



The Scottish Parliament  
Pàrlamaid na h-Alba

## FINANCE AND CONSTITUTION COMMITTEE

### AGENDA

1st Meeting, 2019 (Session 5)

Wednesday 9 January 2019

The Committee will meet at 9.30 am in the David Livingstone Room (CR6).

1. **Decision on taking business in private:** The Committee will decide whether its consideration of a draft report on the Scottish Government Budget 2019-20 should be taken in private at future meetings.

2. **Budget Scrutiny 2019-20:** The Committee will take evidence on the Scottish Government's Budget 2019-20 from—

Dame Susan Rice, Chair, John Ireland, Chief Executive, Professor Francis Breedon, Commissioner, Professor David Ulph, Commissioner, and Professor Alasdair Smith, Commissioner, Scottish Fiscal Commission;

and then from—

Robert Chote, Chairman, Office for Budget Responsibility.

3. **Work programme (in private):** The Committee will consider its work programme.

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Edinburgh  
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The papers for this meeting are as follows—

**Agenda Item 2**

Budget Paper

FCC/S5/19/1/1

**Agenda Item 3**

PRIVATE PAPER

FCC/S5/19/1/2 (P)

**Finance and Constitution Committee**

**1st Meeting, 2019 (Session 5), Wednesday 9 January 2019**

**Budget 2019-20**

**Purpose**

1. The purpose of this paper is to provide background information in advance of the Committee’s oral evidence sessions with Robert Chote, Chairman of the Office for Budget Responsibility (OBR) and Dame Susan Rice, Chair, Professor Francis Breedon, Commissioner, Professor Alasdair Smith, Commissioner, Professor David Ulph, Commissioner and John Ireland, Chief Executive from the Scottish Fiscal Commission (SFC).

2. The purpose of these evidence sessions is to scrutinise the OBR rUK tax forecasts which inform HM Treasury’s calculation of the Block Grant Adjustment (BGA) and the SFC forecasts of shared, assigned and devolved taxes in Scotland. On 29 October 2018, the OBR published its latest [Economic and Fiscal Outlook \(EFO\)](#). The [executive summary](#) is attached. The briefing material for the Committee’s previous evidence session on the Budget at its meeting on 19 December is available here:

[http://www.scottish.parliament.uk/S5\\_Finance/Meeting%20Papers/public\\_papers.2.pdf](http://www.scottish.parliament.uk/S5_Finance/Meeting%20Papers/public_papers.2.pdf)

**Fiscal Framework**

3. In its submission to the Committee, [Audit Scotland](#) highlights that increases or decreases in the Scottish budget are linked to Scotland’s economic performance relative to the economic performance of the rest of the UK insofar as this affects the relative growth in tax receipts per head.

**Exhibit 1**

**The relationship between Scottish performance and rest of the UK performance on the Scottish budget**



Source: Audit Scotland

4. The size of the Scottish Budget is adjusted annually to reflect the annual growth in tax receipts in Scotland relative to the annual growth in the equivalent tax receipts in the rest of the UK. The adjustment to the block grant is based on OBR forecasts for the rest of the UK which are subsequently reconciled with the outturn data. Likewise the SFC's forecast of Scottish income tax is reconciled with the outturn figures which are published with a lag of around 15 months.

5. The table below which is reproduced from the SFC's economic and fiscal forecasts shows the net position of tax forecasts and the BGAs. The SFC state that: "Forecast receipts are greater than the BGAs over the whole of this period. The differences reflect both policy decisions by the Scottish and UK Governments as well as differences in the underlying growth of tax revenues."<sup>1</sup>

**Table 6: Net position of tax forecasts and Scottish Government Block Grant Adjustments**

£ million		2019-20	2020-21	2021-22	2022-23	2023-24
Income Tax	SFC forecast	11,684	12,285	12,746	13,242	13,805
	BGA forecast	11,501	12,089	12,478	12,954	13,493
	Net difference	182	196	268	288	312
Land & Buildings Transaction Tax	SFC forecast	643	680	716	751	787
	BGA forecast	567	596	632	667	721
	Net difference	76	85	84	83	66
Scottish Landfill Tax	SFC forecast	104	83	13	13	14
	BGA forecast	91	83	81	74	62
	Net difference	13	0	-68	-61	-48
Total	SFC forecast	12,430	13,049	13,475	14,006	14,605
	BGA forecast	12,159	12,768	13,191	13,695	14,276
	Net difference	271	281	284	310	329

Source: Scottish Fiscal Commission, Scottish Government.

Figures may not sum because of rounding. Net difference equals the Scottish Fiscal Commission forecast minus the BGA, a positive number represents additional revenues available to the Scottish Government.

## Income Tax Forecasts

6. For 2019-20 the BGA for income tax will be indexed using growth in receipts from England, Wales and NI. This is because there is no impact from the devolution of income tax in Wales as the Welsh Government have kept rates and bands the same. The Welsh Fiscal Framework states that if the Welsh Government did this for the first year of devolution there would be no impact on their spending power as their BGA would equal receipts in Wales.

<sup>1</sup> <http://www.fiscalcommission.scot/media/1435/scotlands-economic-and-fiscal-forecasts-december-2018-full-report.pdf>

7. For 2020-21, the BGA will be indexed using growth in receipts from England and NI only. This means that rUK becomes England and NI and Welsh receipts are removed.

8. Table 1 below provides a comparison of the OBR's forecasts for rUK income tax. The November 2017 forecasts inform the BGA for the 2018-19 Scottish Budget and the October 2018 forecasts inform the 2019-20 Budget. The rUK figures below for 2017-18 to 2019-20 are based on England, Wales and Northern Ireland income tax forecasts. The rUK figures are for 2020-21 to 2022-23 are based on income tax receipt forecasts for England and Northern Ireland.

#### **OBR rUK Income Tax Forecasts (£bn)**

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>November 2017</b>	154.9	158.3	162.9	166.8	173.4	180.1
<b>October 2018</b>	154.7	161.3	161.8	165.4	171.2	178.2

9. Table 2 below provides a comparison of the SFC forecasts.

#### **SFC Scottish Income Tax Forecasts (£m)**

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>December 2017</b>	11, 584	12,115	12,582	13,084	13,662	14,296
<b>December 2018</b>	11, 008	11,452	11, 684	12,285	12,746	13,242

#### **Next steps**

10. The Committee will take evidence on the Scottish Government's Budget 2019/20 from the Cabinet Secretary for Finance, Economy and Fair Work at its meeting on 16 January 2019.

