Office for
Budget Responsibility

Economic and fiscal outlook

March 2011

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Foreword

The Office for Budget Responsibility (OBR) was established in 2010 to provide independent and authoritative analysis of the UK's public finances. Since the last forecast the OBR has moved out of the Treasury building and into new premises at 20 Victoria Street. The Budget Responsibility and National Audit Act will put the OBR on a formal statutory footing.

In this *Economic and fiscal outlook* we set out our forecast for the period to 2015-16. We also make a formal 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 forecasts we produce, we have also drawn heavily on the help and expertise of officials across government, including in HM Revenue and Customs, the Department for Work and Pensions, HM Treasury, the Department for Communities and Local Government, the Department for Business, Innovation and Skills, the Department of Energy and Climate Change, the Office for National Statistics, the Government Actuary's Department, the UK Debt Management Office 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, the Institute for Fiscal Studies and the National Institute of Economic and Social Research, regarding their recent forecasts, for which again we are very grateful.

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

- We began by commissioning forecasts from the relevant Government departments for the various tax and spending streams that determine the state of the public finances, based on economic determinants (such as growth, inflation and unemployment) derived from the OBR's last published forecast in November. 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.

- Next, the OBR staff prepared a new set of economic determinants, drawing primarily on economic data released since the last published forecast. Our first completed set of economic and fiscal forecasts were sent to the Chancellor on 14 February and discussed with him the following day. We provide the Chancellor with early forecasts and a provisional judgement of compliance with the fiscal mandate in order to inform his choice of Budget measures.

- This first new set of economic determinants 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.

- Meanwhile, the OBR also began to scrutinise the costing of tax and spending measures being considered for inclusion in the Budget. The OBR requested a number of changes to the draft costings prepared by HMRC and DWP. We have certified the final published costings as reasonable central estimates, apart from one measure on short life assets where we were provided with details of the policy too late to subject them to a sufficiently full process of challenge and scrutiny. We explain our treatment of this measure in Chapter 4 and our annex to the Treasury's Budget 2011 policy costings document and we also highlight there the significant uncertainties around a number of the other costings.

- As the fiscal 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 full draft economic forecast. This was used to provide determinants for a third round of fiscal forecasts.

- We provided our final economy forecast and a fiscal forecast based on it to the Chancellor on 11 March. This was intended to provide the Chancellor with a stable base ahead of the Budget on which to take his final policy decisions. To that end, we required details of all major policy decisions with a potential impact on the economy forecast to have been provided to us by 9 March. We received notice of two major decisions, the cut to corporation tax rates and the one pence reduction in fuel duty in April 2011, after this deadline. We did not therefore have sufficient time to incorporate the potential impacts in a full re-run of the economic and fiscal forecasts, although our view is that the effects would have been minimal.

- On 20 March we provided our final fiscal forecast, which incorporated the direct effects of the Chancellor's final set of Budget policy decisions. At the Treasury's written request, and in line with exceptional pre-release access arrangements from the Office for National Statistics, we provided the Chancellor with a full draft of the *Outlook* on Friday 18 March. This allowed the Treasury to prepare the Chancellor's Budget statement and documentation. We provided a full and final copy of the *Outlook* 24 hours in advance of publication. We have published the Treasury's request for exceptional pre-release access and the OBR's response on our website.

During the forecasting period, the BRC has held over fifty 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 advisors, can be found on our website.

We would be very 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

Developments since the November 2010 forecast

1.1 The key economic developments since our November 2010 *Outlook* have been an unexpected fall in UK GDP in the final quarter of 2010, a rise in world oil prices, and higher-than-expected UK inflation. The labour market has performed much as expected, with unemployment rising after registering significant falls in the middle of last year.

1.2 These data have on average prompted external forecasters to reduce their estimates of economic growth in 2010 and 2011. The average external forecasts for CPI and RPI inflation have risen significantly, again reflecting recent data.

1.3 The OBR has endorsed all but one of the costings for the tax and spending measures set out in Budget 2011 as reasonable central estimates, although there are significant uncertainties around a number of them.[1] The measures announced in Budget 2011 will have only a very small direct impact on the outlook for the public finances, with an additional fiscal tightening of just £0.3 billion in 2015-16.

The economic outlook

1.4 Higher-than-expected inflation is likely to squeeze household disposable income in the coming months and thereby weaken consumer spending growth. Recent data also show that the economy had less momentum than we expected entering 2011, even after adjusting for the temporary impact of December's heavy snowfall. Largely reflecting these two factors, we have revised down our central forecast for economic growth in 2011 from 2.1 per cent to 1.7 per cent.

1.5 Below-trend growth will increase the amount of spare capacity in the economy this year, with the output gap then beginning to close in 2012. The downward revision to our near-term growth forecast increases the amount of spare capacity and thus creates scope for slightly stronger growth in later years. But not all the

[1] The OBR has not certified the costing of increasing the time limit in the short life assets regime from four to eight years because insufficient evidence was presented, and after the deadline which would have allowed adequate scrutiny.

lost ground is made up and GDP is expected to be lower – and the output gap bigger – at the end of the forecast than we predicted in November.

1.6 Looking over the whole five-year forecast horizon, we expect this recovery to be weaker than the recoveries of the 1980s and 1990s, with the calendar year growth rate remaining below 3 per cent in every year. This reflects the effects of the fiscal consolidation, the relatively slow easing of tight credit conditions and ongoing private sector deleveraging. We are slightly more pessimistic about the level of GDP over the next year than the average of external forecasters, but slightly more optimistic than them at the end of the forecast horizon.

1.7 Key judgements in our central forecast include that:

- the trend growth rate is around 2.35 per cent a year to the end of 2013 and 2.10 per cent thereafter. This is unchanged from the November 2010 *Outlook*. Policy measures announced in the Budget could increase the economy's productive potential, in time, but we do not believe there is strong enough evidence to raise our trend growth assumption now;

- based on our assessment of a number of cyclical indicators, we estimate that activity in the economy was running around 3 per cent below potential in the third quarter of 2010, the output gap having narrowed from around -3¼ per cent of potential GDP in the second quarter;

- the labour market is likely to weaken further over the next few months before strengthening as economic growth picks up. LFS unemployment is forecast to rise from its current 8.0 per cent to 8.3 per cent of the labour force by the second quarter, falling back to 6.4 per cent by 2015. The claimant count rises from 1.45 million to 1.56 million by the second quarter, falling back to 1.18 million by 2015. We expect market sector employment to rise by around 1.3 million by 2015, partly offset by a fall of around 400,000 in general government employment; and

- global energy and food prices are likely to result in higher-than-expected CPI inflation of between 4 and 5 per cent through most of 2011. However, as these effects on the level of prices fall out of the annual rate comparison, and as the spare capacity in the economy continues to weigh down on inflationary pressures, we expect CPI inflation to fall back to around its target level of two per cent in the medium term.

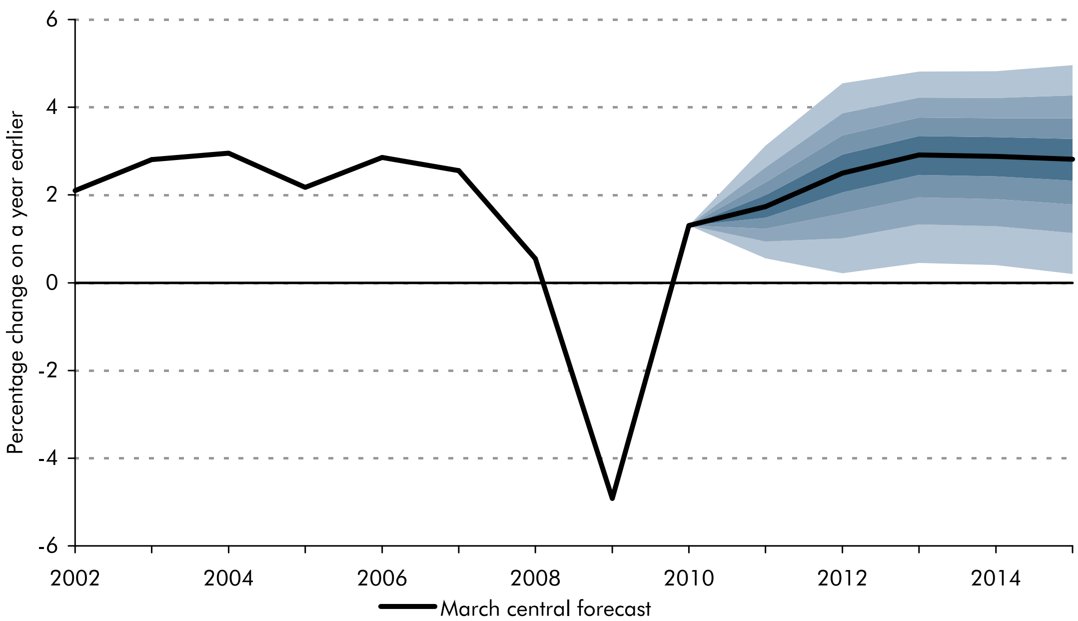
1.8 The composition of the recovery we forecast is broadly as we expected in the November *Outlook*, with growth supported by business investment and a positive net trade contribution. However, real consumption is expected to be weaker in 2011 than we forecast in November, reflecting the pressure exerted on household disposable income by more rapidly rising prices.

1.9 Our world growth and trade forecasts have been revised up for 2010 and 2011, even after taking into account higher world oil prices. The growth profile for 2012 to 2015 is lower, reflecting a higher starting level of trade and output, a softer euro area recovery, the impact of fiscal consolidation among advanced economies, higher world prices and slightly lower emerging market growth. It is too early to fully assess the impact of the tragic events in Japan on the world economy. Japan accounts for a relatively modest share of UK exports.

1.10 As always, there is considerable uncertainty around all the forecast judgements we make – and around the conclusions that we reach. But we believe that growth is as likely to exceed our central projection as it is to fall short.

1.11 To reflect this uncertainty, Chart 1.1 presents our central growth forecast with a fan chart showing the probability of different outcomes based on past Treasury forecasting errors (rather than a subjective assessment of particular risks). The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.[2] More details on this methodology can be found in Annex B of the November 2010 *Outlook*.

Chart 1.1: GDP fan chart



Source: ONS, OBR

[2] The probability bands surrounding our forecast for GDP growth in 2011 are narrower than those published in our November 2010 *Outlook*. Rather than our subjective view of the prevailing level of uncertainty, this reflects the shift from a year-ahead forecast error distribution to an in-year forecast error distribution. In the past, in-year forecasts have proved more accurate than year-ahead forecasts.

Table 1.1: Summary of central forecast and changes since November[1]

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2009	2010	2011	2012	2013	2014	2015
Output at constant market prices							
Gross domestic product (GDP)	-4.9	1.3	1.7	2.5	2.9	2.9	2.8
GDP Levels (2009 =100)	100.0	101.3	103.1	105.6	108.7	111.8	115.0
Expenditure components of GDP at constant market prices							
Household consumption[2]	-3.2	0.8	0.6	1.3	1.8	2.1	2.2
Business investment	-18.9	2.5	6.7	8.9	10.6	10.2	7.8
General government consumption	1.0	1.0	0.8	-1.2	-1.8	-2.4	-1.8
General government investment	16.9	4.4	-12.0	-9.9	-5.6	-1.4	2.4
Net trade[3]	0.9	-0.9	0.7	1.0	0.7	0.6	0.5
Inflation							
CPI	2.2	3.3	4.2	2.5	2.0	2.0	2.0
Labour market							
Employment (millions)	29.0	29.0	29.0	29.2	29.5	29.7	30.0
Average earnings[4]	1.8	1.7	2.0	2.2	3.8	4.3	4.5
ILO unemployment (% rate)	7.6	7.9	8.2	8.1	7.6	7.0	6.4
Claimant count (millions)	1.53	1.50	1.54	1.53	1.43	1.31	1.18
Output gap	-4.2	-3.4	-3.9	-3.6	-3.0	-2.2	-1.4
	Changes since November forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.1	-0.5	-0.4	-0.1	0.0	0.1	0.1
GDP Levels (2009 =100)	0.1	-0.3	-0.7	-0.9	-0.8	-0.8	-0.7
Expenditure components of GDP at constant market prices							
Household consumption[2]	0.2	-0.3	-0.7	-0.1	-0.1	0.0	0.0
Business investment	-0.1	1.2	-1.9	0.5	0.3	0.4	0.2
General government consumption	0.0	-0.8	1.1	0.1	0.0	0.0	-0.2
General government investment	2.7	3.4	3.3	-0.2	0.4	0.1	-0.2
Net trade[3]	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Inflation							
CPI	0.0	0.1	1.1	0.6	0.1	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Average earnings[4]	0.0	-0.6	-0.2	-0.2	-0.1	0.0	0.1
ILO unemployment (% rate)	0.0	0.0	0.2	0.4	0.4	0.4	0.3
Claimant count (thousands)	0	-3	34	83	90	69	42
Output gap	0.0	-0.1	-0.5	-0.7	-0.7	-0.7	-0.6

[1] The forecast is consistent with output, income and expenditure data for the fourth quarter of 2010, released by the Office for National Statistics on 25th February 2011.

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

[3] Contribution to GDP growth, percentage points

[4] Wages and salaries divided by employees

The fiscal outlook

1.12 Our central forecast for the next five years is that public sector net borrowing (PSNB) will decline steadily as a share of national income from the post-war peak it reached in 2009-10, but more slowly than we forecast in November. As a share of national income, Government revenues are projected to increase up to 2013-14 and then flatten out. Spending on public services and social security is expected to fall, partly offset by increases in spending on debt interest and net public sector pensions.

Table 1.2: Fiscal forecast overview

	Per cent of GDP							
	Outturn		Forecast					
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector net borrowing	6.7	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Cyclically-adjusted net borrowing	6.4	8.9	7.4	5.3	3.7	2.0	1.0	0.5
Surplus on current budget	-3.5	-7.6	-7.1	-5.8	-4.5	-2.7	-1.2	-0.2
Fiscal mandate and supplementary target								
Cyclically-adjusted surplus on current budget	-3.1	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Public sector net debt[1]	43.3	52.7	60.3	66.1	69.7	70.9	70.5	69.1
	Changes since November forecast							
Public sector net borrowing	0.0	0.0	-0.1	0.3	0.6	0.6	0.6	0.6
Cyclically-adjusted net borrowing	0.0	0.0	-0.2	0.0	0.2	0.1	0.2	0.2
Surplus on current budget	0.0	0.0	0.1	-0.2	-0.6	-0.5	-0.6	-0.6
Cyclically-adjusted surplus on current budget	0.0	0.0	0.2	0.1	-0.1	-0.1	-0.1	-0.2
Public sector net debt[1]	-0.8	-0.8	-0.5	-0.2	0.6	1.2	1.7	1.8

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

1.13 We expect PSNB to total £145.9 billion this year, which is £2.6 billion lower than we expected in November, mainly due to lower forecast expenditure. We do not expect receipts to be as strong in the remainder of the year as some external analysts. Over the medium term our central forecast, as summarised in Table 1.2, is for:

- PSNB to fall from 11.1 per cent of GDP in 2009-10 to 1.5 per cent in 2015-16, which is slightly higher than the 1.0 per cent expected in November;

- the cyclically-adjusted current balance, used as the target for the Government's fiscal mandate, is forecast to move from a deficit of 5.3 per cent of GDP in 2009-10 to a surplus of 0.8 per cent of GDP in 2015-16. This is the same level in 2015-16 as we forecast in June and slightly lower than in November; and

- public sector net debt (PSND), the measure used in the Government's supplementary fiscal target, is forecast to peak at 70.9 per cent of GDP in 2013-14 and then decline to 69.1 per cent of GDP in 2015-16. These figures are slightly higher than we forecast in November.

1.14 The Budget policy measures are broadly neutral for borrowing over the forecast period. Table 1.3 shows that, including the effects of these measures, compared to November, we are forecasting higher expenditure as a percentage of GDP in the medium term, with little overall change to the receipts forecasts:

- the increase in our expenditure forecast primarily reflects the impact of our higher inflation forecast on social security and debt interest payments; and

- the small revisions to our receipts forecasts reflect a number of offsetting factors. We expect lower income tax and NICs receipts because we have revised down our forecast for labour income. We expect lower corporation tax and fuel duty receipts, mainly due to policy measures. This is offset in some years by an increased forecast for other receipts, including North Sea revenues, interest receipts and business rates.

1.15 Even though we have revised up our forecast for PSNB, our forecast for the cyclically-adjusted or 'structural' current budget surplus in 2015-16 is only slightly lower. This is because we expect there to be more spare capacity in the economy in 2015-16 than we thought in November, so the net increase in headline borrowing is primarily cyclical rather than structural.

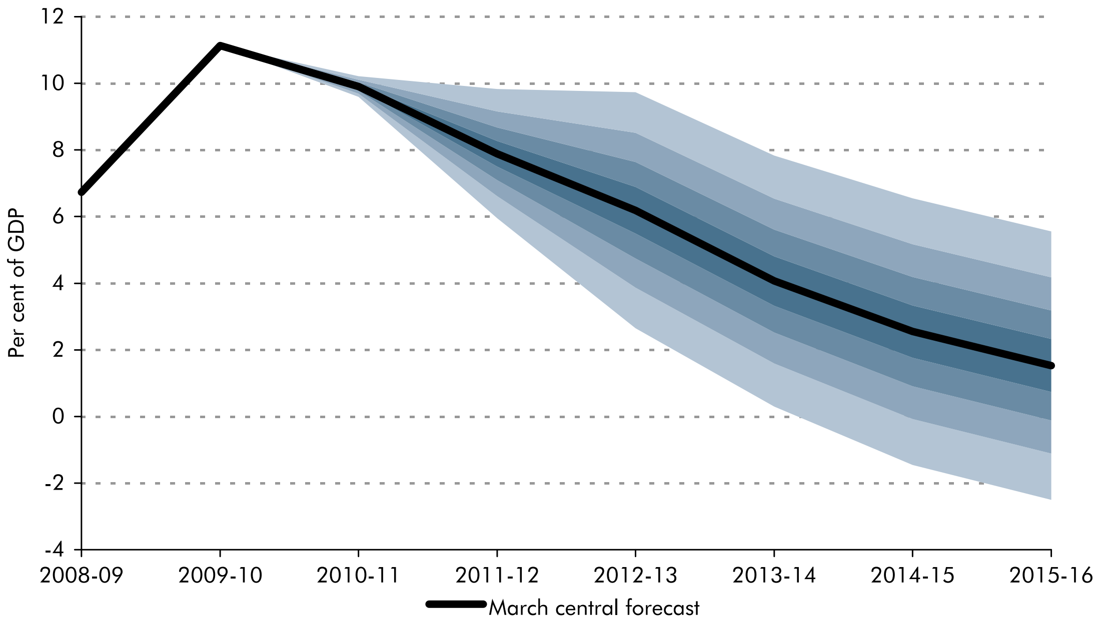
1.16 The changes in the fiscal aggregates since November are small relative to the uncertainties that surround any fiscal forecast. PSNB represents the difference between total public sector receipts and expenditure, both of which are very large numbers influenced by numerous economic and non-economic determinants. Chart 1.2 shows our central forecast for PSNB with the probability of different outcomes, based purely on the Treasury's past forecasting performance, shown in a fan chart.

Table 1.3: Changes to public sector net borrowing since November forecast

	Per cent of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector net borrowing	0.0	-0.1	0.3	0.6	0.6	0.6	0.6
of which:							
Current receipts	-0.1	0.2	0.3	0.0	0.1	0.0	0.0
Total managed expenditure	-0.1	0.0	0.6	0.6	0.7	0.7	0.6

Note: increases in receipts decrease borrowing, while increases in expenditure increase borrowing.

Chart 1.2: Public sector net borrowing fan chart



Source: ONS, OBR

Performance against the Government's fiscal targets

1.17 On taking office in 2010 the Coalition Government set itself two medium-term fiscal targets: to balance the cyclically-adjusted current budget by the end of a rolling, five-year period; and to see public sector net debt (PSND) falling in 2015-16. Taking into account the policy measures announced in Budget 2011, our central forecast suggests that the Government has a greater than 50 per cent probability of meeting both these targets under current policy. It has the same margin for error against the first, and somewhat less against the second, than at the time of the June 2010 Budget.

1.18 There is considerable uncertainty around our central forecast, as there is around all fiscal forecasts. 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 probe the robustness of our central judgement in three ways:

- first, by looking at past forecast errors. If our central forecasts are as accurate as Budget and Pre-Budget Report forecasts were in the past, then there is a roughly 70 per cent probability that the cyclically-adjusted current budget will be in balance in five years' time;

- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest threat is the possibility that we have over-estimated the amount of spare capacity in the economy, now or in the future. If the output gap was roughly 1.5 per cent of potential output smaller than our central estimate then the Government would no longer be on course to balance the cyclically-adjusted current budget in five years' time; and

- third, by looking at alternative economic scenarios. We examine two illustrative scenarios: first, one in which inflation remains persistently higher than in our central forecast; and second, one in which there is a sharp fall in the euro and a further weakening in euro area demand. Neither scenario would put the Government on course to miss its medium-term fiscal targets, although there might be other reasons for concern if events unfolded in either of these ways.

2 Developments since the November 2010 forecast

Summary

2.1 The key economic developments since the OBR's November 2010 *Outlook* have been an unexpected fall in UK GDP in the final quarter of 2010, a rise in world oil prices, and higher-than-expected UK inflation. The labour market has performed much as expected, with International Labour Organisaton (ILO) unemployment rising after registering significant falls in the middle of last year.

2.2 These data have on average prompted external forecasters to reduce their estimates of economic growth in 2010 and 2011. The average external forecasts for CPI and RPI inflation have risen significantly, again reflecting recent data.

2.3 The OBR has endorsed all but one of the costings for the tax and spending measures set out in Budget 2011 as reasonable central estimates, although there are significant uncertainties around a number of them.[1] The measures announced in Budget 2011 will have only a very small direct impact on the outlook for the public finances, with an additional fiscal tightening of just £0.3 billion in 2015-16.

Introduction

2.4 This chapter summarises the main economic and fiscal data developments since November. It also summarises recent external forecasts for the UK economy (from paragraph 2.19) and explains how these have responded to data developments (from paragraph 2.30). It also summarises the policy measures announced in Budget 2011 and the impact we expect these to have on our forecasts (from paragraph 2.35).

Economic developments since the November Outlook

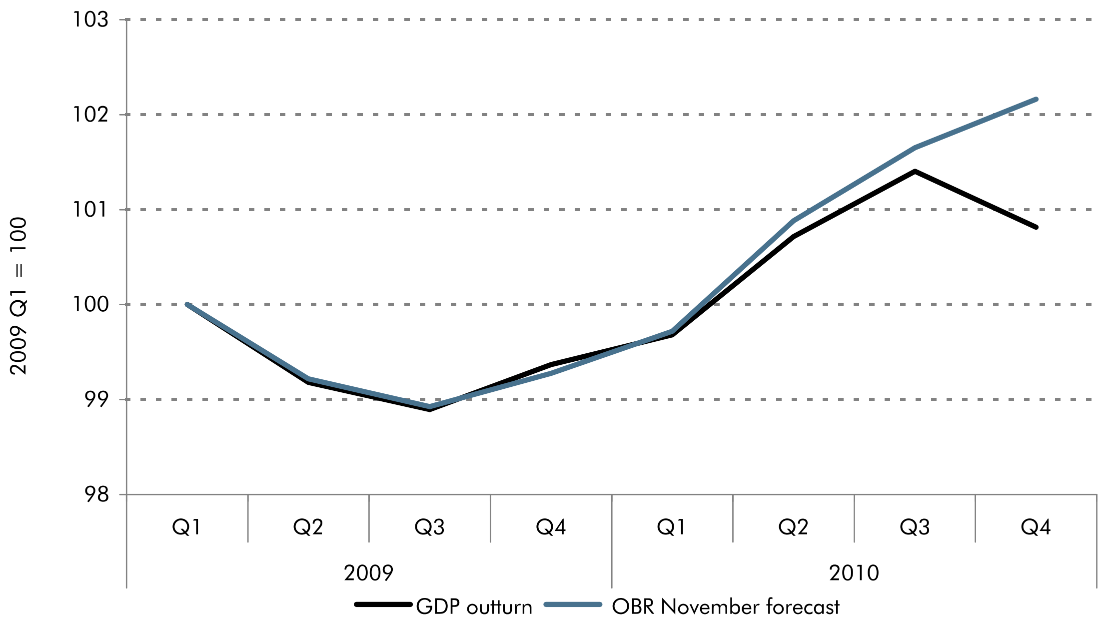
2.5 The most significant data since November have been the unexpectedly weak estimates of GDP for the final quarter of 2010. The ONS currently calculates that GDP fell by 0.6 per cent in this quarter, following four quarters of positive growth.

[1] The OBR has not certified the costing of increasing the time limit in the short life assets regime from four to eight years because of insufficient evidence presented in the time available to consider this measure.

The ONS estimates that the temporary effects of bad weather in December accounted for around 0.5 percentage points of the contraction, which means that in the absence of the bad weather GDP would still have shrunk by 0.1 per cent. In November, we had forecast growth of 0.5 per cent.

2.6 Prior to the release of the GDP estimates for the fourth quarter, the ONS also published the *Quarterly National Accounts* for the third quarter of 2010. This release contained revisions to the level and composition of GDP back to the start of 2009. Quarterly GDP growth rates were revised up in 2009, but down across 2010. Chart 2.1 shows how current ONS estimates of the level of GDP compare to our November forecast.

Chart 2.1: Level of GDP

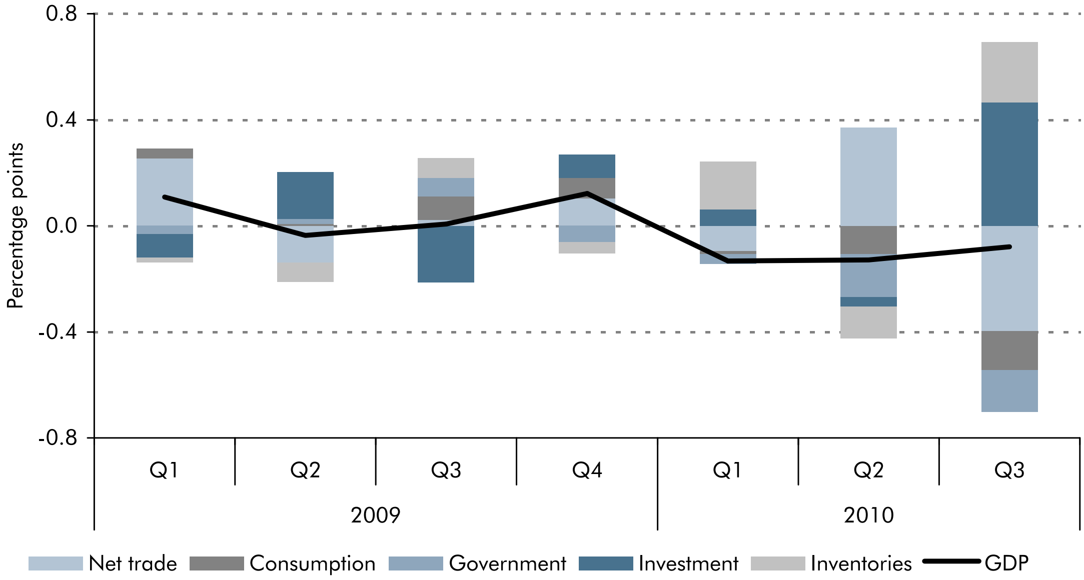


Source: ONS, OBR

2.7 Chart 2.2 shows the ONS's revisions to the contributions that different expenditure components make to GDP growth. These revisions are larger in more recent quarters, reflecting the more provisional nature of the most recent estimates. In particular, there have been significant changes to the composition of growth in the third quarter of 2010. However the revisions have been largely offsetting, leaving the estimate of GDP growth in the third quarter broadly unchanged.

2.8 At the time of our November forecast, net trade was estimated to have made a strong positive contribution to growth in the third quarter of 2010, while investment was thought to have added only slightly to growth. That position has since been reversed, with net trade now estimated to have subtracted slightly from GDP growth, while investment made a strong positive contribution. Revisions to net trade for earlier quarters have in turn offset the third quarter revisions, leaving the level of the net trade contribution (i.e. the change in the trade balance) at the start of our current forecast relatively unchanged from the November 2010 *Outlook*.

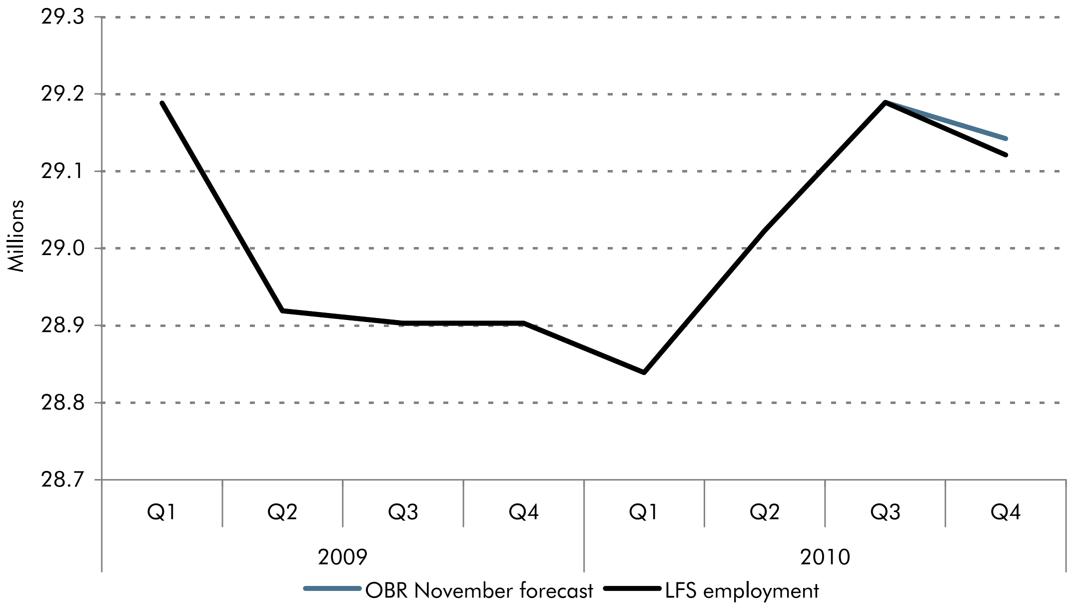
Chart 2.2: Revisions to the contribution of expenditure components to GDP growth



Source: ONS

2.9 Labour market indicators have generally performed as expected in the November forecast. The ILO unemployment rate, as measured by the Labour Force Survey (LFS), reached 7.9 per cent in the final quarter of 2010, in line with the slight pick up in the ILO unemployment rate that we expected in the near term November forecast. The overall level of employment stood at just over 29.1 million in the final quarter, slightly below the level in the preceding quarter. This is shown in Chart 2.3.

Chart 2.3: LFS employment and November forecast



Source: ONS, OBR

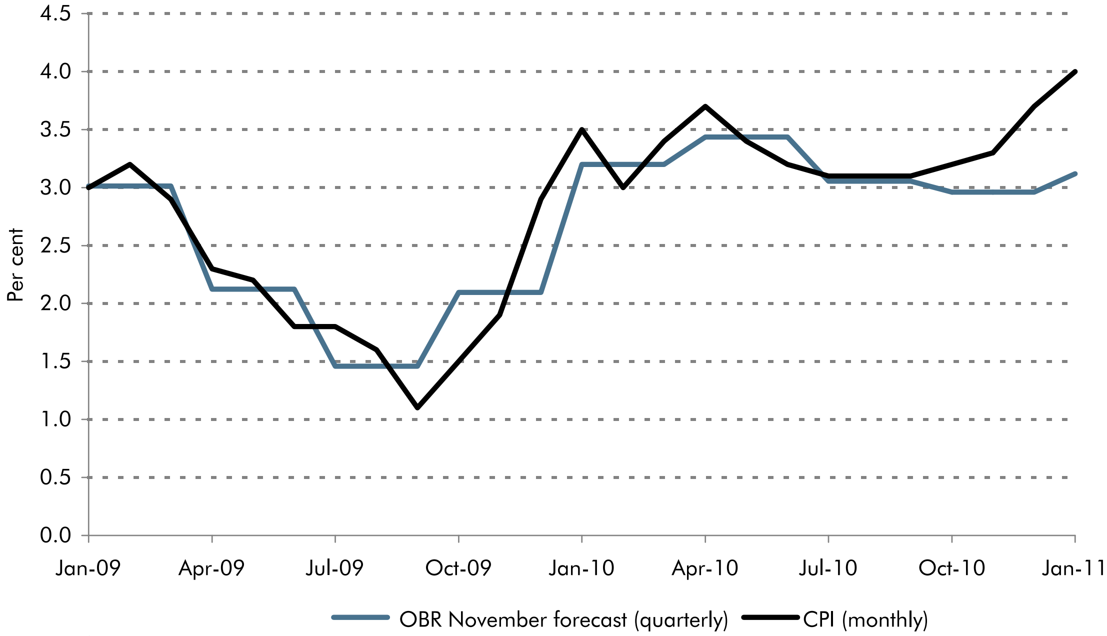
2.10 The claimant count measure of unemployment declined slightly in the fourth quarter of 2010 to 1.46 million. The inactivity rate (for people aged 16 and over) similarly picked up by 0.2 percentage points to just under 37 per cent in the fourth quarter of 2010, partly accounted for by an increase in the number of people in retirement.

2.11 CPI inflation has remained above 3 per cent since November, reaching 4 per cent in January. [2] Chart 2.4 shows that CPI inflation is significantly higher than we expected in the November forecast. Recent movements in CPI inflation reflect a number of factors, including higher-than-expected contributions from energy and food prices. Chart 2.5 shows the rise in sterling Brent oil prices since November.

2.12 World GDP and world trade have grown more strongly than we forecast in November. The latter half of the year saw a rebound in consumption and exports in some advanced economies, including the US, Japan and Germany, and continued strong growth in many emerging economies. Euro area GDP grew by 1.7 per cent in 2010; Germany performed strongly, while the peripheral economies continued to struggle. The recent tragic events in Japan will have significant economic implications for Japan's economy, though it is too early to fully assess the implications for the world economy.

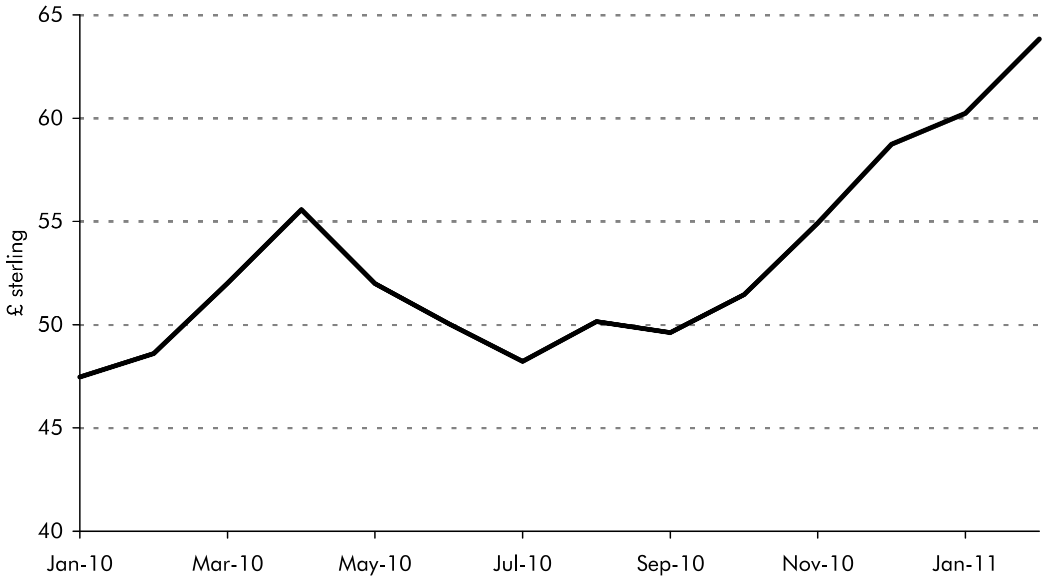
[2] Our forecast takes into account CPI inflation outturns up to and including January 2011.

Chart 2.4: CPI inflation and November forecast



Source: ONS, OBR

Chart 2.5: Brent oil prices



Source : Ecowin

2.13 On a trade-weighted basis, the sterling exchange rate has been broadly stable since the last forecast, depreciating by around 0.3 per cent by 4 March, the date that we use as the basis for the current forecast.

2.14 The FTSE All-Share index was around 4 per cent up on November in the ten days to 4 March, the period we use as the basis for the current forecast. The weighted average interest rate on conventional gilts has risen from around 3.1 per cent in the November forecast to 3.8 per cent in the ten working days to 4 March.

2.15 Surveys continue to send mixed signals about the prospects for economic activity. On the positive side, the Markit/CIPS Purchasing Managers' Indices now show that expectations of business activity in 12 months time are above the November level in the service and construction sectors. The CBI services survey also shows business optimism rising above its long run average, with expectations for profits and employment over the next three months increasing since November. However, the Bank of England Agents' survey shows a more ambiguous outlook, with firms expecting only a small increase in employment over the next few months, reflecting continued expectations of spare capacity. The Gfk NOP consumer confidence index also paints a subdued picture, having registered a large fall at the start of the year.

Fiscal developments since November

2.16 The joint ONS/HM Treasury *Public finances release* provides monthly data on central government receipts and expenditure and provisional estimates for the public sector fiscal aggregates. The pattern of public finance data through the year can be very volatile, making it difficult to compare against full year forecasts. This is particularly the case in the latter part of the financial year, so developments since the last forecast should be treated with some care.

2.17 One-off factors, such as the temporary bank payroll tax, boosted receipts growth in the first part of the year. This led us to forecast in November that year-on-year growth in central government receipts would slow from 9.5 per cent in the first half of 2010-11 to 7.3 per cent for the year as a whole. Provisional outturns for the first ten months of the year showed growth of 8.4 per cent over the same period in 2009-10, well above the forecast for the year as a whole. Growth in January receipts was particularly high, but this partly reflected timing effects. Substantial amounts of self assessment tax are due for payment on 31 January. This fell on a Monday this year while in 2010 it was a Sunday. This meant that a much greater proportion of the 2011 payments were scored in January than in 2010, when more payments slipped into February.

2.18 We forecast in November that central government expenditure, other than debt interest, would grow at broadly the same rate over the second half of 2010-11 as in the first half of the year. Provisional figures for the first ten months show growth of 3.7 per cent, only slightly above the November forecast of 3.5 per cent for the year as whole. Debt interest spending in the first half of 2010-11 was 80 per cent higher than in the same period of 2009-10, mainly because of the effect of RPI changes on accrued interest on index-linked gilts. Growth in debt interest spending was expected in November to moderate over the second half of the year. And indeed growth in the four months to January was only 18 per cent. However, while the growth rate for the first ten months of the year has slowed to 48 per cent, this is still well above the November forecast of 38 per cent for the year as a whole.

Developments in external forecasts

2.19 Many organisations undertake forecasts of the UK economy, using a wide array of techniques and data. A number of publications collate the views of subsets of these forecasters and average their predictions. This section sets out some of the movements in the forecasts collected over the months since the November forecast.[3]

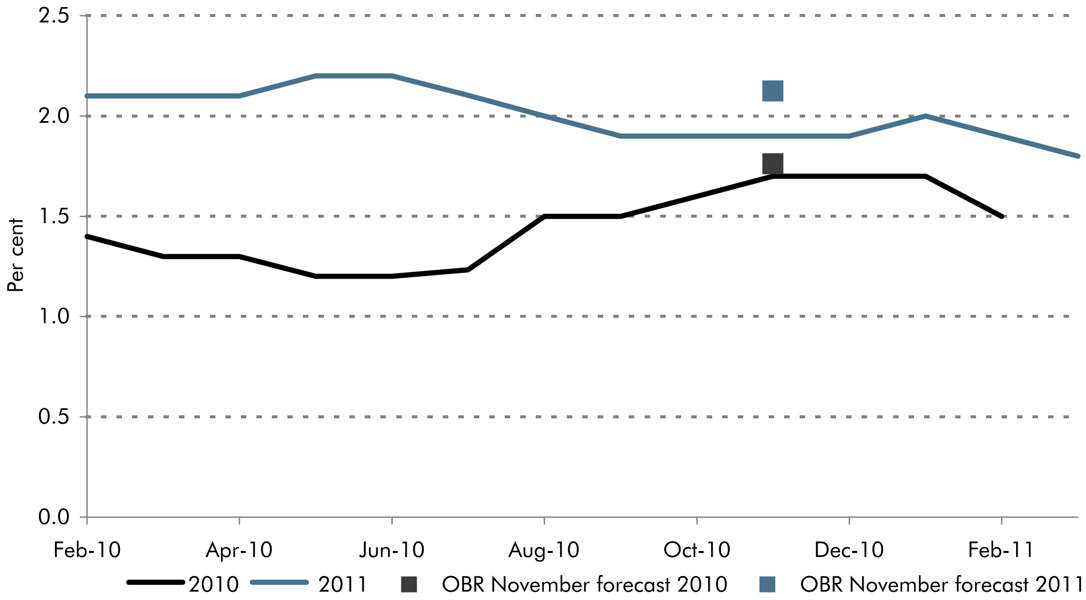
2.20 When interpreting the average of independent forecasts, there are often real or apparent inconsistencies that need to be borne in mind. Often, the subset of analysts who provide forecasts for one variable is different to that for another variable. This makes it harder to compare our central forecast with the headline average of external forecasts.

Growth

2.21 The average (mean) forecast for GDP growth in 2011, submitted in the three months to March, was 1.8 per cent. This is a fall from the 2 per cent average in the three months to January and is slightly below the figure in November of 1.9 per cent. On average, forecasters seem to have reacted to the unexpectedly weak final quarter of 2010 by reducing their growth forecasts in both 2010 and 2011 (see Chart 2.6).

[3] See HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts,* March 2011. A number of financial reporting services also monitor these average or consensus figures. A full list of contributors is available at the back of the publication.

Chart 2.6: Average forecasts for GDP in 2010 and 2011



Source: HM Treasury, OBR

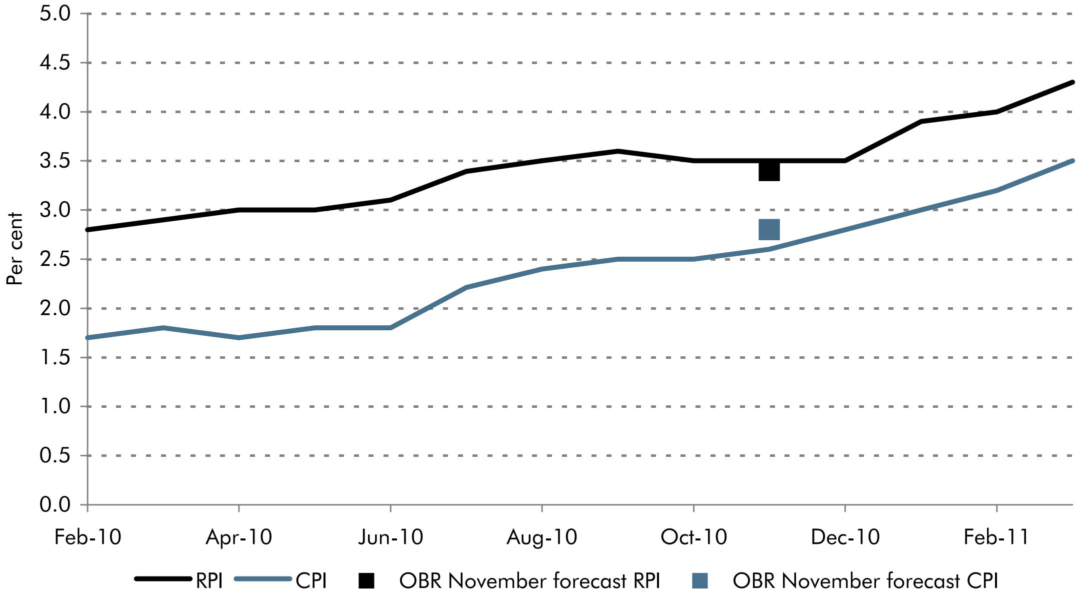
2.22 Expectations for the composition of demand in 2011 changed between November and March. The average forecast for private consumption growth was revised down by 0.4 percentage points. Those for government consumption were revised up by 0.3 percentage points and the average expectation for growth in fixed investment increased to 3.8 per cent from 3.6 per cent in November. The net trade contribution as a percentage of GDP remained unchanged in March.

2.23 The Treasury also reports a small number of medium-term forecasts. The most recent are available in the February comparison. In February, the average forecast for GDP growth in 2012 was unchanged at 2.1 per cent and the average forecast was 0.1 percentage points higher in 2013 and 2014 compared to the November comparison. The medium term forecasts have, on average, seen the contribution of domestic demand to growth rise slightly in 2013 and 2014. This drives the overall increase in GDP growth, as the contribution of net exports is unchanged.

Inflation

2.24 The average forecasts of CPI and RPI inflation in the fourth quarter of 2011 are 3.5 per cent and 4.3 per cent respectively, as shown in Chart 2.7. The average forecast for CPI inflation has been rising since June, when it stood at 1.8 per cent. Since November, the forecast for RPI inflation has picked up by 0.8 percentage points. The average forecast for inflation in the fourth quarter of 2012 has risen slightly by 0.1 percentage points since February, at 2.1 per cent for the CPI and 3.2 per cent for the RPI in March.

