3.2 per cent in 2013, more than we estimated at the time of our March forecast. But we now expect it to grow by 3.3 per cent in 2014, compared with a forecast of 3.8 per cent in March. The downward revision reflects weaker-than-expected outturn data in some of the major economies during the first half of 2014.

3.37 The euro area economy has remained weak. In the third quarter of 2014, GDP was just 0.8 per cent up on a year earlier. GDP was 1.2 per cent up on a year earlier in Germany, 0.4 per cent up in France and 0.4 per cent down in Italy. We now expect euro area growth of 0.8 per cent in 2014 as a whole and 1.3 per cent in 2015, slightly below our March forecast. We have made further small downward revisions across the rest of the forecast.

3.38 Persistently low inflation – and the possibility of deflation – in the euro area remain a risk to the global and UK outlook. Euro area core inflation in November was 0.7 per cent, the same as October and down from 0.8 per cent in September. 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. Unemployment in the euro area has been steady at 11.5 per cent in recent months.

3.39 Adverse weather conditions in the US contributed to GDP falling by 0.5 per cent in the first quarter of 2014, but it has bounced back in the second and third quarters. In the third quarter, GDP grew 1.0 per cent on the previous quarter. The US Federal Reserve has now concluded asset purchases under its latest quantitative easing programme, but it is not yet clear to what extent or when it might start to reduce the size of its asset holdings in the

future. The eventual path of monetary policy will have an impact on US output growth and may also have wider spillover effects on emerging market economies.

3.40 GDP in China was up 7.3 per cent on a year earlier in the third quarter of 2014. GDP growth has been slowing in China in recent years, following three decades in which it averaged around 10 per cent a year. There have also been widespread falls in Chinese house prices in recent months. In its latest *World Economic Outlook*, which informs our world forecast, the IMF revised down its forecast for Chinese GDP growth from 2015 onwards.

Box 3.2: Euro area rebalancing

In previous *EFOs* and again in this forecast, we have identified the ongoing adjustment in the euro area as a risk to the UK economic outlook. This adjustment has progressed since the late 2000s recession, but remains far from complete.

Chart A presents four different indicators of macroeconomic and banking sector adjustment that are among those used by commentators to monitor how rebalancing is progressing. They compare developments in Germany with those on average in Greece, Italy, Spain and Portugal as a representative composite 'periphery' economy.

Indicators of macroeconomic adjustment include:

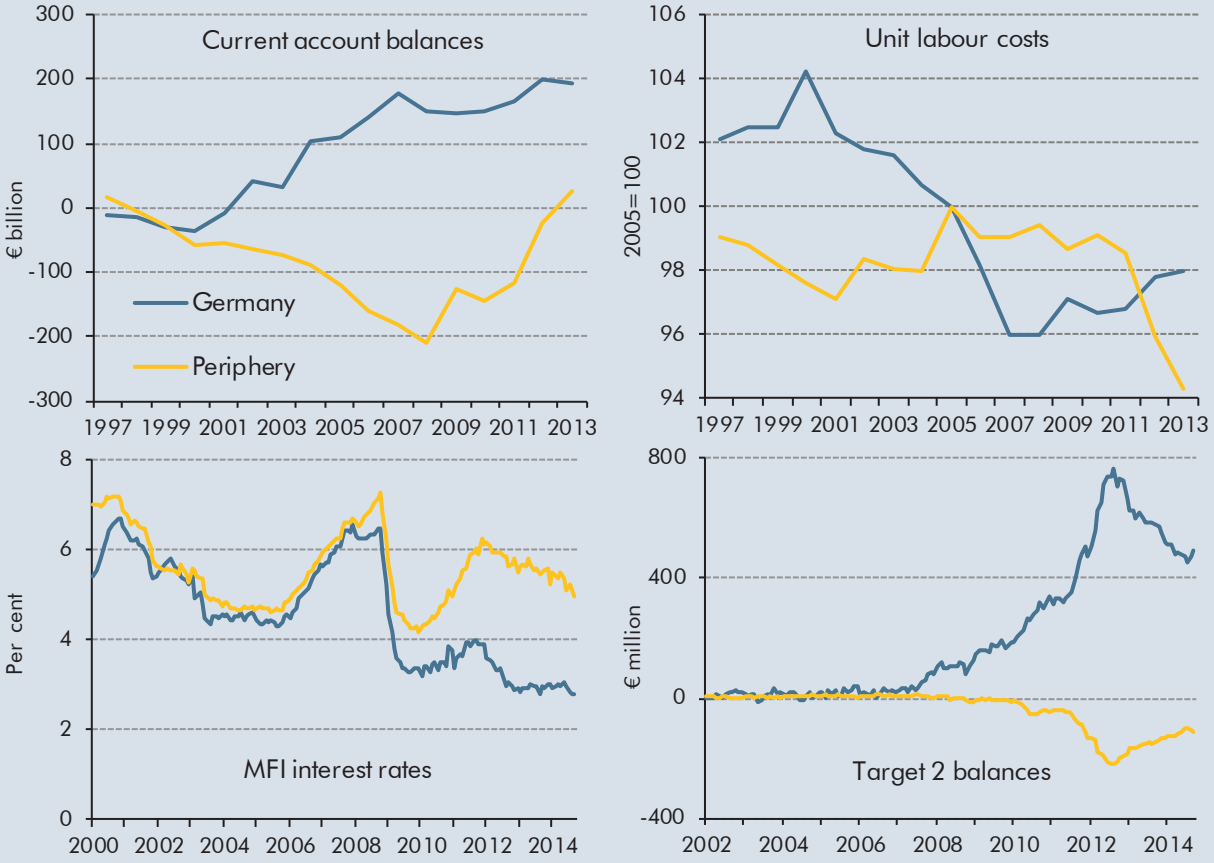
- **current account balances**: these illustrate the balance of domestic demand and supply in individual economies. Periphery deficits widened up to 2008 and have narrowed since, while surpluses in Germany have continued widening. A recent IMF paper argued that the adjustment there has been to date has been largely cyclical and relative to non-EA countries. Given that the EU accounts for over 40 per cent of UK exports, this will have weighed on the UK economy via weakness in external demand.[a]
- **relative unit labour costs**: these illustrate the relative competitiveness of economies. From the introduction of the euro in 1999 up to the crisis, unit labour costs fell substantially in Germany but increased in the periphery. Unit labour costs have fallen dramatically in the periphery since 2011 as a result of internal devaluation and have increased in Germany over the same period, showing progress in rebalancing.

Indicators of banking sector adjustment include:

- **interest rates paid by the private sector**: these illustrate the extent to which banking sector imbalances are affecting domestic private sectors. Interest rates paid by companies in the periphery and Germany have diverged since the financial crisis, with those in the periphery substantially higher. The spread has narrowed somewhat since the ECB's pledge to do 'whatever it takes' to preserve the euro in July 2012, but a large part of the difference remains; and
- **'Target2' balances in the euro area central banking system**: Target2 is the payment system that processes interbank transfers in the EU, with imbalances reflecting the extent to which commercial banks need to draw on the support of their national central banks. The German Bundesbank accrued large surpluses on these balances between 2008 and

2012, with corresponding deficits at the central banks of periphery economies. These disparities have since narrowed, but remain higher than their pre-crisis levels.

Chart A: Indicators of euro area rebalancing



Source: Eurostat, IMF International Financial Statistics

[a] Tressel and Wang (2014): *IMF working paper: Rebalancing in the euro area and cyclicality of current account adjustments*.

World trade

3.41 We expect world trade to grow more slowly in 2014 than we forecast in March, reflecting weaker global GDP growth. We have revised down world trade growth in each year of the forecast period.

3.42 UK export markets are expected to grow more slowly than world trade in 2014 because economies that have experienced slower-than-expected growth in 2014, notably the euro area, make up a larger share of UK exports. Over the full forecast period, UK export markets are expected to grow slightly more slowly than world trade due to the higher weight of slower-growing advanced economies in the UK's export markets. For example, China makes up around 10 per cent of world trade but only 3.4 per cent of the UK's export markets.

Other conditioning assumptions

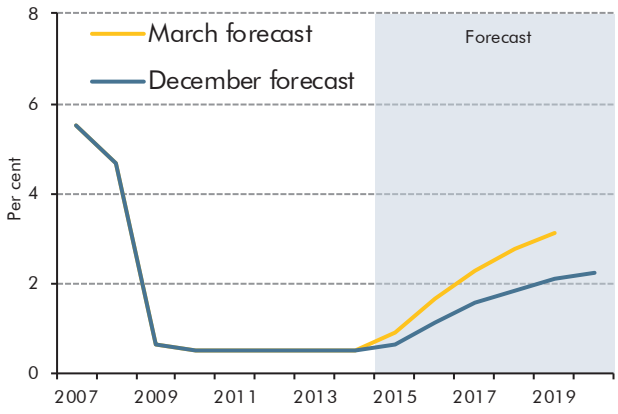
3.43 We use conditioning assumptions for interest rates, the exchange rate, oil prices and equity prices. The following charts show the assumptions used in this *EFO* and how they have moved since our March *EFO*. We have not made any methodological changes since March.

3.44 There have been quite large changes in market expectations since March. In particular:

- Bank Rate expectations have fallen. The first increase is now expected in late, rather than early, 2015. Bank Rate expectations are 1.0 percentage points lower than in March for the first quarter of 2019 and only reach 2.2 per cent by the first quarter of 2020; and

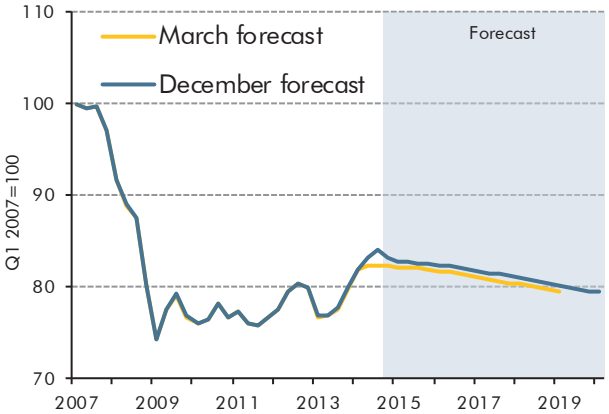
- the oil price has fallen sharply in recent months and reached $79.1 in the 10 days to 21 November. The futures curve has fallen slightly less than spot prices, but our conditioning assumption is still 13 per cent lower than March by the first quarter of 2019.

Chart 3.11: Bank Rate assumption



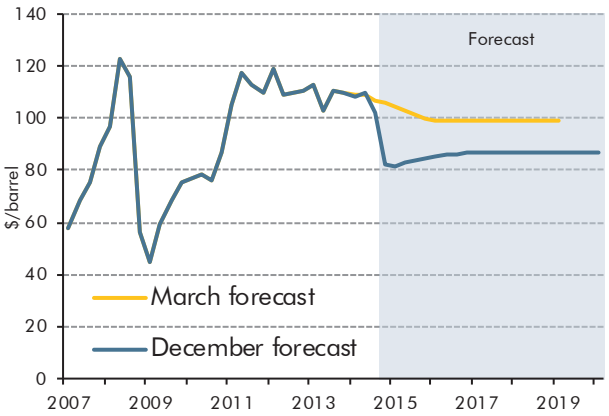
Source: Bank of England, OBR

Chart 3.12: Sterling effective exchange rate assumption



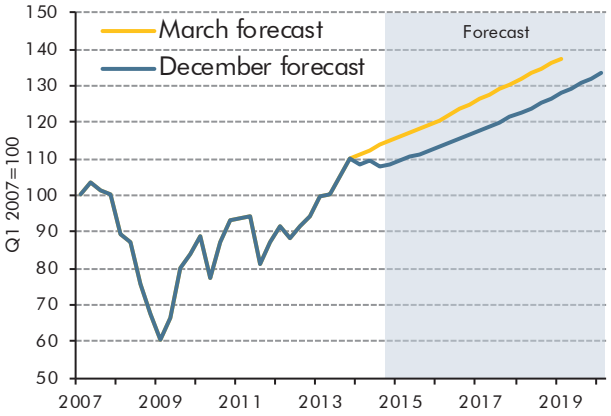
Source: Bank of England, Bloomberg, OBR

Chart 3.13: Oil price assumption



Source: Thomson Reuters Datastream, OBR

Chart 3.14: Equity prices assumption



Source: Thomson Reuters Datastream, OBR

Summary

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

- monetary policy remains very loose and does not begin to tighten until late-2015;
- 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 Autumn Statement have a negligible overall impact on demand and 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 March; and
- financial markets are stable and commodity prices recover slightly from recent falls.

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

The pace of the recovery

3.47 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 output gap closes.

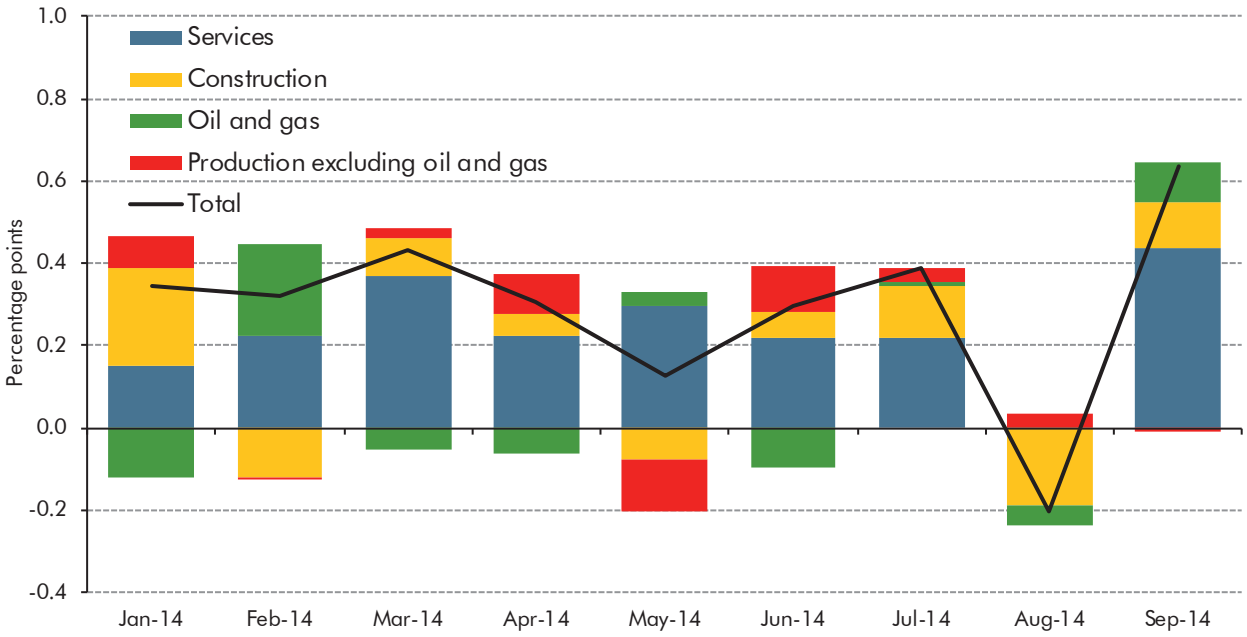
The short-term outlook for GDP

3.48 The economy grew by 0.9 and 0.7 per cent in the second and third quarters of 2014 respectively, both stronger than we expected in March. The outturn data for the first three quarters of 2014, together with our estimate for the final quarter, has led us to raise our forecast for GDP growth in 2014 as a whole from 2.7 per cent in March to 3.0 per cent.

3.49 On a monthly basis, Chart 3.15 shows steady contributions to growth from the services sector in the first half of 2014. Contributions from the construction and production industries were more volatile, as in 2013. Monthly output fell in August, largely reflecting the volatile path of construction sector output through the third quarter. The Markit/CIPS *Purchasing Managers' Index* (PMI) data for September and October also indicated weaker growth in the services sector in particular. Reflecting this evidence of slowing momentum, we expect growth in the fourth quarter of 0.6 per cent. This is in line with our March forecast.

3.50 We expect momentum in GDP growth to continue easing through 2015, as private consumption growth slows more in line with household income growth. In the first quarter of 2015, we expect GDP to grow by 0.6 per cent. We then expect growth to slow to 0.5 per cent a quarter over the rest of the year, compared to 0.6 per cent a quarter in March. This implies growth of 2.4 per cent in 2015 as a whole, slightly up on March because stronger-than-expected growth through 2014 implies a higher starting point.

Chart 3.15: 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
December forecast[1]	0.7	0.9	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.6	0.6	0.6
March forecast[2]	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.7	0.7
Change [3]	*0.0*	*0.3*	*0.1*	*0.1*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*

[1] Forecast from fourth quarter of 2014.
[2] Forecast from first quarter of
[3] Changes may not sum due to rounding.

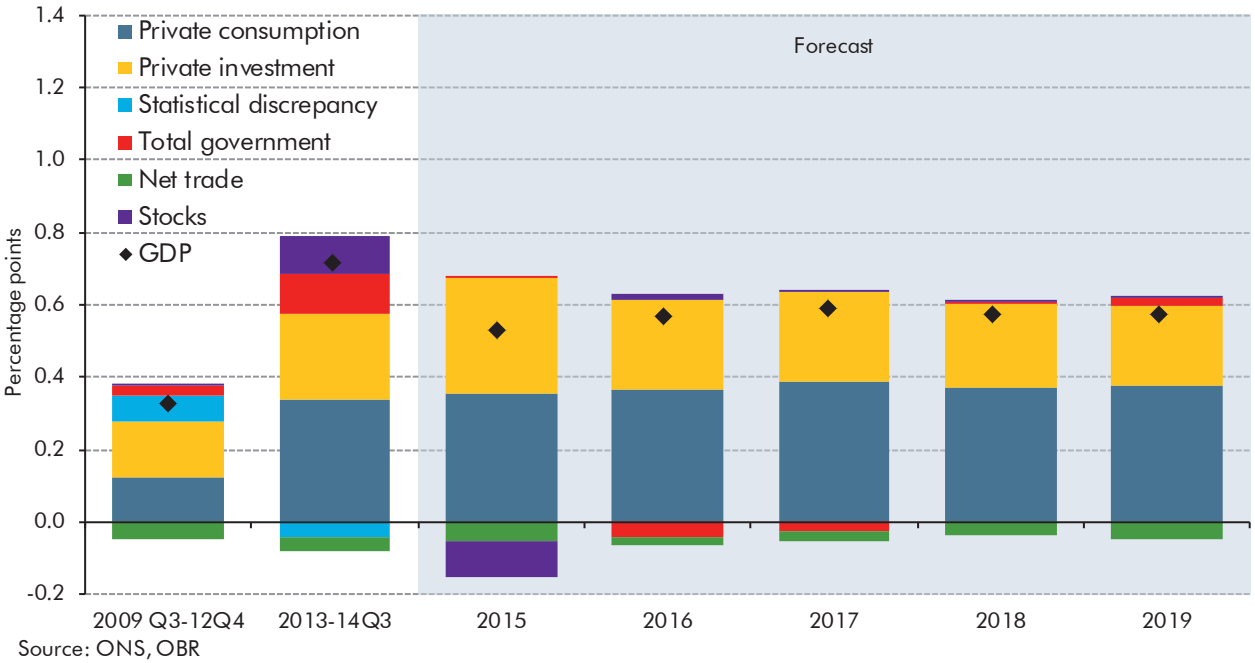
The medium-term outlook for GDP

3.51 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 that we discussed in the previous section all inform that judgement.

3.52 The latest data continue to suggest a significant pick-up in activity in 2013 and the first three quarters of 2014. Quarterly GDP growth has averaged 0.7 per cent since the first quarter of 2013, compared to just 0.3 per cent between the end of the recession and the final quarter of 2012. Much of the increase in growth is attributable to a pick-up in consumer spending, as well as an acceleration in business investment, which on revised data shows a much stronger recovery since the end of the recession, though it is estimated to have fallen in the third quarter of 2014. Continued weakness of productivity, real income and UK export markets over the past two years make it difficult to explain why growth picked up as sharply as it did. The most likely explanation is a general improvement in credit conditions and

confidence, together with a strengthening housing market, supporting spending through reduced saving, plus slightly less of a drag from fiscal consolidation.

Chart 3.16: Contributions to average quarterly GDP growth

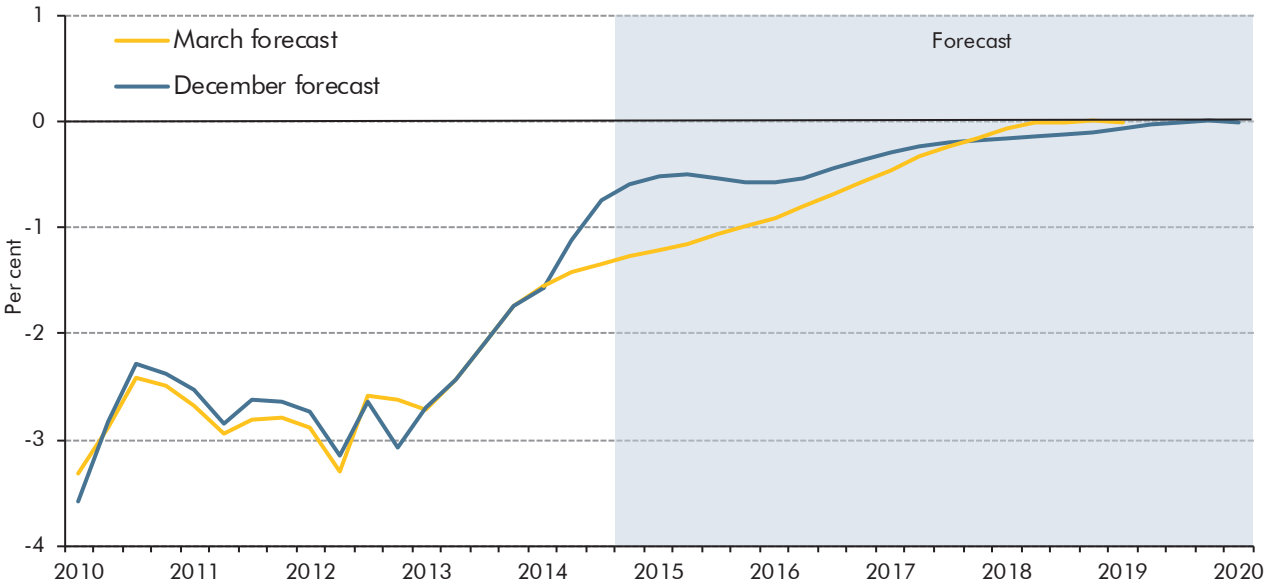


Source: ONS, OBR

3.53 The deterioration in the outlook for the euro area and the appreciation of sterling means that we expect net trade to subtract from growth in 2015, while the contribution from consumption is expected to shrink as spending falls back in line with relatively weak real income growth. Consequently we expect the quarterly rate of GDP growth to fall back to around 0.5 per cent from the second quarter of 2015. As real incomes and export markets gradually improve, growth is expected to pick up again to around 0.6 per cent a quarter from mid-2016 onwards, although the mechanical effect of relatively weak growth at the end of 2015 means that calendar year growth is slightly lower in 2016 than in 2015.

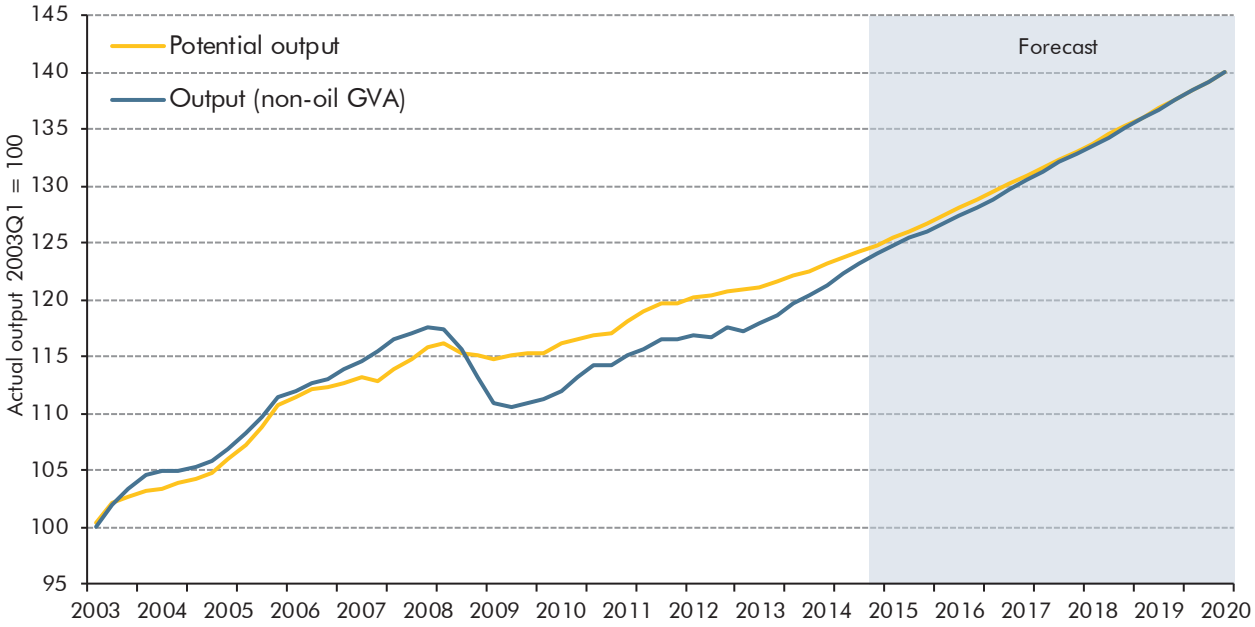
3.54 We have not revised our estimates of the output gap up to the end of 2013 significantly, so most of the upward revision to the GDP data since the recession is judged to be structural rather than cyclical. Our forecast for the output gap from 2014 is narrower than our March forecast, largely reflecting our judgement that spare capacity in the labour market has been taken up faster than expected. As output growth eases, we expect the output gap to remain broadly stable through 2015, gradually closing from 2016 as GDP growth picks up. The output gap is expected to close by the third quarter of 2019. That it does not close more quickly reflects a number of headwinds to growth over the medium term, including relatively slow growth in productivity and real incomes, a pick-up in the pace of fiscal tightening, the gradual 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 3.17: The output gap



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 3.18: Projections of actual and potential output



Source: ONS, OBR

3.55 Our forecast for cumulative real GDP growth between the fourth quarter of 2013 and the start of 2019 is slightly lower than our March forecast (13.4 versus 13.7 per cent), as a narrower initial output gap implies less scope for above-trend growth in the forecast period. Table 3.3 summarises the expenditure composition of our real GDP forecast. Relative to our March forecast, we expect weaker business investment growth – partly reflecting the fact that business investment has been revised higher over the past. Conversely, we have revised up real government consumption growth from 2015, having revisited our assumptions about

the way cuts in cash spending will affect growth in real GDP and the GDP deflator. Later sections of this chapter discuss the expenditure components of GDP in more detail.

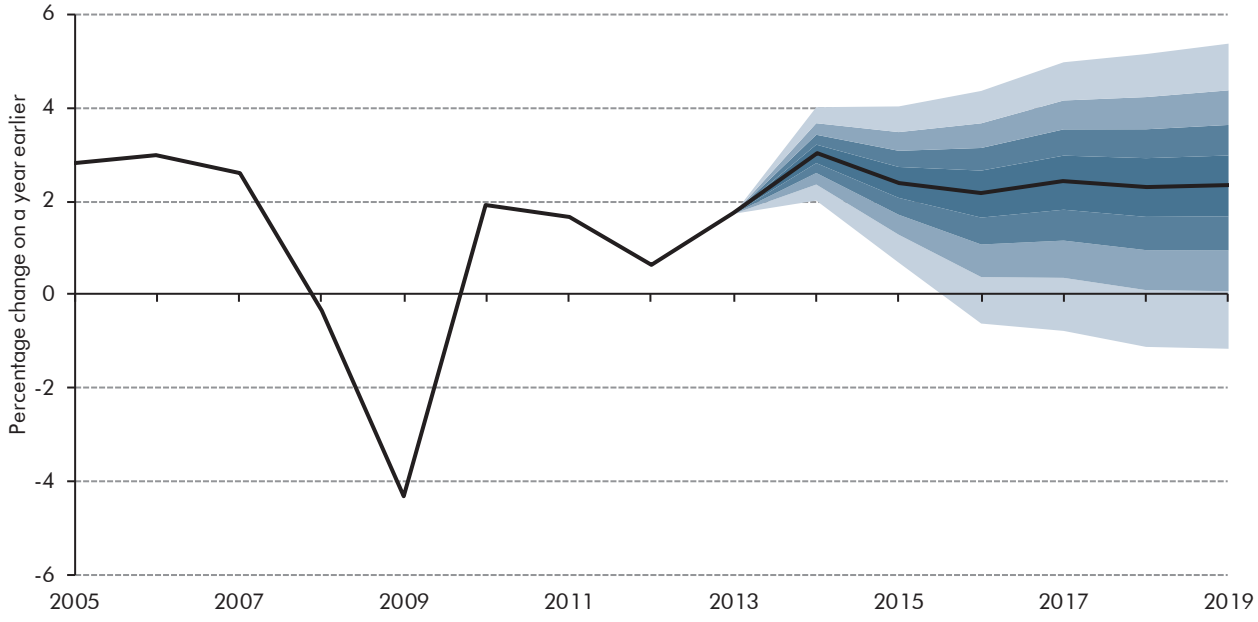
Table 3.3: Expenditure contributions to growth

	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
GDP growth, per cent	**1.7**	**3.0**	**2.4**	**2.2**	**2.4**	**2.3**	**2.3**
Main contributions							
Private consumption	1.1	1.5	1.8	1.4	1.6	1.5	1.5
Business investment	0.5	0.8	0.9	0.7	0.7	0.8	0.8
Dwellings investment[1]	0.2	0.5	0.5	0.3	0.3	0.2	0.1
Government[2]	0.0	0.3	0.0	-0.1	-0.1	0.0	0.1
Change in inventories	0.3	0.3	-0.2	0.0	0.0	0.0	0.0
Net trade	0.0	-0.2	-0.5	-0.1	-0.1	-0.1	-0.2

[1] The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.
[2] The sum of government consumption and general government investment.
Note: Components may not sum to total due to rounding and the statistical discrepancy.

3.56 Our central GDP growth forecast is shown in Chart 3.19. 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 3.19: Real GDP growth fan chart



Source: ONS, OBR

Prospects for inflation

3.57 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.[5]

3.58 The RPI and CPI measures of inflation are important because they have different effects on 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 for calculating interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties. The ONS publishes other inflation measures, but these do not currently affect the public finances, so we do not forecast them.

CPI inflation

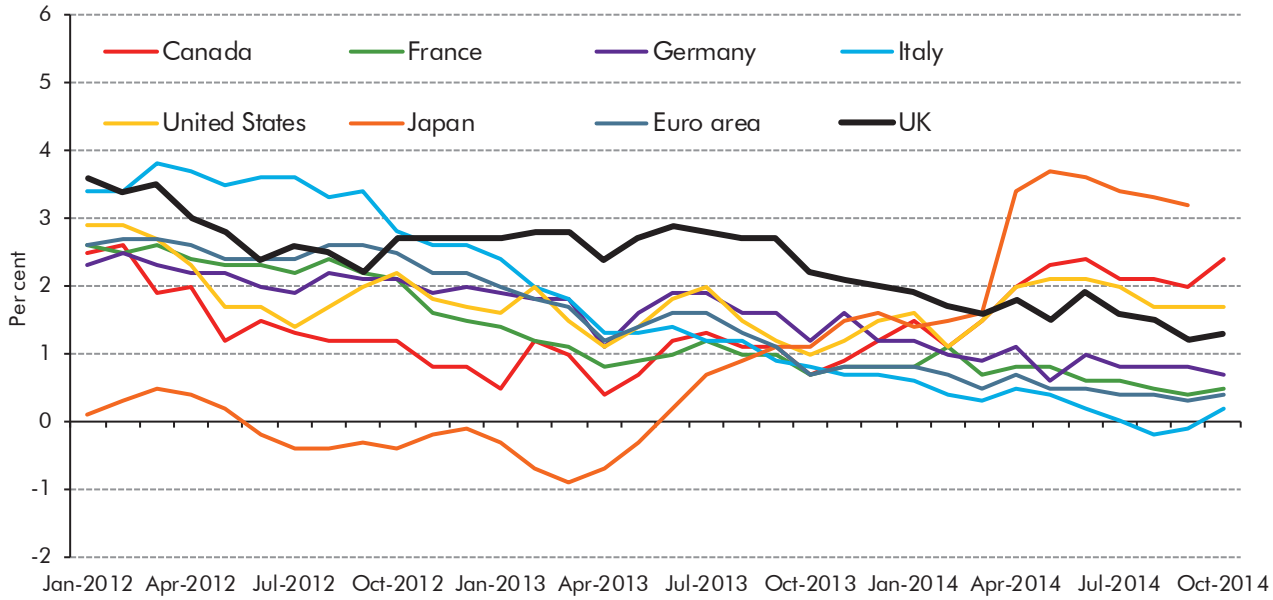
3.59 CPI inflation came in at 1.5 per cent in the third quarter of 2014, lower than our March forecast of 1.8 per cent. We expect CPI inflation to reach a low of 0.9 per cent in the first quarter of 2015, well below our March forecast of 1.9 per cent (Chart 3.21). The reasons for the lower near-term inflation profile include:

- lower food price inflation, thanks to good domestic and international harvests, sterling appreciation and more intense supermarket price competition;
- lower petrol and diesel prices. Dollar oil prices have fallen much more than we assumed in March and sterling has appreciated, reducing fuel prices;
- lower inflation for import-intensive goods. Again, sterling appreciation has reduced prices for goods with high import content; and
- lower-than-expected unit labour costs. Average earnings growth has continued to be weaker than expected, outweighing the shortfall in productivity.

3.60 Some of these inflation dynamics, including lower food and energy prices, are common to other advanced economies. Inflation in most advanced economies is now below 2 per cent (Chart 3.20), the target rate for many central banks.

[5] For more details on the differences between the RPI and CPI see Miller (2011) Working Paper No. 2: *The long-run difference between RPI and CPI inflation*.

Chart 3.20: Headline inflation in advanced economies

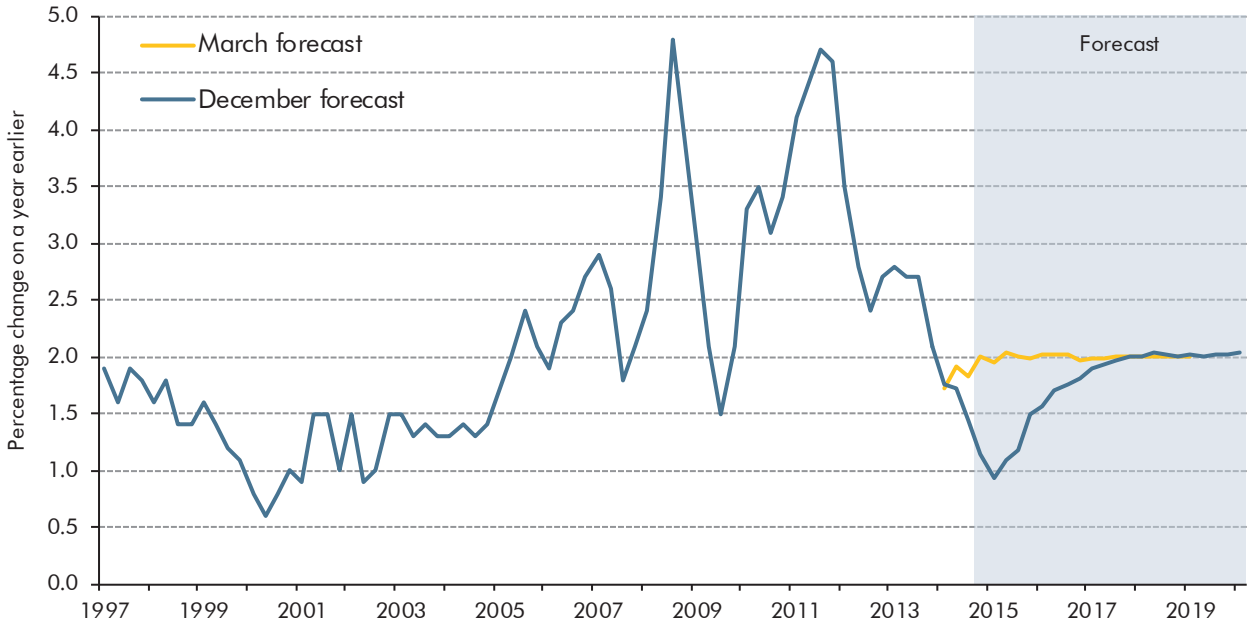


Source: OECD
Note: Japan's inflation rate is currently boosted by an increase in the rate of consumption tax from 5 to 8 per cent in April.

3.61 We expect inflation to fall further from its current level as recent falls in the oil price futures curve and the lagged effects of the past sterling appreciation work their way through to consumer prices. Most energy companies have also pledged to hold the price of electricity and gas constant until either the end of 2014 or 2015, subject to wholesale prices not increasing significantly. We assume that they stick to this commitment, which lowers annual inflation as there were large increases in utility prices in late 2013 and early 2014. CPI inflation is therefore expected to fall from 1.5 per cent in the third quarter of 2014 to a trough of 0.9 per cent at the beginning of 2015 (Chart 3.21). Inflation could fall even further, as we assume that firms use some of the fall in input prices to rebuild margins that have been squeezed in recent years. But margins could be rebuilt more quickly than expected.

3.62 Inflation is expected to remain below the 2 per cent target for an extended period as the effects of the recent sterling appreciation and falls in commodity prices feed through with lags. Inflation is forecast to return to the 2 per cent target at the end of 2017. That is consistent with the Bank of England's November 2014 *Inflation Report* forecast and the assumption that inflation expectations remain anchored around the target.

Chart 3.21: CPI inflation



Source: ONS, OBR

RPI inflation

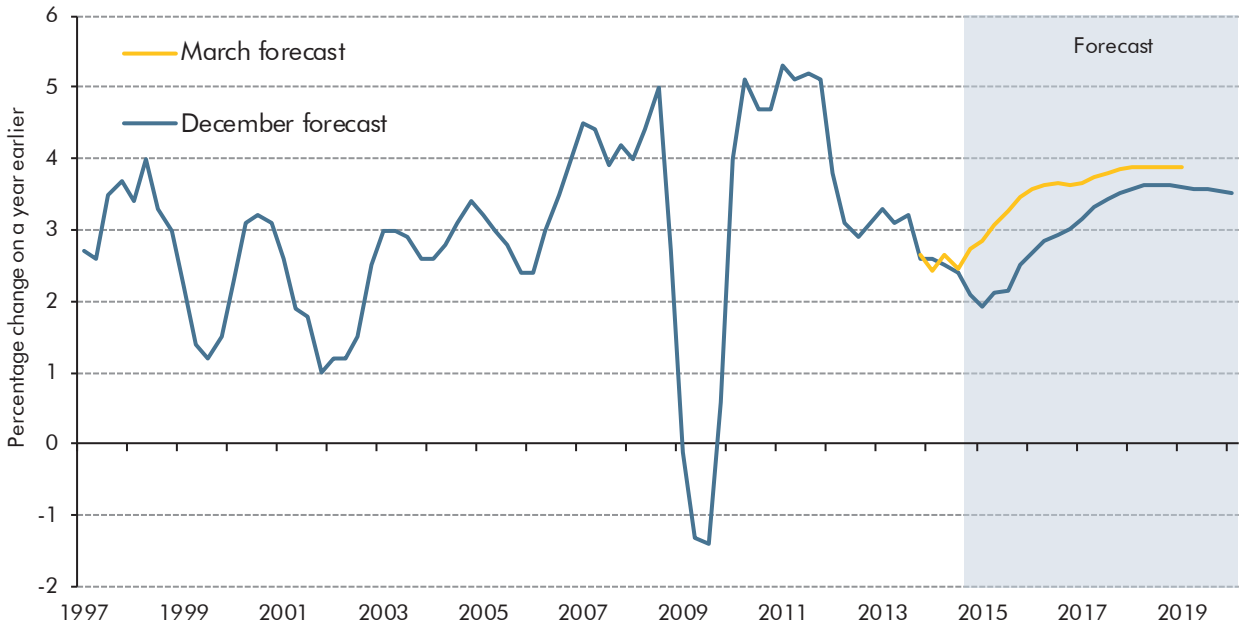
3.63 The calculation of RPI inflation in the UK does not meet international statistical standards, but we continue to produce RPI forecasts as they are necessary inputs in our fiscal forecasts.[6] The method of calculation drives a wedge between RPI inflation and CPI inflation (the 'formula effect') and leads RPI to overstate inflation. The RPI also includes mortgage interest payments (MIPs), council tax and housing depreciation, which are not included in the CPI.

3.64 RPI inflation was 2.4 per cent in the third quarter of 2014, close to our March forecast of 2.5 per cent. The items contributing to the negative CPI surprise were partly offset by stronger-than-expected MIPs, as mortgage rates have risen unexpectedly, and faster growth in housing depreciation due to higher-than-expected house price inflation.

3.65 In the near term, we expect RPI inflation to fall back for the same reasons as CPI inflation. Over 2015, RPI inflation rises in line with CPI inflation before an increase in MIPs pushes RPI inflation to around 3.5 per cent. The initial rise in MIPs is driven by an increase in mortgage debt, before a rise in market-derived Bank Rate expectations imply that mortgage interest rates will also rise. Compared to our March forecast, RPI inflation is lower over the whole forecast period. The lower near term RPI is in line with lower CPI inflation, with lower interest rates explaining much of the medium-term difference.

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

Chart 3.22: RPI inflation



Source: ONS, OBR

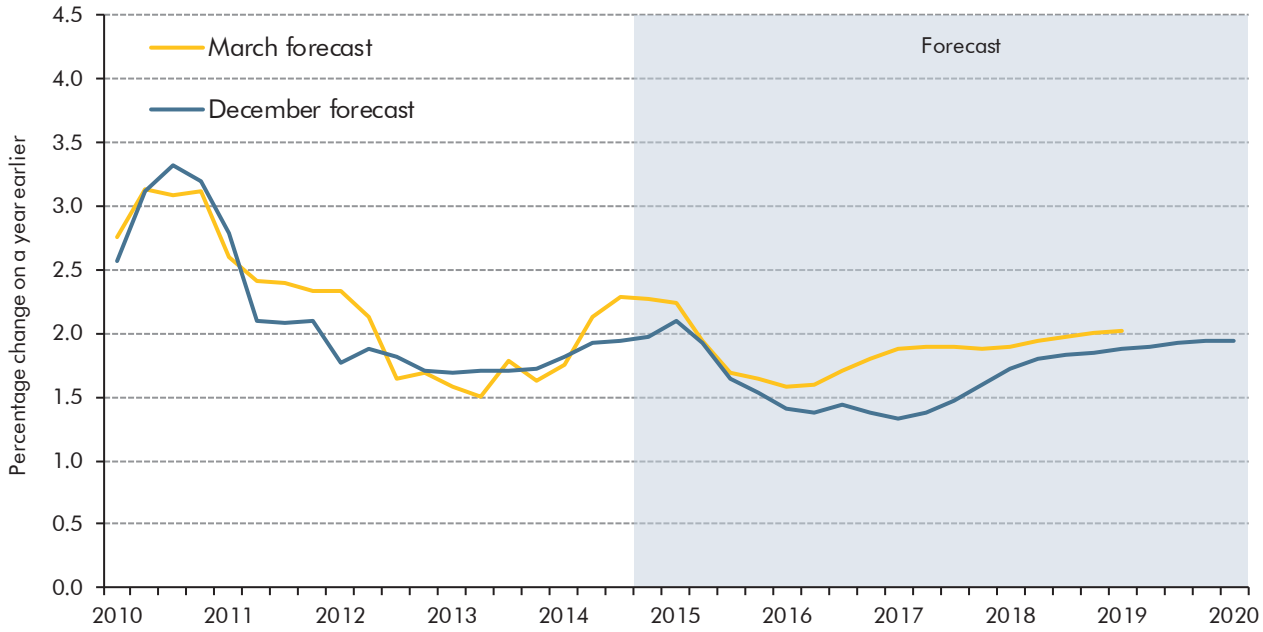
The GDP deflator

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 sector spending policy assumption, described in Chapter 4.

3.67 Historical estimates of the GDP deflator and its components have been revised significantly, with lower growth over the recovery (see Chapter 2). The GDP deflator grew by 2.1 per cent in the year to the third quarter of 2014, below our March forecast of 2.5 per cent. This was mainly due to a lower private consumption deflator, in line with lower CPI inflation.

3.68 Our forecast for the GDP deflator is similar to the March forecast in the near term as lower private consumption prices are broadly offset by stronger investment prices (Chart 3.23). GDP deflator growth is then weaker than our March forecast, thanks to lower CPI inflation and lower growth in the price of government consumption goods and services reflecting the ongoing sharp squeeze on such spending. (As noted in the introduction to this chapter, the assumed levels of public spending underpinning our economy forecast are unfortunately not fully consistent with our fiscal forecast, thanks to late policy decisions – one area this will have affected is the GDP deflator, via the government consumption deflator.)

Chart 3.23: GDP deflator



Source: ONS, OBR

Prospects for nominal GDP growth

3.69 Most public discussion of macroeconomic 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 Since March, the ONS has significantly revised its historical estimates of nominal GDP, reflecting a new system of accounts (ESA10) and other methodological changes implemented in Blue Book 2014. The main effect has been to raise the level of nominal GDP across time – by 6 per cent in 2013. Compared to the data available at the time of the March forecast, cumulative growth in nominal GDP between the end of the recession and the end of 2013 was revised up by only 0.1 percentage point, as upward revisions to real GDP growth were offset by downward revisions to the growth of the GDP deflator.

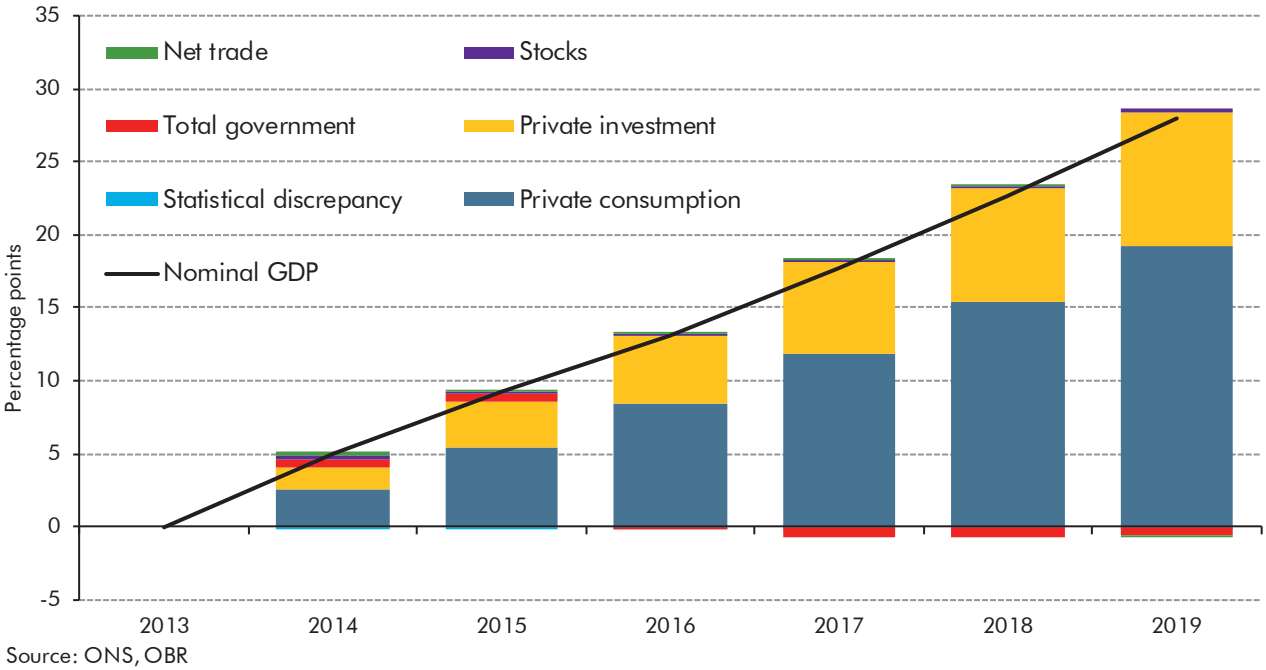
3.71 The latest ONS data indicate that nominal GDP grew by 4.4 per cent in the first three quarters of 2014, stronger than the 3.2 per cent growth we expected in March. While the breakdown of GDP by income components for the first three quarters of 2014 will not be available until later in December, the high-level breakdown published so far suggests that the unexpected strength of nominal GDP growth has been concentrated in corporate profits and other non-labour income components. As labour income and private consumption are the most heavily taxed components of income and expenditure respectively, the composition of GDP since our March forecast has been less favourable for the public finances.

3.72 We forecast that nominal GDP will grow by 4.0 per cent in 2015, falling back to 3.6 per cent in 2016 as calendar-year real GDP growth slows. We then expect growth of 4.1 per cent in 2017, picking up to 4.3 per cent by 2019 as temporary downward influences on the GDP deflator ease. Overall, cumulative nominal GDP growth between the fourth quarter of 2013 and the start of 2019 is around 1.1 percentage points lower than in our March forecast (23.8 versus 24.9 per cent). Of this, around 0.3 percentage points is due to lower real GDP growth, with the remainder accounted for by weaker growth of the GDP deflator.

Expenditure

3.73 Chart 3.24 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 around 14 per cent in 2013 to just over 18 per cent in 2019. This offsets a fall in the contribution of government consumption and investment, which drops from around 23 per cent of nominal GDP in 2013 to just over 17 per cent by 2019. (These figures would be somewhat different had our economy forecast been fully aligned to the Government's final spending totals in our fiscal forecast.) Prospects for individual sectors are set out in more detail later in this chapter.

Chart 3.24: Contributions to nominal GDP growth: expenditure

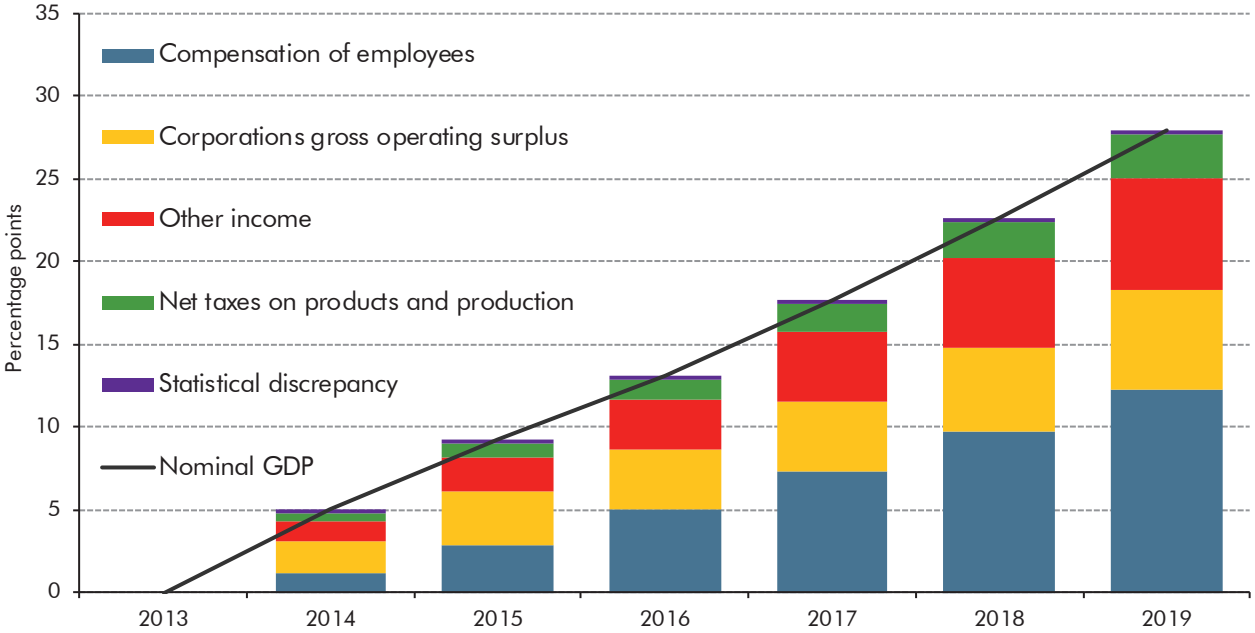


Source: ONS, OBR

Income

3.74 Chart 3.25 shows the contribution of different sources of income to cumulative growth in nominal GDP between 2013 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 3.25: Contributions to nominal GDP growth: income



Source: ONS, OBR

Prospects for individual sectors of the economy

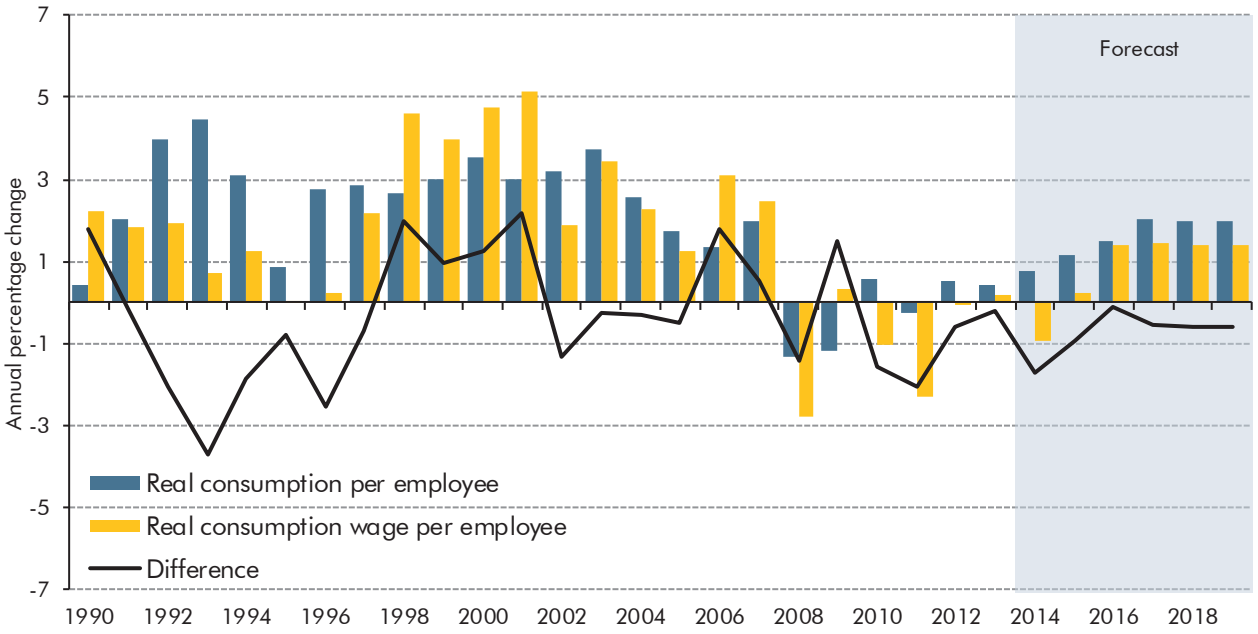
The household sector

3.75 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

3.76 Real consumer spending growth has been strong in recent quarters. Consumption grew by a cumulative 2.1 per cent in real terms in the first three quarters of 2014, despite limited growth in real wages (Chart 3.26). Indeed, we estimate that the margin by which consumption growth will outstrip real wage growth in 2014 will be the second largest since the mid-1990s. Meanwhile, the GfK index of consumer confidence remains above its long-run average.

