HM TREASURY

2010-11 Convergence Programme for the United Kingdom

submitted in line with the Stability and Growth Pact

April 2011

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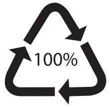

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1 Introduction

1.1 The Stability and Growth Pact (SGP) requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Articles 121 and 126 of the EU Treaty.

1.2 Assessments under the SGP are subject to parliamentary scrutiny. The UK presents copies of the UK's Convergence Programme and Excessive Deficit Procedure (EDP) assessments to Parliament along with an Explanatory Memorandum.

1.3 Since the last Convergence Programme, a new Government has been elected. One of its first actions was to set up the new independent Office for Budget Responsibility (OBR), which introduces independence, greater transparency and credibility to the economic and fiscal forecasts. Major fiscal events since the election have been June Budget 2010, the October 2010 Spending Review and Budget 2011. This Convergence Programme draws on those publications, particularly Budget 2011.

1.4 The forecasts for the economy and public finances included in the United Kingdom's Convergence Programme are prepared by the independent OBR, information on which is set out in Chapter 5. The forecasts set out are taken from the OBR's March 2011 *Economic and fiscal outlook*, which was published alongside Budget 2011.[1]

1.5 The Convergence Programme is subject to UK Parliamentary scrutiny under Section 5 of the European Communities (Amendment) Act 1993.

Government policy

1.6 The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries.

1.7 Creating lasting prosperity requires the economy to change and to rebalance from unsustainable public spending toward net trade and private-sector investment. This will support the UK's long-term economic potential and help to create new jobs.

1.8 Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimising risks to the recovery. The Government has set out a strategic policy response to the UK's exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK's post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;

[1] *Economic and fiscal outlook*, OBR, March 2011.

- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government's ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

1.9 In June Budget 2010 and Spending Review 2010 the Government took the first steps in implementing this strategy through urgent action to address the extraordinary rise in the deficit prior to and during the crisis.

1.10 Budget 2011 confirmed that the Government is continuing this course, and accelerates the process of reforming the British economy, to achieve a new model of sustainable and balanced growth.

Performance against EU obligations

1.11 Following the action the Government has taken, detail of which is set out in this Convergence Programme, the path set for fiscal policy is now consistent with the UK meeting its Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP in 2014-15. The OBR projects that the Treaty deficit will fall from 11.4 per cent of GDP in 2009-10 to 2.6 per cent of GDP in 2014-15, and that the Treaty debt ratio will be restored to a downward path from 2014-15.

Structure of the Convergence Programme

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

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

1.14 Annex A provides details of the financial impact of June Budget 2010, Spending Review 2010 and Budget 2011 policy decisions. Annex B provides supplementary data.

2 Overall Policy Framework and Objectives

2.1 All data included in this chapter is correct at the time of Budget 2011, which was published on 23 March 2011.

A strong and stable economy

Rebalancing the UK economy

2.2 Over the pre-crisis decade, developments in the UK economy were driven by unsustainable levels of private sector debt and rising public sector debt. Indeed, it has been estimated that the UK became the most indebted country in the world.[1]

2.3 Chart 2.1 highlights the rise in private sector debt in the UK. Households took on rising levels of mortgage debt to buy increasingly expensive housing, while by 2008 the debt of non-financial companies reached 110 per cent of GDP. Within the financial sector, the accumulation of debt was even greater. By 2007, the UK financial system had become the most highly leveraged of any major economy. The level of public sector net debt as a share of GDP steadily rose from 2001-02, as the government ran a persistent structural deficit, despite continued economic growth.

2.4 Public and private sector borrowing relied on finance from abroad. The UK's current account went from near balance in 1997 to a deficit of more than 3 per cent of GDP by 2006, which was, in absolute terms, the third largest in the world.

2.5 Increasing reliance on the financial sector and borrowing in the private and public sectors drove growing imbalances in the UK economy:

- Chart 2.2 shows that from 2001 onwards public spending grew steadily as a share of the economy and a structural deficit began to emerge. According to the OECD, by 2007 the UK had the largest structural deficit of any G7 economy. Moreover, the spending plans set out in the 2007 Comprehensive Spending Review were based on unsustainable revenue streams from the property boom and the financial sector. As tax receipts fell away during the crisis, the persistent gap between spending and revenue widened, with total public spending rising to around 47½ per cent of GDP by 2009-10; and
- higher public borrowing was used to finance increased public spending, driving up the price of public services, so that the proportion of the economy made up by government rose in the pre-crisis decade. By contrast, business investment as a percentage of GDP fell, leaving its share in the UK among the lowest in advanced economies.

2.6 Economic growth was unbalanced across the UK, concentrated in the South East, with some other parts of the country increasingly reliant on jobs funded by public spending. Growth relied on a limited number of sectors. Financial services' share of GDP rose from 6½ per cent in 1997

[1] *Debt and deleveraging The global credit bubble and its economic consequences*, McKinsey Global Institute, January 2010.

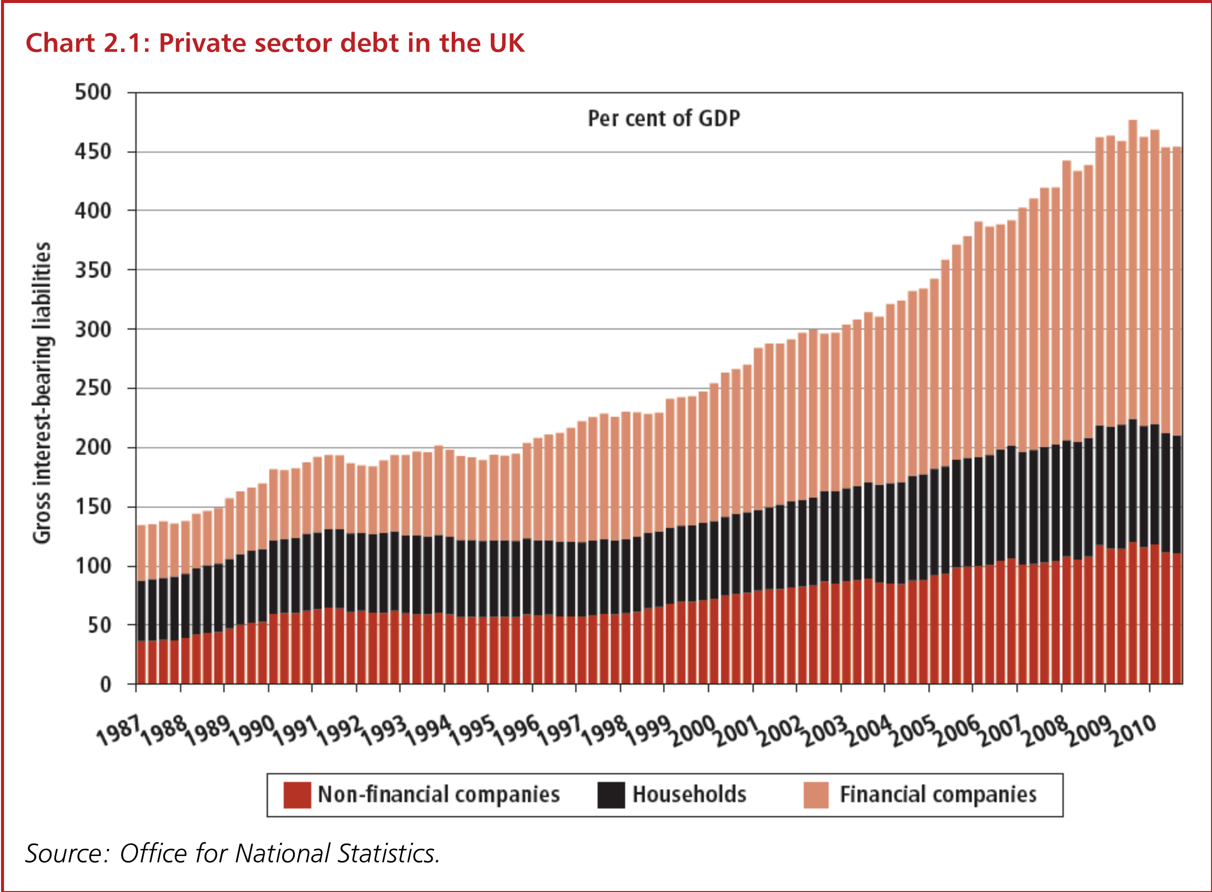
to 8½ per cent in 2007, while manufacturing's share nearly halved over the same period, from over 20 per cent to 12½ per cent.

2.7 This model of growth proved to be unsustainable. More than a quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009. As the OECD concluded in its March 2011 Economic Survey of the UK:

"The global financial crisis and the associated recession ended a 15-year period of continuous growth, rising employment and stable inflation. Significant imbalances had developed, however, in terms of public and external deficits, an excessively leveraged financial sector, high house prices and low household savings. The imbalances exacerbated the downturn during the global recession and contributed to a more pronounced fall in GDP, a larger fiscal deficit and higher inflation than in most of the OECD."[2]

2.8 The level of UK economic activity in current prices (money GDP) is estimated to be around 10 per cent lower in 2010-11 than it was forecast to be at Budget 2008. In other words, the economy is now around 10 per cent smaller than it was forecast to be only three years ago, reducing the resources available for government spending.

Chart 2.1: Private sector debt in the UK



Source: Office for National Statistics.

The Government's strategy

2.9 The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries. Creating lasting prosperity requires the economy to change and to rebalance: from unsustainable public

[2] *OECD Economic Surveys: United Kingdom 2011,* Organisation for Economic Co-operation and Development (OECD), March 2011.

spending toward net trade and investment, which will support the UK's long-term economic potential and help to create new jobs.

2.10 Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimising risks to the recovery. The Government has set out a strategic policy response to the UK's exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK's post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;
- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government's ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

Fiscal Policy

2.11 The current historically high level of public borrowing risks undermining fairness, growth and economic stability in the UK. Tackling the deficit is essential as it will:

- reduce the UK's vulnerability to further shocks or a loss of market confidence, which could force a much sharper correction;
- underpin private sector confidence, supporting growth and job creation over the medium term;
- help keep long-term interest rates down, helping families and businesses through the lower costs of loans and mortgages;
- keep debt and debt interest paid by the Government – and ultimately the taxpayer – lower than would otherwise have been the case; and
- avoid accumulating substantial debts to fund spending that benefits today's generation at the expense of tomorrow's, which would be irresponsible and unfair.

2.12 June Budget 2010 set out comprehensive policies to bring the public finances back under control, demonstrating the Government's determination to reduce public sector borrowing and debt and promote confidence in the sustainability of the public finances. The Government:

- set fiscal plans to restore the public finances to a sustainable position;
- created the new Office for Budget Responsibility (OBR), introducing independence, greater transparency and credibility to the economic and fiscal forecast on which fiscal policy is based; and
- announced a clear, forward-looking fiscal mandate to guide fiscal policy decisions over the medium term.

Fiscal consolidation plan

2.13 The Government's fiscal consolidation plans have been designed with growth and fairness in mind, as far as possible:

- protecting the most productive public investment expenditure;
- avoiding punitive increases in tax rates on capital and labour; and
- reforming the welfare system to reward work.

2.14 As set out in Table 2.1, the Government plans a total consolidation of £126 billion a year by 2015-16, consisting of total reductions in spending of £95 billion and a net increase in taxes of £30 billion. Implementation of these plans is now underway. Under the plans that this Government inherited, £14 billion of spending cuts were planned in 2011-12, compared with 2010-11. This Government's spending cuts amount to £16 billion over the same period.

2.15 Taking the consolidation as a whole, 73 per cent of the total will be delivered by lower spending in 2014-15, rising to 76 per cent in 2015-16. This is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth.[3]

Table 2.1: Total consolidation plans over the forecast period

	£ billion					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Policy inherited by the Government	**1**	**26**	**41**	**58**	**72**	
Spending[1]	0.0	14	25	39	51	
Tax	1.0	12	16	19	21	
Spending share of consolidation (per cent)	*0*	*54*	*61*	*67*	*71*	
Total discretionary consolidation	**9.4**	**41**	**61**	**88**	**110**	**126**
Spending[1, 2, 3]	5.5	22	38	59	80	95
Tax[4]	3.8	20	23	29	30	30
Spending share of consolidation (per cent)	*59*	*53*	*62*	*67*	*73*	*76*

[1] *Spending consolidation is attributable to three factors. Reductions in DEL are calculated by assessing the latest nominal DEL totals (set out in Table 2.4) against a counterfactual of growing DELs in line with general inflation in the economy, as set out in Table 4.8 of the OBR's pre-Budget forecast (June 2010). The reduction in AME is the net effect of AME policy changes announced since June Budget 2010. Finally, the spending reduction also includes estimated debt interest savings now updated for Budget 2011 debt interest forecast assumptions.*

[2] *The spending share of the total consolidation is lower across the forecast period than that set out in Table 1.1 of June Budget 2010. This is largely the result of updating the total consolidation savings attributable to AME policies in line with the OBR's Budget 2011 AME forecast and the revision to the capital envelope at Spending Review 2010. (See Table 2.2 for updated costings of policy measures announced in Spending Review 2010 or earlier, but still to be implemented).*

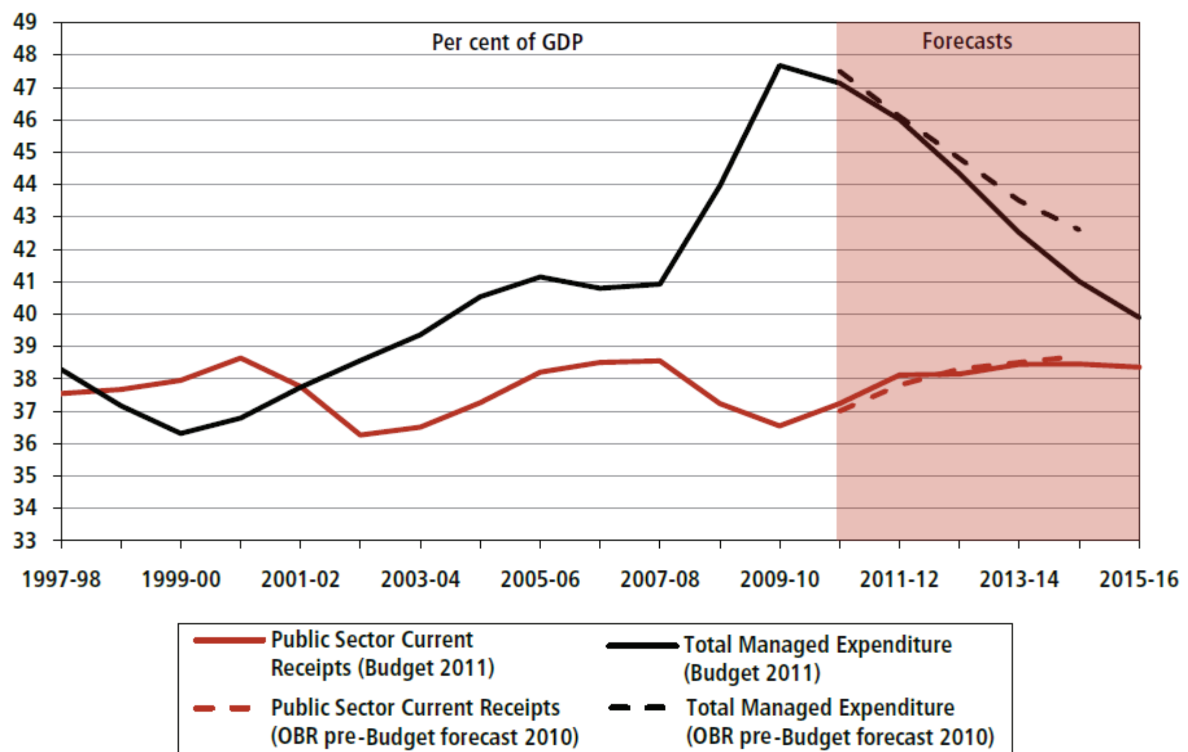
[3] *The Government has not set DELs for 2015-16. Figures shown above are based on the assumption that Total Managed Expenditure between 2014-15 and 2015-16 grows in line with inflation. (See Table 2.3 for the breakdown of Total Managed Expenditure across the forecast period).*

[4] *The tax consolidation figure includes an updated costing for the pensions tax relief measure (see Table 2.2) and tax measures from the scorecard (see Table 2.1).*

2.16 Chart 2.2 shows that, as a result of these plans, public spending is projected by the OBR to fall from around 47½ per cent of GDP in 2009-10 to around 40 per cent of GDP by 2015-16, while tax receipts are projected to rise from 36½ to around 38½ per cent of GDP over the same period, addressing the imbalances in the public finances.

[3] See *Economic Outlook No.81*, OECD, June 2007 and *OECD Economic Surveys: United Kingdom 2011*, OECD, March 2011.

Chart 2.2: Receipts and expenditure



Source: Office for Budget Responsibility and Office for National Statistics.

Implementation of fiscal consolidation

2.17 Implementation of the Government's fiscal plans is underway. The Government is on course to deliver the £6.2 billion of savings announced in May 2010.

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

2.19 The Government is implementing plans and reforms announced in the Spending Review. Legislation has been introduced to Parliament where necessary, including the Welfare Reform and Pensions and Savings Bills. Detailed funding settlements have also been announced, including for local government, schools and science.

2.20 The Government is committed to ensuring the spending consolidation is delivered. The Public Expenditure Cabinet Committee will oversee departments' implementation of their Spending Review plans, holding them to account on their progress. Business plans for each department, setting out information on key reform programmes and performance data on public services, are being finalised this spring. The public will be able to monitor progress on plans through monthly reports and a quarterly performance scorecard for each department.

2.21 The Government has implemented the tax plans for 2011-12 announced or confirmed in June Budget 2010, including the increase in the standard rate of VAT to 20 per cent on 4 January 2011.

The fiscal policy framework

The Office for Budget Responsibility

2.22 The creation of the independent OBR has significantly enhanced the credibility of the UK's fiscal policy. The IMF has welcomed the OBR as "*addressing deficiencies in the previous Government's fiscal framework*" and "*complementing the Government's commitment to fiscal discipline*",[4] while the OECD concluded "*This is clearly an important initiative in terms of strengthening government management of public spending and improving public confidence in the government's fiscal policy*".[5]

2.23 The OBR has now been placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011, which received Royal Assent on 22 March. The OBR has produced all the official forecasts of the economy and public finances since the General Election, independently of Ministers.

Fiscal objectives

2.24 To promote transparent fiscal policy-making, the new fiscal policy framework introduces a requirement for the Government to set out its fiscal policy objectives and fiscal mandate before Parliament in the Charter for Budget Responsibility. The Government published the Charter in draft on 22 November 2010, with the final version published on 4 April 2011. The Government's fiscal policy objectives, presented in the Charter, are to:

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

The fiscal mandate and supplementary target for debt

2.25 The Government has set a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. At Budget 2011, the end of the forecast period was 2015-16.

2.26 The fiscal mandate is based on:

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

2.27 June Budget 2010 also announced a supplementary target for debt. This requires public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

2.28 The Government has asked the OBR independently to judge whether fiscal policy is consistent with: a greater than 50 per cent chance of meeting the mandate; and with a greater than 50 per cent chance of meeting the target for debt.

2.29 The choices of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflect the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is

[4] *IMF UK Article IV Report*, November 2010.

[5] UK: Policies for a Sustainable Recovery, OECD, July 2010.

delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

Monetary policy framework

2.30 At Budget 2011, the Government reaffirmed the inflation target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times. The Monetary Policy Committee (MPC) of the Bank of England has full operational independence to set policy to meet the inflation target. The MPC has maintained Bank Rate at 0.5 per cent since March 2009, and undertaken a programme of asset purchases, through the Asset Purchase Facility, financed by the issuance of central bank reserves totalling £200 billion. The Government confirmed in Budget 2011 that the Asset Purchase Facility will remain in place for the financial year 2011-12.

Financial regulation framework

2.31 The Government is implementing its plans to overhaul the tripartite system of financial regulation, by meeting its commitment to provide the Bank of England with:

- control of macro-prudential regulation, which relates to system-wide risks. The Government will legislate to create a Financial Policy Committee (FPC) within the Bank of England, with a clear macro-prudential remit to identify the risks that build up across the system as a whole and the power to ensure that action is taken to address those risks before they can threaten wider stability. An interim FPC was established in February 2011; and
- oversight of micro-prudential regulation, which focuses on risks within individual financial institutions. The Government will establish the Prudential Regulation Authority (PRA) as a subsidiary of the Bank. The PRA will promote the safety and soundness of the financial institutions it regulates, minimising the wider economic impact should a firm fail.

2.32 The Government intends to introduce primary legislation in 2011 to implement these reforms.

Microeconomic policy to support growth

2.33 *The Plan for Growth*,[6] published alongside Budget 2011, contains four overarching ambitions that will ensure progress is made towards achieving strong, sustainable and balanced growth. The ambitions are to:

- create the most competitive tax system in the G20;
- make the UK the best place in Europe to start, finance and grow a business;
- encourage investment and exports as a route to a more balanced economy; and
- create a more educated workforce that is the most flexible in Europe.

[6] *The Plan for Growth*, HM Treasury and Department for Business, Innovation and Skills, March 2011.

2.34 Each ambition is supported by a number of measurable benchmarks against which the Government expects to be judged. The Government will constantly benchmark the UK against best practice around the world.

2.35 More detail can also be found in the UK's National Reform Programme (NRP) 2011, under the Europe 2020 strategy, which sets out the UK's economic prospects and plans. This includes the actions taken to address the five key "bottlenecks" or obstacles to growth as agreed by the EU's Economic and Finance Affairs Council and the UK in June 2010. It also outlines the UK's approach to national monitoring and actions taken in support of the five headline European targets under Europe 2020 and agreed by the European Council in June 2010.

Recent economic developments

2.36 Global developments, the legacy of the past economic imbalances that built up over recent years, and the action that the Government is taking to address them provides the backdrop to UK economic developments since June Budget 2010.

Global developments

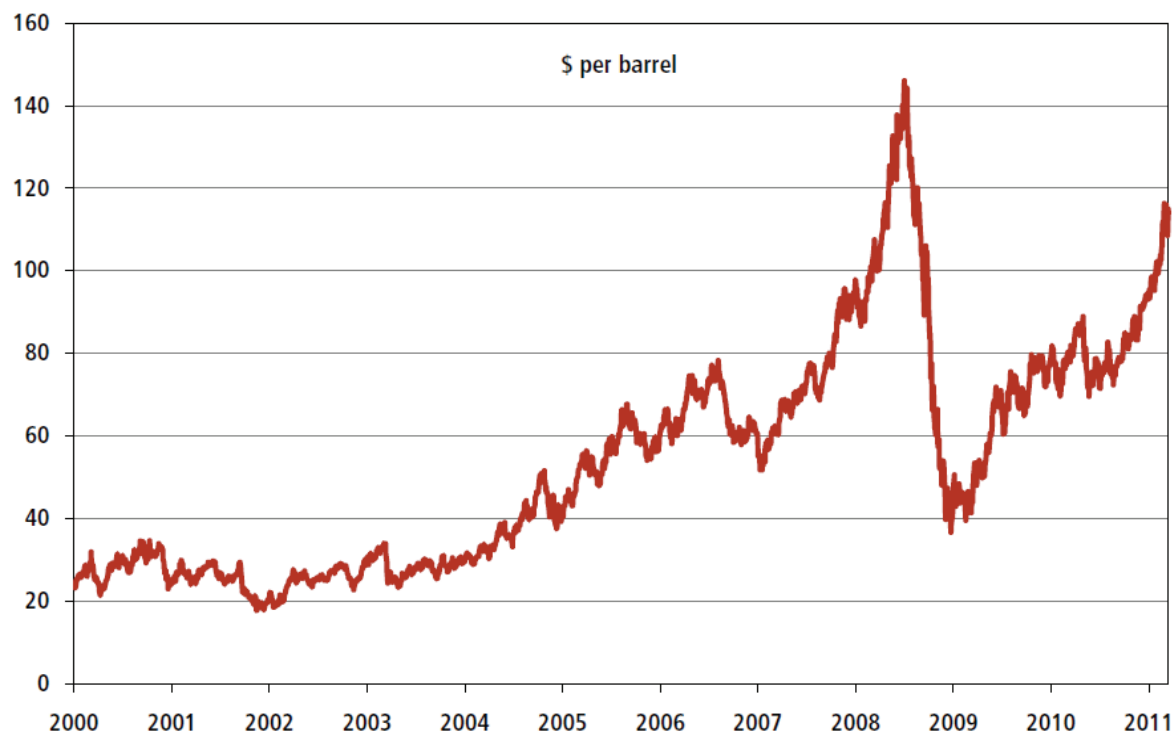
2.37 The world economy returned to growth in 2010, with world GDP rising by 5 per cent over the year.[7] However, this masks divergences across regions. In the major emerging markets, GDP and credit growth have rebounded rapidly. In advanced economies, such as the US and core euro area, recoveries have been more moderate and unemployment remains high. Growth in the euro area periphery has been hampered by sovereign debt crises. The UK is supporting Ireland through EU, IMF and bilateral packages. The G20 continue to work towards policy that delivers "*strong, sustainable and balanced growth*".[8]

2.38 Global financial markets have continued to experience volatility and heightened uncertainty in recent months, as a series of shocks have hit the global economy. Commodity prices have risen sharply, with dollar oil prices around 50 per cent higher than June last year, as shown in Chart 2.3, in part reflecting instability in the Middle East and North Africa. Stock markets gradually improved through the course of 2010, as the recovery in the world economy strengthened. In more recent weeks, markets have seen sharp falls following the devastating earthquake and tsunami in Japan. In response to volatility in the yen exchange rate associated with the events in Japan, the UK along with other G7 countries took part in a co-ordinated foreign currency intervention on 18 March 2011.

[7] *World Economic Outlook update,* IMF, January 2011.

[8] *G20 Finance Ministers and Central Bank Governors meeting,* Paris, February 2011.

Chart 2.3: Brent crude oil price



Source: Reuters.

UK activity and rebalancing[9]

2.39 In 2010, the UK economy grew by 1.3 per cent, but in line with previous recoveries, quarterly GDP growth has been choppy. Inflation has risen sharply, lifted by temporary factors such as a surge in global commodity prices and the effect of the 2008 depreciation of sterling on import prices. The labour market has shown signs of recovery with private sector employment growing by 428,000 over the course of 2010.

2.40 After four consecutive quarters of growth, the latest estimate from the Office for National Statistics (ONS) suggests GDP fell by 0.5 per cent in the final quarter of 2010.[10] The estimated decline largely reflects the temporary effect of bad weather in December, although the ONS estimate of the underlying strength of the economy was still weaker than expected. The bad weather adds to the significant uncertainty in assessing the underlying strength of the economy.

2.41 The rebalancing of the economy appears to be underway:

- manufacturing output continues to expand rapidly. In 2010, manufacturing output grew by 3.6 per cent, its fastest rate since 1994;
- the value of UK goods exports rose by 17 per cent in 2010, supported by growth to emerging markets: exports of goods to China rose by more than 40 per cent over the year. Recent surveys point toward continued export growth in the coming months, with both the Confederation of British Industry (CBI) and the Chartered Institute of Purchasing and Supply (CIPS) measures of export orders above their long-run averages; and

[9] All data from the Office for National Statistics unless otherwise stated.

[10] Estimate for Q4 GDP updated since Budget to a fall of 0.5%.

- business investment fell very sharply through the recession, but has started to recover and at an earlier stage than in previous recoveries. According to the latest estimate from the ONS, business investment has grown by nearly 7 per cent since the third quarter of 2009. Survey measures of investment intentions have strengthened, as shown in Chart 2.4. The reductions in the rate of corporation tax and healthy financial position of UK companies in aggregate should help support further investment growth.

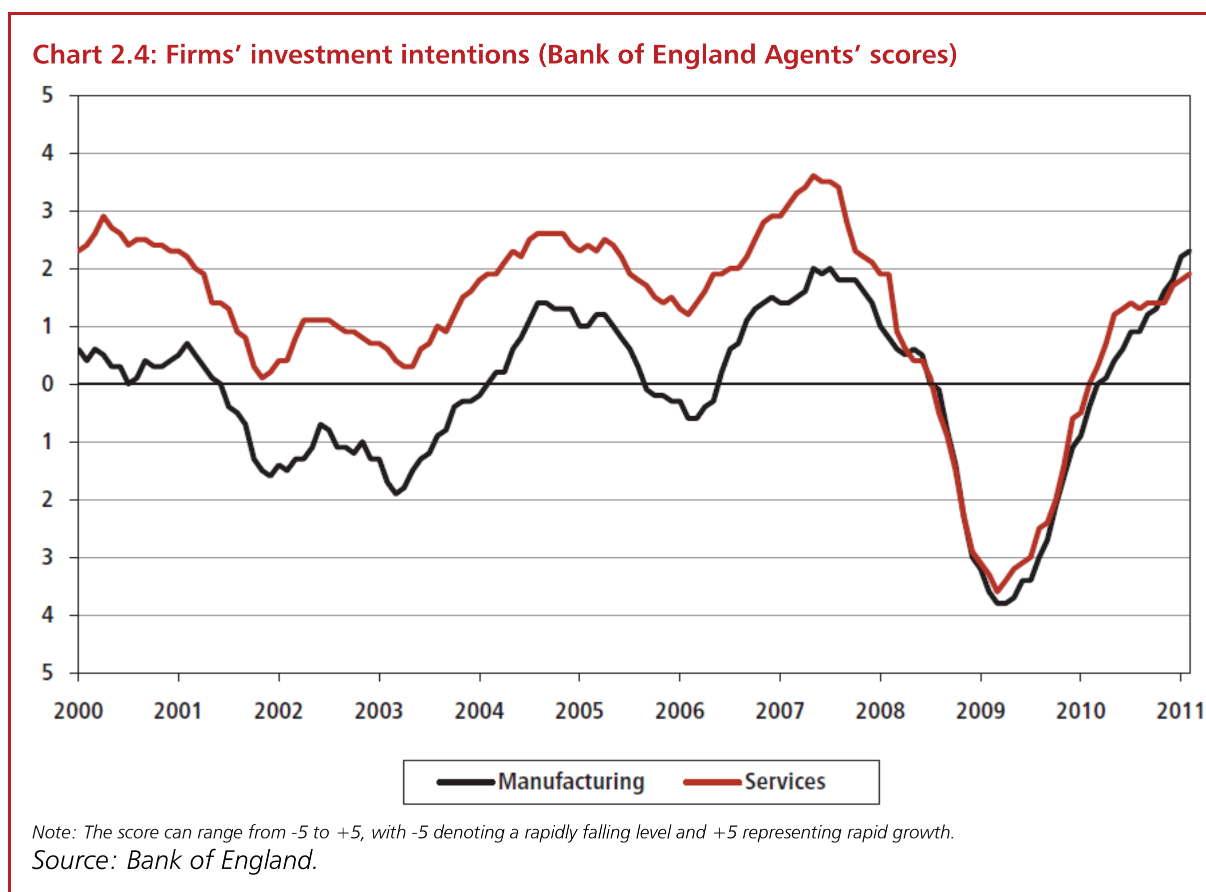


Chart 2.4: Firms' investment intentions (Bank of England Agents' scores)

Note: The score can range from -5 to +5, with -5 denoting a rapidly falling level and +5 representing rapid growth.

Source: Bank of England.

2.42 Output in the services sector, which constitutes around three quarters of the economy, rose by 1.1 per cent in 2010. Construction output rose by 5.6 per cent in 2010, although quarterly output data, which can be volatile, has been uneven. Both the construction and services sectors were affected by the bad weather in December, but survey measures point to recovery at the start of this year.

2.43 Credit conditions have shown signs of stabilisation. Reports from the Bank of England Agents suggest credit availability for larger companies has improved and the cost of credit has decreased. However, credit conditions for smaller firms remain tight. According to the latest Bank of England Credit Conditions Survey, the availability of secured credit to households remained broadly unchanged over the second half of 2010. Net secured lending to households has remained stable, albeit at low levels.

2.44 In February 2011, the five largest banks operating in the UK (Barclays, HSBC, Lloyds Banking Group, The Royal Bank of Scotland and Santander) agreed to make £190 billion of new credit available to businesses this year. Of this total, £76 billion will be made available to small and medium-sized enterprises (SMEs), £10 billion more than the banks lent to SMEs in 2010.

Labour market

2.45 Employment has started to recover, in line with the rise in activity. While public sector employment began to fall from December 2009, and was down by 132,000 in the year to December 2010, private sector employment rose by 428,000. Consistent with this, redundancies

have fallen to their lowest level since August 2008. The ILO unemployment rate rose slightly in the three months to January, to 8.0 per cent. The claimant count fell in February 2011 and is down by almost 130,000 on a year earlier.

2.46 Excluding the effect of bonus payments, whole economy earnings growth picked up progressively through 2010, but remains subdued by historical standards.

Inflation

2.47 Recent months have seen a large and unexpected surge in commodity prices. Since the summer of 2010, world agricultural commodity prices have risen by over 50 per cent,[11] while sterling oil prices have increased by around 40 per cent. These global developments along with other temporary factors, including the lagged effects of the 2008 depreciation of sterling, helped to push up inflation over the past year. CPI inflation was 4.4 per cent in February 2011. In its latest Inflation Report,[12] the Bank of England estimated that, excluding the contribution of these temporary factors, prices of other goods and services have on average increased at a rate below the inflation target in 2010 and that import prices, energy prices, and the increases in the standard rate of VAT together could be adding between 2 to 4 percentage points to CPI inflation in the final quarter of 2010.

