



HM TREASURY

2012-13 Convergence Programme for the United Kingdom:

submitted in line with the Stability
and Growth pact

April 2013



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Foreword

The UK economy is recovering from the biggest financial crisis in generations, one of the deepest recessions of any major economy and a decade of growth built on unsustainable levels of debt. Across the world, recovery over the past four years has been slower than forecast and the euro area is now in recession.

The Government's economic strategy, first set out in the June Budget 2010, is designed to protect the economy through this period of global uncertainty and provide the foundations for recovery. The Government's plan for the economy is based on:

- fiscal responsibility to deal with our debts through credible deficit reduction plans;
- monetary activism to support demand and keep interest rates low; and
- supply-side reform to help businesses create jobs and deliver lasting prosperity.

In 2010 the Government set out clear, credible and specific medium-term fiscal consolidation plans to return the public finances to a sustainable path. The Government's fiscal plans have been effective in providing protection against a challenging backdrop of global uncertainty and fiscal vulnerabilities. This has restored fiscal credibility, allowing activist monetary policy and the automatic stabilisers to support the economy.

Autumn Statement 2012 and Budget 2013 announced further detail on the Government's deficit reduction plans and further measures to ease the long-term pressure on the public finances. As a result, public sector net borrowing is forecast to fall from its post-war peak of 11.2 per cent of GDP to 2.2 per cent of GDP by 2017-18, the end of the forecast period. Public sector net borrowing is forecast to have fallen by a third over the three years from 2009-10. The Government remains committed to tackling the UK's Treaty deficit and bringing it in line with the 3 per cent target set out in the Stability and Growth Pact.

Budget 2013 also announced new steps to ensure active monetary policy continues to play a full role in supporting the economy, with an updated remit for the Monetary Policy Committee.

The Government is delivering an ambitious programme of supply-side reforms to invest in infrastructure, support enterprise and industry, as well as create a fair and competitive tax system to support growth. Autumn Statement 2012 and Budget 2013 built on the progress that the Government has already made. This strategy has helped the Government to equip the UK to compete in the global race and support aspiration. Employment is at record levels, exceeding the pre-crisis peak, and the UK is now eighth in the World Economic Forum Global Competitiveness Report.

1

Introduction

1.1 The Stability and Growth Pact (SGP) requires Member States to provide information on economic developments in their country for the purposes of the multilateral surveillance procedure under Articles 121 and 126 of the EU Treaty. Member States submit either annual Stability Programmes (euro area countries) or annual Convergence Programmes (non euro area countries) setting out their medium-term fiscal policies.

1.2 The UK is not a member of the single currency and cannot face sanctions under the EU's SGP. The UK's obligation under the SGP is to "endeavour to avoid an excessive government deficit" as a result of its Protocol to the EU Treaties (Protocol 15). The Convergence Programme sets out the UK's medium-term fiscal policies.

1.3 Major fiscal events since the last Convergence Programme have been Autumn Statement 2012 and Budget 2013. This Convergence Programme draws on those publications, particularly Budget 2013.

1.4 The forecasts for the economy and public finances included in the UK's Convergence Programme are prepared by the independent Office for Budget Responsibility (OBR), information on which is set out in Chapter 5. The forecasts set out in the Convergence Programme are from the OBR's March 2013 *Economic and fiscal outlook*, which was published alongside Budget 2013.

1.5 Under Section 5 of the European Communities (Amendment) Act 1993, Parliament is required to approve the Government's assessment of the UK's medium-term economic and budgetary position. This forms the basis of the UK's Convergence Programme. The UK presents copies of assessments of its Convergence Programme and assessments under the Excessive Deficit Procedure (EDP) to Parliament along with an Explanatory Memorandum. The UK Parliament's Commons European Scrutiny Committee held a debate on 14 June 2012 on the European Semester, including the Council's draft recommendations and Opinion on the UK's National Reform Programme and Convergence Programme.

Structure of the Convergence Programme

1.6 The first five chapters of this Convergence Programme set out the Government's policy on the fiscal position, sustainability of the public finances and the macro-economy, as required by the Code of Conduct.

1.7 Reflecting the establishment of the independent OBR, detail on their economic and fiscal forecasts is set out separately in the final four chapters of the Convergence Programme, drawing upon the OBR's March 2013 *Economic and fiscal outlook* and 2012 *Fiscal sustainability report*.

1.8 Annex A provides details of the financial impact of Autumn Statement 2012 and Budget 2013 policy decisions. Annex B provides supplementary data.

2

Overall policy framework and objectives

2.1 All data included in this chapter is correct at the time of Budget 2013, which was published on 20 March 2013.

The economy and public finances

2.2 The UK economy is recovering from the most damaging financial crisis in generations after a decade of growth built on unsustainable levels of debt. The Government inherited the largest deficit since the Second World War and the UK experienced one of the deepest recessions of any major economy. Across the world, recovery over the past four years has been slower than forecast and the euro area is now in recession.

2.3 The Government's economic strategy, set out in the June Budget 2010, is designed to protect the economy through the recent period of global uncertainty and provide the foundations for recovery. This strategy is restoring the public finances to a sustainable path and the deficit has been reduced by a third over the three years from 2009-10. The UK is seen as a relative safe haven, with low market interest rates helping to keep interest payments lower for families, businesses and the taxpayer. This strategy has helped the Government to equip the UK to compete in the global race to build a stronger economy and a fairer society. The UK has the fourth lowest corporation tax rate in the G20 and will reduce the rate by an additional 1 percentage point in April 2015 to 20 per cent, the joint lowest in the G20; it has risen to eighth in the 2012 World Economic Forum Global Competitiveness Report; and the 2012 KPMG Annual Survey of Tax Competitiveness looked at six key competitor economies and found that out of these the UK was the most commonly cited as being in the top three.¹

The UK economy since 2010

2.4 Three key factors, first set out in the Office for Budget Responsibility's (OBR) November 2011 *Economic and fiscal outlook*, have resulted in a more subdued and uneven recovery than expected and continue to weigh on the UK economy through 2012:

- evidence has accumulated that suggests the impact of the financial crisis on GDP and underlying productivity has been greater than expected;
- the euro area sovereign debt crisis and global uncertainty have damaged confidence and reduced external demand; and
- commodity price driven inflation since 2011 has reduced real incomes and raised business costs.

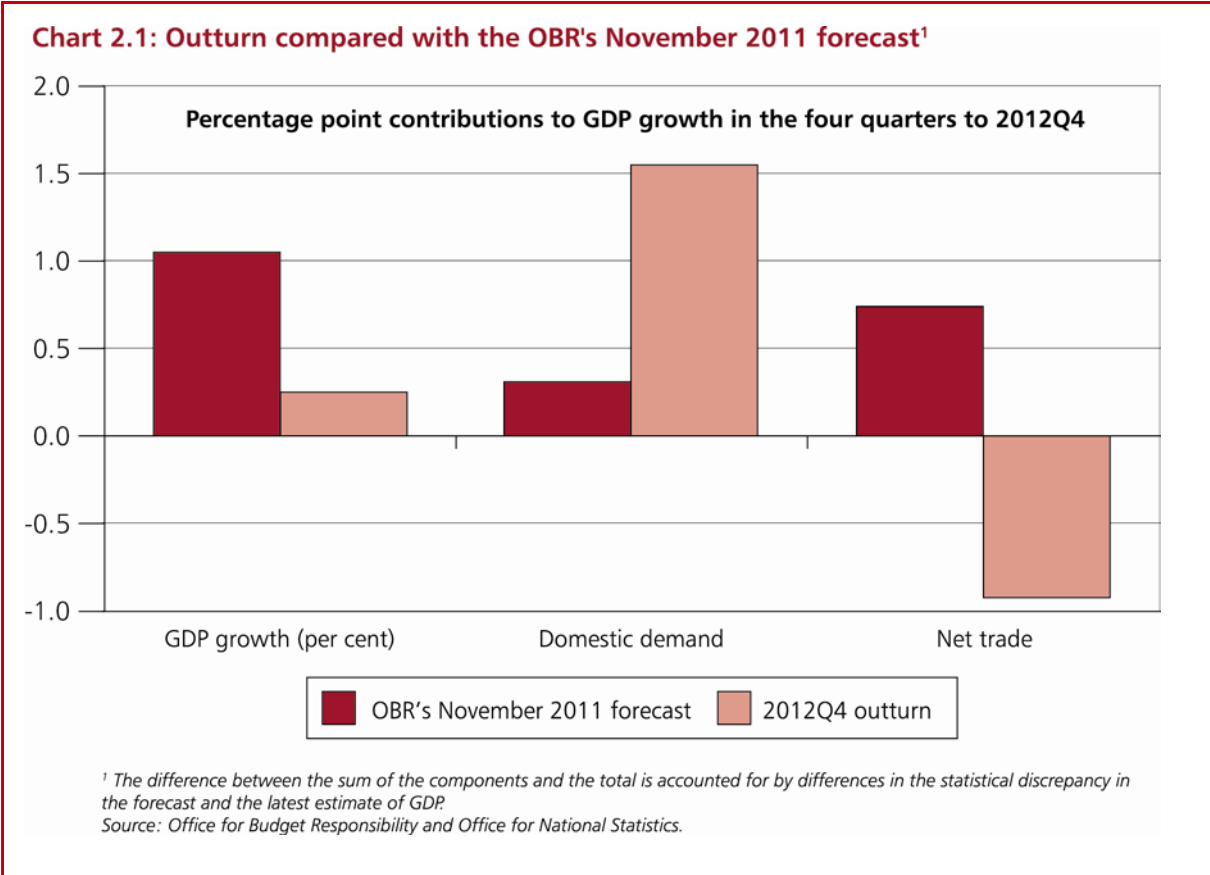
2.5 Economic recovery continues to be more uneven than originally expected. While UK GDP grew by 0.3 per cent in the year to the fourth quarter of 2012, slightly higher than forecast at Autumn Statement 2012, it was choppy through the year and fell 0.3 per cent in the fourth quarter.² Nominal GDP growth in the year to the fourth quarter of 2012 was only 1.3 per cent.

¹ The Global Competitiveness Report 2012-13, World Economic Forum, 2012. KPMG Annual Survey of Tax Competitiveness, KPMG, February 2013.

² All UK economy data from the Office for National Statistics (ONS) unless otherwise stated.

Recovery has also been uneven in other countries. Euro area GDP fell by 0.9 per cent in the year to the fourth quarter of 2012, falling by 0.6 per cent in the fourth quarter alone. GDP growth for the US and Japan was also weak in the fourth quarter.³ The OBR’s Budget 2013 forecast revises down UK GDP growth slightly in 2013 and 2014, reflecting this reduced momentum in the UK and globally, and smaller contributions to growth from net trade and consumption. By the end of the forecast horizon, the level of GDP is 0.6 per cent below the level forecast at Autumn Statement 2012. The OBR assumes around two thirds of the reduction in real GDP growth to be cyclical rather than structural.

2.6 The UK economy’s performance through 2012 included relative strength in domestic demand but relative weakness in external sources of growth. Compared with the OBR forecast in the November 2011 *Economic and fiscal outlook*, GDP growth in the year to the fourth quarter of 2012 under-performed by 0.8 percentage points. The contribution of domestic demand out-performed that forecast by 1.2 percentage points and net trade under-performed by 1.7 percentage points, as shown in Chart 2.1. Indeed, given the relative strength of domestic demand, GDP could have grown by 2.1 per cent in the year to the fourth quarter had exports grown by the 5.7 per cent forecast in November 2011, and adjusting for the likely import content of those additional exports. Over that period, goods export volumes to the European Union (EU) fell by 2.5 per cent, while goods export volumes outside the EU grew by 1.2 per cent.



2.7 UK inflation has fallen by almost half from its peak of 5.2 per cent in September 2011 to 2.8 per cent in February 2013. Pressure from commodity price rises in 2011 has eased, though commodity prices remain high.

2.8 The OBR’s October 2012 *Forecast evaluation report* showed that the shortfall in growth compared with its June Budget 2010 forecast could largely be explained by private

³ Main Economic Indicators, Organisation for Economic Co-operation and Development (OECD).

consumption, investment and net trade, in roughly equal measure, reflecting shocks from commodity prices, financial conditions and confidence. The *Forecast evaluation report* noted that nominal consumer spending had been broadly in line with forecast, with unexpected inflation explaining the weakness of real private consumption relative to forecast. Table 2.1 shows a broadly similar breakdown across the private sector by the third quarter of 2012 using the same approach with the latest data. The direct contribution of government consumption and investment subtracted less from GDP growth than forecast at the June Budget 2010, largely due to lower than expected inflation in the government sector with nominal spending lower than forecast but real spending higher than forecast with higher public sector productivity.

Table 2.1: Contributions to real GDP growth from 2010Q1 to 2012Q3

	Percentage points					
	Private consumption	Private investment	Total government	Net trade	Stocks	GDP
June 2010 forecast	2.3	2.9	-1.6	2.1	0.8	6.5
Latest data	0.6	0.7	-0.5	0.6	0.9	2.3
Difference ¹	-1.7	-2.2	1.1	-1.5	0.1	-4.2

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

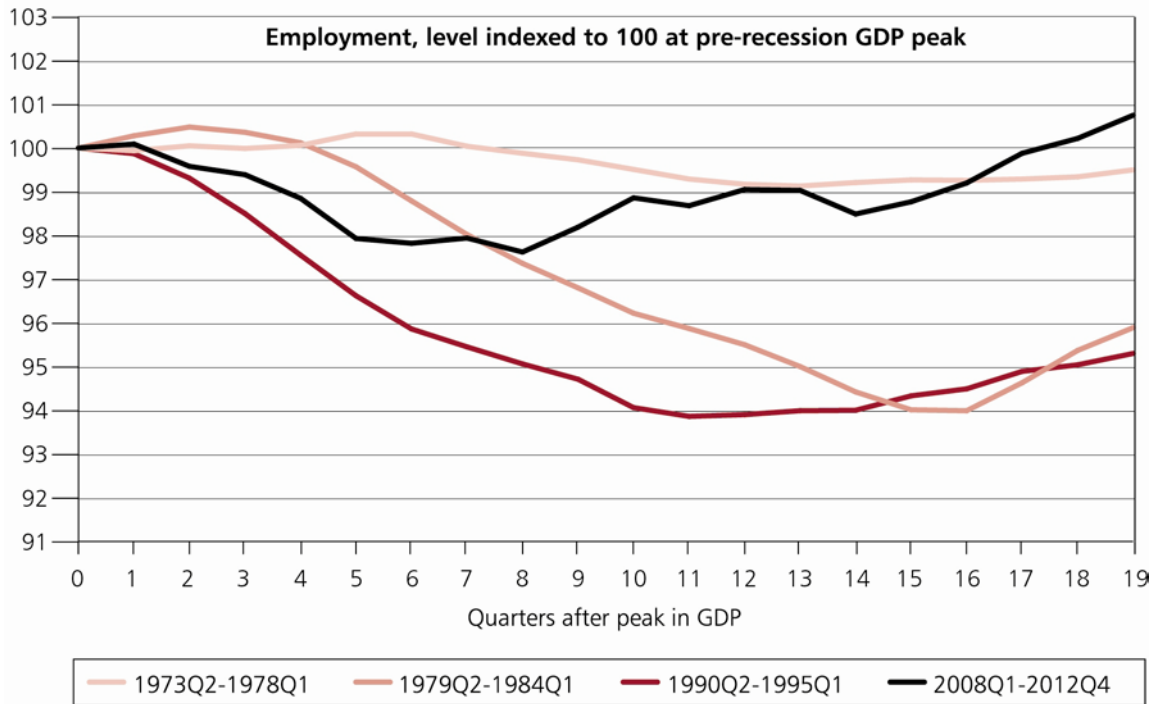
Source: Office for Budget Responsibility and HM Treasury.

2.9 Fiscal multipliers estimate the impact of different elements of tax and spending consolidation on GDP. The OBR's October 2012 *Forecast evaluation report* did not see evidence to suggest that multipliers were significantly different than estimated in the June Budget 2010 forecast. The OBR has not altered the estimated fiscal multipliers being used in its latest forecast.

2.10 The UK labour market has continued to perform more strongly than forecast despite the headwinds to GDP growth, with a net increase of over one million jobs in the private sector since the first quarter of 2010.⁴ Comparing the fourth quarter of 2012 to a year earlier, employment rose by 584,000, the fastest growth since 1989, with participation in the labour market rising by 428,000 and unemployment falling by 156,000. At the end of 2012, employment levels were the highest recorded and above the pre-crisis peak. Unemployment in the three months to December 2012 stood at 7.8 per cent in the UK, lower than in the euro area and lower than that following previous UK recessions. Employment performance in the UK compares favourably with post-war experience, as shown in Chart 2.2, and internationally, as discussed later in this chapter. The OBR expects employment to continue to rise over the forecast period.

⁴ Labour Market Statistics, ONS, January 2013. These figures exclude the impact of the reclassification from June 2012 of 196,000 employees in some educational bodies from the public to the private sector.

Chart 2.2: Employment levels through recessions and recoveries



Source: Office for National Statistics and HM Treasury.

2.11 The persistent effects of the financial crisis continue to weigh on the UK recovery. The Bank of England's November 2012 *Inflation Report* and the OBR's December 2012 *Economic and fiscal outlook* set out the channels along which productivity might have been held back due to these persistent effects.⁵ For example: the higher cost and availability of credit; the pace at which credit is reallocated to more efficient uses; and a lower risk appetite among lenders.

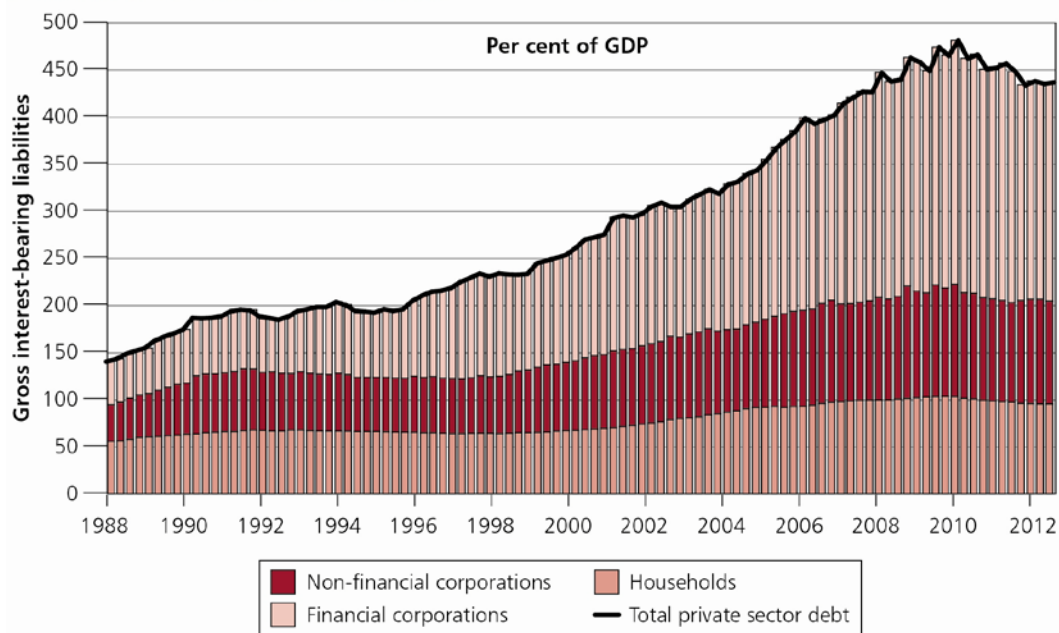
UK imbalances and relative economic performance

2.12 It has been estimated that by 2008, as the crisis hit, the UK private sector had become the most indebted in the world.⁶ Deleveraging has since weighed on UK growth. Some progress has been made, with private sector debt falling by over 40 percentage points of GDP since its peak in the first quarter of 2010, as Chart 2.3 shows.

⁵ Inflation Report, Bank of England, November 2012. Economic and fiscal outlook, OBR, December 2012.

⁶ Debt and deleveraging: The global credit bubble and its economic consequences, McKinsey Global Institute, January 2010.

Chart 2.3: Private sector debt in the UK



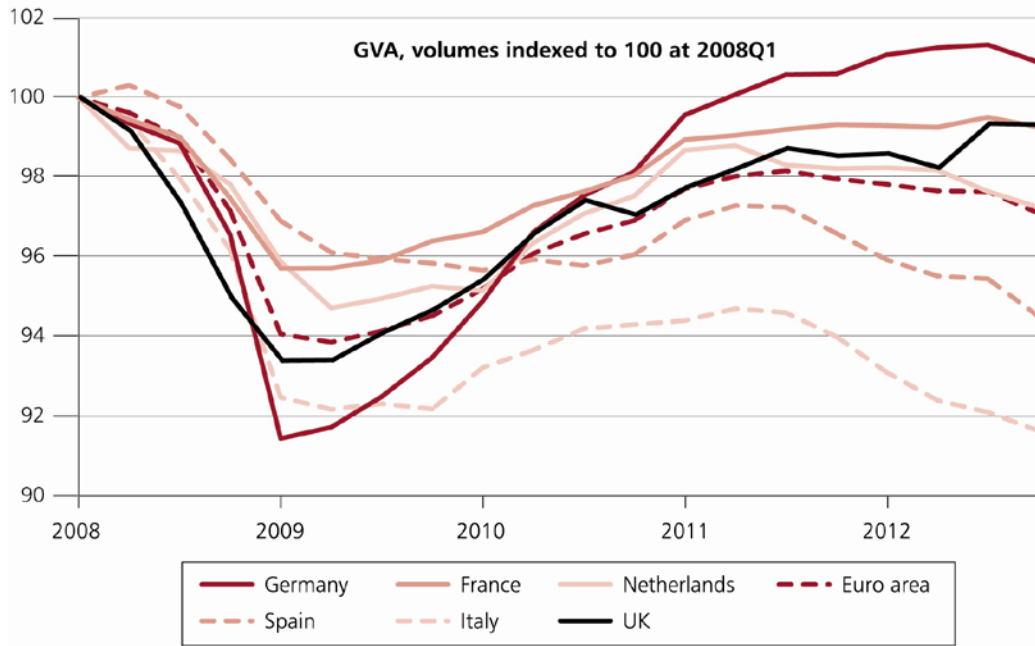
Source: Office for National Statistics.

2.13 Autumn Statement 2012 illustrated the impact of the financial crisis and post-crisis deleveraging on the financial sector, which has contracted 13 per cent in real terms since the economy's pre-crisis peak. Output of the North Sea oil and gas sector, which has continued a long-term decline related to maturing fields, has fallen 47 per cent since the economy's pre-crisis peak. The rest of the economy, accounting for nearly 90 per cent of Gross Value Added (GVA), has performed more strongly.

2.14 Outside the energy and financial sectors, the UK economy has performed better than the euro area and similarly to France, as Chart 2.4 shows.⁷

⁷ Chart 1.4 uses OECD data and energy sector refers to the energy extraction and usage category. This is comprised of 'mining and quarrying (including oil and gas extraction)', 'electricity, gas, and air' and 'water supply and sewerage'.

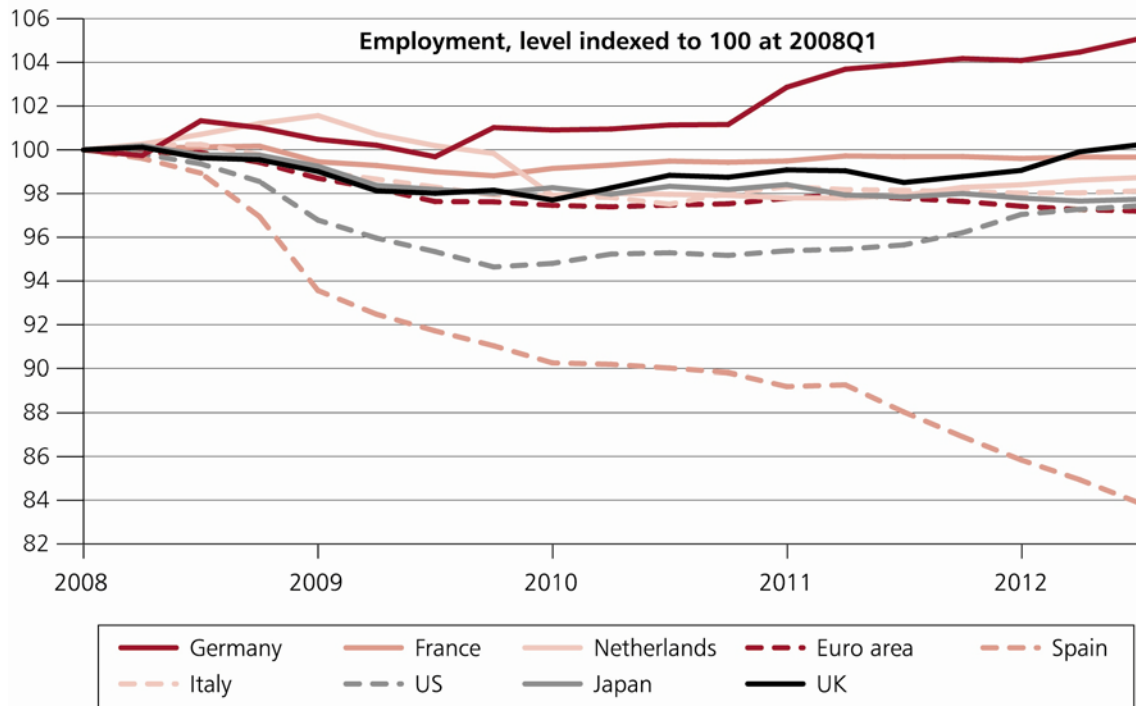
Chart 2.4: GVA excluding energy and financial services in the largest EU economies



Source: OECD and HM Treasury.

2.15 Chart 2.5 shows employment in the UK has performed relatively strongly in international context. By comparison with the first quarter of 2008, UK employment is higher than all major advanced economies except Germany. UK employment growth was stronger than all G7 economies except the US between the third quarter of 2012 and a year earlier.

Chart 2.5: International comparison of employment since the crisis



Source: OECD and HM Treasury.

Euro area crisis and global developments

2.16 Autumn Statement 2012 highlighted three key global risks to the UK economy: the euro area sovereign debt crisis, the US 'fiscal cliff' and slowing growth in emerging economies. These risks have started to ease in recent months and there are signs of confidence returning to financial markets, but this is yet to feed through to the performance of the wider economy.

2.17 The euro area is the key market for UK exporters, accounting for 42 per cent of UK exports in 2011. As a consequence, the euro area sovereign debt crisis and subsequent recession have weighed heavily on the UK recovery. Action by European policy makers in 2012 helped ease the crisis and there are signs of investor confidence improving, but as the situation in Cyprus demonstrates the challenges facing the euro area are not fully resolved. Output has been weaker than anticipated, and the OBR has revised down its forecast for 2013 GDP growth in the euro area to -0.5 per cent and does not expect it to start recovering until the second half of 2013.

2.18 The US was the destination for around 16 per cent of UK exports in 2011. The American Taxpayer Relief Act enacted on 2 January 2013 averted over half of the sharp fiscal tightening that was possible for 2013, the 'fiscal cliff'.⁸ The US Congressional Budget Office expects the US fiscal consolidation to reduce US GDP growth by around 1½ percentage points in 2013, leaving growth for the year at around 1½ per cent.⁹ However, with further US fiscal negotiations outstanding, there may be further changes to the US fiscal outlook in coming months.

2.19 Brazil, Russia, India and China taken together were the destination for 6.5 per cent of UK exports in 2011. Growth has stabilised in China and the International Monetary Fund (IMF) has forecast China's GDP will grow by 8.2 per cent in 2013 compared with 7.8 per cent in 2012. The IMF forecast for 2013 GDP growth in emerging economies as a whole is 5.5 per cent. Emerging markets and developing economies remain an important driver of global growth. In 2011 they accounted for 36 per cent of world GDP, up from 28 per cent in 2007 before the global crisis hit.¹⁰ From a low base, UK exporters continue to take advantage of this trend through trade with emerging economies. Between 2009 and 2012 UK goods exports to Brazil increased by 49 per cent, to Russia by 133 per cent, to India by 59 per cent and to China by 96 per cent.¹¹

2.20 The easing of risks has been reflected in global stock markets. Between Autumn Statement 2012 and Budget 2013 the UK's FTSE 100 index has risen 10 per cent, the US's S&P 500 index 11 per cent and the euro area's Euro Stoxx 50 index 5 per cent. Over the same period global stock market values have risen by more than \$3 trillion.¹²

⁸ The US 2013 financial year runs from October 2012 to September 2013.

⁹ The Budget and Economic Outlook: Fiscal Years 2013 to 2023, US Congressional Budget Office, February 2013.

¹⁰ World Economic Outlook, IMF, October 2012.

¹¹ UK Trade – January 2013, ONS, March 2013.

¹² Bloomberg. Closing price 5 December 2012 and 15 March 2013.

Economic forecast

Table 2.2: Summary of the OBR's central economic forecast¹

	Percentage change on a year earlier, unless otherwise stated						
	Forecast						
	2011	2012	2013	2014	2015	2016	2017
GDP growth	0.9	0.2	0.6	1.8	2.3	2.7	2.8
Main components of GDP							
Household consumption ²	-1.0	1.0	0.5	1.2	1.7	2.4	2.8
General government consumption	-0.1	2.6	0.4	-0.7	-0.4	-1.0	-1.8
Fixed investment	-2.9	1.4	2.2	6.7	8.1	7.7	7.8
Business	3.1	4.9	1.9	6.1	8.6	8.6	8.6
General government	-26.2	2.7	2.6	5.0	1.8	-1.5	-1.2
Private dwellings	2.3	-5.4	2.0	8.9	10.0	10.0	9.7
Change in inventories ³	0.3	-0.2	-0.2	0.0	0.0	0.0	0.0
Net trade ³	1.2	-0.8	0.1	0.1	0.1	0.1	0.1
CPI inflation	4.5	2.8	2.8	2.4	2.1	2.0	2.0
Employment (millions)	29.2	29.5	29.8	29.9	30.1	30.3	30.5

¹ All figures in this table are rounded to the nearest decimal place. This is not intended to convey a degree of unwarranted accuracy. Components may not sum to total due to rounding, omission of transfer costs of land and existing buildings, and the statistical discrepancy.

² Includes households and non-profit institutions serving households.

³ Contribution to GDP growth, percentage points.

Source: Office for Budget Responsibility.

2.21 GDP growth in 2012 was slightly stronger than expected at Autumn Statement 2012. However, reflecting the lower-than-expected momentum in the final quarter of 2012, the OBR has revised its forecast for GDP growth in 2013 from 1.2 per cent to 0.6 per cent. The OBR has revised its forecast for GDP growth in 2014 from 2.0 per cent to 1.8 per cent. These revisions reflect smaller contributions to growth from net trade and consumption. The OBR forecast for GDP growth from 2015 onwards is unchanged from its forecast at Autumn Statement 2012. By the end of the forecast horizon, the level of GDP is 0.6 per cent below the level forecast at Autumn Statement 2012. The OBR assumes around two thirds of the reduction in real GDP growth to be cyclical rather than structural.

2.22 Risks to UK growth have become more balanced. Global risks have started to ease. As the Funding for Lending Scheme (FLS) begins to gain traction, UK credit conditions have improved. Interest rates have fallen, in particular mortgage rates, and credit availability for businesses has increased. House prices increased by 2.2 per cent in the year to January 2013 and property transactions have risen.¹³ As credit conditions continue to ease, the property market is expected to pick up and growth in transactions to continue. While growth remains subdued, the Governor of the Bank of England has said "*there are good reasons to suppose that a gentle recovery is underway*".¹⁴ The IMF forecasts UK GDP per person to grow faster than the rest of the G7 between 2012 and 2017, with the exception of the US.¹⁵

2.23 The OBR has revised up its forecast for UK employment from 2013. It has revised down its unemployment forecast by 0.3 percentage points to 7.9 per cent in 2013 and by 0.2 percentage points in 2017 to 6.9 per cent. It expects employment to rise in every year of the forecast period, reaching 30.5 million by 2017. The OBR expects total market sector employment to rise by around 2.6 million between the start of 2011 and the start of 2018, more than offsetting the total reduction in general government employment of around 1.2 million.

¹³ House Price Index, January 2013, ONS, March 2013. Monthly Property Transactions, January 2013, HM Revenue and Customs, February 2013.

¹⁴ Mervyn King, speech, the Confederation of British Industry (CBI), Northern Ireland Mid-Winter Dinner, Belfast, 22 January 2013.

¹⁵ World Economic Outlook, IMF, October 2012.

2.24 The OBR has revised its inflation forecast up, broadly in line with the Bank of England's February 2013 *Inflation Report* forecast. The OBR attributes this to higher oil prices and higher import prices as a result of recent exchange rate movements. This upward pressure is partially offset in 2013 and 2014 by cancellation of the fuel duty rise that was planned for 1 September 2013. The OBR forecasts inflation to return to target by early 2016 and remain close to target thereafter. The OBR's forecast for the GDP deflator, a broader measure of inflation in the economy, has been revised down. This, combined with the revisions to real GDP, leaves the level of nominal GDP 2.5 per cent lower in 2017 than was forecast at Autumn Statement 2012. Real GDP accounts for around 0.6 percentage points of this revision, with the remainder reflecting a lower GDP deflator.

2.25 The OBR forecast shows the UK economy rebalancing over the forecast period. Having grown by almost 5 per cent in 2012, business investment is forecast to pick up again in 2014 and make an increasing contribution to GDP growth thereafter, rising to nearly 1 percentage point by 2017. After falling in 2012, UK exports are also expected to pick up and net trade is forecast to make a small positive contribution to growth from 2013. Household consumption is forecast to grow more slowly than GDP on average, with the saving ratio declining but remaining at 5 per cent or above throughout.

The Government's strategy

2.26 The Government's strategy is designed to protect the economy through this period of global uncertainty, to maintain market confidence in the UK and to lay the foundations for a stronger, more balanced economy in the future. The Government is taking decisive action through:

- monetary activism and credit easing, stimulating demand, maintaining price stability and supporting the flow of credit in the economy;
- deficit reduction, returning the public finances to a sustainable position and ensuring that fiscal credibility underpins low long-term interest rates;
- reform of the financial system, improving the regulatory framework to reduce risks to the taxpayer and build the resilience of the system; and
- a comprehensive package of structural reforms, rebalancing and strengthening the economy for the future, including an ambitious housing package and programme of infrastructure investment.

Monetary activism

Monetary policy

2.27 Monetary policy has a critical role to play in supporting the economy as the Government delivers on its commitment to necessary fiscal consolidation. To ensure that it can continue to play that role fully, the Government has reviewed the monetary policy framework in international and historical context. This *Review of the monetary policy framework* is published alongside Budget 2013.¹⁶ As a result, the Government has:

- retained a flexible inflation targeting framework and reaffirmed the 2 per cent inflation target, which applies at all times;
- updated the remit to clarify the trade-offs that are involved in setting monetary policy to meet a forward-looking inflation target; and

¹⁶ Available on the HM Treasury website at www.hm-treasury.gov.uk.

- requested that the Monetary Policy Committee (MPC) provides in its August 2013 *Inflation Report* an assessment of the merits of using intermediate thresholds in the operation and communication of monetary policy.

2.28 The Government has concluded that a flexible inflation targeting framework has served, and will continue to serve, the UK well, and that the credible commitment to medium-term price stability provided by the 2 per cent inflation target must remain at the core of the framework. Price stability is an essential pre-requisite for economic prosperity. In Budget 2013, the Government reaffirms the operational target for the MPC remains an inflation rate of 2 per cent, measured by the 12-month increase in the Consumer Prices Index (CPI). The target applies at all times.

2.29 The remit continues to recognise that the actual inflation rate may depart from its target as a result of shocks and disturbances, and that the MPC may therefore wish to allow inflation to deviate from the target temporarily in order not to cause undesirable volatility in output. It clarifies the consideration that, in some circumstances, may be given to financial imbalances and requires that the MPC should have regard to the policy actions of the Financial Policy Committee (FPC). The remit goes further by clarifying that in exceptional circumstances, where shocks are particularly large and with persistent effects, the MPC is likely to be faced with more significant trade-offs between the speed with which it aims to bring inflation back to target and the consideration that should be placed on the variability of output. The remit requires that in forming and communicating its judgements the MPC should promote understanding of the trade-offs inherent in setting monetary policy to meet a forward-looking inflation target while giving due consideration to output volatility.

2.30 The remit also continues to require an exchange of open letters between the Governor of the Bank of England and the Chancellor of the Exchequer if inflation moves away from the target by more than 1 percentage point in either direction. The Government believes the open letter system, required in the remits for the MPC since 1997, provides a formal mechanism of transparency and accountability. The remit now requires that the open letter from the Governor should be sent alongside the minutes of the MPC meeting that followed the publication of the CPI data, referring as necessary to the Bank's latest *Inflation Report* and forecasts and covering the MPC's judgements on the trade-offs inherent in setting monetary policy. The reason for publishing this letter alongside the minutes is to allow the MPC time to form and communicate its strategy towards returning inflation to the target after consideration of the trade-offs. The Government believes that any future open letters will therefore result in a more meaningful exchange about the MPC's strategy than has been possible before now.

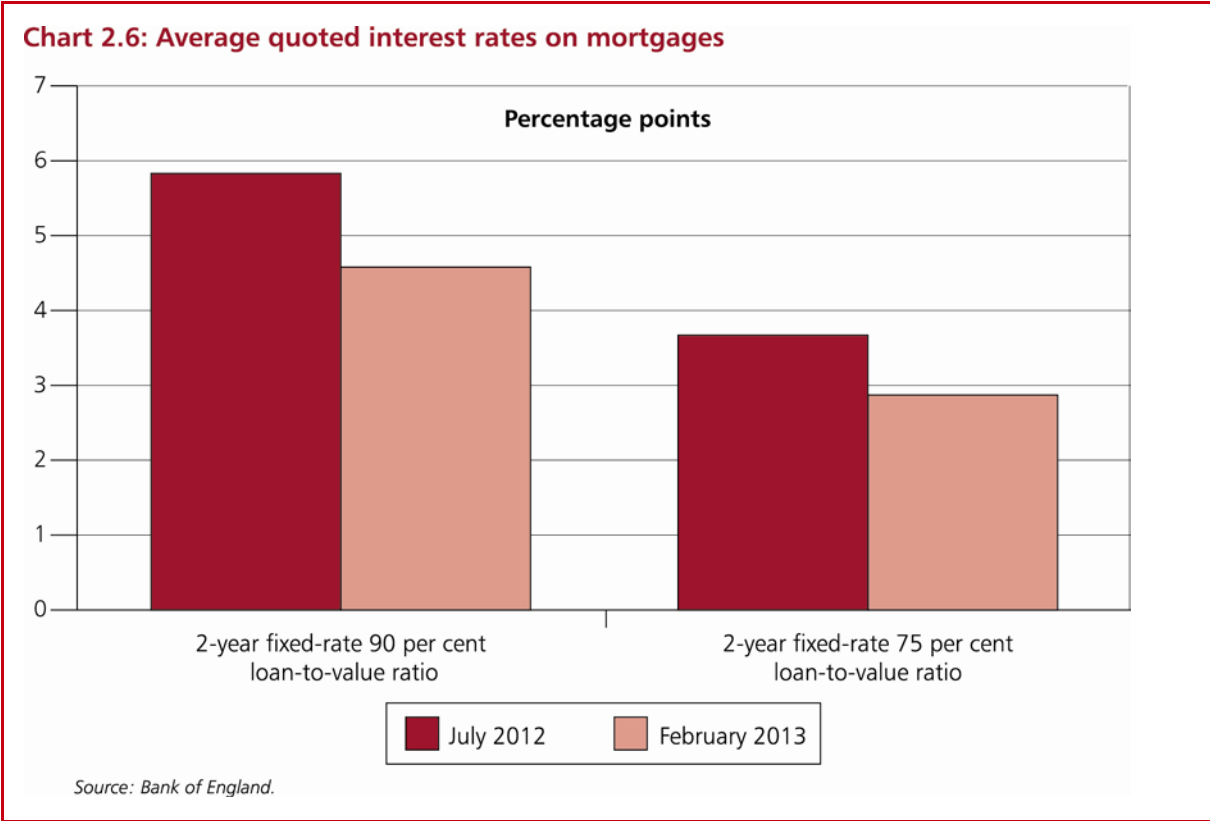
2.31 As with many central banks in advanced economies since the global financial crisis hit, the Bank of England has deployed a range of unconventional instruments in order to deliver the support it judged necessary. Alongside holding Bank Rate at a record low, the Bank of England, with the Treasury, has launched the FLS, discussed below, and the MPC's programme of asset purchases financed by the issuance of central bank reserves reached a stock of £375 billion in November 2012. The Government confirms in Budget 2013 that the Asset Purchase Facility will remain in place for the financial year 2013-14.

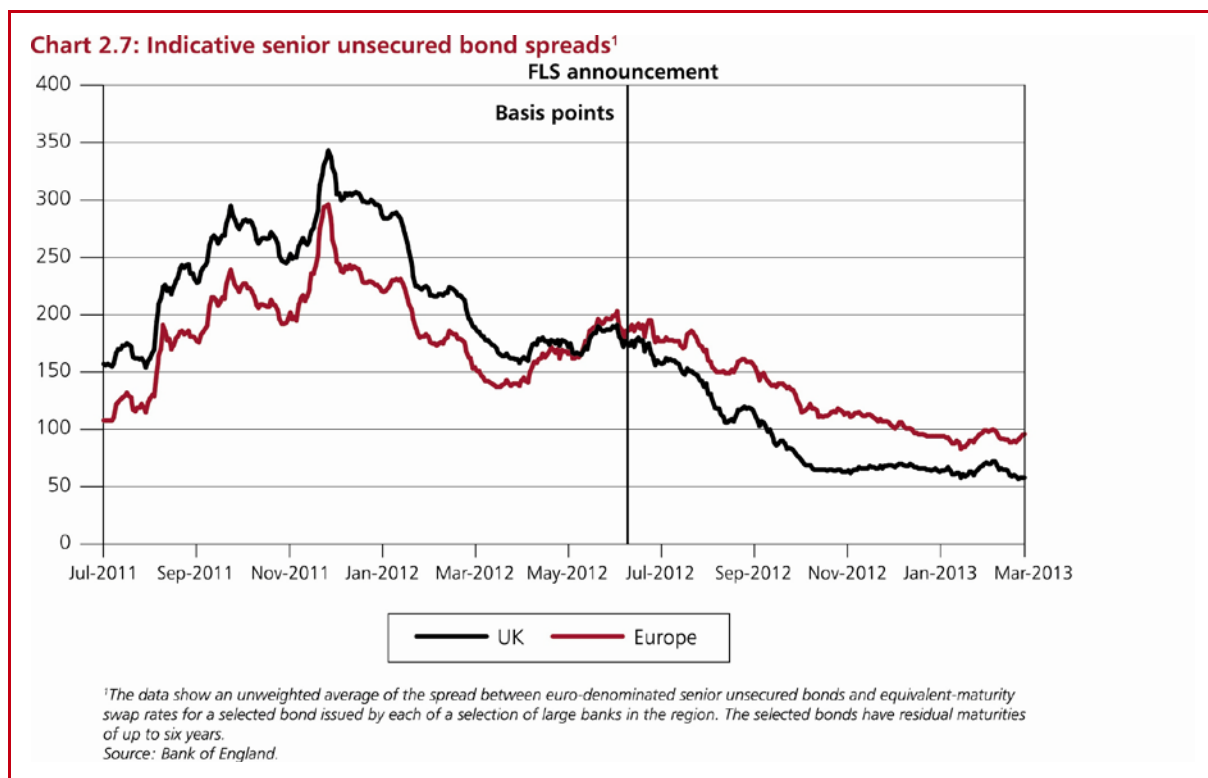
2.32 With the UK continuing to face exceptional economic challenges, the remit recognises that the MPC may judge it necessary to use other unconventional instruments in order to support the economy in the context of price stability. Where those instruments have implications for credit risk or credit allocation, the remit ensures that appropriate governance arrangements are in place to ensure accountability. The MPC may also judge it to be appropriate to deploy explicit forward guidance including intermediate thresholds – policy commitments conditional on future economic developments – in order to influence expectations and thereby meet its objectives more effectively. The remit requests that the MPC provides in its August 2013 *Inflation Report* an assessment of the merits of using intermediate thresholds.

Credit easing

2.33 The FLS complements the Bank of England’s asset purchase programme by delivering support to the economy through the banking system. The FLS reduces bank funding costs and provides strong incentives for banks to increase their lending to households and non-financial businesses in the UK. There are currently 39 banks and building societies participating in the Scheme, who make up over 80 per cent of the stock of loans.

2.34 The FLS is improving credit conditions in the UK. Wholesale bank funding costs have declined significantly as a result of the FLS and wider international developments and are now at very low levels. This is feeding through to the wider economy. The number of high loan-to-value mortgage products available in the market has increased by about 30 per cent and mortgage approvals are increasing. Between July 2012 and January 2013, the average quoted rate for 2-year fixed-rate mortgages with 90 per cent loan-to-value ratio fell by more than one percentage point, as shown in Chart 2.6. Chart 2.7 shows that, together with a general improvement in financial markets, the FLS has led to reductions in bank funding costs. Credit availability for businesses has also improved and is expected to improve further in the coming months. Several banks participating in the FLS have introduced discounted loans for small and medium-sized enterprises.





2.35 The FLS has been a clear success, with strong signs that lower bank funding costs are now being reflected in lower lending rates and increased credit availability. Banks expect to expand their lending to the real economy and their use of the Scheme throughout the year. HM Treasury and the Bank of England are now actively considering whether there are potential extensions to the scheme that will boost lending further.

2.36 Building on the FLS, the Government wants to go further in order to deliver on its commitment to make the aspiration of home ownership a reality for as many households as possible. Budget 2013 announced Help to Buy, a package of measures that will increase the supply of low-deposit mortgages for credit-worthy households, increase the supply of new housing and contribute to economic growth.

Deficit reduction

Fiscal strategy

2.37 The Government inherited the largest deficit in post-war history due to the financial crisis of 2008 and 2009 and unsustainable pre-crisis increases in public spending. The historically high level of borrowing risked undermining fairness, growth and economic stability in the UK. In 2010 the Government set out clear, credible and specific medium-term fiscal consolidation plans to return the public finances to a sustainable path.

2.38 The Government's fiscal strategy has been effective in providing protection against a challenging backdrop of global uncertainty and fiscal vulnerabilities. This has restored fiscal credibility, allowing activist monetary policy and the automatic stabilisers to support the economy, and is consistent with the approach recommended by international organisations. As stated by the Organisation for Economic Co-operation and Development (OECD), "monetary policy and the operation of the automatic stabilisers should support the economy in the short

term".¹⁷ Uncertainty in the global outlook further reinforces the case for stability in the Government's consolidation plans.

2.39 In line with the Government's fiscal strategy, Budget 2013 set out:

- a fiscally neutral Budget that reinforces the Government's commitment to deficit reduction, primarily through spending consolidation;
- a reduction in Resource Departmental Expenditure Limits (RDEL) of £1.1 billion in 2013-14 and £1.2 billion in 2014-15, helping to support the housing package in the short term and contributing to the overall savings required from current spending in 2015-16;
- an envelope for current spending in 2015-16 of £694.2 billion, enabling the Government to increase capital spending plans by £3 billion a year and ensuring consolidation is underpinned by clear, credible and specific medium-term plans for delivery; and
- a sustained decline in the structural deficit as headwinds to growth ease, with cyclically-adjusted net borrowing falling by an annual average of around 1 per cent of GDP over the forecast period.

Implementing fiscal consolidation

2.40 The Government remains committed to reducing the deficit and addressing the permanent structural deterioration in the public finances caused by the lasting impact of the financial crisis. Implementation of the fiscal consolidation plans is well underway:

- by the end of 2012-13, around 70 per cent of the annual fiscal consolidation planned for the Spending Review 2010 period will have been achieved, with around 65 per cent of the spending and around 90 per cent of the tax consolidation in place. As set out in Table 2.4, 80 per cent of the total consolidation in 2015-16 will be delivered by lower spending;
- by the end of April 2013, the Government will have implemented measures to deliver over 90 per cent of the total savings expected from reforms to the welfare system; and
- the majority of tax consolidation measures announced before Budget 2013 will have been legislated by 6 April 2013.¹⁸

2.41 As a result, the Government has made significant progress in reversing the unprecedented rise in borrowing between 2007-08 and 2009-10:

- public sector net borrowing is forecast to fall by a third over the three years from 2009-10, from 11.2 per cent of GDP in 2009-10 to 7.4 per cent of GDP in 2012-13 (as shown in Table 2.5);
- cyclically-adjusted general government net borrowing – a measure of the deficit that excludes the effects of the cycle, and so illustrates the structural fiscal position – is forecast by the IMF to fall by 4.3 percentage points of GDP between 2009 and 2012, which is a larger reduction than any other country in the G7;

¹⁷ OECD Economic Survey: United Kingdom 2013, OECD, February 2013.

¹⁸ Based on net savings in 2014-15. This estimate is consistent with Table 2.4.

- Total Managed Expenditure (TME) is planned to be £10.2 billion lower in 2012-13 than forecast at Budget 2012, ensuring the deficit continues to fall; and
- cumulative debt interest payments from 2010-11 to 2015-16 are forecast to be £31 billion lower than expected at the June Budget 2010.¹⁹

Table 2.4: Total consolidation plans over this Parliament

	£ billion				
	2011-12	2012-13	2013-14	2014-15	2015-16
Policy inherited by the Government	25	40	54	68	
Spending ^{1,2}	14	25	37	48	
Tax ²	11	15	17	20	
<i>Spending share of consolidation (per cent)</i>	<i>57</i>	<i>62</i>	<i>69</i>	<i>71</i>	
Total discretionary consolidation	41	74	84	103	130
Spending ^{1,2,3,4}	23	53	58	80	105
Tax ^{2,3}	18	21	25	23	25
<i>Spending share of consolidation (per cent)</i>	<i>56</i>	<i>72</i>	<i>70</i>	<i>77</i>	<i>80</i>

¹ Spending consolidation is attributable to three factors: (a) reductions in DEL are calculated by assessing nominal DEL totals against a counterfactual of growing DEL from 2010-11 in line with general inflation in the economy, as set out in Table 4.8 of the OBR's pre-Budget forecast (June 2010); (b) reductions in AME due to the net effect of policy changes announced since the June Budget 2010; and (c) estimated debt interest savings, updated for market interest rates consistent with the OBR's March 2013 Economic and fiscal outlook.

² This takes account of the latest costings.

³ Where costings do not go out to 2015-16, they have been grown in line with general inflation in the economy.

⁴ The Government will set DEL budgets for 2015-16 at the Spending Round. Figures shown for 2015-16 are based on overall Resource and Capital DEL envelopes, as set out in Table 2.3.

Source: Office for Budget Responsibility and HM Treasury.

Reducing risks

2.42 The UK's fiscal vulnerabilities argue strongly in favour of maintaining a credible path of deficit reduction. Despite significant progress since 2010, the UK is forecast to have the largest deficit in the EU in 2013.²⁰ Among the G7, only the US and Japan are forecast to have larger deficits in 2013.²¹ Uncertainty in the global outlook reinforces the case for stability in the Government's plans for fiscal consolidation.

2.43 In February Moody's downgraded the UK sovereign credit rating from Aaa to Aa1 with stable outlook, reflecting "the anticipated slow growth of the global economy and the drag on the UK economy from the ongoing public and private sector deleveraging process". Moody's highlighted a number of factors that could lead them to downgrading the UK further, including "reduced political commitment to fiscal consolidation" and "additional material deterioration in the country's economic prospects".²² Among the G7, only Canada and Germany are now rated AAA by all three major credit rating agencies; Canada and Germany had the lowest pre-crisis structural deficits in 2007, while Chart 2.8 shows that the UK had the largest pre-crisis structural deficit in 2007.²³

¹⁹ Fiscal Monitor, IMF, October 2012.

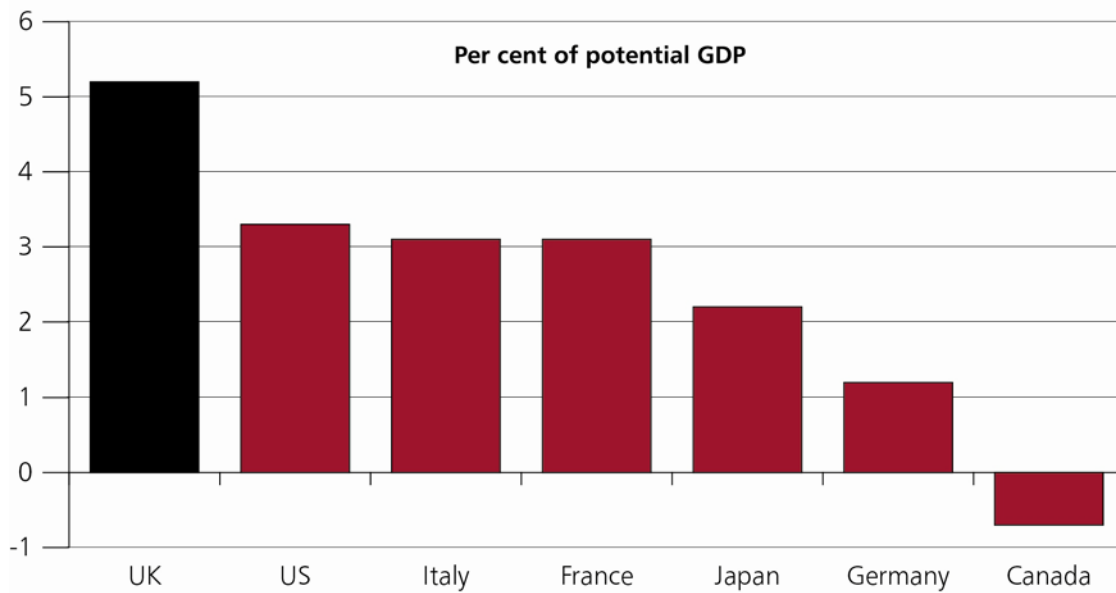
²⁰ European Economic Forecast Winter 2013, European Commission, February 2013.

²¹ Fiscal Monitor, IMF, October 2012.

²² Press notice: Moody's downgrades UK's government bond rating to Aa1 from Aaa; outlook is now stable, Moody's, 22 February 2013.

²³ Fiscal Monitor, IMF, October 2012.

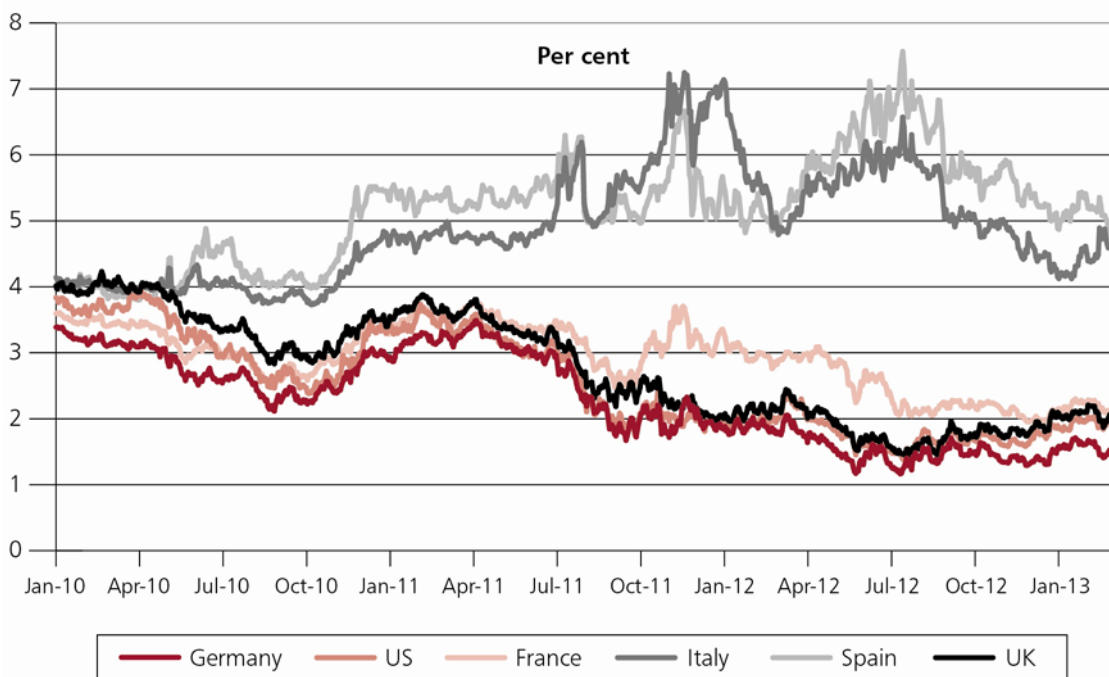
Chart 2.8: General government cyclically-adjusted deficit in 2007



Source: International Monetary Fund.

2.44 The credit rating is one of many important benchmarks, but near historic low gilt yields continue to reflect the market-tested credibility earned by the Government's economic strategy. As Chart 2.9 shows, UK long-term interest rates were around the same level as those of Italy and Spain in May 2010. Italy and Spain now face long-term interest rates of around 5 per cent, compared with near record lows of around 2 per cent for the UK.

Chart 2.9: 10-year government bond yields



Source: Bloomberg.

2.45 Clear and credible consolidation plans remain essential for reducing the risk of a costly loss of market confidence in the UK. As noted by the OECD, "global developments have shown that the consequences of losing market confidence can be sudden and severe and a sharp rise in

interest rates would be particularly damaging to an economy with the United Kingdom's level of indebtedness".²⁴ Table 2.3 shows that a 1 percentage point increase in government bond yields would add around £8.1 billion to annual debt interest payments by 2017-18. A 1 percentage point rise in effective mortgage rates would add £12 billion a year to households' mortgage interest payments.

2.46 Fiscal consolidation also reduces the risk of adverse feedback between weak public finances and a strained financial sector. This feedback can be very damaging, as evidenced by recent events in the euro area. Globally, the UK has one of the largest financial systems relative to the size of its economy, meaning that any loss of investor confidence in the UK's fiscal position would not only affect the UK, but also the global economy. As the IMF has stated, "*the UK financial system thus serves as a global public good*".²⁵ It is the IMF's view that the UK's economic and financial sector policies have a systemic impact on the global economy.

Fiscal forecast

2.47 The establishment of the OBR has placed the UK at the forefront of institutional reform internationally. It has significantly enhanced the credibility of the UK's fiscal framework by ensuring that the Government's fiscal policy decisions are based on independent forecasts for the economy and public finances.

2.48 Budget 2013 presented deficit forecasts excluding the effect of the transfer of assets from the Royal Mail Pension Plan to the public sector, except where otherwise indicated. On this basis, public sector net borrowing is forecast to continue to fall from its post-war peak of 11.2 per cent of GDP in 2009-10 to:

- 5.0 per cent of GDP in 2015-16, the end of this Parliament; and
- 2.2 per cent of GDP in 2017-18.

2.49 Public sector net debt as a percentage of GDP is forecast to:

- be 5.1 percentage points higher in 2015-16 than forecast at Autumn Statement 2012; and
- peak at 85.6 per cent of GDP in 2016-17, before falling to 84.8 per cent of GDP in 2017-18.²⁶

²⁴ OECD Economic Survey: United Kingdom 2013, OECD, February 2013.

²⁵ 2012 Spillover Report, IMF, July 2012.

Table 2.5: Overview of the OBR's central fiscal forecast

	Per cent of GDP							
	Outturn		Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Deficit								
Public sector net borrowing	9.5	7.9	7.4	6.8	5.9	5.0	3.4	2.2
Surplus on current budget	-6.9	-6.0	-6.0	-5.2	-4.3	-3.5	-1.9	-0.9
Primary balance	-6.8	-5.1	-5.3	-4.8	-3.8	-2.6	-0.6	0.9
Cyclically-adjusted net borrowing	7.3	6.0	5.4	4.3	3.3	2.7	1.3	0.6
Cyclically-adjusted surplus on current budget	-4.7	-4.2	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Cyclically-adjusted primary balance	-4.6	-3.2	-3.3	-2.3	-1.2	-0.3	1.4	2.5
Treaty deficit ¹	9.6	7.8	7.4	6.8	6.0	5.2	3.5	2.3
Cyclically-adjusted Treaty deficit	7.4	5.9	5.4	4.4	3.4	2.8	1.5	0.7
<i>Memo: Public sector net borrowing including Royal Mail Pension Plan transfer</i>								
	9.5	7.9	5.6	6.8	5.9	5.0	3.4	2.2
<i>Memo: Treaty deficit including Royal Mail Pension Plan transfer¹</i>								
	9.6	7.8	5.6	6.8	6.0	5.2	3.5	2.3
Debt								
Public sector net debt ²	66.5	71.8	75.9	79.2	82.6	85.1	85.6	84.8
Treaty debt ratio ³	79.9	86.0	90.7	94.9	98.6	100.8	100.8	99.4
Output gap								
	-2.8	-2.7	-2.9	-3.7	-3.6	-3.3	-2.7	-2.1
<i>Memo: total policy decisions⁴</i>								
				0.1	-0.1	-0.2	0.1	0.1

Note: Deficit figures exclude the effect on public sector net investment in 2012-13 of transferring assets from the Royal Mail Pension Plan to the public sector, which reduces net borrowing by £28 billion (1.8 per cent of GDP) in that year, unless otherwise stated.

¹ General government net borrowing on a Maastricht basis.

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

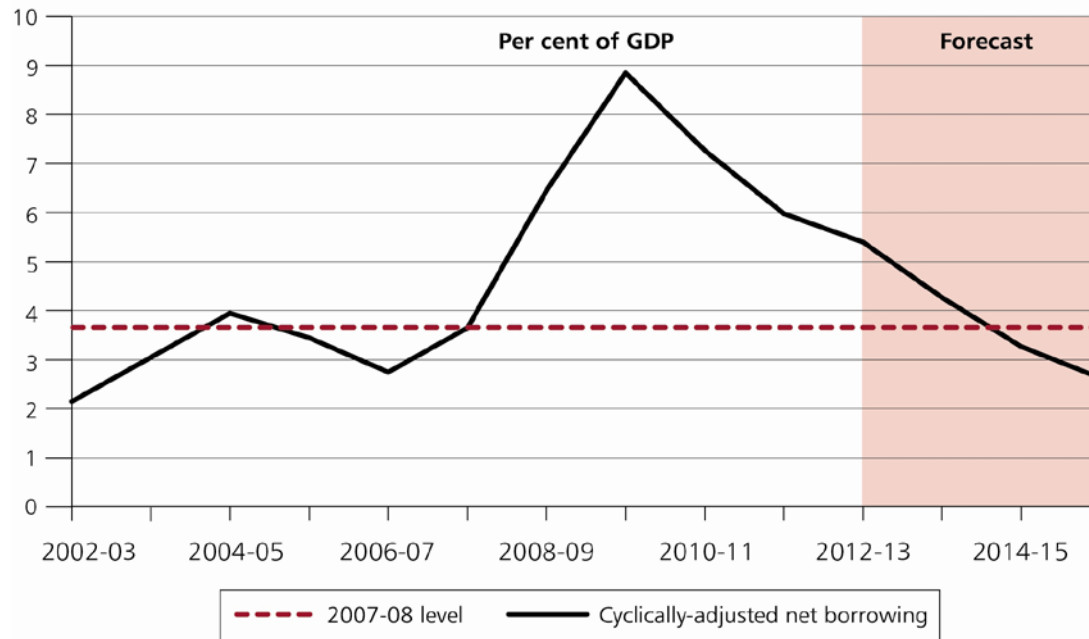
³ General government gross debt on a Maastricht basis.

