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From:	Ivan Rogers, Permanent Representative, UK Representation to the EU
date of receipt:	28 April 2015
To:	Mr Carsten PILLATH, Director General, Council of the European Union
Subject:	2014-15 Convergence Programme for the United Kingdom

Delegations will find attached the first part of the Convergence Programme for the United Kingdom.

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Mr Carsten Pillath
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28 April 2015

Dear Carsten,

UK Convergence Programme 2014-2015 and UK National Reform Programme 2015

I am writing to provide you with the UK's Convergence Programme for this year (2014-2015) and the UK's National Reform Programme for 2015.

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.

As in previous years, the UK's 2015 National Reform Programme has been prepared jointly with other Government departments and the Devolved Administrations of Scotland, Wales and Northern Ireland.

These programmes were submitted to the European Commission on 26 March and I also include a copy of the letters sent to Catherine Day, Secretary General of the European Commission.

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Yours,

M. Ivan Rogers

IVAN ROGERS

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HM Treasury

2014-15 Convergence Programme for the United Kingdom:

submitted in line with the Stability and Growth pact

March 2015

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Foreword

In 2010, unemployment was at 8% and the budget deficit was over 10% of GDP – the largest deficit in post-war history. One pound in every four the government spent was being borrowed. Since 2010, the government's long-term economic plan has delivered the stability and security needed to build a resilient economy. The UK had the fastest growth among G7 economies in 2014, employment has reached its highest ever level, and inflation is at a record low. Debt as a share of GDP is now forecast to start falling in 2015-16 – meeting the debt target set out in 2010. Public sector net borrowing is lower in every year to 2018-19 than at Autumn Statement 2014, and the deficit as a share of GDP is forecast to have halved by the end of 2014-15. In 2015-16, Office for Budget Responsibility (OBR) forecasts show that only one pound in every ten spent by the government will be borrowed.

Now the government needs to finish the job. The deficit remains too high and productivity too low, there are still long-standing structural weaknesses in the economy, and the gap between the economic performance of London and the rest of the UK remains too wide. The government is continuing to take decisive action for the long term in order to reduce borrowing, create full employment and secure a truly national recovery. The government's ambition is to build a stronger economy and a fairer society, and for the UK to become the most prosperous major economy in the world by 2030.

The UK economy and public finances: GDP grew 2.6% in 2014, the strongest annual growth since 2007, and the fastest in the G7. Debt is forecast to be falling as a share of GDP in 2015-16, meeting the debt target set out by the government in 2010. Borrowing is forecast to be lower in every year to 2018-19 than at Autumn Statement 2014, and the public finances are forecast to achieve a larger surplus in 2018-19. Falling debt and improving borrowing mean that consolidation can end a year earlier than planned, and that spending will grow in line with GDP in 2019-20. Budget 2015 builds on existing reforms to create a dynamic, regionally balanced and stronger economy.

Growth: At the end of 2014, employment was at its highest ever level with 1.85 million more people in work since the current government came to power. Business investment has increased by 25.6% since Q1 2010, and the UK will have the joint lowest rate of Corporation Tax in the G20 from April 2015. Budget 2015 sets out a significant package of measures for a truly national recovery by investing in infrastructure, housing, science and innovation across the whole of the UK, and building a Northern Powerhouse. Fuel Duty will be frozen for another year, the government will substantially reduce oil and gas taxes to improve competitiveness in the North Sea, and further support for energy intensive industries will begin in 2015-16. A comprehensive review of Business Rates has been launched, and there will be a radical simplification of the tax system by abolishing the annual tax return.

Fairness: The government's plan is underpinned by a firm commitment to support those who want to work hard and get on, and to ensure that the most vulnerable receive the care and services they need. The richest households continue to make the biggest contribution to reducing the deficit, both in cash terms and as a proportion of their income. Budget 2015 builds on the government's priority of helping families and making work pay with further substantial increases to the personal allowance to £11,000, passing on full gains to higher-rate taxpayers. Saving will be supported by a new tax free Personal Savings Allowance and the Help to Buy: ISA.

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Budget 2015 also invests in mental health services for children and young people and sets out further action to tackle tax evasion and avoidance.

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1 Introduction

1.1 The Stability and Growth Pact (SGP) requires Member States to provide information on economic developments in their country for the purposes of the multilateral surveillance procedure under Articles 121 and 126 of the EU Treaty. 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 2014 and Budget 2015. This Convergence Programme draws on those publications, particularly Budget 2015.

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 2015 Economic and fiscal outlook, which was published alongside Budget 2015.

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.

Structure of the Convergence Programme

1.6 The first 5 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 2015 Economic and fiscal outlook and 2014 Fiscal sustainability report.

1.8 Annex B provides details of the financial impact of Autumn Statement 2014 and Budget 2015 policy decisions. Annex C provides supplementary data.

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2 Overall policy framework and objectives

The UK economy and public finances

2.1 In 2008 the UK was hit by the most damaging financial crisis in generations and in 2010 the government inherited the largest deficit since the Second World War and rapidly rising debt. Since 2010 the government's long-term economic plan has laid the foundations for a stronger economy and a fairer society. The UK had the fastest growth among G7 economies in 2014. The Office for Budget Responsibility (OBR) has revised up its forecasts for UK growth in 2015 and 2016. The deficit is forecast to have fallen by a half as a percentage of GDP from its 2009-10 peak in 2014-15 and the deficit is forecast to be lower in every year from 2015-16 than forecast at Autumn Statement 2014. Debt is forecast to start falling as a share of GDP in 2015-16, a year earlier than the OBR expected at Autumn Statement 2014. This is the first time public sector net debt has been forecast to fall as a share of GDP in 2015-16 since Budget 2012.

2.2 The government's long-term economic plan is delivering stability and growth, in the face of rising instability around the world. At the end of 2014 the employment rate was at its joint highest level ever and in January 2015 inflation was at its lowest rate on record. Now the government must finish the job. The deficit remains high, productivity too low and the UK is not immune to the problems being experienced in Europe and other parts of the world economy. The government will go on taking the difficult decisions needed to secure a truly national recovery and to build a stronger economy and a fairer society that provides opportunity for all. The government's ambition is to create the most prosperous major economy in the world by 2030, with prosperity widely shared.

UK economy since 2010

2.3 The government's balanced programme of deficit reduction has restored fiscal credibility, allowing activist monetary policy and the automatic fiscal stabilisers to support the economy. This has been supported by far-reaching reform of the financial system, a comprehensive package of structural reforms and investment in infrastructure.

2.4 The UK economic recovery is now well established and growth is broad based across the main sectors of the economy. GDP in 2014 was 2.6% higher than in 2013, the strongest annual growth since 2007.[1] Manufacturing, construction and services all grew by 2.5% or more in 2014.

2.5 UK GDP exceeded its pre-crisis peak in Q3 2013 and in Q4 2014 was 3.4% higher than the pre-crisis peak in Q1 2008. The Organisation for Economic Co-operation and Development (OECD) in the 'Economic Survey of the United Kingdom 2015' set out that "against the background of subdued growth in the euro area, the (UK) recovery has benefitted from the cumulative impact of wide-ranging domestic policies. These included highly-accommodative

[1] All UK economy data from Office for National Statistics (ONS) unless otherwise stated. Further detail can be found in 'Budget 2015 Data Sources'.

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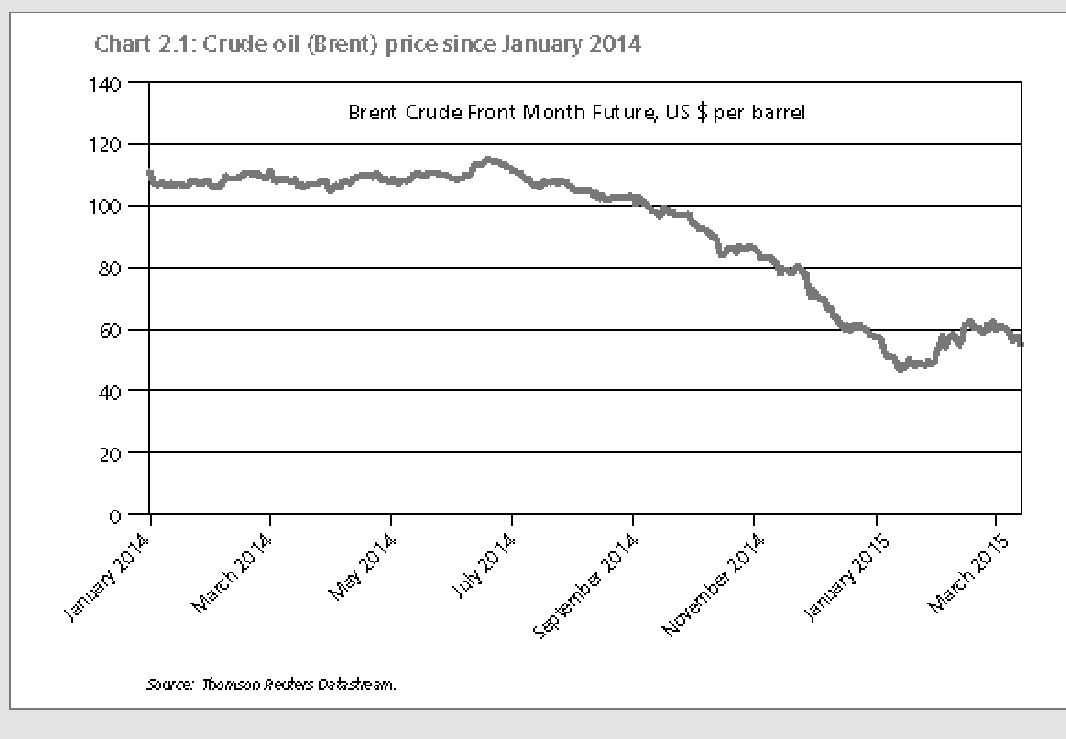
monetary policy and measures to support lending and revive the housing market".[2] As the OECD Secretary-General set out "Britain has a long term economic plan, but it needs to stick with it".[3]

2.6 CPI inflation was 0.3% in January 2015, down from 0.5% in December 2014. The low inflation recently experienced by the UK has mostly been driven by global factors, notably the sharp fall in oil prices and the decline in food prices. The Governor of the Bank of England has set out that three-quarters of the movement in inflation relative to the 2% inflation target has been caused by food, energy and other goods prices.[4] Box 2.A sets out the impact of lower oil prices on the global and UK economy.

Box 2.A: Impact of lower oil prices on the global and UK economy

Between 2009 and 2011 global commodity prices rose rapidly, resulting in higher-than-expected inflation in the UK, which peaked at 5.2% in September 2011. This in turn impacted the UK economy by reducing real incomes and raising business costs. In the second half of 2014 the oil price fell significantly. From a 2014 peak of $115 a barrel in June, the price of oil fell to a low of $46 a barrel in January.[5] It has since picked up, but the OBR's medium-term assumption is around 17% lower than in December. The OBR judges that the fall in oil prices reflects both lower-than-expected global demand and higher-than-expected global supply of oil.[6]

Chart 2.1: Crude oil (Brent) price since January 2014



Source: Thomson Reuters Datastream.

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[2] 'Economic Survey of the United Kingdom 2015', Organisation for Economic Co-operation and Development (OECD), February 2015.
[3] Remarks by Angel Gurria at the press conference for the 'Economic Survey of the United Kingdom 2015', OECD, February 2015.
[4] Governor of the Bank of England, oral evidence to the Treasury Committee, Bank of England Inflation Report hearings, 24 February 2015.
[5] Thomson Reuters Datastream.
[6] 'Economic and fiscal outlook', Office for Budget Responsibility (OBR), March 2015.

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The OBR expects the decline in the oil price "is likely to affect economic activity in a number of ways: boosting real household incomes and thereby consumer spending and, to a lesser extent, encouraging business investment, but weighing on North Sea production and investment".[7] The OBR expects the fall in the oil price since Autumn Statement 2014 to increase GDP growth by around 0.4 percentage points across 2015 and 2016, more than offsetting the effect on net trade of a further deterioration in the outlook for the UK's export markets.

At the global level, lower oil prices can support aggregate demand if oil consumers increase their spending by more than oil producers cut theirs. In the February 2015 'Inflation Report' the Bank of England estimate that "the fall in oil prices since mid-2014 could boost the level of UK-weighted world GDP by around 0.8%, offsetting some of the negative news in world demand since the summer, and helping to support UK exports".[8] There is a considerable margin of uncertainty around the global impact.

Low inflation driven by the fall in global oil and food prices is good news for households. At Budget 2014, the OBR forecast that UK CPI inflation in 2015 would be 2.0%. The OBR's revised forecast for CPI inflation in 2015 is 0.2%. Lower inflation means that on average the cost of running a household in 2015 will be £450 cheaper than was forecast a year ago.[9]

The fall in oil prices has supported household budgets. Due to petrol pump prices falling by 19p per litre since March 2014, the cost of filling up a tank for the typical motorist has fallen by £11 since Budget 2014.[10] The government has made very clear that it will watch industry to ensure that savings from the fall in oil prices are being passed through to consumers.

Employment, earnings and productivity

Employment

2.7 The UK labour market has continued to strengthen. At the end of 2014 employment was at its highest level ever at 30.9 million, more than 1 million above its pre-crisis peak, and up 1.85 million since the current government came into power. The employment rate was 73.2% for the 3 months to December 2014, the joint highest level since records began. In 2014 the annual increase in the employment level and the annual decrease in the unemployment level were the largest since 1988. At the end of 2014 youth unemployment had fallen by a fifth compared to a year earlier.

2.8 Employment has increased faster in the UK since Q1 2010 than in any other country in the G7, as shown in Chart 2.2.[11] Over the last year the UK government has come closer to achieving its full employment ambition to have the highest employment rate in the G7. The internationally comparable employment rate for the UK was 72.0% in Q3 2014, the fourth highest in the G7.[12]

[7] 'Economic and fiscal outlook', OBR, March 2015.
[8] 'Inflation Report', Bank of England, February 2015.
[9] HM Treasury calculations based on March 2014 and March 2015 OBR forecasts for the consumer expenditure deflator, March 2015 OBR forecasts for private consumption, ONS household statistics and Department for Communities and Local Government (DCLG) household projections.
[10] 'Weekly road fuel prices', Department of Energy and Climate Change (DECC), as of 10 March 2015.
[11] 'Short-Term Labour Market Statistics: Employed Population', OECD, March 2015.
[12] 'Short-Term Labour Market Statistics: Employed Population', OECD, March 2015.

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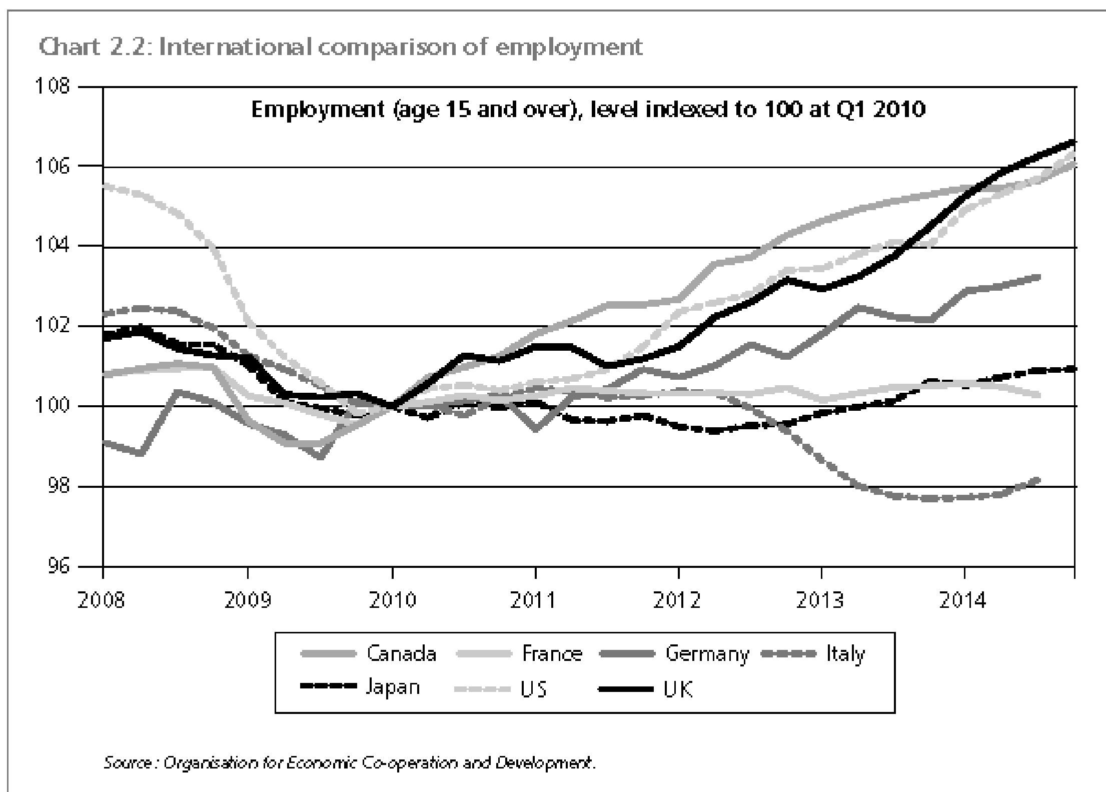

2.9 The overall growth in employment predominantly reflects increases in the number of people employed in high and medium-skilled occupations. In the 4 years since Q1 2010 more than two-thirds of the increase in employment has been in high-skilled occupations.[13] Since Q1 2010 over 70% of the increase in employment has come from full-time workers, including self-employed workers, and nearly 60% of the increase in employment has come from full-time employees.

2.10 Participation has also increased, with the working age participation rate at levels last seen in the early 1990s and 1.2 million more people in the workforce at the end of 2014 than when the current government came into power. The growth in the number of women joining the workforce has helped drive this increase. Since 2008, over 70% of the increase in working age participation has come from women. This has led to the gender gap in participation rates reaching a record low at the end of 2014. Older workers are also playing a greater role in the labour market, with the participation rate in 2014 for those aged over 50 at its highest since records began.

Earnings

2.11 Earnings growth has been strengthening, with total pay up 2.1% in the 3 months to December 2014 compared to a year earlier. In the year to December 2014 real pay growth was 1.9%, marking the fourth month of positive real wage growth. The OBR forecasts real terms growth in average earnings for all years of the forecast.[14]

2.12 Lower fuel and food prices are welcome news for households, boosting real household incomes and helping family budgets stretch further. Real household disposable income (RHDI) per capita is the most up to date and comprehensive measure of living standards, used by the OECD, the Office for National Statistics (ONS) and its use welcomed by the UK Statistics Authority, as it takes into account employment levels, the effects of tax and benefits, as well

[13] High and medium-skilled occupations as defined in 'Economic Review', ONS, December 2014.
[14] All forecasts refer to the OBR 'Economic and fiscal outlook', March 2015, unless otherwise stated.

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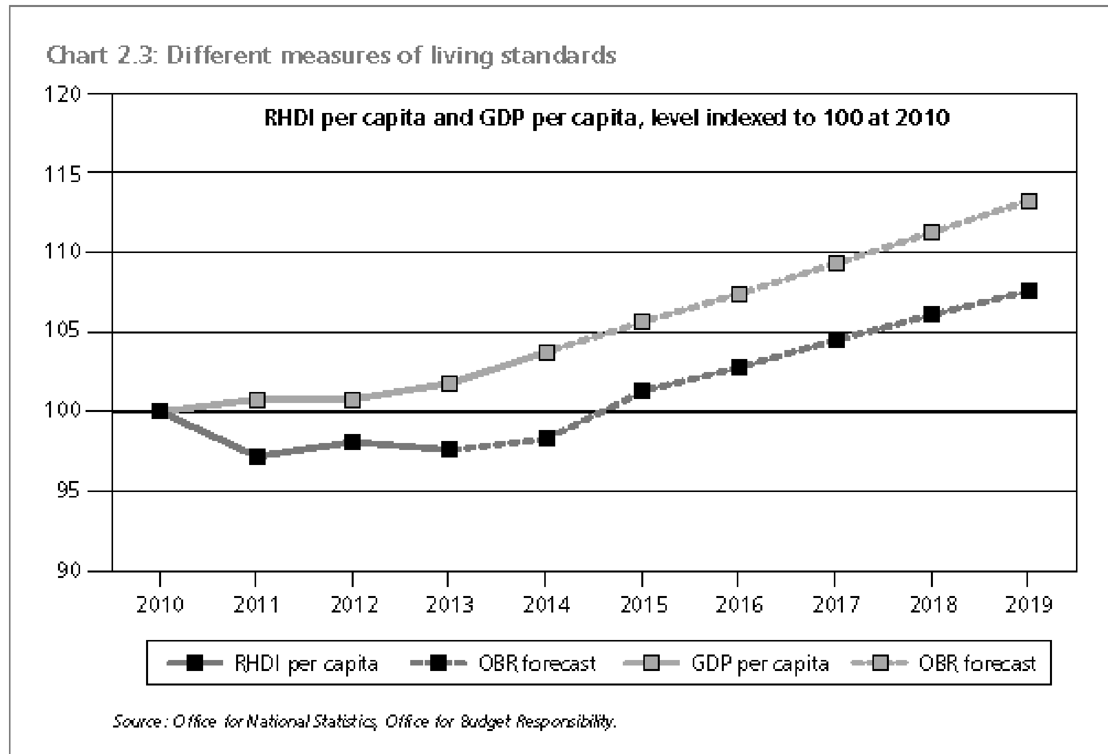
as inflation.[15] The OBR forecasts imply that in 2015 living standards, as measured by RHDI per capita, will be higher than in 2010 or any previous year and will continue to grow strongly every year for the rest of the forecast period. The OBR forecasts that in 2015 RHDI per capita will grow at its fastest rate for 14 years at 3.1%. This will mean that on average households will be £1,100 better off in 2015 than 2014 and around £900 better off in 2015 than in 2010.[16] The Institute for Fiscal Studies (IFS) have nowcast households below average income (HBAI) to 2014-15, and on current trends median income in 2015-16 is likely to be higher than in 2010-11.[17]

2.13 GDP per capita is forecast to be over 5% higher in 2015 than in 2010. Chart 2.3 shows the projected path of GDP per capita and RHDI per capita.



Productivity

2.14 Poor productivity growth has been a long-term issue affecting the UK economy. Since the financial crisis UK productivity performance has been weak. Factors related to the nature of the financial crisis are likely to be having a persistent impact on the level of productivity.

2.15 The latest data has been mixed and shows output per hour productivity grew by 0.6% and output per worker productivity grew by 0.4% in Q3 2014 on the previous quarter. Productivity in the public sector has been increasing steadily since the financial crisis. Between 2010 and 2012 public sector productivity increased by a total of 3.7%.[18] The OBR forecasts productivity growth picking up to 0.9% in 2015, 2.1% in 2016 and 2.5% in 2017.

2.16 The UK is not alone in having weak productivity growth recently and the relationship between pre and post-crisis productivity in the UK is qualitatively similar to that of other

[15] The UK Statistics Authority (UKSA) recently welcomed "Greater use of the estimates of Household Disposable Income (a component of the ONS National Accounts) to give insight into household income at both the aggregate and individual level". Monitoring Review 1/2015 – 'The Coherence and Accessibility of Official Statistics on Income and Earnings', UKSA, February 2015.
[16] HM Treasury calculations based on March 2015 OBR forecasts for Real Household Disposable Income (RHDI), ONS household statistics and DCLG household projections.
[17] 'Living standards: recent trends and future challenges', Institute for Fiscal Studies (IFS), March 2015.
[18] 'Public Service Productivity Estimates: Total Public Services, 2012', ONS, February 2015.

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developed countries.[19] The recent weakness in productivity has occurred alongside strong employment growth. Since Q1 2010 the UK has seen the fastest growth in employment of all the G7 countries.

2.17 Productivity growth is the main factor determining average living standards in the medium term. The government has implemented far-reaching structural reforms to improve the UK's long-term productivity. The OECD Secretary-General in February 2015 set out that the "United Kingdom has made tremendous progress in recovering from the largest economic crisis in 80 years. And this progress has laid the foundations for further reforms needed to boost productivity and inclusiveness".[20]

UK rebalancing, investment and trade

2.18 As the recovery has become established, growth has been broadly balanced across sectors, and it is also becoming more balanced across the UK. There has been widespread growth across all major sectors since the start of 2013, including manufacturing, construction and services.

2.19 Business investment has been a key factor driving the recovery. Business investment has increased 25.6% since Q1 2010 and is 5.3% above its pre-crisis peak in Q2 2008. Business investment in 2014 saw the largest annual growth since 2007. Since Q1 2010, business investment has grown 4 times faster than household consumption. The OBR forecasts 2.6% household consumption growth in 2015, alongside continued strong business investment growth of 5.1% in 2015. Budget 2015 announces a package of measures to support investment in the oil and gas sector. The OBR's assessment is these measures will boost the level of oil production by 2019 by 15%, equivalent to around 0.1% of GDP.[21]

2.20 This government is committed to rebalancing growth across the regions and nations of the UK and is committed to the creation of a Northern Powerhouse. The latest data shows that output per head in the North West, North East, West Midlands and Wales all grew faster than London in 2013. In addition, in the year to the end of 2014, employment in the North East, North West and the East Midlands all grew faster than in London.

2.21 The UK is one of the most open economies in the world, with significant trade and financial links with other countries. UK exports performance is highly dependent on the economic performance of the euro area, the UK's largest trading partner.

2.22 The UK's current account deficit widened to 6.0% of GDP in Q3 2014. Chart 2.4 shows the income balance has declined since early 2012, reflecting lower income received from investment abroad. Weaker euro area growth and global prospects have seen UK investments abroad yield lower returns while, in contrast, as the UK economy has continued to recover, the payments made on foreign holdings of UK investment have increased. The OBR forecasts that the current account deficit will diminish over the forecast period from 4.3% of GDP in 2015, to 3.2% in 2016 and 2.3% in 2019.

2.23 Weak euro area growth has meant goods exports to EU countries have been subdued. But UK exporters have continued to expand in other markets and the volume of goods exports to non-EU countries has increased by 24% since Q1 2010. The UK's trade deficit in the 3 months to January 2015 was £4.4 billion, the lowest deficit since October 2000. The narrowing of the deficit in the 3 months to January 2015 reflected a fall of £1.2 billion in UK imports and an increase in exports of £2.4 billion.

[19] 'The UK productivity puzzle: an international perspective', speech by Martin Weale, December 2014.
[20] Remarks by Angel Gurria for the 'Economic Survey of the United Kingdom 2015', OECD, February 2015.
[21] 'Economic and fiscal outlook', OBR, March 2015.

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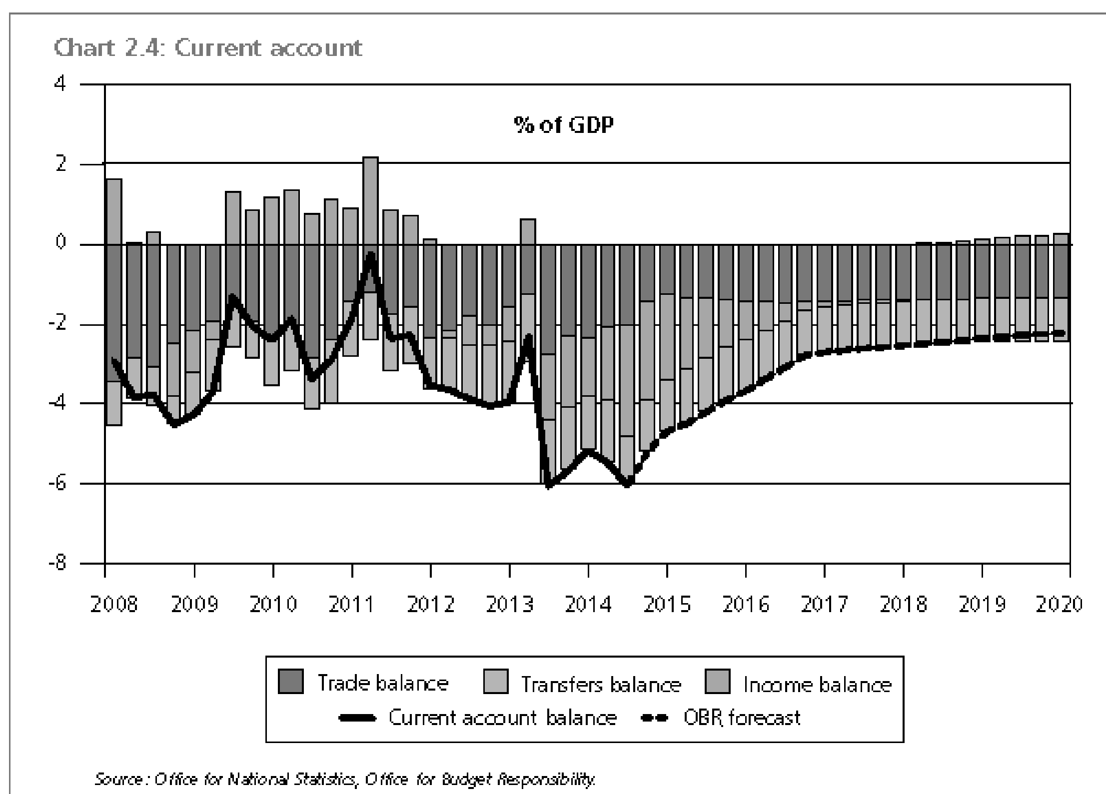

2.24 There continue to be signs of normalisation in the housing market with indicators suggesting continued increases in house building and moderating house price growth. Housing starts were up 10% in England in 2014 and house prices grew by 9.8% in the year to December 2014, down from 12.1% in the year to September 2014.[22] Effective mortgage rates fell to 2.8% in January 2015, the lowest rate on record.[23] Lower effective mortgage rates should make it easier to service a mortgage and support housing demand. Budget 2015 announces the Help to Buy: ISA to help first-time buyers realise their aspirations of homeownership.

Global developments and risks

2.25 Abandoning the government's long-term economic plan would represent the most significant risk to the UK economy. A sustained improvement in productivity growth is critical to delivering the OBR's forecast for the economy. The global economic recovery remains uneven and the UK is not immune to the severe problems being experienced in Europe and other parts of the world economy.

2.26 In January 2015, the International Monetary Fund (IMF) again downgraded its global growth forecast for 2015 to 3.5%.[24] In the euro area, recovery remains slow and inflation has turned negative. The IMF expects euro area growth of 1.2% in 2015. In contrast, the US economy is forecast to continue to recover strongly and the IMF projects growth of 3.6% in 2015. In Japan, growth is forecast to be just 0.6% in 2015. Chinese growth continues to moderate as the government implements an ambitious reform plan to rebalance the economy and control credit growth, and is expected to fall below 7% in 2015. Across emerging and developing markets, the IMF expects growth to slow to 4.3% in 2015.

[22] 'House Building in England: October to December 2014', DCLG, February 2014.
[23] 'Effective interest rates: January 2015', Bank of England, February 2015.
[24] 'World Economic Outlook Update', International Monetary Fund (IMF), January 2015.

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2.27 The UK economy faces a number of external risks from key trading partners. These include a prolonged standoff between Greece and the euro area, weak growth and disinflationary pressure in the euro area and Japan, risks to growth in key emerging markets, and the situation in Russia and Ukraine.

2.28 The Greek government has indicated that it wishes to discuss the terms of its current loans from the euro area. Greece and the euro area need to work together to identify a sustainable way forward and ensure economic and financial stability. In that context, the UK welcomed the agreement in February towards extending the euro area's existing financial assistance for a further 4 months while these discussions continue. A prolonged or turbulent stand-off between Greece and the euro area would represent the biggest external risk to the UK economy. Although the UK's direct economic and financial links with Greece are limited, the UK is highly exposed to wider market instability.

2.29 Commodity exporting countries face pressures from recent falls in the price of oil and other commodities which could lead to external and public-sector financing challenges. Separately, risks remain around the market impact on some emerging economies of monetary policy normalisation in some advanced economies, but those which have pressed on with reforms appear increasingly well-prepared to maintain market confidence.

2.30 Finally, geopolitical uncertainty raised by the tensions between Russia and Ukraine is likely to create uncertainty in global markets, particularly if the situation deteriorates. Support from the IMF, EU and other partners is necessary to address Ukraine's urgent financial needs while the Ukrainian government undertakes essential economic reforms. The UK welcomes approval, by the IMF Board, of new IMF financial assistance. The UK's direct economic links with Russia and Ukraine are limited and sanctions have been targeted to ensure that the impact on the UK and the rest of the EU is limited.

Economic outlook

Table 2.A: Summary of the OBR's central economic forecast[1]

	Percentage change on a year earlier, unless otherwise stated						
			Forecast				
	2013	2014	2015	2016	2017	2018	2019
GDP growth	**1.7**	**2.6**	**2.5**	**2.3**	**2.3**	**2.3**	**2.4**
Main components of GDP							
Household consumption[2]	1.7	2.0	2.6	2.7	2.5	2.3	2.2
General government consumption	-0.3	1.5	0.8	-0.7	-0.9	-0.2	1.5
Fixed investment	3.4	6.8	4.3	6.2	5.6	5.7	4.4
Business	5.3	6.8	5.1	7.5	6.5	6.4	4.4
General government[3]	-8.1	7.3	2.3	1.9	1.6	1.5	2.8
Private dwellings[3]	6.2	6.6	3.5	5.4	5.5	6.2	5.2
Change in inventories[4]	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Net trade[4]	0.0	-0.5	-0.1	-0.4	-0.2	-0.2	-0.2
CPI inflation	**2.6**	**1.5**	**0.2**	**1.2**	**1.7**	**1.9**	**2.0**
Employment (millions)	**30.0**	**30.7**	**31.1**	**31.4**	**31.5**	**31.7**	**31.9**
ILO unemployment (% rate)[5]	**7.6**	**6.2**	**5.3**	**5.2**	**5.3**	**5.3**	**5.3**

[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.
[5] International Labour Organization.
Source: Office for Budget Responsibility, Office for National Statistics.

2.31 The OBR has revised up its forecasts for UK growth in 2015 from 2.4% to 2.5% and in 2016 from 2.2% to 2.3%. The OBR forecasts growth of 2.3% in 2017, rising to 2.4% in 2019. The OBR forecasts employment to be 31.1 million in 2015, rising to 31.9 million by 2019. The OBR has revised down its forecast for the unemployment rate in 2015 from 5.4% to 5.3%. The OBR forecasts unemployment of 5.2% in 2016 and 5.3% for the remainder of the forecast period.

2.32 The output gap represents the amount of spare capacity in the economy. Higher GDP growth in 2015 and 2016 means that spare capacity in the economy will be reduced more quickly than expected at the time of Autumn Statement 2014. The OBR therefore forecasts remaining spare capacity in the economy to be used up by late 2017, a year and a half earlier than forecast at Autumn Statement 2014.

2.33 The OBR forecasts business investment growth of 5.1% in 2015 and 7.5% in 2016. The OBR expects private dwelling investment to grow by 3.5% in 2015, 5.4% in 2016 and 5.5% in 2017. The OBR forecasts exports growth of 3.9% in 2015 and 4.0% in 2016 and growth of over 4.0% over the remainder of the forecast.

2.34 CPI inflation is forecast to be below target in 2015 and remain below target before returning to 2.0% in 2019.

The government's plan

2.35 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 debt, 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, lower job taxes and a long-term industrial strategy
- capping welfare and controlling immigration so the 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

2.36 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 sector, and a comprehensive package of structural reforms.

Monetary policy

2.37 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 and remit for the Monetary Policy Committee (MPC) at Budget 2013.

2.38 The MPC has full operational independence to set policy to meet the inflation target. **Budget 2015 reaffirms the inflation target of 2% for the 12-month increase in the CPI, which applies at all times.** This target is symmetric meaning deviations below the target are treated the same way as deviations above the target. Symmetric targets help to ensure that inflation expectations remain anchored and that monetary policy can play its role fully. **The government also confirms the Asset Purchase Facility (APF) will remain in place for the financial year 2015-16.**

2.39 Inflation fell markedly to 0.5% in December 2014 and 0.3% in January 2015, triggering the first open letter for inflation falling more than 1 percentage point below target, published on 12 February 2015.[25] In its February 2015 'Inflation Report', the MPC forecast that inflation is likely to remain low for the next year or so, mostly reflecting the recent falls in commodity and food prices, before returning to target in 2 years' time.[26] The Chancellor's open letter to the Governor of the Bank of England welcomed "that the MPC remains vigilant to both upside and downside risks to its forecast and stands ready to act if these risks materialise".[27]

Credit easing

2.40 Since its introduction, the Funding for Lending Scheme (FLS) has helped to reduce bank funding costs to historic lows and improve credit conditions for households and businesses, including small and medium-sized enterprises (SMEs). As of end-Q4 2014, participants have £55.7 billion of borrowing outstanding in the scheme to support lending to the real economy.[28]

2.41 In December 2014, the Treasury and the Bank of England announced that the FLS would be extended by 1 year to 29 January 2016. This extension will maintain support for lending where it is most needed – for SMEs – and will provide certainty over cheap funding to support lending, even in the event of negative shocks to bank funding conditions.

Deficit reduction

Fiscal strategy

2.42 The government inherited the largest deficit in post-war history as a result of the Great Recession and unsustainable pre-crisis increases in public spending.[29] The IMF estimates that the UK entered the Great Recession with the largest cyclically-adjusted deficit of any major advanced economy, at 5.3% of GDP in 2007.[30] Unchecked, the historically high level of borrowing could have undermined fairness, growth and economic stability in the UK. In 2010, the government set out medium-term fiscal consolidation plans to return the public finances to a sustainable path.

2.43 The government is making significant progress in delivering its fiscal consolidation. Public sector net borrowing as a percentage of GDP is forecast to have halved between 2009-10 and 2014-15.[31] The latest data from the IMF shows that, between 2010 and 2013, the government reduced the structural deficit by more than half. The structural deficit fell by 4.6% of GDP over this period, a larger absolute reduction than any other country in the G7.[32] When this government came into office around 1 pound in every 4 being spent was borrowed.[33] In 2015-16 the Office for Budget Responsibility's (OBR) forecasts show that only 1 pound in every 10 spent will be borrowed.[34]

2.44 The government is forecast to meet its new forward-looking fiscal mandate in the third year of the forecast period, which is currently 2017-18, having reduced the cyclically-adjusted current budget deficit from its peak of 4.8% of GDP in 2009-10 to 2.6% of GDP in 2013-14.[35] The supplementary aim for public sector net debt to fall as a share of GDP in 2016-17 is forecast to be met a year early with debt falling as a share of GDP in 2015-16. This is the first time public sector net debt has been forecast to fall as a share of GDP in 2015-16 since Budget 2012.

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[25] Open letter from the Governor of the Bank of England to the Chancellor of the Exchequer, February 2015.
[26] 'Inflation Report', Bank of England, February 2015.
[27] Open letter from the Chancellor of the Exchequer to the Governor of the Bank of England, February 2015.
[28] 'Funding for Lending Scheme usage and lending data publication – Q4 2014', Bank of England, February 2015.
[29] 'Public Sector Finances', ONS, January 2015.
[30] 'World Economic Outlook', IMF, October 2014.
[31] 'Public Sector Finances', ONS, January 2015; 'Economic and fiscal outlook', OBR, March 2015.
[32] 'World Economic Outlook', IMF, October 2014.
[33] 'Public Sector Finances', ONS, January 2015.
[34] 'Economic and fiscal outlook', OBR, March 2015.
[35] 'Public finances databank', OBR, March 2015.

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2.45 Since Autumn Statement 2014, the fiscal position has improved across the forecast period. Higher receipts in 2014-15 and lower debt interest costs across the forecast period are reflected in an improved path of public sector net borrowing. The overall surplus on public sector net borrowing in 2018-19 is higher than at Autumn Statement 2014. Public sector net debt as a percentage of GDP is forecast to fall one year earlier than at Autumn Statement 2014 and is lower in cash terms and as a percentage of GDP from 2015-16 than was forecast previously. The faster pace of debt reduction in this forecast, largely due to the sale of financial sector assets in 2015-16, will improve the sustainability of the public finances and means that Total Managed Expenditure (TME) is able to grow in line with GDP in 2019-20, when it will be 36% of GDP and when public sector net debt will fall by 3.2 percentage points of GDP.

2.46 The government remains committed to restoring the public finances to a sustainable position and getting public sector net debt onto a declining path as a share of GDP. The latest forecast from the OBR shows that the cyclically-adjusted current budget will be in balance in 2017-18, with an overall surplus from 2018-19. Getting to grips with the public finances will speed up the process of debt reduction, reducing the burden on taxpayers and strengthening the ability of future governments to respond to economic shocks.

Consolidation in this Parliament

2.47 The government has to date delivered £83 billion of the £98 billion planned discretionary reductions in spending and £106 billion of the £121 billion planned total discretionary consolidation by the end of 2015-16, as set out in Table 2.B.