Budget 2011 decisions

Fiscally neutral

2.48 Fiscal consolidation is necessary to reduce risks in the short term, restore private-sector confidence and underpin sustainable economic growth. Budget 2011 took place against a backdrop of ongoing global economic uncertainty in the wake of the financial crisis, including from ongoing sovereign debt concerns, most apparent in the euro area periphery, and continued adjustment in the global financial sector. This uncertainty reinforces the case for stability in the Government's plans for fiscal consolidation:

- delivering the Government's fiscal consolidation plan is essential to reduce the risks of a costly loss of market confidence in UK fiscal sustainability. There is evidence that the Government's fiscal plans are delivering improved market confidence;
- a consistent approach from Government in tackling the UK's large structural deficit provides much needed stability and certainty for businesses making hiring and investment decisions; and
- in the current context, stepping back from the Government's commitment to fiscal consolidation would, other things equal, risk prompting an offsetting monetary tightening such that overall there would be little, if any, net support to economic activity even in the short-term.

2.49 The IMF has endorsed the UK Government's action as "*essential*"[13] to ensure debt sustainability and concluded that it will help rebalance the economy. Similarly, the OECD's view is that "*the announcement and initial implementation of the fiscal consolidation programme strikes the right balance between addressing fiscal sustainability and thereby reducing tail-risks on the one hand, and preserving short-term growth on the other*."[14]

[11] As of mid March, according to the S&P GSCI Agricultural Index.

[12] *Inflation Report*, Bank of England, February 2011.

[13] IMF UK Article IV statement, September 2010.

[14] *OECD Economic Surveys: United Kingdom 2011*, OECD, March 2011.

2.50 Previous UK and international experience demonstrates that fiscal consolidation can be achieved alongside continued economic growth. The evidence from the fiscal tightening currently underway in the UK supports this conclusion. Table 2.3 shows Treasury estimates, based on the OBR's forecast, of the cyclically-adjusted primary balance, a measure that excludes the effects of the cycle and debt interest payments on the deficit and so illustrates the underlying fiscal position. This measure tightened by 2.3 per cent of GDP in 2010-11, compared with a year earlier, while the economy returned to growth of 1.3 per cent in 2010. In 2011-12, the projected tightening in the cyclically-adjusted primary balance is of an equivalent scale, at 2.2 per cent of GDP, and the economy is forecast to grow by 1.7 per cent in 2011.

2.51 The OBR forecasts public sector net borrowing to fall from its post-war peak of 11.1 per cent of GDP in 2009-10 to 9.9 per cent of GDP in 2010-11. This fall is largely as a result of the implementation of consolidation measures, including in-year reductions in spending and increases in VAT. The OBR forecasts borrowing to fall further to 7.9 per cent of GDP in 2011-12, which is still above the previous post-war peaks seen in the early 1990s and mid-1970s. Over the medium term, while the OBR forecasts for borrowing and debt are slightly higher than in June Budget 2010, their estimate of the path of the cyclically-adjusted current balance is broadly unchanged. This unchanged outlook for the underlying fiscal position, combined with the significant ongoing uncertainty in the outlook, demonstrates the need to stay the course of planned structural consolidation in the public finances.

2.52 Budget 2011 discretionary policy decisions have a neutral impact on the public finances. The costs of policy decisions announced in Budget 2011 are broadly offset in each year by measures to raise revenue. This balanced judgement reinforces the fiscal consolidation plans announced at June Budget 2010 and Spending Review 2010. Further detail is provided in Chapter 4.

Debt and reserves management

2.53 The *Debt and Reserves Management Report 2011-12*,[15] published alongside Budget 2011, set out details of the Government's financing plans for 2011-12. The projection for the Net Financing Requirement (NFR) in 2011-12 is £167.4 billion. This will be met by gross gilt sales of £169.0 billion and a reduction in the Treasury bill stock of £1.6 billion. Financing for 2011-12 will provide £6.0 billion of financing for the Official Reserves. The Government envisages sterling financing for the Official Reserves being held at a similar level on average over the three years up to, and including, 2014-15. This sterling financing will be sufficient to meet potential calls on the Official Reserves from the IMF and ensure the level of foreign currency reserves is sufficient. The Government retains the option of issuing foreign currency denominated securities. Following any such issuance, sterling financing for the reserves would be adjusted accordingly.

Reform of the spending framework

2.54 Delivering the Government's spending plans will require a more robust framework for spending control, given the scale of the challenge. The current framework splits expenditure into Departmental Expenditure Limits (DEL), which are fixed departmental budgets, and Annually Managed Expenditure (AME), which is not subject to such firm control. The Government is therefore considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets. This will improve incentives to manage AME, in particular social security spending which is the most significant component. Further detail will be set out by the summer.

[15] *Debt and Reserves Management Report 2011-12*, HM Treasury, March 2011.

2.55 Budget 2011 announced that a new Budget Exchange system will be introduced in 2011-12, to replace the End-Year Flexibility system. Further details are set out in Chapter 5. In addition, the Government is introducing a new framework to manage DECC's levy-funded spending, in order to cap the total impact of these policies on energy bills.

Action to address long-term fiscal pressures

2.56 Budget 2011 also announced action to address longer-term fiscal pressures, in particular those arising from an ageing population. The Government has already taken significant action to address future fiscal pressures arising from demographic change, including bringing forward the rise in the State Pension Age (SPA) from 65 to 66 to 2020 from 2026.

2.57 The Budget announced further measures to address long-term spending pressures, setting out the Government's initial response to the final report of the Independent Public Service Pensions Commission, and announcing that the Government will bring forward proposals to manage future increases in the State Pension Age more automatically in response to increases in longevity, including through a regular independent review of the implications of longevity changes.

2.58 The decisions the Government is taking to strengthen the tax system – including the increase in VAT announced at June Budget 2010, the move to CPI indexation of the benefit and direct tax system, and the introduction of the carbon price floor announced at Budget 2011 – will also help to support the long-term sustainability of the public finances.

2.59 Chapter 9 of the Convergence Programme sets out information on long-term fiscal sustainability, according to the OBR's November *Economic and fiscal outlook*. The OBR will publish its first fiscal sustainability report in July, which will provide a full analysis of the long-term sustainability of the UK's public finances.

Economic and fiscal forecast

2.60 Table 2.2 provides a summary of the OBR's central economic forecast. Chapters 6 and 7 of the Convergence Programme reproduce the OBR's economy and fiscal chapters from the March 2011 *Economic and fiscal outlook*, published alongside Budget 2011 and include key tables on the economic and fiscal forecast.[16]

Economic prospects

2.61 The OBR forecast is for a gradual recovery, as the legacy of unbalanced growth and excessive levels of debt continue to weigh on the economic outlook. The economy is forecast to grow by 1.7 per cent in 2011, lower than forecast in June Budget 2010. This mainly reflects higher-than-expected inflation this year, as a result of recent global commodity prices shocks, and the weak, weather-affected final quarter of 2010. GDP growth is then forecast to strengthen, with growth peaking at 2.9 per cent in 2013. Table 2.2 shows the forecast for GDP and contributions to growth.

[16] *Economic and fiscal outlook*, OBR, March 2011.

Table 2.2: Summary of OBR's central economic forecast

	Percentage points, unless otherwise stated						
	Pre-crisis decade average contribution[2]		Forecast				
		2010	2011	2012	2013	2014	2015
Gross domestic product	2.9	1.3	1.7	2.5	2.9	2.9	2.8
Main contributions							
Private consumption	2.1	0.5	0.4	0.8	1.2	1.3	1.4
Business investment	0.6	0.2	0.6	0.8	1.1	1.1	0.9
Dwellings investment[3]	0.1	0.1	0.2	0.2	0.3	0.3	0.2
Government[4]	0.6	0.4	-0.2	-0.5	-0.5	-0.5	-0.3
Change in inventories	0.0	1.4	0.2	0.0	0.0	0.0	0.0
Net trade	-0.6	-0.9	0.7	1.0	0.7	0.6	0.5
CPI inflation (Q4)		3.4	3.9	2.2	2.0	2.0	2.0

[1] *See OBR's* March 2011 Economic and Fiscal Outlook *for further details. All growth rates in this table are rounded to the nearest 1 decimal place. This is not intended to convey a degree of unwarranted accuracy. Components may not sum to total due to rounding, omission of transfer costs of land and existing buildings, and the statistical discrepancy.*

[2] *The average contribution to real GDP growth between 1997 and 2007. In 2006, private consumption accounted for 64 per cent of GDP, business investment for 10 per cent, dwellings investment for 6 per cent, Government for 23 per cent and change in inventories for less than 1 per cent. As explained in paragraph 1.6, more than a quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009.*

[3] *The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.*

[4] *The sum of government consumption and general government investment.*

Source: Office for Budget Responsibility and Office for National Statistics.

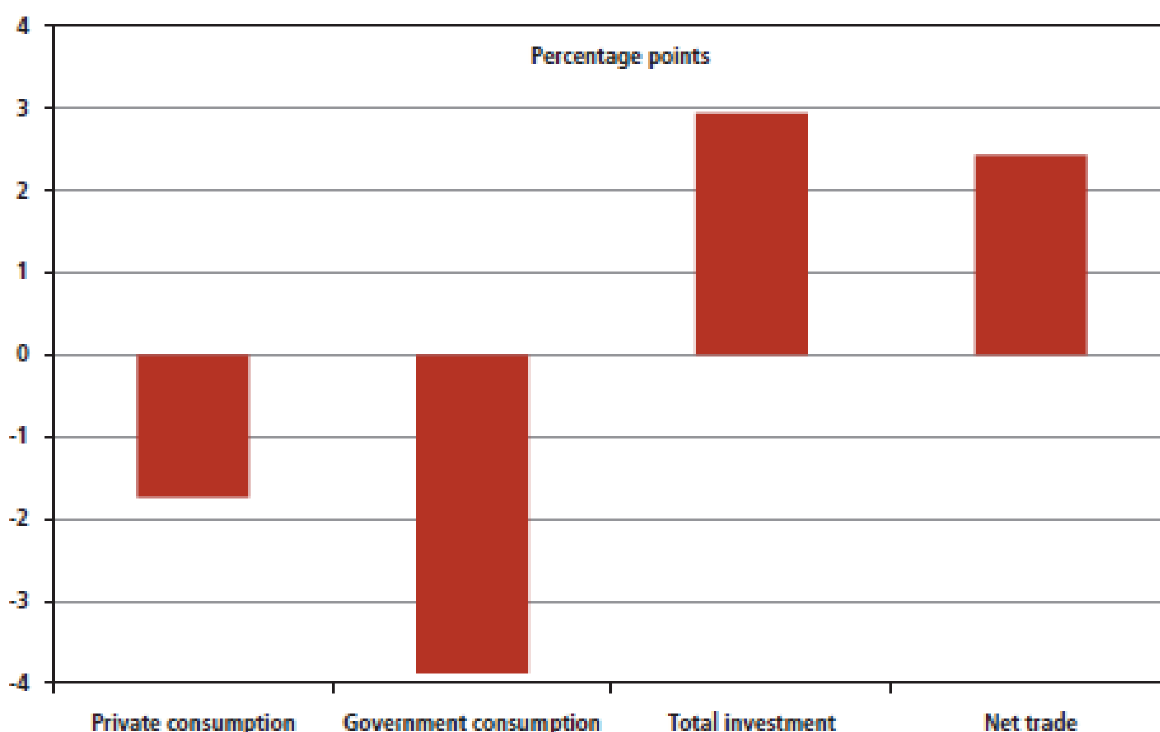
Rebalancing the economy

2.62 As set out earlier in the chapter, significant imbalances in the UK economy built up during the pre-crisis decade. The OBR are forecasting the economy to rebalance, away from private and government consumption towards net trade and investment. As Table 2.2 shows:

- the contribution of private consumption to growth is lower over the forecast period than in the pre-crisis decade. The contribution of government consumption is also forecast to be lower;
- business investment is forecast to grow by between 6½ to 11 per cent in each year over the forecast, and as a result its contribution to growth picks up to over 1 percentage point per year. However, business investment does not return to its pre-recession peak until the third quarter of 2013. This is almost a year later than whole economy output (GDP), and in line with previous recoveries; and
- having made a negative contribution on average through the pre-crisis decade, net trade is forecast to make a significant positive contribution to growth throughout the forecast period, with UK exporters continuing to gain market share into 2013.

2.63 Chart 2.5 shows that as a result of these trends the share of private consumption and government consumption in the economy is forecast to fall and the share of net trade and total investment to rise.

Chart 2.5: OBR forecast change in shares of GDP between 2010 and 2015[1]



[1] *Percentage point change in the share of nominal GDP between 2010-2015 for each expenditure component. Private consumption is forecast to change from 65.7 per cent of GDP in 2010 to 64.0 per cent in 2015, government consumption from 23.2 per cent to 19.3 per cent, fixed investment from 14.6 per cent to 17.5 per cent and net trade (the balance of trade) from -3.2 per cent to -0.8 per cent.*

Source: Office for Budget Responsibility and Office for National Statistics.

Trend output

2.64 The OBR's assessment of trend output growth, including the assumption of a constant structural unemployment rate of around 5¼ per cent, remains unchanged from their previous forecast in November 2010. The OBR's judgement is that the trend rate of growth is projected to be 2.35 per cent, falling back to 2.10 per cent from 2014 as demographic changes reduce the growth of potential labour supply. Based on the latest evidence from cyclical indicators, the output gap is judged to have been around -3 per cent in the third quarter of 2010.

Fiscal prospects

2.65 Table 2.3 provides a summary of the OBR's central forecast for the public finances.

Table 2.3: Overview of OBR central fiscal forecast

	Per cent of GDP						
	Outturn	Forecasts					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Deficit							
Public sector net borrowing	11.1	9.9	7.9	6.2	4.1	2.5	1.5
Surplus on current budget	-7.6	-7.1	-5.8	-4.5	-2.7	-1.2	-0.2
Primary balance	-9.2	-7.1	-5.0	-3.5	-1.3	0.3	1.3
Cyclically-adjusted net borrowing	8.9	7.4	5.3	3.7	2.0	1.0	0.5
Cyclically-adjusted surplus on current budget	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
Total policy decisions [1]		0.0	0.0	0.0	0.0	0.0	0.0
Treaty Deficit[2]	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Debt							
Public sector net debt[3]	52.7	60.3	66.1	69.7	70.9	70.5	69.1
Treaty Debt ratio[4]	71.2	78.7	84.1	87.0	87.2	85.7	83.5
Output Gap	-4.2	-3.4	-3.9	-3.5	-2.8	-2.0	-1.3
Memo: HMT estimate of cyclically-adjusted primary balance [5]	-6.9	-4.6	-2.4	-0.9	0.8	1.9	2.3

[1] Equivalent to the 'Total policy decisions' line in Table 2.1.

[2] General government net borrowing on a Maastricht basis.

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

[4] General government gross debt on a Maastricht basis.

[5] This is a Treasury estimate of the cyclically-adjusted primary balance. It has been calculated by applying the cyclical-adjustment methodology set out in Public finances and the cycle: Treasury Economic Working Paper No.5 (November 2008), which the OBR also use for their forecast of cyclically-adjusted aggregates.

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

2.66 Taking account of the policy measures announced by the Government, the OBR projects that:

- public sector net borrowing will decline from its peak of 11.1 per cent of GDP in 2009-10 to 7.9 per cent of GDP in 2011-12, still higher than its peak in the 1990s recession, and then to 1.5 per cent of GDP in 2015-16;
- the cyclically-adjusted or 'structural' current deficit will be eliminated by 2014-15, with a projected surplus of 0.4 per cent of GDP in that year, rising to 0.8 per cent of GDP in 2015-16; and
- public sector net debt will peak at 70.9 per cent of GDP in 2013-14, before declining to 70.5 per cent of GDP in 2014-15 and 69.1 per cent of GDP in 2015-16.

2.67 The OBR's latest forecast shows that the outlook for the public finances is broadly unchanged since June Budget 2010. Public sector net borrowing this year is slightly lower than forecast in June and November, largely as a result of lower than expected public spending. The forecast for public sector net borrowing is slightly higher over the medium term, by 0.5 per cent of GDP in 2015-16, compared with June Budget 2010. This reflects the OBR's higher forecast for inflation, which results in higher projected AME expenditure on debt interest and social security payments, and also a slightly weaker short-term outlook for economic growth compared with June Budget 2010. However, the OBR's judgement is that this increased borrowing is largely

temporary, cyclical borrowing that will reduce automatically as the economy returns to trend. This means that the forecast for the structural position of the public finances, as measured by the cyclically-adjusted current balance, is broadly unchanged since June Budget 2010, although slightly lower than estimated in November.

Performance against the mandate

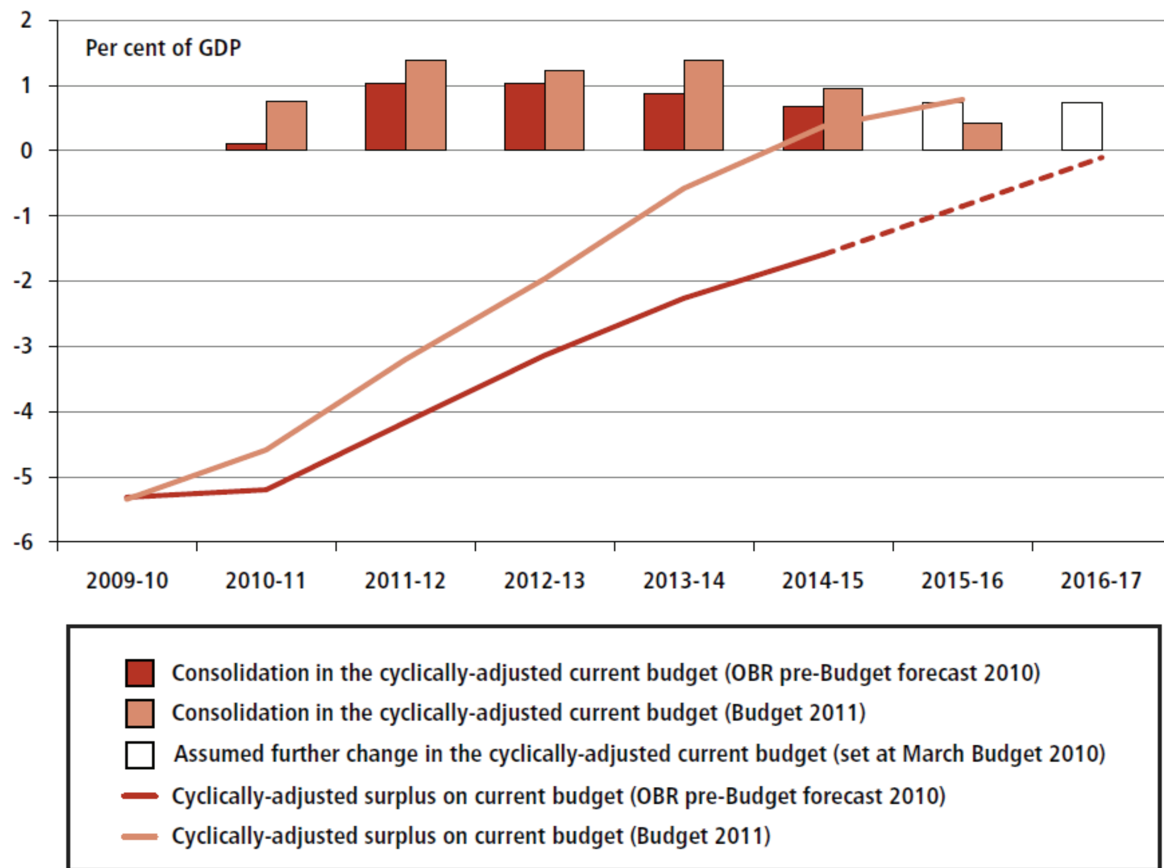
2.68 Charts 2.6 and 2.7 show performance against the Government's fiscal mandate and the supplementary debt target.

2.69 As set out in the OBR's March 2011 *Economic and fiscal outlook* the OBR's judgement is that the policies set out in Budget 2011 are consistent with a greater than 50 per cent chance of achieving the Government's fiscal mandate. Based on past forecasting performance and their central forecast, the OBR estimates that there is a roughly 70 per cent probability that the Government's fiscal mandate will be met.

2.70 It is also the OBR's assessment that the Government's policies have a greater than 50 per cent chance of meeting the target for debt in 2015-16.

2.71 As the OBR has highlighted, all forecasts are subject to uncertainty, but this applies in particular to fiscal forecasts at the present time. Recognising this, the Government has set policy to achieve a surplus on the cyclically-adjusted current budget, so that moderate shocks can be absorbed should they arise. The OBR's central Budget forecast is for the fiscal mandate to be achieved in 2014-15, a year early. The forecast also shows the debt target being achieved a year early in 2014-15.

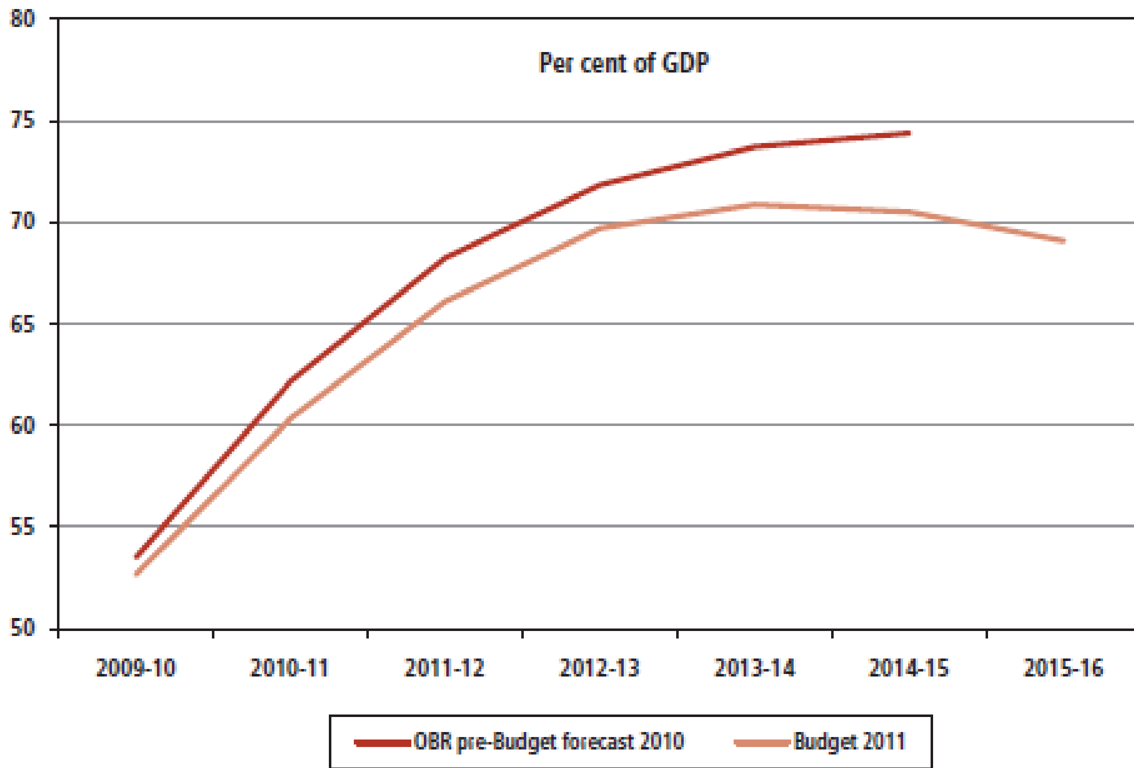
Chart 2.6: Consolidation in the cyclically-adjusted current budget



Note: The OBR pre-Budget forecast 2010 contained projections to 2014-15. The March Budget 2010 assumed further consolidation to 2016-17 based on the average change in the cyclically-adjusted current balance between 2009-10 and 2014-15. This Budget forecasts to 2015-16.

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

Chart 2.7: Public sector net debt



Source: Office for Budget Responsibility and Office for National Statistics.

3 Excessive Deficit Procedure

3.1 The UK entered into Excessive Deficit Procedure (EDP) following a decision by ECOFIN Council in July 2008. In November 2009, the Council concluded that the UK should correct its excessive deficit by reducing the Treaty deficit below 3 per cent of GDP by 2014-15 at the latest. A deadline of 2 June 2010 was established by the Council for the Government to take effective action to meet the recommendations. Some 23 other EU Member States are also currently subject to the Excessive Deficit Procedure.

3.2 As a result of the policy measures announced at June Budget 2010, the Treaty deficit was forecast by the OBR to fall to 2.2 per cent of GDP. Consequently, ECOFIN concluded in July that the UK had acted in accordance with its recommendations, and no additional step in the excessive deficit procedure was therefore necessary at this stage.

3.3 As Table 3.1 shows, the Office for Budget Responsibility's forecast in their March 2011 *Economic and fiscal outlook* projects that the Treaty deficit will fall from 11.4 per cent of GDP in 2009-10 to 2.6 per cent of GDP in 2014-15. Consequently, the path set for fiscal policy is consistent with the UK meeting the European Union's Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP in 2014-15.

3.4 Furthermore, the UK's Treaty debt ratio will be restored to a downward path from 2014-15, also shown in Table 3.1.

Table 3.1: Fiscal projections on a Maastricht basis

	Per cent of GDP						
	Outturn	Forecasts					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Deficit							
Treaty Deficit[1]	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Debt							
Treaty Debt ratio[2]	71.2	78.7	84.1	87.0	87.2	85.7	83.5

1 General government net borrowing on a Maastricht basis.

2 General government gross debt on a Maastricht basis.

Source: Office for National Statistics, Office for Budget Responsibility.

4 Quality of Public Finances

The Government's spending choices and priorities

4.1 The Spending Review, published on 20 October 2010, set out how the Government will carry out Britain's deficit reduction plan.

4.2 The Government made choices through the Spending Review, with particular focus given to reducing welfare costs and wasteful spending. This has enabled the Government to prioritise spending on the NHS, schools, early years provision and the capital investments that support long term economic growth, setting the country on a new path towards long term prosperity and fairness. As a result of these choices, the Spending Review set out that departmental budgets other than health and overseas aid will be cut by an average of 19 per cent over four years, the same pace as planned by the previous government.

4.3 For the first time, the Spending Review covered key areas of Annually Managed Expenditure (AME) in addition to Departmental Expenditure Limits (DELs) for each government department and for the devolved administrations. It set out departmental spending plans for the four years until 2014-15 as well as savings and reforms to welfare, environmental levies and public service pensions.

4.4 On current spending, the Spending Review announced the detailed departmental budgets and other reforms necessary to deliver the planned reductions set out in June Budget 2010. On capital spending, the Spending Review undertook a zero-based review of projects to identify those with the highest economic value. In light of this, the Government increased the capital envelope by £2.3 billion a year by 2014-15 relative to the June Budget 2010 plan in order to ensure that capital projects of high long term economic value were funded. This change has no direct impact on the fiscal mandate, which targets the cyclically-adjusted current balance, and will also not alter the year in which public sector net debt as a percentage of GDP begins to fall.

4.5 As illustrated in Chart 2.2, the spending consolidation will restore spending as a share of the economy to a level closer to its historical average, thereby addressing the structural imbalance in the public finances.

Box 4.A: The Government's approach to the Spending Review

The Government took a completely new approach to the Spending Review, based on openness, innovation and consultation. The Spending Review Framework, published in June 2010, committed the Government to:

- engaging widely. It consulted with experts and the public through roundtable discussions and regional events, and has invited public sector workers and the public to submit money saving ideas through the Spending Challenge website. The most promising ideas from the Spending Challenge website and other representations made by consultees and others were taken into account;
- thinking innovatively about the role of government in society. The Spending Review set out a comprehensive programme of public service reform. The Government appointed an Independent Challenge Group to work with departments and the Treasury to consider opportunities for reform; and
- taking decisions collectively through the Public Expenditure Cabinet committee.

4.6 Decisions taken at the Spending Review confirmed key components of the Coalition Agreement setting out the Government's objectives and priorities for the Parliament, including commitments to:

- provide an NHS that is free at the point of use and available to everyone based on need not the ability to pay, with total NHS spending increasing in real terms in each year of the Parliament, including funding for priority hospital schemes including St Helier, Royal Oldham and West Cumberland;
- uprate the basic State Pension by a triple guarantee of earnings, prices or 2.5 per cent, whichever is highest, from 2011, while bringing forward the date at which the State Pension Age will start to rise to 66 to 2018 in order to ensure this is fiscally sustainable; and
- spend 0.7 per cent of GNI on overseas aid from 2013.

4.7 The Spending Review also secured an increase in the schools budget every year in real terms and additional early years provision for disadvantaged children, as well as meeting Britain's key security and defence commitments. Beyond this, the Spending Review aligned the allocation of public resources with the Government's overall objectives as set out in the Coalition Agreement. These prioritise:

- spending that promotes long term economic growth, introducing structural reforms to enable a private sector led recovery and building a low carbon economy; and
- fairness and social mobility, providing sustained routes out of poverty for the poorest.

4.8 These priorities are underpinned by radical reform of public services to build the Big Society where everyone plays their part, shifting power away from central government to the local level as well as getting the best possible value for taxpayers' money.

Growth

Prioritising growth-enhancing spending

4.9 Over the last decade, the UK's economy became unbalanced, and relied on unsustainable public spending and rising levels of public debt. For economic growth to be sustainable in the medium term, it must be based on a broad-based economy supporting private sector jobs, exports, investment and enterprise.

4.10 At the Spending Review the Government announced that it will:

- protect high value transport maintenance and investment, including over £10 billion over the Spending Review period on road, regional and local transport schemes,[1] including construction of the Mersey Gateway bridge; £14 billion for Network Rail, including major improvements to the East and West Coast Main Lines; £6 billion for upgrades and capital maintenance on the London Underground network; and funding to enable Crossrail to go ahead;
- ensure the UK remains a world leader in science and research by continuing support for the highest value scientific research, maintaining the science budget in cash terms over the Spending Review period with resource spending of £4.6 billion;
- increase adult apprenticeship funding by £250 million a year by 2014-15 relative to the level inherited from the previous government;
- invest in the low carbon economy, including through £1 billion of DEL funding and additional significant proceeds from asset sales for a UK-wide Green Investment Bank, and up to £1 billion for one of the world's first commercial scale carbon capture and storage demonstrations on an electricity generation plant; and
- put higher education on a sustainable financial footing, while providing support to individuals from low income backgrounds. Building on Lord Browne's Review of higher education funding and student finance, universities will be able to increase graduate contributions from the 2012-13 academic year.

The Plan for Growth

4.11 Building on the Government's action to restore economic stability and prioritise growth-enhancing spending, *The Plan for Growth*, published alongside Budget 2011, announced further measures to achieve four overarching ambitions for the British economy:

- to create the most competitive tax system in the G20;
- to make the UK the best place in Europe to start, finance and grow a business;
- to encourage investment and exports as a route to a more balanced economy; and
- to create a more educated workforce that is the most flexible in Europe.

4.12 *The Plan for Growth* set out a range of measures to support these ambitions. For example, the Government will:

- reduce the main rate of corporation tax by a further 1 per cent beyond the reductions announced in June Budget 2010. From April 2011, the rate will be reduced to 26 per cent and, by 2014, it will be reduced to 23 per cent;

[1] Subject to completion of the appropriate statutory process

- drop existing proposals for specific regulations which would have cost business over £350 million a year;
- introduce a powerful new presumption in favour of sustainable development, so that the default answer to development is 'yes';
- reform the Enterprise Investment Scheme (EIS) and Venture Capital Trusts, including raising the rate of EIS income tax relief to 30 per cent from April 2011;
- invest an additional £100 million in science capital development in 2011-12 and £200 million of new funding for rail projects;
- establish 21 new Enterprise Zones;
- fund an additional 80,000 work experience places for young people, ensuring up to 100,000 places will be available over the next two years, and fund up to 50,000 additional apprenticeship places over the next four years; and
- expand the University Technical Colleges programme to establish at least 24 new colleges.

Fairness

Fairness for the future

4.13 Fairness is integral to the Government's fiscal strategy and to sustainable growth. Tackling the deficit will ensure that future generations are not burdened with unsustainable debt and will underpin private sector confidence, supporting growth and job creation over the medium term.

4.14 Social mobility is at the heart of the Government's vision for a fairer Britain. The Government believes that the existing system of support for the poorest has failed to deliver because it:

- relies too heavily on a complex means tested system of cash transfers and traps too many families in a cycle of welfare dependency; and
- fails to provide effective education and other services, particularly for young children, to help disadvantaged families improve their prospects.

4.15 As announced in the Spending Review, the Government is therefore protecting schools spending and increasing support for the poorest in the early years and at every stage of their education by:

- introducing a new fairness premium – worth £7.2 billion in total over the Spending Review period – to support the poorest which includes:
    - an extension from 2012-13 to 15 hours per week of free early education and care to all disadvantaged two year old children, as the cornerstone of a new focus on the foundation years before school;
    - a substantial new premium worth £2.5 billion targeted on the educational development of disadvantaged pupils. The premium will sit within a generous overall settlement for schools, with the 5 to 16s schools budget rising by 0.1 per cent in real terms each year; and
    - protecting those on the lowest incomes in higher education through a National Scholarship fund of £150 million a year by 2014-15.

- providing capital funding for new schools, rebuilding or refurbishing over 600 schools through the Building Schools for the Future programme and investing in new school provision in areas of demographic pressure;
- protecting funding for Sure Start services in cash terms, including new investment in Sure Start health visitors; and
- supporting further increases in participation for 16 to 19 learning, while moving towards raising the participation age to 18 by 2015.

