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From:	Mark Browman, Director General - International Finance, HM Treasury
date of receipt:	8 May 2014
To:	Carsten Pillath, Director General, DGG - Economic Affairs and Competitiveness, General Secretariat of the Council of the European Union
Subject:	UK Convergence Programme 2013-2014

Delegations will find attached the UK's Convergence Programme 2013-2014 - first part.

Encl.:

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30 April 2014

UK Convergence Programme 2013-2014

Dear Carsten

I am writing to provide you with the UK's Convergence Programme for this year (2013-2014).

This document sets out the UK's medium term fiscal plans and is drawn from the UK's Autumn Statement 2013, Budget 2014 and the independent Office for Budget Responsibility's economic and fiscal outlook.

The UK Government is committed to its medium-term fiscal consolidation plans which we believe remain key to ensuring sustainable economic recovery. Abandoning the Government's long-term economic plan and the path of fiscal credibility would represent the most significant risk to the recovery.

The Government remains committed to tackling the UK's Treaty deficit and bringing it below the 3% target set out in the Stability and Growth Pact. We have set out a credible plan to eliminate the deficit over the next four years. The UK's Budget 2014 set out the next steps in the Government's long term economic plan, which include further difficult decisions to reduce the deficit and debt, further action to help businesses invest and export, to reduce energy costs and to increase housing supply, and radical reforms to give people greater freedom over how they access their pension savings and to support savers at every stage of their lives.

Our Houses of Parliament have approved the Government's assessment of the UK's medium term economic and budgetary position, which forms the basis of the Convergence Programme.

I am writing in similar terms to Marco Buti, Director-General, Economic and Financial Affairs, and Catherine Day, Secretary-General of the European Commission. I am also copying this letter to Ivan Rogers, the UK's Permanent Representative to the EU.

Mark Bowman

Director General, International Finance

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submitted in line with the Stability and Growth pact

April 2014

HM Treasury

2013-14 Convergence Programme for the United Kingdom:

submitted in line with the Stability and Growth pact

April 2014

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Foreword

The UK economy continues to recover from the most damaging financial crisis in generations and the largest deficit since the Second World War. The government's long-term economic plan has protected the economy through a period of uncertainty, and provided the foundations for the UK's economic recovery which is now well established. Since the government produced the 2012-13 Convergence Programme in April last year, economic growth has exceeded forecasts, inflation is below target, and the deficit has been reduced year on year.

The UK's Budget 2014 set out the next steps in the government's long term economic plan, which include further difficult decisions to reduce the deficit and debt, further action to help businesses invest and export, to reduce energy costs and to increase housing supply, and radical reforms to give people greater freedom over how they access their pension savings and to support savers at every stage of their lives.

Medium-term fiscal consolidation remains key to ensuring a sustainable economic recovery. Abandoning the government's long-term economic plan and the path of fiscal credibility would represent the most significant risk to the recovery. The government has set out a credible plan to eliminate the deficit over the next four years, but further difficult decisions are required. High levels of public debt impose significant burdens now and in the future through higher interest rate payments, and increase the UK's vulnerability to future shocks. Given these costs and risks, once the UK's supplementary debt target has been met, any future government will need to ensure that debt falls as a percentage of GDP. The government's fiscal strategy is set out in more detail in Chapter 2.

Autumn Statement 2013 and Budget 2014 set out more detail on the government's deficit reduction plans and further measures to ease the long-term pressure on the public finances. As a result the UK government remains on course to meet its fiscal mandate one year early, in 2017-18. 'Underlying' public sector net borrowing as a percentage of GDP is forecast to have fallen by half from its 2009-10 peak by 2014-15, and the OBR forecasts a small surplus in 2018-19. The supplementary debt target is missed by one year, as forecast at Autumn Statement 2013. Public sector net debt is forecast to peak at 78.7% of GDP in 2015-16 – 1.2% lower than forecast at Autumn Statement 2013 – before falling each year and reaching 73.8% of GDP in 2018-19. The government remains committed to tackling the UK's Treaty deficit and bringing it below the 3% target set out in the Stability and Growth Pact. Further detail is set out in Chapters 2-4.

Alongside its fiscal consolidation plans, the government continues its ambitious programme of structural reform, which is creating the right environment for businesses to invest, export and grow. Budget 2014 announced further reforms to capital allowances, energy and housing to support investment and a sustained recovery across the UK. More detail on these reforms is set out in the UK's National Reform Programme, produced alongside the Convergence Programme.

The UK had the fastest growth of the G7 economies in the year to the fourth quarter of 2013 and an increase in private sector employment of over one and a half million since the first quarter of 2010. The government has continued to take the difficult decisions needed to secure a resilient recovery for all, build a fairer society and to help equip the UK to succeed in the global race.

1 Introduction

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

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

1.3 Major fiscal events since the last Convergence Programme have been Autumn Statement 2013 and Budget 2014. This Convergence Programme draws on those publications, particularly Budget 2014.

1.4 The forecasts for the economy and public finances included in the UK's Convergence Programme are prepared by the independent Office for Budget Responsibility (OBR), information on which is set out in Chapter 5. The forecasts set out in the Convergence Programme are from the OBR's March 2014 Economic and fiscal outlook, which was published alongside Budget 2014.

1.5 Under Section 5 of the European Communities (Amendment) Act 1993, Parliament is required to approve the Government's assessment of the UK's medium-term economic and budgetary position. This forms the basis of the UK's Convergence Programme. The UK presents copies of assessments of its Convergence Programme to Parliament. The UK Parliament's Commons European Scrutiny Committee held a debate on 17 June 2013 on Economic Governance: European Semester and Macroeconomic Imbalances. This covered the Council's draft Country Specific Recommendations and Opinion on the UK's National Reform Programme and Convergence Programme.

Structure of the Convergence Programme

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

1.7 Reflecting the establishment of the independent OBR, detail on their economic and fiscal forecasts is set out separately in Annex A of the Convergence Programme, drawing upon the OBR's March 2014 Economic and fiscal outlook and 2013 Fiscal sustainability report.

1.8 Annex B provides details of the financial impact of Autumn Statement 2013 and Budget 2014 policy decisions. Annex C provides supplementary data.

2 Overall policy framework and objectives

The UK economy and public finances

2.1 The UK has been hit by the most damaging financial crisis in generations and the government inherited the largest deficit since the Second World War. Through this period of uncertainty, the government's long-term economic plan ensured economic stability and provided the foundations for the UK's economic recovery. The plan is working. The UK had the fastest growth of the G7 economies in the year to the fourth quarter of 2013 and an increase in private sector employment of over one and a half million since the first quarter of 2010. The government has continued to take the difficult decisions needed to secure a resilient recovery for all, build a fairer society and to help equip the UK to succeed in the global race.

UK economy since 2010

2.2 After gaining momentum through 2013 the UK economic recovery is now well established. UK GDP grew 0.7% in the fourth quarter of 2013. UK inflation in January was below the 2% target for the first time since November 2009. The government's long-term economic plan has restored fiscal credibility, allowing activist monetary policy and the automatic fiscal stabilisers to support the economy. Measures such as the Funding for Lending Scheme (FLS) have helped ease credit conditions. This has been supported by far-reaching reform of the financial system and a comprehensive package of structural reforms.

2.3 UK annual GDP growth was 1.8% in 2013, exceeding the Office for Budget Responsibility's (OBR) Autumn Statement forecast of 1.4%, and significantly higher than GDP growth of 0.6% forecast at Budget 2013.[1] GDP growth in the year to the fourth quarter of 2013 was broad-based across the main sectors of the economy: the services sector grew by 2.7%, the production sector grew by 2.2% and the construction sector grew by 3.4%.[2] Reflecting increased momentum, the OBR's Budget 2014 forecast revises up GDP growth in 2014 to 2.7% and in 2015 to 2.3%.[3]

2.4 Recent UK growth has been strong compared to other advanced economies. In the fourth quarter of 2013 the UK experienced the fastest growth of the G7 economies, joint with Canada.[4] In the International Monetary Fund's (IMF) latest 'World Economic Outlook Update', GDP growth forecasts for the UK were revised up by more than any other G7 economy in both 2014 and 2015.[5]

[1] All UK economy data from the Office for National Statistics (ONS) unless otherwise stated.
[2] Service sector growth, 'Second estimate of GDP', ONS, February 2014; Construction sector growth, 'Construction output', ONS, March 2014; Production sector growth, 'Index of production', ONS, March 2014.
[3] 'Economic and fiscal outlook', OBR, March 2014.
[4] 'Quarterly National Accounts: Quarterly Growth Rates of Real GDP, change over previous quarter', Organisation for Economic Co-operation and Development (OECD), March 2014.
[5] 'World Economic Outlook Update', IMF, January 2014.

2.5 The UK saw a net increase of over 1.6 million jobs in the private sector between the first quarter of 2010 and the third quarter of 2013.[6] Around 4 jobs have been created in the private sector for every public sector job lost. Over the same period all nations and regions of the UK saw an increase in employment. And Scotland has the highest employment rate of all the nations in the UK.

2.6 In the last year, employment in the UK has grown faster than in France, Germany, Italy, Japan and the averages for the EU and G7 countries.[7] Employment at the end of 2013 has surpassed 30 million and the employment rate in the UK is higher than in the US for the first time since 1978.[8] The UK unemployment rate was 7.2% in the 3 months to December 2013, the lowest rate for nearly 5 years.

2.7 The effect of the financial crisis, high global commodity prices and euro area economic uncertainty were the main causes of lower than expected economic growth, especially in 2011 and 2012. The OBR's October 2013 'Forecast evaluation report' confirms their previous conclusion that fiscal policy "does not look the most obvious explanation for the bulk of the shortfall" in growth compared to their 2010 forecast.[9] Supporting this judgement, analysis by the Organisation for Economic Co-operation and Development (OECD) shows that the effect of the euro area crisis "has been a more important source of [forecast] error" than fiscal consolidation.[10] Furthermore, if Greece is excluded from the analysis, the OECD states that there does not appear to be any identifiable impact from fiscal consolidation on forecast errors.

Earnings and incomes

2.8 Only a sustained economic recovery, with growing productivity, will deliver a lasting improvement in living standards. Living standards have been directly affected by the financial crisis, as recognised by external commentators including the Institute for Fiscal Studies.[11] Against this, a resilient labour market and falling inflation have eased pressures on households' budgets.

2.9 Autumn Statement 2013 analysis made clear there has not been a break in the long-run relationship between productivity and total compensation, which takes into account both earnings and employer social contributions. Increases in productivity should therefore feed through into higher earnings growth; the Bank of England's February 'Inflation Report' reiterated this link.[12]

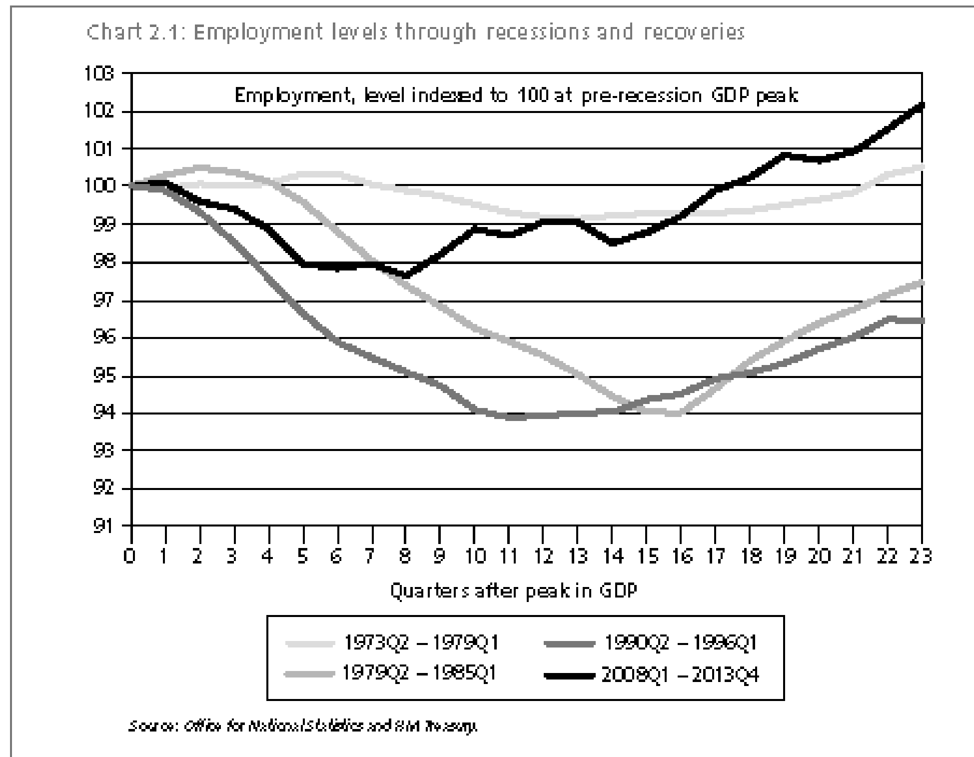
2.10 The OBR forecasts "productivity growth to pick up" to 2.2% in 2015 from 1.2% in 2014. Reflecting this, the OBR forecasts average earnings growth to increase to 3.2% in 2015 from 2.5% in 2014 and to rise more rapidly than inflation throughout the forecast period.

2.11 Earnings alone do not provide a complete picture of living standards, since they do not take into account other sources of income or the effect of tax and benefits. Taking tax policy into account, including the government's rise in the personal allowance, between April 2012 and April 2013 take-home pay increased faster than inflation on average across the earnings distribution, except for the top 10%.[13] Real household disposable income takes tax and benefits into account. The OBR forecasts growth in real household disposable income per capita to turn positive this year, growing at 0.5% in 2014 and 1.2% in 2015.

[6] 'Labour Market Statistics', ONS, February 2014. The net increase in private sector jobs between February to April 2010 and August to October 2013, excludes the impact of the reclassification from May to July 2012 of 196,000 employees in some educational bodies from the public to the private sector.
[7] 'Short-Term Labour Market Statistics: Employed Population', 2012 Q3 to 2013 Q3, OECD, March 2014.
[8] 'Databases, Tables & Calculators by Subject', 16 plus employment rate, Bureau of Labor Statistics, March 2014.
[9] 'Forecast evaluation report', OBR, October 2013.
[10] 'OECD Forecasts During and After the Financial Crisis: A Post Mortem', OECD, February 2014.
[11] Paul Johnson, Institute for Fiscal Studies, "There have been very significant falls in real earnings as a direct but delayed result of the 2008 recession, essentially." Treasury Select Committee experts hearing, December 2013.
[12] 'Inflation Report', Bank of England, February 2014.
[13] 'BIS analysis of changes in earnings net of income tax and NICs 2012-2013', Department for Business, Innovation and Skills, February 2014.

2.12 An individual's living standards are best supported by being in employment. The UK labour market has proved more resilient than expected since the start of the financial crisis, with employment performing strongly compared to previous recessions and recoveries, as set out in Chart 1.1. Employment returned to its pre-crisis level faster than in any other previous recovery over the last 40 years. Since early 2010, the pace of net employment creation has been 3 times as fast as over the same period in previous recessions and recoveries, with over 1 million more people in work.

Chart 2.1: Employment levels through recessions and recoveries



Source: Office for National Statistics and HM Treasury.

2.13 Relatively strong performance in employment has implications for movements in average wages. Looking only at jobs in which the employee has been in post for at least 1 year removes the influence of the changes in composition of the labour market.[14] Of all full-time employees, around two-thirds have stayed in the same job continuously for over a year.[15]

[14] 'Annual Survey of Hours and Earnings', ONS, December 2013 (provisional results).
[15] 'Annual Survey of Hours and Earnings' data, ONS, December 2012 and December 2013 (provisional results) and HM Treasury.

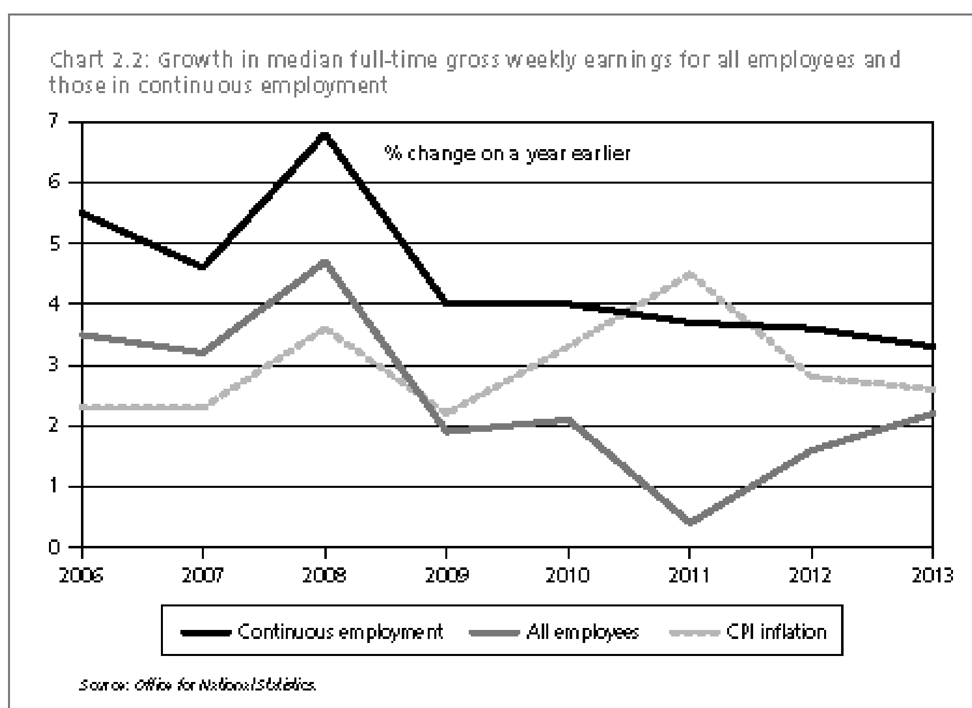


Chart 2.2: Growth in median full-time gross weekly earnings for all employees and those in continuous employment

Source: Office for National Statistics.

2.14 Chart 1.2 shows the difference in median earnings growth between all full-time employees and those who have stayed in continuous employment. As the chart shows, those who have been continuously employed for at least 1 year are typically experiencing faster earnings growth than the overall average. They have also typically seen their wages grow faster than inflation, with the exception of 2011 when the UK experienced commodity price driven inflation. Changes within the labour force, such as new entrants, can lower average wage growth across the whole economy. In practice however, in most cases where individuals are entering the workforce, they will benefit from an increase in income overall. The growth rate of average earnings therefore does not fully reflect the earnings growth seen by many individuals.

UK rebalancing, investment and trade

2.15 During the pre-crisis period weaknesses developed in the UK economy including low levels of investment and geographical imbalances. The manufacturing sector fell from 19% of the economy in 1997 to 11% in 2008. Over the same period the services sector grew from 69% of the economy to 77%. While total investment remained stable at roughly 17% of the economy the UK performed poorly compared to international peers. In the UK, the investment share of the economy was the lowest of all the G7 economies in every year since 1999. In 1998, imports exceeded exports for the first time since 1992, and have continued to do so.

2.16 Between 1997 and 2008, London's economy grew by 95% in nominal terms, much faster than any other nation or region of the UK. As a consequence, the percentage of the UK economy accounted for by London rose from 19% in 1997 to 22% in 2008. As the recovery has become established, growth has been balanced across all main sectors in the year to the fourth quarter of 2013. This Budget sets out further action to help businesses to invest and export, and to ensure that growth is balanced across all sectors and throughout the UK.

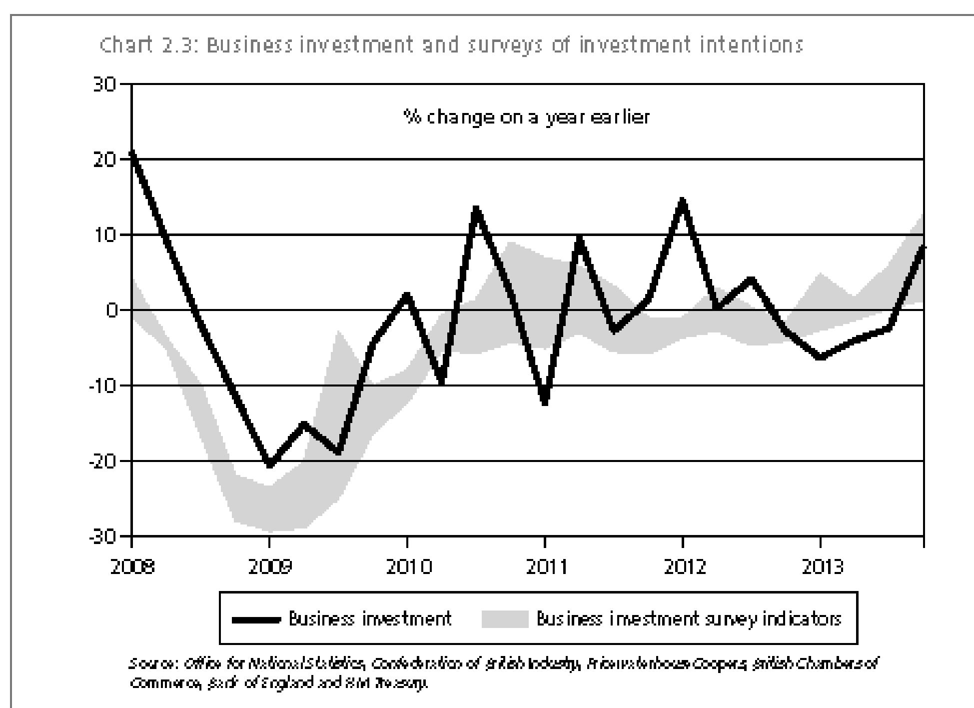
2.17 Recent activity has seen expansion across all sectors of the economy. According to the Confederation of British Industry (CBI), business optimism in the services sector is the highest

it has been since the survey began in 1998.[16] Business surveys suggest strong expansion in the construction sector with 10 consecutive months of growth.[17] Residential housing sector surveys have been especially strong and are considerably higher than the long-run average.

2.18 As the UK economy stabilises, uncertainty recedes and credit conditions ease, the investment environment will continue to improve. Business surveys have indicated improving conditions since the end of 2012 and for much of 2013 suggested positive business investment growth. Business investment strengthened during 2013 with growth of 8.5% in the year to the fourth quarter.

2.19 The OBR expects investment activity to gather pace this year. Its Budget 2014 forecast revises up annual business investment growth to 8.0% in 2014 and 9.2% in 2015.

Chart 2.3: Business investment and surveys of investment intentions



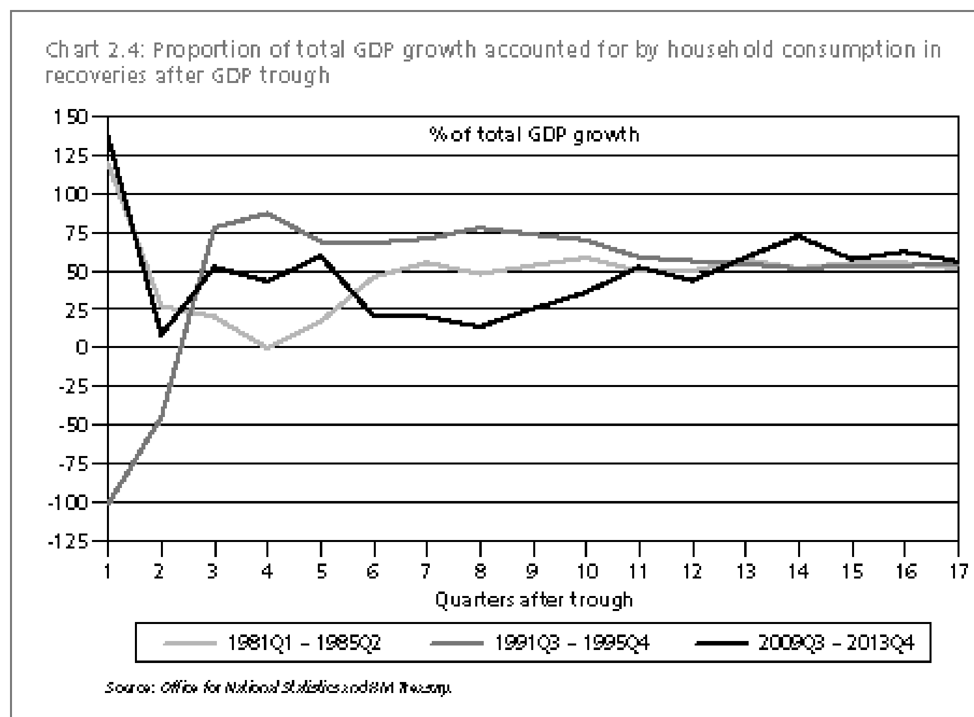
Source: Office for National Statistics, Confederation of British Industry, PricewaterhouseCoopers, British Chambers of Commerce, Bank of England and HM Treasury.

2.20 Net trade contributed 0.4 percentage points to GDP growth in the fourth quarter of 2013. But it was volatile through the year contributing 0.1 percentage points to GDP growth over the year as a whole. Goods exports to other EU countries have been subdued, but should pick up as confidence and growth in the euro area improves. At the same time, UK exporters have continued to expand in other markets, with goods exports to countries outside the EU rising 23% since 2010. Business surveys suggest exports may have risen further over the most recent period and January saw the fastest growth in export orders in nearly 3 years.[18]

2.21 Household consumption accounts for around two-thirds of UK GDP. In the immediate aftermath of the financial crisis household consumption was constrained by the need to pay down debt. This weighed on growth. As confidence has returned and the pace of household deleveraging has eased, consumption has increased and helped drive growth. This is consistent with historical precedent. Chart 1.4 shows that consumption made a contribution to GDP

[16] 'Service Sector Survey', CBI, February 2014.
[17] 'Markit/CIPS UK construction PMI', Markit, February 2014.
[18] 'Markit/CIPS UK manufacturing PMI', Markit, January 2014.

growth in the last 2 recoveries similar to that in the current recovery. In recent quarters the contribution of consumption to growth has been smaller than the consumption share of GDP.



2.22 Having fallen as low as ¼% in the first quarter of 2008, the saving ratio peaked at 8½% in the second quarter of 2009. It has since declined to around 5½% in the third quarter of 2013. Falls in the rate of saving are to be expected in periods where confidence is increasing. But the total stock of savings continues to increase and the total stock of financial assets rose 31% between the second quarter of 2009 and the third quarter of 2013. Total household debt as a percentage of disposable income has fallen over 30 percentage points since its pre-crisis peak. Unsecured debt as a percentage of disposable income has fallen 13 percentage points since its pre-crisis peak and is below its long-run average.[19]

Global developments and risks

2.23 Abandoning the government's long-term economic plan and the path of fiscal credibility would represent the most significant risk to the recovery. In addition, the UK faces a number of external risks. The nature of these risks is evolving. Autumn Statement 2013 highlighted an easing of some tail risks, particularly in the euro area, but with some political and economic risks remaining with regard to US fiscal policy and emerging markets. In the intervening period, global growth has picked up, led by advanced economies. US fiscal risks have diminished further, but risks in some emerging markets have increased, and the situation in Ukraine in particular represents a significant new risk.

2.24 In the US, which accounted for 17% of UK goods and services exports in 2012, fiscal uncertainties have eased. A bipartisan deal on expenditures through 2014 and 2015 was

[19]Total household debt as a percentage of household disposable income has fallen from a pre-crisis peak of 170% in the first quarter of 2008 to 138% in the third quarter of 2013. Unsecured household debt as a percentage of household disposable income has fallen from a pre-crisis peak of 42% in the first quarter of 2007 to 28% in the third quarter of 2013.

agreed in December, and legislation to raise the debt ceiling was passed by Congress in January. Stronger and relatively broad-based growth has been established and the unemployment rate continues to decline. As a result the Federal Reserve decided to slow its rate of asset purchases in December. Recent economy data has been mixed but it has been adversely affected by severe weather.

2.25 The euro area accounted for 40% of UK goods and services exports in 2012. Economic rebalancing in the periphery economies has been considerable. But while growth has returned, it is weak and unemployment remains high. Structural reforms will be necessary for individual countries to improve growth, employment and the competitiveness of the euro area. The UK is leading the argument for completion of the EU single market.

2.26 Emerging markets are a key focus of ongoing UK efforts to increase exports and rebalance the economy. Of these the BRIC economies (Brazil, Russia, India and China) taken together accounted for 7% of UK goods and services exports in 2012. China is undertaking substantial economic reform to rebalance its economy from investment and exports towards slower, consumption-driven growth, which would also increase their imports of goods and services the UK produces. Managing this transition and moving to a more moderate rate of credit growth while maintaining financial stability is a significant challenge but one upon which the Chinese authorities are acting.

2.27 The situation in some other emerging markets remains a concern as growth is below trend in many cases. But many emerging markets are more robust to shocks than in the mid 1990s. Tighter global financial conditions have contributed to capital outflows and currency depreciations since last summer. The underlying causes of vulnerability are domestic fragilities in many countries, which have built up over a long period of time and which require countries to undertake significant reforms. The reform challenge that has led Ukraine to seek international financial assistance is an example of such risk. In common with other emerging markets, the economic priority is for Ukraine, backed by external support, to undertake the reforms that will generate economic stability and prosperity for its citizens.

2.28 The broader geopolitical risks prompted by Russia's actions in Crimea and the potential impact of any disruption to energy markets are more serious. Any further deterioration in the situation is likely to have some impact on the UK, but the exact nature of any impact will depend on future political developments and in particular how persistent they are. As the Prime Minister said in the House of Commons on 10 March 2014: "…sanctions would have consequences for many EU member states, including Britain, but… the costs of not standing up to aggression are far greater."

Scotland in the UK

2.29 In September 2014, a referendum will ask the people in Scotland whether they want to stay in the UK, or leave and become a separate state.

2.30 Scotland has performed strongly because it is part of the UK. After gaining momentum in 2013, the recovery in the Scottish economy is now well established. And growth is better balanced, with all sectors of the economy contributing to growth in the most recent quarters. Like the rest of the UK, the Scottish labour market has also performed strongly, with employment growing by over 90,000 in the year to the fourth quarter of 2013.[20]

[20] 'Regional labour market statistics', ONS, February 2014. Annual increase in total employment to the fourth quarter of 2013.

2.31 Being part of a larger economy allows Scotland to pool resources and risks, and shields it from volatility. This provides Scotland with stable and secure funding to face major challenges, most notably from:

- fluctuating and declining North Sea tax revenues – in the last year alone, the OBR has revised down oil and gas revenues by £8 billion over the next 5 years. Since Budget 2010 the OBR has revised down these tax revenues over the 5 years to 2015-16 by £21 billion. Instead of needing to cut spending, the Scottish government has benefited from an additional £2.2 billion during the same period.
- a more rapidly ageing population than the UK, and a proportionately smaller working age population, which will increase pressures on Scottish health and welfare spending

2.32 Driven primarily by these 2 factors, a number of independent bodies have forecast that the fiscal positions of the UK and Scotland will diverge over time, with Scotland's notional fiscal position being worse than the UK as a whole.[21]

2.33 Earlier this year, the Treasury published 'Scotland analysis: Assessment of a sterling currency union' which concluded that it would not be in the economic interests of the UK or Scotland to enter a currency union.[22] This analysis has been supported by external commentators such as the National Institute of Economic and Social Research. A currency union would expose the UK to unacceptable risks, and an independent Scotland would have severe limitations on its sovereignty and the prospect of much more costly adjustment to economic shocks, both of which have been seen in the euro area. All 3 major UK political parties have ruled out sharing the pound as part of a currency union in the event of a vote for independence. Budget 2014 confirms the UK government's decision.

2.34 Regardless of the choice of currency, significant, long-lasting costs would come from dividing the UK market. Scottish businesses trade more with the rest of the UK than with the rest of the world combined. The separation of tax, regulation and welfare systems, and the emergence of a 'border effect', would make it harder for goods, capital and workers to move between Scotland and the continuing UK.

2.35 As part of the UK, Scottish individuals, businesses and sectors benefit from the support of the UK government. This is demonstrated by Budget 2014 which announces:

- a freeze on duties on spirits, which will support the Scotch whisky industry, one of Scotland's global success stories
- oil and gas measures to support further investment, exploration and the supply chain, which will support Scottish jobs
- an additional increase in the personal allowance to £10,500 in 2015-16; 2.3 million people in Scotland have benefited from this government's increases to the personal allowance, with 263,000 people lifted out of income tax altogether

[21] 'The next five years look better, but tough choices remain for Scotland', Institute for Fiscal Studies (IFS), 2014. 'UK – Scottish Independence: Will It Happen? What Would Be the Implications?', Citigroup, 2014. 'CPPR Briefing Paper: Analysis of Scotland's past and future fiscal position', Centre for Public Policy for Regions (CPPR), 2013.
[22] 'Scotland analysis: Assessment of a sterling currency union', HM Treasury, 2014.

Summary of economic forecast

Table 2.1: Summary of the OBR's central economic forecast[1]

	Percentage change on a year earlier, unless otherwise stated						
			Forecast				
	2012	2013	2014	2015	2016	2017	2018
GDP growth	0.3	1.8	2.7	2.3	2.6	2.6	2.5
Main components of GDP							
Household consumption[2]	1.5	2.3	2.1	1.8	2.5	2.7	2.4
General government consumption	1.6	0.9	1.2	-0.5	-1.2	-1.8	-0.9
Fixed investment	0.7	-0.5	8.6	8.2	7.8	7.9	6.8
Business	3.9	-1.2	8.0	9.2	8.1	8.7	7.7
General government[3]	0.6	-6.4	10.7	1.0	2.2	0.8	-0.5
Private dwellings[3]	-3.5	4.3	9.0	10.0	10.0	9.5	8.1
Change in inventories[4]	-0.2	0.3	0.1	0.0	0.0	0.0	0.0
Net trade[4]	-0.7	0.1	-0.2	0.1	0.0	0.0	-0.1
CPI inflation	2.8	2.6	1.9	2.0	2.0	2.0	2.0
Employment (millions)	29.5	29.9	30.4	30.6	30.9	31.2	31.4

[1] All figures in this table are rounded to the nearest decimal place. This is not intended to convey a degree of unwarranted accuracy. Components may not sum to total due to rounding and statistical discrepancy.
[2] Includes households and non-profit institutions serving households.
[3] Includes transfer costs of non-produced assets.
[4] Contribution to GDP growth, percentage points.
Source: Office for Budget Responsibility.

2.36 Reflecting increased momentum during 2013, the OBR has revised up its forecasts for UK GDP growth in 2014 from 2.4% to 2.7% and in 2015 from 2.2% to 2.3%. The OBR forecasts GDP growth of 2.6% in 2016, 2.6% in 2017 and 2.5% in 2018. The OBR forecasts that GDP will return to its pre-crisis peak in the third quarter of 2014.

2.37 The claimant count fell by 327,600 in the year to January 2014, the largest annual fall since March 1998. At the start of 2014, the claimant count was 1.2 million, the lowest level since December 2008. The claimant count is forecast to continue falling, dropping below 1 million for the first time since 2008 by the middle of 2017.

2.38 The OBR has revised down its forecast for unemployment in all years, and expects a rate of 6.8% in 2014, falling to 5.4% in 2018. It has revised up its forecast for employment, and expects it to rise by 1 million over the forecast period from 30.4 million in 2014 to 31.4 million in 2018. Youth unemployment is falling, including for those who are long-term unemployed. Youth unemployment fell 48,000 in the fourth quarter of 2013 and 58,000 in the year. Long-term youth unemployment fell 25,000 in the fourth quarter of 2013 and 20,000 in the year.

2.39 The output gap, which represents the amount of spare capacity in the economy, is expected to be smaller across the forecast period than in the Autumn Statement forecast. With faster growth in GDP, unemployment falling more quickly and slack in the labour market now reducing, the OBR now expects the output gap to close in the second quarter of 2018, around a year earlier than forecast at Autumn Statement 2013. As the economy approaches full capacity, GDP growth returns to around its potential growth rate, and this narrowing of the output gap means that the upward revision to GDP growth is largely cyclical rather than structural.

2.40 The Chief Secretary to the Treasury said in March 2014: "There is now just one remaining major ingredient that needs to be added to make this recovery sustainable, and based on the rising productivity necessary for rising living standards. Business investment."[23] The OBR has

[23] 'Memo to the City: It's time to invest', City AM, RT Hon Danny Alexander MP, 4 March 2014.

revised up its business investment growth forecast in 2014 from 5.1% to 8.0% and expects it to rise further in 2015 with growth of 9.2%. The OBR's 'Economic and fiscal outlook' assumes that the temporary increase in the Annual Investment Allowance announced in Budget 2014 "leads to a total of just under £1 billion of business investment being brought forward from 2016 and 2017 into 2014 and 2015."[24] The OBR also expects private dwellings investment to grow strongly at 9.0% in 2014, 10.0% in 2015 and 10.0% in 2016. The OBR expects exports growth of 2.6% in 2014, rising to 4.7% in 2015 and 5.0% in 2016. The OBR expects this to be broadly offset by imports growth with net trade expected to make a negligible contribution to GDP growth through the forecast period.

2.41 The OBR expects CPI inflation to be below target in 2014 at 1.9% and then stay at the 2.0% target for the rest of the forecast period. The OBR forecasts average earnings to grow 2.5% in 2014. It expects average earnings to grow faster than inflation through the forecast period, rising to 3.8% in 2018. The OBR also expects growth in real household disposable income to rise through the forecast period, from 1.2% in 2014 to 2.2% in 2018.

The government's plan

2.42 The government's long-term economic plan builds a stronger, more competitive economy, a fairer society, and secures a better future for Britain by:

- reducing the deficit to deal with the UK's debts, safeguard the UK economy for the long term and keep mortgage rates low
- cutting income taxes and freezing fuel duty to help hardworking people be more financially secure
- creating more jobs by backing small business and enterprise with better infrastructure and lower job taxes
- capping welfare and controlling immigration so the UK economy delivers for people who want to work hard and play by the rules
- delivering the best schools, skills and apprenticeships for young people so the next generation can succeed in the global race

2.43 In order to safeguard the economy for the long term, the government is continuing to take decisive action through: monetary activism and credit easing, deficit reduction, reform of the financial system, and a comprehensive package of structural reforms.

Monetary activism

Monetary policy

2.44 Monetary policy has a critical role to play in supporting the economy as the government delivers on its commitment for necessary fiscal consolidation. The government has ensured that monetary policy can continue to play that role fully by updating the UK's monetary policy framework at Budget 2013. The Monetary Policy Committee (MPC) of the Bank of England has full operational independence to set policy to meet the inflation target. In this Budget, the government reaffirms the inflation target of 2% for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times. The government also confirms that the Asset Purchase Facility (APF) will remain in place for the financial year 2014–15.

2.45 In August 2013, the MPC announced its decision to deploy forward guidance to help to secure the nascent recovery. On 12 February 2014, the MPC outlined the next phase of guidance, setting out the factors that will guide its decisions and how Bank Rate is likely to

[24] 'Economic and fiscal outlook', OBR, March 2014.

evolve as the economy continues to recover. The MPC judged that there remained scope to absorb spare capacity further before raising Bank Rate, and that when Bank Rate does increase, the appropriate path is expected to be gradual. The actual path of interest rates over the next few years will depend on economic developments. Survey evidence, reported in the Bank of England's February 2014 'Inflation Report', suggested that forward guidance is working. The majority of businesses indicated that the Bank of England's forward guidance had made them more confident about the near term prospects for the UK economy, in many cases encouraging them to hire and invest.[25]

Credit easing

2.46 The FLS has been successful in meeting its objective to provide incentives for banks and building societies to boost their lending to the UK economy. Overall net lending by banks and building societies participating in the FLS was £10.3 billion between its launch and the end of 2013.[26] Following the refocusing of the scheme announced by the Treasury and the Bank of England in November 2013, 34 participants have signed up, of which 28 will receive Initial Allowances totalling £32.7 billion. Of this Initial Allowance, £17 billion reflects 10 times the positive net lending to small and medium-sized enterprises (SME) since the start of the second quarter of 2013.

2.47 Against this backdrop, credit conditions are improving for SMEs. According to the Bank of England's 'Credit Conditions Survey 2013 Q4,' the net balance of lenders reporting increased credit availability for small businesses was the second highest since the question was first asked in the fourth quarter of 2009 and gross lending to SMEs was 13% higher in 2013 than in 2012.[27]

Deficit reduction

Fiscal strategy

2.48 The government inherited the largest deficit in post-war history due to the financial crisis of 2008 and 2009 and unsustainable pre-crisis increases in public spending.[28] The historically high level of borrowing risked undermining fairness, growth and economic stability in the UK. In 2010 the government set out clear, credible and specific medium-term fiscal consolidation plans to return the public finances to a sustainable path. The government's fiscal strategy has restored fiscal credibility, allowing activist monetary policy and the automatic stabilisers to support the economy and ensure the burden is shared fairly across society.

