Office for Budget Responsibility: Economic and fiscal outlook

Presented to Parliament by
the Economic Secretary to the Treasury
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Contents

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 2018-19. 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. 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 full-time 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 (HMRC), the Department for Work and Pensions (DWP), 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, Transport for London, 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 Bank of England and the National Institute for Economic and Social Research, regarding their recent forecasts, for which we are very grateful.

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

- In January, the Treasury requested that we finalise the Budget forecast on a 'pre-measures' basis (i.e. before incorporating the effect of new policy announcements) around two weeks ahead of the Budget in order to provide the Chancellor with a stable base for his final policy decisions.

- We began the forecast process with the preparation by OBR staff of a revised economic forecast, drawing on economic data released since the last published forecast in December 2013 and with our preliminary judgements on the outlook for the economy.

- 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 31 January and our first fiscal forecast, including a provisional judgement on progress towards meeting the fiscal mandate, on 13 February. We provided the Chancellor with these early forecasts and provisional judgement on compliance with the fiscal mandate in order to inform his policy choices for the Budget.

- As the forecasting process continued, we identified the key judgements that we would have to make in order to generate our full economic forecast. Where we thought it would be helpful, we commissioned analysis from the relevant experts in the Treasury and consulted outside forecasters 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 26 February.

- Meanwhile, we also began to scrutinise the costing of tax and spending measures that were being considered for announcement at the Budget. The OBR requested a number of changes to the draft costings prepared by HMRC, DWP and other departments. We have certified the final published costings for new Budget policies as reasonable and central estimates. In the Treasury's Budget 2014 policy costings document, we highlight the uncertainties around many of these costings.

- 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 7 March, and we met with him and Treasury officials to discuss it on 10 March. Alongside our third fiscal forecast, we provided a pre-measures forecast of spending subject to the Government's new welfare cap.

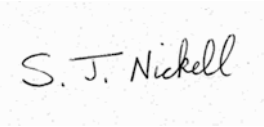
- During the week before publication we produced our final forecast, incorporating the effects of the final package of policy measures. We were provided with final details of all major policy decisions with a potential impact on the economy forecast on 11 March. We provided the Treasury with our final post-measures forecast on 13 March. Our final fiscal forecast included the direct fiscal effects of the full set of Budget policy decisions, the final version of which was provided to us on 14 March.

- At the Treasury's written request, and in line with pre-release access arrangements for data releases from the ONS, we provided the Chancellor with a full draft of the *EFO*

on 14 March. 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 around 50 scrutiny and challenge meetings with officials from 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 The UK economy has continued to recover. In the final quarter of 2013, GDP growth matched our December forecast, inflation fell back to target and unemployment dropped more quickly than expected. But productivity and wage growth remained disappointing.

1.2 Revised data published since our last forecast suggest the economy grew slightly faster over 2013 as a whole than we expected in December, with GDP up 1.8 per cent on the previous year. Consumer spending, supported by a falling saving ratio, has been the biggest driver of recent growth, while the latest data suggest business investment is recovering. Housing market indicators have picked up sharply, but export performance remains disappointing.

1.3 Given the momentum the economy carried into 2014, we have revised our GDP growth forecast up slightly to 2.7 per cent in 2014 and 2.3 per cent in 2015. We expect quarterly growth rates to ease through 2014 as consumer spending growth slows to rates more aligned with household income growth. The outlook for productivity growth, which underpins income growth and the sustainability of the recovery, remains the key uncertainty. We expect inflation to remain close to target and unemployment to continue falling in the coming years, though at a slower pace than in recent months.

1.4 We estimate that activity in the economy was 1.7 per cent below its sustainable potential level at the end of 2013, a slightly narrower output gap than in our December forecast. This is consistent with the unexpectedly large fall in the unemployment rate to 7.2 per cent in the fourth quarter. Combining this narrower output gap with a slightly stronger GDP growth forecast, we now expect the economy to return to normal capacity and the output gap to close by mid-2018, around a year earlier than forecast in December.

1.5 Public sector net borrowing (PSNB) – the gap between what the Government spends and raises in revenue – is expected to be £107.8 billion this year (measured on an underlying basis, excluding transfers related to the Royal Mail Pension Plan and quantitative easing). This is £3.4 billion lower than our December forecast and £7.0 billion lower than in 2012-13. Borrowing is forecast to fall by a further £12.4 billion in 2014-15, to £95.5 billion, moving below £100 billion for the first time in six years. The largest drivers of our downward revisions to borrowing in 2013-14 are an upward revision to stamp duty receipts (due to higher house prices and property transactions) and a downward revision to debt interest costs (due to lower inflation). But borrowing in 2014-15 is little changed from our December forecast, in part because we expect social security spending to be higher and because stronger growth in the UK is expected to raise EU contributions in that year (an effect we expect to unwind in the future due to the UK rebate).

1.6 We have revised borrowing lower in each subsequent year of the forecast, reflecting stronger receipts in every year and slightly lower spending from 2015-16, including the effects of policy measures. The downward revision averages almost £6 billion a year from 2015-16 to 2017-18, before falling to £2.6 billion in 2018-19. The improvement in 2018-19 is smaller because of slower GDP and employment growth, once the output gap has closed, and the Government's assumption that it will raise total public spending in line with whole economy inflation in that year, the forecast for which we have revised higher since December. In 2018-19, we forecast the public finances to move into surplus for the first time in 18 years.

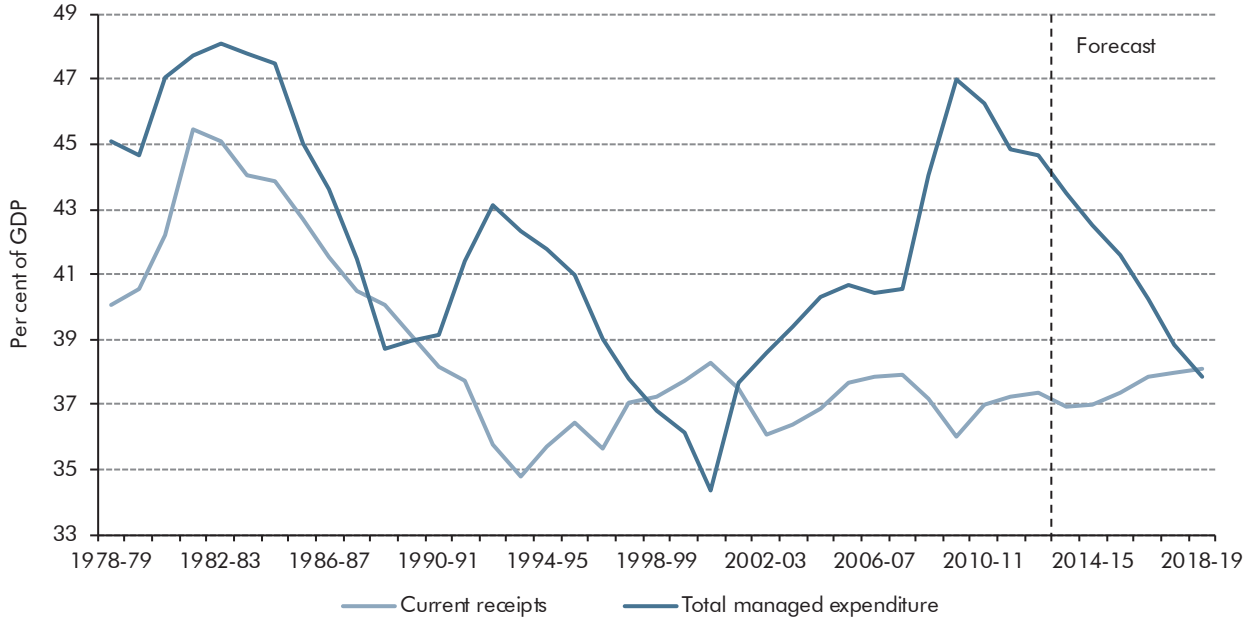
1.7 The tax and spending measures that the Treasury has included in its Budget policy decisions table have little cumulative effect on borrowing over the forecast, with a £5½ billion cumulative net tax cut offset by a £5¾ billion cumulative reduction in spending. The net tax cut reflects the partly offsetting effects of a number of measures that reduce receipts – including raising the income tax personal allowance, the package of savings measures and the temporary increase in the annual investment allowance to £500,000 – and others that increase receipts – including accelerated payments in anti-avoidance cases and the income tax associated with more flexible access to pension assets. Spending cuts are focused in the years from 2016-17 to 2018-19, for which detailed plans have not yet been set. The Government has also made spending commitments related to energy intensive industries in this Budget that it estimates will cost around £0.5 billion a year from 2016-17.

1.8 A number of measures have markedly different implications for revenue beyond the 5-year scorecard period than within it. These include: the pension withdrawals measure, which brings forward income tax receipts but has a small steady-state cost in the long term; voluntary NICs, which increases NICs receipts in the short term but also increases long-term state pension costs; the temporary annual investment allowance increase, which raises the amount of tax relief that can be claimed until December 2015, but then reduces it thereafter, largely recouping the scorecard costs; and accelerated payments related to tax avoidance schemes, which brings forward receipts from future years.

1.9 The net effect of these measures is to increase receipts over the scorecard horizon by £1.2 billion a year on average, but the revenue raised then drops sharply in 2019-20 and averages only £0.2 billion a year over the 15 years beyond the scorecard period. Given the uncertainty associated with costing these policy measures over a 5-year horizon, the longer-term implications will be also be subject to considerable uncertainty.

1.10 Our forecast implies that by 2018-19 the UK's budget deficit will have fallen by 11.2 per cent of GDP from its post-war peak in 2009-10 (around £190 billion in today's terms). Just over 80 per cent of the reduction is accounted for by lower public spending. This will take government consumption of goods and services – a rough proxy for day-to-day spending on public services and administration – to its smallest share of national income at least since 1948, when comparable National Accounts data are first available. Just under 20 per cent of the drop in borrowing is accounted for by higher receipts, with the majority having taken place by 2012-13, largely as result of rises in the standard rate of VAT.

Chart 1.1: Total public sector spending and receipts



Source: ONS, OBR. Excludes Royal Mail and APF transfers.

1.11 The Government's 'fiscal mandate' requires it to balance the cyclically-adjusted current budget (CACB) – the amount the Government has to borrow to finance non-investment spending, adjusted for the state of the economy – five years ahead. In December, we forecast that the CACB would be in surplus by 1.6 per cent of GDP in 2018-19. We now forecast the surplus in 2018-19 to be 1.5 per cent of GDP, fractionally less than we forecast in December. This reflects the net effect of lower assumed spending beyond the current Spending Review period, including the further spending reductions from Budget policy measures in that year, and receipts being slightly lower as a share of GDP despite a narrower output gap.

1.12 The Government's supplementary target is for public sector net debt (PSND) to be falling as a share of GDP in 2015-16. As in each forecast we have produced since December 2012, we expect PSND still to be rising in that year. We now expect PSND to peak at 78.7 per cent of GDP in 2015-16, to fall by a small margin in 2016-17 and then to fall more rapidly to 74.2 per cent of GDP by 2018-19. Debt as a share of GDP is lower in each year of our forecast than in December, reflecting lower borrowing and upward revisions to our nominal GDP forecast.

1.13 Needless to say, there is huge uncertainty around all public finance projections, which increases over longer time horizons. We stress test the Government's chances of achieving its targets using sensitivity and scenario analysis. A key risk is that potential output turns out to be lower over the coming five years than we currently assume. More of the deficit would then be structural and would remain after the economy recovers.

Economic developments since our previous forecast

1.14 GDP growth in the fourth quarter of 2013 was in line with our December forecast at 0.7 per cent. Revised data suggest growth in the first half of the year was stronger than previously estimated, so growth in the year as a whole was 1.8 per cent, a little faster than the 1.4 per cent we forecast in December. Consumer spending was the main driver of growth in 2013, with lower saving playing a bigger role than higher incomes in financing the rise in spending through the year. Revised data now suggest that business investment picked up in 2013, rising 8.5 per cent in the year to the final quarter – although further revisions are highly likely. Inflation fell a little more than we expected, with the latest rate below the Bank of England's inflation target of 2 per cent for the first time since late 2009.

1.15 Despite the forecast revisions we made in December, labour market data continued to surprise us with lower unemployment, higher employment and lower wage growth than we had expected in the final quarter of 2013. Productivity growth remains very weak. Output per hour was just 0.2 per cent higher in the second half of 2013 than in the first half.

1.16 Housing market indicators accelerated. House prices increased 5.5 per cent in the final quarter of the year on the ONS measure, with lenders' price indices showing some sharp monthly increases so far this year. Mortgage approvals point to continued growth in activity, rising by 42 per cent in the year to January. There are also signs of this feeding through to construction, with housing starts up 33 per cent in the year to mid-2013. But reports of shortages in building materials and skilled labour suggest the housing supply response may be constrained in the short term.

The economic outlook

1.17 Given the momentum the economy carried into 2014, we have revised up our forecast for GDP growth in 2014 by 0.3 percentage points to 2.7 per cent, in line with the average of outside forecasts, and in 2015 by 0.1 percentage points to 2.3 per cent, slightly below the outside average. The largest source of upward revision in 2014 is business investment, following further extensive revisions to 2013 data.

1.18 Consumer spending increased faster than household disposable incomes in 2013, reducing the saving ratio to an estimated 5.0 per cent from 7.2 per cent in 2012. We expect consumption growth to slow to rates more aligned with household income growth during 2014. However, income growth should be boosted by a recovery in productivity growth, though employment growth is expected to slow from recent high rates.

1.19 Unemployment fell to 7.2 per cent in the final quarter of 2013, 0.2 percentage points below our December forecast. Partly reflecting this, we estimate the output gap to have been -1.7 per cent of GDP in that quarter, 0.2 percentage points narrower than our December estimate. We continue to judge that much of the recovery in 2013 can be attributed to stronger demand that was not accompanied by improved underlying supply potential. That judgement is supported by weak productivity growth, tighter labour market conditions and the fall in the saving ratio.

1.20 The combination of a slightly stronger near-term outlook for GDP growth and a slightly narrower output gap than forecast in December means the output gap is now expected to close by mid-2018, around a year earlier than in our December forecast. Since we assume that growth will be in line with its trend rate once the output gap has closed, rather than forecasting further cyclical fluctuations around that trend, we have revised our GDP growth forecast in 2018 down slightly to 2.5 per cent.

1.21 We are conscious that forecast revisions tend to lag economic developments at turning points, leading to repeated overestimates of economic activity in downturns and repeated underestimates when activity finally picks up. But the experience of 2010 provides a recent example of what appeared to be a turning point in the cycle ebbing as the factors needed to generate self-sustaining recovery failed to take hold. And with productivity growth, real income growth and UK export markets remaining weak, and risks in the euro area and emerging markets remaining, our central forecast assumes that growth slows to rates of around 0.6 per cent a quarter through 2014 and 2015, with risks to both the upside and downside.

1.22 While most discussion of economic forecasts focuses on real GDP, the key driver of our fiscal forecast is nominal GDP – the cash value of economic activity – and its composition. This reflects developments in real GDP and whole economy inflation. Nominal GDP is higher across the forecast than in December. That mainly reflects stronger than expected nominal GDP growth in the final quarter of 2013 and slightly higher expected GDP deflator growth looking forward, thanks to a change in the way we forecast the private consumption deflator. Overall, we forecast nominal GDP to grow by 5.0 per cent in 2014, to dip to 4.0 per cent in 2015 and to average around 4½ per cent a year thereafter. The dip in 2015 is explained by strong growth in the second half of 2013 lifting the 2014 annual average growth rate, rather than an expectation that quarterly growth rates will slow in 2015.

1.23 With regards to the composition of nominal GDP:

- in **income** terms: labour income is forecast to grow more slowly than GDP in the near term, as employment growth slows and productivity and earnings growth remain subdued. But it picks up from 2015 as productivity growth recovers. Corporate profits have grown faster than GDP this year and are forecast to continue to do so; and

- in **expenditure** terms: private consumption is forecast to grow slightly faster than household income, with the saving ratio falling a little further. Private investment is forecast to recover towards its pre-crisis share of GDP, implying strong growth in business and residential investment for a sustained period. By contrast, the Government's ongoing fiscal consolidation implies large and sustained falls in government consumption of goods and services as a share of GDP, which is projected to reach its lowest level since comparable records began in 1948.

Table 1.1: Economic forecast overview

	Percentage change on a year earlier, unless otherwise stated						
	Outturn		Forecast				
	2012	2013	2014	2015	2016	2017	2018
Output at constant market prices							
Gross domestic product (GDP)	0.3	1.8	2.7	2.3	2.6	2.6	2.5
GDP levels (2012=100)	100.0	101.8	104.5	107.0	109.7	112.6	115.4
Output gap	-2.8	-2.2	-1.4	-1.1	-0.7	-0.3	0.0
Expenditure components of GDP							
Household consumption	1.5	2.3	2.1	1.8	2.5	2.7	2.4
General government consumption	1.6	0.9	1.2	-0.5	-1.2	-1.8	-0.9
Business investment	3.9	-1.2	8.0	9.2	8.1	8.7	7.7
General government investment	0.6	-6.4	10.7	1.0	2.2	0.8	-0.5
Net trade[1]	-0.7	0.1	-0.2	0.1	0.0	0.0	-0.1
Inflation							
CPI	2.8	2.6	1.9	2.0	2.0	2.0	2.0
Labour market							
Employment (millions)	29.5	29.9	30.4	30.6	30.9	31.2	31.4
Average earnings	2.0	1.5	2.5	3.2	3.6	3.7	3.8
LFS unemployment (% rate)	7.9	7.6	6.8	6.5	6.1	5.7	5.4
Claimant count (millions)	1.59	1.42	1.20	1.13	1.06	0.98	0.94
	Changes since December forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.1	0.3	0.3	0.1	0.0	0.0	-0.3
GDP levels (2012=100)	0.0	0.3	0.7	0.8	0.8	0.7	0.5
Output gap	-0.2	0.1	0.4	0.5	0.5	0.4	0.2
Expenditure components of GDP							
Household consumption	0.3	0.4	0.2	0.2	0.1	-0.2	-0.4
General government consumption	-0.1	0.3	0.8	0.1	-0.3	0.0	0.3
Business investment	1.2	4.2	2.9	0.6	-0.7	-0.2	-0.3
General government investment	-4.0	0.5	3.3	-0.1	0.1	0.3	0.6
Net trade	0.0	0.3	-0.2	0.0	0.0	0.0	0.0
Inflation							
CPI	0.0	0.0	-0.4	-0.1	0.0	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	0.2	0.2	0.2	0.2	0.2
Average earnings	0.0	0.1	0.0	-0.1	0.1	0.0	0.1
LFS unemployment (% rate)	0.0	0.0	-0.3	-0.4	-0.4	-0.4	-0.2
Claimant count (millions)	0.00	-0.01	-0.07	-0.10	-0.12	-0.15	-0.16

[1] Contribution to GDP growth.

1.24 We have revised up our employment forecast, with total employment expected to reach 31.4 million or 59.9 per cent of the adult population in 2018. Unemployment is forecast to fall steadily over the coming years, reaching 7 per cent in the coming months, 6 per cent by the end of 2016 and settling at our estimate of its sustainable rate, around 5¼ per cent, in 2018. The path of unemployment is lower than we forecast in December.

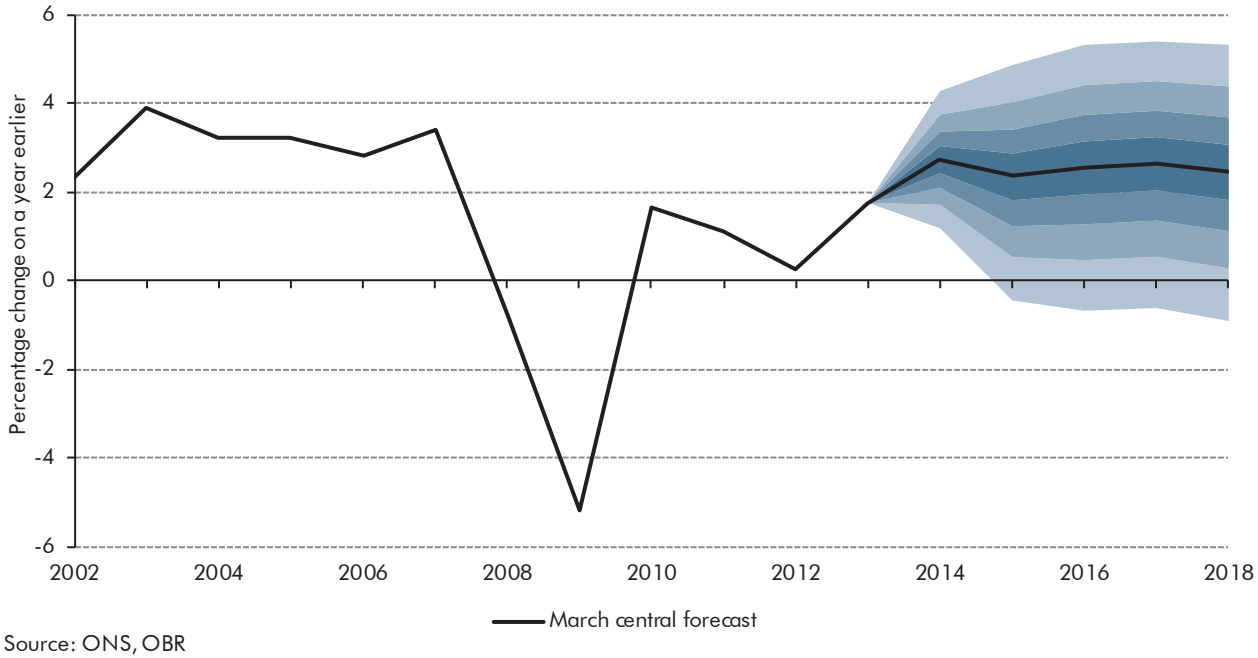
1.25 Total market sector employment is forecast to rise by 3.3 million between the start of 2011, the beginning of the period covered by the Government's 2010 Spending Review, and the start of 2019. This more than offsets a 1.0 million fall in general government employment.

1.26 We expect CPI inflation to remain close to the 2 per cent target through the forecast period. Relative to our December forecast, the extra downward pressure on inflation from a slightly stronger exchange rate broadly offsets the reduced downward pressure from there being less spare capacity in the economy.

1.27 We have revised our house price inflation forecast up again, reflecting greater momentum in house prices in recent months. We expect annual house price inflation to peak at more than 9 per cent later this year.

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 headline public finance measures have been affected by a number of one-off or temporary factors in recent years. Two of these have had large effects on borrowing – the one-off transfer of the Royal Mail Pension Plan's assets (and associated future pension liabilities) to the Government in 2012-13 and the ongoing transfers of cash from the Asset Purchase Facility (APF) to the Exchequer. We focus our assessment of the public finances on

an underlying measure of public sector net borrowing ('underlying PSNB') that excludes these two factors. Headline ONS measures are also presented.

1.30 Underlying PSNB is expected to halve from its 11.0 per cent of GDP peak in 2009-10 to 5.5 per cent of GDP by 2014-15. The rate of decline slowed in recent years as the recovery faltered, but appears to have gathered pace again. Table 1.2 shows that we expect the deficit to continue falling over the next five years, reaching a small surplus in 2018-19.

1.31 As set out above, we consider the unexpected strength of GDP growth over the past year to have been largely cyclical. As such, downward revisions to borrowing across the forecast are largely cyclical, with little change on average to our estimates of the structural position of the public finances – cyclically-adjusted PSNB – over the forecast period.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Excluding Royal Mail and APF transfers							
Public sector net borrowing	7.3	6.6	5.5	4.2	2.4	0.8	-0.2
Cyclically-adjusted net borrowing	5.3	5.0	4.5	3.4	1.9	0.6	-0.3
Surplus on current budget	-5.9	-5.1	-3.9	-2.7	-0.9	0.5	1.5
Headline fiscal aggregates							
Public sector net borrowing	5.1	5.8	4.9	3.8	2.2	0.9	-0.1
Cyclically-adjusted net borrowing	3.1	4.3	3.8	3.0	1.7	0.7	-0.1
Surplus on current budget	-5.4	-4.4	-3.3	-2.3	-0.7	0.5	1.5
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-3.5	-2.8	-2.2	-1.5	-0.2	0.7	1.5
Public sector net debt	74.2	74.5	77.3	78.7	78.3	76.5	74.2
	Changes since December forecast						
Excluding Royal Mail and APF transfers							
Public sector net borrowing	0.0	-0.2	-0.1	-0.2	-0.4	-0.4	-0.1
Cyclically-adjusted net borrowing	-0.1	-0.2	0.2	0.1	0.0	-0.1	0.0
Surplus on current budget	0.1	0.2	0.1	0.2	0.3	0.3	0.1
Headline fiscal aggregates							
Public sector net borrowing	0.0	-0.2	0.0	-0.2	-0.4	-0.4	-0.1
Cyclically-adjusted net borrowing	-0.1	-0.2	0.2	0.1	0.0	-0.1	0.0
Surplus on current budget	0.1	0.2	0.0	0.2	0.3	0.3	0.1
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	0.2	0.1	-0.2	-0.2	0.0	0.0	0.0
Public sector net debt	0.3	-1.0	-1.0	-1.2	-1.6	-1.9	-1.8

1.32 Table 1.3 shows that we have reduced our forecasts for the underlying deficit in 2013-14 by £3.4 billion, thanks primarily to an upward revision to stamp duty receipts (due to higher house prices and property transactions) and a downward revision to debt interest costs (due to lower inflation). But borrowing in 2014-15 is little changed from our December forecast, in part because we expect social security spending to be higher and because stronger

growth in the UK is expected to raise EU contributions in that year (an effect we expect to unwind in the future due to the UK rebate).

1.33 We have revised borrowing lower in each subsequent year of the forecast, reflecting stronger receipts in every year and slightly lower spending from 2015-16. The downward revision averages almost £6 billion a year from 2015-16 to 2017-18, before falling to £2.6 billion in 2018-19. The improvement is smaller in 2018-19 because of slower GDP and employment growth once the output gap has closed, and the Government's assumption that it will raise total public spending in line with whole economy inflation in that year, the forecast for which we have revised higher since December. In 2018-19, we forecast the public finances to move into surplus for the first time in 18 years.

Table 1.3: Changes to underlying public sector net borrowing since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing[1]						
December forecast	111.2	96.0	78.7	51.1	23.4	-2.2
March forecast	107.8	95.5	75.2	44.5	16.5	-4.8
Change	**-3.4**	**-0.6**	**-3.5**	**-6.6**	**-6.9**	**-2.6**
of which:						
Changes in the receipts forecast[1,2]	-1.1	-2.0	-3.5	-4.7	-4.0	-2.5
Changes in the spending forecast[1,2]	-2.3	0.9	-0.6	-1.7	-2.2	0.3
Receipts measures in the Treasury's policy decision table	0.0	0.0	0.6	1.8	1.4	1.7
Spending measures in the Treasury's policy decision table	0.0	0.5	-0.1	-2.0	-2.1	-2.1

[1] Excluding APF transfers.

[2] This includes the re-allocation of the policy measure for tax free childcare announced in Budget 2013. More information is available in our online supplementary fiscal tables.

1.34 Our forecast suggests that underlying net borrowing will have fallen by 11.2 per cent of GDP over the nine years from 2009-10 (around £190 billion in today's terms), taking it from its post-war peak to what would be the first budget surplus since 2000-01. On our central forecast, the contributions to this would be:

- 9.2 per cent of GDP, just over 80 per cent of the deficit reduction, from lower expenditure, with Total Managed Expenditure falling from 47.0 per cent of GDP in 2009-10 to 37.8 per cent of GDP by 2018-19. Within this total:[1]
  - PSCE in RDEL, a proxy for day-to-day spending on public services and administration, falls by 7.7 per cent of GDP, from 21.8 per cent of GDP in 2009-10 to 14.2 per cent in 2018-19, as shown in Chart 1.3. This is mirrored in our GDP forecast, where government consumption of goods and services falls from

[1] We have adjusted spending figures in outturn for significant spending-neutral switches between DEL and AME.

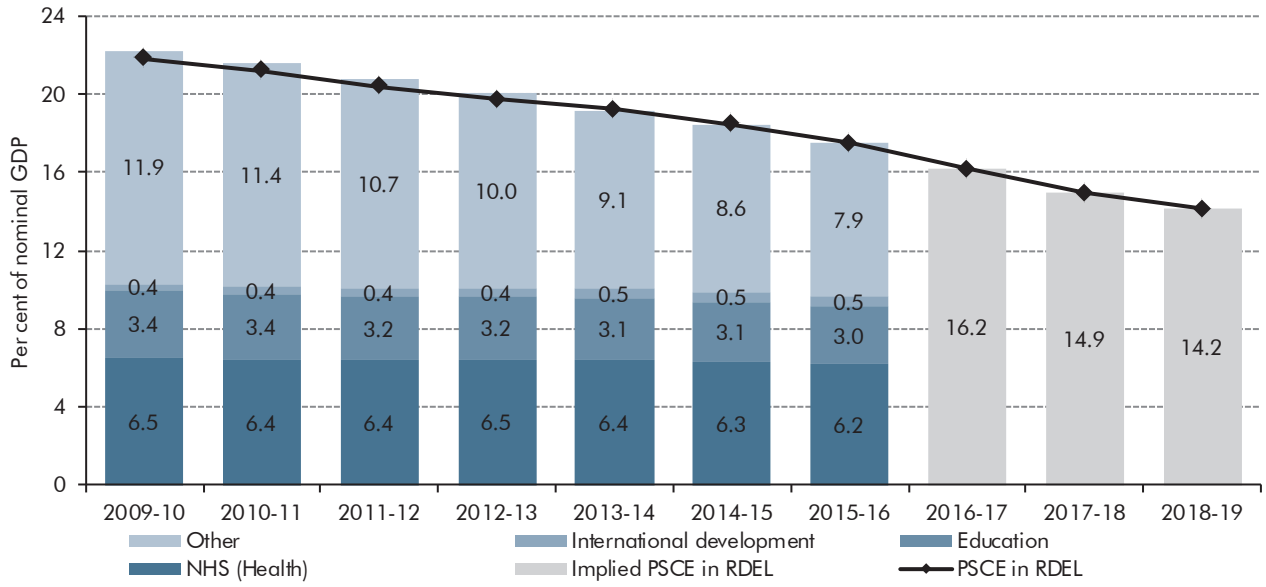
23.2 per cent of nominal GDP in 2009 to 16.1 per cent by the end of the forecast, its lowest at least since 1948;

- PSGI in CDEL, public sector gross investment, falls by 1.6 per cent of GDP, from 3.5 per cent in 2009-10 to 1.9 per cent in 2018-19. In 2007-08, PSGI in CDEL was 2.7 per cent of GDP; and

- social security spending falls by 1.1 per cent of GDP, from 11.1 per cent in 2009-10 to 10.0 per cent in 2018-19, approaching its pre-crisis level.

- 2.0 per cent of GDP, just under 20 per cent of the deficit reduction, from higher receipts, with the majority of the increase having taken place by 2012-13, largely as a result of the increases in the standard rate of VAT. This is followed by further increases towards the end of our forecast due to the resumption of fiscal drag, as above-inflation earnings growth pushes more income into higher tax brackets, and strong growth in capital taxes like stamp duty and inheritance tax.

Chart 1.3: Current spending on public services and administration



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 Budget 2014, HM Treasury Public Expenditure Statistical Analyses, July 2013

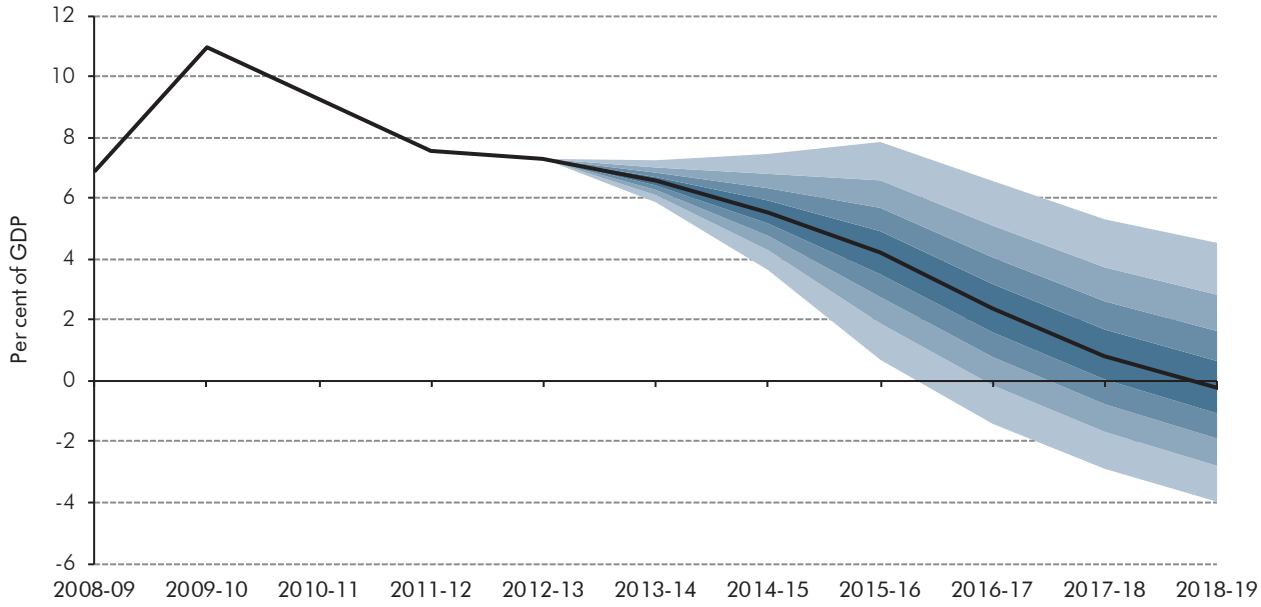
1.35 The current budget balance, which excludes borrowing to finance net investment spending, is forecast to show a deficit of £71.5 billion this year (£83.7 billion on an underlying basis), down from a peak of £108.9 billion in 2009-10. The current balance moves into surplus in 2017-18 and records a surplus of £30.5 billion in 2018-19. With planned investment spending little changed, revisions to the current balance are similar to those to PSNB.

1.36 The cyclically-adjusted current budget (CACB) moves from a deficit of 2.8 per cent of GDP in 2013-14 to a surplus of 1.5 per cent of GDP in 2018-19. We expect the CACB to move

into surplus in 2017-18. As with cyclically-adjusted PSNB, the CACB is little changed on average over the forecast period.

1.37 All forecasts are subject to significant uncertainty. Chart 1.4 shows our median forecast for underlying PSNB with successive pairs of shaded areas around it representing 20 per cent probability bands. As in Chart 1.2 above, the bands show the probability of different outcomes if past official forecast errors were a reasonable guide to future forecast errors.

Chart 1.4: Underlying PSNB fan chart



Source: ONS, OBR. Excludes Royal Mail pension fund and APF transfers.

1.38 We forecast public sector net debt (PSND) to rise as a share of GDP in each year up to and including 2015-16, peaking at 78.7 per cent of GDP. It then falls by a small margin in 2016-17 and more rapidly thereafter, reaching 74.2 per cent of GDP in 2018-19. PSND in 2018-19 is forecast to be 1.8 per cent of GDP lower than we forecast in December. Table 1.4 breaks this change down as follows:

- upward revisions to our nominal GDP forecast have reduced the ratio of the cash value of debt to GDP in each year, with the effect rising from 0.4 per cent of GDP in 2013-14 to 0.6 per cent of GDP in 2018-19; and

- our forecast for PSND in cash terms is lower by £10 billion in 2013-14, rising to £25 billion in 2018-19. In the near term, the largest effect is from the cash flow measure of borrowing this year being revised down by more than the headline measure. In later years, cumulative revisions to net borrowing are more important.

Table 1.4: Changes to public sector net debt since December

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	73.9	75.5	78.3	80.0	79.9	78.4	75.9
March forecast	74.2	74.5	77.3	78.7	78.3	76.5	74.2
Change	**0.3**	**-1.0**	**-1.0**	**-1.2**	**-1.6**	**-1.9**	**-1.8**
of which:							
Change in nominal GDP[1]	0.1	-0.4	-0.5	-0.5	-0.6	-0.7	-0.6
Change in cash level of net debt	0.2	-0.6	-0.6	-0.7	-0.9	-1.2	-1.2
	£ billion						
December forecast	1182	1269	1365	1451	1515	1554	1573
March forecast	1185	1258	1355	1439	1497	1530	1548
Change in cash level of net debt	**3**	**-10**	**-10**	**-13**	**-18**	**-24**	**-25**
of which:							
Budget measures	0	0	1	2	4	6	8
Other changes in net borrowing	0	-4	-4	-8	-14	-21	-23
Other	3	-7	-6	-6	-8	-9	-9

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

1.39 Later this year, the ONS will implement significant revisions to the public finance statistics. For this *EFO*, our forecasts are presented on the existing basis, but we have provided a preliminary assessment of the possible implications of future revisions in Annex B. These methodological and classification changes are expected to raise the measured level of net debt by around £140 billion in 2014-15, falling to around £125 billion by 2018-19. This is equivalent to around 7¾ and 6 per cent of our current forecasts for nominal GDP respectively. But at the same time the ONS is also expected to revise nominal GDP higher, by roughly 2½ to 5 per cent. A revision in middle of this range would reduce the upward revision to the debt to GDP ratio to around 4¾ per cent of GDP in 2013-14 and around 3¼ per cent in 2018-19. 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.

Performance against the fiscal targets

1.40 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 2018-19; and
- to see public sector net debt (PSND) falling as a share of GDP in 2015-16.

1.41 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 1.5 per cent of GDP in 2018-19, fractionally less than we forecast in December.

1.42 PSND is forecast to rise to a peak of 78.7 per cent of GDP in 2015-16, which is slightly lower than we forecast in December. However, as in each of our *EFO*s since December 2012, our forecast does not show the Government on course to achieve the supplementary target – we forecast that debt will rise by 1.5 per cent of GDP in the target year, down from an increase of 1.7 per cent of GDP in our December forecast.

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 for any given state of the economy. Given these uncertainties we test the robustness of our central 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 75 per cent probability that the CACB will be in balance or surplus in 2018-19 (as the mandate requires) and a roughly 65 per cent chance a year earlier;

- 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 2018-19, the probability of meeting the mandate would fall to 65 per cent. The level of potential output would need to be over 2 per cent lower in 2018-19 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 where interest rates are higher than assumed in our central forecast. In one scenario, that happens for good reasons – stronger growth in household incomes and company profits. In the other scenario, it happens for bad reasons – instability in emerging markets intensifies, triggering risk aversion that drives up credit spreads meaning interest rates facing households and companies rise without corresponding increases in incomes and profits. The Government would continue to meet the fiscal mandate in both scenarios, reflecting the substantial CACB surplus in 2018-19 in our central forecast. The supplementary debt target would be missed in the bad scenario, but met by a very small margin in the good scenario.

1.44 The forthcoming ONS revisions to the public finances data are unlikely to have a significant impact on the measured CACB at the forecast horizon, and thus on the Government's chances of meeting the fiscal mandate. But even though the measured level of net debt will be significantly higher after the revisions, the chances of it falling in 2015-16 are likely to be greater if the APF starts selling gilts before the end of 2015-16, as assumed in our central forecast – although still not greater than 50 per cent. Debt would also fall more steeply if the Government was to sell more of the shares that it purchased as a result of financial interventions. This does not feature in our central forecast, given uncertainties over the potential scale and timing of such sales.

2 Developments since the last forecast

Introduction

2.1 This chapter summarises:

- the main economic and fiscal data developments since our last forecast in December 2013 (from paragraph 2.2); and
- recent external forecasts for the UK economy (from paragraph 2.13).

Economic developments

Data revisions

2.2 Since our December forecast, the ONS has published the *Quarterly National Accounts* (QNA) for the third quarter of 2013. This included upward revisions to GDP growth back to the first quarter of 2012. The ONS also published the first and second estimates of GDP for the fourth quarter of 2013, which were consistent with our forecast of 0.7 per cent quarterly growth. The second estimate included further revisions back to the first quarter of 2013. Real GDP is now estimated to have risen 2.2 per cent between the first quarter of 2012 and the third quarter of 2013, compared to the 1.7 per cent in the data at the time of the December forecast. The upward revisions were mainly to private consumption, as spending on insurance, food, petrol and motor vehicles was revised up. The most recent ONS estimates also show a larger contribution to growth from private investment and government consumption which, along with less of a drag from net trade, is only partially offset by a lower stocks contribution.

Table 2.1: Contributions to real GDP growth from 2012Q1 to 2013Q3[1]

	Percentage points						
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	GDP growth, per cent
December data	1.9	0.5	0.1	-0.2	-1.9	1.2	1.7
Latest data	2.5	0.7	0.0	0.2	-1.7	1.0	2.2
Difference[2]	0.6	0.2	-0.1	0.4	0.2	-0.2	0.5

[1] Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is the difference between the headline estimate of GDP and the expenditure estimate. The statistical discrepancy is -0.1 and -0.6 percentage points for December and latest data respectively.

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

2.3 Since our December forecast, the whole economy GDP deflator and its components have been revised significantly. In December, we noted that there was an unusual divergence between the export and import services deflators, with a large measured fall in import prices lifting the terms of trade. This divergence has been revised away, with service import prices higher. The revision was related to the price of tourism services, so the private consumption deflator was revised up too, offsetting the effect of higher import prices on the GDP deflator. In the QNA, the private consumption deflator was revised up further, reflecting larger price rises in actual rent and imputed rent (a measure of the service that an owner occupier consumes from living in their own home), based on information from the Living Cost and Food survey. In the second estimate of fourth quarter GDP, actual and imputed rent were revised down significantly as the ONS moved towards using a different source for rent data in the National Accounts.[1] The net effect of these various revisions has been to lower the GDP deflator by 0.7 per cent in the third quarter of 2013, relative to the data available at the time of our last forecast.

Table 2.2: Contributions to GDP deflator growth from 2012Q1 to 2013Q3[1]

	Percentage points						
	Private consumption	Government consumption	Total investment	Exports	Imports	Stocks	GDP growth, per cent
December data	2.7	-0.3	-0.1	0.5	1.0	0.0	3.5
Latest data	2.7	-0.3	0.2	0.1	0.5	0.0	2.8
Difference[2]	0.0	0.0	0.3	-0.4	-0.5	0.0	-0.7

[1] Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is the difference between the headline estimate of GDP and the expenditure estimate.
[2] Difference in unrounded numbers, rounded to one decimal place.

GDP growth since the December 2013 forecast

2.4 In the fourth quarter of 2013, real GDP is estimated to have grown 0.7 per cent, as we forecast in December. The composition of quarterly real GDP growth relative to our December forecast is shown in Table 2.3, broken down by categories of spending. Weaker private and government consumption were offset by a smaller drag from stocks.

Table 2.3: Contributions to real GDP growth in 2013Q4[1]

	Percentage points						
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	GDP growth, per cent
OBR Dec forecast	0.4	0.2	0.0	0.2	0.5	-0.7	0.7
Latest data	0.1	0.1	0.1	0.2	0.4	-0.2	0.7
Difference[2]	-0.4	-0.2	0.1	0.0	-0.1	0.5	0.0

[1] Components may not sum to total due to rounding.
[2] Difference in unrounded numbers, rounded to one decimal place.

[1] For more information see ONS, *Introducing a new method for deriving rental data in the calculation of Household Final Consumption Expenditure in the National Accounts.*

2.5 Nominal GDP was stronger in the fourth quarter of 2013 than we expected in December (Table 2.4). This reflected larger-than-expected contributions from net trade, investment and stocks, partly offset by weaker private and government consumption.

Table 2.4: Contributions to nominal GDP growth in 2013Q4[1]

	Percentage points					
	Private consumption	Government consumption	Total investment	Net trade	Stocks	GDP growth, per cent
OBR December forecast	0.8	0.3	0.2	0.5	-0.5	1.3
Latest data	0.5	0.1	0.3	0.9	0.1	1.9
Difference[2]	-0.3	-0.2	0.1	0.4	0.6	0.7

[1] Components may not sum to total due to rounding.
[2] Difference in unrounded numbers, rounded to one decimal place.

Business surveys

2.6 Most survey evidence suggests that the recent pick-up in activity will be maintained in coming months. While the composite CIPS *Purchasing Managers' Index* (PMI) has eased slightly from its 16-year high of 61.2 in October, at 58.4 in February it still remains above its historical average and consistent with stronger growth in GDP than is currently estimated. The easing back in the index has been driven by the services sector PMI, which has fallen from a peak of 62.5 in October to 58.2 in February. The manufacturing index has maintained its expansionary level in recent months. The construction index hit a 6-year high in January as the residential building activity index hit a level not seen for over a decade, before falling back slightly as recent flooding affected some construction projects.

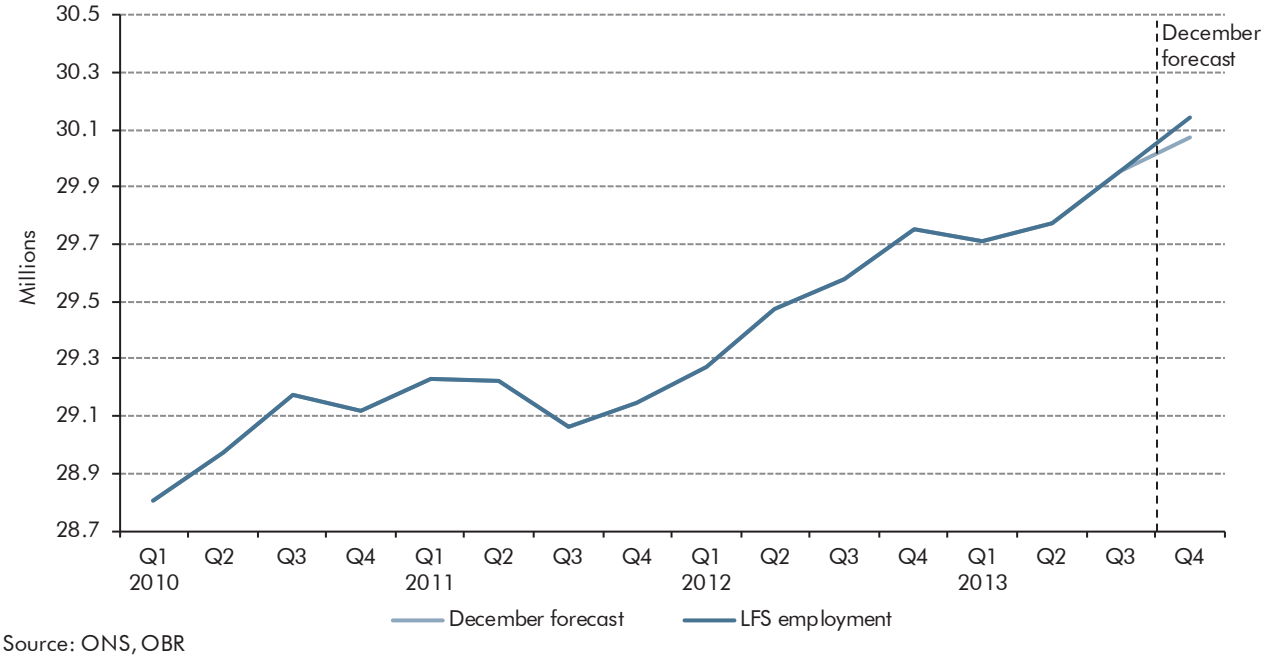
2.7 The Bank of England *Agents' Summary* reports a small further increase in investment intentions and domestic manufacturing activity since the time of our December forecast. There was also a significant pick-up in construction output, including indications that this extends beyond the residential sector. The *GfK Consumer Confidence* measure was above its long-run average in January for the first time in six years, with a broad-based increase in all of the sub-components, and maintained that level in February. 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 stronger than at the time of our December forecast and are above their long-run averages. The CBI's *Distributive Trades Survey* reported an easing in retail sales volume growth in January and February. In the first quarter of 2014, the CBI's *Services Sector Survey* showed the highest level of business optimism in the survey's 15-year history and a rise in business volumes for the current and next quarters.

Labour market

2.8 The labour market has generally continued to out-perform our forecasts. Employment increased to 30.15 million in the fourth quarter of 2013, compared with our forecast of 30.08 million (Chart 2.1). LFS unemployment in the same period was 47,000 lower than

our forecast and claimant count unemployment was 32,000 lower. Employment is now 396,000 higher than a year earlier, while LFS and claimant count unemployment are down 161,000 and 292,000 respectively. That represents a 6 per cent fall in the number of LFS unemployed people and a much larger 19 per cent fall in the number on the claimant count. But while the employment figures have surprised on the upside, private sector earnings growth has been weaker than we expected in December. Average weekly earnings in the private sector in the year to the fourth quarter of 2013 grew by 1.5 per cent, compared with our forecast of 1.9 per cent.

Chart 2.1: LFS employment and December forecast



Source: ONS, OBR

Inflation

2.9 The rate of CPI inflation has fallen slightly more quickly than we expected. It was 0.1 percentage points lower than our December forecast in the fourth quarter of 2013 (Chart 2.2). Food price inflation has fallen faster than expected as improved domestic production has put downward pressure on seasonal food price inflation and as falling global commodity prices and stronger sterling fed through to non-seasonal food prices. Also, there were larger-than-expected falls in petrol and diesel prices. The energy policy announcements in Autumn Statement 2013 (see Box 3.2 of our December *EFO*), which were not incorporated in the December forecast, have resulted in below-forecast utility prices.

Chart 2.2: CPI inflation and December forecast

Source: ONS, OBR

The housing market

2.10 In recent months, the housing market has accelerated more than expected, owing to lower mortgage interest rates, rising consumer confidence and a supportive policy environment. House price inflation reached 5.5 per cent in the year to the fourth quarter of 2013 against our forecast of 4.0 per cent. Mortgage approvals for house purchase have risen by 42 per cent in the year to January. Property transactions in the fourth quarter were around 9,000 higher than our December forecast of 285,000. Transactions in January 2014 were 103,000, up 30 per cent on a year earlier. The housing market in London, which on average has more expensive houses than the rest of the country, has been notably strong, which has had a disproportionate impact on the public finances.

The global economy

2.11 GDP growth in advanced economies continues to recover, although there is still significant variation between countries. Growth in the US was stronger than forecast in the fourth quarter of 2013, at 0.6 per cent. Euro area growth was in line with our forecast at 0.3 per cent. Japanese GDP growth came in slightly below forecast at 0.2 per cent. The US Federal Reserve announced tapering of their asset purchases from $85 billion a month to $75 billion in December and $65 billion in January. There has been significant volatility in emerging economies' financial markets, with the US tapering contributing to large capital outflows and currency depreciations, including in Brazil, Argentina and Turkey. Monetary policy has been tightened in some of these countries to try to arrest these flows. Concerns about growth prospects in China have also affected global commodity prices.

Fiscal data developments

2.12 The latest ONS public finance data show underlying public sector net borrowing in the first ten months of 2013-14 has been £4.0 billion lower than in the same period last year, a somewhat larger fall than implied by our December forecast. Spending growth has been broadly in line with our December forecast, once timing effects related to local authority grants and payments to EU institutions have been taken into account. Receipts growth has also been broadly in line with forecasts, once the one-off boosts from Swiss capital tax receipts in May and APF transfers from April to July are taken into account. These developments and their implications for our latest fiscal forecast are discussed in more detail in Chapter 4.

Developments in outside forecasts

2.13 Many private sector, academic and other outside organisations produce economic forecasts for the UK.[2] This section sets out some of the movements in these forecasts since our December *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.

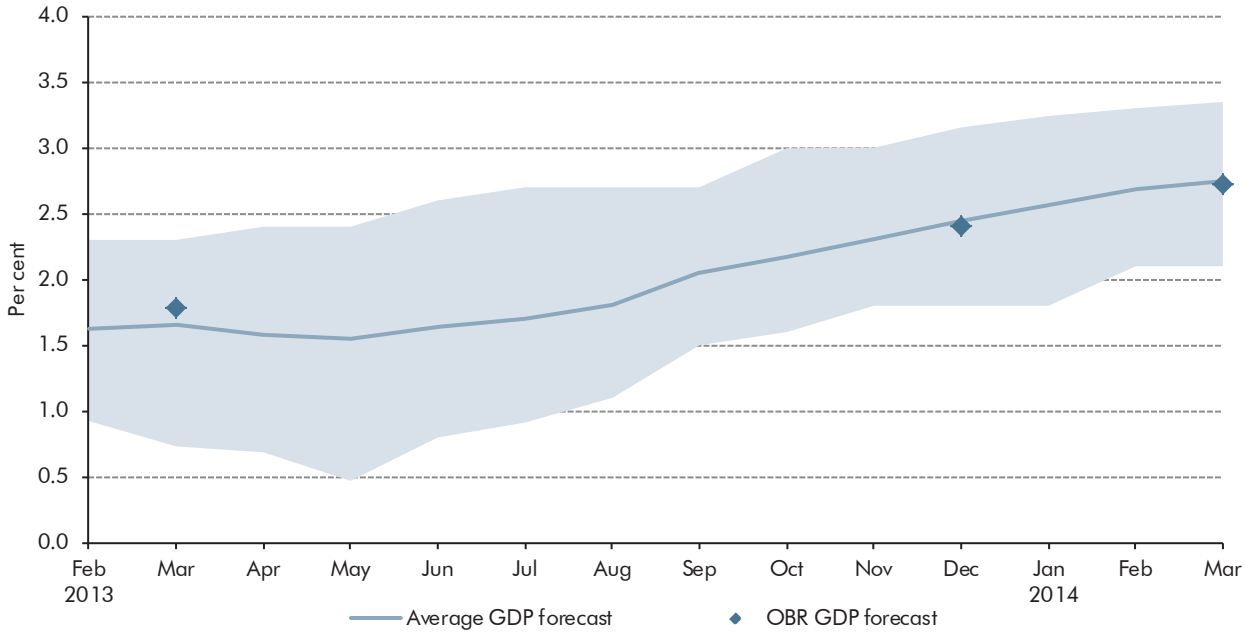
GDP growth

2.14 Outside forecasts for GDP growth in 2014 were increasing in the run-up to our December forecast, reflecting momentum in GDP data in 2013, strength in survey measures of activity and confidence, and easing credit conditions. Our forecast of 2.4 per cent was in line with the average of outside forecasts at that time (Chart 2.3). Forecasts have been revised up since then, with the March average at 2.7 per cent for 2014, the same as our forecast in this *EFO*. The average forecast for 2015 is 2.4 per cent, slightly higher than our forecast in this *EFO*.

2.15 Expectations for the composition of demand in 2014 have changed slightly since December. The average forecast for the contribution of net trade to GDP growth has fallen from 0.1 to -0.1 percentage points, with expected growth of exports having been revised down. The average forecasts for growth in private and government consumption have increased by 0.2 and 0.5 percentage points respectively, while the average forecast for investment growth has risen by 0.6 percentage points.

[2] See HM Treasury, March 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.

Chart 2.3: Forecasts for GDP growth in 2014



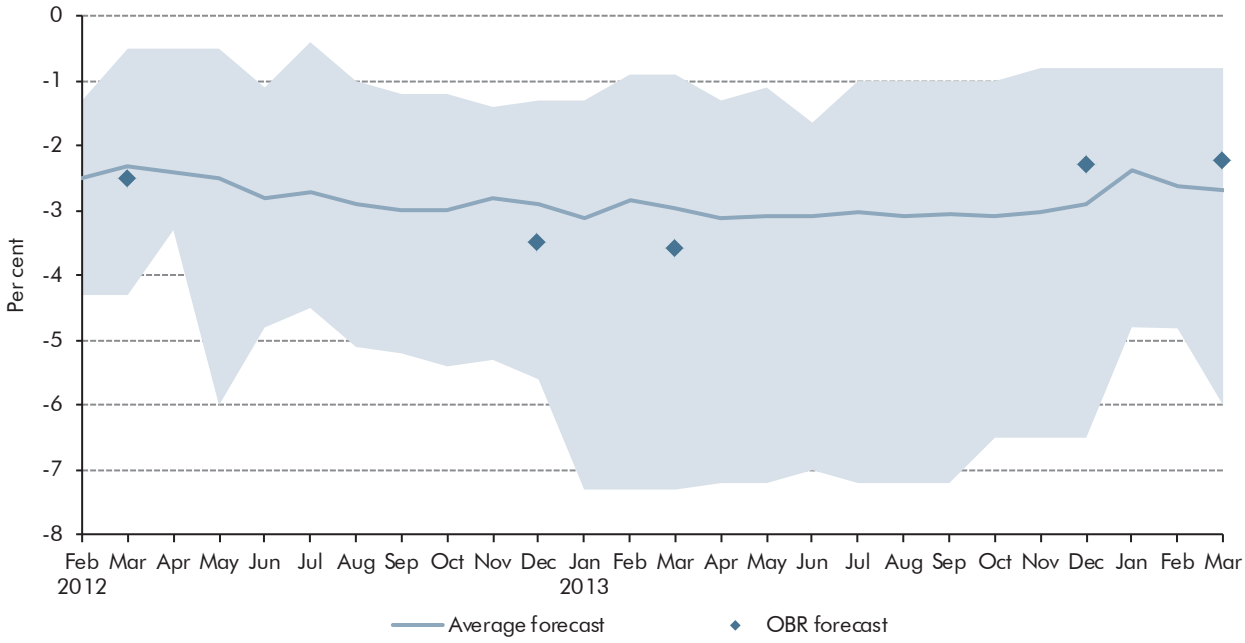
Source: HM Treasury, OBR

2.16 Looking at the smaller sample of medium-term forecasts, the average forecast for GDP growth in 2016 is unchanged since the December *EFO* at 2.4 per cent. The forecasts for 2015 and 2017 have increased by 0.1 percentage point to 2.5 and 2.4 per cent respectively. The first average forecast for 2018 is also 2.4 per cent. These medium-term forecasts are slightly lower than our central forecast in this *EFO* in most years.

Output gap

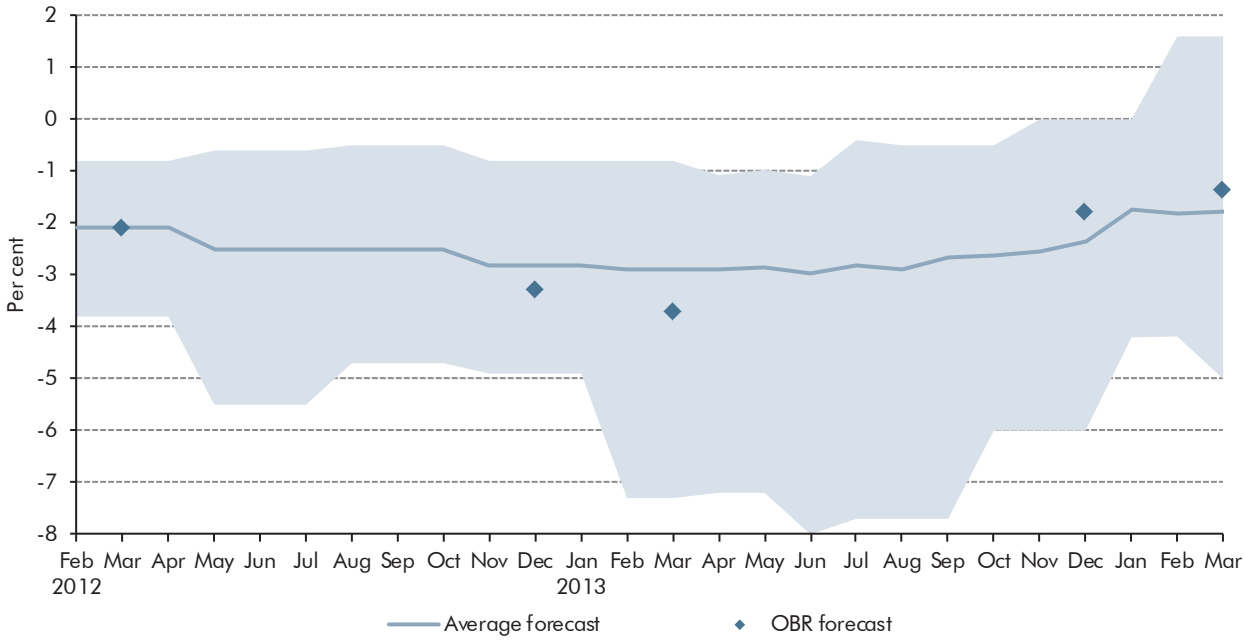
2.17 The average estimate for the output gap in 2013 has narrowed slightly since December (Chart 2.4). The latest average estimate is -2.7 per cent, compared to our slightly narrower estimate of -2.2 per cent for the year as a whole. Over the same period, the average forecast for the output gap in 2014 has narrowed from -2.4 per cent to -1.8 per cent, again a little wider than our central forecast of -1.4 per cent (Chart 2.5). The range of output gap forecasts is considerably greater than that for GDP growth.