4.16 The Government also announced plans in the Spending Review to:

- introduce fundamental reforms to simplify the welfare system, promoting work and personal responsibility through the new Universal Credit as well as providing enhanced support for those with the greatest barriers to employment through the Work Programme. The Universal Credit will be introduced over two Parliaments to replace the current complex system of means tested working age benefits. It will ensure that work always pays and reduce fraud and error, while helping ensure that the welfare system is affordable;
- put the welfare system on a sustainable footing, making net welfare savings of £7 billion a year, including through withdrawing Child Benefit from families with a higher rate taxpayer, reforming Employment and Support Allowance, controlling the cost of tax credits, and capping the amount a workless household can receive in benefits to no more than an average family gets by going out to work;
- make social housing more responsive, flexible and fair so that more people can access social housing in ways that better reflect their needs. In future, social housing will more effectively reflect individual needs and changing circumstances. Social landlords will be able to offer a growing proportion of new social tenants new intermediate rental contracts that are more flexible, at rent levels between current market and social rents. The terms of existing social tenancies and their rent levels remain unchanged. Taken together with continuing, but more modest, capital investment in social housing, this will allow the Government to deliver up to 150,000 new affordable homes over the Spending Review period; and
- allocate £2 billion a year of additional funding by 2014-15 to support social care. Combined with a programme of reform and efficiency savings, such as greater use of personal budgets, this will mean local authorities will be able to improve outcomes and will not need to reduce eligibility for services.

4.17 The reforms underpinning the Spending Review represent a significant increase in the opportunities and funding available to the voluntary and community sector (VCS) in the medium and longer term. However, to help VCS organisations prepare for these opportunities, the Spending Review made provision for a Transition Fund to support VCS organisations in the short term.

4.18 At Budget 2011 the Government set out the next steps in realising its vision of a fair, simple and efficient tax, benefit and pensions system which rewards work, saving and personal responsibility. In particular the Government will:

- increase the personal allowance for under 65s by £630 in April 2012, with the higher rate threshold unchanged, a further step towards the £10,000 personal allowance commitment;
- change the underlying indexation basis for direct taxes to the Consumer Prices Index (CPI) from April 2012. For the duration of this Parliament, the annual increases in the

employer NICs threshold, the age related allowance and other thresholds for older people will be over-indexed compared to the CPI and will increase by the equivalent of the Retail Prices Index (RPI);

- cut fuel duty by 1 pence per litre on Budget day. The fuel duty escalator will be replaced with a fair fuel stabiliser that increases tax on North Sea oil production when oil prices are high. The April 2011 inflation-only increase will be delayed to January 2012. The April 2012 increase will be delayed to August 2012. The Government will increase the Supplementary Charge on oil and gas production to 32 per cent from 24 March 2011;
- reform the state pension system for future pensioners so that it provides simple, contributory, flat-rate support above the level of the means tested Guarantee Credit;
- reform the taxation of non domiciles, including an increase in the annual charge for non domiciled individuals who have been in the UK for more than twelve years;
- tackle tax avoidance including action to prevent attempts to disguise employment income, raising around £4 billion over the Parliament; and
- reduce the rate of inheritance tax to 36 per cent from April 2012 for estates leaving 10 per cent or more to charity. Charities will also be allowed to claim new Gift Aid on up to £5,000 of small donations per year.

Everyone making a fair contribution

4.19 The Government will continue to support the most vulnerable while ensuring all sections of society who are able to do so contribute to deficit reduction. To do this and ensure that the choices made are fair, the Government for the first time has undertaken and published a distributional analysis of the impacts of the entire fiscal consolidation. Budget 2011 set out the most recent analysis. While the estimates have limitations and continue to be refined, they show that those in most need will continue to receive the most support from the state in absolute terms and, relative to the amount they consume, those on the highest incomes will experience the greatest reduction in the services they receive. The estimates also show that after combining the impact of tax, benefits and public service spending changes, the highest quintile of earners will make the greatest contribution towards reducing the deficit as a percentage of their income and benefits in kind.

4.20 Like all parts of the UK, the devolved administrations will bear a share of the cuts, although they will not be disproportionately affected. The reduction to their overall budget will be slightly better than the UK average, and they are free to allocate their budgets in line with local needs and priorities.

4.21 To ensure deficit reduction is implemented fairly, the Government will:

- take further action to combat tax fraud, evasion and avoidance with over £900 million of funding to raise an estimated £7 billion a year of extra tax revenue by 2014-15, while also making 25 per cent efficiency savings to focus funds on frontline tax collection;
- consult on major reforms to the legal aid system, targeting funding on those who need it most; and
- protect essential investment, which will mean that some public transport fare increases will be unavoidable. This will include raising rail fares where necessary.

4.22 The Government wants the UK to be one of the most competitive global centres for financial services. But it is only right that during difficult times, steps are taken to ensure that the banks make a full and fair contribution. The Government is taking forward its announcement in June Budget 2010 of a Bank Levy as an additional and permanent tax on the industry. Working

with international partners, the Government is also committed to taking forward work on a Financial Activities Tax on profits and remuneration.

4.23 As announced at Budget 2011, from January 2012 the Government will increase the rate of the Bank Levy, a permanent tax on banks' balance sheets which, with the increase announced previously for 2011, is now expected to raise £10 billion over the lifetime of this Parliament. The increase in the rate from January 2012 offsets the further reduction in the rate of corporation tax announced in Budget 2011. This change will ensure that banks continue to make a fair contribution while also ensuring that they continue to be encouraged to move to less risky funding models. The Bank Levy will raise over £2.5 billion each year, as compared with the one-off net yield of £2.3 billion from the bank payroll tax.

Reform

4.24 The Government's plans are underpinned by a radical programme of public service reform, changing the way services are delivered by redistributing power away from central government and enabling sustainable, long term improvements in services. This programme is built on the Coalition principles of increasing freedom and sharing responsibility, by:

- localising power and funding, including by removing ringfencing around resources to local authorities and extending the use of personal budgets for service users;
- cutting burdens and regulations on frontline staff, including policing, education and procurement;
- increasing diversity of provision in public services through further use of payment by results, removing barriers to greater independent provision, and supporting communities, citizens and volunteers to play a bigger role in shaping and providing services; and
- improving the transparency, efficiency and accountability of public services.

4.25 As a result, the plans set out at the Spending Review:

- provide a settlement for local government that radically increases local authorities' freedom to manage their budgets, but will require tough choices on how services are delivered within reduced allocations;
- announce that the sentencing framework will be reformed so that it both punishes the guilty and rehabilitates offenders more effectively, stemming the unsustainable rise in the UK prison population. This will include paying private and voluntary sector providers by results for delivering reductions in reoffending;
- ensure the effectiveness of frontline policing can be protected by reviewing terms and conditions of service, and making efficiencies in IT, procurement and the back office to deliver savings; and
- take decisive action to cut the cost of central government, with a 34 per cent cut in administration budgets across the whole of Whitehall and its Arms Length Bodies, saving £5.9 billion a year by 2014-15.

4.26 The final report of Lord Hutton's Independent Public Service Pensions Commission was published on 10 March 2011. The Government accepts Lord Hutton's recommendations as a basis for consultation with public sector workers, trades unions and others, recognising that the position of the uniformed services will require particularly careful consideration. The Government will set out proposals in the autumn that are affordable, sustainable and fair to both the public sector workforce and the taxpayer.

4.27 On Defence, the Spending Review provides the resources needed to defend the UK and its interests, and to fulfil the Government's objectives to strengthen international peace and stability. The Spending Review fully funds Britain's operations in Afghanistan, and targets investment on cyber defence and other expected future threats, in line with the outcome of the Strategic Defence and Security Review.

Implementing the Spending Review

4.28 Implementation of the Government's fiscal plans is underway. The Government is on course to deliver the £6.2 billion of savings announced in May 2010.

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

4.30 The Government is implementing plans and reforms announced in the Spending Review. Legislation has been introduced to Parliament where necessary, including the Welfare Reform and Pensions and Savings Bills. Detailed funding settlements have also been announced, including for local government, schools and science.

4.31 The Government is committed to ensuring the spending consolidation is delivered. The Public Expenditure Cabinet Committee will oversee departments' implementation of their Spending Review plans, holding them to account on their progress. Business plans for each department, setting out information on key reform programmes and performance data on public services, are being finalised this spring. The public will be able to monitor progress on plans through monthly reports and a quarterly performance scorecard for each department.

4.32 The Government has implemented the tax plans for 2011-12 announced or confirmed in June Budget 2010, including the increase in the standard rate of VAT to 20 per cent on 4 January 2011.

4.33 Each Government department has published a business plan setting out the details of its reform plans, in particular:

- vision and priorities to 2014-15;
- a structural reform plan, including actions and deadlines for implementing reforms over the next two years; and
- the key indicators against which it will publish data to show the cost and impact of public services and departmental activities.

Summary of Total Managed Expenditure

4.34 Table 4.1 sets out the path for Total Managed Expenditure (TME), Public Sector Current Expenditure (PSCE) and Public Sector Gross Investment (PSGI) to 2015-16. This reflects the Spending Review 2010 announcement of an increase in PSGI of £2.3 billion a year by 2014-15 relative to the spending envelopes set out at June Budget 2010, to ensure that capital projects of high long term economic value are funded. It also reflects updated estimates of savings from AME policies. Budget 2011 confirmed that TME in 2015-16 will increase in line with general inflation in the economy.

Table 4.1: Total Managed Expenditure

	£ billion					
			Forecasts			
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
CURRENT EXPENDITURE						
Resource Annually Managed Expenditure	287.4	314.4	324.9	333.3	346.4	360.8
Resource Departmental Expenditure Limits[1]	345.4	342.3	344.7	349.1	348.2	352.5
of which						
RDEL excluding depreciation [2]	*326.1*	*326.3*	*327.1*	*331.1*	*329.0*	*333.1*
Public sector current expenditure	632.8	656.7	669.6	682.4	694.6	713.4
CAPITAL EXPENDITURE						
Capital Annually Managed Expenditure	11.5	9.2	8.0	8.5	8.8	7.7
Capital Departmental Expenditure Limits[1]	50.0	44.5	42.6	39.2	40.3	42.7
Public sector gross investment	61.6	53.7	50.7	47.7	49.1	50.4
TOTAL MANAGED EXPENDITURE	694.4	710.4	720.2	730.1	743.6	763.8
Memo:						
TME if AME margin as set for Spending Review 2010 period is spent		*711.4*	*722.2*	*733.1*	*747.6*	

[1] The Government has not set DEL for 2015-16. Implied DEL numbers for 2015-16 are calculated as the difference between Resource AME and PSCE for Resource DEL (RDEL) and the difference between Capital AME and PSGI in the case of Capital DEL.

[2] RDEL excluding ring-fenced non-cash depreciation is the Treasury's primary control within resource budgets and the basis on which Spending Review settlements were agreed.

Source: HM Treasury, Budget 2011

5 Institutional features of public finances

The fiscal policy framework

5.1 As detailed in Chapter 2, June Budget 2010 set out comprehensive policies to bring the public finances back under control, this action involved substantial fiscal framework reform, including:

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

Office for Budget Responsibility

5.2 The Government's fiscal policy decisions are now based on the independent forecasts of the economy and public finances prepared by the OBR. These forecasts were previously determined by the judgements of the Chancellor of the Exchequer. Since the General Election in May 2010 the OBR has produced all the official forecasts of the economy and public finances, independently of Ministers.

5.3 The Government established the OBR on an interim basis on 17 May 2010. The interim body, chaired by Sir Alan Budd, provided an independent assessment of the UK economy and public finances on 14 June 2010.[1] The OBR produced the economy and public finances forecast on the basis of the Government's plans at June Budget 2010.

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

5.5 On 9 September 2010, the Government announced Robert Chote as its preferred candidate for the position of Chair of the OBR. Mr Chote's appointment was approved by the Treasury Select Committee on 16 September 2010. On 12 October 2010, the Government announced Professor Stephen Nickell and Graham Parker as its preferred candidates for membership of the Budget Responsibility Committee alongside Mr Chote. They were subsequently approved under the same process. The non-executive members are currently being recruited.

Remit of the OBR

5.6 The OBR has now been placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011, which received Royal Assent on 22 March 2011. Prior to this, the OBR operated on an interim basis consistent with the Terms of Reference published by the Treasury.

[1] Office for Budget Responsibility, pre-Budget forecast, June 2010

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

5.8 As set out in the Budget Responsibility and National Audit Act 2011, the OBR's responsibilities include:

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

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

Transparent framework

5.10 To ensure credibility of the fiscal framework and protect the independence of the OBR it is vital for there to be transparency in the responsibilities of the OBR and the rest of Government. To support and clarify the provisions in the Act, there are a number of documents that seek to achieve this.[2]

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

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

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

Fiscal objectives

5.14 To promote transparent fiscal policy-making, the new fiscal policy framework, established by the Budget Responsibility and National Audit Act 2011, introduces a requirement for the Government to set out its fiscal policy objectives and fiscal mandate before Parliament in the

[2] Documents available at http://www.hm-treasury.gov.uk/data_obr_index.htm

Charter for Budget Responsibility. The Government published the final version of the Charter on 4 April 2011, having published a draft version on 22 November 2010.

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

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

The fiscal mandate and supplementary target for debt

5.16 As previously detailed in Chapter 2, the Budget Responsibility & National Audit Act 2011 also requires the Government to set a means to achieving its fiscal objectives, its "fiscal mandate". The Government has set out a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. At Budget 2011, the end of the forecast period was 2015-16.

5.17 The fiscal mandate is based on:

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

5.18 June Budget 2010 also announced a supplementary target for debt. This requires public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

5.19 The Government has asked the OBR independently to judge whether fiscal policy is consistent with: a greater than 50 per cent chance of meeting the mandate; and with a greater than 50 per cent chance of meeting the target for debt.

5.20 The choices of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflect the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which cyclically-adjusted current balance must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

Reform of the spending framework

5.21 Delivering the Government's spending plans, set out in Chapters 2 and 4, will require a more robust framework for spending control, given the scale of the challenge. The current framework splits expenditure into Departmental Expenditure Limits (DEL), which are fixed departmental budgets, and Annually Managed Expenditure (AME), which is not subject to such firm control. The Government is therefore considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets. This will improve incentives to manage AME, in particular social security spending which is the most significant component. Further detail will be set out by the summer.

5.22 At Budget 2011, the Government announced that a new Budget Exchange system will be introduced in 2011-12, to replace the End-Year Flexibility system which has now been abolished. This will provide departments with flexibility to deal with slippage in expenditure while strengthening spending control. Budget Exchange will allow departments to surrender an

underspend in advance of the end of the financial year in return for a corresponding increase in their budget in the following year, subject to a prudent limit.

5.23 In addition, the Government is introducing a new framework to control the levy-funded spending of the Department of Energy and Climate Change (DECC).

Accounting and Statistics

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

5.25 Information on the UK's contingent liabilities are published for all Central Government departments. The forthcoming publication of Whole of Government Accounts (WGA) will extend the coverage across Government.

5.26 Whole of Government Accounts (WGA) are full accruals based accounts covering the whole public sector and audited by the National Audit Office. WGA is a consolidation of the accounts of around 1500 bodies from central government, devolved administrations, the health service, local government and public corporations.

OBR's Economic and fiscal outlook: selected chapters

The Government's fiscal policy decisions are based on independent forecasts for the economy and public finances, prepared by the Office for Budget Responsibility (OBR). Creating the new OBR has introduced independence, greater transparency and credibility to the economic and fiscal forecasts on which fiscal policy is based.

In order to provide the EU Commission with the detail required by the Code of Conduct, the Convergence Programme draws on the reports produced by the OBR. Required information on Government policy and objectives has been set out in Chapters 1 to 5.

Chapters 6 to 8 reproduce the relevant chapters from the OBR's March 2011 *Economic and fiscal outlook.* All data contained in these chapters is correct as of 23 March 2011. Chapter 9 reproduces information on long-term fiscal sustainability from the OBR's November 2010 *Economic and fiscal outlook.* The OBR will publish its first fiscal sustainability report in July, which will provide a full analysis of the long-term sustainability of the UK's public finances.

These chapters are structured as follows:

- Chapter 6 of the Convergence Programme sets out the economic outlook for the UK;
- Chapter 7 of the Convergence Programme sets out the fiscal outlook for the UK, including information on general government balance and debt;
- Chapter 8 of the Convergence Programme relates to performance against the Government's targets. This includes sensitivity analysis and recognises uncertainty; and
- Chapter 9 of the Convergence Programme sets out information on the sustainability of the public finances.

Further detail and explanation can be found in the OBR reports.

Office for
Budget
Responsibility

Economic and fiscal outlook

6 Economic outlook

Summary

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

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

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

6.4 Key judgements in our central forecast include that:

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

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

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

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

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

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

6.7 To reflect this uncertainty, Chart 6.1 presents our central growth forecast with a fan chart showing the probability of different outcomes based on past Treasury forecasting errors (rather than a subjective assessment of particular risks). The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.[1] More details on this methodology can be found in Annex B of the November 2010 *Outlook*.

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

Table 6.1: Summary of central forecast and changes since November[1]

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

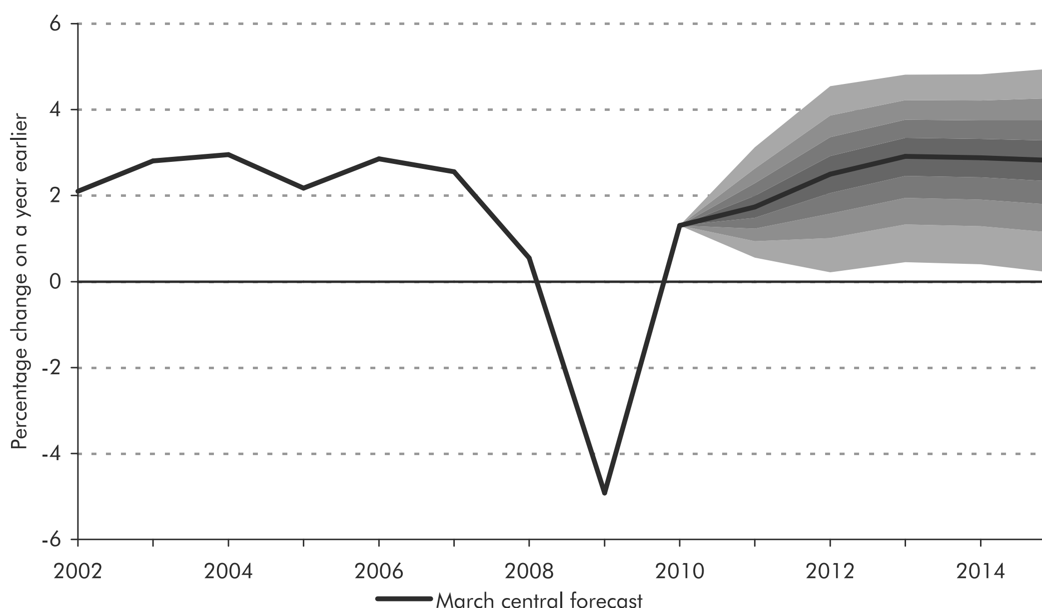
[1] The forecast is consistent with output, income and expenditure data for the fourth quarter of 2010, released by the Office for National Statistics on 25th February 2011.

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

[3] Contribution to GDP growth, percentage points

[4] Wages and salaries divided by employees

Chart 6.1: GDP fan chart



Source: ONS, OBR

6.8 Later in this chapter we detail two illustrative economic scenarios that reflect some of the debates among external forecasters. These help illustrate the risks to our central forecast and in Chapter 5 (equivalent to chapter 8 of this Convergence Programme) we describe the implications of these scenarios for the public finances. In summary these scenarios are:

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

Introduction

6.9 In this chapter, we begin by setting out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (paragraphs 6.10-6.19). We then discuss how quickly the economy is likely to return to its full potential (paragraphs 6.20-6.35) before describing the outlook for credit conditions (paragraphs 6.36-6.46). After setting out the likely composition of the recovery (paragraphs 6.47-6.82) we assess prospects for inflation and the labour market (paragraphs 6.83-6.98 and 6.99-6.106). We then compare our forecast with external forecasts (paragraphs 6.107-6.114) and conclude by setting out two illustrative economic scenarios (from paragraph

6.115), the fiscal implications of which we assess in Chapter 5 (equivalent to chapter 8 of this Convergence Programme).

Potential output, trend growth and the ouput gap

Latest estimates of the output gap and potential output

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

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

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

- in its January *Economic Review*, the National Institute for Economic and Social Research (NIESR) estimated that output was 4 per cent or more below potential;
- in its *Autumn Forecast*, the European Commission estimated that output was just over 5 per cent below potential in 2010, compared to 5½ per cent in 2009;
- in its October 2010 *World Economic Outlook*, the IMF estimated that output was 2.7 per cent below potential in 2010;
- in its latest *Economic Survey of the United Kingdom*, the OECD estimated that output was 4.6 per cent below potential in 2010; and

- a number of external members of the Bank of England's Monetary Policy Committee (MPC) have expressed views on the size of the output gap. In speeches made in the final quarter of 2010, Adam Posen suggested that output was at least 3 per cent below potential and probably more than 4 per cent below, and Martin Weale estimated that output was 4-6½ per cent below potential.[2]

6.13 Chart 6.2 presents our updated estimates of the output gap using two approaches:

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

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

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

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

6.16 The full set of survey data needed to estimate the output gap in the fourth quarter of 2010 is not yet available and the information that is available is mixed. BCC indicators of capacity utilisation in both services and manufacturing fell back slightly, while the CBI manufacturing indicator increased. Similarly, the BCC recruitment difficulties indicators picked up slightly in services, but fell back

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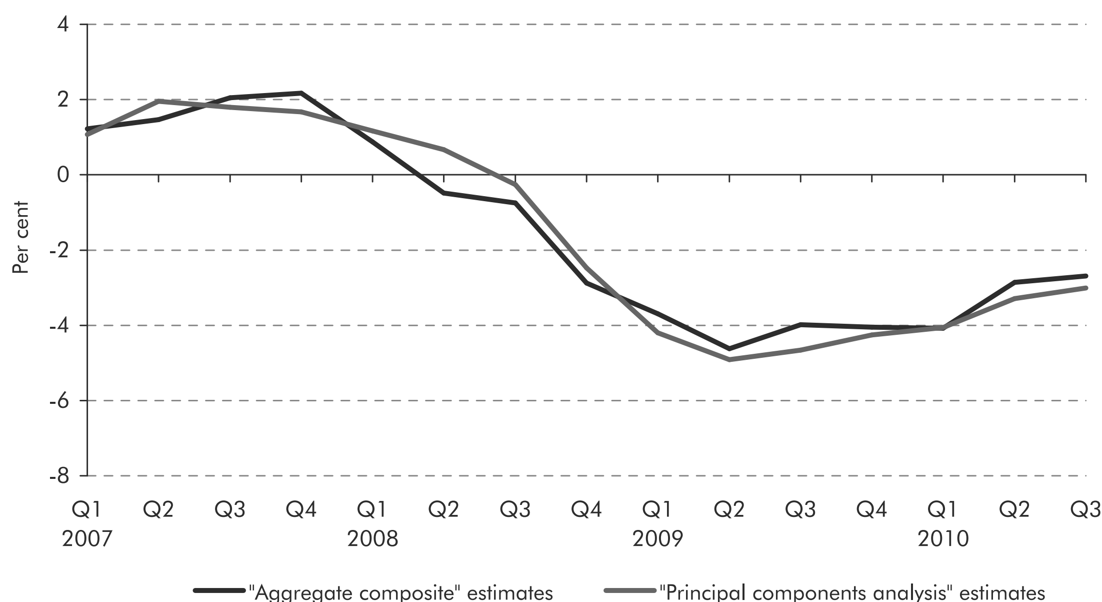
[2] http://www.bankofengland.co.uk

significantly in manufacturing. By contrast, ONS labour market indicators suggest greater labour market slack in the final quarter, with the unemployment rate picking up to 7.9 per cent from 7.7 per cent in the previous quarter and annual private sector average earnings growth slowing to 1.7 per cent.

Chart 6.2: Estimates of the output gap based on cyclical indicators



Source:OBR

Decomposing the output gap

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

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

The growth of potential

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

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

6.19 As discussed in Box 6.1, we do not believe there is sufficiently strong evidence to justify changing our trend growth assumption in light of policy measures announced in Budget 2011. If these measures do improve the long-term productive potential of the economy, we expect this would, in time, show up in our contemporaneous estimates of the output gap.

Table 6.2: Trend output assumptions (annualised growth rates, per cent)

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

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

Box 6.1: The impact of policy changes on the economy forecast

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

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

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

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

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

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

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

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

The pace of the recovery

The short-term outlook

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

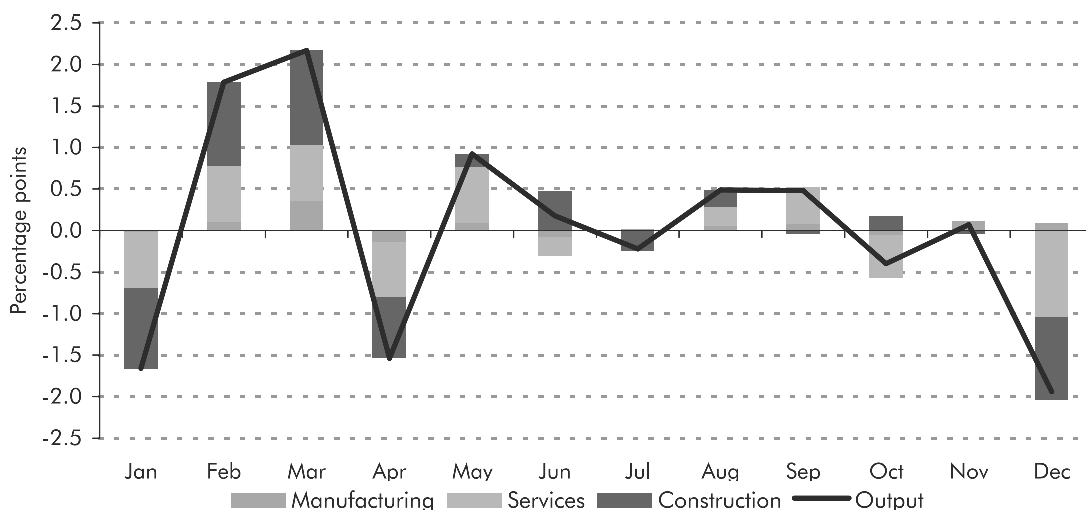
6.21 Independent forecasters surveyed in January, after the snow had fallen, were still, on average, expecting GDP to have risen by 0.5 per cent in the fourth quarter, with the range of estimates extending from 0.2 to 0.6 per cent. The explanation for such a large near-term forecast error is two-fold.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

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

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

6.24 Chart 6.3 shows the effect of previous disturbances on the monthly growth rate of output. A useful comparison is with January 2010, when heavy snow last disrupted activity. Services output contracted sharply on the month before recovering in February.

Chart 6.3: Monthly output growth in 2010 – seasonally adjusted[1]



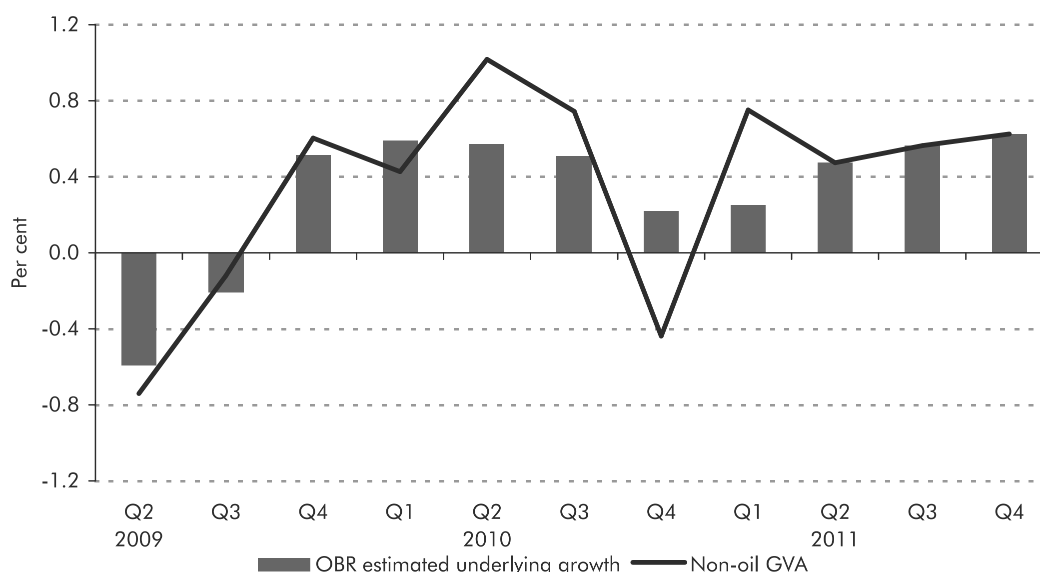
[1] Seasonally adjusted monthly construction data are not available so the quarterly seasonal adjustments have been applied to their constituent months. No construction data are available for December 2009 so the January growth rate is relative to the average output in the final quarter of 2009.

Source: ONS, OBR

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

6.26 Chart 6.4 attempts to isolate the underlying growth momentum of the economy by stripping out the effects of both snow and VAT changes, as well as the recent volatility in construction data. Underlying growth is defined here as non-oil GVA excluding construction. Adjustments have been made to the quarterly profile around the turn of the year in both 2009 and 2010 consistent with our estimate of the timing effects attributable to changes in VAT and adverse weather. Overall, these timing adjustments have a neutral effect on the level of output. The chart suggests that the headline growth figures not only overstated the underlying weakness of the economy in the fourth quarter, but also that they overstated the underlying strength of the economy in the previous two quarters.

Chart 6.4: OBR-estimated underlying growth rate



Source: ONS, OBR

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

6.28 We expect growth to slow again in the second quarter of the year, as the snow-related rebound falls out of the quarterly comparison. We then expect growth to pick up gradually through the second half of the year, but at a slower pace than we forecast in November. Higher commodity prices represent a shock to the level of prices which reduces the purchasing power of income. The depressing impact of weaker real household disposable income on consumption is the main driver of the weaker outlook for GDP growth in 2011. Box 6.2 discusses the impact of the higher oil price on the economic forecast.

Table 6.3: The quarterly GDP profile

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

[1] Forecast from fourth quarter of 2010
[2] Forecast from third quarter of 2010

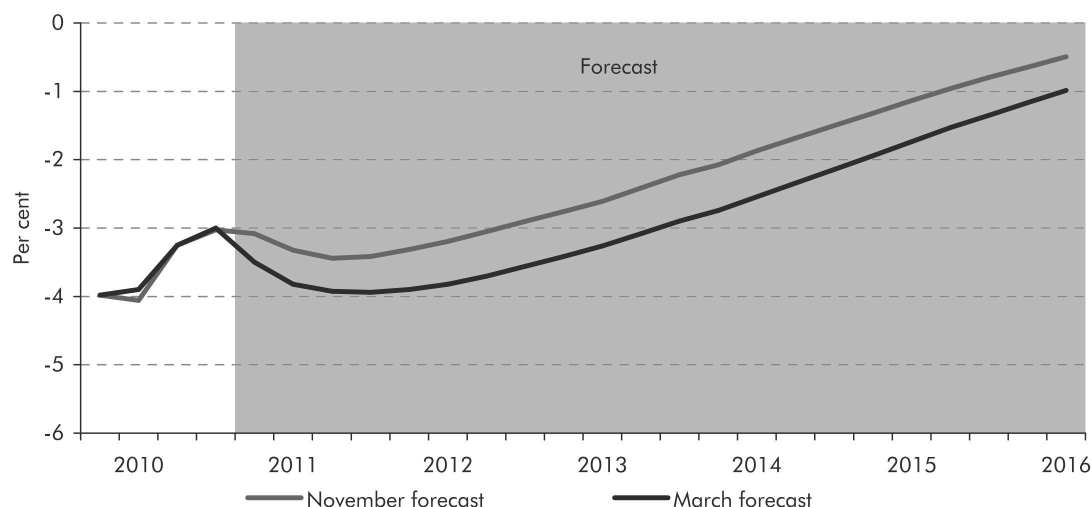
6.29 To conclude, judging the underlying pace of growth of the economy throughout 2010 and into 2011 is more difficult than usual. In these circumstances it makes sense to concentrate on the average growth rate across the final quarter of 2010 and the first quarter of 2011. On average, we have revised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

The medium-term outlook

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

6.31 Chart 6.5 shows that, after widening a little in 2011, we expect the output gap to begin closing in 2012, and then to narrow steadily from 2013. On this basis, year-on-year GDP growth is forecast to strengthen only slightly in 2011 before picking up steadily to reach a peak of 2.9 per cent in 2013. Compared to our November forecast, near-term growth has been revised down, but there are small upward revisions to later years, reflecting the increased scope for growth implied by a slightly larger amount of spare capacity. This leaves the level of real GDP at the end of the forecast around 0.7 per cent lower than we expected in November.