Chart 3.26: Real consumption wage and real consumption



Source: ONS,OBR

3.77 Since our March forecast, the ONS has significantly revised the household saving ratio (see below). But the acceleration in consumption in 2013 and 2014 was still financed mainly by lower saving, rather than stronger income growth. The picture is complicated by the volatility of earnings data in recent quarters and by an unusually large disparity between the National Accounts measure of wages and salaries and the proxy calculated from Labour Force Survey (LFS) data on employee numbers and average weekly earnings (AWE).

3.78 We expect quarterly consumption growth to ease in 2015, such that consumer spending grows more in line with relatively weak productivity and real earnings. As real earnings growth picks up from 2016, we expect consumption growth to strengthen, with real consumption broadly stable as a share of GDP in the medium term.

Nominal consumer spending

3.79 Nominal consumption growth remained relatively strong in 2014, growing by 3.1 per cent over the first three quarters of the year. This reflected strong real growth, offsetting lower consumer price inflation. We expect nominal consumption growth of 4.3 per cent in 2015, slightly stronger than our March forecast. Slower momentum in consumer spending through 2015 and weak consumer price inflation have prompted us to revise down nominal consumption growth in 2016 to 4.1 per cent. Thereafter, rising nominal earnings growth helps push nominal consumption growth towards an average of around 4¾ per cent a year over the medium term.

The labour market and household income

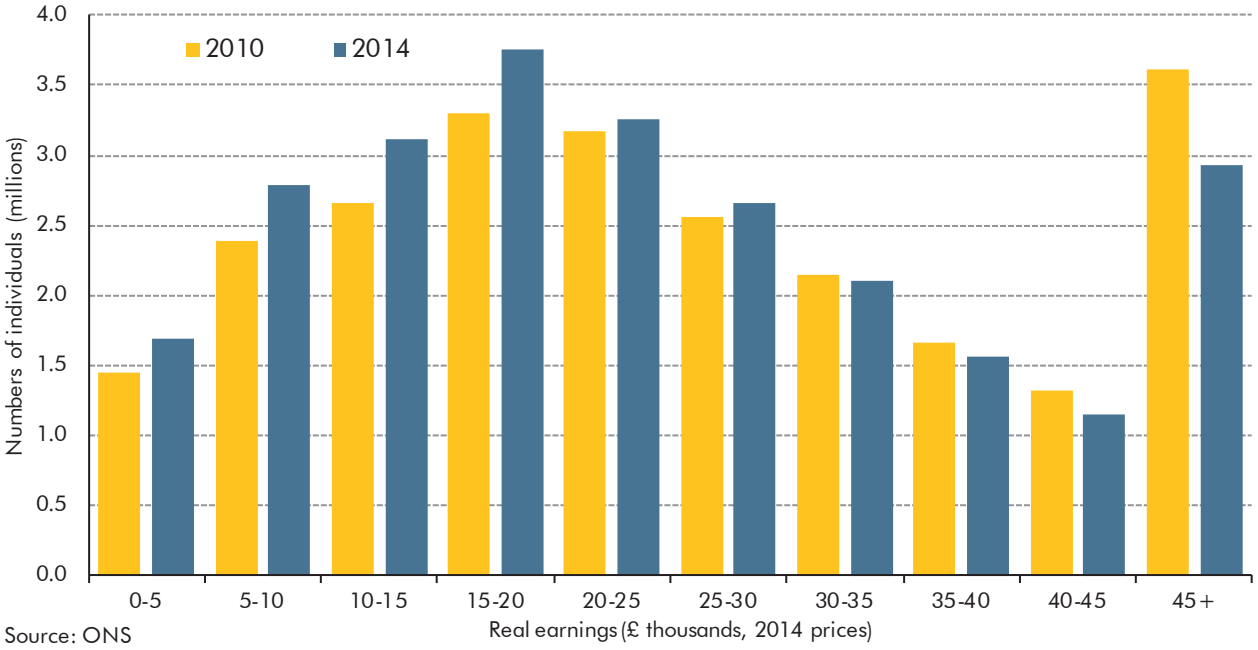
3.80 Unemployment has fallen faster this year than we forecast in March. We expect the rate of decline to ease over coming quarters as GDP growth slows and productivity growth picks

up, allowing firms to expand output through their existing workforce rather than through recruitment. But we now expect a more gradual recovery in productivity and sufficient momentum in the labour market for the unemployment rate to drop marginally below its equilibrium level from mid-2015. A small gap is expected to persist over much of the forecast period, as productivity growth takes time to fill the slack.

3.81 The National Accounts measure of wages and salaries is currently stronger than would be implied by multiplying employee numbers in the LFS by the AWE measure of earnings. This means that the measure of average earnings growth we forecast – based on the National Accounts – is stronger than the headline AWE measure. 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 soon. But one consequence is that our forecast measure is now slightly above consumer price inflation, whereas the AWE measure is slightly below. The big picture is that real earnings have been broadly flat over the recent past, having fallen considerably following the recession. 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 be just below its pre-crisis peak in the third quarter of 2007 by the end of the forecast period.

3.82 Growth in wages and salaries has not been spread evenly across the income distribution. Chart 3.27 shows the distribution of real incomes captured in the annual survey of hours and earnings (ASHE), an April snapshot of tax administration data. It suggests that much of the growth in employee numbers between 2010 and 2014 occurred towards the lower end of the income distribution.

Chart 3.27: Income distribution



Source: ONS

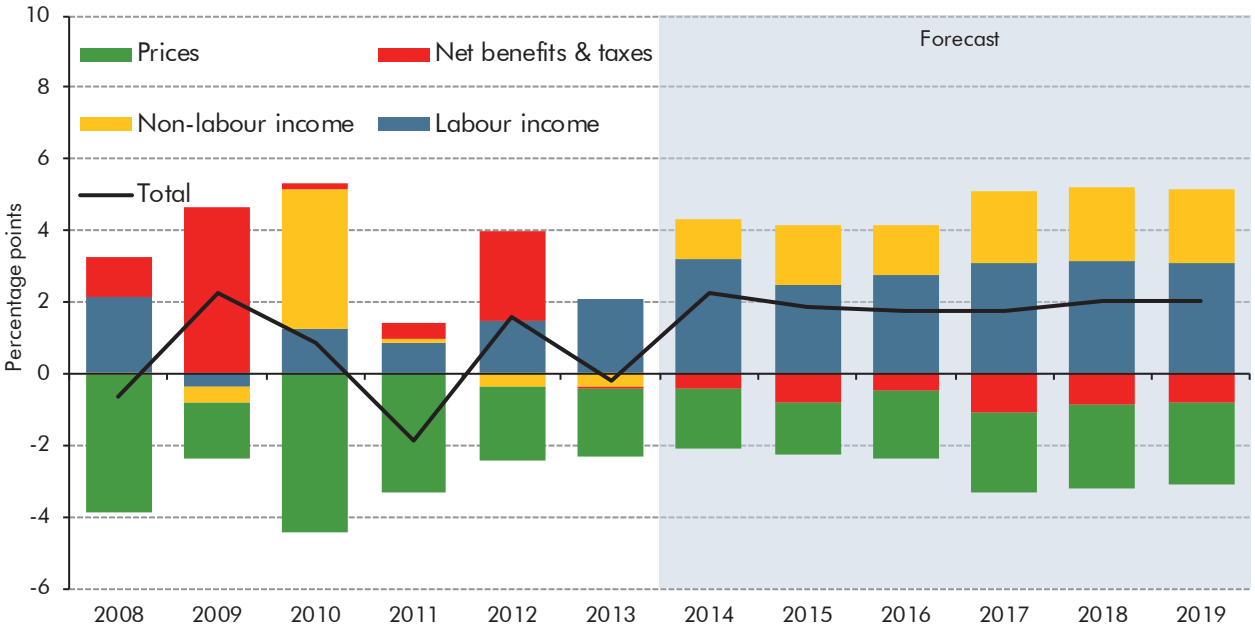
3.83 This compositional effect will have dragged down estimates of whole economy earnings growth, but also – given the structure of the tax system – depressed the effective tax rate on labour income, which we discuss in more detail in Chapter 4. In addition, the rise in self-employment – which is not shown in the chart – appears to have been disproportionately towards the lower end of the distribution.

3.84 Labour income was by far the biggest source of real household income growth before the recession, reflecting the expansion of the population and strong productivity growth. Non-labour income made a positive contribution and net benefits and taxes made a small negative contribution.

3.85 Real household incomes grew very little during the recession and the early years of the recovery, rising by just 0.3 per cent a year from 2008 to 2013. Labour income growth was initially depressed as unemployment rose and pay growth slowed. Employment has since risen, but earnings growth remains low. In aggregate, non-labour income contributed much as it did prior to the crisis, with weaker contributions from dividends and interest on savings broadly offset by lower debt servicing costs. The automatic stabilisers supported household income during the course of the recession, and a higher personal allowance and welfare upratings boosted incomes in 2012. But until recently it was offset by elevated inflation.

3.86 Over the forecast period, we expect labour income to return to being 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. Net benefits and taxes will return to being a small drag on real household income growth, given ongoing fiscal consolidation and the return of fiscal drag (when earnings rise faster than inflation-linked allowances and thresholds in the tax system). The contraction of the public sector will also weaken labour income growth directly, via public sector employment and wages, and indirectly, via procurement spending on private sector output. Lower inflation over the near term will also support real income growth. The result is average real income growth of around 2 per cent a year over the forecast period, somewhat below its pre-crisis average.

Chart 3.28: Contributions to real household income growth



Source: ONS, OBR

The saving ratio

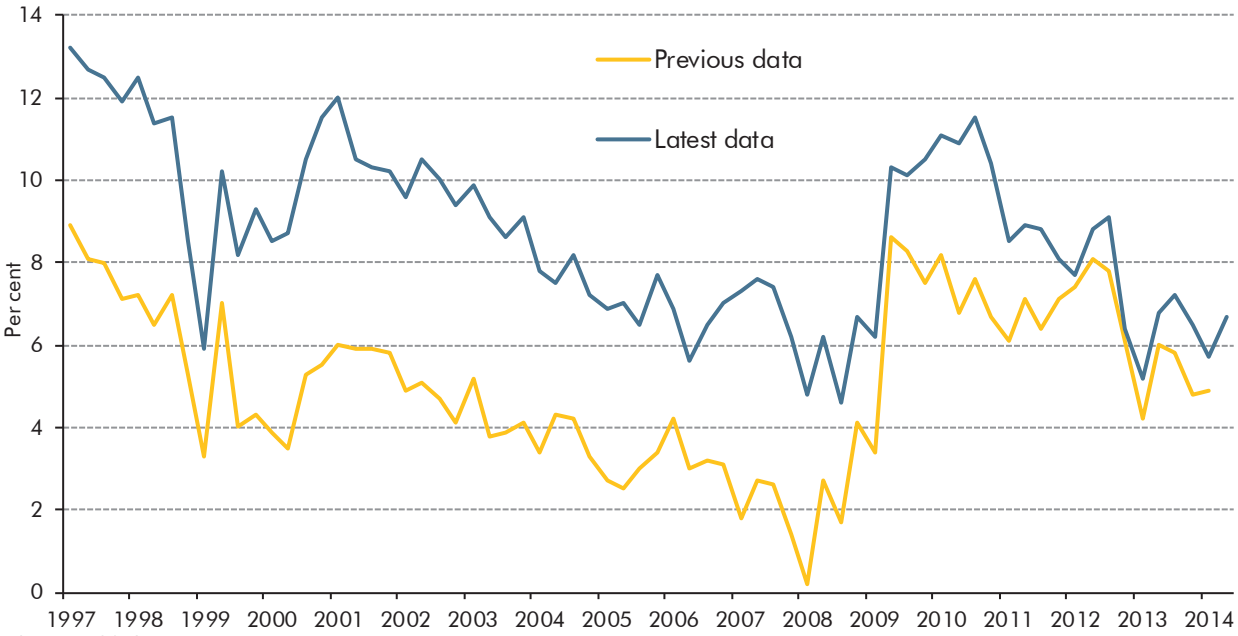
3.87 Since our March forecast, the ONS has significantly revised the level of the household saving ratio. This largely reflects a change in the treatment of household pension assets, consistent with ESA10, the new international guidance introduced in this year's Blue Book. In particular, household pension saving is now determined by the promised pension benefits from pension schemes, rather than the actual contributions paid into schemes.

3.88 This raises the measured saving ratio as household incomes are notionally higher, but consumption is unaffected. The saving ratio has been revised up by around 3.6 percentage points on average since 1997 (Chart 3.29). The revisions have also changed the profile since the end of the recession, with the latest data suggesting a steady decline between 2010 and 2012, rather than a broadly flat path over this period. This reflects a reduction in the effect of pension changes on the saving ratio over this period, in turn largely accounted for by the effect of lower gilt yields on investment income.[7] These changes mean that the household saving ratio now falls back to pre-crisis levels in 2013 and the first half of 2014.

3.89 Alternative measures of saving unaffected by the change in pensions treatment – such as saving out of 'available' income, as estimated by the Bank of England in its latest *Inflation Report* – suggest that the rate of saving remains above the levels seen prior to the recession, although it still fell back in 2013 and 2014 as consumption growth increased.[8]

[7] See ONS, *Changes to National Accounts; The Impact of the Changes to the Treatment of Pensions in the National Accounts*, September 2014; and ONS, *Impact of changes in the National Accounts and economic commentary for Q2 2014*, September 2014.
[8] See Bank of England, *Inflation Report*, November 2014, page 19. 'Available income' is defined as household post-tax income excluding income flowing into employment-related pension schemes.

Chart 3.29: The household saving ratio



Source: ONS

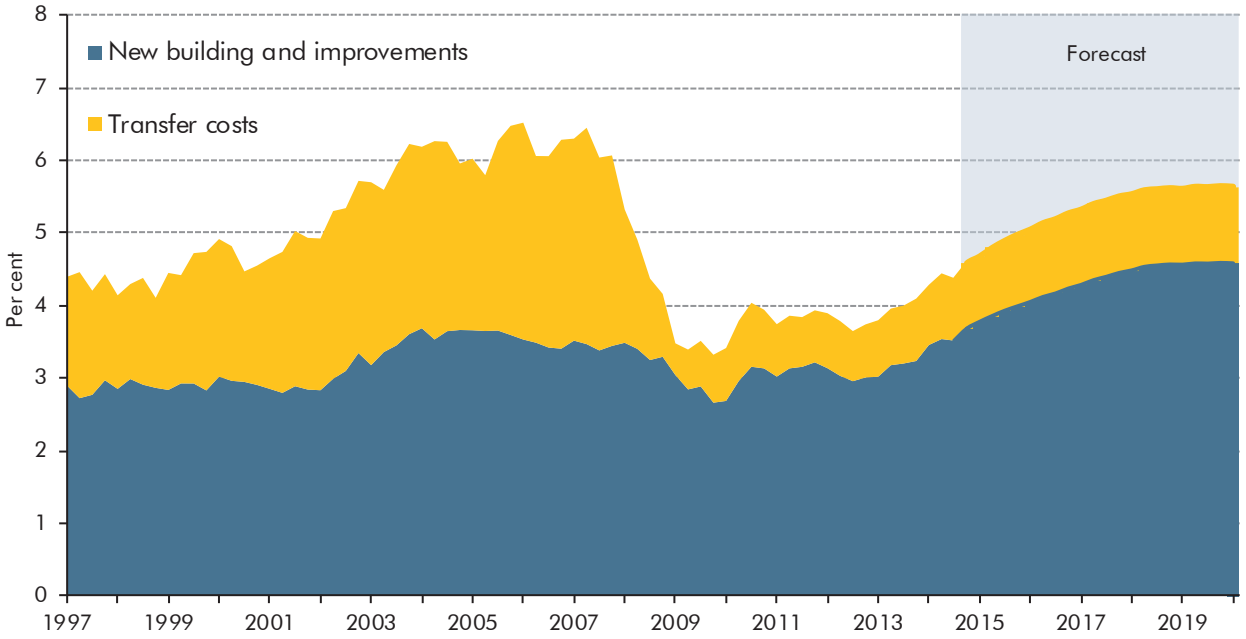
3.90 With consumption expected to continue to outpace real household disposable income growth in the near term, we expect the saving ratio to fall back slightly in 2015. It then stabilises as consumption slows to grow more closely with incomes. Relative to our March forecast, the saving ratio is higher throughout the forecast period, but the profile is similar.

The housing market and dwellings investment

3.91 Residential investment growth in 2014 has been stronger than we expected in March, consistent with stronger than expected house price growth over the first half of the year. By contrast, property transactions have fallen short of our March forecast. Among other factors, it appears that the Mortgage Market Review regulations on lending had a larger and more persistent effect than we had assumed. In the third quarter of 2014, transactions were 9.7 per cent lower than expected. We have revised down our near-term forecast in light of this slower momentum and weaker indications from mortgage approvals and property surveys. We assume that the volume of transactions returns towards its historical average as a percentage of the housing stock over the forecast period. As described in Box 3.1, we have assumed that reforms to the stamp duty regime announced in the Autumn Statement will over time raise the level of property transactions by around 1 per cent and therefore residential investment by around 0.2 per cent.

3.92 In line with our forecasts for house prices and property transactions, we expect relatively strong growth in residential investment in the near term. As growth in housing market activity slows over the medium term, we expect annual growth in residential investment to slow from 2016, growing broadly in line with GDP by 2019. Despite relatively strong rates of growth early in the forecast, total private residential investment is expected to remain below its pre-crisis peak throughout the forecast period.

Chart 3.30: Residential investment, share of nominal GDP



Source: ONS

Net lending and the balance sheet

3.93 The saving ratio is expected to fall back slightly between 2014 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, provides the offset to the Government's fiscal consolidation (Chart 3.41). With negative net lending and strong house price growth, the ratio of households' gross debt to income is projected to rise again from 2015, having fallen steadily since 2008 (Chart 3.31).

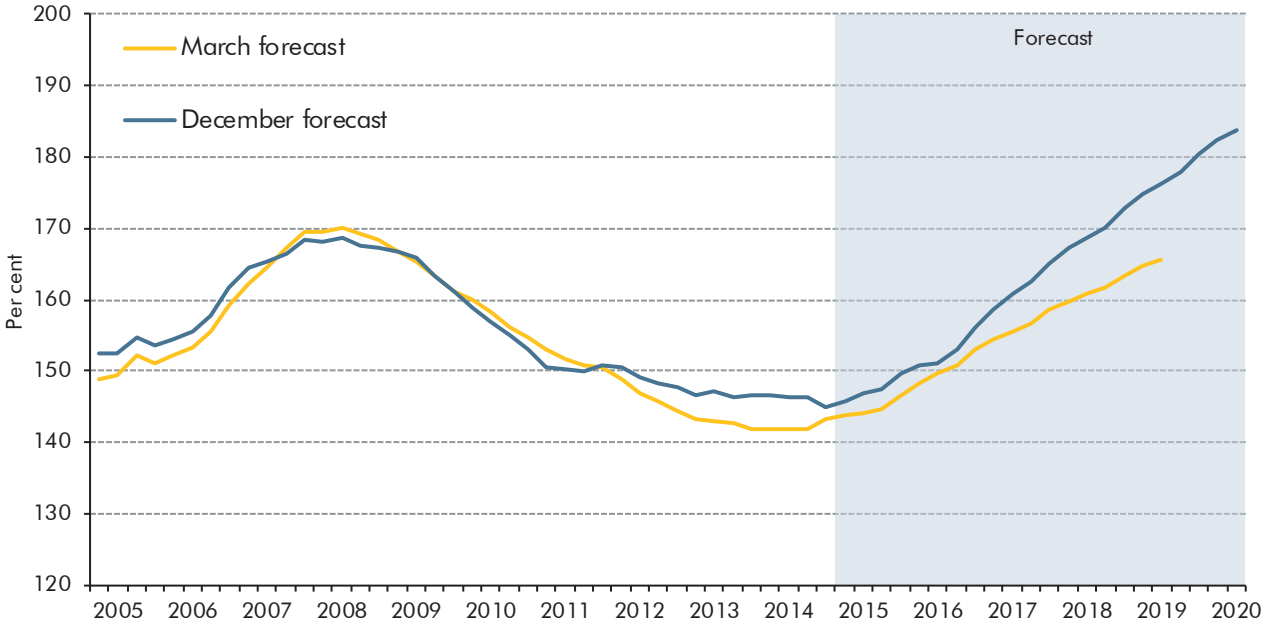
3.94 The gross household debt to income ratio has been revised up significantly since our March forecast. This reflects a number of factors:

- in cash terms, the level of gross debt is expected to be around £174 billion higher by the start of 2019 than we expected in March;
- almost half this change reflects a higher starting point – the latest data indicate that total household debt was £1,670 billion in the second quarter of 2014, £84 billion higher than implied by the March forecast. This reflects revisions to historic ONS data, rather than stronger-than-expected debt accumulation in the first half of the year. The remaining change to the 2019 forecast reflects an upward revision to the accumulation of debt over the forecast period. This partly reflects higher expected house price growth and the corresponding accumulation of around £49 billion more secured debt than expected in March;
- we also expect more accumulation of unsecured debt than in March, due to greater momentum in consumption relative to income. This partly reflects the reduction in

market interest rate expectations since March. We have revised up our saving ratio forecast since March, but much of this relates to the changes in the treatment of pension saving, which do not imply a change in the rate at which households accumulate debt. The rise in unsecured debt between the second quarter of this year and the start of 2019 is now expected to be around £41 billion more than expected in March, although the share of total debt that is unsecured remains in line with the levels seen prior to the recession; and

- the effect of a higher cash level of household debt on the debt to income ratio is offset slightly by a small upward revision to household income. The level of household disposable income is forecast to be 1¼ per cent higher by the start of 2019 than expected in our March forecast, as upward revisions to historical data more than offset a weaker forecast for wage growth.

Chart 3.31: Household gross debt to income



Source: ONS, OBR

The corporate sector

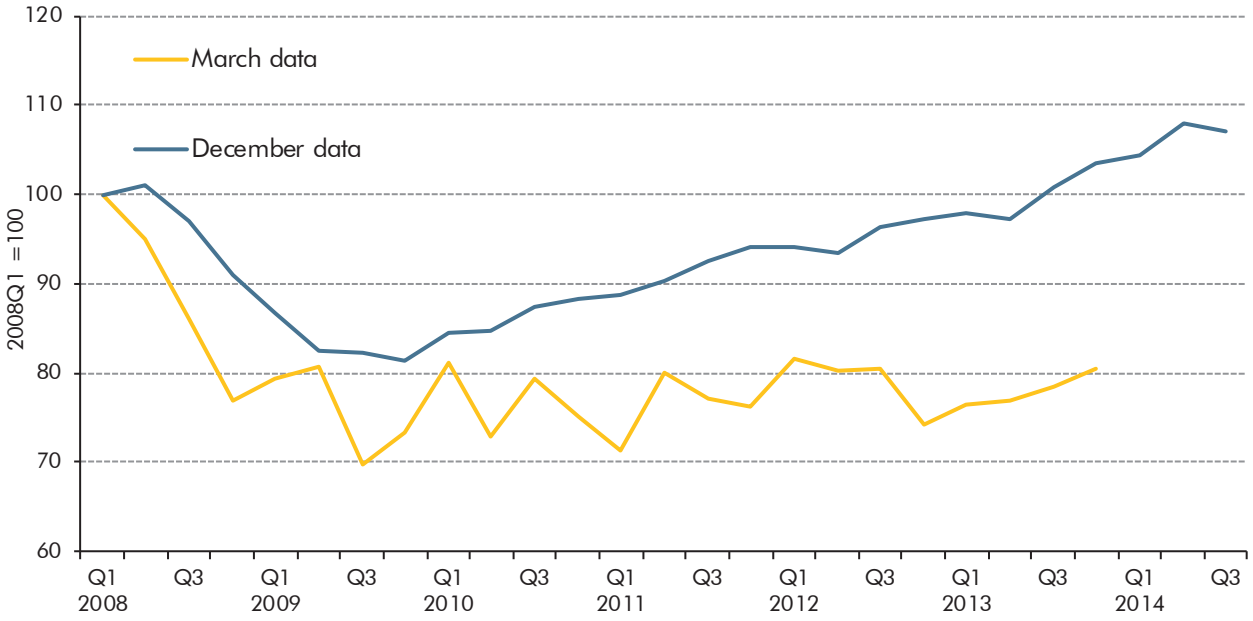
Business investment and stockbuilding

3.95 Business investment data have been revised significantly since our March forecast, reflecting a number of substantive changes to methodology and updated data sources in this year's Blue Book. The annual level of real business investment has been revised up by an average of around 12 per cent between 1997 and 2013,[9] mainly reflecting the inclusion of research and development spending as investment rather than intermediate consumption.

[9] ONS, *Investment – impact analysis of changes to the estimation of gross fixed capital formation and business investment for Blue Book 2014*, September 2014.

3.96 More important for our forecast judgements, the path of business investment since the end of the recession has been redrawn: cumulative growth between the end of 2009 and the final quarter of 2013 is now estimated to have been 27 per cent, revised up from 10 per cent based on the data available for our March forecast. The level of business investment in the final quarter of 2013 now stands around 3 per cent above its pre-crisis peak; the data available in March suggested that it was almost 20 per cent below it (Chart 3.32). This illustrates how challenging it is to estimate and forecast business investment. For example, the error in our June 2010 forecast for cumulative business investment growth between the start of 2010 and the start of 2014 was 39 percentage points against the June 2014 vintage of ONS data, but only half that against the latest data.

Chart 3.32: Real business investment

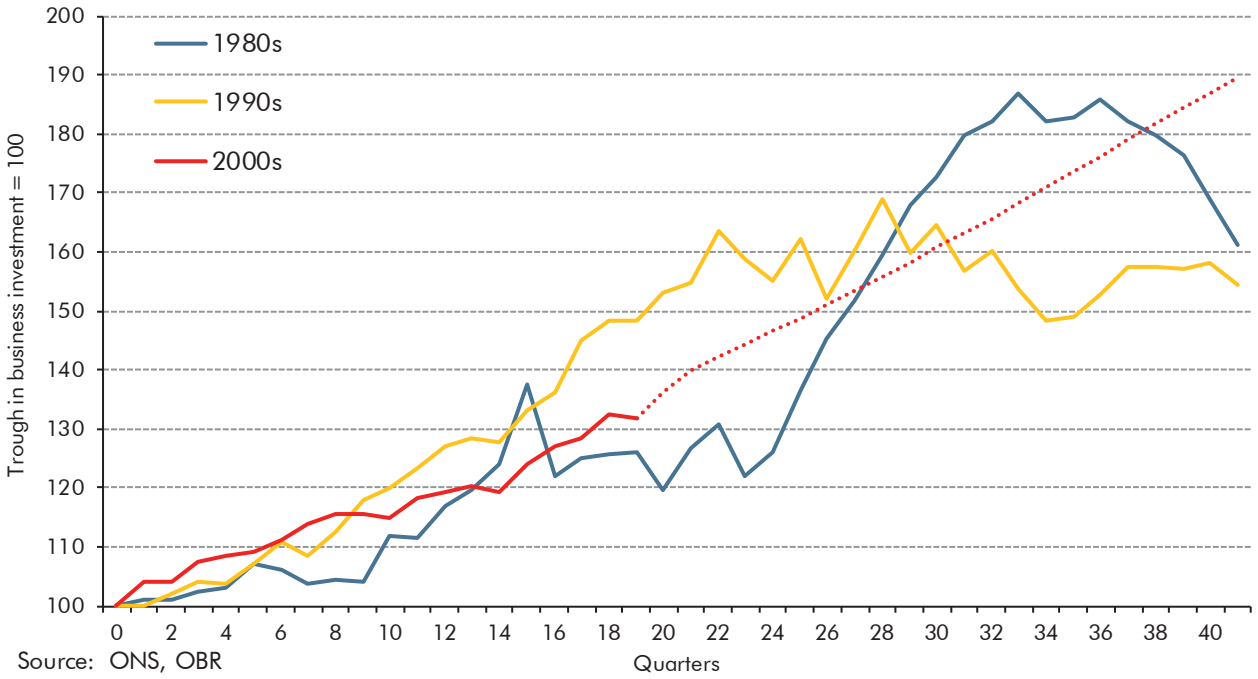


Source: ONS

3.97 Recent data point to ongoing strength. Business investment grew by 3.5 per cent in the first three quarters of the year, though on a quarterly basis it dipped in the third quarter. Investment intentions remain relatively strong, although the CBI survey indicator has eased over the past few quarters while there has been a pick-up in the net balance of firms reporting demand uncertainty as a constraint on investment plans.

3.98 We expect business investment to grow by 7.7 per cent in 2014, down from 8.0 per cent in March. As productivity growth and profits pick up, we expect business investment to continue to grow relatively strongly, averaging 6.7 per cent a year from 2015 to 2019. Our forecasts for annual business investment growth from 2015 are somewhat lower than our March forecast, as we have concluded that the substantial upward revision to business investment growth since 2009 implies somewhat less scope for growth in the future. As Chart 3.33 shows, the latest data and our current forecast imply cumulative growth in business investment from the post-recession trough that is broadly in line with the experience of previous UK recoveries. This forecast is, of course, subject to considerable uncertainty.

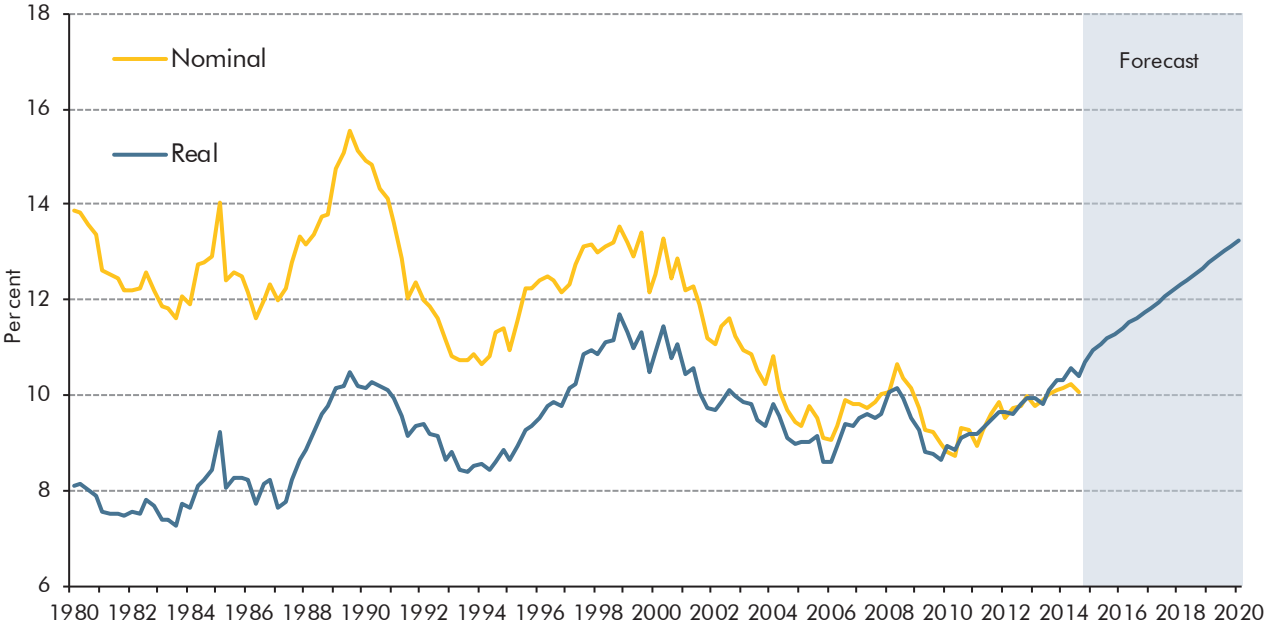
Chart 3.33: Real business investment following the last three recessions



Source: ONS, OBR

3.99 As Chart 3.34 shows, our forecast implies real business investment rising as a share of GDP, as usual 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.

Chart 3.34: Business investment as a share of GDP



Source: ONS, OBR

3.100 The ONS has also significantly revised its historical stocks data, reflecting a number of methodological changes, including: the inclusion of single use military equipment; the

removal of changes in inventories from the supply-use balancing process; and changes to the deflators used to produce volume estimates.

3.101 The latest ONS data indicate that stocks contributed -0.1 percentage points to cumulative growth in the first three quarters of 2014. We expect inventories to make a small negative contribution to GDP growth of -0.2 percentage points in 2015 and to be neutral from 2016.

Corporate profits

3.102 Non-oil, non-financial company profits are forecast to grow more quickly than GDP over the near term as productivity picks up (supporting recovery in margins) and the output gap narrows. Relative to our March forecast, we have revised up our forecast of profit growth in 2015, partly reflecting the strength of recent outturns. From 2016 we expect profits to grow broadly in line with nominal GDP.

The government sector

3.103 Total public spending amounted to around 41.5 per cent of GDP in 2013-14.[10] 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 23 per cent of GDP in 2013-14.

Real government consumption

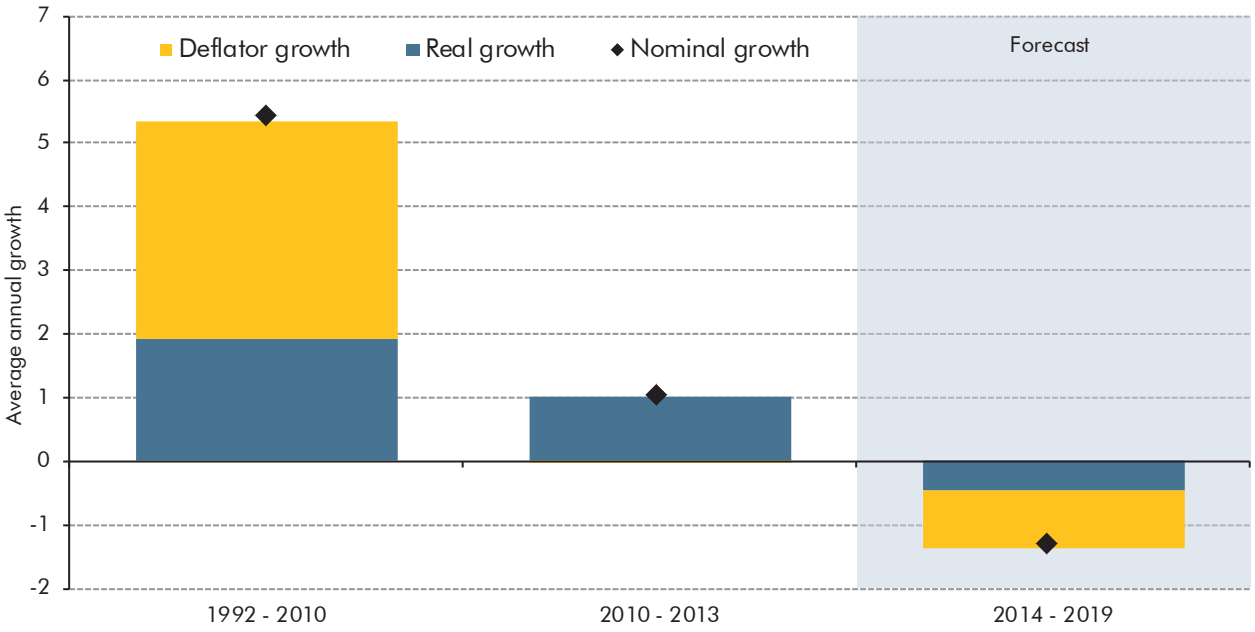
3.104 The value of government consumption in our economy forecast is not fully consistent with the spending totals in our fiscal forecast, as explained in the introduction to this chapter. The difference in spending in 2016-17 would be equivalent to 0.6 per cent of government consumption and 0.1 per cent of GDP. Had we been able to factor this into our forecast, the broad conclusions set out in this section – including the historical comparisons – would continue to hold.

3.105 Real government consumption continues to contribute positively to GDP growth despite ongoing restraint in nominal spending. Real government consumption grew by 0.7 per cent in 2013, despite cash spending growth slowing to 0.8 per cent. This largely reflects the way in which a large part of real government activity is measured in the National Accounts: two-thirds of real government consumption is estimated using 'direct' indicators of activity, such as the number of prescriptions, school pupils, court cases or hospital beds. Growth in these quantity indicators has not slowed as much as cash spending.

3.106 As a consequence, growth in the implicit price of government consumption – the ratio of nominal spending to real government consumption – has fallen back significantly as cash spending has slowed. The government consumption deflator was flat between 2010 and 2013, compared to an average increase of 3.4 per cent a year between 1992 and 2010 (Chart 3.35).

[10] Total managed expenditure (TME).

Chart 3.35: Government consumption



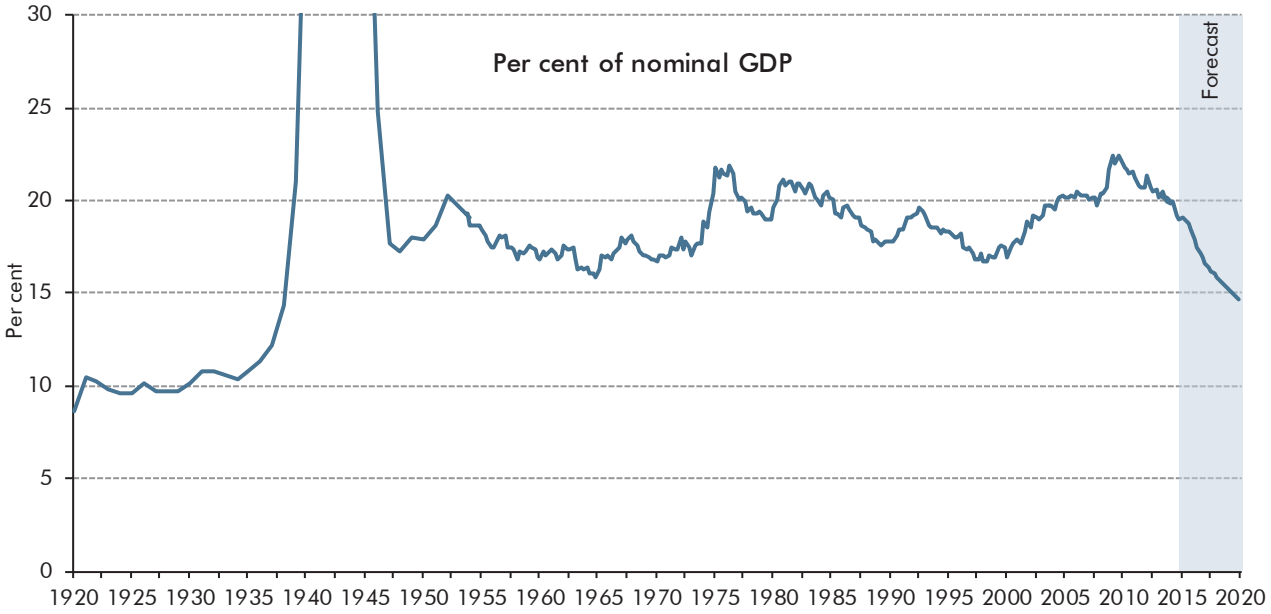
Source: ONS, OBR

3.107 Given the way in which the ONS measures real government activity, it seems reasonable to assume that a greater proportion of future cuts in nominal spending will be reflected in a weaker deflator, rather than reductions in real government consumption. With nominal government consumption expected to fall by 3 per cent in both 2016 and 2017, we expect the government consumption deflator to fall by around 2¼ per cent in these years. This reduces the direct effect of the spending cuts on real government consumption and GDP growth.

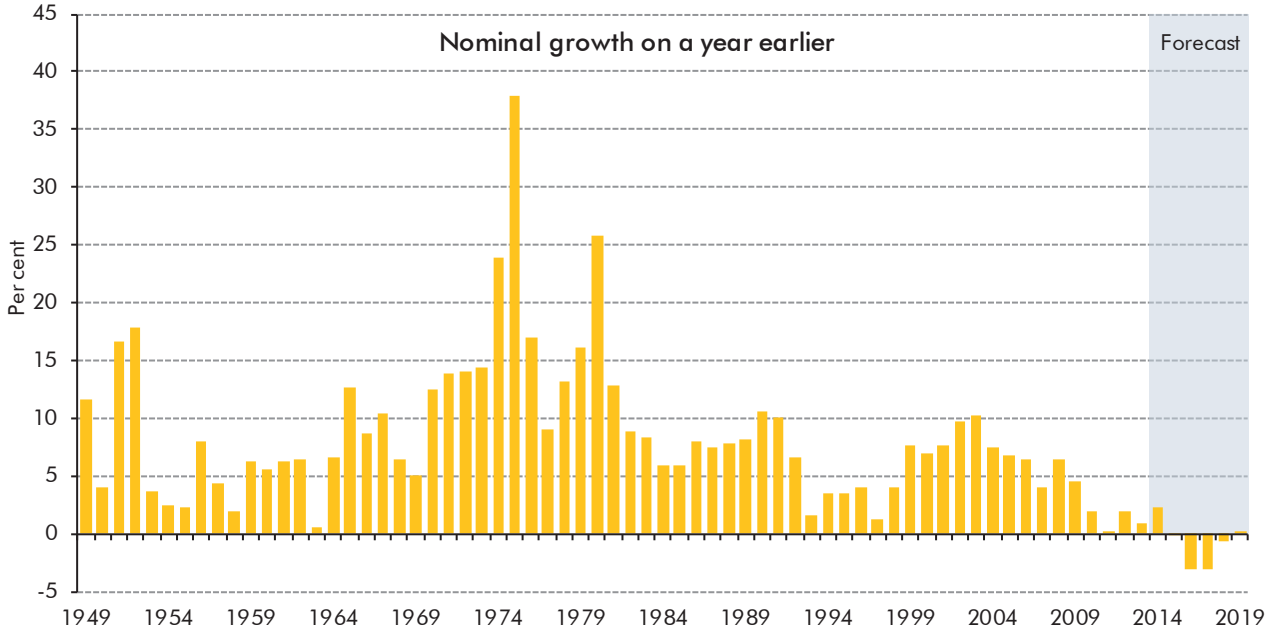
3.108 Relative to the size of the economy, nominal government consumption is forecast to fall from 20.2 per cent of GDP in 2013 to 14.7 per cent of GDP at the end of the forecast period, the lowest level on record in consistent national income data back to 1948 – and the lowest since 1938 using the Bank of England's historical dataset (Chart 3.36). Nominal government investment is expected to remain broadly stable as a share of GDP.

3.109 The four successive year-on-year reductions in nominal government consumption during the next parliament – implied by the Government's policy assumption for total spending beyond 2015-16 – would be the first since the Second World War. (Our fiscal forecast implies three successive year-on-year reductions in nominal government consumption, which would be the first time this has happened since 1948.)

Chart 3.36: 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



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

General government employment

3.110 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. 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.

3.111 Relative to its level at the start of 2011, the beginning of the period covered by the Government's 2010 Spending Review, general government employment had fallen by around 250,000 by mid-2014. That fall was front-loaded, particularly among local authorities. In terms of total employment, it was more than offset by a 1.5 million rise in market sector employment.[11]

3.112 Our government consumption forecast implies that general government employment will fall by a further 1.0 million by the start of 2020, making a total fall from early 2011 of 1.3 million. That represents a 20 per cent fall in headcount, consistent with an 8 per cent cut in departmental and local authorities' cash spending, and modest annual wage growth. Again, we expect the fall to be more than offset by a 2.0 million rise in market sector employment, making a rise in total employment of 1.0 million by the start of 2020. Had we been able to reflect the Government's final spending totals in our economy forecast, these figures would have changed slightly, with the fall in government employment slightly smaller and an equivalent reduction in the rise in market sector employment.

The external sector

Export and import volumes

3.113 Export growth remains relatively weak, with the data very volatile from month to month. The volume of exports has fallen for three successive quarters, declining by a cumulative 1.2 per cent so far in 2014. At least part of this reflects a deterioration in external demand: UK export markets are now expected to grow by 3.7 per cent in 2014, revised down from our March forecast of 4.7 per cent, with much of the downward revision attributable to weaker activity in the euro area. The appreciation of sterling since the start of 2013 is also likely to have depressed export activity, and may partly account for the acceleration in the loss of UK export share in 2014 (Chart 3.37)

3.114 We expect the strength of sterling and the weakness of UK export markets to continue to bear down on export growth. Exports are now expected to grow by 2.4 per cent in 2015, down from our March forecast of 4.7 per cent. This reflects a downward revision to export market growth and a steeper loss of market share than expected in March. With our forecast conditioned on a broadly stable sterling exchange rate, we expect export growth to recover to just under 5 per cent from 2016, although this remains below the growth rate of UK export markets. This implies an ongoing loss of market share during the forecast period (Chart 3.37), albeit at a slightly slower pace than in the pre-crisis decade (see Box 3.3).

[11] 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 over the assumptions for public sector wages and employment can be found in the supplementary economy tables available on our website.

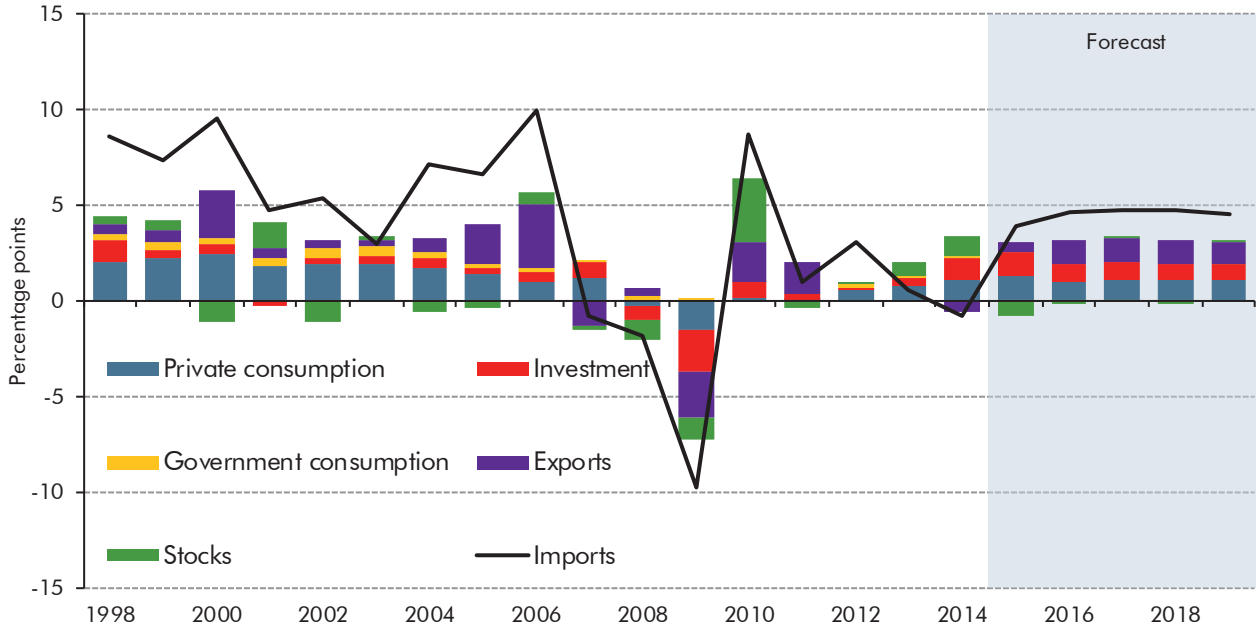
Chart 3.37: Export market share

Source: OECD, ONS, OBR. 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.

3.115 Our forecast for imports is determined by the outlook for import-weighted domestic demand and a trend rise in the import intensity of demand. Imports fell back sharply over the first half of the year, although this may be distorted by an error in overseas travel and tourism data.[12] Reflecting the latest data, we have revised down our forecast for import growth in 2014 to -0.8 per cent from our March forecast of 3.0 per cent. Within domestic demand, both private consumption and investment have relatively high import intensity, driving the growth of imports over the forecast period. The fall in real government activity implies relatively little drag on import-weighted domestic demand, given the low import intensity of government spending.

[12] See ONS, *Overseas Travel and Tourism, Provisional Results for September 2014*, November 2014.

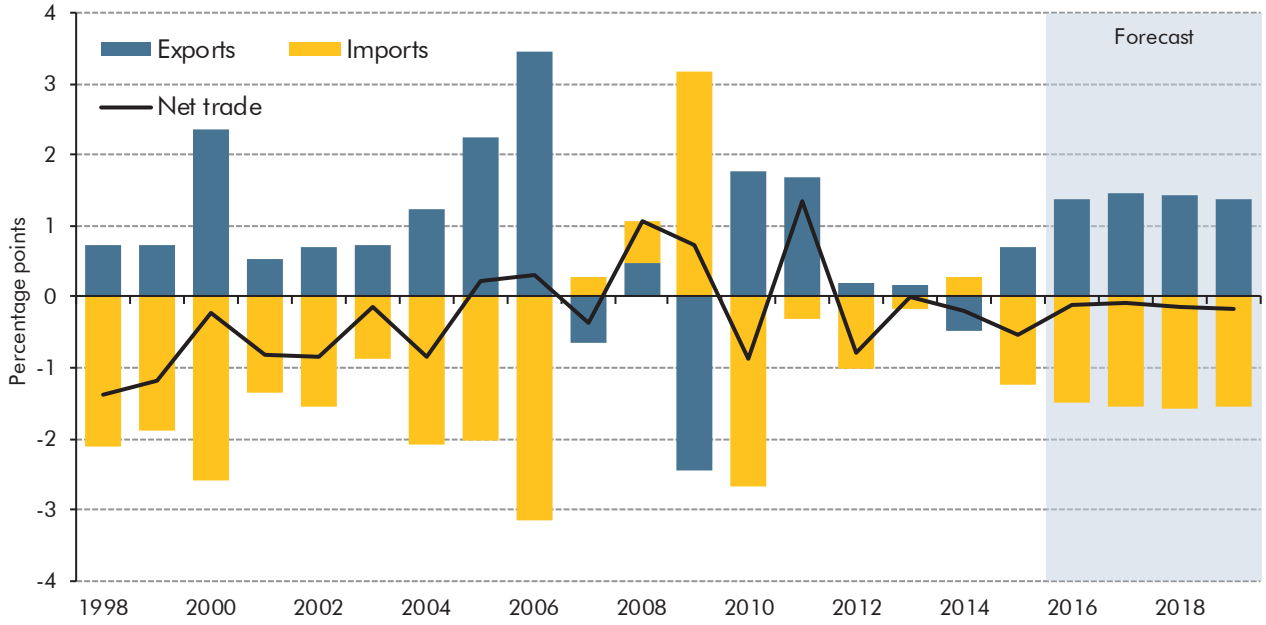
Chart 3.38: Contributions to import-weighted domestic demand and UK import growth



Source: ONS, OBR

3.116 Reflecting the deterioration in the outlook for exports, we expect net trade to make a negative contribution of -0.5 percentage points to growth in 2015, revised down from a small positive contribution in our March forecast. Thereafter, net trade is expected to make a small negative contribution to annual GDP growth in each year over the remainder of the forecast period, 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. The contribution of these factors – and how our forecast compares to the pre-crisis decade – is discussed further in Box 3.3.

Chart 3.39: Net trade contribution to GDP



Source: ONS, OBR

Box 3.3: Contributions to UK net trade

Trade makes an important contribution to the UK economy, with nominal exports and imports each worth around 30 per cent of GDP. Changes in net trade – exports minus imports – can have material effects on GDP and are therefore important parts of our forecast.