Chart 2.4: Forecasts for the output gap in 2013



Source: HM Treasury, ONS, OBR

Chart 2.5: Forecasts for the output gap in 2014



Source: HM Treasury, ONS, OBR

Box 2.1: External agencies' forecast evaluations

Each autumn, we publish our *Forecast evaluation report (FER)*, a detailed examination of the performance of past economic and fiscal forecasts relative to the latest outturn data. In a similar vein, the Bank of England recently published a review of its forecast errors since 2010,[a] while the OECD has published an assessment of its forecasts since the global financial crisis.[b]

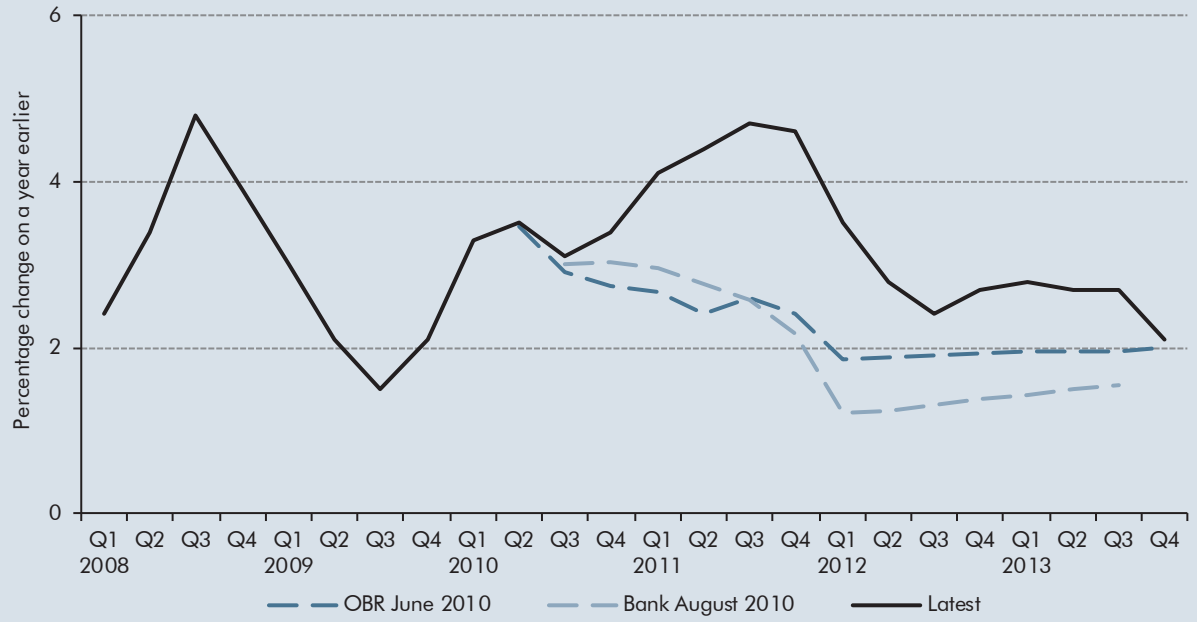
Like most other forecasters, the OECD found that average GDP growth came in below its country-level forecasts between 2007 and 2012, during both the global recession and recovery. It made larger forecast errors over the whole period for countries that were more exposed to global developments, with important factors including openness to international trade and prevalence of foreign-owned banks. This suggested that it had underestimated the impact of global shocks on individual countries. There were also larger errors for those countries with tighter labour and product market regulation, suggesting that it did not fully take into account the role of flexibility in the face of shocks. Its largest errors were for countries where banks entered the recession with low capital ratios, suggesting that it may also have underestimated the negative impact on an economy of banks repairing their balance sheets.

In contrast to the IMF,[c] the OECD concluded that larger-than-expected impacts from fiscal consolidations did not contribute much to weaker-than-expected growth. The lack of narrowing of euro area sovereign bond spreads, as the euro area crisis failed to ease as expected, had a larger impact.

The Bank of England, like us, over-forecast the recovery in real GDP growth following the financial crisis. We compared our real GDP forecast errors with the Bank's in Box 2.1 of our December *EFO*. The Bank have now also published an analysis of the inflation forecast errors made in the August 2010 *Inflation Report*. Again like us, the Bank under-forecast inflation from mid-2010 (Chart A). The Bank's average forecast error on inflation between the third quarter of 2010 and third quarter of 2013 was 1.4 percentage points. The average error from our June 2010 forecast was 1.2 percentage points over the same period.

The Bank estimate that energy prices, non-energy import prices and university tuition fees explain most of the errors in its inflation forecasts. The drivers of these errors were larger-than-expected increases in global oil, gas and agricultural commodity prices, higher energy distribution costs, greater impact from sterling depreciation and the large rise in tuition fees in 2012. In the 2013 *FER*, we identified similar factors, notably higher global commodity prices. We also believe that higher-than-expected unit labour costs contributed to our errors, as nominal rigidities in wage-setting may have meant that some of the weakness in real incomes arising from lower-than-expected productivity was felt via higher prices, as firms passed on those higher costs of production to consumers.

Chart A: CPI forecasts and outturns



Source: Bank of England, ONS, OBR

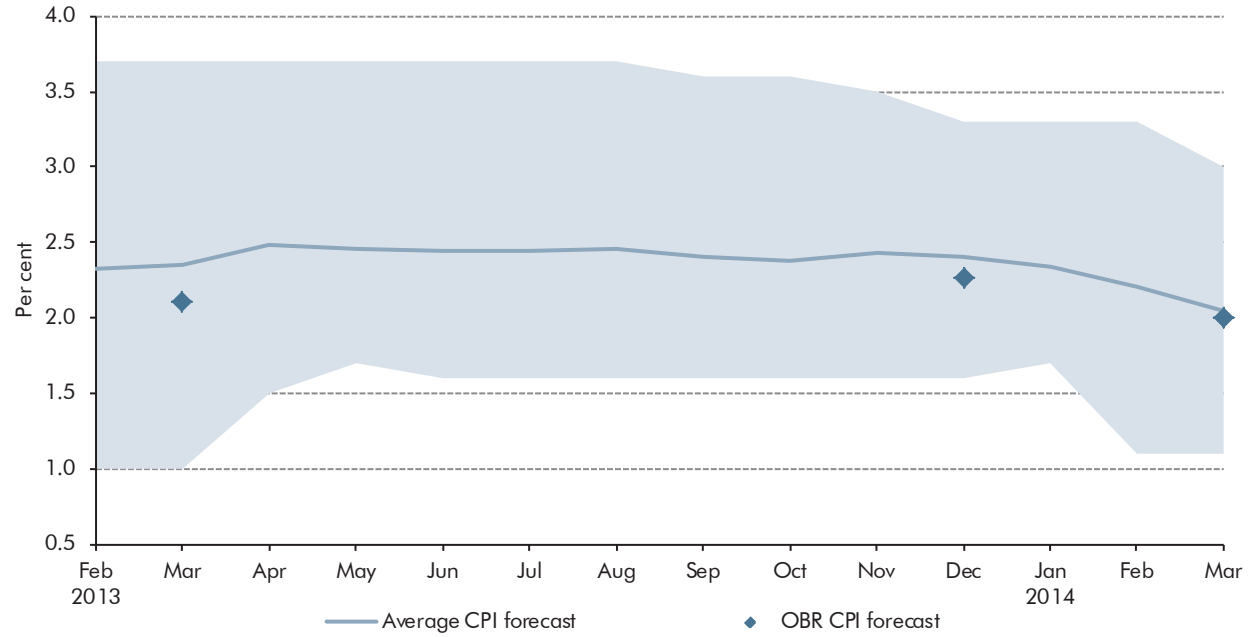
Forecasters use the analysis of past forecast errors to inform future forecasts, including forecast methodology changes. The process of producing the *FER* allows us to learn lessons that we can apply to future forecasts. The OECD state that their review of forecast errors has led them to increase the top-down element of their country forecasts, where the central world view has more of an influence, and they are now making more use of anecdotal evidence from business contacts. Another lesson most forecasters have taken is the need to focus more on financial market developments. The OECD now makes use of financial condition indices and are working on incorporating the banking sector more fully into models, as failure to take these factors into account were found to be a major source of its forecast errors. We look closely at developments in credit conditions and bank funding markets when producing our forecasts.

[a]See Bank of England, 2013 Q4 Quarterly Bulletin, *Understanding the MPC's forecast performance since mid-2012*
[b]See OECD, February 2014, Policy Note no. 23: *OECD forecasts during and after the financial crisis: a post mortem*
[c]See Blanchard and Leigh, January 2013, *Growth forecast errors and fiscal multipliers*

Inflation

2.18 The average forecast for CPI inflation in the fourth quarter of 2014 at the time of our December forecast was 2.4 per cent. This has since fallen back to 2.0 per cent, the same as our forecast in this *EFO*, reflecting lower recent outturns (Chart 2.6). The average forecast for CPI inflation in the fourth quarter of 2015 was 2.1 per cent in March, compared with our forecast of 2.0 per cent.

Chart 2.6: Forecasts for CPI inflation in the fourth quarter of 2014

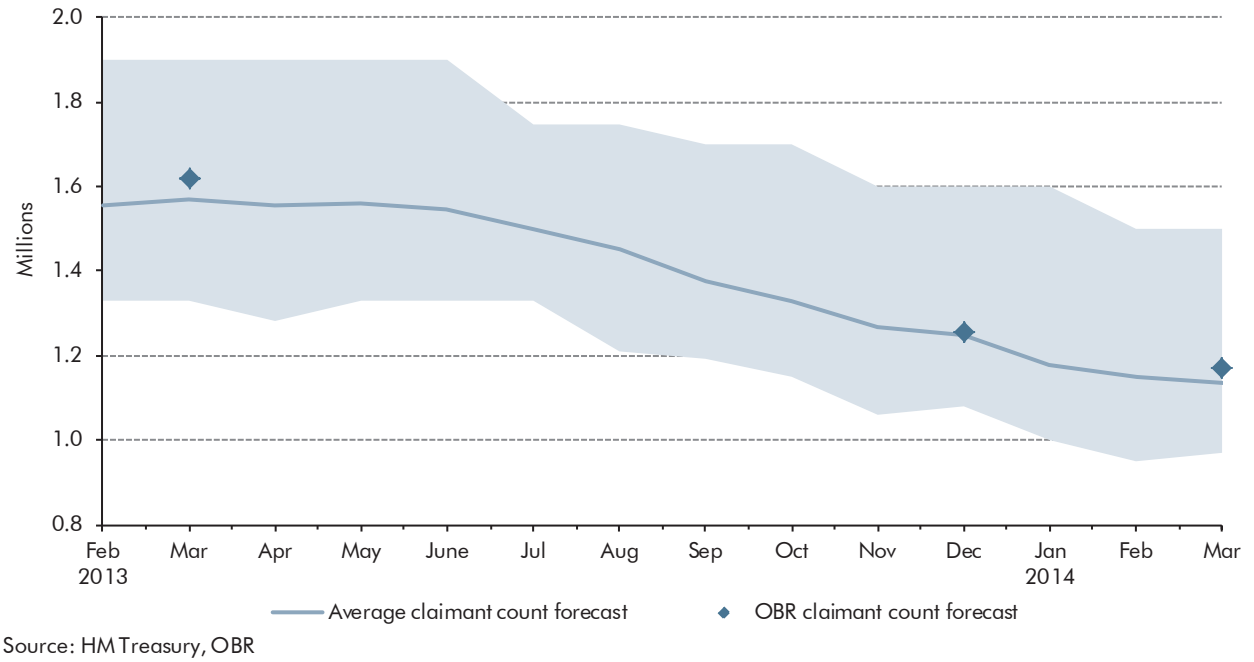


Source: HM Treasury, OBR

Labour market

2.19 The average forecast for claimant count unemployment in the final quarter of 2014 has fallen since our December forecast. It currently stands at 1.13 million, which is 120,000 lower than in December and similar to our 1.17 million forecast (Chart 2.7). The average forecast for employment growth in 2014 has risen from 1.1 per cent in December to 1.6 per cent in March. Average earnings in 2014 are now expected to rise by 2.3 per cent compared to 2.4 per cent in December.

Chart 2.7: Forecasts for the claimant count in the fourth quarter of 2014



Source: HM Treasury, OBR

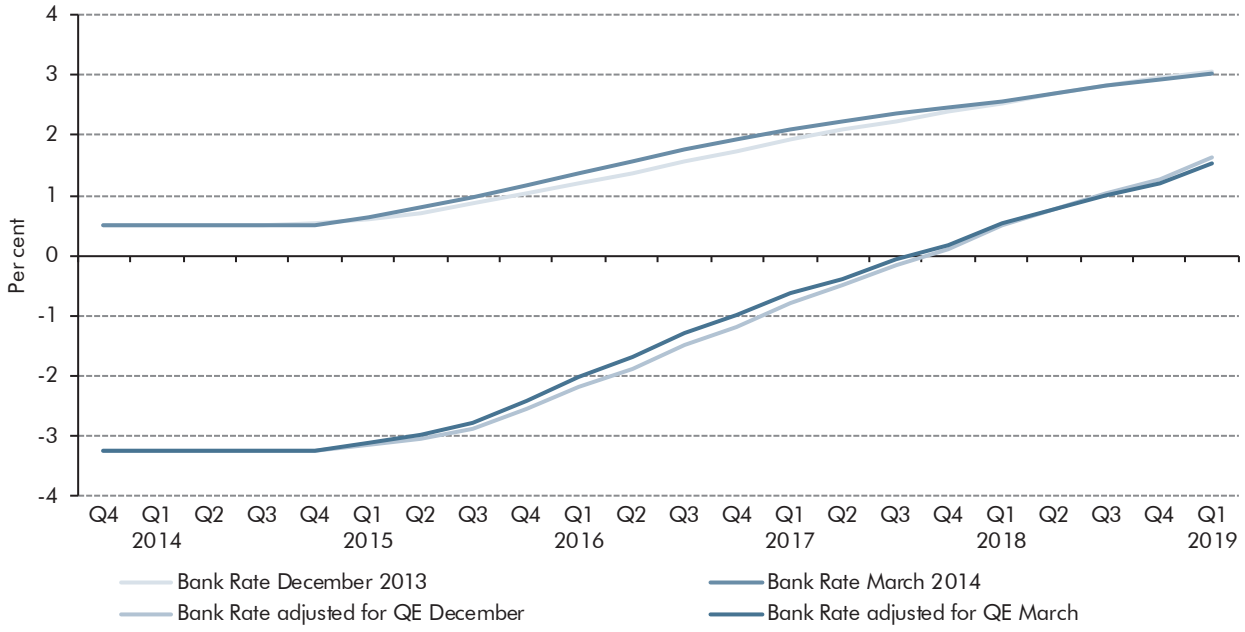
Public finances

2.20 The average forecast for public sector net borrowing (PSNB) for 2013-14 has fallen slightly since December, while the forecast for 2014-15 has risen slightly. Medium term forecasts, compiled in February, suggest PSNB will fall by £17 billion a year on average thereafter.

Market expectations of interest rates

2.21 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. The first quarter in which a rise in Bank Rate to 0.75 per cent is fully priced in is the second quarter of 2015, one quarter earlier than at the time of the December *EFO*. Bank Rate is now expected to reach 2.0 per cent in the first quarter of 2017, one quarter earlier than in December. The shift in expectations towards a slightly tighter monetary stance since December is similar when quantitative easing (QE) is taken into account alongside expectations of Bank Rate, as Chart 2.8 demonstrates. The chart uses our projection for the sale of assets by the APF, which is based on a simple conditioning assumption described in Box 4.1 – this is not our forecast of the Bank's future QE decisions. The latest Treasury survey showed no expected change in the level of QE in 2014 and only two forecasters predicting the sale of QE assets will begin in 2015.

Chart 2.8: Market expectation for Bank Rate adjusted for QE[3]



Source: Bank of England, HM Treasury, OBR

[3] We adjust Bank Rate expectations by 100 basis points for each £100 billion of QE expected in our forecast, consistent with Bank of England analysis. For more details see Joyce, Tong, and Woods, 2011, Bank of England Quarterly Bulletin Volume 51 No. 3, *The United Kingdom's quantitative easing policy: design, operation and impact*. Subsequent analysis has suggested the impact of unwinding QE could be different to that when it was built up. For more details see Miles and Schanz, 2014, Bank of England External MPC Unit Discussion Paper No. 41: *The relevance or otherwise of the central bank's balance sheet*.

3 Economic outlook

Introduction

3.1 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.2);
- describes the key conditioning assumptions for the forecast, including monetary policy, fiscal policy, credit conditions and the world economy (from paragraph 3.26);
- sets out our short- and medium-term real GDP growth forecasts, as spare capacity is brought back into productive use (from paragraph 3.54) and the associated outlooks for inflation (from paragraph 3.65) and nominal GDP (from paragraph 3.78);
- discusses recent developments and prospects for the household, corporate, government and external sectors of the economy (from paragraph 3.84); and
- outlines risks and uncertainties associated with our forecasts and compares our central forecast to those of selected external organisations (from paragraph 3.117).

Potential output and the output gap

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

3.3 Estimating the size of the output gap allows us to 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.

3.4 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

3.5 The first step in our forecast process is to assess how the current level of activity in the economy compares with the potential level consistent with stable inflation in the long term. We cannot measure the supply potential of the economy directly, but various techniques can be used to estimate it indirectly.

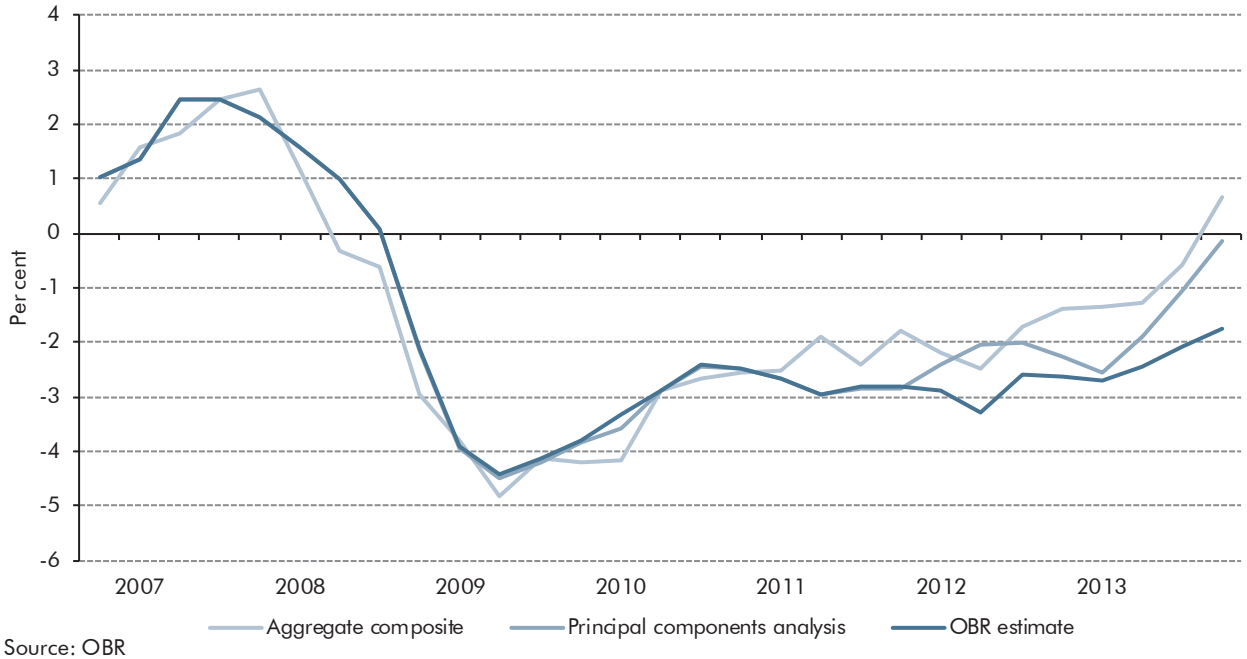
3.6 Our judgement regarding the current size of the output gap is informed by estimates of spare capacity derived from cyclical indicators, as well as other approaches. To estimate the output gap from cyclical indicators, we use two techniques: 'aggregate composite' (AC) estimates, which weight together business survey indicators; and 'principal components analysis' (PCA), which combines survey and non-survey based indicators.[1] But we also take a wide range of other evidence into account and, since our December 2012 *EFO*, we have placed less emphasis on the cyclical indicators in forming our view on the economy's supply potential.

3.7 Reflecting this, Chart 3.1 shows that our central estimate of the output gap has diverged from the PCA and AC measures since the beginning of 2012.[2] Real GDP was only slightly higher at the end of 2012 than at the beginning, but the cyclical indicators implied that the output gap had narrowed. Taking into account the growth of the workforce and capital stock, this implied a fall in potential total factor productivity (TFP) – the efficiency with which the economy could combine labour and capital to generate output.[3]

3.8 A fall in potential TFP seemed plausible in the depths of the recession, given the impact of the financial crisis on the efficient allocation of resources in the economy. But it seemed less plausible that potential TFP should start falling again in 2012 when cyclical influences seemed the better explanation of weak growth. We therefore assumed that potential TFP had remained flat over that year and made an adjustment to the output gap path consistent with that judgement.

[1] More details are set out in OBR, April 2011, Briefing Paper No.2: *Estimating the output gap*; and Pybus, T, November 2011, Working Paper No.1: *Estimating the UK's historical output gap*.
[2] Our cyclical indicator based estimates include a small number of adjustments for outliers – the BCC recruitment difficulties data in the second quarter of 2013, for example.
[3] We used a production function to estimate total factor productivity, which is described in Box 3.1 of our December 2012 *EFO*.

Chart 3.1: Estimates of the output gap



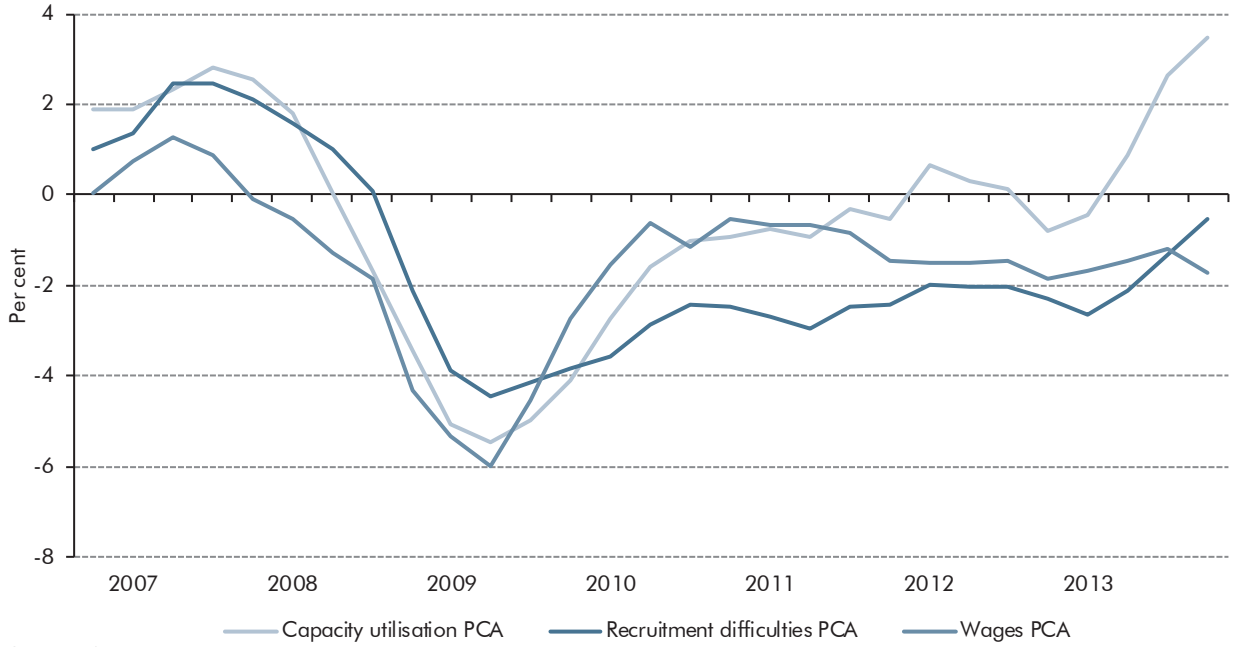
Source: OBR

3.9 It remains difficult to explain why the cyclical indicators should have pointed to such a substantial erosion of spare capacity in 2012. Our latest PCA estimates, combined with capital stock estimates and GDP data revisions, are consistent with a small widening of the output gap towards the end of 2012 and slightly positive TFP growth in the first quarter of 2013. Since then, GDP has grown much faster than we and many other forecasters expected, and the cyclical indicators point to another, sharper, narrowing of the output gap by around 2.3 per cent of GDP over the final three quarters of 2013.

3.10 To understand why the PCA output gap measure has narrowed so significantly we have looked at the disaggregated PCA series. To do so, we have taken three principal components from subsets of the data used to calculate the aggregate measure and standardised them around their sample averages (Chart 3.2). These show that firms are:

- operating at a rate of capacity utilisation typically associated with a boom;
- finding it harder to hire than in early 2013, but easier than would have been the case on average historically; and
- increasing wages at rates well below those consistent with normal levels of productivity growth and unemployment.

Chart 3.2: Principal component subsets



Source: OBR

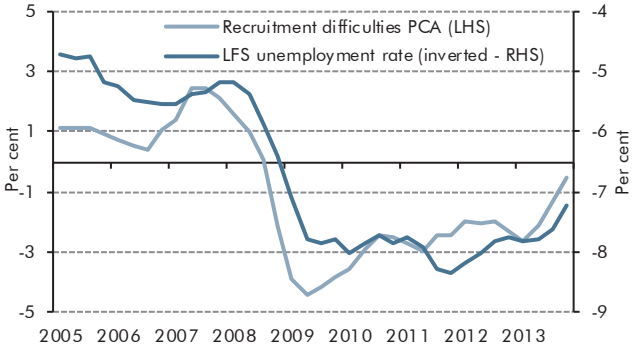
3.11 One possibility is that surveys of recruitment difficulties capture not only the level of slack in the labour market but also the pace of hiring, which may make it feel temporarily more difficult to find staff. We find some evidence of this, with both the level of unemployment and its rate of change significant in explaining the path of the recruitment difficulties principal component. Our estimates suggest that the large fall in unemployment over 2013 may explain around half of the increase in recruitment difficulties over that period. It is harder to explain why the rate of capacity utilisation within firms appears to have risen so much over 2013, but it is possible that respondents may be reporting the amount of capacity available right now, discounting mothballed capacity that could be brought online relatively quickly, though perhaps at a cost.

3.12 Real wages continue to fall. This mainly reflects the ongoing weakness of productivity growth and, in an environment of squeezed profit margins and lower inflation, it is likely that real wage adjustment will continue in the short term as firms return to a normal rate of profitability. Unemployment may also be weighing on earnings and, although a wide range of indicators point to reduced slack in the labour market, we think the survey data probably overstate the narrowing of the output gap.

3.13 The rise in employment towards the end of 2013 was bigger than we and many others expected. As it was not matched by a rise in labour supply, unemployment fell, suggesting there is somewhat less spare capacity in the labour market than we expected in December. The increase in recruitment difficulties points to a sharper narrowing than the unemployment rate suggests (Chart 3.3).

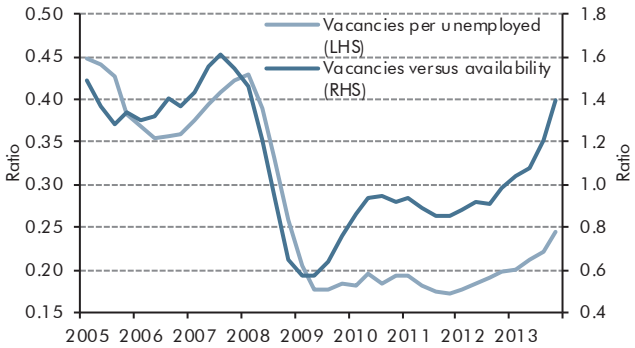
3.14 Other measures of labour market slack also point to a tightening. Chart 3.4 shows that the ratio of vacancies to the reported availability of staff from the REC report on jobs suggests ongoing but receding slack in the labour market. Similarly, the ratio of vacancies to the number of unemployed shows that, while vacancies have risen over 2013, they have done so by less than the fall in unemployment, so the pool of unemployed is smaller relative to the number of jobs available. A broad range of indicators presented by the Office for National Statistics (ONS) in its March 2014 *Economic Review* are also consistent with the output gap having narrowed over 2013, but with some spare capacity remaining in the labour market.

Chart 3.3: Labour market slack (A)



Source: ONS, OBR

Chart 3.4: Labour market slack (B)



Source: ONS, REC

3.15 Considering the balance of evidence, we now judge that the output gap was around 0.2 percentage points narrower in the final quarter of 2013 than we forecast in our December *EFO*, consistent with unemployment being around 0.2 percentage points lower than forecast and leaving the output gap at -1.7 per cent of potential GDP.

3.16 We continue to judge that the recovery in demand over 2013 was not matched by an equivalent improvement in potential supply. This assessment reflects a number of features that, beyond the growth arising from a larger population, lead us to conclude that growth has been largely cyclical:

- productivity growth remains exceptionally weak, consistent with very slow underlying TFP growth;
- the labour market appears to have tightened significantly over the second half of 2013; and
- stronger private consumption has been facilitated predominantly by lower saving rather than from higher real household incomes.

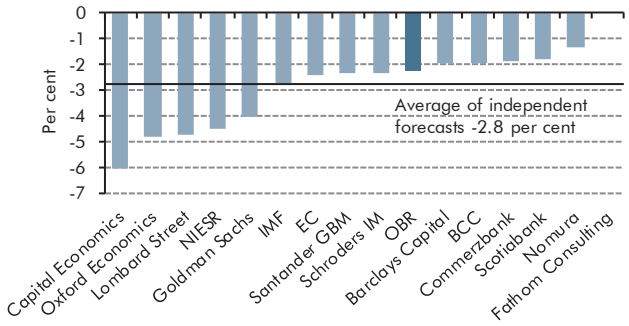
3.17 The recession and subsequent recovery have highlighted a number of difficulties associated with the always-uncertain measurement of the economy's supply potential and we are not alone in grappling with those challenges. In practice, every method has its limitations and

no approach avoids the application of judgement entirely. We intend to review our methods over the summer, ahead of our next *EFO*.

3.18 With these challenges in mind, Charts 3.5 and 3.6 compare our central output gap estimates for 2013 and 2014 to those produced by other forecasters, including those set out in the Treasury's March *Comparison of independent forecasts* and estimates produced by NIESR, the European Commission and the OECD. The average estimate is -2.8 per cent in 2013 and -2.1 per cent in 2014, wider than our central estimates of -2.2 and -1.4 per cent respectively. However, reflecting the skew of the distribution, our forecasts are closer to the median estimates of -2.3 and -1.8 per cent in 2013 and 2014 respectively.

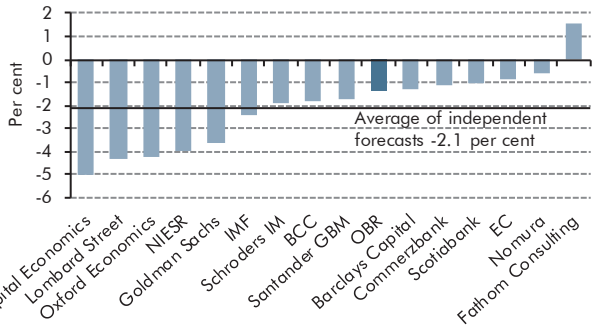
3.19 It is worth remembering that these measures could vary in their definition, so they may not be directly comparable – as discussed in Box 3.1. In Chapter 5, we test the sensitivity of our judgements regarding the Government's performance against its fiscal targets to different estimates of the output gap.

Chart 3.5: Estimates of the output gap in 2013



Source: HM Treasury, March 2014, *Forecasts for the UK economy: a comparison of independent forecasts,* plus additions or updates where known.

Chart 3.6: Estimates of the output gap in 2014



Source: see Chart 3.5

3.20 Of the -1.7 per cent output gap we estimate for the final quarter of 2013, we attribute -1.8 percentage points to the employment rate lying below its potential level and -1.9 percentage points to output-per-hour lying below potential (i.e. cyclical weakness in productivity). These are partly offset by +2.0 percentage points from average hours lying above their long-run trend decline, possibly reflecting unexpectedly weak income growth and negative wealth shocks for many households, leading them to increase labour market input temporarily.

3.21 Given that indirectly measuring the overall size of the output gap is a significant challenge, it should not be surprising that its composition is also a key area of uncertainty. Different decompositions would have different implications for the public finances, reflecting the implied split of labour income between employment, hours and wages.

Box 3.1: Spare capacity in the February 2014 *Inflation Report*

The February 2014 *Inflation Report* saw the Bank of England publish more information about its projections and increase transparency over its assessment of spare capacity. This has prompted external commentators to compare the Bank's assessment of spare capacity with our estimate of the output gap, which are both around -1½ per cent of GDP at the beginning of 2014. In making such comparisons, it is important to recognise that the Bank's estimate of economic slack is conceptually different to the one we use to adjust the fiscal position for the effects of the economic cycle.

We are interested in what might be considered a long-term measure of spare capacity, which we call the output gap. This gives an indication of where the level of output might settle once all shocks have worked their way through the economy. The Bank is more concerned with what could be called a medium-term measure of spare capacity or economic slack, which is what can be expected to influence inflation over its shorter term policy horizon.

For example, long-term unemployment picked up over the course of the recession and around a third of those currently without jobs have been without one for six months or more. To the extent that these individuals have become disconnected from the labour market, there may be less room for employment to grow before exerting upward pressure on wages, and therefore inflation. Taking this into account, the Bank currently judges that the medium-term equilibrium unemployment rate is 6 to 6½ per cent and therefore unemployment currently lies around ¾ to 1¼ percentage points above this.

But, in the fullness of time, many of the long-term unemployed are likely to find their way back into work, and spending on out-of-work benefits and receipts from income tax will come to reflect that. So to estimate the structural fiscal deficit, we need to take a longer view – we judge that the long-term structural unemployment rate is around 5¼ per cent and unemployment is around 1¾ percentage points above it. This assessment is broadly consistent with the Bank's view that the medium-term equilibrium unemployment rate will fall as demand recovers.

Similarly, average hours worked have trended downwards for as long as the ONS has recorded them and we expect this long-run decline to continue, bearing down on tax receipts. But there may be more room to expand average hours over the Bank's policy horizon without generating inflationary pressure. And while both we and the Bank expect productivity per hour to pick up as demand recovers, we see more scope for output to expand without employees putting in more hours.

So, while 'slack in the economy' sounds very much like 'output gap', it depends on the time horizon under consideration and, for this reason, our estimates and those of the Bank are not directly comparable. As it happens, both estimates currently lie at around -1½ per cent of GDP, but this masks a number of differing judgements over both where slack lies and the overall scope for growth in the medium term.

The growth of potential output

3.22 In our December *EFO*, we forecast a gradual strengthening in potential output growth over the forecast period and that remains our central judgement. The growth of potential productivity per hour remains below the rate consistent with historical trends throughout the forecast, reflecting our view that the slow pace of financial system normalisation and related pace at which resources are reallocated to more productive uses will continue to weigh on the sustainable rate of growth for some years.

3.23 While the headline potential growth rate forecast is little changed, we have made some small adjustments to its composition. We expect rising population to be a slightly bigger source of potential growth over 2014 with net migration holding up a little more than we assumed in December, but for a little less to come from productivity growth, reflecting weak actual productivity towards the end of 2013. Therefore, on a per capita basis, growth will be a little weaker. We explore the historical context of this in Box 3.2.

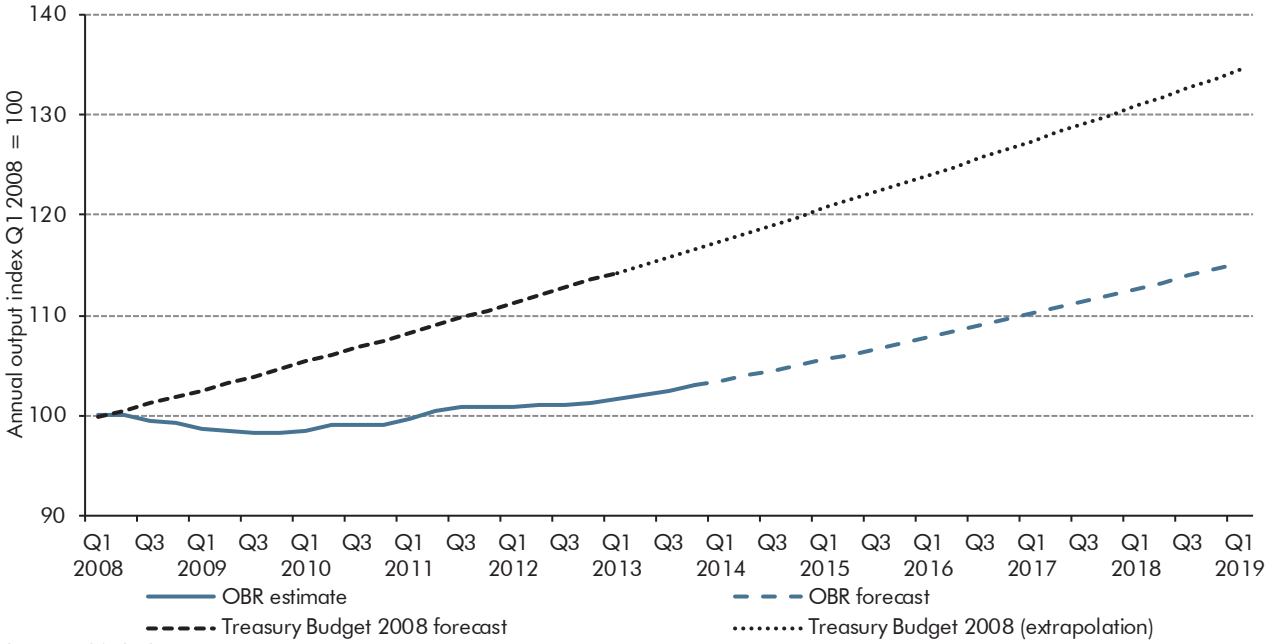
Table 3.1: Potential output growth forecast (annual growth rate, per cent)

	Potential productivity[1]	Potential average hours	Potential employment rate[2]	Potential population[2]	**Potential output[3]**
2013	0.6	-0.2	0.1	0.7	1.2
2014	1.4	-0.2	0.0	0.7	1.9
2015	1.7	-0.2	-0.1	0.6	2.1
2016	1.9	-0.2	-0.1	0.6	2.2
2017	2.0	-0.2	-0.1	0.5	2.2
2018	2.0	-0.2	-0.1	0.5	2.2

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

3.24 We judge that the level of potential output in the final quarter of 2013 is around 12 per cent below the level consistent with an extrapolation of the Treasury's March 2008 Budget forecast – the last before the recession – with the difference widening by a further 2½ percentage points over the forecast period (Chart 3.7). This reflects our view that much of the loss of productivity over the recession was structural and will not return even as the economy recovers and the financial system returns to full health. 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 the rate consistent with historical trends – Box 3.2 illustrates that recent developments are without precedent.

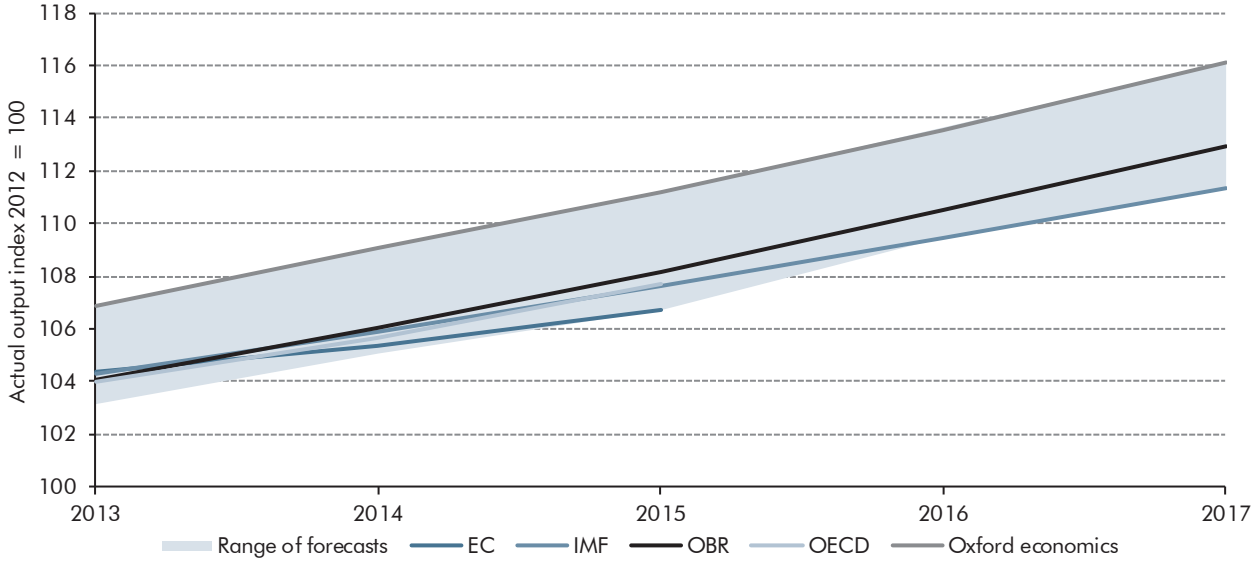
Chart 3.7: Potential output relative to the Treasury's Budget 2008 forecast



Source: ONS, OBR

3.25 Chart 3.8 presents our potential output projection alongside those of external forecasters that publish similar projections. It shows that we, the IMF and the OECD have made similar judgements over the margin of spare capacity in 2013 and forecast a similar growth rate of potential output in 2014. Thereafter, we expect potential to grow a little faster than the IMF and OECD. The range presented in the chart illustrates the uncertainty surrounding this crucial judgement – we test the sensitivity of the Government's fiscal mandate to it in Chapter 5.

Chart 3.8: Potential output forecasts



Source: OBR; OECD, November 2013, *Economic Outlook* ; European Commission, February 2014, *Winter European Economic Forecast*; IMF, October 2013, *World Economic Outlook*; HM Treasury, March 2014, *Forecasts for the UK economy: A comparison of independent forecasts*. Range of forecasters includes Commerzbank, Goldman Sachs, Nomura and Oxford Economics - constructed using GDP growth and output gap forecasts (not all forecasters present forecasts for all years).

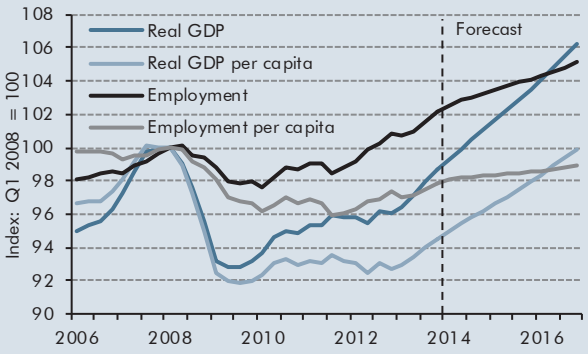
Box 3.2: GDP per capita and productivity

Since the beginning of 2010, real GDP has risen by around 5¼ per cent and 1.3 million more people are in work. But the population aged 16 and older has grown by 1.4 million and so GDP per capita on this basis has grown by just 2½ per cent, remaining 5½ per cent below its pre-crisis peak. Likewise, real per capita consumption has fared far worse than aggregate consumer spending and remains 5½ per cent lower than before the crisis. Similarly, while employment now exceeds its pre-crisis level, the proportion of the population employed does not.

Fundamentally, GDP per capita cannot be expected to grow sustainably unless productivity grows and productivity has been exceptionally weak in the recent past. We expect recent trends to become less dominant – population growth is forecast to slow and productivity growth to pick up. Chart A shows that we expect the economy to be bigger than it was before the crisis by mid-2014, but we do not expect GDP per capita to reach its pre-crisis peak until early 2017.

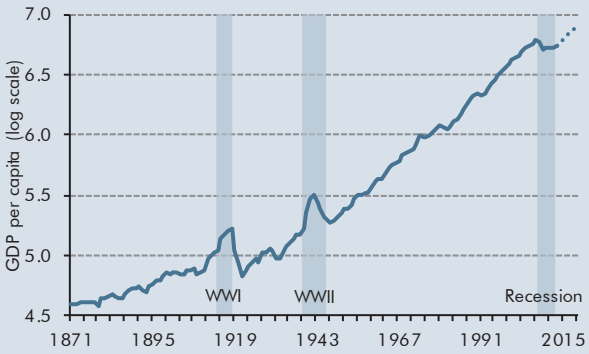
The uncertainty over this judgement is highlighted in Chart B, which shows that the recent persistent shortfall of per capita GDP is without peace-time historical precedent. It seems reasonable to us that the rate of productivity growth should return to historical norms, but, without the past as a useful guide, it is difficult to judge how long this might take.

Chart A: Real GDP and employment[a]



Source: ONS, OBR

Chart B: Real GDP per capita[b]



Source: Bank of England, ONS, OBR

Even the judgement that efficiency improvements will resume is subject to extensive debate among external commentators. Some believe the financial crisis of 2008 coincided with a permanent slowdown in productivity growth, perhaps reflecting the exhaustion of 'low-hanging fruit' efficiency gains in the IT sector.[c] Others are more optimistic, assuming efficiency gains have continued apace but that weak demand is masking the process.[d]

Our central judgement lies between these two views. We expect productivity growth to return to its historical average as the pace at which resources are reallocated to more productive uses picks up, but with the level of productivity, and therefore per capita GDP, permanently lower relative to its pre-crisis trend. This judgement is subject to significant risks in both directions.

[a] Population on age 16+ basis.
[b] Total population basis.
[c] Gordon, R, 2012, NBER Working Paper: *Is economic growth over? Faltering innovation confronts the six headwinds.*
[d] Martin, B. & Rowthorn, R, 2012, CBR Working Paper: *Is the British economy supply constrained II?*

Key economy forecast assumptions

Monetary policy

3.26 Our forecast assumes that the Bank of England will endeavour to bring inflation to target over its forecast horizon, consistent with the Monetary Policy Committee (MPC) remit set by the Chancellor. Since our December *EFO*, the Bank has provided further guidance on the broader assessment of spare capacity in the economy that will guide policy once its unemployment threshold of 7 per cent has been reached. The February *Inflation Report* stated that *"the MPC will seek to close the spare capacity in the economy over the next two to three years while keeping inflation close to the target. To that end, it judges that there is scope for the economy to recover further before Bank Rate is raised and, even when Bank Rate does rise, it is expected to do so only gradually and to a level materially below its pre-crisis average of 5 per cent."*[4] The impact of this guidance should be captured in the market-derived interest rate expectations on which we condition our forecast.

3.27 In November 2013, further changes were announced to the Funding for Lending Scheme (FLS), reorienting the scheme towards SME lending. Since the changes have come into effect, there has been little effect on bank funding costs, consistent with our December forecast judgement.

Fiscal policy and Budget measures

3.28 Applying the multipliers we have used in previous forecasts to the latest estimates of the fiscal consolidation produced by the Institute for Fiscal Studies (IFS) would suggest that consolidation measures announced since 2008 have reduced the level of GDP by around 1.7 per cent in 2012-13. When taken together with estimated underspends by central government, they imply a positive impact on GDP growth in both 2013-14 and 2014-15 of 0.2 percentage points, as the effects of previous tightening fade a little faster than new tightening bears down on GDP. There is significant uncertainty associated with such estimates. As set out in Box 3.3, the net effect on GDP of measures announced in Budget 2014, which is fiscally neutral over the forecast period, is expected to be negligible.

[4] Bank of England, February 2014, *Inflation Report,* page 7.

Box 3.3: The economic effects of policy measures

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

The Government has announced a number of measures between 2014-15 and 2018-19 that are expected to have a neutral fiscal impact, with 'giveaways' offsetting 'takeaways' over this period. Using the same multipliers that the interim OBR used in June 2010, these measures are expected to have a negligible effect on annual GDP growth and have no effect on our GDP forecast. Given the relatively small size of these measures, using larger multipliers would not change this conclusion.

The Government has adjusted its assumption for the growth of Total Managed Expenditure beyond 2015-16 and reduced spending further on top of that change. The overall effect of these changes leaves spending as a share of GDP little changed from our December forecast. Within total spending, the level of implied resource DEL, the key input into our economy forecast, is little changed from our December forecast: so nominal government consumption is expected to be just 0.4 per cent higher by 2018-19 than in December. At that time horizon, we assume any change affects the composition of GDP rather than the level, as monetary policy is assumed to determine the overall amount of spending in the economy.

We have examined measures that could directly affect the price level. Changes to air passenger duty bands, alcohol duty, tobacco duty and the lower trajectory of the Carbon Price Floor are expected to have very small and offsetting effects on inflation.

The Government has announced that the temporary increase in the Annual Investment Allowance will be extended for a further year, to December 2015, and increased to £500,000. This is likely to induce some firms to bring forward investment spending. Although all firms investing over £25,000 in plant and machinery qualifying for capital allowances will benefit, it is worth noting that only around 9 per cent of qualifying investment is spent by firms investing within the relevant threshold (and thus having the greatest incentive to bring forward investment). We have assumed that this measure leads to a total of just under £1 billion of business investment being brought forward from 2016 and 2017 into 2014 and 2015, based on the temporary effect of the measure on the cost of capital and the cash flow effect of the allowance. This is a small change relative to the size of the economy, so has a negligible effect on real GDP growth. As this is a temporary measure, it has no effect on the long-run cost of capital, and so the level of investment by the end of the forecast is unchanged.

The Government's decision to increase the personal allowance could affect the labour supply decision of individuals at the margin – the higher personal allowance increases the reward to work. But given the small size of these potential effects we have not made any explicit adjustments to our forecast.

The Government has announced a package of savings and pensions measures. They include raising and equalising the limits for both cash ISAs and stocks and shares ISAs to one overall limit of £15,000; reducing tax on the first band of savings income from 10 per cent to zero and extending that band to £5,000; and the introduction of an attractively-priced National Savings

and Investments (NS&I) product for pensioners. The Government has also announced a number of tax measures that increase the flexibility with which individuals can access their defined contribution pension assets.

It is likely that such measures will affect the composition of households' financial and non-financial assets, as households reallocate assets to benefit from the different tax treatments. By reducing the extent to which the tax system discourages the withdrawal of pension saving, for example, it is possible that funds will be redirected from annuities into other assets, such as other financial products or housing. Some people will temporarily increase pension saving in order to benefit from tax-free lump sum withdrawals. It is also possible that such funds could be used to finance consumption, although such effects are likely to be small. The scale and timing of such effects are subject to very considerable uncertainty, not least because households are able to shift very large deposit balances over relatively short timeframes (see Box 3.4). As we consider the principal effect of these measures will be on the composition of household assets, rather than aggregate flow of saving or spending, we have not adjusted our forecast for these measures.

The Government has announced that it will extend the equity loan element of the Help to Buy scheme from 2016-17. At this horizon, with the economy and financial system expected to have recovered further, we have not assumed any additional effect from the extension of the scheme. To the extent that any lending associated with this extension is additional, the measure would help to support our forecast for relatively strong rates of residential investment growth and the return of property transactions back toward a historical trend relative to the housing stock.

Credit conditions

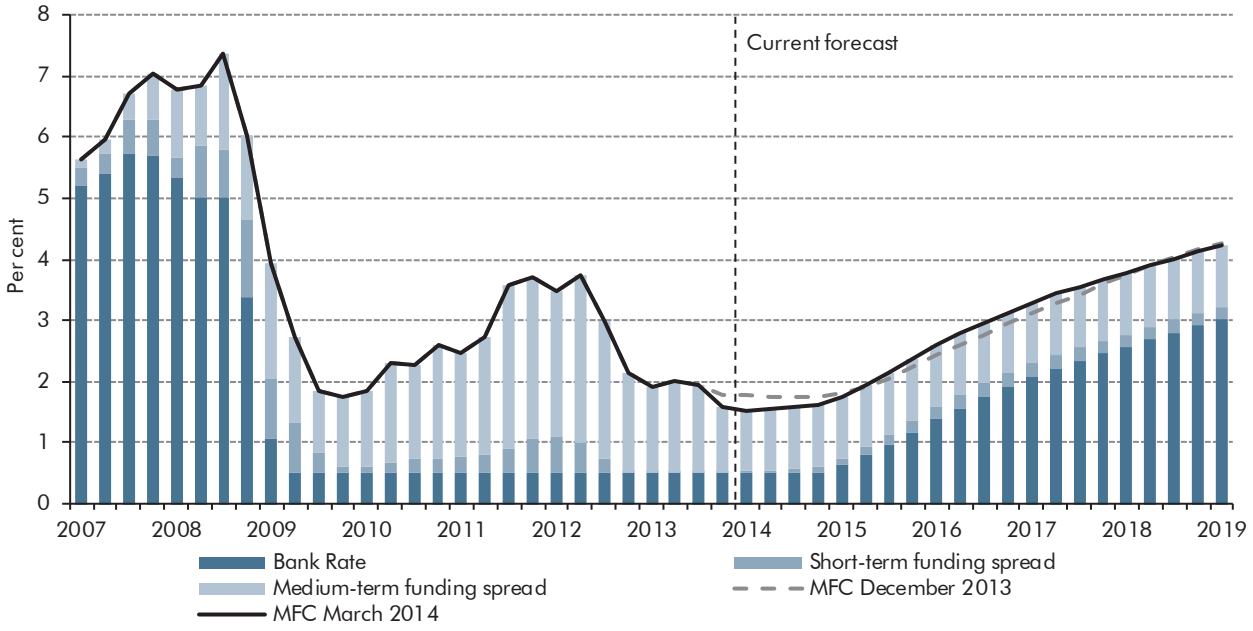
3.29 Domestic financial and credit market conditions continue to improve. Better prospects for the euro area financial system, reduced uncertainty over the path of fiscal policy in the US, the strengthening of the UK economy and availability of the FLS have all helped to lower perceived risks to UK banks' balance sheets and contain funding costs.[5] We assume the current, relatively benign, environment for bank funding will be sustained across the forecast period. Risks around this assumption are tested in the scenarios presented in Chapter 5.

The price of credit

3.30 With spreads stable, we do not expect banks' variable-rate funding costs (the benchmark for new variable-rate mortgages) to rise until early-2015, when markets expect the first Bank Rate rise (Chart 3.9). Costs then rise gradually, consistent with a gradual normalisation of monetary policy. Relative to our December forecast, higher Bank Rate expectations have been offset by lower medium-term spreads and so the outlook is little changed. However, swap rates – a benchmark for new fixed-rate mortgages – have already started to rise, reflecting market expectations for future Bank Rate rises (Chart 3.10). This may push up interest rates on new fixed-rate mortgages sooner than variable-rate mortgages.

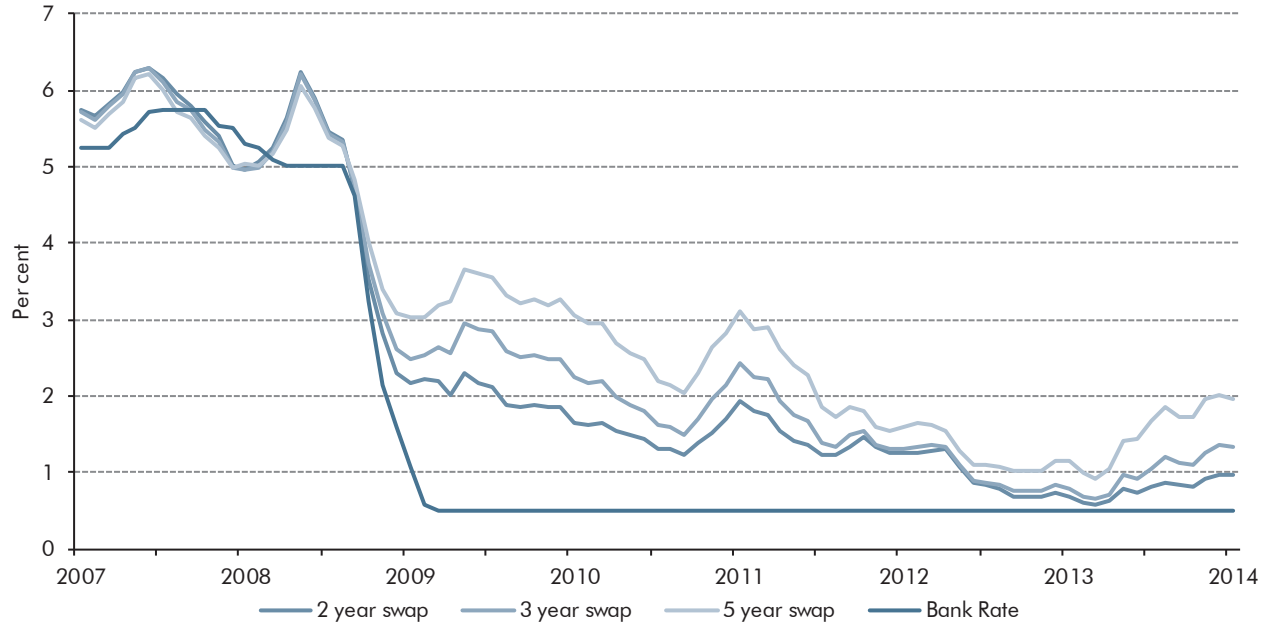
[5] The latest Bank of England systemic risk survey shows that the perceived probability of a high impact event in the UK financial system has fallen to its lowest level since the survey began in 2008.

Chart 3.9: Banks' marginal funding costs



Source: Bank of England, Thomson Reuters Datastream, OBR

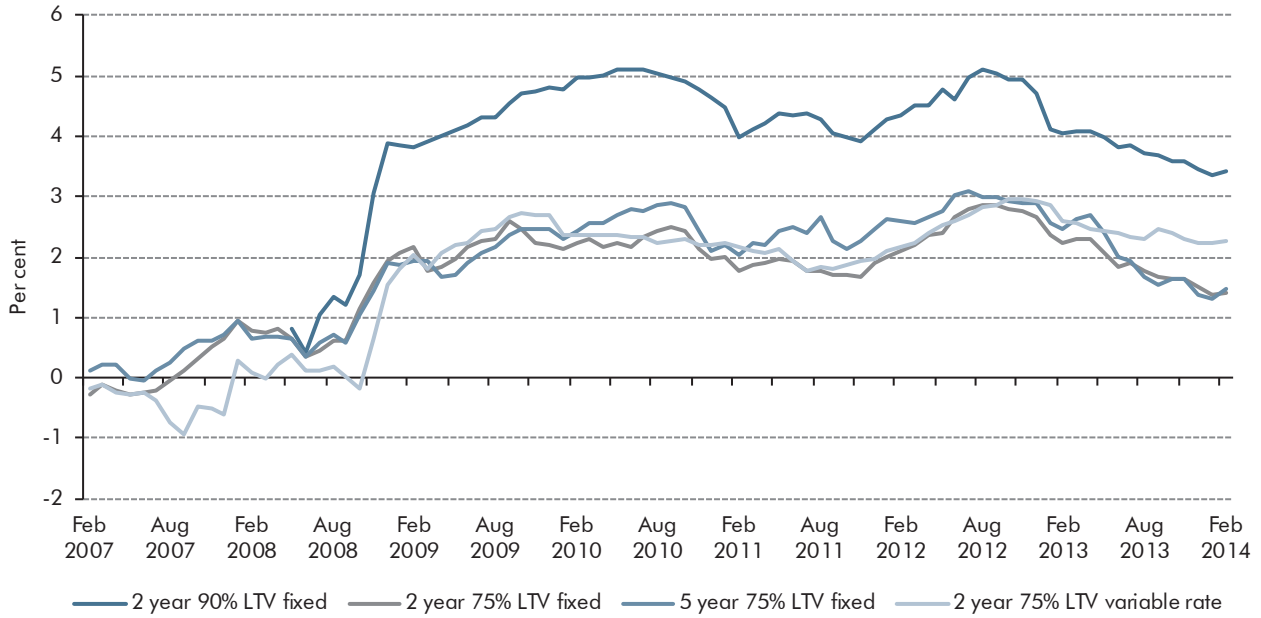
Chart 3.10: Market interest rates



Source: Bank of England, Bloomberg

3.31 Lower bank funding costs continue to feed through to lower lending rates and easier access to credit for customers, particularly for mortgages. The revival in the housing market, together with the Government's Help to Buy scheme, may also have pushed down on mortgage rates (Chart 3.11). We expect competition between lenders to further squeeze profit margins on high-LTV mortgages.

Chart 3.11: Spreads on average quoted mortgage rates



Source: Bank of England, Bloomberg

3.32 Although new mortgage rates have fallen rapidly 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 – terms on existing mortgages are revised only when contracts expire, usually every 2 to 3 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 effective mortgage rates will rise more slowly than Bank Rate over the forecast period.

3.33 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) have fallen slightly in recent months on some measures, but other survey-based measures are more equivocal.[6] Overall, we expect the spread of corporate loan rates over reference rates to narrow over the forecast, as profitability and perceptions of creditworthiness improve.

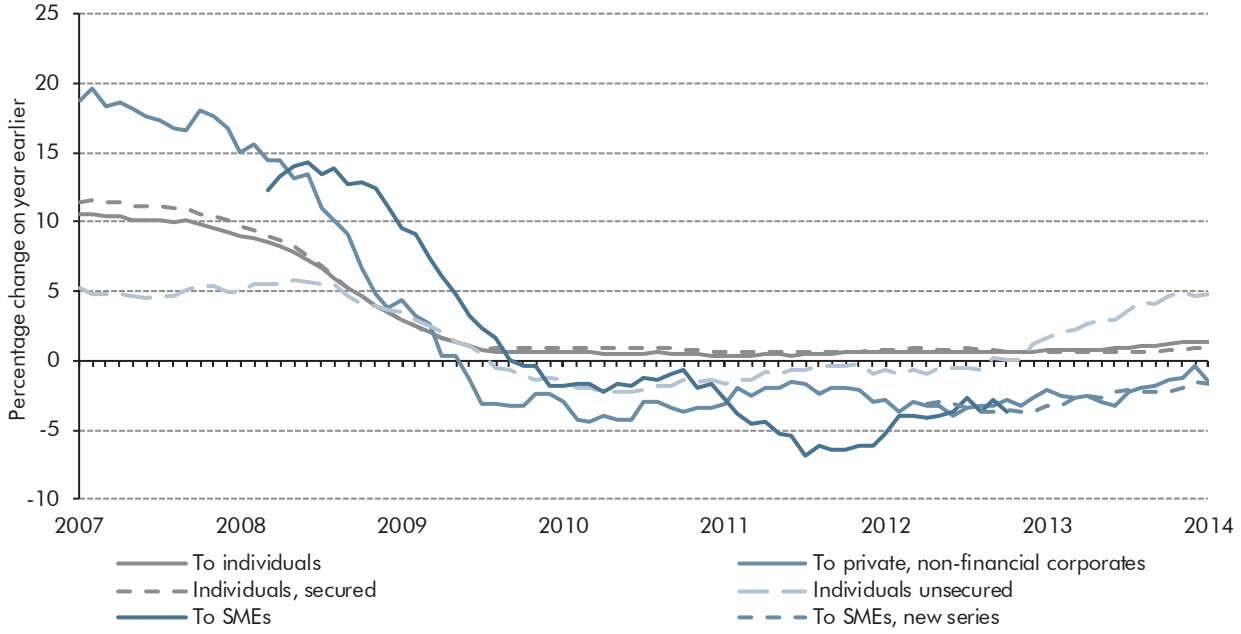
The flow of credit

3.34 Household borrowing continues to pick up, reflecting rising house prices and housing market turnover. Gross new secured borrowing, which primarily consists of mortgages, has risen by nearly 50 per cent since mid-2012 and the introduction of the FLS, although much of this appears to have been offset by repayments (see Box 3.4). We expect net secured lending to grow over the forecast period as house prices rise and the number of first-time

[6] Bank of England, January 2014, *Trends in Lending*.

buyers increases, supported by Help to Buy, with some moderating effect from the implementation of stricter Mortgage Market Review rules from April 2014.[7]

Chart 3.12: Net lending to the wider economy



Source: Bank of England

3.35 The growth of net unsecured borrowing has picked up, boosted by loans for car purchase. To the extent that growth in car finance is linked to compensation related to payment protection insurance (PPI) mis-selling (which has reportedly provided some households with enough cash for a deposit), the growth of unsecured lending may slow as the flow of PPI claims tails off.[8] But most household debt is secured against houses, so this will have little impact on the overall stock of household debt over the forecast period.