Chart 6.5: The output gap[1]



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

Source: OBR

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

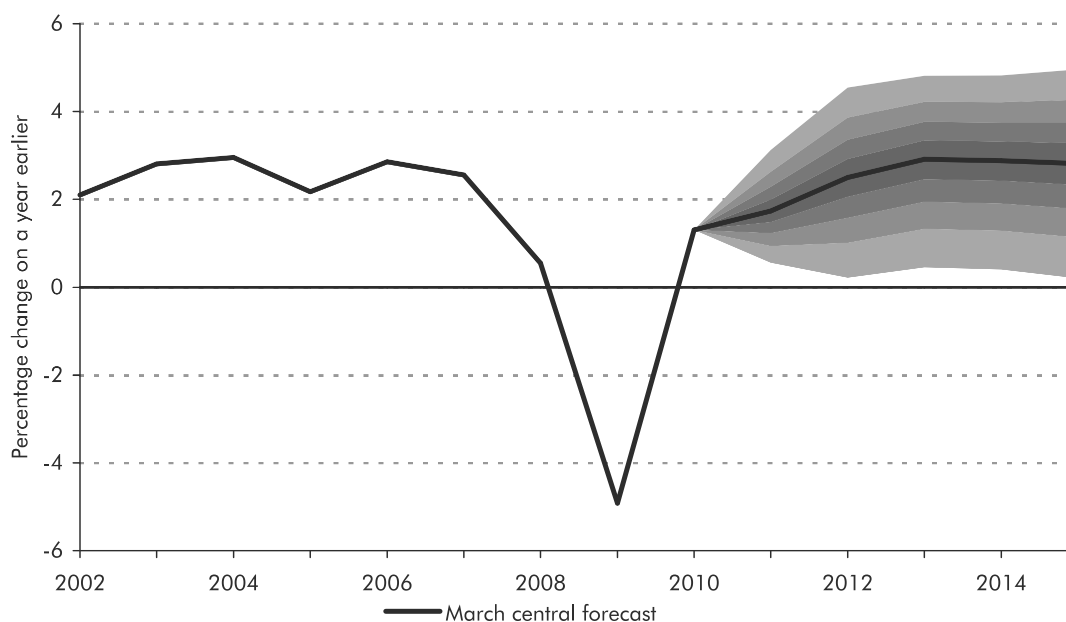
6.33 As in November, given our judgement about the degree of spare capacity in the economy, we assume that the Bank of England will allow above-trend growth in order for the economy to return to its trend level of output.

6.34 Our central growth forecast is shown in Chart 6.6. The distribution surrounding it shows the probability of different outcomes if you expected our forecasts to be as accurate as official Budget and PBR forecasts have been in the past. The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.[4]

[3] www.bankofengland.co.uk

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

Chart 6.6: GDP fan chart



Source: ONS, OBR

6.35 Chart 6.7 compares our GDP forecast with the historical paths of output following the 1980s and 1990s recessions, starting from the same stage of recovery.[5] We also plot the GDP forecast implied by the average of independent forecasts.[6] While we expect a slightly stronger recovery than that implied by the average of independent forecasts beyond 2011, our GDP growth forecast is slow relative to previous recoveries. This reflects the effects of the fiscal consolidation, the relatively slow easing of tight credit conditions and ongoing private sector deleveraging.

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

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

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

Chart 6.7: The level of GDP in previous recoveries and current forecasts

Source: ONS, HMT, OBR

Credit conditions

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

Financial sector

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

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

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

Box 6.2: The oil price and the economic forecast

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

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

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

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

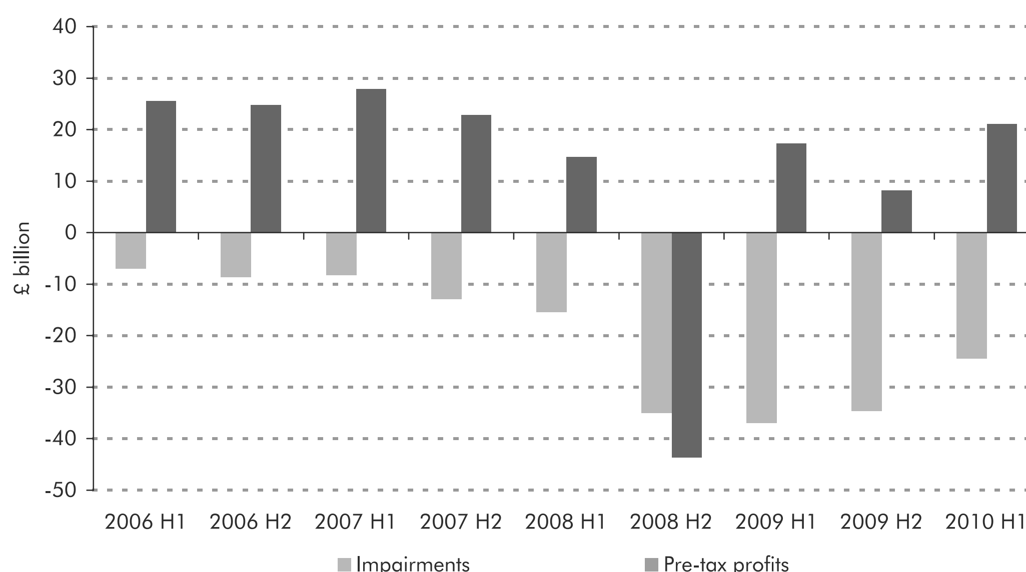
It is too soon to assess whether recent increases in the oil price have affected or will affect the economy's long-run supply potential. In the event that the increase in the oil price is both persistent and has an effect on potential supply this will tend to reduce the size of the output gap. In such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

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

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

6.40 The capital positions of major UK banks improved in the first half of 2010, mainly due to increased profits led by improved trading income and a fall in impairments, as shown in Chart 6.8. Announcements of full year profits in recent months, and market expectations, point to a continued improvement in profitability that should further strengthen the capital positions of UK banks this year.

Chart 6.8: Major UK banks' pre-tax profits and impairments



Source: Bank of England

Credit supply and demand

6.41 In 2009 and 2010, the private sector paid back more existing debt than it took on new debt, as shown in Table 6.4.[7] This is likely to reflect a combination of tighter supply (reflected in higher funding costs) and reduced demand (as deleveraging continues). Analysis of past financial crises has shown that subsequent economic recoveries have not typically been associated with a rebound in the stock of credit. IMF analysis has found that credit growth tends to turn positive only seven quarters after the resumption of output growth.[8]

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[7] www.bankofengland.co.uk

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

Table 6.4: UK lending to PNFCs and individuals

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

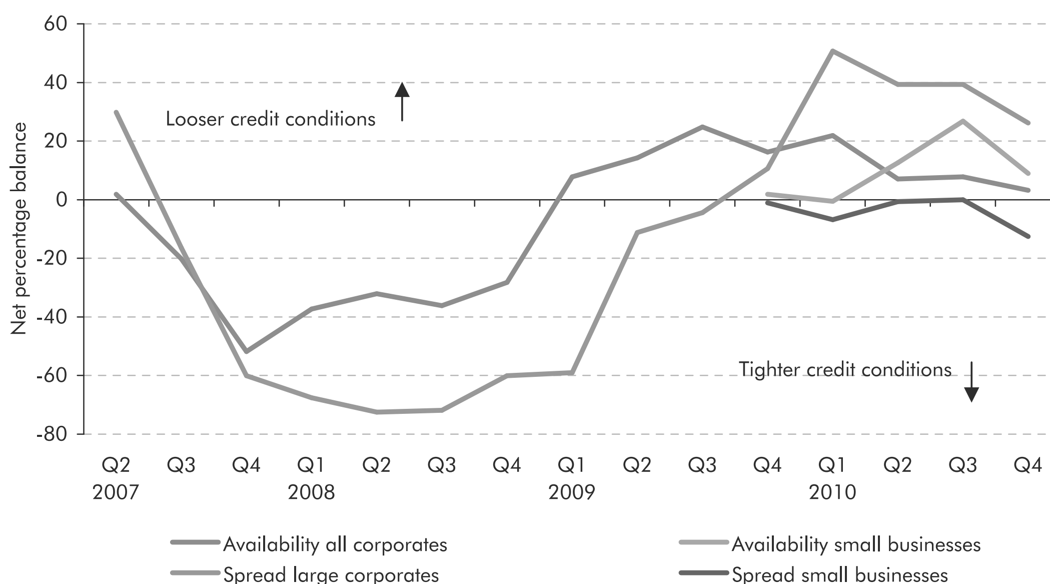
[1] Lending by UK monetary financial institutions both sterling and foreign currency

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

Corporations

6.42 The Bank of England's *Credit Conditions Survey* has reported an improvement in the availability and cost of credit to corporations since 2009, but the rate of improvement in both appears to have slowed a little over 2010. There are also differences between the experiences of small and large firms. Chart 6.9 shows that while large firms saw an improvement in borrowing spreads over 2010, small firms did not.

Chart 6.9: Availability and cost of credit to UK corporations



Source: Bank of England

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

[9] www.bankofengland.co.uk

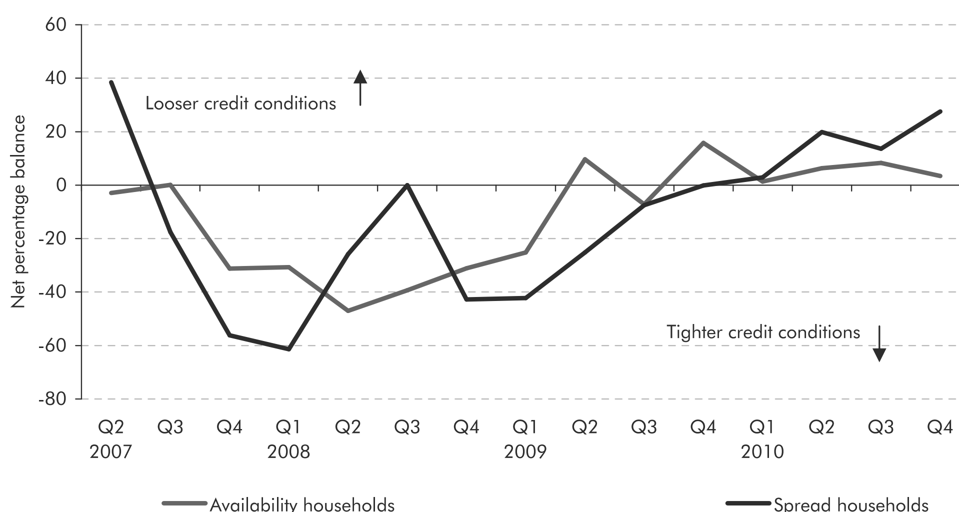
corporations to pick up in 2011, in line with increased mergers and acquisition activity. Aside from economic conditions, lower demand for bank credit could also reflect a renewed preference for other forms of finance. Figures from the Bank of England show that net equity issuance was positive in both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

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

Households

6.45 Lenders reported a modest rise in the availability of secured credit to UK households in the fourth quarter of 2010, as shown in Chart 6.10. However, the outlook for the housing market was reported to have weighed on demand for secured credit and also reduced the availability of higher loan to value ratio mortgage finance.

Chart 6.10: Availability and cost of secured credit to UK households



Source: Bank of England

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

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

The composition of growth

Income and expenditure

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

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

6.49 Total final expenditure comprises domestic spending plus overseas spending on UK exports. Chart 6.11 shows that this measure of spending has recovered even more strongly than nominal GDP, growing by just under 7 per cent last year, and that we expect this growth to be sustained.

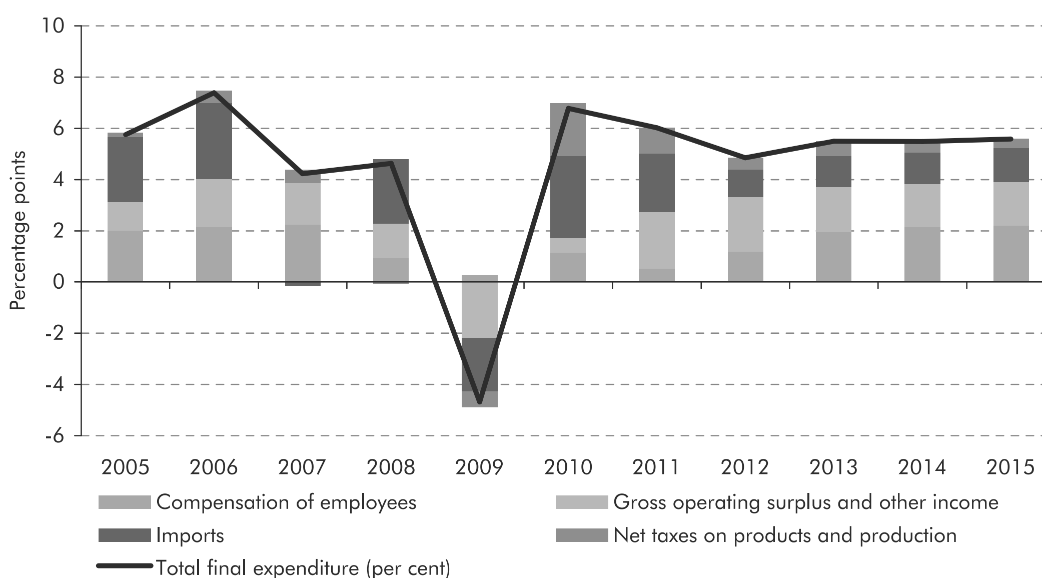
6.50 As all spending in the economy must generate an income flow, the strength of nominal spending implies strong growth in nominal income. However, Chart 6.11 shows that relatively little of the recent strength in nominal spending has translated into domestic household wages or corporate profits. The majority of last year's increase in spending was accounted for by higher spending on imports and higher taxes, generating income flows for overseas companies and the government rather than UK households or firms.

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

[11] Source: Bank of England

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

Chart 6.11: Income counterparts to growth in total final expenditure



Source: ONS, OBR

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

Table 6.5: Expenditure contributions to GDP growth[1]

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

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

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

[3] The sum of government consumption and general government investment.

Components of domestic demand

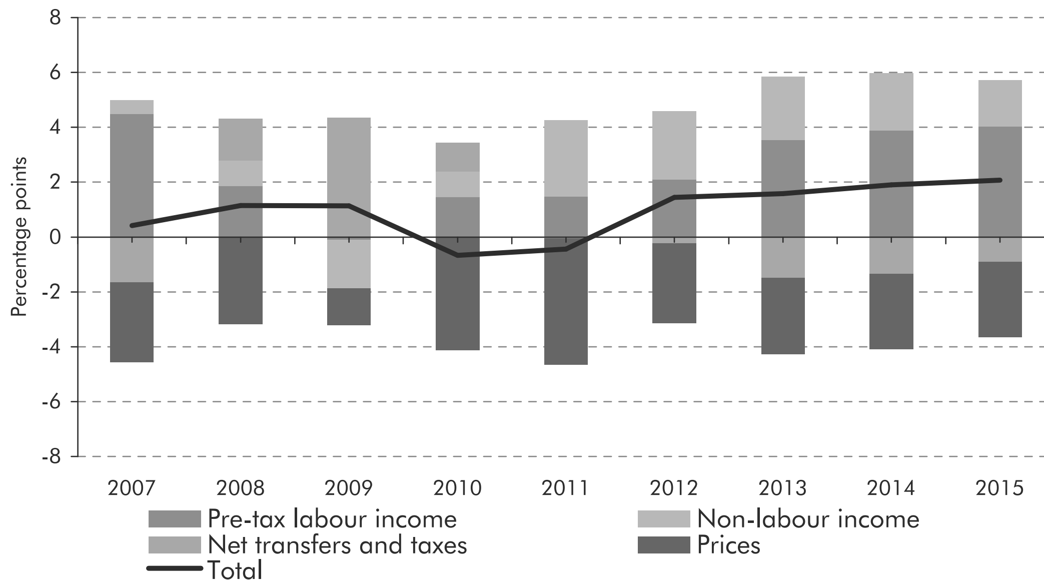
Consumer spending

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

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

6.55 Our forecast for growth in the constituent parts of household income is shown in Chart 6.12. Reflecting the operation of the automatic stabilisers, significant support was provided to households through net taxes and transfers in 2009 and, to a lesser extent, 2010. This reverses in the later years of the forecast as the fiscal consolidation builds up. The effects of higher near-term inflation also unwind in the medium term as temporary influences drop out of the comparison and spare capacity continues to weigh down on inflationary pressures. Labour income is normally the largest contributor to household income growth, but it does not recover this role until 2013.

Chart 6.12: Contributions to growth in real household disposable income



Source: ONS, OBR

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

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

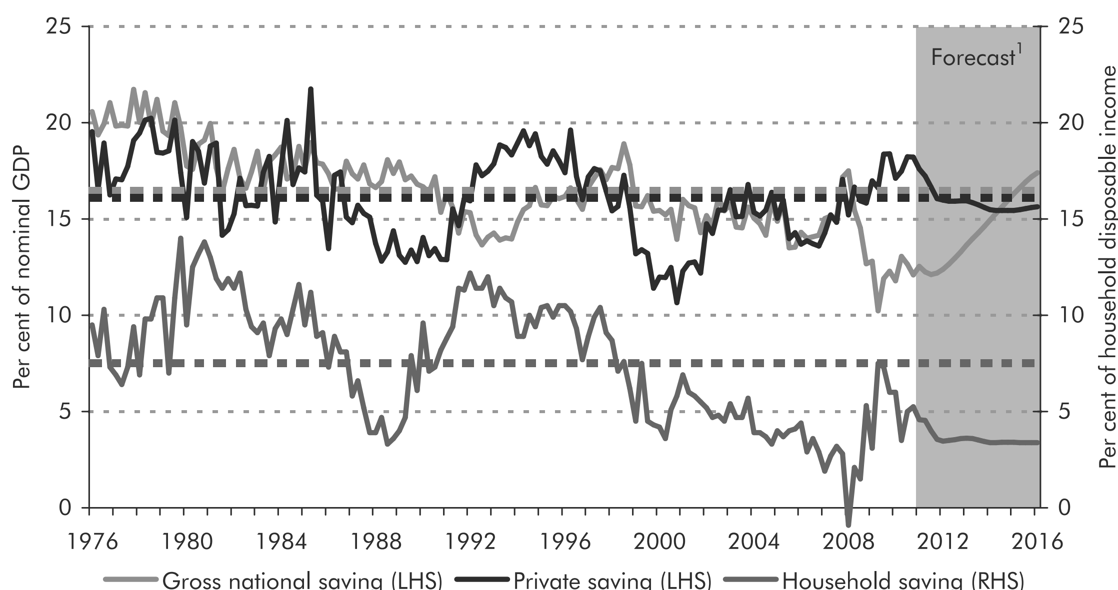
6.58 The historically low forecast level of the household saving ratio reflects two main factors:

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

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

6.59 This means that, as we can see in Chart 6.13, the UK's national private saving ratio is close to its average over the past 35 years and we expect it to remain around that level over the forecast period. Once the effects of the fiscal consolidation (i.e. increased government saving) are included, gross national saving is forecast to rise a little above its long-run average by the end of the forecast period.

Chart 6.13: Household and national saving



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

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

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

Box 6.3: Decomposing the saving ratio

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

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

In the National Accounts, saving is defined as:

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

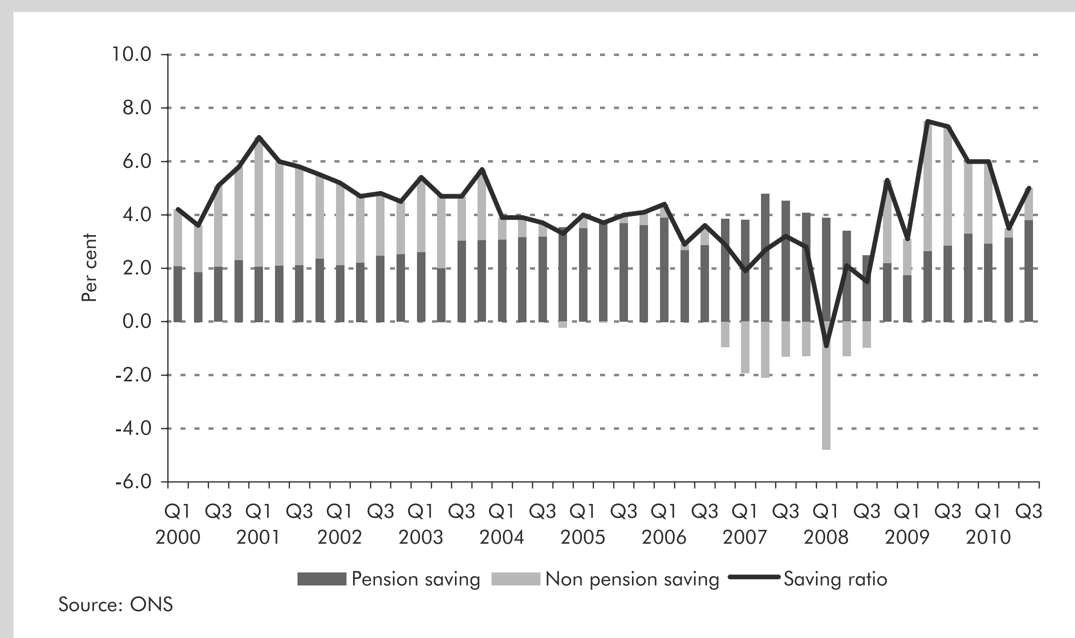
The saving ratio is defined as:

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

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

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

Chart A: Pension and non-pension saving



Source: ONS

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

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

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

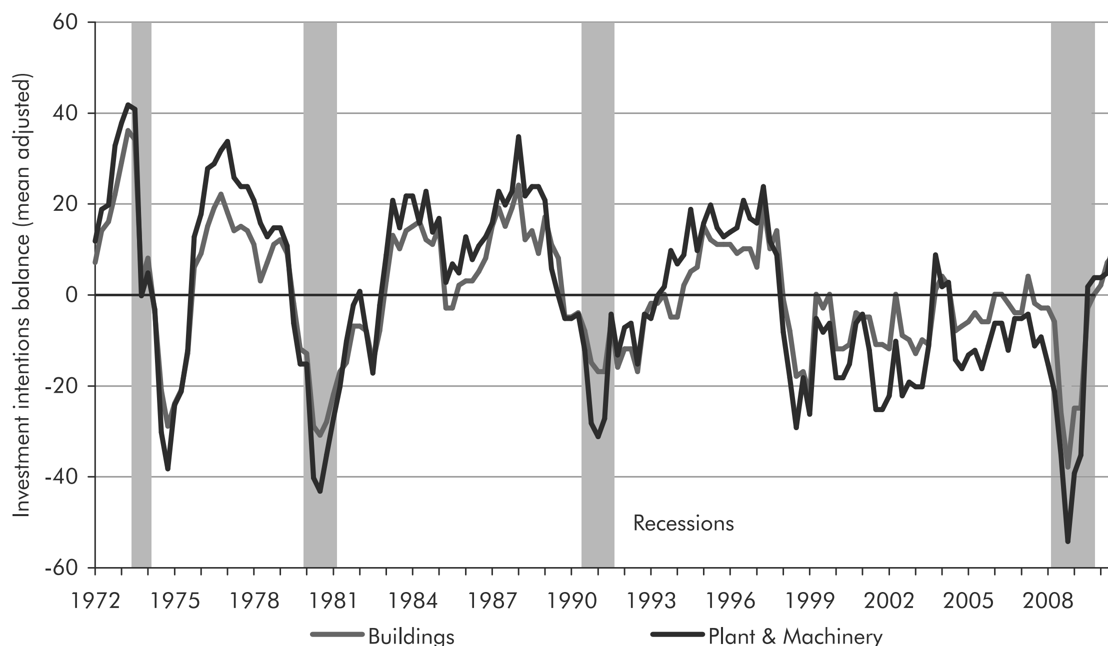
[b] See Pension Trends Chapter 14: Pensions and the National Accounts, January 2010 edition. Available from: http://www.statistics.gov.uk

Business investment

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

6.61 Further out, our forecast also remains little changed from November. Investment intentions have continued to rise in both the CBI and Bank of England Agents surveys. The rise in the Agents' score partly reflected reports that exporters are beginning to invest in additional capacity to keep up with rapid growth in foreign demand, as anticipated in our exports forecast. Chart 6.14 shows that the (mean-adjusted) investment intentions balance in the CBI Industrial Trends Survey returned to positive territory at the end of 2009, earlier than in previous post-recession recoveries.

Chart 6.14: Investment intentions



Source: CBI Industrial Trends Survey

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

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

Residential investment

6.64 In our November 2010 *Outlook*, we anticipated a slowdown in residential investment growth around the turn of the year. Although the split of non-business investment is not yet available for the final quarter of 2010, it looks likely that residential investment contracted, given the fall in activity in the construction sector of 2.3 per cent in the same quarter. Early indications are that some of this weakness continued in January. However, we expect this to be a temporary period of weakness with growth returning throughout the rest of the forecast. In

comparison to the size of the decline during the recession, the forecast recovery is relatively moderate and residential investment does not recover to its pre-recession level by the end of our five year forecast horizon.

Stock building

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

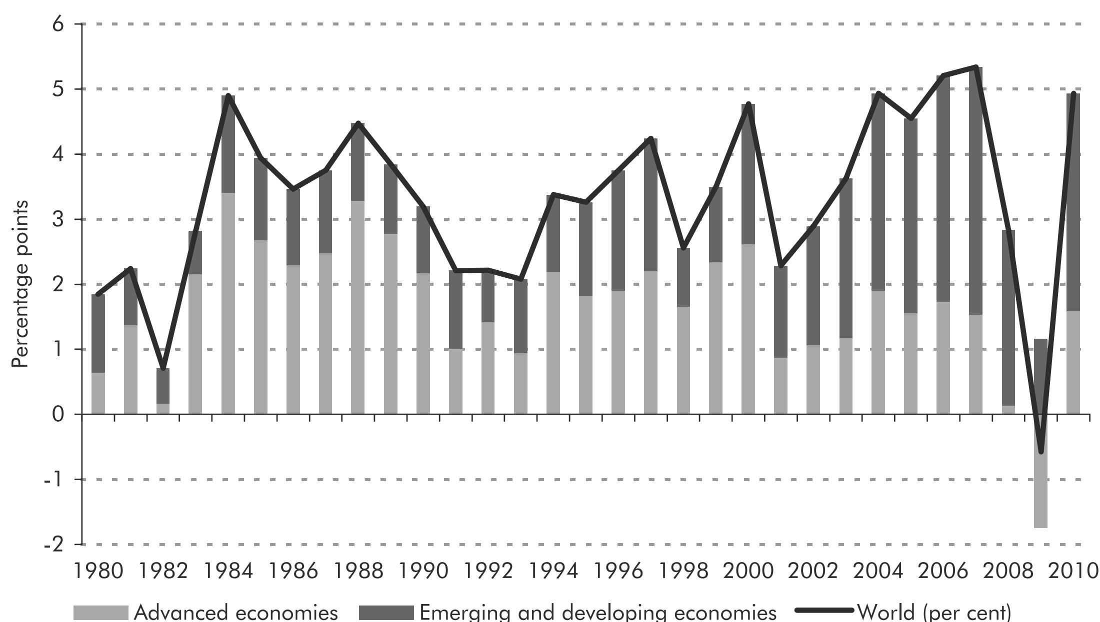
Government

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

World economy

6.67 World growth and world trade have been stronger in 2010 than forecast in November. The latter half of the year saw a rebound in consumption and exports in advanced economies, including the US, Japan and Germany, and continued strong growth in many emerging economies. Despite renewed strength in some developed economies, the two tier recovery continues, as shown in Chart 6.15. In 2010, emerging and developing economies accounted for around 70 per cent of world GDP growth.

Chart 6.15: Contributions to world GDP growth



Source: IMF, *World Economic Outlook*

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

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

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

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

6.72 Our world growth and trade forecast has been revised up for 2010 and 2011, even after taking into account higher world oil prices. This mainly reflects higher growth in advanced economies and stronger-than-expected performance in the final quarter of 2010. The growth profile for 2012 to 2015 is lower, reflecting a higher starting level of trade and output, a softer euro area recovery, the impact of fiscal consolidation among advanced economies, higher world prices and slightly lower emerging market growth. A continued rise in the price of oil would weaken world trade and growth. Box 6.2 looks in more detail at the economic impact of a rise in oil prices for the UK.

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

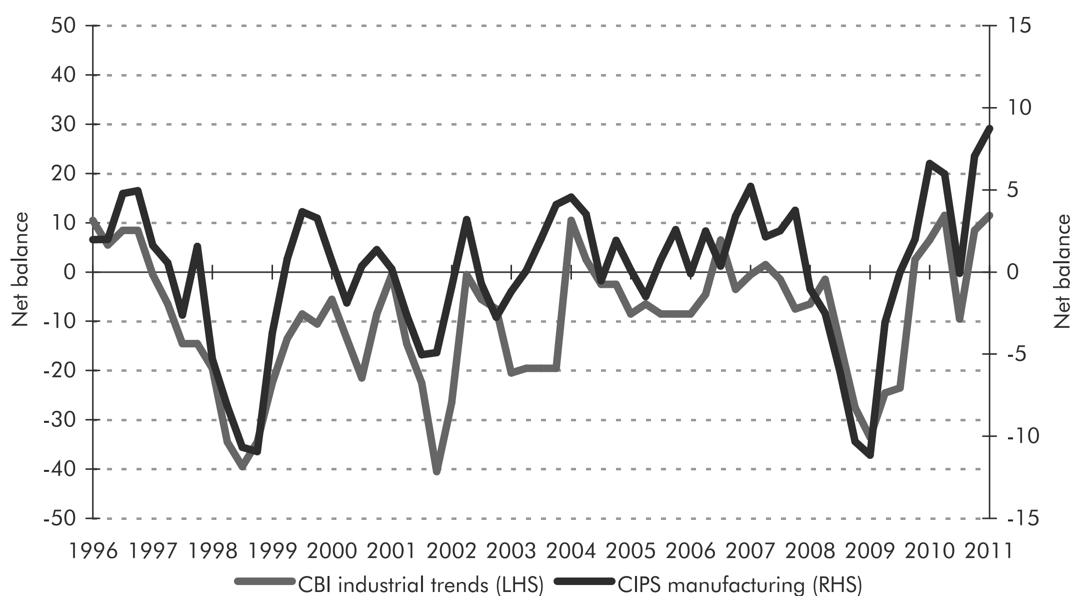
6.74 Japan represented around 6 per cent of world output (PPP) and between 4 and 5 per cent of world trade in 2010. The impact on world growth and trade is therefore likely to be relatively moderate. Japan represents only around 2 per cent of UK export markets so the impact on UK exports should be comparatively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

Exports

6.75 UK export growth has continued to be rapid in recent months. January's monthly trade release showed that, after appearing to slow a little in the second half of last year, goods exports resumed their upward path and are currently estimated to be up 15 per cent over the past year. The monthly trade data can be very volatile, but Chart 6.16 shows that the strength of the outlook is supported across the survey measures, with the CBI Industrial Trends and CIPS PMI export orders surveys both significantly above their long-run averages.

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

Chart 6.16: Survey measures of UK export orders



Source: Ecowin

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

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

Imports

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

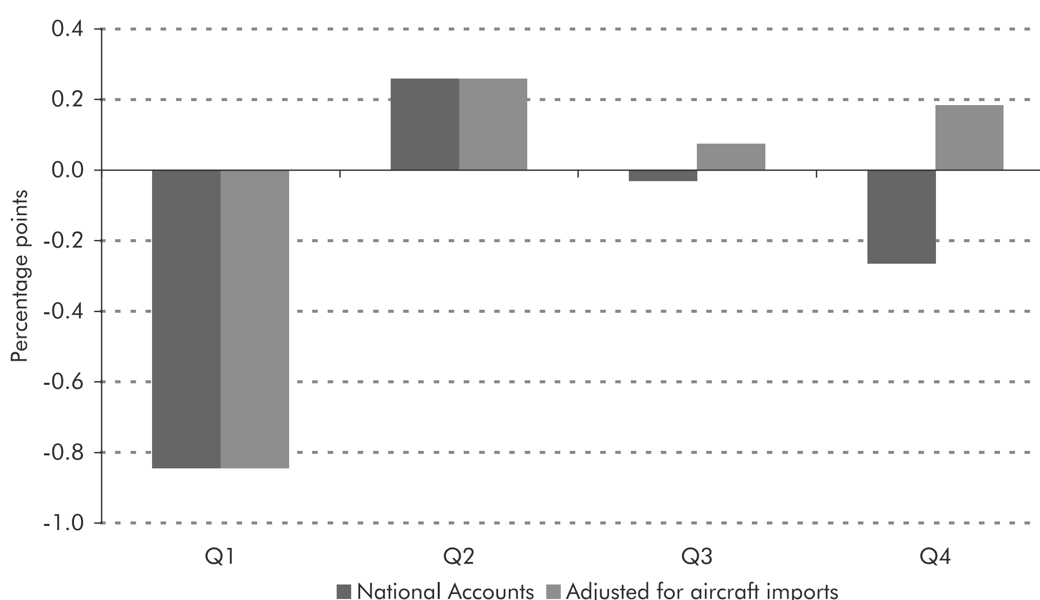
6.79 In recent quarters, a number of temporary factors have also been at work. As we set out earlier, the inventory rebuild is likely to have accounted for a reasonable proportion of import growth over the past year. In addition, imports of aircraft, a normally stable data series, were particularly high in December. Indeed, imports of aircraft appear to have given a significant boost to import volumes in the second half of 2010. Chart 6.17 shows that if these unusually high imports are excluded from the data, net trade makes small positive contributions to GDP in the last two quarters of 2010.