2.49 The government is making significant progress in reversing the unprecedented rise in borrowing between 2007-08 and 2009-10. The OBR's preferred measure of 'underlying' public sector net borrowing has fallen by a third as a percentage of GDP since 2009-10 and is forecast to have fallen by a half as a percentage of GDP by 2014-15.[29] Public sector net borrowing is forecast to reach a small surplus in 2018-19. The government's consolidation plans, as set out in Table 2.2, have been central to the reduction in the deficit, with £64 billion of the £80 billion spending reductions over Spending Review 2010 already implemented. The government is continuing to take action to improve financial management and spending control. Departments remain ahead of their consolidation targets and are again forecast to underspend by £7 billion in 2013-14. Underspends are forecast to continue to the end of this Parliament.

2.50 The OBR now expects the 'underlying' deficit to be £24 billion lower over the forecast period than predicted at Autumn Statement 2013. In the OBR's view, this reflects

[25] 'Inflation Report', Bank of England, February 2014
[26] 'New Release – Bank of England and HM Treasury Funding for Lending Scheme – 2013Q4 Usage and Lending Data and Initial Allowance data for the Scheme Extension', Bank of England, March 2014.
[27] 'Credit Conditions Survey 2013 Q4', Bank of England, January 2014; Bank of England, March 2014.
[28] 'Three Centuries of data on the UK economy', Bank of England; 'Public Sector Finances', ONS, February 2014.
[29] 'Public Sector Finances', ONS, February 2014; 'Economic and Fiscal Outlook', OBR, March 2014. Public sector net borrowing fell from 11% of GDP in 2009-10 to 7.3% in 2012-13 and is forecast to fall to 5.5% in 2014-15.

the improvement in the economic outlook since Autumn Statement 2013 rather than an improvement in the economy's growth potential. As a result, there is little change since the Autumn Statement to the structural deficit, which reflects the fiscal position taking account of the effects of the economic cycle. The persistence of this structural challenge supports the government's argument that economic growth alone cannot be relied upon to eliminate a structural deficit.

2.51 Public sector net debt is forecast to peak at 78.7% of GDP in 2015-16, 1.2% lower than at Autumn Statement 2013, but an increase of around 40% of GDP since 2007-08.[30] The UK therefore continues to face a long-term challenge in reducing debt to sustainable levels.

2.52 Reflecting the government's commitment to responsible fiscal policy, and despite the improved borrowing forecast by the OBR, Budget 2014 sets out a fiscally neutral response with the improvement in the fiscal forecast helping to return the public finances to a sustainable position.

Table 2.2: Total consolidation plans over this Parliament

	£ billion			
	2012-13	2013-14	2014-15	2015-16
Policy inherited by the government	41	56	70	
Spending[1,2]	25	37	49	
Tax[2]	17	18	21	
Spending share of consolidation (%)	*59*	*67*	*69*	
Total discretionary consolidation	78	90	104	126
Spending[1,2,3]	56	64	80	101
Tax[2,3]	22	25	23	25
Spending share of consolidation (%)	*72*	*72*	*78*	*80*

[1] Spending consolidation is attributable to 3 factors: (a) reductions in DEL are calculated by assessing nominal DEL totals against a counterfactual of growing DEL from 2010–11 in line with general inflation in the economy, as set out in Table 4.8 of the OBR's pre-Budget forecast (June 2010); (b) reductions in AME due to the net effect of policy changes announced since the June Budget 2010; and (c) estimated debt interest savings, updated for market interest rates consistent with the OBR's March 2014 Economic and fiscal outlook. This calculation excludes the one-off impact of the 4G spectrum asset sale and financial transactions in CDEL.
[2] This takes account of the latest costings.
[3] Where costings do not go out to 2015-16, they have been grown in line with general inflation in the economy.
Source: Office for Budget Responsibility and HM Treasury.

Fiscal forecast

2.53 Consistent with the OBR's definition of 'underlying' public sector net borrowing, the deficit forecasts in this Budget are presented excluding the effect of the transfer of assets from the Royal Mail Pension Plan to the public sector and excluding the effects of the transfers to and from the Asset Purchase Facility (APF).

2.54 From its post-war peak of 11% of GDP in 2009-10, public sector net borrowing is forecast to:[31]

- be 4.2% of GDP in 2015-16, the end of this Parliament
- be in a small surplus by 0.2% of GDP in 2018-19

2.55 Public sector net debt is forecast to:

- be 1.2% of GDP lower in 2015-16 than forecast at Autumn Statement 2013
- peak at 78.7% of GDP in 2015-16, before falling each year and reaching 74.2% of GDP in 2018-19

[30] 'Public Sector Finances', ONS, February 2014; 'Economic and Fiscal Outlook', OBR, March 2014.
[31] 'Public Sector Finances', ONS, February 2014.

Table 2.3: Overview of the OBR's central fiscal forecast

	% GDP, unless otherwise stated							
	Outturn		Forecast					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Fiscal mandate								
Cyclically-adjusted surplus on current budget	-3.8	-3.5	-2.8	-2.2	-1.5	-0.2	0.7	1.5
Deficit excluding Royal Mail Pension Plan transfer and APF cash transfers (OBR's 'underlying' deficit)[1]								
Public sector net borrowing	7.6	7.3	6.6	5.5	4.2	2.4	0.8	-0.2
Public sector net borrowing (£bn)	117.4	114.8	107.8	95.5	75.2	44.5	16.5	-4.8
Cyclically-adjusted net borrowing	5.6	5.3	5.0	4.5	3.4	1.9	0.6	-0.3
Surplus on current budget	-5.7	-5.9	-5.1	-3.9	-2.7	-0.9	0.5	1.5
Primary balance	-4.8	-4.7	-4.0	-2.9	-1.4	0.5	2.1	3.2
Cyclically-adjusted primary balance	-2.8	-2.8	-2.5	-1.9	-0.6	1.0	2.3	3.2
Deficit excluding Royal Mail Pension Plan transfer								
Public sector net borrowing	7.6	6.9	5.8	4.9	3.8	2.2	0.9	-0.1
Public sector net borrowing (£bn)	117.4	108.4	95.6	83.9	68.3	41.5	17.8	-1.1
Deficit including Royal Mail Pension Plan transfer								
Public sector net borrowing	7.6	5.1	5.8	4.9	3.8	2.2	0.9	-0.1
Public sector net borrowing (£bn)	117.4	80.3	95.6	83.9	68.3	41.5	17.8	-1.1
Treaty deficit[2]	7.6	5.2	6.0	5.0	4.0	2.4	1.1	0.1
Cyclically-adjusted Treaty deficit	5.6	3.2	4.4	4.0	3.2	1.8	0.9	0.1
Debt								
Public sector net debt[3]	70.9	74.2	74.5	77.3	78.7	78.3	76.5	74.2
Treaty debt[4]	84.9	88.3	89.6	91.8	93.1	91.9	89.4	86.6
Output gap	-2.9	-2.8	-2.0	-1.3	-1.0	-0.6	-0.2	0.0
Memo: total policy decisions[5]			*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

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

[1] OBR's underlying public sector net borrowing excludes the transfers associated with the Royal Mail Pension Plan in 2012-13 and ongoing between the Exchequer and the Bank of England's Asset Purchase Facility.

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

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

ESA10 and ONS Review of Public Sector Finance Statistics

2.56 The Office for National Statistics (ONS) has published 2 articles highlighting significant revisions to public sector net borrowing and public sector net debt that will take place in September 2014.[32] These revisions result from the introduction of the European System of Accounts 2010 (ESA10), an update of Statistical Guidance that applies across all EU member states, and the implementation of changes from the 2013 ONS review of Public Sector Finance Statistics and will apply from 1997-98 or earlier.

2.57 The OBR has provided further details of the effects of the forthcoming changes on the forecast in Annex B of its March 2014 'Economic and fiscal outlook'. These changes are summarised in Table 2.4. As noted by the OBR, "these are changes to the way the public sector's finances are measured, not to the underlying activities being measured."[33]

[32] 'Transition to ESA10: Update to Impact on Public Sector Finances', ONS, February 2014 and '2013 Review of Public Sector Finance Statistics: Consultation Response', ONS, February 2014.
[33] 'Economic and fiscal outlook', OBR, March 2014.

2.58 The most significant change from the implementation of ESA10 is the classification of Network Rail, which from September 2014 will be reclassified to central government with effect from 2004-05. As set out in Autumn Statement 2013, the decision on the classification of Network Rail will not change the industry structure or affect the day-to-day operations of the rail network. The implementation of ESA10 also changes the way in which the receipts from the sale of 3G and 4G Licences are recorded. These are now considered to be rental payments received over the period of the licence rather than as one-off capital receipts recorded at the point of the sales in 2000-01 and 2012-13 respectively.

2.59 As part of its review of Public Sector Finances, the ONS has reviewed the treatment of the APF and the Special Liquidity Scheme in the fiscal aggregates (which revise them back to 2008-09). These are now treated as part of the public sector in the same way as all the other parts of the Bank of England. The OBR notes that they will also continue to look at a measure of net borrowing that is broadly comparable to their current 'underlying' measure of public sector net borrowing.[34] The ONS's review also changes the treatment of the government's holding of shares in Royal Bank of Scotland (RBS) and Lloyds, which are now treated in the same way as other government shareholdings rather than as a liquid asset which reduces public sector net debt.

Table 2.4: Impact of ESA10 and PSF Review changes on deficit and debt[1]

	Implied Outturn	Implied forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Deficit (£ billion)							
Public sector net borrowing (current)[2]	108.4	95.6	83.9	68.3	41.5	17.8	-1.1
Public sector net borrowing (ESA10), *of which:*	120.1	98.3	86.6	68.7	41.6	16.1	-4.8
Network Rail borrowing	*2.8*	*2.8*	*3.7*	*4.0*	*3.7*	*3.6*	*2.3*
Financial sector interventions	*-3.5*	*-0.2*	*-0.9*	*-3.5*	*-3.5*	*-5.2*	*-5.7*
Public sector net borrowing (ESA10) ex RMPP and APF, *of which:*	123.5	110.6	99.1	79.1	48.1	19.9	-2.9
APF	*9.9*	*12.4*	*12.5*	*10.4*	*6.4*	*3.9*	*2.0*
Debt (% GDP)[3]							
Public sector net debt (current)	74.2	74.5	77.3	78.7	78.3	76.5	74.2
Public sector net debt ex banks (ESA10), *of which:*	78.3	79.4	82.0	83.1	82.3	80.1	77.3
Network Rail debt	*1.8*	*1.9*	*2.0*	*2.1*	*2.2*	*2.3*	*2.3*
Financial sector interventions	*5.0*	*5.7*	*5.5*	*5.1*	*4.6*	*4.1*	*3.5*
Treaty debt (current)[4]	88.3	89.6	91.8	93.1	91.9	89.4	86.6
Treaty debt (ESA10)[5]	86.9	88.3	90.5	91.9	90.9	88.6	85.8

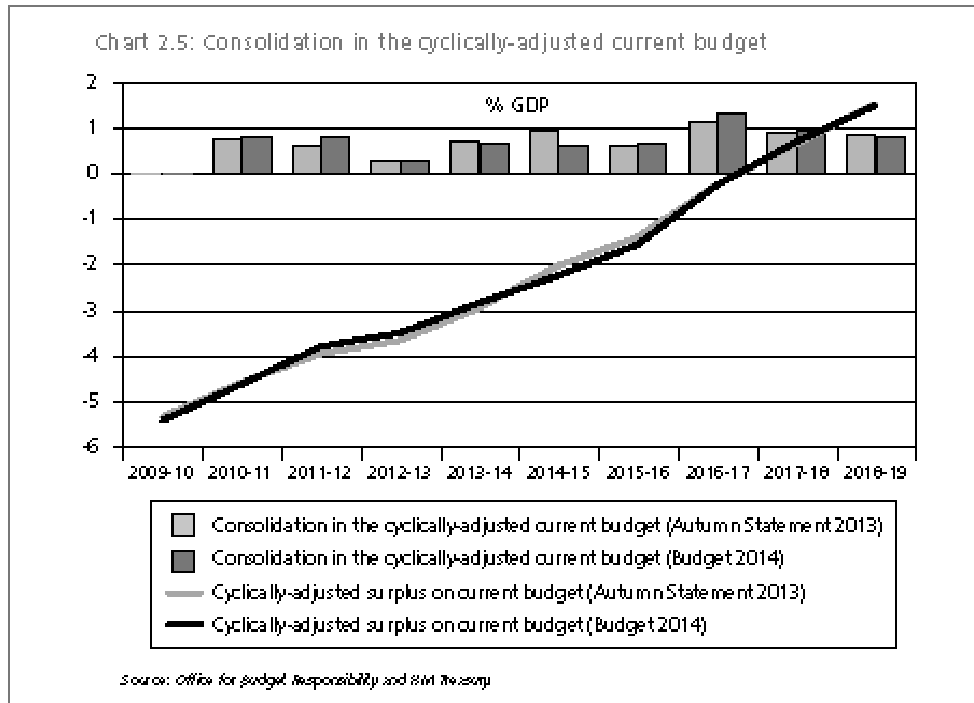
[1] Revisions apply back to 1997-98 or earlier.
[2] Excluding the transfers associated with the Royal Mail Pension Plan in 2012-13.
[3] Debt at end March; GDP centred on end March (adjusted ESA10 nominal GDP by mid-point of ONS's 2.5% to 5% range).
[4] General government gross debt on a Maastricht basis.
[5] The different treatment of financial sector interventions under ESA10 does not affect Treaty debt.
Source: Office for National Statistics and Office for Budget Responsibility.

[34] The OBR notes that such a measure would continue to exclude the one-off impact of the transfer of the assets and liabilities of the Royal Mail Pension Plan in 2012-13 (a £10 billion increase to public sector net borrowing under ESA10) and also, in effect, to remove the impact on the cost of debt interest each year of the stock of gilt assets in the APF related to quantitative easing.

Performance against the fiscal mandate

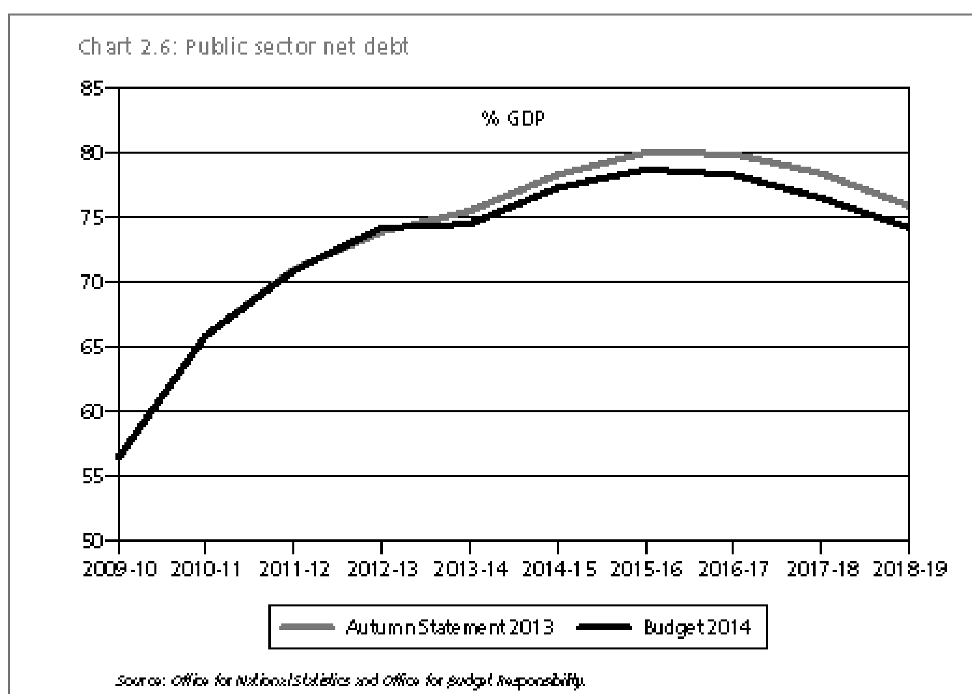
2.60 As announced at June Budget 2010, the government's fiscal strategy is underpinned by a forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, 5-year forecast period.

2.61 Including all measures set out in this Budget, the OBR's March 2014 'Economic and fiscal outlook' shows that the government remains on course to meet the fiscal mandate. The OBR's judgement is that the government's policies are consistent with a roughly 75% chance of achieving the fiscal mandate in 2018-19. The OBR's forecast is for the fiscal mandate to be achieved a year early, in 2017-18. Chart 1.5 shows performance against the government's fiscal mandate.



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

2.63 The OBR has forecast that public sector net debt as a percentage of GDP will be falling in 2016-17, a year later than set out in the supplementary target for debt. Chart 1.6 shows the forecast for public sector net debt as a percentage of GDP.



Performance against EU targets

2.64 The government remains committed to bringing the UK's Treaty deficit in line with the 3% target set out in the EU Stability and Growth Pact (SGP). The UK is forecast to meet the EU SGP target for the Treaty deficit in 2016-17.

Spending consolidation over the longer term

2.65 In line with previous policy, Budget 2014 confirms that the fiscal assumption, expressed in terms of Total Managed Expenditure (TME), will continue to fall in 2016-17 and 2017-18 at the same rate as over this Parliament. As set out in Autumn Statement 2013, the fiscal assumption expressed as TME will be held flat in real terms in 2018-19.

2.66 The TME growth rate is now calculated on a consistent basis, comparing the 2010-11 plans inherited by this government to 2015-16 plans. By 2018-19 this is equivalent to a £4.5 billion reduction in TME. At the same time ONS and OBR revisions to GDP deflators have the effect of increasing TME in 2018-19. The net effect is that the baseline, pre-measures, level of TME, from which further Budget 2014 savings are subtracted, is broadly in line with the Autumn Statement 2013 forecast.

2.67 Budget 2014 reaffirms the government's continued willingness to take tough decisions to get the public finances onto a sustainable footing and announces that TME will be reduced by around a further £2 billion each year from 2016-17 to take account of:

- permanent reductions to spending as a result of Autumn Statement measures to reduce spending in 2015-16
- action to ensure that employers are meeting the cost of public service pension schemes, which will result in a permanent reduction to Annually Managed Expenditure (AME) of £725 million in 2015-16, rising to around £1 billion a year from 2016-17 onwards

Efficiency and reform

2.68 Over the course of this Parliament, the government has taken significant action to reduce costs by increasing the efficiency of the public sector. Meeting future fiscal assumptions will require further consolidation over the next Parliament. In this context it becomes even more important that the government gets the most out of each pound of taxpayers' money. This Budget sets out further action to prepare for future challenges.

2.69 This government has introduced a programme to drive efficiencies and reduce wasteful expenditure. By 2014-15, departments working with HM Treasury and the Efficiency and Reform Group in the Cabinet Office will be saving £20 billion a year compared to 2009-10. Spending Round 2013 identified over £5 billion additional efficiency savings in 2015-16. Further efficiency savings will be required to support the government's commitment to put the public finances on a sustainable path. The Chief Secretary to the Treasury has asked the Minister for the Cabinet Office to set out an ambitious new efficiency programme to deliver savings from 2016-17 and across the next Parliament, in time for Autumn Statement 2014.

2.70 On 13 March 2014, the government confirmed that in 2014-15 pay awards for most public sector workers covered by the recent Pay Review Body recommendations will be limited to 1%.

2.71 The government has exercised firm restraint over public sector pay. By 2014-15 pay restraint will have reduced spending pressures by an estimated £12 billion. In the civil service, the government is making good progress towards removing progression pay by 2015-16. Proposals have now been agreed with departments covering over 50% of the civil service workforce previously identified with progression pay.

2.72 The next government will need to continue to reform and take tough decisions on public sector pay and workforce beyond 2015-16. Autumn Statement 2013 announced that the government will pilot pay bill control in a number of government organisations from 2014-15. This is a new method of pay restraint where the overall pay budget is controlled for the organisation, rather than average pay awards. The organisations participating in the pay bill control pilot will be the Intellectual Property Office and the Department for Environment, Food and Rural Affairs (DEFRA).

2.73 The government has taken action to free up land for productive economic use. The Government Property Unit's Strategic Land and Property Review has now concluded and identified scope to generate £5 billion of receipts from land and property to support growth and drive efficiency. A significant amount of this will be brownfield land. Departments have already committed to reforms which will release £3.5 billion of land and property. A further £1.5 billion will be identified through ongoing operational reviews. By Autumn Statement 2014 the government will look to quantify its housing and growth ambitions for this new surplus land programme.

2.74 Budget 2014 announces the Government Property Unit will increase its work with local areas on better use of public sector assets, linking in with Growth Deals and building on the Strategic Land and Property Review. As with the One Public Estate pilots already taking place, this work will focus on opportunities for cross public sector working, efficiency and growth.

2.75 The government has supported local areas to radically reform public services, including through the Troubled Families Programme and Budget 2014 announces an acceleration of this programme, expanding early to start working with up to 40,000 additional families in 2014-15. The government is looking now to further reduce the waste and complexity of public services, whilst protecting outcomes for individuals. This could include reshaping public services to better support the unemployed into work, vulnerable children and

young people, people experiencing mental health problems, and in the criminal justice system, while continuing to bear down on costs for the taxpayer. The government is launching a seminar series led by HM Treasury which will engage with key stakeholders to consider opportunities for further reform, and to develop ideas to support further fiscal consolidation in the next Parliament.

Welfare cap

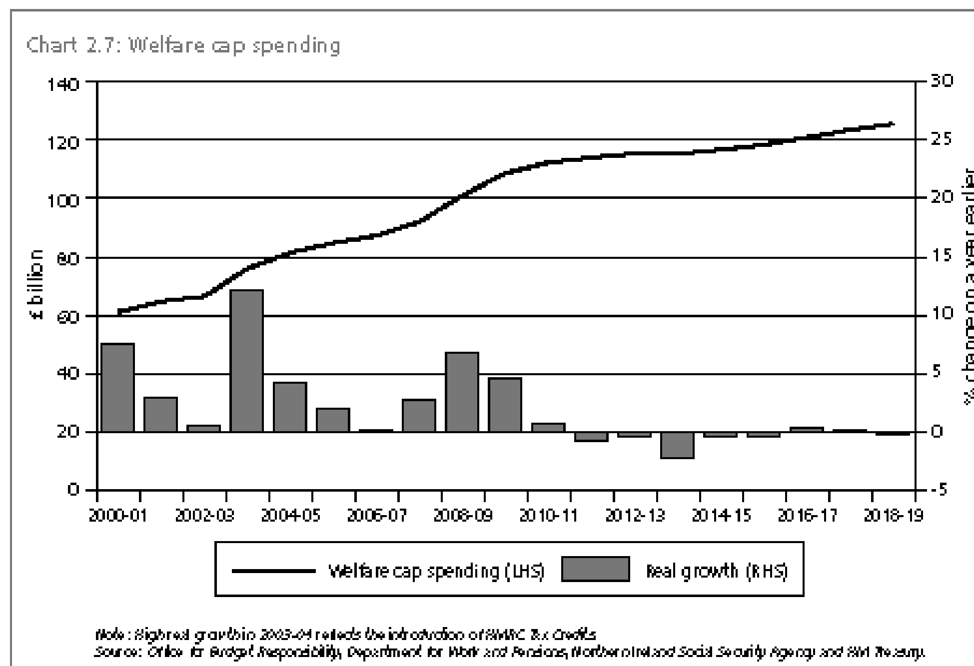
2.76 The government announced at Spending Round 2013 that a cap on welfare spending will be introduced to improve spending control. Budget 2014 caps welfare spending in scope for the years 2015-16 to 2018-19 at the level of the OBR's forecast, as published in the OBR's March 2014 'Economic and fiscal outlook'. The level of the welfare cap is set out in Table 2.5 and Chart 1.7. This will ensure that significant increases in spending do not go uncorrected. A forecast margin of 2% above this level will ensure that policy action is not triggered by small fluctuations in the forecast, but will not allow for discretionary policy action which breaches the level of the cap.

Table 2.5: The level of the welfare cap and the forecast margin

	£ billion			
	2015-16	2016-17	2017-18	2018-19
Welfare cap	119.5	122.0	124.6	126.7
Forecast margin (2%)	2.4	2.4	2.5	2.5

Source: Office for Budget Responsibility and HM Treasury.

Chart 2.7: Welfare cap spending



Note: High real growth in 2003-04 reflects the introduction of HMRC Tax Credits.
Source: Office for Budget Responsibility, Department for Work and Pensions, Northern Ireland Social Security Agency and HM Treasury.

2.77 The welfare cap will be included in the 'Charter for Budget Responsibility' alongside the fiscal mandate. An updated 'Charter for Budget Responsibility' and motion for approval was laid before Parliament on 19 March 2014. The OBR will make its first assessment of performance at Autumn Statement 2014.

2.78 As set out at Autumn Statement 2013, the cap will apply to all welfare spending in AME, with the exception of the state pension and the automatic stabilisers. In future, any new lines of spending that fall within the OBR's social security or personal tax credits forecasts and impact upon Public Sector Current Expenditure (PSCE) will be presumed to be included within the cap. A full list of expenditure items within the scope of the welfare cap is published at Annex A. The list of benefits in scope will be published at every Budget. As set out in the modified 'Charter for Budget Responsibility' laid before the House of Commons, any subsequent changes to that list must be voted on.

Longer term debt challenge

2.79 Action taken by this government has reduced the 'underlying' deficit by a third and public sector net borrowing will reach a small surplus by 2018-19. However, the record deficit inherited by the government means that public sector net debt will have risen by around 40% of GDP to a forecast peak of 78.7% of GDP in 2015-16, and will be 74.2% of GDP in 2018-19 – or over £50,000 per household.[35] This is the highest level of debt since the end of the 1960s.[36]

2.80 As set out in Annex B, high levels of debt impose significant burdens now and in the future through higher interest payments, reducing resources available to support public services. The government's consolidation plans over this Parliament are estimated to result in debt interest savings of around £10 billion per year by 2015-16.[37] Nevertheless, in 2015-16, interest payments are forecast to be £59 billion – more than the budget of the Department for Education as set out in Table 2.4. Reducing debt in future will help control these costs. For every 10% of GDP that debt was lower, debt interest payments would be reduced by £8 billion a year.[38]

2.81 High public debt also increases the UK's vulnerability to future shocks. Starting from a higher level of debt, it is more likely that a new shock will increase debt to levels the markets would view as potentially unsustainable – increasing uncertainty, pushing up interest rates, and potentially threatening economic stability. The government's fiscal strategy has allowed the automatic stabilisers to operate, supporting the economy.

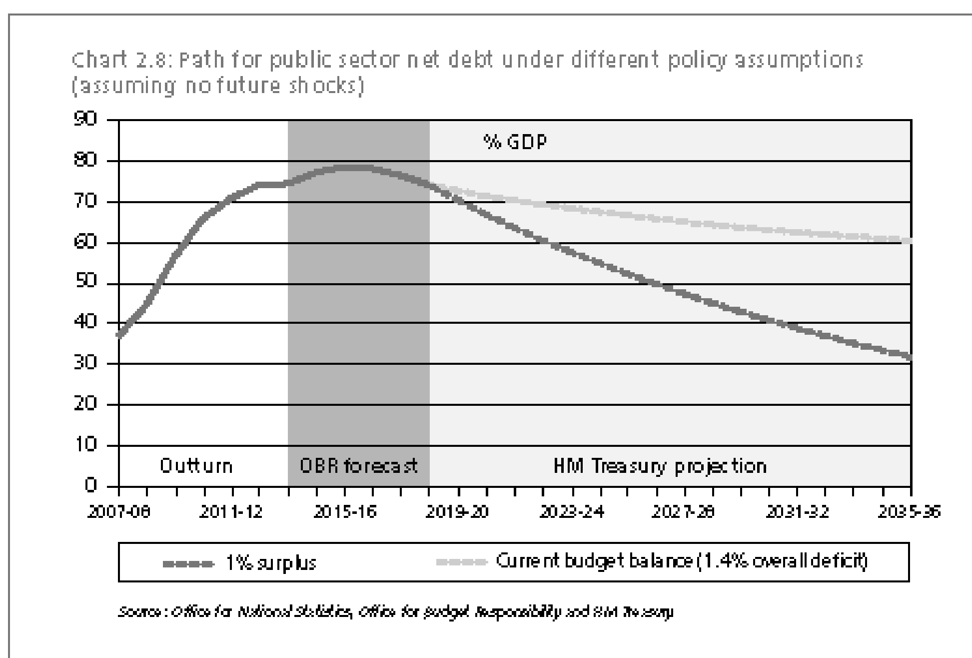
2.82 While longer life expectancies are to be welcomed, funding pensions and healthcare for an ageing population will create significant cost pressures for the UK as in other countries. Alongside reforms to the State Pension Age, prudent fiscal policy to bring debt down from its current high levels will help prepare the UK to deal with these pressures.

2.83 Given these costs and risks, once the supplementary debt target has been met, any future government will need to ensure that debt continues to fall as a percentage of GDP. As illustrated by Chart 1.8, even in the absence of future shocks, sustained action will be needed to bring down debt.

2.84 Although the timing and nature are inherently uncertain, the UK economy will be hit by shocks in the future. Prudent fiscal policy design should take account of this.

2.85 Over the period since 1955, the UK has had 7 recessions.[39] As set out in Annex B, the size of past recessions and their impact on public sector borrowing have varied over time. The consequences of borrowing for public debt have also varied over time. For example, the recessions of the 1970s and early 1980s increased borrowing, with deficits averaging 5.3% of

[35] 'Economic and Fiscal Outlook', OBR, March 2014; 'Public Sector Finances', ONS, February 2014; debt per household based on DCLG projections for the number of households in the UK in 2018.
[36] 'Three Centuries of data on the UK economy', Bank of England; 'Public Sector Finances', ONS, February 2014.
[37] Table 2.2 sets out the government's consolidation plans over this Parliament. These figures include the estimated debt interest savings at 2015-16 borrowing costs, resulting from the tax rises, reductions to departmental expenditure and measures to reduce AME spending that will take place over this Parliament, but not changes to financial transactions.
[38] HM Treasury calculation, consistent with the ready-reckoner published by the OBR in 2012, based on 2018-19 GDP and borrowing costs forecasts.
[39] 'Quarterly National Accounts, Q3 2013 Dataset', ONS, December 2013.



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

GDP between 1974-75 and 1980-81.[40] However, very high inflation eroded the value of the debt stock by so much that, despite high borrowing, debt as a percentage of GDP declined over this period.[41] Public sector net borrowing was similar in the period following the (milder) 1990s recession, but lower inflation meant that these deficits resulted in a substantial increase in debt – with public sector net debt peaking in 1996-97 at around 15% of GDP above pre-recession levels.[42] With independent monetary policy delivering low and stable medium-term inflation, to the benefit of the whole economy, future shocks to the public finances are also likely to occur in low inflation environments.

2.86 The scale and timing of future shocks are inherently unpredictable, so any analysis of potential future shocks can only be illustrative. Chart 1.9 shows how the level of debt in 2035-36 would be affected by a simple scenario in which, rather than there being no shocks, the economy is hit once every 8 years by a shock that increases public sector net debt by 10% (less than the peak increase following the 1990s recession).[43] This should not be treated as a prediction. However increases in debt of this magnitude are consistent with the experience of economic downturns on public borrowing. With a permanent 1.4% deficit, equivalent to a balanced current budget with investment equal to its 2018-19 forecast level, under this illustrative scenario by 2035-36 debt only falls by around 2% of GDP from its 2015-16 peak. With a 1% surplus under the same scenario, by 2035-36 debt falls by around 30% of GDP from its peak. Of course, larger or more frequent shocks in future would result in higher levels of public debt and vice versa.

[40] 'Public Sector Finances', ONS, February 2014.
[41] 'Public Sector Finances', ONS, February 2014.
[42] 'Public Sector Finances', ONS, February 2014.
[43] 'Quarterly National Accounts, Q3 2013 Dataset', ONS, December 2013. The approximate average frequency of UK recessions since the 1950s – though past recessions have not been evenly spaced.

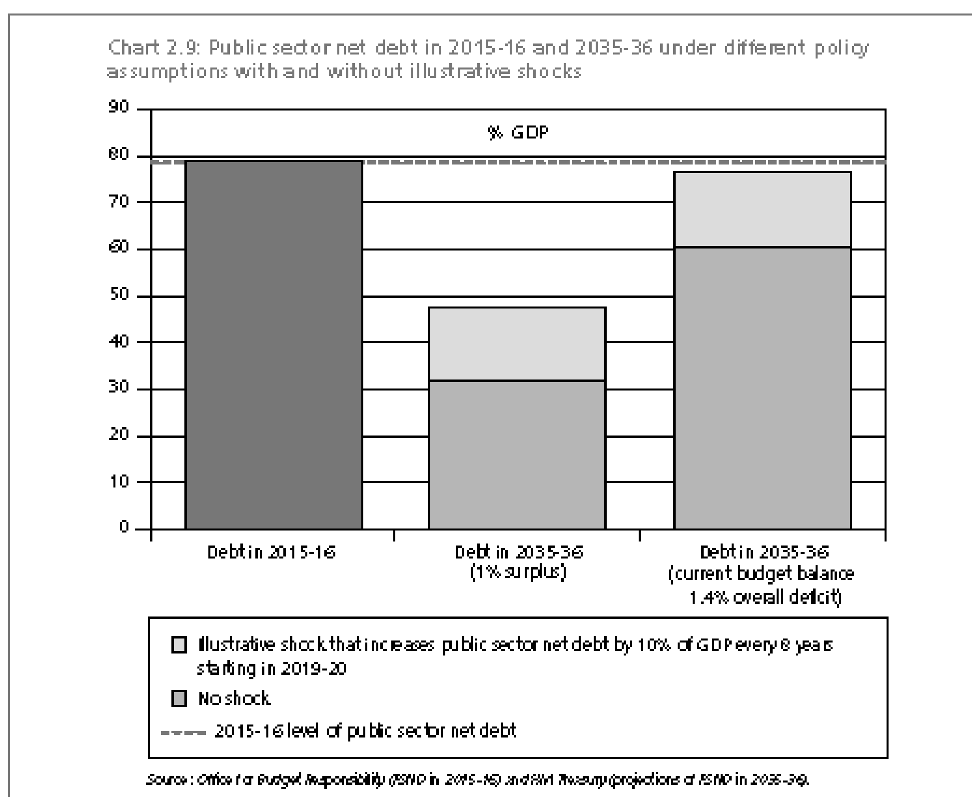


Chart 2.9: Public sector net debt in 2015-16 and 2035-36 under different policy assumptions with and without illustrative shocks

Reviewing the UK's fiscal policy framework

2.87 As announced at Autumn Statement 2013, the government is reviewing the current fiscal policy framework. The outcome of the review will inform an updated 'Charter for Budget Responsibility' which will be presented to Parliament alongside Autumn Statement 2014.

Debt Management

2.88 The government's financing plans for 2014-15 are summarised in Annex C. They are set out in full in the 'Debt and reserves management report 2014-15,' published alongside the Budget. It is anticipated that the net financing requirement of £144.9 billion will be met through gilt issuance of £128.4 billion and an increase of £16.5 billion in the stock of Treasury bills.

2.89 National Savings and Investments (NS&I) will have a net financing target of £13.0 billion in 2014-15, within a range of £11.0 to £15.0 billion. This will allow NS&I to support savers by launching in January 2015 a choice of fixed-rate market leading savings bonds for people aged 65 or over, taxed in line with other savings income. For the purposes of costing this measure, the central assumption made at this Budget is that NS&I will launch a 1-year bond paying 2.8% gross/annual equivalent rate (AER) and a 3-year bond paying 4.0% gross/AER, with an investment limit of £10,000 per bond. Precise details will be confirmed at Autumn Statement 2014, to take account of prevailing market conditions at that time. NS&I will also raise the Premium Bond limit from £30,000 to £40,000 from 1 June 2014, and increase the number of £1 million prizes from August 2014. An increase in the Premium Bond limit to £50,000 in 2015-16 will be factored into NS&I's 2015-16 remit, which will be set at Budget 2015.

2.90 The financing arithmetic provides for £6 billion of sterling financing for the Official Reserves in 2014-15. This additional financing, announced at Budget 2011, is intended to meet potential calls on the Official Reserves that may arise and ensure that the level of foreign

currency reserves held is sufficient. The government will consider any additional financing needs beyond 2014-15 as required.

£1 coin

2.91 The current £1 coin has been in circulation for 30 years, longer than the normal life cycle of a modern British coin. Its technology is no longer suitable for a coin of its value, leaving it vulnerable to counterfeiting. The Royal Mint estimates that about 3% of all £1 coins in circulation are now forgeries. In some parts of the UK, this number is as high as 6%.[44]

2.92 Budget 2014 announces that the government will introduce a new and highly secure £1 coin. The government expects the new coin to be bi-metallic with 12 sides, and to adopt new Royal Mint technology to protect against counterfeiting. A public consultation will be held over the summer focusing on how to manage any impacts to industry. A final decision on the precise specification of the new coin, including the metal composition, will be taken following the consultation.

2.93 Following the public consultation, the government will launch a public competition to decide the design on the reverse or 'tails' of the new coin.

Reform of the financial system

2.94 The government has introduced the biggest reforms to the banking sector in a generation to make banks more resilient to shocks, easier to fix when they get into difficulties, and to reduce the severity of future financial crises.

2.95 The Financial Services (Banking Reform) Act 2013 received Royal Assent on 18 December 2013, bringing into law structural and cultural changes to the banking system. The Act is at the forefront of efforts to ensure that no bank is 'too big to fail', by ring-fencing banking services for households and small businesses from investment banking activities, and introducing powers for the Bank of England to bail-in shareholders and creditors of a bank in the event of failure, recapitalising the bank and allowing restructuring measures to be implemented that address the cause of the failure. Following the recommendations of the Parliamentary Commission on Banking Standards, the Act also introduces a tougher new regime to regulate conduct in the banking industry, as well as introducing a criminal sanction for reckless misconduct in the management of a bank.

2.96 The government launched a consultation on 13 March 2014 on implementation of the bail-in powers, including drafts of the secondary legislation that will be made in order to complete the legislation and commence the powers.[45]

2.97 The government has overhauled the previous tripartite system of financial regulation through the Financial Services Act 2012, which gained Royal Assent in December 2012. The Act gives the Bank of England responsibility for macro-prudential regulation, through a new Financial Policy Committee (FPC). The Prudential Regulation Authority (PRA), a new micro-prudential regulator, has been established as a subsidiary of the Bank and is responsible for ensuring the effective prudential regulation of deposit takers, insurers and large investment firms. The new independent conduct of business regulator, the Financial Conduct Authority (FCA), is responsible for ensuring that the markets it regulates function well and in a way that supports its consumer protection, market integrity and competition statutory objectives.

2.98 The FPC is responsible for identifying, monitoring and tackling risks to the financial system as a whole, and therefore has a central role to play in safeguarding UK financial stability. The Chancellor of the Exchequer today (19 March, 2014) has provided the FPC with its Remit and recommendations for the year ahead, as required by the Bank of England Act 1998 (as amended by the Financial Services Act 2012).[46]

[44] Royal Mint Counterfeiting Survey as at November 2013.
[45] 'Open consultation: Bail-in powers implementation', HM Treasury, March 2014.
[46] 'Remit and recommendations for the Financial Policy Committee', HM Treasury, March 2014.

Growth

2.99 The changing global economy is creating new opportunities for British businesses, but there is more work to do to take full advantage of this. This Budget helps Britain go further, and announces structural reforms to support businesses in key stages of their development – helping them to invest in their future, to export and to grow. Budget 2014 contains a radical package to support the manufacturing sector by sharply reducing the cost of energy, and takes further action to boost the supply of housing. This will secure long-term economic prosperity and ensure that growth is balanced across all sectors and throughout the UK.

2.100 Since 2010, this government has worked systematically to address barriers to growth, unlock business investment and support the UK's competitiveness. These reforms are achieving results. Corporation tax will fall to 21% in April 2014 before reaching 20% in April 2015 – the joint lowest rate in the G20. The introduction of the £2,000 Employment Allowance in April 2014 will also support businesses to grow and create jobs, lifting 450,000 employers out of employer National Insurance Contributions (NICs) altogether. Figure 1.1 sets out the impact of this government's key supply-side reforms.

