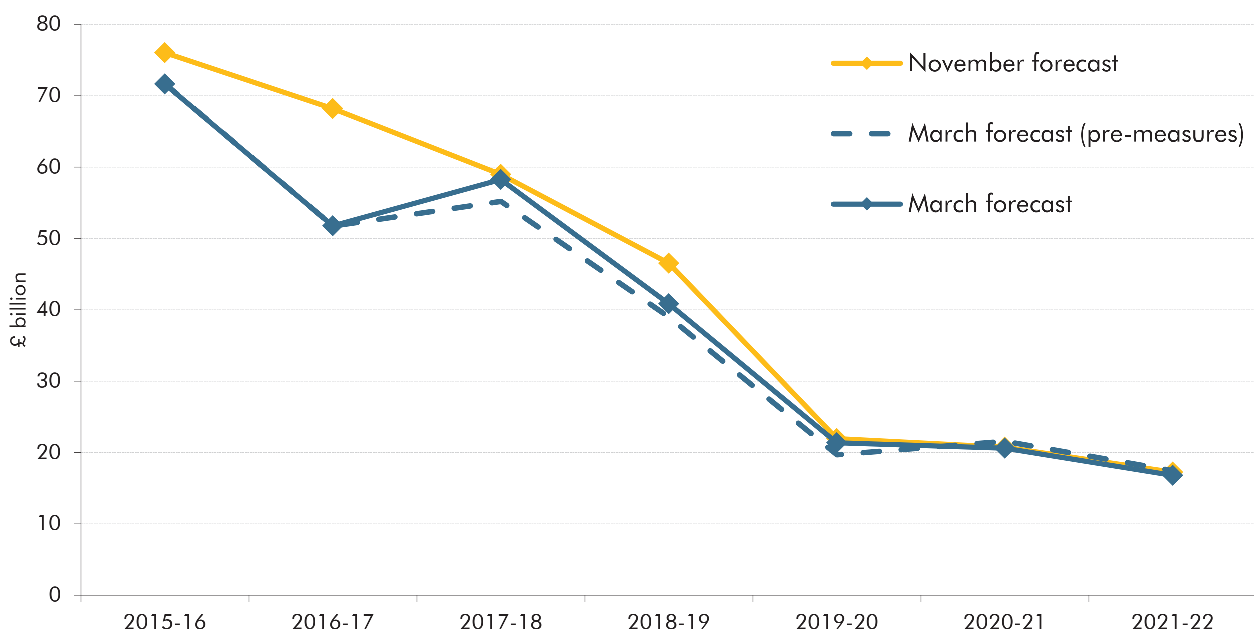
1 Executive summary

Overview

1.1 Public sector net borrowing is likely to be significantly lower this year than we anticipated at the time of the Autumn Statement in November, largely reflecting one-off factors and timing effects that flatter the figures at the expense of next year. So much so, in fact, that borrowing is now forecast to rise in 2017-18 before returning to a very similar downward trajectory to that we anticipated in November. This leaves the Chancellor on course to meet his target for structural borrowing in 2020-21 with room to spare, but not yet to achieve his goal of balancing the public finances "*at the earliest possible date in the next Parliament*".

1.2 The deficit is now forecast to come in at £51.7 billion this year, down from the £68.2 billion we forecast in November (Chart 1.1). We now expect the deficit to increase by £6.5 billion next year rather than shrinking by £7.2 billion (adjusted for a change in how the ONS records corporate taxes). Factors explaining this turnaround include changes in the timing of contribution requests from the European Union, evidence of greater income shifting to beat the April 2016 rise in dividend taxation, and changes in the timing of corporation tax payments. Budget policy decisions will also push up public spending next year, whereas government departments appear to be underspending this year by more than expected.

Chart 1.1: Public sector net borrowing



Source: ONS, OBR

1.3 The Budget decisions that the Treasury has chosen to report on its 'scorecard' imply a modest short-term giveaway of around £1.7 billion in 2017-18, dominated by additional funding for local authorities to deliver adult social care. This is followed by a modest medium-term takeaway averaging around £750 million a year from 2019-20 onwards. This includes an increase in National Insurance contributions on self-employment profits and reducing the generosity of the new dividend tax allowance.

1.4 Taking policy changes excluded from the scorecard and indirect effects into account, the total impact of the Budget policy decisions is a giveaway of £3.1 billion in 2017-18. The modest takeaway begins in 2020-21. The biggest non-scorecard policy effects arise from the Ministry of Justice's decision to reduce the personal injury discount rate, which will substantially increase the size of one-off settlement payments. The Government has set aside an extra £1.2 billion a year to meet the expected costs to the public sector (notably to the NHS Litigation Authority). The change is also expected to increase insurance premiums, boosting receipts from insurance premium tax. But as that feeds through to inflation – particularly RPI inflation – it will increase debt interest via accrued interest on index-linked gilts. There is a small offset from higher excise duties, which are revalorised using the RPI.

1.5 Developments in the economy since November have had a relatively modest impact on the public finances. The first estimate of real GDP growth for 2016 as a whole was slightly weaker than we anticipated in November, but with momentum strengthening through the year rather than slowing as earlier vintages of data and our November forecast suggested. With business investment falling as predicted, this largely reflected stronger-than-expected growth in consumer spending, which significantly outpaced growth in incomes. This will have contributed to recent strength in tax revenues, but consumer spending growth cannot continue to outpace income growth by such a margin indefinitely.

1.6 Looking ahead, we expect real GDP growth to moderate during the first half of 2017, as rising inflation squeezes household budgets and real consumer spending. The relatively strong start to the year implies 2.0 per cent growth in real GDP in 2017 as a whole, up from 1.4 per cent in November, with small downward revisions thereafter reflecting the consequently smaller margin of spare capacity. Thanks largely to a weaker outlook for whole economy inflation, we expect weaker cumulative growth in nominal GDP over the forecast than in November, while its composition is also slightly less favourable for tax receipts. We have made no changes to our policy assumptions regarding Brexit.