⁴ Equivalent to the 'Total policy decisions' line in Table 2.1.

Source: Office for Budget Responsibility, Office for National Statistics and HM Treasury.

2.50 The structural position of the public finances remains on a sustainable path. The Government's plans ensure a sustained decline in the structural deficit. Chart 2.10 shows that cyclically-adjusted net borrowing – a measure of the deficit that excludes the effects of the cycle and so illustrates the structural fiscal position – is forecast to fall below the pre-crisis level by the end of this Parliament. Cyclically-adjusted net borrowing falls by an annual average of around 1 per cent of GDP over the forecast period, in line with the structural consolidation set out in Autumn Statement 2012.

Chart 2.10: Cyclically-adjusted net borrowing until the end of this Parliament¹



¹ Cyclically-adjusted net borrowing excluding the effect on public sector net investment in 2012-13 of transferring assets from the Royal Mail Pension Plan to the public sector.
Source: Office for Budget Responsibility, Office for National Statistics and HM Treasury.

The fiscal mandate

2.51 As announced in the June Budget 2010, the Government's fiscal strategy is underpinned by a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. The fiscal mandate guides fiscal policy decisions over the medium term, ensuring that the Government sets plans consistent with a reduction in the structural deficit. The fiscal mandate is based on:

- a cyclically-adjusted aggregate, to allow some fiscal flexibility at times of economic uncertainty and to allow the automatic stabilisers to operate;
- a rolling five-year forecast period, to ensure that fiscal consolidation is delivered over a realistic and credible timeframe; and
- the current balance, to protect the most productive public investment expenditure.

2.52 The Government's fiscal mandate is supplemented by a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16.

Performance against the mandate

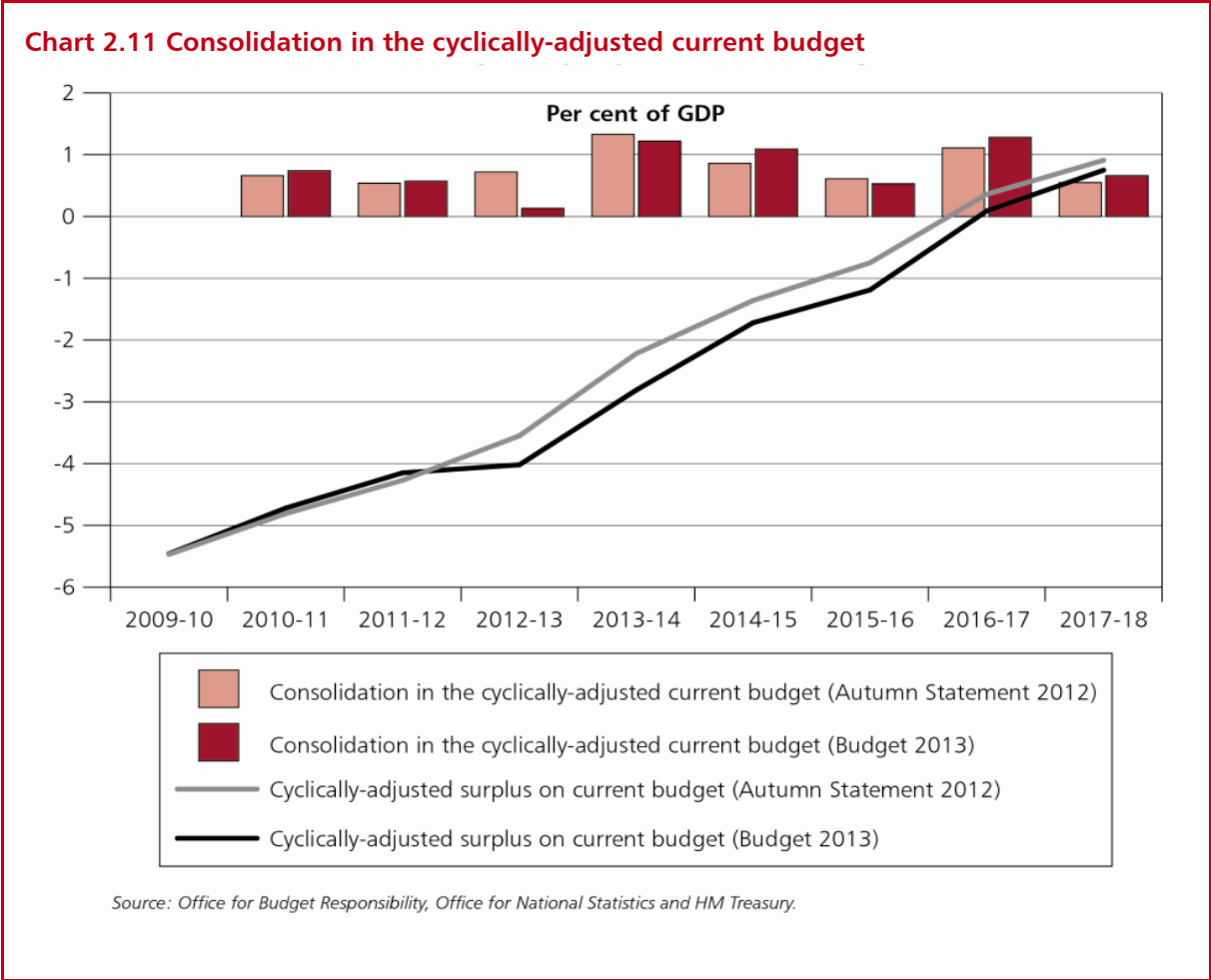
2.53 Including all measures set out in this Budget, the OBR's March 2013 *Economic and fiscal outlook* concludes that the Government remains on course to meet the fiscal mandate. The OBR's judgement is that the Government's policies are consistent with a roughly 70 per cent chance of achieving the fiscal mandate in 2017-18. The OBR's forecast is for the fiscal mandate to be achieved a year early, in 2016-17.

2.54 The OBR has also forecast that public sector net debt as a percentage of GDP will be falling in 2017-18, two years later than set out in the supplementary debt target.

2.55 The Government’s judgement is that significant changes to the path of consolidation in the short term would constrain the operation of the automatic stabilisers, limiting their ability to support the economy. The Government’s response is in line with the recommendations of international organisations. The OECD stated that “the Government’s decision in the December 2012 Autumn Statement to continue with its existing consolidation plans and not override the automatic stabilisers in order to meet the supplementary debt target is appropriate.”²⁷ At this time of rising debt, the Government remains committed to restoring debt to a sustainable, downward path and will retain the existing supplementary debt target.

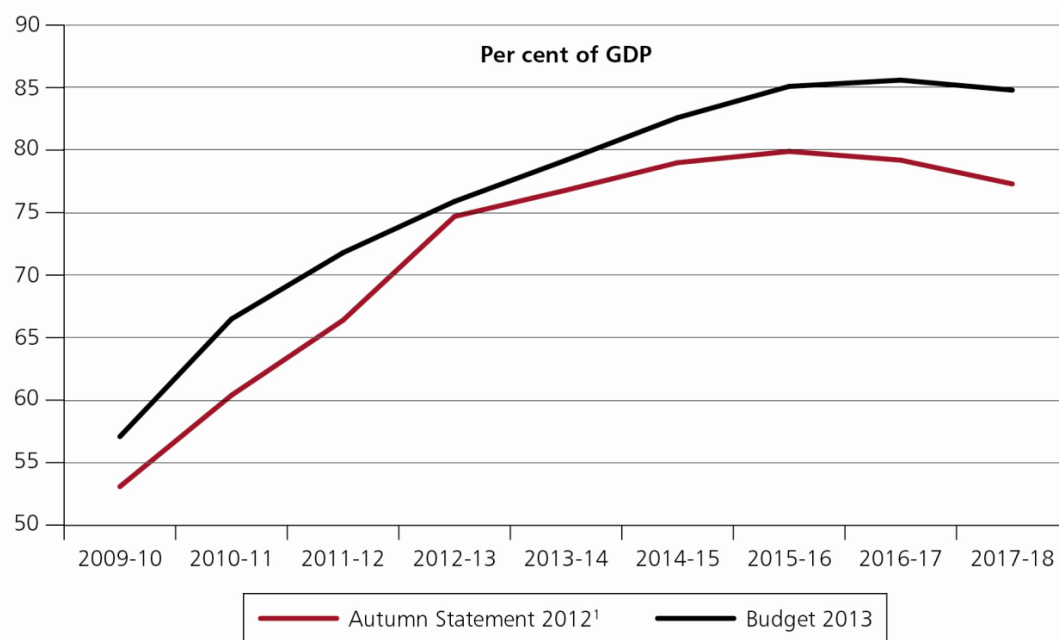
2.56 As set out in the June Budget 2010, once the public finances are closer to balance, the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR’s assessment of the long-term sustainability of the public finances.

2.57 Charts 2.11 and 2.12 show performance against the Government’s fiscal mandate and the supplementary debt target. The cyclically-adjusted current balance in 2017-18 is broadly unchanged from the OBR’s December 2012 forecast.



²⁷ OECD Economic Survey: United Kingdom 2013, OECD, February 2013.

Chart 2.12 Public sector net debt



¹ Autumn Statement 2012 excluded the reclassification of Northern Rock (Asset Management) and Bradford and Bingley plc between 2009-10 and 2011-12.
Source: Office for Budget Responsibility, Office for National Statistics and HM Treasury.

Debt management

2.58 The Government's financing plans for 2013-14 are set out in full in the *Debt and reserves management report 2013-14*, published alongside the Budget. It is anticipated that the net financing requirement of £162.9 billion will be met through gilt issuance of £151.0 billion and an increase of £11.9 billion in the stock of Treasury bills.

2.59 The financing arithmetic provides for £6 billion of sterling financing for the Official Reserves in 2013-14. The Government continues to envisage sterling financing being held at a similar level in 2014-15. This additional financing, announced at Budget 2011, is intended to meet potential calls on the Official Reserves that may arise and ensure that the level of foreign currency reserves held is sufficient.

RPI indexation

2.60 The National Statistician's announcement in January, which confirmed that the Retail Prices Index (RPI) would remain unchanged, stated that a method of calculation used in the RPI would not be chosen were the Office for National Statistics (ONS) to construct a new price index. The Government will keep the use of RPI for indexation purposes under evaluation until after the UK Statistics Authority has concluded reviewing the governance arrangements and structures supporting the production of price indices and how best to ensure that these statistics best meet the needs of users in future. This will allow sufficient time for new ONS price indices, Consumer Prices Index including Housing and Retail Prices Index Jevons, to become established. For gilt investors, their future cash flows on existing index-linked gilts will continue to be calculated by reference to the RPI in accordance with the terms and conditions of those gilts. The Government will continue to issue new index-linked gilts linked to the RPI.

Reform of the financial system

2.61 As set out in February 2013, this is the year that the Government's financial sector reforms will reset the banking system.

2.62 Following the London Inter-Bank Offered Rate (LIBOR) rate-fixing and other recent scandals, the Government intends to reform the culture and ethics of the banking industry to improve the way that banks work for their customers. In summer 2012, the Government proposed the establishment of the Parliamentary Commission on Banking Standards, which completed its pre-legislative scrutiny work on the Draft Financial Services (Banking Reform) Bill in December. The Commission has said it will produce a final report in mid-May, and is expected to produce far reaching proposals to improve professional standards and culture in the banking industry.

2.63 The Government is also undertaking ambitious reform to create a more resilient, stable and competitive banking sector, based on the recommendations of the Independent Commission on Banking (ICB), chaired by Sir John Vickers. The Financial Services (Banking Reform) Bill was introduced into the House of Commons in February 2013 and has had its second reading. The Government will be bringing forward further measures in the Bill, in line with recommendations from the Parliamentary Commission on Banking Standards, to create a powerful new tool for the regulator to ensure the independence of the ring-fence bank. The Government will seek to amend the Bill to include provisions giving the regulator the power to enforce full separation between retail and wholesale banking in a specified group, subject to approval from the Treasury.

2.64 The Government continues to implement its plans to overhaul the tripartite system of financial regulation. The Financial Services Act 2012 came into force on 1 April 2013. It provides the Bank of England with control of macro-prudential regulation, through the FPC, and with the establishment of the Prudential Regulation Authority (PRA) as a subsidiary of the Bank of England, creates a new micro-prudential regulator of deposit-takers, insurers and large investment firms. The new Financial Conduct Authority (FCA) will be responsible for ensuring the markets it regulates function well and in a way that supports consumer protection, market integrity and competition with strong statutory objective.

3

Excessive Deficit Procedure

3.1 The UK entered into Excessive Deficit Procedure (EDP) following a decision by ECOFIN Council in July 2008. In November 2009, the Council made recommendations to the UK, including a target to correct its excessive debt by reducing the Treaty deficit below 3 per cent of GDP by 2014-15. 19 other EU Member States are also currently subject to the Excessive Deficit Procedure.

3.2 The Government remains committed to bringing the UK's Treaty deficit in line with the 3 per cent target set out in the SGP. As Table 3.1 shows, the UK is forecast to meet the EU SGP target for the Treaty deficit in 2017-18.

Table 3.A: OBR fiscal forecast on a Maastricht basis

	Per cent of GDP						
	Outturn		Forecasts				
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Deficit							
Treaty deficit ⁽¹⁾	7.8	5.6	6.8	6.0	5.2	3.5	2.3
Debt							
Treaty debt ratio ⁽²⁾	86.0	90.7	94.9	98.6	100.8	100.8	99.4
⁽¹⁾ General government net borrowing on a Maastricht basis							
⁽²⁾ General government gross debt on a Maastricht basis							
Source: Office for Budget Responsibility							

3.3 As set out in paragraphs 4.13 to 4.17 in Chapter 4, since Budget 2012 the Government has maintained its commitment to deficit reduction and set clear, credible and specific medium-term consolidation plans through:

- additional spending consolidation measures in the near term including a reduction in Resource Departmental Expenditure Limits (RDEL) of £1.1 billion in 2013-14 and £1.2 billion in 2014-15;
- setting a fixed envelope of current spending at £694.2 billion in 2015-16, making savings of £11.5 billion;
- providing permanent savings, additional investment in infrastructure, support for businesses in the short-term and an increase in capital spending plans by £3 billion a year from 2015-16 onwards;
- a fiscal assumption that Total Managed Expenditure (TME) in 2016-17 and 2017-18 will continue to fall at the same rate as over the Spending Review 2010 period, ensuring the public finances return to a sustainable path over the longer term; and
- setting plans to 2020-21 for the most economically valuable areas of capital expenditure.

3.4 Implementation of the fiscal consolidation strategy is well underway and the Government has made significant progress in reversing the unprecedented rise in borrowing between 2007-08 and 2009-10:

- public sector net borrowing is forecast to fall by a third over the three years from 2009-10, from 11.2 per cent of GDP in 2009-10 to 7.4 per cent of GDP in 2012-13);
- cyclically-adjusted general government net borrowing – a measure of the deficit that excludes the effects of the cycle, and so illustrates the structural fiscal position – is forecast by the IMF to fall by 4.3 percentage points of GDP between 2009 and 2012, which is a larger reduction than any other country in the G7;
- TME is planned to be £10.2 billion lower in 2012-13 than forecast at Budget 2012, ensuring the deficit continues to fall; and
- cumulative debt interest payments from 2010-11 to 2015-16 are forecast to be £31 billion lower than expected at the June Budget 2010.¹

3.5 Budget 2013 set out the Government's plan to deliver its objective to lay the foundations for a stronger, more balanced economy. As detailed in Chapters 2 and 4 and in the UK's National Reform Programme 2013, the Government has taken action to promote growth by introducing additional supply-side reforms to invest in infrastructure, support enterprise and industry, as well as create a fair and competitive tax system. The OBR March 2013 forecast shows the UK economy rebalancing over the forecast period to 2017 with business investment providing increased contributions to GDP growth from 2014 onwards and net trade also making small positive contributions from 2013.

3.6 Consistent with its fiscal strategy at Autumn Statement 2012, the Government's judgement is that significant changes to the path of consolidation in the short term would constrain the automatic stabilisers, limiting their ability to support the economy. At this time of rising debt, the Government remains committed to restoring debt to a sustainable, downward path and to taking further action if necessary to protect the economy and maintain financial stability.

¹ Based on net savings in 2014-15.

4

Quality of public finances

The Government's consolidation strategy

4.1 80 per cent of the total consolidation in 2015-16 will be delivered by lower spending. This is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that are focused on spending are more likely to be successful.¹

4.2 As a result of the plans set out in Budget 2013, public spending is projected by the OBR to fall from 47.4 per cent of GDP in 2009-10 to 40.5 per cent of GDP by 2017-18, around the same level as 2004-05 and close to its long-run average. Public sector current receipts are projected to rise from around 36.2 per cent of GDP in 2009-10 to around 38.3 per cent of GDP by 2017-18

4.3 Public spending control is central to the Government's commitment to reduce the deficit. Since 2010 the Government has taken firm action to ensure good financial management in departments.

4.4 The Government is also committed to creating a more competitive tax system that is fair and supports growth. Budget 2013 announced wide-reaching reforms to support the Government's ambition for the UK tax system to be the most competitive in the G20, cutting corporation tax to 20 per cent from April 2015.

Spending consolidation

4.5 At Autumn Statement 2012, the Government announced a further £6.6 billion of savings in the Spending Review 2010 period (2011-12 to 2014-15) from welfare, Official Development Assistance and departmental current spending. This package will fund £5.5 billion of additional infrastructure investment as well as provide further support for businesses. The Government also confirmed its fiscal assumption that Total Managed Expenditure (TME) in 2015-16, 2016-17 and 2017-18 will continue to fall at the same rate as in the Spending Review 2010 period.

4.6 Budget 2013 reinforced the Government's commitment to deficit reduction, announcing a reduction in resource Departmental Expenditure Limits (DEL) of £1.1 billion in 2013-14 and £1.2 billion in 2014-15. This follows faster progress in delivering savings, combined with improvements to spending control, which have resulted in departmental underspends in 2012-13 being higher than usual at £11.5 billion. These savings will be used to help support housing in the short term and contribute to the overall savings required from current spending in 2015-16.

4.7 Budget 2013 fixed the envelope for TME for 2015-16 and confirmed that individual departmental budgets will be published in a Spending Round on 26 June 2013. The Government also announced at Budget 2013 that it will strengthen the public spending framework by introducing a firm limit on a significant proportion of Annually Managed

¹ See *Economic Outlook*, OECD, June 2007; *OECD Economic Survey: United Kingdom 2011*, OECD, March 2011; and *UK Article IV consultation*, IMF, May 2009.

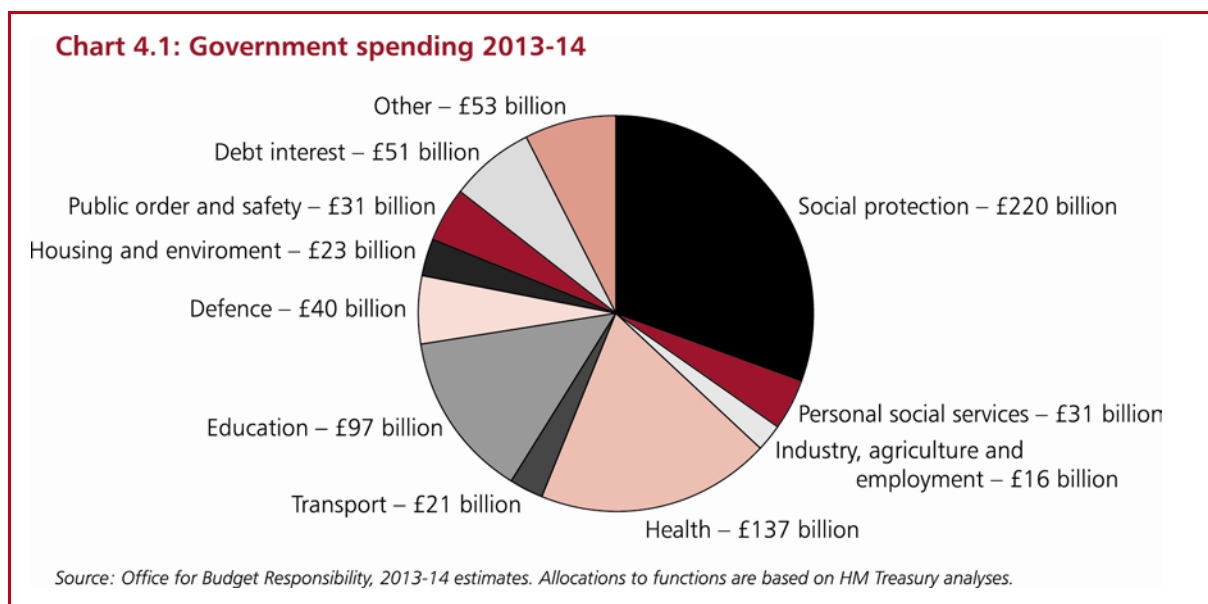
Expenditure (AME), including areas of welfare expenditure. This will be designed in a way that allows the automatic stabilisers to operate to support the economy.

Composition, efficiency and effectiveness of expenditure

4.8 Spending Review 2010 set firm and fixed departmental budgets for four years from 2011-12 to 2014-15, as well as announcing reforms to AME, including welfare and public service pensions. The Government protected spending on health, schools and overseas aid and also made choices to: prioritise fairness and social mobility; focus on spending that promotes long-term economic growth; and reform public services, shifting power away from central government to the local level and improving value for money.

4.9 As a result of the plans set out in Budget 2013, public spending is projected by the Office for Budget Responsibility (OBR) to fall from 47.4 per cent of GDP in 2009-10 to 40.5 per cent of GDP by 2017-18, around the same level as 2004-05 and close to its long-run average. 80 per cent of the total consolidation in 2015-16 will be delivered by lower spending. This is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that are focused on spending are more likely to be successful.²

4.10 Chart 4.1 presents public spending by main function. TME in 2013-14 is expected to be around £720 billion. TME is divided into DEL and AME.



Implementation of spending control

4.11 Since 2010, the Government has taken firm action to ensure good financial management in departments and to improve spending control by:

- delivering £6.2 billion of in-year efficiency savings in 2010-11;
- establishing the Cabinet Office Efficiency and Reform Group in 2010 and introducing tighter spending controls over areas of corporate spending including procurement, property and information communications technology;
- taking a zero-based approach to capital spending at Spending Review 2010 to prioritise those projects with the highest economic value; and

² See Economic Outlook, OECD, June 2007; OECD Economic Survey: United Kingdom 2011, OECD, March 2011; and UK Article IV Consultation, IMF, May 2009.

- tightening in-year spending control by departments, including through the guidance published in *Improving Spending Control*.

4.12 Building on this, Autumn Statement 2012 announced additional permanent savings from departmental current spending of £4 billion over 2013-14 and 2014-15 and savings from current welfare spending of £2.6 billion. These savings will fund £5.5 billion of additional investment in infrastructure and support for businesses.

4.13 As set out at Budget 2013, action to improve financial management and spending control has continued this year, with a strengthened cross-government effort to scrutinise end-of-year spending and ensure that value-for-money criteria around departmental spending are upheld.

4.14 Over the last three years departments have under-spent against plans by an average of £4.0 billion across total DEL. This has been spread across a number of departments. Faster progress in delivering savings, combined with the improvements to spending control set out above, mean that departmental under-spends in 2012-13 are higher than usual. Departments are collectively expected to spend £11.5 billion less in total DEL in 2012-13 than in the plans at Budget 2012.

4.15 Departments are ahead of their consolidation targets. By the end of 2012-13 around 65 per cent of the £80 billion of spending reductions planned by 2014-15 will have been delivered. To reflect this, and in line with the Government's commitment to ensuring that borrowing continues to fall, Budget 2013 announced a reduction in resource DEL by £1.1 billion in 2013-14 and £1.2 billion in 2014-15. This is equivalent to a 1 per cent reduction for most departments. The budget of the Department for International Development will also be reduced by £135 million in 2013-14 and £165 million in 2014-15 to reflect the downward revisions to nominal Gross National Income set out in the OBR forecast. These savings will be used to help support housing in the short term and contribute to the overall savings required from current spending in 2015-16.

2015-16 Spending Round

4.16 Budget 2013 set out the next steps in the UK's fiscal consolidation by fixing an envelope for TME for 2015-16. The Government has set this envelope in line with the assumption that total spending will continue to fall in 2015-16 at the same rate as over the Spending Review 2010 period. The Government will make savings from current spending of £11.5 billion in 2015-16. The envelope for current spending in 2015-16 is therefore set at £694.2 billion. Individual departmental budgets will be published in the 2015-16 Spending Round to be announced on 26 June 2013. Health, schools and Official Development Assistance (ODA) will be protected.

4.17 As a result of these savings, Budget 2013 announced that the Government will increase capital spending plans by £3 billion a year from 2015-16 onwards, maintaining the temporary increases to capital announced at Autumn Statement 2011 and Autumn Statement 2012. The capital envelope for 2015-16 will be £50.4 billion. The Government will take a long-term approach to capital as part of the 2015-16 Spending Round, setting plans out to 2020-21 for the most economically valuable areas of capital expenditure.

4.18 Public sector pay restraint has been a key part of the fiscal consolidation. Budget 2013 announced that public sector pay awards in 2015-16 will be limited to an average of up to 1 per cent. In addition, the Government will seek significant further savings through reforms to progression pay in the Spending Round, with the exclusion of the Armed Forces.

4.19 The Government's themes for the 2015-16 Spending Round will be growth, efficiency and public service reform, including localism and fairness. The increase to capital spending plans and long-term approach to capital planning set out above will strengthen UK infrastructure and support growth in the economy. The Spending Round will require a continued focus on

delivering higher-quality services and better outcomes at lower cost. This will be achieved both through further operational efficiencies in central government and the wider public sector, and ongoing reform of public services – including strengthened joint working at a local level and across services. The Government is committed to ensuring that decisions on public spending are as transparent, accountable and fair as possible, and will again publish analysis of the distributional impact of the Spending Round.

4.20 The 2015-16 Spending Round will extend the Government's efficiency programme into 2015-16. Departments saved £5.5 billion in 2011-12 through efficiencies and reducing wasteful expenditure and are expected to deliver comparable additional efficiency savings in each of the succeeding years including 2015-16. Moving transactional services online will save £1.2 billion in this Parliament and the Government's programme for improving back-office shared services across departments and Arm's Length Bodies will deliver savings of around £250 million in 2015-16. Further savings will come from the review of projects announced at the Autumn Statement 2012, further centralisation of the procurement of common goods and services, and reducing the cost of information technology.

Spending beyond 2015-16

4.21 In line with previous policy, Budget 2013 restated the Government's fiscal assumption that TME in 2016-17 and 2017-18 will continue to fall in real terms at the same rate as over the Spending Review 2010 period.³

³ The Government's fiscal assumption excludes the effect of measures announced at Budget 2013 and Autumn Statement 2012, all capital measures announced at Autumn Statement 2011, and the OBR's underspends forecast.

Table 4.1: Total Managed Expenditure¹

	£ billion					
	2012-13 ²	2013-14	2014-15	Forecasts		
				2015-16	2016-17	2017-18
CURRENT EXPENDITURE						
Resource AME	317.4	334.1	345.1	362.3	378.5	396.1
Resource DEL excluding depreciation	317.6	320.7	315.7			
Ring-fenced depreciation	22.2	18.1	19.3			
<i>Implied Resource DEL, including depreciation</i>				331.9	325.1	316.9
Public sector current expenditure	657.2	672.9	680.0	694.2	703.7	713.0
CAPITAL EXPENDITURE						
Capital AME ²	-20.0	5.0	5.5	6.3	8.6	9.2
Capital DEL	36.1	42.2	44.9			
<i>Implied Capital DEL³</i>				44.2	42.7	42.9
Public sector gross investment	16.1	47.2	50.4	50.4	51.3	52.1
Total Managed Expenditure	673.3	720.0	730.4	744.7	754.9	765.1
<i>Total Managed Expenditure (% GDP)</i>	<i>43.6%²</i>	<i>45.2%</i>	<i>44.0%</i>	<i>43.1%</i>	<i>41.8%</i>	<i>40.5%</i>
Envelope for 2015-16 Spending Round				744.7		
<i>of which</i>						
Current spending envelope				694.2		
Capital spending envelope				50.4		
<i>Memo: TME baseline for years beyond 2014-15⁴</i>			735.9	744.7	754.9	765.1
<i>Average annual real growth SR10 period</i>			-0.4%	<i>Beyond SR10 period: -0.4%</i>		

Reform of the spending framework

4.22 AME typically consists of large, demand-led programmes. It accounts for around half (some £350 billion) of total public expenditure, the largest component of which is welfare spending, but is not subject to fixed spending controls.

4.23 The Government has already taken action to manage AME spending pressures, including through the delivery of significant welfare reforms. As a result, working-age welfare expenditure is projected to fall in real terms over the current spending review period.

4.24 Budget 2013 announced that the Government will strengthen the spending framework by introducing a firm limit on a significant proportion of AME, including areas of welfare expenditure. This will enable the Government to manage increases in spending and make trade-offs across different areas of expenditure, ensuring that limited resources are directed toward public spending priorities. The limit will be designed in a way that allows the automatic stabilisers to operate to support the economy.

4.25 As set out in Autumn Statement 2012, the Government is also developing a framework for managing liabilities that do not appear in the fiscal aggregates and a control total for the commitments arising from off-balance sheet Private Finance Two (PF2) contracts signed. The Government will provide further details in the 2015-16 Spending Round.

A competitive tax system

4.26 The Government's *Corporate Tax Roadmap*, published in 2010, set out major reforms to the tax system designed to support UK businesses and ensure the UK is an attractive location for foreign investment.

4.27 At the heart of the reform package was a commitment to reduce the main rate of corporation tax. So far the Government has cut the main rate from 28 per cent to 24 per cent, and announced further reductions to come, to 23 per cent from April 2013 and 21 per cent from April 2014.

4.28 At Budget 2013 the Government announced it will go further, and will reduce the main rate of corporation tax by an additional 1 percentage point in April 2015, so it will reach 20 per cent. In the process, the Government will unify the small profits rate and the main rate so there is a single rate of corporation tax, simplifying the tax system. This means that by the end of this Parliament the UK will have the joint lowest rate of corporation tax in the G20

4.29 Research and development (R&D) incentives recognise the importance of business investment in new ideas and technologies and form a key part of the Government's commitment to an internationally competitive tax system. As announced at Autumn Statement 2011, the Government will introduce a new 'above the line' (ATL) credit for large company R&D investment from April 2013. The ATL credit is designed to make R&D relief more visible to those making investment decisions and provide greater cash flow support to companies with no corporation tax liability.

4.30 The headline rate of the ATL credit will be 10 per cent, increased from the 9.1 per cent rate proposed at Budget 2012. This will make the UK a more attractive location for large company R&D activity by further reducing the after tax cost of investment.

Support for enterprise

4.31 The Government's ambition is for the UK to be the best place in Europe to start, finance and grow a business. Small businesses report that costs of employment are one of the biggest barriers to success they face. Budget 2013 announces that from April 2014 every business and charity will be entitled to a £2,000 Employment Allowance towards their employer NICs bill.

4.32 In addition, the Seed Enterprise Investment Scheme, launched at Budget 2012, offers 50 per cent income tax relief on investments made into small, early-stage companies. The Government has decided to provide a limited extension of the capital gains tax holiday to continue to encourage investors to take up the new scheme. Any investors making capital gains in 2013-14 will receive a 50 per cent capital gains tax relief when they reinvest those gains into seed companies in either 2013-14 or 2014-15.

4.33 Long-term economic success depends on today's small and high growth companies being able to access affordable long term financing to grow into the large businesses of tomorrow. On 13 March 2013 the Government launched a consultation on extending Individual Savings Account (ISA) eligibility to include a wider range of small company shares. To further support these companies, the Government will abolish Stamp Tax on Shares for companies listed on growth markets including the Alternative Investment Market (AIM) and the ISDX Growth Market, from April 2014. This will directly benefit hundreds of smaller quoted UK firms, lowering their cost of capital, helping to promote jobs and growth across the UK.

4.34 Social enterprises play an important role in growing the economy, reforming public services and promoting social justice. The Government will introduce a new tax relief to encourage private investment in social enterprise.

4.35 The Government will abolish the Percentage Threshold Scheme and recycle funding into creating the health and work assessment and advisory service for those at danger of long-term sickness absence. The Government will also introduce a targeted tax relief so that amounts up to a cap of £500 paid by employers on health-related interventions recommended by the service are not treated as a taxable benefit in kind. The Government will consult on implementation later in 2013.

Supporting households through the tax system

4.36 The Government is committed to promoting aspiration, rewarding work and supporting households' standard of living. Budget 2013 announces policies that cut income tax for those on low and middle incomes, and reduce pressures on the cost of living. In total, Budget 2013 provides an additional £7 billion of support for households over the forecast period.

4.37 In May 2010, the Coalition Agreement set out the Government's commitment to make the first £10,000 of income free from income tax. The ambition was to reach this level by the end of the Parliament. Budget 2013 announces that this commitment will be met a year ahead of schedule: the personal allowance will be increased by £560 to £10,000 in 2014-15. Meeting the commitment earlier will benefit an estimated 24.5 million individuals in 2014-15. The Government believes this is the most effective way to support those on low and middle incomes, because it enables people to keep more of the money they earn. Reducing the amount of income tax that people pay also rewards those who want to work hard and progress.

4.38 In 2010, the personal allowance was just £6,475, but successive above-inflation increases totalling £3,525 will mean that it has risen by more than 50 per cent in just four years.

4.39 The Government has taken extensive action to support households and businesses with the high cost of fuel by abolishing the fuel duty escalator, cutting fuel duty and introducing the fair fuel stabiliser.

4.40 Nevertheless, in recognition of the impact that persistently high pump prices have on the cost of living, Budget 2013 announces that the 1.89 pence per litre fuel duty increase that was planned for 1 September 2013 will be cancelled. This means that fuel duty will have been frozen for nearly three and half years, the longest duty freeze for over 20 years.

4.41 The Government is committed to supporting communities as well as individual households. Budget 2013 announces that general beer duty will be reduced by 2 per cent from 25 March 2013. The Government will then cancel the escalator for beer duty next year and instead increase it by inflation thereafter.

Tackling tax evasion and avoidance

4.42 The vast majority of individuals and businesses pay their fair share of tax. Budget 2013 takes action against those who do not by announcing a significant crackdown on offshore tax evasion, tax avoidance and aggressive tax planning in four key areas:

- offshore tax evasion;
- avoidance of employment taxes;
- tax avoidance schemes; and
- corporation tax.

4.43 Collectively, these announcements will raise over £4.6 billion in new revenue over the next five years and protect against the loss of billions of pounds of revenue.

5

Institutional features of public finances

The fiscal policy framework

5.1 June Budget 2010 set out comprehensive policies to restore sustainable public finances. This involved substantial fiscal framework reform, entailing:

- the creation of the new Office for Budget Responsibility (OBR), introducing independence, greater transparency and credibility to the economic and fiscal forecasts on which the Government's fiscal policy is based; and
- the announcement of a clear, forward-looking fiscal mandate to guide fiscal policy decisions over the medium-term, as well as a supplementary target for debt.

Office for Budget Responsibility

5.2 The Government's fiscal policy decisions are based on the independent forecasts of the economy and public finances, prepared by the OBR. Since May 2010 the OBR has produced all the official forecasts of the economy and public finances, independently of Ministers.

5.3 The Government established the OBR on an interim basis on 17 May 2010. Since then the OBR has been placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011 (the Act), which received Royal Assent on 22 March 2011.

5.4 The OBR is comprised of the Chair of the OBR and two other members of the Budget Responsibility Committee (BRC), and at least two non-executive members. It is supported by a civil service staff.

5.5 The three BRC members – Mr Robert Chote (Chair of the OBR), Professor Stephen Nickell and Mr Graham Parker – were appointed by the Chancellor in October 2010, with the approval of the Treasury Select Committee. The non-executive members – Lord Burns and Ms Kate Barker – were appointed by the Chancellor in June 2011.

Remit of the OBR

5.6 The main duty of the OBR is to examine and report on the sustainability of the public finances. This duty feeds directly into the Treasury's fiscal objective to deliver sound and sustainable public finances.

5.7 As set out in the Act, the OBR's responsibilities include:

- the production of at least two fiscal and economic forecasts each financial year, including independent scrutiny of the impact of policy measures and any resultant impact on the forecasts;
- an assessment of the extent to which the fiscal mandate has been, and is likely to be, achieved alongside these forecasts;
- an assessment on the accuracy of the previous fiscal and economic forecasts at least once each financial year; and

- an analysis of the sustainability of the public finances at least once each financial year.

5.8 This remit provides for the OBR to investigate the impact of trends and policies on the public finances from a multitude of angles including through forecasting, long term projections and balance sheet analysis. The OBR must perform its duty objectively, transparently and impartially and on the basis of Government policy. This protects the independence of the OBR and ensures a clear separation between analysis (which is the role of the OBR) and policy making (which is the responsibility of ministers). The OBR has complete discretion in the performance of its duty, subject to its statutory obligations.

Transparent framework

5.9 Transparency in the responsibilities of the OBR and the rest of Government to ensure the credibility of the fiscal framework and protect the independence of the OBR is vital. There are a number of documents that support and clarify the provisions in the Act.

5.10 The Charter for Budget Responsibility provides guidance to the OBR in line with, and in support of, the provisions in the Act. This guidance helps to explain the role of the OBR within the fiscal framework and provide greater clarity as to the OBR's duty to independently examine and report on the sustainability of the public finances.

5.11 For the OBR to perform its duties accurately and efficiently, close working with the rest of Government will be essential. A Memorandum of Understanding establishes a transparent framework for cooperation between the OBR and the Treasury, as well as other parts of Government that the OBR will need to work closely with to perform its forecasting and analytical duties.

5.12 The OBR is accountable to Parliament and the Chancellor for the analysis it produces and the way it uses public funds. A framework document sets out the broad governance and management framework within which the OBR will operate.

Fiscal objectives and the fiscal mandate

5.13 The Act introduced a requirement for the Government to set out its fiscal policy objectives in the Charter for Budget Responsibility, which must be approved by the House of Commons. The Government published the final version of the Charter on 4 April 2011.

5.14 The Government's fiscal policy objectives, presented in the Charter, are to:

- ensure sustainable public finances that support confidence in the economy, promote intergenerational fairness, and ensure the effectiveness of wider Government policy; and
- support and improve the effectiveness of monetary policy in stabilising economic fluctuations.

5.15 The Government sets the fiscal mandate as a means to achieving its fiscal objectives. As announced in the June Budget 2010, the Government has set a forward-looking fiscal mandate to achieve cyclically adjusted current balance by the end of the rolling, five-year forecast period. At Budget 2013, the end of the forecast period was 2017–18.

5.16 The fiscal mandate is based on:

- the current balance, to protect the most productive public investment expenditure;
- a cyclically-adjusted aggregate, to allow some fiscal flexibility at times of economic uncertainty; and

- a rolling five year forecast period, ensuring that fiscal consolidation is delivered over a realistic and credible timetable.

5.17 The fiscal mandate is supported by a supplementary target for debt that requires public sector net debt as a percentage of GDP to be falling at a fixed date of 2015–16. As set out in the June Budget 2010, once the public finances are closer to balance, the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

Reform of the spending framework

5.18 It is important that the Government can manage increases in spending and make trade-offs across different areas of expenditure, ensuring that limited resources are directed toward public spending priorities. To deliver this, a more robust public spending framework is required. Budget 2013 announces that the Government will strengthen the spending framework by introducing a firm limit on a significant proportion of AME, including areas of welfare expenditure. Further detail is set out in Chapter 4.

5.19 As set out in Autumn Statement 2012, the Government is also developing a framework for managing liabilities that do not appear in the fiscal aggregates and a control total for the commitments arising from off-balance sheet Private Finance Two (PF2) contracts signed. The Government will provide further details in the 2015-16 Spending Round.

Accounting and statistics

5.20 The independent Office for National Statistics and HM Treasury compile monthly statistics for the public sector and sub-sectors, on both a cash and accrued basis. Reconciliation tables between these are produced. The production is guided by the UK's code of practice which is consistent with the United Nations Fundamental Principles of Official Statistics and the European Statistics Code of Practice.

5.21 Information on the UK's contingent liabilities is published for all Central Government departments. The publication of the first audited Whole of Government Accounts (WGA), based on International Financial Reporting Standards, extends the coverage across Government for the year ending 31 March 2010.

5.22 WGA are full accruals based accounts covering the whole public sector and audited by the National Audit Office. WGA is a consolidation of the accounts of around 1,500 organisations across the public sector, including central government departments, local authorities, devolved administrations, the health service, and public corporations.

6 Economic outlook

Introduction

6.1 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.2);
- discusses how quickly economic activity is likely to return to potential (from paragraph 3.17), how monetary policy and credit conditions are assumed to affect this, (from paragraph 3.32) and how the composition of growth is likely to evolve (from paragraph 3.48);
- assesses prospects for inflation (from paragraph 3.87) and the labour market (from paragraph 3.106); and
- compares our central forecast to selected external forecasts (from paragraph 3.117).

Potential output and the output gap

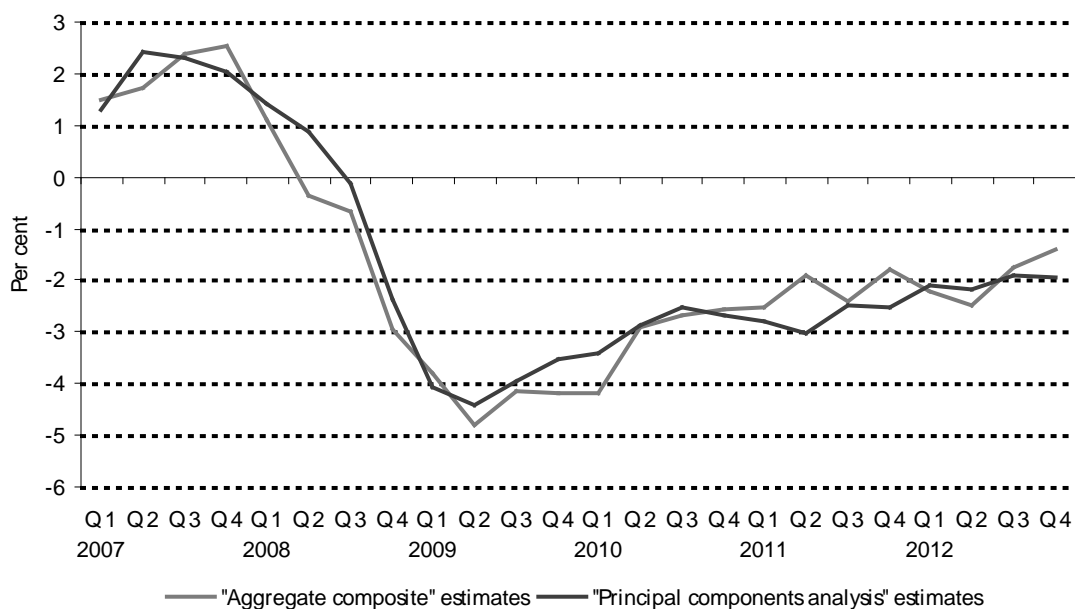
6.2 The amount of spare capacity in the economy (the 'output gap') and the growth rate of potential output are key judgements in our forecast. Together, they determine the scope for actual growth as activity returns to a level consistent with maintaining stable inflation in the long term. The size of the output gap also determines how much of the budget deficit at any given time is cyclical and how much is structural. In other words, how much will disappear automatically, as the recovery boosts revenues and reduces spending, and how much will be left when economic activity has returned to its full potential. The narrower the output gap, the larger the proportion of the deficit that is structural, and the less margin the Government will have against its fiscal mandate, which is set in structural terms.

6.3 In this section we first consider how far below potential the economy is currently operating. We then consider how quickly potential output has grown in the recent past and the speed at which it is likely to grow in the future.

Latest estimates of the output gap

- 6.4 The first step in the forecast process is to assess how the current level of activity in the economy compares with the potential level consistent with stable inflation in the long term. We cannot measure the supply potential of the economy directly, but various techniques can be used to estimate it indirectly.
- 6.5 We use cyclical indicators to help us judge the amount of spare capacity in the economy, as well as looking at estimates derived from other methodological approaches. To estimate the output gap from cyclical indicators, we use two approaches: 'aggregate composite' estimates, which weight together business survey indicators; and 'principal components analysis', which combine survey and non-survey based indicators.¹ The latest cyclical indicator estimates point towards a flat or a narrowing output gap in the final quarter of 2012 since the third quarter, suggesting a fall in potential output (Chart 3.1).

Chart 6.1: Estimates of the output gap based on cyclical indicators

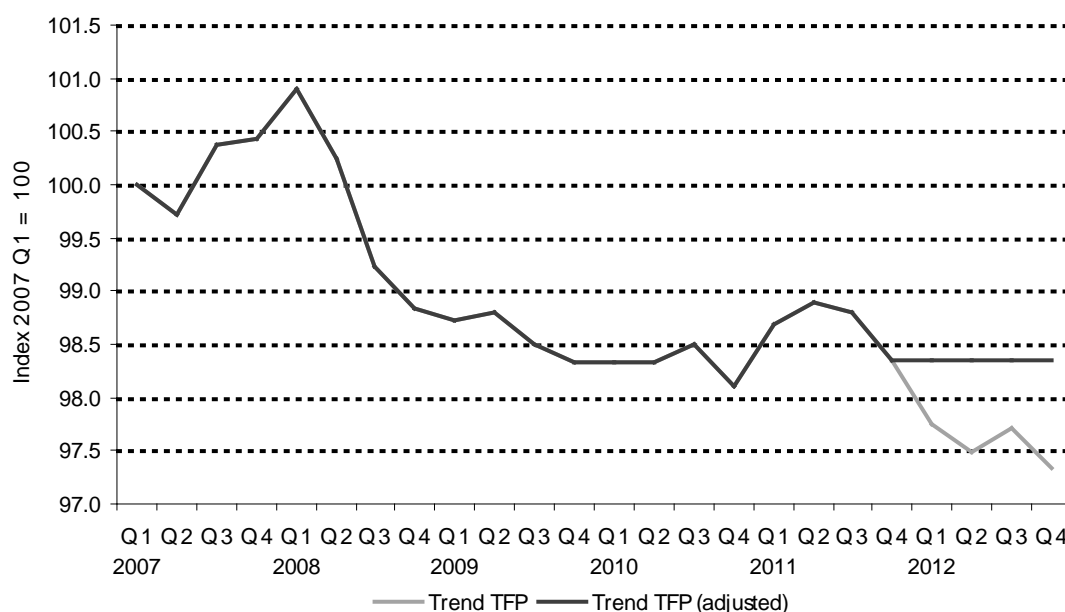


¹ More details are set out in OBR, 2011, Briefing Paper No.2: *Estimating the output gap*, April; and Pybus, T, 2011, Working Paper No.1: *Estimating the UK's historical output gap*, November.

6.6 As in our December *Economic and fiscal outlook (EFO)* we have used our assessment of trend labour input and the capital stock in a production function framework to analyse what these estimates of the output gap, and therefore potential output, imply for trend total factor productivity (TFP) – the efficiency with which different inputs could be combined to produce a unit of output. Further information on the production function framework can be found in Box 3.1 in our December 2012 *EFO*.

6.7 As shown on Chart 3.2, using this production function the cyclical indicators imply a sharp fall in trend TFP through 2012, which would imply that the economy has become noticeably less efficient in its ability to combine inputs to produce a unit of output. Given likely movements in the capital stock, this also implies a fall in trend labour productivity. A sustained fall in trend TFP and trend labour productivity seemed plausible during 2008-09, given the severity of the financial crisis at that time, its impact on output from the financial sector, and the consequences for capital allocation in the rest of the economy. In recent quarters, however, the financial system has not been under anything like the same strain (although it remains impaired). As a result, we believe that it is unlikely that trend TFP would have fallen sharply over this period.

Chart 6.2: Implied trend TFP from cyclical indicators approach



Source: OBR

6.8 Consequently, and in line with the approach we took in December, we have adjusted the output gap estimate derived from the cyclical indicators approach so that it is consistent with flat rather than falling

trend TFP from the first quarter of 2012. Using the production function approach, this suggests an output gap of -2.7 per cent in the first quarter, -3.2 per cent in the second, -2.4 per cent in the third and -2.7 per cent in the final quarter. Overall the output gap is estimated to have been -2.7 per cent in 2012.

6.9 Estimates of potential output and the output gap are particularly uncertain at present because of the ongoing 'productivity puzzle'. Output per hour and output per worker were 12 per cent and 13 per cent below their pre crisis levels in the fourth quarter of 2012, respectively, measured as non-oil GVA.² In December we set out various possible explanations for very weak productivity seen in the UK economy since the 2008-09 recession, some of which imply a permanent hit to productivity and potential and some of which imply a temporary hit. Recent research in this area includes the following:

- A recent ONS paper³ attempts to find evidence to explain the productivity puzzle using firm-level data. The authors find the dispersion of productivity across firms in 2008 and 2009 has increased, with high productivity firms becoming more productive and low productivity firms less so, and in some cases experiencing negative productivity. This gives some support to the view that there has been an increase in the degree of misallocation of capital in the economy. The widening distribution suggests that some firms continue to operate despite low or even negative returns, potentially hindering capital flow to firms with higher returns.
- A Bank of England working paper⁴ from January this year looks at the long and short-term effects of financial crises on labour productivity, capital and output. The findings support the view that credit rationing and impaired financial markets can negatively affect productivity. Banking crises on average are found to reduce the short-run growth rate of labour productivity by between 0.6 and 0.7 percentage points per year and permanently reduce the level of productivity by around 1 per cent for each year of the crisis.

² We estimate the pre-crisis trend as the average growth rate, per quarter, from the first quarter of 2003 to the first quarter of 2008.

³ ONS, 2013, *Micro-data perspective on the UK productivity conundrum*, January.

⁴ Oulton and Sebastia-Barriol, 2013, *Long and short-term effects of the financial crisis on labour productivity, capital and output*, Bank of England Working Paper No. 470, January.

- A paper by Goodridge et.al.,⁵ published in February, investigates whether the exclusion of investment in intangibles from GDP might explain the slowdown in measured productivity. The authors argue that real output growth was probably underestimated in 2009-2011, but overstated in most of the 2000s, as a result of this omission. They believe this measurement error explains only a small part of the puzzle from the start of 2011.

6.10 In estimating potential output we continue to assume that a significant part of the shortfall in productivity is structural. Compared to our December forecast, the level of potential output is around 0.4 per cent lower from the final quarter of 2012. This reflects the fact that the output gap appears to have been narrower in the fourth quarter than we expected in December, as well as revisions to the trend employment rate and capital input. The impact is partly offset by an upward revision to the level of real non-oil GVA.⁶

6.11 Any sensible forecaster will recognise that there is considerable uncertainty around any central estimate of the output gap. Charts 3.3 and 3.4 compare our central output gap forecasts for 2012 and 2013 to those produced by other forecasters, including those set out in the Treasury's March *Comparison of Independent Forecasts* and estimates produced by NIESR, the European Commission and OECD. The average estimate is -2.9 per cent in 2012, slightly wider than our central estimate, and -3.1 per cent in 2013, somewhat narrower than our central estimate. In Chapter 5 we test the sensitivity of our judgements regarding the Government's performance against its fiscal targets to different estimates of the size of the output gap.

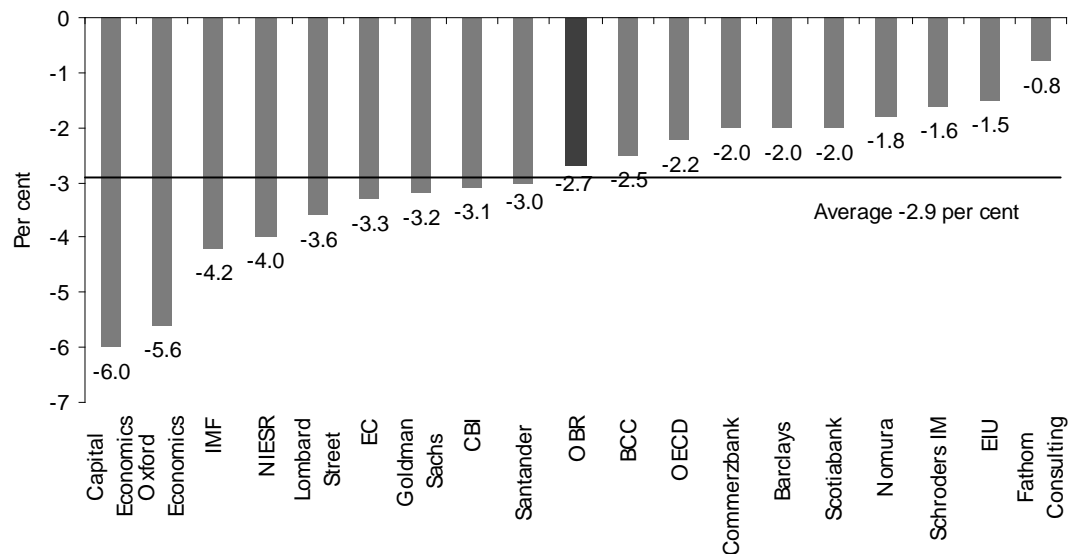
6.12 Of the -2.7 per cent output gap we estimate for the fourth quarter of 2012, we attribute 2.3 percentage points to the employment rate lying below its potential level (consistent with a variety of indicators pointing to slack in the labour market) and 1.5 percentage points to output-per-hour lying below potential (i.e. cyclical weakness in productivity). These are

⁵ Goodridge et.al., 2013, *Can Intangible Investment Explain the UK Productivity Puzzle?*, February.

⁶ If we used the same principal components approach as in the March 2012 *EFO* our estimate of the output gap in 2012 would now be 2.0 per cent. Other things being equal, this would imply lower potential output and a higher structural deficit. But, at the same time as adjusting the principal components approach to assume flat trend TFP in December 2012, we assumed a weaker profile for potential GDP growth over the medium term. The two judgements taken together mean that potential output is forecast to be 0.2 per cent lower than would otherwise be the case at the end of the forecast horizon. This increases the size of the structural deficit and makes the Government's fiscal mandate marginally harder to achieve.

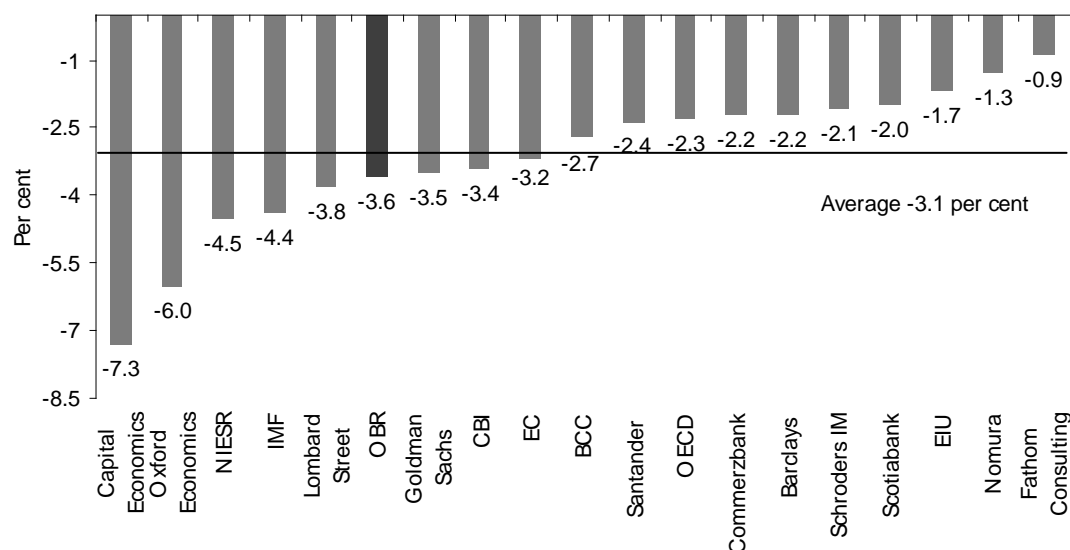
offset by 1.2 percentage points from average hours lying above their trend level, perhaps reflecting the impact of unexpectedly weak income growth and negative wealth shocks for many households temporarily increasing labour market participation.

Chart 6.3: Estimates of the output gap in 2012



Source: HM Treasury, 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, March, plus additions or updates where known. Goldman Sachs estimate refers to the fiscal year 2011-12.

Chart 6.4: Estimates of the output gap in 2013



Source: HM Treasury, 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, March, plus additions or updates where known. Goldman Sachs estimate refers to fiscal year 2012-13.

The growth of potential output

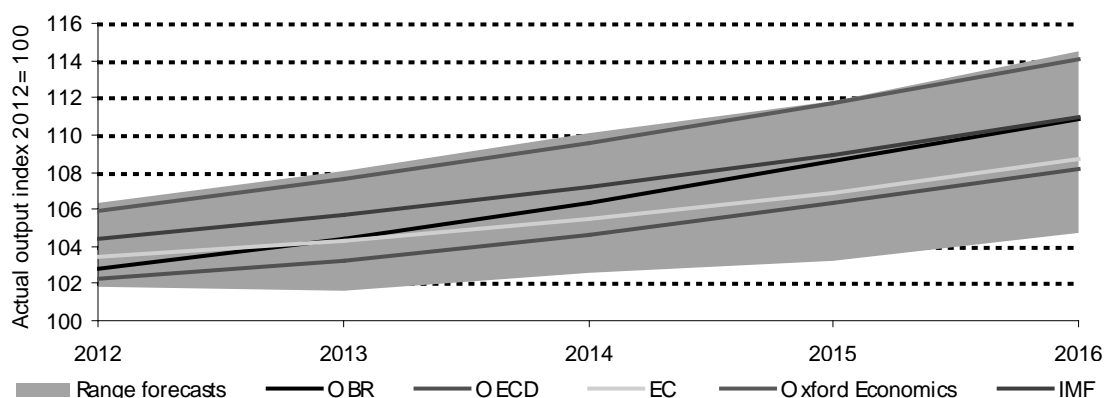
- 6.13 We assume a similar medium-term path for potential output growth as in our December forecast. Potential output growth remains below its long-run rate at the end of the forecast horizon, consistent with financial and credit markets taking time to normalise and downward pressure on potential GDP while the output gap remains negative. As discussed in the credit conditions section, financial markets have strengthened since December and bank funding conditions have continued to improve, helped by the period of relative calm in the euro area and the impact of the Funding for Lending Scheme (FLS). But there is limited evidence that this is yet feeding through to increased lending to the real economy.
- 6.14 Taken together, revisions to non-oil GVA, investment and trend labour input as well as our revision to trend TFP growth in the fourth quarter of 2012 have prompted a small downward revision to potential output growth in 2012 and 2013.⁷ Potential output is now forecast to have grown

⁷ We have also updated our methodology for estimating the trend activity and employment rate in the economy since December. We now use a simple Hodrick–Prescott (HP) filter to estimate the trend level up to the latest data point. We forecast the trend rate going forward using the cohort model. For further information on the cohort model see our June 2010 *Pre-Budget forecast* page 77.

by 0.4 per cent in 2012 and is assumed to recover gradually to 2.2 per cent growth in 2016.

- 6.15 Our projections for population growth are based on average inward net migration of 140,000 per annum, in line with the long-term assumption underpinning the ONS's low migration variant population projections. We continue to assume that the long-term non-accelerating inflation rate of unemployment (NAIRU) is 5.4 per cent.⁸
- 6.16 Chart 3.5 compares our forecast for the level of potential output with other forecasters. Our forecast for potential output in 2016 is higher than that of the OECD and European Commission, similar to that of the IMF but lower than that of Oxford Economics. Our estimate is within a wide range of outside estimates.

Chart 6.5: Potential output comparison with other forecasters¹



¹ The range of forecasts is based on those set out in the February *comparison of independent forecasts* only, as this is the latest edition that contains forecasts beyond 2014.

Source: OBR, OECD, November 2012 *Economic Outlook* up to 2014 and June 2012 *Economic Outlook* for 2015 2016; European Commission, 2013, *Winter European Economic Forecast*, February; Oxford Economics, March 2013; IMF, 2012, *World Economic Outlook*, October; HM Treasury, 2013, *Forecasts for the UK economy: A comparison of independent forecasts*, February. Range of city forecasters includes Barclays, Capital Economics, Commerzbank, Goldman Sachs, Nomura and Schroders, GDP growth and output gap forecasts.

⁸ This is in line with the unemployment rate at the beginning of 2008.

Table 6.1: Potential output growth forecast (annual growth rate, per cent)

	Potential productivity ¹	Potential average hours	Potential employment rate ²	Potential population ²	Potential output ³
2012	-0.1	-0.2	0.1	0.7	0.4
2013	1.0	-0.2	0.0	0.7	1.5
2014	1.6	-0.2	-0.1	0.5	1.9
2015	1.8	-0.2	-0.1	0.5	2.1
2016	1.9	-0.2	-0.1	0.5	2.2
2017	2.0	-0.2	-0.1	0.5	2.2

¹ Output per hour.

² Corresponding to those aged 16 and over.

