

Office for
**Budget
Responsibility**

Economic and fiscal outlook

December 2013



Office for Budget Responsibility: Economic and fiscal outlook

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

December 2013

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Contents

	Foreword.....	1
Chapter 1	Executive summary	
	Overview	5
	Economic developments since our previous forecast	8
	The economic outlook	8
	The fiscal outlook	12
	Performance against the fiscal targets.....	17
Chapter 2	Developments since the last forecast	
	Introduction.....	19
	Economic developments	19
	Fiscal data developments.....	26
	Developments in outside forecasts.....	26
Chapter 3	Economic outlook	
	Introduction	33
	Potential output and the output gap.....	33
	Key economy forecast assumptions.....	39
	The pace of the recovery.....	50
	Prospects for inflation	56
	Prospects for nominal GDP growth	60
	Prospects for individual sectors of the economy	63
	Risks and uncertainties.....	81
	Comparison with external forecasters	82

Chapter 4	Fiscal outlook	
	Introduction	87
	Economic determinants of the fiscal forecast	88
	Policy announcements, risks and classification changes	93
	Public sector receipts	99
	Public sector expenditure	116
	Loans and other financial transactions.....	144
	The key fiscal aggregates.....	151
	International comparisons.....	161
Chapter 5	Performance against the Government’s fiscal targets	
	Introduction	163
	The Government’s fiscal targets	163
	The implications of our central forecast.....	163
	Recognising uncertainty	166
Annex A	Autumn Statement 2013 policy measures	177

Foreword

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

In this *Economic and fiscal outlook (EFO)* we set out forecasts to 2018-19. We also make an updated assessment of whether the Government is on course to meet the medium-term fiscal objectives that it has set itself. The forecasts presented in this document represent the collective view of the three independent members of the OBR's Budget Responsibility Committee (BRC). We take full responsibility for the judgements that underpin them and for the conclusions we have reached.

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

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

- In October, the Treasury requested that we finalise the Autumn Statement forecast on a 'pre-measures' basis (i.e. before incorporating the effect of new policy announcements) around two weeks ahead of the Autumn Statement in order to provide the Chancellor with a stable base for his final policy decisions.
- We began the forecast process with the preparation by OBR staff of a revised economic forecast, drawing on economic data released since the last published forecast in March 2013 and with our preliminary judgements on the outlook for the economy.
- Using the economic determinants from this forecast (such as the components of nominal income and spending, plus inflation and unemployment), we then commissioned new forecasts from the relevant government departments for the various tax and spending streams that in aggregate determine the state of the public finances. We then discussed these in detail with the officials producing them, which allowed us to investigate proposed changes in forecasting methodology and to assess the significance of recent

tax and spending outturns. In many cases, the BRC requested changes to methodology and/or the interpretation of recent data.

- We sent our first economic forecast to the Chancellor on 11 October and our first fiscal forecast, including a provisional judgement on progress towards meeting the fiscal mandate, on 30 October. We provided the Chancellor with these early forecasts and provisional judgement on compliance with the fiscal mandate in order to inform his policy choices for the Autumn Statement.
- As the forecasting process continued, we identified the key judgements that we would have to make in order to generate our full economic forecast. Where we thought it would be helpful, we commissioned analysis from the relevant experts in the Treasury and consulted outside forecasters to help inform our views. The BRC then agreed the key judgements, allowing the production by OBR staff of a second full economic forecast.
- This provided the basis for a further round of fiscal forecasts. Discussion of these forecasts with HMRC, DWP and the other departments gave us the opportunity to follow up the various requests for further analysis, methodological changes and alternative judgements that we made during the previous round. We provided the second round economic and fiscal forecast to the Chancellor on 13 November, and we met with him and Treasury officials to discuss it on 14 November.
- Meanwhile, we also began to scrutinise the costing of tax and spending measures that were being considered for announcement at the Autumn Statement and recosted the measures announced at Spending Round 2013 in June. The OBR requested a number of changes to the draft costings prepared by HMRC, DWP and other departments. We have certified the final published costings for new Autumn Statement policies as reasonable and central estimates. In the Treasury's Autumn Statement 2013 policy costings document, we highlight the uncertainties around a number of the costings.
- We then produced a third economy and fiscal forecast, which allowed us to take on latest data and to ensure that our judgements on the fiscal forecast had been incorporated. We finalised this forecast and sent it to the Chancellor on 21 November.
- During the week before publication we produced our final forecast, incorporating the third quarter GDP data released by the ONS on 27 November and the final package of policy measures. We were provided with final details of all major policy decisions with a potential impact on the economy forecast on 26 November. We provided the Treasury with our final post-measures forecast on 29 November. Our final fiscal forecast included the direct fiscal effects of the full set of Autumn Statement policy decisions, the final version of which was provided to us on 29 November.
- At the Treasury's written request, and in line with pre-release access arrangements for data releases from the ONS, we provided the Chancellor with a full draft of the *EFO* on 29 November. This allowed the Treasury to prepare the Chancellor's statement and documentation. We provided a full and final copy 24 hours in advance of publication.

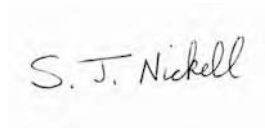
During the forecasting period, the BRC has held around 60 scrutiny and challenge meetings with officials from departments, in addition to numerous further meetings at staff level. We

have been provided with all the information and analysis that we requested. We have come under no pressure from Ministers, advisers or officials to change any of our conclusions as the forecast has progressed. A full log of our substantive contact with Ministers, their offices and special advisers can be found on our website.

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



Robert Chote



Steve Nickell



Graham Parker

The Budget Responsibility Committee

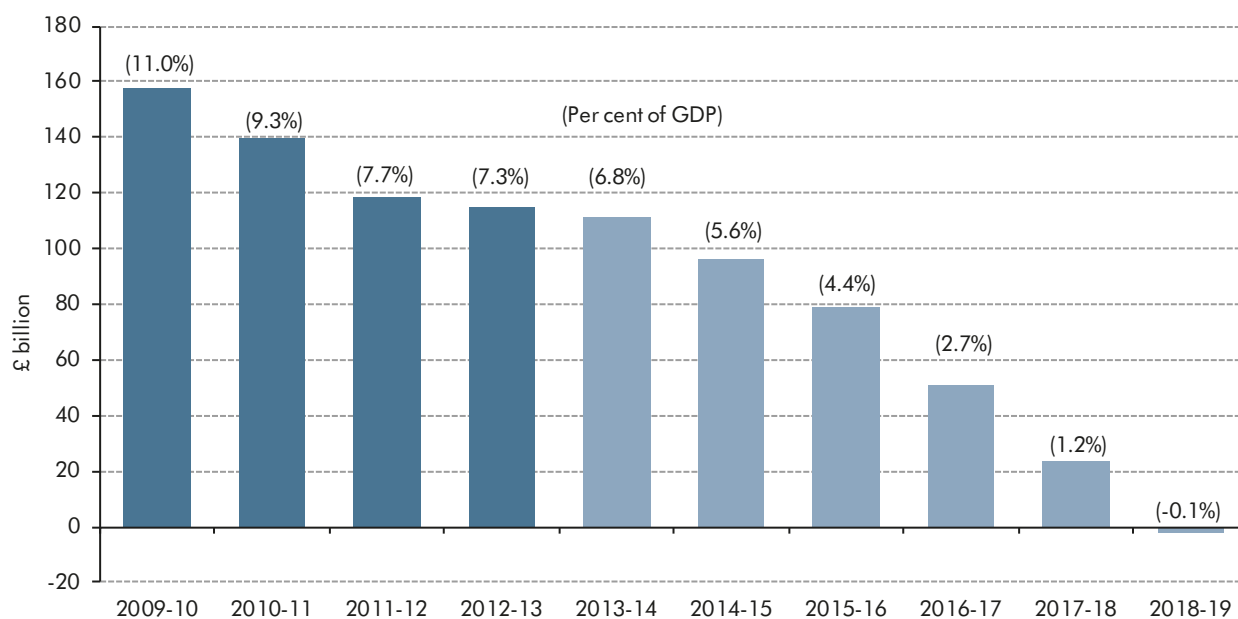
1 Executive summary

Overview

- 1.1 The UK economy has picked up more strongly in 2013 than we expected in our March forecast. Private consumption and housing investment have surprised on the upside, while business investment and net trade have continued to disappoint. Short-term indicators suggest that this momentum has been maintained into the final quarter of the year, leading us to revise up our forecast for GDP growth in 2013 as a whole from 0.6 per cent to 1.4 per cent. We judge the positive growth surprise to have been cyclical, reducing the amount of spare capacity in the economy, rather than indicating stronger underlying growth potential.
- 1.2 We do not expect the quarterly growth rates seen during 2013 to be sustained in 2014. While consumer confidence, credit conditions and the housing market have improved, productivity and real earnings growth have remained weak. Ultimately, productivity-driven growth in real earnings is necessary to sustain the recovery. So we expect quarterly GDP growth to slow into 2014, and then to strengthen gradually as productivity picks up. The outlook for productivity growth is the key uncertainty confronting all UK forecasters.
- 1.3 Even though the quarterly growth rates we expect during 2014 are the same as in March, our forecast for growth in 2014 as a whole has risen from 1.8 per cent to 2.4 per cent – simply because the year begins with GDP at a higher level. We expect fractionally weaker growth from 2015 onwards than in March, reflecting weaker exports. Nonetheless, the level of GDP is higher throughout the forecast than in March and we expect the remaining spare capacity in the economy to be absorbed by early 2019 – two years earlier than in March.
- 1.4 Public sector net borrowing (PSNB) – the gap between what the Government spends and raises in revenue – is forecast to be £111.2 billion this year (measured on an underlying basis, excluding transfers related to the Royal Mail Pension Plan and quantitative easing). This is £8.6 billion lower than our March forecast and £3.8 billion lower than in 2012-13.
- 1.5 We have revised our receipts forecast for this year up by £3.4 billion (excluding the effects of borrowing-neutral changes that raise both receipts and spending). VAT, onshore corporation tax and stamp duty are all expected to out-perform our March forecast. We have revised spending down by £5.2 billion on the same basis. This largely reflects the fact that we expect central government departments to underspend the Treasury limits they faced in March by £7 billion, rather than the £3.5 billion we forecast at the time. The Treasury has cut the central reserve against those limits by £2 billion in the Autumn Statement, presenting that portion of the underspend as a policy measure.

- 1.6 The downward revisions to our borrowing forecasts increase over time, reaching £19.3 billion in 2017-18, giving a cumulative downward revision of £73.1 billion between 2013-14 and 2017-18. Mirroring our judgement that the upward revision to our economic growth forecast since March is cyclical rather than structural, the downward revisions to our borrowing forecasts reduce the overall budget deficit but not the structural budget deficit.
- 1.7 Stronger receipts explain the majority of the downward revision to borrowing, with higher profits supporting onshore corporation tax receipts and a stronger property market lifting stamp duty and other capital tax receipts. Our medium-term forecasts for public spending are little changed since March, with a number of factors broadly offsetting each other. In 2018-19, we expect the underlying balance to move into surplus for the first time in 18 years. But the headline balance will still be in modest deficit, as we expect the Treasury to have to find money to transfer to the Bank of England's Asset Purchase Facility.
- 1.8 The tax and spending measures that the Treasury has included in its Autumn Statement policy decisions table have little cumulative impact on borrowing over the forecast, with the £2 billion cut in departmental spending limits and special reserve this year offsetting a £1.4 billion cumulative net tax cut through to 2018-19 and a £0.6 billion cumulative increase in spending in 2014-15 and 2015-16, the last two years for which detailed departmental spending plans have been set. (This increase in spending comprises £5.5 billion of additional departmental spending, less a £2.2 billion downward 'adjustment', implicitly to other departmental spending, and a £2.7 billion cut in social security and other 'annually managed expenditure'.)
- 1.9 But there are specific decisions on departmental spending identified in the Autumn Statement policy table that, if continued after 2015-16, would require extra spending between 2016-17 and 2018-19. For example, the extension of free school meals costs £755 million in 2015-16, while the Autumn Statement confirms that removing the cap on student numbers rises to a cost of £720 million by 2018-19. (The size of additional departmental spending pressures was spelt out in detail in the Autumn Statement 2012 and Budget 2013 policy decisions tables, but the Treasury has chosen not to quantify them this time.) This spending would reduce the amount available for departments to spend on other things when plans for those years are set out in future spending reviews. The cost of the net tax cuts in the policy table will also continue to accumulate beyond 2018-19.

Chart 1.1: Public sector net borrowing excluding the Royal Mail and Asset Purchase Facility transfers



Source: ONS, OBR

- 1.10** Our forecast implies that the UK's budget deficit will have fallen by 11.1 per cent of GDP over the nine years from 2009-10 (around £180 billion in today's terms). Around 80 per cent of the reduction is accounted for by lower public spending. This will take government consumption of goods and services – a rough proxy for day-to-day spending on public services and administration – to its smallest share of national income at least since 1948, when comparable National Accounts data are first available. The remaining 20 per cent of the drop in borrowing is accounted for by higher receipts, with the majority having taken place by 2012-13, largely as result of rises in the standard rate of VAT.
- 1.11** The Government's 'fiscal mandate' requires it to balance the cyclically-adjusted current budget (CACB) – the amount the Government borrows to finance non-investment spending, adjusted for the state of the economy – five years ahead. In March, we forecast that the CACB would be in surplus by 0.8 per cent of GDP in the then target year of 2017-18. We now expect a slightly smaller surplus of 0.7 per cent of GDP in that year. Thanks to a rise in the average tax rate on national income, and the Government's decision to continue cutting public services spending as a share of GDP, we forecast a bigger surplus of 1.6 per cent of GDP in the new target year of 2018-19, implying significant headroom against the fiscal mandate.
- 1.12** The Government's supplementary target is for public sector net debt (PSND) to be falling as a share of GDP in 2015-16. But, as in our December 2012 and March 2013 forecasts, we expect PSND still to be rising in that year. We expect PSND to peak at 80.0 per cent of GDP in 2015-16, to fall by a statistically and fiscally insignificant margin in 2016-17, and then to fall more rapidly to 75.9 per cent of GDP by 2018-19. This implies that, relative to the size of the economy, debt will peak at more than double its pre-crisis level.

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

Economic developments since our previous forecast

- 1.14 The economy grew significantly faster over the first three quarters of 2013 than we forecast in March. Cumulative growth was 1.8 per cent over this period, 1.3 percentage points higher than our March forecast. Private consumption grew by 1.6 per cent, 1.4 percentage points higher than our March forecast. Most survey indicators suggest the economy gathered momentum during 2013, although that momentum may have eased slightly in the final months. Inflation has fallen a little more than we expected in March.
- 1.15 Employment has been higher and unemployment lower than we forecast, continuing the pattern of recent years. The claimant count has fallen particularly rapidly. By contrast, average earnings growth has remained weak. And while GDP has grown far more strongly than we forecast so far this year, the number of hours worked was also higher than expected – productivity per hour grew by just 0.2 per cent over the first three quarters of 2013, weaker even than the modest 0.4 per cent rise we expected in March.
- 1.16 The housing market has picked up more strongly than forecast this year. House prices increased by 3.8 per cent in the year to September while the volume of property transactions was up 22.6 per cent. So far, this has not translated into strong growth in net mortgage lending. But some forms of credit growth have picked up, in particular car finance, which has supported strong growth in car purchases and contributed to the unexpected strength of private consumption.

The economic outlook

- 1.17 We have revised up our forecast for growth in 2013 from 0.6 per cent to 1.4 per cent and in 2014 from 1.8 per cent to 2.4 per cent, the latter purely as a consequence of GDP starting the year higher. The main explanation for those upward revisions has been stronger-than-expected private consumption growth in 2013. Residential investment has also grown more strongly than expected. By contrast, business investment and net trade have continued to disappoint. These upward revisions to GDP are broadly in line with those made by external forecasters between March and now.
- 1.18 We judge the growth surprise in 2013 to have been cyclical, reducing the amount of spare capacity relative to our March forecast, rather than indicating stronger underlying growth potential. As such, we estimate the output gap in the third quarter of 2013 to have been -2.2 per cent of potential output, having narrowed from -2.6 per cent in the fourth quarter of 2012. In March, we expected the output gap to widen over this period. Our output gap forecast is around 1½ percentage points narrower by the end of the forecast period.

- 1.19 We do not expect the pace of quarterly expansion seen during 2013 to be sustained in 2014. While consumer confidence has recovered, credit conditions have eased and prospects for the housing market have improved, productivity and real earnings growth have remained weak. The unexpected strength of private consumption this year has largely come from lower saving, not higher income. Ultimately, productivity-driven growth in real earnings is necessary to sustain the recovery and raise living standards. We therefore expect quarterly GDP growth to slow into 2014, gradually strengthening thereafter as productivity picks up and real earnings growth provides the foundation for a stronger and more sustained upswing. This recovery in productivity growth is perhaps the most important judgement in our economy forecast. We expect the remaining spare capacity in the economy to be absorbed by early 2019 – two years earlier than we forecast in March.
- 1.20 We are conscious that forecast revisions tend to lag economic developments at turning points, leading to repeated overestimates of economic activity in downturns and repeated underestimates when activity finally picks up. But the experience of 2010 provides a recent example of what appeared to be a turning point in the cycle ebbing as the factors needed to generate self-sustaining recovery failed to take hold. And with productivity, real income growth and UK export markets remaining weak, and problems in the euro area far from fully resolved, our central forecast – like that of the Bank of England – does not assume that the growth rates seen in the last couple of quarters are maintained through next year and beyond. We assume that growth slows to rates of around 0.5 per cent a quarter through 2014, with risks to both the upside and downside.
- 1.21 While most public discussion of economic forecasts focuses on real GDP, the key driver of our fiscal forecast is nominal GDP – the cash value of economic activity – and its composition. The level of nominal GDP is higher across the forecast period than in March. That reflects methodological changes to the way in which the ONS calculates nominal GDP, as well as stronger real growth in 2013. Whole economy inflation – as measured by the GDP deflator – is little changed from March. Overall, we forecast nominal GDP to grow by 3.6 per cent in 2013 and to average around 4¼ per cent a year thereafter, with cumulative growth from the end of 2013 unchanged from our March forecast.
- 1.22 With regards to the composition of nominal GDP:
- in **income** terms: labour income is forecast to grow more slowly than GDP in the near term, despite the strength of employment, as productivity and earnings growth remain subdued. But it picks up from 2015 as productivity growth recovers. Corporate profits have grown faster than GDP this year and are forecast to continue to do so; and
 - in **expenditure** terms: private consumption is forecast to grow slightly faster than household income, with the saving ratio falling marginally. Private investment is forecast to recover towards its pre-crisis share of GDP, implying strong growth in business and residential investment for a sustained period. By contrast, the Government's ongoing fiscal consolidation implies large and sustained falls in government consumption of goods and services as a share of GDP, which is projected to reach its lowest level on record in data back to 1948.

Table 1.1: Economic forecast overview

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast ¹					
	2012	2013	2014	2015	2016	2017	2018
Output at constant market prices							
Gross domestic product (GDP)	0.1	1.4	2.4	2.2	2.6	2.7	2.7
GDP level (2012=100)	100.0	101.4	103.9	106.2	108.9	111.8	114.8
Output gap (per cent of potential output)	-2.6	-2.3	-1.8	-1.6	-1.2	-0.7	-0.2
Expenditure components of GDP at constant market prices							
Household consumption ²	1.2	1.9	1.9	1.7	2.4	2.8	2.8
Business investment	2.6	-5.5	5.1	8.6	8.7	8.9	7.9
General government consumption	1.7	0.7	0.4	-0.5	-1.0	-1.8	-1.1
General government investment	4.6	-6.9	7.3	1.2	2.1	0.5	-1.1
Net trade ³	-0.7	-0.2	0.0	0.1	0.0	0.0	-0.1
Inflation							
CPI	2.8	2.6	2.3	2.1	2.0	2.0	2.0
Labour market							
Employment (millions)	29.5	29.9	30.2	30.4	30.7	30.9	31.2
Average earnings ⁴	2.0	1.5	2.6	3.3	3.5	3.7	3.8
ILO unemployment (% rate)	7.9	7.6	7.1	7.0	6.6	6.1	5.6
Claimant count (millions)	1.59	1.43	1.27	1.23	1.18	1.13	1.10
Changes since March forecast							
Output at constant market prices							
Gross domestic product (GDP)	0.0	0.8	0.6	-0.1	-0.1	-0.1	
GDP level (2012=100) ⁵	0.0	0.8	1.4	1.3	1.2	1.1	
Output gap (per cent of potential output)	0.1	1.2	1.9	1.8	1.7	1.6	
Expenditure components of GDP at constant market prices							
Household consumption ²	0.2	1.5	0.7	0.0	0.0	0.0	
Business investment	-2.3	-7.4	-1.0	0.0	0.1	0.3	
General government consumption	-0.9	0.3	1.1	-0.1	0.0	0.0	
General government investment	1.9	-9.5	2.4	-0.7	3.6	1.7	
Net trade ³	0.1	-0.3	-0.1	-0.1	-0.1	-0.1	
Inflation							
CPI	0.0	-0.2	-0.1	0.0	0.0	0.0	
Labour market							
Employment (millions)	0.0	0.1	0.3	0.3	0.4	0.4	
Average earnings ⁴	0.0	0.0	-0.2	-0.4	-0.4	-0.3	
ILO unemployment (% rate)	0.0	-0.3	-0.9	-0.9	-0.9	-0.8	
Claimant count (millions)	0.00	-0.15	-0.36	-0.35	-0.30	-0.24	

¹ The forecast is consistent with the second estimate of GDP data for the third quarter of 2013, released by the Office for National Statistics on 27 November 2013.

² Includes households and non-profit institutions serving households.

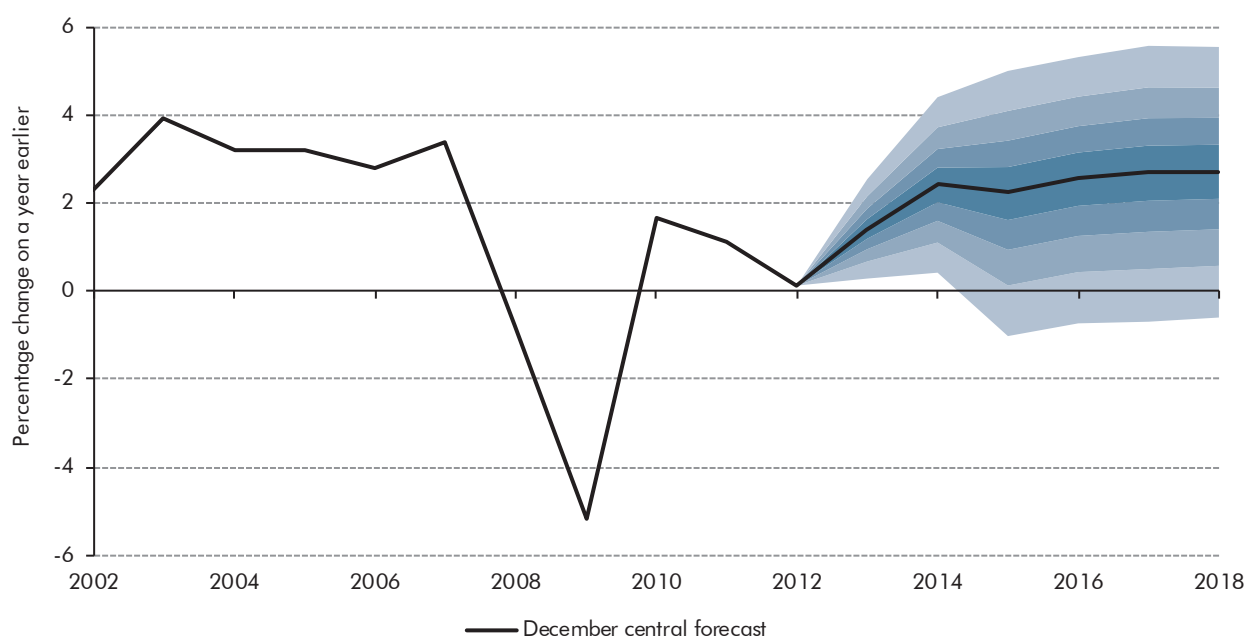
³ Contribution to GDP growth, percentage points.

⁴ Wages and salaries divided by employees.

⁵ Per cent change since March.

- 1.23 We have revised up our employment forecast, with total employment expected to reach 31.2 million in 2018. Unemployment is forecast to fall steadily over the coming years, reaching 7 per cent in mid-2015 and 6 per cent by the end of 2017. The path of unemployment is lower than we forecast in March, reflecting lower-than-expected unemployment this year carrying through to the rest of the forecast.
- 1.24 Total market sector employment is forecast to rise by 3.1 million between the start of 2011, the beginning of the period covered by the Government's 2010 Spending Review, and the start of 2019. This more than offsets a 1.1 million fall in general government employment.
- 1.25 With CPI inflation having fallen back more than expected, our forecast is slightly lower in the near term than it was in March. Currently at 2.2 per cent, CPI inflation is forecast to fall back to the Bank of England's 2 per cent target during 2016. Relative to our March forecast, the extra downward pressure on inflation from a slightly stronger exchange rate broadly offsets the reduced downward pressure from spare capacity in the economy.
- 1.26 Our house price inflation forecast has been revised up significantly, reflecting the momentum in house prices this year and supportive mortgage financing conditions. We expect house price inflation to be above 5 per cent in 2014 and 7 per cent in 2015. Relative to our March forecast, we have revised the level of house prices up 10 per cent by 2017-18.
- 1.27 There is considerable uncertainty around any economic forecast. Chart 1.2 presents our central growth forecast with a fan showing the probability of different outcomes based on the pattern of past official forecast errors. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. It suggests there is a roughly 5 per cent chance that the economy will shrink in 2014 and a similar chance it will grow by more than 5 per cent.

Chart 1.2: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

- 1.28** The headline public finance measures have been affected by a number of one-off or temporary factors in recent years. Two of these have had large effects on borrowing – the one-off transfer of the Royal Mail Pension Plan’s assets (and associated future pension liabilities) to the Government in 2012-13 and the ongoing transfers of cash from the Asset Purchase Facility (APF) to the Exchequer. We focus our assessment of the public finances on an underlying measure of public sector net borrowing (‘underlying PSNB’) that excludes these two factors. Headline ONS measures are also presented.
- 1.29** Underlying PSNB is estimated to have fallen by around a third between 2009-10 and 2012-13. The pace of deficit reduction slowed in 2012-13, reflecting weak growth and the delayed impact on the public finances of high inflation in the previous year. We expect another relatively modest decline this year. Table 1.2 shows that we forecast the deficit to fall more rapidly over the next five years, reaching a small surplus in 2018-19. Headline borrowing remains in modest deficit in 2018-19, as we assume that the Government will have to borrow to fund transfers from the Exchequer to the APF as quantitative easing unwinds.
- 1.30** As set out above, we judge the unexpected strength of real GDP growth this year to have been cyclical and so we have not changed our view of the economy’s underlying supply potential. This judgement means that our estimate of the structural position of the public finances – cyclically-adjusted PSNB – is little changed from March, with the downward revisions to unadjusted borrowing judged to be cyclical.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn		Forecast				
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Underlying fiscal aggregates							
Public sector net borrowing ¹	7.3	6.8	5.6	4.4	2.7	1.2	-0.1
Cyclically-adjusted net borrowing ¹	5.5	5.2	4.3	3.3	1.9	0.7	-0.3
Surplus on current budget ¹	-5.9	-5.3	-4.0	-2.9	-1.2	0.2	1.4
Headline fiscal aggregates							
Public sector net borrowing	5.1	6.0	4.9	4.0	2.6	1.3	0.1
Cyclically-adjusted net borrowing	3.3	4.4	3.6	2.9	1.7	0.8	-0.1
Surplus on current budget	-5.5	-4.5	-3.3	-2.5	-1.1	0.2	1.4
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-3.6	-2.9	-2.0	-1.4	-0.2	0.7	1.6
Public sector net debt	73.9	75.5	78.3	80.0	79.9	78.4	75.9
Changes since March forecast							
Public sector net borrowing ¹	-0.5	-0.7	-0.9	-1.1	-1.0	-1.1	
Cyclically-adjusted net borrowing ¹	-0.4	0.1	0.3	0.1	0.2	0.0	
Surplus on current budget ¹	0.5	0.7	0.9	1.1	1.1	1.1	
Cyclically-adjusted surplus on current budget	0.4	-0.1	-0.3	-0.2	-0.3	-0.1	
Public sector net debt	-2.0	-3.6	-4.3	-5.1	-5.7	-6.4	

¹ Excluding Royal Mail and APF transfers.

1.31 Table 1.3 shows that we have reduced our forecast for the underlying deficit in 2013-14 by £8.6 billion, due to stronger-than-expected receipts and a forecast of larger-than-expected underspending by departments. Excluding borrowing-neutral changes that have raised both receipts and annually managed expenditure (AME) since March, receipts have been revised up by £3.4 billion in 2013-14. VAT, onshore corporation tax and stamp duty are all expected to out-perform our March forecast by more than £1 billion. We have revised spending down by £5.2 billion on the same underlying basis. This largely reflects the fact that we expect government departments to underspend the Treasury limits they faced in March by £7 billion, rather than the £3.5 billion we forecast at the time. The Treasury has cut the central reserve against those limits by £2 billion in the Autumn Statement, presenting that portion of the underspend as a policy measure. The underlying deficit is expected to fall by £3.8 billion between 2012-13 and 2013-14, compared to £3.5 billion in the previous year and a more rapid average decline of £19.7 billion over the previous two years.

1.32 The downward revisions to our borrowing forecasts increase over time, reaching £19.3 billion in 2017-18. This gives a cumulative reduction in our underlying borrowing forecasts of £73.1 billion since March between 2013-14 and 2017-18. Stronger receipts explain the majority of that change, with higher profits supporting onshore corporation tax receipts and a stronger property market lifting stamp duty and other capital tax receipts. Our forecasts for public spending are little changed since March, with a number of factors largely offsetting each other. However, these factors increase our AME forecast, reducing the

implied amount available for departmental spending on public services and administration and on investment.

Table 1.3: Change in underlying public sector net borrowing

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing¹							
March forecast	120.9	119.8	108.4	95.5	67.0	42.7	
December forecast	115.0	111.2	96.0	78.7	51.1	23.4	-2.2
Change	-5.9	-8.6	-12.4	-16.8	-15.9	-19.3	
of which:							
Pre-measures forecasts							
of which:							
Receipts ^{1,2}	-4.3	-3.4	-9.6	-13.2	-14.5	-14.6	
DEL spending ³	-0.5	-1.8	0.0	-1.3	0.3	-4.0	
AME spending ^{1,2,3}	-1.1	-1.4	-2.9	-2.4	-2.1	-1.3	
Measures in the Treasury's policy decision table	0.0	-2.0	0.1	0.1	0.4	0.6	

¹ Excluding Royal Mail and APF transfers.

² Excluding fiscally neutral switches, which include changes in the proportion of tax credits treated as negative tax, Renewables Obligation and the treatment of artistic originals in public corporations' gross operating surplus and capital expenditure.

³ DEL and AME have been adjusted to remove the effects of the OSCAR classification changes on DEL, which are largely offset in AME, explained in Box 4.4.

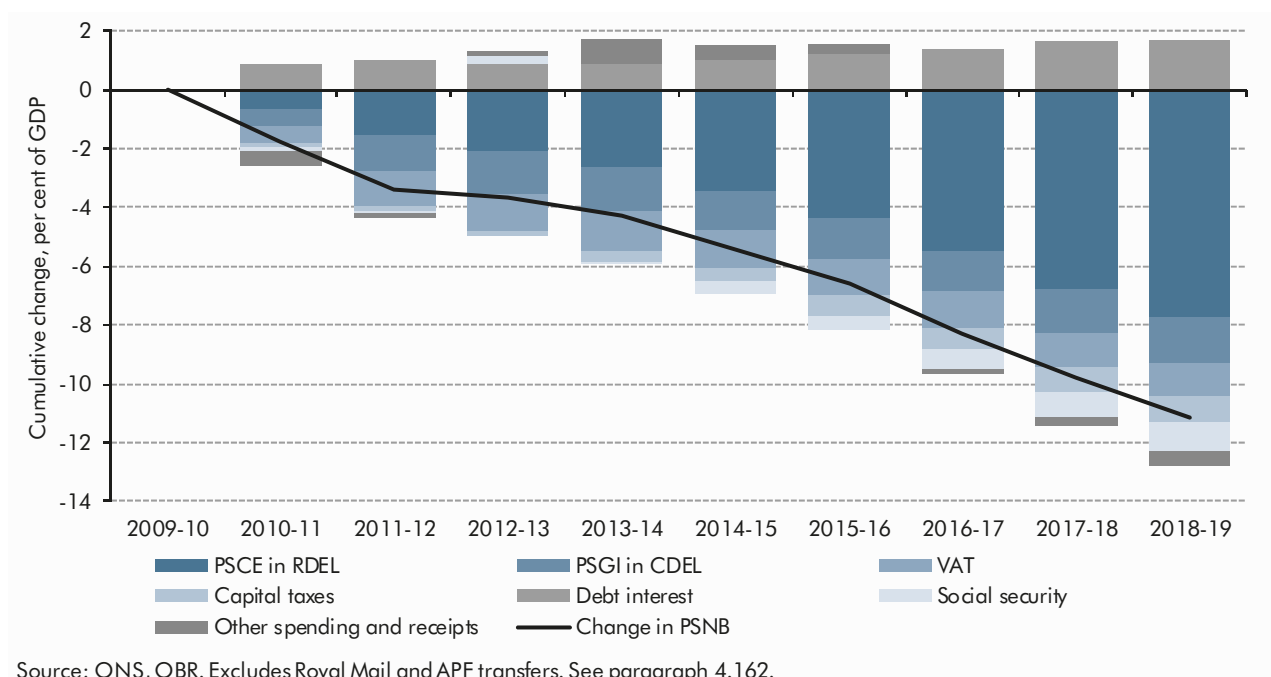
1.33 Our forecast suggests that underlying net borrowing will have fallen by 11.1 per cent of GDP over the nine years from 2009-10 (around £180 billion in today's terms), taking it from its post-war peak to what would be the first budget surplus since 2000-01. On our central forecast, as Chart 1.3 shows, the contributions to this would be:

- 8.8 per cent of GDP, or around 80 per cent of the deficit reduction, from lower expenditure, with Total Managed Expenditure falling from 47.1 per cent of GDP in 2009-10 to 38.2 per cent of GDP by 2018-19. Within this total:¹
 - PSCE in RDEL, a proxy for day-to-day spending on public services and administration, falls by 7.8 per cent of GDP to 14.2 per cent in 2018-19. This is mirrored in our GDP forecast, where government consumption of goods and services falls from 23.2 per cent of nominal GDP in 2009 to 16.1 per cent by the end of the forecast period, its lowest on record in data back to 1948;
 - PSGI in CDEL, a measure of public sector investment, falls by 1.6 per cent of GDP to 1.9 per cent in 2018-19. In 2007-08, PSGI in CDEL was 2.6 per cent of GDP; and

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

- social security spending falls by 1.0 per cent of GDP to 10.0 per cent in 2018-19 – still higher than its pre-crisis level.
- 2.3 per cent of GDP, or around 20 per cent of the deficit reduction, from higher receipts, with the majority of the increase having taken place by 2012-13, largely as a result of the increases in the standard rate of VAT. This is followed by further increases towards the end of our forecast due to the resumption of fiscal drag, as above-inflation earnings growth pushes more income into higher tax brackets.

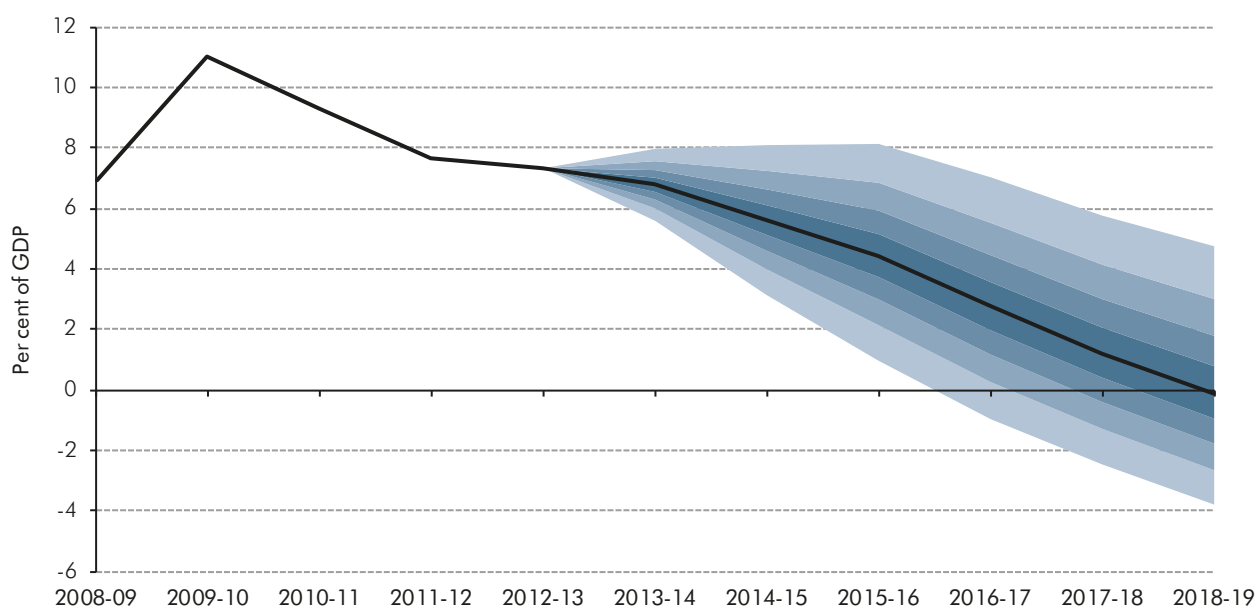
Chart 1.3: Sources of deficit reduction



Source: ONS, OBR. Excludes Royal Mail and APF transfers. See paragraph 4.162.

- 1.34** The current budget balance, which excludes borrowing to finance net investment spending, is forecast to show a deficit of £74.2 billion this year (£86.3 billion on an underlying basis), down from a peak of £109.5 billion in 2009-10. The current balance moves into surplus in 2017-18 and records a surplus of £28.0 billion in 2018-19. With planned investment spending little changed, revisions to the current balance are similar to those to PSNB.
- 1.35** The cyclically-adjusted current budget (CACB) moves from a deficit of 2.9 per cent of GDP in 2013-14 to a surplus of 1.6 per cent of GDP in 2018-19. We expect the CACB to move into surplus in 2017-18. As with cyclically-adjusted PSNB, there have been relatively small revisions to the CACB as we judge the improvement in the current balance to be largely cyclical rather than structural.
- 1.36** All forecasts are subject to significant uncertainty. Chart 1.4 shows our median forecast for underlying PSNB with successive pairs of shaded areas around it representing 20 per cent probability bands. As in Chart 1.2 above, the bands show the probability of different outcomes if the pattern of past official forecast errors were to be a reasonable guide to future forecast errors.

Chart 1.4: Underlying PSNB fan chart



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

1.37 We forecast public sector net debt (PSND) to rise as a share of GDP in each year up to and including 2015-16, peaking at 80.0 per cent of GDP. It falls by a statistically and fiscally insignificant margin in 2016-17, and more rapidly thereafter, reaching 75.9 per cent of GDP in 2018-19. PSND in 2017-18 is now forecast to be 6.4 per cent of GDP lower than we forecast in March. Table 1.4 breaks this change down as follows:

- nominal GDP was revised up by around 1.3 per cent in Blue Book 2013, due largely to methodological changes. Combined with changes to our nominal GDP forecast, this reduces the ratio of the cash value of debt to GDP by 2.3 per cent of GDP in the peak year of 2015-16 and by 2.2 per cent in 2017-18; and
- our forecast for PSND in cash terms is £51 billion lower in 2015-16 and £82 billion lower in 2017-18 than in March, which is largely due to lower cumulative net borrowing over the forecast period. This reduces PSND by 2.8 per cent of GDP in 2015-16 and 4.2 per cent in 2017-18.

Table 1.4: Change in public sector net debt

	Per cent of GDP					
	Outturn	Forecast				
		2012-13	2013-14	2014-15	2015-16	2016-17
March forecast	75.9	79.2	82.6	85.1	85.6	84.8
December forecast	73.9	75.5	78.3	80.0	79.9	78.4
Change	-2.0	-3.6	-4.3	-5.1	-5.7	-6.4
<i>of which:</i>						
Change in nominal GDP ¹	-1.5	-2.6	-2.4	-2.3	-2.3	-2.2
Change in cash level of net debt	-0.4	-1.0	-1.9	-2.8	-3.4	-4.2
	£ billion					
March forecast	1189	1286	1398	1502	1580	1637
December forecast	1182	1269	1365	1451	1515	1554
Change in cash level of net debt	-7	-18	-33	-51	-65	-82
<i>of which:</i>						
Changes in net borrowing	-6	-15	-28	-43	-56	-74
Financial transactions and other	-1	-3	-5	-7	-9	-9

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

Performance against the fiscal targets

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

- to balance the cyclically-adjusted current budget (CACB) by the end of a rolling, five-year period, which is now 2018-19; and
- to see public sector net debt (PSND) falling as a share of GDP in 2015-16.

1.39 We judge that the Government has a greater than 50 per cent chance of meeting the fiscal mandate. The CACB is forecast to be in surplus by 1.6 per cent of GDP in 2018-19, the first surplus in excess of 1 per cent of GDP we have forecast for a mandate year.

1.40 PSND is forecast to rise to a peak of 80.0 per cent of GDP in 2015-16, which is slightly lower and a year earlier than we forecast in March. However, as in March, our forecast does not show the Government on course to achieve the supplementary target – we forecast that debt will rise by 1.7 per cent of GDP in the target year, down from an increase of 2.4 per cent of GDP in our March forecast.

1.41 There is considerable uncertainty around our central forecast. This reflects uncertainty both about the outlook for the economy and about the performance of revenues and spending for any given state of the economy. Given these uncertainties we test the robustness of our central judgement in three ways:

- first, by looking at past forecast errors. If our central forecasts are as accurate as official forecasts were in the past, then there is a roughly 80 per cent probability that

the CACB will be in balance or surplus in 2018-19 (as the mandate requires) and a roughly 65 per cent chance a year earlier;

- second, by looking at its sensitivity to varying key features of the economic forecast. The biggest risk to the achievement of the mandate relates to our estimates of future potential output. If potential output is lower than we estimate, reducing the size of the output gap in the target year, the structural portion of borrowing would be larger. If potential output was 1 per cent lower than in our central forecast in 2018-19, the probability of meeting the mandate would fall to 70 per cent; and
- third, by looking at alternative economic scenarios. We have looked at four scenarios for the pace at which unemployment falls back to the 7 per cent threshold in the Bank of England's monetary policy forward guidance – reaching the threshold either a year earlier or a year later than in the central forecast. Unemployment could fall faster than expected for good reasons – stronger demand – or bad reasons – lower potential output. Equally, it could fall more slowly than expected for good reasons – higher potential output – or bad reasons – weaker demand. The Government would continue to meet the fiscal mandate in all scenarios, reflecting the substantial CACB surplus in 2018-19 in our central forecast. The supplementary debt target would be missed in all scenarios. The most challenging of the scenarios is that where unemployment falls more rapidly than expected due to lower potential output implying less scope for the economy to grow before spare capacity has been fully absorbed.

2 Developments since the last forecast

Introduction

2.1 This chapter summarises:

- the main economic and fiscal data developments since our last forecast in March 2013 (from paragraph 2.2); and
- recent external forecasts for the UK economy (from paragraph 2.16).

Economic developments

Data revisions and Blue Book 2013 changes

2.2 Each year, the publication of the Blue Book provides the ONS with an opportunity to make methodological changes to the National Accounts. This year has seen relatively significant changes, including:

- changes in the way gross fixed capital formation is deflated, chain linked and seasonally adjusted. These have led to significant downward revisions to the path of measured real investment and an increase in its volatility from quarter to quarter;
- a reassessment of imputed rent on owner-occupied housing to include repairs and maintenance. This has raised the level of private consumption and GDP; and
- new data sources and methodology for the measurement of investment in artistic originals. These have increased the measured level of gross fixed capital formation in most years since 1997, therefore increasing the level of GDP.

2.3 Blue Book 2013 has revised GDP growth back to 1948. The most significant changes are for recent years, including through the recession. The fall in real GDP in 2008 has been revised from -1.0 per cent to -0.8 per cent, while the fall in 2009 has been revised from -4.0 per cent to -5.2 per cent. The peak-to-trough fall in GDP is now estimated to have been 7.2 per cent between the first quarter of 2008 and the second quarter of 2009, compared to 6.3 per cent at the time of the March forecast.

2.4 The changes have also affected GDP and its composition over more recent years. The latest data show that GDP grew by 0.3 per cent between the second quarter of 2011 and the fourth quarter of 2012, down from 0.5 per cent in the data available in March (Table 2.1). Private consumption, net trade and stocks are estimated to have contributed more to growth over this period than at the time of our March forecast, while government consumption has

Developments since the last forecast

contributed less. There has been a particularly large revision to the contribution of private investment, which previously added to real growth and now subtracts from it.

Table 2.1: Contributions to real GDP growth from 2011Q2 to 2012Q4¹

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
March data	0.8	0.7	0.1	0.1	-0.6	-0.2	0.5
Latest data	1.2	0.3	0.1	-1.0	-0.2	0.1	0.3
Difference ²	0.4	-0.3	-0.1	-1.1	0.4	0.3	-0.2

¹ Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is the difference between the headline estimate of GDP led by the output approach, and the expenditure estimate. The statistical discrepancy is -0.3 and -0.2 percentage points for March and latest data respectively

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

GDP growth since the March 2013 forecast

2.5 In March, we forecast that the economy would grow by 0.1 per cent in the first quarter of 2013, followed by growth of 0.2 per cent and 0.3 per cent in the second and third quarters respectively; cumulatively 0.5 per cent. The latest ONS estimates show that GDP growth has been significantly stronger in each of these three quarters; cumulatively 1.8 per cent.

2.6 The composition of quarterly real GDP growth relative to our March forecast is shown in Table 2.2, broken down by categories of spending. Stronger stocks, private consumption and government consumption more than account for the positive surprise to growth. Private investment and net trade made smaller contributions than forecast, with net trade making a larger negative contribution after very weak export growth in the third quarter.

Table 2.2: Contributions to real GDP growth from 2012Q4 to 2013Q3¹

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
OBR March forecast	0.1	0.0	0.0	0.4	0.2	-0.3	0.5
Latest data	1.1	0.2	0.0	0.3	-0.6	0.7	1.8
Difference ²	0.9	0.1	0.0	-0.1	-0.9	1.1	1.3

¹ Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is the difference between the headline estimate of GDP led by the output approach, and the expenditure estimate. The statistical discrepancy is 0.0 and 0.1 percentage points for March and latest data respectively

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

2.7 Nominal GDP also grew more than we expected in March, but by a smaller margin than real GDP (Table 2.3). Stronger nominal consumption and net trade contributions account for the unexpected strength of nominal GDP. With the net trade contribution to real growth over the period negative, the positive nominal contribution reflects changes in the terms of trade – import prices are reported to have fallen by 1 per cent between the final quarter of 2012 and the third quarter of 2013 while export prices have risen by 2.2 per cent over the

same period. Private investment and government consumption in nominal terms have both been weaker than forecast.

Table 2.3: Contributions to nominal GDP growth from 2012Q4 to 2013Q3¹

	Percentage points						GDP growth, per cent
	Private consumption	Government consumption	Government investment	Private investment	Net trade	Stocks	
OBR March forecast	1.4	0.2	0.0	0.6	0.2	-0.1	2.4
Latest data	2.1	-0.2	0.1	0.4	0.4	0.4	3.2
Difference ²	0.6	-0.4	0.1	-0.3	0.2	0.5	0.8

¹ Components may not sum to total due to rounding and the statistical discrepancy. The statistical discrepancy is the difference between the headline estimate of GDP led by the output approach, and the expenditure estimate. The statistical discrepancy is 0.0 and 0.2 percentage points for March and latest data respectively

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

Business surveys

- 2.8 Most survey evidence suggests a strong pick-up in underlying activity in recent months. In October, the composite CIPS *Purchasing Managers' Index (PMI)* rose to its highest level since May 1997, 7.1 points above the series average of 54.0. The *PMIs* for manufacturing, construction and services are all well above the average of recent years, although the manufacturing index fell back slightly in October. The construction *PMI* has been lifted by the housing sector; the sub-index has risen 8.6 points since its recent trough in June 2013.
- 2.9 The Bank of England *Agents' Summary* reports a sustained increase in investment intentions and exports of goods as well as stronger demand for consumer goods and services since the time of our March forecast. The *GfK Consumer Confidence* measure suggests that consumer sentiment has risen since March and returned close to its long-run average after nearly 6 years running below it. Within this measure, there has been a significant improvement in the climate for major purchases and in expectations for the general economy. The Confederation of British Industry's (CBI) quarterly *Industrial Trends Survey* reported that growth in manufacturing output and new orders for the second and third quarter of 2013 were both stronger than their long-run averages. The CBI's *Service Sector Survey* reported business volumes in the three months to November increasing at their strongest pace since 2007.

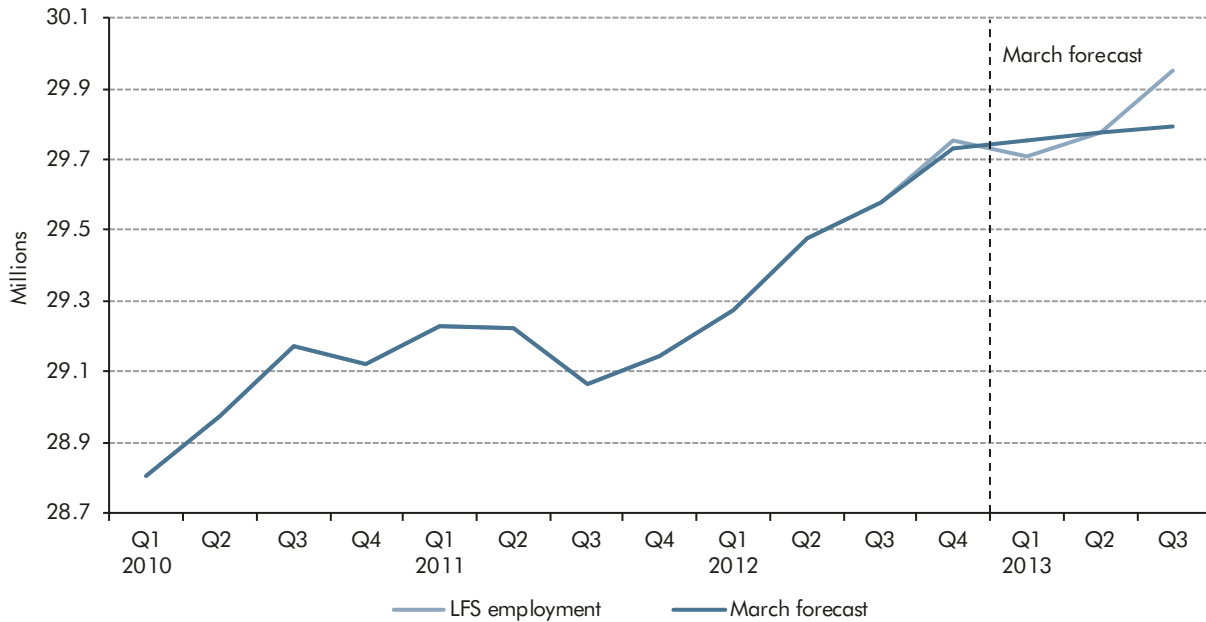
Labour market

- 2.10 On most measures, the labour market has out-performed our March forecast. Employment has risen to 30.0 million in the third quarter of 2013, compared with our forecast of 29.8 million (Chart 2.1). Unemployment in the same period was 111,000 lower than our forecast and the claimant count was 199,000 lower. The claimant count has fallen by 210,000 over the past six months, the largest 6-monthly fall since August 1997, a year when real GDP grew by 4.4 per cent. But, while the employment figures have surprised on the upside, private sector earnings growth has been weaker than we expected in March. Average

Developments since the last forecast

weekly earnings in the private sector in the year to the third quarter of 2013 grew by 1.3 per cent, compared to our forecast of 1.8 per cent.

Chart 2.1: LFS employment and March forecast

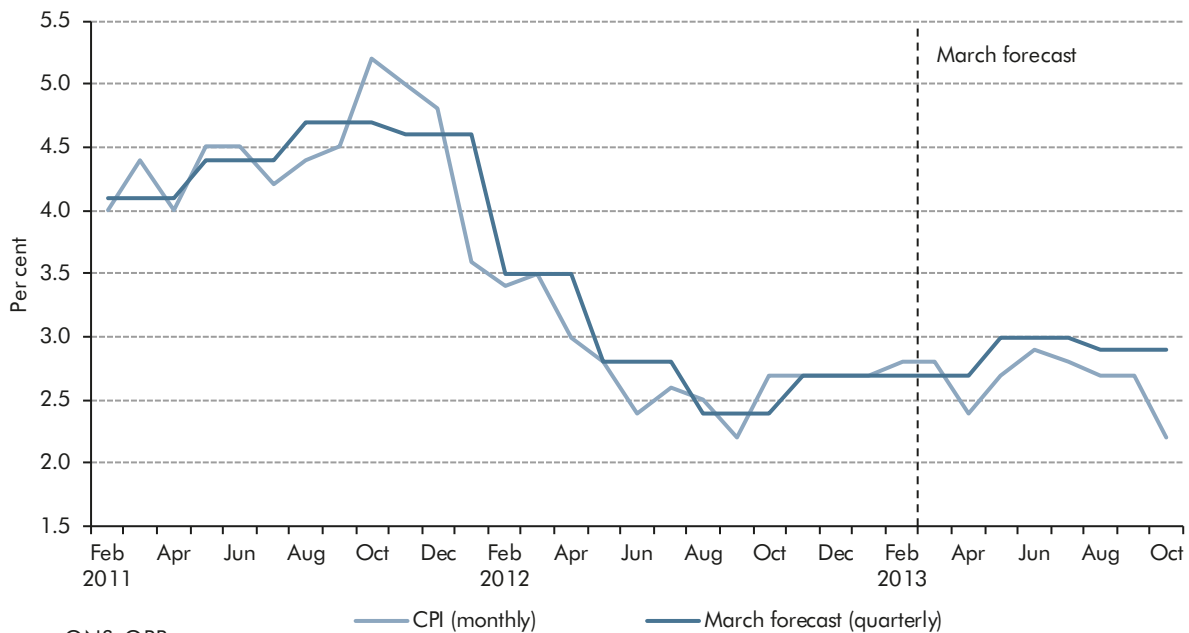


Source: ONS, OBR

Inflation

2.11 Annual CPI inflation has been lower than our March forecast every month since April (Chart 2.2). Oil prices, a key driver of petrol and diesel prices, have fallen around 10 per cent in sterling terms since March, helped by sterling's 3.8 per cent appreciation against the dollar, the currency in which oil is priced. Recent announcements of utility price increases have not yet affected measured inflation, but were a little higher than we expected in March. Overall, the downside surprise in annual CPI inflation to October is judged to reflect weaker than expected contributions to inflation from accommodation, airfares and financial services.

Chart 2.2: CPI inflation and March forecast



Source: ONS, OBR

The housing market

2.12 After a period of broadly flat prices and subdued activity, the housing market has picked up more strongly than expected in 2013. Partly, this reflects reduced funding costs for banks feeding through to lower mortgage rates. The impact of the Funding for Lending Scheme on the cost and availability of mortgages, together with improvements in consumer confidence, are also likely to have been supportive. House price inflation reached 3.8 per cent in the year to September and mortgage approvals for house purchase have risen by 29 per cent in the year to October. Property transactions in the third quarter were around 3,000 higher than our March forecast of 270,000, up 21 per cent on a year earlier. Activity in London has been notably strong, which appears to have had a disproportionate impact on the public finances.

The global economy

2.13 GDP in the US and euro area were both weaker than forecast in the first quarter of 2013, but recovered in the second quarter. Growth in the third quarter was only slightly lower than our March forecast. Japanese GDP growth was stronger than forecast in the first half of 2013 and in line with forecast in the third quarter. Growth in emerging markets, in particular India and China, has been weaker than expected. In its October *World Economic Outlook (WEO)*, the IMF reduced the contribution to world growth it expects from emerging market economies and pushed up the contribution from advanced economies, leaving its overall world growth forecast slightly lower than its April *WEO* forecast.

2.14 World output growth since the fourth quarter of 2012 has been slightly weaker than our March forecast, although recent survey evidence points to increasing strength in world

activity. For example, the JP Morgan *Global Manufacturing PMI* has been rising since April 2013 and is at its highest level since June 2011.

Box 2.1: The performance of past OBR economic and fiscal forecasts

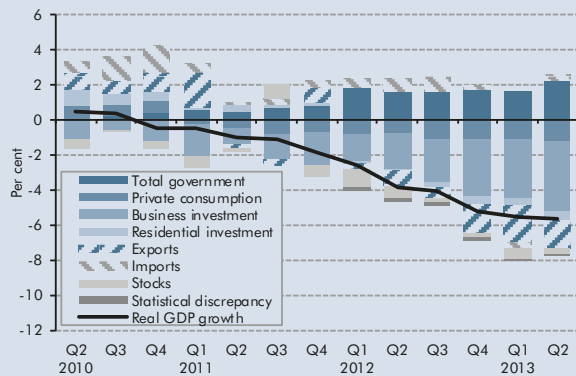
Each autumn, we publish our *Forecast evaluation report (FER)*, a detailed examination of the performance of past economic and fiscal forecasts relative to the latest outturn data.