Table 2.B: Total consolidation plans over this Parliament

	£ billion		
	2013-14	2014-15	2015-16
Policy inherited by the government	**56**	**70**	**–**
Spending[1,2]	38	48	–
Tax[2]	18	21	–
Spending share of consolidation (%)	*67*	*69*	–
Total discretionary consolidation	**92**	**106**	**121**
Spending[1,2,3]	67	83	98
Tax[2,3]	24	23	23
Spending share of consolidation (%)	*74*	*78*	*81*

[1] *Spending consolidation is attributable to 3 factors: (a) reductions in Departmental Expenditure Limits (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 Annually Managed Expenditure (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 2015 'Economic and fiscal outlook.' This calculation excludes the impact of financial transactions in Capital DEL.*

[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 calculations.

2.48 Public spending control is central to the government's commitment to reduce the deficit. As a result of good financial management and firm spending control, departments have been able to exceed the consolidation targets that have been set for them. Since 2010 departments have underspent against plans by an average of over £5 billion a year, with the OBR forecasting further underspends for 2014-15 of £3.5 billion.[36]

2.49 Since Autumn Statement 2014, the government has made good progress in driving efficiency across a number of areas. **Budget 2015 confirms that proposals have been agreed with all departments to abolish progression pay across the Civil Service.**

[36] 'Public Expenditure Statistical Analyses', HM Treasury; 'Economic and Fiscal Outlook', OBR, March 2015.

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Financial sector and other asset sales

2.50 During this Parliament the government has made substantial progress in selling assets it no longer needs to hold, and in getting taxpayers' money back from the bank bailouts. Total sales of corporate and financial assets since May 2010 amount to over £19.9 billion.[37] As set out in the OBR's March 2015 'Economic and fiscal outlook', this government has recovered from its financial sector interventions:

- nearly £9 billion through selling shares in Lloyds Banking Group, which has reduced the government's shareholding to below 23% – Lloyds' announcement on 27 February 2015 of a dividend payment will further contribute at least £100 million to the Exchequer
- in excess of £9.5 billion in fees from Lloyds Banking Group and Royal Bank of Scotland (RBS) relating to government support and participation in government intervention schemes – all of which are no longer required
- more than £21 billion in repayments from the sale of Northern Rock plc, and the ongoing wind-down of NRAM plc and Bradford & Bingley
- over £1 billion in respect of the Dunfermline Building Society administration
- over £2.6 billion in repayments from the Landsbanki LBI (Icesave) estate in Iceland
- a total of £11 billion from the Financial Services Compensation Scheme, from the estates of failed banks, and fees from the wider banking sector in respect of the Credit Guarantee Scheme and Special Liquidity Scheme (not including RBS or Lloyds)

2.51 Chart 2.5 sets out the calculated impact of previous financial sector interventions on net debt over 2007-08 to 2015-16. The government remains determined to complete the state's exit from ownership of banks, delivering value for money for the taxpayer, boosting competition in the financial sector, and paying down the debt. Having de-risked the financial sector and returned the economy to a stable and sustainable path, the government is now in a position to set out the next steps in reducing the taxpayers' exposure to the financial sector.

2.52 The government's long-term economic plan has underpinned positive market conditions. Together with Lloyds moving into profit and paying a dividend, this will enable the government to continue its sales programme for the taxpayers' remaining stake in the bank. As a result **this Budget announces the government's plan to sell £9 billion of Lloyds shares over the next year, continuing the progress of the last year**. The government will continue to consider options for allowing the British public to participate directly in future sales of bank shares.

2.53 The government is also taking action to continue to exit from the nationalised banks. **UK Asset Resolution (UKAR), which manages the government's ownership of NRAM plc and Bradford & Bingley plc, is announcing a major sale of assets held from the forced nationalisation of Northern Rock and Bradford & Bingley plc.** In parallel, UKAR will explore potential options for the sale or outsourcing of its mortgage servicing activities. Any sales will be contingent on ensuring value for money for the taxpayer. The government's central estimate, certified by the OBR, is that these sales of Lloyds shares and UKAR assets are expected to raise approximately £20 billion in 2015-16.[38]

[37] Published sales of corporate and financial assets (800MHz and 2.6 GHz spectrum, the Tote, Northern Rock, High Speed 1 (30 year concession), Lloyds Banking Group (multiple sales), Royal Mail, mortgage style student loan book, Plasma Resources UK, UK Asset Resolution Ltd mortgage portfolio, ConstructionLine, Greencoat UK Wind, Food and Environment Research Agency, Defence Support Group, Eurostar) total over £19.9 billion. In general proceeds from sales of corporate and financial assets will reduce public sector net debt. There may also be an impact on public sector net borrowing as future income (or costs) are foregone, such as dividend payments, loan repayments, or the need for future investment. The specific arrangements for some assets may vary.
[38] 'Economic and fiscal outlook', OBR, March 2015.

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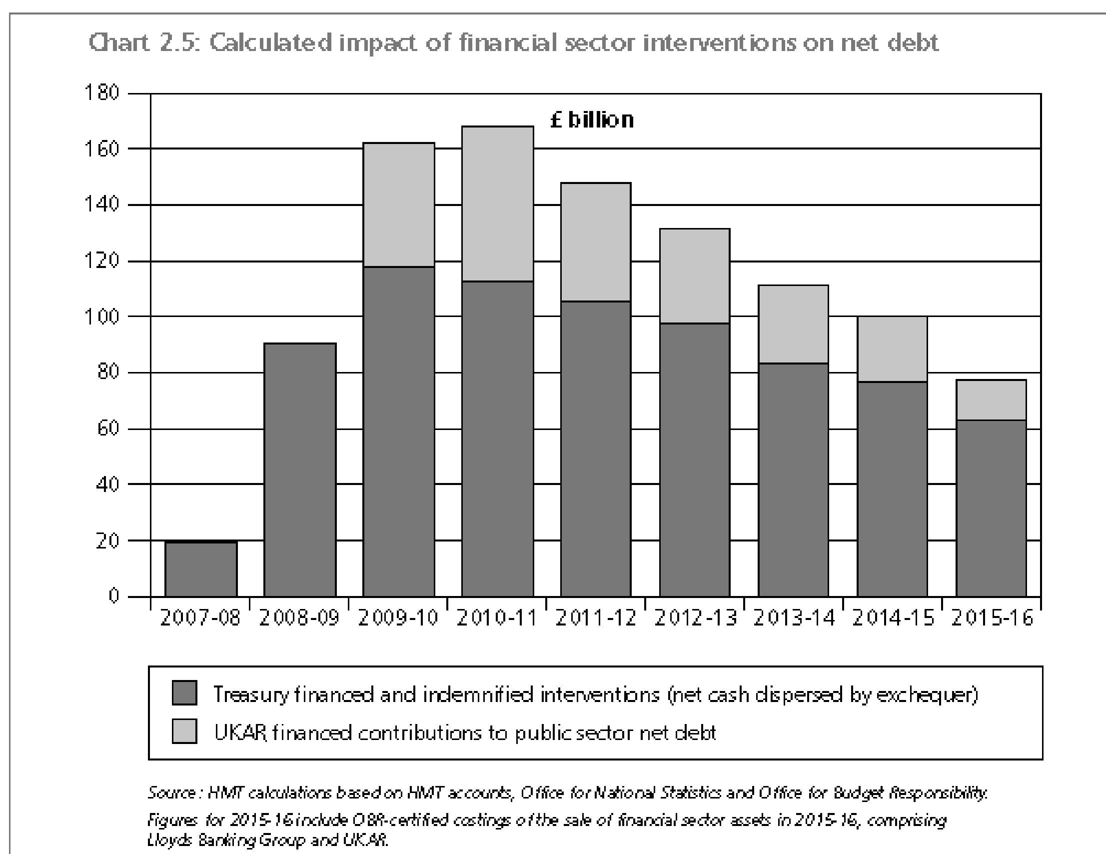

Source: HMT calculations based on HMT accounts, Office for National Statistics and Office for Budget Responsibility.
Figures for 2015-16 include OBR-certified costings of the sale of financial sector assets in 2015-16, comprising Lloyds Banking Group and UKAR.

2.54 As set out in Budget 2014, RBS's new management committed to a new strategy for serving its UK customers, reducing assets in its 'bad bank', and supporting lending to British businesses. This has brought forward the point at which the bank can start being returned to private ownership. It is not good for taxpayer value or for the competitiveness of the UK's banking system to have such a large and complex bank in state hands for too long. As a result, the government intends to take a decision on the timing of any exit programme from RBS early in the next Parliament.

2.55 In March 2015, the Treasury signed a binding agreement to sell its entire holding in Eurostar International Limited for £757 million. Other asset sales include those of shares in Greencoat UK Wind for £52 million, ConstructionLine for £35 million, Food and Environment Research Agency for £20 million and Defence Support Group for £140 million. Progress also continues towards the sale of the government's stake in Urenco, the pre-2012 Income Contingent Repayment student loan book and public sector spectrum. A central estimate of approximately £12 billion is expected from the sale of the Income Contingent Repayment student loan book.[39]

2.56 Autumn Statement 2013 set a target to deliver £20 billion of corporate and financial asset sales between 2014 and 2020. More than £8.9 billion of sales have now completed, or will shortly.[40] With over £20 billion in sales expected to complete in 2015-16 the government is on track to meet this target early and significantly exceed it.

[39] 'Economic and fiscal outlook', OBR, March 2015.
[40] Published sales of corporate and financial assets since January 2014 (Lloyds Banking Group (multiple sales), UK Asset Resolution Ltd mortgage portfolio, ConstructionLine, Greencoat UK Wind, Food and Environment Research Agency, Defence Support Group, Eurostar) total over £8.9 billion, of which £2 billion since Autumn Statement 2014.

Fiscal forecast

2.57 As set out in Table 2.C, from its post-war peak of 10.2% of GDP in 2009-10, the OBR forecasts public sector net borrowing will fall in each year of the forecast period, to:[41]

- 5.0% of GDP in 2014-15
- 4.0% of GDP in 2015-16, the final year for which the government has set departmental spending plans
- a surplus of 0.2% of GDP in 2018-19, increasing to 0.3% of GDP in 2019-20

2.58 Public sector net debt is forecast to peak at 80.4% of GDP in 2014-15, the same level as at Autumn Statement 2014, before falling each year and reaching 71.6% of GDP in 2019-20. In 2015-16 public sector net debt is forecast to be 80.2% of GDP, 0.2 percentage points lower than 2014-15.

Table 2.C: Overview of the OBR's central fiscal forecast

	% GDP, unless otherwise stated						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Fiscal mandate							
Cyclically-adjusted current budget deficit	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Deficit							
Public sector net borrowing	5.6	5.0	4.0	2.0	0.6	-0.2	-0.3
Public sector net borrowing (£ billion)	97.3	90.2	75.3	39.4	12.8	-5.2	-7.0
Cyclically-adjusted net borrowing	4.1	4.2	3.7	1.9	0.6	-0.3	-0.3
Current budget deficit	4.1	3.3	2.4	0.5	-0.8	-1.7	-1.7
Primary balance	-3.8	-3.4	-2.5	-0.3	1.3	2.1	2.1
Cyclically-adjusted primary balance	-2.3	-2.7	-2.2	-0.1	1.3	2.1	2.1
Treaty deficit[1]	5.8	5.2	4.3	2.2	0.8	0.0	-0.1
Cyclically-adjusted Treaty deficit	4.2	4.4	4.0	2.0	0.8	0.0	-0.1
Debt							
Public sector net debt[2]	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Treaty debt[3]	87.9	88.4	88.8	88.7	87.1	84.4	81.4
Memo: Output gap	*-2.0*	*-0.8*	*-0.4*	*-0.2*	*0.0*	*0.0*	*0.0*
Memo: total policy decisions[4]		*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

[1] General government net borrowing on a Maastricht basis.
[2] Debt at end March; GDP centred on end March.
[3] General government gross debt on a Maastricht basis. Taken from http://budgetresponsibility.org.uk/wordpress/docs/Correction-to-Treaty-debt-ratio-forecast-March-2015-Economic-and-fiscal-outlook.pdf
[4] Equivalent to the 'Total policy decisions' line in Table 8.2.
Source: Office for National Statistics, Office for Budget Responsibility and HM Treasury calculations.

2.59 The OBR's March 2015 'Economic and fiscal outlook' includes a comparison of key fiscal aggregates to Autumn Statement 2014. Public sector net borrowing is forecast to be £7.2 billion lower in 2014-15 than in 2013-14, and it continues to fall year on year throughout the forecast period. Public sector net debt has been revised down relative to Autumn Statement 2014 from 2015-16 onwards in both cash terms and as a share of GDP. By the end of the forecast period, public sector net debt is forecast to be 71.6% of GDP, 1.2 percentage points lower than forecast at Autumn Statement 2014.

[41] 'Public Sector Finances', ONS, January 2015.

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Table 2.D: Comparison of key fiscal aggregates to Autumn Statement 2014

	% GDP, unless otherwise stated						
	Outturn	Forecast					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net borrowing (£ billion)							
Budget 2015	97.3	90.2	75.3	39.4	12.8	-5.2	-7.0
Autumn Statement 2014	97.5	91.3	75.9	40.9	14.5	-4.0	-23.1
Change compared to Autumn Statement	-0.2	-1.1	-0.7	-1.5	-1.8	-1.2	16.1
Public sector net debt							
Budget 2015	79.1	80.4	80.2	79.8	77.8	74.8	71.6
Autumn Statement 2014	78.8	80.4	81.1	80.7	78.8	76.2	72.8
Change compared to Autumn Statement	0.3	0.0	-0.9	-0.9	-1.0	-1.4	-1.2
Cyclically-adjusted current budget deficit							
Budget 2015	2.6	2.5	2.1	0.4	-0.8	-1.7	-1.7
Autumn Statement 2014	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
Change compared to Autumn Statement	0.0	-0.2	-0.1	-0.1	-0.2	-0.2	0.5

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

Performance against the fiscal mandate

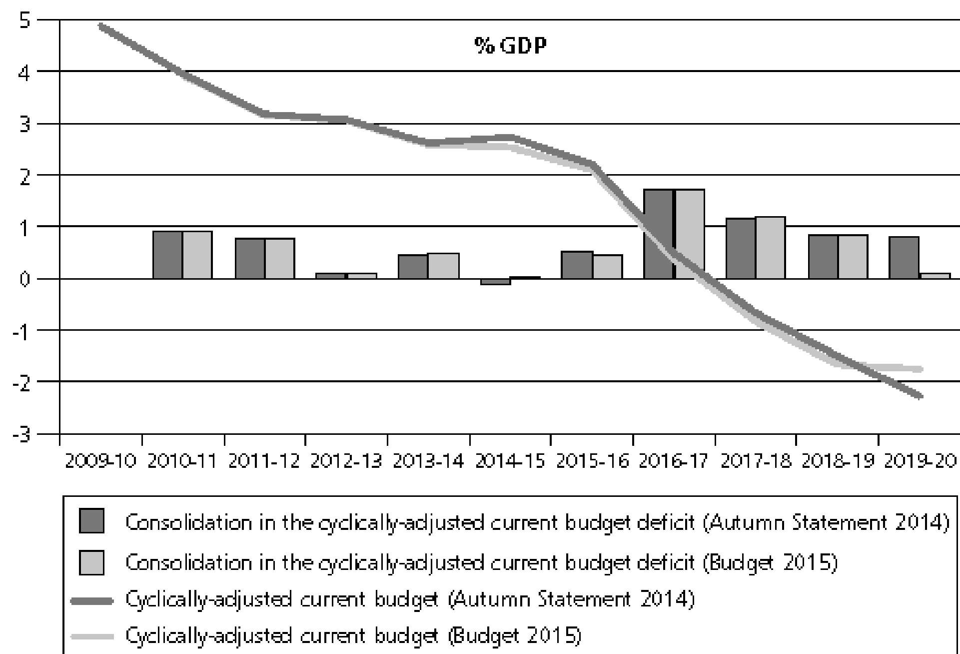
2.60 The government's fiscal strategy is underpinned by a forward-looking mandate, as updated in the Charter for Budget Responsibility approved by Parliament on 13 January 2015, to achieve a cyclically-adjusted current balance in the third year of a rolling 5-year forecast period.[42]

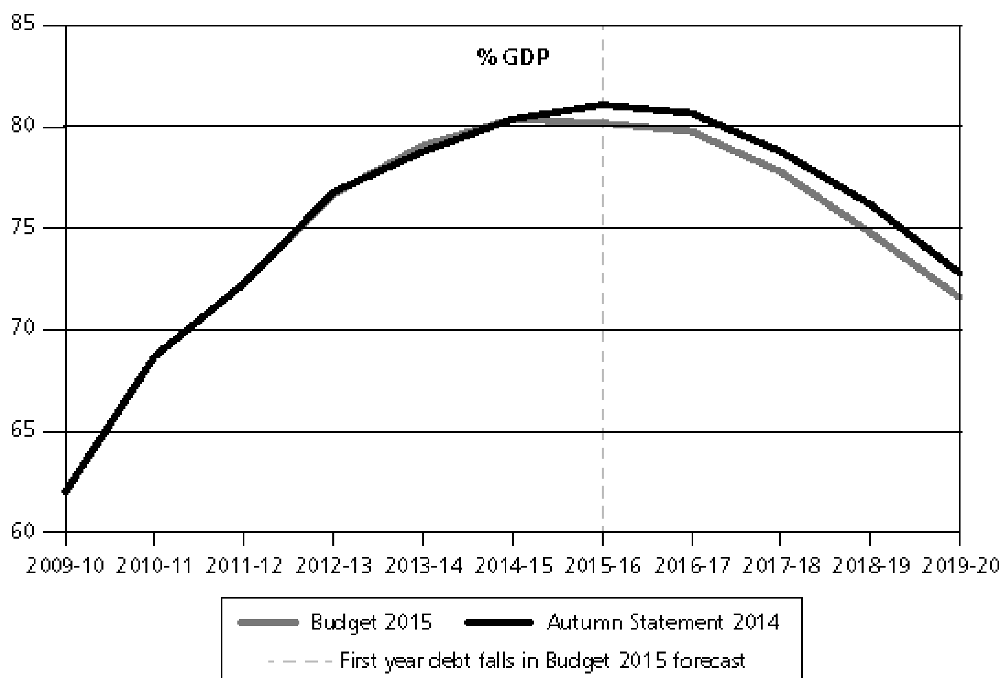
2.61 The OBR's March 2015 'Economic and fiscal outlook' confirms the government is on course to meet the fiscal mandate in the third year of the forecast period, 2017-18. The OBR's judgement is that the government's policies are consistent with roughly a 65% chance of achieving the fiscal mandate in 2017-18. Chart 2.6 shows the government's performance against its fiscal mandate.

2.62 The government's fiscal mandate is supplemented by an aim for public sector net debt as a percentage of GDP to be falling at a fixed date of 2016-17. As set out in Chart 2.7, the OBR forecasts that the supplementary debt aim will be met a year early, with debt falling by 0.2% of GDP between 2014-15 and 2015-16. Public sector net debt falls by 0.4% of GDP between 2015-16 and 2016-17.

2.63 Public sector net debt is forecast to peak in 2014-15 as a share of GDP, before falling from 2015-16 and thereafter across the forecast horizon. This is the first time debt has been forecast to fall as a share of GDP in the coming year since Budget 2002. The government is forecast to meet the target for debt to be falling as a share of GDP by the end of 2015-16, as set out in the June Budget 2010.

[42] 'Charter for Budget Responsibility: Autumn Statement 2014 update', HM Treasury, December 2014.





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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 Stability and Growth Pact (SGP). The government is forecast to meet the EU SGP target for the Treaty deficit in 2016-17.

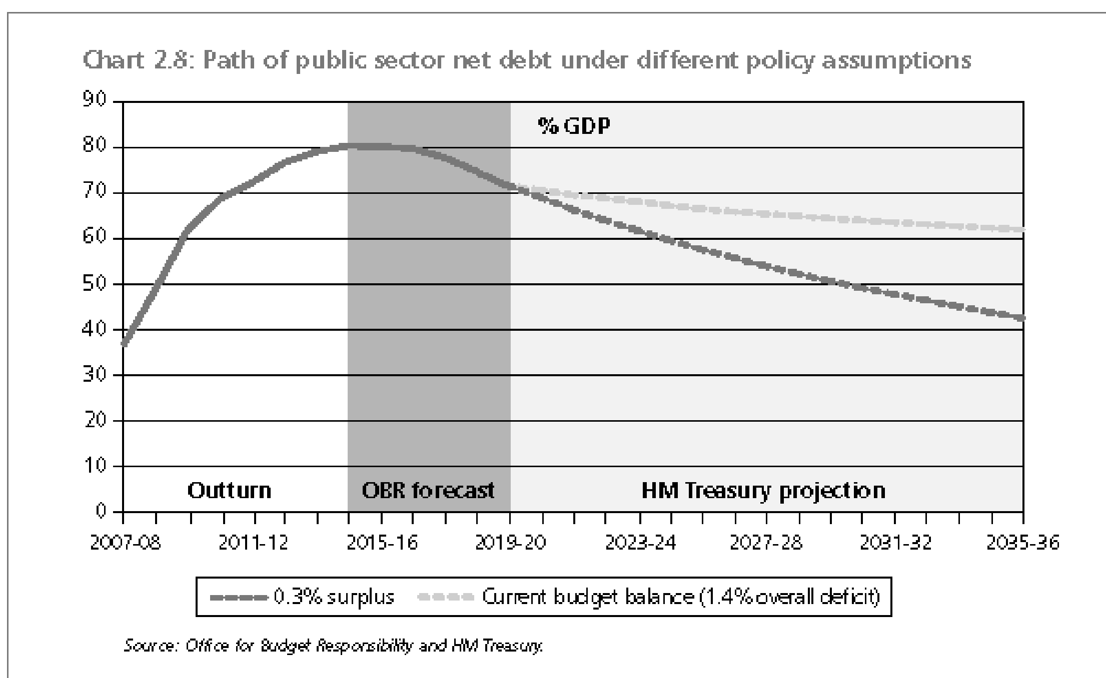
The long-term debt challenge

2.65 As a result of the Great Recession, public sector net debt is forecast to have risen by more than 40% of GDP since the financial crisis, to a peak of 80.4% of GDP in 2014-15.[43] The peak in debt will be the highest level of debt since the late 1960s.[44] By the time public sector net debt begins to fall, it will have been increasing as a percentage of GDP in every year since 2001-02. This is the longest period of year-on-year increases in debt as a percentage of GDP since at least 1700.[45] Debt would be even higher if the government had not pursued its plan to reduce the deficit.

2.66 Central government (gross) spending on debt interest is forecast to be £45.7 billion this year. Reducing debt in future will help control these costs and reduce the burden on future generations. Debt interest would be £3.6 billion a year lower for every reduction in debt of 10% of GDP, based on the market interest rates used by the OBR in its March 2015 'Economic and fiscal outlook.'

2.67 High public debt also increases the UK's vulnerability to future shocks. It is more likely a new shock would increase debt to potentially unsustainable levels if starting from a higher level, increasing uncertainty, pushing up interest rates and undermining economic stability. Chart 2.8 shows projections for the path of public sector net debt as a percentage of GDP, assuming two different scenarios for levels of borrowing from the end of the 5-year forecast horizon. This chart is based on a simple scenario in which there are no shocks to the economy.

Chart 2.8: Path of public sector net debt under different policy assumptions



Source: Office for Budget Responsibility and HM Treasury.

2.68 As illustrated by Chart 2.8, sustained action will be needed to bring down debt even in the absence of future shocks. Prudent fiscal policy should, however, take account of future

[43] 'Public Sector Finances', ONS, January 2015.
[44] 'Three Centuries of Data on the UK Economy', Bank of England data.
[45] 'Three Centuries of Data on the UK Economy', Bank of England data.

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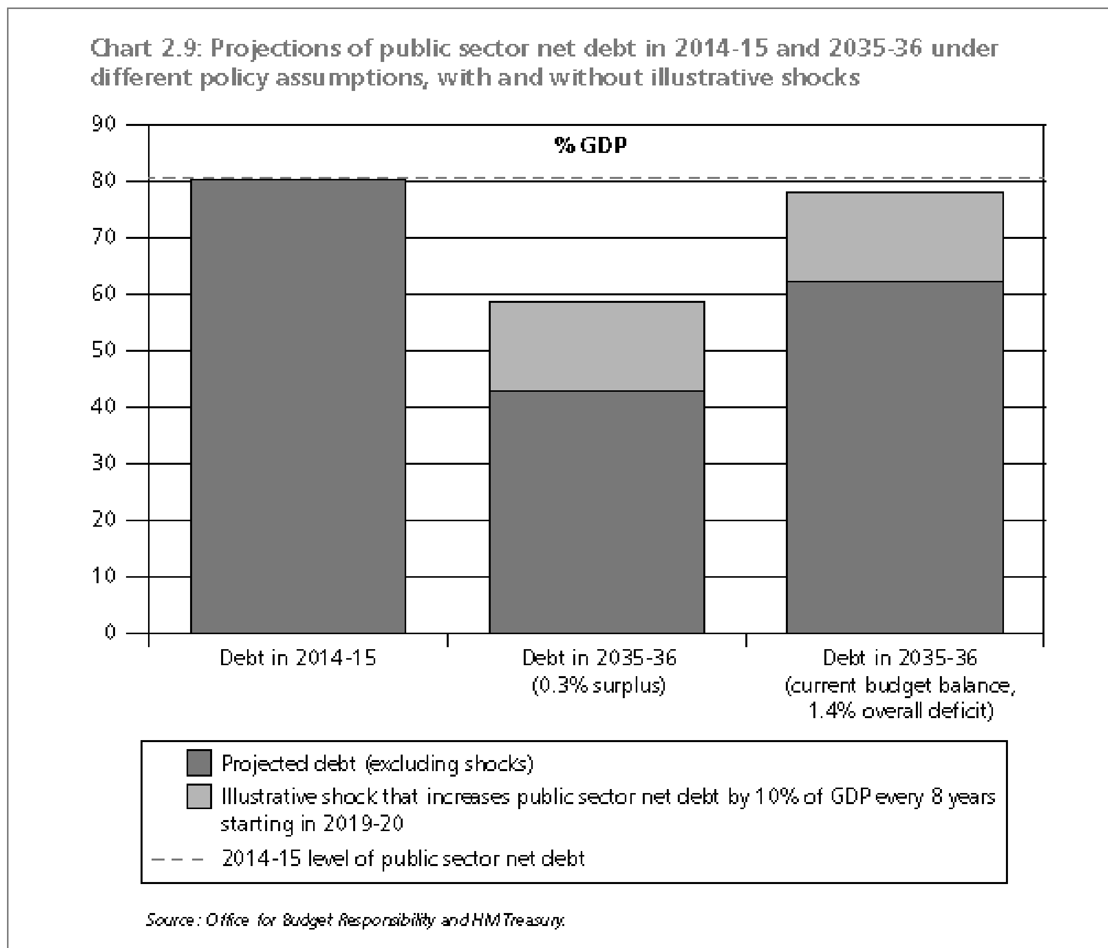
shocks to the economy, even though the scale and timing are inherently unpredictable and any analysis of potential future shocks can only be illustrative. Chart 2.9 shows how the level of public sector net debt in 2035-36 would be affected by a simple scenario in which the economy is hit once every 8 years by a shock that increases public sector net debt by 10% of GDP (less than the peak increase following the recession in the 1990s). This should not be interpreted as a prediction, though increases in debt of this magnitude are consistent with the previous impacts of economic downturns on public borrowing.



2.69 In this illustrative scenario, a permanent 1.4% deficit, equivalent to a balanced current budget with investment equal to its 2019-20 forecast level, results in debt falling by only around 3% of GDP by 2035-36 from its 2014-15 peak, still leaving debt at historically high levels. A permanent 0.3% surplus, as forecast by the OBR for 2019-20, under the same scenario results in debt falling from its peak by around 25% of GDP by 2035-36. Larger or more frequent shocks in the future would result in higher levels of public debt and vice versa.

Consolidation in the next Parliament

2.70 Budget 2015 confirms that, in line with previous policy, the government's planned consolidation in the next Parliament is reflected in the fiscal assumption that Total Managed Expenditure (TME) will fall in real terms in 2016-17 and 2017-18 at the same rate as over the period 2010-11 to 2014-15. Alongside the updated Charter for Budget Responsibility the government estimated that around £30 billion of discretionary consolidation is likely to be required over these years. From 2018-19 the government has set a neutral fiscal assumption,

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holding TME flat in real terms in 2018-19 and in 2019-20 increasing TME in line with nominal GDP.

2.71 The government will continue to prioritise capital investment. At Spending Round 2013, the government set out a long-term pipeline of capital investment worth more than £100 billion over the next Parliament. Autumn Statement 2014 set out in detail how over £30 billion of this money will be invested in Britain's infrastructure and growth promoting sectors, including roads, flood and coastal defences, and science. The government will continue to hold public sector gross investment (PSGI) constant in real terms in 2016-17 and 2017-18, and it will increase in line with GDP from 2018-19.

2.72 The fiscal assumption for 2016-17, 2017-18, 2018-19 and 2019-20 is expressed in terms of TME. It would, of course, be possible to do more of this further consolidation through tax instead.

2.73 The government's fiscal assumption for the years 2016-17 to 2019-20 set out above, combined with the OBR's forecast for Annually Managed Expenditure (AME) (excluding AME policy decisions in this Budget) and the PSGI assumption give projections for implied Departmental Expenditure Limits (DEL) including depreciation. The projections for implied DEL including depreciation at this Budget are higher in each year over 2016-17 to 2019-20 compared with Autumn Statement 2014.

Delivering on future consolidation plans

2.74 Choices will need to be made on the composition of further consolidation in the next Parliament, including funding any new commitments. The Budget provides further detail on some of these choices.

2.75 To deliver the necessary reductions in spending, the government will continue to identify and deliver significant efficiency savings. At Autumn Statement 2014 the government set out an aspiration to find £10 billion in further efficiency savings by 2017-18. This included a commitment to be much more ambitious in the use of digital technology.

2.76 **Budget 2015 announces that the digital ambition will extend beyond central government and arms-length bodies, to consider local services.** HM Treasury, the Department for Communities and Local Government and the Government Digital Service will collaborate with partners in local government, as the sector develops a set of proposals that will enable more customer-focussed, digitally-enabled and efficient local services in time to inform future budget allocations.

2.77 In this Parliament the government has delivered significant savings from centralising the procurement of goods and services. **Budget 2015 announces that, following a successful trial, the government will implement 'GOV.UK Verify' – a new way for people to prove their identity online when using government services – across central government.** This means that departments will use the same tool for their digital services, reducing duplication. Further, to prevent individual departments paying different amounts to either build their own data centres or outsource this service, the government will create a joint venture to host departments' non-cloud based servers, which could save up to £100 million.[46]

2.78 In education, evidence shows that the best performing schools focus their spending on teachers over the 'back-office'.[47] However, spending on back-office costs varies from £202 to £1,432 per pupil, and between 2003 and 2013 back-office spending per pupil in maintained schools increased by around 60% in real terms.[48] To help schools further improve their efficiency

[46] Cabinet Office business case analysis, February 2015.
[47] 'Review of efficiency in the schools system', Department for Education, June 2013.
[48] 'Review of efficiency in the schools system', Department for Education, June 2013; HM Treasury calculations based on Local Authority and School Expenditure 2002-03 and 2012-13. The 2012-13 data is available at gov.uk.

and focus their budgets on providing excellent teachers for their students, the government is launching a number of initiatives:

- **re-launching the energy supply framework**: schools are already realising savings by purchasing goods and services through procurement frameworks provided by the Crown Commercial Service (CCS); the government expects the recent launch of the updated CCS school energy supply framework to deliver significant savings for schools in the next Parliament
- **publishing improved management information and benchmarks**: by the end of 2015, the Department for Education (DfE) will provide schools with a new indicator to compare their overall efficiency, and parents will be able to access school benchmarking tools, allowing them to compare their child's school's spending with that of other schools and see how effectively the school uses its budget to promote educational attainment
- **piloting a cost comparison tool in 2015 to help schools identify a target price for their most commonly purchased items**
- **introducing a range of initiatives to improve the effectiveness of education support staff**, through a series of projects being run by the Education Endowment Foundation

2.79 The government will have increased the health budget in real terms every year this Parliament.[49] At Autumn Statement 2014, the government announced £2 billion of additional funding for frontline NHS services in 2015-16 that will be added to the NHS's baseline funding in future years. This will help to meet growing demand, improve services and kick-start the transformation set out in the NHS's 'Five Year Forward View'. However, the 'Five Year Forward View' also made it clear that the NHS will need to find significant annual efficiency savings in order to meet demand and maintain good quality patient care.[50]

2.80 Lord Carter, as Chair of the NHS Procurement and Efficiency Board, is undertaking action to help the NHS to deliver its efficiency aspiration. Interim findings from Lord Carter's work show that action in a number of areas, including procurement, pharmacy and property, could deliver significant savings that the NHS could recycle back into frontline care. For example, local savings of up to £5 million a year have been found in one Trust alone by improving contract management and engaging with suppliers to find ways to resist cost increases.[51] Measures such as this will be key to delivering the efficiency savings set out in the 'Five Year Forward View'.

2.81 In the criminal justice system, Sir Brian Leveson's report on the efficiency of court proceedings has highlighted that there is still significant scope to reduce cost and delay.[52] For example, measures to encourage the retention of cases in the Magistrates' courts rather than sending them to the Crown Courts should improve efficiency and reduce costs in the court system. The government notes these recommendations and, as part of the ongoing programme to reform the courts, which is intended to save in excess of £100 million a year by 2019-20, will explore how these recommendations can be taken forward.

2.82 The government will also expand the use of benchmarking public service performance as a means to identify savings. It has already demonstrated the potential in this area; for example, the programme to benchmark public sector prisons is driving down unit costs and will deliver annual savings of £300 million by 2015-16.[53]

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[49] 'Public Expenditure Statistical Analyses', HM Treasury
[50] 'Five Year Forward View', NHS, October 2014.
[51] 'Better procurement better value better care: a procurement development programme for the NHS', Department for Health and NHS England, August 2013.
[52] 'Review of Efficiency in Criminal Proceedings: Final Report', Sir Brian Leveson, January 2015.
[53] 'National offender management service business plan 2014-15', National Offender Management Service, April 2014.

2.83 Police forces are already delivering efficiency savings, in a period where crime is down by more than a fifth according to the independent 'Crime survey for England and Wales'.[54] This summer, Her Majesty's Inspectorate of Constabulary will carry out an in-depth efficiency inspection of every police force in the country, to help all forces make best use of resources and highlight best practice to continue driving down crime. The government is also committed to supporting a collaborative programme to standardise what the police buy, and aggregate police procurement to drive additional savings above the £200 million already achieved this Parliament.[55]

More strategic management of government land, property and spectrum

2.84 Over the next Parliament the government will transform how it manages the significant land and property assets it owns. **Budget 2015 announces that the government will implement a new commercially-driven approach to land and property asset management across the central government estate**, based on departments paying market-level rents for the freehold assets they own. The government will create a new central body or bodies, which, working under a cross-government framework and direction provided by the Treasury and the Government Property Unit of the Cabinet Office, will own and manage relevant property and land assets, as well as leasehold assets where appropriate. This will help drive better strategic oversight and management of the estate, and provide greater incentives for departments to rationalise the space they occupy. It will also deliver efficiencies, and release land and property for productive use, including building new homes. Implementation of the reform will commence immediately, with the model becoming operational by March 2017, subject to legislation.

2.85 Given their very large property and land holdings, there is also the potential to generate significant efficiencies within the Ministry of Defence estate. However, the Ministry of Defence maintains a varied estate, including assets of strategic military importance. Therefore, the department will introduce a similar charging mechanism, to the same timescale, within its existing estate management organisation, to incentivise users of the Ministry of Defence estate to reduce their footprint and release value, including land for development. Given the specialised nature of the Foreign and Commonwealth Office's overseas estate, appropriate charging principles will also be developed with land and property managed in their existing departmental boundary.

2.86 In addition to implementing this model for land and property, **Budget 2015 announces that the government will take a more strategic approach to managing public sector spectrum**. The government will implement a central management system, which will enable it to better prioritise spectrum management, and maximise the economic value of public sector spectrum.

Integrating services to improve outcomes and reduce costs

2.87 Further savings will also be achieved by making local services work better for the people who need them. The £448 million invested in the Troubled Families programme has helped over 105,000 families to turn their lives around, the government has demonstrated its commitment to early intervention in a child's earliest years and the £5.3 billion Better Care Fund is helping people to benefit from joined up health and social care.[56] This is based on the principles that intervening early can prevent problems arising later on and locally joined up services can better meet the needs of vulnerable people. Building on the government's ambitious programme of reform, **the Budget announces that the government is exploring the cost-effectiveness**

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[54] 'Crime Survey for England and Wales – year ending September 2014', ONS, January 2015.
[55] Home Office analysis of data on Police Forces' non-IT procurement savings between 2010 and Q3 2014.
[56] 'Troubled Families programme: progress information at December 2014 and families turned around at February 2015', Department for Communities and Local Government, March 2015.

of options to integrate spending around some of the most vulnerable groups of people, including:

- taking the next steps on from the Better Care Fund to continue to join up services for people with health and social care needs, and learning from Greater Manchester's experience following their recent landmark agreement to bring together commissioning of around £6 billion of local health and social care budgets
- improving the links between health and employment support for people who are unable to work because of a health condition, learning from the roll out of Fit for Work and the mental health pilots agreed as part of the Growth Deals and at Autumn Statement 2014 – Budget 2015 takes a major step forward through a package of measures to improve employment outcomes for people with mental health conditions
- exploring whether improving housing can help people with care needs stay in their homes longer and reduce costs to the NHS
- assessing the scope to reduce the estimated £4.3 billion spent because of a failure to support troubled individuals struggling with homelessness, addiction and mental health problems including through social investment[57]
- designing a more integrated, multi-agency approach to divert from custody, where appropriate, female offenders who are convicted of petty, non-violent offences

Future welfare spending

2.88 Since 2010, the government has legislated for measures in the welfare system in order to reduce spending by £21 billion in 2015-16, through reform of benefit structures, and changes to eligibility and rates.[58] The reforms promote work and personal responsibility while protecting the most vulnerable members of society. The government is introducing Universal Credit, which will help more people off welfare and into work. However, as the OBR has noted in its 'Welfare trends report', over the next Parliament and beyond a number of factors will continue to put upward pressure on spending in some areas.[59] Outcomes could also be further improved for claimants. While 46% of disabled people of working age are in work, in each quarter only one economically-inactive disabled person in a hundred moves into work.[60] The government remains committed to helping people into work and improving outcomes.

Welfare cap

2.89 At Budget 2014, the government introduced the welfare cap to ensure that significant increases in welfare spending do not go uncorrected. The cap is a firm limit on total welfare spending, applying to all welfare spending in AME with the exception of the state pension and automatic stabilisers. The OBR's assessment at Autumn Statement 2014 was that the welfare cap was met. The OBR will next assess performance against the cap in autumn 2015, when the cap will cover from 2016-17 until the end of the rolling forecast period. At Budget 2015, the OBR's forecast for spending within scope of the cap is on average £2 billion per year lower than at Autumn Statement 2014 and in total £9.7 billion lower over the forecast period.

[57] 'Hard edges: mapping severe and multiple disadvantage in England', Lankelly Chase Foundation, January 2015.
[58] 'Policy measures database', OBR, February 2015.
[59] 'Welfare trends report', OBR, October 2014.
[60] 'Labour market status of disabled people (Equality Act core disabled)', ONS Statistical Bulletin: UK Labour Market, February 2015; 'The disability and health employment strategy: the discussion so far', Department for Work and Pensions, December 2013.

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Table 2.E: Spending within the welfare cap

	£ billion				
	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare cap	119.7	122.3	124.8	127.0	129.8
Forecast margin (2%)	2.4	2.4	2.5	2.5	2.6
Total spending: difference from welfare cap	0.8	-1.3	-3.0	-2.9	-3.2
of which: Budget policy decisions[1]	+0.0	-0.0	-0.0	-0.1	-0.1
Total spending: difference from Autumn Statement 2014	-0.1	-1.4	-2.2	-2.8	-3.2
Total spending within scope of the welfare cap	120.6	121.0	121.8	124.0	126.5

[1] Welfare cap impact of policy decisions set out in Chapter 2.

Source: Office for Budget Responsibility

Debt and reserves management

2.90 The government's financing plans for 2015-16 are set out in full in the 'Debt and reserves management report 2015-16', published alongside the Budget. It is anticipated that the net financing requirement of £140.4 billion will be met through gilt issuance of £133.4 billion and an increase of £7.0 billion in the stock of Treasury bills.