One way to think about the net trade contribution to UK GDP growth is to decompose it into different drivers. UK exports can be thought of as being driven by world GDP growth and UK imports by domestic demand growth. However, for UK exports, a country's GDP growth only matters if it is an export market for the UK, if its GDP growth translates into import growth and if UK exporters take advantage of that import growth by exporting more to that country. UK export growth can therefore be decomposed into contributions from GDP growth in UK export markets, import penetration in UK export markets and the UK's export market share. For imports, certain components of domestic demand are more import intensive than others and the import intensity can change over time. UK import growth can therefore be decomposed into contributions from import-weighted domestic demand growth and UK import penetration.

Chart B uses this method of decomposing the net trade contribution to illustrate the sources of the negative contributions to GDP growth in the seven years before the crisis (-0.4 percentage points a year on average), the positive contributions in the seven years since the recession began (+0.2 percentage points) and the negative contributions we expect in the forecast period (-0.2 percentage points).

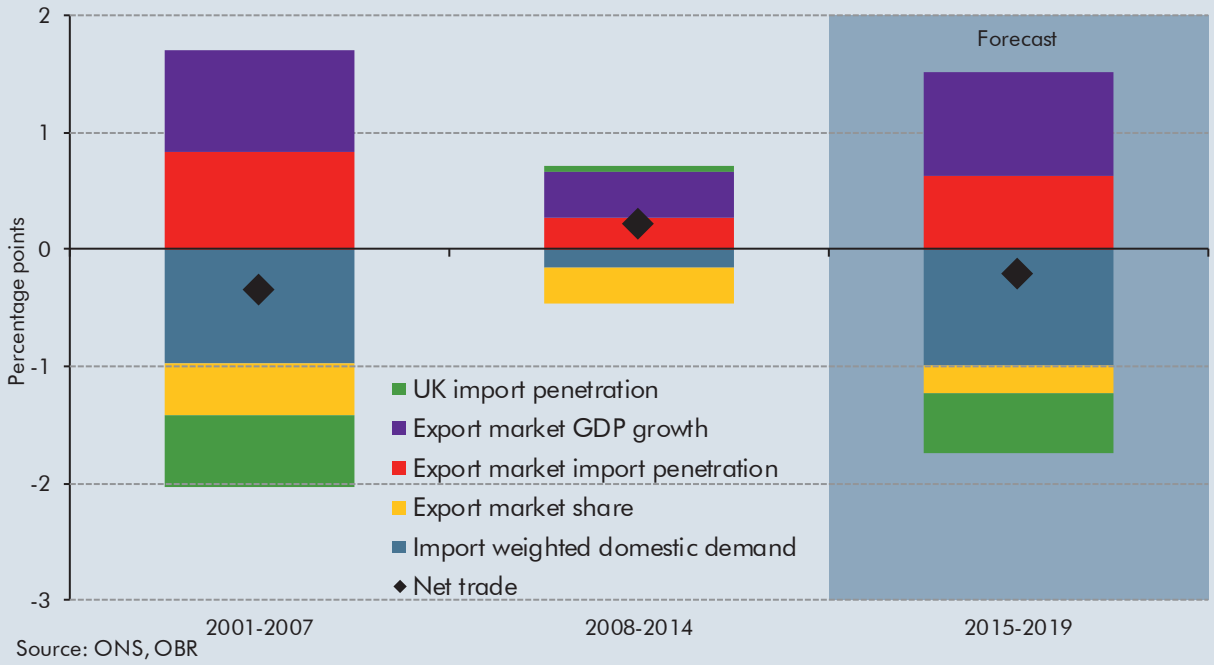
The chart shows that, relative to the pre-crisis period, the net trade contribution to GDP growth has been more positive in recent years because, although exports have fallen, this has been more than offset by a smaller negative contribution from imports. Import weighted domestic demand made a smaller negative contribution to GDP growth over this period and import

penetration also made a small positive contribution to GDP growth, having made a negative contribution in the pre-crisis period.

Again relative to the pre-crisis decade, the net trade contribution to growth over the forecast period is slightly less negative due to:

- demand drivers of trade – export market GDP growth and import-weighted domestic demand growth – recover to close to pre-crisis trends, which has a broadly offsetting impact for net trade compared to the pre-crisis average;
- the trade intensity of demand – import penetration rates in the UK and export markets – rise from recent levels, but to less than their pre-crisis averages. This would be consistent with emerging markets integrating into the global trading system more slowly. The differences are also broadly offsetting for net trade compared to the pre-crisis average; and
- the UK's export market share falls, but at a slower pace than the pre-crisis average. This would also be consistent with a slowing in the rate at which emerging markets' export market share rises. It is positive for net trade compared to the pre-crisis average.

Chart B: Net trade contributions to GDP growth



Source: ONS, OBR

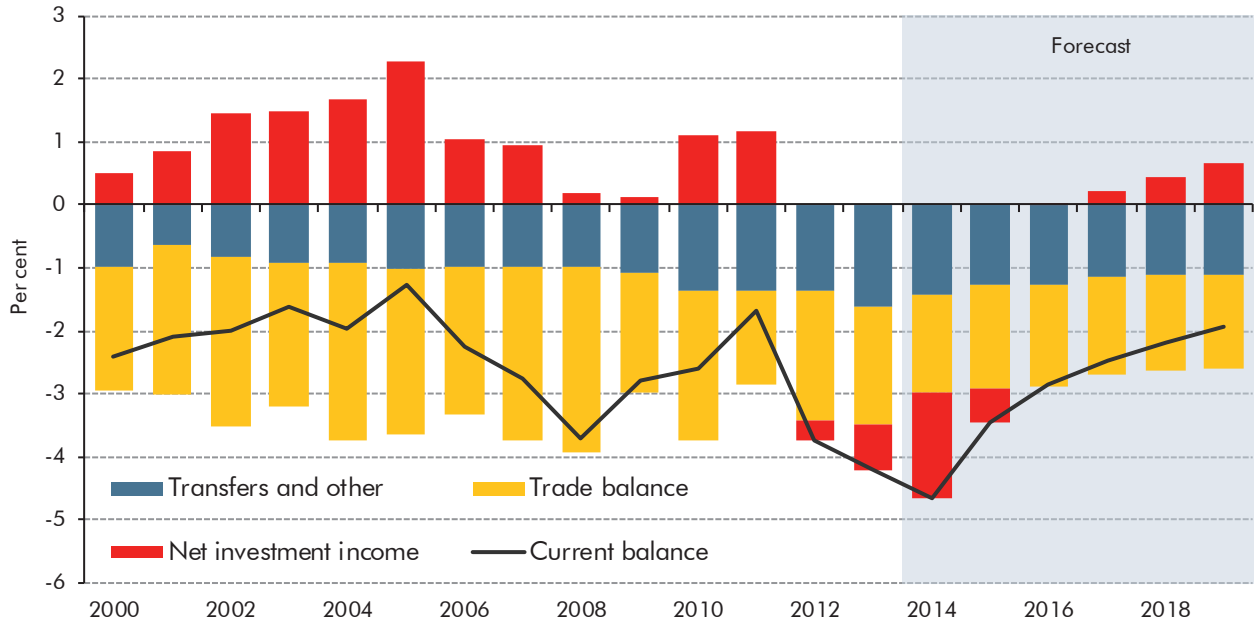
The current account balance

3.117 The current account deficit remains wide by historical standards, largely thanks to a significant deterioration in the income balance since 2012, as net rates of return on equities and bonds have fallen. The income account deficit widened to just over 2 per cent of GDP in the second quarter of 2014. That compares to an average surplus of around 1 per cent in the pre-crisis decade. While the trade balance improved slightly over the first half of the

year, the deficit was 1.4 per cent of GDP in the second quarter, contributing to an overall current account deficit of just over 5 per cent of GDP.

3.118 The volatility of the income balance, arising mostly from the income flows from direct investment, makes forecasting extremely difficult. We expect the income account to improve more gradually than we did in March, implying a slower return to more historically typical net rates of return. But our income account forecast is subject to significant uncertainty. It is based on an assumption that relative rates of return have been temporarily depressed. Taken together with a gloomier outlook for the trade balance, this means that we have revised our forecast of the current account deficit wider over the forecast period – by an average of just under 1½ per cent of GDP between 2014 and 2018.

Chart 3.40: Current account balance as a share of GDP



Source: ONS, OBR

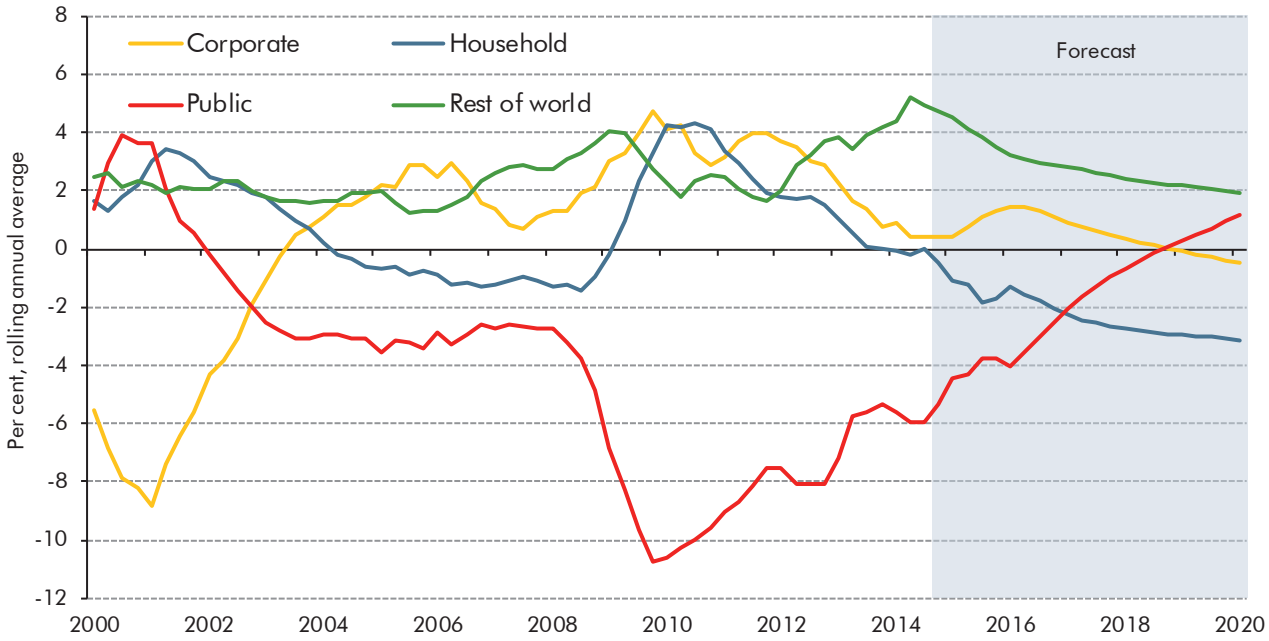
Sectoral net lending

3.119 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 close to balance, and companies and the rest of the world to be in surplus (Chart 3.41).

3.120 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 a large part of the offsetting change, with household net lending moving from a deficit of 0.4 per cent of GDP in 2014 to a historically large deficit of 3.1 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 over the forecast period.

Corporate sector net lending is expected to narrow slightly by the end of the forecast as business investment grows faster than profits.

Chart 3.41: Sectoral net lending



Source: ONS, OBR

Risks and uncertainties

3.121 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.

3.122 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:

- euro area economies and banking systems have yet to complete the adjustment toward sustainable demand and competitiveness (Box 3.2). Further damaging instability remains possible. Concerns have been expressed about the difficulty of completing these adjustments in an environment of very low inflation, which has become more challenging since our March forecast;

- global monetary policy has been exceptionally loose for an extended period. As investors anticipate a return to more normal monetary conditions, the risk of spillover effects to the wider economy remains. Since March, the tapering of US monetary stimulus has been completed in line with market expectations. Market expectations of the first rise in US interest rates have not shifted significantly since March. Developments in China have remained a focus of attention;

- geopolitical events and the potential spread of contagious disease pose risks to the central forecast, particularly those events that could have a direct impact on the UK economy. As ever, there could also be a broader risk through trade linkages and financial exposures to affected countries;

- 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, the consumer spending and housing investment that has driven the recovery could falter as the resources to sustain them would be lacking;

- we expect some big changes in the structure of spending and income associated with another five years of 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. Since we consider one of the sources of disappointing productivity growth in recent years to be related to the pace of resource reallocation, the scale of the adjustments this switch in spending implies may also represent a risk to the economy evolving in line with our central forecast; and

- household consumption outpaces disposable income in our forecast, with the saving ratio falling gradually. Meanwhile, residential investment grows strongly, leaving households' finances in deficit and the gross debt to income ratio rising well above its pre-crisis peak by the forecast horizon. That seems consistent with supportive monetary policy and other interventions (such as Help to Buy), but it could pose risks to the sustainability of the recovery over the medium term.

Comparisons with external forecasters

3.123 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.

3.124 In its October *World Economic Outlook*, the **International Monetary Fund** (IMF) forecasts real GDP growth of 2.7 per cent in 2015, around 0.3 percentage points above our central forecast. The IMF published its forecast before the estimate of GDP growth in the third quarter of 2014, which may partly explain the difference. In 2016, the IMF forecasts growth of 2.4 per cent, again slightly stronger than our central forecast.

3.125 The **Organisation for Economic Cooperation and Development** (OECD) published an updated forecast as part of its November *Economic Outlook*, with stronger expected growth in 2015 and 2016. There are some differences in the expected composition of growth in both years, with the OECD forecasting that net trade will make no contribution to GDP growth, compared with our forecast that net trade will make a negative contribution over this period. The OECD also expects investment to grow more quickly in 2016. Conversely, the OECD expects the contribution of government consumption to GDP growth to be lower than us in both 2015 and 2016.

3.126 The **European Commission** published its latest forecast in November. The Commission expects growth of 2.7 per cent in 2015 and 2.5 per cent in 2016. The Commission expects government consumption to grow in 2015 and 2016, whereas we forecast a fall in government consumption over the same period. The Commission also expects the contribution to GDP growth from net trade to be less negative than our central forecast in 2015. Conversely, the Commission's forecast for private consumption growth is weaker than our central forecast.

3.127 In its November *Economic Review*, the **National Institute for Economic and Social Research** (NIESR) forecast GDP growth of 2.5 per cent in 2015 and 2.0 per cent in 2016 – slightly above our forecast in 2015, but slightly below in 2016. NIESR expects a less negative contribution to GDP growth from government consumption in 2015 and a stronger contribution from net trade in 2016 owing to a faster recovery in the euro area.

3.128 The November forecast from **Oxford Economics** predicts growth of 2.6 and 2.5 per cent in 2015 and 2016 respectively. Our central forecast assumes a negative contribution to GDP growth from net trade in 2015 whereas Oxford Economics expects a positive contribution.

3.129 The **Bank of England** Monetary Policy Committee's forecast for growth is higher than our central forecast in 2015, 2016 and 2017 by 0.5, 0.4 and 0.2 percentage points respectively. The MPC's forecast for CPI inflation is above our forecast in 2015 and 2016, with both forecasts assuming a return to target in 2017. Alongside its November *Inflation Report*, the Bank of England published additional forecasts, which we have compared to our own forecast in more detail in the next section.

Table 3.4: Comparison with external forecasts

	Per cent					
	2013	2014	2015	2016	2017	2018
OBR (December 2014)						
GDP growth	1.7	3.0	2.4	2.2	2.4	2.3
CPI inflation	2.6	1.5	1.2	1.7	2.0	2.0
Output gap	-2.2	-1.0	-0.5	-0.5	-0.2	-0.1
IMF (October 2014)						
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		
EC (November 2014)						
GDP growth	1.7	3.1	2.7	2.5		
CPI inflation	2.6	1.5	1.6	1.9		
Output gap	-2.4	-0.8	0.1	0.6		
NIESR (November 2014)[1]						
GDP growth	1.7	3.0	2.5	2.0	2.3	2.3
CPI inflation	2.6	1.7	1.8	1.8	2.1	2.0
Oxford Economics (November 2014)						
GDP growth	1.7	3.0	2.6	2.5	2.6	2.5
CPI inflation	2.6	1.6	1.3	1.9	2.0	2.0
Output gap	-5.2	-4.8	-4.4	-4.3	-4.2	-4.0
Bank of England (November 2014)[2]						
GDP growth (mode)[3]		3.5	2.9	2.6	2.6	
CPI inflation (mode)		1.2	1.4	1.8	2.0	

[1] Output gap not published.

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

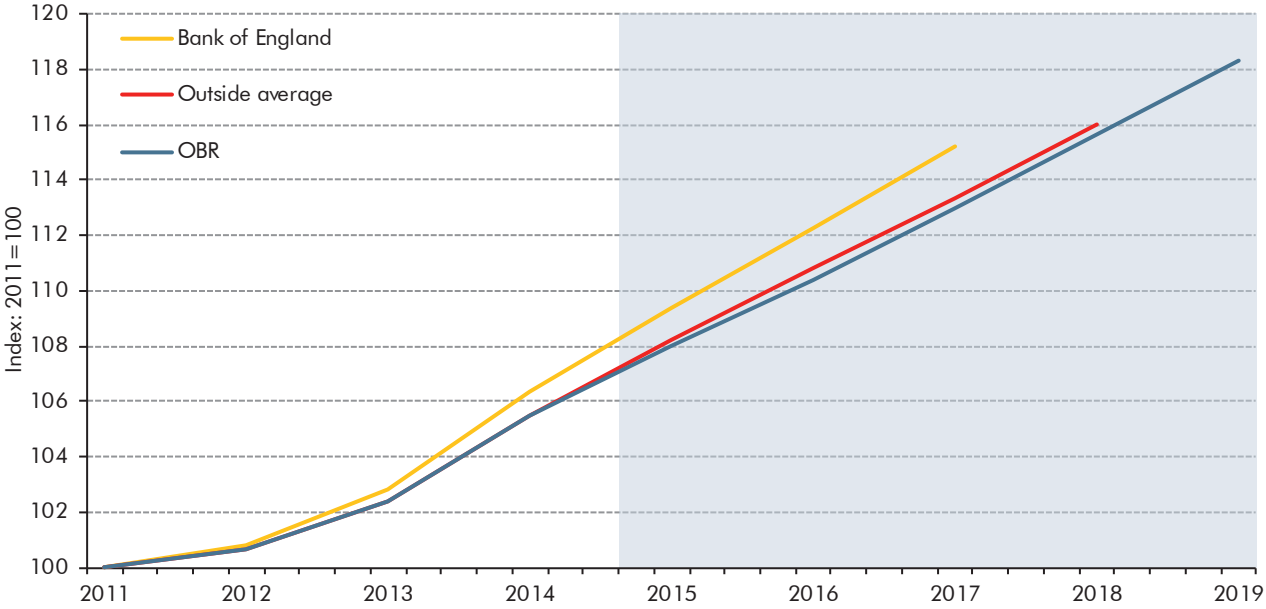
[3] Fourth quarter year-on-year growth rate.

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

3.130 Alongside its November 2014 *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.

3.131 Table 3.5 shows that the Bank's modal expectation for household consumption growth in 2015 is somewhat weaker than our forecast, whereas the Bank expect stronger household consumption growth in 2016. The Bank also forecasts a somewhat stronger path for business investment growth between 2015 and 2017.

Chart 3.42: Comparison of forecasts for the level of GDP



Source: Bank of England, *Inflation Report,* November 2014, HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts* November, 2014, ONS, OBR

Table 3.5: Bank of England illustrative projections

	Per cent			
	2014[1]	2015	2016	2017
Bank of England November *Inflation Report* forecast				
Household consumption	2	2½	2¾	2¾
Business investment	9½	10	8¼	8
Housing investment[2,3]	13	7½	4¾	1¾
Exports	-1	4	5½	5
Imports	-¾	5	5¾	5
Employment[4]	2½	1¼	1	¾
Average weekly earnings[3,4]	1¼	3¼	3¾	3¾
Difference from OBR forecast				
Household consumption	-0.3	-0.3	0.6	0.3
Business investment	1.8	1.6	1.9	1.7
Exports	0.6	1.6	0.8	0.1
Imports	0.1	1.1	1.1	0.3
Employment[4]	0.4	0.1	0.5	0.4

[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	3.0	2.4	2.2	2.4	2.3	2.3
GDP level (2013=100)	100.0	103.0	105.5	107.8	110.4	112.9	115.5
Nominal GDP	3.5	5.0	4.0	3.6	4.1	4.2	4.3
Output gap (per cent of potential output)	-2.2	-1.0	-0.5	-0.5	-0.2	-0.1	0.0
Expenditure components of GDP							
Domestic demand	1.9	3.2	2.9	2.2	2.4	2.4	2.4
Household consumption[1]	1.6	2.3	2.8	2.2	2.4	2.3	2.4
General government consumption	0.7	1.1	-0.4	-0.8	-0.9	-0.3	0.0
Fixed investment	3.2	8.1	8.4	5.9	5.6	5.2	4.8
Business	4.8	7.7	8.4	6.3	6.3	6.3	6.3
General government[2]	-7.3	2.1	3.3	1.6	2.2	1.6	2.3
Private dwellings[2]	6.1	13.0	11.0	7.0	5.5	4.0	2.4
Change in inventories[3]	0.3	0.3	-0.2	0.0	0.0	0.0	0.0
Exports of goods and services	0.5	-1.6	2.4	4.7	4.9	4.7	4.4
Imports of goods and services	0.5	-0.8	3.9	4.7	4.7	4.7	4.5
Balance of payments current account							
Per cent of GDP	-4.2	-4.7	-3.5	-2.9	-2.5	-2.2	-1.9
Inflation							
CPI	2.6	1.5	1.2	1.7	2.0	2.0	2.0
RPI	3.0	2.4	2.2	2.9	3.4	3.6	3.6
GDP deflator at market prices	1.7	2.0	1.5	1.4	1.6	1.9	1.9
Labour market							
Employment (millions)	30.0	30.7	31.2	31.4	31.5	31.6	31.7
Wages and salaries	3.0	3.3	3.6	3.8	4.3	4.3	4.2
Average earnings[4]	1.8	1.8	2.0	3.1	3.9	3.9	3.8
LFS unemployment (% rate)	7.6	6.2	5.4	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.84	0.83	0.84	0.85	0.86
Household sector							
Real household disposable income	-0.2	2.2	1.9	1.7	1.8	2.0	2.1
Saving ratio (level, per cent)	6.4	6.6	5.4	5.4	5.1	4.9	4.8
House prices	3.5	10.2	7.4	5.9	5.8	5.1	3.8
World economy							
World GDP at purchasing power parity	3.2	3.3	3.8	4.0	4.0	4.1	4.1
Euro area GDP	-0.4	0.8	1.3	1.6	1.6	1.6	1.6
World trade in goods and services	3.1	3.8	5.1	5.4	5.6	5.6	5.6
UK export markets[5]	2.4	3.7	4.3	5.0	5.3	5.3	5.3

[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 forecast

	Percentage change on a year earlier, unless otherwise stated					
	Outturn	Forecast				
	2013	2014	2015	2016	2017	2018
UK economy						
Gross domestic product (GDP)	0.0	0.3	0.1	-0.4	-0.2	-0.1
GDP level (2013=100)[1]	0.0	0.3	0.3	0.0	-0.3	-0.4
Nominal GDP	0.1	0.0	0.0	-0.8	-0.5	-0.3
Output gap (per cent of potential output)	0.0	0.4	0.6	0.3	0.1	-0.1
Expenditure components of GDP						
Domestic demand	0.0	0.3	0.6	-0.3	-0.2	-0.1
Household consumption[2]	-0.7	0.2	1.0	-0.3	-0.2	0.0
General government consumption	-0.2	-0.1	0.1	0.5	0.9	0.6
Fixed investment	3.7	-0.5	0.1	-1.9	-2.3	-1.6
Business	6.0	-0.2	-0.8	-1.7	-2.4	-1.3
General government[3]	-0.9	-8.6	2.3	-0.6	1.3	2.1
Private dwellings[3]	1.7	3.9	1.0	-3.0	-4.0	-4.1
Change in inventories[4]	0.0	0.2	-0.2	0.0	0.0	0.0
Exports of goods and services	-0.2	-4.2	-2.3	-0.3	0.0	0.0
Imports of goods and services	0.1	-3.8	-0.4	-0.1	-0.1	0.0
Balance of payments current account						
Per cent of GDP	-0.6	-2.3	-1.5	-1.1	-0.9	-0.7
Inflation						
CPI	0.0	-0.3	-0.8	-0.3	0.0	0.0
RPI	0.0	-0.2	-1.0	-0.7	-0.4	-0.3
GDP deflator at market prices	0.1	-0.3	-0.1	-0.4	-0.3	-0.2
Labour market						
Employment (millions)	0.1	0.4	0.5	0.5	0.3	0.2
Wages and salaries	0.2	-0.4	-0.5	-0.8	-0.4	-0.2
Average earnings[5]	0.3	-0.7	-1.2	-0.5	0.1	0.1
LFS unemployment (% rate)	0.0	-0.6	-1.2	-0.9	-0.4	0.0
Claimant count (millions)	0.00	-0.16	-0.29	-0.23	-0.14	-0.09
Household sector						
Real household disposable income	-0.1	1.0	0.0	0.2	-0.5	-0.2
Saving ratio (level, per cent)	1.5	2.5	1.2	1.9	1.8	1.7
House prices	0.0	1.7	-0.4	0.9	2.1	1.5
World economy						
World GDP at purchasing power parity	0.3	-0.5	-0.1	-0.1	-0.1	-0.1
Euro area GDP	0.0	-0.2	-0.1	-0.1	-0.3	-0.4
World trade in goods and services	-0.1	-1.4	-0.7	-0.6	-0.5	-0.5
UK export markets[6]	0.2	-1.0	-0.9	-0.3	-0.1	-0.1

[1] Per cent change since March.

[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 4.5);
- explains the effects of reclassifications and new policies announced in this Autumn Statement and since the Budget 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 March (from paragraph 4.32);
- describes the outlook for public sector expenditure, focusing on departmental expenditure limits and the components of annually managed expenditure including the Government's new welfare cap (from paragraph 4.89);
- presents spending subject to the Government's new welfare cap (from paragraph 4.114);
- describes the outlook for government lending to the private sector and other financial transactions (from paragraph 4.166);
- describes the outlook for the key fiscal aggregates: public sector net borrowing (PSNB), the current budget, the cyclically adjusted current budget and public sector net debt (PSND) (from paragraph 4.186);
- summarises risks and uncertainties (paragraph 4.201); and,
- provides a comparison with forecasts from international organisations (from paragraph 4.202).

4.2 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in 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 provisional ONS outturn data for April to October and then forecasts to 2019-20.[1] As in previous *Economic and fiscal outlooks (EFOs)*, this fiscal forecast:

- represents our central view of the path of the public finances. We believe that the outturns are 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 Autumn Statement; and
- focuses on official 'headline' fiscal aggregates that exclude public sector banks. These reflect the updated European System of Accounts (ESA10) and the conclusions of the ONS's Public Sector Finances Review. The Government's fiscal mandate and supplementary target are defined in terms of these measures.

4.3 In this *Economic and fiscal outlook*, our economy and fiscal forecasts are unfortunately not fully consistent. The inconsistency arises because after the economy forecast had been closed, the Government allocated £1.2 billion of spending from the reserve to the NHS in 2015-16 and changed its total spending assumption in a way that added around £2 billion a year to spending from 2016-17. These changes were relative to the amounts on which our final economy forecast was based and that had been provided in accordance with the forecast timetable agreed between the Treasury and OBR in September.

4.4 Relative to the size of the economy, the amounts of additional spending are small but not negligible. For example, £2 billion is equal to 0.6 per cent of government consumption and 0.1 per cent of GDP in 2016-17. Had we been informed of this ahead of our final economy forecast, the main impact would have been on the expenditure composition of GDP. That would have had small, but again not negligible, implications for our fiscal forecast.

Economic determinants of the fiscal forecast

4.5 Our forecasts for the public sector finances 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 in 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 March.

GDP and the output gap

4.6 Most economic forecasts focus on the outlook for real GDP, but it is nominal GDP that matters most when forecasting the public finances. As explained in Chapter 2, Blue Book

[1] Outturn data are consistent with the Public Sector Finances October 2014 Statistical Bulletin published by the Office for National Statistics and HM Treasury.

2014 revised the level of nominal GDP up significantly, but had fewer implications for its growth profile from year to year. Relative to our March forecast, cumulative nominal GDP growth between the 2013-14 and 2018-19 has been revised down by 1.7 percentage points. This reflects lower growth in both real GDP and the GDP deflator.

4.7 The structural, or cyclically adjusted, component of net borrowing and the current budget balance is estimated using the output gap. A negative output gap implies that the economy is operating below capacity, providing scope for tax revenues 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 narrower across the forecast period than in March, reflecting our judgement that spare capacity in the labour market has been taken up more rapidly than expected so far in 2014. We estimate that the output gap was -0.8 per cent of GDP in the third quarter of 2014, and that it will close slowly over the forecast period.

Income and expenditure components of GDP

4.8 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.

4.9 The largest source of labour income is wages and salaries, which are determined by employment and earnings. Stronger growth in employment has helped offset weaker earnings growth in 2014-15. Thereafter, wage and salary growth is lower in each year of the forecast, compared with March. This is explained by lower earnings growth in 2015-16 and 2016-17 and by weaker employment growth, consistent with lower real GDP growth, over the rest of the forecast.

4.10 Nominal consumer spending growth has remained relatively strong in 2014, with our 2015 forecast little changed from March. Growth in 2016 has been revised down as a result of lower inflation.

4.11 Non-oil, non-financial company profits are forecast to grow slightly faster than the economy as a whole over the next two years, as productivity picks up and the output gap continues to close. Financial sector profits are forecast to grow more slowly than non-financial sector profits due to the effect of both near-term conduct fines and pressures from regulation throughout the forecast period.

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	2.2	3.0	2.2	2.2	2.4	2.3	2.3
Nominal GDP[1]	4.2	5.1	3.6	3.6	4.2	4.2	4.3
Nominal GDP (£ billion)[1,2]	1733	1822	1888	1956	2038	2124	2215
Nominal GDP (centred end-March £bn)[1,3]	1779	1853	1921	1996	2079	2169	2263
Wages and salaries[4]	2.9	3.5	3.5	3.9	4.4	4.2	4.2
Non-oil PNFC profits[4,5]	5.0	7.5	7.0	3.5	4.0	4.1	4.3
Non-oil PNFC net taxable income[4,5]	2.8	6.3	4.8	0.7	1.0	1.6	1.9
Consumer spending[4,5]	3.6	4.0	4.3	4.1	4.7	4.7	4.7
Prices and earnings							
GDP deflator	1.8	2.1	1.4	1.3	1.7	1.9	1.9
RPI (September)	3.2	2.3	2.1	2.9	3.4	3.6	3.6
CPI (September)	2.7	1.2	1.2	1.8	2.0	2.0	2.0
Average earnings[6]	1.7	1.8	2.1	3.3	4.0	3.9	3.8
'Triple-lock' guarantee (September)	2.7	2.5	2.5	3.0	3.8	4.0	3.9
Key fiscal determinants							
Claimant count (millions)	1.33	0.96	0.83	0.83	0.84	0.85	0.86
Employment (millions)	30.2	30.9	31.2	31.4	31.5	31.6	31.8
VAT gap (per cent)	10.3	11.1	11.0	11.0	11.0	11.0	11.0
Output gap (per cent of potential output)	-2.0	-0.7	-0.5	-0.4	-0.2	-0.1	0.0
Financial and property sectors							
Equity prices (FTSE All-Share index)	3475	3570	3672	3805	3963	4130	4308
HMRC financial sector profits[1,5,7]	1.4	2.3	3.8	3.7	4.1	4.1	4.3
Financial sector net taxable income[1,5]	2.9	-5.0	-6.1	3.3	3.7	3.3	0.9
Residential property prices[8]	5.0	10.6	6.5	5.9	5.7	4.8	3.5
Residential property transactions (000s)[9]	1140	1215	1293	1385	1439	1473	1503
Commercial property prices[9]	17.3	11.3	0.9	1.2	2.7	2.1	2.7
Commercial property transactions[9]	8.4	4.2	0.5	2.0	2.9	2.5	2.6
Volume of stampable share transactions	13.6	1.2	-3.2	-0.6	-0.6	-0.6	-0.6
Oil and gas							
Oil prices ($ per barrel)[5]	108.8	100.6	83.1	86.1	86.5	86.5	86.5
Oil prices (£ per barrel)[5]	69.6	60.9	53.1	55.1	55.3	55.1	56.8
Gas prices (p/therm)[5]	66.9	50.1	54.5	56.8	56.8	56.8	56.8
Oil production (million tonnes)[5,10]	40.6	39.2	39.2	39.2	39.2	39.2	37.2
Gas production (billion therms)[5,10]	12.8	12.8	12.7	12.7	12.7	12.7	12.1
Interest rates and exchange rates							
Market short-term interest rates (%)[11]	0.5	0.6	0.9	1.5	1.9	2.1	2.4
Market gilt rates (%)[12]	2.4	2.5	2.4	2.7	2.9	3.1	3.2
Euro/Sterling exchange rate (€/£)	1.19	1.25	1.26	1.25	1.23	1.21	1.19
Memo: March 2014 nominal GDP (derived ESA10 basis)	*1733*	*1813*	*1885*	*1972*	*2061*	*2153*	

[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] Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data

[11] 3-month sterling interbank rate (LIBOR).

[12] Weighted average interest rate on conventional gilts.

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

	Percentage point change unless otherwise specified					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
GDP and its components						
Real GDP	-0.1	0.4	-0.2	-0.4	-0.2	-0.1
Nominal GDP[1]	-0.5	0.5	-0.3	-1.0	-0.4	-0.2
Nominal GDP (£ billion)[1,2]	89	101	100	85	82	81
Nominal GDP (centred end-March £bn)[1,3]	91	100	93	83	80	81
Wages and salaries[4]	-1.0	0.1	-0.7	-0.8	-0.3	-0.2
Non-oil PNFC profits[4,5]	-2.0	-3.1	2.1	-1.9	-1.3	-0.6
Non-oil PNFC net taxable income[4,5]	-4.1	-3.5	1.6	-2.6	-1.8	-0.9
Consumer spending[4,5]	-1.0	-0.5	0.2	-0.6	-0.3	0.0
Prices and earnings						
GDP deflator	0.1	-0.1	-0.2	-0.5	-0.2	-0.1
RPI (September)	0.0	-0.2	-1.1	-0.7	-0.4	-0.2
CPI (September)	0.0	-0.6	-0.8	-0.3	0.0	0.0
Average earnings[6]	-0.9	-0.6	-1.2	-0.4	0.2	0.1
'Triple-lock' guarantee (September)	0.0	0.0	-0.8	-0.6	0.1	0.2
Key fiscal determinants						
Claimant count (millions)	-0.02	-0.22	-0.28	-0.21	-0.13	-0.09
Employment (millions)	0.2	0.4	0.5	0.4	0.3	0.2
VAT gap (per cent)	0.0	1.2	1.1	1.1	1.1	1.1
Output gap (per cent of potential output)	0.0	0.6	0.5	0.2	0.0	-0.1
Financial and property sectors						
Equity prices (FTSE All-Share index)	-23	-177	-225	-269	-297	-319
HMRC financial sector profits[1,5,7]	0.0	0.0	-0.2	-1.0	-0.4	-0.4
Financial sector net taxable income[1,5]	0.3	-4.9	-9.2	-3.7	0.2	-0.4
Residential property prices[8]	0.1	2.0	-0.8	1.5	2.0	1.1
Residential property transactions (000s)[9]	-6	-142	-114	-65	-54	-52
Commercial property prices[9]	5.5	9.2	-1.2	-2.5	-0.4	0.1
Commercial property transactions[9]	-0.9	0.2	-2.6	-1.9	-1.2	-0.5
Volume of stampable share transactions	3.1	-2.8	-0.7	2.0	2.0	2.0
Oil and gas						
Oil prices ($ per barrel)[5]	0.0	-6.9	-19.0	-13.2	-12.7	-12.7
Oil prices (£ per barrel)[5]	0.0	-3.8	-8.0	-4.1	-3.7	-4.0
Gas prices (p/therm)[5]	0.0	-10.1	-8.7	-6.4	-6.4	-6.4
Oil production (million tonnes)[5,10]	0.0	0.0	0.0	0.0	0.0	0.0
Gas production (billion therms)[5,10]	0.0	0.0	0.0	0.0	0.0	0.0
Interest rates and exchange rates						
Market short-term interest rates[11]	0.0	-0.1	-0.4	-0.6	-0.7	-1.0
Market gilt rates[12]	-0.2	-0.5	-0.9	-0.9	-1.0	-1.0
Euro/Sterling exchange rate (€/£)	0.00	0.03	0.03	0.01	-0.02	-0.05

[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] Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data
[11] 3-month sterling interbank rate (LIBOR).
[12] Weighted average interest rate on conventional gilts.

Inflation

4.12 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 since March, reflecting lower food price inflation, lower petrol and diesel prices and lower inflation for import-intensive goods. It returns to the Bank of England's 2 per cent target by late 2017.

4.13 RPI inflation determines the interest paid on index-linked gilts and is used to revalorise excise duties and uprate business rates. RPI inflation is expected to fall in 2015, for the same reasons as CPI inflation, before an increase in mortgage interest payments (MIPs) pushes it up relative to CPI inflation. Compared to our March forecast, RPI inflation is lower over the forecast period as lower market interest rates feed through to the MIPs profile.

4.14 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, we assume the BSP will be uprated by the minimum 2.5 per cent in 2015-16 and 2016-17. These would be the fourth and fifth successive years since the triple-lock was announced that the BSP had increased faster than average earnings, with a cumulative difference over that period of 8.3 per cent. On our current forecast, uprating will be in line with average earnings growth from 2017-18 onwards.

Property market

4.15 The residential property market is a key driver of receipts from stamp duty land tax and inheritance tax. House price growth has picked up further since our March forecast. Our latest forecast is for 10.6 per cent growth in 2014-15 as a whole, 2.0 percentage points higher than our forecast in March. House prices rise faster than earnings for most of the forecast period thanks to low interest rates and the fact that household income growth has historically had a more than one-for-one impact on house prices.

4.16 Residential property transactions have been lower than expected in recent months, with growth in 2014-15 expected to be 6.6 per cent, well below the 18.4 per cent forecast in March. The level of transactions relative to the housing stock is assumed to take longer to return to its historical average. Transactions are expected to be affected by the reforms to stamp duty announced in the Autumn Statement (see Box 4.5).

4.17 Commercial property prices and transactions increased strongly in the second quarter of 2014. Average prices are now expected to grow by 11.3 per cent in 2014-15 and the volume of transactions by 4.2 per cent. We have assumed that more activity in the near term means that growth in future years will be slightly lower than forecast in March.

Oil and gas sector

4.18 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 21 November, and then remain at that level. Movements in oil prices and the sterling/dollar exchange rate mean that the sterling price of oil is significantly lower than we assumed in March. We use the same method to project gas prices, which are also lower.

4.19 Oil and gas production forecasts are based on the central projection published by the Department of Energy and Climate Change (DECC) and are unchanged since March. Projections for capital and operating expenditure by oil and gas firms are also important. Compared to March, we expect lower levels of capital and operating expenditure over the forecast period, since lower oil and gas prices will have reduced the net present value of potential capital projects and should reduce upward pressures on operating costs.

Equity markets

4.20 Equity prices are a significant determinant of capital gains tax, inheritance tax and stamp duty receipts. 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 21 November were below our March assumption – and that is locked in by our forecast assumption – they remain lower across the forecast period.

Interest rates

4.21 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 21 November. The futures curve implies that rates will be lower in all years of the forecast than in March, 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 March.

Policy announcements, fiscal 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.[2] These are discussed in Box 3.1 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.

[2] In March 2014, we published a detailed 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*.

4.23 Box 4.1 provides an update on the fiscal impact of past policy interventions on the financial sector.

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 Northern Rock plc;
- holdings in Bradford & Bingley (B&B) and Northern Rock Asset Management (NRAM), 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 September 2014. In total, £134 billion has been disbursed by the Treasury. (Following the PSF review, the total sum adds to net debt, whereas previously some was netted off as liquid assets.) Principal repayments on loans, proceeds from share sales and redemptions of preference shares amounted to £35 billion. And the Treasury also received a further £17 billion, mainly fees. So the net cash position currently stands at around a £82 billion shortfall.

The Treasury is currently owed £41 billion – largely the value of loans outstanding – while it retains shares in Lloyds and RBS – currently valued at £48 billion - and holdings in B&B and NRAM. Our forecast includes projections for loan repayments from B&B and NRAM, but no other loan repayments or share sales, due to uncertainty over their scale and timing.

If the Treasury were to receive all loan payments in full, and sold the shares at their latest values, it would realise an overall cash surplus of around £8 billion. 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 £20.6 billion to date.

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	7.7	2.7	-	13.7	3.7
RBS	45.8	0.5	4.5	1.2	34.3	-5.3
UK Asset Resolution	41.3	19.3	3.4	21.5	-	3.0
FSCS	20.9	4.3	-	16.6	-	-
Other institutions	5.3	3.1	-	2.1	-	-
Credit Guarantee Scheme	-	-	4.3	-	-	4.3
Special Liquidity Scheme	-	-	2.3	-	-	2.3
Total	**133.8**	**35.0**	**17.2**	**41.5**	**48.0**	**7.9**

[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 21 November 2014.

Direct effect of new policy announcements on the public finances

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

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

4.26 Autumn Statement 2014 policy measures reduce borrowing by £0.2 billion a year on average between 2014-15 and 2019-20. The giveaways – including the reform of stamp duty land tax and raising the income tax personal allowance – broadly offset the takeaways – particularly from banks (including Financial Conduct Authority fines this year, related to foreign exchange trading) and multinational companies. Additional funding for the NHS from the 2015-16 reserve has also been reflected in our forecast. 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. This implies another cut in current spending by central government departments in that year equivalent to £14.5 billion (compared to holding spending flat as a share of potential GDP).

Changes to the TME growth assumption

4.27 Table 4.3 also includes our estimate of the effect on borrowing of the change in the assumption specified by the Government for total spending from 2016-17 onwards. This TME growth assumption is explained more fully below in paragraph 4.96.

4.28 Changes to this assumption do not appear in the Treasury's policy decisions table, but we estimate that the effect has been to reduce implied departmental spending and net borrowing by an average of £1.2 billion a year between 2016-17 and 2018-19 relative to our March forecast.

Table 4.3: Summary of the effect of Government decisions

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Effects of receipts measures	**0.7**	**-0.6**	**-0.2**	**0.2**	**0.2**	**-0.1**
of which:						
Income tax and NICs	0.0	-0.4	-0.2	-0.3	-0.4	-0.5
Onshore corporation tax	0.0	1.2	0.9	1.3	1.5	1.3
Stamp duty land tax	-0.4	-0.7	-0.8	-0.8	-0.7	-0.7
Business rates	0.0	-0.6	-0.1	-0.1	-0.1	-0.1
Foreign exchange fines	1.1	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	-0.1	-0.1
Effects of expenditure measures[1]	**0.1**	**-0.5**	**0.2**	**0.3**	**0.3**	**0.6**
of which:						
Current DEL	0.2	-2.2	-1.8	-2.2	-1.1	-0.6
Current AME	0.0	2.1	2.1	2.5	1.4	1.1
of which:						
Welfare	0.0	0.1	0.5	0.9	-0.2	-0.6
Locally-financed current expenditure	0.0	0.3	0.1	0.1	0.1	0.1
Public service pensions	0.0	1.5	1.6	1.6	1.7	1.7
Other	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Capital DEL	-0.1	-0.3	-0.1	-0.1	-0.1	0.0
Capital AME	0.0	0.0	0.0	0.0	0.0	0.0
Total direct effect of Autumn Statement policy measures on PSNB	**0.9**	**-1.0**	**0.1**	**0.4**	**0.5**	**0.4**
Effect of applying new Autumn Statement spending policy assumptions post 2015-16[2]			0.4	1.6	1.7	16.2
Financial transactions[3]	0.0	-0.1	-0.4	-0.6	-0.6	-0.5

[1]Expenditure categories are equivalent to PSCE in RDEL, PSCE in AME, PSGI in CDEL and PSGI in AME in Table 4.22.

[2] The additional tightening in 2019-20 of £14.5 billion is relative to a baseline that assumes current spending by departments would otherwise have remained constant as a share of potential GDP.

[3] Affects PSNCR, not PSNB.

Note: Annex A reproduces the Treasury's full policy decisions table. Our online supplementary tables also reproduce the policy decisions table with the full classifications consistent with our forecast.

Note: this table uses the Treasury scorecard convention that a positive figure means an improvement in the PSNB, PSNCR and PSND.

4.29 The Treasury Select Committee's report on Autumn Statement 2013 recommended that "*the OBR should do all it can to report on whether yields [from anti-avoidance measures] were attained as originally costed*". Together with HM Revenue and Customs (HMRC), we have considered the available evidence on all measures implemented between 2011-12 and 2013-14 for which sufficient time has elapsed to judge their effect. Due to the difficulty and resource requirements of producing formal counterfactual evaluations, we have instead drawn on evidence from HMRC's monitoring of receipts, operational intelligence and the re-costing of previous measures. There is of course considerable uncertainty around such evidence and estimates. Box 4.2 explains this work in more detail.

Box 4.2: Evaluation of anti-avoidance measures

Our review of material related to past anti-avoidance costings suggests that the performance of these measures has been mixed, with some yielding more and some yielding less than expected. In absolute terms, across all of the measures reviewed, the large shortfall on the UK-Swiss tax agreement means that significantly less has been raised in total than originally expected.

We have discussed the UK-Swiss tax agreement shortfall in detail in previous publications (e.g. Box 4.3 of the December 2013 *Economic and fiscal outlook*). In short, due to a smaller-than-estimated tax base and larger-than-expected behavioural response, the agreement is only forecast to raise £1.9 billion compared to the initial expectation of £5.3 billion.

Total receipts from the information sharing agreement with the Crown Dependencies are currently expected to match the original costing over time, but to be raised later than originally expected. Assumptions around the amount of early disclosures have proven optimistic.

A key lesson from this exercise relates to the profile of expected yield. Anti-avoidance measures – like many new government activities – can take longer than expected to start delivering results. This includes measures that rely on new processes, staff or external contractors.

The Budget 2011 measure on 'disguised remuneration: avoidance' that aimed to levy a tax charge on payments from employee benefits trusts is now expected to raise more than originally estimated. Operational intelligence suggests the number of schemes that would be affected was underestimated and that the legislation has been successful in tackling this form of avoidance.

The package of stamp duty land tax (SDLT) anti-avoidance measures announced at Budget 2012 has also raised more than initially expected. This package included an annual charge on enveloped dwellings and a 15 per cent SDLT rate on newly enveloped properties. HMRC has detailed data on these measures and the latest outturns show that the initial costings vastly underestimated the number of enveloped properties, the average value of these properties and overestimated the incentive to de-envelope. It has been estimated that over the forecast period these measures will yield around £900 million, despite new measures exempting various properties from the charges. The original costing expected £270 million.

This evaluation exercise has confirmed that avoidance costings are subject to significant uncertainty – anti-avoidance measures often target a specific subset of taxpayers who are already actively changing their behaviour in response to the tax system. It also suggests that there has not been systematic bias across the costings: while the shortfall from the UK-Swiss tax agreement means the total yield from the measures considered was below expectations, across other measures there were both upside and downside surprises. We will continue to work with HMRC to review the performance of anti-avoidance measures and ensure that the lessons learnt are applied when we look at future Government policy costings in these areas.

Currently unquantifiable policy commitments and other risks

4.30 Our projections do not include the impact of policies where there is insufficient detail or certainty of implementation to quantify the impact and allocate it to particular years. Where significant, these are noted as fiscal risks:

- the Government has announced asset sales targets for central government, including land and property and corporate and financial assets, including the pre-Browne student loan book. Sales of land and property are netted off gross capital expenditure, but as our forecasts are for net capital spending, further sales would not affect the accuracy of our medium-term forecasts. The Government has outlined plans to raise £12 billion through student loan book sales, but we do not include any other asset sales over the forecast horizon. Additional sales of financial assets would affect our forecasts for net debt, but we will only include sales once sufficiently firm details are available of the nature, size and timing of any such transactions; and,

- we have asked the Treasury to identify any changes to future contingent liabilities as a result of new policy announcements since March. Contingent liabilities are not included in our forecasts, because they are future risks that could materialise but which are not currently expected to. The Treasury has only made one new announcement that increases contingent liabilities in the future: the Enterprise Finance Guarantee scheme has been extended for a year to 2015-16. We will continue to report on the broader suite of contingent liabilities, in our annual *Fiscal sustainability reports*.

Classification changes

4.31 Our forecast incorporates all the classification changes recently made by the ONS, discussed further in Box 4.3. We have also anticipated the changes we expect the ONS to make next year by scoring all tax credits that are currently treated as negative tax as spending in AME from 2014-15 onwards.

Box 4.3: Classification changes affecting the public finances data

Public finances data are subject to regular classification and methodological changes. But the most recent changes have been broader than usual in scope, with the ONS now having taken on board the conclusions of its review of the statistics and the implications of the new 2010 European System of Accounts (ESA10). It is important to stress that these are changes to the way the public sector's finances are measured, not to the underlying activities being measured.

The headline measure of the deficit is now 'public sector net borrowing excluding public sector banks' – which removes the effect of the public sector banks from overall borrowing. The previous measure was 'public sector net borrowing excluding financial interventions' – which also excluded the effects of other unusual operations deemed to result from the financial crisis, such as the Special Liquidity Scheme, but not the cash transfers to the Exchequer from the Asset Purchase Facility (APF) related to quantitative easing. These transfers cancel out in the new headline measure, as does the stream of gilt coupon payments the Exchequer makes on the gilts held by the APF.

The main changes following the alignment with ESA10 have been in the following areas:

- **Network Rail:** has been classified into the public sector, with its liabilities now adding to public sector net debt and PSNB;
- **Royal Mail Pension Plan:** the value of its future pension liability now increases PSNB in

2012-13. The assets were previously recognised upfront and the payments over time. Imputed revenues are now being added to offset the annual pension payments;

- **spectrum auction proceeds:** proceeds from the sale of 3G and 4G licences are now spread over the licence period, rather than reducing PSNB upfront;
- **local government pension schemes:** the underfunding of these schemes is now being added as imputed spending;
- **research and development and most single use military expenditure**: are now treated as capital rather than current spending. As capital assets, they will also attract depreciation. PSNB is unaffected, but the current budget deficit will generally be slightly lower;
- **tax write-offs:** council tax and business rate write-offs are now netted off receipts, rather than being treated as capital spending; and
- **VAT-based contributions to the EU and tax credits:** VAT contributions and (from next year) tax credits that are currently scored as negative tax will both be treated as spending, rather than being netted off tax, with no effect on measures of the deficit.

Of the ESA10-related changes, only the Network Rail reclassification affects public sector net debt. Net debt has also been raised due to the widening of the ex-measures boundary and the decision to treat bank shares bought by the government as illiquid rather than liquid assets (so that they no longer reduce net debt).

Public sector receipts

4.32 Table 4.4 summarises our receipts forecast. We expect taxes to fall by 0.5 per cent of GDP between 2013-14 and 2014-15, to remain flat in 2015-16, but then to increase back to the 2013-14 level by 2018-19 and remain there for the rest of the forecast period. This would be only 1.1 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 0.3 per cent of GDP between 2013-14 and 2019-20. That contributes around 10 per cent of the move from budget deficit to surplus over the forecast period.

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	2019-20
Income tax and NICs	15.3	14.9	15.0	15.5	15.7	15.8	16.0
Value added tax	6.1	6.0	6.0	6.0	6.0	5.9	5.9
Onshore corporation tax	2.1	2.2	2.2	2.1	2.1	2.1	2.0
UK oil and gas receipts	0.3	0.2	0.1	0.1	0.1	0.1	0.1
Fuel duties	1.6	1.5	1.4	1.4	1.4	1.4	1.3
Business rates	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Council tax	1.6	1.5	1.5	1.5	1.5	1.4	1.4
Excise duties	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Capital taxes	1.1	1.3	1.4	1.5	1.6	1.6	1.7
Other taxes	2.7	2.8	2.8	2.7	2.6	2.6	2.5
National Accounts taxes	33.5	33.0	33.0	33.4	33.4	33.5	33.5
Interest and dividend receipts	0.3	0.3	0.4	0.5	0.6	0.6	0.7
Other receipts	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Current receipts	35.9	35.5	35.5	36.1	36.2	36.2	36.2

Sources of changes in the tax-to-GDP ratio

4.33 Growth in receipts has been weak so far in 2014-15, with central government receipts rising by just over 2 per cent in the first seven months of the financial year. We expect stronger growth in the remainder of the year, but the tax-to-GDP ratio is still expected to fall by 0.5 percentage points between 2013-14 and 2014-15. This is despite real and nominal GDP growth picking up strongly, with employment rising sharply and the output gap narrowing – both factors that would normally contribute to a rising tax-to-GDP ratio.

4.34 We expect the ratio to recover over the next two years, but do not expect it to rise any further over the rest of the forecast period. That is also relatively unusual, since the output gap is forecast to close over that period and the expected return of productivity and real earnings growth would lead to positive fiscal drag – where earnings rise faster than income tax thresholds and allowances, dragging more income into higher tax brackets.

4.35 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.