In our 2012 *FER*, we showed that despite much weaker real GDP growth than we forecast in June 2010, our public sector borrowing forecasts for 2010-11 and 2011-12 had performed relatively well. We concluded that this was largely because nominal growth had held up closer to forecast, which is more important for tax receipts. But the ONS has since made significant data revisions, doubling its estimate of real GDP growth between mid-2010 and mid-2012, while revising down its estimate of nominal GDP growth over the same period, as well as changing the composition of growth.

In light of these data revisions, we revisited the relationship between the performance of our economic and fiscal forecasts in this year's *FER*. In June 2010, we forecast a slow but steady recovery, with real GDP growth of 8.9 per cent between the first quarter of 2010 and the second quarter of 2013. The latest data show that real GDP increased by 3.2 per cent over this period. The weakness relative to our forecast is mainly driven by weaker business investment than we expected, which is likely to reflect weak profitability, tight credit conditions and heightened uncertainty. Net trade has made a smaller contribution than forecast, due to euro area weakness and a smaller-than-expected response to sterling depreciation. Private consumption has also been weaker than forecast, as higher inflation squeezed real incomes in 2011. These differences were partly offset by a continued positive contribution from real government consumption and investment, which had been expected to subtract from growth.

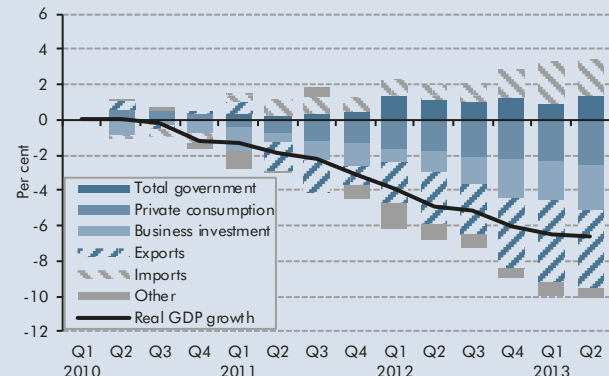
Charts A and B show the cumulative errors in our June 2010 real GDP forecasts alongside the errors in the Bank of England's August 2010 forecast for the same period, drawing on an analysis of the Bank's forecasts published for the first time in its November 2013 *Inflation Report*. The charts show that both institutions overestimated real GDP growth over this period by similar amounts. Our largest error was in overestimating the contribution to growth from business investment, then net trade and then consumption. The Bank's errors were spread more evenly over the three spending categories. (It should be noted that the charts are not precisely comparable. We compare our published forecasts with the latest published outturn data. The Bank adjusted its projections to reflect the effects of subsequent methodological changes implemented in the 2011 Blue Book and then compared them to a 'backcast' of what it believes outturn GDP data will look like after future revisions.)

Chart A: Cumulative errors in June 2010 OBR real GDP forecast



Source: ONS, OBR

Chart B: Cumulative errors in August 2010 Bank of England real GDP forecast



Source: Bank of England

Nominal GDP growth has been revised down since our 2012 FER. As such, the data now suggest that it is the composition of nominal GDP that explains the performance of our June 2010 public sector borrowing forecast:

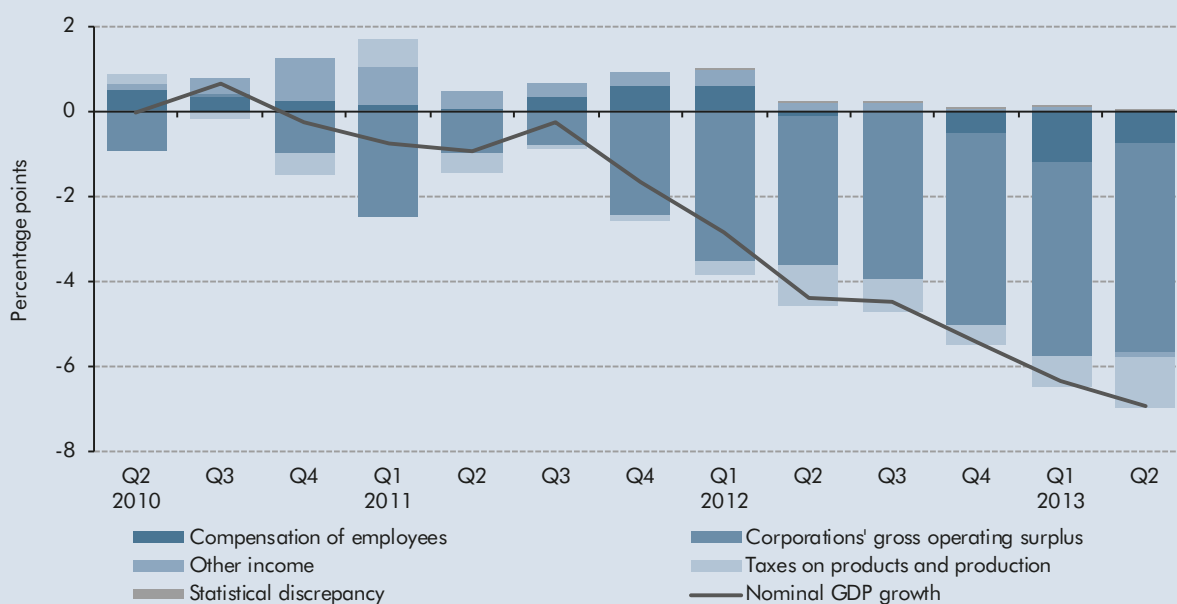
- in 2010-11 and 2011-12, the deficit continued to fall as forecast. The shortfall in nominal GDP compared to our forecast was in areas that are taxed relatively lightly – in private investment rather than private consumption and corporate profits rather than labour income (Chart C); and
- in 2012-13, our forecast for the budget deficit disappointed. While the shortfall in nominal GDP was still concentrated in private investment and corporate profits rather than private consumption, labour income was also weaker than our forecast, as subdued average earnings more than offset strength in employment.

Our March 2012 forecast took on board the ongoing weaknesses in the real economy, driven by disappointing productivity growth, tighter than expected credit conditions, prolonged weakness in the euro area and the failure of asset markets and interest rates to normalise. Yet, real GDP growth continued to disappoint as:

- weakness in private investment persisted and net trade deteriorated as conditions in the euro area failed to improve;
- productivity growth failed to pick up as forecast, which had further negative effects on labour income and nominal GDP; and
- North Sea production fell sharply.

The effect of these factors in lowering receipts was outweighed by larger-than-forecast underspending by central government departments and local authorities. This explains why public sector borrowing in 2012-13 was lower than our March 2012 forecast.

Chart C: Cumulative errors in June 2010 OBR nominal GDP forecast



Source: ONS, OBR

Fiscal data developments

2.15 Public sector net borrowing – excluding the effects of transfers from the Royal Mail Pension Plan and Asset Purchase Facility – has been £5.8 billion lower in the first seven months of 2013-14 than in the same period last year. Borrowing for 2012-13 has also been revised down substantially since our March forecast. Borrowing is therefore both lower than we forecast in March and on a slightly more downward trajectory. Spending growth has been broadly in line with our forecast, once timing effects related to local authority grants and payments to EU institutions have been taken into account. Receipts growth has been stronger than expected, with nominal consumer spending feeding through to VAT receipts and the pick-up in the housing market lifting stamp duty land tax receipts, which were up 28 per cent on a year earlier in the first seven months of 2013-14.

Developments in outside forecasts

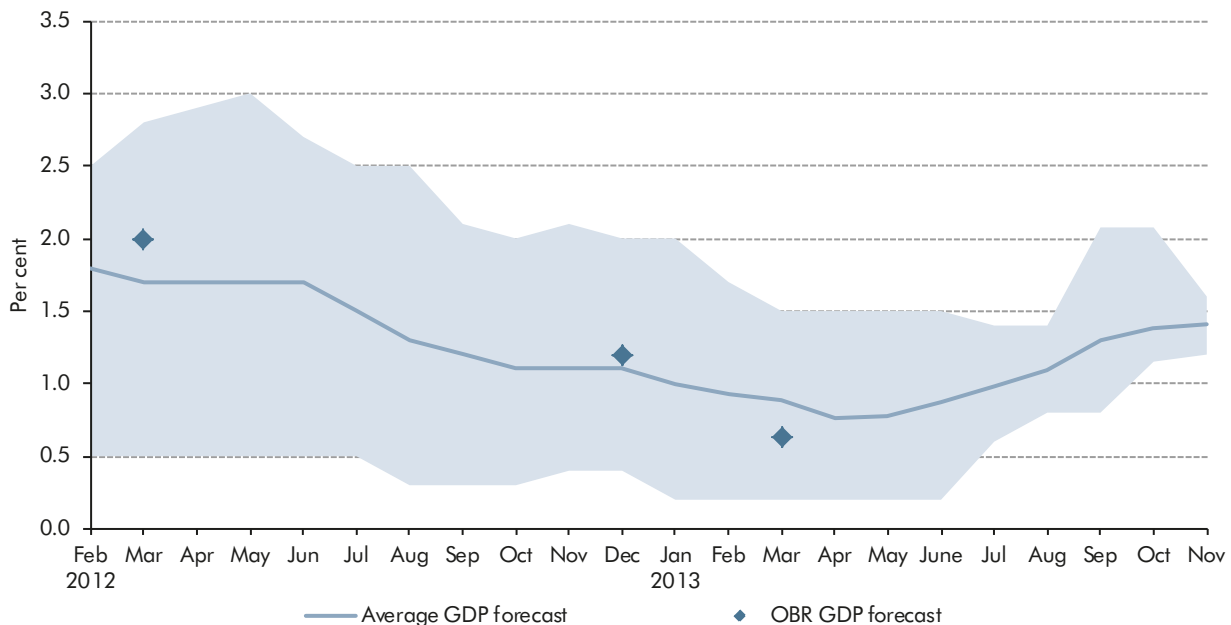
2.16 Many private sector, academic and other outside organisations produce economic forecasts for the UK, using a variety of techniques and data.¹ A number of publications collate and average these forecasts. This section sets out some of the movements in these forecasts since our March *EFO*. When interpreting the average of outside forecasts, it is important to bear in mind that different analysts forecast different variables and the average forecast is not constrained to paint an internally consistent picture.

¹ See HM Treasury, November 2013, *Forecasts for the UK economy: a comparison of independent forecasts*. A full list of contributors is available at the back of the Treasury publication. A number of financial reporting services also monitor these average or consensus figures.

GDP growth

2.17 Outside forecasts for GDP growth in 2013 were falling in the run-up to our March forecast, reflecting weak momentum into the year. Our forecast of 0.6 per cent was a little below the average of outside forecasts at that time (Chart 2.3). From April onwards, a pick-up in survey indicators and stronger-than-expected outturn GDP data prompted successive increases in outside forecasts. The latest average forecast of GDP growth in 2013 is 1.4 per cent. The average forecast for 2014 has also increased since our March forecast, probably reflecting continued strength in forward-looking indicators, outturn GDP data and a more stable outlook for the euro area.

Chart 2.3: Forecasts for GDP growth in 2013



Source: HM Treasury, OBR

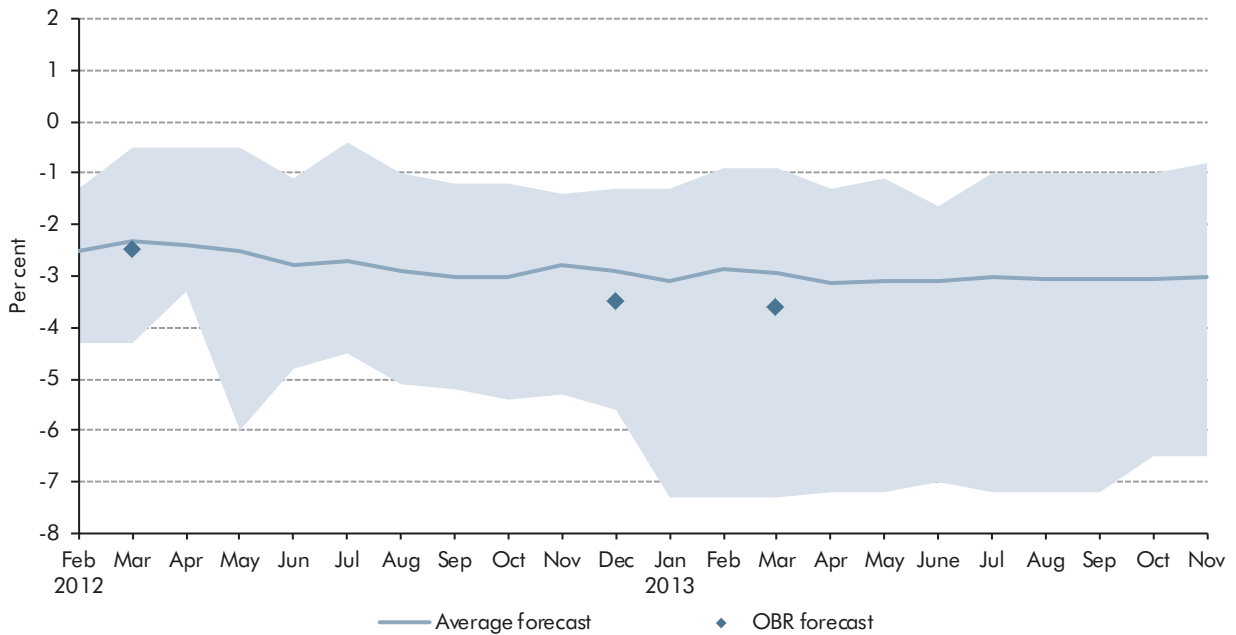
2.18 Expectations for the composition of demand in 2013 have changed significantly since March, reflecting both recent developments and the Blue Book data revisions in the summer. The average forecast for the contribution of net trade to GDP growth rose 0.3 percentage points, with expected growth of exports having risen and imports having fallen; though this may not fully reflect the latest trade data. The average forecasts for growth in private consumption and government consumption have increased by 0.9 and 1.1 percentage points respectively, while the average forecast for fixed investment has fallen by 4.0 percentage points.

2.19 Looking at the smaller sample of medium-term forecasts, the average forecasts for GDP growth in 2015, 2016 and 2017 have increased since the publication of the March *EFO* by 0.4, 0.2 and 0.1 percentage points respectively. These upward revisions are more than explained by an increase in the average forecast for the contribution of domestic demand to GDP growth in each of these years. The average forecast for the contribution of net trade has been revised down by 0.1 percentage points in each of these three years.

Output gap

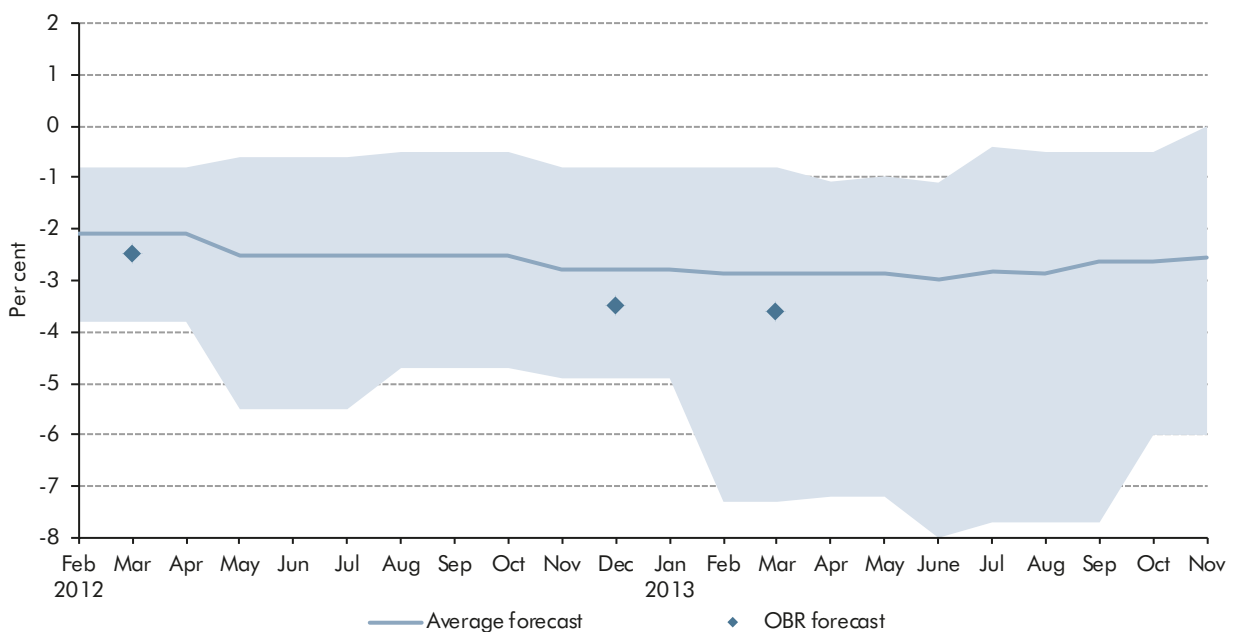
2.20 The average forecast for the output gap in 2013 has remained broadly flat since March (Chart 2.4). The latest average forecast is -3.0 per cent. In the same period, the forecast for the output gap in 2014 has fallen from -2.9 per cent to -2.5 per cent (Chart 2.5). The range of output gap forecasts is considerably wider than that for GDP growth.

Chart 2.4: Forecasts for the output gap in 2013



Source: HM Treasury, ONS, OBR

Chart 2.5: Forecasts for the output gap in 2014

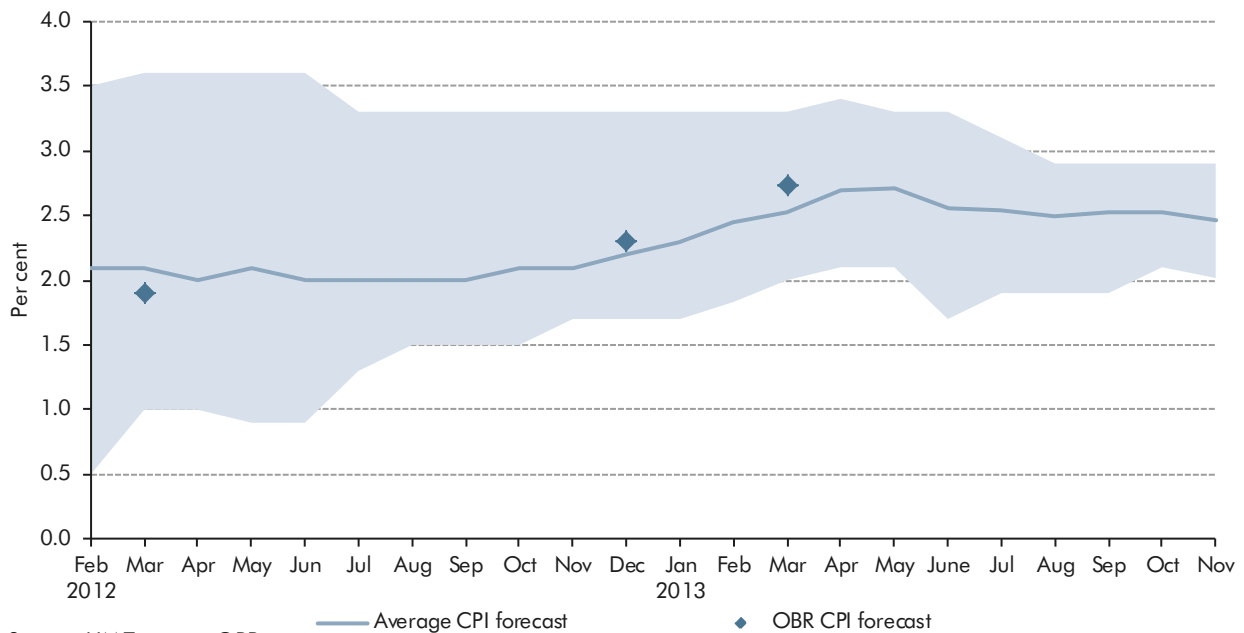


Source: HM Treasury, ONS, OBR

Inflation

2.21 The average forecast for CPI inflation in the fourth quarter of 2013 at the time of our March forecast was 2.5 per cent. This increased in April, but has since fallen back to 2.5 per cent, reflecting lower outturns (Chart 2.6). The average forecast for CPI inflation in the fourth quarter of 2014 was 2.4 per cent in November. Forecasts for RPI inflation have evolved in line with CPI inflation forecasts.

Chart 2.6: Forecasts for CPI inflation in the fourth quarter of 2013

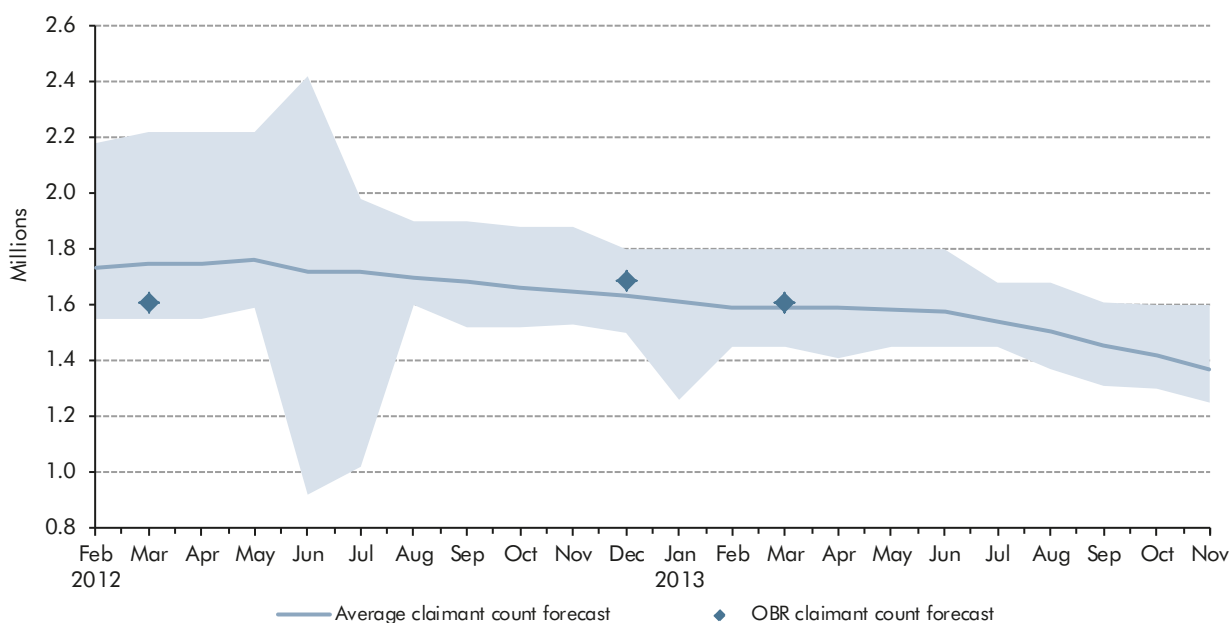


Source: HM Treasury, OBR

Labour market

2.22 The average forecast for claimant count unemployment for the final quarter of 2013 has fallen since our March forecast. It currently stands at 1.37 million, which is 220,000 – nearly 14 per cent – lower than in March (Chart 2.7). The average forecast for employment growth in 2013 has risen from 0.6 per cent in March to 1.1 per cent in November. Average earnings in 2013 are now expected to grow by 1.5 per cent compared to 2.1 per cent in March.

Chart 2.7: Forecasts for the claimant count in the fourth quarter of 2013



Source: HM Treasury, OBR

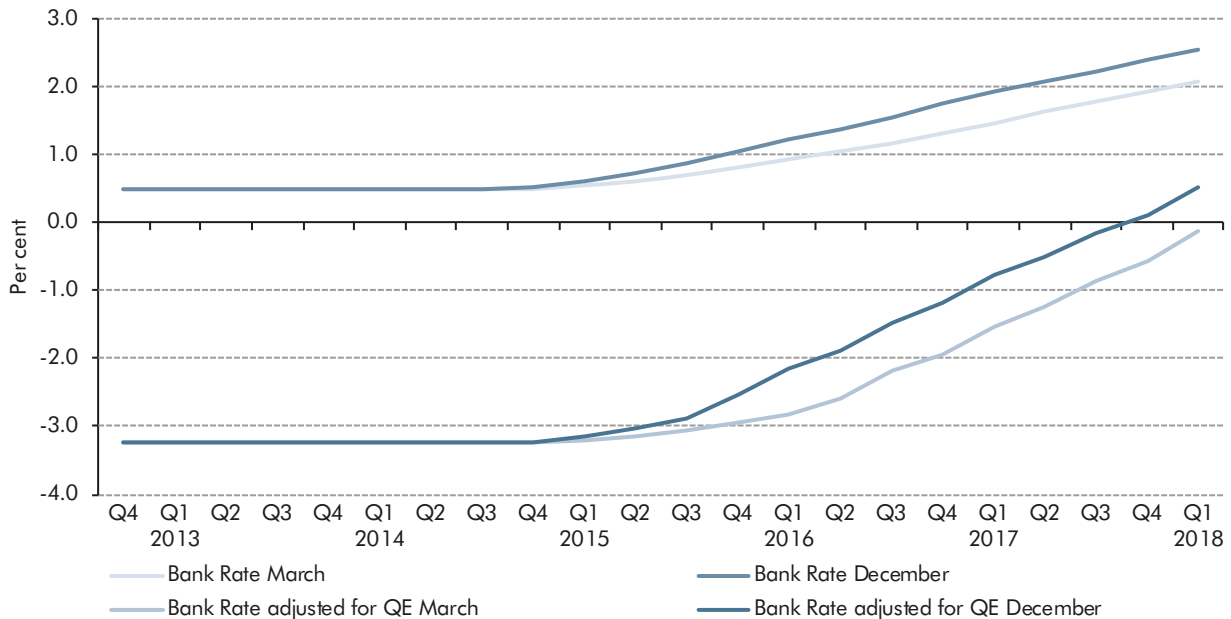
Public finances

2.23 The average forecast for public sector net borrowing (PSNB) for 2013-14 has declined since March from £105.9 billion to £101.9 billion. The average forecast for 2014-15 is £90.2 billion. The latest forecasts include the effect of £12.3 billion of Asset Purchase Facility (APF) transfers in 2013-14 and the market's expectation of transfers in 2014-15, which is likely to have been informed by our March forecast of £10.6 billion.

Market expectations of interest rates

2.24 Expectations of interest rates derived from financial market instruments have direct implications for our forecast, as we assume that monetary policy follows the path implied by financial markets. Market expectations are for Bank Rate to rise to 0.75 per cent in the second quarter of 2015, one quarter earlier than at the time of the March *EFO*. Bank Rate is now expected to be 1.25 per cent in the first quarter of 2016, a little higher than expected in March. The shift in expectations towards a tighter monetary stance since March is clearer when expectations of quantitative easing (QE) are taken into account alongside expectations of Bank Rate, as Chart 2.8 demonstrates. The chart uses our projection for the sale of assets by the APF, which is based on a simple conditioning assumption described in Box 4.1 – this is not our forecast of the Bank's future QE decisions. The latest Treasury survey showed market participants expecting no change in the level of QE in 2013 and 2014. In March, the median external forecast was for £50 billion of further easing to take place in 2013.

Chart 2.8: Market expectation for Bank Rate adjusted for QE²



Source: Bank of England, HM Treasury, OBR

Key judgements and scenarios

2.25 Forecasters differ not just in their numerical forecasts for key variables, but also in their assessment of important economic and policy trends. This can help explain the dispersion of external forecasts. One current topic of interest is the Bank of England’s forward guidance. Under forward guidance, the Monetary Policy Committee has committed to maintaining Bank Rate at 0.5 per cent until the unemployment rate falls below a threshold of 7 per cent, subject to certain ‘knockouts’. As a result, there has been increased debate about when the unemployment rate will fall below that threshold, and therefore when the Bank of England will consider increasing Bank Rate. In Chapter 5, we explore different ways in which the unemployment rate can fall more quickly or slowly than in our central forecast, and examine the potential impact on our central economic and fiscal forecasts of such scenarios.

² We adjust Bank Rate expectations by 100 basis points for each £100 billion of QE expected in our forecast, consistent with Bank of England analysis. For more details see Joyce, Tong, and Woods, 2011, *The United Kingdom’s quantitative easing policy: design, operation and impact*, Bank of England Quarterly Bulletin Volume 51 No. 3.

3 Economic outlook

Introduction

3.1 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.2);
- describes the key conditioning assumptions for the forecast, including monetary policy, fiscal policy, credit conditions and the world economy (from paragraph 3.20);
- sets out our short- and medium-term real GDP growth forecasts, as spare capacity is brought back into productive use (from paragraph 3.54) and the associated outlooks for inflation (from paragraph 3.70) and nominal GDP (from paragraph 3.83);
- discusses recent developments and prospects for the household, corporate, government and external sectors of the economy (from paragraph 3.89); and
- outlines risks and uncertainties associated with our forecasts and compares our central forecast to those of selected external organisations (from paragraph 3.135).

Potential output and the output gap

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

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

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

The latest estimates of the output gap

- 3.5 The first step in our forecast process is to assess how the current level of activity in the economy compares with the potential level consistent with stable inflation in the long term. We cannot measure the supply potential of the economy directly, but various techniques can be used to estimate it indirectly.
- 3.6 Our judgement regarding the current size of the output gap is informed by estimates of spare capacity derived from cyclical indicators as well as other approaches. To estimate the output gap from cyclical indicators, we use two techniques: 'aggregate composite' (AC) estimates, which weight together business survey indicators; and 'principal components analysis' (PCA), which combines survey and non-survey based indicators.¹
- 3.7 Following the 2008-09 recession, the cyclical indicators implied there had been a permanent loss of output relative to pre-crisis trends, as the fall in actual output exceeded the estimated widening of the output gap. By 2010, GDP was growing and the cyclical indicators were consistent with a gradual reduction of spare capacity. Growth then slowed towards the end of 2011 as higher global commodity prices squeezed real incomes and developments in the euro area damaged confidence and demand for exports.
- 3.8 The slowdown in GDP growth continued into 2012, with non-oil output at the end of the year only 0.1 per cent higher than a year earlier. But the PCA and AC measures of the output gap narrowed by 0.2 and 0.4 percentage points respectively over the same period. Taking into account the growth of the workforce and capital stock, this implied a fall in potential total factor productivity (TFP) – the efficiency with which the economy is able to combine labour and capital to generate output.² A fall in potential TFP seemed plausible in the depths of the recession, given the impact of the financial crisis on the efficient allocation of resources in the economy. But it seemed less plausible that potential TFP should start falling again in 2012. Cyclical influences seemed the better explanation of weak growth.
- 3.9 Reflecting this assessment, we assumed in our December 2012 and March 2013 *Economic and Fiscal Outlooks (EFO)* that potential TFP had been flat during 2012 and would show a small rise in 2013. Since then, actual output growth (excluding the volatile oil sector) has exceeded our March forecast in the first three quarters of 2013. In March, we expected non-oil output to expand by around 0.3 per cent over that period, with the output gap widening from -2.7 per cent of potential output in the final quarter of 2012 to -3.8 per cent in the third quarter of 2013. Outturn data show that growth has exceeded our March forecast by 1.3 percentage points over these three quarters, with the economy expanding by 1.8 per cent over that period.

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

² We used a production function to estimate total factor productivity, which is described in Box 3.1 of our December 2012 *EFO*.

Chart 3.1: Estimates of the output gap based on cyclical indicators



Source: OBR

- 3.10 Taking data revisions into account, we now judge that the output gap was a little narrower in the final quarter of 2012 than we thought in March, at -2.6 per cent. Thereafter, we judge that all of the upside surprise to output growth has been cyclical – reflecting stronger-than-expected demand, with our view of supply potential unchanged. This implies that the output gap has narrowed by 0.4 percentage points over that period, in contrast to the 1 percentage point widening that we expected in March. This leaves our estimate of the output gap in the third quarter of 2013 at -2.2 per cent of potential output.
- 3.11 The 0.4 percentage point narrowing of the output gap in our forecast between the final quarter of 2012 and the third quarter of 2013 is broadly consistent with the 0.3 percentage point narrowing implied by the PCA measure of spare capacity, but less than the 0.8 percentage point narrowing implied by the AC measure. Similarly, our -2.2 per cent estimate for the current output gap is a little wider than the PCA estimate of -2.0 per cent, but significantly wider than the AC estimate of -0.6 per cent. It remains unclear why the PCA and AC measures did not reflect the slowdown in GDP growth over 2012 and whether they are giving an accurate steer as to the direction of spare capacity. One possibility is that reported recruitment difficulties were influenced more by the pace of employment growth than by the amount of slack in the labour market.
- 3.12 As described below, we have also revised up our GDP growth forecast for the final quarter of 2013. Again, we consider this to be a cyclical improvement, so the output gap is forecast to narrow further. Taking the year as a whole, we expect the output gap to average -2.3 per cent in 2013, relative to our March forecast of -3.6 per cent.
- 3.13 It is important to recognise that there is considerable uncertainty around any central estimate of the output gap. Charts 3.2 and 3.3 compare our central output gap forecasts

for 2013 and 2014 to those produced by other forecasters, including those set out in the Treasury’s November *Comparison of Independent Forecasts* and estimates produced by NIESR, the European Commission and the OECD. The average estimate is -3.2 per cent in 2013 and -2.7 per cent in 2014, wider than our central estimates of -2.3 and -1.8 per cent respectively. However, reflecting the skew of the distribution, our forecasts are much closer to the median estimates of -2.5 and -1.9 per cent in 2013 and 2014 respectively.

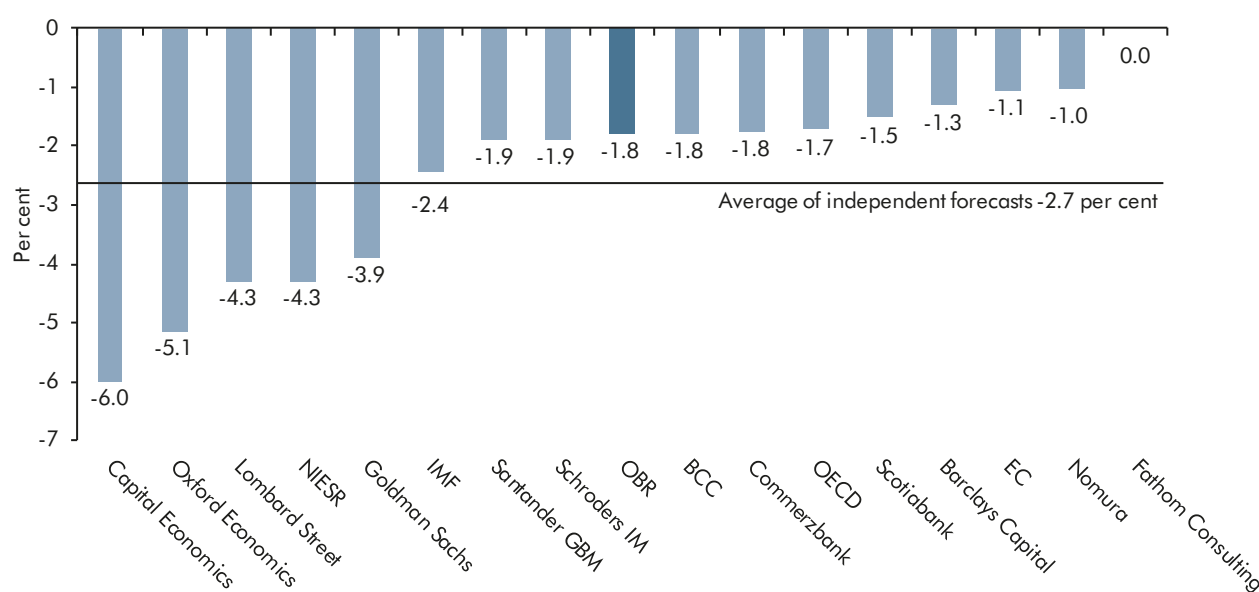
3.14 Relative to March, our estimates and forecasts of spare capacity in the economy have moved from an average to a below-average estimate because most forecasters appear to have assumed some of the growth surprise reflects faster growth of supply potential. In Chapter 5, we test the sensitivity of our judgements regarding the Government’s performance against its fiscal targets to different estimates of the output gap.

Chart 3.2: Estimates of the output gap in 2013



Source: HM Treasury, November 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, plus additions or updates where known.

Chart 3.3: Estimates of the output gap in 2014



Source: HM Treasury, November 2013, *Forecasts for the UK economy: a comparison of independent forecasts*, plus additions or updates where known.

3.15 Of the -2.2 per cent output gap we estimate for the third quarter of 2013, we attribute -2.2 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 -2.1 percentage points to output-per-hour lying below potential (i.e. cyclical weakness in productivity). These are partly offset by +2.2 percentage points from average hours lying above their trend level, possibly reflecting unexpectedly weak income growth and negative wealth shocks for many households, leading them to increase labour market input temporarily. Given that indirectly measuring the overall size of the output gap is a significant challenge, it should not be surprising that its composition is also a key area of uncertainty. Different decompositions would have different implications for the public finances, reflecting the implied split of labour income between employment, hours and wages.

The growth of potential output

3.16 Consistent with our view that the growth surprise in 2013 has been cyclical, we have not changed our view of the underlying growth momentum of potential output. Our March forecast was for a pick-up in potential output growth over 2013, gradually strengthening over the forecast period. That remains our central judgement. The growth of potential productivity per hour remains below the rate consistent with historical trends throughout the forecast, reflecting our view that the slow pace of financial sector normalisation and persistent spare capacity will continue to be a drag on the sustainable rate of growth for some years to come.

3.17 Our latest forecast reflects updated ONS population projections, released on 6 November. The ONS has revised down the assumed rate of long-run net inward migration for the 'low migration' variant that we use for our central forecast from 140,000 to 105,000, but this has little impact on the growth of potential output over the five-year horizon. We continue to

assume that the long-term non-accelerating inflation rate of unemployment (NAIRU) is 5.35 per cent. This is also consistent with the actual pre-crisis rate of unemployment in 2008.

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

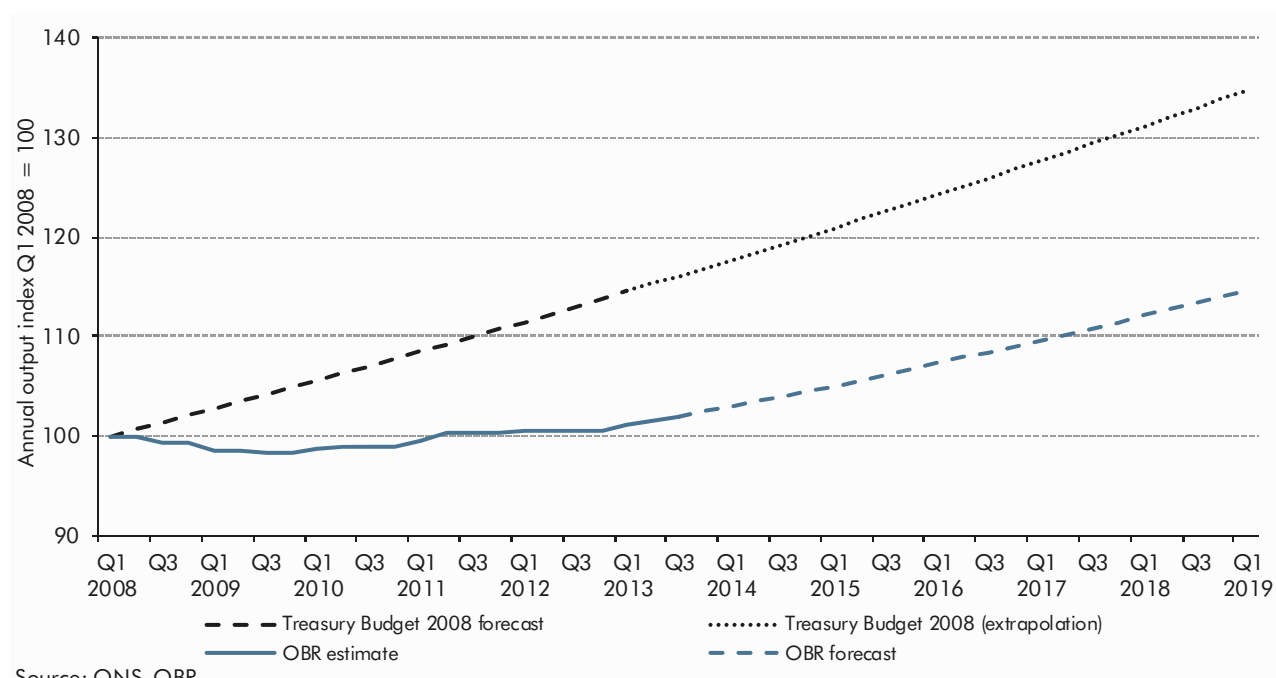
	Potential productivity ¹	Potential average hours employment rate ²	Potential employment rate ²	Potential population ²	Potential output ³
2013	0.6	-0.2	0.1	0.7	1.2
2014	1.6	-0.2	0.0	0.6	1.9
2015	1.8	-0.2	-0.1	0.5	2.1
2016	1.9	-0.2	-0.1	0.5	2.2
2017	2.0	-0.2	-0.1	0.5	2.2
2018	2.0	-0.2	-0.1	0.5	2.2

¹ Output per hour.

² Corresponding to those aged 16 and over.

³ Components may not sum to total due to rounding

Chart 3.4: Potential output relative to the Treasury’s Budget 2008 forecast



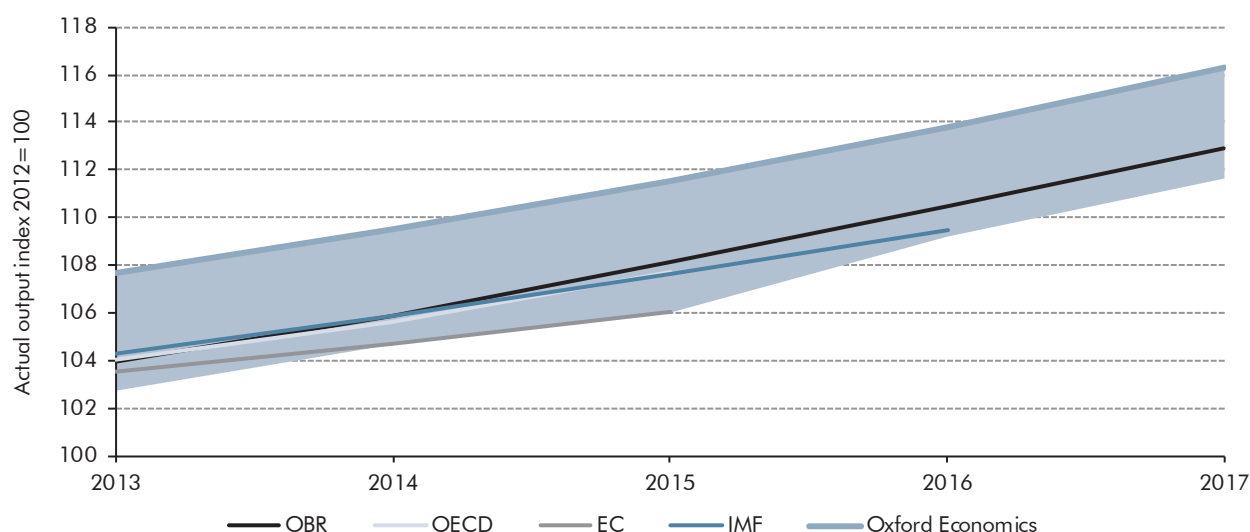
Source: ONS, OBR

3.18 We judge that the level of potential output in the third quarter of 2013 is around 12 per cent below the level consistent with the Treasury’s March 2008 Budget forecast – the last before the recession – with the difference widening to over 15 per cent by the first quarter of 2019. This reflects our view that much of the loss of productivity over the recession was structural and will not return even as the economy recovers and the financial system returns to full health. Since it is difficult to explain the abrupt fall and persistent weakness of productivity in the past, it is also hard to judge when or if productivity growth will return to the rate consistent with historical trends.

3.19 Chart 3.5 presents our potential output projection alongside those of external forecasters that publish similar projections. It shows that we, the IMF and the OECD have made similar

judgements over the margin of spare capacity in 2013 and forecast a similar growth rate of potential output in 2014. Thereafter, we expect potential to grow a little faster than the IMF or OECD. The range presented in the chart illustrates the uncertainty surrounding this crucial judgement – we test the sensitivity of the Government’s fiscal mandate to it in Chapter 5.

Chart 3.5: Potential output



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

Key economy forecast assumptions

Monetary policy

- 3.20** Our forecast assumes that the Bank of England will endeavour to bring inflation to target over 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 respectively stimulating or softening aggregate demand.
- 3.21** That said, there are ongoing limits to the speed at which the economy is likely to return to potential. Accordingly, we continue to expect the output gap to narrow at a gradual rate over the remainder of the forecast period. In every previous *EFO*, we have assumed that output remains below potential at the end of our five-year forecast horizon, implying limits to the Bank’s ability or willingness to soak up the spare capacity in the economy over its own shorter three-year forecast horizon. This seems consistent with the Bank’s newly published forecasts for the unemployment rate, which remain above its published estimates of the medium-term and long-term NAIU at the end of that three-year horizon.

- 3.22 In April 2013, the Bank of England announced an extension of the Funding for Lending Scheme (FLS), extending the period for which funds will be available and adapting its terms to encourage lending to small and medium-sized enterprises (SMEs). The impact of this change, and the further reorientation of the FLS towards SME lending announced last week, is discussed in the credit conditions section below.
- 3.23 In August, the Bank of England provided forward guidance on the future path of monetary policy, conditional on the unemployment rate and three other judgements. Box 3.1 sets out more details. As in previous EFOs, we assume that Bank Rate moves in line with market expectations, which have risen since our March forecast, as described in Chapter 2. Bank Rate is therefore expected to reach 3.0 per cent by the end of our forecast period.

Box 3.1: Forward guidance by the Monetary Policy Committee

On 7 August 2013, the Bank of England announced that it will not consider raising Bank Rate from its current level of 0.5 per cent (or unwinding its asset purchase programme) until the unemployment rate has fallen to 7.0 per cent. But this forward guidance will no longer hold if any one of three knockout conditions is breached: CPI inflation in 18-24 months is more likely than not to be 2.5 per cent or more; medium-term inflation expectations are no longer sufficiently anchored; or, financial stability is put at risk by the monetary policy stance.

This guidance was announced with three stated goals: to clarify the Bank's view on the trade-off between inflation and supporting the recovery; to reduce uncertainty about the future path of monetary policy; and, to allow the Bank to explore the scope for higher economic growth while maintaining price and financial stability. The guidance provides thresholds rather than triggers for decisions, which means that neither the unemployment rate reaching 7.0 per cent nor a breach of the knockouts would necessarily result in a tightening of monetary policy.

Our forecasts are conditioned on market expectations for Bank Rate, so we have not made an explicit judgement about the effect of forward guidance on the future path of interest rates. As it happens, we forecast that unemployment will reach 7.0 per cent in the second quarter of 2015, one quarter before the market has fully priced in the first 25 basis point Bank Rate increase.

Our forecast does not imply that any of the knockouts would be breached. Our forecast for inflation in 18-24 months' time is 2.3 per cent, comfortably below the 2.5 per cent threshold. Also, we assume that inflation expectations remain well anchored, which is one reason we do not forecast that inflation will fall below target despite a negative output gap over the forecast period. Finally, we expect financial stability risks to be contained over the forecast period.

Despite the recent pick-up in house prices and housing market activity, as the Bank of England notes, "there is little evidence of an immediate threat to stability".⁹ A greater threat could arise if there is excessive growth in household debt or weakening of underwriting standards, but we assume that these risks are managed successfully by the financial stability authorities.

⁹ Bank of England, November 2013, *Financial Stability Report*.

Fiscal policy and Autumn Statement measures

- 3.24 As we set out in our 2013 *Forecast evaluation report (FER)*, applying the multipliers we have used in previous forecasts to estimates of the consolidation produced by the Institute for Fiscal Studies (IFS) would suggest that the consolidation measures announced since 2008 have been sufficient to reduce the level of GDP by around 1.5 per cent in 2012-13. With the effects of previous tightening assumed to fade a little faster than new tightening bears down on GDP, this suggests a slightly smaller reduction in the level of GDP in 2013-14 of 1.4 per cent, mechanically implying a positive impact on GDP growth of 0.1 percentage point.
- 3.25 These calculations are based on the IFS estimates of the size of the fiscal consolidation produced at the time of the March 2013 forecast. They exclude the effect of underspending by central and local government departments in 2013-14, as well as the measures in the Autumn Statement. Mechanically applying the same multipliers would imply that the underspend might have reduced the level of GDP by a further 0.3 per cent in 2013-14. Taken together with the estimates set out in our *FER*, this would imply a modest drag to growth from the fiscal consolidation of around -0.1 per cent in 2013-14. As set out in Box 3.2, the Autumn Statement measures are expected to have a negligible effect on GDP.
- 3.26 When setting out these calculations, it is important to remember that both the size of the multiplier effects and the speed with which they decay is highly uncertain and impossible to verify even after the event.

Box 3.2: The economic effects of policy measures

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

The Government has announced a number of measures between 2013-14 and 2018-19 that are expected to have a neutral fiscal impact, with 'giveaways' offsetting 'takeaways' over this period. Using the same multipliers that the interim OBR used in June 2010, these measures are expected to have a negligible effect on annual GDP growth and have no effect on our GDP forecast. Given the relatively small size of these measures, using larger multipliers would not change this conclusion.

The Government has set a spending assumption for 2018-19 that holds total spending flat in real terms and gross capital spending flat as a share of GDP. Taken together with our forecasts for other elements of spending, this implies a fall in nominal government consumption from 17.3 per cent of GDP in 2017-18 to 16.4 per cent in 2018-19. This is a relatively large change in the composition of GDP, but we assume that monetary policy determines the level of demand in the economy at this time horizon, so we have not adjusted our overall GDP growth forecast.

We have adjusted our inflation forecasts to take account of measures that directly affect the price level. The Government's cancellation of the September 2014 **fuel duty** increase is estimated to reduce annual CPI inflation by around 0.1 percentage point in the subsequent year 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 has announced a number of measures that are designed to reduce energy bills. Firstly, the Government has amended the **Energy Company Obligation**, by reducing the carbon saving target, retaining the fuel poverty targets and extending the targets at these levels for a further two years. The Government has also announced funding to help offset the costs of policies on bills. These measures could have an effect on inflation and disposable incomes by reducing household bills. Final details of these measures were not available at the time our forecast was completed, so we have not made an adjustment for these policies.

A number of policies affect our forecast by boosting the housing market, both demand and supply. Most substantial is **Help to Buy**, which will relieve collateral constraints on prospective mortgagors via equity loans or mortgage guarantees. The equity loan part has been in place since April. By September, it had lent more than £200 million in England. Our forecast assumes nearly £4 billion of loans over the next three fiscal years. The mortgage guarantee part has been available for reservations since October, with full operation from January 2014. Its ultimate scale is uncertain. A cap of £12 billion on the Government's contingent liability, which could have been associated with £130 billion of mortgage lending, was previously cited by Government, but this is unlikely to be used in full. For a forecast, the important variable is not total Help to Buy lending, but its additionality, which is highly uncertain given other factors, including the FLS and general pick-up in sentiment, supporting mortgage lending. To the extent that Help to Buy lending is additional, our modelling suggests it would feed through roughly one-for-one into house prices in the short term, which we would then expect to feed through to a much smaller extent into house-building – underpinning our forecast for a strong recovery in residential investment. Help to Buy is a temporary scheme, which could imply a negative effect on the housing market when it is removed. In our central forecast, we have assumed that any withdrawal can take place without disruption, as we assume the economy and financial system will have recovered further in the intervening period.

We have not adjusted our forecast for the changes to the FLS announced on 28 November, which did not have an immediate effect on bank funding costs that would be expected to feed through to mortgage rates. But we will keep this under review ahead of our next forecast.

Credit conditions

3.27 UK financial market conditions remain stable, broadly in line with the March forecast assumption and significantly improved from 2012. This reflects several factors:

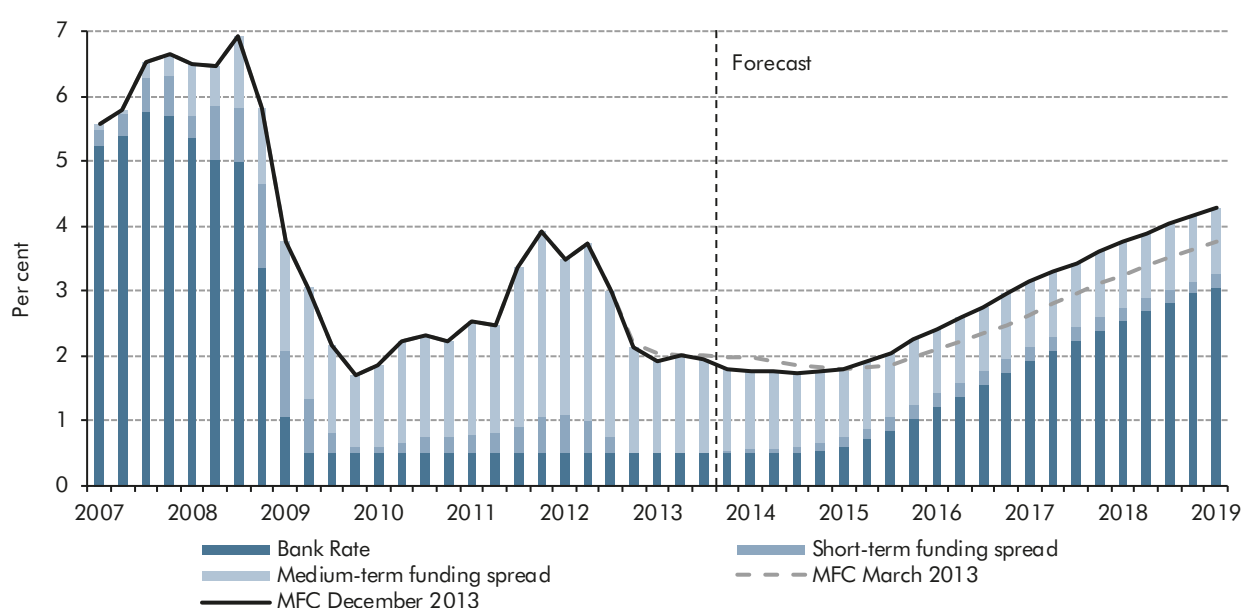
- the European Central Bank's (ECB's) Outright Monetary Transactions announcement in mid-2012, which removed significant tail risks from euro markets and their knock-on effects for UK financial institutions;
- the introduction of the Bank of England's FLS; and
- a more general improvement in macroeconomic conditions, domestically and in key global markets.

3.28 In the UK market, improved confidence has reduced risk premia in wholesale funding markets, lowering banks' funding costs. To varying degrees, this has fed through to interest rates faced by borrowers in the wider economy.

The price of credit

3.29 Our central assumption is that UK banks' marginal funding costs fall slightly until mid-2015 (Chart 3.6), when the first Bank Rate rise is expected. Costs then rise gradually, in line with a gradual normalisation of monetary policy. Changes in our marginal funding costs assumption since March are explained by changes in market expectations of Bank Rate.

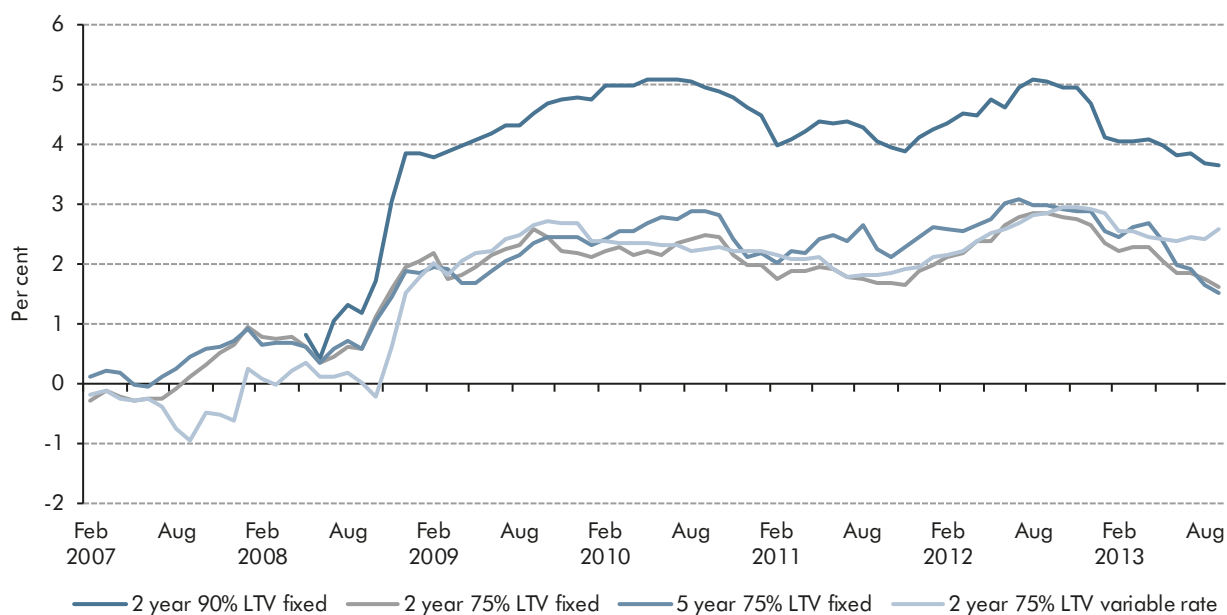
Chart 3.6: Banks' marginal funding costs



Source: Bank of England, Thomson Reuters Datastream

3.30 Narrower bank funding spreads have fed through to lower lending rates in the wider economy, particularly in the mortgage market. Chart 3.7 shows the spreads for a range of mortgage products, relative to an appropriate reference rate – an interest rate swap of equivalent maturity for fixed rate loans and 3-month LIBOR for variable rate loans.