3.36 Bank lending to non-financial companies continues to fall, although at a slowing annual rate (Chart 3.12). Large corporates continue to choose non-bank sources of funds: favourable wholesale market conditions have encouraged strong net issuance of bonds. Recent improvements in loan spreads, fees and availability of bank credit, and further improvements expected in the near term, suggest stronger demand for and supply of loans to corporates in 2014.

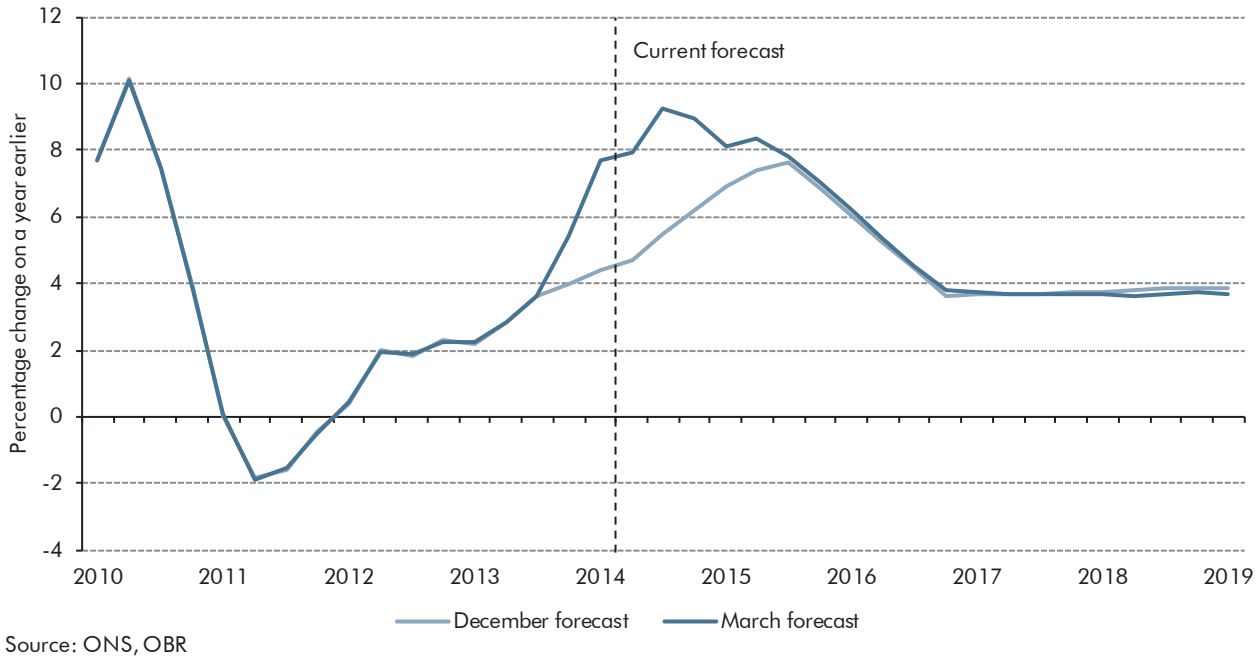
3.37 Lending to small businesses remains weak. Credit availability has been slower to improve than for mid-size and large corporates, with little movement in loan spreads.[9] But both demand and supply are expected to pick up, given improvements in the economy and changes to the terms of the FLS to refocus it towards SME lending.

[7] A key effect will be the application of affordability tests to new mortgagors by lenders (rather than intermediaries) based on the outlook of interest rates for the next five years, proven income and committed/essential expenditure.
[8] Bank provisions currently amount to around £19 billion; with £13.5 billion already paid out, we assume the flow will taper off in 2015.
[9] Bank of England, Q4 2013 Credit Conditions Survey.

House prices

3.38 House prices have continued to accelerate since our December forecast, with annual growth reaching 5.5 per cent in December 2013. Market indicators, including other house price indices, suggest further acceleration through the first quarter of 2014. We expect this momentum to carry on through the early years of the forecast. Relative to our December forecast, there is no additional pressure from the fundamentals of housing demand or supply, given little change to our outlook for real incomes or residential investment. We therefore expect house price growth to peak higher and earlier than in our December forecast, at 9.2 per cent in the third quarter of 2014, with prices rising by around 30 per cent by 2018-19. By the end of the forecast period, house prices are expected to be 0.5 per cent below their pre-crisis peak in real terms and the house price to income ratio to be 2.3 per cent below its pre-crisis peak.

Chart 3.13: House price inflation forecast



Source: ONS, OBR

Box 3.4: Bank deposits, mortgage lending and the housing recovery

In 2013, households' balances in 'time deposit' accounts (savings with fixed maturity) fell by £36 billion. This has been interpreted by some as consumers drawing down their savings to finance consumption. Households can use their savings in many ways – to reduce debt, buy different assets (such as houses) or indeed to fund current consumption – but it is impossible to know which from aggregated data.

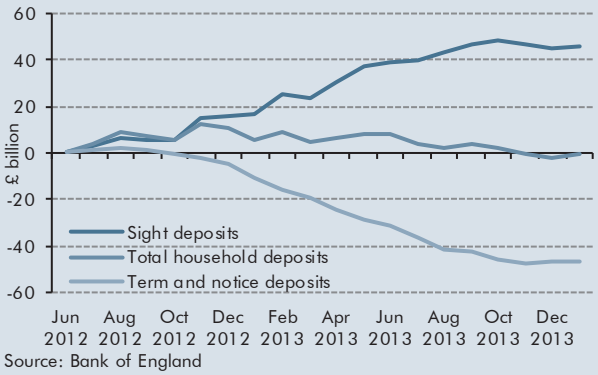
We find a more likely answer in the wider picture of household savings behaviour. While some deposit balances have been falling, others have been rising: deposits in 'sight' accounts (with no restriction on access, for example current accounts) have increased rapidly and household deposits as a whole have continued to rise (Chart C). This shift in composition could be explained by the narrowing spread between 'time' and 'sight' deposit interest rates. Or this could be a normalisation of household investment behaviour: the split of total deposits between 'time' and 'sight' has now returned to pre-crisis levels.

The revival of the housing market could also affect switching between deposit types: some households could be withdrawing savings built up after the crisis and, with borrowing conditions easing, using them as down-payments on house purchases. At the other end of the transaction, sellers are paying off their mortgage and initially depositing the proceeds as 'sight' deposits.

Greater housing market activity could also be contributing to the overall strength of deposit growth. The recent pick-up in property transactions and prices has been matched by strong growth in new mortgage lending, but mostly offset by mortgage repayments, as sellers pay off their mortgages (Chart D). Net mortgage lending has also started to rise, contributing to the overall stock of deposits. Remortgaging, the engine of equity withdrawal and deposit growth before the financial crisis, remains subdued. Continued housing market recovery will lead to more debt and deposit growth.

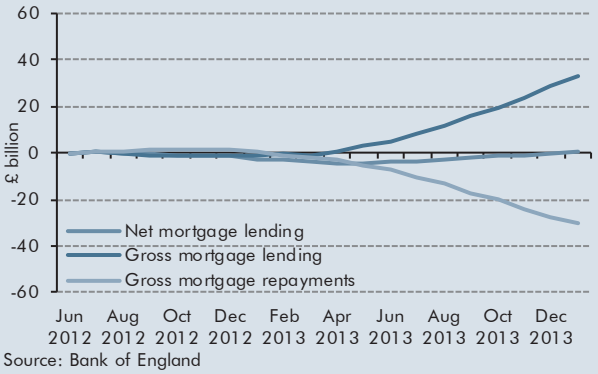
An important conclusion that can be drawn from these developments is that households are able to shift very large deposit balances over relatively short timeframes. This is one reason why the impact of the policy measures discussed in Box 3.3 is subject to considerable uncertainty.

Chart C: Cumulative change in annual deposit flows



Source: Bank of England

Chart D: Cumulative change in annual mortgage flows



Source: Bank of England

World economy

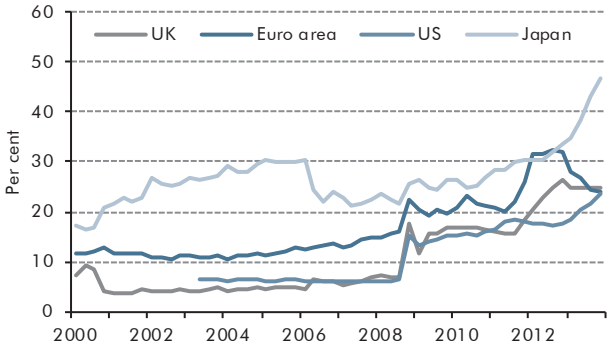
3.39 World output grew by 3.1 per cent in 2012 and appears to have slowed thereafter to 2.9 per cent in 2013. Stronger performance in advanced economies in the second half of 2013 has been offset by weaker growth for some emerging market economies, partly reflecting tighter financial conditions. Recent survey evidence suggests strong global output growth in the first quarter of 2014. For example, the JP Morgan *Global Manufacturing PMI* is at the highest level since May 2011, showing expansion across the euro area, US and Japan. Surveys in China have weakened since the start of 2014.

3.40 The euro area economy contracted by 0.4 per cent in 2013 as a whole, but much of this reflects weak growth at the end of 2012, with GDP having expanded by 0.7 per cent in the final three quarters of 2013. Growth of 0.3 per cent in the final quarter was broad based across core and periphery countries, which has been reflected in sovereign bond yields falling steadily in periphery countries. The pace of fiscal tightening is set to ease in 2014. Some cyclical momentum and the steady return of confidence are reflected in our forecast of 1.0 per cent growth in 2014 and 1.4 per cent growth in 2015, up 0.2 and 0.1 percentage points respectively from our December forecast.

3.41 Considerable downside risks remain to the outlook for the euro area, including the extent to which lower sovereign bond yields are passed through to the private sector, and ongoing adjustments to competitiveness and institutional reform continue. Persistently low inflation and the possibility of deflation in the euro area also remain a risk to the global and UK outlook. Euro area core inflation in January was 0.8 per cent (consumer price inflation excluding food and energy is shown in Chart 3.15). 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 12 per cent in recent months.

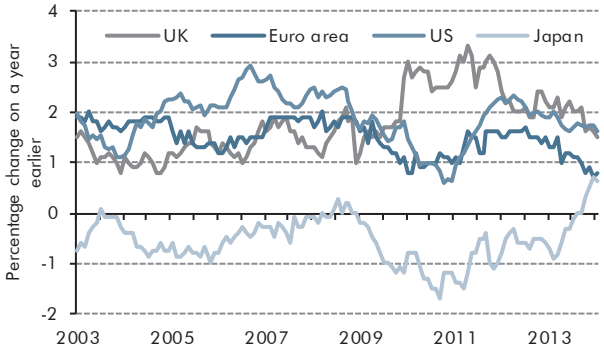
3.42 The ECB staff projections published in March 2014 show inflation at 1.3 per cent and the unemployment rate at 11.7 per cent in 2015. Meanwhile the ECB's balance sheet is shrinking (Chart 3.14). In particular, since December 2013, banks have repaid loans made from long-term refinancing operations. This contrasts with further expansion of central bank balance sheets in the US and Japan, and no change in the UK.

Chart 3.14: Central bank balance sheets as a share of nominal GDP



Source: European Commission, Thomson Reuters Datastream

Chart 3.15: Inflation excluding food and energy prices



Source: Thomson Reuters Datastream

3.43 Ongoing weakness in the region has had a wider effect on the UK economy as the EU is the UK's largest export market. The volume of non-oil goods exports from the UK to the EU was unchanged between 2012 and 2013, while the volume of non-oil goods exports to the rest of the world increased by 1.2 per cent over the same period. Detailed ONS data for foreign direct investment in 2012 show that the fall in the rate of return on UK-owned investments abroad is to some extent driven by euro area weakness.

3.44 The US economy grew by 1.9 per cent in 2013, with strong momentum through the second half of the year. A budget deal was reached by the US Congress in December 2013, which eased the programme of government spending cuts and tax rises planned for 2014. As a result, we have revised up our forecast for US growth in 2014 to 3.0 per cent. The US central bank has slowed the pace of asset purchases under its QE programme.

3.45 Since our December forecast, some emerging market economies have experienced significant capital outflows and accompanying currency depreciations, triggered partly by US monetary policy. This volatility seems to reflect country-specific factors, rather than broad-based capital outflows, but other as yet unaffected emerging economies with large current account deficits and high inflation remain at risk. Our forecast for emerging markets assumes that the impact of the recent instability is short lived. Downside risks remain, as described by the IMF: "*a persistent tightening of financial conditions [from emerging market financial volatility] could undercut investment and growth in some countries*".[10]

3.46 China's economy grew by 7.7 per cent in 2013. With strong growth in the final quarter, we have raised our forecast for China's GDP growth in 2014 slightly. Recently, there have been concerns that momentum in the Chinese economy may be slowing and about risks in the Chinese financial system, and the extent to which policy makers can offset such developments. This is likely to have contributed to the instability in emerging market financial conditions and global commodity prices.

3.47 The recent crisis in Ukraine and the impact on financial markets in Russia has not yet had much direct effect on global economic activity. At the time of closing down our forecast,

[10] IMF, February 2014, *Global prospects and policy challenges*.

there had only been a small impact on global commodity prices, which have also been affected by other factors (including developments in China). A prolonged crisis, or an escalation of tensions, could have a larger effect on global commodity prices and growth prospects.

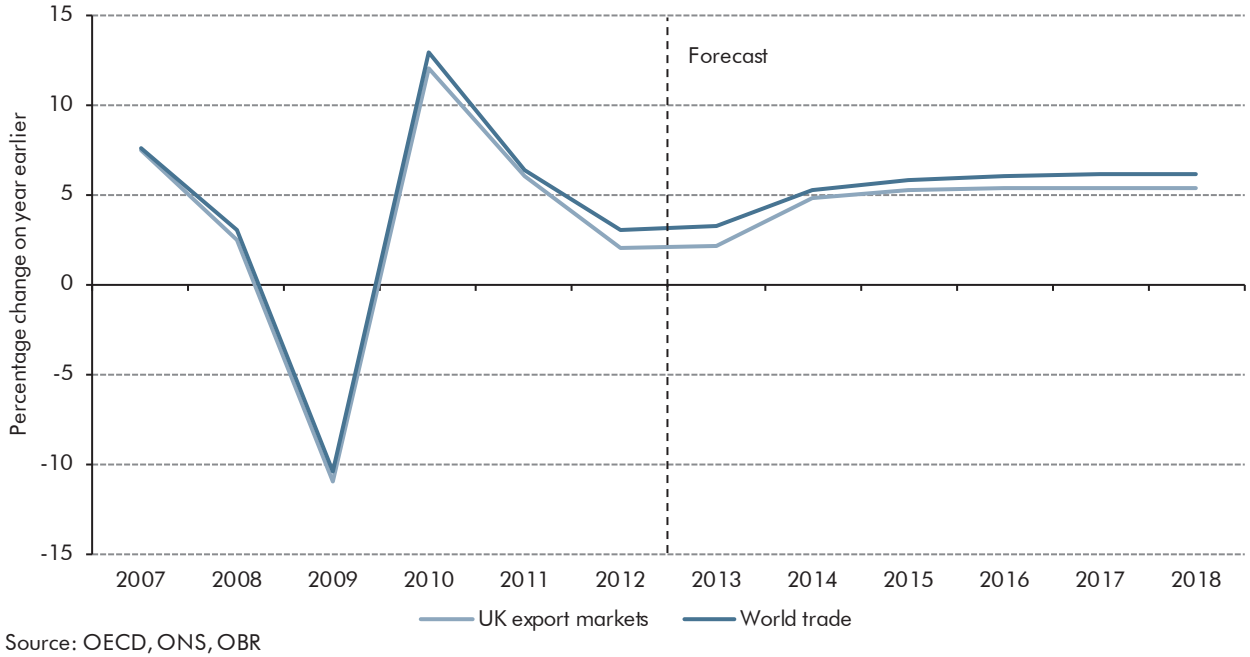
3.48 We explore the potential impact of global risks affecting the price of credit in the UK in our scenarios in Chapter 5.

World trade

3.49 Historic world trade data have been revised up since 2010. But world trade in the second and third quarter of 2013 is estimated to have been slightly weaker than our December forecast. Within the euro area, weaker trade in core countries was partly offset by much stronger trade in the periphery. Similarly, mixed outturns across emerging market economies have broadly offset one another. Overall, the changes have increased our estimate of world trade growth in 2013 by 0.4 percentage points to 3.2 per cent. But the weakness in the most recent trade data has led us to reduce our forecast for world trade growth in 2014 by 0.2 percentage points to 5.2 per cent.

3.50 Growth in UK export markets is expected to be slower than growth in world trade (see Chart 3.16). This is because slower-growing economies, such as the euro area and the US, make up a larger share of UK exports. We have revised our forecast for growth in UK export markets in 2014 down by 0.1 percentage point to 4.7 per cent. From 2015 onwards, our forecast is unchanged from our December *EFO*.

Chart 3.16: World trade and UK export market weighted trade growth

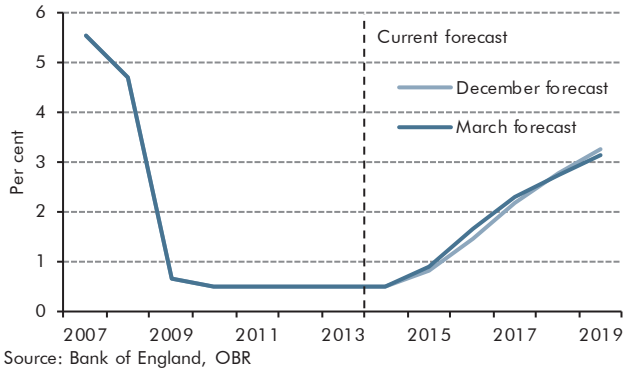


Source: OECD, ONS, OBR

Other conditioning assumptions

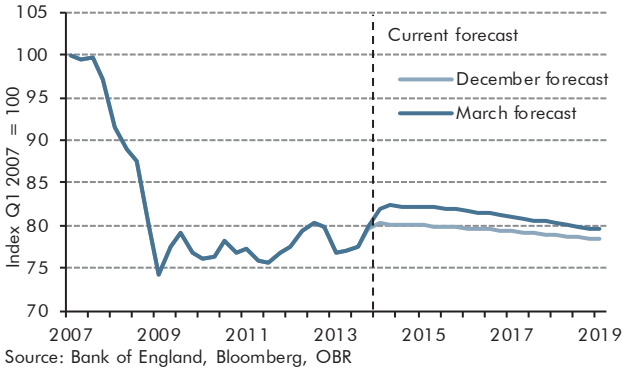
3.51 We use conditioning assumptions for interest rates, the exchange rate, oil prices and equity prices. The following charts show the assumptions used in this *EFO* and how they have moved since our December *EFO*. The only methodological change we have made since the December forecast has been to switch from Bloomberg data to Bank of England data for market-derived Bank Rate expectations.

Chart 3.17: Bank Rate assumption



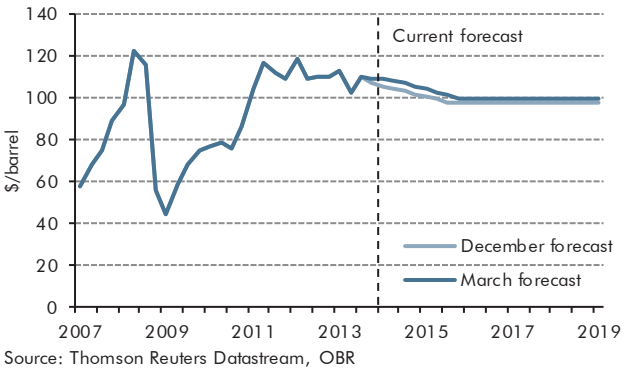
Source: Bank of England, OBR

Chart 3.18: Sterling effective exchange rate assumption



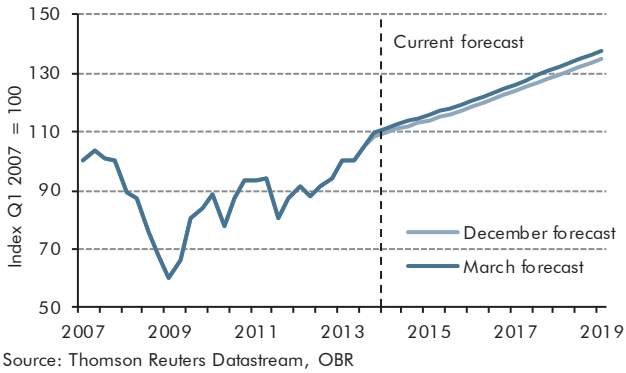
Source: Bank of England, Bloomberg, OBR

Chart 3.19: Oil price assumption



Source: Thomson Reuters Datastream, OBR

Chart 3.20: Equity prices assumption



Source: Thomson Reuters Datastream, OBR

Summary

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

- monetary policy remains very loose and does not begin to tighten until early-2015;
- fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past three years;
- the measures announced in this Budget have a negligible overall impact on demand and CPI inflation, though they are expected to bring forward some business investment;

- credit conditions and the financial system continue to normalise gradually;
- global activity and demand for UK exports picks up steadily, albeit slightly more slowly in the near term than expected in December; and
- financial markets are broadly stable and commodity prices ease a little.

3.53 Risks and uncertainties associated with these assumptions and other facets of the forecast are discussed from paragraph 3.117.

The pace of the recovery

3.54 In this section, we set out the expected path of GDP growth over the forecast period. We first consider the short-term outlook, using information from 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

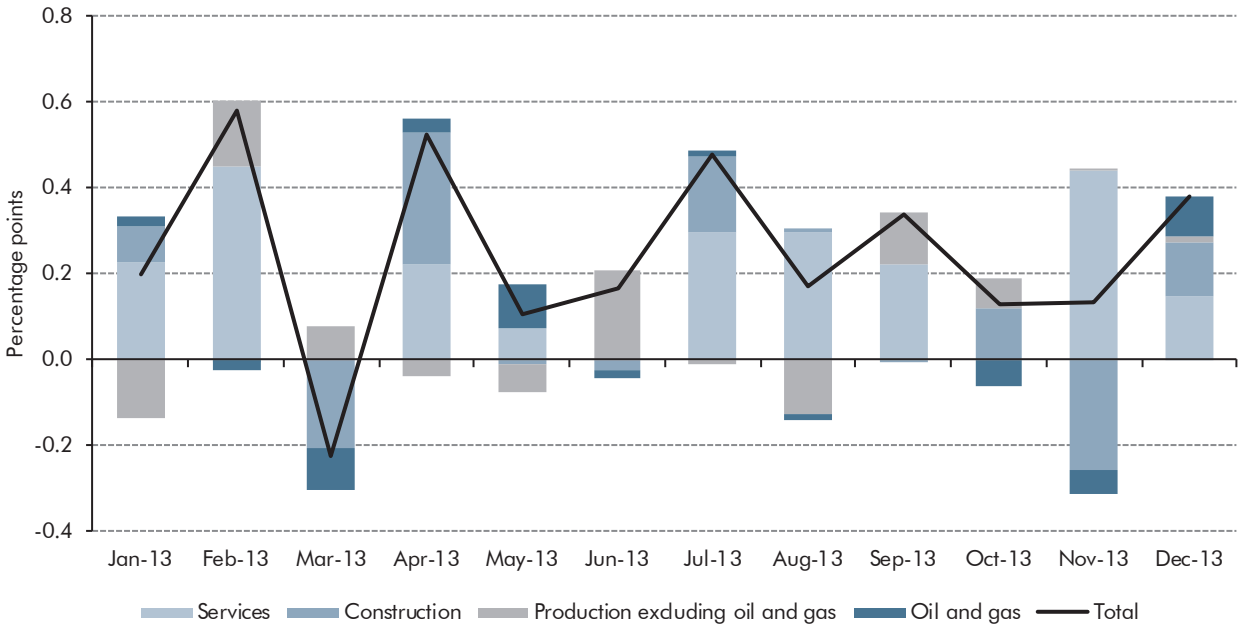
3.55 The economy grew by 0.7 per cent in the final quarter of 2013, in line with our December forecast. As discussed in Chapter 2, since our December forecast the ONS have revised GDP growth back to the start of 2012. As a result, the latest data show GDP grew by 1.8 per cent in 2013, higher than our forecast of 1.4 per cent in December.

3.56 On a monthly basis, Chart 3.21 shows steady contributions to growth from the service sector in the second half of 2013, but more volatile contributions from the construction and production industries. The construction industry makes up just 6 per cent of GDP, yet can drive large changes in monthly output growth, as seen from October to December.

3.57 Chart 3.21 shows all sectors contributing positively in December, pointing to momentum being carried into 2014. We therefore forecast growth in the first quarter of 0.7 per cent, 0.2 percentage points higher than our December forecast (Table 3.2), and growth in the second quarter of 0.6 per cent.

3.58 Recent flooding across various parts of the UK is likely to have had an impact on activity in the affected regions. The Markit/CIPS *Purchasing Managers' Index* for construction showed an easing in construction output growth in February, attributed to disruptions to house building activity from the adverse weather conditions. However, construction work resulting from flood relief and repairs and maintenance of infrastructure and buildings are also reported to have risen. As a result, we expect the net impact of the flooding on GDP growth in the first quarter of 2014 to be small.

Chart 3.21: Contributions to monthly output growth in 2013



Source: ONS, OBR

Table 3.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
March forecast[1]	0.0	-0.4	0.8	-0.1	0.4	0.7	0.8	0.7	0.7	0.6	0.6	0.6
December forecast[2]	0.0	-0.5	0.6	-0.3	0.4	0.7	0.8	0.7	0.5	0.5	0.5	0.5
Change[3]	*0.0*	*0.0*	*0.2*	*0.2*	*0.0*	*0.1*	*0.0*	*0.0*	*0.2*	*0.1*	*0.0*	*0.1*

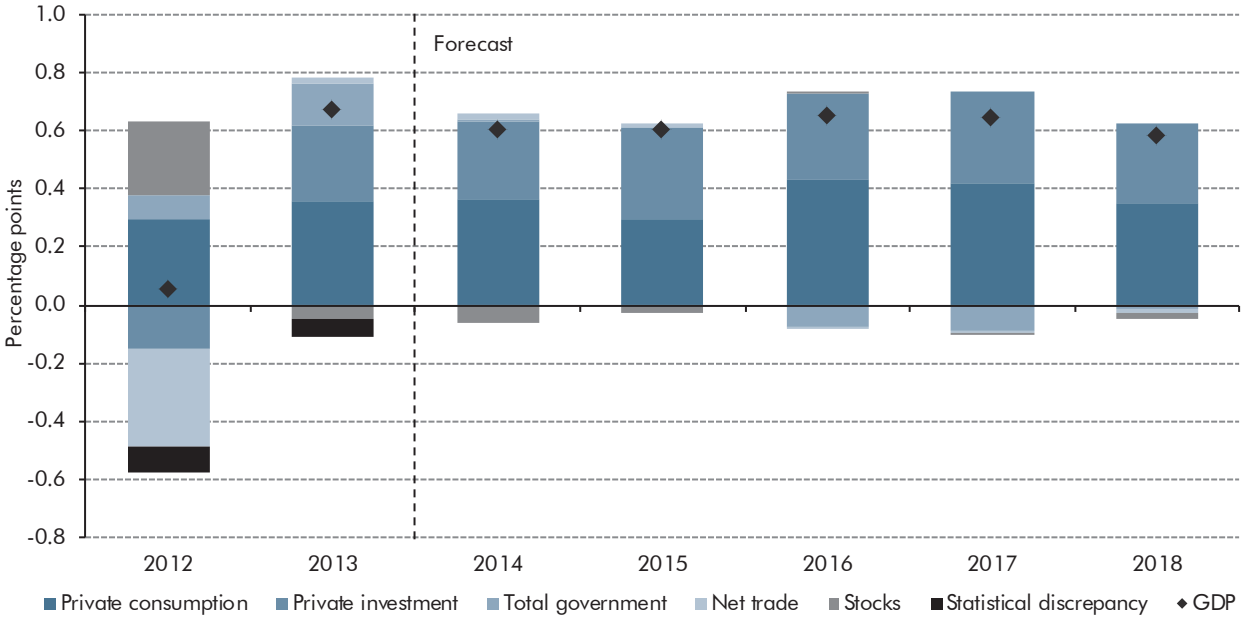
[1] Forecast from first quarter of 2014.
[2] Forecast from fourth quarter of 2013.
[3] Changes may not sum due to rounding.

The medium-term outlook for GDP

3.59 Our forecasts for medium-term growth are shaped by our estimate of 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.

3.60 Activity picked up sharply in 2013. Having averaged 0.1 per cent in 2012, quarterly GDP growth picked up to an average of 0.7 per cent in 2013, accounted for by relatively strong growth of consumer spending and, on the latest estimates, investment. The ongoing weakness of productivity, real incomes and UK export markets over this period make it difficult to explain why activity has picked up as strongly as it has, although general improvements in credit conditions and confidence releasing pent-up demand, the gathering pace in the housing market and a smaller drag from the fiscal consolidation may all have provided some support to growth.

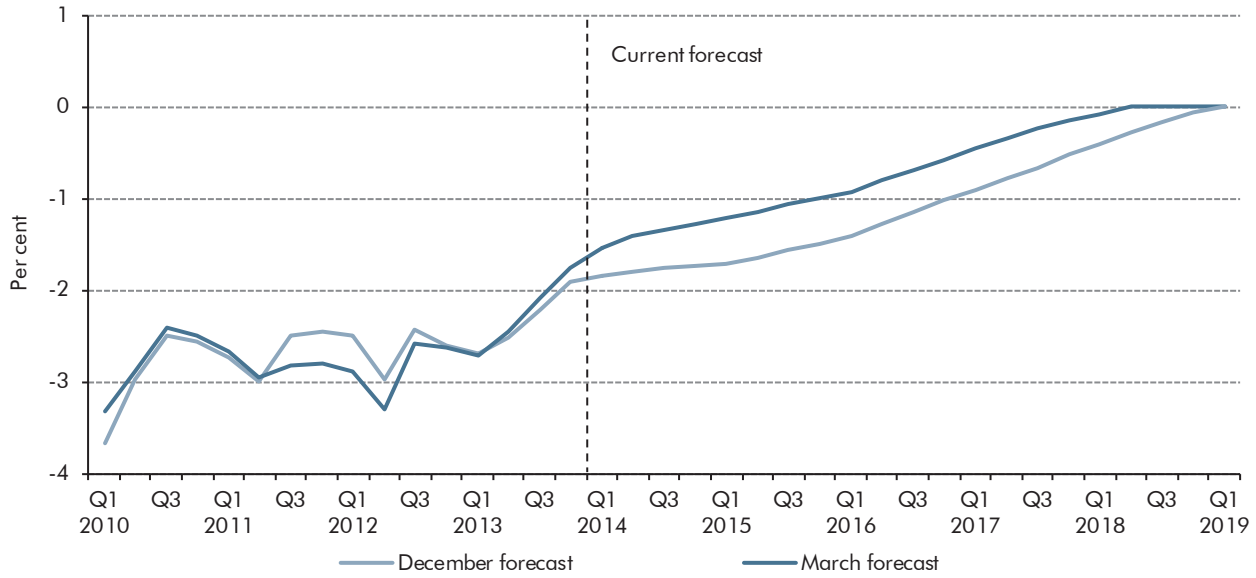
Chart 3.22: Contributions to average quarterly GDP growth



Source: ONS, OBR

3.61 With productivity growth, real income growth and UK export markets remaining weak in 2014, we expect the quarterly rate of growth to slow to 0.6 per cent from the second quarter. With GDP growth close to the growth of potential output, this implies that the output gap closes relatively slowly over this period (Chart 3.23). We expect the quarterly rate of growth to remain at around the same pace through 2015 as consumption grows in line with steadily improving real incomes, rather than being funded out of further reductions in saving. However, the mechanical effect of relatively strong output growth at the end of 2013 and the start of 2014 means that our forecast for calendar year growth in 2014 is higher than our forecast for 2015. As productivity, real incomes and UK export markets pick up, quarterly growth is then expected to reach 0.7 per cent by mid-2016, before falling back over the remainder of the forecast as output approaches potential. The output gap is forecast to close by the second quarter of 2018.

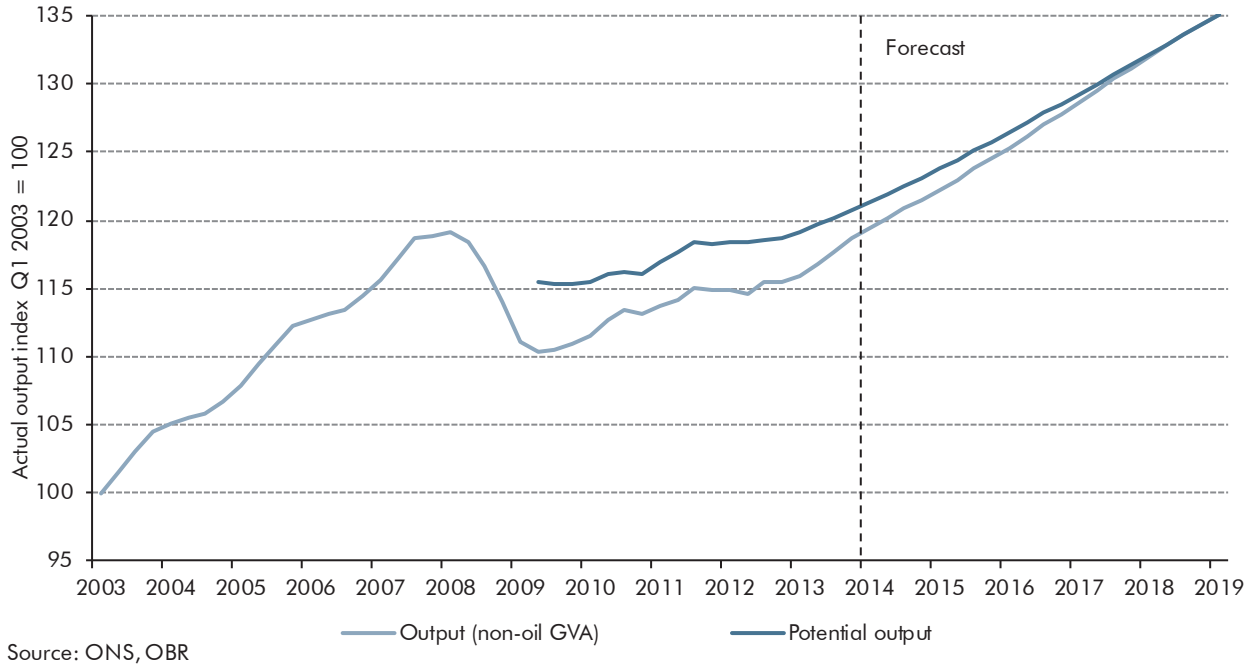
Chart 3.23: The output gap



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

3.62 Our forecast for the output gap is slightly narrower than our December forecast, reflecting our judgement that spare capacity in the labour market has been taken up a little faster than we expected. Unemployment was around 0.2 percentage points lower than forecast in the final quarter of 2013 while output was in line with our expectations. This has led us to reduce slightly (by 0.2 percentage points) our forecast of cumulative growth between the end of 2013 and the beginning of 2019. We now expect the output gap to close around a year earlier than our December forecast. The output gap does not close more quickly because of slow growth in productivity and real incomes, 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 aggregate demand in such an environment.

Chart 3.24: Projections of actual and potential output



Source: ONS, OBR

3.63 Our forecast for cumulative growth of real GDP over the forecast period is little changed since December and changes to its expected composition by expenditure mainly reflect news in the data. Table 3.3 summarises the expenditure composition of our real GDP forecast. Later sections of this chapter discuss the expenditure components of GDP in more detail.

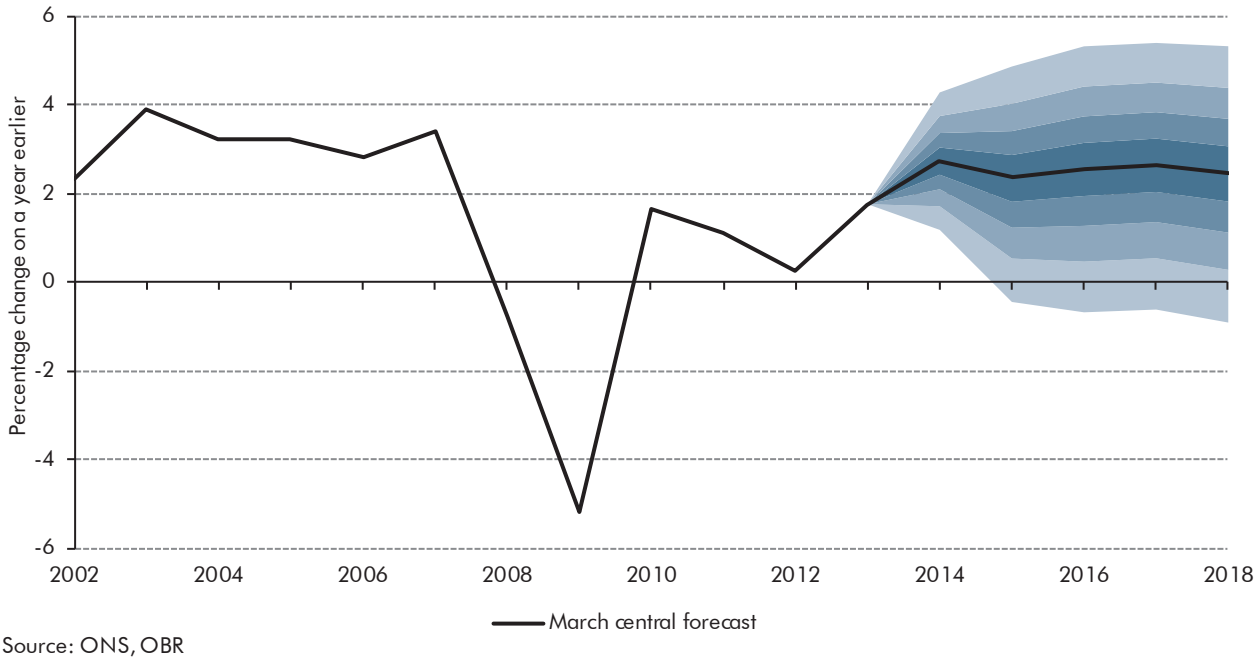
Table 3.3: Expenditure contributions to growth

	Percentage points, unless otherwise stated					
	Outturn	Forecast				
	2013	2014	2015	2016	2017	2018
GDP growth, per cent	**1.8**	**2.7**	**2.3**	**2.6**	**2.6**	**2.5**
Main contributions						
Private consumption	1.5	1.4	1.2	1.6	1.7	1.5
Business investment	-0.1	0.6	0.8	0.7	0.8	0.8
Dwellings investment[2]	0.2	0.4	0.4	0.5	0.5	0.4
Government[3]	0.1	0.5	-0.1	-0.2	-0.4	-0.2
Change in inventories	0.3	0.1	0.0	0.0	0.0	0.0
Net trade	0.1	-0.2	0.1	0.0	0.0	-0.1

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

3.64 Our central growth forecast is shown in Chart 3.25. The distribution surrounding it shows the probability of different outcomes if you expect our forecasts to be as accurate as past official forecasts. The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 20 per cent probability bands. The probability bands 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.

Chart 3.25: Real GDP growth fan chart



Source: ONS, OBR

Prospects for inflation

3.65 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 of these indices is the same, although there are a number of differences in coverage and the methods used to construct them.[11]

3.66 The RPI and CPI measures of inflation are important because they have different effects on our fiscal forecast. The Government uses 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.[12]

CPI inflation

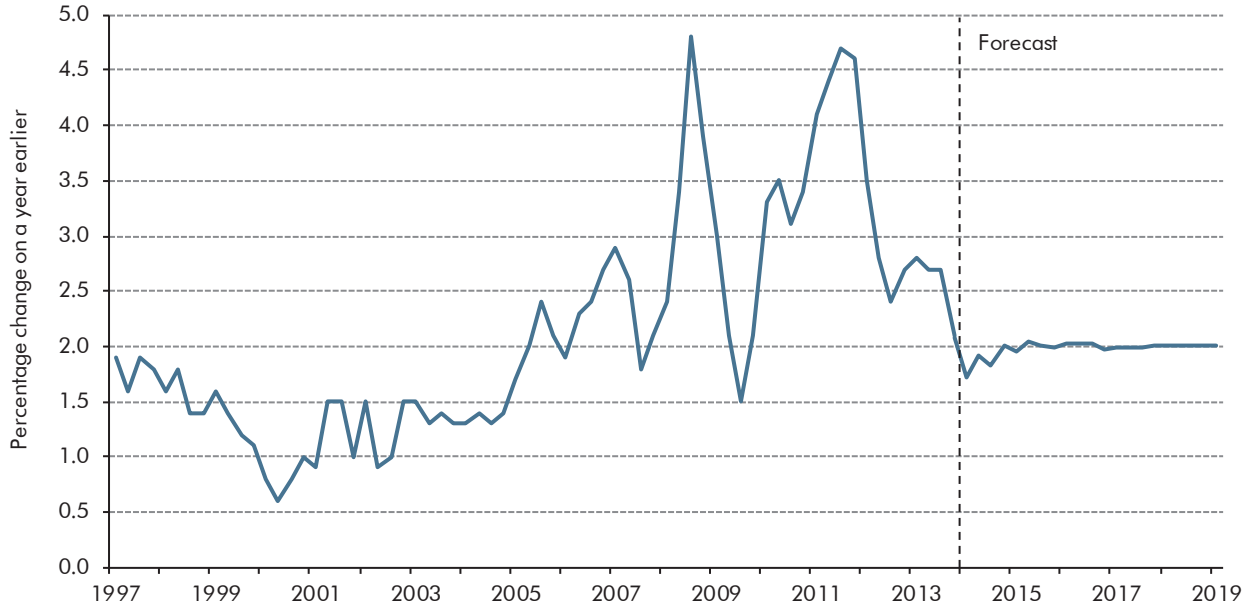
3.67 CPI inflation averaged 2.1 per cent in the fourth quarter of 2013, slightly lower than our December forecast of 2.2 per cent. The difference was due to lower-than-expected food, air transport and petrol prices. Inflation was down significantly from 2.7 per cent in the third quarter. Seasonal food price inflation fell significantly in the fourth quarter as harvests were better than the same time last year, when there were disruptions due to poor weather, and non-seasonal food inflation fell on the back of lower world commodity prices. Education inflation also fell as the increase in the tuition fee cap in October 2012 had less impact on

[11] For more details on the differences between the RPI and CPI see Miller, R, November 2011, OBR Working Paper No. 2: *The long-run difference between RPI and CPI inflation*.
[12] ONS, March 2013, *Introducing the New CPIH Measure of Consumer Price Inflation* and ONS, March 2013, *Introducing the New RPIJ Measure of Consumer Price Inflation*.

prices in 2013 than in 2012. Petrol prices fell in the fourth quarter as lower oil prices and a rise in sterling were passed on.

3.68 Inflation is expected to fall further in the first quarter of 2014, as lower commodity prices and the recent appreciation of sterling continue to flow through to food price inflation and petrol prices (Chart 3.26). Also, energy companies should begin to pass savings on to households arising from policy announcements in Autumn Statement 2013. CPI inflation is expected to be slightly below the Bank of England's 2 per cent target on average over 2014, with the annual inflation rate uneven due to base effects from petrol and food prices in the previous year. Recent flooding may pose an upside risk to seasonal food prices if domestic supply is disrupted, but the areas that have been most seriously affected account for a relatively low share of total UK farm land.

Chart 3.26: CPI inflation forecast



Source: ONS, OBR

3.69 The annual inflation forecast profile is lower in the near term than in our December forecast, partly thanks to an unexpectedly fast fall in food price inflation. We also now have enough information to incorporate the impact of the Autumn Statement energy policy announcements (see Box 3.2 of December *EFO* for more details). In the near term, the effect of the narrower output gap than we forecast in December on inflation is broadly offset by an increase in the level of sterling implied by our conditioning assumption.

3.70 CPI inflation is then expected to settle at target in the medium term. Downward pressure on inflation from a negative output gap is forecast to be offset by other factors, including environmental energy policies and excise duties being indexed using RPI, which rises faster than the CPI. Anchored expectations are also assumed to help keep inflation around target.

3.71 Announcements by the major energy companies suggest that the Autumn Statement environmental policy changes will push down electricity and gas prices by around 4 per cent on average over 2014, reducing our pre-measures forecast for an 8.5 per cent increase in utility prices between November 2013 and November 2014 to 4.5 per cent. This reduces the contribution from utility prices to CPI inflation from 0.4 percentage points to 0.2 percentage points. Reasons cited by the companies for the remaining increases include higher wholesale, distribution and network costs. A number of the major energy companies have announced that they will not increase their prices over 2014 unless there is a substantial increase in wholesale electricity costs. Wholesale gas and oil price futures, on which we condition our forecasts, suggest this will not be the case.

RPI inflation

3.72 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.[13] 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.

3.73 RPI inflation averaged 2.6 per cent in the fourth quarter of 2013, compared to our December forecast of 2.8 per cent. The lower RPI figure was driven by items contributing to lower CPI inflation as well as lower-than-expected housing depreciation.

3.74 In the first quarter of 2014, we expect RPI inflation to fall back for the same reasons as CPI inflation. Over 2014, a rise in housing depreciation (resulting from higher house price inflation) boosts RPI inflation relative to CPI inflation. From 2015 onwards, market-derived Bank Rate expectations imply that mortgage interest rates will rise, pushing RPI inflation towards 4 per cent at the end of the forecast period. As with the path of CPI inflation, the path of RPI inflation is below that of the December forecast in the near term, but similar in the medium term.

The GDP deflator

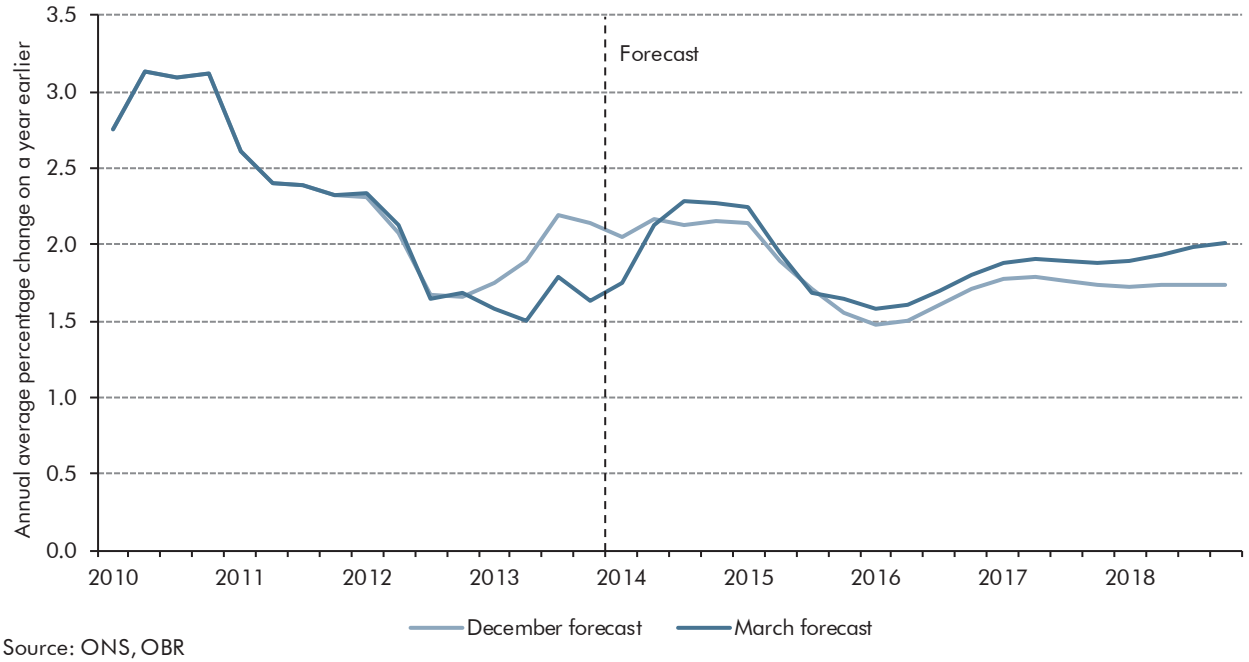
3.75 GDP deflator growth is the broadest measure of inflation in the domestic economy. It measures changes in prices of the goods and services that make up GDP, including price movements in private and government consumption, investment and the relative price of exports and imports – the terms of trade. The GDP deflator plays an important role in our fiscal forecast through its role in the Government's chosen public sector spending assumption, described in Chapter 4.

3.76 The GDP deflator and its components have been revised significantly over 2012 and 2013 (see paragraph 2.3 for details). The result is that the starting point for the GDP deflator is 0.7 per cent lower in the third quarter of 2013 than at the time of the December *EFO*.

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

3.77 Annual growth in the GDP deflator was 1.7 per cent in the final quarter of 2013, below our December forecast. Our forecast for the GDP deflator is similar in the short term but slightly higher over the medium term than our December forecast (Chart 3.27). This change is driven by the private consumption deflator, as the result of a change in the way we forecast imputed rent. We now assume that this will grow in line with average earnings rather than the CPI. As we set house price inflation equal to average earnings growth in the medium term, this implies a flat house price-to-rent ratio, which we consider to be an appropriate neutral assumption. As imputed rent is not in the CPI measure of inflation, and average earnings are forecast to grow faster than CPI in the medium term, this leads to a 0.25 percentage point wedge between CPI inflation and consumption deflator growth.

Chart 3.27: GDP deflator



Source: ONS, OBR

Prospects for nominal GDP growth

3.78 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).

3.79 Since our December forecast, the ONS has revised the path of nominal GDP in 2012 and the first three quarters of 2013 and provided a first estimate of nominal GDP for the fourth quarter of 2013. Taken together, the level of nominal GDP at the end of 2013 is around 0.5 per cent higher than we expected in December, as stronger-than-expected growth in the

final quarter more than offset downward revisions to the level in the first three quarters of the year. In expenditure terms, the stronger-than-expected nominal GDP growth in the fourth quarter was largely accounted for by a stronger nominal net trade contribution, in turn reflecting a sharp pick-up in the terms of trade. On the income side, the additional nominal GDP growth was largely accounted for by corporations' gross operating surplus.

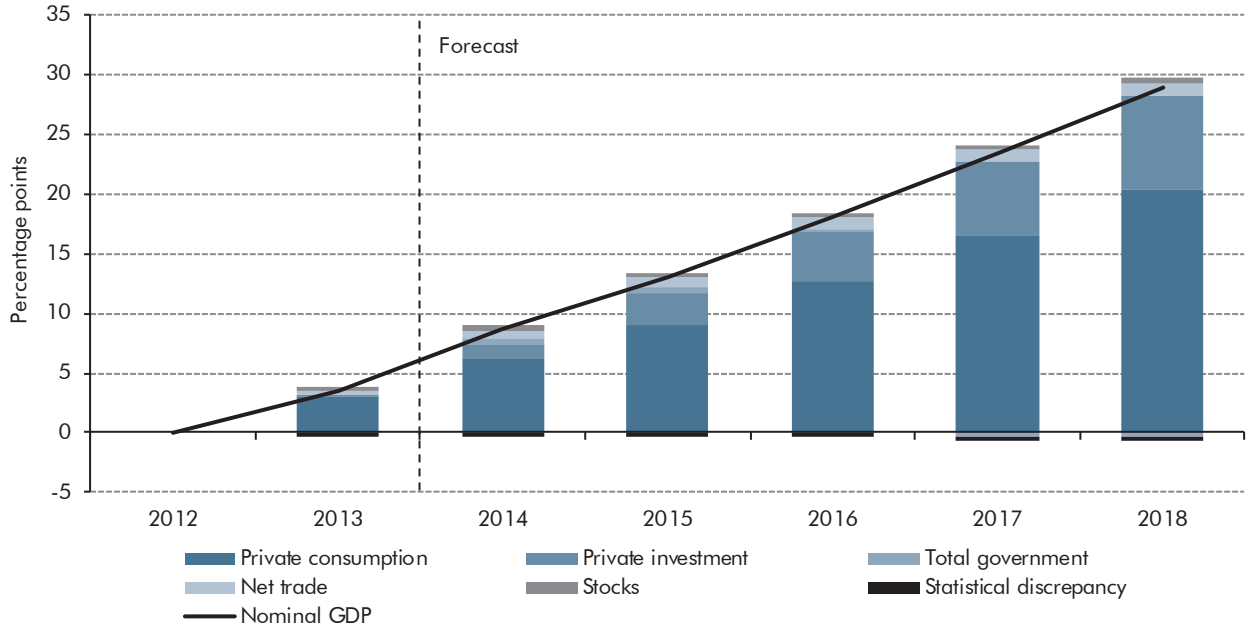
3.80 We forecast nominal GDP growth of 5 per cent in 2014, falling back to 4 per cent in 2015 as calendar-year real GDP growth eases slightly and temporary upward influences on the GDP deflator pass. In particular, the significant increase in the terms of trade in the fourth quarter of 2013 – which is assumed to be partly reversed in subsequent quarters – arithmetically raises growth in the GDP deflator in 2014. We then expect growth of about 4½ per cent a year in the medium term. This profile is broadly in line with our December forecast. Overall, adding the outturn and forecast changes, nominal GDP at the start of 2019 is 0.7 per cent higher than in our December forecast. Of this, around 0.3 per cent reflects higher real GDP, with the remainder largely accounted for by an upward revision to the consumption deflator.

Expenditure

3.81 We have revised up the level of nominal consumption and nominal investment over the forecast period, reflecting recent outturns. But we have revised down the contribution of net trade to the level of nominal GDP as the improvement in the terms of trade and stronger-than-expected net trade volumes in the fourth quarter were not enough to make up for the downward revision to the terms of trade over the first three quarters of 2013.

3.82 Chart 3.28 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 to the cumulative growth of nominal GDP over the forecast period. However, given the relatively slow growth of disposable incomes, we do not expect consumption to rise significantly relative to GDP, with the share of consumption in nominal GDP expected 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 12 per cent in 2013 to 15½ per cent in 2018. 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 18 per cent by 2018. Prospects for individual sectors are set out in more detail later in this chapter.

Chart 3.28: Contributions to nominal GDP growth: expenditure

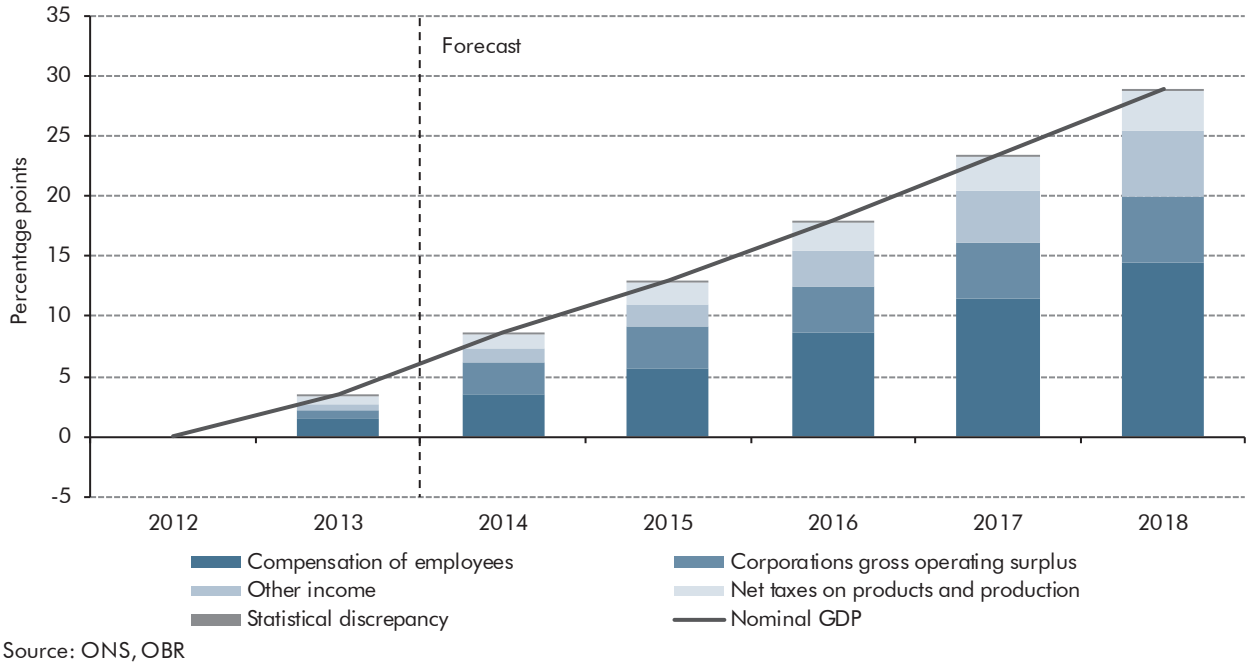


Source: ONS, OBR

Income

3.83 Chart 3.29 shows the contribution of different sources of income to cumulative growth in nominal GDP between 2012 and 2018. As productivity picks up, we expect profit margins to recover, with profit growth slightly outpacing nominal GDP growth over the medium term. With real earnings forecast to grow in line with productivity in the medium term, the share of labour income in nominal GDP is expected to remain broadly stable from 2014.

Chart 3.29: Contributions to nominal GDP growth: income



Source: ONS, OBR

Prospects for individual sectors of the economy

The household sector

3.84 The household sector is the largest source of income and spending in the economy, with consumer spending making up 66 per cent of nominal GDP by expenditure and household disposable income making up 69 per cent of nominal GDP by income in 2012.

Real consumer spending

3.85 The latest ONS data indicate that real consumption grew by 1.1 per cent in the third quarter of 2013, although growth fell back to 0.1 per cent in the fourth. Monthly retail sales data fell back slightly in January, although this followed a particularly strong pick-up in December. By contrast the GfK index of consumer confidence reached its highest level since 2007 in January, above its long-run average, and remained there in February.

3.86 Annual consumer spending growth in 2013 now appears to have been somewhat stronger than the data suggested at the time of our December forecast, reflecting upward revisions to consumption growth at the end of 2012 and start of 2013. These changes were broadly matched by upward revisions to elements of household income, leaving the profile of the saving ratio broadly unchanged (see paragraph 3.95). It remains the case that the increase in consumption in 2013 was financed mainly by lower saving, rather than stronger income growth, although the picture is complicated by the shifting of income from the first quarter into the second to take advantage of the additional rate of income tax being reduced from 50p to 45p.

3.87 Taking into account the ongoing weakness of real earnings growth and real disposable incomes, we expect the pace of quarterly growth to be somewhat slower than some of the rates seen in 2013. As growth in productivity and real wages gathers strength, we expect consumption growth to pick up, with real consumption growing broadly in line with real GDP from 2016.

Nominal consumer spending

3.88 In line with real consumer spending, we expect nominal private consumption growth to ease beyond the near term. We have revised our forecast for growth in 2014 up from 3.9 per cent in December to 4.5 per cent, largely thanks to stronger growth in the consumption deflator. Subdued earnings growth means that we expect nominal private consumption growth to ease to just over 4 per cent in 2015, slightly higher than our December forecast. Thereafter, rising nominal earnings growth is expected to contribute to a pick-up in nominal consumption growth towards 5 per cent. In line with the adjustment we have made to the GDP deflator, we expect changes from imputed rent to add around 0.25 per cent to the annual growth of nominal consumption in the medium term.

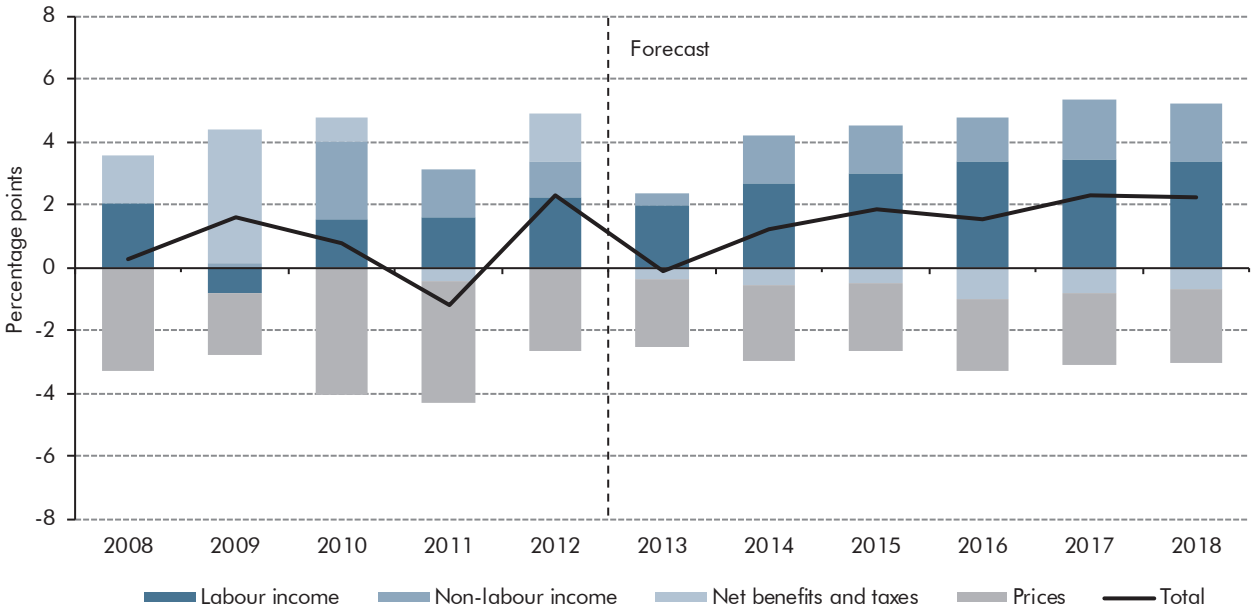
The labour market and household income

3.89 Unemployment fell faster in the final quarter of 2013 than we forecast in December. More timely claimant count data suggest that momentum in the labour market is easing. Our forecast is for spare capacity to be absorbed at a slower rate over 2014 than in 2013, with unemployment passing 7 per cent in the second quarter of the year before gradually falling back to its equilibrium rate in 2018. Despite stronger employment growth, the weakness of average earnings, relative to forecast, implies wages and salaries grew a little slower towards the end of 2013 than we expected in December.