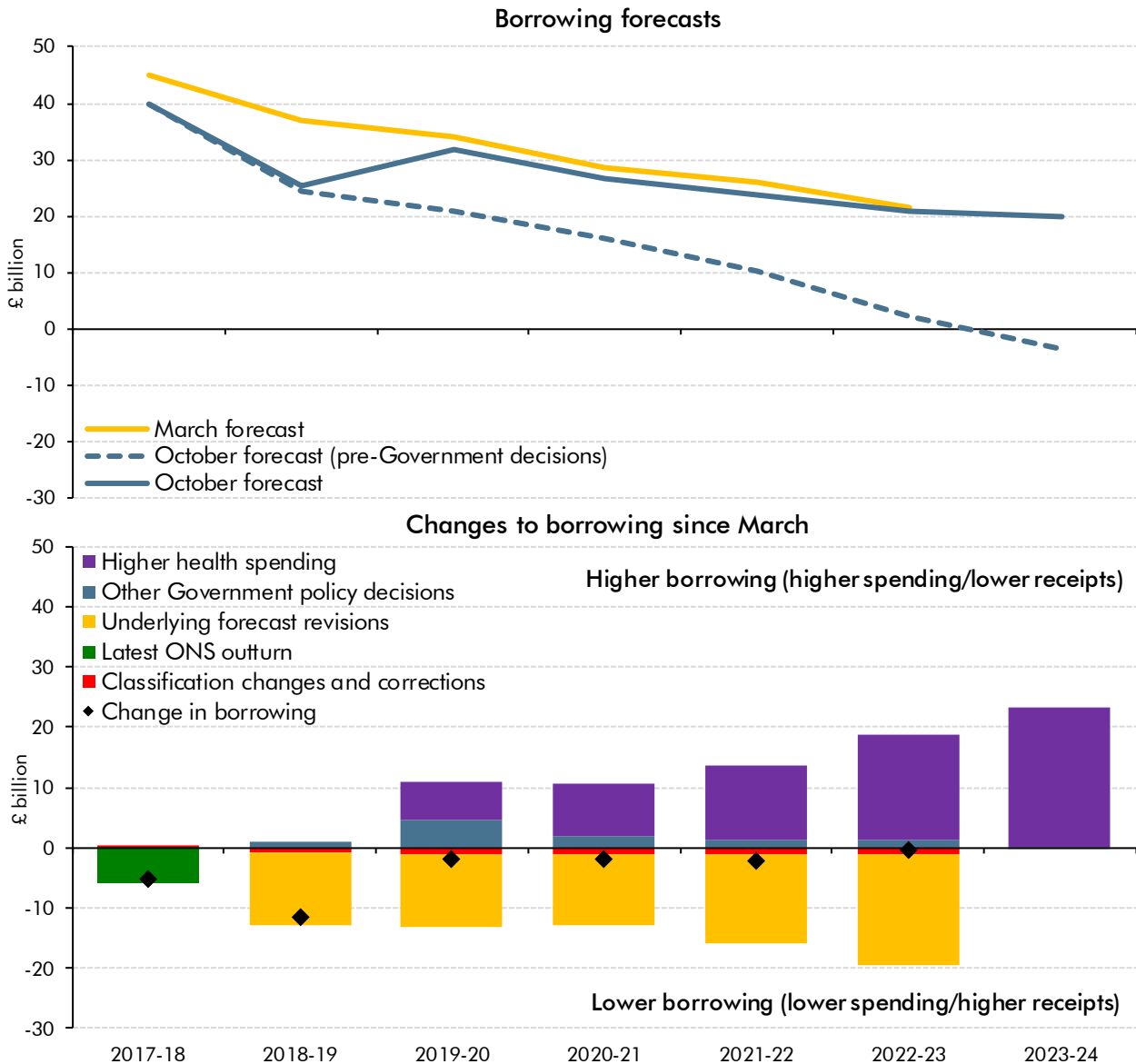
**Committee clerks  
December 2018**

# 1 Executive summary

## Overview

- 1.1 At first glance the outlook for the public finances in the medium term looks much the same as it did in March. But this masks a significant improvement in the underlying pace of deficit reduction, that on its own would have put the Government on course to achieve its objective of a balanced budget for the first time. As it happens, this underlying improvement had already been swallowed up by the Prime Minister's promise of higher spending on the NHS made in June. The remaining Budget policy measures are a further near-term giveaway that gradually diminishes over the forecast, leaving the deficit in 2022-23 little changed overall.
- 1.2 The public finances have performed better so far this year than we and outside forecasters expected back in March, even though the economy has grown less quickly. Once again, the ONS has revised last year's budget deficit lower, relative both to its initial estimate in April and to our forecast from March. Borrowing has also fallen more sharply in the first half of 2018-19 than anticipated, relative to the same period last year. As a result – and before the impact of any policy decisions – we have revised borrowing £11.9 billion lower for the full year (like for like), creating a more favourable starting point for the forecast. This reflects stronger tax revenues and lower spending on welfare and debt interest than expected.
- 1.3 The performance of the real economy has been less impressive relative to expectations. We have revised real GDP growth in 2018 down from 1.5 to 1.3 per cent, but primarily due to the temporary effects of the snowy first quarter. Thereafter we expect slightly stronger growth over the forecast as a whole than in March, reflecting a downward revision to our estimate of the sustainable rate of unemployment and an upward revision to potential labour market participation, reflecting new data on participation by age that we flagged back in July.
- 1.4 The upward revision to cumulative GDP growth means that the underlying improvement in the budget deficit rises from £11.9 billion this year to £18.1 billion by 2022-23. At 0.6 per cent of GDP, on average, this is the largest favourable underlying forecast revision we have made since December 2013, but only the sixth largest we have made in either direction since 2010. On its own, this would have been sufficient to achieve a budget surplus of £3.5 billion in 2023-24, meeting the 'fiscal objective' of balancing the budget by 2025.
- 1.5 But the Budget spends the fiscal windfall rather than saving it. Most significantly, it confirms funding for the NHS settlement announced in June, the cost of which rises from £7.4 billion in 2019-20 to £27.6 billion in 2023-24 in gross terms and from £6.3 billion to £23.4 billion adjusting for the boost it gives to nominal GDP. The rest of the package has the familiar Augustinian pattern of a near-term giveaway followed by a longer-term takeaway, increasing borrowing by £5.3 billion in 2019-20 but reducing it by £0.2 billion by 2023-24.

Chart 1.1: Public sector net borrowing: October versus March



Source: ONS, OBR

1.6 The giveaways include raising the income tax personal allowance to £12,500, increasing the generosity of universal credit and the traditional one-year freeze in fuel duty rates. Public services spending outside health also gets a boost rising to £3.2 billion by 2022-23, so that it no longer falls in real terms over the forecast. The main takeaways include a new tax on large digital businesses, a tightening of rules on people who work through their own company, the reversal of the 2016 decision to abolish Class 2 National Insurance contributions for the self-employed and the restriction of the NICs employment allowance to small businesses. Departmental capital spending has also been cut from 2019-20 onwards, a decision that does not appear on the Treasury’s scorecard of policy measures.

1.7 The overall effect of the Budget measures is to increase the deficit by £1.1 billion this year and £10.9 billion next year, rising to £23.2 billion in 2023-24. This is the largest discretionary fiscal loosening at any fiscal event since the creation of the OBR. Combined

with the underlying forecast improvement and some small classification changes, the deficit has been revised down by £11.6 billion this year (to £25.5 billion), but by only around £2 billion a year on average thereafter. This leaves a deficit of £19.8 billion or 0.8 per cent of GDP in 2023-24, with just two years left to meet the balanced budget objective.