Chart 3.7: Spreads on new mortgage rates



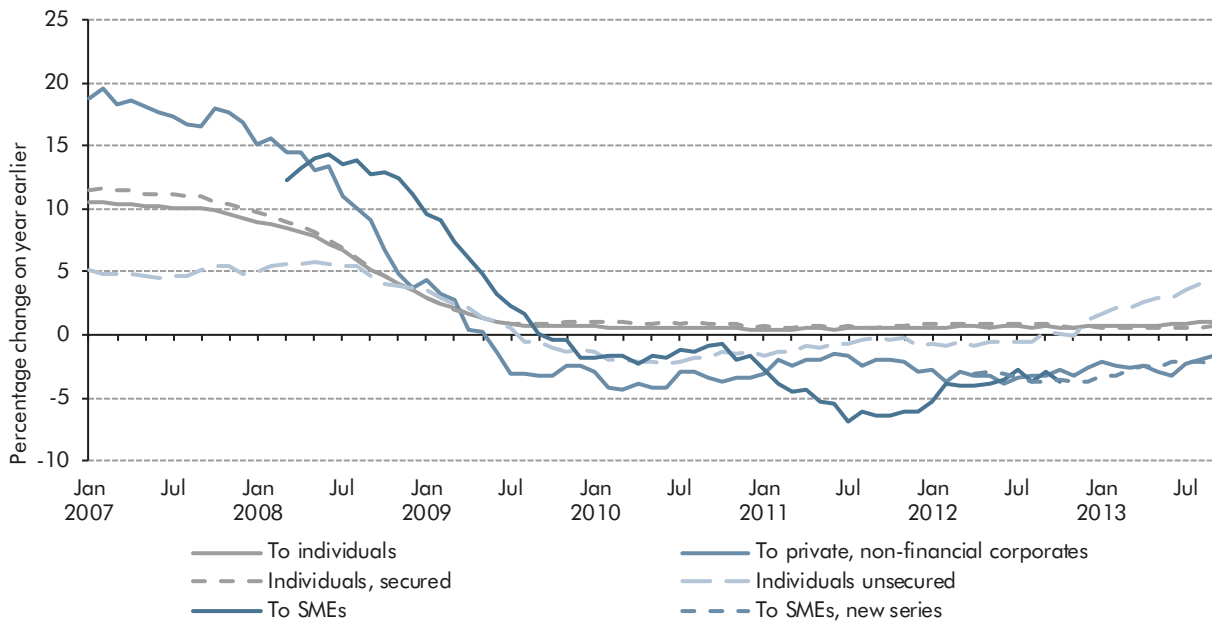
Source: Bank of England, Bankstats; Bloomberg

- 3.31 While mortgage rates have fallen in 2013, the extra cost of a 90 per cent loan-to-value (LTV) ratio mortgage relative to a 75 per cent LTV ratio mortgage remains large. The gap has narrowed a little since the peak of the crisis and we expect this to continue with ongoing financial market normalisation and as the Government's Help to Buy scheme gets under way. While the cost of new loans is falling, we expect effective mortgage rates to fall only modestly in the near term, as existing mortgages are refinanced and lower rates are paid on a growing share of the stock of mortgages. Over the long term, we expect the effective rate to rise as Bank Rate increases.
- 3.32 The Bank of England reports that headline lending rates offered to small businesses have been little changed in the past year, in marked contrast to the mortgage market, and although rates offered to larger corporates have fallen so has the cost of borrowing from wholesale funding markets, to which many have access.

The flow of credit

- 3.33 Net lending has remained extremely weak. Lenders continue to struggle with depressed profits, large conduct fines and the pressures of regulatory reform. FLS data reveal a disparity between stronger and weaker banks' lending behaviour over the past year – the former growing their loan books, the latter shrinking them. Net lending to corporates continues to contract while to households it is growing only modestly (Chart 3.8).

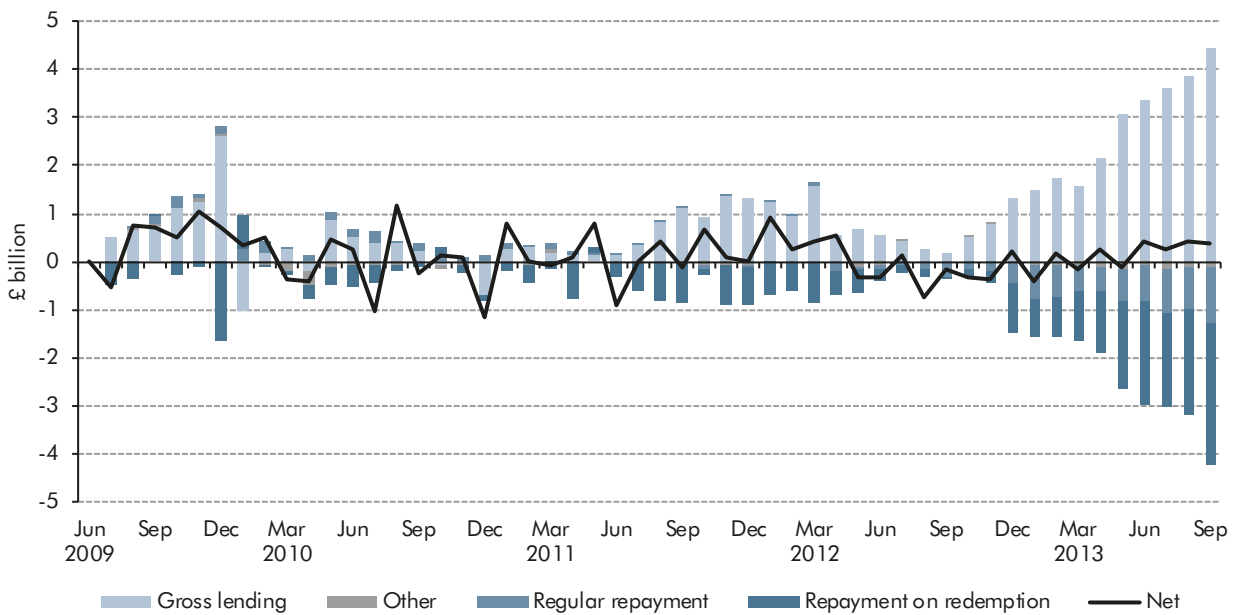
Chart 3.8: Net lending to the wider economy



Source: Bank of England

3.34 Gross mortgage lending has begun to recover from its very low post-crisis level, but this has not yet translated into significant growth in the stock of debt. As Chart 3.9 shows, new loan growth has been largely matched by repayments. So while net mortgage lending remains relatively subdued, this masks significantly more underlying activity.

Chart 3.9: Cumulative change in monthly flows of mortgage debt



Source: Bank of England

Economic outlook

- 3.35 The strength of repayments is being driven in part by remortgaging, as existing customers move from standard variable rates to new, lower fixed-rate deals.³ As house prices rise and the number of first-time buyers increases – supported by Help to Buy – we expect net lending to rise, increasing the household debt stock more rapidly. Unsecured credit growth has outpaced all other lending so far this year, mostly through unsecured loans rather than credit card lending. A substantial part has been for car purchase, as described in Box 3.4.
- 3.36 Bank lending to non-financial companies has continued to contract, but has been offset by more capital market issuance by larger firms. This trend is likely to persist while banks face pressure from regulators to deleverage, but the effect should diminish as credit conditions normalise.
- 3.37 Bank lending to SMEs is also shrinking, as Chart 3.8 shows, and small businesses do not have access to capital markets. But alternative non-bank sources of funding (such as asset finance, factoring and invoice discounting) are available and have been growing rapidly. An extension of the FLS, announced in April 2013, means that for every additional pound lent to SMEs in 2013, lenders gain access to 10 pounds of initial allowance, falling to five pounds in 2014. A further modification, announced in November 2013, means that during 2014 additional lending to households will no longer earn an additional allowance from the FLS. The initial allowance remains unchanged. Both changes should provide an incentive for banks to increase SME lending, assuming there is a recovery in SME demand for credit as the economy strengthens.

House prices

- 3.38 House prices have increased faster than we expected in March, rising by 3.6 per cent on a year earlier in the third quarter of 2013 against a forecast of flat prices. More timely indicators point to further rises in annual house price inflation in coming months. We have increased our forecast for future house price inflation, based on a new forecast method set out in a supplementary note on our website. This bases our near-term house price forecast on underlying demand, credit and supply-side drivers, with house prices then assumed to rise in line with average earnings after two years. We now expect house prices to be 10 per cent higher in 2017-18 than in our March 2013 forecast.

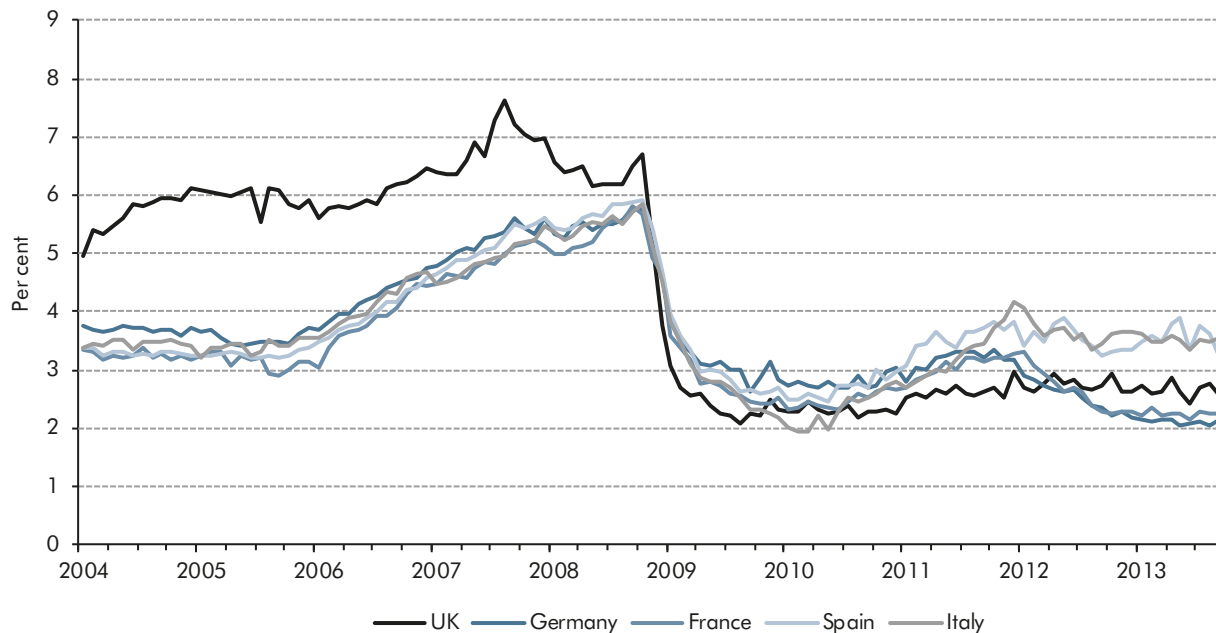
World economy

- 3.39 World output grew by 3.2 per cent in 2012, but appears to have slowed unexpectedly thereafter. We forecast growth of 2.9 per cent for 2013, down from 3.4 per cent in March. However, some recent survey evidence suggests a pick-up from the third quarter of 2013. For example, the JP Morgan *Global Manufacturing PMI* has been rising since April 2013 and has reached its highest level since June 2011. Despite a fall in September, the overall *Composite PMI* has since risen, and is now also at its highest level since early 2011.

³ The share of fixed rate deals in all new mortgages rose to 75 per cent in the second quarter of 2013, up from 50 per cent in mid-2012.

- 3.40 Conditions in the euro area have stabilised in 2013, with the pace of additional fiscal tightening slowing and the unemployment rate broadly flat following increases towards the end of 2012. Following six consecutive quarters of falling output, the euro area economy grew by 0.3 per cent in the second quarter and 0.1 per cent in the third quarter. Several economies contracted, including the region's second and third largest economies, France and Italy. The *Markit euro area Composite PMI* rose to its highest level in more than two years in September, before falling back slightly into October. Inflation has fallen significantly since July, reaching a 4-year low of 0.7 per cent in October, which prompted the ECB to cut interest rates to a record low of 0.25 per cent in November. The recovery of the euro area remains fragile and uneven.
- 3.41 We have revised up our forecast of euro area GDP growth in 2013 to -0.4 per cent from our March forecast of -0.5 per cent. We expect the euro area to grow by 0.9 per cent in 2014. Thereafter, the forecast is broadly unchanged from March. Although market concerns over the euro area have subsided, adjustments to competitiveness and institutional reform have further to run. Furthermore, ongoing impairment of the banking sector continues to hamper the transmission of the ECB's expansionary monetary policy to the periphery, resulting in tighter credit conditions in weaker economies (Chart 3.10).

Chart 3.10: Interest rate on new loans to non-financial corporations in selected European countries



Source: Bank of England, ECB

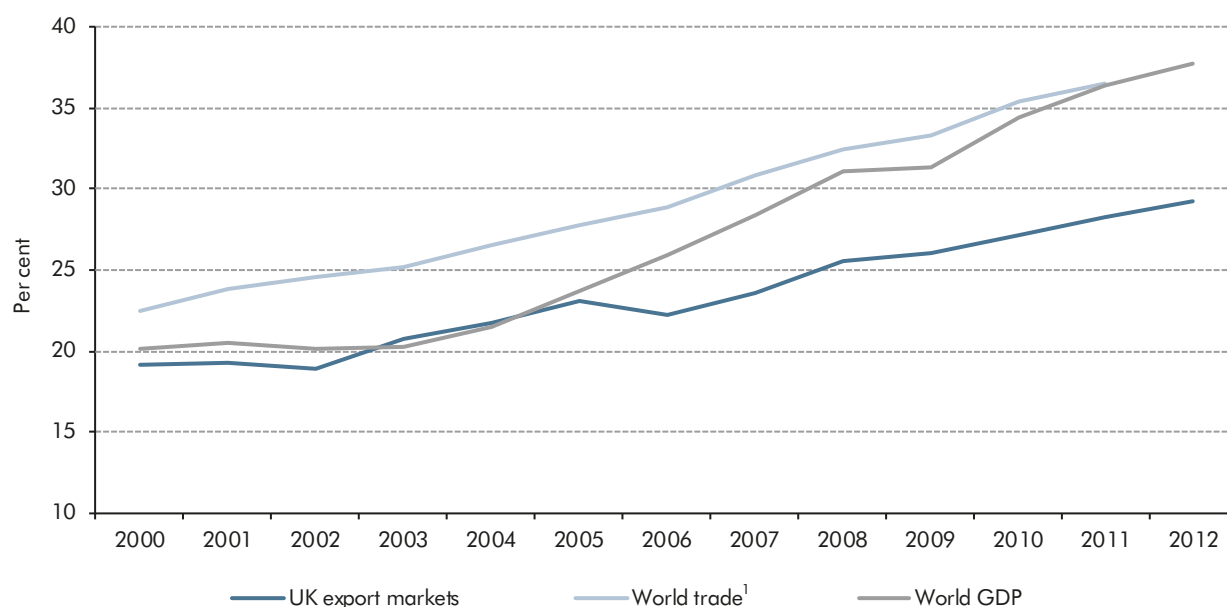
- 3.42 US GDP growth in the first quarter of 2013 was below our March forecast, but has since improved. Reflecting this weakness in the early part of the year, we have revised down our estimate of growth in 2013 from 2.0 per cent to 1.7 per cent. Growth so far in 2013 has been driven by domestic demand, with fiscal tightening continuing to weigh on activity, although labour market indicators have picked up more recently.

- 3.43 The US federal government shutdown in October is likely only to have a small effect on growth in the final quarter of 2013. The OECD and European Commission expect it to have subtracted somewhere between 0.1 and 0.2 percentage points from the quarterly growth rate. Our forecast assumes that the US negotiates further budget deadlines in early 2014 without major mishap. But these events continue to pose a downside risk to growth.
- 3.44 We have revised down our growth forecasts for emerging markets. China is targeting more balanced growth, accepting a slower pace of expansion to reduce reliance on exports and investment in favour of domestic consumption. The growth rate has eased over the past couple of years and we expect it to stabilise at around 7 per cent. We have also lowered our growth forecasts for India and Russia, which are both experiencing high inflation and slowing activity, which may reflect supply constraints. Speculation about US monetary tightening earlier this year had unexpectedly large effects on emerging markets, with several countries experiencing capital outflows, currency depreciation, and higher interest rates.

World trade

- 3.45 Consistent with slower global growth, world trade has been weaker than we expected in our March forecast, largely due to weaker-than-forecast trade in advanced economies and parts of Asia. We have revised our trade forecast to reflect this and now expect trade to grow by 3.0 per cent in 2013 before picking up to 5.4 per cent in 2014. We have also revised down our trade forecast for emerging economies over the forecast period. The IMF and European Commission have made similar downward revisions to their trade forecasts.
- 3.46 Growth in UK export markets is expected to be slower than growth in world trade: the euro area and the US make up a larger share of UK exports, and import demand from these regions is forecast to grow more slowly than import demand from emerging markets. We now expect UK export markets to grow by 3.2 per cent in 2013 and 5.2 per cent in 2014, which is lower than our March forecast. These downward revisions reflect current weakness in euro area import growth and weaker import growth in emerging economies.
- 3.47 The euro area's contribution to UK exports is expected to stabilise from 2015 and at the same level as in our March forecast. Our forecast also incorporates a weaker outlook for US import demand from 2015 onwards. These downward contributions are only partly offset by our forecast for higher trade from European countries outside the euro area following 2016. Taken together, along with expectations of lower emerging market growth, this has led us to significantly revise down our forecast of UK export markets growth since March.
- 3.48 Chart 3.11 shows the growing importance of emerging markets, with steady growth in their share of world output, world trade and UK export markets since 2000. The weight of emerging markets has risen substantially in all three, but less so in the case of UK export markets, which remain dominated by mature economies.

Chart 3.11: Emerging markets share of nominal world GDP, world trade and UK export markets



¹2012 data not available

Source: IMF, ONS, World Bank, OBR.

Other conditioning assumptions

3.49 In this forecast, we have altered our approach to projecting oil prices. We now assume that prices move in line with the average of the futures curve over the ten working days to 22 November 2013 for the next two years, then we hold prices flat in the final three years of the forecast. This raises the forecast in the later years since the futures curve is downward sloping. The thinness of oil futures trading beyond two years suggests there is little information content in the prices at that horizon and that a simple flat assumption – a ‘random walk’ – would provide a better neutral assumption for our five-year fiscal forecast. This is supported by analysis published by the IMF.⁴ Movements in oil prices and the sterling/dollar exchange rate since March mean the sterling oil price forecast is actually a little lower than our March forecast. Gas prices are projected forward in the same way as the new methodology for oil prices. As a result, prices are lower than we expected in March in 2013 and 2014, then higher later in the forecast.

3.50 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 to 22 November 2013. Share prices in the fourth quarter of 2013 were 4.2 per cent higher than in our March forecast, which is carried through to higher prices over the forecast period.

3.51 Exchange rates are taken from the forward rates for the current quarter and the quarter ahead. From the second quarter of 2014 onwards, exchange rates are assumed to follow a

⁴ Reichsfeld and Roache, November 2011, IMF Working Paper: *Do Commodity Futures Help Forecast Spot Prices?*

path implied by the uncovered interest parity (UIP) condition. This relates exchange rate movements to interest rate differentials. It implies that the sterling effective exchange rate will edge lower over the forecast period.

Summary

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

- monetary policy remains very loose and does not begin to tighten until mid-2015;
- the fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past three years;
- the measures announced in this Autumn Statement have a negligible overall impact on demand, while the cancellation of the planned fuel duty increase in September 2014 reduces CPI inflation by around 0.1 percentage points over the subsequent year;
- credit conditions and the financial system continue to normalise gradually, with the effect felt more in the housing market than among businesses, particularly small businesses, in the near term;
- global activity and demand for UK exports picks up steadily, but less quickly than we expected in March; and
- financial markets are broadly stable and commodity prices ease a little, as priced into financial market instruments.

3.53 Risks and uncertainties associated with these assumptions and other facets of the forecast are discussed from paragraph 3.135.

The pace of the recovery

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

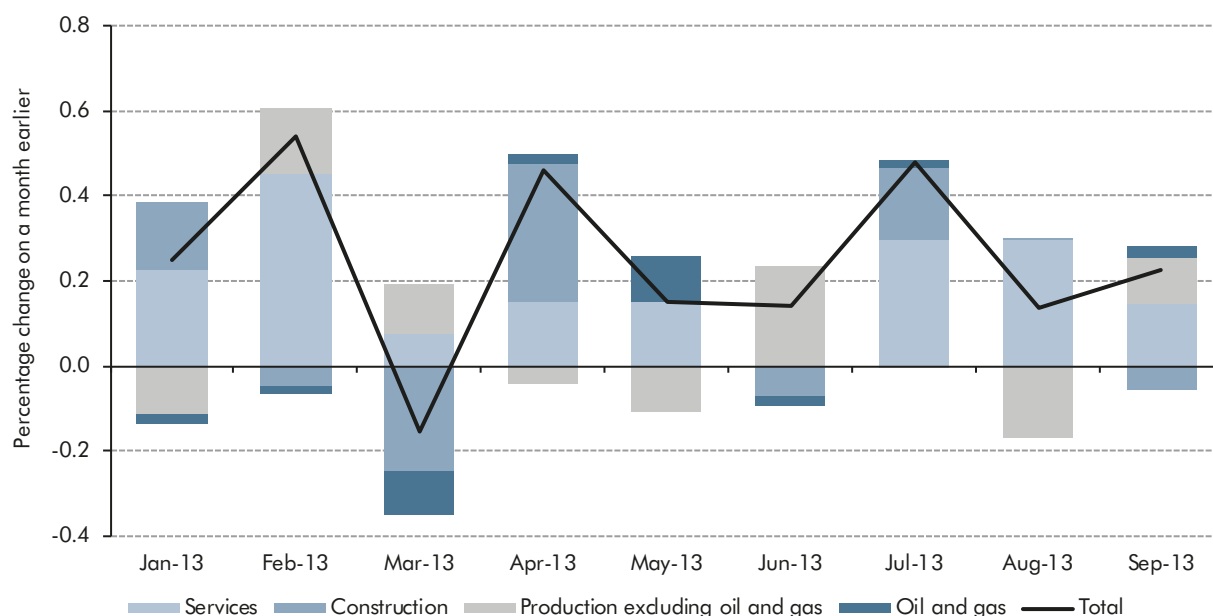
The short-term outlook for GDP

3.55 The economy grew modestly in the first quarter of 2013 and more strongly in the second and third quarters. The outturn data for the first three quarters of 2013, together with an estimate for growth in the final quarter, has led us to increase our forecast for growth in 2013 as a whole from 0.6 per cent in March to 1.4 per cent now.

3.56 On a monthly basis, Chart 3.12 shows a steady contribution to growth from the service sector through the last quarter, but more volatile contributions from the production and

construction sectors. In previous years a number of special factors, such as heavy snowfall, the Olympics and extra bank holidays, have affected the quarterly profile of GDP growth. There are no such special factors affecting GDP growth in 2013.

Chart 3.12: Monthly output growth in 2013

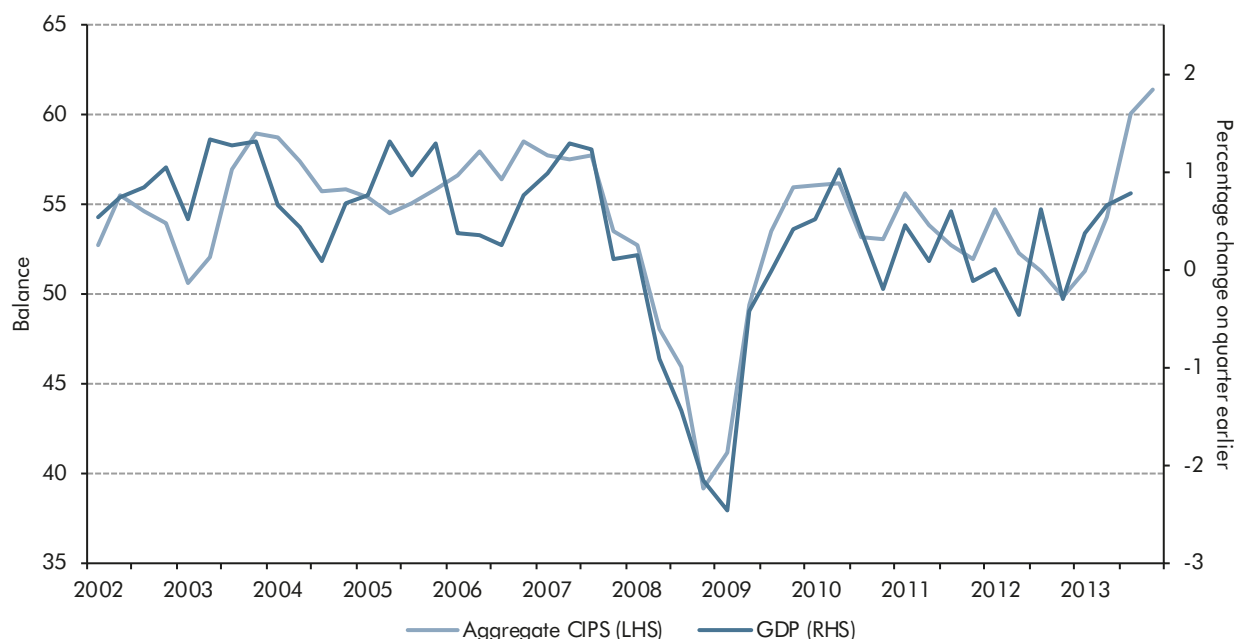


Source: ONS, OBR

3.57 As we set out in Chapter 2, various survey indicators pointed to a significant improvement in economic activity in the third quarter of 2013, with the pace of improvement easing slightly in October. Surveys have often been a good leading indicator for official estimates of economic growth. In common with other external forecasters, we use them to inform our view of GDP growth in the current quarter, before the official ONS estimates are released. Chart 3.13 shows the relatively strong relationship between the composite *CIPS Purchasing Managers' Index (PMI)* and GDP growth.

3.58 The composite PMI would have suggested GDP growth significantly greater than the ONS currently estimate. Similarly, the October surveys point to very strong GDP growth in the final quarter of 2013. Given the surveys' over-estimation of the official growth estimate for the third quarter, we have used them to inform our view of the change in momentum into the fourth quarter, rather than the quarterly growth rate itself. We therefore forecast growth in the fourth quarter of 0.7 per cent, 0.3 percentage points higher than our March forecast (Table 3.2).

Chart 3.13: Composite CIPS and GDP growth



Source: Markit, ONS, OBR

Table 3.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
December forecast¹	0.0	-0.5	0.6	-0.3	0.4	0.7	0.8	0.7	0.5	0.5	0.5	0.5
March forecast²	-0.1	-0.4	1.0	-0.3	0.1	0.2	0.3	0.4	0.5	0.5	0.5	0.5
Change	0.1	-0.1	-0.3	-0.1	0.3	0.5	0.5	0.3	0.0	0.0	0.0	0.0

¹ Forecast from fourth quarter of 2013.² Forecast from first quarter of 2013.

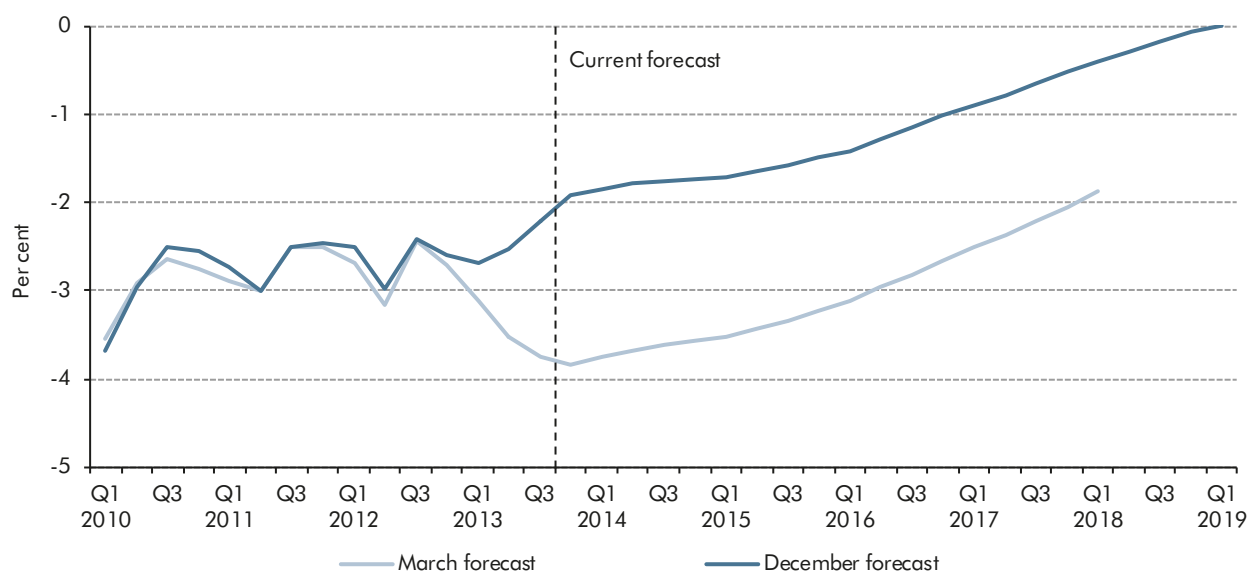
The medium-term outlook for GDP

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

3.60 Activity in the economy has certainly accelerated dramatically in recent quarters. Our short-term forecast implies growth of 2.6 per cent between the fourth quarters of 2012 and 2013, compared with a 0.2 per cent fall between the fourth quarters of 2011 and 2012. Explaining why the pace of activity has picked up so abruptly is not easy, especially as real wages are still falling and most components of demand show only modest growth in recent data. Activity may have been buoyed by greater confidence in future domestic and external demand, improving credit conditions, the pick-up in the housing market, a smaller drag from fiscal consolidation and diminishing fears of a further damaging setback in the euro area. It may also be the case that future vintages of National Accounts data will show a less dramatic transformation between 2012 and 2013 than is currently the case.

- 3.61 We are conscious that forecast revisions tend to lag economic developments at turning points, leading to repeated overestimates of economic activity in downturns and repeated underestimates when activity finally picks up. But the experience of 2010 provides a recent example of what appeared to be a turning point in the cycle ebbing as the factors needed to generate self-sustaining recovery failed to take hold. With productivity, real income growth and UK export markets remaining weak, and problems in the euro area far from fully resolved, we do not assume that the growth rates seen in the last couple of quarters are maintained through next year and beyond. We assume that growth slows to rates of around 0.5 per cent a quarter through 2014, with risks to both the upside and downside.
- 3.62 Our quarterly growth rates for 2014 are close to the estimated growth rate of potential output over this period, implying little change in the size of the output gap (Chart 3.14). As productivity growth and real earnings gradually recover, we expect the quarterly rate of growth to gather pace through 2015. But, despite the quarterly growth rate strengthening, the mechanical effect of relatively strong output growth at the end of 2013 means that our forecast for annual growth in 2014 is slightly higher than our forecast for 2015. This reflects the arithmetic effect of greater near-term momentum, rather than an expectation that the recovery will lose momentum between 2014 and 2015.

Chart 3.14: The output gap



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

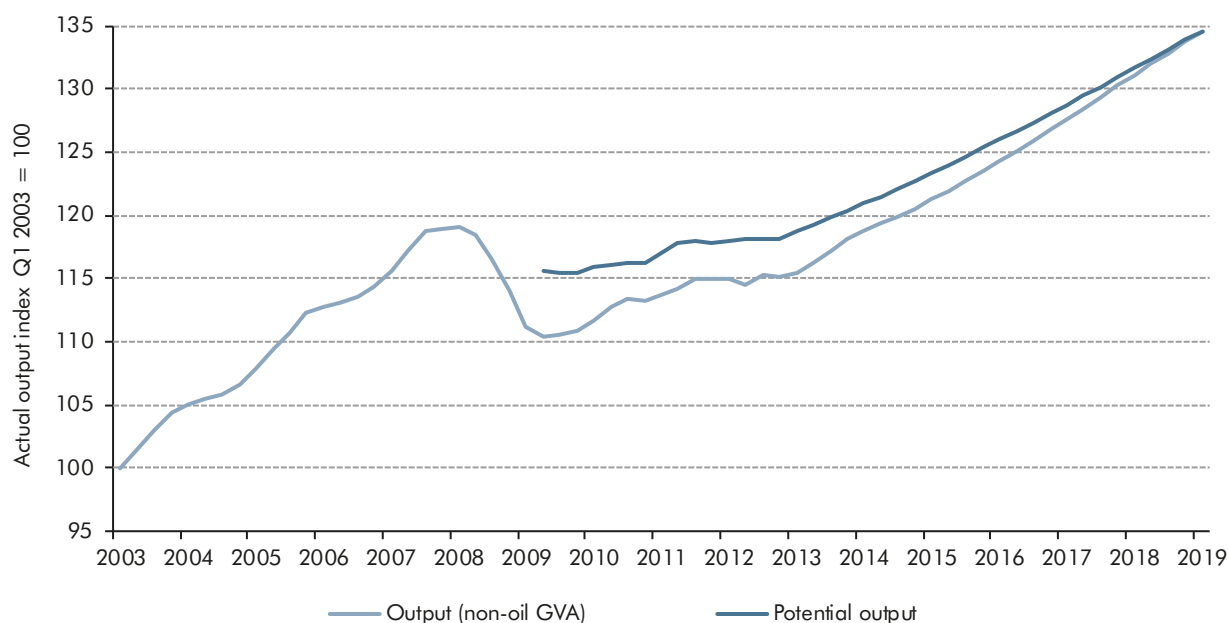
Source: OBR

- 3.63 Growth is expected to move more firmly above-trend from the start of 2016, with the output gap closing at a steady, if gradual, rate thereafter. The output gap does not close more quickly because of slow growth in productivity and real incomes, the gradual return to health of the financial system, limits to what monetary policy can do to stimulate aggregate demand in such an environment, and below-average growth in UK export markets.
- 3.64 As reported in our *FER*, and as discussed in the previous section, the fiscal consolidation is likely to have reduced growth in recent years. Looking forward, we expect the effect of the

ongoing consolidation on growth to be smaller as the effect of past measures dissipates over time – although both the timing of these effects and their size are highly uncertain. Other things equal, we assume that the output gap would be somewhat narrower and the level of GDP somewhat higher in the absence of some of the discretionary fiscal tightening. However, in the absence of any discretionary tightening at all, with a budget deficit of around 11 per cent of GDP other things would almost certainly not have been equal.

3.65 Our judgement that the upside surprise to output growth in 2013 reflects stronger demand, but not improved supply, implies a significantly narrower output gap profile than in our March forecast. We now expect output to reach its potential at the very end of the forecast horizon in early 2019 (Chart 3.15) – around 2 years earlier than in March. While the cyclical surprise to growth leaves the output gap 1.9 percentage points narrower relative to our March forecast by the end of 2013, it is only 1.5 percentage points narrower by the first quarter of 2018. This reflects our expectation that UK export markets will grow a little more slowly over the forecast period than we thought in March, weighing on demand.

Chart 3.15: Projections of actual and potential output



Source: ONS, OBR

3.66 Relative to our March forecast, we have revised cumulative real GDP growth from the end of 2012 to the start of 2018 up by 1.4 percentage points. Of this, around 1.7 percentage points reflects higher growth in the year to the final quarter of 2013, with private consumption accounting for 1.2 percentage points of this upward revision. This is partly offset by the effect of weaker export growth from 2015. Table 3.3 summarises the expenditure composition of our real GDP forecast. Later sections of this chapter discuss the expenditure components of GDP in more detail.

Table 3.3: Expenditure contributions to real GDP growth¹

	Percentage points, unless otherwise stated						
	Outturn	Forecast					
	2012	2013	2014	2015	2016	2017	2018
GDP growth, per cent	0.1	1.4	2.4	2.2	2.6	2.7	2.7
Main contributions							
Private consumption	0.7	1.2	1.2	1.1	1.5	1.8	1.8
Business investment	0.2	-0.4	0.4	0.7	0.7	0.8	0.7
Dwellings investment ²	-0.2	0.2	0.4	0.4	0.5	0.5	0.5
Government ³	0.5	0.0	0.3	-0.1	-0.2	-0.4	-0.2
Change in inventories	-0.3	0.4	0.2	0.0	0.0	0.0	0.0
Net trade	-0.7	-0.2	0.0	0.1	0.0	0.0	-0.1

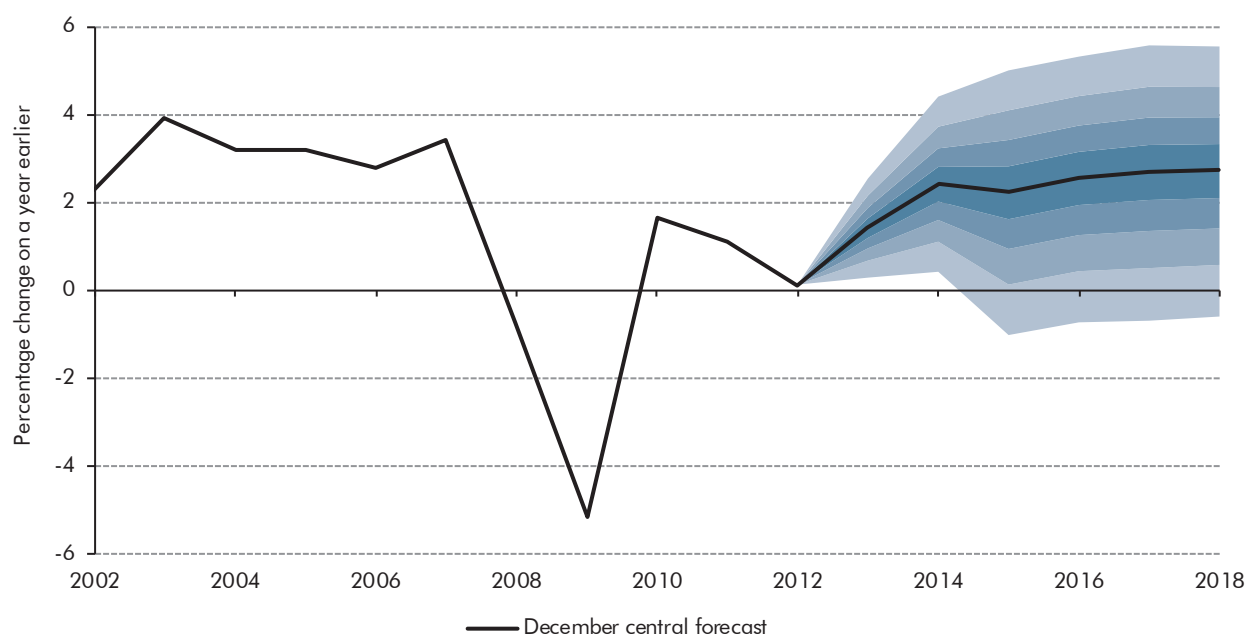
¹ Components may not sum to total due to rounding and the statistical discrepancy.

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

³ The sum of government consumption and general government investment.

3.67 Our central growth forecast is shown in Chart 3.16. The distribution surrounding it shows the probability of different outcomes if you expected our forecasts to be as accurate as past official forecasts. The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 20 per cent probability bands. The probability bands are based on the distribution of official forecast errors since 1987. They do not represent a subjective measure of the distribution of risks around the central forecast.

Chart 3.16: Real GDP growth fan chart



Source: ONS, OBR

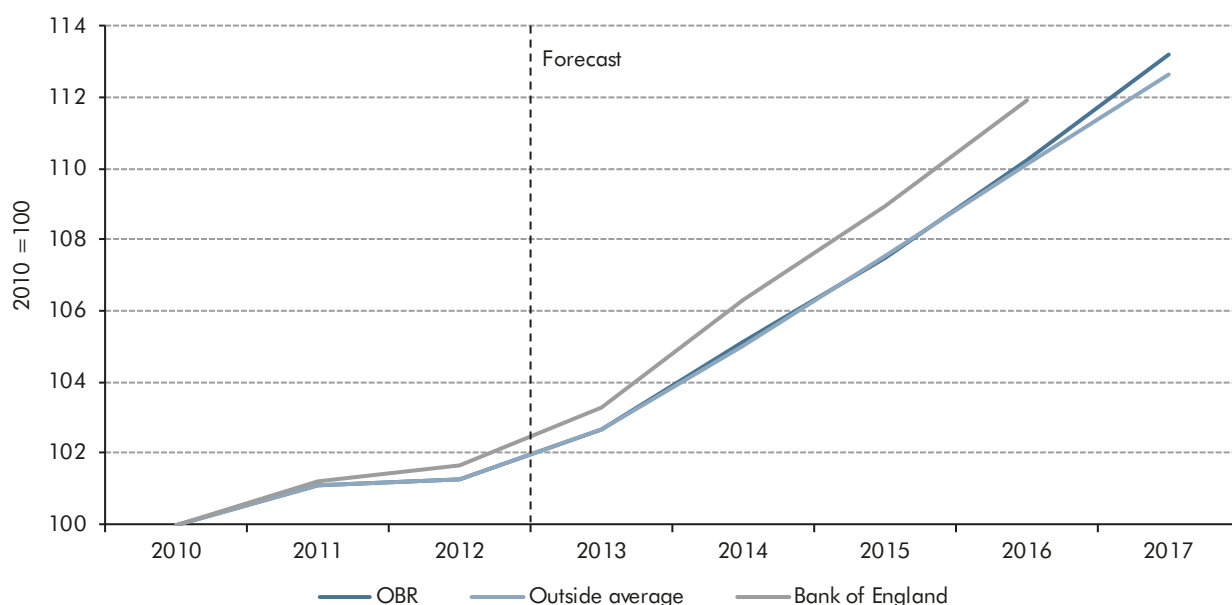
3.68 Chart 3.17 plots our central GDP forecast for the next three years against the average of outside forecasts and the Bank of England's November *Inflation Report* forecast.⁵ For the

⁵ Bank of England, November 2013, *Inflation Report*; HM Treasury, November 2013, *Forecasts for the UK economy: a comparison of independent forecasts*.

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 November *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 2016.

3.69 Our forecast for the level of GDP over the next few years is somewhat weaker than the Bank’s modal forecast. This largely reflects weaker expected growth in 2013 and 2014, as well as the Bank’s ‘backcast’, which points to stronger growth over the recent past than in the latest ONS data. Our forecast is broadly in line with the latest outside average over the next three years, and slightly stronger beyond that. 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*.

Chart 3.17: Forecasts of the level of GDP



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

Prospects for inflation

3.70 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation, including the Consumer Prices Index (CPI) and the Retail Prices Index (RPI). The basic measurement approach of these indices is the same, although there are a number of differences in coverage and the methods used to construct them.⁶

3.71 The RPI and CPI measures of inflation are important because they have different effects on our fiscal forecast. The Government uses CPI for the indexation of many tax rates, allowances and thresholds, and for the uprating of benefits and public sector pensions. The RPI is used for calculating interest payments on index-linked gilts, student loan payments

⁶ For more details on the differences between the RPI and CPI see Miller, R, November 2011, OBR Working Paper No. 2: *The long-run difference between RPI and CPI inflation*.

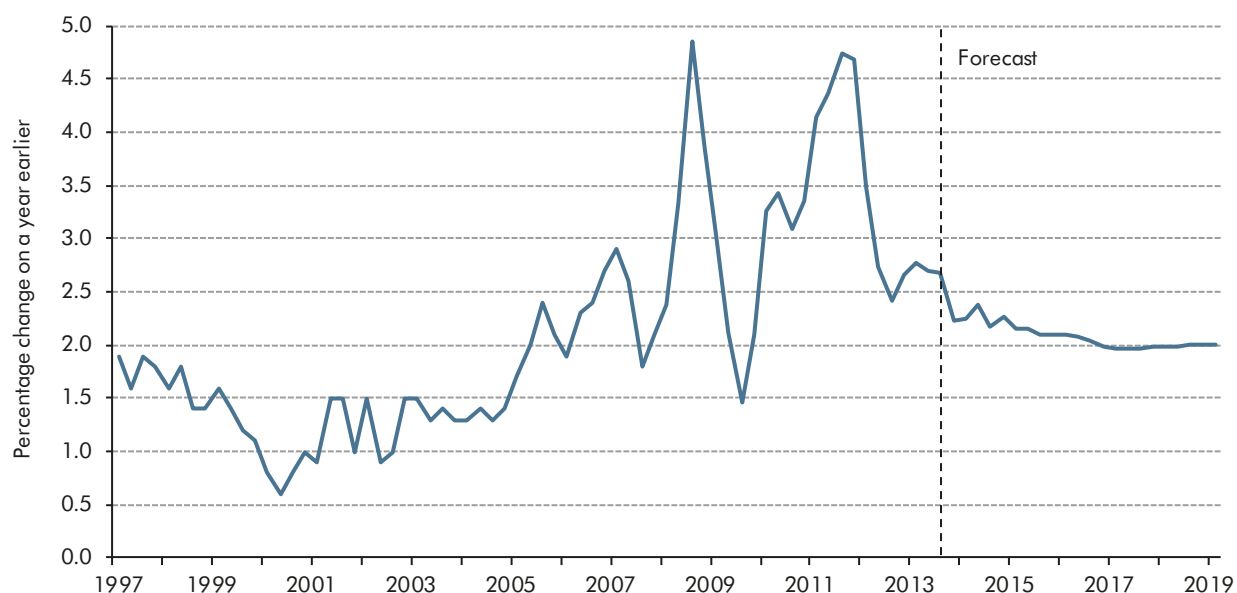
and the revalorisation of excise duties. The ONS publishes other inflation measures, but these do not currently affect the public finances, so we do not forecast them.⁷

CPI inflation

3.72 CPI inflation came in at 2.7 per cent in both the second and third quarters of 2013, slightly lower than our March forecasts of 3.0 per cent and 2.9 per cent respectively. Headline CPI inflation is currently being boosted by large increases in tuition fees and significant rises in retail gas and electricity prices last winter. Annual food price inflation is still being lifted by the effect of wet UK weather in late 2012 and by rises in global grain prices in mid-2012, following drought conditions in the US and Europe.

3.73 Inflation is expected to fall in the final quarter of 2013, as large rises in food prices in the final quarter of 2012 drop out of the calculation and as increases in tuition fees have less impact on the CPI (Chart 3.18). Also, petrol prices have fallen significantly over the start of the quarter, whereas they rose in the final quarter of 2012. CPI inflation is then held above the Bank of England's 2 per cent target in 2014, partly as a result of recently-announced utility price increases. Inflation then slowly falls towards the Bank's target over 2015 and 2016, as utility prices are expected to increase at a lower rate and as the impact of tuition fee increases fade. Food price inflation is assumed to ease from its current elevated rate.

Chart 3.18: CPI inflation forecast



Source: ONS, OBR

3.74 Inflation is then expected to settle around target in the medium term. Downward pressure on inflation from a negative output gap is forecast to be offset by policy measures, including environmental energy policies and excise duties being indexed using RPI, which grows faster

⁷ ONS, March 2013, *Introducing the New CPIH Measure of Consumer Price Inflation* and ONS, March 2013, *Introducing the New RPI Measure of Consumer Price Inflation*.

than the CPI. Beyond the next quarter, the annual inflation forecast profile is similar to that contained in the March forecast. In the near term, the narrower output gap over 2013 compared with the March forecast is offset by sterling being stronger than assumed in the March forecast. Inflation expectations are assumed to remain anchored to the target.

- 3.75 Announcements by the major energy companies suggest that retail electricity and gas prices will increase by around 8.5 per cent on average at the end of 2013 and beginning of 2014, slightly bigger increases than last winter and higher than the 7 per cent we expected in March. Reasons cited by the companies for the increases include higher wholesale, distribution and network costs as well as the impact of environmental policy. The price rises in retail electricity and gas prices next year are expected to be slightly lower than this year as wholesale gas futures prices suggest that that source of pressure on prices will ease. The Government has announced a number of measures that are designed to reduce energy bills and could have an effect on inflation (see Box 3.2 for more details). Final details of these measures were not available at the time our forecast was completed, so we have not made an adjustment for these policies.
- 3.76 We expect policy and network costs to continue to contribute to increases in retail utility prices over the medium term. The Department of Energy and Climate Change (DECC) has projected policy costs to add an average of around 2.5 and 0.5 percentage points to retail electricity and gas price inflation respectively over the forecast period. Network costs are anticipated to add a further 1.0 and 0.5 percentage points respectively, bringing the total average impact of network and policy costs on CPI inflation to 0.1 percentage points.⁸ Increases in wholesale and other costs, plus an allowance for a profit margin, are expected to add around 2.0 percentage points to retail electricity and gas price inflation, resulting in 5.5 and 3.0 per cent a year increases in electricity and gas prices respectively over the medium term. There are significant uncertainties around these estimates, including the impact of policy, changes in margins and the evolution of wholesale prices, with futures contracts illiquid beyond the next year.
- 3.77 The decision by the Government to cancel the rise in fuel duty in September 2014 has been incorporated into our inflation forecast. It is expected to reduce annual CPI inflation by around 0.1 percentage points in the subsequent twelve months, relative to the base which included the fuel duty increase.

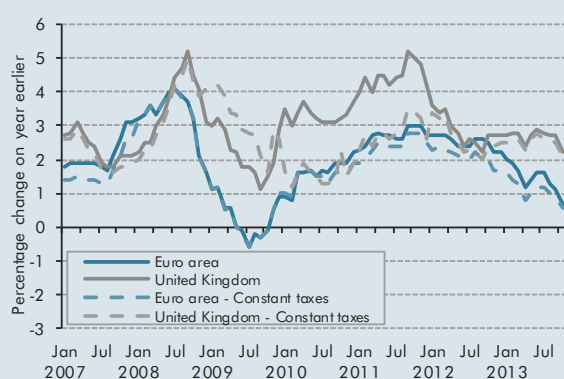
⁸ These figures have been calculated based on Table E1 in DECC, March 2013, *Estimated impacts of energy and climate change policies on energy prices and bills*.

Box 3.3: Why has inflation been higher in the UK than the euro area?

CPI inflation has been consistently higher in the UK than in the euro area since late-2008 (Chart A). This experience of higher inflation in the UK can be divided into three periods:

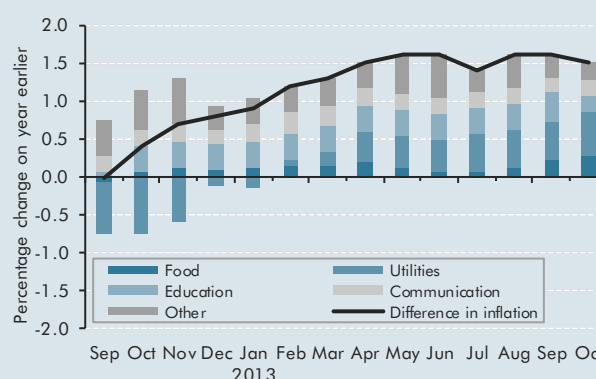
- in late 2008 and 2009, inflation in the UK was boosted by the 25 per cent depreciation of sterling from mid-2007, which lifted UK import prices and more than outweighed the 2.5 percentage point cut in the main rate of UK VAT on 1 December 2008;
- in 2010 and 2011, UK inflation was pushed higher by two separate 2.5 percentage point increases in the main rate of VAT, in January 2010 and January 2011. The impact is illustrated in Chart A, where 'constant tax' CPI inflation is estimated to have been broadly similar in the UK and euro area; and
- after a short period of similar inflation rates in mid-to-late-2012, UK inflation has not fallen as quickly as euro area inflation over the past year. Annual inflation in October 2013 was 2.2 per cent in the UK and 0.7 per cent in the Euro area.

Chart A: CPI inflation in the euro area and the UK



Source: Eurostat

Chart B: Contribution to difference in euro area and UK inflation



Source: ONS, Eurostat

Over the past six months, UK inflation has been around 1.5 percentage points higher than euro area inflation. The recent divergence reflects a number of factors. Since mid-2012, the euro has appreciated, while sterling has depreciated slightly and the lags associated with these exchange rate movements are likely to explain part of the difference. Food and utility prices also make significant contributions (Chart B), with core inflation in October 0.9 percentage points higher in the UK than the euro area. Education and communication price inflation also contribute, reflecting rises in UK tuition fees and higher telephone service price increases.

Higher utility price rises reflect an element of catch up. Eurostat estimates that energy price levels remain lower in the UK than the euro area average. Retail gas and electricity prices per kilowatt hour in the UK are estimated to be €0.05 and €0.17 versus €0.07 and €0.21 in the euro area, with lower taxes, levies and network costs explaining much of the difference.

RPI inflation

- 3.78 The calculation of RPI inflation in the UK does not meet international statistical standards, but we continue to produce RPI forecasts as they are necessary inputs in our fiscal forecasts.⁹ The method of calculation drives a wedge between RPI inflation and CPI inflation (the ‘formula effect’) and leads RPI to overstate inflation. The RPI also includes mortgage interest payments (MIPs), council tax and housing depreciation, which are not included in the CPI.
- 3.79 RPI inflation came in as forecast in March at 3.2 per cent in the third quarter of 2013. The items contributing to the negative CPI surprise were offset by stronger-than-expected mortgage interest payments as mortgage rates have held up more than expected.
- 3.80 In the final quarter of 2013, we expect RPI inflation to fall back for the same reasons as CPI inflation. Over 2014, a rise in housing depreciation (resulting from rising house prices) boosts RPI inflation relative to CPI inflation. From 2015 onwards, market-derived Bank Rate expectations imply that mortgage interest rates will rise, pushing RPI inflation towards 4.0 per cent at the end of the forecast period. As with the path of CPI inflation, the path of RPI inflation is close to that in the March forecast.

The GDP deflator

- 3.81 GDP deflator growth is the broadest measure of inflation in the domestic economy. It measures changes in prices for the goods and services that make up GDP, including price movements in consumption, government spending, investment and trade. The GDP deflator plays an important role in our fiscal forecast through its role in the Government’s chosen public sector spending assumption, described in Chapter 4.
- 3.82 Annual growth in the GDP deflator came in as forecast in March in the third quarter of 2013 at 2.3 per cent. Lower-than-expected investment prices and weaker private and government consumption deflators were offset by a stronger-than-anticipated terms of trade. Sector-specific deflators are described in more detail later in this chapter. Over the forecast period, the path of the GDP deflator is similar to the March forecast.

Prospects for nominal GDP growth

- 3.83 Most public discussion of macroeconomic forecasts focuses on real GDP – the volume of goods and services produced in the economy. But the nominal or cash value of GDP – and its composition broken down both by income and expenditure – is more important in understanding the behaviour of the public finances. Taxes are driven more by nominal than real GDP. The share of GDP devoted to public spending is also driven more by nominal GDP, as a large proportion of that spending is set out in multi-year cash plans (public services and administration) or linked to measures of inflation (benefits, tax credits and interest on index linked gilts).

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

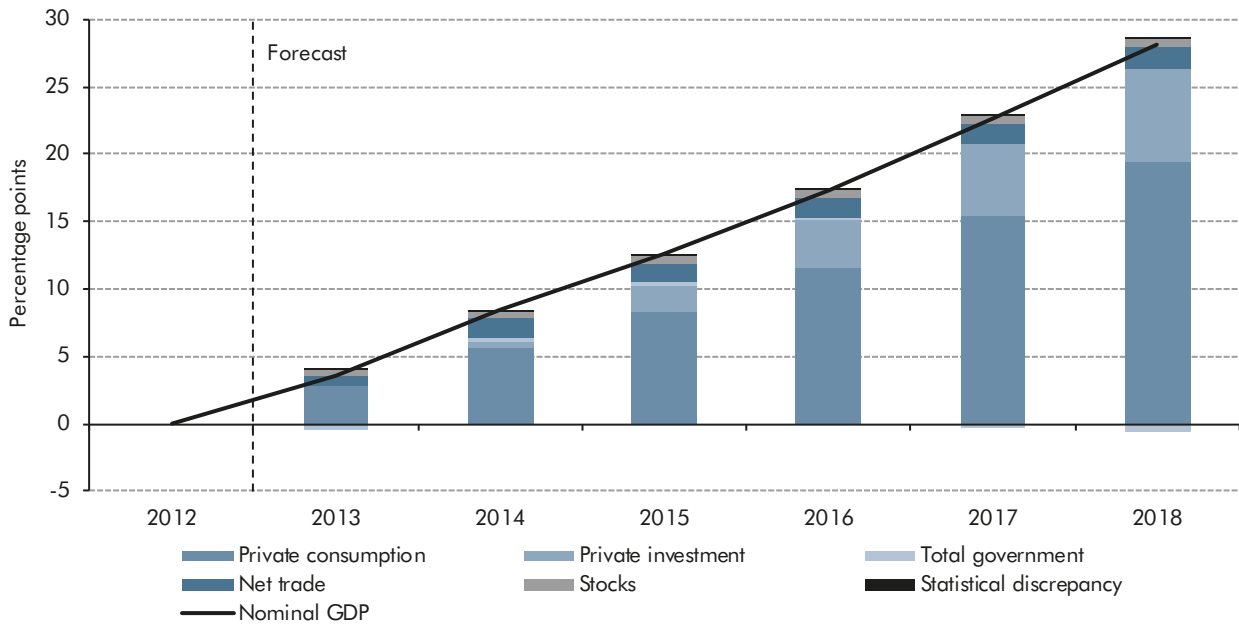
- 3.84 Since our March forecast, the level of nominal GDP in 2012 has been revised up by 1.3 per cent in Blue Book 2013. In expenditure terms, this revision largely reflected changes to the way investment in artistic originals and owner occupiers' imputed rent are measured.¹⁰ In income terms, it showed up in the operating surpluses of companies and households.
- 3.85 Over the first three quarters of 2013, nominal GDP grew more than we expected in our March forecast as the significantly stronger real GDP growth more than offset weaker whole economy inflation. We expect nominal GDP to grow by 3.6 per cent in 2013 and 4.6 per cent in 2014. After dipping to 3.8 per cent in 2015, as temporary upward influences on the GDP deflator pass, we then expect growth of about 4.5 per cent a year in the medium term. This profile is slightly stronger than in March, with outturns and forecast changes increasing the level of nominal GDP by around 1 per cent by early 2018 on top of the upward revision to history. Overall, adding the outturn and forecast changes to the Blue Book and other revisions, nominal GDP in 2017 is 2.7 per cent higher than in the March forecast. This upward forecast revision is due to higher real GDP growth, with growth in the deflator similar over the forecast period. The stronger real GDP growth is concentrated in 2013, with growth beyond that little changed from March.