Chart 2.7: Average forecasts for CPI and RPI inflation in the fourth quarter of 2011



Source: HM Treasury, OBR

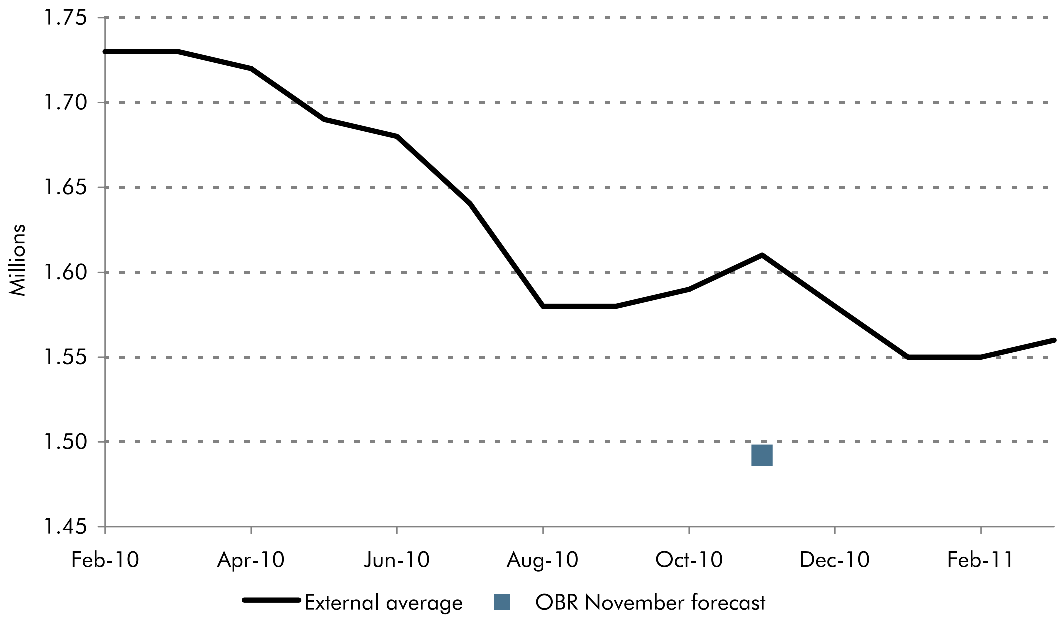
Labour market

2.25 The average forecast for claimant count unemployment in the fourth quarter of 2011 has been falling since November but rose slightly in March to 1.56 million. This compares with 1.61 million in November, as shown in Chart 2.8. The average unemployment forecast among City forecasters continues to be consistently below that of academic and other external forecasters in 2011, at 1.55 million in March.

2.26 The average forecast for employment growth in 2011 remained the same in March as the previous month, at 0.2 per cent. This is slightly below the average forecast of 0.3 per cent in November.

2.27 The average forecast for claimant count unemployment in the medium term is available in the February forecast comparison, measured by the annual average rather than the fourth quarter. This was higher for 2012 than in November, but lower for 2013 and 2014.

Chart 2.8: Average forecast for claimant count in the fourth quarter of 2011



Source: HM Treasury, OBR

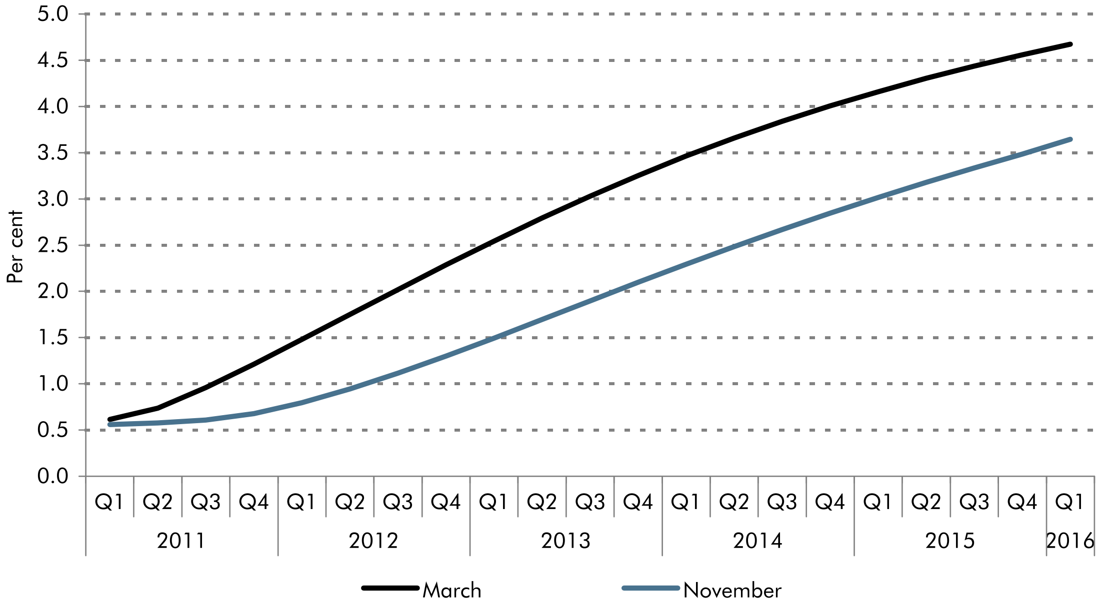
Public finances

2.28 In March, the average external forecast for public sector net borrowing (PSNB) was £121.6 billion for 2011-12 and £98.1 billion for 2012-13. The average of external forecasts for 2011-12 has been rising since November. However, this is set against the steady decline in the average of external forecasts since March 2010. In its February 2011 *Green Budget,* the Institute for Fiscal Studies forecast PSNB of £145.6 billion in 2010-11, falling to £115.6 billion in 2011-12.

Market expectations of interest rates

2.29 Expectations of interest rates derived from financial market instruments have direct implications for our forecast, as we assume that monetary policy follows the path expected by participants in financial markets. As Chart 2.9 demonstrates, expectations of three-month gilt rates are now higher than in November.

Chart 2.9: Market expectation of three month gilt rates



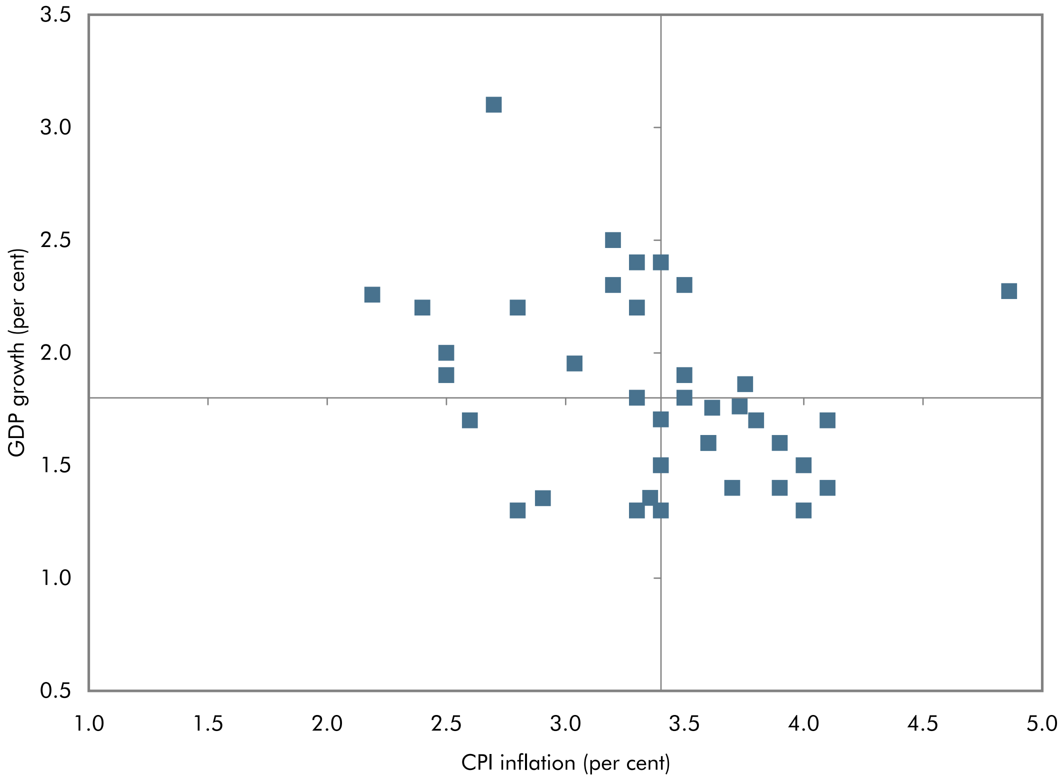
Source: Bank of England

Forecast dispersion

2.30 Looking at an average of external forecasts facilitates easy comparison, but does not reflect the degree of consensus that there might be around those figures. It can therefore be informative also to look at the dispersion of forecasts. However, given that we do not always know what has informed each individual forecaster's view, it is still not possible fully to explain this dispersion.

2.31 Charts 2.10 and 2.11 illustrate the dispersion of short-term forecasts by plotting current external GDP growth and CPI inflation forecasts for 2011 and 2012. There is not a clear negative relationship between the two variables, as one might expect. One explanation could be that views differ on the current size of the output gap, the difference between the economy's actual level of output and its estimated potential level. Another is that recent changes in the level of import prices and the contribution of changes in VAT are driving inflation, and that these are masking any disinflationary effect of the output gap.

Chart 2.10: Distribution of external forecasts for CPI inflation and GDP growth in 2011



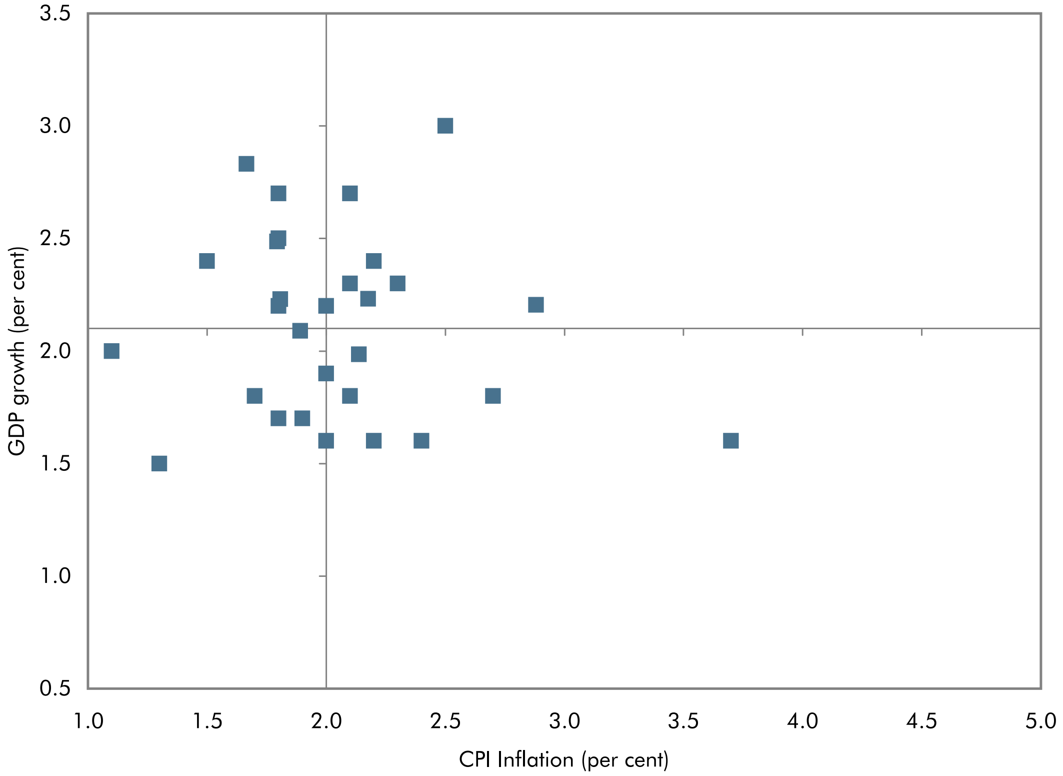
Source: HM Treasury

2.32 Forecasters differ not just in their numerical forecasts for key variables, but also in their assessment of important economic and policy trends. The November *Outlook* highlighted some of these debates, such as the impact of fiscal tightening and different interpretations of the surprising strength of GDP growth in the second and third quarters of 2010.

2.33 Differences of opinion in areas like these help explain the dispersion of external forecasts. Current areas of discussion include:

- the extent and timing of 're-balancing': the composition of demand in the economy differs greatly between forecasts. In our November forecast we illustrated how differences here can have a significant impact on fiscal outcomes, even under the same overall growth path. Determinants of the likelihood and extent of such re-balancing include world economic activity, as well as the domestic saving behaviour of households and businesses. Different expectations for the European economy are also an important influence on expectations of re-balancing, given Europe's position as the UK's primary trading partner;

Chart 2.11: Distribution of external forecasts for CPI inflation and GDP growth in 2012



Source: HM Treasury

- monetary policy: the persistence of above target inflation has helped shift debate about the prospects for monetary policy. In November, external forecasters were largely focused on the possibility of further quantitative easing, while attention has now shifted to the likelihood and timing of interest rate increases. Many forecasters believe that recent commodity price increases have raised inflation expectations and that the Bank of England will respond by raising rates if this were to feed into higher wages. Others cite the one-off nature of some recent price increases, weak monetary growth and low average earnings growth as evidence that inflation pressure is low and an early rate increase unnecessary. This debate is reflected in the differing votes and views on the Monetary Policy Committee; and

- short-term growth momentum: the unexpected fall in GDP in the fourth quarter has also created discussion of the extent to which this represents a significant hit to the momentum of the recovery, or a temporary blip. Some forecasters expect a full and rapid rebound, while others foresee a more persistent slowdown.

2.34 We investigate the potential impact of some current areas of uncertainty on our fiscal forecasts through the use of scenarios. In this *Outlook* we examine the potential impact of a persistent inflation scenario and a weak euro scenario. The economic implications are described in Chapter 3 and their implications for the Government's fiscal mandate and supplementary target in Chapter 5.

Policy announcements in Budget 2011

2.35 The economic and fiscal forecasts that we present in Chapters 3 and 4 reflect what we have learned from the recent economic and fiscal developments described in this chapter. But, unlike the external forecasts summarised in the previous section, we are also able to take into account the likely impact of measures announced in Budget 2011 and other measures announced since November but not officially costed until now.

2.36 In the run-up to the Budget, the Government presents the OBR with provisional estimates of the direct impact of its proposed tax and spending measures on the public finances. The OBR then undertakes an intensive period of challenge and scrutiny of these costings, suggesting where and how they could be improved. At the end of this process, the Government sets out its final estimates in the Budget document (repeated for convenience in Annex A of this *Outlook*). The OBR then states whether it agrees or disagrees with the Government's final estimates, or whether it has been given insufficient time or information to reach a view. On this occasion, we are able to endorse the final costings for Budget 2011 as reasonable central estimates apart from one measure on short life assets, where we were provided with details too late to subject them to the full process of challenge and scrutiny. In a number of cases (as we discuss below) there is significant uncertainty around the costings. It is then for the OBR to judge any second-round and indirect effects from the policy measures on its forecasts.

2.37 Consistent with the draft *Charter for Budget Responsibility*, ("*the Charter*" in this *Outlook*) the OBR includes an estimate of the impact of a policy in the forecast only when a firm announcement has been made that provides sufficient detail to quantify the effect of the policy. The Minister responsible would typically make a firm announcement through a statement to Parliament, such as at Budgets or Spending Reviews.

2.38 Accordingly, this forecast incorporates the effects, where significant, of the following policies announced since the November forecast:

- tax and expenditure measures announced since November and in Budget 2011 that have a direct effect on the public finances that has been estimated as set out in Annex A;

- the potential indirect effects of other policy announcements that do not have a direct effect estimated on the public finances and so are not included in Annex A, such as some measures announced as part of the Government's Growth Review; and

- the Government's financial assistance package for Ireland. This was first announced to Parliament by the Chancellor on 22 November 2010. However, insufficient detail was available at that point to allow the effects of the package to be quantified in the November forecast.

2.39 Consistent with the *Charter for Budget Responsibility,* the projections do not include the impact of policies for which insufficient detail is available to allow the effects to be quantified. Instead, these are noted as fiscal risks. Examples of policies not included are:

- statements of Government policy where final details have not been announced and included in Budget scorecards. For example, Budget 2011 states that: "as set out in the *Coalition Agreement*, the Government has a long-term objective to support lower and middle income earners by raising the personal allowance to £10,000. The timetable for reaching this objective will be set out in future Budgets, and there will be real terms progress towards that goal every year". The Treasury has confirmed that this is the most recent, definitive statement of Government policy and that no commitment has been made regarding the progress to be achieved over our forecast horizon. This Budget does include a firm announcement to increase the personal allowance to £8,105 in 2012-13, and the cost of this is included in our central forecast. The impact of further increases would depend on their timing and the outlook for inflation, among other things. The impact of modest changes to the personal allowance can be calculated from HMRC's published ready-reckoners;

- policies where details have been provided to Parliament, but for which final decisions are still to be taken on issues that will significantly affect the impact on the public finances. An example is the Single Tier Pension, where Budget 2011 sets out the principles of possible reforms, but a number of significant policy and operational decisions would need to be taken before the costs could be quantified; and

- similar issues relate to privatisation proceeds and financial asset sales. At the 2010 Spending Review the Government made a commitment to sell a number of assets, such as the Tote, public sector spectrum, student loans and NATS. It is also the Government's intention eventually to sell its shareholdings in the Royal Bank of Scotland and Lloyds Banking Group. It is not appropriate to include such sales in the central forecast at this point. This is because they are typically complex to conclude and therefore not guaranteed to take place. They are also very difficult to quantify until a firm and final sale agreement has been reached. However, we highlight in Chapter 4 the possible risks to the forecast from some of these commitments. We will look to provide more illustrations of similar risks in future outlooks.

2.40 It should be noted that there are both upside and downside risks to the forecast from these policy commitments. The personal allowance commitment would lead to an increase in PSNB. Certain financial asset sales would reduce public sector net debt, but the impact on net borrowing would depend on whether the Government lost a future income flow associated with the asset.

Direct effects of Budget 2011 policy announcements

2.41 Annex A reproduces HM Treasury's table of Budget 2011 policy decisions, which sets out the direct effects of each policy announcement on the public finances. As explained above, the Government is responsible for the production of these costings with independent scrutiny provided by the OBR. The costings in Annex A capture the direct effects of a policy change on the receipt or expenditure component to which the policy applies and on closely related components. They do not capture any potential indirect effects from the policy on the wider economic forecast.

2.42 Further detail on the assumptions and methods used to produce the costings is provided in *Budget 2011 policy costings,* published by HM Treasury alongside the Budget. This document includes an annex produced by the OBR which explains the costings scrutiny process. It also highlights the following measures where we have identified particular uncertainties:

- controlled foreign companies measures, where the costings are sensitive to the behavioural responses of a few large companies;

- tobacco duty measures, where there is significant degree of uncertainty given the declining tax base and the availability of cross-border shopping and illicit products;

- entrepreneurs' relief, where the recent changes to the capital gains tax regime and the absence of recent data makes the estimation of the tax base uncertain;
- review of non-domicile taxation, whose yield heavily depends on the decision of a limited number of individuals on whether to accept the higher charge or become a non-resident; and
- avoidance measures, where the effect of taxpayers seeking alternative methods of avoidance is uncertain.

2.43 In Chapter 4 we provide a summary of the direct effects of Budget 2011 policy measures on the public finance forecast. This sets out the contributions of the Government's policy measures to changes in our forecasts for receipts and expenditure, and the impact on overall public sector net borrowing. Overall, the direct effects on the outlook for the public finances are very modest, with a net fiscal tightening, or reduction in borrowing, of £0.3 billion in 2015-16.

Indirect effects of policy announcements

2.44 In addition to these direct effects, a policy may have a wider indirect effect on the overall economic forecast. We have considered the measures announced in the Budget and have concluded that the only significant second round effects are on the inflation forecast from the changes to fuel duty, air passenger duty and tobacco duty. Further detail on this is provided in Box 3.1 in Chapter 3. We were notified of the change of the rate of corporation tax and the one pence per litre reduction in fuel duty in April 2011 too late to include any potential second round effects in the forecast. However, we believe that any such effects would be minimal.

3 Economic outlook

Summary

3.1 Higher-than-expected inflation is likely to squeeze household disposable income in the coming months and thereby weaken consumer spending growth. Recent data also show that the economy had less momentum than we expected entering 2011, even after adjusting for the temporary impact of December's heavy snowfall. Largely reflecting these two factors, we have revised down our central forecast for economic growth in 2011 from 2.1 per cent to 1.7 per cent.

3.2 Below-trend growth will increase the amount of spare capacity in the economy this year, with the output gap then beginning to close in 2012. The downward revision to our near-term growth forecast increases the amount of spare capacity and thus creates scope for slightly stronger growth in later years. But not all the lost ground is made up and GDP is expected to be lower – and the output gap bigger – at the end of the forecast than we predicted in November.

3.3 Looking over the whole five-year forecast horizon, we expect this recovery to be weaker than the recoveries of the 1980s and 1990s, with the calendar year growth rate remaining below 3 per cent in every year. This reflects the effects of the fiscal consolidation, the relatively slow easing of tight credit conditions and ongoing private sector deleveraging. We are slightly more pessimistic about the level of GDP over the next year than the average of external forecasters, but slightly more optimistic than them at the end of the forecast horizon.

3.4 Key judgements in our central forecast include that:

- the trend growth rate is around 2.35 per cent a year to the end of 2013 and 2.10 per cent thereafter. This is unchanged from the November 2010 *Outlook*. Policy measures announced in the Budget could increase the economy's productive potential, in time, but we do not believe there is strong enough evidence to raise our trend growth assumption now;

- based on our assessment of a number of cyclical indicators, we estimate that activity in the economy was running around 3 per cent below potential in the third quarter of 2010, the output gap having narrowed from around -3¼ per cent of potential GDP in the second quarter;

- the labour market is likely to weaken further over the next few months before strengthening as economic growth picks up. LFS unemployment is forecast to rise from its current 8.0 per cent to 8.3 per cent of the labour force by the second quarter, falling back to 6.4 per cent by 2015. The claimant count rises from 1.45 million to 1.56 million by the second quarter, falling back to 1.18 million by 2015. We expect market sector employment to rise by around 1.3 million by 2015, partly offset by a fall of around 400,000 in general government employment; and

- global energy and food prices are likely to result in higher-than-expected CPI inflation of between 4 and 5 per cent through most of 2011. However, as these effects on the level of prices fall out of the annual rate comparison, and as the spare capacity in the economy continues to weigh down on inflationary pressures, we expect CPI inflation to fall back to around its target level of two per cent in the medium term.

3.5 The composition of the recovery we forecast is broadly as we expected in the November *Outlook*, with growth supported by business investment and a positive net trade contribution. However, real consumption is expected to be weaker in 2011 than we forecast in November, reflecting the pressure exerted on household disposable income by more rapidly rising prices.

3.6 As always, there is considerable uncertainty around all the forecast judgements we make – and around the conclusions that we reach. But we believe that growth is as likely to exceed our central projection as it is to fall short.

3.7 To reflect this uncertainty, Chart 3.1 presents our central growth forecast with a fan chart showing the probability of different outcomes based on past Treasury forecasting errors (rather than a subjective assessment of particular risks). The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.[1] More details on this methodology can be found in Annex B of the November 2010 *Outlook*.

[1] The probability bands surrounding our forecast for GDP growth in 2011 are narrower than those published in our November 2010 *Outlook*. Rather than our subjective view of the prevailing level of uncertainty, this reflects the shift from a year-ahead forecast error distribution to an in-year forecast error distribution. In the past, in-year forecasts have proved more accurate than year-ahead forecasts.

Table 3.1: Summary of central forecast and changes since November[1]

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2009	2010	2011	2012	2013	2014	2015
Output at constant market prices							
Gross domestic product (GDP)	-4.9	1.3	1.7	2.5	2.9	2.9	2.8
GDP Levels (2009 =100)	100.0	101.3	103.1	105.6	108.7	111.8	115.0
Expenditure components of GDP at constant market prices							
Household consumption[2]	-3.2	0.8	0.6	1.3	1.8	2.1	2.2
Business investment	-18.9	2.5	6.7	8.9	10.6	10.2	7.8
General government consumption	1.0	1.0	0.8	-1.2	-1.8	-2.4	-1.8
General government investment	16.9	4.4	-12.0	-9.9	-5.6	-1.4	2.4
Net trade[3]	0.9	-0.9	0.7	1.0	0.7	0.6	0.5
Inflation							
CPI	2.2	3.3	4.2	2.5	2.0	2.0	2.0
Labour market							
Employment (millions)	29.0	29.0	29.0	29.2	29.5	29.7	30.0
Average earnings[4]	1.8	1.7	2.0	2.2	3.8	4.3	4.5
ILO unemployment (% rate)	7.6	7.9	8.2	8.1	7.6	7.0	6.4
Claimant count (millions)	1.53	1.50	1.54	1.53	1.43	1.31	1.18
Output gap	-4.2	-3.4	-3.9	-3.6	-3.0	-2.2	-1.4
	Changes since November forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.1	-0.5	-0.4	-0.1	0.0	0.1	0.1
GDP Levels (2009 =100)	0.1	-0.3	-0.7	-0.9	-0.8	-0.8	-0.7
Expenditure components of GDP at constant market prices							
Household consumption[2]	0.2	-0.3	-0.7	-0.1	-0.1	0.0	0.0
Business investment	-0.1	1.2	-1.9	0.5	0.3	0.4	0.2
General government consumption	0.0	-0.8	1.1	0.1	0.0	0.0	-0.2
General government investment	2.7	3.4	3.3	-0.2	0.4	0.1	-0.2
Net trade[3]	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Inflation							
CPI	0.0	0.1	1.1	0.6	0.1	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Average earnings[4]	0.0	-0.6	-0.2	-0.2	-0.1	0.0	0.1
ILO unemployment (% rate)	0.0	0.0	0.2	0.4	0.4	0.4	0.3
Claimant count (thousands)	0	-3	34	83	90	69	42
Output gap	0.0	-0.1	-0.5	-0.7	-0.7	-0.7	-0.6

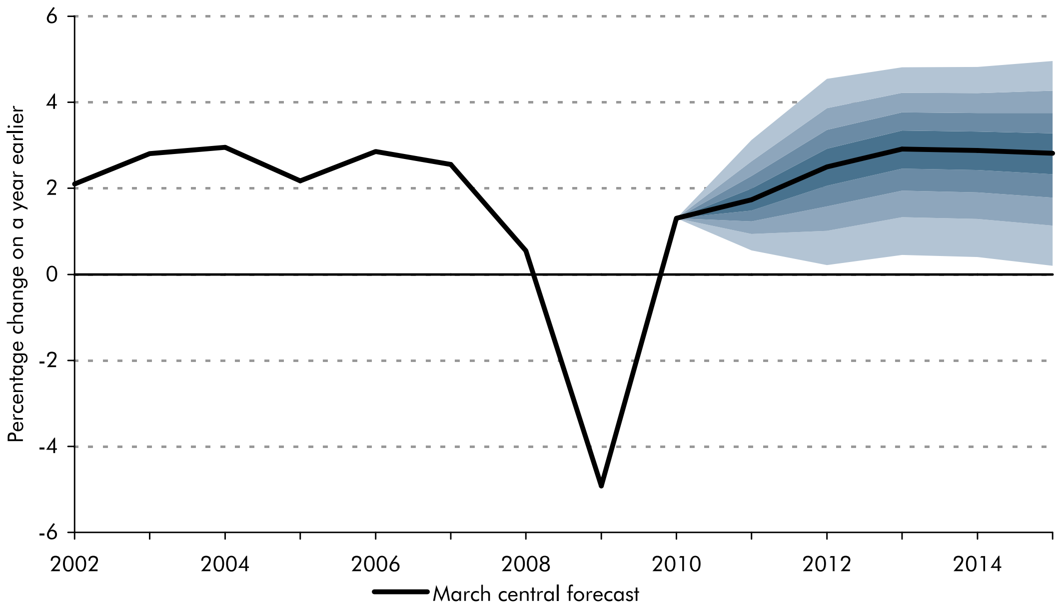
[1] The forecast is consistent with output, income and expenditure data for the fourth quarter of 2010, released by the Office for National Statistics on 25th February 2011.

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

[3] Contribution to GDP growth, percentage points

[4] Wages and salaries divided by employees

Chart 3.1: GDP fan chart



Source: ONS, OBR

3.8 Later in this chapter we detail two illustrative economic scenarios that reflect some of the debates among external forecasters. These help illustrate the risks to our central forecast and in Chapter 5 we describe the implications of these scenarios for the public finances. In summary these scenarios are:

- a persistent inflation scenario in which the temporary factors currently pushing up prices feed into inflation expectations and wage settlements, leading the Bank of England to respond by raising interest rates; and

- a weak euro scenario in which sterling appreciates significantly against the euro and euro area demand is weaker than in our central forecast.

Introduction

3.9 In this chapter, we begin by setting out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (paragraphs 3.10-3.19). We then discuss how quickly the economy is likely to return to its full potential (paragraphs 3.20-3.35) before describing the outlook for credit conditions (paragraphs 3.36-3.46). After setting out the likely composition of the recovery (paragraphs 3.47-3.82) we assess prospects for inflation and the labour market (paragraphs 3.83-3.98 and 3.99-3.106). We then compare our forecast with external forecasts (paragraphs 3.107-3.114) and conclude by setting out two illustrative economic scenarios (from paragraph 3.115), the fiscal implications of which we assess in Chapter 5.

Potential output, trend growth and the ouput gap

Latest estimates of the output gap and potential output

3.10 We begin the forecasting process by asking how the current level of activity in the economy compares to the potential level consistent with sustaining stable inflation in the long term. Estimating the size of this output gap is difficult because we cannot observe the supply potential of the economy directly so as to compare it to the actual level of GDP. Our approach, set out in more detail in our November 2010 *Outlook*, is to estimate the size of the current output gap directly using contemporaneous indicators of the amount of spare capacity.

3.11 Estimating the history of the output gap using this approach is not straightforward, partly because many of these indicators have a short time series. We intend to publish a paper exploring methods of estimating a historical output gap series later this year.

3.12 The ongoing uncertainty surrounding the current size of the output gap is reflected in recent estimates by other forecasters:

- in its January *Economic Review*, the National Institute for Economic and Social Research (NIESR) estimated that output was 4 per cent or more below potential;
- in its *Autumn Forecast*, the European Commission estimated that output was just over 5 per cent below potential in 2010, compared to 5½ per cent in 2009;
- in its October 2010 *World Economic Outlook*, the IMF estimated that output was 2.7 per cent below potential in 2010;
- in its latest *Economic Survey of the United Kingdom*, the OECD estimated that output was 4.6 per cent below potential in 2010; and
- a number of external members of the Bank of England's Monetary Policy Committee (MPC) have expressed views on the size of the output gap. In speeches made in the final quarter of 2010, Adam Posen suggested that output was at least 3 per cent below potential and probably more than 4 per cent below, and Martin Weale estimated that output was 4-6½ per cent below potential.[2]

[2] http://www.bankofengland.co.uk

3.13 Chart 3.2 presents our updated estimates of the output gap using two approaches:

- we produce an aggregate composite measure of the output gap by combining indicators of recruitment difficulties and capacity utilisation from the British Chambers of Commerce (BCC), Confederation of British Industry (CBI) and Bank of England Regional Agents' surveys; and

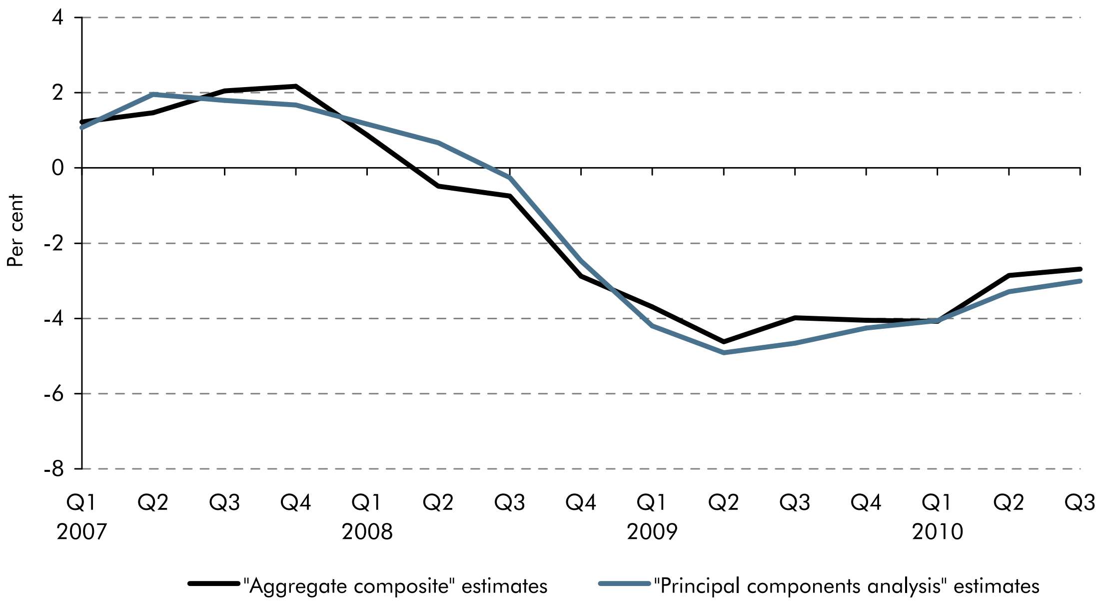
- we weight spare capacity indicators together using principal components analysis, a statistical technique used to identify the common cyclical component in a set of indicators. Unlike composite estimates, our principal components estimates take into account ONS indicators of spare capacity (such as wage inflation) as well as survey-based measures.

3.14 Our latest estimates using these methods suggest some narrowing of the output gap between the second and third quarter of 2010, albeit at a slower pace than seen over the first half of the year. This partly reflects mixed signals from different surveys. While nearly all survey measures pointed to a reduction in spare capacity over the first half of the year, they were less consistent between the second and third quarters. For example, while the BCC and Bank of England capacity utilisation indicators for manufacturing and services picked up in the third quarter, the CBI manufacturing capacity utilisation indicator fell back below its long-run average. ONS indicators suggest some narrowing of spare capacity in the third quarter, with a small reduction in the ILO unemployment rate and an increase in annual private sector average earnings growth to just under 2 per cent.

3.15 On the basis of these indicators, we have assumed that output was around 3 per cent below potential in the third quarter of 2010, which remains within a range of credible external estimates.

3.16 The full set of survey data needed to estimate the output gap in the fourth quarter of 2010 is not yet available and the information that is available is mixed. BCC indicators of capacity utilisation in both services and manufacturing fell back slightly, while the CBI manufacturing indicator increased. Similarly, the BCC recruitment difficulties indicators picked up slightly in services, but fell back significantly in manufacturing. By contrast, ONS labour market indicators suggest greater labour market slack in the final quarter, with the unemployment rate picking up to 7.9 per cent from 7.7 per cent in the previous quarter and annual private sector average earnings growth slowing to 1.7 per cent.

Chart 3.2: Estimates of the output gap based on cyclical indicators



Source:OBR

Decomposing the output gap

3.17 We can decompose our output gap estimate into a productivity (output per hour) gap, an average hours gap, an employment rate (age 16+) gap and a population (age 16+) gap. Of the -3 per cent output gap in the third quarter of 2010, we estimate that:

- around -1 percentage point is accounted for by output per head being below potential;
- around -0.9 percentage points reflects below-trend average hours;
- around -1.5 percentage points reflects the gap between the employment rate and its estimated trend level. This is consistent with both ONS and survey-based indicators, which continue to point to spare capacity in the labour market; and
- the gap between the level of the population aged 16+ and its estimated trend reduces the negative output gap by just over 0.3 percentage points.

The growth of potential

3.18 Consistent with our November forecast, we assume that potential output will grow by 2.35 per cent up to the end of 2013, and 2.10 per cent thereafter. This projection is based on the following assumptions:

- trend productivity growth of 2 per cent a year, in line with previous UK trends;
- trend average hours growth of -0.2 per cent a year, reflecting a continuation of the steady decline in average hours since the 1970s;
- trend employment rate growth of -0.15 per cent a year up to the end of 2013 and -0.2 per cent thereafter, based on a constant non-accelerating inflation rate of unemployment (NAIRU) of around 5¼ per cent and a decline in the activity rate as the baby boom generation moves beyond the State Pension age; and
- trend population growth of 0.7 per cent a year up to the end of 2013, slowing to 0.5 per cent thereafter as natural population growth slows.

3.19 As discussed in Box 3.1, we do not believe there is sufficiently strong evidence to justify changing our trend growth assumption in light of policy measures announced in Budget 2011. If these measures do improve the long-term productive potential of the economy, we expect this would, in time, show up in our contemporaneous estimates of the output gap.

Table 3.2: Trend output assumptions (annualised growth rates, per cent)

	Trend productivity[1]	Trend average hours	Trend employment rate[2]	Trend population[2]	**Trend output**
2010Q3 to 2013Q4	2.00	-0.20	-0.15	0.70	**2.35**
2014Q1 to 2016Q1	2.00	-0.20	-0.20	0.50	**2.10**

[1] Output per hour
[2] Corresponding to people aged 16 and over

Box 3.1: The impact of policy changes on the economy forecast

In November the Government launched its growth review. The aim of the review was "to identify structural reforms with the potential to improve the business environment and benefit the whole economy; and examine the barriers to growth that affect specific sectors and set out what the Government will do to address them."[a]

As part of the growth review, the Government has announced a number of measures in Budget 2011, including changes to the planning system and regulation policy. More details are set out in the Budget 2011 documentation.

Such measures could affect growth. For example, a number of studies point to a link between productivity growth and the operation of planning systems.[b] However, there remains significant uncertainty around the size of these effects. In the event that these measures have an impact on growth, there is likely to be some lag before the effects are realised; the effects will also depend on how the measures are implemented.

As a result, identifying the quantitative impact of such policies may not be possible for some time. Set against this uncertainty, we judge there is insufficient evidence at this stage to adjust our trend growth assumptions in light of these measures. It is also important to bear in mind the considerable uncertainty that surrounds the baseline estimate of trend productivity growth. To make a small and precisely calibrated change to this estimate would involve a spurious degree of precision.

Budget 2011 also includes a number of other measures which may, in principle, affect our economic forecast. For those measures which directly affect inflation, for example the postponement of fuel duty increases, we have made an explicit adjustment to our inflation forecast. For the remaining measures, such as the increase in the personal allowance, we have deemed the effects to be too small to make explicit adjustments to our forecast that are directly attributable to specific policy measures. The aggregate effect of all the measures announced in Budget 2011 forms part of our overall assessment of the economic outlook.

We were notified of the change of the rate of corporation tax and the one pence per litre reduction in fuel duty in April 2011 too late to include any potential second round effects in the forecast. However, we believe that any such effects would be minimal.

[a] HM Treasury and the Department for Business, Innovation and Skills, (2010), 'The path to strong, sustainable and balanced growth.'

[b] See, for example, Haskell, J. and Sadun, R., (2009) 'Regulation and UK Retailing Performance,' *IZA*, DP.4028; Barker, K. (2006), 'Review of Land Use Planning, Interim Report-Analysis,' and Maher, M. and Wise, M., (2005), 'Product Market Competition and Economic Performance in the United Kingdom,' *OECD*, Working Paper No. 433.

The pace of the recovery

The short-term outlook

3.20 The UK economy shrank unexpectedly in the final quarter of 2010. The ONS currently estimates that GDP fell by 0.6 per cent in the quarter, compared to our November forecast of a 0.5 per cent increase. Some volatility in the quarterly path of GDP is to be expected, particularly following recessions, but a significant part of the forecast error is also attributable to the heavy snowfall in December.

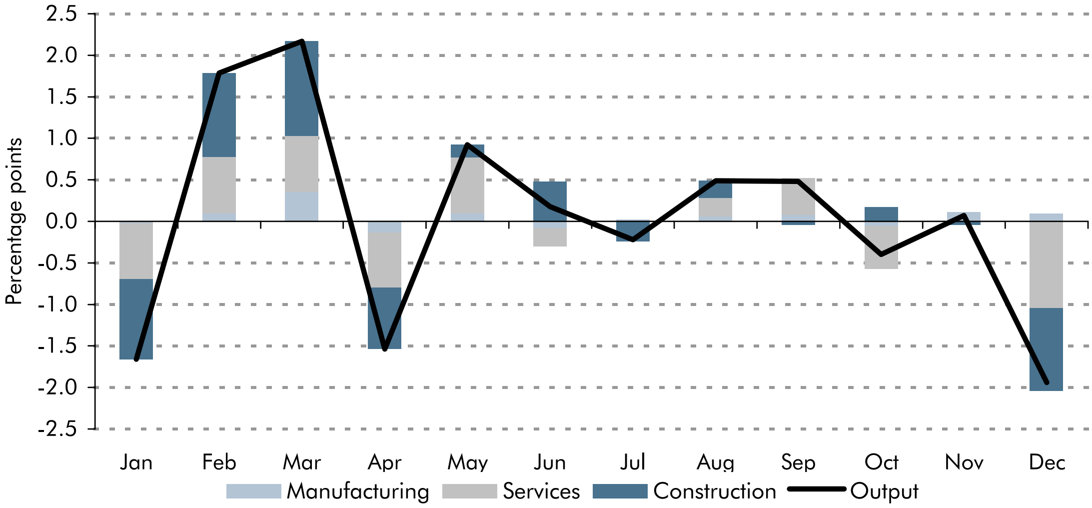
3.21 Independent forecasters surveyed in January, after the snow had fallen, were still, on average, expecting GDP to have risen by 0.5 per cent in the fourth quarter, with the range of estimates extending from 0.2 to 0.6 per cent. The explanation for such a large near-term forecast error is two-fold. First, the ONS judged that the snow had had a much bigger depressing impact than forecasters had expected. Second, the underlying growth momentum in the economy appears to have slowed much more sharply than we and other external forecasters expected. The ONS estimates that, even in the absence of snow, the economy would still have contracted by around 0.1 per cent in the fourth quarter.

3.22 Looking at the output measure of GDP, which drives early estimates, the largest contribution to the fall in output in the fourth quarter came from the business services and finance sector. This is the largest of the main sectors, so it is perhaps not surprising, but this sector did not show any evidence of being affected by the heavy snowfall at the start of last year. This is further evidence that the slowing in output growth can only partly be attributed to the weather.

3.23 We believe that growth is likely to bounce back in the first quarter of 2011, as activity resumes unhindered by the weather. However, we expect any further positive contribution from postponed activity in the final quarter of 2010 to be offset by weaker underlying growth momentum. For this reason, the average growth rate we expect across the two quarters is lower than in our November forecast.

3.24 Chart 3.3 shows the effect of previous disturbances on the monthly growth rate of output. A useful comparison is with January 2010, when heavy snow last disrupted activity. Services output contracted sharply on the month before recovering in February.

Chart 3.3: Monthly output growth in 2010 – seasonally adjusted[1]



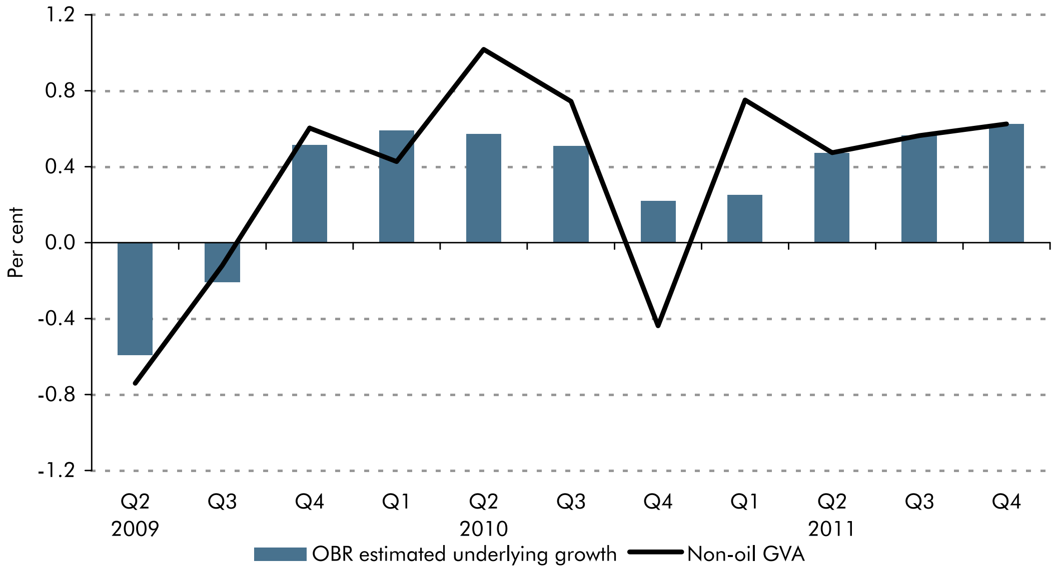
[1] Seasonally adjusted monthly construction data are not available so the quarterly seasonal adjustments have been applied to their constituent months. No construction data are available for December 2009 so the January growth rate is relative to the average output in the final quarter of 2009.

Source: ONS, OBR

3.25 The increase in the standard rate of VAT on 4 January 2011, further complicates the story. This should have encouraged consumers to bring spending forward to the fourth quarter to avoid the increase in prices but early indications are that this happened less than we anticipated in November.

3.26 Chart 3.4 attempts to isolate the underlying growth momentum of the economy by stripping out the effects of both snow and VAT changes, as well as the recent volatility in construction data. Underlying growth is defined here as non-oil GVA excluding construction. Adjustments have been made to the quarterly profile around the turn of the year in both 2009 and 2010 consistent with our estimate of the timing effects attributable to changes in VAT and adverse weather. Overall, these timing adjustments have a neutral effect on the level of output. The chart suggests that the headline growth figures not only overstated the underlying weakness of the economy in the fourth quarter, but also that they overstated the underlying strength of the economy in the previous two quarters.

Chart 3.4: OBR-estimated underlying growth rate



Source: ONS, OBR

3.27 Taking both underlying momentum and erratic factors into account, our forecast for GDP growth in the first quarter of 2011 is 0.8 per cent. The NIESR's latest monthly estimate for GDP was for growth of 0.2 per cent in the three months to February. This estimate implies that our forecast for the first quarter will be met if output expands in March by a similar amount to the estimate for February.

3.28 We expect growth to slow again in the second quarter of the year, as the snow-related rebound falls out of the quarterly comparison. We then expect growth to pick up gradually through the second half of the year, but at a slower pace than we forecast in November. Higher commodity prices represent a shock to the level of prices which reduces the purchasing power of income. The depressing impact of weaker real household disposable income on consumption is the main driver of the weaker outlook for GDP growth in 2011. Box 3.2 discusses the impact of the higher oil price on the economic forecast.