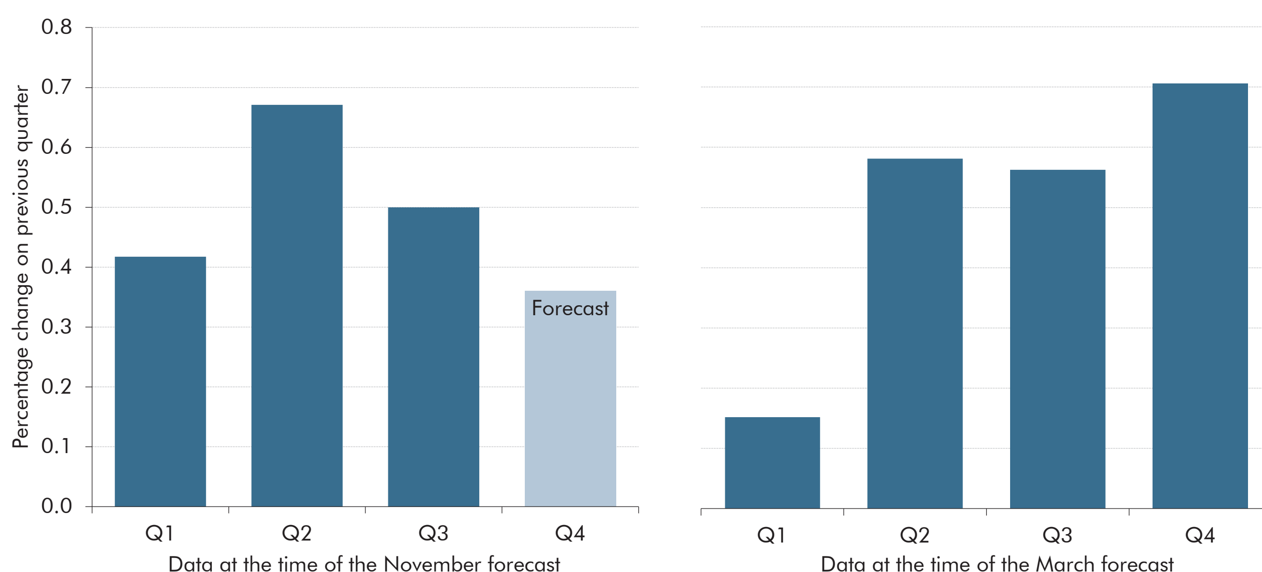
1.7 Taking both forecast and Budget policy changes into account, we expect the deficit (in both headline and structural terms) to fall from 2.6 per cent of GDP this year to around 1 per cent in 2019-20 and then to edge slightly lower in the subsequent two years. We still expect debt to peak as a share of GDP in 2017-18 and to fall thereafter. So the Government remains on track to meet its targets for the structural deficit and public sector net debt.

1.8 But the Government does not appear to be on track to meet its stated fiscal objective to "*return the public finances to balance at the earliest possible date in the next Parliament*". The deficit falls little in 2020-21 and 2021-22, while the ageing population and cost pressures in health are likely to put upward pressure on the deficit in the next Parliament.

Economic developments since our last forecast

1.9 The ONS's initial estimate of 1.8 per cent for GDP growth in 2016 was weaker than the 2.0 per cent we anticipated in November. The release also suggested a rather different pattern through the year, with growth revised down in the first and second quarters but up in the third. So, rather than slowing between the second and third quarters as the data available at the time of the Autumn Statement suggested, it is now estimated to have been broadly stable at 0.6 per cent a quarter. The latest estimate for the fourth quarter shows growth picking up to 0.7 per cent, whereas we had expected it to slow, from 0.5 to 0.4 per cent.

Chart 1.2: Quarter-on-quarter real GDP growth through 2016



Source: ONS, OBR

1.10 The pick-up in GDP growth has largely been driven by consumer spending, which may have been supported by the past boost to real incomes from temporarily low inflation. Spending rose by 3.2 per cent in the year to the fourth quarter (the fastest since late 2007), compared to an estimate of flat real incomes, implying a sharp fall in household saving. Excluding pension saving (some of which is imputed in the National Accounts measure), the saving ratio fell from 2.8 per cent in the final quarter of 2015 to 0.6 per cent in the third quarter of 2016. We estimate that it fell further to *minus* 0.3 per cent in the fourth quarter, the first drop into negative territory since mid-2008. However, it is worth noting that the weakness in income growth over the past year was most marked in pension and dividend income – to which consumer spending might be relatively unresponsive in the short term.

1.11 Among the other components of GDP, business investment fell 1.0 per cent in the fourth quarter and 1.5 per cent in the year as a whole. This is broadly in line with expectations, as heightened uncertainty is likely to lead some businesses to put investment plans on hold.

1.12 CPI inflation has picked up as the effects of a weaker pound feed through to import prices and then on to consumer prices. The rise in inflation has been a little less rapid than we expected, partly due to the small rebound in the value of sterling since our November forecast was completed. House price inflation has slowed on most measures.

The economic outlook

1.13 Parliament requires us to produce our forecasts on the basis of stated Government policy, but not necessarily assuming that particular objectives are achieved. With the negotiations over the UK's exit from the EU yet even to commence, this is far from straightforward.

1.14 The Government has now set out some of its objectives for the UK after EU exit at greater length, but there is no meaningful basis for predicting the precise end-point of the negotiations as a basis for our forecast. There is also considerable uncertainty about the economic and fiscal implications of different outcomes, even if they could be predicted. So we have retained the same broad-brush assumptions that underpinned our November forecast (as set out in Chapter 3). These are consistent with a range of possible outcomes.

1.15 With these assumptions unchanged, we have not changed our central expectation for potential output growth over the next five years. But given limited evidence of wage pressures at present, we have lowered our estimate of the equilibrium unemployment rate to 5.0 per cent of the labour force. This is offset by a change in our estimate of the productivity gap, leaving the overall output gap unaffected. Equilibrium unemployment is still expected to edge higher as the National Living Wage is increased faster than productivity growth.

1.16 The economy ended 2016 with greater momentum than we expected in November and we assume that this will carry over into early 2017 with growth of 0.6 per cent in the first quarter. Growth then slows to 0.3 per cent in the second quarter, as the sterling-driven rise in inflation squeezes real incomes and consumer spending, and as the saving ratio stabilises. Growth then picks up slowly from the third quarter as business investment begins to strengthen. From mid-2018, the inflation-related squeeze on consumer spending growth abates. Net trade adds to GDP growth this year and next, but acts as a drag in later years.

1.17 Cumulative growth over the forecast as a whole is slightly weaker than in November, as we now believe that the economy was running slightly above potential at the end of last year, rather than slightly below it. The firm start to this year lifts our growth forecast for calendar year 2017 to 2.0 per cent from 1.4 per cent in November. There are then modest downward revisions in subsequent years, reflecting the smaller margin of spare capacity that needs to be absorbed. Calendar year growth troughs at 1.6 per cent in 2018 and picks up slowly thereafter, in line with our assumption that growth in trend productivity will gradually return towards its historical average. We remain a little more optimistic about the outlook for GDP growth than the average of external forecasters in most years.