Expenditure

- 3.86 Turning to the composition of nominal GDP by expenditure, we have revised up nominal consumer spending over the forecast horizon due to stronger real growth this year. But we have revised down nominal investment growth following weaker outturns.
- 3.87 Chart 3.19 sets out our forecast for cumulative nominal GDP growth by expenditure component. As the largest component of demand, private consumption is expected to be the biggest contributor to the cumulative growth of nominal GDP over the forecast period. However, given the relatively slow growth of disposable incomes, we do not expect consumption to grow significantly *relative* to GDP, with the share of consumption in nominal GDP expected to remain broadly stable over the forecast period. Private investment is expected to make a growing contribution to nominal GDP growth, as usual during a recovery, with its share of nominal GDP increasing from 11 per cent in 2013 to just under 15 per cent in 2018. This offsets a fall in the contribution of total government spending, which drops from 23 per cent of nominal GDP in 2013 to 18 per cent by 2018. Prospects for individual sectors are set out in more detail later in this chapter.

¹⁰ ONS, June 2013, *Impact of changes in the National Accounts and economic commentary for Q1 2013*.

Chart 3.19: Contributions to nominal GDP growth: expenditure

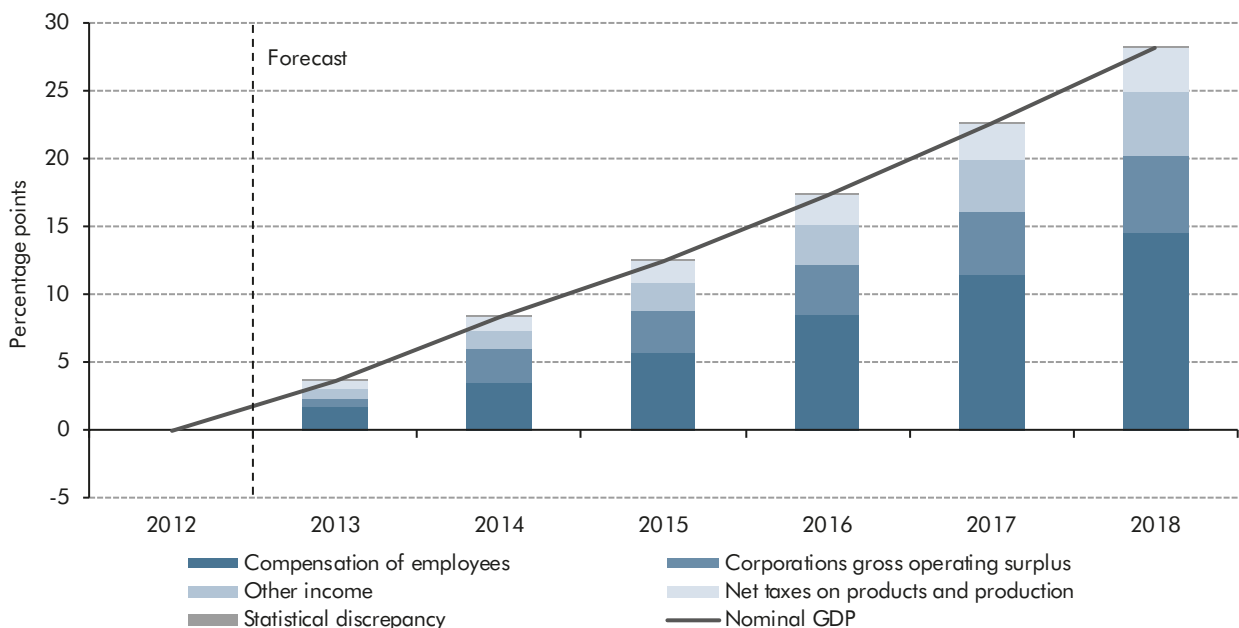


Source: ONS, OBR

Income

3.88 Chart 3.20 shows the contribution of different sources of income to cumulative growth in nominal GDP between 2012 and 2018. As productivity picks up, we expect profit margins to recover gradually, with profit growth only slightly outpacing nominal GDP growth over the forecast period. With real earnings expected to grow in line with productivity in the medium term, the share of labour income in nominal GDP is expected to remain broadly stable from 2014.

Chart 3.20: Contributions to nominal GDP growth: income



Source: ONS, OBR

Prospects for individual sectors of the economy

3.89 The following sections describe our detailed forecasts for the household, corporate, government and external sectors. Given the different fiscal consequences of growth in different sources of expenditure and income across the economy, these detailed sectoral judgements provide the foundation for the fiscal forecasts described in Chapter 4.

The household sector

3.90 The household sector is the largest source of income and spending in the economy, with consumer spending making up 66 per cent of nominal GDP by expenditure in 2012 and labour income making up 54 per cent of nominal GDP by income.

Real consumer spending

3.91 Consumer spending has been stronger than expected in the first three quarters of 2013, contributing 1.1 percentage points to the 1.8 per cent cumulative growth in real GDP over that period. Retail sales performed strongly in the summer, with some evidence of a positive effect from the warm weather in July.¹¹ Recent retail sales data suggest some momentum heading into the end of the year and we expect private consumption to contribute another 0.4 percentage points to real GDP growth in the final quarter.

3.92 As consumer confidence has picked up and credit conditions have eased, purchases of consumer durables have also strengthened: real consumption of durables grew by just over 4 per cent in the first half of 2013. Car registrations have gathered pace in 2013, while the GFK consumer confidence indicator for major purchases has picked up sharply through the year, reaching a three-year high in the third quarter. Box 3.4 describes the role of car consumption and production in recent economic developments.

3.93 With real disposable income growth remaining relatively weak over the first half of the year, the pick-up in consumption has been accommodated by a fall in saving, although comparisons are distorted by the income shifted from the first quarter into the second to take advantage of the lower additional rate of income tax. Taking into account the weakness of real earnings growth, we expect the current momentum in consumer spending growth to fade, with the pace of quarterly growth slightly slower next year than the average rate over 2013. As growth in productivity and real wages gather strength, we expect consumption growth to pick up further, with real consumption growing broadly in line with real GDP from 2016.

¹¹ <http://www.ons.gov.uk/ons/rel/rsi/retail-sales/august-2013/sty-patterns-in-retail-sles.html>

Box 3.4: Car consumption and production

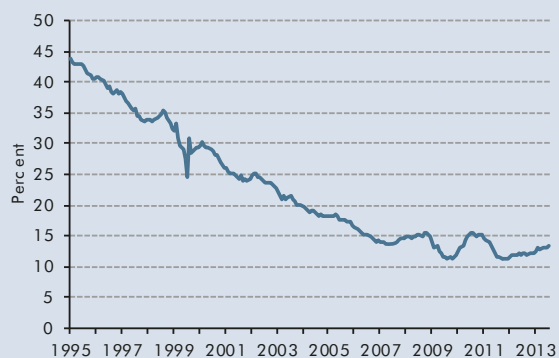
In volume terms, spending on cars in the UK has grown strongly, accounting for nearly a third of household consumption growth since the third quarter of 2011. Facilitating this spending, car finance has been the main reason for the strong recent growth in unsecured credit.

Demand for durable goods, such as cars, is highly sensitive to consumer confidence and access to credit, both of which fell sharply in 2008 as the financial crisis deepened. The introduction of the car scrappage scheme in April 2009 gave a temporary boost to demand that ended in 2010.^a The current recovery began in mid-2011, and has continued, with new car registrations rising more than 10 per cent a year.

But UK car consumption is highly import intensive. Chart C shows that the share of new car registrations met by domestic production has fallen from 45 per cent two decades ago to just 14 per cent now. This limits the benefit to GDP growth of stronger car consumption. Indeed, Chart D shows that more than half the contribution to household consumption growth from car consumption was accounted for by imports.

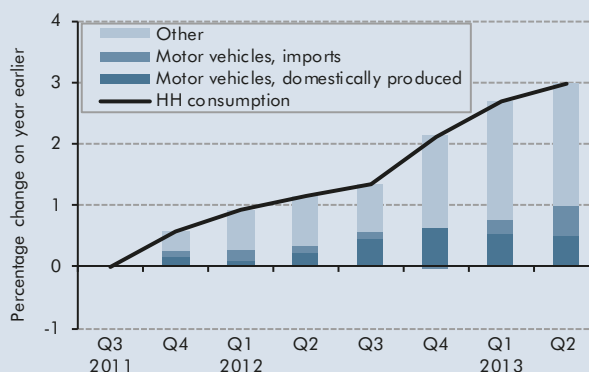
But the UK also produces cars for export and overseas demand has also been strong. While overall net trade has made a very modest contribution to GDP in recent years, the UK car-trade balance has moved from a 0.5 per cent of GDP deficit in 2007 to a small surplus in the first three quarters of 2013, helped by the strength of non-EU exports (particularly to China).^b But again the impact on GDP is limited, as domestic car production uses nearly three times more imports for every pound of output than the economy as a whole.^c So while domestic car consumption is a good indicator of consumer confidence, and car trade in isolation has helped reduce the UK's trade deficit, the overall effect on the economy has been less positive.

Chart C: Domestic share of car production



Source: SMMT

Chart D: Consumption growth



Source: ONS

^a Nearly 400,000 new cars were sold under the scrappage scheme up to mid-2010, around a sixth of all new registrations over the period and roughly equivalent to the growth in the annual registration rate. By end-2011, new registrations had fallen back to a level only slightly higher than when the scrappage scheme was introduced.

^b The share of cars for export sent to China rose from 1.4 per cent in 2008 to 8.1 per cent in 2012.

^c Based on the 2011 ONS supply-use tables.

Nominal consumer spending

3.94 We expect nominal private consumption growth to be stronger over the forecast period than in March, as a result of higher near-term growth. The boost to volumes has been partly offset by prices being weaker than we expected in March. After peaking at around 4 per cent annual growth in 2013, subdued earnings growth and lower inflation is expected to see nominal private consumption growth ease to just under 4 per cent in 2014. Thereafter, rising nominal earnings growth will contribute to a pick-up in nominal consumption growth towards 5 per cent. The additional near-term private consumption, relative to our March forecast, has been driven by lower saving rather than higher incomes and we expect the lower saving ratio to be maintained over the forecast period.

The labour market and household income

3.95 Labour income is the largest source of household income. This *EFO* contains two important judgements that help determine the overall shape of the labour market forecast and prospects for household income growth:

- average earnings growth has been weaker than we expected in March, relative to productivity. We assume that this weakness in earnings will not be offset by stronger earnings growth in subsequent years; and
- our labour income forecasts have held up reasonably well over the past few years, but we have tended to under-forecast employment and over-forecast earnings growth. In this forecast, we assume that the gap between actual employment and its potential level will close a little faster, implying stronger employment growth over and above that implied by the upward revision to our near-term GDP forecast. Conversely, we have revised down our wage growth forecast. These revisions have offsetting effects on the labour share of income, which follows a similar trajectory to that in the March forecast.

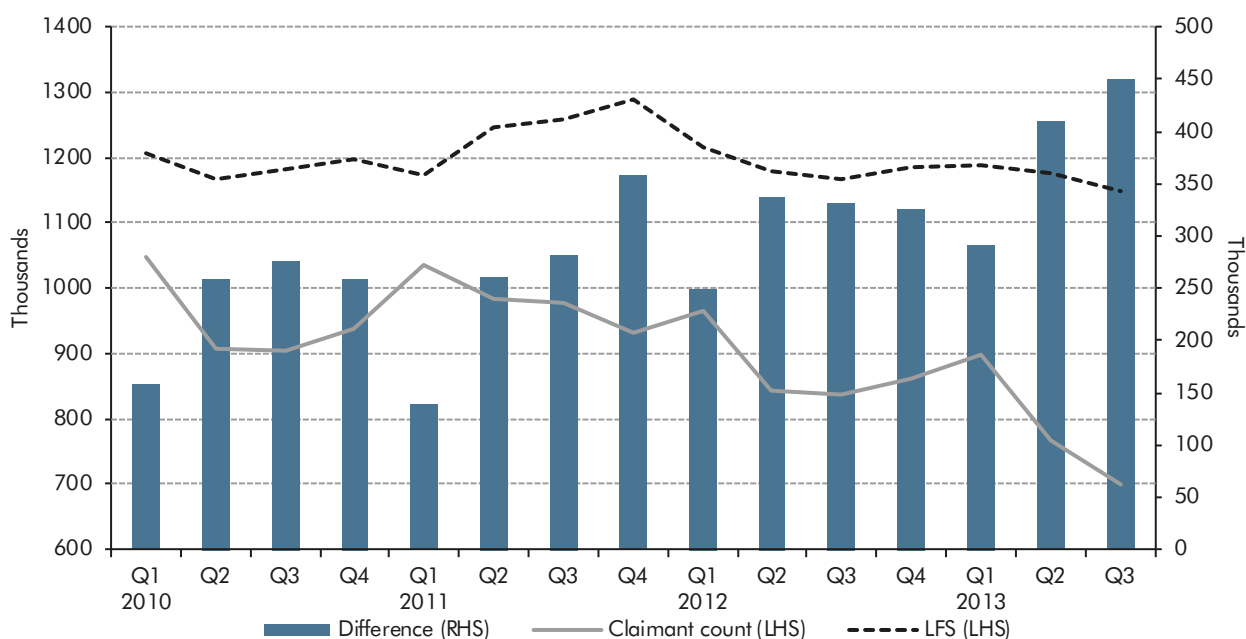
3.96 The fiscal implications of these judgements are set out in Chapter 4.

3.97 Unemployment is lower than we forecast in March, owing to stronger-than-expected employment rather than weaker participation in the labour market – the Labour Force Survey (LFS) unemployment rate was 7.6 per cent in the third quarter, 0.2 percentage points below the March forecast. We expect unemployment to continue to fall at a relatively fast pace over the next couple of quarters to around 7.2 per cent in the first quarter of 2014, as spare capacity in the economy is taken up. Thereafter, we expect the decline in unemployment to slow as the current momentum in GDP growth eases and productivity growth picks up. Our central forecast is consistent with unemployment reaching the 7 per cent threshold for the Bank of England's forward guidance in the second quarter of 2015. We present scenarios for alternative paths for unemployment in Chapter 5.

3.98 The claimant count and the LFS measure have painted very different pictures of unemployment so far in 2013. Claimant count unemployment has fallen by 172,000 between the final quarter of 2012 and the third quarter of 2013, while LFS unemployment

has fallen by just 37,000. Almost all the fall in claimant count unemployment can be explained by reduced inflows, which has resulted in a sharp drop in short-term claimant count unemployment – Chart 3.21. But this fall in short-term unemployment has not been mirrored to anything like the same degree in the LFS measure.

Chart 3.21: Short-term unemployment (up to six months)



Source: ONS

3.99 It is not clear why this should be the case and there are no policy developments that we are aware of that could explain this shift. In the absence of a compelling explanation, we have placed less weight on the recent improvement in the claimant count in making our judgement regarding prospects for the broader LFS measure. Instead, our forecast is consistent with both measures converging on their medium-term anchors over the forecast period, with the claimant count therefore falling less than the LFS measure overall.

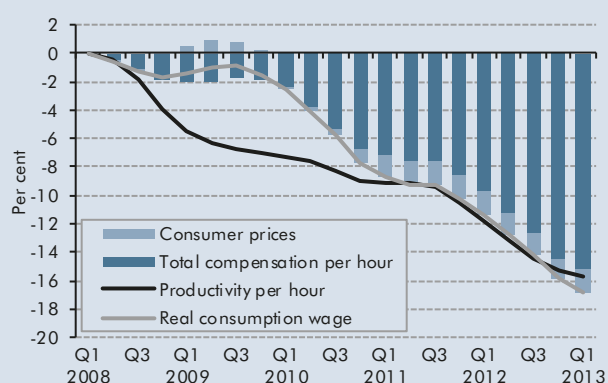
3.100 Productivity growth has been a little slower than we forecast so far this year, while average earnings growth has remained weak – although tax-related income shifting makes the data difficult to interpret. A key question is whether we should expect workers to recover the difference between their earnings and productivity implied by recent outturns. As noted above, our central judgement is that they will not. First, some of the weakness is explained by growth in public sector wages and we do not expect this to be offset by larger pay rises later in the forecast, given the squeeze on departmental spending. Second, comparing the change in productivity since the recession with the change in the product wage (described in Box 3.5), suggests that wages may still remain high relative to productivity.

Box 3.5: Productivity, wages and the cost of living

Nominal and real wages have been consistently weaker over the past five years than forecasters expected, largely because productivity – output per hour – fell sharply during the recession of 2008-09 and has then failed to recover over the subsequent years. Chart E shows the cumulative fall in real wages and productivity relative to the pre-recession March 2008 Budget forecast.

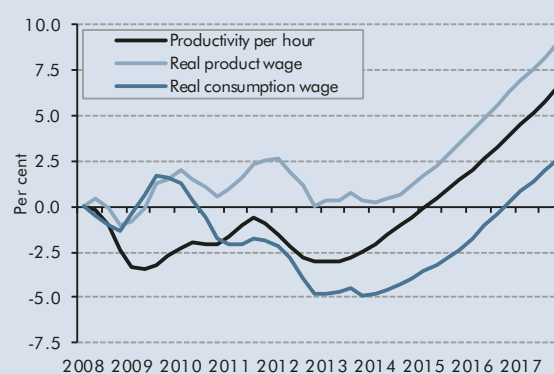
Productivity and real wages^a

Chart E: Difference from Budget 2008



Source: OBR, ONS

Chart F: Relative to pre-crisis peak



Source: ONS, OBR

In thinking about wages, it is important to remember that employers and employees have different perspectives. Employers care about the 'real product wage' – the level of wages relative to the price of the output they sell. Employees care about the 'real consumption wage' – the level of wages relative to the price of the things they consume.^b

Chart F shows that the real product wage has not fallen as productivity has since 2008, which implies a squeeze on profit margins. But this has not left employees better off – the real consumption wage has fallen even further than productivity. This is because consumer prices have been pushed higher relative to domestic product prices by the crisis-related fall in sterling (which raised import prices), by the VAT increases in 2010 and 2011, and by the increase in global commodity prices in 2011. The VAT cut in 2009 helped the real consumption wage outstrip productivity that year, while personal tax measures have offered some support to take-home wages. But real consumption wages have performed worse over the recovery than in any equivalent period since at least 1979. And the impact has of course been felt more by some than others, as these trends are averages for the working population.

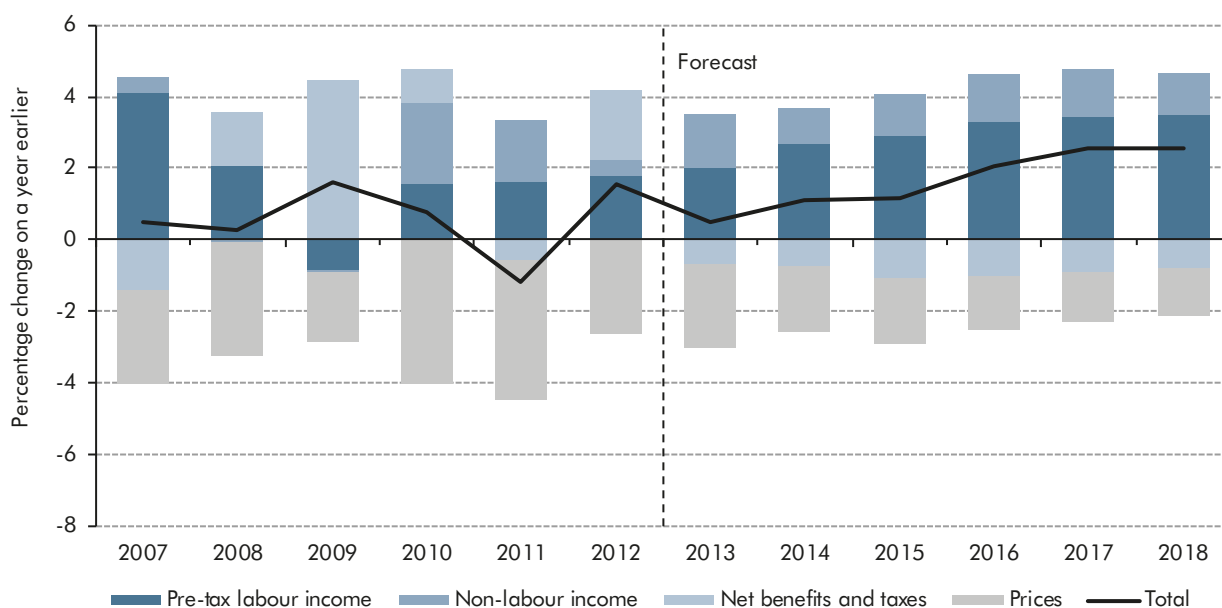
The squeeze on the real consumption wage, which has continued for nearly four years, explains why there is such concern about the 'cost of living' across the political spectrum. But it is worth bearing in mind that each of the influences on the real consumption wage described above can be thought of as a 'one-off'. Policy measures cannot continually improve the terms of trade, taxes cannot be cut indefinitely and workers can only work so many more hours in a day. Productivity growth is the only sustainable source of real income growth in the long term.

^a In Chart E, the cumulative totals are an approximation because the series are multiplicative rather than additive. Charts E and F are presented as three-quarter centred averages to abstract from volatility in the underlying series.

^b The real product and consumption wage are defined as total compensation of employees per hour worked, deflated by the price of gross value added and the price of consumption respectively.

3.101 We expect the weakness of real wage growth to persist into 2014 before picking up gradually to match productivity growth. We do not expect real take-home consumption wages to reach their pre-crisis peak until late 2015, mainly reflecting the slow recovery of productivity growth toward its historical average. With wage growth remaining weak over the near term, real disposable income is expected to pick up relatively gradually, before strengthening over the medium term as earnings growth gathers pace and inflation falls back (Chart 3.22).

Chart 3.22: Contributions to real household disposable income growth



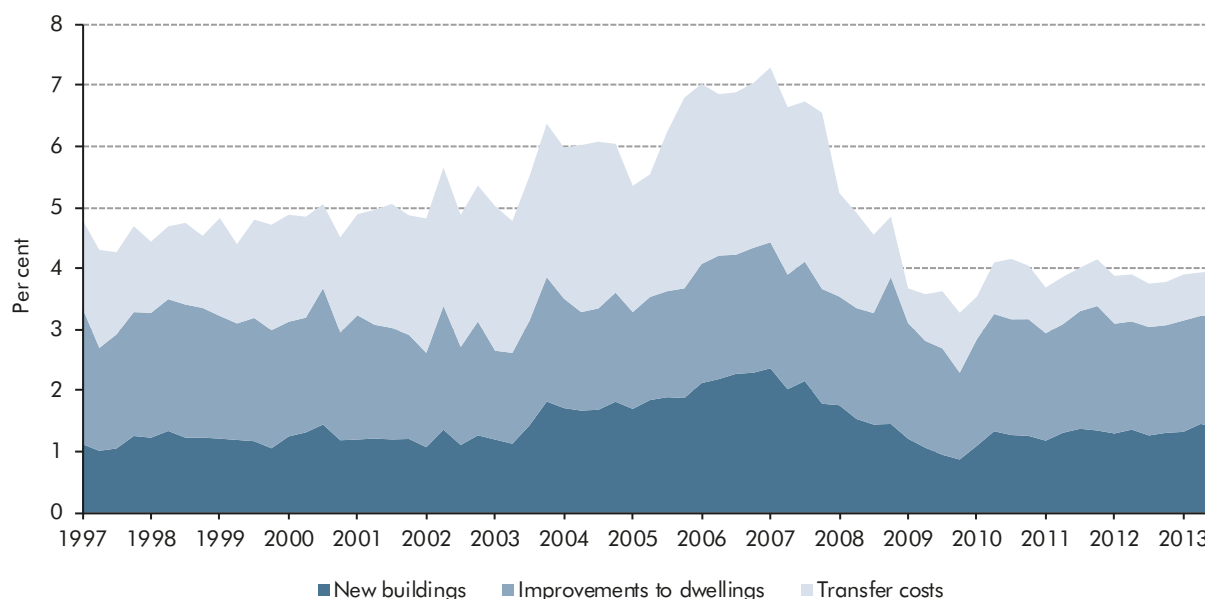
Source: ONS, OBR

The saving ratio

3.102 The saving ratio has been volatile through 2013 as high income individuals shifted income between the first and second quarters of the year to take advantage of the additional rate of income tax being reduced from 50p to 45p. With consumer spending growth forecast to outpace disposable income growth, we forecast that the saving ratio will decline gradually from just above 5½ per cent in 2013 to just under 4½ per cent in 2018.

The housing market and dwellings investment

3.103 Residential investment – which consists of investment in new buildings, improvements to dwellings, and the transfer costs associated with changes in ownership – fell sharply over the recession, reaching a low of 3.3 per cent of nominal GDP in the final quarter of 2009. Most of the fall was accounted for by new dwellings investment and transfer costs (Chart 3.23), which fell sharply, in line with other indicators of housing market activity.

Chart 3.23: Residential investment, share of nominal GDP¹

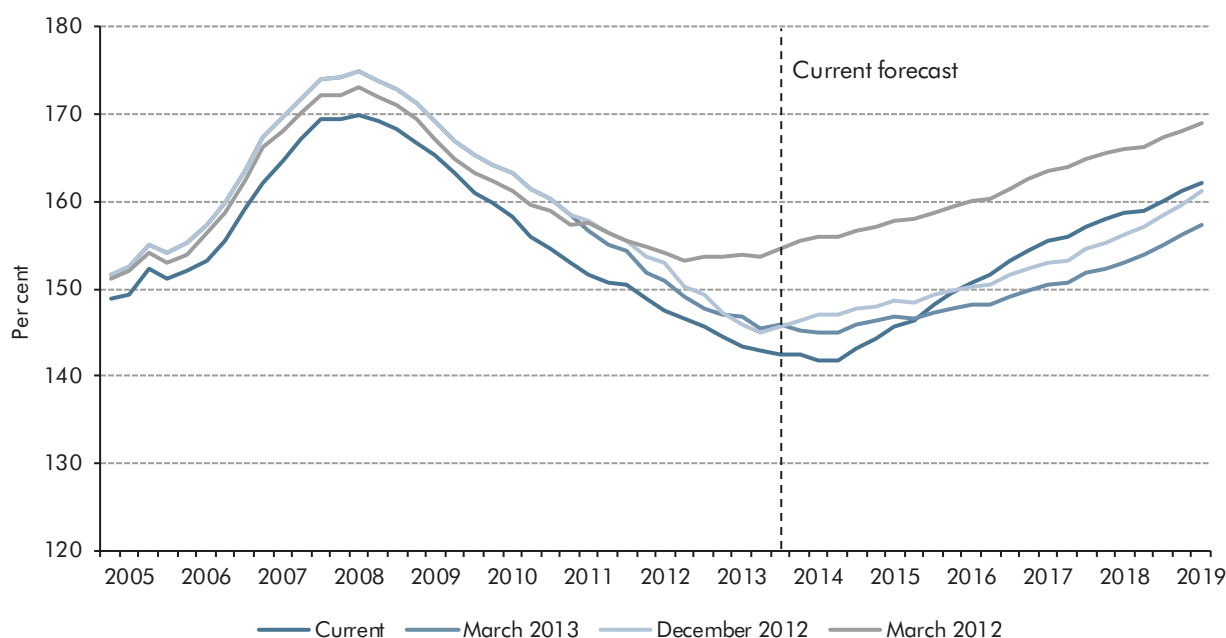
¹ Private sector, including transfer costs.
Source: ONS

- 3.104** The gathering momentum in the housing market has helped to support a pick-up in residential investment in 2013, which grew by around 7½ per cent in real terms between the final quarter of 2012 and the third quarter of this year. This was somewhat stronger than the 4.1 per cent we expected in March. Within this, investment in new dwellings has exhibited the steepest increase, rising by just under 10 per cent over the first three quarters of the year. Despite this, residential investment remains well below pre-recession levels, with total real dwellings investment barely half its pre-crisis peak.
- 3.105** Residential property transactions accelerated in the third quarter, growing by 8 per cent from the second quarter and 21 per cent on a year earlier. Mortgage approvals have also accelerated, suggesting further growth in transactions in the near term. Both are being boosted by a substantial fall in mortgage interest rates and improved confidence. Growth to date has matched our March forecast, but improvements in the economy since then, and the introduction of the Government's Help to Buy scheme (which will ease collateral constraints on home buyers), have lifted our transactions forecast. The equity loan element of Help to Buy – worth up to 20 per cent of the value of a new build property – will encourage building, as will more transactions and rising house prices.
- 3.106** Given the strength of housing activity we expect residential investment to grow by just over 6 per cent in 2013 and by around 10 per cent in 2014. Growth rates remain relatively strong over the medium term as the number of transactions continues to move back toward its long-run trend. Despite these growth rates, and the strength of recent data, residential investment remains below its pre-crisis peak throughout the forecast period, with the level of residential investment in 2018 still around 11 per cent below its level in 2007.

Net lending and the balance sheet

3.107 With the saving ratio declining over the forecast period and household investment rising strongly, households' overall net lending position – total income less total spending – moves into deficit. In an accounting sense, this provides the offset to the Government's fiscal consolidation. The combination of this net lending position and house price growth means that households' gross debt to income ratio is projected to rise from 2014, and slightly faster than in recent forecasts (Chart 3.24). This is largely because rises in the value of housing assets are typically associated with rises in the value of the debt secured against them. We expect the cost of servicing debt as a share of average household disposable incomes to rise, but to remain well below pre-crisis levels for most of the forecast period, given current market expectations for only a gradual rise in Bank Rate.

Chart 3.24: Household gross debt to income ratio



Source: ONS

The corporate sector

3.108 The corporate sector contributes to expenditure through business investment and stocks, while contributing to income in the form of profits. Business investment made up around 8 percent of nominal GDP by expenditure and corporate profits made up around 13 per cent of nominal GDP by income in 2012.

Business investment and stockbuilding

3.109 It is difficult to gauge the true strength of business investment. Significant methodological changes introduced by the ONS in Blue Book 2013 have left the path of business investment significantly more volatile and, on average, weaker since the end of the recession. Previous data suggested a modest recovery in business investment between 2010 and 2013, but the

new data suggest little growth over this period, with the level of business investment around 26 per cent below the pre-crisis peak (Chart 3.25).

3.110 Since our March forecast, the investment deflator has also been revised significantly back to 1991, as a result of ONS deflating components of investment at a more disaggregated level. The series has become more volatile on a quarterly basis – and noticeably more volatile than the equivalent series in other G7 countries. It now grows more slowly in the 1990s and more rapidly in the 2000s. These revisions have created a degree of uncertainty over their implications for future price movements. We have adopted a neutral assumption that the investment deflator grows at an average rate of around 1½ per cent between 2014 and 2018, broadly in line with its historical average. Meanwhile, growth in business investment volumes continues to come in below our forecasts as firms remain reluctant to increase capital spending. As a consequence, we have revised down our nominal investment forecasts.

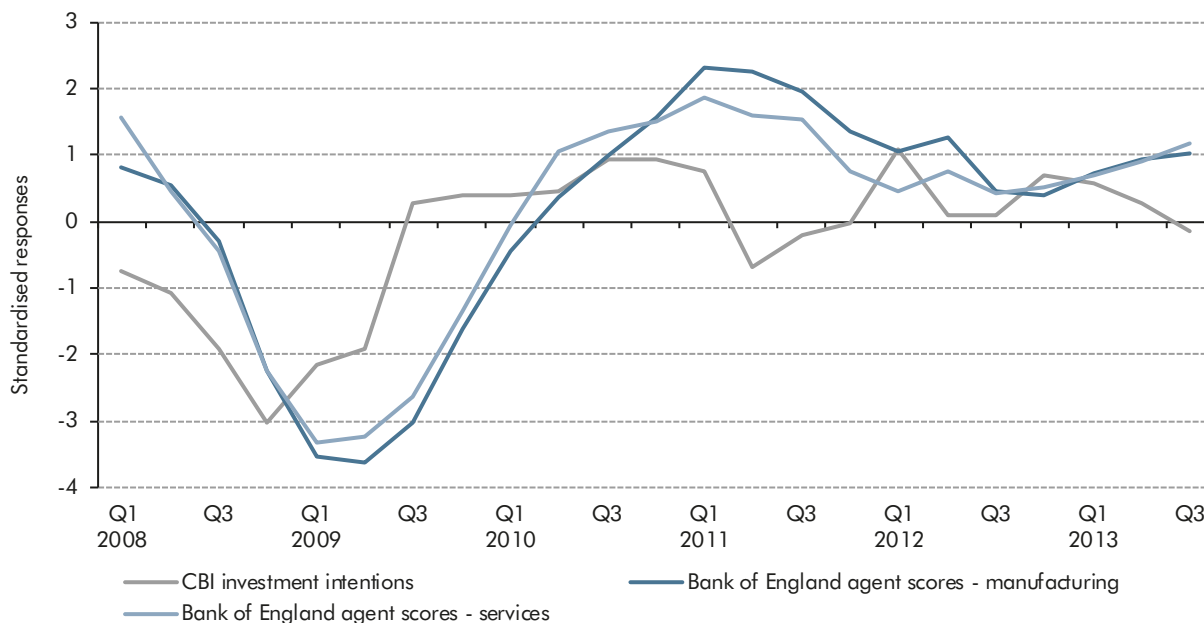
Chart 3.25: Business investment



Source: ONS

3.111 Other indicators paint a mixed picture. The Bank of England's regional Agents' scores suggest a steady rise in investment intentions since mid-2012, although the level remains below pre-crisis levels (Chart 3.26). Similarly, a special survey by the Bank's Agents in October suggested a much smaller net balance of firms reporting uncertainty as a drag on investment than a similar survey in December 2012. By contrast, the CBI *Industrial Trends Survey* suggests little change in investment intentions over the past 12 months.

Chart 3.26: Investment intentions



Source: Bank of England, CBI

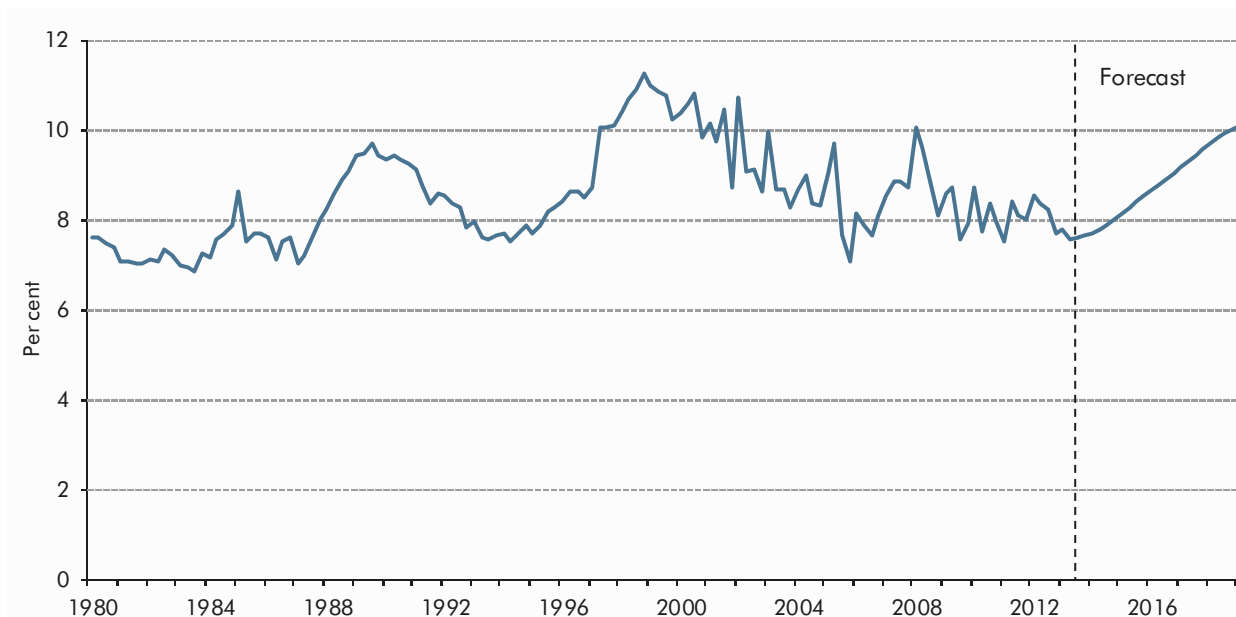
3.112 While there may be some conflicting signals over recent quarters, most indicators generally point to a relatively subdued level of business investment, despite the strong cash position of the corporate sector.¹² There are a number of possible explanations:

- sustained uncertainty over the demand outlook may have discouraged firms from committing to substantial and difficult-to-reverse investment projects;
- weak profits may have reduced internal finance for those firms unable to access other sources, although this would be unlikely to be a major constraint on larger firms; and
- weak profits and productivity growth may have led firms to reduce their expectations of future profitability, further discouraging large-scale capital projects.

3.113 As productivity growth picks up and uncertainty about demand recedes, we expect business investment to gather pace, growing at an average rate of 8.5 per cent between 2015 and 2018. These growth rates are sufficient to increase the share of real business investment in GDP from 8 per cent in 2012 to just under 10 per cent by the end of the forecast. This share remains some way below the levels following the 1990s recession (Chart 3.27).

¹² The latest ONS data indicate that the corporate surplus has averaged 2.6 per cent of GDP between 2003 and 2012.

Chart 3.27: Business investment as a share of real GDP



Source: ONS, OBR

3.114 The latest ONS data suggest that stocks acted as a slightly larger drag on growth in 2012 than was estimated at the time of our March forecast, with a contribution of -0.3 percentage points. Having also subtracted from growth in the first quarter of 2013, inventories subsequently made a contribution of 0.2 percentage points to GDP growth in the second quarter and a significant contribution of 0.9 percentage points in the third.

3.115 Reflecting the latest data, stockbuilding is expected to make a positive contribution to GDP growth of 0.4 per cent in 2013 and 0.2 per cent in 2014 and to be neutral thereafter.

Corporate profits

3.116 Non-oil, non-financial company profits are forecast to grow slightly faster than the economy as a whole. We have revised our near-term forecast higher on the strength of recent outturn data. In later years, our forecast has been revised lower, in part reflecting weaker nominal net export earnings. Financial sector profits are forecast to grow more slowly than non-financial profits due to the effect of provisions for likely conduct costs in the near term and the ongoing pressure of regulation throughout the forecast.

The government sector

3.117 The government sector contributes directly to GDP via consumption of goods and services, and investment. Public spending on welfare payments and debt interest, for example, do not contribute directly to GDP as they merely transfer income from some individuals to others.

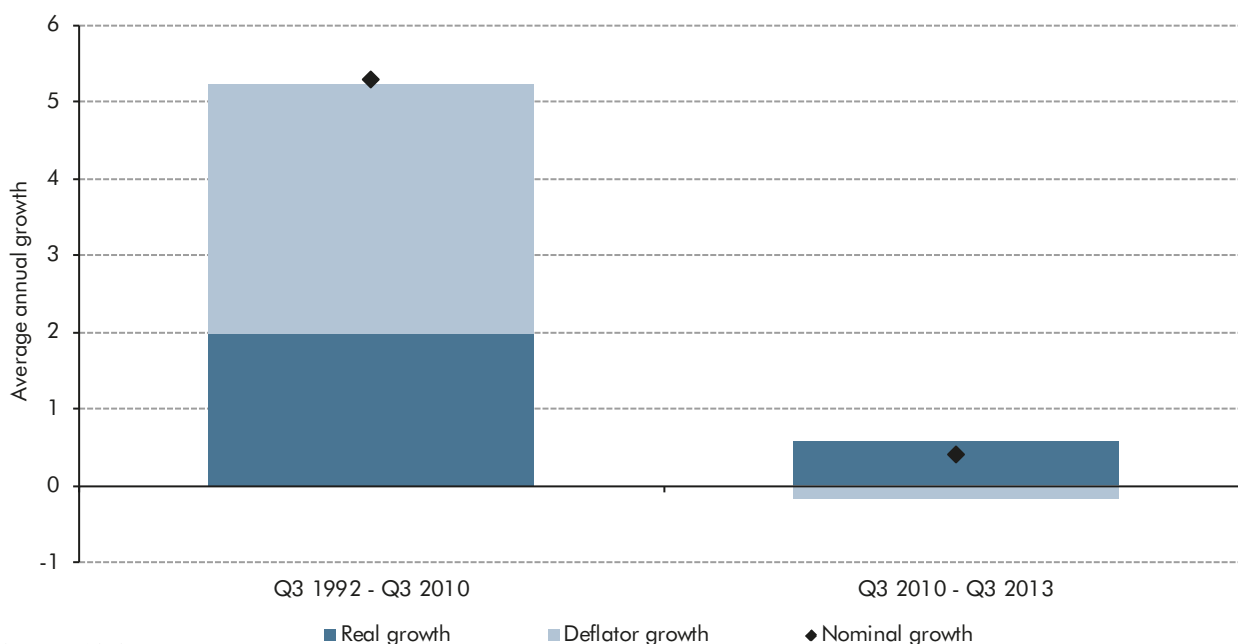
Real government consumption

3.118 Real government consumption remains strong, given the slowdown in nominal spending growth. The latest ONS data indicate that government consumption grew by 1.7 per cent in

2012 in real terms. It continued to hold up over the first half of this year, despite a sharp reduction in nominal government consumption: real spending grew by a cumulative 0.8 per cent in the first three quarters of this year despite a fall in cash spending of 0.7 per cent.

3.119 While quarterly data should be treated with caution, given its volatility and tendency to revision, the recent strength of real government consumption growth relative to nominal government consumption growth is consistent with the pattern seen over the past few years. As we have discussed previously, this is likely to reflect the fact that around two-thirds of real government activity is measured directly – for example, by the number of prescriptions, school pupils, court cases or hospital beds. (Indeed, corrections to estimates of hospital bed numbers prompted a significant revision to real government consumption in 2012.) As nominal spending has been squeezed, these indicators of real activity have held up and so measured real government consumption has grown (whether or not the quality of services has been affected). As a result, the implicit price of government consumption has fallen: the government consumption deflator has declined at an average rate of 0.2 per cent a year over the past three years, compared to an annual average increase of 3.2 per cent between 1992 and 2010 (Chart 3.28).

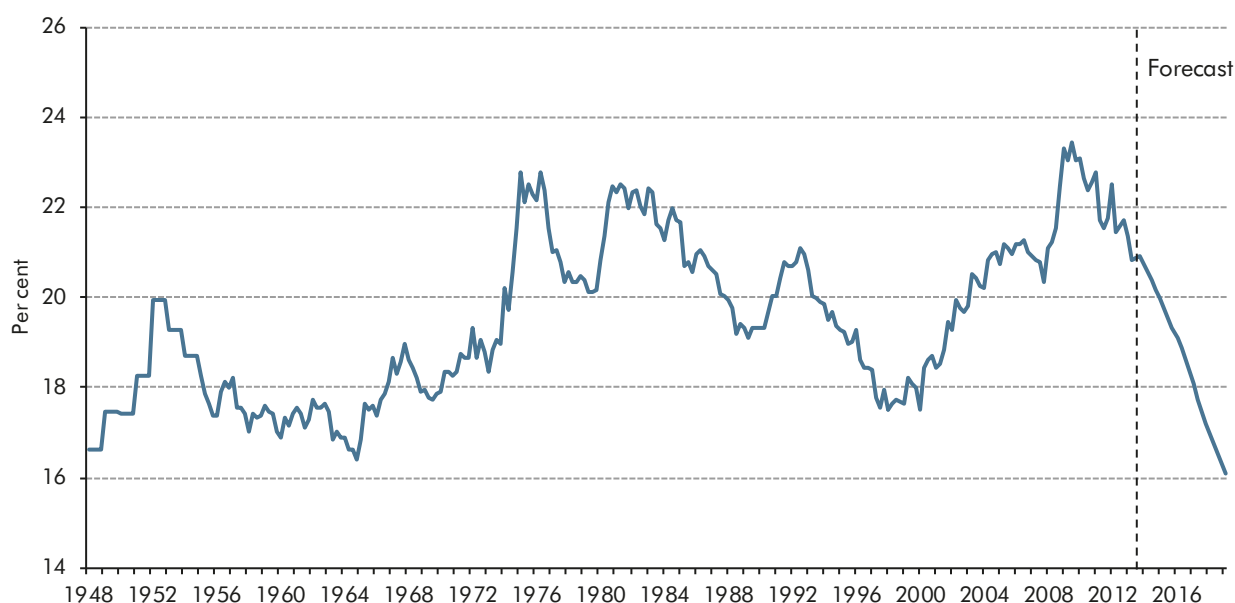
Chart 3.28: Government consumption



Source: ONS

3.120 With cash spending constrained by the Government’s ongoing squeeze on departmental budgets, our forecast for real government consumption assumes that the implicit government consumption deflator will grow at an average rate of 0.1 per cent between 2015 and 2018 – well below its historical average. In nominal terms, government consumption is forecast to fall from 21.8 per cent of GDP in 2012 to 16.1 per cent of GDP at the end of the forecast period, the lowest level on record in data back to 1948 (Chart 3.29). Nominal government investment is also expected to decline slightly as a share of GDP.

Chart 3.29: Government consumption of goods and services as share of nominal GDP



Source: ONS, OBR

General government employment

- 3.121** In the absence of specific workforce plans, we project general government employment based on some simple and transparent assumptions. We begin by taking our forecasts of government spending on total pay – the payroll. Then we combine these top down numbers with forecasts of government wage growth to derive payroll per head. From this we derive a projection of general government employment – headcount. In reaching a judgement on general government wage growth, we take into account stated government policy (such as pay freezes), historical rates of pay drift within the public sector and recent data. Reflecting the uncertain timing of employment cuts and wage changes, we then average the overall fall in employment and distribute it evenly over the forecast period.
- 3.122** Public sector wage growth has been exceptionally weak in the recent past, even below the rate consistent with historical trends for pay drift – about 1 per cent a year. That weakness may help explain why general government employment has not fallen as far as we forecast in March in recent quarters. We expect some of this weakness in wage growth to persist. Combining this with a pay cap of 1 per cent in 2015-16, announced at the March Budget (but too late to incorporate into our forecast at that time), we have revised down our overall wage growth forecast. This implies a smaller average fall in general government employment between the second quarter of 2013 and the start of 2018 of 35,000 a quarter, down from 36,000 in our March forecast.
- 3.123** Relative to its level at the start of 2011, the beginning of the period covered by the Government's 2010 Spending Review, we expect general government employment to fall by around 1.1 million by the start of 2019 – with around 0.5 million of that decline having

already taken place. But this should be more than offset by a 3.1 million rise in market sector employment over the same period, of which 0.8 million has already taken place.¹³

The external sector

Export and import volumes

- 3.124 Data available at the time of our March forecast pointed to a significant drop in export volumes in 2012. Part was attributable to the relative weakness of UK export markets, but the data also indicated a steep fall in UK export market share, with financial services particularly weak.¹⁴ Since March, the ONS has revised up the level of exports in 2012. The latest data suggest that exports grew by 1 per cent in 2012, compared to a fall of 0.3 per cent at the time of our March forecast. This implies a much smaller loss of market share. Much of this change reflects a significant upward revision to the path of financial services exports, in turn reflecting a substantial revision to exports of insurance services.
- 3.125 Recent data have also been erratic. Exports grew by 3 per cent in the second quarter of the year, but recent data suggest a subsequent fall of 2.4 per cent in the third. Exports are estimated to have grown by a cumulative 0.6 per cent between the final quarter of 2012 and the third quarter of this year, somewhat weaker than the growth of 2.6 per cent we expected in March.
- 3.126 Reflecting the weakness of the recent data, we have revised down our forecast for export growth in the near term. We expect exports to grow by 1.2 per cent in 2013 and by 4.0 per cent in 2014, representing downward revisions of 0.3 and 0.4 percentage points respectively. Downward revisions to UK export market growth over the medium term also mean that we expect export growth to be around 0.3 per cent weaker per year from 2015 onwards than we forecast in March. Our forecast for exports continues to imply a loss of market share, continuing the general trend seen over the past decade (Chart 3.30).

¹³ These estimates exclude a classification change introduced in the second quarter of 2012, which moved around 196,000 employees from the public to the private sector. Further details over the assumptions for public sector wages and employment can be found in the supplementary economy tables available on our website.

¹⁴ See Box 3.4 of our March 2013 *EFO* for more details.

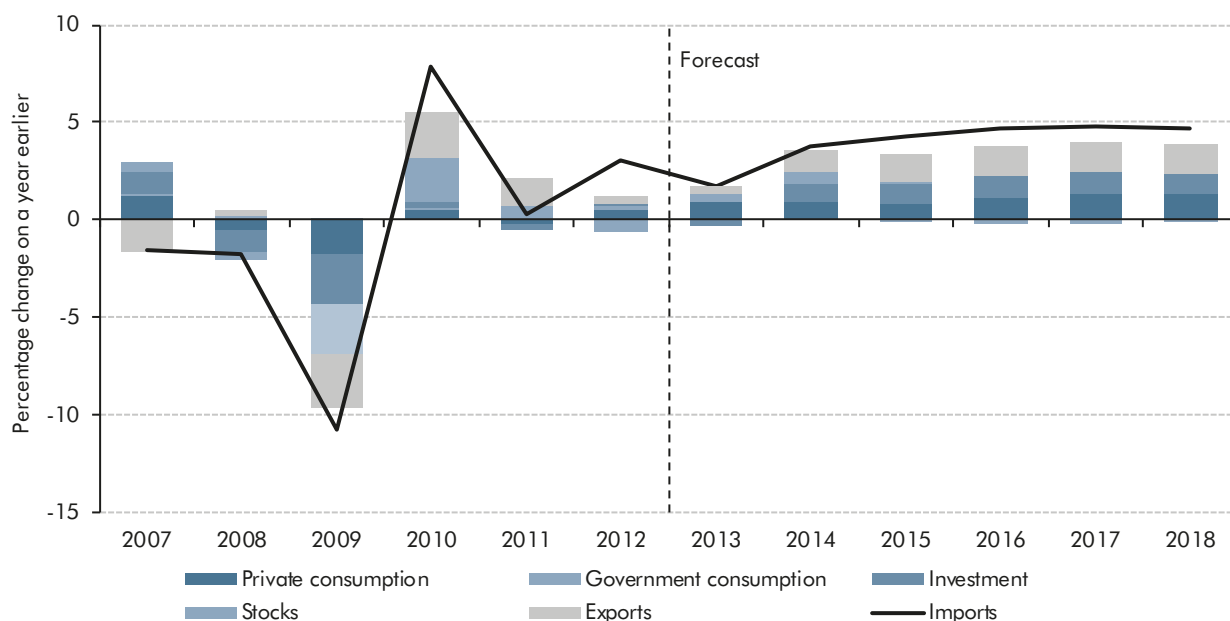
Chart 3.30: Export market share



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.

- 3.127** Our forecast for imports is determined by the outlook for import-weighted domestic demand, set out in Chart 3.31. Recent data, together with stronger domestic demand growth in 2013 and 2014, means that we now expect stronger import growth in 2013. 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 its relatively low import intensity.
- 3.128** We expect net trade to make a weaker contribution to growth than we forecast in March. Net trade is now expected to subtract 0.2 percentage points from growth in 2013 and make no contribution to growth in 2014, revised down from the 0.1 percentage point positive contribution we expected in our March forecast. The downward revisions largely reflect weaker than expected data over the first three quarters of this year. Downward revisions to export market growth mean that we have reduced the contribution of net trade to growth from 2015, as weaker export growth more than offsets the slightly slower growth of imports.

Chart 3.31: Contributions to import-weighted domestic demand and UK import growth



Source: ONS, OBR

The terms of trade and the trade balance

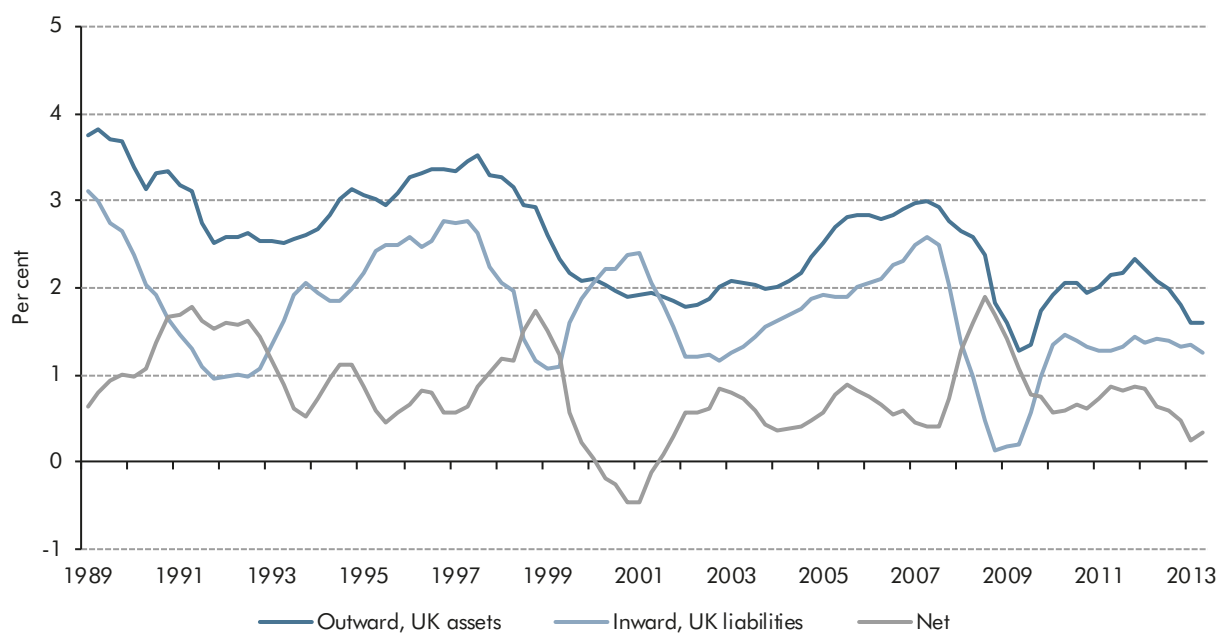
- 3.129 The terms of trade were significantly stronger than expected in the first three quarters of 2013 as import prices were weaker than we expected. Based on the split, for which we only have data up to the second quarter, the error was driven by large falls in services imports prices which were not accompanied by offsetting falls in service export prices – as would typically be expected. We have assumed similar growth rates for export and import prices in the medium term as in the March forecast, based on their long-run averages. But we have maintained the higher level of the terms of trade over the forecast period. As it is difficult to explain the recent divergence between service import and export prices, there is also uncertainty over this judgement on the level of the terms of trade.
- 3.130 We have revised down our world growth and trade forecasts, which have flowed through to weaker nominal exports over the forecast period. Despite this downward revision to world growth, the continuing recovery in world trade results in nominal export growth picking up over the forecast period, reaching almost 7 per cent in 2017. The effect of weaker net trade volumes on the trade balance is more than offset by the stronger terms of trade, implying a narrower trade deficit than we forecast in March: the trade deficit is now expected to fall to 0.6 per cent of GDP by 2017, compared to our March forecast of 1.4 per cent.

The current account balance

- 3.131 There have been large swings in the current account in recent years, mostly due to movements in the UK's income balance rather than the trade balance. Net income from foreign direct investments (FDI) – those held domestically by foreign investors and abroad by UK investors – has played the largest part. A short-lived improvement in the current account in 2008 was matched by a large increase in net FDI returns (Chart 3.32),

particularly from the banking sector (reflecting the net balance of losses rather than profits). Similarly, a 1.7 per cent of GDP deterioration in the current account in the first quarter of 2013 coincided with the income balance dropping by 2.2 per cent of GDP, the largest quarterly fall since records began in 1955.