Table 3.3: The quarterly GDP profile

	Percentage change on previous quarter											
	2009				2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
March forecast [1]	-2.2	-0.8	-0.3	0.5	0.3	1.0	0.7	-0.6	0.8	0.4	0.5	0.6
November forecast [2]	-2.3	-0.8	-0.3	0.4	0.4	1.2	0.8	0.5	0.3	0.4	0.6	0.7
Change	*0.1*	*0.0*	*0.0*	*0.1*	*-0.1*	*-0.1*	*-0.1*	*-1.1*	*0.5*	*0.0*	*-0.1*	*-0.1*

[1] Forecast from fourth quarter of 2010

[2] Forecast from third quarter of 2010

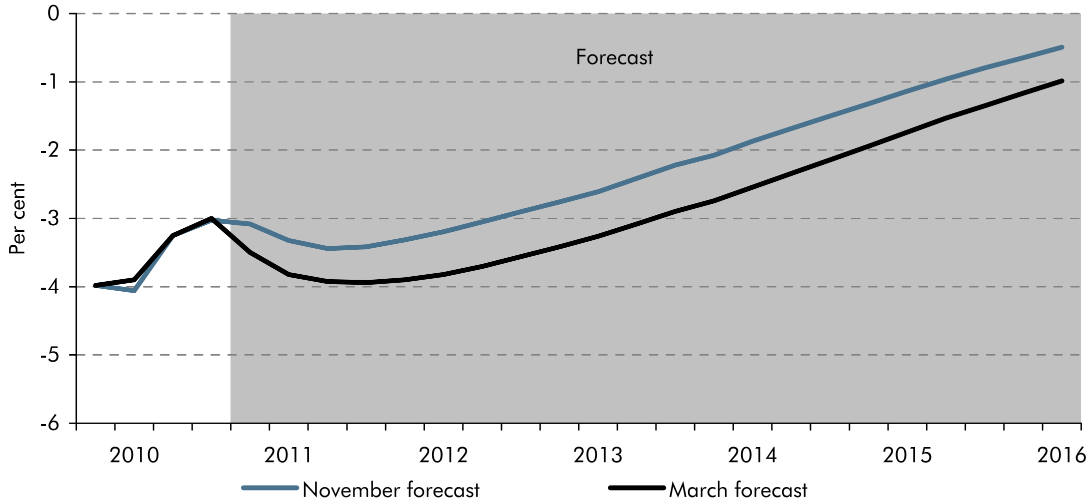
3.29 To conclude, judging the underlying pace of growth of the economy throughout 2010 and into 2011 is more difficult than usual. In these circumstances it makes sense to concentrate on the average growth rate across the final quarter of 2010 and the first quarter of 2011. On average, we have revised down our forecast of GDP growth across the two quarters from 0.4 per cent a quarter to 0.1 per cent a quarter. The exact split between the two quarters will be important in determining calendar year growth rates. But it is the extent to which the short-term weakness persists into the medium-term that matters most for the outlook for the public finances.

The medium-term outlook

3.30 As we set out in our November 2010 *Outlook*, our forecasts for medium-term growth are determined by our view of the amount of spare capacity in the economy, and the speed with which it seems likely to be eroded. Over the near term, we have excluded the estimated effect of snow on output from our forecast of the output gap. This adjustment temporarily reduces the size of the output gap in the fourth quarter by around ½ percentage point, relative to that implied by the latest output data. The output gap subsequently widens in the first quarter of 2011 as quarterly output growth, excluding the snow-related rebound, remains below trend. Over the two quarters, the effect of our adjustment to the output gap is neutral.

3.31 Chart 3.5 shows that, after widening a little in 2011, we expect the output gap to begin closing in 2012, and then to narrow steadily from 2013. On this basis, year-on-year GDP growth is forecast to strengthen only slightly in 2011 before picking up steadily to reach a peak of 2.9 per cent in 2013. Compared to our November forecast, near-term growth has been revised down, but there are small upward revisions to later years, reflecting the increased scope for growth implied by a slightly larger amount of spare capacity. This leaves the level of real GDP at the end of the forecast around 0.7 per cent lower than we expected in November.

Chart 3.5: The output gap[1]



[1] 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

3.32 In our forecast, policy interest rates are assumed to follow the path expected by participants in financial markets – Chart 2.9. Market participants now expect the Bank of England to tighten monetary policy sooner and faster than they did in November. However, the average expectation masks divergent views on the degree of spare capacity and the likelihood that above target inflation will feed into wage settlements. Indeed, as the Governor of the Bank of England recently pointed out, there are real differences of view among members of the Monetary Policy Committee about the likely path of inflation in the medium term.[3]

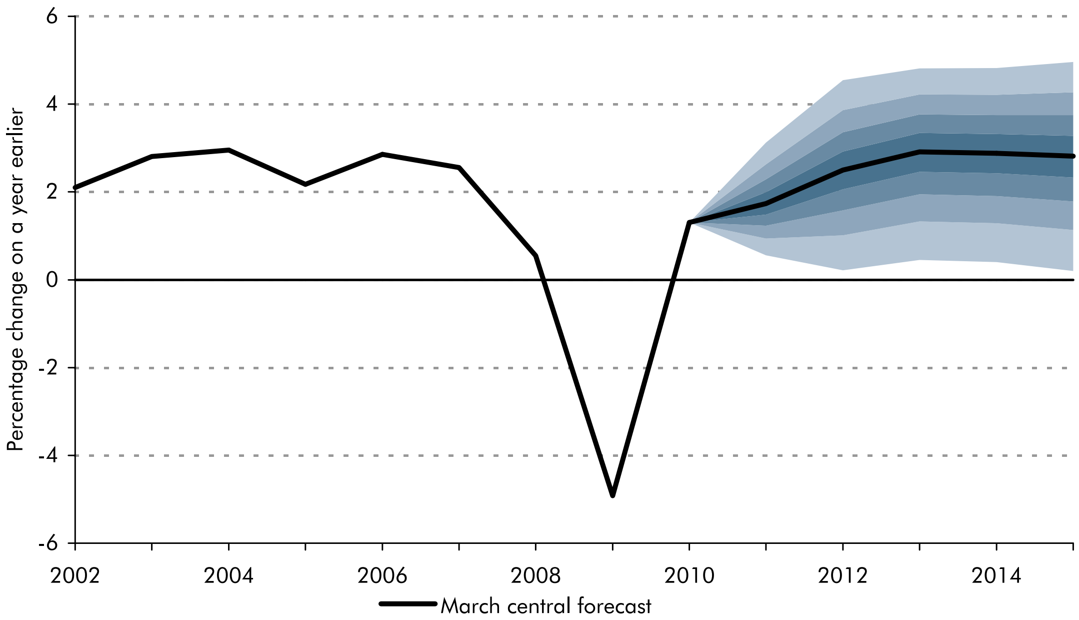
3.33 As in November, given our judgement about the degree of spare capacity in the economy, we assume that the Bank of England will allow above-trend growth in order for the economy to return to its trend level of output.

3.34 Our central growth forecast is shown in Chart 3.6. The distribution surrounding it shows the probability of different outcomes if you expected our forecasts to be as accurate as official Budget and PBR forecasts have been in the past. The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.[4]

[3] www.bankofengland.co.uk

[4] The probability bands surrounding our forecast for GDP growth in 2011 are narrower than those published in our November 2010 *Outlook*. Rather than our subjective view of the prevailing level of uncertainty, this reflects the shift from a year-ahead forecast error distribution to an in-

Chart 3.6: GDP fan chart



Source: ONS, OBR

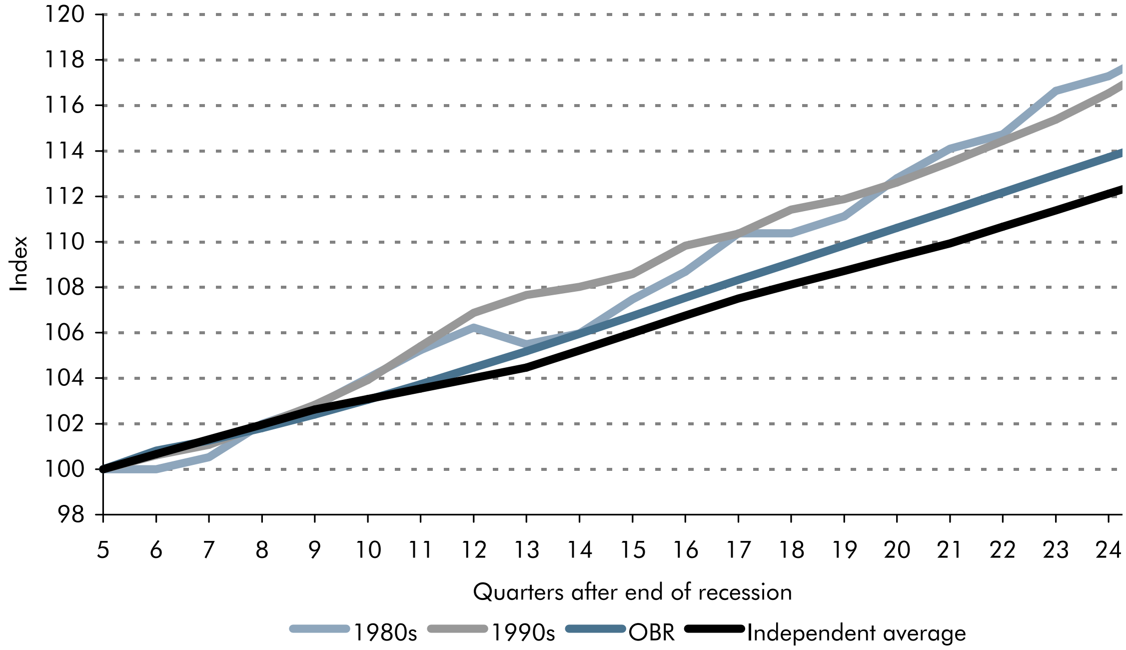
3.35 Chart 3.7 compares our GDP forecast with the historical paths of output following the 1980s and 1990s recessions, starting from the same stage of recovery.[5] We also plot the GDP forecast implied by the average of independent forecasts.[6] While we expect a slightly stronger recovery than that implied by the average of independent forecasts beyond 2011, our GDP growth forecast is slow relative to previous recoveries. This reflects the effects of the fiscal consolidation, the relatively slow easing of tight credit conditions and ongoing private sector deleveraging.

year forecast error distribution. In the past, in-year forecasts have proved more accurate than year ahead forecasts.

[5] All series are based at 100 five quarters after the end of the respective recessions.

[6] Only a subset of forecasters included in the Treasury's *Comparison of Independent Forecasts* submit forecasts beyond a two year horizon.

Chart 3.7: The level of GDP in previous recoveries and current forecasts



Source: ONS, HMT, OBR

Credit conditions

3.36 As we stated in November, the relatively slow easing of tight credit conditions is one reason why we expect a slower recovery relative to past recessions. The availability of credit, as well its price, are likely to weigh on consumption over the forecast period.

Financial sector

3.37 The capital positions of UK banks and the availability and cost of funding they experience are important factors in determining the supply of credit and the terms of lending to households and companies. Those factors, which came under pressure during the financial crisis, improved a little in 2010 but are still far from their pre-crisis levels.

3.38 The Bank of England's latest *Inflation Report* shows that major UK lenders made good progress in raising finance in 2010, issuing around £150 billion of new term debt in public markets and around £70 billion in private markets. The next two years will see continued pressure on UK banks' funding positions with around £400 - £500 billion of debt maturing by the end of 2012.

3.39 Some of UK banks' refinancing requirements reflect the expiry of the Government's Special Liquidity Scheme (SLS) at the end of January 2012. According to the Bank of England's latest *Financial Stability report,* by end of November 2010, £65 billion of Treasury bills issued under the scheme had been repaid.

Box 3.2: The oil price and the economic forecast

Since the publication of the November 2010 *Outlook,* the sterling price of crude oil has risen by just over £15. Oil price futures, which we use to forecast the oil price, have increased by £15 in the short term and £10 in the medium term. Increased demand from fast growing emerging markets like China may account for part of this increase, but recent spikes in the oil price also reflect unrest in the Middle East and North Africa.

An oil price shock can affect the output of net oil importing nations, like the UK. For example, a higher oil price will tend to reduce real household disposable income, thereby reducing household consumption. The magnitude of the output loss depends on factors like oil intensity of the economy, the scale and persistence of the price shock, pre-existing inflationary pressures and monetary policy credibility. The impact varies substantially between countries, with income being redistributed from oil importing to oil exporting economies. Overall, the impact on world output is thought to be negative. The IMF has estimated that a 100 per cent increase in the price of crude oil, caused by a reduction in supply, lowers global GDP by around 1.4 per cent at the trough.[a]

We estimate that the recent increase in the oil price will increase UK CPI inflation by around 0.5 percentage points in 2011, relative to our November forecast. All else equal, this implies a reduction in the growth of real household disposable income of 0.4 percentage points and a reduction in output growth of around 0.2 percentage points relative to our November forecast. Of the downward revision to our forecast for output by 2015-16, a little over a quarter can therefore be attributed to the increase in the oil price since November. Further movements in the oil price, in either direction, could be expected to have proportionate effects.

Persistent changes in the real oil price can affect the economy's supply potential if they affect the rate of capital accumulation. A key consideration is the extent to which any change in the oil price is transitory or permanent. A temporary spike in the oil price might be expected to have very little lasting impact. On the other hand, a permanent increase in the oil price may reduce potential output if it affects the equilibrium capital stock.[b]

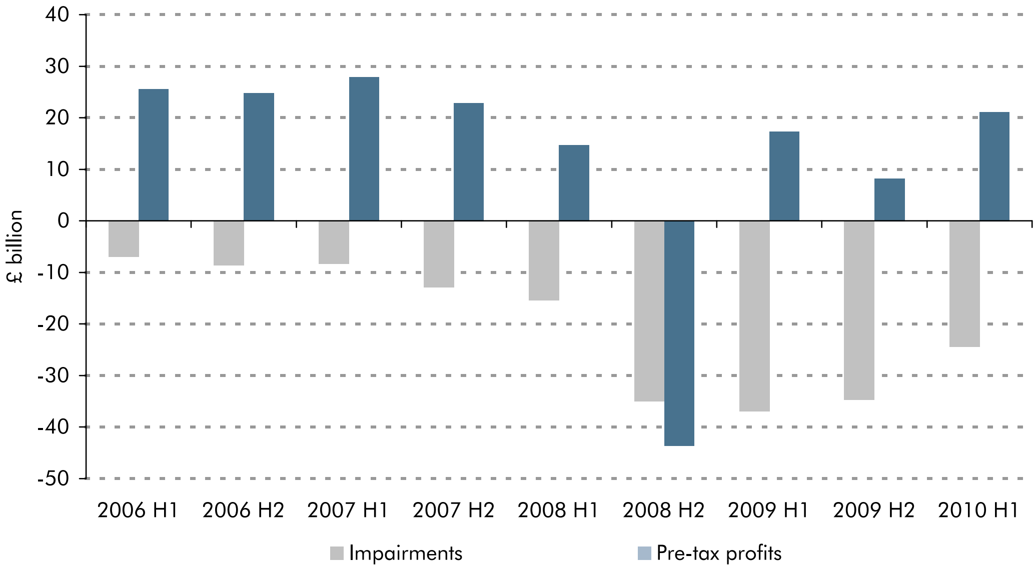
It is too soon to assess whether recent increases in the oil price have affected or will affect the economy's long-run supply potential. In the event that the increase in the oil price is both persistent and has an effect on potential supply this will tend to reduce the size of the output gap. In such circumstances we might expect to observe evidence of a smaller degree of spare capacity than expected.

[a] IMF, (2007), 'Spillovers and Cycles in the Global Economy', *World Economic Outlook.*

[b] Work undertaken by the interim OBR suggested that a permanent exogenous increase in the real oil price of 20 per cent may reduce trend output by around 0.3 - 0.5 percentage points.

3.40 The capital positions of major UK banks improved in the first half of 2010, mainly due to increased profits led by improved trading income and a fall in impairments, as shown in Chart 3.8. Announcements of full year profits in recent months, and market expectations, point to a continued improvement in profitability that should further strengthen the capital positions of UK banks this year.

Chart 3.8: Major UK banks' pre-tax profits and impairments



Source: Bank of England

Credit supply and demand

3.41 In 2009 and 2010, the private sector paid back more existing debt than it took on new debt, as shown in Table 3.4.[7] This is likely to reflect a combination of tighter supply (reflected in higher funding costs) and reduced demand (as deleveraging continues). Analysis of past financial crises has shown that subsequent economic recoveries have not typically been associated with a rebound in the stock of credit. IMF analysis has found that credit growth tends to turn positive only seven quarters after the resumption of output growth.[8]

[7] www.bankofengland.co.uk

[8] IMF, (2009), 'Crisis and recovery,' *World Economic Outlook*.

Table 3.4: UK lending to PNFCs and individuals

	Net average monthly flow £ billions			
	2007	2008	2009	2010
Lending to UK businesses (PNFCs)[1]	7.4	3.9	-3.9	-2.1
Secured lending to UK individuals (sterling)[2]	9.0	3.4	1.0	0.7
Consumer credit lending UK individuals (sterling)[2]	1.1	0.9	-0.1	0.2

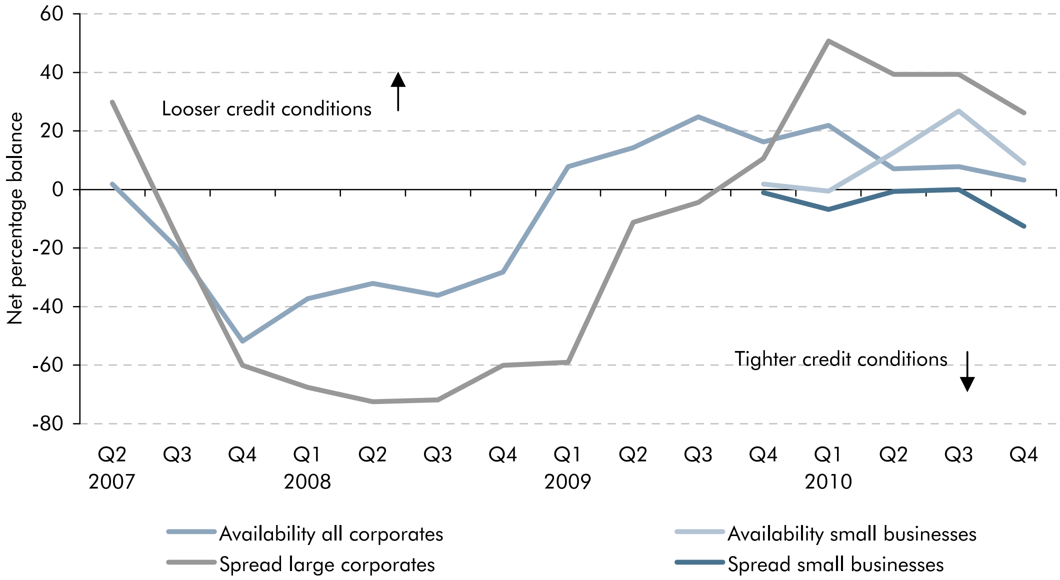
[1] Lending by UK monetary financial institutions both sterling and foreign currency

[2] Sterling lending by UK monetary financial institutions and other lenders

Corporations

3.42 The Bank of England's *Credit Conditions Survey* has reported an improvement in the availability and cost of credit to corporations since 2009, but the rate of improvement in both appears to have slowed a little over 2010. There are also differences between the experiences of small and large firms. Chart 3.9 shows that while large firms saw an improvement in borrowing spreads over 2010, small firms did not.

Chart 3.9: Availability and cost of credit to UK corporations



Source: Bank of England

3.43 Both the supply and demand for corporate lending fell sharply in 2008, but unlike supply, demand from large firms has generally continued to fall.[9] However, lenders surveyed by the Bank of England expect demand by large

[9] www.bankofengland.co.uk

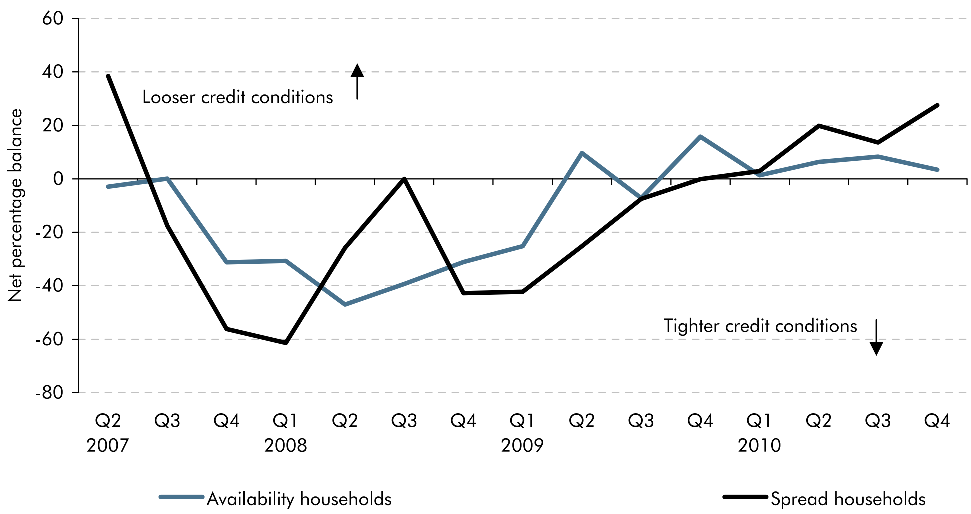
corporations to pick up in 2011, in line with increased mergers and acquisition activity. Aside from economic conditions, lower demand for bank credit could also reflect a renewed preference for other forms of finance. Figures from the Bank of England show that net equity issuance was positive in both 2009 and 2010, having been negative in 2007 and 2008.

3.44 In November 2008, HMRC launched a new business payment support system designed to help viable businesses having difficulty in meeting tax payments because of economic conditions.[10] 'Time to pay' proved popular and in 2009 over 250,000 agreements were approved, amounting to £4.5 billion. Requests for time to pay have fallen substantially throughout 2010. By December, the value and number of arrangements were around half that of December 2009. This suggests that firms' short-term finance requirements may have eased over the year.

Households

3.45 Lenders reported a modest rise in the availability of secured credit to UK households in the fourth quarter of 2010, as shown in Chart 3.10. However, the outlook for the housing market was reported to have weighed on demand for secured credit and also reduced the availability of higher loan to value ratio mortgage finance.

Chart 3.10: Availability and cost of secured credit to UK households



Source: Bank of England

[10] More information can be found in HMRC information note *Business Payment Support Service – An Official Statistics release,* January 2011 on the HMRC website: www.hmrc.gov.uk

3.46 Spreads on secured lending fell in the latter half of 2010, in line with a fall in demand and a modest improvement in availability. However, the cost of unsecured lending was reported to be unchanged. Despite improvements in the cost of secured lending, spreads over Bank Rate remain elevated. In July 2007, the effective interest rate on new mortgages was around 5¾ per cent while Bank Rate was 5¾ per cent.[11] In December 2010 the effective rate of new mortgages was around 3.6 per cent compared to a base rate of 0.5 per cent.

The composition of growth

Income and expenditure

3.47 Our forecast for the level of GDP in the medium term is a key driver of our assessment of the outlook for the public finances. But, as we illustrated in the delayed rebalancing scenario in our November 2010 *Outlook*, the composition of GDP also affects the public finances. This section discusses the broad outlook for the income and expenditure measures of GDP, before considering the expenditure components in more detail.

3.48 Nominal GDP – the total cash value of economic activity – fell sharply during the recession, but has since rebounded relatively strongly. Nominal GDP at market prices grew by 5.2 per cent in the year to the third quarter of 2010, only a little below its long-run average. The growth rate slipped back in the final quarter of 2010, but at first sight still appears to be consistent with relatively robust levels of nominal spending.

3.49 Total final expenditure comprises domestic spending plus overseas spending on UK exports. Chart 3.11 shows that this measure of spending has recovered even more strongly than nominal GDP, growing by just under 7 per cent last year, and that we expect this growth to be sustained.

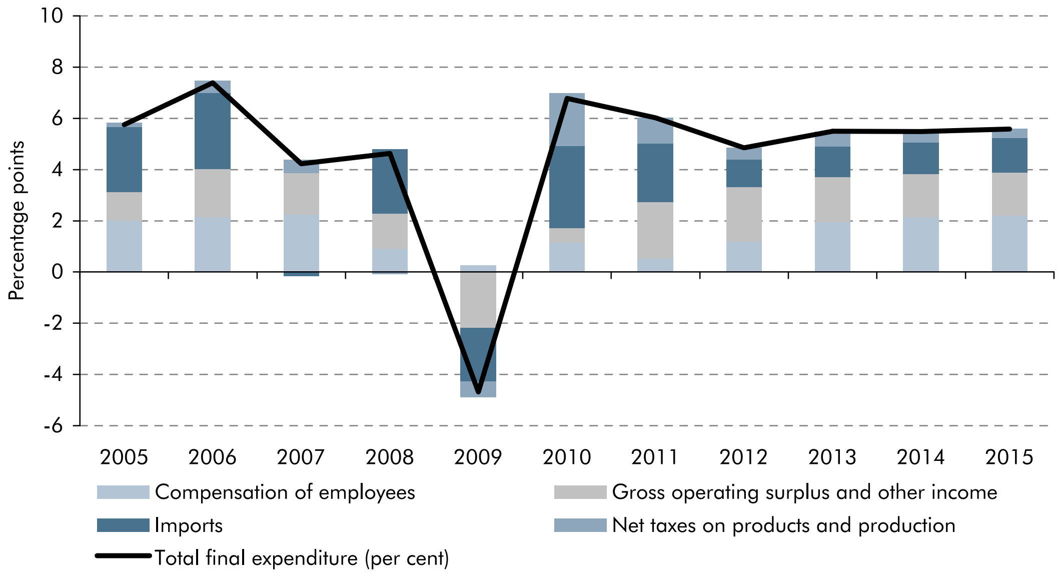
3.50 As all spending in the economy must generate an income flow, the strength of nominal spending implies strong growth in nominal income. However, Chart 3.11 shows that relatively little of the recent strength in nominal spending has translated into domestic household wages or corporate profits. The majority of last year's increase in spending was accounted for by higher spending on imports and higher taxes, generating income flows for overseas companies and the government rather than UK households or firms.

3.51 We expect this pattern to unwind only partially this year, with some recovery in domestic profit growth, while wage growth remains very subdued. Sustained growth in spending on imports and the increase in VAT to 20 per cent, means

[11] Source: Bank of England

that less than half of the income growth in 2011 accrues to domestic households and firms. Given the strong growth in import prices, this highlights the importance of inflation in generating the strong nominal income and expenditure flows. But higher inflation is also likely to have squeezed domestic real income growth. It is not until 2013 that wage and profit growth return to their pre-recession shares of nominal income growth.

Chart 3.11: Income counterparts to growth in total final expenditure



Source: ONS, OBR

3.52 Turning to the expenditure measure of GDP, our forecast continues to show a rebalancing of demand away from consumption towards business investment and net exports. The reduction in our GDP growth forecast for 2011, relative to November, is almost entirely accounted for by a weaker outlook for consumption growth as higher inflation squeezes household disposable income.

Table 3.5: Expenditure contributions to GDP growth[1]

	Percentage points, unless otherwise stated						
	Outturn	Forecasts					
	2009	2010	2011	2012	2013	2014	2015
GDP growth, per cent	-4.9	1.3	1.7	2.5	2.9	2.9	2.8
Main contributions							
Private consumption	-2.0	0.5	0.4	0.8	1.2	1.3	1.4
Business investment	-2.0	0.2	0.6	0.8	1.1	1.1	0.9
Dwellings investment[2]	-0.8	0.1	0.2	0.2	0.3	0.3	0.2
Government[3]	0.6	0.4	-0.2	-0.5	-0.5	-0.5	-0.3
Change in inventories	-1.2	1.4	0.2	0.0	0.0	0.0	0.0
Net trade	0.9	-0.9	0.7	1.0	0.7	0.6	0.5

[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.

Components of domestic demand

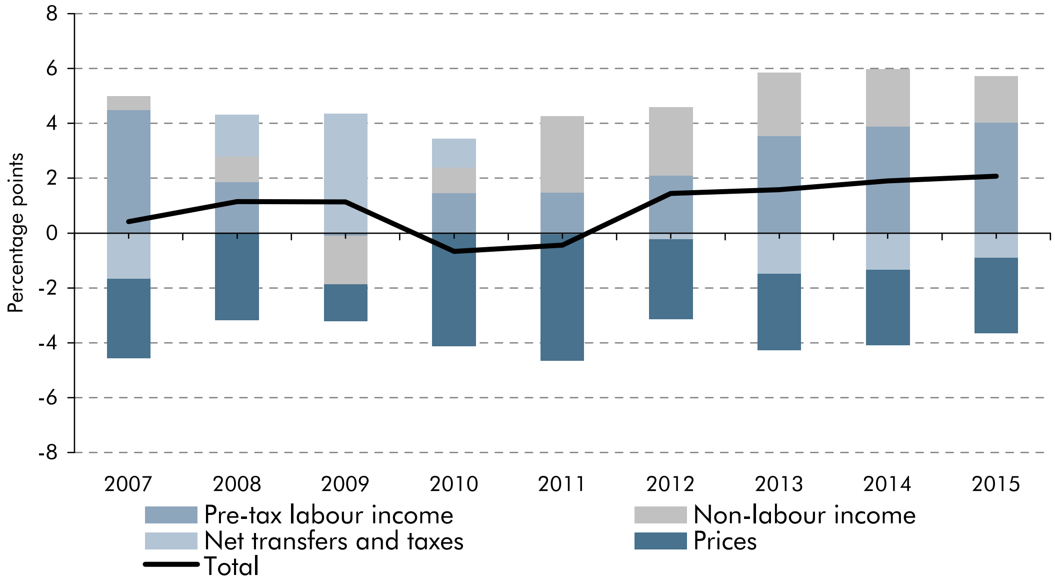
Consumer spending

3.53 The outlook for consumption growth has weakened further since our November forecast. Given the weakness of our forecast for real household disposable income growth, this is not surprising. We now expect real household incomes to fall further in 2011 and to end the year 1½ per cent lower than in our previous forecast. The deterioration in 2011 is driven almost entirely by a considerably higher forecast for inflation, which in turn reflects the strong increases in food and oil prices in recent months.

3.54 We do not expect nominal wages to respond to this increase in prices, which means that nominal wage growth is not forecast to outpace CPI inflation until 2012. The absence of a stronger wage response is a key judgement for this forecast, which we discuss in the inflation section. We therefore set out an alternative scenario at the end of this chapter which contains a stronger response from nominal wages, in other words, greater real wage resistance.

3.55 Our forecast for growth in the constituent parts of household income is shown in Chart 3.12. Reflecting the operation of the automatic stabilisers, significant support was provided to households through net taxes and transfers in 2009 and, to a lesser extent, 2010. This reverses in the later years of the forecast as the fiscal consolidation builds up. The effects of higher near-term inflation also unwind in the medium term as temporary influences drop out of the comparison and spare capacity continues to weigh down on inflationary pressures. Labour income is normally the largest contributor to household income growth, but it does not recover this role until 2013.

Chart 3.12: Contributions to growth in real household disposable income



Source: ONS, OBR

3.56 The household sector is also unlikely to receive support from the housing market this year. After stabilising last year, house prices are expected to experience a further small fall in 2011 and negligible growth in 2012. February's data on mortgage approvals continue to remain significantly below their long-run average and show little evidence of returning towards it. We have slightly revised down our forecast for property transactions over 2011.

3.57 We have revised down our forecast for consumption growth in 2011 from 1.3 per cent to 0.6 per cent, with further small downward revisions in 2012 and 2013. This subdued consumption outlook requires households to dip into their savings again in 2011, so the saving ratio continues to fall back from its post recession peak. Thereafter, the saving ratio stabilises at around 3½ per cent in our forecast (much the same as forecast in November), which is around half its average over the last 50 years.

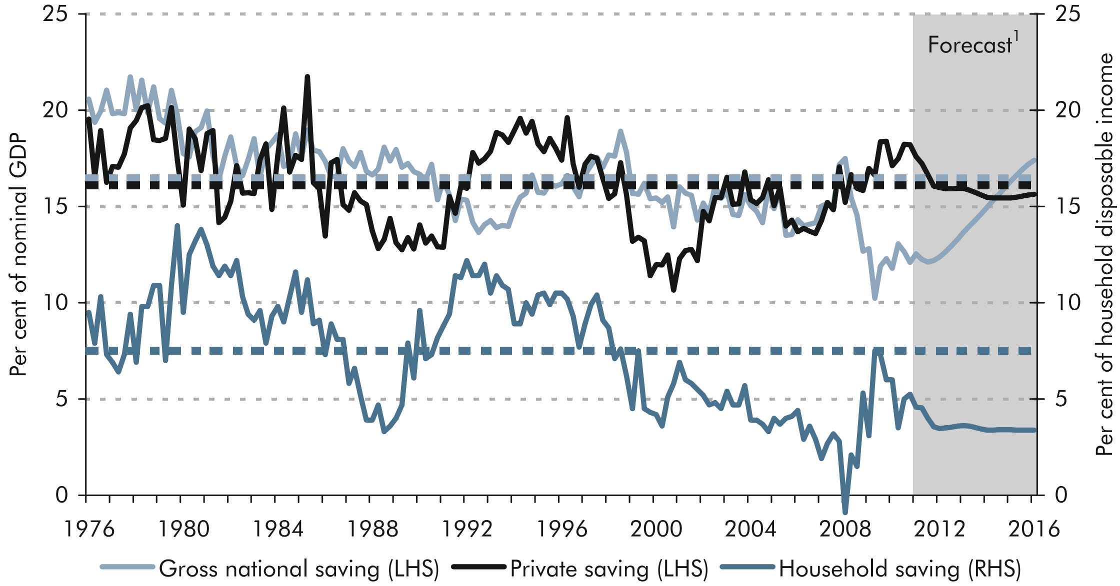
3.58 The historically low forecast level of the household saving ratio reflects two main factors:

- first, the UK's recent experience of relatively low and stable inflation has reduced the amount that households need to save to maintain the real value of their nominal assets; and

- second, saving by companies should eventually flow back to households in the form of dividends.[12] It is the overall level of saving in the economy that really matters for households. And, as discussed later, the UK corporate sector is currently running a large financial surplus (an excess of saving over investment). Although not all of the corporate sector is owned by UK households, the majority of this income is ultimately available to households to finance consumption. [13]

3.59 This means that, as we can see in Chart 3.13, the UK's national private saving ratio is close to its average over the past 35 years and we expect it to remain around that level over the forecast period. Once the effects of the fiscal consolidation (i.e. increased government saving) are included, gross national saving is forecast to rise a little above its long-run average by the end of the forecast period.

Chart 3.13: Household and national saving



[1]Four-quarter average over the forecast period.
Source: ONS, OBR

[12] In the case of companies that choose not to pay dividends, households with direct equity ownership can sell their holdings should they wish to raise income. However, the majority of such holdings are indirectly held through pension funds and the distribution of ownership is highly uneven.

[13] In 2008 over 40 per cent of UK quoted ordinary shares were owned by foreign investors. Conversely some UK households own shares in foreign companies, so the level of corporate saving in other countries may also affect household saving in the UK.

Box 3.3: Decomposing the saving ratio

The household saving ratio is the proportion of disposable income that is not spent on consumption. However, this is not as straightforward a definition as its sounds because of the way in which contributions to pension funds and the interest and dividends earned by them are attributed to households.

In the National Accounts, changes to the equity households have in pension funds are driven by employer and employee contributions to pension funds. The employee contributions, in 2009, consisted of around £5 billion of direct payments and around £35 billion of interest and dividends accrued to existing pension assets. Employer contributions were around £48 billion. So the share of contributions to pension funds that might be considered an active part of household saving, was only around 7 per cent of the total in 2009.

In the National Accounts, saving is defined as:

$$\text{disposable income} - \text{consumption} + \text{change in net equity in pension reserves}$$

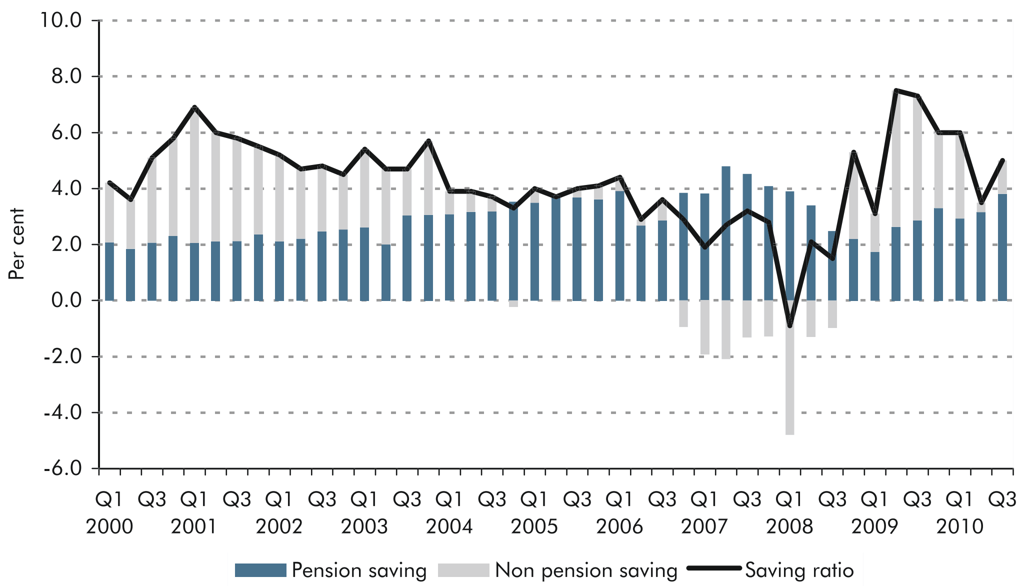
The saving ratio is defined as:

$$\frac{\text{disposable income} - \text{consumption} + \text{change in net equity in pension reserves}}{\text{disposable income} + \text{change in net equity in pension reserves}}$$

Because the change in net equity is a far greater share of the numerator than the denominator it can have a substantial effect on the saving ratio.

To illustrate this, Chart A decomposes the saving ratio into contributions from pension and non-pension saving.[a]

Chart A: Pension and non-pension saving



Source: ONS

One reason for the increase in pension saving from 2000 to 2006 was the need for firms to make special payments to make up shortfalls in defined benefit pension funds.[b] Over the course of the recession, these funds moved into surplus, decreasing required contributions at a time when employers were also under greater financial pressure. This explains some of the fall in the saving ratio. Over the same period, household non-pension saving also fell as households dipped into savings to smooth their consumption.

Recent movements in the pension saving contribution to the saving ratio will have been affected by the increased volatility of dividend payments and interest accrued by pension funds.

[a] The pension saving contribution is calculated as the residual of the saving ratio less the contribution of non-pension saving [(disposable income less consumption)/disposable income].

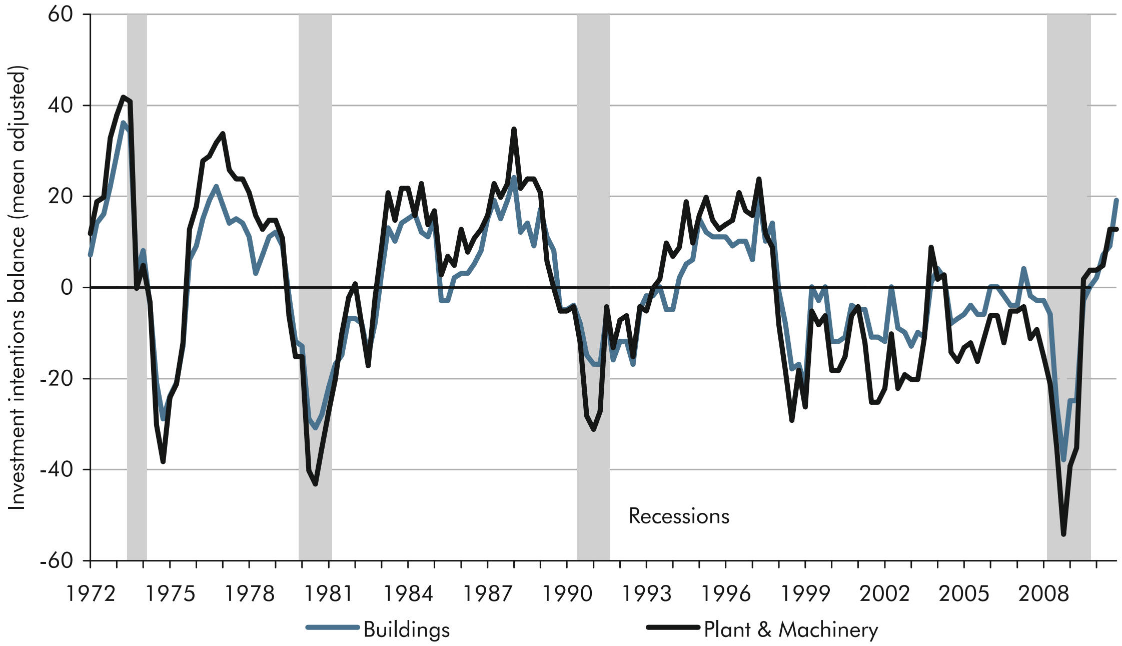
[b] See Pension Trends Chapter 14: Pensions and the National Accounts, January 2010 edition. Available from: http://www.statistics.gov.uk

Business investment

3.60 Business investment has recovered strongly, but erratically, over the past year. It ended 2010 up 10 per cent on the final quarter of 2009. In the most recent quarter, business investment contracted by 2.5 per cent, but this followed a strong increase in the third quarter (during which, business investment was provisionally estimated to have fallen). The end result is that business investment starts this forecast in much the same place as it was in our November 2010 *Outlook*.

3.61 Further out, our forecast also remains little changed from November. Investment intentions have continued to rise in both the CBI and Bank of England Agents surveys. The rise in the Agents' score partly reflected reports that exporters are beginning to invest in additional capacity to keep up with rapid growth in foreign demand, as anticipated in our exports forecast. Chart 3.14 shows that the (mean-adjusted) investment intentions balance in the CBI Industrial Trends Survey returned to positive territory at the end of 2009, earlier than in previous post-recession recoveries.

Chart 3.14: Investment intentions



Source: CBI Industrial Trends Survey

3.62 This may appear surprising as prospects for future demand remain uncertain. But, at least in the near term, we expect much of this investment to be driven by firms' need to repair and maintain existing capital. Even after a year of strong growth, the ratio of business investment to GDP remains very low, reflecting the depth of the downturn in investment during the recession.

3.63 While credit conditions experienced by small firms remain very tight, financing conditions for large corporations, who account for the bulk of investment, are more favourable. An extended period of low interest rates, reductions in the rate of corporation tax, and strong growth in profitability all underpin our forecast for strong business investment growth over the next five years. On average, firms will also be able to rely on internal financing as the corporate sector is running a large financial surplus (the majority of investment is typically funded from retained earnings).

Residential investment

3.64 In our November 2010 *Outlook*, we anticipated a slowdown in residential investment growth around the turn of the year. Although the split of non-business investment is not yet available for the final quarter of 2010, it looks likely that residential investment contracted, given the fall in activity in the construction sector of 2.3 per cent in the same quarter. Early indications are that some of this weakness continued in January. However, we expect this to be a temporary period of weakness with growth returning throughout the rest of the forecast. In comparison to the size of the decline during the recession, the forecast recovery is relatively moderate and residential investment does not recover to its pre-recession level by the end of our five year forecast horizon.

Stock building

3.65 The stock cycle now appears to be largely complete. Stock-building made a small positive contribution to GDP growth in the final quarter of 2010, but the period of large contributions to growth from this component looks to be at an end, as the pace of stock-building is now back to around its average pre-recession levels. However, the completion of the inventory rebuild does have wider implications for our forecast. As the component of domestic demand with the highest import content, it is likely to have been a temporary factor behind the strong growth in imports in 2010.

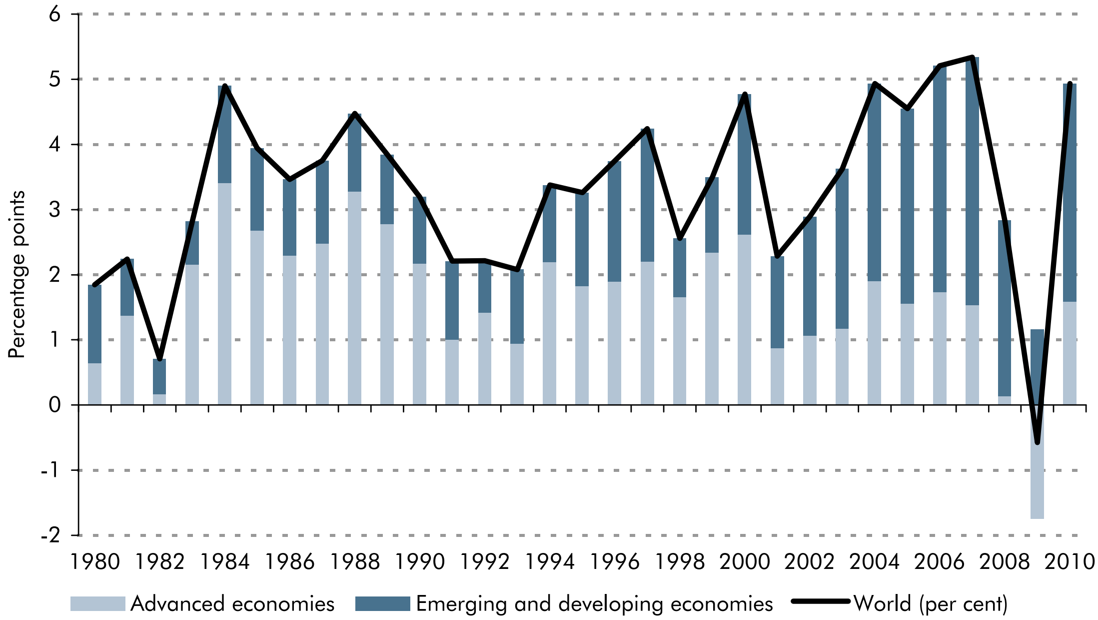
Government

3.66 The medium-term profile for government consumption and investment is little changed from our November 2010 *Outlook*, which was consistent with the plans set out in the 2010 Spending Review. With little adjustment to the profile for fiscal consolidation, the changes to our forecast reflect the incorporation of new and revised data. The Quarterly National Accounts for the third quarter of 2010 included revisions which reduced the level of government consumption by around 1½ per cent, relative to our November forecast. However growth of 0.7 per cent in the final quarter of last year reversed much of this shortfall against our forecast. The result is that while the growth rates for 2010 and 2011 have been revised, our forecast for the level of government consumption is much the same as in November.

World economy

3.67 World growth and world trade have been stronger in 2010 than forecast in November. The latter half of the year saw a rebound in consumption and exports in advanced economies, including the US, Japan and Germany, and continued strong growth in many emerging economies. Despite renewed strength in some developed economies, the two tier recovery continues, as shown in Chart 3.15. In 2010, emerging and developing economies accounted for around 70 per cent of world GDP growth.

Chart 3.15: Contributions to world GDP growth



Source: IMF, *World Economic Outlook*

3.68 The US economy grew by 2.8 per cent in 2010, led by a recovery in household consumption and investment supported by further quantitative easing and fiscal stimulus.