4.36 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

4.37 Chart 4.1 shows that the main sources of the expected 0.5 percentage point fall in the tax-to-GDP ratio this year are:

- a 0.5 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, falling real wages and by changes in the composition of employment. Lower paid age groups and lower paid occupations and industries have recently seen stronger growth in employment;

- 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 rising more slowly than GDP (alcohol and fuel);

- a 0.1 per cent of GDP fall in VAT receipts, due to nominal consumer spending growing more slowly than GDP and an apparent increase in the VAT gap – the difference between theoretical and actual VAT receipts; and

- a 0.1 per cent of GDP fall in oil and gas receipts, due largely to lower oil and gas prices and higher expenditure reducing taxable profits.

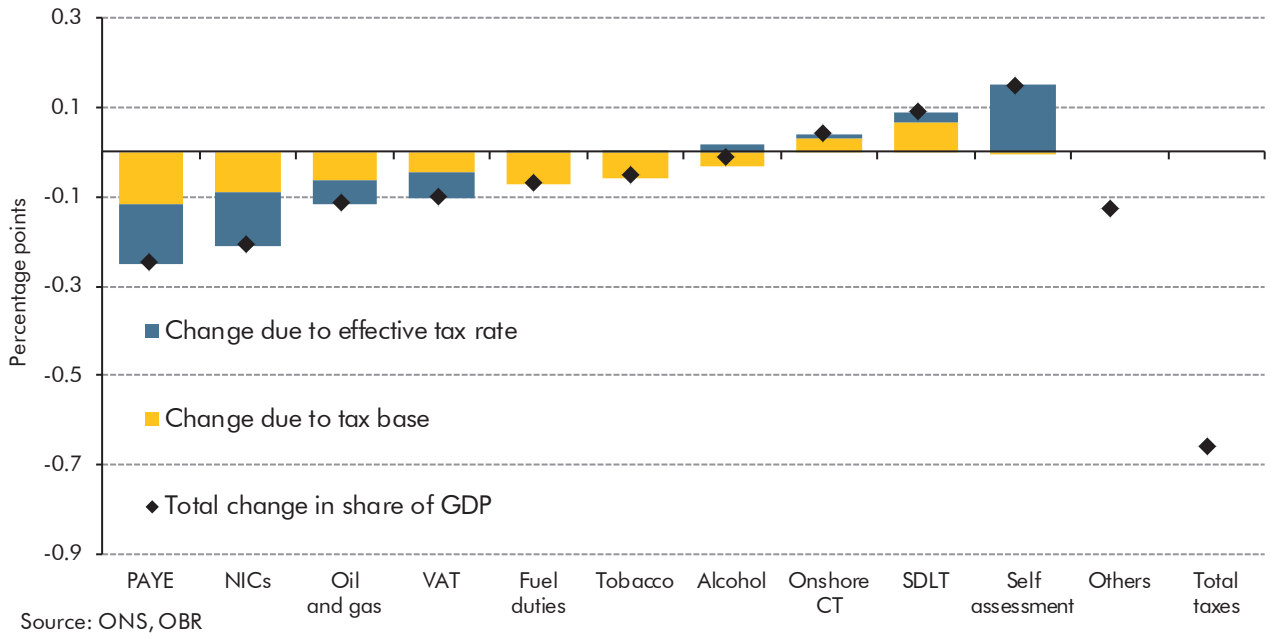
4.38 Partly offsetting these falls are:

- a 0.1 per cent of GDP rise in self-assessment (SA) income tax receipts, due to the effects of income shifting as a result of the reduction in the additional rate of income tax to 45p in April 2013. With liabilities having been delayed into 2013-14 and SA paid with a one-year lag, that is expected to increase receipts in January 2015;

- a 0.1 per cent of GDP rise in stamp duty land tax (SDLT) receipts, which reflects both strong growth in the tax base due to growth in house prices and property transactions and a higher effective tax rate as more transactions take place at prices that attract higher rates. Reforms to stamp duty announced at Autumn Statement are expected to reduce receipts by £0.4 billion this year; and

- a less than a 0.1 per cent of GDP rise in onshore corporation tax receipts, primarily because of strong growth in industrial and commercial profits.

Chart 4.1: Sources of changes in the tax-to-GDP ratio (2013-14 to 2014-15)



Source: ONS, OBR
1. 2013-14 data is adjusted to remove the effect of negative tax credits

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

4.39 Chart 4.2 shows that the main sources of the expected 0.5 percentage point rise in the tax-to-GDP ratio over the forecast period are:

- a 1.0 per cent of GDP rise in PAYE and NICs receipts, driven entirely by a rise in the effective tax rate. The majority of this increase is explained by a return of positive fiscal drag, as productivity and real earnings growth 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 NICs contracting out, which is expected to raise NICs receipts by around £5½ billion in 2016-17;

- a 0.3 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 return of property transactions to a level consistent with its historical average. With SDLT thresholds fixed in cash terms over the forecast period, rising house prices mean that a rising share of transactions are taxed at higher rates. Under the new SDLT regime announced at the Autumn Statement, receipts are expected to be £0.8 billion a year lower than would have been the case under the previous regime; and

- a 0.2 per cent of GDP rise in SA receipts, again driven by the effective tax rate.

4.40 Partly offsetting these rises are:

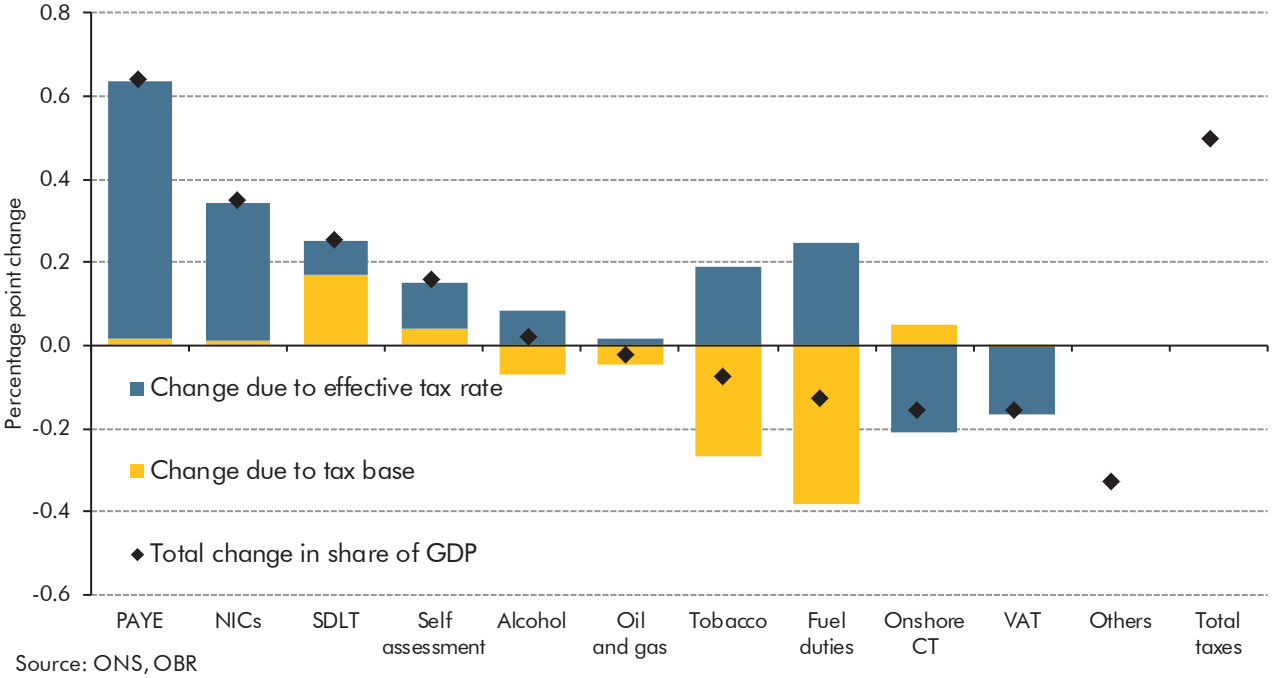
- a 0.2 per cent of GDP fall in VAT receipts, as housing costs – most of which are zero-rated – make up a rising share of consumer spending, reducing the effective tax rate;

- a 0.2 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;

- 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; and,

- a less than a 0.1 per cent of GDP fall in oil and gas receipts. We assume that production remains flat through most of the forecast period, while the effective tax rate continues to be affected by tax-deductible operating and capital expenditure and the use of past losses against future liabilities.

Chart 4.2: Sources of changes in the tax-to-GDP ratio (2014-15 to 2019-20)



Source: ONS, OBR

Detailed current receipts forecast

4.41 Tables 4.5, 4.6 and 4.7 present our detailed receipts forecasts and the changes since March due to ESA10 classification changes and underlying forecast changes.

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]	157.8	163.0	170.7	181.0	191.5	202.1	213.9
of which: Pay as you earn	*135.5*	*137.9*	*142.8*	*151.2*	*161.3*	*171.4*	*181.8*
Self assessment	*20.9*	*24.6*	*27.7*	*30.0*	*30.8*	*31.9*	*33.3*
Tax credits (negative income tax)	-2.8	0.0	0.0	0.0	0.0	0.0	0.0
National insurance contributions	107.3	109.0	112.9	122.9	128.2	134.1	140.2
Value added tax	106.5	110.1	114.1	117.7	121.6	125.7	130.2
Corporation tax[2]	40.3	41.7	43.2	43.8	44.5	45.6	45.9
of which: Onshore	*36.7*	*39.4*	*41.5*	*42.0*	*42.9*	*43.6*	*44.2*
Offshore	*3.6*	*2.3*	*1.7*	*1.8*	*1.6*	*2.1*	*1.7*
Corporation tax credits[3]	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-1.0
Petroleum revenue tax	1.1	0.5	0.5	0.6	1.0	1.0	1.0
Fuel duties	26.9	27.0	27.0	27.7	28.3	29.0	29.8
Business rates	26.8	27.1	27.6	29.2	29.9	31.2	32.6
Council tax	27.3	27.8	28.4	29.0	29.8	30.6	31.5
VAT refunds	13.8	13.9	13.8	13.2	12.9	12.6	12.6
Capital gains tax	3.9	5.1	5.9	6.5	7.1	7.7	8.4
Inheritance tax	3.4	3.8	4.2	4.7	5.2	5.8	6.3
Stamp duty land tax	9.4	11.5	12.6	14.5	16.3	18.1	19.5
Stamp taxes on shares	3.1	2.9	2.9	3.0	3.1	3.2	3.4
Tobacco duties	9.6	9.1	9.0	9.0	9.1	9.2	9.3
Spirits duties	2.9	3.1	3.2	3.4	3.6	3.7	3.9
Wine duties	3.7	3.9	4.1	4.4	4.8	5.2	5.6
Beer and cider duties	3.7	3.6	3.5	3.6	3.7	3.8	3.8
Air passenger duty	3.0	3.2	3.1	3.2	3.4	3.6	3.8
Insurance premium tax	3.0	3.2	3.3	3.5	3.6	3.7	3.7
Climate change levy	1.2	1.7	2.1	2.0	1.8	1.7	1.6
Other HMRC taxes[4]	6.5	6.7	6.9	7.1	7.3	7.5	7.8
Vehicle excise duties	6.1	6.2	6.0	5.9	5.8	5.7	5.5
Bank levy	2.3	2.7	2.9	2.8	2.8	2.8	2.8
Licence fee receipts	3.1	3.2	3.2	3.2	3.3	3.4	3.5
Environmental levies	3.3	4.8	5.8	7.0	7.6	8.5	9.1
Swiss capital tax	0.9	0.0	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.4	0.3	0.3	0.3	0.3	0.4	0.6
Other taxes	6.6	6.6	6.4	5.9	5.9	5.8	5.9
National Accounts taxes	**580.0**	**600.5**	**622.9**	**653.9**	**681.4**	**710.9**	**741.3**
Less own resources contribution to EU	-2.9	-3.0	-2.8	-2.5	-2.6	-2.8	-3.0
Interest and dividends	5.9	6.3	7.7	10.0	11.6	13.1	14.8
Gross operating surplus	37.9	39.2	41.0	42.9	44.7	46.5	48.4
Other receipts	1.5	2.8	1.5	1.5	1.6	1.6	1.6
Current receipts	**622.3**	**645.8**	**670.3**	**705.8**	**736.7**	**769.3**	**803.0**
Memo: UK oil and gas revenues[5]	*4.7*	*2.8*	*2.2*	*2.4*	*2.6*	*3.1*	*2.7*

[1] Includes PAYE and self assessment and also includes 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] Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

[5] Consists of offshore corporation tax and petroleum revenue tax.

Note: Table is on accruals basis in line with national accounts definitions.

Table 2.8 in the online supplementary tables presents receipts on a cash basis.

4.42 Table 4.6 shows the effects on our receipts forecast from classification changes due to ESA10 and the PSF review. In summary:

- research and development and single use military expenditure are now treated as capital rather than current spending. As capital assets, they will also attract depreciation, which has increases the gross operating surplus component of receipts;
- cash transfers to the Exchequer from the Asset Purchase Facility (APF) related to quantitative easing are now removed from receipts;
- VAT-based EU contributions and negative tax credits that were previously scored as negative tax are now treated as spending;
- council tax and business rate write-offs are now included in receipts;
- proceeds from 3G and 4G spectrum auctions are now accrued over a period of years, rather than being scored as a one-off cash receipt.

Table 4.6: ESA10 and PSF review changes to current receipts since March

	£ Billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast (ESA95 basis)	619.8	648.1	675.4	711.0	743.4	777.7
March forecast (ESA10 basis)	620.7	652.9	685.1	724.9	759.2	794.4
ESA10 effect	**0.9**	**4.7**	**9.8**	**13.9**	**15.9**	**16.8**
December forecast (ESA10 basis)	622.3	645.8	670.3	705.8	736.7	769.3
Underlying Change	**1.6**	**-7.0**	**-14.9**	**-19.1**	**-22.5**	**-25.1**
of which:						
Autumn Statement measures	0.0	0.7	-0.6	-0.2	0.2	0.2
ESA10 changes						
of which:						
R+D and SUME	9.6	10.0	10.7	11.4	12.1	12.7
Asset Purchase Facility	-12.2	-11.6	-7.2	-2.9	-0.4	0.0
Other interest and dividends[1]	-0.8	-0.8	-0.9	-1.0	-1.1	-1.2
VAT-based EU contributions	2.2	2.4	2.5	2.6	2.7	2.8
Council tax and business rates write-offs	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Negative tax switch	0.0	2.6	2.5	1.6	0.3	0.0
Royal Mail Pension Plan imputed receipts	1.3	1.3	1.3	1.4	1.5	1.6
Spectrum auction proceeds	1.2	1.2	1.2	1.2	1.2	1.2

[1]Mainly removal of imputed Network Rail dividend.

Table 4.7: Underlying forecast changes to current receipts since March

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax (gross of tax credits)[1]	2.1	-3.6	-6.1	-8.2	-9.9	-11.1
of which: Pay as you earn	0.0	-2.3	-5.4	-6.9	-7.3	-7.7
Self assessment	0.0	-2.5	-1.3	-1.1	-2.0	-2.1
Tax credits (negative income tax)	0.0	0.0	0.0	0.0	0.0	0.0
National insurance contributions	0.0	-1.0	-2.1	-3.2	-3.8	-4.1
Value added tax	0.0	-0.6	-0.9	-1.5	-1.8	-2.0
Corporation tax[2]	0.1	0.3	0.9	1.1	0.1	-0.3
of which: Onshore	0.1	0.5	1.8	1.5	0.8	0.2
Offshore	0.0	-0.2	-0.9	-0.4	-0.7	-0.5
Corporation tax credits[3]	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Petroleum revenue tax	0.0	-0.7	-0.8	-0.4	0.0	0.1
Fuel duties	0.1	0.1	-0.1	-0.6	-0.7	-0.8
Business rates	0.5	0.5	-0.7	-0.5	-0.6	-0.7
Council tax	0.2	0.2	0.3	0.1	0.0	-0.2
VAT refunds	-0.1	-0.3	-0.1	-0.3	-0.1	-0.2
Capital gains tax	0.0	-0.2	-0.8	-0.9	-1.1	-1.3
Inheritance tax	-0.1	0.0	-0.1	-0.2	-0.1	0.0
Stamp duty land tax	-0.1	-1.2	-1.8	-1.2	-0.6	0.0
Stamp taxes on shares	0.0	-0.2	-0.3	-0.2	-0.2	-0.1
Tobacco duties	-0.1	-0.8	-1.1	-1.4	-1.5	-1.7
Spirits duties	-0.1	0.1	0.1	0.0	0.0	0.0
Wine duties	0.0	0.0	-0.1	-0.2	-0.2	-0.2
Beer and cider duties	0.0	0.1	0.0	0.0	0.0	0.0
Air passenger duty	0.0	0.0	0.0	-0.1	-0.1	-0.3
Insurance premium tax	0.0	0.0	0.1	0.1	0.2	0.2
Climate change levy	-0.1	-0.3	-0.4	-0.3	-0.3	-0.4
Other HMRC taxes[4]	0.0	0.0	0.0	0.0	0.0	0.0
Vehicle excise duties	0.0	0.3	0.2	0.2	0.2	0.3
Bank levy	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Licence fee receipts	0.0	0.0	0.0	0.0	0.0	0.0
Environmental levies	-0.8	-0.1	-0.1	0.6	0.7	0.7
Swiss capital tax	0.0	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	0.0	-0.1	0.0	0.0	0.0
Other taxes	-0.2	-0.2	-0.6	-0.8	-0.8	-0.7
National Accounts taxes	**1.3**	**-7.8**	**-14.7**	**-18.1**	**-20.9**	**-23.0**
Less own resources contribution to EU	0.5	-0.2	0.3	0.1	0.1	0.0
Interest and dividends	-0.2	-0.7	-0.9	-1.5	-1.9	-2.3
Gross operating surplus	0.0	0.2	0.2	0.2	0.0	0.0
Other receipts	0.1	1.4	0.2	0.2	0.2	0.2
Current receipts	**1.6**	**-7.0**	**-14.9**	**-19.1**	**-22.5**	**-25.1**
Memo: UK oil and gas revenues [5]	*0.0*	*-0.9*	*-1.6*	*-0.8*	*-0.8*	*-0.4*

[1] Includes PAYE and self assessment receipts, and also includes 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] Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

[5] Consists of offshore corporation tax and petroleum revenue tax.

Changes in the receipts forecast since March

4.43 Abstracting from changes due to ESA10 and the PSF review, our forecast for public sector current receipts is lower across the forecast period compared with March. Receipts are £7.0 billion lower in 2014-15 and £25.1 billion lower in 2018-19. ESA10 and PSF review changes increase our receipts forecast relative to March across the forecast period. Table 4.8 sets out step-by-step the changes to our forecast since March.

4.44 The key reasons for the deterioration in the underlying forecast are:

- income tax and NICs, where lower earnings more than outweigh higher employment growth to reduce receipts. Lower interest rates through the forecast also reduce tax on savings income;
- VAT receipts, where weaker consumer spending and steeper falls in government procurement associated with implied falls in DEL spending reduce growth in the tax base;
- UK oil and gas revenues, which are lower due to lower oil and gas prices;
- tobacco receipts, which have been lower-than-expected this year and we have assumed a steeper fall in clearances over the forecast period;
- capital gains tax receipts, which are expected to be lower due to lower equity prices; and
- interest and dividend receipts, due to lower interest rates reducing returns on the government's stock of financial assets.

Table 4.8: Sources of changes to the receipts forecast since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast (ESA95 basis)	648.1	675.4	711.0	743.4	777.7
March forecast (ESA10 basis)	652.9	685.1	724.9	759.2	794.4
ESA10 effect	**4.7**	**9.8**	**13.9**	**15.9**	**16.8**
December forecast (ESA10 basis)	645.8	670.3	705.8	736.7	769.3
Underlying change	**-7.0**	**-14.9**	**-19.1**	**-22.5**	**-25.1**
of which:					
Income and expenditure	**-3.0**	**-5.6**	**-10.4**	**-13.1**	**-15.0**
Average earnings	-2.8	-7.2	-9.3	-8.9	-9.0
Employee numbers	1.9	3.2	2.5	1.4	0.8
Non-financial company profits	-0.8	-1.1	-1.1	-1.7	-2.1
Consumer expenditure	-0.4	-0.1	-0.6	-0.8	-0.8
Investment	-1.0	-1.0	-1.5	-1.8	-2.0
Other	0.0	0.7	-0.4	-1.3	-1.8
North Sea	**-0.9**	**-1.2**	**-0.7**	**-0.5**	**-0.2**
Production	0.0	0.0	0.0	0.0	0.0
Oil and gas prices	-0.9	-1.2	-0.8	-0.7	-0.7
Expenditure	0.0	0.0	0.1	0.2	0.4
Market assumptions	**-1.0**	**-3.2**	**-3.5**	**-3.4**	**-3.6**
Residential property market	-0.3	-0.9	-0.2	0.5	1.2
Commercial property market	0.1	0.1	0.0	-0.1	-0.1
Equity prices	-0.3	-0.9	-1.2	-1.4	-1.6
Interest rates	-0.4	-1.5	-2.0	-2.4	-3.0
Prices	**-0.1**	**-0.2**	**0.1**	**0.4**	**0.3**
Other economic determinants	**-0.1**	**-0.4**	**-0.5**	**-0.5**	**-0.4**
Other assumptions	**-2.7**	**-3.7**	**-3.9**	**-5.6**	**-6.3**
IT and NICs receipts and modelling	-2.1	-2.3	-2.8	-3.9	-4.2
CGT modelling and outturns	-0.2	-0.2	-0.2	-0.2	-0.2
Corporation tax receipts and modelling	1.5	2.1	2.4	2.2	2.0
VAT receipts and modelling	-0.1	0.1	0.4	0.7	0.7
North Sea receipts and modelling	0.0	-0.4	0.0	-0.2	-0.1
Interest and dividend receipts and modelling	-0.6	-0.4	-0.8	-0.9	-1.1
Environmental taxes and levies	-0.6	-0.6	0.2	0.3	0.3
Stamp duty land tax judgement	-0.5	-0.4	-0.3	-0.1	0.1
Gross operating surplus	0.2	0.2	0.2	0.0	0.0
Tobacco receipts modelling	-0.4	-0.6	-0.8	-1.0	-1.2
VAT refunds	-0.3	-0.1	-0.3	-0.1	-0.2
Other judgements and modelling	0.4	-1.1	-2.2	-2.4	-2.3
Autumn Statement measures	**0.7**	**-0.6**	**-0.2**	**0.2**	**0.2**

Receipts in 2014-15

4.45 Table 4.9 looks at receipts growth so far in 2014-15 and the extent to which we expect growth to pick up in the remainder of the year. In particular, we expect strong growth in receipts from both SA and capital gains tax. SA receipts should be boosted by the effect of income shifting, related to the reduction in the additional rate of income tax to 45p, while

capital gains tax receipts should be boosted by the rise in equity prices during 2013-14. Other tax streams are likely to record slower growth in the final months of 2014-15. With residential property transactions weakening in recent months – and the cost of the reforms announced at the Autumn Statement - we expect slower growth in SDLT receipts in the second half of the year than the first.

Table 4.9: Receipts in 2014-15

	£ billion			Percentage change on 2013-14		
	Outturn	Forecast		Outturn	Forecast	
	Apr-Oct	Nov-Mar	Full year	Apr-Oct	Nov-Mar	Full year
Income tax and NICs[1]	144.6	122.2	271.9	0.8	4.7	2.6
of which:						
PAYE and NICs	137.6	109.3	246.8	1.4	2.0	1.7
SA	7.7	16.9	24.6	7.7	23.7	18.2
Value added tax	63.2	46.9	110.1	3.7	2.9	3.4
Corporation tax	25.7	15.0	40.7	4.2	3.0	3.7
Petroleum revenue tax	0.3	0.2	0.5	-62.5	-51.3	-59.3
Fuel duties	16.0	11.0	27.0	0.9	-0.5	0.3
Capital gains tax	0.0	5.1	5.1		31.2	31.4
Inheritance tax	2.3	1.5	3.8	9.9	13.9	11.4
Stamp duties	8.6	5.8	14.4	21.4	7.1	15.2
Tobacco duties	4.8	4.2	9.1	-3.5	-6.8	-5.0
Alcohol duties	6.1	4.5	10.6	3.7	1.4	2.7
Business rates	16.1	11.0	27.1	1.9	0.2	1.2
Council tax	16.4	11.5	27.8	2.7	0.7	1.9
Other[2]	29.8	21.5	51.3	-0.5	6.5	2.3
National Accounts taxes	**334.0**	**265.5**	**599.4**	**2.0**	**4.0**	**2.9**

[1] Historical data has been adjusted to take out the negative tax element of income tax credits.
[2] Forecast data has been adjusted to exclude feed-in-tariffs and warm home discounts, which are currently excluded by the ONS.

Tax-by-tax analysis

Income tax and NICs

4.46 Receipts of income tax and NICs in 2014-15 are expected to be £4.5 billion lower than in our March forecast. We have revised down PAYE and NIC by £3.3 billion and self-assessment (SA) income tax receipts by £2.5 billion. A lower level of income tax repayments partly offsets the reductions in receipts from PAYE, NICs and SA. The shortfall relative to March widens through the forecast, reaching £15.2 billion by 2018-19.

4.47 The shortfall in PAYE and NIC receipts in 2014-15 relative to our March forecast reflects weaker earnings growth and a steeper drop in the effective tax rate than expected. This more than offsets stronger than forecast employment growth so far this year. We expect growth in PAYE and NIC receipts to remain weak over the remainder of 2014-15. In particular, we expect a small drop in financial sector bonuses. Prospects for bonuses are particularly uncertain as new regulations may have prompted financial sector firms to pay their employees higher base salaries or role-based allowances instead. If this is the case, HMRC will have already received receipts that previously would have been remitted in the January to April 2015 bonus season.

4.48 We expect earnings growth to remain subdued for longer than in March. This is the key driver in the lower forecast for PAYE and NIC receipts. By 2018-19, the shortfall relative to March is £11.8 billion, with lower earnings explaining around £9.0 billion. Given the recent weakness in effective tax rates and the further rise in the personal allowance to £10,600 in April 2015, we have assumed that the effective tax rate is broadly flat in 2015-16. However, despite the downward revision to the forecast, we expect a rise in PAYE and NIC receipts as a proportion of GDP from 2016-17 onwards. This reflects a rising effective tax rate, due to the abolition of NICs contracting out in that year and the return of positive fiscal drag.

4.49 Self-assessment (SA) receipts are expected to increase by 18 per cent in 2014-15, primarily due to income shifting related to the reduction in the additional rate of income tax to 45p. Some individuals will have deferred income from 2012-13 to 2013-14 to take advantage of the lower tax rate. This depressed receipts relating to 2012-13 liabilities when they were paid in 2013-14 and will boost receipts in January 2015 when the balancing payment on 2013-14 liabilities is due. Compared with March, we have revised down our forecast of SA receipts for 2014-15 by £2.5 billion. This reflects further analysis of 2012-13 SA returns and that we expect income tax paid through the PAYE sub-contractors deduction scheme to be higher, resulting in lower SA receipts.

4.50 We expect further growth in SA receipts in 2015-16, despite the one-off boost to 2014-15 from the income shifting. This in part reflects around £2 billion from the Budget 2013 and Autumn 2013 measures on partnerships and measures announced at recent Budgets and Autumn Statements on accelerating payments in follower cases, where taxpayers will have to pay disputed tax much earlier if HMRC win a legal test case. As with all anti-avoidance measures, the yield from these is subject to considerable uncertainty (see Box 4.2).

4.51 The number of people in self-employment has continued to rise rapidly and annual growth was 6.6 per cent in the third quarter of the year. The limited amount of information on self-employment incomes suggests that the growth in self-employment has been concentrated at the lower end of the income distribution, which would reduce the overall effective tax rate.

4.52 Tax paid on savings is mainly collected through SA and the tax deduction scheme for interest (TDSI). Our forecast reflects lower market interest rates and that deposit rates will remain broadly stable when Bank Rates start to rise. This would mean deposit rates fall below Bank Rates, as was the case prior to the crisis. These two factors take £2.9 billion off the forecast by 2018-19. TDSI receipts are broadly flat over the forecast period.

4.53 We have re-assessed the yield from a number of earlier measures. As noted in Box 4.2, we expect the yield from the agreements with the Crown Dependencies to come in later than originally profiled. We also expect the yield from past pension tax relief measures to build up more slowly, in part because of weaker earnings growth. The 'Accounting for Tax' element of income tax (the relevant tax stream for much of the yield from these measures) is expected to be around £0.5 billion lower than expected in 2014-15.

Table 4.10: Key changes to the income tax and NICs forecast since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	276.5	291.8	315.3	333.3	351.4
December forecast	271.9	283.6	303.9	319.7	336.2
Change	**-4.5**	**-8.2**	**-11.4**	**-13.6**	**-15.2**
of which:					
(by economic determinant)					
Average earnings	-2.8	-7.2	-9.3	-8.9	-9.0
Employee numbers	1.9	3.2	2.5	1.4	0.8
Self-employment income	0.1	0.4	0.2	0.0	-0.1
Savings income	-0.3	-1.2	-1.9	-2.4	-2.9
Other economic determinants	-1.3	-0.7	0.1	0.5	0.7
(by other category)					
Lower PAYE and NICs effective tax rate	-2.5	-2.6	-3.6	-4.1	-4.2
Other modelling and receipts changes	0.3	0.4	0.8	0.2	0.0
Autumn Statement measures	0.0	-0.4	-0.2	-0.3	-0.4

VAT

4.54 Accrued VAT receipts are expected to grow by 3.4 per cent in 2014-15. This is a little slower than the 4.0 per cent growth in nominal consumer spending, which accounts for over two-thirds of the tax base. Compared to our March forecast, accrued VAT receipts in 2014-15 are expected to be £0.6 billion lower than previously forecast. The VAT gap is the difference between the theoretical level of VAT payments and actual receipts received by HMRC. Given that growth in receipts is weaker than growth in the theoretical level of VAT payments, the VAT gap rises slightly in 2014-15. We assume that the VAT gap falls slightly in 2015-16, due to a lower projection for VAT debt, and then remains constant.

4.55 By 2018-19, accrued VAT receipts are expected to be £2.0 billion lower than in our March forecast, thanks mainly to lower nominal consumer spending. There is a partial offset from a higher standard rated share of consumer spending through the forecast. This reflects a higher share in 2014 and the fact that the squeeze in spending on standard-rated goods from an increase in housing costs in the latter years of the forecast is expected to be more modest than in our March forecast. We have also reduced the VAT forecast by £0.5 billion from 2015-16 onwards, as a result of a recent European Court of Justice ruling that defined benefit pension schemes can recover VAT on all investment management services.

4.56 VAT receipts are expected to fall from 6.0 per cent of GDP in 2014-15 to 5.9 per cent in 2019-20. This reflects the fact that some elements of the VAT tax base, particularly the VAT paid by the government itself, are likely to be reduced by continued fiscal consolidation. The standard-rated share of consumer spending also starts to fall from 2016-17 onwards.

Table 4.11: Key changes to the VAT forecast since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	110.7	115.0	119.2	123.3	127.7
December forecast	110.1	114.1	117.7	121.6	125.7
Change	**-0.6**	**-0.9**	**-1.5**	**-1.8**	**-2.0**
of which:					
Household spending	-0.5	-0.3	-0.8	-1.0	-1.0
Latest receipts	-1.5	-1.4	-1.3	-1.3	-1.3
VAT debt	0.0	0.2	0.2	0.2	0.2
SRS of consumer spending	1.4	1.3	1.5	1.8	1.9
Other spending	0.0	-0.1	-0.6	-0.9	-1.2
VAT on defined benefit pension schemes	0.0	-0.5	-0.5	-0.5	-0.5
Autumn Statement measures	0.0	0.0	0.0	0.0	0.0

Onshore corporation tax

4.57 We have revised our forecast for onshore corporation tax receipts up by £0.5 billion in 2014-15, in light of stronger-than-expected instalment payments on 2014 profits from the financial sector and life assurance firms. This helped offset lower-than-expected receipts from industrial and commercial companies. Receipts in 2014-15 are expected to be up by 7 per cent on a year earlier, despite the 2 percentage point cut in the main rate of corporation tax to 21 per cent from April 2014.

Table 4.12: Key changes to the onshore corporation tax forecast since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	38.9	39.7	40.5	42.1	43.3
December forecast	39.4	41.5	42.0	42.9	43.6
Change	**0.5**	**1.8**	**1.5**	**0.8**	**0.2**
of which:					
Industrial and commercial company profits	-0.8	-1.1	-1.1	-1.7	-2.1
Industrial and commercial company investment	-0.2	-0.5	-0.8	-1.0	-1.1
Other economic determinants	0.1	0.2	0.1	0.0	0.0
Financial sector losses profile	-0.3	-0.7	-1.0	-1.0	-1.0
Latest receipts data	0.7	1.0	0.8	1.0	1.1
Modelling updates	1.1	1.8	2.6	2.2	1.9
Autumn Statement measures	0.0	1.2	0.9	1.3	1.5

4.58 Compared to March, onshore corporation tax receipts are expected to be higher throughout the forecast. The two main downward effects on receipts are from lower projections of industrial and commercial profits in most years, and a higher projected level of losses in the financial sector being brought forward and used against taxable profits. These are more than offset by latest receipts data, modelling changes and the measures announced in this Autumn Statement. The measures to tackle profit shifting by multinational companies, and

to limit the amount of profits in a year that losses brought forward by banking companies can be set against, raise over £1 billion a year from 2016-17.

4.59 Despite the revenue-raising measures announced in this Autumn Statement, we expect previously announced measures - such as the further reduction 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 and extension to December 2015 - to reduce receipts growth further out. In addition, despite the measure to limit the use of trading losses by the banking sector, corporation tax paid by the financial sector is still expected to be more than £4 billion lower than its pre-crisis peak in 2019-20. As a result of these various factors, onshore corporation tax is expected to fall from 2.2 per cent of GDP in 2014-15 to 2.0 per cent by the end of the forecast period.

UK oil and gas revenues

4.60 Receipts from UK oil and gas companies are expected to fall by 40 per cent between 2013-14 and 2014-15 to just £2.8 billion. This compares with receipts of around £11 billion just three years earlier. As discussed in Box 4.4, changes of this magnitude are not unprecedented. The sharp fall in receipts in 2014-15 reflects the weakness in wholesale gas prices throughout the year and the more recent sharp fall in oil prices. The low level of receipts in 2014-15 also reflects the level of capital expenditure in the industry. Spending on several large projects and strong cost pressures mean that capital expenditure in 2014 is around 40 per cent higher than in 2011. With 100 per cent first year allowances available to oil and gas firms, higher investment leads to an immediate reduction in receipts.

Table 4.13: Key changes to the oil and gas revenues forecast since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	3.7	3.8	3.2	3.4	3.5
December forecast	2.8	2.2	2.4	2.6	3.1
Change	**-0.9**	**-1.6**	**-0.8**	**-0.8**	**-0.4**
of which:					
Dollar oil prices	-0.3	-1.1	-0.8	-0.8	-0.7
Dollar-Sterling exchange rate	0.0	0.4	0.4	0.4	0.3
Gas prices	-0.6	-0.5	-0.4	-0.3	-0.3
Expenditure	0.0	0.0	0.1	0.2	0.4
Modelling and other	0.0	-0.4	0.0	-0.2	-0.1
Autumn Statement measures	0.0	-0.1	-0.1	-0.1	-0.1

4.61 Compared to our March forecast, UK oil and gas revenues are expected to be £1.6 billion lower in 2015-16, with smaller reductions thereafter. We use oil and gas futures to project prices for 2015 and 2016 and then hold them flat. Oil and gas prices in 2015 are expected to be $19 a barrel and 9p a therm lower than in our March forecast.

4.62 We continue to project weak oil and gas revenues throughout the forecast, with receipts of just £2.7 billion or 0.1 per cent of GDP in 2019-20. Oil and gas production is expected to

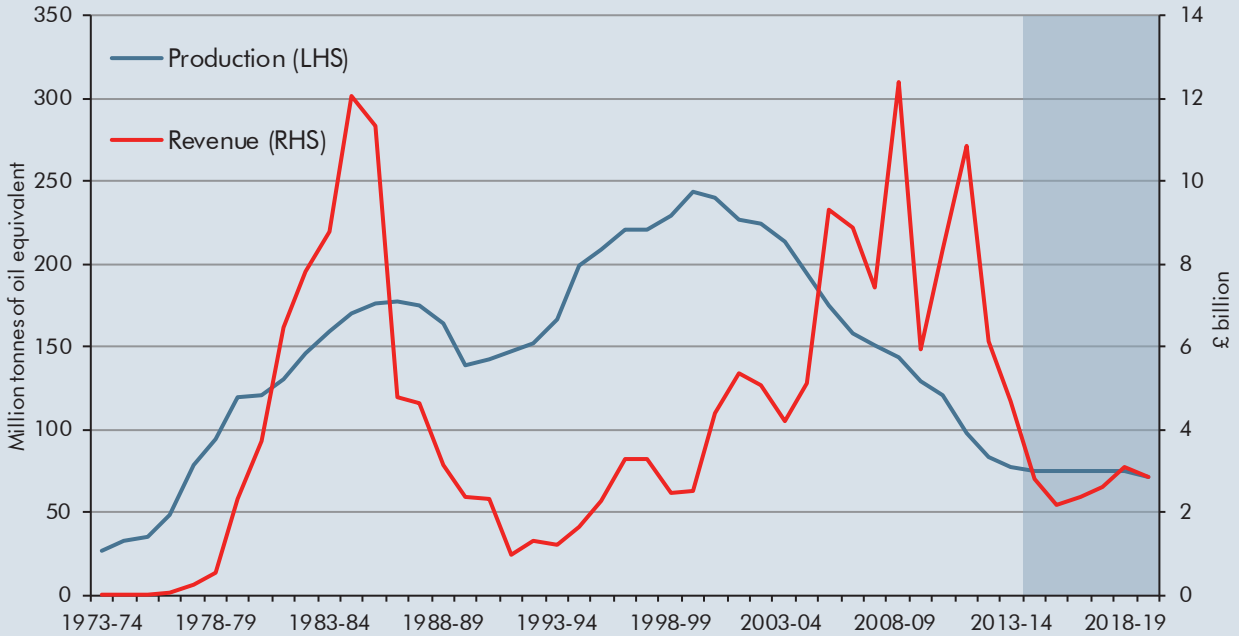
be broadly flat over the forecast period, as the current high levels of capital expenditure prevent further falls in production until 2019. Compared to March, we expect lower levels of capital and operating expenditure over the forecast period, since lower oil prices will have reduced the net present value of potential capital projects and should reduce upward pressures on operating costs.

Box 4.4: The rise and fall of oil and gas revenues

North Sea oil and gas revenues have proved to be a source of significant and one-sided forecast errors in recent years, as receipts have fallen by around 75 per cent between 2011-12 and our current estimate of receipts in 2014-15.

As shown in Chart A, dramatic rises and falls in oil and gas receipts are not unprecedented. North Sea revenues increased sharply in the early years of production, reaching £12.0 billion (3.4 per cent of GDP) in 1984-85, before falling sharply to just £1.0 billion in 1991-92 (0.1 per cent of GDP) and rising again to £12.4 billion (0.8 per cent of GDP) in 2008-09.

Chart A: Oil and gas revenues and production



Source: DECC, ONS, OBR

Trends in oil and gas revenues – and the drivers of those trends – can be decomposed to identify the most important sources of change during different periods. Table B shows how movements between the peaks and troughs since the early 1970s can be explained by drivers of taxable profits – the volume and price of production, which together provide a proxy for sales, and the implied profit margin on those sales – and the effective tax rate paid on those profits.

- **between 1979-80 and 1984-85** receipts increased by 420 per cent to £12.0 billion. That was driven by a 40 per cent rise in production, strong growth in sterling oil prices, higher profit margins and an increasing effective tax rate;
- **between 1984-85 and 1991-92** receipts fell by more than 90 per cent to £1.0 billion.

While sterling oil prices fell sharply over that period, the largest driver was a reduction in the effective tax rate paid on North Sea profits. This reflected a cut in the main rate of offshore corporation tax from 45 to 33 per cent and strong growth in operating and capital expenditure;

- **between 1991-92 and 2008-09** receipts increased strongly to £12.4 billion. Again, prices and the effective tax rate explained the rise, with oil prices hitting an all-time high in cash terms in mid-2008 and the introduction of the supplementary charge of corporation tax at 10 per cent in April 2002 and the increase to 20 per cent from January 2006;
- **between 2008-09 and 2014-15** receipts have fallen by around 75 per cent to £2.8 billion. While the 50 per cent fall in production over the period explains much of the fall, the biggest factor has been a drop in the effective tax rate. Capital expenditure – which is fully tax-deductible – is expected to have increased by around 150 per cent over this period, and operating expenditure has also risen significantly. The drop in the effective tax rate comes despite a rise in the supplementary charge to 32 per cent from March 2011; and
- **between 2014-15 and 2019-20** receipts are expected to marginally fall by £0.1 billion to £2.7 billion. Over the forecast period, we expect both production and the sterling oil price to be broadly flat. But the recent surge in capital expenditure is not expected to continue. Lower tax-deductible capital expenditure increases the effective tax rate.

Table B: Breakdown of changes in revenues

	£ billion				
	1979-80 to 1984-85	1984-85 to 1991-92	1991-92 to 2008-09	2008-09 to 2014-15	2014-15 to 2019-20
Annual revenue at start of period	2.3	12.0	1.0	12.4	2.8
Annual revenue at end of period	12.0	1.0	12.4	2.8	2.7
Change	**9.7**	**-11.1**	**11.4**	**-9.6**	**-0.1**
of which:					
Production[1]	1.8	-0.9	-0.1	-6.2	-0.1
Oil and gas prices[1]	6.4	-2.8	5.3	3.4	0.0
Gross profit margin[1]	0.2	-0.8	-0.1	-1.1	-0.1
Effective tax rate	1.3	-6.6	6.2	-5.6	0.1

[1]Production, price and profit data has been taken on a calendar year basis

Stamp duties

4.63 Stamp duty land tax (SDLT) is forecast to increase from £11.5 billion in 2014-15 to £19.5 billion in 2019-20. Since March, we have decreased our forecast for 2014-15 receipts by £1.2 billion, reflecting slower than expected growth in transactions and the effect from the reforms announced in the Autumn Statement.

4.64 Higher house prices, relative to our March forecast, add around £1.4 billion to receipts in 2019-20. SDLT increases from 0.6 per cent of GDP in 2014-15 to 0.9 per cent in 2019-20. This is driven by an increase in the effective tax rate, as price growth pushes more into

higher bands and a rise in residential property transactions to a level consistent with its historical average by the end of the forecast. The Autumn Statement reforms to SDLT reduce receipts by an average of £0.8bn over the next five years. Box 4.5 describes how these figures were estimated.

Table 4.14: Key changes to the SDLT receipts forecast since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	12.7	14.4	15.7	16.8	18.1
December forecast	11.5	12.6	14.5	16.3	18.1
Change	**-1.2**	**-1.8**	**-1.2**	**-0.6**	**0.0**
of which:					
House Prices	0.1	0.3	0.6	1.1	1.4
Residential Property Transactions	-0.5	-1.0	-0.7	-0.6	-0.7
Commercial Property	0.0	0.0	-0.1	-0.1	-0.2
Modelling and receipts outturns	-0.5	-0.4	-0.3	-0.1	0.1
Introduction of Scottish LBTT	0.0	0.0	0.0	0.0	0.1
SDLT Reforms	-0.4	-0.8	-0.8	-0.9	-0.8
Enveloping Measure	0.0	0.1	0.1	0.0	0.1

Box 4.5: The impact of reforms to the taxation of property transactions

The Government has announced substantial reforms to the residential stamp duty land tax (SDLT) system, which take effect from 4 December across the UK. The measure moves SDLT from a 'slab' system (where a single tax rate is paid on the entire purchase price) to a 'slice' system (where successive bands of the purchase price are taxed at increasing rates). The Scottish Government had already announced in October that it would move to a slice system for residential and non-residential properties with the introduction of its land and buildings transactions tax (LBTT) next April. This has a different rate schedule to that announced for the UK, with those rates still subject to approval by the Scottish Parliament (see Table C).

Table C: Tax rates under each system

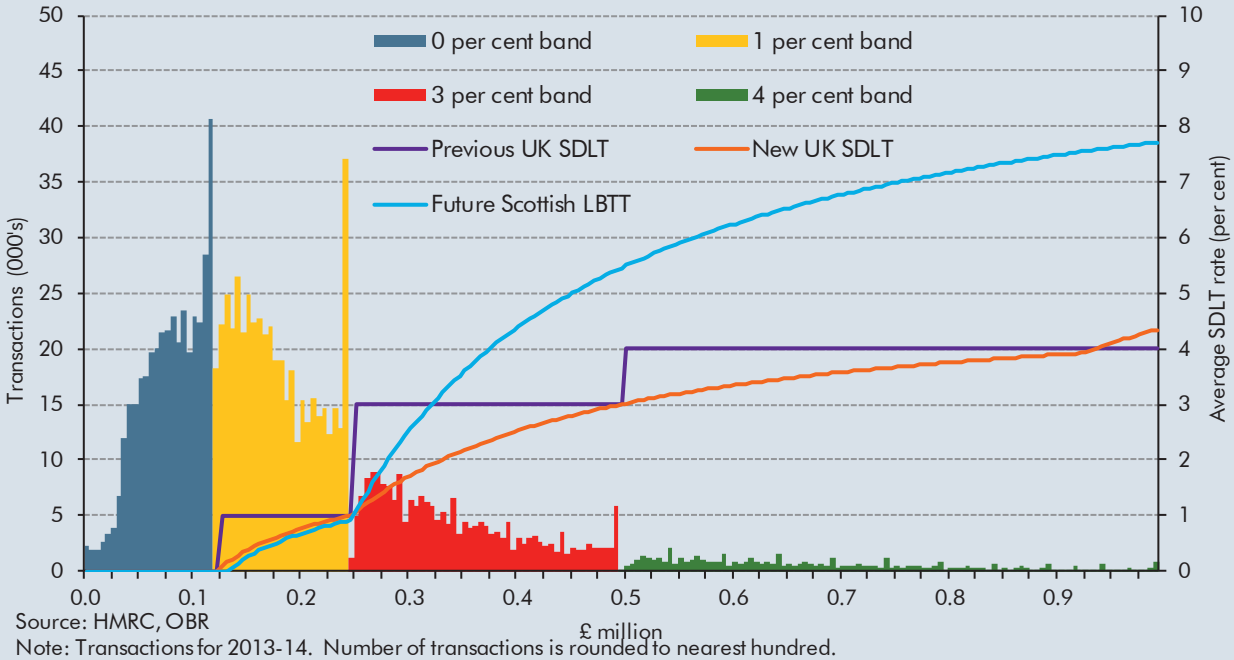
Previous UK SDLT		New UK SDLT		Future Scottish LBTT	
Property value (£'s)	Rate on property value (Per cent)	Value between (£'s)	Marginal rate (Per cent)	Value between (£'s)	Marginal rate (Per cent)
£0-£125k	0	£0-£125k	0	£0-£135k	0
£125k-£250k	1	£125k-£250k	2	£135k-£250k	2
£250k-£500k	3	£250k-925k	5	£250k-£1m	10
£500k-£1m	4	£925k-£1.5m	10	£1m+	12
£1-2m	5	£1.5m+	12		
£2m+	7				

Our pre-measures forecast for this *Economic and fiscal outlook* is based on the slab SDLT system. Our post-measures forecast for 2014-15 is based on the new slice SDLT system being applied throughout the UK and from 2015-16 it is based on the LBTT system being applied in Scotland and the slice SDLT system in the rest of the UK. This box describes how the effects of

these measures on our forecast were costed.[a]

The first step is to establish the tax base – in this case the number and distribution of property transactions in the pre-measures forecast. The next step is to estimate the static or pre-behavioural costing. This simply involves applying the new tax system to the pre-measures tax base. Chart B shows the effective tax rate paid on property transactions at different prices up to £1 million under each system, and the distribution of housing transactions in 2013-14. It underlines the fact that most transactions take place below the £250,000 threshold. If the new regime had been in place in 2013-14 then roughly 2 per cent of transactions would have paid more stamp duty than under the old regime and around 98 per cent the same or less.

Chart B: Average SDLT rates under different transaction tax schedules



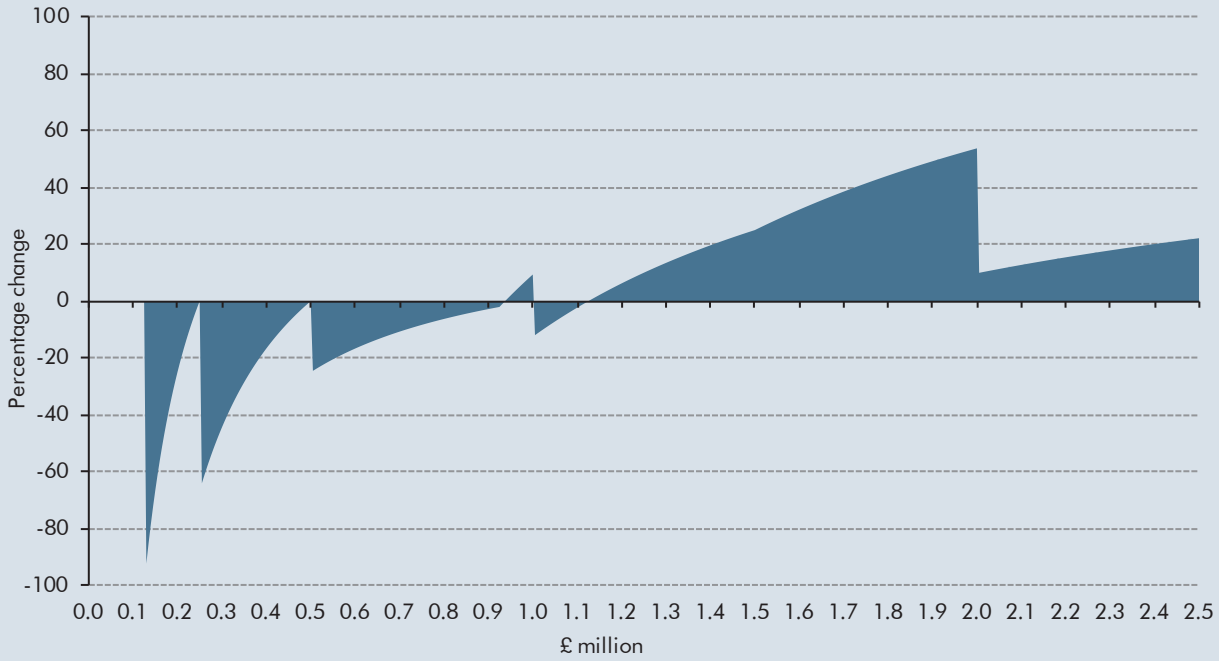
Source: HMRC, OBR
Note: Transactions for 2013-14. Number of transactions is rounded to nearest hundred.

The most complex step in most costings is to estimate the behavioural response of taxpayers. The shift from the old slab to the new slice system is expected to prompt a number of responses:

- the slice system removes the cliff edges between tax bands that caused 'dead zones' in the price distribution of transactions, whereby very few transactions take place immediately above the thresholds at which the tax liability jumps. That should smooth the distribution of prices, particularly around the £250,000 threshold where many transactions take place, but also at the £500,000, £1 million and £2 million thresholds where fewer transactions take place;
- the future transaction costs associated with selling a house are reflected in the price of the house, so changes in those costs due to the policy will affect house prices. As shown in Chart C, the new system reduces or leaves unchanged SDLT for all residential properties from £125,000 to £935,000 and raises it for most properties above £935,000. So the distribution of house prices will change. (The uneven profile of these changes reflects the cliff edges in the old slab system that the new system is being compared against); and

- SDLT costs affect the frequency of property transactions. For the vast majority of house values where SDLT costs will fall, sales would be expected to be more frequent.

Chart C: Percentage change in tax paid between UK slab and slice SDLT systems



The smoothing of the price distribution was estimated simply by adjusting the distribution of transactions around the slab thresholds to match the distribution elsewhere. (That does not mean an entirely smooth distribution, as transactions tend to cluster at round numbers even when there is no SDLT threshold to induce that effect.)

The effects of changes in transactions costs on house prices and property transactions were factored into the costing using estimates of the relationship between such changes. HMRC produced these estimates, which we certified as reasonable and central:

- for prices, the costing is based on a 1 percentage point change in the average SDLT rate leading to a 1.4 per cent change in the house price. The same elasticity is applied across the price distribution;
- for transactions, the costing assumes that the effect will be different across the price distribution, because each percentage point change in SDLT reflects a different percentage of transaction costs at different prices. The estimates applied range from 3.5 at the bottom of the distribution to 1.5 at the top. Two further adjustments are made: first, to reflect the fact that lower SDLT would allow a purchaser to put more of their savings towards a deposit, enabling more would-be purchasers to meet lenders' loan-to-value criteria; and second, that higher effective tax rates are likely to encourage efforts to avoid or evade the tax towards the top of the price distribution.

For Scotland, a similar methodology was applied to an estimate of the Scottish tax base and using the differences between the slab SDLT system and the forthcoming LBTT. Because the proposed LBTT rates have been pre-announced, a further adjustment is made to account for

behavioural effects on the timing of transactions – some transactions at higher prices will be brought forward to pay the lower UK SDLT rates while some transactions at lower prices will be delayed to benefit from the lower LBTT rates.