³ Components may not sum to total due to rounding

The pace of the recovery

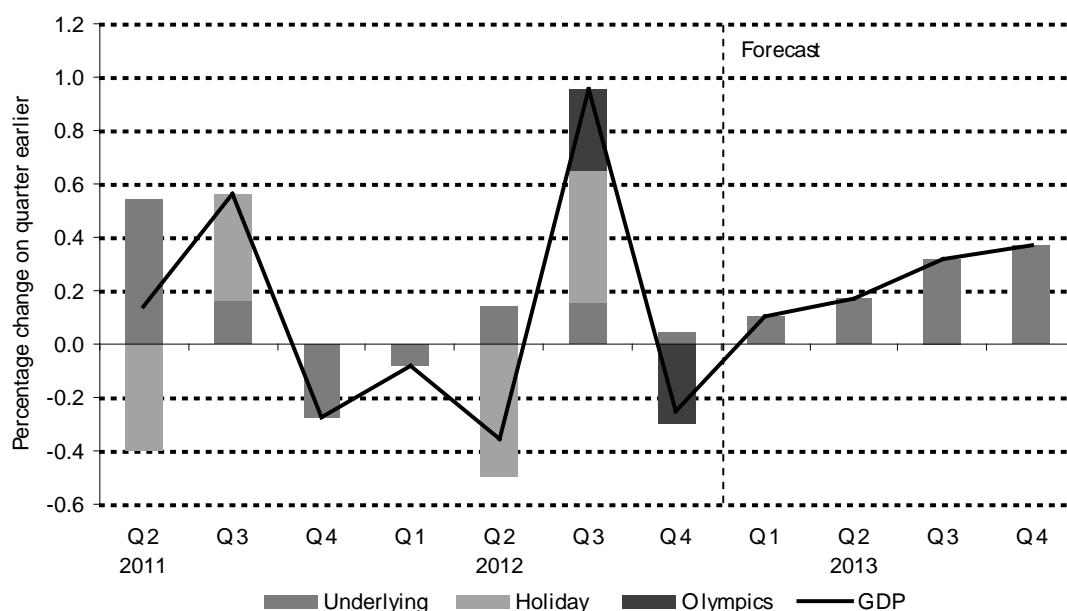
6.17 In this section we set out the expected path of GDP growth over the forecast period. We first consider the short-term outlook using information from recent economic data and forward-looking surveys. We then consider the rate at which GDP will grow over the medium term as spare capacity is taken up and economic activity approaches the potential level identified in the previous section.

The short-term outlook

6.18 GDP is currently estimated to have fallen by 0.3 per cent in the fourth quarter of 2012, slightly more than the 0.1 per cent we forecast in December. The difference can be explained by unexpected weakness in the oil and gas sector, which we have assumed to be a one-off effect.

6.19 It has been difficult to judge the underlying momentum of GDP growth during 2012, due to one-off factors affecting the second, third and fourth quarters (Chart 3.6). Our best estimate is that the Olympics boosted GDP growth by around 0.3 percentage points in the third quarter, before reducing it by the same amount in the fourth quarter. This would imply that the underlying trend in GDP in the fourth quarter was broadly flat.

Chart 6.6: Underlying and headline growth in GDP



Source: ONS, OBR

6.20 Based on the economy’s momentum at the turn of the year, and the latest survey data, we expect growth in the first quarter of 2013 to be 0.1 per cent.⁹ This implies a slightly less than 50 per cent chance of a ‘triple-dip’ recession, with particular uncertainty around the extraction and construction sectors.

6.21 We expect growth to pick up more strongly in the second half of 2013, though by slightly less than in our December forecast (Table 3.2). This reflects weaker net trade and earnings growth in the data since December. Taking into account revisions already made to previous data, we now expect GDP growth of 0.6 per cent in 2013, compared to 1.2 per cent in our December forecast.

⁹ The January construction output and index of production outturn data was not available at the time of finalising our economy forecast.

Table 6.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2011				2012				2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
March forecast¹	0.4	0.1	0.6	-0.3	-0.1	-0.4	1.0	-0.3	0.1	0.2	0.3	0.4
December forecast²	0.5	0.1	0.5	-0.4	-0.3	-0.4	1.0	-0.1	0.3	0.4	0.5	0.5
<i>Change</i>	<i>0.0</i>	<i>0.1</i>	<i>0.0</i>	<i>0.1</i>	<i>0.2</i>	<i>0.0</i>	<i>0.0</i>	<i>-0.1</i>	<i>-0.2</i>	<i>-0.2</i>	<i>-0.2</i>	<i>-0.1</i>

¹ Forecast from first quarter of 2013.

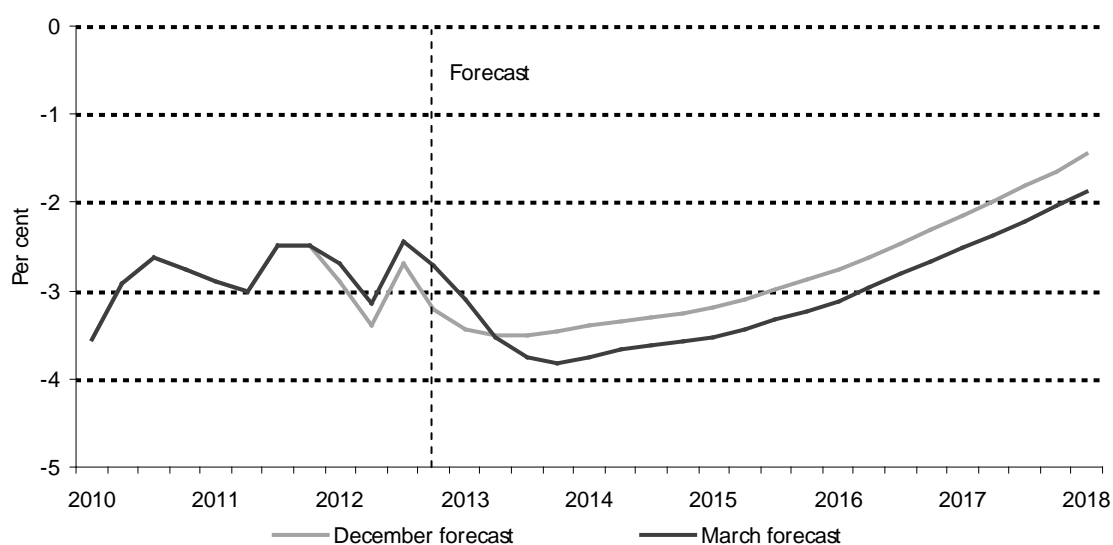
² Forecast from fourth quarter of 2012.

- 6.22 As we set out in our October 2012 *Forecast Evaluation Report*, mechanically applying the 'multipliers' we have used in previous forecasts to the consolidation measures put in place by the previous and current governments would have been sufficient to reduce the level of GDP in 2011-12 by around 1.4 per cent, reflecting both their direct impact on GDP via government consumption and investment and their indirect effect on the private sector's contribution. The same approach would imply that the consolidation measures could have reduced GDP in 2012-13 by around 1.9 per cent. That said, estimates of the size of multipliers and the timescale over which they take effect are both highly uncertain.
- 6.23 This calculation is based on Institute for Fiscal Studies (IFS) estimates of the size of the fiscal consolidation produced at the time of the March 2012 forecast. It therefore excludes the effect of the substantial underspending by central and local government departments in 2012-13 that has arisen over the course of the year and the modest tax measures in the Autumn Statement. The direct effect of the underspends on government consumption and investment is impossible to identify at this stage, as the eventual impact is uncertain and it would take some time to feed through fully to the National Accounts. But mechanically applying the same multipliers would imply that these underspends might have reduced GDP by around a further 0.5 per cent in 2012-13.
- 6.24 This should be seen as an upper bound of the possible impact for this choice of multipliers – some of the areas where the underspends occurred, for example payments to international institutions, might not have a significant effect on recorded economic activity, either directly or indirectly. Nevertheless, it is possible that the multiplier effect of these additional underspends could explain at least part of the weakness of GDP in 2012-13 relative to our March 2012 forecast, although the unexpectedly poor performance of exports is more than sufficient on its own to explain the shortfall.

The medium-term outlook

- 6.25 Our forecasts for medium-term growth are shaped by our estimate of the amount of spare capacity in the economy, and the speed with which it seems likely to be absorbed. The judgements surrounding the effect of monetary policy and credit conditions, which underpin this growth forecast, are set out in the next section.
- 6.26 Quarterly growth in GDP is expected to remain well below trend rates over the short term, with the output gap widening to around -3.8 per cent of potential by the end of 2013 (Chart 3.7). This deterioration reflects a drag from both net trade and consumption, as relatively weak UK export markets reduce the scope for export growth and sluggish disposable income weighs on household consumption. Growth is not expected to return to above-trend rates until 2015, as credit conditions begin to normalise and real wages and productivity start to recover, supporting the growth of consumption. However, the output gap is assumed to narrow at a relatively gradual rate over the medium term, reflecting the constraints on economic growth over this period: the slow growth of productivity and real incomes, continued problems in financial markets, the fiscal consolidation and the weak outlook for the global economy.

Chart 6.7: The output gap



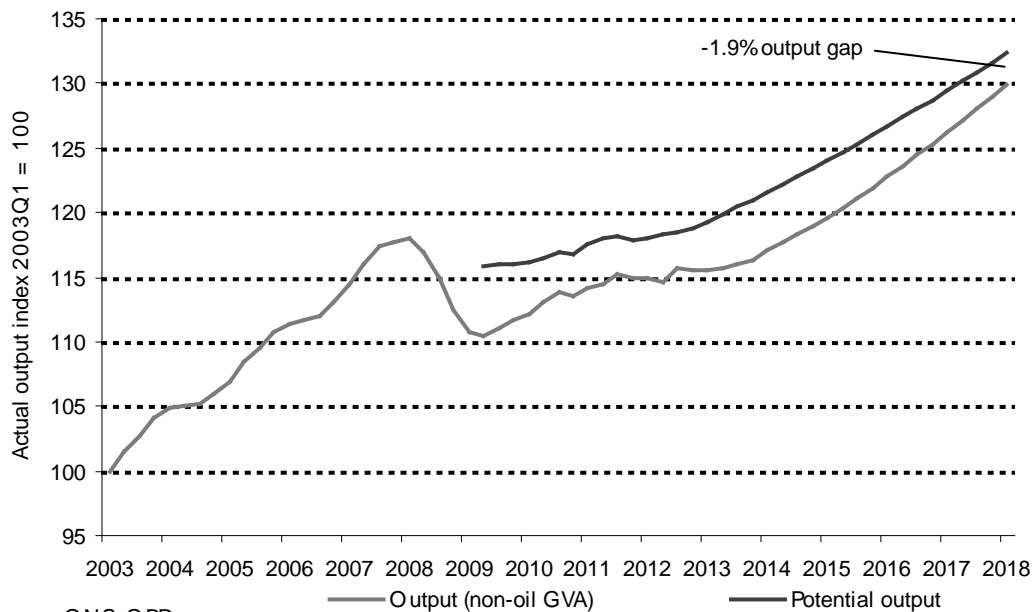
Output gap estimates on a quarterly basis, based on the latest National Accounts data and expressed as actual output less trend output as a percentage of trend output (non-oil basis).

Source: OBR

- 6.27 The weaker short-term outlook for consumption and exports means that growth in 2013 and 2014 is expected to be lower than we forecast in

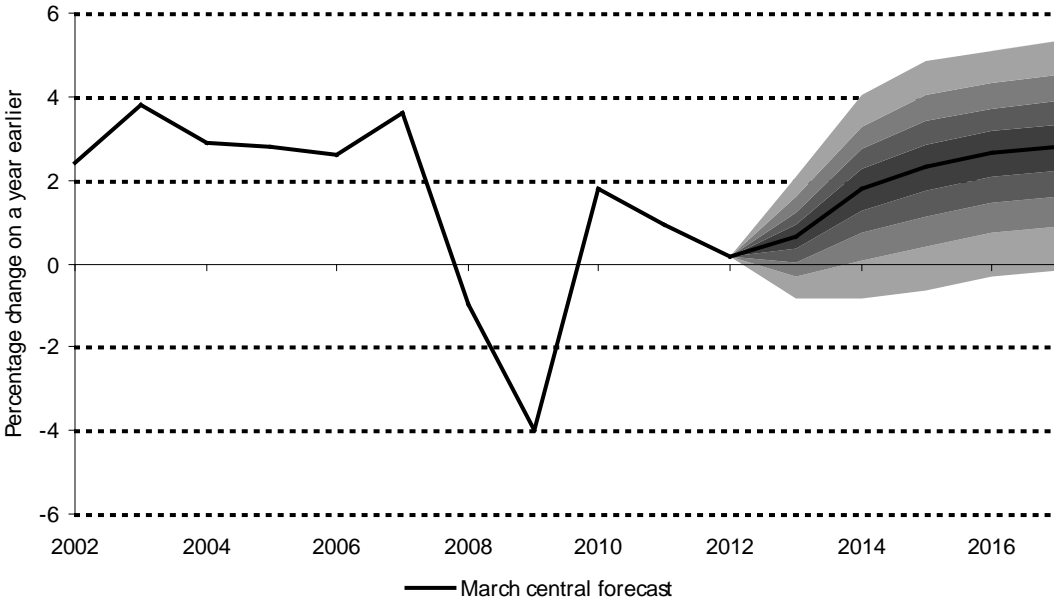
December, while our forecast for growth from 2015 onwards is broadly unchanged. Taken together with the latest data, these downward revisions leave the level of real GDP in 2017 0.6 per cent lower than in our December forecast.

Chart 6.8: Projections of actual and potential output



- 6.28 Our central growth forecast is shown in Chart 3.9. The distribution surrounding it shows the probability of different outcomes if you expected our forecasts to be as accurate as official 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 20 per cent probability bands.
- 6.29 The probability bands are based on the distribution of official forecast errors since 1987. They do not represent a subjective measure of the distribution of risks around the central forecast. It suffices to say that although we believe that the chances of growth being above or below our central forecast are broadly equal, the risk of a disorderly outcome in the euro area means that a much weaker outcome is more likely than a much stronger one.

Chart 6.9: GDP fan chart



Source: ONS, OBR

Box 6.1: The economic effects of policy measures

This box considers the possible effects on the economy of policy measures announced in Budget 2013. More details of each measure are set out in the Treasury's Budget document and our assessment of the fiscal implications can be found in Chapter 4.

The Government has announced a number of policy measures that are expected to have a broadly neutral fiscal impact in aggregate between 2012-13 and 2017-18, with 'giveaways' almost exactly offsetting 'takeaways' over this period. Correspondingly, we also assume that they will have a broadly neutral effect on the economy, with no impact on the level of GDP at the end of the forecast horizon.

There is a small negative GDP effect from lower **current departmental spending** in 2013-14 and 2014-15. This is offset from 2013-14 by a number of other measures, including an increase in the **personal allowance** to £10,000 and the introduction of an **employer NICs allowance** in 2014-15. Taken together these measures reduce GDP growth by less than 0.1 per cent in 2013 and increase GDP growth by less than 0.1 per cent in 2014. These estimates are based on the same multipliers that the interim OBR used in June 2010. Given the relatively small size of these measures, using larger multipliers would have little effect on our estimate of the overall GDP effect.

There are a number of other measures which could affect economic activity in the medium term. The reduction in the **main rate of corporation tax** from 2015-16 has a small positive effect on business investment in our forecast, while the decision to abolish the **contracted-out NICs rebate** slightly reduces disposable income and household consumption. The Government has also decided to increase **capital spending** and reduce **current departmental spending** from 2015-16. Given the long time horizon and the fact that the overall net effect of these changes is relatively small, we have not adjusted our overall GDP forecast.

We have adjusted our inflation forecast to take account of measures that directly impact the price level. These include the decisions to cancel the September 2013 **fuel duty** increase and to reduce **beer duty** by 2 per cent in 2013-14 and raise it by RPI rather than RPI plus 2 per cent in 2014-15. These measures are estimated to reduce annual CPI inflation by around 0.1 percentage points at the end of 2013 and in the first half of 2014 relative to the continuation of pre-announced changes. This is a permanent effect on the price level but a temporary effect on inflation.

The Government's decision to increase the **personal allowance** and the decision to abolish the **contracting-out NICs rebate** could marginally impact the labour supply decision of individuals. The higher personal allowance makes it marginally more attractive to work, while the abolishing of

contracting out makes it marginally less so. The policy decision to introduce an **employers' NICs allowance** could marginally boost labour demand. Given the small size of these potential effects we have not made any explicit adjustments to our forecast.

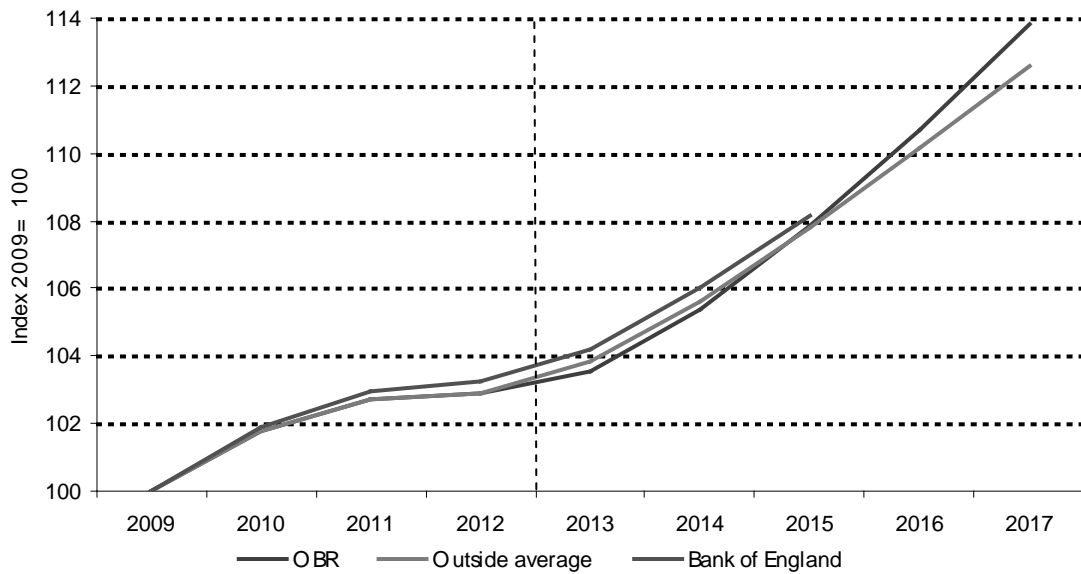
The Government has announced various measures aimed at improving the supply of UK housing and supporting property transactions. These include an extension and expansion of the Government's **Help to Buy** scheme, the **Right to Buy** scheme and the **Build to Rent Fund**, and the introduction of a **Mortgage Equity Guarantee** aimed at high loan-to-value mortgages. The expansion of the existing schemes is likely to have a relatively small additional impact on transactions and residential investment. The details and timing of the guarantee scheme have yet to be finalised and it is therefore too early to quantify the likely impact. Overall, however, these measures, alongside the **Funding for Lending Scheme**, should support the significant growth in property transactions and residential investment that we forecast over the next two years.

- 6.30 Chart 3.10 plots our central GDP forecast for the next three years against the average of outside forecasts and the Bank of England's February *Inflation Report* forecast.¹⁰ For the purposes of comparison we have used the Bank of England's modal forecast – that is, the most likely outcome implied by their forecast distribution. The negative 'skew' in the February *Inflation Report* forecast distribution means that the mean forecast is somewhat lower, implying a level of GDP around 0.5 per cent below the modal forecast by 2015.
- 6.31 Our forecast for the level of GDP over the next few years is slightly weaker than the Bank's modal forecast. This reflects weaker expected growth in 2013, as well as the fact that the Bank's 'backcast' points to stronger growth over the recent past than the latest ONS data. Our forecast is broadly in line with the latest outside average, although slightly stronger in the medium term.
- 6.32 It should be emphasised that the differences between these point forecasts are dwarfed by the uncertainties around them – as demonstrated by the fan charts in this *EFO* and the Bank of England's *Inflation Report*. Outside forecasts for cumulative GDP growth between

¹⁰ HMT, 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, February and March; Bank of England, 2013, *Inflation Report*, February.

2012 and 2016 vary significantly, with our latest forecast toward the middle of a very wide range (Chart 3.11).¹¹

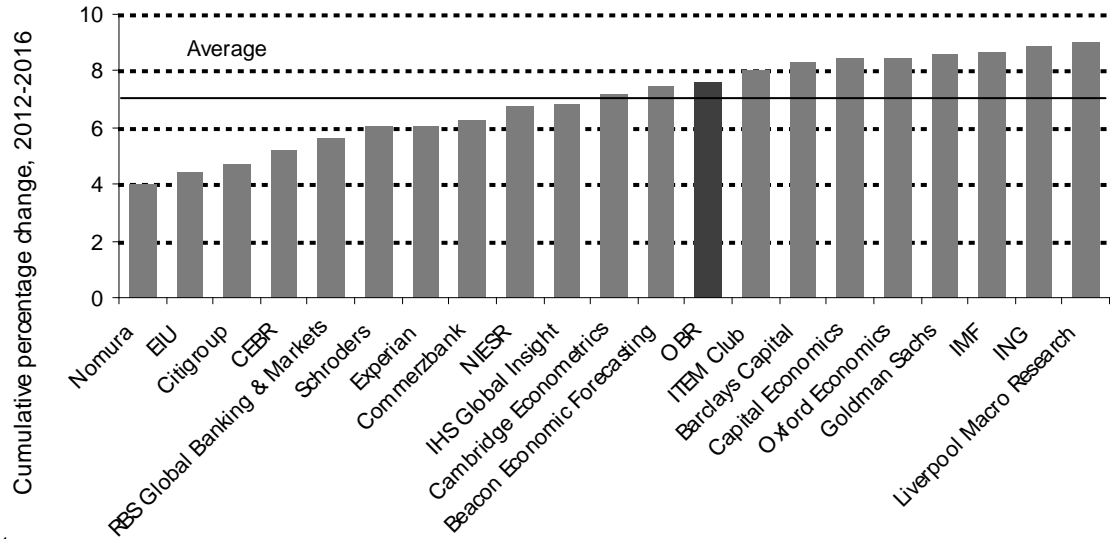
Chart 6.10: Forecasts of the level of GDP



Source: ONS; OBR; Bank of England, 2013, *Inflation Report*, February; HM Treasury, 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, February and March.

¹¹ Based on numbers set out in the February Comparison only, as this is the latest edition that contains forecasts beyond 2014.

Chart 6.11: Forecasts of cumulative growth between 2012 and 2016¹



¹ The range of forecasts is based on those set out in the February *comparison of independent forecasts* only, as this is the latest edition that contains forecasts beyond 2014.

Source: OBR, HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, February.

Box 6.2: Is it plausible to assume a negative output gap after five years?

In normal times it would be unusual to forecast that the economy would be operating with significant spare capacity at the end of a five year forecast horizon. Typically forecasts assume that monetary policy and other equilibrating factors will ensure that economic activity returns to a sustainable level in the medium term.

But in light of the depth of the recent downturn, and the weakness of the subsequent recovery, most major forecasters assume that some negative output gap will persist at the end of their forecast horizon, even though most also assume a significant sustained reduction in potential output relative to pre-crisis trends. Our forecast in this *EFO* implies that potential output would be 14.6 per cent below an extrapolation of its pre-crisis trend in 2017, with actual output a further 2.3 per cent below that.

How plausible is this combination of a big reduction in potential output and a persistently negative output gap, relative to the alternatives? And what impact would those alternatives have on the Government's chances of meeting the fiscal mandate?

- 1 Some economists^a argue that the current output gap is significantly wider than in our central forecast, judging that there was little or no hit to potential output following the financial crisis. Unless you assume a very strong economic recovery, or a significant and sustained slowdown in potential output growth in future years, this would imply an even larger negative output gap after five years than in our forecast. This would be even more at odds with the usual assumed effect of monetary policy and other equilibrating factors. We find the argument that the output gap is much larger today than in our central forecast hard to square with the recent strength of private sector employment growth, the persistence of above-target inflation and most surveys of capacity utilisation.
- 2 One way to avoid having a negative output gap at the end of the medium-term horizon would be to assume an even bigger hit to potential as a result of the financial crisis, and thus a significantly smaller output gap today. Given the relative strength of the labour market, this would imply an even bigger hit to the level of potential productivity – deepening the ‘productivity puzzle’ that most economists are already struggling to solve.^b
- 3 One way to be more pessimistic about the supply potential of the economy, without having to explain why the financial crisis has

done so much to reduce it, would be to assume that the trend growth rate of potential output was significantly overestimated even before the crisis.^c Forecasters who derive their estimates of potential output from statistical filters of actual GDP data – or from production functions that use filters to identify the trend path of the different factors of production – will tend to move in this direction over time as the continued weakness of actual GDP mechanically drags down the assumed path of potential output both before and after the downturn. As we can see from the estimates of bodies like the International Monetary Fund and the Organisation for Economic Co-operation and Development (OECD), this implies an increasingly large positive output gap immediately prior to the crisis in 2007. (For example, the latest OECD *Economic Outlook* estimates that output was 4.4 per cent above potential in 2007, compared to 0.2 per cent in its June 2008 *Outlook*.) We find a large positive output gap in the period running up to the crisis hard to square with low rates of inflation and other cyclical indicators at that time.

- 4 The final way to close the output gap over the five year horizon would be to assume a much stronger recovery in actual GDP. As shown in Chart 3.10 most outside forecasters are expecting relatively weak growth in coming years. Even if we were to combine our estimate of trend output with the strongest forecast for actual output growth from Chart 3.11, we would still have a negative output gap by the end of the forecast horizon.

All these alternatives have different implications for the Government's chances of meeting its fiscal mandate i.e. balancing the structural current budget after five years. The first alternative would make it easier to meet the mandate, as a wider output gap implies that more of the current deficit is cyclical rather than structural. The second and third alternatives^d imply a larger structural deficit and a tougher task meeting the mandate, as they imply a narrower output gap today than in our forecast. The fourth alternative – a stronger recovery – would boost receipts and lower spending, reduce the headline deficit and lower the path for public sector net debt. But this would not increase the chances of meeting the mandate if the improvement was purely cyclical.

^a See for example: Capital Economics, 2012, *Is the output gap a crack or a chasm*, October and Martin and Rowthorn, 2012, *Is the British economy supply constrained II? A renewed critique of productivity pessimism*, UK-IRC May.

^b See for example: Nomura, 2013, *The moribund metastable equilibrium*, January.

^c See for example: OECD, 2012, *Economic Outlook*, November.

^d Assuming that the hit to supply following the crisis is not smaller than in our central forecast.

Monetary policy

- 6.33 An important anchoring assumption in our forecast is that the Bank of England will endeavour to bring inflation to target by the end of its forecast horizon. Coupled with a view that domestic price pressures – as represented by the output gap – are important drivers of inflation in the medium term, this implies that monetary policy would generally reduce the size of any negative or positive output gap over time by stimulating or softening aggregate demand respectively.
- 6.34 That said, there are limits to the speed at which the economy is likely to return to potential. As set out above, we expect constrained real income growth, ongoing dislocation in financial markets, the fiscal consolidation and weak global growth to limit the rate of growth over the medium term. As a consequence, we expect the output gap to narrow at a relatively gradual rate, leaving a negative output gap at the end of the forecast period. We expect inflation to fall back to target over the forecast period, with downward pressure on prices from the negative output gap offset to some extent by upward pressure from above trend growth rates and falling unemployment in the later years of the forecast.
- 6.35 Chart 2.6 shows that, relative to December, policy rates are now expected to be 30 basis points higher by the end of the forecast period, with Bank rate not expected to rise until 2015. This has implications for our fiscal forecast, which we discuss in Chapter 4.
- 6.36 In July 2012 the Bank of England and HM Treasury launched the Funding for Lending Scheme (FLS), which provides banks with relatively cheap funding from the Bank of England, for up to four years. The next section discusses recent evidence on the effect of the FLS.

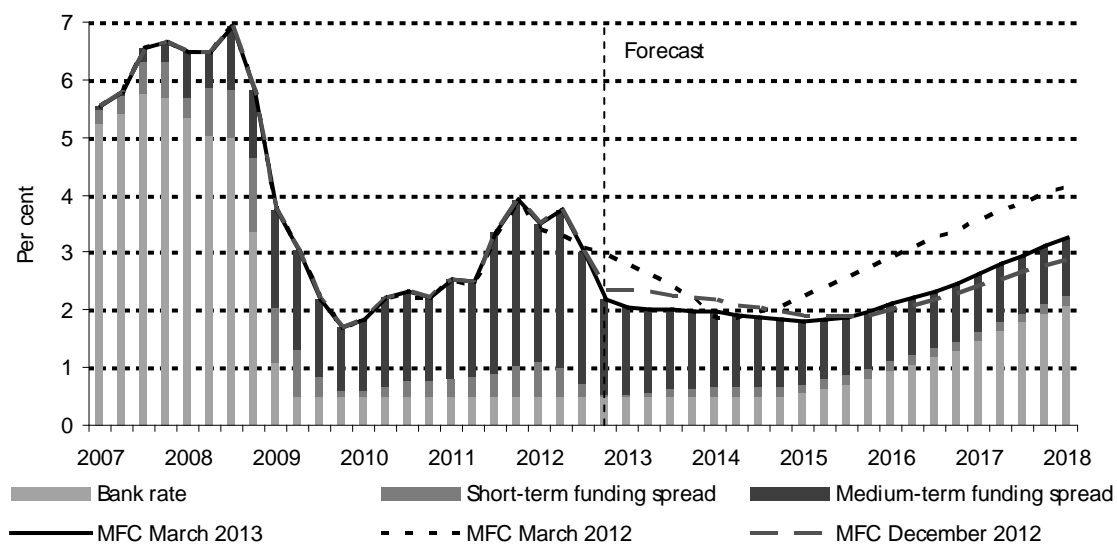
Credit conditions

- 6.37 The improvement in financial market sentiment that began in mid-2012 has continued. The European Central Bank's (ECB) reasserted commitment to the euro area has reassured investors by reducing the risk of a euro exit. Most indicators of stress have subsided substantially. Debt costs for peripheral euro area sovereigns have fallen, banks have begun to repay the emergency funds provided by the ECB in 2011-12, and the euro has appreciated markedly against a basket of currencies. Financial

market conditions have also continued to improve outside the euro area, with equity prices generally rising and credit spreads narrowing.

- 6.38 However, real economy growth prospects have deteriorated in many developed economies since our last forecast. For euro area countries this could lead to renewed concern over the sustainability of sovereign finances. Indeed, the risk remains that renewed weakness in any one part of the system – real economy, banks or sovereigns – will destabilise the rest, as in early 2012. Some key institutional reforms which aim to reduce systemic vulnerability are in train. For example, some progress has been made in establishing a single euro area banking supervisor. This is an important step in reducing negative feedbacks between bank and sovereign balance sheets. But these are unlikely to be complete until at least 2014, even assuming they obtain the necessary backing from euro members.
- 6.39 Financial market sentiment in the UK has also improved further. Measures of wholesale market stress, such as short-term counterparty risk (as measured by the LIBOR-OIS differential), have fallen to near pre-crisis levels. Other measures of the funding spreads paid by banks, in both retail and wholesale markets, have also continued to fall. This may be due to lower market perceptions of bank credit risk; but also partly to the limited supply of UK bank debt relative to investor demand, reduced by bank deleveraging plans, the FLS and easing of regulatory liquidity requirements. There has now been a sustained fall in banks' funding costs since June 2012 and we expect further improvement in the short to medium term (Chart 3.12).

Chart 6.12: Indicative marginal funding cost (MFC) of UK banks¹



¹ The short-term funding spread is proxied by 3m LIBOR-Bank rate spread; and the medium-term funding spread is proxied by 5-year CDS premia.

Source: OBR, Thomson Reuters

Credit supply

- 6.40 Our forecast for lower bank funding costs depends on both continued stability in the euro area and the success of the FLS. Launched by the Bank of England and the Government in July 2012, this scheme provides funding to banks and building societies for an extended period at below current market rates. It is designed to encourage banks and building societies to expand lending to households and private non-financial corporates, with both the price and quantity of funding provided linked to their lending performance.
- 6.41 To the extent that FLS costs are lower than those prevailing in private markets, they should directly reduce banks' borrowing costs. On this measure, given that private funding costs have fallen substantially, the FLS may now have less direct impact than was expected when it was introduced. However, the FLS may also be partly responsible for lower costs in other markets, as it reduces banks' non-FLS funding requirements and pricing. Given the difficulty of isolating FLS from non-FLS influences, we include it in our forecast as one contributing factor to a sustained, general improvement in UK bank funding conditions (Chart 3.12).
- 6.42 Lower bank funding costs should then lead to lower offered interest rates, which generate more loan applications, approvals, advances, lower effective rates on new loans and, eventually, lower average borrowing costs for corporates and households. Each step will take time, but there is

already some evidence of an impact on the mortgage market. Offered interest rates on new household loans, particularly fixed-rate mortgages, have fallen significantly, and mortgage loan approvals and advances are beginning to rise. We expect offered rates to fall further given how far bank funding costs have fallen. This has not yet translated appreciably into greater supply of real economy credit – net flows of lending remain very weak – but we expect a greater impact as 2013 progresses, particularly on mortgage lending.

- 6.43 However, the extent to which lower bank costs lead to more credit will be limited by banks' own risk appetite. Access to capital remains a concern. For domestic banks profits on average remain very weak. Access to markets for new equity capital appears limited given most banks' low profitability. Regulatory changes, such as the most recent recommendation of the Financial Policy Committee that banks' capital reflect "a proper valuation of their assets" could lead to greater provisions or regulatory capital requirements. Combined with the long-run target of Basel III compliance, banks are likely to remain cautious in taking on more risky lending throughout the forecast period.
- 6.44 Some boost to lending should come from the activity of those relatively healthy banks that are unencumbered by poor loans or are new to the market,¹² depending on competition conditions. The recent relaxation of Basel III liquidity rules could allow further relaxation in UK banks' liquidity buffers, increasing profits and generating more real economy lending. However, we expect capital to remain a constraint throughout the forecast period and the supply of bank credit to remain weak.

Credit demand

Households

- 6.45 Recent data show some signs of greater household demand for credit. Mortgage approvals rose moderately in the fourth quarter of 2012, as did loan advances, particularly for house purchase. We expect this trend to continue through 2013, boosted by greater mortgage availability and falling new mortgage rates. We also expect the spread between risk categories to narrow as easier bank funding conditions feed greater competition for higher loan-to-value borrowers. This should encourage more low-equity buyers into the housing market and increase property

¹² There is some evidence of this in the distribution of new lending in the Bank of England's latest FLS data.

transactions. However, we do not expect a return to conditions prevailing before the recession, given tighter prudential regulation. Some potential borrowers will therefore remain limited by their ability to raise sufficient equity, as well as their own concerns over affordability.

- 6.46 Demand for consumer credit (credit cards and personal loans) also picked up at the end of 2012, according to the Bank of England's most recent *Credit Conditions Survey*. Lower bank funding costs have helped reduce personal loan rates (although to a much lesser extent than mortgage rates), encouraging a rise in personal loans in early 2013. The result has been a return to annual growth in unsecured household borrowing after more than three years of contraction. However, this is a small part of the average household's balance sheet¹³ and we do not expect unsecured borrowing to outpace secured borrowing consistently, given both banks' risk appetite and the relatively high cost of unsecured debt.¹⁴

Private, non-financial corporations (PNFCs)

- 6.47 Bank credit to corporates continues to contract across a range of sectors. This is partly due to the availability of alternatives. For large corporates, the attraction and use of wholesale debt are currently strong. The cost of non-financial corporate bonded debt is very low, helped by low interest rates and reduced bank debt issuance. In aggregate, PNFCs are substituting wholesale for bank debt and equity and we expect this to continue while monetary policy remains loose.
- 6.48 However, smaller companies, without access to wholesale funds, are also reducing their bank borrowing. This is part due to their own perceptions of reduced availability, and part due to banks' own risk management and the depressed economic outlook. Affordability, based on profit projections depressed by the current macroeconomic environment,¹⁵ remains a constraint. Combined with their own subdued confidence, this means small companies prefer internal to external funds, which will limit their ability to expand and contribute to the recovery. Improvement in bank funding costs should gradually feed through to small and medium

¹³ Around 16 per cent of household loan debt, according to ONS statistics, the rest being secured on property.

¹⁴ Unsecured debt rates, particularly on credit cards, are considerably higher than mortgage rates and have responded much less to changes in Bank rate since the crisis.

¹⁵ Although the proportion of small and medium sized enterprises (SMEs) making a profit remained fairly stable in 2012, for those making profits, median profit levels fell by more than half – see *SME Finance Monitor*, Q4 2012 for the Business Finance Taskforce.

sized enterprises (SME) loan rates, but recovery in SME credit demand also depends on the outlook for profits and growth.

The composition of GDP

6.49 Our forecast for the level of GDP is a key driver of our assessment of the outlook for the public finances. But the composition of GDP is also important. This section discusses the broad outlook for the income and expenditure measures of GDP, and our forecasts of the expenditure components in more detail.

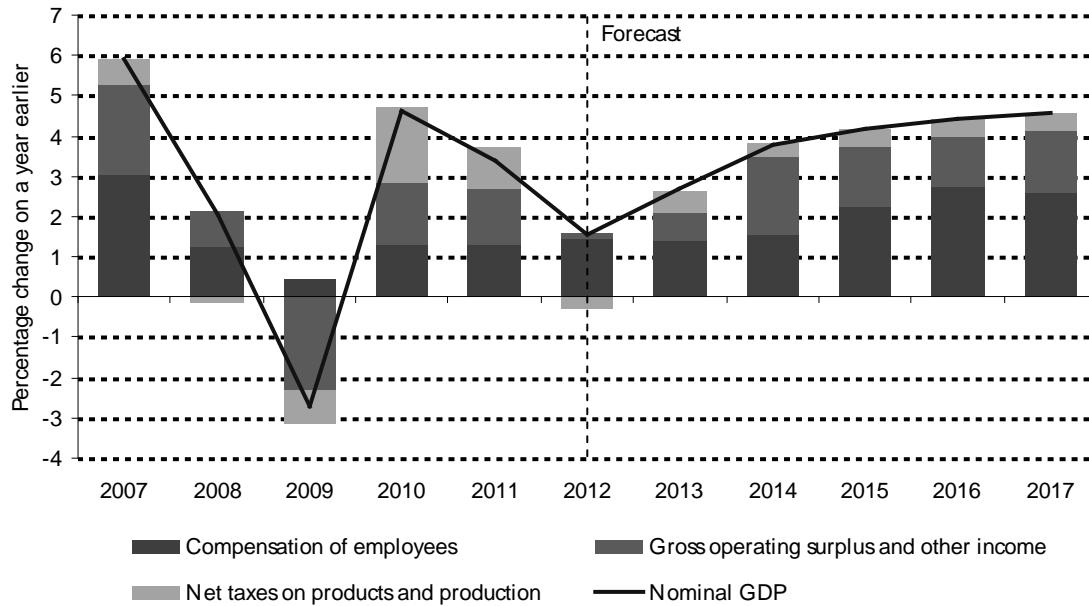
Nominal and real GDP

Income

6.50 For a given profile of nominal GDP, the outlook for the public finances will vary with the relative contribution of different types of income flow. This is mainly because the Government receives more revenue from every pound of labour income than from every pound of profits.

6.51 Chart 3.13 shows the pattern of income flows associated with our forecast for nominal GDP growth. Weak nominal income growth in 2012 was attributable to a smaller contribution from net taxes and profits than in recent years, while the contribution from labour income was slightly higher, consistent with the relative strength of the labour market. We expect wages and salaries growth to slow slightly in 2013, reflecting relatively weak average earnings growth, with nominal GDP growth supported by rebounds in profits and net taxes. The contribution of labour income to nominal GDP growth is expected to strengthen gradually in subsequent years.

Chart 6.13: Income counterparts to nominal GDP growth



Source: ONS, OBR

Expenditure

6.52 Table 3.3 shows our forecast for the contribution of different expenditure components to real GDP growth. Private consumption is expected to make a limited contribution to GDP growth in the short term, before picking up as real disposable income starts growing again. We expect a relatively large contribution from business investment, although lower than in December. Net trade is expected to make only a very small positive contribution to growth, in part reflecting relatively weak growth of UK export markets. We discuss our forecast for these expenditure components in more detail in the following sections.

Table 6.3: Expenditure contributions to growth¹

	Percentage points, unless otherwise stated						
	Outturn			Forecast			
	2011	2012	2013	2014	2015	2016	2017
GDP growth, per cent	0.9	0.2	0.6	1.8	2.3	2.7	2.8
Main contributions							
Private consumption	-0.6	0.6	0.3	0.8	1.1	1.5	1.8
Business investment	0.3	0.4	0.2	0.5	0.8	0.8	0.9
Dwellings investment ²	0.0	-0.2	0.1	0.4	0.4	0.5	0.5
Government ³	-0.7	0.6	0.2	-0.1	-0.1	-0.3	-0.4
Change in inventories	0.3	-0.2	-0.2	0.0	0.0	0.0	0.0
Net trade	1.2	-0.8	0.1	0.1	0.1	0.1	0.1

¹ Components may not sum to total due to rounding and the statistical discrepancy.

² The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.

³ The sum of government consumption and general government investment.

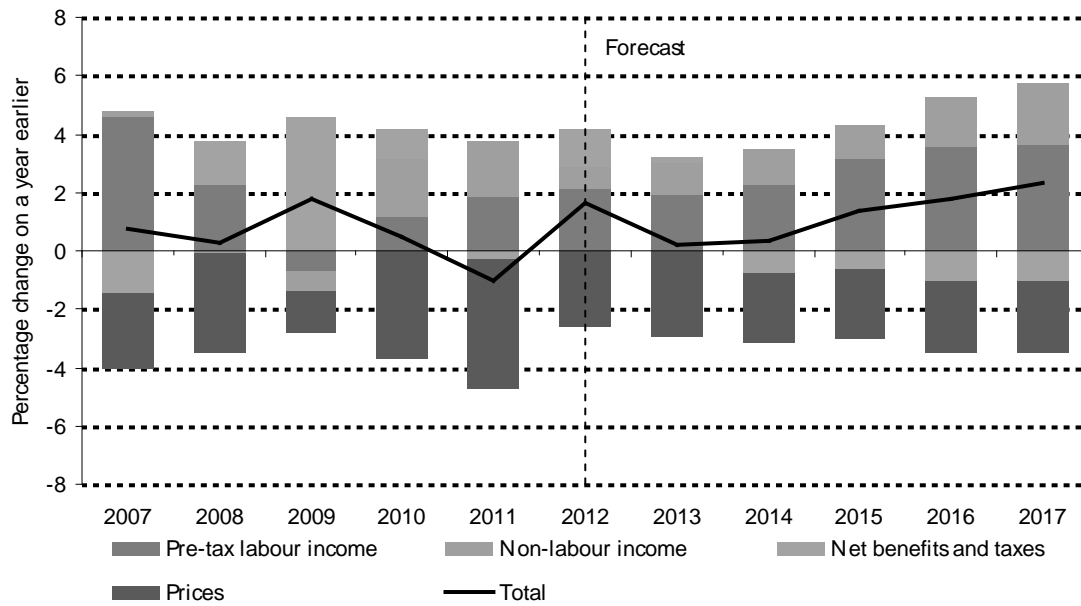
Components of domestic demand

Consumer spending

- 6.53 Consumer spending remains subdued. Private consumption increased by a cumulative 0.3 per cent in the second half of 2012, weaker than the 0.5 per cent growth implied by our December forecast. Despite this, revisions to outturns in earlier quarters mean that consumption growth in 2012 is now slightly above the 0.5 per cent implied by our December forecast, with the latest data indicating growth of 1 per cent for the full year.
- 6.54 Household disposable income picked up strongly over the first half of 2012, supported by the up-rating of household benefits in line with the September 2011 CPI inflation outturn of 5.2 per cent (Chart 3.14). Real disposable income is now estimated to have grown by 2.8 per cent in the year to the third quarter of 2012, although the relative weakness of consumption meant the saving ratio picked up over the year, reaching 7.7 per cent.
- 6.55 Consumer confidence indicators point to limited consumption growth in the near term. While the GfK *Consumer Confidence* balance picked up slightly in January, the indicator remains well below its long-run average. Retail sales fell back in January in both value and volume terms, pointing to little momentum in consumer spending heading into 2013.
- 6.56 We expect a weaker outlook for disposable income to reduce the contribution of consumption to GDP growth relative to our December forecast. Consumption growth is expected to slow this year and remain

subdued in 2014, before gathering pace from 2015 as disposable income growth picks up.

Chart 6.14: Contributions to real household disposable income growth



Source: ONS, OBR

Box 6.3: Household saving and balance sheets

The household saving ratio – the average propensity of UK households to save out of current income – continued to rise in 2012. A significant contribution comes from an adjustment for employers' net contributions to funded pension schemes,^a rather than from active household savings decisions. This adjustment is driven by corporate balance sheet management and profitability, and has been quite variable in recent years. However, with or without this adjustment, by the third quarter of 2012 the saving ratio had risen to a level comparable to 2009 (the highest since the 1990s), when the economy was contracting severely.

Households may be choosing to save more for a number of reasons, including: tighter credit conditions, resulting in bigger down payments to buy a house; and fear of future negative income shocks, perhaps from fiscal consolidation or unemployment or a new tightening of credit conditions. The latest NMG Consulting survey^b shows a growing share of those respondents planning to increase their saving in 2013 doing so for a deposit, or to reduce their existing debts. Different sections of the population may also be affected in different ways: the young particularly by tighter credit conditions and greater deposit requirements for first-time home buyers.

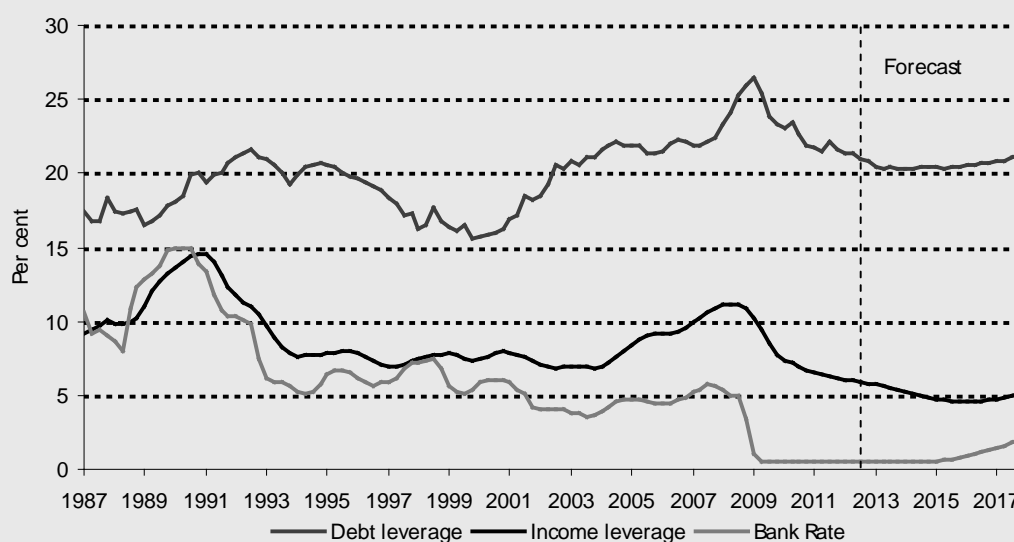
Looking forward, improvements in credit conditions could put downward pressure on the saving ratio. The Funding for Lending Scheme (FLS) could encourage lenders to compete for new borrowers by lowering deposit requirements. A further rise in inflation and fall in real incomes could also reduce the ratio as households save less in order to continue consuming essentials. But concerns over future income levels are only likely to recede slowly, as economic growth and public finances stabilise, and we do not expect a rapid return to the record-low saving ratios seen prior to the crisis.

The higher saving ratio, combined with the resilience of nominal household disposable income levels (and further growth in 2012, see paragraph 3.53), has increased the flow of money into household balance sheets. Faced with the choice of purchasing new assets or paying off existing debts, households in aggregate appear to be choosing more financial assets, particularly deposits, perhaps in part due to higher collateral requirements for mortgages. The absolute level of household (loan) debt has even risen slightly, beyond its pre-recession peak. However, given resilient house prices, record low Bank rate and continued accumulation of financial assets, the effective burden of household debt has fallen steadily since the peak of the crisis (Chart A).

Given other key features of our forecast (a very gradual pick up in Bank rate, continued improvement in credit conditions, weak growth in disposable

income and house prices), we expect the burden of servicing household debt, on average, to remain well below the crisis and pre-crisis period – even with a moderate pick up in new borrowing. We expect slower accumulation of debt than in our March 2012 forecast, given consistently weak actual borrowing data, by pre-crisis standards. But we do not expect a rapid or unstable path of debt reduction, which could induce a more significant response in the saving ratio, consumption and GDP growth.

Chart A: Household leverage indicators



Note: Debt leverage = gross household debt / net financial and non-financial equity;
Income leverage = annual debt servicing costs / annual disposable income

Source: ONS, Bank of England, OBR

^a Exclusion of which, from the denominator and numerator, can reduce the saving ratio by 2-4 per cent.

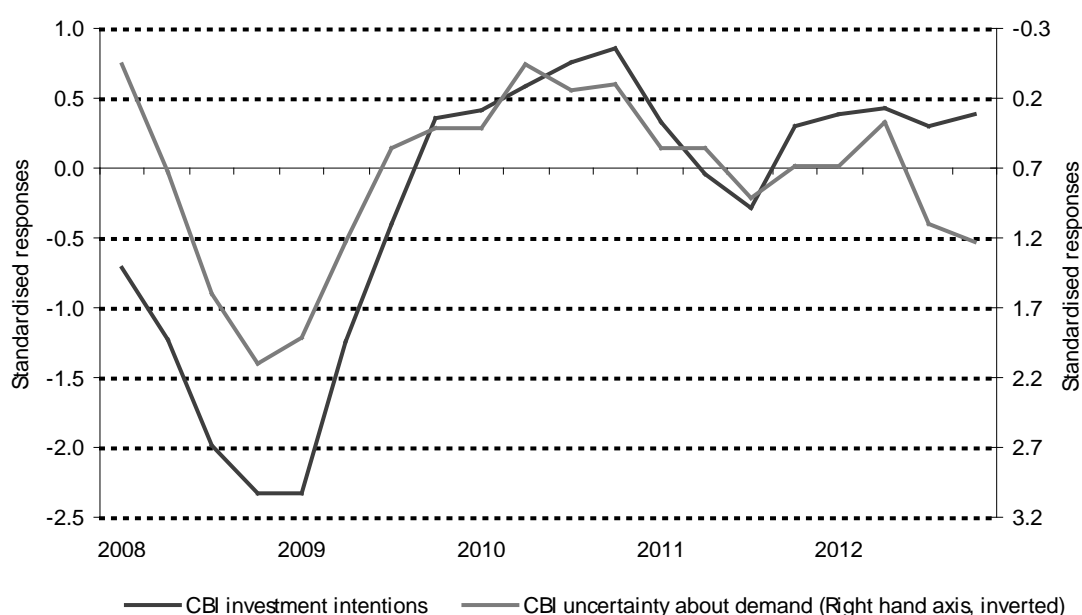
^b Bank of England, 2012, Quarterly Bulletin, *Influences on household spending, 2012Q4*.

Business investment

6.57 Business investment data can be exceptionally volatile from quarter to quarter, and is often subject to significant revision. The latest data suggest that business investment fell by just over 1 per cent in the final quarter of 2012, having increased by just under 0.5 per cent in the third. Business investment is now estimated to have grown by 4.9 per cent in 2012 as a whole, a slightly stronger rate than we were expecting in December.

6.58 Surveys of investment intentions indicate little substantive change in the near-term outlook (Chart 3.15), namely a moderate rate of business investment growth. Over the near term we expect relatively subdued rates of investment, with overall growth in 2013 expected to be somewhat weaker than in 2012, partly reflecting the sharp recorded fall in business investment in the final quarter of last year.

Chart 6.15: Investment intentions and uncertainty about demand



Source: CBI

6.59 As we have set out previously, it may be the case that the asset position of private non-financial corporations is currently overstated. In particular, the significant recent growth in deposits held overseas by UK firms may have been incorrectly attributed to non-financial companies rather than financial intermediaries.¹⁶ This does not necessarily mean that the corporate sector has been in deficit. However, it could suggest the size of corporate surplus as measured on the financial account has been over recorded.¹⁷

¹⁶ OBR, 2011, *Economic and fiscal outlook*, November, Box 3.5.

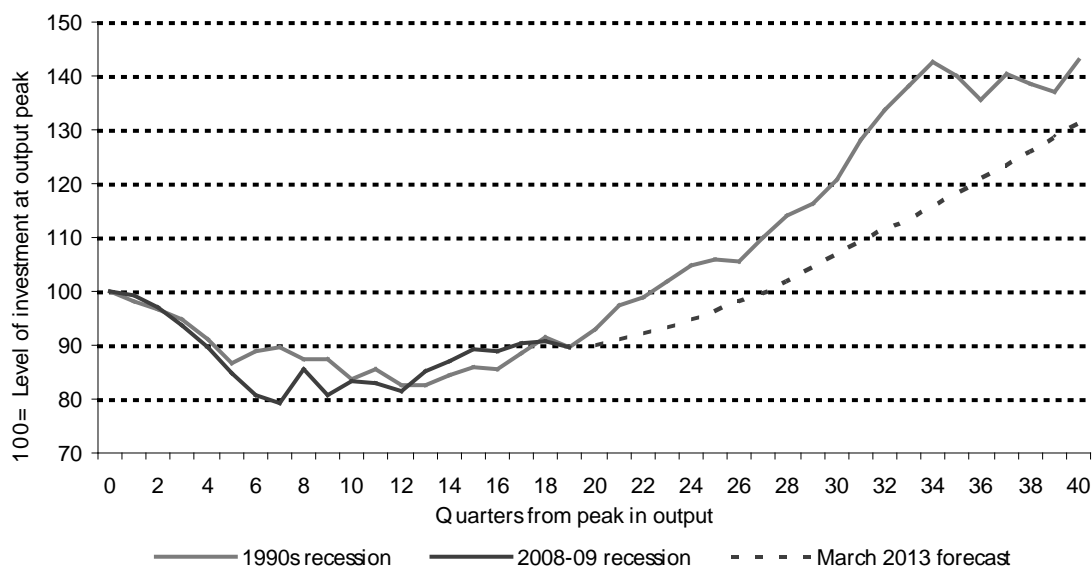
¹⁷ In 2012 the ONS established a working group examining issues related to the allocation of foreign deposits – see ONS, 2012, *Reviewing and Improving ONS statistics: Measurement of UK Private Non-Financial Corporations' Overseas Deposits and Loans*, September. As part of their development work for the 2013 Blue Book, the ONS have announced planned improvements to

- 6.60 Our medium-term forecast for business investment is conditioned on the possibility that corporates' asset position is not as strong as suggested in the National Accounts. Upward revisions to outturns also mean there has been a greater bounce back in business investment since the end of the recession than previously thought – suggesting that less growth is required in future years to achieve a recovery in the medium-term level of business investment.
- 6.61 As a result our medium-term forecast for business investment growth is weaker than in previous forecasts. Business investment is now expected to grow at an average rate of just over 8½ per cent between 2014 and 2017, lower than the average rate of just under 10 per cent assumed in our December forecast. These growth rates continue to mean that business investment rises as a share of GDP, continuing the general trend seen over the past two decades.¹⁸ Nevertheless, the cumulative recovery in business investment is expected to be weaker than that seen following the recession of the early 1990s (Chart 3.16), even though the pick-up in investment to date has been broadly in line with the 1990s.
- 6.62 The 1 per cent reduction in the main rate of corporation tax announced in the Budget is assumed to reduce the cost of capital faced by firms, and increases the level of business investment by around 0.5 per cent by 2017.

the method of allocating UK non-bank deposits and loans held with overseas banks. See ONS, 2012, *Content of Blue Book 2013*, November.

¹⁸ Between 1990 and 2008 the ratio of business investment to GDP at the peak and trough of each cycle has risen in successive cycles, which could be attributable to a fall in the relative price of capital goods. Our forecast implies that the real share will reach just under 11 per cent by 2017.

Chart 6.16: Level of business investment



Source: ONS, OBR. Data for 1990s recession constructed using latest available ONS estimates for business investment growth prior to 1997, and latest available business investment levels from 1997.

Residential investment

- 6.63 Residential investment remains volatile. The latest data suggest that residential investment fell by just under 7 per cent in the third quarter of 2012, having grown cumulatively by just over 5 per cent over the first half of the year. The weakness in the third quarter is consistent with other indicators of housing market activity: construction output, for example, fell by just over 2 per cent. Taken together, the latest data now suggest that residential investment declined by just over 2 per cent between the final quarter of 2011 and the third quarter of 2012, compared to our December forecast for growth of just over 2 per cent.
- 6.64 Residential property transactions picked up strongly in the fourth quarter of 2012, increasing by 4.4 per cent compared to the third quarter and largely in line with our December forecast. This is consistent with improvements in credit conditions and a slight increase in new mortgage lending over the same period. We expect credit conditions to continue to improve in 2013, manifesting as better terms and availability of secured credit to households. Easier credit will lead to continued growth in the pace of house purchases in 2013, albeit from a very low base. While we still expect strong growth in property transactions in 2013 and 2014, supported by the FLS and other Government schemes, we have reduced our forecast relative to December to a level which is more consistent with other outside forecasters.

- 6.65 We expect transactions to start to slow in the first half of 2014 as the FLS drawdown period ends. We expect steady growth to resume thereafter, with the level of transactions converging slowly on the long-run average rate of property turnover over the rest of the forecast period. The pace of recovery in transactions – which are currently running at just over half their peak rate in mid-2000 – will be limited by ongoing capital constraints for some buyers. Accumulation of a deposit will remain a considerable hurdle to first-time buyers, as well as existing owners with negative or insufficient equity. We expect a relaxation of loan-to-value (LTV) limits in 2013 (the average LTV ratio for first time buyers reached 80 per cent in 2012,¹⁹ its lowest level for at least 30 years), but we do not expect a rapid return to pre-financial crisis standards.
- 6.66 We expect relatively subdued residential investment over the near term, with overall annual growth of 2 per cent in 2013. Residential investment is then forecast to pick up strongly from the second half of this year, consistent with a relatively robust recovery in residential property transactions. Residential investment growth rates remain relatively strong over the medium term as transactions continue to move back toward the long-run trend; despite this, the level of residential investment remains below its pre-crisis peak throughout the forecast period.

Stock building

- 6.67 In our December forecast we expected stocks to make a negative contribution to growth in 2012 of -0.6 percentage points. Data released for the fourth quarter of 2012, taken together with revisions to earlier quarters, now suggest that stocks acted as a much smaller drag on GDP growth last year, contributing -0.2 percentage points. There have been significant revisions to the quarterly profile of stocks through the course of 2012. The latest estimates now suggests that stocks contributed 0.5 percentage points to growth in the third quarter, while data available at the time of our December forecast indicated a negative contribution of 0.3 percentage points.
- 6.68 We expect stocks to make a small negative contribution of -0.2 percentage points to growth in 2013, as the stock-to-output ratio declines from its relatively elevated level at the end of 2012. We expect no contribution from this component over the medium term, with measures of stock adequacy moving back towards normal levels.

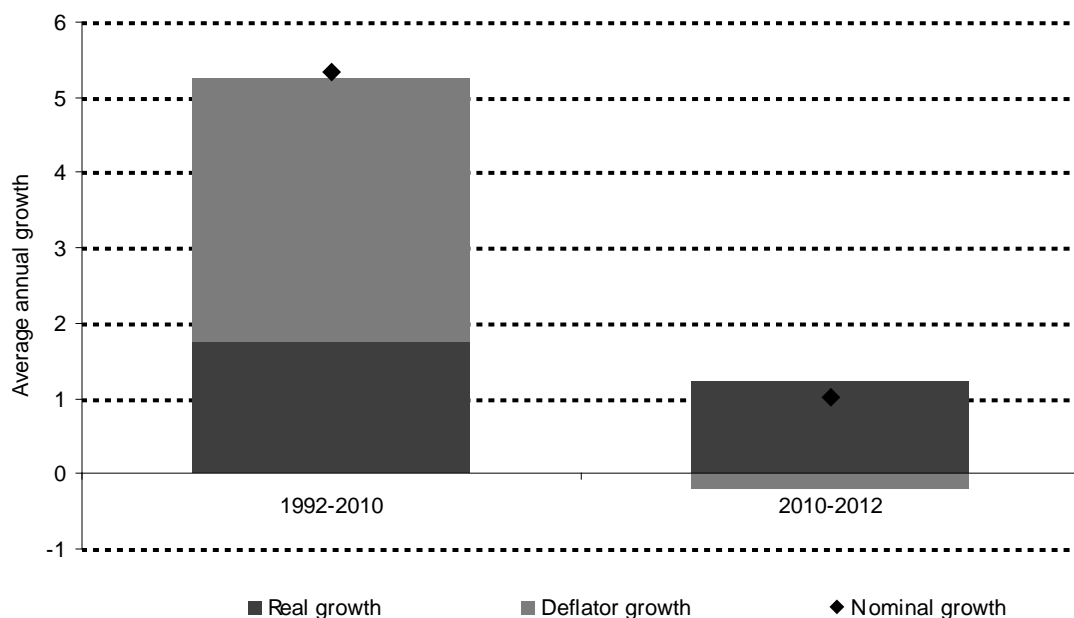
¹⁹ See Home Builders Federation report, 2013, *Broken Ladder III, The Locked Out Generation*, February.

Government

- 6.69 The latest ONS data indicate that real government consumption grew by 2.6 per cent in 2012, slightly above our December forecast of 2.4 per cent. However, government consumption growth was weaker than expected in cash terms. Downward revisions to outturns over the first half of the year now mean that nominal government consumption grew by 2 per cent in 2012, compared to our December forecast for growth of 3.6 per cent.
- 6.70 The relatively robust growth of real government consumption relative to nominal consumption is likely to reflect the way in which much of government activity is measured.²⁰ Around two-thirds of real government activity is measured directly – for example, using the number of prescriptions, or school pupils. If these measures of activity hold up when nominal spending growth falls back, then real government consumption growth will rise relative to nominal growth. As a result the implicit price of government consumption has grown much more slowly over the past few years: since 2010, annual growth of the implied government consumption deflator has been close to zero, compared to an average annual growth rate of 3.5 per cent between 1992 and 2010 (Chart 3.17).

²⁰ OBR, 2012, *Economic and fiscal outlook*, December, Box 3.6.

Chart 6.17: Government consumption (average annual growth)



Source: ONS

- 6.71 In December we reduced our forecast for the growth of the government consumption deflator, implying a stronger contribution from real government consumption growth. However, the latest outturn data suggest that the government consumption deflator has been even weaker – and real government consumption even stronger – than we thought at the time. Data available at the time of the December forecast indicated that the government consumption deflator grew by 2.7 per cent in the year to the third quarter of 2012; recent outturns now indicate growth of 0.4 per cent over the same period.
- 6.72 Given this, and the way in which government activity is measured, we have made a further downward adjustment to our forecast for the growth of the government consumption deflator. For a given profile for cash spending, this revision has the effect of increasing real government consumption growth by 0.7 percentage points in 2014 and just over 1½ percentage points in subsequent years.

World economy

- 6.73 World output growth appears to have slowed to 3.1 per cent in 2012 from 3.9 per cent in 2011. Some survey evidence suggests it is beginning to pick-up again at the start of this year. For example, the *JP Morgan Global Manufacturing Purchasing Managers' Index* (PMI) rose to a ten-month high in January. Although the overall *Composite PMI* has fallen slightly

since December, the average level so far during the first quarter of 2013 is above the average level during the final quarter of 2012. Our forecast for world growth in 2013 of 3.4 per cent remains broadly unchanged from our December forecast.