3.69 Euro area GDP grew by 0.3 per cent in the fourth quarter of 2010, with strong growth in household consumption and exports tempered by a fall in fixed investment. Growth was not uniform, with ongoing weakness in the periphery states. Our growth forecast for the euro area has been revised down since November, partly reflecting continued sovereign debt challenges facing some of the member states and the impact of rising oil prices. Our second illustrative scenario, presented at the end of this chapter, sets out the potential impact of a weaker euro and euro area demand on our forecast.

3.70 We have revised up our 2011 growth forecast for the advanced economies. The weaker outlook for consumer spending, arising from higher fuel prices, is expected to be more than offset by the effect of further planned fiscal stimulus in the US and improved labour market conditions. Positive manufacturing figures in the first quarter also point towards stronger exports growth.

3.71 Growth in emerging economies picked up strongly in 2010 with Asia leading the way. However, there is some evidence of slowing towards the end of the year as higher inflation and monetary tightening begin to bite. Our forecast is for continued strong, but slightly lower, growth in 2011 and 2012.

3.72 Our world growth and trade forecast has been revised up for 2010 and 2011, even after taking into account higher world oil prices. This mainly reflects higher growth in advanced economies and stronger-than-expected performance in the final quarter of 2010. The growth profile for 2012 to 2015 is lower, reflecting a higher starting level of trade and output, a softer euro area recovery, the impact of fiscal consolidation among advanced economies, higher world prices and slightly lower emerging market growth. A continued rise in the price of oil would weaken world trade and growth. Box 3.2 looks in more detail at the economic impact of a rise in oil prices for the UK.

3.73 It is too early fully to assess the impact of the tragic events in Japan on the world economy. Typically, events such as these cause destruction of capital stock and disturbance to economic activity mainly due to damaged infrastructure. Output is likely to be lower in the short term followed by a recovery. For comparison, the economic cost of the smaller Hanshin earthquake in January 1995 is estimated to have been around $120 billion or around 2.5 per cent of GDP. The impact on measured output was limited, with GDP falling by 0.3 per cent in the first quarter before recovering.[14] The economic impact is likely to be larger this time, given the wider effects of the recent earthquake.

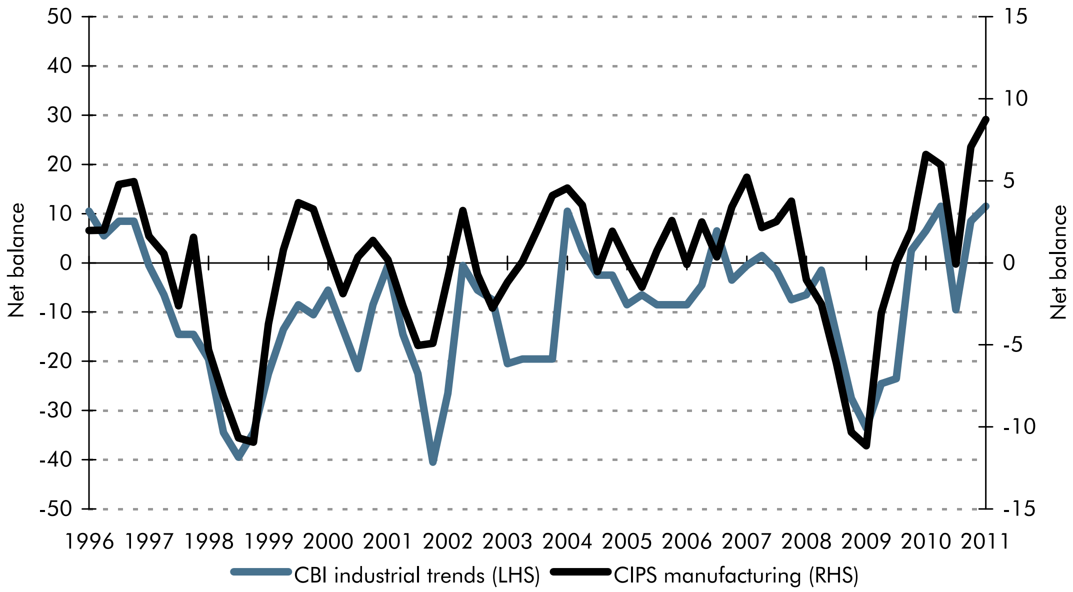
3.74 Japan represented around 6 per cent of world output (PPP) and between 4 and 5 per cent of world trade in 2010. The impact on world growth and trade is therefore likely to be relatively moderate. Japan represents only around 2 per cent of UK export markets so the impact on UK exports should be comparatively small. There is some downside risk to our forecast from the potential impact on wider Southeast Asian supply chains as well as some upside risk from potentially stronger imports in the region due to reconstruction activities.

Exports

3.75 UK export growth has continued to be rapid in recent months. January's monthly trade release showed that, after appearing to slow a little in the second half of last year, goods exports resumed their upward path and are currently estimated to be up 15 per cent over the past year. The monthly trade data can be very volatile, but Chart 3.16 shows that the strength of the outlook is supported across the survey measures, with the CBI Industrial Trends and CIPS PMI export orders surveys both significantly above their long-run averages.

[14] IMF, (September, 2001), *World Economic Outlook*.

Chart 3.16: Survey measures of UK export orders



Source: Ecowin

3.76 The ONS has also revised up its estimates of export growth over the last two years, particularly in 2009. We have revised up our forecast for the UK's export market share, with UK exporters now expected to continue to gain market share into 2013. This forecast remains comparatively modest relative to the experience of the early 1990s, which saw UK exporters capture market share for five continuous years following a sterling depreciation.

3.77 However, the weaker medium-term outlook for the world economy implies weaker prospects for growth in UK export markets. We have therefore revised down our medium-term forecast for export growth. UK exporters are forecast to capture a greater share of smaller export markets relative to November.

Imports

3.78 The absence of a positive net trade contribution to growth, despite the strength of export growth, is explained by the comparable surge in UK imports in 2010. But unlike our forecast for exports, we do not expect this strength to persist. In the medium term, the primary factor will be the weakness of the outlook for domestic demand. The larger rises in import prices might also encourage UK consumers to substitute away from imports towards domestically produced goods, although as yet there is little sign of this in the data.

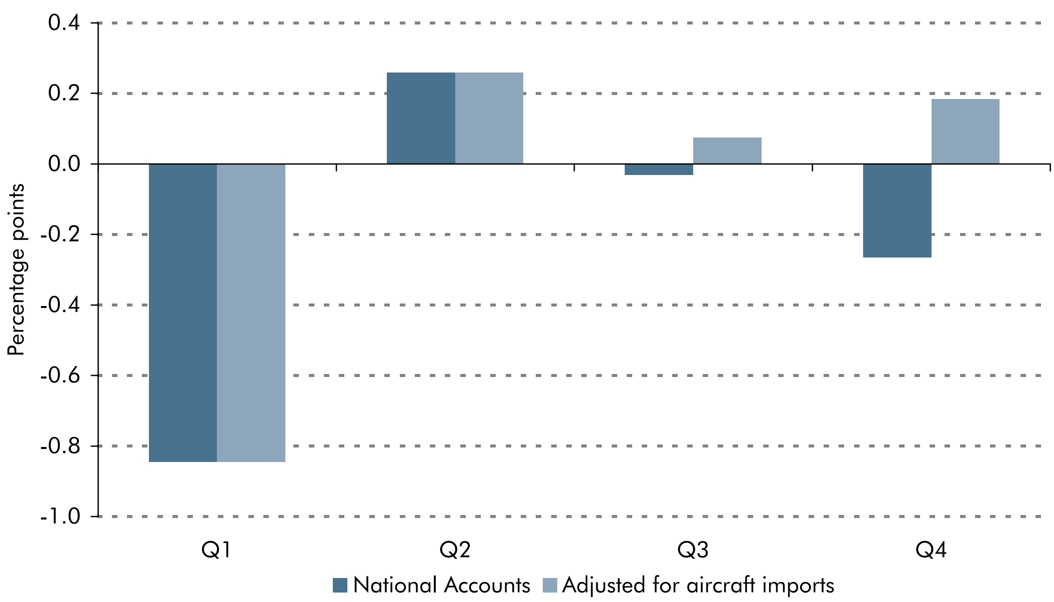
3.79 In recent quarters, a number of temporary factors have also been at work. As we set out earlier, the inventory rebuild is likely to have accounted for a reasonable proportion of import growth over the past year. In addition, imports of aircraft, a normally stable data series, were particularly high in December. Indeed, imports of aircraft appear to have given a significant boost to import volumes in the second half of 2010. Chart 3.17 shows that if these unusually high imports are excluded from the data, net trade makes small positive contributions to GDP in the last two quarters of 2010.

Net trade

3.80 At the time of our November 2010 *Outlook*, net trade in the third quarter of 2010 was estimated by the ONS to have made a strong contribution to growth. Subsequent revisions have eliminated the positive contribution in that quarter, but have also left the level of net trade (i.e. the trade balance) a bit higher than in our November forecast. Given the outlook for domestic demand and the size and persistence of the sterling depreciation, we continue to expect net trade to make a significant contribution to growth throughout the forecast period.

3.81 Although it would be unwise to place too much emphasis on the early estimates of trade data, the latest monthly trade release is consistent with this assessment of the outlook. The total trade deficit narrowed sharply in January, driven by a sharp narrowing in the trade in goods deficit. Some unwinding of unusually strong aircraft imports is likely to explain part of the movement, but exports of manufacturing goods, in particular, continue to grow rapidly.

Chart 3.17: Net trade contributions excluding aircraft imports



Source: ONS, OBR

Balance of payments

3.82 The current account has been especially volatile in recent quarters, with the net investment income balance, in particular, subject to large revisions. A downward revision of around £10 billion to the income balance in 2009 has widened the estimate of the current account. From this slightly wider starting point, and given our broadly unchanged outlook for the UK's trade balance, we expect the current account deficit to narrow at much the same rate as in November.

Inflation and nominal GDP

3.83 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation. The Consumer Prices Index (CPI) and the Retail Prices Index (RPI) are both average measures of the change in prices of goods and services, based on the changing cost of a basket of goods and services. The basic approach to the measurement of inflation using these indices is the same, although differences arise due to their coverage. For example, the RPI measure includes housing costs and mortgage interest payments, which are not included in the CPI. Other differences include the representative population covered by the indices and the way in which the RPI and CPI measures of inflation are constructed.[15]

3.84 The Bank of England's policy target, as set by the Government, is an annual CPI inflation rate of 2 per cent. Other measures of inflation include RPIX, which excludes mortgage interest payments, and was the target measure until it was switched to CPI in 2003. The broadest measure of domestic price movements is the GDP deflator, which reflects the prices of domestic value added in its entirety, including the prices of investment goods as well as consumption goods.

CPI inflation

3.85 Since November, CPI inflation has remained above 3 per cent, reaching 4 per cent in January, significantly above our November forecast.[16] Recent movements in CPI inflation reflect a number of factors, including higher energy and world commodity prices. Since November, there have been further announcements of increases in domestic gas and electricity prices in early 2011. Consequently, we

[15] For example, the RPI excludes high-income households, defined as those households, in which total household income lies within the top 4 per cent of all households, as measured by the Living Costs and Food Survey and pensioner households that derive at least three-quarters of their total income from state pensions and benefits. The CPI is representative of all private UK households, foreign visitors to the UK and institutional households' expenditure. www.statistics.gov.uk

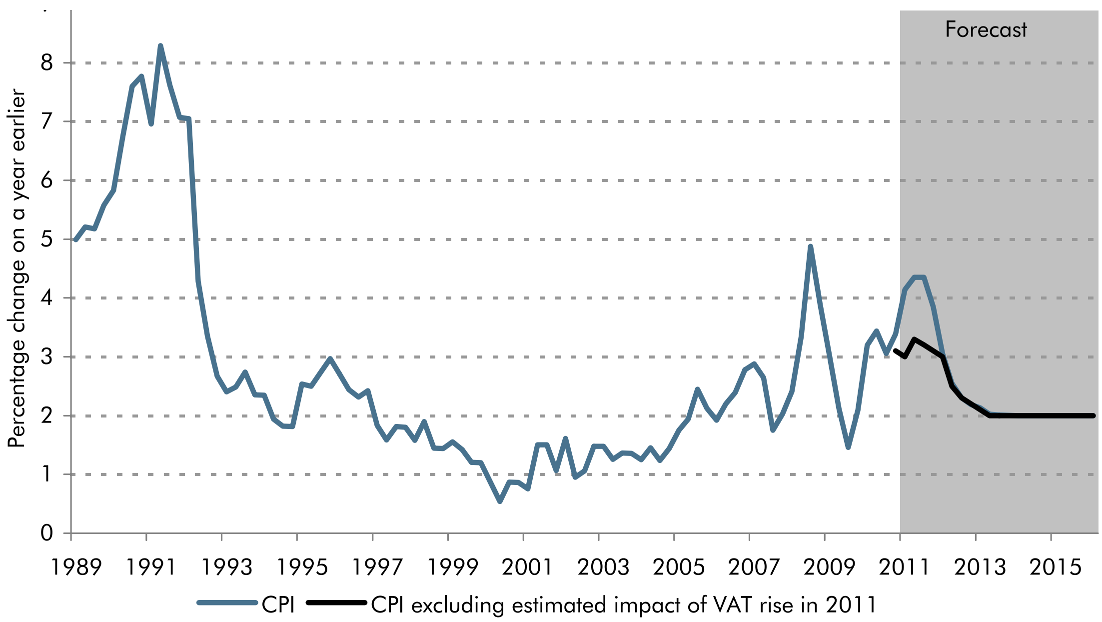
[16] Our forecast takes into account inflation outturns up to and including January 2011.

expect utility prices to continue to make a positive contribution to CPI inflation over coming months.

3.86 We expect CPI inflation to remain between 4 and 5 per cent over most of 2011, following the increase in VAT to 20 per cent in January 2011 and contributions from higher energy and world commodity prices since November. Although we cannot yet quantify the precise upward impact of the rise in VAT, it is likely to have a significant effect. The Bank of England Agents' summary of business conditions found that the majority of retail contacts surveyed intended to pass on the rise in VAT in full, with the rest planning to pass on at least half.[17]

3.87 Chart 3.18 plots our estimate of CPI inflation, excluding the rise in VAT to 20 per cent, based on our assumption that 75 per cent of the increase in VAT will be passed through to prices. We discuss this issue in more detail in Box 3.4.

Chart 3.18: CPI inflation



Source: ONS, OBR

3.88 We expect CPI inflation to fall back swiftly in the final quarter of 2011 and the first quarter of 2012 as the rise in VAT falls out of the comparison. We also expect that the upward pressure from higher energy and commodity prices will gradually fade while the disinflationary impact of spare capacity continues to bear down on inflation. CPI inflation is therefore forecast to fall back to target by the middle of 2013.

[17] www.bankofengland.co.uk

3.89 Oil and agricultural commodity prices have recently contributed significantly to UK inflation. Oil prices are assumed to move in line with the prices implied by futures markets as of 4 March 2011. These fall back only slightly over the forecast period. Recently, the global supply of agricultural commodities has been affected by adverse weather conditions. The speed of the world recovery has also led to increased demand, particularly from emerging economies. On balance, we expect the supply response to higher prices to be offset by a continued rise in global demand, leaving prices broadly stable at their current levels over the forecast period.

3.90 Relative to the experience of the 1970s, when shocks to commodity prices drove wages and inflation higher, there has been no corresponding pick-up in earnings growth over recent years. This likely reflects changes in features of the labour market, such as the reduced incidence of wage indexation to measures of inflation. However, it is also likely that monetary policy independence has provided a stable anchor for medium-term inflation expectations, reducing the potential for pass-through of above target inflation into wage settlements.

3.91 There is little evidence that above-target inflation has fed through to wages over 2010. Chart 3.19 shows that year-ahead inflation expectations have picked up a little but that average annual earnings growth has remained subdued. Neither inflation expectations nor measures of actual inflation have a strong correlation with regular pay growth. When asked how they would react to changes in their inflation expectations over the next 12 months, around two thirds of respondents said they would shop around for a better deal, just over half said they would spend less but only 1 in 10 said they would push for higher wages.[18] We set out a scenario to assess the implications of greater pass-through from prices to wages later in the chapter.

3.92 A number of policy announcements made by the Government have also been incorporated in the economy forecast. The estimated impacts reported here are relative to a baseline that includes all pre-announced duty changes. We estimate that changes in duties only affect the annual rate of inflation for a year, with a change in duty having a permanent effect on the level of prices but a temporary effect on inflation.

[18] www.bankofengland.co.uk

3.93 The delay in the rise in fuel duty from April 2011 to January 2012 and the delay in the rise in fuel duty from April 2012 to August 2012 are estimated to reduce CPI inflation by around 0.1 per cent in 2011-12 and to have no overall effect on CPI inflation in 2012-13. These effects are based on a freeze in fuel duty in April 2011. We were notified of the further 1 pence per litre reduction in fuel duty in April 2011 too late to include the impact in our forecasts. However, we estimate that this would reduce CPI inflation by an additional 0.04 per cent in 2011-12 relative to our forecast. The rebalancing of specific and ad valorem duty on tobacco is estimated to increase CPI inflation by around 0.1 per cent in 2011-12. The freeze to Air Passenger Duty is estimated to reduce CPI inflation by around 0.1 per cent in 2011-12 based on the assumed impact on airfares, although the impact may differ if other related components of CPI are affected, such as package holidays.

Chart 3.19: Inflation expectations and average earnings growth

Source: Bank of England, ONS

RPI inflation

3.94 Since the November forecast, RPI inflation has been higher than expected, with the annual rate rising above 5 per cent in January. RPI inflation is expected to follow a similar profile to that of CPI inflation but, unlike the CPI, it is also influenced by movements in mortgage interest payments and housing depreciation.

3.95 Since the November forecast, we have improved the methodology we use to project house price changes in the forecast. In the near term, we now assume that house prices rise in line with the median forecast of those external organisations who forecast Communities and Local Government (CLG) house prices, rather than a median forecast for a range of house price indices. This is more appropriate for our purposes since the CLG house price measure is the primary source for housing depreciation data in the RPI. The median of external forecasts of CLG house prices implies a fall in house prices over 2011, recovering over 2012. From 2014 onwards, house prices inflation is assumed to rise broadly in line with the long-term average rate of earnings growth.

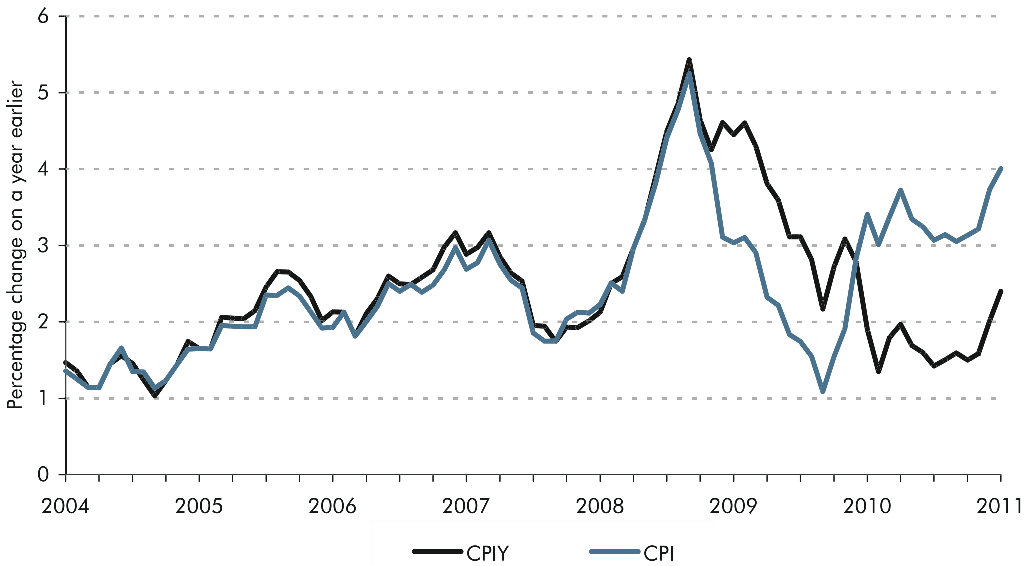
3.96 The difference between RPI and CPI inflation is expected to narrow over 2011, partly as a result of the expected slowdown in house price inflation. In addition, we now expect the difference between the CPI and RPI to be around 0.3 percentage points higher as a result of an increased contribution from the formula effect, as set out in more detail in Box 3.5. Since our November forecast, the contribution from mortgage interest payments has risen over the near term but fallen slightly in the medium term. This reflects market expectations for more monetary tightening in the near term and less towards the end of the forecast period.

Box 3.4: Consumer prices index excluding indirect taxes (CPIY)

Changes in the Consumer Prices Index excluding indirect taxes (CPIY) provide a measure of inflationary pressures excluding the effects that policy changes have on the CPI. For example, it excludes price changes which are due to changes in indirect taxation, such as VAT, alcohol, tobacco and fuel duties.

Chart A plots CPI inflation and CPIY inflation to give an illustration of the possible effect of changes in the rate of VAT on CPI inflation over recent years. The temporary reduction in the VAT rate from 17½ per cent to 15 per cent from December 2008 put downward pressure on CPI inflation over 2009. Similarly, annual CPIY inflation remained within the range of 1.3 to 2 per cent over 2010, highlighting the upward pressure on CPI inflation as a result of the return of VAT to 17.5 per cent in 2010. However, the CPIY measure assumes that VAT changes are passed on to the consumer immediately and in full. To the extent that firms absorb some of the rise in VAT in margins, underlying inflation may be higher than implied by CPIY.

Chart A: CPIY and CPI inflation



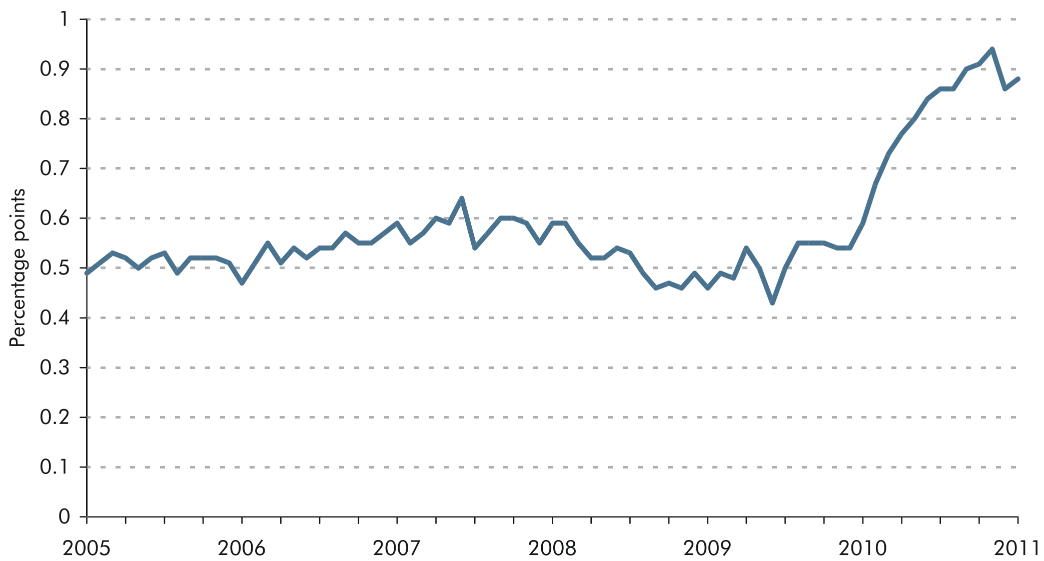
Source: ONS

Box 3.5: The long-run difference between the CPI and RPI

The key differences between the CPI and RPI inflation measures arise from the goods and services included in the indices, the representative population they cover and the way in which the indices are constructed. The CPI mostly uses a geometric mean to aggregate price changes, whereas in the RPI an arithmetic mean is used. The former is better-suited to accounting for the effect of substitution between goods and services when relative prices change. The extent to which the results using these approaches differ depends on the variance of price changes in the underlying components of the index.

The difference between the CPI and RPI inflation rates, as a result of using different formulae, has risen from around 0.5 percentage points over 2009 to around 0.8 percentage points over 2010, as shown in Chart A.[a] The ONS has indicated that changes in the way in which prices of clothing are measured, first implemented in January 2010, have the potential to increase the formula effect.[b]

Chart A: Contribution of the difference between RPI and CPI from the formula effect



Source: ONS

We assume that the larger contribution from the formula effect in 2010 will persist, implying a permanent increase in the difference between CPI and RPI inflation of around 0.3 percentage points. Therefore, if mortgage interest payments grow in line with average earnings growth, we might expect the wedge between CPI and RPI inflation to be around 1.2 percentage points in the long run. However, in our central forecast, mortgage interest payments are rising faster than average earnings throughout, so the wedge is a little larger than that implied by our long-run estimate.

[a] More information can be found in the Office for National Statistics (ONS) Statistical bulletin *'Consumer Prices Indices'* on the ONS website; www.statistics.gov.uk

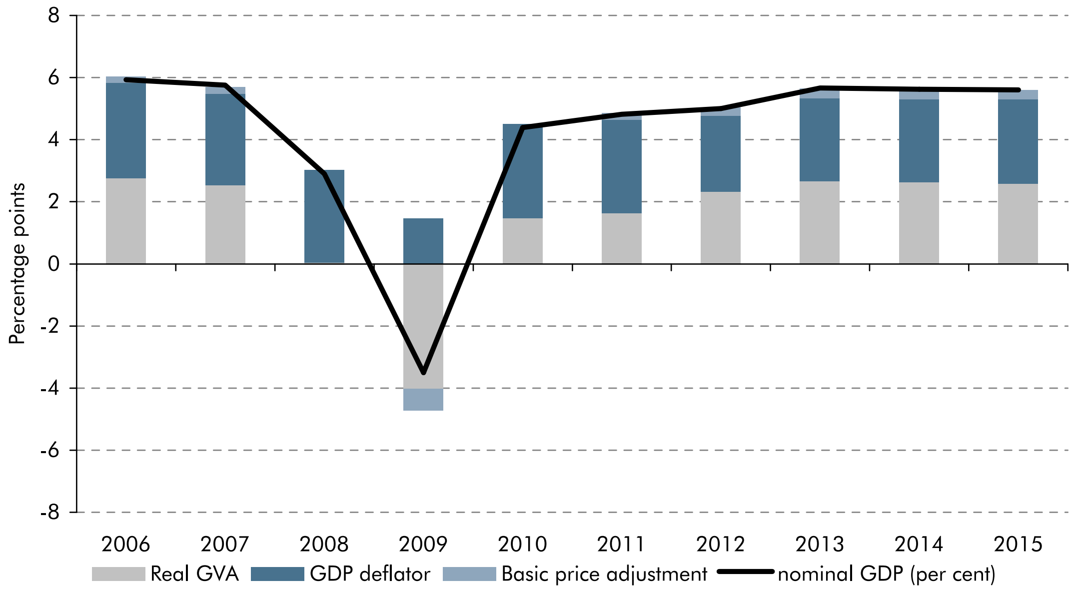
[b] More information can be found in the Office for National Statistics (ONS) information note *'CPI and RPI: the increased impact of the formula effect in 2010'* January 2011 on the ONS website; www.statistics.gov.uk

Nominal GDP

3.97 Nominal GDP is a measure of the total cash value of activity in the economy. It reflects the combination of real growth in the economy and changes in the GDP deflator. GDP deflator inflation is a broad measure of general inflation in the domestic economy. It measures the changes in the overall level of prices for goods and services that make up GDP, including price movements in household spending, government spending, investment and net trade.

3.98 Nominal GDP growth is expected to rise in 2011 compared with 2010, reflecting the pick-up in real growth, which is shown in Chart 3.20. Since November, contributions to CPI and RPI inflation have largely been driven by external factors such as higher oil and import prices. Therefore, they do not have a large upward effect on the GDP deflator in our forecast. We expect the temporary effects on inflation to diminish, while real GDP growth picks up in 2012. As inflation returns to target through 2013 and real GDP growth remains above trend, nominal GDP is expected to rise by 5.6 per cent a year from 2014 onwards.

Chart 3.20: Nominal GDP decomposed



Source: ONS,OBR

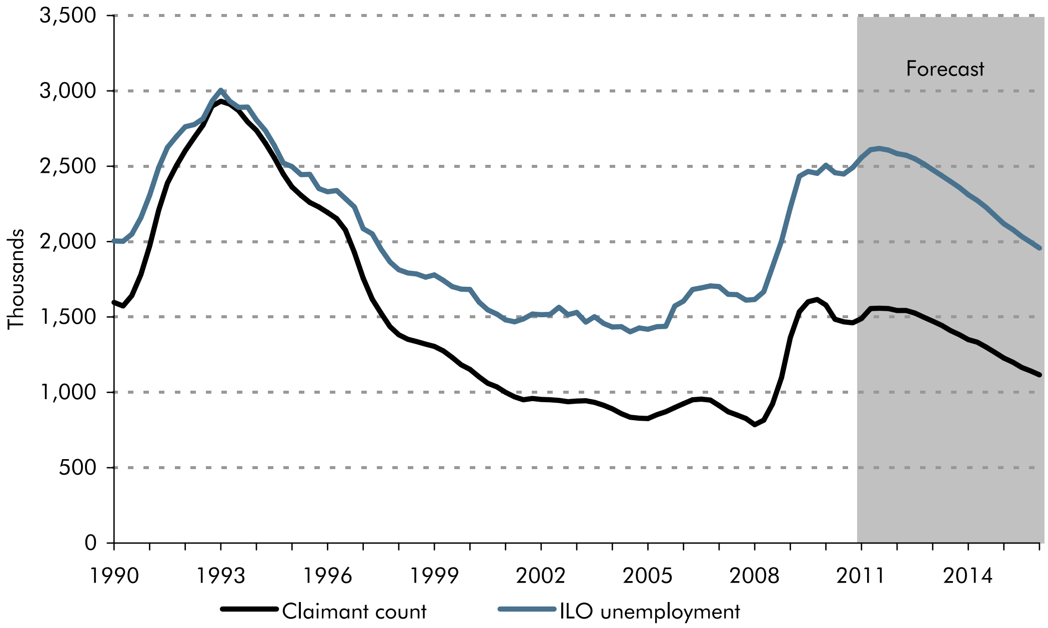
The labour market

Employment, unemployment and inactivity

3.99 In line with a weaker outlook for output growth, we expect employment to be lower than forecast in November. We forecast employment will be largely flat between 2010 and 2011 before picking up steadily from 2012 as output growth returns to above-trend rates. We expect unemployment to rise over the next few quarters, with the ILO unemployment rate forecast to increase from 7.9 per cent in the final quarter of 2010 to 8.3 per cent in the second quarter of this year.

3.100 In line with the increase in ILO unemployment, the claimant count is forecast to pick up to 1.56 million by the second quarter of this year before falling back from 2012, as shown in Chart 3.21. We expect the level of the claimant count to be around 30,000 higher this year and around 80,000 higher in 2012 than we predicted in our November forecast. The impact of weaker output growth is partially offset by a reduction in the impact of the Lone Parent Obligation on claimant count inflows. Following updates to modelling, the effect of the Lone Parent Obligation on the claimant count is assumed to be around 10,000 lower in 2011 and around 20,000 lower in 2012 than previously estimated in November.

Chart 3.21: Unemployment levels



Source: ONS

3.101 Between 2010 and 2015 we expect total employment to increase by around 900,000. This comprises an increase in market sector employment of around 1.3 million, partly offset by a reduction in general government employment of around 400,000 between 2010-11 and 2015-16. Our projections for general government employment are presented in Box 3.6. Total weekly hours worked are expected to fall back slightly over the course of 2011, consistent with below-trend growth. Beyond 2011, total hours are forecast to rise as employment growth picks up, offsetting a fall in average hours worked. We expect average hours worked to revert to a gradual trend decline over the medium term.

Box 3.6: General government employment

For our projection of general government employment we have maintained the same top-down approach we used for our November forecast, combining estimates of paybill growth and the growth of paybill per head to generate a forecast for employment growth.[a]

Since November, we have updated our projections for paybill growth, which are based on growth in the sum of RDEL, LASFE and BBC current expenditure. Taking into account latest outturn information, the latest projections imply growth in the sum of RDEL, LASFE and BBC current expenditure of just over 2.6 per cent between 2010-11 and 2014-15, compared to 2 per cent in our November forecast. All else equal, this implies a slightly smaller reduction in general government employment over this period than in our November forecast.

The level of general government employment in the past has also been revised up since November, largely reflecting the ONS re-classification of employees in further education colleges from the private sector to the public sector. The effect of this has been to move around 220,000 employees from the private sector to the public sector from 1999. For any given percentage change in projected workforce growth, this upward revision implies a greater absolute change in general government employment over the projection period.

Table A sets out:

i) our November forecast for general government employment;

ii) the profile for general government employment using our November projections for RDEL, LASFE and BBC current expenditure, but with the latest ONS outturns for general government employment; and

iii) our updated forecast for general government employment, based on the latest ONS outturns and our updated projections for RDEL, LASFE and BBC current expenditure.

The difference between (i) and (ii) provides an estimate of the impact of ONS data revisions (including the reclassification of employees working in further education colleges) to our forecast of general government employment, while the difference between (ii) and (iii) indicates the effect of our updated projections for RDEL, LASFE and BBC current expenditure.

Our latest forecast implies a reduction in general government employment of around 310,000 between 2010-11 and 2014-15, compared to the reduction of around 330,000 implied by our November forecast. Of the change since November, changes to growth in the sum of RDEL, LASFE and BBC current expenditure reduce the implied reduction in general government employment by around 30,000. This is partially offset by the effect of the ONS upward revision to the level of general government employment, which increases the absolute reduction in general government employment between 2010-11 and 2014-15 by around 10,000.[b] Our implied forecast for RDEL, LASFE and BBC current expenditure implies a further reduction in general government employment of around 90,000 between 2014-15 and 2015-16, bringing the total decline over five years to around 400,000.

The sensitivity of these projections to relatively small adjustments to government expenditure forecasts is one drawback of using a top-down approach to forecast general government employment. But this is the best approach available until the Government obviates the need for a forecast by publishing specific workforce plans.

Table A: General government employment

General government employment (millions, final quarter of the financial year)		2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
(i) November forecast[1]	November RDEL[2] + LASFE[3]+BBC current expenditure	5.49	5.45	5.42	5.34	5.17	5.09[5]
(ii)[1]	November RDEL+LASFE +BBC current expenditure and latest outturns for general government employment	5.67[4]	5.62	5.60	5.51	5.33	5.25[5]
(iii) March forecast[1]	Latest RDEL + LASFE + BBC current expenditure and latest outturns for general government employment	5.67[4]	5.65	5.64	5.55	5.36	5.28[5]

[1] Estimates cannot be compared directly to the interim OBR's June 2010 pre-Budget forecast because of changes to the underlying methodology and assumptions between the OBR's June 2010 pre-Budget forecast and the OBR's June 2010 Budget forecast. For more information see http://budgetresponsibility.independent.gov.uk.

[2] Excluding depreciation

[3] Local Authority Self-Financed Expenditure

[4] Latest ONS outturn for general government employment. This estimate includes the effect of the ONS re-classification of employees in further education colleges from the private sector to the public sector. For more information see http://www.statistics.gov.uk/pdfdir/pse0311.pdf.

[5] Estimates for implied resource DEL growth in 2015-16 are derived from the Government's plan for constant real Total Managed Expenditure growth and our updated forecast for Annually Managed Expenditure.

[a] More information about this approach can be found in the November 2010 *Economic and fiscal outlook*.

[b] As the general government employment projection is based on a top-down approach, changes in the forecast cannot be decomposed by specific sub-groups of general government.

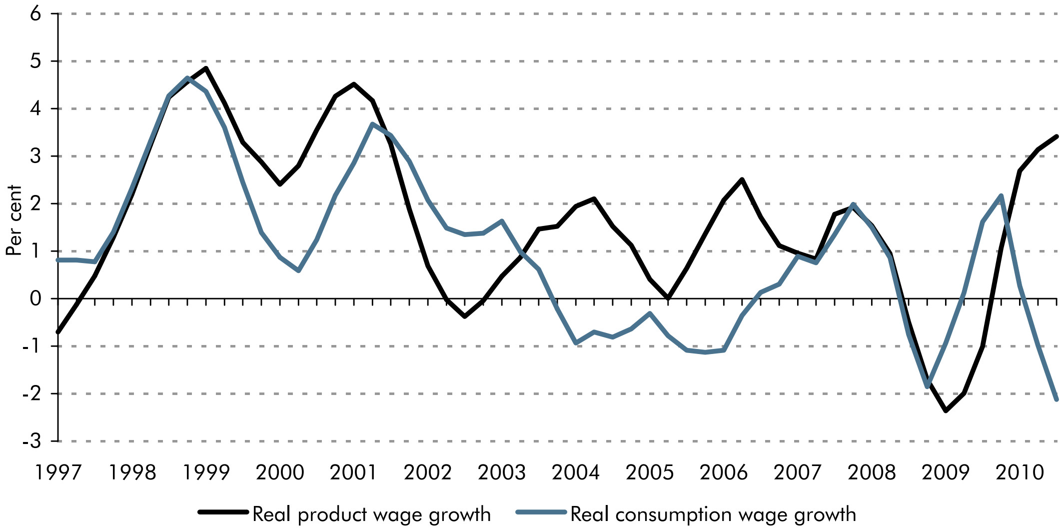
Earnings

3.102 Average earnings growth remains subdued. Following an increase in the third quarter, annual nominal private sector average earnings growth fell back to 1.7 per cent in the year to the final quarter of 2010.

3.103 Measures of real earnings growth display contrasting patterns over recent quarters, as we show in Chart 3.22. We estimate the real wage earned by workers (real consumption wage), by deflating net wages and salaries by the price of consumption goods. For the real wage paid by firms (the real product wage) we deflate total employee compensation, which includes employer pension contributions as well as wages and salaries, by the basic price of output, which excludes the effects of changes in taxes on products, such as VAT.

3.104 Chart 3.22 shows that the real wage earned by workers has fallen back sharply in 2010, as growth of wages and salaries has remained low relative to changes in the price of consumption. However, the real wage paid by firms picked up over 2010, reflecting relatively subdued increases in basic output prices and increases in employers' contributions to pension schemes.

Chart 3.22: Annual real wage growth[1]



[1]Four-quarter rolling growth rates. Real product wage equal to total compensation of employees per employee deflated by the implied GVA deflator. Real consumption wage equal to net wages and salaries per employee deflated by RPIX.
Source: ONS, OBR

3.105 We expect average earnings to continue to grow relatively slowly over the near term, despite elevated price inflation. This is consistent with the limited evidence so far of pass-through from higher inflation and inflation expectations to wage growth. In line with our forecast of weaker output growth, we also expect slightly slower growth of average earnings than we forecast in November. We now see whole economy average earnings growing by around 2 per cent this year, compared to 2¼ per cent in our November forecast. Average earnings growth is expected to pick up gradually from 2012 as output grows at above-trend rates.

3.106 As employment growth remains flat this year, we expect aggregate wages and salaries, a measure of total labour income, to grow in line with average earnings growth, before accelerating to an increase of around 5¼ per cent a year by the end of the forecast. Taken together, the downward revisions to average earnings growth and employment imply that aggregate wages and salaries is around 1 per cent lower by 2015-16 than expected in November.

Comparison with external forecasts

3.107 As we noted in Chapter 2, external forecasts differ on a number of key issues. On centre stage is the degree to which the economy will rebalance away from private consumption growth towards investment growth and net exports. Other important differences arise from expectations of the impact of fiscal consolidation and the extent to which monetary policy offsets it. In what follows, we briefly compare the main themes of selected outside forecasts to our own.

3.108 In its January *Economic Review*, the National Institute of Economic and Social Research (NIESR) presents a more downbeat view of the economy than our own, in which GDP growth is considerably weaker across the forecast horizon. A significantly stronger net trade contribution is more than offset by weaker growth in private consumption and investment. The outlook for consumption reflects a much weaker view of prospects for the UK housing market. Like us, the NIESR takes market interest rate expectations as a conditioning assumption for its forecast. The NIESR forecast for CPI inflation is below ours in 2011, before converging on 2 per cent in the medium term. Part of the difference in 2011 is likely to reflect the *Review's* publication date, given the substantive increases in commodity prices since January.

3.109 In its January *World Economic Outlook Update*, the IMF expects stronger growth than us in 2011. Most of this difference is likely to reflect the effect of snow in the final quarter of 2010 on calendar year growth rates. The IMF forecast for growth in 2010 was 1.7 per cent, which has come out at 1.3 per cent. The January update does not contain medium-term forecasts but the October *World Economic Outlook* was for weaker growth in all years to 2015. Again, recent commodity price increases have made a direct comparison with our forecast difficult.

3.110 In its February *Interim Forecast*, the European Commission expects a stronger rebound from the effects of snow in the first quarter of 2011. This reflects a stronger assumption about how much postponed construction activity will be recovered and helps explain why the EC has revised down its 2011 growth forecast less than us. The EC forecasts that CPI inflation will be lower than we project in our central forecast in 2011. The interim forecast does not contain forecasts beyond 2011, but in its November *Autumn Economic Forecast* the EC projected that net trade and private investment would support the recovery with GDP growth of 2.5 per cent in 2012, consistent with our central forecast.

3.111 In its March *UK Economic Survey*, the OECD expects slower GDP growth in both 2011 and 2012. Like us, the OECD points to slow real income growth in 2011 but presents a weaker consumption outlook than in our central forecast. In 2012, the OECD expects private consumption growth to pick up, consistent with our forecast, but it expects weaker investment growth and stronger imports growth, resulting in a weaker net trade contribution to GDP growth.

3.112 Comparison with the MPC's median economic forecast is not straightforward because the Bank of England only publishes point estimates for two variables, CPI inflation and GDP growth. The GDP forecast appears alongside the February *Inflation Report*, but is not available on a calendar year basis. However, looking at annual growth forecasts for the final quarters of 2011, 2012 and 2013, we are forecasting weaker growth than the MPC in the first two years, followed by slightly stronger growth in 2013.

3.113 Because the MPC's forecast is conditioned on its backcast of GDP, a comparison of the MPC's forecast for the level of output with our forecast (which does not include expectations of revisions to past data) cannot be inferred directly. The MPC judges that GDP fell by around 1 per cent less than reported in the National Accounts over the course of the recession. This implies that its forecast for the level of output in 2013 is some way above that of our central projection.

3.114 The MPC's median forecast for annual CPI inflation in the final quarter of 2011 is a little above our central projection and is consistent with the central forecast in the final quarter of 2013. Recent speeches by the Governor are consistent with our central view that above target inflation will squeeze households' real incomes and weigh on the outlook for growth in the coming year.

Economic forecast tables

Table 3.6: External forecasts comparison

	Per cent					
	2010	2011	2012	2013	2014	2015
OBR (March 2011)						
GDP growth	1.3	1.7	2.5	2.9	2.9	2.8
CPI inflation	3.3	4.2	2.5	2.0	2.0	2.0
Output gap	-3.4	-3.9	-3.6	-3.0	-2.2	-1.4
IMF (January 2011)[1]						
GDP growth	1.7	2.0	2.3	2.4	2.5	2.6
CPI inflation	3.1	2.5	1.7	1.9	2.0	2.0
Output gap	-2.7	-2.3	-2.0	-1.6	-1.2	-0.6
OECD (March 2011)						
GDP growth	1.4	1.5	2.0			
CPI inflation	3.3	3.3	1.8			
Output gap	-4.6	-4.5	-4.0			
EC (November 2010)						
GDP growth	1.4	2.0				
CPI inflation	3.3	3.4				
Output gap	-5.0	-4.1	-3.1			
NIESR (January 2011)						
GDP growth	1.4	1.5	1.8	2.4	2.5	2.4
CPI inflation	3.3	3.8	1.8	1.8	2.0	2.0
Output gap[2]		-4				
Bank of England (February 2011)						
GDP growth (median)[3]		2.6	2.8	2.7		
CPI inflation (median)[3]		4.2	2.1	2.0		

[1]Forecasts for 2013-15 are taken from October 2010 *World economic outlook*

[2]Output gap not provided in main features of forecast

[3]Median forecast based on market interest rates. Figures relate to Q4-on-Q4. Median figures represent central forecast of probability distribution illustrated by fan charts.