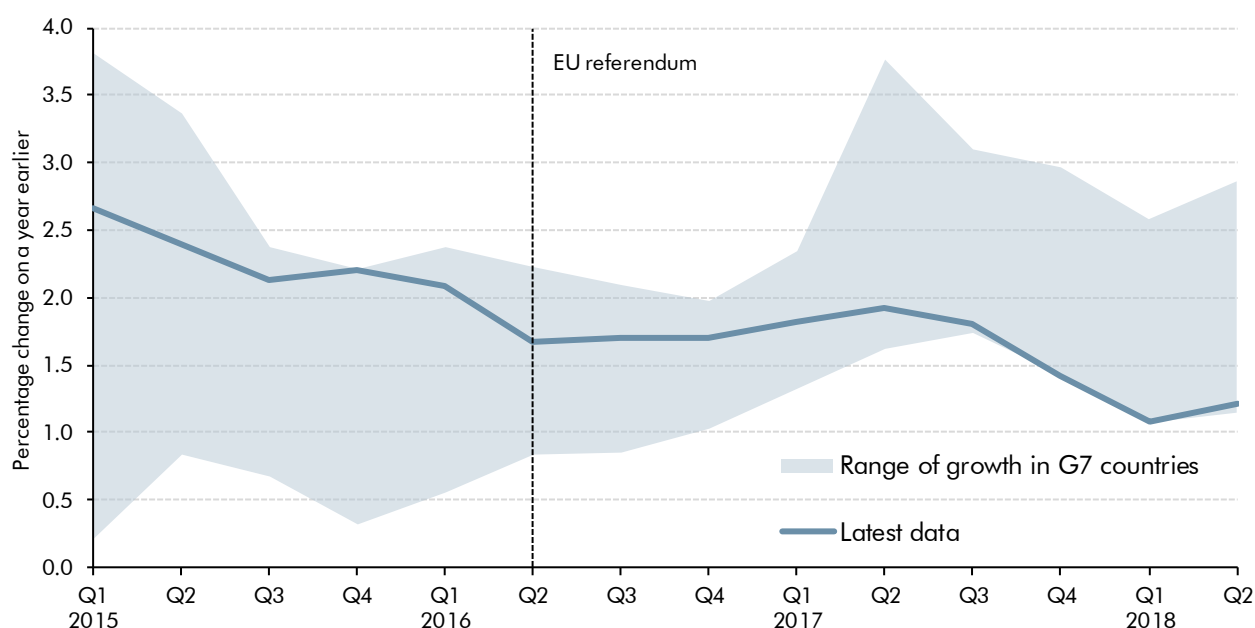
- 1.8 The forecast changes and policy decisions leave the Chancellor with £15.4 billion (0.7 per cent of GDP) of headroom against his ‘fiscal mandate’, which requires the structural budget deficit to lie below 2 per cent of GDP in 2020-21. The Budget policy package has been fine-tuned to ensure that this is precisely the same margin as he had in March.
- 1.9 The Chancellor also meets his supplementary target of reducing public sector net debt as a share of GDP in 2020-21. In this forecast it falls by 3.2 per cent of GDP in that year, compared to 3.0 per cent of GDP in March. (The ending of the Bank of England’s Term Funding Scheme contributes 2.3 percentage points of the decline.) Net debt falls from 83.7 per cent of GDP this year to 75.0 per cent of GDP in 2022-23. This is down from 77.9 per cent of GDP in our March forecast, reflecting higher nominal GDP, slightly lower cumulative borrowing over the forecast, plus further planned sales of RBS shares and student loans.
- 1.10 As always, we highlight the considerable uncertainty that lies around any medium-term fiscal forecast. Experience shows that a favourable revision in one forecast can be followed by an unfavourable one in the next and that policy decisions ought to be robust to that. As we explain in the Foreword, this has also been an unusually challenging forecast process, with repeated failures to observe the agreed timetable. This has resulted in a regrettable (but thankfully small) inconsistency between our economy and fiscal forecasts, as well as the Government announcing a complicated package of measures that further delays and increases the generosity of universal credit, where we cannot certify the impact on borrowing as central and reasonable on the basis of the information we were provided. This implies greater scope for subsequent revisions than would normally be the case.
- 1.11 The big picture in this forecast is of a relatively stable but unspectacular trajectory for economic growth – close to 1½ per cent in every year – plus a gradual further decline in the budget deficit and in net debt as a share of GDP. Given the lack of any meaningful basis on which to predict the outcome of the negotiations over the future relationship between the UK and the EU – which may continue well beyond any near-term Withdrawal Agreement – we have based this forecast on the same broad-brush assumptions regarding the impact of Brexit that we have made in our previous post-referendum forecasts.
- 1.12 As we explained last month in *Discussion Paper No.3: Brexit and the OBR’s forecasts*, we will adjust our assumptions as necessary for the eventual agreements on trade, migration, budget contributions and other issues. In the near term, it is worth emphasising that this forecast assumes a relatively smooth exit from the EU next year. A disorderly one could have severe short-term implications for the economy, the exchange rate, asset prices and the public finances. The scale would be very hard to predict, given the lack of precedent.



## Economic developments since our previous forecast

- 1.13 Thanks in part to severe winter weather, the UK economy grew by just 0.5 per cent in the first half of the year, less quickly than we expected in March. But employment has continued to outstrip expectations, rising by 240,000 in the same period, almost three times quicker than we forecast. Average hours failed to rebound from their dip at the end of 2017, as we had expected, so total hours worked were 0.5 per cent weaker and productivity (measured as output per hour) was 0.2 per cent stronger than forecast.
- 1.14 CPI inflation has declined in line with our March forecast in the first half of 2018. But higher oil prices and a weaker exchange rate than we had assumed pushes up inflation in subsequent quarters. Sterling oil prices have risen steadily since their trough in early 2016 and futures prices suggest that they will be nearly 50 per cent higher than our March projection in the fourth quarter of 2018. The trade-weighted exchange rate is 2½ per cent lower than we assumed it would be in March, pushing up import prices.
- 1.15 Since our last *Economic and fiscal outlook (EFO)*, the ONS has released its 2018 *Blue Book* and the full Quarterly National Accounts up to the second quarter. This year's changes had little impact on the paths of real and nominal GDP. Meanwhile, the income measure of real GDP has been noticeably weaker than the equivalent expenditure and output measures. With receipts exceeding expectations across most major taxes, this raises the possibility that current estimates of real and nominal GDP growth may in time be revised higher.
- 1.16 Notwithstanding potential future revisions, the referendum vote to leave the EU appears to have weakened the economy. The fall in the pound has squeezed real household incomes and consumption, while providing only a modest boost to net trade. Meanwhile, uncertainty regarding the Brexit negotiations appears to have dampened business investment (by more than earlier data suggested). Studies that construct a pre-vote 'doppelganger' for the UK suggest that the economy was 2 to 2½ per cent smaller by mid-2018 than it would have been if the referendum had not been called. The average quarterly growth rate has slowed from 0.6 per cent between 2013 and 2015 to 0.4 per cent since the beginning of 2016, taking the UK from near the top of the G7 growth league table to near the bottom.