2.91 National Savings and Investments (NS&I) will have a net financing target of £10.0 billion in 2015-16, within a range of £8.0 to £12.0 billion. This target accommodates the extension of NS&I's market-leading bonds for people aged 65 and over (the '65+ bond'), as well as the increase in the Premium Bond limit from £40,000 to £50,000 from 1 June 2015, both of which are key elements of the government's plan to support savers. As a result of their popularity, the government announced that NS&I's 65+ bonds would remain on sale until 15 May 2015. This longer timeframe is expected to raise an additional £3.2 billion of financing, above the original £10 billion of inflows announced at Budget 2014.

2.92 The financing arithmetic provides for £6 billion of sterling financing for the Official Reserves in 2015-16. The government is planning on the basis of sterling financing for the Official Reserves at a similar level on average over the 4 years from 2016-17 up to, and including, 2019-20. This additional financing, announced at Autumn Statement 2014, is intended to meet potential calls on the reserves that may arise and ensure that the level of foreign currency reserves held is sufficient for the UK to remain resilient to possible future shocks.

2.93 Budget 2014 announced the government's plans to introduce a new and highly secure £1 coin. Since then, the Royal Mint has conducted a public design competition to determine the artwork to feature on the first reverse, or 'tails' side. **Budget 2015 announces the winning entry**, giving the British people a first chance to see what the new coin in their pocket will look like. The winning design, by 15 year-old David Pearce, pays tribute to the 4 nations of the United Kingdom.

2.94 HM Treasury carried out a consultation alongside this design competition, focusing on the physical and material characteristics of the new £1 coin. The government response to that consultation is published alongside the Budget, and **confirms the specification of the new coin and the key milestones ahead of an expected introduction in early 2017**.

Devolution

2.95 The government continues to deliver against its commitment for further devolution to Scotland, Wales and Northern Ireland. The Smith Commission was established on 19 September

2014, as a cross-party process to decide what new powers should be transferred to the Scottish Parliament. Following the Smith Commission report on 27 November 2014, the government published draft legislative clauses on 22 January 2015. The clauses published will make it possible to translate the Smith Commission Agreement into law quickly in the next Parliament. Work has started on Scotland's new fiscal framework and this will be agreed alongside the introduction of legislation.

2.96 The government announced new devolution arrangements for Wales on 27 February 2015. The measures include the introduction of a floor in the level of relative funding the UK government provides to the Welsh Government, in the expectation that it will call a referendum on Income Tax powers in the next Parliament. Work has already started on the funding floor and the details will be agreed in the next Parliament. Additionally, the government will consider the case and options for devolving powers to the Assembly over Air Passenger Duty (APD), informed by a review of potential options to mitigate the impacts of APD devolution on regional airports in England.

2.97 The Scottish and Welsh governments' sources of borrowing are also being extended to include bond issuance for capital investment. These powers will be within existing borrowing limits, and subject to a number of conditions, including that the Scottish and Welsh governments will be solely responsible for meeting their liabilities and that the UK government will provide no guarantee on any bonds issued.[61]

2.98 In December 2014, as part of the Stormont House Agreement, the government agreed a package of significant financial support for the Northern Ireland Executive. The agreement emphasised the need for the Executive to demonstrate that its finances are being put on a sustainable long-term footing. On that basis, legislation was introduced to Parliament on 8 January 2015 to devolve a Corporation Tax rate-setting power to the Northern Ireland Assembly. The Bill has now completed consideration by the House of Commons, and is expected to receive Royal Assent before the 2015 General Election.

2.99 The Agreement was also clear that the Corporation Tax powers would only be commenced in 2017 if the Executive demonstrates that its finances are on a sustainable footing, which will require successfully implementing a range of reform measures, including changes to the welfare system. It is critical that the parties continue to focus on meeting their commitments, so that the opportunities presented by the Stormont House Agreement are not lost.

Building a strong and stable financial system

2.100 Over this Parliament, the government has introduced a significant set of reforms that have built a much stronger and more stable financial system. The government has now completed the task of ensuring that banks separate their core high street banking services from investment banking. The government legislated to implement this ring-fence through the Banking Reform Act (2013). On 5 March 2015 the Banking Reform Pension Regulations were passed in Parliament, completing the fourth and final piece of legislation required to implement the ring-fence. The package of financial sector reforms completed in this Parliament will help make sure that taxpayers will never again need to bail out the banks.

2.101 Safeguarding financial stability requires constant vigilance. The Financial Policy Committee (FPC), created by this government, plays a central role in monitoring the financial system. The government has granted the FPC the powers it needs to make sure that the banks do not recreate the conditions that led to the last crisis. Alongside the Budget, **the Chancellor of the Exchequer has provided the FPC with its remit and recommendations for the**

[61] Further detail on the conditions for the Scottish and Welsh governments' bond issuance powers can be found in the 'Debt and reserves management report' published alongside the Budget.

year ahead, as required by the Bank of England Act 1998 (and amended by the Financial Services Act 2012). On 12 February 2015, the government laid legislation that will grant the FPC powers of direction on housing market tools and a leverage ratio framework to further safeguard the stability of Britain's financial system.

Financial sanctions

2.102 The government will review the structures within HM Treasury for the implementation of financial sanctions and its work with the law enforcement community to ensure these sanctions are fully enforced, with significant penalties for those who circumvent them. This review will take into account lessons from structures in other countries, including the US Treasury Office of Foreign Assets Control. It will consider how to maintain and improve the service that HM Treasury provides to the private sector, maintain the integrity of, and confidence in, the UK financial services sector, and strengthen the government's ability to implement and help enforce this vital tool in the UK's national security interests.

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2.103 The UK economy had the fastest annual growth among G7 economies in 2014 – its strongest performance since 2007.[62] At the end of 2014 there were more people in work than ever before, unemployment was falling, and average weekly earnings were increasing in real terms.[63] In order to sustain the UK's growth and international competitiveness, further work is needed to support businesses and boost productivity. This Budget sets out a comprehensive package of measures that builds on existing reforms to create a dynamic, regionally balanced economy and to support future productivity growth, including:

- setting out a significant package of support through the tax system to back British business, including freezing fuel duty for another year and substantially reducing oil and gas taxes to improve competitiveness in the North Sea
- supporting long-term investment in the UK's digital communications infrastructure, including by setting out a new ambition that ultrafast broadband of at least 100 Megabits per second should be available to nearly all UK premises
- securing a truly national recovery by investing in infrastructure, housing, science and innovation across the whole of the UK, and building a Northern Powerhouse
- supporting manufacturers by bringing forward compensation for small-scale feed in tariffs for energy intensive industries to 2015-16, and supporting the retail and hospitality sectors by cutting alcohol duty on beer, cider and spirits
- developing a more highly-skilled UK labour market by strengthening support for postgraduate research and apprenticeships, and setting out plans for further investment in the UK's world-leading science and innovation base
- creating a dynamic economy that is the best place in the world to start, invest in, and grow a business, including through a package of measures to help unlock the potential of the sharing economy, improve access to finance and boost exports
- backing business by launching a comprehensive review of business rates, piloting schemes that reward additional business rates growth, and radically simplifying tax administration by abolishing the annual tax return

2.104 The government will continue to take the difficult decisions needed to implement its long-term economic plan of rebalancing the economy, supporting jobs and growth, and building a stronger economy and fairer society. Figure 1 sets out some of the key supply-side reforms that the government has implemented and the impact they have had so far.

[62] Quarterly National Accounts, OECD, March 2015. Further detail can be found in 'Budget 2015 Data Sources'
[63] Labour Market Statistics, ONS, February 2015, and Consumer Price Inflation, ONS, December 2014. Further detail can be found in 'Budget 2015 Data Sources'

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Figure 1: Implementation of the government's growth commitments

Tax and reliefs	Exports, inward investment and access to finance
✦ The main rate of **corporation tax** has been cut from 28% to 21%, and to 20% in April 2015, the joint lowest in the G20 ✦ The **personal allowance** will increase to £10,600 from April 2015, this is worth £825 to a typical taxpayer and will take over 3m individuals out of income tax ✦ Over 1m employers have now benefited from the **NICs Employment Allowance**. Around 500,000 employers will have been taken out of Employer NICs altogether in 2014-15 thanks to the Allowance ✦ The abolition of **Employer NICs for under 21 year olds** from April 2015 will benefit employers of almost 1.5m young people, by £332 per employee on average ✦ **Business rates** support of £2.7bn for 5 years from April 2014 will benefit 1.8m properties in England ✦ Action on **fuel duty** since 2011 will save a typical motorist £675 by the end of 2015-16	✦ **UKTI** has more than doubled the number of businesses it helps from 24,550 in 2010-11 to over 50,000 in the year to June 2014 ✦ **British Business Bank** programmes are supporting £3bn of finance for businesses, including over £140m for more than 27,000 **Start Up Loans** ✦ UKTI has helped secure 5,100 **inward investment projects**, creating or safeguarding 333,000 jobs since 2010 ✦ **UK Export Finance** is delivering its services to record numbers of British businesses and has provided over £16bn of support for exports since 2009-10 ✦ **Enterprise Zones** have created over 12,500 jobs and attracted £2bn in private investment ✦ The annual net burden of **regulation on business** has fallen by £2.2bn since January 2011 ✦ The **Red Tape Challenge** has identified over 3,200 regulations to be scrapped or improved, bringing over £1bn in annual savings to business
Housing, planning and local growth	**Infrastructure**
✦ Almost 83,000 households have bought a home through the **Help to Buy scheme** ✦ Levels of **planning approvals** and **housing starts** are at 7-year highs ✦ More than 537,000 **new homes** have been built over this Parliament ✦ £2.9bn has been committed to more than 470 **Regional Growth Fund** projects ✦ Over 400 local projects agreed through **Growth Deals** are due to begin in 2015-16, including work on more than 150 roads, 150 housing developments and 20 stations ✦ **Northstowe** public sector-led development to deliver up to 10,000 homes	✦ From 2010-11 to 2013-14 average **annual public and private infrastructure investment** was around £47bn. Over 2,650 **infrastructure projects** have been completed since 2010 ✦ Over 2m more premises can access **superfast broadband** thanks to £1.7bn government investment ✦ To improve the **Strategic Road Network,** 15 major schemes worth £3.4bn have been completed with a further 16 schemes worth £2.3bn underway ✦ Over the Parliament, Network Rail has completed improvements to over **400 stations**
Education and skills	**Science and innovation**
✦ Government has established 4,580 **academies**, including 322 **free schools, studio schools** and **UTCs** ✦ In 2015-16 over £2.5bn will be delivered to schools via the **Pupil Premium** ✦ Around 260,000 two-year-olds are entitled to a funded **early education place** ✦ Over 2.1m people have started **apprenticeships** this Parliament, with a six-fold increase in **higher apprenticeships** started since 2009-10 ✦ The government will remove the arbitrary **cap on university student numbers** for 2015-16. Since the controls were lifted in 2014-15, an extra 10,000 students have taken up places	✦ Government has provided £4.6bn of **research funding** per year since 2010 ✦ At SR13 the government provided a long term commitment to **science capital infrastructure** – £1.1bn a year rising with inflation from 2016-2021 ✦ Over £1.4bn of public and private investment in 27 research infrastructure projects through the **Research Partnership Investment Fund** ✦ 7 **Innovation Catapults** launched to support sectors such as High Value Manufacturing ✦ Government has introduced a new 'above the line' **R&D expenditure credit** and increased the rate of **SME R&D tax credits**, benefiting over 15,000 innovative businesses

Source: HMT, KPMG, HMRC, DCMS, DCLG, BIS, Start Up Loans, UKTI, UKEF, British Business Bank, DfE, DfT, Regional growth funds, HEFCE

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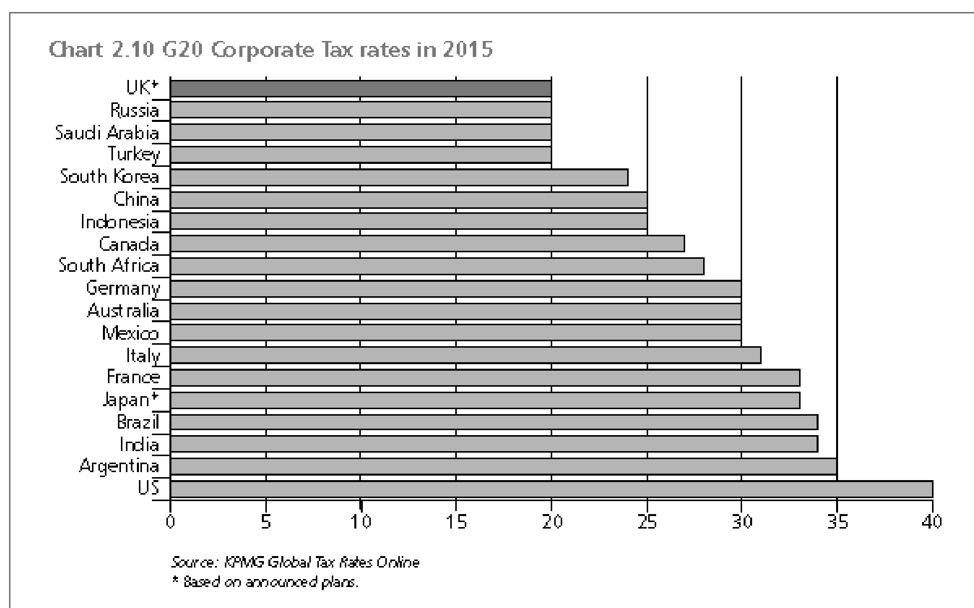
Supporting business through the tax system

2.105 The government aims to have a tax system that supports businesses, is simple to understand, and encourages growth. The main rate of corporation tax has been reduced from 28% in 2010 to 21% today, and it will be cut to 20% in April 2015 – the joint lowest in the G20. Chart 2.10 sets out the expected main rate of corporation tax in G20 economies from April 2015, while Table 2.F shows the benefits to 4 illustrative businesses as a result of selected tax cuts introduced by the government.

Chart 2.10 G20 Corporate Tax rates in 2015



Source: KPMG Global Tax Rates Online
* Based on announced plans.

Table 2.F: Cumulative cash savings to selected illustrative small businesses between 2010-11 and 2015-16

	Employer National Insurance contributions (NICs)	Business rates	Fuel duty	Total savings
Small retailer	£4,443	£6,763	£675	**£11,881**
Computer repair shop	£8,234	£6,763	£338	**£15,335**
Food manufacturer	£32,790	£540	£4,150	**£37,480**
Hi-tech manufacturer	£15,008	£480	£1,400	**£16,888**

Source: HMT calculations based on illustrative businesses.
Notes: The modelled businesses have 3, 8, 44 and 13 staff respectively (including some apprentices), pay business rates on premises with rateable values ranging from £10,000 to £45,000, and run vehicles ranging from part-time use of a car to a combination of cars and vans.

Fuel Duty

2.106 Budget 2015 builds on the support provided by the government to motorists over this Parliament. **The Fuel Duty increase by RPI planned for 1 September 2015, due to be 0.54 pence per litre, will be cancelled.** In total, the government will have eased the burden on motorists by £22.4 billion by the end of 2015-16. This equates to a saving of £675 for a typical motorist, £1,400 for a small business with a van, and £21,000 for a haulier.[64] Due to government action on fuel duty since 2011, by the end of 2015-16 the typical motorist will save £9 each time they fill their tank.[65] By the end of 2015-16, fuel duty will have been frozen for 5 years, the longest freeze for more than 2 decades.

[64] HMRC/HMT calculations based on OBR 2015 RPI forecasts and compared to pre-2010 fuel duty plans
[65] HMRC/HMT calculations based on OBR 2015 RPI forecasts and compared to pre-2010 fuel duty plans

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The long-term impact of the government's tax reforms

The government has focussed its policy interventions on areas that can most effectively increase growth, and support businesses to invest, export and create jobs. In order to better analyse the effectiveness of policy to achieve these goals, HM Revenue and Customs (HMRC) has developed a Computable General Equilibrium (CGE) model. This analyses the dynamic effects of policies, going beyond the immediate cost and impact to look at the behavioural impact on the wider economy.[66]

This model has shown that the effects of cuts to Corporation Tax and Fuel Duty have a large, dynamic impact on decisions made by firms and individuals. Lower Corporation Tax will increase investment and the demand for labour, which in turn raises wages and increases consumption. Fuel Duty reductions enable businesses to retain more profit, and increase wages and consumption.

Taken together, the modelling suggests that the cuts in Corporation Tax and Fuel Duty will increase GDP by between 0.9% and 1.3%, and investment by up to 6.5% in the long term. The modelling also shows that increased profits, wages and consumption all add to higher tax revenues. This reduces the costs of the cuts to Corporation Tax and Fuel Duty by up to 60% and 56% respectively.

Making tax easier

2.107 Over the course of this Parliament, the government has taken significant action to make tax easier, quicker and simpler. This includes investing £200 million in HMRC's digital services, reducing the burden on business by £250 million a year, and introducing cash accounting as recommended by the Office of Tax Simplification (OTS), which has been taken up by more than one million small businesses.[67]

2.108 Building on these foundations, **Budget 2015 announces that the government will transform the tax system over the next Parliament by introducing digital tax accounts, removing the need for annual tax returns.** By the end of the next Parliament over 50 million individuals and small businesses will be able to see and manage their tax affairs online.

2.109 'Making Tax Easier' sets out what this will mean for taxpayers.[68] As a first step, the government will:

- publish a roadmap later this year setting out the policy and administrative changes needed to implement this reform
- introduce digital tax accounts for all 5 million small businesses and the first 10 million individuals by early 2016
- abolish Class 2 NICs in the next Parliament and consult on reforming Class 4 NICs to include a contributory benefit test.

Business rates

2.110 The government wants to ensure that the tax system provides stable and sustainable revenues to fund public services in the least distortive way. **The government is therefore conducting a broad review of business rates** to ensure that they are fit for purpose for

[66] 'Analysis of the dynamic effects of Corporation Tax reductions', HM Treasury and HM Revenue and Customs, 5 December 2013, and 'Analysis of the dynamic effects of Fuel Duty Reductions', HM Treasury and HM Revenue and Customs, 14 April 2014, both show the results of applying the Computable General Equilibrium model to government policies
[67] 'Spending Round 2013', HM Treasury, June 2013, and other HMRC Internal Analysis
[68] 'Making Tax Easier', HMRC, March 2015

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a 21st century economy. The terms of reference for this review were published on 16 March 2015.[69]

2.111 As part of the government's work to strengthen the financial incentives to encourage business growth, **Budget 2015 announces pilot schemes in Cambridgeshire and Peterborough and, subject to the formal approval of Greater Manchester Combined Authority, in Greater Manchester and Cheshire East, which will enable these areas to retain 100% of any additional business rate growth beyond expected forecasts.** These pilots will begin in April 2015 and will reward additional growth to the local business rate base whilst maintaining the nationwide business rate retention and redistribution system.

Support for the creative sector and the media

2.112 The creative industries deliver both cultural and economic benefits to the UK. The government has introduced new tax reliefs for high-end television, video games, animation and theatre, and has expanded the film tax relief. These reliefs have been highly successful in encouraging investment. To further encourage growth in the sector the government will:

- **increase the rate of film tax relief to 25% for all qualifying expenditure, and extend the high-end television tax relief** by reducing the minimum UK expenditure requirement from 25% to 10% and modernising the cultural test
- **introduce a new children's television tax relief from April 2015**, which will include children's programmes that are game shows or competitions
- **introduce a new orchestra tax relief from April 2016 at a rate of 25%**

2.113 To invest in skills and business development in the creative industries, the government will also:

- **extend the Skills Investment Fund**, providing £4 million to ensure that it can continue to match fund support for training and development in film, television, visual effects, video games and animation for a further two years
- **promote a vibrant business environment for new and growing video games companies across the UK by committing £4 million to a new Video Games Prototype Fund over the next 4 years**; this fund is designed to aid access to finance and business support, and to target games development talent

2.114 Local newspapers are an important source of information for local communities and a vital part of a healthy democracy. To support them as they adapt to new technology and changing circumstances, **the government will consult on whether to introduce a business rates relief for local newspapers in England.**

Alcohol Duty

2.115 The government is committed to helping pubs. Building on the steps the government has already taken, **Budget 2015 announces that, for the third year in a row, the tax on a typical pint of beer will be cut by one penny from 23 March 2015.** This means that an average pint of beer is 9 pence cheaper than under the previous government's duty plans.

2.116 To further support the great British success story, the Scotch whisky industry, **the duty on spirits will be cut by 2%.** Recognising the important contribution of cider makers to the rural economy, **the duty on lower strength cider will be cut by 2%.** To support the UK's growing wine industry, **the duty on wine will be frozen.** Beer and wine duties will continue to be broadly similar.

[69] 'Business Rates Review: Terms of Reference and Discussion Paper', HM Treasury, March 2015

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Energy intensive industries

2.117 Budget 2014 announced a package of reforms to radically reduce the energy costs faced by the most energy intensive manufacturers – around 80% of which are based in the North of England, Scotland and Wales – to ensure that they are as competitive as possible. This included compensation for the indirect costs of small-scale feed in tariffs (FITs) and the renewables obligation from 2016-17. **Budget 2015 announces that the government will bring forward the FITs component of the compensation to the earliest point at which State Aid approval is received in 2015-16.** This is expected to save energy intensive industries a further £25 million in 2015-16.

Agriculture

2.118 The government believes that it is important to have a productive and resilient agricultural sector. Uncontrollable factors such as the weather lead to volatile profits for farmers, making it difficult to plan for the future. **The government will provide further support to farmers by increasing the period over which they can average their profits for income tax from 2 to 5 years from April 2016.**

R&D

2.119 The government wants to ensure that R&D tax credits remain effective in helping small businesses grow. Following consultation, **the government will implement a package of measures to improve the accessibility of R&D tax credits for smaller businesses,** including producing new guidance aimed at smaller firms and setting out a roadmap for further improvements over the next 2 years.

Company car tax

2.120 Recent changes to the company car tax regime have supported the move to fuel efficient cars while ensuring that the benefit-in-kind is taxed fairly. **The Budget announces that in 2019-20 rates for Ultra Low Emission Vehicles will increase more slowly than previously announced, and that rates for other cars will increase by three percentage points.**

Delivering long-term infrastructure

Digital communications infrastructure

2.121 Better, faster fixed and mobile broadband drives economic growth, innovation and excellence, enhances national competitiveness, and underpins the government's long-term economic plan. The government has already provided access to superfast broadband to over 2 million homes and businesses across the UK, with 40,000 extra premises being connected each week.[70] The broadband connection voucher scheme has directly supported broadband upgrades for more than 12,600 small and medium-sized businesses in 22 cities so far.[71]

2.122 To further enhance the UK's digital communications infrastructure, **the government is announcing a new ambition that ultrafast broadband of at least 100 Megabits per second (Mbps) should be available to nearly all UK premises.**

2.123 **The government will also take further action to support the delivery of broadband in rural areas,** including looking to raise the Universal Service Obligation – the legal entitlement to a basic service – from dial-up speeds to 5 Mbps broadband, and subsidising the costs of installing superfast capable satellite services.

[70] 'Superfast broadband reaches 2 million more homes & businesses', Press release, DCMS, February 2015
[71] DCMS management information

2.124 The broadband connection voucher scheme, extended at Autumn Statement 2014 to March 2016, will be available in a total of 50 cities by 1 April 2015.

2.125 **The government will provide up to £600 million to support the delivery of the change of use of 700MHz spectrum,** which will further enhance the UK's mobile broadband connectivity. These funds will support the infrastructure costs of clearing the spectrum frequency, including support to consumers where appropriate, and retuning broadcast transmitters to enable broadcasters to move into a lower frequency. This will free up 700MHz spectrum for 4G mobile communications use through an auction next Parliament. **The government will also centralise the operational management of public sector spectrum, and will reset the release target.**

2.126 To affirm its commitment to the long-term digital future of the UK, the government is publishing its 'Digital Communications Infrastructure Strategy', proposing how best to support market delivery.[72]

Energy

2.127 A competitive, diverse, clean and secure energy sector is a vital component of sustainable economic growth. Budget 2015 outlines a package of measures to strengthen the UK's energy supply in both the short and longer term.

2.128 The UK Continental Shelf represents a huge opportunity for the UK: the oil and gas industry is the UK's largest industrial investor, supporting hundreds of thousands of jobs and supplying a large portion of the UK's primary energy needs.[73]

2.129 At Autumn Statement 2014, the government set out a plan for reform of the oil and gas fiscal regime.[74] This plan established a new set of principles to underpin taxation decisions, including recognising that the tax burden will need to fall as the basin matures and committing to consider the competitiveness of commercial opportunities – and the wider economic benefits of oil and gas production – when making decisions about fiscal policy. Delivering on this long-term plan, **the government will introduce a package of reforms to ensure that the North Sea continues to attract investment and to safeguard the future of this vital national asset.** Specifically, the government will:

- **introduce a new Investment Allowance to stimulate investment at all stages of the industry life cycle,** simplify the existing system of offshore field allowances, and provide investors with greater certainty which they can factor into their long-term investment decisions
- **reduce the Supplementary Charge from 30% to 20%,** building on the 2% cut announced at Autumn Statement, to send a strong signal that the UK is open for business and ensure the UK Continental Shelf remains competitive as the basin matures
- **reduce Petroleum Revenue Tax from 50% to 35%** to promote investment in incremental projects in older fields and extend the life of key infrastructure
- **provide £20 million of funding for a programme of seismic surveys** to boost offshore exploration in under-explored areas of the UK Continental Shelf
- **ensure that the Oil and Gas Authority has the powers it needs to scrutinise companies' plans for decommissioning programmes** to ensure they are cost effective

2.130 Together these measures are expected to lead to over £4 billion of additional investment and at least 120 million barrels of oil equivalent of additional production in the next 5 years,

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[72] 'Digital Communications Infrastructure Strategy', HM Treasury and DCMS, March 2015
[73] 'Digest of United Kingdom Energy Statistics 2014', Department of Energy and Climate Change, July 2014
[74] 'Driving investment: a plan to reform the oil and gas fiscal regime', HM Treasury, December 2014

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boosting oil production in 2019 by 15%, equivalent to around 0.1% of GDP.[75] This will provide certainty for investors and create the right conditions for the basin to flourish and deliver maximum economic benefits for the UK.

2.131 **The government will also bring forward proposals for legislation in the next Parliament for competitive tendering of onshore electricity transmission infrastructure.** This could significantly reduce the cost of building this infrastructure. Competition in the offshore regime has worked well, having already saved consumers between £200 million and £400 million and helping to lower electricity bills.[76]

2.132 The government's first competitive auction for renewable electricity in February 2015 saw over 2GW of new capacity being supported across the UK: over 1GW of offshore wind and 748MW of onshore wind – enough to power more than 1.4 million homes. By introducing competition, the government has saved over £100 million per year, driving down costs for consumers.[77]

2.133 The government believes that there is significant potential for the deployment of tidal lagoons and tidal range technologies. Lagoon technology could theoretically contribute up to 25TWh/year, the equivalent of 8% of the UK's electricity consumption in 2013 of indigenous, predictable and low carbon electricity. Therefore, **the government has decided to enter in to the first phase of negotiations on a Contract for Difference for Swansea Bay Tidal Lagoon (without prejudice to the planning decision on the project)** to determine whether the project is affordable and value for money for consumers, and whether it will drive down costs for tidal lagoon energy in the UK.

Housing, planning and local growth

2.134 A streamlined, accessible planning system and a housing supply that is readily able to meet demand are essential components of a flexible, resilient and prosperous economy. Annual housing starts and planning approvals are at 7-year highs and over 537,000 new homes have been built during this Parliament.[78] In total, the government has committed investment of £24 billion up to 2020 into affordable housing, access to finance, and helping households into home ownership.[79]

2.135 The government is already delivering the most ambitious programme of affordable house building for a generation. It has delivered 217,000 affordable homes since April 2010, including over 63,000 for Affordable Home Ownership.[80] A further 275,000 homes will be provided in the five years from April 2015 to March 2020 – building more new affordable homes than during any equivalent period in the last 20 years.

2.136 The government has introduced a number of measures to support home ownership. Since Help to Buy was launched at Budget 2013, the equity loan scheme has boosted housing supply with almost 43,000 new-build completions, supporting first-time buyers across the

[75] 'Economic and Fiscal Outlook', Office for Budget Responsibility, March 2015
[76] 'Conclusions of Consultation on the Evaluation of OFTO Tender Round 1 Benefits', Ofgem, September 2014
[77] 'World-leading auctions to provide major green electricity boost', Press Release, Department of Energy and Climate Change, February 2015
[78] 'Table 222: Permanent Dwellings started and completed, by tenure, England', Department for Communities and Local Government, February 2015, and 'New Housing Pipeline: Q3 2014 Report', Home Builders Federation, December 2014
[79] HM Treasury Internal Calculations
[80] 'Table 1000: additional affordable homes provided by type of scheme, England' and 'Table 1012: affordable housing starts and completions funded by the HCA and the GLA', Department for Communities and Local Government, February 2015. 'Help to Buy (equity loan) scheme monthly statistics', Department for Communities and Local Government, March 2015

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country to get onto the property ladder.[61] In the year to the third quarter of 2014-15, the number of Right to Buy sales increased by 15%.[62]

2.137 Budget 2015 sets out further progress on the government's commitments to ambitious housing and regeneration projects. **The government is designating the first 20 Housing Zones outside London, and continuing to work with the other 8 shortlisted areas** – at least doubling the ambition announced by the Chancellor in his Mansion House speech to create 10 housing zones outside London.[63] Backed by government technical support and planning funding, brokerage and investment, these Zones could support up to 45,000 new homes.

2.138 **The government is committing to enable the public sector to lead development on the next phases of Northstowe.** Under the delivery model set out at Autumn Statement 2014, the government expects that three-quarters of the homes started on the public sector-owned site by 2020 will be built under direct contract with the public sector, with the rest in that period delivered through serviced plots in line with the public sector's overall master plan for the development. This model will help the development to build out at twice the rate of a conventional private sector route. The government has appointed the University of York to lead a study into the feasibility and economic impacts of direct commissioning of housing on a significantly wider scale, and to evaluate the development at Northstowe.

2.139 **Budget 2015 also announces £97 million of funding and ring fencing of the local 50% share of business rate growth to support the London Borough of Barnet and the Greater London Authority's (GLA) plans for the regeneration of Brent Cross.** This will unlock 7,500 new homes and create 4.9 million square feet of new commercial development with space for up to 27,000 jobs.

2.140 Following legislative authority from the Deregulation Bill later in March 2015, the government expects that the Urban Development Corporation (UDC) established to deliver a new garden city at Ebbsfleet will be operational from April 2015. **The Department for Communities and Local Government is announcing the Board members for the UDC for the garden city at Ebbsfleet**, who will lead the Corporation alongside the Chairman Designate, Michael Cassidy.

2.141 The government will consult shortly on a specification to deliver the master plan for the development at Ebbsfleet, which will provide the Development Corporation with a vision for the next stage of development. The Homes and Communities Agency (HCA) will shortly bring forward the Northfleet Embankment site for marketing, to deliver high-quality homes and employment opportunities. To further support development of the garden city, **the Chancellor has asked the UDC to work with the government to produce a prioritised, realistic and costed plan for infrastructure needs at Ebbsfleet.**

2.142 **Budget 2015 launches a consultation into the compulsory purchase regime to make it clearer, faster and fairer for all parties.** This will support the government's commitment to improving the consenting and planning processes for applicants and claimants, to support brownfield development.

2.143 Following the successful roll-out of City Deals across England, in 2014 the government signed an ambitious City Deal for Glasgow and the Clyde Valley, alongside the Scottish Government and the Glasgow and Clyde Valley local authorities. The government believes that there is merit in extending the City Deal model further in Scotland and Wales. Therefore, **Budget 2015 announces that the government is opening negotiations with local**

[61] 'Help to Buy Equity Loan Scheme', Department for Communities and Local Government, March 2015
[62] 'Right to Buy sales: October to December 2014, England', Department for Communities and Local Government, February 2015
[63] 'Mansion House 2014: Speech by the Chancellor of the Exchequer', HM Treasury, June 2014, available on gov.uk

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partners and the Scottish and Welsh Governments for City Deals for Cardiff, Aberdeen and Inverness. In Inverness, the government is making funding available in 2015-16 to help progress the deal.

Building a truly national recovery

2.144 The government is committed to building a truly national recovery, closing the long-term gaps between the north and south, London and the rest of the country, and strengthening the UK economy as a whole.

2.145 Outside London and the South East, the rest of England has grown more slowly than the national average since 1997.[84] The Chancellor has set out long-term economic plans for each region, with an ambition to raise the long-term growth rate of slower growing parts of England to at least the rate currently forecast for the UK as a whole. This could add an extra £90 billion to the UK economy by 2030.[85]

2.146 In contrast to strategies based on redistributing public sector activity, the long-term economic plans promote private sector growth, backing business and helping areas attract new investment by investing in better infrastructure, innovation and quality of life. They are tailored to the particular strengths of each part of the country: from tourism and farming to manufacturing and financial services – to build a stronger economy and fairer society.

2.147 Budget 2015 announces further steps to create a truly national recovery.

Northern Powerhouse

2.148 To build the Northern Powerhouse, the government is already:

- committing £13 billion of investment to transport in the north of England: connecting cities, electrifying the main rail routes, building the northern rail hub, and providing new trains through the new northern rail franchise[86]
- supporting a further £2.7 billion of investment for new trains on the east coast, and investing in major road upgrades including the A1, M62, M1, A556 and Mersey Gateway Bridge, in addition to the £50 billion commitment to develop High Speed 2 (HS2)[87]
- building on the north's existing strengths in science and technology with major new projects including the Sir Henry Royce Institute, Cognitive Computing Centre at Daresbury, Newcastle Institute for Ageing and National Graphene Institute, as well as ensuring that future revenue benefits of shale gas exploitation are reinvested through a long-term investment fund
- investing in the vibrant cultural life of the north, including £78 million for the Factory Manchester
- devolving power to Greater Manchester, including through the creation of a new directly elected metro Mayor, to give the north a powerful new voice
- devolving power to Sheffield, including over transport, skills and business support

2.149 Budget 2015 sets out further action to build a Northern Powerhouse.

2.150 Transport: In October 2014, the Chancellor announced the creation of Transport for the North (TfN), which will draw up a comprehensive Northern Transport Strategy. **TfN will shortly publish an interim report, committing to build on the concept of HS3 to develop a**

[84] Regional Gross Value Added (Income Approach), ONS, December 2014
[85] Long Term Economic Plan press releases, HM Treasury, January-February 2015
[86] 'Road Investment Strategy', Department for Transport , December 2014, 'National Infrastructure Pipeline', HM Treasury, December 2014, 'Local transport capital block funding', Department for Transport, March 2014 and Local Growth Fund figures provided by Local Enterprise Partnerships
[87] 'Investing in Britain's Future', HM Treasury, June 2013

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network of high quality rail connections across the north – the TransNorth vision; bring the benefits of HS2 to the north sooner than planned; and work towards a single smart and integrated ticketing system across the region. **The government will now proceed with electrification of the Selby to Hull line,** subject to an acceptable contribution from Hull Trains and a business case, to complete the full electrification of the historic trade route between Liverpool and Hull.

2.151 **Science and innovation:** In January 2015, the Chancellor convened discussions with clinicians and biomedical scientists to discuss how to build on the north's strengths in health science. **The government is now committing £20 million to Health North,** to enable better care for patients, and to promote innovation through analysis of data on the effectiveness of different drugs, treatments and health pathways.

2.152 **The government is also committing £14 million over two years to invest in an Advanced Wellbeing Research Centre (AWRC) in Sheffield,** which will be a world-leading research centre to design, develop and implement physical activity interventions and products to improve wellbeing. The AWRC will form part of Sheffield's Olympic Legacy Park and is due to open in 2016.

2.153 **Tech:** In February 2015, the Chancellor convened tech entrepreneurs to launch the Tech Nation report, which revealed that over 170,000 people are now working in digital business in the North, many in rapidly expanding tech clusters.[89] To accelerate this growth, **the government will support the development of innovative businesses across the north through an £11 million investment in tech incubators in Manchester, Leeds and Sheffield.** These tech incubators will create thriving local ecosystems by nurturing start ups, fostering collaboration, and providing mentoring, learning and business support:

- **Sheffield 'Maker Hub' – £3.5 million government investment** to renovate a former Co-Op department store in the Castlegate area
- **Leeds 'Future Labs' – £3.7 million government investment** to renovate a derelict police headquarters in the heart of Leeds, creating a 6 floor incubator
- **Manchester 'Forward Plan' – £4 million government investment** towards an 8 floor incubator in Federation House, located in Manchester's Northern Quarter

2.154 **The government will also provide funding to develop a financial technology incubator in Leeds.**

2.155 **Chemical innovation:** The government will provide **£1 million to the Centre for Process Innovation** to support innovation and knowledge transfer in the North East's chemicals sector.

2.156 **Supporting enterprise: The government will extend Enterprise Zones in Manchester and Mersey Waters,** focusing respectively on logistics and healthcare, and on advanced manufacturing. **The Humber Enterprise Zone will be extended,** enabling it to capitalise on investment by Siemens, with their wind turbine supply chain facilities to be based on site. **The designation of the Leeds Enterprise Zone will be changed** to support energy and waste technology businesses. The government will also **extend the Enterprise Zone at Tees Valley, for oil and gas decommissioning.** After business case completion the government will also **create a new Enterprise Zone at Blackpool.**

2.157 **Quality of life and tourism:** Following previous significant cultural investments, including a £78 million investment in the Factory Manchester, **the government will now support the refurbishment of the Muni theatre in Pendle.** Building on previous measures

[89] Tech Nation: Powering the digital economy, Tech City, February 2015

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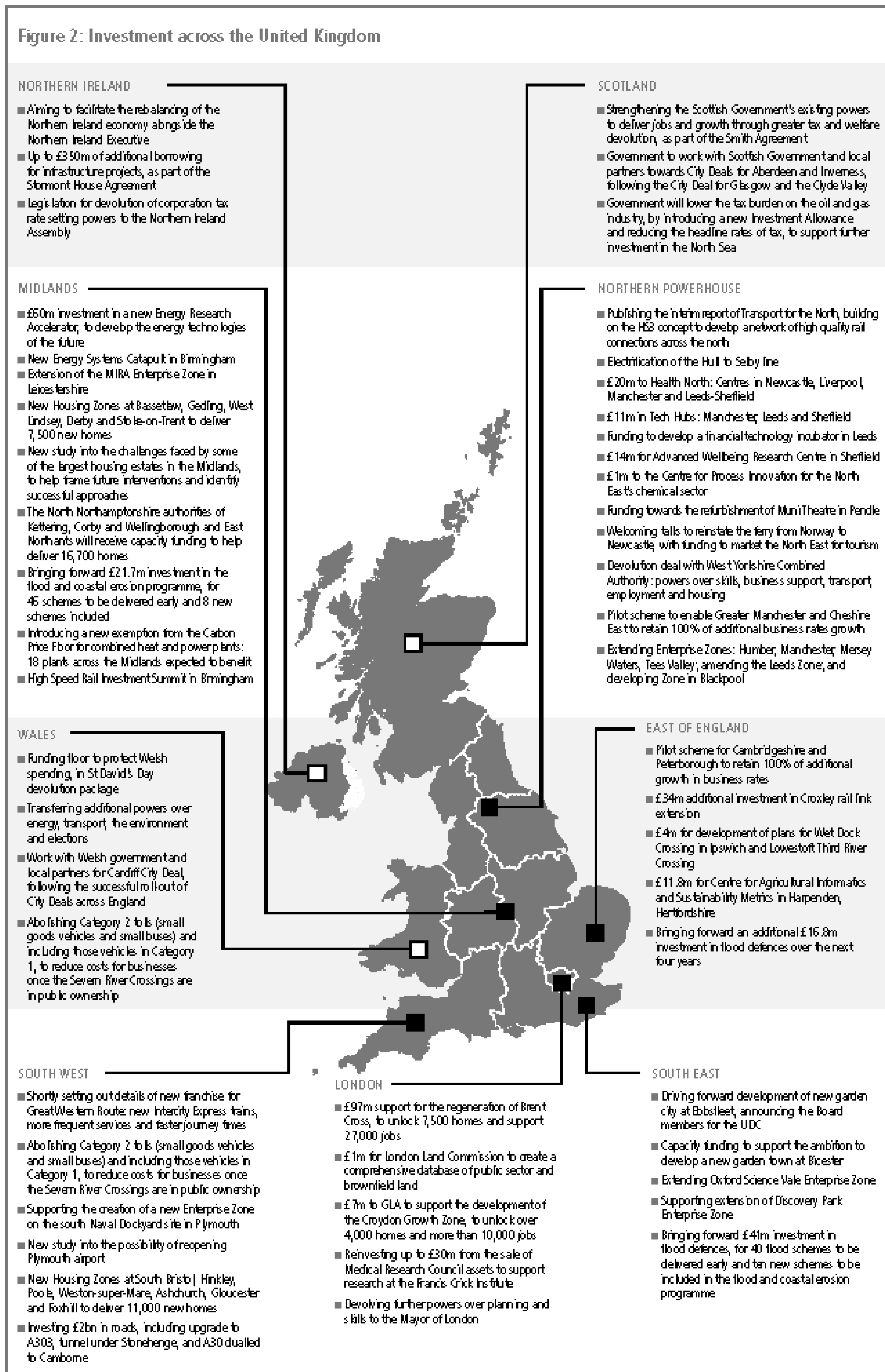

Figure 2: Investment across the United Kingdom

to support tourism in the North East, **the government welcomes talks to reinstate the ferry from Norway to Newcastle and will provide funding to market the North East to help bring more visitors from Scandinavia.**

2.158 Devolution: A new devolution deal with the West Yorkshire Combined Authority will give West Yorkshire new powers over skills, business support and transport.