Unlocking business investment

2.101 Business investment is critical to improving productivity and long-run economic growth. This government is committed to supporting all UK businesses to invest in their future.

2.102 To continue to support business investment, the government is doubling the annual investment allowance (AIA) to £500,000 from April 2014 until the end of 2015. This will particularly benefit small and medium sized firms. The increased AIA will mean that up to 4.9 million firms – 99.8% of businesses – will receive 100% up-front relief on their qualifying investment in plant and machinery. Three-quarters of the companies that will benefit from this increased tax relief on investment are outside London and the South East, and it will particularly help the agriculture and manufacturing sectors.[47]

2.103 To further support innovative start ups and early stage companies to invest in research and development, the government will raise the rate of the R&D tax credit payable to loss making small and medium sized companies from 11% to 14.5% from April 2014. Over the next 5 years this increase will support £1.3 billion of investment in innovation.[48]

Secure and affordable energy for business

2.104 Manufacturing is playing a key role in the UK's economic recovery. As a vital export industry, manufacturers produce more than half of the UK's exports, but the cost of energy acutely impacts the international competitiveness of the sector – particularly for energy intensive industries (EIIs).[49] The recent Executive Survey by EEF, the manufacturers' organisation, showed that the most cited risk to growth for manufacturing in the next year is rising input costs – mainly the cost of energy.[50]

2.105 While UK electricity prices are currently close to the International Energy Agency (IEA) average, a typical EII in Britain currently pays almost 50% more for their electricity than they do in France, and the cost to businesses of policies to deliver new low-carbon energy infrastructure is set to increase by around 300% by 2020.[51] This Budget announces a package of reforms to radically reduce the costs of energy policy for business – particularly in manufacturing – while

[47] HMT internal analysis.
[48] HMRC internal analysis.
[49] ONS supply use tables, available at www.ons.gov.uk.
[50] Executive Survey, EEF, January 2014.
[51] 'Industrial Electricity Prices in the EU for small, medium and extra large consumers; DECC price and bill impacts note', DECC, available at www.gov.uk.

Figure 1.1: Implementation of the government's growth commitments

Tax and reliefs	Infrastructure, planning and housing
• Cuts in the main rate of corporation tax from 28% to 23%, and to 20% by 2015-16, the joint lowest in the G20 • From April 2014 the NICs Employment Allowance will benefit up to 1.25 million employers. 98% of the benefit of this allowance goes to SMEs • Business rates support of £2.7 billion for 5 years from April 2014 will benefit 1.8 million ratepayers in England • Government's action on fuel duty will save a typical motorist £680 by 2015-16 • Oil and gas allowances have supported £7 billion of investment in North Sea fields over the past year alone	• Over 1,900 infrastructure projects completed since 2010, including over 550 road and rail projects • Between 2011 and 2013, average annual public and private infrastructure investment was around £45 billion, significantly up on the previous period • Over 330,000 more premises have access to superfast broadband • Help to Buy: equity loan has supported over 25,000 reservations for new build homes and over 6,000 households have put in offers for homes supported by the mortgage guarantee scheme in the first 3 months • Levels of planning approvals are at a 5-year high
Access to finance and regulation	**Exports and inward investment**
• More than 14,000 entrepreneurs have been supported through Start Up Loans since April 2012 • Over 1,600 companies have raised over £135 million from the SEIS since April 2012 • The Business Bank helped over 25,000 businesses in 2013, with 70% more finance made available during 2013 than in 2012 • The annual net burden of regulation on business has fallen by almost £1.2 billion so far since January 2011 • The Red Tape Challenge has identified over 3,000 regulations to be either scrapped or improved	• Since 2010, UKTI has supported almost 66,000 businesses to export • In 2013-14 UKTI has provided UK businesses in India and China with assistance over 8,000 times • UKTI has helped secure 4,100 inward investment projects, creating or safeguarding 270,000 jobs since 2010 • Enterprise Zones have created 7,500 jobs and attracted £1.2 billion in private investment • UK Export Finance has delivered record levels of financial support to British businesses and a total of around £11.8 billion since 2009-10
Education and skills	**Science and innovation**
• 174 new free schools and 3,486 academies have been opened across England since 2010, providing places for 2 million pupils • 1.6 million people starting apprenticeships this Parliament, with advanced level apprenticeship starts up 137% between 2009-10 and 2012-13 • Over 130,000 two-year-olds are now eligible for 15 hours of free early education a week • 50 University Technical Colleges and 46 studio schools have been approved	• Since 2010, Research Councils have invested £1.69 billion in research capital • Over this Parliament, government has invested £21.5 billion in science, including major investments in the 8 Great Technologies • Over £1 billion of public and private investment in 22 research infrastructure projects through the Research Partnership Investment Fund • 7 Catapult centres launched to support sectors such as high value manufacturing

Source: HMT, DfE, BIS, DCLG, UKTI, UKEF

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improving security of supply and maintaining the government's ambition to increase renewable generation. This package will benefit every household, business and region in the country saving a total of up to £7 billion by 2018-19. This will particularly benefit the most energy intensive manufacturers, around 80% of which are based in the North of England, Scotland and Wales.

2.106 The UK's Carbon Price Floor (CPF) sets a rising trajectory for the carbon tax paid by electricity generators, which raises the cost of electricity. The government remains committed to the CPF as a means to stimulate investment in low carbon infrastructure, but is capping the Carbon Price Support rate at £18.00 from 2016-17 to 2019-20 to limit any competitive disadvantage British companies face in the global race. This could save British businesses up to £4 billion by 2018-19, over £1.5 billion in 2018-19 alone, and £15 off a typical household energy bill in the same year. The government believes it is vital to reform and strengthen the EU Emissions Trading System, including through agreement of an ambitious EU climate and energy package for 2030. The government will review the CPF trajectory for the 2020s, including whether a continued cap on the Carbon Price Support rate might be necessary, once the direction of reform of the EU Emissions Trading System is clearer.

2.107 The government is announcing specific measures to tackle the energy costs faced by the most energy intensive industries to ensure they are as competitive as possible. Building on previous announcements to exempt EIIs from the support cost of Contracts for Difference, Budget 2014 announces that the government will:

- extend the compensation for energy intensive industries for the cost of the CPF and EU emissions trading system to 2019-20
- introduce a new compensation scheme, to help energy intensive industries with higher electricity costs resulting from the renewables obligation and small-scale feed in tariffs for renewable generation, from 2016-17

2.108 The combined cost of these compensation measures is expected to be around £500 million a year from 2016-17. Together with previous announcements, this package means that EIIs will be compensated for all government policy designed to support low carbon and renewable investment up until 2019-20, saving the average EII up to £19 million by 2018-19.

2.109 The government will exempt fuel used in Combined Heat and Power (CHP) plants for electricity generated to supply manufacturing firms from the CPF.

2.110 Taken together, these measures will ensure that the UK businesses at greatest risk from high energy prices remain competitive and have long-term certainty on energy prices by reducing energy costs for the economy by up to £7 billion by 2018-19.

Table 2.6: Savings from Budget 2014 energy package in 2018-19

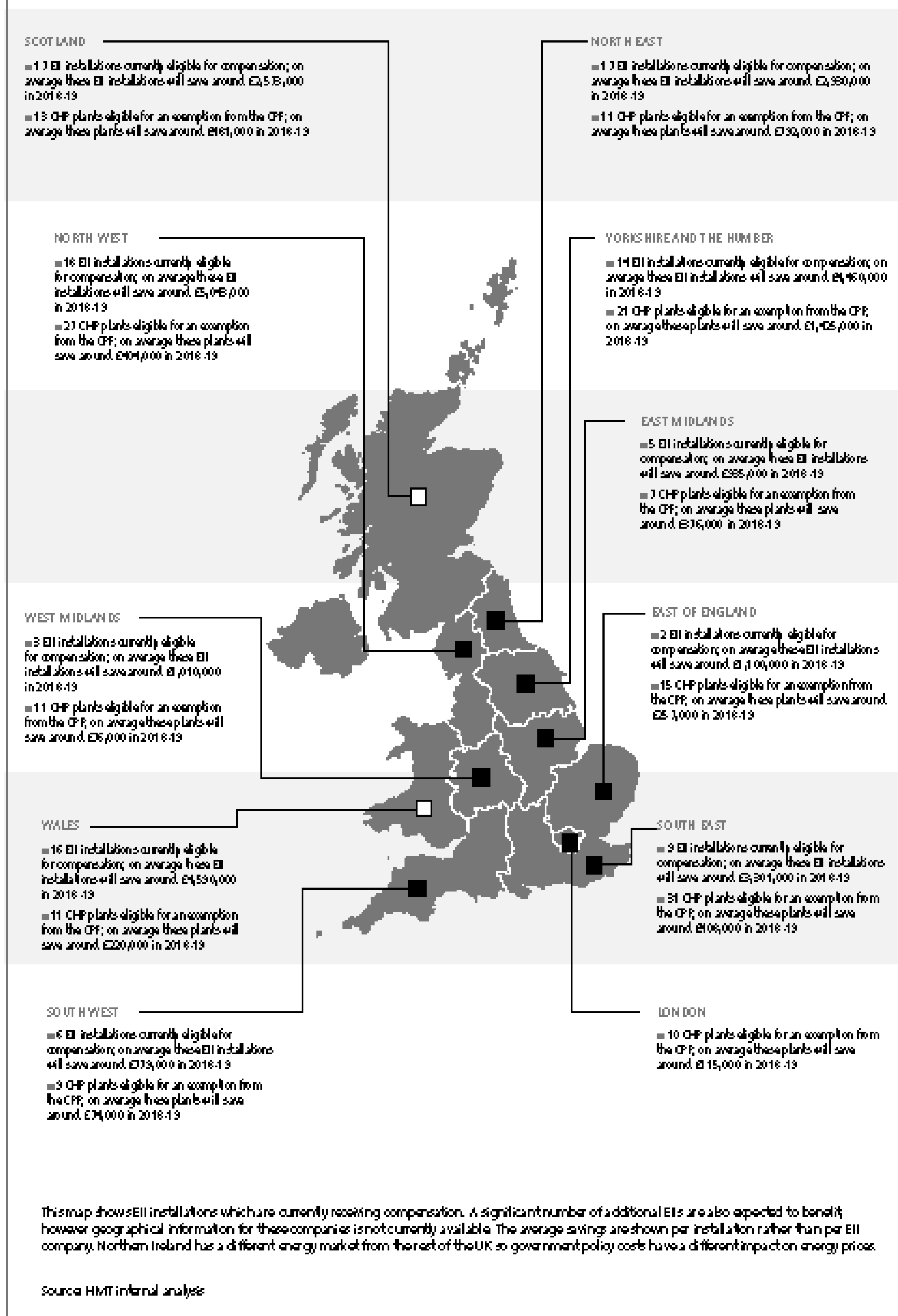
	Average household	Medium-sized manufacturer	Heavy Industrial firm	Typical compensated EII
Estimated total savings from package in 2018-19	£15	£50,000	£800,000	£6.25m

Source: Internal HM Treasury analysis

2.111 The government is fully committed to ensuring the UK has safe, secure and sustainable energy sources. The government is introducing a Capacity Market to ensure security of supply via incentivising investment in new gas capacity and getting the best out of existing power plants. This will ensure the lights stay on at the lowest possible cost. Final decisions on Capacity Market design will be announced today (19 March 2014) ahead of the first capacity auction at the end of the year.

2.112 There is no change in the government's ambition for the deployment of new renewable generation or strike prices. The government remains committed to growth in low-carbon

Figure 2.2: The regional impact of Budget energy policy announcements on energy intensive industries and combined heat and power plants



This map shows EII installations which are currently receiving compensation. A significant number of additional EIIs are also expected to benefit; however geographical information for these companies is not currently available. The average savings are shown per installation rather than per EII company. Northern Ireland has a different energy market from the rest of the UK so government policy costs have a different impact on energy prices.

Source: HMT internal analysis

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technologies. The established Levy Control Framework arrangements and budget provide the flexibility to achieve the investment and growth that is needed to tackle climate change and meet the renewable energy target. The buying power of the Levy Control Framework will be unaffected by other Budget decisions.

2.113 The government wants the UK to be the best place in the world to invest in innovative new technologies. The government is therefore providing £60 million for new low-carbon innovation to support carbon capture and storage (CCS) technologies that show significant potential to reduce the cost of low-carbon generation in the UK.

Oil and gas

2.114 The government is committed to maximising the benefit of North Sea oil and gas for the UK economy. Sir Ian Wood's review clearly set out the size of the prize that remains in the North Sea – and the government will ensure that it has the right long-term plan to capture this value.[52] Budget 2014 announces that the government, working with the new oil and gas body, will review the UK's tax treatment of the North Sea to ensure that it continues to incentivise economic recovery as the basin matures.

2.115 The government has already provided significant tax incentives for oil and gas projects that have unlocked billions of pounds of investment – around £7 billion in 2013 alone.[53] Building on the success of these allowances and embracing the challenges set out by Sir Ian, the government will introduce a new allowance for ultra high pressure, high temperature (HPHT) clusters and consult on the details. The allowance is expected to support the development of big HPHT projects which would create and sustain thousands of jobs, provide a significant portion of UK gas demand, and generate billions of pounds of capital investment. The new allowance will also encourage exploration in the central North Sea and help position the UK's supply chain to become world leading in this important new technology.

2.116 The government is committing to work with the oil and gas industry to ensure that the UK has the right skills and supply chain in place to benefit from the huge potential of the country's oil and gas reserves. This will be crucial not only to ensure the UK benefits fully from its shale gas reserves, but also the offshore oil and gas fields – including new high pressure, high temperature projects – and to make the UK's oil and gas supply chain world leading, creating local jobs and growth across the UK.

Supporting access to finance and competition in banking

2.117 To ensure venture capital schemes continue to effectively support small and growing businesses, the government will make the Seed Enterprise Investment Scheme (SEIS) and the capital gains tax 50% reinvestment relief permanent. The government will also explore options for the tax reliefs to apply where individuals make investments in the form of convertible loans, and to better target high-risk investment will change the eligibility criteria of venture capital schemes to avoid subsidising low-risk activities that already benefit from certain government programmes.

2.118 The government wants to encourage new investors to put money into social enterprises. The government will set a rate of 30% income tax relief – the same as the rate for the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) – for the Social Investment Tax Relief. This rate will allow eligible social enterprises to receive a maximum of around £290,000 investment over 3 years.

2.119 The government is determined to support increased competition and new entrants in the banking system, to deliver better results for consumers and businesses and to improve the conditions for small businesses looking to access the finance they need to invest and grow. The Office of Fair Trading (OFT) expressed concerns about competition in the SME banking

[52] 'UKCS Maximising Recovery Review: final report', Sir Ian Wood, February 2014.
[53] Oil and Gas UK Activity Survey 2014, available at www.oilandgasuk.co.uk

market in their 11 March update and the Competition and Markets Authority (CMA) are due to take a decision on whether to undertake a more detailed investigation of the whole retail banking market in Autumn 2014.[54]

2.120 This work of the competition authorities is part of a wide-reaching programme of government reforms to address competition issues in banking. Action to remove barriers to enter the banking market has been successful, with 25 applicants currently seeking a banking licence compared to only 6 in March 2013. Building on these reforms, Budget 2014 announces:

- more competition at the heart of the banking system – switching on key competition powers of the Payment Systems Regulator one year ahead of schedule, enabling the new regulator, should it decide to do so, to act decisively on competition issues, such as the ownership of payment systems by the big banks, as soon as it is resourced to do so
- faster and easier banking services – a new agreement from current account providers to give their customers standardised data which will enable millions of people to work out which current account will suit them best
- better banking for businesses – building on the Autumn Statement 2013 announcement to open up SME credit data to challenger banks and other finance providers, a new consultation on legislating to help match SMEs who are turned down for a loan with alternative lenders in order to broaden the sources of finance available to small businesses

2.121 To support more bank lending to SMEs and encourage a more diverse banking sector, the British Business Bank will issue a request for proposals to implement an innovative wholesale guarantees programme alongside the Budget.

2.122 RBS has recently laid out further detail on its new strategy for serving its UK customers, reducing assets in its 'bad bank', and supporting lending to British businesses. This is further evidence of the bank's new management getting to grips with the problems of the past and creating a more resilient bank in the long term.

Simplifying the tax system

2.123 The government's aim is that the tax system is simple to understand and easy to comply with. Following Office of Tax Simplification (OTS) recommendations, the government will simplify NICs for the self-employed by collecting class 2 NICs through Self Assessment from April 2016, and will implement OTS recommendations to simplify the taxation of employee benefits and expenses, employee share schemes and partnerships. The OTS will report this summer on how the competitiveness of UK tax administration can be improved, to help meet the Prime Minister's aim that the UK rank in the top 5 countries in the world in which to do business.

Exports

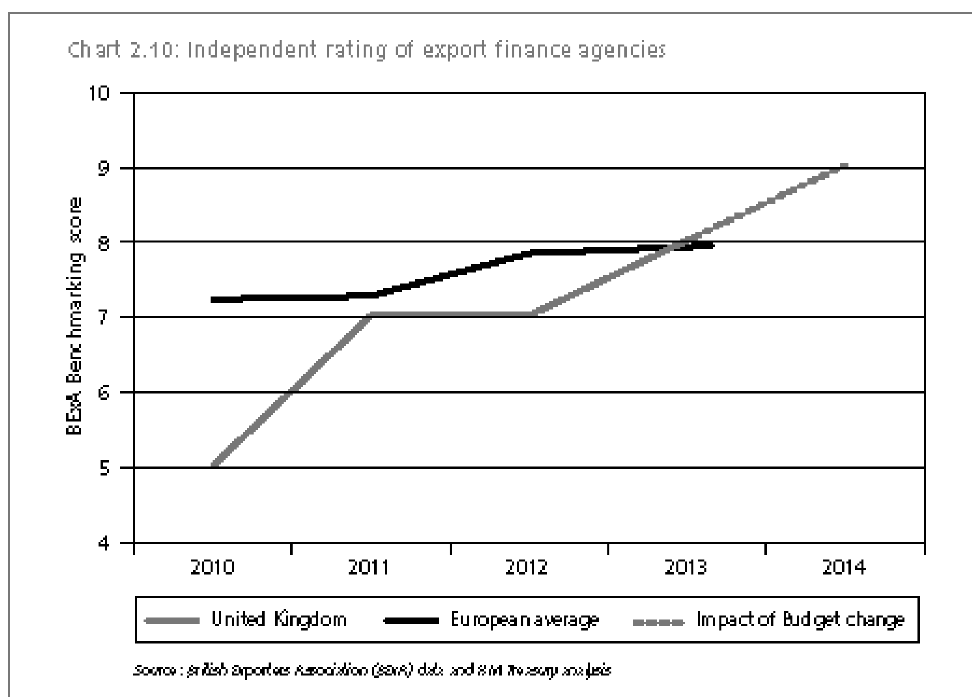
2.124 This government is taking further action to support dynamic UK businesses, providing the finance and support they need to take advantage of fast-growing emerging economies and expand in the global recovery. Budget 2014 announces measures to build on the government's world-class help for exporters, and give UK businesses access to the best export finance in Europe in order to win international trade contracts. The government will:

- overhaul UK Export Finance's (UKEF) direct lending programme, doubling it to £3 billion and cutting interest rates to the lowest permitted levels to provide competitive financing that helps UK firms win contracts and expand overseas

[54] 'OFT update on SME banking market study', Office of Fair Trading, March 2014.

- become much more proactive in support of UK business who want to expand globally, including supporting the UK-based supply chains of exporters and intangible exports for the first time by expanding the remit of UKEF and changing its underpinning legislation
- step up marketing so that more businesses are aware of UKEF's products and services

2.125 Chart 1.10 shows the British Exporters Association's (BExA) benchmarking of UK Export Finance against export credit agencies in other European countries.



2.126 The government already offers a world-class export support service through UK Trade and Investment (UKTI). To target and attract more of the world's most talented entrepreneurs to establish businesses and create jobs in the UK, the government will double the funding and ambition of UKTI's Global Entrepreneur Programme. The government will also strengthen its support for export promotion and inward investment in the financial services sector.

2.127 International students contribute over £10 billion to the UK's economy.[55] To support the important role that higher education plays in economic development and to strengthen the UK's strategic partnerships with emerging markets, the government will triple the number of Chevening Scholarships from 2015-16. The government will also expand the 'Education is GREAT' campaign to help attract more international students to the UK, and build on its reputation as a world-leading place to study.

2.128 To help British businesses strengthen links with high growth markets, and to go further to make the UK an attractive option for business visitors and tourists, Budget 2014 announces that the government will reform air passenger duty (APD) by abolishing bands C and D from 1 April 2015. This will eliminate the two highest rates of APD charged on flights to

[55] 'International Education: Global Growth and Prosperity', HM Government, July 2013.

countries over 4,000 miles from Britain, cutting tax for millions of passengers travelling to China, India, Brazil and many other emerging markets. This will mean that flights to South Asia and the Caribbean will pay tax at the lower band B rate. The rates applying to private jets which offer an enhanced level of comfort will be set at 6 times the level of rates applying to economy class. The government will also extend the scope of the existing Regional Air Connectivity Fund to include start-up aid for new routes from regional airports.

Education, science and innovation

2.129 Apprenticeships play a vital role in equipping young people with the skills they need to compete in the labour market, and that employers need to grow their businesses. The government is building on the success of the Apprenticeship Grants for Employers (AGE) scheme, by providing an extra £85 million in both 2014-15 and 2015-16 for over 100,000 grants to employers. The government will ensure that grants are targeted where they are most effective.

2.130 The changing nature of the labour market is demanding higher skilled workers. There are however potential barriers in the postgraduate system that may be restricting the supply of these higher skills. To ensure the UK can compete successfully in the global economy, the government will investigate options to support increasing participation in postgraduate studies and will put forward its ideas at Autumn Statement 2014.

2.131 Science and innovation are key drivers of long-run economic growth. The government will continue its drive to help commercialise research and ensure the UK economy benefits from its world leading science base. This Budget announces that the government will:

- provide £42 million over 5 years for the Alan Turing Institute – this will be a national institute which will undertake new research in ways of collecting, organising and analysing large sets of data ('Big Data'); Big Data analysis can allow businesses to enhance their manufacturing processes, target their marketing better, and provide more efficient services
- invest £74 million over 5 years in a Cell Therapy manufacturing centre and a Graphene innovation centre as part of the UK's Catapult network – these will enable large-scale manufacturing of cell therapies for late-stage clinical trials, and will provide SMEs with access to cutting-edge equipment for research and development of novel graphene products
- provide £106 million over 5 years for around 20 additional Centres for Doctoral Training – partnerships between universities, businesses and government to research new technologies and train postgraduate students

2.132 The Budget announces that the government will introduce Theatre Tax Relief from September 2014. This relief will support the production of plays, musicals, opera, ballet and dance at a rate of 25% for touring productions and 20% for other theatre productions. A consultation on the relief will be launched shortly.

Infrastructure

2.133 Many parts of the UK have been subjected to severe flooding. Budget 2014 provides £140 million of new funding to repair and restore the condition of vital flood defences that have suffered damage. This complements the government's long-term strategy, which in Spending Round 2013 allocated capital funding of £2.3 billion from 2015, allowing an increase in annual investment of 15% in real terms on that over the current spending period, even with the extra short-term funding allocated in this Budget. The

government is developing a long-term plan that will direct this investment to protect the country from future flooding and will publish this in the autumn.

2.134 In addition, Budget 2014 provides an extra £200 million, across the UK, to set up a potholes challenge fund. This emergency funding set aside by government will allow local authorities to repair up to 3.2 million potholes following the severe weather.

2.135 The government is committed to the UK's system of independent economic regulation, which is widely considered to be one of the best in the world. The government welcomes the creation of the UK Regulators' Network (UKRN), with its focus on key issues including facilitating efficient multi-sector infrastructure investment projects and action on customer engagement and switching in regulated markets. The government intends to consult on whether further measures would support and embed the work of the UKRN.

2.136 The government has made significant progress this year on the delivery of High Speed 2 (HS2), depositing a hybrid bill in Parliament, and appointing Sir David Higgins – former Chief Executive of Network Rail and the Olympic Delivery Authority – as Executive Chairman of HS2 Ltd. Sir David Higgins recently set out his proposals to maximise and accelerate the benefits HS2 can offer.[56] In response to this report, the government has commissioned HS2 Ltd to develop proposals for accelerating the project and opening the line to Crewe by 2027, 6 years earlier than planned, as well as exploring options for undertaking a substantial redevelopment of Euston station, one of the biggest undeveloped commercial opportunities in central London.

2.137 In 2012 the government introduced the UK Guarantees scheme, to avoid delays to investment in UK infrastructure projects by providing a government backed guarantee to investors. The Budget announces approval of a guarantee of up to £270 million to support the Mersey Gateway Bridge. Work can now begin on this critical infrastructure project which will help relieve traffic congestion across the Mersey and promote regeneration in the area.

2.138 The government will provide £20 million for a grant scheme for repairs to cathedrals in recognition of their heritage significance and role in forthcoming remembrance activities to commemorate the First World War.

Housing and planning

2.139 As a result of government reforms to date, planning approvals and housing starts are at 5 year highs, and housing activity recently expanded at its fastest rate for 10 years.[57]

Home ownership

2.140 The Help to Buy: equity loan scheme is expected to help at least 74,000 households buy a new-build home by March 2016. To help a further 120,000 households purchase a home and to continue to support house building as the market improves, the government will extend the equity loan scheme to March 2020. The Help to Buy: mortgage guarantee scheme will continue to support access to high loan to value mortgages until the scheme ends on 31 December 2016.

Housing supply

2.141 To support SME access to finance, the government will create a £500 million Builders Finance Fund, which will provide loans to developers to unlock 15,000 housing units stalled due to difficulty in accessing finance.

[56] 'HS2 Plus', Sir David Higgins, March 2014.
[57] 'Live tables on house building (222)', DCLG, February 2014.
'New Housing Pipeline', Home Builders Federation, February 2014.
'Markit/CIPS UK Construction PMI', Markit, February 2014.

2.142 For people who want to build their own home, the government will consult on creating a new 'Right to Build', giving custom builders a right to a plot from councils, and a £150 million repayable fund to help provide up to 10,000 serviced plots for custom build. The government will also look to make the Help to Buy: equity loan scheme available for custom build.

2.143 The government will establish a £150 million fund to kick start the regeneration of large housing estates through repayable loans, helping to boost housing supply. Bids will shortly be invited from private sector developers, working with local authorities on estates that might be able to benefit. Following the Autumn Statement, expressions of interest have already been made through the Greater London Authority relating to the Aylesbury Estate, Blackwall Reach and Grahame Park regeneration projects in London.

2.144 The government will work with the Mayor of London and the Greater London Authority (GLA) to develop proposals for extending the Gospel Oak to Barking Line to Barking Riverside, and to ensure that any public investment unlocks the construction of up to 11,000 new homes. It will also work with the GLA and the London Borough of Barnet to look at proposals for the Brent Cross regeneration scheme, subject to value for money and affordability.

New garden city

2.145 The government will support a new Garden City at Ebbsfleet. Ebbsfleet has capacity for up to 15,000 new homes, based on existing brownfield land. To date, under 150 homes have been built on the largest site. The government will form a dedicated Urban Development Corporation for the area, in consultation with local MPs, councils and residents, to drive forward the creation of Ebbsfleet Garden City, and will make up to £200 million of infrastructure funding available to kick start development. This will represent the first new garden city since Welwyn Garden City in 1920.

2.146 The government will also publish a prospectus by Easter 2014, setting out how local authorities could develop their own, locally-led proposals for bringing forward new garden cities.

Reform of the planning system

2.147 The government has taken decisive steps to improve and streamline the planning system. To support businesses and households further, the government will review the General Permitted Development Order. The refreshed approach is based on a three-tier system to decide the appropriate level of permission, using permitted development rights for small-scale changes, prior approval rights for development requiring consideration of specific issues, and planning permission for the largest scale development. As part of this, the government will consult on specific change of use measures, including greater flexibilities for change to residential use, for example from warehouses and light industry structures, and allowing businesses greater flexibilities to expand facilities such as car parks and loading bays within existing boundaries, where there is little impact on local communities.

Local growth

2.148 Enterprise Zones are a key part of the government's strategy for enabling growth in local areas. The government will continue to support Enterprise Zones to create even more new jobs and attract private investment to local areas. Availability of business rate discounts and Enhanced Capital Allowances will each be extended by 3 years as an incentive for new and expanding businesses to locate in Enterprise Zones.

2.149 The government will shortly take forward a Wales Bill that will devolve new tax and borrowing powers to Wales, enabling the Welsh government to raise more of the money it spends and providing it with further tools to support growth in the Welsh economy. In

advance of implementing these new powers, the government has also agreed that the Welsh government can use existing borrowing powers to begin investing in improvements to the M4.

2.150 The government will commit £100 million to Greater Cambridge until 2019-20 to support their ambitious transport and infrastructure proposals through a Gain Share mechanism. This agreement could be worth up to £500 million over 15 to 20 years, dependent on the economic impact of their investments and, in addition to Greater Cambridge's own plans, could deliver over £1 billion of infrastructure investment in the Greater Cambridge area.

2.151 Following the announcement at Autumn Statement 2013, the government is in detailed discussion with Glasgow to develop a city deal that will drive employment and economic development across the city region. Glasgow has identified infrastructure, strengthening the local labour market, and support for business growth as priorities, and good progress is being made in determining how best the government can support Glasgow to take forward this ambitious plan.

Fairness

2.152 The government's long-term economic plan is underpinned by its commitment to fairness. As the economy recovers, the government will continue to support and reward hard-working families. This Budget announces radical measures to help savers at all stages of their lives. The government will also take further action to reduce tax avoidance, and to ensure that everyone pays their fair share.

Supporting savers

2.153 Over the last 5 years, low interest rates have helped households and businesses through difficult economic times. These have kept mortgage payments down, but it has also meant that returns on savings have been low. The government recognises this has made it difficult for people's savings to grow, and that it has been harder for people to secure the income they expected in retirement.

2.154 The Budget reduces taxes for the lowest income savers, gives all savers greater flexibility in how they save and invest through the ISA system, and introduces new products to help retired savers with a better return. The Budget also introduces the most fundamental change to the way people access their pension in almost a century, through removing the effective requirement to buy an annuity.

2.155 The reforms in this Budget will ensure that people have greater freedom and choice over how they save money and access their pension, and will support savers to make the long-term decisions that ensure they can benefit from a better and more secure financial future.

Greater freedom and choice at retirement

2.156 This government has made security in retirement a central part of its reforms, through the introduction of auto-enrolment, the announcement of the single tier pension and uprating of the basic State Pension by the triple lock. These reforms to the way people build their pension change the context for how people can access their savings. The nature of retirement is changing as people live longer and their needs in retirement become more varied. With the right consumer advice and support, people should now be able to make their own choice about how and when to spend their pension funds.

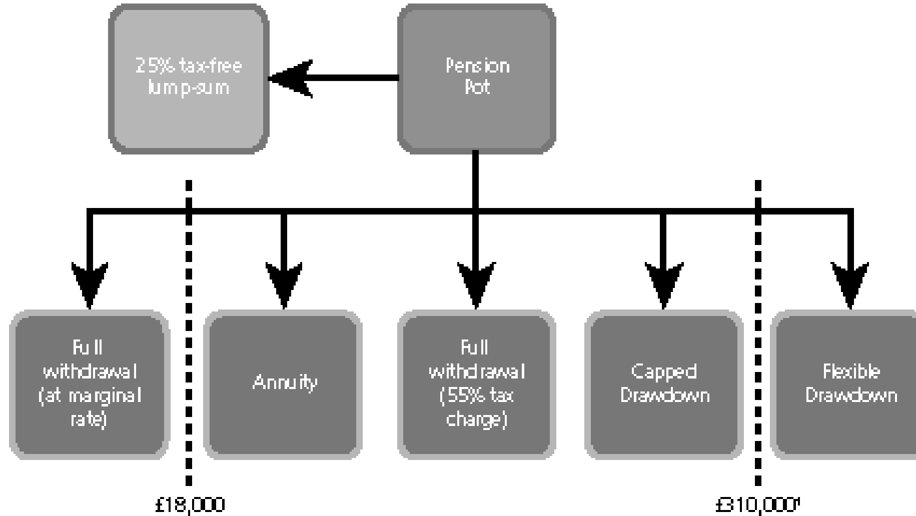
2.157 In this Parliament, the government has already removed the requirement to annuitise by age 75, and introduced flexible drawdown of pension savings for those who meet a minimum income requirement in retirement. This Budget announces further radical changes that will offer people more options in how and when they access their defined contribution pension.

2.158 From April 2015, the government will change the tax rules to allow people to access their defined contribution pension savings as they wish from the point of retirement. Drawdown of pension income under the new, more flexible arrangements will be taxed at marginal income tax rates rather than the current rate of 55% for full withdrawals. The tax-free pension lump sum will continue to be available. Those who continue to want the security of an annuity will be able to purchase one. Equally, those who want greater control over their finances in the short term will be able to extract all their pension savings in a lump sum. And those who do not want to purchase an annuity or withdraw their money in one go will be able to keep their pension invested and access it over time.

2.159 The government wants to ensure the current tax rules that apply to certain pensions on death continue to be appropriate under the new system. In particular, the government believes that a flat 55% charge will be too high in many cases in the future. The government will engage with stakeholders to review these rules.

Figure 2.3: Current system for accessing defined contribution pensions at retirement

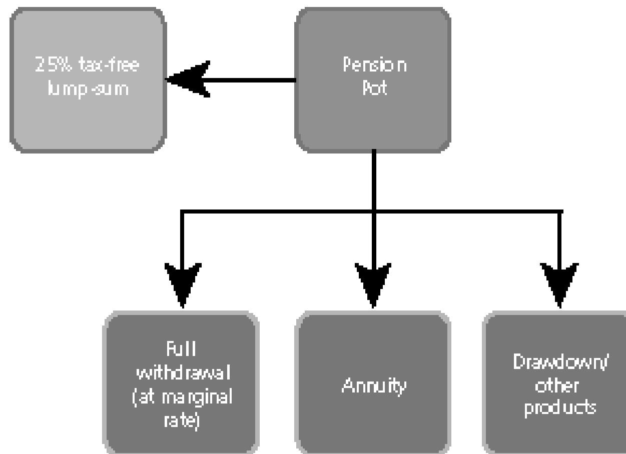
Under the current system, people's choices are constrained by the size of their defined contribution pension pot. There is some flexibility for those with small and very large pension pots, but around three-quarters of those retiring each year purchase an annuity.



[1] *This is a stylised assumption based on an individual with a full basic state pension of £5,799 per year, who takes the maximum tax free lump sum (25%) from their defined contribution pension pot and purchases a single life, level, no guarantee annuity worth £14,256 per year (an annuity rate of 6.1%) at age 65. This will enable them to meet the minimum income requirement of £20,000 per year for entering flexible drawdown.*

Figure 2.4: Future system for accessing defined contribution pensions at retirement

Under the new system, regardless of the size of their defined contribution pension pot, everyone will be able to choose any of the options in the below diagram. This will mean that everyone has access to full withdrawal, an annuity or drawdown, and potentially other products created by providers.



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2.160 The government recognises that under the new system it will be important that people are equipped to make decisions that best suit their personal circumstances. The Budget therefore announces that the government will introduce a new guarantee that everyone who retires with a defined contribution pension will be offered free and impartial face-to-face guidance on their choices at the point of retirement. This will take effect from April 2015. To deliver this, the government will introduce a new duty on pension providers and trust-based pension schemes to offer this guidance guarantee. The government will make available up to £20m over the next 2 years to develop this initiative.

2.161 These changes have implications for defined benefit pensions. Defined benefit schemes will continue to offer their members a secure income in retirement, and for the vast majority of defined benefit members that will be the best approach. However, the government recognises that greater flexibility could lead to more people seeking to transfer from defined benefit to defined contribution schemes. For public service defined benefit schemes, this could represent a significant cost to the taxpayer, as these schemes are largely unfunded.

2.162 Having considered this carefully, the government intends to introduce legislation to remove the option to transfer for those in public sector schemes, except in very limited circumstances. Whilst the government would in principle welcome the opportunity to extend greater choice to members of private sector defined benefit pension schemes, it will not do so at the expense of significant damage to the wider economy. Funded defined benefit schemes play an important role in funding long-term investment in the UK economy, which the government does not want to put at risk. The government's starting point is therefore that, whilst in principle it would like to permit transfers from private sector defined benefit schemes under the new freedoms, it will only consider doing so if the risks and issues around doing so can be shown to be manageable.

2.163 The government has today published a consultation on how best to implement the changes to defined contribution pensions, and how to treat private sector defined benefit schemes. The government is keen to engage with a wide range of stakeholders and the public.[58]

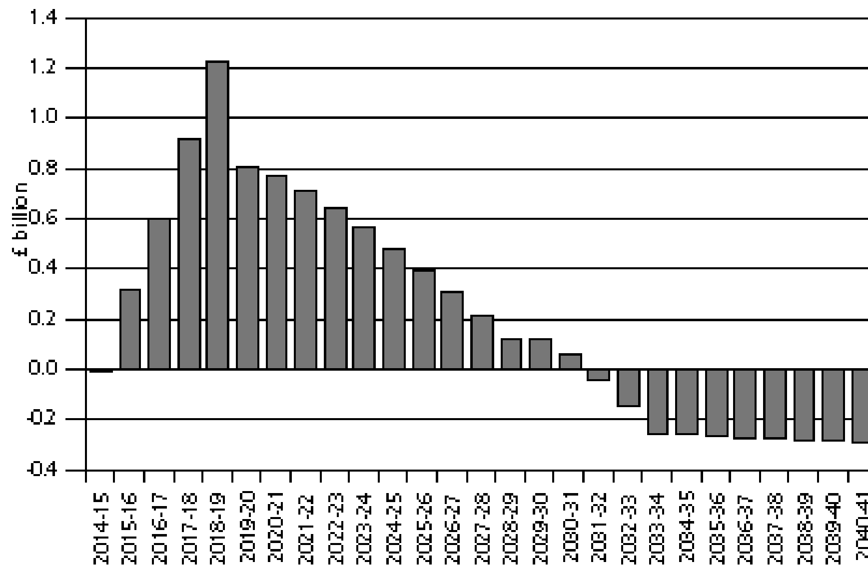
2.164 As a first step towards this reform, the Budget introduces a number of immediate changes, to allow people greater freedom and choice now over how to access their defined contribution pension. From 27 March 2014 the government will:

- reduce the amount of guaranteed pension income people need in retirement to access their savings flexibly, from £20,000 to £12,000
- increase the capped drawdown limit from 120% to 150% to allow more flexibility to those who would otherwise buy an annuity
- increase the size of a single pension pot that can be taken as a lump sum, from £2,000 to £10,000
- increase the number of pension pots of below £10,000 that can be taken as a lump sum, from 2 to 3
- increase the overall size of pension savings that can be taken as a lump sum, from £18,000 to £30,000

2.165 Under the current tax system, people are charged 55% if they choose to withdraw all of their defined contribution pension savings at the point of retirement. This means the majority of people instead purchase an annuity and receive taxable income over the course of their retirement. Under the new system, an individual will be able to withdraw their savings at a time of their choosing subject to their marginal rate of income tax. The government anticipates that under these circumstances some people will choose to draw down their pension sooner in order

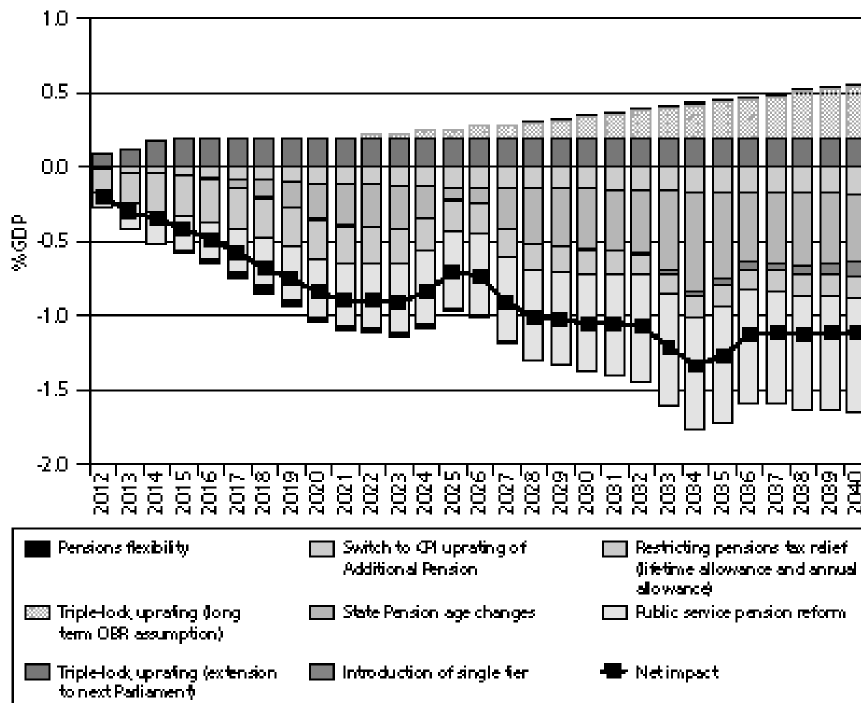
[58] 'Freedom and choice in pensions', HM Treasury, March 2014.