Net trade

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

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

Chart 6.17: Net trade contributions excluding aircraft imports



Source: ONS, OBR

Balance of payments

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

Inflation and nominal GDP

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

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

CPI inflation

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

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

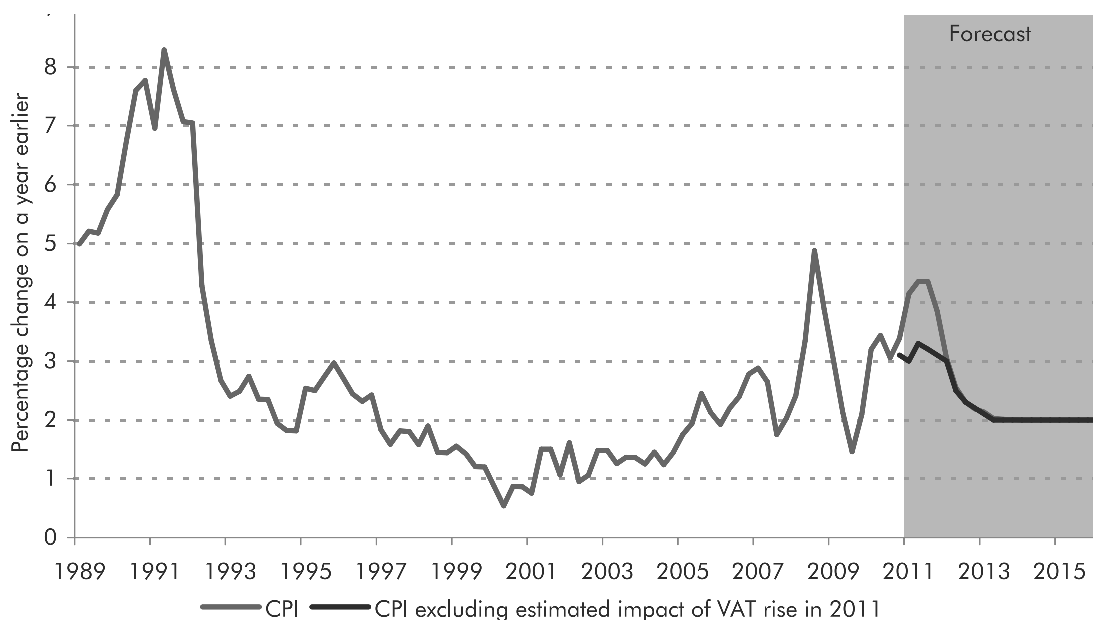
[16] Our forecast takes into account inflation outturns up to and including January 2011.

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

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

6.87 Chart 6.18 plots our estimate of CPI inflation, excluding the rise in VAT to 20 per cent, based on our assumption that 75 per cent of the increase in VAT will be passed through to prices. We discuss this issue in more detail in Box 6.4.

Chart 6.18: CPI inflation



Source: ONS, OBR

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

[17] www.bankofengland.co.uk

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

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

6.91 There is little evidence that above-target inflation has fed through to wages over 2010. Chart 6.19 shows that year-ahead inflation expectations have picked up a little but that average annual earnings growth has remained subdued. Neither inflation expectations nor measures of actual inflation have a strong correlation with regular pay growth. When asked how they would react to changes in their inflation expectations over the next 12 months, around two thirds of respondents said they would shop around for a better deal, just over half said they would spend less but only 1 in 10 said they would push for higher wages.[18] We set out a scenario to assess the implications of greater pass-through from prices to wages later in the chapter.

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

[18] www.bankofengland.co.uk

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

Chart 6.19: Inflation expectations and average earnings growth

Source: Bank of England, ONS

RPI inflation

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

6.95 Since the November forecast, we have improved the methodology we use to project house price changes in the forecast. In the near term, we now assume that house prices rise in line with the median forecast of those external

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

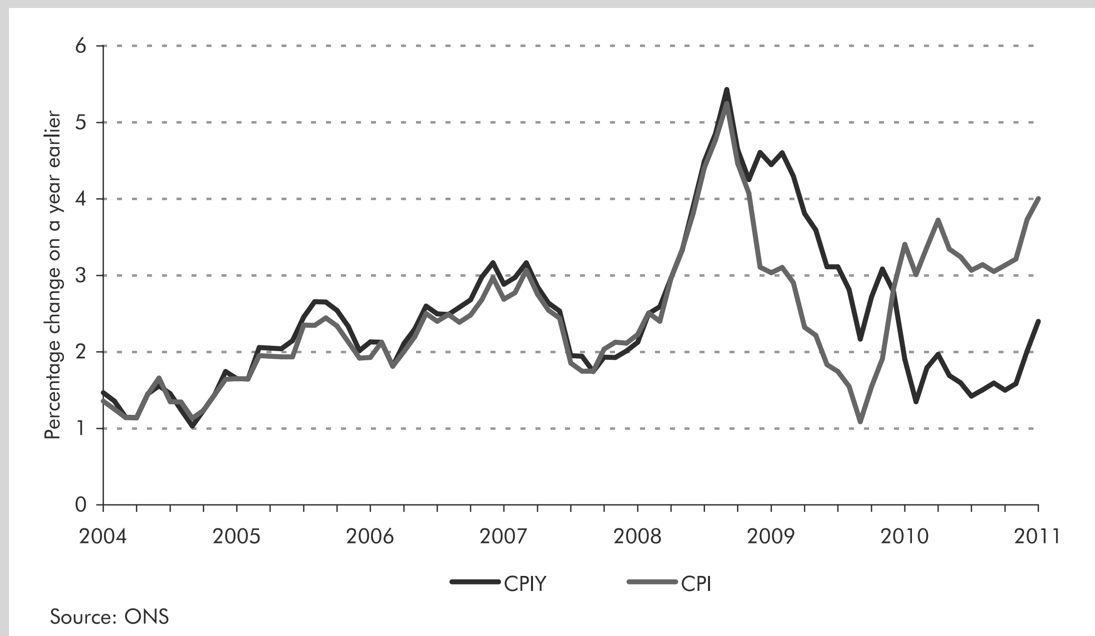
6.96 The difference between RPI and CPI inflation is expected to narrow over 2011, partly as a result of the expected slowdown in house price inflation. In addition, we now expect the difference between the CPI and RPI to be around 0.3 percentage points higher as a result of an increased contribution from the formula effect, as set out in more detail in Box 6.5. Since our November forecast, the contribution from mortgage interest payments has risen over the near term but fallen slightly in the medium term. This reflects market expectations for more monetary tightening in the near term and less towards the end of the forecast period.

Box 6.4: Consumer prices index excluding indirect taxes (CPIY)

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

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

Chart A: CPIY and CPI inflation



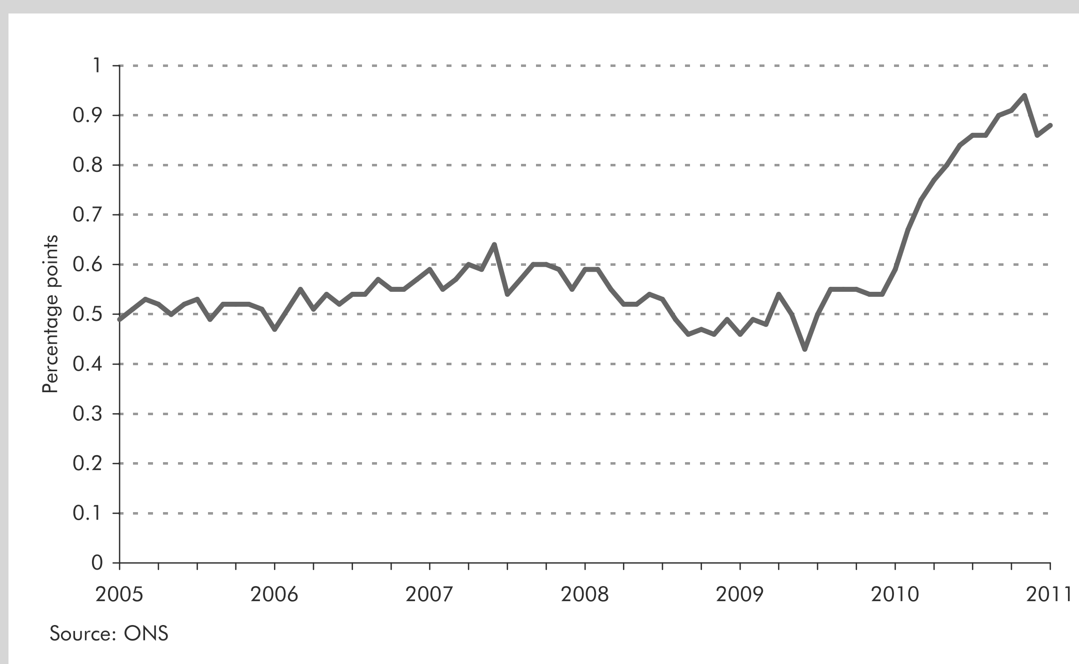
Source: ONS

Box 6.5: The long-run difference between the CPI and RPI

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

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

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



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

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

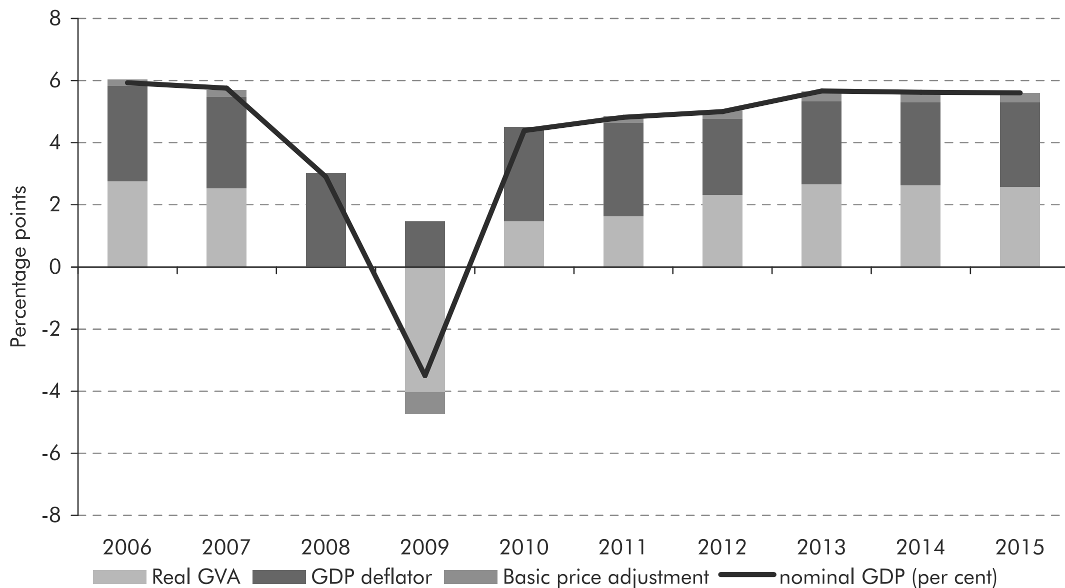
[b] More information can be found in the Office for National Statistics (ONS) information note *'CPI and RPI: the increased impact of the formula effect in 2010'* January 2011 on the ONS website; www.statistics.gov.uk

Nominal GDP

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

6.98 Nominal GDP growth is expected to rise in 2011 compared with 2010, reflecting the pick-up in real growth, which is shown in Chart 6.20. Since November, contributions to CPI and RPI inflation have largely been driven by external factors such as higher oil and import prices. Therefore, they do not have a large upward effect on the GDP deflator in our forecast. We expect the temporary effects on inflation to diminish, while real GDP growth picks up in 2012. As inflation returns to target through 2013 and real GDP growth remains above trend, nominal GDP is expected to rise by 5.6 per cent a year from 2014 onwards.

Chart 6.20: Nominal GDP decomposed



Source: ONS,OBR

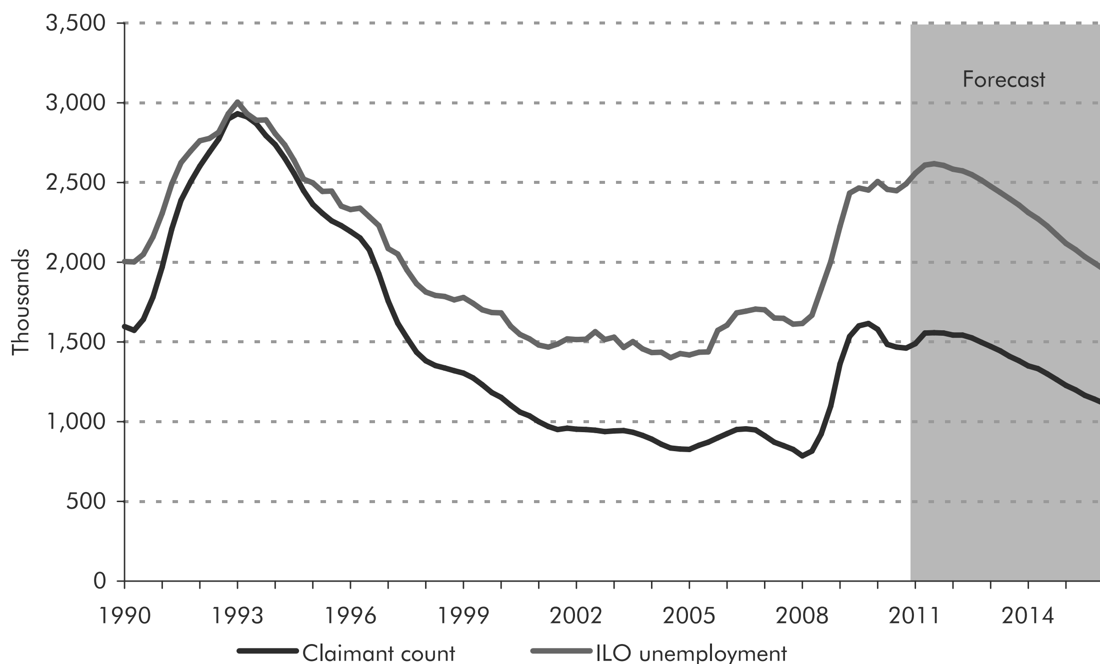
The labour market

Employment, unemployment and inactivity

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

6.100 In line with the increase in ILO unemployment, the claimant count is forecast to pick up to 1.56 million by the second quarter of this year before falling back from 2012, as shown in Chart 6.21. We expect the level of the claimant count to be around 30,000 higher this year and around 80,000 higher in 2012 than we predicted in our November forecast. The impact of weaker output growth is partially offset by a reduction in the impact of the Lone Parent Obligation on claimant count inflows. Following updates to modelling, the effect of the Lone Parent Obligation on the claimant count is assumed to be around 10,000 lower in 2011 and around 20,000 lower in 2012 than previously estimated in November.

Chart 6.21: Unemployment levels



Source: ONS

6.101 Between 2010 and 2015 we expect total employment to increase by around 900,000. This comprises an increase in market sector employment of around 1.3 million, partly offset by a reduction in general government employment of around 400,000 between 2010-11 and 2015-16. Our projections for general government employment are presented in Box 6.6. Total weekly hours worked are expected to fall back slightly over the course of 2011, consistent with below-trend growth. Beyond 2011, total hours are forecast to rise as employment growth picks up, offsetting a fall in average hours worked. We expect average hours worked to revert to a gradual trend decline over the medium term.

Box 6.6: General government employment

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

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

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

Table A sets out:

i) our November forecast for general government employment;

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

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

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

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

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

Table A: General government employment

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

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

[2] Excluding depreciation

[3] Local Authority Self-Financed Expenditure

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

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

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

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

Earnings

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

6.103 Measures of real earnings growth display contrasting patterns over recent quarters, as we show in Chart 6.22. We estimate the real wage earned by workers (real consumption wage), by deflating net wages and salaries by the price of consumption goods. For the real wage paid by firms (the real product wage) we deflate total employee compensation, which includes employer pension contributions as well as wages and salaries, by the basic price of output, which excludes the effects of changes in taxes on products, such as VAT.

6.104 Chart 6.22 shows that the real wage earned by workers has fallen back sharply in 2010, as growth of wages and salaries has remained low relative to changes in the price of consumption. However, the real wage paid by firms picked up over 2010, reflecting relatively subdued increases in basic output prices and increases in employers' contributions to pension schemes.

Chart 6.22: Annual real wage growth[1]

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

6.105 We expect average earnings to continue to grow relatively slowly over the near term, despite elevated price inflation. This is consistent with the limited evidence so far of pass-through from higher inflation and inflation expectations to wage growth. In line with our forecast of weaker output growth, we also expect slightly

slower growth of average earnings than we forecast in November. We now see whole economy average earnings growing by around 2 per cent this year, compared to 2¼ per cent in our November forecast. Average earnings growth is expected to pick up gradually from 2012 as output grows at above-trend rates.

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

Comparison with external forecasts

6.107 As noted in Chapter 2 from the March 2011 EFO, external forecasts differ on a number of key issues. On centre stage is the degree to which the economy will rebalance away from private consumption growth towards investment growth and net exports. Other important differences arise from expectations of the impact of fiscal consolidation and the extent to which monetary policy offsets it. In what follows, we briefly compare the main themes of selected outside forecasts to our own.

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

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

6.110 In its February *Interim Forecast*, the European Commission expects a stronger rebound from the effects of snow in the first quarter of 2011. This reflects a stronger assumption about how much postponed construction activity will be

recovered and helps explain why the EC has revised down its 2011 growth forecast less than us. The EC forecasts that CPI inflation will be lower than we project in our central forecast in 2011. The interim forecast does not contain forecasts beyond 2011, but in its November *Autumn Economic Forecast* the EC projected that net trade and private investment would support the recovery with GDP growth of 2.5 per cent in 2012, consistent with our central forecast.

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

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

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

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

Economic forecast tables

Table 6.6: External forecasts comparison

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

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

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

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

Table 6.7: Detailed summary of forecast

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

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

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

[3] Contribution to GDP growth, percentage points

[4] Trade levels are distorted by MTIC fraud

[5] Ratio of export to import prices

[6] Wages and salaries divided by employees

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

Table 6.8: Changes to detailed summary of forecast

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

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

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

[3] Contribution to GDP growth, percentage points

[4] Trade levels are distorted by MTIC fraud

[5] Ratio of export to import prices

[6] Wages and salaries divided by employees

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

Scenario analysis

6.115 In assessing the outlook for the public finances, it is useful to think about ways in which the economy might diverge from our central forecast and what the fiscal consequences might be. In this section we set out two illustrative economic scenarios, which are intended to address the concerns of outside commentators. The fiscal implications are assessed in Chapter 5 (equivalent to chapter 8 of this Convergence Programme). We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from the central forecast and we do not attempt to attach particular probabilities to them. They are:

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

6.116 Our central fiscal projection is produced using a wide range of economic determinants from a large-scale macroeconomic model. The approach we take in producing scenarios is simpler and depends on 'ready-reckoning' the effect of changes in a small selection of determinants on the central forecast. Box 6.7 sets out some of the assumptions applied to produce these scenarios.

Scenario one: persistent inflation

6.117 The VAT rise of January 2010, sterling's depreciation and rising commodity prices, have pushed the level of prices higher and kept annual CPI inflation significantly above the Bank of England's target. This is set to continue in 2011, as VAT rose again in January. CPIY inflation, which strips out the effect of changes to indirect taxes on inflation (see Box 6.4), is running at an annual rate of a little over 2 per cent suggesting that underlying inflationary pressures are relatively subdued.

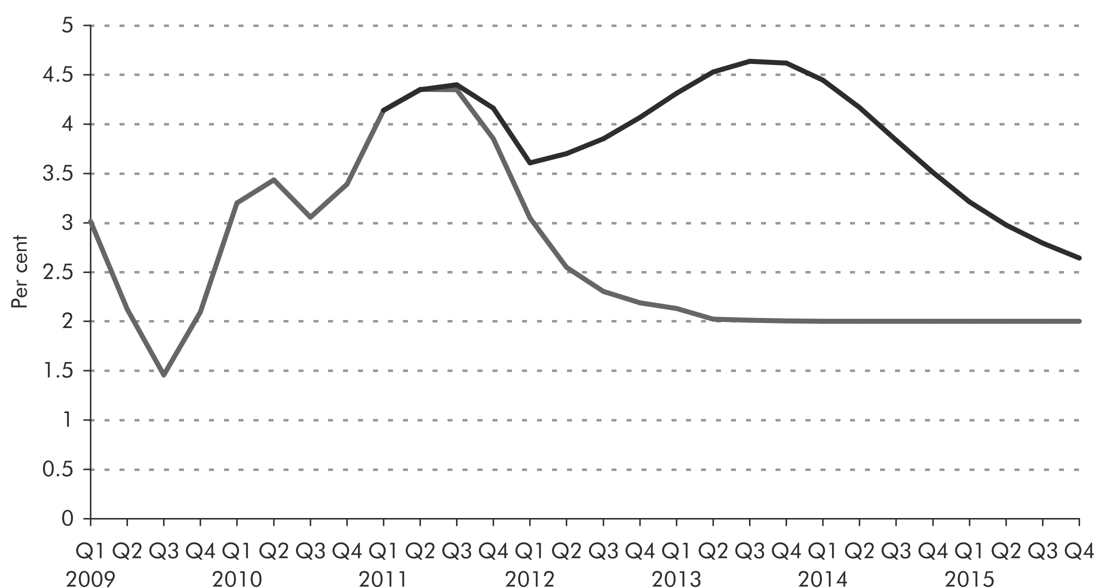
6.118 During the recession, average earnings growth was weak and households' real incomes were squeezed as inflation eroded the purchasing power of pay. Our central forecast is for this to continue over 2011 as average earnings growth struggles to keep up with rising prices. Thereafter, inflation returns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

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

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

6.121 Greater real wage resistance is assumed to make it more difficult for the Bank to return inflation to target than would normally be the case. Chart 6.23 shows that CPI inflation remains significantly above target for some time in this scenario, before spare capacity and the re-anchoring of inflation expectations weigh on earnings.

Chart 6.23: CPI inflation



Source: ONS, OBR

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

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

Table 6.9: Persistent inflation scenario summary

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

Table 6.10: Persistent inflation scenario relative to central forecast

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

Box 6.7: Monetary policy, output and employment in alternative scenarios

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

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

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

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

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

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

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

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

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

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

Again, taking differences relative to the central forecast:

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

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

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

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

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

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

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

Scenario two: weak euro

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

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

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

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

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

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

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

Table 6.11: Weak euro scenario summary

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

Table 6.12: Weak euro scenario relative to central forecast

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

7 Fiscal outlook

Summary

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

Table 7.1: Fiscal forecast overview

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

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

7.2 We expect PSNB to total £145.9 billion this year, which is £2.6 billion lower than we expected in November, mainly due to lower forecast expenditure. We do not expect receipts to be as strong in the remainder of the year as some external analysts. Over the medium term our central forecast, as summarised in Table 7.1, is for:

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

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

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

7.3 The Budget policy measures are broadly neutral for borrowing over the forecast period. Table 7.2 shows that, including the effects of these measures, compared to November we are forecasting higher expenditure as a percentage of GDP in the medium term, with little overall change to the receipts forecasts:

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

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

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

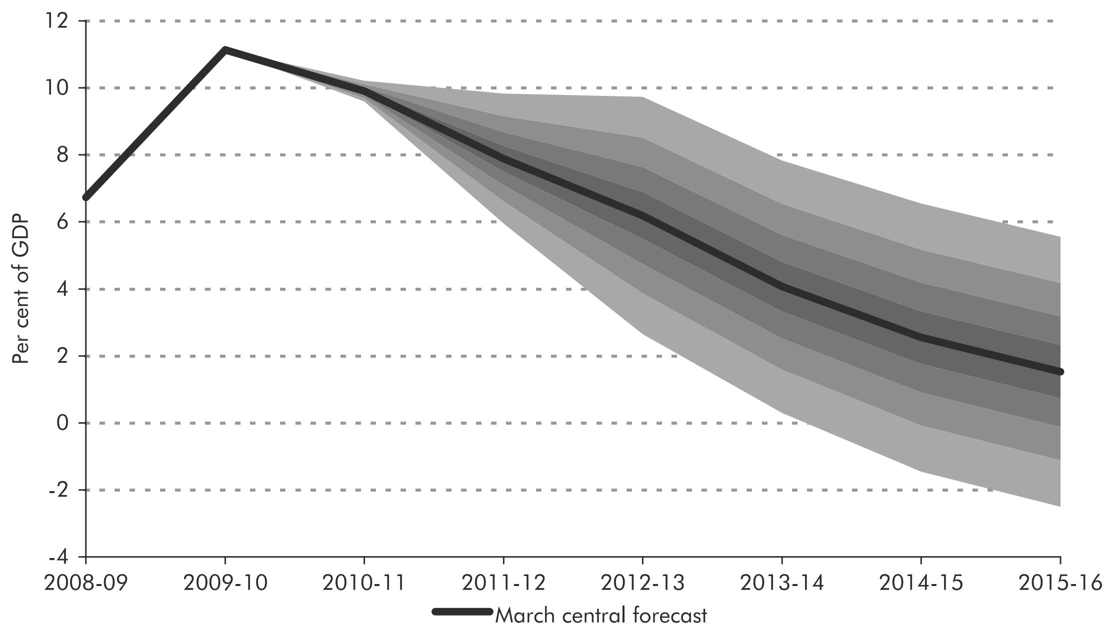
7.5 The changes in the fiscal aggregates since November are small relative to the uncertainties that surround any fiscal forecast. PSNB represents the difference between total public sector receipts and expenditure, both of which are very large numbers influenced by numerous economic and non-economic determinants. Chart 7.1 shows our central forecast for PSNB with the probability of different outcomes, based purely on the Treasury's past forecasting performance, shown in a fan chart. The solid black line represents the median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands.

Table 7.2: Changes to public sector net borrowing since November forecast

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

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

Chart 7.1: Public sector net borrowing fan chart



Source: ONS, OBR

Introduction

7.6 In this chapter we set out our forecasts for the public finances to 2015-16. We begin by explaining our approach to the fiscal forecast. We then describe the judgements and assumptions that help determine the forecast, from paragraph 7.15. We then set out the effect of policy announcements that have been made since the OBR's November forecast, starting in paragraph 7.27. The outlook for receipts, including tax by tax analysis, is described in paragraph 7.33 onwards. We then turn to expenditure, focusing in particular on the components of AME, from paragraph 7.77. Our forecast of financial transactions and our approach to asset sales is set out from paragraph 7.144. Finally, in paragraph 7.159 onwards, we draw together the implications of the preceding analysis for the key fiscal aggregates, including public sector net borrowing, the surplus on the current budget and public sector net debt. Further breakdowns of receipts and

expenditure and other details of our fiscal forecasts are provided in the OBR's supplementary tables available on our website.

Approach to the fiscal forecast

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

7.8 Public sector receipts are highly dependent on the path of the economy and so projections are subject to all of the risks and uncertainties set out in Chapter 3 (equivalent to chapter 6 of this Convergence Programme). Equally, while a portion of public expenditure is typically set in firm multi-year plans, a substantial portion, such as social security and debt interest payments, is also closely linked to the economy. In addition, each individual line of receipts and expenditure will be subject to a wide range of specific uncertainties, for example around the behaviour of taxpayers or benefit claimants in response to changes in the tax or benefit system.

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

Process for producing the fiscal forecast

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

7.11 We base the forecast on outturn data on the public finances produced by the Office for National Statistics (ONS). In this forecast we have used the data from

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

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

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

Cyclical adjustment methodology

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

Basis of the fiscal aggregates

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

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

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

public finances of the interventions taken in 2008 and 2009 to stabilise the financial sector, but capture the permanent effects.

Determinants of the fiscal forecast

7.15 This section sets out the main assumptions and judgements we have made in producing our central fiscal forecast. Table 7.3 shows the path of key determinants and Table 7.4 shows the changes compared to the OBR's November forecast. Chapter 3 (equivalent to chapter 6 of this Convergence Programme) includes a discussion of determinants from the economy forecast, such as GDP, its components, inflation and claimant count unemployment. These judgements reflect our central view of the path of the economy and public finances.

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

Table 7.3: Determinants of the fiscal forecast

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

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

Table 7.4: Changes to determinants since the November forecast

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

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

Equity prices

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

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

HMRC financial sector profits

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

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

Residential property prices and transactions

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

Commercial property prices and transactions

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

Oil prices

7.23 Oil prices are assumed to move in line with the prices implied by futures markets as of 4 March 2011. On an approximate ready-reckoner basis, if oil prices were to be $1 higher than assumed, direct North Sea receipts would rise by around £150 million. There would however be offsetting effects on the public finances from the wider effects of an oil price rise on GDP and inflation. The impact of recent rises in oil prices on the fiscal forecast is set out in Box 7.1.

Oil and gas production

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

Short-term interest rates

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

Gilt rates

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

Effect of new policy announcements

7.27 Chapter 2 from the OBR's March 2011 EFO explains the OBR's approach to incorporating the effects of policy change on the economic and fiscal forecast. The Government is responsible for quantifying the direct impact of policy decisions on the public finances. The OBR provides independent scrutiny and certification of these costings. The OBR is also responsible for determining any indirect effects of policy measures on the economic forecast, which are discussed in Chapter 6 of CP.

7.28 Annex A reproduces the Treasury's table of Budget 2011 policy decisions. The OBR has endorsed all of the costings in Table A.3, with the exception of the measure which extends the short life assets regime from four to eight years. Our forecast incorporates the Treasury's scorecard estimate of the direct cost of this measure (£170 million by 2015-16). However, as we explain in our annex to the Treasury's *Budget 2011 policy costings* document, we were provided with the details of this measure after the deadline by which we had told the Treasury that we could guarantee to undertake the proper process of challenge and scrutiny necessary to certify the costing. The costing of this measure is highly uncertain and we will need to ensure it receives proper scrutiny after the Budget. If we end up disagreeing with the current costing this will need to be reflected in our next forecast.

7.29 Table7.5 summarises the overall direct effects of the Budget policy measures on the public finance forecast. The overall effect on PSNB is very small with a fiscal tightening of £0.3 billion in 2015-16.

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

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

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

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

Table 7.5: Impact of policy announcements included since November

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

Receipts

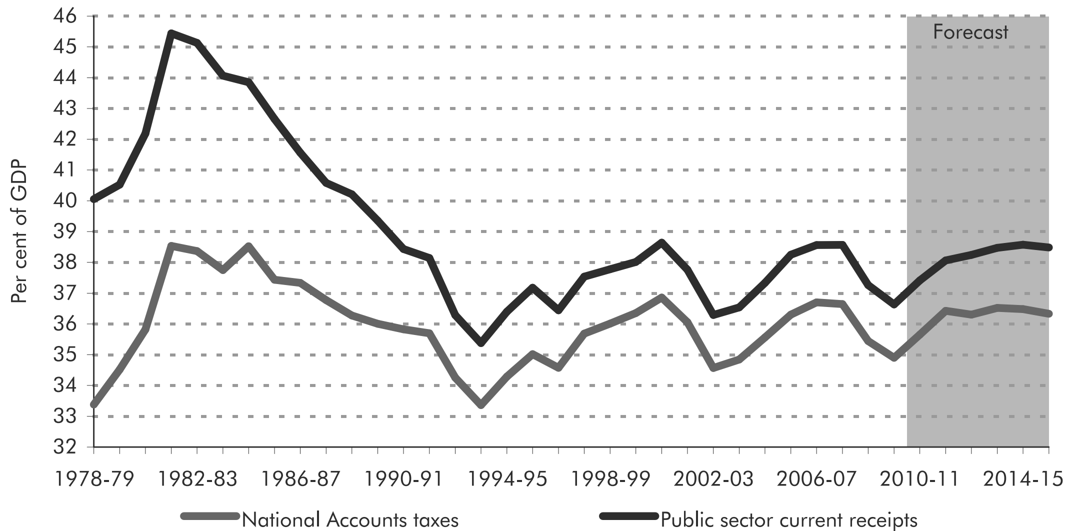
7.33 Tables 7.6 and 7.7 set out our central forecast for receipts, and Table 7.8 shows changes since the November forecast. As in the November forecast, receipts are shown on an accruals basis, as defined in the National Accounts. A similar table on a cash basis, comparable with the receipts tables in the June Budget and earlier forecasts, is available in the OBR's supplementary tables on our website. The supplementary tables also include the net taxes and NICs measure which was previously used as a measure of the overall tax level.

Table 7.6: Major taxes as a percentage of GDP

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

7.34 Chart 7.2 shows public sector receipts as a share of national income. Two measures are presented, both of which are on an accrued rather than cash basis. National Accounts taxes show total public sector tax receipts, as defined in the National Accounts. Public sector current receipts (PSCR) additionally includes non-tax receipts such as interest and dividend receipts and the gross operating surplus of public corporations. The forecast shows tax receipts rising as a share of national income from their 2009-10 level in 2010-11 and 2011-12 and then staying broadly flat for the rest of the forecast period. The short-term increase is driven primarily by the impact of the policy measures introduced since Budget 2008 aimed at consolidating the public finances and by a partial recovery in tax receipts from the financial sector.

Chart 7.2: Receipts as a percentage of GDP



Source: ONS, OBR

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

Table 7.7: Current receipts

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

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

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

[3] Includes enhanced company tax credits

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

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

Table 7.8: Changes to current receipts since November forecast

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

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

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

[3] Includes enhanced company tax credits

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

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

Tax by tax analysis

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

Income tax and National Insurance contributions

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

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

Table 7.9: Key changes to income tax and NICs since November forecast

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

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

7.40 Changes to our employment and earnings assumptions since our November forecast lead to lower wages and salaries levels across the forecast period. By 2015-16, the level is 1 per cent lower. As shown in Table 7.9, this reduces receipts by around £5 billion a year at the end of the forecast period. We have also assumed that the lower effective tax rate observed in 2010-11 persists across the forecast. Although the income tax personal allowance up until 2012-13 has been set by policy announcements, the higher level of RPI in this forecast does increase the level of some allowances and thresholds leading to lower receipts. Modelling changes raise receipts over the forecast period and include the updating of costings and a revision to the number of individuals eligible for contracted-out rebates of NICs.