Chart 1.2: GDP growth in the UK and other G7 countries



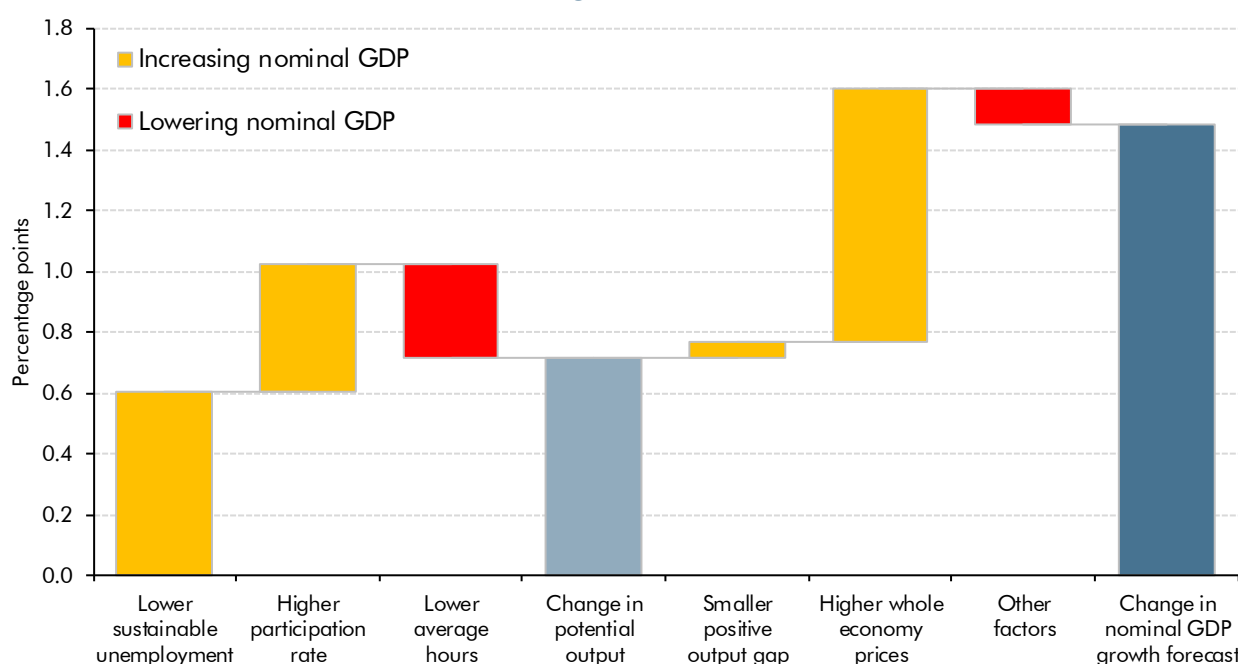
Source: OECD, ONS

## The economic outlook

- 1.17 There remains no meaningful basis on which to predict the outcome of the current negotiations over the relationship between the UK and the EU after Brexit, so we have retained the broad-brush assumptions on productivity, trade and migration that we have made in our previous post-referendum forecasts. The one exception – in line with the March draft Withdrawal Agreement – is that we now assume that there will be a two-year transition period in which the trading relationship will remain as it is now. This delays the decline in trade intensity that we expect after we leave the EU.
- 1.18 In order to estimate how much the economy can grow over the next five years, subject to the Bank of England meeting its inflation target in the medium-term, we start by estimating the extent to which the economy is currently operating above or below potential, and by forming a judgement as to the rate at which potential output will grow over time.
- 1.19 In this forecast we judge that the economy was running 0.2 per cent above potential in the second quarter of 2018, slightly below the 0.3 per cent we expected in March. Real GDP is then expected to grow by 6.1 per cent up to 2022-23, up from 5.5 per cent in March. One reason for the change is higher expected labour market participation, reflecting the incorporation of new data on participation by age in our cohort model (as flagged in our *Fiscal sustainability report* in July). We have also lowered our estimate of the sustainable rate of unemployment from 4½ per cent of the labour force to 4 per cent, reflecting the absence of a significant pick-up in wage growth as the jobless rate has continued to fall. (This takes us from slightly above to slightly below the Bank of England’s latest published estimate.) This increases GDP over the forecast, partly offset by lower average hours.

1.20 Most discussion of the economic outlook focuses on real GDP – the volume of goods and services produced in the economy. But the nominal (or cash) value is more important for the public finances, especially for the path of tax receipts. We expect nominal GDP to rise by 14.4 per cent between 2018-19 and 2022-23, up from 12.9 per cent in March. About half of the increase comes from higher potential output, but there is an even bigger contribution from higher whole economy inflation – thanks mostly to the higher public spending in the Budget. The change in expected nominal GDP growth since March (Chart 1.3) contributes to steady increases in government receipts and lower borrowing over time. Less obviously, higher whole economy inflation means that a given amount of cash spending stretches less far in terms of the quality and quantity of public services it can deliver.

Chart 1.3: Revisions to nominal GDP growth



Source: OBR

1.21 So how do we expect the economy to evolve over the next five years, consistent with our slightly more upbeat view of its growth potential? We attribute the unexpectedly weak start this year to temporary factors, but they are still sufficient to lower real GDP growth for 2018 as a whole to 1.3 per cent from 1.5 per cent in March. We then expect it to pick up to 1.6 per cent next year, up from 1.3 per cent in March thanks to the Budget giveaway. Growth thereafter is only fractionally higher than in March, picking up from 1.4 per cent in 2020 and 2021 to 1.6 per cent by 2023 as underlying productivity growth improves.

1.22 With the economy currently running slightly above potential, the effect of higher public spending on GDP growth is assumed to fall to zero as the economy adjusts through wages and prices, as well as changes in monetary policy. We assume that financial market participants will not have fully anticipated the scale of the fiscal giveaway – perhaps assuming that some of the additional health spending would be financed by tax rises – and that it will not therefore be fully reflected in the market interest rate expectations that underpin our forecast. So output is still slightly above potential by the end of the forecast.

- 1.23 As noted in the Foreword, this forecast is based on a slightly larger fiscal giveaway than the Government eventually decided on, as we were notified of changes to the policy package after the agreed point at which our economy forecast was closed. But we do not believe that it would have altered real GDP growth in any year to one decimal place. The big picture is one of relatively steady growth of around 1½ per cent a year. We are slightly more pessimistic than the average of external forecasters, particularly in the later years.
- 1.24 Underlying our revisions to the overall path of GDP are relatively large changes in composition, thanks largely to the announced increase in NHS and other day-to-day public spending. Nominal government consumption is expected to end the forecast slightly higher as a share of GDP than it started, rather than fall as we expected in March. This is the first time that we have forecast such a rise. Growth in business investment no longer seems to have held up as well since the EU referendum as the data suggested in March – we continue to expect it to rise slightly as a share of GDP over the forecast, but at a slightly slower pace. Household consumption growth is stronger than forecast in March in the near term, and then expected to grow in line with income growth, consistent with our previous forecasts. The contribution of net trade to GDP growth is expected to be broadly neutral, and we continue to expect virtually no growth in both exports and imports for the last three years of our forecast, partly the result of an assumed reduction in trade intensity after leaving the EU.
- 1.25 In the household sector, the saving ratio (excluding pension contributions) is very slightly negative through the forecast, while unsecured debt rises steadily as a share of household income. But we are not assuming a growth outlook that is dependent on an unsustainable debt-fuelled increase in consumption. Experience shows that the saving ratio is frequently revised significantly (as it has been since March) and that the relatively flat outlook is probably more meaningful than the downward revision to the level. And only a small part of unsecured debt is made up of consumer credit. A growing share is accounted for by the stock of student loans, which are likely to continue to rise over the next five years.
- 1.26 Following recent increases in oil prices and a further modest fall in sterling, we expect CPI inflation to tick up in the second half of the year and to end the year 0.5 percentage points above our March forecast at 2.6 per cent. It then falls back in 2019 as the impact of higher oil prices fades and thanks to policy measures on duties and energy prices. In the medium term, CPI inflation stays a little above the Bank's 2 per cent target, due to the small positive output gap. House price inflation averages just over 3 per cent a year.
- 1.27 Unemployment fell to 4.0 per cent of the labour force in the second quarter, continuing the downward trend since late 2011. We expect it to fall to 3.7 per cent by the start of next year, before stabilising and then edging up towards its equilibrium rate, reaching 4.0 per cent in 2023. By the end of the forecast, employment is 400,000 higher than we forecast in March, reflecting both the downward revision to equilibrium unemployment and higher labour market participation. Thanks to the increase in departmental spending in the Budget, we project that general government employment will rise by 150,000 between the second quarter of 2018 and the first of 2023, compared with a fall of 250,000 projected in March.