Chart 2.11: Projected tax impacts of pensions flexibility measures



Source: HMRC analysis

Chart 2.12: Pension provision sustainability and longevity: net fiscal impact projections of changes announced in this Parliament



Note: The chart includes both tax and spending impacts. The State Pension age changes line includes both the bringing forward of the rise to age 66 and 67, and the announcement at Autumn Statement 2013 of the core principle which will underpin future SPA reviews, which implies a further increase to 68 within this timescale. It does not include the impact of single tier reform on NICs revenue. The net impact line includes the introduction of a new class of voluntary NICs (Class 3A) but the fiscal impact is not significant enough to be visible on the chart.

Source: DWP, HM Treasury and HMRC analysis, based on OBR projections

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to suit their personal situation. This will increase income tax revenue in the short to medium term.

2.166 Chart 1.11 shows the projected impact on tax revenues of the measures to introduce greater flexibility and choice to defined contribution pensions. Chart 1.12 shows this impact in the context of wider pensions policies introduced by this government. This shows that the net impact is a saving to the Exchequer of around 1.1% of GDP in 2030, or around £17 billion in today's terms, putting pensions provision on a more sustainable basis for the long term.

New ISAs

2.167 Budget 2014 announces a radical reform of the ISA system. Around half of all UK adults have an ISA, and in order to give these savers greater choice in how they decide to save, the Budget announces that the ISA will be reformed into a New ISA (NISA), which will be a simpler product with equal limits for cash and stocks and shares. This will mean that for the first time ever, savers will be able to transfer previous years' funds from stocks and shares ISAs into cash ISAs. From now on, savers will have complete flexibility over how they choose to save and invest, within the overall limit.

2.168 The government also wishes to allow people to save more tax-free, so they can see their savings grow year on year. The Budget announces that the annual investment limit for the NISA will be £15,000 a year. This nearly trebles the current limit of £5,760 a year for saving in cash ISAs, and will benefit more than 5 million people who currently reach their cash ISA limit, three-quarters of whom are basic rate taxpayers. It will also increase the stocks and shares limit by nearly a third, from £11,520, and means in total over 6 million people will benefit from the higher overall limit.[59] The government will also raise the limits for Junior ISAs and Child Trust Funds from £3,720 to £4,000. These changes will be introduced from 1 July 2014.

2.169 To further increase the choice that ISA savers have about how they invest, ISA eligibility will be extended to peer-to-peer loans, and all restrictions around the maturity dates of securities held within ISAs will be removed. The government will also explore extending the ISA regime to include debt securities offered by crowdfunding platforms.

Abolishing the 10% starting rate for savings

2.170 Currently, the first £2,790 of savings income above the tax-free personal allowance is taxed at a starting rate of 10%. In order to provide further support for the lowest income savers, the Budget announces that from April 2015 the 10% savings rate will be reduced to 0%. The government will also increase the band of savings income that is subject to the 0% rate to £5,000. As a result of these measures, the government expects 1.5 million people to benefit, with an average gain of over £150 per year. This means that anyone with total income of less than £15,500 per annum will no longer pay any tax on their savings income.

2.171 This will simplify the tax system for over 1 million savers who will no longer be liable for any tax on their savings. These savers can benefit from a simpler system by registering for their interest to be paid gross via their bank or building society, rather than having to reclaim overpaid tax from HMRC.

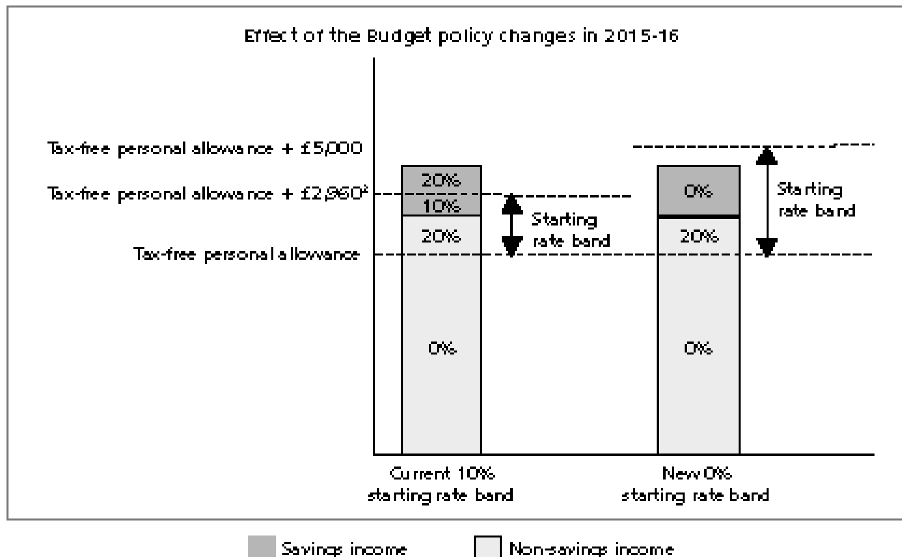
2.172 Increasing the ISA limit and reducing the 10% tax rate to 0% mean that the effective rate of taxation on savings for many people will be zero. This moves the tax system for savings closer to the approaches outlined by the Meade and Mirrlees reviews, which considered the appropriate principles on which a tax system should be based.[60, 61]

[59] Individual Savings Account (ISA) Statistics, HM Revenue and Customs, September 2013.
[60] 'The structure of reform of direct taxation', Report of a Committee chaired by Professor J.E. Meade, 1978.
[61] 'The Mirrlees Review', IFS, 2011.

Figure 2.5: Changes to the starting rate of savings income tax

Currently, the low income saver below is liable for the 10% tax rate on some of their savings income and 20% tax on the rest of their savings income.

From April 2015, all their savings income will be taxed at 0%. As the starting rate band for savings is only available for savings income, a saver with other income (for example income from employment) above £15,500 (personal allowance of £10,500 plus £5,000 savings band) would not benefit from this policy.[1]



Savings income   Non-savings income

[1] Note that in 2015-16 the tax-free personal allowance will be £10,500 for everyone born on or after 6 April 1938. For everyone born before that date, it will be £10,660.
[2] It has also been estimated that were these policy changes not going ahead, the starting rate band would have been uprated to £2,960 in 2015-16.

Pensioner savings bonds and Voluntary National Insurance contributions

2.173 The Budget announces that National Savings and Investments (NS&I) will launch a choice of fixed-rate, market-leading savings bonds for people aged 65 or over, available from January 2015 and allowing inflows of up to £10 billion. These will provide certainty and a good return for those who have saved all their lives and now mostly rely on their savings for income. Interest on the bonds will be taxed in line with all other savings income, at the individual's marginal rate, meaning that pensioners who do not pay savings tax will be eligible to receive the interest tax-free. For the purposes of costing this measure, the central assumption made at this Budget is that NS&I will launch a 1-year bond paying 2.8% gross/annual equivalent rate (AER) and a 3-year bond paying 4.0% gross/AER, with an investment limit of £10,000 per bond. Precise details will be confirmed at Autumn Statement 2014, to take account of prevailing market conditions at that time.

2.174 The Budget also announces further details of a new scheme of Voluntary National Insurance contributions (VNICs) to allow pensioners to top up their Additional State Pension. The scheme will be open for 18 months from October 2015 and available to everyone reaching State Pension age before 6 April 2016. This will help pensioners with savings who want to boost their State Pension income in a way that protects them from price inflation and provides them with an income for life. It could particularly benefit those with gaps in their Additional State Pension record, such as the self-employed and women who have taken time out from work to raise children.

Increasing the incentives to invest in Premium Bonds

2.175 Premium Bonds, offered by NS&I, are one of the oldest and best known savings products, held by over 21 million people. The Budget announces that the cap on investments in Premium Bonds will be lifted for the first time since 2003, from £30,000 to £40,000, from 1 June 2014. It will then be lifted again to £50,000 in 2015-16. NS&I will also now offer 2 £1 million prizes per month, rather than 1, starting from the prize draw in August this year. This will increase savers' chances of winning the largest prize and allow people who want to save more through Premium Bonds to do so.

Supporting households

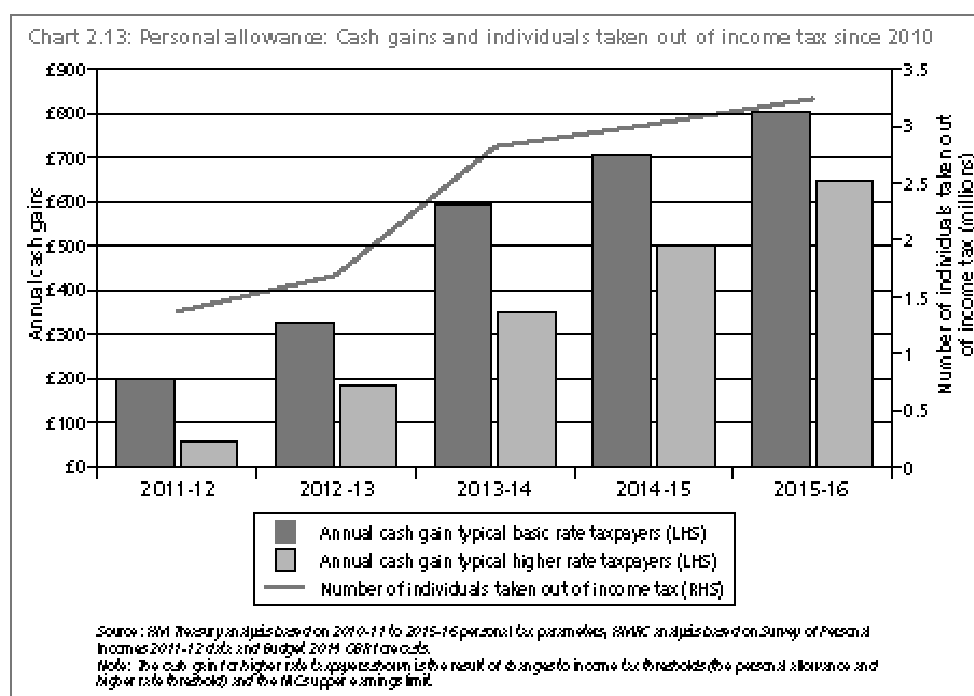
Personal allowance

2.176 As announced at Budget 2013, from April 2014 the tax-free personal allowance will be increased to £10,000 a year. Budget 2014 goes even further, and announces that the personal allowance will be increased to £10,500 from April 2015. This will be worth £100 to a typical basic or higher rate taxpayer (£62 in real terms), and will lead to a further 288,000 individuals no longer paying income tax. 25.4 million individuals will benefit. Overall, over 3.2 million people will have been lifted out of income tax by April 2015.

2.177 This increase in the personal allowance will benefit most higher rate taxpayers equally, as well as those paying only the basic rate. The government's increases to the personal allowance since 2010 have been worth £646 to a typical higher rate taxpayer in cash terms, and £805 to a typical basic rate taxpayer.[58]

2.178 The Budget also announces that the transferable tax allowance for married couples and civil partners announced at Autumn Statement 2013 will be set at 10% of the personal allowance from 2015-16. This means it will be £1,050 in 2015-16.

Chart 2.13: Personal allowance: Cash gains and individuals taken out of income tax since 2010



Source: HM Treasury analysis based on 2010-11 to 2015-16 personal tax parameters, HMRC analysis based on Survey of Personal Incomes 2011-12 data and Budget 2014 OBR forecasts.
Note: The cash gain for higher rate taxpayers shown is the result of changes to income tax thresholds (the personal allowance and higher rate threshold) and the NICs upper earnings limit.

[58] HMRC analysis based on Survey of Personal Incomes (SPI) 2011-12 data and Budget 2014 OBR forecasts.

Table 2.7: Illustrative income tax and National Insurance contributions paid per year, by income level

Gross income (£)	2010-11 (£)	2011-12 (£)	2012-13 (£)	2013-14 (£)	2014-15 (£)	2015-16 pre-Budget 2014 (£)	2015-16 post-Budget 2014 (£)
10,000	1,180	840	670	380	250	190	130
20,000	4,280	4,040	3,870	3,580	3,450	3,390	3,330
30,000	7,380	7,240	7,070	6,780	6,650	6,590	6,530
40,000	10,480	10,440	10,270	9,980	9,850	9,790	9,730
50,000	14,190	14,390	14,220	14,040	13,860	13,760	13,700
60,000	18,290	18,590	18,420	18,240	18,060	17,960	17,900
70,000	22,390	22,790	22,620	22,440	22,260	22,160	22,100
80,000	26,490	26,990	26,820	26,640	26,460	26,360	26,300

Source: HM Revenue and Customs calculations.

Note: Calculations are based on all changes to rates and thresholds in both the income tax and National Insurance system implemented or announced up to and including Budget 2014. The table is also based on an individual born after 5th April 1948. Gross income refers to pay only (i.e. all gross income is subject to income tax and class 1 NICs). Income tax calculations assume no other allowances or deductions. NICs calculations are on a weekly basis and then annualised. All figures are rounded to the nearest £10.

National Minimum Wage

2.179 The Low Pay Commission's (LPC) recommendations for increases in the National Minimum Wage (NMW) rates have been accepted by the government. The adult NMW rate will increase by 3% to £6.50 from October 2014, representing the largest cash increase since 2008 and the first real terms increase since 2007. There will also be increases of 2% for the youth and apprentice NMW rates from October 2014. As a result, over a million people will see a pay increase.[63] Beyond 2014, the LPC has made clear that it shares the government's aim for further real terms increases beyond this, with the real value of the minimum wage restored and exceeded in time, provided economic conditions continue to improve.

Universal Credit

2.180 Universal Credit will provide the right incentives for people to work, target support at those who need it most, reduce fraud and error, and streamline the administration of the welfare system. Up to 300,000 more people will be in work, worklessness and inactivity will fall, and in-work earnings and hours will rise over time.[64]

2.181 The roll out of Universal Credit continues, with the live service expanding to couples in the summer. The government continues to roll out the service in a controlled manner in order to assess how claimants are responding, and to inform development of the enhanced digital solution. Based on current plans, Universal Credit will be fully available in each part of Great Britain during 2016.

Childcare and early years education

2.182 At Budget 2013 the government announced an additional £200 million support for childcare in Universal Credit, equivalent to providing 85% support for families where both parents, or a single parent, pay income tax. The government has consulted on this proposal and has now announced that all families eligible for Universal Credit will benefit from additional support at this level. In line with the principles of the welfare cap, offsetting savings to fund this expansion will be found from within the Universal Credit programme. Further details will be set out at Autumn Statement.

2.183 Budget 2014 confirms that the Tax-Free Childcare costs cap, against which parents can claim 20% support, will be increased to £10,000 per year for each child. This will mean that eligible parents can now benefit from greater support, worth up to £2,000 per child each year. At the same time the government is rolling out Tax-Free Childcare more

[63] 'National Minimum Wage 2014 Report', LPC, March 2014.
[64] 'Universal Credit Impact Assessment', DWP, December 2012.

quickly than previously announced. From autumn 2015, the scheme will be rolled out to all eligible families with children under 12 within the first year of the scheme's operation.

2.184 High quality early education has a significant impact on children's life chances. Since 2010 the government has extended free early education for all three- and four-year-olds to 15 hours, and has rolled out this offer to 20% of two-year-olds. This offer is also being extended further, to around 40% of two-year-olds from September 2014. Budget 2014 announces £50 million for an early years pupil premium, to help improve outcomes for the most disadvantaged three- and four-year-olds in government-funded early education. The government will allocate £350 million to increase the per-pupil school budgets of the least fairly funded local areas in 2015-16.

Tackling fuel poverty

2.185 The government is committed to helping households with their energy bills and reducing fuel poverty. The government will shortly be publishing its proposals for a new fuel poverty target and strategy and as part of this will consider the particular challenges faced by those households that are not connected to the gas grid.

Support for Mortgage Interest

2.186 The Support for Mortgage Interest (SMI) scheme provides support for homeowners receiving certain income-related benefits. During the recession, the SMI scheme was temporarily set at a higher capital limit of £200,000 with a shorter waiting period of 13 weeks. The scheme has helped over 200,000 people a year remain in their homes.[65] To continue support for homeowners facing difficulties during the recovery, the SMI scheme will remain at its current, higher level until 31 March 2016.

Alcohol and gambling duties

2.187 Budget 2014 announces that the tax on a typical pint of beer will be cut by 1 penny from 24 March 2014. This will support jobs in the pub industry, and means that a pint of beer will be 8p cheaper than under the previous government's duty plans. In addition, the duty on ordinary cider will be frozen this year, and the duty escalator for wine will end, keeping the duty on wine and beer broadly similar.

2.188 To support the domestic market for the thriving Scotch whisky industry and jobs in Scotland, the Budget announces that the duty on spirits will be frozen for 2014-15. This means that a bottle of Scotch whisky will be 42p lower than under the previous government's duty plans.

2.189 The number of bingo halls has fallen by three-quarters over the last 30 years. The government recognises the important role that bingo clubs play in bringing local communities together, supporting employment and contributing to British culture. To support bingo and encourage investment, the government announces that the rate of bingo duty will be reduced to 10%.

2.190 The Department of Culture, Media and Sport has a review underway to consider the regulation of Category B2 gaming machines (also known as fixed-odds betting terminals), which will report before Easter. These machines are one of the most profitable forms of high street gambling. Alongside the review, the government will create a new higher rate of machine games duty at 25% for B2 machines to bring their profitability more into line with other gaming machines on the high street.

[65] DWP expenditure tables, Autumn Statement 2013.

Ensuring individuals and businesses pay their share

A fair contribution from all

2.191 The government remains committed to a fair tax system where everyone contributes to reducing the deficit, and those with the most make the largest contributions. An estimated 28.3% of all income tax receipts come from the top 1% of taxpayers.[66] This Budget announces a number of policies to enhance the fairness of the tax system further.

2.192 As announced at Budget 2012, the government has introduced a number of new measures to discourage placing property in corporate envelopes to avoid stamp duty land tax (SDLT). These apply to residential properties valued over £2 million, and include a new higher rate of SDLT when the property is first 'enveloped'; a new Annual Tax on Enveloped Dwellings (ATED); and a capital gains tax charge on any gains on disposal of enveloped properties from April 2013.

2.193 ATED has raised 5 times the amount forecast for 2013-14, with significantly more properties above £2 million in envelopes than expected. As well as discouraging SDLT avoidance, ATED incentivises commercial activities by providing relief where, for example, a property is rented out.

2.194 The government believes that ATED and the associated measures can discourage the use of corporate envelopes to invest in high value UK housing which is left empty or under-used while avoiding paying tax. The Budget therefore announces 2 new bands for ATED, to bring properties worth £500,000 to £1 million and £1 million to £2 million into the charge. The ATED-related capital gains tax charge will apply to properties in the new ATED bands. The 15% rate of SDLT that applies to acquisitions of properties by corporate envelopes will also be applied to properties valued above £500,000 with effect from 20 March 2014.

2.195 The government recognises that the structure of ATED can create some administrative burdens for genuine property rental, trading and development companies. The government will therefore stagger the introduction of the new ATED bands, with the £1 million to £2 million band coming into effect from April 2015, and the £500,000 to £1 million band coming into effect from April 2016. The government will also consult on possible simplifications to ATED administration to reduce compliance burdens for genuine businesses.

2.196 As highlighted by the OTS review of employee benefits and expenses, working practices have changed. The current rules for benefits and expenses are complex and can lead to unfair outcomes. The government will undertake a call for evidence on remuneration practices in the 21st century to inform future changes.

2.197 The Budget confirms recent announcements on migrants' access to benefits and tax credits. In addition, the Budget announces that the government will increase compliance checks on European Economic Area (EEA) migrants to establish whether they meet the entitlement conditions to receive Child Benefit or Child Tax Credit. The checks will be applied to both new claims and existing awards to prevent EEA migrants claiming benefits they are not entitled to.

Tackling tax avoidance

2.198 Most individuals and businesses throughout the UK pay the tax they owe upfront. However, a persistent minority seek to avoid their responsibilities, preventing the tax system

[66] 'Survey of Personal Income Statistics', table 2.4, HMRC, February 2014. These figures are based on the 2011-12 Survey of Personal Incomes using economic assumptions consistent with the OBR's December 2013 Economic and Fiscal Outlook.

from raising revenue fairly and imposing costs on all taxpayers. The government intends to fundamentally reduce the incentives for avoidance to address this problem.

2.199 At Autumn Statement 2013, the government announced that it would, following consultation, introduce a new requirement for taxpayers to pay disputed tax upfront where the avoidance scheme being used has been defeated in another party's litigation through the courts.

2.200 Tax avoidance scheme promoters must give HMRC information about schemes they promote under the Disclosure of Tax Avoidance Scheme (DOTAS) rules. Anyone using such a scheme must declare to HMRC they are using a notified tax avoidance scheme. Following consultation, this Budget announces that the government intends to extend the new requirement for taxpayers to pay upfront any disputed tax associated with schemes covered by the DOTAS rules or counteracted under the General Anti Abuse Rule (GAAR).

2.201 This new power will remove the cashflow advantage for the taxpayer of holding onto the disputed tax during an avoidance dispute. It will also provide HMRC with additional tools to address a legacy stock of an estimated 65,000 avoidance cases. The new power will only apply to tax avoidance schemes that are disputed by HMRC. The legislation will make it clear that HMRC will only be able to issue an accelerated payment notice where they have first sent the taxpayer an enquiry notice or issued them with a notice of assessment. It is not a new tax demand and does not make any changes to tax liabilities. If the taxpayer subsequently wins their case in the courts, they will be reimbursed with interest.

2.202 Following consultation, the Budget confirms the introduction of new rules to allow HMRC to identify and place new obligations and penalties on "high-risk promoters" of tax avoidance schemes. To reflect the extra revenue anticipated from the measures in this Budget, the government will increase HMRC's compliance yield target by a total of £1.6 billion over the coming 2 financial years.

International action on tax avoidance

2.203 The government is committed to working with G20 and OECD partners to prevent multinational companies engaging in aggressive tax planning, by taking forward the 15 point Action Plan to counter Base Erosion and Profit Shifting.[67] It is today publishing a position paper which sets out the UK's priorities for the ongoing work on this global initiative.[68] The first outputs are expected this year, including a proposal initiated under the UK's G8 presidency in 2013 for a country-by-country reporting template to give tax authorities worldwide a clear picture of where multinationals generate profits and pay tax.

2.204 The government is committed to completing work on all the actions to the agreed deadlines in 2014 and 2015, and will ensure that changes to the tax rules are implemented in the UK as soon as possible to make sure a fair amount of tax is paid by these businesses.

2.205 Alongside working with G20 and OECD partners, Budget 2014 announces action to block arrangements involving payments between companies within a group which transfer profits to avoid tax. These payments will be disregarded for tax purposes, and companies will pay tax on profits generated in the UK.

2.206 The OECD is due to consult on a new rule to address hybrid mismatches, which occur when the tax treatment of a financial instrument or entity differs between countries, allowing for exploitation by multinational groups looking to lower their effective tax rates. The government believes that banks and insurers should not be unfairly advantaged under this rule, and does not see a strong case for a full carve out of their intra-group hybrid capital

[67] 'Action plan on Base Erosion and Profit Shifting', OECD, July 2013.
[68] 'Tackling aggressive tax planning in the global economy: UK priorities for the G20/OECD project for countering Base Erosion and Profit Shifting', HM Treasury, March 2014.

instruments. However, as part of the consultation, the government will consider whether there should be special rules when these instruments are a direct consequence of regulatory requirements.

Debt recovery

2.207 The Budget announces that tax credit debt recovery rates for the highest earners in the tax credit system will be increased. This means that households with higher incomes and smaller tax credit awards will repay their debts earlier.

2.208 The government will modernise and strengthen HMRC's debt collection powers to recover financial assets from the bank accounts of debtors who owe over £1,000 of tax or tax credit debts, have the financial means to pay, and have been contacted multiple times by HMRC to pay. A minimum of £5,000 will be left across debtors' accounts. This brings the UK in line with many other tax authorities which already have the power to recover debts directly from an individual's account, such as France and the US.

Distributional Analysis

2.209 Information on the estimated distributional impact of this Budget is available in 'Impact on households: distributional analysis to accompany Budget 2014'.[69] Distributional analysis confirms that the richest are continuing to contribute the most to reducing the deficit, both in cash terms and as a percentage of income and benefits in kind from public services. ONS data show that income inequality is at its lowest level since 1986.[70]

[69] 'Impact on households: distributional analysis to accompany Budget 2014', HM Treasury, March 2014.
[70] 'The effects of taxes and benefits on household income, 2011/12', ONS, June 2013.

3 Excessive Deficit Procedure

3.1 In recent years the UK has been hit by the most damaging financial crisis in generations. The UK entered into the Excessive Deficit Procedure (EDP) following a decision by ECOFIN Council in July 2008. In November 2009, the Council made recommendations to the UK, including a target to correct its excessive deficit by reducing the Treaty deficit below 3% of GDP by 2014-15. 16 other EU Member States are also currently subject to the Excessive Deficit Procedure.

3.2 On coming to power in 2010, the government inherited the largest deficit since the Second World War. In response, the government set out clear, credible and specific medium-term consolidation plans to restore the public finances to a sustainable path. The government's fiscal strategy has restored fiscal credibility, allowing activist monetary policy and the automatic stabilisers to support the economy and ensure the burden is shared fairly across society.

3.3 In spite of the lasting effects of the financial crisis, high global commodity prices and euro area economic uncertainty, the government has made significant progress in reversing the unprecedented rise in borrowing between 2007-08 and 2009-10:

- the OBR's preferred measure of 'underlying' public sector net borrowing has fallen by a third as a percentage of GDP since 2009-10 and is forecast to have fallen by a half as a percentage of GDP by 2014-15[1]
- public sector net borrowing is forecast to reach a small surplus in 2018-19
- the government's consolidation plans have been central to the reduction in the deficit with £64 billion of the £80 billion spending reductions over Spending Review 2010 already implemented

3.4 Since 2013, economic growth has exceeded forecasts, inflation is below target, and the deficit has been reduced year on year. The government is continuing to take difficult decisions to put the public finances on a sustainable path.

3.5 However, in recognition of the need to continue reducing the deficit and debt, Budget 2014:

- is fiscally neutral despite lower borrowing costs across the OBR's forecast period, with an overall reduction in tax funded by a reduction in spending
- set the level of the welfare cap announced at Spending Round 2013 to improve spending control, from 2015-16 to 2018-19 at the OBR's forecast of spending in scope, with a forecast margin of 2% above this level
- confirmed that departments remain ahead of their consolidation targets; the OBR forecasts that departments will underspend by £7 billion in 2013-14, and will continue to underspend until the end of this Parliament

[1] 'Public Sector Finances' ONS, February 2014; 'Economic and Fiscal Outlook', OBR, March 2014. Public sector net borrowing fell from 11.0% of GDP to 7.3% in 2012-13 and is forecast to fall to 5.5% in 2014-15.

- reduced spending in the next Parliament by locking in spending reductions announced at Autumn Statement 2013 for future years.

3.6 However the job is not yet done and more work will be needed to tackle historic weaknesses, including low productivity, poor skills and inadequate infrastructure. The UK also faces a number of external risks, including slowing growth and financial instability in some emerging markets, and ongoing weakness in the euro area. Abandoning the government's long-term economic plan and the path of fiscal credibility would represent the most significant risk to the recovery.

3.7 The government remains committed to bringing the UK's Treaty deficit in line with the 3% target set out in the Stability and Growth Pact (SGP). As Table 3.A shows, the UK is forecast to meet the EU SGP target for the Treaty deficit in 2016-17.

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

	Per cent of GDP						
	Outturn	Forecasts					
	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**
Deficit							
Treaty deficit[1]	5.2	6.0	5.0	4.0	2.4	1.1	0.1
Debt							
Treaty debt ratio[2]	88.3	89.6	91.8	93.1	91.9	89.4	86.6

[1] General government net borrowing on a Maastricht basis
[2] General government gross debt on a Maastricht basis

Source: Office for Budget Responsibility

3.8 While the OBR forecasts that underlying public sector net borrowing will reach a small surplus by 2018-19, the record deficit inherited in 2009-10 means that public sector net debt will have risen by around 40% of GDP to a forecast peak of 78.7% of GDP in 2015-16; the highest level since the end of the 1960s.[2]

3.9 High levels of debt impose significant burdens now and in the future through higher interest payments, reducing resources available to support public services as well as increasing the UK's vulnerability to future shocks. The UK therefore faces a long-term challenge in reducing debt to sustainable levels. Given these costs and risks, once the current supplementary debt target has been met, any future government will need to ensure that debt continues to fall as a percentage of GDP. Even in the absence of future shocks, sustained action will be needed to bring down debt.

[2] 'Three centuries of data on the UK economy', Bank of England; 'Public Sector Finances', ONS, February 2014.

4 Quality of public services

The Government's consolidation strategy

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

4.2 As a result of the plans set out in Budget 2014, public spending is projected by the OBR to fall from 47.0% of GDP in 2009-10 to 38.0% of GDP by 2018-19. Public sector current receipts are projected to rise from 36.0% of GDP in 2009-10 to 38.1% of GDP by 2018-19.

4.3 Public spending control is central to the government's commitment to reduce the deficit. £64 billion of the £80 billion spending reductions over Spending Review 2010 have already been implemented and the government is continuing to take action to improve financial management and spending control.

4.4 The government is also committed to creating a more competitive tax system that is fair and supports growth. Budget 2014 announces radical measures to help savers and gives people greater freedom over how they access their pension savings and supports investment through reforms to capital allowances and energy.

Spending consolidation

4.5 Departments remain ahead of their consolidation targets and are forecast by the Office for Budget Responsibility (OBR) to underspend by £7 billion in 2013-14. Underspends are forecast to continue to the end of this Parliament, reflecting a continued focus on improved spending control and good financial management.

4.6 To lock in lower levels of spending, Autumn Statement 2013 announced a reduction in unprotected Resource Departmental Expenditure Limit (RDEL) budgets of £1.1 billion in 2014-15 and £1 billion in 2015-16. This represents a reduction of 1.1%. Health, schools and Official Development Assistance (ODA) budgets continue to be protected.

Composition, efficiency and effectiveness of expenditure

4.7 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 health, schools and overseas aid and also made choices to: prioritise fairness and social mobility; focus on spending that promotes long-term economic growth; and reform public services, shifting power away from central government to the local level and improving value for money.

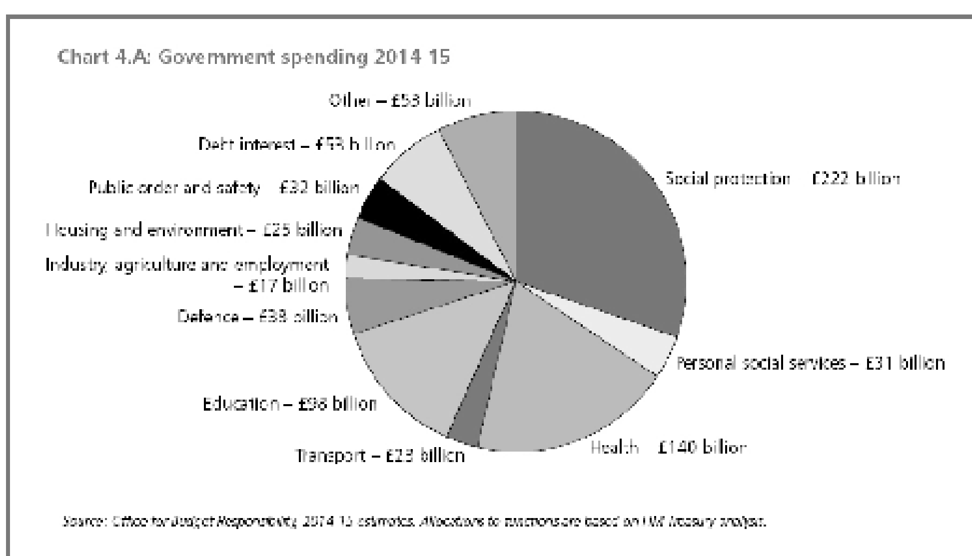
[1] See Economic Outlook, OECD, June 2007; OECD Economic Survey: United Kingdom 2011, OECD, March 2011; and UK Article IV consultation, IMF, May 2009.

4.8 Spending Round 2013 set departmental budgets for a further year, reducing current spending by £11.5 billion in 2015-16, enabling an increase of £3 billion a year to capital spending plans from 2015-16 at the same time as ensuring a sustained reduction in the deficit. The government also set out long-term plans for capital investment to 2020 and beyond. The government continued to protect spending on health, schools and overseas development.

4.9 This government has introduced a programme to drive efficiencies and reduce wasteful expenditure. By 2014-15, departments working with HM Treasury and the Efficiency and Reform Group in the Cabinet Office will be saving £20 billion a year compared to 2009-10. Spending Round 2013 identified over £5 billion additional efficiency savings in 2015-16. The government has also exercised firm restraint over public sector pay. By 2014-15 pay restraint will have reduced spending pressures by an estimated £12 billion.

4.10 Chart 4.A presents public spending by main function. Total Managed Expenditure (TME) in 2014-15 is expected to be around £730 billion. TME is divided into DEL and AME.

Chart 4.A: Government spending 2014 15



Source: Office for Budget Responsibility 2014-15 estimates. Allocations to functions are based on HM Treasury analysis.

Spending beyond 2015-16

4.11 In line with previous policy, Budget 2014 restated the government's fiscal assumption that TME in 2016-17 and 2017-18 will continue to fall in real terms at the same rate as over this Parliament. TME will be held flat in real terms in 2018-19. Reflecting permanent reductions to spending as a result of the spending reductions announced at Autumn Statement and the reduced AME costs of public service pensions, TME will be reduced by around a further £2 billion each year from 2016-17.

4.12 The government will continue to prioritise capital investment over the medium to longer term, so within the overall TME assumption, public sector gross investment (PSGI) will be constant in real terms in 2016-17 and 2017-18 and will grow in line with GDP from 2018-19.

Table 4.A: Total Managed Expenditure[1]

	£ billion					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
CURRENT EXPENDITURE						
Resource AME	326.2	341.6	356.3	373.6	391.6	407.5
Resource DEL, excluding depreciation	315.4	317.9	312.9			
Ring-fenced depreciation	26.4	20.4	22.3			
Implied Resource DEL, including depreciation[2]				*325.2*	*314.8*	*311.8*
Public sector current expenditure	**667.9**	**679.9**	**691.5**	**698.8**	**706.4**	**719.3**
CAPITAL EXPENDITURE						
Capital AME	6.5	6.3	5.1	3.4	5.5	6.0
Capital DEL	41.1	45.9	47.0			
Implied Capital DEL[2]				*50.3*	*49.2*	*51.2*
Public sector gross investment	**47.5**	**52.1**	**52.1**	**53.8**	**54.8**	**57.2**
TOTAL MANAGED EXPENDITURE[3]	**715.5**	**732.0**	**743.6**	**752.5**	**761.2**	**776.5**
Total Managed Expenditure (% GDP)	*43.5%*	*42.5%*	*41.6%*	*40.2%*	*38.9%*	*38.0%*

Memo: average annual real growth in Total Managed Expenditure (2010-11 to 2015-16): -0.7%

[1] *Budgeting totals are shown net of the OBR's forecast Allowance for Shortfall. Resource DEL excluding ring-fenced depreciation is the Treasury's primary control within resource budgets and is the basis on which Spending Review settlements are agreed. The OBR publishes public sector current expenditure in DEL and AME, and public sector gross investment in DEL and AME. A reconciliation is published by the OBR.*

[2] *Implied DELs beyond 2015-16 assume no future policy changes to AME. Departmental budgets will be set at the next Spending Review.*

[3] *The 2010-11 baseline for calculating the TME growth rate excludes in-year spending reductions announced at June Budget 2010 and departmental underspends against 2010-11 plans. The 2015-16 baseline excludes the OBR's forecast Allowance for Shortfall and the effect of all policy measures announced at Autumn Statement 2013 and Budget 2014. Following the application of this growth rate, TME from 2016-17 onwards has been reduced to take account of Budget measures: pensions revaluations and ongoing savings from reductions set out at Autumn Statement 2013*

Reform of the spending framework

4.13 The government announced at Spending Round 2013 that a cap on welfare spending will be introduced to improve spending control. Budget 2014 capped welfare spending in scope for the years 2015-16 to 2018-19 at the level of the OBR's forecast, as published in the OBR's March 2014 'Economic and fiscal outlook'. This will ensure that significant increases in spending do not go uncorrected. A forecast margin of 2% above this level will ensure that policy action is not triggered by small fluctuations in the forecast, but will not allow for discretionary policy action which breaches the level of the cap.

4.14 The welfare cap will be included in the government's 'Charter for Budget Responsibility' alongside the fiscal mandate. An updated 'Charter for Budget Responsibility' and motion for approval was laid before Parliament on 19 March 2014. The OBR will make its first assessment of performance at Autumn Statement 2014.

4.15 As set out at Autumn Statement 2013, the cap will apply to all welfare spending in AME, with the exception of the state pension and the automatic stabilisers. In future, any new lines of spending that fall within the OBR's social security or personal tax credits forecasts and impact upon Public Sector Current Expenditure (PSCE) will be presumed to be included within the cap.

Unlocking business investment

4.16 The government's ambitious programme of structural reform is creating the right environment for businesses to invest, export and grow. Corporation tax will fall to 21% in April 2014 before reaching 20% in April 2015 – the joint lowest rate in the G20. The introduction of the £2,000 Employment Allowance in April 2014 will also support businesses to grow and create jobs.

4.17 Budget 2014 announces further reforms to support investment and a sustained recovery across the UK.

4.18 To continue to support business investment, the government is doubling the annual investment allowance (AIA) to £500,000 from April 2014 until the end of 2015. This will particularly benefit small and medium sized firms. The increased AIA will mean that up to 4.9 million firms – 99.8% of businesses – will receive 100% up-front relief on their qualifying investment in plant and machinery.

4.19 To further support innovative start ups and early stage companies to invest in research and development, the government will raise the rate of R&D tax credit payable to loss making small and medium sized companies from 11% to 14.5% from April 2014. Over the next 5 years this increase will support £1.3 billion of investment in innovation.

4.20 Budget 2014 announces a package of reforms to radically reduce the costs of energy policy for business – particularly in manufacturing. This package includes capping the Carbon Price Support rate at £18 from 2016-17 to 2019-20 and providing targeted support to energy intensive industries and Combined Heat and Power plants.

4.21 To help British businesses strengthen links with high growth markets, and to go further to make the UK an attractive option for business visitors and tourists, Budget 2014 announces that the government will reform air passenger duty (APD) by abolishing bands C and D from1 April 2015. This will eliminate the two highest rates of APD charged on flights to countries over 4,000 miles from Britain, cutting tax for millions of passengers travelling to China, India, Brazil and many other emerging markets.

Supporting households

4.22 The government's long-term economic plan is underpinned by its commitment to fairness. In April 2014, the income tax personal allowance will rise to £10,000, and a typical basic rate taxpayer will pay £705 less income tax per year in cash terms than they would have paid in 2010-11. Fuel duty remains frozen for the remainder of this Parliament, saving the average motorist £11 every time they fill their tank by 2015-16.

4.23 Budget 2014 goes even further, and announces that the personal allowance will be increased to £10,500 from April 2015. This will be worth £100 to a typical basic or higher rate taxpayer (£62 in real terms), and will lead to a further 288,000 individuals no longer paying income tax. Overall, over 3.2 million people will have been lifted out of income tax by April 2015.

4.24 This increase in the personal allowance will benefit most higher rate taxpayers equally, as well as those paying only the basic rate. The government's increases to the personal allowance since 2010 have been worth £646 to a typical higher rate taxpayer in cash terms, and £805 to a typical basic rate taxpayer.