The UK costing also includes adjustments to take account of:

- the transitional relief announced by the Government, which means that transactions that have reached exchange of contracts, but have not been completed by 4 December, will be subject to whichever SDLT system is cheapest for the purchaser; and
- a likely temporary increase in error in the initial months of operation, when transactions will be processed manually while IT systems are updated for the new structure.

Elsewhere in our forecast, we need to take into account the effect of the behavioural responses described above on other taxes. We have done so explicitly for inheritance tax and capital gains tax. The net effect on these receipts depends on the price distribution of those properties liable for the tax. These effects have been estimated using HMRC's tax models.

The overall effect on our forecast of the reforms to SDLT in England, Wales and Northern Ireland is shown in Table D and the introduction of LBTT in Scotland is set out in Table E. As with any policy changes that are expected to generate behavioural responses, these estimates are subject to considerable uncertainty. But we consider these estimates to be reasonable and central, so we have certified the Government's costing and included the effects in our forecast.

Our forecast for Scottish LBTT in 2015-16 of £499 million is higher than the Scottish Government's estimate of £441 million. This is despite including forestalling and other behavioural effects, which would reduce expected receipts. A higher forecast would be consistent with the evidence of stronger receipts so far in 2014-15 from the Scottish element of UK SDLT than we expected in March, but such are the uncertainties around all costings of this type that the difference between the two estimates should not be regarded as significant.

Table D: UK SDLT costing

	£ million					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Stamp duty land tax	-395	-760	-840	-850	-815	-785
Capital gains tax	-	-5	-5	-5	-5	-10
Inheritance tax	-	5	10	10	15	15
Total	**-395**	**-760**	**-835**	**-845**	**-805**	**-780**

Table E: Scotland LBTT costing

	£ million					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Scottish SDLT (pre-measures)[1]	476	503	567	629	685	734
Forestalling effect - Scotland	14	-25				
Effect of UK SDLT reform	-15					
Scottish LBTT		499	600	676	749	811
Scottish tax from SDLT and LBTT	**475**	**499**	**600**	**676**	**749**	**811**

[1] Based on constant share of UK SDLT.

[a] For more information on our overall approach to policy costings, see: *Briefing Paper No.6: Policy costings and our forecast*.

4.65 Stamp duty on shares is expected to fall over the forecast, reflecting an assumed decline in the volume of share transactions subject to duty. Compared to our March, our forecast has been revised downward in line with the lower projection for equity prices.

Taxes on capital

4.66 Capital gains tax (CGT) is paid 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 are expected to increase from £3.9 billion in 2013-14 to £5.1 billion in 2014-15, reflecting 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 should also benefit from the recovery in the housing market in 2013-14, as CGT is payable on disposals of non-principal residences.

4.67 Compared to our March forecast, CGT receipts have been revised down sharply from 2015-16, in light of lower equity prices that are assumed to grow in line with nominal GDP. By 2018-19, CGT receipts are expected to be £1.3 billion lower than in our March forecast.

4.68 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 deposits, as well as the effect of freezing the nil-rate band until 2017-18. Compared to March, our forecast for inheritance tax receipts is slightly lower in each year. Lower growth in equity prices and modelling changes more than offset the positive effect from higher house prices.

Fuel duties

4.69 The volume of fuel clearances is on a long-term downward trend, reflecting the increasing 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.

4.70 Fuel duty revenues in each year between 2011-12 and 2015-16 are below their 2010-11 level, thanks in part to the reduction in the duty rate in April 2011and subsequent duty freezes. The next duty rate rise, planned for September 2015, means that receipts are expected to increase by 0.3 per cent in 2015-16. From April 2016 onwards duty rate rises are assumed to be in line with RPI inflation, leading to receipts growth of 2.5 per cent on average between 2016-17 and 2019-20. Table 4.14 illustrates the sources of fuel duty growth over the forecast period, with the effect of the fuel duty uprating policy being the only driver behind receipts growth given the declining tax base. While the number of miles driven rises over time, this is more than offset by increases in fuel efficiency.

Table 4.15: Sources of fuel duty growth over the forecast period

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Receipts	27.0	27.0	27.7	28.3	29.0	29.8
Change since 2013-14	**0.1**	**0.1**	**0.8**	**1.4**	**2.2**	**2.9**
of which, changes due to:						
Growth of the tax base	**0.1**	**-0.2**	**-0.5**	**-0.8**	**-1.0**	**-1.2**
of which:						
Mileage	0.3	0.4	0.8	1.3	1.9	2.6
Fuel efficiency	-0.3	-0.6	-1.3	-2.1	-3.0	-3.9
Changes in the effective duty rate	**0.0**	**0.3**	**1.3**	**2.2**	**3.2**	**4.1**

Alcohol and tobacco duties

4.71 Alcohol duty is expected to increase from £10.6 billion to £13.2 billion between 2014-15 and 2019-20. Within this total, receipts from wine and spirits are expected to increase by £1.7 billion and £0.8 billion respectively, while beer and cider duties are expected to be up just £0.2 billion. This largely reflects our assumption that the downward trend in beer consumption in recent years will continue over the forecast period. Clearances of beer have fallen by over 30 per cent in the 10 years to 2013-14.

4.72 Tobacco duties are expected to fall from £9.6 billion in 2013-14 to £9.1 billion in 2014-15, despite the RPI plus 2 per cent rise in duty in March 2014. The fall in HMRC clearances of cigarettes have been affected by the recent above-RPI increases in duty, changing attitudes to smoking, policies such as the display ban and the growing popularity of e-cigarettes.

4.73 We expect receipts from tobacco duty to rise by only around £0.2 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 largely offset by the downward trend in cigarette clearances. In light of the recent weakness in tobacco receipts and the expected effects of the Tobacco Products Directive, we have revised the underlying downward trend in clearances from 2 to 4 per cent a year. This revision, coupled with our lower RPI inflation forecast, largely explains why the forecast has been revised down by £1.7 billion by 2018-19.

Other taxes

4.74 **Business rates** are lower by at least £0.5 billion each year from 2015-16 than in our March forecast (abstracting from ESA10 changes). This reflects the measures announced in the Autumn Statement to extend the doubling of small business rate relief for another extra year, making the discount to small shops, pubs, cafes and restaurants more generous and limiting the annual indexation to 2 per cent in 2015-16. Only the latter has an effect beyond 2015-16, with the downward revision thereafter primarily due to lower RPI inflation. Business rates are calculated by multiplying the rateable value of non-domestic property by the multiplier (which is uprated in line with RPI inflation).

4.75 Receipts from **council tax** are expected to be slightly higher in the near term than in our March forecast. Assumptions and changes relating to council tax 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.

4.76 Where claimants of **tax credits** pay income tax, the amount of personal tax credit that offsets all or some of the tax they would otherwise have paid was classified as negative tax under ESA95. As described in Box 4.3, under ESA10 this will be classified as spending. While the ONS have not yet implemented this change for outturns, our forecasts are on the new basis.

4.77 **Air passenger duty (APD)** receipts are expected to rise from £3.2 billion in 2014-15 to £3.8 billion in 2019-20. This reflects duty rate rises and growth in passenger numbers. Our forecast is slightly lower than in March, reflecting RPI inflation, affecting future rates.

4.78 **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 higher than in March, reflecting the latest information on receipts year-to-date.

4.79 **Environmental levies** include levy-funded spending policies such as the Renewables Obligation and Contracts for Difference, Feed-In tariffs and the Warm Homes Discount, as well as revenues from the Carbon Reduction Commitment. The rise in environmental levies over the forecast reflects the expected rise in electricity generation from renewable sources. The upward revision from 2016-17 to our forecast since March is due to a re-assessment of projects deploying under Renewables Obligation and Contracts for Difference.

4.80 **Environmental taxes** include the aggregates levy, climate change levy (including the carbon price floor), landfill tax and the EU emissions trading scheme (EU ETS). Climate change levy receipts have been revised downwards by £0.3 to £0.4 billion in all years of the forecast, reflecting weak receipts in 2014-15.

4.81 Expected receipts from the **bank levy** remain close to our March forecast. Receipts are forecast to rise from £2.3 billion in 2013-14 to £2.8 billion in 2019-20.

4.82 **VAT refunds** to central and local government are fiscally neutral, 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 1.8 per cent a year between 2015-16 and 2019-20.

4.83 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 raised our provision for future litigation losses over the whole forecast period from £3.6 billion to £5.6 billion, in line with the higher provision included in the 2013-14 HMRC Trust Statement.

Other receipts

4.84 The ONS PSF review changed the treatment of flows related to the Asset Purchase Facility (APF). Under the previous treatment, APF flows from the Bank of England to the Exchequer boosted interest and dividend receipts. Under the revised treatment, they boost central government receipts with an equal and offsetting reduction in the Bank of England element of public corporation receipts, leaving public sector receipts unchanged. The effect on PSNB from quantitative easing therefore now scores as lower debt interest payments. Table 4.7 shows this effect takes off £11.6 billion in 2014-15, diminishing over the forecast.

4.85 **Interest and dividend** receipts capture the interest income on the government's stock of financial assets. Lower interest rates through the forecast both in the UK and abroad reduce receipts compared with our March forecast. Lower inflation also reduces interest income from student loans, while a lower Bank Rate also lowers the interest income on some older student loans. We have also allowed for the government's decision to raise foreign exchange reserves by £6 billion a year from 2014-15. This raises receipts by £350 million in 2019-20.

Table 4.16: Key changes to the interest and dividend receipts forecast since last March

	£ billion				
	2014-15	2015-16	2016-17	2017-18	2018-19
March Forecast	19.3	16.7	15.4	15.1	16.6
December Forecast	6.3	7.7	10.0	11.6	13.1
Change	-13.1	-9.0	-5.5	-3.4	-3.5
of which:					
removal of APF (ESA10)	-11.6	-7.2	-2.9	-0.4	0.0
Other changes	-1.5	-1.8	-2.5	-3.0	-3.5
Other Changes					
Lower interest rates	0.0	-0.4	-0.6	-0.9	-1.1
Lower foreign interest rates	-0.1	-0.1	-0.1	-0.3	-0.5
Rise in foreign exchange reserves	0.0	0.0	0.0	0.1	0.2
Accrued interest on student loans	-0.1	-0.2	-0.5	-0.7	-0.6
Removing Network Rail imputed dividend(ESA10)	-0.8	-0.9	-1.0	-1.1	-1.2
Inclusion of Lloyds Dividends	0.0	0.5	0.8	0.8	0.8
Other Modelling Changes	-0.4	-0.7	-1.1	-1.0	-1.1

4.86 We have included an estimate of future dividend payments to the Exchequer associated with its current holding of shares in Lloyds Banking Group. These payments are subject to some uncertainty, relating to the Prudential Regulation Authority's need to approve Lloyds restarting dividend payments. We have based the amounts on a sample of current market expectations. Any future sales of Lloyds shares – which we do not include in the central forecast as their timing and scale is unknown – would lead to reduced dividend receipts in our forecast, as well as the capital receipt associated with the sale proceeds.

4.87 Our forecast for **gross operating surplus** (GOS) comprises our forecasts for general government depreciation and public corporations gross operating surplus. ESA10 changes related to research and development and single use military expenditure will raise the

depreciation element of GOS. Abstracting from ESA10 changes, there is little movement in our GOS forecast from March.

4.88 Other ESA10 changes have also boosted other receipts. **Proceeds from the 3G and 4G spectrum auctions** are accrued over a period of years. This adds £1.2 billion to receipts each year. The change in the treatment of the **Royal Mail Pension Plan** means that imputed receipts of between £1.3 billion and £1.6 billion are scored in each year. These offset the annual pension payments, scored in spending

Public sector expenditure

4.89 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)[3] – 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.

4.90 For the years 2014-15 to 2015-16, our projections are constructed using the latest plans for PSCE in RDEL and PSGI in CDEL,[4] plus our latest forecast for departments' underspending against those plans. To this, we add our detailed forecast for AME spending, which includes items of welfare spending that are subject to the Government's new welfare cap.

4.91 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 stated TME policy assumptions, which are set out in paragraphs 4.97 and 4.98. 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 benefits – are offset by changes in implied DELs.

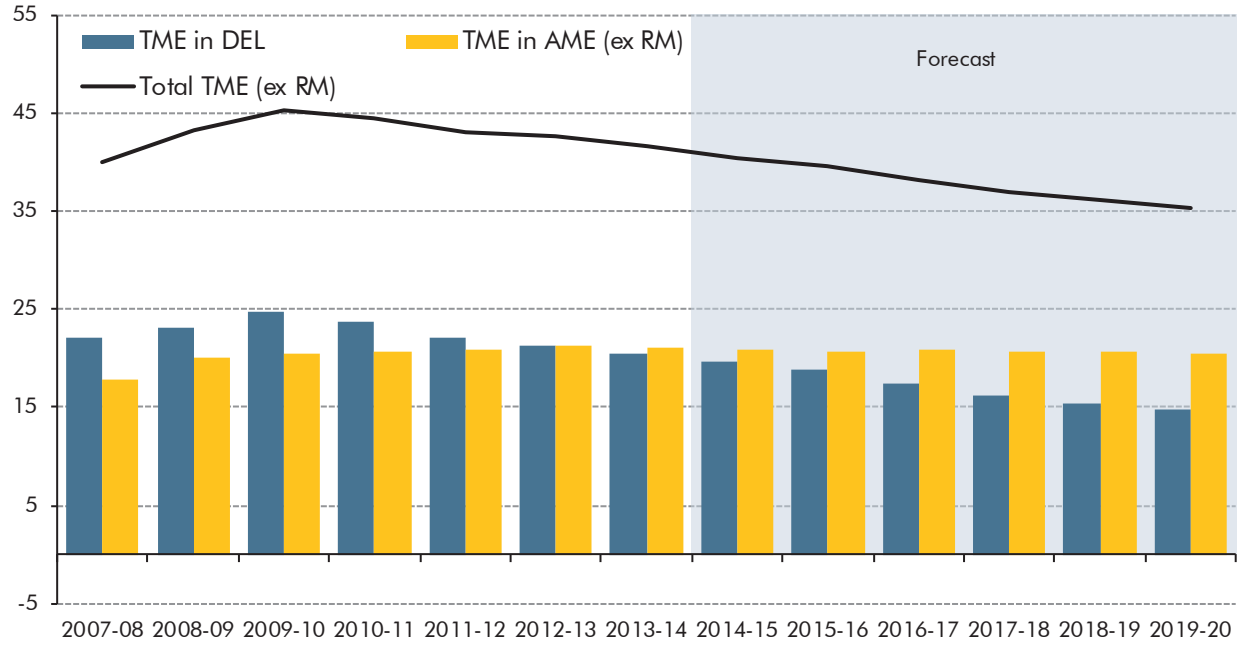
4.92 Chart 4.3 shows TME as a share of GDP from 2007-08 to the end of the forecast period, and how TME splits between DEL and AME. Spending increased sharply as a share of GDP during the late-2000s recession, reaching a peak of 45.3 per cent of GDP in 2009-10. With DELs fixed in cash terms through to 2010-11 in the 2007 Comprehensive Spending Review,

[3] 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.
[4] 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.

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.[5]

4.93 From its peak in 2009-10, we estimate TME will reach 40.5 per cent of GDP in 2014-15 and 39.5 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 35.2 per cent of GDP in 2019-20. That would probably be the lowest in around 80 years.

Chart 4.3: DEL and AME components of TME



Source: ONS, OBR

Summary of the expenditure forecast

4.94 Table 4.17 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.

4.95 Table 4.18 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 are broadly flat as a share of GDP this year and next, and then rise gradually in the following two years before stabilising. The Government's TME growth assumptions imply DEL spending will fall as a share of total spending in each year of the forecast period. As described in Box 4.6, this aspect of our forecast is subject to particular uncertainties relating to future policy decisions of future governments.

[5] 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*.

Table 4.17: 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	41.5	40.5	39.5	38.2	36.9	36.0	35.2
of which:							
Public sector current expenditure	38.0	36.9	36.0	34.8	33.6	32.7	31.9
Public sector gross investment	3.5	3.6	3.5	3.4	3.3	3.3	3.3
Total public sector expenditure that contributes directly to GDP[1]	23.3	22.3	21.7	20.4	19.3	18.5	17.8
of which:							
General government consumption	20.2	19.4	18.9	17.6	16.5	15.8	15.1
General government gross fixed capital formation	2.6	2.6	2.4	2.4	2.3	2.3	2.3
Public corporations gross fixed capital formation	0.4	0.4	0.4	0.4	0.4	0.3	0.3

[1] GDP at market prices.

Table 4.18: 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	19.7	18.9	17.3	16.1	15.4	14.8
TME in AME	21.0	20.8	20.6	20.8	20.8	20.6	20.4
of which:							
Welfare spending	11.9	11.8	11.6	11.4	11.2	11.0	10.9
Debt interest net of APF	2.1	2.0	2.1	2.4	2.7	2.7	2.7
Locally-financed current expenditure	2.0	1.9	2.0	2.0	2.0	2.1	2.0
Other PSCE in AME	3.7	3.8	3.6	3.7	3.6	3.6	3.7
PSGI in AME	1.3	1.3	1.3	1.3	1.3	1.2	1.1

[1] In relation to table 4.17, 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 SUME. SUME is single use military equipment.

The Government's spending growth assumptions

4.96 For the years beyond those covered by detailed spending plans, our forecasts for spending are based on the Government's assumptions for growth in total spending. The precise terms of these assumptions tend to change at each Budget and Autumn Statement. The implication of this assumption for spending on public services is explained in Box 4.6.

4.97 The Government's chosen policy assumption for the growth of TME between 2016-17 and 2019-20 at this Autumn Statement is:

- **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, but include the retrospective effect of our decision to show spending gross of the negative tax element of tax credits,

consistent with the prospective treatment under ESA10. For 2014-15, the measure of TME should exclude our allowance for shortfall. It should also be excluded for the measure of TME in 2015-16 from which the real growth rates are applied. The effect of the policy measures should also be taken into account, while the effect of the historic adjustment to the UK's GNI-based contributions to the EU in 2014-15 and associated rebate in 2015-16 should be excluded. Within TME, PSGI should be held flat in real terms from a level in 2015-16 that includes our allowance for shortfall; and

- for 2018-19 and 2019-20: TME should be held flat in real terms from a baseline that continues to include the effect of Budget measures. Within TME, PSGI should grow in line with nominal GDP.

4.98 This formulation 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 our GDP deflator forecast, which determine the amount of cash spending needed to achieve the assumed real growth rates; and
- Government decisions shown in the Treasury's table of policy decisions and changes in its spending assumptions.

4.99 Table 4.19 sets out the changes since March to the cash values of TME implied by the latest policy assumption, including changes related to ESA10 and the PSF review:

- changes due to ESA10 and the PSF review (including our decision to anticipate the ESA10 treatment of all tax credits as spending, which the ONS will implement in due course) would raise TME due to their effect on spending in 2015-16. Absent a TME growth assumption, that effect would continue to rise over time;
- underlying forecast revisions to spending in 2015-16 – notably the effect of lower debt interest costs – would reduce TME by an average of £9.0 billion a year;
- revisions to our GDP deflator forecast reduce spending by a further £3.6 billion a year on average; and
- the change in the TME assumption between March and December reduces spending by a further £1.2 billion a year on average.

Table 4.19: Changes to TME from 2015-16

	£ billion			
	Forecast			
	2015-16	2016-17	2017-18	2018-19
March forecast excluding APF (ESA95)	743.4	752.5	759.4	772.9
Capital transfers to APF	0.3	0.0	1.7	3.7
March forecast, headline TME (ESA95)	743.6	752.5	761.2	776.5
Changes due to implementation of ESA10 and the ONS PSF review				
ESA10 changes (AME)	9.8	13.8	13.9	14.2
March forecast, headline TME (ESA10)	**753.4**	**766.3**	**775.1**	**790.8**
Forecast changes and consequences for implied government spending				
Forecast changes since March 2014				
Of which:				
AME	-9.3	-11.9	-15.9	-19.2
DEL plans	1.6	-	-	-
Changes to implied DEL by applying Budget 14 policy spending assumptions	-	-4.1	-2.7	0.2
GDP deflator	-	-3.0	-3.3	-4.4
December forecast before effects of Government decisions	**745.7**	**747.3**	**753.1**	**767.2**
Changes due to Government decisions				
Autumn Statement policy measures	0.5	-0.2	-0.3	-0.3
Effect of applying new Autumn Statement spending policy assumptions post 2015-16	-	-0.4	-1.6	-1.7
December forecast, headline TME (ESA10)	**746.2**	**746.7**	**751.3**	**765.3**

4.100 Table 4.20 sets out real growth rates and shares of GDP for different spending aggregates, determined by the Government's spending growth assumptions and our forecast of AME spending. It illustrates the extent to which real terms cuts to spending since 2010-11 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.

Table 4.20: Spending: real growth rates and as a per cent of GDP

	Real terms growth rate (per cent)						
	2010 Spending Review (2010-11 to 2014-15)[1]	2013 Spending Round	Post Spending Review years				**Total change between 2010-11 and 2019-20[1]**
	Average annual change	Change in 2015-16	Change in 2016-17	Change in 2017-18	Change in 2018-19	Change in 2019-20	
TME	-0.6	-0.2	-1.3	-1.1	0.0	0.0	**-4.7**
of which:							
PSCE	-0.2	-0.1	-1.3	-1.2	-0.2	-0.3	**-3.7**
PSGI	-4.2	-0.8	-0.9	0.0	2.3	2.2	**-13.3**
TME in AME	1.4	1.2	3.4	2.1	1.5	1.3	**16.3**
TME in DEL	-2.8	-1.6	-6.4	-4.9	-1.9	-1.9	**-24.9**
of which:							
PSCE in RDEL	-2.4	-1.5	-6.7	-5.4	-3.5	-3.0	**-26.3**
PSGI in CDEL	-5.6	-2.4	-3.7	-1.4	9.5	5.3	**-15.2**
	Per cent of GDP						
TME	-1.0	-0.9	-1.4	-1.3	-0.8	-0.8	**-9.3**
of which:							
PSCE	-0.8	-0.8	-1.2	-1.2	-0.8	-0.8	**-8.0**
PSGI	-0.2	-0.1	-0.1	-0.1	0.0	0.0	**-1.3**
TME in AME	-0.1	-0.2	0.2	-0.1	-0.2	-0.2	**-0.7**
TME in DEL	-1.0	-0.7	-1.6	-1.2	-0.7	-0.6	**-8.9**
of which:							
PSCE in RDEL	-0.8	-0.6	-1.5	-1.2	-0.8	-0.7	**-8.0**
PSGI in CDEL	-0.2	-0.1	-0.1	-0.1	0.1	0.1	**-0.9**

[1]Growth rates on comparable definitions, the changes in relation to 2010-11 are calculated on a base which includes the negative tax element of tax credits, consistent with our forecast and the prospective treatment under ESA10.

Summary of changes to the expenditure forecast since March

4.101 Table 4.22 shows our latest forecast of public spending. Tables 4.21, 4.23 and 4.24 detail changes, since our March forecast. These are broken down to changes due to ESA10 National Accounts classification changes and underlying forecast changes. In summary, the main drivers of the changes are:

- changes to economic determinants. In particular:
  - movements in inflation reduce spending in all years, with the profile largely explained by changes to debt interest as a result of RPI inflation;
  - revisions to the GDP deflator reduce spending in 2016-17 by £3.0 billion, rising to £4.4 billion in 2018-19;
  - lower claimant count unemployment progressively reduces spending, but modelling changes to incapacity and disability benefits broadly offset that effect;

  - lower gilt rates and short rates reduce debt interest costs by £0.6 billion in 2014-15, with the reduction increasing to £7.0 billion by 2018-19.

- the latest information from the Treasury suggests that spending pressures within departmental spending limits in 2014-15 are greater than expected in December, so we have reduced our underspend assumption by £1.9 billion;

- various modelling changes made to social security, explained in more detail in the relevant section, increase the forecast in all years;

- changes to the policy spending assumptions have reduced spending by £1.7 billion in 2018-19; and

- the policy changes announced in the Autumn Statement, summarised in Table 4.3 and set out in full in Annex A, have relatively minor effects on spending in total.

Table 4.21: Changes to the underlying spending forecast since March

	£ billion				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast (ESA95)	732.0	743.6	752.5	761.2	776.5
ESA10 effects	7.3	9.8	13.8	13.9	14.2
March forecast (ESA10)	739.3	753.4	766.3	775.1	790.8
December forecast (ESA10)	737.1	746.2	746.7	751.3	765.3
Forecast changes	**-2.1**	**-7.2**	**-19.7**	**-23.8**	**-25.4**
of which:					
Economic determinants	**-3.5**	**-6.0**	**-9.8**	**-9.8**	**-10.6**
Inflation	-3.2	-5.0	-5.3	-4.8	-4.7
Unemployment	-0.6	-1.3	-1.2	-0.8	-0.6
GDP deflator			-3.0	-3.3	-4.4
Other determinants	0.2	0.2	-0.3	-0.8	-0.9
Market assumptions	**-0.6**	**-2.3**	**-4.3**	**-5.9**	**-7.0**
Gilt rates	-0.2	-1.4	-2.8	-4.2	-5.3
Short rates	-0.4	-0.8	-1.4	-1.7	-1.7
Other assumptions/changes	**2.1**	**0.6**	**-5.0**	**-6.2**	**-5.9**
Changes to DEL underspend assumptions	0.0	1.9			
Other changes to implied DELs			-4.1	-2.7	0.2
Social security modelling changes	0.9	1.0	1.5	1.3	0.8
Non-economic pension costs	0.6	0.5	0.7	0.6	0.5
Other debt interest changes	-1.6	-3.6	-6.0	-7.7	-8.9
Locally-financed and public corporations capital expenditure	0.4	0.4	1.0	1.8	1.1
Other	1.8	0.5	1.9	0.5	0.4
Effect of TME growth rule			-0.4	-1.6	-1.7
Autumn Statement measures	**-0.1**	**0.5**	**-0.2**	**-0.3**	**-0.3**

Table 4.22: 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 RDEL[1]	**317.5**	**316.8**	**316.3**	**299.0**	**287.9**	**282.9**	**279.7**
PSCE in AME[2]	**341.0**	**354.9**	**364.1**	**381.6**	**396.2**	**412.4**	**427.3**
of which:							
Welfare spending[2]	206.7	215.0	218.3	222.5	227.5	234.1	240.7
of which:							
Inside Welfare Cap	*113.5*	*119.6*	*120.7*	*122.4*	*124.0*	*126.8*	*129.8*
Outside Welfare Cap	*93.2*	*95.3*	*97.7*	*100.1*	*103.5*	*107.3*	*110.9*
Company and other tax credits	1.9	2.1	2.3	2.5	2.6	2.6	2.6
Net public service pension payments	10.9	11.8	10.4	11.4	12.2	13.2	14.3
National lottery current grants	1.2	1.4	1.3	1.3	1.3	1.4	1.4
BBC domestic services current expenditure	3.2	4.0	3.7	3.9	3.9	4.0	4.1
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	1.0	1.0	1.1	1.1	1.1	1.1
Expenditure transfers to EU institutions	11.1	11.0	9.9	11.5	9.6	10.7	11.2
of which:							
EU VAT contributions	*2.2*	*2.4*	*2.5*	*2.6*	*2.7*	*2.8*	*3.0*
EU expenditure transfers under ESA 95	*9.0*	*8.6*	*7.4*	*8.8*	*6.9*	*7.8*	*8.2*
Locally-financed current expenditure	33.8	35.0	37.2	39.5	41.6	43.5	45.0
Central government debt interest, net of APF	36.1	35.9	40.4	47.3	54.0	57.5	60.1
of which:							
Central government gross debt interest	*48.7*	*48.1*	*51.9*	*56.2*	*61.3*	*63.4*	*64.8*
Reductions in debt interest due to APF	*-12.6*	*-12.2*	*-11.5*	*-8.9*	*-7.3*	*-5.8*	*-4.6*
Depreciation	27.7	28.9	30.3	31.8	33.3	34.9	36.5
Current VAT refunds	11.6	11.7	11.7	11.0	10.6	10.4	10.3
R&D expenditure	-7.1	-7.5	-7.8	-8.3	-8.3	-8.3	-8.3
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	6.8	7.6	8.9	9.9
Local authority imputed pensions	1.9	1.8	1.9	2.0	2.1	2.2	2.2
Other National Accounts adjustments	-3.7	-2.9	-3.4	-3.5	-3.5	-3.6	-3.8
Total public sector current expenditure	**658.5**	**671.7**	**680.4**	**680.6**	**684.1**	**695.3**	**707.0**
Public sector gross investment (PSGI)							
PSGI in CDEL[1]	**38.4**	**41.4**	**41.0**	**40.0**	**40.1**	**44.8**	**48.0**
PSGI in AME	**23.0**	**24.0**	**24.8**	**26.0**	**27.0**	**25.2**	**24.9**
of which:							
National lottery capital grants	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Network Rail capital expenditure	3.1	1.8	1.7	1.5	1.4	1.8	1.4
Other PSGI items in departmental AME	-0.5	0.3	0.2	0.0	0.2	0.2	0.2
Locally-financed capital expenditure	6.4	6.1	5.9	7.4	8.1	6.4	6.2
Public corporations capital expenditure	7.4	7.6	8.0	7.8	7.8	7.4	7.5
R&D expenditure	7.1	7.5	7.8	8.3	8.3	8.3	8.3
Other National Accounts adjustments	-1.0	0.2	0.7	0.5	0.7	0.6	0.7
Total public sector gross investment	**61.4**	**65.4**	**65.8**	**66.0**	**67.2**	**70.0**	**72.9**
Less depreciation	-36.1	-37.7	-39.2	-40.9	-42.5	-44.3	-46.0
Public sector net investment	**25.3**	**27.7**	**26.5**	**25.2**	**24.6**	**25.7**	**26.9**
Total managed expenditure	**719.9**	**737.1**	**746.2**	**746.7**	**751.3**	**765.3**	**779.9**

[1] Implied DEL numbers for 2016-17, 2017-18 and 2018-19. 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 exclude negative tax credit element of tax credit spending, but this element is included in forecast years.

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

Table 4.23: Effect of major classification changes on spending

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector current expenditure (PSCE)						
PSCE in RDEL	0.0	0.0	0.0	0.0	0.0	0.0
PSCE in AME	-9.4	-5.1	-1.8	1.7	3.6	5.2
of which:						
Include negative tax element of personal tax credits in welfare cap in AME[1]	-	2.6	2.5	1.6	0.3	0.0
Include Network Rail other current expenditure[2]	0.4	0.9	1.0	0.7	0.4	-0.2
Include EU VAT contributions	2.2	2.4	2.5	2.6	2.7	2.8
Debt interest	-11.1	-11.2	-9.0	-4.7	-1.9	0.2
of which:						
Reductions in debt interest due to APF	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0
Include Network Rail debt interest payments	1.2	1.3	1.4	1.8	2.0	2.2
Depreciation	9.6	10.0	10.7	11.4	12.1	12.7
of which, depreciation of:						
Network Rail capital asssets	1.5	1.7	1.9	2.1	2.2	2.4
Additional capital assets from R&D expenditure	4.1	4.2	4.5	4.7	5.0	5.3
Additional capital assets from single use military expenditure	4.0	4.1	4.3	4.6	4.8	5.1
Switch R&D current expenditure to capital	-7.1	-7.5	-7.8	-8.3	-8.3	-8.3
Switch single use military expenditure to capital	-4.2	-3.4	-2.7	-2.6	-2.7	-3.0
Include local authority imputed pensions	1.9	1.8	1.9	2.0	2.1	2.2
Other National Accounts adjustments	-0.8	-0.8	-0.9	-1.0	-1.1	-1.2
of which:						
Remove Network Rail imputed subsidy	-0.8	-0.8	-0.9	-1.0	-1.1	-1.2
Total public sector current expenditure[1]	-9.4	-5.1	-1.8	1.7	3.6	5.2
Public sector gross investment (PSGI)						
PSGI in CDEL	4.2	3.4	2.7	2.6	2.7	3.0
of which:						
SUME switched in to CDEL under ESA10	4.2	3.4	2.7	2.6	2.7	3.0
PSGI in AME	9.8	8.9	8.9	9.5	7.6	6.1
of which:						
Network Rail capital expenditure	3.1	1.8	1.7	1.5	1.4	1.8
R&D expenditure	7.1	7.5	7.8	8.3	8.3	8.3
Remove capital payments to the APF	0.0	0.0	-0.3	0.0	-1.7	-3.7
Other National Accounts adjustments	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Of which:						
Switch business rates write-offs to current receipts	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*
Total public sector gross investment	14.0	12.3	11.6	12.1	10.3	9.1
Less depreciation	-9.6	-10.0	-10.7	-11.4	-12.1	-12.7
Public sector net investment	4.4	2.3	0.8	0.7	-1.8	-3.7
Total managed expenditure [1]	4.5	7.3	9.8	13.8	13.9	14.2

[1] Excluding negative tax credits in 2013-14. ONS have announced that they will transfer negative tax credits from current receipts to current spending as part of the ESA10 changes in their 2015 Blue Book. Our forecast anticipates this change from 2014-15 onwards, but we have not adjusted the ONS outturn data for 2013-14 .

[2] This table also includes changes for Network Rail current expenditure within debt interest, depreciation and current National Accounts adjustments

Table 4.24: Underlying forecast changes to total managed expenditure since March

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector current expenditure (PSCE)						
PSCE in RDEL[1]	**1.6**	**-1.0**	**3.8**	**-3.5**	**-4.2**	**-6.1**
PSCE in AME	**-1.6**	**-2.1**	**-13.1**	**-16.4**	**-21.7**	**-23.0**
of which:						
Welfare spending	-0.6	1.1	-0.4	-2.0	-3.0	-2.1
of which:						
Inside Welfare Cap	*-0.1*	*1.9*	*1.2*	*0.4*	*-0.5*	*0.1*
Outside Welfare Cap	*-0.5*	*-0.8*	*-1.6*	*-2.4*	*-2.5*	*-2.3*
Company and other tax credits	0.3	0.1	0.2	0.2	0.2	0.1
Net public service pension payments	0.4	1.4	-1.3	-1.3	-1.6	-1.7
National lottery current grants	-0.2	0.0	-0.1	-0.1	-0.1	-0.1
BBC domestic services current expenditure	-0.3	0.2	0.2	0.2	0.0	0.0
Other PSCE items in departmental AME	0.1	-0.2	-0.3	-0.1	-0.2	-0.1
Expenditure transfers to EU institutions	0.1	0.5	-0.8	0.9	-0.2	-0.1
Locally-financed current expenditure	-0.2	-0.1	0.3	0.1	-0.4	-0.5
Central government debt interest, net of APF	-1.1	-5.0	-9.7	-13.1	-15.7	-17.8
of which:						
Central government gross debt interest	-1.0	-5.2	-8.6	-10.6	-12.3	-14.0
Reductions in debt interest due to APF	-0.2	0.3	-1.1	-2.5	-3.4	-3.8
Depreciation	0.0	0.0	0.0	0.0	0.1	0.2
Current VAT refunds	-0.1	-0.2	-0.1	-0.3	-0.2	-0.3
Single use military expenditure	-0.1	-0.5	-1.3	-1.5	-1.4	-1.3
Environmental levies	0.1	0.0	0.0	0.4	0.5	0.7
Other National Accounts adjustments	-0.1	0.6	0.2	0.2	0.2	0.2
Total public sector current expenditure	**0.0**	**-3.1**	**-9.3**	**-19.8**	**-25.9**	**-29.1**
Public sector gross investment (PSGI)						
PSGI in CDEL[1]	**0.9**	**0.6**	**1.6**	**-0.6**	**0.2**	**2.7**
PSGI in AME	**-1.0**	**0.4**	**0.5**	**0.8**	**1.9**	**1.0**
of which:						
National lottery capital grants	0.0	0.0	0.0	0.0	0.0	0.0
Network Rail capital expenditure	0.0	0.0	0.0	0.0	0.0	0.0
Other PSGI items in departmental AME	-1.1	-0.2	-0.3	-0.2	-1.7	-3.7
Locally-financed capital expenditure	0.0	-0.1	-0.6	0.0	0.9	0.2
Public corporations capital expenditure	0.5	0.6	1.0	1.0	0.9	0.9
R&D expenditure	0.0	0.0	0.0	0.0	0.0	0.0
Capital payments to the APF	0.0	0.0	0.3	0.0	1.7	3.7
Other National Accounts adjustments	-0.6	0.0	0.1	0.0	0.0	0.0
Total public sector gross investment	**-0.2**	**0.9**	**2.1**	**0.1**	**2.1**	**3.7**
Less depreciation	-3.1	-3.4	-3.4	-3.5	-3.5	-3.7
Public sector net investment	**-3.2**	**-2.4**	**-1.1**	**-3.3**	**0.3**	**3.7**
Total managed expenditure	**-0.1**	**-2.1**	**-7.2**	**-19.7**	**-23.8**	**-25.4**

[1] Implied DEL numbers for 2016-17, 2017-18 and 2018-19. 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] Other than debt interest and depreciation, which are included in totals shown separately in this table.

Expenditure in 2014-15

4.102 Total spending growth has been broadly in line with our March forecast so far in 2014-15. Table 4.21 shows that on a like-for-like basis we have revised down TME by £2.1 billion in 2014-15, largely due to lower inflation reducing the costs of servicing index-linked gilts.

4.103 Monthly outturn information is only available for central government spending. Since September 2014, the monthly public sector finances statistics have been compiled in line with ESA10 and the conclusions of the PSF review. Data for the first seven months of 2014-15 showed that central government current expenditure was 1.9 per cent higher than last year. We expect spending growth in the final five months of the year to be lower than in the first seven. The biggest source of that change is the effect of recent and expected falls in RPI inflation on the monthly profile of debt interest on index-linked gilts.

Table 4.25: Central Government spending in 2014-15

	Spending in 2014-15			Percentage change on 2013-14		
	Outturn	Forecast		Outturn	Forecast	
	Apr-Oct	Nov-Mar	Full Year	Apr-Oct	Nov-Mar	Full Year
Total current expenditure[1,2,3]	380.8	269.5	650.4	1.9	0.1	1.1
of which:						
Net social benefits[2]	116.1	83.4	199.6	2.7	3.6	3.1
Debt interest	30.3	17.8	48.1	1.6	-5.6	-1.2
Other[3]	234.4	168.2	402.6	1.5	-1.0	0.5
Total net investment	17.9	16.6	34.5	12.4	6.5	9.5
Depreciation	11.0	7.9	18.9	4.7	3.0	4.0
Total central government expenditure in TME	409.8	294.0	703.8	2.4	0.5	1.6

[1] Forecast data has been adjusted to take out the negative tax element of income tax credits.

[2] Forecast data has been adjusted to exclude the warm homes discount, which is currently excluded by the ONS.

[3] Forecast data has been adjusted to exclude feed-in-tariffs, which is currently excluded by the ONS.

Departmental expenditure limits (DELs)

4.104 Table 4.22 shows our latest forecasts for PSCE in RDEL and PSGI in CDEL, and the changes since March. They reflect DEL plans published by the Treasury in *Public Expenditure Statistical Analyses (PESA) 2014*. The forecasts also include our latest assumptions for departments' underspending against those plans, as shown in Table 4.27. 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.

4.105 In 2014-15 and 2015-16, the years covered by detailed spending plans, we have made a number of relatively small adjustments to our forecast since March, many of which relate to ESA10 and other accounting changes:

- PSCE in RDEL is reduced in 2014-15 due to the correction of our treatment of one-off pension fund transfers that were included in the March forecast. (These are spending neutral as there is an offsetting effect in AME, described under 'public service pensions'

below). In 2015-16, it is increased, mainly due to Treasury decisions on switches between the DEL and AME elements of its spending control framework. We have made a small adjustment to our underspend assumption in 2014-15, and reduced our underspend assumption by £1.4 billion in 2015-16, which increases spending by this amount. These changes are explained in the section on DEL underspend assumptions that follows below. ESA10 changes do not affect PSCE in RDEL in either year; and

- PSGI in CDEL is increased by the amount of single use military expenditure (SUME) that is switched from current to capital spending in the National Accounts. The Treasury manage SUME within CDEL, but in previous forecasts we have included it within PSCE in AME. For this forecast, in line with ESA10 treatment, most SUME is included in PSGI in CDEL.

4.106 From 2016-17 onwards, DELs are inferred from the Government's TME policy assumptions and our AME forecast. Changes since March therefore reflect interaction between those assumptions and other changes to the forecast since March, including ESA10 changes, underlying changes to our forecasts of spending and the GDP deflator (since TME assumptions are set in real terms) and the Government's decision to change the TME policy assumptions from those used in March. As a result of all of these changes:

- PSCE in RDEL is reduced in 2014-15 due to the correction of our treatment of one-off pension fund transfers that were included in the March forecast. (These are spending neutral as there is an offsetting effect in AME, described under 'public service pensions' below). In 2015-16, it is increased, mainly due to Treasury decisions on switches between the DEL and AME elements of its spending control framework. We have made a small adjustment to our underspend assumption in 2014-15, and reduced our underspend assumption by £1.4 billion in 2015-16, which increases spending by this amount. These changes are explained in the section on DEL underspend assumptions that follows below. ESA10 changes do not affect PSCE in RDEL in either year; and

- PSGI in CDEL is increased by the amount of single use military expenditure (SUME) that is switched from current to capital spending in the National Accounts. The Treasury manage SUME within CDEL, but in previous forecasts we have included it within PSCE in AME. For this forecast, in line with ESA10 treatment, most SUME is included in PSGI in CDEL.

Table 4.26: Key changes to DEL since March

	£ billion				
	Forecast		Implied DEL[1]		
	2014-15	2015-16	2016-17	2017-18	2018-19
PSCE in RDEL					
March forecast	317.8	312.5	302.5	292.1	289.1
December forecast	316.8	316.3	299.0	287.9	282.9
Change	**-1.0**	**3.8**	**-3.5**	**-4.2**	**-6.1**
of which:					
Changes to underspend assumptions	-0.3	1.4	-	-	-
SUME transferred to RDEL	0.5	1.3	1.5	1.4	1.3
Transfers to CDEL	-0.2	-0.9	-	-	-
Remove pension fund transfers included in March forecast	-0.8	-	-	-	-
Other changes to DEL plans	0.0	-0.1	-	-	-
GDP deflator	-	-	-2.6	-2.8	-3.9
Changes to implied RDEL[1]	-	-	-3.7	-3.3	-2.9
of which:					
Offsets to AME increases from ESA changes	-	-	-4.0	-6.6	-8.4
Offsets to AME increases from forecast changes	-	-	0.3	3.2	5.6
Effect of applying new Autumn Statement spending policy assumptions post 2015-16	-	-	-0.4	-1.6	-1.7
Autumn Statement measures	-0.2	2.2	1.8	2.2	1.1
PSGI in CDEL					
March forecast (ESA95)	37.4	36.7	38.0	37.2	39.1
ESA10 change: SUME included in CDEL	3.4	2.7	2.6	2.7	3.0
March forecast (ESA10)	40.8	39.4	40.6	39.9	42.1
December forecast	41.4	41.0	40.0	40.1	44.8
Change	**0.6**	**1.6**	**-0.6**	**0.2**	**2.7**
of which:					
Changes to underspend assumptions	0.3	0.5	-	-	-
Transfers from RDEL	0.2	0.9	-	-	-
Other changes to DEL plans	0.1	-0.2	-	-	-
GDP deflator	-	-	-0.4	-0.5	-0.5
Changes to implied CDEL	-	-	-0.4	0.6	3.2
of which:					
Offsets to AME increases from ESA changes	-	-	-0.3	1.7	3.5
Offsets to AME increases from forecast changes	-	-	0.0	-1.1	-0.3
Autumn Statement measures	0.1	0.3	0.1	0.1	0.0
SUME (CDEL, but treated as PSCE under ESA95)					
March forecast (ESA95): SUME in PSCE in AME	4.2	4.2	4.4	4.3	4.5
ESA10 change: SUME included in CDEL	-3.4	-2.7	-2.6	-2.7	-3.0
March forecast (ESA10)	0.7	1.5	1.7	1.6	1.5
December forecast	0.3	0.2	0.2	0.2	0.2
Change	-0.5	-1.3	-1.5	-1.4	-1.3
of which:					
SUME transferred to RDEL in plans	-0.5	-1.3	-	-	-
SUME transferred to implied RDEL	-	-	-1.5	-1.4	-1.3

Latest underspends in this forecast			Previous underspends in our March forecast		
	2014-15	2015-16		2014-15	2015-16
PSCE in RDEL	-2.0	-0.6	PSCE in RDEL	-0.8	-1.0
			SUME	-1.0	-1.0
PSGI in CDEL	-0.5	-0.5	PSGI in CDEL	-0.8	-1.0
TME in DEL	**-2.5**	**-1.1**	TME in DEL	**-2.5**	**-3.0**

[1] Changes to implied RDEL are calculated as changes to total PSCE less changes to PSCE in AME. Changes to implied CDEL are calculated as changes to total PSGI less changes to PSGI in AME.

DEL underspend assumptions

4.107 In years for which detailed spending plans have been set by the Government – 2014-15 and 2015-16 at this forecast – we need to judge the extent to which departments are likely to under- or over-spend the limits that have been set by the Treasury. Departments typically underspend somewhat against those plans, so we make an 'allowance for shortfall' adjustment to ensure our forecasts are central.

4.108 In March, we expected departments to underspend against their 2013-14 plans by £7.0 billion. The latest estimates suggest the shortfall was smaller at £4.6 billion. Our estimate of underspending against plans in 2014-15 – net of spending brought forward under the Treasury's Budget Exchange scheme – is unchanged from March at £2.5 billion, smaller than in 2013-14. We have revised the composition between current and capital spending. Our assumptions for this year are based on a review of departments' own forecasts of their outturn spending for the year and discussion with the Treasury over their management of in-year spending pressures.

4.109 We have reduced our underlying estimate of underspending against plans in 2015-16 by around £2.0 billion. This judgement is based on evidence of a declining trend in underspending over the past three years and expected pressures on budgets. We have also taken into account the £1.2 billion claim on the 2015-16 reserve that has been allocated to the NHS (and devolved authorities), along with the Department of Health's own redeployment of £0.7 billion to increase NHS spending, and the Treasury's allocation of £0.3 billion of the receipts from bank foreign exchange fines to the NHS transformation fund in 2015-16. We expect that all these allocations will reduce the scope for net underspends, but in light of the pattern of historic underspends that not all the additional amounts allocated will be fully spent. We have therefore reduced our forecast for DEL underspends by an additional £0.9 billion, which increases our forecast of DEL spending. This change is reflected in our overall underspend assumption for 2015-16.

4.110 Table 4.27 shows estimated outturn DEL underspends in 2013-14 and our latest assumptions for 2014-15 and 2015-16, and compares them with the latest amounts of Budget Exchange being taken forward into those years.

Table 4.27: DEL shortfalls against latest plans for 2014-15 and 2015-16

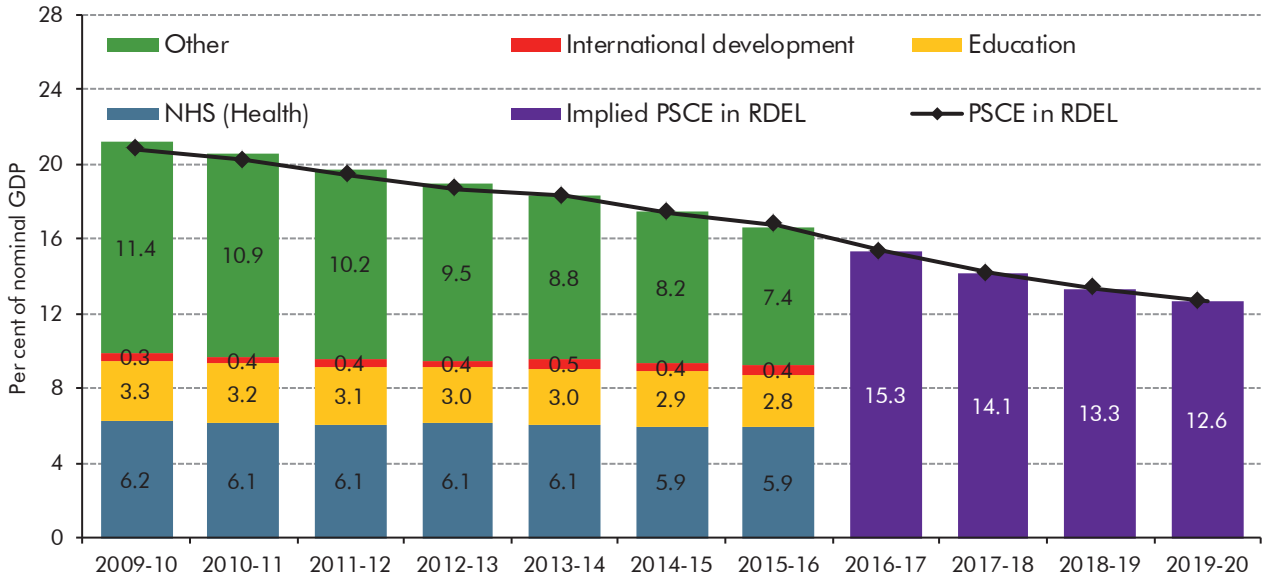
	£ billion								
	PSCE in RDEL			PSGI in CDEL			TME in DEL[1]		
	Outturn	Forecast		Outturn	Forecast		Outturn	Forecast	
	13-14	14-15	15-16	13-14	14-15	15-16	13-14	14-15	15-16
Budget Exchange carried forward	1.6	2.2	0.0	0.6	1.0	0.7	2.3	3.2	0.7
Gross underspend	**-4.5**	**-4.2**	**-0.6**	**-1.0**	**-1.5**	**-1.2**	**-6.8**	**-5.7**	**-1.8**
Of which:									
Supplementary Estimates	-3.3	-4.2	-0.6	0.0	-1.5	-1.2	-4.5	-5.7	-1.8
Further underspend	-1.2			-1.0			-2.3		
Net underspend against PESA plans [2]	**-2.9**	**-2.0**	**-0.6**	**-0.4**	**-0.5**	**-0.5**	**-4.6**	**-2.5**	**-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.

4.111 Chart 4.4 shows the trend in PSCE in RDEL as a share of GDP – the proportion of national income devoted to day-to-day spending on public services and administration.[6] 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). 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. Box 4.6 looks in more detail at what this implied for the post-Spending Review period and the associated uncertainties.

Chart 4.4: Resource DEL and implied resource DEL relative to GDP



Plans for RDEL excluding depreciation upto 2015-16. Beyond 2015-16 based on implied PSCE in RDEL calculated from the Government assumption for TME. Other includes unallocated amounts.

Source: HM Treasury Autumn Statement 2014, HM Treasury Public Expenditure Statistical Analyses, July 2014

[6] In outturn, includes council tax benefit and excludes the local share of business rates consistent with current budgeting treatment.

4.112 For 2016-17 onwards, our spending forecast includes an implied envelope for PSGI in CDEL that is determined by the Government's spending growth assumptions. From 2016-17 to 2019-20, PSGI in CDEL averages £43 billion a year. In order to test whether this aspect of our forecast is central, we have reviewed evidence provided to us by the Treasury and Infrastructure UK on future public investment commitments, within and beyond our current forecast period. We also looked at the use of guarantees that would give rise to future contingent liabilities. The Government has set out capital commitments over the period from 2015-16 to 2020-21 that total around £100 billion. The largest of these are in the transport sector – which total £73 billion and include High Speed 2 and the plans of Network Rail – and schools – which total around £21 billion.[7] Having reviewed this evidence, we are reassured that future commitments announced to date are consistent with the implied envelope for CDEL in our forecast.

Box 4.6: What does our forecast imply for day-to-day public services spending?

The remit set for the OBR by Parliament requires us to base our forecasts on the current policy of the current Government, and not to consider alternative policies. But we are also tasked with producing a central forecast. So we have been asked by stakeholders whether we consider the implications for current spending on public services (RDEL) of our forecast to be central.

The Government has set out detailed spending plans, department by department, through to 2015-16. For the remaining years of the forecast – which are also the remaining years of the next Parliament – it has made a 'policy assumption' regarding the growth of the current and capital components of total spending or Total Managed Expenditure (TME). By subtracting our forecasts for debt interest, social security and other so-called Annually Managed Expenditure (AME), we can derive implied limits on capital and current (or 'resource') spending by central government departments. These are referred to as Capital Department Expenditure Limits (CDEL) and Resource Departmental Expenditure Limits (RDEL). In essence, RDEL corresponds to day-to-day central government spending on public services and administration (including grants to local government). It is largely made up of spending on public sector pay and procurement.

Our forecast shows TME dropping from 45.3 per cent of GDP at its peak in 2009-10 to 40.5 per cent of GDP this year. It then drops to 39.5 per cent in 2015-16, the final year for which there are detailed departmental spending plans. The Government's TME policy assumptions then imply a further drop to 35.2 per cent by 2019-20. Taken together, this implies a total cut in spending of 10.1 per cent of GDP over 10 years, with 48 per cent of that reduction due to be achieved by this year (the half-way point) and therefore 52 per cent still to come.

Within TME, the burden of cutting public spending falls most heavily on RDEL – especially over the remaining years of the consolidation. This is largely because of upward pressure on major parts of AME (notably debt interest and – thanks to the 'triple lock' – state pension costs) and the Government's assumption that it would not cut the share of GDP spent on investment further from 2018-19 onwards.