1.18 Our CPI inflation forecast is slightly higher than in November for 2017, but slightly lower for 2018 and 2019. In the near term, household energy bills are set to rise faster than previously assumed and the change in the personal injury discount rate is expected to raise motor insurance premiums. Thereafter, the modest recent appreciation of sterling reduces somewhat the upward pressure on import prices from the large depreciation around the time of the referendum. We also expect the soft drinks industry levy to raise prices less than we had expected, because producers have responded to the levy by reducing the sugar-content of drinks more aggressively than previously assumed.

Table 1.1: Overview of the economy forecast

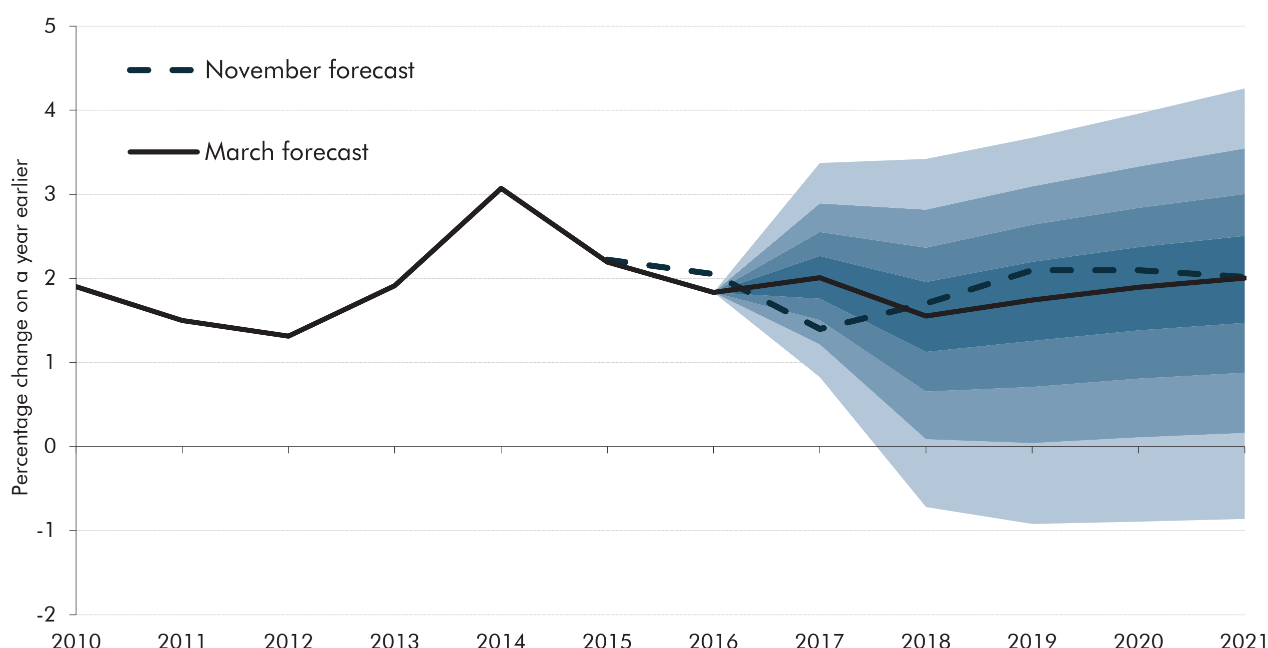
	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2015	2016	2017	2018	2019	2020	2021
Output at constant market prices							
Gross domestic product (GDP)	2.2	1.8	2.0	1.6	1.7	1.9	2.0
GDP per capita	1.4	1.1	1.3	0.9	1.1	1.2	1.4
GDP levels (2015=100)	100.0	101.8	103.9	105.5	107.3	109.4	111.5
Output gap	-0.3	0.0	0.2	0.0	-0.1	-0.1	0.0
Expenditure components of real GDP							
Household consumption	2.4	3.0	1.8	0.9	1.7	1.7	1.9
General government consumption	1.3	0.8	1.2	0.7	0.4	0.9	1.3
Business investment	5.1	-1.5	-0.1	3.7	4.2	3.9	3.6
General government investment	-2.6	1.4	0.1	1.2	2.1	6.1	3.8
Net trade[1]	0.0	-0.4	0.3	0.3	0.0	-0.1	-0.1
Inflation							
CPI	0.0	0.7	2.4	2.3	2.0	2.0	2.0
Labour market							
Employment (millions)	31.3	31.7	31.9	32.1	32.2	32.3	32.5
Average earnings	1.9	2.2	2.6	2.7	3.0	3.4	3.6
LFS unemployment (rate, per cent)	5.4	4.9	4.9	5.1	5.2	5.2	5.1
	Changes since November forecast						
Output at constant market prices							
Gross domestic product (GDP)	0.0	-0.2	0.6	-0.2	-0.4	-0.2	0.0
GDP per capita	0.0	-0.2	0.6	-0.2	-0.4	-0.2	0.0
GDP levels (2015=100)	0.0	-0.2	0.4	0.2	-0.1	-0.3	-0.3
Output gap	0.0	0.2	0.7	0.6	0.2	0.0	0.0
Expenditure components of real GDP							
Household consumption	-0.1	0.1	0.6	-0.2	-0.4	-0.3	-0.1
General government consumption	-0.2	-0.2	0.5	0.2	0.1	0.3	0.4
Business investment	0.0	0.7	0.2	-0.4	-1.2	-0.2	0.0
General government investment	-0.6	-1.0	-3.2	-0.9	0.2	-2.7	0.5
Net trade[1]	0.4	-0.1	0.0	0.0	0.1	0.0	0.0
Inflation							
CPI	0.0	-0.1	0.1	-0.2	-0.1	0.0	0.0
Labour market							
Employment (millions)	0.0	0.0	0.1	0.2	0.2	0.1	0.1
Average earnings	0.0	0.0	0.2	-0.1	-0.4	-0.2	-0.1
LFS unemployment (rate, per cent)	0.0	-0.1	-0.3	-0.3	-0.2	-0.2	-0.2

[1] Contribution to GDP growth.