Table 3.7: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast[1]					
	2009	2010	2011	2012	2013	2014	2015
World economy							
World GDP at purchasing power parity	-0.7	5.0	4.2	4.3	4.3	4.4	4.4
Euro Area GDP	-4.0	1.7	1.4	1.8	1.8	1.9	1.9
World trade in goods and services	-11.1	12.7	6.9	6.8	6.9	7.0	7.0
UK export markets[1]	-11.4	10.7	5.8	5.8	5.8	6.1	6.0
UK economy							
Gross domestic product (GDP)	- 4.9	1.3	1.7	2.5	2.9	2.9	2.8
Expenditure components of GDP							
Domestic demand	-5.5	2.5	1.1	1.5	2.2	2.3	2.3
Household consumption[2]	-3.2	0.8	0.6	1.3	1.8	2.1	2.2
General government consumption	1.0	1.0	0.8	-1.2	-1.8	-2.4	-1.8
Fixed investment	-15.4	3.1	2.3	6.0	8.8	8.7	7.0
Business	-18.9	2.5	6.7	8.9	10.6	10.2	7.8
General government	16.9	4.4	-12.0	-9.9	-5.6	-1.4	2.4
Private dwellings	-25.5	5.2	5.3	6.9	8.5	7.8	6.5
Change in inventories[3]	-1.2	1.4	0.2	0.0	0.0	0.0	0.0
Exports of goods and services[4]	-10.1	5.8	7.9	6.5	6.2	5.7	5.6
Imports of goods and services[4]	-11.9	8.5	5.0	2.9	3.8	3.8	4.1
Balance of payments current account							
£ billion	-24	-35	-41	-34	-28	-22	-15
Per cent of GDP	-1.7	-2.4	-2.7	-2.1	-1.6	-1.2	-0.8
Inflation							
CPI	2.2	3.3	4.2	2.5	2.0	2.0	2.0
RPI	-0.5	4.6	5.1	3.6	3.5	3.6	3.8
Terms of trade[5]	-0.9	-0.3	-2.6	-1.0	-0.2	-0.1	0.0
GDP deflator at market prices	1.5	3.0	3.0	2.4	2.7	2.7	2.7
Labour market							
Employment (millions)	29.0	29.0	29.0	29.2	29.5	29.7	30.0
Wages and salaries	- 0.1	1.5	1.8	2.8	4.8	5.3	5.4
Average earnings[6]	1.8	1.7	2.0	2.2	3.8	4.3	4.5
ILO unemployment (% rate)	7.6	7.9	8.2	8.1	7.6	7.0	6.4
Claimant count (millions)	1.53	1.50	1.54	1.53	1.43	1.31	1.18
Household sector							
Real household disposable income	1.1	-0.7	-0.4	1.4	1.6	1.9	2.1
Saving ratio (level, per cent)	6.0	4.9	3.6	3.6	3.4	3.4	3.4
House prices	-7.8	7.4	-2.3	0.1	3.5	4.3	4.3
Nominal indicators							
Nominal GDP	-3.5	4.4	4.8	5.0	5.7	5.6	5.6
Non-oil PNFC profits[7]	-6.5	1.8	6.9	11.4	9.0	8.8	7.3

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

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

[3] Contribution to GDP growth, percentage points

[4] Trade levels are distorted by MTIC fraud

[5] Ratio of export to import prices

[6] Wages and salaries divided by employees

[7] Private non-oil non-financial corporations' gross trading profits

Table 3.8: Changes to detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast[1]					
	2009	2010	2011	2012	2013	2014	2015
World economy							
World GDP at purchasing power parity	0.0	0.3	0.2	0.1	-0.1	-0.1	-0.1
Euro Area GDP	0.0	0.1	0.1	0.0	-0.2	-0.4	-0.5
World trade in goods and services	-0.2	3.1	0.5	-0.1	-0.3	-0.2	-0.2
UK export markets[1]	0.1	1.7	1.1	-0.5	-1.1	-0.4	-0.5
UK economy							
Gross domestic product (GDP)	0.1	-0.5	-0.4	-0.1	0.0	0.1	0.1
Expenditure components of GDP							
Domestic demand	0.0	-0.1	-0.3	-0.2	0.0	0.0	0.1
Household consumption[2]	0.2	-0.3	-0.7	-0.1	-0.1	0.0	0.0
General government consumption	0.0	-0.8	1.1	0.1	0.0	0.0	-0.2
Fixed investment	-0.2	1.1	-1.0	-0.5	0.5	0.4	0.4
Business	-0.1	1.2	-1.9	0.5	0.3	0.4	0.2
General government	2.7	3.4	3.3	-0.2	0.4	0.1	-0.2
Private dwellings	0.0	-0.2	0.8	0.7	-0.1	-0.1	0.5
Change in inventories[3]	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Exports of goods and services[4]	1.0	0.4	1.1	-0.5	-0.2	-0.1	0.1
Imports of goods and services[4]	0.3	0.4	1.2	-0.5	-0.1	-0.1	0.0
Balance of payments current account							
£ billion	-6	2	-4	-3	-2	-2	-2
Per cent of GDP	-0.4	0.1	-0.3	-0.2	-0.1	-0.1	-0.1
Inflation							
CPI	0.0	0.1	1.1	0.6	0.1	0.0	0.0
RPI	0.0	0.2	1.5	0.6	0.4	0.3	0.2
Terms of trade[5]	0.1	-0.2	0.1	0.1	-0.1	-0.1	0.0
GDP deflator at market prices	0.1	-0.2	0.4	0.3	0.0	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Wages and salaries	0.0	-0.6	-0.4	-0.3	0.0	0.0	0.2
Average earnings[6]	0.0	-0.6	-0.2	-0.2	-0.1	0.0	0.1
ILO unemployment (% rate)	0.0	0.0	0.2	0.4	0.4	0.4	0.3
Claimant count (thousands)	0	-3	34	83	90	69	42
Household sector							
Real household disposable income	0.1	-0.5	-1.2	0.3	-0.4	-0.2	-0.1
Saving ratio (level, per cent)	-0.3	0.8	0.2	0.5	0.2	0.1	0.0
House prices	0.0	0.7	0.8	-1.0	-0.2	0.0	0.0
Nominal indicators							
Nominal GDP	0.2	-0.6	0.0	0.2	0.1	0.0	0.1
Non-oil PNFC profits[7]	0.0	-0.6	-2.0	1.1	0.1	0.5	-0.9

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

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

[3] Contribution to GDP growth, percentage points

[4] Trade levels are distorted by MTIC fraud

[5] Ratio of export to import prices

[6] Wages and salaries divided by employees

[7] Private non-oil non-financial corporations' gross trading profits

Scenario analysis

3.115 In assessing the outlook for the public finances, it is useful to think about ways in which the economy might diverge from our central forecast and what the fiscal consequences might be. In this section we set out two illustrative economic scenarios, which are intended to address the concerns of outside commentators. The fiscal implications are assessed in Chapter 5. We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from the central forecast and we do not attempt to attach particular probabilities to them. They are:

- a persistent inflation scenario in which the temporary factors currently pushing up prices, feed into inflation expectations and wage settlements, leading the Bank to respond by raising interest rates; and
- a weak euro scenario in which sterling appreciates significantly against the euro and euro area demand is weaker than in our central forecast.

3.116 Our central fiscal projection is produced using a wide range of economic determinants from a large-scale macroeconomic model. The approach we take in producing scenarios is simpler and depends on 'ready-reckoning' the effect of changes in a small selection of determinants on the central forecast. Box 3.7 sets out some of the assumptions applied to produce these scenarios.

Scenario one: persistent inflation

3.117 The VAT rise of January 2010, sterling's depreciation and rising commodity prices, have pushed the level of prices higher and kept annual CPI inflation significantly above the Bank of England's target. This is set to continue in 2011, as VAT rose again in January. CPIY inflation, which strips out the effect of changes to indirect taxes on inflation (see Box 3.4), is running at an annual rate of a little over 2 per cent suggesting that underlying inflationary pressures are relatively subdued.

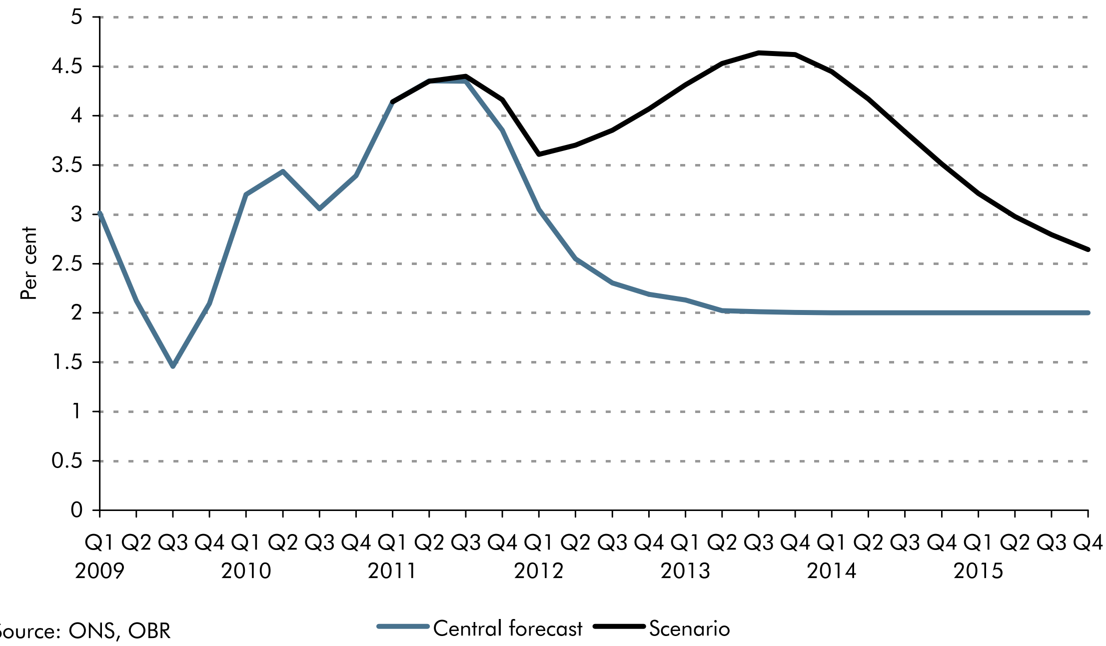
3.118 During the recession, average earnings growth was weak and households' real incomes were squeezed as inflation eroded the purchasing power of pay. Our central forecast is for this to continue over 2011 as average earnings growth struggles to keep up with rising prices. Thereafter, inflation returns to target and earnings growth recovers.

3.119 However, there remains a risk that persistently above-target inflation could feed into wage settlements or pricing intentions, particularly if workers' expectations are adaptive and it takes time for the response to the erosion of real earnings growth to materialise. This scenario is designed to reflect this concern.

3.120 In this scenario, average earnings growth is stronger than in the central forecast, keeping pace with the private consumption deflator. As inflation picks up, the Bank of England responds with tighter monetary policy and the Taylor rule prescribes a sharp increase in Bank Rate relative to the central projection.

3.121 Greater real wage resistance is assumed to make it more difficult for the Bank to return inflation to target than would normally be the case. Chart 3.23 shows that CPI inflation remains significantly above target for some time in this scenario, before spare capacity and the re-anchoring of inflation expectations weigh on earnings.

Chart 3.23: CPI inflation



Source: ONS, OBR

3.122 GDP growth is weaker than in the central forecast, reflecting the fact that tighter monetary policy encourages saving and weighs on consumption and investment. The output gap widens relative to the central forecast, rising to around 1.8 per cent of potential GDP larger than in the central forecast. In this scenario, households do not benefit from the inflationary event, insofar as real wages are lower than they are in the central forecast due to the real effects of monetary policy on output.

3.123 The fall in consumption growth is less than the overall fall in GDP growth as households are assumed to protect their consumption, to some extent. The effect on investment is magnified, however, because higher interest rates and weaker (real terms) profitability reduce the incentive to invest. For simplicity, net trade is assumed to evolve in line with the central forecast, although we would probably expect some effect on imports due to lower consumption and an effect on both exports and imports from possible movements in the exchange rate.

Table 3.9: Persistent inflation scenario summary

	Percentage change on a year earlier, unless otherwise stated				
	2011	2012	2013	2014	2015
Output at constant market prices					
Gross domestic product (GDP)	1.7	2.4	2.1	2.0	2.8
Expenditure components of GDP at constant market prices					
Household consumption	0.6	1.4	1.5	1.5	2.3
Total investment	2.2	6.2	7.3	6.8	7.5
General government consumption	0.7	-2.0	-3.0	-3.4	-2.3
Net trade	0.7	1.0	0.7	0.6	0.5
Inflation					
CPI	4.3	3.8	4.5	4.0	2.9
RPI	5.0	5.4	6.5	5.7	4.2
Bank Rate	1.3	4.8	6.1	6.3	5.7
Labour market					
Employment (millions)	29.0	29.2	29.3	29.5	29.7
Average earnings	2.1	3.8	6.0	6.0	5.5
ILO unemployment (% rate)	8.2	8.1	8.0	7.8	7.3
Claimant count (millions)	1.54	1.55	1.56	1.57	1.45
Output gap	-3.9	-3.7	-3.9	-4.0	-3.2

Table 3.10: Persistent inflation scenario relative to central forecast

	Percentage change on a year earlier, unless otherwise stated				
	2011	2012	2013	2014	2015
Output at constant market prices					
Gross domestic product (GDP)	0.0	-0.1	-0.8	-0.9	0.0
Expenditure components of GDP at constant market prices					
Household consumption	0.0	0.0	-0.4	-0.5	0.0
Total investment	-0.1	0.2	-1.5	-1.9	0.5
General government consumption	-0.1	-0.8	-1.2	-1.0	-0.5
Net trade	0.0	0.0	0.0	0.0	0.0
Inflation					
CPI	0.1	1.3	2.5	2.0	0.9
RPI	0.0	1.8	3.0	2.2	0.4
Bank Rate	0.5	3.0	3.3	2.8	1.6
Labour market					
Employment (millions)	0.0	0.0	-0.1	-0.3	-0.3
Average earnings	0.1	1.6	2.3	1.7	1.0
ILO unemployment (% rate)	0.0	0.1	0.4	0.8	0.8
Claimant count (millions)	0.00	0.02	0.13	0.26	0.27
Output gap	0.0	-0.1	-0.9	-1.7	-1.8

Box 3.7: Monetary policy, output and employment in alternative scenarios

In our central forecast, interest rates are assumed to evolve as financial markets expect. These expectations are calculated from forward curves published on the Bank of England's website and are derived from a number of financial market instruments.[a] In the November 2010 *Outlook*, the economic scenarios we presented featured broadly unchanged output gap and inflation projections relative to the central forecast. However, for the scenarios we present here, it is useful to specify simple rules for the way monetary policy is set and for how output and employment respond. To this end, we use three very simple rules: the Taylor rule, a simple aggregate demand relation and Okun's law.

In its simplest form, the Taylor rule relates the interest rate to a natural nominal interest rate, the current deviation of the rate of Consumer Prices Index (CPI) inflation from target and the output gap.[b] Here we use the original coefficients from Taylor's 1993 study and decompose the nominal rate into inflation and the real natural rate:

$$i_t = i_r^* + \pi_t + 0.5(\pi_t - \pi^*) + 0.5(y_t - y_t^*)$$

Where i_t is the policy rate at time t, i_r^* is the real natural interest rate, π_t is the rate of CPI inflation, π^* is the inflation target, y_t is the level of output and is the y_t^* estimated potential level of output. The difference between the level of output and potential output is known as the output gap.

We take differences of this rule relative to the central forecast to arrive at marginal responses to deviations from the central forecast. It is assumed that the inflation target and the real natural interest rate are the same in both the scenario and the central forecast – superscript s denotes a variable relates to the scenario.

$$i_t^s - i_t = 1.5(\pi_t^s - \pi_t) + 0.5[(y_t^s - y_t^{s*})-(y_t - y_t^*)]$$

This expression indicates that if inflation is one percentage point higher under an alternative scenario, the Bank will set interest rates 1.5 percentage points higher than in the central forecast – a coefficient above unity ensures that the Bank returns inflation to target. If the output gap is 1 percentage point wider than in the central forecast, the Bank will set interest rates 0.5 percentage points lower under an alternative scenario.

Output responses to monetary policy are assumed consistent with a very simple aggregate demand equation:

$$y_t = y_{t-1} - \beta_i (i_t - \pi_t - i_r^*)$$

The variables have the same interpretation as above and the β coefficient represents the sensitivity of output to deviations of the real interest rate from the real natural rate.

Again, taking differences relative to the central forecast:

$$y_t^s - y_t = (y_{t-1}{}^s - y_{t-1}) + \beta_i[(i_t - \pi_t) - (i_t^s - \pi_t^s)]$$

This expression indicates that the difference in output between the scenario and the central forecast is a function of the real interest rate differential in the current period and the output differential in the preceding period.

The beta coefficient gives the sensitivity of output to real interest rates. We assume a one percentage point increase in interest rates takes around 6 months to have its maximum impact on output of around -0.3 percentage points.

The output gap is assumed to have an effect on unemployment consistent with Okun's law.[c] Unemployment in the scenario rises by around half a per cent for a one percentage point wider output gap relative to the central forecast.

[a] Anderson, N. and Sleeth, J. (1999) 'New estimates of the UK real and nominal yield curves,' Bank of England Quarterly Bulletin, Bank of England, London.

[b] Taylor, J. (1993) 'Discretion versus policy rules in practice' Carnegie-Rochester conference series on public policy, 39, pp195-214

[c] Baily, N. and Okun, A. (1965) The Battle Against Unemployment and Inflation: Problems of the Modern Economy. New York.

Scenario two: weak euro

3.124 Since November, we have revised down our forecast for euro area GDP, in part reflecting the ongoing funding challenges faced by periphery states and the impact of higher oil prices. Reflecting the concerns expressed by some external analysts and commentators, this scenario examines the potential impact of a significant weakening in the euro and a further deterioration in euro area demand prospects.

3.125 In this scenario, persistent euro area weakness is assumed to reduce the volume of UK exports by around 7 per cent by 2015, relative to our central forecast. Net trade only contributes around 1 percentage point to the increase in the level of GDP by 2015, compared to around 3.5 percentage points in our central forecast.

3.126 We also assume that the 25 per cent depreciation of sterling against the euro following the onset of the recession is reversed.[19] This leads to a trade-weighted sterling appreciation of around half this size and a contemporaneous fall in import prices of around 10 per cent. It takes around a year for the maximum effect on consumer prices to be felt and leaves the level of CPI around 2½ per cent lower than it would otherwise have been by 2015. While real wages are stronger than in the central forecast, the weaker inflation profile translates into slightly weaker wages and salaries growth, beyond that implied by a wider output gap.

[19] In this scenario, the expected response of monetary policy to the external demand shock is assumed to be included in the overall depreciation.

3.127 The Monetary Policy Committee (MPC) is assumed not to respond to this change in relative prices and to allow CPI inflation to fall below target. However, it does lean against the negative effect of weak external demand on CPI, lowering interest rates in line with the Taylor rule. Overall, CPI inflation is lower than in the central forecast and remains slightly below target as the negative shock from external demand extends across the forecast horizon.

3.128 The MPC's looser monetary stance is key in minimising the effect of persistently weak external demand on UK prices and output. Lower interest rates stimulate private consumption and investment growth. The lower level of prices in this scenario is also assumed to have a positive effect on government consumption growth, which is fixed in nominal terms. The government consumption deflator is assumed to fall relative to the central projection by around one tenth of the change in prices arising from sterling appreciation, reflecting the intensity of imports, and one for one with the disinflationary effect of the domestic output gap.

3.129 The overall impact of this scenario is to leave the outlook for GDP slightly weaker, with domestic demand stronger, external demand weaker and inflation lower. However, this scenario is limited to trade and exchange rate effects arising from a substantially weaker euro area growth outlook. Should euro area sovereign debt issues translate into a weaker domestic financial sector, prospects for the UK economy would likely be worse than those we present here.

Table 3.11: Weak euro scenario summary

	Percentage change on a year earlier, unless otherwise stated				
	2011	2012	2013	2014	2015
Output at constant market prices					
Gross domestic product (GDP)	1.5	2.3	2.9	2.9	2.9
Expenditure components of GDP at constant market prices					
Household consumption	0.8	1.5	2.2	2.4	2.6
Total investment	2.9	7.0	10.1	9.8	8.0
General government consumption	0.9	-0.5	-0.9	-1.8	-1.4
Net trade	0.2	0.3	0.1	0.1	0.1
Inflation					
CPI	3.7	1.0	1.2	1.8	1.9
RPI	4.4	1.9	2.6	3.5	3.9
Bank Rate	0.7	1.4	2.4	3.2	3.9
Labour market					
Employment (millions)	29.0	29.1	29.4	29.7	29.9
Average earnings	1.7	1.5	3.4	4.4	4.6
ILO unemployment (% rate)	8.3	8.3	7.8	7.2	6.5
Claimant count (millions)	1.57	1.59	1.49	1.37	1.22
Output gap	-4.1	-4.1	-3.4	-2.6	-1.7

Table 3.12: Weak euro scenario relative to central forecast

	Percentage change on a year earlier, unless otherwise stated				
	2011	2012	2013	2014	2015
Output at constant market prices					
Gross domestic product (GDP)	-0.2	-0.2	0.0	0.1	0.1
Expenditure components of GDP at constant market prices					
Household consumption	0.1	0.2	0.3	0.4	0.3
Total investment	0.6	1.0	1.3	1.1	0.9
General government consumption	0.1	0.7	0.9	0.6	0.4
Net trade	-0.5	-0.7	-0.6	-0.5	-0.4
Inflation					
CPI	-0.5	-1.5	-0.8	-0.2	-0.1
RPI	-0.7	-1.7	-0.9	-0.1	0.1
Bank Rate	-0.2	-0.4	-0.4	-0.4	-0.3
Labour market					
Employment (millions)	0.0	-0.1	-0.1	-0.1	0.0
Average earnings	-0.2	-0.7	-0.4	0.0	0.1
ILO unemployment (% rate)	0.1	0.2	0.2	0.2	0.1
Claimant count (millions)	0.03	0.07	0.06	0.06	0.04
Output gap	-0.2	-0.4	-0.4	-0.4	-0.3

4 Fiscal outlook

Summary

4.1 Our central forecast for the next five years is that public sector net borrowing (PSNB) will decline steadily as a share of national income from the post-war peak it reached in 2009-10, but more slowly than we forecast in November. As a share of national income, Government revenues are projected to increase up to 2013-14 and then flatten out. Spending on public services and social security is expected to fall, partly offset by increases in spending on debt interest and net public sector pensions.

Table 4.1: Fiscal forecast overview

	Per cent of GDP							
	Outturn		Forecast					
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector net borrowing	6.7	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Cyclically-adjusted net borrowing	6.4	8.9	7.4	5.3	3.7	2.0	1.0	0.5
Surplus on current budget	-3.5	-7.6	-7.1	-5.8	-4.5	-2.7	-1.2	-0.2
Fiscal mandate and supplementary target								
Cyclically-adjusted surplus on current budget	-3.1	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Public sector net debt[1]	43.3	52.7	60.3	66.1	69.7	70.9	70.5	69.1
	Changes since November forecast							
Public sector net borrowing	0.0	0.0	-0.1	0.3	0.6	0.6	0.6	0.6
Cyclically-adjusted net borrowing	0.0	0.0	-0.2	0.0	0.2	0.1	0.2	0.2
Surplus on current budget	0.0	0.0	0.1	-0.2	-0.6	-0.5	-0.6	-0.6
Cyclically-adjusted surplus on current budget	0.0	0.0	0.2	0.1	-0.1	-0.1	-0.1	-0.2
Public sector net debt[1]	-0.8	-0.8	-0.5	-0.2	0.6	1.2	1.7	1.8

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

4.2 We expect PSNB to total £145.9 billion this year, which is £2.6 billion lower than we expected in November, mainly due to lower forecast expenditure. We do not expect receipts to be as strong in the remainder of the year as some external analysts. Over the medium term our central forecast, as summarised in Table 4.1, is for:

- PSNB to fall from 11.1 per cent of GDP in 2009-10 to 1.5 per cent in 2015-16, which is slightly higher than the 1.0 per cent expected in November;

- the cyclically-adjusted current balance, used as the target for the Government's fiscal mandate, is forecast to move from a deficit of 5.3 per cent of GDP in 2009-10 to a surplus of 0.8 per cent of GDP in 2015-16. This is the same level in 2015-16 as we forecast in June and slightly lower than in November; and

- public sector net debt (PSND), the measure used in the Government's supplementary fiscal target, is forecast to peak at 70.9 per cent of GDP in 2013-14 and then decline to 69.1 per cent of GDP in 2015-16. These figures are slightly higher than we forecast in November.

4.3 The Budget policy measures are broadly neutral for borrowing over the forecast period. Table 4.2 shows that, including the effects of these measures, compared to November we are forecasting higher expenditure as a percentage of GDP in the medium term, with little overall change to the receipts forecasts:

- the increase in our expenditure forecast primarily reflects the impact of our higher inflation forecast on social security and debt interest payments; and

- the small revisions to our receipts forecasts reflect a number of offsetting factors. We expect lower income tax and NICs receipts because we have revised down our forecast for labour income. We expect lower corporation tax and fuel duty receipts, mainly due to policy measures. This is offset in some years by an increased forecast for other receipts, including North Sea revenues, interest receipts and business rates.

4.4 Even though we have revised up our forecast for PSNB, our forecast for the cyclically-adjusted or 'structural' current budget surplus in 2015-16 is only slightly lower. This is because we expect there to be more spare capacity in the economy in 2015-16 than we thought in November, so the net increase in headline borrowing is primarily cyclical rather than structural.

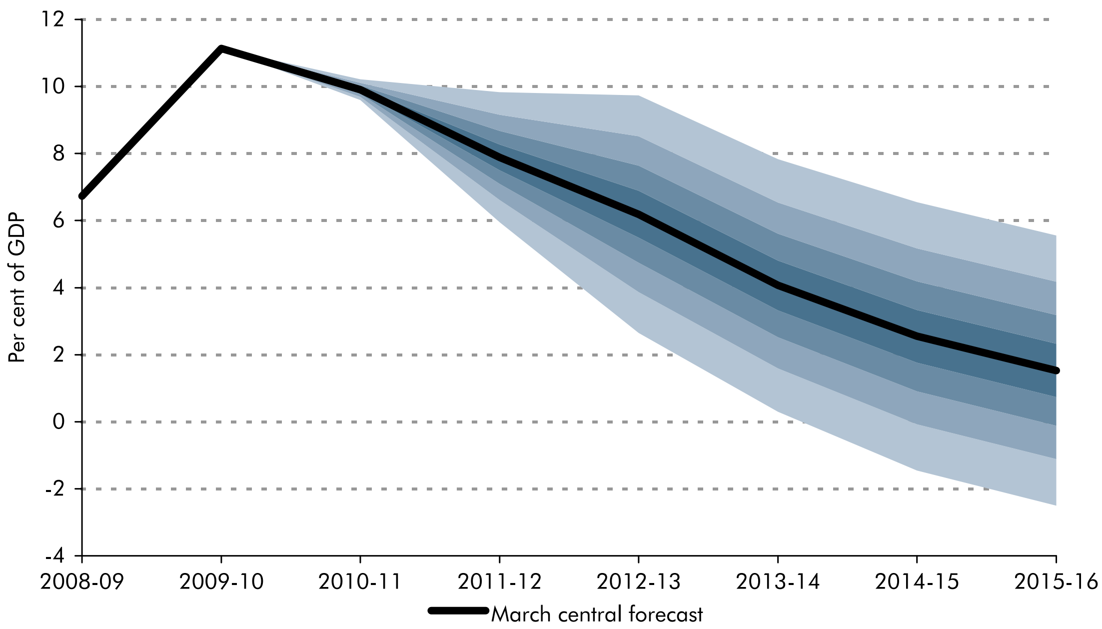
4.5 The changes in the fiscal aggregates since November are small relative to the uncertainties that surround any fiscal forecast. PSNB represents the difference between total public sector receipts and expenditure, both of which are very large numbers influenced by numerous economic and non-economic determinants. Chart 4.1 shows our central forecast for PSNB with the probability of different outcomes, based purely on the Treasury's past forecasting performance, shown in a fan chart. The solid black line represents the median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.

Table 4.2: Changes to public sector net borrowing since November forecast

	Per cent of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector net borrowing	0.0	-0.1	0.3	0.6	0.6	0.6	0.6
of which:							
Current receipts	-0.1	0.2	0.3	0.0	0.1	0.0	0.0
Total managed expenditure	-0.1	0.0	0.6	0.6	0.7	0.7	0.6

Note: increases in receipts decrease borrowing, while increases in expenditure increase borrowing.

Chart 4.1: Public sector net borrowing fan chart



Source: ONS, OBR

Introduction

4.6 In this chapter we set out our forecasts for the public finances to 2015-16. We begin by explaining our approach to the fiscal forecast. We then describe the judgements and assumptions that help determine the forecast, from paragraph 4.15. We then set out the effect of policy announcements that have been made since the OBR's November forecast, starting in paragraph 4.27. The outlook for receipts, including tax by tax analysis, is described in paragraph 4.33 onwards. We then turn to expenditure, focusing in particular on the components of AME, from paragraph 4.77. Our forecast of financial transactions and our approach to asset sales is set out from paragraph 4.144. Finally, in paragraph 4.159 onwards, we draw together the implications of the preceding analysis for the key fiscal aggregates, including public sector net borrowing, the surplus on the current budget and public sector net debt. Further breakdowns of receipts and expenditure and other details of our fiscal forecasts are provided in the OBR's supplementary tables available on our website.

Approach to the fiscal forecast

4.7 As with our previous forecasts, this fiscal forecast represents our central view of the path of the public finances. It is based on our central forecast for the strength and composition of economic growth, and the fiscal assumptions and judgements represent our central view.

4.8 Public sector receipts are highly dependent on the path of the economy and so projections are subject to all of the risks and uncertainties set out in Chapter 3. Equally, while a portion of public expenditure is typically set in firm multi-year plans, a substantial portion, such as social security and debt interest payments, is also closely linked to the economy. In addition, each individual line of receipts and expenditure will be subject to a wide range of specific uncertainties, for example around the behaviour of taxpayers or benefit claimants in response to changes in the tax or benefit system.

4.9 Our tax and benefit forecasts are consistent with the Government's approach to indexation of rates, thresholds, levels and allowances. Where tax rates or benefit allowances for a given year have not yet been announced by the Government, the individual tax or benefits baseline forecast incorporates an assumed level of indexation consistent with the forecasting conventions set out in Annex A of the Treasury's *Budget 2011 policy costings* document, published alongside the Budget.

Process for producing the fiscal forecast

4.10 All judgements and assumptions in the forecasts are made by the OBR's Budget Responsibility Committee (BRC), and the BRC takes full responsibility for the final forecast. We set out the process by which we produce our fiscal forecast in detail in our first briefing paper, *Forecasting the public finances*.[1] This paper describes the way in which the OBR works with Government departments to assemble a comprehensive forecast for the public finances from numerous separate forecasts for the individual categories of receipts, spending and financial transactions. For each element of receipts and expenditure, the paper briefly describes the way in which the forecast is produced, and lists the main economic determinants used and the key judgements taken.

4.11 We base the forecast on outturn data on the public finances produced by the Office for National Statistics (ONS). In this forecast we have used the data from the *Public sector finances* release published in February 2011, which included

[1] Office for Budget Responsibility, 2011, *Briefing paper No. 1: Forecasting the public finances*.

provisional outturn data up to January 2011. We have also used administrative data on central government receipts and spending in February to inform our forecast, where HMRC and the Treasury have provided these data to us under rigorous 'conditions of use' restrictions, following the UK Statistics Authority's *Code of Practice for Official Statistics*.

4.12 One of our core responsibilities is a requirement to produce an analysis of past forecasting performance. To fulfil this, we will produce a full and detailed report each year analysing the accuracy of our economy and fiscal forecasts, and explaining the differences between forecast and outturn. The first opportunity for us to publish a detailed analysis of our forecast accuracy is later this year, once reliable outturn data is available for 2010-11.

Cyclical adjustment methodology

4.13 The forecast includes cyclically-adjusted versions of key fiscal aggregates, which attempt to adjust for the effect of the economic cycle on the public finances. Forecasts of cyclically-adjusted aggregates are subject to particular uncertainty, as they depend on projections of the current position of the economy relative to trend. They also rely on analysis of the effect of the economic cycle on borrowing from previous cycles, which may not hold in the future, partly because of changes in the composition of both receipts and expenditure. Although we recognise the potential shortcomings, we have used the Treasury's approach to cyclical adjustment as set out in *Public finances and the cycle*.[2] It should be noted that the cyclical adjustment coefficients we use are based on the relationship between past fiscal aggregates and the Treasury's estimates of past output gaps. We use a different methodology to estimate output gaps over the forecast period than the Treasury used in the past. We have not yet published our own estimates of past output gaps. We plan to do so later this year, and we will also then be able to reassess the size of the cyclical adjustment coefficients.

Basis of the fiscal aggregates

4.14 The fiscal aggregates are based on the National Accounts. The forecast presents the fiscal aggregates on the basis that excludes the temporary effects of the interventions in the financial sector. The ONS publishes outturn data for borrowing and debt on this basis, and the Government has chosen to use it as the basis for the fiscal aggregates targeted in its fiscal mandate and supplementary target.[3] These aggregates remove the temporary effects on the public finances of the interventions taken in 2008 and 2009 to stabilise the financial sector, but capture the permanent effects.

[2] HM Treasury, 2008, *Public finances and the cycle: Treasury Economic Working Paper No. 5*.

[3] Office for National Statistics, 2010, *Public sector finances excluding financial interventions*.

Determinants of the fiscal forecast

4.15 This section sets out the main assumptions and judgements we have made in producing our central fiscal forecast. Table 4.3 shows the path of key determinants and Table 4.4 shows the changes compared to the OBR's November forecast. Chapter 3 includes a discussion of determinants from the economy forecast, such as GDP, its components, inflation and claimant count unemployment. These judgements reflect our central view of the path of the economy and public finances.

4.16 For some determinants, ready-reckoners are presented. These are approximate estimates of the fiscal effect of varying the level of specific determinants within the appropriate receipts or expenditure model. These estimates should be treated with caution as they estimate only the direct effect of a change in the value of a determinant and not any wider indirect effects. The actual effect of a change in the value of a determinant will depend on the particular set of economic circumstances at the time of the change.

Table 4.3: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
GDP and its components							
Real GDP	-3.6	1.9	1.8	2.7	2.9	2.9	2.8
Nominal GDP (£ billion)[1]	1405	1473	1544	1625	1717	1814	1915
Nominal GDP[1]	-1.9	4.9	4.8	5.2	5.7	5.6	5.6
Nominal GDP (centred end-March)	2.9	4.5	5.0	5.6	5.7	5.6	5.5
Wages and salaries[2]	0.2	1.7	1.8	3.3	5.1	5.3	5.4
Non-oil PNFC profits[2,3]	-6.5	1.8	6.9	11.4	9.0	8.8	7.3
Consumer spending[2,3]	-1.9	5.1	5.2	4.2	4.6	4.8	5.0
Prices and earnings							
GDP deflator	1.8	2.9	2.9	2.5	2.7	2.7	2.7
RPI (September)	-1.4	4.6	5.2	3.4	3.5	3.6	3.8
CPI (September)	1.1	3.1	4.3	2.3	2.0	2.0	2.0
Whole economy earnings growth	2.4	1.3	2.0	2.5	4.1	4.4	4.5
Key fiscal determinants							
Claimant count unemployment (millions)[4]	1.58	1.48	1.55	1.51	1.40	1.28	1.16
Employment (millions)	28.9	29.1	29.0	29.2	29.5	29.8	30.0
VAT gap (per cent)	13.3	11.9	12.0	12.0	12.0	12.0	12.0
Financial and property sectors							
Equity prices (FTSE All-share index)	2619	2892	3168	3333	3524	3721	3929
HMRC financial sector profits[1,3,5]	2.4	4.0	5.3	5.3	5.8	5.6	5.6
Residential property prices[6]	-2.9	5.5	-2.9	1.2	3.9	4.3	4.3
Residential property transactions	14.2	-1.9	-1.9	20.2	20.4	10.5	5.2
Commercial property prices[7]	5.9	4.7	2.1	3.9	5.6	5.2	4.2
Commercial property transactions[7]	-17.5	11.0	4.5	3.1	5.1	5.3	5.2
Volume of share transactions	8.7	-10.7	-2.0	3.3	3.6	1.9	1.4
Oil and gas							
Oil prices ($ per barrel)[3]	62	80	113	112	109	107	107
Oil prices (£ per barrel)[3]	39.5	52.0	69.3	68.6	67.0	66.3	66.2
Gas prices (p/therm)	38.3	43.3	53.1	58.4	61.4	61.9	63.3
Oil production (million tonnes)[3,8]	67.8	63.0	60.2	57.1	55.3	53.4	50.8
Gas production (billion therms)[3,8]	21.6	20.6	18.9	18.0	17.3	16.6	15.8
Interest rates and exchange rates							
Market short-term interest rates (per cent)[9]	0.8	0.7	1.6	2.7	3.4	4.0	4.4
Market gilt rates (per cent)[10]	3.6	3.8	3.8	4.3	4.7	4.9	5.1
Euro/Sterling exchange rate	1.13	1.18	1.16	1.16	1.16	1.16	1.15

[1] Not seasonally adjusted
[2] Nominal
[3] Calendar year
[4] UK seasonally-adjusted claimant count
[5] HMRC Gross Case 1 trading profits
[6] Outturn data from Communities and Local Government (CLG) property prices index
[7] Outturn data from HMRC information on stamp duty land tax
[8] DECC forecasts available at www.og.decc.gov.uk
[9] 3-month sterling interbank rate (LIBOR)
[10] Weighted average interest rate on conventional gilts

Table 4.4: Changes to determinants since the November forecast

	Percentage point change unless otherwise specified						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
GDP and its components							
Real GDP	0.1	-0.6	-0.2	-0.1	0.0	0.1	0.1
Nominal GDP (£ billion)[1]	1.5	-9.4	-5.9	-3.6	-3.3	-3.0	-1.2
Nominal GDP[1]	0.1	-0.8	0.3	0.2	0.0	0.0	0.1
Nominal GDP (centred end-March)	-0.2	-0.6	0.4	0.1	0.0	0.1	0.3
Wages and salaries[2]	0.0	-0.7	-0.4	-0.2	0.0	0.1	0.2
Non-oil PNFC profits[2,3]	0.0	-0.6	-2.0	1.1	0.1	0.5	-0.9
Consumer spending[2,3]	0.2	-0.5	0.5	0.2	0.0	0.0	0.0
Prices and earnings							
GDP deflator	0.1	-0.2	0.5	0.3	0.0	0.0	0.0
RPI (September)	0.0	0.4	1.7	0.4	0.5	0.3	0.2
CPI (September)	0.0	0.0	1.2	0.5	0.0	0.0	0.0
Whole economy earnings growth	0.0	-0.8	-0.1	-0.1	0.0	0.0	0.1
Key fiscal determinants							
Claimant count unemployment (millions)[4]	0.00	0.00	0.05	0.09	0.08	0.06	0.04
Employment (millions)	0.0	0.0	-0.1	-0.2	-0.2	-0.1	-0.1
VAT gap (per cent)	0.1	-1.5	-1.2	-1.1	-1.1	-1.1	-1.2
Financial and property sectors							
Equity prices (FTSE All-share index)	0	35	63	72	77	82	91
HMRC financial sector profits[1,3,5]	0.0	-1.2	0.1	0.1	0.6	0.4	0.4
Residential property prices[6]	0.1	1.2	-0.2	-0.7	-0.1	0.0	0.0
Residential property transactions	0.0	2.5	-11.1	-5.2	7.6	1.5	2.1
Commercial property prices[7]	0.0	-1.3	-3.8	-3.1	-0.9	0.5	1.2
Commercial property transactions[7]	0.0	-2.0	-3.5	-0.4	0.9	0.8	0.8
Volume of share transactions	0.0	-3.7	-1.8	0.0	0.0	0.0	0.0
Oil and gas							
Oil prices ($ per barrel)[3]	0	0	28	25	22	20	19
Oil prices (£ per barrel)[3]	0.0	0.5	15.3	13.6	11.5	10.4	9.7
Gas prices	0.9	0.2	3.1	3.2	2.3	1.9	2.0
Oil production (million tonnes)[3,8]	0.0	-1.6	-1.4	-1.3	-0.3	0.7	0.7
Gas production (billion therms)[3,8]	0.0	0.3	-0.4	-0.4	-0.2	-0.2	-0.2
Interest rates and exchange rates							
Market short-term interest rates (per cent)[9]	0.0	-0.1	0.3	0.6	0.7	0.7	0.5
Market gilt rates (per cent)[10]	0.0	0.7	0.1	0.1	0.2	0.1	0.1
Euro/Sterling exchange rate	0.00	0.00	-0.02	-0.02	-0.01	-0.01	-0.01

[1] Not seasonally adjusted
[2] Nominal
[3] Calendar year
[4] UK seasonally-adjusted claimant count
[5] HMRC Gross Case 1 trading profits
[6] Outturn data from Communities and Local Government (CLG) property prices index
[7] Outturn data from HMRC information on stamp duty land tax
[8] DECC forecasts available at www.og.decc.gov.uk
[9] 3-month sterling interbank rate (LIBOR)
[10] Weighted average interest rate on conventional gilts

Equity prices

4.17 Equity prices are assumed to rise from their present level in line with nominal GDP growth. The present level is taken from the average of the closing price of the FTSE All-Share index over the ten working days ending 4 March 2011. Our assumption reflects the rationale that, in the long run, equity prices represent an expectation of future profits. To the extent that the profits share of GDP remains broadly constant in the long run, it is therefore reasonable to assume that equity prices increase in line with nominal GDP.

4.18 Equity prices are among the more volatile and unpredictable determinants of the forecast. On an approximate ready-reckoner basis, if equity prices were to be 1 per cent higher than assumed, receipts from capital taxes and corporation tax from life insurers would increase by around £100 million a year once the change had fully worked through.

HMRC financial sector profits

4.19 Financial sector profits are represented by the corporation tax gross Case 1 trading profits series from HMRC. Our forecast remains consistent with the assumption that profits return to their 20-year average level of just under 4 per cent of GDP by the end of the forecast period. We expect a lower level of financial sector profitability over 2010-11 than we thought in November, based on the sector's performance over the second half of the year. Higher nominal GDP growth leads to higher growth rates over the remainder of the period, with profits as a percentage of GDP reaching a similar level to November in 2015-16.

4.20 Gross Case 1 financial sector profits are derived from the difference between corporation tax receipts for the financial sector and information on incomes and deductions derived from tax return data. There are significant time lags associated with tax return data, and the 2009-10 outturn figure therefore represents a preliminary view.

Residential property prices and transactions

4.21 In the near term, we assume that house prices rise in line with the median forecast of those external organisations who forecast Communities and Local Government (CLG) house prices. The median of external forecasts of CLG house prices implies a fall in house prices in the year to the fourth quarter of 2011, recovering over 2012. From 2013-14 onwards, house price inflation is assumed to rise broadly in line with the long-term average rate of earnings growth. We have revised down our forecast for property transactions in 2011-12 and 2012-13. Thereafter, we forecast strong growth in transactions over the remainder of the period.

Commercial property prices and transactions

4.22 Forecasts of commercial property prices and transactions are based on HMRC outturn data for properties subject to stamp duty land tax. The forecast is for prices to grow by around 4½ per cent over 2010-11, and by around 2 per cent in 2011-12. Commercial property transactions are forecast to rise by 11 per cent in 2010-11, reflecting strong growth recorded in the first three quarters of the year. From 2011-12, transactions are expected to grow by an average of 4½ per cent a year. Prices and transactions are still below their pre-recession peaks at the end of the forecast period.

Oil prices

4.23 Oil prices are assumed to move in line with the prices implied by futures markets as of 4 March 2011. On an approximate ready-reckoner basis, if oil prices were to be $1 higher than assumed, direct North Sea receipts would rise by around £150 million. There would however be offsetting effects on the public finances from the wider effects of an oil price rise on GDP and inflation. The impact of recent rises in oil prices on the fiscal forecast is set out in Box 4.1.

Oil and gas production

4.24 The forecast uses the detailed central projections for oil and gas production published by the Department of Energy and Climate Change (DECC), last updated on 7 March 2011. These are based on the latest survey data provided by oil and gas producers.

Short-term interest rates

4.25 Short-term interest rates are assumed to move in line with market expectations. Short-term rates are defined as the 3-month sterling interbank rate (LIBOR). Rates used in this forecast are the average for the ten working days ending 4 March 2011. Increases in short-term rates are broadly neutral for the public finances as higher receipts from tax on savings income, corporation tax and interest receipts offset higher debt interest payments.

Gilt rates

4.26 Gilt rates are also assumed to move in line with market expectations. Rates used in this forecast are the average for the ten working days ending 4 March 2011. The approximate ready-reckoner effect on net borrowing of a 1 percentage point rise in gilt rates throughout the forecast period would be around £5 billion in 2015-16 through higher debt interest spending. This is a compound ready-reckoner effect, taking into account the second-round effect of higher borrowing caused by increased debt interest payments.

Effect of new policy announcements

4.27 Chapter 2 explains the OBR's approach to incorporating the effects of policy change on the economic and fiscal forecast. The Government is responsible for quantifying the direct impact of policy decisions on the public finances. The OBR provides independent scrutiny and certification of these costings. The OBR is also responsible for determining any indirect effects of policy measures on the economic forecast, which are discussed in Chapter 3.

4.28 Annex A reproduces the Treasury's table of Budget 2011 policy decisions. The OBR has endorsed all of the costings in Table A.1, with the exception of the measure which extends the short life assets regime from four to eight years. Our forecast incorporates the Treasury's scorecard estimate of the direct cost of this measure (£170 million by 2015-16). However, as we explain in our annex to the Treasury's *Budget 2011 policy costings* document, we were provided with the details of this measure after the deadline by which we had told the Treasury that we could guarantee to undertake the proper process of challenge and scrutiny necessary to certify the costing. The costing of this measure is highly uncertain and we will need to ensure it receives proper scrutiny after the Budget. If we end up disagreeing with the current costing this will need to be reflected in our next forecast.

4.29 Table 4.5 summarises the overall direct effects of the Budget policy measures on the public finance forecast. The overall effect on PSNB is very small with a fiscal tightening of £0.3 billion in 2015-16.

4.30 Within the broadly neutral overall direct effect there are a number of offsetting movements. The bulk of the measures result in changes to the receipts forecast, in particular:

- a fall in corporation tax of around £2.2 billion in 2015-16 due to the cut in the main CT rate, changes to the Controlled Foreign Companies regime and a number of other measures;
- an increase in North Sea oil and gas revenues of around £2 billion per year due to the increase in the supplementary charge;
- a reduction in fuel duty receipts of around £2 billion per year; and
- an increase in income tax and NIC receipts of around £1.4 billion in 2015-16 due to the increase in revenue from the change to the indexation of NICs and the disguised remuneration measure, partially offset by the increase in the personal allowance.

4.31 In this Budget there is a relatively small change to the expenditure forecast due to policy measures. The AME forecast is around £0.3 billion higher in 2015-16. There are also relatively small DEL measures.

4.32 Table 4.5 also shows the impact of policy announcements incorporated since the November forecast which affect the central government net cash requirement rather than PSNB as they are financial transactions. The bilateral loan to Ireland was announced in November but final details were not available for us to incorporate in the November forecast. The Green Investment Bank announcement at this Budget is discussed further in the financial transactions section later in this chapter.