3.90 Over 2013, claimant count unemployment fell by 290,000, but this was not reflected fully in the Labour Force Survey (LFS) measure, which fell by 160,000. Some former claimants may have stopped claiming because they are now in receipt of another benefit, such as incapacity benefit, while others may have stopped claiming benefits altogether. Our central forecast is conditioned on the view that this will not reverse in coming quarters and so the claimant count is permanently lower, relative to the LFS measure, than in our December *EFO*. Towards the end of the forecast, the claimant count settles at around 2¾ per cent of the workforce, compared with an LFS unemployment rate of 5¼ per cent.

3.91 Real wages continue to fall, with annual growth in average weekly earnings, at 1.5 per cent in December, outstripped by CPI inflation of 2.0 per cent. As we pointed out in Box 3.5 of our December *EFO*, weak productivity growth and subdued output price inflation have squeezed firms' margins. We therefore expect real wage growth to fall short of productivity growth in the near term as firms return to more normal rates of profitability. The prolonged weakness of nominal earnings growth has prompted us to lower our forecast going into 2014 and it is not until the end of 2016 that we expect real hourly earnings to exceed the level at which they stood in the second quarter of 2008, when the recession began. Unsurprisingly, GDP per capita returns to its pre-crisis peak at a similar time – early 2017 (see Box 3.2). Households also earn income from other sources, such as dividends from equity holdings and interest from savings, as shown in Chart 3.30.

Chart 3.30: Contributions to real household income growth



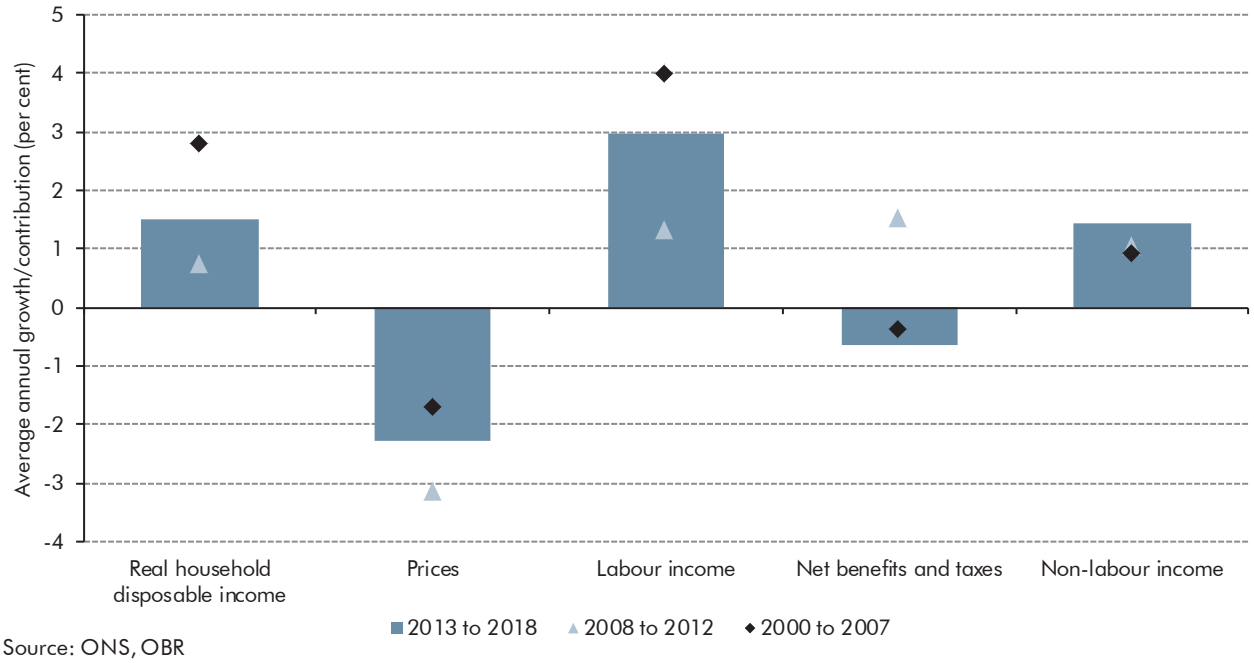
Source: ONS, OBR

3.92 On average before the recession, labour income (mostly wages and salaries) was by far the biggest source of real income growth, 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.

3.93 As people lost their jobs and pay growth slowed, the automatic stabilisers boosted household incomes on average through the recession and the weak recovery. But the additional support from a smaller tax burden and rising social benefit payments was offset by elevated inflation over that period and real household disposable income grew by just 0.8 per cent a year from 2008 to 2012. 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.

3.94 Over the forecast period, we expect labour income to be the largest contributor to growth in real household disposable income, although to a lesser extent than in the pre-crisis period, given our forecast for weaker productivity growth. 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. We expect non-labour income to provide a small offset, helped by a cyclical recovery in corporate profits. Lower inflation will also help, given our assumption that the Bank meets its inflation target. The result is average real income growth of around 1.5 per cent a year over 2013 to 2018, rising steadily (as in Chart 3.30) but remaining a long way below the pre-crisis average of 2.8 per cent.

Chart 3.31: Contributions to real household income growth



Source: ONS, OBR

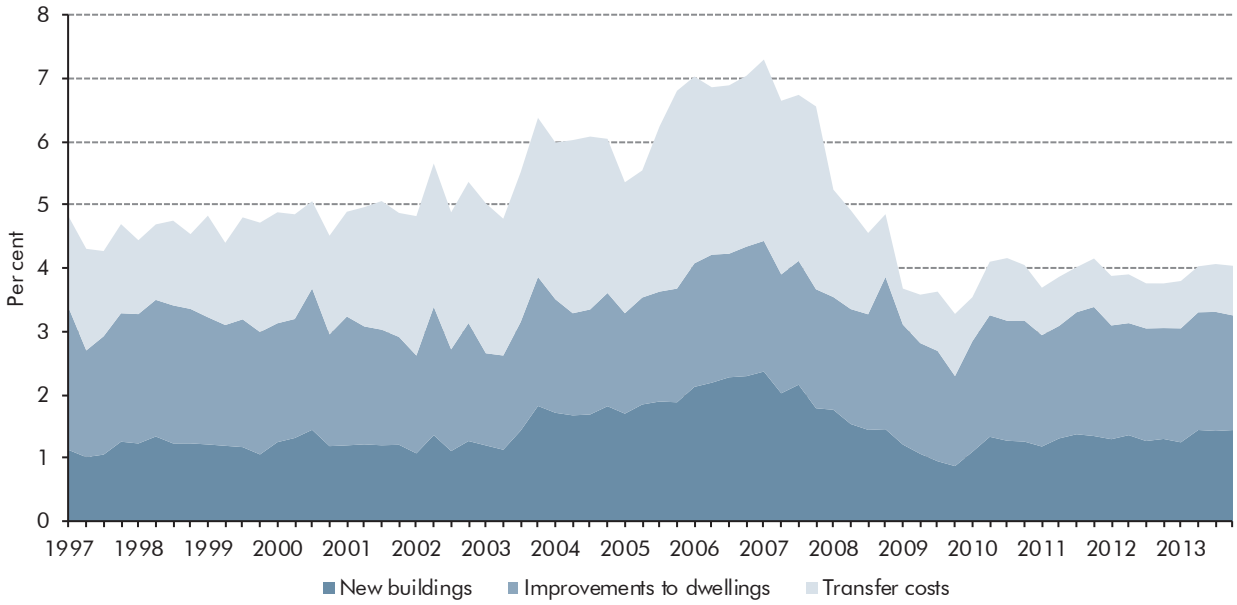
The saving ratio

3.95 The saving ratio was volatile through 2013 as high income individuals shifted income between the first and second quarters of the year to take advantage of the additional rate of income tax being reduced from 50p to 45p. Overall, consumer spending growth in 2013 appears to have been financed more by lower saving than by higher incomes. With consumer spending growth forecast to outpace disposable income growth over the near term, we forecast that the saving ratio will fall from just under 5 per cent in 2013 to just over 4 per cent in 2014, before declining gradually to around 3 per cent by the end of the forecast period.

The housing market and dwellings investment

3.96 Residential property transactions accelerated again in the final quarter of 2013, rising by 8 per cent from the previous quarter and 26 per cent on a year earlier. Mortgage approvals have also accelerated, suggesting further growth in transactions in the near term. Both are being boosted by a substantial fall in mortgage interest rates and improved confidence, and by the Government's Help to Buy scheme (which eases collateral constraints on home-buyers). Growing momentum in recent months has lifted our transactions forecast over the period from 2014 to 2016, compared to our December forecast. By 2018, we expect a similar level of transactions as in December, in line with the long-run rate of turnover of the housing stock. More transactions and rising house prices should encourage more house-building. We forecast cumulative growth in real residential investment of 58 per cent over the forecast period, continuing the strength seen in 2013. Despite that, residential investment is not expected to return to its pre-crisis peak by the end of the forecast horizon.

Chart 3.32: Residential investment, share of nominal GDP[1]

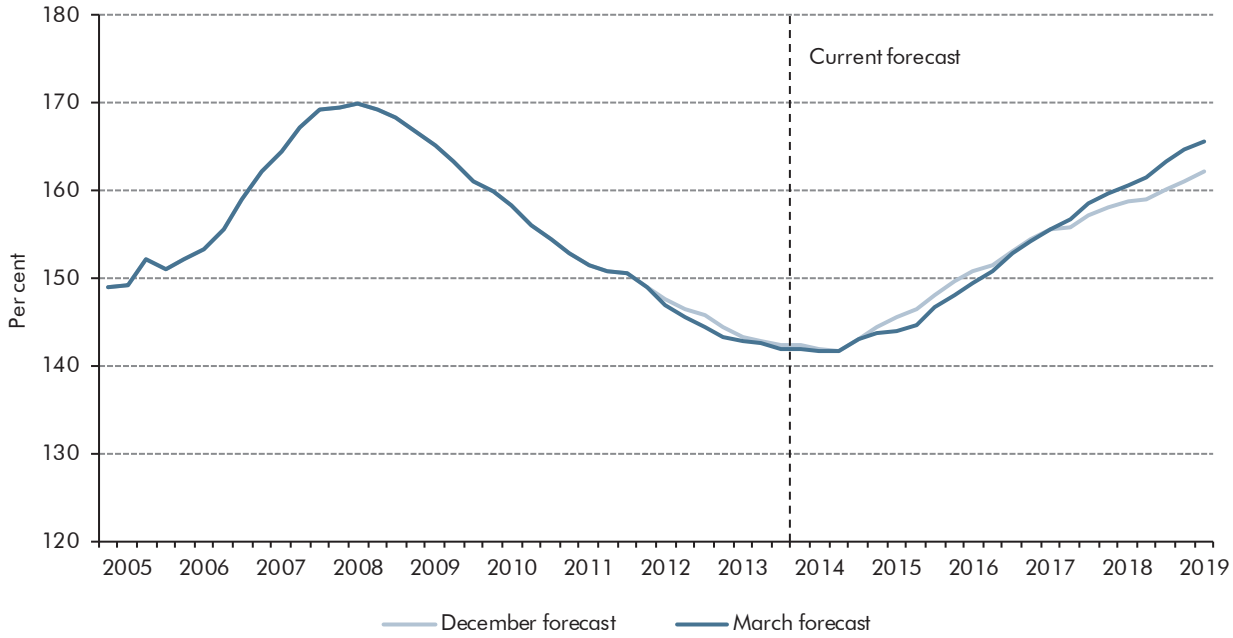


[1] Private sector, including transfer costs.
Source: ONS

Net lending and the balance sheet

3.97 The saving ratio is expected to fall over the forecast period, at a slightly faster rate than in our December forecast. With household investment rising strongly, households' overall net lending position – total income less total spending – will move into deficit. In an accounting sense, this provides the offset to the Government's fiscal consolidation (Chart 3.44). With negative net lending and house price growth, households' gross debt to income ratio is projected to rise again from 2014 having fallen steadily since 2008. The ratio rises faster than we expected in December and approaches its pre-crisis peak by the end of the forecast period (Chart 3.33). We expect the cost of servicing debt will rise relative to household disposable incomes, but will remain near its pre-crisis level (discussed further in Box 3.5).

Chart 3.33: Household gross debt to income

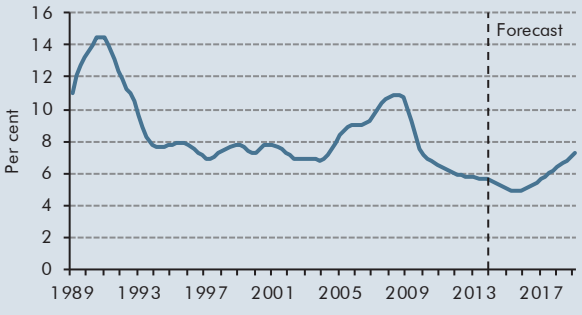


Source: ONS, OBR

Box 3.5: The impact of rising interest rates on household finances

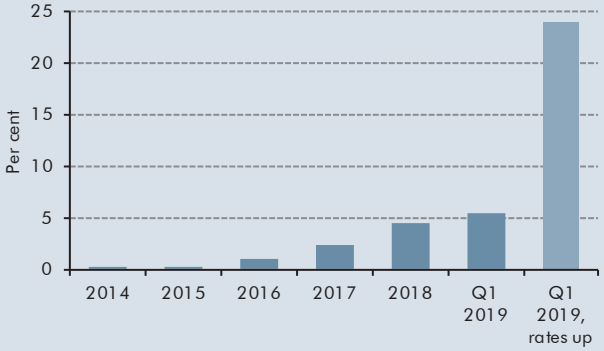
We expect house price inflation to outstrip income growth in the near term, which is consistent with an increase in the average size of mortgages and household debt relative to income. Combined with a gradual increase in Bank Rate, of 2.5 percentage points by Q1 2019, this means debt servicing costs as a share of disposable income, or 'income leverage', will rise. But our central forecast assumes only a 0.8 percentage point rise in average mortgage rates over the same period, as spreads narrow to more historically normal levels. So although mortgage servicing costs are likely to rise, we expect them to remain close to pre-crisis averages (Chart E).

Chart E: Household income leverage



Source: ONS, OBR

Chart F: Share of mortgagors reacting to rising debt servicing costs



Source: OBR

Chart E shows whole economy income leverage over the forecast period, but the effect of rising interest rates will be felt more by some than by others. Survey data compiled for the Bank of England show that two-thirds of households may be less negatively affected by rising interest rates because they do not have a mortgage. Indeed, if they have savings, they would be

positively affected. Of the remainder, those who start with high income leverage tend to be more exposed to rate increases than those with low income leverage, because they have larger mortgages.[a, b]

Using survey responses to the question "*About how much do you think your monthly mortgage payments could increase for a sustained period without you having to take some kind of action to find extra money e.g. cut spending, work longer hours, or request a change to your mortgage?*", we can simulate what our forecast might mean for aggregate household behaviour.[c] Chart F is constructed by assuming respondents' mortgage debt, income and mortgage interest rate grow in line with our aggregate forecast and that the threshold is also adjusted over time for rising income. On this basis, our central forecast is consistent with 5.5 per cent of households with a mortgage changing their behaviour by Q1 2019 because debt servicing costs have risen. This reflects the fact that both interest rates and incomes are forecast to rise as the economy recovers.

Our central forecast assumes mortgage rates rise more slowly than Bank Rate. If mortgage rates were to rise by 2.5 percentage points by Q1 2019, in line with our central assumption for Bank Rate, the effect on borrowers could be more significant, with 24 per cent of mortgagors changing behaviour. This illustration assumes household debt grows in line with our central forecast. An increase in mortgage interest rates of 2.5 percentage points, without more income growth, would almost certainly reduce household demand for debt. The proportion of households needing to respond to higher interest rates would be significantly lower if that were the case. Faced with a larger rise in debt servicing costs, households could change their behaviour in a number of ways, as described in the survey question. In practice, the aggregate response would include a combination of these. We explore the consequences of shocks to interest rates in Chapter 5.

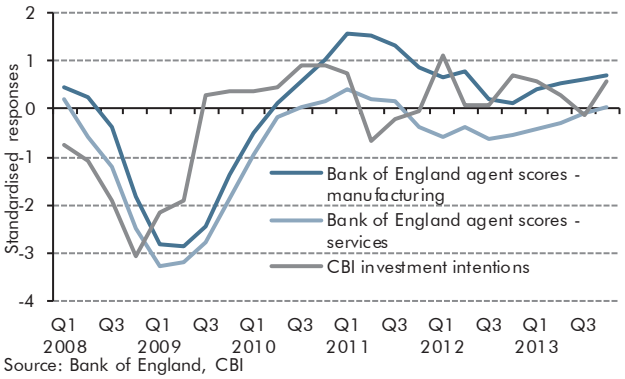
[a] The Living Costs and Food Survey (published by ONS) 2012 shows 36 per cent of households have a mortgage, and the NMG survey (published by Bank of England) shows 31 per cent.
[b] Raw data are available on the Bank of England website.
[c] This is largely methodologically consistent with analysis used in the Bank of England Quarterly Bulletin, Q4 2013, "The financial position of British households: evidence from the 2013 NMG Consulting survey".

The corporate sector

Business investment and stockbuilding

3.98 Business investment is now estimated to have picked up more sharply through 2013 than data available at the time of our December forecast suggested. The latest official data suggest that business investment grew by a cumulative 4.5 per cent over the second half of 2013. Other indicators also point to a pick-up in investment activity: investment intentions strengthened in the fourth quarter (Chart 3.34) while there was a drop in the net balance of firms reporting demand uncertainty as a constraint on investment plans (Chart 3.35). Nevertheless the fall in business investment during the recession, and the lack of growth thereafter, means that the real level of investment remains around 20 per cent below its pre-crisis peak at the end of 2013.

Chart 3.34: Investment intentions



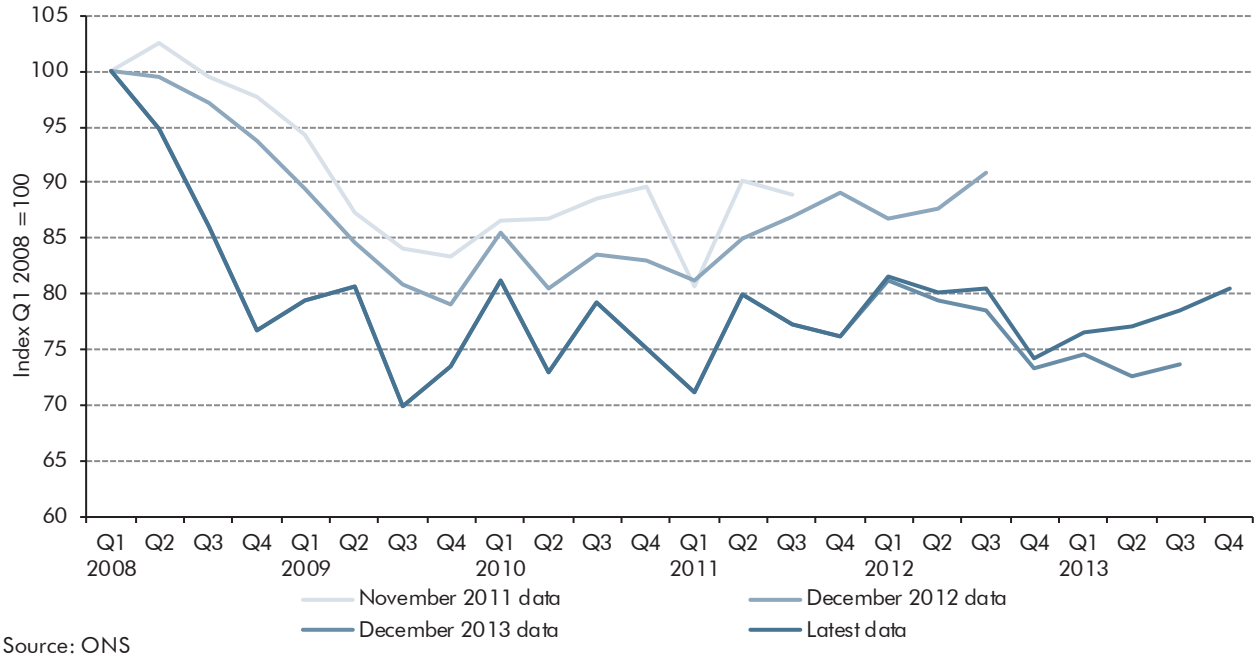
Source: Bank of England, CBI

Chart 3.35: Uncertainty about demand

Source: CBI

3.99 As set out in our December *EFO*, changes to the ONS methodology for the deflation of investment, introduced in Blue Book 2013, have left the recent path of business investment weaker and significantly more volatile, making the interpretation of quarterly movements more uncertain. Set against this volatility, it remains to be seen whether the recent pick-up in business investment indicates a turning point in investment spending. That said, some of the factors that may have constrained business investment in recent years – such as an unwillingness to commit to investment projects given the uncertainty around demand, and credit constraints for smaller firms – have receded through 2013 as activity has picked up and credit conditions have improved.

Chart 3.36: Business investment

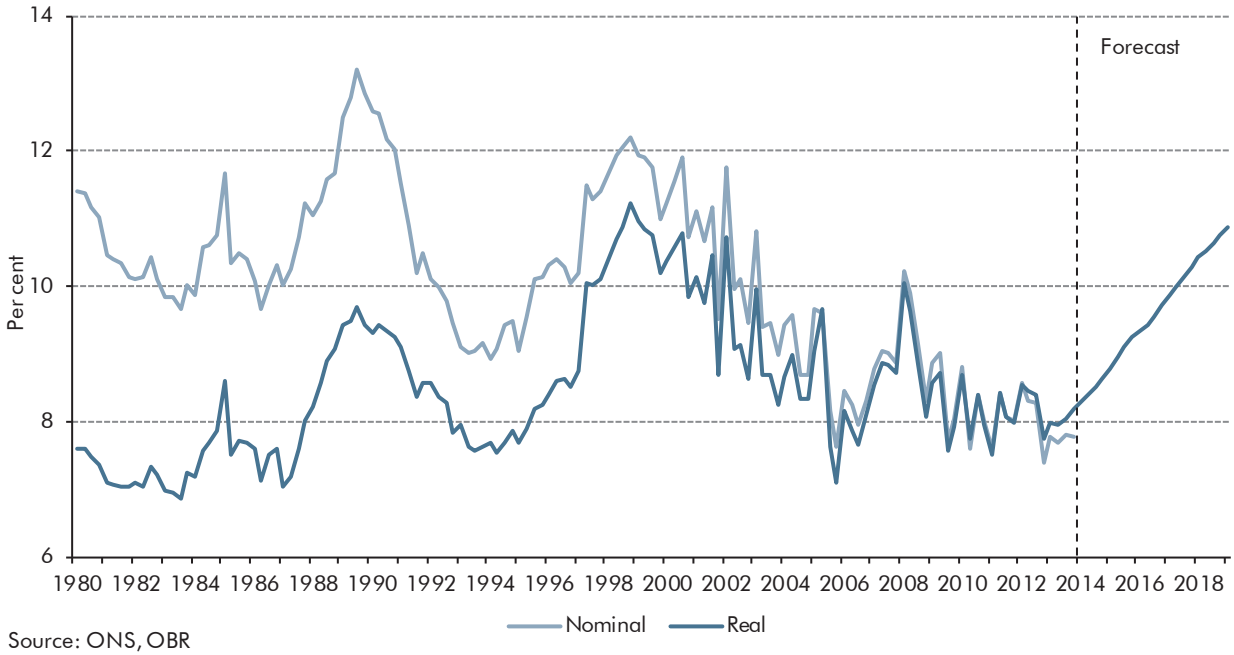


Source: ONS

3.100 We now expect business investment to grow by 8.0 per cent in 2014, revised up from 5.1 per cent in our December forecast. This upward revision reflects both the strength of recent data and the effect of the temporary increase in the Annual Investment Allowance, which is assumed to lead some investment being brought forward to 2014 and 2015 (see Box 3.3). As productivity growth and profits pick up, business investment is forecast to grow relatively

rapidly, with growth averaging 8.4 per cent a year between 2015 and 2018. This implies a rising share of real business investment in GDP, as usual during the later stages of a recovery (Chart 3.37). Chart 3.37 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 overall inflation. Box 3.6 considers UK investment in international context.

Chart 3.37: Business investment as a share of GDP



Source: ONS, OBR

3.101 The latest ONS data indicate that stocks contributed 0.3 percentage points to growth in 2013. This is slightly weaker than the contribution of 0.4 percentage points that we expected in December, reflecting downward revisions to the rate of stockbuilding in the first half of 2013. Having contributed 0.9 percentage points to growth in the third quarter, inventories were estimated to have subtracted 0.2 percentage points in the final quarter. We expect inventories to make a small positive contribution to GDP growth of 0.1 percentage point in 2014 and to be neutral from 2015.

Box 3.6: An international comparison of sectoral investment

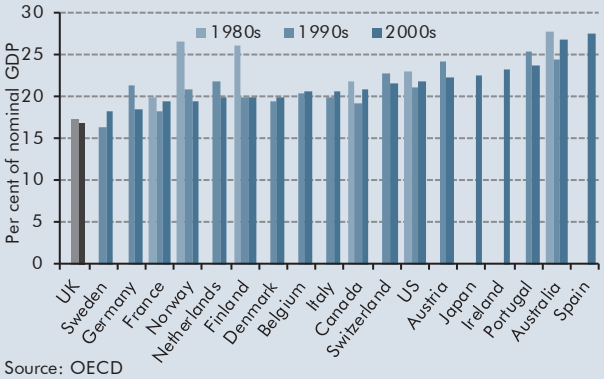
From peak to trough, total investment in the UK fell by 23 per cent during the recession, half as far again as the 15 per cent average in similarly developed economies. The recovery in UK investment since the recession has also been far weaker than expected. With profitability rising, confidence building and credit conditions easing, we expect total investment to grow by nearly 50 per cent in real terms over the forecast period. Some doubt whether such a recovery is possible given the lack of growth in recent years. This box assesses UK investment patterns relative to other advanced OECD economies in order to test our forecast judgement further.

By international standards, total nominal investment as a share of GDP is low in the UK. This seems to be true in all sectors – corporate investment, housing investment and government investment – and has been true over a sustained period. There are many factors that could help explain this – for example, outsourced production as a result of globilisation[a] and a relatively large share of services. MPC member Ian McCafferty noted in a recent speech that *"over the past twenty years, there appears to have been a steady decline in the [capital to output] ratio… probably as a result of the growing importance of the service sector in GDP."*[b] A larger UK service sector has also generated a relatively high rate of intangible investment.[c]

One possible factor that is common across sectors is the rationing effect of the planning regime, which may reduce the quantity of all forms of investment. During the pre-crisis decade, when the UK (like many advanced economies) experienced rapid house price growth, the rise in house building was less marked than in other countries.[d] Dwellings investment in the UK peaked at 6.4 per cent of GDP, far below the 14.4 per cent seen in Ireland or even the 8.9 per cent in the US. The Government has introduced reforms to the planning system that may support investment growth among private firms and house builders over the forecast period.

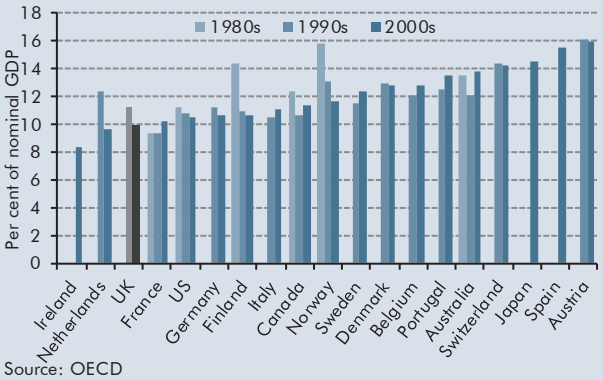
The persistence of low levels of investment in the UK raises the question of whether a sustained period of strong investment growth, such as that in our forecast, would require an implausible improvement in our relative investment position. But, given the very low starting point, by the end of the forecast period we expect the total investment-to-GDP ratio to reach 17 per cent in the UK, which would still be below the OECD average of the past decade.

Chart G: Total investment, decade averages



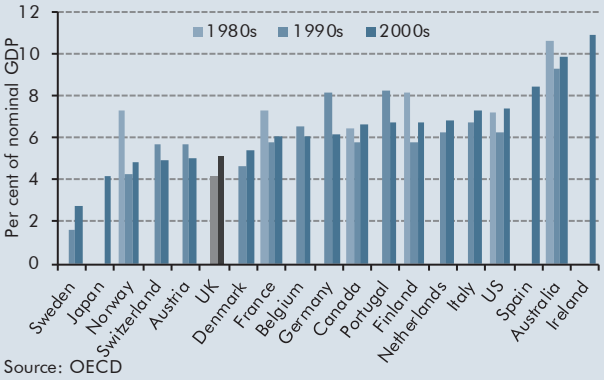
Source: OECD

Chart H: PNFC investment, decade averages



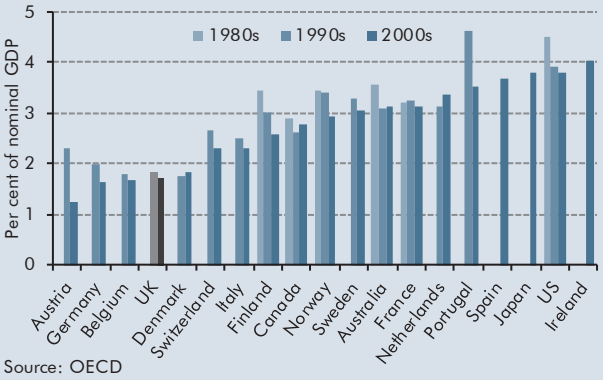
Source: OECD

Chart I: Household investment, decade averages



Source: OECD

Chart J: General government investment, decade averages



Source: OECD

[a] Gieve, John, Q4 2006, Bank of England Quarterly Bulletin: *The puzzle of UK business investment*
[b] McCafferty, Ian, January 2014, Bank of England Speech: *Achieving a sustainable recovery: where next for business investment?*
[c] Corrado, Haskel, Jona-Lasinio, & Iommi, Massimiliano, 2012, Institute for the Study of Labor (IZA) Discussion Paper: *Intangible Capital and Growth in Advanced Economies: Measurement Methods and Comparative Results*
[d] Ahrend, Cournède & Price, March 2008, OECD Working Paper: *Monetary policy, market excesses and financial turmoil*

Corporate profits

3.102 Non-oil, non-financial company profits are forecast to grow faster than the economy as a whole. We have revised our near-term forecast higher on the strength of recent outturn data, supported by an improvement in the terms of trade, which we expect to feed through to corporate income. Financial sector profits are forecast to grow more slowly than non-financial profits due to the effect of provisions for likely ongoing conduct costs (such as PPI claims) in the near term and the pressure of regulation throughout the forecast period.

The government sector

3.103 Total public spending amounted to around 45 per cent of GDP in 2012-13.[14] However, 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 24 per cent of GDP in 2012-13.

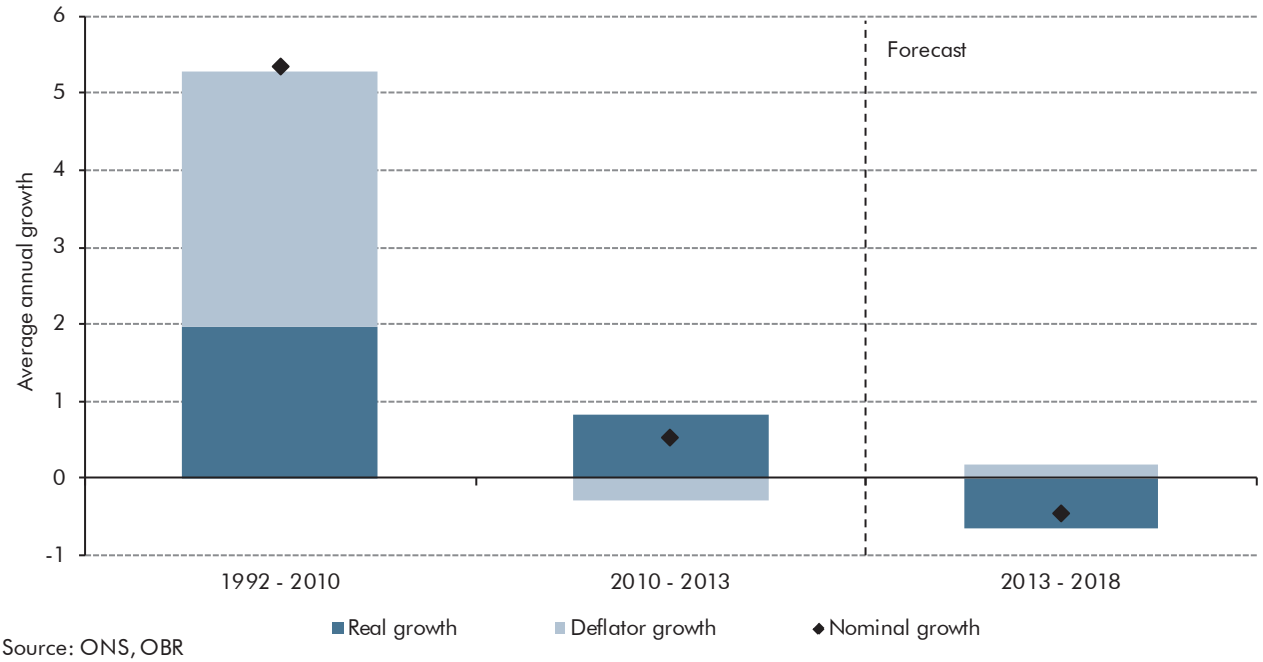
Real government consumption

3.104 Real government consumption continues to contribute strongly to GDP, despite slower growth in nominal spending. Real government consumption grew by 0.9 per cent in 2013, despite nominal growth slowing to 0.3 per cent. This is likely to reflect the fact that around two-thirds of real government activity is measured directly – for example, by the number of prescriptions, school pupils, court cases or hospital beds. As nominal spending has been squeezed, these indicators of real activity have held up and so measured real government

[14] Total Managed Expenditure (TME) excluding transfers related to the Royal Mail Pension Plan and Asset Purchase Facility.

consumption has grown (whether or not the quality of services has been affected). As a result, the implicit price of government consumption has fallen: the government consumption deflator has declined at an average rate of 0.3 per cent a year over the past three years, compared to an annual average increase of 3.3 per cent between 1992 and 2010 (Chart 3.38).

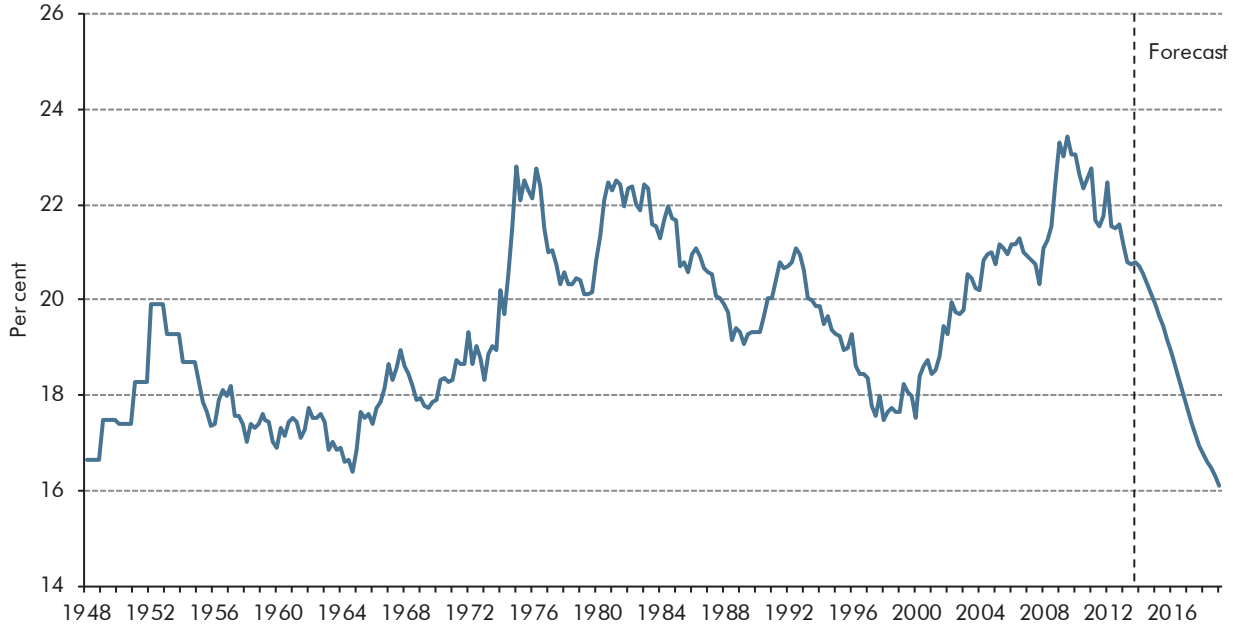
Chart 3.38: Government consumption



Source: ONS, OBR

3.105 With nominal spending subject to ongoing constraint over the next five years, we assume that the implicit government consumption deflator rises only slowly, at an average rate of 0.1 per cent a year between 2015 and 2018. In nominal terms, government consumption is forecast to fall from 21.8 per cent of GDP in 2012 to 16.1 per cent of GDP at the end of the forecast period, the lowest level on record in data back to 1948 (Chart 3.39). Nominal government investment is also expected to fall slightly as a share of GDP.

Chart 3.39: Government consumption of goods and services as a share of nominal GDP



Source: ONS, OBR

General government employment

3.106 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 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 within the public sector and recent data. Reflecting the uncertain timing of employment cuts and wage changes, we then average the overall fall in employment and distribute it evenly over the forecast period.

3.107 Relative to its level at the start of 2011, the beginning of the period covered by the Government's 2010 Spending Review, we expect general government employment to fall by around 1 million by the start of 2019. But this should be more than offset by a 3.3 million rise in market sector employment over the same period.[15] Our forecast is consistent with an average fall in general government employment of 36,000 a quarter, slightly bigger than our December forecast for 35,000 a quarter.

[15] 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.

The external sector

Export and import volumes

3.108 Exports remain volatile. Having grown by just over 3 per cent in the second quarter of 2013, export volumes fell back by just under 3 per cent in the third. Taking the year as a whole, exports are now estimated to have grown by 0.8 per cent in 2013, slightly weaker than the 1.2 per cent growth we expected in December. This is also somewhat weaker than the growth of UK export markets, implying further loss of market share, although the rate of decline appears to have slowed in recent years.

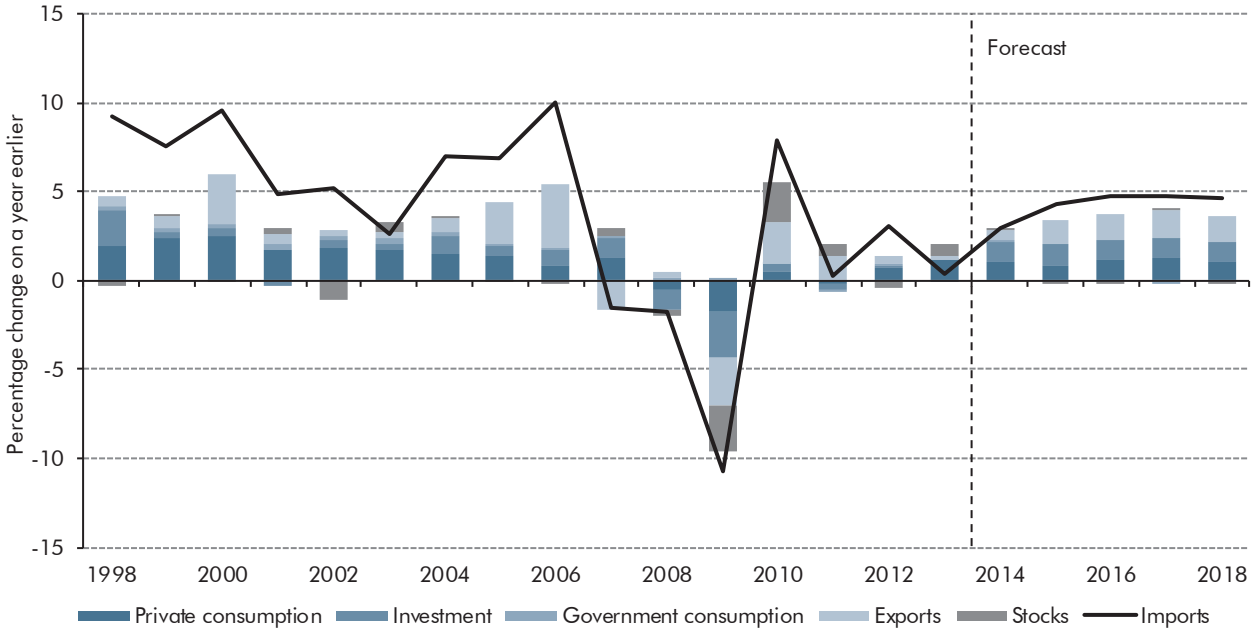
3.109 We expect exports to grow by 2.6 per cent in 2014, revised down from our December forecast of 4.0 per cent. The downward revision reflects weaker growth than expected in the second half of 2013. With UK export market growth little changed from December, our forecast for export growth is similar from 2015 onwards, averaging just under 5 per cent. This implies an ongoing loss of market share (Chart 3.40).

Chart 3.40: 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.

3.110 Our forecast for imports is determined by the outlook for import-weighted domestic demand. Import growth is now estimated to have been weaker in 2013 than we forecast in December, largely reflecting ONS revisions to the first half of the year. Reflecting the latest data, we have revised down our forecast for import growth in 2014 to 3.0 per cent from our December forecast of 3.8 per cent. Within domestic demand, both consumption and investment have relatively high import intensity, driving the growth of imports over the forecast period. The fall in real government activity implies little drag on import weighted domestic demand, given the low import intensity of government spending.

Chart 3.41: Contributions to import-weighted domestic demand and UK import growth



Source: ONS, OBR

3.111 Reflecting the sharp fall in exports in the third quarter of 2013, we expect net trade to make a small negative contribution of -0.2 percentage points to growth in 2014, revised down from no contribution in our December forecast. As in December, net trade is expected to make little contribution to growth over the remainder of the forecast period, reflecting the weakness of export market growth and a gradual decline in export market share.

Chart 3.42: Net trade contribution to GDP

Source: ONS, OBR

The terms of trade and the trade balance

3.112 Since our December forecast, the terms of trade have been revised down significantly. In the December *EFO*, we noted that there was an unusual divergence between export and import services prices. This divergence has since been revised away by an upward revision to service import prices, although the second estimate of fourth quarter GDP showed part of the divergence re-emerging. The medium-term profile of the terms of trade is similar to December, with near-term changes reflecting data revisions, the appreciation of sterling and higher oil prices, with the assumptions for the first quarter of 2014 higher by 2.2 per cent and 3.3 per cent respectively (Chart 3.18 and 3.19). However, downward revisions to the trade balance in the first three of quarters of 2013 mean that we now expect a wider trade deficit than in December. With the terms of trade and real net exports largely unchanged thereafter, the wider trade deficit is maintained throughout the forecast.

The current account balance

3.113 Current account data continue to be extremely volatile, primarily because of large swings in the income balance. Data revisions are often substantial: in December's Quarterly National Accounts, the income balance for the second quarter of 2013 was revised up by 1.9 per cent of GDP. The subsequent swing back into deficit in the third quarter was huge and contrary to our December forecast. The volatility of the income account, mostly in the income flows derived from direct investments, makes forecasting extremely difficult.

3.114 We expect the income account to return to surplus in 2014, but this forecast is subject to significant uncertainty and is based on an assumption that recent rates of return on the UK's overseas assets have been temporarily depressed. With a worse outlook for the trade balance, this means we have revised our forecast of the current account deficit wider – by around ½ per cent of GDP by the end of the horizon.

Chart 3.43: Current account balance as a share of GDP

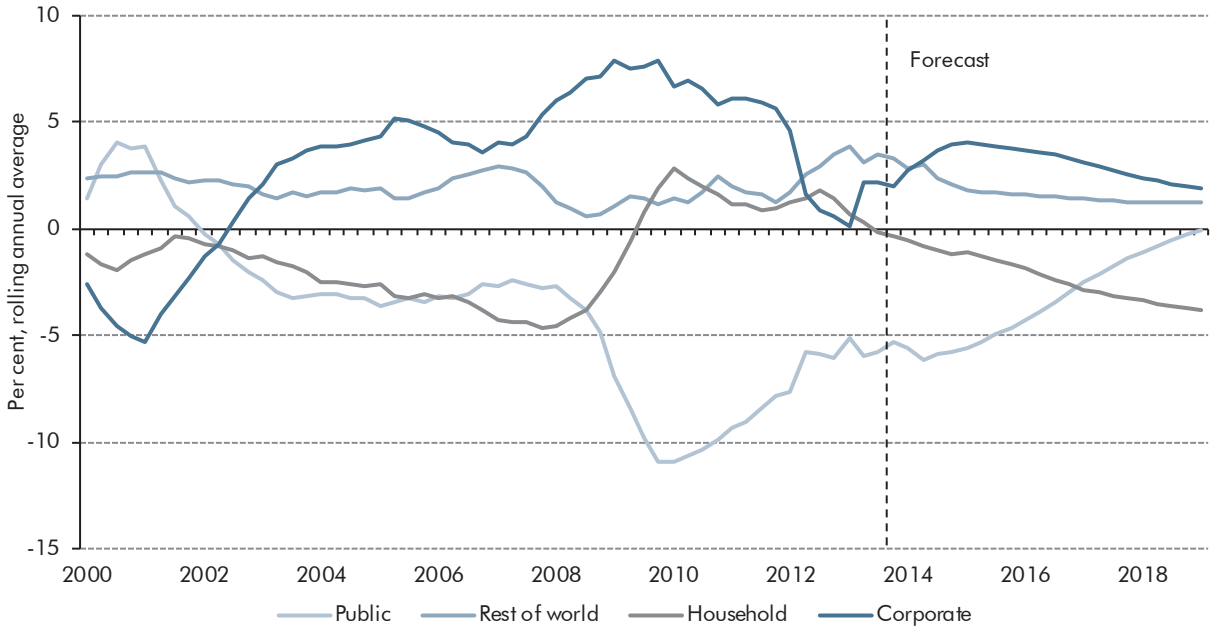
Source: ONS, OBR

Sectoral net lending

3.115 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 2013, we estimate the government sector to be in deficit, households close to balance, and companies and the rest of the world to be in surplus (Chart 3.44).

3.116 By the end of the forecast period, we expect the government's deficit to have returned to balance as the fiscal consolidation continues (see Chapter 4). The household and corporate sectors provide the majority of the offsetting change, with household net lending moving from a deficit of 1.2 per cent of GDP in 2014 to a larger deficit of 3.7 per cent of GDP in 2018 and corporate net lending moving from a surplus of 4.0 per cent of GDP in 2014 to a surplus of 2.0 per cent of GDP in 2018. After an initial improvement, we do not expect the current account deficit to narrow significantly over the rest of the forecast period, so the external sector plays little role in offsetting the fiscal consolidation after 2014.

Chart 3.44: Sectoral net lending



Source: ONS, OBR

Risks and uncertainties

3.117 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 how the economy functions may change.

3.118 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:

- global monetary policy has been exceptionally loose for an extended period. As investors anticipate a return to more normal monetary conditions, most importantly in the US, this has caused some volatility in a number of emerging markets, and the risk of spillover effects to the wider economy remains. Developments in China have also recently been a focus of attention;

- euro area economies and banking systems have yet to complete the adjustment toward sustainable demand and competitiveness. While policy managed the adjustment process more effectively in 2013, further damaging instability remains possible. Concerns have been expressed about the difficulty of completing these adjustments in an environment of very low inflation;[16]

[16] See, for example, the IMF's global economy forum: http://blog-imfdirect.imf.org/2014/03/04/euro-area-deflation-versus-lowflation/

- developments in Ukraine are not expected to have a large impact on the UK in our central forecast. However, if the situation escalates or continues for a prolonged period, there is a risk of higher commodity prices affecting inflation and output growth. There could also be a broader risk through trade linkages and financial exposure to Ukraine, Russia and other affected countries;

- domestically, productivity and real wages remain weak and the pick-up we forecast from the second half of 2014 is a key judgement. If productivity fails to pick up as predicted, the consumer spending and housing investment that has driven the recovery through 2013 could falter as the resources to sustain them would be lacking; 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 towards 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 may pose risks to the sustainability of the recovery over the medium term.

3.119 Methodological changes to the National Accounts can have a considerable effect on the measured path and composition of growth, as demonstrated by last year's Blue Book revisions.[17] Looking ahead, the ONS is planning to introduce a large number of methodological changes to the National Accounts in Blue Book 2014. A number of these changes relate to the transition to the 2010 European System of Accounts (ESA10), with recent ONS analysis suggesting this may result in an upward revision to the annual level of nominal GDP of between 2½ and 5 per cent, for example due to spending on research and development being reclassified as investment (contributing to GDP) rather than intermediate consumption (which does not).[18] This estimate does not include a number of other methodological changes planned for Blue Book 2014, including to gross fixed capital formation and inventories. The saving ratio may be subject to significant revisions when the treatment of defined benefit pension contributions is revised. In the US, where similar revisions were implemented last year, changes to the treatment of pensions contributed to a 1.5 percentage point upward revision to the saving ratio. Annex B discusses the possible implications of forthcoming ESA10 revisions for the public finances.

Comparisons with external forecasters

3.120 In this section, we compare our latest projections with those of key outside forecasters. Estimates of the current degree of spare capacity and the potential growth rate of the economy, where available, differ widely as discussed from paragraph 3.16.

3.121 In its January *World Economic Outlook Update*, the **International Monetary Fund** (IMF) forecast real GDP growth of 2.4 per cent in 2014, around 0.3 percentage points below our central forecast. The IMF published its forecast before the estimate of GDP growth in the

[17] See our 2013 *FER* for further details.
[18] Marks, C, November 2013, *Content of Blue Book and Pink Book 2014*.

final quarter of 2013, which may partly explain the difference. In 2015, the IMF forecasts growth of 2.2 per cent, slightly weaker than our central forecast. The IMF's January update did not include new medium-term forecasts. The October *World Economic Outlook* forecast growth to average 2.1 per cent between 2016 and 2018, which is below the average growth rate implied by our forecast.

3.122 The **Organisation for Economic Cooperation and Development** (OECD) published an updated forecast as part of its November *Economic Outlook*. The short-term outlook is slightly below our central forecast, although this forecast was published prior to the estimate of GDP in the final quarter of 2013 and the revisions made to growth in 2012 and 2013 in December's Quarterly National Accounts. The OECD forecasts growth of 2.5 per cent in 2015 – stronger than our central forecast – and there are some differences in the expected composition of growth, with the OECD expecting a stronger contribution from consumption and net trade, but a weaker contribution from investment.

3.123 The **European Commission** published its *European Economic Forecast* in February. It expects growth of 2.5 per cent in 2014 and 2.4 per cent in 2015, a little weaker than our central forecast in 2014 and a little stronger in 2015. The Commission expects net trade to contribute 0.0 percentage points to 2014 growth, which compares to our forecast of -0.2 percentage points. This is offset by weaker domestic demand, contributing 2.6 and 2.5 percentage points in 2014 and 2015 respectively, relative to our forecast of 2.9 and 2.3 percentage points.

3.124 In its February *Economic Review*, the **National Institute for Economic and Social Research** (NIESR) forecast GDP growth of 2.5 per cent in 2014 and 2.1 per cent in 2015, both below our central forecast. NIESR also forecasts weaker growth over the medium term, with an average growth rate of 2.3 per cent from 2016 to 2018, compared to an average growth rate of 2.6 per cent in our latest forecast. Much of the difference between the forecasts in the medium term is attributable to weaker outlook for investment and private consumption, partly offset by a stronger contribution from net trade.

3.125 The **Bank of England** Monetary Policy Committee's forecast for growth is higher than our central forecast in 2014, 2015 and 2016 by 0.7, 0.4 and 0.3 percentage points respectively. The higher growth forecast does not generate higher inflation, with the MPC's forecast for CPI inflation being lower in 2015 and 2016. Alongside its February *Inflation Report*, the Bank of England published additional forecasts (Table 3.5), which we have compared to our own forecast in more detail in the next section.

3.126 The February forecast from **Oxford Economics** assumes slightly weaker growth than our central forecast in 2014, and slightly stronger in 2015. Growth forecasts are the same from 2016 onwards. It also expects much weaker CPI inflation than we do, which may partly reflect the much larger negative output gap implied by their forecast.

Table 3.4: Comparison of external forecasts

	Per cent						
	2012	2013	2014	2015	2016	2017	2018
OBR (March 2014)							
GDP growth	0.3	1.8	2.7	2.3	2.6	2.6	2.5
CPI inflation	2.8	2.6	1.9	2.0	2.0	2.0	2.0
Output gap	-2.8	-2.2	-1.4	-1.1	-0.7	-0.3	0.0
IMF (October 2013)							
GDP growth[1]	0.3	1.7	2.4	2.2	2.0	2.1	2.3
CPI inflation	2.8	2.7	2.3	2.0	1.9	2.0	2.0
Output gap	-2.9	-2.7	-2.4	-2.1	-1.8	-1.5	-1.0
OECD (November 2013)							
GDP growth	0.1	1.4	2.4	2.5			
CPI inflation	2.8	2.6	2.4	2.3			
Output gap	-2.7	-2.5	-1.7	-1.2			
EC (February 2014)							
GDP growth	0.3	1.9	2.5	2.4			
CPI inflation	2.8	2.6	2.0	2.0			
Output gap	-3.4	-2.4	-0.9	0.2			
NIESR (February 2014)							
GDP growth	0.3	1.9	2.5	2.1	2.1	2.2	2.5
CPI inflation	2.8	2.6	2.2	1.9	1.8	1.9	1.9
Output gap		-4.5	-4.0				
Bank of England (February 2014)[2]							
GDP growth (mode)[3]	0.6	2.0	3.4	2.7	2.9		
CPI inflation (mode)[3, 4]	2.8	2.6	1.9	1.8	1.9		
Oxford Economics (February 2014)[5]							
GDP growth	0.3	1.8	2.6	2.4	2.6	2.6	2.5
CPI inflation	2.8	2.6	1.7	1.8	1.7	1.9	2.0
Output gap		-4.8	-4.2	-3.7	-3.2	-2.9	

[1] GDP growth up to 2015 is from the January 2014, *World Economic Outlook Update*.

[2] Output gap not published.

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

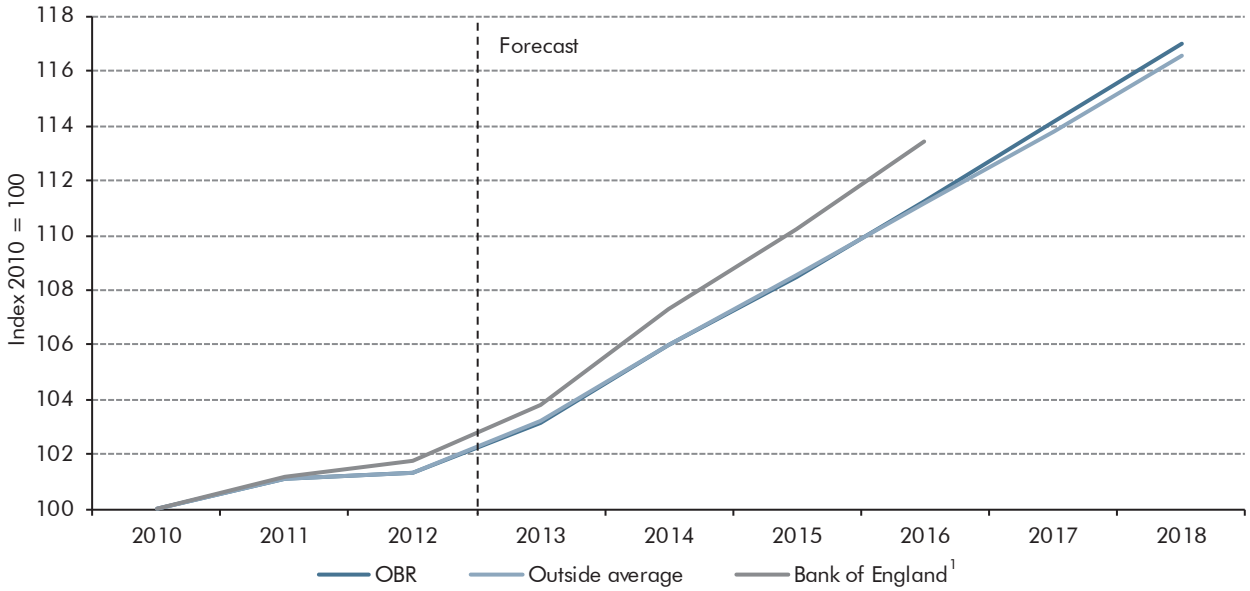
[4] Fourth quarter year-on-year growth rate.

[5] GDP growth and the output gap up to 2015 is from the HM Treasury, March 2014, *Forecasts for the UK economy: a comparison of independent forecasts*.

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

3.127 Chart 3.45 presents our central GDP forecast for the next three years against the average of outside forecasts and the Bank of England's February *Inflation Report* forecast. For the purposes of comparison, we have used the Bank of England's modal forecast – that is, the most likely outcome implied by their forecast distribution. The small negative 'skew' in the February *Inflation Report* forecast distribution means that the median forecast is somewhat lower, implying a level of GDP around 0.1 per cent below the modal forecast by 2016. Our forecast for the level of GDP over the next few years is somewhat below the Bank's modal forecast. This largely reflects weaker expected growth in all years of the Bank's forecast, as well as the Bank's 'backcast', which points to stronger growth over the recent past than in the latest ONS data.

Chart 3.45: Comparison of forecasts for the level of GDP



[1]Based on the Bank of England's 'backcast' for GDP growth.
Source: Bank of England, HM Treasury, ONS, OBR

3.128 Alongside its February 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.

3.129 Table 3.5 shows that the Bank's modal expectation for household consumption growth in 2014 and 2015 is somewhat stronger than our forecast, which may be attributable to a stronger forecast for average earnings growth. The Bank also forecasts a somewhat stronger path for investment growth in 2014 and 2015. Consistent with our forecast, the Bank expects business investment to rise as a share of GDP, although its projections imply stronger growth between 2014 and 2016. Partly offsetting this, the Bank expects much stronger growth in imports in 2014 and weaker export growth in 2015.

Table 3.5: Bank of England illustrative projections[19]

	Per cent				
	Outturn	Forecast			
	2012	2013[1]	2014	2015	2016
Bank of England February *Inflation Report* forecast					
Household consumption	1½	2¼	3¼	2¾	2¼
Business investment	3¾	-3¼	11½	12¾	13¾
Housing investment[2,3]	-5¼	5¾	23¼	10½	3
Exports	1¼	¾	3½	3¾	5
Imports	3¼	1½	6¼	4¼	4¼
Employment[4]	2	1½	1½	¾	¾
Average weekly earnings[3,4]	1¼	1	2¾	3¾	3¾
Difference from OBR forecast					
Household consumption	0	0	1¼	1	-¼
Business investment	0	-2	3½	3½	5¾
Exports	¼	0	1	-1	0
Imports	0	1	3¼	0	-½
Employment[4]	0	¼	½	0	-¼

[1] 2013 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.

[19] Bank of England, *Conditioning assumptions, MPC key judgements, and indicative projections: February 2014*.

Table 3.6: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2012	2013	2014	2015	2016	2017	2018
UK economy							
Gross domestic product (GDP)	0.3	1.8	2.7	2.3	2.6	2.6	2.5
GDP level (2012=100)	100.0	101.8	104.5	107.0	109.7	112.6	115.4
Nominal GDP	2.0	3.4	5.0	4.0	4.4	4.6	4.5
Output gap (per cent of potential output)	-2.8	-2.2	-1.4	-1.1	-0.7	-0.3	0.0
Expenditure components of GDP							
Domestic demand	1.2	1.9	2.9	2.2	2.5	2.6	2.5
Household consumption[1]	1.5	2.3	2.1	1.8	2.5	2.7	2.4
General government consumption	1.6	0.9	1.2	-0.5	-1.2	-1.8	-0.9
Fixed investment	0.7	-0.5	8.6	8.2	7.8	7.9	6.8
Business	3.9	-1.2	8.0	9.2	8.1	8.7	7.7
General government[2]	0.6	-6.4	10.7	1.0	2.2	0.8	-0.5
Private dwellings[2]	-3.5	4.3	9.0	10.0	10.0	9.5	8.1
Change in inventories[3]	-0.2	0.3	0.1	0.0	0.0	0.0	0.0
Exports of goods and services	1.1	0.8	2.6	4.7	5.0	5.0	4.7
Imports of goods and services	3.1	0.4	3.0	4.3	4.8	4.8	4.7
Balance of payments current account							
Per cent of GDP	-3.7	-3.6	-2.3	-1.9	-1.7	-1.5	-1.5
Inflation							
CPI	2.8	2.6	1.9	2.0	2.0	2.0	2.0
RPI	3.2	3.0	2.6	3.2	3.6	3.8	3.9
GDP deflator at market prices	1.7	1.6	2.3	1.6	1.8	1.9	2.0
Labour market							
Employment (millions)	29.5	29.9	30.4	30.6	30.9	31.2	31.4
Wages and salaries	2.8	2.9	3.8	4.1	4.6	4.7	4.5
Average earnings[4]	2.0	1.5	2.5	3.2	3.6	3.7	3.8
LFS unemployment (% rate)	7.9	7.6	6.8	6.5	6.1	5.7	5.4
Claimant count (millions)	1.59	1.42	1.20	1.13	1.06	0.98	0.94
Household sector							
Real household disposable income	2.3	-0.1	1.2	1.8	1.5	2.3	2.2
Saving ratio (level, per cent)	7.2	5.0	4.1	4.2	3.6	3.3	3.2
House prices	1.6	3.5	8.5	7.8	5.0	3.7	3.7
World economy							
World GDP at purchasing power parity	3.1	2.9	3.8	3.9	4.1	4.2	4.2
Euro area GDP	-0.7	-0.4	1.0	1.4	1.7	1.9	2.0
World trade in goods and services	3.0	3.2	5.2	5.8	6.0	6.1	6.1
UK export markets[5]	2.0	2.1	4.7	5.2	5.3	5.4	5.4

[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					
	2012	2013	2014	2015	2016	2017	2018
UK economy							
Gross domestic product (GDP)	0.1	0.3	0.3	0.1	0.0	0.0	-0.3
GDP level (2012=100)[1]	0.0	0.3	0.7	0.8	0.8	0.7	0.5
Nominal GDP	0.2	-0.2	0.4	0.2	0.1	0.1	0.0
Output gap (per cent of potential output)	-0.2	0.1	0.4	0.5	0.5	0.4	0.2
Expenditure components of GDP							
Domestic demand	0.2	0.5	0.5	0.1	0.0	-0.1	-0.3
Household consumption[2]	0.3	0.4	0.2	0.2	0.1	-0.2	-0.4
General government consumption	-0.1	0.3	0.8	0.1	-0.3	0.0	0.3
Fixed investment	-0.2	2.0	1.9	0.3	-0.4	-0.1	-0.2
Business	1.2	4.2	2.9	0.6	-0.7	-0.2	-0.3
General government[3]	-4.0	0.5	3.3	-0.1	0.1	0.3	0.6
Private dwellings[3]	-1.0	-1.8	-0.7	0.0	0.0	-0.2	-0.3
Change in inventories[4]	0.1	-0.1	-0.1	-0.1	0.0	0.0	-0.1
Exports of goods and services	0.1	-0.4	-1.4	0.0	0.0	0.0	0.0
Imports of goods and services	0.1	-1.3	-0.8	0.0	0.0	0.0	0.0
Balance of payments current account							
Per cent of GDP	0.1	-0.2	-0.8	-0.4	-0.3	-0.3	-0.4
Inflation							
CPI	0.0	0.0	-0.4	-0.1	0.0	0.0	0.0
RPI	0.0	0.0	-0.3	-0.1	0.0	0.1	-0.1
GDP deflator at market prices	0.0	-0.5	0.1	0.1	0.1	0.2	0.3
Labour market							
Employment (millions)	0.0	0.0	0.2	0.2	0.2	0.2	0.2
Wages and salaries	0.0	0.0	0.0	0.2	0.1	0.0	-0.2
Average earnings[5]	0.0	0.1	0.0	-0.1	0.1	0.0	0.1
LFS unemployment (% rate)	0.0	0.0	-0.3	-0.4	-0.4	-0.4	-0.2
Claimant count (millions)	0.00	-0.01	-0.07	-0.10	-0.12	-0.15	-0.16
Household sector							
Real household disposable income	0.8	-0.6	0.1	0.7	-0.5	-0.3	-0.4
Saving ratio (level, per cent)	0.4	-0.7	-0.9	-0.4	-1.0	-1.1	-1.1
House prices	0.0	0.4	3.3	0.6	0.1	0.0	-0.1
World economy							
World GDP at purchasing power parity	-0.1	0.0	0.2	0.0	0.0	0.0	0.0
Euro area GDP	0.0	0.0	0.2	0.1	0.0	0.0	0.0
World trade in goods and services	0.6	0.4	-0.2	0.0	0.0	0.0	0.0
UK export markets[6]	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0

[1] Per cent change since December.

