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COVER NOTE

From:	Ivan Rogers, Permanent Representative, UK Representation to the EU
date of receipt:	15 October 2015
To:	Mr Carsten PILLATH, Director General, Council of the European Union
Subject:	United Kingdom: Report on Effective Action, as laid down in Article 3(4a) of Council Regulation (EC) 1467/97 on action taken by United Kingdom in response to the Council's recommendation under Article 126(7) TFEU.

Delegations will find attached the second part of the addendum to the Report on Effective Action, as laid down in Article 3(4a) of Council Regulation (EC) 1467/97 on action taken by United Kingdom in response to the Council's recommendation under Article 126(7) TFEU.

Public sector expenditure

Definitions and approach

4.73 This section explains our central forecast for public sector expenditure, which is based on the National Accounts aggregates for public sector current expenditure (PSCE), public sector gross investment (PSGI), and total managed expenditure (TME), which is the sum of PSCE and PSGI. In our forecast, we combine these National Accounts aggregates with the two administrative aggregates used by the Treasury to manage public spending:

- departmental expenditure limits (DELs)[4] – mostly spending on public services, grants, administration and capital investment, which can be planned over extended periods. Our fiscal forecast therefore shows PSCE in resource DEL and PSGI in capital DEL. These are described simply as RDEL and CDEL in the chapter; and

- annually managed expenditure (AME) – categories of spending less amenable to multi-year planning, such as social security spending and debt interest. Again, our fiscal forecast shows PSCE in current AME and PSGI in capital AME.

Summary of the expenditure forecast

4.74 Table 4.12 summarises our latest forecast for public spending. TME is expressed as a share of GDP, but not all of TME contributes directly to GDP – as benefit payments, debt interest and other cash transfers merely transfer income from some individuals to others. The table also shows how TME is split between DEL and AME, and the main components of each.

4.75 The table shows that total spending is forecast to fall by 4.4 per cent of GDP between 2014-15 and 2019-20 (over the current Parliament) and to remain flat as a share of GDP in 2020-21. This decline is more than explained by:

- RDEL spending falling by 3.1 per cent of GDP, having already fallen by 3.3 per cent of GDP in the five years up to 2014-15 (the previous Parliament). We consider these trends in more detail in the DELs section of this chapter; and

- welfare spending falling by an expected 1.8 per cent of GDP, with the majority of that fall reflecting items that are subject to the welfare cap (in other words excluding the state pension and those benefit payments linked most closely to the ups and downs of the economy). In general, welfare cap spending is expected to fall as a share of GDP as the generosity of benefits rises by less than average earnings and some working-age benefits are frozen for four years. Spending outside the welfare cap falls only slightly as a share of GDP, with that fall due to increases in the state pension age that reduce the caseload as a share of the adult population. The welfare spending cuts

[4] Our presentation of expenditure only shows those components of RDEL, CDEL and AME that are included in the fiscal aggregates of PSCE and PSGI. For budgeting purposes, the Treasury also includes other components in DEL and AME such as non-cash items.

announced in the Budget are sufficient to push total expected welfare spending on this measure to less than 10 per cent of GDP for the first time in thirty years[5].

4.76 Partially offsetting these declines:

- debt interest spending rises by 0.6 per cent of GDP by 2019-20, as higher interest rates more than offset the effect of net debt falling as a share of GDP; and
- there is a small rise in the net cost of public service pensions, as the continued decline in the public sector workforce (implied by cuts in RDEL) reduces contributions immediately but does not reduce payments until much later.

Table 4.12: TME split between DEL and AME

	Per cent of GDP						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
TME	40.7	39.6	38.7	37.8	37.0	36.3	36.3
of which:							
TME in DEL[1]	19.6	18.8	18.2	17.4	16.9	16.5	16.8
of which:							
PSCE in RDEL	17.5	16.8	16.4	15.6	14.9	14.5	14.8
PSGI in CDEL	2.1	1.9	1.9	1.8	2.0	2.0	2.0
TME in AME[1]	21.0	20.9	20.5	20.4	20.1	19.8	19.5
of which:							
Welfare spending	11.8	11.6	11.0	10.7	10.3	10.0	9.8
Debt interest net of APF	1.8	1.8	2.1	2.3	2.4	2.4	2.3
Locally-financed current expenditure	1.9	2.1	2.1	2.1	2.1	2.0	2.0
Net public service pension payments	0.7	0.6	0.6	0.6	0.7	0.7	0.7
Other PSCE in AME	3.1	3.1	3.1	3.1	3.1	3.2	3.2
PSGI in AME	1.6	1.7	1.7	1.6	1.4	1.4	1.4

[1] In relation to table 4.13, TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME, and TME in AME is defined as PSCE in AME plus PSGI in AME minus single use military equipment (SUME).

4.77 Tables 4.13 and 4.14 detail our latest spending forecast and the changes since March.

[5] See our 2014 Welfare trends report for a detail discussion of historical trends in welfare spending on this measure.