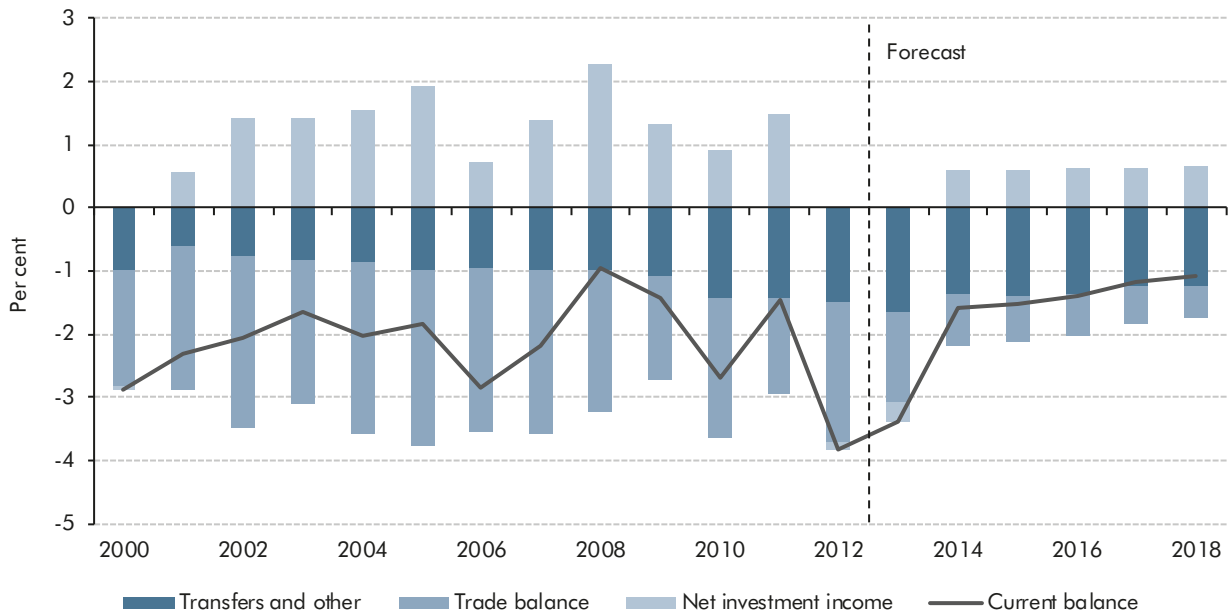
Chart 3.32: Quarterly rates of return on UK direct investments, domestic and foreign



Source: ONS

3.132 The fall in the current account balance in first quarter of 2013 reversed in the second, illustrating the volatility of the data. We assume that rates of return normalise over time, but this is not sufficient to return the income balance to either its pre-crisis levels or to our March 2013 forecast. With little improvement in the trade balance either, this means the current account deficit does not narrow a great deal in the forecast period after 2014 (Chart 3.33). The deficit is somewhat narrower across the forecast period than we expected in March, reflecting recent trade data.

Chart 3.33: Current account balance as a share of GDP

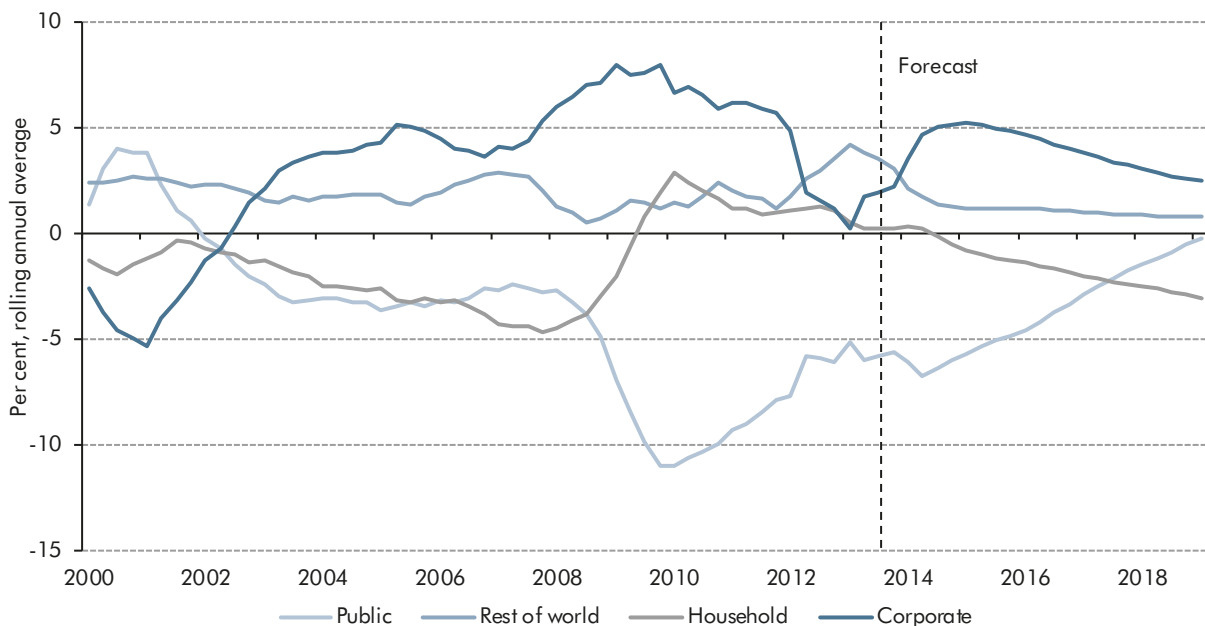


Source: ONS, OBR

Sectoral net lending

3.133 In the National Accounts framework that we use for our economic forecast, the income and expenditure of the different sectors imply paths for each sector’s net lending or borrowing from others. By identity, these must sum to zero – for each borrower, there must be a lender. In 2013, we estimate the government sector to be in deficit, households close to balance, and companies and the rest of the world to be in surplus (Chart 3.34).

Chart 3.34: Sectoral net lending as a share of GDP



Source: ONS, OBR

3.134 By the end of the forecast period, we expect the government's deficit to have been reduced close to balance as the fiscal consolidation continues. The household and corporate sectors provide the majority of the offsetting change, with household net lending moving from a small deficit of 0.5 per cent of GDP in 2014 to a larger deficit of 2.9 per cent of GDP in 2018 and corporate net lending moving from a surplus of 5.2 per cent of GDP in 2014 to a surplus of 2.6 per cent of GDP in 2018. As set out above, after an initial improvement, we do not expect the current account deficit to narrow significantly over the rest of the forecast period, so the external sector plays little role in offsetting the fiscal consolidation after 2014.

Risks and uncertainties

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

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

- euro area economies and banking systems have yet to complete the adjustment towards sustainable demand and competitiveness. While policy has managed the process more effectively this year, further damaging instability remains possible;
- global monetary policy has been exceptionally loose for an extended period. As investors anticipate a return to more normal monetary conditions, this could cause disruptive volatility in markets with potential spillover effects for the wider economy;
- domestically, productivity and real wages remain weak and the pick-up we forecast from next year is a key judgement. If productivity fails to pick up as predicted, the consumer spending and housing investment that has driven the recovery through 2013 could falter as the resources to sustain them would be lacking; and
- household consumption outpaces disposable income in our forecast, with the saving ratio declining gradually. Meanwhile, residential investment grows strongly, leaving households' finances in deficit and the gross debt to income ratio rising. That seems consistent with supportive monetary policy and other interventions (such as Help to Buy), but it may pose risks to the sustainability of the recovery over the medium term.

3.137 Methodological changes to the National Accounts can have a considerable effect on the path and composition of growth, as demonstrated by this year's Blue Book revisions.¹⁵ Looking ahead, the ONS is planning to introduce a large number of methodological changes to the National Accounts in Blue Book 2014. A number of these changes relate to the transition to the new European System of Accounts (ESA10), with recent ONS analysis

¹⁵ See our 2013 *FER* for further details.

suggesting this may result in an upward revision to the annual level of nominal GDP of between 2½ and 5 per cent.¹⁶ This estimate does not include a number of other methodological changes planned for Blue Book 2014, including further changes to gross fixed capital formation and inventories. Chapter 4 discusses the possible implications of ESA10 for the public finances.

Comparisons with external forecasters

- 3.138 In this section, we compare our latest projections with those of key outside forecasters. Estimates of the current degree of spare capacity and the potential growth rate of the economy, where available, differ widely as discussed from paragraph 3.13.
- 3.139 In its October *World Economic Outlook*, the **International Monetary Fund** forecasts real GDP growth of 1.9 per cent in 2014, around 0.5 percentage points weaker than our central forecast. Further out, the IMF assumes growth of 2.0 per cent in 2015, picking up to 2.3 per cent by 2018. These rates are up to 0.5 percentage points lower than our forecasts. The IMF estimates a negative output gap of 2.7 per cent in 2013, 0.4 percentage points wider than our own estimate. After 2013, the output gaps close at similar rates suggesting that the IMF believes potential growth in the UK is lower than our forecast.
- 3.140 The **Organisation for Economic Cooperation and Development** published an updated forecast as part of its November *Economic Outlook*. Their forecast for GDP growth in 2014 is the same as ours at 2.4 per cent. It then expects an acceleration of growth in 2015 to 2.5 per cent whereas we expect a drop off to 2.2 per cent. There are also differences in the composition of the growth forecasts. The OECD expects a larger contribution from net trade in both 2013 and 2014. In 2013, this is fully offset by a smaller contribution from domestic demand, but in 2014 the OECD also has a stronger domestic demand forecast as a result of higher private consumption growth.
- 3.141 The **European Commission** published its latest forecast in November. It expects growth of 2.2 per cent in 2014 and 2.4 per cent in 2015, a little weaker than our central forecast in 2014 and a little stronger in 2015. The Commission expects a stronger contribution from trade, with net exports contributing 0.3 percentage points to growth in 2013 and 2014 – this compares to our forecasts of 0.0 percentage points in 2014 and 0.1 percentage points in 2015. This is offset by weaker domestic demand, contributing 1.8 and 2.0 percentage points in 2014 and 2015 respectively versus our forecasts of 2.4 and 2.2 percentage points. The Commission's weaker domestic demand is driven by slower growth in investment.
- 3.142 In its November *Economic Review*, the **National Institute for Economic and Social Research (NIESR)** forecast GDP growth of 2.0 per cent in 2014 and 1.9 per cent in 2015, both slightly below our central forecast. It also forecasts slightly weaker growth over the medium term, with growth of 2.1 per cent between 2016 and 2018, compared to an average growth rate of 2.7 per cent implied by our latest forecast. Much of the difference between the forecasts

¹⁶ Marks, C, November 2013, *Content of Blue Book and Pink Book 2014*.

is attributable to a weaker medium-term outlook for investment and private consumption, partly offset by a stronger contribution from net trade.

3.143 Comparison with the Monetary Policy Committee's economic forecast is not straightforward because the **Bank of England** only publishes point estimates for three variables: CPI inflation, GDP growth and unemployment. The Bank's modal forecast for GDP is stronger in 2014, 2015 and 2016 than our central forecast by 0.5, 0.3 and 0.1 percentage points respectively. This does not generate higher inflation, with the two CPI profiles being similar.

3.144 The November forecasts from **Oxford Economics** assume slightly higher GDP growth than our central forecast in 2014 and 2015. Growth forecasts are the same in 2016 but our forecast is slightly higher in 2017. It also expects weaker CPI inflation than we do, which may partly reflect the much larger output gap implied by their forecast.

Table 3.4: Comparison of external forecasts

	Per cent						
	2012	2013	2014	2015	2016	2017	2018
OBR (December 2013)							
GDP growth	0.1	1.4	2.4	2.2	2.6	2.7	2.7
CPI inflation	2.8	2.6	2.3	2.1	2.0	2.0	2.0
Output gap	-2.6	-2.3	-1.8	-1.6	-1.2	-0.7	-0.2
IMF (October 2013)							
GDP growth	0.2	1.4	1.9	2.0	2.0	2.1	2.3
CPI inflation	2.8	2.7	2.3	2.0	1.9	2.0	2.0
Output gap	-2.9	-2.7	-2.4	-2.1	-1.8	-1.5	-1.0
OECD (November 2013)							
GDP growth	0.1	1.4	2.4	2.5			
CPI inflation	2.8	2.6	2.4	2.3			
Output gap	-2.7	-2.5	-1.7	-1.2			
EC (November 2013)							
GDP growth	0.1	1.3	2.2	2.4			
CPI inflation	2.8	2.6	2.3	2.1			
Output gap	-2.8	-2.2	-1.1	0.0			
NIESR (November 2013)							
GDP growth	0.1	1.4	2.0	1.9	2.1	2.1	2.2
CPI inflation	2.8	2.6	2.5	1.9	1.9	2.0	2.0
Output gap		-4.7	-4.3				
Bank of England (November 2013)¹							
GDP growth (mode) ²	0.4	1.6	2.9	2.5	2.7		
CPI inflation (mode) ^{2, 3}	2.7	2.2	2.1	1.9	1.9		
Oxford Economics (November 2013)							
GDP growth	0.1	1.4	2.5	2.4	2.6	2.6	
CPI inflation	2.8	2.6	1.8	1.8	1.7	1.9	
Output gap	-5.8	-5.8	-5.1	-4.6	-4.0	-3.6	

¹ Output gap not published

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

³ Fourth quarter year-on-year growth rate

Table 3.5: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2012	2013	2014	2015	2016	2017	2018
UK economy							
Gross domestic product (GDP)	0.1	1.4	2.4	2.2	2.6	2.7	2.7
GDP level (2012=100)	100.0	101.4	103.9	106.2	108.9	111.8	114.8
Nominal GDP	1.8	3.6	4.6	3.8	4.3	4.5	4.5
Output gap (per cent of potential output)	- 2.6	- 2.3	- 1.8	- 1.6	- 1.2	- 0.7	- 0.2
Expenditure components of GDP							
Domestic demand	1.0	1.4	2.4	2.1	2.5	2.7	2.7
Household consumption ¹	1.2	1.9	1.9	1.7	2.4	2.8	2.8
General government consumption	1.7	0.7	0.4	-0.5	-1.0	-1.8	-1.1
Fixed investment	0.9	-2.5	6.7	7.9	8.2	8.0	7.0
Business	2.6	-5.5	5.1	8.6	8.7	8.9	7.9
General government ²	4.6	-6.9	7.3	1.2	2.1	0.5	-1.1
Private dwellings ²	-2.5	6.1	9.7	10.0	10.0	9.7	8.4
Change in inventories ³	-0.3	0.4	0.2	0.0	0.0	0.0	0.0
Exports of goods and services	1.0	1.2	4.0	4.8	5.1	4.9	4.7
Imports of goods and services	3.1	1.7	3.8	4.3	4.7	4.8	4.7
Balance of payments current account							
Per cent of GDP	-3.8	-3.4	-1.6	-1.5	-1.4	-1.2	-1.1
Inflation							
CPI	2.8	2.6	2.3	2.1	2.0	2.0	2.0
RPI	3.2	3.1	2.9	3.3	3.6	3.7	4.0
GDP deflator at market prices	1.7	2.1	2.2	1.6	1.7	1.7	1.7
Labour market							
Employment (millions)	29.5	29.9	30.2	30.4	30.7	30.9	31.2
Wages and salaries	2.8	2.9	3.7	3.9	4.4	4.7	4.7
Average earnings ⁴	2.0	1.5	2.6	3.3	3.5	3.7	3.8
ILO unemployment (% rate)	7.9	7.6	7.1	7.0	6.6	6.1	5.6
Claimant count (millions)	1.59	1.43	1.27	1.23	1.18	1.13	1.10
Household sector							
Real household disposable income	1.6	0.5	1.1	1.1	2.1	2.5	2.6
Saving ratio (level, per cent)	6.8	5.7	5.0	4.6	4.6	4.4	4.3
House prices	1.6	3.2	5.2	7.2	4.8	3.7	3.8
World economy							
World GDP at purchasing power parity	3.2	2.9	3.6	3.9	4.1	4.2	4.2
Euro area GDP	-0.6	-0.4	0.9	1.2	1.7	1.9	2.0
World trade in goods and services	2.4	2.8	5.4	5.8	6.0	6.1	6.1
UK export markets ⁵	2.0	2.3	4.9	5.2	5.3	5.4	5.4

¹ Includes households and non-profit institutions serving households

² Includes transfer costs of non-produced assets

³ Contribution to GDP growth, percentage points

⁴ Wages and salaries divided by employees

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

Table 3.6: Detailed summary of changes to forecast

	Percentage change on a year earlier, unless otherwise stated					
	Outturn	Forecast				
		2012	2013	2014	2015	2016
UK economy						
Gross domestic product (GDP)	0.0	0.8	0.6	-0.1	-0.1	-0.1
GDP level (2012=100) ¹	0.0	0.8	1.4	1.3	1.2	1.1
Nominal GDP	0.3	0.9	0.8	-0.4	-0.1	-0.1
Output gap (per cent of potential output)	0.1	1.2	1.9	1.8	1.7	1.6
Expenditure components of GDP						
Domestic demand	-0.2	0.9	0.8	0.0	0.0	0.0
Household consumption ²	0.2	1.5	0.7	0.0	0.0	0.0
General government consumption	-0.9	0.3	1.1	-0.1	0.0	0.0
Fixed investment	-0.5	-4.7	0.0	-0.2	0.5	0.2
Business	-2.3	-7.4	-1.0	0.0	0.1	0.3
General government ³	1.9	-9.5	2.4	-0.7	3.6	1.7
Private dwellings ³	2.8	4.1	0.8	0.0	0.0	0.0
Change in inventories ⁴	-0.1	0.6	0.1	0.1	0.0	0.0
Exports of goods and services	1.4	-0.3	-0.4	-0.3	-0.3	-0.3
Imports of goods and services	1.0	0.7	0.0	-0.1	-0.1	-0.1
Balance of payments current account						
Per cent of GDP	-0.2	-0.7	0.7	0.4	0.3	0.2
Inflation						
CPI	0.0	-0.2	-0.1	0.0	0.0	0.0
RPI	0.0	-0.1	0.1	0.1	0.0	-0.2
GDP deflator at market prices	0.3	0.1	0.2	-0.2	0.0	0.0
Labour market						
Employment (millions)	0.0	0.1	0.3	0.3	0.4	0.4
Wages and salaries	0.0	0.5	0.7	-0.3	-0.4	-0.2
Average earnings ⁵	0.0	0.0	-0.2	-0.3	-0.4	-0.3
ILO unemployment (% rate)	0.0	-0.3	-0.9	-0.9	-0.9	-0.8
Claimant count (millions)	0.00	-0.15	-0.36	-0.35	-0.30	-0.24
Household sector						
Real household disposable income	-0.1	0.3	0.8	-0.2	0.3	0.2
Saving ratio (level, per cent)	-0.2	-0.9	-0.8	-1.0	-0.8	-0.6
House prices	0.0	1.9	3.6	4.0	0.8	-0.3
World economy						
World GDP at purchasing power parity	0.1	-0.5	-0.5	-0.5	-0.4	-0.4
Euro area GDP	-0.1	0.0	-0.1	-0.1	0.0	0.0
World trade in goods and services	-0.1	-0.9	-0.2	-0.2	-0.2	-0.2
UK export markets ⁶	0.1	-1.2	-0.3	-0.4	-0.4	-0.4

¹ Per cent change since March² Includes households and non-profit institutions serving households³ Includes transfer costs of non-produced assets⁴ 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

4 Fiscal outlook

Introduction

4.1 This chapter:

- sets out the key economic and market determinants that drive the fiscal forecast (paragraphs 4.3 to 4.20);
- explains the effects of new policies announced in this Autumn Statement and since the Budget in March, and reclassifications, on the fiscal forecast (paragraphs 4.21 to 4.24);
- describes the outlook for public sector receipts, including a tax-by-tax analysis explaining how the forecasts have changed since March (paragraphs 4.25 to 4.72);
- describes the outlook for public sector expenditure, focusing on departmental expenditure limits and the components of annually managed expenditure (paragraphs 4.73 to 4.138);
- describes the outlook for government lending to the private sector and other financial transactions (paragraphs 4.139 to 4.157);
- describes the outlook for the key fiscal aggregates: public sector net borrowing (PSNB), the current budget, the cyclically-adjusted current budget and public sector net debt (PSND) (paragraphs 4.158 to 4.168); and
- provides a comparison with European Commission and International Monetary Fund forecasts (paragraph 4.169).

4.2 Further breakdowns of receipts and expenditure and other details of our fiscal forecast are provided in the supplementary tables available on our website. The medium-term forecasts for the public finances in this chapter consist of an in-year estimate for 2013-14, which makes use of provisional ONS outturn data for April to October, and then forecasts to 2018-19.¹ 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;

¹ Outturn data are consistent with the Public Sector Finances October 2013 Statistical Bulletin published by the Office for National Statistics and HM Treasury.

- is based on announced Government policy on the indexation of rates, thresholds and allowances for taxes and benefits, and incorporates the impact of certified costings for all new policy measures announced by the Chancellor in the Autumn Statement;
- focuses on official ‘headline’ fiscal aggregates that exclude the temporary effects of interventions in the financial sector.² The Government’s fiscal mandate and supplementary target are defined in terms of these measures; and
- since the key ‘ex’ measures of PSNB, the current budget balance and PSND have been affected by a variety of additional one-off or temporary factors in recent years, we also focus on an ‘underlying’ measure of borrowing that adjusts for the largest of them. Specifically, we exclude the one-off transfer in 2012-13 related to the Royal Mail Pension Plan assets and the ongoing transfers from the Bank of England’s Asset Purchase Facility (APF) to the Exchequer, which we assume will reverse within the forecast period. We similarly adjust receipts and spending aggregates where they are affected by these transfers.

Economic determinants of the fiscal forecast

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

GDP and the output gap

4.4 Most economic forecasts focus on the outlook for real GDP, but it is nominal GDP that matters most when forecasting the public finances. As explained in Chapter 3, Blue Book 2013 revised up the level of nominal GDP. Relative to our March forecast, nominal GDP growth is 1.4 percentage points higher in 2013-14 and 0.3 percentage points higher in 2014-15, but 0.4 percentage points lower in 2015-16. In the short term, these revisions are mostly explained by stronger real growth in 2013.

4.5 The structural, or cyclically-adjusted, component of net borrowing and the current budget balance is estimated using the output gap. A negative output gap implies that the economy is operating below capacity, providing scope for tax revenues to increase and spending to fall as a share of GDP as the economy returns to its potential level. Our latest estimate of the output gap is narrower across the forecast period than in March, reflecting our judgement that the unexpected strength of real GDP growth in 2013 is cyclical. We estimate that the output gap was -2.2 per cent of GDP in the third quarter of 2013. From 2014-15 onwards, the output gap is narrower by between 1.5 and 1.8 percentage points.

² Office for National Statistics, 2010, *Public sector finances excluding financial sector interventions*.

Table 4.1: Determinants of the fiscal forecast

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
GDP and its components							
Real GDP	0.0	2.0	2.3	2.3	2.6	2.7	2.7
Nominal GDP (£ billion) ¹	1570	1642	1712	1777	1857	1940	2026
Nominal GDP ¹	1.4	4.6	4.3	3.8	4.5	4.4	4.5
Nominal GDP (centred end-March)	2.6	5.1	3.8	4.1	4.5	4.5	4.5
Wages and salaries ²	2.4	3.9	3.4	4.1	4.5	4.7	4.7
Non-oil PNFC profits ^{2,3}	4.3	6.9	7.1	5.8	6.3	6.3	4.8
Non-oil PNFC net taxable income ^{2,3}	9.9	8.2	7.0	4.6	4.7	4.3	2.9
Consumer spending ^{2,3}	3.8	4.4	3.9	3.8	4.5	4.9	4.9
Prices and earnings							
GDP deflator	1.8	2.0	2.1	1.5	1.8	1.7	1.7
RPI (September)	2.6	3.2	2.8	3.3	3.6	3.8	4.0
CPI (September)	2.2	2.7	2.2	2.1	2.0	2.0	2.0
Whole economy earnings growth	1.1	2.4	2.5	3.4	3.6	3.7	3.7
'Triple-lock' guarantee (September)	2.5	2.7	2.5	3.3	3.5	3.7	3.8
Key fiscal determinants							
Claimant count (millions) ⁴	1.57	1.37	1.26	1.22	1.17	1.12	1.10
Employment (millions)	29.6	30.0	30.3	30.5	30.7	31.0	31.3
VAT gap (per cent)	11.4	10.8	10.4	10.4	10.4	10.4	10.4
Financial and property sectors							
Equity prices (FTSE All-share index)	3091	3473	3690	3831	4001	4180	4367
HMRC financial sector profits ^{1,3,5}	3.4	1.4	2.3	3.8	4.5	4.4	4.5
Financial sector net taxable income ^{1,3}	3.7	0.4	3.0	3.0	5.5	4.0	4.5
Residential property prices ⁶	2.1	3.7	5.8	7.0	4.2	3.7	3.8
Residential property transactions	931	1110	1280	1355	1410	1467	1527
Commercial property prices ⁷	1.6	1.4	2.9	3.8	4.0	3.5	3.0
Commercial property transactions ⁷	1.5	4.3	4.0	2.9	3.9	4.5	4.6
Volume of stampable share transactions	-18.1	10.2	4.1	-2.4	-2.6	-2.7	-2.8
Oil and gas							
Oil prices (\$ per barrel) ³	112.0	108.3	103.7	98.9	97.4	97.4	97.4
Oil prices (£ per barrel) ³	70.6	69.3	64.0	60.8	59.7	59.6	59.7
Gas prices (p/therm)	59.1	64.5	67.4	65.6	65.6	65.6	65.6
Oil production (million tonnes) ^{3,8}	44.6	39.2	39.2	39.2	39.2	39.2	39.2
Gas production (billion therms) ^{3,8}	13.8	12.5	12.5	12.5	12.5	12.5	12.5
Interest rates and exchange rates							
Market short-term interest rates (%) ⁹	0.7	0.5	0.6	1.2	1.9	2.5	3.1
Market gilt rates (%) ¹⁰	1.6	2.6	3.0	3.4	3.7	4.0	4.2
Euro/Sterling exchange rate	1.23	1.18	1.20	1.20	1.21	1.22	1.23

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 ONS House Price 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-data⁹ 3-month sterling interbank rate (LIBOR).¹⁰ Weighted average interest rate on conventional gilts.

Table 4.2: Changes in determinants since March 2013 forecast

	Percentage point change unless otherwise specified					
	Outturn	Forecast				
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
GDP and its components						
Real GDP	-0.2	1.2	0.3	-0.1	-0.1	-0.1
Nominal GDP (£ billion) ¹	24	47	54	49	51	51
Nominal GDP ¹	0.1	1.4	0.3	-0.4	0.0	-0.1
Nominal GDP (centred end-March)	0.6	1.4	-0.3	-0.3	0.0	-0.1
Wages and salaries ²	-0.6	1.5	0.1	-0.4	-0.3	-0.1
Non-oil PNFC profits ^{2,3}	1.3	5.1	1.3	-0.4	-0.6	-1.1
Non-oil PNFC net taxable income ^{2,3}	-1.1	9.4	5.3	0.3	-0.5	-1.8
Consumer spending ^{2,3}	0.1	1.0	0.4	0.0	0.0	0.0
Prices and earnings						
GDP deflator	0.5	-0.2	0.2	-0.3	0.0	0.0
RPI (September)	0.0	-0.1	0.0	0.1	0.0	-0.2
CPI (September)	0.0	-0.2	-0.1	0.0	0.0	0.0
Whole economy earnings growth	-0.6	0.7	-0.5	-0.4	-0.4	-0.3
'Triple-lock' guarantee (September)	0.0	-0.2	-0.1	-0.3	-0.5	-0.3
Key fiscal determinants						
Claimant count (millions) ⁴	-0.01	-0.23	-0.36	-0.34	-0.29	-0.23
Employment (millions)	0.0	0.2	0.3	0.3	0.4	0.4
VAT gap (per cent)	0.7	0.3	-0.1	-0.1	-0.1	-0.1
Financial and property sectors						
Equity prices (FTSE All-share index)	11	68	150	141	145	148
HMRC financial sector profits ^{1,3,5}	1.4	0.0	0.0	1.0	0.8	-0.2
Financial sector net taxable income ^{1,3}	5.3	-5.0	-1.5	-0.6	-0.6	-3.3
Residential property prices ⁶	-0.1	2.8	3.9	3.3	0.2	-0.3
Residential property transactions ('000's)	-7	27	142	147	131	112
Commercial property prices ⁷	1.7	1.5	0.3	0.2	0.2	0.1
Commercial property transactions ⁷	-1.3	5.9	4.0	0.0	-0.5	-0.6
Volume of stampable share transactions	0.9	-1.8	6.0	0.0	0.0	0.0
Oil and gas						
Oil prices (\$ per barrel) ³	0.0	-5.1	-2.6	-1.9	0.6	4.5
Oil prices (£ per barrel) ³	0.0	-4.1	-4.8	-4.4	-2.8	-0.5
Gas prices (p/therm)	0.0	-4.1	-0.6	1.7	4.7	7.3
Oil production (million tonnes) ^{3,8}	0.1	-5.2	-5.1	-4.9	-4.8	-4.7
Gas production (billion therms) ^{3,8}	0.0	-1.6	-1.5	-1.4	-1.4	-1.3
Interest rates and exchange rates						
Market short-term interest rates ⁹	0.0	-0.1	0.0	0.2	0.4	0.5
Market gilt rates ¹⁰	-0.2	0.2	0.3	0.1	0.1	0.1
Euro/Sterling exchange rate	0.00	0.03	0.04	0.05	0.05	0.06

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 ONS House Price 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-data⁹ 3-month sterling interbank rate (LIBOR).¹⁰ Weighted average interest rate on conventional gilts.

Income and expenditure components of GDP

- 4.6 The composition of nominal GDP growth is also very important for the fiscal forecast. On the income side, labour income is generally taxed more heavily than company profits. On the expenditure side, consumer spending is subject to VAT and other indirect taxes while business investment attracts capital allowances that reduce corporation tax receipts in the short term.
- 4.7 The largest source of labour income is wages and salaries, which are determined by employment and earnings. Total wages and salaries are expected to be around £13 billion higher in 2013-14 than we forecast in March, mainly reflecting data revisions and the scale of income shifted between years to benefit from the reduction in the additional rate of income tax to 45p. However, we have revised down expected earnings growth since March reflecting the ongoing weakness of underlying earnings data this year. As a result, the upward revision to wages and salaries falls to around £8 billion by 2017-18.
- 4.8 Nominal consumer spending growth is estimated to have been slightly stronger in 2013 than we forecast in March. Our forecast thereafter is little changed. Consumer spending is now expected to grow at an average annual rate of 4.4 per cent between 2013 and 2018.
- 4.9 Non-oil, non-financial company profits are forecast to grow slightly faster than the economy as a whole. We have revised our near-term forecast higher on the strength of recent outturn data. In later years, our forecast has been revised lower, in part reflecting weaker nominal net export earnings in our economy forecast. We forecast financial sector profits to remain weak this year and in 2014, then to grow in line with nominal GDP. Financial sector profits are forecast to grow more slowly than non-financial profits due to the effect of provisions for mis-selling and likely conduct fines in the near term and the ongoing pressure of regulatory changes throughout the forecast.

Inflation

- 4.10 The CPI measure of inflation is used to index many tax rates, allowances and thresholds and to uprate benefits and public sector pensions. Our forecast for CPI inflation has been revised down since March reflecting lower outturns in recent months. It settles at the Bank of England's 2 per cent target from 2016.
- 4.11 RPI inflation determines the interest paid on index-linked gilts and is used to revalorise excise duties. RPI inflation is expected to be slightly higher in 2014 than we assumed in March, reflecting an increase in our forecast for housing costs. RPI inflation rises relative to CPI inflation in the later years of the forecast, as market expectations for Bank Rate feed through to a rising forecast for the mortgage interest payments component of RPI inflation.
- 4.12 The Basic State Pension (BSP) is uprated in April each year in line with the 'triple-lock' guarantee that it will increase by the highest of average earnings growth, CPI inflation in the previous September and 2.5 per cent. As a result, we assume the BSP will be uprated by 2.7 per cent in 2014-15, in line with the outturn CPI inflation rate in September 2013. This will

be the third successive year that the BSP has increased faster than average earnings, with the cumulative difference over that period 4.7 per cent. On our current forecast, uprating will be in line with the 2.5 per cent minimum in 2015-16, and by average earnings growth thereafter.

Equity markets

4.13 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 to 22 November 2013. The starting point for share prices is around 4.2 per cent higher than in our March forecast, which affects all years of the forecast. The volume of stampable transactions has been higher this year than we expected in March, reflecting a greater volume of total share transactions. However, the proportion of stampable transactions has continued to decline, which we assume will persist over the forecast period.

Property market

4.14 The residential property market is a key driver of receipts from stamp duty land tax and inheritance tax. House price inflation has been stronger than expected in 2013. Our forecast has been revised up substantially since March, broadly in line with external forecasts. This leaves the level of house prices 10 per cent higher by 2017-18.

4.15 Residential property transactions have grown strongly in 2013, with the latest quarterly level up 21 per cent on a year earlier. With mortgage approvals signalling further growth in coming months, and policy providing additional support for the mortgage market through Help to Buy, we have revised our transactions forecast up in each year of the forecast.

4.16 We expect commercial property prices to be higher in 2013-14 than we assumed in March, based on the latest information from HMRC. Thereafter, we assume prices rise by an average of around 3½ per cent a year. The latest data for the volume of commercial property transactions have also been stronger than we expected in March. We have assumed this higher level persists through the forecast.

Oil and gas sector

4.17 Movements in dollar oil prices and the sterling/dollar exchange rate since March mean the sterling oil price forecast is a little lower than our March forecast. Gas prices are lower than we expected in March in 2013 and 2014, then higher later in the forecast. In both cases, we now hold prices flat in the later years of the forecast rather than using futures prices as we did in March. The change in methodology is described in Chapter 3.

4.18 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 is expected to fall by around 11 per cent in 2013. Thereafter, production is expected to be broadly flat.

Overall, oil and gas production is expected to be around 10 per cent lower on average in each year of the forecast than we expected in March. The estimated level of production in 2013 is around half that in 2008, representing the steepest 5-year fall on record.

Interest rates

- 4.19 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 22 November 2013. The futures curve is slightly lower in 2013-14 than in March and slightly higher from 2015-16 onwards.
- 4.20 Our forecast assumes gilt yields move in line with market expectations based on the average of the forward rates for the ten days to 22 November 2013. Gilt yields have risen this year, though they remain relatively close to the assumption in our March forecast.

Policy announcements, risks and classification changes

- 4.21 The Government publishes estimates of the direct impact of tax and spending policy decisions on the public finances in its Autumn Statement policy decisions table. We provide independent scrutiny and certification of these costings and explain if we agree with them. If we disagreed, we would 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 3.2 in Chapter 3. We also note as risks to the fiscal forecast any significant policy commitments that are not quantifiable. In this section, we also set out the impact of any significant statistical classification changes.

Direct effect of new policy announcements on the public finances

- 4.22 Annex A reproduces the Treasury's table of the direct effect on PSNB of policy decisions in the Autumn Statement or announced since the Budget. 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 *Autumn Statement 2013 policy costings* document, a number of these costings are highly uncertain, in particular the announcements on alcohol fraud, amending the final exemption period for private residences on capital gains tax, the tax support for cleaner fuels for heavy goods vehicles, the onshore allowance for shale gas and information sharing agreements with Overseas Territories.
- 4.23 The top section of Table 4.3 summarises the Treasury's Autumn Statement policy decisions table. A positive figure means an improvement in PSNB, i.e. higher receipts or lower expenditure.

Table 4.3: Summary of the effect of identified policy measures

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Effects of receipts measures	0.0	-0.1	0.5	-0.4	-0.6	-0.9
<i>of which:</i>						
Income tax and NICs	0.0	0.7	0.7	0.0	-0.2	-0.3
Onshore corporation tax	0.0	0.4	0.7	0.2	0.1	0.1
Bank levy	0.0	0.3	0.5	0.5	0.5	0.5
Fuel duty	0.0	-0.4	-0.7	-0.7	-0.8	-0.8
Business Rates	0.0	-1.0	-0.7	-0.3	-0.3	-0.3
Effects of expenditure measures ¹	2.0	0.0	-0.6	0.0	0.0	0.0
<i>of which:</i>						
Current DEL	1.9	-1.0	-1.7	-1.5	-1.6	-1.9
Current AME	0.0	1.3	1.4	1.5	1.6	1.9
<i>of which:</i>						
Social security benefits	0.0	0.4	0.6	1.0	1.4	1.8
Tax credits	0.0	0.4	0.6	0.4	0.1	0.0
Locally-financed current expenditure	0.0	0.5	0.2	0.0	0.1	0.1
Capital DEL	0.1	-0.3	-0.3	0.1	0.0	-0.2
Capital AME	0.0	0.0	0.0	-0.1	0.0	0.2
Total direct effect of policy measures on PSNB	2.0	-0.1	-0.1	-0.4	-0.6	-0.9
Total direct effect of policy measures on current balance	1.9	0.1	0.2	-0.4	-0.6	-0.9
Financial transactions	0.0	-0.2	0.3	0.7	0.3	0.1

¹Expenditure categories are equivalent to PSCE in RDEL, PSCE in AME, PSGI in CDEL and PSGI in AME in Table 4.19.

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

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

Box 4.1: Projected Asset Purchase Facility flows

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

Transfers up to the level of the Bank's income in the previous year are treated as dividends, reducing net borrowing; beyond that, they are financial transactions, reducing the net cash requirement but not borrowing. Future payments made from the Exchequer to the APF will be treated as capital grants, increasing net borrowing but not affecting the current budget.

To estimate the size of future flows, we have to make assumptions about when quantitative easing (QE) will be unwound and how quickly. Our approach to this is unchanged since March. We assume QE remains at £375 billion and that it begins to be unwound once Bank Rate rises above 1 per cent, with sales evenly paced at £10 billion a quarter thereafter. We also assume redemptions will not be reinvested once sales begin. The first sale is now assumed to be in the fourth quarter of 2015, two quarters earlier than assumed in March.

Our projection for the overall net transfer to the Treasury is now £40 billion, down from our March projection of £45 billion. The change can largely be explained by higher gilt rates, which imply lower gilt prices at the point of sale and therefore greater capital losses.

There is huge uncertainty about the timing and pace of QE unwinding and our assumptions should be regarded as a neutral way of illustrating the potential fiscal impact of the QE, rather than as a forecast of how the Bank of England is likely to act. The estimates of the overall net transfer to the Exchequer are also highly sensitive to changes in gilt rates. In a scenario where gilt rates rise by 200 basis points when QE unwinding starts, the Treasury would receive £61 billion, only to pay back £58 billion over the following years, giving a net transfer of £4 billion.

Table A: Fiscal impact of projected APF flows

	£ billion										
	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Receipts	6.4	12.2	12.1	7.4	3.2	0.5	0.0	0.0	0.0	0.0	0.0
Capital spending	0.0	0.0	0.0	0.2	0.0	1.8	4.1	6.3	6.0	6.0	0.1
Net borrowing	-6.4	-12.2	-12.1	-7.2	-3.2	1.4	4.1	6.3	6.0	6.0	0.1
Current budget	6.4	12.2	12.1	7.4	3.2	0.5	0.0	0.0	0.0	0.0	0.0
Net cash requirement	-11.3	-30.7	-12.1	-7.2	-3.2	1.4	4.1	6.3	6.0	6.0	0.1
Public sector net debt	-11	-42	-54	-61	-64	-63	-59	-53	-47	-41	-40

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

	£ billion										
	12-13	13-14	14-15	15-16	16-17	17-18	18-19	19-20	20-21	21-22	22-23
Receipts	0.0	0.0	0.9	-1.0	-3.0	-1.0	0.0	0.0	0.0	0.0	0.0
Capital spending	0.0	0.0	0.0	0.2	0.0	1.0	1.2	0.4	0.0	-1.0	-2.7
Net borrowing	0.0	0.0	-0.9	1.2	3.0	2.0	1.2	0.4	0.0	-1.0	-2.7
Current budget	0.0	0.0	0.9	-1.0	-3.0	-1.0	0.0	0.0	0.0	0.0	0.0
Net cash requirement	0.2	1.5	-0.9	1.2	3.0	2.0	1.2	0.4	0.0	-1.0	-2.7
Public sector net debt	0	2	1	2	5	7	8	9	9	8	5

Currently unquantifiable policy commitments

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

- the Government has announced a target for central government to deliver at least £15 billion of asset sales between 2015 and 2020, comprising at least £5 billion of land and property and £10 billion of corporate and financial assets, including the pre-Browne student loan book. Sales of land and property are netted off gross capital expenditure, but as our forecasts are for net capital spending, further sales than would otherwise be expected would not affect the accuracy of our medium-term forecasts. Additional sales of financial assets would however affect our forecasts for net debt;
- we only include the impact of financial asset sales in our medium-term forecasts once sufficiently firm details are available of the nature, size and timing of the transactions for the effects to be quantified with reasonable accuracy. In this forecast we have included the proceeds from the sale of shares in Lloyds Banking Group and Royal Mail and the sale of part of the student loan book, which the Government expects to yield around £12 billion over a five year period from 2015-16. More detail on the specific effects of these sales can be found in the financial transactions section later in this chapter;
- we have asked the Treasury to identify any changes to future contingent liabilities as a result of new policy announcements since March. Contingent liabilities are not included in our forecasts, because they are future risks that could materialise but which are not currently expected to. The Treasury has only made one new announcement that increases contingent liabilities in the future; UK Export Finance's gross exposure to losses on its guarantees and insurance policies is to be expanded from £25 billion to £50 billion. Removing RBS's Contingent Capital Facility a year early reduces the Government's exposure to the banking system. We will continue to report on the broader suite of contingent liabilities, including updates on existing liabilities in our annual *Fiscal sustainability reports*; and
- there are a number of potential revisions to the public finances data in prospect (see Box 4.2).

Box 4.2: Potential changes to public finances data

Public finances data are subject to regular classification changes due to real world events, such as the sale of Royal Mail shares in October 2013, or methodological changes, such as the treatment of artistic originals in Blue Book 2013.

Over the coming months, the headline measures of PSND and PSNB are likely to be revised significantly following: first, the conclusion of ONS's review of its published Public Sector Finances (PSF) statistics, which aims to ensure the 'ex' measures remain relevant and are easily understood; and second, the ONS making the PSF data consistent with the new 2010 European System of Accounts (ESA10).^a

It is for the ONS to decide which changes to implement and to determine their quantitative impact. But, in the interests of identifying risks to the published public finance aggregates that form the basis of our forecasts in this *EFO*, we can draw on existing data and our forecasts to quantify some aspects that are subject to potential revision.

The ONS has already announced that, among other things, the PSF review will consider:

- **the ex-measures boundary:** the ex-measures definition currently excludes a number of large bodies or schemes from the headline measures of debt and borrowing, including Lloyds Banking Group, Royal Bank of Scotland and the Bank of England's Asset Purchase Facility (APF), plus a number of smaller interventions. The public sector banks currently add a little under £1 trillion to debt including financial interventions – 'PSND inc' – which is almost double PSND ex. The gilts currently held by the APF, purchased for £375 billion, have a nominal value of £326.5 billion. The £48.5 billion difference between the nominal value and purchase price currently increases PSND inc by around 3 per cent of GDP, but not the headline PSND ex measure that we forecast. Our projections of the flow of transfers between the Exchequer and the APF that affect borrowing are set out in Box 4.1. The ONS will consult on the Review's recommendations, with any resulting changes likely to affect both the deficit and debt; and
- **the definition of liquid assets:** unlike other shares held by the public sector, shares purchased as a result of financial sector interventions are currently treated as liquid assets, as is compensation to depositors. Liquid assets net off against the public sector's gross debt when calculating PSND and so these currently reduce PSND by over £55 billion or 3.3 per cent of GDP.

Areas that the ONS and/or Eurostat have said publicly might be subject to revision as ESA10 is implemented include:

- **the treatment of the Royal Mail Pension Plan transfer:** this currently appears as £28 billion of negative capital spending that improves borrowing in 2012-13, equal to the value of the assets transferred to central government. The future pension liability of £37 billion only affects PSNB as the pension payments are made. The final effect on borrowing under ESA10 is not yet clear and will depend on further Eurostat guidance. However, the largest change to borrowing would happen if it was decided that the one-off effect on PSNB under ESA10 reflected the £9 billion difference between the value of the assets and the

future liability, rather than only the value of the assets. This would increase PSNB by 0.6 per cent of GDP in that year, rather than reducing it;

- **imputed contributions to local government pension schemes:** the ONS may decide under ESA10 guidance to include imputed employers' contributions for local government funded pension schemes (and other funded schemes) in order to record the under- or over-funding of these schemes. Such an imputed contribution would have a small impact on local government net borrowing;
- **the classification of Network Rail:** Network Rail is currently classified as a private sector body. The ONS is reviewing that classification against the revised guidance in ESA10. Network Rail had £30 billion of debt recorded in its latest accounts, up from £8 billion at formation in 2002. Based on published plans, its operations imply the equivalent of around £3 billion of borrowing a year on average over the coming years. A change of classification could therefore increase PSND by about 2 per cent of GDP and PSNB by 0.2 per cent of GDP on average, with implications for future debt;
- **neutral movements between capital and current spending:** research and development spending will be capitalised under ESA10, potentially adding around £7 billion to spending with an offsetting reduction in current spending. Most expenditure on Single Use Military Equipment (SUME), which is around £4 to 5 billion a year in our forecast, will also be treated as capital rather than current spending; and
- **neutral movements in receipts and spending:** VAT paid to the EU, around £2 to 3 billion a year in our forecast, will be recorded as VAT paid to government with offsetting spending on current transfers to the EU. Together, these two changes would increase receipts and spending by around 0.3 per cent of GDP in 2013-14. In 2015, ONS will change the classification of tax credits that currently score as negative tax so that these will be treated as spending (also raising receipts and spending by the same amount). Tax credits were around £3 billion in 2012-13, but are expected to fall over the forecast period as personal tax credits are replaced by Universal Credit.

To summarise, there are potentially a number of significant methodological changes or classifications in prospect over the coming year. In most cases, these reflect methodological decisions rather than real world changes affecting the public finances, but they could have large measured effects that will need to be borne in mind when considering outturns against our forecasts. We will provide a further update in our March *EFO* and will discuss the implications of any specific ONS decisions in our monthly commentaries on PSF data releases.

^a Marks, 2013, Content of Blue Book and Pink Book 2014 (ONS)

Public sector receipts

4.25 Table 4.4 summarises our central forecast for the major taxes as a share of GDP. Table 4.5 shows our detailed forecast for individual taxes and other receipts, Table 4.6 shows how our forecast has changed since March.

Table 4.4: Major taxes as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax and NICs	16.4	16.0	16.1	16.4	16.9	17.1	17.3
Value added tax	6.4	6.5	6.4	6.4	6.3	6.3	6.2
Onshore corporation tax	2.3	2.2	2.2	2.2	2.2	2.1	2.1
UK oil and gas receipts	0.4	0.3	0.3	0.2	0.2	0.2	0.2
Fuel duties	1.7	1.6	1.6	1.5	1.5	1.5	1.5
Business rates	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Council tax	1.7	1.7	1.6	1.6	1.6	1.5	1.5
Excise duties	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Capital taxes	1.0	1.2	1.4	1.6	1.6	1.7	1.8
Other taxes	2.7	2.9	2.8	2.9	2.8	2.8	2.8
National Accounts taxes	35.4	35.2	35.3	35.6	35.9	36.1	36.2
Interest and dividend receipts exc. APF	0.5	0.4	0.5	0.6	0.7	0.8	0.9
Other receipts	1.4	1.4	1.3	1.3	1.3	1.3	1.3
Current receipts exc. APF	37.4	37.0	37.1	37.4	38.0	38.2	38.3
APF dividend receipts	0.4	0.7	0.7	0.4	0.2	0.0	0.0
Current receipts	37.8	37.7	37.8	37.9	38.1	38.2	38.3

4.26 Public sector current receipts (excluding transfers from the APF) are forecast to fall as a share of GDP between 2012-13 and 2013-14, largely as a result of lower income tax and NICs receipts. This is partially offset by the increase in capital taxes – notably stamp duty, as the housing market has picked up – and other taxes – including the one-off effect of receipts from the Swiss capital tax. The tax-to-GDP ratio then increases gradually over the following two years, before a 0.6 per cent of GDP increase in 2016-17, which largely reflects the Budget 2013 measure to abolish the NICs contracting out rebate.

4.27 Within the overall profile, some receipts streams are expected to rise as a share of GDP over the forecast period:

- income tax and NICs receipts, as a result of the return of positive fiscal drag, where earnings rise faster than inflation moving more income into higher income tax bands;
- capital and stamp taxes, as prices and transactions pick up in the residential property market; and
- interest and dividend receipts, excluding APF transfers, as higher rates of interest are earned on a rising stock of financial assets.

4.28 Some receipts streams are expected to fall as a share of GDP over the forecast period:

- oil and gas revenues, reflecting the falling value of production relative to nominal GDP and higher operating and capital expenditure by firms, which can be offset against tax liabilities;
- fuel duties, as improvements in vehicle efficiency and policy changes reduce growth in revenues. Duty rates will be held constant until September 2015, in line with policy announcements and then revalorised in line with RPI from April 2016 – RPI inflation grows at a slower rate than nominal GDP;
- onshore corporation tax receipts, reflecting the staggered reduction in the corporation tax rate to 20 per cent from 2015-16;
- VAT, due to a fall in the standard-rated share of consumer spending and the effect of fiscal consolidation on the government procurement; and
- dividend receipts from the APF, which are projected to wind down in line with the assumed path of monetary policy set out in Box 4.1.

Table 4.5: Current receipts

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax (gross of tax credits) ¹	152.3	155.5	167.3	177.9	189.5	201.2	214.0
<i>of which: Pay as you earn</i>	132.0	134.8	139.6	148.4	157.7	167.8	178.8
<i>Self assessment</i>	20.6	20.8	27.4	28.6	30.5	32.0	33.6
Tax credits (negative income tax)	-3.0	-2.7	-2.7	-2.6	-1.6	-0.3	0.0
National insurance contributions	104.5	106.9	109.2	113.5	124.4	130.6	137.2
Value added tax	100.7	106.2	109.8	113.7	117.7	121.8	126.1
Corporation tax ²	40.4	39.5	41.5	42.0	42.4	43.9	44.7
<i>of which: Onshore</i>	35.6	35.8	38.2	39.1	40.1	41.2	41.9
<i>Offshore</i>	4.8	3.7	3.2	2.8	2.3	2.7	2.8
Corporation tax credits ³	-0.9	-1.0	-0.9	-0.8	-0.8	-0.8	-0.9
Petroleum revenue tax	1.7	1.3	1.4	1.4	1.2	1.2	1.2
Fuel duties	26.6	26.8	26.6	26.9	28.0	28.7	29.6
Business rates	26.1	26.6	27.0	28.9	30.3	31.0	32.4
Council tax	26.3	27.1	27.7	28.2	29.0	30.0	30.9
VAT refunds	13.8	13.8	13.7	13.4	13.3	12.9	12.5
Capital gains tax	3.9	5.0	6.7	8.0	8.9	9.8	10.8
Inheritance tax	3.1	3.5	3.8	4.2	4.7	5.2	5.6
Stamp duty land tax	6.9	8.9	10.8	12.5	13.9	15.2	16.8
Stamp taxes on shares	2.2	2.9	2.8	2.9	2.9	3.0	3.0
Tobacco duties	9.6	9.7	9.9	10.1	10.3	10.5	10.7
Spirits duties	3.0	3.0	3.1	3.3	3.4	3.6	3.8
Wine duties	3.5	3.7	3.9	4.2	4.6	5.1	5.5
Beer and cider duties	3.6	3.6	3.5	3.5	3.6	3.7	3.8
Air passenger duty	2.8	3.1	3.2	3.4	3.7	3.9	4.3
Insurance premium tax	3.0	3.1	3.2	3.3	3.4	3.4	3.5
Climate change levy	0.7	1.7	2.1	2.6	2.7	2.8	3.0
Other HMRC taxes ⁴	5.9	6.4	6.5	6.9	7.1	7.4	7.6
Vehicle excise duties	6.0	6.0	5.8	5.7	5.6	5.4	5.3
Bank levy	1.6	2.2	2.7	2.9	2.9	2.9	2.9
Licence fee receipts	3.1	3.1	3.2	3.2	3.2	3.3	3.3
Environmental levies	2.3	4.1	4.8	5.6	6.4	7.4	8.7
Swiss capital tax	0.0	0.9	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.3	0.4	0.3	0.4	0.4	0.4	0.4
Other taxes	6.6	6.1	6.7	6.8	6.5	6.6	6.5
National Accounts taxes	556.6	577.3	603.6	632.0	667.6	699.6	733.1
Less own resources contribution to EU	-5.3	-5.1	-5.0	-5.2	-5.0	-5.2	-5.4
Interest and dividends exc. APF	8.0	7.1	8.1	9.8	12.7	15.1	17.5
Gross operating surplus	27.8	28.3	28.9	29.9	31.1	32.0	32.9
Other receipts	-0.2	-1.0	-1.1	-1.1	-1.2	-1.2	-1.3
Current receipts exc. APF	586.9	606.6	634.5	665.3	705.2	740.3	776.8
APF dividend receipts	6.4	12.2	12.1	7.4	3.2	0.5	0.0
Current receipts	593.3	618.8	646.6	672.7	708.4	740.8	776.8
<i>Memo: UK oil and gas revenues⁵</i>	<i>6.5</i>	<i>5.0</i>	<i>4.6</i>	<i>4.2</i>	<i>3.5</i>	<i>3.9</i>	<i>4.0</i>

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

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

³ Includes reduced liability company tax credits.

⁴ Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

⁵ Consists of offshore corporation tax and petroleum revenue tax.

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

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

Table 4.6: Changes to current receipts since March

	£ billion					
	Outturn	Forecast				
		2012-13	2013-14	2014-15	2015-16	2016-17
Income tax (gross of tax credits) ¹	1.8	0.8	1.7	3.5	2.9	2.2
<i>of which: Pay as you earn</i>	1.0	1.1	1.9	0.7	-0.2	-0.8
<i>Self assessment</i>	0.0	0.5	0.0	2.2	2.3	2.1
Tax credits (negative income tax)	0.1	0.0	-0.3	-1.2	-1.1	-0.1
National insurance contributions	0.7	0.2	0.6	-0.4	-1.1	-1.5
Value added tax	0.0	2.9	2.6	2.5	2.5	2.5
Corporation tax ²	0.1	0.3	3.4	5.4	4.2	4.3
<i>of which: Onshore</i>	0.1	1.2	4.5	5.6	5.2	4.7
<i>Offshore</i>	0.0	-0.9	-1.1	-0.2	-0.9	-0.3
Corporation tax credits ³	0.1	0.0	0.0	0.0	0.0	0.0
Petroleum revenue tax	0.0	-0.8	-0.3	-0.2	-0.3	-0.1
Fuel duties	0.0	0.7	0.2	-0.2	-0.3	-0.5
Business rates	0.4	-0.1	-1.1	-0.7	-0.2	-0.3
Council tax	0.0	-0.3	-0.6	-1.0	-1.0	-1.0
VAT refunds	-0.3	-0.8	-0.9	-1.3	-1.1	-1.3
Capital gains tax	0.0	-0.1	0.2	0.8	1.1	1.2
Inheritance tax	0.0	0.1	0.4	0.6	0.9	1.0
Stamp duty land tax	0.0	1.1	2.5	3.2	3.4	3.5
Stamp taxes on shares	0.0	0.0	0.1	0.1	0.1	0.1
Tobacco duties	0.0	-0.1	-0.3	-0.2	-0.3	-0.3
Spirits duties	0.0	0.1	0.0	0.0	0.0	0.1
Wine duties	0.0	0.1	0.0	0.0	0.0	0.0
Beer and cider duties	-0.1	0.1	0.0	-0.1	0.0	0.1
Air passenger duty	0.0	0.2	0.2	0.1	0.2	0.1
Insurance premium tax	0.0	0.0	0.1	0.1	0.1	0.2
Climate change levy	0.0	0.2	0.1	0.1	0.3	0.3
Other HMRC taxes ⁴	0.0	0.0	-0.1	-0.1	-0.1	0.0
Vehicle excise duties	0.1	0.1	0.1	0.0	0.0	-0.1
Bank levy	0.0	-0.4	-0.2	0.0	0.0	0.0
Licence fee receipts	0.0	0.0	0.0	0.0	0.0	0.0
Environmental levies	0.3	1.8	2.0	2.5	2.9	3.4
Swiss capital tax	0.0	-2.3	0.0	0.0	0.0	0.0
EU ETS auction receipts	-0.1	-0.2	-0.4	-0.4	-0.5	-0.5
Other taxes	-0.1	-0.6	-0.3	-0.3	-0.7	-0.6
National Accounts taxes	2.9	2.9	9.6	12.9	11.8	12.7
Less own resources contribution to EU	0.1	0.2	0.1	0.1	0.6	0.7
Interest and dividends exc. APF	-0.4	0.4	0.7	1.2	2.6	3.2
Gross operating surplus	3.6	2.9	2.2	2.2	2.3	2.3
Other receipts	0.4	-0.1	-0.1	-0.1	-0.1	-0.1
Current receipts exc. APF	6.5	6.4	12.5	16.2	17.2	18.8
APF dividend receipts	0.0	0.0	0.9	-1.0	-3.0	-1.0
Current receipts	6.6	6.4	13.5	15.2	14.3	17.7
<i>Memo: UK oil and gas revenues</i> ⁵	0.0	-1.7	-1.5	-0.4	-1.3	-0.4

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

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

³ Includes reduced liability company tax credits.

⁴ Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

⁵ Consists of offshore corporation tax and petroleum revenue tax.

Changes in the underlying receipts forecast since March

- 4.29 Our forecast for public sector current receipts excluding APF transfers is higher in every year than in March, and by £6.4 billion in 2013-14. Excluding PSNB-neutral changes that have raised both receipts and AME since March, receipts have been revised up by £3.4 billion (see Table 4.37). The upward revision reflects the recent strength of nominal consumer spending, the residential property market and industrial and commercial company profits. This has led to higher-than-expected VAT, stamp duty land tax and onshore corporation tax receipts.
- 4.30 A change in the way the ONS calculates receipts from the Renewables Obligation (RO) also raises receipts from environmental levies relative to our March forecast (with an offsetting revision to AME spending described later in the chapter). Changes to the profile of migration to Universal Credit increase the negative tax element of personal tax credits. This change is also offset within AME. New information on the gross operating surpluses of public corporations has also led to upward revisions. Receipts from North Sea oil and gas firms are lower than forecast. And the yield from the Swiss capital tax has been significantly lower than expected this year, as described in Box 4.3.
- 4.31 Current receipts are expected to be higher by £18.8 billion in 2017-18 than we forecast in March. Table 4.6 shows the changes to current receipts since March. Table 4.7 breaks down these changes into those that result from revised economic determinants, changes to modelling and other assumptions, and the effect of policy measures. We explain the changes on a tax-by tax basis in the next section of this chapter.
- 4.32 In summary, we have revised up most of the main receipts streams:
- income tax and NICs, where the stronger-than-expected outturn for 2012-13 is pushed through the forecast. This is partly offset by lower wages and salaries growth than previously assumed, where weaker average earnings growth offsets higher employment;
 - VAT, reflecting stronger near-term growth in nominal consumer spending and a narrower VAT gap;
 - onshore corporation tax receipts, as our company profits forecast has been revised up in the early years of the forecast, although the growth rates in the later years have been revised down;
 - capital taxes, as higher equity prices and house prices boost inheritance tax and capital gains tax receipts;
 - stamp taxes, mainly reflecting higher commercial and residential property prices and volumes of transactions; and

- environmental levies, mainly as a result of the new methodology adopted by the ONS to calculate receipts from the Renewables Obligation.