[2] Includes households and non-profit institutions serving households.

[3] Includes transfer costs of non-produced assets.

[4] Contribution to GDP growth, percentage points.

[5] Wages and salaries divided by employees.

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

4 Fiscal outlook

Introduction

4.1 This chapter:

- sets out the key economic and market determinants that drive the fiscal forecast (from paragraph 4.3);
- explains the effects of new policies announced in this Budget and since the Autumn Statement in December, and reclassifications, on the fiscal forecast (from paragraph 4.22);
- describes the outlook for public sector receipts, including a tax-by-tax analysis explaining how the forecasts have changed since December (from paragraph 4.32);
- describes the outlook for public sector expenditure, focusing on departmental expenditure limits and the components of annually managed expenditure (from paragraph 4.78);
- presents spending subject to the Government's new welfare cap and looks at some of the recent trends in welfare spending (from paragraph 4.138);
- describes the outlook for government lending to the private sector and other financial transactions (from paragraph 4.157);
- 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 4.173); and
- provides a comparison with forecasts from international organisations (from paragraph 4.184).

4.2 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in the supplementary tables available on our website. The medium-term forecasts for the public finances in this chapter consist of an in-year estimate for 2013-14, which makes use of provisional ONS outturn data for April to January and some preliminary data

on tax receipts in February and early March, and then forecasts to 2018-19.[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. We illustrate the uncertainties that are inherent in any fiscal forecast by using fan charts, sensitivity analysis and alternative economic scenarios;

- is based on announced Government policy on the indexation of rates, thresholds and allowances for taxes and benefits, and incorporates the impact of certified costings for all new policy measures announced by the Chancellor in the Budget;

- focuses on official 'headline' fiscal aggregates that exclude the temporary effects of interventions in the financial sector.[2] The Government's fiscal mandate and supplementary target are defined in terms of these measures; and

- since the key 'ex' measures of PSNB, the current budget balance and PSND have been affected by a variety of additional one-off or temporary factors in recent years, we also focus on an 'underlying' measure of borrowing that adjusts for the largest of them. Specifically, we exclude the one-off transfer in 2012-13 related to the Royal Mail Pension Plan assets and the ongoing transfers from the Bank of England's Asset Purchase Facility (APF) to the Exchequer, which we assume will reverse within the forecast period. We similarly adjust receipts and spending aggregates where they are affected by these transfers.

Economic determinants of the fiscal forecast

4.3 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 path 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 December.

GDP and the output gap

4.4 Most economic forecasts focus on the outlook for real GDP, but nominal GDP is a more important measure for the public finances. This reflects developments in real GDP and whole economy inflation. Nominal GDP is slightly higher in 2013-14 than in our December forecast.

[1] Outturn data are consistent with the Public Sector Finances January 2014 Statistical Bulletin published by the Office for National Statistics and HM Treasury.
[2] Office for National Statistics, 2010, *Public sector finances excluding financial sector interventions*.

4.5 The structural, or cyclically-adjusted, component of net borrowing and the current budget is estimated using the output gap. A negative output gap implies that the economy is operating below capacity, providing scope for tax revenues to increase and spending to fall as a share of GDP as the economy returns to its potential level. We estimate that the output gap was -1.7 per cent of GDP in the final quarter of 2013, slightly narrower than in our December forecast. We now expect the economy to return to its potential level and the output gap to close by mid-2018, around a year earlier than in December.

Income and expenditure components of GDP

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

4.7 The largest source of labour income is wages and salaries, which are determined by employment and earnings. Wages and salaries growth is slightly higher in 2014-15 to 2016-17 than we forecast in December, but slower than previously assumed by the end of the forecast, once the output gap has closed.

4.8 Nominal consumer spending growth is higher in each year up until 2017-18 than we assumed in December. It is now expected to grow at an average rate of 4.6 per cent a year between 2014-15 and 2018-19.

4.9 Non-oil non-financial company profits are expected to grow by 10.7 per cent in 2014, over 3 percentage points higher than we forecast in December, reflecting strength in recent quarters. We have revised down our forecast for growth in each year thereafter, but still expect average growth of just over 5 per cent a year between 2015-16 and 2018-19.

Table 4.1: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
GDP and its components							
Real GDP	0.3	2.3	2.6	2.4	2.6	2.6	2.4
Nominal GDP[1]	1.4	4.7	4.6	3.9	4.6	4.5	4.4
Nominal GDP (£ billion)[1,2]	1571	1644	1721	1788	1871	1956	2042
Nominal GDP (centred end-March £bn)[1,3]	1597	1688	1754	1827	1913	1999	2088
Wages and salaries[4]	2.4	3.9	3.5	4.2	4.7	4.6	4.4
Non-oil PNFC profits[4,5]	2.8	7.0	10.7	4.9	5.4	5.3	4.8
Non-oil PNFC net taxable income[4,5]	6.4	6.9	9.8	3.1	3.2	2.9	2.4
Consumer spending[4,5]	4.1	4.5	4.5	4.1	4.8	5.0	4.7
Prices and earnings							
GDP deflator	1.6	1.8	2.2	1.6	1.9	1.9	2.0
RPI (September)	2.6	3.2	2.5	3.3	3.7	3.8	3.9
CPI (September)	2.2	2.7	1.8	2.0	2.0	2.0	2.0
Average earnings[6]	1.0	2.6	2.4	3.3	3.7	3.7	3.8
'Triple-lock' guarantee (September)	2.5	2.7	2.5	3.3	3.6	3.7	3.8
Key fiscal determinants							
Claimant count (millions)	1.57	1.35	1.18	1.11	1.04	0.97	0.94
Employment (millions)	29.6	30.0	30.4	30.7	31.0	31.2	31.4
VAT gap (per cent)	10.9	10.3	9.9	9.9	9.9	9.9	9.9
Output gap (per cent of potential output)	-2.8	-2.0	-1.3	-1.0	-0.6	-0.2	0.0
Financial and property sectors							
Equity prices (FTSE All-Share index)	3066	3498	3747	3897	4074	4260	4449
HMRC financial sector profits[1,5,7]	3.4	1.4	2.3	4.0	4.7	4.6	4.4
Financial sector net taxable income[1,5]	4.2	2.6	-0.2	3.1	7.0	3.4	3.7
Residential property prices[8]	2.1	4.9	8.6	7.4	4.3	3.7	3.7
Residential property transactions (000s)[9]	930	1146	1357	1407	1450	1493	1526
Commercial property prices[9]	2.3	11.9	2.1	2.0	3.7	3.0	2.0
Commercial property transactions[9]	1.5	9.3	3.9	3.1	3.9	4.1	3.0
Volume of stampable share transactions	-18.1	10.5	3.9	-2.6	-2.6	-2.6	-2.6
Oil and gas							
Oil prices ($ per barrel)[5]	112.0	108.8	107.5	102.0	99.3	99.3	99.3
Oil prices (£ per barrel)[5]	70.6	69.6	64.7	61.1	59.2	59.0	59.1
Gas prices (p/therm)[5]	59.1	66.9	60.2	63.2	63.2	63.2	63.2
Oil production (million tonnes)[5,10]	44.5	40.6	39.2	39.2	39.2	39.2	39.2
Gas production (billion therms)[5,10]	13.8	12.8	12.8	12.7	12.7	12.7	12.7
Interest rates and exchange rates							
Market short-term interest rates (%)[11]	0.7	0.5	0.6	1.3	2.0	2.6	3.1
Market gilt rates (%)[12]	1.6	2.6	2.9	3.3	3.6	3.9	4.0
Euro/Sterling exchange rate (€/£)	1.23	1.19	1.22	1.22	1.23	1.25	1.26

[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 determinants of the fiscal forecast since December

	Percentage point change unless otherwise specified						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
GDP and its components							
Real GDP	0.2	0.3	0.3	0.1	0.0	-0.1	-0.3
Nominal GDP[1]	0.0	0.1	0.4	0.1	0.1	0.1	0.0
Nominal GDP (£ billion)[1,2]	0	3	8	11	14	16	16
Nominal GDP (centred end-March £bn)[1,3]	-2	8	10	12	16	17	17
Wages and salaries[4]	0.0	0.0	0.1	0.1	0.2	-0.1	-0.2
Non-oil PNFC profits[4,5]	-1.5	0.0	3.5	-0.9	-0.9	-1.0	0.0
Non-oil PNFC net taxable income[4,5]	-3.5	-1.3	2.8	-1.4	-1.4	-1.5	-0.5
Consumer spending[4,5]	0.3	0.2	0.6	0.3	0.3	0.1	-0.2
Prices and earnings							
GDP deflator	-0.2	-0.3	0.1	0.1	0.1	0.2	0.3
RPI (September)	0.0	0.0	-0.3	0.0	0.1	0.0	-0.1
CPI (September)	0.0	0.0	-0.3	-0.1	0.0	0.0	0.0
Average earnings[6]	0.0	0.2	-0.1	-0.1	0.1	0.0	0.1
'Triple-lock' guarantee (September)	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Key fiscal determinants							
Claimant count (millions)	0.00	-0.02	-0.08	-0.11	-0.13	-0.15	-0.16
Employment (millions)	0.0	0.0	0.2	0.2	0.3	0.2	0.1
VAT gap (per cent)	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Output gap (per cent of potential output)	-0.1	0.2	0.4	0.5	0.5	0.4	0.1
Financial and property sectors							
Equity prices (FTSE All-Share index)	-25	25	58	66	73	80	82
HMRC financial sector profits[1,5,7]	0.0	0.0	0.0	0.2	0.1	0.1	0.0
Financial sector net taxable income[1,5]	0.5	2.2	-3.2	0.1	1.5	-0.6	-0.8
Residential property prices[8]	0.0	1.2	2.7	0.4	0.1	0.0	-0.2
Residential property transactions (000s)[9]	-1	37	77	52	40	26	-1
Commercial property prices[9]	0.6	10.5	-0.7	-1.8	-0.3	-0.5	-1.0
Commercial property transactions[9]	0.0	5.0	-0.1	0.3	0.0	-0.3	-1.6
Volume of stampable share transactions	0.0	0.3	-0.2	-0.2	0.1	0.2	0.2
Oil and gas							
Oil prices ($ per barrel)[5]	0.0	0.5	3.8	3.1	1.9	1.9	1.9
Oil prices (£ per barrel)[5]	0.0	0.3	0.7	0.3	-0.5	-0.6	-0.6
Gas prices (p/therm)[5]	0.0	2.4	-7.2	-2.4	-2.4	-2.4	-2.4
Oil production (million tonnes)[5,10]	-0.1	1.4	0.0	0.0	0.0	0.0	0.0
Gas production (billion therms)[5,10]	0.0	0.3	0.3	0.2	0.2	0.2	0.2
Interest rates and exchange rates							
Market short-term interest rates[11]	0.0	0.0	0.0	0.1	0.2	0.1	0.0
Market gilt rates[12]	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.2
Euro/Sterling exchange rate (€/£)	0.00	0.00	0.02	0.02	0.02	0.03	0.04

[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

4.10 The CPI measure of inflation is used to index many tax rates, allowances and thresholds and to uprate benefits and public sector pensions. Our forecast for CPI inflation has been revised down slightly in the first two years of the forecast, reflecting the lower-than-expected outturns in recent months. CPI inflation is expected to be close to the Bank of England's target of 2 per cent throughout the forecast.

4.11 RPI inflation determines the interest rate paid on index-linked gilts and is used to revalorise excise duties. We have revised RPI inflation down slightly in the near term. RPI inflation is higher than CPI inflation in each year of the forecast, partly because its method of calculation drives a wedge between the two (the 'formula effect'), but also that market expectations for Bank Rate gradually feed through to the mortgage interest rate payment component of RPI inflation, which is not included in CPI.

4.12 The Basic State Pension (BSP) is uprated in April each year in line with the 'triple-lock' guarantee: by whichever is the highest of average earnings growth, CPI inflation in the previous September, or 2.5 per cent. On our current forecast, it will rise by the minimum 2.5 per cent in 2015-16 and by average earnings growth of between 3.3 per cent and 3.8 per cent from 2016-17 onwards.

Property market

4.13 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 December forecast. Our latest forecast is for 8.6 per cent growth in 2014-15, 2.7 percentage points higher than our forecast in December. Growth remains strong in 2015-16, after which we assume house prices rise in line with earnings.

4.14 Residential property transactions have been higher than expected in recent months and are forecast to continue growing strongly in 2014-15, by more than 18 per cent over the previous year. We have revised the profile for our residential property transactions forecast, bringing more of the growth in transactions into the early years of the forecast and reducing growth rates in the later years. The level of transactions remains close to our December forecast by 2018-19.

4.15 Commercial property prices and transactions showed very strong growth in the final quarter of 2013. Average prices are now expected to grow by around 12 per cent in 2013-14 and the volume of transactions by around 9 per cent. With more activity in the near term, growth in future years is slightly lower than in December. In 2018-19, prices are forecast to be around 6 per cent higher and the volume of transactions around 3 per cent higher than we forecast in December.

Oil and gas sector

4.16 Our oil price forecast moves in line with the average of the futures curve over the ten working days to 27 February 2014 for the next two years, and is held flat at that level for the remainder of the forecast period. Movements in oil prices and the sterling/dollar exchange rate mean that the sterling price of oil is slightly higher than we assumed in December until 2015-16 and lower thereafter. We use the same method to project gas prices. These are also lower than we assumed in December.

4.17 Oil and gas production forecasts are based on the central projection published by the Department of Energy and Climate Change (DECC). Oil production fell 8.8 per cent in 2013 and gas production fell by 7.2 per cent. Oil production is expected to fall a further 3.6 per cent in 2014 and then remain flat across the remainder of the forecast. These forecasts are little changed since December.

4.18 Projections for capital and operating expenditure by oil and gas firms are a key driver of oil and gas revenues. We have incorporated DECC estimates which are based on recent industry data. Capital expenditure is expected to remain close to its current record levels over the next couple of years. We have built in more of a decline at the end of the forecast than in the DECC estimates, on the basis that some capital plans may not take place during the forecast period.

Equity markets

4.19 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. The current level is determined by the average closing price of the FTSE All-Share Index over the ten working days to 27 February 2014.

Interest rates

4.20 We use the 3-month sterling interbank rate as a benchmark for our short-term interest rate determinant. Our forecast incorporates the average forward rates for the ten working days to 27 February 2014. The futures curve implies rates will be slightly higher from 2015-16, before returning to our December assumption by the final year.

4.21 Our forecast assumes gilt yields move in line with market expectations based on average forward rates for the ten days to 27 February 2014. Gilt yields are marginally lower across the forecast than we assumed in December.

Policy announcements, risks and classification changes

4.22 The Government publishes estimates of the direct impact of tax and spending policy decisions on the public finances in its Budget 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. These are discussed in Box 3.3 in Chapter 3. We also note as risks to the fiscal forecast any significant policy commitments that are not quantifiable, as well as potential statistical classification changes. We have 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*.

Direct effect of new policy announcements on the public finances

4.23 Annex A reproduces the Treasury's table of the direct effect on PSNB of policy decisions in the Budget or announced since the Autumn Statement. The OBR has endorsed all of the tax and AME expenditure costings in the Treasury's table as being reasonable central estimates of the measures themselves. As we explain in more detail in our annex to the Treasury's *Budget 2014 policy costings* document, a number of these costings are highly uncertain. In particular the savings and pensions package – which includes the pension withdrawals, voluntary NICs, ISA equalisation and ISA peer-to-peer loans and retail bonds measures. Measures which include assumptions on EEA net migration and the accelerated payments measure are also particularly uncertain.

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

4.25 The tax and spending measures that the Treasury has included in its Budget policy decisions table have little cumulative effect on borrowing over the forecast, with a £5½ billion cumulative net tax cut offset by a £5¾ billion cumulative reduction in spending. The net tax cut reflects the partly offsetting effects of a number of measures that reduce receipts – including raising the income tax personal allowance, the package of savings measures and extending temporary annual investment allowances at £500,000 – and others that increase receipts – including accelerated payment in anti-avoidance cases and the income tax associated with the pension withdrawals measure. Spending cuts are focused in the years from 2016-17 to 2018-19, for which detailed plans have not yet been set. The Government has also made spending commitments related to energy intensive industries in this Budget that it estimates will cost around £0.5 billion a year from 2016-17.

Table 4.3: Summary of the effect of identified policy measures

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Effects of receipts measures	0.0	0.0	-0.6	-1.8	-1.4	-1.7
of which:						
Income tax and NICs	0.0	0.3	0.1	-0.4	-0.5	-0.7
Onshore corporation tax	0.0	0.0	-0.3	-0.7	0.1	0.3
Alcohol duty	0.0	-0.3	-0.3	-0.3	-0.3	-0.3
Stamp duty	0.0	0.1	0.1	0.2	0.1	0.1
Air passenger duty	0.0	0.0	-0.2	-0.2	-0.2	-0.2
Climate change levy	0.0	0.0	-0.1	-0.4	-0.7	-1.0
Tobacco duty	0.0	0.0	0.0	0.1	0.1	0.1
Other	0.0	0.0	0.0	0.1	0.0	0.0
Effects of expenditure measures[1]	0.0	-0.5	0.1	2.0	2.1	2.1
of which:						
Current DEL	0.0	-0.3	-0.3	1.2	1.2	1.2
Current AME	0.0	0.0	0.4	0.8	0.8	0.9
of which:						
Social security benefits	0.0	0.0	-0.1	0.0	0.0	0.0
Tax credits	0.0	0.0	0.0	-0.1	-0.1	-0.1
Public service pensions	0.0	0.0	0.7	1.0	1.0	1.0
Debt interest	0.0	0.0	-0.2	-0.1	-0.1	0.0
Capital DEL	0.0	-0.3	-0.1	0.0	0.0	0.0
Capital AME	0.0	0.0	0.0	0.0	0.0	0.0
Total direct effect of policy measures on PSNB	**0.0**	**-0.6**	**-0.6**	**0.2**	**0.6**	**0.4**
Total direct effect of policy measures on current balance	**0.0**	**-0.3**	**-0.5**	**0.2**	**0.6**	**0.4**
Financial transactions	0.0	-0.3	-0.5	-2.6	-2.3	-2.5

[1]Expenditure categories are equivalent to PSCE in RDEL, PSCE in AME, PSGI in CDEL and PSGI in AME in Table 4.17.

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.

4.26 Our forecast also includes the reallocation of the tax free childcare measure that was announced in Budget 2013, which provided government support for childcare up to a limit of £1,200 per child. At Budget 2013, the Government included this measure in its table of policy decisions, allocating the costs to RDEL from 2015-16 onwards. We have certified a new costing for this measure that shifts this to welfare spending in AME, with offsetting increases in receipts and reductions in RDEL. This increases welfare spending by £0.9 billion a year by the end of the forecast period. Implied PSCE in RDEL is also reduced beyond 2015-16 by the additional AME spending. These effects are set out in a supplementary fiscal table on our website, which shows a full breakdown of all the policy decisions in Budget 2014. The policy has been made more generous at this Budget, adding a further £0.1 billion to welfare spending from 2016-17 onwards.

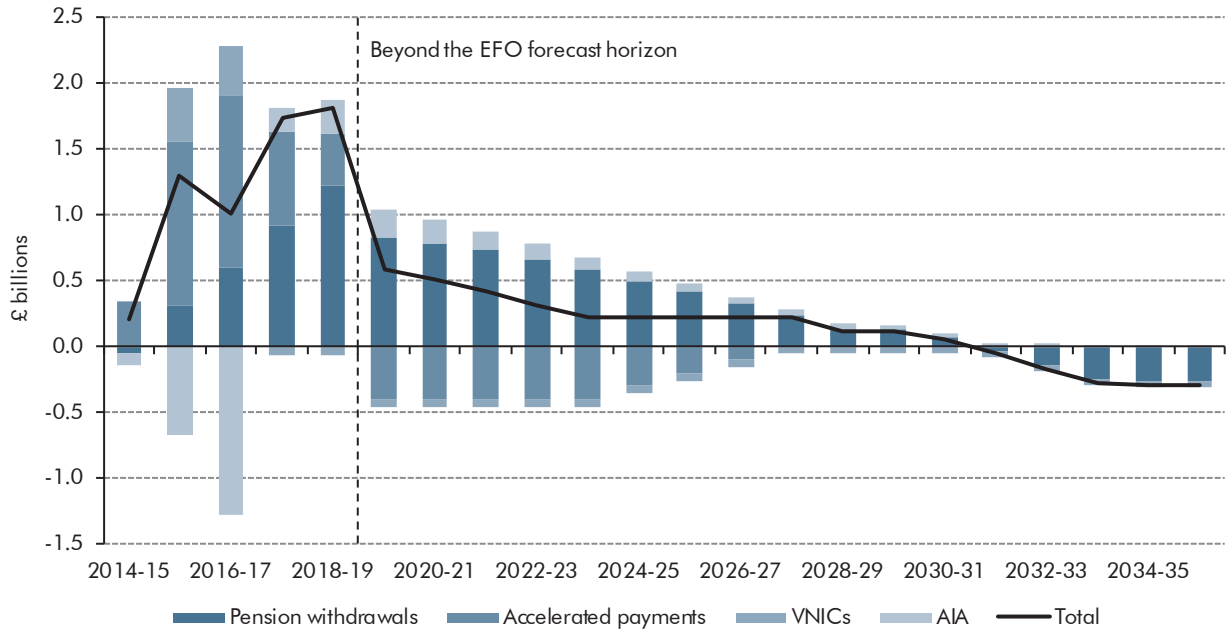
4.27 A number of measures have markedly different implications for revenue beyond the five-year scorecard period than within it, which we will consider in more detail in our next *Fiscal*

sustainability report. The Treasury has provided estimates of the longer-term revenue consequences of these measures, which are presented in Chart 4.1. These include:

- the pension withdrawals measure, which brings forward income tax receipts but has a small steady-state cost in the long term;
- voluntary NICs, which increases NICs receipts in the short term but also increases long-term state pension costs;
- the temporary annual investment allowance increase, which raises the amount of tax relief that can be claimed until December 2015, but then reduces it thereafter, largely recouping the scorecard costs; and
- accelerated payments related to tax avoidance schemes, which brings forward receipts from future years.

4.28 The net effect of these measures is to increase receipts over the scorecard horizon by £1.2 billion a year on average, but the revenue raised then drops sharply in 2019-20 and averages only £0.2 billion a year over the 15 years beyond the scorecard horizon. Given the uncertainty associated with costing these policy measures over a 5-year horizon, the longer-term implications will be also be subject to considerable uncertainty.

Chart 4.1: Revenue raised by selected Budget policy measures



Source: HM Treasury, OBR

Box 4.1: Asset Purchase Facility flows

Since late 2012-13, excess cash held in the Bank of England's Asset Purchase Facility (APF) has been transferred to the Exchequer on an ongoing basis.

Transfers up to the level of the Bank's income in the previous year are currently treated as dividends, reducing net borrowing; beyond that, they are financial transactions, reducing the net cash requirement but not borrowing. Any payments made from the Exchequer to the APF are also currently treated as capital grants, increasing net borrowing but not affecting the current budget. This treatment will change following the ONS's Public Sector Finances Review, to be implemented later this year, and the possible implications are discussed in Annex B.

To estimate the size of future flows, we have to make assumptions about when quantitative easing (QE) will be unwound and how quickly. Our central forecast assumes that Bank Rate follows market expectations, but there is no equivalent guide to expectations for the path of QE. We therefore take a neutral set of assumptions, unchanged since we first included the APF figures in our forecast in December 2012. We assume QE remains at £375 billion and that it begins to be unwound once Bank Rate rises above 1 per cent, with sales evenly paced at £10 billion a quarter thereafter. We also assume redemptions will not be reinvested once sales begin. The first sale is assumed to be in the fourth quarter of 2015, as assumed last December.

Our projection for the overall net transfer to the Treasury is now £42 billion, up slightly from our December projection of £40 billion. A slightly higher Bank Rate reduces net interest income between 2015-16 and 2017-18, offset later by lower gilt rates, which imply higher gilt prices at the point of sale and therefore smaller capital losses.

There is huge uncertainty about the timing and pace of QE unwinding and our assumptions should be regarded as a neutral way of illustrating the potential fiscal impact, rather than as a forecast of how the Bank of England is likely to act. Table C also shows two alternative scenarios: the first where gilt rates rise by 200 basis points when QE unwinding starts; and the second where the stock runs down only through redemptions once Bank Rate moves above 1 per cent.

The estimates of the overall transfer to the Exchequer are highly sensitive to changes in gilt rates. In the first scenario the Treasury would receive £61 billion, only to pay back £57 billion over the following years, giving a net transfer of £5 billion. In the second, the Exchequer would continue to receive cash from the APF over the next five years, reducing debt by £72 billion in total, before covering losses over a protracted period. Both scenarios would have much bigger effects beyond our *EFO* forecasting horizon, which we will revisit in this July's *Fiscal sustainability report*.

Table A: Fiscal impact of projected APF flows

	£ billion										
	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Receipts	6.4	12.2	11.6	7.2	2.9	0.4	0.0	0.0	0.0	0.0	0.0
Capital spending	0.0	0.0	0.0	0.3	0.0	1.7	3.7	5.7	5.4	5.5	0.4
Net borrowing	-6.4	-12.2	-11.6	-6.9	-2.9	1.3	3.7	5.7	5.4	5.5	0.4
Current budget	6.4	12.2	11.6	7.2	2.9	0.4	0.0	0.0	0.0	0.0	0.0
Net cash requirement	-11.3	-31.1	-11.6	-6.9	-2.9	1.3	3.7	5.7	5.4	5.5	0.4
Public sector net debt	-11	-42	-54	-61	-64	-63	-59	-53	-48	-42	-42

Table B: Changes to the fiscal impact of projected APF flows since December

	£ billion										
	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Receipts	0.0	0.0	-0.5	-0.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Capital spending	0.0	0.0	0.0	0.0	0.0	-0.1	-0.5	-0.6	-0.7	-0.5	0.2
Net borrowing	0.0	0.0	0.5	0.3	0.3	-0.1	-0.5	-0.6	-0.7	-0.5	0.2
Current budget	0.0	0.0	-0.5	-0.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Net cash requirement	0.0	-0.4	0.5	0.3	0.3	-0.1	-0.5	-0.6	-0.7	-0.5	0.2
Public sector net debt	0	0	0	0	1	1	0	-1	-1	-2	-2

Table C: Fiscal impact of alternative APF scenarios

	£ billion										
	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Central											
Net borrowing	-6.4	-12.2	-11.6	-6.9	-2.9	1.3	3.7	5.7	5.4	5.5	0.4
Public sector net debt	-11	-42	-54	-61	-64	-63	-59	-53	-48	-42	-42
200bps gilt shock											
Net borrowing	-6.4	-12.2	-11.6	-5.2	4.1	8.5	10.9	13.0	13.0	5.1	0.0
Public sector net debt	-11	-42	-54	-59	-55	-47	-36	-23	-10	-5	-5
Redemptions only[1]											
Net borrowing	-6.4	-12.2	-11.6	-7.6	-6.5	-3.2	-1.2	1.8	0.9	6.0	2.1
Public sector net debt	-11.3	-42	-54	-61	-68	-71	-72	-71	-70	-64	-61

[1] Under this scenario the APF transfers would continue to directly affect net borrowing and net debt beyond 2022-23.

Currently unquantifiable policy commitments

4.29 Consistent with the *Charter for Budget Responsibility,* 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 a target for central government to deliver at least £25 billion of asset sales between 2015 and 2020, comprising at least £5 billion of land and property and £20 billion of 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 than would otherwise be expected 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;

- the Treasury and Royal Bank of Scotland are in negotiations to simplify the bank's capital structure by retiring the Dividend Access Share, but the outcome is too

uncertain to anticipate. The Government's shareholdings in Lloyds Banking Group may also attract dividend payments, but Lloyds would require regulatory approval to disburse any dividends and so we do not include payments over the forecast period. We also do not assume any further stakes in the banks are sold over the next few years; and

- we have asked the Treasury to identify any changes to future contingent liabilities as a result of new policy announcements since December. 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; support of debt for the Mersey Gateway Bridge project, provided through the UK Infrastructure Guarantee Scheme. We will continue to report on the broader suite of contingent liabilities, including updates on existing liabilities, in our annual *Fiscal sustainability reports*.

Classification and accounting standards changes

4.30 From September 2014, the ONS will implement a number of changes to the public sector finances statistics. Following their review of the public sector finances, the ONS will introduce new measures that only exclude the debt and borrowing of public sector banks, as well as a number of other changes in the presentation of the data. In addition, there are a number of changes resulting from the introduction of the 2010 European System of Accounts (ESA10). We have provided further information on these changes and produced some illustrative forecasts of the effects on a number of key aggregates in Annex B. We will continue to present our forecasts on the same basis as the ONS produces outturn data. As a result, we intend to publish our autumn 2014 *EFO* forecast on the basis of the post ESA10 and PSF review measures of the public sector finances.

4.31 The International Accounting Standards Board (IASB) is finalising an accounting standard (IFRS9) which will change the basis for calculating impairment provisions for financial assets. This will raise the size of these provisions resulting in reduced corporation tax. Ahead of the publication of the standard and endorsement by the EU, the scale and timing of the impact is uncertain.

Public sector receipts

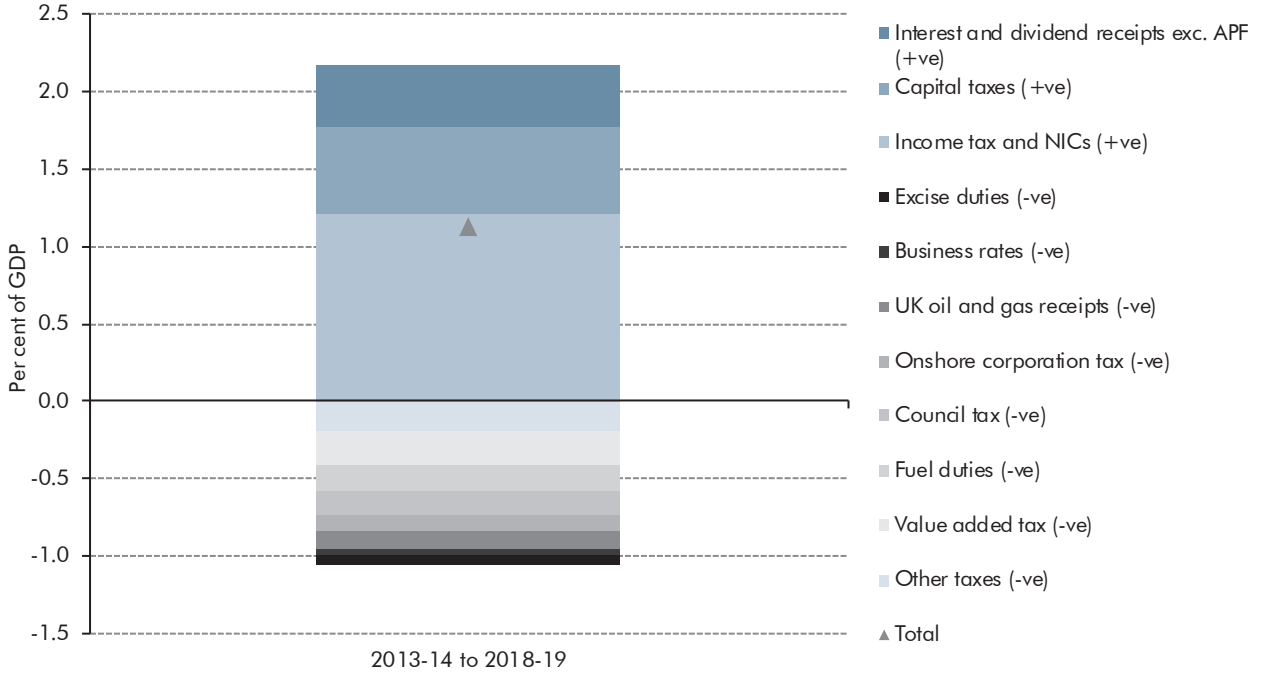
4.32 Public sector current receipts are expected to fall as a share of GDP in 2013-14, mainly as a result of lower income tax and NICs receipts. This is partly due to the £1,335 rise in the personal allowance, subdued earnings growth and the deferral of self-assessment income to take advantage of the reduction in the additional rate to 45p. A fall in oil and gas revenues has also contributed to the decline. From 2014-15 onwards, current receipts are expected to rise as a share of GDP and Chart 4.2 illustrates the sources of changes to underlying current receipts as a share of GDP by 2018-19. Table 4.4 summarises our central forecast for the major taxes as a share of GDP. Table 4.5 shows our detailed forecast for individual taxes and other receipts.

Table 4.4: Major receipts as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax and NICs	16.4	16.0	16.1	16.3	16.8	17.0	17.2
Value added tax	6.4	6.5	6.4	6.4	6.4	6.3	6.3
Onshore corporation tax	2.3	2.2	2.3	2.2	2.2	2.2	2.1
UK oil and gas receipts	0.4	0.3	0.2	0.2	0.2	0.2	0.2
Fuel duties	1.7	1.6	1.6	1.5	1.5	1.5	1.5
Business rates	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Council tax	1.7	1.7	1.6	1.6	1.5	1.5	1.5
Excise duties	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Capital taxes	1.0	1.2	1.5	1.6	1.7	1.7	1.8
Other taxes	2.7	2.9	2.9	2.9	2.8	2.8	2.7
National Accounts taxes	35.5	35.2	35.2	35.5	35.8	35.9	35.9
Interest and dividend receipts exc. APF	0.5	0.4	0.4	0.5	0.7	0.7	0.8
Other receipts	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Current receipts exc. APF	37.4	37.0	37.0	37.4	37.8	38.0	38.1
APF dividend receipts	0.4	0.7	0.7	0.4	0.2	0.0	0.0
Current receipts	37.8	37.7	37.7	37.8	38.0	38.0	38.1

4.33 Current receipts (on an underlying basis, excluding transfers from the APF) are expected to increase by 1.1 per cent of GDP between 2013-14 and 2018-19. Receipts that are increasing as a share of GDP add 2.2 per cent to the receipts-to-GDP ratio over this period. These are offset by steady declines in a number of other taxes, which offset the increase by 1.0 per cent of GDP.

Chart 4.2: Cumulative changes in major receipts as a share of GDP



4.34 The main drivers of increases in the receipts-to-GDP ratio come from:

- income tax and NICs, which increase as a share of GDP over the forecast as positive fiscal drag returns. On top of this, the Budget 2013 measure that abolished the NICs contracting out rebate raises NICs by 0.3 per cent of GDP from 2016-17 onwards;
- capital taxes, including stamp duty on land and shares, capital gains tax and inheritance tax, which are forecast to increase by half, from 1.2 to 1.8 per cent of GDP between 2013-14 and 2018-19. Stamp duty land tax contributes more than half of this increase as house prices and transactions continue to strengthen; and
- interest and dividend receipts, excluding APF transfers, as higher interest rates are earned on a rising stock of assets.

4.35 The main offsetting falls include:

- revenues from oil and gas producers, reflecting flat production and high operating and capital expenditure in the industry, which is tax deductible;
- onshore corporation tax, reflecting recent policy measures which lower the main rate to 20 per cent by 2015-16;
- VAT receipts, as the share of household spending on goods and services subject to the tax falls; and
- fuel duty, as improvements in vehicle efficiency and policy measures reduce growth in revenues.

Table 4.5: Current receipts

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax (gross of tax credits)[1]	152.3	155.6	166.5	176.8	189.2	201.3	213.2
of which: Pay as you earn	*132.0*	*135.5*	*140.2*	*148.2*	*158.1*	*168.6*	*179.1*
Self assessment	*20.6*	*20.9*	*27.2*	*29.0*	*31.2*	*32.8*	*34.0*
Tax credits (negative income tax)	-3.0	-2.7	-2.7	-2.5	-1.6	-0.3	0.0
National insurance contributions	104.5	107.3	110.0	115.0	126.1	132.0	138.2
Value added tax	100.7	106.5	110.7	115.0	119.2	123.3	127.7
Corporation tax[2]	40.4	40.1	41.4	42.3	42.6	44.5	45.9
of which: Onshore	*36.0*	*36.6*	*38.9*	*39.7*	*40.5*	*42.1*	*43.3*
Offshore	*4.4*	*3.6*	*2.5*	*2.6*	*2.2*	*2.4*	*2.6*
Corporation tax credits[3]	-0.9	-1.0	-0.9	-0.8	-0.8	-0.8	-0.9
Petroleum revenue tax	1.7	1.1	1.2	1.3	1.0	1.0	0.9
Fuel duties	26.6	26.8	26.8	27.2	28.3	29.1	29.8
Business rates	26.3	26.6	26.9	28.7	30.0	30.8	32.3
Council tax	26.3	27.1	27.6	28.0	28.9	29.8	30.8
VAT refunds	13.8	13.9	14.1	13.9	13.4	13.0	12.8
Capital gains tax	3.9	3.9	5.4	6.7	7.5	8.2	9.0
Inheritance tax	3.1	3.5	3.9	4.3	4.9	5.4	5.8
Stamp duty land tax	6.9	9.5	12.7	14.4	15.7	16.8	18.1
Stamp taxes on shares	2.2	3.1	3.1	3.2	3.2	3.3	3.3
Tobacco duties	9.6	9.7	9.9	10.1	10.3	10.6	10.9
Spirits duties	3.0	3.0	3.0	3.2	3.3	3.5	3.7
Wine duties	3.5	3.7	3.9	4.2	4.5	5.0	5.4
Beer and cider duties	3.6	3.7	3.5	3.5	3.6	3.7	3.7
Air passenger duty	2.8	3.0	3.2	3.1	3.3	3.6	3.9
Insurance premium tax	3.0	3.1	3.2	3.3	3.4	3.4	3.5
Climate change levy	0.7	1.3	2.0	2.5	2.3	2.2	2.1
Other HMRC taxes[4]	5.9	6.5	6.7	7.0	7.1	7.3	7.5
Vehicle excise duties	6.0	6.1	5.9	5.8	5.7	5.6	5.4
Bank levy	1.6	2.3	2.7	2.9	2.9	2.9	2.9
Licence fee receipts	3.1	3.1	3.2	3.2	3.2	3.3	3.4
Environmental levies	2.3	4.1	4.9	5.9	6.4	7.0	7.8
Swiss capital tax	0.0	0.9	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.3	0.4	0.3	0.4	0.4	0.4	0.4
Other taxes	6.6	6.8	6.9	7.0	6.7	6.7	6.5
National Accounts taxes	**556.8**	**579.1**	**606.0**	**635.4**	**670.7**	**702.4**	**734.2**
Less own resources contribution to EU	-5.3	-5.5	-5.1	-5.6	-5.2	-5.4	-5.6
Interest and dividends exc. APF	8.0	6.8	7.7	9.5	12.5	14.7	16.6
Gross operating surplus	27.6	28.3	28.9	30.0	31.3	32.6	33.8
Other receipts	-0.2	-1.0	-1.0	-1.1	-1.2	-1.2	-1.3
Current receipts exc. APF	**586.9**	**607.7**	**636.5**	**668.2**	**708.1**	**742.9**	**777.7**
APF dividend receipts	6.4	12.2	11.6	7.2	2.9	0.4	0.0
Current receipts	**593.4**	**619.8**	**648.1**	**675.4**	**711.0**	**743.4**	**777.7**
Memo: UK oil and gas revenues[5]	*6.1*	*4.7*	*3.7*	*3.8*	*3.2*	*3.4*	*3.5*

[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.

Table 4.6: Changes to current receipts since December

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax (gross of tax credits)[1]	0.0	0.1	-0.7	-1.1	-0.4	0.2	-0.8
of which: Pay as you earn	0.0	0.6	0.6	-0.2	0.4	0.8	0.3
Self assessment	0.0	0.1	-0.2	0.4	0.7	0.8	0.4
Tax credits (negative income tax)	0.0	0.0	0.0	0.0	0.1	0.0	0.0
National insurance contributions	0.0	0.4	0.8	1.5	1.7	1.4	1.1
Value added tax	0.0	0.3	0.9	1.3	1.5	1.5	1.6
Corporation tax[2]	0.0	0.6	-0.1	0.3	0.2	0.6	1.2
of which: Onshore	0.4	0.8	0.6	0.5	0.4	0.9	1.4
Offshore	-0.4	-0.2	-0.7	-0.3	-0.2	-0.3	-0.2
Corporation tax credits[3]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Petroleum revenue tax	0.0	-0.2	-0.2	-0.1	-0.2	-0.2	-0.2
Fuel duties	0.0	0.0	0.3	0.3	0.3	0.3	0.3
Business rates	0.2	0.0	-0.1	-0.2	-0.3	-0.1	-0.1
Council tax	0.0	0.0	0.0	-0.1	-0.1	-0.2	-0.2
VAT refunds	0.0	0.1	0.4	0.5	0.1	0.1	0.3
Capital gains tax	0.0	-1.1	-1.3	-1.3	-1.5	-1.6	-1.8
Inheritance tax	0.0	0.0	0.0	0.1	0.2	0.2	0.2
Stamp duty land tax	0.0	0.6	1.9	1.9	1.8	1.6	1.3
Stamp taxes on shares	0.0	0.2	0.3	0.3	0.3	0.3	0.3
Tobacco duties	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Spirits duties	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Wine duties	0.0	0.0	-0.1	-0.1	0.0	-0.1	-0.1
Beer and cider duties	0.0	0.1	0.0	0.0	0.0	-0.1	0.0
Air passenger duty	0.0	-0.1	0.0	-0.3	-0.3	-0.4	-0.4
Insurance premium tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Climate change levy	0.0	-0.3	-0.1	-0.1	-0.5	-0.7	-0.9
Other HMRC taxes[4]	0.0	0.2	0.2	0.0	0.0	-0.1	-0.1
Vehicle excise duties	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Bank levy	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Licence fee receipts	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Environmental levies	0.0	0.0	0.2	0.3	0.0	-0.5	-0.9
Swiss capital tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Other taxes	0.0	0.7	0.2	0.2	0.2	0.1	0.0
National Accounts taxes	**0.2**	**1.8**	**2.4**	**3.4**	**3.1**	**2.8**	**1.1**
Less own resources contribution to EU	0.0	-0.5	-0.1	-0.4	-0.2	-0.2	-0.2
Interest and dividends exc. APF	0.0	-0.3	-0.3	-0.3	-0.2	-0.4	-0.9
Gross operating surplus	-0.2	0.0	0.1	0.1	0.2	0.5	0.9
Other receipts	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Current receipts exc. APF	**0.0**	**1.1**	**2.0**	**2.8**	**2.9**	**2.6**	**0.8**
APF dividend receipts	0.0	0.0	-0.5	-0.2	-0.3	0.0	0.0
Current receipts	**0.0**	**1.1**	**1.5**	**2.6**	**2.6**	**2.6**	**0.8**
Memo: UK oil and gas revenues[5]	*-0.4*	*-0.4*	*-0.9*	*-0.4*	*-0.3*	*-0.5*	*-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 2013-14 receipts forecast since December

4.36 Our forecast for current receipts in 2013-14 is £1.1 billion higher than in December. This mainly reflects higher-than-expected receipts from corporation tax paid by industrial and commercial companies, PAYE income tax and NICs and stamp duty land tax. This is partly offset by much lower receipts from capital gains tax and lower oil and gas revenues.

Changes in the medium-term underlying receipts forecast since December

4.37 Our forecast for public sector current receipts, excluding APF transfers, is higher in each year than in December. The upward revision increases from £2.0 billion in 2014-15 to £2.6 billion in 2017-18, before falling back to £0.8 billion, by 2018-19. The biggest upward revisions are for stamp duty land tax, onshore corporation tax and VAT. This reflects upward revisions to our forecast for nominal consumption and company profits, as well as the strength of the residential property market.

4.38 The main downward revisions come from lower capital gains tax, largely due to the weakness in outturn receipts in 2013-14, and from lower oil and gas revenues.

4.39 Table 4.6 shows the changes in individual taxes since December and Table 4.7 breaks down these changes into those that result from revised economic determinants, changes to modelling and underlying assumptions, and the effect of policy measures announced in the Budget. We explain the changes in individual taxes in the next section of this chapter.

4.40 In summary, most of the main receipts streams have been revised up:

- VAT, reflecting our forecast for higher nominal consumption than in December;
- onshore corporation tax, reflecting higher outturn receipts in 2013-14 and an upward revision to our forecast for industrial and commercial company profits in 2014-15, which offsets the effect of our forecast for increased company investment;
- stamp duty land tax, which continues to increase with strength in transactions and prices in the residential property market, particularly in London; and
- PAYE income tax and NICs are higher in each year, reflecting higher wages and salaries.

Table 4.7: Changes to the receipts forecast since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast[1]	606.6	634.5	665.3	705.2	740.3	776.8
March forecast[1]	607.7	636.5	668.2	708.1	742.9	777.7
Change	**1.1**	**2.0**	**2.8**	**2.9**	**2.6**	**0.8**
of which:						
Income and expenditure	**0.5**	**1.4**	**2.1**	**2.8**	**2.7**	**2.0**
Wages and salaries	0.3	0.3	0.4	1.1	1.0	0.5
Non-financial company profits	0.0	0.7	1.2	0.8	0.5	0.2
Consumer expenditure	0.1	0.6	0.8	1.0	1.1	1.0
Investment	0.1	-0.1	-0.5	-0.5	-0.5	-0.6
Other	0.0	-0.1	0.2	0.3	0.6	0.9
North Sea	**0.2**	**-0.8**	**-0.3**	**-0.2**	**-0.4**	**-0.2**
Production	0.1	0.1	0.0	0.0	0.0	0.1
Oil and gas prices	0.1	-0.4	-0.1	-0.2	-0.3	-0.2
Expenditure	0.0	-0.5	-0.2	0.0	-0.1	-0.1
Market assumptions	**0.5**	**1.6**	**2.0**	**2.2**	**2.3**	**2.2**
Residential property market	0.3	1.2	1.4	1.5	1.5	1.3
Commercial property market	0.2	0.2	0.2	0.2	0.2	0.2
Equity market	0.0	0.2	0.4	0.4	0.5	0.6
Interest rates	0.0	-0.1	0.0	0.1	0.1	0.1
Prices	**0.0**	**-0.1**	**-0.1**	**0.0**	**0.0**	**-0.1**
Other economic determinants	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.0**
Other assumptions	**-0.3**	**-0.1**	**-0.5**	**-0.3**	**-0.8**	**-1.4**
IT and NICs receipts and modelling	0.4	-0.4	-0.1	0.4	0.5	-0.3
CGT modelling and outturns	-1.1	-1.5	-1.7	-1.9	-2.1	-2.3
Corporation tax receipts and modelling	0.8	0.3	0.2	0.7	0.8	1.4
VAT receipts and modelling	0.1	0.2	0.5	0.4	0.5	0.5
North Sea receipts and modelling	-0.5	-0.2	-0.2	-0.1	-0.2	-0.2
Interest and dividend receipts and modelling	-0.3	-0.4	-0.4	-0.4	-0.5	-0.9
Environmental taxes and levies	-0.1	0.5	0.4	0.0	-0.4	-0.7
Stamp duty on shares judgement	0.2	0.2	0.2	0.2	0.2	0.2
Stamp duty land tax judgement	0.0	0.6	0.4	0.3	0.1	0.1
Gross operating surplus	0.0	0.1	0.1	0.2	0.5	0.9
High income child benefit charge costing	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3
VAT refunds	0.1	0.4	0.5	0.1	0.1	0.3
Other judgements and modelling	0.3	0.2	-0.2	0.0	-0.1	-0.1
Budget measures	**0.0**	**0.0**	**-0.6**	**-1.8**	**-1.4**	**-1.7**

[1] Excludes APF dividend receipts.

Tax-by-tax analysis

Income tax and NICs

4.41 Receipts of income tax and NICs in 2013-14 are expected to be £0.6 billion higher than in the December forecast. We have revised up PAYE and NIC receipts on employee salaries by £1.1 billion, while self-assessment (SA) income tax (which has been subject to large forecast errors in recent years) is £0.1 billion higher than we expected. The final PAYE and NIC

outturn for 2013-14 remains uncertain, given that the majority of financial sector bonuses are usually paid out in February and March, with HMRC receiving the tax in March and April. We have assumed that financial sector bonuses will be unchanged between 2012-13 and 2013-14.

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

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	262.4	276.4	291.4	313.9	331.7	351.2
March forecast	262.9	276.5	291.8	315.3	333.3	351.4
Change	**0.6**	**0.0**	**0.4**	**1.4**	**1.6**	**0.3**
of which:						
(by economic determinant)						
Average earnings	0.4	-0.3	-0.5	-0.1	-0.1	0.3
Employee numbers	-0.1	0.5	1.0	1.1	1.0	0.2
RPI inflation	0.0	-0.1	0.2	0.2	0.2	0.1
SA determinants	0.0	-0.2	-0.2	0.0	0.4	0.6
Other determinants	0.1	0.3	0.3	0.3	0.3	0.4
(by other category)						
Latest receipts data	0.2	0.0	0.1	0.3	0.3	0.4
Other modelling updates	0.2	0.0	-0.1	-0.1	-0.1	-1.1
Revised high income child benefit charge costing	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3
Revised Lichtenstein Disclosure Facility costing	-0.1	-0.4	-0.1	0.0	0.0	0.0
Effect from Tax-Free Childcare	0.0	0.0	0.0	0.1	0.3	0.4
Budget measures	0.0	0.3	0.1	-0.4	-0.5	-0.7

4.42 PAYE and NIC receipts have been falling as a share of GDP in recent years, reflecting subdued earnings growth and policy measures, particularly the rises in the personal allowance. A further drop in this ratio is likely in 2014-15 given the rise in the personal allowance to £10,000 from April 2014 and continued modest wage growth. A further rise in the personal allowance to £10,500 from April 2015 announced in the Budget will lower PAYE receipts in 2015-16. Thereafter, PAYE and NIC receipts are expected to rise by 0.8 per cent of GDP, reflecting stronger earnings growth, the return of positive fiscal drag from earnings rising faster than tax thresholds and allowances, and the abolition of contracting out in 2016-17, which is forecast to raise NICs by around £5½ billion.

4.43 SA income tax receipts are estimated to have risen by 1.7 per cent in 2013-14, close to our December forecast. SA receipts that related to 2012-13 liabilities were affected by some individuals shifting income from 2012-13 into 2013-14 to take advantage of the reduction in the additional rate of income tax to 45p. This income shifting will boost receipts in 2014-15 when tax on 2013-14 liabilities is paid. Thereafter, we expect SA receipts to be boosted by higher dividend and savings income, reflecting stronger profits and a higher path for interest rates in the later years of the forecast. SA receipts, particularly from 2015-16, will also be boosted by policy measures. The yield from the Budget 2013 and Autumn Statement

2013 measures on partnerships and the measures in this Budget and Autumn Statement 2013 designed to accelerate payments in follower cases, where taxpayers will have to pay disputed tax up front if HMRC win a test legal case, are expected to yield in total around £2 billion in 2015-16. As with all anti-avoidance measures, the yield from these measures is subject to considerable uncertainty.

4.44 We have revised a number of policy costings since the December forecast. Indications from SA returns suggest that the high-income child benefit charge, which recovers child benefit from some families with a higher rate taxpayer via the income tax system, is raising less than anticipated. This is likely due to a combination of: the survey data used previously overestimating the number of households affected; more customers failing to declare their liability than previously estimated; and a larger than expected behavioural response. We have revised total receipts down by £0.2 billion to £0.3 billion a year. We have also looked again at receipts from the Liechtenstein Disclosure Facility, which is designed to encourage UK investors with unpaid tax liabilities linked to offshore accounts to disclose and settle liabilities with HMRC. Receipts between 2014-15 and 2016-17 are likely to be around £0.5 billion lower in total than previously expected. We have also included the tax effects from the Budget 2013 move to the new tax-free childcare scheme (which will score as AME spending). The current employer-supported childcare scheme will be closed to new entrants from autumn 2015. This will reduce the tax relief granted through the scheme and raise receipts by around £0.4 billion by the end of the forecast.

4.45 The Budget announced a number of measures to reduce the income tax paid on savings income. Most tax on savings is collected through SA and the Tax Deduction Scheme for Interest (TDSI). Revenues from TDSI had dropped from a peak of £4.4 billion prior to the crisis to around £1.9 billion in 2013-14. With interest rates assumed to rise through the forecast period, we would have expected receipts to recover to £4.0 billion by 2018-19 in the absence of new measures. The measures announced in Budget 2014 will mean a more limited rise in TDSI receipts to £3.4 billion by 2018-19.

VAT

4.46 Accrued VAT receipts are expected to have risen by 5.8 per cent in 2013-14, helped by the pick-up in nominal consumer spending in 2013 and a lower VAT gap. The VAT gap is the difference between the theoretical level of VAT payments and the actual receipts received by HMRC. Compared with the December forecast, accrued VAT receipts are expected to be £0.3 billion higher in 2013-14. By 2018-19, accrued VAT receipts are expected to be £1.6 billion higher, with the main factor being the higher level of nominal consumer spending.

4.47 Growth in VAT receipts is expected to slow in 2014-15 reflecting some easing in the momentum of nominal consumer spending through the year. Thereafter, growth in VAT receipts is expected to rise by less than nominal GDP and fall from 6.5 per cent of GDP in 2013-14 to 6.3 per cent of GDP by 2018-19. We assume that the VAT gap remains constant from 2014-15 onwards, but cuts in government spending will reduce VAT payments by the government itself. The share of household spending subject to the standard

rate of VAT is expected to decline over the forecast period, as households spend relatively more on housing costs, which are not subject to VAT.

Table 4.9: Key changes to the VAT forecast since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	106.2	109.8	113.7	117.7	121.8	126.1
March forecast	106.5	110.7	115.0	119.2	123.3	127.7
Change	**0.3**	**0.9**	**1.3**	**1.5**	**1.5**	**1.6**
of which:						
Household spending	0.2	0.7	0.7	1.0	1.1	1.0
Latest receipts	0.0	0.1	0.1	0.1	0.1	0.1
VAT debt	0.0	0.1	0.1	0.1	0.1	0.1
SRS of consumer spending	0.0	0.1	0.4	0.3	0.3	0.4
Other spending	0.0	0.0	0.1	0.1	0.0	0.1

Onshore corporation tax

4.48 Higher receipts from industrial and commercial companies more than explain the £0.8 billion rise in onshore corporation tax in 2013-14. Receipts from the sector have been boosted by an estimated 7.0 per cent rise in non-oil, non-financial profits in 2013. This has helped offset the effects of the reduction in the main rate of corporation tax from 24 per cent in 2012-13 to 23 per cent in 2013-14, the introduction of the Patent Box and the initial increase in the annual investment allowance.

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

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	35.8	38.2	39.1	40.1	41.2	41.9
March forecast	36.6	38.9	39.7	40.5	42.1	43.3
Change	**0.8**	**0.6**	**0.5**	**0.4**	**0.9**	**1.4**
of which:						
Industrial and commercial company profits	0.0	0.7	1.2	0.8	0.5	0.2
Industrial and commercial company investment	0.0	-0.1	-0.2	-0.3	-0.4	-0.4
Other economic determinants	0.0	-0.2	-0.2	-0.2	-0.1	-0.1
Reallocation from North Sea to Onshore CT	0.2	0.2	0.2	0.2	0.2	0.2
Modelling updates and latest receipts data	0.6	0.1	0.0	0.5	0.6	1.2
Budget measures	0.0	0.0	-0.3	-0.7	0.1	0.3

4.49 Compared to December, we have revised up our forecast for onshore corporation tax in each year. The effect from stronger non-oil, non-financial profit growth is partly offset by higher investment, which raises capital allowance claims against taxable profits, and by policy changes. Continued strong profit growth in 2014 is the main driver of the rise in receipts in 2014-15, countering the 2 per cent reduction in the main rate of corporation tax to 21 per cent from April 2014. The further cut in the main rate to 20 per cent from April

2015 and the increase of the annual investment allowance to £500,000 and extension to December 2015 reduce onshore corporation tax receipts growth further out.

4.50 Corporation tax receipts from the financial sector fell further in 2013-14 to around £4.5 billion. This is less than half their peak level in 2006-07. In contrast, receipts from industrial and commercial companies are already higher than their pre-crisis peak. We expect receipts from the financial sector to remain low throughout the forecast period, reflecting subdued profit growth, the cuts in the main rate of corporation tax and the high level of losses being carried forward and used against taxable profits.

4.51 Although profits growth is slightly above nominal GDP growth across the forecast, this is outweighed by the combined effect of rate cuts, higher investment allowances and other policy measures. As a result onshore CT receipts fall from 2.3 per cent of GDP in 2012-13 to 2.1 per cent in 2018-19.

UK oil and gas revenues

4.52 Receipts from UK oil and gas companies in 2013-14 are expected to fall by 24 per cent to £4.7 billion. This compares with receipts of around £11 billion just two years earlier. The sharp fall in receipts primarily reflects the fall in oil and gas production and a 60 per cent rise in capital expenditure over the past two years. Sterling oil prices were broadly flat between 2011 and 2013. Gas prices were flat between 2011 and 2012, but rose 13 per cent in 2013. Oil and gas production fell by around 8 per cent in 2013, after a 14 per cent drop in the previous year. Spending on several large projects, and strong cost pressures are the main drivers for the sharp rise in capital and operating expenditure. With 100 per cent first year allowances available to oil and gas firms, higher investment leads to an immediate reduction in receipts.

Table 4.11: Key changes to the oil and gas revenues forecast since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	5.0	4.6	4.2	3.5	3.9	4.0
March forecast	4.7	3.7	3.8	3.2	3.4	3.5
Change	**-0.4**	**-0.9**	**-0.4**	**-0.3**	**-0.5**	**-0.4**
of which:						
Oil and gas production	0.1	0.1	0.0	0.0	0.0	0.1
Sterling oil prices	0.0	0.1	0.0	-0.1	-0.1	-0.1
Gas prices	0.1	-0.5	-0.1	-0.1	-0.2	-0.1
Expenditure	0.0	-0.5	-0.2	0.0	-0.1	-0.1
Reallocation from North Sea to Onshore CT	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Modelling and other	-0.3	0.1	0.0	0.1	0.1	0.0

4.53 Receipts in 2013-14 are now expected to be around £0.4 billion lower than we assumed in the December forecast, with petroleum revenue tax and offshore corporation tax each accounting for around half of the shortfall. The shortfall on offshore corporation tax comes from a re-allocation of £0.2 billion of receipts to onshore corporation tax. This reflects

updated information on the allocation of receipts between ring-fenced and non-ring-fenced activities of oil and gas companies (i.e. tax on profits from oil and gas production to tax on profits arising from supplying gas and electricity or running petrol stations).

4.54 Compared with our December forecast, UK oil and gas revenues are expected to be £0.9 billion lower in 2014-15 and then up to £0.5 billion lower each year over the rest of the forecast period. Operating expenditure by oil and gas firms was higher than expected in 2013. We are now assuming continued higher operating expenditure throughout the forecast period, based on recent industry forecasts. The steeper downward revision in 2014-15 reflects gas prices around 7p a therm lower than in the December forecast.

4.55 Our forecast continues to project falling oil and gas revenues, reaching £3.5 billion in 2018-19. This is primarily due to oil futures indicating lower oil prices over the next two years. Oil and gas production is expected to be flat between 2014-15 and 2018-19, as the current high levels of capital expenditure prevent further falls in production. By 2018-19 oil and gas revenues will be 0.2 per cent of GDP, compared to the recent high of 0.7 per cent in 2011-12.

Stamp duties

4.56 Stamp duty land tax (SDLT) is forecast to increase from £9.5 billion in 2013-14 to £18.1 billion in 2018-19. In December, we increased our forecast for 2013-14 by £1.1 billion, reflecting strength in the housing market. In this forecast we have increased this estimate again, by a further £0.6 billion, as the housing market, particularly in London, has continued to outperform our forecast and receipts have been higher than expected.