- 6.74 The euro area remains a major risk to our forecast. The improvements in euro area financial markets seen since last summer have been maintained so far this year. However, these improvements have yet to feed through to the real economy and the underlying situation remains very fragile. Euro area GDP contracted by 0.6 per cent in the final quarter of 2012, the sharpest quarterly fall since 2009.
- 6.75 We have revised down our forecast for euro area growth in 2013 to -0.5 per cent, reflecting the sharp fall in output at the end of 2012 and the latest survey indicators. The *Markit euro area Composite PMI* rose to a ten-month high in January but fell back in February and remains at a level consistent with a further fall in euro area GDP. We expect the euro area to start recovering in the second half of 2013, with growth of 1 per cent in 2014, broadly unchanged from our December forecast. The difficulties of the euro area will not be resolved quickly and our central assumption remains that they are likely to constrain growth for several years to come.
- 6.76 US growth was zero in the final quarter of 2012. This sharp slowdown was due to large falls in inventories, defence spending and exports. Meanwhile consumption and investment, the main components of domestic demand, both held up. We assume that this weakness is short-lived, with growth in the US economy picking-up in the first quarter of 2013. The extent of fiscal tightening in the US during 2013 continues to create uncertainty. The *American Taxpayer Relief Act* of January 2012 removed part of the uncertainty around at the time of our December forecast, but some remains due to negotiations over spending cuts that took effect at the start of March and attempts to agree a budget for 2013. In line with external forecasters, such as the IMF, we expect fiscal tightening worth around 1.5 per cent of GDP in 2013. Even if the risk of greater tightening is avoided in 2013, the long process of reform and consolidation of US public finances is likely to remain a source of ongoing uncertainty.
- 6.77 Developments in China's economy have been more positive since our December forecast. Growth in China appears to be picking-up, having slowed in the middle of last year, and leading indicators, such as the *HSBC China Composite PMI*, which rose to a two-year high in January, suggest this pick-up will continue into 2013.

World trade

- 6.78 Whereas outturns for world growth this year have been broadly in line with our December forecast, world trade has been weaker than we expected. The slowdown in world trade has been broad based, with trade growth slower in nearly all regions during 2012 than in 2011. The CPB Netherlands Bureau for Economic Policy Analysis *World Merchandise Index* suggests that world trade growth remained weak in the final quarter of 2012. We now expect world trade to grow by 2.5 per cent in 2012 and assume that the weakness of trade relative to world output is likely to continue. As a result, the increase in world trade generated by higher global output growth during the next couple of years will be less sharp than we forecast in December. We now expect world trade to grow by 3.7 per cent in 2013 and 5.6 per cent in 2014, a revision down of 0.7 and 0.3 percentage points from December. In their January *World Economic Outlook Update* the IMF made similar downward revisions to its world trade forecasts.
- 6.79 Growth in UK export markets is expected to be slower than growth in world trade (see Chart 3.18). This is because slower-growing economies, such as the euro area, make up a larger share of UK exports. We now expect growth of 1.9 per cent in 2012, 3.4 per cent in 2013 and 5.2 per cent in 2014, which is lower than in our December forecast. These downward revisions reflect weaker import growth in the euro area and the US, two key UK export markets, than we were expecting in December.

Chart 6.18: World trade and UK export market weighted trade growth



Source: ONS, OECD, OBR

Exports

- 6.80 UK exports have slowed significantly over the past year. The latest data indicate that volumes fell 0.3 per cent in 2012, weaker than the 0.1 per cent growth we expected in December and weaker than in 2011, when volumes grew 4.6 per cent. Recent data suggest that exports remained weak going into 2013, with volumes falling by 1.5 per cent in the final quarter of 2012.
- 6.81 At least part of the weakness in exports reflects the deterioration in UK export markets. The latest data indicate that UK export market growth slowed to just under 2 per cent in 2012 from just under 6 per cent in 2011, as output in the euro area declined and world trade volumes slowed. However, weak export performance cannot be attributed solely to slower export market growth. While export volumes declined in 2012, export markets continued to grow, albeit at a relatively slow rate. This implies a fall in exporters' market share. Box 3.4 discusses recent movements in UK exporters' market share in more detail.
- 6.82 The downward revision to our forecast for UK export markets means that we now expect weaker export growth than in December. We have revised down our forecast for export growth in 2013 from 3.1 per cent to 1.5 per cent, reflecting both the relative weakness of UK exports at the end of 2012 and slower UK export market growth through 2013. Weaker

export markets growth also reduces export growth in 2014 by around 0.1 per cent relative to our December forecast.

- 6.83 Our forecast for exports continues to imply a loss of export market share, continuing the general trend seen over the past decade (Chart 3.19). The decline in share is expected to be less steep than over the recent past, as some of the factors behind the sharp deterioration in exports – such as the relatively weak performance of the financial sector – might not be expected to exert the same drag in future years. This, taken together with relatively subdued export price growth, points to a more modest decline in export share than recent trends.

Chart 6.19: UK exports market share



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

Box 6.4: UK export markets

Rising exports added 4.3 per cent to GDP between the trough of the recession in the second quarter of 2009 and the final quarter of 2011. But, since the end of 2011, exports have fallen and reduced GDP by 0.8 per cent rather than rising and increasing it by 1.2 per cent as we forecast in March 2012. This disappointing performance in part reflects weaker-than-expected growth in UK export markets and some rise in sterling. However, part of the weakness remains unexplained.

In assessing recent trends it is useful to distinguish between goods and services exports. Between 1997 and 2007, UK exporters lost market share in G7 import markets for goods exports (Table A). Since the sterling depreciation between 2007 and 2009 the UK market share of goods exports has been broadly unchanged. For services, the UK market share expanded rapidly between 2002 and 2007 with strong growth in financial services exports. Since 2007, the UK market share for services exports remained broadly steady before falling sharply from the start of 2012. The value of UK financial services exports has fallen by a tenth in the four quarters to the third quarter of 2012 on a year earlier (Chart B).^a

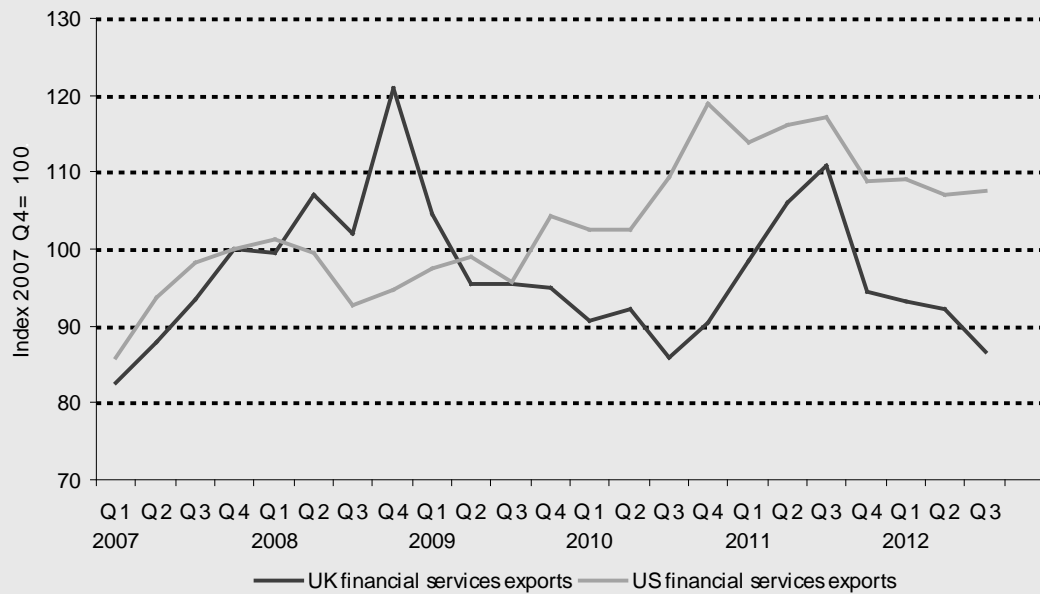
Table A: Average quarterly growth in the ratio of UK exports to rest of the G7 imports

	1997Q1-2001Q4	2002Q1-2007Q3	2007Q4-2011Q4	2012Q1-2012Q3
Goods	-0.8	-0.8	0.2	-0.2
Services	0.0	1.4	-0.1	-2.3
Total	-0.6	-0.1	0.1	-0.9

It is not clear why UK exports of financial services have fallen so sharply in the past year or whether this trend will continue. Over the last few years there have been large revisions to the export data (see Box 2.1 in Chapter 2), so this fall could be revised away in subsequent data vintages. There may also be problems with measuring financial service activity.^b

However, US financial exports have also fallen by 7 per cent in the four quarters to the third quarter of 2012 on a year earlier. A recent report highlights that global cross-border capital flows remain well down on their pre-recession level and have fallen back since 2010.^c The Bank of England argues that the fall in UK financial services exports could reflect changes in both the demand for and supply of UK financial services.^d In particular, demand for the types of financial products that the UK specialises in may have fallen, while banks may be trying to make changes to the riskiness of their balance sheets by reducing their overseas and domestic business.^e

Chart B: US and UK financial services exports



Source: ONS, Bureau of Economic Analysis, OBR

^a The ONS do not currently publish volume data for different types of services exports. The latest data available for the types of services exports by value is the third quarter of 2012.

^b Martin Weale, 2009, *Growth prospects and financial services*, January.

^c McKinsey Global Institute, 2013, *Financial globalization: Retreat or reset*, March.

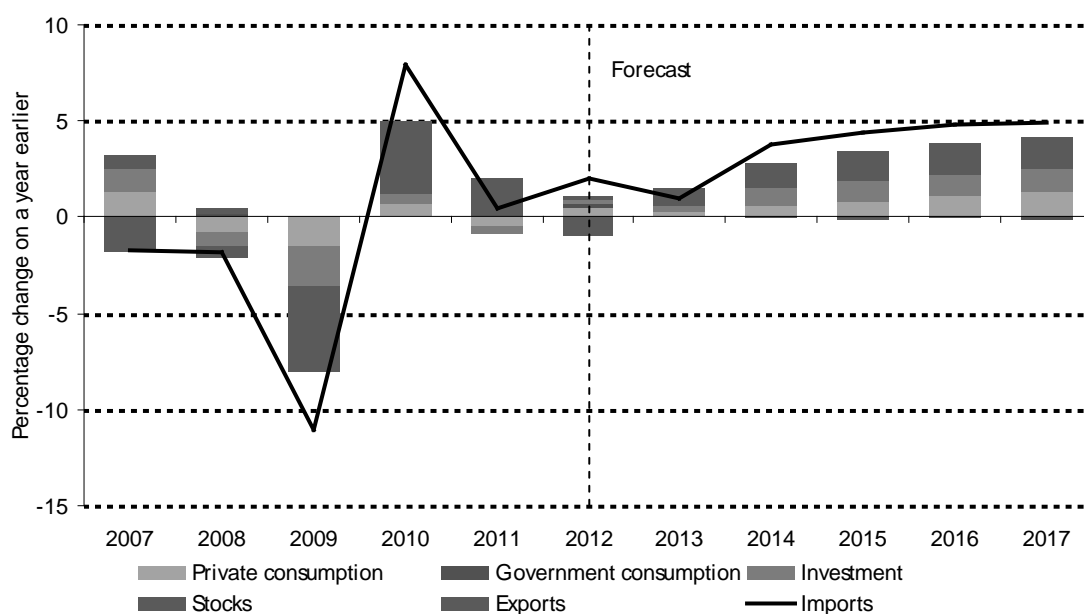
^d Bank of England, 2013, *Inflation Report*, February.

^e Bank of England, 2012, *Financial Stability Report*, November.

Imports

6.84 Our forecast for imports is determined by the outlook for import-weighted domestic demand, set out in Chart 3.20. The downward revision to domestic demand growth in 2013 and 2014 means that we now expect slightly weaker import growth over the near term, although the effect on net trade is more than offset by weaker export growth. Within domestic demand, both consumption and investment have relatively high import intensity and the recovery in these components supports the pick up in import growth from 2015. The weakness of government activity has relatively little offsetting effect on import growth, reflecting the relatively low import intensity of this component of demand.

Chart 6.20: Contributions to import-weighted domestic demand growth and UK import growth



Source: ONS, OBR

Net trade

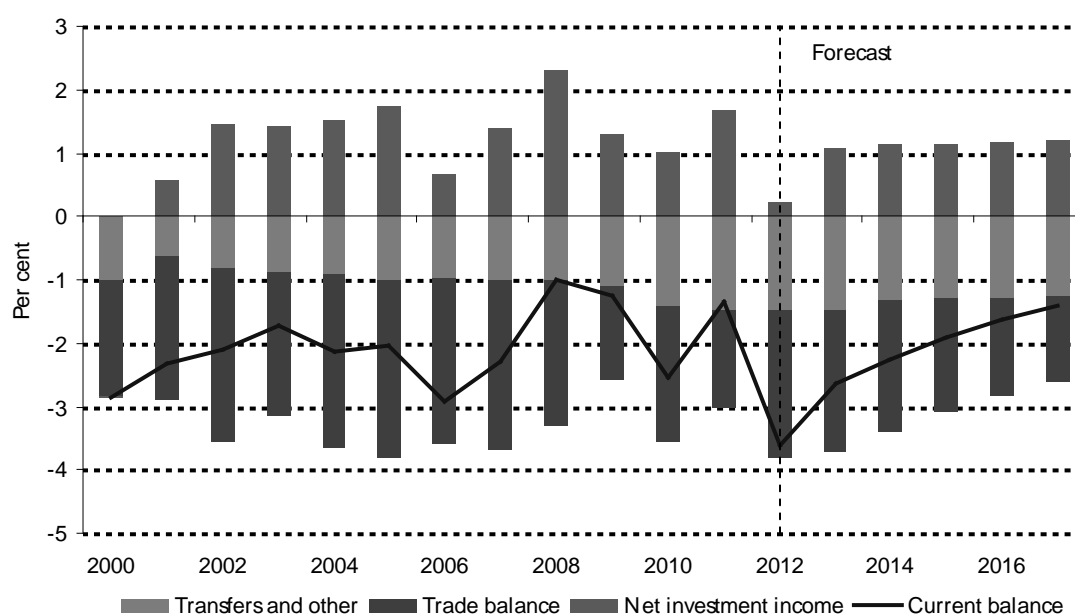
6.85 We expect net trade to make a weaker contribution to near-term growth than we forecast in December. Net trade is now expected to contribute 0.1 percentage points to growth in 2013, revised down from the 0.3 percentage points we expected in our December forecast. This partly reflects the effect of data released since December. Net trade is now estimated to have added slightly less to growth over the final two quarters 2012 than we expected in December. Net trade is also expected to contribute slightly less to growth through this year, as weaker export market growth is only partially offset by the effect of slower domestic demand growth on imports. The contribution from net trade to growth is expected to remain at around 0.1 percentage points in subsequent years of the forecast.

Balance of payments

6.86 The current account deficit widened sharply over the first half of 2012, reflecting both a widening of the trade deficit and a significant deterioration in the investment income balance in the second quarter.²¹ Despite a subsequent improvement in the trade and investment balances, the current account deficit remained relatively large in the third quarter, at just over 3 per cent of GDP.

6.87 The gradual improvement in net exports means that we expect the current account deficit to narrow slowly over the forecast period, reaching around 1.4 per cent of GDP by 2017. We expect the investment income balance to recover from its relatively weak position in 2012, although we do not expect it to return to its pre-crisis share of GDP.

Chart 6.21: Current account balance as a share of GDP



Source: ONS, OBR

Inflation and the GDP deflator

6.88 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation, including the Consumer

²¹ For more discussion of recent movements in the current account balance see Martin Weale, 2013, *The Balance of Payments*, February.

Prices Index (CPI) and the Retail Prices Index (RPI) measures. The basic approach to the measurement of inflation using these indices is the same, although there are a number of differences due to coverage, the representative population covered by the indices and the methods used to construct them.²²

- 6.89 The RPI and CPI measures of inflation are important because they have different effects on our fiscal forecast. The Government uses CPI for the indexation of most tax rates, allowances and thresholds and for the uprating of benefits and public sector pensions. The RPI is used for calculating interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties.
- 6.90 In November 2012, the ONS announced that a new additional measure of consumer price inflation (CPIH), including owner occupiers' housing costs, will be published.²³ We have not produced a forecast of CPIH inflation in this *EFO*, as this variable is not required for our fiscal forecast.

CPI inflation

- 6.91 CPI inflation has been slightly higher than in our December forecast, at 2.7 per cent both over the final quarter of 2012 and in January 2013.²⁴ Retail gas and electricity price rises and increases in university tuition fees made a significant contribution to CPI inflation at the end of 2012. Food prices have also contributed more, in part due to bread, cereal and vegetable prices.²⁵
- 6.92 Looking ahead, we have raised our forecast for CPI inflation in 2013 due to recent outturn data and higher oil prices. We also assume that there will be upward pressure on CPI inflation over the next few years due to higher import prices as a result of sterling's recent depreciation. We expect retail food price inflation to be relatively elevated in 2013 as we continue to assume that rises in food commodity prices in 2012 feed through into higher retail food prices. Overall, we expect CPI inflation to rise towards the middle of this year and then fall gradually over 2014 and 2015.

²² For more details on the differences between the RPI and CPI see Miller, R, 2011, OBR Working Paper No. 2: *The long-run difference between RPI and CPI inflation*, November.

²³ ONS, 2013, *Introducing the New CPIH Measure of Consumer Price Inflation*, March.

²⁴ Our forecast takes into account inflation outturns up to and including January 2013.

²⁵ ONS Statistical Bulletin, *Consumer Price Indices*, November 2012 to January 2013.

- 6.93 Our forecast assumes that world oil prices will move in line with the prices implied by futures markets. For our forecast we take an average over the ten working days ending 25 February 2013. These are higher than in our December forecast.
- 6.94 Rises in retail electricity and gas prices by the major UK energy suppliers at the end of 2012 and beginning of 2013 have now been implemented, with the last occurring on 18 January. Some UK energy suppliers have pointed to increased distribution, network and environmental policy costs as well as wholesale costs.
- 6.95 We expect these environmental policy and network costs to persist in coming years, contributing to rises in domestic gas and electricity prices. Policy costs could account for an average increase of around 2 per cent per annum in retail electricity prices and around 0.5 per cent per annum increases in household gas prices in the years to 2020.²⁶ Network costs could add a further 2 per cent per annum to domestic energy prices over the next few years.²⁷ While wholesale energy costs are inherently uncertain, there may also be some further upward pressure from increased wholesale prices in winter 2013 based on the forward prices at the time of producing this forecast.
- 6.96 Overall we assume rises in domestic energy prices of around 7 per cent in winter 2013. We also assume that there is a rise of around 3 per cent towards the end of 2014. This implies that the contribution to CPI inflation from retail energy prices is around 0.3 and 0.1 percentage points in winter 2013 and winter 2014 respectively. However there are uncertainties around these estimates, depending on the pricing strategies used by suppliers and the extent to which these non-wholesale costs may already be factored into current retail prices.
- 6.97 In the medium term we expect CPI inflation to fall back to target, remaining close to 2 per cent from 2016 onwards (Chart 3.22). We expect downward pressure on prices from the negative output gap over the

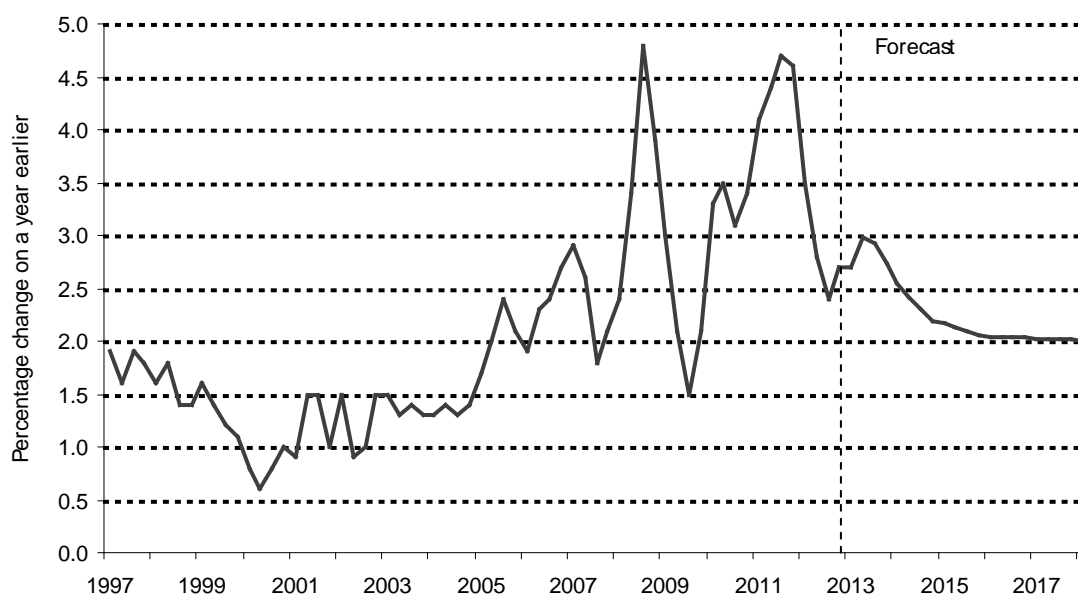
²⁶ This has been calculated based on figures in Table E1 and E2 in DECC, 2011, *Estimated impacts of energy and climate change policies on energy prices and bills*, November.

²⁷ This is based on increases in agreed allowed revenue taking into account forecasted decreases in demand. For percentage changes in allowed revenues see: Ofgem, 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd*, April; Ofgem, 2012, *RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas*, December. Ofgem, 2009 *Final proposals for Electricity Distribution Price Control Review*, December.

forecast period to be offset, to some extent, by upward pressure from above trend growth rates and falling unemployment in the later years.

- 6.98 Policy announcements by the Government have also been incorporated into our inflation forecast. Cancelling the rise in fuel duty in September 2013 will reduce annual CPI inflation by around 0.1 percentage points at the end of 2013 and in the first half of 2014.²⁸ Reducing beer duty by 2 per cent in 2013-14 and raising it by RPI rather than RPI plus 2 per cent in 2014-15 has an additional small downward effect on CPI inflation relative to the continuation of pre-announced changes.

Chart 6.22: CPI inflation forecast



Source: ONS, OBR

RPI inflation

- 6.99 The ONS has considered methodological changes to the RPI based on the use of different formulae to aggregate prices at the lowest level.²⁹ Since our December forecast, the National Statistician has concluded that the RPI formula will remain unchanged – even though it does not meet international standards – and that a new inflation index will be

²⁸ This impact is relative to a baseline including pre-announced changes to fuel duty.

²⁹ OBR, 2012, *Economic and fiscal outlook*, December, Box 3.7.

published from March 2013, called RPIJ.³⁰ We have not produced a forecast of RPIJ inflation in our *EFO*, as this variable is not used in our fiscal forecast. The announcement has not affected our RPI forecast.

- 6.100 RPI inflation is expected to follow a similar path to CPI inflation, but this measure also includes mortgage interest payments (MIPs) and housing depreciation.
- 6.101 House price inflation was higher than expected in the final quarter of 2012. We assume that house prices move in line with the median outside forecast of ONS house prices.³¹ This suggests a weaker annual rate of ONS house price inflation in the fourth quarter of 2013 and 2014 compared to our December forecast. In the medium term, we expect house price inflation to rise broadly in line with the long-term average rate of earnings growth.
- 6.102 Lower bank funding spreads lead to a gradual fall in average mortgage rates in the first few years of our forecast. Rising Bank rate then feeds into higher mortgage rates and put upward pressure on the RPI in the medium term. Our forecast for the contribution of MIPs to RPI inflation is higher in the medium term than in December, largely as a result of higher expectations for Bank rate.

The GDP deflator

- 6.103 GDP deflator growth is the broadest measure of 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 consumption, government spending, investment and trade.
- 6.104 The GDP deflator was lower through 2012 than we thought in December, reflecting ONS revisions. Going forward, our forecast for growth in the consumption deflator is higher than previously expected, in line with the upward revisions to our forecast for CPI inflation.

³⁰ This will use a geometric formulation (Jevons). For more details see: National Statistician's Consumer Prices Advisory Committee *Outcome from the National Statistician's consultation on the Retail Prices Index, October – November 2012*; ONS, 2013, *Introducing the New RPIJ Measure of Consumer Price Inflation*, March.

³¹ See HM Treasury, 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, February.

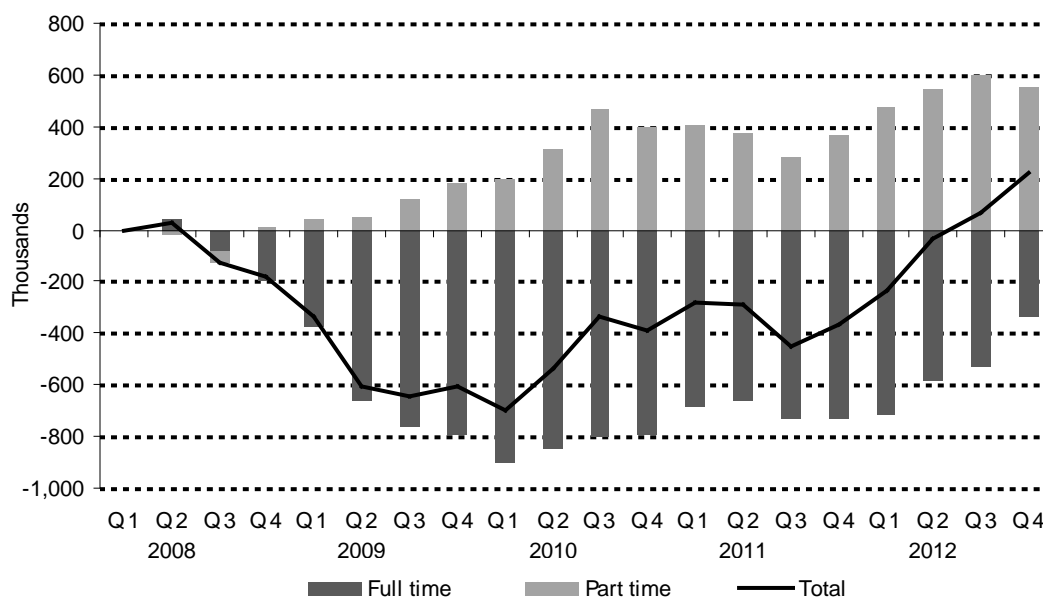
- 6.105 Recent outturn data suggest that the government consumption deflator has been even weaker – and real government consumption has been even stronger – than we thought at the time of our December forecast. Given this, and the way in which government activity is measured, we have made a further downward adjustment to our forecast for the growth of the government consumption deflator (see paragraphs 3.68 to 3.71 for more details).
- 6.106 The level of nominal GDP is lower than we forecast in December throughout the forecast period. This reflects both a weaker forecast for real GDP growth and a downward adjustment to the GDP deflator. Taken together these adjustments leave the level of nominal GDP in 2017-18 around 2.6 per cent lower than in our December forecast. Of this, around 0.6 of a percentage point is attributable to a lower level of real GDP, with the remainder reflecting a lower GDP deflator.

The labour market

Employment, unemployment and inactivity

- 6.107 As set out in Chapter 2, the labour market performed more strongly in the fourth quarter than we expected in December. Employment rose to 29.7 million in the final quarter of 2012, compared to our forecast of 29.6 million, while the unemployment rate remained at 7.8 per cent rather than rising to 7.9 per cent. The rise in employment was driven by people working full time, while the number of people working part time fell. This is in contrast with the trend we have seen in most previous quarters where the rise in employment has been driven by part-time workers as shown in Chart 3.23.
- 6.108 People employed in government supported training and employment programmes fell marginally in the fourth quarter after rising in the four preceding quarters. Of the total increase in employment in 2012, compared to 2011, around 14 per cent reflects increased participation in those programmes.

Chart 6.23: Cumulative change in employment of people working full time and part time since 2008



Source: ONS

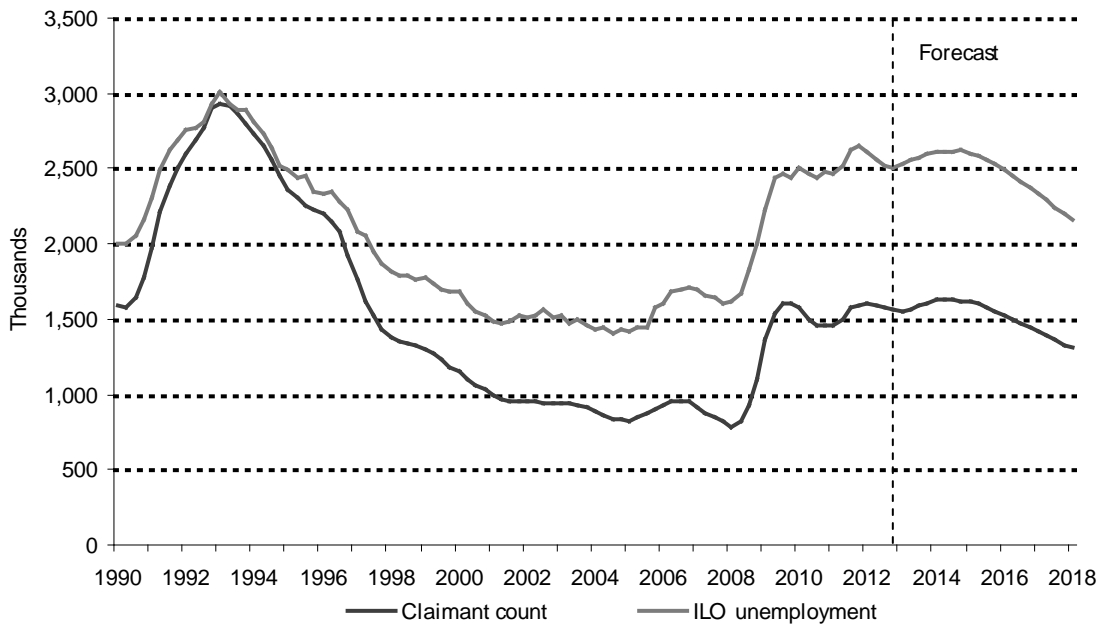
6.109 The activity rate continued to rise in the final quarter of 2012. At 63.6 per cent, it is now only fractionally below its pre-crisis peak of 63.7 per cent. Activity has increased among older workers,³² compensating for a fall in activity among younger people. This is consistent with later retirement age of women and greater participation in full-time education.

6.110 We have revised up our employment forecast in line with continued strength of employment in the fourth quarter and survey indicators suggesting increased employment at the start of 2013. We now expect unemployment to peak at 8.0 per cent in 2014 before falling back to 6.9 per cent in 2017.

6.111 Consistent with our unemployment profile, we now expect the claimant count to remain relatively flat in the next few years, peaking at 1.63 million in 2014 before falling back to 1.38 million in 2017 (Chart 3.24).

³² See for example: Cribb et.al. 2013, *Incentives, shocks or signals: Labour supply effects of increasing the female state pension age in the UK*, IFS working paper, March.

Chart 6.24: Unemployment levels



Source: ONS

6.112 Total market sector employment is expected to rise by around 2.6 million between the start of 2011 and the start of 2018, more than offsetting the total reduction in general government employment of around 1.2 million. Excluding the reclassification of almost 200,000 employees from the public to the private sector in 2012, market sector employment is forecast to rise by 2.4 million and public sector employment to fall by 1 million (Box 3.5).

Box 6.5: General government employment

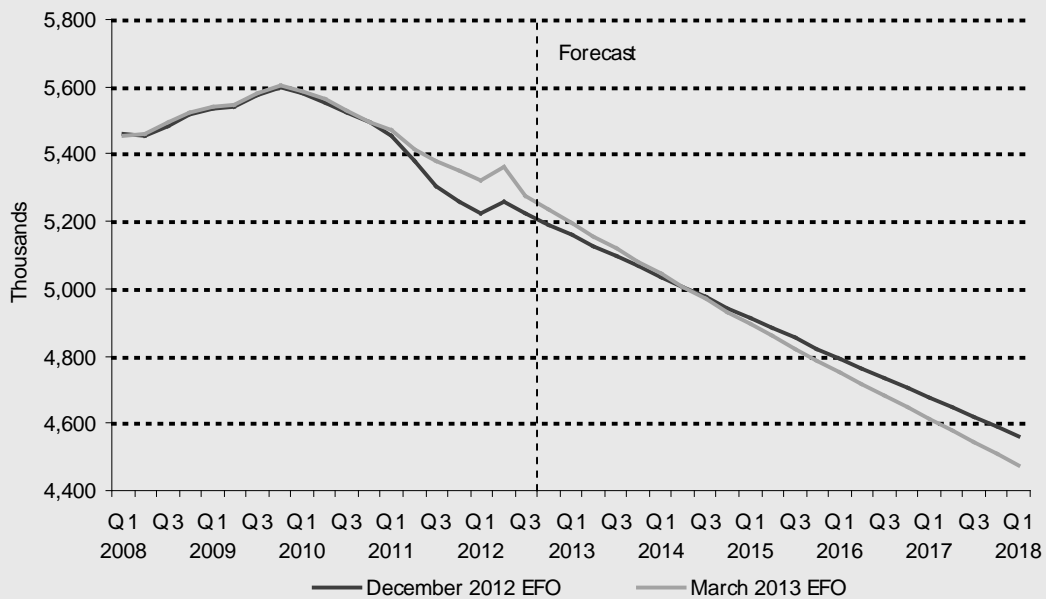
Our projection for general government employment (GGE) is built up from projections of total government paybill and paybill per head. We use these projections to estimate the total decline in GGE from the start of the 2010 Spending Review period to the end of the forecast and then make a stylised assumption that employment falls at a constant rate from the latest outturn data.

Our latest projections incorporate updated expenditure projections and new data on average earnings and workforce reductions so far in 2012-13:

- In December we forecast a 1.1 million fall in general government employment from the start of 2011 to the start of 2018. Excluding a classification change introduced in the second quarter of 2012, which moved around 196,000 employees from the public to the private sector, the fall was around 930,000.
- Data on public sector average earnings growth since December was marginally stronger than we expected, resulting in a small upward revision to our paybill per head growth assumption in 2012-13 to 2.0 per cent from 1.9 per cent. For the rest of the forecast the assumptions are unchanged since December.
- Our latest forecast assumes that there will be around 2 per cent less departmental spending available for paybill at the start of 2018 compared to our December forecast. Combining this assumption with our paybill per head growth assumptions implies a total reduction in GGE of around 1.2 million from the start of 2011 to the start of 2018 or around 1 million excluding the reclassification.^a
- In December, the ONS^b revised up its estimate of central government employment after improving the method it uses to estimate the level of employment in Academy schools in England. The size of the revision increases from around 20,000 more employees at the start of 2011 to around 100,000 more in the second quarter of 2012. As shown on Chart C this is consistent with a more gradual decline in employment and less frontloading than previous data suggested.

All this implies an average fall in GGE of around 36,000 per quarter over the remainder of the period, compared to an average fall to date of around 34,000 per quarter from the first quarter of 2011 to the third quarter of 2012, excluding the classification change.

Chart C: Forecast for GGE – December 2012 compared to March 2013 adjusted for reclassification



Source: ONS, OBR

In our December *EFO* we mentioned that growth in paybill per head, measured using ONS data on wages and salaries divided by number of employees, had been considerably stronger than growth in public sector average weekly earnings (AWE) in recent years. Some commentators suggested that higher paybill per head – rather than frontloading – explained the sharp reduction in GGE to date and suggested that the total reduction going forward would be larger. The data revision mentioned above, as well as downward revisions to wages and salaries since December, has narrowed this gap. Looking at the last three fiscal years (2009-10 to 2011-12), aggregate growth in the two measures is now roughly the same although the rates vary in individual years.

There are various reasons for the growth rates to differ. For example, some elements of redundancy payments, expenses and wages and salaries in kind (such as discounted meals and provision of recreation facilities) are included in wages and salaries but not in AWE.

^a More details on the paybill per head forecast and the general government employment projections by year in the latest forecast can be found in the supplementary tables accompanying this *EFO*, available on our website.

^b ONS, 2012, *Change in method for estimating employment in education in England*,

December.

6.113 The strong performance of the labour market in recent quarters provides little evidence of a significant structural deterioration since our December forecast. We have not therefore adjusted our estimate of the long-term non-accelerating inflation rate of unemployment (NAIRU). Long-term unemployment, as a share of total unemployment, fell marginally in the final quarter of 2012. The youth unemployment rate, for those aged 16 to 24, was broadly flat. Excluding those in full-time education, the rate fell by 0.3 percentage points in the fourth quarter.

Earnings

6.114 Average earnings growth continued to fall in the fourth quarter with average weekly earnings (AWE) in the private sector growing by only 1.3 per cent compared to 2.0 per cent in the third quarter and our forecast of 2.0 per cent in December.

6.115 Key determinants of the prospects for average earnings growth include the growth rate of productivity, the extent of labour market slack, and the degree of real wage resistance to changes in price inflation. We have made a slight downward revision to our forecast for nominal wage growth since December. This reflects both the weak outturns in the fourth quarter for nominal wages and productivity and a weaker forecast for productivity growth going forward, consistent with a stronger employment but a weaker output growth forecast. Whole economy wages are expected to grow by 1.4 per cent this year and around 2.7 per cent in 2014, rising gradually to 4.0 per cent in 2016.

6.116 With an upward revision to price inflation and a downward revision to wage growth, our forecast for real wage growth is weaker than in December. We now expect real wage growth to be negative in 2013 and only marginally positive in 2014, before picking up in 2015 and reaching 2 per cent in 2016.

6.117 Despite a downward revision to average earnings our forecast for wages and salaries – a key determinant for tax receipts from labour income – is only around 1 per cent lower by 2017 than we expected in December with an upward revision to employment partly offsetting the fall in earnings.

Comparison with external forecasts

- 6.118 In this section, we compare our latest projections with those of key outside forecasters. Estimates of the current degree of spare capacity and the potential growth rate of the economy, where available, differ widely as discussed in Box 3.2.
- 6.119 In its January *World Economic Outlook Update*, the **IMF** forecast GDP growth of 1 per cent in 2013, around 0.4 percentage points stronger than our central forecast. The IMF published its forecast before the estimate of GDP growth in the final quarter of 2012, which may partly explain the difference. Further out, the IMF's update assumed growth of 1.9 per cent in 2014, slightly stronger than our central forecast. The IMF's January update did not include new medium-term forecasts. However, the IMF's October *World Economic Outlook* forecast growth to average around 2.6 per cent between 2014 and 2017, in line with the average growth rate implied by our latest forecast.
- 6.120 The **OECD** published an updated forecast as part of its November *Economic Outlook*. Their short-term forecast for GDP growth is slightly stronger than our central forecast: the OECD expect growth of 0.9 per cent in 2013, although this forecast was published prior to the estimate of GDP for the final quarter of 2012. The OECD forecast growth of 1.6 per cent in 2014 – slightly below our central forecast – and there are some differences in the expected composition of growth, with the OECD expecting a larger contribution from consumption and net trade, but a weaker contribution from investment and government consumption.
- 6.121 The **European Commission** published its latest forecast in February. They expect growth of 0.9 per cent this year and 1.9 per cent in 2014, a little stronger than our central forecast in both years. The Commission expect a stronger contribution from trade, with net exports contributing 0.2 percentage points to growth in 2013 and 0.6 percentage points in 2014 – this compares to our forecast for a contribution of 0.1 percentage point

in each year. They also expect a stronger contribution from consumer spending, with consumption growth expected to average 1.3 per cent between 2012 and 2014, compared to an average growth rate of 0.8 per cent in our central forecast. The effect of stronger contributions from consumption and net trade on GDP growth is partially offset by a weaker forecast for government consumption and investment than our central case.

- 6.122 In its February *Economic Review*, the **National Institute for Economic and Social Research (NIESR)** forecast GDP growth of 0.7 per cent in 2013, slightly above our central forecast. However, they forecast slightly weaker growth over the medium term with growth averaging around 2.1 per cent between 2013 and 2017, compared to an average growth rate of 2.4 implied by our latest forecast. Much of the difference between the forecasts is attributable to a weaker medium-term outlook for investment and government consumption, partly offset by a stronger contribution from net trade. NIESR also expect lower average inflation than our central forecast. This may be attributable to a larger output gap forecast, but we cannot be sure as they do not publish the profile for this variable.
- 6.123 Comparison with the Monetary Policy Committee's economic forecast is not straightforward because the Bank of England only publishes point estimates for two variables, CPI inflation and GDP growth. The **Bank of England's** modal forecast for GDP is slightly stronger in 2013 and 2014 than our central forecast, although they assume slightly weaker growth in 2015. The MPC's modal forecast for CPI inflation is higher in both 2013 and 2014 than our central forecast.
- 6.124 **Oxford Economics'** forecast, published in March 2013, assumes higher GDP growth than our central forecast in all years. They also expect weaker CPI inflation than we do, which may partly reflect the larger output gap implied by their forecast.

Table 6.4: Comparison of external forecasts

	Per cent						
	2011	2012	2013	2014	2015	2016	2017
OBR (March 2013)							
GDP growth	0.9	0.2	0.6	1.8	2.3	2.7	2.8
CPI inflation	4.5	2.8	2.8	2.4	2.1	2.0	2.0
Output gap	-2.7	-2.7	-3.6	-3.7	-3.4	-2.9	-2.3
IMF (October 2012)							
GDP growth ¹	0.9	-0.2	1.0	1.9	2.6	2.6	2.7
CPI inflation	4.5	2.7	1.9	1.7	1.8	1.8	1.9
Output gap	-2.6	-4.2	-4.4	-3.6	-2.7	-2.1	-1.4
OECD (November 2012)							
GDP growth	0.9	-0.1	0.9	1.6			
CPI inflation	4.5	2.6	1.9	1.8			
Output gap	-1.4	-2.2	-2.3	-2.0			
EC (February 2013)							
GDP growth	0.9	0.0	0.9	1.9			
CPI inflation	4.5	2.8	2.6	2.3			
Output gap	-2.7	-3.3	-3.2	-2.5			
NIESR (February 2013)							
GDP growth	0.9	0.0	0.7	1.5	2.1	2.3	2.3
CPI inflation	4.5	2.8	2.4	2.3	2.2	1.8	1.9
Output gap		-4	-4 ½				
Bank of England (February 2013)							
GDP growth (mode) ²		0.3	0.9	1.8	2.0		
CPI inflation (mode) ²		2.8	3.0	2.7	2.2		
Oxford Economics (March 2013)							
GDP growth	0.9	0.2	0.9	2.0	2.5	2.8	2.9
CPI inflation	4.5	2.8	2.6	1.6	1.5	1.5	1.7
Output gap	-3.6	-5.6	-6.0	-5.5	-5.0	-4.2	-3.5

¹ GDP growth up to 2014 is from the IMF January 2013 World Economic Outlook Update

² Mode forecast based on market interest rates and the Bank of England's 'backcast' for GDP growth.

Table 6.5: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn			Forecast			
	2011	2012	2013	2014	2015	2016	2017
UK economy							
Gross domestic product (GDP)	0.9	0.2	0.6	1.8	2.3	2.7	2.8
GDP Level (2011= 100)	100.0	100.2	100.8	102.6	105.0	107.8	110.8
Nominal GDP	3.4	1.5	2.7	3.8	4.2	4.4	4.6
Output Gap (per cent of potential output)	- 2.7	- 2.7	- 3.6	- 3.7	- 3.4	- 2.9	- 2.3
Expenditure components of GDP							
Domestic demand	-0.6	1.2	0.5	1.6	2.2	2.5	2.7
Household consumption ¹	-1.0	1.0	0.5	1.2	1.7	2.4	2.8
General government consumption	-0.1	2.6	0.4	-0.7	-0.4	-1.0	-1.8
Fixed investment	-2.9	1.4	2.2	6.7	8.1	7.7	7.8
Business	3.1	4.9	1.9	6.1	8.6	8.6	8.6
General government ²	-26.2	2.7	2.6	5.0	1.8	-1.5	-1.2
Private dwellings ²	2.3	-5.4	2.0	8.9	10.0	10.0	9.7
Change in inventories ³	0.3	-0.2	-0.2	0.0	0.0	0.0	0.0
Exports of goods and services	4.6	-0.3	1.5	4.4	5.1	5.3	5.3
Imports of goods and services	0.5	2.0	1.0	3.8	4.4	4.8	4.9
Balance of payments current account							
Per cent of GDP	-1.3	-3.6	-2.7	-2.2	-1.9	-1.6	-1.4
Inflation							
CPI	4.5	2.8	2.8	2.4	2.1	2.0	2.0
RPI	5.2	3.2	3.2	2.8	3.2	3.6	3.9
GDP deflator at market prices	2.5	1.3	2.1	2.0	1.8	1.8	1.7
Labour market							
Employment (millions)	29.2	29.5	29.8	29.9	30.1	30.3	30.5
Wages and salaries	2.7	2.8	2.4	3.1	4.3	4.8	4.8
Average earnings ⁴	2.3	2.1	1.4	2.7	3.6	4.0	4.0
ILO unemployment (% rate)	8.1	7.9	7.9	8.0	7.9	7.4	6.9
Claimant count (millions)	1.53	1.59	1.58	1.63	1.59	1.48	1.38
Household sector							
Real household disposable income	-1.0	1.6	0.2	0.4	1.3	1.8	2.3
Saving ratio (level, per cent)	6.6	7.0	6.6	5.8	5.6	5.4	5.0
House prices	-1.0	1.6	1.3	1.6	3.3	4.0	4.0
World economy							
World GDP at purchasing power parity	3.9	3.1	3.4	4.1	4.4	4.6	4.6
Euro Area GDP	1.5	-0.5	-0.5	1.0	1.3	1.7	1.9
World trade in goods and services	5.7	2.5	3.7	5.6	6.0	6.2	6.3
UK export markets ⁵	5.9	1.9	3.4	5.2	5.6	5.7	5.8

¹ Includes households and non-profit institutions serving households

² Includes transfer costs of non-produced assets

³ Contribution to GDP growth, percentage points

⁴ Wages and salaries divided by employees

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

Table 6.6: Detailed summary of changes to forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2011	2012	2013	2014	2015	2016	2017
UK economy							
Gross domestic product (GDP)	0.0	0.3	-0.6	-0.3	0.0	0.0	0.0
GDP Level (2011= 100) ¹	0.0	0.3	-0.3	-0.6	-0.6	-0.6	-0.6
Nominal GDP	-0.2	-0.7	-0.6	-0.3	-0.2	-0.3	-0.3
Output Gap (per cent of potential output)	0.0	0.3	-0.1	-0.3	-0.3	-0.3	-0.4
Expenditure components of GDP							
Domestic demand	-0.2	0.7	-0.4	-0.2	0.0	0.0	0.0
Household consumption ²	-0.1	0.4	-0.4	-0.3	-0.1	-0.1	-0.1
General government consumption	-0.3	0.2	1.1	0.7	0.8	1.1	1.3
Fixed investment	-0.5	0.4	0.0	-1.4	-0.4	-1.0	-0.9
Business	0.2	1.1	-3.0	-2.1	-1.6	-1.5	-0.9
General government ³	-5.9	11.9	5.1	0.1	4.8	1.1	-1.9
Private dwellings ³	2.0	-7.8	3.1	-0.6	0.0	0.0	0.0
Change in inventories ⁴	0.0	0.4	-0.4	0.0	0.0	0.0	0.0
Exports of goods and services	0.1	-0.4	-1.6	-0.1	-0.1	-0.1	-0.1
Imports of goods and services	0.0	0.0	-1.1	-0.1	-0.1	-0.1	-0.1
Balance of payments current account							
Per cent of GDP	0.6	0.4	-0.1	0.0	0.1	0.0	0.0
Inflation							
CPI	0.0	0.0	0.3	0.2	0.1	0.0	0.0
RPI	0.0	0.0	0.2	0.2	0.0	0.2	0.2
GDP deflator at market prices	-0.2	-1.0	0.0	-0.1	-0.2	-0.3	-0.3
Labour market							
Employment (millions)	0.0	0.0	0.2	0.1	0.1	0.1	0.1
Wages and salaries	0.1	-0.5	-0.3	-0.1	-0.2	0.0	0.0
Average earnings ⁵	0.1	-0.7	-0.8	0.0	-0.1	0.0	0.0
ILO unemployment (% rate)	0.0	0.0	-0.3	-0.2	-0.1	-0.2	-0.2
Claimant count (thousands)	0	-4	-78	-63	-41	-49	-53
Household sector							
Real household disposable income	0.5	-0.5	-0.2	-0.4	-0.3	-0.2	0.0
Saving ratio (level, per cent)	0.6	-0.1	0.4	0.3	0.1	0.0	0.0
House prices	0.0	0.2	0.6	-0.9	-0.5	0.0	0.0
World economy							
World GDP at purchasing power parity	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Euro Area GDP	0.0	-0.1	-0.4	-0.1	0.0	0.0	0.0
World trade in goods and services	-0.1	-0.5	-0.7	-0.3	-0.3	-0.3	-0.2
UK export markets ⁶	0.0	-0.7	-0.8	-0.4	-0.2	-0.3	-0.3

¹ Per cent change since December² Includes households and non-profit institutions serving households³ Includes transfer costs of non-produced assets, which were excluded in previous forecasts⁴ Contribution to GDP growth, percentage points⁵ Wages and salaries divided by employees⁶ Other countries' imports of goods and services weighted according to the importance of those countries in the UK's total exports

7 Fiscal outlook

Introduction

7.1 This chapter:

- sets out the key economic and market determinants that drive the fiscal forecast (paragraphs 4.3 to 4.23);
- explains the effects of new policies announced in this Budget, and since the Autumn Statement in December, and reclassifications on the fiscal forecast (paragraphs 4.24 to 4.45);
- describes the outlook for public sector receipts, including a tax-by-tax analysis explaining how the forecasts have changed since December (paragraphs 4.46 to 4.95);
- describes the outlook for public sector expenditure, focusing on departmental expenditure limits and the components of annually managed expenditure (paragraphs 4.96 to 4.167);
- describes the outlook for government lending to the private sector and other financial transactions (paragraphs 4.168 to 4.187);
- sets out the outlook for the key fiscal aggregates: public sector net borrowing, the current budget, the cyclically-adjusted current budget and public sector net debt (paragraphs 4.188 to 4.201); and
- provides a comparison with external forecasts (paragraphs 4.202 to 4.207).

7.2 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in the supplementary tables available on our website. The medium-term forecasts for the public finances in this chapter consist of an in-year estimate for 2012-13, which makes use of

provisional ONS outturn data for April to January, and then forecasts to 2017-18.³³ As in previous *Economic and fiscal outlooks*, this fiscal forecast:

- represents our central view of the path of the public finances. We believe that the outturns are as likely to be above the forecast as below it. We illustrate the uncertainties that are inherent in any fiscal forecast by using fan charts, sensitivity analysis and alternative economic scenarios;
- is based on announced Government policy on the indexation of rates, thresholds and allowances for taxes and benefits, and incorporates the impact of certified costings for all new policy measures announced by the Chancellor in the Budget; and
- focuses on fiscal aggregates that exclude the temporary effects of interventions in the financial sector.³⁴ The Government's fiscal mandate and supplementary target are defined in terms of these measures. We also present measures of underlying public sector net borrowing, which exclude some significant one-off or temporary transactions.

Economic determinants of the fiscal forecast

7.3 Our forecasts for the public sector finances are based on the economic forecasts presented in Chapter 3. Forecasts of tax receipts are particularly dependent on the path and composition of economic activity. And while much of public sector expenditure is set out in multi-year plans, large elements (such as social security and debt interest payments) are linked to developments in the economy. Table 4.1 sets out some of the key economic determinants of the fiscal forecast and Table 4.2 shows how these have changed since our forecast in December.

³³ Outturn data is consistent with the Public Sector Finances January 2013 Statistical Bulletin published by the Office for National Statistics and HM Treasury. We have also used HMRC administrative data on central government receipts in February and early March to inform our forecast.

³⁴ Office for National Statistics, 2010, *Public sector finances excluding financial sector interventions*.

Table 7.1: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
GDP and its components							
Real GDP	0.7	0.2	0.8	2.0	2.4	2.7	2.8
Nominal GDP (£ billion) ¹	1526	1546	1595	1658	1728	1806	1889
Nominal GDP ¹	3.1	1.3	3.2	4.0	4.2	4.5	4.6
Nominal GDP (centred end-March)	2.1	2.0	3.7	4.1	4.3	4.6	4.6
Wages and salaries ²	2.4	3.0	2.4	3.3	4.5	4.8	4.8
Non-oil PNFC profits ^{2,3}	6.4	3.0	1.8	5.8	6.3	6.8	7.4
Non-oil PNFC net taxable income ^{2,3}	9.4	11.0	-1.2	1.7	4.2	5.2	6.1
Consumer spending ^{2,3}	3.5	3.7	3.4	3.5	3.8	4.5	4.9
Prices and earnings							
GDP deflator	2.1	1.3	2.3	1.9	1.8	1.7	1.7
RPI (September)	5.6	2.6	3.3	2.8	3.2	3.6	3.9
CPI (September)	5.2	2.2	2.9	2.3	2.1	2.0	2.0
Whole economy earnings growth	2.7	1.7	1.8	2.9	3.8	4.0	4.0
'Triple-lock' guarantee (September)	5.2	2.5	2.9	2.6	3.6	4.0	4.0
Key fiscal determinants							
Claimant count (millions) ⁴	1.57	1.57	1.60	1.62	1.56	1.46	1.35
Employment (millions)	29.2	29.6	29.8	29.9	30.1	30.4	30.6
VAT gap (per cent)	9.5	10.7	10.5	10.5	10.5	10.5	10.5
Financial and property sectors							
Equity prices (FTSE All-share index)	2903	3080	3405	3540	3690	3856	4032
HMRC financial sector profits ^{1,3,5}	-5.0	2.0	1.4	2.3	2.8	3.8	4.7
Financial sector net taxable income ^{1,3}	3.2	-1.6	5.4	4.5	3.6	6.1	7.3
Residential property prices ⁶	-0.9	2.2	0.9	1.9	3.6	4.0	4.0
Residential property transactions ('000's)	915	938	1083	1139	1208	1279	1355
Commercial property prices ⁷	4.9	-0.1	-0.1	2.6	3.6	3.8	3.4
Commercial property transactions ⁷	-2.8	2.8	-1.6	0.1	2.8	4.4	5.0
Volume of stampable share transactions	-9.7	-18.9	12.0	-1.9	-2.4	-2.6	-2.7
Oil and gas							
Oil prices (\$ per barrel) ³	111	112	113	106	101	97	93
Oil prices (£ per barrel) ³	69.2	70.6	73.4	68.8	65.2	62.5	60.1
Gas prices (p/therm)	60.6	59.1	68.6	68.0	63.9	60.9	58.3
Oil production (million tonnes) ^{3,8}	51.9	44.5	44.4	44.3	44.1	44.0	43.9
Gas production (billion therms) ^{3,8}	16.1	13.8	14.1	14.0	13.9	13.9	13.8
Interest rates and exchange rates							
Market short-term interest rates (%) ⁹	1.0	0.7	0.6	0.7	0.9	1.4	2.0
Market gilt rates (%) ¹⁰	2.2	1.8	2.4	2.7	3.3	3.6	3.9
Euro/ Sterling exchange rate	1.16	1.23	1.16	1.16	1.16	1.15	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 Department for Communities and Local Government (CLG) property prices index							
⁷ Outturn data from HMRC information on stamp duty land tax							
⁸ Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data							
⁹ 3-month sterling interbank rate (LIBOR)							
¹⁰ Weighted average interest rate on conventional gilts							

Table 7.2: Changes to determinants since the December forecast

	Percentage point change unless otherwise specified						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
GDP and its components							
Real GDP	0.2	0.1	-0.7	-0.1	0.0	0.0	0.0
Nominal GDP (£ billion) ¹	-3	-18	-26	-30	-35	-42	-50
Nominal GDP ¹	-0.2	-1.0	-0.5	-0.2	-0.2	-0.3	-0.3
Nominal GDP (centred end-March)	-0.4	-0.8	-0.4	-0.2	-0.3	-0.3	-0.3
Wages and salaries ²	0.0	-0.7	-0.1	-0.2	-0.1	0.0	0.0
Non-oil PNFC profits ^{2,3}	-1.3	1.0	-3.3	-2.1	-1.5	-1.9	-0.2
Non-oil PNFC net taxable income ^{2,3}	0.0	7.4	-5.9	-4.8	-1.5	-1.9	0.6
Consumer spending ^{2,3}	-0.3	0.0	-0.4	-0.2	-0.1	0.0	0.0
Prices and earnings							
GDP deflator	-0.2	-1.3	0.3	-0.1	-0.3	-0.3	-0.3
RPI (September)	0.0	0.0	0.2	0.1	0.1	0.2	0.2
CPI (September)	0.0	0.0	0.3	0.1	0.1	0.0	0.0
Whole economy earnings growth	0.0	-1.0	-0.5	-0.1	-0.1	0.0	0.0
'Triple-lock' guarantee (September)	0.0	0.0	0.3	0.0	-0.1	0.0	0.0
Key fiscal determinants							
Claimant count (millions) ⁴	0.00	-0.02	-0.08	-0.05	-0.04	-0.05	-0.05
Employment (millions)	0.0	0.1	0.2	0.1	0.1	0.1	0.1
VAT gap (per cent)	-0.2	0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Financial and property sectors							
Equity prices (FTSE All-share index)	0.0	101	304	309	313	318	321
HMRC financial sector profits ^{1,3,5}	0.0	0.0	-1.1	-0.2	0.3	-0.3	-0.3
Financial sector net taxable income ^{1,3}	0.0	0.7	-1.2	-1.1	0.1	0.1	1.6
Residential property prices ⁶	0.0	0.4	0.3	-1.0	-0.2	0.0	0.0
Residential property transactions ('000's)	1.1	-7	-33	-86	-103	-109	-101
Commercial property prices ⁷	0.5	2.1	-1.1	-0.5	0.0	-0.1	-0.1
Commercial property transactions ⁷	0.0	4.9	2.8	-1.1	0.0	0.0	-0.2
Volume of stampable share transactions	0.5	-9.0	10.6	-1.9	-2.4	-2.6	-2.7
Oil and gas							
Oil prices (\$ per barrel) ³	0.0	0.0	7.0	4.7	3.2	2.1	1.1
Oil prices (£ per barrel) ³	0.0	-0.1	6.5	5.1	4.1	3.4	2.7
Gas prices (p/therm)	0.0	1.3	12.7	14.8	13.1	12.0	11.0
Oil production (million tonnes) ^{3,8}	0.0	-1.1	-0.7	-0.4	-0.3	-0.1	0.1
Gas production (billion therms) ^{3,8}	0.0	-0.4	-0.1	0.0	0.0	0.1	0.1
Interest rates and exchange rates							
Market short-term interest rates ⁹	0.0	0.0	-0.1	0.0	0.0	0.2	0.3
Market gilt rates ¹⁰	0.0	0.1	0.1	0.1	0.4	0.5	0.5
Euro/ Sterling exchange rate	0.00	-0.02	-0.09	-0.09	-0.10	-0.10	-0.10

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 Department for Communities and Local Government (CLG) property prices index
⁷ Outturn data from HMRC information on stamp duty land tax
⁸ Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data
⁹ 3-month sterling interbank rate (LIBOR)
¹⁰ Weighted average interest rate on conventional gilts

GDP and the output gap

- 7.4 Most economic forecasts focus on the outlook for real GDP, but it is the outlook for nominal GDP that matters most when forecasting the public finances. Nominal GDP growth is lower than in our December forecast in each year of the forecast. As explained in Chapter 3, the downward revision reflects both lower real GDP growth and a lower GDP deflator.
- 7.5 The 'structural', or cyclically-adjusted, component of net borrowing and the current budget balance is determined by the size of the output gap. A negative output gap implies that the economy is operating below capacity and we would therefore expect tax revenues to increase and spending to shrink automatically as the economy returns to its potential level. Our latest estimate of the output gap is wider than we thought in December in each year of the forecast. We assume that the output gap was -2.7 per cent of GDP in the final quarter of 2012. It widens to -3.7 per cent in 2014 before narrowing to -2.3 per cent in 2017.

Income and expenditure

- 7.6 The composition of GDP growth is also very important for the fiscal forecast. For example: labour income is generally taxed at higher effective rates than company profits; indirect tax receipts, such as VAT, are driven by movements in household consumption; and, stronger business investment will increase capital allowances, reducing corporation tax receipts in the short-term.
- 7.7 The most important element of labour income is wages and salaries, which are determined by employment and earnings. Reflecting recent data, we now expect earnings growth to be lower than in December, which is only partially offset by higher employment. Overall, this means growth in wages and salaries is marginally lower in most years than in the December forecast. Total wages and salaries have been revised down by around £9.5 billion in 2017-18.
- 7.8 Nominal consumer spending is the main driver of receipts from VAT and other indirect taxes. Growth is expected to be slightly weaker than we assumed in December over the next two years. Consumer spending is now expected to grow at an average rate of 4.1 per cent between 2012 and 2017.
- 7.9 Company profits are an important determinant of corporation tax receipts. Non-oil, non-financial company profits growth was slightly higher in 2012 than we expected in December, but we continue to forecast

subdued growth next year. We then expect growth to pick up from 2014, although at a much weaker pace than we assumed in December, reflecting the downward revision to our business investment forecast. Non-oil, non-financial company profits are expected to be around £28 billion lower in 2017 than we assumed in December. Our financial sector profits growth forecast has also been revised down, in line with our overall GDP forecast. Financial sector profits continue to grow more slowly than non-financial profits, constrained by regulatory and structural reforms in the later years of the forecast.

- 7.10 Net taxable income is calculated by adjusting our company profits forecast for estimates of other corporate income and deductions relating to losses, allowances and reliefs. For non-financial companies, slower net taxable income growth than in December across most of the forecast reflects the downward revisions to our profits forecast. Income growth from next year is lower than profit growth as firms offset profits with losses made in previous years and increasingly make use of capital allowances to offset taxable liabilities. In contrast, financial company income increases faster than profits, reflecting a rise in interest income as interest rates start to rise.

Inflation

- 7.11 The CPI measure of inflation is used to index most tax rates, allowances and thresholds and to uprate benefits and public sector pensions. Our forecast for CPI inflation is slightly higher over the next few years than we assumed in December. This reflects the effect of recent outturn data, higher oil prices and higher import prices, the latter being largely a consequence of the recent depreciation of sterling.
- 7.12 RPI inflation determines the interest paid on index-linked gilts and is used to revalorise excise duties. RPI inflation is expected to follow a similar path to CPI inflation over the forecast period but higher expected interest rates in the later years of the forecast have resulted in upward revisions.
- 7.13 From 2014-15 the GDP deflator is lower than we assumed in December, which reflects a downward revision to the government consumption component.
- 7.14 The basic state pension is uprated in April each year in line with the 'triple-lock' guarantee and rises by the highest of average earnings growth, CPI inflation in the previous September and 2.5 per cent. As a result, pension payments will be uprated by 2.5 per cent in 2013-14. On

our current forecast, uprating will be in line with CPI in 2014-15 and by average earnings growth in each year thereafter.