2.159 To build on Greater Manchester's ambitious devolution deal, **the government will, subject to the formal approval of Greater Manchester Combined Authority, pilot a scheme in Greater Manchester and Cheshire East to enable the retention of 100% of any additional business rate growth, starting in April 2015.** This will mean local areas will see the full benefits of policy decisions that increase the local growth rate and business rate revenues, sharpening incentives to boost jobs and growth.

Midlands

2.160 Transport: The government has already committed £5.2 billion to transport infrastructure across the Midlands. On top of this, the government is delivering HS2. To maximise the benefits for the Midlands, **the government will fund a High Speed Rail Investment Summit in Birmingham,** to attract overseas investment into regeneration projects in the region.

2.161 Science: **The government will invest an initial £60 million in a proposal by six universities across the Midlands for a new Energy Research Accelerator,** a major project to develop the energy technologies of the future. **As part of the government's creation of science catapult centres across the country, it is supporting a new Energy Systems Catapult in Birmingham,** which will bring together researchers and industry in order to develop new technologies and products.

East of England

2.162 Transport: The government has already committed £4.2 billion to transport infrastructure in the East of England. **Budget 2015 sets out plans to go further, including £34 million of additional government funding plus a further £16 million from Transport for London (TfL) for the development of the Croxley rail link to extend the Metropolitan Line on the London Underground to Watford Junction on the West Coast Main Line, and £4 million for further development of the Wet Dock Crossing in Ipswich, and Lowestoft Third River Crossing.**

2.163 Investment: **Budget 2015 announces a pilot scheme in Cambridgeshire and Peterborough to enable the retention of 100% of any additional business rate growth, starting in April 2015.** This will mean local areas will see the full benefits of policy decisions that increase the local growth rate and business rate revenues, sharpening incentives to boost jobs and growth.

2.164 Flood defences: The government has made significant investment in flood and coastal defences across the East during this Parliament, and in December 2014 set out a £240 million investment programme for the next 6 years. **The government is bringing forward an additional £16.8 million over the next 4 years.** Key schemes will start in Canvey Island in 2016, and new projects in Great Yarmouth and Canvey Island will be funded within the 6-year programme.

2.165 Innovation: Building on existing strengths in agri-tech, **the government will invest £11.8 million in a new Centre for Agricultural Informatics and Sustainability Metrics in Harpenden, Hertfordshire.** This world-leading big data centre will use data science and modelling to make food production more efficient and sustainable.

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South West

2.166 Transport: The government has already committed £7.2 billion to transport infrastructure in the South West. This includes: £2 billion on upgrading key roads such as the A30, A303, A358 and the M5; a new tunnel at Stonehenge; and electrification of the Great Western Main Line. In January 2015, the Chancellor announced a new South West Peninsula Rail Task Force to bring forward proposals for strategic and local rail schemes.

2.167 The Secretary of State for Transport will shortly set out details of the **new franchise for the Great Western Route, which will introduce the new £3 billion Intercity Express trains, more frequent services and faster journey times.** To reduce costs for businesses, once the Severn River Crossings are in public ownership after 2018, **the government will abolish Category 2 tolls (small goods vehicles and small buses) and include those vehicles in Category 1 (motor cars and motor caravans)**.

2.168 Transport: **The government has asked the South West Peninsula Task Force on rail to consider improvements to the Exeter to Salisbury line as part of its work. The government also encourages the relevant local authorities and Local Enterprise Partnership to develop a business case for investment in the North Devon Link road,** to form the basis of a future application to the Local Growth Fund.

2.169 **Plymouth Marine Enterprise Zone and airport: The government will seek to create a new Enterprise Zone** on the south Naval Dockyard site, and **commission a new study into the possibility of reopening Plymouth airport.**

2.170 **Housing: To meet the housing needs of the South West and regenerate brownfield sites the government will support the new housing zones at South Bristol, Hinkley, Poole, Weston-super-Mare, Ashchurch, Gloucester and Foxhill.** These zones will see the government providing support and finance to enable the regeneration of brownfield sites into new homes. Together the zones across the South West will deliver over 11,000 new homes.

London

2.171 Housing: In February 2015, the Chancellor set out a plan to tackle housing in London, the biggest challenge facing the city. As well as announcing new housing zones, the government announced the creation of the London Land Commission (LLC), tasked with developing brownfield and public sector land. **Budget 2015 provides £1 million to allow the LLC to create a comprehensive database of public sector and brownfield land.** Alongside ongoing support for the regeneration of Barking Riverside and Brent Cross, **the government will also provide £7 million to the Greater London Authority to support the development of the Croydon Growth Zone.** This could unlock over 4,000 homes and 10,000 jobs.

2.172 Science: The government has already made major investments in science in London, including the Francis Crick Institute and Alan Turing Institute. **The government will now reinvest up to £30 million from the sale of Medical Research Council assets to support research at the Francis Crick Institute, with matched funding from Cancer Research UK and the Wellcome Trust.**

2.173 **Devolution: The government is devolving further powers to the Mayor of London, including over planning and skills.** This will allow the Mayor to accelerate the provision of new homes by reducing planning delays, and to tailor decisions over skills provision to London's needs.

South East

2.174 Housing: Housing remains a significant challenge across the South East. In 2014, the government created an Urban Development Corporation (UDC) to drive forward development of a new garden city at Ebbsfleet. **The government is announcing the Board members for the UDC, and expects it to be up and running from April 2015.** The UDC will now produce a business plan ahead of the next spending review. **The government will also provide capacity funding to support Bicester's ambition to become a garden town, including assessing the potential for recoverable government investment, subject to a business case.**

2.175 Innovation: Building on the science strengths in the South East is crucial to maintaining strong economic growth. **The government will extend the Oxford Science Vale Enterprise Zone for advanced energy, space and satellite science, and will extend Discovery Park Enterprise Zone,** subject to a business case, allowing it to expand its operations in life sciences and environmental technologies.

Strengthening the UK's skills and innovation base

Education and skills

2.176 The government has implemented a package of measures to improve access to training and higher education. Over 2 million people have started apprenticeships during this Parliament, and in the academic year 2014-15 the highest ever number of young students and students from disadvantaged backgrounds applied to, and were accepted into, university.[89] The youth Claimant Count more than halved between May 2010 and January 2015.[90] At Autumn Statement 2014 the government announced that it would increase the financial support for students on postgraduate taught courses with a new income-contingent loan offer.

PhD funding

2.177 The UK excels both in terms of volume and quality of research. The government has supported researchers by ring-fencing the science budget and strengthening partnerships with industry, for example through Doctoral Training Centres. However, demand for individuals with doctorates is outstripping supply, both in the UK and internationally. Despite increases in the proportion of the labour market with a PhD in the US and UK, wage differentials with those whose highest qualification is an undergraduate degree have risen substantially.[91]

2.178 In addition, the market for postgraduate skills is becoming more internationally competitive. Countries such as the US and China are competing more for top researchers and have increased PhD student numbers in recent years, whereas in the UK PhD enrolment has remained relatively flat.[92]

2.179 **The government will introduce a package of measures to broaden and strengthen support for postgraduate researchers (including both masters and PhDs).** This additional support will focus on seizing new opportunities in postgraduate research and build on partnerships with industry, charities, academies and individual members of society. It will include:

[89] 'FE Data Library: Apprenticeships - Apprenticeships by quarter: starts and achievements 2002-02 to 2012-13, Skills Funding Agency and Department for Business, Innovation and Skills, February 2015; and FE Data Library: Apprenticeships - Breakdown by geography, equality, diversity and sector subject area: starts 2002/03 to 2014/15, Skills Funding Agency and Department for Business, Innovation and Skills, February 2015. 'End of Cycle Report 2014', UCAS, December 2014
[90] Labour Market Statistics, ONS, February 2015. Further detail can be found in 'Budget 2015 Data Sources'.
[91] 'Rising Wage Inequality and Postgraduate Education', Lindley, J., and Machin, S., Centre for Economic Performance Discussion Paper No1075, September 2011
[92] 'International Comparative Performance of the UK Research Base', prepared by Elsevier for the Department for Business, Innovation and Skills, 2013

- **launching a review into how the government can strengthen its funding for postgraduate research.** This review will examine the balance between number and level of research stipends to ensure that the UK's offer remains internationally competitive
- **assessing, as part of this review, options to strengthen partnerships and co-funding between government, industry and charities.** This will include increased support for crowd-funding for wider research to attract investment from individual members of society and business
- **introducing income-contingent loans of up to £25,000 to support PhDs and research-based masters degrees.** These loans will be in addition to existing funding, and designed to minimise public subsidy. The government will work with research councils, universities and industry to examine how best to design them so that they complement existing funding streams and continue to support the most excellent research

Apprenticeship funding

2.180 Apprenticeships equip people with the skills they need to compete in the labour market, and that employers need to grow their businesses. **The government, through the introduction of an Apprenticeship Voucher, will put employers in control of the government funding for the training apprentices need.** The new mechanism, which will be developed and tested with employers and providers immediately and fully implemented from 2017, will give employers the purchasing power to have an even greater say in the quality, value for money and relevance of the training that their apprentices receive. As confirmed at Autumn Statement 2013, the government and employers will make cash contributions towards the cost of training for apprentices.

Support for road hauliers

2.181 **The government will review the speed with which Heavy Goods Vehicles (HGV) driving tests and driver medical assessments currently take place and will consider options to accelerate both in order to help address the shortage of qualified HGV drivers.** The government will also work with road haulage firms on an industry-led solution to the driver shortage, including looking at the right level of access to, and funding support for, training.

Supporting science and innovation

2.182 Science and innovation are core drivers of economic growth, and the UK's ability to transform its world-leading science base into new products, services and markets is critical to increasing productivity, providing jobs, and improving societal wellbeing. That is why the government has prioritised overall science funding throughout this Parliament (£4.6 billion each year to 2015-16), and provided the longest commitment to capital investment in science facilities of any Parliament (£1.1 billion per year, rising with inflation, between 2016 and 2021).[93]

2.183 The government has also increased its direct support to innovation – having raised the annual budget of Innovate UK from £360 million in 2010-11 to over £500 million in 2015-16 – and committed £845 million over 7 years to develop a network of Catapult centres to help bring innovative ideas to market.[94]

2.184 This Budget goes further, announcing that **the government will commit £400 million to 2020-21 for the next round of funding for cutting-edge scientific infrastructure.** This will be a competitive fund, based on scientific excellence, which seeks to lever industrial and charitable funds. The government welcomes exciting proposals from across the UK that aim to push scientific boundaries and maximise scientific impact.

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[93] 'Spending Review 2010', HM Treasury, October 2010 and 'Spending Round 2013', HM Treasury, June 2013
[94] 'Annual Report and Accounts, 2010-11', Technology Strategy Board, May 2012

2.185 **The government will also provide further strategic science and innovation investments to make the UK a global leader in emerging markets and technologies,** drawing on and supporting the UK's existing world-class research base. The government will commit:

- **£138 million of funding towards the UK Collaboratorium for Research in Infrastructure and Cities (UKCRIC),** subject to a satisfactory business case and the provision of substantial co-funding. The UKCRIC will apply research to ensure that the UK's infrastructure is resilient and responsive to environmental and economic impacts. It will have hubs in London, and further centres initially in Birmingham, Newcastle, Sheffield and Southampton
- **£100 million for Research and Development into Intelligent Mobility,** which will focus on enhancing the development of driverless car technology and the systems required to implement and adopt the technology, such as telecommunications
- **£40 million for demonstrator programmes, business incubator space and a research hub to develop applications for Internet of Things technologies in healthcare and social care, and Smart Cities**

2.186 Smart City technology could prove transformative, as well as providing significant opportunities for supporting jobs and growth. To ensure that the UK can take advantage of this technology local areas will need to be empowered to make decisions, and collaborations will need to be built between cities, universities and business. **The government will support a competition to fund a Smart Cities demonstrator as part of the Internet of Things programme** to trial and showcase these new technologies.

2.187 **Budget 2015 confirms that the government will invest a further £100 million in cutting-edge research projects through the current UK Research Partnership Investment Fund round.** The Higher Education Funding Council for England received 22 proposals in the latest competition round from areas ranging from advanced steel research to compound semi-conductor technology and tissue repair. The successful projects will leverage over £350 million of private sector investment and are being led by universities from across the UK.

2.188 **The government will also provide the UK's world-leading Research Institutes with greater freedoms** to attract the brightest minds, re-invest commercial income, and develop cutting-edge technology.

2.189 The government would like to ensure that academics and researchers are appropriately rewarded when they contribute towards valuable intellectual property used in spin out companies. **The government will therefore review the availability of capital gains tax (CGT) entrepreneurs' relief on disposals by academics of shares in such companies.**

2.190 The government wants to ensure that regulations do not restrict the creation of valuable and innovative products, services and business models. **The government will therefore engage with business to determine where regulations inhibit innovation, including disruptive technologies, and develop a programme for addressing this in the next Parliament.**

2.191 The government announced in February 2015 the launch of a £10 million ultra-low emission vehicle (ULEV) battery prize, which will see a UK-based collaboration of manufacturers and researchers develop a new commercially viable battery pack for ULEVS. The winner will be announced in summer 2015.

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Creating a dynamic economy

2.192 Creating the right conditions to start and grow a business, across all sectors and regions, is vital to ensuring a prosperous and balanced economy. This Budget announces a package of measures to unlock the potential of the sharing economy and to help UK businesses to succeed domestically and to expand into new markets overseas.

Support for the sharing economy

2.193 The government wants to ensure that Britain is the global centre for the sharing economy, enabling individuals and businesses to make the most of their assets, resources, time and skills through a range of online platforms. This Budget therefore announces a comprehensive package of measures that will break down barriers, create opportunities for sharing, and unlock the potential of this dynamic and growing area. Building on the recommendations of the independent review of the sharing economy, the government will:[95]

- **make it easier for individuals to sub-let a room through its intention to legislate to prevent the use of clauses in private fixed-term residential tenancy agreements that expressly rule out sub-letting or otherwise sharing space on a short-term basis, and consider extending this prohibition to statutory periodic tenancies**
- **enable government employees to use sharing economy solutions to book accommodation and transport when travelling on official business, where this represents value for money**
- **encourage Local Authorities to use their business rates discretionary relief powers to support the sharing economy,** including shared workspaces and makerspaces

2.194 The sharing economy also presents an opportunity to drive local growth and deliver local public services more innovatively and efficiently. To demonstrate the benefits of the sharing economy **the government will launch two pilots in Leeds City Region and Greater Manchester in 2015-16, to trial local sharing initiatives in the areas of shared transport, shared public space, and health and social care.**

2.195 These and other initiatives are set out in the government's response to the independent review of the sharing economy.[96]

Improving access to finance and markets

Exports

2.196 The government is committed to improving economic ties with major emerging markets. **Budget 2015 continues progress in this area and announces a near doubling of funding for UK Trade and Investment (UKTI) activities in China,** including a focus on the advanced manufacturing, transport, financial services, healthcare and life sciences sectors, to ensure that opportunities for British businesses to trade with China are maximised.

2.197 **Budget 2015 also announces funding for an ambitious series of trade missions focused on regional strengths,** and to ensure that the UK makes the most of the International Festival for Business in Liverpool.

Access to finance

2.198 On 12 March 2015, the Chancellor of the Exchequer announced the UK's intention to become the first major Western economy to be a prospective founding member of the Asian

[95] 'Unlocking the sharing economy: an independent review', www.gov.uk, November 2014
[96] 'Independent Review of the sharing economy: Government response', Department for Business, Innovation and Skills, March 2015

Infrastructure Investment Bank (AIIB). The AIIB will support access to finance for infrastructure projects across Asia to boost investment across a range of sectors including transportation, energy, telecommunication, agriculture and urban development. Subject to agreement by the existing prospective founder members, the government will join discussions to agree the AIIB's Articles of Agreement, governance and accountability arrangements.

2.199 The government is committed to helping the best businesses access the finance they need to grow. To improve access to finance for smaller firms, **the British Business Bank is launching a pilot 'Help to Grow' programme to increase the supply of growth loans to firms that need between £500,000 and £2 million to achieve their potential. Budget 2015 announces a request for proposals to deliver the pilot**, which will facilitate up to £100 million of finance for growing businesses.

2.200 The government will make amendments to the Seed Enterprise Investment Scheme (SEIS), Enterprise Investment Scheme (EIS), and Venture Capital Trusts (VCTs) to ensure that the UK continues to offer significant and well-targeted support for investment into small and growing companies, in line with new EU rules. The government will, subject to state aid approval:

- **require that companies must be less than 12 years old when receiving their first EIS or VCT investment, except where the investment will lead to a substantial change in the company's activity**
- **introduce a cap on total investment received under the tax-advantaged venture capital schemes of £15 million, increasing to £20 million for knowledge-intensive companies**
- **increase the employee limit for knowledge-intensive companies to 499 employees,** from the current limit of 249 employees

2.201 The government will also smooth the interactions between the schemes by removing the requirement that 70% of the funds raised under SEIS must have been spent before EIS or VCT funding can be raised.

Competition

2.202 Competition is a key driver of productivity and growth, and the government is committed to improving the functioning of markets. **The government will take forward Competition and Markets Authority (CMA) recommendations, and other actions agreed with the CMA, to improve the market for residential property management services (RPMS).** These changes will make tangible improvements in the RPMS market to the benefit of both leaseholders and landlords. **The government will also support customers to make informed choices in other key markets**, by developing improved guidance so that supermarkets can unit price most everyday items consistently, and by improving information for SMEs on access to legal services.

2.203 The government is determined to drive increased competition in the banking market, so that banks, alternative providers and financial technology (FinTech) firms compete vigorously, on a level playing field, to win and retain customers. **Budget 2015 announces a package of measures to further support competition in banking**, details of which have been published separately in 'Banking for the 21st Century: driving competition and choice'.[97] The lead measures in this package set out the government's approach to establishing a supportive framework for legitimate digital currency businesses and helping FinTech firms gain access to banking data.

[97] 'Banking for the 21st Century: driving competition and choice', HM Treasury, March 2015

2.204 The FinTech sector comprises a wide range of activities and companies with the potential to bring increased competition and innovation in financial services markets, to the benefit of UK customers. The government wants the UK to be the world's leading FinTech hub, and is now taking steps to supports innovation across the whole of the UK while safeguarding financial stability and consumer protection. In support of this, this Budget announces that:

- **the Financial Conduct Authority's (FCA) 'Project Innovate' will work with HMT and the Prudential Regulation Authority (PRA) to investigate the feasibility of developing a regulatory 'sandbox' for financial services innovators**
- **the FCA, working with the PRA, will also identify ways to support the adoption of new technologies to facilitate the delivery of regulatory requirements – so-called 'RegTech'**
- **Innovate Finance has agreed to deliver its FinTech regional strategy through a series of local partnerships;** the first partnership has already been established in Leeds, and further partnerships will be established in Manchester and Edinburgh by April, and in Newcastle, Bristol and other centres before the end of the year

Fairness

2.205 The government's long-term economic plan is underpinned by a firm commitment to support those who want to work hard and get on, while continuing to support and protect the most vulnerable in society. The government's ambition is to build a stronger economy and a fairer society. This Budget builds on the government's priorities over this Parliament of helping families and making work pay by raising the personal allowance and reducing the burden of Income Tax for the lowest paid; supporting and rewarding savers at every stage of their life; and taking firm action to tackle tax evasion and avoidance. The government's welfare reforms continue to promote work and personal responsibility, while putting expenditure on a sustainable footing.

2.206 As a result of the government's reforms to tax, welfare and public spending across the Parliament, the richest households will make the biggest contribution to reducing the deficit, both in cash terms and as a proportion of their income.

Supporting households

Personal allowance

2.207 The government's commitment to reduce taxes for low and middle-income earners has been a centre piece of this Parliament. The Coalition Agreement commitment to raise the Income Tax personal allowance to £10,000 over the course of this Parliament was achieved a year early in 2014-15. From April 2015, the personal allowance will be increased to £10,600, from £6,475 in April 2010.

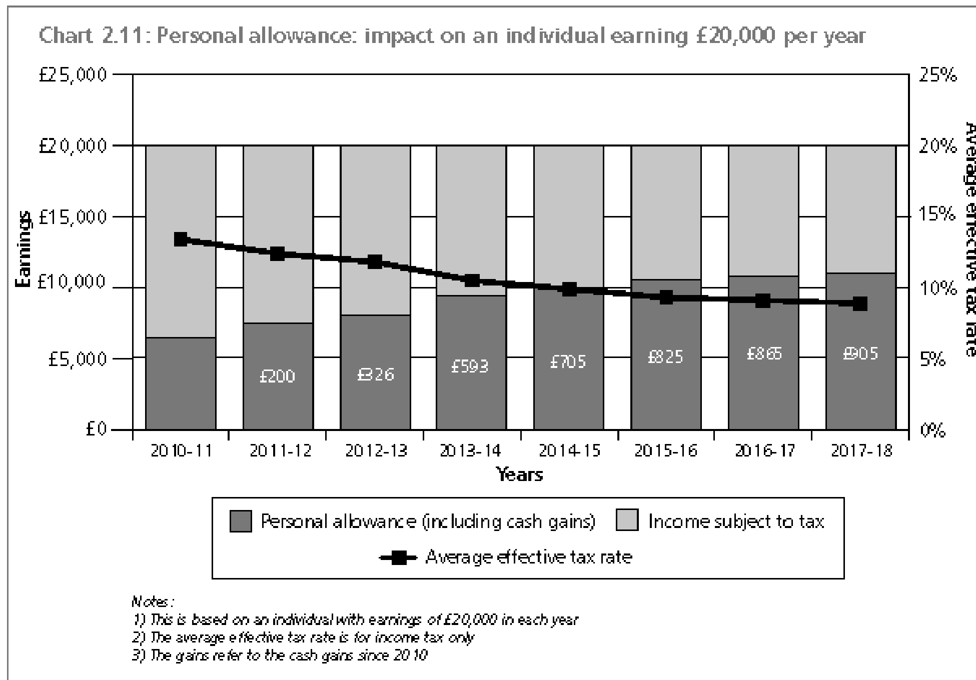
2.208 Budget 2015 announces that the personal allowance will be increased to £10,800 in 2016-17 and to £11,000 in 2017-18. The Marriage Allowance will also rise in line with the personal allowance.

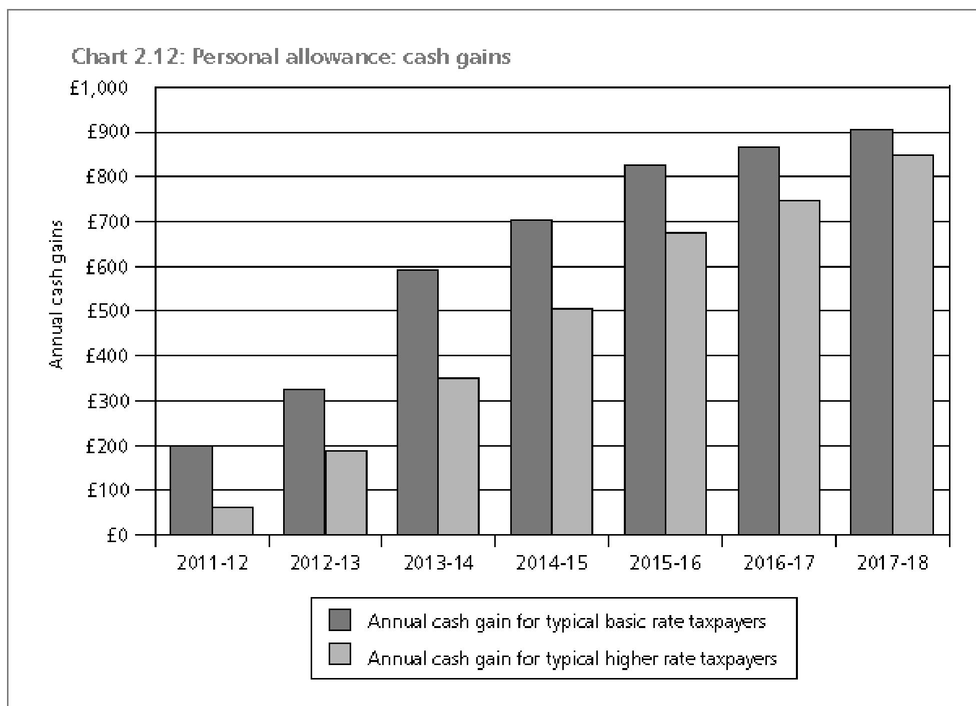
2.209 The successive increases in the personal allowance total £4,525 since 2010, representing a rise of 70% under this government. Taken together, these changes will benefit 27.2 million individuals and provide a cash gain of £905 to the typical basic rate taxpayer in 2017-18. By 2017-18, the government will have taken 3.7 million working-age individuals out of Income Tax altogether.

2.210 To ensure the full gain of the personal allowance increase is passed on to higher-rate taxpayers, the higher-rate threshold will rise in line with the personal allowance, taking it to £42,700 in 2016-17 and £43,000 in 2017-18. This is the first above-inflation increase in the higher-rate threshold for 7 years. A typical higher-rate taxpayer will have a cash gain of £848 by 2017-18.

2.211 The cumulative impact of these changes has significantly reduced the effective tax rate paid by individuals. In 2010, an individual earning £20,000 paid £2,705 in Income Tax. By 2017, an individual earning £20,000 will pay £1,800 in Income Tax, equivalent to a 33% reduction in the tax paid. The effective tax rate for an individual earning £20,000 in 2017-18 will be 9%.

2.212 Someone working full time on the National Minimum Wage (NMW) in 2015-16 will earn around £12,000. In 2010, an individual earning £12,000 paid £1,105 in Income Tax. In 2017-18, an individual earning £12,000 will pay £200 in Income Tax, an 82% reduction in tax paid. The effective tax rate for an individual earning £12,000 in 2017-18 will be 1.7%.





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National Minimum Wage

2.213 As announced by the Prime Minister and Deputy Prime Minister, the government has accepted the Low Pay Commission's recommendations for increases to the adult, 18-19 and 16-17 (NMW) rates. The adult NMW rate will increase by 3.1% to £6.70 from October 2015, representing the largest real-terms increase since 2006. This means that, from 1 October 2015, someone working full time on the adult NMW will see their annual salary rise by over £350.

2.214 The apprentice rate will increase by 57p an hour to £3.30, halving the gap to the 16-17 rate. This will result in an annual salary increase of over £1,000 for a full time worker on the current apprentice rate, and ensure those undertaking this important type of training are better rewarded.

Energy

2.215 The government is committed to improving competition in energy markets, to lower bills for consumers and drive efficiencies and innovation. In February 2015, the government launched the 'Power to Switch' campaign to help consumers reduce their energy bills by shopping around for the best possible deal. Over 300,000 households switched electricity supplier in February, up 30% on the same period in 2014.[98] Households switching energy supplier via a price comparison website are currently saving an average of around £300 on their annual energy bill as a result.[99]

2.216 The government commits to respond quickly to any recommendations from the Competition and Markets Authority's ongoing investigation into energy markets and to take forward appropriate implementation as quickly as possible. The government will also provide £1.3 million to fund the Big Energy Saving Network (BESN) in 2015-16. This will enable the BESN frontline workers to reach a predicted 100,000 vulnerable individuals, helping them to cut their energy bills.

2.217 The government will consult on reducing electricity distribution costs for consumers in the North of Scotland, to ensure that they pay no more for electricity distribution than consumers in the next most expensive region. The government estimates that this could save an average household in the North of Scotland around £30 per year on their electricity bill.

2.218 The government recognises that motorists in some rural areas face particularly high pump prices compared to the rest of the UK, and has now received full approval from the Council of the European Union to extend the rural fuel rebate scheme to 17 areas of the UK mainland, enabling retailers in eligible areas to register for a 5 pence per litre fuel duty discount. The government is also committed to ensuring that all consumers are able to take advantage of the best deal for their energy supply, including those consumers off the mains gas grid. The government will continue to work with the heating oil and liquefied petroleum gas (LPG) sectors to improve transparency and protections for vulnerable households who are off the gas grid.

Savings and pensions

2.219 Since the financial crisis, low interest rates have helped households and businesses through difficult economic times. These have kept mortgage payments down, but have also meant that returns on savings have been low. The government recognises that 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.

2.220 At Budget 2014, the government announced a reduction in taxes for the lowest income savers, increased flexibility in saving and investment choices by reforming ISAs into a simpler product with a record increase in the ISA limit to £15,000, and introduced a market-leading National Savings & Investment bond to help retired savers. The government also announced the most fundamental change to the way people access their pension savings in almost a century, through removing the

[98] Electricity Switching, Energy UK, February 2015.
[99] Savings estimates based on industry data provided to DECC.

effective requirement to buy an annuity. The government is now going further to reduce taxes on savings, and to give people greater flexibility over how they hold those savings.

Reducing tax on savings

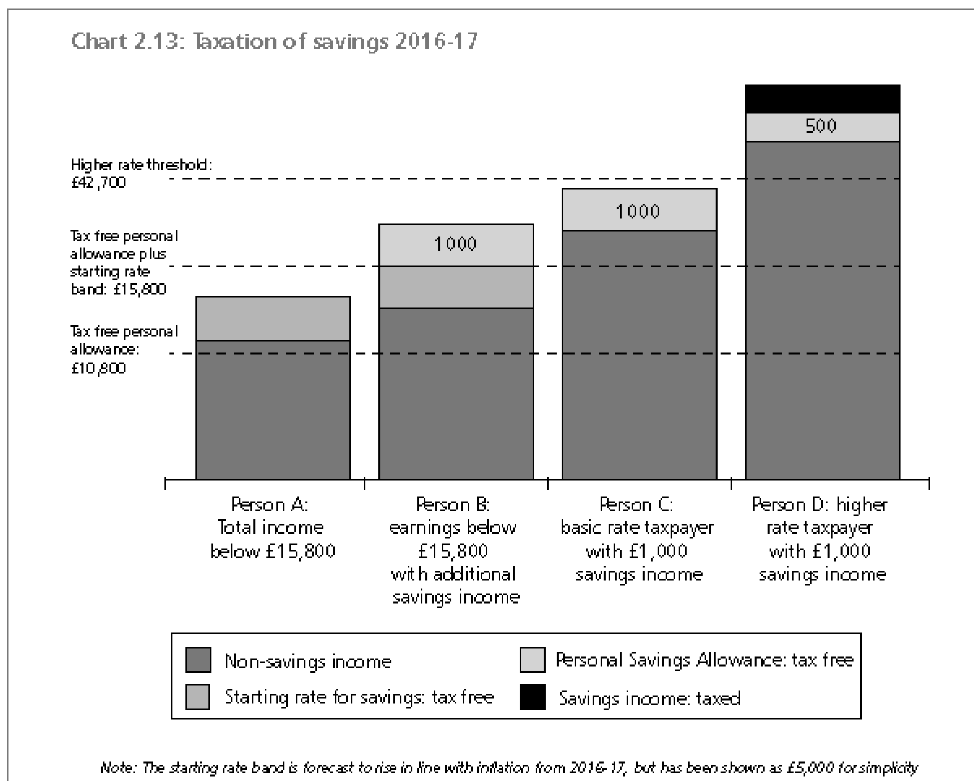
2.221 In their respective reviews of the UK tax system, the Nobel Prize-winning economists James Meade and Sir James Mirrlees considered that ordinary savings were over-taxed. Mirrlees concluded that ordinary savings "should just face a straightforward … system: saved out of taxed earnings and then no more tax applied," though noting that there is a case for some limits.[100]

2.222 In a radical reform to the savings tax system, **a new Personal Savings Allowance will be created from April 2016, exempting the first £1,000 of savings income from any tax for basic rate taxpayers and the first £500 for higher rate taxpayers, saving up to £200 off an annual tax bill**. This will not apply to additional rate taxpayers.

2.223 From April 2016, 95% of taxpayers can save completely tax free each year and choose from a range of savings products to meet their specific needs.

2.224 Because so many people will no longer pay tax on their savings, the automatic deduction of tax by banks and building societies will no longer be necessary. At present, 20% Income Tax is automatically deducted from most interest on savings outside ISAs. For those on low incomes, a 0% rate is applied, but only for those who have filled out a form to confirm they are eligible to receive gross interest. Higher rate taxpayers owe 40% tax and are therefore required to notify HMRC of their savings income so they can pay the additional 20%. Both the opt out and the requirement to notify HMRC are complex, burdensome and poorly understood. **Budget 2015 announces that the automatic deduction of 20% income tax by banks and building societies on non-ISA savings will cease from April 2016**. These changes represent a major tax simplification.

Chart 2.13: Taxation of savings 2016-17



Note: The starting rate band is forecast to rise in line with inflation from 2016-17, but has been shown as £5,000 for simplicity

[100] Tax by Design, Oxford University Press (2011), p344. See also p316.

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2.225 The government will allow ISA savers to withdraw and replace money from their cash ISA without counting towards their annual ISA subscription limit for that year, as long as the repayment is made in the same tax year as the withdrawal. This will enable savers to access their ISA savings more flexibly without losing the benefits they have built up. These changes will be introduced in autumn 2015, following consultation with ISA providers.

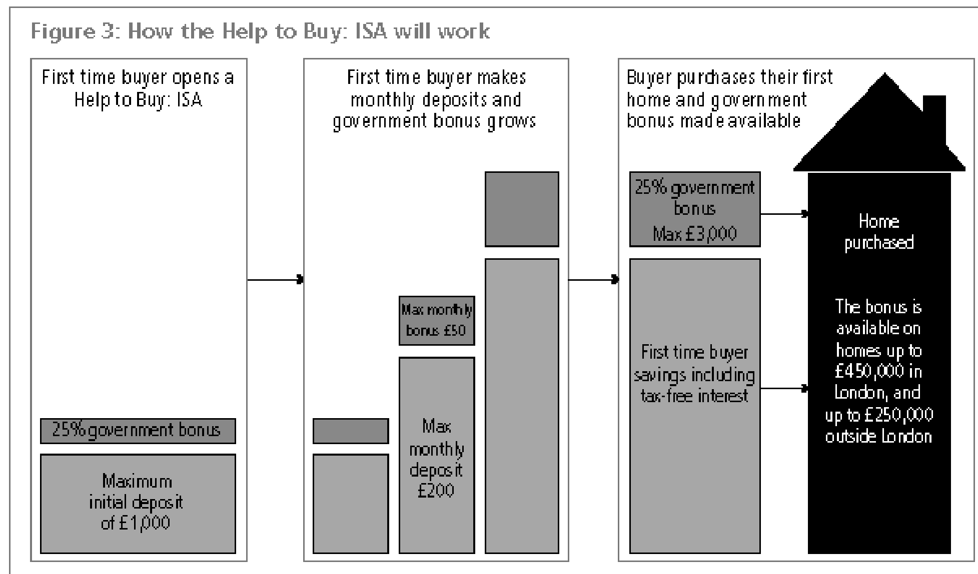
2.226 Following technical consultation with the financial services industry, **the government will extend the range of ISA eligible investments in 2015-16 to include listed bonds issued by a co-operative society and community benefit society and SME securities issued by companies trading on a recognised stock exchange. The government will also explore further extending the list to include debt and equity securities offered via crowd funding platforms**, and will consult in summer 2015 alongside a response to the consultation on how to include peer-to-peer loans.

2.227 As a result of their popularity, the government announced in February 2015 that National Savings and Investments 65+ bonds would remain on sale until 15 May 2015. These bonds have seen unprecedented demand – the biggest opening sale of any retail financial product in Britain's modern history – and the government has extended the issuance to ensure that eligible investors do not miss out on the market-leading rates on offer.

Help to Buy: ISA

2.228 In recognition of the impact the low interest rate environment has had on the ability of first time buyers to get on the housing ladder, Budget 2015 announces the Help to Buy: ISA. This will reward people that are making the difficult choices required to save regularly, and help them realise their aspirations of homeownership for the first time. The scheme will work by providing a government bonus to each person who has saved into a Help to Buy: ISA at the point they use their savings to purchase their first home. For every £200 a first time buyer saves, the government will provide a £50 bonus up to a maximum bonus of £3,000 on £12,000 of savings. Savers will have access to their own money and will be able to withdraw funds from their account if they need them for another purpose but the bonus will only be made available for home purchase. Further details are provided in the document 'Help to Buy: ISA'.[101]

Figure 3: How the Help to Buy: ISA will work



[101] Help to Buy: ISA, HM Treasury, March 2015.

Extending freedom and choice at retirement

2.229 This government has already introduced major reforms to allow people entering retirement much more flexibility over how they use their defined contribution pension pot, instead of being required to purchase an annuity. The government now wants to allow people who have already bought an annuity to also enjoy flexibility in how they access the value of their annuity, without interfering with binding contractual requirements.

2.230 **From April 2016, the government will therefore change the tax rules to allow people who are already receiving income from an annuity to sell that income to a third party, subject to agreement from their annuity provider.** The proceeds of the sale could then be taken directly or drawn down over a number of years, and would be taxed at their marginal rate, in the same way as those taking their pension after April 2015.

2.231 The government believes that for most people, continuing to hold their annuity will be the right decision. However, for others, this reform will allow them the flexibility to use the value of their annuity as they see fit. The government is therefore publishing a consultation on how best to remove the barriers to the creation of a secondary market in annuities, inviting views on how best to ensure that consumers are in a position to make an informed decision. The government will work with the Financial Conduct Authority (FCA) to consult on how best to support people's choices through consumer protection, and protect those who are most vulnerable.[102]

2.232 It is important that the UK's pensions tax system remains fair, affordable and sustainable for the future. In 2013-14, Income Tax relief for pension savings cost the government around £34.3 billion, up from £30.8 billion in 2009-10, with around two-thirds of this relief going to higher or additional rate taxpayers.[103] To protect the public finances from this growing cost, **the government will therefore reduce the lifetime allowance for pension contributions that benefit from tax relief from £1.25 million to £1 million.** This will be effective from 6 April 2016. **The lifetime allowance will be indexed to increase annually by CPI from 6 April 2018.** Over 96% of individuals currently approaching retirement have a pension pot worth less than £1 million, so this change will affect only the wealthiest pension savers.[104]

Mental health

2.233 The government is committed to parity of esteem between physical and mental health. The NHS Mandate includes a commitment to closing the health gap between people with mental health problems and the population as a whole and from April 2015 there will be new access and waiting times standards introduced for key mental health services. Autumn Statement 2014 committed £150 million over five years to caring for young people with eating disorders and funding to expand pilots testing new ways to support those with mental health problems to return to work. **To go further, Budget 2015 announces a £1.25 billion package of additional investment.**

2.234 Many children and young people experience problems with their mental health, and the government wants to ensure that they get the services that they need. **This is why Budget 2015 will be providing over £1 billion over the next 5 years to start new access standards which will see over 110,000 more children cared for over the next Parliament. Alongside this, the government will be providing £118 million by 2018-19 to complete the roll-out of the Children and Young People's Increasing Access to Psychological Therapies (CYP IAPT) programme**, ensuring that there are talking therapists in every part of the country providing the best quality treatment for children.

[102] Creating a secondary annuity market, HM Treasury and Department for Work and Pensions, March 2015.
[103] HMRC Statistics Table *PEN6* – Registered pension schemes: cost of tax relief.
[104] HMRC analysis of Office for National Statistics Wealth and Assets Survey, 2010-12 data.

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2.235 Young people can develop mental health problems as a consequence of maternal mental illness. **Budget 2015 announces an additional £75 million over the next 5 years to give the right care to more women who experience mental ill health during the perinatal or antenatal period**. The Department for Education will also provide an additional £1.5 million towards piloting joint training for designated leads in Child and Adolescent Mental Health Services (CAMHS) and schools to improve access to mental health services for children and young people, including the most vulnerable.

2.236 Budget 2015 also announces a package of measures to improve employment outcomes for people with mental health conditions. Starting from early 2016, **the government will provide online Cognitive Behavioural Therapy (CBT) to 40,000 Employment and Support Allowance and Jobseeker's Allowance claimants and individuals being supported by Fit for Work. From summer 2015, the government will also begin to co-locate Improving Access to Psychological Therapies (IAPT) therapists in over 350 Jobcentres**, to provide integrated employment and mental health support to claimants with common mental health conditions.