4.25 The Budget also announces that the transferable tax allowance for married couples and civil partners announced at Autumn Statement 2013 will be set at 10% of the personal allowance from 2015-16. This means it will be £1,050 in 2015-16.

4.26 The Budget announces the government will cut beer duty to take 1 penny off a pint, freeze duty on most cider, and abolish the above inflation duty escalator for wine to support community pubs; and freeze duty on spirits to support the whisky industry. It will also reduce bingo duty to 10% and raise duty on fixed odds betting terminals to 25%.

Supporting savers and greater freedom at retirement

4.27 This Budget announces radical measures to help savers at all stages of their lives, and to give people greater freedom over how they access their pension savings.

4.28 This Budget will help households to save through a package of measures for people at every stage of their lives, including introducing a New ISA (NISA) for cash and stocks and shares with a significantly raised annual limit of £15,000, abolishing the 10% savings tax rate and extending the 0% band to £5,000, and issuing new National Savings and Investments pensioner bonds.

4.29 From April 2015, the government will change the tax rules to allow people to access their defined contribution pension savings as they wish from the point of retirement. Drawdown of pension income under the new, more flexible arrangements will be taxed at marginal income tax rates rather than the current rate of 55% for full withdrawals. The tax-free pension lump sum will continue to be available. Those who continue to want the security of an annuity will be able to purchase one. Equally, those who want greater control over their finances in the short term will be able to extract all their pension savings in a lump sum. And those who do not want to purchase an annuity or withdraw their money in one go will be able to keep their pension invested and access it over time.

Ensuring individuals and businesses pay their share

4.30 As announced at Budget 2012, the government has introduced a number of new measures to discourage placing property in corporate envelopes to avoid stamp duty land tax (SDLT).These apply to residential properties valued over £2 million, and include a new higher rate of SDLT when the property is first 'enveloped'; a new Annual Tax on Enveloped Dwellings (ATED); and a capital gains tax charge on any gains on disposal of enveloped properties from April 2013.

4.31 The government believes that ATED and the associated measures can discourage the use of corporate envelopes to invest in high value UK housing which is left empty or underused while avoiding paying tax. The Budget therefore announces 2 new bands for ATED, to bring properties worth £500,000 to £1 million and £1 million to £2 million into the charge. The ATED-related capital gains tax charge will apply to properties in the new ATED bands. The 15% rate of SDLT that applies to acquisitions of properties by corporate envelopes will also be applied to properties valued above £500,000 with effect from 20 March 2014.

4.32 Tax avoidance scheme promoters must give HMRC information about schemes they promote under the Disclosure of Tax Avoidance Scheme (DOTAS) rules. Anyone using such a scheme must declare to HMRC they are using a notified tax avoidance scheme. Following consultation, this Budget announces that the government intends to extend the new requirement for taxpayers to pay upfront any disputed tax associated with schemes covered by the DOTAS rules or counteracted under the General Anti Abuse Rule (GAAR).

5 Institutional features of public finances

The fiscal policy framework

5.1 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
- 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 based on the independent forecasts of the economy and public finances, prepared by the OBR. 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. Since then the OBR has been placed on a permanent, statutory footing through the Budget Responsibility and National Audit Act 2011 (the Act), which received Royal Assent on 22 March 2011.

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

5.5 The three BRC members: Robert Chote (Chair of the OBR), Steve Nickell and Graham Parker were appointed by the Chancellor in October 2010, with the approval of the Treasury Select Committee. Steve Nickell was re-appointed for a second term of office in October 2013 and in March 2014 the Chancellor also nominated Graham Parker for re-appointment to the BRC. The non-executive members: Lord Burns and Kate Barker were appointed by the Chancellor in June 2011. In March 2014 Kate Barker was re-appointed to serve a second term of office.

Remit of the OBR

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

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

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

- an assessment on the accuracy of the previous fiscal and economic forecasts at least once each financial year
- an analysis of the sustainability of the public finances at least once each financial year

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

Transparent framework

5.9 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.

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

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

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

Fiscal objectives

5.13 To promote transparent fiscal policy-making, the new fiscal policy framework, established by the Act, introduced a requirement for the government to set out its fiscal policy objectives and fiscal mandate before Parliament in the Charter for Budget Responsibility.

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

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

The fiscal mandate and supplementary target for debt

5.15 The Budget Responsibility and National Audit Act 2011 also requires the government to set a means to achieving its fiscal objectives, its "fiscal mandate". As announced in the June 2010 Budget, the government 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 2014, the end of the forecast period was 2018-19.

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5.16 The fiscal mandate is based on:

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

5.17 The fiscal mandate is supported by a supplementary target for debt that requires public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

5.18 Complementing the fiscal framework, in Spending Review 2013 the government announced that a cap on welfare spending would be announced to improve spending control. The OBR will assess the government's performance against the welfare cap once a year alongside Autumn Statement. To support transparency and public scrutiny, the OBR will also report annualy on trends in and drivers of welfare expenditure in the scope of the cap.

5.19 The welfare cap was included in an updated Charter for Budget Responsibility and a motion for approval before Parliament on 19 March 2014. This motion was approved by the House of Commons on 26 March 2014.

5.20 Autumn Statement 2013 also announced that the government is reviewing the current fiscal policy framework. The outcome of this review will inform an updated Charter for Budget Responsibility which will be presented to Parliament alongside Autumn Statement 2014.

Accounting and Statistics

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

5.22 Information on the UK's contingent liabilities is published for all Central government departments. The publication of the first audited Whole of government Accounts (WGA), based on International Financial Reporting Standards, extends the coverage across government for the year ending 31 March 2010. A summary of publically available information on contingent liabilities is also published in the OBR's annual *Fiscal sustainability report*.

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

A OBR analysis

A.1 This annex contains analysis prepared by the Office for Budget Responsibility (OBR). The first three pieces of analysis are Chapters 3, 4 and 5 of the OBR's 2014 Economic and Fiscal Outlook. They cover in turn, the Economic Outlook, the Fiscal Outlook, and the Performance against the Government's fiscal targets. The final part of this annex is the executive summary of the OBR's 2013 Fiscal Sustainability Report.

3 Economic outlook

Introduction

3.1 This chapter:

- sets out our estimates of the amount of spare capacity in the economy and the likely growth in its productive potential (from paragraph 3.2);
- describes the key conditioning assumptions for the forecast, including monetary policy, fiscal policy, credit conditions and the world economy (from paragraph 3.26);
- sets out our short- and medium-term real GDP growth forecasts, as spare capacity is brought back into productive use (from paragraph 3.54) and the associated outlooks for inflation (from paragraph 3.65) and nominal GDP (from paragraph 3.78);
- discusses recent developments and prospects for the household, corporate, government and external sectors of the economy (from paragraph 3.84); and
- outlines risks and uncertainties associated with our forecasts and compares our central forecast to those of selected external organisations (from paragraph 3.117).

Potential output and the output gap

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

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

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

The latest estimates of the output gap

3.5 The first step in our forecast process is to assess how the current level of activity in the economy compares with the potential level consistent with stable inflation in the long term. We cannot measure the supply potential of the economy directly, but various techniques can be used to estimate it indirectly.

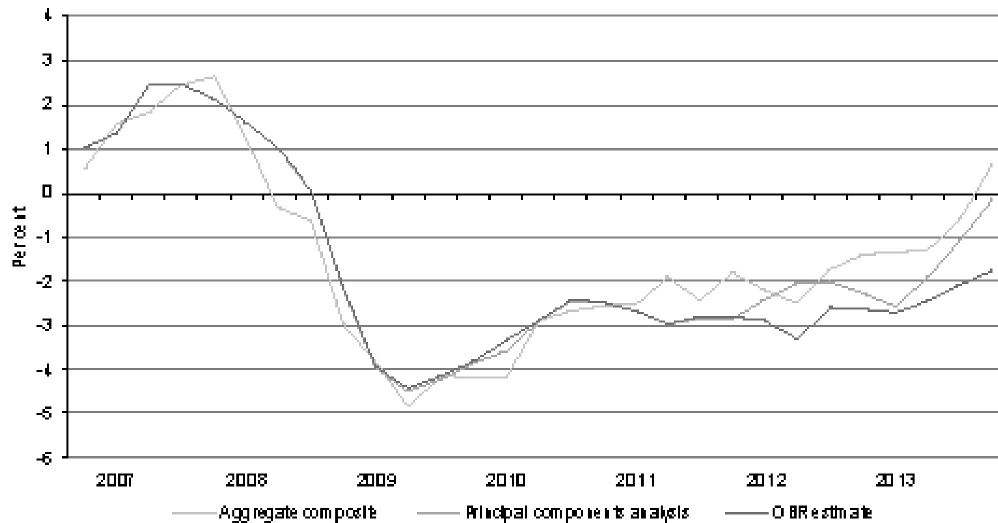
3.6 Our judgement regarding the current size of the output gap is informed by estimates of spare capacity derived from cyclical indicators, as well as other approaches. To estimate the output gap from cyclical indicators, we use two techniques: 'aggregate composite' (AC) estimates, which weight together business survey indicators; and 'principal components analysis' (PCA), which combines survey and non-survey based indicators.[1] But we also take a wide range of other evidence into account and, since our December 2012 *EFO*, we have placed less emphasis on the cyclical indicators in forming our view on the economy's supply potential.

3.7 Reflecting this, Chart 3.1 shows that our central estimate of the output gap has diverged from the PCA and AC measures since the beginning of 2012.[2] Real GDP was only slightly higher at the end of 2012 than at the beginning, but the cyclical indicators implied that the output gap had narrowed. Taking into account the growth of the workforce and capital stock, this implied a fall in potential total factor productivity (TFP) – the efficiency with which the economy could combine labour and capital to generate output.[3]

3.8 A fall in potential TFP seemed plausible in the depths of the recession, given the impact of the financial crisis on the efficient allocation of resources in the economy. But it seemed less plausible that potential TFP should start falling again in 2012 when cyclical influences seemed the better explanation of weak growth. We therefore assumed that potential TFP had remained flat over that year and made an adjustment to the output gap path consistent with that judgement.

[1] More details are set out in OBR, April 2011, Briefing Paper No.2: *Estimating the output gap*; and Pybus, T, November 2011, Working Paper No.1: *Estimating the UK's historical output gap*.
[2] Our cyclical indicator based estimates include a small number of adjustments for outliers – the BCC recruitment difficulties data in the second quarter of 2013, for example.
[3] We used a production function to estimate total factor productivity, which is described in Box 3.1 of our December 2012 *EFO*.

Chart 3.1: Estimates of the output gap



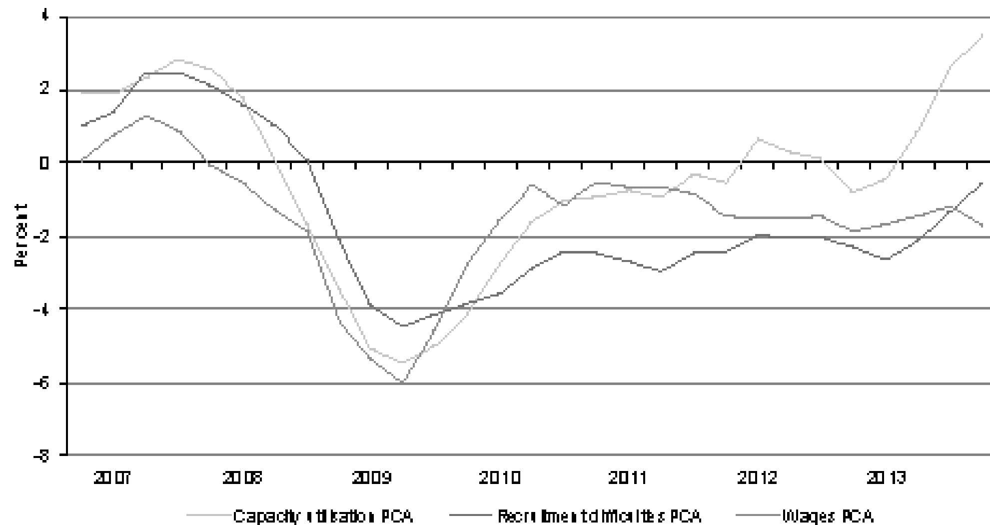
Source: OBR

3.9 It remains difficult to explain why the cyclical indicators should have pointed to such a substantial erosion of spare capacity in 2012. Our latest PCA estimates, combined with capital stock estimates and GDP data revisions, are consistent with a small widening of the output gap towards the end of 2012 and slightly positive TFP growth in the first quarter of 2013. Since then, GDP has grown much faster than we and many other forecasters expected, and the cyclical indicators point to another, sharper, narrowing of the output gap by around 2.3 per cent of GDP over the final three quarters of 2013.

3.10 To understand why the PCA output gap measure has narrowed so significantly we have looked at the disaggregated PCA series. To do so, we have taken three principal components from subsets of the data used to calculate the aggregate measure and standardised them around their sample averages (Chart 3.2). These show that firms are:

- operating at a rate of capacity utilisation typically associated with a boom;
- finding it harder to hire than in early 2013, but easier than would have been the case on average historically; and
- increasing wages at rates well below those consistent with normal levels of productivity growth and unemployment.

Chart 3.2: Principal component subsets



Source: OBR

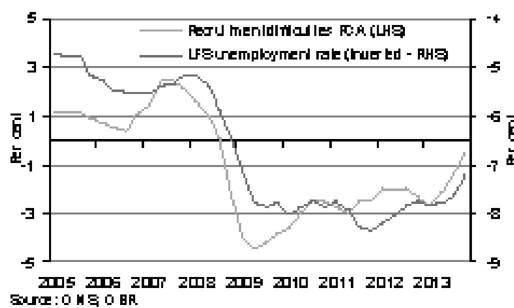
3.11 One possibility is that surveys of recruitment difficulties capture not only the level of slack in the labour market but also the pace of hiring, which may make it feel temporarily more difficult to find staff. We find some evidence of this, with both the level of unemployment and its rate of change significant in explaining the path of the recruitment difficulties principal component. Our estimates suggest that the large fall in unemployment over 2013 may explain around half of the increase in recruitment difficulties over that period. It is harder to explain why the rate of capacity utilisation within firms appears to have risen so much over 2013, but it is possible that respondents may be reporting the amount of capacity available right now, discounting mothballed capacity that could be brought online relatively quickly, though perhaps at a cost.

3.12 Real wages continue to fall. This mainly reflects the ongoing weakness of productivity growth and, in an environment of squeezed profit margins and lower inflation, it is likely that real wage adjustment will continue in the short term as firms return to a normal rate of profitability. Unemployment may also be weighing on earnings and, although a wide range of indicators point to reduced slack in the labour market, we think the survey data probably overstate the narrowing of the output gap.

3.13 The rise in employment towards the end of 2013 was bigger than we and many others expected. As it was not matched by a rise in labour supply, unemployment fell, suggesting there is somewhat less spare capacity in the labour market than we expected in December. The increase in recruitment difficulties points to a sharper narrowing than the unemployment rate suggests (Chart 3.3).

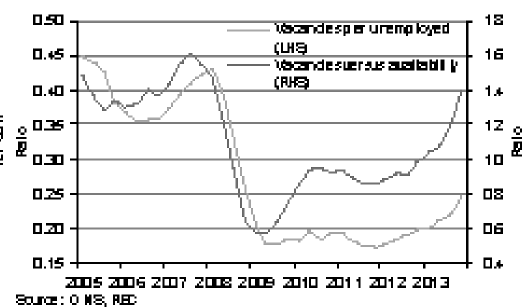
3.14 Other measures of labour market slack also point to a tightening. Chart 3.4 shows that the ratio of vacancies to the reported availability of staff from the REC report on jobs suggests ongoing but receding slack in the labour market. Similarly, the ratio of vacancies to the number of unemployed shows that, while vacancies have risen over 2013, they have done so by less than the fall in unemployment, so the pool of unemployed is smaller relative to the number of jobs available. A broad range of indicators presented by the Office for National Statistics (ONS) in its March 2014 *Economic Review* are also consistent with the output gap having narrowed over 2013, but with some spare capacity remaining in the labour market.

Chart 3.3: Labour market slack (A)



Source: ONS, OBR

Chart 3.4: Labour market slack (B)



Source: ONS, REC

3.15 Considering the balance of evidence, we now judge that the output gap was around 0.2 percentage points narrower in the final quarter of 2013 than we forecast in our December *EFO*, consistent with unemployment being around 0.2 percentage points lower than forecast and leaving the output gap at -1.7 per cent of potential GDP.

3.16 We continue to judge that the recovery in demand over 2013 was not matched by an equivalent improvement in potential supply. This assessment reflects a number of features that, beyond the growth arising from a larger population, lead us to conclude that growth has been largely cyclical:

- productivity growth remains exceptionally weak, consistent with very slow underlying TFP growth;
- the labour market appears to have tightened significantly over the second half of 2013; and
- stronger private consumption has been facilitated predominantly by lower saving rather than from higher real household incomes.

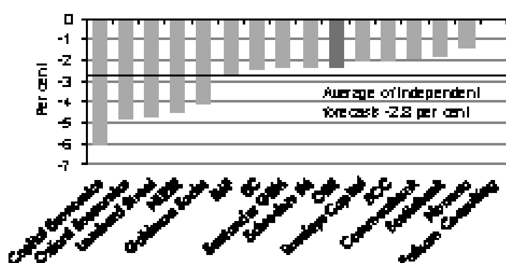
3.17 The recession and subsequent recovery have highlighted a number of difficulties associated with the always-uncertain measurement of the economy's supply potential and we are not alone in grappling with those challenges. In practice,

every method has its limitations and no approach avoids the application of judgement entirely. We intend to review our methods over the summer, ahead of our next *EFO*.

3.18 With these challenges in mind, Charts 3.5 and 3.6 compare our central output gap estimates for 2013 and 2014 to those produced by other forecasters, including those set out in the Treasury's March *Comparison of independent forecasts* and estimates produced by NIESR, the European Commission and the OECD. The average estimate is -2.8 per cent in 2013 and -2.1 per cent in 2014, wider than our central estimates of -2.2 and -1.4 per cent respectively. However, reflecting the skew of the distribution, our forecasts are closer to the median estimates of -2.3 and -1.8 per cent in 2013 and 2014 respectively.

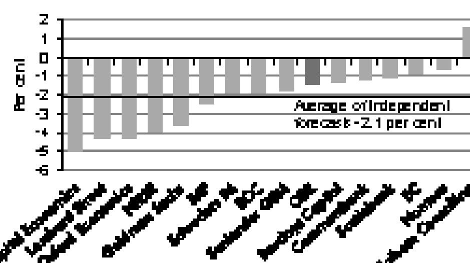
3.19 It is worth remembering that these measures could vary in their definition, so they may not be directly comparable – as discussed in Box 3.1. In Chapter 5, we test the sensitivity of our judgements regarding the Government's performance against its fiscal targets to different estimates of the output gap.

Chart 3.5: Estimates of the output gap in 2013



Source: HM Treasury, March 2014, *Forecasts for the UK economy: a comparison of independent forecasts*, plus additions or updates where known.

Chart 3.6: Estimates of the output gap in 2014



Source: see Chart 3.5

3.20 Of the -1.7 per cent output gap we estimate for the final quarter of 2013, we attribute -1.8 percentage points to the employment rate lying below its potential level and -1.9 percentage points to output-per-hour lying below potential (i.e. cyclical weakness in productivity). These are partly offset by +2.0 percentage points from average hours lying above their long-run trend decline, possibly reflecting unexpectedly weak income growth and negative wealth shocks for many households, leading them to increase labour market input temporarily.

3.21 Given that indirectly measuring the overall size of the output gap is a significant challenge, it should not be surprising that its composition is also a key area of uncertainty. Different decompositions would have different implications for the public finances, reflecting the implied split of labour income between employment, hours and wages.

Box 3.1: Spare capacity in the February 2014 *Inflation Report*

The February 2014 *Inflation Report* saw the Bank of England publish more information about its projections and increase transparency over its assessment of spare capacity. This has prompted external commentators to compare the Bank's assessment of spare capacity with our estimate of the output gap, which are both around -1½ per cent of GDP at the beginning of 2014. In making such comparisons, it is important to recognise that the Bank's estimate of economic slack is conceptually different to the one we use to adjust the fiscal position for the effects of the economic cycle.

We are interested in what might be considered a long-term measure of spare capacity, which we call the output gap. This gives an indication of where the level of output might settle once all shocks have worked their way through the economy. The Bank is more concerned with what could be called a medium-term measure of spare capacity or economic slack, which is what can be expected to influence inflation over its shorter term policy horizon.

For example, long-term unemployment picked up over the course of the recession and around a third of those currently without jobs have been without one for six months or more. To the extent that these individuals have become disconnected from the labour market, there may be less room for employment to grow before exerting upward pressure on wages, and therefore inflation. Taking this into account, the Bank currently judges that the medium-term equilibrium unemployment rate is 6 to 6½ per cent and therefore unemployment currently lies around ¾ to 1¼ percentage points above this.

But, in the fullness of time, many of the long-term unemployed are likely to find their way back into work, and spending on out-of-work benefits and receipts from income tax will come to reflect that. So to estimate the structural fiscal deficit, we need to take a longer view – we judge that the long-term structural unemployment rate is around 5¼ per cent and unemployment is around 1¾ percentage points above it. This assessment is broadly consistent with the Bank's view that the medium-term equilibrium unemployment rate will fall as demand recovers.

Similarly, average hours worked have trended downwards for as long as the ONS has recorded them and we expect this long-run decline to continue, bearing down on tax receipts. But there may be more room to expand average hours over the Bank's policy horizon without generating inflationary pressure. And while both we and the Bank expect productivity per hour to pick up as demand recovers, we see more scope for output to expand without employees putting in more hours.

So, while 'slack in the economy' sounds very much like 'output gap', it depends on the time horizon under consideration and, for this reason, our estimates and those of the Bank are not directly comparable. As it happens, both estimates currently lie at around -1½ per cent of GDP, but this masks a number of differing judgements over both where slack lies and the overall scope for growth in the medium term.

The growth of potential output

3.22 In our December *EFO*, we forecast a gradual strengthening in potential output growth over the forecast period and that remains our central judgement. The growth of potential productivity per hour remains below the rate consistent with historical trends throughout the forecast, reflecting our view that the slow pace of financial system normalisation and related pace at which resources are reallocated to more productive uses will continue to weigh on the sustainable rate of growth for some years.

3.23 While the headline potential growth rate forecast is little changed, we have made some small adjustments to its composition. We expect rising population to be a slightly bigger source of potential growth over 2014 with net migration holding up a little more than we assumed in December, but for a little less to come from productivity growth, reflecting weak actual productivity towards the end of 2013. Therefore, on a per capita basis, growth will be a little weaker. We explore the historical context of this in Box 3.2.

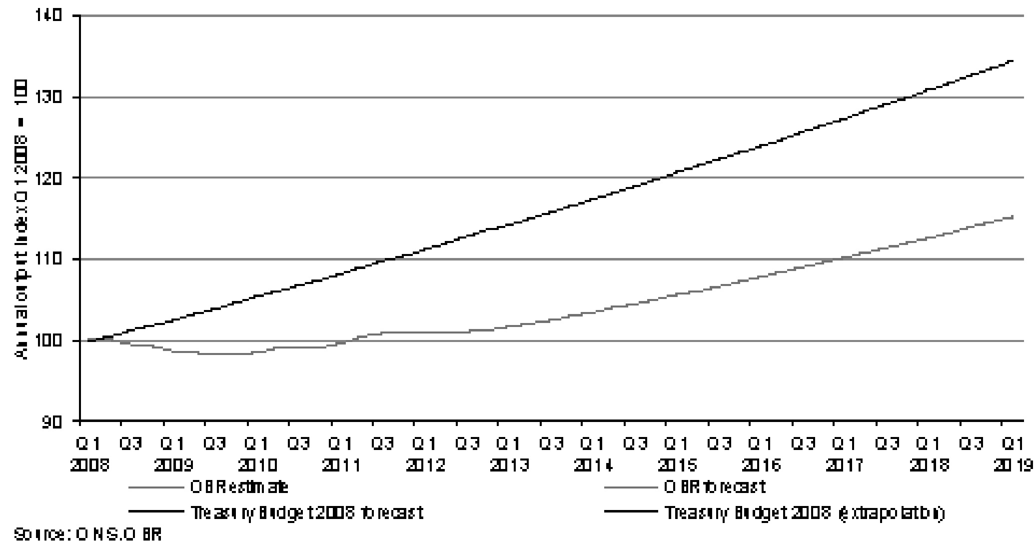
Table 3.1: Potential output growth forecast (annual growth rate, per cent)

	Potential productivity[1]	Potential average hours	Potential employment rate[2]	Potential population[2]	Potential output[3]
2013	0.6	-0.2	0.1	0.7	1.2
2014	1.4	-0.2	0.0	0.7	1.9
2015	1.7	-0.2	-0.1	0.6	2.1
2016	1.9	-0.2	-0.1	0.6	2.2
2017	2.0	-0.2	-0.1	0.5	2.2
2018	2.0	-0.2	-0.1	0.5	2.2

[1] Output per hour.
[2] Corresponding to those aged 16 and over.
[3] Components may not sum to total due to rounding.

3.24 We judge that the level of potential output in the final quarter of 2013 is around 12 per cent below the level consistent with an extrapolation of the Treasury's March 2008 Budget forecast – the last before the recession – with the difference widening by a further 2½ percentage points over the forecast period (Chart 3.7). This reflects our view that much of the loss of productivity over the recession was structural and will not return even as the economy recovers and the financial system returns to full health. Since it is difficult to explain the abrupt fall and persistent weakness of productivity in recent years, it is also hard to judge when or if productivity growth will return to the rate consistent with historical trends – Box 3.2 illustrates that recent developments are without precedent.

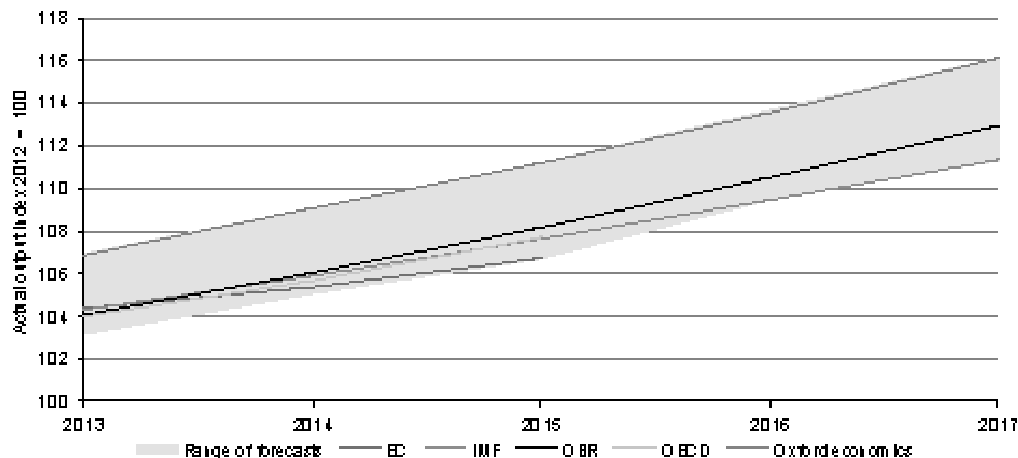
Chart 3.7: Potential output relative to the Treasury's Budget 2008 forecast



Source: ONS, OBR

3.25 Chart 3.8 presents our potential output projection alongside those of external forecasters that publish similar projections. It shows that we, the IMF and the OECD have made similar judgements over the margin of spare capacity in 2013 and forecast a similar growth rate of potential output in 2014. Thereafter, we expect potential to grow a little faster than the IMF and OECD. The range presented in the chart illustrates the uncertainty surrounding this crucial judgement – we test the sensitivity of the Government's fiscal mandate to it in Chapter 5.

Chart 3.8: Potential output forecasts



Source: OBR; OECD, November 2013, *Economic Outlook*; European Commission, February 2014, *Winter European Economic Forecast*; IMF, October 2013, *World Economic Outlook*; HM Treasury, March 2014, *Forecasts for the UK economy: A comparison of independent forecasts*. Range of forecasters includes Commerzbank, Goldman Sachs, Nomura and Oxford Economics - constructed using GDP growth and output gap forecasts (not all forecasters present forecasts for all years).

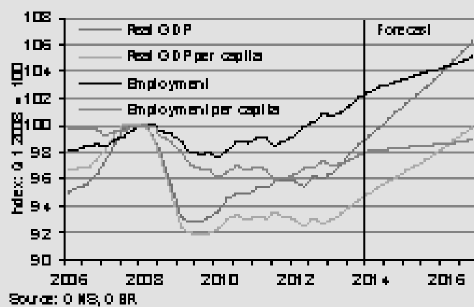
Box 3.2: GDP per capita and productivity

Since the beginning of 2010, real GDP has risen by around 5¼ per cent and 1.3 million more people are in work. But the population aged 16 and older has grown by 1.4 million and so GDP per capita on this basis has grown by just 2½ per cent, remaining 5½ per cent below its pre-crisis peak. Likewise, real per capita consumption has fared far worse than aggregate consumer spending and remains 5½ per cent lower than before the crisis. Similarly, while employment now exceeds its pre-crisis level, the proportion of the population employed does not.

Fundamentally, GDP per capita cannot be expected to grow sustainably unless productivity grows and productivity has been exceptionally weak in the recent past. We expect recent trends to become less dominant – population growth is forecast to slow and productivity growth to pick up. Chart A shows that we expect the economy to be bigger than it was before the crisis by mid-2014, but we do not expect GDP per capita to reach its pre-crisis peak until early 2017.

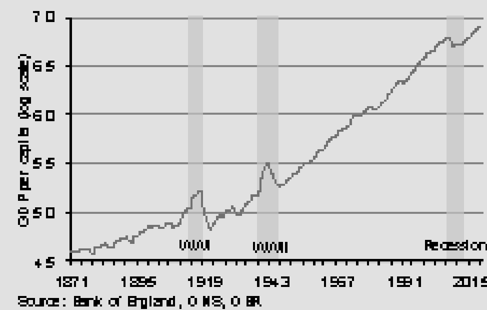
The uncertainty over this judgement is highlighted in Chart B, which shows that the recent persistent shortfall of per capita GDP is without peace-time historical precedent. It seems reasonable to us that the rate of productivity growth should return to historical norms, but, without the past as a useful guide, it is difficult to judge how long this might take.

Chart A: Real GDP and employment[a]



Source: ONS, OBR

Chart B: Real GDP per capita[b]



Source: Bank of England, ONS, OBR

Even the judgement that efficiency improvements will resume is subject to extensive debate among external commentators. Some believe the financial crisis of 2008 coincided with a permanent slowdown in productivity growth, perhaps reflecting the exhaustion of 'low-hanging fruit' efficiency gains in the IT sector.[c] Others are more optimistic, assuming efficiency gains have continued apace but that weak demand is masking the process.[d]

Our central judgement lies between these two views. We expect productivity growth to return to its historical average as the pace at which resources are reallocated to more productive uses picks up, but with the level of productivity, and therefore per capita GDP, permanently lower relative to its pre-crisis trend. This judgement is subject to significant risks in both directions.

[a] Population on age 16+ basis.
[b] Total population basis.
[c] Gordon, R, 2012, NBER Working Paper: *Is economic growth over? Faltering innovation confronts the six headwinds*.
[d] Martin, B. & Rowthorn, R, 2012, CBR Working Paper: *Is the British economy supply constrained II?*

Key economy forecast assumptions

Monetary policy

3.26 Our forecast assumes that the Bank of England will endeavour to bring inflation to target over its forecast horizon, consistent with the Monetary Policy Committee (MPC) remit set by the Chancellor. Since our December *EFO*, the Bank has provided further guidance on the broader assessment of spare capacity in the economy that will guide policy once its unemployment threshold of 7 per cent has been reached. The February *Inflation Report* stated that "*the MPC will seek to close the spare capacity in the economy over the next two to three years while keeping inflation close to the target. To that end, it judges that there is scope for the economy to recover further before Bank Rate is raised and, even when Bank Rate does rise, it is expected to do so only gradually and to a level materially below its pre-crisis average of 5 per cent.*"[4] The impact of this guidance should be captured in the market-derived interest rate expectations on which we condition our forecast.

3.27 In November 2013, further changes were announced to the Funding for Lending Scheme (FLS), reorienting the scheme towards SME lending. Since the changes have come into effect, there has been little effect on bank funding costs, consistent with our December forecast judgement.

Fiscal policy and Budget measures

3.28 Applying the multipliers we have used in previous forecasts to the latest estimates of the fiscal consolidation produced by the Institute for Fiscal Studies (IFS) would suggest that consolidation measures announced since 2008 have reduced the level of GDP by around 1.7 per cent in 2012-13. When taken together with estimated underspends by central government, they imply a positive impact on GDP growth in both 2013-14 and 2014-15 of 0.2 percentage points, as the effects of previous tightening fade a little faster than new tightening bears down on GDP. There is significant uncertainty associated with such estimates. As set out in Box 3.3, the net effect on GDP of measures announced in Budget 2014, which is fiscally neutral over the forecast period, is expected to be negligible.

[4] Bank of England, February 2014, *Inflation Report*, page 7.

Box 3.3: The economic effects of policy measures

This box considers the possible effects on the economy of policy measures announced in Budget 2014. More details of each measure are set out in the Treasury's Budget document and our assessment of the fiscal implications can be found in Chapter 4.

The Government has announced a number of measures between 2014-15 and 2018-19 that are expected to have a neutral fiscal impact, with 'giveaways' offsetting 'takeaways' over this period. Using the same multipliers that the interim OBR used in June 2010, these measures are expected to have a negligible effect on annual GDP growth and have no effect on our GDP forecast. Given the relatively small size of these measures, using larger multipliers would not change this conclusion.

The Government has adjusted its assumption for the growth of Total Managed Expenditure beyond 2015-16 and reduced spending further on top of that change. The overall effect of these changes leaves spending as a share of GDP little changed from our December forecast. Within total spending, the level of implied resource DEL, the key input into our economy forecast, is little changed from our December forecast: so nominal government consumption is expected to be just 0.4 per cent higher by 2018-19 than in December. At that time horizon, we assume any change affects the composition of GDP rather than the level, as monetary policy is assumed to determine the overall amount of spending in the economy.

We have examined measures that could directly affect the price level. Changes to air passenger duty bands, alcohol duty, tobacco duty and the lower trajectory of the Carbon Price Floor are expected to have very small and offsetting effects on inflation.

The Government has announced that the temporary increase in the Annual Investment Allowance will be extended for a further year, to December 2015, and increased to £500,000. This is likely to induce some firms to bring forward investment spending. Although all firms investing over £25,000 in plant and machinery qualifying for capital allowances will benefit, it is worth noting that only around 9 per cent of qualifying investment is spent by firms investing within the relevant threshold (and thus having the greatest incentive to bring forward investment). We have assumed that this measure leads to a total of just under £1 billion of business investment being brought forward from 2016 and 2017 into 2014 and 2015, based on the temporary effect of the measure on the cost of capital and the cash flow effect of the allowance. This is a small change relative to the size of the economy, so has a negligible effect on real GDP growth. As this is a temporary measure, it has no effect on the long-run cost of

capital, and so the level of investment by the end of the forecast is unchanged.

The Government's decision to increase the personal allowance could affect the labour supply decision of individuals at the margin – the higher personal allowance increases the reward to work. But given the small size of these potential effects we have not made any explicit adjustments to our forecast.

The Government has announced a package of savings and pensions measures. They include raising and equalising the limits for both cash ISAs and stocks and shares ISAs to one overall limit of £15,000; reducing tax on the first band of savings income from 10 per cent to zero and extending that band to £5,000; and the introduction of an attractively-priced National Savings and Investments (NS&I) product for pensioners. The Government has also announced a number of tax measures that increase the flexibility with which individuals can access their defined contribution pension assets.

It is likely that such measures will affect the composition of households' financial and non-financial assets, as households reallocate assets to benefit from the different tax treatments. By reducing the extent to which the tax system discourages the withdrawal of pension saving, for example, it is possible that funds will be redirected from annuities into other assets, such as other financial products or housing. Some people will temporarily increase pension saving in order to benefit from tax-free lump sum withdrawals. It is also possible that such funds could be used to finance consumption, although such effects are likely to be small. The scale and timing of such effects are subject to very considerable uncertainty, not least because households are able to shift very large deposit balances over relatively short timeframes (see Box 3.4). As we consider the principal effect of these measures will be on the composition of household assets, rather than aggregate flow of saving or spending, we have not adjusted our forecast for these measures.

The Government has announced that it will extend the equity loan element of the Help to Buy scheme from 2016-17. At this horizon, with the economy and financial system expected to have recovered further, we have not assumed any additional effect from the extension of the scheme. To the extent that any lending associated with this extension is additional, the measure would help to support our forecast for relatively strong rates of residential investment growth and the return of property transactions back toward a historical trend relative to the housing stock.

Credit conditions

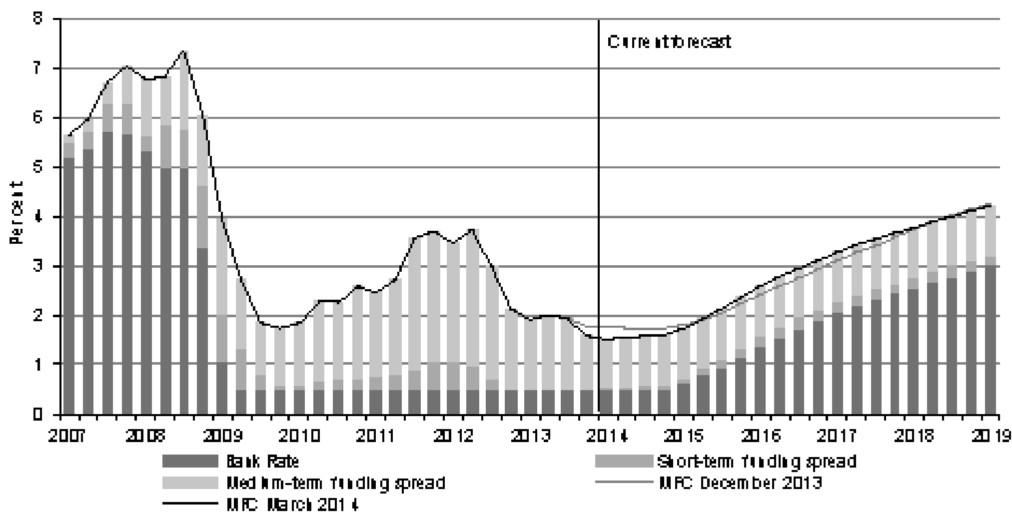
3.29 Domestic financial and credit market conditions continue to improve. Better prospects for the euro area financial system, reduced uncertainty over the path of fiscal policy in the US, the strengthening of the UK economy and availability of the FLS have all helped to lower perceived risks to UK banks' balance sheets and

contain funding costs.[5] We assume the current, relatively benign, environment for bank funding will be sustained across the forecast period. Risks around this assumption are tested in the scenarios presented in Chapter 5.

The price of credit

3.30 With spreads stable, we do not expect banks' variable-rate funding costs (the benchmark for new variable-rate mortgages) to rise until early-2015, when markets expect the first Bank Rate rise (Chart 3.9). Costs then rise gradually, consistent with a gradual normalisation of monetary policy. Relative to our December forecast, higher Bank Rate expectations have been offset by lower medium-term spreads and so the outlook is little changed. However, swap rates – a benchmark for new fixed-rate mortgages – have already started to rise, reflecting market expectations for future Bank Rate rises (Chart 3.10). This may push up interest rates on new fixed-rate mortgages sooner than variable-rate mortgages.