4.57 In the medium term, the strength in the housing market feeds into even higher receipts, as the average UK house price moves above the threshold for the 3 per cent rate, pushing receipts per transaction up sharply. Higher house prices, relative to our December forecast, add around £0.9 billion to receipts by 2018-19. Box 4.2 describes some of the drivers in stamp duty land tax in more detail. SDLT increases from 0.4 per cent of GDP in 2012-13 to 0.9 per cent of GDP in 2018-19.

4.58 Stamp duty on shares is expected to increase across the forecast, reflecting rising equity prices, which are assumed to move in line with nominal GDP. The volume of share transactions subject to the duty is on a declining path, which we have built into our forecast. Changes since December reflect stronger-than-expected receipts in the year-to-date, which are assumed to persist throughout the forecast.

Taxes on capital

4.59 We now have information on capital gains tax (CGT) receipts paid in early 2014, which reflect asset disposals in 2012-13. This suggests that CGT receipts were much weaker than we anticipated in December, resulting in a downward revision to our forecast for 2013-14 of £1.1 billion. This may be due to the weakness of the economy during 2012-13 affecting the number and value of disposals. By 2018-19, CGT receipts are expected to be £1.8 billion lower than in our December forecast, reflecting the effect of the lower starting point.

CGT receipts are still expected to grow strongly over the forecast, reflecting growth in house and equity prices.

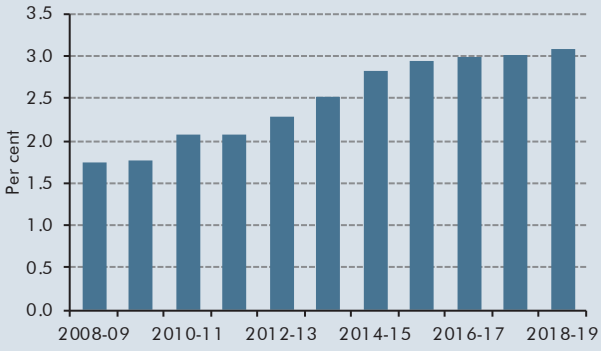
4.60 Inheritance tax receipts are expected to grow by an average of nearly 11 per cent a year between 2014-15 and 2018-19. This reflects our forecast for house and equity prices and the stock of household deposits, as described in more detail in Box 4.2, and the effect of freezing the nil rate band until 2017-18. Our forecast for inheritance tax receipts is slightly higher than in December, mainly reflecting the upward revision to the forecast for house prices.

Box 4.2: Receipts from capital taxes

Receipts from capital taxes – which include capital gains tax (CGT), inheritance tax (IHT), stamp duty land tax (SDLT) and stamp duty on shares – are expected to rise sharply from 1.0 per cent of GDP in 2012-13 to 1.8 per cent of GDP by 2018-19. This would be higher than their 1.6 per cent of GDP peak in 2007-08, prior to the financial crisis. This reflects rising asset prices over the forecast period and the structure of the particular taxes.

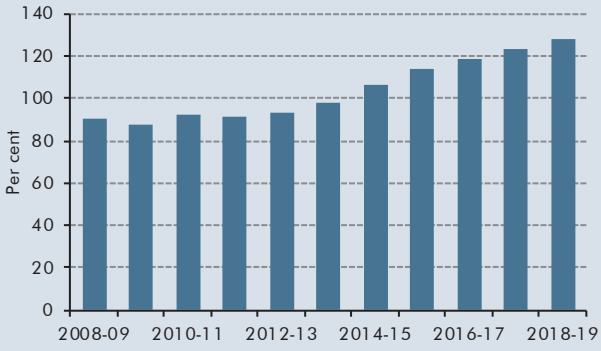
SDLT receipts are expected to have risen by 37 per cent in 2013-14. This reflects the rebound in property transactions from depressed levels as credit conditions have eased, strong house price inflation in London (which already accounts for over 40 per cent of total SDLT) and the tax structure of SDLT. With a 'slab' structure, where you pay one rate on the whole property price, and fixed nominal thresholds, SDLT is highly geared to changes in house prices. In particular, with the rate of stamp duty rising from 1 per cent to 3 per cent at a threshold of £250,000 the amount of stamp duty paid on a transaction rises from £2,500 for a transaction worth £250,000 to £7,500 for one worth £1 more. We now expect the average house price to exceed the 3 per cent threshold for the first time this year. The average effective tax rate on SDLT is expected to rise from 1.7 per cent in 2008-09 to over 3 per cent by the end of the forecast period.

Chart A: Stamp duty land tax effective tax rate



Source: HMRC, OBR

Chart B: Average house prices as a proportion of the 3 per cent threshold

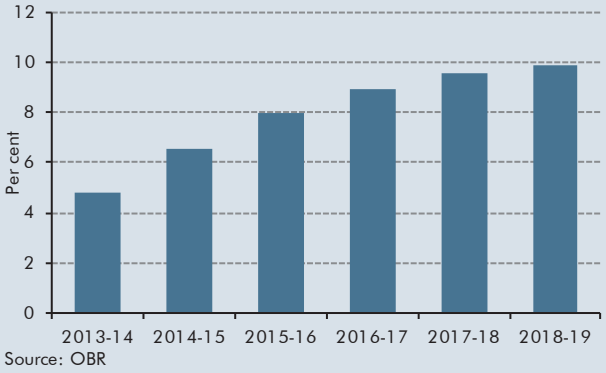


Source: HMRC, OBR

With housing accounting for around 50 per cent of estates notified for probate, the recovery in house prices over the past year has also helped to generate an 11 per cent rise in inheritance tax receipts in 2013-14. Further rises in house prices, equity prices and the stock of household deposits over the forecast period and the tax structure of IHT are expected to drive a rise of

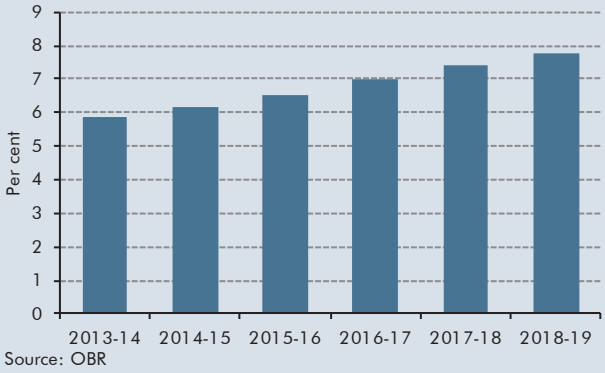
nearly 70 per cent in IHT receipts by 2018-19. The nil-rate band of £325,000 and transferable nil rate (for widows and widowers) of a further £325,000 are both being frozen until the end of 2017-18. Our forecast suggests that the proportion of deaths resulting in estates large enough to attract IHT liabilities will double over the next five years from a little under one in 20 to a little under one in ten. The effective tax rate on estates that attract IHT will also increase, largely as IHT is paid on a bigger proportion of the overall estate.[a] However, these effects would be partly offset by a roughly 40 per cent fall in the average size of estates, as a larger number of relatively smaller estates are brought into IHT.

Chart C: Share of deaths subject to IHT



Source: OBR

Chart D: Inheritance tax effective tax rate



Source: OBR

Although CGT was flat in 2013-14, we expect yield from the tax to more than double by 2018-19. 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 whole disposal price. We assume equity prices will rise from their current starting point in line with nominal GDP.

[a] The effective tax rate is calculated as a proportion of the total net chargeable value of estates where probate is granted.

Fuel duties

4.61 The volume of fuel clearances is on a long-term downward trend, reflecting the increasing fuel efficiency of motor vehicles. Total clearances fell 10 per cent in the decade to 2012-13, with lower petrol clearances more than offsetting a rise in diesel clearances.

4.62 Fuel duty revenues in each year between 2011-12 and 2015-16 are below their 2010-11 level, helped by the reduction in the duty rate in April 2011 and subsequent duty freezes. The next duty rate rise, planned for September 2015, means that receipts are expected to grow by 1.3 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 3.2 per cent on average between 2016-17 and 2018-19.

Alcohol and tobacco duties

4.63 Alcohol duty is expected to increase from £10.4 billion to £12.8 billion between 2013-14 and 2018-19. Within this total, receipts from wine and spirits are expected to add £1.6

billion and £0.7 billion respectively, while beer and cider duties are expected to be up just £0.1 billion. This partly reflects the announcement of a 1p cut in beer duty in the Budget, but also that we expect the downward trend seen in recent years to continue over the forecast period. Clearances of beer have fallen by over 25 per cent in the ten years to 2012-13.

4.64 We expect receipts from tobacco duty to increase from £9.7 billion in 2013-14 to £10.9 billion in 2018-19. While a long-term decline in tobacco clearances reduces tax revenues, increases in the duty rate paid on tobacco more than offset that fall. Following the Budget 2014 announcement, tobacco duty rates are planned to increase by 2 per cent above RPI inflation in each year of the forecast.

Other taxes

4.65 **Business rates** are calculated by multiplying the rateable value of non-domestic property by the multiplier (the proportion of the rateable value due in tax). The multiplier is uprated in line with RPI inflation from 2015-16 onwards. Revenues are expected to increase from £26.6 billion in 2013-14 to £32.3 billion in 2018-19. However, we expect only modest growth in receipts from business rates in 2014-15, reflecting the announcements in Autumn Statement 2013. These include a one-year extension of the doubling of small business rates relief, the £1,000 discount for many smaller shops, pubs and restaurants and the 2 per cent cap on the multiplier increase for 2014-15.

4.66 In this forecast, we have taken on new information on the cost of a range of measures. We now have outturn data from local authorities on the take-up of Enterprise Zone relief, introduced in Budget 2011. We have reduced our forecast for the cost of reliefs on Enterprise Zones from £30 million in 2015-16 to just £6 million, a reduction of around 80 per cent. This evidence was reflected in the related Budget 2014 policy announcement.

4.67 Receipts from **council tax** are expected to be slightly lower than we forecast in December, by around £0.2 billion in 2018-19. 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.

4.68 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 is classified as negative tax. This negative tax element is subject to the Government's new welfare cap. The negative tax share falls to zero in the final year of the forecast as claimants are assumed to migrate onto Universal Credit, which will be entirely classified as spending.

4.69 **Air passenger duty (APD)** receipts are expected to rise from £3.0 billion in 2013-14 to £3.9 billion in 2018-19. Growth in APD receipts reflects duty rate rises and growth in passenger numbers. Our forecast is slightly lower than in December, reflecting lower-than-expected receipts for the year-to-date and the Budget announcement halving the number of APD bands, which reduces receipts by £0.2 billion a year on average from 2015-16.

4.70 **Vehicle excise duty** is levied annually on road vehicles and is based on the amount of 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 December, reflecting the latest information on receipts in the year-to-date.

4.71 **Environmental levies** include levy-funded spending policies such as the Renewables Obligation (RO) and Contracts for Difference, Feed-In tariffs and the Warm Homes Discount, as well as revenues from the Carbon Reduction Commitment. The rise in the environmental levies across the forecast reflects the expected rise in electricity generation from renewable sources. The downward revisions to our forecast since December for the later years mainly reflect project delays reducing income from Contracts for Difference. Receipts from the Carbon Reduction Commitment are also slightly lower, reflecting a revised path for emissions.

4.72 **Environmental taxes** include the aggregates levy, climate change levy (including the carbon price floor), landfill tax and the EU emissions trading scheme (EU ETS). The Budget announcements on the carbon price floor reduce receipts by £0.9 billion by 2018-19.

4.73 Receipts from the **bank levy** are expected to be close to our December forecast throughout the forecast period. Receipts are forecast to rise from £2.3 billion in 2013-14 to £2.9 billion by 2018-19.

4.74 **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 plans. VAT refunds are forecast to fall by an average of 1.6 per cent a year between 2014-15 and 2018-19.

4.75 We incorporate a provision for **losses related to tax litigation** in our receipts forecast. Once cases are settled, and their effects in particular years can be quantified, they are incorporated into forecasts of specific taxes. The magnitude and timing of losses is difficult to forecast as it depends on the nature of the judgement and the response from the Government. In some cases, it may represent an upside risk for the Government. We assume future litigation losses across all taxes will total £3.6 billion over the forecast period.

Other receipts

4.76 **Interest and dividend** receipts capture interest income on the government's stock of financial assets. Receipts (excluding the dividend flows from the APF) are expected to more than double between 2013-14 and 2018-19. This reflects market expectations of the path of interest rates and that the stock of government assets is substantially higher than prior to the crisis. The Government holds larger foreign exchange reserves, more deposits at the Debt Management Office and a bigger stock of student loans. Compared with our December forecast, we expect interest and dividend receipts (excluding APF flows) to be lower over the forecast period by between £0.3 billion and £0.9 billion. The downward revision reflects

modelling changes and lower earnings on foreign exchange reserves, in part due to market expectations that euro area interest rates will stay lower for longer.

4.77 Our forecast for **gross operating surplus** (GOS) comprises our forecasts for general government depreciation and public corporations gross operating surplus. Together these increase broadly in line with GDP across the forecast, except for 2014-15, when our forecast assumes that Royal Mail is reclassified to the private sector, consistent with an ONS classification decision. Since December our forecast for GOS has increased in the last three years of the forecast due to new information from the business plans for Transport for London and Scottish Water. These increases are partly offset by a reduction in the forecast for the imputed subsidy for equity injection into the Housing Revenue Account (HRA), which is broadly fiscally neutral because it is offset by a reduction in the National Accounts adjustments in spending, discussed below.

Public sector expenditure

4.78 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 DELs, which were extended to include 2015-16 in Spending Round 2013 (SR13), 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 categories of spending out to 2018-19, based on determinants derived from our economic forecast.

4.79 For the years 2013-14 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.

4.80 Beyond 2015-16, our projections for total spending from 2016-17 to 2018-19 are based on the Government's stated TME policy assumption, which is set out in paragraphs 4.85 and 4.86. 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 assumption to derive

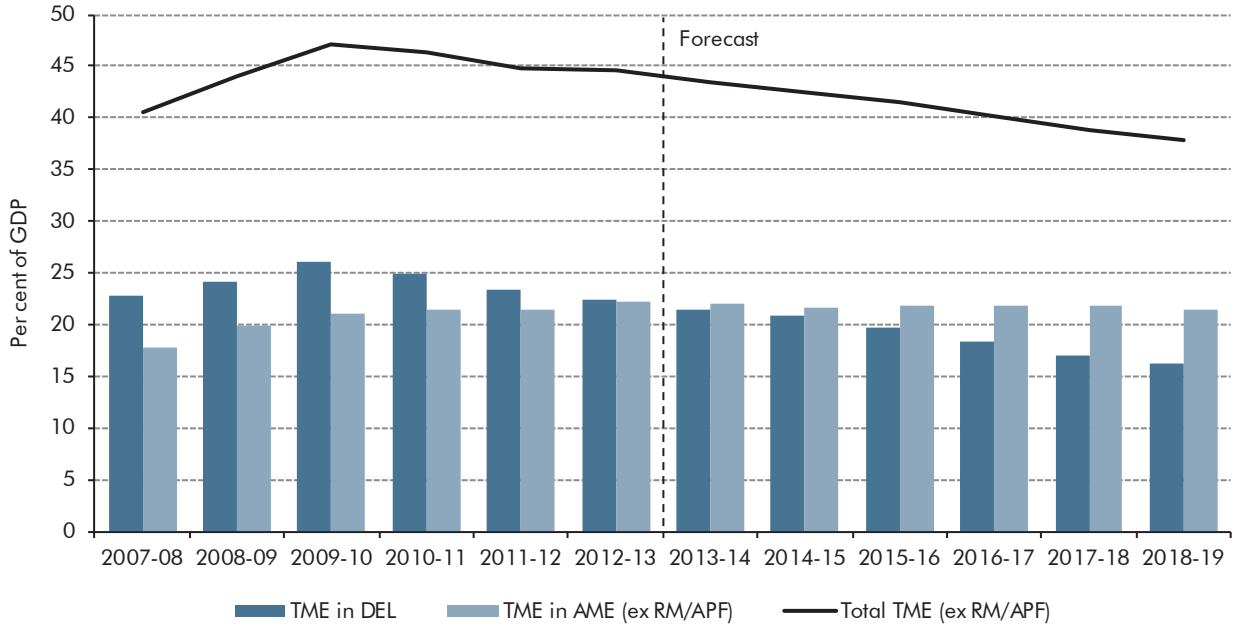
[3] Our presentation of expenditure only shows those components of RDEL, CDEL and AME that are included in the fiscal aggregates of PSCE and PSGI. For budgeting purposes, the Treasury also includes other components in DEL and AME such as non-cash items.
[4] Our forecasts for PSCE in RDEL and PSGI in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

implied DELs. This approach means that changes in AME spending beyond 2015-16, for example, debt interest or benefits, are offset by changes in implied DELs.

4.81 Chart 4.3 shows TME as a percentage of GDP since 2007-08, and how it splits between DEL and AME. TME increased sharply as a share of GDP through the recession of 2008-09 and 2009-10, reaching a peak of 47.0 per cent of GDP in 2009-10. With DELs fixed in cash terms through to 2010-11 in the 2007 Comprehensive Spending Review, this mainly reflected the large shortfall in nominal GDP in 2008-09 and 2009-10 relative to forecast.[5] AME spending on social security and debt interest also increased over this period.

4.82 TME has fallen from 47.0 per cent of GDP in 2009-10 to 43.5 per cent of GDP in 2013-14 and is projected to fall further to 37.8 per cent of GDP in 2018-19, excluding the effect of APF transfers in that year.

Chart 4.3: DEL and AME components of TME



Source: ONS, OBR

Summary of the expenditure forecast

4.83 Table 4.12 summarises our latest forecast for public expenditure. TME is expressed as a share of GDP, but not all of TME contributes directly to the calculation of GDP, as it comprises benefit payments, debt interest and other cash transfers that merely transfer income from some individuals to others.

4.84 Table 4.13 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. Social

[5] The nominal GDP forecast underpinning the 2007 CSR projections of the public finances showed an increase of 10.4 per cent between 2007-08 and 2009-10. The latest ONS data show nominal GDP fell by 1.1 per cent over that period. That 11.5 percentage point shortfall in nominal GDP would add around 4½ percentage points to the ratio of TME to GDP, all else equal.

security payments are forecast to fall gradually as a share of GDP as the economy recovers, while debt interest payments rise due to higher debt and interest rates. AME spending is expected to exceed DEL spending for the first time in 2013-14 and by a rising margin thereafter. This partly reflects the transfer of some spending from DEL to AME from 2013-14 onwards, reflecting local authorities retention of business rates and the localised council tax reduction schemes.[6] But it also reflects the Government's policy in setting total DELs up to 2015-16 in Spending Review 2010 (SR10) and SR13, and also beyond that, by applying the Government's TME growth assumption and further cuts to spending from 2016-17 announced in this Budget. The effect on implied DEL spending is described below.

Table 4.12: Expenditure as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Total managed expenditure[1]	44.7	43.5	42.5	41.6	40.2	38.8	37.8
of which:							
Public sector current expenditure	41.8	40.6	39.5	38.7	37.3	36.1	35.2
Public sector gross investment[1]	2.9	2.9	3.0	2.9	2.9	2.7	2.6
Total public sector expenditure that contributes directly to GDP[2]	24.0	23.3	22.6	21.5	20.3	19.1	18.3
of which:							
General government consumption	21.6	21.0	20.2	19.3	18.2	17.1	16.4
General government gross fixed capital formation	1.9	1.9	2.0	1.8	1.8	1.7	1.7
Public corporations gross fixed capital formation	0.4	0.4	0.4	0.4	0.4	0.4	0.3

[1] Excludes Royal Mail and APF spending. Royal Mail and APF spending as a percentage of GDP is shown here, and headline TME is shown in Table 4.17.

Royal Mail and APF spending	-1.8	0.0	0.0	0.0	0.0	0.1	0.2

[2] GDP at market prices.

[6] These switches between DEL and AME were set out in Box 4.2 of the December 2012 *EFO*.

Table 4.13: TME split between DEL and AME

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
TME in DEL[1,2,3]	22.5	21.5	20.9	19.8	18.4	17.1	16.3
TME in AME[4]	22.2	22.0	21.7	21.8	21.8	21.8	21.6
of which:							
Social security[2]	11.6	10.9	10.7	10.6	10.4	10.2	10.0
Debt interest	3.0	2.9	3.0	3.3	3.5	3.7	3.7
Locally-financed current expenditure [3]	1.5	2.1	2.0	2.1	2.1	2.1	2.2
Other PSCE in AME	5.2	5.2	5.0	5.0	5.0	5.0	5.1
PSGI in AME[4]	0.8	0.9	0.9	0.8	0.8	0.8	0.7

[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.

[2] From 2013-14, grants to local authorities in TME in RDEL were increased to cover the introduction of the localised council tax reduction schemes, and social security in TME in AME was reduced because the new localised schemes replaced council tax benefit.

[3] From 2013-14, locally-financed current expenditure in TME in AME increased to include local authorities retention of business rates, and TME in RDEL was reduced because it no longer included grants to distribute these business rates to local authorities.

[4] Excludes Royal Mail and APF spending. Royal Mail and APF spending as a percentage of GDP is shown in table 4.12 and headline TME is shown in Table 4.17.

Spending growth assumptions: effects on implied DELs

4.85 Our TME projections for 2016-17 to 2018-19 are based on the Government's stated policy assumption for TME growth. As in the Autumn Statement last year, there are two parts to the assumption:

- for 2016-17 and 2017-18, TME should continue to fall at the same average real rate as over the period covered by SR10 and SR13, with PSGI flat in real terms; and
- for 2018-19, TME should be held flat in real terms, with PSGI growing in line with nominal GDP.

4.86 For this forecast, the Government has changed the way the fall in TME over the SR10 and SR13 period is measured. As before, the Government states that both the growth rate and the baseline should be calculated excluding from 2015-16 our projected underspends in DEL and all policy measures announced in Autumn Statement 2013 and this Budget. However, the Government now also states that the 2010-11 base year should exclude underspends in DEL and all spending measures announced in the June 2010 Budget.

4.87 Applying the assumption, TME is now projected to fall by an average of 0.73 per cent a year in real terms between 2010-11 and 2015-16. This compares with the 0.49 per cent average fall projected in our December forecast. This change results from a number of factors:

- a downward revision of £0.6 billion to our forecast for AME in 2015-16, largely reflecting lower debt interest costs, reduces the nominal growth in TME over the period relative to our December forecast;

- revisions to ONS estimates of GDP deflator growth between 2010-11 and 2012-13 and to our forecast for GDP deflator growth to 2015-16 reduce the fall in real terms spending over the period. Applying this deflator change on top of the downward revision to TME in 2015-16 further increases TME in 2018-19 by £0.8 billion; and

- the 2010-11 base year has been raised by removing spending consolidation announced in the June 2010 Budget (worth £5.2 billion) and 2010-11 underspends against final plans (worth £4.7 billion). This change increases the average real cuts significantly, equivalent to a £4.5 billion reduction in TME by 2018-19.

4.88 We have raised our forecast for the GDP deflator from 2016-17 to 2018-19, which raises the nominal TME levels produced by applying the spending growth assumptions. Taken together, revisions to the GDP deflator raised TME in 2018-19 by £5.1 billion. The Government's changes to the TME growth assumption largely offset that increase. In addition, Budget measures reduce spending by a further £2.1 billion in 2018-19.

Table 4.14: Changes in TME from 2015-16

	£ billion			
	Forecast			
	2015-16	2016-17	2017-18	2018-19
December forecast	744.3	756.3	765.5	778.7
March forecast	743.6	752.5	761.2	776.5
Change	**-0.6**	**-3.7**	**-4.4**	**-2.2**
of which:				
TME in 2015-16	-0.6	-0.6	-0.7	-0.7
GDP deflator	0.0	1.1	2.8	5.1
TME growth rule	0.0	-2.2	-4.4	-4.5
Budget measures	-0.1	-2.0	-2.1	-2.1

Note: TME includes RM/APF consistent with the Treasury's spending growth rule.

4.89 Table 4.15 shows our forecast for spending growth in real terms and as a percentage of GDP, including the effects of DEL underspends and all policy measures. On the basis of current policy, including the policy measures announced in the Budget, we have derived implied levels of PSCE in RDEL and PSGI in CDEL, which grow as follows:

- implied PSCE in RDEL falls in real terms by 5.0 per cent in 2016-17, 5.2 per cent in 2017-18, and 3.0 per cent in 2018-19 – a total cut of 12.6 per cent. These reductions are illustrated in Chart 4.4; and

- implied PSGI in CDEL rises in real terms by 1.6 per cent in 2016-17, falls by 3.8 per cent in 2017-18 and rises by 3.0 per cent in 2018-19 – a total increase of 0.6 per cent.

Table 4.15: Spending real growth rates and as a per cent of GDP

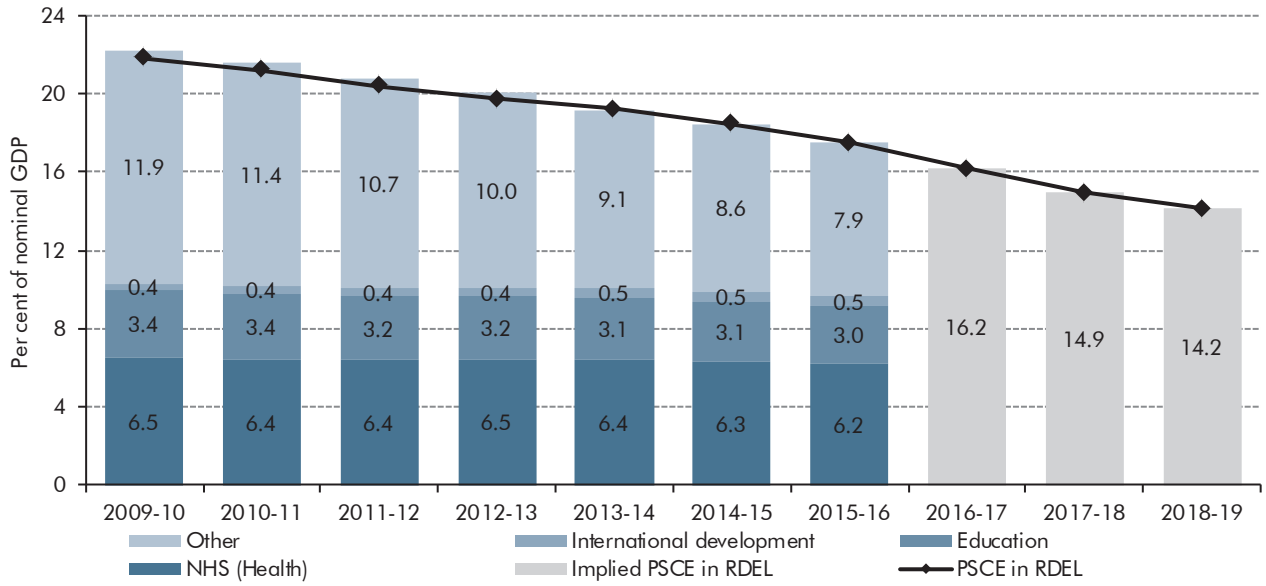
	Real terms growth rate (%)					
	Spending Review years 2011-12 to 2015-16		Post Spending Review years			Total change between 2010-11 and 2018-19
	Total change	Average annual change	Change in 2016-17	Change in 2017-18	Change in 2018-19	
Total managed expenditure	**-2.6**	**-0.5**	**-0.7**	**-0.7**	**0.0**	**-3.9**
of which:						
PSCE	-0.9	-0.2	-0.8	-0.8	-0.2	-2.7
PSGI	-20.1	-4.4	1.2	0.0	2.4	-17.3
TME in AME	10.6	2.0	2.5	2.9	1.8	18.8
TME in DEL	-13.9	-2.9	-4.2	-5.1	-2.2	-23.5
of which:						
PSCE in RDEL	-12.4	-2.6	-5.0	-5.2	-3.0	-23.5
PSGI in CDEL	-23.0	-5.1	1.6	-3.8	3.0	-22.5
	Per cent of GDP					
Total managed expenditure	**-4.7**	**-0.9**	**-1.4**	**-1.3**	**-0.9**	**-8.2**
of which:						
PSCE	-3.6	-0.7	-1.3	-1.2	-0.9	-7.1
PSGI	-1.0	-0.2	0.0	-0.1	0.0	-1.2
TME in AME	0.4	0.1	0.0	0.1	-0.1	0.4
TME in DEL	-5.1	-1.0	-1.3	-1.4	-0.8	-8.6
of which:						
PSCE in RDEL	-4.1	-0.8	-1.3	-1.2	-0.8	-7.5
PSGI in CDEL	-0.8	-0.2	0.0	-0.1	0.0	-1.0

Note: All growths shown here include RM/APF consistent with the Treasury's spending growth rule.

4.90 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.[7] 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 Government's total spending assumption and our forecast for PSCE in AME.

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

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 Budget 2014, HM Treasury Public Expenditure Statistical Analyses, July 2013

Summary of changes to the expenditure forecast since December

4.91 Table 4.16 shows the main reasons for the changes in our forecast of public sector expenditure since December. Tables 4.17 and 4.18 provide our detailed forecasts for spending and the changes since December. These are explained in more detail in the subsequent sections. 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 increase spending in 2016-17 by £1.1 billion rising to £5.1 billion in 2018-19; and
  - a lower claimant count unemployment forecast progressively reduces social security payments over the forecast period, with the effect rising to £1.5 billion by 2018-19.
- the latest information from the Treasury suggests DEL spending pressures in 2014-15 are greater than expected in December, so we have reduced our underspend assumption by £0.5 billion;
- various modelling changes made to social security, explained in more detail in the relevant section, increase the forecast in all years;

- lower debt interest costs, which reflect the reductions in our forecast for borrowing since December, reduce spending by amounts which rise to £2 billion by 2018-19;

- changes to the measurement of the TME growth assumption determined by the Government have reduced spending by £4.5 billion in 2018-19, largely reversing the increase in spending that would have resulted from an unchanged assumption being applied to our updated economy and fiscal forecasts; and

- the policy changes announced in the Budget, which are summarised in Table 4.3 and set out in full in Annex A, which reduce spending by £2 billion a year from 2016-17.

Table 4.16: Changes to the underlying spending forecast since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
March forecast[1]	715.5	732.0	743.6	752.5	761.2	776.5
December forecast[1]	717.8	730.5	744.3	756.3	765.5	778.7
Change[1]	**-2.3**	**1.5**	**-0.6**	**-3.7**	**-4.4**	**-2.2**
of which:						
Economic determinants	**-1.1**	**-1.7**	**-1.1**	**0.1**	**0.8**	**2.6**
Inflation	-1.0	-1.2	-0.5	-0.2	-0.9	-1.2
Unemployment	-0.2	-0.6	-0.9	-1.0	-1.3	-1.5
GDP deflator	-	-	-	1.1	2.8	5.1
Other determinants	0.0	0.1	0.2	0.2	0.2	0.3
Market assumptions	**0.0**	**0.0**	**0.0**	**0.0**	**-0.2**	**-0.5**
Gilt rates	0.0	0.0	-0.1	-0.2	-0.3	-0.5
Short rates	0.0	0.0	0.2	0.2	0.1	0.0
Other assumptions/changes	**-1.2**	**2.6**	**0.5**	**-1.8**	**-2.9**	**-2.3**
Changes to DEL underspend assumptions	0.0	0.5	0.0	-	-	-
Change to TME growth rule	-	-	-	-2.2	-4.4	-4.5
Other changes to implied DELs	-	-	-	-1.1	0.7	2.5
Social security modelling changes	0.2	1.7	1.9	1.4	1.0	0.9
Debt interest costs from financing CGNCR	0.0	-0.5	-1.3	-1.5	-1.8	-2.0
Other	-1.4	1.0	-0.1	1.5	1.6	0.7
Budget measures	**0.0**	**0.5**	**-0.1**	**-2.0**	**-2.1**	**-2.1**

[1] Excludes Royal Mail and APF spending.

Table 4.17: Total managed expenditure

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector current expenditure (PSCE)							
PSCE in RDEL[1]	**316.5**	**315.9**	**317.8**	**312.5**	**302.5**	**292.1**	**289.1**
PSCE in AME	**339.9**	**352.0**	**362.1**	**379.0**	**396.3**	**414.3**	**430.3**
of which:							
Social security benefits	182.8	180.0	184.3	189.1	193.7	198.6	203.3
Tax credits	28.6	28.9	28.9	29.2	31.4	34.0	35.4
Net public service pension payments	10.2	10.5	10.4	11.7	12.7	13.8	14.9
National lottery current grants	1.1	1.3	1.4	1.4	1.4	1.4	1.5
BBC domestic services current expenditure	3.4	3.6	3.8	3.5	3.6	3.9	4.0
Other PSCE items in departmental AME	1.1	1.2	1.3	1.3	1.2	1.3	1.2
Expenditure transfers to EU institutions	8.3	8.9	8.1	8.1	7.9	7.1	7.9
Locally-financed current expenditure	22.8	34.0	35.1	37.0	39.5	42.0	44.1
Central government gross debt interest	47.6	48.4	52.1	59.1	65.1	71.6	75.2
Depreciation	17.3	18.1	18.8	19.6	20.3	21.2	22.0
Current VAT refunds	11.6	11.7	11.9	11.9	11.3	10.8	10.7
Single use military expenditure	4.8	4.6	4.2	4.2	4.4	4.3	4.5
Environmental levies	1.7	3.6	4.4	5.6	6.3	7.1	8.3
Other National Accounts adjustments	-1.5	-2.8	-2.6	-2.6	-2.6	-2.6	-2.7
Total public sector current expenditure	**656.3**	**667.9**	**679.9**	**691.5**	**698.8**	**706.4**	**719.3**
Public sector gross investment (PSGI)							
PSGI in CDEL[1]	**32.2**	**33.3**	**37.4**	**36.7**	**38.0**	**37.2**	**39.1**
PSGI in AME[2]	**13.2**	**14.2**	**14.7**	**15.2**	**15.8**	**15.8**	**14.4**
of which:							
National lottery capital grants	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Other PSGI items in departmental AME[2]	-1.7	0.6	0.5	0.3	0.3	0.2	0.2
Locally-financed capital expenditure	6.5	6.4	6.2	6.5	7.4	7.2	6.3
Public corporations capital expenditure	7.0	6.8	7.0	7.0	6.8	6.9	6.4
Other National Accounts adjustments	1.0	-0.1	0.5	0.9	0.8	1.0	1.0
Total public sector gross investment[2]	**45.4**	**47.6**	**52.1**	**51.9**	**53.8**	**53.0**	**53.5**
Less depreciation	-22.5	-23.4	-24.3	-25.1	-26.0	-27.0	-27.9
Public sector net investment[2]	**22.9**	**24.1**	**27.9**	**26.8**	**27.7**	**26.1**	**25.7**
Total managed expenditure[2]	**701.7**	**715.5**	**732.0**	**743.4**	**752.5**	**759.4**	**772.9**
Royal Mail and APF spending	-28.0	0.0	0.0	0.3	0.0	1.7	3.7
Total managed expenditure (headline)	**673.7**	**715.5**	**732.0**	**743.6**	**752.5**	**761.2**	**776.5**

[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] Excludes Royal Mail and APF spending.

Table 4.18: Changes to total managed expenditure since December

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector current expenditure (PSCE)							
PSCE in RDEL[1]	**0.0**	**-0.5**	**1.2**	**-0.1**	**-3.2**	**-2.1**	**1.7**
PSCE in AME	**-0.9**	**-1.2**	**0.0**	**-0.2**	**-0.1**	**-2.0**	**-3.6**
of which:							
Social security benefits	-0.1	0.0	1.1	1.2	1.1	0.4	-0.2
Tax credits	-0.1	0.1	0.3	0.4	0.5	0.3	0.3
Net public service pension payments	0.0	0.3	-0.7	-0.9	-1.1	-1.1	-1.2
National lottery current grants	0.0	0.0	-0.1	-0.1	-0.2	-0.3	-0.3
BBC domestic services current expenditure	0.0	-0.1	-0.2	-0.2	-0.2	0.0	0.1
Other PSCE items in departmental AME	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Expenditure transfers to EU institutions	0.0	0.1	0.8	-0.4	-0.2	-0.2	-0.2
Locally-financed current expenditure	0.0	-0.2	0.1	0.0	0.3	0.2	0.2
Central government gross debt interest	0.0	-1.1	-1.8	-0.9	-0.2	-0.9	-1.7
Depreciation	0.0	0.0	0.0	0.1	0.1	0.2	0.3
Current VAT refunds	0.0	0.3	0.5	0.7	0.2	0.2	0.3
Single use military expenditure	0.0	-0.2	0.0	0.0	-0.1	0.0	0.0
Environmental levies	-0.3	0.0	0.0	0.3	0.2	-0.3	-0.6
Other National Accounts adjustments	-0.5	-0.5	-0.3	-0.5	-0.6	-0.7	-0.6
Total public sector current expenditure	**-0.9**	**-1.7**	**1.1**	**-0.3**	**-3.4**	**-4.1**	**-1.9**
Public sector gross investment (PSGI)							
PSGI in CDEL[1]	**0.0**	**0.8**	**0.3**	**0.1**	**0.0**	**0.0**	**0.3**
PSGI in AME[2]	**0.7**	**-1.4**	**0.0**	**-0.4**	**-0.3**	**-0.1**	**-0.1**
of which:							
National lottery capital grants	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Other PSGI items in departmental AME[2]	0.0	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Locally-financed capital expenditure	0.7	-0.2	0.9	0.5	1.2	1.1	1.3
Public corporations capital expenditure	-0.3	-1.0	-1.2	-1.2	-1.4	-1.3	-1.8
Other National Accounts adjustments	0.2	-0.1	0.4	0.4	0.1	0.4	0.7
Total public sector gross investment[2]	**0.7**	**-0.6**	**0.3**	**-0.3**	**-0.3**	**-0.2**	**0.2**
Less depreciation	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3
Public sector net investment[2]	**0.7**	**-0.8**	**0.2**	**-0.5**	**-0.5**	**-0.4**	**-0.1**
Total managed expenditure[2]	**-0.2**	**-2.3**	**1.5**	**-0.7**	**-3.7**	**-4.3**	**-1.7**
Royal Mail and APF spending	-0.1	0.0	0.0	0.0	0.0	-0.1	-0.5
Total managed expenditure (headline)	**-0.3**	**-2.3**	**1.5**	**-0.6**	**-3.7**	**-4.4**	**-2.2**

[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] Excludes Royal Mail and APF spending.

Expenditure in 2013-14

4.92 Compared to our December forecast, we have reduced TME in 2013-14 by £2.3 billion, consisting of a £1.7 billion reduction in PSCE and a £0.6 billion reduction in PSGI. The reduction in PSCE is mostly due to lower inflation reducing debt interest costs. The reduction in PSGI mainly reflects the latest available data on Housing Revenue Account spending,

offset partly by a decrease in our capital DEL underspend assumption. Detailed sectoral breakdowns of our forecasts are shown in the supplementary fiscal tables on our website.

4.93 Monthly outturn information is only available for central government spending. The February release of the monthly Public Sector Finances statistics showed that central government current expenditure in the first ten months of 2013-14 was 1.3 per cent higher than the same period last year. This compares with the 1.7 per cent increase that we are now forecasting for 2013-14 as a whole. This comparison is affected by differences in the monthly profile of central government grants to local authorities, which are lagging behind the 2012-13 profile, partly offset by transfers to EU institutions, which are ahead. The monthly profile of debt interest also varies considerably from year to year, reflecting differences in the monthly profile of the RPI, which affects debt interest on index-linked gilts.

Departmental expenditure limits (DELs)

4.94 Table 4.19 shows our latest forecasts for PSCE in RDEL and PSGI in CDEL, and the changes in these forecasts since December. They reflect DEL plans published by the Treasury in *Public Expenditure Statistical Analyses (PESA) 2013* and *PESA 2013: Update for 2015-16*, adjusted to include the effects of policy measures announced in Autumn Statement 2013 and Budget 2014. The forecasts also include our latest assumptions for departments underspending against those plans, as shown in Tables 4.20 and 4.21, and discussed further below. For the years after 2015-16, where no plans have yet been set, our forecasts for implied PSCE in RDEL and PSGI in CDEL have been derived from the latest spending growth assumptions, as discussed above.

4.95 The main changes to our forecasts for PSCE in RDEL and PSGI in CDEL up to 2015-16 reflect changes to our underspend assumptions. Other changes to the DEL plans for these years reflect Budget measures, and switches between DEL and AME, where the Treasury has decided that spending should be reclassified between these two parts of their spending control framework. Details of the spending switched in this way are shown in a new supplementary fiscal table which accompanies this *EFO* on our website. Other changes to DEL plans in 2014-15 include an increase of £0.8 billion in RDEL to finance one-off transfers of pension liabilities for pension funds that are being transferred into the Principal Civil Service Pension Scheme. These transfers are spending neutral because they are offset by additional receipts in AME, as discussed below. CDEL is also reduced by £0.2 billion in 2014-15 to reflect the rescheduling of receipts from 2013-14 for the sale of the Olympic Village.

4.96 For the period after 2015-16, our forecasts for PSCE in RDEL and PSGI in CDEL are implied figures calculated by residual. These are the amounts that remain after the latest forecasts for PSCE in AME and PSGI in AME are deducted from the latest forecasts for total PSCE and PSGI, which are determined by the Government's spending growth assumptions plus Budget measures. Since the growth assumptions are set in real terms, movements in our forecasts for the GDP deflator directly affect our forecasts for total PSCE and PSGI, and thus implied PSCE in RDEL and PSGI in CDEL. Table 4.19 breaks down the total movements in implied DELs to show the effects of the movement in the GDP deflator, the changes in the spending

growth rule and the other changes in our forecasts that affect implied DELs after 2015-16. This shows that the reductions in PSCE in RDEL by 2018-19 from the changes to the growth assumptions only partly offset the increases from our revised forecast for the GDP deflator. PSCE in RDEL also increases by £2.4 billion in 2018-19, reflecting our lower forecast for PSCE in AME in that year (primarily due to lower unemployment). The net effect of Budget measures is to reduce PSCE in RDEL by £1.2 billion.

DEL underspend assumptions

4.97 Our latest forecast assumes a total underspend of £7 billion in 2013-14, unchanged from our December forecast. We have changed the composition of these underspends slightly, so that we are forecasting £¾ billion more underspending within PSCE, and £¾ billion less underspending within PSGI.

4.98 The £7 billion underspend this year is measured net of DEL spending brought forward into 2013-14 under the Treasury's Budget Exchange scheme. This increased DELs by £2.3 billion, so we expect a £9.3 billion underspend against those higher DELs. In 2012-13, Budget Exchange increased DELs by £0.9 billion, and departments underspent against those increased plans by a total of £12.5 billion. As we explained in our March 2013 *EFO,* underspends were exceptionally large in 2012-13 partly because the Government encouraged departments to reduce spending further in that year.

4.99 Table 4.20 shows the detailed components of our forecast for underspends against DEL plans in 2013-14, compared with 2012-13. Compared with the initial plans in PESA 2013, the final plans for DEL spending in 2013-14 in the Supplementary Estimates in February reduced spending by £2.3 billion. (This is the net reduction, after taking account of Budget Exchange.) This £2.3 billion reduction included £2.2 billion of underspends which the Treasury has agreed that departments can carry forward into future years as Budget Exchange (as shown in Table 4.21). The £2.3 billion net underspends surrendered in this year's Supplementary Estimates are much lower than the £4.6 billion surrendered last year.

4.100 Table 4.20 also shows the further shortfalls against final DEL plans that departments have assumed in their forecasts of full year outturns submitted to the Treasury in February. These only show a further £1.2 billion of underspending. This is in marked contrast to the outturns forecast a year ago, which showed £5.8 billion of further underspends, but last year's forecasts were exceptional. Our judgement is that, consistent with past form, departments are being cautious and not forecasting the scale of underspends against final plans that we expect to materialise. Our forecast therefore assumes a further shortfall of £3.5 billion, so that in total we expect departments to spend £4.7 billion below their final plans. This is consistent with levels of underspending against final plans seen over the last five years (excluding the exceptional 2012-13). Departments' surrenders of underspends in their final plans under the Budget Exchange regime may serve to reduce subsequent underspends against their final plans. But the experience of the last two years under Budget Exchange suggests that departments still have strong incentives to deliver underspends, in order to avoid the risks of exceeding the absolute limits set by final plans.

Table 4.19: Key changes to DEL since December

	£ billion					
	Forecast			Implied DEL[2]		
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
PSCE in RDEL						
December forecast	316.4	316.6	312.6	305.7	294.1	287.4
March forecast	315.9	317.8	312.5	302.5	292.1	289.1
Change	**-0.5**	**1.2**	**-0.1**	**-3.2**	**-2.1**	**1.7**
of which:						
Changes to underspend assumptions[1]	-0.5	0.3	0.0	-	-	-
AME DEL switches		-0.1	-0.4			
Budget measures	0.0	0.3	0.3	-1.2	-1.2	-1.2
GDP deflator	-	-	-	1.1	2.6	4.9
New TME growth rule	-	-	-	-2.2	-4.4	-4.5
Other changes to implied RDEL	-	-	-	-0.9	0.9	2.4
Other changes	0.0	0.8	0.0	-	-	-
PSGI in CDEL						
December forecast	32.6	37.1	36.6	38.0	37.3	38.8
March forecast	33.3	37.4	36.7	38.0	37.2	39.1
Change	**0.8**	**0.3**	**0.1**	**0.0**	**0.0**	**0.3**
of which:						
Changes to underspend assumptions[1]	0.8	0.3	0.0	-	-	-
Budget measures	0.0	0.3	0.1	0.0	0.0	0.0
GDP deflator	-	-	-	0.1	0.1	0.2
Other changes to implied CDEL	-	-	-	-0.1	-0.2	0.1
Other changes	0.0	-0.2	0.0	-	-	-
SUME (CDEL in PSCE in AME)[3]						
December forecast	4.9	4.2	4.2	4.4	4.3	4.5
March forecast	4.6	4.2	4.2	4.4	4.3	4.5
Change	**-0.2**	**0.0**	**0.0**	**-0.1**	**0.0**	**0.0**
of which:						
Changes to underspend assumptions[1]	-0.3	0.0	0.0	-	-	-
Other	0.0	0.0	0.0	-0.1	0.0	0.0

[1] Our total underspend assumption in 2013-14 is unchanged from December, but the distribution of the underspend between current and capital spending has changed as shown here. The underspends in 2013-14 include the £2 billion reduction in the DEL reserves that the Treasury included in the Autumn Statement:

	Latest underspends in this forecast				Previous underspends in our December forecast		
	2013-14	2014-15	2015-16		2013-14	2014-15	2015-16
PSCE in RDEL	-4.5	-0.8	-1.0	PSCE in RDEL	-4.0	-1.0	-1.0
SUME	-1.3	-1.0	-1.0	SUME	-1.0	-1.0	-1.0
PSGI in CDEL	-1.3	-0.8	-1.0	PSGI in CDEL	-2.0	-1.0	-1.0
TME in DEL	**-7.0**	**-2.5**	**-3.0**	TME in DEL	**-7.0**	**-3.0**	**-3.0**

[2] 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.

[3] SUME is part of CDEL but is included in PSCE in AME in our tables because SUME is classified as current expenditure in the National Accounts. TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME.

Table 4.20: DEL shortfalls against PESA plans for 2013-14

	£ billion					
	PSCE in RDEL		PSGI in CDEL		TME in DEL[1]	
	Outturn	Forecast	Outturn	Forecast	Outturn	Forecast
	12-13	13-14	12-13	13-14	12-13	13-14
Budget Exchange carried forward	0.6	1.6	0.2	0.6	0.9	2.3
Further changes to final plans in Supplementary Estimates [2]	-3.9	-3.3	0.0	0.0	-5.4	-4.5
Shortfall against final plans in departments' full year forecast outturn in February [3]	-3.8	-0.4	-1.9	-0.7	-5.8	-1.2
OBR estimate of further shortfall	-1.4	-2.4	0.0	-1.1	-1.3	-3.5
Total shortfall against PESA plans [2,4]	**-8.5**	**-4.5**	**-1.6**	**-1.3**	**-11.7**	**-7.0**

[1] TME in DEL includes SUME.

[2] In 2013-14, the changes to plans in the Supplementary Estimates and the estimates of shortfall include the policy changes announced in the Autumn Statement which reduced PSCE in RDEL by £1.9 billion and PSGI in CDEL by £0.1 billion.

[3] In 2012-13, these forecast outturns were reduced by Treasury policy actions, which included pushing an additional £1.6 billion of spending forward into future years. The amounts carried forward were shown as 'exceptional inter-period flexibility' in Table 2.5 in *Budget 2013* .

[4] Net of increases in plans from Budget Exchange carried forward.

4.101 Table 4.21 shows our latest assumptions for DEL underspends in 2014-15 and 2015-16 against the latest amounts of Budget Exchange being taken forward into those years.

Table 4.21: 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
	14-15	15-16	14-15	15-16	14-15	15-16
Budget Exchange carried forward in PESA 2013	1.2	0.0	0.4	0.0	1.6	0.0
Further Budget Exchange carried forward in 2013-14 Supplementary Estimates	0.9	0.0	0.6	0.7	1.5	0.7
Total Budget Exchange carried forward	2.1	0.0	1.0	0.7	3.2	0.7
OBR estimate of further shortfall	-2.9	-1.0	-1.8	-1.7	-5.7	-3.7
Total shortfall against PESA plans [2]	**-0.8**	**-1.0**	**-0.8**	**-1.0**	**-2.5**	**-3.0**

[1] TME in DEL includes SUME.

[2] Net of increases in plans from Budget Exchange carried forward.

4.102 Compared with our December forecast, we have reduced our assumption for DEL underspends by £½ billion in 2014-15. This reflects additional spending pressures on 2014-15 spending plans from £1.5 billion carried forward into 2014-15 under Budget Exchange. Our forecast now assumes total DEL underspends against latest plans of £2½ billion for 2014-15 and £3 billion for 2015-16. These underspends are lower than our forecast for 2013-14, because they reflect additional pressures on total DELs from policy measures in previous fiscal events, the increased amounts carried forward under Budget Exchange, and also the additional £1½ billion carried forward into future years under the exceptional arrangements for 2012-13.

Annually managed expenditure

4.103 Table 4.17 sets out our latest central projections of AME spending to 2018-19, based on our economic forecast, the latest estimates of agreed policy commitments and the measures announced in the Budget.

Social security

4.104 Table 4.13 shows that social security expenditure is forecast to fall from 11.6 per cent of GDP in 2012-13 to 10.0 per cent by 2018-19, as lower unemployment and policy measures reduce spending.

4.105 The Government announced in Autumn Statement 2013 that it will introduce a cap on a significant amount of welfare spending, and that the OBR would assess its performance against the cap. Our forecast of spending subject to the welfare cap and some initial analysis of trends in welfare spending are set out later in the chapter.

4.106 Social security spending is higher than in our December forecast by around £1 billion a year from 2014-15 to 2016-17, and reducing thereafter. Revisions to economic determinants reduce spending by an increasing amount over the forecast period, but these are more than offset by estimating and modelling increases and the switch of tax free childcare from DEL to social security spending. Changes in social security spending are shown in Table 4.22.

4.107 The main changes arising from our economic forecast are driven by:

- lower claimant count unemployment, which reduces benefit payments by £0.6 billion in 2014-15 increasing to £1.5 billion in 2018-19; and
- our forecast of CPI inflation in 2014-15 and 2015-16 is lower, which leads to small decreases in the uprating of benefits.

Table 4.22: Key changes to social security since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	180.0	183.2	187.9	192.6	198.2	203.5
March forecast	180.0	184.3	189.1	193.7	198.6	203.3
Change	**0.0**	**1.1**	**1.2**	**1.1**	**0.4**	**-0.2**
of which:						
CPI	0.0	0.0	-0.3	-0.4	-0.4	-0.4
Claimant count unemployment	-0.2	-0.6	-0.9	-1.0	-1.3	-1.5
Pension Credit modelling	0.0	0.0	0.1	0.2	0.4	0.5
ESA modelling	0.2	0.8	0.8	0.6	0.3	0.2
DLA/PIP modelling	0.0	0.8	0.7	0.4	0.1	0.1
Housing benefit modelling	0.0	0.1	0.3	0.3	0.2	0.1
Tax free childcare	0.0	0.0	0.2	0.7	0.8	0.9
Budget measures	0.0	0.0	0.1	0.0	0.0	0.0
Other	-0.1	0.1	0.2	0.3	0.2	-0.1

4.108 We have made various estimating and modelling changes to our forecasts, in particular for employment and support allowance (ESA), pension credit and disability living allowance (DLA) and personal independence payments (PIP):

- ESA is higher by £0.8 billion in 2014-15 and 2015-16, and by lower amounts thereafter. We have increased the assumed caseload because the latest evidence suggests the caseload is higher than we assumed in December, despite substantial upward revisions made at that time. We have also updated the modelling on repeat work capability assessments, which has increased our assumption about the length of time and number of claimants waiting for a repeat assessment, meaning more claims continue for longer;

- pension credit spending is higher by amounts rising to £0.5 billion by 2018-19 mostly as a result of us assuming a greater number of new claimants. Recent evidence suggests the declining trend in new claimants aged 67 or over seen over recent years has abated, so we now assume a flatter trend in the forecast; and

- DLA/PIP spending is higher over the next few years. This is partly driven by the fact that the Government has adopted a phased rollout to reassessment of current DLA recipients. It also reflects preliminary analysis of the latest evidence that suggests success rates – the number of claimants successful in securing awards – have been higher than expected in the early stages of PIP rollout. We have assumed a higher success rate for claims at the start of 2014-15, which then reduces to the previous success rate assumption by the start of 2015-16. The reduction assumes that success rates will decrease as the PIP process beds in and more claims are assessed, but given the preliminary evidence on which these assumptions have been based, they are subject to significant uncertainty and we will consider the evidence again in the autumn.

4.109 The Government has decided that tax free childcare, which was announced as a policy measure in Budget 2013, will now be classified as AME spending in social security instead of DEL, as scored at the time. The policy has been made more generous at this Budget, adding a further £0.1 billion a year to AME spending from 2016-17.

Tax credits

4.110 Tax credit expenditure falls as a share of GDP over the forecast period, largely because of the intention to uprate the main personal elements by 1 per cent or CPI inflation in the medium term. Where claimants pay income tax, the amount of personal tax credit that offsets all or some of the tax they would otherwise have paid is currently classified as negative tax and any remaining amount is treated as spending. The negative tax share falls in later years as claimants migrate onto universal credit, which will be entirely classified as spending. As explained in Annex B, the classification of tax credits will change in 2015, so that it is all scored as spending.

4.111 Our forecast for personal tax credits is broadly unchanged since December, with slightly higher spending on households eligible for the child element only. We had assumed the number of such households would decline with unemployment, but claims have remained broadly flat despite lower unemployment. We project this to continue in future years.

Table 4.23: Key changes to tax credits since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	31.5	31.3	31.4	32.6	34.0	35.1
March forecast	31.7	31.6	31.7	33.0	34.3	35.4
Change[1]	**0.1**	**0.3**	**0.3**	**0.4**	**0.3**	**0.3**
of which:						
Households entitled to Child Element only	0.0	0.2	0.3	0.4	0.4	0.3
Budget measures	0.0	0.0	0.0	0.0	0.1	0.1
Other	0.1	0.1	0.0	0.0	-0.2	-0.1
[1] This table shows changes to total tax credits, which are split between current receipts (shown in table 4.5) and AME current spending (shown in table 4.17). This split is shown below.						
Changes to tax credits treated as AME spending	0.1	0.3	0.4	0.5	0.3	0.3
Changes to tax credits treated as negative tax	0.0	0.0	0.0	-0.1	0.0	0.0

Public service pensions

4.112 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 fire-fighters' pension schemes.[8] Gross expenditure rises steadily over the forecast period reflecting the impact of demographic trends on 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

[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.

determined by pensionable paybill. A breakdown of spending and income for the major schemes covered is included in the supplementary tables on our website.

Table 4.24: Key changes to public service pensions since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Net public service pensions						
December forecast	10.2	11.1	12.5	13.8	14.9	16.1
March forecast	10.5	10.4	11.7	12.7	13.8	14.9
Change	**0.3**	**-0.7**	**-0.9**	**-1.1**	**-1.1**	**-1.2**
Expenditure						
December forecast	35.6	37.0	38.6	40.4	42.3	44.3
March forecast	35.8	37.3	38.7	40.4	42.3	44.2
Change	**0.2**	**0.3**	**0.1**	**0.0**	**0.0**	**-0.1**
of which:						
CPI	0.0	0.0	-0.1	-0.2	-0.2	-0.2
Other	0.2	0.3	0.2	0.2	0.1	0.1
Income						
December forecast	-25.4	-25.9	-26.1	-26.6	-27.4	-28.2
March forecast	-25.3	-26.9	-27.0	-27.7	-28.5	-29.3
Change	**0.1**	**-1.0**	**-0.9**	**-1.1**	**-1.1**	**-1.1**
of which:						
Budget measure	0.0	0.0	-0.7	-1.0	-1.0	-1.0
PCSPS transfer	0.0	-0.8	0.0	0.0	0.0	0.0
Other	0.1	-0.2	-0.2	-0.1	-0.1	-0.1

4.113 While gross expenditure rises steadily in nominal terms, it remains broadly flat as a share of GDP. There have mainly been minor changes since our December forecast, driven by in-year data for 2013-14, which also affects later years, and small downward revisions to CPI inflation affecting uprating.

4.114 Our income forecast now includes a large one-off transfer of £0.8 billion in 2014-15 into the civil service pension scheme as a result of the House of Commons and General Lighthouse Fund schemes being transferred. This is neutral in spending because it is directly offset by increased spending in DEL. We expect more such transfers in accordance with Schedule 10 of the Public Sector Pensions Act 2013, which lists a number of bodies that are required to join the civil service pension scheme by 2018. Further details of the timing are not yet known, so they are not included at this stage, but they are also likely to be spending neutral when they take place.

4.115 Budget 2014 has announced changes to employer contribution rates for the civil service, NHS, teachers and police pension schemes as a result of near-final valuation results. These are included as a Budget measure and are expected to yield around £1 billion a year from 2015-16. We understand that some departments have already planned for this pressure, and our view is that these pressures are not significant enough for us to change our high-level assumption about the level of departmental spending in 2015-16.

4.116 Our forecast does not take account of the new pension schemes that are expected to be implemented in April 2015 as announced in the Public Service Pensions Act 2013, which set out that new schemes would be designed for all the public service pension schemes based on career average earnings. We expect these to have a minimal effect over the forecast period because of the transitional arrangements in place. The impact of the new schemes and any revisions to employer contribution rates from the remaining valuation exercises will be fully reflected in our autumn forecast.

EU contributions

4.117 The main component of the AME transfer to EU institutions is the UK's gross national income (GNI)-based contribution, minus the UK's abatement. The forecast for the GNI-based contribution depends mainly on the level of the agreed EU Budget and the relative GNI of each Member State. The UK abatement is affected by the UK's share of the EU VAT base and the UK's share of EU abatable receipts.[9]

4.118 The profile of UK contributions in AME over the forecast period is largely explained by the profile of EU expenditure across the 2014-2020 Multiannual Financial Framework, which was reported in Table 4.26 of our March 2013 forecast. Our December *EFO* explained the effect on the timing of payments from the new Own Resources Decision, which we assume will come into effect in 2016 retrospective from 2014. This will affect the relationship between AME and EU expenditure across the forecast period.

4.119 The change in our forecast for EU contributions shown in Table 4.25 is almost completely accounted for by us aligning our forecasts of VAT, GNI and Traditional Own Resources (TOR, mostly customs duties) for 2013 and 2014 with the latest data from the European Commission and with our economy forecast. This shows UK growth out-performing other EU countries relative to the bases used in our December forecast, increasing the UK's GNI-based contributions. This will increase UK payments in 2014-15, because of higher contributions in respect of 2014 and anticipated adjustments needed to UK contributions for 2013, but will reduce them in later years. This is due to the rebate, which adjusts UK contributions to be consistent with our VAT share rather than GNI share. Increased customs duties collection costs also directly reduce AME spending in 2015-16 onwards.

Table 4.25: Key changes to EU contributions since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	8.7	7.3	8.6	8.1	7.3	8.2
March forecast	8.9	8.1	8.1	7.9	7.1	7.9
Change	**0.1**	**0.8**	**-0.4**	**-0.2**	**-0.2**	**-0.2**
of which:						
Revised 2013 and 2014 bases	0.0	0.8	-0.6	-0.3	-0.3	-0.3
Other	0.1	0.0	0.1	0.1	0.1	0.1

[9] A supplementary fiscal table on our website provides further details of UK transactions with the EU, including how these various contributions score in the National Accounts and our forecast.

Locally financed current expenditure

4.120 Locally financed current expenditure in AME contains two components. The largest is local authority self-financed expenditure (LASFE) – local authority spending that is financed from local authorities' own sources of income, other than central government grants. Locally financed expenditure also contains Scottish Government spending financed by local taxation, which currently only consists of spending financed by business rates.[10]

4.121 The forecast of current LASFE shown in Table 4.26 is largely driven by the forecasts for council tax, and for retained business rates in England. Our forecast reflects the recent CIPFA announcement of an average 0.6 per cent council tax increase in 2014-15 in England. We have assumed the same increase applies for 2015-16, the last year for which the Government has announced that additional grant is available for councils that freeze their council tax. These increases are slightly lower than we had forecast in December, which reduces our forecast for current LASFE slightly from 2014-15 onwards. After 2015-16, we assume that council tax rises in line with CPI inflation for England, Scotland and Wales.[11] 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, and we have assumed that retained business rates increase with RPI inflation over the rest of the forecast period. Council tax and retained business rates assumptions are neutral for the overall fiscal aggregates as they are consistent with our receipts forecast.

4.122 Local authorities' additions to current reserves have been an important source of past forecast errors (see our 2012 and 2013 *Forecast evaluation reports*). These additions to reserves reduce local authority current spending. For 2013-14, we assume that English local authorities will have added £2.2 billion to reserves, and that they underspend their total service expenditure current budgets by £4.4 billion. This reflects the latest quarterly in-year current spending information collected by DCLG. We have assumed that English local authorities make net additions to their reserves of just under £2 billion in 2014-15, reducing to zero by 2018-19.