Table 4.7: Breakdown of changes to the underlying receipts forecast since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast ¹	600.2	622.0	649.1	687.9	721.6
December forecast ¹	606.6	634.5	665.3	705.2	740.3
Change	6.4	12.5	16.2	17.2	18.8
<i>of which:</i>					
Income and expenditure	3.4	6.1	6.2	5.4	4.6
Wages and salaries	1.4	2.3	1.0	-0.1	-0.8
Non-financial company profits	0.7	1.7	1.9	1.9	1.8
Consumer expenditure	0.8	1.1	1.2	1.3	1.4
Investment	-0.1	-0.1	0.4	0.6	0.7
Dividend income	0.2	0.2	0.5	0.6	0.8
Other	0.5	0.8	1.2	1.1	0.6
North Sea	-2.2	-1.8	-1.6	-1.1	-0.8
Production	-1.4	-1.2	-1.0	-0.8	-1.0
Oil and gas prices	-0.8	-0.6	-0.6	-0.2	0.2
Market assumptions	0.7	2.8	4.7	5.6	6.0
Residential property market	0.5	1.8	2.9	3.4	3.5
Commercial property market	0.1	0.3	0.3	0.3	0.3
Equity market	0.2	0.6	1.0	1.0	1.0
Interest rates	0.0	0.1	0.5	1.0	1.2
Prices	-0.1	-0.2	0.0	-0.1	-0.3
Other economic determinants	0.1	0.1	0.1	0.2	0.2
Other assumptions	4.5	5.6	6.5	7.7	9.7
IT and NICs receipts and modelling	0.7	0.2	0.9	0.7	0.4
Corporation tax receipts and modelling	0.4	2.0	2.2	2.3	2.0
VAT gap and receipts	1.6	2.1	2.2	2.3	2.3
North Sea revenues modelling	0.6	0.4	1.3	-0.1	0.4
Renewables Obligation methodology	1.9	2.3	2.7	3.1	3.7
Public sector gross operating surplus	2.9	2.2	2.3	2.5	2.6
Swiss capital tax	-2.3	-0.3	-0.6	-0.1	-0.1
Tax credits profile	0.0	-0.4	-1.3	-1.1	-0.1
Interest and dividend receipts	0.0	0.3	0.6	1.2	2.2
Pensions tax relief measure re-costing	-1.2	-0.7	-0.1	-0.1	0.0
Council tax	-0.3	-0.6	-1.0	-1.0	-1.0
VAT refunds	-0.8	-0.9	-1.3	-1.1	-1.3
Other judgements and modelling	0.9	-1.0	-1.4	-0.7	-1.4
Autumn Statement measures	0.0	-0.1	0.5	-0.4	-0.6

¹ Excludes APF dividend receipts.

Receipts in 2013-14

- 4.33 Growth in National Accounts taxes in the first seven months of 2013-14 was 4.6 per cent on a year earlier. We expect growth of around 2.6 per cent in the remainder of the financial year, and 3.7 per cent for the year as whole. Receipts in the early part of the year were boosted by income tax and NICs, as a result of income shifted into 2013-14 to take advantage of the reduction in the additional rate of income tax. PAYE and NICs growth has since fallen and is expected to remain at around these lower levels for the rest of the year. The payments-on-account regime for self-assessment (SA) means that receipts in the first half of the year are not a good guide to receipts in the remainder of the year. Receipts growth in the first seven months of the financial year has also been boosted by receipts from the UK-Swiss tax agreement, which are accrued to May 2013.
- 4.34 Stamp duty receipts, and the land tax element in particular, have exhibited strong growth in the year-to-date. We expect similar growth in the remainder of the year, as the housing market continues to show signs of strength. VAT receipts are up 6.8 per cent on a year earlier in the first seven months. We expect VAT receipts to grow at a slower rate for the remainder of the financial year. Corporation tax and petroleum revenue tax receipts are expected to fall, due to lower receipts from offshore oil and gas companies

Table 4.8: Receipts in 2013-14

	£ billion			Percentage change on 2012-13		
	Outturn	Forecast		Outturn	Forecast	
	Apr-Oct	Nov-Mar	Full Year	Apr-Oct	Nov-Mar	Full Year
Income tax and NICs	142.6	122.0	264.7	3.8	1.4	2.7
of which:						
PAYE and NICs	136.8	105.0	241.7	2.5	1.8	2.2
SA	7.3	13.6	20.8	4.3	0.0	1.4
Value added tax	61.8	44.4	106.2	6.8	3.7	5.5
Corporation tax	24.7	13.8	38.5	-0.8	-5.0	-2.3
Petroleum revenue tax	0.8	0.5	1.3	-33.2	-7.2	-25.2
Fuel duties	15.8	11.0	26.8	1.0	0.9	0.9
Inheritance tax	2.1	1.4	3.5	9.6	13.5	11.2
Stamp duties	7.0	4.8	11.8	31.7	25.3	29.0
Tobacco duties	5.0	4.7	9.7	0.6	1.6	1.1
Alcohol duties	5.8	4.5	10.3	2.8	-0.1	1.5
Business rates	15.7	10.9	26.6	3.0	0.4	1.9
Council tax	15.9	11.2	27.1	3.9	2.4	3.3
Other	30.3	20.5	50.8	9.0	12.4	10.3
National Accounts taxes	327.6	249.7	577.3	4.6	2.6	3.7

Tax-by-tax analysis

Income tax and NICs

- 4.35 Receipts from income tax and NICs in 2013-14 are expected to be £1.0 billion higher than in the March forecast. This primarily reflects an upward revision of £1.1 billion to PAYE and NIC1 receipts on employee salaries. Other elements of income tax, such as SA and tax on

savings income are also expected to be moderately stronger than previously assumed. Partly offsetting that, the pensions tax relief measure from Budget 2011 is expected to raise £1.2 billion less in 2013-14 than previously estimated.

- 4.36 Both bonus and underlying non-bonus receipts in the final two months of 2012-13 were higher than we forecast in March. This boosted PAYE and NIC1 receipts by £1.4 billion, which we have pushed through the forecast. The effect on 2013-14 receipts from stronger employment so far this year is partly offset by weak earnings growth. We have assumed that the cash value of financial sector bonuses remains at the higher-than-expected level recorded in 2012-13. This compares with an assumed 5 per cent fall in 2013-14 in our March forecast.
- 4.37 We have revised our employment forecast for 2014-15 onwards up, but our earnings growth forecast down. The combined effect is to take around £1 billion off PAYE and NIC1 receipts by the end of the forecast period relative to March. The combination of weak earnings growth and the rise in the personal allowance to £10,000 reduce PAYE and NIC1 growth in 2014-15. Thereafter, income tax and NICs receipts are expected to rise by around 1.2 per cent of GDP by 2018-19. This reflects stronger earnings growth, the return of positive fiscal drag from earnings rising faster than tax thresholds and allowances, and the abolition of contracting out in 2016-17, which is forecast to raise NICs receipts by £5.5 billion.
- 4.38 We expect growth of just 1.4 per cent in SA income tax receipts in 2013-14. The final payments on 2012-13 SA liabilities are due at the end of January 2014. Although we assume that underlying SA liabilities have risen, we expect receipts to be depressed by income shifted due to the reduction in the additional rate of income tax to 45p. This shift of taxable income related to 2012-13 into 2013-14 was evident in the PAYE data at the start of 2013-14 and we have allowed for a similar effect in the SA forecast. This income shifting is expected to raise SA receipts in 2014-15.
- 4.39 Self-employment has risen in recent years, but the available evidence suggests that many of the newly self-employed were not earning sufficient income to pay much tax. This reduced the effective tax rate on self-employment income and we have allowed for a further fall in the effective tax rate on 2012-13 liabilities. Relative to our March forecast, we expect SA receipts to be boosted by higher dividend and savings income, reflecting stronger profits and a higher path for interest rates in the latter years of the forecast.
- 4.40 Receipts related to the reforms in pension tax relief announced at Budget 2011 are expected to build up more slowly than previously assumed. The yield from the reduction in the annual allowance to £50,000 has been affected by lower-than-expected earnings growth, which has reduced the level of defined benefit pension contributions assessed against the annual allowance. As unused allowances can be carried forward, this reduces the yield for a number of years. The yield from the measure is around £1.2 billion lower in 2013-14 than in the March forecast, but little changed from 2015-16 onwards. We have also revised down the expected future yield from interest income on Swiss bank deposits (described in Box 4.3).

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

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	261.3	274.1	288.3	312.2	331.0
December forecast	262.4	276.4	291.4	313.9	331.7
Change	1.0	2.3	3.1	1.7	0.8
<i>of which:</i>					
<i>(by economic determinant)</i>					
Average earnings	-0.8	-1.2	-2.8	-4.4	-5.6
Employee numbers	2.2	3.4	3.7	4.3	4.8
SA dividend income	0.2	0.2	0.5	0.6	0.8
SA savings income	0.0	0.1	0.2	0.3	0.4
Other SA determinants	0.2	0.3	0.9	0.9	0.6
Other determinants	-0.1	-0.2	-0.1	-0.1	-0.2
<i>(by other category)</i>					
Latest receipts data	0.5	0.7	0.8	0.7	0.7
Other modelling updates	0.4	-0.1	0.2	-0.1	0.0
Revised pension tax relief costing	-1.2	-0.7	-0.1	-0.1	0.0
Revised Swiss yield	-0.1	-0.3	-0.6	-0.1	-0.1
Revisions to other costings	-0.3	-0.7	-0.4	-0.4	-0.5
Autumn Statement measures	0.0	0.7	0.7	0.0	-0.2

VAT

- 4.41 Our estimate for accrued VAT receipts in 2013-14 has been increased by £2.9 billion, leaving receipts 5.5 per cent up on 2012-13. Stronger growth in nominal consumer spending, which accounts for over two-thirds of the tax base, and a fall of around 0.6 percentage points in the VAT gap, are the main drivers of the upward revision to receipts this year. The VAT gap is the difference between the theoretical level of VAT payments and the actual receipts received by HMRC. The level of outstanding VAT debt is lower than expected in March, which leads to a lower estimate of the VAT gap.
- 4.42 VAT receipts are then expected to be around £2.5 billion higher than in our March forecast in each year from 2014-15 onwards. The current momentum of consumer spending is expected to slow, with quarterly growth rates from 2014 onwards in line with the March forecast. The higher level of consumer spending accounts for around £0.9 billion of the change in the VAT forecast from 2014-15 onwards.
- 4.43 We expect VAT receipts to decline from 6.5 per cent of GDP in 2013-14 to 6.2 per cent of GDP by the end of the forecast period. This reflects the government element of the tax base falling as the fiscal consolidation proceeds. The forecast also assumes that the proportion of consumer spending subject to the standard rate of VAT will continue to fall over the forecast period. Despite the pick-up in spending on durable goods in 2013, particularly on new cars, the standard rated share of consumer spending is expected to fall this year. This largely reflects higher housing costs, which are exempt from VAT. The National Accounts proxy owner-occupier housing costs by imputed rents. These grew by around 6½ per cent in

the first half of 2013 compared with a year earlier. We expect the share of spending on housing to increase, as house prices rise and mortgage interest rates begin to normalise.

Table 4.10: Key changes to the VAT forecast since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	103.3	107.2	111.2	115.2	119.3
December forecast	106.2	109.8	113.7	117.7	121.8
Change	2.9	2.6	2.5	2.5	2.5
<i>of which:</i>					
Latest receipts	2.0	1.6	1.7	1.8	1.8
Household spending	0.8	0.8	0.9	0.9	0.9
Household investment	0.2	0.2	0.3	0.3	0.3
SRS of consumer spending	-0.1	-0.7	-1.3	-1.3	-1.2
VAT debt	0.0	0.4	0.4	0.5	0.4
Other	-0.1	0.2	0.3	0.3	0.2

Onshore corporation tax

- 4.44 Onshore corporation tax receipts in 2013-14 are expected to be £1.2 billion higher than expected in our March forecast. This is more than explained by higher receipts from industrial and commercial companies. These are expected to be around £2 billion higher than forecast and offset downward revisions to receipts from the financial and life assurance sectors. Our forecast is for receipts in 2013-14 to be marginally up on a year earlier despite the reduction in the main rate of corporation tax from 24 per cent in 2012-13 to 23 per cent in 2013-14, the introduction of the Patent Box and the temporary increase in the annual investment allowance. The effect of these measures has been offset by stronger than expected non-oil, non-financial profit growth during 2013.
- 4.45 Compared to March, our forecast for onshore corporation tax receipts is at least £4½ billion higher in each year of the forecast from 2014-15. This again reflects upward revisions to receipts expected from industrial and commercial companies, due to a higher level of non-oil, non-financial profits throughout the forecast, lower investment (which reduces capital allowance claims against taxable profits) and modelling changes. However, we still expect onshore corporation tax receipts to fall as a share of GDP from 2.2 per cent in 2013-14 to 2.1 per cent by the end of the forecast. This partly reflects further reductions in the main rate of corporation tax to 20 per cent by 2015-16.
- 4.46 Corporation tax receipts from the financial sector are expected to remain low relative to pre-recession levels throughout the forecast period. Even by 2018-19, receipts from the sector are still only expected to be around half their peak level in 2006-07. This reflects subdued profit growth, the reductions in the main rate of corporation tax and the high level of losses being carried forward and used against taxable profits.

Table 4.11: Key changes to the onshore corporation tax forecast since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	34.6	33.7	33.5	34.9	36.5
December forecast	35.8	38.2	39.1	40.1	41.2
Change	1.2	4.5	5.6	5.2	4.7
<i>of which:</i>					
Industrial and commercial company profits	0.7	1.7	1.9	1.9	1.8
Industrial and commercial company investment	0.0	0.2	0.3	0.5	0.6
Financial company profits	0.0	0.0	0.0	0.1	0.1
Other economic determinants	0.1	0.7	0.7	0.5	0.1
Modelling updates and latest receipts data	0.3	1.6	1.9	2.0	2.0
Autumn Statement measures	0.0	0.4	0.7	0.2	0.1

UK oil and gas revenues

- 4.47 We have revised oil and gas revenues down by around £1.7 billion in 2013-14, compared with our March forecast. This reflects in-year data on petroleum revenue tax paid to date and the two instalments made by oil and gas firms on their 2013 profits. The final instalment payments will be made in January 2014. Revenues from the sector in 2013-14 are likely to be down by over 20 per cent on 2012-13. The main reasons for this drop are the fall in oil and gas production and record levels of capital expenditure. With 100 per cent first-year allowances available to oil and gas firms, higher investment leads to an immediate reduction in receipts. Oil prices in sterling terms are only marginally down on a year earlier, while gas prices are higher than in 2012.
- 4.48 We have incorporated DECC's latest production projections. Oil and gas production are expected to be 12 per cent and 9 per cent lower respectively in 2013 than in 2012. The March forecast had assumed that production would be broadly flat in 2013. The lower production level is expected to persist throughout the forecast, reducing revenues by around £1 billion a year, relative to our March forecast. The lower path for oil prices implied by the futures curve also lowers receipts in the early years of the forecast. Thereafter, our revised method for projecting oil and gas prices beyond 2015 raises revenues relative to using futures prices. Updates to the HMRC oil and gas revenue forecasting model, including incorporating new survey data and field ownership records, have raised receipts in most years of the forecast.
- 4.49 Total revenues are expected to fall by a further 20 per cent, from £5.0 billion in 2013-14 to £4.0 billion in 2018-19. With high levels of capital expenditure eventually assumed to prevent further falls in production, the decline in revenues primarily results from the fall in the oil price from \$108 a barrel in 2013 to \$97 a barrel in 2018.

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

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	6.8	6.1	4.7	4.8	4.3
December forecast	5.0	4.6	4.2	3.5	3.9
Change	-1.7	-1.5	-0.4	-1.3	-0.4
<i>of which:</i>					
Oil and gas production	-1.4	-1.2	-1.0	-0.8	-1.0
Sterling oil prices	-0.7	-0.8	-0.7	-0.5	-0.2
Gas prices	-0.3	0.1	-0.1	0.2	0.4
Modelling and other	0.6	0.4	1.3	-0.2	0.4

Fuel duties

4.50 Fuel duty revenue is affected by the duty rate and the demand for fuel. The announcement in the Autumn Statement to freeze the fuel duty rate until September 2015 reduces the forecast by £0.4 billion in 2014-15, rising to £0.8 billion by 2018-19. This offsets some upward revisions to the forecast compared to March, which mainly reflect stronger-than-expected receipts this year, which are assumed to persist through the forecast period.

4.51 Fuel duty is expected to be marginally higher in 2013-14 than in 2012-13, having fallen in the previous two years. With no change in duty rates between the two years, this reflects a slight increase in duty-paid consumption so far this year, which contrasts with the average 1 per cent a year fall over the past ten years. We expect the downward trend to resume from 2014-15, due to improvements in the fuel efficiency of cars. Fuel duty receipts pick up from 2015-16 onwards, reflecting the duty rate rise currently assumed for September 2015 and further annual increases in line with RPI inflation from April 2016 onwards.

Capital taxes

4.52 Capital gains tax (CGT) is paid in the final quarter of the financial year after the year in which the gains from the sale of an asset are realised. So CGT receipts in 2013-14 reflect asset disposals in 2012-13. CGT receipts are expected to increase from £3.9 billion to £5.0 billion between 2012-13 and 2013-14, a rise of 27 per cent. This is largely the result of a higher number of asset disposals and higher equity prices. Over the forecast period, CGT receipts are expected to show strong growth, as house prices and equity prices rise. Our forecast for CGT is around £1.2 billion higher in 2017-18 than in our March forecast.

4.53 Inheritance tax is expected to increase by around 10 per cent a year over the forecast period as house prices, equity prices and the stock of household deposits rise. The freeze in the nil rate band and the transferable nil rate band until the end of 2017-18 also boosts growth in receipts due to fiscal drag, as more estates become subject to inheritance tax.

Stamp taxes

- 4.54 Our forecast for stamp duty land tax (SDLT) is much higher than in March. We now expect receipts to almost double over the forecast period, from £8.9 billion in 2013-14 to £16.8 billion in 2018-19. The in-year estimate for 2013-14 has been revised up by £1.1 billion, reflecting strength in outturn receipts so far this year. This has been driven by strong growth in London property prices – London accounts for over 40 per cent of total SDLT receipts.
- 4.55 Growth in SDLT receipts is boosted by our forecasts for house prices and transactions, which are significantly higher than in our March forecast. Higher house prices add around £1.8 billion to the forecast by 2017-18, while a higher volume of property transactions boosts receipts by nearly £1 billion in the later years of the forecast. This pushes up the effective tax rate of stamp duty on residential property transactions significantly. In 2012-13, the latest available outturn data, the effective rate of stamp duty on residential property transactions was around 2 per cent. Our forecast is consistent with that rising by around 1 percentage point over the forecast period, a roughly 50 per cent increase, as fiscal drag means a greater proportion of transactions become subject to higher stamp duty bands.

Table 4.13: Key changes to the stamp duty land tax forecast since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	7.7	8.4	9.3	10.5	11.7
December forecast	8.9	10.8	12.5	13.9	15.2
Change	1.1	2.5	3.2	3.4	3.5
<i>of which:</i>					
Residential property prices	0.4	0.8	1.4	1.6	1.8
Residential property transactions	0.1	0.8	0.9	0.9	0.8
Commercial property market	0.1	0.3	0.3	0.3	0.3
Latest receipts data and modelling changes	0.5	0.6	0.6	0.6	0.6

- 4.56 Stamp duty on shares is also higher than we forecast in March, by around £0.1 billion in each year from 2014-15. This mainly reflects the higher starting point for equity prices.

Alcohol and tobacco duties

- 4.57 Alcohol duty is expected to increase from £10.3 billion in 2013-14 to £13.1 billion in 2018-19, little changed from our March forecast. Receipts from wine, cider and spirits duties are expected to increase in each year of the forecast, while receipts from beer duty are expected to fall next year as a result of measures announced in Budget 2013. Beer duty receipts are forecast to increase thereafter. We forecast wine, spirits and cider clearances to rise over the forecast period, in line with recent trends, while beer clearances are expected to fall.
- 4.58 Receipts from tobacco duty are expected to increase from £9.7 billion to £10.7 billion between 2013-14 and 2018-19, reflecting increases in duty rates. Duty rate rises offset the longer-term fall in cigarette clearances and consumption. Revenues are around £0.2 to

£0.3 billion lower throughout the forecast compared to March. This is largely due to lower receipts in 2013-14 being pushed through the forecast.

Other taxes

- 4.59 The main changes to the **business rates** forecast come from announcements in the Autumn Statement. Policy measures such as the one-year extension of the doubling of small business rate relief, the £1,000 discount for many smaller shops, pubs and restaurants for two years and the 2 per cent cap on the multiplier increase for 2014-15 take around £1 billion off the forecast in that year. By the end of the forecast, business rates are £0.3 billion lower than assumed in March, reflecting the permanent effect of capping the multiplier for 2014-15. Business rate bills are calculated by multiplying the rateable value of a non-domestic property by the multiplier, which is assumed to be uprated in line with RPI inflation from 2015-16 onwards.
- 4.60 Receipts from **council tax** are expected to be around £1.0 billion lower than we expected in March from 2015-16. This mainly reflects the Government's announcement in Spending Round 2013 that it would extend council tax freeze grants to cover 2014-15 and 2015-16. Assumptions and changes relating to council tax receipts are explained in more detail in the expenditure section of this chapter. Changes in council tax receipts are offset within the locally financed expenditure forecast, and are therefore neutral for net borrowing.
- 4.61 Where claimants of **tax credits** pay income tax, the amount of personal tax credit that offsets all or some of the tax they would otherwise have paid is classified as negative tax. The negative tax share falls in later years of the forecast as claimants migrate onto Universal Credit, which will be entirely classified as spending. This switch between negative tax and spending now occurs later due to changes in the planned migration onto the new benefit (see Box 4.5). The delays in migration lead to large increases in the negative tax element relative to our March forecast in 2015-16 and 2016-17, which are entirely offset within spending. In 2015 the ONS will change the classification of tax credits, so that they score as spending instead of negative tax.
- 4.62 **VAT refunds** to central and local government are fiscally neutral as they are offset within spending. The forecast for VAT refunds largely reflects the path of government procurement and investment plans. The large downward revision to VAT refunds since March reflects a change in outturn data, which means we now assume that a larger proportion of local authority spending is assigned to wages and salaries, rather than procurement.
- 4.63 **Air passenger duty** receipts are expected to rise from £3.1 billion in 2013-14 to £4.3 billion in 2018-19. This reflects higher passenger numbers and the assumption that duty rates rise in line with RPI inflation. The forecast is slightly higher than we expected in March, reflecting our forecast for GDP and that passenger numbers have been higher than expected.
- 4.64 **Vehicle excise duty** (VED) revenues are expected to fall from £6.0 billion in 2013-14 to around £5.3 billion in 2018-19, which is largely unchanged relative to our March forecast.

The downward path reflects a gradual shift in the stock of vehicles towards newer models that are designed to be less polluting, which moves vehicles into lower VED bands.

4.65 **Environmental levies** include 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. The large increase, relative to our March forecast, in environmental levies across the forecast period is more than accounted for by a change in the way the ONS calculates imputed tax and expenditure from the RO.³ This is now calculated by multiplying the announced buy-out price by the industry's overall renewables obligation. This change does not affect net borrowing as it is offset in the expenditure forecast. Abstracting from the methodological change, levy-funded spending on the RO would be lower than in March, reflecting a different mix of sources of renewable energy generation.

Table 4.14: Key changes to the Renewables Obligation forecast since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	0.6	0.7	0.9	1.1	1.4
December forecast	2.5	3.1	3.6	4.2	5.1
Change	1.9	2.3	2.7	3.1	3.7
<i>of which:</i>					
Methodology change	2.0	2.4	3.0	3.7	4.7
Forecast change	-0.1	-0.1	-0.3	-0.6	-1.0

¹Forecast includes Contracts for Differences from 2015-16 onwards.

4.66 **Environmental taxes** include the climate change levy, landfill tax and aggregates levy, as well as receipts from the EU emissions trading scheme (EU ETS). Lower carbon prices mean receipts from the EU ETS over the forecast are around half the level we projected in March.

4.67 The **bank levy** was announced in June 2010 and introduced in January 2011. It has proved difficult to forecast, as the tax base – specific types of bank liability – has fallen away more quickly than expected. With bank levy receipts expected to be £0.4 billion lower in 2013-14 than projected in March, we have reduced our estimate of the size of the tax base in 2013-14 and have assumed further falls over the next two years.

4.68 Since its introduction, the levy rate has been increased six times in order to offset the loss of receipts from a smaller tax base, including the rise announced in this Autumn Statement. For 2014-15, this means that receipts are forecast to be £2.7 billion, slightly more than the £2.4 billion for that year that appeared on the June 2010 Budget scorecard. So the £1.8 billion increase in receipts that has been scored for the six measures that raised the bank levy rate from its initial 0.07 per cent to the 0.156 per cent announced in this Autumn

³ Matthewson and Richardson, 2013, Improving Government statistics – Aligning the Public Sector Finances and National Accounts and other developments to public sector statistics, (ONS).

Statement has largely served to offset the loss of revenue from the unexpected weakness of the tax base rather than bringing in significantly more money than originally intended.

- 4.69 We incorporate a provision for **losses related to tax litigation** in our receipts forecast. Once cases are settled, and their effects in particular years can be quantified, they are incorporated into forecasts of specific taxes. The magnitude and timing of losses is difficult to forecast as it depends on the 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 represents an upside risk to the Government. We assume that future litigation losses across all taxes will total £3.8 billion over the forecast period.

Box 4.3: Tax agreements with offshore centres

The UK has entered into agreements with a number of offshore centres that are designed to ensure effective taxation of UK individuals with offshore assets. Estimating the prospective yield from such agreements is difficult due to the lack of information on the assets held in offshore centres and the extent of any behavioural response to these agreements.

The costing for the UK-Swiss tax agreement was certified at Autumn Statement 2012. It consisted of a one-off payment covering tax liabilities between 2003 and 2012, plus a future withholding tax from 2013 onwards. Original estimates from HMRC suggested a yield of between £4 billion and £7 billion from the agreement.^a Table C shows the costing certified in Autumn 2012. Of the £5.3 billion yield, £4.4 billion related to past liabilities, at the lower end of the original HMRC estimate, and £0.9 billion related to the future withholding tax.

Table C: Autumn 2012 costing for UK-Swiss tax agreement

	£ billion						Total
	2012-13	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	
Autumn 2012 Costing	0.3	3.1	0.6	0.9	0.2	0.2	5.3
Yield relating to past liabilities							
Swiss capital tax	0.3 ¹	2.9	0.0	0.0	0.0	0.0	3.2
Yield via LDF or HMRC	0.0	0.1	0.4	0.7	0.0	0.0	1.2
Yield relating to current and future liabilities							
Future receipts	0.0	0.1	0.2	0.2	0.2	0.2	0.9

¹After this costing, the ONS classification decision was to score all Swiss capital tax to May 2013 (i.e. 2013-14).

At the time, we stressed the uncertainty of the original costing due to the lack of hard information about the value of UK individuals' financial assets in Switzerland, and how these individuals would respond to the policy. Both receipts data and the July announcement from the Swiss Bankers' Association (SBA)^b indicate that the yield from the one-off levy (Swiss capital tax) will be significantly lower than estimated in the certified costing. Receipts of Swiss capital tax have totalled £789 million so far this year. Table D shows the revised costing for the UK-Swiss tax agreement included in our latest forecast.

Table D: Revised costing for UK-Swiss tax agreement

	£ billion						Total
	2012-13	Forecast					
		2013-14	2014-15	2015-16	2016-17	2017-18	
Latest Costing	0.0	1.1	0.3	0.3	0.1	0.1	1.9
Yield relating to past liabilities							
Swiss capital tax	0.0	0.9	0.0	0.0	0.0	0.0	0.9
Yield via LDF or HMRC	0.0	0.2	0.2	0.2	0.0	0.0	0.5
Yield relating to current and future liabilities							
Future receipts	0.0	0.1	0.1	0.1	0.1	0.1	0.5

The overestimate in this costing is in contrast to the Liechtenstein Disclosure Facility (LDF), which has yielded over £800 million to date (excluding receipts related to the Swiss agreement) with two-and-a-half years left to run. This compares to an initial costing of £1 billion.

The lower-than-expected yield is likely to reflect both a smaller initial tax base and a larger behavioural response than was estimated. The smaller tax base is likely to reflect some combination of: fewer assets held by UK individuals in Swiss banks; more of the assets belonging to non-domiciles or people who are already compliant; and the failure of Swiss banks to identify UK individuals holding assets; or circumvention of the deal. The SBA announcement suggested a high number of individuals with non-domicile status. The extent of capital flight to other offshore centres is likely to have been greater than expected.

Individuals could disclose via the LDF or to HMRC directly rather than pay the levy on their Swiss assets. There are indications that a higher proportion of individuals have decided to disclose via these routes. However, evidence from LDF and HMRC cases so far suggests that the average yield per case is lower than expected. As a result, the yield expected from these two routes has been reduced to less than half the original costing. The smaller-than-expected tax base means that the yield from the future withholding tax has also been revised down.

In Budget 2013, we certified the expected yield from other tax agreements and disclosure facilities, such as those with Jersey, Guernsey and the Isle of Man. The overall yield from these agreements between 2013-14 and 2017-18 is expected to be just over £1 billion. Reflecting experience of the Swiss agreement, we have re-profiled the yield between years, but left the total unchanged. Compared with the Swiss agreement, there is better information on the size of funds and we have reduced the estimate of UK funds by around 80 per cent to allow for substantial numbers of individuals having non-domicile status and for many to be compliant already or to have disclosed via previous HMRC schemes. This is a larger reduction than assumed in the UK-Swiss tax agreement.

Information agreements with several British Overseas Territories were announced at the Autumn Statement. These will provide additional information on UK accounts and assets held in these territories. The costing includes the lessons from previous costings relating to offshore centres.

^a Closing the Tax Gap: HMRC's record at ensuring tax compliance, House of Commons Treasury Committee. March 2012.

^b Swiss Bankers Association, 2013 - <http://www.swissbanking.org/en/medienmitteilung-20130705.htm>

Other receipts

- 4.70 Interest and dividend receipts capture the interest income on the stock of financial assets held by the government. Receipts (excluding the dividend flows from the APF) are expected to rise strongly from £7.1 billion in 2013-14 to £17.5 billion by 2018-19. This reflects both the path of market interest rates and that the stock of government assets is substantially higher than prior to the crisis. The Government holds higher foreign exchange reserves, larger deposits at the Debt Management Office and a higher stock of student loans. Relative to the March forecast, we expect interest and dividend receipts (excluding APF) to be higher in each year of the forecast. This primarily reflects modelling changes but also that market expectations indicate a slightly higher path for interest rates than was the case in March.
- 4.71 Box 4.1 provides details of our forecast for dividends from the APF. After dividend flows of just over £12 billion in both 2013-14 and 2014-15, these fall to zero by 2018-19.
- 4.72 Our forecasts for the gross operating surplus (GOS) are over £2 billion higher in each year of the forecast. This largely reflects changes to estimates for the recent past, which we push into the future. An increase in estimates of investment in artistic originals – the creation of entertainment, literary and artistic original assets – by public corporations that ONS included in Blue Book 2013 raised GOS in 2012-13 by over £1 billion. This change is neutral for borrowing, as it is offset by higher public corporations' capital expenditure. Aligning estimates with the latest companies' financial accounts also raised GOS for a number of public corporations. The ONS decision to classify Royal Mail into the private sector from October 2013 following the sale of shares, reduces GOS over the forecast period.

Public sector expenditure

- 4.73 This section explains our central projections for public sector expenditure, which are based on the National Accounts aggregates for public sector current expenditure (PSCE), public sector gross investment (PSGI), and total managed expenditure (TME), which is the sum of PSCE and PSGI. The Treasury plans public spending using two administrative aggregates:
- departmental expenditure limits (DELs)⁴ – mostly spending on public services and administration, which can be planned some years in advance. Our forecast is based on the Government's latest plans for DELs, which were extended to include 2015-16 in Spending Round 2013 (SR13), plus our view of the extent to which departments might underspend against these limits; and
 - annually managed expenditure (AME) – categories of spending less amenable to multi-year planning, such as social security spending and debt interest. We forecast these categories of spending out to 2018-19, based on determinants derived from our economic forecast.

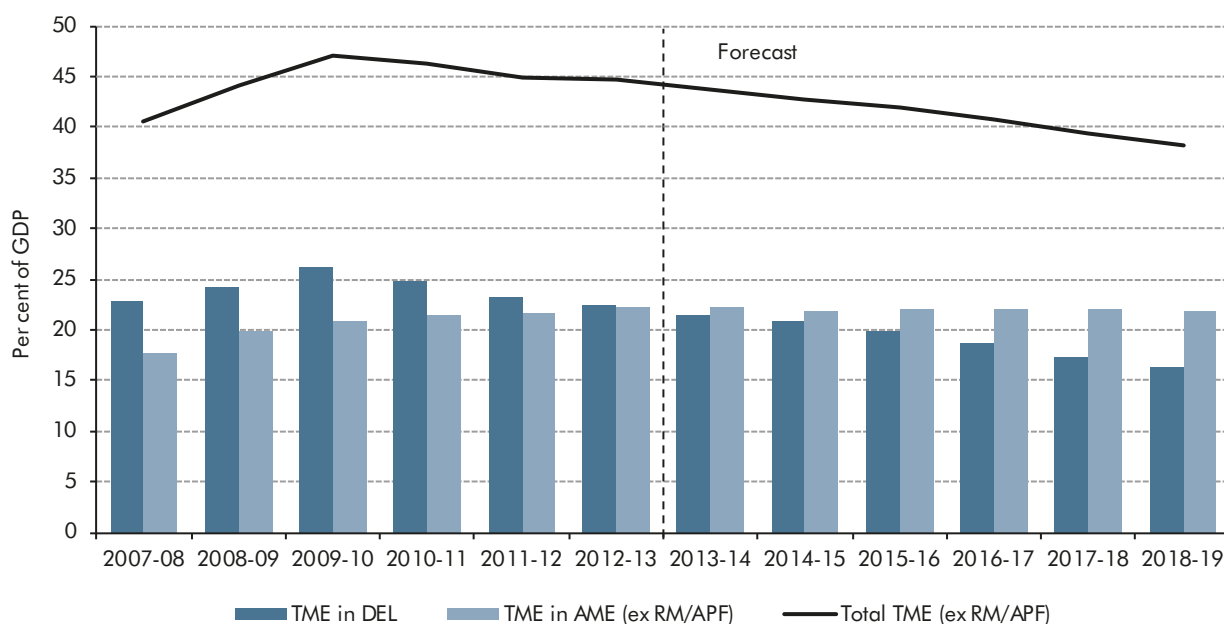
⁴ Our presentation of expenditure only shows those components of RDEL, CDEL and AME that are included in the fiscal aggregates of PSCE and PSGI. For budgeting purposes, the Treasury also includes other components in DEL and AME such as non-cash items.

- 4.74 For the years 2013-14 to 2015-16, our projections are constructed using the latest plans for PSCE in RDEL and PSGI in CDEL,⁵ plus our latest forecast for departments' underspending against those plans. To this, we add our detailed forecast for AME spending. This is the first time that we have constructed a forecast for 2015-16 in this 'bottom-up' way, reflecting the SR13 DEL plans.
- 4.75 Beyond 2015-16, our projections for total spending from 2016-17 to 2018-19 are based on the Government's stated TME policy assumption, which is set out in paragraph 4.81. We continue to produce a bottom-up forecast of AME for these years, which is subtracted from the level of TME that results from the Government's policy assumption to derive implied DELs. This approach means that changes in AME spending beyond 2015-16 on, for example, debt interest or benefits, are offset by changes in implied DELs.
- 4.76 Chart 4.1 shows TME as a percentage of GDP since 2007-08, and how it splits between DEL and AME. TME increased sharply as a share of GDP through the recession of 2008-09 and 2009-10, reaching a peak of 47.1 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 large shortfall in nominal GDP in 2008-09 and 2009-10 relative to forecast.⁶ AME spending on social security and debt interest also increased over this period.
- 4.77 TME fell from 47.1 per cent of GDP in 2009-10 to 44.9 per cent of GDP in 2011-12 due mainly to cuts to investment and slower growth in current spending. Excluding the effects of the Royal Mail Pension Plan transfer, TME was broadly flat in 2012-13, with lower DEL offset by higher AME. TME is projected to fall progressively across the forecast period, from 43.7 per cent of GDP in 2013-14 to 38.2 per cent of GDP in 2018-19, excluding the effect of APF transfers in that year. Of that 5.5 percentage point reduction, PSCE in RDEL accounts for 5.1 percentage points.

⁵ Our forecasts for PSCE in RDEL and PSGI in CDEL are consistent with the Government's plans for RDEL and CDEL presented in the Autumn Statement. A reconciliation between the Treasury's DEL figures and ours is published in the supplementary fiscal tables on our website.

⁶ The nominal GDP forecast underpinning the 2007 CSR projections of the public finances showed an increase of 10.4 per cent between 2007-08 and 2009-10. The latest ONS data show nominal GDP fell by 1.1 per cent over that period. That 11.5 percentage point shortfall in nominal GDP would add around 4½ percentage points to the ratio of TME to GDP, all else equal.

Chart 4.1: DEL and AME components of TME



Source: ONS, OBR

Summary of the expenditure forecast

4.78 Table 4.15 summarises our latest forecast for public expenditure. TME is expressed as a share of GDP, but not all of TME contributes directly to the calculation of GDP, as it comprises benefit payments, debt interest and other cash transfers that reallocate income from some individuals to others.

4.79 Table 4.16 shows how TME is split between DEL and AME, and the main components of AME. AME is forecast to be relatively flat as a share of GDP over the forecast period. Social security payments are forecast to fall gradually as a share of GDP as the economy recovers, while debt interest payments rise due to higher debt and interest rates. AME spending is expected to exceed DEL spending for the first time in 2013-14 and then continue to do so thereafter. This partly reflects some spending being transferred from DEL to AME from 2013-14 onwards, reflecting the decision to allow local authorities to retain around half their business rates income. But it also reflects the Government's policy in setting total DELs up to 2015-16 in Spending Review 2010 (SR10) and SR13, and also beyond that, by applying the Government's TME growth assumption. The effect of the latest assumption on implied DEL spending is described below.

Welfare cap

4.80 The Government announced in Budget 2013 that it intended to introduce a cap on a significant amount of AME spending. SR13 confirmed that this cap would be applied to welfare spending, excluding state pensions and the most counter-cyclical elements of welfare. The Autumn Statement contains further details about how the welfare cap will operate. The cap will be set initially at Budget 2014, and will apply from 2015-16 onwards,

over the forecast period. The Government has asked the OBR to assess its performance against the cap.

Table 4.15: Expenditure as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Total managed expenditure ¹	44.7	43.7	42.7	41.9	40.7	39.4	38.2
of which:							
Public sector current expenditure	41.9	40.8	39.6	38.9	37.8	36.6	35.6
Public sector gross investment ¹	2.8	2.9	3.0	2.9	2.9	2.7	2.6
Total public sector expenditure that contributes directly to GDP ²	24.0	23.3	22.6	21.7	20.7	19.4	18.4
of which:							
General government consumption	21.7	21.0	20.3	19.4	18.5	17.3	16.4
General government gross fixed capital formation	1.9	1.8	1.9	1.8	1.8	1.7	1.6
Public corporations gross fixed capital formation	0.5	0.5	0.5	0.5	0.4	0.4	0.4
¹ Excludes Royal Mail and APF spending. Royal Mail and APF spending as a percentage of GDP is shown here, and headline TME is shown in Table 4.19.							
Royal Mail and APF spending	-1.8	0.0	0.0	0.0	0.0	0.1	0.2
² GDP at market prices.							

Table 4.16: TME split between DEL and AME

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
TME in DEL ^{1,2,3}	22.5	21.6	20.9	19.9	18.7	17.3	16.3
TME in AME ⁴	22.2	22.2	21.8	22.0	22.0	22.1	21.9
of which:							
Social security ²	11.6	11.0	10.7	10.6	10.4	10.2	10.0
Debt interest	3.0	3.0	3.1	3.4	3.5	3.7	3.8
Locally-financed current expenditure ³	1.5	2.1	2.0	2.1	2.1	2.2	2.2
Other PSCE in AME	5.3	5.2	5.0	5.1	5.1	5.1	5.2
PSGI in AME ⁴	0.8	1.0	0.9	0.9	0.9	0.8	0.7

¹ In relation to table 4.19, 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 retain, and this source of local authorities own finance for spending replaces grant previously contained in RDEL which distributed these business rates to local authorities.

⁴ Excludes Royal Mail and APF spending. Royal Mail and APF spending as a percentage of GDP is shown in table 4.15 and headline TME is shown in Table 4.19.

Spending growth assumptions: effects on implied DELs

- 4.81 Our TME projections for 2016-17 to 2018-19 are based on the Government's stated policy assumption for TME growth. There are now two parts to the assumption:
- for 2016-17 and 2017-18, TME should continue to fall at the same average real rate as over the period covered by SR10 and SR13, with PSGI flat in real terms;⁷ and
 - for 2018-19, TME should be held flat in real terms, with PSGI growing in line with nominal GDP.
- 4.82 Applying the assumption, TME is now projected to fall by an average of 0.49 per cent a year in real terms between 2010-11 and 2015-16. This compares with the 0.36 per cent average fall between 2010-11 and 2014-15 used to derive TME from 2015-16 onwards under the Government's policy assumption used in our March forecast. This difference leads to a fall of around £1 billion in TME in 2016-17 and falls of around £2 billion in 2017-18 and 2018-19. The slightly larger real-terms fall in spending in the base period that gets projected forward is the result of a number of factors:
- upward revisions by ONS to TME in 2010-11 and a downward revision to our forecast for TME in 2015-16 reduce the nominal growth in TME over the period relative to our March forecast; and
 - revisions to ONS estimates of GDP deflator growth between 2010-11 and 2012-13 and revisions to our forecast for GDP deflator growth thereafter mean less growth in TME over the period is considered to be 'real' for the purposes of the TME assumption.
- 4.83 Table 4.17 shows that as a result of these assumptions, spending grows in real terms as follows:
- in 2016-17, against total spending in 2015-16 (which includes DEL underspends and policy measures), TME falls in real terms by 0.2 per cent, PSGI increases by 1.3 per cent and PSCE falls by 0.3 per cent;
 - in 2017-18, TME falls in real terms by 0.5 per cent, PSGI is flat and PSCE falls by 0.5 per cent; and
 - in 2018-19, TME is flat in real terms, PSGI increases by 2.7 per cent and PSCE falls by 0.2 per cent.
- 4.84 On the basis of current policy, including the policy measures announced in the Autumn Statement, we expect total AME to rise in real terms by 2.6 per cent in 2016-17, 3.5 per cent in 2017-18 and 2.5 per cent in 2018-19. For these years, we have derived implied levels for our definitions of RDEL and CDEL by subtracting the forecasts for AME from the

⁷ The Government has stated that both the growth rate and the baseline should be calculated excluding our projected underspends in DEL and all policy measures announced in the Autumn Statement.

forecasts for PSCE and PSGI. On the basis of our latest forecast for TME in DEL, including Autumn Statement policy measures and our estimates of departments' underspending against DEL plans in 2015-16:

- implied PSCE in RDEL falls in real terms by 3.9 per cent in 2016-17, 5.4 per cent in 2017-18, and 3.9 per cent in 2018-19. (The implications of these falls for our economy forecast and for the fiscal aggregates are discussed in Chapter 3 and later in this chapter respectively.) In the March forecast, implied PSCE in RDEL was projected to fall by 3.8 per cent in 2016-17 and 4.3 per cent in 2017-18; and
- implied PSGI in CDEL increases in real terms by 2.0 per cent in 2016-17, falls by 3.6 per cent in 2017-18 and increases by 2.4 per cent in 2018-19. In the March forecast, implied PSGI in CDEL was projected to fall by 0.5 per cent in 2016-17 and 1.1 per cent in 2017-18.

4.85 Some of the factors squeezing implied DELs include higher imputed spending on environmental levies, which reduces implied RDEL, and transfers to the APF, which reduces implied CDEL.

Table 4.17: Spending real growth rates and as a per cent of GDP

	Real terms growth rate (%)					Total change between 2010-11 and 2018-19
	Spending Review years 2011-12 to 2015-16		Post Spending Review years			
	Total change	Average annual change	Change in 2016-17	Change in 2017-18	Change in 2018-19	
Total managed expenditure	-2.7	-0.6	-0.2	-0.5	0.0	-3.4
<i>of which:</i>						
PSCE	-1.1	-0.2	-0.3	-0.5	-0.2	-2.1
PSGI	-19.9	-4.3	1.3	0.0	2.7	-16.6
TME in AME	10.5	2.0	2.6	3.5	2.5	20.2
TME in DEL	-14.1	-3.0	-3.2	-5.2	-3.2	-23.7
<i>of which:</i>						
PSCE in RDEL	-12.6	-2.7	-3.9	-5.4	-3.9	-23.7
PSGI in CDEL	-23.4	-5.2	2.0	-3.6	2.4	-22.9
	Per cent of GDP					
Total managed expenditure	-4.4	-0.9	-1.2	-1.2	-1.0	-7.8
<i>of which:</i>						
PSCE	-3.4	-0.7	-1.1	-1.2	-1.0	-6.7
PSGI	-1.0	-0.2	0.0	-0.1	0.0	-1.1
TME in AME	0.6	0.1	0.0	0.2	0.0	0.7
TME in DEL	-5.0	-1.0	-1.1	-1.4	-1.0	-8.5
<i>of which:</i>						
PSCE in RDEL	-4.0	-0.8	-1.1	-1.3	-1.0	-7.4
PSGI in CDEL	-0.8	-0.2	0.0	-0.1	0.0	-1.0

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

Summary of changes to the expenditure forecast since March

4.86 Table 4.18 shows the main reasons for the changes in our forecast of public sector expenditure since March. Tables 4.19 and 4.20 provide our detailed forecasts for spending and the changes since March. These are explained in more detail in the subsequent sections. In summary, the main drivers of the changes are:

- changes to the economic determinants. In particular:
 - movements in RPI inflation increase costs in 2014-15 and 2015-16, but reduce costs in other years;
 - revisions to GDP deflators reduce spending in 2016-17 and 2017-18;
 - a lower claimant count unemployment forecast decreases social security payments; and
 - a lower average earnings forecast reduces the cost of state pension uprating through the triple lock, but increases the cost of tax credits;
- latest in-year spending information and advice from the Treasury suggests departments will underspend in 2013-14 by more than we expected in March, and we have extended our underspend assumption of £3 billion to 2015-16 since firm plans were announced in SR13;
- higher imputed spending on environmental levies, mainly as a result of the new methodology adopted by the ONS to calculate spending from the Renewables Obligation;
- various modelling changes made to social security and local authority spending, which are explained in more detail in the relevant sections; and
- the policy changes announced in the Autumn Statement and SR13, which are summarised in Table 4.3 and set out in full in Annex A.

Table 4.18: Changes to the underlying spending forecast since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast ¹	720.0	730.4	744.7	754.9	764.2
December forecast ¹	717.8	730.5	744.0	756.3	763.7
Change¹	-2.2	0.1	-0.6	1.3	-0.5
of which:					
Economic determinants	-1.9	-1.1	-1.3	-2.8	-2.3
Inflation	-0.9	0.8	0.5	-1.0	-0.6
Unemployment	-1.1	-1.8	-1.6	-1.2	-0.8
State pension uprating	0.0	-0.1	-0.2	-0.4	-0.3
Average earnings	0.1	0.0	0.0	0.1	0.1
GDP deflator	-	-	-	-0.3	-0.7
Market assumptions	0.1	0.3	0.9	1.4	1.8
Gilt rates	0.0	0.3	0.5	0.6	0.7
Short rates	0.1	0.0	0.4	0.8	1.1
Other assumptions/changes	1.6	0.9	-0.7	2.7	-0.1
Changes to DEL underspend assumptions ²	-1.5	0.0	-3.0	-	-
Other changes to implied DEL	-	-	-	0.2	-4.1
Social security modelling changes	0.7	1.2	2.1	2.7	3.1
Local authority spending judgements	-0.8	-2.0	-1.2	-0.9	-0.2
Renewables Obligation methodology	1.9	2.3	2.7	3.1	3.7
Debt interest costs from financing CGNCR	0.0	0.0	-0.4	-0.8	-1.3
Other	1.2	-0.6	-1.0	-1.6	-1.3
Autumn Statement measures	-2.0	0.0	0.6	0.0	0.0

¹ Excludes Royal Mail and APF spending.

² Our underspend assumption in 2013-14 is £3.5 billion higher than in March but this includes a £2 billion reduction in the DEL reserve that the Treasury has included in Autumn Statement measures.

Table 4.19: Total managed expenditure

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector current expenditure (PSCE)							
PSCE in RDEL¹	316.5	316.4	316.6	312.6	305.7	294.1	287.4
PSCE in AME	340.8	353.3	362.1	379.2	396.4	416.4	433.9
<i>of which:</i>							
Social security benefits	182.9	180.0	183.2	187.9	192.6	198.2	203.5
Tax credits	28.7	28.8	28.6	28.8	31.0	33.7	35.1
Net public service pension payments	10.2	10.2	11.1	12.5	13.8	14.9	16.1
National lottery current grants	1.1	1.3	1.5	1.5	1.6	1.7	1.8
BBC domestic services current expenditure	3.4	3.6	4.0	3.7	3.8	3.9	3.9
Other PSCE items in departmental AME	1.1	1.2	1.1	1.1	1.1	1.1	1.1
Expenditure transfers to EU institutions	8.3	8.7	7.3	8.6	8.1	7.3	8.2
Locally-financed current expenditure	22.8	34.3	35.0	36.9	39.2	41.7	43.9
Central government gross debt interest	47.6	49.5	53.9	60.0	65.3	72.5	76.9
Depreciation	17.3	18.1	18.8	19.5	20.2	21.0	21.7
Current VAT refunds	11.6	11.4	11.4	11.2	11.0	10.6	10.4
Single use military expenditure	4.8	4.9	4.2	4.2	4.4	4.3	4.5
Environmental levies	2.0	3.5	4.4	5.3	6.2	7.4	8.9
Other National Accounts adjustments	-1.0	-2.3	-2.4	-2.1	-2.0	-2.0	-2.1
Total public sector current expenditure	657.2	669.7	678.7	691.8	702.2	710.5	721.3
Public sector gross investment (PSGI)							
PSGI in CDEL¹	32.2	32.6	37.1	36.6	38.0	37.3	38.8
PSGI in AME²	12.5	15.6	14.7	15.6	16.1	15.9	14.5
<i>of which:</i>							
National lottery capital grants	0.4	0.5	0.5	0.5	0.6	0.6	0.6
Other PSGI items in departmental AME ²	-1.7	0.7	0.6	0.4	0.4	0.4	0.4
Locally-financed capital expenditure	5.7	6.5	5.3	6.0	6.2	6.1	5.0
Public corporations capital expenditure	7.3	7.8	8.2	8.2	8.2	8.1	8.3
Other National Accounts adjustments	0.7	0.0	0.1	0.4	0.7	0.7	0.2
Total public sector gross investment²	44.7	48.2	51.8	52.2	54.1	53.2	53.4
Less depreciation	-22.5	-23.3	-24.1	-24.9	-25.8	-26.7	-27.6
Public sector net investment²	22.2	24.9	27.7	27.3	28.3	26.5	25.7
Total managed expenditure²	701.9	717.8	730.5	744.0	756.3	763.7	774.6
Royal Mail and APF spending	-28.0	0.0	0.0	0.2	0.0	1.8	4.1
Total managed expenditure (headline)	673.9	717.8	730.5	744.3	756.3	765.5	778.7

¹ Implied DEL numbers for 2016-17, 2017-18 and 2018-19. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

² Excludes Royal Mail and APF spending.

Table 4.20: Changes to total managed expenditure since March

	£ billion					
	Outturn	Forecast				
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector current expenditure (PSCE)						
PSCE in RDEL¹	-3.1	-4.4	-0.6	-1.5	-1.6	-5.0
PSCE in AME	3.1	1.2	-0.7	-0.8	0.1	2.5
<i>of which:</i>						
Social security benefits	0.1	-0.4	-1.2	-1.2	-0.4	0.6
Tax credits	0.1	-0.2	-1.1	-2.5	-2.3	-0.7
Net public service pension payments	-0.4	-0.9	-1.3	-1.1	-1.0	-1.2
National lottery current grants	0.1	0.1	0.1	0.1	0.1	0.0
BBC domestic services current expenditure	0.0	0.1	0.0	0.0	0.0	0.0
Other PSCE items in departmental AME	-0.3	0.1	0.2	0.0	0.0	0.0
Expenditure transfers to EU institutions	0.9	2.2	1.6	2.5	2.2	1.4
Locally-financed current expenditure	-1.0	-1.9	-3.0	-2.6	-1.8	-1.4
Central government gross debt interest	1.0	0.0	2.0	2.3	0.9	1.2
Depreciation	0.4	0.4	0.4	0.3	0.4	0.4
Current VAT refunds	0.0	-0.9	-0.9	-1.2	-1.1	-1.3
Single use military expenditure	0.1	0.2	0.0	-0.5	-0.3	-0.4
Environmental levies	0.7	1.9	2.3	2.7	3.1	3.5
Other National Accounts adjustments	1.3	0.3	0.2	0.4	0.5	0.5
Total public sector current expenditure	0.0	-3.2	-1.2	-2.4	-1.5	-2.5
Public sector gross investment (PSGI)						
PSGI in CDEL¹	0.9	-1.1	0.2	0.5	1.5	0.5
PSGI in AME²	-0.3	2.1	1.2	1.2	1.3	1.4
<i>of which:</i>						
National lottery capital grants	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Other PSGI items in departmental AME ²	-2.4	0.0	-0.3	-0.3	-0.2	-0.1
Locally-financed capital expenditure	-1.4	0.1	-1.0	-0.8	-0.8	-0.6
Public corporations capital expenditure	1.1	2.0	2.3	2.3	2.0	1.8
Other National Accounts adjustments	2.4	0.1	0.3	0.2	0.5	0.5
Total public sector gross investment²	0.6	1.0	1.4	1.8	2.8	1.9
Less depreciation	-0.4	-0.3	-0.3	-0.3	-0.4	-0.5
Public sector net investment²	0.2	0.7	1.1	1.5	2.4	1.5
Total managed expenditure²	0.7	-2.2	0.1	-0.6	1.3	-0.5
Royal Mail and APF spending	0.0	0.0	0.0	0.2	0.0	1.0
Total managed expenditure (headline)	0.7	-2.2	0.1	-0.4	1.3	0.5

¹ Implied DEL numbers for 2016-17, 2017-18 and 2018-19. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

² Excludes Royal Mail and APF spending.

Expenditure in 2013-14

4.87 Compared to our March forecast, we have reduced TME in 2013-14 by £2.2 billion. Broken down by sector, we have reduced our spending forecasts by £3.0 billion for central government, £0.9 billion for local government, and increased our forecast for public corporations by £1.7 billion. Detailed breakdowns by sector are shown in the

supplementary fiscal tables on our website. The £2.2 billion overall reduction reflects net increases in our forecasts for TME in AME that are more than offset by increases in our DEL underspends. Excluding PSNB-neutral changes that have raised receipts and AME since March, spending has been revised down by £5.2 billion (see Table 4.37).

4.88 Monthly outturn information is only available for central government spending. Table 4.21 compares the increases in spending so far this year with the same period in 2012-13 and our overall growth forecast for 2013-14. Total central government current spending has increased by 2.1 per cent in the first seven months of the year, compared to the 1.8 per cent increase that we are now forecasting for 2013-14 as a whole. In the 2013-14 outturn seen so far, central government spending growth has been increased by the front-loading of central government grants to local authorities and transfers to EU institutions. The former has now largely unwound, while the latter continue to affect year-on-year comparisons. The monthly profile of debt interest also varies considerably from year to year, reflecting differences in the monthly profile of the RPI, which affects debt interest on index-linked gilts. Abstracting from these factors, outturn for central government current spending to date is broadly in line with our forecast.