1.19 We have revised down unemployment in each year of the forecast, reflecting both the shallower slowdown in GDP growth and the downward revision to our estimate of the equilibrium rate. Employment growth has been revised up this year and next, again in line with our GDP forecast revisions, but it is little changed from 2019 onwards. By contrast, our forecast for earnings growth, while little changed in the short term, has been revised down from 2019 onwards. This largely reflects the lower profile for whole economy inflation and productivity growth in the medium term.

1.20 The future is, of course, uncertain and any central forecast is most unlikely to be fulfilled. One way of illustrating the uncertainty around our GDP growth forecast is shown in Chart 1.3. This presents our central forecast together with a fan that portrays the probability of different outcomes based on past errors on official forecasts. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. These are not subjective judgements about the extent of uncertainty, which for the reasons discussed above could be greater than usual at present. The chart shows that the change in our central growth forecast since November is very small relative to the uncertainty around either forecast implied by past forecast performance.

Chart 1.3: Real GDP growth fan chart



Source: ONS, OBR

The fiscal outlook

1.21 Public sector net borrowing peaked at 9.9 per cent of GDP (£151.6 billion) in 2009-10 as the financial crisis and subsequent recession dealt the public finances a major blow. Fiscal consolidation and economic recovery then reduced the deficit to 3.8 per cent of GDP (£71.7 billion) by 2015-16. We expect it to have reached 2.6 per cent of GDP (£51.7 billion) in 2016-17, smaller than we forecast in November. With little sign of either spare capacity or overheating in the economy, we judge that the structural deficit (which excludes the effects of the economic cycle) is close to the headline deficit at 2.6 per cent of GDP.

1.22 Table 1.2 shows that on current policy – including the decisions announced in this Budget and our assumptions regarding the UK's exit from the EU – we expect the deficit to reach £16.8 billion in 2021-22, little changed from our November forecast. Our central forecast is for a structural deficit of 0.9 per cent of GDP in 2020-21, well below the 2 per cent of GDP ceiling set out for the year in the Chancellor's 'fiscal mandate'.

Table 1.2: Fiscal forecast overview

	Per cent of GDP						
	Outturn	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Revenue and spending							
Public sector current receipts	36.2	36.7	36.7	37.1	37.2	37.1	37.2
Total managed expenditure	40.0	39.3	39.6	39.0	38.2	38.0	37.9
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	3.6	2.6	2.9	1.9	0.9	0.9	0.7
Public sector net borrowing	3.8	2.6	2.9	1.9	1.0	0.9	0.7
Cyclically adjusted current budget deficit	1.9	0.8	0.9	-0.1	-1.1	-1.4	-1.6
Debt: Supplementary target							
Public sector net debt	83.6	86.6	88.8	88.5	86.9	83.0	79.8
	£ billion						
Revenue and spending							
Public sector current receipts	682.3	721.1	744.2	776.4	806.5	834.8	869.5
Total managed expenditure	753.9	772.8	802.4	817.2	827.9	855.4	886.4
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	67.4	51.8	59.3	40.4	19.8	19.3	16.5
Public sector net borrowing	71.7	51.7	58.3	40.8	21.4	20.6	16.8
Cyclically adjusted current budget deficit	35.8	15.2	19.3	-1.5	-22.9	-30.9	-37.5
Debt: Supplementary target							
Public sector net debt	1606	1730	1830	1885	1918	1904	1904

Changes in public sector net borrowing and net debt

1.23 We expect borrowing to be significantly lower this year than we forecast in November – and somewhat lower than we expected a year ago. But revisions thereafter are much smaller, averaging £1.5 billion a year between 2017-18 and 2021-22. As Chart 1.1 showed, the path of deficit reduction is more uneven across years than in our November forecast, reversing temporarily in 2017-18 and almost stalling in 2020-21.

Expected borrowing in 2016-17

1.24 We have revised our 2016-17 borrowing forecast down by £16.4 billion. On a like-for-like basis, excluding the effect of the ONS's change to the accounting treatment for corporate taxes, the downward revision is £13.4 billion. This reflects a £7.5 billion upward revision to receipts and a £6.0 billion downward revision to spending. This more than reverses the underlying upward revision of £11.2 billion we made in November. The changes reflect data revisions to the first half of the year, recent unexpectedly strong growth in receipts and reductions in departmental spending plans.

1.25 When we completed our November forecast, we had access to ONS outturn data for April to September and some information on administrative receipts for October. The ONS data showed the deficit in the first half of 2016-17 down 4.8 per cent on the same period a year earlier. Following revisions to receipts and spending data, the latest official estimate is that the deficit fell by no less than 16.8 per cent over that period.

1.26 Unexpectedly strong receipts growth since our last forecast is the biggest contributor to lower borrowing. This includes:

- stronger-than-expected growth in cash **onshore corporation tax receipts**. According to the information available to us in November, CT receipts were around 20 per cent higher in October than a year earlier. We assumed that this rate of increase would not persist, but the increase in January was even stronger at around 26 per cent. On a like-for-like basis this lifts our receipts forecast by £4.3 billion this year;

- growth in cash receipts from **PAYE income tax and NICs** has picked up, averaging 6.8 per cent on a year earlier compared to 4.5 per cent over the first seven months of the year. On that basis, we have revised up 2016-17 PAYE and NICs by £1.8 billion; and

- an upward revision of £1.4 billion in our forecast for **capital gains tax** receipts. That reflects very strong growth in gains on disposals of financial assets in 2015-16, despite a fall in the FTSE all-share index in that year.

1.27 Lower spending has also reduced our borrowing forecast. This reflects two main factors:

- **departmental spending** has been revised down by £2.3 billion. This reflects the larger-than-expected downward revision to plans in February's 'Supplementary Estimates' and the latest information departments have provided to the Treasury; and

- changes to the timing of **expenditure transfers to EU institutions**, which move spending from the first quarter of 2017 to later in the year. That reallocated spending within the EU's calendar accounting year, but relative to our November forecast it moves £1.8 billion of spending from the UK's 2016-17 April to March fiscal year into 2017-18.