4.123 Table 4.26 summarises the main changes to our forecasts for current LASFE. This shows that we have increased our forecasts over the second half of the forecast period, largely because we have reduced our forecasts for capital expenditure financed from the revenue account (CERA). The CERA transfers reduce current spending and increase capital spending. The lower CERA forecast has therefore increased current LASFE and reduced capital LASFE by offsetting amounts. This reflects new information on Transport for London (TfL) spending plans that is discussed below.

[10] Further detail on future devolved Scottish tax receipts is available in the supplementary material on our website.
[11] These council tax increases are assumed to apply in conjunction with an increase in the council tax base, which averages 1.2 per cent per 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 table on our website.

Table 4.26: Key changes to locally financed expenditure and public corporations capital expenditure since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Locally-financed current expenditure						
December forecast	34.3	35.0	36.9	39.2	41.7	43.9
March forecast	34.0	35.1	37.0	39.5	42.0	44.1
Change	**-0.2**	**0.1**	**0.0**	**0.3**	**0.2**	**0.2**
of which:						
Council tax	0.0	0.0	-0.1	-0.1	-0.2	-0.2
Capital expenditure from revenue account	0.0	0.0	0.2	0.5	0.5	0.5
Budget measures	-0.2	0.1	-0.1	-0.1	-0.1	-0.2
Locally-financed capital expenditure, and public corporations capital expenditure						
December forecast	14.3	13.5	14.2	14.4	14.3	13.3
March forecast	13.2	13.2	13.5	14.2	14.0	12.7
Change	**-1.1**	**-0.3**	**-0.7**	**-0.2**	**-0.2**	**-0.6**
of which:						
Capital expenditure from revenue account	0.0	0.0	-0.2	-0.5	-0.5	-0.5
HRA capital spending	-0.4	-0.3	-0.3	-0.4	-0.4	-0.5
Capital spending of TfL PC subsidiaries [1]	0.0	0.0	0.1	0.6	0.7	0.7
Other	-0.7	0.0	-0.2	0.1	0.0	-0.3

[1] This increase is the net result of a reduction in the adjustment included in capital LASFE that removes the financing of TfL's PC subsidiaries capital spending, which is only partly offset by a reduction in the OBR forecast for public corporations capital expenditure, to reflect the latest TfL business plans.

Locally financed and public corporations capital expenditure

4.124 Our latest forecasts for locally financed capital expenditure (capital LASFE) and public corporations capital spending are shown in Table 4.26. Capital LASFE is measured net of asset sales and of capital spending by local authorities' Housing Revenue Accounts (HRAs) and TfL subsidiaries, which are treated as public corporations in the National Accounts.[12] We switch these items out of capital LASFE to ensure our forecast is consistent with the National Accounts. This means that changes in capital spending by HRAs or TfL have largely offsetting effects on capital LASFE and public corporations' capital spending.

4.125 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 also boosted by an additional £0.8 billion of spending financed from capital reserves from 2015-16 to 2017-18 related to the closing stages of Crossrail construction. Further details of the components of our forecasts for current and capital local authority spending are shown in supplementary fiscal tables available on our website.

[12] 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.

4.126 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. Table 4.26 groups our forecasts for capital LASFE and public corporations together to show the overall impact of the revisions. There are two main areas of changes:

- we have adopted a new methodology for forecasting capital spending on major repairs and other capital spending financed from the HRA. Previously, as noted in December, we needed to use uncertain assumptions about the effects of recent HRA reforms. We are now able to forecast from HRA outturn data for 2012-13. This new approach has reduced our forecast of HRA capital spending by £0.5 billion by the end of the forecast period. We will continue to monitor trends in this spending as more outturn information becomes available; and

- we have incorporated new information supplied by TfL, consistent with their latest published business plan. This now extends to 2020-21, whereas our December forecast was consistent with plans to 2014-15 and assumptions thereafter. The latest plans are lower than our December forecast, although the profile is lumpy. TfL also plan to finance some of the public corporation subsidiaries' capital spending from the subsidiaries' operating profits, which reduces the amounts netted off capital LASFE by more than the reductions in the public corporations capital spending, raising our forecast for capital spending in total. We have also reduced capital LASFE by reducing CERA in our forecast, due to the lower current grants flowing through to finance this capital spending.

4.127 Other changes to capital LASFE include an increase in the forecast for asset sales over the first half of the forecast period, due to higher property prices and transactions, where these higher asset sales reduce net capital spending. For 2013-14, we assume that English local authorities will underspend their capital budgets by a net total of £5 billion. This reflects the latest quarterly in-year capital spending information collected by DCLG.

Debt interest

4.128 Central government debt interest payments rise as a share of GDP over the forecast period, reflecting projected increases in interest rates and RPI inflation, and the rising stock of public debt. A lower net cash requirement, lower gilt rates and generally lower RPI inflation all reduce our forecast relative to December. These changes are partially offset by higher spending on National Savings and Investment products and a modelling change over the medium term.

4.129 We break down the debt interest forecast by financing component in the supplementary fiscal tables on our website, including a distinction between debt interest on conventional gilts for new and existing debt. Payments on the existing stock of conventional gilts are fixed for the lifetime of those gilts. With a long average maturity for UK gilts, over half of the payments on conventional gilts by the end of the forecast period relate to fixed debt interest costs on gilts that have already been issued. We also include a separate ready-reckoner

table showing the approximate effect on debt interest of movements in interest rates, RPI inflation and the CGNCR.

Table 4.27: Key changes to debt interest since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	49.5	53.9	60.0	65.3	72.5	76.9
March forecast	48.4	52.1	59.1	65.1	71.6	75.2
Change	**-1.1**	**-1.8**	**-0.9**	**-0.2**	**-0.9**	**-1.7**
of which:						
Financing CGNCR	0.0	-0.5	-1.3	-1.5	-1.8	-2.0
Gilt rates	0.0	0.0	-0.1	-0.2	-0.3	-0.5
Short rates	0.0	0.0	0.2	0.2	0.1	0.0
Inflation	-1.0	-1.2	-0.1	0.4	-0.3	-0.6
NS&I	-0.1	-0.1	0.1	0.6	1.0	1.0
Other	0.0	0.0	0.3	0.3	0.3	0.3

Other AME spending

4.130 Our forecast of **BBC** spending is slightly lower than in December as a result of slightly lower spending in 2013-14 and downward revisions to BBC spending plans.

4.131 The forecast of **National Lottery** spending had been revised down in 2013-14 as a result of latest outturn data. This feeds through to other years of the forecast, and we have also reduced growth rates across the forecast period.

4.132 Revisions to **other PSCE in departmental AME** and **other PSGI items in departmental AME** are very small. The spending included in these categories is detailed in the supplementary tables available on our website.

4.133 Table 4.17 shows a separate entry in PSCE in AME for **single-use military expenditure (SUME)**. This expenditure is treated as capital DEL in the spending control framework, but is classified as current expenditure in the National Accounts. To align with the National Accounts, we therefore exclude this spending from PSGI in CDEL and add it to PSCE in AME. This is largely unchanged since our December forecast. Most of SUME will be reclassified as capital spending this summer (see Annex B).

4.134 **Environmental levies** include spending on DECC levy-funded policies such as the Renewables Obligation, Feed-In Tariffs and Warm Homes Discount. Most of these are neutral for borrowing as they are balanced by receipts. The forecasts are explained in the receipts section.

4.135 The AME forecast includes forecasts for the further adjustments that are included in the National Accounts definitions for PSCE and PSGI.[13] Explanations and the background to **National Accounts adjustments** are given in Annex D to PESA 2013.[14]

4.136 Table 4.18 shows that current accounting adjustments have decreased by around £½ billion in each year of the forecast. This is mostly caused by downward revisions to the Housing Revenue Account imputed subsidy for equity injection, which is offset by reduced receipts in the gross operating surplus of public corporations.

4.137 Capital accounting adjustments have increased in each year of the forecast to reflect changes to our forecast of Crossrail finance and spending, which we tried to align with the likely treatment in outturn in the National Accounts. Offsetting this in 2013-14 is a large one-off receipt of £¾ billion from the mineworkers' pension scheme as a result of a surplus identified in the recent revaluation.

Welfare cap

4.138 The Government announced in Autumn Statement 2013 that it will introduce a cap on certain items of welfare spending, excluding state pensions and the most cyclical elements of welfare. The cap has been formally defined and initially set by the Government in this Budget, and will apply from 2015-16 to the end of the forecast period. It has set a forecast margin above the cap of 2 per cent in each year. The Government has asked the OBR to assess its performance against the cap and to produce an annual report on trends in welfare spending.

4.139 In future autumn *EFO*s we will formally assess whether relevant spending exceeds the welfare cap for discretionary policy reasons or the cap-plus-forecast-margin due to changes in forecast assumptions. In Budget *EFO*s, we will update our analysis without carrying out a formal assessment. We will produce our first report on welfare trends in the autumn and foreshadow that with some initial high-level analysis below.

4.140 Based on the definition set out in the Budget, Table 4.28 shows welfare spending inside the cap and welfare spending outside the cap. The welfare cap relates to these nominal spending totals. Table 4.29 presents the same welfare spending as a share of GDP, showing that on this definition it is forecast to fall from 12.8 per cent of GDP in 2013-14 to 11.6 per cent of GDP in 2018-19. Spending subject to the welfare cap is forecast to fall more steeply, from 7.1 per cent to 6.2 per cent of GDP, while spending outside the cap falls more gradually, from 5.7 per cent to 5.4 per cent of GDP.

[13] Further detail is provided in the supplementary fiscal tables on our website.
[14] See HM Treasury, July 2013, Public Expenditure Statistical Analyses 2013.

Table 4.28: Welfare cap spending

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Welfare cap							
DWP social security	71.2	71.5	73.3	74.3	75.0	76.0	76.8
of which:							
Incapacity benefits[1]	13.3	13.3	13.4	13.5	13.7	14.0	14.3
Statutory maternity pay	2.3	2.3	2.4	2.4	2.5	2.6	2.7
Income support (non-incapacity)	2.7	2.6	2.6	2.5	2.6	2.7	2.8
Pension credit	7.4	7.0	6.6	6.5	6.3	6.1	5.9
Winter fuel payments	2.1	2.2	2.1	2.1	2.1	2.1	2.0
Disability living allowance and personal independence payments	13.4	13.9	14.8	14.7	14.1	13.5	13.6
Attendance allowance	5.4	5.4	5.5	5.6	5.7	5.8	6.0
Carer's allowance	1.9	2.1	2.3	2.4	2.6	2.7	2.8
Universal credit[2]	0.0	0.0	0.0	0.0	0.1	0.5	-0.2
Housing benefit (not unemployed)	19.9	20.3	21.3	22.1	22.9	23.5	24.2
Other DWP in welfare cap	2.6	2.4	2.4	2.4	2.4	2.5	2.5
Personal tax credits (AME spending)	26.8	27.2	26.8	27.1	29.3	31.7	33.0
Tax free childcare	0.0	0.0	0.0	0.2	0.7	0.8	0.9
NI social security in welfare cap	3.2	3.2	3.2	3.3	3.3	3.3	3.3
Child benefit	12.2	11.6	11.7	11.9	12.1	12.4	12.6
Paternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Welfare cap in AME	**113.5**	**113.6**	**115.1**	**116.9**	**120.4**	**124.2**	**126.7**
Personal tax credits (negative tax element)	3.0	2.7	2.7	2.5	1.6	0.3	0.0
Total welfare cap	**116.5**	**116.4**	**117.8**	**119.5**	**122.0**	**124.6**	**126.7**
Welfare spending outside the welfare cap							
DWP social security	93.3	90.7	93.0	96.1	99.2	102.6	106.1
of which:							
Jobseeker's allowance	5.1	4.3	3.6	3.4	3.3	3.2	3.1
State pension	79.8	83.0	86.5	90.0	93.1	96.8	100.3
Council tax benefit[3]	4.8	-	-	-	-	-	-
Housing benefit (unemployed)	3.6	3.2	2.9	2.8	2.8	2.7	2.7
Discretionary housing payments[3]	0.1	0.2	-	-	-	-	-
NI social security outside welfare cap	2.2	2.2	2.3	2.4	2.5	2.6	2.7
War pensions	0.9	0.9	0.9	0.8	0.8	0.8	0.8
Total welfare outside the welfare cap	**96.4**	**93.8**	**96.1**	**99.3**	**102.5**	**106.0**	**109.6**
Total welfare[4]	**212.9**	**210.1**	**213.9**	**218.8**	**224.5**	**230.6**	**236.3**
Memo: welfare cap as proportion of total welfare	*54.7*	*55.4*	*55.1*	*54.6*	*54.4*	*54.0*	*53.6*

[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] Transferred to departmental expenditure limits.

[4] Total welfare includes welfare spending in AME and the negative tax element of personal tax credits, which will move into spending under ESA10.

Table 4.29: Welfare cap spending (per cent of GDP)

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Welfare cap							
DWP social security	4.5	4.3	4.3	4.2	4.0	3.9	3.8
of which:							
Incapacity benefits[1]	0.8	0.8	0.8	0.8	0.7	0.7	0.7
Statutory maternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Income support (non-incapacity)	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Pension credit	0.5	0.4	0.4	0.4	0.3	0.3	0.3
Winter fuel payments	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Disability living allowance and personal independence payments	0.9	0.8	0.9	0.8	0.8	0.7	0.7
Attendance allowance	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Carer's allowance	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Universal credit[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Housing benefit (not unemployed)	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Other DWP in welfare cap	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Personal tax credits (AME spending)	1.7	1.7	1.6	1.5	1.6	1.6	1.6
Tax free childcare	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NI social security in welfare cap	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Child benefit	0.8	0.7	0.7	0.7	0.6	0.6	0.6
Paternity pay	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Welfare cap in AME	**7.2**	**6.9**	**6.7**	**6.5**	**6.4**	**6.4**	**6.2**
Personal tax credits (negative tax element)	0.2	0.2	0.2	0.1	0.1	0.0	0.0
Total welfare cap	**7.4**	**7.1**	**6.8**	**6.7**	**6.5**	**6.4**	**6.2**
Welfare spending outside the welfare cap							
DWP social security	5.9	5.5	5.4	5.4	5.3	5.2	5.2
of which:							
Jobseeker's allowance	0.3	0.3	0.2	0.2	0.2	0.2	0.2
State pension	5.1	5.0	5.0	5.0	5.0	4.9	4.9
Council tax benefit[3]	0.3	-	-	-	-	-	-
Housing benefit (unemployed)	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Discretionary housing payments[3]	0.0	0.0	-	-	-	-	-
NI social security outside welfare cap	0.1	0.1	0.1	0.1	0.1	0.1	0.1
War pensions	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Total welfare outside the welfare cap	**6.1**	**5.7**	**5.6**	**5.6**	**5.5**	**5.4**	**5.4**
Total welfare[4]	**13.6**	**12.8**	**12.4**	**12.2**	**12.0**	**11.8**	**11.6**

[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] Transferred to departmental expenditure limits.

[4] Total welfare includes welfare spending in AME and the negative tax element of personal tax credits, which will move into spending under ESA10.

Welfare trends

4.141 The Government has asked us to produce a new annual report on trends in welfare spending, the first of which we intend to publish alongside our *Forecast evaluation report* in the autumn. This section highlights some of the drivers of the overall welfare budget that we will be exploring in greater detail later in the year.

4.142 There are various ways of expressing public spending. For example, we can look at spending in cash terms: over the past 30 years, total spending on welfare and tax credits in Great Britain (hereafter 'welfare spending') has risen at an average rate of 6.3 per cent a year from £32 billion in 1983-84 to an estimated £204 billion this year and it is forecast to rise by 2.3 per cent a year over the next five years to £229 billion in 2018-19.[15] But without the context of what any cash amount could purchase or how much national income is available to fund it, interpreting these changes is difficult.

4.143 Two other ways of expressing spending help to address these issues, as shown in Table 4.30. In real terms, correcting for whole economy inflation, welfare spending has risen at an average rate of 3.2 per cent a year over the past 30 years and is forecast to rise at a slower 0.4 per cent a year over the coming 5 years. This implies that purchasing power of welfare spending continues to rise. Relative to national income, welfare spending was 2.1 per cent of GDP higher in 2013-14 than 30 years ago and is forecast to fall by 1.2 per cent of GDP over the next 5 years. This shows that in order to deliver the 3.2 per cent a year rise in the purchasing power of welfare spending, a larger share of national income had to be transferred to welfare recipients; that trend is expected to reverse over the forecast period.

Table 4.30: DWP and HMRC benefits and personal tax credits spending (Great Britain)

	£ billion, nominal terms			£ billion, real 2013-14 prices			Per cent of GDP		
	1983-84	2013-14	2018-19	1983-84	2013-14	2018-19	1983-84	2013-14	2018-19
Welfare spending	32	204	229	80	204	208	10.3	12.4	11.2

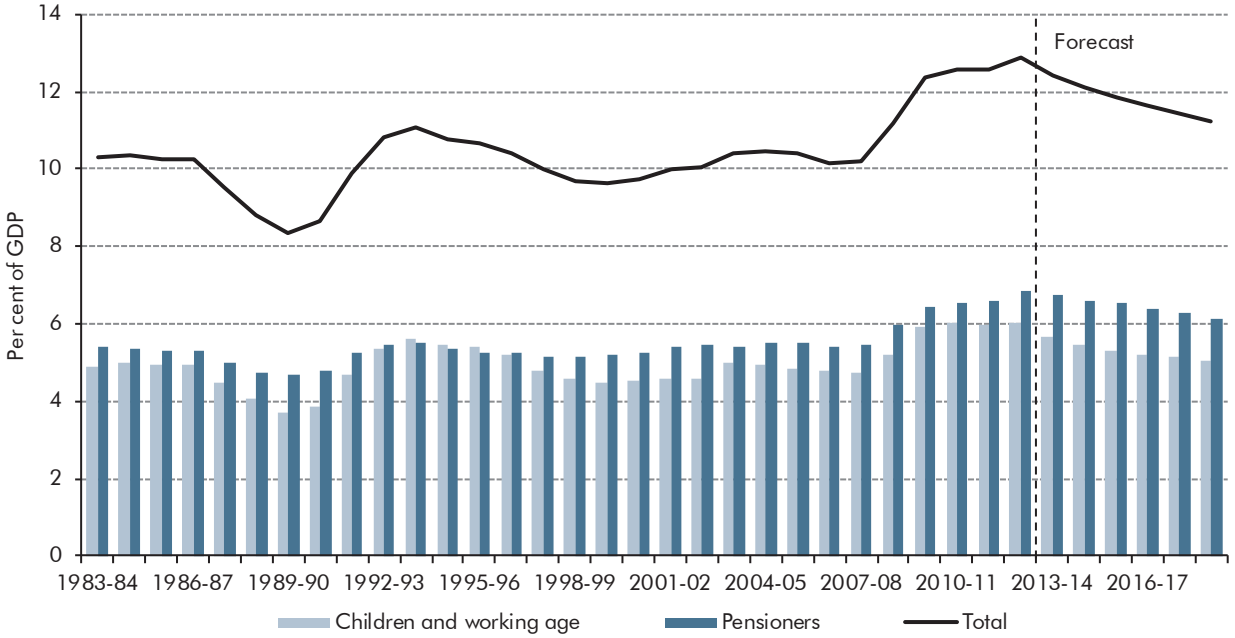
4.144 Not all elements of the welfare budget have evolved in line with the aggregate measures in Table 4.30. Chart 4.5 shows the trend in welfare spending relative to GDP over the past 30 years and the forecast period, split into spending on pensioners (mainly state pensions) and spending on children and the working-age (the largest elements of which are tax credits and housing benefit). It shows the cyclical pattern in welfare spending through the late 1980s boom and early 1990s recession, and the sharp rise and slower fall in the most recent recession and ongoing recovery.

4.145 Welfare spending increased by 2.1 per cent of GDP between 2007-08 and 2009-10, as cash spending increased by 19.7 per cent and nominal GDP fell by 1.1 per cent. The further rise between 2009-10 and 2012-13, to a peak of 12.9 per cent of GDP, was largely explained by higher spending on pensioner benefits. Having fallen in 2013-14, welfare

[15] Unless otherwise stated, all figures in this section are consistent with DWP's and HMRC's current coverage and relate to spending in Great Britain only.

spending is forecast to fall by a further 1.2 per cent of GDP by 2018-19, with working-age and pensioner benefits contributing roughly equal amounts to the fall. At 11.2 per cent of GDP in 2018-19, welfare spending is forecast to remain 1.0 per cent of GDP above its pre-recession level with pensioner benefits accounting for around 0.7 percentage points of the difference.

Chart 4.5: Trends in welfare spending



Source: DWP, HMRC, OBR

4.146 There are many factors that explain the trends shown in Chart 4.5. One route into understanding these drivers is to group them into two parts, each of which can be broken down further:

- changes in caseloads as a percentage of the population. This can reflect changes in the age structure of the population – the number of people receiving pensions has risen because there are more people of pension age. Or it can reflect changes in the likelihood of a given age group claiming a benefit – the percentage of people claiming housing benefit has risen because there are more people renting rather than owning their homes, while the proportion of people claiming jobseekers allowance is related to the cyclical position of the economy; and

- changes in average awards relative to national income per person. This can reflect changes in the composition of the caseload – the rising share of employment and support allowance recipients in the contributory support group, which attracts the highest average awards. Or it can reflect changes in the generosity of the system as a whole – the 'triple lock' on state pensions has led to the average pension rising faster than average earnings in recent years.

4.147 One factor that has pushed up most elements of welfare spending in recent years has been the fact that inflation (which is used to uprate most benefits) has out-paced growth in average earnings and nominal GDP. As Table 4.31shows, inflation in the previous September, the month used for benefit uprating, has been higher than growth in average earnings and nominal GDP per capita in four of the five years from 2008-09 to 2012-13. In the five years to 2012-13, the cumulative growth in inflation used to uprate means-tested benefits was 11½ percentage points higher than growth in average earnings and 15½ percentage points higher than growth in nominal GDP per capita.

Table 4.31: Inflation, earnings and nominal GDP per capita

	Per cent					
	2008-09	2009-10	2010-11	2011-12	2012-13	Total change between 2008-09 and 2012-13
RPI inflation[1]	3.9	5.0	-1.4	4.6	5.6	18.8
ROSSI inflation[1]	2.3	6.3	1.8	4.8	6.8	23.9
CPI inflation[1]	1.8	5.2	1.1	3.1	5.2	17.4
Average earnings growth[2]	0.6	3.0	1.0	2.7	1.0	8.5
Growth in nominal GDP per 16+ person	-1.2	-1.4	4.1	2.4	0.7	4.5

[1] Prior to 2011-12, means-tested benefits were generally uprated with ROSSI and other benefits with RPI (in 2010-11 these were uprated by +1.5% rather than -1.4%). The baseline assumption since 2011-12 has been to uprate most benefits with CPI.
[2] Wages and salaries per employee.

4.148 To illustrate the type of assessment we will undertake later this year, the following paragraphs explore recent trends in spending on state pension, housing benefit and jobseekers allowance.

State pension

4.149 Total state pension spending increased by 0.7 per cent of GDP through the recession and by a further 0.4 per cent of GDP by 2012-13. This is the largest element of the total welfare budget, but the Government has chosen not to include it in its welfare cap. We expect state pension spending to fall slightly relative to GDP over the forecast period.

4.150 The main factors raising pension spending relative to GDP over the recent past have been the steady rise in the share of the population above pension age and the substantial rise in the average pension relative to average earnings, which was focused in the period from 2007-08 to 2012-13. The latter was due to state pension being uprated by more than average earnings growth, first with inflation and then in line with the 'triple lock'. This effect was particularly big in 2012-13 when pensions were uprated by 5.2 per cent, reflecting September 2011 CPI inflation, while average earnings grew by just 1.0 per cent. The proportion of pensioners that receive the additional pension has also risen, as have average entitlements. State pension spending is expected to be broadly stable as a share of GDP over the next five years, as the male and female state pension ages are equalised and in the final few months the rise to 66 years is phased in. These changes will offset the mounting costs of the ageing population.

Table 4.32: Trends in state pension spending as a share of GDP

	Per cent of GDP			
	2007-08	2009-10	2012-13	2018-19
State pension spending	3.98	4.67	5.08	4.92
Percentage point change since 2007-08		0.69	1.10	0.94
of which percentage point contributions from:				
Change in pensioner share of 16+ population		0.10	0.14	0.03
Change in average pension relative to GDP per 16+ person		0.60	0.97	0.90

Housing benefit

4.151 Spending on housing benefit has increased substantially in recent years, rising from 1.1 per cent of GDP in 2007-08 to 1.5 per cent of GDP in 2012-13. The majority of spending on housing benefit is subject to the welfare cap. It is an area of welfare spending that has been under-forecast in recent years as we under-estimated the extent of caseload growth. We now expect housing benefit spending to fall slightly relative to GDP over the forecast period.

4.152 The largest driver of the rise in spending on housing benefit has been caseload growth in the private rented sector. This reflects both a rising share of households living in private rented accommodation and a rising proportion of those households claiming housing benefit. As a result, the share of spending accounted for by the private rented sector is forecast to rise from 30 per cent in 2007-08 to 40 per cent by 2018-19.

4.153 The trend towards renting from private landlords and away from owner-occupation pre-dated the 2008-09 recession. However, it accelerated between 2007-08 and 2012-13 as the combination of high house prices relative to average earnings and increased mortgage deposit requirements reduced access to owner-occupation for people without substantial savings or help from their families. Labour Force Survey data show the fall in owner-occupation since the recession to have been particularly marked for younger age groups.

4.154 The rising proportion of the renting population claiming housing benefit may be related to the weakness of average wage growth relative to rent inflation. This explanation is supported by DWP data, which suggest that almost all the recent rise in the private-rented sector housing benefit caseload has been accounted for by people in employment. We expect the share of claimants in the private rented sector to continue rising over the forecast period, but for average awards to rise more slowly than nominal GDP per capita due to policy, including on uprating.

Table 4.33: Trends in housing benefit spending as a share of GDP

	Per cent of GDP			
	2007-08	2009-10	2012-13	2018-19
Housing benefit spending	1.09	1.40	1.52	1.34
Percentage point change since 2007-08		0.31	0.43	0.26
of which percentage points contribution from:				
Private-rented sector (PRS) - 30% of HB in 2007-08 - of which:		0.20	0.27	0.21
Change in PRS caseload as a share of 16+ population		0.14	0.24	0.24
Change in average PRS award relative to GDP per 16+ person		0.06	0.02	-0.03
LAs, social-rented and other (SRS) - 70% of HB in 2007-08 - of which:		0.10	0.17	0.05
Change in SRS caseload as a share of 16+ population		0.02	0.04	0.00
Change in average SRS award relative to GDP per 16+ person		0.09	0.13	0.05

Jobseeker's allowance

4.155 Spending on jobseeker's allowance (JSA) is small relative to total welfare spending and national income, but is also relatively volatile. During the recession, JSA spending more than doubled as a share of GDP, with the vast majority of the increase explained by the rise in the share of the population out of work as the economy contracted. JSA spending is not subject to the welfare cap because of this close link to the cyclical position of the economy and the fiscal 'automatic stabilisers' that cushion the economy from the effects of shocks.

4.156 We expect JSA spending to reverse the recent increase relative to GDP over the forecast period as claimant count unemployment falls back below 1 million by 2018-19, and as payments are uprated by only 1 per cent up to 2015-16 and by CPI inflation thereafter.

Table 4.34: Trends in JSA spending as a share of GDP

	Per cent of GDP			
	2007-08	2009-10	2012-13	2018-19
Jobseekers allowance spending	0.15	0.33	0.33	0.16
Percentage point change since 2007-08		0.17	0.17	0.00
of which percentage point contributions from:				
Change in caseload as share of 16+ population		0.15	0.14	0.00
Change in average award relative to GDP per 16+ person		0.02	0.04	0.00

Loans and other financial transactions

4.157 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.

4.158 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.[16] 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.

4.159 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;
- **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;
- **transactions in financial assets:** the public sector may buy or sell financial assets, such as corporate bonds or equities. When it exchanges one asset for an equivalent cash asset the transaction does not affect PSNB, but the associated cash flow will affect PSNCR; and
- **other factors:** this category includes one-off financial transactions that do not fall into the categories above and some other adjustments.

4.160 Net lending by the public sector to the private sector, in particular for student loans, raises the net cash requirement relative to net borrowing in each year of our forecast. The cash requirement is expected to rise in 2014-15, in contrast to net borrowing, with both measures falling in subsequent years. The rise next year can be more than explained by a number of one-offs reducing this year's cash requirement, in particular the transfer of the Asset Purchase Facility's (APF's) historic cash balance, which amounted to £31.1 billion in 2013-14 of which only £12.2 billion lowered net borrowing. Table 4.35 shows the steps from PSNB to PSNCR (on a headline basis, including the APF transfers) while Table 4.36 shows the changes since our December forecast.

[16] Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the temporary effects of financial sector interventions.

Table 4.35: Reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing	**95.6**	**83.9**	**68.3**	**41.5**	**17.8**	**-1.1**
Loans and repayments	**13.4**	**17.3**	**19.1**	**18.6**	**18.0**	**18.6**
of which:						
Student loans[1, 2]	8.5	10.7	12.0	13.1	14.1	14.8
DfID	1.3	1.2	1.2	1.1	1.1	1.1
Green Investment Bank	0.3	1.0	1.1	0.0	0.0	0.0
Business Bank & Finance Partnership	0.5	0.8	0.4	0.2	-0.3	0.0
Help to Buy equity loans[3]	0.8	1.6	1.3	1.4	1.4	1.4
UK Export Financing	0.0	0.2	0.4	0.5	0.5	0.5
Ireland	0.8	0.0	0.0	0.0	0.0	-0.4
Other	1.2	1.9	2.8	2.3	1.2	1.2
Accruals adjustments	**4.8**	**-2.1**	**-5.6**	**6.8**	**4.6**	**-8.2**
of which:						
Student loan interest[1,2]	1.1	1.7	2.4	3.6	4.7	5.6
PAYE income tax and NICs	0.8	1.4	1.5	2.4	2.0	2.0
Indirect taxes	1.9	1.0	0.9	1.0	1.0	1.1
Other receipts	0.8	0.4	0.4	0.3	0.2	0.1
Index-linked gilts[4]	3.3	-10.4	-14.2	-3.4	-6.5	-20.0
Conventional gilts	3.5	2.9	2.3	1.9	2.2	1.9
Other expenditure	-6.6	1.0	1.0	1.0	1.0	1.0
Transactions in financial assets	**-6.3**	**0.0**	**-2.3**	**-2.3**	**-2.3**	**-2.3**
of which:						
Lloyds shares	-3.2	0.0	0.0	0.0	0.0	0.0
Royal Mail shares	-2.0	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	-1.0	0.0	0.0	0.0	0.0	0.0
Student loan book	-0.2	0.0	-2.3	-2.3	-2.3	-2.3
Other factors	**-26.9**	**-6.9**	**-7.1**	**-7.0**	**-6.7**	**-5.3**
of which:						
Asset Purchase Facility proceeds	-18.9	0.0	0.0	0.0	0.0	0.0
B&B and NRAM alignment	-8.3	-7.2	-7.4	-7.3	-7.0	-5.6
Public sector net cash requirement	**80.5**	**92.3**	**72.3**	**57.6**	**31.4**	**1.6**

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

Cash spending on new loans	10.3	12.7	14.4	15.6	16.7	17.4
Cash repayments	1.8	2.1	2.3	2.5	2.5	2.6

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

[3] This excludes Barnett Consequentials.

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

Table 4.36: Changes in the reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing	**-3.4**	**-0.1**	**-3.3**	**-6.3**	**-7.0**	**-3.0**
Loans and repayments	**-0.7**	**1.1**	**1.2**	**2.9**	**2.2**	**2.6**
of which:						
Student loans[1, 2]	0.3	0.5	0.5	0.4	0.5	0.5
DfID	0.0	0.0	0.0	0.0	0.0	0.0
Green Investment Bank	0.0	0.0	0.0	0.0	0.0	0.0
Business Bank & Finance Partnership	0.1	0.1	-0.2	-0.1	-0.5	0.0
Help to Buy equity loans	-0.4	0.4	0.0	1.4	1.4	1.4
UK Export Financing	-0.3	-0.1	0.1	0.6	0.6	0.5
Ireland	0.0	0.0	0.0	0.0	0.0	0.0
Other	-0.5	0.2	0.9	0.6	0.1	0.1
Accruals adjustments	**-4.7**	**2.2**	**0.1**	**-0.3**	**0.7**	**0.9**
of which:						
Student loan interest[1,2]	0.0	0.1	-0.1	0.1	0.2	0.0
PAYE income tax and NICs	0.4	0.1	-0.2	0.0	0.0	-0.2
Indirect taxes	0.3	0.1	0.1	0.1	0.0	0.1
Other receipts	0.0	0.1	0.0	0.0	-0.1	-0.2
Index-linked gilts[3]	1.0	1.3	0.2	-0.3	0.3	0.7
Conventional gilts	0.8	0.6	0.1	-0.1	0.4	0.5
Other expenditure	-7.2	0.0	0.0	0.0	0.0	0.0
Transactions in financial assets	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
of which:						
Lloyds shares	0.0	0.0	0.0	0.0	0.0	0.0
Royal Mail shares	0.0	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	0.0	0.0	0.0	0.0
Student loan book	0.0	0.0	0.0	0.0	0.0	0.0
Other factors	**-3.5**	**0.1**	**-1.0**	**-1.4**	**-0.6**	**0.3**
of which:						
Asset Purchase Facility proceeds	-0.4	0.0	0.0	0.0	0.0	0.0
B&B and NRAM alignment	-3.1	0.1	-1.0	-1.4	-0.6	0.3
Public sector net cash requirement	**-12.3**	**3.3**	**-3.0**	**-5.1**	**-4.6**	**0.8**

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

Cash spending on new loans	0.1	0.2	0.1	0.0	0.0	-0.1
Cash repayments	-0.2	-0.3	-0.4	-0.5	-0.5	-0.6

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

[3] This excludes Barnett Consequentials.

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

Loans and repayments

4.161 The recent student loan reforms have increased the size of upfront loans, with repayments being made over a longer period. In our 2013 *Fiscal sustainability report (FSR)*, we showed that on current policy settings we might expect the difference between new loans and repayments to peak around the early 2030s and then fall away.

4.162 Our forecast for new student loan outlays is little changed from December. The forecast for the repayment of English loans now makes greater use of Student Loans Company data, in addition to survey data, and also makes greater use of historic earnings data to project forward individuals' future earnings paths. These changes have widened the projected earnings distribution over time, which, since payments are only due over a particular threshold, has reduced our forecast for aggregate repayments. As a consequence, we now expect greater write-offs beyond our medium-term forecast horizon, and will update the longer-term projections in our next *FSR*, to be published in July.

4.163 Other loans include lending through the Department for International Development's contributions to multilateral development banks, loans to Ireland and a range of other Government schemes. Loans through a number of these schemes, including Help to Buy equity loans, have been lower than forecast in 2013-14 and some of this is expected to be made up in following years. The Government has announced in the Budget that it will extend Help to Buy equity loans beyond 2015-16, raising lending in later years. The Budget also extends lending via UK Export Finance, superseding the Autumn Statement 2012 provisions, which were not taken up by the private sector. We now include lending budgets for the Devolved Administrations, which raises the forecast in each year.

Accruals adjustments

4.164 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 more momentum in accrued receipts over the near term, and for this year's cash receipts to lag a little further behind.

4.165 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 broadly unchanged since December.

4.166 Similar timing adjustments are made for expenditure. The largest is for the timing of payments on index-linked gilts. These adjustments are very sensitive to RPI inflation, as well as to the profile of redemptions, which is not smooth. 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 December forecast, lower RPI inflation has reduced accrued debt interest, with an essentially 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.

4.167 Timing effects relating to other elements of cash spending are much more difficult to forecast. We therefore typically assume that the adjustment over the forecast period is equal to its historic average. The latest central government cash data are somewhat lower than our bottom-up forecasts for the cash requirement would imply and we have set a negative spending accrual of £7 billion to reconcile the two for 2013-14. This is likely to relate to unusual activity towards the end of 2012-13. The central government net cash requirement for March 2013 was over £7 billion higher than expected in our March 2013 *EFO*, but this seems to have unwound in subsequent months.

Transactions in financial assets

4.168 Consistent with the *Charter for Budget Responsibility*, and our wider approach to policy announcements, we only include the impact of financial asset sales or purchases once firm details are available that allow the effects to be quantified with reasonable accuracy. 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, but do not include any other asset sales over the forecast horizon. The loan book sale will reduce future repayments and interest paid to the Exchequer.

Other factors

4.169 Some of the cash transfers between the APF and the Exchequer in 2012-13 and 2013-14 have been treated as financial transactions, affecting the net cash requirement but not PSNB. The amount of cash being transferred this year is now expected to be a little higher than assumed in December.

4.170 The rundown of the Bradford & Bingley and Northern Rock (Asset Management) (B&B and NRAM) loan book reduces the net cash requirement directly, a small part of which also reduces net borrowing. The loan book has been wound down by more than previously expected in 2013-14, and the current plans also show a slightly quicker pace over the forecast period.

Central government net cash requirement

4.171 The other important cash measure is the central government net cash requirement (CGNCR). Table 4.37 shows how CGNCR relates to PSNCR and Table 4.38 sets out the changes in this relationship since the December forecast. The CGNCR is derived by adding or removing transactions that are associated with local authorities and public corporations from the PSNCR. Changes in the CGNCR forecast since December closely follow changes to our PSNCR forecast. We expect local authorities and public corporations to be net lenders from 2013-14 onwards.

4.172 The inclusion of B&B and NRAM 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.[17] Classifying B&B and NRAM within central government has two effects. First, the banks' own cash requirement is now included in headline CGNCR. Running down the banks' loan books reduces CGNCR by around £6 billion to £8 billion a year, but these do not directly affect the Exchequer. Secondly, some of these surpluses are used to make loan repayments to the Treasury which net off within the headline measure, but reduce the Exchequer's financing requirement. These loan repayments vary from around £3 billion to £5 billion a year. The net consequence is that the headline CGNCR is between £3 billion and £6 billion lower than the Exchequer's own financing requirement over the forecast period.

Table 4.37: Reconciliation of PSNCR and CGNCR

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net cash requirement (NCR)	**106**	**81**	**92**	**72**	**58**	**31**	**2**
of which:							
Local authorities and public corporations NCR	3	-2	-3	-3	-2	-2	-4
Central government (CG) NCR own account	104	83	95	75	60	34	5
CGNCR own account	104	83	95	75	60	34	5
Net lending within the public sector	1	0	1	2	2	2	2
CG net cash requirement	**105**	**83**	**96**	**76**	**61**	**35**	**7**
B&B and NRAM adjustment	5	4	4	5	6	3	3
CGNCR excl. B&B and NRAM	**110**	**87**	**101**	**81**	**67**	**38**	**10**

Table 4.38: Changes in the reconciliation of PSNCR and CGNCR since December

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net cash requirement (NCR)	**0**	**-12**	**3**	**-3**	**-5**	**-5**	**1**
of which:							
Local authorities and public corporations NCR	0	-1	1	0	0	0	0
Central government (CG) NCR own account	0	-12	3	-3	-5	-5	1
CGNCR own account	0	-12	3	-3	-5	-5	1
Net lending within the public sector	0	-2	-1	0	0	0	0
CG net cash requirement	**0**	**-14**	**2**	**-3**	**-5**	**-5**	**1**
B&B and NRAM adjustment	0	2	0	0	1	0	0
CGNCR excl. B&B and NRAM	**0**	**-12**	**2**	**-3**	**-4**	**-5**	**0**

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

Box 4.3: Fiscal impact of the financial interventions

We have certified the Treasury's approach for calculating the net loss or gain to the taxpayer of the interventions to stabilise the financial system. In particular, these are:

- equity injections into Royal Bank of Scotland (RBS), Lloyds Banking Group (LBG) and Northern Rock plc;
- the Asset Protection Scheme (APS);
- bank funding support through the Special Liquidity Scheme (SLS) and Credit Guarantee Scheme (CGS);
- holdings in Bradford & Bingley (B&B) and Northern Rock Asset Management (NRAM); and
- other loans through the Financial Services Compensation Scheme (FSCS), various wholesale and depositor guarantees and a contingent capital facility (CCF).

The APS, SLS and CGS have now closed, with net gains to the Exchequer of £5.0 billion, £2.3 billion and £4.3 billion respectively. Fees relating to the RBS CCF, which was closed in December 2013, and to underwrite the RBS and LBG share purchases add a further £1.3 billion and £0.7 billion respectively. These figures have been captured in PSNB.

The Treasury paid £66 billion for shares in the two banks. The market value of the shares at the time of purchase was £53 billion, with the difference of £12.4 billion added to PSND. This treatment is expected to change once the conclusions of the PSF Review are implemented (see Annex B). This market value includes an estimate for the value of the Dividend Access Share (DAS) in RBS, which gives the Treasury enhanced dividends rights if RBS were to pay dividends on ordinary shares, as long as the share price remains below 650p. Changes in the market prices of the Government's shareholdings in RBS and LBG are not reflected in PSNB and PSND until shares are sold. The Treasury sold £3.2 billion of LBG shares in September 2013, at a price above their implied value on the public sector balance sheet (but only fractionally more than it paid for them), reducing PSND by £0.6 billion. Excluding the DAS, the value of the shares sold, plus the latest volume-weighted average market prices for the remaining shares, imply a total loss of £15.6 billion on the equity shares, close to the implied loss of £15.3 billion reported in December, as LBG's share price has risen, but RBS' has fallen.

Following its review of RBS, the Treasury announced it is in advanced negotiations to simplify the bank's capital structure by retiring the DAS. The DAS is valued at £1.5 billion in the Treasury's latest accounts. This value is uncertain as the DAS is not traded.

The Treasury continue to assume that the other interventions, including holdings in B&B and NRAM, will not materially affect the aggregate loss or gain. Although the Exchequer is expected to recover its support for B&B and NRAM in cash terms, there may be a net present value cost once risk and the delay in proceeds are considered.

Overall, their approach implies an estimated direct loss to the taxpayer on the financial interventions of £0.6 billion, including the DAS and underwriting fees. If all interventions were financed through debt, the Treasury estimate that additional debt interest costs would have totalled £18.4 billion over the five and a half years to date.

The key fiscal aggregates

4.173 Our central forecast for the key fiscal aggregates is presented in Table 4.39. It incorporates the forecasts for receipts, expenditure and financial transactions set out earlier in this chapter. Detailed tables of the fiscal aggregates and changes since December are presented at the end of this section. 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 useful for illustrating the reasons for changes since the previous forecast. We focus on public sector net borrowing excluding the effects of transfers between the APF and the Exchequer;

- 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 surplus on the current budget adjusted to reflect the estimated impact of fluctuations in the economic cycle. It represents an estimate of the underlying or 'structural' surplus on the 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 also the fiscal measure used for the Government's supplementary fiscal target.

4.174 Table 4.39 shows our latest forecast for some of the key fiscal aggregates. The public finances are often affected by one-off items or other factors that it can be useful to strip out to assess underlying fiscal trends. Table 4.40 provides outturn and, where relevant, forecasts for the key special factors affecting PSNB. In this *EFO*, we have focused on PSNB excluding the impact of the one-off Royal Mail Pension Plan transfer in 2012-13 and the flow of cash transfers between the Exchequer and the APF across the forecast period. We have described this as 'underlying PSNB', though as the table shows, there are a number of other factors that it might be appropriate to strip out of the headline PSNB measure to assess underlying fiscal trends.

Table 4.39: Selected 'underlying' fiscal aggregates

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Receipts and expenditure							
Public sector current receipts[1] *(a)*	37.4	37.0	37.0	37.4	37.8	38.0	38.1
Total managed expenditure[1] *(b)*	44.7	43.5	42.5	41.6	40.2	38.8	37.8
of which:							
Public sector current expenditure[1] *(c)*	41.8	40.6	39.5	38.7	37.3	36.1	35.2
Public sector net investment[1] *(d)*	1.5	1.5	1.6	1.5	1.5	1.3	1.3
Depreciation[1] *(e)*	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing[1] *(b-a)*	7.3	6.6	5.5	4.2	2.4	0.8	-0.2
Surplus on current budget[1] *(a-c-e)*	-5.9	-5.1	-3.9	-2.7	-0.9	0.5	1.5
Cyclically-adjusted surplus on current budget[1]	-3.9	-3.6	-2.9	-1.9	-0.4	0.7	1.5
Cyclically-adjusted net borrowing[1]	5.3	5.0	4.5	3.4	1.9	0.6	-0.3
Primary balance[1]	-4.7	-4.0	-2.9	-1.4	0.5	2.1	3.2
Cyclically-adjusted primary balance[1]	-2.8	-2.5	-1.9	-0.6	1.0	2.3	3.2
	£ billion						
Public sector net borrowing[1]	114.8	107.8	95.5	75.2	44.5	16.5	-4.8
Surplus on current budget[1]	-91.9	-83.7	-67.6	-48.4	-16.7	9.6	30.5
Cyclically-adjusted surplus on current budget[1]	-60.9	-58.4	-49.6	-34.5	-7.0	13.9	31.3
Cyclically-adjusted net borrowing[1]	83.8	82.6	77.5	61.3	34.7	12.1	-5.6
Primary balance[1]	-74.5	-65.6	-50.4	-24.8	9.0	41.3	64.4
Cyclically-adjusted primary balance[1]	-43.5	-40.3	-32.4	-11.0	18.7	45.7	65.2

[1]Excluding Royal Mail and APF transfers.

Table 4.40: Special factors affecting public sector net borrowing

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing	80.3	95.6	83.9	68.3	41.5	17.8	-1.1
Special factors:							
Royal Mail	-28.0						
APF	-6.4	-12.2	-11.6	-6.9	-2.9	1.3	3.7
B&B and NRAM	-0.2	-0.6	-0.7	-0.9	-1.0	-1.1	-1.0
4th Generation Spectrum proceeds	-2.3						
Special liquidity scheme fees	-2.3						
Swiss Capital Tax		-0.9					

Public sector net borrowing

4.175 Underlying PSNB is estimated to have fallen from its post-war peak of £157.3 billion, or 11.0 per cent of GDP, in 2009-10 to £117.4 billion (7.6 per cent of GDP) in 2011-12. This fall was driven by the recovery of the economy from the trough of the 2009 recession, the

withdrawal of the temporary stimulus measures put in place by the previous Government, and by the current Government's fiscal consolidation plans.

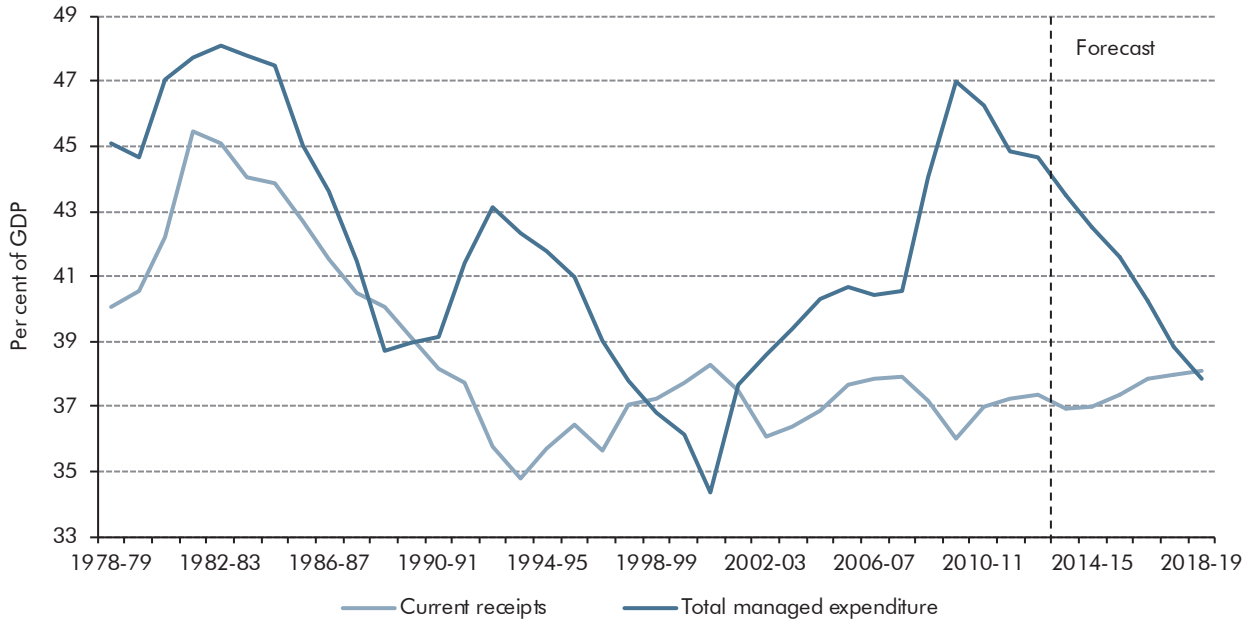
4.176 In 2012-13, the downward path of underlying PSNB slowed, with borrowing falling by only £2.6 billion as the recovery failed to take hold and the impact of high inflation in 2011 fed through to the public finances. Borrowing is forecast to fall again this year – by £7.0 billion – before resuming a more rapid decline averaging £22.5 billion a year from 2014-15 to 2018-19. As a result, underlying PSNB is forecast to show a small surplus in 2018-19 of £4.8 billion (0.2 per cent of GDP).

4.177 The 11.2 per cent of GDP reduction in underlying PSNB forecast between 2009-10 and 2018-19 would represent one of the largest deficit reductions among advanced economies in the post-war period. As Charts 4.6 and 4.7 show, the contributions to the reduction would be:

- 9.2 per cent of GDP, just over 80 per cent of the deficit reduction, from lower expenditure, with TME falling from 47.0 per cent of GDP in 2009-10 to 37.8 per cent of GDP by 2018-19. Within this total:
  - PSCE in RDEL, a proxy for day-to-day spending on public services and administration, falls by 7.7 per cent of GDP, from 21.8 of GDP in 2009-10 to 14.2 per cent in 2018-19, as shown in Chart 4.4. This is mirrored in our GDP forecast, where government consumption of goods and services falls from 23.2 per cent of nominal GDP in 2009 to 16.1 per cent by the end of the forecast, its lowest at least since 1948;[18]
  - PSGI in CDEL, public sector gross investment, falls by 1.6 per cent of GDP, from 3.5 per cent in 2009-10 to 1.9 per cent in 2018-19. In 2007-08, PSGI in CDEL was 2.7 per cent of GDP; and
  - social security spending falls by 1.1 per cent of GDP, from 11.1 per cent of GDP to 10.0 per cent in 2018-19, approaching its pre-crisis level.[19]
- 2.0 per cent of GDP from higher receipts, with the majority of the increase having taken place by 2012-13, largely as a result of the increases in the standard rate of VAT. This is followed by further increases towards the end of our forecast due to the resumption of fiscal drag, as above-inflation earnings growth pushes more income into higher tax brackets, and strong growth in capital taxes like stamp duty and inheritance tax (see Box 4.2).

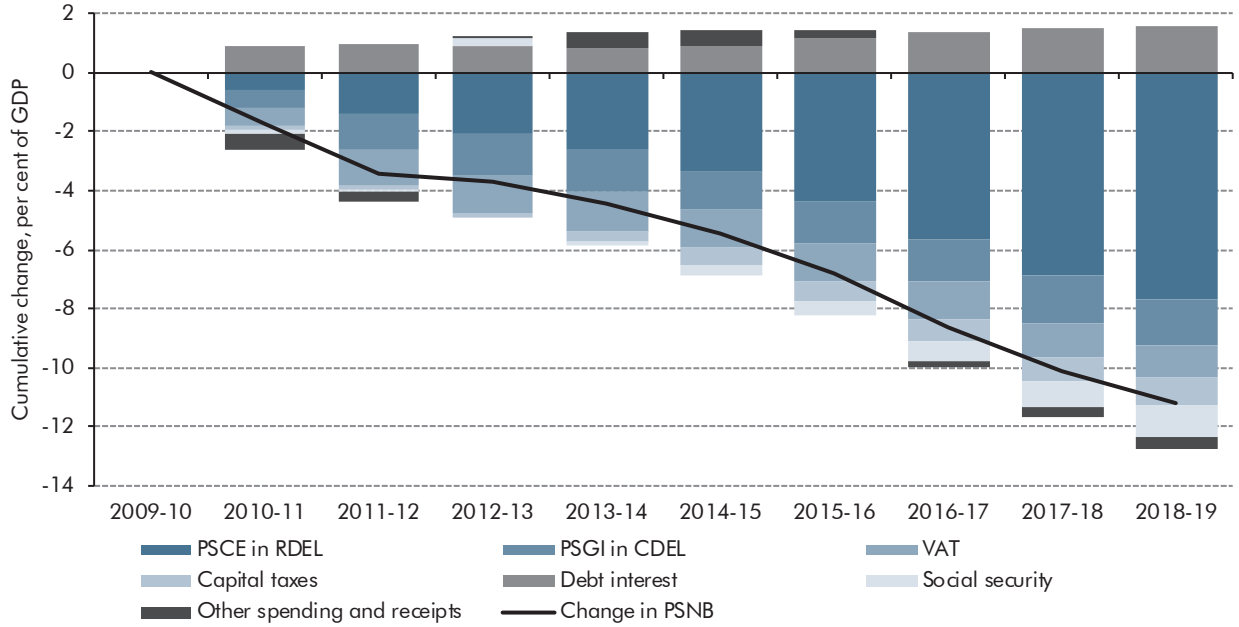
[18] In outturn, includes council tax benefit and excludes the local share of business rates consistent with current budgeting treatment.
[19] In outturn, excludes council tax benefit consistent with current budgeting treatment.

Chart 4.6: Total public sector spending and receipts



Source: ONS, OBR. Excludes Royal Mail and APF transfers.

Chart 4.7: Sources of deficit reduction



Source: ONS, OBR. Excludes Royal Mail and APF transfers.

Public sector net borrowing in 2013-14: changes since December

4.178 We have revised our forecast for underlying PSNB in 2013-14 down by £3.4 billion relative to our December forecast. With no change in our estimate of APF transfers to the Exchequer in 2013-14, the same revision applies to our forecast of headline PSNB. Table 4.41 shows that these downward revisions are driven by the following factors:

- a £1.1 billion upward revision to receipts, reflecting higher-than-expected revenues from onshore corporation tax, stamp duty land tax, income tax and NICs and VAT. This is offset by a lower estimate for capital gains tax and revenues from North Sea companies; and

- a £2.3 billion downward revision to spending, £1.1 billion of which is from lower debt interest and a similar amount from lower public corporations' capital expenditure.

Table 4.41: Changes to underlying PSNB since December

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing[1]						
December forecast	111.2	96.0	78.7	51.1	23.4	-2.2
March forecast	107.8	95.5	75.2	44.5	16.5	-4.8
Change	**-3.4**	**-0.6**	**-3.5**	**-6.6**	**-6.9**	**-2.6**
of which:						
Changes in the receipts forecast[1,2]	-1.1	-2.0	-3.5	-4.7	-4.0	-2.5
Changes in the spending forecast[1,2]	-2.3	0.9	-0.6	-1.7	-2.2	0.3
Receipts measures in the Treasury's policy decision table	0.0	0.0	0.6	1.8	1.4	1.7
Spending measures in the Treasury's policy decision table	0.0	0.5	-0.1	-2.0	-2.1	-2.1

[1] Excluding APF transfers.

[2] This includes the re-allocation of the policy measure for tax free childcare announced in Budget 2013. More information is available in our online supplementary fiscal tables.

Public sector net borrowing from 2014-15: changes since December

4.179 For future years we have revised down our PSNB forecast by £0.6 billion in 2014-15, rising to £6.9 billion in 2017-18 and falling again to £2.4 billion in 2018-19. Our forecast for the cash transfers between the APF and the Exchequer has changed only marginally since December, so the revisions to headline and underlying PSNB are of similar size. Table 4.41 shows that these downward revisions are driven by the following factors:

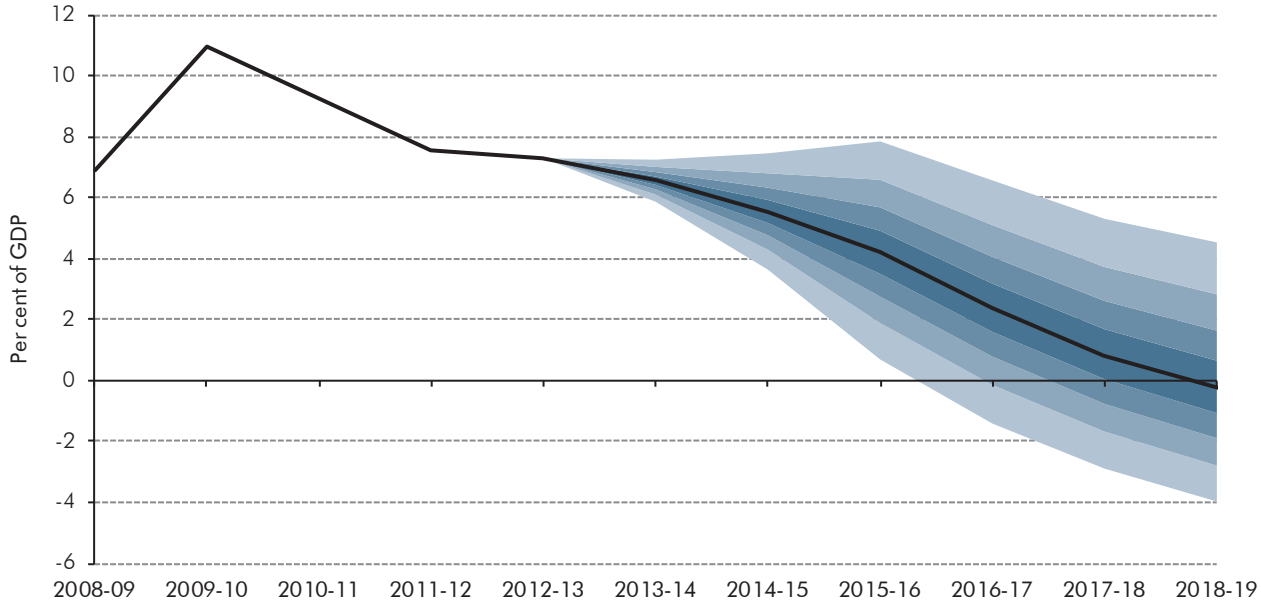
- higher receipts in each year of the forecast, with the revision increasing from £1.1 billion in 2013-14 to £4.0 billion in 2017-18. The upward revision to receipts slows in 2018-19 due to slower GDP and employment growth, once the output gap has closed;

- small changes to our forecast for spending in 2014-15 and 2015-16, followed by changes to spending from 2016-17 that reflect the Government's change to the baseline spending assumption and our revised GDP deflator forecast;

- the tax and spending measures that the Treasury has included in its Budget policy decisions table have little cumulative impact on borrowing over the forecast, with a £5½ billion cumulative net tax cut offset by a £5¾ billion cumulative reduction in spending.

4.180 All fiscal forecasts are subject to significant uncertainty. Chart 4.8 shows our central forecast for underlying PSNB with successive pairs of shaded areas around it, representing 20 per cent probability bands based in 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 be back to balance rises from 5 per cent in 2015-16 to 20 per cent in 2016-17, 40 per cent in 2017-18 and just over 50 per cent in 2018-19.

Chart 4.8: Underlying PSNB fan chart



Source: ONS, OBR. Excludes Royal Mail pension fund and APF transfers.

Current budget

4.181 Our central forecast shows the current budget moving from a deficit of £71.5 billion in 2013-14 (£83.7 billion excluding APF transfers) to a surplus of £30.5 billion in 2018-19. Relative to our December forecast, the current budget balance has improved by £2.6 billion in 2013-14, rising to £6.5 billion higher in 2017-18 and £2.5 billion in 2018-19. The drivers of the improvement in the current budget are similar to those for underlying PSNB described above.

Cyclically-adjusted current budget

4.182 The cyclically-adjusted current budget (CACB) moves from a deficit of 2.8 per cent of GDP in 2013-14 to a surplus of 1.5 per cent of GDP in 2018-19. We expect the CACB to move into surplus in 2017-18. As with cyclically-adjusted PSNB, the CACB is little changed on average over the forecast period. The CACB is discussed further in Chapter 5.

Public sector net debt

4.183 We forecast public sector net debt (PSND) to rise as a share of GDP in each year up to and including 2015-16, peaking at 78.7 per cent of GDP. It falls by a small margin in 2016-17 and more rapidly thereafter, reaching 74.2 per cent of GDP in 2018-19. PSND in 2018-19 is forecast to be 1.8 per cent of GDP lower than we forecast in December. Table 4.42 breaks this change down as follows:

- upward revisions to our nominal GDP forecast have reduced the ratio of the cash value of debt to GDP in each year, with the effect rising from 0.4 per cent of GDP in 2013-14 to 0.6 per cent of GDP in 2018-19; and

- our forecast for PSND in cash terms is lower by £10 billion in 2013-14, rising to £25 billion in 2018-19. In the near term, the largest effect is from the cash flow measure of borrowing this year being revised down by more than the headline measure of borrowing. In later years, cumulative revisions to net borrowing are more important, partially offset by Budget measures that increase lending.