Equity markets

- 7.15 Equity prices are a significant determinant of capital gains tax, inheritance tax and stamp duty receipts. Equity prices are assumed to rise from their current level in line with nominal GDP. The current level is determined by the average of the closing price of the FTSE All-Share index over the ten working days ending 25 February 2013. The starting point for share prices is expected to be 10 per cent higher than in our December forecast reflecting recent rises in UK and worldwide equity markets. Thereafter, share prices are between 8 to 10 per cent higher throughout the forecast.
- 7.16 The volume of taxable share transactions is an important determinant of receipts from stamp duty on shares. Stampable share transactions are expected to be lower than we assumed in December in the near term, reflecting lower volumes of trades reported to HMRC within the current financial year. In light of the recent downward trend in the volume of transactions, we now assume a slight fall across the forecast period.

Property market

- 7.17 The residential property market is a key driver of receipts from stamp duty land tax and inheritance tax. House price inflation was higher than expected at the end of 2012. Residential property prices are assumed to grow in line with the median of independent forecasters. This suggests a slightly weaker rate of house price inflation in 2014. In the medium-term house prices are then expected to rise in line with average earnings, which we have revised down slightly in the later years of the forecast.
- 7.18 While we still expect strong growth in property transactions in 2013 and 2014, supported by the Funding for Lending Scheme (FLS) and other Government schemes, we have reduced our forecast relative to December to a level which is more consistent with other outside forecasts. Transactions are then expected to converge gradually to the long-run average rate of turnover.
- 7.19 Commercial property prices are expected to be higher in 2012-13 than we assumed in December, based on the latest information from HMRC. Thereafter, we expect prices to remain flat in 2013-14 and then increase by between 2 per cent and 4 per cent a year. The latest data for the volume of commercial property transactions have also been stronger

than we expected in December. The higher starting point means that we now assume a higher number of transactions throughout the forecast.

Oil and gas sector

- 7.20 Oil prices are assumed to move in line with the prices implied by futures markets. For our forecast we took an average of the futures curve over the ten working days ending 25 February 2013. Oil prices are therefore assumed to be slightly higher than in our December forecast in the early years of the forecast period, but return to similar levels to our December forecast towards the later years of the forecast horizon. Gas prices are assumed to follow the trend in oil prices, but with a considerably higher starting point as a result of recent rises in wholesale prices.
- 7.21 Oil and gas production forecasts are based on the central projection published by the Department of Energy and Climate Change (DECC). Oil and gas production in 2013 is expected to remain at a similar level to last year. Thereafter production is expected to be broadly flat across the remainder of the forecast period. Overall, production is expected to be slightly lower than we expected at the time of our December *EFO*.

Interest rates

- 7.22 We use the 3-month sterling interbank rate as a benchmark for our short-term interest rate determinant. Our forecast incorporates the average forward rates for the ten working days to 25 February 2013. The futures curve is slightly higher than in December in most years across the forecast period.
- 7.23 Our forecast assumes gilt rates move in line with market expectations based on the average of the rates prevailing over the ten days up to and including 25 February 2013. Relative to our December assumptions, gilt rates are between 0.1 and 0.5 basis points higher in each year of the forecast.

Policy announcements, risks and classifications

- 7.24 The Government publishes estimates of the direct impact of tax and spending policy decisions on the public finances in its Budget policy decisions table. We provide independent scrutiny and certification of these costings and explain if we agree with them. If we disagree, we use our own estimate of costings in our forecast. We are also responsible for assessing any indirect effects of policy measures on the economic forecast. These are discussed in Box 3.1 in Chapter 3. We also note any

significant policy commitments that are not quantifiable at the current time as risks to the fiscal forecast. In this section we also set out the impact of any significant statistical classifications.

Direct effect of new policy announcements on the public finances

- 7.25 Annex A reproduces the Treasury's table of the direct effect on public sector net borrowing (PSNB) of policy decisions in the Budget or announced since the Autumn Statement in December 2012. The OBR has endorsed all of the tax and AME expenditure costings in the Treasury's table as being reasonable central estimates of the measures themselves. As we explain in more detail in our annex to the Treasury's *Budget 2013 policy costings* document, a number of these costings are highly uncertain, in particular the announcements on tax repatriation from Isle of Man, Jersey and Guernsey, other anti-avoidance measures, stamp duty on shares, employee shareholder status, right-to-buy, and the single tier pension.
- 7.26 The top section of Table 4.3 summarises the Treasury's Budget policy decisions table. A positive figure means an improvement in PSNB, i.e. higher receipts or lower expenditure. The measures shown in the Treasury table are neutral overall in their impact on public sector net borrowing across the forecast horizon. Reductions in expenditure and tax avoidance measures drive a small fiscal tightening in 2013-14. These are offset from 2014-15 by the increase in the personal allowance, the introduction of a £2000 employer NICS allowance, and the full-year effect of the cancellation of the September 2013 fuel duty increase, leading to a small fiscal loosening in 2014-15 and 2015-16. In 2016-17 and 2017-18 the revenue from ending contracting-out means that overall there is a small fiscal tightening in these years.
- 7.27 In addition to the measures set out in the Treasury's Budget policy decisions table, the Government has taken action to ensure that central government departments spend less in 2012-13 than set out in plans at the start of the year. As we discuss from paragraph 4.114, this has a number of elements: money that the Treasury has allowed departments to move into future years; money that the Treasury has not allowed departments to bring forward from future years; money that departments do not now expect to spend either this year or in the future; and payments that were due to be made late in the current financial year (for example payments to international institutions), but which are being delayed into 2013-14.

- 7.28 As set out in Table 4.3, we estimate this has reduced borrowing in 2012-13 by at least £1.6 billion. This is a minimum figure because, as we explain in paragraph 4.119, the Government's actions will also have accounted for further additional underspends, but we cannot easily distinguish this from normal departmental underspending. These actions have transferred some spending to 2013-14 and 2014-15, which we estimate increases borrowing by £1.0 billion in 2013-14 and £0.5 billion in 2014-15, in addition to the effects of the policies shown in the Treasury's Budget policy decisions table.
- 7.29 The Government has also announced two housing measures – extensions to the Help to Buy and Build to Rent schemes – which are classified as financial transactions and so do not affect PSNB. These will increase the Government's net cash requirement and public sector net debt by £1.3 billion in 2013-14 and £1.9bn in 2014-15 and 2015-16.

Table 7.3: Summary of the effect of policy measures

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Effects of receipts measures	0.0	-0.3	-2.7	-2.8	1.7	1.3
<i>of which:</i>						
Income tax and NICs	0.0	0.0	-2.0	-1.8	3.2	2.8
Onshore corporation tax	0.0	0.3	0.5	0.1	-0.3	-0.3
Stamp duty	0.0	0.0	-0.3	-0.3	-0.3	-0.4
Bank levy	0.0	0.0	0.2	0.2	0.2	0.2
Fuel duty	0.0	-0.5	-0.8	-0.8	-0.9	-0.9
Other	0.0	-0.2	-0.3	-0.3	-0.2	-0.1
Effects of expenditure measures ¹	0.0	1.6	1.1	0.0	0.0	0.0
<i>of which:</i>						
Current DEL	0.0	1.4	1.2	2.9	3.0	2.9
Current AME	0.0	0.0	0.1	0.1	0.0	0.1
<i>of which:</i>						
Net public service pension payments	0.0	0.0	0.1	0.1	0.0	0.0
Social security benefits	0.0	0.0	0.1	0.1	0.1	0.2
Tax credits	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Capital DEL	0.0	0.1	-0.2	-3.0	-3.1	-3.1
Capital AME	0.0	0.1	0.0	0.0	0.1	0.1
<i>of which:</i>						
LA other capital income	0.0	0.0	0.0	0.0	0.1	0.1
Other departmental expenditure (capital)	0.0	0.1	-0.1	-0.1	0.0	0.0
Total direct effect of policy measures on PSNB	0.0	1.3	-1.6	-2.8	1.7	1.3
Total direct effect of policy measures on current balance	0.0	1.1	-1.4	0.2	4.7	4.3
Other policy changes to departmental expenditure	1.6	-1.0	-0.5	0.0	0.0	0.0
Financial transactions	0.0	1.3	1.9	1.9	0.0	0.0

¹Expenditure categories are equivalent to PSCE in RDEL, PSCE in AME, PSGI in CDEL and PSGI in AME in Table 4.18

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

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

Projected Asset Purchase Facility flows

7.30 In November 2012 the Government announced that the excess cash held in the Bank of England's Asset Purchase Facility (APF) would be transferred to the Exchequer on an ongoing basis. At the time of our December forecast, the Office for National Statistics had not decided how to classify the resulting financial flows and we had to judge for ourselves how this was likely to be done. The ONS have now announced their decision and the impact is as follows:

- as we expected the ONS has decided that all transactions will affect the net cash requirement and therefore net debt;
- transfers from the APF to the Treasury up to the level of the previous year's income will be treated as dividends and so will affect public sector net borrowing. Any amount over this threshold will be classified as a financial transaction and hence not affect public sector net borrowing. We had assumed this distinction would be based on the current year's income. The ONS's income calculation will also only take account of interest flows and not capital gains or losses following the redemption of gilts;
- payments from the Treasury to the APF will be classified as capital grants (and therefore capital expenditure), increasing net borrowing but not the current budget deficit. This is line with our original assumption;
- transfers will materialise a few days after the quarter they relate to. We had assumed they would be accrued back to the previous quarter; and
- the ONS will treat the APF as an arm of the Bank, rather than a separate body. The calculations will therefore take into account the Bank's wider activities and payments to the Treasury.

7.31 Alongside these decisions the ONS has also reclassified the one-off £2.3 billion proceeds from the Special Liquidity Scheme (SLS) as dividends from the Bank to the Treasury, rather than a capital grant.

7.32 The biggest impact on our projections comes from the final decision on the income calculation and the reclassification of the SLS. The impact on borrowing in 2012-13 is now based on the Bank's income in 2011-12 of £9.1 billion (rather than £11.5 billion we projected in December). Including the SLS around £2.7 billion of non-APF proceeds have been transferred to the Treasury this year. That means that only £6.4 billion of APF transfers can be scored as reducing net borrowing in 2012-13 before the income threshold of £9.1 billion is reached, with the remainder scoring as a financial transaction. This is £5.1 billion less than we assumed in our December forecast.

7.33 Using the previous year's income as the benchmark also changes the picture in 2017-18, but not materially in the intervening period. We project the APF to make an accrued loss in 2017-18, but as net cash transfers to the Treasury will exceed 2016-17 income, net borrowing and the current

budget deficit will be lower. As only the flows into the Treasury affect the current budget, and not the flows out, the current budget deficit is now forecast to be £1.5 billion smaller.

- 7.34 To estimate the size of future flows between the APF and the Treasury, we have to make assumptions about when quantitative easing (QE) will be unwound and how quickly. Our approach to this is unchanged since December. We assume QE purchases remain at their current level and that it begins to be unwound once Bank Rate rises above 1 per cent, with sales evenly paced at £10 billion per quarter thereafter. We also assume redemptions will not be reinvested once sales begin (so the actual drawdown of QE will be larger in any given period when redemptions occur). This is broadly in line with monetary policy tightening equally between Bank Rate rises and QE withdrawal.
- 7.35 The first sale is now projected to be in the second quarter of 2016, a quarter earlier than assumed in our December forecast. Our projection for the total sum of transfers to the Treasury is broadly unchanged since December, at around £71 billion. Payments out of the Treasury are now projected to be around £26 billion, up from the £18 billion we projected in December.
- 7.36 Our projections assume that gilt rates move in line with current market expectations. Larger projected transfers in later years can be almost entirely explained by higher gilt rates relative to previous market expectations, as higher gilt rates imply lower gilt prices at the point of sale and therefore greater capital losses. Estimates of the overall net transfer to the Treasury are therefore currently projected to be around £45 billion, down from our projection of £55 billion in the December *EFO*.
- 7.37 Table 4.4 shows that under our central projection the eventual net direct impact of QE would be to reduce PSND by roughly 2 per cent of GDP in 2022-23 – a small amount relative to the uncertainty surrounding any projections of PSND over this 10 year horizon. In the counterfactual where the Government had not decided to change the treatment of these flows, there would have been no transfers until the end of the scheme in 2022-23 at which point a single payment of around £45 billion would have been made to the Exchequer – presumably treated as a financial transaction.
- 7.38 As we noted in December, as the overall transfer to the Exchequer is expected to be positive, debt interest costs will be lower over this projection period. But the Government is now likely to issue fewer gilts in the near term and more in the longer term than it otherwise would have

done, leaving it more exposed to future yield curve movements. As gilt rates are expected to rise, debt interest payments will be higher beyond the horizon presented in this projection, possibly outweighing lower costs in the preceding years.

- 7.39 It is also important to again emphasise that there is huge uncertainty about the timing and pace of QE unwinding and our assumptions should be regarded as a way of illustrating the potential fiscal impact of the APF decision rather than as a firm prediction of how the Bank of England is likely to behave. It is not based on any guidance from the Bank regarding its plans.
- 7.40 As we illustrated in our December *EFO*, if the unwinding of QE was to begin earlier, or were to be faster than in our central projection, the eventual overall impact on net debt would be little affected. But as we also showed, estimates of the overall net transfer to the Treasury are highly sensitive to changes in gilt rates.
- 7.41 Gilt rates may be higher than currently projected if, for example, the withdrawal of QE has not been fully priced into the markets, or if demand for safe assets falls as economic uncertainty recedes. In a scenario where gilt rates rise by 200 basis points, the Treasury would receive £66 billion up to the beginning of 2016, only to pay back £57 billion over the following years, giving an overall net transfer of £9 billion.

Table 7.4: Projected APF flows and the impact on the fiscal forecast

	£ billion											
	up to12-13	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Income		14.0	14.5	14.5	14.7	13.7	11.3	8.6	6.1	3.8	1.8	0.1
Interest payments		-1.8	-1.9	-1.9	-2.8	-4.3	-5.3	-5.2	-4.3	-3.0	-1.5	-0.1
Redemptions		-0.5	-0.3	-2.0	-4.0	-1.5	-4.0	-2.0	-1.8	-0.2	-2.1	0.0
Sales		0.0	0.0	0.0	0.0	-3.5	-4.4	-5.0	-5.5	-6.0	-5.5	-1.1
Net flow	23.8	11.7	12.3	10.6	7.8	4.3	-2.3	-3.5	-5.5	-5.4	-7.3	-1.1
Cumulative flow	23.8	35.5	47.8	58.4	66.2	70.5	68.3	64.7	59.2	53.8	46.5	45.4
Receipts		6.4	12.2	11.2	8.4	6.2	1.5	0.0	0.0	0.0	0.0	0.0
Capital spending		0.0	0.0	0.0	0.0	0.0	0.8	2.9	5.9	6.0	7.1	2.8
Net borrowing		-6.4	-12.2	-11.2	-8.4	-6.2	-0.7	2.9	5.9	6.0	7.1	2.8
Current budget		6.4	12.2	11.2	8.4	6.2	1.5	0.0	0.0	0.0	0.0	0.0
Net cash requirement		-11.5	-32.2	-11.2	-8.4	-6.2	-0.7	2.9	5.9	6.0	7.1	2.8
Public sector net debt		-11	-44	-55	-63	-69	-70	-67	-61	-55	-48	-45
<i>Memo: Illustrative effect on debt interest payments</i>		0.0	-0.5	-1.3	-1.7	-2.0	-2.3	-2.4	-2.2	-1.9	-1.7	-0.5
<i>Memo: Per cent of GDP:</i>												
<i>Net borrowing</i>		-0.4	-0.8	-0.7	-0.5	-0.3	0.0	0.1	0.3	0.3	0.3	0.1
<i>Current budget</i>		0.4	0.8	0.7	0.5	0.3	0.1	0.0	0.0	0.0	0.0	0.0
<i>Net debt</i>		-0.7	-2.7	-3.2	-3.6	-3.8	-3.6	-3.3	-2.9	-2.5	-2.1	-1.9

Table 7.5: Changes in projected APF flows and the impact on the fiscal forecast since December

	£ billion											
	up to 12-13	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Income		0.0	0.0	0.0	0.1	-0.2	-0.4	-0.4	-0.4	-0.4	-0.4	-0.2
Interest payments		0.2	0.0	0.0	-0.3	-0.4	-0.6	-0.6	-0.4	-0.1	0.2	0.1
Redemptions		0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.2	0.0	0.5	0.0
Sales		0.0	0.0	0.0	0.0	-1.7	-1.2	-1.2	-1.1	-1.0	-1.0	0.9
Net flow	0.0	0.2	0.0	0.0	-0.2	-2.3	-2.0	-2.0	-1.7	-1.5	-0.7	0.9
Cumulative flow	0.0	0.2	0.2	0.2	0.1	-2.3	-4.2	-6.2	-7.9	-9.4	-10.2	-9.3
Receipts		-5.1	-0.1	0.5	0.5	-0.4	1.5	0.0	0.0	0.0	0.0	0.0
Capital spending		0.0	0.0	0.0	0.0	0.0	0.5	1.3	2.1	2.1	0.5	0.9
Net borrowing		5.1	0.1	-0.5	-0.5	0.4	-1.0	1.3	2.1	2.1	0.5	0.9
Current budget		-5.1	-0.1	0.5	0.5	-0.4	1.5	0.0	0.0	0.0	0.0	0.0
Net cash requirement		0.0	-0.2	0.0	0.1	1.9	2.0	2.1	1.8	1.5	0.9	-0.8
Public sector net debt		0	0	0	0	2	4	6	8	9	10	9
<i>Memo: Illustrative effect on debt interest payments</i>		0.0	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.1	0.1	0.2	0.1
<i>Memo: Per cent of GDP:</i>												
<i>Net borrowing</i>		0.3	0.0	0.0	0.0	0.0	-0.1	0.1	0.1	0.1	0.0	0.0
<i>Current budget</i>		-0.3	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
<i>Net debt</i>		0.0	-0.1	-0.1	-0.1	0.0	0.1	0.2	0.3	0.3	0.4	0.3

Currently unquantifiable policy commitments

7.42 Consistent with the *Charter for Budget Responsibility*, our projections do not include the impact of policies where there is insufficient detail or certainty of implementation to quantify the impact and allocate it to particular years. Where significant, these are noted as fiscal risks:

- the Government has made proposals on **minimum alcohol pricing** which were subject to a period of consultation. As no final decisions have been taken we have not included an estimate of the impact in our central forecast. If the policy is confirmed there is likely to be an impact on our forecast of inflation, alcohol duties and VAT; and
- we only include the impact of **asset sales** in our medium-term forecasts once details of the nature, size and timing of the transactions are sufficiently firm for the effects to be quantified with reasonable accuracy. In this forecast we include the final proceeds from the auction of 4G spectrum. No other substantive announcements have been made that would allow us to quantify the effects of other proposed sales with reasonable accuracy. This includes the Government's intention to attract private capital into Royal Mail.

- 7.43 There are both upside and downside risks to the forecast from these policies. If the Government was to sell some more of its financial assets, this would reduce PSND initially, but the impact on net borrowing would depend on the future income flows associated with the assets. At current market prices, as set out in Box 4.2, the sale of the public sector banks would lead to a significant loss to the taxpayer.
- 7.44 In previous *EFOs* we have identified the Coalition Agreement's long-term objective to raise the personal allowance to £10,000 as a specific fiscal risk, on the grounds that additional policy action would be required to achieve it within our forecast horizon. In this Budget the Government has announced an increase in the personal allowance to £10,000 in 2014-15.

Classification changes from ESA 2010

- 7.45 The National Accounts and Public Sector Finance statistics released by the ONS are currently based on the European System of Accounts (ESA) 1995, which is the National Accounts framework currently used by all European countries. In the 2014 *Blue Book*, the ONS are due to base their National Accounts and Public Sector Finance statistics on the new ESA 2010 framework. This is likely to change the definitions of some aspects of the public finances, and affect all of the fiscal aggregates. Eurostat have not yet completed their work on ESA 2010 and they have yet to produce a revised Manual on Government Deficit and Debt. The ONS will provide full details of the final effects on the public finances when they have all the necessary Eurostat guidance, and we will provide an update on this process and any guidance issued by the ONS in future *EFOs*.

Public sector receipts

7.46 Table 4.6 summarises our central forecast for the major taxes as a share of GDP. Table 4.7 shows our detailed forecast for individual taxes and other receipts, and Table 4.8 shows how our forecast has changed since December.

7.47 Public sector current receipts rise as a proportion of GDP in 2012-13 and 2013-14 driven mainly by 'interest and dividend receipts' and 'other taxes'. They then remain broadly flat over the remainder of the forecast period. National Accounts taxes follow a broadly flat profile from 2013-14 to 2015-16, before rising by 0.5 per cent of GDP in 2016-17, largely as a result of the abolition of the NIC contracting out rebate.

Table 7.6: Major taxes as a per cent of GDP

	Per cent of GDP						
	Outturn		Forecast				
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Income tax and NICs	16.7	16.5	16.4	16.5	16.7	17.3	17.5
Value added tax	6.4	6.5	6.5	6.5	6.4	6.4	6.3
Onshore corporation tax	2.2	2.3	2.2	2.0	1.9	1.9	1.9
UK oil and gas receipts	0.7	0.4	0.4	0.4	0.3	0.3	0.2
Fuel duties	1.8	1.7	1.6	1.6	1.6	1.6	1.6
Business rates	1.6	1.7	1.7	1.7	1.7	1.7	1.7
Council tax	1.7	1.7	1.7	1.7	1.7	1.7	1.6
Excise duties	1.3	1.3	1.2	1.3	1.2	1.2	1.2
Capital taxes	1.1	1.0	1.2	1.3	1.3	1.4	1.5
Other taxes	2.5	2.7	3.1	2.9	3.0	2.9	2.9
National Accounts taxes	36.0	35.8	36.0	35.8	35.8	36.3	36.4
Interest and dividend receipts	0.4	1.0	1.2	1.1	1.0	0.9	0.7
Other receipts	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Current receipts	37.5	38.0	38.4	38.2	38.1	38.4	38.3

7.48 Within this overall profile the following receipts are expected to rise as a share of GDP over the forecast period:

- income tax and NICs, reflecting policy changes and fiscal drag in the later years of the forecast. Once earnings start to rise faster than tax thresholds and allowances, people will find more of their income taxed at higher rates. Additionally the decision in this Budget to abolish the NIC contracting-out rebate increases receipts from 2016-17;
- capital taxes, mainly reflecting rising equity prices;

- other taxes, particularly in 2013-14. This reflects receipts from the UK Swiss agreement and new revenues from environmental levies and the EU Emissions Trading Scheme; and
- interest and dividend receipts rise sharply in 2012-13 reflecting the transfers from the Asset Purchase Facility and then start to fall as these payments decline. Underlying interest and dividend receipts rise gradually across the forecast period as interest rates rise and interest payments on student loans increase.

7.49 The following receipts are expected to fall as a share of GDP:

- oil and gas revenues, due to a drop in oil and gas prices and continued high levels of capital and operating expenditures that offset tax liabilities;
- fuel duties, reflecting policy changes, improvements in vehicle efficiency and because duty rates are revalorised in line with RPI which grows at a slower rate than GDP;
- onshore corporation tax, reflecting the staggered reduction in the corporation tax rate; and
- VAT, due to a slight fall in the share of consumer spending in GDP and the effect of fiscal consolidation on government procurement.

Table 7.7: Current receipts

	£ billion						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Income tax (gross of tax credits) ¹	152.7	150.5	154.7	165.5	174.4	186.7	198.9
<i>of which: Pay as you earn</i>	<i>132.0</i>	<i>130.7</i>	<i>133.7</i>	<i>137.7</i>	<i>147.8</i>	<i>158.0</i>	<i>168.6</i>
<i>Self assessment</i>	<i>20.3</i>	<i>20.6</i>	<i>20.3</i>	<i>27.4</i>	<i>26.4</i>	<i>28.2</i>	<i>29.9</i>
Tax credits (negative income tax)	-4.7	-3.1	-2.8	-2.4	-1.3	-0.5	-0.3
National insurance contributions	101.6	103.8	106.7	108.6	113.9	125.5	132.0
Value added tax	98.1	100.7	103.3	107.2	111.2	115.2	119.3
Corporation tax ²	43.1	40.3	39.3	38.1	36.6	38.2	39.5
<i>of which: Onshore</i>	<i>33.8</i>	<i>35.5</i>	<i>34.6</i>	<i>33.7</i>	<i>33.5</i>	<i>34.9</i>	<i>36.5</i>
<i>Offshore</i>	<i>9.2</i>	<i>4.8</i>	<i>4.7</i>	<i>4.4</i>	<i>3.1</i>	<i>3.3</i>	<i>3.0</i>
Corporation tax credits ³	-0.9	-1.0	-1.0	-0.9	-0.8	-0.8	-0.9
Petroleum revenue tax	2.0	1.7	2.1	1.7	1.6	1.5	1.3
Fuel duties	26.8	26.6	26.1	26.3	27.1	28.3	29.3
Business rates	24.9	25.7	26.7	28.1	29.6	30.5	31.2
Council tax	26.0	26.3	27.4	28.3	29.1	30.0	31.0
VAT refunds	14.0	14.0	14.6	14.6	14.7	14.5	14.2
Capital gains tax	4.3	3.9	5.1	6.5	7.2	7.9	8.7
Inheritance tax	2.9	3.1	3.3	3.5	3.6	3.9	4.1
Stamp duty land tax	6.1	6.9	7.7	8.4	9.3	10.5	11.7
Stamp taxes on shares	2.8	2.3	2.9	2.7	2.7	2.8	2.9
Tobacco duties	9.9	9.6	9.8	10.2	10.3	10.5	10.8
Spirits duties	2.9	2.9	2.9	3.1	3.3	3.4	3.6
Wine duties	3.4	3.5	3.6	3.9	4.2	4.6	5.0
Beer and cider duties	3.8	3.7	3.5	3.6	3.6	3.6	3.7
Air passenger duty	2.6	2.8	2.9	3.0	3.3	3.5	3.8
Insurance premium tax	3.0	3.0	3.1	3.1	3.2	3.2	3.3
Climate change levy	0.7	0.7	1.5	2.0	2.5	2.5	2.5
Other HMRC taxes ⁴	5.9	5.9	6.3	6.6	7.0	7.2	7.4
Vehicle excise duties	5.9	5.9	5.9	5.7	5.6	5.6	5.5
Bank levy	1.8	1.6	2.7	2.9	2.9	2.9	2.9
Licence fee receipts	3.1	3.1	3.1	3.2	3.2	3.2	3.3
Environmental levies	0.5	2.0	2.3	2.8	3.1	3.5	4.0
Swiss capital tax	0.0	0.0	3.2	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	0.3	0.7	0.7	0.8	0.8	0.9
Other taxes	6.2	6.7	6.8	7.0	7.1	7.2	7.1
National Accounts taxes	549.5	553.7	574.3	594.0	619.1	655.8	686.9
<i>Less own resources contribution to EU budget</i>	<i>-5.2</i>	<i>-5.4</i>	<i>-5.3</i>	<i>-5.1</i>	<i>-5.3</i>	<i>-5.6</i>	<i>-5.9</i>
Interest and dividends	5.7	14.8	18.9	18.5	17.1	16.3	13.4
Gross operating surplus	23.6	24.2	25.3	26.7	27.8	28.8	29.7
Other receipts	-1.0	-0.6	-0.9	-1.0	-1.0	-1.1	-1.1
Current receipts	572.6	586.8	612.4	633.1	657.6	694.1	723.0
<i>Memo: UK oil and gas revenues⁵</i>	<i>11.3</i>	<i>6.5</i>	<i>6.8</i>	<i>6.1</i>	<i>4.7</i>	<i>4.8</i>	<i>4.3</i>

¹ Includes PAYE and self assessment and also includes tax on savings income and other minor 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

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

Table 2.8 in the supplementary table presents receipts on a cash basis

Table 7.8: Changes to current receipts since December

	£ billion						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Income tax (gross of tax credits) ¹	0.0	-3.4	-6.9	-6.5	-7.1	-7.2	-7.6
<i>of which: Pay as you earn</i>	-0.1	-1.5	-3.4	-4.5	-4.7	-5.0	-5.2
<i>Self assessment</i>	0.0	-2.1	-3.5	-2.0	-2.5	-2.4	-2.4
Tax credits (negative income tax)	0.0	0.8	1.0	0.8	0.5	0.2	-0.2
National insurance contributions	0.0	-0.4	-1.2	-2.5	-3.1	2.0	1.8
Value added tax	0.0	-0.4	-0.8	-1.0	-1.3	-1.6	-2.1
Corporation tax ²	0.0	0.5	0.4	-0.6	-2.1	-3.0	-3.3
<i>of which: Onshore</i>	0.0	0.9	0.3	-0.7	-2.0	-3.1	-3.2
<i>Offshore</i>	0.0	-0.4	0.1	0.1	-0.1	0.1	0.0
Corporation tax credits ³	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Petroleum revenue tax	0.0	-0.5	0.0	0.0	-0.1	0.0	-0.1
Fuel duties	0.0	0.4	-0.4	-0.8	-0.8	-0.7	-0.7
Business rates	-0.1	0.0	-0.1	-0.1	-0.1	0.0	0.0
Council tax	0.0	0.0	0.2	0.3	0.3	0.3	0.3
VAT refunds	0.0	0.0	0.0	0.0	0.1	0.1	-0.1
Capital gains tax	0.0	0.2	0.5	1.1	1.1	1.2	1.3
Inheritance tax	0.0	0.0	0.0	0.0	0.0	0.1	0.2
Stamp duty land tax	0.0	0.4	0.2	-0.2	-0.4	-0.5	-0.5
Stamp taxes on shares	0.0	-0.1	0.3	-0.1	-0.1	-0.2	-0.3
Tobacco duties	0.0	-0.3	-0.1	0.2	0.2	0.2	0.2
Spirits duties	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Wine duties	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Beer and cider duties	0.0	0.0	-0.3	-0.3	-0.3	-0.3	-0.3
Air passenger duty	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Insurance premium tax	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Climate change levy	0.0	0.0	0.0	0.2	0.1	0.1	0.1
Other HMRC taxes ⁴	0.0	-0.1	0.0	-0.1	-0.1	-0.1	-0.1
Vehicle excise duties	0.0	0.0	0.0	-0.2	-0.1	-0.1	-0.1
Bank levy	0.0	-0.2	-0.1	0.1	0.1	0.1	0.1
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	0.0	-0.2	-0.3	-0.2
Swiss capital tax	0.0	-0.3	0.3	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1
Other taxes	0.3	0.0	-0.1	-0.1	0.2	0.3	0.4
National Accounts taxes	0.2	-3.5	-7.3	-10.2	-13.5	-9.9	-11.4
<i>Less own resources contribution to EU budget</i>	0.0	0.0	-0.1	0.4	0.3	0.2	0.2
Interest and dividends	2.8	-2.8	0.0	0.7	-0.1	-1.7	0.3
Gross operating surplus	0.1	-1.0	-0.8	-0.7	-0.7	-0.7	-0.3
Other receipts	0.0	0.3	0.0	0.0	0.0	0.0	0.0
Current receipts	3.1	-7.1	-8.2	-9.9	-13.9	-12.0	-11.2
<i>Memo: UK oil and gas revenues⁵</i>	0.0	-0.8	0.1	0.1	-0.2	0.1	-0.1

¹ Includes PAYE and self assessment receipts, and also includes tax on savings income and other minor 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.

Changes in the 2012-13 receipts forecast since December

- 7.50 Our forecast for current receipts in 2012-13 is £7.1 billion lower than in December. Around £5.1 billion of this shortfall relates to lower APF dividend income following the ONS classification decision, which is explained in more detail in paragraph 4.30.
- 7.51 Excluding the impact of the APF transfers, receipts are £2.0 billion lower than in December. However, this includes the impact of two fiscally-neutral reclassifications from expenditure to receipts: the £2.3 billion Special Liquidity Scheme (SLS) payment and a £0.8 billion reduction in the share of income tax credits treated as negative tax in the National Accounts. Excluding these reclassifications, underlying receipts are £5.1 billion lower than we forecast in December.
- 7.52 The largest downward revisions in 2012-13 are in income tax and NICs, which account for £3.8 billion of the difference. There are also downward revisions of £1.0 billion in the gross operating surplus of public corporations, £0.8 billion in UK oil and gas revenues and £0.4 billion in VAT receipts. These are partly offset by strength in year-to-date receipts for onshore corporation tax, stamp duty land tax and fuel duties, and the inclusion of LIBOR fines.

Changes in the medium-term receipts forecast since December

- 7.53 Current receipts are expected to be lower in every year of the forecast, with the difference reaching £13.9 billion in 2015-16. Table 4.8 shows the changes by receipts stream and Table 4.9 shows the key drivers of these differences. In the next section in this chapter we explain changes to individual taxes in more detail.
- 7.54 In summary, there are downward revisions since December to most of the main receipts streams:
- income tax and NICs are lower in each year with the difference peaking at £10.2 billion in 2015-16. This primarily reflects the lower path for average earnings from next year, as well as lower-than-expected receipts in early 2013 being assumed to persist throughout the forecast. From 2016-17 this is partly offset by the decision in this Budget to abolish the NIC contracting-out rebate;

- onshore corporation tax is lower due to the lower path for company profits, which offsets the impact of higher-than-expected receipts in 2012-13;
- offshore corporation tax receipts are lower, largely as a result of much higher assumptions for capital and operating expenditure which offset tax liabilities;
- VAT receipts are weaker, reflecting lower profiles for nominal consumer expenditure, GDP and government procurement. Lower receipts in the year-to-date are also assumed to persist throughout the forecast; and
- capital taxes are generally higher due to recent increases in equity price levels.

Table 7.9: Changes to the receipts forecast since December

	£ billion					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	593.8	620.6	643.0	671.4	706.1	734.2
March forecast	586.8	612.4	633.1	657.6	694.1	723.0
Change	-7.1	-8.2	-9.9	-13.9	-12.0	-11.2
<i>of which:</i>						
Income and expenditure	0.0	-1.9	-4.2	-5.5	-6.6	-7.6
Wages and salaries	0.0	-0.9	-1.5	-2.0	-2.2	-2.4
Non-financial company profits	0.0	-0.5	-1.4	-2.0	-2.8	-3.4
Consumer expenditure	0.0	-0.2	-0.4	-0.5	-0.5	-0.6
Dividend income	0.0	-0.2	-1.0	-0.9	-1.1	-1.3
North Sea	-0.2	0.3	0.2	-0.2	0.0	-0.8
Production and expenditure	-0.2	-2.0	-1.6	-1.8	-1.7	-2.0
Sterling oil and gas prices	0.0	2.3	1.8	1.7	1.7	1.2
Market assumptions	0.1	0.8	1.2	1.0	0.9	1.0
Property market	0.1	0.0	-0.4	-0.6	-0.7	-0.7
Equity prices	0.0	0.8	1.5	1.6	1.6	1.7
Prices	0.0	0.3	0.4	0.3	0.5	0.5
Other economic determinants	-0.2	-0.9	0.4	-0.1	0.2	0.4
Other assumptions	-6.7	-6.5	-5.1	-6.6	-8.6	-6.1
IT and NICs receipts and modelling	-3.6	-6.8	-5.8	-6.0	-6.0	-6.0
APF and SLS flows	-2.8	-0.1	0.5	0.5	-0.4	1.5
Corporation tax receipts and modelling	0.9	0.2	-0.2	-0.5	-0.4	0.0
NRAM and B&B interest income	-0.3	-0.2	-0.2	-0.7	-1.1	-1.0
VAT gap	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1
Public sector gross operating surplus	-1.0	-0.8	-0.7	-0.7	-0.6	-0.3
Tax credits	0.8	1.0	0.8	0.5	0.2	-0.2
Other judgements and modelling	-0.3	0.2	0.5	0.4	-0.2	0.0
Budget measures	0.0	-0.3	-2.7	-2.8	1.7	1.3

Tax by tax analysis

Income tax and NICs

- 7.55 Receipts of income tax and NICs are expected to be £3.8 billion lower in 2012-13 than assumed in the December *EFO*, reflecting lower-than-expected receipts over recent months. Around half of this shortfall reflects lower SA income tax and half reflects lower PAYE and NIC1 receipts on employee salaries.

Table 7.10: Key changes to income tax and NICs receipts since December

	£ billion					
	2012-13	2013-14	Forecast			
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	258.1	269.4	283.1	298.5	317.4	336.8
March forecast	254.3	261.3	274.1	288.3	312.2	331.0
Change	-3.8	-8.1	-9.0	-10.2	-5.2	-5.8
<i>of which:</i>						
<i>(by economic determinant)</i>						
Average earnings	0.0	-1.5	-1.9	-2.3	-2.5	-2.6
Employee numbers	0.0	0.6	0.5	0.3	0.3	0.2
SA determinants	0.0	-0.1	0.6	0.3	0.7	0.9
Other determinants	0.0	-0.2	-0.4	-0.7	-0.7	-0.9
<i>(by other category)</i>						
Latest PAYE and NIC1 receipts data	-2.9	-3.0	-3.0	-3.0	-3.1	-3.2
Latest SA income tax receipts data	-1.9	-2.0	-1.7	-1.7	-1.7	-1.7
Revised PAYE forestalling estimate	0.7	-0.7	0.0	0.0	0.0	0.0
Lower SA effective tax rate	0.0	-1.2	-0.9	-1.0	-1.1	-1.2
Other	0.4	0.0	-0.3	-0.3	-0.2	-0.1
Budget measures	0.0	0.0	-2.0	-1.8	3.2	2.8

- 7.56 While employment has continued to rise over the past year, wages and salaries growth has moderated further, because of lower average earnings. Average weekly earnings were up only 1.4 per cent in the final quarter of 2012 from a year earlier. Slow earnings growth, which also reduces the average effective income tax rate, is likely to be the main factor behind the weakness in PAYE and NIC1 receipts, particularly in the non-financial sector, since our last forecast. Based on initial data on receipts from financial sector bonuses, we have continued to assume a 10 per cent fall in bonuses in 2012-13.
- 7.57 The final outturn for PAYE and NIC1 receipts in 2012-13 remains uncertain. The majority of bonuses are usually paid in February and March, with HMRC receiving the tax in March and April. In addition, there are uncertainties on the extent of 'reverse forestalling' ahead of the reduction in the additional rate of income tax to 45p from April 2013.

Some taxpayers are expected to shift taxable income from 2012-13 to 2013-14 to take advantage of the lower rate.

- 7.58 We expect only a modest pick up in PAYE and NIC1 receipts in 2013-14. Earnings growth is expected to remain subdued for longer, reflecting recent outturns and a weaker forecast for productivity. The £1,335 rise in the personal allowance in April 2013 and a further 5 per cent fall in receipts from financial sector bonuses will also constrain receipts growth during 2013-14.
- 7.59 Receipts growth is then expected to pick up, with the income tax and NICs to GDP ratio rising by 1.0 per cent of GDP between 2014-15 and 2017-18. This is driven by our forecast that earnings growth will rise to around 4 per cent in the final three years of the forecast period. With earnings rising faster than tax thresholds and allowances, there will also be an effect from fiscal drag as taxpayers find more of their income taxed at higher rates. The decision in this Budget to abolish the NIC contracting-out rebate also increases receipts from 2016-17.
- 7.60 The final payments for 2011-12 SA income tax liabilities were due at the end of January and were lower than expected. As a result, we have reduced SA income tax receipts by £2.1 billion in 2012-13. SA income tax receipts are now expected to have risen by just 1.3 per cent in 2012-13, compared with our December *EFO* forecast of 11 per cent growth.
- 7.61 SA receipts were depressed last year by the unwinding of the forestalling that took place ahead of the introduction of the 50 per cent additional rate. Any further unwinding was expected to be substantially lower this year, which we expected to boost the annual growth rate. Initial analysis of SA returns suggests that tax from individuals with incomes above £150,000 did rise from last year, consistent with our judgement about unwinding from the forestalling.
- 7.62 The weakness in receipts instead seems to reflect lower-than-expected income from those self-employed who pay tax at either the basic or higher rate. This is despite a rise of around 200,000 in self-employment in the year to the first quarter of 2012. This indicates a fall in the effective tax rate on these incomes, with many of the newly self-employed, as well as some of the existing self-employed, not earning sufficient incomes to pay much tax. We have allowed for a further fall in the effective tax rate on 2012-13 SA liabilities. This takes around £1 billion off the SA forecast from 2013-14 onwards. The reverse forestalling mentioned earlier will depress 2012-13 liabilities (paid in 2013-14) and boost 2013-14 liabilities (paid in 2014-15).

Value added tax

- 7.63 Accrued VAT receipts are expected to have grown by 2.7 per cent in 2012-13, slightly lower than growth in nominal consumer spending, the main driver of VAT receipts. This implies a higher VAT gap – the difference between the theoretical level of VAT payments and actual receipts received by HMRC. The VAT gap is assumed to have risen from its historically low level of 9.5 per cent in 2011-12 to 10.7 per cent in 2012-13. The estimate of the VAT gap remains provisional and may change with updated ONS information.

Table 7.11: Key changes to VAT receipts since December

	£ billion					
	2012-13	2013-14	Forecast			2017-18
December forecast	101.1	104.1	108.3	112.5	116.8	121.5
March forecast	100.7	103.3	107.2	111.2	115.2	119.3
Change	-0.4	-0.8	-1.0	-1.3	-1.6	-2.1
<i>of which:</i>						
Outturn VAT receipts	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5
VAT debt	0.0	0.4	0.4	0.4	0.4	0.5
SRS of consumer spending	0.0	-0.2	-0.2	-0.3	-0.5	-0.9
Consumer spending	0.0	-0.3	-0.4	-0.5	-0.5	-0.6
Other spending	-0.2	-0.5	-0.6	-0.7	-0.9	-1.0
Other (including modelling)	0.2	0.3	0.4	0.4	0.4	0.4

- 7.64 Compared to December we have reduced the accrued VAT forecast by £0.4 billion in 2012-13 and by around £2.1 billion by 2017-18. The increasing deterioration reflects weaker growth in the tax base. Growth in nominal consumer spending is a little lower than we forecast in December, with slower real consumer spending growth in 2013 and 2014 only partly offset by higher inflation. The weaker UK economy also has an effect on other elements of the tax base such as the exempt and housing sectors. VAT on government procurement is being squeezed by the further reductions in the Government's expenditure plans.
- 7.65 A key assumption for the VAT forecast is the proportion of consumer spending subject to the standard rate of VAT. This rose marginally in 2012-13, aided by strong growth in new car sales. From a slightly higher starting point, we expect the share to be lower than in December by the end of the forecast period, reflecting modelling changes and a modestly higher path for interest rates pushing up mortgage interest payments and

squeezing spending on standard rated goods. This has the effect of reducing VAT receipts by £0.9 billion by 2017-18 relative to the December forecast.

Onshore corporation tax

- 7.66 Overall corporation tax receipts were £2.8 billion (or 6.3 per cent) lower in 2012-13 than in 2011-12, but this fall is more than explained by lower receipts from oil and gas companies. Receipts from onshore firms are expected to be up by £1.7 billion over the year. Although there was only modest profit growth in both the financial and non-financial sectors, repayments relating to liabilities from past years were around £1.8 billion less than in 2011-12, more than offsetting the effect of the reduction in the main rate of corporation tax from 26 per cent to 24 per cent. Relative to the December forecast, onshore receipts are expected to be £0.9 billion higher in 2012-13.

Table 7.12: Key changes to onshore CT receipts since December

	£ billion					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	34.7	34.3	34.5	35.6	38.0	39.7
March forecast	35.5	34.6	33.7	33.5	34.9	36.5
Change	0.9	0.3	-0.7	-2.0	-3.1	-3.2
<i>of which:</i>						
Industrial and commercial company profits	0.0	-0.5	-1.4	-2.0	-2.8	-3.4
Financial company profits	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Investment	0.0	0.0	0.1	0.3	0.4	0.5
Other economic determinants	0.0	0.3	0.3	0.2	0.0	0.0
Latest receipts data	0.7	0.5	0.6	0.6	0.6	0.7
Modelling changes	0.2	-0.4	-0.8	-1.1	-1.1	-0.7
Budget measures	0.0	0.3	0.5	0.1	-0.3	-0.3

- 7.67 We expect onshore corporation tax receipts to fall each year until 2015-16, mainly because of the staggered reduction in the main rate of corporation tax from 24 per cent in 2012-13 to 20 per cent in 2015-16 and the effects of policy measures such as the Patent Box and the temporary increase in the annual investment allowance. In the absence of these measures, we would have expected onshore corporation tax receipts to rise, reflecting forecast increases in profits.
- 7.68 Compared to December our forecast for onshore corporation tax is lower in every year from 2014-15. Our reduced forecast for company profit growth takes around £3.5 billion off the forecast by 2017-18. The announcement of the reduction in the main corporation tax rate to 20 per cent in 2015-16 and a number of measures to combat tax avoidance

by companies have the combined effect of reducing receipts by £0.3 billion by 2017-18.

- 7.69 Corporation tax from the financial sector is expected to be £5.0 billion in 2012-13, close to our estimate in the December *EFO*. We expect receipts from the sector by the end of the forecast period to be only around half the peak in receipts received in 2006-07. Receipts are being held back by sluggish profit growth, the reduction in the tax rate and by large losses from the financial downturn being set against future profits.

UK oil and gas revenues

- 7.70 Oil and gas revenues are expected to fall by over 40 per cent in 2012-13 from the previous year. This is despite oil and gas prices in 2012 being almost unchanged from their 2011 levels. The sharp decline in receipts reflects a 14 per cent drop in production, the result of high levels of maintenance and the unplanned temporary closure of several large fields during 2012. Higher maintenance levels, along with cost pressures and spending on several major, large scale projects are responsible for a sharp rise in capital expenditure in 2012, up around a third on 2011. With 100 per cent first year allowances available to oil and gas firms, higher investment leads to an immediate reduction in receipts.

Table 7.13: Key changes to oil and gas revenues since December

	£ billion					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	7.3	6.7	6.0	4.9	4.6	4.4
March forecast	6.5	6.8	6.1	4.7	4.8	4.3
Change	-0.8	0.1	0.1	-0.2	0.1	-0.1
<i>of which:</i>						
Oil and gas production	-0.3	-0.3	-0.1	-0.1	-0.1	0.0
Expenditure	0.0	-1.7	-1.5	-1.7	-1.6	-2.0
Sterling oil price	0.0	1.2	0.8	0.6	0.6	0.5
Gas price	0.0	1.0	1.0	1.0	1.1	0.8
Inflation	0.0	0.0	0.1	0.1	0.1	0.1
Latest outturns and modelling	-0.6	-0.2	-0.2	-0.1	0.0	0.5

- 7.71 Oil and gas revenues are expected to be £0.8 billion lower in 2012-13 than in our December forecast. Offshore corporation tax and petroleum revenue tax each account for around half of the lower receipts.
- 7.72 Oil and gas revenues are expected to decline further over the forecast period, from £6.5 billion to £4.3 billion, between 2012-13 and 2017-18. This reflects the declining path for oil prices, as determined by futures markets, which fall from \$113 to \$93 per barrel between 2013 and 2017.

Gas prices are assumed to follow a similar path to oil prices. DECC's latest forecasts for oil and gas production are broadly flat between 2013 and 2017, with the high levels of capital expenditure assumed to prevent further declines in production over this period. Relative to our December forecast, the effect on revenues from a higher path for oil and gas prices is largely offset by significantly higher capital, exploration and operating expenditure across the forecast period. This reflects recent industry data collected by DECC and Oil & Gas UK. This leaves oil and gas revenues broadly unchanged from the December forecast.

Fuel duties

- 7.73 The forecast for fuel duties is affected by the duty rate and the demand for fuel. The announcement in the Budget of the cancellation of the September 2013 rise in fuel duty is the main factor behind a lower projection than in our December *EFO* from 2013-14 onwards.
- 7.74 Even with fuel duty expected to be £0.4 billion higher in 2012-13 than assumed in December, receipts will still have fallen for the second consecutive year. This reflects the continued decline in duty paid consumption since its peak in 2007-08 and the absence of any duty changes since April 2011 (when the duty rate was cut by 1p). Duty-paid consumption is assumed to continue to decline over the forecast period, in part because of the improvements in the fuel efficiency of cars. Our forecast assumes RPI-related rises in duty rates to apply in September 2014 and 2015, and from April 2016 onwards. These rises start to reverse the decline in fuel duty receipts from 2014-15 onwards, with receipts above their 2010-11 peak by 2016-17.

Taxes on capital

- 7.75 Capital gains tax (CGT) is paid in the final quarter of the financial year following the year in which the gains from the sale of an asset were realised. This means that CGT receipts in 2012-13 reflect asset disposals in 2011-12. CGT receipts are expected to fall from £4.3 billion to £3.9 billion between 2011-12 and 2012-13. It is likely that forestalling ahead of the June 2010 rate increase boosted disposals in 2010-11, partly at the expense of lower disposals in 2011-12.
- 7.76 The CGT forecast is very sensitive to equity prices, as around three-quarters of chargeable gains are on financial assets and CGT is charged on the gain rather than the overall price. CGT receipts are expected to increase sharply from current levels over the rest of the forecast period. CGT is expected to rise to £5.1 billion in 2013-14 and to £8.7 billion in 2017-

18. A higher path for equity prices in our latest forecast adds around £1.2 billion to the forecast in 2017-18 compared to the December *EFO*.

- 7.77 We expect growth in inheritance tax to average around 6 per cent over the forecast period. Inheritance tax is charged on the value of estates notified for probate and will be driven by house prices, equity prices and the stock of household deposits. Inheritance tax receipts are expected to be higher than our December forecast due to the extension of the freeze in the inheritance tax threshold for three years from 2015-16 onwards.

Stamp duties

- 7.78 Receipts from stamp duty land tax (SDLT) are expected to be £0.4 billion higher in 2012-13 than assumed in December, in part reflecting that receipts from commercial property have held up better than anticipated. We expect SDLT receipts to grow from £6.9 billion in 2012-13 to £11.7 billion by 2017-18. This rise is particularly driven by a recovery in residential property transactions to a rate consistent with a long-run average rate of property turnover. However, we expect this recovery in transactions to be a little slower than we assumed in December. This is the main reason that SDLT receipts are forecast to be £0.5 billion lower by 2017-18 than in our previous forecast.
- 7.79 Stamp duty on shares is expected to be £0.1 billion lower in 2012-13 than we expected in December. This reflects continued weakness in receipts in the year to date, which we expect to continue throughout the forecast. However, we expect receipts to be around £0.3 billion higher in 2013-14 due to higher equity prices. Higher equity prices increase receipts throughout the forecast, but are increasingly offset by a decline in the volume of taxable share transactions and the effect from the Budget announcements on the abolition of the Schedule 19 charge and the abolition of stamp duty on AIM and other junior shares.

Alcohol and tobacco duties

- 7.80 Alcohol duty is expected to be flat between 2011-12 and 2012-13, having been revised up by £0.1 billion in 2012-13 to reflect recent strength in receipts from wine and spirits duty. The rises in duty in Budget 2012 were offset by a fall in overall alcohol consumption. From 2013-14 onwards, alcohol duties are expected to be around £0.2 billion lower than in December, reflecting the Budget announcement of a 1p reduction in beer duty for 2013-14 and a RPI increase for 2014-15. Alcohol duties increase from £10.2 billion in 2012-13 to £12.3 billion in 2017-18, reflecting pre-announced duty rises for other types of alcohol of 2 per cent above RPI inflation to 2014-15 and by RPI inflation thereafter.

- 7.81 We expect receipts from tobacco duty to fall by £0.3 billion to £9.6 billion in 2012-13, before rising over the rest of the period, to £10.8 billion in 2017-18 as increases in duty rates raise revenues by more than they are offset by declining cigarette consumption. Receipts are expected to be around £0.2 billion higher in each year from 2014-15 than we expected in December. This reflects our revised forecast for RPI inflation and the recent depreciation of sterling against the euro, which is assumed to discourage cross-border shopping.

Other taxes

- 7.82 Our forecast for **business rates** is similar to our December forecast. The downward effect from updated information on liabilities is offset by the effect of higher RPI inflation on the multiplier. Business rates bills are calculated by multiplying the rateable value of a non-domestic property by the multiplier, which is updated in line with RPI inflation.
- 7.83 The assumptions used in the **council tax** projection are described in paragraph 4.147. The revised assumptions add around £0.3 billion to the council tax forecast by the end of the forecast period. Changes to council tax are broadly offset by changes to locally financed expenditure, so are largely fiscally neutral.
- 7.84 For households claiming **tax credits**, the amount of credits that notionally offsets their income tax payments is treated as a negative tax in the National Accounts. The share assumed to be negative tax is expected to be lower than previously assumed, raising receipts by between £0.8 billion and £1.0 billion between 2012-13 and 2014-15. This change is fiscally neutral with higher receipts offset by higher AME spending.
- 7.85 **VAT refunds** to central and local government are fiscally neutral as receipts are fully offset within AME. The forecast for VAT refunds largely reflects the path of government procurement and investment plans. The VAT refund forecast is largely similar to the forecast in December.
- 7.86 We forecast **air passenger duty (APD)** revenues to rise by around £1.0 billion over the forecast period, from £2.8 billion in 2012-13 to £3.8 billion in 2017-18. This is slightly lower than we expected in December due to our revised forecast for household disposable income and updates to our methodology for forecasting passenger numbers. The rise in receipts over the forecast period reflects growth in passenger numbers and that duty rates are assumed to rise in line with inflation.

- 7.87 **Vehicle excise duty** (VED) revenues are expected to fall from £5.9 billion in 2012-13 to £5.5 billion by 2017-18. The decline in VED receipts in part reflects lower new car CO₂ emissions which cause a gradual shift in the stock of road vehicles to lower VED bands over time. It also reflects a cut in VED rates for Heavy Goods Vehicles from April 2014, as part of a package that introduces a lorry road user levy. The VED cut is intended to ensure that UK hauliers are no worse off following the introduction of the charge. The lorry road user levy has been included in the 'other taxes' line in Table 4.7.
- 7.88 Combined receipts from **environmental levies**, which includes levy funded spending policies such as the Renewables Obligation (RO), Feed-in tariffs and Warm Homes Discount, as well as revenues from the Carbon Reduction Commitment. Strong growth in revenues across the forecast reflects the expected increase in electricity generation from renewable sources. Of the four environmental levies included in our forecast only RO receipts are currently included in ONS outturn data.
- 7.89 **Environmental taxes** include receipts from the climate change levy, aggregates levy, landfill tax and the EU Emissions Trading Scheme. Combined receipts are expected to increase from £2.4 billion to £4.9 billion over the forecast period, which is close to our December forecast. Receipts from the EU Emissions Trading Scheme do not yet appear in ONS outturn data but are incorporated into our forecast years from 2012-13 as we expect this to be rectified in the future.
- 7.90 The **UK-Swiss agreement**, in which deposits of UK residents held in Swiss bank accounts become liable to a withholding tax to cover UK taxation, came into force on 1 January 2013. The Swiss authorities made an initial payment of £0.3 billion to the Exchequer in January 2013. In December we assumed that this payment would be accrued to the month in which it had been received, however, the ONS have announced that this payment would accrue in May 2013. The estimated £3.2 billion one-off element of the Swiss agreement will be scored as a capital tax in 2013-14, whilst any other ongoing revenues are incorporated within the income tax, capital gains tax and inheritance tax revenue totals.
- 7.91 Our forecast for proceeds from the **bank levy** in the current financial year has been revised down by £0.2 billion, based on the latest information from actual receipts and likely full-year liabilities. We expect some of this weakness in receipts to continue through the forecast, but is offset from 2014-15 onwards by the Budget announcement of a further rise in the bank levy rate.

- 7.92 We have included £0.3 billion from **LIBOR fines** in 2012-13 following the announcement that revenue from regulatory fees in excess of enforcement case costs will go to the Exchequer rather than being used to reduce Financial Services Authority (FSA) fees from the financial sector in the following year. We have not assumed any effect from fines in future years. These are included in the 'other receipts' line in Table 4.7.
- 7.93 We incorporate a provision for losses related to **tax litigation** cases in our receipts forecast. Once cases are settled, and their effects in particular years can be quantified, they are incorporated into forecasts of specific taxes. The magnitude and timing of actual losses is difficult to forecast as it depends on the legal process and final judgement. Even when a case is lost, the impact on receipts depends on the nature of the judgement and the response from the Government, and in some cases represent an upside risk to the Government. We assume that future tax litigation losses across all taxes will total £3.6 billion over the five-year forecast period, slightly lower than our December forecast as losses in the current financial year should now be incorporated into individual tax forecasts.

Other receipts

- 7.94 **Interest and dividend** receipts capture the interest income on the stock of financial assets held by the Government. They also include the proceeds from the APF and interest income (largely from mortgage interest payments) that Bradford & Bingley and Northern Rock (Asset Management) receive as the latter are now classified as central government by the ONS. These two elements are the primary drivers of changes since December. The £2.8 billion shortfall in interest and dividend receipts in 2012-13 compared with December reflects the impact of the final ONS classification decision on the APF and SLS, as discussed in paragraphs 4.30 and 4.31. As noted earlier, the profile for APF dividend income beyond 2012-13 has changed following the ONS classification decision. We have also included a lower path for interest income for Bradford & Bingley and Northern Rock (Asset Management), particularly in the later years of the forecast.
- 7.95 The gross operating surplus (GOS) forecast is lower by £0.3 billion by 2017-18 compared to the December forecast. This is mostly driven by the Housing Revenue Account (HRA). GOS is revised down in every year of the forecast as a result of lower outturn data for 2011-12. This is partly offset by an upward revision of the Transport Trading Limited gross trading surplus forecast on the basis on the latest business plan published earlier this year.

Public sector expenditure

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

- departmental expenditure limits (DELs)³⁵ – mostly spending on public services and administration, which can be planned some years in advance. Our forecast is based on the Government’s latest plans for DELs, which have been set out up to 2014-15, plus our view of the extent to which departments might underspend against these limits; and
- annually managed expenditure (AME) – categories of spending less amenable to multi-year planning, such as social security spending and debt interest. We forecast these categories of spending out to 2017-18, based on determinants derived from our economic forecast.

7.97 Beyond the current Spending Review period, our projections for total spending in the period 2015-16 to 2017-18 are based on the Government’s stated policy assumption, which is set out in paragraph 4.104. We continue to forecast AME components for these years and then subtract them from the Government’s overall spending assumption to derive implied DELs. This top-down approach means that higher AME spending beyond 2014-15 on, for example, debt interest or APF transfers, is offset by cuts in the residual implied DEL totals.

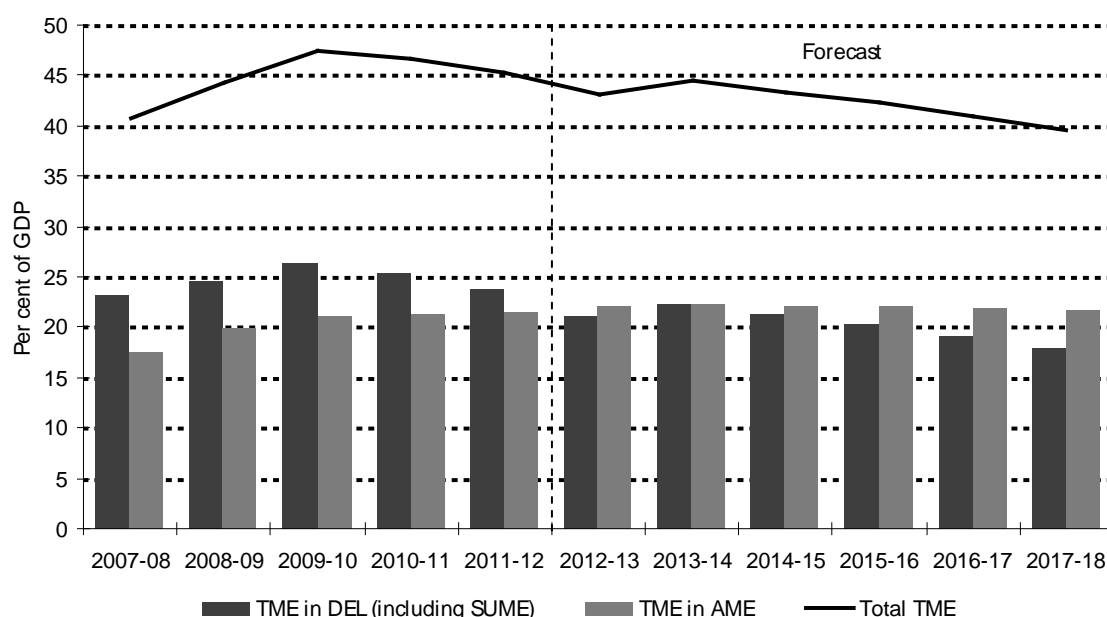
7.98 Chart 4.1 shows TME as a percentage of GDP since 2007-08, and how this splits between DEL and AME. TME increased sharply as a share of GDP through the recession of 2008-09 and 2009-10, reaching a peak of 47 per cent of GDP in 2009-10. With DELs fixed in cash terms through to 2010-11 in the 2007 Comprehensive Spending Review, this increase mainly reflected the sharp fall in nominal GDP in 2008-09 and 2009-10. However

³⁵ Our presentation of expenditure only shows those components of RDEL and CDEL and AME that are included in the fiscal aggregates of PSCE and PSGI. For budgeting purposes HM Treasury also includes other components in DEL such as non-cash items. A reconciliation between HM Treasury’s DEL figures and ours is published in the supplementary fiscal tables on our website.

AME spending on social security and debt interest also increased over this period, as a result of the recession.

7.99 TME fell from 47 per cent of GDP in 2009-10 to 45 per cent of GDP in 2011-12 due mainly to the reductions in expenditure under the Government's fiscal consolidation plan. The further decline between 2011-12 and 2012-13 mainly reflects the transfer to the public sector of the Royal Mail pension fund assets and 4G spectrum auction receipts, which score as negative expenditure. Excluding these factors, TME is forecast to be broadly flat between 2011-12 and 2013-14. Nominal GDP growth over this period is expected to be relatively weak which acts to increase expenditure (much of which is fixed in cash terms) as a share of the economy. TME is then expected to start to decline again due to the combined effect of the forecast pick-up in economic growth and the continued reductions in expenditure in the Government's fiscal consolidation plans.

Chart 7.1: DEL and AME components of TME



Source: ONS, OBR

Summary of the expenditure forecast

7.100 Table 4.14 summarises our latest forecast for public expenditure. TME is expressed as a share of the economy, but not all of TME contributes directly to the calculation of GDP, as it comprises benefit payments, debt interest and other cash transfers rather than the production or consumption of goods and services. Table 4.15 shows how TME is split

between DEL and AME over the forecast period, and the main components of AME.