Table 4.5: Impact of policy announcements included since November

	£ billion				
	2011-12	2012-13	2013-14	2014-15	2015-16
Effect of receipts measures	0.7	0.1	0.3	0.1	0.3
of which: Onshore corporation tax	-0.4	-1.2	-1.6	-2.0	-2.2
Offshore corporation tax	1.8	2.2	2.1	2.1	1.9
Fuel duties	-1.9	-1.6	-1.7	-2.1	-2.1
Income tax and NICs	0.8	0.6	0.7	1.0	1.4
Effect of expenditure measures	-0.7	-0.4	-0.3	-0.2	0.0
Total effect of policy decisions on PSNB	**0.0**	**-0.3**	**0.0**	**-0.1**	**0.3**
Memo: Effect on CGNCR of Ireland package	1.2	1.6	0.4	0.0	0.0
Effect on CGNCR of Green Investment Bank	0.0	0.8	0.0	0.0	0.0

Receipts

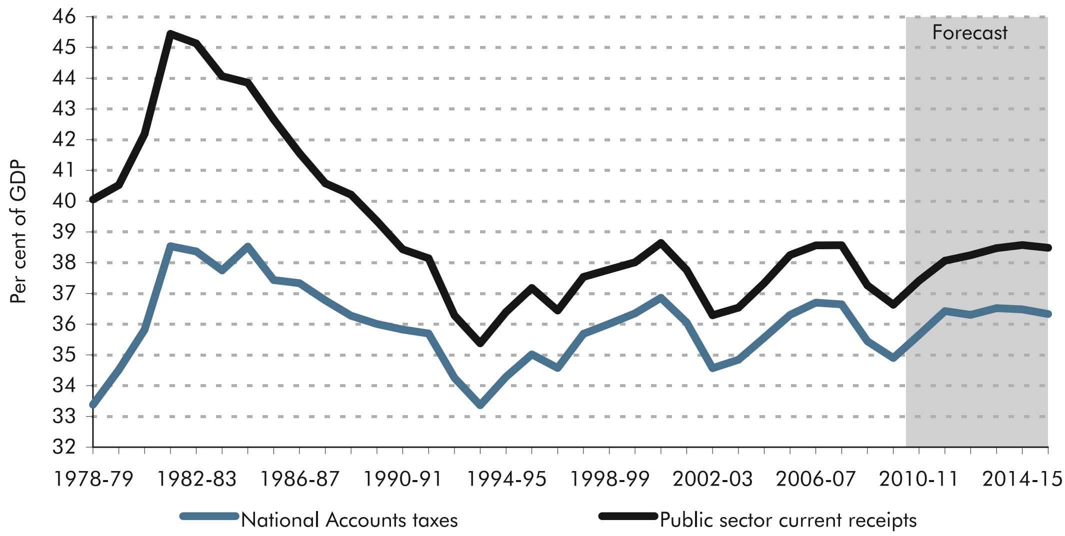
4.33 Tables 4.6 and 4.7 set out our central forecast for receipts, and Table 4.8 shows changes since the November forecast. As in the November forecast, receipts are shown on an accruals basis, as defined in the National Accounts. A similar table on a cash basis, comparable with the receipts tables in the June Budget and earlier forecasts, is available in the OBR's supplementary tables on our website. The supplementary tables also include the net taxes and NICs measure which was previously used as a measure of the overall tax level.

Table 4.6: Major taxes as a percentage of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Income tax and NICs	17.4	16.8	16.7	16.7	17.0	17.1	17.3
Value added tax	5.2	5.8	6.5	6.4	6.3	6.2	6.1
Onshore corporation tax	2.2	2.4	2.4	2.4	2.4	2.4	2.4
UK oil and gas receipts	0.5	0.6	0.9	0.8	0.7	0.7	0.6
Fuel duties	1.9	1.9	1.7	1.8	1.7	1.7	1.7
Business rates	1.7	1.6	1.6	1.7	1.7	1.6	1.6
Council tax	1.8	1.7	1.7	1.7	1.7	1.7	1.6
Excise duties	1.3	1.3	1.2	1.2	1.2	1.2	1.1
Capital taxes	0.9	1.0	1.0	1.0	1.1	1.2	1.3
Other taxes	2.1	2.5	2.6	2.7	2.7	2.7	2.7
National Accounts taxes	34.9	35.6	36.4	36.3	36.5	36.5	36.3
Gross operating surplus	1.7	1.7	1.7	1.7	1.6	1.6	1.6
Other receipts	0.0	-0.1	0.0	0.2	0.3	0.3	0.4
Current receipts	36.5	37.2	38.1	38.1	38.4	38.5	38.4

4.34 Chart 4.2 shows public sector receipts as a share of national income. Two measures are presented, both of which are on an accrued rather than cash basis. National Accounts taxes show total public sector tax receipts, as defined in the National Accounts. Public sector current receipts (PSCR) additionally includes non-tax receipts such as interest and dividend receipts and the gross operating surplus of public corporations. The forecast shows tax receipts rising as a share of national income from their 2009-10 level in 2010-11 and 2011-12 and then staying broadly flat for the rest of the forecast period. The short-term increase is driven primarily by the impact of the policy measures introduced since Budget 2008 aimed at consolidating the public finances and by a partial recovery in tax receipts from the financial sector.

Chart 4.2: Receipts as a percentage of GDP



Source: ONS, OBR

4.35 Current receipts in 2010-11 are expected to be £1.1 billion below the November forecast, reflecting weaker than expected PAYE and NIC receipts and, to a lesser extent, corporation tax. These were partly offset by stronger than expected VAT and self-assessment receipts. The forecast has allowed for relatively weak accrued receipts in February and March, relative to a year earlier. Accrued PAYE and NIC receipts were particularly strong at the end of 2009-10, reflecting strong bonuses and forestalling ahead of the introduction of the 50 pence tax rate.

Table 4.7: Current receipts

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Income tax (gross of tax credits)[1]	147.5	151.5	157.6	165.7	180.0	192.1	204.6
of which: Pay as you earn	*126.5*	*129.1*	*131.9*	*136.3*	*145.9*	*156.1*	*167.0*
Self assessment	*21.7*	*22.7*	*25.4*	*28.1*	*30.8*	*32.5*	*34.1*
Tax credits (negative income tax)	-5.6	-5.5	-4.7	-4.3	-4.2	-4.2	-4.2
National insurance contributions	96.6	96.5	100.7	106.1	111.8	118.6	125.7
Value added tax	73.5	86.1	100.3	103.5	108.1	112.8	117.8
Corporation tax[2]	36.5	42.7	49.0	50.3	51.7	53.7	55.0
of which: Onshore	*31.0*	*35.3*	*37.6*	*39.5*	*41.6*	*43.4*	*45.6*
Offshore	*5.6*	*7.4*	*11.4*	*10.8*	*10.1*	*10.3*	*9.5*
Corporation tax credits[3]	-0.7	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0
Petroleum revenue tax	0.9	1.5	2.0	2.0	1.8	1.8	1.6
Fuel duties	26.2	27.3	26.9	28.5	30.0	31.3	32.7
Business rates	23.4	23.8	25.5	27.2	28.5	29.7	30.1
Council tax	25.3	25.7	26.1	27.1	28.8	30.0	31.2
VAT refunds	11.2	13.2	15.0	15.0	14.7	14.6	14.9
Capital gains tax	2.5	3.2	3.4	2.9	3.7	4.6	5.1
Inheritance tax	2.4	2.7	2.7	2.8	2.9	3.1	3.3
Stamp duty land tax	4.9	6.0	5.8	6.9	8.4	9.8	11.0
Stamp taxes on shares	3.0	3.0	3.3	3.6	3.9	4.2	4.5
Tobacco duties	8.8	9.1	9.3	9.5	9.7	10.0	10.2
Spirits duties	2.7	2.7	2.7	2.7	2.8	2.9	3.0
Wine duties	3.0	3.1	3.3	3.5	3.7	4.0	4.3
Beer and cider duties	3.5	3.7	3.7	3.9	4.0	4.2	4.4
Air passenger duty	1.9	2.2	2.5	2.8	3.1	3.3	3.6
Insurance premium tax	2.3	2.5	2.9	3.0	3.0	3.1	3.2
Climate Change Levy	0.7	0.7	0.7	0.7	1.4	1.7	2.0
Other HMRC taxes[4]	5.4	6.0	6.4	6.7	6.9	7.2	7.4
Vehicle excise duties	5.6	5.7	5.9	6.0	6.1	6.2	6.2
Temporary bank payroll tax	0.0	3.5	0.0	0.0	0.0	0.0	0.0
Bank levy	0.0	0.0	1.9	2.6	2.7	2.7	2.7
Licence fee receipts	3.0	3.1	3.1	3.1	3.2	3.2	3.2
Environmental levies	0.5	0.6	1.8	2.1	2.9	3.3	3.9
EU ETS Auction Receipts	0.0	0.4	0.3	0.7	2.0	2.1	2.2
Other taxes	5.3	5.3	5.3	6.1	6.5	6.7	6.9
National Accounts taxes	**490.3**	**525.3**	**562.4**	**589.8**	**627.2**	**661.7**	**695.7**
Less own resources contribution to EU budget	-3.8	-4.8	-4.9	-5.0	-5.2	-5.4	-5.5
Interest and dividends	3.4	3.3	5.2	7.8	10.0	11.8	13.8
Gross operating surplus	23.3	24.5	25.8	27.1	28.3	29.5	30.7
Other receipts	0.1	0.2	0.1	0.0	-0.1	-0.1	-0.1
Current receipts	**513.3**	**548.5**	**588.6**	**619.7**	**660.3**	**697.5**	**734.5**
Memo:							
UK oil and gas revenues[5]	*6.5*	*8.8*	*13.4*	*12.8*	*11.9*	*12.1*	*11.1*

[1] Income tax includes PAYE and Self Assessment receipts, and also includes tax on savings income and other minor income tax components.
[2] National Accounts measure, gross of enhanced and payable tax credits
[3] Includes enhanced 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.

Table 4.8: Changes to current receipts since November forecast

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Income tax (gross of tax credits)[1]	0.3	0.6	1.0	-2.7	-2.0	-4.4	-5.2
of which: Pay as you earn	0.0	-1.9	-1.3	-3.3	-3.5	-4.0	-4.2
Self assessment	*0.0*	*2.5*	*1.8*	*-0.3*	*-0.9*	*-2.5*	*-2.8*
Tax credits (negative income tax)	0.0	0.0	0.0	0.0	0.0	0.1	0.2
National insurance contributions	-0.3	-2.1	-2.2	-2.2	-2.4	-2.1	-1.6
Value added tax	0.0	1.2	0.1	-0.1	0.3	0.3	0.2
Corporation tax[2]	0.0	-0.8	3.6	2.5	1.5	1.1	0.6
of which: Onshore	*0.0*	*-0.5*	*0.3*	*-0.7*	*-1.5*	*-2.0*	*-2.5*
Offshore	*0.0*	*-0.3*	*3.3*	*3.2*	*3.0*	*3.2*	*3.1*
Corporation tax credits[3]	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Petroleum revenue tax	0.0	0.0	0.4	0.3	0.3	0.4	0.3
Fuel duties	0.0	-0.4	-2.4	-2.1	-2.1	-2.4	-2.3
Business rates	0.0	0.0	-0.2	0.3	0.6	0.7	0.8
Council tax	0.0	0.0	0.0	-0.1	-0.1	0.0	0.0
VAT refunds	0.0	-0.4	0.0	0.1	0.0	-0.1	-0.1
Capital gains tax	0.0	0.4	0.2	0.2	0.3	0.6	0.7
Inheritance tax	0.0	0.0	0.1	0.0	-0.1	-0.1	-0.2
Stamp duty land tax	0.0	0.0	-0.6	-1.0	-0.8	-0.7	-0.5
Stamp taxes on shares	0.0	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2
Tobacco duties	0.0	-0.3	0.0	0.0	0.1	0.1	0.1
Spirits duties	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Wine duties	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Beer and cider duties	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0
Air passenger duty	0.0	0.0	-0.1	0.0	0.1	0.0	0.0
Insurance premium tax	0.0	0.1	0.1	0.2	0.2	0.2	0.2
Climate Change levy	0.0	0.0	0.0	0.0	0.7	1.0	1.4
Other HMRC taxes[4]	0.0	0.0	0.1	0.2	0.2	0.2	0.3
Vehicle excise duties	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0
Temporary bank payroll tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bank levy	0.0	0.0	0.7	0.3	0.2	0.3	0.4
Licence fee receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Environmental levies	0.0	0.0	0.0	0.1	0.3	0.4	0.5
EU ETS Auction Receipts	0.0	-0.1	0.1	0.1	-0.1	0.0	0.0
Other taxes	-0.1	0.6	0.2	0.8	0.9	0.8	0.8
National Accounts taxes	**0.0**	**-1.4**	**0.9**	**-3.3**	**-2.2**	**-3.9**	**-3.6**
Less own resources contribution to EU budget	0.0	0.1	-0.1	0.0	0.0	0.0	0.0
Interest and dividends	-0.1	-0.5	0.6	1.6	2.2	2.2	2.3
Gross operating surplus	-0.3	0.7	0.9	1.1	1.1	1.2	1.3
Other receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current receipts	**-0.4**	**-1.1**	**2.4**	**-0.7**	**1.1**	**-0.5**	**-0.1**
Memo:							
UK oil and gas revenues[5]	*0.0*	*-0.3*	*3.7*	*3.5*	*3.3*	*3.5*	*3.4*

[1] Income tax includes PAYE and Self Assessment receipts, and also includes tax on savings income and other minor income tax components.

[2] National Accounts measure, gross of enhanced and payable tax credits

[3] Includes enhanced 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.

Tax by tax analysis

4.36 This section explains our forecast of the main public sector receipts and sets out the reasons for changes from the November forecast. We provide tables for each of the major taxes containing a breakdown of the key drivers of changes from the previous forecast.

Income tax and National Insurance contributions

4.37 PAYE and NIC receipts from employees are expected to be around £3½ billion lower than in the November forecast in 2010-11. This results from lower wage and salary growth, a lower effective tax rate on those wages and salaries, and a downward revision to the projection for financial sector bonuses. Even after allowing for a 0.7 per cent downward revision in wage and salary growth for 2010-11, receipts were less than expected. The decline in the effective tax rate is consistent with the majority of the employment rise over the last year being in part-time jobs, where earnings are likely to be subject to lower tax rates.

4.38 This forecast assumes a 10 per cent fall in the cash value of financial sector bonuses in 2010-11, compared with an assumption of 5 per cent growth in the November forecast. With many bonuses subject to the 50 pence tax rate for the first time, receipts from bonuses are very slightly higher than last year. The downward revision to our estimate of bonus payments reflects information from February cash receipts relating to bonuses paid in January and announcements from some banks about their bonus pools. However, with over 60 per cent of bonuses typically paid out in February and March, this estimate is still particularly uncertain.

Table 4.9: Key changes to income tax and NICs since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	249.5	259.4	276.8	296.2	317.2	337.2
March forecast	248.0	258.2	271.8	291.8	310.7	330.4
Change	**-1.5**	**-1.2**	**-4.9**	**-4.4**	**-6.4**	**-6.8**
of which:						
Wages and salaries	-1.6	-3.1	-4.4	-5.2	-5.3	-5.0
Inflation	0.1	0.2	-1.4	-2.1	-2.7	-3.2
Other economic changes	0.0	0.6	1.3	1.1	0.7	0.4
Lower 10-11 financial sector bonuses	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Lower PAYE and NIC for given level of wages and salaries and bonuses	-1.4	-1.4	-1.5	-1.5	-1.6	-1.7
Revised 2010 SA forecast (IT and NIC)	2.0	1.6	1.8	1.9	1.9	1.6
SA - adjustments for forestalling and lower savings income in future	0.0	-0.8	-0.7	-0.8	-1.2	-1.6
Modelling changes	0.3	0.9	1.7	2.0	2.0	2.1
Revisions to pensions tax costing	0.2	1.0	-1.2	0.8	-0.2	0.4
Measures	0.0	0.8	0.6	0.7	1.0	1.4

4.39 Growth in PAYE and NIC receipts is likely to remain modest in 2011-12 given labour market prospects. In particular, earnings growth is likely to remain subdued in 2011, with little evidence of pass-though of higher inflation onto wage growth. Thereafter, wage and salary growth picks up, but is expected to grow more slowly than overall growth in nominal GDP throughout the forecast period.

4.40 Changes to our employment and earnings assumptions since our November forecast lead to lower wages and salaries levels across the forecast period. By 2015-16, the level is 1 per cent lower. As shown in Table 4.9, this reduces receipts by around £5 billion a year at the end of the forecast period. We have also assumed that the lower effective tax rate observed in 2010-11 persists across the forecast. Although the income tax personal allowance up until 2012-13 has been set by policy announcements, the higher level of RPI in this forecast does increase the level of some allowances and thresholds leading to lower receipts. Modelling changes raise receipts over the forecast period and include the updating of costings and a revision to the number of individuals eligible for contracted-out rebates of NICs.

4.41 In contrast to PAYE and NIC receipts, self assessment (SA) income tax in 2010-11 is now expected to be £2½ billion higher than in the November forecast. An initial analysis of SA returns which relate to 2009-10 liabilities indicates that both the savings and dividend income components were stronger than expected:

- with the base rate at 0.5 per cent since early 2009, savings income had been expected to drop very steeply. However, an initial analysis suggests a decrease of around 40 per cent, substantially less than that assumed in the November forecast; and

- stronger dividend growth than expected may be related to greater dividend payouts in closed companies ahead of the introduction of the 50p tax rate.

4.42 This analysis is provisional at this stage and judgements may change as more data becomes available. However, both these factors mean there is less scope for the very strong growth which we assumed in November for this component of SA over the rest of the forecast period. The lower growth now assumed acts to offset much of the effect of the 2010-11 overshoot by the end of the forecast.

4.43 The main Budget 2011 measures affecting income tax and NICs are the increase in the personal allowance from 2012-13, the change to the indexation of NICs, and the anti-avoidance measure on disguised remuneration. In the June 2010 Budget the Government committed to introduce a pensions tax relief measure that raised at least as much revenue as was already included in the forecasts relating to the pensions measure introduced in Finance Act 2010. The main specification of the Government's measure was announced on 14 October 2010, and final details were confirmed on 3 March 2011. The OBR has scrutinised the costing of the new measure and certified it as a central estimate. The total revenue raised over the forecast period is slightly higher than the previous estimates but, as shown in Table 4.9, there are some larger profiling differences in individual years.

Value added tax

4.44 Accrued VAT receipts are forecast to be £1.2 billion higher in 2010-11 than expected in the November forecast. This is despite a smaller VAT tax base in 2010 than previously assumed, the result of the particularly weak final quarter of the year. Nominal consumer spending was more muted and consumers did not bring forward as much spending on durables because of the increase in the standard rate of VAT as had been anticipated in the November forecast. This is partly offset by a lower estimate of the VAT gap (the difference between the theoretical level of VAT liability and actual receipts). It is also offset by a reduced estimate and longer time profile for repayments relating to the judicial ruling in the Fleming and Condé Nast cases. While decisions will have been made in 2010-11, a greater amount of these repayments are now likely to be made in 2011-12.

4.45 The VAT gap has fallen over the past two years as VAT debt has fallen from its recession-related peak in 2008-09. The combination of stronger receipts and faster than expected falls in VAT debt have led to an estimated VAT gap of

11.9 per cent in 2010-11, around 1.5 percentage points less than assumed in the November *Outlook*. The March forecast assumes the gap will be close in percentage terms to this lower level from 2011-12 onwards. This raises projected VAT receipts in each year of the forecast.

4.46 VAT receipts are expected to grow by 17 per cent in 2011-12, mainly reflecting the rise in the standard rate of VAT to 20 per cent. While real consumer spending in 2011 has been revised down in light of the stronger squeeze on real disposable incomes, higher inflation means that growth in nominal consumer spending in 2011 is likely to be maintained close to its 2010 rate.

4.47 The forecast allows for a fall in the share of consumer spending subject to the standard rate of VAT in 2011-12. While a higher value of petrol sales would boost the share, other factors reduce the share. These include weak car sales following the end of the scrappage scheme, and consumers substituting away from standard-rated goods in light of the higher rate.

Table 4.10: Key changes to VAT since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	84.9	100.1	103.6	107.8	112.5	117.6
March forecast	86.1	100.3	103.5	108.1	112.8	117.8
Change	**1.2**	**0.1**	**-0.1**	**0.3**	**0.3**	**0.2**
of which:						
Nominal consumer expenditure	-0.2	0.0	0.1	0.1	0.1	0.1
Other economic determinants	-0.3	-0.2	-0.4	-0.4	-0.4	-0.4
Standard rated share of consumer spending	-0.2	-0.6	-0.6	-0.6	-0.6	-0.8
Litigation estimates	0.8	-0.2	0.0	0.0	0.0	0.0
VAT gap	1.0	1.0	1.0	1.1	1.1	1.2
Measures	0.0	0.0	0.1	0.2	0.2	0.2

4.48 Slow growth in the consumer and government elements of the VAT tax base constrain growth in receipts from 2012-13. These elements account for just over 80 per cent of the tax base. We also expect further falls in the share of consumer spending subject to the standard rate of VAT. With mortgage rates rising, higher spending on such housing costs is likely to squeeze demand for goods subject to VAT. VAT receipts as a proportion of GDP are expected to fall back from a peak of 6.5 per cent in 2011-12 to 6.1 per cent by the end of the forecast period.

4.49 As shown in Table 4.10, VAT receipts are close to the November forecast from 2011-12 onwards. Positive effects on receipts arising from the lower VAT gap assumption and slightly higher nominal consumer spending are offset by negative effects from other economic determinants. These include household investment and government procurement. Changes to the standard-rated share of consumer spending also reduce receipts.

Corporation tax

4.50 Receipts of onshore corporation tax in 2009-10 had been reduced by the enhanced capital allowances measure and high repayments. From this base, receipts are estimated to have grown by 14 per cent in 2010-11, helped by the resumption of profit growth. Relative to the November forecast, receipts in 2010-11 are expected to be around £0.5 billion lower. This reflects lower than expected payments relating to liabilities for 2009 and earlier years. Overall receipts relating to current year liabilities were in line with the November forecast, with stronger receipts from industrial and commercial companies offset by weaker receipts from the financial sector. The profitability of investment banking fell in the second half of 2010, leading companies to reduce their estimates of taxable profits for the year. Consequently, their January quarterly instalment payments of tax were lower.

Table 4.11: Key changes to corporation tax since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	35.8	37.3	40.2	43.1	45.4	48.0
March forecast	35.3	37.6	39.5	41.6	43.4	45.6
Change	**-0.5**	**0.3**	**-0.7**	**-1.5**	**-2.0**	**-2.5**
of which:						
Industrial and commercial profits	0.0	-0.4	-0.4	-0.3	-0.3	-0.4
Other economic determinants	0.0	0.2	0.4	0.5	0.6	0.6
Modelling changes	0.0	0.5	0.3	-0.2	-0.4	-0.5
Receipts data	-0.5	0.3	0.2	0.1	0.1	0.0
Measures	0.0	-0.4	-1.2	-1.6	-2.0	-2.2

4.51 Although non-oil, non-financial profits are expected to be a little weaker than in the November forecast, they are still expected to rise as a proportion of GDP as the economy rebalances towards investment and exports. This helps corporation tax receipts in the industrial and commercial sector rise above their pre-crisis peak in 2011-12. In contrast, receipts from the financial sector remain below their 2006-07 peak even by the end of the forecast horizon in 2015-16. This reflects:

- the fact that financial sector profits are expected to grow broadly in line with nominal GDP;
- the reductions in the corporation tax rate; and

- the fact that some firms will be still be carrying forward downturn-related losses to use against future profits.

4.52 As shown in Table 4.11, the projection for onshore corporation tax is lower in the medium term than in the November forecast reflecting lower non-oil, non-financial profits, modelling changes, and policy measures announced in the Budget, such as the further rate cut and the Controlled Foreign Companies measures.

UK oil and gas revenues

4.53 UK oil and gas revenues from offshore corporation tax and petroleum revenue tax are expected to be over £3 billion higher in each year from 2011-12 onwards, compared with the November forecast. This reflects the run up in oil prices to over $110 a barrel in recent weeks and the increase in the supplementary charge from 20 per cent to 32 per cent announced in the Budget. Dollar oil prices are assumed to move in line with oil futures, which average $113 a barrel in 2011, gradually falling to $107 a barrel by 2015. Relative to the November forecast, prices are up by $28 a barrel in 2011 and $19 a barrel by the end of the forecast period. Only a small element of the rise in the dollar oil price is offset by the appreciation of sterling against the dollar. The impact of sterling oil prices on expected receipts compared with November is shown in Table 4.12.

Table 4.12: Key changes to UK oil and gas revenues since November forecast

	£ billion					
		Forecast				
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	9.1	9.8	9.4	8.6	8.6	7.7
March forecast	8.8	13.4	12.8	11.9	12.1	11.1
Change	**-0.3**	**3.7**	**3.5**	**3.3**	**3.5**	**3.4**
of which:						
Sterling oil prices	0.1	3.7	3.0	2.4	2.2	1.9
Gas prices	0.0	0.2	0.2	0.1	0.1	0.0
Production and expenditure	0.0	-2.0	-1.9	-1.3	-0.7	-0.3
Lower January instalment payments	-0.4	0.0	0.0	0.0	0.0	0.0
Measures	0.0	1.8	2.2	2.1	2.1	1.9

4.54 The forecast reflects DECC's latest projections of UK oil and gas production and recent industry data on capital expenditure plans. This provides a partial offset to the impact from higher oil prices and the rise in the supplementary charge. The latest DECC survey concludes that production will be modestly lower and capital expenditure will rise sharply in 2011 and 2012. This may in part reflect the fact that higher oil prices have made investment more attractive. With 100 per cent first year capital allowances, this has an immediate effect on offshore corporation

Box 4.1: The oil price and the fiscal forecast

The world price of oil has increased sharply since November, reflecting rising world demand and the unrest in the Middle East and North Africa. As explained in Box 3.2 in Chapter 3, this has contributed a reduction in our forecast of UK GDP growth of 0.2 per cent in 2015-16.

Changes in the oil price affect the public finances through a number of different channels. These were explored in detail in the interim OBR's *Assessment of the effect of oil price fluctuations on the public finances* published in September 2010. Table A shows the approximate effect of higher oil prices on our current public finances forecast, which is broadly consistent with the September analysis. In the September paper, the interim OBR used the example of a £10 increase in the price of oil. Since November the oil futures curve which we use to base our projections has increased by £15 in the short-term and £10 in the medium-term.

In the current forecast the £15 increase in the oil price improves the public finances by around £1½ billion in 2011-12. Tax revenues from the UK oil and gas sector and VAT on fuel duty is increased by around £4 billion in 2011-12. This is only partly offset by:

- reductions in fuel duty, as higher oil prices reduce demand for fuel;
- indexation effects, as higher inflation leads to higher social security and debt interest payments; and
- economy effects, as higher inflation reduces real income and consumption leading to lower income tax and wider VAT receipts.

Over the forecast period, the overall effect on the public finances is broadly neutral, with an overall increase in borrowing in 2014-15 and 2015-16. The increase in revenues from the North Sea is lower in the medium term as the increase in oil prices since the November forecast is lower and because North Sea production is expected to fall over the medium term. In addition, the GDP effect is slightly higher in the medium term.

The September paper highlighted the uncertainty around the estimates and this is clearly also the case for our forecast projections. The medium-term oil price and its overall impact on the economy are highly uncertain, as are the projections of future North Sea oil production.

Table A: Estimated impact of higher oil prices on public sector net borrowing

	£ billion				
	2011-12	2012-13	2013-14	2014-15	2015-16
UK oil and gas revenues	3.7	3.0	2.4	2.2	1.9
Fuel duty	-0.5	-0.5	-0.4	-0.4	-0.4
VAT	0.3	0.2	0.1	0.1	0.0
Indexation	-1.1	-1.0	-0.8	-0.9	-0.9
GDP effects	-1.0	-1.3	-1.3	-1.4	-1.5
Overall effect	**1.4**	**0.5**	**0.0**	**-0.4**	**-0.9**
Memo: Rise in sterling oil price futures since November forecast	15	14	11	10	10

Note: Negative figure implies a rise in borrowing tax receipts. The forecast has also assumed only limited pass-through from higher oil prices on to gas prices.

4.55 Growth in UK oil and gas revenues is expected to be around 50 per cent in 2011-12, because of higher oil prices across the year as a whole, and the new rate of the supplementary charge. Thereafter, receipts are expected to decline, reflecting the modest drop in oil futures prices and the fact that oil and gas production are expected to fall by around 5 per cent a year.

4.56 Box 4.1 looks in more detail at the interaction between the oil price and our fiscal forecast.

Taxes on capital

4.57 Receipts from capital gains tax (CGT) are expected to be around £3.2 billion in 2010-11, around £0.4 billion higher than estimated in the November forecast and £0.7 billion higher than in 2009-10. With CGT paid in 2010 relating to gains made in the previous financial year, the rise in CGT receipts relates to the improvement in the equity market through 2009-10. CGT is particularly sensitive to equity prices, since it is charged on the gain rather than the whole disposal price and financial assets account for around three quarters of chargeable gains. Higher than expected receipts in 2010-11 are pushed through to future years, although there is some offset from lower projections for both property and equity transactions than in the November forecast.

4.58 Inheritance tax receipts are expected to have grown by 13 per cent in 2010-11, reflecting the lagged impact of the rise in house and equity prices through the latter half of 2009 and in 2010 and the freeze in the 2010-11 inheritance tax threshold. Housing accounts for around half of assets in estates notified for probate, so the renewed drop in house prices which is expected to persist through 2011 will slow the growth in inheritance tax receipts in 2011-12. Receipts are expected to grow by just 1 per cent and 2 per cent in 2011-12 and 2012-13 respectively.

Stamp duties

4.59 Stamp duty land tax (SDLT) receipts in 2010-11 are expected to be in line with our November forecast. However, SDLT receipts are now projected to fall in 2011-12 given that both residential prices and transaction volumes are expected to be lower than in 2010-11. The latest data on mortgage approvals suggest that residential property transactions will remain subdued over the next few months. The recovery in property transactions to a medium-term trend level consistent with the average duration of home ownership is expected to be more prolonged than envisaged in the November forecast. This takes around £0.6 billion off the SDLT forecast in 2012-13. SDLT receipts from commercial property are expected to rise further in 2011-12, although price growth is expected to be more subdued than previously assumed.

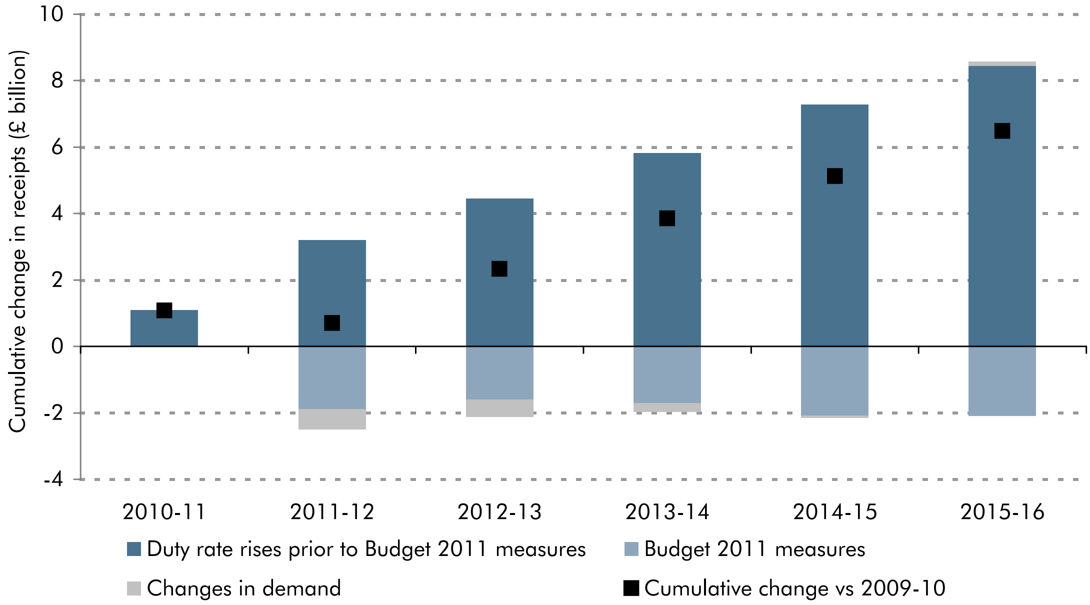
4.60 Stamp taxes on shares is expected to be slightly lower in each year of the forecast compared to the projection made in November. This reflects our forecast that lower volumes of taxable transactions will more than offset a slightly higher path for equity prices.

Fuel duties

4.61 Fuel duties are charged on petrol, diesel and rebated oils on a pence per litre basis. Chart 4.3 breaks down the cumulative growth over the forecast period into its key drivers: previously-announced rises in the fuel duty rate; the effect of measures announced at this Budget; and changes in the demand for fuel.

4.62 Prior to Budget 2011, duty rates were set to rise by RPI inflation plus an escalator of 1 pence per litre in future years. As shown in the chart, these pre-announced rises are the main driver of increases in fuel duty receipts. The rises in rate are partly offset by the measures announced at the Budget which remove the escalator, delay the 2011 and 2012 scheduled RPI upratings, and cut rates by a further 1 pence per litre. The rises are further offset by modest reductions in the demand for fuel in most years. Falling demand is mainly driven by the increased fuel efficiency of new vehicles. Rising real fuel prices also tend to suppress demand, but this effect is relatively small. Over the forecast period, receipts fall from 1.9 to 1.7 per cent of GDP.

Chart 4.3: Drivers of the fuel duties forecast



Source: OBR

4.63 Table 4.13 sets out the key changes to our forecast of fuel duty receipts since November. Overall, receipts are expected to be over £2 billion lower in each year from 2011-12. The main changes are:

- measures announced at this Budget reduce fuel duty receipts by up to £2.1 billion by the end of the forecast period. But as future rate rises are linked to inflation, our higher RPI forecast partly offsets this: higher inflation-linked duty rates raise the forecast by up to £1.1 billion;
- oil prices, which have risen considerably since November, raise the non-duty price of fuel and reduce demand and hence receipts;
- fuel duty receipts since November have been lower than expected. While this is partly due to the temporary effect of the bad winter weather, an element is expected to reflect a permanent shift in demand and this reduces the forecast by up to £0.4 billion by the end of the period; and
- our assumption on fuel efficiency is driven by the latest Department for Transport projections, which lower the forecast by £0.5 billion. These projections show that average efficiency is higher than was expected in November. This is thought to reflect increased purchases of newer, more fuel-efficient cars because of the car scrappage scheme of 2009-10, although higher pump prices may also be driving this change.

Table 4.13: Key changes to fuel duties since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	27.7	29.3	30.7	32.1	33.8	35.0
March forecast	27.3	26.9	28.5	30.0	31.3	32.7
Change	**-0.4**	**-2.4**	**-2.1**	**-2.1**	**-2.4**	**-2.3**
of which:						
Measures	0.0	-1.9	-1.6	-1.7	-2.1	-2.1
RPI	0.0	0.5	0.7	0.8	1.0	1.1
Oil prices	0.0	-0.5	-0.5	-0.4	-0.4	-0.4
Receipts data	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4
Fuel efficiency	0.0	-0.2	-0.3	-0.4	-0.5	-0.5

Alcohol and tobacco duties

4.64 The forecast for alcohol duties is broadly unchanged from November. Over the forecast period, the main driver of growth in receipts is the pre-announced duty rises of 2 per cent above RPI inflation in each year to 2014-15, and the rise by RPI alone in 2015-16. Quantities of beer and spirits clearances are expected to fall over time, while wine and cider clearances are expected to rise. Compared with the November forecast, the positive effect on receipts from increases in forecast RPI inflation is broadly offset by lower real consumer expenditure.

4.65 The tobacco duty forecast shows a downward trend in duty-paid cigarette clearances. Duty rates are assumed to rise in line with the RPI forecast plus 2 per cent each year until 2014-15, and by RPI alone thereafter. Duty rates will also be affected by the Budget 2011 measures to rebalance the specific and ad valorem elements of cigarette duty, and to increase hand-rolled tobacco duty. Receipts are expected to rise modestly over the forecast period, as the falls in clearances are more than offset by the duty rate rises. Compared with November, tobacco receipts are expected to be around £0.3 billion lower in 2010-11, reflecting lower outturn clearances. This downward adjustment continues across the forecast period, but is more than offset in later years by the effect of the higher RPI forecast, which raises forecast duty rates.

Other receipts

4.66 The fiscal forecast includes many other receipts streams. The definitions of these series, and the methodologies with which they are forecast, are set out in more detail in our briefing paper, *Forecasting the public finances*, available on our website. More detail on environmental levies, other taxes and other receipts lines in Table 4.7 is set out in the OBR's supplementary tables available on our website.

4.67 The **council tax** forecast for 2011-12 includes the one-year freeze announced in the June Budget. Thereafter, the forecast assumes that council tax rises by the three-year average of council tax rises prior to the freeze (i.e. 2008-09 to 2010-11). Changes to council tax are broadly balanced by changes to locally financed expenditure, so they have little material impact on the current balance or net borrowing.

4.68 The forecast for **business rates** is up by £0.8 billion by 2015-16, compared with the November forecast. Business rates bills are calculated by multiplying the rateable value of a non-domestic property by the multiplier, which is uprated for the following financial year in line with inflation. The higher forecasts for RPI inflation thus push up receipts.

4.69 **VAT refunds** to central and local government are fiscally neutral as receipts are offset by a positive AME accounting adjustment. The key determinants of the forecast are local government procurement and investment, and central government procurement. VAT refunds are expected to rise from the start of 2011 onwards, reflecting the increase in the standard rate of VAT, and then remain broadly flat.

4.70 The forecast for the **bank levy** on banks' balance sheets incorporates the February 2011 announcement that the 2011 levy would not be at a reduced rate. The changes since the November forecast also include the effects from revisions to the tax base and the Budget decision to revise the rate to 0.078 percentage points.

4.71 **TV licence fee** receipts have been classified as a tax in National Accounts since 2006. The forecast reflects the longer freeze in the price of TV licences announced in October 2010.

4.72 Almost all of the changes to the **climate change levy** (CCL) forecast since November are the result of the Budget measure removing existing exemptions for fossil fuels used in electricity generation. This is expected to boost receipts from CCL in the final three years of the forecast. In 2015-16, CCL receipts are expected to be £2.0 billion, compared with a projection of £0.7 billion in the November forecast.

4.73 **Environmental levies** include receipts from DECC levy-funded spending policies such as the Renewables Obligation (RO), Feed-In Tariffs and the forthcoming Warm Homes Discount, as well as receipts from the Carbon Reduction Commitment. The strong rise in receipts from levy-funded spending policies reflects increased take up of the Feed-In tariffs scheme and an expected rise in electricity generation from renewables, which would raise the level of receipts and spending through the RO. Relative to the November forecast, the bringing forward of the build of offshore wind facilities increases the RO. However, this is fiscally neutral, since it is balanced by spending within AME.

4.74 **Interest and dividend receipts** are expected to rise sharply over the forecast period from £3.3 billion in 2010-11 to £13.8 billion in 2015-16. The key drivers of the forecast are the stock of government financial assets and the short-term interest rate. The latter uses market expectations of interest rates which are expected to rise from 0.7 per cent in 2010-11 to 4.4 per cent in 2015-16. Relative to the November forecast, interest and dividend receipts are over £2 billion higher from 2013-14 onwards. This reflects market expectations of higher interest rates, a higher level of foreign exchange reserves which raises earnings on those reserves, and stronger accrued interest on student loans from the upward revisions to RPI inflation. We have also incorporated an estimate for the interest received on loans to Ireland.

4.75 The **gross operating surplus** forecast has increased since the November *Outlook* by £1.3 billion by the end of the forecast period. This is largely driven by an increase in the gross operating surplus of the Housing Revenue Account (HRA). The forecast of the gross operating surplus of the whole economy has also increased and is used to uprate the gross operating surplus of other public corporations.

4.76 The receipts forecast includes an assumption that repayments relating to future tax litigation losses will amount to £0.5 billion per year, rising with total receipts across the forecast period. This is included in the other receipts line in Table 4.7. We currently use an approach which is based on a broad assumption informed by publicly-available outturn data.[4] We will review this approach ahead of future forecasts. Our estimate excludes the effect of cases where repayments are currently being made: such repayments are already accounted for in the individual tax forecasts.

Expenditure

4.77 This section gives full details of our latest central projections for public spending. The spending projections cover the whole of the public sector, and are based on the National Accounts aggregate total managed expenditure (TME).

4.78 In the National Accounts, TME is split into the fiscal aggregates of public sector current expenditure (PSCE) and public sector gross investment (PSGI). For budgeting and public spending control purposes, TME is split into departmental expenditure limits (DEL) and annually managed expenditure (AME). Departments have separate resource and capital budgets containing resource and capital DEL, called RDEL and CDEL, and resource and capital departmental AME.

[4] Our estimate is in line with the average utilisation of the provision made in HMRC's accounts for litigation payments. Source: HM Revenue & Customs, 2010, *2009-10 Accounts* (p132).

4.79 DEL consists of expenditure by Government departments that is subject to fixed multi-year plans set at each Spending Review. AME spending is not subject to similar set limits, because it is affected by economic determinants and is therefore considered to be demand-led and more volatile. It primarily consists of transfer payments, such as social security, and other volatile items such as the Government's debt interest payments.

4.80 Table 4.15 sets out our latest projections for total public spending. The formats of Tables 4.15 and 4.16 have changed in this *Economic and fiscal outlook*. Each row now only shows spending which scores in PSCE or PSGI and therefore affects the fiscal aggregates that we forecast. Previously, some of these rows also included spending, such as non-cash items, which was included in DEL or departmental AME but which did not score in PSCE or PSGI, and which was therefore removed in other rows of the table. This meant that some changes were not easy to understand. The new tables also have additional rows to show the larger items of spending that score in PSCE or PSGI in the National Accounts, but which were previously subsumed within the row for accounting adjustments.

4.81 All comparisons of expenditure with the November *Outlook* shown in this chapter are based on the November forecasts being restated in line with the new row definitions shown in Table 4.15. Full details of the changes in the formats of these spending tables are included in the OBR's supplementary fiscal tables, which are available on our website. These further tables also show the latest spending forecasts in the previous format. The supplementary tables also include further breakdowns of spending, including allocations across subsectors and economic categories.

Table 4.14: Expenditure as a percentage of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Total managed expenditure	47.7	47.1	46.0	44.3	42.5	41.0	39.9
of which:							
Public sector current expenditure	42.8	42.9	42.5	41.2	39.7	38.3	37.3
Public sector gross investment	4.9	4.2	3.5	3.1	2.8	2.7	2.6
Total public sector expenditure that contributes to GDP[1]	26.7	26.2	25.4	24.2	23.0	21.9	21.1
of which:							
General government consumption	23.4	23.0	22.7	21.8	20.9	19.8	19.1
General government gross fixed capital formation	2.6	2.5	2.1	1.8	1.6	1.6	1.5
Public corporations gross fixed capital formation	0.6	0.6	0.6	0.6	0.5	0.5	0.5

[1] GDP at market prices

4.82 Table 4.14 sets out our forecast for public spending as a percentage of GDP. Total managed expenditure is expressed as a share of the economy, but not all of TME contributes to the calculation of GDP. The difference between TME and the public sector element of GDP is primarily accounted for by benefit payments and other transfer payments, which do not score in the public sector element of GDP under the National Accounts.

Spending assumptions

4.83 The OBR's forecast includes a detailed and updated AME forecast to 2015-16. Our forecast of DEL expenditure for 2010-11 uses departments' own estimates of forecast outturn, less our estimates for an expected further shortfall against their reported DEL spending. Our forecasts for DEL spending from 2011-12 to 2014-15 assume that the latest Government plans for DEL will be fully spent. The RDEL and CDEL plans from 2011-12 up to 2014-15 have increased slightly compared with the figures set in the 2010 Spending Review. These changes are explained in the section on DEL spending below.

4.84 Our forecasts for total PSCE and PSGI spending beyond 2014-15 are based on the Government's stated policy that TME will grow in line with general inflation in the economy. For 2015-16, the implied DEL spending is derived as a residual, since it is the amount that will be left for DELs after subtracting the latest forecast for AME spending from the assumed PSCE and PSGI spending levels.

Changes to total managed expenditure since the November forecast

4.85 Table 4.16 shows the changes in TME since the OBR's November *Economic and fiscal outlook*. Full detail on these changes are provided in subsequent sections.

4.86 Our forecast for TME in 2010-11 is some £4 billion lower than in the November *Outlook*, reflecting the latest available information on spending over the first 10 months of the year. PSCE is expected to be £2½ billion lower and PSGI is expected to be £1½ billion lower than forecast in November.

4.87 The most significant revision to our forecast for TME in 2010-11 is on local authority self-financed current expenditure, where we have revised our forecast down by £2 billion. This is explained further in the section on locally financed expenditure in AME below.

Table 4.15: Total managed expenditure

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector current expenditure (PSCE)							
PSCE in RDEL [1]	**319.8**	**327.2**	**327.6**	**328.9**	**331.9**	**330.9**	**335.4**
PSCE in Annually Managed Expenditure	**281.1**	**305.6**	**329.1**	**340.7**	**350.4**	**363.6**	**378.0**
of which:							
Social security benefits [2, 3]	162.8	169.0	174.3	179.4	178.8	183.2	189.3
Tax credits [2, 3]	24.3	25.2	26.9	28.4	28.8	28.9	29.6
Net public service pension payments [3]	4.7	5.8	7.0	7.8	8.0	8.7	9.7
of which: *CG unfunded pension schemes*	*3.7*	*4.6*	*5.7*	*6.4*	*6.5*	*7.2*	*8.1*
LG police and fire pension schemes	*1.1*	*1.2*	*1.3*	*1.4*	*1.5*	*1.5*	*1.6*
National lottery current grants [3]	0.8	0.9	0.9	0.8	0.9	0.9	0.9
BBC domestic services current expenditure	3.5	3.4	3.6	3.5	3.7	3.5	3.5
Fees associated with financial interventions	-2.5	-2.5	-1.7	-0.4	0.0	0.0	0.0
Other PSCE items in departmental AME [3]	1.0	0.4	0.7	1.1	1.0	0.9	0.9
Expenditure transfers to EU institutions [3]	4.9	6.6	7.3	6.8	7.5	8.1	7.3
Locally-financed current expenditure [3]	25.0	24.2	26.6	28.3	29.7	30.9	31.9
Central government gross debt interest	30.9	43.1	48.6	50.9	56.6	62.4	66.8
Depreciation	14.3	15.2	16.1	16.9	17.6	18.4	19.1
Current VAT refunds	9.4	11.0	12.9	13.0	12.9	12.9	13.2
Single use military expenditure	5.3	5.4	6.4	5.8	5.7	5.2	5.2
Environmental levies	0.5	0.6	1.1	1.5	2.1	2.7	3.5
Other National Accounts adjustments [3]	-3.8	-2.6	-1.8	-3.1	-2.9	-3.0	-2.9
Total public sector current expenditure	**600.9**	**632.8**	**656.7**	**669.6**	**682.4**	**694.6**	**713.4**
Public sector gross investment (PSGI)							
PSGI in CDEL	**49.9**	**43.8**	**37.9**	**36.5**	**33.2**	**34.7**	**37.1**
PSGI in Annually Managed Expenditure	**18.9**	**17.7**	**15.8**	**14.2**	**14.6**	**14.4**	**13.3**
of which:							
National lottery capital grants [3]	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Central government grants to public sector banks	4.5	0.0	0.0	0.0	0.0	0.0	0.0
Other PSGI items in departmental AME [3]	0.5	0.5	-7.3	0.1	0.3	0.3	0.3
Locally-financed capital expenditure	6.4	6.7	13.2	5.3	4.9	4.5	3.8
Public corporations capital expenditure [3]	8.7	9.5	9.2	9.2	9.2	9.6	9.2
Other National Accounts adjustments [3]	-1.7	0.5	0.1	-0.9	-0.5	-0.5	-0.6
Total public sector gross investment	**68.9**	**61.6**	**53.7**	**50.7**	**47.7**	**49.1**	**50.4**
Less depreciation	-19.3	-20.5	-21.9	-22.9	-23.9	-24.9	-25.9
Public sector net investment	**49.5**	**41.1**	**31.8**	**27.8**	**23.8**	**24.2**	**24.5**
Total managed expenditure [4]	**669.7**	**694.4**	**710.4**	**720.2**	**730.1**	**743.6**	**763.8**

[1] Implied DEL numbers for 2015-16. Calculated as the difference between Resource AME and PSCE in the case of Resource DEL, and between Capital AME and PSGI in the case of capital DEL.