Forecast borrowing from 2017-18 onwards

1.28 Our borrowing forecast from 2017-18 onwards reflects our assumptions regarding the UK's exit from the EU. The most relevant to our fiscal forecast are that:

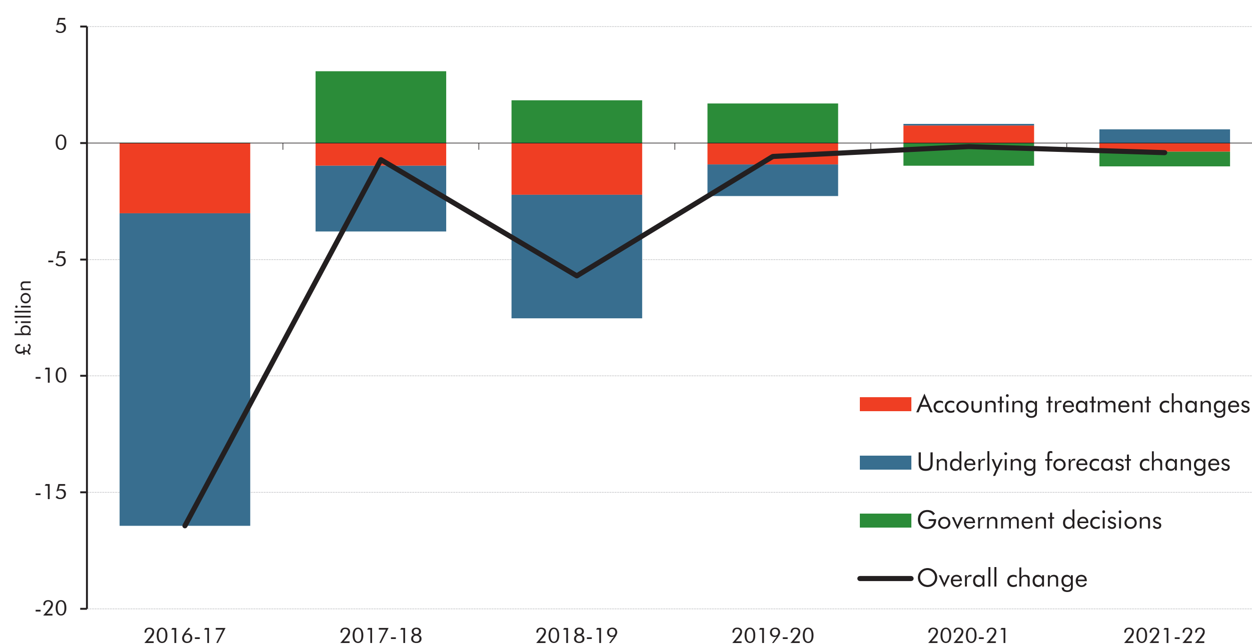
- **the UK leaves the EU in April 2019** – two years after the date by which the Prime Minister has stated that Article 50 will be invoked;

- any reduction in **expenditure transfers to EU institutions** is recycled fully into extra domestic spending – this assumption is fiscally neutral;

- no allowance for **any one-off or ongoing EU exit-related payments** – the 'divorce settlement' – can be made until more information becomes available; and

- there are no changes to the structure or membership of **tax systems for which there are common EU rules** (such as VAT and the EU emissions trading scheme or the customs duties that are deemed to be collected on behalf of the EU).

Chart 1.4: Changes to public sector net borrowing forecasts since November



Source: OBR

1.29 Chart 1.4 and Table 1.3 document how accounting treatment changes, our underlying forecast judgements and the Government's policy decisions have affected our forecast for borrowing. (The table shows contributions to changes in borrowing since November, so higher receipts appear as negative contributions). The main changes include:

- in order to compare the forecasts on a like-for-like basis, we have restated our November forecast to take account of the change to **ONS methodology** to record corporate tax receipts on a time-shifted accruals basis. This has uneven effects across years by concentrating the impact of cuts to the CT rate in the years they take place;

- we have revised up our **pre-measures receipts forecast** by £3.5 billion a year on average between 2017-18 and 2019-20, but down by £2.0 billion a year on average in 2020-21 and 2021-22. The profile reflects some timing effects that boost 2016-17 receipts relative to 2017-18 (in particular forestalling ahead of the April 2016 dividend tax rise). These overlay a small downward revision to cumulative growth in the main tax bases – wages and salaries and nominal consumer spending – that reduce income tax and VAT receipts from 2019-20;

- higher interest rates and (in the short term) RPI inflation have increased **central government debt interest spending**, despite lower cumulative borrowing;

- **other spending** is lower in all years. One of the bigger sources of revision is welfare spending, where our lower earnings growth forecast has reduced spending on state pensions while universal credit is expected to save more over time; and

- **Government decisions** increase borrowing by £3.1 billion in 2017-18 and smaller amounts in 2018-19 and 2019-20. They reduce borrowing in 2020-21 and 2021-22. The Treasury's scorecard reports only some of these decisions. It shows a small giveaway in the near term – in particular central government funding for adult social care. There is a small takeaway in later years – including an increase in Class 4 NICs on self-employment profits and reducing the generosity of the new dividend tax allowance. Decisions not shown on the scorecard include setting aside around £1.2 billion a year to ensure that the NHS and others can meet the cost of a lower personal injury discount rate. That discount rate change is also the biggest source of indirect knock-on effects in our forecast, as it is expected to raise insurance premiums and therefore RPI inflation, adding £0.8 billion to the accrued interest on index-linked gilts.

1.30 Overall, the underlying forecast revision averages just 0.2 per cent of GDP over the full forecast period – one of the smaller revisions since the OBR was created in 2010. That is in spite of the in-year revision to 2016-17 being the largest such change we have made.

Table 1.3: Changes to public sector net borrowing since November

	£ billion						
	Outturn	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
November forecast	**76.0**	**68.2**	**59.0**	**46.5**	**21.9**	**20.7**	**17.2**
Accounting treatment change	-1.4	-3.0	-1.0	-2.2	-0.9	0.8	-0.4
November forecast restated	**74.7**	**65.2**	**58.0**	**44.3**	**21.0**	**21.5**	**16.8**
Total forecast changes	**-3.0**	**-13.4**	**-2.8**	**-5.3**	**-1.4**	**0.1**	**0.6**
of which:							
Receipts	-1.2	-7.5	-4.3	-4.6	-1.5	1.5	2.4
CG debt interest spending	0.0	-0.3	2.7	-0.4	0.9	1.2	1.2
Other spending	-1.8	-5.7	-1.2	-0.3	-0.7	-2.7	-3.0
March forecast pre-policy decisions	**71.7**	**51.7**	**55.2**	**39.0**	**19.7**	**21.6**	**17.4**
Total effect of Government decisions			**3.1**	**1.8**	**1.7**	**-1.0**	**-0.6**
of which:							
Scorecard receipts measures			0.2	-0.5	-1.5	-1.4	-1.5
Scorecard AME measures			-0.1	-0.1	-0.2	-0.1	-0.1
Total RDEL policy changes			1.4	1.2	2.4	2.5	2.5
Total CDEL policy changes			-0.8	-0.6	1.0	-0.9	-1.0
Non-scorecard receipts and AME measures			2.3	2.0	0.1	-0.8	-0.4
Indirect effect of Government decisions			0.1	-0.2	-0.1	-0.2	-0.1
March forecast	**71.7**	**51.7**	**58.3**	**40.8**	**21.4**	**20.6**	**16.8**
Memo items:							
Overall change since November	*-4.4*	*-16.4*	*-0.7*	*-5.7*	*-0.6*	*-0.2*	*-0.4*
Overall like-for-like change since November	*-3.0*	*-13.4*	*0.3*	*-3.5*	*0.3*	*-0.9*	*0.0*
Direct effect of policies on the scorecard			*1.7*	*0.7*	*-0.8*	*-0.9*	*-0.4*
Direct effect of policies not on the scorecard			*1.3*	*1.3*	*2.6*	*0.2*	*0.0*