- 7.101 AME is forecast to be relatively flat as a share of GDP over the forecast period. Social security payments are forecast to fall as a share of GDP as the economy recovers, while debt interest payments rise due to high levels of borrowing. From 2012-13, total AME spending is expected to exceed DEL for the first time.
- 7.102 Local authority spending is split between spending financed by central government grants (in DEL), and spending financed by local authorities' own sources of income (in AME). Spending has been transferred from DEL to AME from 2013-14 onwards, reflecting the new policy under which local authorities retain around half of their business rates income, which pushes up the AME forecast in 2013-14 and later years.
- 7.103 Public sector gross investment falls sharply in 2012-13 due to the transfer of the Royal Mail pension assets and the spectrum auction receipts, which are classified as negative capital expenditure.

Table 7.14: Expenditure as a per cent of GDP

	Per cent of GDP						
	Outturn		Forecast				
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Total managed expenditure	45.5	43.6	45.2	44.0	43.1	41.8	40.5
<i>of which:</i>							
Public sector current expenditure	42.2	42.5	42.2	41.0	40.2	39.0	37.8
Public sector gross investment	3.3	1.0	3.0	3.0	2.9	2.8	2.8
Total public sector expenditure that contributes directly to GDP ¹	24.7	24.5	24.1	23.4	22.5	21.4	20.2
<i>of which:</i>							
General government consumption	22.2	22.1	21.9	21.0	20.2	19.1	18.1
General government gross fixed capital formation	2.1	2.0	1.9	2.0	1.9	1.9	1.8
Public corporations gross fixed capital formation	0.4	0.4	0.4	0.4	0.3	0.3	0.3

¹ GDP at market prices

Table 7.15: TME split between DEL and AME

	Per cent of GDP						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
TME in DEL ^{1,2,3}	23.8	21.2	22.5	21.6	20.5	19.3	18.0
TME in AME	21.7	22.4	22.6	22.4	22.6	22.5	22.5
<i>of which:</i>							
Social security ²	11.5	11.8	11.3	11.1	10.9	10.7	10.5
Debt interest	3.1	3.0	3.1	3.1	3.3	3.6	3.8
Locally-financed current expenditure ³	1.4	1.5	2.3	2.3	2.3	2.3	2.3
Other PSCE in AME	4.7	5.2	5.1	5.1	5.1	5.2	5.1
PSGI in AME	1.0	0.8	0.8	0.8	0.8	0.8	0.8

¹ In relation to table 4.18, TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME, and TME in AME is defined as PSCE in AME plus PSGI in AME minus SUME. SUME is single use military equipment.

² From 2013-14, TME in RDEL contains grants to local authorities to finance the localised council tax reduction scheme, which replaces grants to local authorities to finance council tax benefits previously contained within social security.

³ From 2013-14, locally-financed current expenditure contains the business rates that local authorities will retain, and there is an offsetting reduction in the grant in RDEL which distributes business rates to local authorities.

7.104 Beyond the current Spending Review period, our projections for the period 2015-16 to 2017-18 are based on the Government's stated policy assumption that TME should continue to fall at the same average real rate as over the Spending Review period, with PSGI flat in real terms. The Government has specified a number of exclusions when making these calculations.³⁶

7.105 Applying the Government's assumption, TME is projected to fall by an average of 0.4 per cent a year in real terms in the Spending Review period, compared with the 0.6 per cent fall implied by the Government's policy assumption in our December forecast. The fall is less than in

³⁶ The Government has stated that the growth rate should be projected forward using a baseline that excludes our forecast underspends in DEL, all the spending measures announced in the Autumn Statement 2012 and in the March Budget 2013, and the capital measures announced in the Autumn Statement 2011. Growth over the Spending Review period includes the capital measures announced in the Autumn Statement 2011, but excludes our forecast underspends in DEL, and excludes the measures announced in the Autumn Statement 2012 and in the March Budget 2013.

December largely due to the reduction in our forecast of the GDP deflator. A lower deflator implies higher real spending growth over the Spending Review period for a given set of nominal spending totals. Our GDP deflator forecast is also lower after 2014-15, which decreases nominal expenditure in 2015-16, 2016-17 and 2017-18 compared to the December forecast. These two GDP deflator effects partly offset each other.

7.106 Within TME, the Budget measure that increases PSGI by £3 billion each year from 2015-16 to 2017-18 effectively increases PSGI in CDEL, since that is derived by residual from PSGI less PSCE in AME. And this measure reduces PSCE by £3 billion in each of these years, since that is derived by residual from TME less PSGI. This reduction in PSCE then knocks through to PSCE in RDEL, since that is derived by residual from PSCE less PSCE in AME.

7.107 Table 4.16 shows that as a result of these assumptions and the Budget measure increasing PSGI, against a baseline that includes all spending in 2014-15:

- in 2015-16, TME increases in real terms by 0.2 per cent, PSGI still declines by 1.7 per cent and PSCE increases by 0.3 per cent;
- in 2016-17, TME now declines in real terms by 0.4 per cent, PSGI declines by 0.1 per cent and PSCE declines by 0.4 per cent; and
- in 2017-18, TME now declines in real terms by 0.4 per cent, PSGI declines by 0.1 per cent and PSCE declines by 0.4 per cent.

7.108 On the basis of current policy, including the policy measures announced in this Budget, we expect total AME to rise in real terms by 2.9 per cent in 2015-16, 2.5 per cent in 2016-17, and 2.7 per cent in 2017-18. For these years, we have derived implied levels for our definitions of RDEL and CDEL by subtracting the forecasts for AME from the forecasts for total PSCE and total PSGI. On the basis of our latest forecast for TME in DEL, including our estimates of departments' shortfall in spending against DEL plans in 2014-15:

- implied PSCE in RDEL falls in real terms by 2.7 per cent in 2015-16, 3.8 per cent in 2016-17, and 4.3 per cent in 2017-18. In the December forecast the equivalent falls in PSCE in RDEL were 1.6 per cent in 2015-16, 3.5 per cent in 2016-17, and 4.1 per cent in 2017-18; and
- implied PSGI in CDEL falls in real terms by 3.9 per cent in 2015-16, 0.5 per cent in 2016-17, and 1.1 per cent in 2017-18. In the December

forecast the equivalent falls were 8.6 per cent in 2015-16 and 0.3 per cent in 2016-17, and real terms growth of 0.4 per cent in 2017-18.

7.109 In the Budget the Government has announced that the totals set out here for PSCE and PSGI in 2015-16 will form the envelope for the summer spending round. In the Autumn 2013 *EFO* we will therefore produce a bottom-up forecast of 2015-16 total expenditure based on the plans set out in the summer and our latest AME forecast, rather than deriving it on the basis of the Government's spending growth assumption.

Table 7.16: Spending real growth rates and as a per cent of GDP

	Spending Review years 2011-12 to 2014-15		Post Spending Review years			Total change between 2010-11 and 2017-18
	Total change	Average annual change	Change in 2015-16	Change in 2016-17	Change in 2017-18	
Real terms growth rate (%)						
Total managed expenditure	-2.2	-0.5	0.2	-0.4	-0.4	-2.7
<i>of which:</i>						
PSCE	-0.5	-0.1	0.3	-0.4	-0.4	-0.9
PSGI	-20.4	-5.6	-1.7	-0.1	-0.1	-21.9
TME in AME	8.7	2.1	2.9	2.5	2.7	14.6
TME in DEL	-11.4	-3.0	-2.7	-3.5	-3.9	-16.7
<i>of which:</i>						
PSCE in RDEL	-9.8	-2.5	-2.7	-3.8	-4.3	-19.2
PSGI in CDEL	-21.1	-5.8	-3.9	-0.5	-1.1	-25.4
Per cent of GDP						
Total managed expenditure	-2.7	-0.7	-1.0	-1.3	-1.3	-6.3
<i>of which:</i>						
PSCE	-1.8	-0.5	-0.8	-1.2	-1.2	-5.1
PSGI	-0.9	-0.2	-0.1	-0.1	-0.1	-1.2
TME in AME	1.0	0.2	0.1	-0.1	0.0	1.0
TME in DEL	-3.7	-0.9	-1.1	-1.2	-1.3	-6.0
<i>of which:</i>						
PSCE in RDEL	-2.9	-0.7	-0.9	-1.2	-1.2	-6.2
PSGI in CDEL	-0.7	-0.2	-0.1	-0.1	-0.1	-1.0

Summary of changes to the expenditure forecast since December

7.110 Table 4.17 shows the main reasons for the changes in our forecast of public sector expenditure since December. Tables 4.18 and 4.19 show the detailed spending forecasts and the changes in these forecasts since the *December EFO*. These are explained in more detail in the subsequent sections. In summary the main drivers of changes since the December forecast are:

- changes to the economic determinants. In particular, a higher RPI inflation forecast has increased debt interest payments from 2013-14 onwards, a lower claimant count unemployment forecast decreases social security payments, and a reduction in our forecast of the sterling/euro exchange rate increases the UK contribution to the EU;
- the Government's decision to reduce departmental expenditure in 2012-13, partly by pushing some spending into 2013-14 and 2014-15. Further details are set out in the DEL section below;
- in 2012-13, the Special Liquidity Scheme capital receipt has been reclassified by the ONS from spending to current receipts, hence this increase in spending is offset by an increase in receipts;
- the new EU Multi-annual Fiscal Framework deal that sets EU budgets from 2014 to 2020 is lower than we had assumed, hence reducing our forecast of the UK payments to the EU. Further details are set out in the EU contributions section;
- changes to the implied DELs in 2015-16 to 2017-18 resulting from applying the government's spending growth assumption and increases in AME spending;
- changes to the modelling of some social security benefits, mainly housing benefit and state pension, which increase social security spending. Further details are set out in the section on social security spending below; and

- the policy changes announced in the March Budget, which are summarised in Table 4.3 and set out in full in Annex A.

Table 7.17: Changes to the spending forecast since December

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	674.3	719.9	731.0	744.7	755.1	765.5
March forecast	673.3	720.0	730.4	744.7	754.9	765.1
Change	-1.0	0.2	-0.5	0.0	-0.2	-0.4
<i>of which:</i>						
Economic determinants	-0.5	0.6	0.4	1.2	1.8	2.1
Inflation	-0.3	1.0	0.5	0.9	1.5	1.6
Unemployment	-0.1	-0.4	-0.3	-0.3	-0.3	-0.3
State pension uprating	0.0	0.0	0.2	0.2	0.1	0.1
Exchange rate	0.0	-0.1	0.0	0.3	0.4	0.6
Average earnings	0.0	0.2	0.1	0.1	0.1	0.1
Market assumptions	0.0	0.1	0.1	0.5	1.1	1.7
Gilt rates	0.0	0.1	0.1	0.4	1.0	1.5
Short rates	0.0	0.0	0.0	0.1	0.1	0.3
Other assumptions/changes	-0.6	1.1	0.0	-1.7	-3.1	-4.2
Changes to DEL underspend assumptions	-3.4	1.0	0.5	-	-	-
Changes to implied DEL	-	-	-	-2.3	-4.1	-6.0
Social security modelling changes	0.3	1.0	1.1	1.4	0.9	1.2
Special Liquidity Scheme reclassification	2.3	-	-	-	-	-
Debt interest costs from financing	0.0	-0.2	-0.1	0.4	0.8	1.3
CGNCR	0.0	-0.2	-0.1	0.4	0.8	1.3
EU Multi-annual Fiscal Framework deal	0.0	-0.6	-1.4	-0.7	-0.2	-0.6
Other	0.3	-0.1	-0.1	-0.5	-0.6	-0.1
Budget measures	0.0	-1.6	-1.1	0.0	0.0	0.0

Table 7.18: Total managed expenditure

	£ billion						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector current expenditure (PSCE)							
PSCE in RDEL ¹	322.6	319.5	320.8	317.2	314.2	307.4	299.1
PSCE in Annually Managed Expenditure	321.2	337.7	352.1	362.8	380.1	396.3	413.9
<i>of which:</i>							
Social security benefits	174.9	182.8	180.4	184.4	189.1	193.1	197.6
Tax credits	27.2	28.6	29.0	29.8	31.3	33.2	34.4
Net public service pension payments	8.0	10.5	11.1	12.4	13.6	14.9	16.2
<i>of which: CG unfunded pension schemes</i>	<i>6.7</i>	<i>8.9</i>	<i>9.5</i>	<i>10.7</i>	<i>11.9</i>	<i>12.9</i>	<i>14.1</i>
<i> LG police and fire pension schemes</i>	<i>1.4</i>	<i>1.6</i>	<i>1.6</i>	<i>1.6</i>	<i>1.8</i>	<i>1.9</i>	<i>2.0</i>
National lottery current grants	1.1	1.1	1.2	1.3	1.5	1.6	1.7
BBC domestic services current expenditure	3.8	3.4	3.5	4.0	3.7	3.8	3.9
Fees associated with financial interventions	-2.0	-0.6	-0.3	-0.2	0.0	0.0	0.0
Other PSCE items in departmental AME	1.1	2.0	1.4	1.2	1.1	1.1	1.2
Expenditure transfers to EU institutions	5.9	7.4	6.5	5.7	6.1	5.9	6.0
Locally-financed current expenditure	21.6	23.8	36.1	38.0	39.5	41.0	43.1
Central government gross debt interest	47.9	46.5	49.5	51.8	57.8	64.4	71.3
Depreciation	16.0	16.9	17.7	18.4	19.2	19.9	20.6
Current VAT refunds	11.7	11.6	12.3	12.3	12.4	12.2	11.8
Single use military expenditure	5.5	4.7	4.7	4.2	4.7	4.7	4.7
Environmental levies	0.5	1.3	1.7	2.1	2.6	3.1	3.8
Other National Accounts adjustments	-2.2	-2.4	-2.6	-2.6	-2.5	-2.5	-2.4
Total public sector current expenditure	643.8	657.2	672.9	680.0	694.2	703.7	713.0
Public sector gross investment (PSGI)							
PSGI in CDEL ¹	34.8	3.3	33.7	36.9	36.1	36.5	36.7
PSGI in Annually Managed Expenditure	15.0	12.8	13.5	13.5	14.4	14.7	15.4
<i>of which:</i>							
National lottery capital grants	0.4	0.4	0.5	0.6	0.6	0.7	0.7
Other PSGI items in departmental AME	-7.0	0.8	0.8	0.9	0.8	0.7	1.3
Locally-financed capital expenditure	16.5	7.1	6.4	6.3	6.8	7.0	6.7
Public corporations capital expenditure	6.7	6.2	5.9	5.9	6.0	6.2	6.4
Other National Accounts adjustments	-1.6	-1.7	-0.1	-0.2	0.2	0.2	0.2
Total public sector gross investment	49.8	16.1	47.2	50.4	50.4	51.3	52.1
<i>Less depreciation</i>	<i>-21.1</i>	<i>-22.1</i>	<i>-23.0</i>	<i>-23.8</i>	<i>-24.6</i>	<i>-25.4</i>	<i>-26.3</i>
Public sector net investment	28.7	-6.0	24.2	26.6	25.8	25.8	25.8
Total managed expenditure	693.6	673.3	720.0	730.4	744.7	754.9	765.1

¹ Implied DEL numbers for 2015-16, 2016-17 and 2017-18. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

Table 7.19: Changes to total managed expenditure since December

	£ billion						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector current expenditure (PSCE)							
PSCE in RDEL ¹	0.0	-2.9	-0.4	-0.4	-4.6	-6.3	-7.6
PSCE in Annually Managed Expenditure	0.7	-0.6	1.3	-1.1	1.4	3.1	4.4
<i>of which:</i>							
Social security benefits	0.0	0.2	0.5	0.9	1.2	0.8	0.9
Tax credits	0.0	0.8	1.1	1.2	0.9	0.7	0.3
Net public service pension payments	0.0	-0.4	-0.2	-0.4	-0.3	-0.2	-0.1
<i>of which: CG unfunded pension schemes</i>	<i>0.0</i>	<i>-0.4</i>	<i>-0.2</i>	<i>-0.4</i>	<i>-0.3</i>	<i>-0.2</i>	<i>-0.1</i>
<i> LG police and fire pension schemes</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>-0.1</i>	<i>-0.1</i>	<i>0.0</i>	<i>0.0</i>
National lottery current grants	0.0	0.0	0.1	0.1	0.2	0.3	0.4
BBC domestic services current expenditure	0.0	-0.2	0.1	0.3	0.0	0.0	0.0
Fees associated with financial interventions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other PSCE items in departmental AME	1.1	0.3	0.1	0.0	0.0	-0.1	-0.1
Expenditure transfers to EU institutions	0.0	0.1	-0.1	-1.6	-0.5	0.1	0.0
Locally-financed current expenditure	0.0	0.6	0.1	0.2	0.3	0.4	0.4
Central government gross debt interest	0.8	-0.6	0.9	0.0	1.2	2.8	4.2
Depreciation	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Current VAT refunds	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1	-0.2
Single use military expenditure	0.0	-0.4	0.0	-0.5	-0.1	-0.1	-0.2
Environmental levies	0.0	0.0	0.0	0.0	-0.2	-0.4	-0.5
Other National Accounts adjustments	-1.1	-0.9	-1.0	-1.1	-1.1	-1.1	-0.9
Total public sector current expenditure	0.7	-3.5	1.0	-1.5	-3.1	-3.2	-3.2
Public sector gross investment (PSGI)							
PSGI in CDEL ¹	0.0	0.9	-0.6	0.7	2.3	2.2	1.6
PSGI in Annually Managed Expenditure	2.0	1.5	-0.2	0.3	0.8	0.8	1.3
<i>of which:</i>							
National lottery capital grants	0.0	-0.1	0.0	0.0	0.0	0.1	0.1
Other PSGI items in departmental AME	0.6	2.3	-0.3	-0.1	-0.2	-0.2	0.2
Locally-financed capital expenditure	0.5	0.9	1.6	1.4	1.5	1.4	1.3
Public corporations capital expenditure	0.0	-1.6	-1.4	-0.9	-0.9	-0.7	-0.6
Other National Accounts adjustments	0.9	0.0	0.0	0.0	0.3	0.2	0.2
Total public sector gross investment	2.0	2.4	-0.8	0.9	3.1	3.0	2.9
<i>Less depreciation</i>	<i>0.0</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>
Public sector net investment	2.0	2.5	-0.8	1.0	3.2	3.1	3.0
Total managed expenditure	2.7	-1.0	0.2	-0.5	0.0	-0.2	-0.4

¹ Implied DEL numbers for 2015-16, 2016-17 and 2017-18. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

Expenditure in 2012-13

- 7.111 Our forecast for TME in 2012-13 is £1.0 billion lower than in the December *EFO*, comprising a £3.5 billion reduction in PSCE and a £2.4 billion increase in PSGI. The increase in PSGI mainly reflects the fiscally neutral reclassification of the £2.3 billion capital receipt from the SLS from expenditure to tax. Excluding this reclassification, PSGI is broadly unchanged from December while PSCE is around £3.5 billion lower primarily reflecting the Government's decisions to reduce expenditure by central government departments, which are discussed below.
- 7.112 Detailed sectoral breakdowns of our forecasts are shown in the supplementary fiscal tables on our website. Overall, compared to December, we have decreased our expenditure forecast by £0.7 billion for central government and by £0.6 billion for public corporations, and increased it by £0.4 billion for local government.
- 7.113 The February release of the monthly Public Sector Finance statistics showed that central government expenditure in the first ten months of 2012-13 was 2.7 per cent higher than the same period last year, which is higher than our forecast of 2.1 per cent growth for the full year in this *EFO*. However, as we pointed out in our commentary on the February release, at least 0.3 per cent of the increase in the spending in the first 10 months is accounted for by timing differences on spending on EU payments and grants to local authorities. These payments have been made earlier than last year and so spending on these transfers is expected to be lower over the next two months. We are also expecting the usual end-year surge in spending to be lower this year given the Government's actions to reduce end-year spending which are explained in the following section on DELs.

Departmental expenditure limits (DELs)

- 7.114 Table 4.20 summarises the changes in our forecasts for PSCE in RDEL and PSGI in CDEL since December. The main changes result from the Government's decision to reduce spending by central government departments in 2012-13, partly by pushing some spending forward into future years. These are described in detail below. Other changes include a £1.2 billion increase in CDEL in 2012-13, because the 4G spectrum auction receipts (which score as negative capital spending) were lower than expected.

Table 7.20: Key changes to DEL since December

	£ billion					
	Forecast			Implied DEL		
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
PSCE in RDEL						
December forecast	322.4	321.1	317.6	318.7	313.7	306.7
March forecast	319.5	320.8	317.2	314.2	307.4	299.1
Change	-2.9	-0.4	-0.4	-4.6	-6.3	-7.6
<i>of which:</i>						
Policy changes affecting underspends	-0.8	0.8	0.5	-	-	-
Other changes to underspend ¹	-2.1	0.0	0.0	-	-	-
Budget measures	0.0	-1.4	-1.2	-2.9	-3.0	-2.9
Other changes to implied DEL ²	-	-	-	-1.7	-3.3	-4.7
Other	0.0	0.2	0.3	-	-	-
PSGI in CDEL						
December forecast	2.3	34.3	36.2	33.8	34.3	35.2
March forecast	3.3	33.7	36.9	36.1	36.5	36.7
Change	0.9	-0.6	0.7	2.3	2.2	1.6
<i>of which:</i>						
Policy changes affecting underspends	-0.8	0.2	0.5	-	-	-
Other changes to underspend ¹	0.6	0.0	0.0	-	-	-
Budget measures	0.0	-0.1	0.2	3.0	3.1	3.1
Change to 4G Spectrum receipt	1.2	-	-	-	-	-
Fiscal to non-fiscal switches	0.0	-0.7	0.0	-	-	-
Other changes to implied DEL ²	-	-	-	-0.6	-0.8	-1.5
SJME (CDEL in PSCE in AME)³						
December forecast	5.0	4.7	4.7	4.7	4.8	5.0
March forecast	4.7	4.7	4.2	4.7	4.7	4.7
Change	-0.4	0.0	-0.5	-0.1	-0.1	-0.2
<i>of which:</i>						
Changes to underspends ¹	-0.4	0.0	-0.5	-	-	-
Other	0.0	0.0	0.0	-0.1	-0.1	-0.2

¹ The overall underspend assumptions in this forecast, including SJME, are as follows:

	2012-13	2013-14	2014-15
PSCE in RDEL	-7.4	-1.2	-1.0
SJME	-1.7	-1.0	-1.0
PSGI in CDEL	-1.9	-1.3	-1.0
TME in DEL	-10.9	-3.5	-3.0

² Changes to implied RDEL are calculated as changes to total PSCE less changes to PSCE in AME. Changes to implied CDEL are calculated as changes to total PSGI less changes to PSGI in AME.

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

- 7.115 In our December *EFO*, we forecast total underspends of £7.5 billion for TME in DEL in 2012-13, relative to the plans set out by the Treasury in the Public Expenditure Statistical Analysis (PESA) document in July 2012. We have now updated this estimate, based on the amount of spending that the Treasury agreed to allow departments to carry forward in future years under its Budget Exchange arrangements, some additional spending reductions revealed in the Supplementary Estimates presented to Parliament in February, plus information from the Treasury on further spending reductions that it has agreed with departments subsequently.
- 7.116 On the basis of this evidence, plus the fact that on average departments typically underspend even against the final plans they agree with the Treasury, we have increased the total forecast underspend against the 2012 PESA plans to £10.9 billion.
- 7.117 It is very rare for the Government to underspend the departmental plans it has set out less than a year ago by such a large margin. To ensure that our forecast is a central one, we have asked the Treasury for a detailed breakdown of the spending reductions that it expects departments to deliver, which we publish in Table 4.22.
- 7.118 Our overall forecast of under-spending has a number of elements: money that the Treasury has agreed to allow departments to move into future years; money that the Treasury has not allowed departments to bring forward from future years; money that departments thought they would spend this year, but which they do not now expect to spend either this year or in the future; and payments (for example to some international institutions) that were due to be made late in the current financial year, but which are being delayed into 2013-14. In the last of these cases, departments have assumed that these payments will be accrued to 2013-14 rather than 2012-13, although we see some risk that this may not always be the case and some could be accrued to the original date.
- 7.119 In more detail, our forecast of the total underspend is built up as follows:
- Supplementary Estimates presented to Parliament in February showed that departments had reduced their spending plans for TME in DEL in 2012-13 by £5.1 billion against PESA plans, adjusted for policy changes announced in the Autumn Statement. This included £3.9 billion that departments surrendered to take forward into 2013-14 and 2014-15 under the Treasury's Budget Exchange scheme. This was more than we had assumed in December, and much more

than the £0.8 billion that departments surrendered under Budget Exchange in 2011-12, its first year of operation;

- Supplementary Estimates are departments' final spending plans for the year and form an absolute upper limit. Departments face severe sanctions if they exceed them and so they typically underspend them by some margin. Underspends against these final plans have been in the range of £4 billion to £6 billion over the past five years, but that was mostly before the introduction of Budget Exchange. Given that departments surrendered £3.9 billion of their underspends in Budget Exchange in their Supplementary Estimates this year, we would have expected smaller underspends against these final plans that we have seen on average in the past;
- however, departments' February forecasts of their spending over the whole of 2012-13 showed that they nonetheless expected to deliver further reductions of £5.3 billion against their final spending plans.³⁷ These reductions included departments' estimates of their further underspends, plus additional reductions agreed with the Treasury. We estimate that at least £1.6 billion of the further shortfall in departments' February forecasts is the direct result of the Government's actions to reduce spending in 2012-13 by pushing money forward into future years. The Government's actions will probably account for even more of the remaining £3.7 billion of shortfall in department's forecasts of outturn – in practice this will reflect a mixture of departments' normal drive to remain safely below their final spending limits, and the further results of Government pressure to deliver further underspends. But we have no way of distinguishing these effects; and finally
- departments usually underspend even against their February forecasts – last year by a further £1.4 billion. Our forecast for 2012-13 assumes an additional further underspend of only £0.5 billion, given the large underspends and reductions already agreed against final plans.

³⁷ Departments submit forecast outturn data each month to the Treasury, which includes their outturns and forecast outturns for all 12 months of 2012-13. Their forecast outturn returns in February reflect their best view of their spending for the whole year, including their underspends against their final plans. This year, the forecast outturn data reflected the additional agreements to reduce spending, and the Treasury further supplemented the data with further reductions agreed after departments submitted their returns.

7.120 As a result of all this information, we are forecasting a total underspend of £10.9 billion against TME in DEL in 2012-13. This consists of underspends of £7.4 billion for PSCE in RDEL, £1.9 billion for PSGI in CDEL, and £1.7 billion for Single Use Military Expenditure (SUME), which is part of CDEL but is included in current expenditure in the National Accounts. The detailed components of the underspends are set out in footnote 1 of Table 4.20.

Table 7.21: Components of shortfall against DEL plans 2012-13

	PSCE in RDEL	PSGI in CDEL	TME in DEL ¹
PESA plans at start of year	328.2	8.8	343.3
Autumn Statement measures	-1.4	-2.4	-3.7
Classification change of European Investment Bank		-1.3	-1.3
OBR assumption of shortfall against PESA plans (post AS measures and classification change)	-7.4	-1.9	-10.9
<i>of which:</i>			
Changes to plans published in Supplementary Estimates ²	-4.2	0.8	-5.1
Shortfall against revised plans in departments' February full year forecast outturn ^{2,3}	-3.0	-2.4	-5.3
OBR estimate of allowance for further shortfall	-0.3	-0.3	-0.5
OBR forecast in March <i>EFO</i>	319.5	3.3	327.4

¹ TME in DEL includes SUME.
² Approximate estimates of fiscal spending in RDEL and CDEL.
³ Reflects departments estimates of forecast outturn in February 2013 plus additional reductions agreed with HM Treasury.

7.121 Table 4.22 sets out the total reductions in spending that the Treasury expects departments to deliver in 2012-13. It also shows the additional spending carried forward into 2013-14 and 2014-15 by individual departments under Budget Exchange. The table also shows the £1.6 billion of additional spending that the Treasury expects to fund from the DEL reserves as a result of the additional agreements it reached with departments after the Supplementary Estimates, which transferred spending into 2013-14 and 2014-15.

Table 7.22: Reductions in DEL spending in 2012-13, and spending carried forward to 2013-14 and 2014-15

	£ billion								
	RDEL excl depreciation			CDEL ²			TME in DEL		
	Estimated under-spends ³	Budget exchange ⁴		Estimated under-spends ³	Budget exchange ⁴		Estimated under-spends ³	Budget exchange ⁴	
	12-13	13-14	14-15	12-13	13-14	14-15	12-13	13-14	14-15
Education	-1.0	0.4	0.2	0.0	0.1	0.0	-1.1	0.5	0.2
NHS (Health)	-1.4	0.0	0.0	-0.8	0.0	0.0	-2.2	0.0	0.0
Transport	-0.7	0.1	0.0	-0.2	0.3	0.1	-0.9	0.4	0.1
CLG Communities	-0.5	0.2	0.0	-0.3	0.0	0.0	-0.8	0.2	0.0
Home Office	-0.7	0.1	0.0	-0.1	0.0	0.0	-0.8	0.1	0.0
Defence	-0.5	0.5	0.8	-2.5	0.1	0.2	-3.0	0.6	1.0
International Development	-0.5	0.1	0.0	0.0	0.0	0.0	-0.5	0.1	0.0
Work and Pensions	-0.7	0.0	0.0	0.1	0.0	0.0	-0.7	0.0	0.0
Other ⁵	-1.6	0.4	0.2	0.0	0.6	0.1	-1.6	1.0	0.3
Total	-7.6	1.7	1.2	-3.8	1.1	0.4	-11.5	2.9	1.6
Remove non fiscal spending	0.3	0.0	0.0	0.3	-0.5	0.0	0.6	-0.5	0.0
Total fiscal RDEL and CDEL	-7.4	1.7	1.2	-3.5	0.6	0.4	-10.9	2.4	1.6
<i>Carry forward agreements⁶</i>		<i>0.4</i>	<i>0.4</i>		<i>0.4</i>	<i>0.4</i>		<i>0.8</i>	<i>0.8</i>

¹ These changes exclude measures from this Budget and Autumn Statement 2012.

² Changes in Capital DEL control totals including Single Use Military Equipment (SUME), which scores as current spending in National Accounts. SUME reduced by £1.7 billion in 2012-13.

³ The difference between plans published at Budget 2012 and departments' latest estimates of their full-year position.

⁴ These are the amounts carried forward from 2012-13 through Budget Exchange, presented in the Spring Supplementary Estimates.

⁵ Includes changes to all other departments, the Reserve, Special Reserve and Budget Exchange adjustments.

⁶ Carry forward agreements identified post Supplementary Estimates; provisional figures.

7.122 In 2013-14 and 2014-15, there are now additional pressures from spending transferred from 2012-13, as shown in Table 4.22. Table 4.20 also shows that Budget policy decisions have reduced DEL spending plans by £0.5 billion in 2013-14 and 2014-15.³⁸ In the light of the remaining additional pressures on the Treasury's DEL reserves in 2013-14 and 2014-15, we have reduced our underspend assumptions by £1.0 billion and £0.5 billion in these years respectively, compared with our December forecast. This means that we are now forecasting total underspends on TME in DEL of

³⁸ This includes 'Budget measures', 'policy changes affecting underspends' and 'changes to underspend assumptions in SUME' in Table 4.20.

£3.5 billion in 2013-14, and £3 billion in 2014-15, relative to the DEL plans set out in PESA 2012.

7.123 Table 4.20 shows that, in the years after the 2010 Spending Review, the implied RDEL envelope has been reduced by £4.6 billion, £6.3 billion and £7.6 billion through 2015-16 to 2017-18. The implied CDEL envelope has increased by £2.3 billion, £2.2 billion and £1.6 billion through 2015-16 to 2017-18. This includes the Budget measure to increase CDEL spending by £3 billion in each of these years, which is offset by reductions in RDEL.

Annually managed expenditure

7.124 Table 4.18 sets out our latest central projections of AME spending to 2017-18, based on our economic forecast, the latest estimates of agreed policy commitments, and the measures announced in the Budget.

Social security

7.125 Table 4.15 shows that social security expenditure is forecast to fall from 11.8 per cent of GDP to 10.5 per cent over the forecast period, as the economy recovers and unemployment falls, and as policy measures take effect.

7.126 Social security spending is forecast to be higher than we forecast in December, with the difference reaching £1.2 billion by 2015-16, as shown in Table 4.23. The main changes arising from our economic forecast are driven by:

- our forecast of CPI between 2014-15 and 2016-17 is higher than we expected in December. Excluding the impact on state pension uprating, the higher CPI increases social security spending by £0.3 billion in 2016-17 and 2017-18. For 2014-15 and 2015-16, the higher CPI only affects benefits which are not affected by the Autumn Statement announcement to uprate working age discretionary benefits by 1 per cent for 3 years, and to increase local housing allowance for two years from 2014-15;
- the decrease in our claimant count unemployment forecast, which reduces benefit payments by a maximum of £0.4 billion in 2013-14;
- our forecast of average earnings growth in 2014-15 and 2016-17 is lower than we expected in December, and excluding the impact on state pension uprating, the lower earnings growth reduces social security spending by £0.2 billion from 2014-15 onwards; and

- our higher CPI forecast in 2013-14 increases state pension costs by £0.2 billion in 2014-15 and 2015-16, but our lower average earnings forecast in 2016-17 reduced the overall impact to an increase of £0.1 billion in 2016-17 and 2017-18 (the state pension is uprated by the highest of 2.5 per cent, average earnings growth, and CPI inflation).

Table 7.23: Key changes to social security since December

	£ billion					
	2012-13	2013-14	Forecast			
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	182.6	179.8	183.5	187.9	192.3	196.6
March forecast	182.8	180.4	184.4	189.1	193.1	197.6
Change¹	0.2	0.5	0.9	1.2	0.8	0.9
<i>of which:</i>						
CPI	0.0	0.0	0.2	0.2	0.3	0.3
Claimant count unemployment	-0.1	-0.4	-0.3	-0.3	-0.3	-0.3
State pension uprating	0.0	0.0	0.2	0.2	0.1	0.1
Average earnings	0.0	0.0	-0.2	-0.2	-0.2	-0.2
Universal Credit modelling	0.0	0.0	0.0	-0.1	-0.4	-0.5
State pension modelling	0.1	0.3	0.5	0.8	1.0	1.3
Disability benefits modelling	0.0	-0.1	-0.2	-0.4	-0.7	-0.9
Housing benefit modelling	0.0	0.5	0.6	0.8	0.8	1.0
Budget measures ²	0.0	0.0	-0.1	-0.1	-0.1	-0.2
Other	0.2	0.2	0.1	0.2	0.2	0.3

¹ For 2012-13 to 2014-15, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

² Budget measures are shown in Annex A.

7.127 There are a number of modelling changes in universal credit, including refinements to the modelling of the number of in work claimants receiving the universal credit disability additions, and more detailed modelling using DWP's INFORM model, which lowered our forecast of universal credit spending by up to £0.5 billion in 2017-18.

7.128 There are also some significant changes as a result of new estimates of awards for housing benefit, state pension, and disability benefits:

- higher state pension caseloads increase spending by up to £1.3 billion in 2017-18. Recent administrative data suggests that inflows to the state pension are higher, and mortality rates are lower than previously assumed;
- housing benefit spending is higher by around £1.0 billion in 2017-18. Around three quarters of the change reflects more detailed modelling of the housing benefit incapacity group by benefit type, and more detailed modelling of housing benefit entitlement to

reflect differences in population and rent growth in different regions; and

- Attendance Allowance (AA) expenditure has been reduced by up to £0.9 billion in 2017-18. Recent administrative data suggests that inflows to AA will be lower than previously thought.

Tax credits

7.129 Tax credit expenditure falls as a share of GDP over the forecast period, largely because of the intention to uprate the main personal elements by 1 per cent or CPI inflation in the medium term. Compared to our December forecast, expenditure on personal tax credits is broadly unchanged, with slightly lower spending this year being offset by weaker earnings growth in future years.

7.130 Where claimants pay income tax, the amount of personal tax credit that offsets all or some of the tax they would otherwise have paid is classified as negative tax and any remaining amount is treated as spending. Changes in income tax and tax credit thresholds have led to a larger fall in the negative tax share in 2012-13 than we anticipated in earlier forecasts and we now expect a bigger drop next year. As Universal Credit payments will be entirely classified as spending, the negative tax share falls dramatically in later years as claimants migrate onto the new benefit.

Table 7.24: Key changes to tax credits since December

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	31.7	31.7	31.8	32.3	33.3	34.2
March forecast	31.7	31.7	32.1	32.7	33.8	34.7
Change ^{1,2}	0.0	0.0	0.4	0.4	0.5	0.5
<i>of which:</i>						
Average earnings growth	0.0	0.2	0.2	0.3	0.3	0.3
2012-13 in-year expenditure and model calibration	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Company tax credits changes	0.1	0.1	0.1	0.2	0.2	0.2
Budget measures ³	0.0	0.0	0.1	0.1	0.1	0.1
Other	0.0	-0.1	0.0	0.0	0.1	0.0

¹ This table shows changes to total tax credits, which are split between current receipts (shown in table 4.7) and AME current spending (shown in table 4.18). This split is shown below.

Changes to tax credits treated as AME spending	0.8	1.1	1.2	0.9	0.7	0.3
Changes to tax credits treated as negative tax	-0.8	-1.0	-0.8	-0.5	-0.2	0.2

² For 2012-13 to 2014-15, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

³ Budget measures are shown in Annex A.

Box 7.1: Universal credit

Universal credit has to date been included within our forecast for social security in AME only as an additional cost on top of what would be spent on the existing social security benefits and tax credits system if that system was left in place.

Over time people will migrate from the old system to the new and we have been working with DWP and HMRC to show this shift in expenditure in our forecasts (leaving the total cost unaffected).

Table A, shown below, compares the current presentation, which reflects how the forecasts are currently produced, with the new presentation, which shows the build up of universal credit. This new presentation is still work in progress, and it is only another way of viewing our existing forecast for total tax credits and DWP benefits in AME, which is still forecast using previous systems, plus the forecast for the marginal, additional costs of universal credit. There are still a number of uncertainties around the new methodology. The figures shown in Table A for the new presentation are therefore not yet robust enough to be used for monitoring, and we will work with DWP and HMRC to improve the new methodology further, for our Autumn 2013 forecast.

Table B: Social security, tax credits and UC: current presentation and new presentation including the build-up of UC

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
Current presentation; PSCE in AME currently includes:					
DWP benefits in social security, which include:					
DWP existing benefits, forecast before UC	163.3	167.2	171.4	175.0	179.2
Additional costs of Universal Credit	163.3	167.1	171.3	174.7	178.9
Tax credits, which include:	0.0	0.0	0.1	0.3	0.3
Personal tax credits, forecast before UC ¹	27.3	27.7	29.3	31.2	32.3
Total DWP benefits and personal tax credits	190.6	194.9	200.8	206.2	211.5
New presentation; PSCE in AME will include:					
DWP benefits in social security, which will include:					
DWP existing benefits	163.3	171.7	187.7	200.5	208.8
Universal Credit	0.3	11.8	36.2	52.3	63.3
Remaining DWP benefits	163.0	159.9	151.5	148.2	145.5
Tax credits, which will include:					
Remaining personal tax credits ²	27.3	23.2	13.1	5.7	2.7
Total DWP benefits and personal tax credits	190.6	194.9	200.8	206.2	211.5

¹ Includes personal tax credits which will become UC, but which were previously included as negative tax

² All personal tax credits will be replaced by UC by 2018-19

The additional cost of universal credit is expected to be lower than we forecast in December. Table B shows the total movement in the estimate of the additional costs of universal credit. A number of factors have contributed to this change, including:

- changes in the economic assumptions;
- policies announced in the 2012 Autumn Statement, including finalising the universal credit disregards and changes to the uprating of working age discretionary benefits, tax credits and housing benefit, which significantly reduced the costs of universal credit. The total impact of these measures were included in our social security and tax credit forecasts in December, but we do not disaggregate the impact into different components of the social security and tax credit forecasts until after each fiscal event, and therefore the March forecast of the additional costs of universal credit presented in table B also excludes the impact of policy measures announced in the 2013 Budget, which are described in table 4.3;
- refinements to the methodology and assumptions used for the universal credit forecast, including more detailed modelling using DWP's INFORM model; and
- changes to a number of policy parameters for universal credit, including small changes to the transitional profile in 2013-14, and how the disability additions within universal credit will be phased in.

The revised forecast for the additional costs of universal credit is still subject to significant uncertainties, which we described in Box 4.3 of our December *EFO*.

Table C: Additional costs of universal credit, included within social security in PSCE in AME

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	-0.1	0.1	1.0	1.8	2.2
March forecast	0.0	0.0	0.1	0.3	0.3

Public service pensions

7.131 The net public service pensions expenditure forecast is prepared 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 locally administered police

and fire-fighters' pension schemes.³⁹ A breakdown for the major schemes covered is included in the supplementary tables on our website. Table 4.25 shows the main changes since the December *EFO*.

Table 7.25: Key changes to public service pensions since December

	£ billion					
	2012-13	2013-14	Forecast		2016-17	2017-18
Net public service pensions						
December forecast	11.0	11.3	12.8	14.0	15.0	16.3
March forecast	10.5	11.1	12.4	13.6	14.9	16.2
Change	-0.4	-0.2	-0.4	-0.3	-0.2	-0.1
Expenditure						
December forecast	35.2	36.9	38.8	40.5	42.4	44.5
March forecast	34.6	36.4	38.2	40.0	42.0	44.1
Change	-0.6	-0.5	-0.5	-0.5	-0.4	-0.3
<i>of which:</i>						
CPI	0.0	0.0	0.1	0.1	0.2	0.2
Other	-0.6	-0.5	-0.6	-0.6	-0.5	-0.5
Income						
December forecast	-24.2	-25.6	-25.9	-26.5	-27.3	-28.2
March forecast	-24.1	-25.3	-25.8	-26.4	-27.1	-27.9
Change	0.2	0.3	0.1	0.1	0.2	0.3
<i>of which:</i>						
Budget measures ¹	0.0	0.0	-0.1	-0.1	0.0	0.0
Other	0.2	0.3	0.2	0.2	0.2	0.3

¹ Budget measures are shown in Annex A.

7.132 Gross expenditure rises steadily across the forecast as the age profile of each scheme's membership changes and people live longer. The reduction in expenditure since the December forecast largely reflects latest outturn and in-year information, particularly on lump sums, which feeds through to all later years. There has been a very small impact from the increase in our forecast of CPI.

7.133 The income of each pension scheme is almost entirely made up of employer and employee pension contributions, and is largely driven by the pensionable payroll. The small reduction in pensions income since the December forecast also reflects latest outturn and in-year information.

³⁹ 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.

7.134 The forecast does not take account of the Public Service Pensions Bill that is still passing through Parliament, which will lead to new schemes being implemented in April 2015. We expect these changes to have a minimal impact on income and expenditure over this forecast period.⁴⁰

EU contributions

7.135 The main component of the AME transfer to EU institutions is the UK's gross national income (GNI) contribution, minus the UK's abatement. The forecast for the GNI-based contribution depends mainly on the level of the agreed EU Budget and the relative GNI of each member state. The UK abatement is affected by the UK's share of EU VAT and the UK's share of EU receipts.⁴¹

7.136 The changes in our latest forecast for these expenditure transfers are shown in Table 4.27. The largest change is as a result of the new Multi-annual Financial Framework (MFF) agreed at the February European Council (FEC), which reduces UK contributions to the EU by £3.5 billion over the forecast period to 2017-18.

7.137 The new MFF sets the EU payment ceiling for the period 2014 to 2020 at €1,024 billion⁴², €50 billion lower than our previous modelling assumption of €1,074 billion. The agreed payment ceilings are used to derive annual budgets by applying assumed implementation rates each year. The assumed annual budgets over the period 2014 to 2020 are €994 billion, which is €24 billion lower than our December *EFO*. It is the assumed annual budgets that determine the UK contributions rather than the payment ceilings.

7.138 The table below shows the reductions in the payment ceilings agreed at the FEC, and changes in the assumed implementation rates and derived annual budgets, compared with the modelling assumptions used in our December *EFO*. In addition to lower payment ceilings and corresponding decreases in annual budgets, we have revised our implementation rates

⁴⁰ Information on the new schemes is available at http://www.hm-treasury.gov.uk/tax_pensions_index.htm

⁴¹ A further supplementary fiscal table on our website provides further details of UK transactions with the EU, including how all these various contributions score in the National Accounts and in this forecast.

⁴² €908.4 billion in 2011 prices.

to assume higher implementation in the early years of the next MFF. This is because spending is likely to be much tighter, given the decreases in payment ceilings, and because we expect some existing projects to require finance in the next MFF. This explains the larger decreases in 2013-14 of £0.6 billion and 2014-15 of £1.4 billion, and then smaller decreases in later years.

Table 7.26: EU annual budget

	£ billion							2014-2020 total
	2014	2015	Forecast				2020	
December forecast								
Payment ceilings	164.2	163.7	145.4	142.1	146.5	159.0	153.2	1074
Implementation rates	90.7	90.7	94.0	97.3	97.3	97.2	97.3	
Assumed Budget	148.9	148.6	136.7	138.2	142.5	154.6	149.0	1018
March forecast								
Payment ceilings ¹	135.9	141.9	144.7	142.8	149.1	153.4	156.3	1024
Implementation rates	100.0	97.7	95.4	95.4	95.4	97.7	98.1	
Assumed Budget	135.9	138.6	138.0	136.2	142.3	149.9	153.3	994

¹ Total payment ceiling of €1,024 billion is equivalent to €908.4 billion in 2011 prices.

7.139 Although the MFF deal has been unanimously agreed by member states, it still requires agreement by the European Parliament before it comes into effect, which could mean further changes. We expect this to be agreed over the next few months, well in advance of our Autumn Statement forecast.

7.140 The forecast also shows an increase in the UK contribution in 2012-13 and 2013-14 of £0.2 billion and £0.7 billion as a result of us assuming an increase in the 2013 budget of €7 billion through amending budgets. This is based on there being significant pressure on the 2013 budget, the fact that the 2012 budget increased by €6.7 billion through amending budgets, and we expect the final stages of the MFF agreement process set out above to involve some trade offs with the 2013 budget.

7.141 Our forecast of the sterling/euro exchange rate is lower compared with December. This increases the UK's contributions in sterling terms from 2015-16 onwards.

Table 7.27: Key changes to EU contributions since December

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	7.3	6.6	7.3	6.6	5.8	6.0
March forecast	7.4	6.5	5.7	6.1	5.9	6.0
Change	0.1	-0.1	-1.6	-0.5	0.1	0.0
<i>of which:</i>						
2013 Budget assumption	0.2	0.7	0.0	0.0	0.0	0.0
New Multi-annual Fiscal Framework deal	0.0	-0.6	-1.4	-0.7	-0.2	-0.6
Exchange rate	0.0	-0.1	0.0	0.3	0.4	0.6
Other	0.0	0.0	-0.2	-0.1	-0.1	0.0

Locally financed expenditure

7.142 Locally financed expenditure consists mainly of local authority self-financed expenditure (LASFE) – local authority spending that is not financed by central government grants – and Scottish Government spending financed by local taxation. The main components of LASFE are spending financed by council tax and, from 2013-14 onwards, business rates that are retained by local authorities.

7.143 Table 4.28 summarises the main changes to our forecasts for current and capital LASFE. Further details on all the components of our local authorities spending forecasts, including LASFE, are given in the supplementary tables to our fiscal forecast that are on our website. These further tables also include a table which shows our detailed assumptions on council tax increases, which are explained further below.

7.144 Overall the medium-term changes compared to our December forecast are relatively small. On current expenditure the forecast is £0.4 billion higher in 2017-18 but most of this is due to a change in our council tax forecast which is matched by an equivalent change to the receipts forecast. On capital expenditure the forecast is £1.3 billion higher than December by 2017-18, but close to half of this is due to a change to local authority spending which is fiscally-neutral as it is offset by an equivalent change to our public corporations' capital expenditure forecast.

7.145 For 2012-13 we have revised our forecasts to be consistent with outturn data on local authority spending in the first three quarters of the year.⁴³

⁴³ The outturn data we have used are the quarterly Capital Payment Returns and Quarterly Revenue Outturns collected from English local authorities by the Department for Communities and Local Government (DCLG), and the quarterly Capital Return collected from Scottish local authorities by the Scottish Executive.

The degree to which local authorities underspend against their budgets and add to their reserves is a particular area of uncertainty in the forecast. As we explained in our October 2012 *Forecast evaluation report*, the outturn for current LASFE in 2011-12 was much lower than we had previously forecast, because local authorities added £2.7 billion to their revenue reserves, which reduced their spending. On the basis of the latest outturn data we now assume that local authorities add £1.5 billion to their reserves in 2012-13, which is £0.7 billion less than we assumed in our December *EFO*. Overall, for English local authorities, we assume that current spending will be £3 billion below budgets, and that capital spending will be £2 billion below budgets.⁴⁴

- 7.146 For future years we continue to assume that local authorities make net additions to their reserves. Evidence suggests that individual local authorities build up their reserves to act as buffers against future uncertainties and pressures on their finances. The uncertainties for local authorities are greater now with the additional flexibilities and potential pressures created by new schemes such as business rates retention and localised council tax reduction. The bulk of their reserves are held in earmarked funds which they set in the context of medium term financial plans. Our forecast assumes that authorities make net additions to their reserves of around £1.0 billion in 2013-14 and 2014-15, reducing to £0.5 billion by the end of the forecast period, which is broadly unchanged from our December forecast.
- 7.147 We have revised our forecasts of council tax increases in 2013-14 to reflect the latest CIPFA report of an expected overall increase in England of 0.8 per cent. For 2014-15 onwards, we continue to assume that council tax increases in England rise in line with our CPI forecast. This follows the Government's announcement that referenda would be triggered if English councils set their council tax increases at 2 per cent or above. We also assume this applies in Wales from 2013-14 onwards, and in Scotland from 2016-17 onwards. Council tax increases are assumed to be frozen in Scotland until the end of the current Scottish Parliament.
- 7.148 The forecast for council tax also contains an assumption for the increase in the council tax base, which is net of the various discounts and reductions offered by local authorities, for instance for students and empty homes. These reductions now include the new localised council

⁴⁴ The budgets data we refer to for comparison purposes are the Revenue Budgets and the Capital Expenditure Returns collected from English local authorities by DCLG. We use similar data collected by the devolved administrations.

tax reduction schemes, which start in 2013-14, and replace the previous system of council tax benefits. For England, Scotland and Wales we assume that the reductions offered by local authorities under this new scheme will be 90 per cent of the forecast for spending on the previous council tax benefit regime. This matches the additional funding that local authorities will receive. There is some risk that local authorities will offer higher reductions than this, at least initially, which could reduce council tax and LASFE. Our assumptions about increases in council tax are neutral for the overall fiscal aggregates as they are also applied to the council tax projections in our receipts forecast.

7.149 We have also revised our forecast of business rates retained by local authorities, which are included within LASFE from 2013-14 onwards, in line with the revised forecast for business rates included in the forecast for current receipts.

Table 7.28: Key changes to locally financed expenditure since December

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Locally-financed current expenditure						
December forecast	23.2	36.0	37.8	39.2	40.6	42.7
March forecast	23.8	36.1	38.0	39.5	41.0	43.1
Change	0.6	0.1	0.2	0.3	0.4	0.4
<i>of which:</i>						
Council tax ¹	0.0	0.2	0.3	0.3	0.3	0.3
Net use of current reserves	0.7	-0.1	-0.1	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.1	0.2
Locally-financed capital expenditure						
December forecast	6.2	4.8	4.9	5.3	5.6	5.4
March forecast	7.1	6.4	6.3	6.8	7.0	6.7
Change	0.9	1.6	1.4	1.5	1.4	1.3
<i>of which:</i>						
Community Infrastructure Levy	-0.3	-0.4	-0.1	0.0	0.0	0.1
Unsupported borrowing	-0.8	0.6	0.6	0.6	0.6	0.6
Remove TfL and HRA capital spending ²	1.9	1.4	0.9	0.9	0.7	0.6
Other	0.0	0.0	0.0	0.0	0.0	0.1

¹ includes changes to the council tax base and an increase in our assumed council tax increases in England in 2013-14 from 0.3% to 0.8%.

² TfL and HRA capital spending included in the PC capital expenditure forecast, reflecting the classification of TfL and HRA in the National Accounts.

7.150 Our forecasts for local authority capital LASFE from 2013-14 onwards have changed for three main reasons. The largest changes are in respect of the adjustments that remove our forecasts of capital spending by Housing Revenue Accounts (HRAs) and Transport Trading Limited (TTL)

subsidiaries, because these bodies are treated as public corporations in the National Accounts. We have increased our forecasts of capital spending by these bodies reflecting the latest information on 2011-12 outturns, and new forecasts received from Transport for London. These changes are neutral because they switch spending from LASFE to our forecast of public corporations net capital spending.

- 7.151 The other main change to our forecast for capital LASFE is that we have increased our forecast for local authorities unsupported borrowing from 2013-14 onwards. This reflects the latest information on English local authorities' plans for capital expenditure in 2013-14 collected by DCLG, and the latest information on Scottish local authorities' quarterly outturns for capital spending in 2012-13, which showed that there was additional unsupported borrowing which we had not previously included in our forecasts. We have also reduced our forecasts of capital spending financed from the new Community Infrastructure Levy, reflecting latest information that take-up of this new scheme has been lower than expected.

Public corporations capital expenditure

- 7.152 Public corporations capital expenditure is lower in every year of the forecast period compared to the December *EFO*. The revision is mostly driven by the 2011-12 outturn for HRA net capital expenditure being £0.9 billion lower than we expected in our December forecast, which is carried forward in every subsequent year of the forecast.
- 7.153 As in previous *EFOs*, we have revised the capital spending forecast of the TTL subsidiaries on the basis of detailed information supplied by Transport for London, which has enabled us to improve the accuracy of our forecast for capital spending by the TTL subsidiaries.
- 7.154 The revisions in our forecast of public corporations capital expenditure because of changes to TTL and HRA net capital expenditure are offset within our forecast for capital LASFE. This is because the finance for TTL and HRA net capital spending is initially included within the local authority sector but the final TTL and HRA spending is then switched into public corporations capital spending, reflecting the classification of TTL and HRA in the National Accounts.

Debt interest

- 7.155 Central government debt interest payments are broadly flat as a share of GDP between 2011-12 and 2014-15 as existing debt is refinanced at current lower interest rates. Payments then rise as a share of GDP over

the remainder of the forecast period, reflecting expected increases in interest rates and RPI inflation, and the rising stock of debt.

- 7.156 Compared to December, revisions to our RPI forecast reduce debt interest costs in 2012-13, but increase it in all subsequent years. The 2013-14 financing remit allows for greater Treasury bill issuance and lower gilt issuance than we had assumed, lowering debt interest costs slightly in that year. But a higher CGNCR, and market interest rates increase payments thereafter.
- 7.157 Following the reclassification of B&B and NRAM into the central government sector, our forecasts assume that the interest they pay on debt provided by the private sector increases central government debt interest payments. Interest rates have fallen relative to what had been assumed in earlier business plans, lowering projected payments in the medium term.

Table 7.29: Key changes to debt interest since December

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	47.1	48.6	51.8	56.6	61.6	67.1
March forecast	46.5	49.5	51.8	57.8	64.4	71.3
Change	-0.6	0.9	0.0	1.2	2.8	4.2
<i>of which:</i>						
Financing	0.0	-0.2	-0.1	0.4	0.8	1.3
Gilt rates	0.0	0.1	0.1	0.4	1.0	1.5
Short rates	0.0	0.0	0.0	0.1	0.1	0.3
Inflation	-0.3	1.0	0.3	0.6	1.0	1.1
B&B and NRAM	0.0	-0.1	-0.1	-0.3	-0.4	-0.3
Other	-0.2	0.0	-0.1	0.1	0.3	0.4

- 7.158 We include a breakdown of the debt interest forecast by financing component in the supplementary fiscal tables on our website, including a distinction between debt interest on conventional gilts for new and existing debt. Payments on the existing stock of conventional gilts are fixed for the lifetime of those gilts. With a long average maturity for UK conventional gilts, around half of the payments relate to static debt interest costs on existing conventional gilts. We also include a separate ready-reckoner table showing the approximate effect on debt interest of movements in interest rates, RPI inflation and the CGNCR.

Other AME spending

- 7.159 Current and capital expenditure from **National Lottery** grants is forecast to be £0.5 billion higher by 2017-18, compared with our

December forecast. We now assume 5 per cent annual growth in lottery income, which is broadly consistent with increases seen recently in outturn, because we believe income will continue to increase as a result of the terms achieved in the third licence since February 2009, which more closely aligns the operator's commercial incentives with maximising returns to good causes. We assume that this additional income for good causes will be fully drawn down by Lottery distributors by 2016-17.

- 7.160 The main change to **other PSCE items in departmental AME** and **other PSGI items in departmental AME** is the inclusion in 2011-12 of Bradford & Bingley and Northern Rock (Asset Management) spending, which is consistent with the ONS including this for the first time in public sector finances. Our December *EFO* pre-empted this, so it was already included for the forecast years. In 2012-13, the Special Liquidity Scheme capital receipt has been re-classified by the ONS from spending to current receipts, so spending increases by £2.3 billion, offset by an increase in receipts.
- 7.161 The forecast of expenditure by the **BBC** has decreased in 2012-13 and increased in 2013-14 and 2014-15 to reflect refinements in BBC spending plans. Some savings initiatives have come through earlier than expected, some costs have slipped back, and some additional spending is expected to be financed from cash reserves in the short term.
- 7.162 Table 4.18 shows a separate entry in PSCE in AME for **single-use military expenditure (SUME)**. This expenditure is treated as capital DEL in the control framework, but is classified as current expenditure in the National Accounts. To align with National Accounts we therefore exclude this spending from PSGI in CDEL and add it to PSCE within current AME expenditure.
- 7.163 The reduction in SUME in 2012-13 of £0.4 billion since our December forecast reflects in-year spending data submitted by departments, which shows more underspending than the £1.3 billion we assumed in our December forecast. We have also revised our underspend assumption in 2014-15 so we now assume £1 billion of underspend in both 2013-14 and 2014-15. SUME is only one component of the defence budget and underspends in SUME can be offset by increases in capital and current spending in the Ministry of Defence budget.
- 7.164 **Environmental levies** include spending on DECC levy-funded policies such as the Renewables Obligation, Feed-In Tariffs and Warm Homes Discount. Most of these are fiscally-neutral as they are balanced by receipts, and the forecasts are explained in the receipts section. The

Renewable Heat Incentive policy, which is not offset by receipts, has decreased by £0.2 billion by 2017-18 since December as a result of a slower take-up rate.

- 7.165 The change in our forecast of **VAT refunds** is explained in paragraph 4.85 of the receipts section of this chapter.
- 7.166 The AME forecast includes forecasts for the further adjustments that are included in the National Accounts definitions for PSCE and PSGI.⁴⁵ Explanations and the background to all the **National Accounts adjustments** are given in Annex D to PESA 2012.⁴⁶
- 7.167 Table 4.19 shows that our forecasts for current accounting adjustments have decreased by around £1 billion in all years. This includes a £0.5 billion revision to the forecast of the adjustment ONS make to reconcile different data sources for debt interest payments and a £0.3 billion revision to the forecast of the HRA imputed subsidy. Our forecasts for capital accounting adjustments are largely unchanged over the forecast period.

Loans and other financial transactions

- 7.168 Public sector net borrowing (PSNB) is the difference between total public sector receipts and expenditure each year measured on an accrued basis. As we show in Table 4.30, and as we explain in greater detail in the next section, we forecast that PSNB will fall from £86 billion in 2012-13 to £42 billion in 2017-18.
- 7.169 But the public sector's fiscal position also depends on the flow of financial transactions, which are mainly loans and repayments between Government and the private sector. These do not directly affect PSNB, but they do lead to changes in the Government's cash flow position and stock of debt.
- 7.170 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.⁴⁷ It drives the forecast of public sector net debt (PSND), which is largely a cash measure.

⁴⁵ Further details and data for these National Accounts adjustments are provided in the supplementary fiscal tables on our website.

⁴⁶ See HM Treasury, July 2012, Public Expenditure Statistical Analyses 2012.

⁴⁷ Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the temporary effects of financial sector interventions.

Estimating the PSNCR also allows us to estimate the central government net cash requirement (CGNCR), which in turn largely determines the Government's net financing requirement – the amount it needs to raise from treasury bills, gilt issues and National Savings.

7.171 Differences between the PSNCR and PSNB can be split into the following categories:

- **Loans and repayments:** loans that the public sector make to the private sector and that it expects to be repaid do not directly affect PSNB, but the cash flows do affect the PSNCR;
- **Cash flow timing effects:** PSNB is an accruals measure of the budget deficit in which, where possible, spending and receipts are attributed to the year that they relate to. In contrast PSNCR is a cash measure in which spending and receipts are attributed to the year in which the cash flow takes place;
- **Transactions in company securities:** the public sector may buy or sell company securities, such as corporate bonds or equities. When it swaps one asset for an equivalent cash asset the transaction does not affect PSNB, but the associated cash flow will affect PSNCR; and
- **Other:** this category includes one-off financial transactions that do not fall into the categories above and some other adjustments.

7.172 Table 4.30 shows the steps from PSNB to PSNCR while Table 4.31 highlights the changes since our December forecast.

Table 7.30: Reconciliation of PSNB and PSNCR

	£ billion					
	2012-13	2013-14	Forecast			
	2014-15	2015-16	2016-17	2017-18		
Public sector net borrowing	86	108	97	87	61	42
Loans and repayments	10.4	14.5	14.9	14.0	11.7	11.5
<i>of which:</i>						
Student loans ^{1, 2}	5.8	7.3	8.6	9.3	9.6	9.6
Financial sector interventions ³	-1.3	0.0	0.0	0.0	0.0	0.0
DfID	1.0	1.7	1.1	1.1	1.1	1.1
Ireland	1.2	0.8	0.0	0.0	0.0	0.0
Green Investment Bank	0.2	0.7	0.9	0.0	0.0	0.0
Business Finance Partnership	0.0	0.5	0.4	0.3	0.1	0.0
Business Bank	0.0	0.1	0.3	0.3	0.3	0.2
Budget lending measures	0.0	1.3	1.9	1.9	0.0	0.0
Other	3.3	2.1	1.8	1.0	0.7	0.6
Cash flow timing effects	-1.9	9.6	-2.7	-4.1	6.9	4.2
<i>of which:</i>						
Student loan interest ²	0.8	1.1	1.6	2.4	3.2	4.2
PAYE income tax and NICs	0.6	1.3	0.8	1.8	2.5	1.9
Indirect taxes	0.7	0.6	0.9	1.0	0.8	1.0
Other receipts	0.1	0.8	0.6	0.4	0.4	0.4
Index-linked gilts ³	-8.5	1.4	-10.6	-13.4	-3.4	-6.7
Conventional gilts	3.4	3.6	3.3	2.9	2.6	2.5
Other expenditure	0.8	0.8	0.8	0.8	0.8	0.8
Transactions in company securities	-9.1	-1.0	0.0	0.0	0.0	0.0
<i>of which:</i>						
Northern Rock plc	-0.1	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	-9.0	-1.0	0.0	0.0	0.0	0.0
Other	19.0	-19.7	0.3	0.3	0.3	0.3
<i>of which:</i>						
Royal Mail transfer	23.5	0.0	0.0	0.0	0.0	0.0
Asset Purchase Facility proceeds	-5.1	-20.0	0.0	0.0	0.0	0.0
Manchester Airport Group	0.4	0.0	0.0	0.0	0.0	0.0
Public sector net cash requirement	105	111	110	97	80	58

A breakdown based on ONS classifications is available on our website.