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

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

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

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

7.43 The main Budget 2011 measures affecting income tax and NICs are the increase in the personal allowance from 2012-13, the change to the indexation of NICs, and the anti-avoidance measure on disguised remuneration. In the June 2010 Budget the Government committed to introduce a pensions tax relief measure that raised at least as much revenue as was already included in the forecasts relating to the pensions measure introduced in Finance Act 2010. The main specification of the Government's measure was announced on 14 October 2010, and final details were confirmed on 3 March 2011. The OBR has scrutinised the costing of the new measure and certified it as a central estimate. The total revenue raised over the forecast period is slightly higher than the previous estimates but, as shown in Table 7.9, there are some larger profiling differences in individual years.

Value added tax

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

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

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

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

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

Table 7.10: Key changes to VAT since November forecast

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

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

7.49 As shown in Table 7.10, VAT receipts are close to the November forecast from 2011-12 onwards. Positive effects on receipts arising from the lower VAT gap assumption and slightly higher nominal consumer spending are offset by negative effects from other economic determinants. These include household

investment and government procurement. Changes to the standard-rated share of consumer spending also reduce receipts.

Corporation tax

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

Table 7.11: Key changes to corporation tax since November forecast

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

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

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

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

7.52 As shown in Table 7.11, the projection for onshore corporation tax is lower in the medium term than in the November forecast reflecting lower non-oil, non-financial profits, modelling changes, and policy measures announced in the Budget, such as the further rate cut and the Controlled Foreign Companies measures.

UK oil and gas revenues

7.53 UK oil and gas revenues from offshore corporation tax and petroleum revenue tax are expected to be over £3 billion higher in each year from 2011-12 onwards, compared with the November forecast. This reflects the run up in oil prices to over $110 a barrel in recent weeks and the increase in the supplementary charge from 20 per cent to 32 per cent announced in the Budget. Dollar oil prices are assumed to move in line with oil futures, which average $113 a barrel in 2011, gradually falling to $107 a barrel by 2015. Relative to the November forecast, prices are up by $28 a barrel in 2011 and $19 a barrel by the end of the forecast period. Only a small element of the rise in the dollar oil price is offset by the appreciation of sterling against the dollar. The impact of sterling oil prices on expected receipts compared with November is shown in Table 7.12.

Table 7.12: Key changes to UK oil and gas revenues since November forecast

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

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

Box 7.1: The oil price and the fiscal forecast

The world price of oil has increased sharply since November, reflecting rising world demand and the unrest in the Middle East and North Africa. As explained in Box 6.2 in Chapter 6, this has contributed a reduction in our forecast of UK GDP growth of 0.2 per cent in 2015-16.

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

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

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

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

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

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

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

Note: Negative figure implies a rise in borrowing

tax receipts. The forecast has also assumed only limited pass-through from higher oil prices on to gas prices.

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

7.56 Box 7.1 looks in more detail at the interaction between the oil price and our fiscal forecast.

Taxes on capital

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

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

Stamp duties

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

further in 2011-12, although price growth is expected to be more subdued than previously assumed.

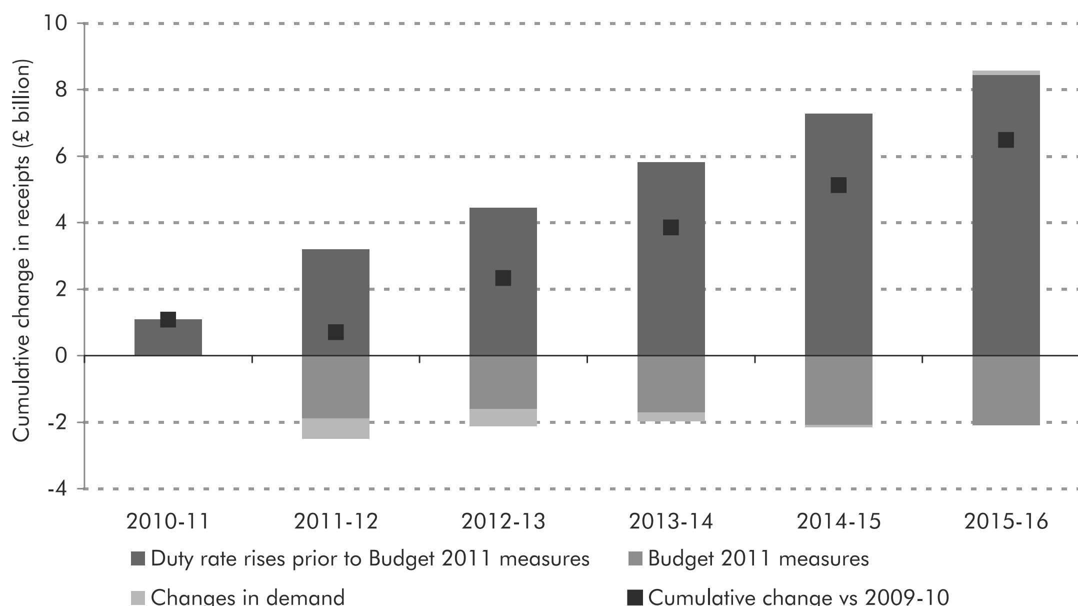
7.60 Stamp taxes on shares is expected to be slightly lower in each year of the forecast compared to the projection made in November. This reflects our forecast that lower volumes of taxable transactions will more than offset a slightly higher path for equity prices.

Fuel duties

7.61 Fuel duties are charged on petrol, diesel and rebated oils on a pence per litre basis. Chart 7.3 breaks down the cumulative growth over the forecast period into its key drivers: previously-announced rises in the fuel duty rate; the effect of measures announced at this Budget; and changes in the demand for fuel.

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

Chart 7.3: Drivers of the fuel duties forecast



Source: OBR

7.63 Table 7.13 sets out the key changes to our forecast of fuel duty receipts since November. Overall, receipts are expected to be over £2 billion lower in each year from 2011-12. The main changes are:

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

Table 7.13: Key changes to fuel duties since November forecast

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

Alcohol and tobacco duties

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

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

Other receipts

7.66 The fiscal forecast includes many other receipts streams. The definitions of these series, and the methodologies with which they are forecast, are set out in more detail in our briefing paper, *Forecasting the public finances*, available on our website. More detail on environmental levies, other taxes and other receipts lines in Table 7.7 is set out in the OBR's supplementary tables available on our website.

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

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

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

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

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

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

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

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

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

7.76 The receipts forecast includes an assumption that repayments relating to future tax litigation losses will amount to £0.5 billion per year, rising with total receipts across the forecast period. This is included in the other receipts line in Table 7.7. We currently use an approach which is based on a broad assumption informed by publicly-available outturn data.[4] We will review this approach ahead of future forecasts. Our estimate excludes the effect of cases where repayments are currently being made: such repayments are already accounted for in the individual tax forecasts.

Expenditure

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

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

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

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

7.80 Table 7.15 sets out our latest projections for total public spending. The formats of Tables 7.15 and 7.16 have changed in this *Economic and fiscal outlook*. Each row now only shows spending which scores in PSCE or PSGI and therefore affects the fiscal aggregates that we forecast. Previously, some of these rows also included spending, such as non-cash items, which was included in DEL or departmental AME but which did not score in PSCE or PSGI, and which was therefore removed in other rows of the table. This meant that some changes were not easy to understand. The new tables also have additional rows to show the larger items of spending that score in PSCE or PSGI in the National Accounts, but which were previously subsumed within the row for accounting adjustments.

7.81 All comparisons of expenditure with the November *Outlook* shown in this chapter are based on the November forecasts being restated in line with the new row definitions shown in Table 7.15. Full details of the changes in the formats of these spending tables are included in the OBR's supplementary fiscal tables, which are available on our website. These further tables also show the latest spending forecasts in the previous format. The supplementary tables also include further breakdowns of spending, including allocations across subsectors and economic categories.

Table 7.14: Expenditure as a percentage of GDP

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

[1] GDP at market prices

7.82 Table 7.14 sets out our forecast for public spending as a percentage of GDP. Total managed expenditure is expressed as a share of the economy, but not all of TME contributes to the calculation of GDP. The difference between TME and the public sector element of GDP is primarily accounted for by benefit payments and other transfer payments, which do not score in the public sector element of GDP under the National Accounts.

Spending assumptions

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

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

Changes to total managed expenditure since the November forecast

7.85 Table 7.16 shows the changes in TME since the OBR's November *Economic and fiscal outlook*. Full detail on these changes are provided in subsequent sections.

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

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

Table 7.15: Total managed expenditure

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

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

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

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

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

Table 7.16: Changes to total managed expenditure since November forecast

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

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

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

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

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

Table 7.17: Derivation of PSCE in RDEL and PSGI in CDEL

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

Departmental expenditure limits

7.88 The presentation of the DEL figures in Table 7.15 only includes the components of RDEL and CDEL that score towards PSCE and PSGI. Table 7.17 reconciles these components with the Treasury totals of 'total RDEL', 'total RDEL excluding depreciation', and 'CDEL'. The differences relate to various non-cash spending items, and receipts which finance spending but which are treated as current receipts in the National Accounts, including passport fees and rail franchise premia. [5] Within CDEL, the main component that does not score in PSGI is

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

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

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

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

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

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

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

Annually managed expenditure

7.94 Table 7.15 sets out our latest central projections of AME spending to 2015-16, based on the economic determinants in this forecast, the latest estimates of agreed policy commitments, and the effect of measures announced in Budget 2011. The largest changes to the main AME components are driven by changes to the key economic determinants of the AME forecast:

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

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

Social security

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

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

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

7.99 Social security spending is forecast to decrease by an annual average of 0.4 per cent in real terms over the five years to 2015-16. This is partly as a result of policy changes announced in recent fiscal events. Compared with November, this forecast shows an increase in social security spending of approximately £3 billion per year from 2012-13 onwards, with the exception of 2015-16, where modelling improvements reduce the increase to £2 billion. The key changes to the social security forecast are shown in Table 7.18.

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

7.101 Table 7.18 also shows an increase in the forecast caused by the remodelling of the savings from the Spending Review measure to time-limit contributory Employment and Support Allowance (ESA) for those in the Work Related Activity Group. The expected savings from this measure have been reduced for two reasons. First, we have updated the assumptions to reflect the effect of the migration of cases from incapacity benefit on the composition of the time-limited caseload over time. Second, the forecast now assumes a higher level of appeals by those assigned to the Work Related Activity Group, which means more moving into the Support Group where time-limiting does not apply.

7.102 Table 7.18 also shows the impact of improvements to the forecast for working age claimants who are entitled to receive housing benefit. The increase in the first few years is driven by the most recent data, showing a larger proportion of people receiving other benefits who also receive housing benefit. The decrease in later years is caused by an expected reduction in the ESA caseload and the correction of a modelling error related to unemployed housing benefit recipients.

Table 7.18: Key changes to social security since November forecast

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

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

Tax credits

7.103 The child and working tax credits forecast has been produced on our behalf by HMRC, based on our central economic forecast and agreed judgements and methodology. The key economic determinants of the forecast are CPI inflation, average earnings, and claimant count unemployment. For the first time, as part of the wider presentational changes to Table 7.15 set out earlier in the section, the tax credit numbers now include company tax credits, which were previously included in accounting adjustments and other departmental spending. The breakdown between household and company tax credits is shown in the supplementary tables on our website.

Table 7.19: Key changes to tax credits since November forecast

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

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

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

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

7.104 Total tax credit expenditure rises in real terms to 2012-13 and then declines somewhat in real terms thereafter. By 2015-16, it is forecast to be approximately 3 per cent higher in real terms than in 2010-11. Compared with November, this forecast shows an increase of around £1 billion per year from 2013-14 onwards. This is largely because of changes to the forecasts of CPI inflation and average earnings growth. Table 7.19 summarises the changes to the tax credits forecast since the November forecast. The detailed changes apply to the forecast for household tax credits, i.e. child and working tax credits, which account for the bulk of this spending.

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

7.106 Where recipients do not pay tax, all their tax credits are classified as AME spending. Where the recipient pays some tax, the amount of tax credit that serves to offset all or some of the tax paid is classified as negative tax and any remaining amount scores as AME. Overall, negative tax tax credits account for around 15 to 20 per cent of total tax credit payments, but this proportion is decreasing as a result of announced policy measures. The negative tax element is shown in Table 7.7 and the AME spending shown in Table 7.15.

Public service pensions

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

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

Table 7.20: Key changes to net CG unfunded pension schemes since November forecast

	£ billion					
	Forecast					
	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
November forecast	4.3	5.1	5.4	5.4	6.1	7.2
March forecast [1]	4.6	5.7	6.4	6.5	7.2	8.1
Change	**0.2**	**0.5**	**0.9**	**1.1**	**1.1**	**1.0**
of which:						
CPI	0.0	0.0	0.3	0.4	0.4	0.5
Paybill growth	0.0	0.4	0.6	0.6	0.6	0.4
[1] The March forecast of net pension payments is made up of expenditure and income as follows:						
Gross expenditure	26.1	27.4	29.2	30.6	32.2	33.7
Income	-21.5	-21.7	-22.8	-24.1	-25.0	-25.6

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

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

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

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

adjustment to total receipts. It is therefore not included in the scheme by scheme analysis shown in the supplementary fiscal tables. For the purposes of separating out CG schemes from the locally-administered police and fire-fighters' schemes in Table 7.15, we have assumed that approximately £0.2 billion of this is in respect of police and fire-fighters' pensions schemes.[8]

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

EU contributions

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

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

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

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

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

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

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

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

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

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

Locally financed expenditure

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

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

7.122 The forecast for current LASFE in 2010-11 has been reduced by £2 billion since the November forecast. There is currently very little information available on local authority current expenditure during the current year, so this is a key area of uncertainty in the forecast. The first outturn estimates for English local authorities are not available until almost five months after the end of the financial year and there is a longer lag before figures for Scotland and Wales become available. However this information gap should be partially filled during 2011-12

because Communities and Local Government (CLG) plan to collect and publish quarterly local authority current spending data. This is a very welcome and useful development.

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

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

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

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

Debt interest

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

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

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

7.130 The debt interest forecast for payments on new issuance of conventional gilts depends on the level of new issuance and the effective gilt interest rate. The level of new gilt issuance is determined by the central government net cash requirement (CGNCR), the profile of redemptions of existing gilts and the projected mix of financing instruments. The forecast for the CGNCR is shown in Table 7.22. This has increased since the November forecast and results in an extra £1.6 billion in debt interest costs by 2015-16. This, and other significant changes to the debt interest forecast, are shown in Table 7.21.

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

Table 7.21: Key changes to debt interest since November forecast

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

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

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

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

Fees associated with the financial interventions

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

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

Other items in departmental AME

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

Other AME spending

7.137 Table 7.15 now shows separate forecasts for single-use military expenditure. We remove this from CDEL and include it in current AME spending because it is classified as current expenditure in the National Accounts.

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

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

Public corporations

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

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

Accounting adjustments

7.142 Accounting adjustments are necessary to reconcile between spending components, which are sourced from departments' spending data, and the National Accounts definition of TME. They replace some data where National Accounts uses an alternative source and they add in some items that should be included in TME but are not included in the budgeting aggregates. The number and amount of accounting adjustments has been significantly reduced as a result of the new presentation of TME shown in Table 7.15. A full table of accounting adjustments is included in the OBR supplementary fiscal tables.

7.143 Table 7.16 shows a small reduction in current and capital accounting adjustments over the forecast period when compared with November. The reduction in capital is caused by a current to capital switch of DfID bilateral aid grants being removed. This anticipates the ONS correcting this classification in the near future and therefore making this adjustment unnecessary. The consequential increase on the current accounting adjustments is more than offset by revisions to the local authority accounting adjustments.

Financial transactions

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

7.145 Table 7.22 shows the steps required to move from the PSNB to the PSNCR and CGNCR. The first step is to move from PSNB to PSNCR by including financial transactions, which represent the difference between the net borrowing aggregates and the cash measures. These transactions arise either from timing differences known as 'accruals adjustments' or from exchanges of financial assets involving cash – 'financial transactions'.

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

Table 7.22: Reconciliation of PSNB and CGNCR

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

7.146 The PSNCR measures the cash required by the public sector as a whole. As shown in Table 7.22, the cash requirements for local authorities (LANCR) and public corporations (PCNCR) are removed from the PSNCR to produce an estimate of the cash required by the Government to fund its own operations – the CGNCR 'own account'. In addition, central government lends money to local authorities and public corporations. The lending to local authorities is done via the Public Works Loans Board (the PWLB). The adjustment for the net effect of this on lending produces the CGNCR.

7.147 We use the following approach to forecast financial transactions:

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

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

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

- changes to the forecasts for RPI which affects the accruals uplift on index linked gilts and student loans. A higher RPI raises net borrowing but has no immediate cash implications. This therefore increases the size of the accruals adjustment which is removed within the financial transactions;

- an increase in the proportion of borrowing which some local authorities are doing from the market, rather than from the PWLB, which increases the LANCR and reduces the CGNCR. Our forecast assumes this borrowing increases to £2 billion a year by 2012-13, compared with levels of borrowing of £2-3 billion from the PWLB. We also assume that local authorities borrow a net, one-off amount of £5 billion from the market in 2011-12 to finance their net payment of £7.5 billion to central government as part of the HRA reforms discussed in the AME spending sections above;

- an increase of £775 million in 2012-13 reflecting the Government's announcement of funding for the Green Investment Bank;

- the inclusion of an estimate of the funding necessary for the bilateral loan to Ireland. This amounts to £3.2 billion between 2011-12 and 2013-14; and

- changes to the path of loans to the wholly owned banks which are neutral for the public sector as a whole but decrease the CGNCR.

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

7.150 As Table 7.22 shows, in most years there is a reasonably stable relationship between PSNB and the CGNCR. They differed by much more than usual in 2008-

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

Box 7.2: Fiscal impact of the financial interventions

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

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

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

Treatment of financial asset sales and privatisation proceeds

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

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

7.153 Consistent with the *Charter*, and our wider approach to policy announcements, we only include the impact of such sales in our central forecast once firm and final details are available that allow the effects to be quantified with reasonable accuracy. At the present time, only the sale of High Speed 1, which was completed last year, is included in the central forecast. Consistent with

the *Charter*, we note risks to the forecast from commitments that cannot yet be quantified. Two significant risks relate to spectrum sales and the Government's shareholdings in public sector banks.

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

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

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

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

7.158 The Government's holdings in RBS and LBG represent another significant risk to the forecast. In this case the risks to PSND are on the downside because, as Box 7.2 explains, on the basis of current market prices the sale of these shares would lead to a loss to the taxpayer of £1.6 billion. Given that no announcement has been made on the terms or timing of any sale it would not be appropriate to include this in the central forecast.

The key fiscal aggregates

7.159 Table 7.23 sets out our central forecast for the key fiscal aggregates, reflecting the preceding analysis of forecasts for the receipts and spending components. The arithmetic of the fiscal aggregates is set out in an annex to our briefing paper, *Forecasting the public finances*. In this section we focus on describing changes in four key fiscal aggregates:

- **public sector net borrowing**, which represents the difference between total public sector receipts and expenditure on an accrued basis each year. As the widest accrued measure of borrowing it is a key measure of the fiscal position and useful for illustrating the reasons in changes since the previous the forecast;

- the **surplus on the current budget**, which is the difference between public sector current expenditure and receipts each year. In other words it is public sector net borrowing excluding borrowing to finance investment;

- the **cyclically-adjusted current budget**, which is the surplus on the current budget adjusted to remove the estimated effect of the economic cycle. It therefore represents an estimate of the underlying or 'structural' surplus on the current budget. It is used as the target measure for the Government's fiscal mandate; and

- **public sector net debt**, which is a stock measure of the public sector's net liability position i.e. its liabilities minus liquid assets. It is the fiscal measure used for the Government's supplementary fiscal target.

Net borrowing

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

Table 7.23: Fiscal aggregates

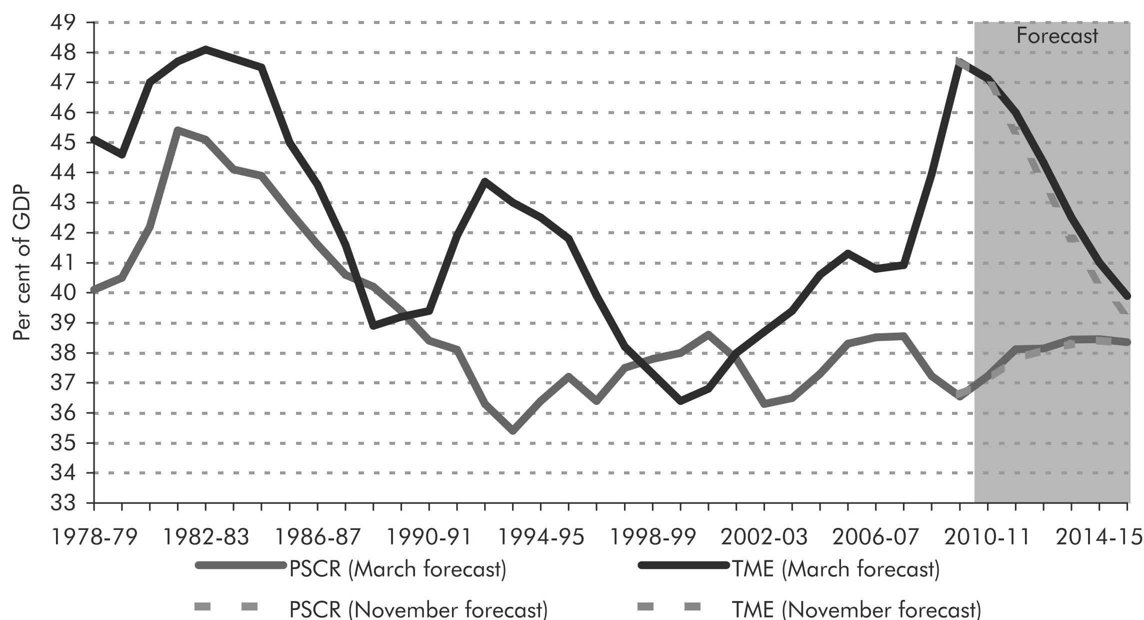
	Per cent of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Receipts and expenditure							
Public sector current receipts (*a*)	36.5	37.2	38.1	38.1	38.4	38.5	38.4
Total managed expenditure (*b*)	47.7	47.1	46.0	44.3	42.5	41.0	39.9
of which: PSCE (*c*)	42.8	42.9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

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

[2] General government net borrowing on a Maastricht basis

[3] General government gross debt on a Maastricht basis

Chart 7.4: Receipts and expenditure



Source: ONS, OBR

Table 7.24: Components of net borrowing

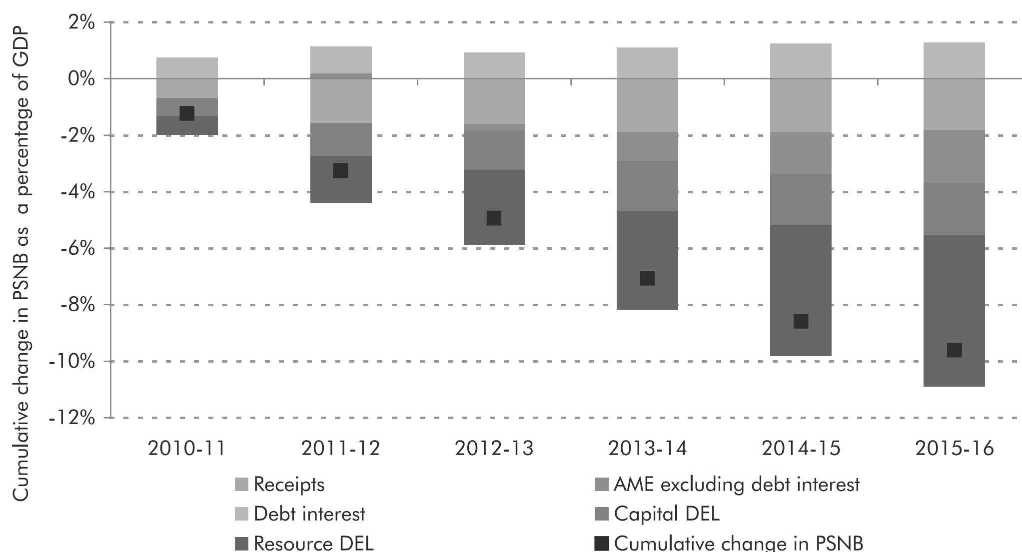
	£ billion						
	Outturn		Forecast				
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Current budget							
Current receipts	513.3	548.5	589	620	660	697	735
Current expenditure	600.9	632.8	657	670	682	695	713
Depreciation	19.3	20.5	22	23	24	25	26
Surplus on current budget	**-106.9**	**-104.8**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

[1] Net of asset sales.

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

7.162 In the medium term we expect PSNB to decline from a peak of 11.1 per cent of GDP in 2009-10 to 9.9 per cent of GDP this year and 1.5 per cent of GDP in 2015-16. As shown in Chart 7.4, this is driven by an increase in public sector receipts as a share of GDP up to 2013-14 and a fall in expenditure across the whole period. Total public sector expenditure is forecast to fall from 47.1 per cent of GDP this year to 39.9 per cent of GDP in 2015-16. Total receipts are forecast to rise from 37.2 per cent of GDP this year to 38.4 per cent in 2015-16.

Chart 7.5: Contributions to changes in PSNB



Source: OBR

Box 7.3: Impact of inflation on the public finances

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

Direct effects

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

Impact on nominal tax bases

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

Impact on departmental spending and the debt-GDP ratio

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

7.163 Chart 7.5 shows the contributions of expenditure components and receipts as shares of GDP to the cumulative change in PSNB from 2009-10 onwards. Increases to debt interest as a percentage of GDP raise borrowing across the period.

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

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

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

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

7.166 Table 7.25 sets out an alternative presentation of the change in PSNB compared to the November forecast, split by the cyclical component, the impact of policy measures and other changes.

Table 7.25: Changes to public sector net borrowing since November forecast

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

7.167 The cyclical component captures changes that reflect the change in our view of the output gap over the forecast period. As set out in Chapter 6 of CP, compared to November, GDP growth is expected to be lower and the output gap wider by up to 0.7 per cent of potential output across the forecast. The consequent increase in borrowing, primarily from the impact of lower labour income in reducing income tax receipts, is therefore cyclical rather than structural.

7.168 The effect of measures reflects the broadly neutral impact of measures announced since November as set out in Table A.3.

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

Current budget

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

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

Cyclically-adjusted current budget

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

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

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

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

Net debt

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

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

- there is a higher projected path for the public sector net borrowing and financial transactions. Together these comprise the public sector net cash requirement, as set out in Table 7.22, which drives the size of the nominal stock of debt. This acts to increase the level of nominal PSND; and

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

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

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

7.179 Table 7.26 sets out the key changes to PSND since our November forecast.

7.180 Table 7.27 summarises the changes to our forecasts for the key fiscal aggregates since the interim OBR's June Budget forecast.

Table 7.26: Key changes to net debt since November forecast

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

Table 7.27: Changes to the fiscal forecast

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

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

Comparison with external forecasts

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

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

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

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

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

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

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

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

Table 7.28: Comparison of the IFS and OBR fiscal forecasts

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

8 Performance against the Government's fiscal targets

Summary

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

8.2 There is considerable uncertainty around our central forecast, as there is around all fiscal forecasts. This reflects uncertainty both about the outlook for the economy and about the performance of revenues and spending for any given state of the economy. Given these uncertainties we probe the robustness of our central judgement in three ways:

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

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

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

Introduction

8.3 This chapter begins by setting out the Government's medium-term fiscal targets (paragraphs 8.4 to 8.7). It then examines whether the Government has a better than 50 per cent chance of meeting those targets, given our central forecast for the public finances (paragraphs 8.8 to 8.12). We then assess how robust this judgement is to the uncertainties inherent in any fiscal forecast, by looking at: past forecast errors, sensitivity to key parameters of the forecast, and alternative economic scenarios (paragraphs 8.13 to 8.42). We conclude by outlining our plans to analyse the longer-term outlook for the public finances in our *Fiscal sustainability report*, planned for July (paragraphs 8.43 to 8.44).

The fiscal mandate and supplementary target

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

8.5 The *Charter for Budget Responsibility* defines the fiscal mandate as "a forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period". For the purposes of the current *Outlook*, this means that total public sector receipts need to exceed total public sector spending (minus spending on net investment) in 2015-16, after adjusting for the impact on receipts and spending of any remaining spare capacity in the economy.

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

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

The implications of our central forecast

8.8 Table 8.1 shows our central forecasts for the cyclically-adjusted current budget and PSND in each year to 2015-16, as set out in Chapter 4 (equivalent to chapter 7 of this Convergence Programme). These are median forecasts, which means that we believe it is equally likely that the eventual outturns will come in above them as below them.

Table 8.1: Performance against the Government's fiscal targets

		Per cent of GDP						
		2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Cyclically-adjusted current budget balance	March forecast	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
	November forecast	-5.3	-4.7	-3.3	-1.8	-0.5	0.5	0.9
	June forecast	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
Public sector net debt	March forecast	52.7	60.3	66.1	69.7	70.9	70.5	69.1
	November forecast	53.5	60.8	66.3	69.1	69.7	68.8	67.2
	June forecast	53.5	61.9	67.2	69.8	70.3	69.4	67.4

8.9 Table 8.1 shows that in our central forecast the cyclically-adjusted current balance is expected to be in surplus by 0.8 per cent of GDP in 2015-16 on current policies. This means that there is a better than 50 per cent chance of the Government achieving cyclically-adjusted current balance in 2015-16 and that it is therefore on course to achieve the fiscal mandate. Our central forecast also shows that the cyclically-adjusted current balance is expected to be in surplus by 0.4 per cent of GDP in 2014-15. So the Government also has a greater than 50 per cent chance of meeting the fiscal mandate in that year too.

8.10 Table 8.1 also shows our central forecast for public sector net debt to be falling by 1.4 per cent of GDP between 2014-15 and 2015-16. So the Government has a greater than 50 per cent chance of achieving its supplementary target. Like the fiscal mandate, the supplementary target is forecast to be met in the previous year too, as PSND is also forecast to fall between 2013-14 and 2014-15.

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

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

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

Recognising uncertainty

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

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

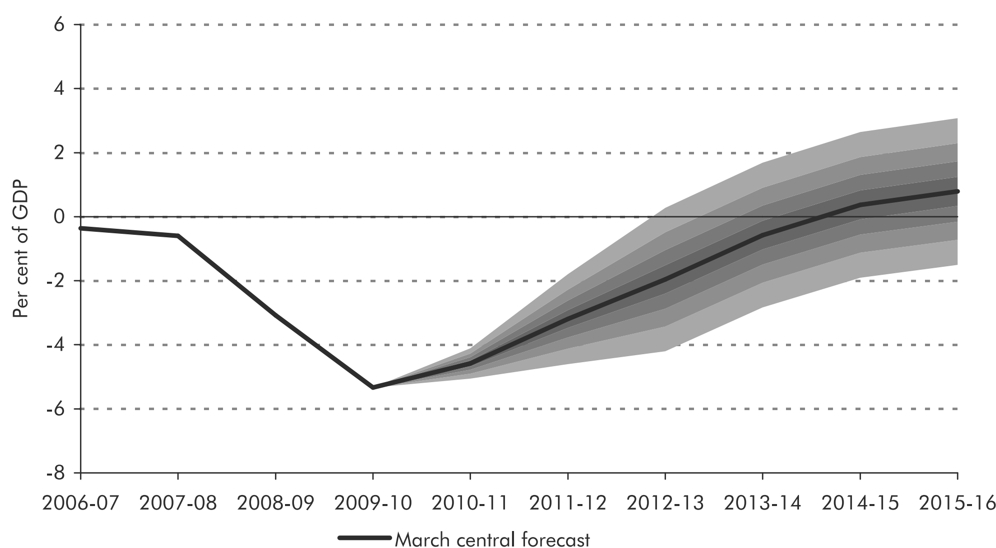
- by looking at the lessons from past forecast errors;
- by seeing how our central forecast would change if we altered some of the key judgements that underpin it; and
- by looking at alternative economic scenarios.

Past forecast performance

8.15 One relatively simple way to illustrate the uncertainty around our central forecast is to draw lessons from the accuracy of previous official public finance forecasts. This can be illustrated through the use of fan charts like those we presented for GDP growth in Chapter 3 (equivalent to chapter 6 of this Convergence Programme) and public sector net borrowing (PSNB) in Chapter 4 (equivalent to chapter 7 of this Convergence Programme). These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that our central forecast was likely to be as accurate as previous HM Treasury Budget and Pre-Budget Report forecasts were in the past.

8.16 In this spirit, Chart 8.1 shows the probability distribution around our central forecast for the cyclically-adjusted current budget balance, based on past Treasury forecasting errors (which, in normal times, tend to be dominated by errors in the fiscal forecast rather than the underlying economic forecast). The solid black line shows the median forecast, with the successive pairs of lighter shaded areas around it representing 10 per cent probability bands. This implies that there would be an 80 per cent probability of the outturn lying within the shaded bands on current policy.

Chart 8.1: Cyclically-adjusted current budget fan chart



Source: OBR

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

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

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

Sensitivity analysis

8.20 It is very difficult to produce a full subjective probability distribution for the Government's target fiscal variables because they are affected by a huge variety of economic and non-economic determinants. However, to recognise the uncertainty in our forecast we can go further than using the lessons of past

forecasting errors, by quantifying roughly how sensitive our central forecast is to certain key economic parameters.

8.21 In thinking about the evolution of the public finances over the medium term, there are several parameters that have a particularly important bearing on the forecast. In this section we focus on four:

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

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

8.23 Tables 8.2 and 8.3 present illustrative estimates of the impact of these variants on:

- the level of the cyclically-adjusted current budget balance in 2015-16; and
- the change in PSND between 2014-15 and 2015-16.