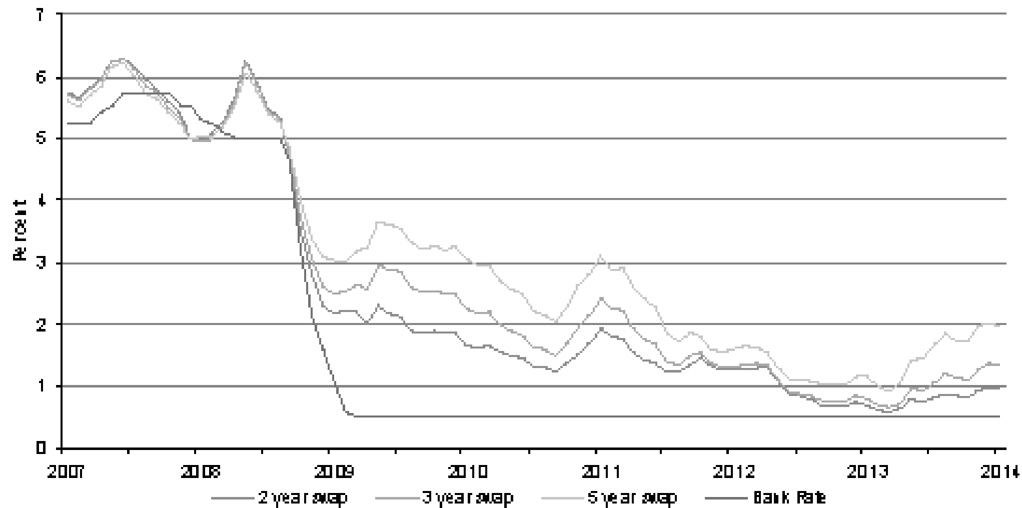
Chart 3.9: Banks' marginal funding costs



Source: Bank of England, Thomson Reuters Datastream, OBR

[5] The latest Bank of England systemic risk survey shows that the perceived probability of a high impact event in the UK financial system has fallen to its lowest level since the survey began in 2008.

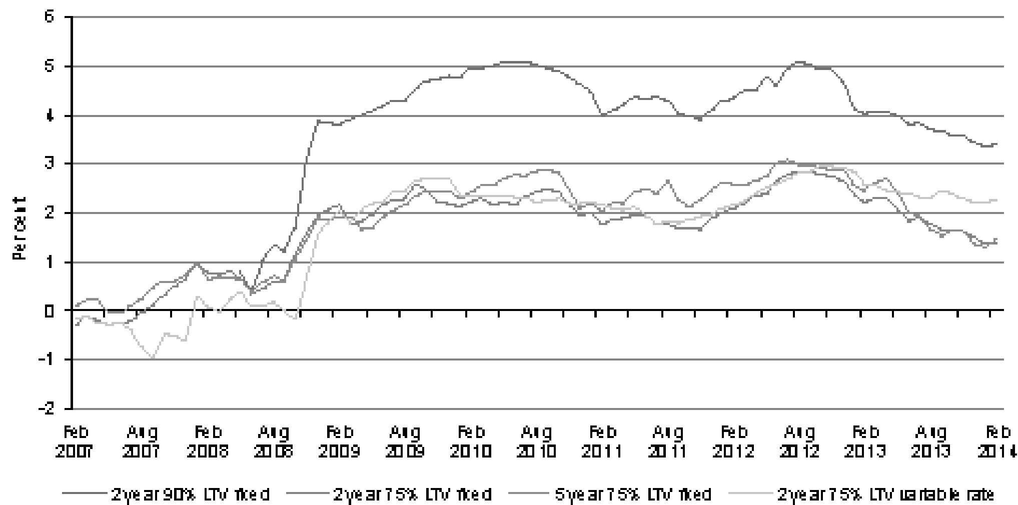
Chart 3.10: Market interest rates



Source: Bank of England, Bloomberg

3.31 Lower bank funding costs continue to feed through to lower lending rates and easier access to credit for customers, particularly for mortgages. The revival in the housing market, together with the Government's Help to Buy scheme, may also have pushed down on mortgage rates (Chart 3.11). We expect competition between lenders to further squeeze profit margins on high-LTV mortgages.

Chart 3.11: Spreads on average quoted mortgage rates



Source: Bank of England, Bloomberg

3.32 Although new mortgage rates have fallen rapidly since mid-2012, the effective interest rate paid on the stock of all UK mortgages has fallen by less. This is because the amount of new lending is much smaller than the stock – terms on existing mortgages are revised only when contracts expire, usually every 2 to 3 years. For the same reason, the combination of gradually maturing mortgage contracts, competitive pressure on margins and the lagged effect of previous falls in new mortgage rates means that effective mortgage rates will rise more slowly than Bank Rate over the forecast period.

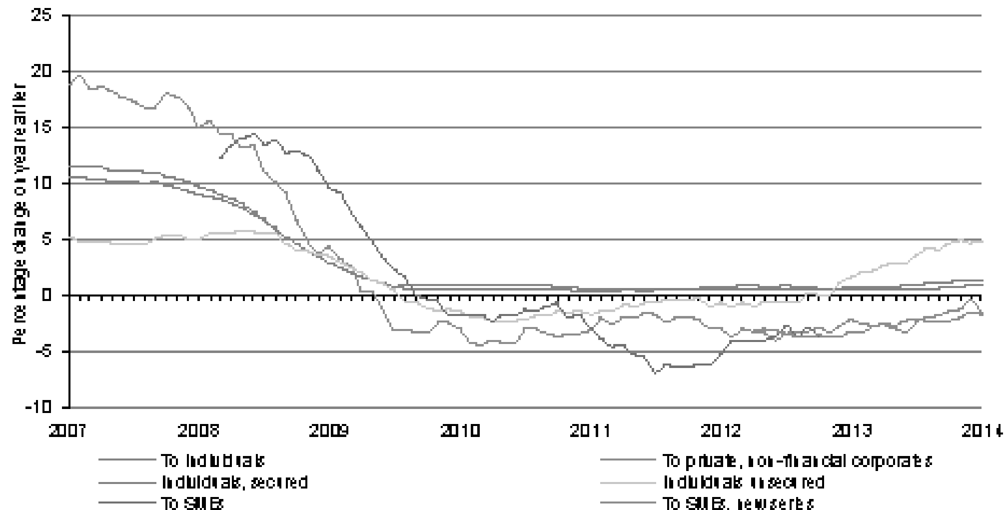
3.33 Interest rates on business loans vary much more than mortgage rates because companies have a wider range of characteristics relevant to lending decisions than households. In aggregate, businesses appear to have benefitted much less from the improvement in bank funding conditions than households. Loan interest rates for small businesses (SMEs) have fallen slightly in recent months on some measures, but other survey-based measures are more equivocal.[6] Overall, we expect the spread of corporate loan rates over reference rates to narrow over the forecast, as profitability and perceptions of creditworthiness improve.

The flow of credit

3.34 Household borrowing continues to pick up, reflecting rising house prices and housing market turnover. Gross new secured borrowing, which primarily consists of mortgages, has risen by nearly 50 per cent since mid-2012 and the introduction of the FLS, although much of this appears to have been offset by repayments (see Box 3.4). We expect net secured lending to grow over the forecast period as house prices rise and the number of first-time buyers increases, supported by Help to Buy, with some moderating effect from the implementation of stricter Mortgage Market Review rules from April 2014.[7]

[6] Bank of England, January 2014, *Trends in Lending*.
[7] A key effect will be the application of affordability tests to new mortgagors by lenders (rather than intermediaries) based on the outlook of interest rates for the next five years, proven income and committed/essential expenditure.

Chart 3.12: Net lending to the wider economy



Source: Bank of England

3.35 The growth of net unsecured borrowing has picked up, boosted by loans for car purchase. To the extent that growth in car finance is linked to compensation related to payment protection insurance (PPI) mis-selling (which has reportedly provided some households with enough cash for a deposit), the growth of unsecured lending may slow as the flow of PPI claims tails off.[6] But most household debt is secured against houses, so this will have little impact on the overall stock of household debt over the forecast period.

3.36 Bank lending to non-financial companies continues to fall, although at a slowing annual rate (Chart 3.12). Large corporates continue to choose non-bank sources of funds: favourable wholesale market conditions have encouraged strong net issuance of bonds. Recent improvements in loan spreads, fees and availability of bank credit, and further improvements expected in the near term, suggest stronger demand for and supply of loans to corporates in 2014.

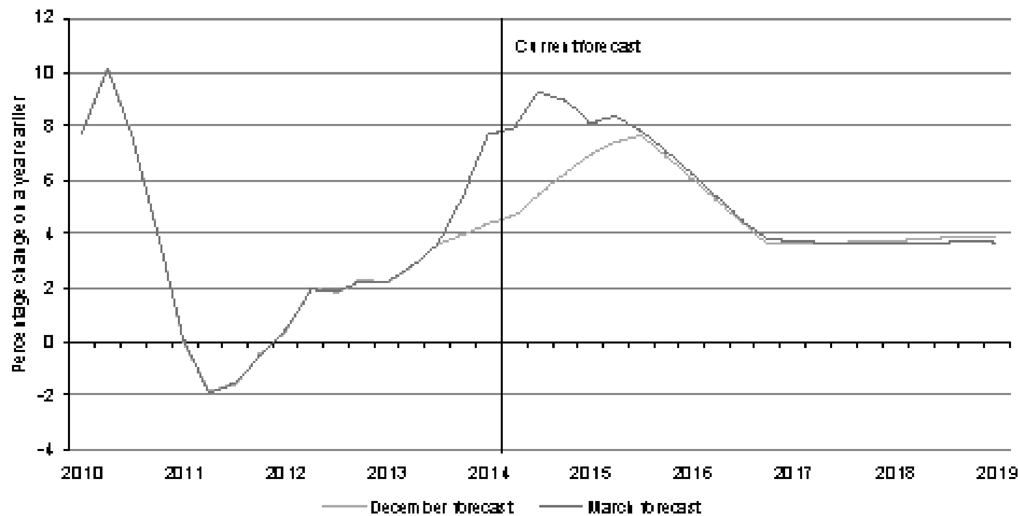
3.37 Lending to small businesses remains weak. Credit availability has been slower to improve than for mid-size and large corporates, with little movement in loan spreads.[7] But both demand and supply are expected to pick up, given improvements in the economy and changes to the terms of the FLS to refocus it towards SME lending.

[6] Bank provisions currently amount to around £19 billion; with £13.5 billion already paid out, we assume the flow will taper off in 2015.
[7] Bank of England, Q4 2013 Credit Conditions Survey.

House prices

3.38 House prices have continued to accelerate since our December forecast, with annual growth reaching 5.5 per cent in December 2013. Market indicators, including other house price indices, suggest further acceleration through the first quarter of 2014. We expect this momentum to carry on through the early years of the forecast. Relative to our December forecast, there is no additional pressure from the fundamentals of housing demand or supply, given little change to our outlook for real incomes or residential investment. We therefore expect house price growth to peak higher and earlier than in our December forecast, at 9.2 per cent in the third quarter of 2014, with prices rising by around 30 per cent by 2018-19. By the end of the forecast period, house prices are expected to be 0.5 per cent below their pre-crisis peak in real terms and the house price to income ratio to be 2.3 per cent below its pre-crisis peak.

Chart 3.13: House price inflation forecast



Source: ONS, OBR

Box 3.4: Bank deposits, mortgage lending and the housing recovery

In 2013, households' balances in 'time deposit' accounts (savings with fixed maturity) fell by £36 billion. This has been interpreted by some as consumers drawing down their savings to finance consumption. Households can use their savings in many ways – to reduce debt, buy different assets (such as houses) or indeed to fund current consumption – but it is impossible to know which from aggregated data.

We find a more likely answer in the wider picture of household savings behaviour. While some deposit balances have been falling, others have been rising: deposits in 'sight' accounts (with no restriction on access, for example current accounts) have increased rapidly and household deposits as a whole have continued to rise (Chart C). This shift in composition could be explained by the narrowing spread between 'time' and 'sight' deposit interest rates. Or this could be a normalisation of household investment behaviour: the split of total deposits between 'time' and 'sight' has now returned to pre-crisis levels.

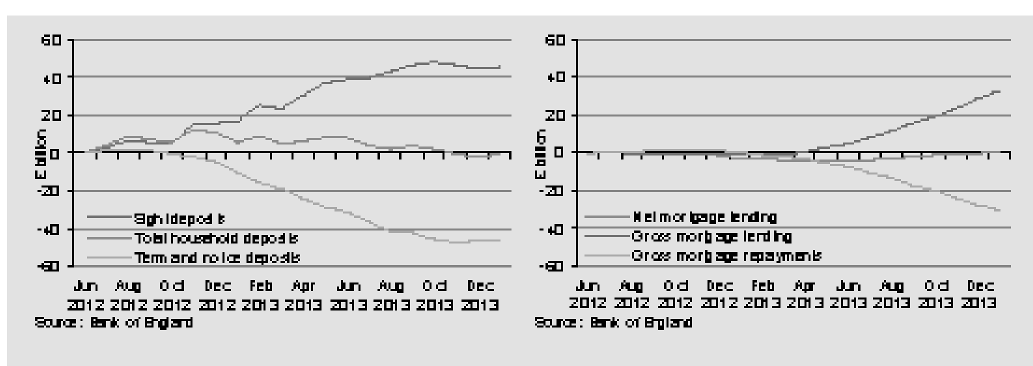
The revival of the housing market could also affect switching between deposit types: some households could be withdrawing savings built up after the crisis and, with borrowing conditions easing, using them as down-payments on house purchases. At the other end of the transaction, sellers are paying off their mortgage and initially depositing the proceeds as 'sight' deposits.

Greater housing market activity could also be contributing to the overall strength of deposit growth. The recent pick-up in property transactions and prices has been matched by strong growth in new mortgage lending, but mostly offset by mortgage repayments, as sellers pay off their mortgages (Chart D). Net mortgage lending has also started to rise, contributing to the overall stock of deposits. Remortgaging, the engine of equity withdrawal and deposit growth before the financial crisis, remains subdued. Continued housing market recovery will lead to more debt and deposit growth.

An important conclusion that can be drawn from these developments is that households are able to shift very large deposit balances over relatively short timeframes. This is one reason why the impact of the policy measures discussed in Box 3.3 is subject to considerable uncertainty.

Chart C: Cumulative change in annual deposit flows

Chart D: Cumulative change in annual mortgage flows



World economy

3.39 World output grew by 3.1 per cent in 2012 and appears to have slowed thereafter to 2.9 per cent in 2013. Stronger performance in advanced economies in the second half of 2013 has been offset by weaker growth for some emerging market economies, partly reflecting tighter financial conditions. Recent survey evidence suggests strong global output growth in the first quarter of 2014. For example, the JP Morgan *Global Manufacturing PMI* is at the highest level since May 2011, showing expansion across the euro area, US and Japan. Surveys in China have weakened since the start of 2014.

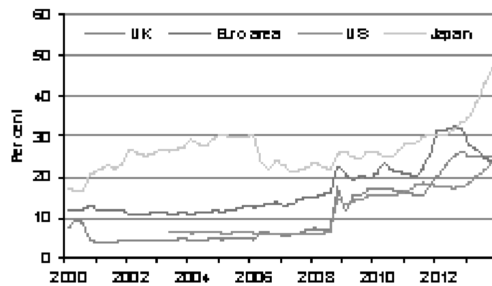
3.40 The euro area economy contracted by 0.4 per cent in 2013 as a whole, but much of this reflects weak growth at the end of 2012, with GDP having expanded by 0.7 per cent in the final three quarters of 2013. Growth of 0.3 per cent in the final quarter was broad based across core and periphery countries, which has been reflected in sovereign bond yields falling steadily in periphery countries. The pace of fiscal tightening is set to ease in 2014. Some cyclical momentum and the steady return of confidence are reflected in our forecast of 1.0 per cent growth in 2014 and 1.4 per cent growth in 2015, up 0.2 and 0.1 percentage points respectively from our December forecast.

3.41 Considerable downside risks remain to the outlook for the euro area, including the extent to which lower sovereign bond yields are passed through to the private sector, and ongoing adjustments to competitiveness and institutional reform continue. Persistently low inflation and the possibility of deflation in the euro area also remain a risk to the global and UK outlook. Euro area core inflation in January was 0.8 per cent (consumer price inflation excluding food and energy is shown in Chart 3.15). Since January 2013, inflation has fallen well below the European Central Bank's inflation target of below but close to 2 per cent and a number of euro area countries are experiencing deflation. Unemployment in the euro area has been steady at 12 per cent in recent months.

3.42 The ECB staff projections published in March 2014 show inflation at 1.3 per cent and the unemployment rate at 11.7 per cent in 2015. Meanwhile the ECB's balance sheet is shrinking (Chart 3.14). In particular, since December 2013, banks

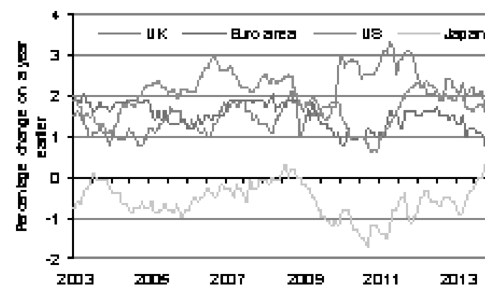
have repaid loans made from long-term refinancing operations. This contrasts with further expansion of central bank balance sheets in the US and Japan, and no change in the UK.

Chart 3.14: Central bank balance sheets as a share of nominal GDP



Source: European Commission, Thomson Reuters Datastream

Chart 3.15: Inflation excluding food and energy prices



Source: Thomson Reuters Datastream

3.43 Ongoing weakness in the region has had a wider effect on the UK economy as the EU is the UK's largest export market. The volume of non-oil goods exports from the UK to the EU was unchanged between 2012 and 2013, while the volume of non-oil goods exports to the rest of the world increased by 1.2 per cent over the same period. Detailed ONS data for foreign direct investment in 2012 show that the fall in the rate of return on UK-owned investments abroad is to some extent driven by euro area weakness.

3.44 The US economy grew by 1.9 per cent in 2013, with strong momentum through the second half of the year. A budget deal was reached by the US Congress in December 2013, which eased the programme of government spending cuts and tax rises planned for 2014. As a result, we have revised up our forecast for US growth in 2014 to 3.0 per cent. The US central bank has slowed the pace of asset purchases under its QE programme.

3.45 Since our December forecast, some emerging market economies have experienced significant capital outflows and accompanying currency depreciations, triggered partly by US monetary policy. This volatility seems to reflect country-specific factors, rather than broad-based capital outflows, but other as yet unaffected emerging economies with large current account deficits and high inflation remain at risk. Our forecast for emerging markets assumes that the impact of the recent instability is short lived. Downside risks remain, as described by the IMF: *"a persistent tightening of financial conditions [from emerging market financial volatility] could undercut investment and growth in some countries"*.[10]

3.46 China's economy grew by 7.7 per cent in 2013. With strong growth in the final quarter, we have raised our forecast for China's GDP growth in 2014 slightly.

[10] IMF, February 2014, *Global prospects and policy challenges*.

Recently, there have been concerns that momentum in the Chinese economy may be slowing and about risks in the Chinese financial system, and the extent to which policy makers can offset such developments. This is likely to have contributed to the instability in emerging market financial conditions and global commodity prices.

3.47 The recent crisis in Ukraine and the impact on financial markets in Russia has not yet had much direct effect on global economic activity. At the time of closing down our forecast, there had only been a small impact on global commodity prices, which have also been affected by other factors (including developments in China). A prolonged crisis, or an escalation of tensions, could have a larger effect on global commodity prices and growth prospects.

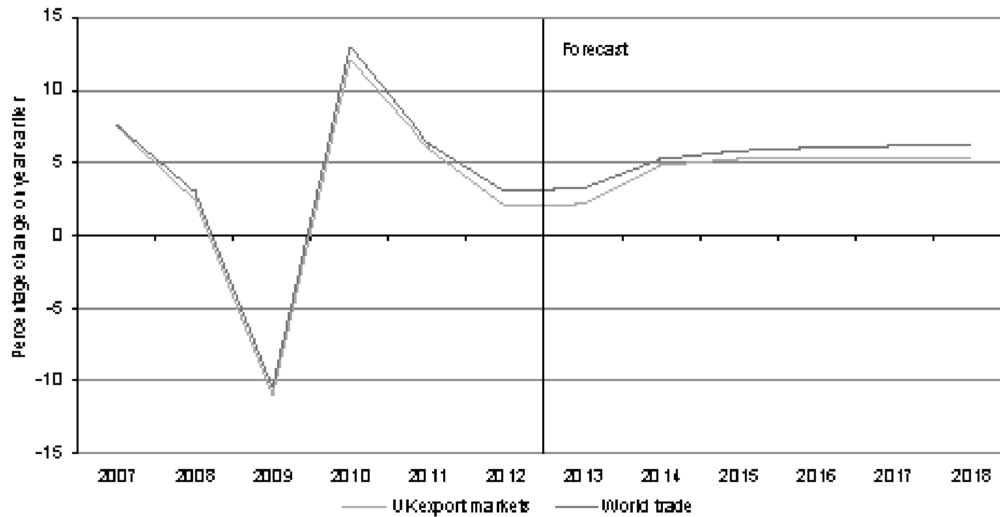
3.48 We explore the potential impact of global risks affecting the price of credit in the UK in our scenarios in Chapter 5.

World trade

3.49 Historic world trade data have been revised up since 2010. But world trade in the second and third quarter of 2013 is estimated to have been slightly weaker than our December forecast. Within the euro area, weaker trade in core countries was partly offset by much stronger trade in the periphery. Similarly, mixed outturns across emerging market economies have broadly offset one another. Overall, the changes have increased our estimate of world trade growth in 2013 by 0.4 percentage points to 3.2 per cent. But the weakness in the most recent trade data has led us to reduce our forecast for world trade growth in 2014 by 0.2 percentage points to 5.2 per cent.

3.50 Growth in UK export markets is expected to be slower than growth in world trade (see Chart 3.16). This is because slower-growing economies, such as the euro area and the US, make up a larger share of UK exports. We have revised our forecast for growth in UK export markets in 2014 down by 0.1 percentage point to 4.7 per cent. From 2015 onwards, our forecast is unchanged from our December *EFO*.

Chart 3.16: World trade and UK export market weighted trade growth

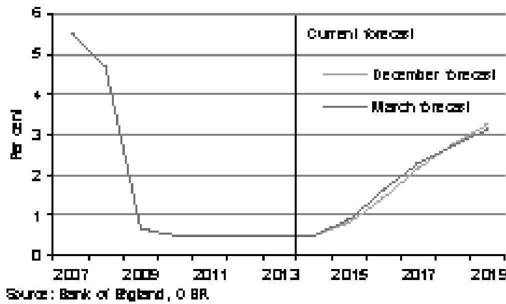


Source: OECD, ONS, OBR

Other conditioning assumptions

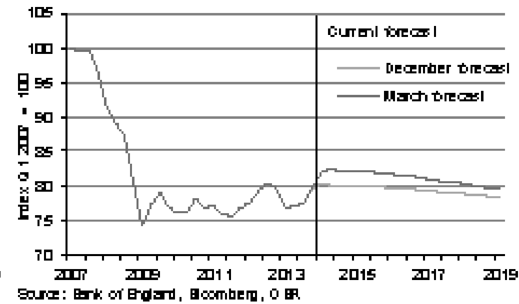
3.51 We use conditioning assumptions for interest rates, the exchange rate, oil prices and equity prices. The following charts show the assumptions used in this *EFO* and how they have moved since our December *EFO*. The only methodological change we have made since the December forecast has been to switch from Bloomberg data to Bank of England data for market-derived Bank Rate expectations.

Chart 3.17: Bank Rate assumption



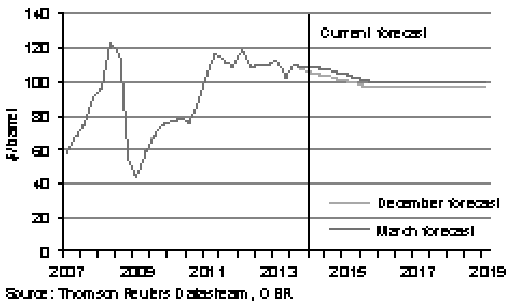
Source: Bank of England, OBR

Chart 3.18: Sterling effective exchange rate assumption



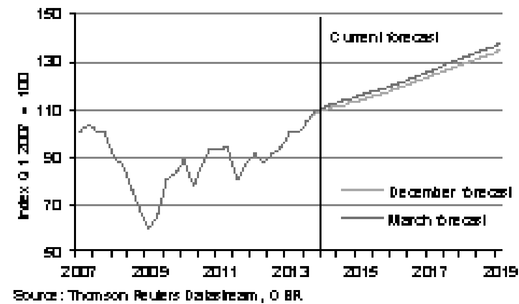
Source: Bank of England, Bloomberg, OBR

Chart 3.19: Oil price assumption



Source: Thomson Reuters Datastream, OBR

Chart 3.20: Equity prices assumption



Source: Thomson Reuters Datastream, OBR

Summary

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

- monetary policy remains very loose and does not begin to tighten until early-2015;
- fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past three years;
- the measures announced in this Budget have a negligible overall impact on demand and CPI inflation, though they are expected to bring forward some business investment;
- credit conditions and the financial system continue to normalise gradually;
- global activity and demand for UK exports picks up steadily, albeit slightly more slowly in the near term than expected in December; and
- financial markets are broadly stable and commodity prices ease a little.

3.53 Risks and uncertainties associated with these assumptions and other facets of the forecast are discussed from paragraph 3.117.

The pace of the recovery

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

The short-term outlook for GDP

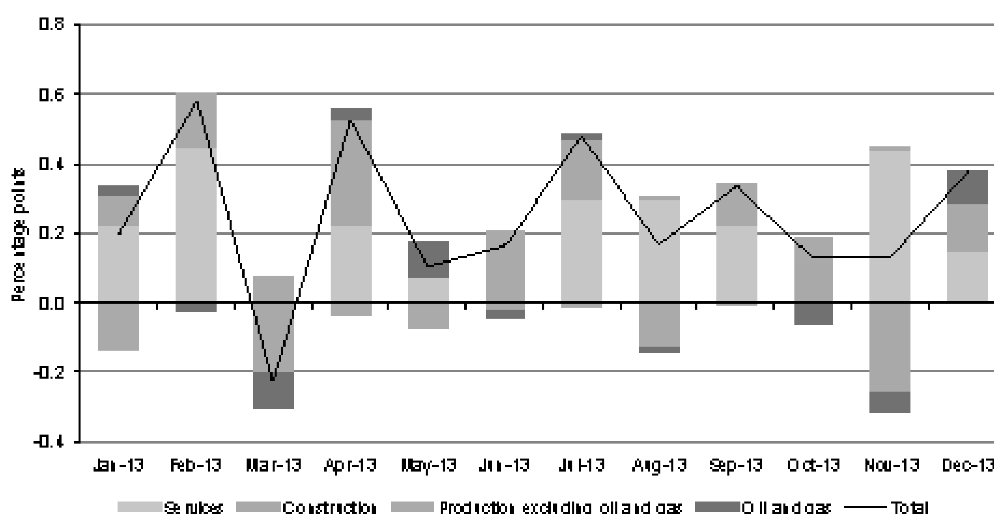
3.55 The economy grew by 0.7 per cent in the final quarter of 2013, in line with our December forecast. As discussed in Chapter 2, since our December forecast the ONS have revised GDP growth back to the start of 2012. As a result, the latest data show GDP grew by 1.8 per cent in 2013, higher than our forecast of 1.4 per cent in December.

3.56 On a monthly basis, Chart 3.21 shows steady contributions to growth from the service sector in the second half of 2013, but more volatile contributions from the construction and production industries. The construction industry makes up just 6 per cent of GDP, yet can drive large changes in monthly output growth, as seen from October to December.

3.57 Chart 3.21 shows all sectors contributing positively in December, pointing to momentum being carried into 2014. We therefore forecast growth in the first quarter of 0.7 per cent, 0.2 percentage points higher than our December forecast (Table 3.2), and growth in the second quarter of 0.6 per cent.

3.58 Recent flooding across various parts of the UK is likely to have had an impact on activity in the affected regions. The Markit/CIPS *Purchasing Managers' Index* for construction showed an easing in construction output growth in February, attributed to disruptions to house building activity from the adverse weather conditions. However, construction work resulting from flood relief and repairs and maintenance of infrastructure and buildings are also reported to have risen. As a result, we expect the net impact of the flooding on GDP growth in the first quarter of 2014 to be small.

Chart 3.21: Contributions to monthly output growth in 2013



Source: ONS, OBR

Table 3.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
March forecast[1]	0.0	-0.4	0.8	-0.1	0.4	0.7	0.8	0.7	0.7	0.6	0.6	0.6
December forecast[2]	0.0	-0.5	0.6	-0.3	0.4	0.7	0.8	0.7	0.5	0.5	0.5	0.5
Change[3]	*0.0*	*0.0*	*0.2*	*0.2*	*0.0*	*0.1*	*0.0*	*0.0*	*0.2*	*0.1*	*0.0*	*0.1*

[1] Forecast from first quarter of 2014.
[2] Forecast from fourth quarter of 2013.
[3] Changes may not sum due to rounding.

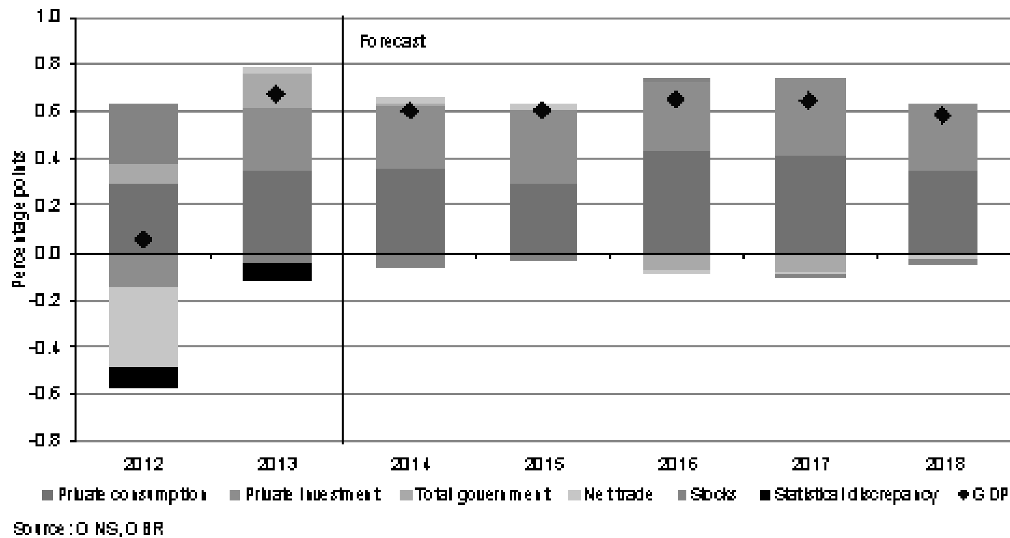
The medium-term outlook for GDP

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

3.60 Activity picked up sharply in 2013. Having averaged 0.1 per cent in 2012, quarterly GDP growth picked up to an average of 0.7 per cent in 2013, accounted for by relatively strong growth of consumer spending and, on the latest estimates, investment. The ongoing weakness of productivity, real incomes and UK export markets over this period make it difficult to explain why activity has picked up as strongly as it has, although general improvements in credit conditions and confidence releasing pent-up demand, the gathering pace in the housing market

and a smaller drag from the fiscal consolidation may all have provided some support to growth.

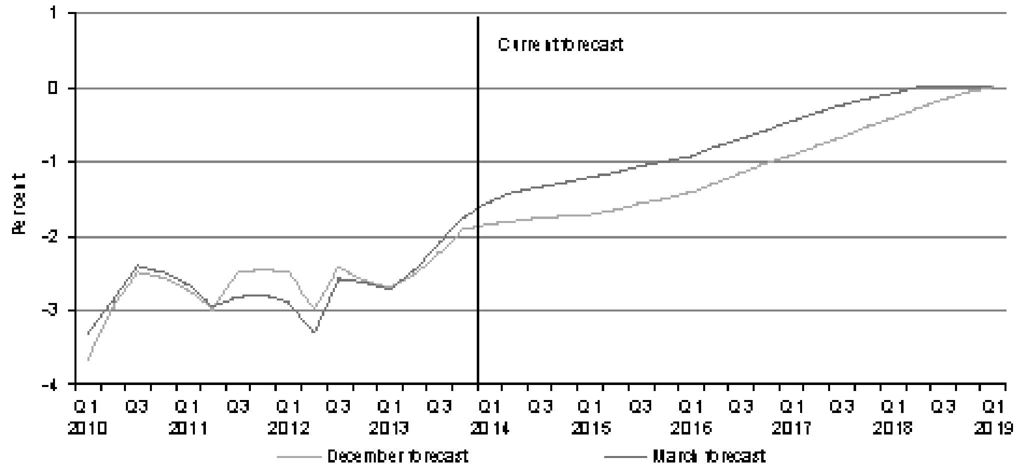
Chart 3.22: Contributions to average quarterly GDP growth



Source: ONS, OBR

3.61 With productivity growth, real income growth and UK export markets remaining weak in 2014, we expect the quarterly rate of growth to slow to 0.6 per cent from the second quarter. With GDP growth close to the growth of potential output, this implies that the output gap closes relatively slowly over this period (Chart 3.23). We expect the quarterly rate of growth to remain at around the same pace through 2015 as consumption grows in line with steadily improving real incomes, rather than being funded out of further reductions in saving. However, the mechanical effect of relatively strong output growth at the end of 2013 and the start of 2014 means that our forecast for calendar year growth in 2014 is higher than our forecast for 2015. As productivity, real incomes and UK export markets pick up, quarterly growth is then expected to reach 0.7 per cent by mid-2016, before falling back over the remainder of the forecast as output approaches potential. The output gap is forecast to close by the second quarter of 2018.

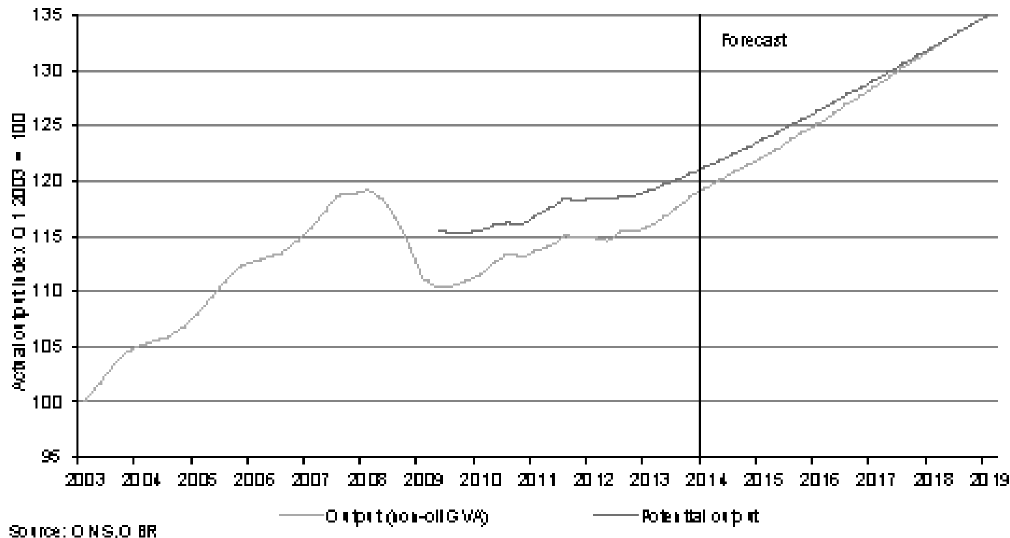
Chart 3.23: The output gap



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

3.62 Our forecast for the output gap is slightly narrower than our December forecast, reflecting our judgement that spare capacity in the labour market has been taken up a little faster than we expected. Unemployment was around 0.2 percentage points lower than forecast in the final quarter of 2013 while output was in line with our expectations. This has led us to reduce slightly (by 0.2 percentage points) our forecast of cumulative growth between the end of 2013 and the beginning of 2019. We now expect the output gap to close around a year earlier than our December forecast. The output gap does not close more quickly because of slow growth in productivity and real incomes, the gradual return to health of the financial system, ongoing weakness in UK export markets and limits to what monetary policy can do to stimulate aggregate demand in such an environment.

Chart 3.24: Projections of actual and potential output



Source: ONS, OBR

3.63 Our forecast for cumulative growth of real GDP over the forecast period is little changed since December and changes to its expected composition by expenditure mainly reflect news in the data. Table 3.3 summarises the expenditure composition of our real GDP forecast. Later sections of this chapter discuss the expenditure components of GDP in more detail.

Table 3.3: Expenditure contributions to growth

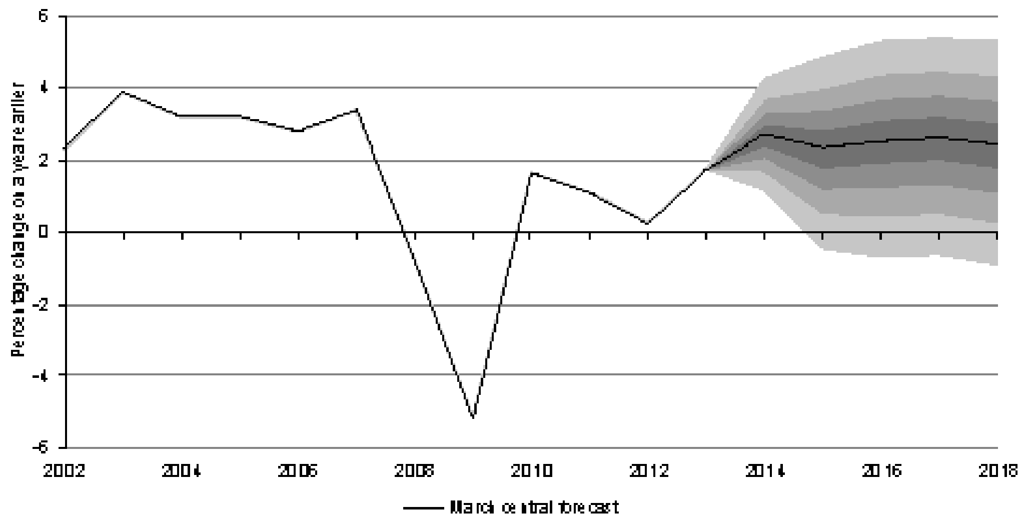
	Percentage points, unless otherwise stated					
	Outturn	Forecast				
	2013	2014	2015	2016	2017	2018
GDP growth, per cent	1.8	2.7	2.3	2.6	2.6	2.5
Main contributions						
Private consumption	1.5	1.4	1.2	1.6	1.7	1.5
Business investment	-0.1	0.6	0.8	0.7	0.8	0.8
Dwellings investment[2]	0.2	0.4	0.4	0.5	0.5	0.4
Government[3]	0.1	0.5	-0.1	-0.2	-0.4	-0.2
Change in inventories	0.3	0.1	0.0	0.0	0.0	0.0
Net trade	0.1	-0.2	0.1	0.0	0.0	-0.1

[1] Components may not sum to total due to rounding and the statistical discrepancy.
[2] The sum of public corporations and private sector investment in new dwellings and improvements to dwellings.
[3] The sum of government consumption and general government investment.

3.64 Our central growth forecast is shown in Chart 3.25. The distribution surrounding it shows the probability of different outcomes if you expect our forecasts to be as accurate as past official forecasts. The solid black line shows our median forecast, with the successive pairs of lighter shaded areas around it representing 20 per cent probability bands. The probability bands are based on the distribution of official

forecast errors since 1987. They do not represent a subjective measure of the distribution of risks around the central forecast.

Chart 3.25: Real GDP growth fan chart



Source: ONS,OBR

Prospects for inflation

3.65 In assessing the outlook for the economy and the public finances, we are interested in a number of measures of inflation, including the Consumer Prices Index (CPI) and the Retail Prices Index (RPI). The basic measurement approach of these indices is the same, although there are a number of differences in coverage and the methods used to construct them.[11]

3.66 The RPI and CPI measures of inflation are important because they have different effects on our fiscal forecast. The Government uses CPI for the indexation of many tax rates, allowances and thresholds, and for the uprating of benefits and public sector pensions. The RPI is used for calculating interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties. The ONS publishes other inflation measures, but these do not currently affect the public finances, so we do not forecast them.[12]

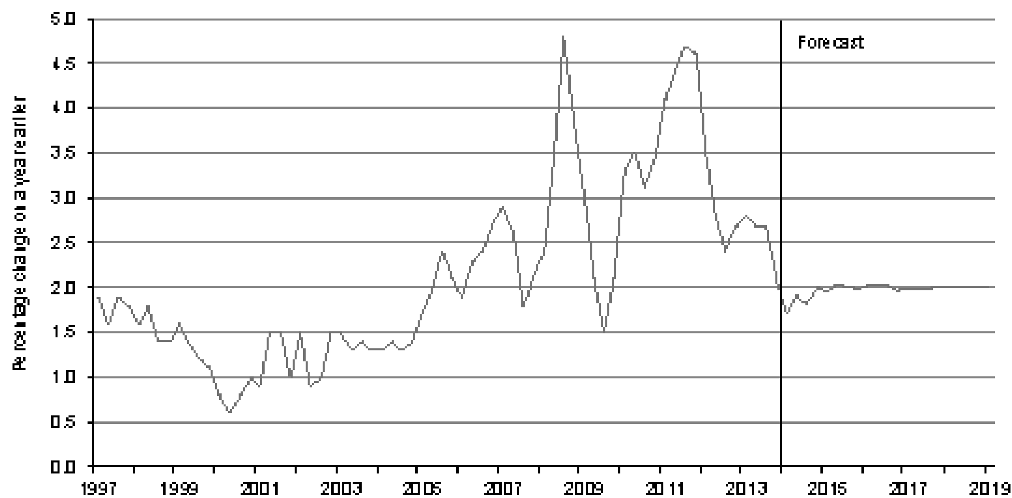
[11] For more details on the differences between the RPI and CPI see Miller, R, November 2011, OBR Working Paper No.2: *The long-run difference between RPI and CPI inflation*.
[12] ONS, March 2013, *Introducing the New CPIH Measure of Consumer Price Inflation* and ONS, March 2013, *Introducing the New RPIJ Measure of Consumer Price Inflation*.