Table 4.13: Total managed expenditure

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Public sector current expenditure (PSCE)							
PSCE in RDEL[1]	317.4	315.1	318.8	316.7	316.2	320.3	345.1
PSCE in AME	351.2	360.1	366.9	381.7	395.2	408.1	419.7
of which:							
Welfare spending	214.3	216.9	213.8	216.5	219.4	222.2	227.3
of which:							
Inside welfare cap	119.1	120.6	115.2	114.6	114.0	113.5	114.9
Outside welfare cap	95.1	96.4	98.6	101.8	105.4	108.7	112.4
Company and other tax credits	2.0	2.2	2.4	2.5	2.5	2.6	2.6
Net public service pension payments	12.1	11.1	11.5	12.9	14.5	16.0	16.1
National lottery current grants	1.4	1.4	1.4	1.4	1.5	1.5	1.5
BBC current expenditure	3.9	3.9	3.8	3.8	3.7	3.6	3.5
Network Rail other current expenditure[2]	1.1	1.3	0.8	0.5	-0.1	-0.1	-0.1
Other PSCE items in departmental AME	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Expenditure transfers to EU institutions	10.4	11.3	10.4	9.5	10.8	11.3	11.7
Locally-financed current expenditure	35.2	38.5	40.2	42.1	43.7	45.1	46.4
Central government debt interest, net of APF	33.0	34.6	40.8	47.7	50.7	53.2	54.3
of which:							
Central government gross debt interest	45.4	46.7	51.1	55.9	57.2	58.5	58.6
Reductions in debt interest due to APF	-12.4	-12.1	-10.3	-8.3	-6.5	-5.3	-4.3
Depreciation	27.2	29.5	31.0	32.6	34.2	35.9	37.8
Current VAT refunds	11.5	11.5	11.6	11.5	11.3	11.4	12.2
R&D expenditure	-7.5	-8.2	-8.2	-8.1	-8.1	-8.2	-8.9
Single use military expenditure	0.3	0.2	0.2	0.2	0.2	0.2	0.3
Environmental levies	3.2	5.7	7.3	8.5	10.7	13.2	14.9
Local authority imputed pensions	1.8	1.8	1.9	2.0	2.1	2.3	2.4
Other National Accounts adjustments	-0.1	-2.9	-3.0	-3.1	-3.2	-3.3	-3.4
Total public sector current expenditure	668.6	675.2	685.7	698.4	711.4	728.5	764.8
Public sector gross investment (PSGI)							
PSGI in CDEL[1]	37.5	36.1	36.2	37.0	42.2	44.5	46.6
PSGI in AME	29.4	31.0	32.3	32.7	30.7	31.4	33.1
of which:							
National lottery capital grants	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Network Rail capital expenditure	6.0	7.0	6.3	6.0	4.8	5.0	5.3
Other PSGI items in departmental AME	0.4	0.3	1.3	1.7	2.2	2.6	3.3
Locally-financed capital expenditure	7.9	7.0	7.8	8.2	6.5	6.5	6.5
Public corporations capital expenditure	8.5	7.4	7.7	7.7	7.7	7.5	7.6
R&D expenditure	7.5	8.2	8.2	8.1	8.1	8.2	8.9
Other National Accounts adjustments	-1.4	0.7	0.6	0.4	0.8	0.9	0.9
Total public sector gross investment	66.9	67.1	68.6	69.6	72.9	75.9	79.7
Less depreciation	-36.0	-38.4	-40.1	-41.9	-43.6	-45.5	-47.6
Public sector net investment	30.9	28.6	28.4	27.8	29.2	30.4	32.1
Total managed expenditure	735.5	742.3	754.3	768.0	784.3	804.4	844.5

[1] Implied DEL numbers for 2016-17 to 2020-21. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

[2] Other than debt interest and depreciation, which are included in totals shown separately in this table.

Table 4.14: Changes to total managed expenditure since March

	£ billion					
	Estimate	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector current expenditure (PSCE)						
PSCE in RDEL[1]	0.9	-1.3	17.2	27.0	28.3	12.1
PSCE in AME	-1.6	2.2	-2.3	-2.0	-2.5	-3.7
of which:						
Welfare spending	-0.2	0.0	-5.7	-7.1	-9.9	-12.9
of which:						
Inside welfare cap	-0.2	0.0	-5.7	-7.2	-10.1	-13.1
Outside welfare cap	0.0	0.1	0.0	0.1	0.2	0.1
Company and other tax credits	-0.1	-0.1	-0.2	-0.2	-0.2	-0.3
Net public service pension payments	-0.3	0.1	0.3	1.0	1.8	2.2
National lottery current grants	0.1	0.1	0.1	0.1	0.1	0.1
BBC current expenditure	0.0	0.0	0.1	0.2	0.0	-0.2
Network Rail other current expenditure[2]	0.2	0.3	0.1	0.1	0.2	0.2
Other PSCE items in departmental AME	0.0	0.1	-0.1	0.0	-0.1	-0.1
Expenditure transfers to EU institutions	-0.6	0.2	0.9	0.0	0.3	0.3
Locally-financed current expenditure	-0.5	0.9	0.2	0.2	0.1	0.1
Central government debt interest, net of APF	-0.6	0.9	0.5	1.1	1.7	2.1
of which:						
Central government gross debt interest	-0.3	0.7	0.4	0.7	1.0	1.2
Reductions in debt interest due to APF	-0.3	0.2	0.1	0.4	0.7	0.9
Depreciation	-1.3	-0.4	-0.2	-0.2	-0.1	-0.1
Current VAT refunds	-0.2	-0.2	0.7	1.0	0.9	0.3
R&D expenditure	0.2	0.0	0.2	0.6	1.1	1.4
Single use military expenditure	0.0	0.0	0.0	0.0	0.0	0.0
Environmental levies	-1.2	0.1	0.6	0.9	1.4	2.9
Local authority imputed pensions	-0.1	-0.2	-0.2	-0.2	-0.1	-0.1
Other National Accounts adjustments	3.1	0.4	0.4	0.5	0.5	0.5
Total public sector current expenditure	-0.7	0.9	14.8	24.9	25.8	8.4
Public sector gross investment (PSGI)						
PSGI in CDEL[1,3]	-0.5	-1.8	-1.8	-2.1	-0.8	-1.6
PSGI in AME[3]	-0.4	0.6	0.9	1.3	0.1	0.3
of which:						
National lottery capital grants	0.0	0.0	0.0	0.0	0.0	0.0
Network Rail capital expenditure[3]	-0.4	0.6	0.4	0.1	-1.1	-0.6
Other PSGI items in departmental AME	-0.2	0.4	0.9	1.1	1.3	1.7
Locally-financed capital expenditure	0.8	0.0	-0.3	0.5	0.4	0.5
Public corporations capital expenditure	0.8	-0.5	-0.1	-0.1	0.0	-0.1
R&D expenditure	-0.2	0.0	-0.2	-0.6	-1.1	-1.4
Other National Accounts adjustments	-1.1	0.1	0.2	0.4	0.4	0.4
Total public sector gross investment	-0.9	-1.3	-0.8	-0.9	-0.8	-1.3
Less depreciation	1.3	0.4	0.1	0.0	0.0	0.0
Public sector net investment	0.4	-0.9	-0.7	-0.8	-0.7	-1.3
Total managed expenditure	-1.6	-0.3	14.0	24.1	25.1	7.1