Table F also shows what this implies. In cash terms, we expect RDEL to have fallen from £317.8

[7] See HM Treasury, *Investing in Britain's future* (2013) and *National Infrastructure Plan* (2014).

billion in 2009-10 to £316.8 billion in 2014-15, a period over which nominal GDP will have risen by 21.3 per cent, whole economy prices by 10.6 per cent and the population by 3.6 per cent. This implies that over this Parliament, RDEL will have fallen by 17.8 per cent relative to the size of the economy, by 9.9 per cent in real terms and by 13.1 per cent in terms of real spending per person (from £5,650 per head to £4,910 per head in 2014-15 prices). Over the full 10 years, taking into account the final year of detailed spending plans and the four years of the spending assumptions, these declines increase to 40.3, 26.7 and 31.3 per cent respectively (taking real spending per head to £3,880).

On each definition, the figures imply that roughly 40 per cent of the total implied cut in day-to-day public services spending between 2009-10 and 2019-20 will have taken place over this Parliament, with roughly 60 per cent to come in the next. And most of the implied spending cuts in the next Parliament lie beyond the period for which there are currently firm departmental plans. Consistent historical data for RDEL are not available over a long period, but the closest equivalent in the National Accounts implies that by 2019-20 day-to-day spending on public services would be at its lowest level since 2002-03 in real terms (based on whole economy inflation), since 2001-02 in real terms per capita and since the late-1930s as a share of GDP.

Table F: Resource DEL spending

	Outturn	Spending plans		Implied spending			
	2009-10	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Per cent of GDP	21.2	17.4	16.8	15.3	14.1	13.3	12.6
Nominal spending[1]	317.8	316.8	316.3	299.0	287.9	282.9	279.7
Real spending[2]	351.5	316.8	311.9	291.0	275.4	265.7	257.7
Real spending per capita[3]	5,650	4,910	4,810	4,460	4,190	4,020	3,880

[1] £ billion. [2] £ billion, 2014-15 prices.

[3] £, 2014-15 prices. Per capita figures have been calculated using ONS mid-year population estimates and ONS low-migration variant population projections.

In considering whether the levels of RDEL implied by the Government's detailed plans and spending assumption are consistent with a central forecast, we also need to address any additional constraints implied by their possible composition. As noted above, the Government has not set out a policy on the composition of RDEL beyond 2016-17, so we need to make an assumption in the spirit of current policy. Two obvious options present themselves:

- the composition of RDEL remains constant from 2015-16 onwards, the final year for which detailed plans have been set; or
- the real terms protections of spending on health and schools, and the per cent of GNI target for aid, are maintained, leading to sharper cuts in unprotected spending.

Table G sets out the implications of these assumptions. If all departments experienced proportionately equal cuts, health spending would be 1.4 per cent of GDP lower in 2019-20 than in 2014-15, down 16.0 per cent in real terms, taking real per capita spending down by 18.5 per cent. But if existing protections were assumed to continue through to 2019-20, health spending would be just 0.5 per cent of GDP lower than in 2014-15. In real terms, it would be flat from 2015-16 (a year in which health RDEL spending reflects changes announced in the Autumn Statement) and down 1.2 per cent in real per capita terms. However, spending on other

departments would be 3.9 per cent of GDP lower than in 2014-15 and 7.1 per cent lower than the peak in 2009-10. Real per capita spending on these other departments would be 43.4 per cent lower than planned this year and 57.3 per cent lower than in 2009-10. The largest departments included in this 'other' line are the Ministry of Defence (£26.8 billion of RDEL excluding depreciation in 2014-15, or 1.5 per cent of GDP) and the Department for Business, Innovation and Skills (£13.8 billion or 0.8 per cent of GDP).

Table G: Implied breakdown of RDEL in 2019-20

	2009-10	2014-15	Implied spending in 2019-20	
	Outturn	Spending plans	Constant shares	Protections
		Per cent of GDP		
Health	6.2	5.9	4.5	5.4
Schools	3.3	2.9	2.1	2.6
ODA	0.3	0.4	0.3	0.4
Other RDEL	11.3	8.1	5.7	4.2
		Real spending (£ billion, 2014-15 prices)		
Health	103.1	108.4	91.1	110.2
Schools	54.5	53.4	43.6	52.7
ODA	5.8	7.8	6.9	9.1
Other RDEL	188.1	147.1	116.2	85.6
		Real spending per capita (£, 2014-15 prices)		
Health	1,660	1,680	1,370	1,660
Schools	870	830	660	790
ODA	90	120	100	140
Other RDEL	3,020	2,280	1,750	1,290

The implied cuts in RDEL during the next Parliament would pose a significant challenge if they were confirmed as firm policy, one that would be all the greater if existing protections were maintained. But we do not believe that it would be appropriate for us to assume, ex ante, that these cuts would be inherently unachievable and make it our central forecast that this or a future Government would breach its stated spending limits if it chose and tried to implement them. After all, the squeeze on spending has already been significant over this Parliament and – to date – central government spending has continued to come in comfortably below the DEL limits set by the Treasury, while local authorities continue in aggregate to build up their financial reserves rather than running them down. But if this ceased to be the case, we might need to include an 'allowance for overspending' in our forecasts, similar to the 'allowance for shortfall' that we currently incorporate to reflect likely underspending against DEL plans.

It is quite possible, of course, that this or a future government would adopt different policies, in terms of its ultimate fiscal objectives, the mix of tax and spending, or the mix within spending. In which case we would reflect this in our central forecast. Indeed, both member parties of the Coalition have said that they would adopt a different approach to tax and spending policies if either was elected to govern alone, as has the Labour Party. Doubtless each party will be asked to provide greater details of its plans in the run-up to the General Election.

Annually managed expenditure

4.113 Table 4.22 sets out our latest central projections of AME spending to 2019-20, based on our economic forecast, the latest estimates of agreed policy commitments and the measures announced in the Autumn Statement.

Welfare cap and other welfare spending

4.114 Total welfare spending in our forecast refers to AME spending on social security and tax credits. We discussed past and expected developments in welfare spending in our October 2014 *Welfare trends report*. We highlighted the upward pressure on spending from ageing, the cyclicality in some parts of spending, the sensitivity to uprating (mainly movements in inflation), and significant uncertainties around the impact of various welfare reforms.

4.115 In Budget 2014, the Government introduced a cap on a subset of welfare spending. We have been tasked with assessing the Government's performance against the cap at each Autumn Statement. Our formal assessment is set out in Chapter 5.

4.116 Table 4.28 shows that total welfare spending is forecast to rise by 12.0 per cent over the forecast, from £215.0 billion in 2014-15 to £240.7 billion in 2019-20. Spending inside the cap is forecast to rise by 8.5 per cent and outside by 16.3 per cent. The higher growth outside the cap is driven by state pensions – in particular due to 'triple lock' uprating of the basic state pension, which in this forecast implies an increase of 2.5 per cent in 2015-16 and 2016-17 and in line with average earnings growth thereafter.

4.117 Changes since our March forecast are shown in Table 4.29. Overall welfare spending is forecast to be around £1.3 billion a year lower on average between 2014-15 and 2018-19 than in March. Spending within the cap is forecast to be £0.6 billion a year higher over the same period, while spending outside the cap is forecast to be £1.3 billion a year lower.

4.118 Since March, the Government has once again delayed the planned full roll-out of universal credit, and we have assumed modest further delays reflecting the optimism bias in past roll-out plans. The Treasury shows this change as a policy measure in its policy decisions table. The updated migration schedule used in this forecast is explained more fully in Box 4.8.

Table 4.28: Welfare spending

	£ 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	71.8	74.5	75.6	76.1	76.6	76.9	78.2
of which:							
Incapacity benefits[1]	13.5	14.0	14.6	14.9	14.8	14.9	15.2
Statutory maternity pay	2.3	2.3	2.3	2.4	2.5	2.6	2.6
Income support (non-incapacity)	2.6	2.6	2.6	2.6	2.7	2.8	2.9
Pension credit	7.0	6.6	6.2	5.9	5.6	5.4	5.4
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	15.2	15.1	14.8	14.5	14.7	15.0
Attendance allowance	5.4	5.4	5.5	5.6	5.7	5.8	6.0
Carer's allowance	2.1	2.3	2.4	2.5	2.7	2.8	3.0
Universal credit[2]	0.0	0.0	0.0	0.2	0.7	-0.1	-0.3
Housing benefit (not on jobseeker's allowance)[3]	20.5	21.6	22.3	22.8	23.2	23.6	24.0
Other DWP in welfare cap	2.3	2.4	2.4	2.4	2.4	2.4	2.4
Personal tax credits (AME spending and negative tax element)	29.7	30.1	29.9	30.8	32.0	33.0	33.8
Tax free childcare	-	-	0.3	0.7	0.8	0.9	0.9
NI social security in welfare cap	3.2	3.4	3.3	3.4	3.4	3.4	3.5
Child benefit	11.4	11.6	11.7	11.8	12.1	12.3	12.7
Paternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Autumn Statement measures	0.0	0.0	-0.2	-0.6	-1.0	0.2	0.6
Total welfare cap[4,5]	**113.5**	**119.6**	**120.7**	**122.4**	**124.0**	**126.8**	**129.8**
Welfare spending outside the welfare cap							
DWP social security	90.8	92.2	94.5	96.9	100.2	103.9	107.4
of which:							
Jobseeker's allowance	4.3	3.0	2.5	2.5	2.7	2.8	2.9
State pension	83.1	86.5	89.8	92.3	95.4	99.0	102.3
Housing benefit (on jobseeker's allowance)	3.2	2.5	2.2	2.0	2.1	2.1	2.2
Discretionary housing payments[6]	0.2	-	-	-	-	-	-
Universal credit[2]	0.0	0.1	-	-	-	-	-
NI social security outside welfare cap	2.2	2.3	2.3	2.4	2.5	2.6	2.7
War pensions	0.9	0.8	0.8	0.8	0.8	0.8	0.7
Autumn Statement measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total welfare outside the welfare cap[5]	**93.2**	**95.3**	**97.7**	**100.1**	**103.5**	**107.3**	**110.9**
Total welfare[4,5]	**206.7**	**215.0**	**218.3**	**222.5**	**227.5**	**234.1**	**240.7**
Memo: welfare cap as proportion of total welfare	*55.3*	*55.7*	*55.3*	*55.0*	*54.5*	*54.2*	*53.9*

[1] Includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part)

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

[4] Outturn data do not include £2.7 billion of tax credits that are currently treated as negative tax in the National Accounts, but which will be treated as spending under ESA10. These tax credits are included in the forecast years, in anticipation of this change.

[5] Total welfare outturn in 2013-14 is sourced from OSCAR, consistent with PESA 2014. Those OSCAR data do not split welfare spending inside and outside the welfare cap, so this split has been estimated based on departments' returns. For 2013-14 only, the components reflect departments' own outturns, which may not be on a consistent basis to OSCAR.

[6] Transferred to departmental expenditure limits.

Table 4.29: Key changes to welfare since March

	£ billion					
	Outturn	Forecast				
			Welfare cap period			
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Welfare cap						
DWP social security	0.3	1.2	1.3	1.1	0.7	0.1
of which:						
Incapacity benefits[1]	0.2	0.6	1.0	1.2	0.8	0.5
Statutory maternity pay	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Income support (non-incapacity)	0.0	0.0	0.1	0.0	0.0	0.0
Pension credit	0.0	0.0	-0.2	-0.4	-0.5	-0.5
Winter fuel payments	0.0	0.0	0.0	0.0	0.0	0.0
Disability living allowance and personal independence payments	0.0	0.4	0.4	0.7	1.0	1.1
Attendance allowance	0.0	-0.1	-0.1	-0.2	-0.2	-0.2
Carer's allowance	0.0	0.0	0.0	0.0	0.0	0.0
Universal credit[2]	0.0	0.0	0.0	0.1	0.1	0.1
Housing benefit (not unemployed)	0.2	0.3	0.3	-0.1	-0.3	-0.6
Other DWP in welfare cap	-0.1	0.0	0.0	-0.1	-0.1	-0.1
Personal tax credits (AME spending and negative tax element)[3]	-0.2	0.6	0.3	0.0	-0.1	0.0
Tax free childcare	0.0	0.0	0.0	0.0	0.0	0.0
NI social security in welfare cap	0.0	0.1	0.1	0.1	0.1	0.1
Child benefit	-0.2	-0.1	-0.2	-0.3	-0.3	-0.3
Paternity pay	0.0	0.0	0.0	0.0	0.0	0.0
Autumn Statement measures	0.0	0.0	-0.2	-0.6	-1.0	0.2
Total welfare cap[3]	**-0.1**	**1.9**	**1.2**	**0.3**	**-0.5**	**0.1**
Welfare spending outside the welfare cap						
DWP social security	0.1	-0.8	-1.6	-2.3	-2.5	-2.3
of which:						
Jobseeker's allowance	0.0	-0.6	-0.9	-0.7	-0.5	-0.4
State pension	0.1	0.0	-0.1	-0.8	-1.4	-1.3
Housing benefit (unemployed)	0.0	-0.4	-0.6	-0.7	-0.6	-0.5
Discretionary housing payments[4]	0.0	0.0	0.0	0.0	0.0	0.0
Universal credit[2]	0.0	0.1	0.0	0.0	0.0	0.0
NI social security outside welfare cap	0.0	0.0	0.0	0.0	0.0	0.0
War pensions	0.0	0.0	0.0	0.0	0.0	0.0
Autumn Statement measures	0.0	0.0	0.0	0.0	0.0	0.0
Other[5]	-0.6	-	-	-	-	-
Total welfare outside the welfare cap[5]	**-0.5**	**-0.8**	**-1.6**	**-2.4**	**-2.5**	**-2.3**
Total welfare[4,5]	**-0.7**	**1.1**	**-0.4**	**-2.0**	**-3.0**	**-2.1**
Memo: welfare cap as proportion of total welfare	*0.0*	*0.6*	*0.7*	*0.6*	*0.5*	*0.6*

[1] Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

[2] Universal credit additional costs not already included against other benefits (i.e. UC payments that don't exist under current benefit structure).

[3] Data for 2013-14 do not include £2.7 billion of tax credits that are currently treated as negative tax in the National Accounts, but which will be treated as spending under ESA10. These tax credits are included in the forecast years, in anticipation of this change.

[4] Transferred to departmental expenditure limits.

[5] Total welfare outturn in 2013-14 is sourced from OSCAR, consistent with PESA 2014. Those OSCAR data do not split welfare spending inside and outside the welfare cap, so this split has been estimated based on departments' returns. For 2013-14 only, the components reflect departments' own outturns, which may not be on a consistent basis to OSCAR.

Table 4.30: Sources of changes in welfare spending since March

	£ billion					
	Outturn	Forecast				
			Welfare cap period			
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Welfare spending inside the welfare cap						
March forecast[1]	113.6	117.8	119.5	122.0	124.6	126.7
December forecast[1,2]	113.5	119.6	120.7	122.4	124.0	126.8
Changes since March	**-0.1**	**1.9**	**1.2**	**0.3**	**-0.5**	**0.1**
Of which:						
Economic determinants	**0.0**	**0.2**	**-0.1**	**-1.1**	**-1.4**	**-1.5**
CPI inflation	0.0	0.0	-0.3	-1.3	-1.5	-1.5
Average earnings	0.0	0.2	0.2	0.1	0.1	0.1
Other	0.0	0.0	0.0	0.0	0.0	-0.1
Estimating/ modelling changes	**-0.4**	**1.3**	**1.2**	**1.7**	**1.5**	**1.1**
Incapacity benefits[3]	0.0	0.4	0.8	1.1	0.9	0.6
Disability living allowance and personal	0.0	0.4	0.5	0.9	1.2	1.3
Housing benefit	0.2	0.2	0.2	0.1	0.0	-0.2
Other	-0.8	0.3	-0.3	-0.4	-0.5	-0.6
Accounting adjustment for DWP	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Other	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.1**
Autumn Statement measures	**0.0**	**0.0**	**-0.2**	**-0.6**	**-1.0**	**0.2**
Welfare spending outside the welfare cap						
March forecast	93.8	96.1	99.3	102.5	106.0	109.6
December forecast[2]	93.2	95.3	97.7	100.1	103.5	107.3
Changes since March	**-0.5**	**-0.8**	**-1.6**	**-2.4**	**-2.5**	**-2.3**
Of which:						
Economic determinants	**0.0**	**-0.6**	**-1.5**	**-2.2**	**-2.4**	**-2.1**
CPI inflation	0.0	0.0	-0.2	-0.4	-0.5	-0.5
Claimant count unemployment	0.0	-0.6	-1.3	-1.3	-0.9	-0.6
Other	0.0	0.0	0.0	-0.5	-1.0	-1.0
Estimating/ modelling changes	**-0.1**	**-0.3**	**-0.2**	**-0.2**	**-0.3**	**-0.3**
Jobseeker's allowance	0.0	-0.2	0.0	0.0	0.0	0.0
Housing benefit	0.0	-0.3	-0.2	-0.2	-0.2	-0.2
Other	-0.1	0.1	0.0	0.0	0.0	0.0
Accounting adjustment for DWP	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other	**-0.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Autumn Statement measures	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Total welfare spending						
March forecast[1]	207.4	213.9	218.8	224.5	230.6	236.3
December forecast[1,2]	206.7	215.0	218.3	222.5	227.5	234.1
Changes since March	-0.7	1.1	-0.4	-2.0	-3.0	-2.1
Of which:						
Economic determinants	**0.0**	**-0.3**	**-1.6**	**-3.4**	**-3.8**	**-3.6**
Estimating/ modelling changes	**-0.6**	**0.9**	**1.0**	**1.5**	**1.3**	**0.8**
Accounting adjustment for DWP	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Other[2]	**-0.4**	**0.1**	**0.1**	**0.1**	**0.0**	**0.1**
Autumn Statement measures	**0.0**	**0.0**	**-0.2**	**-0.6**	**-0.9**	**0.2**

[1] Data for 2013-14 do not include £2.7 billion of tax credits that are currently treated as negative tax in the National Accounts, but which will be treated as spending under ESA10. These tax credits are included in the forecast years, in anticipation of this change.

[2] Total welfare outturn in 2013-14 is sourced from OSCAR, consistent with PESA 2014. Those OSCAR data do not split welfare spending inside and outside the welfare cap, so this split has been estimated based on departments' returns. For 2013-14 only, the components reflect departments' own outturns, which may not be on a consistent basis to OSCAR.

[3] Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

4.119 Table 4.29 breaks down the changes since March into those attributable to economic determinants, other modelling changes and classification changes.

4.120 The main changes arising from revisions to our economic forecast include:

- lower CPI inflation in 2015-16 to 2017-18, which reduces the uprating of certain benefits. Uprating for many benefits is capped at 1 per cent until 2015-16, reverting to CPI uprating thereafter. So lower inflation results in spending being lower on average by £1.1 billion a year inside the welfare cap and £0.4 billion a year outside the welfare cap between 2015-16 and 2018-19;

- lower claimant count unemployment, which reduces spending outside the welfare cap by £0.9 billion a year on average between 2014-15 and 2018-19; and

- the combination of lower average earnings and lower CPI inflation feeds through to the triple-lock guarantee for state pensions (outside the welfare cap), reducing spending from 2016-17 to 2018-19 by £0.8 billion a year on average.

4.121 The key modelling changes arise from our updated judgements on the speed with which reforms to incapacity and disability benefits will be implemented. This raises our forecast for spending on incapacity and disability benefits by an average of £1.6 billion between 2014-15 and 2018-19. Our judgements are explained more fully in Box 4.7.

Box 4.7: Reforms of incapacity and disability benefits

In recent reports we have highlighted the forecasting risks relating to reforms of incapacity and disability benefits. We have made a number of changes to our forecasts as a result of the evidence presented to us ahead of this Autumn Statement.

Incapacity benefits

The key challenge in forecasting the impact of incapacity benefits reform on spending has been the lower-than-expected number of work capability assessments (WCAs) being carried out by the Department of Work and Pensions' private contractor. This has led to a significant backlog of WCAs, with knock-on effects for the composition of the caseload following the outcomes of the WCAs and associated appeals.

On the basis of the latest evidence, we have made the following judgements:

- under the terms of its contract with DWP, the new contractor (Maximus) has committed to deliver 1.1 million WCAs in the first contract year and 1.3 million a year thereafter, which, depending on policy and operational choices, would clear the WCA backlog in between 12 and 18 months. We have assumed it will take two years. Shifting from 18 months to two years increases spending by £0.3 billion a year on average between 2015-16 and 2018-19, with the largest effect (£1.1 billion) in 2016-17; and
- the caseload leaving the support group of ESA has been revised down, raising spending

by £0.5 billion a year on average between 2014-15 and 2018-19.

Together with other changes, this means that relative to March we expect spending on incapacity benefits to be £0.7 billion a year higher on average between 2014-15 and 2018-19.

Disability benefits

The key challenge in forecasting the impact of disability benefits reform has been estimating the proportion of new personal independence payment (PIP) claims that are successful. The proportion has been higher than expected, which also affects the composition of the PIP caseload.

On the basis of the latest evidence, we have revised up the expected success rates for new claims to PIP across the forecast. In particular, we have assumed that, on the basis of existing policy, success rates will not fall as far as was consistent with the original costing of the savings from PIP relative to disability living allowance. This affects the speed at which average awards are forecast to reduce over time. Our new assumption raises spending by £0.4 billion a year on average between 2015-16 and 2018-19 with increasing effects in each year.

Together with other changes, this means that relative to March we expect spending on disability benefits to be by £0.7 billion a year higher on average between 2014-15 and 2018-19.

Box 4.8: Universal credit

Since our March 2014 *EFO*, DWP and HMT have agreed a new business case for universal credit. This has also been agreed with HMRC and local authority representatives, while the plans were assured by the Major Project Authority (MPA). These plans include changes in the rollout schedule with the bulk of the rollout pushed back once again. The schedule is now:

- the pace of the rollout for JSA single cases has been increased slightly with full rollout across the country by March 2016;
- new claims to the legacy benefits are due to cease on a rolling geographical basis from May 2016 to December 2017 with the universal credit caseload growing naturally from when benefits are closed;
- managed migration of JSA, IS and HB claims will begin in January 2018 and last 24 months; and
- the managed migration of ESA and tax credits only cases will occur 'at some point' beyond the forecast profile.

We have considered the evidence on the centrality of these plans – including the cross-government scrutiny that has taken place – and have weighed that against the recent history of optimism bias in universal credit plans and other projects of this sort.

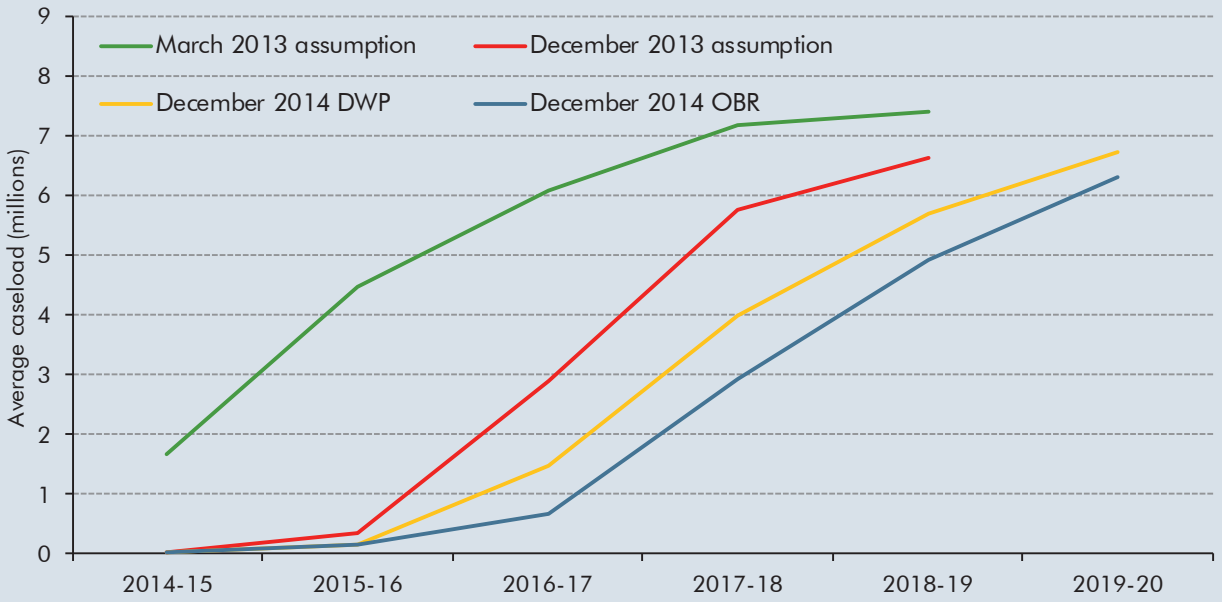
In our view, there remains considerable uncertainty around the delivery of such a complex and

wide-ranging change. On the basis of the evidence we have reviewed, we judge that:

- the first part of the proposed schedule is central. Delivery risks have been reduced by the use of the existing 'live service' and we are reassured by the MPA's assessment; and
- the second part of the rollout is more uncertain and we have assumed for this forecast that it will be delayed by a further six months beyond the new plans. The continuing delays in universal credit and elsewhere in ESA and PIP suggest it would be premature to assume that the digital solution will be ready on this timetable. The detailed MPA assessment on this part of the plan was less reassuring. The recent NAO report on universal credit also noted that "*universal credit remains a highly ambitious and challenging transformation programme*."

The evolution of the rollout plans for universal credit, including the DWP's preferred profile and our central forecast is shown in Chart D.

Chart D: Changes to the universal credit rollout assumption



Source: DWP, OBR

Compared to previous assumptions the combination of the move to DWP's preferred profile and our 6-month delay to non-JSA cases has the effect of migrating about 2.2 million fewer people onto universal credit in 2016-17, 2.9 million in 2017-18, and 1.6 million in 2018-19 than in March, leaving some recipients of ESA and tax credits to migrate later. Despite these large changes in volumes, the impact on the welfare spending forecast is comparatively small since these changes only affect the marginal costs of universal credit.

There are of course broader uncertainties over the eventual cost of universal credit, including the behavioural response of potential claimants and the scope for error and fraud savings and the impact of the minimum income floor for self-employed claimants. We will continue to review progress against the design plans, as well as emerging evidence on the costs and savings.

Public service pensions

4.122 The net public service pensions expenditure forecast measures benefits paid less employer and employee contributions received. It includes central government pay-as-you-go public service pension schemes and locally administered police and firefighters' pension schemes.[8] Gross expenditure is expected to rise steadily over the forecast period as demographic trends affect the age profile of each scheme's membership. The income of each scheme is made up of employer and employee contributions, which are almost entirely determined by the pensionable paybill. A breakdown of spending and income for the major schemes covered by our forecast is included in the supplementary tables on our website.

Table 4.31: Key changes to public service pensions since March

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Net public service pensions						
March forecast	10.5	10.4	11.7	12.7	13.8	14.9
December forecast	10.9	11.8	10.4	11.4	12.2	13.2
Change	**0.4**	**1.4**	**-1.3**	**-1.3**	**-1.6**	**-1.7**
Expenditure						
March forecast	35.8	37.3	38.7	40.4	42.3	44.2
December forecast	36.1	37.8	38.8	40.2	41.9	43.7
Change	**0.3**	**0.5**	**0.1**	**-0.2**	**-0.4**	**-0.5**
of which:						
CPI inflation	0.0	0.0	-0.2	-0.4	-0.5	-0.6
Other	0.3	0.5	0.3	0.2	0.1	0.1
Income						
March forecast	-25.3	-26.9	-27.0	-27.7	-28.5	-29.3
December forecast	-25.1	-26.0	-28.4	-28.8	-29.6	-30.5
Change	**0.2**	**0.9**	**-1.3**	**-1.1**	**-1.1**	**-1.2**
of which:						
Autumn Statement measure	0.0	0.0	-1.5	-1.6	-1.6	-1.7
Increased contracting out impact	0.0	0.0	0.0	0.2	0.2	0.2
Other[1]	0.2	0.9	0.2	0.3	0.3	0.3

[1] This line includes £0.8 billion in 2014-15 that reflects a correction to the scoring of a spending neutral transfer between pension schemes.

4.123 While gross expenditure rises steadily in nominal terms, it remains broadly flat as a share of GDP. Two offsetting sources of revision since our March forecast leave gross expenditure little changed overall. In the near term, higher outturn spending due to higher-than-expected civil service retirements and NHS lump-sum payments lift spending, which feeds through to later years. But the downward revision to our CPI inflation forecast reduces uprating and lowers spending from 2015-16 onwards.

[8] 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, so they are included in the pensions forecast.

4.124 We have corrected the scoring of a £0.8 billion transfer in 2014-15 of the General Lighthouse Fund and House of Commons schemes into the Principal Civil Service Pension Scheme. This was shown as increased pension receipts in our March forecast, but was spending neutral, since it was offset by DEL increases. But, the National Accounts will not record these within public sector transactions in PSCE. Therefore, the equivalent amount has been removed from both DEL spending and AME receipts (which is again spending neutral).

4.125 On the basis of near-final scheme valuations, Budget 2014 announced changes to employer contribution rates for the civil service, NHS, teachers and police pension schemes. These have now been factored into scheme-by-scheme forecasts. The impact of contribution rate changes for a number of other schemes has been scored as an Autumn Statement measure, in light of further scheme valuations: the armed forces; firefighters; judiciary; Scottish NHS and teachers; and Northern Ireland NHS, teachers, civil service and police.

4.126 We have revised down our forecast for receipts from 2015-16 due to:

- a reassessment of the scheme-by-scheme effect on contributions of the Budget 2014 valuations policy measures; and
- a revised assumption about the impact on paybills of the upward pressure on spending associated with abolishing NICs contracting out in 2016-17. We have assumed that across schemes, workforce reductions associated with this spending pressure will be proportionate to the share of total spending on pay.

EU contributions

4.127 As we have stressed in past *EFO*s and in our 2014 *Forecast evaluation report*, our forecast of the UK's net contributions to the EU is subject to significant uncertainty, not least because prospective contributions reflect the expected relative performance of 28 Member States' economies, which can be revised over time, and an EU budget that reflects negotiations between those Member States. The UK's payments are also subject to abatements.

4.128 We attempt to anticipate future adjustments to the EU budget and the UK's net contributions to it, rather than relying on the most recent European Commission estimates, which are only updated infrequently. To do so, we use our own economic and fiscal forecasts for the UK, and the latest forecasts of the IMF or the Commission for other Member States. These are all subject to their own uncertainties. Our forecast for EU contributions is compiled for us by the team in the Treasury responsible for monitoring the development and application of EU funding rules and developments in the EU budget, using methodologies and economic and other assumptions agreed by the OBR's Budget Responsibility Committee.

4.129 Given the heightened interest in the UK's payments to the EU this year, this section explains in more detail the components of our forecast and how they have changed since March.

4.130 Based on an assumption about the total EU budget, informed by the Multiannual Financial Framework for 2014-2020, and adjusted for the degree by which we expect the budget to

be underspent or fully implemented, we first consider three elements of the UK's gross payments to the EU: GNI-based contributions, VAT-based contributions; and Traditional Own Resources (TOR)-based contributions.[9] Of these, the GNI- and VAT-based contributions are the main transactions that directly affect our UK fiscal forecast. But we also need to forecast the VAT- and TOR-based contributions by all Member States in order to forecast EU revenue, because the gap between EU spending and revenue determines the total GNI-based contributions required across all Member States.

4.131 Our GNI-based contribution is determined by total VAT- and TOR-based contributions, miscellaneous revenue, and by the UK's GNI relative to that of other Member States. Our forecast is informed by the latest forecasts for these bases for 2014 and 2015 agreed by the Advisory Committee on Own Resources (ACOR). For this forecast, we are using the May 2014 ACOR forecasts, whereas our March forecast started with the May 2013 forecasts. We then estimate new bases to reflect the latest available information about all Member States' economies, and the relative performance of the UK economy. This determines the extent to which we expect the UK's gross contributions to be adjusted up or down in the normal annual adjustment processes.

4.132 In March, we increased our forecast of expenditure transfers to EU institutions in 2014-15 by £0.8 billion. This included £0.6 billion of additional GNI payments in respect of the 2013 budget as an expected adjustment payment in December 2014. Our forecast of this adjustment was based on updating our forecasts of EU revenue bases to reflect the latest information available at the time.

4.133 Table 4.32 shows that we were correct to anticipate upward revisions to the ACOR forecasts for that year. But we had no way to predict the GNI outturn revisions that would be made in other EU Member States, and the implications that these would have for the ACOR forecasts and the contributions they would imply.

4.134 The forecast material we considered in March did not anticipate the additional one-off contribution that the UK would be required to make this year, as a result of the UK bringing its estimates of GNI into line with Eurostat regulations for the period 2002 to 2013. This would have been hard to quantify precisely at the time in any event, because the necessary data for making this calculation were not available. The subsequent evolution of this adjustment – and its impact in our latest forecast – is explained below.

4.135 In our current forecast, we have again revised our forecasts for future contributions to the EU. Since the latest ACOR bases were agreed, we estimate the UK economy will have accounted for a larger share of the EU in the past due to data revisions and that UK GNI growth prospects have improved relative to the economic outlook for other Members States. We do not anticipate a repeat of the large one-off adjustment seen this year during the forecast period, as we have no indication that the ONS plans to make further significant revisions to its estimates of GNI. But we will keep this under review.

[9] TOR contributions comprise custom duties and sugar levies. These are not included in public sector current receipts because they are collected on behalf of the EU. Customs duties include duties on agricultural products.

4.136 The move from ESA95 to ESA10 has affected the treatment of VAT-based contributions to the EU in this forecast. In our March forecast (on an ESA95 basis), these contributions were not included in public sector current receipts or spending because they were treated as EU revenue in the National Accounts. Under ESA10, a new current transfer in spending has been introduced specifically for VAT and GNI-based EU contributions.[10] This means that VAT-based contributions are now recorded as being received by the UK Government and then transferred to the EU. The impact of this change is to raise current tax receipts and current expenditure by equal amounts.

Table 4.32: GNI and VAT contributions to the EU budget

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast (ESA95)					
GNI contributions	13.1	12.9	13.0	12.4	13.1
Changes due to implementation of ESA10 and the ONS PSF review					
Include VAT contributions	2.4	2.5	2.6	2.7	2.8
March forecast (ESA10)					
GNI and VAT contributions	15.4	15.4	15.6	15.1	16.0
of which:					
Adjustments in respect of previous years	0.6	-	-	-	-
December forecast (ESA10)					
GNI and VAT contributions	16.6	15.5	16.5	15.3	16.1
of which:					
Adjustments in respect of previous years	1.7	0.2	0.4	-	-
Change	**1.1**	**0.1**	**0.9**	**0.1**	**0.1**
of which:					
Adjustments in respect of previous years	1.1	0.2	0.4	-	-
Other	0.1	-0.1	0.5	0.1	0.1

4.137 We use our forecasts of the UK's gross contributions to the EU, and a separate forecast of UK receipts from the EU, to estimate the UK's subsequent abatement. This is based on a set formula and can be derived from various components of the forecast. Nonetheless it adds complexity, because it requires a separate forecast for UK receipts. It also creates a further set of timing differences, since the rebate happens in the year after the payments and has its own schedule for further adjustments following adjustments to the payments that are being abated. Since March, we have revised our forecast of the abatement up – shown as a larger negative value in Table 4.33 - reflecting the higher GNI-based contributions forecast.

[10] This reflects that EU VAT payments affect the level of GNI-based EU contributions, rather than EU VAT being a specific tax on products imposed by the EU.

Table 4.33: UK abatement from the EU budget

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	-4.2	-4.0	-4.4	-4.7	-4.5
December forecast	-4.8	-5.0	-4.4	-5.0	-4.7
Change	**-0.6**	**-1.0**	**0.0**	**-0.3**	**-0.2**
of which:					
Rebate associated with historical adjustment	-	-0.8	-	-	-
Other rebate revisions	-0.6	-0.1	0.0	-0.3	-0.2

4.138 The large one-off adjustment to the UK's contributions revealed this year affects both gross contributions and the abatement. We also expect it to affect the accrued measure of the deficit (public sector net borrowing) differently to the cash measure (public sector net cash requirement). This is because the UK will make the cash payments in two instalments in 2015-16, but we expect the full amount to be accrued to December 2014 (i.e. during 2014-15). The associated abatement is expected to affect 2015-16 on both measures.

4.139 The expected net effect of this payment and associated rebate on the public finances is £0.9 billion over 2014-15 and 2015-16 taken together. That figure represents the net effect of:

- a gross UK contribution of £2.9 billion for payments that would have been due between 2002 and 2013, reflecting the removal of longstanding Eurostat reservations on UK's GNI estimates, and other ONS revisions to the UK National Accounts. These revisions related to the old ESA95 approach to estimating GNI, not the new ESA10 methodology, which raises new uncertainties for the future;

- a refund of £1.2 billion, as the Commission decided in October 2014 to return all the increased Member State contributions related to these revisions, but in proportion to existing Member State GNI shares rather than in proportion to the impact of the revisions in particular countries.[11] As the relevant upward revisions were much larger in the UK relative to other Member States than its current GNI share, this resulted in a net payment due of £1.7 billion; and

- the rebate associated with that net payment will be £0.8 billion, leaving a net overall effect on the UK's public finances of £0.9 billion.

[11] Draft amending budget no.6 to the 2014 Budget. Footnote DAB6/2014

Table 4.34: The effect of the UK retrospective adjustment to EU contributions associated with historical GNI revisions implemented in 2014

	£ billion		
	2014-15	2015-16	Total
PSNB (accruals basis)			
Additional payment	1.7	0.0	1.7
Associated UK abatement	0.0	-0.8	-0.8
Total PSNB	**1.7**	**-0.8**	**0.9**
PSNCR (cash basis)			
Additional payment	0.0	1.7	1.7
Associated UK abatement	0.0	-0.8	-0.8
Total PSNCR	**0.0**	**0.9**	**0.9**

4.140 Table 4.35 summarises the main changes to our forecast of expenditure transfers to the EU discussed above. It shows that on a like-for-like basis – excluding the ESA10 classification change to VAT payments to the EU – the forecast is on average £0.1 billion a year higher than in March, with changes uneven across years.

Table 4.35: Key changes to EU contributions since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast (ESA95)	8.1	8.1	7.9	7.1	7.9
Changes from ESA10 and the PSF review:					
Include VAT payments to the EU[1]	2.4	2.5	2.6	2.7	2.8
March forecast (ESA10)	10.5	10.6	10.5	9.8	10.8
December forecast (ESA10)	11.0	9.9	11.5	9.6	10.7
Change	**0.5**	**-0.8**	**0.9**	**-0.2**	**-0.1**
of which:					
Change in exchange rate	-0.1	-0.2	0.0	-0.1	0.0
Historical revisions[1]	1.1	-0.6	0.4	-	-
Other rebate revisions and adjustments	-0.7	-0.3	0.0	0.0	0.0
Other	0.3	0.4	0.6	0.0	-0.1

[1]UK GNI contributions and rebate changes in respect of historical revisions.

4.141 We aim to produce a central forecast that anticipates future adjustments and negotiations as best we can, but there are a number of important uncertainties to bear in mind when considering this forecast. For example:

- ongoing and future EU budget negotiations;
- the extent to which budgeted expenditure might not be fully spent and the use of flexibilities to carry spending between years;
- future changes in the relative performance of the UK and other Member States;

- scheduled adjustments to update previous interim contributions in respect of actual outturns for GNI, VAT and TOR bases, across all Member States;

- resolution of remaining or future Eurostat reservations on GNI estimates, which could lead to further adjustments to past contributions; and

- forecast movements in the exchange rate, since EU finances are denominated in euros.

Locally financed current expenditure

4.142 We produce our forecast of local authority spending by forecasting the sources of income that local authorities use to finance their spending. Our forecast is therefore constructed as the total of spending financed by grants from central government, which are mostly in DEL, and local authority self-financed expenditure (LASFE) in AME, which is local authority spending that is financed from local authorities' own local sources of income. We also make an assumption about the extent to which spending will be lower or higher than income, thereby adding or subtracting from local authorities' reserves.

4.143 The forecast of current LASFE shown in Table 4.36 is largely driven by the forecasts for council tax and retained business rates in England.[12] 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 kept average council tax increases down to 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.[13]

4.144 Compared with our March forecast, we have revised council tax up slightly in the near term and down a little by the end of the forecast. This reflects the latest information on council tax levels in 2014-15, which are a little higher than we expected in March, and our latest forecast for the changes in the council tax base, which is also higher in the near term and then slightly lower after 2015-16. The forecast for retained business rates in England similarly reflects the latest information collected by the Department for Communities and Local Government (DCLG) for 2014-15. We have assumed that retained business rates then move in line with our overall business rates forecast. Council tax and retained business rates are broadly neutral for borrowing because – other than some minor timing differences – they increase receipts and spending equally.

4.145 The most difficult judgement for the current LASFE forecast is the extent to which English local authorities will continue to underspend their current budgets and add to their current reserves. Table 4.35 shows how English local authorities have added to their current reserves in every year from 2010-11 to 2013-14. This occurred despite substantial reductions in their current spending. In the years immediately before 2010-11, local

[12] Locally financed expenditure also contains Scottish Government spending financed by local taxation from business rates.
[13] These council tax increases are assumed to apply in conjunction with an increase in the council tax base, which averages 1.2 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.

authorities spent more than they forecast in their budget returns to DCLG. By contrast, since 2010-11, they have underspent against their budgets. The largest underspend to date has been £4.2 billion in 2013-14. Part of these recent underspends will reflect the increase in the number of schools becoming Academies. These transfers automatically reduce local authority spending, because spending by Academies is classified to the central government sector. But even abstracting from this, local authorities have underspent against their budgets and added significantly to their reserves in recent years.

Table 4.36: Levels of LA current spending and reserves

	£ billion				
	Local authority own forecasts in their annual budgets				
	2010-11	2011-12	2012-13	2013-14	2014-15
Local authority forecasts of spending from current reserves	0.0	1.0	0.0	1.2	2.1
	Outturn				Forecast
	2010-11	2011-12	2012-13	2013-14	2014-15
Local authority outturns for spending from current reserves [1]	-1.3	-2.6	-2.6	-2.4	-1.5
Local authorities underspends against budgets [2]	-1.2	-2.8	-2.5	-4.2	-3.0
	Per cent of net current expenditure				
Levels of local authorities current reserves [3]	13.5	16.4	19.5	21.2	22.8

[1] DCLG.

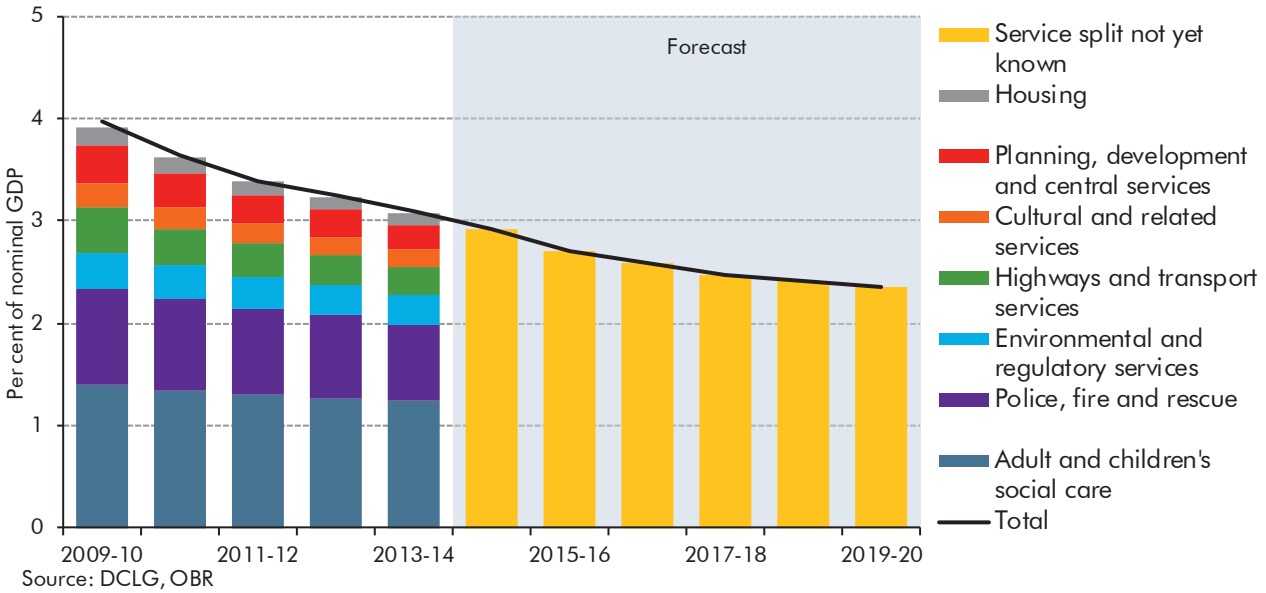
[2] Derived as the difference between outturn and budget data for net current expenditure in statistical returns from local authorities collected by DCLG. Some of the recent underspends may reflect an increase in the number of schools becoming Academies.

[3] Levels of reserves at the end of each year

4.146 The question for our forecast is the extent to which local authorities will continue to cut their current spending in absolute terms and relative to their income – i.e. the extent to which they will continue to add to reserves. Chart 4.5 shows how local authorities have reduced their spending across the main services that they provide. It also shows our forecast of their income in future years, based on assumptions about grants from central government (derived from our forecast of implied PSCE in RDEL – though that assumption would be sensitive to future governments' choices about DEL spending, as discussed in Box 4.6, and the council tax and retained business rates forecasts described above. In order to reach a judgement about future additions to or withdrawals from reserves, we discuss pressures on local authority budgets with a range of experts.[14]

[14] For example, we considered the findings of the recent National Audit Office reports (2014) *Financial sustainability of local authorities* and *The impact of finding reductions on local authorities*.

Chart 4.5: Local authority current spending in England



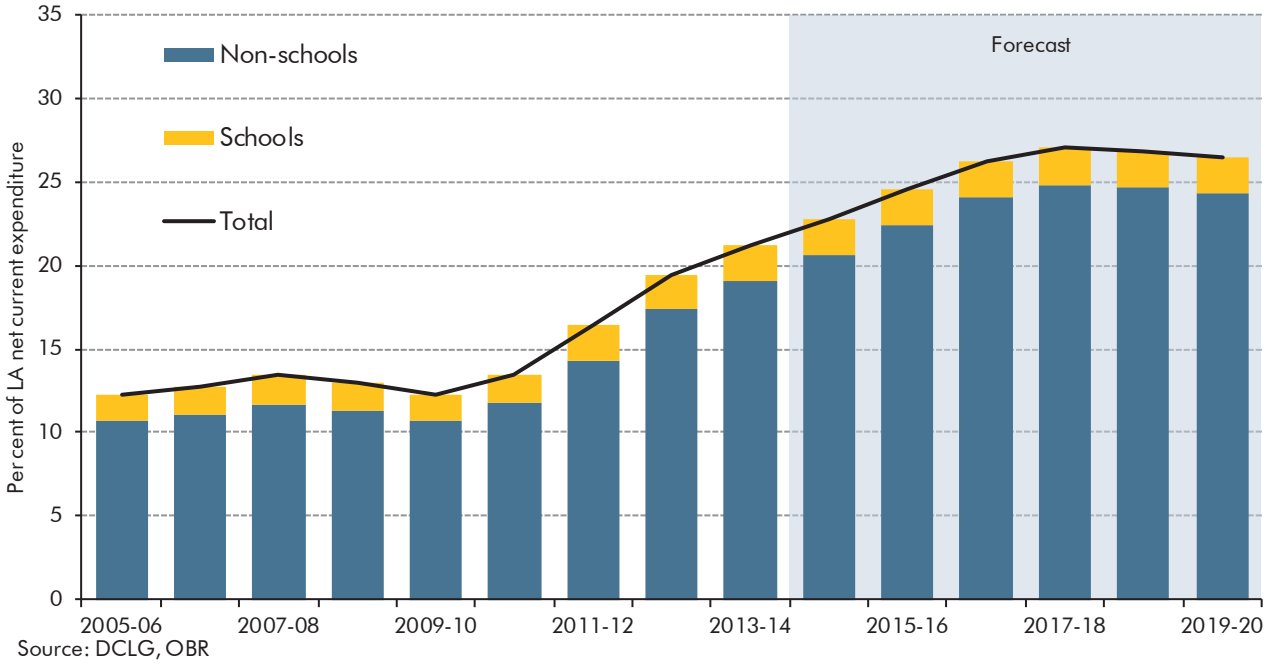
Source: DCLG, OBR

1. Total current spending excludes education and public health, where data are not comparable across years, and also excludes housing benefit, which is largely funded by central government. 2. Total spending from 2016-17 derived on the assumption that central government grants to local authorities decline in line with total implied PSCE in RDEL

4.147 One conclusion we have drawn is that local authorities may be using their 'earmarked' reserves to help manage the effect of expected future reductions in their spending, and manage the additional uncertainties about key aspects of their future income. It is also clear that there are differences in financial conditions and pressures across local authorities.

4.148 Taking all the evidence into account, our forecast assumes that English local authorities will add to their current reserves by £1.5 billion in 2014-15. We assume that they will continue to add to their reserves, but by decreasing amounts, until 2018-19, and that they will be flat thereafter. Chart 4.6 shows that this is consistent with local authorities' current reserves rising as a percentage of their current spending until 2018-19.

Chart 4.6: Local authority current reserves in England, relative to net current expenditure

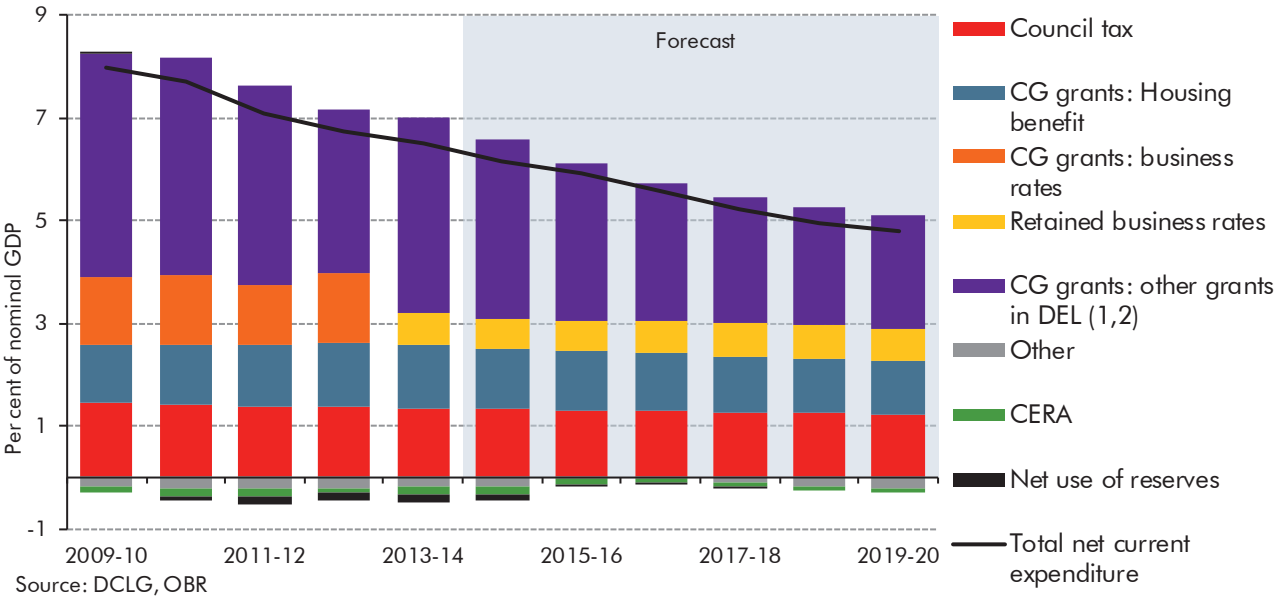


Source: DCLG, OBR

4.149 Our forecast of total local authority spending shown in Chart 4.5 depends critically on the level of central government grants to local authorities, which will be allocated from DELs in future local government settlements. Our forecasts do not try to predict any change in the current allocation of spending between central government departments spending and central government grants to local authorities. Chart 4.7 shows how our forecast for local authority current spending is constructed from the sources of finance. Our forecasts for central government grants after 2015-16 are based on our forecasts for implied PSCE in RDEL discussed above, and assume that local authority grants account for the same proportion of this spending going forward as they do in the latest spending plans for 2015-16. [15] But the amount that will be allocated to local government grants will depend on the next Government's choices on future DEL spending, as set out in Box 4.6 above.

[15] Spending plans for 2015-16 are sourced from HM Treasury, July 2014, *Public Expenditure Statistical Analyses, 2014*.

Chart 4.7: Composition of local authority financing in England



Source: DCLG, OBR

[1] Central government grants in DEL from 2013-14 includes funding for business rates not retained by local authorities.
[2] Figures for central government grants to local authorities in DEL after 2015-16 are assumed to decline in line with total implied PSCE in RDEL

4.150 The other main uncertainty in locally-financed spending is the extent to which local authorities will finance capital expenditure by transfers from their revenue accounts. Table 4.37 shows that we have increased our forecast for capital expenditure from revenue account (CERA) by £0.9 billion in 2014-15, which reduces current LASFE and increases capital LASFE. This change largely reflects the latest information on Transport for London (TfL) spending plans, which has also changed our forecasts for local authorities and public corporations capital spending, discussed below.