8.24 For practical reasons, we have not undertaken complete forecast runs for each variant, but have instead used ready-reckoners and simplifying assumptions to generate illustrative estimates. The cyclical adjustment ready-reckoner assumes that a 1 per cent change in GDP will result in a 0.7 per cent of GDP change in PSNB and the current surplus after two years. The actual change in the public finances would also depend on the composition of any change to GDP. For this reason we also assume that the composition of growth remains as in our central forecast. While we recognise the limitations of these ready-reckoners, applying them yields the results shown in Table 8.2 and Table 8.3.

Table 8.2: Cyclically-adjusted current balance in 2015-16

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

Table 8.3: Change in PSND between 2014-15 and 2015-16

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

8.25 Table 8.2 shows that the starting point for the output gap has a strong effect on the size of the cyclically-adjusted current budget balance in 2015-16. The smaller the output gap, the larger the proportion of the deficit that is structural (and therefore impervious to economic recovery) and the less margin the Government has against its fiscal mandate. Conversely if the output gap is wider, less of the deficit is structural and the Government has more margin against its mandate. Closing the output gap at a different pace will result in a change in cyclical borrowing, but has little effect on the structural balance. For example, closing the output gap more slowly will result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.

8.26 Roughly speaking, the output gap would have to be about 1.5 per cent of output smaller than our central estimate (i.e. about 1.5 per cent of potential output, half its current estimated size) to make it more likely than not that the mandate would be missed. As we saw in Chapter 3 (equivalent to chapter 6 of this Convergence Programme), estimates of the size of the output gap vary considerably, but none of the organisations we cited thought that it was as small as this. However, there is no guarantee that the true figure might not lie outside the bounds of current estimates.

8.27 Table 8.3 shows that the supplementary target is met under all but one of the output gap size and closure date combinations. This is because our central projection for PSNB in 2015-16 is only 1.5 per cent of GDP. As we have outlined, if our forecast is correct until 2014-15 then PSNB would have to be around

3 per cent of GDP in 2015-16 to breach the target. Only one of the changes that we have looked at causes PSNB to deteriorate this much. That said, the longer it takes to close the output gap, the less PSND falls by in 2015-16 for a given output gap in 2011.

8.28 A third potential source of departure from our central forecast is variation in the interest rates that the Government has to pay on future borrowing and some existing debt. As set out in Chapter 4 (equivalent to chapter 7 of this Convergence Programme) our central forecast assumes that gilt rates for future borrowing move in line with market expectations. But what if the central forecast of gilt rates (r) was to suffer a shock? We examine the implications of a negative shock of 50 basis points, making debt cheaper, and increases of 50, 100 and 150 basis points, making debt more expensive. We assume the shock occurs in 2011-12. Table 8.4 shows the level of the cyclically-adjusted current budget balance in 2015-16 and the change in PSND between 2014-15 and 2015-16 under these variants, constructed using a ready-reckoner.

Table 8.4: Fiscal target variables under different gilt rate assumptions

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

8.29 Table 8.4 shows that these illustrative shocks to gilt rates do not have much impact on the chances of meeting the mandate and supplementary target. This is because (as illustrated in Chapter 7 of CP) an increase in rates applies only to new debt issuance, and the UK has a relatively long average debt maturity of 13 years, and because new issuance is projected to fall as borrowing declines. Therefore over a short horizon, such as our five-year forecasting period, the impact of a shock to the average nominal rate on gilts is actually quite slight. However, over a longer horizon shocks such as these will have a more significant impact.

8.30 Our last sensitivity analysis concerns the uncertainty around our cyclical adjustment coefficients. As noted above, cyclical adjustment attempts to remove the effect of the economic cycle from forecasts of the public finances. This is done by adjusting a given fiscal aggregate, such as PSNB, for the size of the output

gap in the current and previous years, using cyclical adjustment coefficients.[1] As set out in Chapter 4 (equivalent to chapter 7 of this Convergence Programme), we have used the Treasury's approach to cyclical adjustment, presented in *Public finances and the cycle*.[2] The coefficients we have used are therefore 0.2 for the previous year's output gap, and 0.5 for the current year's gap.

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

- the output gap is not directly observable, so there is no historical 'fact' from which to estimate the coefficients;
- the number of observations on which to base coefficient estimates is limited;
- the fiscal position is affected by events which do not necessarily move in line with the cycle, such as one-off fiscal policy adjustments and movements in commodity and asset prices; and
- insofar as the current economic cycle differs from the average cycle, the relationship between the public finances and the output gap over the course of that cycle will not be captured in the coefficients.

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

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

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

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

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

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

Scenario analysis

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

8.36 We now set out the fiscal implications of the two new illustrative alternative economic scenarios that we introduced in Chapter 3 (equivalent to chapter 6 of this Convergence Programme). In this section, we briefly reprise the economic scenarios before exploring their fiscal consequences. Table 8.5 below summarises these fiscal consequences.

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

Table 8.5: Key fiscal aggregates under alternative economic scenarios

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

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

8.38 Under this scenario, the Government has a greater chance of meeting its fiscal targets. As noted in Box 7.3, higher inflation has a variety of effects on the public finances with the overall effect dependent on the extent to which the negative direct effect from indexation, leading in particular to higher social security payments, is offset by higher receipts from a larger nominal tax base. In this scenario, persistently above-target inflation feeds through into wage settlements and earnings growth and higher consumer prices raise nominal consumer spending. This is in contrast to the assumption in the central forecast that nominal wages do not respond to the stronger inflation expected in 2011 and 2012.

8.39 The effect on receipts from a larger nominal tax base, particularly from higher earnings, more than offsets the rise in annually managed expenditure (AME) from higher indexation and the jump in debt servicing costs from the rise in gilt rates. The overall effect is to reduce PSNB relative to the central forecast. With the tightening of monetary policy reducing GDP growth, the output gap remains more negative for longer. This leads to a sizeable improvement in the cyclically-

adjusted current balance. PSND as a percentage of GDP is around 5 per cent below the central forecast by the end of the forecast horizon reflecting the effect of both lower borrowing and higher nominal GDP on the ratio.

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

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

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

Long term fiscal sustainability

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

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

9 Long-term fiscal sustainability

Long-term fiscal sustainability

9.1 The OBR's terms of reference also require us to analyse long-term fiscal sustainability. We will examine this issue in detail in our *Fiscal sustainability report* next summer. For the purposes of this report, we confine ourselves to some relatively simple extrapolations of public sector net debt over the next 40 years, building on our medium-term forecasts in Chapter 4. As these projections follow on from the medium-term forecast period they do not change the probability of meeting the Government's fiscal mandate or supplementary target. However, they do illustrate some of potential future fiscal pressures and extend some of the sensitivity analysis that we have conducted. Given the uncertainty inherent even in short- and medium-term forecasts, it is clear that projections over longer time horizons should be treated with even greater caution.

Central case debt extrapolation

9.2 Our starting point in illustrating the long-term outlook for public sector net debt is to take the medium-term forecasts that we presented in Chapter 4 and assume that the structural primary budget balance is unchanged thereafter. In other words, for these illustrative projections we assume that public sector receipts and public sector spending remain constant as shares of national income, with the exception of spending on public sector debt interest. We adjust for the fact that we expect that there will still be a modest amount of spare capacity in the economy in 2015–16, which will depress revenues and increase spending in that year and 2016–17. We then assume that public sector receipts settle from 2017–18 onwards. These imply a long-term primary budget surplus of 2.1 per cent of national income.

9.3 The outlook for public sector debt and public sector debt interest payments depends not just on the size of the primary balance, but also on the average interest rate on the public sector's debt and the growth in nominal GDP. To be precise, public sector net debt will be on a sustainable path beyond 2016–17 as long as the average nominal interest rate on the public sector's net debt does not exceed the growth rate of money GDP by an amount greater than the primary budget surplus as a share of national income.

9.4 The next step is to make projections for real GDP growth and the GDP deflator, and thus for nominal GDP. To project GDP growth, we need to make assumptions about growth in productivity (output per head), the population and employment:

- productivity: we assume that productivity grows by 2% a year, the average rate seen during the past 50 years;

- population: we use the latest population projections from the Office for National Statistics, based on 2008 data. In its central case scenario the ONS assumes annual net inward migration of 180,000 people per year over the long term, but as discussed in Chapter 3 this figure reflects high net inward migration flows in recent years. We instead use the ONS's low migration scenario and assume net inward migration of 140,000 moving to 120,000 people per year for the majority of the projection period. By 2050 this means that the population has risen to slightly over 73 million people, as opposed to nearly 76 million people under the principal scenario; and

- employment: we project long-run changes in the proportion of the working population in employment by using historical labour market participation profiles for different cohorts (groups with different years of birth) to model the participation rate of current cohorts through the projection period. This captures the impact of changes in the demographic structure of the workforce, as older cohorts are replaced by younger ones. The increasing size of the population means that when these participation rates are applied, there is projected employment growth between 2015 and 2050 of around 0.13 per cent per year. Under the principal migration scenario the employment growth rate over the same period averages 0.26 per cent. This is largely due to the extra migrant population being of working age when they arrive in the UK.

9.5 Combining these three determinants leads us to project that real growth in the economy will average around 2.2 per cent between 2016 and 2050. To convert these changes in real GDP into nominal GDP we need to apply a GDP deflator, reflecting the change in overall price levels in the economy each year. For this purpose we have taken the 2.7 per cent GDP deflator from the end of the forecast period and held it constant. Combining the projections for real GDP growth and the GDP deflator leads us to project that nominal GDP will average annual growth of nearly 4.9 per cent. Because the GDP deflator is constant, all underlying movement is driven by changes in the projection of real GDP.

9.6 Having looked at the growth rate, we also need to make projections for the interest rate on government debt. Chapter 4 explains how debt interest is calculated for the fiscal forecast. We follow a similar technique in these projections. The DMO's remit and medium-term strategy are assumed to hold throughout the projections. This means that when calculating the average interest rate on debt the weightings used for different maturities remain the same as those in the forecast. These are applied to projected yield curves from the DMO, to calculate the interest rate out to 2035. As the longest-dated bond matures in around 50 years, half of the points on the 25 year forward curve will be calculated from the actual yield curve and half of them extrapolated beyond the

end of the curve. After this point it is assumed the yield curve is constant, and debt interest therefore stabilises at about 4.4 per cent.

9.7 On the basis of these assumptions for the primary budget balance, nominal GDP and the average interest rate on public sector net debt, we have projected central paths for public sector net debt and public sector net interest payments as shares of GDP through to 2049-50. These projections are shown in the subsequent section. Debt interest is declining from 2015-16, and public sector net debt continues to fall after it meets the supplementary target in 2014-15. On this very simple illustrative extrapolation, the long-term outlook for the public finances looks sustainable, as the assumed primary budget surplus is sufficiently large to keep public sector net debt on a downward path.

Sensitivity analysis

9.8 Needless to say, there is considerable uncertainty around the various determinants that we have used to generate our central illustrative projections – particularly over a time horizon as long as 40 years. So we now examine the sensitivity of these projections to different assumptions regarding interest rates and the long-term growth rate of the economy.

9.9 In the previous section of this chapter, we showed how the structural current budget balance and public sector net debt would be affected in 2015–16 by variants for future gilts rates, which would feed through to the average interest rate on the stock of public sector net debt. We also looked at the impact of different growth rates on the level of debt, by varying the time it takes to close the output gap. In Chart 9.1 and Chart 9.2 we show how these same variants would affect the level of public sector net debt.

Chart 9.1: Sensitivity of PSND to growth rate shock

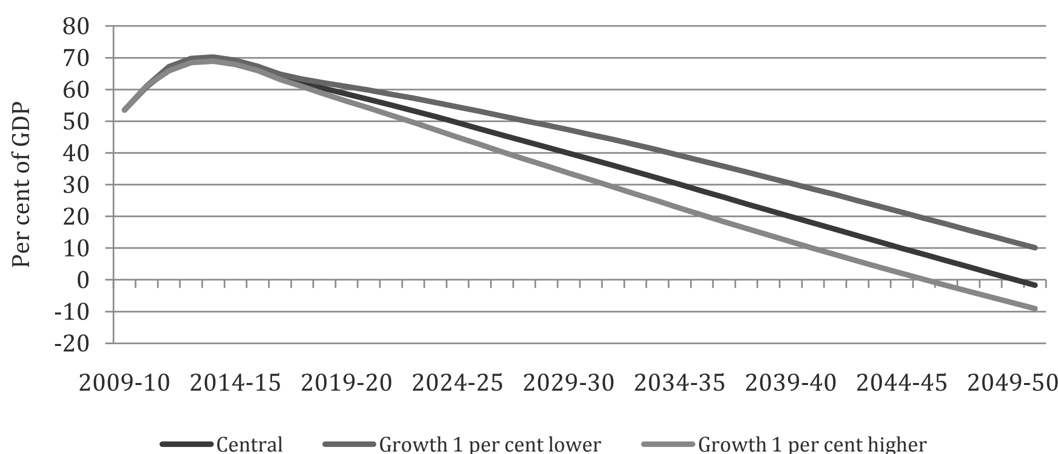
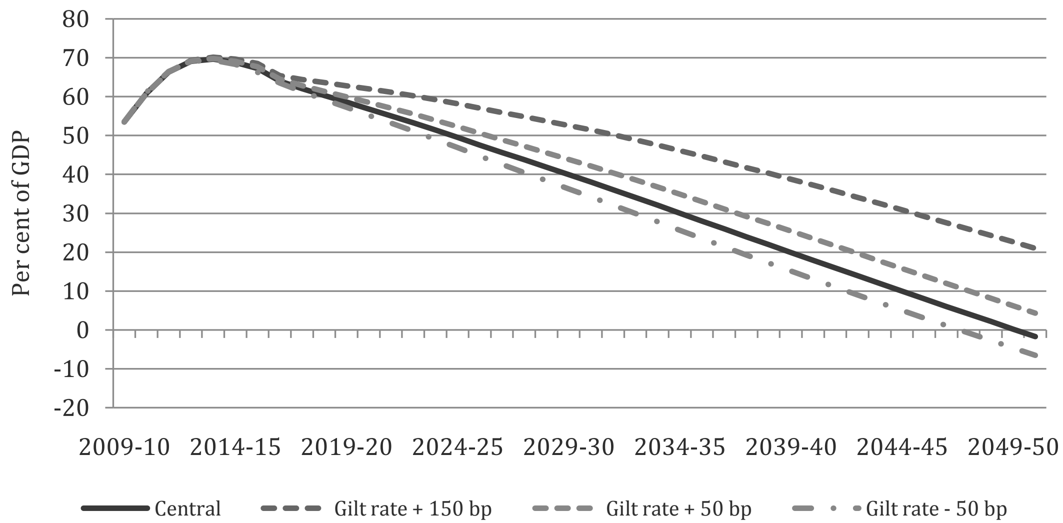


Chart 9.2: Sensitivity of PSND to gilt rate shock



9.10 We have smoothed the pass-through of the gilt rate shock to reflect the average maturity of UK debt, as described earlier. We are also assuming that there is no influence of inflation and therefore on index-linked gilts. In Chart 9.3 and Chart 9.4 we are then able to show how these shocks affect spending on net interest as a proportion of GDP, keeping in mind that non-interest spending as a proportion of GDP is constant.

Chart 9.3: Sensitivity of net interest to growth rate shock

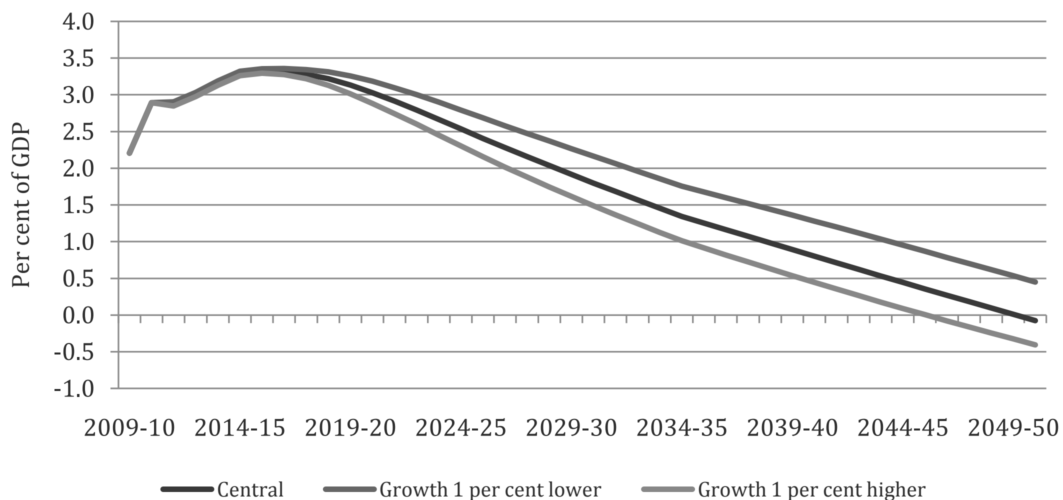
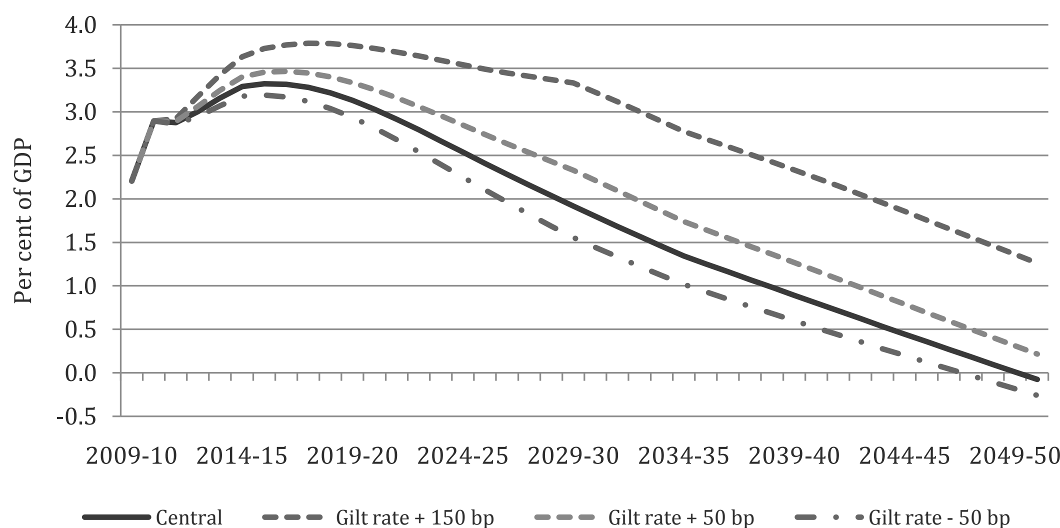


Chart 9.4: Sensitivity of net interest to gilt rate shock



9.11 The charts show the extent to which different GDP growth rates and shocks to gilt rates of different sizes affect future debt paths. While they have a significant impact on the levels of debt reached, they do not reverse the eventual downward trajectory.

Taking account of demographic pressures

9.12 The outlook for public sector net debt will deviate from our central projection not just because of different trends in the economy and interest rates, but also because of upward or downward pressure on spending and revenues – should governments decide not to offset these pressures with policy changes. This will affect the future size of the primary budget balance and thereby feed into future debt dynamics.

9.13 These potential pressures on spending and revenues will be a key focus of our annual *Fiscal sustainability report*s. For the purposes of this *Economic and fiscal outlook*, we only look briefly at the potential impact of the demographic pressures on spending identified and quantified by the Treasury in its 2009 *Long-term public finance report*, the last comprehensive official report on these long-term pressures. These estimates are derived by quantifying the amount of public spending devoted to people of different ages and then assuming that these amounts remain constant as the proportion of the population falling into different age groups changes. The upward pressure on spending arises primarily because a higher proportion of the population is expected to be in older age groups in coming decades, pushing up spending on pensions, healthcare and long-term care. The Treasury's analysis suggested that the total impact of these demographic factors would be to increase spending by 2 per cent of GDP by 2029-30 and almost 4 per cent of GDP by 2049-50.

9.14 These calculations were based on the ONS's central population projections, using 2008 data. As we noted in Chapter 3, we think it is more appropriate to use the population projections in the ONS's low net migration scenario. Choosing a lower population growth scenario than the Treasury used in the 2009 *Long-term public finance report* affects estimates of spending pressures in two ways:

- first, lower projected population growth reduces the expected future level of GDP which means that a given amount of cash spending translates into a higher ratio of spending to GDP; and
- second, different population projections alter the expected proportions of the population in different age and gender groups, and thus the scale of the pressures on spending.

9.15 Updating the Treasury's projections for age-related expenditure (which the interim OBR also reported in Table 5.1 of its June 2010 *pre-Budget forecast*) to reflect the lower population growth implied by the ONS's low net migration scenario, gives us the projections for age-related expenditure reported in Table 9.1.

Table 9.1: Projections for age-related expenditure

Per cent of GDP	2009-10	2019-20	2029-30	2039-40	2049-50
Health	8.0	8.5	9.4	10.2	10.6
Long-term care	1.2	1.4	1.7	2.0	2.2
Education	6.0	5.9	5.9	5.8	5.7
Pensions	5.5	5.3	6.1	6.8	6.8
Public service pensions	1.8	1.9	2.0	1.9	1.8
Total	**22.5**	**23.1**	**25.1**	**26.6**	**27.1**

9.16 The result is that rather than seeing spending pushed up by 2 per cent of GDP by 2029-30 and almost 4 per cent of GDP by 2049-50 as the Treasury's analysis suggested, we see increases of 2.6 per cent of GDP and 4.6 per cent of GDP respectively. This is largely driven by the slightly lower growth rate for GDP, rather than by additional upward pressures to expected cash levels of spending.

9.17 However, recent policy changes mean some of the underlying spending projections are likely to have changed from when these projections were initially constructed. For example, state pension projections previously based on RPI up-rating will not reflect new policy to up-rate pensions by the highest of CPI inflation, earnings or 2.5 per cent. Bringing forward the state pension age to 66 is also likely to have a slightly offsetting effect in the period just after the end of our forecast. Changes to public sector employment and the introduction of CPI up-rating would also have an impact on the projected spending on public service pensions. The Independent Public Service Pension Commission recently published

their interim report, which incorporated some of these changes in their analysis of long-term spending. Beyond pensions we would also expect further adjustments to age-related expenditure to stem from the recommendations of the Independent Review of Higher Education Funding and Student Finance published in October 2010 (see Box 4.3 for more on the impact of Higher Education funding over the forecast), and the Commission on the Funding of Care and Support, due to report in 2011.

9.18 At this point we are not able to robustly quantify the impact of these changes on the long-term projections but consideration of these changes will play an important part in the OBR's long-term analysis in future reports. However, for this preliminary analysis, we can show how the projected changes in age-related expenditure set out in Table 9.1 would affect our central projections of debt and debt interest (Charts 9.5 and 9.6). We can also compare the projections for all elements of age-related expenditure, and for only the non-pension related elements.

9.19 Under the assumption that governments decide not to offset these pressures with policy changes, the effect of including this additional spending pressure is gradually to reduce primary budget surplus and then push it into deficit. Eventually the primary budget balance would deteriorate sufficiently to push public sector net debt back onto an upward path as a share of GDP, given our assumptions for money GDP growth and interest rates. So, as shown in Chart 9.5, in this highly simplified long-term projection the public finances would not remain on a sustainable path indefinitely if these spending pressures were not offset. Chart 9.6 shows the effect of this increasing debt on net interest payments.

Chart 9.5: Impact of demographic change on PSND

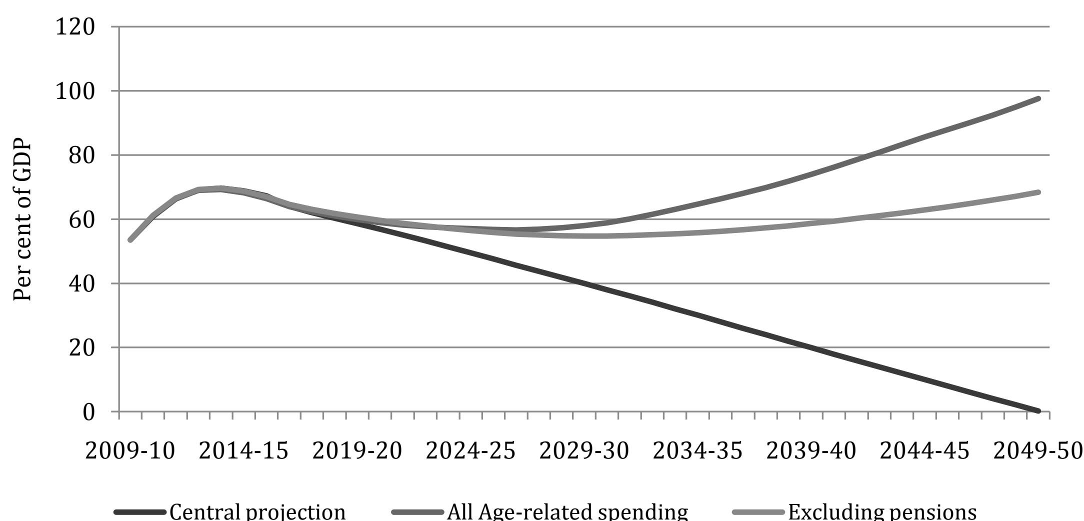
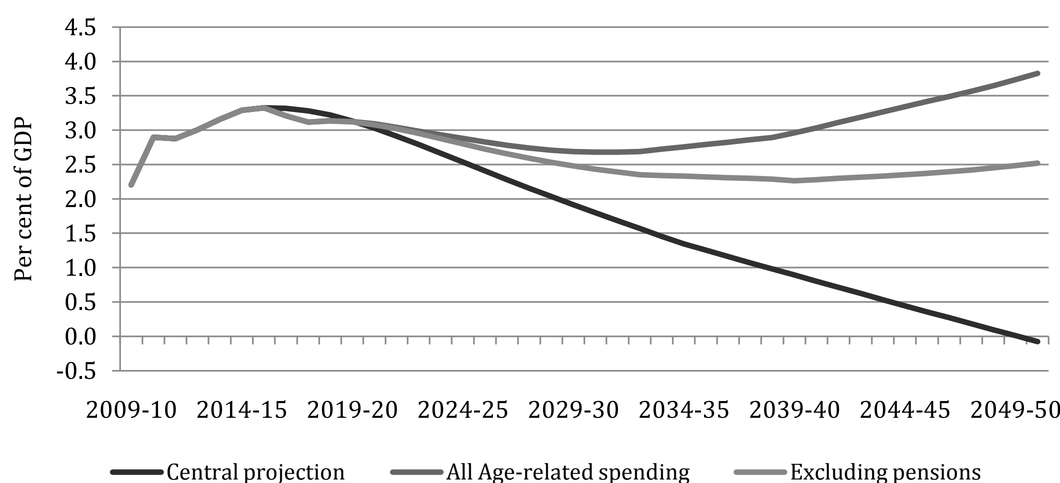


Chart 9.6: Impact of demographic change on net interest



9.20 Given that most of our caveats concern pensions, separating the elements as above is useful. Even if we only include healthcare, long-term care and education spending, we can see that debt eventually begins to increase as a percentage of GDP once the increase in age-related spending exceeds the natural offset from maintaining a constant primary balance under the central projection.

9.21 The upward trajectory of public sector net debt that results from accommodating age-related expenditure is common to many analyses of this subject in many countries. Indeed, the simple projections that we have shown follow similar results published by the IMF, European Commission and the Bank for International Settlements.[1] It is clear that the UK is not unique in confronting these pressures and that most industrial countries have difficult decisions to make about them once the immediate challenge of the current fiscal consolidation is passed.

Extending this analysis

9.22 The projections that we have constructed here are simplistic and highly-stylised, and are not intended to show the likely evolution of debt or interest payments with any accuracy. Instead we have tried to illustrate some of the pressures that may come to bear in future. Our *Fiscal sustainability reports* will deal with this subject in more depth.

9.23 In next summer's report we will aim to assess the full long-term impact of many of the recent policy changes that we have mentioned. These include changes to the up-rating of pension benefits, changes to the public sector workforce, and

[1] For similar long-term projection techniques and ageing costs, see; *Fiscal Implications of the Global Economic and Financial Crisis*, IMF staff note, 2009: *2009 Ageing Report*, European Commission, 2009: *The future of public debt: prospects and implications*, BIS working paper no. 300, 2010.

bringing forward the increase in the state pension age. We have also already noted many of the reviews that may be relevant, including the Independent Review of Higher Education Funding and Student Finance, the Commission on the Funding of Care and Support, and the Independent Public Service Pension Commission. Our analysis has also focused on spending pressures, but the sustainability of different tax bases is also important.

9.24 The OBR will also use the *Fiscal sustainability report* to comment on the evolution of the public sector balance sheet. We expect that the Whole of Government Accounts, due to be published next spring, will be very helpful in quantifying further liabilities that may be material to the Government. The OBR is currently talking to representatives across the public and private sector to identify relevant work in this area.

A Fiscal impact of policy decisions

A.1 Since May 2010, the Government has made a number of tax and spend policy announcements. These have been published in June Budget 2010, Spending Review 2010 and Budget 2011.

June Budget 2010

A.2 The Government announced a number of tax and spend measures to reduce the deficit in June Budget 2010, these are set out in Table A.1. The estimated direct fiscal impact of these measures was based on the Office for Budget Responsibility's (OBR) economic and fiscal forecast at the time, published alongside the Budget.

Table A.1: June Budget 2010 policy decisions[1]

		£ million				
		2010-11	2011-12	2012-13	2013-14	2014-15
	Tax measures announced at this Budget					
	1. Deficit Reduction					
1	VAT: increase main rate to 20% from 4 January 2011	+2,850	+12,100	+12,500	+12,950	+13,450
2	Insurance Premium Tax: increase standard rate to 6% and higher rate to 20% from 4 January 2011	+115	+455	+445	+455	+455
	2. Enterprise and growth					
3	Corporation Tax: decrease to 27% in 2011-12, 26% in 2012-13, 25% in 2013-14 and 24% from 2014-15 [2]	-10	-400	-1,200	-2,100	-2,700
4	Small Profits Rate: decrease to 20% from 2011-12	0	-100	-1,000	-1,300	-1,400
5	Capital allowances: decrease main rate to 18% and special rate to 8% from 2012-13	0	0	+1,000	+1,900	+1,800
6	Annual Investment Allowance: decrease to £25,000 from 2012-13	0	0	+100	+1,200	+1,000
7	Video games tax relief: not introduce	0	+40	+50	+50	+50
8	Bank Levy: introduce from January 2011	0	+1,150	+2,320	+2,500	+2,400
9	Business rates: backdated bills in 2011-12 [3]	+30	-70	-15	-15	-15
10	Employer NICs: relief for new businesses in targeted regions	-50	-320	-390	-180	0
11	Employer NICs: increase threshold in 2011-12	0	-3,130	-3,150	-3,510	-3,720
	3. Fair taxes					
12	Personal allowance: increase by £1,000 in 2011-12, with adjustments to basic rate limit and upper earnings limit	0	-3,490	-3,700	-3,770	-3,910
13	Basic rate limit: freeze in 2013-14	0	0	0	+320	+740
14	Capital Gains Tax: increase rate for higher rate taxpayers to 28% and increase Entrepreneurs' Relief to £5 million from 23 June 2010	0	+725	+825	+850	+925
15	Council Tax: reduction to receipts due to a one year freeze in 2011-12 [4]	0	-625	-630	-635	-640
16	Landline duty: not introduce	-90	-175	-175	-175	-175
17	Cider duty: reverse increase	-10	-15	-15	-15	-20
18	Furnished holiday lettings: reverse plans to repeal existing rules	-5	-30	-15	-10	-10
19	Managed payment plans: not introduce	0	+140	0	0	0
	Total tax policy decisions	**+2,830**	**+6,255**	**+6,950**	**+8,515**	**+8,230**
	Spending measures announced at this Budget [5]					
20	Changes to current spending	+3,465	+6,835	+15,230	+21,700	+29,780
21	Changes to capital spending	+1,780	+2,020	+2,070	+2,120	+2,160
	Total spending policy decisions	**+5,245**	**+8,855**	**+17,300**	**+23,820**	**+31,940**
	Of which specific welfare measures	**+385**	**+2,010**	**+4,710**	**+8,150**	**+11,040**
22	Benefits, tax credits and public service pensions: switch to CPI indexation from 2011-12 [6]	0	+1,170	+2,240	+3,900	+5,840
23	Disability Living Allowance: reform gateway from 2013-14	0	0	0	+360	+1,075
24	Lone parent benefits: extend conditionality to those with children aged 5 and above from October 2011	0	0	+50	+150	+180
25	Health in Pregnancy Grant: abolish	+40	+150	+150	+150	+150
26	Sure Start Maternity Grant: apply to first child only from 2011-12	0	+75	+75	+75	+75
27	Support for Mortgage Interest: set payments at the average mortgage rate from October 2010	+15	-75	-10	+40	+65
28	Saving Gateway: not introduce in July 2010	+10	0	+75	+110	+115
	Housing Benefit reform:	0	+220	+600	+1,640	+1,765
29	*Local Housing Allowance: set at the 30th percentile of local rents from 2011-12*	*0*	*+65*	*+365*	*+415*	*+425*
30	*Deductions for non-dependents: reverse previous freezes on uprating and maintaining link with prices from 2011-12*	*0*	*+125*	*+225*	*+320*	*+340*
31	*Social sector: limit working age entitlements to reflect size of family from 2013-14*	*0*	*0*	*0*	*+490*	*+490*
32	*Switch to CPI indexation for Local Housing Allowance from 2013-14*	*0*	*0*	*0*	*+300*	*+390*
33	*Reduce awards to 90% after 12 months for claimants of Jobseekers Allowance*	*0*	*0*	*0*	*+100*	*+110*
34	*Additional bedroom for carers from 2011-12*	*0*	*-15*	*-15*	*-15*	*-15*
35	*Local Housing Allowance: caps on maximum rates for each property size, with 4-bed limit from 2011-12*	*0*	*+55*	*+65*	*+70*	*+65*
36	*Additional Discretionary Housing Payments from 2011-12*	*0*	*-10*	*-40*	*-40*	*-40*
	Tax credit reforms:	0	+1,180	+2,860	+3,110	+3,220
37	*Tax credits second income threshold: reduce to £40,000 from 2011-12*	*0*	*+140*	*+145*	*+155*	*+145*
38	*First and second withdrawal rates: increase to 41% from 2011-12*	*0*	*+640*	*+710*	*+730*	*+765*
39	*Child Tax Credit: taper the family element immediately after the child element from 2012-13*	*0*	*0*	*+510*	*+515*	*+480*
40	*Child Tax Credit: remove the baby element from 2011-12*	*0*	*+295*	*+275*	*+270*	*+275*
41	*Working Tax Credit: remove the 50 plus element from 2012-13*	*0*	*0*	*+35*	*+40*	*+40*
42	*Child Tax Credit: reverse the supplement for children aged one and two from 2012-13*	*0*	*0*	*+180*	*+180*	*+180*
43	*Reduce the income disregard from £25,000 to £10,000 for two years in 2011-12 then to £5,000 from 2013-14*	*0*	*+105*	*+140*	*+340*	*+420*
44	*Introduce an income disregard of £2,500 for falls in income from 2012-13*	*0*	*0*	*+550*	*+560*	*+585*
45	*New claims and changes of circumstances: reduce backdating from 3 months to 1 month from 2012-13*	*0*	*0*	*+315*	*+320*	*+330*
46	Child Tax Credit: increase the child element by £150 in 2011-12 and £60 in 2012-13 above indexation	0	-1,200	-1,845	-1,930	-1,995
47	Child Benefit: freeze rates for three years from 2011-12	0	+365	+695	+940	+975
48	Basic State Pension: introduce triple guarantee from 2011-12	0	0	-195	-420	-450
49	Pension Credit Minimum Income guarantee: matching basic State Pension cash increase in 2011-12	0	-415	-535	-535	-535
50	Child Trust Funds: phased abolition of Government contributions from 2010-11	+320	+540	+550	+560	+560
	TOTAL POLICY DECISIONS	**+8,075**	**+15,110**	**+24,250**	**+32,335**	**+40,170**
	Memo: debt interest savings as a result of policy decisions in the next spending review period	-	-820	+1,030	+1,810	+3,020
	Memo: total policy decisions excluding debt interest savings	+8,075	+15,930	+23,220	+30,525	+37,150

[1] Costings reflect latest Budget 2010 economic forecast and assumptions.
[2] In 2015-16 the cost will rise to £3.6bn .
[3] The 2010-11 figure results from reallocation of funding to the following year.
[4] This costing is net of expected changes to council tax benefit.
[5] These measures include the impact of the 2010-11 in-year savings, including capital savings from changes to Child Trust Funds. There are no further cuts to capital totals. Current savings include debt interest savings.
[6] The basic State Pension will be increased by the equivalent of RPI in 2011-12.