[1] Implied DEL numbers for 2016-17 to 2020-21. Calculated as the difference between PSCE and PSCE in AME in the case of PSCE in RDEL, and between PSGI and PSGI in AME in the case of PSGI in CDEL.

[2] Other than debt interest and depreciation, which are included in totals shown separately in this table.

[3] Changes exclude reclassification of central governmnet capital grants to Network Rail from PSGI in CDEL to PSGI in AME, as discussed in note 1 of Table 4.17.

4.78 Table 4.15 summarises the sources of changes to our forecast since March. It shows that:

- economy-driven changes to the forecast add between £0.1 billion and £3.2 billion to our forecast, with higher interest rates in 2018-19 and 2019-20 driving the increase as they raise debt interest payments;
- other notable increases in our expenditure forecast have resulted from a change in methodology to our public service pensions forecast, increased spending on environmental levies (most of which are neutral for borrowing) and tax litigation being moved from negative tax to capital AME spending (as discussed above);
- the direct effect of Government decisions to reduce AME spending through the scorecard and to increase departmental spending significantly relative to the amounts penciled in by the Coalition in March has been to add between £9.8 billion and £17.8 billion to total spending between 2016-17 and 2018-19. There are small takeaways in 2015-16 and 2019-20 as a direct result of these decisions; and
- the indirect effects of Government decisions has been to reduce spending in all years from 2016-17 onwards. That reflects lower net public service pension costs (due to smaller falls in the workforce making contributions to the schemes, as departmental spending is boosted), lower debt interest (as further asset sales are sufficient to reduce gilt issuance) and the small net effects of the Living Wage Premium described in Annex B.

Table 4.15: Sources of changes to the spending forecast since March

	£ billion				
March forecast	742.6	740.3	743.9	759.2	797.3
July forecast	742.3	754.3	768.0	784.3	804.4
Changes	-0.3	14.0	24.1	25.1	7.1
	Forecast changes				
Forecast changes since March	2.0	5.1	7.5	8.9	10.5
of which:					
Economic determinants	-0.2	-0.3	-0.3	0.1	0.2
Inflation	-0.3	-0.5	-0.6	-0.5	-0.5
Unemployment	0.1	0.0	0.0	0.1	0.1
Other determinants	0.1	0.3	0.3	0.6	0.6
Market assumptions: interest rates	0.6	0.4	1.4	2.3	3.0
Other assumptions and changes	1.5	4.9	6.4	6.5	7.3
Pensions changes excluding indirect effects of Government decisions	0.1	1.5	2.9	3.8	3.1
Environmental levies	0.1	0.6	0.9	1.4	2.9
Network Rail capital spending forecast changes[1]	-0.4	0.6	0.4	0.1	-1.1
Expenditure transfers to EU institutions	0.2	0.9	0.0	0.3	0.3
Locally-financed current expenditure	0.9	0.2	0.2	0.1	0.1
Locally-financed and public corporations capital expenditure	-0.5	-0.4	0.4	0.5	0.4
Tax litigation moved from negative tax to capital AME	0.5	0.8	1.0	1.3	1.6
Other debt interest changes excluding indirect effects of Government decisions	0.3	0.2	0.1	0.4	-0.1
Other	0.3	0.7	0.4	-1.3	0.2
	Effect of Government decisions				
Total effect of Government decisions	-2.3	8.9	16.6	16.2	-3.4
of which:					
AME scorecard measures	-0.2	-5.6	-7.1	-9.8	-12.9
RDEL changes	-1.3	17.2	27.0	28.3	12.1
CDEL changes[1]	-1.0	-1.8	-2.1	-0.8	-1.6
Indirect effects of Government decisions	0.2	-0.9	-1.2	-1.5	-1.0

[1] CDEL and capital AME changes have been adjusted to exclude the £0.9 billion switch from CDEL to capital AME in 2015-16 as a result of the GAD Milne case, and to exclude the switch from CDEL to capital AME that reflects the reclassification of government grants to Network Rail in our forecast, which is explained in note 1 of Table 4.17.