Table 4.21: Central government spending in 2013-14

	Spending in 2013-14			Percentage change on 2012-13		
	Outturn	Forecast		Outturn	Forecast	
	Apr-Oct	Nov-Mar	Full Year	Apr-Oct	Nov-Mar	Full Year
Total current expenditure	373.8	268.9	642.7	2.1	1.5	1.8
<i>of which:</i>						
Net social benefits	113.0	80.6	193.5	1.0	1.3	1.1
Debt interest	29.0	20.5	49.5	4.5	3.6	4.1
Other	231.8	167.8	399.6	2.3	1.3	1.9
Total net investment ¹	15.2	11.5	26.7	6.0	-7.3	-0.2
Depreciation	5.0	3.8	8.8	4.2	9.2	6.3
Total central government expenditure in TME	394.0	284.2	678.3	2.3	1.2	1.8
¹ This excludes two large one off receipts for Royal Mail (£28 billion) in April 2012 and 4G spectrum (£2.3 billion) in February 2013 because they distort the year on year comparisons. Including these receipts gives the following results:						
Total net investment	15.2	11.5	26.7	-211.5	14.0	-860.8

Departmental expenditure limits (DELs)

4.89 Table 4.22 summarises the changes to our forecasts for PSCE in RDEL and PSGI in CDEL since March. These include changes from the reclassification of some DEL transactions, following changes introduced in the Treasury's new spending database. These changes are broadly neutral within PSCE and PSGI, as shown in Box 4.4.

Box 4.4: Changes to the classification of data in OSCAR

For this forecast, we have used departments' plans data for TME in DEL, which underlie the plans data set out in *Public Expenditure Statistical Analyses (PESA) 2013*, and in *PESA 2013: Update for 2015-16*. PESA data are now held on the Treasury's new spending database, which is their Online System for Central Accounting and Reporting, known as OSCAR. This is the first time that we have used data from OSCAR for our forecasts. Our forecasts for TME in DEL have changed to reflect improvements in the classification of some DEL data on OSCAR. Most of the changes correct the classification of EU-related spending, which is not scored as public expenditure in the National Accounts. The changes only have a very marginal effect on our forecast of TME as a whole, because most of the classification changes in DEL remove the need for accounting adjustments that corrected the classification of the previous DEL data. The changes to TME in DEL are therefore largely offset by changes to accounting adjustments in AME, as shown in Table E.

Table E: OSCAR classification changes in DEL and AME

	£ billion						
	Outturn	Forecast			Implied DEL		
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Classification changes to PSCE in RDEL	-1.9	-1.9	-1.8	-1.8	-1.8	-1.8	-1.8
<i>of which:</i>							
Remove UK's contribution to the cost of EU aid ¹	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0
Remove EU-funded spending	-1.0	-0.9	-0.9	-0.8	-0.8	-0.9	-0.9
Offset by changes in PSCE in AME:	1.9	1.8	1.7	1.8	1.8	1.8	1.8
<i>of which:</i>							
Expenditure transfers to EU institutions ²	0.9	0.9	1.0	1.0	1.0	1.0	1.0
Other National Accounts adjustments	1.0	0.9	0.8	0.8	0.8	0.9	0.9
Classification changes to PSGI in CDEL to remove EU-funded spending	0.3	0.2	0.1	0.1	0.1	0.1	0.1
Offset by changes in PSGI in AME in other National Accounts adjustments	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1

¹ This is the UK's contribution to the cost of EU aid to states outside the EU, which is referred to as 'EU attributed aid'. Previously this used to be covered twice, in PSCE in RDEL and in the UK's expenditure transfers to EU institutions, within PSCE in AME.

² Previously, expenditure transfers to EU institutions included an adjustment to remove EU attributed aid, to prevent double-counting. This change removed this adjustment, which is no longer needed.

Table 4.22: Key changes to DEL since March

	£ billion				
	Forecast			Implied DEL ³	
	2013-14	2014-15	2015-16	2016-17	2017-18
PSCE in RDEL					
March forecast	320.8	317.2	314.2	307.4	299.1
December forecast	316.4	316.6	312.6	305.7	294.1
Change	-4.4	-0.6	-1.5	-1.6	-5.0
<i>of which:</i>					
OSCAR classification changes ¹	-1.9	-1.8	-1.8	-1.8	-1.8
Policy changes affecting underspends ²	-1.9	-	-	-	-
Other changes to underspends ²	-0.9	0.0	-1.0	-	-
Other Autumn Statement measures	0.0	1.0	1.7	1.5	1.6
Other changes to implied RDEL	-	-	-	-1.3	-4.8
Other changes	0.3	0.2	-0.4	-	-
PSGI in CDEL					
March forecast	33.7	36.9	36.1	36.5	36.7
December forecast	32.6	37.1	36.6	38.0	37.3
Change	-1.1	0.2	0.5	1.5	0.5
<i>of which:</i>					
OSCAR DEL classification changes ¹	0.2	0.1	0.1	0.1	0.1
Overallocations in 2013 SR	-	-	1.0	-	-
Policy changes affecting underspends ²	-0.1	-	-	-	-
Other changes to underspends ²	-0.6	0.0	-1.0	-	-
Other Autumn Statement measures	0.0	0.3	0.3	-0.1	0.0
Other changes to implied CDEL	-	-	-	1.5	0.4
Other changes	-0.6	-0.3	0.1	-	-
SUME (CDEL in PSCE in AME)⁴					
March forecast	4.7	4.2	4.7	4.7	4.7
December forecast	4.9	4.2	4.2	4.4	4.3
Change	0.2	0.0	-0.5	-0.3	-0.4
<i>of which:</i>					
Changes to underspend assumptions ²	0.0	0.0	-1.0	-	-
Other	0.2	0.0	0.5	-0.3	-0.4

¹ This includes the reclassification of some transactions in the new Treasury spending database (see Box 4.4).

² Our underspend assumption in 2013-14 is £3.5 billion higher than in March but this includes a £2 billion reduction in the DEL reserve that the Treasury has included in Autumn Statement measures. The overall underspend assumptions in this forecast, including SUME, are as follows:

	2013-14	2014-15	2015-16
PSCE in RDEL	-4.0	-1.0	-1.0
SUME	-1.0	-1.0	-1.0
PSGI in CDEL	-2.0	-1.0	-1.0
TME in DEL	-7.0	-3.0	-3.0

³ 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.

⁴ SUME is part of CDEL but is included in PSCE in AME in our tables because SUME is classified as current expenditure in the National Accounts. TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME.

- 4.90 In 2013-14, the main changes to forecast DEL spending are explained by our assumptions regarding the extent to which departments will underspend the limits set for them. These are discussed further below.
- 4.91 In 2015-16, our forecasts for DELs have changed from being implied DELs, derived by residual in our March forecast, to being actual DELs, as set in SR13. SR13 adopted our March forecasts for AME and our forecasts of total TME, PSCE and PSGI. The Government also announced various AME policy changes, which reduced AME spending. DELs were increased to the extent of those AME savings. All the AME measures from SR13 and the associated SR13 DEL increases have now been included with the further measures announced in the Autumn Statement. The SR13 AME total has been re-estimated, based on our latest forecast.
- 4.92 Our March forecast did not include any shortfall in departments' spending against their DEL spending limits in 2015-16, as limits had not yet been set. In SR13, the Government allocated £1 billion more in CDELs to departments than implied in our March forecast. Our latest forecast now includes a £1 billion shortfall assumption in our forecast for PSGI in CDEL and a £1 billion shortfall against PSCE in RDEL. The RDEL measures announced in the Autumn Statement, which subsume the £0.6 billion SR13 RDEL measures, have now increased PSCE in RDEL by £1.7 billion. This is illustrated in Table 4.23 below. Table 4.22 summarises the effects of all the Autumn Statement measures on DELs. The detailed measures are listed in Annex A.

Table 4.23: Changes in plans for RDEL in 2015-16

	£ billion				
	As published in SR13	As published in PESA update for 2015-16	OBR allowance for shortfall	As published in this forecast, excluding policy measures ¹	As published in this forecast, including policy measures ¹
Total RDEL	335.2	335.2		333.6	335.3
of which:					
PSCE in RDEL	312.9	312.5	-1.0	310.9	312.6
Depreciation	22.3	22.3		22.2	22.2
Other non-PSCE in RDEL	-	0.4		0.4	0.4
RDEL excluding depreciation	312.9	312.9		311.4	313.0

¹The Autumn Statement policy measures include the policy measures announced in SR13.

- 4.93 The remaining changes to DELs shown in Table 4.22 in the years 2013-14 to 2015-16 reflect some small switches from AME to DEL and movements in departments' spending plans recorded in *PESA 2013* and *Public Expenditure Statistical Analyses 2013: update for 2015-16*.⁸ The latter reflects changes between TME in DEL and other categories of spending in DEL that are not included in TME. The Government's spending controls apply to DEL aggregates that include TME and non-TME spending, so departments are able to switch

⁸ The switches apply in 2014-15 and 2015-16. They include £0.1 billion a year for discretionary housing payments, which switch from current AME to RDEL, and £0.2 billion a year for BBC spending on the roll-out of broadband, which switches from capital AME to CDEL.

some spending within their DELs in a way that will affect TME. In particular, in SR13, when the Government set the new total for RDEL excluding depreciation, the main spending control total for RDEL, it assumed that the other non-PSCE spending in RDEL excluding depreciation would be zero. However, as shown in Table 4.23, departments have now switched £0.4 billion of RDEL spending into other, non-PSCE spending elements of RDEL, reducing PSCE in RDEL.

DEL underspend assumptions

4.94 In our March forecast, we assumed that departments would underspend against the 2012-13 DEL plans set out in *PESA 2012* by £10.9 billion.⁹ Table 4.24 shows that, in outturn, departments' underspend was larger still, at £11.7 billion. This is net of £0.9 billion of Budget Exchange spending that departments brought into 2012-13 from 2011-12.

Table 4.24: Components of shortfalls against DEL plans

	£ billion					
	PSCE in RDEL		PSGI in CDEL		TME in DEL ¹	
	Outturn	Forecast	Outturn	Forecast	Outturn	Forecast
	12-13	13-14	12-13	13-14	12-13	13-14
Budget Exchange in PESA 2013 plans	0.6	1.6	0.2	0.6	0.9	2.3
Changes to plans in Supplementary Estimates	-4.8	-5.6	0.5	-2.6	-5.9	-9.3
Further identified policy reductions	-0.8		-0.8		-1.6	
Further underspends	-3.6		-1.6		-5.0	
Total shortfall	-8.5	-4.0	-1.6	-2.0	-11.7	-7.0

¹ TME in DEL includes SUME.

4.95 As we explained in our March *EFO*, the level of underspending in 2012-13 was exceptional and partly driven by policy action, which included pushing some spending forward into 2013-14 and 2014-15.¹⁰ Table 4.24 shows that Budget Exchange in 2012-13 potentially increased departments DEL spending by £2.3 billion in 2013-14.

4.96 Our latest forecast for 2013-14 assumes that departments will underspend their total DELs set out in the PESA plans by £7 billion. This shortfall assumption includes the £2 billion reduction to the Treasury's central DEL reserves that have been announced as a policy measure in the Autumn Statement. This shortfall assumption is also net of the £2.3 billion spending carried forward into 2013-14. It therefore assumes that the Treasury's management of spending pressures and departments' underspends together reduce DEL spending by £9.3 billion in total. This compares with underspending of £12.5 billion in 2012-13, measured on the same basis.

4.97 Our revised assumption is based on the following evidence:

⁹ Underspending measured against DEL plans set out in Public Expenditure Statistical Analyses 2012 (*PESA 2012*), adjusted for Autumn Statement measures and the classification change of the EIB, as set out in Table 4.21 of our March *EFO*.

¹⁰ The amounts of spending expected to be carried forward into 2013-14 and 2014-15 were set out in Table 4.22 of our March *EFO*.

- departments' latest monthly forecast of outturns for 2013-14, which were submitted to the Treasury in November, indicate underspends of around £3 billion against total DELs, net of the spending carried forward into 2013-14. Departments tend to increase their forecast underspends as the year progresses, and we expect their monthly forecasts to follow the path seen in earlier years; and
- the Treasury are discussing underspends with departments, in the run-up to agreeing final spending plans that will be published in the Supplementary Estimates in February. The Treasury have identified further underspends across departments to bring the total underspend to around £5½ billion, again net of the spending carried into 2013-14. The Autumn Statement measure that reduces DEL reserves by £2 billion has effectively captured £2 billion of this £5½ billion identified underspend.

4.98 The Treasury will publish Supplementary Estimates in February that will show the final levels of underspends – relative to PESA 2013 – subsumed into final plans, including underspends surrendered and taken forward into future years under Budget Exchange. We cannot tell how much of the Treasury's expected £5½ billion might be surrendered in the Supplementary Estimates, but we would expect departments to underspend these final plans too, since these form absolute limits that departments must not exceed. We have therefore assumed that departmental spending falls away by a further £1½ billion, as a central estimate, on top of the £5½ billion underspends that the Treasury have currently identified. Our £7 billion shortfall assumption could be increased or reduced in our next forecast, depending on how much of the underspends are surrendered in the Supplementary Estimates, and depending on departments' forecast outturns in February, after their Supplementary Estimates have been published.

4.99 For 2014-15, we have left the assumed shortfall unchanged at £3 billion, net of spending carried forward. Higher levels of underspending have continued in 2013-14, but spending pressure in 2014-15 has also increased due to the Autumn Statement policy measures that have reduced departments' DELs. These pressures may reduce underspends. Our £3 billion assumption is a high-level assumption that tries to balance many uncertainties. We have also set our initial high-level underspend assumption at £3 billion for 2015-16. We will continue to keep our judgements on DEL underspends for future years under review.

4.100 The splits of our underspend assumptions between PSCE in RDEL, PSGI in CDEL and SUME are shown at the bottom of Table 4.22. A supplementary fiscal table on our website shows underspends against final plans and PESA plans, for our forecasts and recent outturn years.

Annually managed expenditure

4.101 Table 4.19 sets out our latest central projections of AME spending to 2018-19, based on our economic forecast, the latest estimates of agreed policy commitments and the measures announced in the Autumn Statement.

Social security

- 4.102 Table 4.16 shows that social security expenditure is forecast to fall from 11.6 per cent of GDP to 10.0 per cent over the forecast period, as lower unemployment and policy measures reduce spending. Within social security, expenditure on state pensions is forecast to remain broadly flat at around 5.2 per cent of GDP.
- 4.103 Social security spending is slightly lower than in our March forecast over the first four years of the forecast period. Revisions to the economic determinants and measures announced in the Autumn Statement reduce the forecast. The delay in migration to Universal Credit also reduces the forecast up until 2016-17, and then increases it in 2017-18 (see Box 4.5). However these reductions are largely offset by modelling changes which increase the forecast, where these changes are larger in the second half of the forecast period. By 2017-18, social security spending is forecast to be £0.6 billion higher than in March. Changes in social security spending are shown in Table 4.25.
- 4.104 The main changes arising from our economic forecast are driven by:
- lower claimant count unemployment, which reduces benefit payments by £1.1 billion in 2013-14 and £1.8 billion in 2014-15, falling to £0.8 billion in 2017-18;
 - the September 2013 outturn for CPI inflation, used for April 2014 uprating, which was lower than forecast. Our forecast of CPI inflation in 2014-15 is also slightly lower, which leads to small decreases in the forecast of benefit spending; and
 - lower average earnings growth, which reduces spending on pension credit and the basic state pension from 2015-16 due to lower uprating.

Table 4.25: Key changes to social security since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	180.4	184.4	189.1	193.1	197.6
December forecast	180.0	183.2	187.9	192.6	198.2
Change¹	-0.4	-1.2	-1.2	-0.4	0.6
<i>of which:</i>					
CPI	0.0	-0.1	-0.2	-0.2	-0.1
Claimant count unemployment	-1.1	-1.8	-1.6	-1.2	-0.8
State pension uprating	0.0	-0.1	-0.2	-0.4	-0.3
Average earnings	0.0	0.0	-0.1	-0.1	-0.2
Updated population estimates	-0.1	0.0	0.1	0.2	0.3
Universal Credit migration delay	0.0	-0.2	-0.5	-0.1	0.3
State pension modelling	-0.4	-0.5	-0.6	-0.7	-0.8
ESA modelling	0.6	0.7	1.6	1.9	2.1
Housing benefit modelling	0.6	0.9	1.2	1.5	1.8
Autumn Statement measures ²	0.0	-0.4	-0.6	-1.0	-1.4
Other	0.1	0.2	-0.3	-0.3	-0.3

¹ For 2013-14 and 2014-15, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

² Autumn Statement measures are shown in Annex A. This also includes the effect of freezing work allowances (disregards) under Universal Credit between 2014-15 and 2016-17, which is not on the Treasury scorecard.

4.105 We have made significant changes to our forecasts for Employment and Support Allowance (ESA) and housing benefit:

- ESA is higher by £2.1 billion by 2017-18. The latest evidence from work capability assessments suggests that the proportion of those assessed moving into the support group will be higher than previously assumed and the proportion declared fit for work lower. Benefit expenditure will also be higher over the next few years because of delays to the work capability assessment programme. We have reduced the assumed number of work capability assessments to reflect recent lower volumes and prospects for clearing the backlog; and
- housing benefit spending is higher by £1.8 billion by 2017-18. About half of this is explained by an increase in the proportion of employed people who receive housing benefit, based on recent data and detailed modelling, which suggests that growth in renting for this part of the working age population is likely to continue to increase further over the forecast period. Changes in the caseloads for other benefits, particularly ESA, explain the majority of the remaining increase.

Box 4.5: Universal Credit

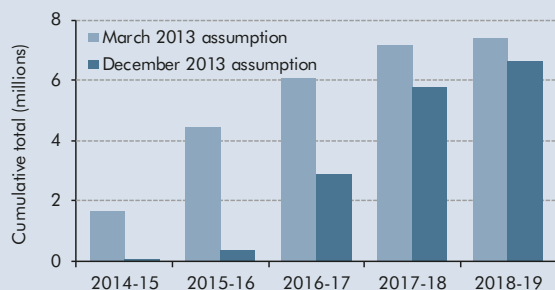
The Government is gradually rolling out Universal Credit, a single benefit that will replace a number of existing benefits and tax credits for working age people. Universal Credit is currently included in our forecast for social security spending as the additional costs or savings compared to what would be spent on existing benefits and tax credits if they were left in place.

Our March forecast for Universal Credit was based on the Government’s then planning assumption for migrating existing claimants onto the new benefit. However, the migration process has fallen behind those assumptions and the Government announced a revised planning assumption this week. This is provisional, pending final decisions on the detail and approval of a new business case for the reform.

Under these latest assumptions, the Government plans that Universal Credit will be fully available in each part of Great Britain during 2016 with the majority of the remaining legacy caseload moving to Universal Credit during 2016 and 2017. Compared to previous assumptions these have the effect of migrating about 700,000 fewer people onto Universal Credit by the end of the forecast horizon than in March, leaving some recipients of Employment and Support Allowance to migrate later. They also mean many fewer people migrating this year and next, concentrating the bulk of the managed migrations into the summer and autumn of 2016 and 2017. The impact on the total planned caseloads, compared to March, is shown in Charts A and B below.

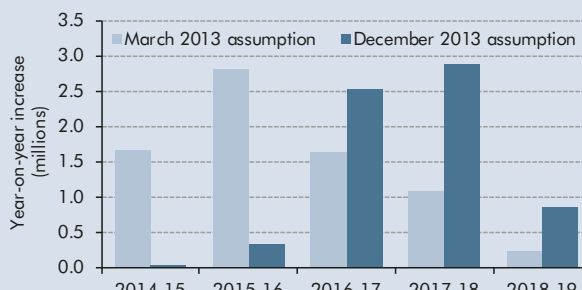
The Government has told us that, while the new migration timetable has yet to be subjected to full business case approval, this should be considered the central policy profile for now – and that the Department for Work and Pensions, HM Revenue and Customs and the Treasury all believe that it can be delivered operationally. But given the delays to date, and the scale of migration required in 2016 and 2017, there is clearly a risk that the eventual profile differs significantly from this new assumption. However, as Table F illustrates, given the current projected costs, further delay would be unlikely to have a significant quantitative impact on the public finances over the forecast horizon.

Chart A: Caseload volumes



Source: DWP

Chart B: Caseload growth



Source: DWP

There are of course broader uncertainties over the eventual cost of Universal Credit, notwithstanding the speed of implementation. We have highlighted a number in past EFOs, including the behavioural response of potential claimants and the scope for error and fraud savings. We have applied lower error and fraud saving assumptions in this forecast, to reflect the new migration profile.

Compared to March, a slower build-up of cases reduces projected spending up to 2015-16, as households that would have been eligible to slightly more generous entitlements under the new benefit no longer move across. This unwinds in subsequent years as the migration process catches up. But we also now assume lower error and fraud savings in the initial stages, which – along with higher transitional costs – increases spending in 2017-18. The new migration profile does not affect the small savings from a number of benefits that have been abolished on schedule, which build from 2013-14. New policy plans – notably the intention to freeze work allowances (disregards) from 2014-15 to 2016-17 – reduce spending in the longer term. We also now expect fewer households to be affected by the minimum income floor, which limits payments to the self-employed, reducing the potential savings from the minimum income floor policy.

Table F: Key changes to Universal Credit since March

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19 ¹
March forecast	0.0	0.0	0.1	0.3	0.3	
December forecast	0.0	-0.1	-0.2	0.0	0.3	-0.3
Change	0.0	-0.1	-0.3	-0.3	0.0	
<i>of which:</i>						
Delayed migration profile	0.0	-0.2	-0.5	-0.1	0.3	
Other caseload changes	0.0	0.1	0.2	0.3	0.3	
Policy measures	0.0	0.0	-0.1	-0.4	-0.6	-0.6
Other	0.0	0.0	0.0	-0.1	-0.1	

¹The March forecast did not extend to 2018-19 but policy announced since March would have reduced spending by £0.6 billion.

Tax credits

- 4.106 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. Cash spending is also lower in each year relative to our March forecast, as increases relating to slightly weaker average earnings growth are more than offset by other factors. Lower births over the short term within the latest ONS population projections reduce spending on the child tax credit element in later years. In light of recent trends and Government policy to provide free childcare to two-year olds, we have also revised down our assumptions for spending on the childcare element. More broadly, spending in the year to date has been lower than would otherwise be expected, and we have reduced our forecasts for future years accordingly. Policy measures announced in the Autumn Statement also reduce net spending from 2014-15.
- 4.107 Where claimants pay income tax, the amount of personal tax credit that offsets all or some of the tax they would otherwise have paid is currently classified as negative tax and any remaining amount is treated as spending. The negative tax share falls in later years as claimants migrate onto Universal Credit, which will be entirely classified as spending. This switch between negative tax and spending now occurs later due to changes in the planned

migration onto the new benefit (see Box 4.5). The classification of tax credits will change in 2015, so that it is all scored as spending (see Box 4.2).

Table 4.26: Key changes to tax credits since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	31.7	32.1	32.7	33.8	34.7
December forecast	31.5	31.3	31.4	32.6	34.0
Change^{1, 2}	-0.2	-0.8	-1.3	-1.2	-0.6
<i>of which:</i>					
Average earnings growth	0.1	0.0	0.1	0.2	0.2
Population projections	0.1	0.0	-0.1	-0.2	-0.3
Childcare	-0.1	-0.2	-0.3	-0.3	-0.3
Latest outturn data	-0.4	-0.5	-0.5	-0.6	-0.5
Autumn Statement measures ³	0.0	-0.4	-0.7	-0.5	-0.1
Other	0.2	0.4	0.2	0.2	0.3

¹ This table shows changes to total tax credits, which are split between current receipts (shown in table 4.5) and AME current spending (shown in table 4.19). This split is shown below.

Changes to tax credits treated as AME spending	-0.2	-1.1	-2.5	-2.3	-0.7
Changes to tax credits treated as negative tax	0.0	0.3	1.2	1.1	0.1

² For 2013-14 and 2014-15, child allowances in income support and jobseekers' allowance have been included in tax credits and excluded from social security benefits.

³ Autumn Statement measures are shown in Annex A.

Public service pensions

4.108 The net public service pensions expenditure forecast measures benefits paid less employer and employee contributions received. It includes central government pay-as-you go public service pension schemes and locally administered police and fire-fighters' pension schemes.¹¹ A breakdown of spending and income for the major schemes covered is included in the supplementary tables on our website. Table 4.27 shows the main changes since our March forecast.

¹¹ The police and firefighters' pension schemes are administered at a local level, but pensions in payment are funded from AME, along with other public service pension schemes so they are included in the pensions forecast.

Table 4.27: Key changes to public service pensions since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
Net public service pensions					
March forecast	11.1	12.4	13.6	14.9	16.2
December forecast	10.2	11.1	12.5	13.8	14.9
Change	-0.9	-1.3	-1.1	-1.0	-1.2
Expenditure					
March forecast	36.4	38.2	40.0	42.0	44.1
December forecast	35.6	37.0	38.6	40.4	42.3
Change	-0.7	-1.2	-1.4	-1.6	-1.8
<i>of which:</i>					
CPI	0.0	-0.1	-0.1	-0.1	-0.1
Teachers pensions modelling	-0.4	-0.5	-0.7	-0.9	-1.1
Other	-0.3	-0.6	-0.6	-0.6	-0.7
Income					
March forecast	-25.3	-25.8	-26.4	-27.1	-27.9
December forecast	-25.4	-25.9	-26.1	-26.6	-27.4
Change	-0.2	-0.1	0.3	0.6	0.6

- 4.109 Gross expenditure rises steadily across the forecast period reflecting the impact of demographic trends on the age profile of each scheme's membership. Compared with our March forecast, spending is lower in all years with the fall increasing from £0.7 billion in 2013-14 to £1.8 billion in 2017-18. Around half of this is explained by a reduction in our forecast of the volume of teacher retirements. This is informed by recent data and is supported by improved reporting and more detailed analyses of the membership age profile. The remaining change is explained by latest data for other large schemes, particularly on lump sums, which we have fed through to the forecast.
- 4.110 The income of each scheme is almost entirely made up of employer and employee pension contributions, and is largely driven by the pensionable paybill. Compared with our March forecast, contributions are forecast to be £0.6 billion lower by 2017-18. This is a combination of lower SR13 settlements for 2015-16, and a reduction of £0.2 billion in each year from 2016-17 to reflect the additional pressure on paybills from the abolition of NICs contracting out. The abolition means government departments (and employees) will pay more NICs and the Government has said departments will have to absorb these costs.
- 4.111 The forecast does not take account of the new pension schemes that are expected to be implemented from April 2015, which we expect to have a minimal effect over the forecast period. Each scheme is currently undertaking a valuation exercise, which will be used to decide the employer contribution rates that will apply from April 2015. The valuations will be completed during 2014 and we will include the impact of this in future forecasts.

EU contributions

- 4.112 The main component of the AME transfer to EU institutions is the UK's gross national income (GNI)-based contribution, minus the UK's abatement. The forecast for the GNI-based contribution depends mainly on the level of the agreed EU Budget and the relative GNI of each member state. The UK abatement is affected by the UK's share of the EU VAT base and the UK's share of EU abatable receipts.¹²
- 4.113 Our forecast profile for EU contributions is uneven from year to year, and more so than in March, reflecting our updated assumptions about the timing of contributions relating to the new EU Multi-Annual Financial Framework (MFF) for 2014 to 2020. Future payments will also be affected by the new Own Resources Decision (ORD). In line with what happened with the 2007 ORD, which came into effect after around two years, we have assumed that the new ORD will come into effect in 2016. This reduces our forecast for payments in 2013-14 and 2014-15, but increases payments in 2015-16 and 2016-17, as we forecast retrospective adjustments will be made to correct for the timing of implementation. A further timing effect can be seen in 2017-18, where contributions are reduced to reflect the impact on the UK's abatement of higher payments in the preceding years.
- 4.114 The changes in our latest forecast for expenditure contributions to the EU are shown in Table 4.28, which shows that our forecast has increased by a cumulative £10 billion between 2013-14 and 2017-18. Around half reflects a spending-neutral classification change that removes a previous adjustment on EU attributed aid in AME. This is discussed further in Box 4.4.

Table 4.28: Key changes to EU contributions since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	6.5	5.7	6.1	5.9	6.0
December forecast	8.7	7.3	8.6	8.1	7.3
Change	2.2	1.6	2.5	2.2	1.4
<i>of which:</i>					
Own Resources Decision timing assumption	-0.2	-0.3	0.5	0.6	-0.4
Attributed aid reclassification	0.9	1.0	1.0	1.0	1.0
New bases for 2013 and 2014	1.0	1.1	0.8	0.8	0.8
2013 annual budget assumption	0.6	0.0	0.0	0.0	0.0
Other	-0.2	-0.2	0.2	-0.1	0.0

- 4.115 The largest change to the forecast relates to new Own Resources bases for 2014 and amended bases for 2013 that were agreed in May 2013. For 2013, these showed downward revisions to the totals across all member states for Traditional Own Resources (TOR), VAT and GNI, largely reflecting lower than expected economic growth across most parts of the EU. This reduced member states' TOR and VAT based contributions, but raised

¹² A supplementary fiscal table on our website provides further details of UK transactions with the EU, including how these various contributions score in the National Accounts and our forecast.

GNI-based contributions to cover the resulting shortfall. UK GNI-based contributions increased by around £1 billion in 2013-14 and 2014-15. These effects persist into the later years of our forecast.

- 4.116 Other changes include our judgement on the EU annual budget and movements in the sterling/euro exchange rate. On the former, as a result of amending budgets that have raised spending in 2013, we assume that spending will reach the ceiling of €144.5 billion, an upward revision from our March assumption of €139.8 billion.

Locally financed expenditure

- 4.117 Locally financed expenditure in AME contains two components. The largest is currently local authority self-financed expenditure (LASFE) – local authority spending that is not financed by central government grants. Local authorities' other sources of finance mainly comprise council tax and, from 2013-14 onwards, the share of business rates they retain. Locally financed expenditure also contains Scottish Government spending financed by local taxation, which currently only consists of spending financed by business rates.¹³
- 4.118 We have increased transparency about the components of our local authorities spending forecasts, including LASFE, through new supplementary fiscal tables available on our website. These tables show our forecasts for local authority spending in England, Scotland, Wales and Northern Ireland, in a way that helps to reconcile the definitions used by local authorities in their returns and the National Accounts definition of local authority current expenditure in PSCE. This new presentation has helped us engage more effectively with local authority stakeholders in producing our forecasts, acting on a lesson identified in our *Forecast evaluation reports (FER)*.
- 4.119 Table 4.29 summarises the main changes to our forecasts for current and capital LASFE. This shows that we have reduced our forecasts for current LASFE by an average of £2 billion a year over the forecast period, primarily because we have increased our forecasts for local authorities' net additions to their current reserves.
- 4.120 Our *FER* analysis has shown that local authorities' additions to their current reserves, and thus lower spending, have been an important source of forecast errors. In 2012-13, final outturn data shows that English local authorities added £2.6 billion to their current reserves, the same amount as in 2011-12. Local authorities appear to build up reserves against future uncertainties and pressures on their finances. The bulk of their reserves are held in earmarked funds, set in the context of medium-term financial plans. Forecasting future movements in these net reserves is difficult. Future uncertainties and the prospect of future pressures on budgets may prompt authorities to continue to add to their reserves, but most of these funds are earmarked to be spent, so the continuing squeeze on local authorities' budgets may lead them to add less to their reserves or draw them down. For this forecast, following discussions with a range of stakeholders, we have assumed that English local authorities make net additions to their reserves of £2 billion in 2013-14 and 2014-15,

¹³ Further detail on future devolved Scottish tax receipts is available in the supplementary material on our website.

reducing to zero by the end of the forecast period. This results in increased additions to reserves, and thus lower spending, compared to our March forecast.

- 4.121 In 2013-14, our forecast assumes that English local authorities will underspend their budgets by £4 billion. This is consistent with the quarterly current spending outturns for the first half of the year. This also reflects lower central government forecast outturn data for grants to schools, which currently show £2½ billion lower spending on schools than assumed in local authorities' budgets at the start of the year. This reflects increases in the number of schools that have become Academies, and are therefore classified as part of the central government sector. This reduces local authority spending against their budgets for education, and increases spending recorded in the central government sector.
- 4.122 We have lowered our council tax forecast since March to reflect the latest outturn data and the Government's SR13 announcement that it would extend council tax freeze grants to cover 2014-15 and 2015-16.
- 4.123 The forecast for council tax also contains an assumption for the increase in the council tax base, net of the various discounts and reductions offered by local authorities. These reductions now include the new localised council tax reduction schemes, which began in 2013-14, and replace the previous system of council tax benefits. There is still some uncertainty about the levels of council tax reductions offered in these schemes, but information that was collected by DCLG in March supported the initial assumptions in our forecasts about the levels of these reductions in England. We will keep this aspect of our forecast under review as more information becomes available.
- 4.124 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. Further details of the assumptions underlying our forecasts for council tax are shown in the supplementary fiscal tables on our website. 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 overall forecast for business rates.

Table 4.29: Key changes to locally financed expenditure since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
Locally-financed current expenditure					
March forecast	36.1	38.0	39.5	41.0	43.1
December forecast	34.3	35.0	36.9	39.2	41.7
Change	-1.9	-3.0	-2.6	-1.8	-1.4
<i>of which:</i>					
Council tax	-0.2	-0.6	-0.9	-0.9	-1.0
Net use of current reserves	-1.0	-1.2	-1.0	-0.5	0.0
Autumn Statement measures ¹	0.0	-0.5	-0.2	0.0	-0.1
Other	-0.7	-0.7	-0.5	-0.4	-0.3
Locally-financed capital expenditure					
March forecast	6.4	6.3	6.8	7.0	6.7
December forecast	6.5	5.3	6.0	6.2	6.1
Change	0.1	-1.0	-0.8	-0.8	-0.6
<i>of which:</i>					
TfL capital spending timing adjustment	0.5	-0.1	0.4	-0.1	0.0
Capital spending of TfL PC subsidiaries	-0.1	-0.5	-0.5	-0.5	-0.5
HRA capital spending	-0.7	-0.5	-0.5	-0.4	-0.4
Autumn Statement measures ¹	0.0	0.0	-0.1	0.1	0.1
Other	0.4	0.1	-0.2	0.1	0.1

¹ Autumn Statement measures are shown in Annex A.

- 4.125 We have also lowered our forecast of capital LASFE by up to £1 billion a year from 2014-15. This mainly reflects increases in elements of the forecast that are netted off capital LASFE, because they appear in the National Accounts as public corporations' net capital expenditure. This includes the net capital spending of local authorities' Housing Revenue Accounts, and most of the subsidiaries of Transport for London (TfL).¹⁴ We have raised our forecasts for these entities' capital spending to reflect information received from TfL, consistent with its latest published business plans, and to reflect the latest outturn information for HRA capital spending in 2012-13. These changes are neutral for spending overall, reducing capital LASFE and raising public corporations capital expenditure.
- 4.126 Our forecasts for HRA net capital spending include estimates for additional capital spending from the HRA policy reforms that were implemented at the end of 2011-12. These estimates rely on uncertain assumptions that we have not yet been able to review, because the relevant outturn data for 2012-13 was not available for this forecast.¹⁵ We will review this evidence for our March forecast.

¹⁴ These TfL transport subsidiaries trade under the company name 'Transport Trading Ltd' (TTL). ONS classify all of the TTL subsidiaries as public corporations apart from Crossrail, which is classified as part of the local authority sector.

¹⁵ The key assumptions that carry particular uncertainties are: that local authorities will increase capital spending on major repairs to the full amount outlined in the reform; that the subsequent surplus gross operating surplus is split evenly between capital spending and reserves; and, that the remaining borrowing headroom would not be utilised.

Public corporations capital expenditure

4.127 The forecast for public corporations' capital expenditure has increased by around £2 billion a year across the forecast period. This reflects two main changes. First, the increase in HRA and TfL subsidiaries' forecast capital spending. Second, an increase in estimates of investment in artistic originals, which raises public corporations' capital spending by about £1 billion in 2012-13, and feeds through to each year of the forecast period. The artistic originals change is neutral for borrowing, being offset by increased public corporations' gross operating surplus. But it is positive for the fiscal mandate measure of borrowing, which is affected by the increased revenue but not by the increased capital spending.

Debt interest

4.128 Central government debt interest payments rise as a share of GDP over the forecast period, reflecting projected increases in interest rates and RPI inflation, and the rising stock of public debt. Compared to March, a lower net cash requirement and an assumption that a greater proportion will be financed by cheaper short-term debt, reduces debt interest spending. But this is more than offset by the effect of higher gilt and short-term interest rates, including the indirect effects on spending on National Savings and Investment products and other government deposits. Movements in RPI inflation increase costs in 2014-15 and 2015-16, but reduce costs in other years. The ONS has also increased estimates for the imputed debt interest on PFI deals, which we assume continues into later years.

4.129 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 gilts, over half of the payments on conventional gilts by the end of the forecast period relate to fixed debt interest costs on existing 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.

Table 4.30: Key changes to debt interest since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	49.5	51.8	57.8	64.4	71.3
December forecast	49.5	53.9	60.0	65.3	72.5
Change	0.0	2.0	2.3	0.9	1.2
<i>of which:</i>					
Financing	0.0	0.0	-0.4	-0.8	-1.3
Gilt rates	0.0	0.3	0.5	0.6	0.7
Short rates	0.1	0.0	0.4	0.8	1.1
Inflation	-0.9	1.0	0.7	-0.7	-0.3
PFI	0.8	0.8	0.8	0.8	0.8
Other	-0.1	0.0	0.3	0.2	0.2

Other AME spending

- 4.130 The forecast of **BBC** spending is little changed from the March forecast. Approximately £0.2 billion a year of BBC capital spending on the roll-out of broadband, which was included in other PSGI items in departmental AME, has switched from AME to DEL.
- 4.131 The forecast of **National lottery** spending is also little changed since our March forecast. The proportion spent on capital projects has reduced slightly to reflect latest outturn data, with corresponding increases in current spending.
- 4.132 Apart from the BBC AME to DEL switch mentioned above, the only other substantive change to the forecast of **other PSGI items in departmental AME** is an increase of around £1 billion in capital grants to the APF in 2017-18, explained in Box 4.1. In 2012-13 outturn, we have followed the Treasury budgeting treatment for the one-off transfer of the Royal Mail Pension Plan assets, moving it from capital DEL to other PSGI items in departmental AME.
- 4.133 Table 4.19 shows a separate entry in PSCE in AME for **single-use military expenditure (SUME)**. This expenditure is treated as capital DEL in the spending control framework, but is classified as current expenditure in the National Accounts. To align with the National Accounts, we therefore exclude this spending from PSGI in CDEL and add it to PSCE within current AME expenditure.
- 4.134 We have extended our £1 billion SUME underspend assumption to 2015-16 following the announcement of plans in SR13. Relative to our March forecast, where SUME in 2015-16 was projected on the basis of the Government's spending growth assumption, this switch from a top-down to bottom-up forecast shows up as a reduction of £0.5 billion.
- 4.135 **Environmental levies** include spending on DECC levy-funded policies such as the Renewables Obligation, Feed-In Tariffs and Warm Homes Discount. Most of these are neutral for borrowing as they are balanced by receipts. The forecasts are explained in the receipts section, which also discusses the effect of an ONS reclassification in accounting for the increase in this forecast since March.
- 4.136 The change in our forecast of **VAT refunds** is explained in paragraph 4.62.
- 4.137 The AME forecast includes forecasts for the further adjustments that are included in the National Accounts definitions for PSCE and PSGI.¹⁶ Explanations and the background to **National Accounts adjustments** are given in Annex D to PESA 2013.¹⁷
- 4.138 Table 4.20 shows that current and capital accounting adjustments have each increased by between £0.1 billion and £0.5 billion in every year of the forecast. This includes corrections to the classification of some EU-related spending, explained in Box 4.4, methodology improvements to the forecast of local authority to central government debt interest

¹⁶ Further detail is provided in the supplementary fiscal tables on our website.

¹⁷ See HM Treasury, July 2013, Public Expenditure Statistical Analyses 2013.

payments, and an increase in our forecast of HRA imputed subsidy, based on latest outturn data, which we had previously assumed would end in 2012-13.

Loans and other financial transactions

4.139 Public sector net borrowing (PSNB) is the difference between total public sector receipts and expenditure each year measured on an accrued basis. But the public sector's fiscal position also depends on the flow of financial transactions, which are mainly loans and repayments between Government and the private sector. These do not directly affect PSNB, but they do lead to changes in the Government's cash flow position and stock of debt.

4.140 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.¹⁸ It drives the forecast of public sector net debt (PSND), which is largely a cash measure. Estimating the PSNCR also allows us to estimate the central government net cash requirement (CGNCR), which in turn largely determines the Government's financing requirement – the amount it needs to raise from treasury bills, gilt issues and National Savings.

4.141 Differences between the PSNCR and PSNB (on a headline basis, including the Royal Mail and APF transfers) can be split into the following categories:

- **loans and repayments:** loans that the public sector makes to the private sector do not directly affect PSNB, but the cash flows affect the PSNCR;
- **accruals adjustments:** PSNB is an accruals measure of borrowing in which, where possible, spending and receipts are attributed to the year of the activity that they relate to. In contrast, PSNCR is a cash measure in which spending and receipts are attributed to the year in which the cash flow takes place;
- **transactions in financial assets:** the public sector may buy or sell financial assets, such as corporate bonds or equities. When it exchanges one asset for an equivalent cash asset the transaction does not affect PSNB, but the associated cash flow will affect PSNCR; and
- **other factors:** this category includes one-off financial transactions that do not fall into the categories above and some other adjustments.

4.142 Table 4.31 shows the steps from PSNB to PSNCR while Table 4.32 shows the changes since our March forecast.

¹⁸ Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the temporary effects of financial sector interventions.

Table 4.31: Reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing	99	84	72	48	25	2
Loans and repayments	14.1	16.3	17.9	15.7	15.8	16.0
<i>of which:</i>						
Student loans ^{1, 2}	8.1	10.2	11.6	12.7	13.6	14.3
DfID	1.3	1.2	1.2	1.1	1.1	1.1
Green Investment Bank	0.3	1.0	1.1	0.0	0.0	0.0
Business Finance Partnership	0.3	0.4	0.2	0.1	0.0	0.0
Business Bank	0.1	0.4	0.4	0.3	0.2	0.0
Help to Buy equity loans	1.2	1.2	1.3	0.0	0.0	0.0
Ireland	0.8	0.0	0.0	0.0	0.0	-0.4
Other	1.9	1.9	2.2	1.6	0.9	1.0
Accruals adjustments	9.5	-4.3	-5.8	7.1	3.9	-9.1
<i>of which:</i>						
Student loan interest ^{1,2}	1.1	1.6	2.5	3.5	4.5	5.6
PAYE income tax and NICs	0.4	1.4	1.8	2.4	2.0	2.2
Indirect taxes	1.6	0.9	0.9	0.9	1.0	1.0
Other receipts	0.8	0.3	0.3	0.3	0.3	0.3
Index-linked gilts ³	2.3	-11.7	-14.4	-3.0	-6.8	-20.7
Conventional gilts	2.7	2.3	2.2	1.9	1.8	1.5
Other expenditure	0.6	0.9	1.0	1.0	1.0	1.0
Transactions in financial assets	-6.3	0.0	-2.3	-2.3	-2.3	-2.3
<i>of which:</i>						
Lloyds shares	-3.2	0.0	0.0	0.0	0.0	0.0
Royal Mail shares	-2.0	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	-1.0	0.0	0.0	0.0	0.0	0.0
Student loan book	-0.2	0.0	-2.3	-2.3	-2.3	-2.3
Other factors	-23.4	-7.0	-6.0	-5.6	-6.1	-5.6
<i>of which:</i>						
Asset Purchase Facility proceeds	-18.5	0.0	0.0	0.0	0.0	0.0
B&B and NRAM alignment	-5.3	-7.3	-6.3	-5.9	-6.4	-5.9
Public sector net cash requirement	93	89	75	63	36	1

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	10.1	12.5	14.3	15.6	16.7	17.4
Cash repayments	2.0	2.4	2.8	3.0	3.1	3.2

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

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

Table 4.32: Changes in the reconciliation of PSNB and PSNCR since March

	£ billion				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net borrowing	-9	-13	-16	-13	-17
Loans and repayments	-0.4	1.4	3.9	4.1	4.3
<i>of which:</i>					
Student loans ^{1, 2}	0.8	1.6	2.2	3.1	4.0
DfID	-0.4	0.1	0.1	0.0	0.0
Green Investment Bank	-0.4	0.1	1.1	0.0	0.0
Business Finance Partnership	-0.1	0.0	-0.2	0.0	0.0
Business Bank	0.0	0.1	0.1	0.0	0.0
Help to Buy equity loans	-0.2	-0.2	-0.3	0.0	0.0
Ireland	0.0	0.0	0.0	0.0	0.0
Other	-0.1	-0.3	0.8	0.9	0.3
Accruals adjustments	-0.2	-1.6	-1.7	0.1	-0.4
<i>of which:</i>					
Student loan interest ^{1,2}	0.0	0.0	0.1	0.3	0.3
PAYE income tax and NICs	-0.9	0.6	0.0	0.0	0.1
Indirect taxes	1.0	0.1	-0.1	0.1	0.0
Other receipts	0.0	-0.3	-0.1	-0.1	-0.1
Index-linked gilts ³	0.8	-1.1	-1.0	0.3	-0.1
Conventional gilts	-0.9	-1.0	-0.8	-0.6	-0.7
Other expenditure	-0.2	0.1	0.1	0.2	0.2
Transactions in financial assets	-5.3	0.0	-2.3	-2.3	-2.3
<i>of which:</i>					
Lloyds shares	-3.2	0.0	0.0	0.0	0.0
Royal Mail shares	-2.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	0.0	0.0	0.0
Student loan book	-0.2	0.0	-2.3	-2.3	-2.3
Other factors	-3.8	-7.3	-6.3	-5.9	-6.4
<i>of which:</i>					
Asset Purchase Facility proceeds	1.5	0.0	0.0	0.0	0.0
B&B and NRAM alignment	-5.3	-7.3	-6.3	-5.9	-6.4
Public sector net cash requirement	-18	-21	-22	-17	-22

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	0.6	1.4	2.1	2.7	3.3
Cash repayments	-0.3	-0.2	-0.2	-0.4	-0.7

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

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

Loans and repayments

4.143 Net lending by the public sector to the private sector, in particular for student loans, raises the net cash requirement relative to net borrowing in each year of our forecast. The recent student loan reforms have increased the size of upfront loans, with repayments being made over a longer period. In our July 2013 *Fiscal sustainability report*, we showed that on

current policy settings we might expect the difference between new loans and repayments to peak around the early 2030s and then fall away.

- 4.144 For the English scheme, we assume average tuition and maintenance loans per borrower of around £7,500 and £4,000 in 2013-14. The total outlay on loans is higher than assumed in our March forecast, mainly due to a higher-than-expected take-up of loans in 2012-13 and Autumn Statement announcements. We assume that the proportion of 2012 entrants taking up loans is representative of future cohorts. The number of new students undertaking courses with alternative providers is expected to peak in 2013-14, but to remain above the March forecast throughout. These changes increase outlays over the five-year forecast period, but have little effect on our repayments forecast over this window.
- 4.145 The Government has announced its intention to sell the pre-Browne student loan book from 2015-16 and to remove the cap on student numbers by that year. Selling the loan book reduces repayments over the latter years of our medium-term forecast, by just under £1 billion in 2018-19, and beyond, whereas removing the numbers cap increases forecast outlays by around £2 billion by 2018-19.
- 4.146 Other loans include lending through the Department for International Development's contributions to multilateral development banks, loans to Ireland and a range of other Government schemes, including a number of Autumn Statement measures. Loans through the Green Investment Bank are expected to be lower than forecast this year, but to then be made up in following years and supplemented by further funding announced since March. £250 million of lending over the forecast period has also been switched from the Business Finance Partnership to the Business Bank.

Accruals adjustments

- 4.147 To move from PSNB to PSNCR, it is also necessary to adjust for the likely impact of timing differences between cash flows and accruals. If receipts are forecast to rise over time, the cash received in any given year will generally be lower than the accrued tax receipts.
- 4.148 We now expect a smaller accruals adjustment relating to PAYE income tax and NICs for 2013-14, mainly due to higher-than-expected cash receipts earlier in the year, which have been accrued back to 2012-13. A stronger pick-up in private consumption this year is also expected to lead to cash lagging accrued VAT receipts by more than usual.
- 4.149 A large component of the receipts timing adjustment relates to the interest on student loans. This is included in the accrued measure of public sector current receipts as soon as the loan is issued. However, cash repayments are not received until the point at which former students earn sufficient income. Changes since March mainly relate to higher student loan outlays, rather than changes in the interest charged. The two Autumn Statement measures to sell the pre-Browne student loan book and to remove the cap on student numbers have broadly offsetting effects on accrued student interest paid to the Exchequer.

- 4.150 Similar timing adjustments are made for expenditure. The largest is for the timing of payments on index-linked gilts. These adjustments are very sensitive to RPI inflation, as well as to the profile of redemptions, which is not smooth. Positive RPI inflation raises the amount the Government is committed to pay on index-linked gilts, and this commitment is recognised in PSNB each year. But the actual cash payments do not occur until redemption of the gilt, which may be many years in the future. Higher RPI inflation in 2014-15 and 2015-16 leads to larger negative accruals adjustments in those years relative to our March forecast, with lower RPI inflation in other years working in the opposite direction.
- 4.151 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 premium on conventional gilts sold in the year to date has been lower than assumed in March. We assume this narrows further in the future, reducing the accruals adjustment over time.

Transactions in financial assets

- 4.152 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.
- 4.153 Since March, the Government has sold £3.2 billion of shares in Lloyds Banking Group, £2.0 billion of Royal Mail shares and the mortgage-style student loan book for £160 million. The Government has also outlined the sale of part of the student loan book, with the intention to sell £12 billion of assets over a five year period from 2015-16. We have included a neutral assumption that this will be evenly spread across the five years. The loan book sale will reduce future repayments and interest paid to the Exchequer.

Other factors

- 4.154 Some of the cash transfers between the APF and the Exchequer in 2012-13 and 2013-14 are treated as financial transactions, affecting the net cash requirement but not PSNB. The amount of cash being transferred this year is now expected to be lower than assumed in March, partly due to payments of around £1 billion being delayed until 2014-15. The delayed payments are expected to reduce net borrowing in that year.
- 4.155 The effects on the net cash requirement of reclassifying Bradford & Bingley and Northern Rock (Asset Management) (B&B and NRAM) into central government were included in ONS outturns for the first time in August 2013. The ONS's approach differs from the assumptions used in our March forecast, with the running down of B&B and NRAM's loan book reducing the net cash requirement directly. We had assumed the net cash requirement would only be affected by the netting out of transactions between B&B and NRAM and the rest of central government. This change only affects the net cash requirement and not net debt.

Central government net cash requirement

- 4.156 The other important cash measure is the central government net cash requirement (CGNCR). Table 4.33 shows how CGNCR relates to PSNCR and Table 4.34 sets out the changes in this relationship since the March forecast. The CGNCR is derived by adding or removing transactions that are associated with local authorities and public corporations from the PSNCR. Changes in the CGNCR forecast since March closely follow changes to our PSNCR forecast. We expect local authorities and public corporations to be net lenders from 2013-14 onwards.
- 4.157 The inclusion of B&B and NRAM in the central government sector means that the CGNCR is no longer simply a measure of the cash required by the Exchequer to fund its operations, which forms the basis for the Government's net financing requirement.¹⁹ Aligning with ONS outturns that now include this effect leads to larger revisions to our forecasts for the headline CGNCR relative to the measure excluding these entities. Changes in the CGNCR excluding B&B and NRAM are closer to changes in our net borrowing forecast.

Table 4.33: Reconciliation of PSNCR and CGNCR

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net cash requirement (NCR)	106	93	89	75	63	36	1
<i>of which:</i>							
Local authorities and public corporations NCR	3	-2	-3	-3	-2	-2	-3
Central government (CG) NCR own account	104	94	92	78	65	38	4
CGNCR own account	104	94	92	78	65	38	4
Net lending within the public sector	1	3	2	2	2	2	2
CG net cash requirement	105	97	95	80	67	40	6
B&B and NRAM adjustment	5	2	4	5	5	3	3
CGNCR excl. B&B and NRAM	110	99	99	84	71	43	9

¹⁹ The Government is publishing a revised financing remit for 2013-14 alongside the Autumn Statement. The OBR provides the Government with the forecast of the CGNCR for this purpose, but plays no further role in the derivation of the net financing requirement.

Table 4.34: Changes in the reconciliation of PSNCR and CGNCR since March

	£ billion					
	Outturn 2012-13	Forecast				
		2013-14	2014-15	2015-16	2016-17	2017-18
Public sector net cash requirement (NCR)	1	-18	-21	-22	-17	-22
<i>of which:</i>						
Local authorities and public corporations NCR	1	-1	-2	-1	-1	-1
Central government (CG) NCR own account	0	-17	-18	-21	-16	-21
CGNCR own account	0	-17	-18	-21	-16	-21
Net lending within the public sector	0	0	0	0	0	0
CG net cash requirement	0	-17	-18	-21	-16	-21
B&B and NRAM adjustment	7	5	8	7	6	6
CGNCR excl. B&B and NRAM	7	-12	-11	-14	-10	-15

Box 4.6: Fiscal impact of the financial interventions

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

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

The APS, SLS and CGS have now closed, with net gains to the Exchequer of £5.0 billion, £2.3 billion and £4.3 billion respectively. Underwriting fees of £0.7 billion relating to the RBS and LBG share purchases and a further £1.3 billion relating to the RBS CCF, due to close this month, have not previously been counted by Treasury in their estimates of the total cost of interventions, but are now. These figures have been captured in PSNB.

The Treasury paid £66 billion for shares in the two banks. The market value of the shares at the time of purchase was £53 billion, with the difference of £12.4 billion added to PSND. This market value includes an estimate for the value of the Dividend Access Share (DAS) in RBS, which gives the Treasury enhanced dividends rights if RBS were to pay dividends on ordinary shares as long as the share price remains below 650p. Changes in the market prices of the Government's shareholdings in RBS and LBG are not reflected in PSNB and PSND until shares are sold. The Treasury sold £3.2 billion of LBG shares in September 2013, at a price above their implied value on the public sector balance sheet (but only fractionally more than it paid for

them), reducing PSND by £0.6 billion. Excluding the DAS, the value of the shares sold, plus the latest volume-weighted average market prices for the remaining shares, imply a total loss of £15.3 billion on the equity shares, relative to an implied loss of £19.8 billion reported in March.

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

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

Overall, their approach implies an estimated direct loss to the taxpayer on the financial interventions of £0.3 billion, including the DAS and fees that were not included in their earlier estimates. This is smaller than the comparable estimate in March of £4.6 billion, as LBG's stock market value has risen. If all interventions were financed through debt, the Treasury estimate that additional debt interest costs would have totalled £17.4 billion over the 64 months to date.

The key fiscal aggregates

4.158 Our central forecast for the key fiscal aggregates is presented in Table 4.35. It incorporates the forecasts for receipts, expenditure and financial transactions set out earlier in this chapter. Detailed tables of the fiscal aggregates and changes since March are presented at the end of this section. In this section we explain the changes in four key fiscal aggregates:

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

accrued basis. It is also the fiscal measure used for the Government's supplementary fiscal target.

Table 4.35: Selected 'underlying' fiscal aggregates

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Receipts and expenditure							
Public sector current receipts ¹ (a)	37.4	37.0	37.1	37.4	38.0	38.2	38.3
Total managed expenditure ¹ (b)	44.7	43.7	42.7	41.9	40.7	39.4	38.2
of which:							
Public sector current expenditure ¹ (c)	41.9	40.8	39.6	38.9	37.8	36.6	35.6
Public sector net investment ¹ (d)	1.4	1.5	1.6	1.5	1.5	1.4	1.3
Depreciation ¹ (e)	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing ¹ (b-a)	7.3	6.8	5.6	4.4	2.7	1.2	-0.1
Surplus on current budget ¹ (a-c-e)	-5.9	-5.3	-4.0	-2.9	-1.2	0.2	1.4
Cyclically-adjusted surplus on current budget ¹	-4.1	-3.7	-2.7	-1.8	-0.4	0.7	1.6
Cyclically-adjusted net borrowing ¹	5.5	5.2	4.3	3.3	1.9	0.7	-0.3
Primary balance ¹	-4.7	-4.2	-2.9	-1.6	0.1	1.8	3.1
Cyclically-adjusted primary balance ¹	-2.9	-2.6	-1.6	-0.4	1.0	2.3	3.3
	£ billion						
Public sector net borrowing ¹	115.0	111.2	96.0	78.7	51.1	23.4	-2.2
Surplus on current budget ¹	-92.8	-86.3	-68.3	-51.4	-22.8	3.1	28.0
Cyclically-adjusted surplus on current budget ¹	-63.6	-60.2	-46.1	-31.6	-7.0	13.0	31.6
Cyclically-adjusted net borrowing ¹	85.8	85.1	73.8	58.9	35.3	13.5	-5.9
Primary balance ¹	-74.5	-68.2	-49.5	-27.7	2.4	34.9	62.6
Cyclically-adjusted primary balance ¹	-45.4	-42.0	-27.3	-7.9	18.1	44.8	66.2

¹ Excluding Royal Mail and APF transfers.

4.159 The public finances are often affected by one-off items or other factors that it can be useful to strip out to assess underlying fiscal trends. Table 4.36 provides outturn and, where relevant, forecasts for the key special factors affecting PSNB. In this *EFO*, we have focused on PSNB excluding the impact of the one-off Royal Mail Pension Plan transfer in 2012-13 and the flow of cash transfers between the Exchequer and the APF across the forecast period. We have described this as 'underlying PSNB', though as the table shows, there are a number of other factors that it might be appropriate to strip out of the headline PSNB measure to assess underlying fiscal trends.

Table 4.36: Special factors affecting public sector net borrowing

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing	80.6	99.0	83.9	71.5	47.8	24.8	1.9
<i>Special factors:</i>							
Royal Mail	-28.0						
APF	-6.4	-12.2	-12.1	-7.2	-3.2	1.4	4.1
B&B and NRAM	-0.2	-0.7	-0.8	-0.9	-1.0	-1.1	-1.0
4th Generation Spectrum proceeds	-2.3						
Special liquidity scheme fees	-2.3						
Swiss Capital Tax		-0.9					

Public sector net borrowing

4.160 Underlying PSNB is estimated to have fallen from its post-war peak of £157.9 billion or 11.0 per cent of GDP in 2009-10 to £118.5 billion or 7.7 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.