2.237 The government is committed to ensuring that those who have given so much in the service of their country should receive the best possible care. **This is why Budget 2015 will provide an additional £8.4 million over the next 5 years to allow the NHS across England to significantly enhance current mental health and support services to the most vulnerable veterans in the community**.

Ensuring a fair contribution through the tax system

2.238 The government is committed to a fair tax system in which everyone contributes to reducing the deficit, and those with the most make the largest contribution. Budget 2015 announces further measures to tackle offshore evasion, close down tax avoidance, and ensure a fair contribution from businesses and individuals.

2.239 The vast majority of people and businesses in the UK pay the tax they owe and do not attempt to avoid their responsibilities. Nevertheless, where it exists, tax evasion and avoidance damages the ability of the tax system to raise revenue fairly and imposes additional costs on all taxpayers. This government has been relentless in its crackdown on tax evasion and avoidance, taking action to prevent such behaviour at the outset, and to detect and counter it effectively where it persists. During this Parliament, HMRC will have secured £100 billion in additional compliance revenue as a result of actions taken to tackle evasion, avoidance and non-compliance.[105]

Evasion

2.240 Tax evasion is a crime that deprives the country of much needed revenue for public services. Over the last two years, this government has led work in Europe, in the G20 and through the UK's G8 Presidency to transform international tax transparency. Agreement has now been reached among 92 countries to exchange information on bank accounts automatically every year. Regulations giving effect to these agreements will be laid shortly after Budget 2015.

2.241 Under these agreements, starting in 2016 for the Crown Dependencies and Overseas Territories, HMRC will receive a wide range of information on offshore accounts held by UK tax residents, including names, addresses, account numbers, interest and balances. This represents an unprecedented change in HMRC's ability to tackle offshore tax evasion.

2.242 Building on this, **the government will toughen sanctions for those who continue to evade tax by closing the existing disclosure facilities for tax evaders early. A tougher 'last chance' disclosure facility will be offered between 2016 and mid-2017, with penalties of at least 30% on top of tax owed and interest and with no immunity from criminal prosecutions in appropriate cases.**

[105] HMRC 2010-11 Annual Report, HMRC 2013-14 Annual Report and HMRC's Mid-Year Report to Parliament – April to September 2014.

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Avoidance

2.243 This government has introduced changes throughout this Parliament to tackle avoidance and to focus in on the diminishing minority who refuse to play by the rules. As proposed in the consultation document 'Strengthening Sanctions for Tax Avoidance,' **the government will introduce tougher measures for those who persistently enter into tax avoidance schemes that fail, and will develop further measures to publish the names of such avoiders and to tackle avoiders who repeatedly abuse reliefs.**[106] **The government will also widen the current scope of the Promoters of Tax Avoidance Schemes regime by bringing in promoters whose schemes are regularly defeated by HMRC.**

2.244 The government introduced a significant new regime for avoidance with the creation of the general anti-abuse rule (GAAR). **The government will increase the deterrent effect by introducing a penalty based on the amount of tax that is tackled by the GAAR.**

2.245 The government changed the economics of tax avoidance with the introduction of the Accelerated Payments regime, removing the cash-flow advantage that users of avoidance schemes have benefitted from. **HMRC has continued to review cases and more accelerated payment notices will now be issued than previously announced.**

2.246 Some companies enter into contrived arrangements, with little economic substance, to convert old losses into new ones and circumvent the loss relief rules. **The government will introduce a targeted anti-avoidance rule to level the playing field between the majority of companies, who follow the rules, and those others who side step them.**

Ensuring a fair contribution from business and individuals

Banking

2.247 This government has been clear that banks should make an additional contribution that reflects the risks they pose to the UK economy. This contribution has always needed to be balanced against financial stability considerations and banks' ability to lend to the real economy. However, with banks now strengthening their balance sheets and returning to profitability, the government believes that the sector should be expected to absorb a greater burden of remaining deficit reduction. **The government will therefore increase the Bank Levy from 0.156% to 0.210% from 1 April 2015.**

2.248 Companies are currently entitled to deduct the costs of compensation payments in calculating their profits liable to corporation tax. The government believes that it is unacceptable that banks' corporation tax receipts continue to be depressed by compensation associated with widespread misconduct in the sector. **The government therefore intends to make these compensation payments non-deductible for corporation tax purposes through legislation in a future Finance Bill.**

2.249 **The government will no longer allow businesses to take account of foreign branches when calculating how much VAT on overhead costs they can reclaim in the United Kingdom.** Under the current system businesses could manipulate their deductions. This measure prevents that and will ensure that all businesses in the United Kingdom pay their fair share of VAT.

Umbrella companies and employment intermediaries

2.250 Autumn Statement 2014 announced that the government would review the growing use of overarching contracts of employment that allow some temporary workers and their employers to benefit from tax relief for home-to-work travel expenses, relief not generally available to other workers. This is unfair. As a result of the review, **the government will change the rules to**

[106] Strengthening sanctions for tax avoidance, HMRC, January 2015.

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restrict travel and subsistence relief for workers engaged through an employment intermediary, such as an umbrella company or a personal service company, and under the supervision, direction and control of the end-user. This will take effect from April 2016 following a consultation on the detail of the changes. It will level the playing field between employment businesses that seek to lower their costs by using these arrangements and those that do not.

2.251 Stakeholders have also raised concerns that individuals do not understand how their take-home pay is affected by these arrangements. The government wants employment intermediaries to provide workers with greater transparency on how they are employed, and what they are being paid. The Department of Business Innovation and Skills will consult on these proposals on transparency later this year.

Capital gains tax

2.252 The government is committed to supporting entrepreneurs and wants to ensure that capital gains tax entrepreneurs' relief is well targeted. The government will therefore address use of the entrepreneurs' relief rules for tax planning which is not in keeping with the policy intention. **The government will target structures set up so that people with only a small indirect stake in a trading company can benefit from the relief. The government will also ensure that entrepreneurs' relief on the disposal of personal assets used in a business is only available when someone is making a meaningful withdrawal from that business.**

Tobacco

2.253 Raw tobacco represents an increasing risk to excise duty revenues, but under current law, raw tobacco can only be seized when officers can prove an intention to fraudulently evade duty at the time of seizure. **To prevent raw tobacco being diverted into the illegal market, the government will introduce a registration scheme for users and dealers of raw tobacco before the end of 2016.**

2.254 Smoking imposes costs on society and it is fair to ask tobacco manufacturers and importers to make a greater contribution towards these costs. However it is essential that this is done in the most effective way. At Autumn Statement 2014, the government announced a consultation on a tobacco levy. The responses revealed issues that the government would like to explore further, and so the consultation will be continued informally with stakeholders in order to develop detailed policy proposals.

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3 Excessive deficit procedure

3.1 The UK entered into the Excessive Deficit Procedure (EDP) under the EU's Stability and Growth Pact (SGP) 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.

3.2 When the UK's current Parliament began in 2010, the budget deficit was over 10% of GDP – the largest deficit in post-war history as a result of the Great Recession and unsustainable pre-crisis increases in public spending. In 2010, the government set out medium-term fiscal consolidation plans to return the public finances to a sustainable path. Since then, the government's long-term economic plan has delivered the stability and security needed to build a resilient economy. The government's plan has restored fiscal credibility, allowing activist monetary policy to support the economy.

3.3 The government is making significant progress in delivering its fiscal consolidation. Public sector net borrowing as a percentage of GDP is forecast to have fallen by half by the end of 2014-15. The latest data from the IMF shows that, between 2010 and 2013, the government reduced the structural deficit by more than half. The structural deficit fell by 4.6% of GDP over this period, a larger absolute reduction than any other country in the G7.

3.4 The government is forecast to meet its new forward-looking fiscal mandate in the third year of the forecast period, which is currently 2017-18, having reduced the cyclically-adjusted current budget deficit from its peak of 4.7% of GDP in 2009-10 to 2.6% of GDP in 2013-14. The supplementary aim for public sector net debt to fall as a share of GDP in 2016-17 is forecast to be met a year early with debt falling as a share of GDP in 2015-16. This is the first time public sector net debt has been forecast to fall as a share of GDP in 2015-16 since Budget 2012.

3.5 The government remains committed to bringing the UK's Treaty deficit in line with the 3% target set out in the 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

	% of GDP						
	Outturn	**Forecasts**					
	2013-14	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**2019-20**
Deficit							
Treaty deficit[1]	5.8	5.2	4.3	2.2	0.8	0.0	-0.1
Debt							
Treaty debt[2]	87.9	88.4	88.8	88.7	87.1	84.4	81.4

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

Source: Office for Budget Responsibility

3.6 The government remains committed to restore the public finances to a sustainable position and get public sector net debt on a declining path as a share of GDP. The latest forecast from the OBR shows that the cyclically adjusted current budget will be in balance in 2017-18 and the government will run an overall surplus from 2018-19. Running a surplus will speed up the process of debt reduction, reducing the burden on taxpayers and strengthening the ability of future governments to respond to economic shocks.

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3.7 Since Autumn Statement 2014, the fiscal position has improved across the forecast period. Higher receipts in 2014-15 and lower debt interest costs across the forecast period are reflected in an improved path of public sector net borrowing. Public sector net debt as a percentage of GDP is forecast to fall 1 year earlier than at Autumn Statement and therefore Total Managed Expenditure (TME) is able to grow in line with GDP in 2019-2020, when public sector net debt will fall by 3.2 percentage points of GDP.

3.8 However, external risks facing the UK have increased since Autumn Statement 2014, with continuing instability in the euro area and Ukraine.

3.9 Budget 2015 announced further detail on how the government will continue to reduce the deficit and debt beyond this Parliament. Reflecting its ongoing commitment to responsible fiscal policy and returning the public finances to a sustainable position, the government is:

- taking action to accelerate the state's exit from ownership of banks, by announcing plans to sell up to £10 billion of the taxpayer's remaining shareholding in Lloyds Banking Group over the next 12 months, continuing the progress of the last year, and launching a major sale of NRAM plc assets from what was known as Northern Rock's 'bad bank'.
- Setting out plans for continuing to reduce the deficit in the next Parliament , with £30 billion of consolidation in 2016-17 and 2017-18, and an assumption that Total Managed Expenditure will be held flat in real terms in 2018-19 and rise in line with GDP in 2019-20
- Setting out further detail on the government's aspiration to find £10 billion in further efficiency savings by 2017-18
- Transforming the management of government land and property assets, by implementing a new commercially-driven approach across the central government estate.

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4 Quality of public finances

Public spending

Total Managed Expenditure

4.1 Spending in the next Parliament – In line with previous policy, the government has set a fiscal assumption that Total Managed Expenditure (TME) in 2016-17 and 2017-18 will continue to fall at the same rate as over the period 2010-11 to 2014-15. In 2018-19 TME will be held flat in real terms. In 2019-20 TME will rise in line with nominal GDP. It would, of course, be possible to do some consolidation through tax instead.

4.2 The government will continue to prioritise capital investment over the medium to longer term, so within the overall fiscal 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					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
CURRENT EXPENDITURE						
Resource AME	332.5	335.7	347.0	361.5	375.5	389.7
Resource DEL, excluding depreciation	315.6	316.3				
Ring-fenced depreciation	21.3	22.3				
Implied Resource DEL, including depreciation[2]			*323.8*	*312.0*	*310.1*	*330.4*
Public sector current expenditure	**669.3**	**674.3**	**670.9**	**673.4**	**685.6**	**720.1**
CAPITAL EXPENDITURE						
Capital AME	22.2	20.6	21.7	21.6	21.2	21.5
Capital DEL	45.6	47.7				
Implied Capital DEL[2]			*47.7*	*48.9*	*52.4*	*55.7*
Public sector gross investment[3]	**67.8**	**68.3**	**69.4**	**70.5**	**73.6**	**77.2**
TOTAL MANAGED EXPENDITURE[4]	**737.1**	**742.6**	**740.3**	**743.9**	**759.2**	**797.3**
Total Managed Expenditure (% GDP)	*40.7%*	*39.6%*	*38.1%*	*36.8%*	*36.0%*	*36.0%*

Memo: average annual real growth in Total Managed Expenditure (2010-11 to 2014-15): -1.1%

[1] Budgeting totals are shown including 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. All totals in the table take into account Budget 2015 spending policy decisions.

[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 PSGI growth rule is applied to a 2015-16 baseline which includes the OBR's forecast Allowance for Shortfall and excludes the effect of all policy measures announced at Autumn Statement 2013, Budget 2014, Autumn Statement 2014 and Budget 2015. Following the application of the PSGI growth rule, PSGI has from 2016-17 onwards been adjusted to take account of the same measure as at Autumn Statement 2014.

[4] The 2010-11 baseline for calculating the TME growth rule excludes in-year spending reductions announced at June Budget 2010 and departmental underspends against 2010-11 plans, but includes an estimate for the outturn effect of classification changes pre-empted by the OBR at Budget 2015. The 2014-15 baseline for calculating the TME growth rule excludes the OBR's forecast Allowance for Shortfall. The TME growth rule is applied to a 2015-16 baseline which excludes the OBR's forecast Allowance for Shortfall and the effect of all policy measures announced at Autumn Statement 2013, Budget 2014, Autumn Statement 2014 and Budget 2015. Following the application of the TME growth rule, TME from 2016-17 onwards has been adjusted to take account of the same measures as at Budget 2014 and Autumn Statement 2014. The effects of the historic adjustments to the UK's GNI-based contributions to the EU, and further anticipated GNI adjustments, and associated rebates, are excluded from the calculation of the TME growth rule. The effects of the reclassification of Multilateral Development Bank loans, pre-empted by the OBR at Budget 2015, are also excluded from the calculation of the TME growth rule.

Implied Departmental Expenditure Limits

4.3 The government's fiscal assumption for the years 2016-17 to 2019-20, combined with the OBR's forecast for Annually Managed Expenditure (excluding AME policy decisions in this Budget) and the PSGI assumption gives a projection for implied DEL including depreciation. The reductions to the OBR's AME forecast since Autumn Statement 2014 result in an increase in the projection for implied DEL. Table 4.B sets out a comparison of the Budget projection for implied DEL including depreciation with the Autumn Statement projection and the cost of all spending policy decisions in this Budget.

Table 4.B: Implied DEL

	2016-17	2017-18	2018-19	2019-20
Autumn Statement 2014 implied DEL, including depreciation[1]	368.7	357.8	357.4	357.5
Budget 2015 implied DEL, including depreciation[1,2]	371.9	361.4	363.2	387.0
Increase in implied DEL, including depreciation[2]	*3.1*	*3.6*	*5.8*	*29.6*
Spending policy decisions:				
Mental Health	-0.3	-0.3	-0.3	-0.3
Help to Buy: ISA	0.2	0.4	0.6	0.8
Other spending policy decisions	0.2	0.3	0.2	0.2
Illustrative increase in implied DEL, including depreciation, after Budget 2015 spending policy decisions[3]	*2.4*	*2.6*	*4.7*	*28.2*

[1] Implied DEL is Implied Resource DEL plus implied Capital DEL. Departmental budgets will be set at the next Spending Review. Implied DELs beyond 2015-16 assume no future policy changes to AME (including welfare spending) or tax (including measures to tackle avoidance and evasion) which all else equal would feed through to a change in implied DEL due to the government's fiscal assumption for the years beyond 2015-16.

[2] This does not take into account Budget 2015 AME policy decisions.

[3] This is the illustrative increase in implied DEL net of all DEL and AME policy decisions announced at Budget 2015.

Departmental Expenditure Limits

4.4 Table 4.C shows departmental expenditure limits (DEL) as announced at Spending Review 2010 and Spending Round 2013, and subsequently adjusted for measures at fiscal events including the policy decisions contained in this Budget.

4.5 Departments remain ahead of their consolidation targets and are forecast to underspend by £3.5 billion in 2014-15. Underspends are forecast to continue into 2015-16, the final year for which departmental budgets have been set.

Other information

4.6 Other information relevant to the quality of public finances is presented in Chapter 2:

- Paragraphs 2.42 - 2.89 deal with deficit reduction;
- Paragraphs 2.238 – 2.246 cover ensuring a fair contribution through the tax system; and
- Paragraphs 2.247 – 2.254 deal with ensuring a fair contribution from business and individuals.

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Table 4.C: Departmental Expenditure Limits

	£ billion	
	Estimate 2014-15	Plans 2015-16
Departmental Programme and Administration Budgets (Resource DEL excluding depreciation[1])		
Education	52.6	53.5
NHS (Health)[2]	109.3	111.8
Transport	2.5	2.4
CLG Communities	2.2	2.7
CLG Local Government	13.7	10.5
Business, Innovation and Skills	13.7	13.4
Home Office	11.2	10.3
Justice	7.1	6.4
Law Officers' Departments	0.6	0.5
Defence[3]	26.7	28.4
Foreign and Commonwealth Office	1.7	1.1
International Development	7.3	8.4
Energy and Climate Change	1.4	1.4
Environment, Food and Rural Affairs	1.7	1.7
Culture, Media and Sport	1.2	1.2
Work and Pensions	6.9	6.4
Scotland[4]	25.7	25.5
Wales[5]	13.8	12.9
Northern Ireland	9.7	9.8
Chancellor's Departments	3.4	3.5
Cabinet Office	2.4	2.2
Small and Independent Bodies	1.7	1.5
Reserve	0.0	1.9
Special Reserve	0.0	0.2
Adjustment for Budget Exchange[6]	0.0	-0.5
Total Resource DEL excluding depreciation plans	316.5	316.9
OBR allowance for shortfall	*-0.9*	*-0.6*
OBR Resource DEL excluding depreciation forecast	*315.6*	*316.3*
Capital DEL		
Education	4.3	4.9
NHS (Health)[2]	4.0	4.8
Transport	9.4	9.7
CLG Communities	4.6	5.3
CLG Local Government	0.0	0.0
Business, Innovation and Skills	2.2	4.0
Home Office	0.4	0.4
Justice	0.3	0.3
Law Officers' Departments	0.0	0.0
Defence[3]	7.8	7.0
Foreign and Commonwealth Office	0.2	0.1
International Development	2.4	2.6
Energy and Climate Change	2.3	2.6
Environment, Food and Rural Affairs	0.6	0.5
Culture, Media and Sport	0.3	0.4
Work and Pensions	0.2	0.2
Scotland[7]	3.5	3.1
Wales[7]	1.5	1.5
Northern Ireland[7]	1.1	1.1
Chancellor's Departments	0.3	0.1
Cabinet Office	0.4	0.4
Small and Independent Bodies	0.1	0.1
Reserve	0.0	0.9
Special Reserve	0.0	0.1
Adjustment for Budget Exchange[6]	0.0	-1.9
Total Capital DEL plans	45.9	48.2
OBR allowance for shortfall	*-0.3*	*-0.5*
OBR Capital DEL forecast	*45.6*	*47.7*

[1] Resource DEL excluding ring-fenced depreciation is the Treasury's primary control total within resource budgets and the basis on which Spending Review settlements were made.

[2] The health budget remains projected to grow in real terms from 2014-15 to 2015-16.

[3] The defence budget for 2015-16 reflects the likely initial drawdown of funding from the Special Reserve for the net additional cost of military operations at Main Estimates.

[4] The Scottish block grant has been adjusted to reflect the devolution of SDLT and Landfill Tax with effect from 1st April 2015

[5] Welsh business rates score as AME rather than DEL from 2015-16

[6] Departmental budgets in 2015-16 include amounts carried forward from 2014-15 through Budget Exchange, which will be voted at Main Estimates. These increases will be offset at Supplementary Estimates in future years so are excluded from spending totals.

[7] Borrowing by Devolved Administrations scores as AME

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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; these were revised in the update to the Charter for Budget Responsibility approved by Parliament on 13 January 2015[1]

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 2 other members of the Budget Responsibility Committee (BRC), and at least 2 non-executive members. It is supported by a civil service staff.

5.5 The 3 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 October 2014 the Chancellor also re-appointed Graham Parker. The non-executive members: Lord Burns and Kate Barker were appointed by the Chancellor in June 2011. In June 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 2 fiscal and economic forecasts each financial year, including independent scrutiny of the impact of policy measures and any resultant impact on the forecasts

[1] 'Charter for Budget Responsibility: Autumn Statement 2014 update', HM Treasury, December 2014.

- 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 is 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 needs 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 which 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". 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, 5-year forecast period. In the update to the Charter, approved by Parliament on 13 January 2015, the fiscal mandate was revised, shortening the period to achieve cyclically-adjusted current balance to the third year of the 5-year forecast period. At Budget 2015, the end of the forecast period was 2019-20.

5.16 The fiscal mandate is based on:

- the current balance, to protect the most productive investment expenditure
- a cyclically-adjusted aggregate, to allow some fiscal flexibility at times of economic uncertainty
- a target of 3 years ahead, rather than 5 years, reflecting the progress achieving in tackling the deficit, which means the mandate can be safely shortened to create a tighter constraint on future fiscal policy choices

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 2016-17, 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 assesses the government's performance against the welfare cap once a year alongside Autumn Statement. To support transparency and public scrutiny, the OBR also reports annually 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.

Accounting and statistics

5.20 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.

5.21 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 publicly available information on contingent liabilities is also published in the OBR's annual 'Fiscal sustainability report'.

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

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A OBR analysis

A.1 This annex contains analysis prepared by the Office for Budget Responsibility (OBR). The first 3 pieces of analysis included are Chapters 3, 4 and 5 of the OBR's March 2015 '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 2014 '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 3.21);
- sets out our short- and medium-term real GDP growth forecasts, as spare capacity is brought back into productive use (from paragraph 3.41) and the associated outlooks for inflation (from paragraph 3.54) and nominal GDP (from paragraph 3.69);
- discusses recent developments and prospects for the household, corporate, government and external sectors of the economy (from paragraph 3.74); and
- outlines risks and uncertainties (from paragraph 3.111) and compares our central forecast to those of selected external organisations (from paragraph 3.113).

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 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 judge how much of the budget deficit at any given time is cyclical and how much is structural.[1] 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 will grow in the future.

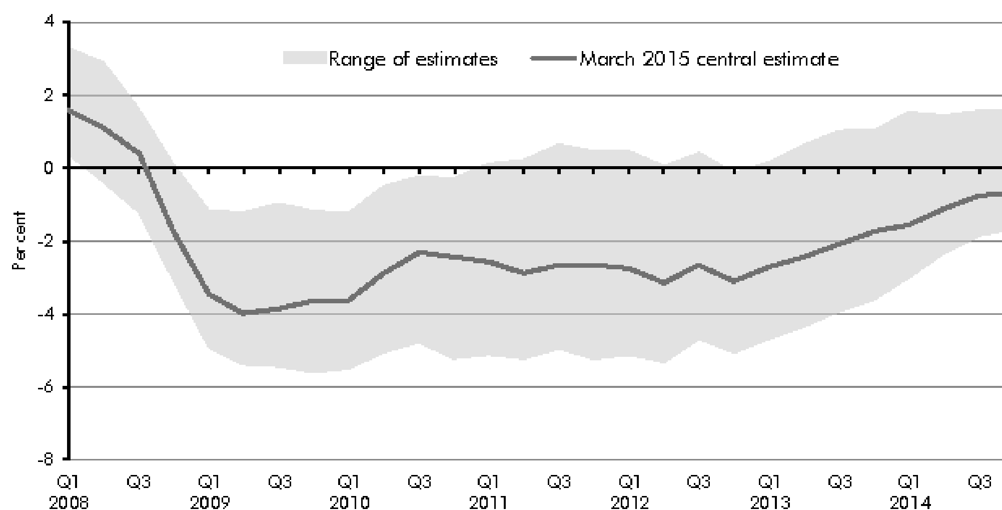
[1] The methodology we use to do so is described in Helgadottir *et al* (2012): *Working Paper No.3: Cyclically adjusting the public finances*.

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, including cyclical indicators, statistical filters and production functions. In practice, every method has its limitations and no approach entirely avoids the application of judgement. We therefore consider a broad set of evidence when reaching a judgement on spare capacity.

3.6 Chart 3.1 shows a range of estimates of the output gap implied by nine different techniques, as well as our own latest central estimates.[2] All of these estimates showed spare capacity increasing during the course of the late 2000s recession, and the range between them increased. The swathe remained relatively stable until early 2013 when actual growth picked up. Most estimates have since narrowed, but the range remains wide. In the fourth quarter of 2014, the estimates vary from -1.7 to +1.6 per cent. But even this range may understate the degree of uncertainty, as such estimates are likely to change as new data become available and past data are revised.

Chart 3.1: Range of output gap model estimates



Source: OBR

3.7 The cyclical indicators approaches that we previously placed greatest emphasis upon implied that the output gap began to narrow in 2012, even though growth remained relatively weak. 'Aggregate composite' (AC) estimates imply that spare capacity continued to be used up at pace, and that output moved above its sustainable level towards the end of

[2] The individual output gap estimates are included in the supplementary economy tables available on our website. The approaches – and the uncertainties associated with them – are discussed in Murray (2014): *Working Paper No.5: Output gap measurement: judgement and uncertainty*.

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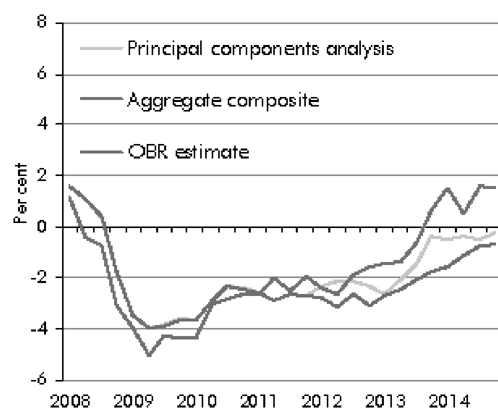
2013. 'Principal components analysis' (PCA) estimates also suggest a significant narrowing of the gap through 2013, but with the gap remaining stable, and slightly negative, through 2014.[3]

3.8 Chart 3.3 shows the disaggregated PCA series underlying the headline indicator. The PCA model varies the weights on the various indicators such that more weight is placed on those that move together and less on those that appear to be outliers. The AC weights are imposed using sector and income shares. It appears that:

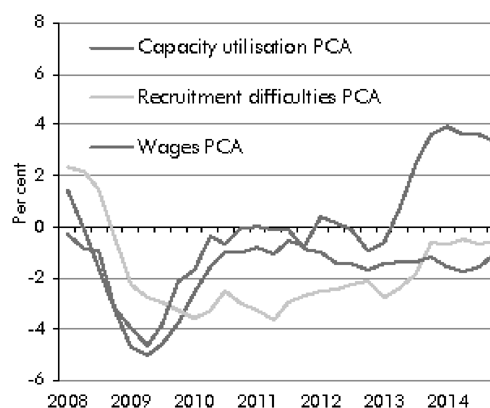
- PCA estimates are increasingly downplaying capacity utilisation indicators that suggest firms are operating at levels associated with significant overheating. These retain a higher weight in our AC estimates, based on the profit share of GDP;
- firms experienced greater recruitment difficulties through 2013, but the aggregate position has remained reasonably stable since – although there are signs of emerging skill shortages in some areas. Our PCA estimates currently place a high weight on recruitment difficulties indicators and so follow a similar path; and
- growth in the real product wage remains low, mainly reflecting the ongoing weakness of productivity growth. We judge that this has been a largely structural phenomenon, rather than indicating scope for further catch-up growth.

Chart 3.2: Cyclical-indicator-based estimates of the output gap



Source: OBR

Chart 3.3: Principal component subsets



3.9 CPI inflation was lower than expected in December, which could in principle suggest more slack in the economy. But we do not consider that likely, since the decline in recent months largely reflects lower food and petrol prices, and the effects of sterling appreciation. The unemployment rate has continued to drop at a steady pace, falling to 5.7 per cent in the

[3] More details are set out in our *Briefing Paper No.2: Estimating the output gap* and in Pybus (2011): *Working Paper No.1: Estimating the UK's historical output gap.*

final quarter of 2014, in line with our December forecast. But, contrary to our expectations, the participation rate has also fallen, as has hourly productivity.

3.10 Considering the balance of evidence, we now judge that the output gap was 0.1 percentage point wider in the fourth quarter of 2014 than we forecast in December, at -0.7 per cent of potential output. This is in line with GDP growth also being 0.1 percentage point lower than forecast in the fourth quarter.

3.11 Of that -0.7 per cent output gap, we attribute -0.3 percentage points to the unemployment rate lying above its sustainable rate and a further -0.2 percentage points to the activity rate lying below its potential. Average hours worked exhibit a declining trend over the long term, but have risen since mid-2011. This may reflect unexpectedly weak income growth and negative wealth shocks for many households, leading them to increase their labour market input. Much of the shock to incomes is expected to be permanent, in which case it is unlikely that average hours will resume their long-term decline quickly. We therefore assume that trend average hours have been flat since the start of the recession, which still implies a positive average hours gap of 1.5 percentage points. This is offset by output-per-hour currently lying 1.6 percentage points below our estimate of its potential (i.e. cyclical weakness in actual productivity on top of the large structural shortfall that built up during and since the late 2000s financial crisis).

3.12 Charts 3.4 and 3.5 compare our central output gap estimates for 2014 and 2015 to those produced by other forecasters, as set out in the Treasury's February and March *Comparison of independent forecasts*. The average estimate is -1.3 per cent in 2014 and -0.6 per cent in 2015, only slightly wider than our central estimates of -1.0 per cent for 2014 and -0.5 per cent for 2015. However, due to the skew of the distribution, the median estimates are closer still, at -1.1 per cent and -0.4 per cent for 2014 and 2015 respectively.

Chart 3.4: Estimates of the output gap in 2014

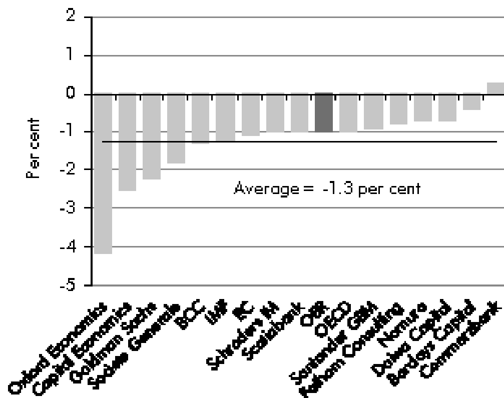
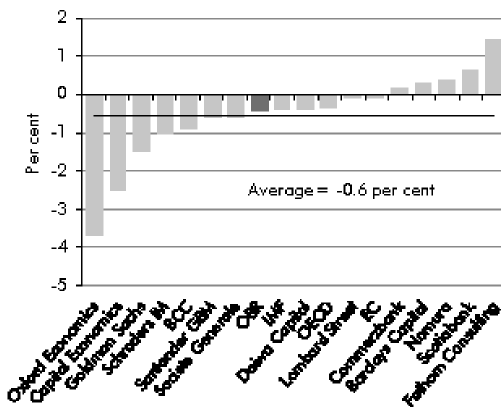


Chart 3.5: Estimates of the output gap in 2015



Source: HM Treasury, plus updates where known

The growth of potential output

3.13 In our December *EFO*, we forecast a gradual strengthening of potential output growth over the forecast period and that remains our central judgement. But that outcome depends on the most important uncertainty in our (and most people's) economic forecast: the timing and strength of the long-awaited return to sustained productivity growth. The effects of significantly lower oil prices on potential output add a new source of uncertainty in this forecast, as do the relatively large shifts in net migration seen in recent quarters.

3.14 The growth of potential productivity per hour remains below its historical average throughout the forecast. That reflects our view that the slow pace of financial system normalisation and the related pace at which resources are reallocated to more productive uses will continue to weigh on the sustainable rate of growth – by diminishing amounts – for some years. But 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 its historical average.[4]

3.15 Actual hourly productivity growth has again been weaker than expected, with a fall in the final quarter of 2014 and a rise of only 0.2 per cent on the year. This suggests productivity growth might remain subdued for longer. But, looking ahead, lower oil prices should encourage additional non-oil business investment and hence the accumulation of capital, which would provide a small boost to productivity growth of around ¼ per cent (Box 3.1). We consider the downside news over the recent past and the potential upside from lower oil prices to be broadly offsetting, leading to an unchanged forecast for potential productivity growth.

3.16 We continue to expect population growth to slow and the potential employment rate to drift down over the medium term as the population ages. (This downward drift is due to the proportion of older people with lower-than-average employment rates increasing, which outweighs the effect of age-specific employment rates at older ages rising.) But we have made some changes to the population and employment rate assumptions underpinning our potential output growth forecast.

3.17 Net migration in the year to September 2014 rose to 298,000, up from 210,000 in the year to September 2013. Our previous forecasts have been underpinned by the assumption in the ONS low migration population projections that net migration will move towards 105,000 a year by mid-2019. A reduction over time seems consistent with the international environment and with the Government's declared efforts to reduce it. But in light of recent evidence, it no longer seems central to assume it will decline so steeply. So we now assume that net migration flows will tend towards 165,000 in the long term, consistent with the ONS principal population projections. Relative to our December forecast, this raises potential output growth by 0.5 per cent over the forecast period via 16+ population growth.

[4] In Chapter 5 of our December 2014 *Economic and fiscal outlook* we presented two scenarios that considered the implications of productivity growth remaining stuck at the low levels of recent years and of growth rebounding in line with the strongest UK performance of recent decades.

3.18 The age structure of inward migrants is skewed towards those of working age (see Chart 4.1 in Chapter 4), which implies that the effects on employment will be slightly bigger than on population growth. We have assumed that, conditional on age and gender, migrants are as likely as the broader population to be employed. Relative to our December forecast, this raises potential output by a further 0.1 per cent, which means that potential output growth has been revised up 0.6 per cent in total by the end of the forecast period. Output per worker is not affected by these changes, although GDP per capita is raised fractionally due to the higher employment rate.

Table 3.1: Potential output growth forecast

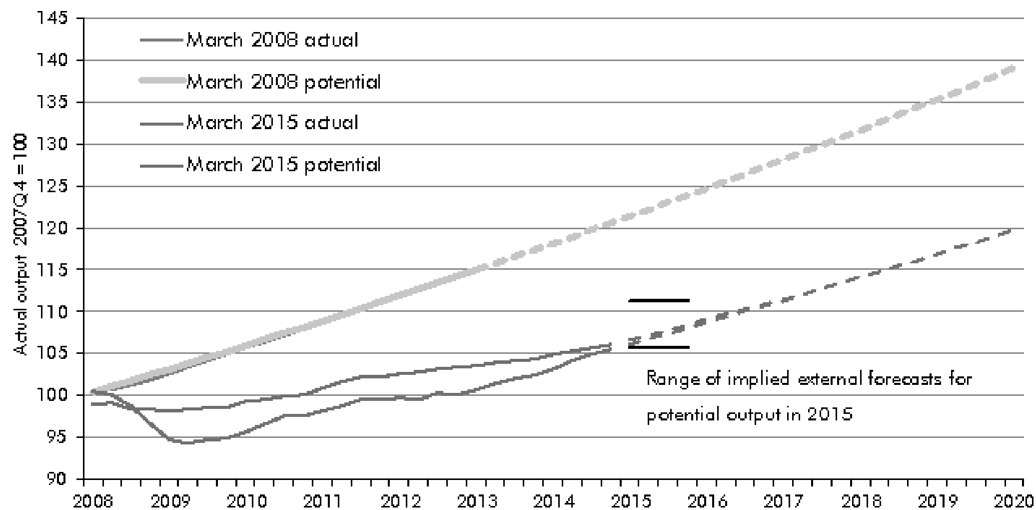
	Annual growth rate (per cent)				
	Potential productivity[1]	Potential average hours	Potential employment rate[2]	Potential population[2]	Potential output[3]
2015	1.4	0.0	0.0	0.6	2.0
2016	1.7	-0.1	0.0	0.6	2.2
2017	1.9	-0.2	0.0	0.6	2.3
2018	2.0	-0.2	0.0	0.5	2.4
2019	2.1	-0.2	0.0	0.6	2.5
2015-2019 average					
December forecast	1.8	-0.1	-0.1	0.5	2.2
March forecast	1.8	-0.1	0.0	0.6	2.3
Change	0.0	0.0	0.0	0.1	0.1

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

3.19 Our latest forecast assumes that potential output was almost 11 per cent lower than an extrapolation of the Budget 2008 forecast by 2013-14 and that it will be almost 14 per cent below that extrapolation by 2019-20. This is little changed since December. Outturn estimates of actual output growth have been revised down for 2014, which implies an equal downward revision to potential output given that we assume that the output gap is essentially unchanged over that period. But this downward revision is offset over the forecast period by our assumption of higher net migration.

3.20 Even the most optimistic external assessments of potential output continue to lie well below the pre-crisis trend implied by Budget 2008. The range presented in the chart illustrates some of the uncertainty surrounding this crucial judgement – we test the sensitivity of the Government's fiscal mandate to it in Chapter 5.

Chart 3.6: Potential output forecasts



Source: HM Treasury, ONS, OBR

Box 3.1: Oil prices and the economy

Since our December forecast, sterling oil prices have fallen significantly. We now expect the sterling oil price to average £36 a barrel in the first quarter of this year – around 30 per cent lower than the level implied by our December forecast. By the end of the forecast period, sterling oil prices are 17 per cent lower in this forecast than was the case in December. There are a number of channels by which this decline is likely to affect prospects for GDP growth in the UK:

- the fall in consumer prices will increase households' real income, which is likely to feed through to higher real consumption;
- lower energy-related production costs and stronger domestic demand may support business investment and capital accumulation;
- UK trade tends to be more heavily weighted to oil importers than to oil exporters, so a boost to real consumption in those economies may support demand for UK exports; and
- lower oil prices make the North Sea less profitable, which is likely to reduce production, exports and investment by oil and gas extraction companies.

As a net oil importer, a fall in the oil price would be expected to have a positive net effect on UK GDP. A number of factors will affect the size of this boost. For example, a temporary oil price change would be expected to have a smaller effect than a permanent change because its effects would also be expected to be temporary. The response of the economy will also depend on the extent to which the oil price change reflects the influence of supply or demand: if lower oil prices primarily reflect weaker world demand, then an associated reduction in UK export growth may partially offset any improvement in real incomes. Disentangling the role of supply and demand in the recent decline in the oil price is difficult, although most analysis points to a role for both

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factors. See Box 2.1 for further discussion.

Empirical studies point to a wide range of possible effects of oil price changes on UK GDP:

- using data since 1984, Blanchard and Gali (2007)[a] find that an increase in oil prices of 10 per cent reduces UK output by around 0.5 per cent;
- simulations produced by the National Institute for Economic and Social Research (NIESR) suggest that a permanent reduction in the oil price of $20 a barrel – a reduction of around 20 per cent relative to NIESR's baseline – could lead to a permanent increase in the level of UK GDP of around 0.5 per cent.[b] A temporary shock would have a much more modest effect, increasing GDP growth by 0.1 percentage points in the near term, but reducing GDP growth after two years as interest rates are assumed to rise in response to the increase in the oil price to previous levels;
- recent simulations by the Bank of England[c] using COMPASS (the Bank's central forecasting model), indicate that a 10 per cent fall in oil prices could raise the level of GDP by around 0.1 per cent after two years, with the increase in demand mainly resulting from higher real wages;
- Millard and Shakir (2013)[d] find that the effect of an oil price shock on UK GDP depends both on the source of the shock and the time period over which the effect is estimated. Based on the period from 1976 to 2011, a 10 per cent increase in the oil price that is entirely driven by weaker supply would be expected to reduce GDP by 0.12 per cent, while a world-demand driven increase in the oil price of the same magnitude would be expected to increase UK GDP by around 0.03 per cent. The size of the GDP effect is even smaller when estimated over a more recent sample period; and
- in 2010, the interim OBR set out an assessment of the effect of oil price fluctuations on the economy and public finances.[e] A permanent 20 per cent increase in the real oil price was assumed to reduce GDP by around ½ per cent, although this estimate did not incorporate any offsetting effect on North Sea output, and was based on the assumption that any effect of oil prices on potential output would occur relatively quickly. We expect the fall in the oil price to provide a small boost to productivity growth of around ¼ per cent. This is smaller than was assumed in the interim OBR study, and reflects an assumption that any effect on potential output from stronger capital accumulation will build relatively slowly. For this forecast we have also incorporated the effect of lower oil prices on North Sea production, which is expected to reduce GDP by 0.3 per cent by the end of the forecast period, part of which we expect to be offset by measures announced in the Budget (see Box 3.2).

[a] Blanchard, O and Gali, J, *The Macroeconomic Effects of Oil Price Shocks: Why are the 2000s so different from the 1970s?*, NBER Working Paper No. 13368, NBER, September 2007.
[b] Kirby, S and Meaning, J, *Oil Prices and Economic Activity*, National Institute Economic Review, February 2015.
[c] Bank of England, *Inflation Report*, February 2015.
[d] Millard, S and Shakir, T, *Oil shocks and the UK economy: the changing nature of shocks and impact over time*, Bank of England Working Paper No. 476, August 2013.
[e] Office for Budget Responsibility, *An Assessment of the Effect of Oil Price Fluctuations on the Public Finances*, September 2010.