Departmental expenditure limits (DELs)

DEL plans in 2014-15 and 2015-16

4.79 In the most recent Spending Round in 2013, the previous Coalition Government set out detailed departmental plans for RDEL and CDEL for 2015-16. These have been adjusted subsequently to reflect classification and policy changes, including the in-year cuts package announced in June. Notwithstanding such changes, in aggregate departments almost always underspend even the most recently announced limits. Our forecasts for RDEL and

CDEL spending take this into account, drawing on the latest information from the Treasury and departments, plus recent outturns and the lessons of past experience

4.80 Table 4.16 shows our latest estimates of RDEL and CDEL spending for 2014-15 and our forecasts for 2015-16, and the changes in them since March.

4.81 In 2014-15, the changes since March reflect departments' provisional estimates of outturns, which were provided to the Treasury in May. These remain subject to change. DEL and AME outturns will be updated in the Treasury's next release of public spending statistics on 16 July. Those estimates should reflect the final outturns in most departments' accounts.

4.82 In 2015-16, the final year covered by detailed Spending Review plans, the changes to our forecast since March include:

- changes to departments' DELs that were announced as part of the package of in-year spending cuts in June;
- changes in Main Estimates, which include a £0.2 billion switch from capital to resource DEL for Health and changes to Northern Ireland RDEL (consistent with the 2014 Stormont House Agreement);
- a classification change that removes the payment of capital grants to Network Rail from both CDEL and capital AME. This reduces CDEL by £4.0 billion in 2015-16 and increases Network Rail spending in capital AME by the same amount. We have removed these grants from our spending figures because, as Network Rail is now classified as part of central government, they are treated as intra-government transfers and are not included in any measure of spending in the National Accounts; and
- increases to our net underspend assumptions, reducing forecast spending against plans. These changes reflect the remaining reductions in reserve pressures that were included in the package of in-year spending cuts, plus other reductions in reserve pressures that the Treasury has informed us about separately. (For example, the Official Development Assistance target of spending 0.7 per cent of GNI on ODA will be defined on the old ESA95 National Accounts measure of GNI, which reduces the cash spending required to meet the target).

4.83 We now assume that departments will underspend against their final plans for 2015-16 by £1 billion on RDEL and £2 billion on CDEL. These are £0.4 billion larger for RDEL and £1.5 billion larger for CDEL than the underspends we forecast in March. The increased underspend for capital reflects reduced pressure on reserves, thanks to:

- a £650 million reduction in departments' CDEL Budget Exchange, as part of the in-year spending cuts. This reduces the level of additional spending brought forward into the year from previous underspends; and

- a switch of £0.9 billion of payments in respect of outstanding legal claims in connection with underpayment of past pension lump sums (described in paragraph 4.111) from a pressure on the CDEL reserve to capital AME.

4.84 Table 4.16 also shows how we have split the reductions in our forecast for DEL spending in 2015-16 between changes to our forecast (thanks to classification changes) and the results of Government decisions:

- for RDEL, the £1.3 billion downward revision has been classified entirely as a policy change. That matches the reductions that the Treasury has included in Main Estimates and for the in-year cuts presented on the Budget scorecard, though it has been calculated in a different way; and

- for CDEL, the £1.8 billion downward revision comprises £0.9 billion of forecast changes (mainly the reclassification of the legal settlement payments described above as capital AME) and a £1.0 billion policy change.

Table 4.16: Changes to DEL in 2014-15 and 2015-16 since March

	£ billion			
	PSCE in RDEL		PSGI in CDEL	
	Estimate 2014-15	Forecast 2015-16	Estimate 2014-15	Forecast 2015-16
March forecast[1]	316.5	316.4	37.9	37.9
July forecast	317.4	315.1	37.5	36.1
Change	0.9	-1.3	-0.5	-1.8
of which:				
Estimated outturn	0.9	-	-0.5	-
Change in net underspend assumption[2]		-0.4		-1.5
Main Estimates	-	0.1	-	-0.2
Announced changes to DEL plans (in-year savings)	-	-1.1	-	-0.2
Other policy changes on Treasury scorecard	-	0.2	-	0.1
Forecast changes and effect of Government decisions				
Forecast changes	0.9	-	-0.5	-0.9
Effect of Government decisions	-	-1.3	-	-1.0
of which:				
Main Estimates	-	0.1	-	-0.2
Scorecard: in-year savings	-	-1.5	-	-1.1
Scorecard: other	-	0.2	-	0.1
Other	-	-	-	0.2
Changes in DEL underspends, net and gross of Budget Exchange				
Net underspend in March	-2.3	-0.6	-1.2	-0.5
of which:				
Budget Exchange[2]	2.2	0.5	1.0	1.2
Gross underspend	-4.5	-1.1	-2.2	-1.7
Net underspend in July	-1.4	-1.0	-1.7	-2.0
of which:				
Budget Exchange[2]	2.2	0.5	1.0	0.6
Gross underspend	-3.6	-1.5	-2.7	-2.6

[1] The March forecast figures for CDEL have been adjusted to include a classification change as described in note 1 of Table 4.17.