- 1.28 Alongside the Budget, the Government has expressed its aspiration to end low pay, noting the definition used by the OECD, which corresponds to two-thirds of median earnings. In the coming months, it intends to consult on the remit for the Low Pay Commission, bearing in mind the potential impact on employment and economic growth. If it confirms that it wishes to pursue this goal, rather than just the current policy of getting to 60 per cent by 2020, that would represent a significant increase in the NLW, taking it to a level with few international precedents. An NLW at this level would directly affect the wages of the bottom quarter of the wage distribution and around half of the workforce directly or indirectly. There is limited evidence that previous increases in the National Minimum Wage and NLW have had a significant effect on employment, but we would expect an NLW at this level to price more workers out of jobs. By way of illustration, we estimate that an NLW set at two-thirds of median earnings would reduce real GDP by 0.2 per cent, and raise the unemployment rate by 0.4 percentage points, or 140,000 jobs in today's terms.
- 1.29 The future is, of course, uncertain and no central forecast will be fulfilled in its entirety. Indeed, past experience suggests that the growth path over the next five years is unlikely to be as smooth as that depicted in our central forecast. One mechanical way of illustrating the uncertainty around our GDP growth forecast is shown in Chart 1.4. This presents our central forecast together with a fan showing 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. It implies a 10 per cent probability that GDP will fall year-on-year in 2019.
- 1.30 Among the downside risks confronting the economy, the most immediate and significant is the possibility of a disorderly exit from the EU next March. As we discussed in our recent *Discussion Paper No.3: Brexit and the OBR's forecasts*, this could have severe short-term implications for economic activity, the exchange rate and asset prices. If it comes to pass, it will be very hard to calibrate the potential impact given the lack of meaningful precedent.

Chart 1.4: Real GDP fan chart

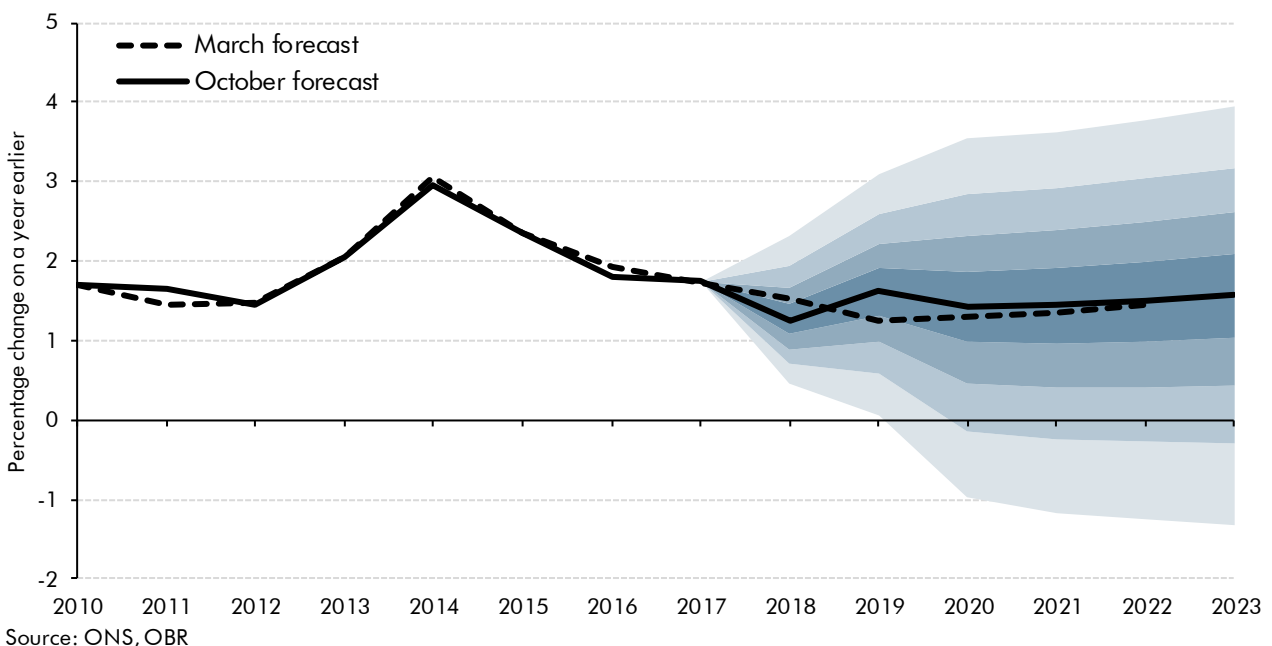


Table 1.1: Overview of the economy forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2017	2018	2019	2020	2021	2022	2023
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	1.7	1.3	1.6	1.4	1.4	1.5	1.6
GDP per capita	1.1	0.6	1.0	0.9	0.9	1.0	1.1
GDP levels (2017=100)	100.0	101.3	102.9	104.4	105.9	107.4	109.1
Output gap	0.0	0.2	0.3	0.2	0.1	0.1	0.1
<b>Expenditure components of real GDP</b>							
Household consumption	1.8	1.3	1.2	1.2	1.3	1.4	1.5
General government consumption	-0.1	1.0	2.1	2.0	1.7	1.6	1.6
Business investment	1.8	0.5	2.3	2.1	2.1	2.1	2.2
General government investment	1.7	-0.2	5.7	3.3	1.8	0.9	1.4
Net trade <sup>1</sup>	0.7	0.2	-0.1	-0.1	0.0	0.0	-0.1
<b>Inflation</b>							
CPI	2.7	2.6	2.0	2.0	2.1	2.1	2.0
<b>Labour market</b>							
Employment (millions)	32.1	32.4	32.7	32.9	33.0	33.1	33.2
Average earnings	2.7	2.6	2.5	2.8	3.0	3.1	3.2
LFS unemployment (rate, per cent)	4.4	4.0	3.7	3.8	3.9	3.9	4.0
<b>Changes since March forecast</b>							
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	0.0	-0.3	0.4	0.1	0.1	0.0	
GDP per capita	0.0	-0.3	0.4	0.1	0.1	0.0	
GDP levels (2017=100)	0.0	-0.3	0.1	0.2	0.3	0.3	
Output gap	-0.1	-0.1	0.2	0.2	0.1	0.1	
<b>Expenditure components of real GDP</b>							
Household consumption	0.1	0.4	0.4	0.1	-0.1	0.0	
General government consumption	-0.4	-0.1	1.3	1.4	0.7	0.5	
Business investment	-0.5	-1.1	0.3	-0.1	-0.4	-0.4	
General government investment	-1.8	-2.3	3.6	-2.8	0.8	-0.3	
Net trade <sup>1</sup>	0.3	-0.2	-0.4	-0.1	0.0	0.0	
<b>Inflation</b>							
CPI	0.0	0.1	0.2	0.0	0.1	0.1	
<b>Labour market</b>							
Employment (millions)	0.0	0.2	0.3	0.4	0.4	0.4	
Average earnings	0.1	-0.2	0.1	0.3	0.2	0.2	
LFS unemployment (rate, per cent)	0.0	-0.4	-0.8	-0.8	-0.7	-0.7	

<sup>1</sup> Contribution to GDP growth.