Table 4.37: Key changes to locally financed expenditure and public corporations capital expenditure since March

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
Locally-financed current expenditure					
March forecast	35.1	37.0	39.5	42.0	44.1
December forecast	35.0	37.2	39.5	41.6	43.5
Change	**-0.1**	**0.3**	**0.1**	**-0.4**	**-0.5**
of which:					
Net use of current reserves	0.3	0.2	-0.2	-0.1	0.0
Capital expenditure from revenue account	-0.9	0.0	0.0	0.0	0.0
Council tax	0.2	0.3	0.1	-0.1	-0.2
Retained business rates	0.1	0.0	0.2	-0.1	-0.2
Other	0.5	-0.2	0.0	0.0	-0.1
Autumn Statement measures	-0.3	-0.1	-0.1	-0.1	-0.1
Locally-financed capital expenditure, and public corporations capital expenditure					
March forecast	13.2	13.5	14.2	14.0	12.7
December forecast	13.7	13.9	15.2	15.9	13.8
Change	**0.4**	**0.4**	**1.0**	**1.8**	**1.1**
of which:					
Change in methodology for modelling asset sales (reduction in asset sales)	0.6	0.9	1.0	0.9	1.0
Capital spending financed by use of capital receipts	-0.6	-0.5	-0.4	-0.2	-0.1
Capital expenditure from revenue account	0.9	0.0	0.0	0.0	0.0
Major repairs and other capital spending financed from HRA	0.2	0.2	0.2	0.2	0.2
OBR timing adjustment for Crossrail	-0.3	-0.3	0.1	0.3	0.3
Capital spending of TfL PC subsidiaries[1]	-0.4	0.1	0.1	0.1	-0.4
Other	0.0	0.0	0.1	0.5	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

4.151 Our latest forecasts for locally financed capital expenditure (capital LASFE) and public corporations capital spending are shown in Table 4.37. Capital LASFE is measured net of asset sales. And 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.[16] We switch these items out of capital LASFE to ensure our forecast is consistent with the National Accounts.

[16] These TfL transport subsidiaries trade under the company name 'Transport Trading Ltd' (TTL). ONS currently classify all of the TTL subsidiaries as public corporations apart from Crossrail, which is classified as part of the local authority sector. However ONS have recently announced that they will be reclassifying several of the other TTL subsidiaries to the local authority sector. We will wait until ONS implement those reclassifications in the outturn data in the Public Sector Finance statistics before we reflect them in our forecast.

4.152 Capital LASFE remains fairly constant across the forecast, with an increase in asset sales (which reduce spending) broadly matched by a reduction in the amounts of TfL public corporations' capital spending netted off. The forecast is boosted by an additional £2.6 billion of spending financed from capital reserves from 2015-16 to 2017-18 related to the closing stages of Crossrail construction. Further details are shown in supplementary fiscal tables available on our website.

4.153 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.

4.154 Table 4.37 groups our forecasts for capital LASFE and public corporations together to show the overall impact of the revisions. The largest change is from our forecast for local authority sales of assets, where we have revised our methodology on housing sales to make better use of DCLG's forecast for sales under the Government's Right to Buy policy programmes. And we have revised our forecast of sales of other, non-housing assets to reflect lower sales in 2013-14. Taken together, these changes have reduced our forecast of asset sales by up to £1 billion across most of the forecast period. Since asset sales are netted off spending, this has increased our forecast for capital spending. However this increase is partly offset by a reduction in the forecast for capital spending financed from the asset sales, particularly in the near term.

4.155 The other main changes to the forecasts reflect changes to our forecasts for capital spending financed from the HRA, which reflect latest DCLG information on HRA finances in 2013-14, and changes to our forecasts for TfL subsidiaries' capital spending, which reflect TfL's latest outturns for 2013-14 and their latest business plans. Our forecast includes a specific timing adjustment for capital spending on Crossrail, which reflects the net transfers that we expect TfL to make in relation to its capital balances that hold the reserves set aside to finance Crossrail spending. Our latest revisions to this adjustment assume further slippage of the capital spending from 2014-15 and 2015-16 into the later years.

Debt interest

4.156 Debt interest payments (central government debt interest, net of the APF) are expected to be broadly flat as a share of GDP this year and next, then to rise in 2016-17 and 2017-18, before stabilising thereafter. The flat near-term profile reflects lower inflation, as well as the refinancing of maturing debt at cheaper rates, which offset the effect of new issuance. In later years, as interest rates and inflation gradually rise, the cash requirement falls.

4.157 Table 4.38 shows changes in central government debt interest (including payments to the APF.[17] Increases to the cash requirement since March are more than outweighed by lower inflation and interest rates. We have also corrected an error in our forecast model that had led to us over-predicting the stock of debt over time. Other underlying changes also reduce the forecast slightly, including taking into account the latest outturns.

[17] Supplementary fiscal tables available on our website break down this forecast by financing component, and provide ready-reckoners of its sensitivity to movements in interest rates, inflation and the CGNCR.

4.158 Following its reclassification, Network Rail's debt interest is now included within the total. But its new and redeeming debt will be financed centrally, which over time reduces the amount of debt interest it pays directly.

Table 4.38: Key changes to central government debt interest since March

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	48.4	52.1	59.1	65.1	71.6	75.2
December forecast	48.7	48.1	51.9	56.2	61.3	63.4
Change	**0.3**	**-3.9**	**-7.2**	**-8.9**	**-10.3**	**-11.8**
of which:						
Financing CGNCR	0.0	0.0	0.1	0.5	0.8	1.1
Gilt rates	0.0	-0.2	-1.4	-2.8	-4.2	-5.3
Short rates	0.0	-0.4	-0.8	-1.4	-1.7	-1.7
Inflation	0.0	-3.2	-4.3	-3.2	-2.3	-2.2
Network Rail	0.0	1.2	1.1	1.0	0.9	0.9
Revisions to stocks	0.0	-0.8	-1.1	-2.3	-3.1	-3.9
Other	0.3	-0.5	-0.7	-0.6	-0.8	-0.8

4.159 The reclassification of the APF means it now affects net borrowing as lower debt interest – the consequence of, in effect, financing debt at Bank Rate rather than by selling gilts – rather than additional receipts as cash is transferred to the Exchequer. Table 4.39 shows the overall changes in the effects of the APF on borrowing since March:

- implementing the change in March would have reduced our forecast by increasing amounts over this forecast horizon. Any losses at redemption or point of sale will now be treated as holding losses, which do not affect borrowing. But they will reduce the transfers between the APF and the Exchequer, which under the old basis would have raised borrowing;

- reductions in market expectations of Bank Rate since March have reduced borrowing further; and

- we now assume that gilts held by the APF will not be actively sold during the forecast period, and will only be run down through redemptions once Bank Rate begins to rise. This implies that the stock of gilts falls from £375 billion in late 2015 to around £250 billion by the beginning of 2020.

Table 4.39: Key changes to the APF impact on borrowing since March

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	-12.2	-11.6	-6.9	-2.9	1.3	3.7
December forecast	-12.6	-12.2	-11.5	-8.9	-7.3	-5.8
Change	**-0.4**	**-0.6**	**-4.6**	**-5.9**	**-8.6**	**-9.5**
of which:						
PSF review	-0.2	-0.9	-3.5	-3.5	-5.2	-5.7
Underlying movements	-0.2	0.3	-1.2	-2.4	-2.5	-2.4
Profile of APF drawdown	0.0	0.0	0.1	0.0	-0.9	-1.5

Other AME spending

4.160 Our forecast of **BBC** spending is slightly higher than in March, reflecting the new Trust-approved budget for 2014 to 2016 and increased purchase of goods and services by the World Service, which moves from deficit to breakeven in 2017-18.

4.161 The forecast of **National Lottery** spending had been revised slightly down in 2013-14 as a result of latest outturn data. This feeds through to later years of the forecast via its impact on the ticket sales revenue forecast.

4.162 Revisions to **other PSCE in departmental AME** and **other PSGI items in departmental AME** include small, downward revisions to forecasts for the Department of Business, Innovation and Skills (BIS) redundancy scheme programme and Gift Aid costs. The spending included in these categories is detailed in the supplementary tables available on our website.

4.163 Table 4.22 shows a separate entry in PSCE in AME for **single-use military expenditure (SUME)**. This was treated as capital DEL in the spending control framework, although it was formerly classified as current expenditure in the National Accounts. Most of SUME has been reclassified as capital spending as a result of the ESA10 changes, now appearing under PSGI in CDEL, although some (around 7 per cent) remains in PSCE in AME.

4.164 **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 offset by receipts. The forecasts are explained in the receipts section.

4.165 The AME forecast includes forecasts for the further adjustments that are included in the National Accounts definitions for PSCE and PSGI.[18] Further details of accounting adjustment breakdowns are included in the supplementary tables on our website. Movements attributable to ESA10 changes are detailed in Table 4.23. Explanations and the background to **National Accounts adjustments** are given in Annex D to PESA 2014.[19].

[18] Further detail is provided in the supplementary fiscal tables on our website.
[19] See HM Treasury, July 2014, *Public Expenditure Statistical Analyses 2014*.

Loans and other financial transactions

4.166 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.

4.167 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.[20] It drives the 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 National Savings and Investment products.

4.168 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;
- **transactions in other financial assets:** the public sector may buy or sell financial assets, such as corporate bonds or equities. When it exchanges an asset for cash the transaction does not affect PSNB, but the associated cash flow will affect PSNCR;
- **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:** this category includes one-off financial transactions that do not fall into the categories above and some other adjustments.

4.169 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 4.40 shows the steps from PSNB to PSNCR while Table 4.41 shows the changes since our March forecast.

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

Table 4.40: Reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net borrowing	**91.3**	**75.9**	**40.9**	**14.5**	**-4.0**	**-23.1**
Loans and repayments	**15.3**	**17.6**	**18.9**	**19.5**	**19.0**	**19.6**
of which:						
Student loans[1,2]	10.3	11.7	13.0	14.1	14.9	15.5
DfID	1.9	1.6	1.5	1.5	1.5	1.5
Green Investment Bank	0.3	0.8	0.0	0.0	0.0	0.0
British Business Bank	0.2	0.5	0.2	0.0	-0.1	-0.1
Help to Buy equity loans	1.3	1.3	1.4	1.3	1.3	1.2
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	1.5	2.5	2.5	2.1	1.5	1.2
Allowance for shortfall	-0.3	-1.0	0.0	0.0	0.0	0.0
Transactions in financial assets	-1.0	-2.8	-2.8	-2.7	-2.6	-2.4
of which:						
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
Accruals adjustments	**-1.1**	**0.9**	**8.0**	**0.7**	**-3.9**	**-3.3**
of which:						
Student loan interest[1,2]	1.5	2.2	3.0	4.0	4.9	5.9
PAYE income tax and NICs	0.6	1.2	2.1	1.8	1.9	1.9
Indirect taxes	0.7	0.5	0.6	0.7	0.7	1.0
Other receipts	2.8	2.7	2.8	2.8	3.0	3.0
Index-linked gilts[4]	-6.8	-9.6	-2.9	-11.6	-17.4	-17.6
Conventional gilts	2.7	3.3	3.6	4.2	4.4	4.0
Other expenditure	-2.7	0.6	-1.2	-1.3	-1.3	-1.4
Other factors	**-14.5**	**-15.5**	**-6.0**	**-5.5**	**-4.6**	**-4.1**
of which:						
B&B and NRAM alignment	-5.1	-10.1	-6.6	-6.2	-5.1	-4.5
Network Rail	0.3	0.4	0.3	0.4	0.2	0.1
Alignment adjustment	-10.0	-6.0	0.0	0.0	0.0	0.0
Public sector net cash requirement	**90.0**	**76.2**	**59.0**	**26.5**	**3.9**	**-13.4**

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

Cash spending on new loans	12.4	14.0	15.4	16.5	17.3	18.0
Cash repayments	2.1	2.3	2.5	2.4	2.4	2.5

[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 4.41: Changes in the reconciliation of PSNB and PSNCR

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing	**7.4**	**7.7**	**-0.6**	**-3.3**	**-2.9**
Loans and repayments	**-2.0**	**-1.5**	**0.3**	**1.4**	**0.4**
of which:					
Student loans[1, 2]	-0.4	-0.4	-0.1	0.0	0.1
DfID	0.6	0.4	0.4	0.4	0.4
Green Investment Bank	-0.7	-0.3	0.0	0.0	0.0
British Business Bank	-0.6	0.1	-0.1	0.3	-0.2
Help to Buy equity loans	-0.3	0.0	-0.1	-0.1	-0.2
UK Export Financing	-0.2	-0.1	0.0	0.0	-0.1
Ireland	0.0	0.0	0.0	0.0	0.0
Other	-0.3	-0.3	0.2	0.9	0.3
Allowance for shortfall	-0.3	-1.0	0.0	0.0	0.0
Transactions in financial assets	-1.0	-0.5	-0.5	-0.4	-0.3
of which:					
Student loan book	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	-1.0	-0.5	-0.5	-0.4	-0.3
Accruals adjustments	**0.9**	**6.5**	**1.2**	**-3.9**	**4.3**
of which:					
Student loan interest[1,2]	-0.2	-0.2	-0.5	-0.7	-0.7
PAYE income tax and NICs	-0.9	-0.3	-0.3	-0.2	-0.1
Indirect taxes	-0.3	-0.5	-0.4	-0.3	-0.4
Other receipts	2.4	2.4	2.6	2.7	2.8
Index-linked gilts[4]	3.7	4.5	0.5	-5.1	2.6
Conventional gilts	-0.1	1.0	1.7	2.0	2.5
Other expenditure	-3.7	-0.4	-2.2	-2.3	-2.4
Other factors	**-7.6**	**-8.4**	**0.9**	**1.2**	**0.8**
of which:					
B&B and NRAM alignment	2.1	-2.8	0.7	0.8	0.6
Network Rail	0.3	0.4	0.3	0.4	0.2
Alignment adjustment	-10.0	-6.0	0.0	0.0	0.0
Public sector net cash requirement	**-2.3**	**3.9**	**1.4**	**-4.9**	**2.3**

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

Cash spending on new loans	-0.3	-0.4	-0.2	-0.1	-0.1
Cash repayments	0.0	0.0	-0.1	-0.1	-0.2

[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.

Loans and repayments

4.170 The recent student loan reforms have increased the size of the upfront loans, with repayments being made over a longer period. In our 2014 *Fiscal sustainability report (FSR)*, we showed that on current policy settings we might expect its impact on the debt to GDP ratio to peak around the mid-2030s and fall thereafter.

4.171 Student numbers were expected to rise this year following the removal of the higher education numbers cap, but have done so by less than expected. The original costing assumed the impact would peak in 2016-17, and it is unclear at this stage whether the latest data indicate a more gradual rise or a lower peak impact. We have reduced our medium-term assumptions slightly, but maintained the same profile. The forecast now takes account of the introduction of new postgraduate loans. Other underlying changes to loan outlays and repayments are small.

4.172 Other loans include lending through the Department for International Development's contributions to multilateral development banks – which are higher since March – loans to Ireland and a range of other Government schemes. Most of these other schemes are now expected to lend less this year than planned in March:

- the British Business Bank is now planning to lend £0.2 billion, rather than the £0.8 billion expected in March;
- lending by the Green Investment Bank is expected to remain flat on a year earlier at £0.3 billion, rather than rising to £1.0 billion;
- only £30 million of the £0.2 billion of lending announced in Budget 2014 through UK Export Finance is expected to happen this year. This follows the Autumn Statement 2012 measure projected at the time to be lending £0.3 billion in 2014-15, for which there was close to zero take-up; and
- Help to Buy equity loans are expected to be £0.3 billion below plans, reflecting a lower average loan per household.

4.173 This continues a recent trend common to many lending schemes. Current plans suggest that, excluding student loans, lending will pick up further in 2015-16, partly as new schemes are introduced. 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 have now allowed for additional shortfalls this year and next of £¼ billion and £1 billion respectively. (This is similar to the adjustment we make for expected underspending by departments against their Treasury plans.)

Transactions in other financial assets

4.174 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.

4.175 The Government has outlined the sale of part of the student loan book, with the intention to sell £12 billion of assets over a 5-year period from 2015-16. We have included a neutral assumption that this will be evenly spread across the five years. The loan book sale will reduce future repayments and interest paid to the Exchequer. We also now include expected sales of illiquid assets transferred along with the Royal Mail pension liability, given firm

plans and a track record of selling such assets over the recent past, but do not include any other asset sales over the forecast horizon.

Accruals adjustments

4.176 To move from PSNB to PSNCR, it is also necessary to adjust for the likely impact of timing differences between cash flows and accruals. If receipts are forecast to rise over time, the cash received in any given year will generally be lower than the accrued tax receipts. We now expect a little less momentum in accrued tax receipts over the near term.

4.177 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 March, reflecting the effects of lower Bank Rate and RPI inflation on the interest rate applied to these loans.

4.178 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. Positive RPI inflation raises the amount the Government is committed to pay on index-linked gilts, and 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 March forecast, lower RPI 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, which affect conventional gilts. For gilts sold at a premium, the cash payments to cover coupons will be larger than the amounts accrued in debt interest.

4.179 A number of ESA10 changes affect accrued borrowing, but not cash, and so are fully unwound via accruals adjustments. This includes accrued spectrum proceeds, imputed receipts relating to the Royal Mail Pension Plan, and imputed local government pension contributions.

Other factors

4.180 The rundown of the Bradford & Bingley and Northern Rock (Asset Management) (B&B and NRAM) loan books directly reduces the net cash requirement, a small part of which also reduces net borrowing. We also now include a small amount of financial transactions associated with Network Rail.

4.181 Cash flows are invariably more volatile than the underlying accrued position and reconciling borrowing and the net cash requirement has recently proved difficult. The net cash requirement has come in lower than the bottom-up data we use to project it forward would suggest, with the gap even wider following recent ONS corrections to the cash figures. So we have asked the Treasury to supply estimates consistent with its central data on projected departmental outlays and our forecasts for other spending and receipts.

4.182 These indicate that the cash requirement will be significantly lower this year and somewhat lower next year than our usual approach would suggest. The alternative numbers are also more consistent with cash outturns in the year to date, so we have aligned our forecasts to this new methodology, reducing the cash requirement by £10 billion and £6 billion in 2014-15 and 2015-16 respectively. Firm spending plans have yet to be set beyond that point, so we cannot do the same for other years.

4.183 We have not been able to reconcile these differences fully, which makes our assumptions for 2016-17 onwards subject to greater uncertainty. To the extent that it reflects spending accruals patterns – accrued spending being higher than cash – it would be expected to reverse in future years. Other causes might be more persistent. In the absence of strong evidence, we have made no further adjustments in 2016-17 and beyond, but will continue to review this part of the forecast. The ONS intends to publish more data on reconciling cash and borrowing, which may shed more light on the issue.

Central government net cash requirement

4.184 The other important cash measure is the central government net cash requirement (CGNCR). Table 4.42 shows how CGNCR relates to PSNCR and Table 4.43 sets out the changes in this relationship since March. 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.

4.185 Including B&B and NRAM 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.[21] 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 £6 billion to £11 billion a year, but these do not directly affect the Exchequer; and

- interactions between the Exchequer and these bodies net off within the headline measure. The banks' loan repayments to the Exchequer vary from around £3 billion to £6 billion a year. 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.

[21] The Government is publishing a revised financing remit for 2014-15 alongside the Autumn Statement. 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 4.42: 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)	**90**	**76**	**59**	**27**	**4**	**-13**
of which:						
Local authorities and public corporations NCR	-5	-6	-2	-2	-4	-5
Central government (CG) NCR own account	95	82	61	29	8	-8
CGNCR own account	95	82	61	29	8	-8
Net lending within the public sector	1	2	2	2	2	2
CG net cash requirement	**96**	**83**	**63**	**31**	**10**	**-7**
B&B and NRAM adjustment	0	5	5	3	2	2
Network Rail adjustment	6	7	6	5	4	3
CGNCR ex. B&B, NRAM and Network Rail	**102**	**95**	**73**	**38**	**16**	**-2**

Table 4.43: Changes in the reconciliation of PSNCR and CGNCR

	£ billion				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net cash requirement (NCR)	**-2**	**4**	**1**	**-5**	**2**
of which:					
Local authorities and public corporations NCR	-2	-3	0	0	0
Central government (CG) NCR own account	0	7	2	-5	3
CGNCR own account	0	7	2	-5	3
Net lending within the public sector	0	0	0	0	0
CG net cash requirement	**0**	**7**	**2**	**-5**	**3**
B&B and NRAM adjustment	-4	1	-1	0	0
Network Rail adjustment	6	7	6	5	4
CGNCR ex. B&B, NRAM and Network Rail	**2**	**14**	**7**	**0**	**7**

The key fiscal aggregates

4.186 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 target.

Public sector net borrowing

4.187 As set out in previous sections of this chapter, the public finances data have been revised substantially since our March forecast following the ONS review of these statistics (the 'PSF review') and the move to ESA10 guidelines for the National Accounts. This means there are a number of steps in the explanation of changes in our fiscal forecasts since March.

4.188 Tables 4.44 and 4.45 show how changes between these forecasts – in cash terms and as a share of GDP – can be decomposed into:

- changes relating to ESA10 and the PSF review;

- changes due to underlying forecast changes, including their interaction with the Government's policy assumption for total managed expenditure beyond 2015-16 (the 'TME assumption') that applied in March; and

- changes resulting from Government decisions, which include the effect of the policies listed in the Treasury's table of policy decisions, plus the effect of changing the March TME assumption that applied from 2016-17 to 2018-19 and applying the new assumption to spending in 2019-20, now that the forecast has rolled on a year.

4.189 In March, we focused on an underlying measure of PSNB that excluded the effects of transfers between the Exchequer and the Asset Purchase Facility (APF) related to quantitative easing, which as treated at the time had been uneven from year to year. The first panel of the table moves from this starting point to the ONS headline measure of PSNB at the time, including those APF transfers.

4.190 The second panel shows changes since March that relate to the implementation of ESA10 and the PSF review by the ONS. This allows us in effect to restate our March forecast on an ESA10 basis, as best we can, to facilitate like-for-like comparisons.[22] The main changes are:

- in cash terms, spending and receipts are higher in every year by amounts that are broadly offsetting. The inclusion of Network Rail in the public sector adds to borrowing

[22] These figures differ from the illustrative ESA10 forecasts presented in Annex B of our March 2014 *EFO* as they are based on ONS data for a number of items for which we could only produce indicative estimates and forecast profiles in March.

in every year, while the change in the treatment of APF flows reduces borrowing by an amount that rises each year. Other effects are largely offsetting, so that overall borrowing is higher in the near term and lower in the medium term; and

- the same factors affect borrowing as a share of GDP, with an additional effect from the largely ESA10-related upward revision to the level of nominal GDP in 2013-14 since March.[23] This has an effect proportionate to the size of the deficit or surplus, so is larger in absolute terms in the early years of the forecast when the deficit is higher.

4.191 The third panel of each table shows the underlying forecast changes since March, as described in earlier sections of this chapter. Overall, these changes have led to higher borrowing across the forecast period due to:

- a large and increasing downward revision to receipts, notably income tax. This raises borrowing by £7.8 billion (0.4 per cent of GDP) in 2014-15, rising to £25.3 billion (1.2 per cent of GDP) in 2018-19;

- a largely offsetting downward revision to 'annually managed expenditure' (AME) spending – in particular lower debt interest costs. This reduces borrowing by £1.3 billion (0.1 per cent of GDP) in 2014-15, rising to £19.2 billion (0.9 per cent of GDP) in 2018-19; and

- the effect of all the revisions to our forecasts of public spending and the GDP deflator on the TME assumption that the Government used in March 2014. These reductions in 'departmental expenditure limits' (DEL) from 2016-17 to 2018-19 – the envelopes for central government spending on public services, grants and capital investment – of £5.8 billion (0.3 per cent of GDP) a year on average.

4.192 The final panel of each table shows the effect on borrowing of the decisions the Government has taken in this Autumn Statement. These are split between:

- the estimated effect of policy measures that are included in the Treasury's table of policy decisions, which on average reduce borrowing by £0.2 billion a year over the forecast period to 2019-20; and

- the effect on TME – and thus on the implied envelope for DEL spending – of the Government's decision to change the TME assumption for the years beyond 2015-16. Between 2016-17 and 2018-19, that reduces borrowing by an average of £1.2 billion a year.

[23] Strictly speaking, the revisions that were implemented in Blue Book 2014 included some that were related to ESA95 and some that stemmed from moving the National Accounts onto an ESA10-basis, but for simplicity the effect of all revisions to the level of nominal GDP in 2013-14 have been combined in this decomposition.

Table 4.44: Public sector net borrowing

	£ billion						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March 2014 underlying PSNB (ESA95)	**107.8**	**95.5**	**75.2**	**44.5**	**16.5**	**-4.8**	
APF effect	12.2	11.6	6.9	2.9	-1.3	-3.7	
March 2014 headline PSNB (ESA95)	**95.6**	**83.9**	**68.3**	**41.5**	**17.8**	**-1.1**	
Changes due to implementation of ESA10 and the ONS PSF review							
Total	**3.6**	**2.5**	**0.0**	**-0.1**	**-2.0**	**-2.5**	
Of which:							
Receipts	-0.9	-4.7	-9.8	-13.9	-15.9	-16.8	
AME spending	*4.5*	*7.3*	*9.8*	*13.8*	*13.9*	*14.2*	
March 2014 headline PSNB (ESA10)	**99.3**	**86.4**	**68.3**	**41.5**	**15.8**	**-3.7**	
Forecast changes and consequences for implied government spending							
Forecast changes since March 2014	**-1.7**	**5.8**	**6.6**	**-0.1**	**0.8**	**1.8**	
Of which:							
Receipts forecast	-1.6	7.8	14.3	18.9	22.7	25.3	
Spending forecast	-0.1	-2.0	-7.7	-19.0	-21.9	-23.5	
Of which:							
AME	*-2.5*	*-1.3*	*-9.3*	*-11.9*	*-15.9*	*-19.2*	
DEL plans	*2.4*	*-0.7*	*1.6*				
Changes to implied total DEL from applying Budget 2014 spending policy assumptions post 2015-16				*-7.1*	*-6.0*	*-4.3*	
December 2014 before effects of Government decisions	**97.5**	**92.1**	**74.9**	**41.3**	**16.6**	**-1.9**	**-6.5**
Changes due to Government decisions							
Autumn Statement policy measures	0.0	-0.9	1.0	-0.1	-0.4	-0.5	-0.4
Effect of applying new Autumn Statement spending policy assumptions post 2015-16[1]				-0.4	-1.6	-1.7	-16.2
December 2014 headline PSNB (ESA10)	**97.5**	**91.3**	**75.9**	**40.9**	**14.5**	**-4.0**	**-23.1**
Change since March on a like-for-like basis	**-1.7**	**4.9**	**7.7**	**-0.6**	**-1.3**	**-0.3**	
Memo: December 2014 implied on ESA95	*101.2*	*93.8*	*76.0*	*40.8*	*12.6*	*-6.6*	

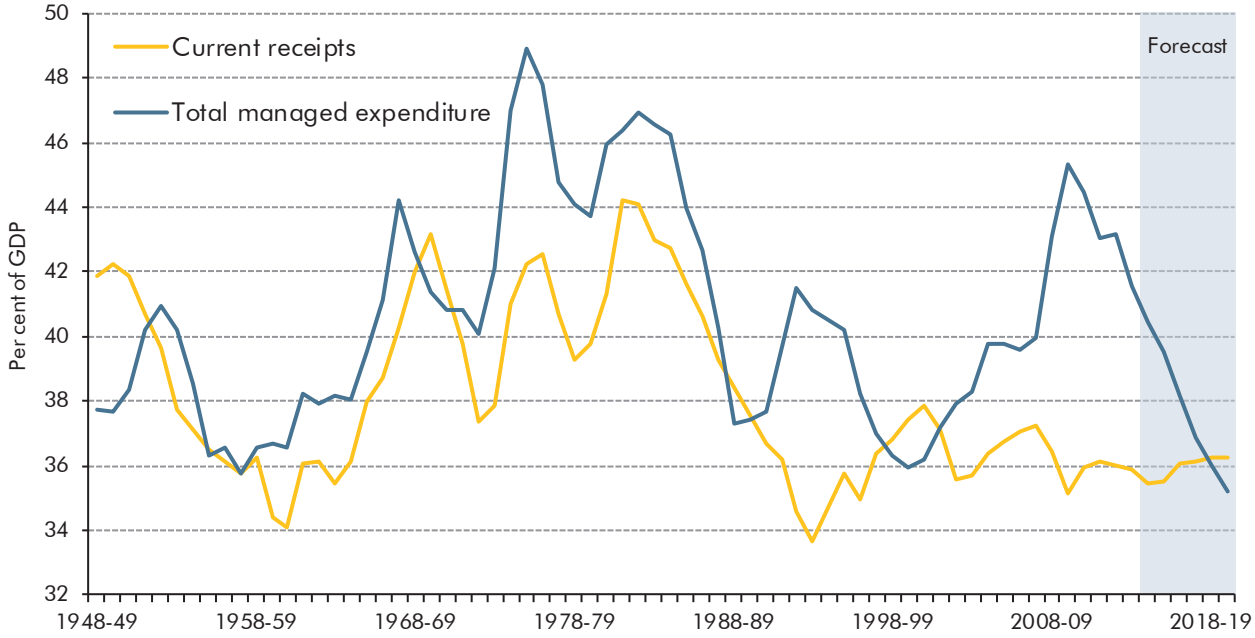
[1]The additional tightening in 2019-20 of £14.5 billion is relative to a baseline that assumes current spending by departments would otherwise have remained constant as a share of potential GDP.

Table 4.45: Public sector net borrowing (per cent of GDP)

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March 2014 underlying PSNB (ESA95)	**6.6**	**5.5**	**4.2**	**2.4**	**0.8**	**-0.2**	
APF effect	0.7	0.7	0.4	0.2	-0.1	-0.2	
March 2014 headline PSNB (ESA95)	**5.8**	**4.9**	**3.8**	**2.2**	**0.9**	**-0.1**	
Changes due to implementation of ESA10 and the ONS PSF review							
Total	**0.2**	**0.1**	**0.0**	**0.0**	**-0.1**	**-0.1**	
Of which:							
Receipts	-0.1	-0.3	-0.5	-0.7	-0.8	-0.8	
AME spending	0.3	0.4	0.5	0.7	0.7	0.7	
Higher level of GDP under ESA10	-0.3	-0.3	-0.2	-0.1	0.0	0.0	
March 2014 headline PSNB (ESA10)	5.7	4.8	3.6	2.1	0.8	-0.2	
Forecast changes and consequences for implied government spending							
Forecast changes since March 2014	**-0.1**	**0.3**	**0.4**	**0.0**	**0.0**	**0.1**	
Of which:							
Receipts forecast	-0.1	0.4	0.8	1.0	1.1	1.2	
Spending forecast	0.0	-0.1	-0.4	-1.0	-1.1	-1.1	
Of which:							
AME	-0.1	-0.1	-0.5	-0.6	-0.8	-0.9	
DEL plans	0.1	0.0	0.1				
Changes to implied total DEL from applying Budget 2014 spending policy assumptions post 2015-16				-0.4	-0.3	-0.2	
December 2014 before effects of Government decisions	**5.6**	**5.1**	**4.0**	**2.1**	**0.8**	**-0.1**	
Changes due to Government decisions							
Autumn Statement policy measures	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Effect of applying new Autumn Statement spending policy assumptions post 2015-16				0.0	-0.1	-0.1	-0.7
December 2014 headline PSNB (ESA10)	5.6	5.0	4.0	2.1	0.7	-0.2	-1.0
Change since March on a like-for-like basis	**-0.1**	**0.2**	**0.4**	**0.0**	**-0.1**	**0.0**	
Memo: December 2014 implied on ESA95	**6.2**	**5.5**	**4.2**	**2.2**	**0.6**	**-0.3**	

[1]The additional tightening in 2019-20 of £14.5 billion is relative to a baseline that assumes current spending by departments would otherwise have remained constant as a share of potential GDP.

Chart 4.8: Total public sector spending and receipts



Source: ONS, OBR

4.193 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 the largest surplus since 2000-01 – a turnaround of 11.2 per cent of GDP (£205 billion in today's terms). By 2014-15, around 46 per cent of that planned reduction – 5.2 per cent of GDP (£94 billion) – will have been completed. As Chart 4.9 shows, the sources of deficit reduction during the first five years of the consolidation differ in their relative importance from those implied by the Government plans and medium-term assumptions that underpin our forecast for the second five years.

4.194 Between 2009-10 and 2014-15, the main factors contributing (positively and negatively) to the reduction in public sector net borrowing have included:

- a relatively small increase in **debt interest spending** (0.2 per cent of GDP). The impact of much higher cash debt has been offset by lower government borrowing costs. This reflects lower gilt yields, plus in effect financing some debt at Bank Rate (via quantitative easing) rather than selling gilts;

- an even smaller increase in **other AME spending** (less than 0.1 per cent), mainly higher net public service pension costs (via lower contributions from a shrinking workforce);

- little change from **receipts** (also less than 0.1 per cent). Tax increases (notably the main rate of VAT) have more than offset tax cuts (notably corporation tax and fuel duty rates and increases in the income tax personal allowance) over this period. But weakness in effective tax rates, associated with subdued productivity and real incomes, have absorbed the remaining net tax increase and have left receipts little changed overall;

- larger contributions from cuts in **welfare spending** (0.7 per cent of GDP) and **capital spending** (1.4 per cent), with welfare spending falling steadily as a share of GDP while investment cuts were concentrated in the early years of the recovery; and

- around two thirds of the deficit reduction has come from cuts in **day-to-day spending on public services and administration** (3.5 per cent of GDP), with the cuts to-date concentrated in unprotected departments outside health, schools and overseas aid.

4.195 Between 2014-15 and 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 further increases in **debt interest** spending (0.7 per cent of GDP) as interest rates are assumed to rise in line with market expectations;

- small reductions in **other AME spending** (0.3 per cent of GDP) and **capital spending** (0.1 per cent). Net public service pensions costs continue to rise as a share of GDP;

- a 0.8 per cent of GDP rise in **receipts**. This includes a 0.5 per cent of GDP rise in the tax-to-GDP ratio – largely due to 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 a 0.3 per cent of GDP rise in non-tax revenues, notably interest on the government's stock of financial assets as interest rates rise;

- a 0.9 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 economy 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

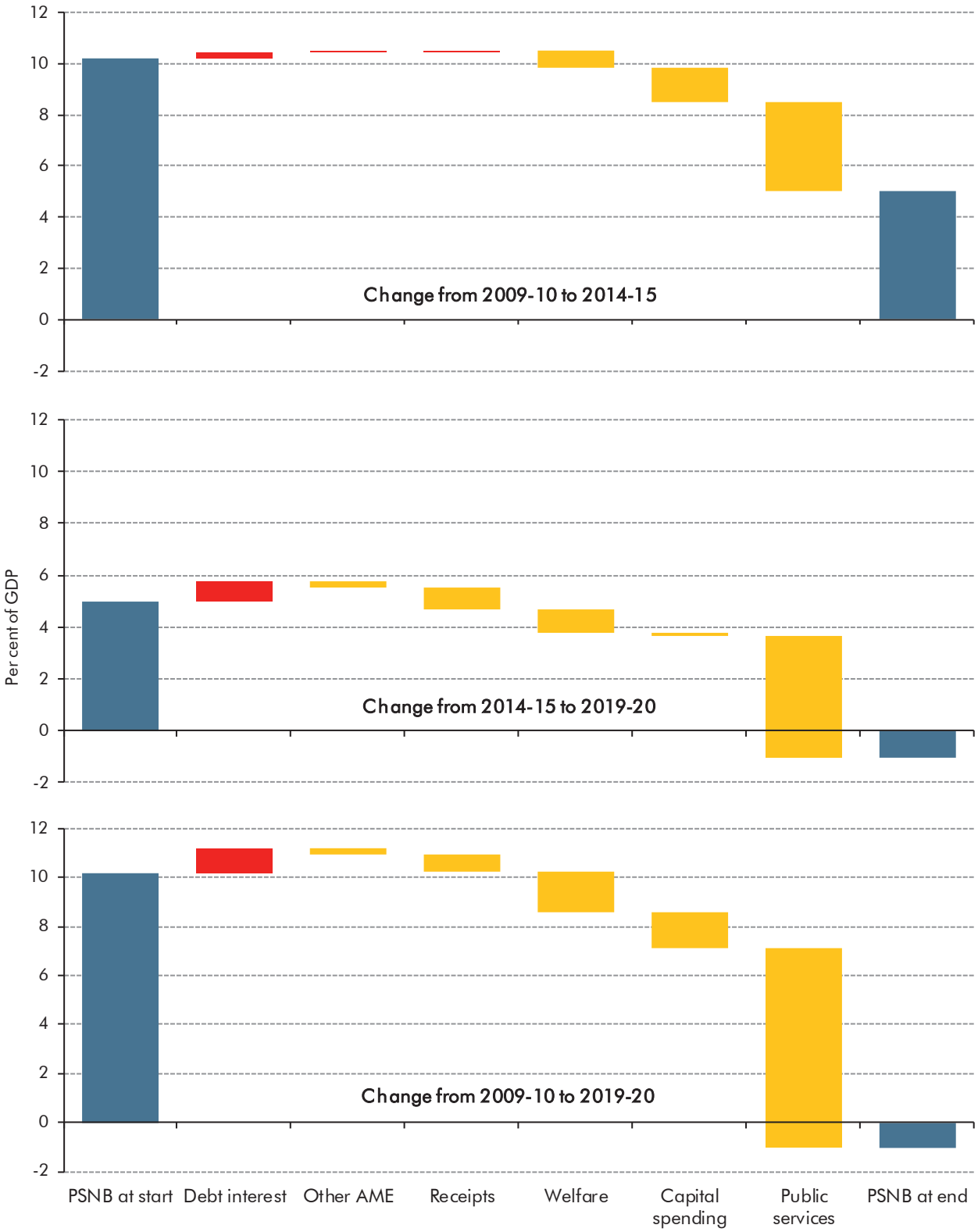
- around 80 per cent of the remaining change in the budget balance (4.7 per cent of GDP or £86 billion in today's terms) comes from the cuts in **day-to-day spending on public services and administration** implied by the Government's firm 2015-16 plans, its assumption for total spending and our forecast for AME spending.

4.196 Over the full decade, based on the Government's policies and policy assumptions, the 11.2 per cent of GDP change in the budget balance will be composed of:

- a 10.5 per cent of GDP reduction in spending – over 90 per cent of the total. Current spending on public services would make up the bulk of that change – 8.2 per cent of GDP – of which around 40 per cent will have taken place by 2014-15. Capital spending would account for 1.5 per cent of GDP of the fall, almost all of which will already have taken place by 2014-15; and

- a 0.7 per cent of GDP rise in receipts – less than 10 per cent of the total. The rise in income tax and NICs receipts as a share of GDP between 2014-15 and 2019-20 in our latest forecast more than explains this rise.

Chart 4.9: Sources of deficit reduction

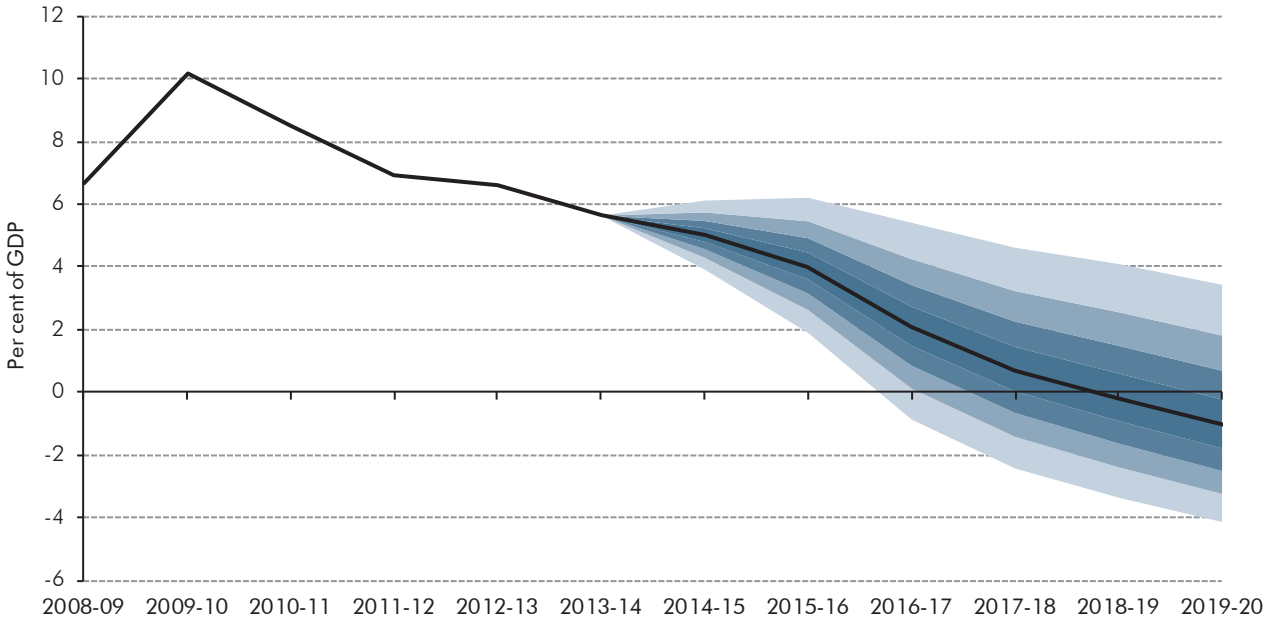


Source: ONS, OBR. Note: Figures adjusted for negtive tax credits and reforms to council tax benefit and business rates.

4.197 All fiscal forecasts are subject to significant uncertainty. Chart 4.10 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 just over 50 and 60 per cent in 2018-19 and 2019-20 respectively.

Chart 4.10: PSNB fan chart



Source: ONS, OBR

Current budget

4.198 Our central forecast shows the current budget (on the new ESA10 basis) moving from a deficit of £63.6 billion in 2014-15 to a surplus of £50.0 billion in 2019-20. Relative to our March forecast, the current budget balance has deteriorated by £7.7 billion in 2014-15, reflecting the lower receipts forecast. Revisions to later years become progressively smaller as the effect of lower current spending offsets the deterioration in the receipts forecast. Revisions due to ESA10 and PSF review changes are relatively small.

Cyclically adjusted current budget

4.199 The cyclically adjusted current budget (CACB) moves from a deficit of 2.6 per cent of GDP in 2013-14 to a surplus of 2.3 per cent of GDP in 2019-20. In 2014-15, the CACB deteriorates year-on-year for the first time since its peak in 2009-10, which is largely explained by the apparent structural deterioration in the tax-to-GDP ratio this year. The CACB deficit has been revised up by 0.5 per cent of GDP in 2014-15, with the size of the deterioration narrowing progressively in subsequent years. We expect the CACB to move into surplus in 2017-18. The CACB is discussed further in Chapter 5.

Public sector net debt

4.200 We forecast that public sector net debt (PSND) will rise as a share of GDP this year and next, peaking at 81.1 per cent of GDP in 2015-16, before then falling at an increasingly rapid rate to 72.8 per cent of GDP in 2019-20. Net debt rises more slowly and then falls more quickly than forecast in March, but the level is higher throughout:

- upward revisions to the opening level of GDP have reduced the ratio of the cash value of debt to GDP in each year, although slower nominal GDP growth over the forecast period unwinds some of this effect;
- in aggregate, ESA10 and PSF review changes increase the debt-to-GDP ratio, by increasing debt relatively more than GDP. The revisions to cash debt reflect:
  - bringing the APF inside the ex-measures boundary, which raises net debt as the nominal value of the gilts are less than the amount the APF paid for them. This effect will fall to zero as the APF is unwound;
  - treating Lloyds and RBS share purchases and compensation to depositors as illiquid rather than liquid assets raises net debt, as liquid assets are subtracted from gross debt to arrive at a net debt figure, but illiquid assets are not. We do not assume any future share sales and payments relating to the compensation schemes in our forecast, due to uncertainty over scale and timing, so this additional amount is assumed to persist; and
  - reclassifying Network Rail into central government means that its liabilities now appear on the public sector balance sheet.
- our borrowing forecast increases net debt in the near term, but reduces it in the medium term, as weaker receipts are offset by larger spending cuts; and
- other changes generally reduce net debt further, in particular our judgement that falls in gilt yields since March imply that the Debt Management Office will issue gilts at a greater premium relative to their nominal value, and that the public sector's cash requirement will be lower than implied by borrowing this year and next.

Table 4.46: Changes to public sector net debt since March

	Outturn	Per cent of GDP Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March forecast (ESA95)	74.5	77.3	78.7	78.3	76.5	74.2	
December forecast (ESA10)	78.8	80.4	81.1	80.7	78.8	76.2	72.8
Change	**4.3**	**3.1**	**2.4**	**2.4**	**2.2**	**2.0**	
of which:							
Change in nominal GDP[1]	-3.8	-4.2	-3.8	-3.2	-2.9	-2.8	
Change in cash level of net debt	8.1	7.2	6.2	5.7	5.2	4.8	
				£ billion			
March forecast	1258	1355	1439	1497	1530	1548	
December forecast	1402	1489	1558	1610	1638	1652	1648
Change in cash level of net debt	**144**	**134**	**119**	**113**	**107**	**104**	
of which:							
PSF review: APF	44	44	43	42	37	34	
PSF review: other	51	51	51	51	51	51	
ESA10: Network Rail	33	37	41	44	47	49	
Other changes in net borrowing	-2	3	11	10	9	8	
Gilt premia	1	-6	-22	-29	-34	-36	
Other	16	5	-5	-5	-3	-3	
[1] Non-seasonally-adjusted GDP centred end-March.							
Memo: Nominal GDP centred end March: ESA10 implied March 2014 forecast	*1779*	*1854*	*1929*	*2019*	*2110*	*2204*	

Table 4.47: Fiscal aggregates

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Receipts and expenditure							
Public sector current receipts *(a)*	35.9	35.5	35.5	36.1	36.2	36.2	36.2
Total managed expenditure *(b)*	41.5	40.5	39.5	38.2	36.9	36.0	35.2
of which:							
Public sector current expenditure *(c)*	38.0	36.9	36.0	34.8	33.6	32.7	31.9
Public sector net investment *(d)*	1.5	1.5	1.4	1.3	1.2	1.2	1.2
Depreciation *(e)*	2.1	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	2.1	0.7	-0.2	-1.0
Current budget deficit *(c+e-a)*	4.2	3.5	2.6	0.8	-0.5	-1.4	-2.3
Cyclically-adjusted net borrowing	4.1	4.2	3.6	1.8	0.5	-0.3	-1.1
Primary balance	-3.8	-3.3	-2.2	-0.1	1.4	2.3	3.2
Cyclically-adjusted primary balance	-2.3	-2.6	-1.8	0.2	1.6	2.4	3.2
Fiscal mandate and supplementary target							
Cyclically-adjusted deficit on current budget	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
Public sector net debt[1]	78.8	80.4	81.1	80.7	78.8	76.2	72.8
Financing							
Central government net cash requirement	4.5	5.3	4.4	3.2	1.5	0.4	-0.3
Public sector net cash requirement	3.7	4.9	4.0	3.0	1.3	0.2	-0.6
Stability and Growth Pact							
Treaty deficit[2]	5.8	5.3	4.3	2.3	0.9	0.0	-0.8
Cyclically-adjusted Treaty deficit	4.2	4.5	3.9	2.0	0.8	-0.1	-0.8
Treaty debt ratio[3]	87.8	88.0	89.9	90.0	88.4	86.1	83.0
	£ billion						
Public sector net borrowing	97.5	91.3	75.9	40.9	14.5	-4.0	-23.1
Current budget deficit	72.3	63.6	49.4	15.7	-10.1	-29.7	-50.0
Cyclically-adjusted net borrowing	70.6	77.4	68.0	34.8	10.9	-6.0	-23.7
Cyclically-adjusted deficit on current budget	45.3	49.7	41.5	9.6	-13.7	-31.8	-50.6
Public sector net debt	1402	1489	1558	1610	1638	1652	1648
Memo: Output gap (per cent of GDP)	*-2.0*	*-0.7*	*-0.5*	*-0.4*	*-0.2*	*-0.1*	*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

4.201 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 3.121);

- recent weakness in the tax-to-GDP ratio and our understanding of the implications of that weakness for our receipts forecast (paragraphs 4.33 to 4.40);
- the wider effects of reforms to stamp duty land tax announced at this Autumn Statement (Box 4.5);
- the implications of the Government's total spending policy assumption for central government day-to-day spending on public services (Box 4.6) and local authority spending (paragraphs 4.96 to 4.112);
- the significant uncertainties associated with forecasting the UK's payments to EU institutions (paragraphs 4.127 to 4.141); and
- a number of policy costings that have been incorporated into our forecast (Annex A).

International comparisons

4.202 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 4.48 and 4.49 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 4.48: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit[1]			Treaty Debt[2]		
	2014	2015	2016	2014	2015	2016
UK (March *EFO*)	5.4	4.6	2.8	88.0	89.5	90.0
UK (EC)	5.4	4.4	3.4	89.0	89.5	89.8
Germany	-0.2	0.0	-0.2	74.5	72.4	69.6
France	4.4	4.5	4.7	95.5	98.1	99.8
Italy	3.0	2.7	2.2	132.2	133.8	132.7
Spain	5.6	4.6	3.9	98.1	101.2	102.1
Euro area	2.6	2.4	2.1	94.5	94.8	93.8

[1] General government net borrowing.

[2] General government gross debt.

Source: European Commission, *European Economic Forecast*, Autumn 2014; OBR

Table 4.49: Comparison with the IMF forecasts

	Per cent of GDP					
	General government net borrowing			General government net debt		
	2014	2015	2019	2014	2015	2019
UK (March *EFO*)	5.4	4.6	-0.6	80.4	81.9	82.4
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

5 Performance against the Government's fiscal targets

Introduction

5.1 This chapter:

- sets out the Government's medium-term fiscal targets (from paragraph 5.3);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.9); 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 5.23).

5.2 As explained in Chapters 3 and 4, in this *Economic and fiscal outlook (EFO)*, our economy and fiscal forecasts are unfortunately not fully consistent. The inconsistency arises because, after the economy forecast had been closed, the Government added modest, but not negligible, amounts to planned spending relative to the amounts on which our final economy forecast was based. Had we been informed of this ahead of our final economy forecast, the main impact would have been on the expenditure composition of GDP. That would have had small, but again not negligible, implications for our fiscal forecast. But we do not believe it would have been sufficient to change any of the conclusions we draw about the Government's performance against its fiscal targets or the welfare cap.

The Government's fiscal targets

5.3 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.

5.4 The *Charter for Budget Responsibility* defines the fiscal mandate as "*a forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period*". This means that total public sector receipts need at least to equal total public sector spending (minus spending on net investment) in five years' time, after adjusting for the impact of any remaining spare capacity in the economy. For the purposes of this forecast, the five-year horizon ends in 2019-20. The *Charter* says that the

supplementary target requires "*public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring the public finances are restored to a sustainable path.*"

5.5 As described in Chapter 4, the public finances data have been revised substantially since our last forecast as the Office for National Statistics has brought the UK's National Accounts into line with updated international guidance (ESA10) and implemented the conclusions of its own review of the public sector finances. The Government has stated that the fiscal mandate and supplementary target should both now be assessed on the new ESA10 basis, excluding public sector banks, but our verdicts would have been the same on the old basis.

5.6 The Government also announced in Autumn Statement 2013 that it would also introduce a cap on social security and tax credit spending, excluding state pensions (which it argued are "*better planned and controlled over a longer time period*") and jobseeker's allowance and associated housing benefit payments (which it identified as "*the most cyclical elements of welfare*" in order "*to allow the automatic stabilisers to operate*").

5.7 This '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 forecast. It has now been extended to 2019-20 and set in line with our new forecast for that year. The Government has set a 2 per cent margin above the cap, which can be used to accommodate forecast changes but not the impact of policy changes. How the cap will operate – including the actions required of the Government if the cap is exceeded – was outlined in the March 2014 update of the *Charter for Budget Responsibility*.

5.8 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 (EFO)*, we are therefore making our first formal assessment of whether relevant spending exceeds the welfare cap for discretionary policy reasons or the cap-plus-forecast-margin due to changes in forecast assumptions.

The implications of our central forecast

5.9 Table 5.1 shows our central forecasts for the cyclically adjusted current budget deficit (CACB), PSND, and the welfare cap, as set out 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	2019-20
Cyclically adjusted current budget							
March forecast	2.8	2.2	1.5	0.2	-0.7	-1.5	
December forecast	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
Public sector net debt							
March forecast	74.5	77.3	78.7	78.3	76.5	74.2	
December forecast	78.8	80.4	81.1	80.7	78.8	76.2	72.8
	£ billion						
Spending within the welfare cap							
March forecast	116.4	117.8	119.5	122.0	124.6	126.7	
December forecast	116.2	119.6	120.7	122.4	124.0	126.8	129.8

Fiscal mandate

5.10 Table 5.1 shows that our central forecast is for the CACB to be in surplus by 2.3 per cent of GDP in 2019-20. This means that there is a significantly greater than 50 per cent chance of the Government achieving balance on this measure in that year. As a result, it is on course to achieve the mandate. This is the first surplus in excess of 2 per cent of GDP that we have forecast for a mandate year.