[2] Increase in underspend shown as negative, reducing DELs. Underspends are measured net of Budget Exchange. Budget Exchange increases departments spending plans.

DELs from 2016-17 onwards

4.85 To produce our economic and fiscal forecasts, we also need to know what the Government intends to spend on DELs beyond the period for which it has detailed plans. To that end we ask the Government what it wishes us to assume that it will spend, conscious that these assumptions will be more tentative than the firm plans set out in Spending Reviews.

4.86 For this forecast, the Government has confirmed that it wants us to assume the RDEL and CDEL figures shown in Table 4.17. And we assume that they will be fully spent.

4.87 The Government has chosen to provide us with a specified path for TME from 2016-17 to 2020-21, from which our AME forecasts can be subtracted to deliver an implied path for DELs. But as the Government knows what our AME forecasts will be when it finalises the path for TME, this remains a roundabout way of presenting its RDEL and CDEL choices.

Over the course of the last Parliament, the Coalition chose to specify the path of TME using an increasingly complex policy assumption. A compilation of the assumptions that applied between March 2011 and March 2015 – and the DEL forecasts that resulted – is available on our website.[6]

Table 4.17: RDEL and CDEL spending and changes since March

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
PSCE in RDEL							
March forecast	316.5	316.4	301.6	289.7	287.9	308.2	
July forecast	317.4	315.1	318.8	316.7	316.2	320.3	345.1
Change	0.9	-1.3	17.2	27.0	28.3	12.1	
PSGI in CDEL[1]							
March forecast[1]	37.9	37.9	38.0	39.1	43.0	46.2	
July forecast[1,2]	37.5	36.1	36.2	37.0	42.2	44.5	46.6
Change[2]	-0.5	-1.8	-1.8	-2.1	-0.8	-1.6	
	Per cent of GDP						
PSCE in RDEL							
March forecast	17.5	16.9	15.5	14.3	13.6	13.9	
July forecast	17.5	16.8	16.4	15.6	14.9	14.5	14.8
Change	0.1	0.0	0.8	1.3	1.3	0.6	
PSGI in CDEL[1]							
March forecast[1]	2.1	2.0	2.0	1.9	2.0	2.1	
July forecast[1]	2.1	1.9	1.9	1.8	2.0	2.0	2.0
Change	0.0	-0.1	-0.1	-0.1	0.0	-0.1	

[1] CDEL figures for both March and July reflect the classification change in this EFO that removes central government capital grants to Network Rail from CDEL, and removes the corresponding receipt of these grants from Network Rail capital spending in PSGI in AME. The grants have been removed because they are transfers within central government, which are not included in the National Accounts. The changes reduce PSGI in CDEL and increase PSGI in AME with an offsetting effect. The capital grants that have been removed are as follows: 4.2 4.0 4.4 4.5 4.1 4.3 4.5

[2] The reduction in CDEL in 2015-16 includes £0.9 billion that has been switched to capital AME reflecting the outcome of the GAD Milne case.

4.88 The changes in the RDEL and CDEL assumptions since March shown in Table 4.17 take account of any classification changes that narrow or broaden the scope of DEL spending, so that the comparison is on a like-for-like basis. In this forecast, we have restated March CDEL to be consistent with the updated treatment of grants from central government to Network Rail. As the reclassification of Network Rail to central government means these are now intra-central government transfers, they have been removed from CDEL. That reduces CDEL and increases capital AME (due to the Network Rail capital spending that they finance) by equal amounts that average around £4 billion a year.

4.89 We treat the like-for-like changes in RDEL and CDEL as policy changes, alongside other tax and spending measures, in explaining how our spending projections and fiscal projections more broadly have moved since past forecasts (e.g. in Tables 4.15 and 4.16). These policy

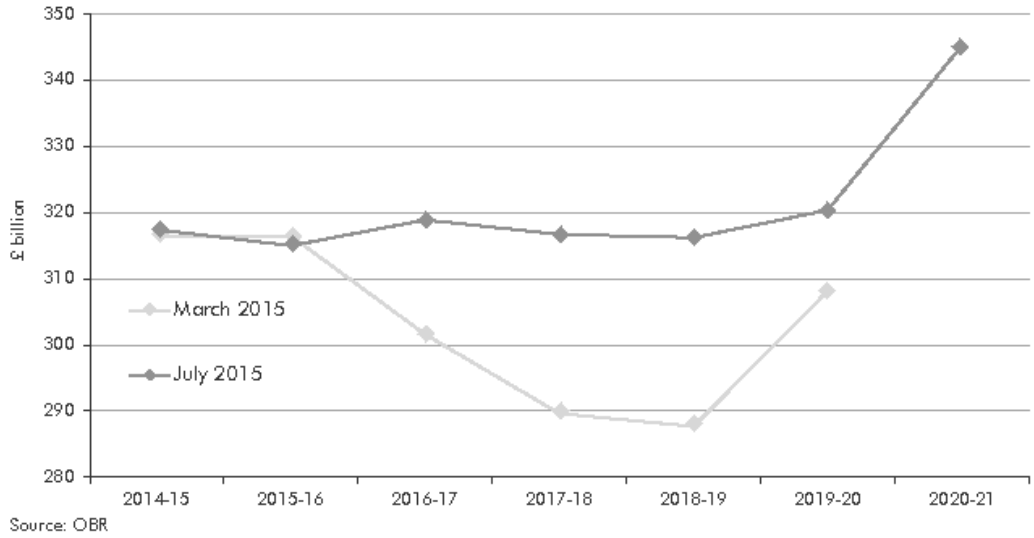
[6] http://budgetresponsibility.org.uk/pubs/Spending-assumptions-2011-2015.pdf

changes in RDEL and CDEL can have knock-on effects on the AME forecast, for example via changes in the prospective cost of net public service pensions and debt interest. These are shown in later sections of this chapter.