Spending Review 2010

A.3 At Spending Review 2010 the Government set DEL spending plans and announced a package of annually managed expenditure (AME) measures, set out in Table A.2. The estimated direct fiscal impact of these AME measures was based on the OBR's economic and fiscal forecast from June Budget 2010.

Table A.2: Spending Review AME policy measures [1, 2]

	£ million			
	2011-12	2012-13	2013-14	2014-15
Welfare measures[3]	**320**	**2,555**	**5,990**	**7,040**
Contributory Employment and Support Allowance: time limit for those in the Work Related Activity Group to one year	0	1,025	1,530	2,010
Housing Benefit: increase age limit for shared room rate from 25 to 35	0	130	225	215
Total household benefit payments capped on the basis of average take-home pay for working households	0	0	225	270
Disability Living Allowance: remove mobility component for claimants in residential care	0	60	130	135
Savings Credit: freeze maximum award for four years from 2011-12	165	215	260	330
Support for Mortgage Interest: extend temporary changes to waiting period and capital limit until January 2012	-70	-20	0	0
Cold Weather Payments: increase rate permanently to £25 from November 2010	-50	-50	-50	-50
Council Tax Benefit:10% reduction in expenditure and localisation	0	0	485	490
Child Benefit: remove from families with a higher rate taxpayer from January 2013	0	590	2,420	2,500
Working Tax Credit: freeze in the basic and 30 hour elements for three years from 2011-12	195	415	575	625
Working Tax Credit: reduce payable costs through childcare element from 80% to 70% restoring 2006 rate	270	320	350	385
Child Tax Credit: increase the child element by £30 in 2011 and £50 in 2012	-190	-510	-545	-560
Working Tax Credit: increase working hours requirement for couples with children to 24 hours	0	380	385	390
Child and Working Tax Credits: use real time information	0	0	0	300
Other AME policy	**335**	**1,285**	**2,770**	**3,515**
Public sector pensions:increase in employee contribution rates	0	160	1,270	1,760
Renewable Heat Incentive: efficiency savings	5	15	45	105
Carbon Reduction Commitment: no recycling of revenues	715	730	995	1,020
Royal Mint: reduction in metal cost for coinage	10	10	10	10
Equitable life payments[4]	-520	-315	-210	-100
Capitalisation: support for local authority restructuring	-240	0	0	0
Public Works Loan Board: interest rate increase	150	310	380	450
TfL Metronet: replace borrowing with central government grant	325	300	200	185
Right to Buy: surrender full receipts to Exchequer receipts	40	50	55	60
Housing Revenue Account System: reform	25	25	25	25
Northern Ireland Reinvestment and Reform Initiative	-175	0	0	0
Total AME measures	655	3,840	8,760	10,555
of which current AME savings	*290*	*3,155*	*8,100*	*9,835*

1 Costings reflect the Budget 2010 economic forecast and assumptions.
2 The costings only show the direct effects on Annually Managed Expenditure and do not take into account any direct effects on receipts, such as changes in Tax Credits that not only affect AME but also change negative tax. The negative tax implications of these policies are set out in the supplementary document Spending Review 2010 policy costings. Any implications for receipts will be taken on in the next forecast.
3 All measures start from the beginning of the financial year unless otherwise stated.
4 Figures include provisional estimates of administration costs that will be transferred to DEL once fixed. The amount that will be made available for payments to policyholders over the SR period is £1.1bn.

Budget 2011

A.4 In March 2011, the Government announced a number of tax and spending measures, set out in Table A.3. The estimated direct fiscal impact of these measures is based on the OBR's latest economic and fiscal forecast published alongside Budget 2011.

Table A.3: Budget 2011 policy decisions[1]

			£ million				
		Head	2011-12	2012-13	2013-14	2014-15	2015-16
Growth and Enterprise							
1	Corporation tax: decrease main rate to 26% in 2011-12, 25% in 2012-13, 24% in 2013-14 and 23% from 2014-15	Tax	-425	-810	-910	-1,000	-1,075
2	Corporation tax: interim improvements to Controlled Foreign Company rules	Tax	-55	-15	-25	-25	-25
3	Corporation tax: taxation of foreign branches reform	Tax	0	-30	-70	-80	-80
4	Corporation tax: corporate capital gains simplification	Tax	+5	-5	-15	-35	-55
5	Corporation tax: full reform to Controlled Foreign Company rules	Tax	0	-210	-540	-770	-840
6	Bank Levy: increase first year effective rate to 0.075% and rate to 0.078% from January 2012	Tax	+630	+285	+100	+105	+100
7	Enterprise Investment Scheme and Venture Capital Trusts: reform	Tax	0	-105	-115	-110	-120
8	R&D tax credits: increase SME rate to 200% from 2011-12 and to 225% from 2012-13	Spend	-20	-75	-105	-105	-
9	Capital allowances: extension of short life assets limit	Tax	-10	-40	-70	-100	-170
10	Capital allowances: extension of business premises renovation allowance	Tax	0	-5	-30	-25	-30
11	Business rates: Enterprise Zones	Tax	0	-20	-40	-65	-80
12	Business rates: one-year extension of relief for small business from October 2011	Tax	-190	-185	+5	0	0
13	Capital gains tax: increase Entrepreneurs' relief lifetime limit to £10 million	Tax	0	-50	-70	-90	-100
14	Science facilities: additional investment	Spend	-100	0	0	0	-
Housing and Employment							
15	Stamp Duty Land Tax: bulk purchasing	Tax	-70	-90	-120	-130	-150
16	Support for Mortgage Interest: one-year extension from January 2012	Spend	-10	-110	-15	0	-
17	FirstBuy: support for first-time buyers	Spend	-250	0	0	0	-
18	Enterprise Allowance: extension	Spend	-5	-15	-5	0	-
19	Work experience: 80,000 additional placements	Spend	-20	-20	0	0	-
20	University Technical Colleges: additional investment	Spend	-150	0	0	0	-
21	Apprenticeships: 50,000 additional places	Spend	-100	-60	-45	-5	-
Personal tax							
22	Personal allowance: increase by £630 in 2012-13, with adjustment to basic rate limit and no change to higher rate threshold	Tax	0	-1,050	-1,210	-1,200	-1,230
23	Direct taxes: switch the default indexation assumption to CPI from 2012-13	Tax	0	+105	+235	+630	+1,080
24	Direct taxes: over-index employer NICs threshold, age related allowances and other allowances [2]	Tax	0	0	0	0	0
25	NICs: implement Government Actuary's 'best estimate' approach on contracted-out rebates from 2012-13 [3]	Tax	0	+640	+630	+620	+610
26	Non-domicile taxation: reform	Tax	0	0	+110	+70	+50
Motoring tax							
27	Fuel duty: 1ppl reduction from 23 March 2011, removal of previously announced above-RPI increases and delay of RPI increases	Tax	-1,900	-1,600	-1,700	-2,100	-2,100
28	North Sea: increase in supplementary charge from 20% to 32% and restriction on decommissioning relief from 2011-12	Tax	+1,780	+2,240	+2,120	+2,090	+1,870
29	Fuel duty: rural rebate	Tax	*	-5	-5	-5	-5

30	Vehicle excise duty: freeze rates for Heavy Goods Vehicles in 2011-12	Tax	-15	-15	-15	-20	-20
31	Approved Mileage Allowance Payments: increase allowances from 2011-12	Tax	-35	-35	-35	-35	-35
Environmental tax							
32	Carbon price floor: introduce from 2013-14 with £30 per tonne of CO_2 target	Tax	0	0	+740	+1,070	+1,410
33	Climate Change Agreements: reform	Tax	0	0	-40	-50	-50
34	Climate change levy exemption: supplies of gas in Northern Ireland	Tax	*	*	+5	+5	+5
35	Company car tax: adjustment to rates for 2013-14	Tax	0	0	+125	+130	+135
36	Air passenger duty: defer RPI increase in 2011-12 to 2012-13	Tax	-145	0	0	0	0
37	Aggregates levy: postpone rate increase until 2012-13	Tax	-15	-15	-20	-20	-20
Indirect tax							
38	VAT: decrease low value consignment relief threshold to £15 from November 2011	Tax	+5	+10	+10	+10	+15
39	Tobacco duty: rebalance for cigarettes and increase for hand rolled tobacco from 2011-12	Tax	+80	+60	+65	+70	+80
Avoidance, evasion and administration							
40	Disguised remuneration: avoidance	Tax	+750	+760	+730	+770	+760
41	Currency for tax calculations: avoidance	Tax	+60	+60	+60	+60	+60
42	Sale of lessor companies: avoidance	Tax	+25	+20	+20	+15	+15
43	Leasing double allowances: avoidance	Tax	+80	+130	+130	+120	+120
44	Stamp Duty Land Tax: avoidance	Tax	+30	+30	+40	+40	+50
45	VAT: supply splitting using printed matter	Tax	+40	+50	+50	+50	+60
46	VAT: fraud on imported road vehicles	Tax	0	0	+125	+110	+105
47	Protection life insurance	Tax	0	0	+60	+90	+120
48	Qualifying Time Deposit accounts: change to tax treatment	Tax	0	*	+35	+40	+40
49	PAYE: holding security	Tax	*	+5	+5	+5	+5
Philanthropy							
50	Inheritance tax: reduce rate to 36% for estates with charitable donations of more than 10% from 2012-13	Tax	0	-25	-75	-125	-170
51	Gift Aid: small donations scheme	Spend	0	0	-50	-85	-
Other spending measures							
52	Housing Benefit: not introduce reductions for long term jobseekers	Spend	0	0	-105	-115	-
53	Disability Living Allowance: mobility components for claimants in residential care	Spend	0	-75	0	0	-
54	Local Housing Allowance: transitional protection for existing claimants	Spend	+30	-30	0	0	-
55	Employment and Support Allowance Youth: abolish National Insurance concession	Spend	0	+10	+10	+15	-
56	Benefit fraud: sanctions and debt recovery	Spend	0	+25	+45	+65	-
57	Coinage: delay implementation of reduction in metal cost	Spend	-10	0	0	0	-
	TOTAL POLICY DECISIONS		**-10**	**-265**	**+25**	**-115**	**+335**

* *Negligible.*

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

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

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

[3] *Announced by DWP on 3 February 2011.*

A.5 Budget 2011 also set out an updated estimate of the fiscal impact of previously announced measures which come into effect from April 2011 or later, based on the OBR's March 2011 forecast. These are set out in Table A.4.

Table A.4: Measures announced at Spending Review 2010 or earlier which take effect from April 2011 or later[1]

		Head	£ million				
			2011-12	2012-13	2013-14	2014-15	2015-16
Measures announced at Spending Review 2010							
a	Contributory Employment and Support Allowance: time limit for those in the Work Related Activity Group to one year from 2012-13	Spend	0	+450	+815	+1,100	+1,180
b	Housing Benefit: increase age limit for shared room rate from 25 to 35 from January 2012	Spend	+10	+170	+230	+215	+205
c	Total household benefit payments capped on the basis of average take-home pay for working households from 2013-14	Spend	0	0	+225	+270	+270
d	Disability Living Allowance: remove mobility components for claimants in residential care from April 2013 [2]	Spend	0	0	+155	+160	+160
e	Savings Credit: freeze maximum award for four years from 2011-12	Spend	+225	+280	+330	+415	+425
f	Council Tax Benefit: 10 per cent reduction in expenditure and localisation	Tax	0	0	+490	+490	+490
g	Child Benefit: remove from families with a higher rate taxpayer from January 2013	Spend	0	+600	+2,435	+2,485	+2,530
h	Working Tax Credit: freeze in the basic and 30 hour elements for three years from 2011-12	Spend	+270	+750	+975	+1,030	+1,035
i	Working Tax Credit: reduce payable costs through childcare element from 80 per cent to 70 per cent restoring 2006 rate from 2011-12	Spend	+335	+350	+370	+390	+405
j	Child Tax Credit: increase the child element by £30 in 2011 and £50 in 2012	Spend	-270	-695	-690	-690	-655
k	Working Tax Credit: increase working hours requirement for couples with children to 24 hours	Spend	0	+515	+510	+505	+515
l	Child and Working Tax Credits: use real time information	Spend	0	0	0	+395	+355
m	Public service pensions: increase in employee contribution rates	Spend	0	+160	+1,270	+1,760	+1,850
n	Renewable Heat Incentives: efficiency savings from 2011-12	Spend	+5	+15	+45	+110	+180
o	Carbon Reduction Commitment: no recycling of revenues from 2011-12	Spend	+715	+735	+1,010	+1,040	+1,080
p	Coinage: reduction in metal cost	Spend	0	+10	+10	+10	+10
q	Equitable life payments	Spend	-520	-315	-210	-100	-70
r	Capitalisation: support for local authority restructuring	Spend	-240	0	0	0	0
s	Public Works Loan Board: interest rate increase	Spend	+165	+330	+400	+465	+525
t	TfL Metronet: replace borrowing with central government grant	Spend	+325	+300	+200	+185	0
u	Right to Buy: surrender full receipts to Exchequer receipts	Spend	+25	+30	+40	+40	+45
v	Housing Revenue Account System: reform	Spend	+25	+25	+25	+25	+5
w	Northern Ireland Reinvestment and Reform Initiative	Spend	-175	0	0	0	0
Measures announced at the June Budget 2010							
x	Corporation tax: decrease to 27 per cent in 2011-12, 26 per cent in 2012-13, 25 per cent in 2013-14 and 24 per cent from 2014-15	Tax	-430	-1,200	-2,150	-3,300	-4,100
y	Small Profits Rate: decrease to 20 per cent from 2011-12	Tax	-50	-800	-1,200	-1,300	-1,400
z	Capital allowances: decrease main rate to 18 per cent and special rate to 8 per cent from 2012-13	Tax	0	+600	+1,600	+1,700	+1,700
aa	Annual Investment Allowance: decrease to £25,000 from 2012- 13	Tax	0	+200	+1,200	+1,000	+1,000
ab	Business rates: backdated bills in 2011-12	Tax	-70	-15	-15	-15	-15
ac	Employer NICs: increase threshold in 2011-12	Tax	-3,110	-3,270	-3,490	-3,690	-3,890
ad	Personal allowance: increase by £1,000 in 2011-12, with adjustments to basic rate limit and upper earnings limit	Tax	-3,340	-3,580	-3,620	-3,710	-3,820
ae	Basic rate limit: freeze in 2013-14	Tax	0	0	+370	+800	+760
af	Council Tax: reduction to receipts due to a one year freeze in 2011-12	Tax	-700	-740	-715	-775	-745

ag	Furnished holiday lettings: reverse plans to repeal existing rules	Tax	-20	+5	*	*	*
ah	Benefits, tax credits and public service pensions: switch to CPI indexation from 2011-12	Spend	+1,500	+3,050	+4,885	+7,555	+10,595
ai	Disability Living Allowance: reform gateway from 2013-14	Spend	0	0	+360	+1,070	+1,450
aj	Lone parent benefits: extend conditionality to those with children aged 5 and above from January 2012	Spend	0	+70	+210	+290	+320
ak	Sure Start Maternity Grant: apply to first child only from 2011-12	Spend	+75	+75	+75	+75	+75
al	Local Housing Allowance: set at the 30th percentile of local rents from April 2011 with transitional protection for existing claimants [3]	Spend	+130	+375	+445	+475	+505
am	Deductions for non-dependents: reverse previous freezes on uprating and maintaining link with prices from 2011-12	Spend	+70	+135	+195	+210	+215
an	Social sector: limit working age entitlements to reflect size of family from 2013-14	Spend	0	0	+490	+490	+490
ao	Switch to CPI indexation for Local Housing Allowance from 2013-14	Spend	0	+45	+140	+290	+465
ap	Additional bedroom for carers from 2011-12		-15	-15	-15	-15	-15
aq	Local Housing Allowance: caps on maximum rates for each property size, with 4-bed limit from 2011-12 with transitional protection for existing claimants [3]	Spend	+35	+115	+145	+165	+185
ar	Additional Discretionary Housing Payments from 2011-12	Spend	-10	-40	-40	-40	-40
as	Tax credits second income threshold: reduce to £40,000 from 2011-12	Spend	+130	+125	+125	+135	+145
at	Tax credits: first and second withdrawal rates: increase to 41 per cent from 2011-12	Spend	+645	+700	+730	+755	+780
au	Child Tax Credit: taper the family element immediately after the child element from 2012-13	Spend	0	+475	+445	+425	+400
av	Child Tax Credit: remove the baby element from 2011-12	Spend	+300	+275	+275	+275	+270
aw	Working Tax Credit: remove the 50 plus element from 2012-13	Spend	0	+45	+50	+50	+55
ax	Child Tax Credit: reverse the supplement for children aged one and two from 2012-13	Spend	0	+180	+180	+180	+180
ay	Tax credits: reduce the income disregard from £25,000 to £10,000 for 2 years in 2011-12 then to £5,000 from 2013-14	Spend	+130	+165	+455	+540	+605
az	Tax credits: introduce an income disregard of £2,500 for falls in income from 2012-13	Spend	0	+245	+510	+510	+520
ba	Tax credits: new claims and changes of circumstances: reduce backdating from 3 months to 1 month from 2012-13	Spend	0	+345	+355	+360	+360
bb	Child Tax Credit: increase the child element by £150 in 2011-12 and £60 in 2012-13 above indexation	Spend	-1,220	-1,865	-1,920	-1,940	-1,965
bc	Child Benefit: freeze rates for three years from 2011-12	Spend	+385	+930	+1,250	+1,285	+1,335
bd	Basic State Pension: introduce triple guarantee from 2011-12	Spend	0	-1,130	-1,450	-1,530	-1,620
be	Pension Credit Minimum Income guarantee: matching basic State Pension cash increase in 2011-12	Spend	-600	-630	-630	-650	-660
Measures announced before June Budget 2010							
bf	Freeze higher rate threshold in 2012-13 (2009 Pre-Budget Report)	Tax	0	+590	+1,310	+1,260	+1,340
bg	Increase NICs primary threshold in 2011-12 (2009 Pre-Budget Report)	Tax	-1,340	-1,360	-1,380	-1,520	-1,660
bh	Increase main employee NICs rate by 1 per cent from 2011-12 (2009 Pre-Budget Report)	Tax	+3,580	+3,700	+3,890	+4,100	+4,330
bi	Increase additional employee NICs rate by 1 per cent from 2011-12 (2009 Pre-Budget Report)	Tax	+600	+600	+620	+660	+710
bj	Increase employer NICs rate by 1 per cent from 2011-12 (2009 Pre-Budget Report)	Tax	+4,580	+4,690	+4,930	+5,200	+5,490
bk	Increase main self-employed NICs rate by 1 per cent from 2011-12 (2009 Pre-Budget Report)	Tax	+220	+200	+200	+190	+180
bl	Increase additional self-employed NICs rate by 1 per cent from 2011-12 (2009 Pre-Budget Report)	Tax	+70	+70	+60	+50	+50
bm	Pensions tax: restrict tax relief [4]	Tax	+1,200	+2,300	+4,400	+4,400	+4,300
bn	Auto-enrolment: slower introduction (2009 Pre-Budget Report)	Tax	0	+100	+700	+1,700	+2,100

bo	Individual savings account: indexation from 2011-12 (March Budget 2010)	Tax	-5	-15	-40	-90	-175
bp	SDLT: properties over £1m from 2011-12 (March Budget 2010)	Tax	+50	+170	+210	+250	+290
bq	Inheritance tax: freeze threshold from 2011-12 to 2014-15 (March Budget 2010)	Tax	+50	+170	+295	+420	+505
br	Salary sacrifice: workplace canteens from 2011-12 (2009 Pre-Budget Report)	Tax	+110	+110	+110	+110	+110
bs	Seafarers' Earning Deduction (2009 Pre-Budget Report)	Tax	-5	-5	-5	-5	-5
bt	Alcohol duty: increase in rates in 2013-14 and 2014-15 (March Budget 2010)	Tax	0	0	+110	+215	+210
bu	Patent box from 2013-14 (2009 Pre-Budget Report)	Tax	0	0	-500	-800	-900
bv	Venture Capital Schemes: State Aid changes (2009 Pre-Budget Report)	Tax	-20	-30	-40	-40	-40
bw	Landfill tax: increase in 2014-15 (2009 Pre-Budget Report)	Tax	0	0	0	+70	+70
bx	Climate change levy: reduction of relief from 2011-12 (2009 Pre-Budget Report)	Tax	+40	+50	+50	+50	+55
by	Company car tax: extend bands from 2012-13 (Budget 2009)	Tax	0	+120	+120	+125	+125
bz	Company car tax: changes to bands and abolition of cap from 2011-12 (Budget 2009)	Tax	+85	+75	+70	+65	+65
ca	EU Emissions Trading Scheme auctions: amendments from 2011-12 (March Budget 2010)	Tax	-10	0	0	0	0
cb	Childcare: employer supported childcare tax relief from 2011-12 (2009 Pre-Budget Report)	Tax	+15	+40	+65	+85	+100
cc	Working tax credit: extend eligibility for over 60s from 2011-12 (March Budget 2010)	Spend	-20	-20	-20	-20	-20

* *Negligible.*

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

[2] *See table 2.1 and paragraph 2.63.*

[3] *See table 2.1 and paragraph 2.62.*

[4] *See paragraph 2.51.*

B Supplementary Data Tables

B.1 Information provided in these data tables is consistent with the OBR's March 2011 *Economic and fiscal outlook* and supplementary tables, unless otherwise note. The OBR's supplementary tables are available at http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook-march.html.

Table B.1: Macro prospects

	Level	Rate of Change				
	2010	2010	2011	2012	2013	2014
Real GDP	1314	1.3	1.7	2.5	2.9	2.9
Nominal GDP	1456	4.4	4.8	5.0	5.7	5.6
Components of real GDP						
Private consumption expenditure	854	0.8	0.6	1.3	1.8	2.1
Government consumption expenditure	299	1.0	0.8	-1.2	-1.8	-2.4
Gross fixed capital formation	203	3.1	2.3	6.0	8.8	8.7
Changes in inventories and net acquisition of valuables (% GDP)	-	0.2	0.4	0.4	0.4	0.4
Exports of goods and services	354	5.8	7.9	6.5	6.2	5.7
Imports of goods and services	393	8.5	5.0	2.9	3.8	3.8
Contributions to real GDP growth						
Final domestic demand	-	1.2	0.9	1.5	2.2	2.3
Changes in inventories and net acquisition of valuables	-	1.3	0.2	0.0	0.0	0.0
External balance of goods and services	-	-0.9	0.7	1.0	0.7	0.6

Table B.2: Price developments

	Level	Rate of Change				
	2010	2010	2011	2012	2013	2014
GDP deflator	110.9	3.0	3.0	2.4	2.7	2.7
Private consumption deflator	112.1	4.2	4.6	2.9	2.8	2.7
HICP	114.5	3.3	4.2	2.5	2.0	2.0
Public consumption deflator	112.8	2.3	3.0	2.5	3.1	3.0
Investment deflator	104.6	1.2	2.2	2.3	2.5	2.7
Export price deflator (goods and services)	121.6	4.1	1.6	0.5	1.0	1.2
Import price deflator (goods and services)	121.4	4.5	4.4	1.4	1.2	1.3

Table B.3: Labour market developments

	Level	Rate of Change, unless otherwise stated				
	2010	2010	2011	2012	2013	2014
Employment, persons (millions)[1]	-	29.0	29.0	29.2	29.5	29.7
Employment, hours worked[1,2]	918	0.6	0.0	0.4	0.9	0.7
Unemployment rate (%)[3]	-	7.9	8.2	8.1	7.6	7.0
Labour productivity, persons[4]	45254	1.1	1.8	1.9	1.9	2.0
Labour productivity, hours worked[5]	28	0.7	1.7	2.1	2.0	2.1
Compensation of employees[6]	796	2.8	1.3	3.0	4.8	5.2
Compensation per employee[7]	27421	2.6	1.4	2.4	3.8	4.3

[1] *All aged 16 and over*

[2] *Millions per week*

[3] *ILO measure, all aged 16 and over*

[4] *GDP per worker, pound sterling*

[5] *GDP per hour, pound sterling*

[6] *Pounds billion*

[7] *Pounds per worker*

Table B.4: Sectoral balances

	2010	2011	2012	2013	2014
Net lending/borrowing vis-à-vis the rest of the world[1]	2.2	2.6	2.0	1.5	1.1
of which[2]*:*					
Balance on goods and services	-3.2	-3.3	-2.5	-1.8	-1.2
Balance of primary incomes and transfers	0.7	0.5	0.4	0.2	0.0
Capital account	0.2	0.2	0.1	0.1	0.2
Net lending/borrowing of the private sector	7.9	5.0	3.8	2.2	1.0
Treaty deficit[3]	9.8	7.9	6.2	4.1	2.6
Statistical discrepancy	0.6	0.9	0.9	0.9	0.9

[1] *Positive numbers indicate net lending from the rest of the world to the UK*

[2] *Negative numbers indicate a UK deficit*

[3] *Expressed in financial rather than calendar years*

Table B.5: General government budgetary prospects

	£ billion	% of GDP				
	Outturn		Forecast			
	2009-10	2009-10	2010-11	2011-12	2012-13	2013-14
Net Borrowing by sub-sector						
General government[1]	160.4	11.4	9.8	7.9	6.2	4.1
Central government	157.5	11.2	9.6	7.1	6.0	4.0
Local government	2.9	0.2	0.2	0.7	0.2	0.1
General government						
Total revenue	505.8	36.0	36.6	37.5	37.5	37.8
Total expenditure[2]	666.2	47.4	46.5	45.4	43.8	42.0
Net borrowing[1]	160.4	11.4	9.8	7.9	6.2	4.1
Interest expenditure	30.9	2.2	2.9	3.2	3.2	3.3
Primary balance[3]	129.5	9.2	6.9	4.7	3.1	0.8
Selected components of revenue						
Taxes on production	169.9	12.1	13.0	13.6	13.6	13.7
Taxes on income and wealth	182.5	13.0	13.2	13.4	13.3	13.6
Taxes on capital	2.4	0.2	0.2	0.2	0.2	0.2
Social contributions	96.6	6.9	6.5	6.5	6.5	6.5
Other	54.4	3.9	3.7	3.8	3.9	3.9
Total revenue	505.8	36.0	36.6	37.5	37.5	37.8
Selected components of expenditure						
Current expenditure on goods and services	329.3	23.4	23.0	22.7	21.8	20.9
Net social benefits	188.0	13.4	13.2	13.2	12.9	12.3
Interest expenditure	30.9	2.2	2.9	3.2	3.2	3.3
Subsidies	10.3	0.7	0.6	0.7	0.7	0.6
Gross fixed capital formation	36.7	2.6	2.5	2.1	1.8	1.6
Other	71.0	5.1	4.2	3.6	3.4	3.2
Total expenditure[2]	666.2	47.4	46.5	45.4	43.8	42.0

[1] *Treaty Deficit*
[2] *Includes swap-related flows*
[3] *General government net borrowing less interest expenditure*

Table B.6: General government debt developments

	% of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Treaty debt[1]	71.2	78.7	84.1	87.0	87.2	85.7	83.5
Change in Treaty debt ratio	15.4	7.4	5.4	2.9	0.2	-1.5	-2.2
Contributions to changes in gross debt							
Primary balance[2]	9.2	6.9	4.7	3.1	0.8	-0.9	-1.9
Interest expenditure	2.2	2.9	3.2	3.2	3.3	3.5	3.5
Stock-Flow Adjustment[3]	2.8	0.9	1.2	0.9	0.7	0.5	0.7
Implicit interest rate on debt[4]	3.9	4.3	4.2	3.9	4.0	4.2	4.3

[1] General government gross debt

[2] General government net borrowing less interest expenditure

[3] Change in Treaty debt less general government net borrowing

[4] Interest expenditure as per cent of Treaty debt in previous year

Table B.7: Cyclical developments

	% of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Real GDP growth (%)	-	1.3	1.7	2.5	2.9	2.9	-
Treaty deficit	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Interest expenditure	2.2	2.9	3.2	3.2	3.3	3.5	3.5
Potential GDP growth (%)	-	-	2.35	2.35	2.29	2.1	-
Output gap	-4.2	-3.4	-3.9	-3.5	-2.8	-2.0	-1.3
Cyclical budgetary component[2]	2.3	2.5	2.6	2.5	2.1	1.6	1.0
Cyclically adjusted Treaty deficit	9.1	7.3	5.3	3.7	2.0	1.0	0.6
Cyclically adjusted primary balance[3]	6.9	4.4	2.1	0.5	-1.3	-2.4	-2.9

[1] General government net borrowing

[2] Treaty deficit less cyclically-adjusted Treaty deficit

[3] Primary balance is general government net borrowing less interest expenditure. The cyclically-adjusted measure is a Treasury estimate and has been calculated by applying the cyclical adjustment methodology set out in Public finances and the cycle: Treasury Economic Working Paper No 5 (November 2008) which the OBR also use for their forecast of cyclically adjusted aggregates.

Table B.8: Divergence from previous update[1]

	% of GDP						
	Outturn	Forecast					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Treaty Deficit[2]							
Previous update	12.6	12.0	9.1	7.3	5.7	4.6	-
Current update	11.4	9.8	7.9	6.2	4.1	2.6	1.6
Difference	-1.2	-2.2	-1.2	-1.1	-1.6	-2.0	-
Treaty Debt[3]							
Previous update	72.9	82.1	88.0	90.9	91.6	91.2	-
Current update	71.2	78.7	84.1	87.0	87.2	85.7	83.5
Difference	-1.7	-3.4	-3.9	-3.9	-4.4	-5.5	-

[1] *Previous update comparison uses the UK's 2009 Convergence Programme, which was based on the Pre-Budget Report 2009*
[2] *General government net borrowing*
[3] *General government gross debt*

Table B.9: Basic assumptions

	2010-11	2011-12	2012-13	2013-14	2014-15
Short-term interest rate (annual average)[1]	0.7	1.6	2.7	3.4	4.0
Long-term interest rate (annual average)[2]	3.8	3.8	4.3	4.7	4.9
Exchange rate vis-à-vis the € (annual average)	1.18	1.16	1.16	1.16	1.16
	2010	2011	2012	2013	2014
EU GDP growth	1.7	1.4	1.8	1.8	1.9
Growth of relevant foreign markets	10.7	5.8	5.8	5.8	6.1
Oil prices (Brent, USD/barrel)	80	113	112	109	107

[1] *3m interbank rate*
[2] *Weighted average interest rate on conventional gilts*

HM Treasury contacts

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