Note: 2015-16 reflects outturn data and has not been adjusted for ONS classification decisions that have been announced but not yet implemented.
Note: This table uses the convention that a negative figure means a reduction in PSNB, i.e. an increase in receipts or a reduction in spending will have a negative effect on PSNB.

The profile of deficit reduction

1.31 We expect borrowing to fall from 3.8 per cent of GDP in 2015-16 to 0.7 per cent in 2021-22 – an average fall of 0.5 percentage points of GDP a year. The profile of deficit reduction over the forecast is uneven from year to year, and much more so than in November. Chart 1.5 shows the sources of the year-on-year changes in the deficit over the forecast period and how they compare to the average fall. It shows that:

- in **2016-17** we expect the deficit to fall by 1.2 per cent of GDP, significantly faster than the average. That partly reflects two one-off boosts to tax receipts growth – the abolition of the NICs contracting out rebate and forestalling ahead of the rise in dividend tax. Growth in onshore corporation tax receipts has also been strong, driven by profits growth, flat business investment (which drives the use of tax-deductible allowances), and measures to restrict use of tax-deductible losses. Welfare spending falls relatively quickly, as tax credits caseloads have fallen more than expected;

- in **2017-18** the deficit rises by 0.2 per cent of GDP. The rise is partly driven by one-off effects on EU and debt interest spending. Tax receipts remain flat as a share of GDP despite the introduction of the apprenticeship levy, as forestalling of dividend income unwinds and the main rate of onshore CT is cut to 19 per cent;

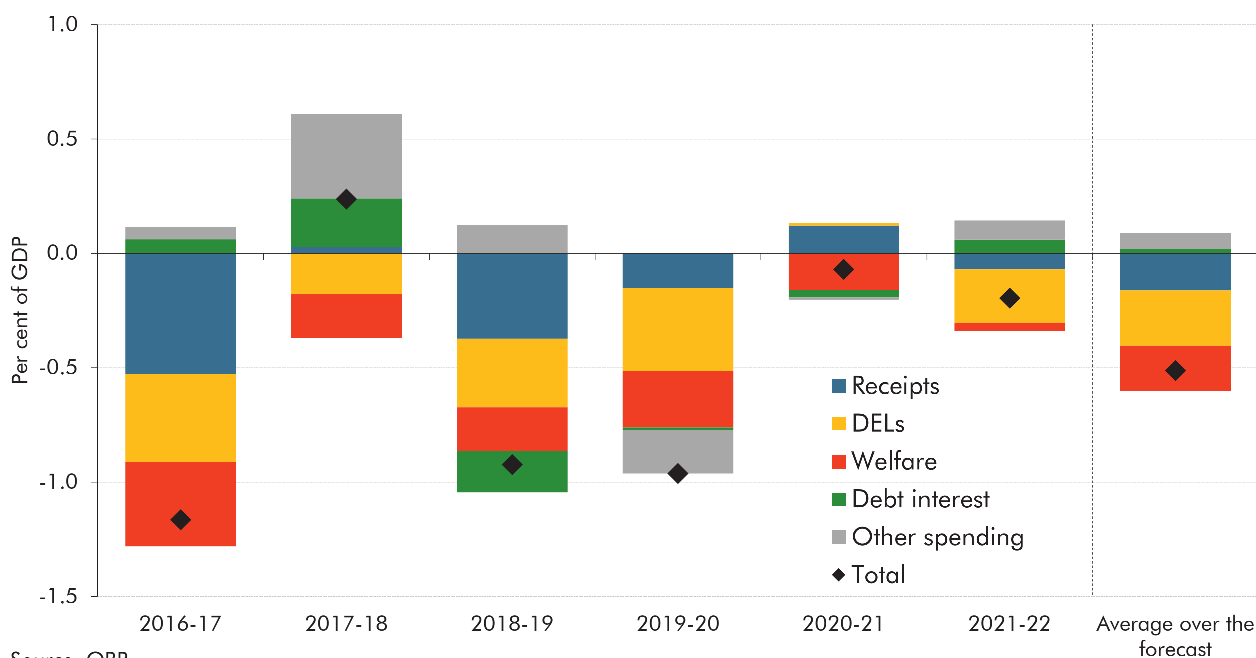
- fiscal consolidation resumes in **2018-19**, with the deficit falling by 0.9 per cent of GDP, faster than the average decline over the forecast period. Receipts rise by 0.4 per cent of GDP, flattered by the shifting of dividend income between years. Debt interest spending falls by 0.2 per cent of GDP, reflecting in particular lower RPI inflation;

- in **2019-20**, the deficit falls by 1.0 per cent of GDP, twice the average over the forecast period. This is partly because real departmental resource spending per person falls by 2.0 per cent, the sharpest decline in any year of the 2015 Spending Review and the third sharpest since 2010-11. Net public service pension spending also falls, as a reduction in the discount rate raises required contributions and puts further pressure on departmental resource budgets;

- in **2020-21**, the deficit falls by just 0.1 per cent of GDP. The main reason it does not fall in line with the average over the forecast is that departmental capital spending rises by 0.3 per cent of GDP. That reflects the large unallocated increase pencilled in for that year in the Spending Review. Onshore CT also falls by 0.1 per cent of GDP, reflecting the cut in the main rate from 19 to 17 per cent. Our pre-measures forecast showed the deficit rising in 2020-21. The Government's 'reprofiling' of spending – including some of the unallocated capital spending – was sufficient to mean that the deficit falls in our post-measures forecast despite rising pre-measures; and

- deficit reduction continues in **2021-22**, but again at a slower-than-average pace with borrowing falling by 0.2 per cent of GDP. Welfare spending falls at its slowest rate since 2012-13 as state pension spending rises as a share of GDP for the first time since 2015-16. The caseload rises 1.4 per cent as the state pension age stops rising.