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Key economy forecast assumptions

Monetary and macro-prudential policy

3.21 Our forecast assumes that the Bank of England will try to bring inflation back to target over its forecast horizon, consistent with the Monetary Policy Committee (MPC) remit set by the Chancellor. In its February 2015 *Inflation Report*, the MPC forecast – on the basis of market interest rate expectations at the time – that CPI inflation would reach 1.96 per cent by the beginning of 2017 and 2.15 per cent by early 2018. In terms of forward guidance on policy, the MPC's expectation was that *"conditional on interest rates following the path currently implied by market yields, it was likely that slack in the economy would be absorbed and inflation would return to the 2 per cent target within two years"*.

3.22 Since our December forecast, there have been no new announcements on macro-prudential policy, but the Bank of England has published its December *Financial Stability Report (FSR)*. That contained an update on progress towards previously announced recommendations and the results of recent commercial bank stress tests. The Bank argued that there had been sufficient progress on the four recommendations made in their June *FSR* (see paragraph 3.22 of our December 2014 *EFO*). The stress tests concluded that *"no system-wide, macro-prudential actions on bank capital are needed given the results of those tests, the capital plans agreed by banks with the PRA Board, and given that the banking system is on the transition path to meet higher standards of loss absorbing capacity."*

Fiscal policy and Budget measures

3.23 Applying the multipliers we have used in previous forecasts to the latest estimates of the size and composition of the fiscal consolidation produced by the Institute for Fiscal Studies would suggest that it had reduced the level of GDP by around 1.5 per cent in 2013-14. They implied a positive impact on GDP growth of 0.3 per cent in 2014-15, as the effects of previous tightening fade a little faster than new tightening bears down on GDP. Needless to say, there is huge uncertainty around the size of fiscal multipliers and their speed of decay.

3.24 As set out in Box 3.2, the net effect on GDP of measures announced in Budget 2015 is expected to be small.

Box 3.2: The economic effects of policy measures

This box considers the possible effects on the economy of the policy measures announced in Budget 2015. More details of each measure are set out in the Treasury's Budget document. Our assessment of their fiscal implications can be found in Chapter 4 and Annex A.

The Government has announced a number of **policy measures** taking effect between 2015-16 and 2019-20 that are expected to have a broadly neutral fiscal impact overall, 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

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larger multipliers would not change this conclusion.

The Government has revised its assumption for the **growth of total managed expenditure** (TME) between 2016-17 and 2019-20, which has a material effect in 2019-20. TME is now assumed to grow in line with nominal GDP in that year, rather than being held flat in real terms. Within total spending, the change in the assumption implies a significant upward revision to the path of nominal government consumption in 2019, which is now forecast to grow by 5.0 per cent in that year, rather than falling 0.7 per cent in our December forecast. As a result, government consumption is now expected to remain broadly flat as a share of GDP between 2018 and 2019, rather than continuing to decline. At that time horizon, we have assumed this change affects the composition of real GDP rather than the level, as monetary policy is assumed to determine the overall amount of spending in the economy. But we have assumed that this adds around 0.6 percentage points to growth in the GDP deflator and nominal GDP in that year via its effect on the government consumption deflator.

The Government has announced a number of **measures that will directly affect inflation**. This includes a 2 per cent reduction in duty on most beer, cider and spirits and freezing duty on wine, relative to previously assumed increases in line with RPI in April, and the cancellation of the planned increase in fuel duty in September 2015 (in line with RPI inflation). These changes are expected to reduce CPI inflation by less than 0.1 percentage points in 2015 and 2016.

The Government has announced a package of policies affecting the **North Sea oil and gas sector**, including the introduction of a new investment allowance, a reduction in the supplementary charge on profits from 30 per cent to 20 per cent, and a 15 per cent reduction in petroleum revenue tax. All else equal, these measures would be expected to reduce the cost of capital associated with investment in the sector and therefore have a positive effect on capital expenditure and production, partially offsetting the negative effect of lower oil prices on the profitability of oil and gas extraction. We have assumed that these measures increase the level of oil production by 2019 by around 15 per cent, equivalent to around 0.1 per cent of GDP. This partly offsets the effect of the significant decline in the oil price since December, which in the absence of these policy changes we assume would have reduced the level of North Sea production by around 30 per cent. In Chapter 4 we provide greater detail on these pre- and post-measures assumptions that underpin our North Sea revenues forecast.

The Government has also introduced a scheme aimed at **first-time house buyers**. The scheme offers a bonus for first-time buyers saving for a deposit, equivalent to 25 per cent of the balance in the account, with a limit on the monthly deposit of £200 and a maximum Government bonus of £3,000. To the extent that this supports prospective first-time owner-occupiers relative to those looking to buy-to-let, then it is possible that the measure will lead to a change in the composition of transactions towards first-time buyers, although the effect on aggregate property transactions is unclear. In supporting overall demand for housing, it is also possible that the policy will add to house price growth, although given the scale of the scheme we would expect any effect to be negligible. We have therefore not adjusted our forecasts for housing transactions and house prices for this measure.

The Government has announced a number of measures relating to **household saving**. These include a tax-free allowance for savings income from April 2016 of £1,000 for basic-rate

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taxpayers and £500 for higher-rate taxpayers; a change to ISA rules that allows savers to withdraw and replenish funds in cash ISAs up to the annual limit; an extension to the 'pensioner' bonds offered by National Savings and Investments; and measures that increase the flexibility with which annuity holders can sell their annuities for a cash lump sum. The net effect of these measures on aggregate spending and saving is highly uncertain. It is possible, for example, that the tax-free allowance will encourage households to change the composition of their saving assets. While a tax-free allowance will also provide an income boost to savers, the amount for most households will be small, suggesting a limited effect on aggregate consumption.

By increasing the flexibility with which individuals can sell an annuity, it is assumed that this will encourage a secondary market in annuities. If the creation of such a market is successful, it is possible that households' funds will be redirected from the assets backing annuities into other assets. As with the pensions flexibility measures introduced in Budget 2014, it is possible that some people may temporarily increase pension saving. Alternatively, lump sums could be used to finance consumption, although such effects are likely to be small. 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 uncertainties associated with them are particularly large.

The Government has introduced measures specific to the **financial sector**, most significantly an increase in the bank levy from 0.156 per cent to 0.21 per cent. These measures will have a negative effect on retained earnings, which may affect banks' ability to meet capital requirements. To the extent that banks are capital constrained, the measures could affect the supply of credit and thereby GDP growth. However, we do not judge that such effects would be significant, given the scale of the changes and that the banking sector as a whole appears to be relatively well capitalised,[a] suggesting that material deleveraging would be unlikely. The changes are likely to have a small effect on the share prices of affected financial institutions by reducing the expected future flow of post-tax income.

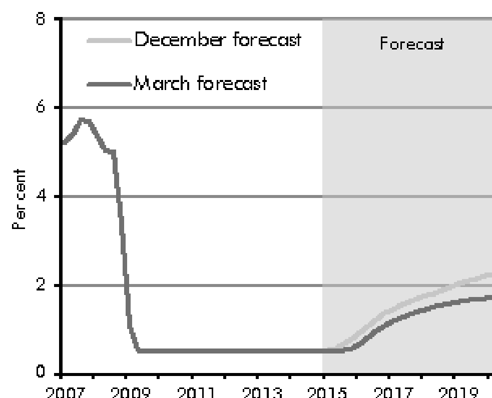
[a] In response to the Bank of England's 2014 stress-test exercise for the UK banking system, the Financial Policy Committee agreed that "the system should be sufficiently capitalised to ensure that banks were able to maintain the supply of lending in the face of adverse shocks". See Bank of England, *Record of the Financial Policy Committee meetings, 8 and 15 December 2014*, December 2014.

Credit conditions

3.25 Domestic financial and credit market conditions continue to ease, with the price of credit generally continuing to fall and volumes picking up. Bank funding spreads have continued to fall back towards pre-crisis levels and we assume that this relatively benign environment for bank funding will be sustained across the forecast period. We base our interest rate forecasts on market expectations for Bank Rate, gilt rates and commercial bank liability rates as published by the Bank of England. Since our December forecast, interest rate expectations have fallen significantly (Chart 3.7). The first increase in Bank Rate is now expected in mid-2016 rather than late 2015. Bank Rate expectations are 0.5 percentage points lower than in December for the first quarter of 2020, only reaching 1.7 per cent by the end of our forecast period. Gilt rate expectations have fallen in line with lower Bank Rate

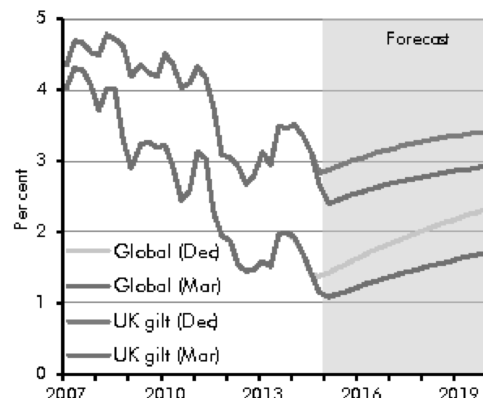
expectations. Movements in UK bond yields have largely matched those in other global bond markets (Chart 3.8).

Chart 3.7: Bank Rate expectations



Source: Bank of England, Thomson Reuters Datastream, OBR

Chart 3.8: Global bond rates

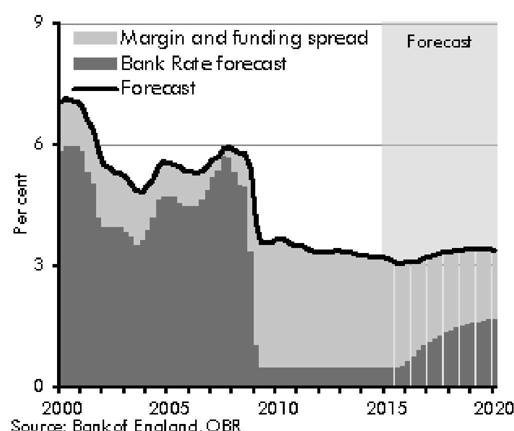


Note: 20-year gilts for UK, trade weighted bond rates for global

3.26 New mortgage rates have fallen significantly since mid-2012, but 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, and terms on existing mortgages are revised only when contracts expire (typically every two to three 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 we expect effective mortgage rates to fall further in the near term and then to rise only slightly over the forecast period as increases in Bank Rate are offset by narrowing margins (Chart 3.9).

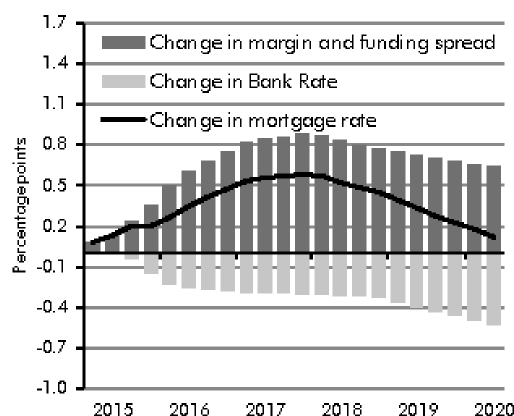
3.27 We have not changed our assumption for the evolution of bank funding spreads since December, so our forecast for bank funding costs is lower than December due to lower Bank Rate expectations. Offsetting these lower funding costs, we have assumed that lenders' margins will be higher over the forecast period than we assumed in December, leaving mortgage rates little changed by the end of the forecast period (Chart 3.10). Previously, we had assumed that margins, which have been elevated in recent years, would return towards their pre-crisis average as Bank Rate rises, normalising around the end of 2017. With market expectations implying later and more gradual Bank Rate rises, we have assumed that margins will normalise at a later date.

Chart 3.9: Mortgage rate forecast



Source: Bank of England, OBR

Chart 3.10: Change in mortgage rate forecast since December



3.28 Lending to households continues to pick up, mainly as rising house prices lead to more secured mortgage lending, which makes up the majority of household debt. However, secured debt has not risen as much as house price and transaction growth would imply, as the share of cash transactions has increased. We expect growth in mortgage debt to continue rising over the forecast period, as the share of cash transactions falls back, house prices continue to rise and transactions increase back towards their pre-crisis turnover rate. Strong growth in car purchases has contributed to the growth of unsecured lending, which in the fourth quarter of 2014 increased at the fastest rate since 2006.[5]

3.29 Bank lending to non-financial companies continues to fall. Large companies continue to choose non-bank sources of funds as favourable wholesale market conditions have encouraged strong net issuance of bonds. Lending to SMEs continues to fall year-on-year, although the rate of decline has eased slightly in the past few months.

World economy

3.30 World GDP is estimated to have increased by 3.3 per cent in 2014, in line with our December forecast. We now expect world GDP to grow by 3.5 per cent in 2015, down from 3.8 per cent in December. The revision is in spite of an overall boost to global GDP from lower oil prices and reflects weaker outturn data in emerging and oil-exporting countries.

3.31 The euro area economy has remained weak. In the fourth quarter of 2014, GDP was 0.9 per cent up on a year earlier. GDP was up 1.5 per cent on a year earlier in Germany and 0.2 per cent in France, but down 0.5 per cent in Italy. Spain saw stronger growth of 2.0 per cent in the year to the fourth quarter. Euro area GDP is estimated to have increased 0.9 per cent in 2014 as a whole and we forecast 1.2 per cent growth in 2015, slightly below our

[5] Car leasing arrangements, which are becoming a more popular way of purchasing cars, are classified as unsecured lending.

December forecast. We have made further small downward revisions across the rest of the forecast.

3.32 Deflation in the euro area remains a risk to the global and UK outlook. Euro area CPI inflation was -0.3 per cent in February, its third consecutive negative reading. Euro area core inflation in February was 0.6 per cent, the same as in January. 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. In response to this and declining medium-term inflation expectations, the European Central Bank announced that it would undertake a programme of quantitative easing. Unemployment in the euro area was 11.2 per cent in January, having fallen slightly in each month since October. Weaker growth, lower inflation and monetary policy easing have helped to push the euro to a seven-year low in relation to sterling and a 12-year low against the dollar. Our latest conditioning assumption for the first quarter of 2015 shows the euro down 8.4 per cent against the US dollar and 6.5 per cent against sterling in the period since our December forecast.

3.33 In our December *EFO*, we identified euro area rebalancing as a risk to the UK economic outlook. Since then, elections in Greece and subsequent negotiations over the country's debt obligations have brought these issues into focus once again. Our central forecast assumes that these issues are resolved without causing undue instability. Greece accounts for only 0.6 per cent of UK exports, so the direct channel of risk is limited, but any spillover to the wider euro area could be damaging, as witnessed between 2010 and 2012.

3.34 Data available at the time of our December forecast showed that US GDP increased by 1.0 per cent in the third quarter of 2014. That estimate has since been revised up to 1.2 per cent. Outturn data for the fourth quarter of 2014 showed growth of 0.5 per cent, leaving US GDP up 2.4 per cent in 2014 as a whole. The IMF's latest forecast suggests the rate of US GDP growth will pick up further in 2015 to 3.6 per cent.

World trade

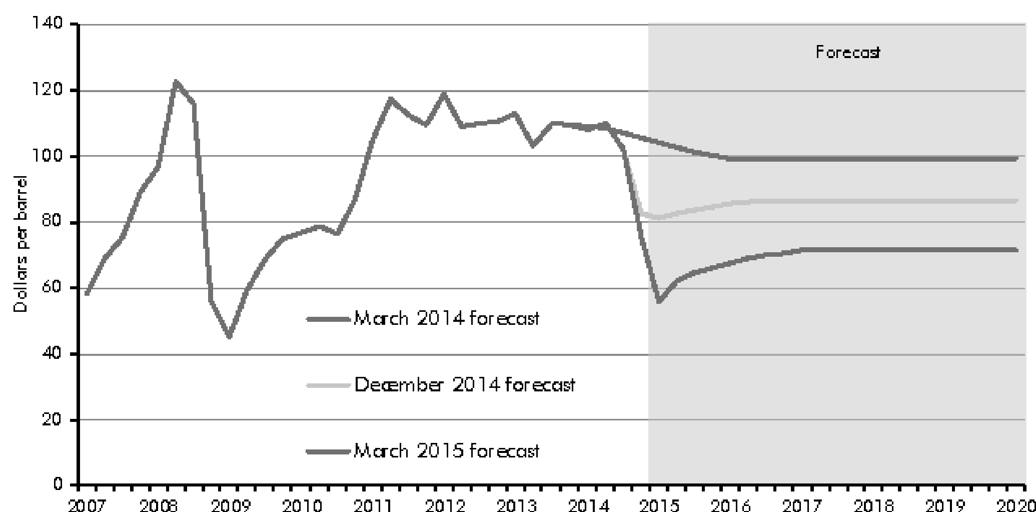
3.35 We expect world trade to grow by 4.0 per cent in 2015. This is slower than we forecast in December, partly reflecting weaker outturn data for the second half of 2014. World trade has also been revised down in each year of the forecast period and by a greater amount than world GDP. That is consistent with the IMF's downward revisions to world GDP and world trade growth in its January 2015 *World economic outlook update*, in particular reflecting lower expected growth in emerging markets.

3.36 UK export markets are expected to grow by 3.7 per cent in 2015. This is below our December forecast, but the change is smaller than the downward revision to overall world trade, which was driven by weaker growth in emerging markets that account for a smaller share of UK exports.

Oil prices

3.37 The most significant change since December to the market-derived assumptions we use in our forecasts relates to oil prices. In the 10 days to 26 February (the period we take for our conditioning assumptions), oil prices averaged $58, which was 27 per cent lower than in our December forecast (Chart 3.11). The fall since our March 2014 forecast has been 47 per cent. By the end of the forecast period, the differences are slightly smaller at 17 per cent lower than the December forecast and 28 per cent lower than the March 2014 forecast. This reflects the change from a downward sloping futures curve in March 2014 to a modestly upward sloping curve in December and a more steeply upward sloping curve now. (We only use the first two years of the futures curve in our forecast, holding prices flat thereafter.)[6] The drivers of the fall in oil prices are discussed in Box 2.1, while Box 3.1 summarises the channels along which lower prices might affect the economy.

Chart 3.11: Oil price assumption



Source: IMF, Thomson Reuters Datastream, OBR

Other conditioning assumptions

3.38 We use market-derived conditioning assumptions for our exchange rate and equity price forecasts. We assume that the exchange rate follows the path implied by the uncovered interest parity condition. In February 2015, the sterling effective exchange rate rose to its highest level since 2008. By the first quarter of 2015 we expect it to have moved 3.5 per cent higher than our December conditioning assumption due to the appreciation of sterling against the euro (Chart 3.12). The exchange rate is expected to depreciate over the forecast period as the forward UK interest rate curve is above the average of the UK's major trading partners. We assume equity prices rise in line with nominal GDP from their current level.

[6] See paragraph 3.49 of our December 2013 *Economic and fiscal outlook* for an explanation of this methodology.

The FTSE all-share index has risen above the December conditioning assumption, reaching an all-time high in February 2015 (Chart 3.13).

Chart 3.12: Sterling effective exchange rate assumption

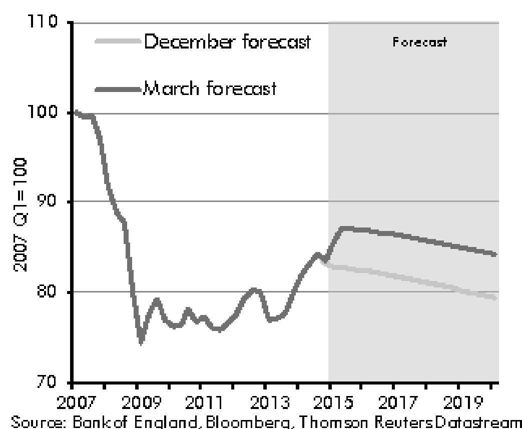
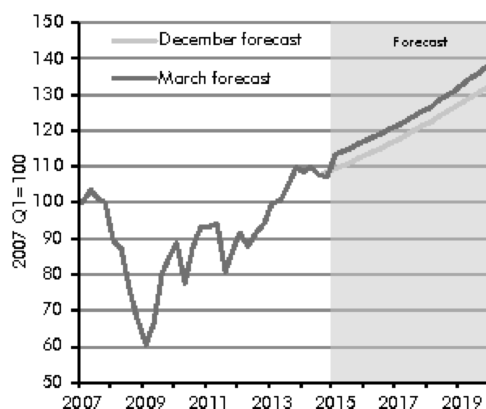


Chart 3.13: Equity prices assumption



Source: Bank of England, Bloomberg, Thomson Reuters Datastream

Summary

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

- monetary policy remains very loose and does not begin to tighten until mid-2016;
- fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past four years;
- the measures announced in the Budget have a negligible overall impact on demand and a very small effect on CPI inflation;
- credit conditions and the financial system continue to normalise gradually;
- global activity and demand for UK exports pick up steadily, albeit slightly more slowly in the near term than expected in December; and
- financial markets are stable and oil prices rise slightly after recent falls.

3.40 Risks and uncertainties associated with these assumptions and other facets of the forecast are discussed later in the chapter.

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Prospects for real GDP growth

3.41 In this section, we set out the expected path of GDP growth over the forecast period. We first consider the short-term outlook, based on 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 relatively small negative output gap closes.

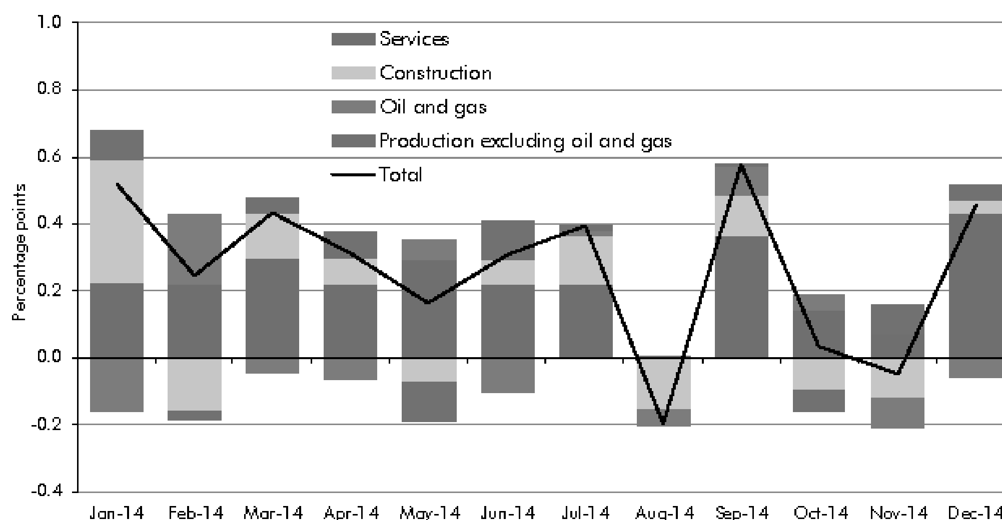
The short-term outlook for GDP

3.42 The economy grew by 0.5 per cent in the fourth quarter of 2014, slightly below the 0.6 per cent we forecast in December. *Quarterly National Accounts* data released after our December forecast contained downward revisions to GDP back to the start of 2013. As a result of this and the second estimate of fourth quarter GDP, the ONS now estimates that GDP increased by 2.6 per cent in 2014, below the 3.0 per cent we expected in December.

3.43 On a monthly basis, Chart 3.14 shows steady contributions to growth from the services sector in the second half of 2014. Contributions from the construction and production sectors were more volatile. The Markit/CIPS *Purchasing Managers' Index* (PMI) for February showed strong growth in the manufacturing and construction sectors. The services sector eased slightly in February, following a strong reading in January.

3.44 The latest survey indicators point to continued momentum into 2015, and we expect GDP growth to pick up to 0.7 per cent in the first quarter. We then forecast growth of 0.6 per cent in each of the remaining quarters of 2015, up slightly from our December forecast of 0.5 per cent a quarter over this period. This reflects a similar judgement to December that momentum would ease over the year, but incorporates an upward revision to growth due to lower oil prices boosting real household consumption. These changes leave GDP growth in 2015 as a whole at 2.5 per cent, slightly above our December forecast.

Chart 3.14: Contributions to monthly output growth in 2014



Source: ONS

Table 3.2: The quarterly GDP profile

	Percentage change on previous quarter											
	2014				2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
March forecast[1]	0.7	0.8	0.7	0.5	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
December forecast[2]	0.7	0.9	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Change[3]	-0.1	-0.2	0.0	-0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0

[1] Forecast from first quarter of 2015.
[2] Forecast from fourth quarter of 2014.
[3] Changes may not sum due to rounding.

The medium-term outlook

3.45 Our forecasts for growth in the medium term are determined by 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 discussed in the previous section all inform that judgement.

3.46 Recent ONS data revisions mean that the pick-up in GDP growth through 2014 now appears somewhat weaker than previously thought. Nevertheless the general picture of a significant pick-up in activity in 2013 and 2014 remains intact. GDP growth has averaged 0.6 per cent a quarter since the start of 2013, compared to just 0.3 per cent between the end of the recession and the end of 2012. Much of the increase in growth is attributable to a pick-up in consumer spending, as well as stronger investment growth, although investment is estimated to have fallen in the second half of 2014.

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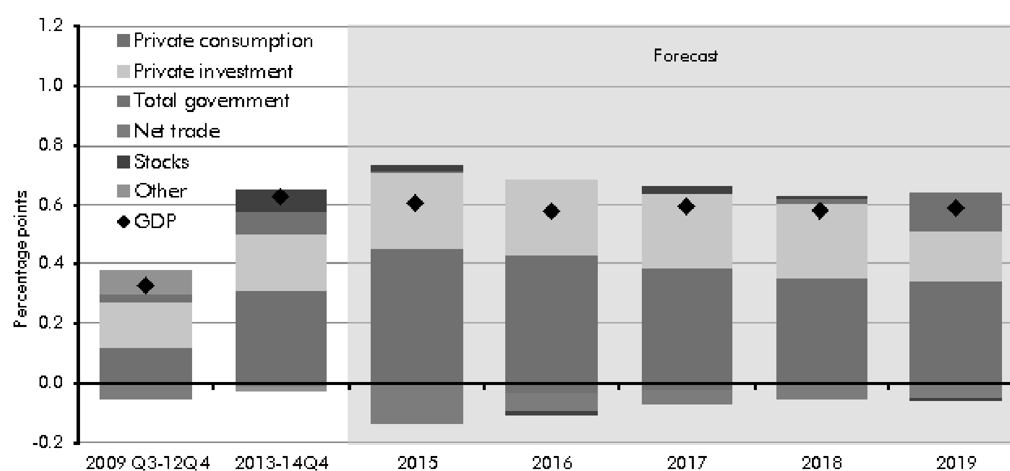
3.47 As set out in Box 3.1, the significant decline in the oil price since December is likely to affect economic activity in a number of ways: boosting real household incomes and thereby consumer spending and, to a lesser extent, encouraging business investment, but weighing on North Sea production and investment. Taken together we expect the fall in the oil price since December to increase GDP growth by around 0.4 percentage points across 2015 and 2016, with the largest effect likely to be observed over the second half of 2015 and first half of 2016. This more than offsets the effect on net trade of a further deterioration in the outlook for the UK's export markets. We have revised up our forecast for GDP growth in 2015 and 2016 by 0.1 and 0.2 percentage points respectively.

3.48 After 2016, the effect of lower oil prices on real income growth dissipates as the oil price is assumed to stabilise. Growth is instead supported by our assumption that productivity growth picks up towards its historical average rate. We therefore forecast the quarterly growth rate to remain at around 0.6 per cent from mid-2016. Lower oil prices are assumed to have a persistent effect on North Sea production in the medium term, implying a cumulative reduction in GDP of around 0.2 per cent by 2019 due to a 20 per cent downward revision to oil and gas production relative to our December forecast.

3.49 Overall, our forecast for cumulative real GDP growth between the third quarter of 2014 and the start of 2020 is slightly stronger than our December forecast (13.7 per cent versus 13.3 per cent). This reflects slightly stronger average growth of potential output, in turn reflecting the upward revision to assumed net inward migration (see paragraphs 3.17 to 3.18).

Chart 3.15: Contributions to average quarterly GDP growth

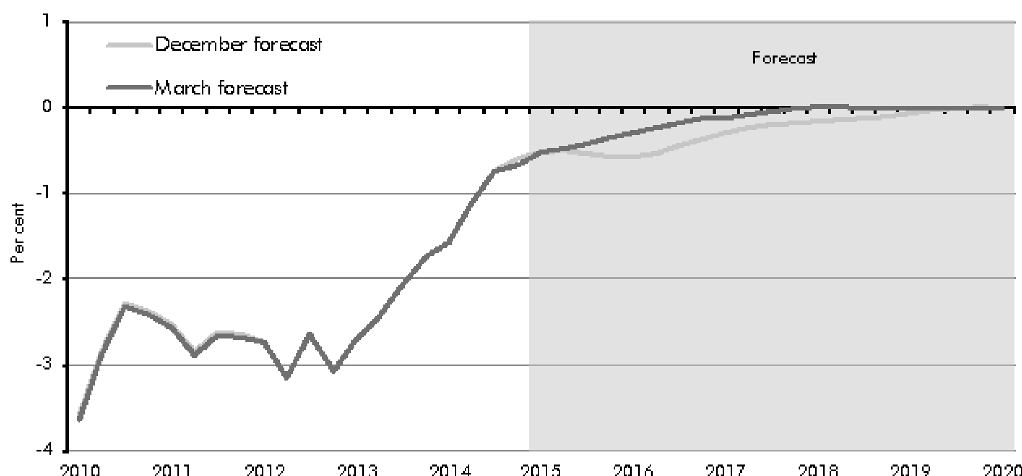


Note: 'Other' category includes the statistical discrepancy and the residual between GDP and the expenditure components prior to the base year (2011).
Source: ONS, OBR

3.50 Our estimate of the output gap at the end of 2014 is little changed from our December forecast. The boost to GDP growth from the lower oil price means that we now expect the output gap to be somewhat narrower from 2015, with output returning to its potential level

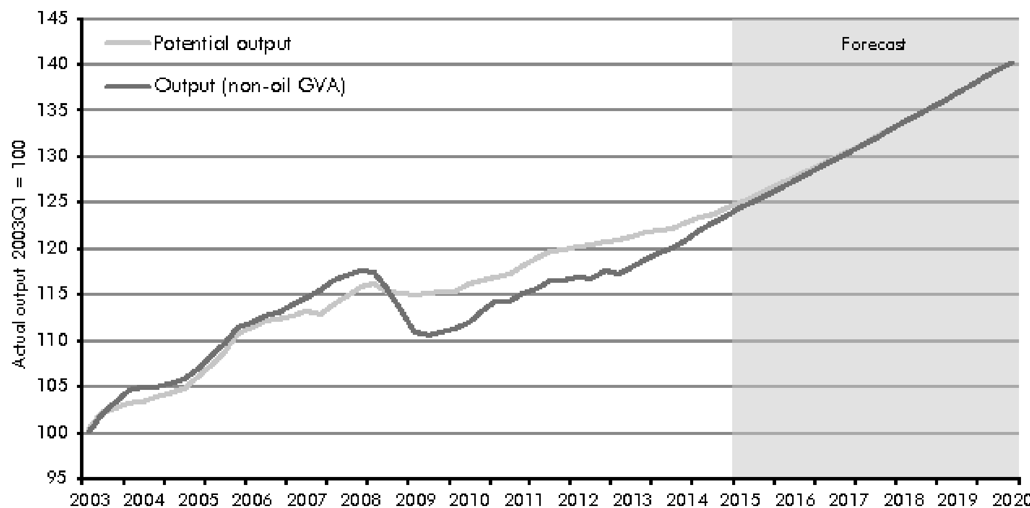
by the final quarter of 2017, around a year and a half earlier than we expected in December. That it does not close more quickly reflects a number of headwinds to growth over the medium term, including a pick-up in the pace of fiscal tightening, the slow return to health of the financial system, ongoing weakness in UK export markets and limits to what monetary policy can do to stimulate demand in these circumstances.

Chart 3.16: The output gap



Note: 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

Chart 3.17: Projections of actual and potential output



Source: ONS, OBR

3.51 Table 3.3 summarises the expenditure composition of our real GDP forecast. Relative to December, we expect stronger consumption growth in the near term, as the fall in the oil price boosts real incomes. We also expect somewhat stronger government consumption. Our forecast for cumulative investment growth is somewhat weaker, reflecting a downward revision to the outlook for both business (particularly North Sea) and residential investment. 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	2019
GDP growth (per cent)	1.7	2.6	2.5	2.3	2.3	2.3	2.4
Main contributions							
Private consumption	1.1	1.3	1.6	1.8	1.6	1.5	1.4
Business investment	0.5	0.7	0.5	0.8	0.7	0.8	0.5
Dwellings investment[1]	0.2	0.3	0.1	0.2	0.2	0.3	0.2
Government[2]	-0.3	0.5	0.2	-0.1	-0.1	0.0	0.3
Change in inventories	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Net trade	0.0	-0.5	-0.1	-0.4	-0.2	-0.2	-0.2

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

3.52 Our central GDP growth forecast is shown in Chart 3.18. The distribution surrounding it shows the probability of different outcomes based on past forecast accuracy. The solid black line shows our median forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. These are 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. Such risks are discussed at the end of the chapter.

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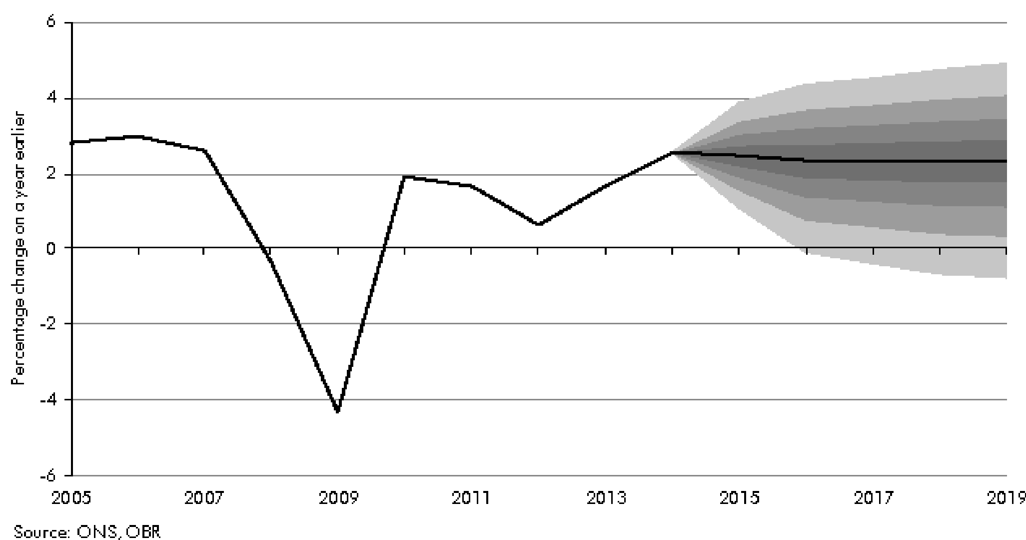
Chart 3.18: Real GDP growth fan chart

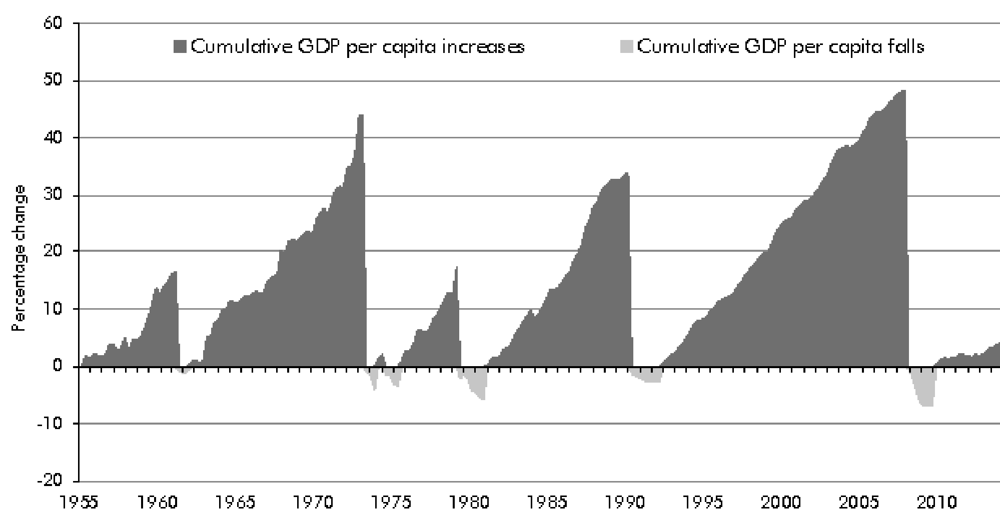


Source: ONS, OBR

3.53 The latest data imply that by the end of 2014, GDP per capita will have risen by 5.6 per cent since its trough in mid-2009, having grown at an average rate of just 1.0 per cent a year over that period. As Chart 3.19 shows, significant falls in GDP per capita like that experienced in the late 2000s recession are historically rare and typically short-lived compared with periods of expansion. The pace of expansion since the 2009 trough is notably subdued relative to the other post-war expansions shown in the chart.[7]

[7] Expansion periods are defined as continuing until GDP per capita falls cumulatively by more than 1 per cent over two consecutive quarters, triggering the start of a contraction period. Conversely, contraction periods are defined as continuing until cumulative GDP per capita growth is higher than 1 per cent over two consecutive quarters, triggering the start of an expansion period.

Chart 3.19: Cumulative growth in real GDP per capita



Source: ONS, OBR

Prospects for inflation

3.54 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 is the same in both indices, although there are a number of differences in coverage and the methods used to construct them (see Box 3.3 for more details). We also forecast the GDP deflator and its components, which are used in generating our nominal GDP forecast.

3.55 The CPI and RPI measures of inflation are important because they each affect our fiscal forecast. The Government uses the 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 to calculate interest payments on index-linked gilts, student loan payments and the revalorisation of excise duties. The GDP deflator, among other items, feeds into the Government's policy assumption for total public spending growth. The ONS publishes other inflation measures, but these do not currently affect the public finances, so we do not forecast them.

CPI inflation

3.56 CPI inflation was 0.9 per cent in the fourth quarter of 2014, below our December forecast of 1.1 per cent. The lower-than-expected outturn is explained by food and fuel prices.

3.57 The most important development since December has been the further sharp fall in oil prices. The assumption for sterling oil prices underpinning our current forecast is 30 per cent lower in the first quarter of 2015 and 17 per cent lower in the medium term than in

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December. This reduction has its greatest impact on inflation directly through fuel prices, with the transmission almost immediate. Fuel prices make up 3.4 per cent of the CPI, although a significant proportion of this reflects fuel duty, which is fixed in pence per litre so does not vary with oil prices. Part of the fuel price also represents other costs and margins for fuel retailers. Taking all this into account, the fall in oil prices is expected to subtract 0.3 percentage points from CPI inflation in 2015 through its direct impact on fuel prices. Some of this impact will be unwound later, as the oil futures curve is upward sloping.

3.58 Oil prices can also have indirect impacts on inflation through their role as a cost of production for firms – e.g. fuel costs affecting airfares, transport costs affecting the whole supply chain and lower production costs affecting global food commodity prices and subsequently retail food prices. We expect these indirect impacts to take longer to flow through to the CPI and eventually take a further 0.1 percentage points off inflation.

3.59 Wholesale gas prices have also fallen, with the average futures curve over the next two years 11 per cent lower than assumed in December. In response to these falls, the 'big six' energy firms have announced cuts to retail gas prices ranging from 1.3 to 5.1 per cent. Wholesale costs are thought to make up slightly less than half of utility prices, but energy companies buy wholesale energy up to two years in advance which means that changes in wholesale prices can take time to feed through to retail prices.[8] The announcements from energy firms take a further 0.1 percentage points off inflation in our forecast. We assume that utility prices will rise more slowly than assumed in December, as the lagged effects of lower wholesale prices partly offset increases in other costs of production.

3.60 Other inflation developments have included:

- more downward pressure on food prices, resulting from further falls in global commodity prices and intensification of competition in the food retail sector; and

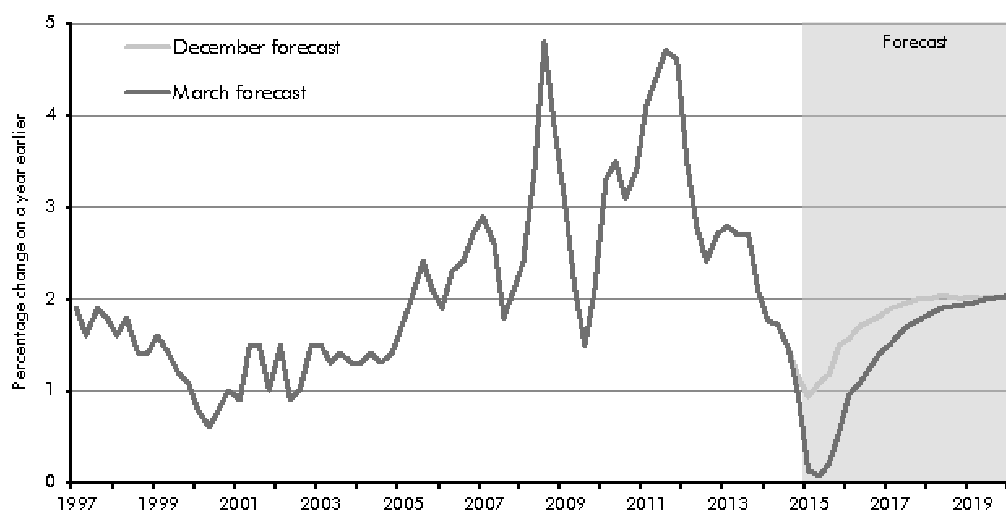
- sterling appreciating further, which lowers the cost of import-intensive goods.