## The fiscal outlook

1.31 Public sector net borrowing has fallen from its post-crisis peak of 9.9 per cent of GDP (£153.1 billion) in 2009-10 to 1.9 per cent of GDP (£39.8 billion) in 2017-18, a smaller deficit than we forecast in March. With the output gap close to zero, we judge that the 2017-18 structural deficit (which excludes the effect of the economic cycle) was the same as the headline deficit at 1.9 per cent of GDP. On both measures, the deficit is expected to fall significantly in 2018-19, rise slightly in 2019-20, and then fall steadily thereafter.

- 1.32 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 remain below 2 per cent of GDP throughout the forecast and, after a modest rise in 2019-20, to fall slowly over the four years to 2023-24. Our central forecast is for a structural deficit of 1.3 per cent of GDP in 2020-21, below the 2 per cent of GDP ceiling set in the Chancellor’s ‘fiscal mandate’. Our forecast is little changed from March, but this reflects the offsetting effects of a significant underlying improvement in the public finances and the Government’s decision to use almost all that improvement to boost public spending.

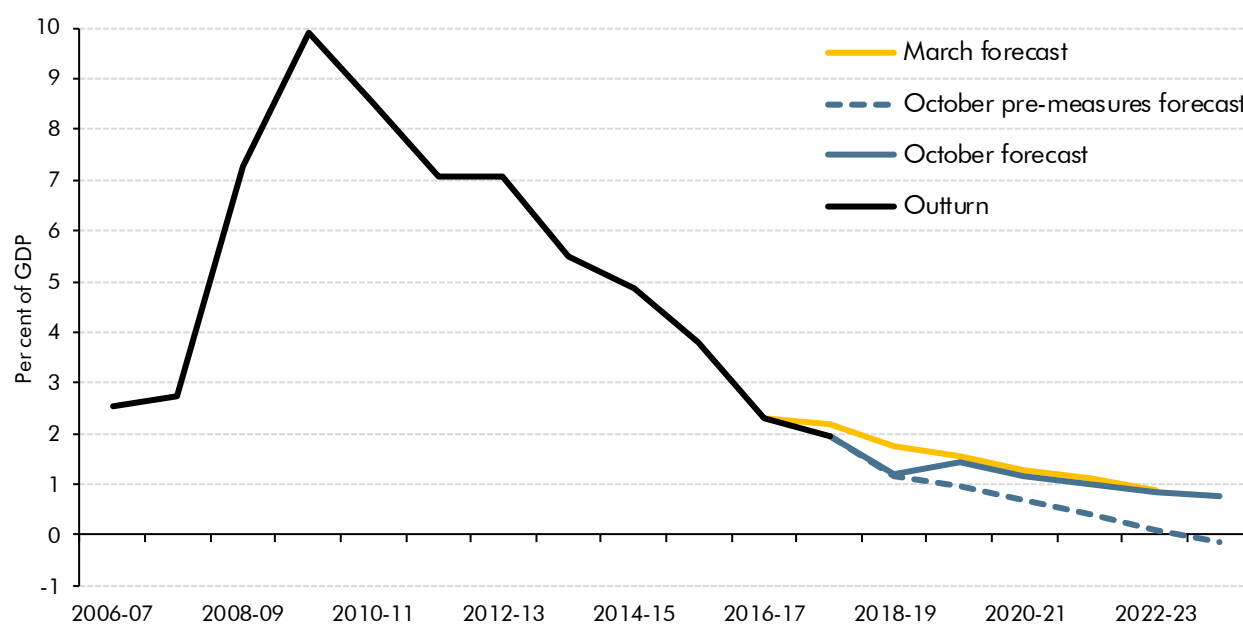
Table 1.2: Overview of the fiscal forecast

	Per cent of GDP						
	Outturn	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
<b>Revenue and spending</b>							
Public sector current receipts	36.6	37.0	36.8	37.0	37.0	37.0	37.2
Total managed expenditure	38.5	38.2	38.3	38.1	38.0	37.9	37.9
<b>Deficit: Current and previous fiscal mandate measures</b>							
Cyclically adjusted net borrowing	1.9	1.3	1.6	1.3	1.1	0.9	0.8
Public sector net borrowing	1.9	1.2	1.4	1.2	1.0	0.9	0.8
Cyclically adjusted current budget deficit	-0.1	-0.6	-0.6	-0.9	-1.1	-1.2	-1.3
<b>Debt: Supplementary target</b>							
Public sector net debt	85.0	83.7	82.8	79.7	75.7	75.0	74.1
£ billion							
<b>Revenue and spending</b>							
Public sector current receipts	754.0	787.3	809.8	840.4	869.6	900.8	935.5
Total managed expenditure	793.8	812.8	841.6	867.1	893.4	921.7	955.3
<b>Deficit: Current and previous fiscal mandate measures</b>							
Cyclically adjusted net borrowing	39.4	28.4	36.0	30.1	25.9	22.2	21.0
Public sector net borrowing	39.8	25.5	31.8	26.7	23.8	20.8	19.8
Cyclically adjusted current budget deficit	-1.8	-12.8	-12.4	-20.5	-24.9	-28.9	-33.5
<b>Debt: Supplementary target</b>							
Public sector net debt	1779	1810	1851	1841	1809	1856	1896

## Changes in public sector net borrowing

- 1.33 We expect borrowing in 2018-19 to be £11.6 billion lower than we forecast in March thanks to unexpected and broadly-based strength in tax receipts, combined with lower-than-expected public spending. This downward revision would have been ever greater were it not for a £1.1 billion within-year fiscal giveaway focused on public services spending.
- 1.34 As Chart 1.5 shows, on a pre-measures basis the budget deficit would have fallen steadily across the forecast and moved into surplus in 2023-24. Adding in the effect of the new settlement for the NHS – financed entirely through borrowing – would have left our forecast for the deficit a little lower than March in the near term and a little higher in the medium term. Factoring in the Chancellor’s further near-term giveaways and tiny medium-term takeaway has resulted in a path for the deficit that is slightly lower than March in all years bar 2022-23. The near-term giveaways mean the deficit is expected to rise year-on-year in 2019-20, before resuming a steady decline to somewhat less than 1 per cent of GDP.

Chart 1.5: Public sector net borrowing



Source: ONS, OBR

### Classification and methodological changes

1.35 Five sources of change to the public finances data since March have affected our forecast, although only two feed through to net borrowing from 2018-19 onwards. These would have reduced our March forecast by £1.1 billion a year on average from 2018-19 onwards. To facilitate comparisons on a like-for-like basis, we have restated our March PSNB forecast by:

- **Removing Scottish and Welsh housing associations' own-account borrowing** from the point at which their reclassification into the private sector took effect. This results in a £0.1 billion downward revision in 2018-19 – a part-year effect – and average reductions of £0.4 billion a year from 2019-20 onwards.
- **Incorporating an estimate for HMRC-levied fines and penalties**, which are not currently being recorded in the public finances. The ONS has identified around £0.7 billion a year of these. We have anticipated their effect in our latest receipts forecast.

### Underlying revisions to borrowing in 2018-19

1.36 Borrowing in 2017-18 is now estimated to have been £5.8 billion lower than our March forecast on a like-for-like basis. Borrowing in the first half of 2018-19 has also been substantially lower than would be consistent with our March forecast. Before factoring in the effect of Government decisions, we would have expected borrowing to fall from £39.8 billion in 2017-18 to £24.3 billion this year, an £11.9 billion like-for-like downward revision from March. That largely reflects two factors that both push the deficit lower:

- First, cash receipts from **the four largest tax streams** – PAYE income tax, NICs, onshore corporation tax and VAT receipts – have risen more strongly than expected this year.