The path of RDELs over the forecast

4.90 The cash levels of RDEL that the Government has asked us to assume are significantly different from those that the Coalition Government asked us to assume in March and at earlier fiscal events, as Table 4.17 shows and as Chart 4.5 illustrates. The cash level of RDEL is broadly flat over the next three years, rather than falling as in March, but with the return to substantial annual increases pushed back a year to 2020-21. In aggregate over the Parliament, RDEL spending is £83.3 billion or 5.5 per cent higher than in March.

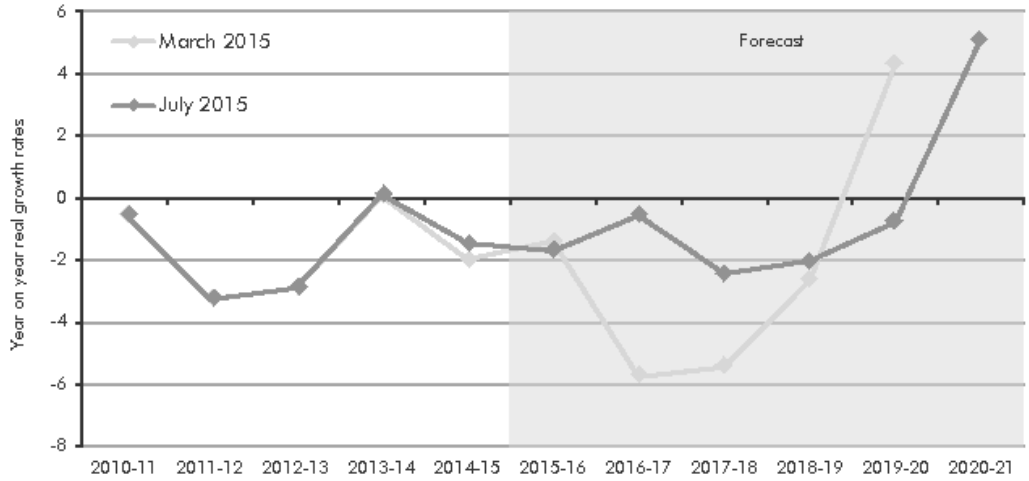
Chart 4.5: Resource DEL spending in cash terms



Source: OBR

4.91 This means that prospective real changes in RDEL also now follow a much smoother path than was implied in March, moving away from the previous 'rollercoaster' pattern. Real terms RDEL cuts now range from 0.5 to 2.4 per cent a year between 2015-16 and 2019-20. In March, the real cuts in 2016-17 and 2017-18 were 5.8 and 5.4 per cent respectively – larger than any seen in the previous Parliament. RDEL spending is now assumed to fall by an average of 1.5 per cent a year in real terms over this Parliament, compared to the 1.6 per cent average over the previous Parliament.

Chart 4.6: Year-on-year real growth in resource DEL

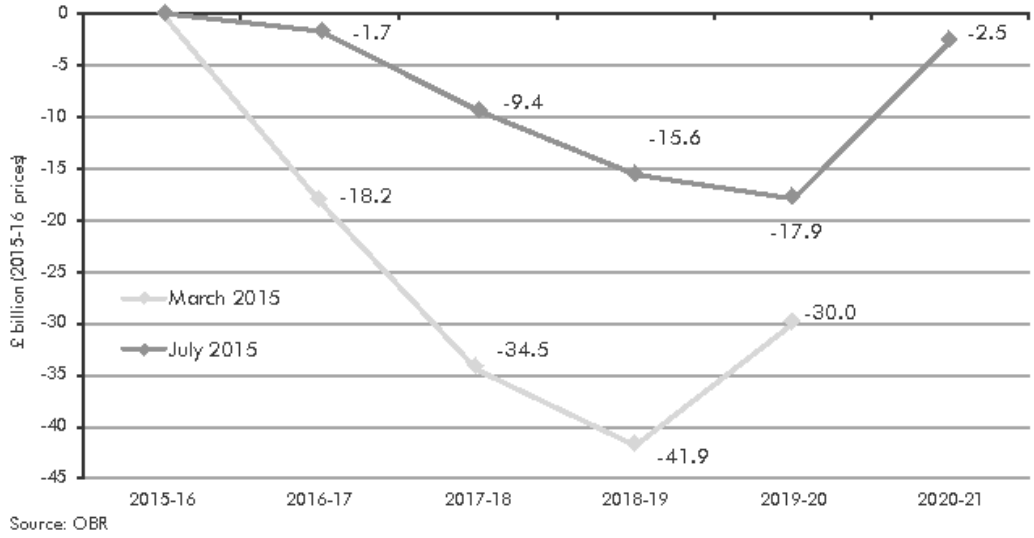


Note: RDEL series excludes major historical switches with AME. Details are in the supplementary fiscal tables on our website.
Source: OBR

4.92 Relative to the planned level of spending in 2015-16, these numbers imply that the Government would have to identify further real cuts in public services spending reaching a peak of £17.9 billion in 2019-20. That is less than half the £41.9 billion cut – required a year earlier in 2018-19 – that was implied by the numbers that the Coalition chose to assume in March. In both cases, once the budget balance has reached surplus (2019-20 in this forecast; 2018-19 in March) the real cut in RDEL spending begins to be reversed.[7]

[7] An alternative way of expressing this comparison would be the cash terms cut relative to a flat real baseline. On that basis, the cut in 2019-20 would be £19.3 billion in our current forecast, down from £44.0 billion in 2018-19 in our March forecast."