3.61 The sum of these developments means that we have significantly lowered our forecast for CPI inflation in the near term (Chart 3.20). Inflation is expected to trough at 0.1 per cent in the first half of 2015 (although it may well be negative in some months). It is expected to rise in the second half of 2015, as oil prices are assumed to rise and as spare capacity is used up. The CPI inflation profile jumps up at the start of 2016 as the peak impact of the recent fall in energy prices drops out of the year-on-year calculation.

3.62 Inflation is then forecast to return to the 2 per cent target slowly as the effects of the recent sterling appreciation and the indirect effects of the recent falls in commodity prices feed through with lags. The Bank of England is expected to look through the effects of these external influences and inflation is forecast to return to its 2 per cent target during 2019, when these effects have worked their way through.

[8] OFGEM, *Charts: Outlook for costs that make up energy bills*, February 2015.

Chart 3.20: CPI inflation



Source: ONS, OBR

RPI inflation

3.63 The calculation of RPI inflation in the UK does not meet international statistical standards,[9] but we continue to forecast RPI as it remains an input in our fiscal forecasts.

3.64 RPI inflation was 2.0 per cent in the fourth quarter of 2014, close to our December forecast of 2.1 per cent. The items contributing to the negative CPI surprise were partly offset by higher-than-expected mortgage interest payments (MIPs) inflation, which are not included in the CPI.

3.65 In the near term, we expect RPI inflation to fall back for the same reasons as CPI inflation. It is forecast to average 1.0 per cent in the first half of 2015, 1.0 percentage points lower than expected in December. Over 2015, RPI inflation rises in line with CPI inflation before an increase in MIPs pushes RPI inflation slightly above 3 per cent. The rise in MIPs is driven by an increase in mortgage debt as housing market turnover increases back towards its pre-crisis average. Compared to our December forecast, RPI inflation is lower over the whole forecast period, partly because we have lowered our assumption for the long-run wedge between RPI and CPI inflation (Box 3.3).

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

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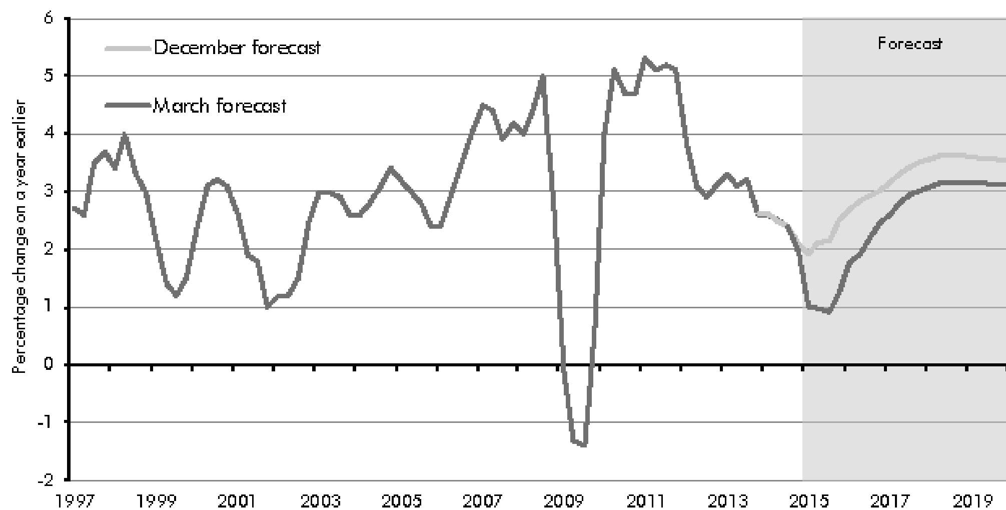
Chart 3.21: RPI inflation



Source: ONS, OBR

Box 3.3: Revised assumption for the long-run wedge between RPI and CPI inflation

RPI inflation differs from CPI inflation for a number of reasons. The ONS decomposes the wedge between the two measures into the following categories:

- the formula effect – the RPI uses a combination of the 'Dutot' and 'Carli' methods of aggregating prices at the most basic level, while the CPI uses a combination of the Dutot and 'Jevons' methods. Jevons is a geometric averaging technique, Dutot is an internationally accepted arithmetic average, but Carli is an arithmetic average that does not meet international standards since it tends to inject spurious inflation into the index. Since the RPI uses Carli it generally overstates inflation;
- housing – the RPI includes a number of housing components that the CPI does not, including depreciation, council tax and mortgage interest payments;
- other differences in coverage – certain items are included in one index but not the other, for example the CPI includes overseas student tuition fees but the RPI does not and the RPI contains vehicle excise duty but the CPI does not; and
- other differences including weights – different data sources and population bases mean other components have different weights.

Chart A illustrates how these different factors have contributed to the wedge between RPI and CPI inflation since 2005, when the ONS switched to its preferred methodology for measuring the wedge, with some factors fluctuating significantly while others have been reasonably constant.

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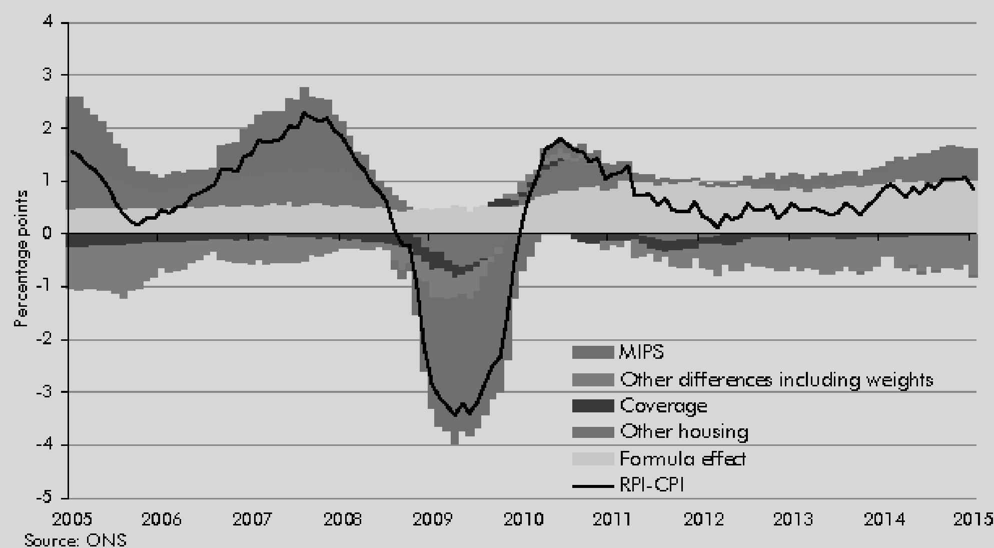
Chart A: Contributions to the RPI-CPI inflation wedge



Source: ONS

The OBR first published an estimate of the long-run wedge between RPI and CPI inflation in a 2011 working paper.[a] Since then, the ONS has begun producing RPIJ, which recalculates the RPI by replacing the Carli averaging method with Jevons. We have also had more time to assess the impact of the 2010 change in the calculation of clothing prices, which has increased the size of the formula effect.[b] On the basis of the latest evidence, we have revised down our estimate of the long-run wedge between RPI and CPI inflation.

Table A sets out the estimated components of the wedge from our 2011 working paper and our updated estimates, as well as comparing them to the averages since 2005 (when the ONS moved to the preferred methodology for measuring the wedge) and since 2010 (when the ONS changed the collection of clothing prices). It shows that:

- we have kept the **formula effect** unchanged at 0.9 percentage points, in line with the average since 2010, when the method of collecting clothing prices was changed;
- we have slightly lowered our estimate of the **housing effect**. We still expect mortgage interest payments and housing depreciation to grow in line with average earnings, but we have reduced our long-run average earnings projection from 4.7 to 4.4 per cent. We now expect council tax to grow in line with CPI inflation of 2 per cent, as in our fiscal forecast, compared to the 3 per cent assumption in 2011, which was based on the historical average growth rate;
- we still expect **other differences in coverage** to contribute nothing to the wedge in steady state; and
- we have revised down the contribution of **other differences including weights** from zero (as assumed in our 2011 paper) to -0.4 percentage points. The ONS calculates this series as a residual so it will pick up differences in weights other than housing as well as any

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interactions between categories. Since 2010, when the method of collecting clothing prices was changed, this component has averaged a -0.4 percentage point contribution to the wedge. This is despite a bottom-up estimate of the difference in weights at the item level (the approach that underpinned our 2011 estimate), suggesting an effect of zero. We believe that part of this difference represents interactions between categories, in particular between the formula and weights effects. This is demonstrated by the gap between RPI and RPIJ (the formula effect using RPI weights), which has averaged 0.6 percentage points since 2010, whereas the published ONS formula effect (the formula effect calculated using CPI weights) remains around 0.9 percentage points. We assume that the average contribution from this category since 2010 will persist.

Summing the contributions gives our new estimate of the long-run wedge between RPI and CPI inflation of 1.0 percentage points. This is lower than our 2011 estimate of 1.4 percentage points. It is also lower than the Bank of England's estimate of 1.3 percentage points. But it is in line with what market participants told the Bank was built into the price of inflation breakevens.[c]

Table A: Long-run assumption for the RPI-CPI inflation wedge

	Percentage points contributions, unless otherwise stated				
	Formula effect	Housing	Coverage	Weights	Total
Bank of England	0.9	0.6	-0.1[1]	-0.1[1]	1.3
2005-current average	0.7	0.3	-0.1	-0.4	0.5
2010-current average	0.9	0.3	-0.1	-0.4	0.7
2011 Working paper	0.9	0.5	0.0	0.0	1.4
New value	0.9	0.5	0.0	-0.4	1.0
Change	0.0	-0.1	0.0	-0.4	-0.4

[1]The Bank of England assumes a combined coverage and weights contribution of -0.2 percentage points. We have split this evenly between the two categories.

Note: Components may not sum to total due to rounding.

[a]Miller (2011) *Working Paper No. 2: The long-run difference between RPI and CPI inflation*.

[b]More information can be found in the ONS information note, *CPI and RPI: the increased impact of the formula effect in 2010*, January 2011.

[c]For more detail see page 34 of the Bank of England's *Inflation Report*, February 2014: 'The long-run RPI-CPI wedge'.

The GDP deflator

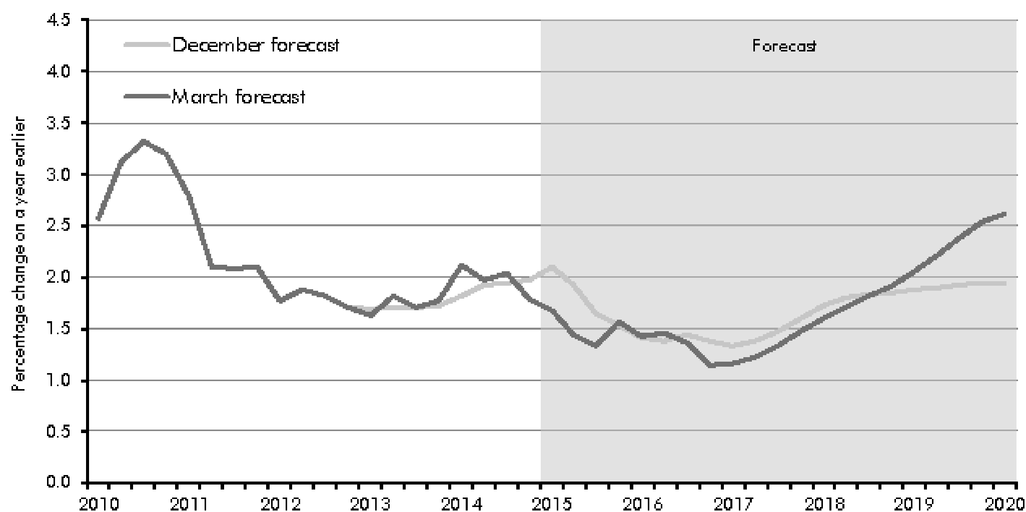
3.66 GDP deflator growth is the broadest measure of inflation in the domestic economy. It measures changes in prices of the goods and services that make up GDP, including price movements in private and government consumption, investment and the relative price of exports and imports – the terms of trade.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

3.67 Our forecast for the GDP deflator has been revised down in the near term as lower private consumption and housing investment prices are only partly offset by a stronger terms of trade (Chart 3.22). The lower consumption deflator is due to revisions to our CPI forecast while lower housing investment prices reflect lower house price growth. The stronger terms of trade partly reflects the fact that the UK is a net importer of oil, the price of which has

fallen significantly. (The oil trade balance moved from surplus to deficit in 2003.) The net impact of the fall in oil prices on the GDP deflator is small as most of the consumption price impact comes from imported products, leaving only a fall in the price of exported oil to affect the GDP deflator. An alternative way to think about this is that the GDP deflator only reflects the price of goods and services produced in the UK and the share of oil production in UK GDP is fairly small, hence the small fall resulting from lower oil prices.

3.68 Medium-term GDP deflator growth is then stronger than our December forecast, thanks to higher growth in the price of government consumption, reflecting a smaller squeeze on such spending implied by the Government's medium-term spending assumption, particularly at the end of the forecast period. Higher growth in housing investment prices, reflecting stronger house price growth, also contributes.

Chart 3.22: GDP deflator



Source: ONS, OBR

Prospects for nominal GDP growth

3.69 Most public discussion of economic 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).

3.70 The latest ONS data indicate that nominal GDP grew by 4.4 per cent in 2014, weaker than the 5.0 per cent we expected in December. Most of this difference reflects ONS revisions to the first three quarters of 2014, which implied a somewhat weaker path for nominal

government spending and private consumption, and a stronger path for imports than earlier estimates (see Chapter 2). The latest estimates indicate nominal GDP growth of 0.4 per cent in the fourth quarter, around 0.2 percentage points weaker than we expected in December. The high-level breakdown published so far suggests that the additional weakness of nominal GDP growth in the fourth quarter has been concentrated in stocks and investment on the expenditure side, and profits on the income side.

3.71 We forecast that nominal GDP will grow by 4.1 per cent in 2015, falling back to 3.5 per cent in 2016 as calendar-year real GDP growth slows. We then expect growth of 3.8 per cent in 2017, picking up to 5.0 per cent by 2019 as temporary downward influences – notably the effect of fiscal consolidation on government consumption prices – ease. Overall, cumulative nominal GDP growth between the third quarter of 2014 and the start of 2020 is 1.9 percentage points higher than in our December forecast (25.5 per cent versus 23.6 per cent). Around 0.4 percentage points of this reflects an upward revision to our forecast of real GDP growth, with cumulative growth in the GDP deflator accounting for the rest.

Expenditure

3.72 Chart 3.23 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 over the forecast period. However, given the relatively slow growth of disposable incomes, we expect the share of consumption in nominal GDP 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 just under 15 per cent in 2014 to just over 17 per cent in 2019. This offsets a fall in the contribution of government consumption and investment, which drops from around 22 per cent of nominal GDP in 2014 to just over 18 per cent by 2019. Prospects for individual sectors are set out in more detail later in this chapter.

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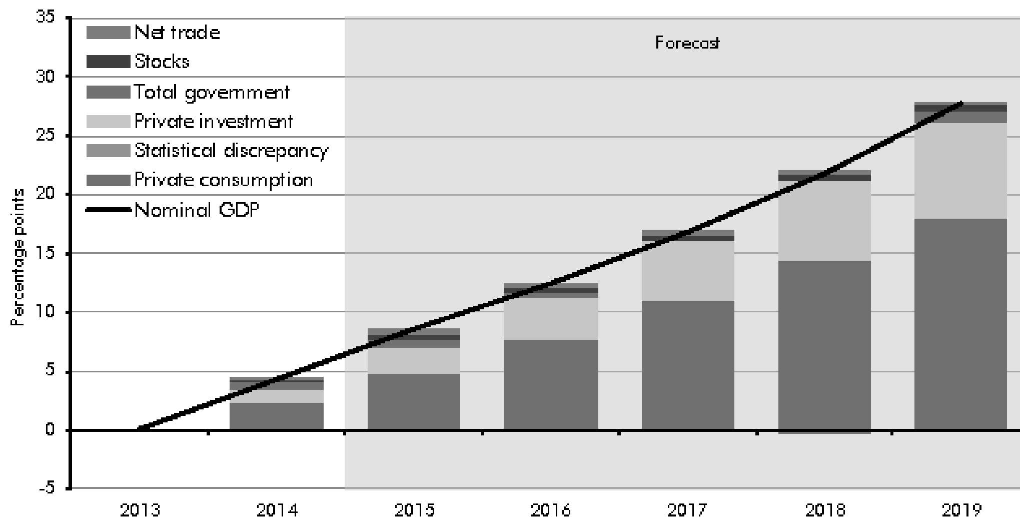
Chart 3.23: Contributions to cumulative nominal GDP growth: expenditure

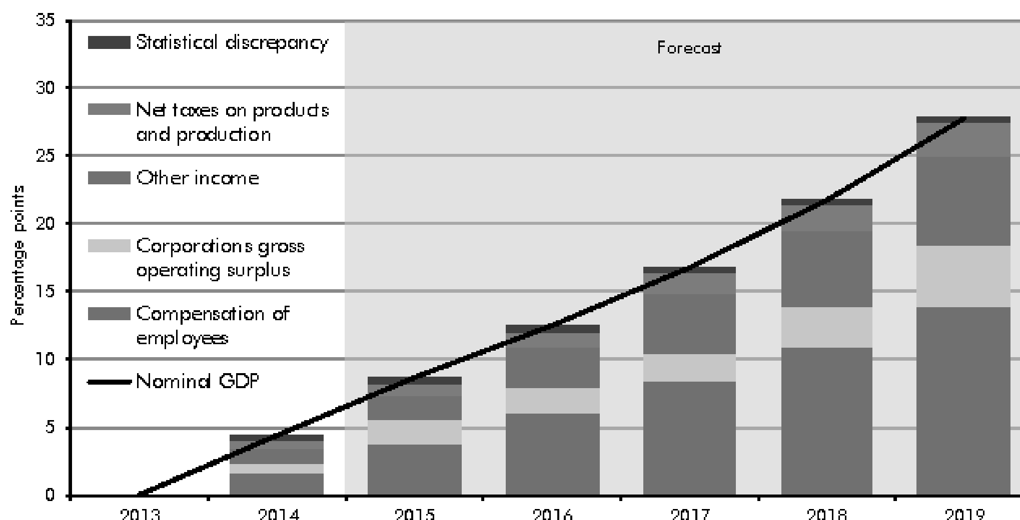


Source: ONS, OBR

Income

3.73 Chart 3.24 shows the contribution of different sources of income to cumulative growth in nominal GDP between 2014 and 2019. As the output gap closes, we expect profit margins to recover, with profit growth slightly outpacing nominal GDP growth in the near term. With real earnings forecast to grow in line with productivity, the share of labour income in nominal GDP is expected to remain broadly stable from 2015.

Chart 3.24: Contributions to cumulative nominal GDP growth: income



Source: ONS, OBR

Prospects for individual sectors of the economy

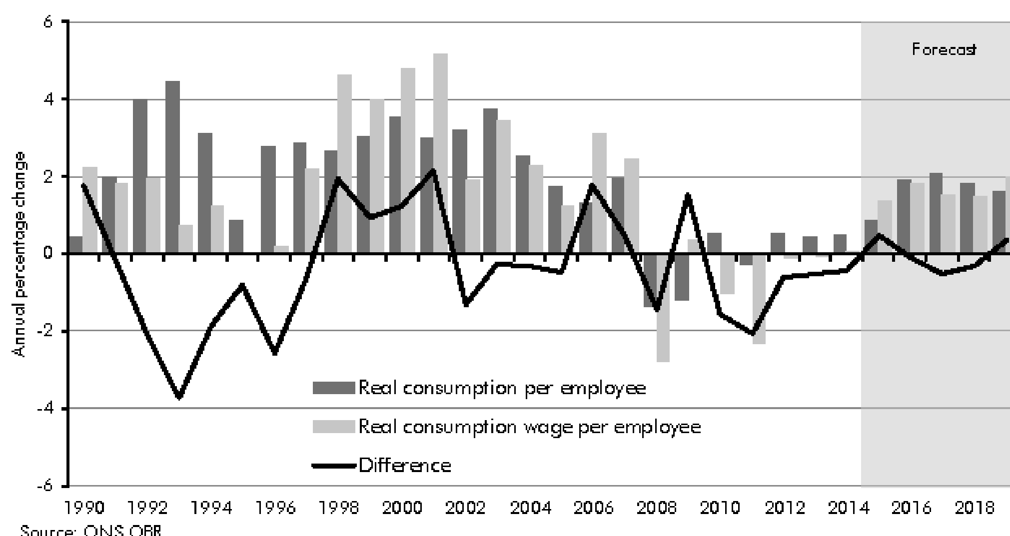
The household sector

3.74 The household sector is the largest source of income and spending in the economy, with consumer spending making up 65 per cent of nominal GDP by expenditure and household disposable income making up 66 per cent of nominal GDP by income in 2013.

Real consumer spending

3.75 Consumption growth slowed to 0.3 per cent in the final quarter of 2014, which implies that it grew by a cumulative 2.0 per cent in real terms through 2014 (Chart 3.25). This was despite little growth in real wages. The real consumption wage per employee is estimated to have been broadly flat in 2014, slightly stronger than we expected in December.

Chart 3.25: Real consumption wage and real consumption



Source: ONS,OBR

The labour market and household income

3.76 The unemployment rate has fallen steadily over recent quarters, reaching 5.7 per cent in the final quarter of 2014. We expect the rate of decline to ease over coming quarters as GDP growth slows and productivity growth picks up, allowing firms to expand output through their existing workforce rather than through recruitment. But the recovery in productivity per worker is likely to be gradual, and we expect sufficient momentum in the labour market for the unemployment rate to drop below its equilibrium level from mid-2015. A small gap is expected to remain until the start of 2018, as productivity growth takes time to fill the slack. The broad picture is similar to our December forecast, but we now forecast that, within productivity per worker, average hours will be somewhat firmer over the near term and hourly productivity growth slightly weaker.

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3.77 The Labour Force Survey (LFS) measure of unemployment has fallen in line with our recent expectations, but the claimant count has fallen further relative to both the LFS measure and our December forecast. This mainly reflects a drop in the rate of inflows, although a rise in the rate of outflows has also played a role. The disproportionate decline in the claimant count could be due to some features of the benefit system, including a tightening of the JSA sanctions regime relative to other benefits and tax credits. But it is difficult to isolate the importance of such factors against more general labour market developments.[10] We expect the claimant count to fall even further relative to the LFS measure, but that both measures will be broadly stable from the beginning of 2016.

3.78 The National Accounts measure of wages and salaries is currently stronger than would be implied by multiplying employee numbers in the LFS by the average weekly earnings (AWE) measure of earnings. This means that the measure of average earnings growth we forecast – based on the National Accounts – has been stronger than the headline AWE measure, rising by an estimated 2.2 per cent in 2014, relative to 1.2 per cent growth in the AWE. The National Accounts uses AWE data (until administrative tax data become available), so in principle the two should be consistent and we expect this gap to unwind in 2015. But one consequence is that our forecast measure is essentially flat across the two years, masking some underlying momentum in earnings.

3.79 We expect real earnings growth to rise in the near term as inflation continues to fall and nominal earnings pick up, and over the medium term as productivity growth returns to more normal levels. This implies that the real consumption wage will not rise above its pre-crisis peak in the third quarter of 2007 until the end of 2018.

3.80 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 weaker productivity growth. We also expect non-labour income growth to pick up, helped by a cyclical recovery in corporate profits supporting dividend income. Lower inflation over the near term will also support real income growth. The result is real household disposable income growth of 3.7 per cent in 2015, and around 2 per cent thereafter, as inflation returns to target and productivity growth picks up.

[10] See Box 8.1 of our 2014 *Welfare trends report* for a fuller discussion.

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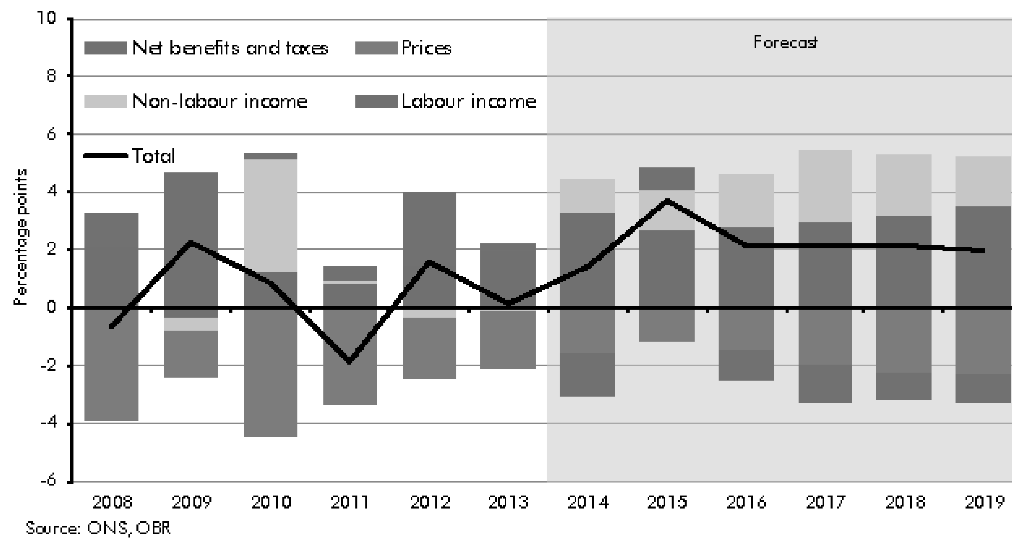
Chart 3.26: Contributions to real household income growth

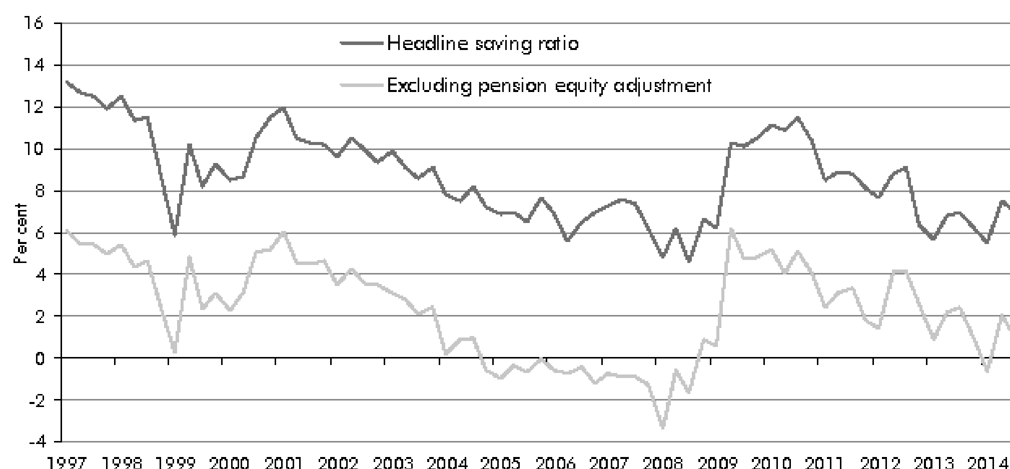


Source: ONS, OBR

The saving ratio

3.81 The headline saving ratio fell back sharply between 2012 and 2013, supporting a pick-up in household consumption despite ongoing weakness in household income growth. Since then, the household saving ratio has stabilised, averaging around 6½ per cent in 2013 and 2014. Nominal household consumption has continued to grow more strongly than household disposable income (with the former growing by around 6½ per cent and the latter by just over 5 per cent between the final quarter of 2012 and the third quarter of 2014), but this has been offset by an increase in measured pension saving. If the adjustment for pension saving is excluded, then the saving ratio continued to decline in 2013 and 2014 (Chart 3.27).

Chart 3.27: The household saving ratio



Note: Estimate of the saving ratio excluding the pension equity adjustment calculated as household disposable income less consumption, as a proportion of houshold disposable income.
Source: ONS, OBR

3.82 With real household disposable income expected to outstrip real consumption over the near term, we expect the saving ratio to pick up slightly in 2015. Thereafter we expect it to remain broadly stable, with consumption growing in line with household incomes. The starting level of the saving ratio is higher than in our December forecast, reflecting the strength of pension saving in the latest data. But from 2015 this is partly offset by a weaker outlook for the *growth* of pension saving, which reflects the direct effect of the fall in gilt yields on investment income.[11]

The housing market and dwellings investment

3.83 House price inflation has eased more quickly than we expected in December, with year-on-year growth of 10.0 per cent in the fourth quarter of 2014, 0.8 percentage points lower than expected (Chart 3.28). Housing market indicators suggest price growth will continue to slow in coming quarters, so we have lowered our near-term house price forecast. But the fundamental factors that drive our house price model thereafter suggest stronger price growth than in December, which has fed through to a higher medium-term forecast.[12]

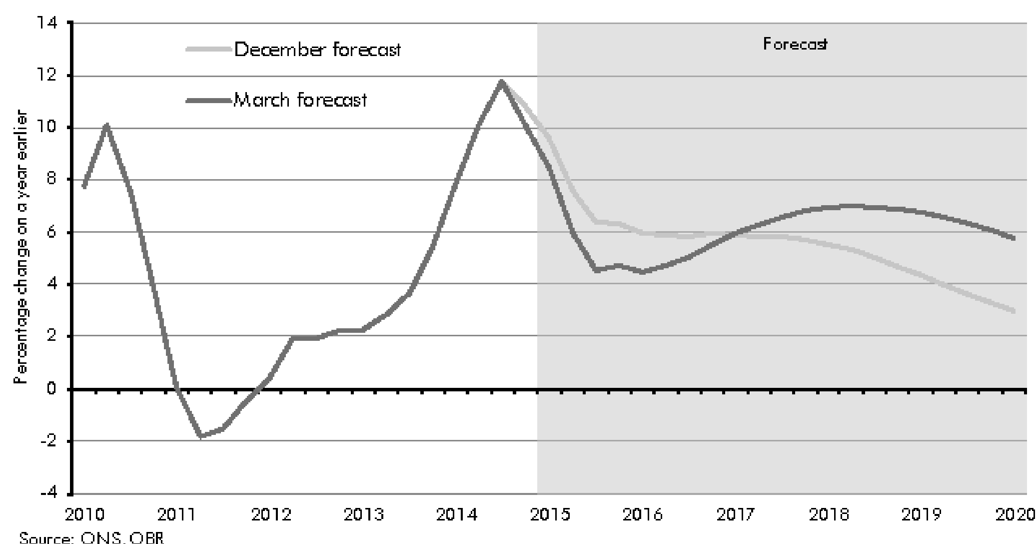
3.84 Relative to our December forecast, there is additional upward pressure on prices from the demand fundamentals with little change in expectations for supply. The additional housing demand mainly comes from stronger real income per household, partly as a result of the recent falls in energy prices, with a partial offset from higher mortgage interest rates over most of the forecast period. The level of house prices in the first quarter of 2020 is 3.9 per cent higher than in our December forecast. Overall, house prices are expected to rise by

[11] Following changes to the treatment of pension saving in Blue Book 2014, investment income is now calculated as opening pension liabilities multiplied by the yield on 15 year gilts. See ONS, *Changes to National Accounts: The Impact of the Changes to the Treatment of Pensions in the National Accounts*, September 2014.
[12] For more information on our house price model see Auterson (2014): *Working paper No. 6: Forecasting house prices.*

35.5 per cent by the first quarter of 2020. Relative to their pre-crisis peaks in 2007, real house prices at the end of the forecast are expected to be 14.4 per cent higher and the ratio of house prices to average earnings 11.2 per cent higher.

3.85 There is a risk that the greater flexibility over people's access to their pension assets, announced in Budget 2014 and due to come into effect in April 2015, could affect the housing market. As we explained in Box 3.1 of the December 2014 *EFO*, we have not adjusted our forecast as we assume that there will be offsetting effects from the flows associated with this policy change, but the effects are highly uncertain and, in reality, are unlikely to net off precisely.

Chart 3.28: House price inflation forecast



Source: ONS, OBR

3.86 We have revised down our near-term residential property transactions forecast again as the latest data have been below our December forecast and mortgage approvals remain subdued. Among other factors, it appears that the Mortgage Market Review regulations on lending have had a larger and more persistent effect than we had assumed. We have also revised down our medium-term transaction forecasts. We assume that the volume of transactions returns towards its historical average as a percentage of the housing stock over the forecast period. Previously the period over which we took the average was 1991 to 2007. We have now excluded the period from 2004 to 2007 – the height of the pre-crisis boom – as a guide to medium-term turnover rates. This has reduced the turnover rate we use to anchor our medium-term forecast (Chart 3.29).

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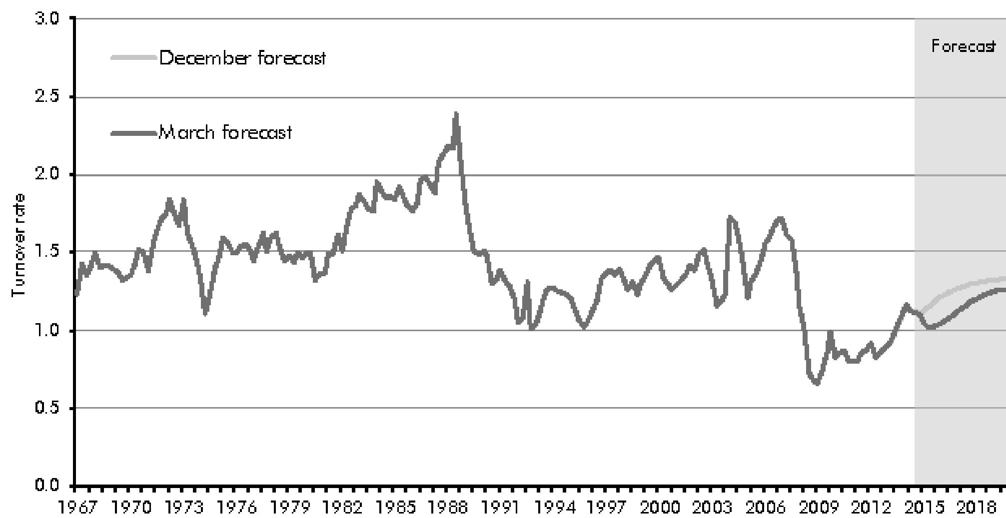
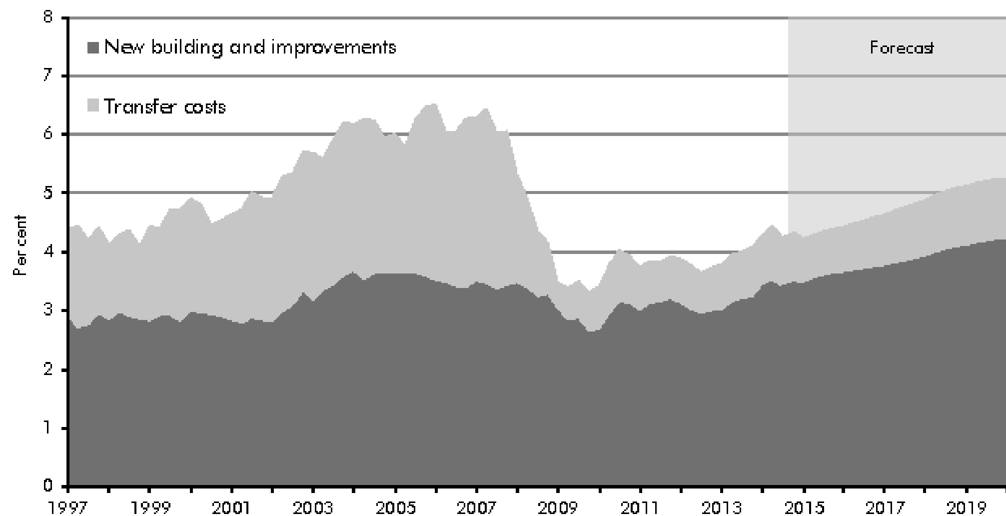
Chart 3.29: Quarterly residential property turnover rate



Source: ONS, OBR

3.87 In line with our forecasts for house prices and property transactions, we expect relatively strong growth in residential investment over the forecast period. Near-term growth in housebuilding is encouraged by recent strong growth in house prices, while medium-term strength is motivated by housing market turnover returning towards its historical average. But, despite relatively strong rates of growth in the forecast, total private residential investment as a share of GDP is expected to remain below its pre-crisis peak throughout the forecast period (Chart 3.30).

Chart 3.30: Residential investment as a share of nominal GDP



Source: ONS, OBR

Net lending and the balance sheet

3.88 The saving ratio is expected to fall back slightly between 2015 and 2019. Taken together with strong growth in household investment, this will push households' overall net lending position – total income less total spending – into deficit. In an accounting sense, this, together with a gradual improvement in the current account and a decline in corporate net lending, provides the offset to the Government's fiscal consolidation (Chart 3.39).

3.89 With household net lending negative and relatively strong house price growth driving mortgage borrowing, the ratio of households' gross debt to income is projected to rise again from 2015, having fallen steadily since 2008 (Chart 3.31). Of the 27 percentage point increase in the ratio over the forecast period, around 16 percentage points reflect an increase in secured debt. The remainder reflects higher unsecured debt relative to income, which in turn reflects the deterioration in households' net balance to an historically large deficit over the forecast period.

3.90 The gross household debt to income ratio has been revised down since our December forecast. This reflects a number of factors:

- in cash terms, the level of gross debt is expected to be £144 billion lower by the start of 2020 than we forecast in December, of which £14 billion reflects a lower starting point;
- around £47 billion of this reflects a lower path for secured debt – which in turn reflects lower growth in property transactions;
- around £83 billion reflects less accumulation of unsecured debt – as we have revised down household investment and consumption. We have also factored in an ongoing reduction in households' outstanding unsecured debt through write-offs, which had not been incorporated in our previous forecasts; and
- the level of household disposable income at the end of the forecast is expected to be around 1 per cent higher than expected in our December forecast.

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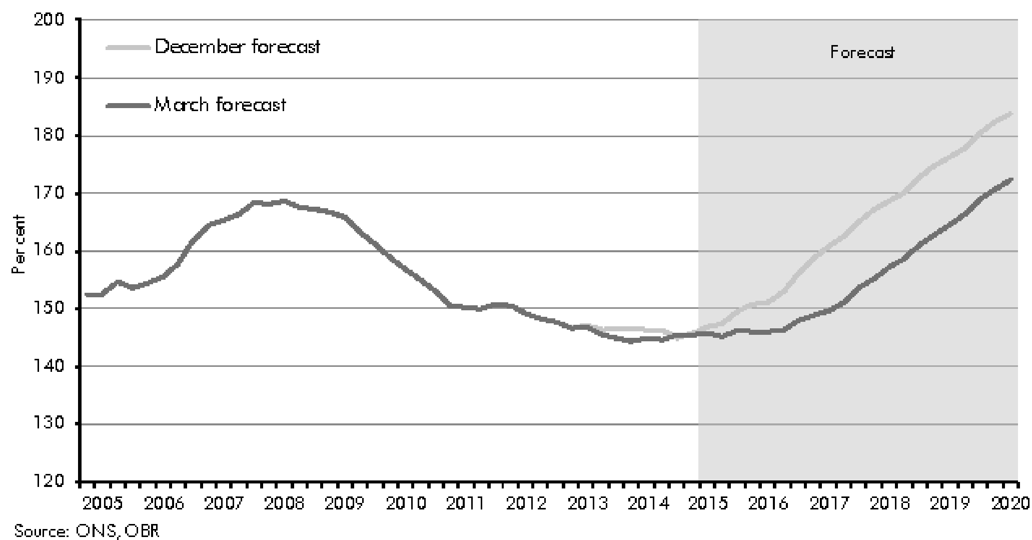
Chart 3.31: Household gross debt to income



Source: ONS, OBR

The corporate sector

Business investment and stockbuilding

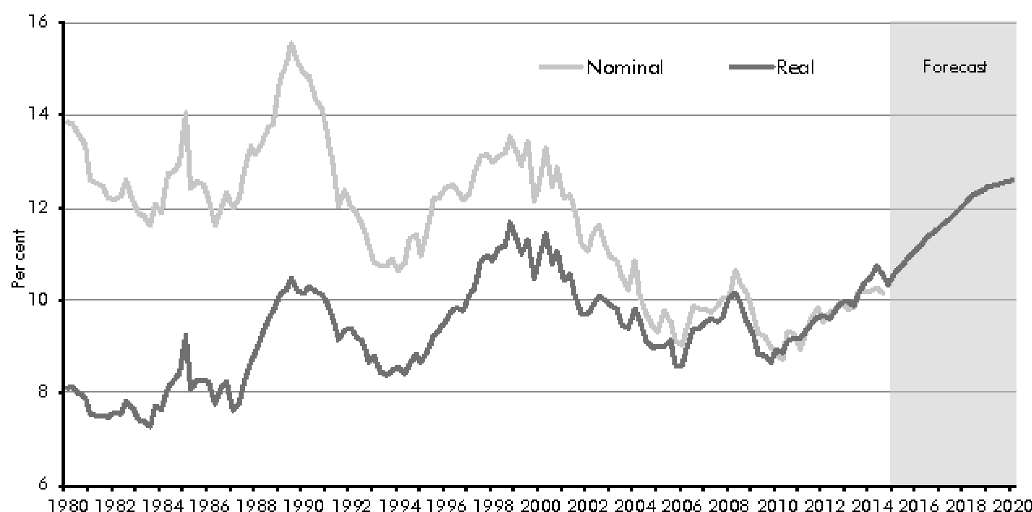
3.91 The latest data show that business investment fell by 1.4 per cent in the fourth quarter of 2014 after a 1.2 per cent fall in the third quarter. Despite that, business investment is estimated to have increased by 6.8 per cent in 2014 as a whole. We expect business investment to continue to grow relatively strongly in 2015, albeit at a slower rate than we forecast in December. Business investment growth has been revised up between 2016 and 2018, but is lower in 2019 than we forecast in December.