[2] For 2009-10 to 2011-12, child allowances in income support and jobseeker's allowance have been included in tax credits and excluded from social security benefits.

[3] The definition of these AME rows has changed since the *November Outlook*. Full details of the changes are shown in the supplementary fiscal tables on the OBR website.

[4] TME is equal to the sum of PSCE, PSNI and public sector depreciation, on a basis which excludes temporary effects of financial interventions.

Table 4.16: Changes to total managed expenditure since November forecast

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector current expenditure (PSCE)							
PSCE in RDEL [1]	**-0.5**	**0.7**	**0.5**	**1.6**	**1.6**	**1.7**	**1.6**
PSCE in Annually Managed Expenditure	**0.5**	**-3.2**	**5.1**	**6.6**	**8.5**	**8.3**	**8.8**
of which:							
Social security benefits [2, 3]	0.1	0.6	0.6	3.2	3.2	2.9	2.1
Tax credits [2, 3]	0.1	-0.3	-0.1	0.6	1.1	1.1	1.3
Net public service pension payments [3]	0.5	0.3	0.6	1.1	1.2	1.2	1.1
of which: CG unfunded pension schemes	*0.5*	*0.2*	*0.5*	*0.9*	*1.1*	*1.1*	*1.0*
LG police and fire pension schemes	*0.0*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
National lottery current grants [3]	0.0	0.1	0.1	0.1	0.1	0.1	0.1
BBC domestic services current expenditure	0.0	-0.1	0.0	0.0	0.0	0.0	-0.1
Fees associated with financial interventions	0.0	0.0	-1.1	-0.1	0.0	0.0	0.0
Other PSCE items in departmental AME [3]	0.0	0.0	0.1	0.1	0.2	0.1	0.1
Expenditure transfers to EU institutions [3]	0.0	-0.2	0.2	0.0	-0.1	-0.4	0.5
Locally-financed current expenditure [3]	-0.1	-2.0	-0.1	0.0	-0.1	-0.1	-0.1
Central government gross debt interest	-0.1	0.4	4.7	2.2	3.1	3.5	3.7
Depreciation	-0.1	0.1	0.0	0.1	0.1	0.1	0.1
Current VAT refunds	0.0	-0.6	-0.3	-0.2	-0.3	-0.3	-0.4
Single use military expenditure	0.0	-0.1	0.7	0.0	0.0	0.0	0.0
Environmental levies	0.0	0.0	-0.1	0.0	0.2	0.2	0.4
Other National Accounts adjustments [3]	0.1	-1.3	-0.3	-0.4	0.0	0.0	0.0
Total public sector current expenditure	**0.0**	**-2.5**	**5.7**	**8.2**	**10.1**	**10.1**	**10.4**
Public sector gross investment (PSGI)							
PSGI in CDEL	**0.0**	**-1.6**	**0.6**	**0.8**	**0.1**	**0.0**	**0.1**
PSGI in Annually Managed Expenditure	**-0.1**	**0.3**	**0.5**	**-0.1**	**0.6**	**0.5**	**0.5**
of which:							
National lottery capital grants [3]	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Central government grants to public sector banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other PSGI items in departmental AME [3]	0.0	0.1	-7.6	0.0	0.0	0.0	0.0
Locally-financed capital expenditure	-0.4	0.2	7.8	0.3	0.3	0.4	0.4
Public corporations capital expenditure [3]	-0.2	0.7	0.7	0.9	0.9	0.9	0.9
Other National Accounts adjustments [3]	0.5	-0.5	-0.4	-1.2	-0.6	-0.7	-0.8
Total public sector gross investment	**-0.1**	**-1.3**	**1.0**	**0.7**	**0.6**	**0.6**	**0.6**
Less depreciation	0.2	0.0	-0.1	-0.1	-0.1	-0.2	-0.2
Public sector net investment	**0.1**	**-1.2**	**1.0**	**0.6**	**0.5**	**0.4**	**0.4**
Total managed expenditure [4]	**-0.1**	**-3.8**	**6.7**	**9.0**	**10.8**	**10.6**	**10.9**

[1] Implied DEL numbers for 2015-16. Calculated as the difference between Resource AME and PSCE in the case of Resource DEL, and between Capital AME and PSGI in the case of capital DEL.

[2] For 2009-10 to 2011-12, child allowances in income support and jobseeker's allowance have been included in tax credits and excluded from social security benefits.

[3] The definition of these AME rows has changed since the *November Outlook* . Full details of the changes are shown in the supplementary fiscal tables on the OBR website. Changes in this table are based on the November forecast being restated so directly comparable.

[4] TME is equal to the sum of PSCE, PSNI and public sector depreciation, on a basis which excludes temporary effects of financial interventions.

Table 4.17: Derivation of PSCE in RDEL and PSGI in CDEL

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
RDEL figures in March forecast							
RDEL	**334.4**	**345.4**	**342.3**	**344.7**	**349.1**	**348.2**	**352.5**
less:							
Depreciation in RDEL	-13.1	-16.4	-14.3	-15.3	-15.3	-15.9	-16.1
Cost of subsidised interest on student loans	-1.6	-3.0	-1.8	-2.2	-2.7	-3.3	-3.3
gives:							
RDEL excluding depreciation	**319.8**	**326.1**	**326.3**	**327.1**	**331.1**	**329.0**	**333.1**
less:							
Other items in RDEL that do not score in PSCE	0.0	1.2	1.3	1.8	0.9	2.0	2.3
gives							
PSCE in RDEL	**319.8**	**327.2**	**327.6**	**328.9**	**331.9**	**330.9**	**335.4**
CDEL figures in March forecast							
CDEL	**57.0**	**50.0**	**44.5**	**42.6**	**39.2**	**40.3**	**42.7**
less:							
Single use military expenditure	-5.3	-5.4	-6.4	-5.8	-5.7	-5.2	-5.2
Capital grants and net lending to PCs	-0.6	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other financial transactions	-1.3	-0.7	-0.4	-0.4	-0.3	-0.4	-0.4
Other items in CDEL that do not score in PSGI	0.2	0.1	0.5	0.3	0.3	0.3	0.3
gives							
PSGI in CDEL	**49.9**	**43.8**	**37.9**	**36.5**	**33.2**	**34.7**	**37.1**
	Percentage growth in real terms						
RDEL		0.4	-3.7	-1.8	-1.4	-2.9	-1.4
RDEL excluding depreciation		-0.9	-2.8	-2.2	-1.5	-3.2	-1.4
PSCE in RDEL		-0.6	-2.7	-2.0	-1.7	-2.9	-1.3
CDEL		-14.7	-13.6	-6.5	-10.4	0.0	3.4
PSGI in CDEL		-14.7	-16.0	-6.1	-11.5	2.0	4.0

Departmental expenditure limits

4.88 The presentation of the DEL figures in Table 4.15 only includes the components of RDEL and CDEL that score towards PSCE and PSGI. Table 4.17 reconciles these components with the Treasury totals of 'total RDEL', 'total RDEL excluding depreciation', and 'CDEL'. The differences relate to various non-cash spending items, and receipts which finance spending but which are treated as current receipts in the National Accounts, including passport fees and rail franchise premia. [5] Within CDEL, the main component that does not score in PSGI is

[5] All the RDEL items not included in PSCE in RDEL and the CDEL items not included in PSGI in CDEL are listed in detail in Table 8 of the Budgeting tables in the *Public Expenditure Outturn* statistical release, which is available at: www.hm-treasury.gov.uk/pespub_natstats_feb2011.htm

single-use military spending. This spending is currently classified as PSCE in the National Accounts.

4.89 Our forecast for 2010-11 assumes an additional shortfall of £1.1 billion on departments' estimates of their spending on RDEL, and £0.6 billion additional shortfall on their CDEL spending. Even so our forecast for PSCE in RDEL is £0.7 billion higher than November. This is because of further increases in non-departmental spending that scores in PSCE, including an increase in subsidies to the train operating companies. This is fiscally neutral as it is financed by additional receipts from rail franchise premia, which score as current receipts.

4.90 PSCE in RDEL has increased by between £½ billion and £1½ billion a year over 2011-12 to 2014-15. This also reflects increases in rail franchise premia. Again, these increases have also been reflected in the current receipts forecast, and are therefore fiscally-neutral.

4.91 The figures shown for CDEL for the years 2011-12 to 2014-15 are as set out in the Spending Review, except for the changes from Budget measures listed in Annex A. PSGI in CDEL shows some small further changes which reflect changes in the distribution of CDEL spending between a number of smaller items.

4.92 Departments have not yet set out their detailed spending plans, and the Treasury has not yet published their analyses of the sectoral and economic distribution of DELs. Therefore, we have continued to assume that departments' economic distributions of their spending in their Spending Review settlements will follow the same distribution as in their plans for 2010-11. The only exception is the forecasts of the current receipts items discussed above.

4.93 The Government has said that TME will be held flat in real terms between 2014-15 and 2015-16. Given our latest AME projections, and following the approach to derive implied RDEL and CDEL set out above, this implies a further fall in real RDEL in 2015-16 of 1.4 per cent, bringing the total real cut from its peak in 2009-10 to 10 per cent. Implied CDEL is forecast to rise by a further 3.4 per cent in 2015-16. The total real cut to CDEL since 2009-10 is 36 per cent.

Annually managed expenditure

4.94 Table 4.15 sets out our latest central projections of AME spending to 2015-16, based on the economic determinants in this forecast, the latest estimates of agreed policy commitments, and the effect of measures announced in Budget 2011. The largest changes to the main AME components are driven by changes to the key economic determinants of the AME forecast:

- inflation, which affects the uprating of benefits, tax credits, the basic state pension and public service pensions. Debt interest is also affected by inflation, because of the UK's issuance of index-linked gilts, where both the ongoing interest payments and the accrued uplift on redemption are linked to the RPI;
- claimant count unemployment, which affects unemployment-related benefits;
- earnings, which affects spending on tax credits and the basic state pension; and
- interest rates, which impact directly on the cost of issuing new debt.

4.95 The AME projections are subject to considerable uncertainty in relation to their key economic determinants. In this section, we provide more detailed analysis of the latest AME forecast and explain the changes since our November forecast. We also include diagnostic tables for some of the main components where there have been significant changes.

Social security

4.96 The main components of the social security forecast have been produced on our behalf by the Department for Work and Pensions (DWP), using their detailed models for each individual benefit. The social security AME row also includes forecasts of child benefit produced for us by HMRC, and forecasts for the relatively small amount of social security spending by other departments. A detailed breakdown showing forecasts for the main components of social security is included in the OBR's supplementary fiscal tables available on our website.

4.97 All these forecasts are based on the economic determinants in our central economic forecast, and on judgements agreed by the BRC on the various other factors affecting the level of benefit receipts. Our approach to forecasting the impact of changes in DWP spending on levels of benefit fraud and take-up is consistent with the approach to HMRC tax compliance, set out in Box 4.1 of the November *Outlook*.

4.98 The social security forecast for 2010-11 has increased by £0.6 billion compared with the November forecast. The majority of this is caused by higher cold weather payments as a result of the sustained sub-zero temperatures in December.

4.99 Social security spending is forecast to decrease by an annual average of 0.4 per cent in real terms over the five years to 2015-16. This is partly as a result of policy changes announced in recent fiscal events. Compared with November, this forecast shows an increase in social security spending of approximately £3 billion per year from 2012-13 onwards, with the exception of 2015-16, where modelling improvements reduce the increase to £2 billion. The key changes to the social security forecast are shown in Table 4.18.

4.100 The most significant changes from economic determinants since November are the forecast increases in CPI in 2011-12 and 2012-13. From 2011-12 onwards the CPI measure of inflation will be used to uprate all benefits apart from the state retirement pension, which is uprated in line with the 'triple guarantee', i.e. the maximum of: the 2.5 per cent flat minimum increase, average earnings, and the CPI. The increase in CPI in 2011-12 means that the 'triple guarantee' costs £0.6 billion more each year from 2012-13, and the impact of higher CPI on other benefits accounts for £0.9 billion of the increase in social security in 2012-13 and around £1.3 billion in each subsequent year. An increase in the claimant count unemployment determinant has also led to higher benefit payments.

4.101 Table 4.18 also shows an increase in the forecast caused by the remodelling of the savings from the Spending Review measure to time-limit contributory Employment and Support Allowance (ESA) for those in the Work Related Activity Group. The expected savings from this measure have been reduced for two reasons. First, we have updated the assumptions to reflect the effect of the migration of cases from incapacity benefit on the composition of the time-limited caseload over time. Second, the forecast now assumes a higher level of appeals by those assigned to the Work Related Activity Group, which means more moving into the Support Group where time-limiting does not apply.

4.102 Table 4.18 also shows the impact of improvements to the forecast for working age claimants who are entitled to receive housing benefit. The increase in the first few years is driven by the most recent data, showing a larger proportion of people receiving other benefits who also receive housing benefit. The decrease in later years is caused by an expected reduction in the ESA caseload and the correction of a modelling error related to unemployed housing benefit recipients.

Table 4.18: Key changes to social security since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	168.5	173.7	176.2	175.7	180.3	187.3
March forecast	169.0	174.3	179.4	178.8	183.2	189.3
Change	**0.6**	**0.6**	**3.2**	**3.2**	**2.9**	**2.1**
of which:						
CPI	0.0	0.0	0.9	1.3	1.4	1.4
Claimant count unemployment	0.0	0.3	0.5	0.5	0.4	0.2
State pension triple guarantee	0.0	0.0	0.6	0.6	0.6	0.6
Time limit on ESA	0.0	0.0	0.4	0.3	0.3	0.3
Housing benefit caseload	0.1	0.5	0.4	0.3	-0.1	-0.3
Higher cold weather payments	0.4	0.0	0.0	0.0	0.0	0.0

[1] For 2010-11 and 2011-12, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

Tax credits

4.103 The child and working tax credits forecast has been produced on our behalf by HMRC, based on our central economic forecast and agreed judgements and methodology. The key economic determinants of the forecast are CPI inflation, average earnings, and claimant count unemployment. For the first time, as part of the wider presentational changes to Table 4.15 set out earlier in the section, the tax credit numbers now include company tax credits, which were previously included in accounting adjustments and other departmental spending. The breakdown between household and company tax credits is shown in the supplementary tables on our website.

Table 4.19: Key changes to tax credits since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	31.0	31.6	32.1	32.0	32.1	32.7
March forecast	30.7	31.6	32.7	33.0	33.2	33.8
Change [1, 2]	**-0.3**	**0.0**	**0.5**	**1.1**	**1.0**	**1.1**
of which:						
CPI	0.0	0.0	0.3	0.5	0.5	0.5
Average earnings growth	0.0	0.1	0.2	0.2	0.2	0.2
Refinement to income calculation	0.0	0.0	0.1	0.3	0.4	0.4

[1] This table shows changes to total tax credits. Tax credits are split between current receipts and AME current spending, and the changes are split as follows:

Changes to tax credits treated as AME spending	-0.3	-0.1	0.6	1.1	1.1	1.3
Changes to tax credits treated as negative tax	0.0	0.0	0.0	0.0	-0.1	-0.2

[2] For 2010-11 and 2011-12, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

4.104 Total tax credit expenditure rises in real terms to 2012-13 and then declines somewhat in real terms thereafter. By 2015-16, it is forecast to be approximately 3 per cent higher in real terms than in 2010-11. Compared with November, this forecast shows an increase of around £1 billion per year from 2013-14 onwards. This is largely because of changes to the forecasts of CPI inflation and average earnings growth. Table 4.19 summarises the changes to the tax credits forecast since the November forecast. The detailed changes apply to the forecast for household tax credits, i.e. child and working tax credits, which account for the bulk of this spending.

4.105 Apart from changes to economic determinants, the main change to the forecast of household tax credits is as a result of a refinement to the income calculation. This now ensures that all income for tax credit calculations is based on the relevant years' data and corresponding earnings growth factors. Previously, income was grown by a single earnings growth profile, regardless of whether the original income stream was based on the previous or current year's income. Now, when previous year's income is used for tax credit calculations, the previous year's earnings growth factor is also applied. This increases the forecast by £0.1 billion in 2012-13 to £0.4 billion by 2015-16.

4.106 Where recipients do not pay tax, all their tax credits are classified as AME spending. Where the recipient pays some tax, the amount of tax credit that serves to offset all or some of the tax paid is classified as negative tax and any remaining amount scores as AME. Overall, negative tax tax credits account for around 15 to 20 per cent of total tax credit payments, but this proportion is decreasing as a result of announced policy measures. The negative tax element is shown in Table 4.7 and the AME spending shown in Table 4.15.

Public service pensions

4.107 The net public service pensions expenditure forecast is measured on a National Accounts basis, and measures benefits paid less employer and employee contributions received. It includes central government pay-as-you go public service pension schemes and, for the first time, the locally administered police and fire-fighters' pension schemes, which have previously been included in the 'other departmental expenditure' category.[6] It excludes the funded Local Government Pension Scheme. A breakdown for the major schemes covered is included in the OBR's supplementary fiscal tables available on our website.

[6] The police and firefighters' pension schemes are administered at a local level, however pensions in payment are funded from AME in the same way as other public service pension schemes so they are included in the pensions forecast.

Table 4.20: Key changes to net CG unfunded pension schemes since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	4.3	5.1	5.4	5.4	6.1	7.2
March forecast [1]	4.6	5.7	6.4	6.5	7.2	8.1
Change	**0.2**	**0.5**	**0.9**	**1.1**	**1.1**	**1.0**
of which:						
CPI	0.0	0.0	0.3	0.4	0.4	0.5
Paybill growth	0.0	0.4	0.6	0.6	0.6	0.4

[1] The March forecast of net pension payments is made up of expenditure and income as follows:

Gross expenditure	26.1	27.4	29.2	30.6	32.2	33.7
Income	-21.5	-21.7	-22.8	-24.1	-25.0	-25.6

4.108 The gross expenditure forecast is based on the demographics of each individual pension scheme, both for existing pensioners and the current workforce. Gross expenditure rises steadily across the forecast period as the age profile of each scheme's membership changes and people live longer. The main economic determinant of gross expenditure on pensions is CPI inflation, which is used to uprate the level of benefits paid. The increase in CPI inflation since the November forecast is the main reason for the increase in gross expenditure.

4.109 The income of each pension scheme is almost entirely made up of employer and employee pension contributions. The key forecasting assumption here is around the rate of growth in the total employee paybill, which directly determines changes in the level of pension contributions. In November, most scheme-by-scheme rates of growth were calculated centrally by the OBR based on departments' resource settlements announced in the Spending Review. Some departments and pension schemes now have better planning assumptions that reflect, or partly reflect, the outcome of the Spending Review DEL settlements. Where sufficient planning information is available, paybill growth from the schemes has been used.[7]

4.110 The forecast also includes additional receipts from an assumed increase in current contribution rates from 2012-13 onwards. This was announced as part of the Spending Review, was included in our November forecast and is forecast to raise approximately £2.8 billion by 2014-15. Details of how this will impact across schemes have not been announced so this is added as an overall global

[7] The Principal Civil Service Pension Scheme (PCSPS) and the police pension scheme have paybill growths calculated by the OBR based on resource DEL settlements announced in the Spending Review. All other schemes paybill growths are based on scheme specific information.

adjustment to total receipts. It is therefore not included in the scheme by scheme analysis shown in the supplementary fiscal tables. For the purposes of separating out CG schemes from the locally-administered police and fire-fighters' schemes in Table 4.15, we have assumed that approximately £0.2 billion of this is in respect of police and fire-fighters' pensions schemes.[8]

4.111 The forecast does not make any allowance for any policy changes that could result from the consultation on the discount rate used to set contribution rates or following Lord Hutton's final report.

EU contributions

4.112 The main components of the AME expenditure transfers to EU institutions are the UK's GNI-based contribution, minus the UK's abatement.[9] The forecast for the GNI-based contribution depends on the level of the agreed EU Budget, and the relative gross national income of each member state. The UK abatement is affected by the UK's share of EU VAT and the UK's share of EU receipts (including departments' receipts from the EU).

4.113 A further supplementary fiscal table on our website provides further details of UK transactions with the EU. The supplementary table also shows how all these various contributions score in the National Accounts, and in this forecast.

4.114 The forecast for AME expenditure transfers to EU institutions in 2010-11 is £0.2 billion lower than forecast in November. This mainly reflects a lower 'draw forward' of some of the UK's GNI-contribution from 2011-12 to 2010-11.

4.115 The EU Budget for 2011 was agreed in December, with the budget increase fixed at 2.9 per cent, as anticipated in our November forecast. At this stage of the year there is no further information available on the EU Budgets that will be set for 2012 and 2013, and so the forecast has not changed, and reflects the commitments agreed in 2005 for the period 2007-2013.

4.116 The forecast for 2014-15 onwards is much more uncertain. There are two main issues. The first is that the current framework for EU Budgets ends in 2013, and the new Budget envelope for 2014 to 2020 has not been agreed. The second issue is the backlog of committed funds from the current framework for EU Budgets that member states have not drawn down and spent.

[8] Hansard HC, 1 March 2011, vol. 254 col.437W.

[9] The other minor adjustments which are now also included within this AME row are shown in the supplementary fiscal tables on our website, in the table that shows how the new AME rows in Table 4.15 are derived.

4.117 Certain member states, including the UK, have proposed an agreement which would limit total spending, including spending from this backlog of available funds. Their joint letter, which was published following the December 2011 European Council, called for EU spending to grow by no more than inflation between 2014 and 2020.

4.118 The OBR forecast for 2014-15 onwards assumes some moderation in EU spending, taking into account the possible implications of the joint letter, but with an assumed increase in spending in 2014 and 2015 to use up the backlog of funding before that is withdrawn.

4.119 The EU contributions forecast is subject to a number of additional uncertainties. Revisions to the GNI and VAT bases, and new projections for total own resources are expected to be announced in May 2011. Also the expected accession of Croatia in 2013, which will be included in the forecast after the formal negotiations close in the summer, could cost the UK some minor amounts over this forecast period and up to £0.2 billion per year in the long run.

Locally financed expenditure

4.120 Locally financed expenditure consists mainly of local authority self-financed expenditure (LASFE) and Scottish Government spending financed by local taxation. The main component of LASFE is council tax receipts. The forecast reflects the June Budget announcement to freeze council tax in England in 2011-12, and then reverts to the usual stylised method of projection for 2012-13 onwards, which assumes that council tax increases by the average of the three most recent years of council tax increases. This approach is also applied to council tax receipts in the public sector receipts part of the forecast, so these assumptions are neutral for the fiscal aggregates. Other factors affecting current LASFE include local authorities' use of reserves and their interest receipts.

4.121 Factors affecting capital LASFE include the latest forecast for the levels of receipts from asset sales, the use of capital receipts retained from latest and previous asset sales, private sector contributions to capital projects, and prudential borrowing for capital investment. Receipts from sales of assets in each year are netted off capital LASFE. All these factors are subject to significant uncertainties as they depend on decisions taken in individual local authorities.

4.122 The forecast for current LASFE in 2010-11 has been reduced by £2 billion since the November forecast. There is currently very little information available on local authority current expenditure during the current year, so this is a key area of uncertainty in the forecast. The first outturn estimates for English local authorities are not available until almost five months after the end of the financial year and there is a longer lag before figures for Scotland and Wales become available. However this information gap should be partially filled during 2011-12 because Communities and Local Government (CLG) plan to collect and publish quarterly local authority current spending data. This is a very welcome and useful development.

4.123 Local authority current expenditure is usually much higher than the plans set in their budgets at the beginning of the year. This is because local authorities do not have enough information about specific grants from central government, and they therefore underestimate spending financed from that additional income. This additional spending is expected to be lower in 2010-11, reflecting reductions in grants following the Government's cuts to spending plans in May 2010. Our forecast includes an assumption that local authority current expenditure matches the levels set in their budgets. This estimate is subject to considerable uncertainty, given the current lack of information on in-year current spending. It reflects all available information on central government grants and local authorities' actual cash borrowing for the first 10 months of the year, and our judgements about the likely overall level of local authority net borrowing.

4.124 This reduction in spending has not been carried forward to the forecast in future years because in our judgement the forecast level of total local authority net borrowing is appropriate over those years.

4.125 The forecast for capital LASFE in 2010-11 and following years has been increased by between £0.2 billion and £0.4 billion, mainly reflecting reductions in the forecast for local authority asset sales. In 2011-12 there is a one-off payment to central government of £7.5 billion as explained in the section on other items in departmental AME.

4.126 Our forecast for capital LASFE in 2010-11 includes an assumption that local authorities spend £0.3 billion on capital grants to public corporations. We are aware that ONS may be recording higher levels of these grants in their provisional estimates and we have identified this as an area where we need to review our forecast. However we are confident that any errors in our forecast will only affect the sectoral splits of capital spending between local authorities and public corporations, and will not affect PSNB.

Debt interest

4.127 The key factors that determine the debt interest forecast are the existing stock of debt; the forecast financing requirement for future years; the mix of debt instruments expected to be used to meet the financing requirement; and the forecast for interest rates and RPI inflation.

4.128 The debt interest forecast is based on the Treasury's advice on the UK Debt Management Office (DMO) debt financing remit for 2011-12,[10] and on the projected mix of debt financing and the associated debt instruments for the remainder of the forecast period. A breakdown of the AME debt interest forecast by financing component is shown in the supplementary fiscal tables on our website.

4.129 Debt interest payments on the existing stock of conventional gilts are fixed for the lifetime of those gilts. The average maturity of the UK conventional gilt is 13 years. Therefore, over the forecast period, approximately 40 per cent of the debt interest forecast consists of fixed debt interest costs on existing conventional gilts.

4.130 The debt interest forecast for payments on new issuance of conventional gilts depends on the level of new issuance and the effective gilt interest rate. The level of new gilt issuance is determined by the central government net cash requirement (CGNCR), the profile of redemptions of existing gilts and the projected mix of financing instruments. The forecast for the CGNCR is shown in Table 4.22. This has increased since the November forecast and results in an extra £1.6 billion in debt interest costs by 2015-16. This, and other significant changes to the debt interest forecast, are shown in Table 4.21.

4.131 The debt interest forecast uses a weighted average of short, medium and long-term gilt rates taken as an average of the 10 working days up to and including 4 March 2011. This is an area of particular uncertainty, especially given the volatility in recent months. The interest rate assumptions in this forecast are on average 10 basis points above the interest rate assumptions used in the November forecast. This has increased the debt interest forecast by £0.9 billion by 2015-16.

Table 4.21: Key changes to debt interest since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	42.7	44.0	48.6	53.5	58.9	63.1
March forecast	43.1	48.6	50.9	56.6	62.4	66.8
Change	**0.4**	**4.7**	**2.2**	**3.1**	**3.5**	**3.7**
Of which:						
Gilt rates	0.0	0.1	0.6	0.7	1.0	0.9
CGNCR	0.0	0.3	0.2	0.8	1.2	1.6
RPI	0.4	3.4	1.2	1.5	0.9	1.1

[10] As set out in the *Debt and reserves management report 2011-12* published alongside the Budget.

4.132 RPI inflation also has a significant impact on the debt interest forecast because of the accrued uplift on index-linked gilts. This is particularly significant in 2011-12, when the RPI effect on payments is £3.4 billion higher than in November because the forecast for RPI inflation has increased from 3.5 per cent to 5.2 per cent.

4.133 A ready-reckoner table showing the approximate effect of movements in interest rates, RPI inflation and the CGNCR, is included in the supplementary fiscal tables on our website. This ready-reckoner table was published in the November *Outlook*, and has been updated to be consistent with the latest debt interest forecast.

Fees associated with the financial interventions

4.134 Estimates of transactions related to the previous Government's interventions to stabilise the financial sector are included in the fiscal projections where they can be quantified with reasonable certainty. Therefore the projections include estimates of fee income from the Asset Protection Scheme (APS) and Credit Guarantee Scheme (CGS), which score as negative AME, and other interest and loan repayments which can be forecast. The projections do not include estimates of components which cannot be quantified at the current time, such as: the sale of shares in Royal Bank of Scotland and Lloyds Banking Group; any potential loss payouts on the schemes; or the final net profit or loss position of the Special Liquidity Scheme.

4.135 The main change from the November forecast is that current spending has been reduced by £1.1 billion in 2011-12 as a result of the inclusion in the forecast of receipts expected in 2011-12 from fees charged for the Credit Guarantee Scheme.

Other items in departmental AME

4.136 The main other items of expenditure in departmental AME are the Housing Revenue Account (HRA) subsidy, Equitable Life payments, and spending of the Redundancy Payments Service. Details are shown in the OBR supplementary tables published on our website. The most significant change since the November forecast is a reduction of £7.5 billion in capital spending in 2011-12 as a result of a large receipt by central government of net capital grants from local authorities that implement the reform of council house financing announced in the Spending Review. These reforms abolish the HRA subsidy and replace it with a devolved system of self-financing for council housing. This net receipt is completely offset by a net payment included within capital LASFE, so this has no impact on the overall public finances. The scoring of this net payment as a capital grant, rather than as a financial transaction, is provisional, and will depend on the final classification of this transaction in the National Accounts.

Other AME spending

4.137 Table 4.15 now shows separate forecasts for single-use military expenditure. We remove this from CDEL and include it in current AME spending because it is classified as current expenditure in the National Accounts.

4.138 Some parts of other AME spending, most notably VAT refunds and depreciation, are also scored within public sector current receipts. The National Lottery payments and the BBC domestic expenditure component of AME are also broadly fiscally neutral as the expenditure is almost entirely financed by Lottery sales and TV licence fee receipts.

4.139 Environmental levies include spending on DECC levy-funded policies such as the Renewables Obligation (RO), Feed-In Tariffs and the forthcoming Warm Homes Discount. All of this spending is fiscally-neutral, since it is balanced by receipts. The latest profile for these forecasts is explained in the receipts section above. Environmental levies also includes spending on the Renewable Heat Incentive policy, which is not balanced by any corresponding receipts.

Public corporations

4.140 Public corporation capital expenditure has increased by £0.9 billion from 2012-13 onwards compared with the November forecast. This mainly reflects increases to the forecast of HRA net capital expenditure, which reflects higher outturn data for 2009-10.

4.141 The ONS announced in January this year that they had decided that British Energy Group Ltd should be reclassified as a private non-financial corporation. This followed the takeover of the company by French power company EDF in January 2009. Although the ONS article reported that this change should have a minimal impact on the key fiscal indicators, we consider that there could be a more sizable impact. The ONS have not yet implemented this change in the National Accounts or the *Public sector finances* release and we have not reflected this change in our forecasts because we do not yet have any reliable estimates of the effects of this change.

Accounting adjustments

4.142 Accounting adjustments are necessary to reconcile between spending components, which are sourced from departments' spending data, and the National Accounts definition of TME. They replace some data where National Accounts uses an alternative source and they add in some items that should be included in TME but are not included in the budgeting aggregates. The number and amount of accounting adjustments has been significantly reduced as a result of the new presentation of TME shown in Table 4.15. A full table of accounting adjustments is included in the OBR supplementary fiscal tables.

4.143 Table 4.16 shows a small reduction in current and capital accounting adjustments over the forecast period when compared with November. The reduction in capital is caused by a current to capital switch of DfID bilateral aid grants being removed. This anticipates the ONS correcting this classification in the near future and therefore making this adjustment unnecessary. The consequential increase on the current accounting adjustments is more than offset by revisions to the local authority accounting adjustments.

Financial transactions

4.144 The public sector net cash requirement (PSNCR) is the cash equivalent of public sector net borrowing. It is important for the fiscal projections as it drives the forecast of public sector net debt (PSND), which is a cash measure of the public sector's stock of net debt. The other important cash measure is the central government net cash requirement (CGNCR). This measures the cash required by central government to fund its operations, and forms the basis for the Government's net financing requirement.[11]

4.145 Table 4.22 shows the steps required to move from the PSNB to the PSNCR and CGNCR. The first step is to move from PSNB to PSNCR by including financial transactions, which represent the difference between the net borrowing aggregates and the cash measures. These transactions arise either from timing differences known as 'accruals adjustments' or from exchanges of financial assets involving cash – 'financial transactions'.

[11] The Government is publishing a financing remit for 2011-12 alongside the Budget. The OBR provides the Government with the forecast of the CGNCR for this purpose, but plays no further role in the derivation of the net financing requirement.

Table 4.22: Reconciliation of PSNB and CGNCR

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector net borrowing	**156.4**	**145.9**	**122**	**101**	**70**	**46**	**29**
Financial transactions	33.0	4.3	7	9	10	11	9
Accruals adjustments	14.7	-4.9	1	-1	3	-5	-7
Public sector net cash requirement	**204.1**	**145.2**	**129**	**109**	**83**	**52**	**32**
minus Local authorities net cash requirement	5.0	3.5	11	3	2	1	0
minus Public corporations net cash requirement	1.4	3.0	1	3	3	6	0
Central government net cash requirement own account	**197.7**	**138.7**	**116**	**103**	**79**	**45**	**31**
Net lending within the public sector	1.1	2.5	4	2	2	2	2
Central government net cash requirement	**198.8**	**141.2**	**120**	**105**	**80**	**46**	**33**

4.146 The PSNCR measures the cash required by the public sector as a whole. As shown in Table 4.22, the cash requirements for local authorities (LANCR) and public corporations (PCNCR) are removed from the PSNCR to produce an estimate of the cash required by the Government to fund its own operations – the CGNCR 'own account'. In addition, central government lends money to local authorities and public corporations. The lending to local authorities is done via the Public Works Loans Board (the PWLB). The adjustment for the net effect of this on lending produces the CGNCR.

4.147 We use the following approach to forecast financial transactions:

- accruals adjustments are produced alongside the main forecasts of receipts and expenditure in particular as part of the forecast of debt interest payments;
- for regular exchanges of financial assets such as repayment of loans to the financial sector and student loans payments, where enough is known about the size and timing of the transactions for the effects to be quantified, estimates based on the latest available information are included in the forecast; and

- where firm plans are not in place, potential exchanges of financial assets are not included in the forecast. For example, if the Government has indicated it wishes to sell a financial asset but the terms of sale have not been agreed the sale would not be included. This is discussed further later in this section.

4.148 The detailed financial transactions forecast is provided in the supplementary tables that are published on the OBR website alongside this forecast. The major changes to the forecast of financial transactions since November are due to:

- changes to the forecasts for RPI which affects the accruals uplift on index linked gilts and student loans. A higher RPI raises net borrowing but has no immediate cash implications. This therefore increases the size of the accruals adjustment which is removed within the financial transactions;
- an increase in the proportion of borrowing which some local authorities are doing from the market, rather than from the PWLB, which increases the LANCR and reduces the CGNCR. Our forecast assumes this borrowing increases to £2 billion a year by 2012-13, compared with levels of borrowing of £2-3 billion from the PWLB. We also assume that local authorities borrow a net, one-off amount of £5 billion from the market in 2011-12 to finance their net payment of £7.5 billion to central government as part of the HRA reforms discussed in the AME spending sections above;
- an increase of £775 million in 2012-13 reflecting the Government's announcement of funding for the Green Investment Bank;
- the inclusion of an estimate of the funding necessary for the bilateral loan to Ireland. This amounts to £3.2 billion between 2011-12 and 2013-14; and
- changes to the path of loans to the wholly owned banks which are neutral for the public sector as a whole but decrease the CGNCR.

4.149 In the November forecast we included an estimate of the effect of the Government's announcements on higher education funding on the CGNCR. This estimate has not changed materially since November. The Government's Budget 2011 announcement on the Green Investment Bank suggests that there may be an additional £1.2 billion of funding made available, in addition to the £775 million included in this forecast for 2012-13 and the £1 billion included in our November forecast. This would bring the total to £3 billion. However, the Government has not announced firm details of the timing or funding sources of this potential additional £1.2 billion. Therefore, we do not include it in our central forecast at this point.

4.150 As Table 4.22 shows, in most years there is a reasonably stable relationship between PSNB and the CGNCR. They differed by much more than usual in 2008-

09 and 2009-10, reflecting the cash implications of the interventions made by the previous Government to stabilise the financial system. There is also a more significant difference than usual in the two measures in 2011-12 and 2013-14, which is attributable to the redemption of index-linked gilts.

Box 4.2: Fiscal impact of the financial interventions

In the November *Economic and fiscal outlook* we certified the Treasury's approach for calculating the overall direct net cost or benefit to the taxpayer of the interventions taken to stabilise the financial sector. This is highly uncertain and will depend in large part on the eventual sale price for the Government's shareholdings in RBS and LBG, which it is not possible to predict with any confidence.

The Treasury's approach therefore uses market prices to value these shares. On the basis of latest market prices this implies a loss of £1.6 billion on these investments. The Treasury then uses the Asset Protection Agency's central projection of a net benefit to the taxpayer from Asset Protection Scheme of £5 billion, including fee income. The aggregate costs of all other interventions are not expected to be material once fees, income and recoveries are taken into account. Overall, this implies an estimated eventual benefit to the taxpayer of £3.4 billion.

Any sale of shares would have an impact on public sector net debt. However, no estimate of this has been included in the central forecast given the significant uncertainties around this, and as there is no firm plan for when, how and at what price such sales would take place. This exclusion therefore represents a risk to the forecast of public sector net debt.

Treatment of financial asset sales and privatisation proceeds

4.151 In the October 2010 Spending Review the Government made a commitment to sell a number of financial assets including High Speed 1, parts of the radio spectrum, NATS, the Tote, part of the student loan book, as well as making a further capital injection into Royal Mail. The Government has provided a further update on its progress on these items in the Budget.

4.152 The cash received from such sales will often score as a financial transaction, so leading to a one-off reduction in the CGNCR and PSND. However, there are likely to be other effects on the public finances. For example, it is often the case that the Government will lose a flow of income associated with the asset which would tend to push up PSNB over the forecast period.

4.153 Consistent with the *Charter*, and our wider approach to policy announcements, we only include the impact of such sales in our central forecast once firm and final details are available that allow the effects to be quantified with reasonable accuracy. At the present time, only the sale of High Speed 1, which was completed last year, is included in the central forecast. Consistent with the *Charter*, we note risks to the forecast from commitments that cannot yet be quantified. Two significant risks relate to spectrum sales and the Government's shareholdings in public sector banks.

4.154 This is an appropriate approach because, in the case of most prospective financial asset sales and privatisations, there is no market price to provide an objective estimate of the potential proceeds. The sale price and terms will typically depend on the outcome of commercially confidential negotiations and on market conditions prevailing in the relevant sector at the time the deal is completed. Moreover, many such assets are inherently very difficult to value, such as rights to use part of the spectrum.

4.155 For example, prices in the 3G spectrum auctions that took place in 2000 were over 100 times higher on a comparable basis than the subsequent spectrum auctions at 3.4GHz, despite the two bands being relatively similar in their physical properties. Recent German auctions for 4G spectrum raised some €4.4 billion. Therefore, the proceeds for the UK auctions due in early 2012 may be substantial, but we do not yet have enough information to make an estimate of the outcome.

4.156 Even when sale terms and prices have been agreed, the effect of asset sales on the public finances is not straightforward. It will often depend on an ONS classification decision that may not be agreed until some time after the sale has been completed.

4.157 The national accounts treatment of awards of licences to use the spectrum is again an example. The OBR follows the ONS practice of treating the receipts as rental payments for the use of an asset. However, Eurostat maintains that the government is actually selling an asset and scores the receipts as negative capital expenditure. Unlike financial asset sales, both treatments of spectrum receipts have a favourable impact on net borrowing, but the timing of the impact will be very different, because the rental treatment means accruing the receipts evenly over the whole licence period.

4.158 The Government's holdings in RBS and LBG represent another significant risk to the forecast. In this case the risks to PSND are on the downside because, as Box 4.2 explains, on the basis of current market prices the sale of these shares would lead to a loss to the taxpayer of £1.6 billion. Given that no announcement has been made on the terms or timing of any sale it would not be appropriate to include this in the central forecast.

The key fiscal aggregates

4.159 Table 4.23 sets out our central forecast for the key fiscal aggregates, reflecting the preceding analysis of forecasts for the receipts and spending components. The arithmetic of the fiscal aggregates is set out in an annex to our briefing paper, *Forecasting the public finances*. In this section we focus on describing changes in four key fiscal aggregates:

- **public sector net borrowing**, which represents the difference between total public sector receipts and expenditure on an accrued basis each year. As the widest accrued measure of borrowing it is a key measure of the fiscal position and useful for illustrating the reasons in changes since the previous the forecast;
- the **surplus on the current budget**, which is the difference between public sector current expenditure and receipts each year. In other words it is public sector net borrowing excluding borrowing to finance investment;
- the **cyclically-adjusted current budget**, which is the surplus on the current budget adjusted to remove the estimated effect of the economic cycle. It therefore represents an estimate of the underlying or 'structural' surplus on the current budget. It is used as the target measure for the Government's fiscal mandate; and
- **public sector net debt**, which is a stock measure of the public sector's net liability position i.e. its liabilities minus liquid assets. It is the fiscal measure used for the Government's supplementary fiscal target.

Net borrowing

4.160 In 2010-11 we now expect PSNB of £145.9 billion which is around £2.6 billion lower than we expected in November and around £3 billion lower than expected in June. This downward revision is mainly due to a lower expenditure forecast, in particular for local authority expenditure. This is discussed in further detail in the expenditure section of this chapter. We do not expect as much strength in accrued receipts in the final month of this year as some external analysts. Last year, accrued receipts in March were boosted by unexpectedly high PAYE and NIC receipts, probably due to forestalling ahead of the 50 pence rate. We do not expect this strength to be repeated this year.

Table 4.23: Fiscal aggregates

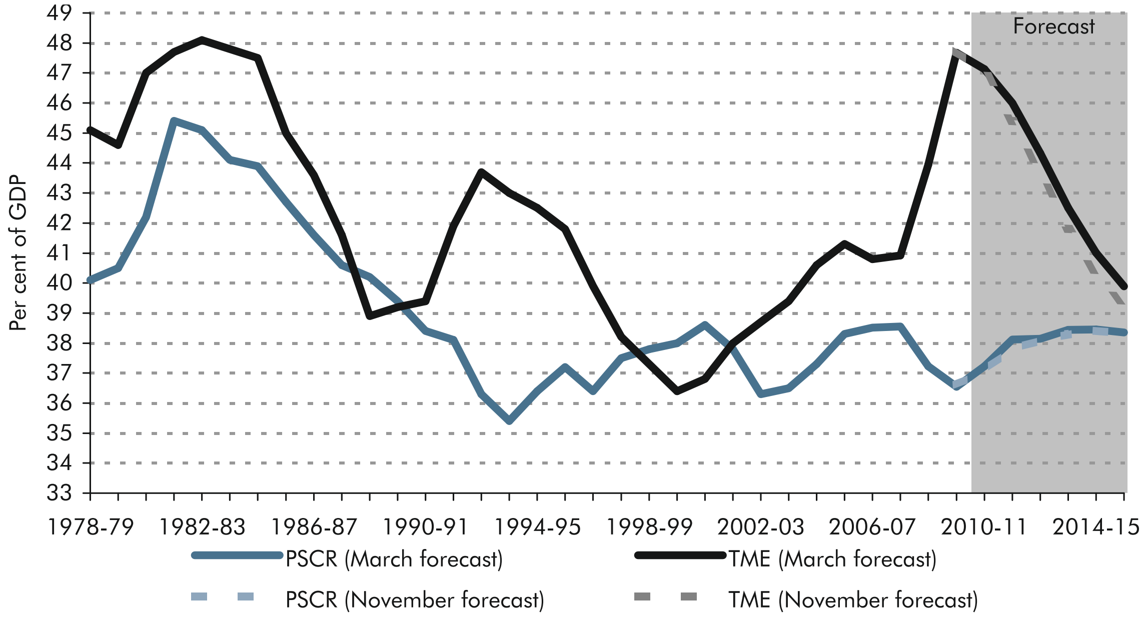
	Per cent of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Receipts and expenditure							
Public sector current receipts (*a*)	36.5	37.2	38.1	38.1	38.4	38.5	38.4
Total managed expenditure (*b*)	47.7	47.1	46.0	44.3	42.5	41.0	39.9
of which: PSCE (*c*)	42.8	42.9	42.5	41.2	39.7	38.3	37.3
PSNI (*d*)	3.5	2.8	2.1	1.7	1.4	1.3	1.3
Depreciation (*e*)	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing (*b-a*)	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Surplus on current budget (*a-c-e*)	-7.6	-7.1	-5.8	-4.5	-2.7	-1.2	-0.2
Cyclically-adjusted net borrowing	8.9	7.4	5.3	3.7	2.0	1.0	0.5
Primary balance	-9.2	-7.1	-5.0	-3.5	-1.3	0.3	1.3
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Public sector net debt[1]	52.7	60.3	66.1	69.7	70.9	70.5	69.1
Financing							
Central government net cash requirement	14.2	9.6	7.8	6.5	4.7	2.6	1.7
Public sector net cash requirement	14.5	9.9	8.4	6.7	4.8	2.9	1.7
Stability and Growth Pact							
Treaty deficit[3]	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Cyclically-adjusted Treaty deficit[2]	9.1	7.3	5.3	3.7	2.0	1.0	0.6
Treaty debt ratio[3]	71.2	78.7	84.1	87.0	87.2	85.7	83.5
	£ billion						
Surplus on current budget	-106.9	-104.8	-90	-73	-46	-22	-5
Net investment	49.5	41.1	32	28	24	24	25
Public sector net borrowing	156.4	145.9	122	101	70	46	29
Central government net cash requirement	198.8	141.2	120	105	80	46	33
Public sector net debt	759.5	909.2	1046	1164	1251	1314	1359
Memo: Output gap (per cent of GDP)	*-4.2*	*-3.4*	*-3.9*	*-3.5*	*-2.8*	*-2.0*	*-1.3*

[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

Chart 4.4: Receipts and expenditure



Source: ONS, OBR

Table 4.24: Components of net borrowing

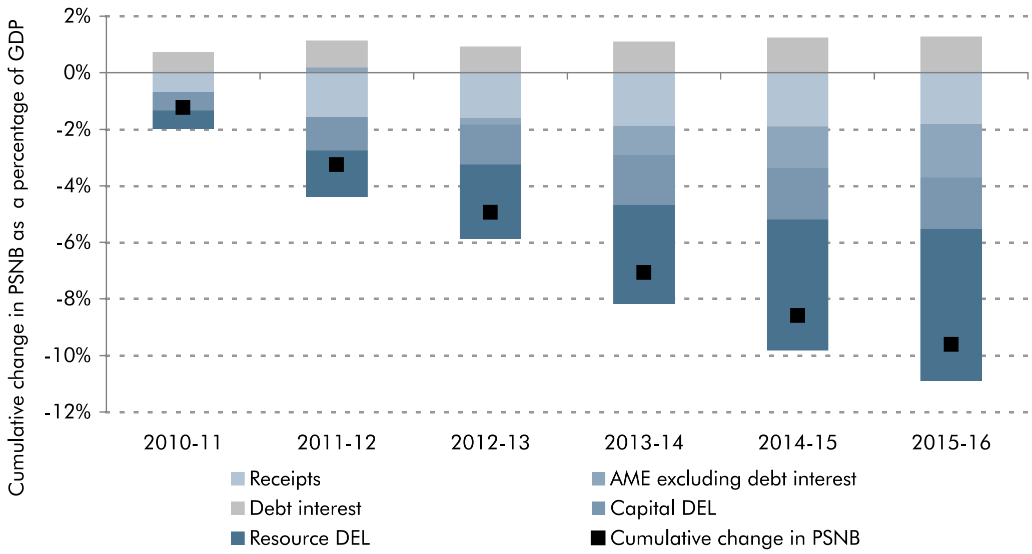
	£ billion						
	Outturn		Forecast				
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Current budget							
Current receipts	513.3	548.5	589	620	660	697	735
Current expenditure	600.9	632.8	657	670	682	695	713
Depreciation	19.3	20.5	22	23	24	25	26
Surplus on current budget	**-106.9**	**-104.8**	**-90**	**-73**	**-46**	**-22**	**-5**
Capital budget							
Gross investment[1]	68.9	61.6	54	51	48	49	50
Less Depreciation	-19.3	-20.5	-22	-23	-24	-25	-26
Net investment	49.5	41.1	32	28	24	24	25
Net borrowing	**156.4**	**145.9**	**122**	**101**	**70**	**46**	**29**

[1] Net of asset sales.