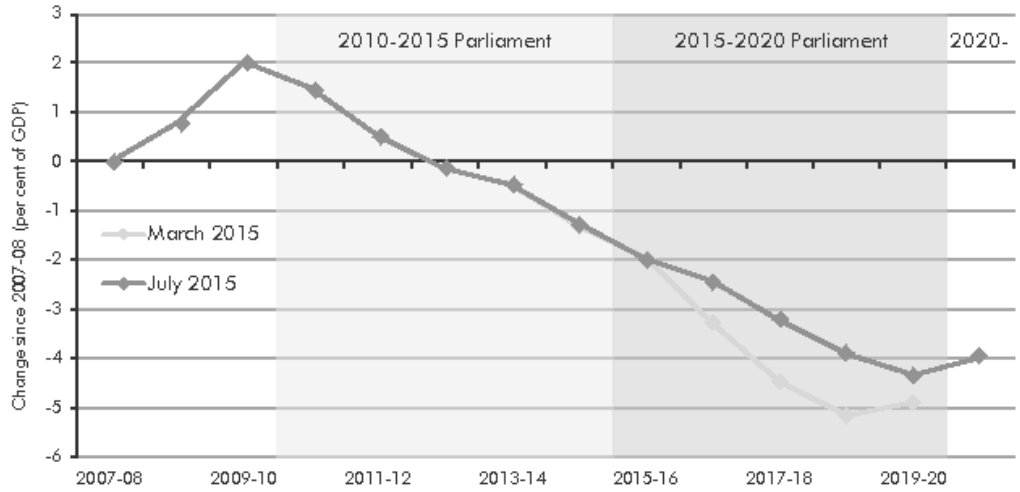
Chart 4.7: Change in real RDEL from 2015-16



Source: OBR

4.93 While the pace of real cuts that was pencilled into the March forecast has been reduced, Chart 4.8 shows that cuts to RDEL as a share of GDP in this Parliament are still expected to be of a similar size and profile as those that took place in the previous Parliament. Between the peak in 2009-10 and the planned trough in 2019-20, RDEL spending is expected to have been reduced by 6.4 per cent of GDP (£120 billion in today's terms) – with 3.3 per cent of GDP delivered in the last Parliament and 3.1 per cent of GDP in this one.

Chart 4.8: Resource DEL as a share of GDP in successive Parliaments

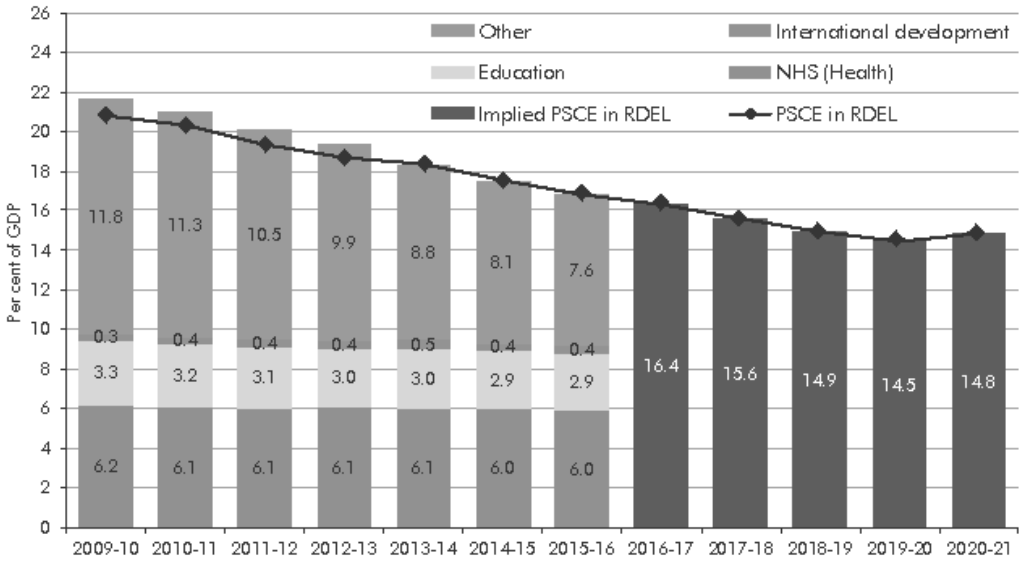


Note: RDEL series excludes major historical switches with AME. Details are in the supplementary fiscal tables on our website.
Source: OBR

4.94 As we discuss in Chapter 3, government consumption of goods and services – the closest equivalent of RDEL in the National Accounts – is forecast to reach a trough of 16.7 per cent of GDP in 2019-20 on the basis of these assumptions. This would be the lowest figure since 1964-65, compared to the near 80 year low of 15.1 per cent of GDP implied by the Coalition Government's December 2014 assumptions.