Chart 1.5: Year-on-year change in public sector net borrowing



Source: OBR

1.32 We have not attempted to update the breakdown of our forecast revisions relative to an illustrative 'no referendum' scenario that we published in our November *EFO*. Over time, maintaining a meaningful counterfactual would be increasingly challenging – for example, how much of the movements in financial markets since November should be ascribed to participants reassessing the effects of Brexit and how much to other factors? The uncertainties to which such a counterfactual was subject would only increase.

Forecast for public sector net debt

1.33 In November we expected public sector net debt (PSND) to peak at 90.2 per cent of GDP in 2017-18, with the August 2016 monetary policy package raising debt significantly in 2016-17 and 2017-18. We continue to expect debt to peak as a share of GDP in 2017-18, but at a slightly lower 88.8 per cent. As in November, we expect it to fall each year thereafter.

1.34 Table 1.4 decomposes the changes in our PSND forecast since November:

- **nominal GDP** is higher in the near term, but lower by the end of the forecast. That reduces the debt-to-GDP ratio up to 2018-19, but raises it slightly thereafter;
- **lower cumulative borrowing** contributes most to the downward revision to cash debt;
- a change in our modelling of the **accounting effect of future APF gilt purchases** as maturing gilts are rolled over reduces cash debt significantly by the end of the forecast. This is because new purchases generally have lower coupons than those they replace. The higher yield curve has also reduced this accounting effect relative to November;

- higher expected drawdown of the Bank of England's **Term Funding Scheme**, with the biggest upward effect in 2016-17. Since the loans have a 4-year term, the unwinding of the scheme then has a bigger downward effect on debt in 2020-21;
- higher real and nominal interest rates imply lower **gilt premia** on future debt issuance, raising cash debt relative to November; and
- a **variety of smaller factors** have affected the level of cash debt. For example, the rise in the Lloyds Banking Group share price adds to expected proceeds from future sales under the Government's trading plan, whereas the lower gold price and stronger pound reduce the value of unhedged currency reserves that net off PSND.

Table 1.4: Changes to public sector net debt since November

	Per cent of GDP						
	Estimate	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
November forecast	84.2	87.3	90.2	89.7	88.0	84.8	81.6
March forecast	83.6	86.6	88.8	88.5	86.9	83.0	79.8
Change	**-0.6**	**-0.7**	**-1.4**	**-1.2**	**-1.1**	**-1.9**	**-1.8**
of which:							
Change in nominal GDP[1]	-0.4	-1.0	-0.9	-0.3	0.1	0.1	0.2
Change in cash level of net debt	-0.2	0.3	-0.5	-0.9	-1.2	-2.0	-2.0
	£ billion						
November forecast	1610	1725	1840	1904	1945	1950	1952
March forecast	1606	1730	1830	1885	1918	1904	1904
Change in cash level of net debt	**-4**	**5**	**-10**	**-19**	**-27**	**-46**	**-48**
of which:							
Borrowing	-4	-21	-22	-27	-28	-28	-28
APF modelling changes	0	-1	-3	-6	-10	-13	-20
APF yield curve changes	0	-1	-3	-4	-5	-2	-9
APF Term Funding Scheme	0	17	5	5	5	-12	0
Gilt premia	0	2	7	6	4	5	5
Other factors	0	8	6	8	7	4	4

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

Performance against the Government's fiscal targets

1.35 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of achieving its fiscal targets under existing policy. The *Charter* has been updated a number of times in recent years as the Government has revised its fiscal targets. The latest version was approved by Parliament in January 2017.

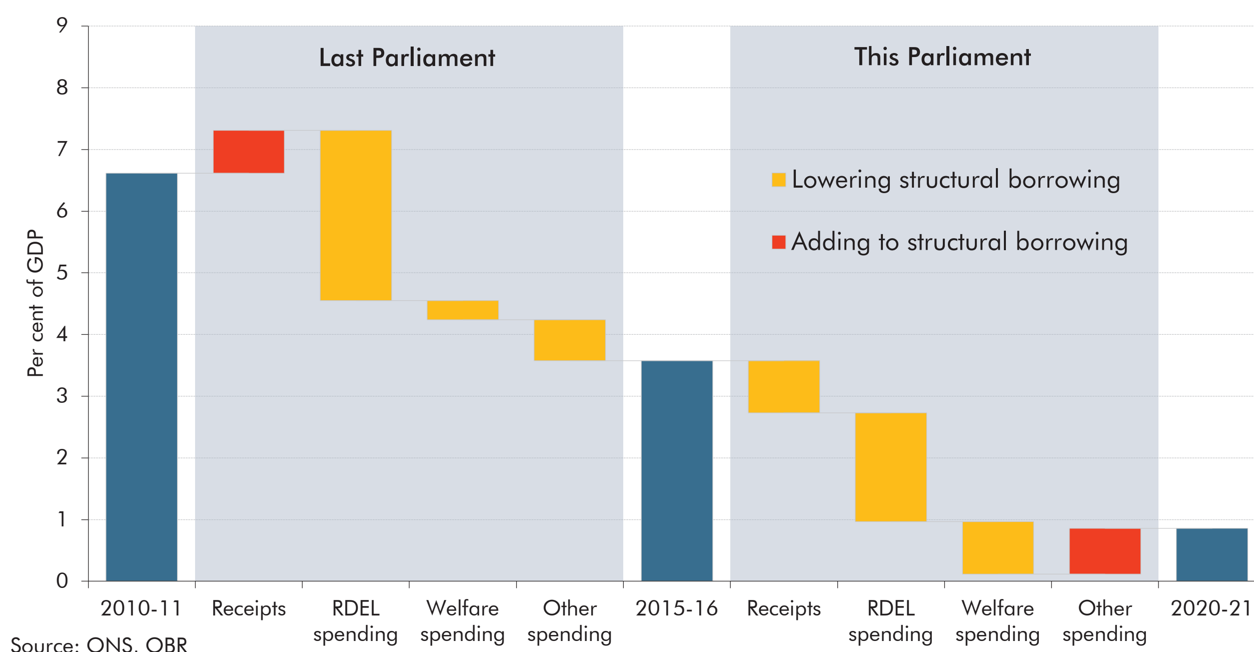
1.36 The *Charter* states that the Government's objective for fiscal policy is to "*return the public finances to balance at the earliest possible date in the next Parliament*". It also sets out targets for borrowing, debt and welfare spending that require:

- the **structural deficit** (cyclically adjusted public sector net borrowing) to be below 2 per cent of GDP by 2020-21;
- **public sector net debt** to fall as a percentage of GDP in 2020-21; and
- welfare spending (excluding the state pension and payments closely linked to the economic cycle) to be below a **welfare cap** that was set for 2021-22, in line with our November 2016 forecast for that year. The Government set a 3 per cent margin for error above the cap, so the effective cap on spending is higher. It has also set out a methodology by which the effect of changes in our inflation forecast relative to November 2016 must be stripped out of the formal assessment of performance against the cap. That assessment is not required until the start of the next Parliament.

1.37 Our central forecast implies that all three of these targets are on course to be met:

- the **structural deficit** falls from 3.6 per cent of GDP in 2015-16 to 0.9 per cent in 2020-21, thereby meeting the Government's target with a margin of 1.1 per cent of GDP – down from 1.2 per cent in November. Chart 1.6 shows the factors that contribute to the 2.7 per cent of GDP fall in the structural deficit over this Parliament – up to the target year of 2020-21 – and how that compares with the 3.0 per cent reduction in the last Parliament. Structural reductions in public spending dominate in both periods, with cyclically adjusted receipts actually falling by 0.7 per cent of GDP in the last Parliament and rising by only 0.8 per cent in this one. Within spending, cuts to day-to-day departmental spending dominate both periods – 2.8 per cent of GDP in the last Parliament and 1.8 per cent in this – while cuts to welfare spending have also been significant at 0.3 and 0.8 per cent of GDP respectively. Day-to-day departmental spending is set to fall 5.7 per cent in real per capita terms in this Parliament;
- **public sector net debt** falls by 3.9 per cent of GDP in 2020-21, up from 3.2 per cent in November. The repayment of loans issued under the Bank's Term Funding Scheme at the end of their four-year term contributes 2.2 per cent of GDP to this decline; and
- **spending subject to the welfare cap** is forecast to be £0.9 billion lower than the cap in 2021-22 and £4.5 billion below the cap-plus-margin once the small adjustment for changes in our inflation forecast since November has been applied. This is a slight increase from £3.8 billion in November, implying slightly more room for error.

Chart 1.6: Sources of changes to the structural deficit over two Parliaments



Source: ONS, OBR

Fiscal objective for the next Parliament

1.38 According to the Charter for Budget Responsibility, the Government's fiscal objective is to *"return the public finances to balance at the earliest possible date in the next Parliament"*. Only one full year of the next Parliament is currently within our forecast horizon. In it, the Government has set policy such that the headline deficit falls by 0.2 per cent of GDP to 0.7 per cent. Meeting its objective beyond that will be challenging. For example:

- if the deficit was **extrapolated to continue falling at the pace that it falls in 2021-22**, it would reach balance in 2025-26. Among other things, the extrapolation would imply the receipts-to-GDP ratio rising by a further 0.3 per cent of GDP and per capita departmental spending continuing to fall each year in real terms;

- as we showed in our 2017 *Fiscal sustainability report (FSR)*, if receipts and annually managed expenditure were **projected forward in line with the approach taken in our medium-term forecast** – but departmental spending was allowed to rise in line with the pressures of an ageing population and other non-demographic pressures on health spending – the deficit would remain roughly flat at around 0.8 per cent of GDP by the end of the next Parliament. Even holding the deficit constant in these circumstances would require the further fiscal tightening implied by uprating tax thresholds and working-age benefits awards for inflation. This would push the receipts-to-GDP ratio up by a further 0.6 per cent of GDP from the 37.2 per cent it reaches in 2021-22 and reduce average working-age welfare payments by a further 10 per cent relative to earnings; and

- using **our central *FSR* projection** itself, the challenge looks even greater. In this projection, we assume that tax thresholds and working-age benefit awards move with

earnings rather than inflation, so receipts are not on an ever-rising path relative to GDP and the incomes of working-age benefit recipients are not on an ever-declining path relative to those of the rest of the population. Adding the pressures on spending from an ageing population, non-demographic pressures specific to health spending and the cost of the triple lock on the uprating of state pensions would put the deficit on a rising path. In our 2017 *FSR*, which was based on our November medium-term forecast, it rose from 0.7 per cent of GDP in 2021-22 to 1.8 per cent by 2025-26.

1.39 The uncertainties around our central forecast reflect those regarding the outlook for the economy and those regarding the performance of revenues and spending in any given state of the economy. We assess the robustness of our judgement in three ways:

- first, by looking at **past forecast errors**. If our central forecasts are as accurate as official forecasts were in the past, then there is a roughly 65 per cent chance that the structural deficit would be below 2 per cent of GDP in 2020-21;
- second, by looking at the **sensitivity of the deficit to key features of the economy forecast**. The 1.1 per cent of GDP margin relative to the 2 per cent structural deficit ceiling would fall to zero if potential output were 2.3 per cent lower, if the effective tax rate were 1.1 per cent of GDP lower for structural reasons, or if the planned spending cuts – which reduce RDEL by 1.3 per cent of GDP between 2016-17 and 2020-21 – were to fall short by around four-fifths; and
- third, by looking at **alternative economic scenarios**. We have considered the implications of two different paths for the household saving ratio – either continuing to fall as it has over the past year or reversing that fall. The scenarios assume that this all happens via higher or lower consumer spending than assumed in our central forecast, with the resulting changes in output growth entirely cyclical. These scenarios have the expected effect on the deficit, which would be lower in the boom scenario and higher in the bust. But even though the shocks are cyclical, with real GDP returning to the same level as in the central forecast by its end, there would be lasting effects on *structural* borrowing. The key reason is that nominal GDP would be permanently higher or lower in these scenarios, but public spending would be little changed in cash terms – for example because departmental spending totals have been set out in multi-year cash terms – meaning it would be lower or higher as a share of GDP. Debt would also be placed on a permanently different path due to the cumulative changes in borrowing. But in neither scenario would the Government's fiscal targets be missed, reflecting the headroom that it has against each.