4.161 This would represent a very small revision to the June forecast for 2010-11, in the context of the uncertainty around any public finance projections. However, even this close to the end of the year there remain a number of significant risks to the 2010-11 forecast. In particular, local authority expenditure is often revised significantly after the end of the year as fuller data becomes available. Receipts can also be difficult to forecast at this time of the year. For instance, as discussed above, accrued receipts in March last year were much higher than expected at the time of the Budget.

4.162 In the medium term we expect PSNB to decline from a peak of 11.1 per cent of GDP in 2009-10 to 9.9 per cent of GDP this year and 1.5 per cent of GDP in 2015-16. As shown in Chart 4.4, this is driven by an increase in public sector receipts as a share of GDP up to 2013-14 and a fall in expenditure across the whole period. Total public sector expenditure is forecast to fall from 47.1 per cent of GDP this year to 39.9 per cent of GDP in 2015-16. Total receipts are forecast to rise from 37.2 per cent of GDP this year to 38.4 per cent in 2015-16.

Chart 4.5: Contributions to changes in PSNB



Source: OBR

Box 4.3: Impact of inflation on the public finances

Higher inflation has a variety of effects on the public finances. These include both the direct effects from indexation and the impact on nominal tax bases.

Direct effects

- The overall impact on receipts from indexation would be small. Higher inflation would push up tax allowances and thresholds for income tax and NICs. This would reduce receipts. However, higher indexation of excise duties and other indirect taxes as well as a higher business rates multiplier would raise receipts.
- The overall direct effect of higher inflation on spending would clearly increase borrowing. Higher inflation would mean that benefits, tax credits and public service pensions were uprated by a greater amount. The impact on the basic state pension would depend on whether higher inflation affected the triple guarantee (uprating is by the greater of earnings growth, inflation or 2.5 per cent). There would also be a substantial rise in spending from a higher inflation uplift on indexed-linked gilts, mainly in the year in which RPI inflation had risen.

Impact on nominal tax bases

- Tax is levied on nominal tax bases such as the wages and salaries of employees, company profits and consumer spending. Higher consumer prices would push up nominal consumer spending and consequently VAT receipts. A higher price level could boost the nominal value of sales for firms, although the impact on profits would depend on the extent to which margins were squeezed by higher costs. The key effect would be the impact of inflation on wage growth since PAYE and NIC account for over 40 per cent of total receipts and have a higher effective tax rate than other taxes.
- The overall effect of higher inflation on public sector net borrowing would depend on whether the positive effect from a higher nominal tax base offsets the negative direct effects from indexation. With the impact of wages crucial for the size of the impact from a higher nominal tax base and the March forecast assuming that wages remain subdued despite higher inflation in 2011 and 2012, the overall impact of the higher inflation on the public finances is likely to be negative in this forecast.

Impact on departmental spending and the debt-GDP ratio

- Departmental expenditure limits are set in nominal terms, so higher inflation would not boost such spending. However, higher inflation would result in deeper falls in real spending than previously envisaged.
- Higher inflation (through the GDP deflator) would raise nominal GDP and lower the public sector net debt to GDP ratio. However, persistently higher inflation is likely to push up gilt rates and increase the cost of servicing the debt.

4.163 Chart 4.5 shows the contributions of expenditure components and receipts as shares of GDP to the cumulative change in PSNB from 2009-10 onwards. Increases to debt interest as a percentage of GDP raise borrowing across the period.

4.164 The improvements to PSNB come from receipts (just under 2 per cent of GDP), resource DEL excluding depreciation (around 5½ per cent of GDP), capital DEL (around 2 per cent of GDP) and AME other than debt interest (also around 2 per cent of GDP).

4.165 The overall medium-term forecast for PSNB in our central forecast is higher than in the November forecast, particularly from 2012-13 onwards. This is driven by an increase in expenditure that is only partly offset in some years by higher receipts. Budget policy measures are broadly neutral in their impact over the forecast period. So the main changes to the forecast, including the effect of measures are:

- an increase in expenditure, primarily resulting from our higher inflation forecast. Higher inflation in particular leads to higher forecast social security payments and higher debt interest payments; and

- small revisions to receipts in some years, reflecting a number of offsetting factors. We expect lower income tax and NICs receipts than in November, mainly due to our lower forecast for labour income. We also expect lower corporation tax and fuel duties, mainly due to policy measures. This is offset in some years by an increased forecast for other receipts including North Sea revenues, interest receipts and business rates.

4.166 Table 4.25 sets out an alternative presentation of the change in PSNB compared to the November forecast, split by the cyclical component, the impact of policy measures and other changes.

Table 4.25: Changes to public sector net borrowing since November forecast

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	156.0	148.5	117	91	60	35	18
March forecast	156.4	145.9	122	101	70	46	29
Change	**0.4**	**-2.6**	**4.3**	**9.6**	**9.6**	**11.1**	**11.0**
of which:							
Cyclical element of borrowing	-0.2	1.3	4.8	7.1	8.0	8.1	7.5
Effect of measures	0.0	0.0	0.0	0.3	0.0	0.1	-0.3
Other forecasting changes	0.6	-3.9	-0.5	2.3	1.7	2.9	3.8

4.167 The cyclical component captures changes that reflect the change in our view of the output gap over the forecast period. As set out in Chapter 3, compared to November, GDP growth is expected to be lower and the output gap wider by up to 0.7 per cent of potential output across the forecast. The consequent increase in borrowing, primarily from the impact of lower labour income in reducing income tax receipts, is therefore cyclical rather than structural.

4.168 The effect of measures reflects the broadly neutral impact of measures announced since November as set out in Table A.1.

4.169 Other forecasting changes capture changes in borrowing for non-cyclical reasons. The significant increase in the AME forecast can be thought of as structural, as it is mainly reflects increases in social security and debt interest expenditure arising from a higher expected price level. However, much of this structural increase in spending is offset by structural increases in receipts from factors such as higher oil prices, a lower VAT gap and some modelling changes.

Current budget

4.170 The current budget forecast moves from a deficit of 7.1 per cent of GDP in 2010-11 to a deficit of 0.2 per cent of GDP in 2015-16. The projected path of the current budget broadly mirrors that of net borrowing. The improvement is less sharp because the Government plans to cut capital spending more sharply than current spending over the forecast period.

4.171 The current budget in 2015-16 is 0.6 per cent of GDP lower than in the June Budget forecast. This is driven by broadly the same factors as the changes in PSNB since November.

Cyclically-adjusted current budget

4.172 The Government's fiscal mandate is to balance the cyclically-adjusted current budget by the end of a rolling, five-year period, currently 2015-16. In this forecast the cyclically adjusted current budget improves from a deficit of 4.6 per cent of GDP in 2010-11 to a surplus of 0.4 per cent of GDP in 2014-15 and 0.8 per cent of GDP in 2015-16.

4.173 The improvement in the cyclically-adjusted current budget between 2009-10 and 2015-16 is less sharp than the improvement in the headline current balance. This is because part of the improvement in current budget is driven by the projected cyclical recovery in the economy, which does not affect the cyclically-adjusted aggregates.

4.174 The cyclically-adjusted current budget in 2015-16 is forecast to be broadly unchanged from the November forecast. This is because the output gap in 2015-

16 is wider than in November, so a portion of the deterioration in the headline current balance compared to November is cyclical rather than structural.

Net debt

4.175 The Government has a supplementary fiscal target for public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16. In our latest forecast, PSND is projected to rise to a peak of 70.9 per cent of GDP in 2013-14 and then to fall to 70.5 per cent of GDP in 2014-15 and 69.1 per cent of GDP in 2015-16. This is around 1.8 per cent of GDP higher than forecast in November.

4.176 PSND as a share of GDP is measured by the total nominal stock of net debt over nominal GDP. This has increased compared to November driven by two offsetting effects:

- there is a higher projected path for the public sector net borrowing and financial transactions. Together these comprise the public sector net cash requirement, as set out in Table 4.22, which drives the size of the nominal stock of debt. This acts to increase the level of nominal PSND; and

- the ONS has revised PSND outturns since 2007-08 following a reassessment of the treatment in PSND of some of the interventions made by the previous Government to stabilise the financial sector. This reduced the level of nominal PSND across the forecast period.

4.177 The level of nominal GDP, the denominator in the calculation of PSND as a share of GDP, is broadly similar to November.

4.178 The peak in the Maastricht Treaty debt measure is significantly higher at almost 87 per cent of GDP. The higher level largely reflects the fact that this is a gross measure of indebtedness and therefore does not net off the value of the UK foreign exchange reserves and other financial assets. We intend to provide a fuller set of comparisons between UK and international fiscal aggregates in future *Outlooks*.

4.179 Table 4.26 sets out the key changes to PSND since our November forecast.

4.180 Table 4.27 summarises the changes to our forecasts for the key fiscal aggregates since the interim OBR's June Budget forecast.

Table 4.26: Key changes to net debt since November forecast

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	772.0	923	1052	1157	1232	1284	1320
March forecast	759.5	909	1046	1164	1251	1314	1359
Change	**-12.5**	**-14**	**-6**	**8**	**19**	**30**	**38**
of which:							
Cumulative change in net borrowing	0.4	-2	2	12	21	32	43
Cumulative change in financial transactions	0.2	-2	-2	3	0	-1	-5
Other (incl lower starting point)	-13.1	-10	-7	-7	-2	-1	-1
	Per cent of GDP						
November forecast	53.5	60.8	66.3	69.1	69.7	68.8	67.2
March forecast	52.7	60.3	66.1	69.7	70.9	70.5	69.1
Change	**-0.8**	**-0.5**	**-0.2**	**0.6**	**1.2**	**1.7**	**1.8**
of which:							
Change in net debt (£ billion)	-0.9	-0.9	-0.4	0.5	1.1	1.6	2.0
Change in nominal GDP	0.0	0.4	0.2	0.1	0.1	0.1	-0.1

Table 4.27: Changes to the fiscal forecast

	£ billion						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Surplus on current budget							
June forecast	-105.6	-110.2	-88	-65	-40	-17	0
November forecast	-106.6	-106.2	-87	-64	-37	-11	6
Change	*-0.3*	*1.4*	*-3*	*-9*	*-9*	*-11*	*-11*
March forecast	-106.9	-104.8	-90	-73	-46	-22	-5
Net investment							
June forecast	49.0	38.9	27	24	20	21	21
November forecast	49.4	42.3	31	27	23	24	24
Change	*0.1*	*-1.2*	*1*	*1*	*0*	*0*	*0*
March forecast	49.5	41.1	32	28	24	24	25
Net borrowing							
June forecast	154.7	149.1	116	89	60	37	20
November forecast	156.0	148.5	117	91	60	35	18
Change	*0.4*	*-2.6*	*4*	*10*	*10*	*11*	*11*
March forecast	156.4	145.9	122	101	70	46	29
	Per cent of GDP						
Net borrowing							
June forecast	11.0	10.1	7.5	5.5	3.5	2.1	1.1
November forecast	11.1	10.0	7.6	5.6	3.5	1.9	1.0
Change	*0.0*	*-0.1*	*0.3*	*0.6*	*0.6*	*0.6*	*0.6*
March forecast	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Cyclically-adjusted surplus on current budget							
June forecast	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
November forecast	-5.3	-4.7	-3.3	-1.8	-0.5	0.5	0.9
Change	*0.0*	*0.2*	*0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.2*
March forecast	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Cyclically-adjusted net borrowing							
June forecast	8.7	7.4	5.0	3.4	1.8	0.8	0.3
November forecast	8.8	7.6	5.3	3.5	1.9	0.8	0.3
Change	*0.0*	*-0.2*	*0.0*	*0.2*	*0.1*	*0.2*	*0.2*
March forecast	8.9	7.4	5.3	3.7	2.0	1.0	0.5
Net debt[1]							
June forecast	53.5	61.9	67.2	69.8	70.3	69.4	67.4
November forecast	53.5	60.8	66.3	69.1	69.7	68.8	67.2
Change	*-0.8*	*-0.5*	*-0.2*	*0.6*	*1.2*	*1.7*	*1.8*
March forecast	52.7	60.3	66.1	69.7	70.9	70.5	69.1

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

Comparison with external forecasts

4.181 The latest average of independent forecasts for public sector net borrowing (PSNB) was £145.0 billion for 2010-11, £121.6 billion for 2011-12 and £98.1 billion for 2012-13.

4.182 The Institute for Fiscal Studies (IFS) is the only institution other than the OBR to produce a detailed bottom-up forecast of the UK public finances. The IFS published their Green Budget in February 2011, which included forecasts of the public finances for the next five years.

4.183 The IFS baseline forecast assumed that the economy evolves largely as the OBR forecast in our November *Economic and fiscal outlook*. As shown in the table, on this basis the IFS forecast slightly lower public sector net borrowing than the OBR November forecast. However, as the IFS pointed out in February, these differences are very small in the context of the uncertainties involved in any forecast of the public finances.

4.184 The differences between the OBR November forecast and the IFS February baseline forecast were due to:

- the IFS expected receipts in 2010-11 to be around £3 billion higher than the OBR November forecast. This was primarily driven by an expectation of higher income tax and NICs receipts, on the basis of year-to-date growth in earnings and employment and outturn income tax and NICs receipts; and

- over the medium-term the IFS forecast very similar levels of receipts growth to the OBR November forecast, though from a slightly higher 2010-11 baseline. Within overall receipts, the IFS expected lower growth than the OBR in taxes such as income tax and fuel duties, but higher growth in NICs, VAT and corporation tax. The IFS forecast very similar medium-term spending growth rates to the OBR.

4.185 In this forecast we expect receipts to be about £4 billion lower in 2010-11 than the IFS February forecast largely because of lower income tax and NIC receipts. However our estimate for expenditure in 2010-11 is around £3½ billion lower so that overall our forecast for PSNB is only £0.3 billion higher than the IFS'.

4.186 Our forecasts for receipts over the medium-term are also slightly below the IFS February forecast. However the differences in PSNB are much larger because the IFS used very much the same expenditure growth forecasts in February as we did in November, and we are now forecasting higher AME spending.

Table 4.28: Comparison of the IFS and OBR fiscal forecasts

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Public sector net borrowing						
OBR November	148.5	117.5	91	60	35	18
IFS February baseline	145.6	115.6	91	59	34	15
OBR March	145.9	121.8	101	70	46	29
	Per cent of GDP					
Cyclically-adjusted surplus on current budget						
OBR November	-4.7	-3.3	-1.8	-0.5	0.5	0.9
IFS February baseline	-4.5	-3.2	-1.8	-0.4	0.6	1.1
OBR March	-4.6	-3.2	-2.0	-0.6	0.4	0.8

5 Performance against the Government's fiscal targets

Summary

5.1 On taking office in 2010 the Coalition Government set itself two medium-term fiscal targets: to balance the cyclically-adjusted current budget by the end of a rolling, five-year period; and to see public sector net debt (PSND) falling in 2015-16. Taking into account the policy measures announced in Budget 2011, our central forecast suggests that the Government has a greater than 50 per cent probability of meeting both these targets under current policy. It has the same margin for error against the first, and somewhat less against the second, than at the time of the June 2010 Budget.

5.2 There is considerable uncertainty around our central forecast, as there is around all fiscal forecasts. 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 probe the robustness of our central judgement in three ways:

- first, by looking at past forecast errors. If our central forecasts are as accurate as Budget and Pre-Budget Report forecasts were in the past, then there is a roughly 70 per cent probability that the cyclically-adjusted current budget will be in balance in five years' time;

- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest threat is the possibility that we have over-estimated the amount of spare capacity in the economy, now or in the future. If the output gap was roughly 1.5 per cent of potential GDP smaller than our central estimate then the Government would no longer be on course to balance the cyclically-adjusted current budget in five years' time; and

- third, by looking at alternative economic scenarios. We examine two illustrative scenarios: first, one in which inflation remains persistently higher than in our central forecast; and second, one in which there is a sharp fall in the euro and a further weakening in euro area demand. Neither scenario would put the Government on course to miss its medium-term fiscal targets, although there might be other reasons for concern if events unfolded in either of these ways.

Introduction

5.3 This chapter begins by setting out the Government's medium-term fiscal targets (paragraphs 5.4 to 5.7). It then examines whether the Government has a better than 50 per cent chance of meeting those targets, given our central forecast for the public finances (paragraphs 5.8 to 5.12). We then assess 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 (paragraphs 5.13 to 5.42). We conclude by outlining our plans to analyse the longer-term outlook for the public finances in our *Fiscal sustainability report*, planned for July (paragraphs 5.43 to 5.44).

The fiscal mandate and supplementary target

5.4 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 assesses whether the Government has a greater than 50 per cent probability of hitting these targets under existing policy.

5.5 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". For the purposes of the current *Outlook*, this means that total public sector receipts need to exceed total public sector spending (minus spending on net investment) in 2015-16, after adjusting for the impact on receipts and spending of any remaining spare capacity in the economy.

5.6 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 the measure of public sector net debt (PSND) which excludes the temporary effects of financial interventions.

5.7 As the rolling, five-year forecast horizon moves on from 2015-16, we will continue to examine whether cyclically-adjusted current balance is on course to be achieved ex ante, or has in fact been achieved ex post, in this and subsequent years – as well as assessing the mandate over the five-year horizon that prevails at the time.

The implications of our central forecast

5.8 Table 5.1 shows our central forecasts for the cyclically-adjusted current budget and PSND in each year to 2015-16, as set out in Chapter 4. These are median forecasts, which means that 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						
		2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Cyclically-adjusted current budget balance	March forecast	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
	November forecast	-5.3	-4.7	-3.3	-1.8	-0.5	0.5	0.9
	June forecast	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
Public sector net debt	March forecast	52.7	60.3	66.1	69.7	70.9	70.5	69.1
	November forecast	53.5	60.8	66.3	69.1	69.7	68.8	67.2
	June forecast	53.5	61.9	67.2	69.8	70.3	69.4	67.4

5.9 Table 5.1 shows that in our central forecast the cyclically-adjusted current balance is expected to be in surplus by 0.8 per cent of GDP in 2015-16 on current policies. This means that there is a better than 50 per cent chance of the Government achieving cyclically-adjusted current balance in 2015-16 and that it is therefore on course to achieve the fiscal mandate. Our central forecast also shows that the cyclically-adjusted current balance is expected to be in surplus by 0.4 per cent of GDP in 2014-15. So the Government also has a greater than 50 per cent chance of meeting the fiscal mandate in that year too.

5.10 Table 5.1 also shows our central forecast for public sector net debt to be falling by 1.4 per cent of GDP between 2014-15 and 2015-16. So the Government has a greater than 50 per cent chance of achieving its supplementary target. Like the fiscal mandate, the supplementary target is forecast to be met in the previous year too, as PSND is also forecast to fall between 2013-14 and 2014-15.

5.11 The Government's margin for error in meeting the targets is slightly lower than in our November forecast in the case of both the fiscal mandate and the supplementary target. But the Chancellor was clear that the publication of our autumn forecast was not a fiscal event, in other words it was not to be accompanied by new scoreable tax and spending measures.

5.12 This suggests that if we wish to judge whether the Chancellor is being more or less cautious in his pursuit of the Government's targets, we should probably focus on how the margin for error has changed since the interim OBR forecast that accompanied the June 2010 Budget – the last fiscal event. This comparison shows that the Chancellor now has the same margin for error against the fiscal mandate and somewhat less margin for error against the supplementary target.

But, in both cases, the size of the change is dwarfed by the uncertainty that surrounds the public finance forecast over that time horizon.

Recognising uncertainty

5.13 Past experience and common sense suggest that there will be significant upside and downside risks to our central forecast for the public finances. These reflect uncertainty both about the outlook for the economy and about the level of receipts and spending that the Government would record in any given state of the economy.

5.14 Given these uncertainties, it is important to stress-test the robustness of our judgement that the Government is currently on course to achieve its targets. We do this in three ways:

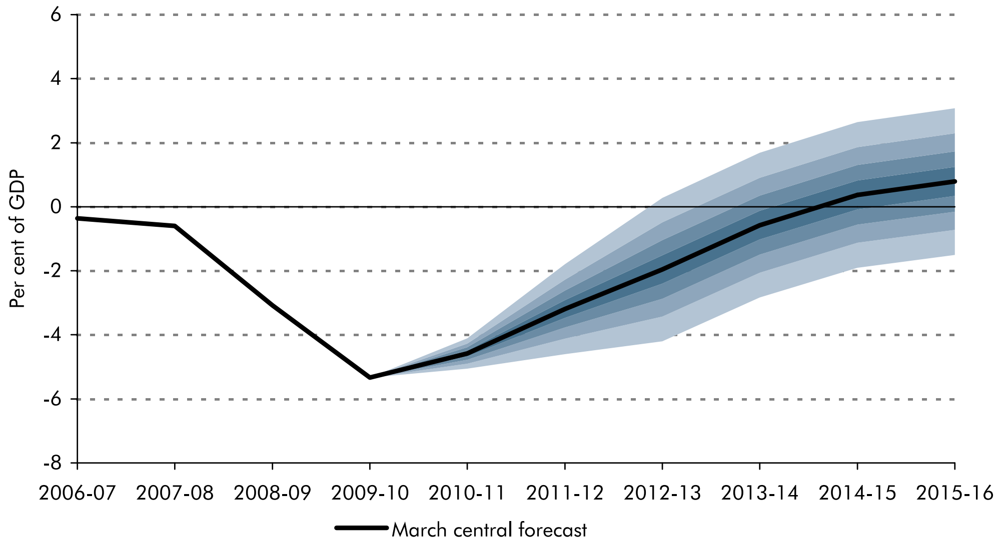
- by looking at the lessons from past forecast errors;
- by seeing how our central forecast would change if we altered some of the key judgements that underpin it; and
- by looking at alternative economic scenarios.

Past forecast performance

5.15 One relatively simple way to illustrate the uncertainty around our central forecast is to draw lessons from the accuracy of previous official public finance forecasts. This can be illustrated through the use of fan charts like those we presented for GDP growth in Chapter 3 and public sector net borrowing (PSNB) in Chapter 4. These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that our central forecast was likely to be as accurate as previous HM Treasury Budget and Pre-Budget Report forecasts were in the past.

5.16 In this spirit, Chart 5.1 shows the probability distribution around our central forecast for the cyclically-adjusted current budget balance, based on past Treasury forecasting errors (which, in normal times, tend to be dominated by errors in the fiscal forecast rather than the underlying economic forecast). The solid black line shows the median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands. This implies that there would be an 80 per cent probability of the outturn lying within the shaded bands on current policy.

Chart 5.1: Cyclically-adjusted current budget fan chart



Source: OBR

5.17 We can see from the chart that, given past forecasting performance, our central forecast of a cyclically-adjusted current budget surplus of 0.8 per cent of GDP in 2015-16 implies that there is a roughly 70 per cent probability that there will be a surplus of any size in that year and that the Government's fiscal mandate would therefore be satisfied.

5.18 Unfortunately, one cannot estimate the probability of achieving the supplementary target easily using this technique. A probability distribution for levels of PSND over the next few years would not translate straightforwardly into probabilities that the debt ratio will fall in a particular year.

5.19 That said, given our central forecast for economic growth and the path of net debt to 2014-15, PSND will fall as a percentage of GDP in 2015-16 if PSNB is less than 3 per cent in that year (assuming that our central forecast is accurate up to that point). Our central forecast implies that in 2015-16 there is a greater than 50 per cent probability that PSNB will be below 3 per cent, which underlines the fact that the Government has some margin for error in achieving this target.

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. However, to recognise the uncertainty in our forecast we can go further than using the lessons of past forecasting errors, by quantifying roughly how sensitive our central forecast is to 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 current 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
- the errors on our cyclical adjustment coefficients.

5.22 Our central forecast is based on a judgement that the economy was running around 3 per cent below potential in the third quarter of 2010 and that there will be above-trend GDP growth from 2012 onwards. Together these imply that the negative output gap would close in 2017-18. But neither the current size of the output gap, nor the pace of recovery, are possible to estimate with confidence, not least because the former is not a variable that we can observe directly in economic data. So what if the current output gap was larger or smaller than our central estimate, and what if the output gap closed earlier or later than our central estimates?

5.23 Tables 5.2 and 5.3 present illustrative estimates of the impact of these variants on:

- the level of the cyclically-adjusted current budget balance in 2015-16; and
- the change in PSND 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. 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 surplus after two years. The actual change in the public finances would also depend on the composition of any change to GDP. For this reason we also assume that the composition of growth remains as in our central forecast. While we recognise the limitations of these ready-reckoners, applying them yields the results shown in Table 5.2 and Table 5.3.

Table 5.2: Cyclically-adjusted current balance in 2015-16

Per cent of GDP		Output gap closes				
		2013-14	2015-16	2017-18	2019-20	2021-22
Output gap in Q3 2010	-1	-0.6	-0.6	-0.6	-0.6	-0.7
	-2	0.1	0.1	0.1	0.1	0.1
	-3	0.8	0.8	0.8	0.8	0.8
	-4	1.6	1.5	1.5	1.5	1.5
	-5	2.3	2.3	2.3	2.2	2.2

Table 5.3: Change in PSND between 2014-15 and 2015-16

Per cent of GDP		Output gap closes				
		2013-14	2015-16	2017-18	2019-20	2021-22
Output gap in Q3 2010	-1	-0.5	-0.6	-0.3	-0.1	0.2
	-2	-1.1	-1.3	-1.0	-0.5	-0.2
	-3	-1.7	-2.0	-1.4	-0.9	-0.5
	-4	-2.4	-2.7	-2.0	-1.4	-0.9
	-5	-3.0	-3.4	-2.6	-1.9	-1.3

5.25 Table 5.2 shows that the starting point for the output gap has a strong effect on the size of the cyclically-adjusted current budget balance in 2015-16. The smaller the output gap, the larger the proportion of the deficit that is structural (and therefore impervious to economic recovery) and the less margin the Government has against its fiscal mandate. Conversely if the output gap is wider, less of the deficit is structural and the Government has more margin against its mandate. Closing the output gap at a different pace will result in a change in cyclical borrowing, but has little effect on the structural balance. For example, closing the output gap more slowly will result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.

5.26 Roughly speaking, the output gap would have to be about 1.5 per cent of output smaller than our central estimate (i.e. about 1.5 per cent of potential output, half its current estimated size) to make it more likely than not that the mandate would be missed. As we saw in Chapter 3, estimates of the size of the output gap vary considerably, but none of the organisations we cited thought that it was as small as this. However, there is no guarantee that the true figure might not lie outside the bounds of current estimates.

5.27 Table 5.3 shows that the supplementary target is met under all but one of the output gap size and closure date combinations. This is because our central projection for PSNB in 2015-16 is only 1.5 per cent of GDP. As we have outlined, if our forecast is correct until 2014-15 then PSNB would have to be around 3 per cent of GDP in 2015-16 to breach the target. Only one of the changes that we have looked at causes PSNB to deteriorate this much. That said, the longer it takes to close the output gap, the less PSND falls by in 2015-16 for a given output gap in 2011.

5.28 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. As set out in Chapter 4 our central forecast assumes that gilt rates for future borrowing move in line with market expectations. But what if the central forecast of gilt rates (r) was to suffer a shock? We examine the implications of a negative shock of 50 basis points, making debt cheaper, and increases of 50, 100 and 150 basis points, making debt more expensive. We assume the shock occurs in 2011-12. Table 5.4 shows the level of the cyclically-adjusted current budget balance in 2015-16 and the change in PSND between 2014-15 and 2015-16 under these variants, constructed using a ready-reckoner.

Table 5.4: Fiscal target variables under different gilt rate assumptions

	Per cent of GDP				
	r-50	r	r+50	r+100	r+150
Cyclically-adjusted current budget balance in 2015–16	1.0	0.8	0.6	0.4	0.3
Change in public sector net debt between 2014–15 and 2015–16	-1.6	-1.4	-1.3	-1.1	-1.0

5.29 Table 5.4 shows that these illustrative shocks to gilt rates do not have much impact on the chances of meeting the mandate and supplementary target. This is because (as illustrated in Chapter 4) an increase in rates applies only to new debt issuance, and the UK has a relatively long average debt maturity of 13 years, and because new issuance is projected to fall as borrowing declines. Therefore over a short horizon, such as our five-year forecasting period, the impact of a shock to the average nominal rate on gilts is actually quite slight. However, over a longer horizon shocks such as these will have a more significant impact.

5.30 Our last sensitivity analysis concerns the uncertainty around our cyclical adjustment coefficients. As noted above, cyclical adjustment attempts to remove the effect of the economic cycle from forecasts of the public finances. This is done by adjusting a given fiscal aggregate, such as PSNB, for the size of the output gap in the current and previous years, using cyclical adjustment coefficients.[1] As set out in Chapter 4, we have used the Treasury's approach to cyclical adjustment, presented in *Public finances and the cycle*.[2] The coefficients we have used are therefore 0.2 for the previous year's output gap, and 0.5 for the current year's gap.

5.31 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 which do not necessarily move in line with the cycle, such as one-off fiscal policy adjustments and movements in commodity and asset prices; and
- insofar as the current economic cycle differs from the average cycle, the relationship between the public finances and the output gap over the course of that cycle will not be captured in the coefficients.

5.32 We intend to publish a paper exploring methods of estimating a historical output gap series later this year. This will enable us to reassess the size of the cyclical adjustment coefficients. In the meantime, however, it is useful to consider how sensitive our central March forecast is to variations in the coefficients, as the Institute for Fiscal Studies did with our November forecast in their 2011 *Green Budget*.[3]

5.33 If the coefficient on the current year's output gap was 0.4, rather than the Treasury's estimate of 0.5, the surplus on the cyclically-adjusted current budget would be 0.13 per cent of GDP lower in 2015-16. If the coefficient on the previous year's output gap was 0.1 rather than 0.2, the cyclically-adjusted current budget would be 0.20 per cent of GDP lower in 2015-16. Equally, higher coefficients would result in a larger surplus on the current budget and lower net borrowing, on a cyclically-adjusted basis.

[1] For example, the cyclically-adjusted current budget (CACB) is calculated as: $CACB = CB - \alpha \cdot (OG_{t-1}) - \beta \cdot (OG_t)$, where OG_t is the output gap in a given fiscal year t and α and β are cyclical adjustment coefficients, and the output gap and current budget (CB) are expressed as percentages of potential output and GDP respectively.

[2] HM Treasury, 2008, *Public finances and the cycle: Treasury Economic Working Paper No. 5*

[3] Institute for Fiscal Studies, 2011, *Green Budget*, pp. 44-45.

5.34 This analysis should be seen in the context of the uncertainty surrounding the size of the coefficients. The Treasury's 2008 paper included a comparison with alternative estimates, looking at the European Central Bank's (ECB) coefficient of 0.65 and the OECD figure of 0.45. Compared with the Treasury's estimate, the lower ECB and OECD coefficients would imply reductions in the cyclically-adjusted current budget in 2015-16 of 0.22 and 0.47 per cent of GDP respectively.[4] So using these coefficents the fiscal mandate would still be met, but with less margin for error than in our central forecast.

Scenario analysis

5.35 The variants discussed in the previous section all assume that the composition of actual GDP growth and the rate at which the potential output of the economy increases are the same as in our central forecast. In our November *Outlook* we assessed the implications for the public finances of two alternative economic scenarios: 'delayed rebalancing' and 'persistent weak demand'. These remain possible alternative scenarios for the economy and the conclusions we reached then remain valid. The persistent weak demand scenario presented the most significant risk to meeting the mandate. This was because in this scenario GDP growth is weaker, with a consequent loss of tax revenues and increase in borrowing; and there is a fall in potential output, which means that the increase in borrowing is structural.

5.36 We now set out the fiscal implications of the two new illustrative alternative economic scenarios that we introduced in Chapter 3. In this section, we briefly reprise the economic scenarios before exploring their fiscal consequences. Table 5.5 below summarises these fiscal consequences.

[4] These estimated effects assume that the ECB and OECD coefficients apply to the current year's output gap, so the coefficient on the previous year's output gap is zero.

Table 5.5: Key fiscal aggregates under alternative economic scenarios

	Per cent of GDP						
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Central forecast							
Public sector net borrowing	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Cyclically-adjusted current budget	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Public sector net debt	52.7	60.3	66.1	69.7	70.9	70.5	69.1
"Persistent inflation"							
Public sector net borrowing	11.1	9.9	7.7	5.6	3.4	2.0	0.9
Cyclically-adjusted current budget	-5.3	-4.6	-3.0	-1.3	0.7	2.0	2.6
Public sector net debt	52.7	60.1	65.0	67.2	67.2	66.3	64.0
"Weak euro area"							
Public sector net borrowing	11.1	9.9	7.9	6.2	4.0	2.5	1.5
Cyclically-adjusted current budget	-5.3	-4.6	-3.0	-1.7	-0.3	0.6	1.0
Public sector net debt	52.7	60.0	65.4	69.5	70.8	70.5	68.9

5.37 Under the 'persistent inflation' scenario, temporary influences on the rate of inflation, such as higher commodity prices and the recent increase in VAT, feed through into inflation expectations and wage settlements. As inflation remains significantly above target, the Bank of England responds with tighter monetary policy. As a result, the output gap is wider than in our central forecast and unemployment rises. Aggregate wages and salaries growth keeps pace with changes in the price of consumption before the higher degree of spare capacity weighs on prices and inflation begins to return to target.

5.38 Under this scenario, the Government has a greater chance of meeting its fiscal targets. As noted in Box 4.3, higher inflation has a variety of effects on the public finances with the overall effect dependent on the extent to which the negative direct effect from indexation, leading in particular to higher social security payments, is offset by higher receipts from a larger nominal tax base. In this scenario, persistently above-target inflation feeds through into wage settlements and earnings growth and higher consumer prices raise nominal consumer spending. This is in contrast to the assumption in the central forecast that nominal wages do not respond to the stronger inflation expected in 2011 and 2012.

5.39 The effect on receipts from a larger nominal tax base, particularly from higher earnings, more than offsets the rise in annually managed expenditure (AME) from higher indexation and the jump in debt servicing costs from the rise in gilt rates. The overall effect is to reduce PSNB relative to the central forecast. With the tightening of monetary policy reducing GDP growth, the output gap remains more negative for longer. This leads to a sizeable improvement in the cyclically-adjusted current balance. PSND as a percentage of GDP is around 5 per cent below the central forecast by the end of the forecast horizon reflecting the effect of both lower borrowing and higher nominal GDP on the ratio.

5.40 But this assumes that nominal departmental expenditure limits (DELs) remain fixed in line with 2010 Spending Review allocations. In this scenario, persistently high inflation would mean substantially bigger cuts in real public services spending than envisaged in the Spending Review. The total real cut in DELs over the five-year forecast period would increase from -13 per cent in our central forecast to -19 per cent in this scenario. The Government would have to accept a lower quantity and/or quality of public services provision, or increase spending settlements, which would lessen the reduction in net borrowing under this scenario.

5.41 Under the 'weak euro' scenario, external demand for UK exports is considerably lower, and sterling appreciates 25 per cent against the euro. The reduction in external demand widens the domestic output gap as export growth falls short of that projected in our central forecast. The Bank of England counteracts this with looser monetary policy, which, combined with the effect of lower inflation on real wages, encourages stronger consumption. The overall impact of this scenario is to leave the outlook for GDP slightly weaker, with domestic demand stronger, external demand weaker and inflation lower.

5.42 The overall impact on net borrowing is small. The appreciation of sterling against the euro would weaken external demand and hence real GDP. At the same time the greater degree of spare capacity and the fall in import prices would put downward pressure on inflation. Both of these factors would reduce the nominal tax base and hence receipts. However, lower AME spending would largely offset the reduced receipts. The drop in inflation, relative to the central projection, would reduce the indexation of benefits and the inflation uplift on index-linked gilts. In addition, lower interest rates would reduce debt servicing costs and the appreciation of sterling reduces the UK's contribution to the EU. While borrowing is similar to the central forecast, the wider output gap results in a slight improvement in the cyclically-adjusted current balance in this scenario.

Long term fiscal sustainability

5.43 The main duty of the Office for Budget Responsibility is to examine and report on the sustainability of the public finances. The November *Outlook* extrapolated from the medium term fiscal forecast to generate simple projections for public sector net debt over the next 40 years. These indicated that, under this stylised methodology and without taking account of demographic pressures, PSND declines beyond the forecast period, even in the event of a growth or gilt rate shock. However, they also suggested that, in the absence of off-setting policy measures, an ageing population could push PSND to around 100 per cent of GDP by 2050.

5.44 On 13 July this year we will produce a more detailed analysis in our first annual *Fiscal sustainability report*. Accordingly we do not repeat November's stylised extrapolation exercise in this *Outlook*. For more detail on how we might address the task of longer-term sustainability analysis we would like to direct readers to our first discussion paper, *What should we include in the Fiscal sustainability report?* which is available on our website. The paper considers different indicators of sustainability, including long-term solvency, intergenerational fairness and growth considerations. It also provides an analytical framework to understand the stock and flow measures of previous and future Government activity. We invite stakeholders to offer further thoughts by 6 May to OBRfeedback@obr.gsi.gov.uk.

A Budget 2011 policy measures

A.1 The *Economic and fiscal outlook* incorporates the Government's costings for all the Budget 2011 policy measures. The OBR has endorsed all but one of these costings as reasonable central estimates, although there are significant uncertainties around a number of them.[1] Chapter 2 and the OBR's annex in the Treasury's *Budget 2011 policy costings* document sets out further details.

Table A.1: HM Treasury's Budget policy decisions[1]

		Head	£ million				
			2011-12	2012-13	2013-14	2014-15	2015-16
Growth and Enterprise							
1	Corporation tax: decrease main rate to 26% in 2011-12, 25% in 2012-13, 24% in 2013-14 and 23% from 2014-15	Tax	-425	-810	-910	-1,000	-1,075
2	Corporation tax: interim improvements to Controlled Foreign Company rules	Tax	-55	-15	-25	-25	-25
3	Corporation tax: taxation of foreign branches reform	Tax	0	-30	-70	-80	-80
4	Corporation tax: corporate capital gains simplification	Tax	+5	-5	-15	-35	-55
5	Corporation tax: full reform to Controlled Foreign Company rules	Tax	0	-210	-540	-770	-840
6	Bank Levy: increase first year effective rate to 0.075% and rate to 0.078% from January 2012	Tax	+630	+285	+100	+105	+100
7	Enterprise Investment Scheme and Venture Capital Trusts: reform	Tax	0	-105	-115	-110	-120
8	R&D tax credits: increase SME rate to 200% from 2011-12 and to 225% from 2012-13	Spend	-20	-75	-105	-105	-
9	Capital allowances: extension of short life assets limit	Tax	-10	-40	-70	-100	-170
10	Capital allowances: extension of business premises renovation allowance	Tax	0	-5	-30	-25	-30
11	Business rates: Enterprise Zones	Tax	0	-20	-40	-65	-80
12	Business rates: one-year extension of relief for small business from October 2011	Tax	-190	-185	+5	0	0
13	Capital gains tax: increase Entrepreneurs' relief lifetime limit to £10 million	Tax	0	-50	-70	-90	-100
14	Science facilities: additional investment	Spend	-100	0	0	0	-
Housing and Employment							
15	Stamp Duty Land Tax: bulk purchasing	Tax	-70	-90	-120	-130	-150
16	Support for Mortgage Interest: one-year extension from January 2012	Spend	-10	-110	-15	0	-
17	First Buy: support for first-time buyers	Spend	-250	0	0	0	-
18	Enterprise Allowance: extension	Spend	-5	-15	-5	0	-
19	Work experience: 80,000 additional placements	Spend	-20	-20	0	0	-
20	University Technical Colleges: additional investment	Spend	-150	0	0	0	-
21	Apprenticeships: 50,000 additional places	Spend	-100	-60	-45	-5	-

[1] The OBR has not certified the costing of increasing the time limit in the short life assets regime from four to eight years because insufficient evidence was presented, and after the deadline which would have allowed adequate scrutiny.

		Head	£ million				
			2011-12	2012-13	2013-14	2014-15	2015-16
Personal tax							
22	Personal allowance: increase by £630 in 2012-13, with adjustment to basic rate limit and no change to higher rate threshold	Tax	0	-1,050	-1,210	-1,200	-1,230
23	Direct taxes: switch the default indexation assumption to CPI from 2012-13	Tax	0	+105	+235	+630	+1,080
24	Direct taxes: over-index employer NICs threshold, age related allowances and other allowances [2]	Tax	0	0	0	0	0
25	NICs: implement Government Actuary's 'best estimate' approach on contracted-out rebates from 2012-13 [3]	Tax	0	+640	+630	+620	+610
26	Non-domicile taxation: reform	Tax	0	0	+110	+70	+50
Motoring tax							
27	Fuel duty: 1ppl reduction in April 2011, removal of previously announced above-RPI increases and delay of RPI increases	Tax	-1,900	-1,600	-1,700	-2,100	-2,100
28	North Sea: increase in supplementary charge from 20% to 32% and restriction on decommissioning relief from 2011-12	Tax	+1,780	+2,240	+2,120	+2,090	+1,870
29	Fuel duty: rural rebate	Tax	*	-5	-5	-5	-5
30	Vehicle excise duty: freeze rates for Heavy Goods Vehicles in 2011-12	Tax	-15	-15	-15	-20	-20
31	Approved Milleage Allowance Payments: increase allowances from 2011-12	Tax	-35	-35	-35	-35	-35
Environmental tax							
32	Carbon price floor: introduce from 2013-14 with £30 per tonne of CO_2 target	Tax	0	0	+740	+1,070	+1,410
33	Climate Change Agreements: reform	Tax	0	0	-40	-50	-50
34	Climate change levy exemption: supplies of gas in Northern Ireland	Tax	*	*	+5	+5	+5
35	Company car tax: adjustment to rates for 2013-14	Tax	0	0	+125	+130	+135
36	Air passenger duty: defer RPI increase in 2011-12 to 2012-13	Tax	-145	0	0	0	0
37	Aggregates levy: postpone rate increase until 2012-13	Tax	-15	-15	-20	-20	-20
Indirect tax							
38	VAT: decrease low value consignment relief threshold to £15 from November 2011	Tax	+5	+10	+10	+10	+15
39	Tobacco duty: rebalance for cigarettes and increase for hand rolled tobacco from 2011-12	Tax	+80	+60	+65	+70	+80
Avoidance, evasion and administration							
40	Disguised remuneration: avoidance	Tax	+750	+760	+730	+770	+760
41	Currency for tax calculations: avoidance	Tax	+60	+60	+60	+60	+60
42	Sale of lessor companies: avoidance	Tax	+25	+20	+20	+15	+15
43	Leasing double allowances: avoidance	Tax	+80	+130	+130	+120	+120
44	Stamp Duty Land Tax: avoidance	Tax	+30	+30	+40	+40	+50
45	VAT: supply splitting using printed matter	Tax	+40	+50	+50	+50	+60
46	VAT: fraud on imported road vehicles	Tax	0	0	+125	+110	+105
47	Protection life insurance	Tax	0	0	+60	+90	+120
48	Qualifying Time Deposit accounts: change to tax treatment	Tax	0	*	+35	+40	+40
49	PAYE: holding security	Tax	*	+5	+5	+5	+5
Philanthropy							
50	Inheritance tax: reduce rate to 36% for estates with charitable donations of more than 10% from 2012-13	Tax	0	-25	-75	-125	-170
51	Gift Aid: small donations scheme	Spend	0	0	-50	-85	-
Other spending measures							
52	Housing Benefit: not introduce reductions for long term jobseekers	Spend	0	0	-105	-115	-
53	Disability Living Allowance: mobility components for claimants in residential care	Spend	0	-75	0	0	-
54	Local Housing Allowance: transitional protection for existing claimants	Spend	+30	-30	0	0	-
55	Employment and Support Allowance Youth: abolish National Insurance concession	Spend	0	+10	+10	+15	-
56	Benefit fraud: sanctions and debt recovery	Spend	0	+25	+45	+65	-
57	Coinage: delay implementation of reduction in metal cost	Spend	-10	0	0	0	-
	TOTAL POLICY DECISIONS		-10	-265	+25	-115	+335

** Negligible*

- Spending measures do not affect borrowing in 2015-16 as they fall within the Total Managed Expenditure assumption.

[1] Costings reflect the OBR's latest economic and fiscal determinants.

[2] The starting rate limit of savings income, income tax age related allowances, age-related income limits, married couples allowances and blind persons allowance will continue to rise by the cash equivalent of RPI for the course of the Parliament. The personal allowance is assumed to increase from 2013-14 by at least the cash equivalent of RPI.

[3] Announced by DWP on 3 February 2011.

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