This partly reflects stronger employment growth than we expected in March, although the unexplained residual strength may indicate stronger growth in nominal GDP than is currently being recorded in the National Accounts.

- Second, **central government spending** has risen less than expected over the first half of the year. Current spending by departments was weaker than expected at the end of 2017-18, which has persisted into the current year. Lower RPI inflation in the first half of 2018 has also helped to reduce spending on inflation-linked gilts.

1.37 As the Budget is taking place unusually early, we have only been able to factor in a little administrative data on central government receipts in October and no data at all on central government spending. October tends to be the fourth largest month in the year for HMRC cash receipts, and so this 'in-year' forecast is subject to greater uncertainty than usual.

### Underlying revisions to borrowing from 2019-20 onwards

1.38 From 2019-20 onwards, our underlying forecast revisions would have seen the deficit fall further and move into surplus in 2023-24. The downward revision in 2022-23 is £18.1 billion relative to our March forecast. This reflects the following factors:

- The largest source of improvement by 2022-23 (around £7 billion) reflects our judgement that **the strength in tax receipts in 2018-19** will persist over the forecast. In effect, this assumes that the rise in the tax-to-GDP ratio this year is structural, though as noted it may also be the case that nominal GDP is greater than currently recorded.
- Around £3 billion of the revision reflects our assumption that the **equilibrium rate of unemployment** is lower. This boosts the level of employment across the forecast, directly raising receipts from income tax and NICs and reducing spending on out-of-work welfare benefits and tax credits. The income from higher employment also boosts nominal consumption across the forecast, raising VAT receipts.
- A further £2 billion reflects lower **debt interest** payments. This largely reflects lower cumulative borrowing in our pre-measures forecast, due to stronger receipts.
- The remaining £6 billion reflects several **smaller factors**, including the boost to North Sea revenues from higher oil prices, as well as a reduction in the expected cost of future HMRC tax litigation payouts following a Supreme Court decision in the summer.

### Government decisions

1.39 The new multi-year settlement for the National Health Service raises the deficit substantially in every year. Further measures announced in the Budget raise borrowing in the near term but reduce it slightly in the medium term. Taken together they turn the £3.5 billion surplus in our pre-measures forecast for 2023-24 into a £19.8 billion deficit.

- 1.40 The overall discretionary fiscal giveaway rises from £10.9 billion in 2018-19 to £23.2 billion in 2023-24. The main components of the package are:
- The Prime Minister's June announcement of **a new multi-year settlement for the National Health Service** in England and its knock-on consequences for spending in Scotland, Wales and Northern Ireland (since health spending is fully devolved). This adds progressively larger amounts to public spending, rising from £7.4 billion in 2018-19 to £27.6 billion in 2023-24.
  - A smaller boost to **other current departmental spending (RDEL)** of £3.6 billion a year on average between 2020-21 and 2022-23.
  - A **near-term tax giveaway**, including an above-inflation rise in the income tax personal allowance and higher rate threshold and freezes to fuel and some alcohol duties.
  - A **welfare spending giveaway** that focuses on making universal credit more generous by increasing work allowances by £1,000 a year in 2019-20 and by several smaller changes that ease claimants' transition to universal credit and reduce losses to some.
- 1.41 Partly offsetting the giveaways, the Government has decided to cut departmental capital spending from 2020-21 onwards and has announced medium-term tax rises that include the extension of reforms to off-payroll working rules (IR35) to the private sector and reversal of the previous decision to abolish Class 2 NICs. It will also impose a new tax on specific revenues of large digital businesses.
- 1.42 The indirect effect of this significant easing in fiscal policy relative to our pre-measures baseline offsets part of its fiscal cost, reducing borrowing by around £4 billion a year on average from 2020-21 onwards. This reflects the cyclical boost to the economy, which pushes up tax receipts, and the additional public service pension contributions that will result from the higher public services spending, which reduce the net cost of public service pensions. These positive indirect effects are partly offset by the debt interest consequences of higher borrowing and higher state pensions spending due to the triple lock on its uprating.

Table 1.3: Changes to public sector net borrowing since March

	£ billion						
	Outturn	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
March forecast	45.2	37.1	33.9	28.7	26.0	21.4	
Classification changes	0.4	-0.8	-1.1	-1.1	-1.2	-1.2	
March forecast restated	45.6	36.2	32.9	27.6	24.8	20.2	
October forecast	39.8	25.5	31.8	26.7	23.8	20.8	19.8
<b>Like-for-like change</b>	<b>-5.8</b>	<b>-10.8</b>	<b>-1.1</b>	<b>-1.0</b>	<b>-1.0</b>	<b>0.6</b>	
<b>Underlying revisions to receipts</b>	<b>-0.4</b>	<b>-7.4</b>	<b>-8.0</b>	<b>-8.0</b>	<b>-11.2</b>	<b>-14.1</b>	
of which:							
In-year judgements	-0.4	-6.4	-6.5	-6.6	-6.8	-7.1	
Equilibrium level of unemployment	0.0	-2.4	-2.4	-2.5	-2.6	-2.7	
Other economy effects	0.0	1.4	0.2	-0.5	-1.9	-3.6	
Other modelling changes	0.0	0.0	0.7	1.6	0.1	-0.7	
<b>Underlying revisions to spending</b>	<b>-5.3</b>	<b>-4.5</b>	<b>-4.1</b>	<b>-3.7</b>	<b>-3.5</b>	<b>-4.1</b>	
of which:							
Equilibrium level of unemployment	0.0	-0.3	-0.6	-0.6	-0.6	-0.5	
Debt interest	0.8	-1.9	-0.3	-1.2	-1.7	-2.2	
Departmental spending changes	-3.5	-0.2	0.2	-1.3	0.6	0.6	
Other changes	-2.6	-2.0	-3.4	-0.7	-1.8	-1.9	
<b>Total effect of Government decisions</b>		<b>1.1</b>	<b>10.9</b>	<b>10.7</b>	<b>13.7</b>	<b>18.8</b>	<b>23.2</b>
of which:							
Impact of NHS settlement on TME		0.0	7.4	11.1	16.1	21.4	27.6
Other RDEL policy changes <sup>1,2</sup>		-0.2	-1.7	4.1	3.6	3.2	-2.2
CDEL policy changes <sup>1</sup>		1.0	-0.7	-3.6	-1.7	-2.9	-0.8
Receipts measures		0.1	4.0	0.2	-2.0	-0.7	0.3
AME measures <sup>2,3</sup>		0.3	3.7	1.9	1.7	2.2	2.5
Indirect effects		-0.1	-1.8	-3.0	-3.9	-4.4	-4.2
Memo: October pre-measures forecast	39.8	24.3	20.8	15.9	10.1	2.1	-3.5
Memo: Overall change since March	-5.4	-11.6	-2.1	-2.1	-2.2	-0.6	

<sup>1</sup> The change in 2023-24 is relative to a baseline that assumes DEL would otherwise have remained constant as a share of GDP.

<sup>2</sup> Excluding health spending changes. Also excluding the impacts from the decision to largely fund departments for the policy to increase employer pension contributions and the supported housing measure, where these changes have offsetting effects in AME.