Table 4.42: Changes to public sector net debt since December

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	73.9	75.5	78.3	80.0	79.9	78.4	75.9
March forecast	74.2	74.5	77.3	78.7	78.3	76.5	74.2
Change	**0.3**	**-1.0**	**-1.0**	**-1.2**	**-1.6**	**-1.9**	**-1.8**
of which:							
Change in nominal GDP[1]	0.1	-0.4	-0.5	-0.5	-0.6	-0.7	-0.6
Change in cash level of net debt	0.2	-0.6	-0.6	-0.7	-0.9	-1.2	-1.2
	£ billion						
December forecast	1182	1269	1365	1451	1515	1554	1573
March forecast	1185	1258	1355	1439	1497	1530	1548
Change in cash level of net debt	**3**	**-10**	**-10**	**-13**	**-18**	**-24**	**-25**
of which:							
Budget measures	0	0	1	2	4	6	8
Other changes in net borrowing	0	-4	-4	-8	-14	-21	-23
Other	3	-7	-6	-6	-8	-9	-9

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

Table 4.43: Headline fiscal aggregates

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Receipts and expenditure							
Public sector current receipts *(a)*	37.8	37.7	37.7	37.8	38.0	38.0	38.1
Total managed expenditure *(b)*	42.9	43.5	42.5	41.6	40.2	38.9	38.0
of which:							
Public sector current expenditure *(c)*	41.8	40.6	39.5	38.7	37.3	36.1	35.2
Public sector net investment *(d)*	-0.3	1.5	1.6	1.5	1.5	1.4	1.4
Depreciation *(e)*	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing *(b-a)*	5.1	5.8	4.9	3.8	2.2	0.9	-0.1
Surplus on current budget *(a-c-e)*	-5.4	-4.4	-3.3	-2.3	-0.7	0.5	1.5
Cyclically-adjusted net borrowing	3.1	4.3	3.8	3.0	1.7	0.7	-0.1
Primary balance	-3.0	-4.0	-2.9	-1.4	0.5	2.0	3.0
Cyclically-adjusted primary balance	-1.0	-2.5	-1.9	-0.6	1.0	2.2	3.0
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-3.5	-2.8	-2.2	-1.5	-0.2	0.7	1.5
Public sector net debt[1]	74.2	74.5	77.3	78.7	78.3	76.5	74.2
Financing							
Central government net cash requirement	6.7	5.1	5.6	4.3	3.3	1.8	0.3
Public sector net cash requirement	6.8	4.9	5.4	4.0	3.1	1.6	0.1
Stability and Growth Pact							
Treaty deficit[2]	5.2	6.0	5.0	4.0	2.4	1.1	0.1
Cyclically-adjusted Treaty deficit	3.2	4.4	4.0	3.2	1.8	0.9	0.1
Treaty debt ratio[3]	88.3	89.6	91.8	93.1	91.9	89.4	86.6
				£ billion			
Public sector net borrowing	80.3	95.6	83.9	68.3	41.5	17.8	-1.1
Surplus on current budget	-85.5	-71.5	-56.0	-41.2	-13.8	10.0	30.5
Cyclically-adjusted net borrowing	49.3	70.4	65.9	54.4	31.8	13.5	-1.9
Cyclically-adjusted surplus on current budget	-54.5	-46.3	-38.0	-27.3	-4.1	14.4	31.3
Public sector net debt	1185	1258	1355	1439	1497	1530	1548
Memo: Output gap (per cent of GDP)	*-2.8*	*-2.0*	*-1.3*	*-1.0*	*-0.6*	*-0.2*	*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.

Table 4.44: Changes to the fiscal forecast

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Surplus on current budget[1]							
June 2010 forecast	-65.1	-40.2	-16.9	0.4			
December 2013 forecast	-92.8	-86.3	-68.3	-51.4	-22.8	3.1	28.0
Change	*0.9*	*2.6*	*0.7*	*3.0*	*6.1*	*6.5*	*2.5*
March 2014 forecast	-91.9	-83.7	-67.6	-48.4	-16.7	9.6	30.5
Net investment[1]							
June 2010 forecast	24.0	19.9	20.6	20.9			
December 2013 forecast	22.2	24.9	27.7	27.3	28.3	26.5	25.7
Change	*0.7*	*-0.8*	*0.2*	*-0.5*	*-0.5*	*-0.4*	*-0.1*
March 2014 forecast	22.9	24.1	27.9	26.8	27.7	26.1	25.7
Net borrowing[1]							
June 2010 forecast	89.1	60.1	37.5	20.5			
December 2013 forecast	115.0	111.2	96.0	78.7	51.1	23.4	-2.2
Change	*-0.2*	*-3.4*	*-0.6*	*-3.5*	*-6.6*	*-6.9*	*-2.6*
March 2014 forecast	114.8	107.8	95.5	75.2	44.5	16.5	-4.8
Net debt							
June 2010 forecast	1162	1235	1284	1316			
December 2013 forecast	1182	1269	1365	1451	1515	1554	1573
Change	*3*	*-10*	*-10*	*-13*	*-18*	*-24*	*-25*
March 2014 forecast	1185	1258	1355	1439	1497	1530	1548
	Per cent of GDP						
Net borrowing[1]							
June 2010 forecast	5.5	3.5	2.1	1.1			
December 2013 forecast	7.3	6.8	5.6	4.4	2.7	1.2	-0.1
Change	*0.0*	*-0.2*	*-0.1*	*-0.2*	*-0.4*	*-0.4*	*-0.1*
March 2014 forecast	7.3	6.6	5.5	4.2	2.4	0.8	-0.2
Cyclically-adjusted surplus on current budget[1]							
June 2010 forecast	-1.9	-0.7	0.3	0.8			
December 2013 forecast	-4.1	-3.7	-2.7	-1.8	-0.4	0.7	1.6
Change	*0.2*	*0.1*	*-0.2*	*-0.2*	*0.0*	*0.0*	*0.0*
March 2014 forecast	-3.9	-3.6	-2.9	-1.9	-0.4	0.7	1.5
Cyclically-adjusted net borrowing[1]							
June 2010 forecast	3.4	1.8	0.8	0.3			
December 2013 forecast	5.5	5.2	4.3	3.3	1.9	0.7	-0.3
Change	*-0.1*	*-0.2*	*0.2*	*0.1*	*0.0*	*-0.1*	*0.0*
March 2014 forecast	5.3	5.0	4.5	3.4	1.9	0.6	-0.3
Net debt[2]							
June 2010 forecast	69.8	70.3	69.4	67.4			
December 2013 forecast	73.9	75.5	78.3	80.0	79.9	78.4	75.9
Change	*0.3*	*-1.0*	*-1.0*	*-1.2*	*-1.6*	*-1.9*	*-1.8*
March 2014 forecast	74.2	74.5	77.3	78.7	78.3	76.5	74.2

[1] Excluding APF and Royal Mail pension fund transfers.

[2] Debt at end March; GDP centred on end March.

International comparisons

4.184 International organisations, such as the European Commission and 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 4.45 and 4.46 provide UK forecasts on a comparable basis. With both modelling and reporting of much tax and spend done primarily on a financial year basis, the calendar year forecasts are illustrative and have been derived by weighting the financial year forecasts.

Table 4.45: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit[1]			Treaty Debt[2]		
	2013	2014	2015	2013	2014	2015
UK (March *EFO*)	5.7	5.5	4.2	90.1	91.2	92.8
UK (EC)	6.3	5.2	4.2	91.4	93.4	94.5
Germany	0.1	0.0	0.0	79.6	77.3	74.5
France	4.2	4.0	3.9	93.9	96.1	97.3
Italy	3.0	2.6	2.2	132.7	133.7	132.4
Spain	7.2	5.8	6.5	94.3	98.9	103.3
Euro area	3.1	2.6	2.5	95.5	95.9	95.4

[1] General government net borrowing.

[2] General government gross debt.

Source: European Commission, *European Economic Forecast*, Winter 2014; OBR

Table 4.46: Comparison with the IMF forecasts

	Per cent of GDP					
	General government net borrowing			General government net debt		
	2013	2014	2017	2013	2014	2017
UK (March *EFO*)	5.7	5.5	1.4	81.4	82.8	82.4
UK (IMF)	6.1	5.8	2.7	84.8	88.0	90.9
Germany	0.4	0.1	-0.2	56.3	54.6	50.8
France	4.0	3.5	1.2	87.2	88.5	85.4
Italy	3.2	2.1	0.5	110.5	111.2	105.4
Japan	9.5	6.8	5.1	139.9	141.8	147.2
U.S.	5.8	4.7	3.8	87.4	88.3	86.6

Source: OBR, IMF, *World Economic Outlook*, October 2013

5 Performance against the Government's fiscal targets

Introduction

5.1 This chapter:

- sets out the Government's medium-term fiscal targets (from paragraph 5.2);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.6); and
- assesses how robust this judgement is 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 5.14).

The Government's fiscal targets

5.2 In the June 2010 Budget, the Government set itself two medium-term fiscal targets for the current Parliament: the fiscal mandate and a supplementary target. The OBR is required to judge whether the Government has a greater than 50 per cent probability of hitting these targets under existing policy.

5.3 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 to at least 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 2018-19.

5.4 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.*" The target refers to public sector net debt (PSND) excluding the temporary effects of financial interventions.

5.5 From our autumn 2014 forecast, we will also assess the Government's performance against its new welfare cap, which is described in Chapter 4.

The implications of our central forecast

5.6 Table 5.1 shows our central forecasts for the cyclically-adjusted current budget (CACB) and PSND in each year to 2018-19, as set out in Chapter 4. These are median forecasts, so we believe it is equally likely that the eventual 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					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
CACB							
December forecast	-3.6	-2.9	-2.0	-1.4	-0.2	0.7	1.6
March forecast excluding Budget measures[1]	-3.5	-2.8	-2.2	-1.5	-0.2	0.7	1.5
March forecast	-3.5	-2.8	-2.2	-1.5	-0.2	0.7	1.5
CACB excluding APF[1]							
December forecast	-4.1	-3.7	-2.7	-1.8	-0.4	0.7	1.6
March forecast excluding Budget measures[1]	-3.9	-3.6	-2.9	-1.9	-0.4	0.7	1.5
March forecast	-3.9	-3.6	-2.9	-1.9	-0.4	0.7	1.5
PSND							
December forecast	73.9	75.5	78.3	80.0	79.9	78.4	75.9
March forecast excluding Budget measures[1]	74.2	74.5	77.2	78.7	78.1	76.3	73.8
March forecast	74.2	74.5	77.3	78.7	78.3	76.5	74.2
PSND excluding APF, B&B and NRAM[1]							
December forecast	69.9	74.4	78.3	80.8	81.2	80.0	77.6
March forecast excluding Budget measures[1]	70.1	73.6	77.4	79.7	79.6	78.1	75.7
March forecast	70.1	73.6	77.5	79.8	79.8	78.4	76.1

[1] These remove the direct effects. No account is taken of indirect effects, including the impact on debt interest payments.

5.7 Table 5.1 shows that in the absence of Budget measures, our central forecast would show the CACB in surplus by 1.5 per cent of GDP in 2018-19, fractionally less than we forecast in December. This remains unchanged after Budget measures are taken into account, so there remains a significantly greater than 50 per cent chance of the Government achieving balance on this measure in that year. As a result, it is still on course to achieve the mandate.

5.8 Table 5.2 decomposes the changes in our forecasts of CACB since December. It shows that:

- setting a spending assumption that extends the real cuts over the Spending Review period from a higher baseline in 2010-11 reduces structural non-investment spending by around 0.2 per cent of GDP in 2017-18 and 2018-19. (The Treasury treats this as a change to the pre-measures baseline, so does not report the additional tightening in its table of policy measures);

- measures appearing in the Treasury's Budget decisions table are broadly neutral in each year, adding a little to the surplus in the final year. This includes 0.1 per cent of

GDP by 2018-19 of further spending reductions, over and above the effect of the change to the spending assumption; and

- these decisions broadly offset other forecasting changes beyond 2016-17. These reduce the CACB by around 0.2 per cent of GDP on average over the next five years, largely due to receipts being slightly lower as a share of GDP despite a narrower output gap.

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

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	-3.6	-2.9	-2.0	-1.4	-0.2	0.7	1.6
March forecast	-3.5	-2.8	-2.2	-1.5	-0.2	0.7	1.5
Change	**0.2**	**0.1**	**-0.2**	**-0.2**	**0.0**	**0.0**	**0.0**
of which:							
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Baseline spending assumption	0.0	0.0	0.0	0.0	0.1	0.2	0.2
Other forecasting changes	0.2	0.1	-0.2	-0.2	-0.1	-0.2	-0.3

5.9 The supplementary target requires PSND to fall as a share of GDP between 2014-15 and 2015-16, with this target year fixed. Our December forecast was for PSND to rise by 1.7 per cent of GDP in that year. We now expect PSND to rise more gradually over the next three years, but a smaller rise of 1.5 per cent of GDP in 2015-16 means that the Government is still 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 in 2015-16, as in December, but then to fall by a bigger margin in 2016-17, of around 0.5 per cent of GDP.

5.10 As Table 5.1 shows, excluding the APF transfers and the rundown of Bradford & Bingley and Northern Rock (Asset Management) (B&B and NRAM) assets, net debt would remain flat as a share of GDP in 2016-17, before falling a year later in 2017-18.

5.11 Table 5.3 decomposes changes in the profile of net debt as a share of GDP since December. This shows that:

- changes in our forecast for nominal GDP affect the denominator we use to calculate PSND as a share of GDP. Stronger nominal GDP growth slows the rise in PSND out to 2016-17, while our forecast that the output gap will closer earlier lowers growth in the final year, having the opposite effect;

- net borrowing is lower in each year of the forecast horizon, largely due to the cyclical recovery in receipts and further cuts to spending after the current Spending Review period. As borrowing now falls more quickly than in our December forecast, debt rises more slowly and then falls more rapidly as a share of GDP in 2016-17 and 2017-18;

- Budget measures that increase lending raise net debt over the period; and

- other changes lead to net debt falling by an additional 0.6 per cent of GDP in 2013-14, but have little effect in subsequent years. The cash flow measure of borrowing this year has been revised down by more than the headline measure, which appears to relate to an unusual pattern in 2012-13 that is now unwinding.

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

	Change in PSND on a year earlier (per cent of GDP)					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
December forecast	1.6	2.8	1.7	-0.1	-1.4	-2.5
March forecast	0.3	2.7	1.5	-0.5	-1.7	-2.4
Change	**-1.3**	**0.0**	**-0.2**	**-0.4**	**-0.3**	**0.1**
of which:						
Nominal GDP	-0.5	-0.1	-0.1	-0.1	0.0	0.0
Budget measures	0.0	0.1	0.0	0.1	0.1	0.1
Other changes in net borrowing	-0.2	-0.1	-0.2	-0.3	-0.3	-0.1
Other	-0.6	0.1	0.0	-0.1	-0.1	0.0

5.12 Over the coming months, the ONS will implement significant revisions to the public finances, as it takes on board the conclusions from its review of the public finance statistics and changes associated with the 2010 European System of Accounts (ESA10). For this *EFO*, our forecasts are presented on the existing basis, and we discuss the possible implications of future revisions in Annex B.

5.13 As shown in Table 5.4, the forthcoming changes to the public finances data are unlikely to have a significant impact on the measured CACB at the end of the forecast horizon, and thus on the Government's chances of meeting the fiscal mandate. But even though the measured level of net debt will be significantly higher after the revisions, the chances of it falling in 2015-16 are likely to be greater if the APF starts selling gilts before the end of 2015-16, as assumed in our central forecast – although still not greater than 50 per cent. Debt would also fall more steeply if the Government was to sell more of the shares that it purchased as a result of financial interventions. This does not feature in our central forecast, given uncertainties over the potential scale and timing of such sales.

Table 5.4: Illustrative CACB and PSND post-PSF Review and ESA10

	Per cent of GDP					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Central forecast						
CACB	-2.8	-2.2	-1.5	-0.2	0.7	1.5
PSND	74.5	77.3	78.7	78.3	76.5	74.2
Year-on-year change in PSND	0.3	2.7	1.5	-0.5	-1.7	-2.4
Implied forecast post-PSF Review and ESA10[1]						
CACB	-2.7	-2.2	-1.4	-0.1	0.8	1.5
PSND	79.4	82.0	83.1	82.3	80.1	77.3
Year-on-year change in PSND	1.0	2.6	1.1	-0.9	-2.1	-2.8

[1] The possible implications for debt and deficit measures are discussed in Annex B. ESA10 nominal GDP has been adjusted by the mid-point of ONS's 2½ to 5 per cent range.

Recognising uncertainty

5.14 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.

5.15 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet the mandate in 2018-19, but not on course to meet the supplementary target in 2015-16. 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.

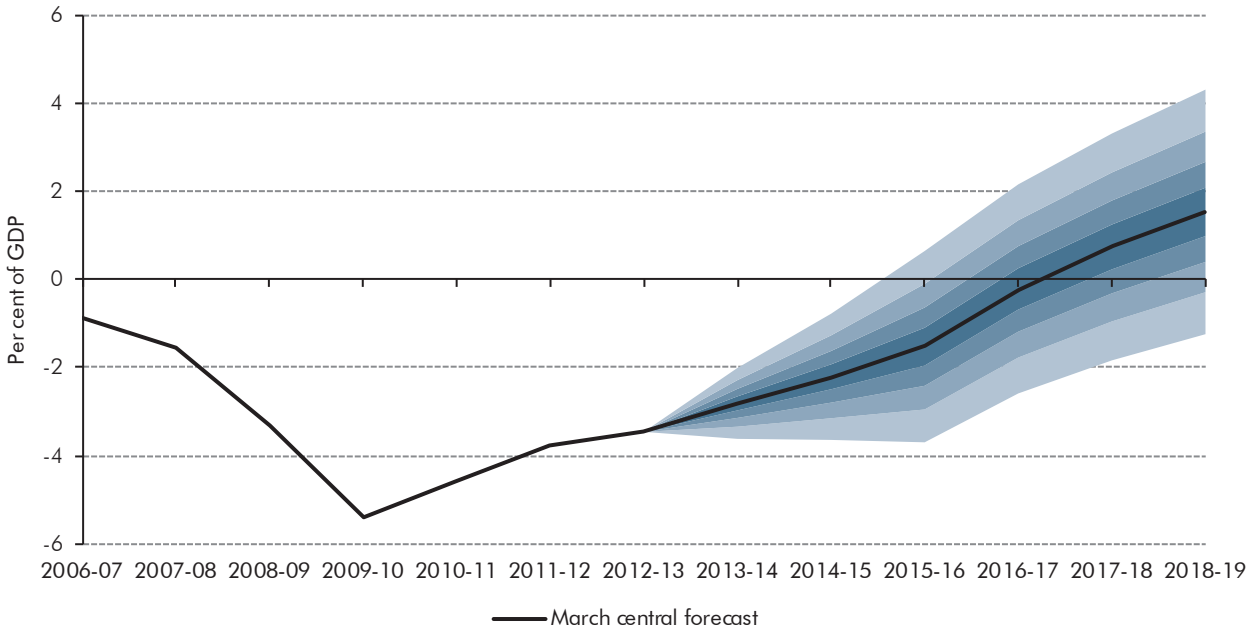
Past performance

5.16 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 underlying 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 forecast errors in the future.

5.17 In this spirit, Chart 5.1 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 5.1: Cyclically-adjusted current budget fan chart



Source: OBR

5.18 A direct reading of the chart would imply that the Government currently has a roughly 75 per cent probability of achieving a surplus on the CACB in 2018-19 and thereby meeting the mandate. The probability of achieving a cyclically-adjusted current surplus in earlier years is lower at around 65 per cent for 2017-18, 45 per cent for 2016-17 and 20 per cent for 2015-16.

5.19 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. That said, our central median forecast shows PSND rising as a percentage of GDP in 2015-16.

Sensitivity analysis

5.20 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.

5.21 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 four:

- the level of potential output, captured by the size of the output gap;

- the speed with which the output gap closes (i.e. the pace of the recovery);
- the interest rates that the Government has to pay on its debt; and
- possible errors in our cyclical adjustment coefficients.

5.22 Our central forecast is based on a judgement that the economy was running 1.7 per cent below potential in the final quarter of 2013, and that above-trend growth over the forecast period will close the output gap by mid-2018, around a year earlier than in December. 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 we can observe 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 than our central estimates?

5.23 Tables 5.5 and 5.6 present illustrative estimates of the impact on:

- the level of the CACB in 2018-19; and
- the change in PSND as a share of GDP between 2014-15 and 2015-16.

5.24 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.

5.25 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 2018-19

	Per cent of GDP				
	Output gap closes				
	2014-15	2016-17	2018-19	2020-21	2022-23
Level of potential in 2018-19 relative to central forecast					
-2	0.1	0.1	0.1	0.1	0.1
-1	0.8	0.8	0.8	0.8	0.8
0	1.5	1.5	1.5	1.5	1.5
1	2.3	2.3	2.3	2.2	2.2
2	3.0	3.0	3.0	3.0	3.0

Table 5.6: Change in public sector net debt between 2014-15 and 2015-16

		Per cent of GDP				
		Output gap closes				
		2014-15	2016-17	2018-19	2020-21	2022-23
Level of potential in 2018-19 relative to central forecast	-2	2.3	2.3	2.2	2.2	2.2
	-1	1.6	1.6	1.9	2.0	2.0
	0	0.9	0.8	1.5	1.7	1.9
	1	0.2	0.0	1.0	1.5	1.7
	2	-0.5	-0.8	0.6	1.2	1.3

5.26 Table 5.5 shows that the level of potential output has a big effect on the size of the CACB balance in 2018-19. 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.

5.27 Closing the output gap at a different pace would typically result in a change in cyclical borrowing, but have little effect on the structural balance. For example, closing the output gap more slowly would result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.

5.28 In broad terms, the level of potential output would need to be over 2 per cent lower in 2018-19 than in our central forecast to make it more likely than not that the mandate would be missed. As set out in Chapter 3, projections of potential output vary considerably.

5.29 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.

5.30 A third potential source of departure from our central forecast is variation in the interest rates that the Government has to pay on future borrowing and some existing debt. Our central forecast assumes that gilt rates for future borrowing move in line with market expectations. But what if a shock meant that those expectations were to prove wrong? We examine the implications of a negative shock of 50 basis points, making debt cheaper to service, and increases of 50, 100, 150 and 200 basis points, making it more expensive. For this analysis, we assume that the shock does not affect any other part of the forecast, including exchange rates and shorter-term interest rates. In reality, a gilt rate shock would be accompanied by other important changes in the economy. Table 5.7 shows the level of the CACB in 2018-19 and the change in PSND as a share of GDP between 2014-15 and 2015-16 under these variants, constructed using a ready-reckoner.

Table 5.7: Fiscal target variables under different gilt rate assumptions

	Per cent of GDP					
	Change in gilt rate (bps)					
	-50	0	50	100	150	200
CACB in 2018–19	1.7	1.5	1.4	1.2	1.0	0.5
Change in PSND between 2014–15 and 2015–16	1.4	1.5	1.5	1.6	1.7	1.7

5.31 Table 5.7 shows that these illustrative shocks to gilt rates have a relatively small impact on the chances of meeting the mandate and supplementary target. This is because an increase in rates only applies to new debt issuance. Since the UK has a relatively long average debt maturity for conventional gilts, 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.

5.32 Gilt rates will also affect transfers between the Exchequer and the APF as gilts are sold. If gilt rates were higher, bond prices would be lower and so capital losses for the APF would be greater. But as gilts are assumed to be sold from late in 2015-16, a gilt rate shock would have only a small effect on our assessment of the supplementary target through this channel, and no effect on the CACB in 2018-19, as transfers from the Exchequer to the APF are classified as capital spending. The treatment of the APF flows within the public finance statistics will change later this year (see Annex B).

5.33 Our final sensitivity analysis concerns uncertainty around our cyclical adjustment coefficients. 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. Our approach to cyclical adjustment applies coefficients of 0.2 for the previous year's output gap and 0.5 for the current year's gap, as described in a Working Paper available on our website.[1]

5.34 The coefficients are derived by analysing the past relationship between the output gap and the fiscal position. They are highly uncertain for a number of reasons:

- the output gap is not directly observable, so there is no historical 'fact' from which to estimate the coefficients;
- the number of observations on which to base coefficient estimates is limited;
- 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

[1] Helgadottir et al, 2012, Working Paper No. 4: *Cyclically adjusting the public finances.*

- 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.

5.35 Given these uncertainties, it is useful to consider how sensitive our central forecast is to variations in the coefficients. Our latest forecast is for the headline current budget balance to move into surplus in 2017-18, improving further to 1.5 per cent of GDP in 2018-19. If the economy is operating either at or below its potential over that period, as in our central forecast, then varying the coefficients would not affect our judgement that the fiscal mandate will be met, although it could affect the margin for error around it. Our current forecast of a very small negative output gap in 2017-18, which closes in the first quarter of 2018-19, implies that applying different coefficients would have very little impact on the CACB in that year. If the coefficients were reduced by 0.1, to 0.4 on the current year's output gap and 0.1 on the previous year's output gap, the CACB would be less than 0.1 per cent of GDP lower in 2018-19.

Scenario analysis

5.36 The sensitivity analysis discussed above focuses on a narrow set of 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.

5.37 One current topic of debate is the path for mortgage rates over the medium term, and their possible impact on households' ability to service their debts. Our central forecast assumes effective mortgage rates rise gradually over the forecast period, and more slowly than Bank Rate, as the lagged effects of previous falls in new mortgage rates feed through to the stock of mortgages, and competition bears down on margins.

5.38 Since our December forecast, some emerging market economies have experienced significant capital outflows and accompanying currency depreciations. This volatility seems to reflect country-specific factors, and our central forecast assumes that the impact of the recent instability is short lived.

5.39 Here we examine two scenarios:

- a 'higher credit spreads' scenario, in which banks' funding costs spike up, which is one channel along which continued volatility in emerging markets could affect the UK; and

- a 'stronger demand' scenario, which could push up interest rates in the wider economy due to a steeper path for Bank Rate, as the Bank of England reacts to stronger growth in incomes and a narrower output gap.

Higher credit spreads scenario

5.40 In this scenario, emerging market instability spills over to global financial markets. This places upward pressure on banks' funding costs that soon push domestic interest rates in the wider economy above our central forecast. The key assumptions and implications of this scenario are:

- banks' marginal funding costs rise by around 150 basis points in mid-2014, and remain elevated for a year. Such a credit shock would be of a similar duration and magnitude to events towards the end of 2011 and in 2012, linked to tensions in the euro area;

- the profile for Bank Rate remains unchanged, so these higher funding costs are passed on to the wider economy. However, the shock affects only the price of credit – the cost of new borrowing for households and businesses – and not its availability, so in that respect it is unlike the withdrawal of credit witnessed in 2008;

- higher new borrowing rates gradually push up effective interest rates, which means that, in aggregate, household interest payments account for a bigger share of disposable income. And disposable income is itself weaker, as GDP growth slows. Substantially more households are pushed to respond, by reducing consumption, restructuring debt or seeking more work (see Box 3.5), illustrating the potential result of mortgage rates rising due to factors other than income growth;

- higher risk premia slow growth of the capital stock and impair the reallocation of resources, reducing trend output, so that only half of the GDP shortfall is recovered in later years;

- weaker growth depresses receipts, and raises unemployment-related spending. Higher mortgage interest payments displace some consumption that would otherwise be subject to VAT, and also increase the RPI-CPI wedge, which raises debt interest on index-linked gilts. Applying the Government's spending assumption for the years beyond the current Spending Review period effectively pushes through the additional spending on welfare and debt interest in 2015-16; and

- both lower receipts and higher spending increase net borrowing in each year. Structural borrowing is higher in the final year, reflecting lower potential output and that the higher cyclical spending is locked in due to the spending assumption. The Government would meet its fiscal mandate, but with a smaller margin, and miss its supplementary target by a wider margin.

Stronger demand scenario

5.41 In this scenario, interest rates in the wider economy pick up faster than in our central forecast because demand picks up by more than we expect. The key assumptions and implications of this scenario are:

- GDP grows faster over the coming two years, continuing quarterly growth rates seen in recent quarters, prompting the output gap to close earlier and then temporarily turn positive;

- this means medium-term inflation is higher relative to the central forecast and so Bank Rate rises earlier, and the yield curve is steeper. This feeds through to higher mortgage rates, with the overall increase comparable to the higher credit spreads scenario. But the rise is more gradual, and the additional mortgage payments are more than matched by higher incomes, so that fewer households are pushed to change their spending behaviour significantly;

- the stronger recovery boosts receipts growth. Spending is lower up to 2015-16 as lower welfare spending outweighs higher spending on debt interest (due to higher RPI inflation), but the total is above our central forecast thereafter, as it is linked to general economy inflation via the spending assumption; and

- net borrowing and therefore net debt are lower over the forecast horizon. The additional above-trend growth in the near term, as the output gap turns positive, and higher inflation, mean that debt falls slightly as a share of GDP in 2015-16 and so the Government's supplementary target is met by a very small margin. The structural position is largely unaffected, leaving the margin against its fiscal mandate essentially unchanged.

5.42 Table 5.8 summarises the economic assumptions we have made, as well as the fiscal consequences of these alternative scenarios. It shows that, under either scenario, the fiscal mandate would still be met and that under the stronger demand scenario the supplementary debt target would also be met by a very small margin, unlike in our central forecast. These scenarios illustrate the difference between what might happen if interest rates rise for good reasons – stronger income growth – and bad reasons – an adverse credit shock.

Table 5.8: Key economic and fiscal aggregates under alternative scenarios

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Central forecast						
Economic assumptions						
GDP (percentage change)	2.3	2.6	2.4	2.6	2.6	2.4
CPI inflation (Q3)	2.7	1.8	2.0	2.0	2.0	2.0
LFS unemployment (% rate)	7.4	6.7	6.4	6.0	5.6	5.4
Output gap	-2.0	-1.3	-1.0	-0.6	-0.2	0.0
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	5.8	4.9	3.8	2.2	0.9	-0.1
Cyclically-adjusted current budget	-2.8	-2.2	-1.5	-0.2	0.7	1.5
Public sector net debt	74.5	77.3	78.7	78.3	76.5	74.2
Higher credit spreads scenario						
Economic assumptions						
GDP (percentage change)	2.3	1.8	2.4	2.9	2.7	2.4
CPI inflation (Q3)	2.7	1.8	1.9	1.9	1.9	2.0
LFS unemployment (% rate)	7.4	7.2	6.8	6.1	5.6	5.4
Output gap	-2.0	-1.8	-1.5	-0.7	-0.2	0.0
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	5.8	5.4	4.5	2.8	1.4	0.4
Cyclically-adjusted current budget	-2.8	-2.5	-1.9	-0.6	0.3	1.1
Public sector net debt	74.5	78.3	80.5	80.3	78.9	76.9
Stronger demand scenario						
Economic assumptions						
GDP (percentage change)	2.3	3.1	3.3	2.5	1.7	2.0
CPI inflation (Q3)	2.7	1.7	2.1	2.4	2.4	2.2
LFS unemployment (% rate)	7.4	6.3	5.2	4.8	5.2	5.3
Output gap	-2.0	-0.8	0.3	0.6	0.2	0.0
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	5.8	4.6	3.0	1.3	0.5	-0.2
Cyclically-adjusted current budget	-2.8	-2.2	-1.4	-0.2	0.8	1.6
Public sector net debt	74.5	76.7	76.6	75.1	73.4	71.1

A Budget 2014 policy measures

A.1 The *Economic and fiscal outlook* incorporates the Government's costings of policy decisions announced in Budget 2014 and since Autumn Statement 2013. The OBR has certified all of the costings of tax and AME measures as being reasonable central estimates. This Annex reproduces HM Treasury's table of policy decisions. Chapter 4 of this report and the OBR's annex in the Treasury's Budget 2014 policy costings document set out further details.

Table A.1: HM Treasury table of Budget 2014 policy decisions

		Head	£ million				
			2014-15	2015-16	2016-17	2017-18	2018-19
Spending							
1	Public Service Pensions: revaluation	Spend	0	+725	+985	+1,015	+1,045
2	Spending adjustment: extending Autumn Statement savings	Spend	0	0	+1,040	+1,040	+1,040
Personal Tax							
3	Personal allowance: increase to £10,500 in 2015-16 with equal gains to higher rate taxpayers	Tax	0	-1,440	-1,770	-1,875	-1,895
4	Transferable marriage allowance: increase to £1,050 and set at 10% of personal allowance	Tax	0	-25	-30	-35	-40
Savings and Pensions							
5	Pensions: reduce withdrawal tax rate from 55% to marginal income tax rate	Tax	-5	+320	+600	+910	+1,220
6	Consumer advice for pensions	Spend	-10	-10	-	-	-
7	Savings tax: abolish the 10% rate and extend 0% band to £5,000	Tax	0	-135	-320	-325	-355
8	ISAs: equalise stocks and shares and cash ISA limits and increase to £15,000	Tax	-5	-80	-230	-395	-565
9	ISAs: including peer-to-peer lending and retail bonds	Tax	0	*	-10	-15	-30
10	NS&I bonds for people aged 65 and over	Spend	-45	-170	-	-	-
11	Voluntary National Insurance Contributions	Tax	0	+415	+435	0	0

Investment and Growth							
12	Annual Investment Allowance: double to £500,000 until December 2015	Tax	-85	-665	-1,270	+175	+270
13	R&D tax credits: increase payable element for SMEs	Spend	-5	-50	-	-	-
14	Alan Turing Institute for Big Data	Spend	*	-20	-	-	-
15	Centres for doctoral training	Spend	-30	-30	-	-	-
16	Catapult centres: cell therapy and graphene	Spend	-5	-20	-	-	-
17	Seed Enterprise Investment Scheme and CGT relief: make permanent	Tax	0	-5	-10	-5	-40
18	Social Investment Tax Relief	Tax	0	-10	-20	-25	-35
19	Business rates for Enterprise Zones	Tax	-5	-5	-5	-5	-5
20	Apprenticeship Grant for Employers programme: extension	Spend	-100	-100	-	-	-
21	Degree level and masters level apprenticeships	Spend	-10	-10	-	-	-
22	Cambridge City Deal	Spend	0	-25	-	-	-
23	Right to Buy	Spend	+10	+20	-	-	-
24	OTS Review: simplification of employee share schemes	Tax	0	+10	+10	0	0
Energy							
25	Carbon Price Floor: limit disparity between UK and EU to £18 from 2016-17	Tax	0	0	-340	-615	-870
26	Combined Heat and Power: relief for onsite generation	Tax	0	-65	-70	-75	-80
27	Climate Change Levy: metallurgical and mineralogical exemption	Tax	-20	-25	-25	-25	-25
28	Oil and gas: changes to offshore chartering and Wood Review implementation	Tax	-10	-15	-10	-5	-5
Duties							
29	Alcohol duty: 1p off pint of beer and freeze cider duty	Tax	-110	-110	-110	-110	-110
30	Alcohol duty: freeze spirits duty and abolish wine escalator	Tax	-185	-185	-195	-205	-215
31	Tobacco duty: continue 2% escalator from 2015-16	Tax	0	+40	+75	+110	+135
32	Bingo duty: reducing rate to 10%	Tax	-30	-40	-40	-40	-40
33	Machine games duty: increasing the rate on B2 machines to 25%	Tax	+5	+75	+80	+85	+90

Transport and Environment							
34	Flooding: maintenance and defences	Spend	-100	-70	-	-	-
35	Potholes: challenge fund	Spend	-200	0	-	-	-
36	Air Passenger Duty: abolish bands C and D	Tax	0	-215	-225	-230	-250
37	Regional Air Connectivity Fund: support for new routes	Spend	-10	-10	-	-	-
38	Company Car Tax: continuing to increase by 2ppt in 2017-18 and 2018-19	Tax	0	0	0	+240	+480
39	Motoring tax: changes to VED and capital allowances	Tax	*	*	-5	-10	-15
40	Aggregates Levy: freeze in 2014-15	Tax	-5	-5	-5	-5	-5
41	Landfill tax and Landfill Communities Fund: uprate and reform	Tax	*	+5	+5	+10	+10
42	Capital allowances: energy and water efficient technologies	Tax	*	*	+5	+10	+15
Education, Welfare and Culture							
43	Tax-free Childcare: increase cap from £6,000 to £10,000	Spend	0	-25	-	-	-
44	Early Years Pupil Premium	Spend	0	-60	-	-	-
45	Support for Mortgage Interest: 12-month extension	Spend	0	-90	-	-	-
46	Restrictions on migrants' access to benefits	Spend	+40	+80	-	-	-
47	Employment and Support Allowance: waiting days	Spend	+5	+10	-	-	-
48	Tax Credits debt: increasing recovery rate	Tax	0	0	+35	+5	0
49	Theatre productions: tax credit	Spend	-5	-15	-	-	-
50	Cathedrals grant repair scheme	Spend	-10	-10	-	-	-
51	Cultural gifts scheme: extension	Tax	-10	-10	-10	-10	-10
Avoidance and Tax Planning							
52	Accelerated payments: extension to disclosed tax avoidance schemes and the GAAR	Tax	+290	+1,230	+1,300	+715	+385
53	Avoidance schemes using the transfer of corporate profits	Tax	+60	+80	+80	+85	+75
54	Direct recovery of debts	Tax	0	+65	+110	+100	+90
55	Enveloped dwellings: new bands between £500,000 and £2 million	Tax	+35	+70	+90	+80	+90
56	Venture capital schemes: restrictions on use	Tax	0	+35	+65	+55	+45
	TOTAL POLICY DECISIONS		**-550**	**-560**	**+225**	**+635**	**+400**
	Total spending policy decisions		-540	+80	+2,025	+2,055	+2,085
	Total tax policy decisions		-10	-640	-1,800	-1,420	-1,685

** 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 and 2018-19 are shown. All other spending measures do not affect borrowing as they fall within the Total Managed Expenditure assumption in those years.

B Forthcoming changes to public finances data

Introduction

B.1 Over the coming months, the ONS will implement significant revisions to the public finance statistics following: first, the conclusion of the ONS review of its published Public Sector Finances (PSF) statistics; and second, the ONS making the PSF data consistent with the new 2010 European System of Accounts (ESA10).[1]

B.2 In this *EFO* our forecasts are presented on the existing basis, but here we provide a preliminary assessment of the possible implications of these future revisions. This assessment is subject to considerable uncertainty in advance of the final ONS estimates later in the year. In summary, the forthcoming changes are likely to raise the measured cash level of public sector debt substantially and to have smaller effects on measures of the deficit. It is important to stress that these are changes to the way the public sector's finances are measured, not changes to the underlying activities being measured.

B.3 The ESA10 changes will also affect how output is measured, which ONS have indicated may raise nominal GDP by between 2½ and 5 per cent. This will reduce all ratios expressed as a share of GDP, such as the net debt to GDP ratio. It is difficult to know how variable the GDP revisions will be across time and therefore their impact on the change in the ratios from one year to the next or over longer periods of time.

Review of PSF statistics

B.4 Following the ONS review of the public finance statistics, which included an aim to ensure the 'ex' measures remain relevant and are easily understood, changes will be made to:[2]

- the definition of liquid assets: unlike other shares held by the public sector, shares purchased as a result of financial sector interventions are currently treated as liquid assets, as is compensation to depositors. Liquid assets are subtracted from the public sector's gross debt when calculating PSND and so these currently reduce PSND by around £55 billion. In future these will be treated as illiquid assets, raising the current measure of net debt by the same amount. If shares are subsequently sold, PSND will now fall by the full amount of the proceeds. As we do not currently include any future share sales in our forecast, due to uncertainty over scale and timing, this additional £55 billion would be assumed to persist over our forecast period; and

[1] ONS, Developments to Public Sector Finance Statistics – February 2014 update (2014)
[2] ONS, 2013 Review of Public Sector Finance Statistics: Consultation Response (2014)

- **the ex-measures boundary**: the ex-measures definition currently excludes a number of large bodies or schemes from the headline measures of debt and borrowing, including Lloyds Banking Group, Royal Bank of Scotland and the Bank of England's Asset Purchase Facility (APF), plus a number of smaller interventions. Following the review, the boundary will be re-defined in September 2014 to exclude the public sector banks only, with other interventions moving into the boundary. Payments between these schemes and the Exchequer, such as the one-off transfer of £2.3 billion from the Special Liquidity Scheme in 2012-13, will therefore no longer affect the ex-measures. Bringing them in will also have other effects, most notably in the case of the APF.

Asset Purchase Facility

B.5 The Bank of England's purchases of gilts under its quantitative easing (QE) programme are undertaken by its subsidiary, the APF. The gilts, which are an asset for the APF, are matched by a liability, a loan from the Bank of England. The APF currently sits outside the ex- boundary, so within the boundary the gilts are a liability for the Exchequer and the loan an asset for the Bank. These will cancel out once the APF is brought within the ex-measures boundary. However, the Exchequer's existing liability is recognised in the public finance statistics as the nominal value of the gilts, currently £326.5 billion,[3] whereas the Bank of England loan is equal to £375 billion (the purchase price for the gilts, which were, on average, bought at a premium). So cancelling the two does not net off to zero, but instead raises PSND by £48.5 billion.

B.6 At present, the APF only affects the ex-measures to the extent that cash flows between the APF and the Exchequer (these transfers are planned to take place regularly with a quarter lag). Transfers up to the level of the Bank's net income from interest in the previous year are currently treated as dividends, reducing net borrowing; beyond that, they are financial transactions, reducing the net cash requirement but not net borrowing. Any payments made from the Exchequer to the APF would be treated as capital grants, increasing net borrowing but not affecting the current budget.

B.7 These cash transfers will no longer have a direct effect on the public finances once the APF is brought within the ex-measures boundary. In terms of flows, the APF receives coupon income on its gilts and pays Bank Rate on its loan from the Bank of England. These flows will cancel out within debt interest, so that when Bank Rate is lower than the average coupon rate on the gilts (as has been the case over the recent past, and we assume will continue over the forecast period), debt interest will be lower and hence so will net borrowing and the current budget deficit.

B.8 The eventual profit or loss to the Exchequer of the APF will depend on the effective rate of interest paid on the gilts, rather than the coupon rate. The effective rate will however not be clear until gilts are either redeemed or sold. As gilts have typically been bought at a premium, the effective interest rate will necessarily be lower for gilts held to redemption, and it will also probably be lower for gilts sold. The difference, which represents a cash shortfall

[3] At the time the pre-measures fiscal forecast closed, in early March.

for the APF, will in effect be treated as a holding loss unrelated to any particular year, raising net debt but not net borrowing.

B.9 Table B.1 shows the APF flows in our central forecast, which, as we discussed in Box 4.1, are subject to much uncertainty. Table B.2 shows how these will directly translate into the public finance figures once the APF is brought into the ex-measures boundary, and Table B.3 illustrates the difference with our current fiscal forecast, based on the existing classification treatment.

B.10 Relative to our current projection, the change in treatment reduces net borrowing and the current budget deficit in each year. This reflects the impact on the interest rate paid on PSND within the newly-defined ex-measures boundary, which is lower due to a larger proportion of that debt being central bank reserves rather than government debt securities. Whereas losses at the point gilts are either redeemed or sold will either reduce the level of transfers from the APF to the Exchequer (which under the current treatment increases both deficit measures), or lead to cash moving the other way (which currently increases borrowing, but not the current budget deficit), these transfers will now net-off within the ex-measures boundary, and the losses in themselves will be treated as holding losses, affecting neither net borrowing nor the current budget.

B.11 Net debt is raised through an altogether different channel – the difference between the Bank of England's loan to the APF and the nominal value of the gilts. This effect on PSND will ultimately fall to zero as QE is assumed to unwind.

Table B.1: Projected APF flows

	£ billion									
	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Coupon income (a)	14.3	14.5	14.4	12.2	9.9	7.3	5.0	2.8	0.9	0.0
Interest payments (b)	-1.9	-2.0	-4.0	-5.7	-6.0	-5.3	-4.0	-2.4	-0.8	0.0
Redemptions (c)	-0.3	-2.0	-3.9	-1.4	-3.5	-1.6	-1.5	-0.2	-1.2	0.0
Sales (d)	0.0	0.0	-1.3	-3.4	-4.0	-4.4	-4.7	-5.0	-3.6	0.0
Net flow (e)	12.1	10.5	5.1	1.7	-3.7	-4.1	-5.2	-4.8	-4.6	0.0
Cumulative flow (f)	47	57	63	64	61	57	51	47	42	42
Premium (g)[1]	49	49	44	37	27	20	12	6	0	0

[1] Difference between the purchase price for the gilts and their nominal value.

Table B.2: Direct fiscal impact of projected APF flows post-PSF review

	£ billion									
	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current spending	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0	-0.9	-0.4	-0.1	0.0
Capital spending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net borrowing (-a-b)	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0	-0.9	-0.4	-0.1	0.0
Current budget deficit (a+b)	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0	-0.9	-0.4	-0.1	0.0
Public sector net debt (g-f)	3	-8	-19	-27	-33	-37	-39	-41	-42	-42

Table B.3: APF-related changes relative to our central fiscal forecast

	£ billion									
	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Receipts	-12.2	-11.6	-7.2	-2.9	-0.4	0.0	0.0	0.0	0.0	0.0
Current spending	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0	-0.9	-0.4	-0.1	0.0
Capital spending	0.0	0.0	-0.3	0.0	-1.7	-3.7	-5.7	-5.4	-5.5	-0.4
Net borrowing	-0.2	-0.9	-3.5	-3.5	-5.2	-5.7	-6.6	-5.7	-5.6	-0.4
Current budget deficit	-0.2	-0.9	-3.2	-3.5	-3.4	-2.0	-0.9	-0.4	-0.1	0.0
Public sector net debt	45	46	42	36	29	22	14	7	0	0

Transition to ESA10

B.12 The ONS is currently in the process of implementing changes to align the UK's National Accounts with the 2010 European System of Accounts (ESA10). These changes are expected to broaden the public sector boundary, include new items and change the treatment of some existing receipts and spending streams. Here we highlight the possible future implications of changes flagged by the ONS in its latest update.[4] The picture is expected to evolve over the coming months, so the figures quoted here can only be considered indicative of what may come.

B.13 The ONS have indicated changes in the following areas:

- **Network Rail**: Network Rail is currently classified as a private sector body, but the ONS has announced it will be classified within central government under ESA10 rules. Moving Network Rail's existing liabilities onto the public sector balance sheet may raise PSND in 2012-13 by around £30 billion (it is the only ESA10 change identified so far that will affect PSND) and net borrowing by around £3 billion in the same year. Most of the increase in borrowing over the past has come through the current budget, as Network Rail's net investment has been broadly offset by capital grants from the Department for Transport that will now cancel out within the public sector. These grants are expected to fall relative to Network Rail's investment spending over the

[4] Gittins, Transition to ESA10: Update to Impact on Public Sector Finances (ONS, 2014)

forecast period, changing the mix between net investment and the current budget deficit. We have used the Office for Rail Regulation's (ORR) draft determination for Control Period 5 to project the effects forward, but the mapping between this and the eventual ONS treatment are uncertain;

- imputed contributions to **local government pension schemes**: under ESA10 guidance the ONS will include imputed employers' contributions for local government funded pension schemes in order to record the under-funding of these schemes. This change is estimated to raise spending by over £2 billion in 2012-13. Projecting this forward with local authorities' spending on wages and salaries would imply this figure remains broadly flat over the next five years;

- **Royal Mail Pension Plan**: this currently appears as a one-off £28 billion of negative capital spending that improves net borrowing in 2012-13, equal to the value of the financial assets transferred to central government. The value of the liabilities associated with future pension payments is greater, and the overall shortfall will be classified as capital spending under ESA10, leading to a one-off swing of around £38 billion in 2012-13 relative to the current treatment. ONS will also introduce an annual flow of imputed revenues to offset pension payments (until the revenues sum to £38 billion). Pension payments are forecast to rise from the latest estimate of £1.2 billion to £1.6 billion by 2018-19;

- **spectrum auction proceeds**: auction proceeds from the sale of 3G and 4G licences are currently treated as one-off negative capital spending items of £22.5 billion in 2000-01 and £2.3 billion in 2012-13 respectively. They will instead be classified as rent, spread over the licence period, increasing borrowing by those amounts in the year of sale and then reducing borrowing by £1.2 billion in each year subsequently and through the forecast period;

- **decommissioning costs**: not all decommissioning costs are currently scored in the public finances, but they will be in future. The majority of such costs for the public sector are expected to relate to nuclear decommissioning, and the total is likely to be relatively small on average, but could be large in some years. The ONS does not expect such costs to have had an impact in 2012-13;

- neutral movements in current and capital spending: **research and development** (R&D) spending will be capitalised under ESA10, adding to capital spending by an estimated £3.5 billion in 2012-13, with an offsetting reduction in current spending. Most expenditure on **Single Use Military Equipment** (SUME), including £4.5 billion of a total of £4.8 billion in 2012-13, will also be treated as capital rather than current spending. These switches will not affect net borrowing, but will reduce the current budget deficit. As capital assets, R&D and SUME will attract depreciation. Depreciation raises both public sector receipts (through a higher gross operating surplus) and current expenditure, and so does not affect borrowing, but it does increase the current budget

deficit.[5] The additional depreciation, estimated at £7.5 billion for 2012-13, will therefore raise receipts, spending and the current budget deficit by the same amounts. Taking into account the additional depreciation, the effects on the current budget are likely to be small in 2012-13, with the ONS estimating R&D and SUME will have improved the current budget deficit by £0.5 billion in total. The effects will probably vary over the forecast period, as a stable flow of depreciation balances against future capital spending;

- neutral movements in receipts and capital spending: council tax and business rate **tax write-offs** are to be scored against their respective tax bases, rather than capital spending, reducing both by equal amounts; and

- neutral movements in receipts and current spending: **VAT based contributions to the EU**, around £2 to £3 billion a year in our forecast, will be recorded as VAT paid to the government with offsetting spending on current transfers to the EU. In 2015, ONS will change the classification of **tax credits** that currently score as negative tax so that these will be treated as spending (also raising receipts and spending by the same amount). Tax credits that score as negative tax were around £3 billion in 2012-13, but are expected to fall over the forecast period as personal tax credits are replaced by Universal Credit. These changes will increase headline receipts and spending, but will not affect measures of the deficit.

Overall impact

B.14 Tables B.4 to B.6 show illustrative projections for the possible impacts of implementing both the conclusions of the PSF Review and ESA10 for the headline measures of net debt, net borrowing and the current budget deficit. These changes will not affect the amount of cash required by the Exchequer to fund its operations, which forms the basis for the Government's net financing requirement.

B.15 We will more fully consider the implications over the forecast period in time for our autumn *EFO*, once the ONS has finalised their estimates of the impact over the recent past.

B.16 The level of PSND is expected to be significantly higher, with the changes to liquid assets, treatment of the APF and inclusion of Network Rail all increasing net debt by large amounts. The change to liquid assets is assumed to persist, whereas including the APF in the ex-measures boundary will have only a temporary effect – ultimately falling to zero – more than offsetting the accumulation of new liabilities by Network Rail over the forecast period. Net debt is projected to be higher by £137 billion in 2014-15 (or around 7.8 per cent of GDP, assuming GDP were unchanged), with the impact falling to £127 billion by 2018-19.

B.17 But as well as increasing the cash level of debt, the introduction of ESA10 is also expected to increase the measured level of GDP. ONS have indicated that nominal GDP may be revised

[5] The current budget deficit is equal to net borrowing excluding net investment, or in other terms, current spending plus depreciation less receipts.

up by between 2½ and 5 per cent, which would lower net debt expressed as a percentage of GDP, as shown in Chart B.1. Taking the mid-point of this range for the purposes of illustration, net debt may end up around 4¾ per cent of GDP higher in 2013-14 than currently measured, with the difference falling to around 3¼ per cent of GDP by the end of the forecast period.

B.18 General government gross debt – or 'Treaty debt' – is a narrower measure of debt calculated on a gross basis and commonly used in international comparisons. Treaty debt is only affected by the reclassification of Network Rail, and not the change in liquid assets (as no assets are subtracted from gross measures, whether liquid or illiquid) or the changes to the ex-measures boundary (as the changes affect bodies that still sit outside general government). Despite the additional Network Rail debt, the Treaty debt ratio could be lower in each year, once the effect of higher GDP is taken into account.

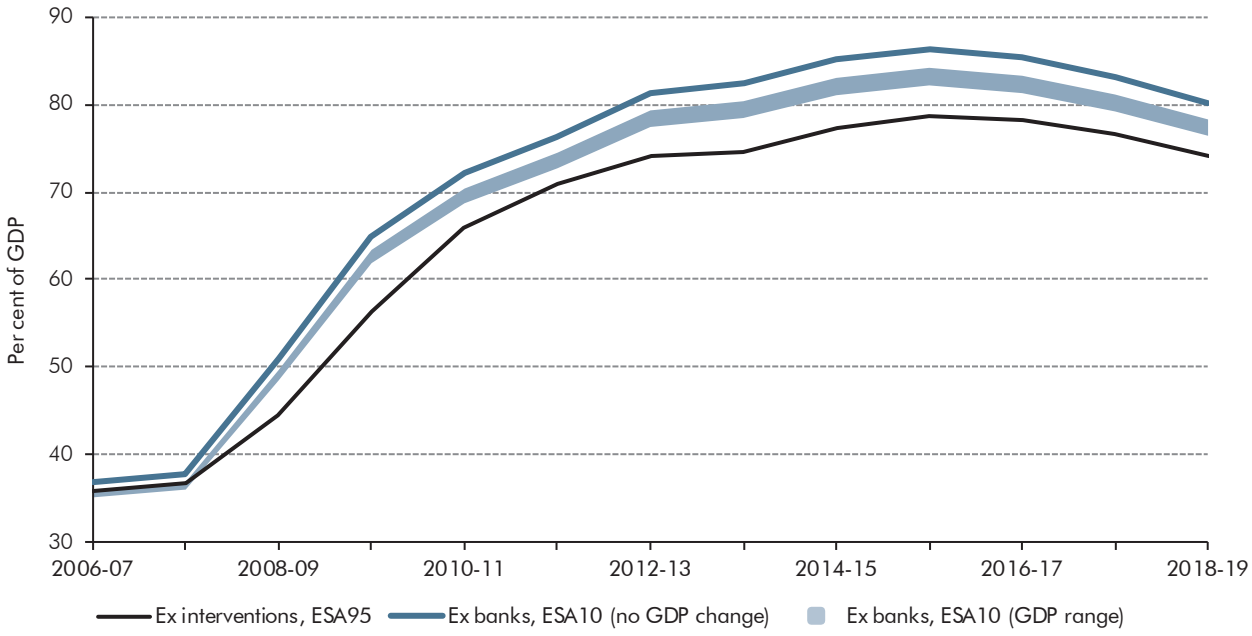
Table B.4: Public sector net debt post-PSF Review and ESA10

	£ billion						
	Implied outturn	Implied forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Excluding financial interventions	1185	1258	1355	1439	1497	1530	1548
Effects from PSF Review:							
add shares of Lloyds, RBS and compensation payments of FSCS	58	55	55	55	55	55	55
add effects of new APF treatment	25	45	46	42	36	29	22
Excluding banks (ESA95)	1268	1358	1456	1536	1588	1614	1625
Effects from move to ESA10:							
add Network Rail debt	30	32	36	40	44	48	50
Excluding banks (ESA10)	1298	1390	1492	1576	1633	1662	1675
	Per cent of GDP						
PSND excluding financial interventions	74.2	74.5	77.3	78.7	78.3	76.5	74.2
PSND ex banks (ESA95)	79.4	80.4	83.0	84.1	83.0	80.7	77.8
PSND ex banks (ESA10)[1]	78.3	79.4	82.0	83.1	82.3	80.1	77.3
Treaty debt ratio (ESA95)[2]	88.3	89.6	91.8	93.1	91.9	89.4	86.6
Treaty debt ratio (ESA10)[1, 2]	86.9	88.3	90.5	91.9	90.9	88.6	85.8

[1] ESA10 nominal GDP has been adjusted by the mid-point of ONS's 2½ to 5 per cent range.

[2] General government gross debt on a Maastricht basis.

Chart B.1: Public sector net debt



Source: ONS, OBR

B.19 Changes to the ex-measures boundary post-PSF Review are expected to reduce borrowing by increasing amounts over the next five years, although this effect would disappear once the APF is eventually wound down (see Table B.3). ESA10 changes are expected to increase borrowing in each year, roughly by the amounts of additional borrowing relating to Network Rail, with the other changes broadly offsetting.

B.20 Taking the two in combination, net borrowing is expected to be around £2.6 billion higher in 2013-14 and £2.8 billion higher in 2014-15 than currently measured and lower in later years (by £3.7 billion in 2018-19). Changes to GDP following the implementation of ESA10 are not expected to affect borrowing expressed as a percentage of GDP materially.

Table B.5: Public sector net borrowing post-PSF Review and ESA10

	£ billion						
	Implied outturn	Implied forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Excluding financial interventions	**80.3**	**95.6**	**83.9**	**68.3**	**41.5**	**17.8**	**-1.1**
excluding Royal Mail (current treatment)	28.0						
excluding APF (current treatment)	6.4	12.2	11.6	6.9	2.9	-1.3	-3.7
Excluding financial interventions ex RMPP and APF	**114.8**	**107.8**	**95.5**	**75.2**	**44.5**	**16.5**	**-4.8**
Effects from PSF Review:							
add effects of new APF treatment	-12.2	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0
add effect of consolidating out SLS	2.3						
Excluding Banks (ESA95) excluding RMPP	**104.9**	**95.4**	**83.0**	**64.8**	**38.0**	**12.6**	**-6.8**
Effects from move to ESA10:							
add Network Rail borrowing	2.8	2.8	3.7	4.0	3.7	3.6	2.3
add treatment of liabilities in LA pension schemes	2.5	2.5	2.5	2.5	2.5	2.5	2.5
add revised treatment of Royal Mail Pension Plan	8.8	-1.2	-1.3	-1.3	-1.4	-1.5	-1.6
add effect from reclassification of 3G and 4G spectrum	1.2	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Excluding banks (ESA10)	**120.1**	**98.2**	**86.6**	**68.7**	**41.6**	**16.0**	**-4.9**
Memo: excluding banks (ESA10) excluding APF	*132.3*	*110.6*	*99.1*	*79.1*	*48.1*	*19.9*	*-2.9*
Memo: excluding banks (ESA10) excluding APF and RMPP	*122.3*	*110.6*	*99.1*	*79.1*	*48.1*	*19.9*	*-2.9*
	Per cent of GDP						
Excluding financial interventions	5.1	5.8	4.9	3.8	2.2	0.9	-0.1
Excluding financial interventions excluding RM and APF	7.3	6.6	5.5	4.2	2.4	0.8	-0.2
Excluding Banks (ESA95) excluding RMPP	6.7	5.8	4.8	3.6	2.0	0.6	-0.3
Excluding banks (ESA10)[1]	7.4	5.8	4.9	3.7	2.1	0.8	-0.2
Memo: Excluding banks (ESA10) excluding APF[1]	*8.1*	*6.5*	*5.6*	*4.3*	*2.5*	*1.0*	*-0.1*
Memo: Excluding banks (ESA10) excluding APF and RMPP[1]	*7.5*	*6.5*	*5.6*	*4.3*	*2.5*	*1.0*	*-0.1*

[1] ESA10 nominal GDP has been adjusted by the mid-point of ONS's 2½ to 5 per cent range.

B.21 To aid comparisons with net borrowing, the ONS will in future show the current budget in deficit terms (spending minus receipts). Transfers from the Exchequer to the APF would currently be treated as capital grants, raising net borrowing but not the current budget deficit. Following the PSF Review these would consolidate out, leading to a larger improvement in net borrowing than the current budget deficit.

B.22 Conversely, the ESA10 changes will lead to a smaller rise in the current budget deficit than net borrowing, as some of Network Rail's borrowing is to fund investment, and the changes include a number of switches out of the current budget into net investment. These switches are likely to be small, and Table B.6 simply assumes the switches relating to R&D and SUME maintain their 2012-13 levels.

B.23 In total, the changes may have only a small effect on the current budget, increasing the deficit by around £1 billion in 2013-14 and 2014-15 and reducing the deficit by a similar amount between 2015-16 and 2017-18, with little impact in 2018-19. Given the way we cyclically adjust, any changes will feed one-for-one into changes in the cyclically-adjusted current balance (CACB).

Table B.6: Current budget deficit post-PSF Review and ESA10

	£ billion						
	Implied outturn	Implied forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Excluding financial interventions	**85.5**	**71.5**	**56.0**	**41.2**	**13.8**	**-10.0**	**-30.5**
excluding APF (current treatment)	6.4	12.2	11.6	7.2	2.9	0.4	0.0
excluding financial interventions ex APF	**91.9**	**83.7**	**67.6**	**48.4**	**16.7**	**-9.6**	**-30.5**
Effects of PSF Review:							
add effects of new APF treatment	-12.2	-12.4	-12.5	-10.4	-6.4	-3.9	-2.0
effect of consolidating out SLS	2.3						
Excluding banks (ESA95)	**82.0**	**71.3**	**55.1**	**38.0**	**10.3**	**-13.5**	**-32.5**
Effects from move to ESA10:							
add Network Rail borrowing	2.4	1.7	2.4	2.6	2.7	3.0	2.5
add treatment of liabilities in LA pension schemes	2.5	2.5	2.5	2.5	2.5	2.5	2.5
add revised treatment of Royal Mail	-1.2	-1.2	-1.3	-1.3	-1.4	-1.5	-1.6
add effect from reclassification from 3G and 4G	-1.1	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
add capitalisation of R&D and SUME	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
add treatment of tax write-offs	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Excluding banks (ESA10)	**84.2**	**72.7**	**57.2**	**40.2**	**12.6**	**-11.0**	**-30.6**
	Per cent of GDP						
ex financial interventions	5.4	4.4	3.3	2.3	0.7	-0.5	-1.5
ex financial interventions ex RM and APF	5.9	5.1	3.9	2.7	0.9	-0.5	-1.5
ex banks (ESA95)	5.2	4.3	3.2	2.1	0.6	-0.7	-1.6
ex banks (ESA10)[1]	5.2	4.3	3.2	2.2	0.6	-0.5	-1.4
Cyclically-adjusted current balance ex financial interventions	3.5	2.8	2.2	1.5	0.2	-0.7	-1.5
Cyclically-adjusted current balance ex banks (ESA95)	3.2	2.8	2.2	1.3	0.0	-0.9	-1.6
Cyclically-adjusted current balance ex banks (ESA10)[1]	3.2	2.7	2.2	1.4	0.1	-0.8	-1.5

[1] ESA10 nominal GDP has been adjusted by the mid-point of ONS's 2½ to 5 per cent range.

B.24 The Government's fiscal targets are based on measures of the cyclically-adjusted current balance and public sector net debt excluding financial interventions. Assuming the targets shift from PSND and CACB 'excluding financial interventions' to the 'excluding banks' measures, we will report on the basis of those aggregates in future *EFO*s.

B.25 The forthcoming changes to the public finances data are unlikely to have a significant impact on the measured CACB at the end of the forecast horizon, and thus on the Government's chances of meeting the fiscal mandate. But even though the measured level

of net debt will be significantly higher after the revisions, the chances of it falling in 2015-16 are likely to be greater if the APF starts selling gilts before the end of 2015-16, as assumed in our central forecast – although still not greater than 50 per cent. Debt would also fall more steeply if the Government was to sell more of the shares that it purchased as a result of financial interventions. This does not feature in our central forecast, given uncertainties over the potential scale and timing of such sales.

B.26 In Chapter 4, we focus on a measure of net borrowing that excludes the relatively large one-off and temporary transfers relating to the Royal Mail Pension Plan and APF. We will continue to look at a comparable measure in the future, since there will continue to be significant, if different, effects on the headline measure of borrowing. The transfer of the Royal Mail Pension Plan has a one-off impact on borrowing in 2012-13 that distorts comparisons between years. The 'ex-APF' measure would in effect remove the impact on the cost of debt interest each year of the stock of assets in the APF related to quantitative easing.

Index of charts and tables