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

Cash spending on new loans	7.8	9.6	11.2	12.3	12.9	13.4
Cash repayments	2.0	2.3	2.6	2.9	3.4	3.8

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

³ These reconciliations to the net cash requirement do not affect public sector net debt (ex).

Table 7.31: Changes in the reconciliation of PSNB and PSNCR since December

	£ billion					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net borrowing	6	8	9	14	12	11
Loans and repayments	-1.2	2.0	2.3	1.7	-0.4	-0.6
<i>of which:</i>						
Student loans ^{1, 2}	0.1	-0.1	-0.3	-0.5	-0.5	-0.5
Financial sector interventions ³	0.0	0.0	0.0	0.0	0.0	0.0
DfID	0.0	0.5	0.0	0.0	0.0	0.0
Ireland	-0.4	0.4	0.0	0.0	0.0	0.0
Green Investment Bank	-0.6	-0.3	0.9	0.0	0.0	0.0
Business Finance Partnership	-0.2	0.0	0.0	0.2	0.1	0.0
Business Bank	0.0	0.0	0.0	0.0	0.0	0.0
Budget lending measures	0.0	1.3	1.9	1.9	0.0	0.0
Other	0.0	0.2	-0.1	0.0	0.1	0.0
Cash flow timing effects	0.8	-0.8	0.0	-0.8	-0.8	-2.2
<i>of which:</i>						
Student loan interest ²	0.0	0.0	0.0	0.0	0.0	0.1
PAYE income tax and NICs	-0.2	-0.9	0.0	-0.1	0.6	-0.1
Indirect taxes	-0.1	-0.2	-0.1	-0.1	-0.1	-0.2
Other receipts	-0.4	0.3	-0.1	0.0	0.0	0.0
Index-linked gilts ³	0.6	-1.1	-0.4	-0.7	-1.3	-1.5
Conventional gilts	0.6	0.6	0.2	-0.3	-0.5	-1.0
Other expenditure	0.3	0.4	0.3	0.4	0.4	0.4
Transactions in company securities	0.0	0.0	0.0	0.0	0.0	0.0
<i>of which:</i>						
Northern Rock plc	0.0	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	0.0	0.0	0.0	0.0
Other	-4.7	-0.3	0.5	0.6	1.4	3.0
<i>of which:</i>						
Royal Mail transfer	0.0	0.0	0.0	0.0	0.0	0.0
Asset Purchase Facility proceeds	-5.1	-0.3	0.5	0.6	1.4	3.0
Manchester Airport Group	0.4	0.0	0.0	0.0	0.0	0.0
Public sector net cash requirement	1	9	12	15	12	11

A breakdown based on ONS classifications is available on our website.

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

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

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

³ These reconciliations to the net cash requirement do not affect public sector net debt (ex).

Loans and repayments

- 7.173 PSNCR is higher than PSNB in each year of our forecast, which largely reflects net lending by the Government to the private sector, in particular for student loans. The recent student loan reforms have increased the size of upfront loans, with repayments being made over a more prolonged period. In our July 2012 *Fiscal sustainability report* we showed that on current policy settings we might expect the difference between new loans and repayments to peak around 2030 and then fall away.
- 7.174 For the English scheme, we assume that the initial average loan per student for tuition fees was £7,000 and the average maintenance loan in 2012-13 was £3,300. Final details on the average loan per student are yet to be confirmed, but overall spending on loans has broadly been in line with our earlier forecasts. In line with recent announcements, we assume the maximum loan amounts rise by 1 per cent in 2014-15. The number of part-time students has fallen by more than expected and we project lower numbers in the future, reducing overall spend in future years. Repayments are also slightly lower due to lower earnings growth.
- 7.175 Other loans include lending through the Green Investment Bank (GIB) and the Department for International Development's (DfID) contributions to multilateral development banks, as well as loans to Ireland and a range of other schemes. Loans issued in the current year to Ireland and through the GIB and Business Finance Partnership have been lower than forecast and we now expect the originally planned outlays to be made up in following years. Budget measures relating to the Help to Buy and Build to Rent schemes also increase lending between 2013-14 and 2015-16.

Cash flow timing effects

- 7.176 As discussed above, to move from PSNB to PSNCR it is necessary to make an adjustment for the likely impact of timing differences between cash flows and accruals. If receipts are forecast to rise over time, the cash received in any given year will generally be lower than the accrued tax receipts, and the difference increases over time.
- 7.177 A large component of the receipts timing adjustment relates to the interest on student loans. This is notionally included in the accrued measure of public sector current receipts as soon as the loan is issued. However, cash repayments are not actually received until the point at which students earn sufficient income.

- 7.178 Since our December forecast, the ONS has announced its intention to accrue Swiss Tax payments made in January into May 2013. Cash income tax payments in 2013-14 are also expected to be weaker relative to accrued receipts.
- 7.179 Similar timing adjustments are made for expenditure. The largest adjustment is for the timing of payments on index-linked gilts. These adjustments are very sensitive to RPI inflation, as well as to the profile of redemptions, which is not smooth. Positive RPI inflation raises the amount the Government is committed to pay on index-linked gilts, and this commitment is recognised in PSNB each year. But the actual cash payments will not occur until redemption of the gilt which may be many years in the future. Higher RPI inflation in the medium term increases the size of the necessary accruals adjustments.
- 7.180 There are also lags due to the timing of cash payments through the year and from auction price effects, which affect conventional gilts. For gilts sold at a premium, the cash payments to cover coupons will be larger than the amounts accrued in debt interest. The accruals adjustment for the current year is larger than we assumed in December, but as we now expect gilts to be sold at less of a premium in the future, accruals effects decline over time.
- 7.181 Timing effects relating to other elements of cash spending are much more difficult to forecast and the figures are subject to large revisions. We therefore assume that the adjustment over the forecast period is equal to the historical average.

Transactions in company securities

- 7.182 Consistent with the *Charter for Budget Responsibility*, and our wider approach to policy announcements, we only include the impact of financial asset sales or purchases once firm details are available that allow the effects to be quantified with reasonable accuracy. The Government intends to sell the non-gilt liquid assets that it received in April alongside the transfer of Royal Mail's historic pension liabilities within two years. We do not make any assumptions for the sales of illiquid assets as it is not possible to do so with reasonable accuracy.

Other factors

- 7.183 The transfer of the Royal Mail pension fund assets reduced PSNB by £28 billion in April 2013. However, only £4.5 billion was liquid cash that reduced PSNCR, so the initial transfer reduced net borrowing by £23.5 billion more than it reduced PSNCR.

7.184 The ONS has now announced how it will treat transfers between the Treasury and the Asset Purchase Facility (APF). Although the overall cash consequences are as we assumed in December, the final treatment does affect what scores as public sector net borrowing versus financial transactions (see from paragraph 4.30).

7.185 Manchester Airport Group (MAG) completed its purchase of Stansted Airport in February. MAG had previously been owned by the public sector and classified as a public corporation, but the newly expanded body will be an equal joint venture between local authorities and the private sector. The accounting treatment of the new body is yet to be announced by the ONS, but for this forecast we have assumed that half of the company will remain on the public sector balance sheet. This raises public sector net debt by around £0.4 billion in 2012-13.

Central government net cash requirement

7.186 The other important cash measure is the central government net cash requirement (CGNCR). The inclusion of Bradford & Bingley and Northern Rock (Asset Management) in the central government sector means that this is no longer simply a measure of the cash required by the Exchequer to fund its operations, which forms the basis for the Government's net financing requirement.⁴⁸ We separate out transactions involving Bradford & Bingley and Northern Rock (Asset Management) in Table 4.32.

7.187 The table also shows how CGNCR relates to PSNCR and Table 4.33 sets out the changes in this relationship since the December forecast. The CGNCR is derived by adding and removing transactions that are associated with local authorities and public corporations from the PSNCR. Excluding Bradford & Bingley and Northern Rock (Asset Management), changes in the CGNCR forecast closely follow changes to our PSNCR forecast. We expect local authorities and public corporations to be marginal net lenders from 2013-14 onwards.

⁴⁸ The Government is publishing a financing remit for 2013-14 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 7.32: Reconciliation of PSNCR and CGNCR

	£ billion						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net cash requirement	124	105	111	110	97	80	58
<i>of which:</i>							
Local authorities and public corporations NCR	7	1	0	-1	-1	-1	-2
Central government NCR own account	118	103	111	111	98	81	60
CGNCR own account	118	103	111	111	98	81	60
Net lending within the public sector	9	2	3	2	2	2	2
Central government net cash requirement	127	105	114	113	100	83	61
Net lending from B&B and NRAM to the rest of CG		3	3	3	2	1	3
CGNCR excl. B&B and NRAM		102	111	110	98	82	59

Table 7.33: Changes in the reconciliation of PSNCR and CGNCR since December

	£ billion						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net cash requirement	0	1	9	12	15	12	11
<i>of which:</i>							
Local authorities and public corporations NCR	0	1	1	1	1	1	1
Central government NCR own account	0	-1	8	11	14	11	10
CGNCR own account	0	-1	8	11	14	11	10
Net lending within the public sector	0	-1	1	0	0	0	0
Central government net cash requirement	0	-1	9	11	14	11	10
Net lending from B&B and NRAM to the rest of CG		0	0	0	0	0	0
CGNCR excl. B&B and NRAM		-1	8	11	15	12	11

Box 7.2: Fiscal impact of the financial interventions

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

- equity injections into RBS, Lloyds (LBG) and Northern Rock plc;
- the Asset Protection Scheme (APS);
- bank financing support through the Special Liquidity Scheme (SLS) and Credit Guarantee Scheme (CGS);
- holdings in Bradford & Bingley (B&B) and Northern Rock (Asset Management) (NRAM); and
- other loans through the Financial Services Compensation Scheme (FSCS) and various wholesale and depositor guarantees.

The APS, SLS and CGS have all now closed, with net gains to the Exchequer of £5 billion, £2.3 billion and £4.3 billion respectively. These figures have already been captured in public sector net borrowing.

Changes in the market prices of the Government's shareholdings in RBS and LBG are not reflected in PSNB and PSND. There will be impacts on PSND (and possibly PSNB) when the shares are sold, but the eventual cost or benefit is highly uncertain. The Treasury uses market prices to value these shares. On the basis of the latest volume weighted average market prices this implies a loss of £19.8 billion on these investments, relative to an implied loss of £28.1 billion reported in the December *EFO*. As the shares were overall bought at above market prices, public sector net debt is already £12.4 billion higher as a result of these transactions.

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

Overall, their approach implies an estimated direct loss to the taxpayer on the financial interventions of £8.2 billion. This is smaller than the December estimate of a loss of £16.5 billion, as RBS' and Lloyds' equity values have since risen.

If all interventions were financed through debt, the Treasury estimate that additional debt interest costs would have totalled £14.7 billion over the 55

months to date.

The key fiscal aggregates

7.188 Our central forecast for the key fiscal aggregates is presented in Table 4.34. These incorporate the forecasts for receipts, expenditure and financial transactions set out earlier in this chapter. In this section we explain the changes in four key fiscal aggregates:

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

Table 7.34: Fiscal aggregates

	Per cent of GDP						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Receipts and expenditure							
Public sector current receipts (a)	37.5	38.0	38.4	38.2	38.1	38.4	38.3
Total managed expenditure (b)	45.5	43.6	45.2	44.0	43.1	41.8	40.5
<i>of which:</i>							
Public sector current expenditure (c)	42.2	42.5	42.2	41.0	40.2	39.0	37.8
Public sector net investment (d)	1.9	-0.4	1.5	1.6	1.5	1.4	1.4
Depreciation (e)	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing (b-a)	7.9	5.6	6.8	5.9	5.0	3.4	2.2
Surplus on current budget (a-c-e)	-6.0	-6.0	-5.2	-4.3	-3.5	-1.9	-0.9
Cyclically-adjusted net borrowing	6.0	3.6	4.3	3.3	2.7	1.3	0.6
Primary balance	-5.1	-3.5	-4.8	-3.8	-2.6	-0.6	0.9
Cyclically-adjusted primary balance	-3.2	-1.5	-2.3	-1.2	-0.3	1.4	2.5
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-4.2	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Public sector net debt ¹	71.8	75.9	79.2	82.6	85.1	85.6	84.8
Financing							
Central government net cash requirement	8.3	6.8	7.1	6.8	5.8	4.6	3.3
Public sector net cash requirement	8.1	6.8	7.0	6.6	5.6	4.4	3.1
Stability and Growth Pact							
Treaty deficit ³	7.8	5.6	6.8	6.0	5.2	3.5	2.3
Cyclically-adjusted Treaty deficit ²	5.9	3.6	4.4	3.4	2.8	1.5	0.7
Treaty debt ratio ³	86.0	90.7	94.9	98.6	100.8	100.8	99.4
£ billion							
Surplus on current budget	-92	-93	-84	-71	-61	-35	-16
Net investment	29	-6	24	27	26	26	26
Public sector net borrowing	121	86	108	97	87	61	42
Central government net cash requirement	127	105	114	113	100	83	61
Public sector net debt	1104	1189	1286	1398	1502	1580	1637
Underlying PSNB							
PSNB ex. Royal Mail and APF (£ billion)	121	121	120	108	96	67	43
PSNB ex. Royal Mail and APF (per cent of GDP)	7.9	7.8	7.5	6.5	5.5	3.7	2.3
Cyclically-adjusted PSNB ex. Royal Mail and APF (per cent of GDP)	6.0	5.9	5.1	4.0	3.2	1.7	0.7
<i>Memo: Output gap (per cent of GDP)</i>	-2.7	-2.9	-3.7	-3.6	-3.3	-2.7	-2.1

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

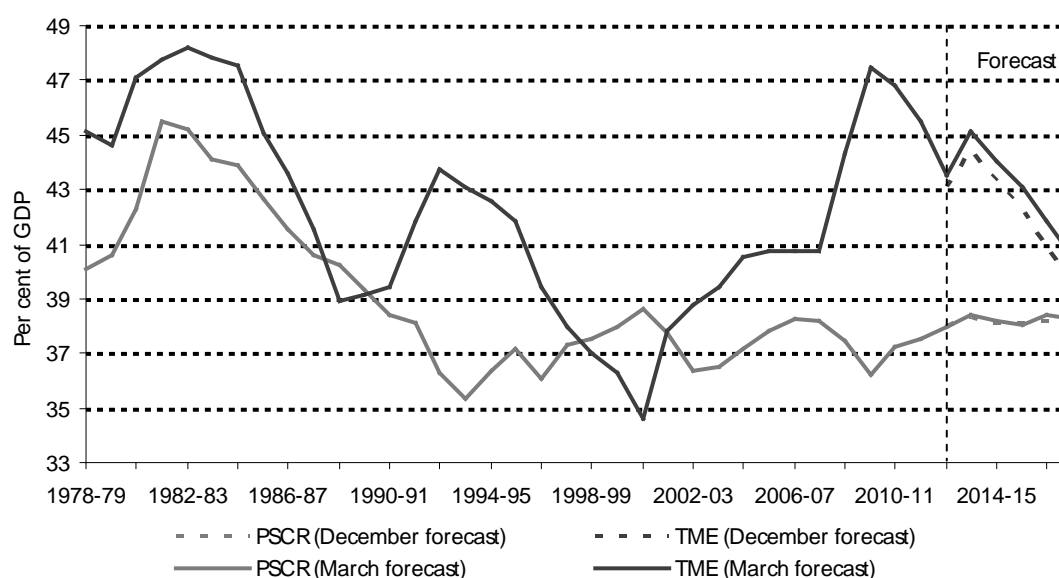
Public sector net borrowing

- 7.189 Public sector net borrowing (PSNB) is estimated to have fallen from its post-war peak of £159 billion or 11.2 per cent of GDP in 2009-10 to £121 billion or 7.9 per cent of GDP in 2011-12. This decline was driven by the recovery of the economy from the trough of the 2009 recession, the withdrawal of the temporary stimulus measures put in place by the previous Government, and by the current Government's fiscal consolidation plans including the increase in the standard rate of VAT in 2010-11 and reductions in expenditure.
- 7.190 Comparisons of PSNB outturn data and forecasts have been complicated recently by a number of policy and statistical classification decisions. These include the Government's decisions to transfer the Royal Mail's historic pension assets to the public sector and to transfer the excess balances from the Asset Purchase Facility (APF) to the Exchequer, as well as ONS decisions to reclassify Bradford & Bingley and Northern Rock (Asset Management) from the private sector to central government, and to reclassify the transfer to the Exchequer of the proceeds from the Special Liquidity Scheme (SLS). In Table 4.36 we show how PSNB outturns and forecasts are affected by removing the same combinations of these special factors that we showed in the December *EFO*, and also by removing the Royal Mail, the APF and the SLS (which the ONS and HM Treasury showed for the 2012-13 year-to-date in the February 2013 *Public Sector Finances* release).
- 7.191 The Royal Mail and APF transfers have significant effects on the headline measure of PSNB particularly in the early years of the forecast. If we look at an underlying measure of PSNB, excluding the Royal Mail and APF transfers, we forecast that this will be £121.0 billion or 7.9 per cent of GDP in 2011-12, £120.9 billion or 7.8 per cent of GDP in 2012-13 and £120 billion or 7.5 per cent of GDP in 2013-14. This would leave underlying PSNB essentially flat, in both cash terms and as a share of the economy, between 2011-12, 2012-13 and 2013-14. Given the uncertainty surrounding all public finance forecasts – and the typical size of revisions to PSNB outturn data – the small decline forecast over this period is fiscally and statistically insignificant.
- 7.192 Nominal GDP growth over this period is expected to be relatively weak, constraining cash receipts growth and increasing expenditure (much of which is fixed in cash terms) as a share of the economy. The Government's fiscal consolidation plan in June 2010 envisaged total expenditure falling to 42.2 per cent of GDP in 2013-14. Our latest forecast

is that it will be 3 per cent of GDP higher than this at 45.2 per cent of GDP, only slightly lower than its level in 2011-12.

7.193 Our central forecast is that PSNB will start to fall again in 2014-15, reaching 2.2 per cent of GDP in 2017-18. As shown in Chart 4.2, as the economy recovers we expect public sector expenditure to start to fall as a share of GDP largely as a result of the Government's fiscal consolidation plan. Public sector receipts are expected to be broadly flat as a share of GDP over the forecast period.

Chart 7.2: Total public sector spending and receipts



Source: ONS, OBR

Public sector net borrowing in 2012-13: changes since December

7.194 Our new forecast for headline PSNB in 2012-13 is £86 billion or 5.6 per cent of GDP. Underlying PSNB, excluding the Royal Mail and APF transfers, is forecast at £120.9 billion, or 7.8 per cent of GDP.⁴⁹ This is £1.0 billion higher than the estimate we made in December. Table 4.35 shows that the main drivers of the change since our previous forecast are:

⁴⁹ The ONS has now reclassified the 2012-13 SLS payment as a dividend but has not formally announced how this payment would be treated in a scenario where the payments from the APF to Government were not occurring. The ONS have provided initial guidance that it would continue to score as dividend payments rather than financial transactions and we have treated it this way. If it were instead treated as a financial transaction then borrowing on this measure would be £2.3bn higher in 2012-13.

- our underlying forecast of tax receipts this year has weakened by £5.1 billion compared to December (excluding the impact of fiscally-neutral reclassifications), reflecting lower-than-expected receipts in recent months. In particular there have been significant shortfalls in payments from UK oil and gas revenues and in receipts from income tax and NICs from both self-assessment and PAYE;
- forecasting changes to expenditure (again excluding fiscally-neutral reclassifications) reduce borrowing by £0.7 billion in 2012-13 compared to December. Higher-than-expected expenditure due to the shortfall in spectrum auction receipts and by local authorities, has been offset by lower-than-expected debt interest, public sector pensions and spending by public corporations; and
- in addition we now expect larger departmental underspends in 2012-13, mainly as a result of action taken by the Government to reduce and/or delay departmental expenditure. We now anticipate that departmental underspends will be £3.4 billion larger than we expected in December.

7.195 Our forecast implies that there will be very low expenditure at the end of this year compared to previous years. However, we know that end-year spending will be lower because EU payments and local government grants have been paid earlier this year than last year. We also expect that it will be lower as a result of the Government's actions to reduce spending. The final outturn for the current year usually remains a little uncertain even in forecasts this close to the end of the year. The average in-year error for PSNB at Budget forecasts over the past twenty years has been 0.3 per cent of GDP or about £5 billion. The ONS's initial outturn estimates are typically revised for several months as further data becomes available.

Table 7.35: Changes to public sector net borrowing since December

	£ billion						
	Outturn		Forecast				
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net borrowing excluding Royal Mail and APF transfers							
December forecast	121.4	119.9	112	99	81	56	31
March forecast	121.0	120.9	120	108	96	67	43
<i>Change</i>	<i>-0.4</i>	<i>1.0</i>	<i>8.3</i>	<i>9.9</i>	<i>14.3</i>	<i>11.4</i>	<i>11.8</i>
<i>of which:</i>							
Receipts forecast ¹	-3.1	5.1	8.9	8.6	11.9	13.5	14.1
Expenditure forecast ¹	2.7	-0.7	-0.3	-0.9	-0.5	-0.4	-1.0
Measures in the Treasury's policy decision table	0.0	0.0	-1.3	1.6	2.8	-1.7	-1.3
Changes to departmental underspends ²	0.0	-3.4	1.0	0.5	0.0	0.0	0.0

¹Excluding fiscally neutral switches including the reclassification of SLS transfers and changes in the proportion of tax credits treated as negative tax

²Including as a result of action taken by the Government to reduce and/or delay expenditure

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

7.196 Compared to our December forecast, underlying PSNB excluding the Royal Mail and APF transfers is considerably higher each year from 2013-14, with the difference reaching around £12 billion in 2017-18. Table 4.35 shows that this is driven by the following factors:

- forecasting changes increase borrowing by £13 billion in 2017-18. This is primarily driven by lower expected receipts, due to our weaker economic forecast. In particular our forecast for income tax and NICs is £6 billion lower by 2017-18 due to a lower forecast for labour income growth and the weakness of these receipts seen in recent months;
- a number of forecasting changes have left medium-term expenditure broadly unchanged from December; and
- policy measures on the Treasury's Budget policy decisions table are neutral over the forecast horizon, with a small fiscal tightening of £1.3 billion in 2017-18.

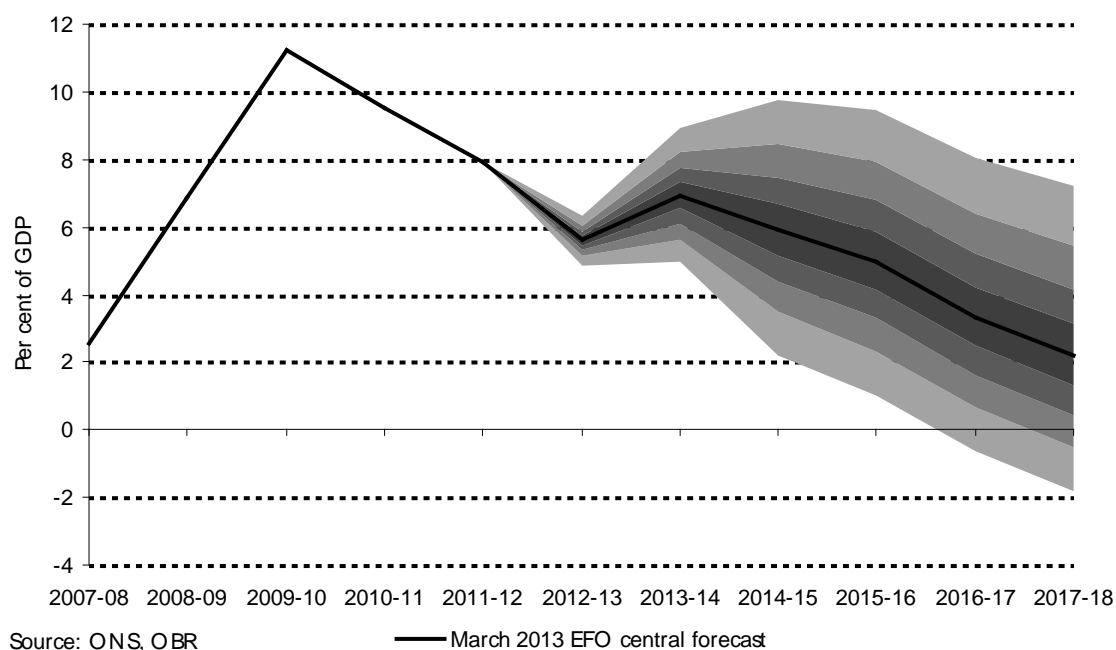
7.197 Table 4.36 sets out our how our forecast for PSNB is affected by a number of one-off and temporary effects. PSNB excluding just the Royal Mail transfer is £6.0 billion higher in 2012-13 than in December. This largely reflects the £5.1bn impact of the final ONS decision on the reclassification of the APF transfers, as set out in paragraph 4.30. The impact of excluding the Royal Mail and APF transfers is discussed above. Further, excluding the impact of the reclassification of Bradford & Bingley and Northern Rock (Asset Management) would only make a small difference to the forecast. Excluding the impact of the Royal Mail, APF and the SLS would increase borrowing in 2012-13 by a further £2.3 billion, with all other years unaffected.

Table 7.36: Special factors affecting public sector net borrowing

	£ billion						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
PSNB							
December forecast	121.4	80.5	99.3	87.9	73.3	49.0	31.2
March forecast	121.0	86.5	107.7	97.3	87.1	60.8	42.0
<i>Change</i>	<i>-0.4</i>	<i>6.0</i>	<i>8.4</i>	<i>9.3</i>	<i>13.8</i>	<i>11.8</i>	<i>10.8</i>
excluding Royal Mail							
December forecast	121.4	108.5	99.3	87.9	73.3	49.0	31.2
March forecast	121.0	114.5	107.7	97.3	87.1	60.8	42.0
<i>Change</i>	<i>-0.4</i>	<i>6.0</i>	<i>8.4</i>	<i>9.3</i>	<i>13.8</i>	<i>11.8</i>	<i>10.8</i>
excluding Royal Mail and APF transfers							
December forecast	121.4	119.9	111.6	98.6	81.2	55.6	30.9
March forecast	121.0	120.9	119.8	108.4	95.5	67.0	42.7
<i>Change</i>	<i>-0.4</i>	<i>1.0</i>	<i>8.3</i>	<i>9.9</i>	<i>14.3</i>	<i>11.4</i>	<i>11.8</i>
excluding Royal Mail, APF and B&B and NRAM classifications							
December forecast	-	120.3	112.1	99.0	82.0	56.7	32.2
March forecast	121.5	120.9	120.3	108.9	96.2	67.7	43.5
<i>Change</i>	<i>-</i>	<i>0.6</i>	<i>8.2</i>	<i>9.9</i>	<i>14.2</i>	<i>11.0</i>	<i>11.3</i>
excluding Royal Mail, APF and SLS transfers							
March forecast	121.0	123.2	119.8	108.4	95.5	67.0	42.7
	Per cent of GDP						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
PSNB							
December forecast	7.9	5.1	6.1	5.2	4.2	2.6	1.6
March forecast	7.9	5.6	6.8	5.9	5.0	3.4	2.2
<i>Change</i>	<i>0.0</i>	<i>0.4</i>	<i>0.6</i>	<i>0.7</i>	<i>0.9</i>	<i>0.7</i>	<i>0.6</i>
excluding Royal Mail							
December forecast	7.9	6.9	6.1	5.2	4.2	2.6	1.6
March forecast	7.9	7.4	6.8	5.9	5.0	3.4	2.2
<i>Change</i>	<i>0.0</i>	<i>0.5</i>	<i>0.6</i>	<i>0.7</i>	<i>0.9</i>	<i>0.7</i>	<i>0.6</i>
excluding Royal Mail and APF transfers							
December forecast	7.9	7.7	6.9	5.8	4.6	3.0	1.6
March forecast	7.9	7.8	7.5	6.5	5.5	3.7	2.3
<i>Change</i>	<i>0.0</i>	<i>0.2</i>	<i>0.6</i>	<i>0.7</i>	<i>0.9</i>	<i>0.7</i>	<i>0.7</i>
excluding Royal Mail, APF and B&B and NRAM classifications							
December forecast	-	7.7	6.9	5.9	4.7	3.1	1.7
March forecast	7.9	7.7	7.4	6.4	5.5	3.7	2.2
<i>Change</i>	<i>-</i>	<i>0.0</i>	<i>0.5</i>	<i>0.6</i>	<i>0.8</i>	<i>0.6</i>	<i>0.6</i>
excluding Royal Mail, APF and SLS transfers							
March forecast	7.9	8.0	7.5	6.5	5.5	3.7	2.3

7.198 All fiscal forecasts are subject to significant uncertainty. Chart 4.3 shows our median (central) forecast for PSNB with successive pairs of shaded areas around it representing 20 per cent probability bands. The bands show the probability of different outcomes if past official forecasting errors are a reasonable guide to likely future forecasting errors.

Chart 7.3: PSNB fan chart



Current budget

7.199 The current budget, which is borrowing excluding net investment spending, is forecast to move from a deficit of £93 billion, or 6.0 per cent of GDP, this year to a deficit of £16 billion, or 0.9 per cent of GDP in 2017-18. Compared to our December forecast, the deterioration in the current budget is slightly smaller than the deterioration in PSNB, due to changes in investment spending.

Cyclically-adjusted current budget

7.200 The cyclically-adjusted current budget (CACB) moves from a deficit of 4.0 per cent of GDP in 2012-13 to a surplus of 0.8 per cent of GDP in 2017-18. The CACB in 2017-18 has deteriorated by 0.2 per cent of GDP compared to our December forecast. While the headline current budget has deteriorated by 0.4 per cent of GDP compared to December, we expect the output gap in that year to be 0.4 per cent of GDP wider, which means that much of the deterioration is assumed to be cyclical.

This reflects our judgement that most of the additional weakness in the economy compared to our December forecast is cyclical rather than structural. Further detail on changes to the CACB since December is provided in Chapter 5.

Public sector net debt

7.201 In our latest forecast, PSND rises as a share of GDP in each year up to and including 2016-17, peaking at 85.6 per cent of GDP, before falling to 84.8 per cent of GDP in 2017-18. PSND in 2017-18 is now expected to be around 7.5 per cent of GDP higher than we forecast in December. Table 4.36 breaks down this change as follows:

- the level of nominal GDP over the past year has been lower than we forecast in December, and we expect lower nominal GDP growth in the future. By reducing the denominator we use when calculating PSND as a share of GDP, this increases PSND by 2.2 per cent of GDP in 2017-18; and
- our forecast for PSND in cash terms is also higher than in December, by 5.3 per cent of GDP in 2017-18. This is a consequence of:
 - higher net borrowing (excluding APF transfers) over the forecast period which leads to a rise in PSND of £56 billion by 2017-18;
 - for the purposes of calculating net debt, gilts are valued at their nominal value rather than their market value. In the past, the Debt Management Office (DMO) has typically sold gilts at close to their nominal value. However, with gilt rates at such low rates in the past couple of years, some of the gilts that the DMO has issued have been sold at a market value significantly above the nominal value, i.e. at a 'premium'. In our December *EFO*, we revised our forecast to reflect the likelihood that the DMO will continue to issue gilts at a premium. Since then, gilt rates have risen and we have also reassessed our modelling. We now expect the premium to fall more considerably and for gilts to be sold much closer to par from 2014-15. This increases our forecast of PSND by £28 billion by 2017-18;
 - larger net transfers from the Treasury to the APF increase PSND by around £4 billion by 2017-18; and
 - other changes increase PSND by £15 billion in 2017-18. Budget measures that affect financial transactions increase net debt by

around £5 billion by 2015-16. The stock of Bradford & Bingley and Northern Rock (Asset Management) liabilities winds down more slowly in later years. These public sector bodies have also been included in 2011-12 outturns for the first time.

Table 7.37: Changes to public sector net debt since December

	Per cent of GDP						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	66.4	74.7	76.8	79.0	79.9	79.2	77.3
March forecast	71.8	75.9	79.2	82.6	85.1	85.6	84.8
Change	5.5	1.2	2.3	3.7	5.1	6.4	7.5
<i>of which:</i>							
Change in nominal GDP ¹	0.4	1.0	1.3	1.5	1.8	2.0	2.2
Change in cash level of net debt	5.1	0.2	1.0	2.2	3.4	4.4	5.3
	£ billion						
December forecast	1025	1186	1270	1362	1442	1498	1534
March forecast	1104	1189	1286	1398	1502	1580	1637
Change in cash level of net debt	78	3	17	36	60	82	103
<i>of which:</i>							
Changes in net borrowing (ex. APF)	0	1	9	19	33	44	56
Auction price effects	0	2	5	12	17	23	28
Asset purchase facility	0	0	0	0	0	2	4
Financial transactions and other	79	1	3	6	10	13	15

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

Table 7.38: Changes to the fiscal forecast

	£ billion						
	Outturn	Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Surplus on current budget							
June 2010 forecast	-88	-65	-40	-17	0		
December 2012 forecast	-95	-89	-74	-62	-51	-26	-8
<i>Change</i>	<i>2</i>	<i>-3</i>	<i>-9</i>	<i>-8</i>	<i>-11</i>	<i>-9</i>	<i>-8</i>
March 2013 forecast	-92	-93	-84	-71	-61	-35	-16
Net investment							
June 2010 forecast	27	24	20	21	21		
December 2012 forecast	27	-9	25	26	23	23	23
<i>Change</i>	<i>2</i>	<i>3</i>	<i>-1</i>	<i>1</i>	<i>3</i>	<i>3</i>	<i>3</i>
March 2013 forecast	29	-6	24	27	26	26	26
Net borrowing							
June 2010 forecast	116	89	60	37	20		
December 2012 forecast	121	80	99	88	73	49	31
<i>Change</i>	<i>0</i>	<i>6</i>	<i>8</i>	<i>9</i>	<i>14</i>	<i>12</i>	<i>11</i>
March 2013 forecast	121	86	108	97	87	61	42
Per cent of GDP							
Net borrowing							
June 2010 forecast	7.5	5.5	3.5	2.1	1.1		
December 2012 forecast	7.9	5.1	6.1	5.2	4.2	2.6	1.6
<i>Change</i>	<i>0.0</i>	<i>0.4</i>	<i>0.6</i>	<i>0.7</i>	<i>0.9</i>	<i>0.7</i>	<i>0.6</i>
March 2013 forecast	7.9	5.6	6.8	5.9	5.0	3.4	2.2
Cyclically-adjusted surplus on current budget							
June 2010 forecast	-3.2	-1.9	-0.7	0.3	0.8		
December 2012 forecast	-4.3	-3.6	-2.2	-1.4	-0.8	0.4	0.9
<i>Change</i>	<i>0.1</i>	<i>-0.5</i>	<i>-0.6</i>	<i>-0.4</i>	<i>-0.4</i>	<i>-0.3</i>	<i>-0.2</i>
March 2013 forecast	-4.2	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Cyclically-adjusted net borrowing							
June 2010 forecast	5.0	3.4	1.8	0.8	0.3		
December 2012 forecast	6.0	3.0	3.8	2.9	2.0	0.9	0.3
<i>Change</i>	<i>0.0</i>	<i>0.6</i>	<i>0.6</i>	<i>0.4</i>	<i>0.6</i>	<i>0.5</i>	<i>0.3</i>
March 2013 forecast	6.0	3.6	4.3	3.3	2.7	1.3	0.6
Net debt¹							
June 2010 forecast	67.2	69.8	70.3	69.4	67.4		
December 2012 forecast	66.4	74.7	76.8	79.0	79.9	79.2	77.3
<i>Change</i>	<i>5.5</i>	<i>1.2</i>	<i>2.3</i>	<i>3.7</i>	<i>5.1</i>	<i>6.4</i>	<i>7.5</i>
March 2013 forecast	71.8	75.9	79.2	82.6	85.1	85.6	84.8

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

Box 7.3: Use of Whole of Government Accounts

The Whole of Government Accounts (WGA) contains information on future fiscal liabilities that are relevant for our forecast. These include:

- public service pensions, where the future costs of providing pension benefits that have already been earned are treated as current costs, and charged to each year's accounts;
- provisions for future liabilities that have resulted from past events, where the liabilities are expected to happen. The WGA information also shows the time period when the liabilities might fall due; and
- contingent liabilities, which are possible future liabilities that have resulted from past events, but which are less likely or unlikely to happen.

The Treasury will publish the 2011-12 WGA later this year, and we will report on the latest picture it shows for future liabilities in our 2013 *Fiscal sustainability report (FSR)*. However, we already know government departments' provisions and future liabilities at the end of 2011-12, from their published accounts. This box explains how we have ensured that those liabilities that are expected to affect the public finances in the next five years are reflected in our forecast.

For future liabilities on spending, this forecast includes the latest forecasts for net payments for public service pensions out to 2017-18. Forecasts to 2062-63 will be contained in our 2013 *FSR*. Most of the future payments for which departments make provisions are included within departments' DELs. These include the largest provisions for nuclear decommissioning and clinical negligence, where the future nuclear decommissioning payments are contained within the DELs for the Department of Energy and Climate Change (DECC) and the Ministry of Defence (MOD) and where the future clinical negligence payments are contained within the DEL for the Department of Health.

Other provisions for future liabilities at 31 March 2012 include:

- HMRC provisions of £2.1 billion for legal disputes over taxes, reduced from £4.4 billion at 31 March 2011. Our forecast assumes payments of £3.6 billion over the next five years, for these existing provisions and further provisions in future years' accounts;
- DWP provisions of £3.9 billion relating to the Financial Assistance Scheme. Payments under this scheme are contained within DWP's DEL. Receipts of £1.4 billion under this scheme are included in our

forecast of capital accounting adjustments; and

- HM Treasury provisions of £1.3 billion for the Equitable Life Payments Scheme. Our forecast assumes payments of £0.9 billion under this scheme over the next five years.

The main contingent liabilities at 31 March 2012 include:

- HM Treasury's contingent commitments associated with financial stability interventions. Our central forecasts do not include any of these potential costs, because they are judged more likely not to be paid than to be paid. In Box 4.2 we assess the potential fiscal cost of these interventions; and
- HMRC contingent liabilities of £20 billion for reductions in petroleum revenue tax and corporation tax where losses on decommissioning oil fields are set off against these taxes, reducing current receipts. Although these future losses of revenue are classified as contingent liabilities rather than provisions in HMRC's accounts, we include a negative effect from oil and gas revenues from decommissioning expenditure of between £0.7 billion and £1.4 billion a year over the forecast period to 2017-18.

Comparisons with external forecasts

Average of independent forecasts

7.202 The latest of average independent forecast for public sector net borrowing was £88.5 billion for 2012-13, £105.9 billion for 2013-14 and £96.0 billion in 2014-15. Forecasters generally expect a higher PSNB than we do for 2012-13. Recent public finance releases have shown higher spending growth and lower receipts growth than our forecast assumed in December. However, the departmental underspends which we have incorporated into our latest forecast are not likely to be seen in the public finance statistics until April or later. The shortfall in receipts growth is unlikely to be reversed, which is reflected in our lower current receipts forecast.

Table 7.39: Comparisons with external forecast of key aggregates

	£ billion					
	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net borrowing						
OBR December	80.5	99	88	73	49	31
IFS February baseline	85.5	103	93	73	48	30
IFS February Oxford Economics central	86.7	108	97	77	48	27
Average of independent forecasters ¹	88.5	106	96	79	64	-
OBR March	86.5	108	97	87	61	42
Per cent of GDP						
Cyclically-adjusted surplus on current budget						
OBR December	-3.6	-2.2	-1.4	-0.8	0.4	0.9
IFS February baseline	-3.9	-2.4	-1.5	-0.7	0.4	1.0
IFS February Oxford Economics central	-2.9	-1.3	-0.6	0.2	1.4	2.1
OBR March	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Public sector net debt						
OBR December	74.7	76.8	79.0	79.9	79.2	77.3
IFS February baseline	75.0	77.3	79.8	80.6	79.9	77.9
IFS February Oxford Economics central	75.6	78.7	81.6	82.7	81.9	79.7
OBR March	75.9	79.2	82.6	85.1	85.6	84.8

¹HM Treasury, *Forecasts for the UK economy*, February and March 2013

IFS Green Budget

7.203 The Institute for Fiscal Studies is the only other organisation that produces a bottom-up forecast for the UK public finances. The Green Budget, published in February, includes forecasts up to 2017-18.

7.204 The IFS baseline scenario uses the economic determinants which we incorporated into our December 2012 forecast. The baseline scenario forecast for PSNB in 2012-13 was £4.9 billion more than our December 2012 forecast, due to £3.3 billion less receipts and £1.6 billion more expenditure. The main area of difference on the spending side is that our forecast assumes much higher departmental underspends, as mentioned above. Lower receipts from income tax, VAT and corporation tax explain the differences between our current receipts forecasts. Our forecasts for PSNB retain a similar gap until 2014-15, again, due to the difference between our assumptions for departmental underspends. From 2015-16 and beyond, our forecasts for PSNB are very similar, given the uncertainties surrounding forecasts over this time horizon.

7.205 The IFS also produced forecasts based on the Oxford Economics central scenario, which uses much the same economic determinants as the IFS baseline and our December forecast. The key difference is their assumption about the size of the output gap. As a result, the main differences between the December 2012 *EFO* forecast and the Oxford

Economics central scenario is that a larger proportion of borrowing is due to cyclical factors and that the fiscal mandate target would be met a year earlier than our forecast implied in December.

International comparisons

7.206 International organisations, such as the European Commission and the IMF, provide forecasts of deficit and debt levels of different countries on a comparable basis. These are based on general government debt and borrowing and are presented on a calendar year basis. To facilitate international comparisons, Tables 4.40 and 4.41 provide UK forecasts on a basis which is comparable to other international organisations forecasts. With both modelling and reporting of much tax and spend done primarily on a financial year basis only, the calendar year forecasts are illustrative and have been generated by weighting the financial year forecasts appropriately.

7.207 Table 4.40 compares our forecasts for Treaty deficit and debt against the latest forecasts from the European Commission, published in February. Their forecast was based on a Treaty deficit measure which excluded APF. On this basis, our calendar year forecast for 2013 is very similar to the Commission's forecast. The UK's Treaty deficit remains high relative to major European countries. The UK's Treaty debt to GDP ratio is now in line with the euro area average. Prior to the downturn, the UK had a debt ratio 20 per cent of GDP less than the euro area average.

Table 7.40: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit ¹			Treaty Debt ²		
	2012	2013	2014	2012	2013	2014
UK (March EFO) ³	6.5	7.6	6.9	89.6	93.9	97.8
UK (EC) ³	6.3	7.4	6.0	89.8	95.4	97.9
Germany	-0.1	0.2	0.0	81.6	80.7	78.3
France	4.6	3.7	3.9	90.3	93.4	95.0
Italy	2.9	2.1	2.1	127.1	128.1	127.1
Spain	10.2	6.7	7.2	88.4	95.8	101.0
Euro area	3.5	2.8	2.7	93.1	95.1	95.2

¹General government net borrowing

²General government net debt

³Treaty deficit excluding APF flows

Source: OBR, European Commission, *European Economic Forecast*, Winter 2013

Table 7.41: Comparison with IMF forecasts

	Per cent of GDP					
	General Government Net Borrowing			General Government Net Debt		
	2012	2013	2017	2012	2013	2017
UK (March EFO) ¹	6.5	7.6	2.7	81.0	85.3	92.1
UK (IMF) ¹	8.2	7.3	1.7	83.7	88.2	88.7
Germany	0.4	0.4	0.0	58.4	57.5	56.2
France	4.7	3.5	0.0	83.7	85.9	80.2
Italy	2.7	1.8	0.7	103.1	103.9	98.7
Japan	10.0	9.1	5.8	135.4	144.7	158.7
U.S.	8.7	7.3	4.4	83.8	87.7	89.4

¹ General government net borrowing excludes APF flows

Source: OBR, IMF, *World Economic Outlook*, October 2012

8 Performance against the Government's fiscal targets

Introduction

8.1 This chapter:

- sets out the Government's medium-term fiscal targets (from paragraph 5.2);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.5); and
- assesses how robust this judgement is to the uncertainties inherent in any fiscal forecast, by looking at: past forecast errors; sensitivity to key parameters of the forecast; and alternative economic scenarios (from paragraph 5.11).

The fiscal mandate and the supplementary target

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

8.3 The *Charter for Budget Responsibility* defines the fiscal mandate as "a forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period". This means that total public sector receipts need to at least equal total public sector spending (minus spending on net investment) in five years time, after adjusting for the impact of any remaining spare capacity in the economy. For the purposes of this forecast, as in our last forecast at the time of the Autumn Statement, the five-year horizon ends in 2017-18. For our autumn 2013 *EFO*, the horizon will roll forward to 2018-19.

8.4 The *Charter* says that the supplementary target requires “public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring the public finances are restored to a sustainable path.” The target refers to public sector net debt (PSND) excluding the temporary effects of financial interventions.

The implications of our central forecast

8.5 Table 5.1 shows our central forecasts for the cyclically-adjusted current budget (CACB) and PSND in each year to 2017-18, 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 8.1: Performance against the Government’s fiscal targets

	Per cent of GDP						
	Outturn			Forecast			
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cyclically-adjusted current budget							
December forecast	-4.3	-3.6	-2.2	-1.4	-0.8	0.4	0.9
March forecast excluding Budget measures ¹	-4.2	-4.0	-2.9	-1.6	-1.2	-0.2	0.5
March forecast	-4.2	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Cyclically-adjusted current budget excluding Royal Mail, APF, B&B and NRAM¹							
December forecast	-4.3	-4.3	-3.1	-2.1	-1.3	-0.1	0.8
March forecast excluding Budget measures ¹	-4.2	-4.5	-3.7	-2.4	-1.7	-0.6	0.4
March forecast	-4.2	-4.5	-3.6	-2.5	-1.7	-0.3	0.6
Public sector net debt							
December forecast	66.4	74.7	76.8	79.0	79.9	79.2	77.3
March forecast excluding Budget measures ¹	71.8	75.9	79.2	82.4	84.6	85.2	84.5
March forecast	71.8	75.9	79.2	82.6	85.1	85.6	84.8
Public sector net debt excluding Royal Mail, APF, B&B and NRAM¹							
December forecast	66.4	72.5	77.1	80.2	82.0	81.9	80.5
March forecast excluding Budget measures ¹	66.8	73.7	79.5	83.8	86.8	87.9	87.5
March forecast	66.8	73.7	79.5	84.0	87.2	88.3	87.8

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

8.6 Table 5.1 shows that in the absence of Budget measures our central forecast would show the CACB in surplus by 0.5 per cent of GDP in 2017-18 and in deficit by 0.2 per cent of GDP in 2016-17. Budget measures improve the balance by a quarter of a per cent of GDP in both years. This is sufficient to put the CACB back into surplus in 2016-17 and to

achieve a surplus in 2017-18 that is only fractionally smaller than that we forecast in December. So there remains a greater than 50 per cent chance of the Government achieving balance on this measure in 2017-18 and as a result we judge it to be on course to achieve the mandate.

- 8.7 Excluding the Chancellor's decision to transfer the cash balances held in the Asset Purchase Facility (APF) to the Exchequer on an ongoing basis – as well as the impact of the reclassification of Bradford & Bingley plc (B&B) and Northern Rock (Asset Management) (NRAM) into central government – the surplus in 2017-18 would be 0.6 per cent of GDP.
- 8.8 Table 5.2 decomposes the changes in our forecasts of CACB since December. It shows that:
- although much of the downward revision to our GDP forecasts since December is assumed to be cyclical and temporary, some is assumed to be structural and persistent. Our assessment of the current output gap and future trend growth reduces the level of potential output by 0.3 per cent of GDP by 2017-18, worsening the CACB by 0.2 per cent of GDP;
 - transfers from the APF to the Exchequer have a small additional positive impact on the CACB in 2017-18, following the ONS's definitive announcement on how these will be treated;
 - measures announced in the Budget improve the CACB by 0.2 per cent of GDP in 2017-18; and
 - other forecasting changes reduce the CACB by 0.3 per cent of GDP from 2015-16. This relates to our latest assessment of the CACB in 2012-13, which knocks through to later years and a smaller decline in current spending as a share of GDP beyond the current Spending Review period.

Table 8.2: Changes to the cyclically-adjusted current budget since December

	Per cent of GDP						
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	-4.3	-3.6	-2.2	-1.4	-0.8	0.4	0.9
March forecast	-4.2	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Change	0.1	-0.5	-0.6	-0.4	-0.4	-0.3	-0.2
<i>of which:</i>							
Judgement on potential output	0.0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
APF transfers	0.0	-0.3	0.0	0.0	0.0	0.0	0.1
Budget measures	0.0	0.0	0.1	-0.1	0.0	0.3	0.2
Other forecasting changes	0.1	-0.1	-0.5	-0.1	-0.3	-0.3	-0.3

8.9 The supplementary target requires PSND to fall as a share of GDP between 2014-15 and 2015-16, and this target year remains fixed. As Table 5.3 shows, our December forecast showed PSND rising by 1 per cent of GDP in that year. We now expect PSND to rise by 2.4 per cent of GDP in 2015-16 and by another 0.5 per cent of GDP in 2016-17. In December, we forecast that PSND would fall as a share of GDP in 2016-17, although excluding the APF transfers and B&B and NRAM reclassifications it would have been broadly flat. It should be emphasised that these are small changes in the context of the uncertainty around the forecast of PSND at these time horizons.

8.10 Table 5.3 shows a decomposition of changes in the profile of net debt as a share of GDP since December. This shows:

- lower forecasts for nominal GDP growth reduce the denominator we use to calculate PSND as a share of GDP and increase the change in PSND from year to year by 0.2 per cent of GDP each year from 2014-15;
- net borrowing is higher in each year of the forecast horizon, largely as a consequence of the weaker economic outlook. As borrowing now falls more gradually, debt rises more quickly as a share of GDP than in December; and
- other changes mean that net debt rises by an additional 0.5 per cent of GDP in both 2015-16 and 2016-17. This mainly reflects our judgement that the Debt Management Office will issue gilts at a lower premium relative to their nominal value than we assumed in December.

Table 8.3: Decomposition of changes in the profile of net debt since December

	Change in PSND on a year earlier (per cent of GDP)				
	2013-14	2014-15	2015-16	2016-17	2017-18
December forecast	2.1	2.2	1.0	-0.8	-1.9
March forecast	3.3	3.5	2.4	0.5	-0.8
Change	1.2	1.3	1.5	1.3	1.1
<i>of which:</i>					
Nominal GDP	0.3	0.2	0.2	0.2	0.2
Changes in net borrowing	0.5	0.6	0.8	0.5	0.5
Other	0.3	0.6	0.5	0.5	0.4

Recognising uncertainty

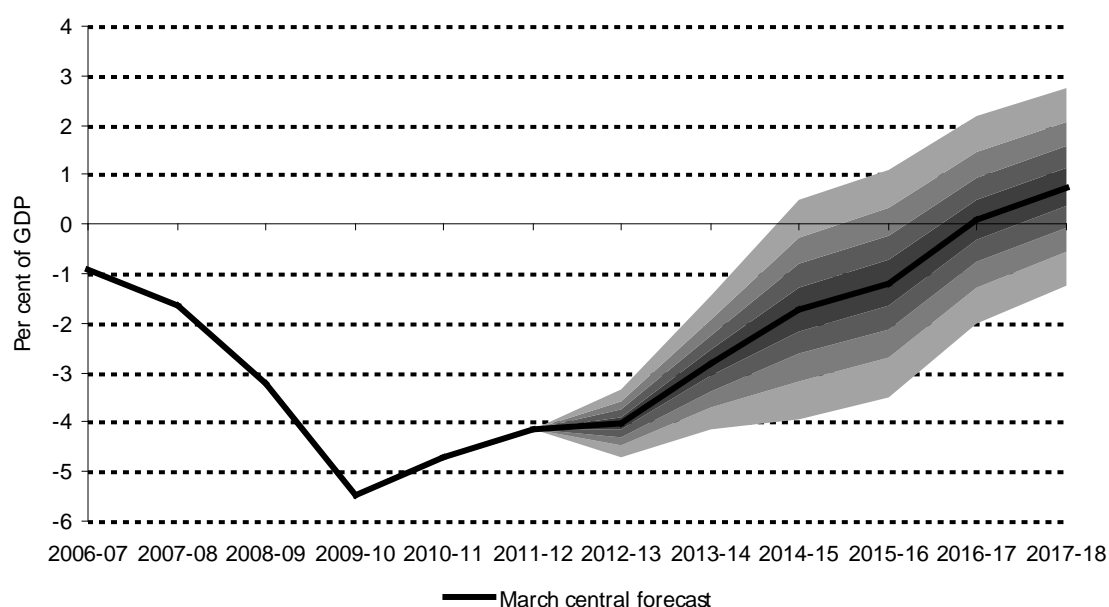
- 8.11 Past experience and common sense suggest that there are significant upside and downside risks to our central forecasts for the public finances. These reflect uncertainty both about the outlook for the economy and about the level of receipts and spending in any given state of the economy.
- 8.12 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet the mandate in 2017-18, but is no longer on course to meet the supplementary target in 2015-16. 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 performance

- 8.13 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 using fan charts like those we presented for GDP growth in Chapter 3 and public sector net borrowing (PSNB) in Chapter 4. These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that errors in the past offered a reasonable guide to errors in the future.

8.14 In this spirit, Chart 5.1 shows the probability distribution around our central forecast for the CACB, based on past official forecasting errors (which are usually 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 20 per cent probability bands. This implies that, based on current policy, there would be an 80 per cent probability of the outturn lying within the shaded bands.

Chart 8.1: Cyclically-adjusted current budget fan chart



Source: OBR

8.15 We can see from the chart that, given past forecasting performance, the margin between the Government meeting and missing its fiscal mandate is small relative to the uncertainty that surrounds the public finance forecast over that time horizon. A direct reading of the chart would imply that the Government currently has a roughly 70 per cent probability of achieving a surplus on the CACB in 2017-18 and thereby meeting the mandate. The probability of achieving a cyclically-adjusted surplus in earlier years is lower at just over 50 per cent for 2016-17 and around 25 per cent for 2015-16.

8.16 Unfortunately, one cannot estimate the probability of achieving the supplementary target, given that we do not have a joint distribution that would allow us to apply the same technique. That said our central median forecast shows PSND rising as a percentage of GDP in 2015-16.

Sensitivity analysis

- 8.17 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.
- 8.18 In thinking about the evolution of the public finances over the medium term, there are several parameters that have a particularly important bearing on the forecast. In this section we focus on four:
- the level of potential output, captured by the size of the output gap;
 - the speed with which the output gap closes (i.e. the pace of the recovery);
 - the interest rates that the Government has to pay on its debt; and
 - possible errors on our cyclical adjustment coefficients.
- 8.19 Our central forecast is based on a judgement that the economy was running around 2.7 per cent below potential in the final quarter of 2012, that the output gap will widen through 2013, and that there will be above-trend GDP growth from 2015.
- 8.20 Our assumptions and forecasts for the level of economic potential and headline growth imply that the negative output gap will close in 2021-22. But neither the level of potential, 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 the economic data. So what if the medium-term level of potential was higher or lower than our central estimate, and what if the output gap closed earlier or later than our central estimates?
- 8.21 Tables 5.4 and 5.5 present illustrative estimates of the impact on:
- the level of the cyclically-adjusted current budget in 2017-18; and
 - the change in PSND between 2014-15 and 2015-16.
- 8.22 For practical reasons, we have not undertaken complete forecast runs for each variant, but have instead used ready-reckoners and simplifying

assumptions to generate illustrative estimates. We assume that a lower or higher level of potential is reflected in our starting output gap, rather than errors in forecasting trend growth rates further forward.

- 8.23 The cyclical adjustment ready-reckoner assumes that a 1 per cent change in GDP will result in a 0.7 per cent of GDP change in PSNB and the current budget after two years. The actual change in the public finances would depend on many other factors, including the composition of growth, inflation and labour market response. While we recognise the limitations of this top-down approach, applying these ready-reckoners yields the results shown in the tables below.

Table 8.4: Cyclically-adjusted current budget in 2017-18

Per cent of GDP	Output gap closes				
	2017-18	2019-20	2021-22	2023-24	2025-26
-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Output gap in					
2012 Q4	0.1	0.0	0.0	0.0	0.0
-1.7	0.8	0.8	0.8	0.7	0.7
-2.7	1.5	1.5	1.5	1.5	1.4
-3.7	2.3	2.2	2.2	2.2	2.1
-4.7					

Table 8.5: Change in PSND between 2014-15 and 2015-16

Per cent of GDP	Output gap closes				
	2017-18	2019-20	2021-22	2023-24	2025-26
-0.7	2.3	2.8	3.0	3.3	3.4
Output gap in					
2012 Q4	1.6	2.4	2.7	3.0	3.2
-1.7	1.1	2.0	2.4	2.8	3.0
-2.7	0.4	1.7	2.1	2.5	2.8
-3.7	0.0	1.3	1.8	2.3	2.6
-4.7					

- 8.24 Table 5.4 shows that the level of potential output has a strong effect on the size of the cyclically-adjusted current budget balance in 2017-18. The lower potential output is, and therefore 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 potential is higher, less of the deficit is structural and the Government has more margin against its mandate.
- 8.25 Closing the output gap at a different pace will typically result in a change in cyclical borrowing, but have 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.

- 8.26 Roughly speaking, the output gap would have to be about 1 per cent of potential output narrower than our central estimate (or rather the level of potential output would need to be 1 per cent lower in 2017-18 than in our central forecast) to make it more likely than not that the mandate would be missed. As we saw in Chapter 3, projections of potential output vary considerably, and this is well within the margins of uncertainty.
- 8.27 Table 5.5 shows that the Government would continue to miss its supplementary target unless the output gap was materially wider than in our central forecast and closed significantly quicker. The former would imply less structural borrowing, whereas the latter would suggest less cyclical borrowing.
- 8.28 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 were to suffer a shock? We examine the implications of a negative shock of 50 basis points, making debt cheaper, and increases of 50, 100, 150 and 200 basis points, making debt more expensive. We assume the shock occurs in 2013-14 and does not affect any other part of the forecast, including exchange rates and shorter-term interest rates. Table 5.6 shows the level of the CACB in 2017-18 and the change in PSND between 2014-15 and 2015-16 under these variants, constructed using a ready-reckoner.

Table 8.6: Fiscal target variables under different gilt rate assumptions

Per cent of GDP	Change in gilt rate (bps)					
	-50	0	50	100	150	200
Cyclically-adjusted current budget balance in 2017–18	1.0	0.8	0.5	0.2	0.0	-0.2
Change in public sector net debt between 2014–15 and 2015–16	2.3	2.4	2.6	2.7	2.8	2.9

- 8.29 Table 5.6 shows that these illustrative shocks to gilt rates have a relatively small impact on the chances of meeting the mandate and supplementary target. This is because an increase in rates only applies to new debt issuance, and the UK has a relatively long average debt maturity for conventional gilts, 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 relatively small.

- 8.30 Gilt rates will also affect transfers between the Exchequer and the APF as gilts are sold. If gilt rates were higher, prices would be lower and therefore capital losses greater. But as gilts are assumed to be sold from the second quarter of 2016, a gilt rate shock would not affect our assessment of the supplementary target through this channel and have only a small effect on the CACB in 2017-18, as transfers to the APF are classified as capital spending.
- 8.31 All else equal, a sustained shock of 150-200 basis points would make it more likely than not that the Government would miss both its fiscal targets. However if short-term interest rates moved in line with gilt rates, there would also be a direct offsetting impact on the public finances through an increase in interest receipts and tax on corporate and household savings. In the November 2011 *EFO* we showed that potentially this could offset around 60 per cent of the direct impact on debt interest payments, though this would depend on the precise change in interest rates at different maturities.
- 8.32 Our last sensitivity analysis concerns the uncertainty around our cyclical adjustment coefficients. Cyclical adjustment attempts to remove the effect of the economic cycle from forecasts of the public finances. This is achieved 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.⁵⁰ We set out our approach to cyclical adjustment in the 2012 working paper *Cyclically adjusting the public finances* and apply coefficients of 0.2 for the previous year's output gap, and 0.5 for the current year's gap.⁵¹
- 8.33 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;

⁵⁰ For example, the cyclically-adjusted current budget is calculated as: $CACB_t = CB_t - \alpha \cdot (OG_{t-1}) - \beta \cdot (OG_t)$, where OG is the output gap in a given fiscal year t , α and β are cyclical adjustment coefficients, and the current budget is expressed as a percentage of GDP.

⁵¹ Helgadottir et al, 2012, Working Paper No. 4: *Cyclically adjusting the public finances*.

- the number of observations on which to base coefficient estimates is limited;
- the fiscal position is affected by events that do not necessarily move in line with the cycle, such as one-off fiscal policy adjustments and movements in commodity and asset prices; and
- 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.

8.34 Given these uncertainties, it is useful to consider how sensitive our central forecast is to variations in the coefficients. If the coefficient on the current year's output gap was 0.4, rather than our estimate of 0.5, the CACB would be 0.2 per cent of GDP lower in 2017-18. If the coefficient on the previous year's output gap was also 0.1 rather than 0.2, the CACB would be 0.5 per cent of GDP lower in 2017-18. Equally, higher coefficients would result in a smaller deficit or larger surplus on the current budget and lower net borrowing, on a cyclically-adjusted basis.

8.35 This analysis should be seen in the context of the uncertainty surrounding the size of the coefficients. The European Central Bank (ECB) assumes a coefficient of 0.65 and the OECD a lower figure of 0.45. Compared with our estimates, the lower ECB and OECD coefficients would imply reductions in the cyclically-adjusted current budget in 2017-18 of 0.23 and 0.65 per cent of GDP respectively.⁵² Using these coefficients the fiscal mandate would still be met, but with less margin for error than in our central forecast.

Scenario analysis

8.36 The variants discussed above focus on a narrow set of factors and therefore only offer a partial assessment of potential uncertainty. In this section we set out the fiscal implications of two broader illustrative alternative economic scenarios, designed to test how dependent our conclusions are on key judgements that are subject to debate in the forecasting community. We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from

⁵² 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.

the central forecast and we do not attempt to attach particular probabilities to their occurrence.