5.11 Our current estimate of the output gap and its path over the forecast period are somewhat narrower than in previous forecasts. The path of the structural deficit therefore more closely matches changes in the headline deficit. It is nevertheless interesting to assess the underlying contributing factors that lead to the CACB progressing from a deficit of 2.6 per cent of GDP in 2013-14 to a surplus of 2.3 per cent of GDP in 2019-20. This can be done using cyclical-adjustment coefficients for particular types of receipts and spending.[1] Using such a methodology, Chart 5.1 shows that:

- the overall improvement of 4.9 per cent of GDP is more than explained by lower structural spending. A structural deterioration in receipts in 2014-15 continues into 2015-16 before largely reversing in 2016-17 – the position is stable in later years. Spending falls as a share of GDP in every year, but the overall structural deficit widens a little in 2014-15 – as the structural weakness in receipts outweighs the spending reductions – before narrowing thereafter;

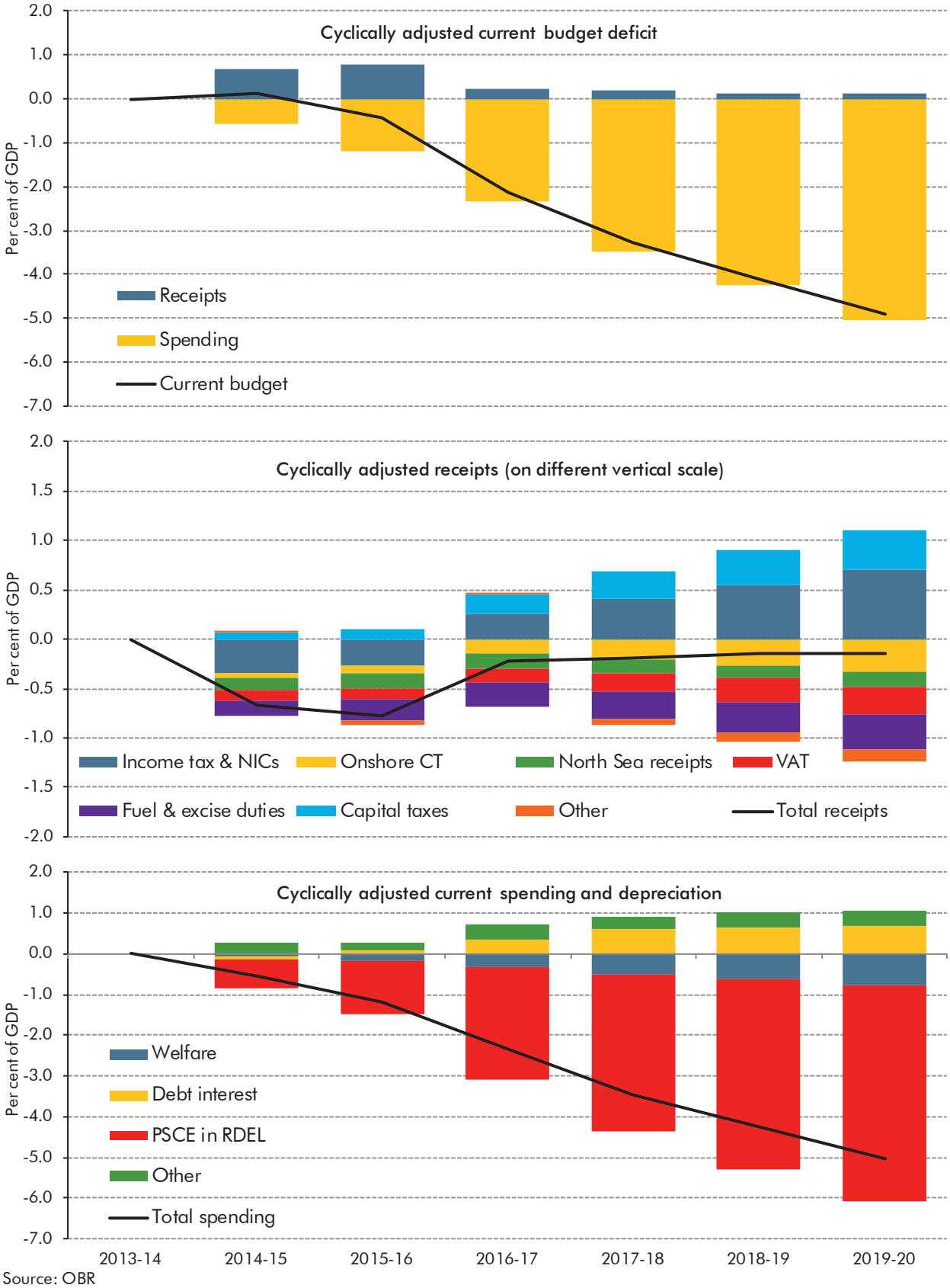
- the hit to receipts this year and next is mainly explained by income tax and NICs. As discussed in Chapter 4, the effective tax rate on labour income is expected to be permanently lower than we thought in March. The abolition of 'contracting out' in 2016-17 increases NICs receipts, and the return of positive fiscal drag raises structural receipts in the medium term. But this is offset by lower fuel and excise duties (largely due to trends in consumption), onshore corporation tax (partly firms carrying over and using losses), VAT (a decline in the share of household consumption subject to VAT

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

and lower government procurement) and North Sea receipts (flat production, so falling as a share of GDP). Capital taxes are highly cyclical, but are more sensitive to asset prices and transactions than the economic cycle directly, showing as a structural improvement under the methodology we have used; and

- most of the improvement in spending is due to cuts to departmental spending, which accelerate in 2016-17. The Government has only set out detailed departmental spending plans through to 2015-16, so the cuts thereafter are implied by its policy assumption for total public spending. Welfare spending also contributes to the structural improvement over time, for example because most working-age benefits are uprated by inflation so fall relative to earnings. Debt interest costs gradually rise and then stabilise towards the end of the period, as the accumulation of debt slows. Other spending rises in 2014-15, but is then broadly constant as a share of potential output.

Chart 5.1: Changes to the cyclically adjusted current budget from 2013-14



Source: OBR

5.12 In our March *EFO*, the relevant year for assessing the fiscal mandate was 2018-19. Our latest forecast is unchanged for that year, with a surplus of 1.5 per cent of GDP. The Government has more headroom against its fiscal mandate in 2019-20 than it had in 2018-19. This is largely because its stated policy assumption for total public spending delivers a further cut in non-investment spending as a share of GDP in 2019-20 where the forecast has rolled on an extra year.

5.13 Table 5.2 decomposes the changes in our forecasts of CACB since March. It shows that:

- upward revisions to the level of GDP reduce deficits and surpluses expressed as a share of nominal GDP, but the impact on the CACB is relatively small, as are the consequences of the ESA10 and PSF review updates;

- revising down cash receipts for 2014-15 – despite stronger actual growth and a narrower output gap – implies a structural deterioration, which is particularly notable in income tax and NICs. This largely persists in future years;

- changes to spending are smaller in the near term, but reductions are sufficient by 2018-19 to outweigh the deterioration in receipts. These partly reflect changes to AME spending, including downward revisions to debt interest that accumulate over time;

- applying the Treasury's latest spending policy assumption reduces spending further from 2016-17 onwards. Relative to the assumption that was applied in March, this reduces structural spending by 0.3 per cent of GDP in each year between 2016-17 and 2018-19;

- setting a policy assumption that total spending is held flat in real terms in 2019-20, within which investment spending rises with GDP, reduces structural non-investment spending by 0.8 per cent of GDP in that year and improves the CACB by the same amount. Within this total, annually managed expenditure (AME) is forecast to fall by 0.1 per cent of GDP – mainly through lower welfare spending falling as a share of GDP, as benefits are uprated with inflation and the state pension age rises. That implies a 0.7 per cent of GDP (£14.5 billion) cut in departmental spending in that year compared to holding spending flat as a share of potential GDP. (The Treasury treats these post-Spending Review assumptions as 'unchanged policy' and so does not report the additional tightening in its table of policy measures); and

- measures appearing in the Treasury's Autumn Statement decisions table are broadly neutral in each year.

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

	Per cent of GDP						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20[1]
March forecast	2.8	2.2	1.5	0.2	-0.7	-1.5	-1.5
December forecast	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
Change	-0.2	0.5	0.7	0.3	0.1	0.0	-0.8
of which:							
GDP revisions	-0.2	-0.2	-0.1	0.0	0.0	0.1	0.1
ESA10/PSF review	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Underlying receipts	-0.1	0.6	0.9	0.7	0.7	0.7	0.7
Underlying spending	0.2	0.1	-0.1	-0.1	-0.4	-0.4	-0.6
Autumn Statement measures	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Baseline spending assumption	0.0	0.0	0.0	-0.3	-0.3	-0.3	-1.0

[1] We did not produce a forecast for the CACB in 2019-20 in our March *EFO*. The table assumes our 2018-19 is rolled over one year, consistent with our 2014 *Fiscal sustainability report* assumption for the year.

Supplementary target

5.14 The supplementary target requires public sector net debt (PSND) to fall as a share of GDP between 2014-15 and 2015-16, with this target year fixed. We expect that PSND will continue to rise as a share of GDP in that year, so the Government is on course to miss its supplementary target. This has been the case in each of our forecasts since December 2012. PSND is expected to peak as a share of GDP in 2015-16, falling in 2016-17 and then by larger amounts each year. Chart 5.2 decomposes year-on-year changes in the ratio over the forecast period. It shows that:

- the movement from year-on-year rises in net debt to year-on-year falls largely reflects improvements to the primary balance (the difference between non-interest receipts and spending). But the primary balance is still in deficit in 2016-17, although modestly enough for debt still to fall as a share of GDP;

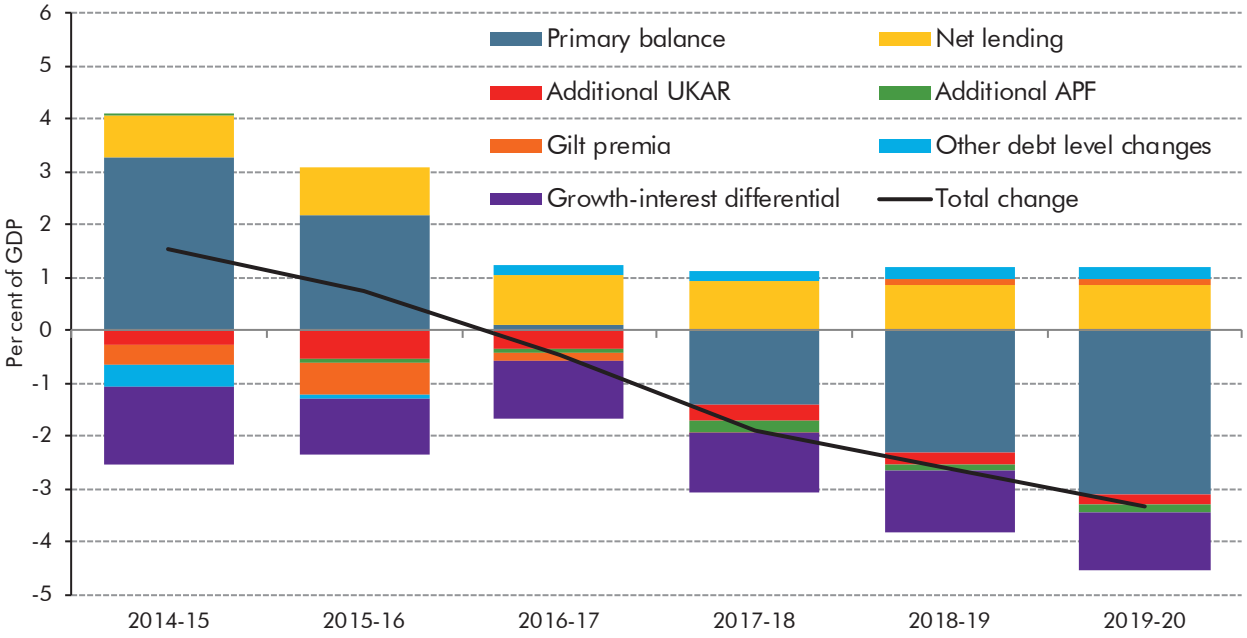
- the fact that nominal GDP growth exceeds expected interest rates means that net debt falls by over 1 per cent of GDP in every year. This differential is an extremely important component of public sector debt dynamics, especially over longer timeframes. In our annual *Fiscal sustainability reports*, we test our results to different assumptions;

- net lending to the private sector – mainly student loans – increases net debt in every year (but, as a financial transaction, does not directly affect measures of the deficit);

- temporary factors, including running down the assets of UK Asset Resolution (UKAR) and the Asset Purchase Facility, and issuing debt at a premium to its nominal value, reduce net debt over the forecast period; and

- other changes, mainly timing effects, are relatively small. Accrued receipts exceed cash receipts over the medium term, partly because some taxes are collected with a lag.

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



Source: OBR

5.15 Relative to our March forecast, we now expect PSND to rise more gradually over the next two years, but to fall at a similar rate thereafter. Table 5.3 decomposes changes in the profile of net debt as a share of GDP since March. It shows that:

- stronger nominal GDP growth slows the rise in PSND this year, while our forecasts for slower real GDP growth (as a smaller output gap closes) and lower whole economy inflation have the opposite effect in subsequent years;
- ESA10 and PSF review changes raise the level of both GDP and PSND. The GDP revisions do not greatly affect the profile of the debt-to-GDP ratio. The additions to net debt are either expected to unwind or to rise more gradually than GDP, thereby reducing year-on-year changes in the debt-to-GDP ratio over the forecast period;
- weaker receipts are expected to raise the debt ratio in 2014-15 and 2015-16, while changes to the Government's spending assumption reduce net debt thereafter. Autumn Statement measures do not have a material effect on the profile; and
- other changes generally reduce net debt further, in particular our judgement that falls in gilt yields since March imply that the Debt Management Office will issue gilts at a greater premium to their nominal value over the forecast period, and that the public sector's cash requirement will be lower than implied by borrowing this year and next.

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

	Change in PSND on a year earlier (per cent of GDP)				
	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast	2.7	1.5	-0.5	-1.7	-2.4
December forecast	1.6	0.8	-0.5	-1.9	-2.6
Change	**-1.2**	**-0.7**	**0.0**	**-0.2**	**-0.2**
of which:					
Nominal GDP	-0.3	0.3	0.6	0.3	0.2
ESA10/PSF review	-0.1	-0.1	-0.2	-0.4	-0.3
Autumn Statement measures	0.0	0.1	0.0	0.0	0.0
Other changes in borrowing	0.3	0.3	0.0	-0.1	0.0
Gilt premia	-0.4	-0.8	-0.3	-0.2	-0.1
Other	-0.7	-0.5	0.0	0.1	0.0

Welfare cap

5.16 The welfare cap was initially set in line with our March 2014 forecast for the items of spending that lie within it. This is our first assessment of the Government's performance against the cap. The *Charter* states that the Government can change the level of the cap to reflect neutral classification changes – such as movements of spending between DEL and AME – so long as the OBR certifies that they do not lead to a change in spending overall. Such a change has taken place at this Autumn Statement.

5.17 Given the distinction between forecasting assumptions and discretionary policy changes in the assessment of the cap, the classification of other 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.

5.18 Following scrutiny of developments that could have fallen into this grey area, the Treasury has chosen to present all of those that we considered to be at the discretion of the Government in its table of policy decisions. That has made for a simpler assessment of performance against the welfare cap than might otherwise have been the case.

5.19 Table 5.4 shows our forecast for spending inside the welfare cap in each year to 2018-19, as described in Chapter 4. Relative to the restated level of the welfare cap, our current forecast for welfare cap spending is higher in 2015-16 and 2016-17 and lower in 2017-18 and 2018-19. In 2015-16 and 2016-17, our post-measures forecast of spending exceeds the cap by 0.8 per cent and less than 0.1 per cent respectively, which is within the 2 per cent margin permitted for forecasting changes. The net effect of policy measures in these years is to reduce spending, so the excess of spending over the cap is due to forecast revisions not policy changes. On the basis of our central forecast, our assessment is therefore that the Government is on track to meet the welfare cap commitment.

Table 5.4: Performance against the welfare cap

	£ billion			
	Forecast			
	2015-16	2016-17	2017-18	2018-19
Welfare cap forecast March 2014	119.5	122.0	124.6	126.7
Neutral classification changes since March	0.3	0.3	0.3	0.3
Welfare cap	**119.7**	**122.3**	**124.8**	**127.0**
2 per cent forecast margin	2.4	2.4	2.5	2.5
Forecasting changes	**1.1**	**0.6**	**0.1**	**-0.3**
of which:				
Economic assumptions	-0.1	-1.1	-1.4	-1.5
CPI inflation	*-0.3*	*-1.3*	*-1.5*	*-1.5*
Average earnings	*0.2*	*0.1*	*0.1*	*0.1*
Other	*0.0*	*0.0*	*0.0*	*-0.1*
Estimating and modelling changes	1.2	1.7	1.5	1.1
Incapacity benefits	*0.8*	*1.1*	*0.9*	*0.6*
Disability living allowance and personal independence payment	*0.5*	*0.9*	*1.2*	*1.3*
Other	*-0.1*	*-0.3*	*-0.5*	*-0.8*
Other changes	0.0	0.0	0.0	0.1
Policy changes announced at Autumn Statement	**-0.2**	**-0.6**	**-1.0**	**0.2**
December forecast	**120.7**	**122.4**	**124.0**	**126.8**
Difference between forecast and welfare cap	0.9	0.1	-0.8	-0.1

Classification changes

5.20 One classification change is relevant to our current forecast. We have judged that spending associated with benefit overpayments written off by DWP, which were previously treated as an accounting adjustment in our forecasts, should be shown within welfare spending. Since this spending would have been present in our March 2014 forecast under this revised treatment, we consider this to be a neutral classification change. The Government has decided to increase the level of the cap by £0.3 billion a year as a result of this change.

Forecasting changes

5.21 Table 5.4 shows that our pre-measures forecast of welfare spending subject to the cap – adjusted for the classification change described above – is higher by £1.1 billion, £0.6 billion and £0.1 billion from 2015-16 to 2017-18 respectively, and £0.3 billion lower in 2018-19. The largest sources of upward revision are modelling changes associated with ongoing reforms to incapacity and disability benefits. These are partly offset by the effects of lower inflation on the uprating of most spending subject to the cap. The largest upward revision – in 2015-16 – is equal to less than 1 per cent of spending subject to the cap, well within the forecast margin of 2 per cent.

Policy changes

5.22 No policy changes would have been necessary to remain within the forecast margin above the cap. The Government has announced policy measures in the Autumn Statement that are estimated to reduce spending subject to the cap by £0.2 billion, £0.6 billion, and £1.0

billion from 2015-16 to 2017-18 respectively. The decision to delay the rollout of universal credit (scored as a policy change for the purposes of the welfare cap) is estimated to reduce spending subject to the cap by £0.1 billion, £0.4 billion and £0.9 billion in those years, while all other welfare cap measures have a net effect of reducing spending by £0.2 billion, £0.1 billion and £0.0 billion over the same period.

Recognising uncertainty

5.23 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.

5.24 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet the mandate in 2019-20 and to maintain welfare spending within the cap plus margin, but not on course to meet the supplementary target in 2015-16.

5.25 We do this in three ways:

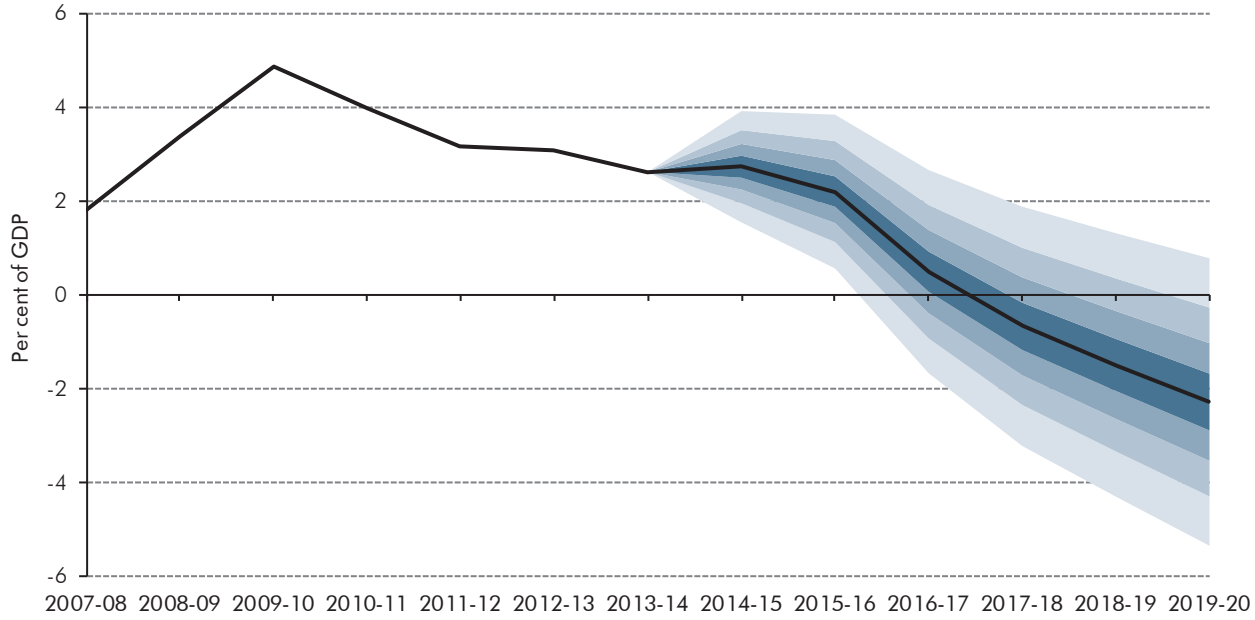
- by looking at the evidence from past forecast errors;
- by seeing how our central forecast would change if we altered some of the key judgements and assumptions that underpin it; and
- by looking at alternative economic scenarios.

Past performance

5.26 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.

5.27 In this spirit, Chart 5.3 shows the probability distribution around our central forecast for the CACB, 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 fan chart



Source: OBR

5.28 A direct reading of the chart would imply that the Government currently has a roughly 80 per cent probability of achieving a surplus on the CACB in 2019-20 and thereby meeting the mandate. The probability of achieving a surplus in earlier years is lower at around 75 per cent for 2018-19, 60 per cent in 2017-18, and just 5 per cent for 2015-16.

5.29 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 rising in 2015-16.

5.30 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. However, as highlighted in our October *Forecast evaluation report*, our underlying June 2010 forecast error for 2013-14 exceeded the 2 per cent forecast margin allowed for within the current cap – although the headline error was below the threshold due to additional welfare policy cuts. Our underlying March 2011 forecast for the same year was also 2.0 per cent, equal to the forecast margin.

Sensitivity analysis

5.31 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.

5.32 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 the recovery).

5.33 Our central forecast is based on a judgement that the economy was running 0.8 per cent below potential in the third quarter of 2014, and that the output gap will close slowly over the forecast period, reaching zero by mid-2019, around a year later than in March. 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?

5.34 Tables 5.5 and 5.6 present illustrative estimates of the impact on:

- the level of the CACB in 2019-20; and
- the change in PSND as a share of GDP between 2014-15 and 2015-16.

5.35 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.

5.36 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.

Table 5.5: Cyclically adjusted current budget in 2019-20

	Per cent of GDP					
		Output gap closes				
		2015-16	2017-18	2019-20	2021-22	2023-24
Level of potential in 2019-20 relative to central forecast (per cent)	-2	0.9	0.9	0.9	0.9	0.9
	-1	1.6	1.6	1.6	1.6	1.6
	0	2.3	2.3	2.3	2.3	2.3
	1	3.0	3.0	3.0	3.0	3.0
	2	3.7	3.7	3.7	3.7	3.7

Table 5.6: Change in public sector net debt between 2014-15 and 2015-16

		Per cent of GDP				
		Output gap closes				
		2015-16	2017-18	2019-20	2021-22	2023-24
Level of potential in 2019-20 relative to central forecast (per cent)	-2	2.3	1.5	1.3	1.2	1.1
	-1	1.3	1.1	1.0	1.0	1.0
	0	0.2	0.7	0.8	0.8	0.8
	1	-0.9	0.2	0.5	0.6	0.7
	2	-2.0	-0.2	0.2	0.4	0.5

5.37 Table 5.5 shows that the level of potential output has a big effect on the size of the CACB balance in 2019-20. The lower potential output is, and therefore the smaller the 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.

5.38 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 or from above would result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.

5.39 In broad terms, the level of potential output would need to be around 3¼ per cent lower in 2019-20 than in our central forecast to make it more likely than not that the mandate would be missed.

5.40 Table 5.6 shows that the Government would continue to miss its supplementary target, unless the output gap was materially wider than in our central forecast and closed faster. The former would imply less structural borrowing, whereas the latter would suggest less cyclical borrowing.

5.41 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 5-year forecast period, the impact of a shock to the average nominal interest rate on gilts is relatively small. In the supplementary fiscal tables available on our website, we present 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 2018-19, which closes 2019-20, implies that using different coefficients would have very little impact on the estimated CACB in 2019-20.

5.42 Our October 2014 *Welfare trends report* presented some illustrative ready-reckoners of the effect on welfare spending of different changes in some of the main economic determinants, as well as the past sensitivity of individual benefits to the output gap. In particular, inflation surprises represent a key risk to the welfare cap, as inflation errors would broadly translate into a one-for-one error in many benefits and tax credits through their effect on uprating. But there are many other broader risks highlighted in that report, including the potential for operational risks during a period of reform.

Scenario analysis

5.43 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 their occurrence.

5.44 As ever, the key judgement underpinning our forecast is about the long-awaited return of sustained productivity growth. This is necessary to finance private spending and to allow domestic producers to compete in export markets and with foreign producers in the domestic market. We currently forecast a gradual strengthening of potential productivity growth over the forecast period. 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. This issue has been, and remains, a subject of considerable debate among forecasters and economic commentators, some of whom have examined the potential impact on the public finances.[2]

5.45 Here we examine two scenarios:

- a 'weak productivity' scenario, in which the weakness of underlying trend productivity growth since the crisis persists over the next five years; and

[2] See for example, Broughton (2014): *SMF briefing paper: A deficit of growth: spending choices after 2015*.

- a 'strong productivity' scenario, where trend productivity growth picks up more strongly, broadly matching the strength seen during the early 1970s and early 1980s.

Weak productivity scenario

5.46 In this scenario we consider the implications of growth in actual productivity per worker remaining at ½ per cent over our medium-term forecast horizon – its average growth rate since 2008 – rather than gradually rising to the 2 per cent we forecast by 2019. We have not tailored this scenario to any one explanation of the post-crisis weakness, which we have discussed in previous *EFOs*. The key assumptions and implications are:

- the output gap profile is unchanged, closing at the same rate as in our central forecast – trend and actual growth are lower in equal measure. Lower productivity is assumed to flow one-for-one into lower average earnings. Inflation, unemployment and interest rates are therefore assumed to be unchanged relative to our central forecast. But living standards are materially lower, with the real consumption wage around 7 per cent below its pre-crisis peak by the end of the period;

- incomes move roughly in line with tax and benefit thresholds, so the fiscal drag we expect to see in the medium term, raising taxes and reducing welfare as shares of GDP, fails to materialise fully. Lower nominal GDP reduces receipts more broadly, with private sources of spending disproportionately affected;

- public sector spending beyond the current Spending Review period is similar to our central forecast, as it is determined by 2014-15 spending and the GDP deflator, both of which are stable. But departmental spending is squeezed further within that total by higher debt interest;

- borrowing falls much more gradually and net debt continues to rise as a share of GDP. The CACB remains in deficit in 2019-20, so the Government would miss its fiscal mandate; and

- we may expect that in such a scenario, welfare spending within the cap would rise for reasons not directly related to economic determinants, such as a higher take-up of benefits. Capturing the economy effects alone would suggest that the welfare commitment would still be met, partly due to weaker earnings reducing pension credit as well as increasing tax credits and housing benefit payments.

Strong productivity scenario

5.47 In this scenario productivity recovers more strongly than in our central forecast, growing at above its historical average rate, and broadly in line with the rates witnessed during the early 1970s and early 1980s. The key assumptions and implications of this scenario are:

- the output gap is again assumed to be unchanged – with trend and actual growth higher in equal measure – and therefore so are inflation, unemployment and interest rates. Productivity per worker quickly rises to an annualised growth rate of close to 4

per cent. Even under this scenario, the level of productivity remains almost 10 per cent below a simple extrapolation of its pre-crisis trend by the end of the forecast period, closing less than half of the gap relative to our central forecast;

- receipts are more buoyant, rising to a higher share of (higher) GDP. As well as additional fiscal drag on labour income, receipts are also geared on corporate incomes and asset prices, which we assume rise in line with stronger average earnings;

- public sector spending is little changed in cash terms given the spending assumption and therefore falls by a greater share of GDP. AME spending is lower, providing a little more headroom for departmental spending within the total;

- within AME, both debt interest and welfare spending subject to the cap are lower. But the triple lock increases state pensions spending, which lies outside the cap; and

- the deficit falls more rapidly, with the improvement entirely structural. Stronger GDP growth in 2015-16 leads to debt falling in that year, so the Government's supplementary target is met. The CACB also moves into a surplus a year earlier than in our central forecast.

5.48 Table 5.7 summarises the economic assumptions we have made, as well as the fiscal consequences of these alternative scenarios. It shows that under the weak productivity scenario the Government would miss its fiscal mandate in addition to its supplementary target, and have less headroom against its welfare cap. A strong productivity scenario would see all three targets met.

Table 5.7: Key economic and fiscal aggregates under alternative scenarios

	Per cent of GDP, unless otherwise stated					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Central forecast						
Economic assumptions						
GDP (percentage change)	3.0	2.2	2.2	2.4	2.3	2.3
Fiscal outcome						
Welfare cap margin (per cent)		0.8	0.0	-0.6	-0.1	
Public sector net borrowing	5.0	4.0	2.1	0.7	-0.2	-1.0
Cyclically adjusted current budget	2.7	2.2	0.5	-0.7	-1.5	-2.3
Public sector net debt	80.4	81.1	80.7	78.8	76.2	72.8
Weak productivity scenario						
Economic assumptions						
GDP (percentage change)	2.8	1.2	1.0	0.9	0.8	0.7
Fiscal outcome						
Welfare cap margin (per cent)		0.9	0.4	0.0	0.9	
Public sector net borrowing	5.1	4.6	3.2	2.5	2.2	2.0
Cyclically adjusted current budget	2.8	2.7	1.6	1.1	0.9	0.8
Public sector net debt	80.6	82.6	84.2	85.1	85.9	86.6
Strong productivity scenario						
Economic assumptions						
GDP (percentage change)	3.4	4.1	4.0	3.9	3.8	3.7
Fiscal outcome						
Welfare cap margin (per cent)		0.5	-0.6	-1.7	-1.6	
Public sector net borrowing	4.8	3.0	0.3	-1.6	-3.1	-4.4
Cyclically adjusted current budget	2.5	1.2	-1.3	-3.0	-4.4	-5.7
Public sector net debt	79.9	78.3	74.9	69.8	63.7	56.7

A Autumn Statement 2014 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. After this scrutiny process is complete, the Government chooses which measures to implement and which costings to include in its table of policy decisions. We then 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 Autumn Statement, we have certified all the costings of tax and annually managed expenditure (AME) measures that appear in the Government's policy decisions tables as reasonable and central. These tables are reproduced in this annex as Tables A.1 and A.2, with further details set out in Chapter 4 of the *EFO* and in the Treasury's *Autumn Statement 2014 policy costings document*, which summarises the methodologies used to produce each costing and provides some information on the main areas of uncertainty within each.

Uncertainty

A.3 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 this *EFO*, we have 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.4 Under our new approach, we have assigned each certified costing a subjective uncertainty rating, which are shown alongside the costings in Tables A.1 and A.2. These 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 measure. We take into account the relative importance of each source of uncertainty for each costing.

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

		Head	£ million						
			2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	Uncertainty
Households									
1	Personal Allowance: increase to £10,600 in 2015-16 with full gains to higher rate taxpayers	Tax	0	-530	-635	-640	-655	-655	Medium
2	ISAs: transfer to surviving spouses	Tax	0	*	*	-5	-5	-10	Medium
3	Air Passenger Duty: exempting children	Tax	0	-40	-80	-85	-90	-95	Medium-low
Property									
4	Stamp duty land tax reform: new marginal rate system	Tax	-395	-760	-840	-850	-815	-785	Medium-high
5	Enveloped dwellings: increase charge for properties over £2m	Tax	+10	+95	+50	+45	+90	+140	Medium
Business and employment									
6	Employer NICs: abolish for apprentices under 25	Tax	0	0	-105	-110	-120	-125	Medium-high
7	Business Rates: small business relief extension	Tax	0	-500	+70	+5	0	0	Medium-low
8	Business Rates: cap increase at 2% in 2015-16	Tax	0	-125	-90	-85	-85	-85	Low
9	Business Rates: increase retail discount to £1,500 in 2015-16	Tax	0	-130	+20	+5	0	0	Low
10	Business Rates: transitional relief	Tax	0	-10	-5	0	0	0	Medium-low
11	Employment Allowance: extend to carers	Tax	0	-10	-10	-10	-10	-10	High
12	R&D tax relief: increase large firms and SME credit	Spend	0	-40	-	-	-	-	Medium-low
13	R&D tax relief: changes to qualifying expenditure	Spend	0	+20	-	-	-	-	Medium
Investment and growth									
14	High value manufacturing catapult	Spend	0	-25	-	-	-	-	N/A
15	R&D: innovation funding	Spend	0	-70	-	-	-	-	N/A
16	Higher education: postgraduate loans	Spend	0	-15	-	-	-	-	N/A
17	Entrepreneurs' Relief: reinvested gains	Tax	0	0	-5	-5	-5	-5	Medium-low
18	Social investment tax relief	Tax	0	0	-10	-15	-20	-25	Medium-high
19	Peer-to-peer lenders: bad debt relief	Tax	0	0	-10	-15	-20	-25	Medium
20	Supporting first-time exporters	Spend	0	-20	-	-	-	-	N/A

Energy and environment									
21	Oil and gas: 2% cut to Supplementary Charge	Tax	0	-55	-60	-50	-65	-60	Medium-low
22	Oil and gas: support for investment	Tax	0	-5	-15	-15	-10	-95	Medium-high
23	Household energy efficiency incentives	Spend	-30	-70	-	-	-	-	N/A
24	Support for off-gas-grid households	Spend	0	-30	-	-	-	-	N/A
25	Corporation tax: flood defence relief	Tax	*	-5	-5	-5	-5	-5	Medium
Community									
26	Schools and children	Spend	0	-40	-	-	-	-	N/A
27	Culture and sport	Spend	-5	-30	-	-	-	-	N/A
28	Listed places of worship: support for repairs	Spend	-15	*	-	-	-	-	N/A
29	VAT: support for search & rescue and hospices	Tax	-5	-10	-5	-5	-5	-5	Low
Base erosion and profit shifting (BEPS)									
30	Diverted profits tax	Tax	0	+25	+270	+360	+345	+355	Medium-high
31	Corporation tax: hybrids	Tax	0	0	+15	+70	+85	+90	High
32	Corporation tax: country-by-country reporting	Tax	0	+5	+5	+10	+10	+15	Very high
Avoidance, tax planning and fairness									
33	Corporation tax: accounting treatment of credit losses	Tax	0	0	+5	+10	+240	+40	Medium
34	Corporation tax: bank losses restriction	Tax	0	+695	+765	+705	+695	+625	Very high
35	Non-domiciles: increase remittance basis charge	Tax	0	0	+120	+90	+90	+90	Medium
36	Self-incorporation: intangible assets	Tax	+5	+30	+80	+110	+135	+155	Medium
37	Investment managers' disguised fee income	Tax	0	*	+160	+80	+65	+55	Medium-high
38	Stamp duty on shares: schemes of arrangement	Tax	*	+65	+65	+55	+50	+50	Medium-high
39	Special purpose share schemes	Tax	0	0	+45	+40	+40	+40	Medium-high
40	Income tax: miscellaneous losses	Tax	0	+5	+5	+5	+5	+5	Medium
41	Venture capital schemes: restrictions on use	Tax	0	-15	+30	+10	+10	+10	Medium-high
42	Income tax: salary sacrifice and expenses, including umbrella companies	Tax	0	0	+120	+90	+75	+75	Very high
43	Office of Tax Simplification: review of expenses	Tax	0	-10	-5	-10	-10	-10	Medium
44	DOTAS regime changes	Tax	0	*	*	+30	+50	+70	High

45	HMRC: operational measures	Tax	0	-10	+260	+365	+145	+55	Medium-high
46	Corporation tax: accelerated payments and group relief	Tax	0	+425	-345	-40	-30	0	Medium-high
Previously announced									
47	Counter-terrorism funding	Spend	-20	-110	-	-	-	-	N/A
48	Pensions flexibility: decisions since Budget 2014	Tax	0	+60	-25	-25	+30	-10	Very high
49	Rail fares cap for 2015	Spend	-25	-95	-	-	-	0	N/A
50	Glasgow City Deal	Spend	0	-15	-	-	-	-	N/A
51	Migrant access to benefits	Spend	0	+15	-	-	-	-	Medium
52	Pool Reinsurance Limited: increased fee	Spend	+50	+175	+175	+175	+175	+175	N/A
Other									
53	Peer-to-peer lenders: withholding tax regime	Tax	0	0	0	+60	+10	+35	Medium
54	Public service pensions: next steps in revaluation	Spend	0	+335	+365	+375	+385	+390	Medium
55	Special Reserve	Spend	+200	0	-	-	-	-	N/A
56	Total fiscal impact of welfare cap measures[3]	Spend	-20	+150	-	-	-	-	See Table A.2
Health									
57	Foreign Exchange fines	Tax	+1,115	0	0	0	0	0	Low
58	NHS: fund to upgrade GP services[4]	Spend	0	-295	-295	-295	-295	0	N/A
59	Mental health and dementia	Spend	0	-45	-	-	-	-	N/A
TOTAL POLICY DECISIONS			**+865**	**-1,030**	**+75**	**+410**	**+450**	**+425**	
Total spending policy decisions			+130	-470	+240	+250	+260	+565	
Total tax policy decisions			+735	-560	-165	+160	+190	-140	
Memo: NHS funding from the Reserve, reflected in 2015-16 spending numbers[4]		*Spend*	*0*	*-1,200*	-	-	-	-	

** Negligible*

[1] Costings reflect the OBR's latest economic and fiscal determinants.

[2] 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.

[3] See Table A.2.

[4] Spending numbers include allocations for Scotland, Wales and Northern Ireland.

Table A.2: HM Treasury table of welfare cap policy decisions and OBR assessment of the uncertainty of costings

		£ million						
		2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	Uncertainty
Previously announced meaures								
a	Universal Credit: updated delivery schedule[3]	*0*	+55	+425	+915	-110	-395	Medium-high
b	Universal Credit: supporting 85% of childcare costs	*0*	0	-10	-130	-245	-310	Medium
c	Employment and Support Allowance: additional healthcare professionals	*0*	+30	+125	+95	+75	0	Medium
d	Employment and Support Allowance: restricting repeat claims	*0*	+25	+25	+10	+10	+15	Medium
e	Personal Independence Payment: updated delivery schedule	*-30*	-85	-45	-5	-10	0	Medium-low
f	Pensions flexibility: notional income rules for benefits	*0*	*	*	-5	-5	-5	Low
g	Bereavement benefits reform	*0*	0	0	-40	-35	-15	Medium-low
Universal Credit								
h	Simplifying assessment periods	*0*	-5	-10	-20	-25	-25	Medium
i	Work allowances: maintain current level in 2017-18	*0*	0	0	+60	+115	+145	Medium-low
Operational policy decisions								
j	DWP fraud and error: additional capacity	*0*	+45	+10	+5	-10	0	Medium
k	DWP fraud and error: local authority incentive scheme	*+10*	+65	+5	0	0	0	Medium
l	Tax credits: prevent overpayments following change of circumstances in-year	*0*	+60	+40	+30	+15	+10	Medium-low
m	Tax credits: self-employment tests for Working Tax Credit	*0*	+45	+45	+30	+15	+10	Medium-high
Other policy decisions								
n	Pension credit passthrough	*0*	-10	*	+5	+10	+15	Low
o	Carer's allowance: higher earnings limit	*0*	-5	-10	-20	-20	-20	Medium
p	Welfare cap impacts of other policy decisions[4]	*0*	-15	-5	+20	+20	+10	N/A
	Total impact of policy decisions on welfare cap	*-20*	**+205**	**+595**	**+950**	**-200**	**-565**	
	Total fiscal impact of welfare cap policy decisions[5]	**-20**	**+150**	**-**	**-**	**-**	**-**	

** Negligible*

[1] Costings reflect the OBR's latest economic and fiscal determinants.

[2] 2014-15 is not covered by the welfare cap.

[3] This reflects the updated delivery schedule announced by the government in October 2014, and the OBR's additional judgements as set out in their Economic and Fiscal Outlook.

[4] This reflects the impacts on benefits within the welfare cap of non-welfare measures, such as the impact of the Personal Allowance changes on UC entitlement.

[5] This reflects the total impact (both inside and outside the cap) of the welfare measures in this table, including impacts on non-welfare cap benefits and DWP DEL funding.

A.5 Table A.3 shows the detailed criteria and applies them to a sample policy measure from this Autumn Statement: 'Air passenger duty: exempting children', which is estimated to cost £80 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 the data, with the least important being behaviour. The data used to estimate this measure are high quality HMRC administrative data, so we consider this to be a 'low' source of uncertainty. The likely behavioural response is reasonably clear: lower post-tax prices for children's flights would be expected to increase demand. But this has only a relatively small impact on the costing, so we deem this a 'medium-low' source of uncertainty. The modelling is more problematic, as assumptions have to be made about the proportion of children travelling in each APD band and how those will change over the forecast period. So we regard this as a 'medium' source of uncertainty. Taking all these judgements into account, we have assigned the costing an overall uncertainty rating of 'medium-low'.

Table A.3: Example of assigning uncertainty rating criteria: 'Air passenger duty: exempting children'

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

A.6 In this Autumn Statement, we have judged seven measures in the policy decisions table to have 'high' or 'very high' uncertainty around the central costing. These represent 12 per cent of the measures in the Autumn Statement by number and 16 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 £4.2 billion in total over the scorecard period. The reasons for their ratings are as follows:

- **pensions flexibility: decisions since Budget 2014**: This costing receives a 'very high' uncertainty rating. The yield over the scorecard period – and the resulting costs in the longer term – depends on take-up and on other behavioural responses. Some people will temporarily increase pension saving in order to benefit from tax-free lump sum withdrawals. It is possible that funds will be redirected from annuities and into other assets, such as other financial products or housing. It is also possible that such funds could be used to finance consumer spending;

- **corporation tax: bank losses restriction:** This costing receives a 'very high' uncertainty rating. The measure restricts banks' ability to set their accumulated losses off against their taxable profits. The yield from this measure is based on uncertain assumptions around the profitability of banks over the scorecard period – a key source of uncertainty in our corporation tax receipts forecast – and their behavioural response to this measure. In particular, we consider the modelling to be both complex and important for the costing. If the banking sector makes higher or lower than expected gross profits over the next few years then the yield from this measure could be considerably higher or lower;

- **exemption on qualifying expenses:** This costing receives a 'very high' uncertainty rating. The measure replaces the 'dispensations' regime with an exemption for qualifying expenses payments, introducing a new rule that the exemption cannot be used in conjunction with salary sacrifice arrangements. HMRC does not hold detailed information in this area and so the costing relied on uncertain external data sources. There are also a large number of behavioural adjustments in the costing that reduce the post-behavioural yield significantly relative to the static costing and are subject with significant uncertainty;

- **base erosion and profit shifting – country-by-country reporting:** This costing receives a 'very high' uncertainty rating. The measure will result in UK multinational corporations filling in a template giving financial information, including tax paid, in each of the jurisdictions where they have a presence. 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 profit shifting that will be captured by this measure. This measure is expected to lead to increased compliance by multinational corporations whose behaviour is very hard to predict;

- **base erosion and profit shifting – corporation tax: hybrids:** This costing receives a 'high' uncertainty rating. The measure implements the proposed OECD rules on hybrid mismatch arrangements, used by companies to gain tax deductions in two jurisdictions for a single payment or to claim a deduction with no corresponding receipt. There is a high level of uncertainty with both the data and behaviour in this costing. The data used to produce the costing is based on incomplete HMRC data and external sources. The behaviour change is likely to be volatile and large due to the characteristics of the companies targeted by this measure;

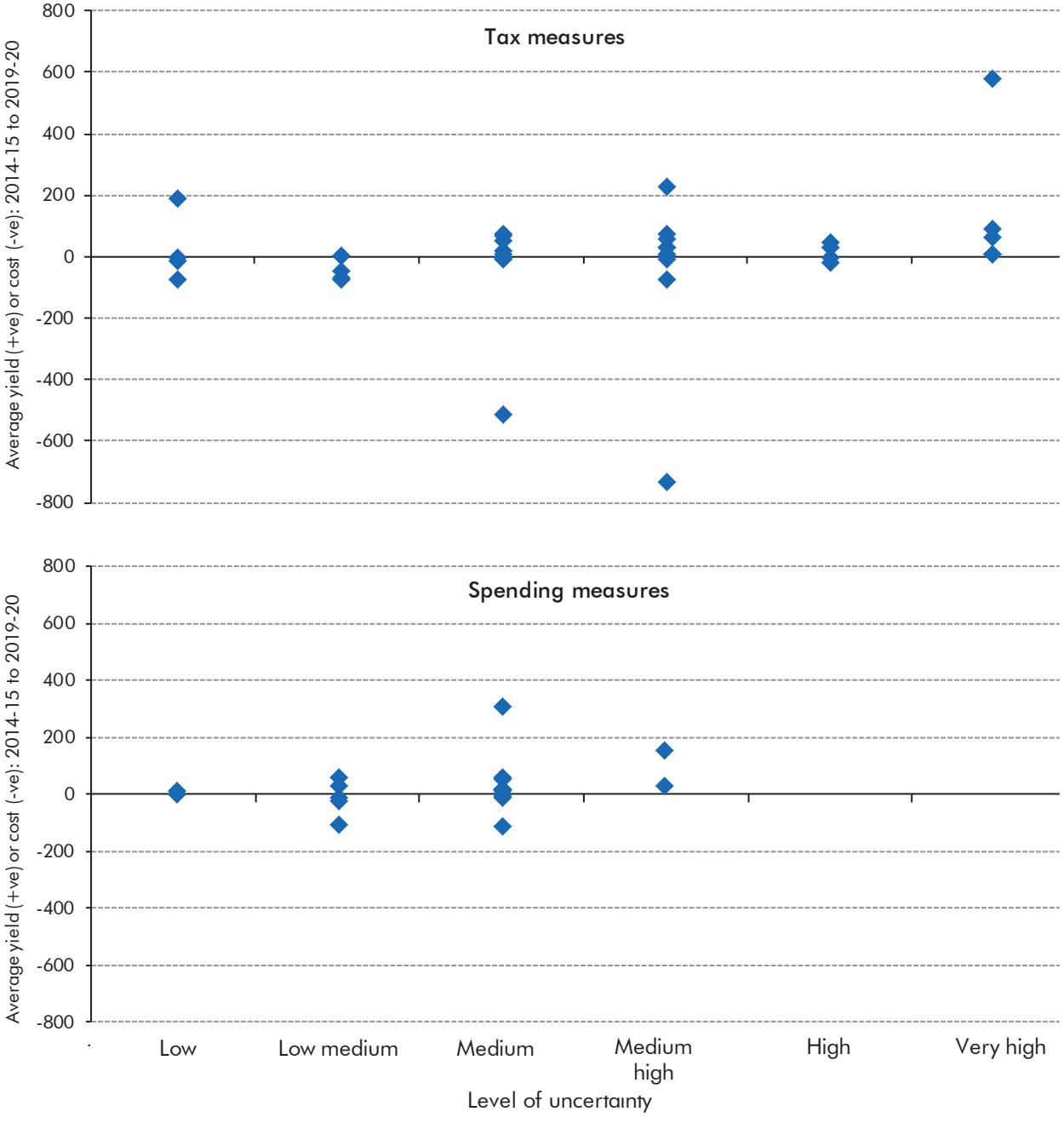
- **employment allowance: extend to carers:** This costing receives a 'high' uncertainty rating. The measure extends the employment allowance to employers of domestic care workers. HMRC does not have detailed information on the amount of employers who will be affected and therefore the costing relies on uncertain external data sources; and

- **DOTAS regime changes:** This costing receives a 'high' uncertainty. The aim of this measure is to expand the existing set of DOTAS hallmarks to identify and tackle avoidance that is not being disclosed. There is likely to be a highly uncertain

behavioural response as the DOTAS regime targets a specific subset of taxpayers who are already actively changing their behaviour in response to the tax system.

A.7 We have judged 23 measures to have 'low-medium' or 'high-medium' uncertainty around the central costing, with a further 6 costings having 'low' uncertainty. That means that 77 per cent of the Autumn Statement measures have been placed in the medium range (78 per cent by absolute value) and 11 per cent have been rated as low uncertainty (6 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



Anti-avoidance costings

A.8 The revenue impact of anti-avoidance measures tends to be particularly uncertain. This has been borne out by an evaluation of past measures. The Treasury Select Committee's report on Autumn Statement 2013 recommended that we report on whether the yields from anti-avoidance measures were attained as originally costed. We have presented our findings in Box 4.2 of the *EFO*. This exercise has confirmed that such costings are subject to significant uncertainty – these measures often target a specific subset of taxpayers who are already actively changing their behaviour in response to the tax system. It also suggests that there has not been systematic bias across the costings: while the shortfall from the UK-Swiss tax agreement means that the total yield from the measures reviewed was lower than expected, across other measures there were both upside and downside surprises. We will continue to work with HMRC to review the performance of anti-avoidance measures and ensure that the lessons learnt are applied when we look at future policy costings in these areas.

Pensions flexibility measures

A.9 Our forecast reflects the expected effect of further changes to the rules governing people's access to their pension assets announced in the Autumn Statement, and an updated assessment of the effect of the changes announced in Budget 2014. Relative to the amounts incorporated in our March forecast, these effects are small. But both the latest adjustments and the original estimate are small relative to the uncertainty associated with the large financial flows that are likely to result from the changes. Among other effects, these include:

- flows out of pension assets for some people incentivised by the reduction in the tax charge and the removal of the requirement to annuitise, which could flow into other financial and real (e.g. housing) assets or immediate spending. Such withdrawals would raise income tax receipts as they happen, but reduce them later; and

- flows into pension assets for some people incentivised by the more flexible access to that tax-efficient saving in the future, which could reduce amounts that would have otherwise flowed into other financial and real assets, or spending if those people saved more to maximise their post-tax returns from this saving.

A.10 We have assumed that these flows will increase income tax receipts in the forecast period, but reduce NICs, which are only affected by greater flows into pension assets. We have also assumed that the effect of flows into other financial and real assets, and consumer spending, will net off. But that reflects the lack of any strong evidence to assume one effect will be larger than the other. In reality, the effect is very unlikely to be perfectly neutral.

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 £25 million in any year;

- there is a good degree of certainty over the tax base;
- it is analytically straightforward;
- there is a limited, well-defined behaviour response; and
- it is not a contentious measure.

A.12 The small measures process has been particularly helpful at this Autumn Statement due to the unusually large number of measures we have been asked to scrutinise.

A.13 A good example of a small measure announced at Autumn Statement 2014 is 'VAT refunds: search and rescue'. This costing was based on qualifying expenditure from published accounts, the modelling involves simple assumptions about the proportion of expenditure that is standard-rated for VAT, and there was judged to be no behavioural response that could plausibly lead to a cost above the small measures cap.

A.14 By definition, any costings that meet all of these conditions will have a maximum uncertainty rating of 'medium'.

Indirect effects on the economy

A.15 The measures in the Autumn Statement do not, in aggregate, alter our GDP growth forecast. The Government has announced a number of measures taking effect between 2014-15 and 2019-20 that are expected to have a neutral fiscal impact overall, with 'giveaways' offsetting 'takeaways' over this period. Further details are provided in Box 3.1

A.16 The immediate reforms to stamp duty land tax announced in the Autumn Statement are likely to have significant effects on the UK housing market. The main effect is likely to be distributional – house prices and transactions will be lifted at lower prices (where the effective tax rate has been reduced) and will be depressed at higher prices (where the effective tax rate has risen). These effects are reflected in the costing of the measure (described in Box 4.5) rather than via our economy forecast.

A.17 We have, however, increased the overall volume of property transactions by an eventual 1.1 per cent to reflect the fact that the volume-weighted effective tax rate has been reduced – i.e. that the costs associated with the vast majority of transactions will be slightly cheaper, more than offsetting the small number where they will be significantly more expensive. As property transactions contribute directly to the measure of residential investment in GDP, we have also adjusted our residential investment forecast upwards by an eventual 0.2 per cent. We assume that this affects the composition of GDP rather than the overall size of the economy, since we have not assumed that the policy raises whole economy productivity.

A.18 We have not adjusted our economy forecast in light of the further changes to the rules governing people's access to their pension assets announced in the Autumn Statement, or our updated assessment of the effect of the changes announced in Budget 2014.

Departmental spending

A.19 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.

Total managed expenditure beyond the Spending Review

A.20 Beyond the years for which the Government has set detailed spending plans, our forecasts are based on the Government's assumption for the growth in Total Managed Expenditure (TME). While changes in this assumption do not 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. The changes that have resulted at this Autumn Statement are described in Chapter 4 of the *EFO*.

Index of charts and tables

Chapter 3 Economic outlook