CPI inflation

3.67 CPI inflation averaged 2.1 per cent in the fourth quarter of 2013, slightly lower than our December forecast of 2.2 per cent. The difference was due to lower-than-expected food, air transport and petrol prices. Inflation was down significantly from 2.7 per cent in the third quarter. Seasonal food price inflation fell significantly in the fourth quarter as harvests were better than the same time last year, when there were disruptions due to poor weather, and non-seasonal food inflation fell on the back of lower world commodity prices. Education inflation also fell as the increase in the tuition fee cap in October 2012 had less impact on prices in 2013 than in 2012. Petrol prices fell in the fourth quarter as lower oil prices and a rise in sterling were passed on.

3.68 Inflation is expected to fall further in the first quarter of 2014, as lower commodity prices and the recent appreciation of sterling continue to flow through to food price inflation and petrol prices (Chart 3.26). Also, energy companies should begin to pass savings on to households arising from policy announcements in Autumn Statement 2013. CPI inflation is expected to be slightly below the Bank of England's 2 per cent target on average over 2014, with the annual inflation rate uneven due to base effects from petrol and food prices in the previous year. Recent flooding may pose an upside risk to seasonal food prices if domestic supply is disrupted, but the areas that have been most seriously affected account for a relatively low share of total UK farm land.

Chart 3.26: CPI inflation forecast



Source: ONS, OBR

3.69 The annual inflation forecast profile is lower in the near term than in our December forecast, partly thanks to an unexpectedly fast fall in food price inflation. We also

now have enough information to incorporate the impact of the Autumn Statement energy policy announcements (see Box 3.2 of December *EFO* for more details). In the near term, the effect of the narrower output gap than we forecast in December on inflation is broadly offset by an increase in the level of sterling implied by our conditioning assumption.

3.70 CPI inflation is then expected to settle at target in the medium term. Downward pressure on inflation from a negative output gap is forecast to be offset by other factors, including environmental energy policies and excise duties being indexed using RPI, which rises faster than the CPI. Anchored expectations are also assumed to help keep inflation around target.

3.71 Announcements by the major energy companies suggest that the Autumn Statement environmental policy changes will push down electricity and gas prices by around 4 per cent on average over 2014, reducing our pre-measures forecast for an 8.5 per cent increase in utility prices between November 2013 and November 2014 to 4.5 per cent. This reduces the contribution from utility prices to CPI inflation from 0.4 percentage points to 0.2 percentage points. Reasons cited by the companies for the remaining increases include higher wholesale, distribution and network costs. A number of the major energy companies have announced that they will not increase their prices over 2014 unless there is a substantial increase in wholesale electricity costs. Wholesale gas and oil price futures, on which we condition our forecasts, suggest this will not be the case.

RPI inflation

3.72 The calculation of RPI inflation in the UK does not meet international statistical standards, but we continue to produce RPI forecasts as they are necessary inputs in our fiscal forecasts.[13] The method of calculation drives a wedge between RPI inflation and CPI inflation (the "formula effect") and leads RPI to overstate inflation. The RPI also includes mortgage interest payments (MIPs), council tax and housing depreciation, which are not included in the CPI.

3.73 RPI inflation averaged 2.6 per cent in the fourth quarter of 2013, compared to our December forecast of 2.8 per cent. The lower RPI figure was driven by items contributing to lower CPI inflation as well as lower-than-expected housing depreciation.

3.74 In the first quarter of 2014, we expect RPI inflation to fall back for the same reasons as CPI inflation. Over 2014, a rise in housing depreciation (resulting from higher house price inflation) boosts RPI inflation relative to CPI inflation. From 2015 onwards, market-derived Bank Rate expectations imply that mortgage interest rates will rise, pushing RPI inflation towards 4 per cent at the end of the forecast

[13] ONS, February 2013, *Response to the National Statistician's consultation on options for improving the Retail Prices Index.*

period. As with the path of CPI inflation, the path of RPI inflation is below that of the December forecast in the near term, but similar in the medium term.

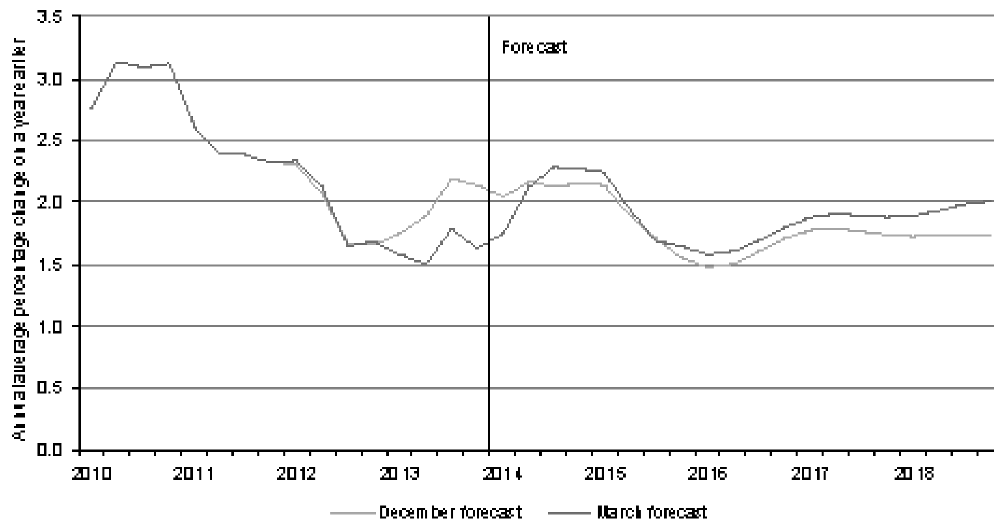
The GDP deflator

3.75 GDP deflator growth is the broadest measure of inflation in the domestic economy. It measures changes in prices of the goods and services that make up GDP, including price movements in private and government consumption, investment and the relative price of exports and imports – the terms of trade. The GDP deflator plays an important role in our fiscal forecast through its role in the Government's chosen public sector spending assumption, described in Chapter 4.

3.76 The GDP deflator and its components have been revised significantly over 2012 and 2013 (see paragraph 2.3 for details). The result is that the starting point for the GDP deflator is 0.7 per cent lower in the third quarter of 2013 than at the time of the December *EFO*.

3.77 Annual growth in the GDP deflator was 1.7 per cent in the final quarter of 2013, below our December forecast. Our forecast for the GDP deflator is similar in the short term but slightly higher over the medium term than our December forecast (Chart 3.27). This change is driven by the private consumption deflator, as the result of a change in the way we forecast imputed rent. We now assume that this will grow in line with average earnings rather than the CPI. As we set house price inflation equal to average earnings growth in the medium term, this implies a flat house price-to-rent ratio, which we consider to be an appropriate neutral assumption. As imputed rent is not in the CPI measure of inflation, and average earnings are forecast to grow faster than CPI in the medium term, this leads to a 0.25 percentage point wedge between CPI inflation and consumption deflator growth.

Chart 3.27: GDP deflator



Source: ONS, OBR

Prospects for nominal GDP growth

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

3.79 Since our December forecast, the ONS has revised the path of nominal GDP in 2012 and the first three quarters of 2013 and provided a first estimate of nominal GDP for the fourth quarter of 2013. Taken together, the level of nominal GDP at the end of 2013 is around 0.5 per cent higher than we expected in December, as stronger-than-expected growth in the final quarter more than offset downward revisions to the level in the first three quarters of the year. In expenditure terms, the stronger-than-expected nominal GDP growth in the fourth quarter was largely accounted for by a stronger nominal net trade contribution, in turn reflecting a sharp pick-up in the terms of trade. On the income side, the additional nominal GDP growth was largely accounted for by corporations' gross operating surplus.

3.80 We forecast nominal GDP growth of 5 per cent in 2014, falling back to 4 per cent in 2015 as calendar-year real GDP growth eases slightly and temporary upward influences on the GDP deflator pass. In particular, the significant increase in the

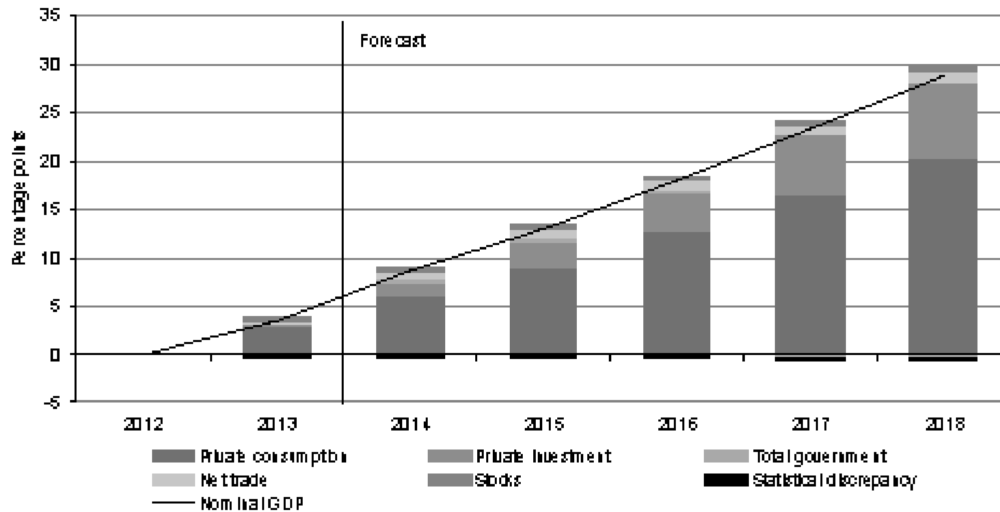
terms of trade in the fourth quarter of 2013 – which is assumed to be partly reversed in subsequent quarters – arithmetically raises growth in the GDP deflator in 2014. We then expect growth of about 4½ per cent a year in the medium term. This profile is broadly in line with our December forecast. Overall, adding the outturn and forecast changes, nominal GDP at the start of 2019 is 0.7 per cent higher than in our December forecast. Of this, around 0.3 per cent reflects higher real GDP, with the remainder largely accounted for by an upward revision to the consumption deflator.

Expenditure

3.81 We have revised up the level of nominal consumption and nominal investment over the forecast period, reflecting recent outturns. But we have revised down the contribution of net trade to the level of nominal GDP as the improvement in the terms of trade and stronger-than-expected net trade volumes in the fourth quarter were not enough to make up for the downward revision to the terms of trade over the first three quarters of 2013.

3.82 Chart 3.28 sets out our forecast for cumulative nominal GDP growth by expenditure component. As the largest component of demand, private consumption is expected to be the biggest contributor to the cumulative growth of nominal GDP over the forecast period. However, given the relatively slow growth of disposable incomes, we do not expect consumption to rise significantly relative to GDP, with the share of consumption in nominal GDP expected to remain broadly stable over the forecast period. Private investment is expected to make a growing contribution to nominal GDP growth, as is typical during a recovery, with its share of nominal GDP increasing from around 12 per cent in 2013 to 15½ per cent in 2018. This offsets a fall in the contribution of government consumption and investment, which drops from around 23 per cent of nominal GDP in 2013 to just over 18 per cent by 2018. Prospects for individual sectors are set out in more detail later in this chapter.

Chart 3.28: Contributions to nominal GDP growth: expenditure

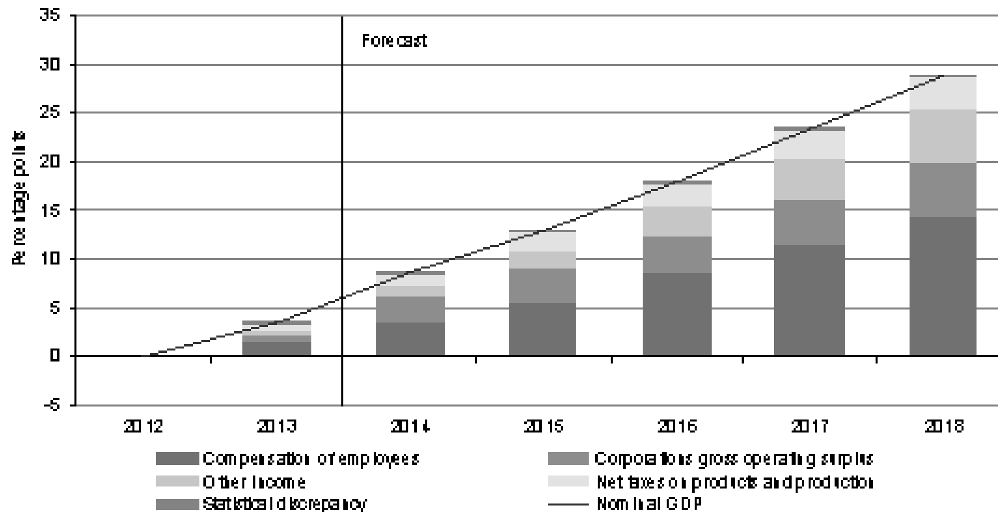


Source: ONS, OBR

Income

3.83 Chart 3.29 shows the contribution of different sources of income to cumulative growth in nominal GDP between 2012 and 2018. As productivity picks up, we expect profit margins to recover, with profit growth slightly outpacing nominal GDP growth over the medium term. With real earnings forecast to grow in line with productivity in the medium term, the share of labour income in nominal GDP is expected to remain broadly stable from 2014.

Chart 3.29: Contributions to nominal GDP growth: income



Source: ONS, OBR

Prospects for individual sectors of the economy

The household sector

3.84 The household sector is the largest source of income and spending in the economy, with consumer spending making up 66 per cent of nominal GDP by expenditure and household disposable income making up 69 per cent of nominal GDP by income in 2012.

Real consumer spending

3.85 The latest ONS data indicate that real consumption grew by 1.1 per cent in the third quarter of 2013, although growth fell back to 0.1 per cent in the fourth. Monthly retail sales data fell back slightly in January, although this followed a particularly strong pick-up in December. By contrast the GfK index of consumer confidence reached its highest level since 2007 in January, above its long-run average, and remained there in February.

3.86 Annual consumer spending growth in 2013 now appears to have been somewhat stronger than the data suggested at the time of our December forecast, reflecting upward revisions to consumption growth at the end of 2012 and start of 2013. These changes were broadly matched by upward revisions to elements of household income, leaving the profile of the saving ratio broadly unchanged (see paragraph 3.95). It remains the case that the increase in consumption in 2013 was financed mainly by lower saving, rather than stronger income growth, although the picture is complicated by the shifting of income from the first quarter into the second to take advantage of the additional rate of income tax being reduced from 50p to 45p.

3.87 Taking into account the ongoing weakness of real earnings growth and real disposable incomes, we expect the pace of quarterly growth to be somewhat slower than some of the rates seen in 2013. As growth in productivity and real wages gathers strength, we expect consumption growth to pick up, with real consumption growing broadly in line with real GDP from 2016.

Nominal consumer spending

3.88 In line with real consumer spending, we expect nominal private consumption growth to ease beyond the near term. We have revised our forecast for growth in 2014 up from 3.9 per cent in December to 4.5 per cent, largely thanks to stronger growth in the consumption deflator. Subdued earnings growth means that we expect nominal private consumption growth to ease to just over 4 per cent in 2015, slightly higher than our December forecast. Thereafter, rising nominal earnings growth is expected to contribute to a pick-up in nominal consumption growth towards 5 per cent. In line with the adjustment we have made to the GDP deflator, we expect changes from imputed rent to add around 0.25 per cent to the annual growth of nominal consumption in the medium term.

The labour market and household income

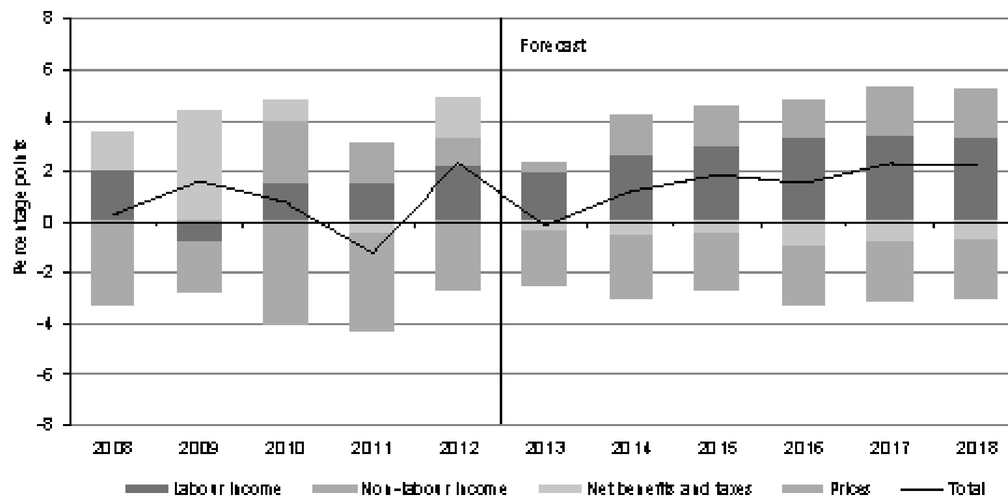
3.89 Unemployment fell faster in the final quarter of 2013 than we forecast in December. More timely claimant count data suggest that momentum in the labour market is easing. Our forecast is for spare capacity to be absorbed at a slower rate over 2014 than in 2013, with unemployment passing 7 per cent in the second quarter of the year before gradually falling back to its equilibrium rate in 2018. Despite stronger employment growth, the weakness of average earnings, relative to forecast, implies wages and salaries grew a little slower towards the end of 2013 than we expected in December.

3.90 Over 2013, claimant count unemployment fell by 290,000, but this was not reflected fully in the Labour Force Survey (LFS) measure, which fell by 160,000. Some former claimants may have stopped claiming because they are now in receipt of another benefit, such as incapacity benefit, while others may have stopped claiming benefits altogether. Our central forecast is conditioned on the view that this will not reverse in coming quarters and so the claimant count is permanently lower, relative to the LFS measure, than in our December *EFO*. Towards the end of the forecast, the claimant count settles at around 2¾ per cent of the workforce, compared with an LFS unemployment rate of 5¼ per cent.

3.91 Real wages continue to fall, with annual growth in average weekly earnings, at 1.5 per cent in December, outstripped by CPI inflation of 2.0 per cent. As we pointed out in Box 3.5 of our December *EFO*, weak productivity growth and subdued output price inflation have squeezed firms' margins. We therefore expect real wage growth to fall short of productivity growth in the near term as firms return to more normal rates of profitability. The prolonged weakness of nominal earnings growth has prompted us to lower our forecast going into 2014 and it is not until the

end of 2016 that we expect real hourly earnings to exceed the level at which they stood in the second quarter of 2008, when the recession began. Unsurprisingly, GDP per capita returns to its pre-crisis peak at a similar time – early 2017 (see Box 3.2). Households also earn income from other sources, such as dividends from equity holdings and interest from savings, as shown in Chart 3.30.

Chart 3.30: Contributions to real household income growth



Source: ONS, OBR

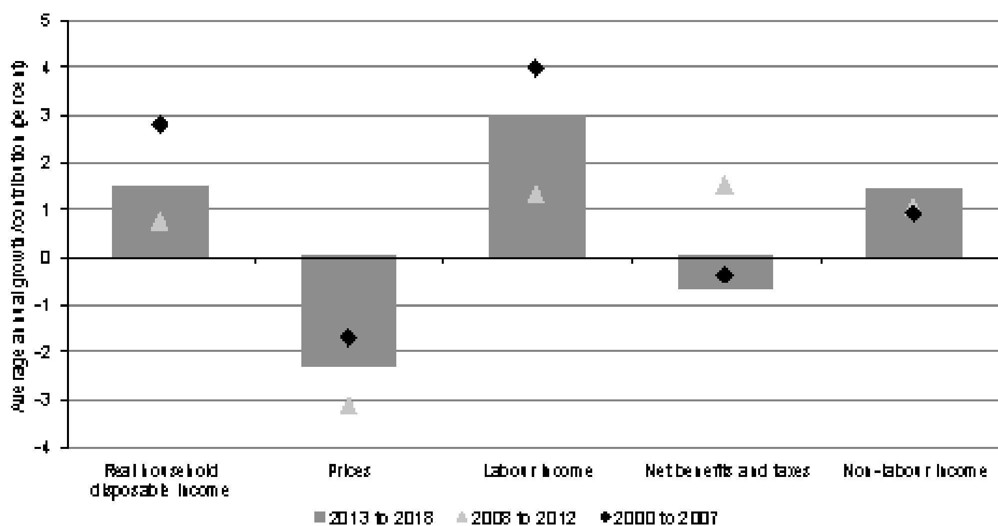
3.92 On average before the recession, labour income (mostly wages and salaries) was by far the biggest source of real income growth, reflecting the expansion of the population and strong productivity growth. Non-labour income made a positive contribution and net benefits and taxes made a small negative contribution.

3.93 As people lost their jobs and pay growth slowed, the automatic stabilisers boosted household incomes on average through the recession and the weak recovery. But the additional support from a smaller tax burden and rising social benefit payments was offset by elevated inflation over that period and real household disposable income grew by just 0.8 per cent a year from 2008 to 2012. In aggregate, non-labour income contributed much as it did prior to the crisis, with weaker contributions from dividends and interest on savings broadly offset by lower debt servicing costs.

3.94 Over the forecast period, we expect labour income to be the largest contributor to growth in real household disposable income, although to a lesser extent than in the pre-crisis period, given our forecast for weaker productivity growth. Net benefits and taxes will return to being a small drag on real household income growth, given ongoing fiscal consolidation and the return of fiscal drag (when earnings rise faster than inflation-linked allowances and thresholds in the tax

system). The contraction of the public sector will also weaken labour income growth directly, via public sector employment and wages, and indirectly, via procurement spending on private sector output. We expect non-labour income to provide a small offset, helped by a cyclical recovery in corporate profits. Lower inflation will also help, given our assumption that the Bank meets its inflation target. The result is average real income growth of around 1.5 per cent a year over 2013 to 2018, rising steadily (as in Chart 3.30) but remaining a long way below the pre-crisis average of 2.8 per cent.

Chart 3.31: Contributions to real household income growth



Source: ONS, OBR

The saving ratio

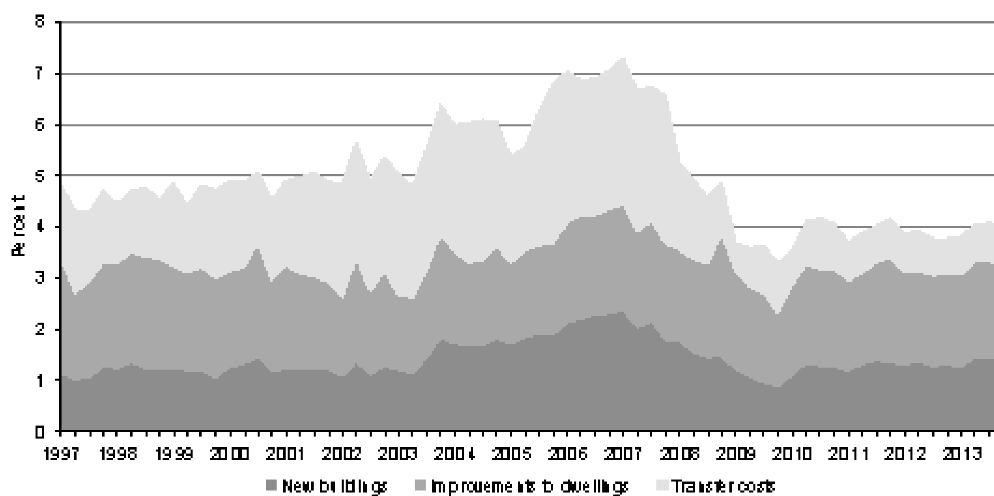
3.95 The saving ratio was volatile through 2013 as high income individuals shifted income between the first and second quarters of the year to take advantage of the additional rate of income tax being reduced from 50p to 45p. Overall, consumer spending growth in 2013 appears to have been financed more by lower saving than by higher incomes. With consumer spending growth forecast to outpace disposable income growth over the near term, we forecast that the saving ratio will fall from just under 5 per cent in 2013 to just over 4 per cent in 2014, before declining gradually to around 3 per cent by the end of the forecast period.

The housing market and dwellings investment

3.96 Residential property transactions accelerated again in the final quarter of 2013, rising by 8 per cent from the previous quarter and 26 per cent on a year earlier. Mortgage approvals have also accelerated, suggesting further growth in transactions in the near term. Both are being boosted by a substantial fall in mortgage interest rates and improved confidence, and by the Government's Help

to Buy scheme (which eases collateral constraints on home-buyers). Growing momentum in recent months has lifted our transactions forecast over the period from 2014 to 2016, compared to our December forecast. By 2018, we expect a similar level of transactions as in December, in line with the long-run rate of turnover of the housing stock. More transactions and rising house prices should encourage more house-building. We forecast cumulative growth in real residential investment of 58 per cent over the forecast period, continuing the strength seen in 2013. Despite that, residential investment is not expected to return to its pre-crisis peak by the end of the forecast horizon.

Chart 3.32: Residential investment, share of nominal GDP[1]

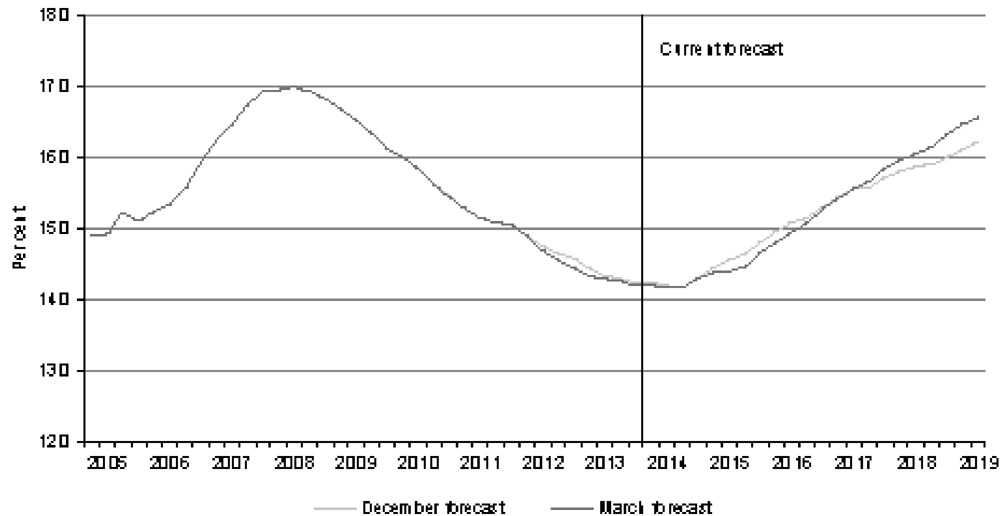


[1] Private sector, including transfer costs.
Source: ONS

Net lending and the balance sheet

3.97 The saving ratio is expected to fall over the forecast period, at a slightly faster rate than in our December forecast. With household investment rising strongly, households' overall net lending position – total income less total spending – will move into deficit. In an accounting sense, this provides the offset to the Government's fiscal consolidation (Chart 3.44). With negative net lending and house price growth, households' gross debt to income ratio is projected to rise again from 2014 having fallen steadily since 2008. The ratio rises faster than we expected in December and approaches its pre-crisis peak by the end of the forecast period (Chart 3.33). We expect the cost of servicing debt will rise relative to household disposable incomes, but will remain near its pre-crisis level (discussed further in Box 3.5).

Chart 3.33: Household gross debt to income

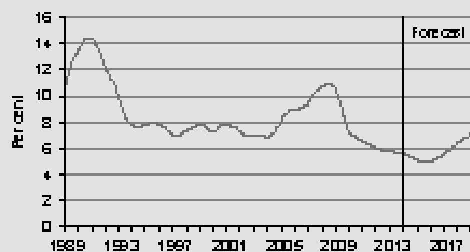


Source: ONS, OBR

Box 3.5: The impact of rising interest rates on household finances

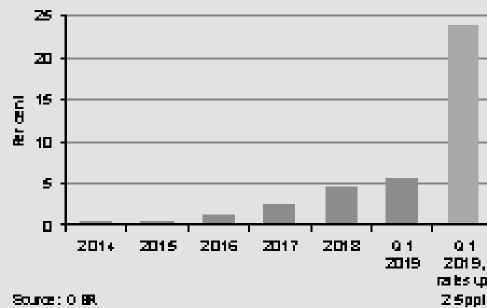
We expect house price inflation to outstrip income growth in the near term, which is consistent with an increase in the average size of mortgages and household debt relative to income. Combined with a gradual increase in Bank Rate, of 2.5 percentage points by Q1 2019, this means debt servicing costs as a share of disposable income, or 'income leverage', will rise. But our central forecast assumes only a 0.8 percentage point rise in average mortgage rates over the same period, as spreads narrow to more historically normal levels. So although mortgage servicing costs are likely to rise, we expect them to remain close to pre-crisis averages (Chart E).

Chart E: Household income leverage



Source: ONS, OBR

Chart F: Share of mortgagors reacting to rising debt servicing costs



Source: OBR

Chart E shows whole economy income leverage over the forecast period, but the effect of rising interest rates will be felt more by some than by others. Survey data compiled for the Bank of England show that two-thirds of households may be less

negatively affected by rising interest rates because they do not have a mortgage. Indeed, if they have savings, they would be positively affected. Of the remainder, those who start with high income leverage tend to be more exposed to rate increases than those with low income leverage, because they have larger mortgages.[a] [b]

Using survey responses to the question *"About how much do you think your monthly mortgage payments could increase for a sustained period without you having to take some kind of action to find extra money e.g. cut spending, work longer hours, or request a change to your mortgage?"*, we can simulate what our forecast might mean for aggregate household behaviour.[c] Chart F is constructed by assuming respondents' mortgage debt, income and mortgage interest rate grow in line with our aggregate forecast and that the threshold is also adjusted over time for rising income. On this basis, our central forecast is consistent with 5.5 per cent of households with a mortgage changing their behaviour by Q1 2019 because debt servicing costs have risen. This reflects the fact that both interest rates and incomes are forecast to rise as the economy recovers.

Our central forecast assumes mortgage rates rise more slowly than Bank Rate. If mortgage rates were to rise by 2.5 percentage points by Q1 2019, in line with our central assumption for Bank Rate, the effect on borrowers could be more significant, with 24 per cent of mortgagors changing behaviour. This illustration assumes household debt grows in line with our central forecast. An increase in mortgage interest rates of 2.5 percentage points, without more income growth, would almost certainly reduce household demand for debt. The proportion of households needing to respond to higher interest rates would be significantly lower if that were the case. Faced with a larger rise in debt servicing costs, households could change their behaviour in a number of ways, as described in the survey question. In practice, the aggregate response would include a combination of these. We explore the consequences of shocks to interest rates in Chapter 5.

[a] The Living Costs and Food Survey (published by ONS) 2012 shows 36 per cent of households have a mortgage, and the NMG survey (published by Bank of England) shows 31 per cent.
[b] Raw data are available on the Bank of England website.
[c] This is largely methodologically consistent with analysis used in the Bank of England Quarterly Bulletin, Q4 2013, "The financial position of British households: evidence from the 2013 NMG Consulting survey".

The corporate sector

Business investment and stockbuilding

3.98 Business investment is now estimated to have picked up more sharply through 2013 than data available at the time of our December forecast suggested. The latest official data suggest that business investment grew by a cumulative 4.5 per cent over the second half of 2013. Other indicators also point to a pick-up in investment activity: investment intentions strengthened in the fourth quarter (Chart 3.34) while there was a drop in the net balance of firms reporting demand uncertainty as a constraint on investment plans (Chart 3.35). Nevertheless the fall in business investment during the recession, and the lack of growth thereafter, means that the

real level of investment remains around 20 per cent below its pre-crisis peak at the end of 2013.

Chart 3.34: Investment intentions

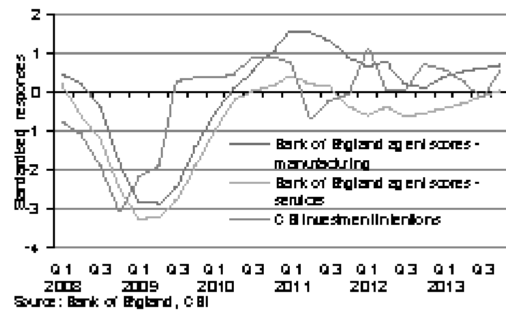
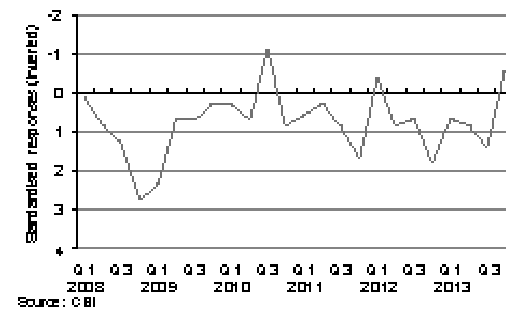
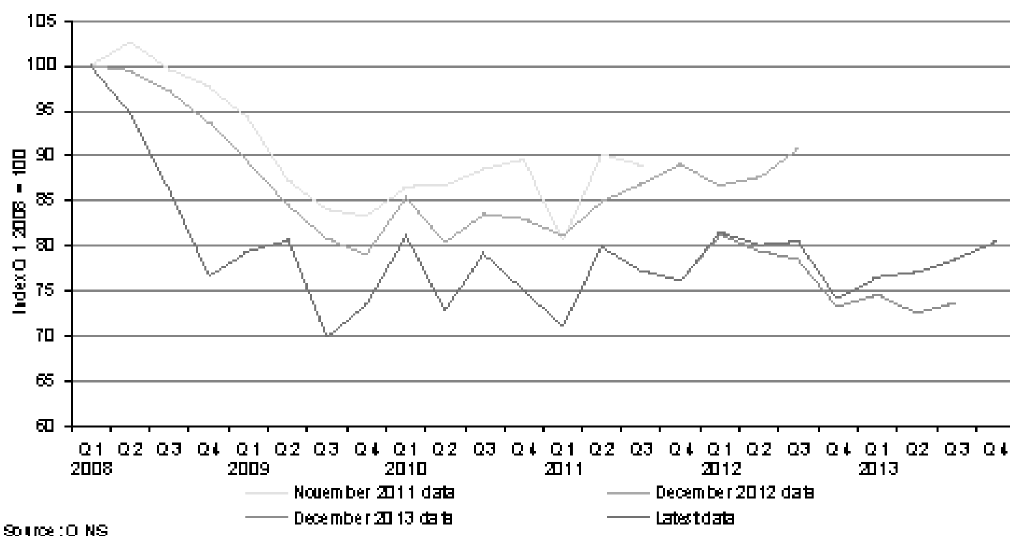


Chart 3.35: Uncertainty about demand



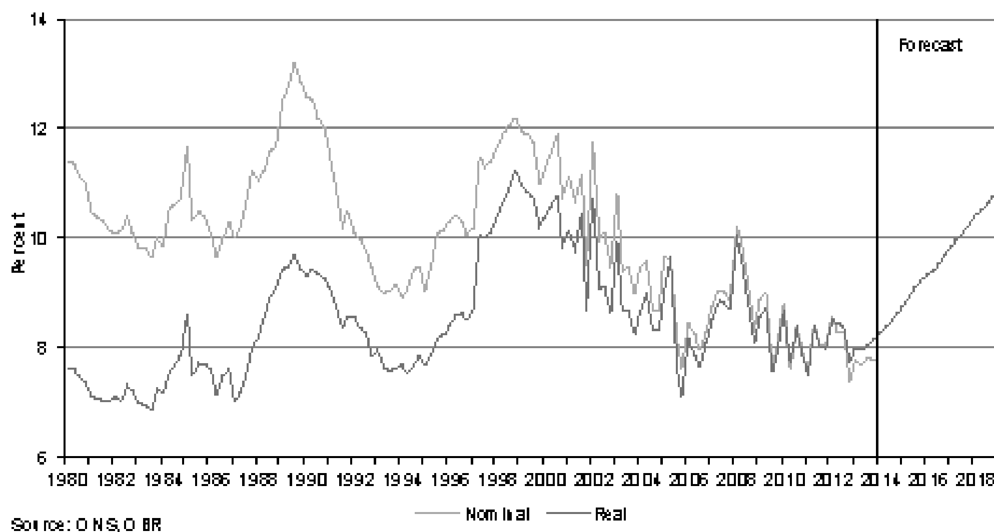
3.99 As set out in our December *EFO*, changes to the ONS methodology for the deflation of investment, introduced in Blue Book 2013, have left the recent path of business investment weaker and significantly more volatile, making the interpretation of quarterly movements more uncertain. Set against this volatility, it remains to be seen whether the recent pick-up in business investment indicates a turning point in investment spending. That said, some of the factors that may have constrained business investment in recent years – such as an unwillingness to commit to investment projects given the uncertainty around demand, and credit constraints for smaller firms – have receded through 2013 as activity has picked up and credit conditions have improved.

Chart 3.36: Business investment



3.100 We now expect business investment to grow by 8.0 per cent in 2014, revised up from 5.1 per cent in our December forecast. This upward revision reflects both the strength of recent data and the effect of the temporary increase in the Annual Investment Allowance, which is assumed to lead some investment being brought forward to 2014 and 2015 (see Box 3.3). As productivity growth and profits pick up, business investment is forecast to grow relatively rapidly, with growth averaging 8.4 per cent a year between 2015 and 2018. This implies a rising share of real business investment in GDP, as usual during the later stages of a recovery (Chart 3.37). Chart 3.37 also shows how the nominal share has tended to fall relative to the real share because investment goods price inflation has tended to be lower than overall inflation. Box 3.6 considers UK investment in international context.

Chart 3.37: Business investment as a share of GDP



Source: ONS, OBR

3.101 The latest ONS data indicate that stocks contributed 0.3 percentage points to growth in 2013. This is slightly weaker than the contribution of 0.4 percentage points that we expected in December, reflecting downward revisions to the rate of stockbuilding in the first half of 2013. Having contributed 0.9 percentage points to growth in the third quarter, inventories were estimated to have subtracted 0.2 percentage points in the final quarter. We expect inventories to make a small positive contribution to GDP growth of 0.1 percentage point in 2014 and to be neutral from 2015.

Box 3.6: An international comparison of sectoral investment

From peak to trough, total investment in the UK fell by 23 per cent during the recession, half as far again as the 15 per cent average in similarly developed economies. The recovery in UK investment since the recession has also been far weaker than expected. With profitability rising, confidence building and credit conditions easing, we expect total investment to grow by nearly 50 per cent in real terms over the forecast period. Some doubt whether such a recovery is possible given the lack of growth in recent years. This box assesses UK investment patterns relative to other advanced OECD economies in order to test our forecast judgement further.

By international standards, total nominal investment as a share of GDP is low in the UK. This seems to be true in all sectors – corporate investment, housing investment and government investment – and has been true over a sustained period. There are many factors that could help explain this – for example, outsourced production as a result of globilisation[a] and a relatively large share of services. MPC member Ian McCafferty noted in a recent speech that *"over the past twenty years, there appears to have been a steady decline in the [capital to output] ratio… probably as a result of the growing importance of the service sector in GDP."*[b] A larger UK service sector has also generated a relatively high rate of intangible investment.[c]

One possible factor that is common across sectors is the rationing effect of the planning regime, which may reduce the quantity of all forms of investment. During the pre-crisis decade, when the UK (like many advanced economies) experienced rapid house price growth, the rise in house building was less marked than in other countries.[d] Dwellings investment in the UK peaked at 6.4 per cent of GDP, far below the 14.4 per cent seen in Ireland or even the 8.9 per cent in the US. The Government has introduced reforms to the planning system that may support investment growth among private firms and house builders over the forecast period.