- 8.37 One current topic of debate is the future path of the exchange rate. In our central forecast, exchange rates, after the first quarter of 2013, are assumed to follow a path implied by the uncovered interest parity condition (UIP). The UIP suggests a relationship between differences in interest rates between countries and exchange rate movements and currently implies that the sterling exchange rate edges marginally lower during our forecast. Given the sharp falls in sterling during January and February and the UK's large current account deficit some commentators have questioned whether there could be a larger fall in sterling.⁵³
- 8.38 The most recent depreciation between 2007 and 2009 generated only a modest improvement in exports, while higher import prices fed into higher inflation, reducing real consumption. Past depreciations – such as that of the early 1990s – appear to have had a greater positive impact on GDP growth. It may be that the greater uncertainty and tighter financial conditions over the last five years deterred companies from devoting resources to export markets. Whether a future depreciation would generate a substantial boost to net trade or more closely resemble the 2007 to 2009 depreciation is uncertain. It would depend on:
- the degree to which exporters extend their market share, rather than pricing to market, selling the same quantity of goods at higher sterling prices; and
 - the extent and speed of pass-through of higher import prices into consumer inflation.
- 8.39 Here we examine two alternative scenarios following a 15 per cent depreciation in the sterling exchange rate relative to our central forecast in 2013, which persists in the medium term. The size of the depreciation, when added to the fall in sterling in the first quarter of 2013, would be around half-way between the scale of the last two large depreciations in sterling.

⁵³ For example, MPC member Martin Weale suggests that "unless we continue to enjoy capital gains, this points to a marked increase in United Kingdom net external debt at the current exchange rate. The likely outcome of this would be a lower real exchange rate." Martin Weale, *The Balance of payments*, February 2013.

8.40 In the first scenario, export volumes rise so that UK exporters' market share increases by a similar amount to the increase after the early 1990s depreciation. In the second scenario, the export response is more muted, and their market share remains flat, rather than falling as in our central forecast. But the pass through into consumer prices is more pronounced and persistent. Other key assumptions and the implications are:

- the Bank looks through the initial rise in consumer prices. Higher inflation reduces consumer spending power, leading to lower real consumption in both scenarios. We assume nominal consumption is broadly unaffected;
- higher inflation increases debt interest costs and overall spending in the later years, which is linked to the general inflation in the economy. This impact is larger in scenario two, where there is greater and more prolonged pass through of import prices to consumer prices;
- demand for imports falls due to higher import prices and lower real consumption, but this is somewhat offset by greater demand for imported materials by exporters;
- nominal GDP growth is higher than in our central forecast, as the nominal value of exports increases. The export share of expenditure therefore rises relative to the consumer share. As consumption is relatively more tax rich, this implies a small structural hit to the public finances, more discernible in scenario one which prompts a larger rebalancing;
- scenario one also prompts a stronger rebound in real GDP growth, as export volumes rise to a greater extent, leading to less spare capacity than in our central forecast. Conversely in scenario two a temporary boost in exports is outweighed by weaker consumption, as a more prolonged rise in prices continues to bear down on incomes. Under that scenario, the degree of spare capacity at the end of the forecast horizon is largely unchanged; and
- under either scenario the supplementary target continues to be missed, as net debt rises as a share of GDP in 2015-16 by a similar amount as in our central forecast. In scenario one there is less cyclical borrowing, but slightly more structural borrowing due to the less tax-rich composition of GDP. So the margin by which the fiscal mandate is met in 2017-18 is therefore slightly smaller. In scenario

two the mandate is met with the same margin for error as in our central forecast.

8.41 Table 5.7 summarises the economic assumptions we have made, as well as the fiscal consequences of these alternative scenarios. It shows that under either scenario, the fiscal mandate would continue to be met and the supplementary target would continue to be breached.

Table 8.7: Key economic and fiscal aggregates under alternative scenarios

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Central forecast						
Economic assumptions						
GDP (percentage change)	0.2	0.8	2.0	2.4	2.7	2.8
CPI inflation (Q3)	2.4	2.9	2.3	2.1	2.0	2.0
ILO unemployment (% rate)	7.9	8.0	8.0	7.8	7.3	6.8
Output gap	-2.9	-3.7	-3.6	-3.3	-2.7	-2.1
Fiscal impact (per cent of GDP)						
Public sector net borrowing	5.6	6.8	5.9	5.0	3.4	2.2
Cyclically-adjusted current budget	-4.0	-2.8	-1.7	-1.2	0.1	0.8
Public sector net debt	75.9	79.2	82.6	85.1	85.6	84.8
Depreciation scenario one						
Economic assumptions						
GDP (percentage change)	0.2	1.1	2.1	2.5	2.9	3.0
CPI inflation (Q3)	2.4	3.0	3.3	2.6	2.2	2.1
ILO unemployment (% rate)	7.9	7.9	7.9	7.6	7.0	6.4
Output gap	-2.9	-3.5	-3.2	-2.8	-2.1	-1.4
Fiscal impact (per cent of GDP)						
Public sector net borrowing	5.6	6.6	5.7	4.8	3.1	1.9
Cyclically-adjusted current budget	-4.0	-2.8	-1.7	-1.3	-0.1	0.5
Public sector net debt	75.9	79.0	82.3	84.6	85.0	83.7
Depreciation scenario two						
Economic assumptions						
GDP (percentage change)	0.2	1.0	1.9	2.3	2.6	2.8
CPI inflation (Q3)	2.4	3.0	3.4	2.9	2.6	2.4
ILO unemployment (% rate)	7.9	7.9	8.0	7.8	7.4	6.8
Output gap	-2.9	-3.5	-3.5	-3.3	-2.8	-2.3
Fiscal impact (per cent of GDP)						
Public sector net borrowing	5.6	6.6	5.7	5.0	3.4	2.2
Cyclically-adjusted current budget	-4.0	-2.7	-1.7	-1.2	0.1	0.8
Public sector net debt	75.9	79.0	82.4	84.9	85.4	84.5

Executive summary

- 5 In the *Fiscal sustainability report (FSR)* we look beyond the medium-term forecast horizon of our twice-yearly *Economic and fiscal outlooks* and ask whether the UK's public finances are likely to be sustainable over the longer term.
- 6 In doing so our approach is twofold:
 - first, we look at the fiscal impact of past government activity, as reflected in the assets and liabilities on the public sector's balance sheet; and
 - second, we look at the potential fiscal impact of future government activity, by making 50-year projections of all public spending, revenues and significant financial transactions, such as government loans to students.
- 7 These projections suggest that the public finances are likely to come under pressure over the longer term, primarily as a result of an ageing population. Under our definition of unchanged policy, the Government would end up having to spend more as a share of national income on age-related items such as pensions and health care. But the same demographic trends would leave government revenues roughly stable as a share of national income.
- 8 In the absence of offsetting tax increases or spending cuts this would widen budget deficits over time and eventually put public sector net debt on an unsustainable upward trajectory. It is likely that such a path would lead to lower long-term economic growth and higher interest rates, exacerbating the fiscal problem. The UK, it should be said, is far from unique in facing such pressures.
- 9 Separate from our central projections, we also update our work on non-demographic trends that are likely to reduce revenue from sources such as North Sea oil as a share of national income. Corporation tax and VAT receipts could also come under pressure from globalisation. So governments would be likely to need some replacement sources of revenue just to keep the tax burden constant, let alone to meet the costs of an ageing population.

- 10 Long-term projections such as these are highly uncertain and the results we present here should be seen as broad-brush illustrations rather than precise forecasts. We illustrate some of the uncertainties around them through sensitivity analyses – by varying key assumptions regarding demographic trends, whole economy and health sector productivity growth, and the position of the public finances at the end of our medium-term forecast horizon.
- 11 It is important to emphasise that we focus here on the additional fiscal tightening that might be necessary beyond our medium-term forecast horizon. The report should not be taken to imply that the substantial fiscal consolidation already in the pipeline for the next five years should be made even bigger over that period.
- 12 But policymakers and would-be policymakers should certainly think carefully about the long-term consequences of any policies they introduce or propose in the short term. And they should give thought too to the policy choices that will confront them once the current crisis-driven consolidation is complete.

Public sector balance sheets

- 13 We assess the fiscal impact of past government activity by looking at measures of assets and liabilities in different presentations of the public sector balance sheet. We draw on National Accounts balance sheet measures and on the 2010-11 Whole of Government Accounts (WGA), which the Treasury is publishing alongside this report in unaudited summary form.
- 14 The current and previous governments have both set targets for the National Accounts measure of public sector net debt (PSND) – the difference between the public sector's liabilities and its liquid financial assets. In March 2012, PSND stood at £1023 billion, 66.1 per cent of GDP or £38,960 per household. Public sector net worth (PSNW) is a broader measure, which also includes physical and illiquid financial assets. At the end of 2010, PSNW stood at minus £155 million, 0.0 per cent of GDP or minus £6 per household. The Treasury has never used PSNW as a target as reliable estimates of physical assets are hard to construct.
- 15 The medium-term outlook for PSND and PSNW has deteriorated since last year's *FSR*. The expected peak in PSND has risen by 5.8 per cent of GDP to 76.3 per cent of GDP in 2014-15, while the expected trough in PSNW has fallen by 12.3 per cent of GDP to -21.1 per cent of GDP in 2014-15.

The deterioration in PSNW is larger because of a difference in the way that liabilities are valued.

- 16 Commentators often criticise the use of PSND as an indicator of fiscal health (and the same criticisms would apply to PSNW) as it excludes future liabilities arising from past government action, for example payments to Private Finance Initiative (PFI) providers and the accrued rights to pension payments built up over the past by public sector workers.
- 17 More information on future and potential liabilities arising from past government action is available in the WGA. These are produced using commercial accounting rules and they have somewhat broader coverage than PSND and PSNW, both in the accounts themselves and in the accompanying notes.
- 18 According to the unaudited WGA:
 - the net present value of future **public service pension payments** arising from past employment was £960 billion or 63.8 per cent of GDP at the end of March 2011. This is £175 billion lower than was reported for the end of March 2010 in last year's *FSR*. The bulk of the difference – almost £126 billion – was due to the Government's decision in 2010 to uprate public sector pension payments by the CPI measure of inflation rather than the RPI. An increase in the real discount rate used to value the liability accounted for a further £69 billion of the decline. This illustrates the sensitivity of such net present value calculations to the choice of discount rate;
 - the total capital liabilities in WGA arising from **Private Finance Initiative** contracts were around £32 billion, up from £28 billion at the end of March 2010. (Only £5 billion of these were on the public sector balance sheet in the National Accounts and therefore included in PSND and PSNW). If all investment undertaken through PFI had been undertaken through conventional debt finance, PSND would be around 2.1 per cent of GDP higher than currently measured – little changed from last year;
 - there were £108 billion (7.2 per cent of GDP) in **provisions** at the end of March 2011 for future costs that are expected (but not certain) to arise, most significantly the hard to predict costs of nuclear decommissioning. Total provisions have risen by £6 billion since last year's WGA. This reflects the fact that roughly £24 billion of new provisions were added, £12 billion were used during the year (less

than the £15 billion expected last year) and £6 billion were removed from future years as deemed unnecessary; and

- there were also £50 billion (3.3 per cent of GDP) of quantifiable **contingent liabilities** – costs that could arise in the future, but where the probability of them doing so is estimated as less than 50 percent. These previously included £165 billion for the Treasury’s guarantee of the Bank of England’s Special Liquidity Scheme. But the boundary of the WGA has been widened this year to include the Bank of England, so this liability has been consolidated out (and the scheme has also subsequently been closed). On a comparable basis, other contingent liabilities increased by £8 billion over the year to almost £50 billion at the end of March 2011, partly as a result of a £4 billion increase in tax payments being challenged in the courts. Contingent liabilities appear in the notes to the WGA, not its balance sheet.

- 19 Overall gross liabilities were £58 billion lower than in 2009-10 WGA at £2,422 billion on a comparable basis. This is largely the result of the £175 billion fall in the estimated net public service pension liabilities, partly offset by a £126 billion increase in the liability for government borrowing and financing. This includes the borrowing needed to finance the 2010-11 net deficit of £106 billion.
- 20 Unlike PSND, the WGA balance sheet also includes the value of tangible and intangible fixed assets, estimated at £757 billion or 50.3 percent of GDP in March 2011. These have reduced by £8 billion since last year’s WGA. The overall net liability in the WGA – total gross liabilities minus total gross assets – was £1,195 billion or 79.5 per cent of GDP at end-March 2011. This compares to PSND of £1,023 billion or 66.1 per cent of GDP at the same date and to a WGA net liability of £1,227 billion or 84.6 per cent of GDP at end March 2010.
- 21 There are significant limits to what public sector balance sheets alone can tell us about fiscal sustainability. For one thing, there is the sensitivity of balance sheet measures to the choice of – and movements in – the discount rate. We cannot easily quantify how much difference the choice of discount rates makes in aggregate, as the different accounts consolidated into the WGA use a variety of different discount rates according to their own accounting rules.
- 22 More fundamentally, balance sheet measures look only at past government activity. They do not include the present value of future spending that we know future governments will wish to undertake, for

example on health, education and pension provision. And, just as importantly, they exclude the public sector's most valuable financial asset – its ability to levy future taxes. This means that we should not overstate the significance of the fact that PSND and the WGA balance sheet both show the public sector's liabilities outstripping its assets, or that our latest *EFO* forecast shows PSNW turning negative from 2010 onwards.

Long-term projections

- 23 We assess the potential fiscal impact of future government activity by making long-term projections of government revenue, spending and financial transactions on an assumption of 'unchanged policy', as best we can define it. In doing so we assume that spending and revenues initially evolve over the next five years as we forecast in our March 2012 *EFO*. This allows us to focus on long-term trends rather than making revisions to the medium-term forecast.

Demographic and economic assumptions

- 24 Demographic change is a key long-term pressure on the public finances. Like many developed nations, the UK is projected to have an 'ageing population' over the next few decades. This reflects increasing life expectancy, declining fertility, and the 'demographic bulge' created by the post-war 'baby boom'.
- 25 We base our analysis on projections of the UK population produced by the Office for National Statistics (ONS) every two years. This year's *FSR* incorporates a new set of 2010-based population projections. Compared to the 2008-based projections we used last year, they project somewhat greater inward migration, slightly lower life expectancy for today's elderly and slightly higher life expectancy for future newborns – together leading over time to a larger population.
- 26 Notwithstanding these changes, the overall nature of the demographic challenge has not changed significantly since last year's *FSR*. Under the ONS scenario that we use for our central projection, the proportion of the population aged 65 and above rises from 17 per cent in 2012 to roughly 26 per cent in 2061, and net inward migration flows average roughly half the rate seen in recent years. But to test the sensitivity of our results to these assumptions, we also examine various alternative scenarios with different estimates of ageing and migration flows.
- 27 As regards the economy, we assume in our central projection that whole economy productivity growth will average 2.2 per cent a year on an

output per worker basis, in line with the average rate over the past 50 years. But we also run alternative scenarios with productivity growth averaging 1.7 and 2.7 percent. We assume CPI inflation of 2 per cent (in line with the Bank of England's target) and a long-term GDP deflator inflation rate of 2.5 per cent. Our long-term projection for nominal GDP growth is consequently unchanged from last year.

Defining 'unchanged' policy

- 28 Fiscal sustainability analysis is designed to identify whether and when changes in government policy may be necessary to move the public finances from an unsustainable to a sustainable path. To make this judgement, it is necessary to define what we mean by 'unchanged' policy in our long-term projections.
- 29 Government policy is rarely clearly defined over the long term. And, in many cases, simply assuming that a stated medium-term policy continues for 50 years would lead to an unrealistic outcome. Where policy is not clearly defined over the long term, the *Charter for Budget Responsibility* allows us to make appropriate assumptions. These are set out clearly in the report. Consistent with the *Charter*, we only include the impact of policy announcements in our central projections when they can be quantified with "reasonable accuracy".
- 30 In our central projections, we assume that beyond 2016-17 underlying spending on public services, such as health, rises in line with per capita GDP. But health care is relatively labour intensive, so we might expect productivity growth in the sector to lag the rest of economy even though wages have to keep up. This implies that if we were to define unchanged policy as keeping health sector output growing at the same rate as the economy, governments would need to spend an increasing share of GDP. We illustrate the impact of this assumption.

Results of our projections

- 31 Having defined unchanged policy we apply our demographic and economic assumptions to project spending and revenue streams over the next fifty years.

Expenditure

- 32 Population ageing will put upward pressure on public spending. In our central projection, spending other than on debt interest rises from 35.6 per cent of GDP at the end of our medium-term forecast in 2016-17 to

40.8 per cent of GDP by 2061-62, an increase of 5.2 per cent of GDP or £80 billion in today's terms.

- 33 The main drivers are upward pressures on key items of age-related spending:
- **health spending** rises from 6.8 per cent of GDP in 2016-17 to 9.1 per cent of GDP in 2061-62, rising smoothly as the population ages. If health care spending per capita was to rise by 3.6 per cent a year in real terms, to reflect possible lower productivity growth as explained above, this could increase spending by a further 7.5 per cent of GDP by 2061-62;
 - **state pension costs** increase from 5.6 per cent of GDP to 8.3 per cent of GDP as the population structure ages and State Second Pension entitlements mature. We assume that the 'triple guarantee' means that the value of the Basic State Pension rises by earnings growth plus 0.26 percentage points a year. This alone increases its cost by 0.6 per cent of GDP by 2061-62; and
 - **social care costs** rise from 1.1 per cent of GDP in 2016-17 to 2 per cent of GDP in 2061-62. The broad trend is in line with projections on unchanged policy published by the Commission on the Funding of Care and Support in 2011, although the results are not directly comparable. We have not pre-judged the Government's policy response to the report.
- 34 These increases are partially offset by a fall in **gross public service pension payments** from 2.2 per cent of GDP in 2016-17 to 1.3 per cent in 2061-62. This compares to a fall from 2.0 to 1.5 per cent of GDP in last year's *FSR*. The higher starting point largely reflects a lower medium-term GDP forecast, while the lower end point reflects the cuts in the public sector workforce implied by the additional public spending cuts announced by the Government last November, plus the latest public service pension reforms announced in the same month.
- 35 In this *FSR* we also assess the impact of all the reforms announced by the current Government on the **net cost of public service pension provision** (i.e. including contributions as well as payments). We estimate that the net cost will fall from 1.7 per cent of GDP in 2016-17 to 0.9 per cent in 2061-62, but that the cost in 2061-62 would be 0.6 per cent of GDP bigger without the reforms. The decision to uprate public service pensions by CPI rather than RPI explains 0.4 percentage points of the difference, with the increases to member contributions announced in the 2010 Spending

Review and the November 2011 recommendations in *Good Pensions that Last* each contributing a further 0.1 percentage points.

Revenue

- 36 Demographic factors will have less impact on revenues than on spending. Non-interest revenues are projected to rise from 37.3 per cent of GDP at the end of our medium term forecast in 2016-17 to 38.2 per cent of GDP in 2061-62, an increase of 0.9 per cent of GDP or £14 billion in today's terms. The increase is little changed since last year, although this masks some changes in composition.
- 37 Long-term fiscal sustainability analyses tend to assume that revenues are constant as a share of GDP or (as in our central projection) that they move only in line with demographic changes. But we also include in this report a discussion of non-demographic factors that might affect the size of particular revenue streams over the long term. The key conclusions are:
- various non-demographic factors are likely to put downward pressure on oil and gas revenues and receipts from transport and environmental taxes and tobacco duties. Our latest projections suggest oil and gas revenues falling to around half the level we projected last year by 2040-41, but the reduction is small as a share of GDP - from 0.1 to 0.05 per cent. So our broad conclusion remains as last year: that these factors could reduce the revenue from these taxes by up to 2 per cent of GDP over the next 30 years;
 - global corporation tax rates have been on a declining trend as governments around the world compete to attract mobile profits and capital. If a similar pattern were to persist whilst the UK headline rate remained unchanged, the incentive to draw profits away from the UK would reduce corporation tax receipts over time. If UK rates were to move in line with a declining global average there would be a direct fall in UK corporation tax receipts. But lower corporation tax rates could increase the level of GDP by reducing the cost of capital; we have not included this effect in our modelling; and
 - another possible effect of globalisation has been to reduce the price of tradeable goods relative to other goods and services. Most tradeable goods are subject to the standard rate of VAT, so if international trade were to exert downward pressure on such prices, and households spent relatively less money on such goods as a consequence, VAT receipts would fall modestly as a share of GDP.

- 38 Our analysis of corporation tax and VAT is highly stylised and we do not produce a central estimate of the likely impact on UK tax receipts in the future. But coupled with the analysis of other revenue streams, it does suggest that future governments are likely to need to find replacement streams of revenue merely to hold the tax burden constant, let alone to meet upward pressures on spending.

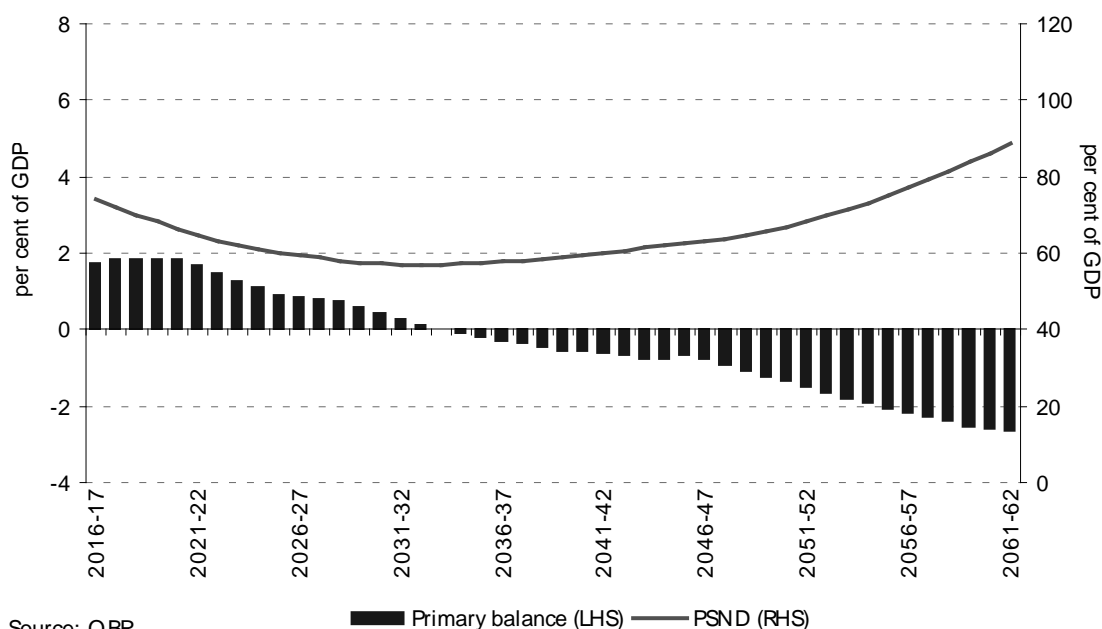
Financial transactions

- 39 In order to move from spending and revenue projections to an assessment of the outlook for public sector net debt, we need also to include the impact of public sector financial transactions. These affect net debt directly.
- 40 For the majority of financial transactions, we assume that the net effect is zero. One exception is the impact of the student financial support arrangements announced in December 2010. Student loans are projected to increase net debt by a maximum of 5.9 percent of GDP (£91 billion in today's terms) around the early 2030s, falling to 3.7 percent of GDP (£57 billion) by 2061-62 as the value of loan repayments rises relative to the value of new loans made. The profile for student loans is little changed since last year.

Projections of the primary balance and public sector net debt

- 41 Our central projections show public sector revenues increasing as a share of GDP beyond our medium-term forecast horizon, but not as quickly as public spending. As a result, the primary budget balance (the difference between non-interest revenues and spending) is projected to move from a surplus of 1.7 per cent of GDP in 2016-17 to a deficit of 2.6 per cent of GDP in 2061-62 – a deterioration of 4.3 percent of GDP or £65 billion in today's terms, slightly smaller than last year. This is shown in Chart 1.
- 42 Taking this and our projection of financial transactions into account, PSND is projected to fall from 74 per cent of GDP in 2016-17 to a trough of 57 per cent in the mid-2020s, before rising increasingly quickly to reach 89 per cent of GDP in 2061-62. The importance of demographic pressures in driving this increase is evident from that fact that if, instead, the primary balance remained constant beyond 2016-17 PSND would fall to zero by the late 2050s.

Chart 1: Central projection of the primary balance and PSND



- 43 Last year we showed a bigger prospective deterioration, with net debt moving from 69 per cent of GDP at the end of the *EFO* forecast to 107 per cent of GDP in 2060-61. The improvement in the outlook largely reflects the fact that we expect a bigger primary surplus at the end of the *EFO* forecast horizon this year than we did last year. The primary balance is forecast to be 1.7 per cent of GDP in 2016-17 compared with last year's forecast of 1.3 per cent of GDP in 2015-16. The deterioration in the primary balance projected over the subsequent 45 years is also 0.2 per cent of GDP smaller this year than last year.
- 44 The improvement is primarily because the Government has responded to a deterioration in the medium-term outlook for the underlying health of the public finances with additional projected cuts in spending that more than compensate and therefore deliver a stronger primary balance at the end of the *EFO* forecast horizon. You could see this as a contribution to the need for long-term fiscal adjustment we identified last year. But this also underlines how sensitive our projections are to the starting point at the end of the medium term forecast.
- 45 The effects of the ageing population are less likely to change from year to year, and policy adjustments to respond to it are likely to be long-term and incremental. Changes to the population projections since last year have a relatively small impact on our projections over time, eventually reducing pressure on the public finances somewhat.

- 46 Needless to say, there are huge uncertainties around any projections extending this far into the future. And it is therefore important to be aware how sensitive our central projections are to the assumptions that underlie them.
- 47 The eventual increase in PSND would be bigger than in our central projection if long-term interest rates turned out to be higher relative to long-term economic growth, if long-term productivity growth was weaker (as this pulls down receipts, but not those areas of spending linked to prices), or if the age structure of the population was to turn out older than in our central projection.
- 48 Higher net inward migration than in our central projection – closer to the levels we have seen in recent years, for example – would put downward pressure on borrowing and PSND, as net immigrants are more likely to be of working age than the population in general. This effect would reverse over a longer time horizon, when those immigrants who remain in the UK reach old age.
- 49 Under the scenario in which governments respond to relatively weak productivity growth in the health service by increasing underlying health spending per capita by 3.6 per cent a year in real terms, the upward debt trajectory would be much more steep. PSND would be in excess of 200 per cent of GDP by the late 2050s.

Economic feedbacks

- 50 Left unaddressed, persistent fiscal deficits could have a number of negative consequences for the economy, and therefore for fiscal sustainability, that are not captured by our central projections. If fiscal deficits reduce national saving, raise interest rates and ‘crowd out’ investment, this would lead to lower levels of output and a reduction in living standards. Higher levels of debt can also restrict policymakers’ ability to respond to future economic difficulties.
- 51 Persistent deficits should be distinguished from temporary deficits, which can help sustain economic activity when private sector demand is depressed. The short-run effects of current fiscal policy on the economy are captured in our medium-term forecasts. In the longer-term projections in this report, output is assumed to remain at its sustainable trend level from 2017-18 onwards.

Summary indicators of fiscal sustainability

- 52 Our central projections, and several of the variants we calculate, show that on current policy we would expect the budget deficit to widen sufficiently over the long-term to put public sector net debt on a continuously rising trajectory as a share of national income. This is clearly unsustainable.
- 53 Summary indicators of sustainability can be used to illustrate the scale of the challenge more rigorously and to quantify the tax increases and/or spending cuts necessary to return the public finances to different definitions of sustainability.
- 54 Most definitions of fiscal sustainability are built on the concept of solvency – the ability of the government to meet its future obligations. In formal terms the government’s ‘inter-temporal budget constraint’ requires it to raise enough revenue in future to cover all its non-interest spending and also to service and eventually pay off its outstanding debt over an infinite time horizon. Under our central projections, the government would need to increase taxes and/or cut spending permanently by around 2.6 per cent of GDP (£39 billion in today’s terms) from 2017-18 onwards to satisfy the inter-temporal budget constraint. This is a slightly smaller figure than we estimated last year.
- 55 The inter-temporal budget constraint has the attraction of theoretical rigour, but it also has several practical limitations. For this reason sustainability is more often quantified by asking how big a permanent spending cut or tax increase is necessary to move public sector net debt to a particular target level at a particular target date. This is referred to as the ‘fiscal gap’.
- 56 The current Government does not have a long-term target for the debt to GDP ratio. So, for illustration, we calculate the additional fiscal tightening necessary from 2017-18 to return PSND to its roughly pre-crisis level of 40 per cent of GDP in 2061-62, as well as that necessary to keep it at the level we expect at the end of our medium-term forecast, namely 75 per cent of GDP, again in 2061-62.
- 57 Under our central projections, the government would need to implement a permanent tax increase or spending cut of 1.1 per cent of GDP (£17 billion in today’s terms) in 2017-18 to get debt back to 40 per cent and 0.3 per cent of GDP (£5 billion in today’s terms) to have it at 75 per cent.

- 58 These calculations depend significantly on the health of the public finances at the end of our medium-term forecast. If the structural budget balance was 1 per cent of GDP weaker or stronger in 2016-17 than we forecast in the *EFO* (which would imply an underlying deficit that much greater throughout the projection horizon), then the necessary tightening would be bigger or smaller by the same amount.
- 59 The sensitivity factors that we identified in the previous section as posing upward or downward risks to our central projections for PSND similarly pose upward or downward risks to our estimates of fiscal gaps. The most dramatic would be the scenario of annual 3.6 per cent per capita real growth in health spending; this would increase the necessary permanent policy adjustment in 2017-18 to 4.4 per cent of GDP for the 40 per cent target or 3.6 per cent of GDP for the 75 per cent target.
- 60 Governments need not respond to fiscal pressures with a one-off permanent tightening. As an alternative to the tightening of 1.1 per cent of GDP in 2017-18 necessary to meet the 40 per cent target, governments could opt for a series of tax increases or spending cuts worth an additional 0.4 per cent of GDP each decade. A more gradual (but ultimately larger) adjustment would mean a smaller fall in the debt to GDP ratio in the early years before PSND stabilises around the target level.

A

Fiscal impact of policy decisions

A.1 Since the last Convergence Programme, the Government has made a number of tax and spend policy announcements. These have been published in Autumn Statement 2012 and Budget 2013.

Autumn Statement 2012

A.2 The Government announced a number of tax and spending measures in Autumn Statement 2012, these are set out in Table A.1. The estimated direct fiscal impact of these measures was based on the Office for Budget Responsibility's (OBR) economic and fiscal forecast in November 2012, published alongside the Autumn Statement.

Budget 2013

A.3 In March 2013, the Government announced a number of tax and spending measures, set out in Table A.2. The estimated direct fiscal impact of these measures was based on the OBR's latest economic and fiscal forecast published alongside Budget 2013.

A.4 Budget 2013 also set out an updated estimate of the fiscal impact of previously announced measures at or before the publication of Autumn Statement 2012 which will take effect from April 2013 or later, based on the OBR's latest forecast. These are set out in Table A.3.

Table A.1: Autumn Statement 2012 policy decisions^{1,2}

	Head	£ million						
		2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	
Departmental Spending and Future Consolidation								
1	Reduction in departmental spending in 2013-14 and 2014-15	Spend	0	+980	+2,400	+2,400	+2,400	+2,400
2	Special Reserve	Spend	+650	0	0	0	0	0
3	Official Development Assistance: adjusting to meet 0.7% GNI target	Spend	+215	+250	+430	+515	+615	+870
4	Council tax: freeze	Spend	0	-270	-270	0	0	0
5	Fiscal consolidation in 2017-18	Spend	0	0	0	0	0	+4,635
6	Capital spending package	Spend	-70	-2,340	-3,045	-	-	-
Growth and Enterprise								
7	4G spectrum sale	Spend	+3,500	0	0	0	0	0
8	Corporation tax: decrease main rate to 21% from 2014-15	Tax	0	-10	-415	-785	-875	-875
9	Annual investment allowance: 2 year temporary increase to £250,000	Tax	-305	-670	-910	-400	+300	+235
10	Business rates: empty property relief	Tax	0	-10	-55	-50	-30	-5
11	Business rates: small business relief extension	Tax	0	-475	+50	0	0	0
12	Cash basis for small businesses	Tax	0	0	-165	+25	-5	*
13	North Sea oil and gas	Tax	-10	-60	-120	-175	-145	-75
14	Capital gains tax relief: employee shareholder status	Tax	0	0	0	*	-20	-80
15	High end television: tax relief	Spend	0	-5	-25	-45	-60	-70
Personal Allowance								
16	Personal allowance: increase by an additional £235 to £9,440 in 2013-14, with equal gains to higher rate taxpayers	Tax	0	-1,000	-1,110	-1,110	-660	-580
Motoring								
17	Fuel duty: cancel January 2013 increase deferred from 2012 and delay future increases to September	Tax	-890	-1,640	-1,625	-1,715	-1,420	-1,465
18	Funding from underspends in 2012-13 through reduced reserve	Spend	+555	0	0	0	0	0
1 per cent Uprating								
19	Working age discretionary benefits and tax credits: increase by 1% for three years from 2013-14	Spend	0	+505	+1,430	+2,280	+2,445	+2,555
20	Child Benefit: increase by 1% for two years from 2014-15	Spend	0	0	+175	+285	+310	+330
21	Housing Benefit: increase Local Housing Allowance by 1% for two years from 2014-15 with provision for high rent areas	Spend	0	0	+105	+225	+245	+260
22	Universal Credit: finalise disregards and increase by 1% for two years from 2014-15	Spend	0	0	+170	+640	+1,000	+1,235
23	Higher rate threshold: index by 1% for two years from 2014-15	Tax	0	0	+295	+875	+1,105	+1,085
24	Inheritance tax: increase nil rate threshold by 1% in 2015-16	Tax	0	0	0	+15	+30	+35
25	Capital gains tax: increase annual exempt amount by 1% for two years from 2014-15	Tax	0	0	0	+5	+5	+5

Other welfare							
26 Support for Mortgage Interest: extension	Spend	-10	-95	-90	-20	0	0
27 New Enterprise Allowance: day one access	Spend	+5	-10	0	0	0	0
28 Tax Credits: error and fraud	Spend	0	0	+315	+185	+85	*
29 Tax Credits: recovering debt	Spend	+5	+80	+205	+125	+105	+90
Avoidance							
30 Tax repatriation from Switzerland	Tax	+330	+3,120	+610	+920	+180	+150
31 HMRC: anti avoidance	Tax	+15	+200	+95	+330	+385	+355
32 HMRC investment	Spend	-10	-80	-25	0	0	0
Other tax							
33 Pensions: restrict tax relief	Tax	+50	+200	+300	+600	+1,000	+1,125
34 Bank Levy	Tax	0	+515	+545	+540	+545	+545
35 VAT: amendments	Tax	-35	-65	-70	-70	-80	-80
36 Carbon Reduction Commitment	Tax	-25	-25	-25	0	+30	+65
37 Gift Aid Small Donation Scheme: amendments	Spend	0	-10	-15	-10	-20	-30
38 Amendments to cap on income tax reliefs	Tax	0	0	-80	-60	-65	-65
TOTAL POLICY DECISIONS		+3,970	-910	-920	-905	+295	+4,940
Total spending policy decisions		+4,840	-1,090	+1,465	0	0	+4,635
of which current spending	Spend	+1,360	+1,170	+4,415	+6,435	+7,100	+7,705
of which welfare ³	Spend	0	+430	+2,165	+3,635	+4,175	+4,500
of which changes to capital spending ⁴	Spend	+3,480	-2,260	-2,950	–	–	–
Total tax policy decisions	Tax	-870	+180	-2,385	-905	+295	+305

* Negligible.

– Capital spending measures do not affect borrowing in 2015-16, 2016-17 and 2017-18 as they fall within the Total Managed Expenditure (TME) assumption.

¹ Costings reflect the Office of Budget Responsibility's (OBR) latest economic and fiscal determinants.

² Italicised spending numbers do not affect borrowing in 2015-16, 2016-17 and 2017-18 as they fall within the TME assumption.

³ There is a tax element of the welfare package that is not included in these numbers, for example on Child Benefit and tax credits.

⁴ 4G spectrum sale will be a capital receipt.

Table A.2: Budget 2013 policy decisions¹

	Head	£ million				
		2013-14	2014-15	2015-16	2016-17	2017-18
Previously announced (smaller measures)						
1 Carbon Reduction Commitment: exclude schools	Tax	0	0	-65	-65	-65
2 Government response to OTS review of share schemes	Tax	-40	-45	-50	-55	-55
3 Carbon price floor: Northern Ireland exemption	Tax	-20	-25	-40	-45	-45
4 Annual charge and SDLT 15% rate: reliefs for commercial businesses	Tax	-30	-40	-40	-40	-45
5 Capital Gains Tax on disposals of high value residential property: extension to UK non-natural persons	Tax	+25	0	0	+5	+5
6 Universal Credit: exempt from income tax	Tax	0	0	-35	-35	-30
7 Debt Cap: tightening of rules	Tax	+50	+60	+50	+35	+30
8 Building Societies: capital instruments	Tax	+20	+20	+20	+20	+30
9 Employee shareholder status: CGT changes	Tax	0	0	*	+5	+30
10 Enterprise Management Incentive: qualification for CGT entrepreneurs' relief	Tax	-10	-15	-20	-25	-25
11 Lorry road user levy and offsetting VED reduction	Tax	0	+25	+25	+25	+25
12 Income tax: transfer of assets abroad	Tax	0	0	-10	-10	-10
13 Cap on reliefs: exemption for EIS share loss relief and overlap relief	Tax	0	-20	-10	-10	-10
14 Carbon price floor: non rate changes	Tax	+5	+5	+5	+5	+5
15 Disincorporation relief	Tax	-10	-5	-5	-5	-5
16 Vehicle Excise Duty: PIP disability exemption	Tax	-10	-10	-10	-5	0
17 Pension Credit pass through	Spend	+5	+5	+5	+5	*
Previously announced (Mid Term Review)						
Single Tier: introduce from 2016-17:						
18 Contracting out NICs: public sector employers	Tax	0	0	0	+3,325	+3,285
19 Contracting out NICs: public sector employees	Tax	0	0	0	+1,365	+1,350
20 Contracting out NICs: private sector employers	Tax	0	0	0	+570	+565
21 Contracting out NICs: private sector employees	Tax	0	0	0	+235	+235
Other Mid Term Review:						
22 Inheritance tax: threshold freeze for 3 years from 2015-16	Tax	0	0	+20	+80	+170
23 Social Care funding reform: introduce Dilnot cap from 2016-17	Spend	0	0	0	-1,000	-1,000
24 Childcare additional funding ²	Spend	0	0	-400	-750	-750
Growth and Enterprise						
25 National Insurance: £2,000 Employment Allowance	Tax	0	-1,255	-1,370	-1,595	-1,725
26 Corporation tax: reduce main rate to 20% from 2015-16	Tax	0	-5	-400	-785	-865
27 Capital Spending: maintain 2014-15 level	Spend	0	0	-3,000	-3,000	-3,000
28 Affordable housing	Spend	0	-125	0	0	0
29 Right to Buy changes	Spend	-5	+45	+40	+50	+50
30 Stamp duty: abolish schedule 19 charge	Tax	0	-145	-145	-150	-160
31 Abolishing stamp duty on AIM and other junior shares	Tax	+5	-170	-170	-170	-175
32 Seed Enterprise Investment Scheme: extend CGT holiday to 2013-14	Tax	0	-5	*	0	0
33 Employee shareholder status: income tax	Tax	0	-15	-45	-65	-75
34 R&D Tax Credits: increase Above the Line credit to 10%	Spend	-20	-80	-85	-90	-95

35 Employee ownership: additional support	Spend	0	-50	-50	-50	-50
36 Industrial Strategy	Spend	-125	-160	-180	-180	-180
37 Growth vouchers	Spend	-10	-25	0	0	0
38 Tax relief: health interventions	Tax	0	-10	-10	-10	-10
39 Health interventions	Spend	0	+10	+10	+10	+15
40 Bank Levy (including offsetting CT changes)	Tax	0	+195	+250	+245	+250
Personal Tax						
41 Personal allowance: increase by an additional £560 to £10,000 in 2014-15	Tax	0	-1,075	-1,045	-1,060	-1,210
42 Pensions tax relief: individual protection	Tax	0	+100	+80	+50	0
Duties						
43 Fuel Duty: cancel September 2013 increase	Tax	-480	-810	-835	-870	-900
44 Alcohol: 1p off pint of beer and abolish escalator in 2014-15	Tax	-170	-215	-210	-205	-205
Avoidance and Debt		+395	+1,025	+1,395	+1,075	+1,020
45 Tax repatriation from Jersey, Guernsey, and Isle of Man	Tax	+80	+240	+325	+235	+170
46 Offshore employment intermediaries	Tax	0	+80	+85	+85	+90
47 Partnerships	Tax	0	+125	+365	+300	+285
48 Corporation Tax: losses	Tax	+260	+305	+270	+205	+190
49 Loans from close companies to participators	Tax	0	+65	+75	+70	+60
50 IHT: limiting deduction of liabilities	Tax	+5	+20	+15	+15	+15
51 General Anti-Abuse Rule: non revenue protection	Tax	0	+60	+50	+40	+85
52 Stamp Duty Land Tax: subsales	Tax	+45	+35	+30	+25	+25
53 Debt: improving coding out	Tax	0	0	+45	+40	+45
54 Avoidance schemes: enhanced information powers	Tax	0	+5	+35	+35	+35
55 Penalties in avoidance cases	Tax	0	+55	+60	+5	+10
Motoring and Environment						
56 Capital allowances: Ultra Low Emission Vehicles	Tax	0	0	-5	-25	-35
57 Company car tax: ULEVs	Tax	0	0	-10	-15	-15
58 VED: freeze rates for HGVs in 2013-14	Tax	-10	-10	-10	-10	-10
59 Aggregates levy: freeze in 2013-14	Tax	-10	-15	-15	-15	-15
60 Capital allowances: energy and water efficient technologies	Tax	+5	+15	+25	+30	+20
61 Capital allowances: energy saving plant & machinery in Northern Ireland	Tax	0	+5	+5	+10	+10
Changes to spending forecasts						
62 Spending total adjustment	Spend	+1,325	+1,085	0	0	0
63 Official Development Assistance: adjusting to meet 0.7% GNI target	Spend	+135	+165	+200	+250	+305
64 Special Reserve	Spend	+300	0	0	0	0
65 Equitable life	Spend	0	-45	0	0	0
TOTAL POLICY DECISIONS		+1,315	-1,650	-2,850	+1,740	+1,305
Total spending policy decisions		+1,605	+1,055	0	0	0
Total tax policy decisions		-290	-2,705	-2,850	+1,740	+1,305
Total tax policy decisions excluding impact on Government departments		-290	-2,705	-2,850	-1,585	-1,980
Financial transactions ³ :						
Help to Buy extension		-1,150	-1,430	-1,550	0	0
Build to Rent extension		-150	-445	-360	0	0

¹ Negligible.

² Spending measures do not affect borrowing in 2015-16, 2016-17 and 2017-18 as they fall within the Total Managed Expenditure assumption.

³ Costings reflect the OBR's latest economic and fiscal determinants.

⁴ Additional funding for childcare will start in Autumn 2015. The Government is allocating £750m per annum for this support.

⁵ Financial transactions impact on PSND and not PSNB so do not feed through to the bottom line.

Table A.3: Measures announced at Autumn Statement 2012 or earlier which take effect from April 2013 or later¹

	Head	£ million					
		2013-14	2014-15	2015-16	2016-17	2017-18	
Measures announced at Autumn Statement 2012							
a	Corporation tax: decrease main rate to 21% from 2014-15	Tax	-5	-370	-705	-790	-825
b	Business rates: empty property relief	Tax	-10	-55	-50	-30	-5
c	Business rates: small business relief extension	Tax	-475	+40	+5	0	0
d	Cash basis for small businesses	Tax	0	-165	+25	-5	*
e	Capital gains tax (CGT) relief: employee shareholder status	Tax	0	0	*	-15	-75
f	High end television: tax relief	Spend	-5	-25	-45	-60	-65
g	Personal allowance: increase by an additional £235 to £9,440 in 2013-14, with equal gains to higher rate taxpayers	Tax	-995	-1,140	-1,155	-655	-570
h	Working age discretionary benefits and tax credits: increase by 1% for three years from 2013-14	Spend	+515	+1,685	+2,680	+2,835	+2,935
i	Child Benefit: increase by 1% for two years from 2014-15	Spend	0	+220	+360	+360	+380
j	Housing Benefit: increase Local Housing Allowance by 1% for two years from 2014-15 with provision to high rent areas	Spend	0	+135	+280	+335	+375
k	Universal Credit impact of work allowance measure and increase by 1% for two years from 2014-15	Spend	0	+170	+680	+1,030	+1,215
l	Higher rate threshold: index by 1% for two years from 2014-15	Tax	0	+350	+960	+1,235	+1,260
m	Inheritance tax: increase nil rate threshold by 1% in 2015-16	Tax	0	0	+20	+40	+45
n	CGT: increase annual exempt amount by 1% for two years from 2014-15	Tax	0	0	+10	+15	+15
o	Tax credits: error and fraud	Spend	0	+315	+185	+85	*
p	Pensions: restrict tax relief	Tax	+200	+300	+600	+1,000	+1,125
q	Gift Aid Small Donation Scheme: amendments	Spend	-10	-15	-10	-20	-30
r	Amendments to cap on Income Tax reliefs	Tax	0	-85	-65	-70	-75
Measures announced at Budget 2012							
s	Personal allowance: increase by £1,100 in 2013-14, with a proportion passed to higher rate tax payers	Tax	-3,465	-3,700	-3,720	-3,875	-3,240
t	Income tax: reduce additional rate to 45p in 2013-14	Tax	-60	-110	-110	-120	-140
u	Income tax: cap on unlimited tax reliefs	Tax	*	+385	+245	+275	+290
v	Stamp Duty Land Tax: avoidance on residential property and associated CGT changes	Tax	+75	+75	+80	+90	+100
w	Corporation tax: decrease main rate to 24% in 2012-13, 23% in 2013-14 and 22% from 2014-15	Tax	-695	-740	-765	-815	-850
x	R&D Tax Credits: Above the Line	Spend	-10	-240	-165	-165	-170
y	Video games and animation: tax relief	Spend	-15	-50	-50	-55	-55
z	North Sea oil & gas: decommissioning certainty	Tax	+140	+425	+365	+330	+480
aa	Climate change levy: levy exemption certificates removal	Tax	+120	+125	+150	+165	+185
ab	Carbon Price Floor: combined heat and power relief and other changes	Tax	-65	-105	-170	-200	-240
ac	Company car tax	Tax	0	+125	+405	+375	+395
ad	Capital allowances: company cars	Tax	*	+25	+125	+225	+215
ae	Age-related allowances: freeze amount and restrict to existing receipts from 6 April 2013	Tax	+315	+700	+1,040	+1,280	+1,520
af	IHT: spouse relief	Tax	*	-5	-5	-5	-5
ag	Local authorities: Tax Increment Financing	Spend	-20	-20	-	-	-

ah	Transfer of assets	Tax	*	*	*	*	*
ai	Insurance tax: Claims Equalisation Reserves	Tax	0	+85	+90	+80	+80
aj	Life assurance premium relief	Tax	0	0	+5	+5	+5
ak	Stamp Duty Land Tax: area based reliefs	Tax	+30	+35	+35	+40	+40
Measures announced at Autumn Statement 2011							
al	Air passenger duty: business jets	Tax	+5	+5	+5	+5	+5
am	Climate change levy: increase electricity tax relief to 90 per cent		-15	-15	-20	-20	-20
Measures announced at Budget 2011							
an	Corporation tax: decrease to 24% in 2013-14 and 23% in 2014-15	Tax	-705	-740	-760	-805	-845
ao	Carbon price floor: introduce from 2013-14 with £30 per tonne of CO ₂ target	Tax	+975	+1,420	+2,025	+2,075	+2,200
ap	Climate change agreements: reform	Tax	-25	-25	-25	-25	-30
aq	Company car tax: adjustment to rates for 2013-14	Tax	+120	+125	+125	+130	+135
ar	VAT: fraud on imported road vehicles	Tax	+110	+100	+95	+90	+85
as	Gift Aid: small donations scheme	Spend	-45	-75	-95	-100	-100
Measures announced at Spending Review 2010							
at	Council Tax Benefit: 10% reduction in expenditure and localisation	Tax	+475	+475	+475	+475	+470
au	Total household benefit payments capped on the basis of average take-home pay for working households from 2013-14	Spend	+110	+185	+185	+185	+185
av	Disability Living Allowance: remove mobility components for claimants in residential care from April 2013	Spend	+155	+160	+160	+160	+165
aw	Child and Working Tax Credits: use real time information	Spend	0	+260	+190	+80	+10
Measures announced at June Budget 2010							
ax	Corporation tax: decrease to 25% in 2013-14 and 24% in 2014-15	Tax	-1,720	-2,500	-2,970	-3,185	-3,335
ay	Basic rate limit: freeze in 2013-14	Tax	+275	+515	+445	+510	+580
az	Disability Living Allowance: reform gateway from 2013-14	Spend	+140	+660	+1,190	+2,000	+2,870
ba	Social sector: limit working age entitlements to reflect size of family from 2013-14	Spend	+465	+465	+465	+470	+470
Measures announced before June Budget 2010							
bb	Alcohol duty: increase in rates in 2013-14 and 2014-15 (March Budget 2010)	Tax	+155	+330	+340	+355	+370
bc	Patent box from 2013-14 (2009 Pre-Budget Report)	Tax	-350	-640	-675	-740	-760
bd	Landfill tax: increase in 2014-15 (2009 Pre-Budget Report)	Tax	0	+65	+60	+60	+60

* Negligible

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

B

Supplementary data tables

B.1 Information provided in these tables is consistent with the OBR's March 2012 *Economic and fiscal outlook* and supplementary tables, unless otherwise noted. The OBR's supplementary tables are available at <http://budgetresponsibility.independent.gov.uk/economic-and-fiscaloutlook-march-2012/>.

Table B.1: Macroeconomic prospects

	Level ¹	Rate of Change					
	2012	2012	2013	2014	2015	2016	2017
Real GDP	1443	0.2	0.6	1.8	2.3	2.7	2.8
Nominal GDP	1539	1.5	2.7	3.8	4.2	4.4	4.6
Components of real GDP							
Private consumption expenditure ²	908	1.0	0.5	1.2	1.7	2.4	2.8
Government consumption expenditure	337	2.6	0.4	-0.7	-0.4	-1.0	-1.8
Gross fixed capital formation	213	1.4	2.2	6.7	8.1	7.7	7.8
Changes in inventories and net acquisition of valuables (% of GDP)	-	-0.2	-0.2	0.0	0.0	0.0	0.0
Exports of goods and services	448	-0.3	1.5	4.4	5.1	5.3	5.3
Imports of goods and services	470	2.0	1.0	3.8	4.4	4.8	4.9
Contributions to real GDP growth							
Final domestic demand	-	1.4	0.7	1.6	2.2	2.5	2.7
Changes in inventories and net acquisition of valuables	-	-0.2	-0.2	0.0	0.0	0.0	0.0
External balance of goods and services	-	-0.8	0.1	0.1	0.1	0.1	0.1

¹Pounds sterling, billion.

²Includes households and non-profit institutions serving households.

Table B.2: Price developments

	Level	Rate of Change					
	2012	2012	2013	2014	2015	2016	2017
GDP deflator	106.7	1.3	2.1	2.0	1.8	1.8	1.7
Private consumption deflator	111.3	2.7	2.9	2.3	2.1	2.0	2.0
HICP	123.0	2.8	2.8	2.4	2.1	2.0	2.0
Public consumption deflator	101.3	-0.5	1.1	1.2	0.4	0.3	0.5
Investment deflator	102.3	0.6	-0.4	1.7	1.8	1.8	1.2
Export price deflator (goods and services)	108.8	-0.8	2.9	0.9	0.8	1.0	1.0
Import price deflator (goods and services)	111.4	-0.6	3.0	0.9	0.5	0.7	0.8

Table B.3: Labour market developments

	Level	Rate of Change					
	2012	2012	2013	2014	2015	2016	2017
Employment, persons (millions) ¹	-	29.5	29.8	29.9	30.1	30.3	30.5
Employment, hours worked ²	939.3	2.0	0.8	0.0	0.2	0.4	0.4
Unemployment rate (%) ³	-	7.9	7.9	8.0	7.9	7.4	6.9
Labour productivity, persons ⁴	48857	-1.1	-0.3	1.5	1.7	1.8	2.0
Labour productivity, hours worked ⁵	29.5	-1.8	-0.1	1.8	2.1	2.3	2.4
Compensation of employees ⁶	837.9	2.7	2.6	2.9	4.2	5.1	4.9
Compensation per employee ⁷	28379	1.4	1.7	2.6	3.6	4.3	4.1

¹All aged 16 and over.

²Millions per week.

³ILO measure, all aged 16 and over.

⁴GDP per worker, pounds sterling.

⁵ GDP per hour, pounds sterling.

⁶ Pounds sterling, billion

⁷Pounds per worker

Table B.4: Sectoral balances

% of GDP		2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Net lending/borrowing vis-à-vis the rest of the world		-1.6	-3.3	-2.3	-1.9	-1.6	-1.4
<i>of which:</i>							
- Balance on goods and services		-2.0	-2.7	-1.9	-1.7	-1.5	-1.4
- Balance of primary incomes and transfers		0.0	-1.1	-0.3	-0.1	-0.2	-0.1
- Capital account		0.2	0.3	0.2	0.2	0.2	0.2

Table B.5: General government budgetary prospects

		£ billion	% of GDP						
			Outturn		Forecast				
			2011-12	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Net lending by sub-sector									
General government ¹		118.2	7.8	5.6	6.8	6	5.2	3.5	2.3
Central government		110.6	7.2	5.7	6.9	6.1	5.2	3.5	2.4
Local government		7.7	0.5	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
General government									
Total revenue		566.9	37.2	37.6	38.0	37.8	37.7	38	37.9
Total expenditure		685.1	44.9	43.2	44.9	43.8	42.8	41.5	40.2
Net borrowing ¹		118.2	7.8	5.6	6.8	6	5.2	3.5	2.3
Interest expenditure		48.2	3.2	3.0	3.2	3.2	3.4	3.6	3.8
Primary balance ²		70.0	4.6	2.6	3.7	2.8	1.8	-0.1	-1.5
Selected components of revenue									
Taxes on production and imports		203.4	13.3	13.5	13.6	13.6	13.6	13.5	13.4
Taxes on income and wealth		198.1	13	12.6	12.5	12.6	12.6	12.9	13.1
Capital taxes		3.0	0.2	0.2	0.4	0.2	0.2	0.2	0.2
Social contributions		101.6	6.7	6.7	6.7	6.5	6.6	7.0	7
Other		60.8	4.0	4.6	4.9	4.8	4.6	4.5	4.2
Total revenue		566.9	37.2	37.6	38	37.8	38	38	37.9
Selected components of expenditure									
Current expenditure on goods and services		338.7	22.2	22.1	21.9	21	20.2	19.1	18.1
Net social benefits		205.9	13.5	14.1	13.9	13.7	13.6	13.4	13.1
Interest expenditure		48.2	3.2	3.0	3.2	3.2	3.4	3.6	3.8
Subsidies		8.5	0.6	0.6	0.6	0.7	0.7	0.7	0.7
Gross fixed capital formation		31.4	2.1	1.8	1.9	2.0	1.9	1.9	1.8
Other		52.4	3.4	1.6	3.4	3.20	3	2.9	2.7
Total expenditure		685.1	44.9	43.2	44.9	43.8	42.8	41.5	40.2

¹Treaty deficit²General government net borrowing less interest expenditure

Table B.6: Breakdown of revenue

	£billion	% of GDP						
	Outturn		Forecast					
	2011-12	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Total revenue at unchanged policies ¹	566.9	37.2	37.6	38.1	38.1	37.9	37.9	37.8
Discretionary revenue measures ²	-	-	-0.06	-0.01	-0.31	-0.22	0.11	0.09

¹ Sum of discretionary revenue measures taken at Autumn Statement 2012 (consistent with the OBR's December 2012 *Economic and fiscal outlook*) and Budget 2013

² General government total revenue less discretionary revenue measures at Autumn Statement 2012 (consistent with the OBR's November 2012 *Economic and fiscal outlook*) and Budget 2013

Table B.7: Central Government expenditure by function^{1,2}

		% of GDP	
		2009-10	2014-15
General public services		3.3%	4.2%
Defence		2.7%	2.1%
Public order and safety		1.2%	0.8%
Economic affairs		2.3%	1.8%
Environmental protection		0.3%	0.3%
Housing and community amenities		0.5%	0.1%
Health		8.3%	8.0%
Recreation, culture and religion		0.5%	0.4%
Education		2.3%	2.2%
Social protection		12.4%	12.5%
Total expenditure		34.5%	33.5%

¹ Consistent with Public Sector Statistical Analyses 2012, HM Treasury July 2012

² On a public sector basis, i.e. General government plus public corporations

Table B.8: General government debt developments

	2010-11 ⁵	% of GDP						
		Outturn	Forecast					
		2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Gross debt ¹	79.9	86.0	90.7	94.9	98.6	100.8	100.8	99.4
Change in gross debt ratio		6.1	4.7	4.2	3.7	2.2	0	-1.4
Contributions to changes in gross debt								
Primary balance ²		5.2	2.6	4.9	4.0	2.8	0.9	-0.7
Interest expenditure		2.7	2.0	1.9	1.9	2.3	2.6	3.0
Stock-flow adjustment ³		0.7	0.2	0.2	1.4	1.0	0.9	0.7
Implicit interest rate on debt ⁴		4.1	3.6	3.6	3.5	3.6	3.7	4.0

¹Treaty debt

²General government net borrowing less interest expenditure

³Change in Treaty debt less general government net borrowing

⁴Interest expenditure as a per cent of Treaty debt in previous year

Table B.9: Cyclical developments

	2010-11 ⁵	% of GDP						
		Outturn	Forecast					
		2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Real GDP growth (%) ¹		0.9	0.2	0.6	1.8	2.3	2.7	2.8
Net borrowing of general government		7.8	5.6	6.8	6.0	5.2	3.5	2.3
Interest expenditure		2.7	2.0	1.9	1.9	2.3	2.6	3.0
Potential GDP growth (%) ¹		-	0.4	1.5	1.9	2.1	2.2	2.2
Output gap ¹		-2.7	-2.9	-3.7	-3.6	-3.3	-2.7	-2.1
Cyclical budgetary component ³		1.9	2.0	2.4	2.6	2.4	2	1.6
Cyclically-adjusted balance		5.9	3.6	4.4	3.4	2.8	1.5	0.7
Cyclically-adjusted primary balance ⁴		3.2	1.6	2.5	1.5	0.5	-1.1	-2.3

¹Expressed in financial rather than calendar years

²A plus sign means deficit-reducing one-off measures.

³Treaty deficit less cyclically-adjusted treaty deficit

⁴Cyclically-adjusted treaty deficit less interest expenditure

Table B.10: Divergence from previous update¹

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Real GDP growth (%)							
Previous update	0.5	0.1	1.5	2.1	2.4	2.7	2.8
Current update	0.7	0.2	0.8	2.0	2.4	2.7	2.8
Difference	0.2	0.1	-0.7	-0.1	0.0	0.0	0.0
Treaty deficit (% GDP)²							
Previous update	7.7	5.2	6.2	5.3	4.3	2.8	1.8
Current update	7.8	5.6	6.8	6.0	5.2	3.5	2.3
Difference	0.1	0.4	0.6	0.7	0.9	0.7	0.5
Treaty debt (% GDP)³							
Previous update	85.8	90.3	93.5	96.3	97.4	96.6	94.4
Current update	86	90.7	94.9	98.6	100.8	100.8	99.4
Difference	0.2	0.4	1.4	2.3	3.4	4.2	5.0

¹ Previous update numbers correspond to the OBR's March 2012 *Economic and fiscal outlook*

² General government net borrowing

³ General government gross debt

Table B.11: Long-term sustainability of public finances¹

	Outturn	% of GDP					
		Forecasts					
		2011-12	2021-22	2031-32	2041-42	2051-52	2060-61
Total expenditure	45.8	39.1	40.2	41.7	42.9	45	45.3
Of which: age-related expenditures	24.1	21.3	22.8	24.2	24.9	26.2	26.3
State pensions	5.7	5.3	6.1	7	7.3	8.2	8.3
Pensioner benefits	1.2	1.1	1.2	1.3	1.2	1.2	1.2
Public service pensions	2.1	2.0	1.7	1.5	1.3	1.3	1.3
Health	8.1	7.1	7.7	8.3	8.7	9	9.1
Long-term care	1.3	1.2	1.5	1.7	1.9	2.0	2.0
Education	5.7	5.3	6.1	7.0	7.3	8.2	8.3
Net interest	3.0	2.5	2.1	2.2	2.5	3.3	3.4
Total revenue	37.5	38.3	38.4	38.9	38.9	39.1	39.2

¹ Consistent with the central projection in the OBR's July 2012 *Fiscal sustainability report*

² Sum of pensions, pensioner benefits, public service pensions, health, long-term care and education

Table B.12: Contingent liabilities¹

£ billion	Year
	2010-11
Total quantifiable contingent liabilities	49.5
<i>Of which: financial stability interventions</i>	9.8

¹ Taken from audited Whole of Governments Accounts- year ended 31 March 2011, HM Treasury, October 2012

Table B.13: Basic assumptions

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Short-term interest rate ¹ (annual average)	1.0	0.7	0.6	0.7	0.9	1.4	2.0
Long-term interest rate ² (annual average)	2.2	1.8	2.4	2.7	3.3	3.6	3.9
Nominal effective exchange rate ³	80.1	82.9	79.3	79.2	79.2	79.2	79.1
Exchange rate vis-à-vis the € (annual average)	1.16	1.23	1.16	1.16	1.16	1.15	1.15
	2011	2012	2013	2014	2015	2017	2016
Oil prices (Brent, USD/barrel)	111	112	113	106	101	97	93
EU GDP growth	1.5	-0.5	-0.5	1	1.3	1.7	1.9
Growth of relevant foreign markets	5.9	1.9	3.4	5.2	5.6	5.7	5.8

¹ 3 month sterling interbank rate (LIBOR)

² Weighted average interest rate on conventional
gilts

³Trade-weighted sterling

HM Treasury contacts

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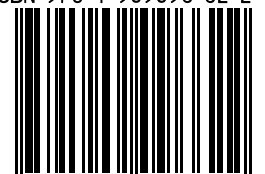
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