3.92 The weight of activity in the North Sea in whole economy investment is much higher (above 7 per cent) than its weight in GDP (less than 2 per cent), in part due to the unusually high North Sea investment of recent years. We therefore expect the boost to onshore investment from lower energy costs to be more than offset by the direct effect of lower investment in the North Sea. (Prospects for investment in the North Sea are covered in more detail in Chapter 4.) As usual, the latest ONS data are subject to potentially large revisions, so our forecast is subject to considerable uncertainty. The Bank of England's *Agents' Summary* reports investment intentions consistent with modest growth over the next twelve months, although investment intentions have eased since our December forecast.

3.93 As Chart 3.32 shows, our forecast implies real business investment rising as a share of GDP, as typically occurs during the later stages of a recovery. It 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 whole economy inflation.

3.94 The latest ONS data indicate that stocks contributed 0.2 percentage points to GDP growth in 2014. We expect inventories to make a contribution to GDP growth of 0.1 percentage points in 2015 and assume they will be neutral from 2016.

Chart 3.32: Business investment as a share of GDP



Source: ONS, OBR

Corporate profits

3.95 Non-oil, non-financial company profits are forecast to grow more quickly than GDP in 2014 and 2015 as the output gap continues to narrow. Relative to our December forecast, we have revised down profit growth in 2015, in line with the downward revision to our forecast of nominal GDP growth and latest outturns. From 2016 we expect profits to grow broadly in line with nominal GDP.

The government sector

3.96 Total public spending amounted to 41.7 per cent of GDP in 2013-14.[13] But not all government spending contributes directly to GDP. Spending on 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 22.4 per cent of GDP in 2013-14.

Real government consumption

3.97 Real government consumption is estimated to have grown by 1.5 per cent in 2014, compared with estimated growth of 1.1 per cent at the time of our December forecast, and is forecast to grow by 0.8 per cent in 2015, having been forecast to fall in our December forecast. Our government consumption forecast is similar to December between 2016 and

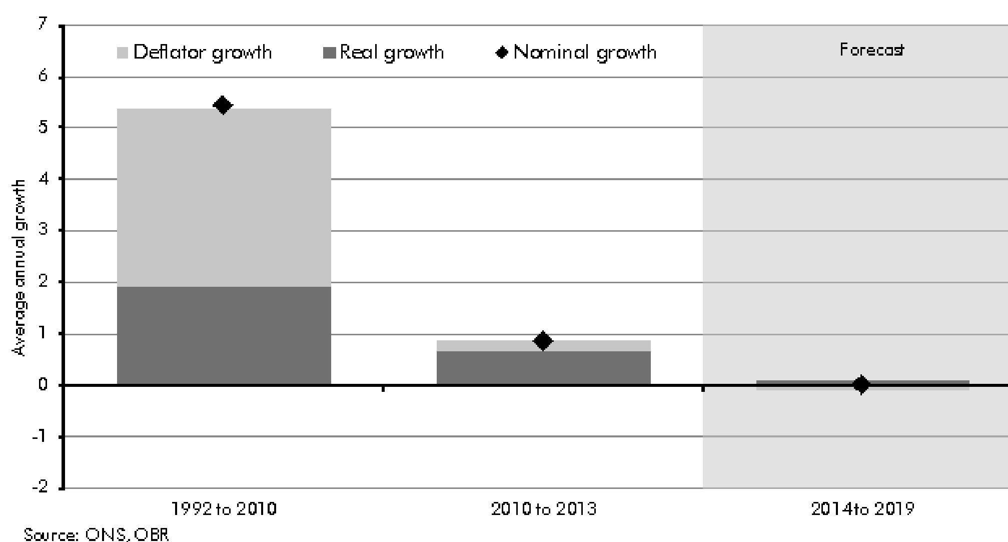
[13] Total managed expenditure (TME).

2018, but has been revised up significantly in 2019, reflecting the Government's decision to change the assumption it applies to total spending in that year.

Nominal government consumption

3.98 Growth in the implied price of government consumption – the ratio of nominal spending to real government consumption – has been subdued as cash spending growth has slowed. The government consumption deflator is not expected to fall to the same extent as in our December forecast (Chart 3.33). The upward revision in 2019 is especially large, with the Government having decided to change its total spending assumption in that year, so that the government consumption deflator rises by 3.5 per cent in 2019. It was flat in December. This change adds around 0.6 percentage points to growth in the GDP deflator and nominal GDP in that year.

Chart 3.33: Government consumption



Source: ONS, OBR

3.99 Relative to the size of the economy, nominal government consumption is forecast to fall from 19.7 per cent of GDP in 2014 to 16.1 per cent of GDP by 2019. This is less of a fall than we forecast in December, but would still leave government consumption as a share of GDP equal to its level in 1964 and would be the joint lowest level in consistent National Accounts data going back to 1948. On a quarterly basis, government consumption falls to 15.9 per cent of GDP at the end of 2018. This is marginally above its previous low of 15.8 per cent, again in 1964. Chart 3.34 also shows pre-war estimates taken from the Bank of England's historical dataset.

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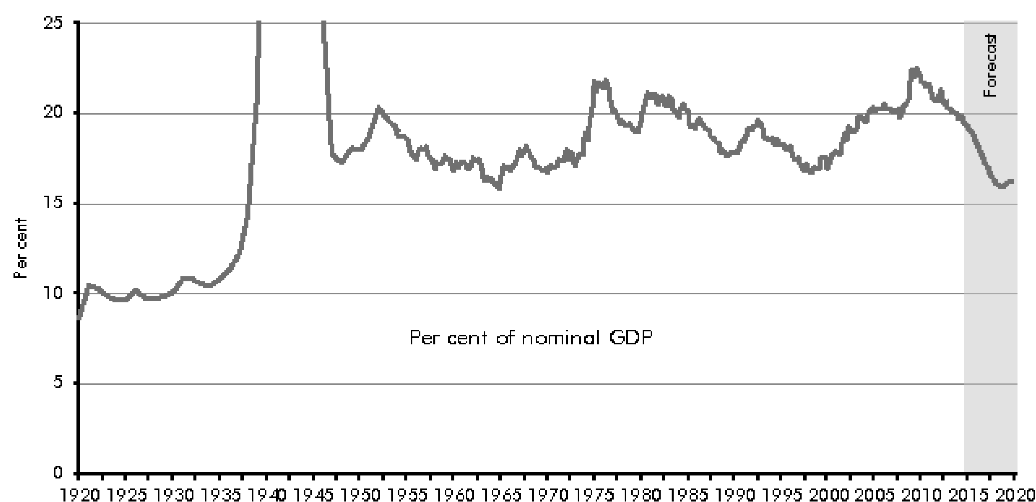
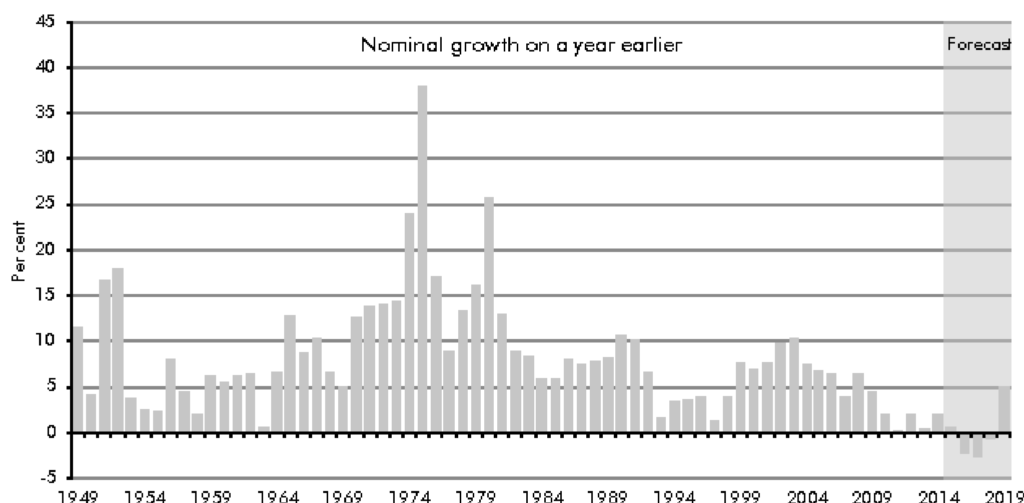
Chart 3.34: Government consumption of goods and services



Note: Government consumption as a share of GDP is estimated to have peaked at 52.2 per cent of GDP in 1944.



Note: Government consumption on a National Accounts basis, excluding Network Rail
Source: ONS, OBR

General government employment

3.100 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, which we proxy using a measure of current government expenditure. We then combine these top-down numbers with our 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 and recent data. Reflecting the uncertain timing of

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employment cuts and wage changes, we simply assume that the profile of government employment will match the profile of government consumption, which largely comprises pay and procurement costs.

3.101 Applying the Government's latest medium-term spending assumptions to our fiscal forecast implies an unusual year-to-year profile for government employment. Overall, our government consumption forecast implies that general government employment will fall by 0.8 million by the first quarter of 2019, making a total fall from early 2011 of 1.1 million, before rising by 150,000 in the final year of the forecast period. This represents an overall 20 per cent fall in headcount, consistent with departmental and local authorities' cash spending remaining broadly flat, and modest annual wage growth. Again, we expect the fall to be more than offset by a 1.7 million rise in market sector employment, making a rise in total employment of 1.1 million by the start of 2020.[14] Even more than usual, we would emphasise the stylised nature of the assumptions underpinning these numbers, which imply sharp falls in general government employment in 2016-17 and 2017-18 but also a rise in 2019-20. If, when detailed spending plans are set by a future Government, any of the simplifying assumptions described above did not hold (as will inevitably be the case) the scale and profile of these reductions would be expected to change.

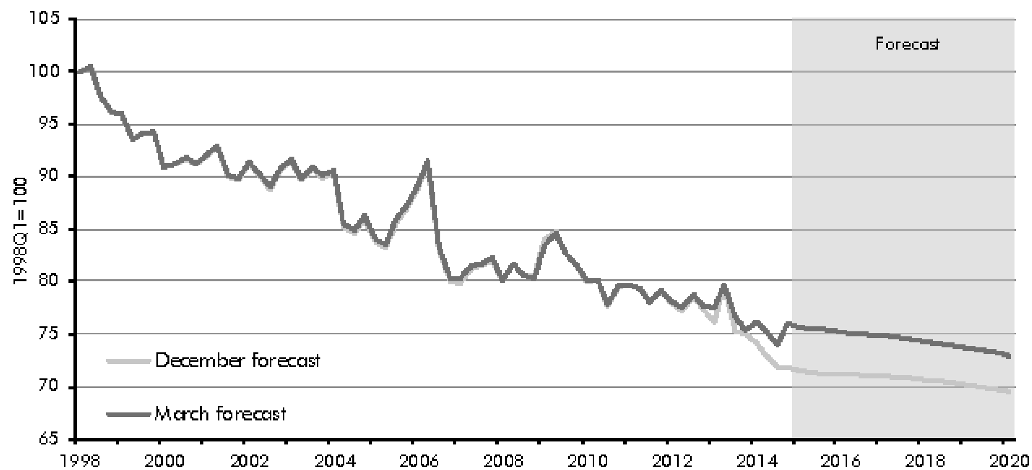
The external sector

Export and import volumes

3.102 The latest ONS data contained upward revisions to export growth in 2014 relative to our December forecast. Strong growth in exports in the fourth quarter of 2014 also means that our forecast for exports has been revised up substantially in 2015. Given that we have lowered our forecast for growth in UK export markets in 2015, this implies a higher export market share (Chart 3.35). Lower expected growth in UK export markets is expected to feed through to lower growth in exports from 2016 onwards, which means that the declining path for the UK export market share is similar to our December forecast.

[14] 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 about the assumptions for public sector wages and employment can be found in the supplementary economy tables available on our website.

Chart 3.35: UK export market share



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

3.103 Outturn data show that imports grew strongly in the fourth quarter of 2014. Revisions to outturn data also suggests that imports growth was stronger over the first three quarters of 2014 than was estimated at the time of our December forecast.

3.104 Our forecast for imports is determined by the outlook for import-weighted domestic demand and a trend rise in the import intensity of that demand. Import-weighted domestic demand has been revised up in 2015, due largely to the boost to real consumer spending from lower oil prices and the data-driven revision to exports growth (which are import intensive).

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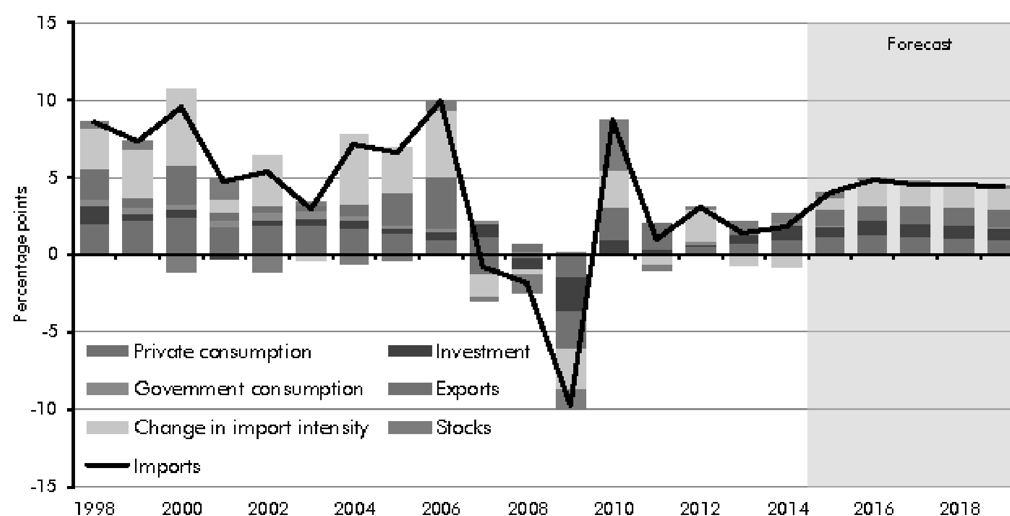
Chart 3.36: Contributions to import-weighted domestic demand and import growth



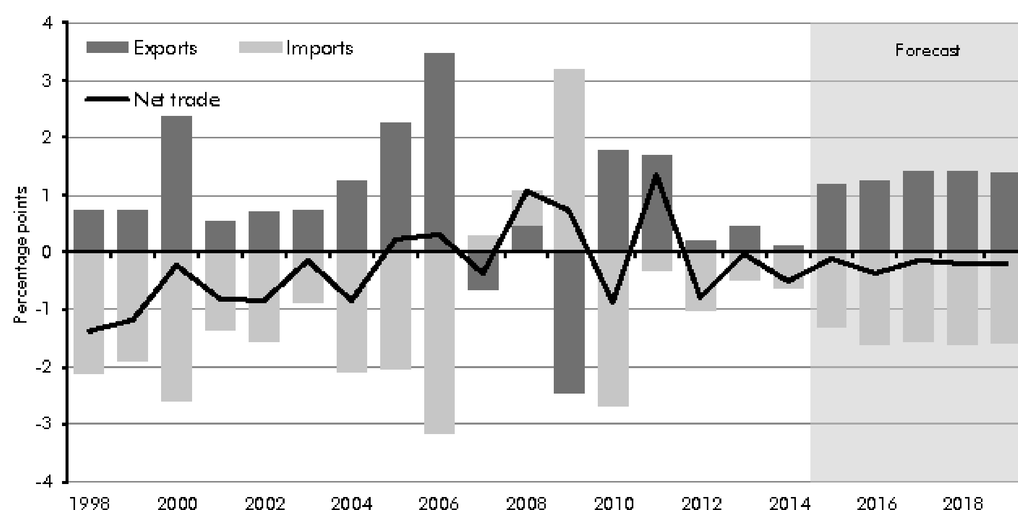
Source: ONS, OBR

The terms of trade and the trade balance

3.105 Since our December forecast, the terms of trade have been revised up slightly in 2014 due to stronger export prices more than offsetting higher import prices. The fall in the oil price boosts the terms of trade slightly in 2015, but it is broadly unchanged thereafter. Compared with our December forecast, we have revised up our forecast for exports growth in 2015, whereas our forecast for imports growth is little changed. Net trade is therefore expected to make a smaller negative contribution to GDP growth in 2015. Thereafter, net trade is expected to make a small negative contribution to annual GDP growth in each year, reflecting the weakness of export market growth, a gradual decline in export market share and a gradual increase in the ratio of imports to import-weighted domestic demand.

3.106 Our trade forecast includes estimates of oil imports and oil exports that are produced in a relatively mechanistic way. In volume terms, oil exports are determined by oil production and the share of North Sea output that is exported, while oil imports are derived from an assumption about the oil intensity of domestic activity and the proportion of North Sea production that is consumed domestically. These volumes are inflated to nominal exports and imports using our oil price assumption. Based on these assumptions, trade in oil subtracts 0.3 percentage points from GDP growth in 2015. This means that the trade deficit widens in 2015, subtracting 0.1 percentage points from GDP growth. Details are available in the supplementary economy tables on our website.

Chart 3.37: Net trade contribution to real GDP



Source: ONS, OBR

The current account balance

3.107 The current account deficit remains wide by historical standards. It increased to around 6 per cent of GDP in the third quarter of 2014, the second largest quarterly deficit in National Accounts data stretching back to 1955. While this in part reflects the ongoing weakness in net trade, much of the recent deterioration reflects a significant worsening of the income balance: the income account deficit widened to 2.7 per cent of GDP in the third quarter of 2014, compared to an average *surplus* of around 1 per cent in the pre-crisis decade. The main source of the deterioration has been weaker rates of return on the UK's assets relative to its liabilities. Box 3.4 discusses recent developments in investment income in more detail.

3.108 We continue to expect the income account to improve gradually over the forecast period. But relative to our December forecast, we now expect a much slower return to typical net rates of return, consistent with the downward revision to our near-term forecast for global growth and movements in global interest rate expectations. The income account forecast remains subject to significant uncertainty, and is based on the assumption that relative rates of return have been temporarily depressed and will normalise as global growth gathers momentum. This has led us to revise our forecast of the current account deficit wider over the forecast period relative to December – by an average of around ½ per cent of GDP between 2014 and 2019.

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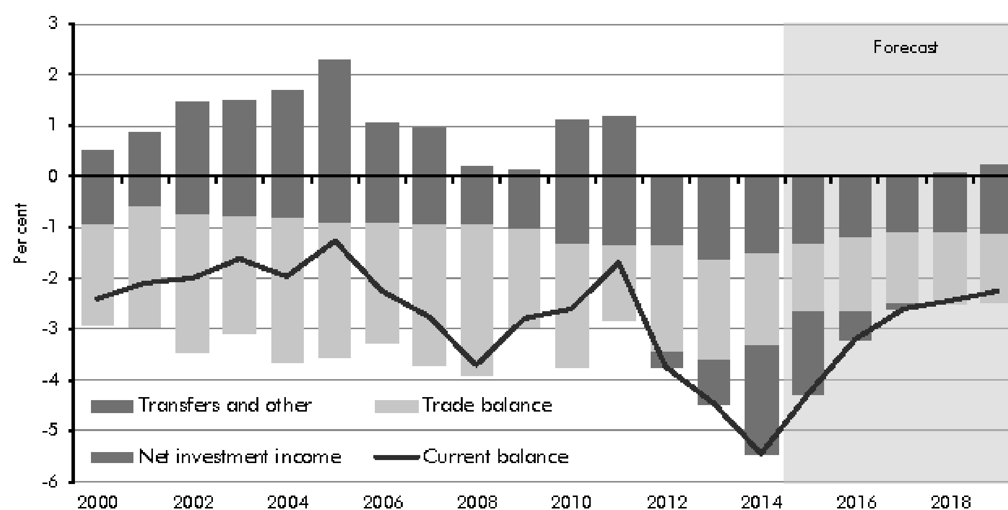
Chart 3.38: Current account balance as a share of GDP



Source: ONS, OBR

Box 3.4: Recent movements in the income balance

We expect the current account deficit in 2014 as a whole to have been 5.4 per cent of GDP. This would be the largest peace-time deficit since at least 1830, based on the Bank of England's historical dataset. [a]

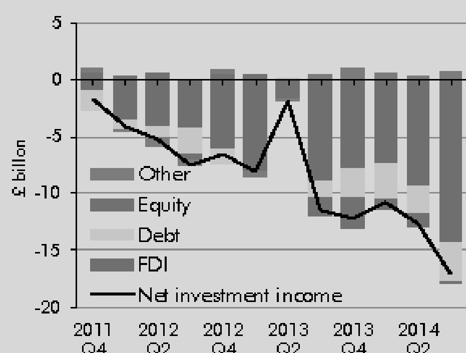
Much of the widening of the deficit in recent years reflects a significant deterioration in the net income earned on cross-border investment. Net investment income – the income earned on the UK's overseas investments, minus the income earned by overseas investors on their UK investments – averaged a surplus of 1.2 per cent of GDP between 2000 and 2008. Since mid-2011, the income balance has deteriorated from a 2.2 per cent of GDP surplus to a 2.7 per cent deficit in the third quarter of 2014.

In assessing changes in the income balance it is useful to decompose net investment income into its four components: net income on foreign direct investment (FDI); net income on debt securities; net income on equity; and net income on other assets. Chart B shows that the deterioration in the net investment income balance since 2011 is largely attributable to the deterioration in net income earned on FDI, with a smaller negative contribution from net income earned on debt securities.

Changes in the net income earned on investments can reflect changes in the stocks of those investments or changes in the net rate of return on them. Since the end of 2011, the stock of FDI assets has fallen while the stock of liabilities has continued to rise. All else equal this will have served to reduce net FDI income. In addition, the net rate of return on FDI has fallen sharply in recent quarters and remains well below pre-crisis levels (Chart C): between 2000 and 2007, the net rate of return on FDI averaged 1.9 percentage points; this compares to an average of 1.6 percentage points since 2012 and 1.2 percentage points so far in 2014.

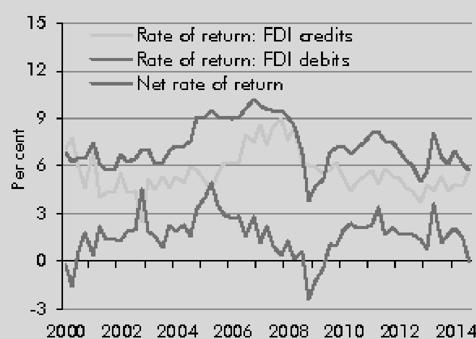
Analysing why the income balance has deteriorated so sharply is complicated both by the volatility of the series and by revisions to early estimates. One possibility is that relatively weak growth in the UK's trading partners – most notably the euro area – has depressed returns on the UK's overseas foreign direct investments relative to overseas foreign direct investment in the UK. Regional analysis of income flows suggests that a large part of the deterioration in FDI earnings can be attributed to lower earnings in Europe – most notably in the information and communications sector.[b] While not verifiable in the published data, it seems likely that the very large cross-border fines and compensation paid by BP and some large banks (to the United States in particular) will also have depressed measured rates of return on those sectors' overseas assets. The deterioration in net income on debt securities may reflect changes in the composition of the debt held by UK residents or issued by UK companies.[c]

Chart B: Change in net investment income since 2011



Note: Change in the level of net investment income relative to its average level in 2011
Source: ONS, OBR

Chart C: Rates of return on foreign direct investment



Note: Annualised earnings as a proportion of the stock of FDI assets/liabilities

[a] Bank of England, *Three centuries of data on the UK economy*, 2010.
[b] ONS, *Economic Review*, February 2015.
[c] Bank of England, *Inflation Report*, May 2014.

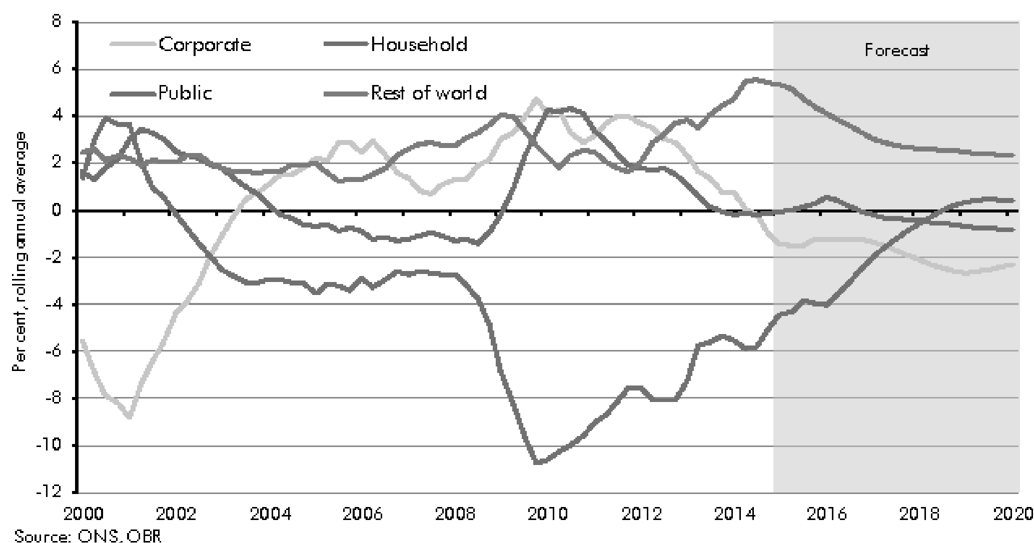
Sectoral net lending

3.109 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 2014, we estimate the public sector to be in deficit, households and companies close to balance, and the rest of the world to be in surplus (Chart 3.39).

3.110 By the end of the forecast period, we expect the public sector's balance to have moved into surplus as the fiscal consolidation continues (see Chapter 4). The household sector provides part of the offsetting change, with household net lending moving from a deficit of -0.1 per cent of GDP in 2014 to a larger deficit of -0.8 per cent of GDP in 2019. The gradual narrowing of the current account deficit over the forecast period means that the external sector also plays a role in offsetting the fiscal consolidation, while the rising share of

business investment in GDP means that corporate sector net lending is also expected to decline over the forecast period.

Chart 3.39: Sectoral net lending



Source: ONS, OBR

Risks and uncertainties

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

3.112 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:

- further instability in euro area economies and banking systems remains a key risk. Recent developments in Greece have once again highlighted concerns about the sustainability of the public finances in the region – particularly in an environment of very low inflation and weak medium-term growth prospects, with a number of euro area countries yet to complete the adjustment toward sustainable growth and competitiveness;

- geopolitical tensions continue to pose risks through trade linkages and financial exposures to affected countries;

- while the UK's main export markets are weighted heavily towards oil-importing countries, the significant fall in the oil price may have adverse implications for the

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outlook if deteriorating prospects for oil producers have significant spillover effects via trade or financial markets;

- domestically, productivity and real wages remain weak and the pick-up we forecast from 2015 is a key judgement. If productivity fails to pick up as predicted, consumer spending and housing investment could falter as the resources to sustain them would be lacking;

- we expect some significant changes in the composition of expenditure associated with the fiscal consolidation and, in particular, with the fact that on current policy so much of that consolidation is delivered through cuts to day-to-day spending on public services that will directly reduce GDP. The scale and speed of the adjustments this switch in spending implies may also represent a risk to the economy evolving in line with our central forecast; and

- strong growth of residential investment and ongoing growth in house prices and property transactions leave households' gross debt to income ratio rising back towards its pre-crisis peak by the forecast horizon. That seems consistent with supportive monetary policy and other interventions (such as Help to Buy and further support for first-time buyers announced in this Budget), but it could pose risks to the sustainability of the recovery over the medium term.

Comparison with external forecasters

3.113 In this section, we compare our latest projections with those of selected outside forecasters. The differences between our forecast and external forecasters are generally small compared with the uncertainty that surrounds them.

3.114 In its February *Economic Review*, the National Institute for Economic and Social Research (NIESR) forecasts GDP growth of 2.9 per cent in 2015, higher than our central forecast. Much of the difference is attributable to NIESR expecting both stronger consumption and investment growth in 2015. The European Commission expects growth of 2.6 per cent in 2015, slightly above our central forecast. The Commission forecasts weaker government consumption growth in 2015, but this is more than offset by stronger forecasts for both private consumption and investment. Global oil prices have fluctuated significantly in the period during which these forecasts were produced. These changes and their assumed impacts on the real economy – both directly via North Sea production and indirectly via changes in real incomes and business input costs – are likely to have been a key reason for differences between the reported forecasts.

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Table 3.4: Comparison with external forecasts

	Per cent					
	2013	2014	2015	2016	2017	2018
OBR (March 2015)						
GDP growth	1.7	2.6	2.5	2.3	2.3	2.3
CPI inflation	2.6	1.5	0.2	1.2	1.7	1.9
Output gap	-2.2	-1.0	-0.4	-0.2	-0.1	0.0
IMF (October 2014)[1]						
GDP growth	1.7	3.2	2.7	2.4	2.4	2.4
CPI inflation	2.6	1.6	1.8	2.0	2.0	2.0
Output gap	-2.7	-1.2	-0.4	-0.3	-0.1	0.0
OECD (November 2014)						
GDP growth	1.7	3.0	2.7	2.5		
CPI inflation	2.6	1.6	1.8	2.1		
Output gap	-1.4	-0.3	0.1	0.0		
European Commission (February 2015)						
GDP growth	1.7	2.6	2.6	2.4		
CPI inflation	2.6	1.5	1.0	1.6		
Output gap	-2.4	-1.1	-0.1	0.6		
NIESR (February 2015)[2]						
GDP growth	1.7	2.6	2.9	2.3	2.3	2.5
CPI inflation	2.6	1.4	0.6	1.6	2.1	2.0
Oxford Economics (February 2015)						
GDP growth	1.7	2.6	2.8	2.7	2.7	2.5
CPI inflation	2.6	1.5	-0.1	1.8	1.9	1.9
Output gap	-4.1	-4.3	-3.7	-3.4	-3.2	-3.1
Bank of England (February 2015)[2,3]						
GDP growth (mode)[4]		3.1	2.9	2.9	2.7	
CPI inflation (mode)		0.9	0.5	1.8	2.1	

[1] The IMF updated its short-term forecasts in the January 2015 *World economic outlook* update. For the UK, it revised GDP growth down to 2.6 per cent in 2014 reflecting latest data, but left its forecasts for 2015 and 2016 at 2.7 per cent and 2.4 per cent.

[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.

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

3.115 Alongside its February 2015 *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.

3.116 The table shows that the Bank's modal expectation for household consumption growth and business investment growth are somewhat stronger than our forecast in 2015 and 2016, helping to explain the Bank's stronger GDP growth forecast relative to our central forecast.

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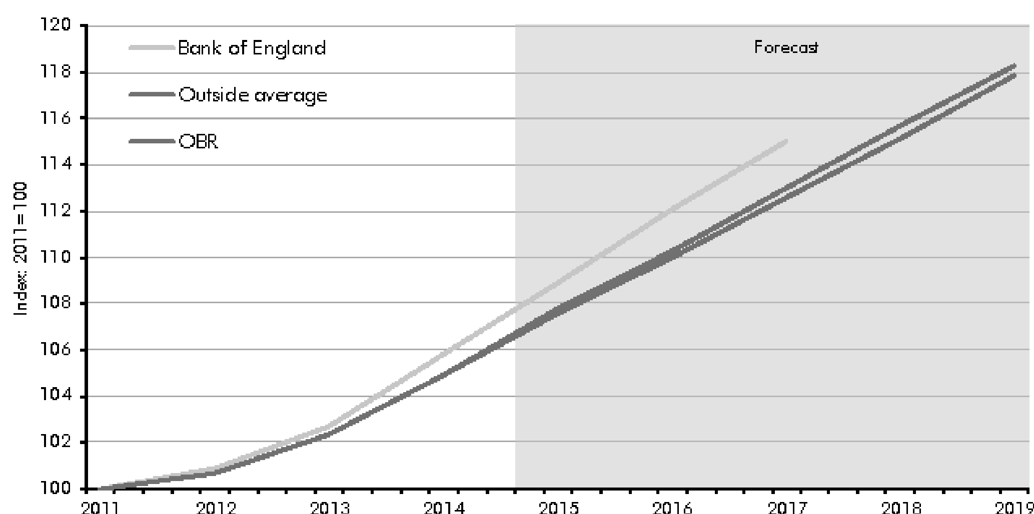
Chart 3.40: Comparison of forecasts for the level of GDP



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

Table 3.5: Comparison with the Bank of England's illustrative projections

	Per cent			
	2014[1]	2015	2016	2017
Bank of England February *Inflation Report* forecast				
Household consumption	2¼	3¾	3½	2½
Business investment	7	6¼	8½	9
Housing investment[2,3]	11¼	2	6¼	5¾
Exports	-¾	3¼	5½	4½
Imports	¾	2	6¼	5
Employment[4]	2	1½	1	¾
Average weekly earnings[3,4]	1¾	3½	4	4
Difference from OBR forecast				
Household consumption	0.2	1.2	0.8	0.0
Business investment	0.2	1.1	1.0	2.5
Exports	-1.1	-0.7	1.5	0.0
Imports	-1.1	-2.0	1.5	0.4
Employment[4]	0.0	0.3	0.4	0.3

[1] 2014 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.

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Table 3.6: Detailed summary of forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
UK economy							
Gross domestic product (GDP)	1.7	2.6	2.5	2.3	2.3	2.3	2.4
GDP level (2013=100)	100.0	102.6	105.1	107.6	110.1	112.7	115.3
Nominal GDP	3.5	4.4	4.1	3.5	3.8	4.3	5.0
Output gap (per cent of potential output)	-2.2	-1.0	-0.4	-0.2	-0.1	0.0	0.0
Expenditure components of GDP							
Domestic demand	1.8	2.9	2.6	2.6	2.4	2.5	2.5
Household consumption[1]	1.7	2.0	2.6	2.7	2.5	2.3	2.2
General government consumption	-0.3	1.5	0.8	-0.7	-0.9	-0.2	1.5
Fixed investment	3.4	6.8	4.3	6.2	5.6	5.7	4.4
Business	5.3	6.8	5.1	7.5	6.5	6.4	4.4
General government[2]	-8.1	7.3	2.3	1.9	1.6	1.5	2.8
Private dwellings[2]	6.2	6.6	3.5	5.4	5.5	6.2	5.2
Change in inventories[3]	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Exports of goods and services	1.5	0.4	3.9	4.0	4.5	4.4	4.3
Imports of goods and services	1.4	1.8	4.0	4.8	4.6	4.6	4.4
Balance of payments current account							
Per cent of GDP	-4.5	-5.4	-4.3	-3.2	-2.6	-2.4	-2.3
Inflation							
CPI	2.6	1.5	0.2	1.2	1.7	1.9	2.0
RPI	3.0	2.4	1.0	2.1	2.8	3.1	3.1
GDP deflator at market prices	1.8	1.8	1.6	1.1	1.5	1.9	2.5
Labour market							
Employment (millions)	30.0	30.7	31.1	31.4	31.5	31.7	31.9
Productivity per hour	-0.1	0.1	0.9	2.1	2.5	2.5	2.4
Wages and salaries	2.9	3.8	4.0	3.9	4.1	4.5	4.9
Average earnings[4]	1.6	2.2	2.3	3.1	3.7	4.0	4.4
LFS unemployment (% rate)	7.6	6.2	5.3	5.2	5.3	5.3	5.3
Claimant count (millions)	1.42	1.04	0.77	0.74	0.76	0.77	0.77
Household sector							
Real household disposable income	0.1	1.4	3.7	2.1	2.2	2.1	2.0
Saving ratio (level, per cent)	6.4	6.7	7.4	7.3	7.2	7.2	7.2
House prices	3.5	10.0	5.9	4.9	6.4	6.9	6.4
World economy							
World GDP at purchasing power parity	3.3	3.3	3.5	3.6	3.9	4.0	4.0
Euro area GDP	-0.4	0.9	1.2	1.4	1.6	1.6	1.6
World trade in goods and services	3.4	3.1	4.0	4.9	5.3	5.4	5.4
UK export markets[5]	2.5	3.1	3.7	4.7	5.1	5.2	5.2

[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 the forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2013	2014	2015	2016	2017	2018	2019
UK economy							
Gross domestic product (GDP)	-0.1	-0.5	0.1	0.2	-0.1	0.0	0.0
GDP level (2013=100)[1]	0.0	-0.4	-0.4	-0.2	-0.3	-0.2	-0.2
Nominal GDP	0.0	-0.7	0.1	-0.1	-0.2	0.1	0.6
Output gap (per cent of potential output)	0.0	0.0	0.1	0.3	0.2	0.1	0.0
Expenditure components of GDP							
Domestic demand	-0.2	-0.3	-0.3	0.4	0.0	0.1	0.0
Household consumption[2]	0.1	-0.3	-0.2	0.6	0.1	0.0	-0.2
General government consumption	-1.0	0.5	1.2	0.0	0.0	0.1	1.5
Fixed investment	0.2	-1.3	-4.0	0.3	0.0	0.6	-0.4
Business	0.5	-1.0	-3.3	1.2	0.2	0.1	-1.9
General government[3]	-0.9	5.2	-1.0	0.3	-0.5	-0.1	0.6
Private dwellings[3]	0.2	-6.4	-7.5	-1.6	-0.1	2.2	2.8
Change in inventories[4]	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Exports of goods and services	0.9	1.9	1.5	-0.7	-0.4	-0.3	-0.1
Imports of goods and services	0.9	2.7	0.0	0.1	-0.2	-0.2	-0.1
Balance of payments current account							
Per cent of GDP	-0.2	-0.8	-0.8	-0.3	-0.1	-0.2	-0.3
Inflation							
CPI	0.0	-0.1	-0.9	-0.5	-0.3	-0.1	0.0
RPI	0.0	0.0	-1.1	-0.8	-0.5	-0.5	-0.4
GDP deflator at market prices	0.0	-0.2	0.0	-0.2	-0.1	0.1	0.6
Labour market							
Employment (millions)	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Productivity per hour	-0.1	-0.4	-0.4	0.2	0.1	0.2	0.0
Wages and salaries	-0.2	0.4	0.3	0.1	-0.1	0.2	0.7
Average earnings[5]	-0.2	0.4	0.3	0.0	-0.2	0.0	0.5
LFS unemployment (% rate)	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0
Claimant count (millions)	0.00	0.00	-0.08	-0.09	-0.08	-0.08	-0.08
Household sector							
Real household disposable income	0.4	-0.8	1.8	0.4	0.4	0.1	-0.1
Saving ratio (level, per cent)	0.0	0.1	2.0	1.8	2.1	2.3	2.4
House prices	0.0	-0.2	-1.5	-1.0	0.6	1.8	2.6
World economy							
World GDP at purchasing power parity	0.0	0.1	-0.3	-0.4	-0.1	0.0	0.0
Euro area GDP	0.0	0.1	0.0	-0.2	-0.1	0.0	0.0
World trade in goods and services	0.3	-0.7	-1.1	-0.5	-0.3	-0.2	-0.2
UK export markets[6]	0.2	-0.6	-0.6	-0.3	-0.2	-0.1	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.