<sup>3</sup> Incorporates the net effect of the pensions contributions measure on TME, where not all departmental costs have been covered.

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.

## Changes to public sector net debt

1.43 In March we expected PSND to peak at 85.6 per cent of GDP in 2017-18, before falling to 85.5 per cent of GDP in 2018-19. Thanks to modest upward revisions to nominal GDP and a smaller-than-expected deficit last year, it now appears that PSND peaked at 85.2 per cent of GDP in 2016-17 and fell slightly to 85.0 per cent in 2017-18. We now expect it to fall to 83.7 per cent of GDP in 2018-19. This partly reflects the reclassification of Scottish and Welsh housing associations to the private sector (which lowers debt by around 0.3 per cent of GDP from 2018-19 onwards), but also the downward revision to our PSNB forecast.

1.44 Our latest PSND forecast is lower in all years than we forecast in March and by 2.9 per cent of GDP in 2022-23. Classification changes explain 0.4 per cent of GDP of this.

1.45 Changes to our pre-measures forecast reduce debt. They arise from:

- The large downward revisions to our pre-measures forecast for **public sector net borrowing**, reflecting higher expected receipts and lower expected spending.
- Higher **nominal GDP** in all years (thanks to a lower sustainable rate of unemployment and higher participation). This reduces the debt-to-GDP ratio in all years.
- **Valuation changes**, which reduce debt in the near term. The fall in the pound since March has increased the sterling value of foreign exchange reserves, but from 2019-20 onwards this is increasingly offset by lower gilt premia.
- Downward revisions to our pre-measures **financial transactions** forecast.
- **Lower-than-expected outturn debt**, which reduces PSND in 2017-18 by £5 billion and is more than explained by PSNB being £6 billion lower than we forecast in March.

Table 1.4: Changes to public sector net debt since March

	Per cent of GDP					
	Outturn	Forecast				
		2017-18	2018-19	2019-20	2020-21	2021-22
March forecast	85.6	85.5	85.1	82.1	78.3	77.9
<i>Reclassification of Scottish and Welsh HAs</i>	0.0	-0.3	-0.3	-0.4	-0.4	-0.4
March forecast restated	85.6	85.2	84.8	81.7	77.9	77.5
October forecast	85.0	83.7	82.8	79.7	75.7	75.0
<b>Like-for-like change</b>	<b>-0.5</b>	<b>-1.5</b>	<b>-1.9</b>	<b>-2.1</b>	<b>-2.2</b>	<b>-2.5</b>
<i>of which:</i>						
Change in nominal GDP <sup>1</sup>	-0.3	-0.7	-0.9	-1.2	-1.2	-1.2
Change in cash level of net debt	-0.2	-0.9	-1.0	-0.9	-1.1	-1.2
	£ billion					
March forecast restated	1784	1829	1872	1860	1831	1882
October forecast	1779	1810	1851	1841	1809	1856
<b>Like-for-like change in cash debt</b>	<b>-5</b>	<b>-19</b>	<b>-21</b>	<b>-18</b>	<b>-22</b>	<b>-25</b>
<b>Underlying forecast revisions</b>	<b>-5</b>	<b>-21</b>	<b>-31</b>	<b>-41</b>	<b>-55</b>	<b>-70</b>
<i>of which:</i>						
Public sector net borrowing (pre-measures)	-6	-18	-30	-41	-56	-74
Financial transactions (pre-measures)	1	-2	-5	-6	-8	-9
Valuation changes	0	-2	4	7	9	13
<b>Effect of Government decisions</b>	<b>0</b>	<b>2</b>	<b>10</b>	<b>22</b>	<b>33</b>	<b>45</b>
<i>of which:</i>						
Affecting public sector net borrowing	0	1	14	28	45	68
Affecting financial transactions	0	1	-2	1	-1	-2
Indirect effects	0	0	-2	-6	-11	-22

<sup>1</sup> Non-seasonally adjusted GDP centred end-March.

1.46 These are partly offset by the net impact of Budget policy measures:

- The direct impact of the measures on **borrowing** increases debt by £68 billion by 2022-23, largely thanks to higher health spending.
- Measures leading to **financial transactions** reduce debt by £2 billion by 2022-23, largely due to selling more RBS shares and student loans.
- The **indirect effects** of the measures lower debt by £22 billion in 2022-23, mostly because of the boost to tax receipts from their impact on nominal GDP.

## Performance against the Government's fiscal targets

1.47 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of hitting its fiscal targets under current policy. It has been updated several times in recent years as governments have revised their fiscal targets. The latest version was approved by Parliament in January 2017.

1.48 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". At the time, this was expected to be the period from 2020 to 2025.

1.49 The *Charter* also sets out targets for borrowing, debt and welfare spending that require:

- The **structural deficit** (cyclically adjusted public sector net borrowing) to lie below 2 per cent of GDP by 2020-21 – this is the 'fiscal mandate'.
- **Public sector net debt** to fall as a percentage of GDP in 2020-21 – this is the 'supplementary target'.
- For welfare spending (excluding the state pension and payments closely linked to the economic cycle) to lie below a '**welfare cap**'. The latest version of the cap was initially set in November 2017, to apply in 2022-23. A non-binding pathway for spending was also specified in the years leading up to the cap year. The Government set the effective cap 3 per cent above our November 2017 forecast for 2022-23, with the expected level of spending to be adjusted for subsequent changes in our inflation forecast.

1.50 Our central forecast implies that all three targets are on course to be met:

- **Fiscal mandate:** the structural deficit falls to 1.3 per cent of GDP in the target year, giving a margin against the fiscal mandate of 0.7 per cent of GDP (£15.4 billion). These margins are precisely the same as in our March forecast, thanks to the Government's decision to use the improvement in our pre-measures forecast (which would have shown a larger margin of 1.1 per cent of GDP (£26.1 billion)) to pay for the Prime Minister's June health spending announcement plus a carefully fine-tuned package of near-term net giveaways in this Budget.

- **Supplementary target:** public sector net debt falls by 3.2 per cent of GDP in 2020-21, slightly more than in our March forecast. The repayment of loans issued under the Bank's Term Funding Scheme at the end of their four-year term contributes 2.3 per cent of GDP to the year-on-year fall.
- **Welfare cap:** the relevant welfare spending is forecast to be £2.0 billion below the cap in 2022-23, and £6.0 billion below the cap-plus-margin.

1.51 Achieving the broader balanced budget fiscal objective in 2025-26, looks challenging (although this lies beyond our formal forecasting horizon). In particular this is a period in which population ageing will continue to exert upward pressure on spending, and more so than in recent years when the State Pension age has been rising. Had there been no fiscal loosening in the Budget, the objective would have been achieved in 2023-24.

1.52 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 judgements 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 0.7 per cent of GDP margin relative to the 2 per cent structural deficit ceiling would fall to zero if potential output were 1.4 per cent lower, or if the effective tax rate were 0.7 per cent of GDP lower for structural reasons.
- Third, by looking at **alternative economic scenarios**. We have considered the implications of two alternative scenarios of rising trade tensions and global protectionism – a temporary trade skirmish scenario and a permanent return to protectionism scenario. Both see GDP growth slow, but the one with permanent tariffs hits potential output too, as firms hold cut investment and productivity growth slows. All three fiscal targets are met in both scenarios. But whereas a temporary trade skirmish leaves the public finances little changed over the longer run, a permanent return to protectionism would deliver a lasting blow to the public finances.