The persistence of low levels of investment in the UK raises the question of whether a sustained period of strong investment growth, such as that in our forecast, would require an implausible improvement in our relative investment position. But, given the very low starting point, by the end of the forecast period we expect the total investment-to-GDP ratio to reach 17 per cent in the UK, which would still be below the OECD average of the past decade.

Chart G: Total investment, decade averages

Chart H: PNFC investment, decade averages

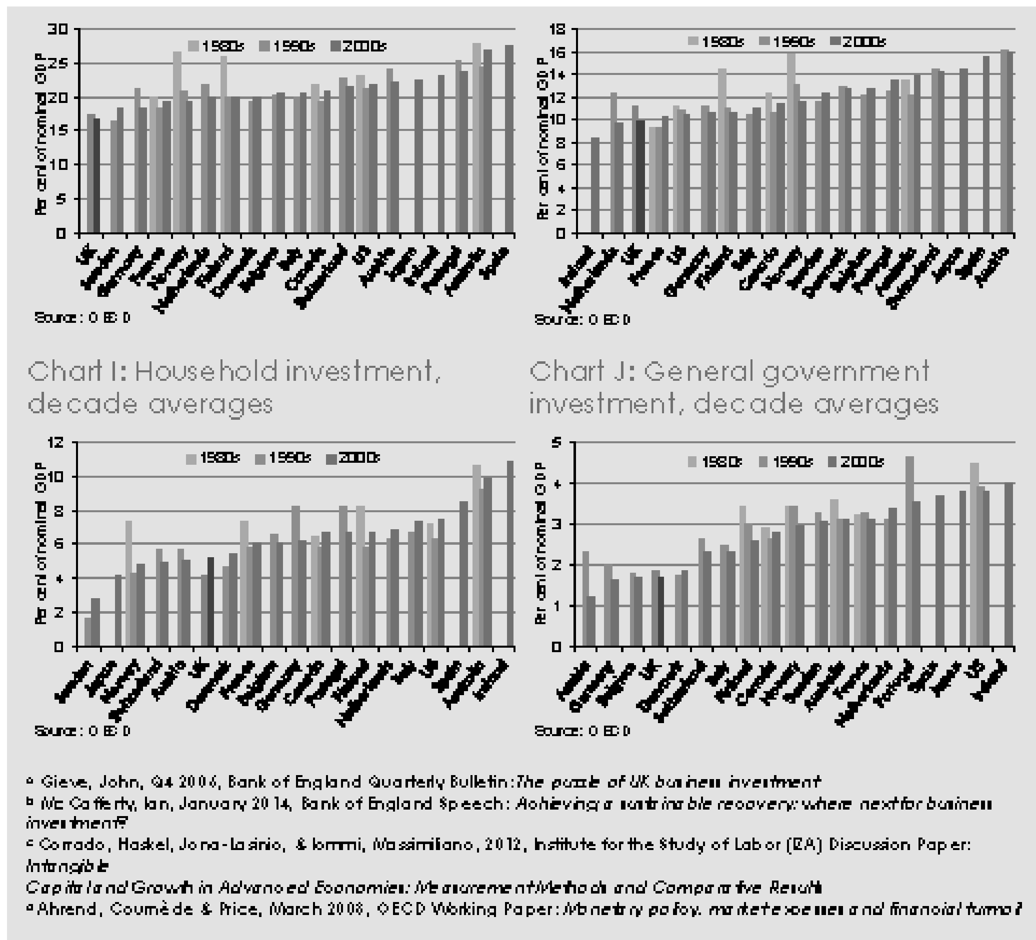


Chart I: Household investment, decade averages

Chart J: General government investment, decade averages

[a] Gieve, John, Q4 2006, Bank of England Quarterly Bulletin: *The puzzle of UK business investment*
[b] Mc Cafferty, Ian, January 2014, Bank of England Speech: *Achieving a sustainable recovery: where next for business investment?*
[c] Corrado, Haskel, Jona-Lasinio, & Iommi, Massimiliano, 2012, Institute for the Study of Labor (IZA) Discussion Paper: *Intangible Capital and Growth in Advanced Economies: Measurement Methods and Comparative Results*
[d] Ahrend, Cournède & Price, March 2008, OECD Working Paper: *Monetary policy, market excesses and financial turmoil*

Corporate profits

3.102 Non-oil, non-financial company profits are forecast to grow faster than the economy as a whole. We have revised our near-term forecast higher on the strength of recent outturn data, supported by an improvement in the terms of trade, which we expect to feed through to corporate income. Financial sector profits are forecast to grow more slowly than non-financial profits due to the effect of provisions for likely ongoing conduct costs (such as PPI claims) in the near term and the pressure of regulation throughout the forecast period.

The government sector

3.103 Total public spending amounted to around 45 per cent of GDP in 2012-13.[14] However, not all government spending contributes directly to GDP. Spending on

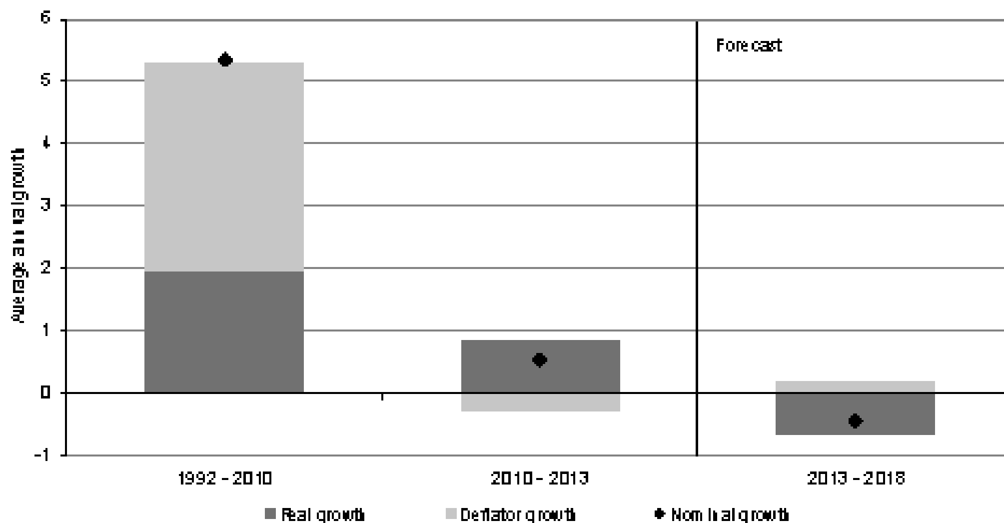
[14] Total Managed Expenditure (TME) excluding transfers related to the Royal Mail Pension Plan and Asset Purchase Facility.

welfare payments and debt interest, for example, merely transfers income from some individuals to others. The government sector contributes directly to GDP via consumption of goods and services, and investment. These together accounted for 24 per cent of GDP in 2012-13.

Real government consumption

3.104 Real government consumption continues to contribute strongly to GDP, despite slower growth in nominal spending. Real government consumption grew by 0.9 per cent in 2013, despite nominal growth slowing to 0.3 per cent. This is likely to reflect the fact that around two-thirds of real government activity is measured directly – for example, by the number of prescriptions, school pupils, court cases or hospital beds. As nominal spending has been squeezed, these indicators of real activity have held up and so measured real government consumption has grown (whether or not the quality of services has been affected). As a result, the implicit price of government consumption has fallen: the government consumption deflator has declined at an average rate of 0.3 per cent a year over the past three years, compared to an annual average increase of 3.3 per cent between 1992 and 2010 (Chart 3.38).

Chart 3.38: Government consumption

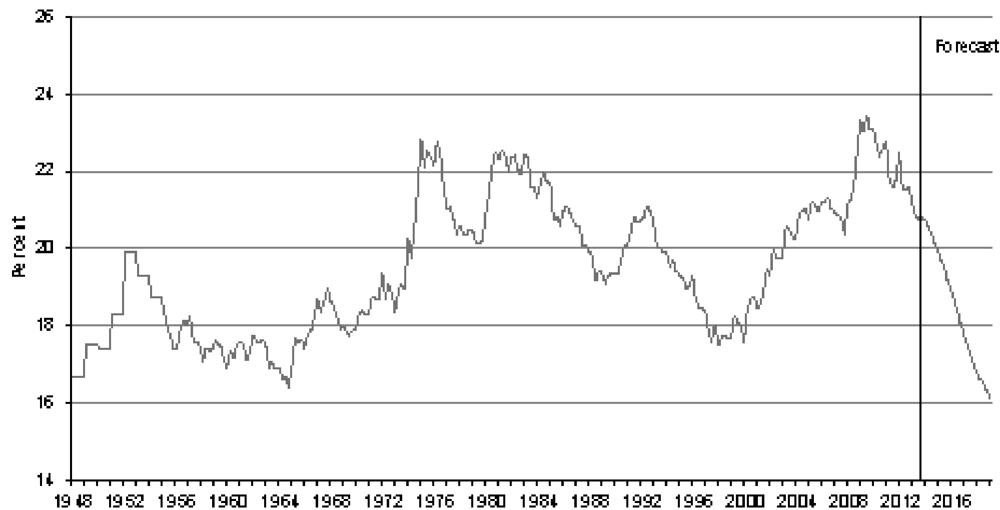


Source: ONS, OBR

3.105 With nominal spending subject to ongoing constraint over the next five years, we assume that the implicit government consumption deflator rises only slowly, at an average rate of 0.1 per cent a year between 2015 and 2018. In nominal terms, government consumption is forecast to fall from 21.8 per cent of GDP in 2012 to 16.1 per cent of GDP at the end of the forecast period, the lowest level on record

in data back to 1948 (Chart 3.39). Nominal government investment is also expected to fall slightly as a share of GDP.

Chart 3.39: Government consumption of goods and services as a share of nominal GDP



Source: ONS, OBR

General government employment

In the absence of specific workforce plans, we project general government employment based on some simple and transparent assumptions. We begin by taking our forecasts of government spending on total pay – the paybill. We then combine these top down numbers with forecasts of government wage growth to derive paybill per head. From this we derive a projection of general government employment – headcount. In reaching a judgement on general government wage growth, we take into account stated government policy (such as pay freezes), historical rates of pay drift within the public sector and recent data. Reflecting the uncertain timing of employment cuts and wage changes, we then average the overall fall in employment and distribute it evenly over the forecast period.

3.107 Relative to its level at the start of 2011, the beginning of the period covered by the Government's 2010 Spending Review, we expect general government employment to fall by around 1 million by the start of 2019. But this should be more than offset by a 3.2 million rise in market sector employment over the same period.[15] Our forecast is consistent with an average fall in general government

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

employment of 33,000 a quarter, slightly smaller than our December forecast for 35,000 a quarter.

The external sector

Export and import volumes

3.108 Exports remain volatile. Having grown by just over 3 per cent in the second quarter of 2013, export volumes fell back by just under 3 per cent in the third. Taking the year as a whole, exports are now estimated to have grown by 0.8 per cent in 2013, slightly weaker than the 1.2 per cent growth we expected in December. This is also somewhat weaker than the growth of UK export markets, implying further loss of market share, although the rate of decline appears to have slowed in recent years.

3.109 We expect exports to grow by 2.6 per cent in 2014, revised down from our December forecast of 4.0 per cent. The downward revision reflects weaker growth than expected in the second half of 2013. With UK export market growth little changed from December, our forecast for export growth is similar from 2015 onwards, averaging just under 5 per cent. This implies an ongoing loss of market share (Chart 3.40).

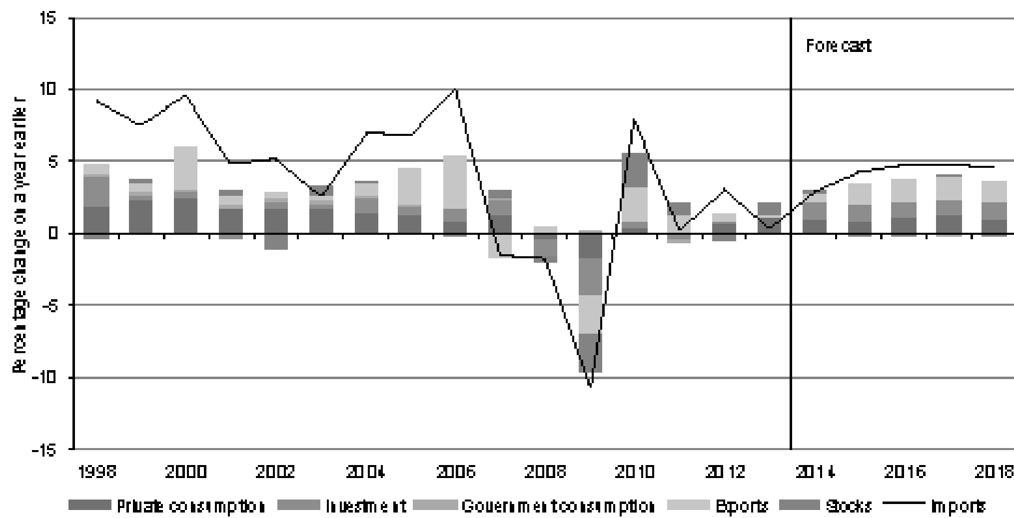
Chart 3.40: Export market share

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

3.110 Our forecast for imports is determined by the outlook for import-weighted domestic demand. Import growth is now estimated to have been weaker in 2013 than we forecast in December, largely reflecting ONS revisions to the first half of the year. Reflecting the latest data, we have revised down our forecast for import growth in 2014 to 3.0 per cent from our December forecast of 3.8 per cent. Within domestic

demand, both consumption and investment have relatively high import intensity, driving the growth of imports over the forecast period. The fall in real government activity implies little drag on import weighted domestic demand, given the low import intensity of government spending.

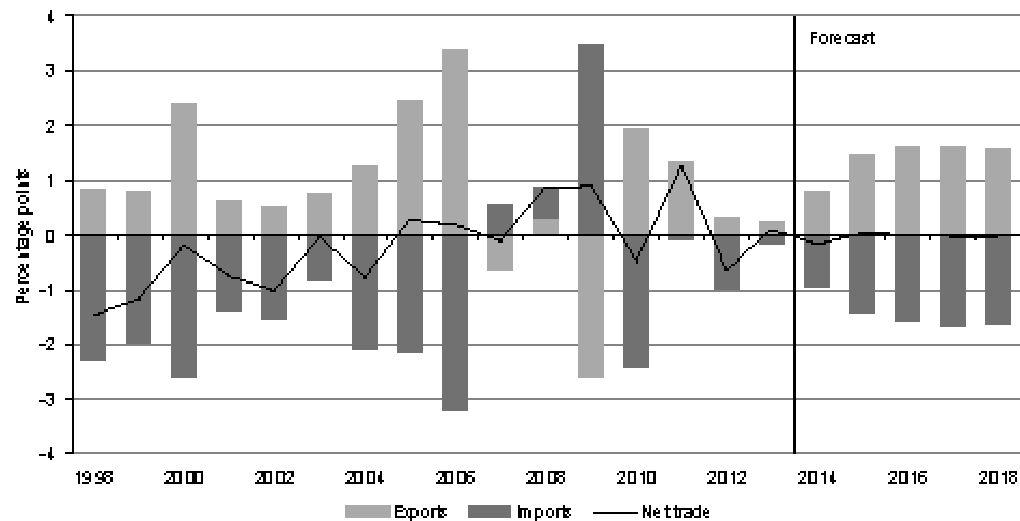
Chart 3.41: Contributions to import-weighted domestic demand and UK import growth



Source: ONS, OBR

3.111 Reflecting the sharp fall in exports in the third quarter of 2013, we expect net trade to make a small negative contribution of -0.2 percentage points to growth in 2014, revised down from no contribution in our December forecast. As in December, net trade is expected to make little contribution to growth over the remainder of the forecast period, reflecting the weakness of export market growth and a gradual decline in export market share.

Chart 3.42: Net trade contribution to GDP



Source: ONS, OBR

The terms of trade and the trade balance

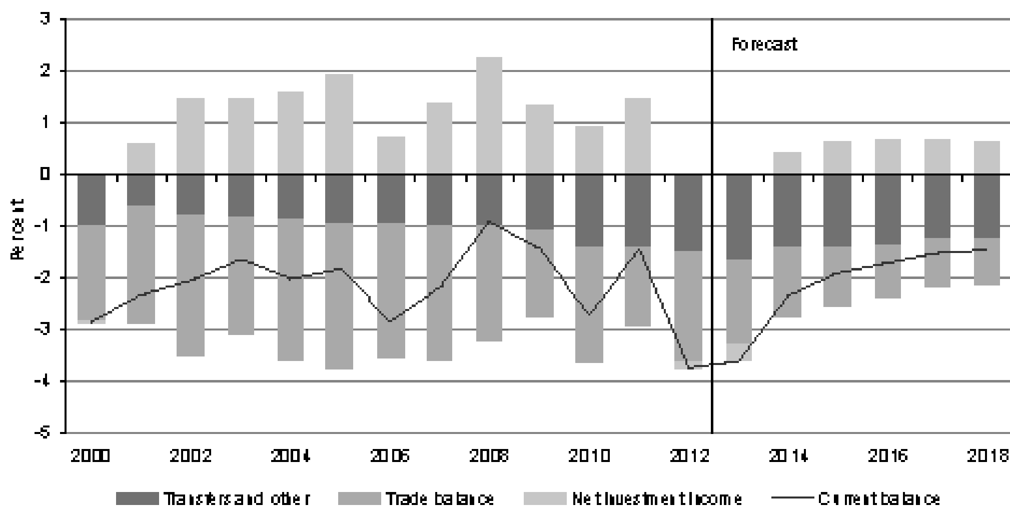
3.112 Since our December forecast, the terms of trade have been revised down significantly. In the December *EFO*, we noted that there was an unusual divergence between export and import services prices. This divergence has since been revised away by an upward revision to service import prices, although the second estimate of fourth quarter GDP showed part of the divergence re-emerging. The medium-term profile of the terms of trade is similar to December, with near-term changes reflecting data revisions, the appreciation of sterling and higher oil prices, with the assumptions for the first quarter of 2014 higher by 2.2 per cent and 3.3 per cent respectively (Chart 3.18 and 3.19). However, downward revisions to the trade balance in the first three of quarters of 2013 mean that we now expect a wider trade deficit than in December. With the terms of trade and real net exports largely unchanged thereafter, the wider trade deficit is maintained throughout the forecast.

The current account balance

3.113 Current account data continue to be extremely volatile, primarily because of large swings in the income balance. Data revisions are often substantial: in December's Quarterly National Accounts, the income balance for the second quarter of 2013 was revised up by 1.9 per cent of GDP. The subsequent swing back into deficit in the third quarter was huge and contrary to our December forecast. The volatility of the income account, mostly in the income flows derived from direct investments, makes forecasting extremely difficult.

3.114 We expect the income account to return to surplus in 2014, but this forecast is subject to significant uncertainty and is based on an assumption that recent rates of return on the UK's overseas assets have been temporarily depressed. With a worse outlook for the trade balance, this means we have revised our forecast of the current account deficit wider – by around ½ per cent of GDP by the end of the horizon.

Chart 3.43: Current account balance as a share of GDP



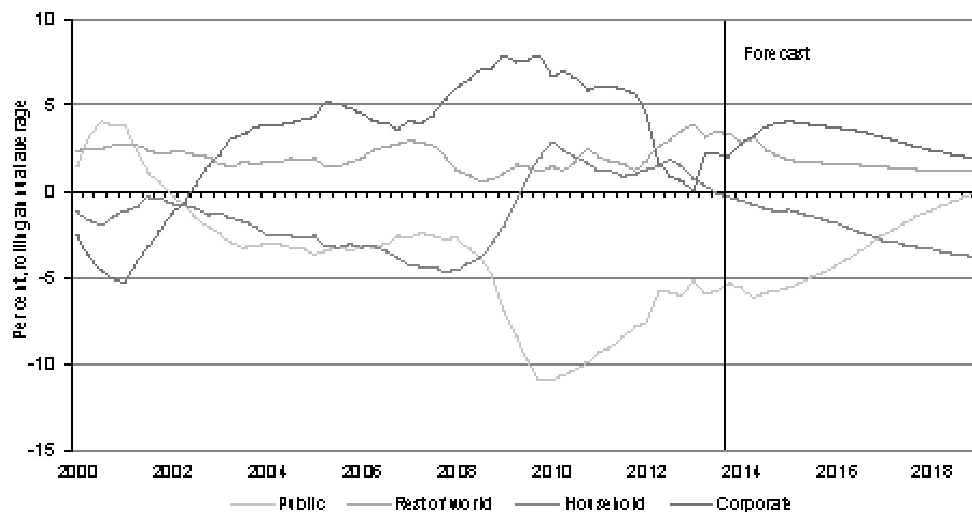
Source: ONS, OBR

Sectoral net lending

3.115 In the National Accounts framework that we use for our economic forecast, the income and expenditure of the different sectors imply paths for each sector's net lending or borrowing from others. By identity, these must sum to zero – for each borrower, there must be a lender. In 2013, we estimate the government sector to be in deficit, households close to balance, and companies and the rest of the world to be in surplus (Chart 3.44).

3.116 By the end of the forecast period, we expect the government's deficit to have returned to balance as the fiscal consolidation continues (see Chapter 4). The household and corporate sectors provide the majority of the offsetting change, with household net lending moving from a deficit of 1.2 per cent of GDP in 2014 to a larger deficit of 3.7 per cent of GDP in 2018 and corporate net lending moving from a surplus of 4.0 per cent of GDP in 2014 to a surplus of 2.0 per cent of GDP in 2018. After an initial improvement, we do not expect the current account deficit to narrow significantly over the rest of the forecast period, so the external sector plays little role in offsetting the fiscal consolidation after 2014.

Chart 3.44: Sectoral net lending



Source: ONS, OBR

Risks and uncertainties

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

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

- global monetary policy has been exceptionally loose for an extended period. As investors anticipate a return to more normal monetary conditions, most importantly in the US, this has caused some volatility in a number of emerging markets, and the risk of spillover effects to the wider economy remains. Developments in China have also recently been a focus of attention;

- euro area economies and banking systems have yet to complete the adjustment toward sustainable demand and competitiveness. While policy managed the adjustment process more effectively in 2013, further damaging instability remains possible. Concerns have been expressed about the

difficulty of completing these adjustments in an environment of very low inflation;[16]

- developments in Ukraine are not expected to have a large impact on the UK in our central forecast. However, if the situation escalates or continues for a prolonged period, there is a risk of higher commodity prices affecting inflation and output growth. There could also be a broader risk through trade linkages and financial exposure to Ukraine, Russia and other affected countries;
- domestically, productivity and real wages remain weak and the pick-up we forecast from the second half of 2014 is a key judgement. If productivity fails to pick up as predicted, the consumer spending and housing investment that has driven the recovery through 2013 could falter as the resources to sustain them would be lacking; and
- household consumption outpaces disposable income in our forecast, with the saving ratio falling gradually. Meanwhile, residential investment grows strongly, leaving households' finances in deficit and the gross debt to income ratio rising towards its pre-crisis peak by the forecast horizon. That seems consistent with supportive monetary policy and other interventions (such as Help to Buy), but it may pose risks to the sustainability of the recovery over the medium term.

3.119 Methodological changes to the National Accounts can have a considerable effect on the measured path and composition of growth, as demonstrated by last year's Blue Book revisions.[17] Looking ahead, the ONS is planning to introduce a large number of methodological changes to the National Accounts in Blue Book 2014. A number of these changes relate to the transition to the 2010 European System of Accounts (ESA10), with recent ONS analysis suggesting this may result in an upward revision to the annual level of nominal GDP of between 2½ and 5 per cent, for example due to spending on research and development being reclassified as investment (contributing to GDP) rather than intermediate consumption (which does not).[18] This estimate does not include a number of other methodological changes planned for Blue Book 2014, including to gross fixed capital formation and inventories. The saving ratio may be subject to significant revisions when the treatment of defined benefit pension contributions is revised. In the US, where similar revisions were implemented last year, changes to the treatment of pensions contributed to a 1.5 percentage point upward revision to the saving ratio. Annex B discusses the possible implications of forthcoming ESA10 revisions for the public finances.

[16] See, for example, the IMF's global economy forum: http://blog-imfdirect.imf.org/2014/03/04/euro-area-deflation-versus-lowflation/

[17] See our 2013 *FER* for further details.
[18] Marks, C, November 2013, *Content of Blue Book and Pink Book 2014*.

Comparisons with external forecasters

3.120 In this section, we compare our latest projections with those of key outside forecasters. Estimates of the current degree of spare capacity and the potential growth rate of the economy, where available, differ widely as discussed from paragraph 3.16.

3.121 In its January *World Economic Outlook Update*, the **International Monetary Fund** (IMF) forecast real GDP growth of 2.4 per cent in 2014, around 0.3 percentage points below our central forecast. The IMF published its forecast before the estimate of GDP growth in the final quarter of 2013, which may partly explain the difference. In 2015, the IMF forecasts growth of 2.2 per cent, slightly weaker than our central forecast. The IMF's January update did not include new medium-term forecasts. The October *World Economic Outlook* forecast growth to average 2.1 per cent between 2016 and 2018, which is below the average growth rate implied by our forecast.

3.122 The **Organisation for Economic Cooperation and Development** (OECD) published an updated forecast as part of its November *Economic Outlook*. The short-term outlook is slightly below our central forecast, although this forecast was published prior to the estimate of GDP in the final quarter of 2013 and the revisions made to growth in 2012 and 2013 in December's Quarterly National Accounts. The OECD forecasts growth of 2.5 per cent in 2015 – stronger than our central forecast – and there are some differences in the expected composition of growth, with the OECD expecting a stronger contribution from consumption and net trade, but a weaker contribution from investment.

3.123 The **European Commission** published its *European Economic Forecast* in February. It expects growth of 2.5 per cent in 2014 and 2.4 per cent in 2015, a little weaker than our central forecast in 2014 and a little stronger in 2015. The Commission expects net trade to contribute 0.0 percentage points to 2014 growth, which compares to our forecast of -0.2 percentage points. This is offset by weaker domestic demand, contributing 2.6 and 2.5 percentage points in 2014 and 2015 respectively, relative to our forecast of 2.9 and 2.3 percentage points.

3.124 In its February *Economic Review*, the **National Institute for Economic and Social Research** (NIESR) forecast GDP growth of 2.5 per cent in 2014 and 2.1 per cent in 2015, both below our central forecast. NIESR also forecasts weaker growth over the medium term, with an average growth rate of 2.3 per cent from 2016 to 2018, compared to an average growth rate of 2.6 per cent in our latest forecast. Much of the difference between the forecasts in the medium term is attributable to weaker outlook for investment and private consumption, partly offset by a stronger contribution from net trade.

3.125 The **Bank of England** Monetary Policy Committee's forecast for growth is higher than our central forecast in 2014, 2015 and 2016 by 0.7, 0.4 and 0.3 percentage

points respectively. The higher growth forecast does not generate higher inflation, with the MPC's forecast for CPI inflation being lower in 2015 and 2016. Alongside its February *Inflation Report*, the Bank of England published additional forecasts (Table 3.5), which we have compared to our own forecast in more detail in the next section.

3.126 The February forecast from **Oxford Economics** assumes slightly weaker growth than our central forecast in 2014, and slightly stronger in 2015. Growth forecasts are the same from 2016 onwards. It also expects much weaker CPI inflation than we do, which may partly reflect the much larger negative output gap implied by their forecast.

Table 3.4: Comparison of external forecasts

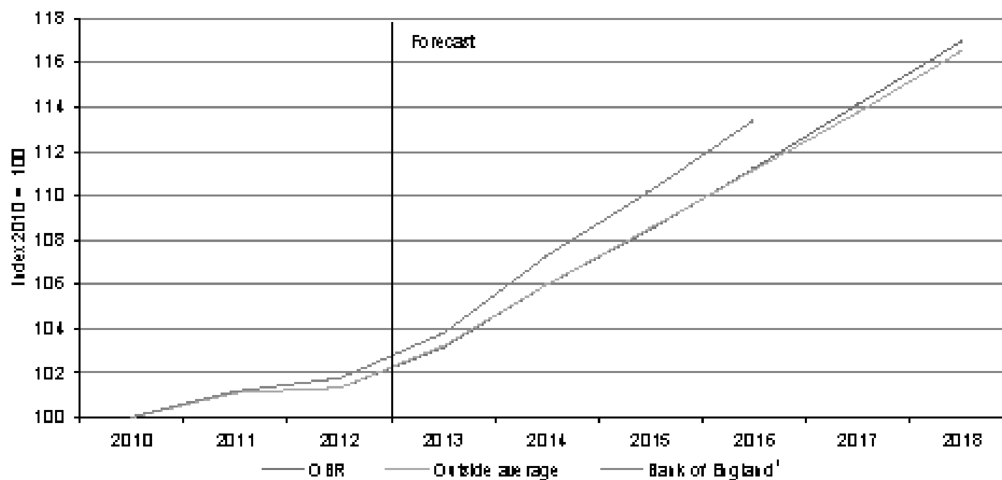
	Per cent						
	2012	2013	2014	2015	2016	2017	2018
OBR (March 2014)							
GDP growth	0.3	1.8	2.7	2.3	2.6	2.6	2.5
CPI inflation	2.8	2.6	1.9	2.0	2.0	2.0	2.0
Output gap	-2.8	-2.2	-1.4	-1.1	-0.7	-0.3	0.0
IMF (October 2013)							
GDP growth[1]	0.3	1.7	2.4	2.2	2.0	2.1	2.3
CPI inflation	2.8	2.7	2.3	2.0	1.9	2.0	2.0
Output gap	-2.9	-2.7	-2.4	-2.1	-1.8	-1.5	-1.0
OECD (November 2013)							
GDP growth	0.1	1.4	2.4	2.5			
CPI inflation	2.8	2.6	2.4	2.3			
Output gap	-2.7	-2.5	-1.7	-1.2			
EC (February 2014)							
GDP growth	0.3	1.9	2.5	2.4			
CPI inflation	2.8	2.6	2.0	2.0			
Output gap	-3.4	-2.4	-0.9	0.2			
NIESR (February 2014)							
GDP growth	0.3	1.9	2.5	2.1	2.1	2.2	2.5
CPI inflation	2.8	2.6	2.2	1.9	1.8	1.9	1.9
Output gap		-4.5	-4.0				
Bank of England (February 2014)[2]							
GDP growth (mode)[3]	0.6	2.0	3.4	2.7	2.9		
CPI inflation (mode)[3, 4]	2.8	2.6	1.9	1.8	1.9		
Oxford Economics (February 2014)[5]							
GDP growth	0.3	1.8	2.6	2.4	2.6	2.6	2.5
CPI inflation	2.8	2.6	1.7	1.8	1.7	1.9	2.0
Output gap		-4.8	-4.2	-3.7	-3.2	-2.9	

[1] GDP growth up to 2015 is from the January 2014, *World Economic Outlook Update*.
[2] Output gap not published.
[3] Forecast based on market interest rates and the Bank of England's 'backcast' for GDP growth.
[4] Fourth quarter year-on-year growth rate.
[5] GDP growth and the output gap up to 2015 is from the HM Treasury, March 2014, *Forecasts for the UK economy: a comparison of independent forecasts*.

Comparison with the Bank of England's *Inflation Report* forecast

3.127 Chart 3.45 presents our central GDP forecast for the next three years against the average of outside forecasts and the Bank of England's February *Inflation Report* forecast. For the purposes of comparison, we have used the Bank of England's modal forecast – that is, the most likely outcome implied by their forecast distribution. The small negative 'skew' in the February *Inflation Report* forecast distribution means that the median forecast is somewhat lower, implying a level of GDP around 0.1 per cent below the modal forecast by 2016. Our forecast for the level of GDP over the next few years is somewhat below the Bank's modal forecast. This largely reflects weaker expected growth in all years of the Bank's forecast, as well as the Bank's 'backcast', which points to stronger growth over the recent past than in the latest ONS data.

Chart 3.45: Comparison of forecasts for the level of GDP



[1]Based on the Bank of England's 'backcast' for GDP growth.
Source: Bank of England, HM Treasury, ONS, OBR

3.128 Alongside its February 2014 *Inflation Report*, the Bank of England published additional information about its projections against which we can compare our own (see Table 3.5). This included information on the Bank staff's forecast for the expenditure composition of GDP, consistent with the MPC's central forecasts of GDP, CPI inflation and the LFS unemployment rate.

3.129 Table 3.5 shows that the Bank's modal expectation for household consumption growth in 2014 and 2015 is somewhat stronger than our forecast, which may be attributable to a stronger forecast for average earnings growth. The Bank also forecasts a somewhat stronger path for investment growth in 2014 and 2015. Consistent with our forecast, the Bank expects business investment to rise as a share of GDP, although its projections imply stronger growth between 2014 and

2016. Partly offsetting this, the Bank expects much stronger growth in imports in 2014 and weaker export growth in 2015.

Table 3.5: Bank of England illustrative projections[19]

	Per cent				
	Outturn	Forecast			
	2012	2013[1]	2014	2015	2016
Bank of England February *Inflation Report* forecast					
Household consumption	1½	2¼	3¼	2¾	2¼
Business investment	3¾	-3¼	11½	12¾	13¾
Housing investment[2,3]	-5¼	5¾	23¼	10½	3
Exports	1¼	¾	3½	3¾	5
Imports	3¼	1½	6¼	4¼	4¼
Employment[4]	2	1½	1½	¾	¾
Average weekly earnings[3,4]	1¼	1	2¾	3¾	3¾
Difference from OBR forecast					
Household consumption	0	0	1¼	1	-¼
Business investment	0	-2	3½	3½	5¾
Exports	¼	0	1	-1	0
Imports	0	1	3¼	0	-½
Employment[4]	0	¼	½	0	-¼

[1] 2013 estimates contain a combination of data and projections.
[2] Whole economy measure. Includes transfer costs of non-produced assets.
[3] We have not shown a comparison for housing investment and average weekly earnings as the definitions of these variables differ and are therefore not directly comparable.
[4] Four-quarter growth rate in Q4.

[19] Bank of England, *Conditioning assumptions, MPC key judgements and indicative projections: February 2014.*

Table 3.6: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2012	2013	2014	2015	2016	2017	2018
UK economy							
Gross domestic product (GDP)	0.3	1.8	2.7	2.3	2.6	2.6	2.5
GDP level (2012=100)	100.0	101.8	104.5	107.0	109.7	112.6	115.4
Nominal GDP	2.0	3.4	5.0	4.0	4.4	4.6	4.5
Output gap (per cent of potential output)	-2.8	-2.2	-1.4	-1.1	-0.7	-0.3	0.0
Expenditure components of GDP							
Domestic demand	1.2	1.9	2.9	2.2	2.5	2.6	2.5
Household consumption[1]	1.5	2.3	2.1	1.8	2.5	2.7	2.4
General government consumption	1.6	0.9	1.2	-0.5	-1.2	-1.8	-0.9
Fixed investment	0.7	-0.5	8.6	8.2	7.8	7.9	6.8
Business	3.9	-1.2	8.0	9.2	8.1	8.7	7.7
General government[2]	0.6	-6.4	10.7	1.0	2.2	0.8	-0.5
Private dwellings[2]	-3.5	4.3	9.0	10.0	10.0	9.5	8.1
Change in inventories[3]	-0.2	0.3	0.1	0.0	0.0	0.0	0.0
Exports of goods and services	1.1	0.8	2.6	4.7	5.0	5.0	4.7
Imports of goods and services	3.1	0.4	3.0	4.3	4.8	4.8	4.7
Balance of payments current account							
Per cent of GDP	-3.7	-3.6	-2.3	-1.9	-1.7	-1.5	-1.5
Inflation							
CPI	2.8	2.6	1.9	2.0	2.0	2.0	2.0
RPI	3.2	3.0	2.6	3.2	3.6	3.8	3.9
GDP deflator at market prices	1.7	1.6	2.3	1.6	1.8	1.9	2.0
Labour market							
Employment (millions)	29.5	29.9	30.4	30.6	30.9	31.2	31.4
Wages and salaries	2.8	2.9	3.8	4.1	4.6	4.7	4.5
Average earnings[4]	2.0	1.5	2.5	3.2	3.6	3.7	3.8
LFS unemployment (% rate)	7.9	7.6	6.8	6.5	6.1	5.7	5.4
Claimant count (millions)	1.59	1.42	1.20	1.13	1.06	0.98	0.94
Household sector							
Real household disposable income	2.3	-0.1	1.2	1.8	1.5	2.3	2.2
Saving ratio (level, per cent)	7.2	5.0	4.1	4.2	3.6	3.3	3.2
House prices	1.6	3.5	8.5	7.8	5.0	3.7	3.7
World economy							
World GDP at purchasing power parity	3.1	2.9	3.8	3.9	4.1	4.2	4.2
Euro area GDP	-0.7	-0.4	1.0	1.4	1.7	1.9	2.0
World trade in goods and services	3.0	3.2	5.2	5.8	6.0	6.1	6.1
UK export markets[5]	2.0	2.1	4.7	5.2	5.3	5.4	5.4

[1] Includes households and non-profit institutions serving households.

[2] Includes transfer costs of non-produced assets.

[3] Contribution to GDP growth, percentage points.

[4] Wages and salaries divided by employees.

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

Table 3.7: Detailed summary of changes to forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2012	2013	2014	2015	2016	2017	2018
UK economy							
Gross domestic product (GDP)	0.1	0.3	0.3	0.1	0.0	0.0	-0.3
GDP level (2012=100)[1]	0.0	0.3	0.7	0.8	0.8	0.7	0.5
Nominal GDP	0.2	-0.2	0.4	0.2	0.1	0.1	0.0
Output gap (per cent of potential output)	-0.2	0.1	0.4	0.5	0.5	0.4	0.2
Expenditure components of GDP							
Domestic demand	0.2	0.5	0.5	0.1	0.0	-0.1	-0.3
Household consumption[2]	0.3	0.4	0.2	0.2	0.1	-0.2	-0.4
General government consumption	-0.1	0.3	0.8	0.1	-0.3	0.0	0.3
Fixed investment	-0.2	2.0	1.9	0.3	-0.4	-0.1	-0.2
Business	1.2	4.2	2.9	0.6	-0.7	-0.2	-0.3
General government[3]	-4.0	0.5	3.3	-0.1	0.1	0.3	0.6
Private dwellings[3]	-1.0	-1.8	-0.7	0.0	0.0	-0.2	-0.3
Change in inventories[4]	0.1	-0.1	-0.1	-0.1	0.0	0.0	-0.1
Exports of goods and services	0.1	-0.4	-1.4	0.0	0.0	0.0	0.0
Imports of goods and services	0.1	-1.3	-0.8	0.0	0.0	0.0	0.0
Balance of payments current account							
Per cent of GDP	0.1	-0.2	-0.8	-0.4	-0.3	-0.3	-0.4
Inflation							
CPI	0.0	0.0	-0.4	-0.1	0.0	0.0	0.0
RPI	0.0	0.0	-0.3	-0.1	0.0	0.1	-0.1
GDP deflator at market prices	0.0	-0.5	0.1	0.1	0.1	0.2	0.3
Labour market							
Employment (millions)	0.0	0.0	0.2	0.2	0.2	0.2	0.2
Wages and salaries	0.0	0.0	0.0	0.2	0.1	0.0	-0.2
Average earnings[5]	0.0	0.1	0.0	-0.1	0.1	0.0	0.1
LFS unemployment (% rate)	0.0	0.0	-0.3	-0.4	-0.4	-0.4	-0.2
Claimant count (millions)	0.00	-0.01	-0.07	-0.10	-0.12	-0.15	-0.16
Household sector							
Real household disposable income	0.8	-0.6	0.1	0.7	-0.5	-0.3	-0.4
Saving ratio (level, per cent)	0.4	-0.7	-0.9	-0.4	-1.0	-1.1	-1.1
House prices	0.0	0.4	3.3	0.6	0.1	0.0	-0.1
World economy							
World GDP at purchasing power parity	-0.1	0.0	0.2	0.0	0.0	0.0	0.0
Euro area GDP	0.0	0.0	0.2	0.1	0.0	0.0	0.0
World trade in goods and services	0.6	0.4	-0.2	0.0	0.0	0.0	0.0
UK export markets[6]	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0

[1] Per cent change since December.
[2] Includes households and non-profit institutions serving households.
[3] Includes transfer costs of non-produced assets.
[4] Contribution to GDP growth, percentage points.
[5] Wages and salaries divided by employees.
[6] Other countries' imports of goods and services weighted according to the importance of those countries in the UK's total exports.