4.161 In 2012-13, the downward path of underlying PSNB slowed, with borrowing falling by only £3.5 billion as the recovery failed to take hold and the impact of high inflation in 2011 fed through to the public finances. Borrowing is forecast to fall relatively modestly again this year – by £3.8 billion – before resuming a more rapid decline averaging £22.7 billion a year from 2014-15 to 2018-19. As a result, underlying PSNB is forecast to show a small surplus in 2018-19, but this is dwarfed by the uncertainty around forecasts at that horizon. Headline borrowing remains in modest deficit in 2018-19, as we assume that the Government will have to borrow in that year to fund transfers from the Exchequer to the APF as quantitative easing unwinds.

4.162 The 11.1 per cent of GDP reduction in underlying PSNB forecast between 2009-10 and 2018-19 would represent one of the largest deficit reductions among advanced economies in the post-war period. As Charts 4.2 and 4.3 show, the contributions to this would be:

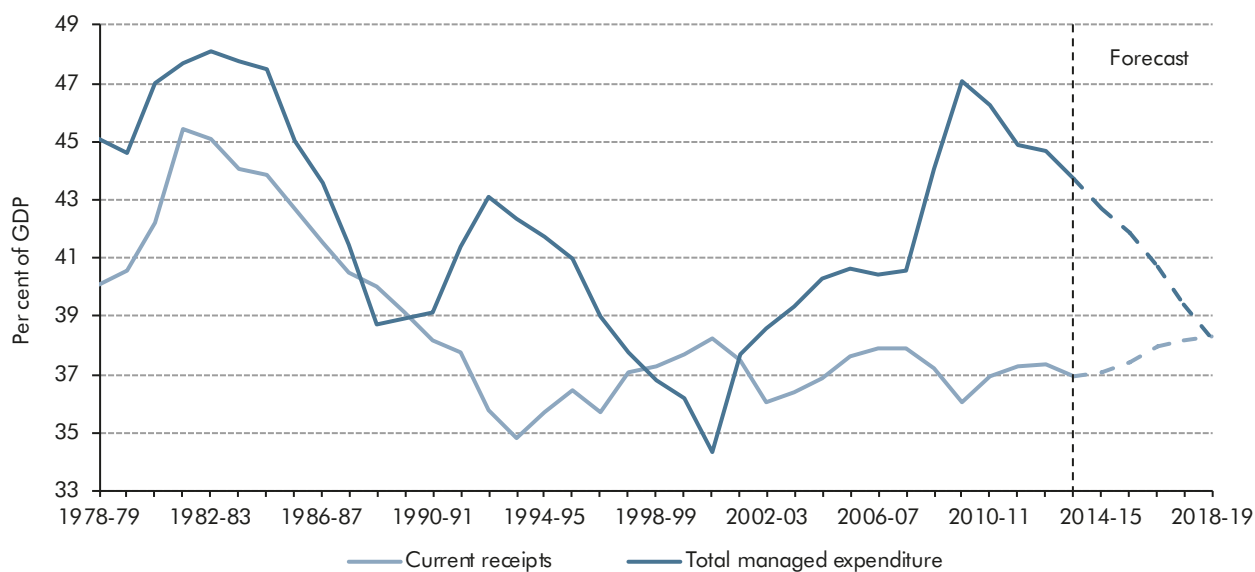
- 8.8 per cent of GDP, or around 80 per cent of the deficit reduction, from lower expenditure, with Total Managed Expenditure falling from 47.1 per cent of GDP in 2009-10 to 38.2 per cent of GDP by 2018-19. Within this total:
 - PSCE in RDEL, a proxy for day-to-day spending on public services and administration, falls by 7.8 per cent of GDP to 14.2 per cent in 2018-19.²⁰ This is mirrored in our GDP forecast, where government consumption of goods and

²⁰ In outturn, includes council tax benefit and excludes the local share of business rates consistent with current budgeting treatment.

services falls from 23.2 per cent of nominal GDP in 2009 to 16.1 per cent by the end of the forecast period, the lowest on record in data going back to 1948;

- PSGI in CDEL, a measure of public sector investment, falls by 1.6 per cent of GDP to 1.9 per cent in 2018-19. In 2007-08, PSGI in CDEL was 2.6 per cent of GDP; and
- social security spending falls by 1.0 per cent of GDP to 10.0 per cent in 2018-19, still higher than its pre-crisis level.²¹
- 2.3 per cent of GDP, or around 20 per cent of the deficit reduction, from higher receipts, with the majority of the increase having taken place by 2012-13, largely as a result of the increases in the standard rate of VAT. This is followed by further increases towards the end of our forecast due to the resumption of fiscal drag, as above-inflation earnings growth pushes more income into higher tax brackets.

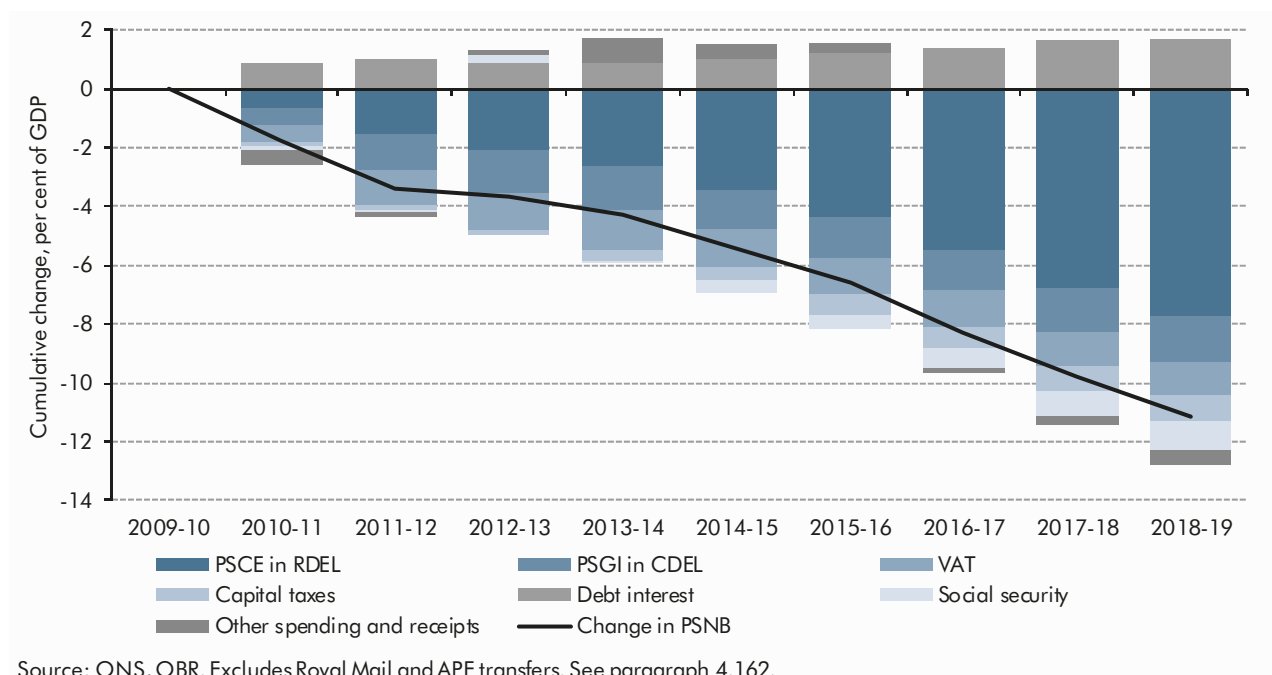
Chart 4.2: Total public sector spending and receipts



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

²¹ In outturn, excludes council tax benefit consistent with current budgeting treatment.

Chart 4.3: Sources of deficit reduction



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

4.163 We have revised our forecast for underlying PSNB in 2013-14 down by £8.6 billion relative to our March forecast. With no change in our estimate of APF transfers to the Exchequer in 2013-14, the same revision applies to our forecast of headline PSNB. Table 4.37 shows that, excluding the effect of borrowing-neutral changes to receipts and AME, the revision to borrowing this year has been driven by the following factors:

- a £3.4 billion upward revision to receipts, largely reflecting unexpectedly strong revenues from VAT, personal taxes, onshore corporation tax and stamp duties, offset by unexpectedly weak North Sea receipts and much lower than expected Swiss capital tax receipts;
- we have revised spending down by £5.2 billion on the same underlying basis. This largely reflects the fact that we expect government departments to underspend the Treasury limits they faced in March by £7 billion, rather than the £3.5 billion we forecast at the time. The Treasury has cut the central reserve against those limits by £2 billion in the Autumn Statement, presenting that portion of the underspend as a policy measure; and
- our overall revisions also reflect changes in the method the ONS use to calculate the imputed tax and spend from the Renewables Obligation, the treatment of artistic originals in public corporations' gross operating surplus and capital expenditure and the proportion of tax credits treated as negative tax that together increase both receipts and spending by a net £3.0 billion, compared to March. This has no impact on PSNB. Including these factors, the revisions were an increase in receipts of £6.4 billion and a reduction in spending of £2.2 billion relative to March.

Table 4.37: Changes to underlying public sector net borrowing since March

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Public sector net borrowing¹							
March forecast	120.9	119.8	108.4	95.5	67.0	42.7	
December forecast	115.0	111.2	96.0	78.7	51.1	23.4	-2.2
Change	-5.9	-8.6	-12.4	-16.8	-15.9	-19.3	
of which:							
Pre-measures forecasts							
of which:							
Receipts ^{1,2}	-4.3	-3.4	-9.6	-13.2	-14.5	-14.6	
DEL spending ³	-0.5	-1.8	0.0	-1.3	0.3	-4.0	
AME spending ^{1,2,3}	-1.1	-1.4	-2.9	-2.4	-2.1	-1.3	
Measures in the Treasury's policy decision table	0.0	-2.0	0.1	0.1	0.4	0.6	

¹ Excluding Royal Mail and APF transfers.

² Excluding fiscally neutral switches, which include changes in the proportion of tax credits treated as negative tax, Renewables Obligation and the treatment of artistic originals in public corporations' gross operating surplus and capital expenditure.

³ DEL and AME have been adjusted to remove the effects of the OSCAR classification changes on DEL, which are largely offset in AME, explained in Box 4.4.

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

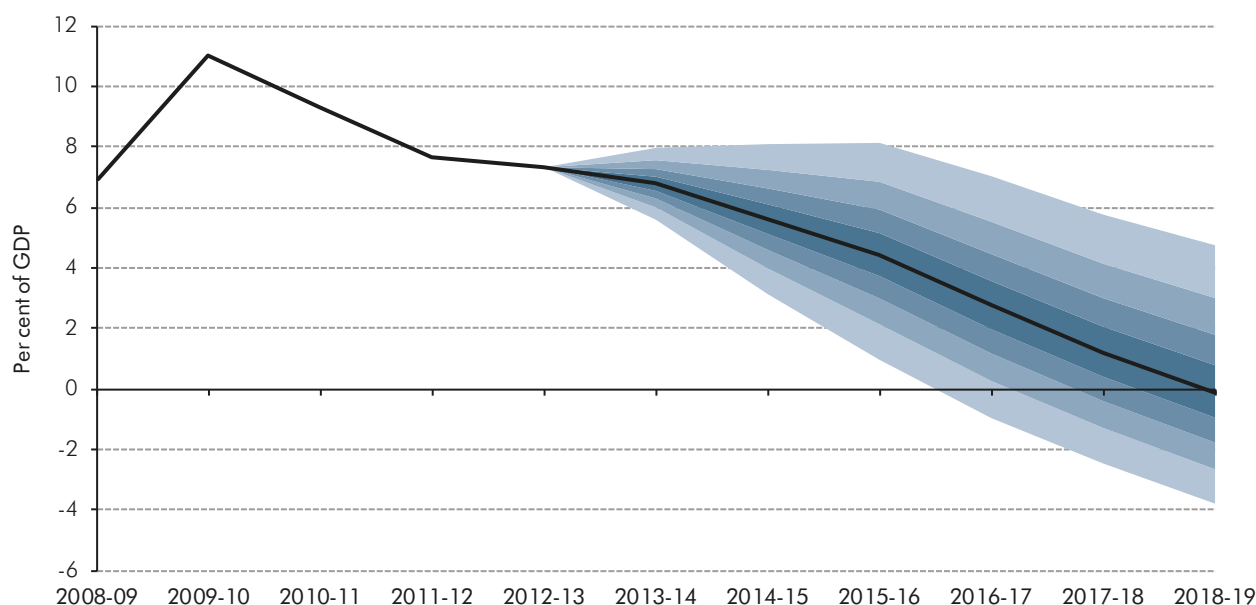
4.164 For future years we have revised down our underlying PSNB forecast by £12.4 billion in 2014-15, rising to £19.3 billion in 2017-18, relative to our March forecast. Our forecast for the cash transfers between the APF and the Exchequer has changed only marginally since March, so the revisions to headline and underlying PSNB are of similar size. Table 4.37 shows that these downward revisions are driven by the following factors:

- higher receipts, the impact of which reaches £14.6 billion in 2017-18, with onshore corporation tax, stamp duties, capital taxes and VAT the main sources of strength;
- slightly lower spending, in particular spending by central government departments. This reflects the departmental expenditure limits set for 2015-16 in SR13 and the effect of the Government's TME growth assumption from 2016-17 onwards; and
- the tax and spending measures that the Treasury has included in its Autumn Statement policy decisions table have little cumulative impact on borrowing over the forecast, with the £2 billion cut in the central reserve for departmental spending this year offsetting a £1.4 billion cumulative net tax cut through to 2018-19 and a £0.6 billion cumulative increase in spending in 2014-15 and 2015-16.

4.165 All fiscal forecasts are subject to significant uncertainty. Chart 4.4 shows our central forecast for underlying PSNB with successive pairs of shaded areas around it representing 20 per cent probability bands based on the pattern of past official forecast errors. (As with our GDP forecast, the central forecast is judged to be a median forecast, with equal probability that

outcomes will be above or below forecast.) On this basis the probability that PSNB will be back to balance rises from 5 per cent in 2015-16 to just under 20 per cent in 2016-17, 35 per cent in 2017-18 and just over 50 per cent in 2018-19.

Chart 4.4: Underlying PSNB fan chart



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

Current budget

4.166 Our central forecast shows the current budget moving from a deficit of £74.2 billion in 2013-14 (£86.3 billion excluding APF transfers) to a surplus of £28.0 billion in 2018-19 (unaffected by APF in that year). Relative to our March forecast, the current budget balance has improved by £9.3 billion in 2013-14, rising to £19.7 billion in 2017-18. The drivers of this improvement are similar to those for underlying PSNB described above.

Cyclically-adjusted current budget

4.167 The cyclically-adjusted current budget (CACB) moves from a deficit of 2.9 per cent of GDP in 2013-14 (3.7 per cent of GDP excluding APF transfers) to a surplus of 1.6 per cent of GDP in 2018-19 (unaffected by the APF in that year). Despite the substantial improvement in the headline current budget balance since March, the CACB surplus in 2017-18 is slightly lower than our March forecast at 0.7 per cent of GDP. This reflects our judgement that the stronger-than-expected pick-up in real GDP since March has been cyclical, narrowing the output gap, rather than structural, reflecting higher potential output. Further detail on changes to the CACB since March is provided in Chapter 5.

Public sector net debt

4.168 We forecast public sector net debt (PSND) to rise as a share of GDP in each year up to and including 2015-16, peaking at 80.0 per cent of GDP. It falls by a statistically and fiscally

insignificant margin in 2016-17, and more rapidly thereafter, reaching 75.9 per cent of GDP in 2018-19. PSND in 2017-18 is now forecast to be 6.4 per cent of GDP lower than we forecast in March. Table 4.38 breaks down this change as follows:

- nominal GDP was revised up by around 1.3 per cent in Blue Book 2013, due largely to methodological changes. Combined with changes to our nominal GDP forecast, this reduces the ratio of the cash value of debt to GDP by 2.3 per cent of GDP in the peak year of 2015-16 and by 2.2 per cent in 2017-18; and
- our forecast for PSND in cash terms is £51 billion lower in 2015-16 and £82 billion lower in 2017-18 than in March, which is largely due to lower cumulative net borrowing over the forecast period. This reduces PSND by 2.8 per cent in 2015-16 and 4.2 per cent in 2017-18.

Table 4.38: Changes to public sector net debt since March

	Per cent of GDP					
	Outturn	Forecast				
		2012-13	2013-14	2014-15	2015-16	2016-17
March forecast	75.9	79.2	82.6	85.1	85.6	84.8
December forecast	73.9	75.5	78.3	80.0	79.9	78.4
Change	-2.0	-3.6	-4.3	-5.1	-5.7	-6.4
<i>of which:</i>						
Change in nominal GDP ¹	-1.5	-2.6	-2.4	-2.3	-2.3	-2.2
Change in cash level of net debt	-0.4	-1.0	-1.9	-2.8	-3.4	-4.2
	£ billion					
March forecast	1189	1286	1398	1502	1580	1637
December forecast	1182	1269	1365	1451	1515	1554
Change in cash level of net debt	-7	-18	-33	-51	-65	-82
<i>of which:</i>						
Changes in net borrowing	-6	-15	-28	-43	-56	-74
Financial transactions and other	-1	-3	-5	-7	-9	-9

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

Table 4.39: Headline fiscal aggregates

	Per cent of GDP						
	Outturn	Forecast					
		2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Receipts and expenditure							
Public sector current receipts (a)	37.8	37.7	37.8	37.9	38.1	38.2	38.3
Total managed expenditure (b)	42.9	43.7	42.7	41.9	40.7	39.5	38.4
of which:							
Public sector current expenditure (c)	41.9	40.8	39.6	38.9	37.8	36.6	35.6
Public sector net investment (d)	-0.4	1.5	1.6	1.5	1.5	1.5	1.5
Depreciation (e)	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Deficit							
Public sector net borrowing (b-a)	5.1	6.0	4.9	4.0	2.6	1.3	0.1
Surplus on current budget (a-c-e)	-5.5	-4.5	-3.3	-2.5	-1.1	0.2	1.4
Cyclically-adjusted net borrowing	3.3	4.4	3.6	2.9	1.7	0.8	-0.1
Primary balance	-3.0	-4.2	-2.9	-1.6	0.1	1.7	2.9
Cyclically-adjusted primary balance	-1.1	-2.6	-1.6	-0.5	1.0	2.2	3.1
Fiscal mandate and supplementary target							
Cyclically-adjusted surplus on current budget	-3.6	-2.9	-2.0	-1.4	-0.2	0.7	1.6
Public sector net debt ¹	73.9	75.5	78.3	80.0	79.9	78.4	75.9
Financing							
Central government net cash requirement	6.7	5.9	5.5	4.5	3.6	2.1	0.3
Public sector net cash requirement	6.8	5.7	5.2	4.2	3.4	1.9	0.0
Stability and Growth Pact							
Treaty deficit ³	5.2	6.2	5.0	4.2	2.7	1.4	0.2
Cyclically-adjusted Treaty deficit ²	3.3	4.6	3.7	3.0	1.9	0.9	0.1
Treaty debt ratio ³	88.3	90.8	93.1	94.7	93.9	91.7	88.7
£ billion							
Public sector net borrowing	80.6	99.0	83.9	71.5	47.8	24.8	1.9
Surplus on current budget	-86.4	-74.2	-56.2	-44.0	-19.6	3.5	28.0
Cyclically-adjusted net borrowing	51.4	72.9	61.7	51.7	32.1	14.8	-1.7
Cyclically-adjusted surplus on current budget	-57.2	-48.0	-34.0	-24.2	-3.8	13.4	31.6
Public sector net debt	1182	1269	1365	1451	1515	1554	1573
Memo: Output gap (per cent of GDP)	-2.7	-2.1	-1.8	-1.5	-1.1	-0.6	-0.1

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.

Table 4.40: Changes to the fiscal forecast

	£ billion						
	Outturn	Forecast					
		2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Surplus on current budget¹							
June 2010 forecast	-65.1	-40.2	-16.9	0.4			
March 2013 forecast	-98.9	-95.7	-81.8	-69.7	-41.2	-17.7	
Change	6.1	9.3	13.5	18.3	18.3	20.8	
December 2013 forecast	-92.8	-86.3	-68.3	-51.4	-22.8	3.1	28.0
Net investment¹							
June 2010 forecast	24.0	19.9	20.6	20.9			
March 2013 forecast	22.0	24.2	26.6	25.8	25.8	25.0	
Change	0.2	0.7	1.1	1.5	2.4	1.5	
December 2013 forecast	22.2	24.9	27.7	27.3	28.3	26.5	25.7
Net borrowing¹							
June 2010 forecast	89.1	60.1	37.5	20.5			
March 2013 forecast	120.9	119.8	108.4	95.5	67.0	42.7	
Change	-5.9	-8.6	-12.4	-16.8	-15.9	-19.3	
December 2013 forecast	115.0	111.2	96.0	78.7	51.1	23.4	-2.2
Net debt							
June 2010 forecast	1162	1235	1284	1316			
March 2013 forecast	1189	1286	1398	1502	1580	1637	
Change	-7	-18	-33	-51	-65	-82	
December 2013 forecast	1182	1269	1365	1451	1515	1554	1573
Per cent of GDP							
Net borrowing¹							
June 2010 forecast	5.5	3.5	2.1	1.1			
March 2013 forecast	7.8	7.5	6.5	5.5	3.7	2.3	
Change	-0.5	-0.7	-0.9	-1.1	-1.0	-1.1	
December 2013 forecast	7.3	6.8	5.6	4.4	2.7	1.2	-0.1
Cyclically-adjusted surplus on current budget¹							
June 2010 forecast	-1.9	-0.7	0.3	0.8			
March 2013 forecast	-4.4	-3.6	-2.4	-1.7	-0.3	0.7	
Change	0.4	-0.1	-0.3	-0.1	-0.1	0.0	
December 2013 forecast	-4.1	-3.7	-2.7	-1.8	-0.4	0.7	1.6
Cyclically-adjusted net borrowing¹							
June 2010 forecast	3.4	1.8	0.8	0.3			
March 2013 forecast	5.9	5.1	4.0	3.2	1.7	0.7	
Change	-0.4	0.1	0.3	0.1	0.2	0.0	
December 2013 forecast	5.5	5.2	4.3	3.3	1.9	0.7	-0.3
Net debt²							
June 2010 forecast	69.8	70.3	69.4	67.4			
March 2013 forecast	75.9	79.2	82.6	85.1	85.6	84.8	
Change	-2.0	-3.6	-4.3	-5.1	-5.7	-6.4	
December 2013 forecast	73.9	75.5	78.3	80.0	79.9	78.4	75.9

¹ Excluding APF and Royal Mail pension fund transfers.² Debt at end March; GDP centred on end March.

International comparisons

4.169 International organisations, such as the European Commission and the IMF, produce forecasts of deficit and debt levels of different countries on a comparable basis. These are based on general government debt and borrowing and are presented on a calendar year basis. To facilitate international comparisons, Tables 4.41 and 4.42 provide UK forecasts on a basis which is comparable to 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.

Table 4.41: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit ¹			Treaty Debt ²		
	2013	2014	2015	2013	2014	2015
UK (December <i>EFO</i>)	5.9	5.5	4.3	90.3	92.5	94.4
UK (EC)	6.4	5.3	4.3	94.3	96.9	98.6
Germany	0.0	-0.1	-0.2	79.6	77.1	74.1
France	4.1	3.8	3.7	93.5	95.3	96.0
Italy	3.0	2.7	2.5	133.0	134.0	133.1
Spain	6.8	5.9	6.6	94.8	99.9	104.3
Euro area	3.1	2.5	2.4	95.5	95.9	95.4

¹General government net borrowing.

²General government gross debt.

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

Table 4.42: Comparison with IMF forecasts

	Per cent of GDP					
	General government net borrowing			General government net debt		
	2013	2014	2017	2013	2014	2017
UK (December <i>EFO</i>)	5.9	5.5	1.8	81.7	83.9	84.3
UK (IMF)	6.1	5.8	2.7	84.8	88.0	90.9
Germany	-0.4	-0.1	0.2	56.3	54.6	50.8
France	4.0	3.5	1.2	87.2	88.5	85.4
Italy	3.2	2.1	0.5	110.5	111.2	105.4
Japan	9.5	6.8	5.1	139.9	141.8	147.2
U.S.	5.8	4.6	3.8	87.4	88.3	86.6

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

5 Performance against the Government's fiscal targets

Introduction

5.1 This chapter:

- sets out the Government's medium-term fiscal targets (from paragraph 5.2);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.5); 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 5.13).

The Government's fiscal targets

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

5.3 The *Charter for Budget Responsibility* defines the fiscal mandate as “a forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period”. This means that total public sector receipts need to at least equal total public sector spending (minus spending on net investment) in five years time, after adjusting for the impact of any remaining spare capacity in the economy. For the purposes of this forecast and the spring 2014 *EFO*, the five-year horizon ends in 2018-19.

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

The implications of our central forecast

5.5 Table 5.1 shows our central forecasts for the cyclically-adjusted current budget (CACB) and PSND in each year to 2018-19, as set out in Chapter 4. These are median forecasts, so we believe it is equally likely that the eventual outturns will come in above them as below them.

Table 5.1: Performance against the Government's fiscal targets

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
CACB							
March forecast	-4.0	-2.8	-1.7	-1.2	0.1	0.8	
December forecast excluding Autumn Statement measures ¹	-3.6	-3.0	-2.0	-1.4	-0.2	0.7	1.6
December forecast	-3.6	-2.9	-2.0	-1.4	-0.2	0.7	1.6
CACB excluding APF¹							
March forecast	-4.4	-3.6	-2.4	-1.7	-0.3	0.7	
December forecast excluding Autumn Statement measures ¹	-4.1	-3.8	-2.7	-1.8	-0.4	0.7	1.6
December forecast	-4.1	-3.7	-2.7	-1.8	-0.4	0.7	1.6
PSND							
March forecast	75.9	79.2	82.6	85.1	85.6	84.8	
December forecast excluding Autumn Statement measures ¹	73.9	75.6	78.4	80.0	79.9	78.5	76.0
December forecast	73.9	75.5	78.3	80.0	79.9	78.4	75.9
PSND excluding APF, B&B and NRAM¹							
March forecast	72.3	78.1	82.6	85.9	87.1	86.6	
December forecast excluding Autumn Statement measures ¹	69.9	74.5	78.4	80.9	81.3	80.1	77.6
December forecast	69.9	74.4	78.3	80.8	81.2	80.0	77.6

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

- 5.6 Table 5.1 shows that our central forecast is for the CACB to be in surplus by 1.6 per cent of GDP in 2018-19. This means that there is a significantly greater than 50 per cent chance of the Government achieving balance on this measure in that year and as a result it is on course to achieve the mandate. It is the first surplus in excess of 1 per cent of GDP we have forecast for a mandate year.
- 5.7 In our March *EFO*, the relevant year for assessing the fiscal mandate was 2017-18. Our central forecast shows that the surplus on the CACB is marginally lower in that year than expected in March, at 0.7 per cent of GDP. This is partly because APF transfers no longer flatter the CACB in 2017-18 as much as they did in March, and partly because the downward revision to spending is not as large as one would have expected given the upward revision to GDP in that year – which we judge to be cyclical.
- 5.8 The CACB also now shows a small deficit in 2016-17, rather than the small surplus we predicted in March. Excluding APF transfers, both forecasts showed the CACB in deficit in 2016-17.
- 5.9 The Government has more headroom against its fiscal mandate in 2018-19 than it had in 2017-18. This is largely because its stated policy assumption for public spending beyond 2015-16 delivers a further cut in non-investment spending as a share of GDP in 2018-19 as the forecast rolls on the extra year. This is in effect a decision to continue increasing the

size of the fiscal consolidation for a further year. Announcements in the Treasury's table of Autumn Statement policy measures have a small effect in that and earlier years.

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

- measures appearing in the Treasury's Autumn Statement decisions table have a relatively small impact in all years, reducing the CACB by less than 0.1 per cent of GDP in 2018-19;
- setting a policy assumption that total spending is held flat in real terms in 2018-19, within which investment spending rises with GDP, reduces structural non-investment spending by 0.8 per cent of GDP in that year and improves the CACB by the same amount. (The Treasury treats this as 'unchanged policy' and so does not report the additional tightening in its table of policy measures.) Implied current spending by departments falls by 1.0 per cent of GDP in that year, more than offsetting the small structural increase we forecast in other current spending – mostly debt interest; and
- other forecasting changes have little effect on the CACB in 2018-19, but weaken the structural balance in earlier years and delay the return to balance until 2017-18. Despite the narrower output gap over the forecast period, spending falls slightly more gradually as a share of GDP from 2014-15. This is offset in the final two years by a stronger pick-up in receipts, reflecting in part for 2018-19 another year of positive fiscal drag as earnings rise by more than income tax thresholds.

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

	Per cent of GDP						
	Outturn		Forecast				
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19 ¹
March forecast	-4.0	-2.8	-1.7	-1.2	0.1	0.8	0.8
December forecast	-3.6	-2.9	-2.0	-1.4	-0.2	0.7	1.6
Change	0.4	-0.1	-0.3	-0.2	-0.3	-0.1	0.8
<i>of which:</i>							
Autumn Statement measures	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Baseline spending assumption	0.0	0.0	0.0	0.0	0.0	0.0	0.8
Other forecasting changes	0.4	-0.2	-0.3	-0.2	-0.3	0.0	0.0

¹We did not produce a forecast for the CACB in 2018-19 in our March EFO. The table assumes our 2017-18 forecast is rolled over one year, consistent with our 2013 *Fiscal sustainability report* assumption for the year.

5.11 The supplementary target requires PSND to fall as a share of GDP between 2014-15 and 2015-16, with this target year fixed. Our March forecast was for PSND to rise by 2.4 per cent of GDP in that year. We now expect PSND to rise more gradually over the next three years, but a smaller rise of 1.7 per cent of GDP in 2015-16 means that the Government is still on course to miss its supplementary target. PSND is now expected to peak in 2015-16, and to fall by a statistically and fiscally insignificant margin in 2016-17, as opposed to our March forecast of a further 0.5 per cent of GDP rise in 2016-17. As Table 5.1 shows, excluding the APF transfers and the rundown of Bradford & Bingley and Northern Rock

(Asset Management) (B&B and NRAM) assets, net debt would rise by 0.4 per cent of GDP in 2016-17, therefore peaking a year later than the headline measure of debt.

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

- changes in our forecast for nominal GDP affect the denominator we use to calculate PSND as a share of GDP. Stronger nominal GDP growth in 2013-14 slows the rise in PSND, while slightly weaker growth in later years has the opposite effect;
- net borrowing is lower in each year of the forecast horizon, largely due to the cyclical recovery in receipts. As borrowing now falls more quickly than in our March forecast, debt rises more slowly and then falls more rapidly as a share of GDP in 2017-18; and
- other changes have a small effect, leading to net debt falling by an additional 0.1 per cent of GDP in each year up to 2016-17.

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

	Change in PSND on a year earlier (per cent of GDP)				
	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18
March forecast	3.3	3.5	2.4	0.5	-0.8
December forecast	1.6	2.8	1.7	-0.1	-1.4
Change	-1.7	-0.7	-0.8	-0.6	-0.6
<i>of which:</i>					
Nominal GDP	-1.1	0.2	0.1	0.0	0.1
Changes in net borrowing	-0.5	-0.7	-0.8	-0.6	-0.7
Other	-0.1	-0.1	-0.1	-0.1	0.0

Recognising uncertainty

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

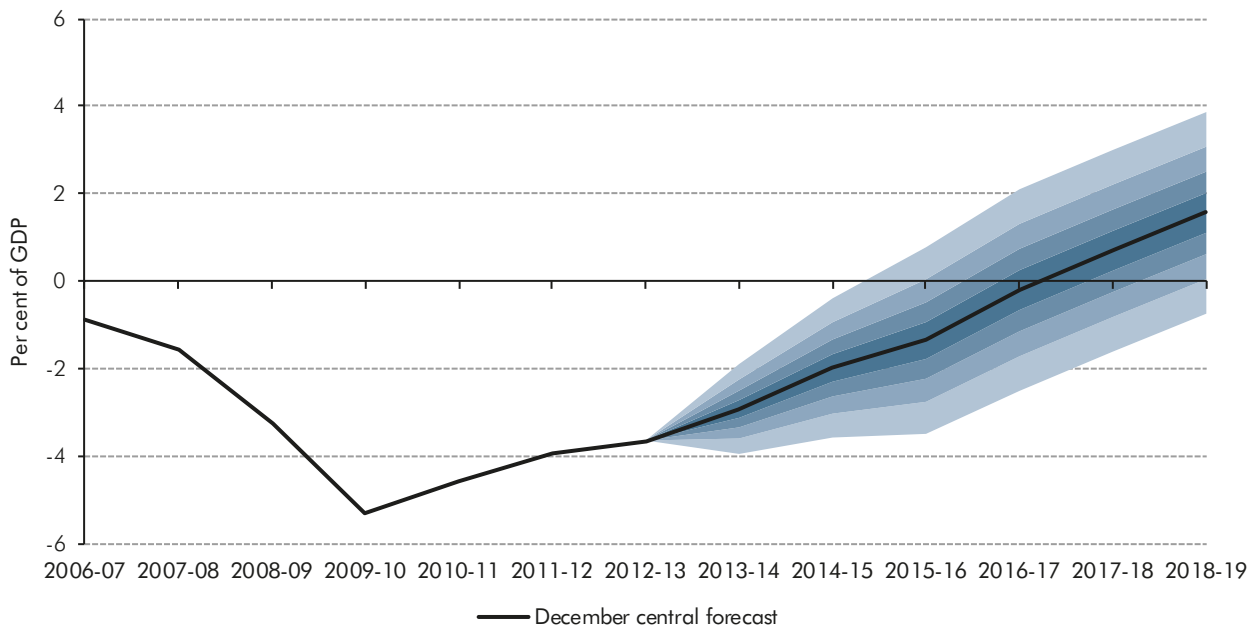
5.14 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet the mandate in 2018-19, but not on course to meet the supplementary target in 2015-16. We do this in three ways:

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

Past performance

- 5.15 One relatively simple way to illustrate the uncertainty around our central forecast is to consider the accuracy of previous official public finance forecasts. This can be done using fan charts like those we presented for GDP growth in Chapter 3 and underlying public sector net borrowing (PSNB) in Chapter 4. These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that forecast errors in the past offered a reasonable guide to forecast errors in the future.
- 5.16 In this spirit, Chart 5.1 shows the probability distribution around our central forecast for the CACB, based on past official forecast errors. The solid black line shows the median forecast, with the successive pairs of lighter shaded areas around it representing 20 per cent probability bands. This implies that, based on current policy, there would be an 80 per cent probability of the outturn lying within the shaded bands.

Chart 5.1: Cyclically-adjusted current budget fan chart



Source: OBR

- 5.17 A direct reading of the chart would imply that the Government currently has a roughly 80 per cent probability of achieving a surplus on the CACB in 2018-19 and thereby meeting the mandate. The probability of achieving a cyclically-adjusted current surplus in earlier years is lower at around 65 per cent for 2017-18, 45 per cent for 2016-17 and 20 per cent for 2015-16.
- 5.18 Unfortunately, one cannot estimate the probability of achieving the supplementary target; we do not have the joint distribution that would allow us to apply the same technique. That said, our central median forecast shows PSND rising as a percentage of GDP in 2015-16.

Sensitivity analysis

- 5.19 It is very difficult to produce a full subjective probability distribution for the Government's target fiscal variables because they are affected by a huge variety of economic and non-economic determinants, many of which are correlated with each other. However, to recognise the uncertainty in our forecast we can go further than using evidence from past forecast errors, by quantifying roughly how sensitive our central forecast is to changes in certain key economic parameters.
- 5.20 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.
- 5.21 Our central forecast is based on a judgement that the economy was running around 2.2 per cent below potential in the third quarter of 2013, and that above-trend output growth over the forecast period will close the output gap by the end of 2018-19. But neither the level of potential nor the pace of recovery are possible to estimate with confidence, not least because the former is not something we can observe directly in economic data. So what if the medium-term level of potential was higher or lower than our central estimate, and what if the output gap closed earlier or later than our central estimates?
- 5.22 Tables 5.4 and 5.5 present illustrative estimates of the impact on:
- the level of the CACB in 2018-19; and
 - the change in PSND between 2014-15 and 2015-16.
- 5.23 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 over the forecast period.
- 5.24 The cyclical adjustment ready-reckoner assumes that a 1 per cent change in GDP will result in a 0.7 per cent of GDP change in PSNB and the current budget after two years. The actual change in the public finances would depend on many other factors, including the composition of growth, inflation and the labour market response. Later in this chapter we construct four alternative scenarios that deliver two alternative paths for unemployment, where trend or actual GDP are weaker or stronger than in our central forecast. These are

produced in a bottom-up way rather than top-down, and highlight the sensitivities to some of these other factors. While we recognise the limitations of this top-down approach, applying these ready-reckoners yields the results shown in the tables below.

Table 5.4: Cyclically-adjusted current budget in 2018-19

	Per cent of GDP					
		Output gap closes				
		2014-15	2016-17	2018-19	2020-21	2022-23
	-0.2	0.1	0.1	0.1	0.1	0.1
	-1.2	0.8	0.8	0.8	0.8	0.8
Output gap in 2013 Q3	-2.2	1.6	1.6	1.6	1.6	1.5
	-3.2	2.3	2.3	2.3	2.3	2.3
	-4.2	3.0	3.0	3.0	3.0	3.0

Table 5.5: Change in public sector net debt between 2014-15 and 2015-16

	Per cent of GDP					
		Output gap closes				
		2014-15	2016-17	2018-19	2020-21	2022-23
	-0.2	2.1	2.3	2.5	2.5	2.5
	-1.2	1.3	1.7	2.0	2.2	2.3
Output gap in 2013 Q3	-2.2	0.5	1.1	1.7	1.9	2.1
	-3.2	-0.3	0.5	1.3	1.7	1.8
	-4.2	-1.1	-0.1	0.9	1.4	1.6

- 5.25 Table 5.4 shows that the level of potential output has a strong effect on the size of the CACB balance in 2018-19. The lower potential output is, and therefore the smaller the output gap, the larger the proportion of the deficit that is structural (and therefore unrelated to economic recovery) and the less margin the Government has against its fiscal mandate. Conversely, if potential output is higher, less of the deficit is structural and the Government has more margin against its mandate.
- 5.26 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.
- 5.27 Roughly speaking, the output gap would have to be over 2 per cent of potential output narrower than our central estimate (or rather the level of potential output would need to be 2 per cent lower in 2018-19 than in our central forecast) to make it more likely than not that the mandate would be missed. As set out in Chapter 3, projections of potential output vary considerably.
- 5.28 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 faster. The former would imply less structural borrowing, whereas the latter would suggest less cyclical borrowing.

5.29 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 a shock meant that those expectations were to prove wrong? We examine the implications of a negative shock of 50 basis points, making debt cheaper to service, and increases of 50, 100, 150 and 200 basis points, making it more expensive. For this analysis, we assume that the shock does not affect any other part of the forecast, including exchange rates and shorter-term interest rates. In reality, an interest rate shock would be accompanied by other important changes in the economy. Table 5.6 shows the level of the CACB in 2018-19 and the change in PSND between 2014-15 and 2015-16 under these variants, constructed using a ready-reckoner.

Table 5.6: Fiscal target variables under different gilt rate assumptions

	Per cent of GDP					
	Change in gilt rate (bps)					
	-50	0	50	100	150	200
CACB in 2018-19	1.8	1.6	1.3	1.1	0.8	0.2
Change in PSND between 2014-15 and 2015-16	1.5	1.7	1.8	2.0	2.1	2.1

5.30 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. Since the UK has a relatively long average debt maturity for conventional gilts, new issuance forms a relatively small proportion of the stock each year. Moreover, new issuance is projected to fall as borrowing declines. Therefore over a short horizon, such as our five-year forecast period, the impact of a shock to the average nominal interest rate on gilts is relatively small.

5.31 Gilt rates will also affect transfers between the Exchequer and the APF as gilts are sold. If gilt rates were higher, bond prices would be lower and therefore capital losses for the APF greater. But as gilts are assumed to be sold from late in 2015-16, a gilt rate shock would have only a small effect on our assessment of the supplementary target through this channel, and no effect on the CACB in 2018-19, as transfers from the Exchequer to the APF are classified as capital spending.

5.32 Our final sensitivity analysis concerns uncertainty around our cyclical adjustment coefficients. Cyclical adjustment attempts to look through the effect of the economic cycle on the public finances. This is achieved by adjusting a given fiscal aggregate, such as the current budget, for the size of the output gap in the current and previous years, using cyclical adjustment coefficients to estimate a cyclically-adjusted aggregate, such as the CACB. Our approach to cyclical adjustment applies coefficients of 0.2 for the previous year's output gap and 0.5 for the current year's gap, as described in a Working Paper available on our website.¹

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

5.33 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;
- 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.

5.34 Given these uncertainties, it is useful to consider how sensitive our central forecast is to variations in the coefficients. Our latest forecast is for the headline current budget balance to move into surplus in 2017-18, improving further to 1.4 per cent of GDP in 2018-19. If the output gap remains negative over that period, as in our central forecast, then varying the coefficients would not affect our judgement that the fiscal mandate will be met, although it would affect the margin for error around it. Our current forecast of a very small negative output gap in 2018-19, which closes during the year, implies that applying different coefficients would have little impact on the CACB in that year. If the coefficients were reduced by 0.1, to 0.4 on the current year's output gap and 0.1 on the previous year's output gap, the CACB would be 0.1 per cent of GDP lower in 2018-19.

Scenario analysis

5.35 The sensitivity analysis discussed above focuses on a narrow set of factors and therefore only offers a partial assessment of potential uncertainty. In this section, we set out the fiscal implications of a number of 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 the central forecast and we do not attempt to attach particular probabilities to their occurrence.

5.36 One current topic of debate is the path for the unemployment rate in the near term. Under forward guidance, the Monetary Policy Committee has explicitly committed to maintain Bank Rate at 0.5 per cent at least until the unemployment rate falls below a threshold of 7 per cent, subject to certain 'knockouts'. As a result, there has been increased debate about when the unemployment rate will fall below this threshold, and therefore when the Bank of England will consider increasing Bank Rate.

5.37 Our latest forecast is for the unemployment rate to fall from its current rate of 7.6 per cent to reach 7.0 per cent in the second quarter of 2015, one quarter before the market has fully

priced in the first 25 basis point Bank Rate increase. It is important to recognise that the path of interest rates we use for our central forecast lies within a distribution of expectations reflecting the balance of financial market participants' views. Some will expect interest rates to rise earlier/later and unemployment to fall faster/slower than others – the scenarios presented below illustrate different possible views of the world.

5.38 We examine two pairs of scenarios:

- the first pair of scenarios are calibrated such that unemployment falls through 7 per cent a year later than our central forecast – in one variant for 'bad' reasons due to weaker demand and in one variant for 'good' reasons due to higher potential output, implying unemployment will fall more slowly for a given path of demand; and
- the second pair of scenarios show unemployment falling through 7 per cent a year earlier than our central forecast – again, in one variant for 'good' reasons due to stronger demand and in one variant for 'bad' reasons due to potential output being weaker than our central forecast, implying unemployment will fall faster for a given path of demand.

5.39 As we highlight in Chapter 3, we judge that a number of influences will weigh on the recovery in coming years and so spare capacity in the economy is likely to be taken up only gradually, with the rate of unemployment falling slowly as it passes 7 per cent in our central forecast. Therefore, small changes in the assumed path of employment, participation or hours could lead to big changes in the date at which the threshold is reached – this forecast judgement is therefore subject to significant uncertainty.

Scenario 1a – weaker demand

5.40 In this view of the world, unemployment falls more slowly than in our central forecast because demand picks up more slowly than we expect. The key assumptions and implications of this scenario are:

- GDP grows more slowly over the coming two years and the output gap closes later than in our central forecast. The shortfall in demand is distributed proportionately between less consumption, investment and net trade;
- spare capacity in the labour market is taken up less quickly and unemployment reaches the 7 per cent threshold a year later, delaying the first Bank Rate rise to mid-2016. Consistent with this view of the world, the yield curve immediately flattens;
- the weaker GDP profile dampens receipts growth, whilst the slower fall in unemployment raises spending on benefits and tax credits. The effects of lower interest rates on debt interest costs are partially offset by lower interest receipts and tax on corporate and household savings; and

- net borrowing and net debt are higher than in our central forecast in each year. But the additional borrowing is cyclical, and the CACB is essentially unchanged over the period.

Scenario 1b – stronger supply

5.41 In this scenario, unemployment falls more slowly than in our central forecast because the economy's supply potential grows more quickly than we expect. The key assumptions and implications of this scenario are:

- output grows at the same rate over the forecast period but less labour is required to produce it because productivity growth is faster than forecast – reflecting this, real average earnings growth is stronger in this scenario;
- the slower reduction of slack in the labour market means spare capacity remains at the forecast horizon and inflation is a little lower relative to the central forecast. The paths for unemployment and Bank Rate are consistent with the wider output gap, with both the unemployment rate reaching the 7 per cent threshold and Bank Rate beginning to rise a year later than in the central forecast;
- lower nominal GDP, given lower inflation and an unchanged profile for real output, leads to lower cash receipts. Unemployment-related spending is slightly higher in the near term, but total spending growth is depressed thereafter, as it is linked to general economy inflation beyond 2015-16; and
- headline net borrowing and net debt are again above our central forecast, but the underlying fiscal position is stronger given the boost to future potential output.

Scenario 2a – stronger demand

5.42 In this view of the world, unemployment falls faster than in our central forecast because demand picks up by more than we expect. The key assumptions and implications of this scenario are:

- GDP grows faster over the coming two years and spare capacity in the labour market is taken up more quickly. This is essentially Scenario 1a in reverse and on a slightly larger scale so that the unemployment reaches the 7 per cent threshold a year sooner;
- the output gap closes sooner, suggesting less cyclical growth towards the end of the forecast period. Inflation is a little higher relative to the central forecast and Bank Rate rises a year earlier, leading to a steeper yield curve;
- the stronger recovery boosts receipts growth, whilst spending is lower up to 2015-16 as lower spending on benefits and tax credits outweighs higher spending on debt interest. Applying the Government's spending assumption for the period beyond 2015-16 essentially pushes this into future years; and

- both higher receipts and lower spending reduce net borrowing and therefore net debt over the forecast horizon. The structural position is unaffected in the first few years, but locking in some of the cyclical spending gains improves the CACB by 2018-19.

Scenario 2b – weaker supply

5.43 In this scenario, unemployment falls faster than in our central forecast because the economy's supply potential grows more slowly than we expect. The key assumptions and implications of this scenario are:

- output grows at the same rate over the coming two years but more labour is required to produce it because productivity growth is weaker than forecast – reflecting this, real average earnings growth is weaker in this scenario;
- the faster reduction of slack in the labour market means the output gap closes sooner, inflation is a little higher than in our central forecast and above-trend growth ceases when the output gap has closed. Unemployment reaches the 7 per cent threshold a year sooner and Bank Rate begins to rise a year earlier than in the central forecast;
- weaker medium-term GDP growth rates depresses receipts, and the composition of lower labour income is also less tax rich, as income tax and NICs receipts are more geared to average earnings growth – which is dampened by lower productivity – than employment growth. Spending is also higher beyond 2015-16 due to higher inflation; and
- higher borrowing by the end of the forecast is entirely structural, and the CACB improves more gradually than in our central forecast.

5.44 Table 5.7 summarises the economic assumptions we have made, as well as the fiscal consequences of these alternative scenarios. It shows that, under every scenario, the fiscal mandate would still be met and the supplementary debt target missed. As described above, the timing of when unemployment reaches the 7 per cent threshold is sensitive to relatively small changes in underlying assumptions. The fiscal implications reflect this.

Table 5.7: Key economic and fiscal aggregates under alternative scenarios

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Central forecast						
Economic assumptions						
GDP (percentage change)	2.0	2.3	2.3	2.6	2.7	2.7
CPI inflation (Q3)	2.7	2.2	2.1	2.0	2.0	2.0
ILO unemployment (% rate)	7.5	7.1	6.9	6.4	5.9	5.5
Output gap	-2.1	-1.8	-1.5	-1.1	-0.6	-0.1
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	6.0	4.9	4.0	2.6	1.3	0.1
Cyclically-adjusted current budget	-2.9	-2.0	-1.4	-0.2	0.7	1.6
Public sector net debt	75.5	78.3	80.0	79.9	78.4	75.9
Scenario 1a - weaker demand						
Economic assumptions						
GDP (percentage change)	2.0	2.0	2.2	2.5	2.7	2.7
CPI inflation (Q3)	2.7	2.2	2.1	2.0	1.9	1.9
ILO unemployment (% rate)	7.5	7.4	7.3	6.9	6.5	6.0
Output gap	-2.1	-2.0	-1.9	-1.6	-1.1	-0.7
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	6.0	5.0	4.2	2.9	1.6	0.5
Cyclically-adjusted current budget	-2.9	-2.0	-1.3	-0.2	0.7	1.6
Public sector net debt	75.5	78.6	80.7	81.0	80.0	78.0
Scenario 1b - stronger supply						
Economic assumptions						
GDP (percentage change)	2.0	2.3	2.3	2.6	2.7	2.7
CPI inflation (Q3)	2.7	2.2	2.1	2.0	1.9	1.9
ILO unemployment (% rate)	7.5	7.4	7.3	6.9	6.5	6.0
Output gap	-2.1	-2.0	-1.9	-1.6	-1.1	-0.7
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	6.0	4.9	4.1	2.7	1.4	0.3
Cyclically-adjusted current budget	-2.9	-1.9	-1.2	0.0	0.9	1.7
Public sector net debt	75.5	78.3	80.1	80.3	79.1	76.9
Scenario 2a - stronger demand						
Economic assumptions						
GDP (percentage change)	2.0	2.5	2.8	3.0	2.3	2.2
CPI inflation (Q3)	2.7	2.2	2.1	2.1	2.1	2.0
ILO unemployment (% rate)	7.5	6.9	6.3	5.5	5.4	5.3
Output gap	-2.1	-1.5	-0.8	0.0	0.0	0.0
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	6.0	4.8	3.7	2.1	0.8	-0.3
Cyclically-adjusted current budget	-2.9	-2.0	-1.4	-0.4	0.6	1.7
Public sector net debt	75.5	78.0	78.9	77.9	76.1	73.6
Scenario 2b - weaker supply						
Economic assumptions						
GDP (percentage change)	2.0	2.3	2.3	2.4	1.7	1.6
CPI inflation (Q3)	2.7	2.2	2.1	2.1	2.1	2.0
ILO unemployment (% rate)	7.5	6.9	6.3	5.5	5.4	5.3
Output gap	-2.1	-1.5	-0.8	0.0	0.0	0.0
Fiscal outcome (per cent of GDP)						
Public sector net borrowing	6.0	4.9	4.0	2.5	1.4	0.5
Cyclically-adjusted current budget	-2.9	-2.1	-1.7	-0.8	0.1	1.0
Public sector net debt	75.5	78.3	79.8	79.5	78.6	77.2

A Autumn Statement 2013 policy measures

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

Table A.1: HM Treasury table of Autumn Statement policy decisions

	Head	£ million						
		2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	
Spending Totals								
1	Spending total adjustment	Spend	+1,080	+1,120	+1,040	-	-	-
2	Special Reserve	Spend	+900	0	0	-	-	-
Households								
3	Income Tax: transferable marriage allowance	Tax	0	0	-495	-600	-660	-775
4	Free School Meals: extension	Spend	0	-620	-755	-	-	-
5	Fuel Duty: cancel 2014 increase	Tax	0	-415	-710	-735	-755	-780
6	Rail fares at RPI for 2014	Spend	-10	-35	-35	-	-	-
7	VED: direct debit	Tax	0	-5	-15	-15	-20	-20
Young People and Support for Work								
8	Employer NICs: abolish for under 21s basic rate earnings	Tax	0	0	-465	-495	-520	-530
9	Higher Education: abolish the cap on student numbers	Spend	0	-120	-290	-	-	-
10	Higher Education: additional funding for STEM subjects	Spend	0	0	-40	-	-	-
11	Further Education: additional higher apprenticeships	Spend	0	-10	-35	-	-	-
12	Help to work: support for long-term unemployed	Spend	0	-190	-230	-	-	-
13	Help to work: benefit savings	Spend	+25	+130	+140	-	-	-
14	New Enterprise Allowance: extension	Spend	0	-25	-55	-	-	-
Business Tax								
15	Business Rates: small business relief extension	Tax	0	-500	+65	+10	0	0
16	Business Rates: relaxing single property criteria	Tax	0	-5	-5	-5	-5	-5
17	Business Rates: cap increase at 2% in 2014-15	Tax	0	-270	-255	-255	-270	-275
18	Business Rates: £1000 discount for two years for shops, pubs and restaurants up to £50,000 rateable value	Tax	0	-350	-425	+70	+10	0
19	Business Rates: reoccupation relief for retail premises	Tax	0	-5	-10	-5	0	0
20	Bank Levy: base and rate	Tax	0	+265	+520	+535	+535	+535

Enterprise and Housing

21 Corporation tax: film tax relief	Spend	0	-10	-20	-	-	-
22 Employee Ownership: further support ³	Tax	0	-15	-25	-25	-25	-30
23 Science: support for quantum technologies	Spend	0	-30	-35	-	-	-
24 Housing Revenue Account: additional flexibility ²	Spend/ tax	0	0	-155	-5	+10	+20
25 Right to Buy	Spend	0	0	-50	-	-	-
26 OTS Review: simplification of employee share schemes	Tax	0	+5	+5	+5	+20	+20

Energy and Environment

27 Energy prices: support for vulnerable households	Spend	0	-320	-320	-	-	-
28 Energy efficiency: grants for households	Spend	0	-120	-120	-	-	-
29 Energy efficiency: grants for landlords	Spend	0	-30	-30	-	-	-
30 Energy efficiency: public sector	Spend	0	-30	-30	-	-	-
31 Fuel Duty: support for cleaner fuels	Tax	0	0	-5	-10	-20	-40
32 Climate Change Levy: data centres	Tax	0	-5	-15	-15	-15	-15
33 Corporation tax: new pad allowance for shale gas	Tax	0	0	*	-5	-20	-20

Avoidance, tax planning and fairness

34 Accelerated payments in follower cases	Tax	0	+135	+660	-35	-40	-45
35 Onshore employment intermediaries	Tax	0	+520	+425	+380	+415	+445
36 Dual Contracts	Tax	0	0	+85	+60	+60	+65
37 Compensating Adjustments	Tax	0	+60	+125	+120	+115	+110
38 Venture Capital Trusts: share buy-backs	Tax	0	+50	+35	+10	+20	+25
39 Avoidance schemes using derivatives	Tax	+40	+40	+20	+10	0	0
40 Oil and gas: offshore chartering	Tax	0	+140	+115	+100	+90	+80
41 Partnerships: confirming extension to Alternative Investment Funds	Tax	0	0	+680	+430	+410	+400
42 Automatic Exchange of Information agreements with Overseas Territories	Tax	*	*	*	+25	+10	+5
43 Double taxation relief: closing loopholes	Tax	+10	+20	+5	0	0	0
44 CGT: amending final exemption period for private residences	Tax	0	0	+65	+90	+100	+105
45 CGT: application to non-residents	Tax	0	0	0	+15	+40	+70
46 Corporation tax: change of ownership rules	Tax	-30	-10	0	0	0	0

Fraud, Error and Debt								
47	Alcohol fraud wholesaler registration ⁴	Tax	0	0	-5	+15	+230	+215
48	HMRC: extending online services ⁴	Tax	0	0	+15	+50	+45	+50
49	Tax credits: improving collection and administration ^{2,4}	Spend/ tax	-5	+355	+615	+75	+10	+5
50	Tax credits: annual entitlement ^{2,4}	Spend/ tax	0	0	+65	+5	0	0
51	Tax debt: improved collection ⁴	Tax	0	+55	+20	0	0	0
52	Overseas life certificates: extension	Spend	0	+20	+25	-	-	-
53	DWP fraud: sharing RTI data	Spend	0	+130	+20	-	-	-
Spending Round and Other Measures								
54	Gross tax costs of tax measures with spending impacts after 2015-16 ⁵	Tax	0	0	0	-20	-60	-85
55	Local authority capital receipts flexibility	Spend	0	+10	-20	-	-	-
56	Pension credit passthrough	Spend	0	-5	0	-	-	-
57	Final impact of Spending Round measures	Spend/ tax	+10	-60	-185	-185	-275	-380
58	Winter Fuel Payments: overseas eligibility	Spend	0	0	+20	-	-	-
59	Alcohol price floor	Tax	0	-5	-5	-5	-5	-5
TOTAL POLICY DECISIONS			+2,020	-135	-75	-410	-570	-855
Total spending policy decisions			+2,000	-45	-565	0	0	0
Total tax policy decisions			+20	-90	+490	-410	-570	-855

*Negligible

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

² Spending measures do not affect borrowing in 2016-17, 2017-18 and 2018-19 as they fall within the Total Managed Expenditure assumption. Where numbers for spending measures are shown, this reflects tax elements to predominantly spending measures.

³ This is additional to the £50m pa provided in Budget 2013.

⁴ HMRC has been provided with additional funding of £150m for these measures. The costings are shown net of additional funding.

⁵ These are adjustments for where tax policies have a spending element which feeds through to the TME assumption but not the bottom line in 2016-17, 2017-18, and 2018-19. See the Policy Costings document for further details.



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