4.95 Chart 4.9 shows the overall path of RDEL as share of GDP since its post-crisis peak in 2009-10. For the outturn years and 2015-16 (for which there are detailed plans), the chart shows the share of spending where the Government has further stated objectives, such as the commitment to maintain total health spending in real terms or to spend 0.7 per cent of gross national income on Official Development Assistance (some of which is capital, so not shown here). The largest departmental budgets included in the 'other' category are the Ministry of Defence and the Department of Business, Innovation and Skills. Beyond the years for which plans have been set, we simply show Government's latest overall assumption.

Chart 4.9: Resource DEL and implied resource DEL relative to GDP



Note: The historical data in this chart have been adjusted for major discontinuities to produce a more comparable series. Details are in the supplementary fiscal tables on our website. In March, we adjusted for some of these discontinuities by adjusting the forecast series instead of the historical series. Our latest approach gives consistent forecast figures throughout the *EFO*. The previous approach added 0.6 per cent of GDP to RDEL on average between 2015-16 and 2019-20. This effect has now been removed, with historical data adjusted instead. Source: HM Treasury Public Expenditure Statistical Analyses, July 2014; HM Treasury Budget, July 2015; OBR

Annually managed expenditure (AME)

4.96 Table 4.13 sets out our latest central projection of AME spending to 2020-21, based on the economic forecast described in Chapter 3, the latest estimates of agreed policy commitments and the measures announced in this Budget.

Welfare cap and other welfare spending

4.97 Total welfare spending in our forecast refers to AME spending on social security and personal tax credits. The Government's welfare cap currently covers 56 per cent of this spending, excluding as it does state pensions and those benefits linked most closely to the ups and downs of the economic cycle. Table 4.18 summarises our forecasts for welfare spending over the next five years. It shows that:

- in cash terms, welfare spending is forecast to rise from £216.9 billion in 2015-16 to £227.3 billion in 2020-21. Within this 4.8 per cent total increase, spending on items inside the cap falls by 4.7 per cent while spending on items outside the cap increases by 16.6 per cent (including a 17.3 per cent rise in spending on state pensions);

- relative to the cash size of the economy that has to finance it, welfare spending is expected to fall by 1.6 per cent of GDP over the current Parliament. This is bigger than the 1.4 per cent fall we forecast in March, reflecting the £12.5 billion of welfare spending cuts by 2019-20 announced in the Budget. The scorecard cuts increase to £13.3 billion in 2020-21, reducing welfare spending falls by a further 0.3 per cent of GDP and taking it below 10 per cent of GDP for the first time in thirty years;[8] and

- most of the cuts announced in the Budget fall within the welfare cap, widening the disparity between the trends in welfare spending inside and outside it. Spending inside the welfare cap is now forecast to fall by 1.5 per cent of GDP over the next five years, while spending outside it is forecast to fall by only 0.3 per cent. By 2020-21 spending inside the cap will be only 0.2 per cent of GDP higher than spending outside it.

Table 4.18: Welfare spending forecast overview

	£ billion						
	Estimate	Forecast					
		Welfare cap period					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
£ billion							
Total welfare spending	214.3	216.9	213.8	216.5	219.4	222.2	227.3
of which:							
Inside welfare cap	119.1	120.6	115.2	114.6	114.0	113.5	114.9
Outside welfare cap	95.1	96.4	98.6	101.8	105.4	108.7	112.4
Per cent of GDP							
Total welfare spending	11.8	11.6	11.0	10.7	10.3	10.0	9.8
of which:							
Inside welfare cap	6.6	6.4	5.9	5.6	5.4	5.1	4.9
Outside welfare cap	5.3	5.1	5.1	5.0	5.0	4.9	4.8

4.98 Table 4.19 sets out our detailed welfare spending forecast. It is followed by an explanation of changes since our March forecast, which focuses on the estimated effects on spending of the policy measures announced in the Budget. The implications of our new forecast for the Government's welfare cap are discussed in Chapter 5.

[8] See our 2014 *Welfare trends report* for a detailed discussion of historical trends in welfare spending on this measure.

Table 4.19: Welfare spending

	£ billion						
	Estimate	Forecast					
			Welfare cap period				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Welfare cap							
DWP social security	74.4	76.0	74.8	72.8	71.2	70.4	71.0
of which:							
Housing benefit (not on JSA)[1]	21.4	22.1	22.0	21.6	21.4	21.1	21.3
Disability living allowance and personal independence payments	15.3	15.6	15.1	14.6	14.6	14.9	15.2
Incapacity benefits[2]	14.1	14.8	14.7	14.4	14.0	14.0	14.0
Pension credit	6.6	6.1	5.9	5.7	5.4	5.4	5.4
Attendance allowance	5.4	5.5	5.6	5.7	5.8	6.0	6.1
Income support (non-incapacity)	2.6	2.5	2.6	2.4	2.3	2.2	2.3
Carer's allowance	2.3	2.5	2.5	2.6	2.8	2.9	3.0
Statutory maternity pay	2.2	2.3	2.3	2.4	2.5	2.5	2.6
Winter fuel payments	2.1	2.1	2.1	2.0	2.0	2.0	2.0
Universal credit[3]	0.0	0.0	-0.2	-0.9	-1.7	-2.7	-3.1
Other DWP in welfare cap	2.3	2.4	2.3	2.2	2.1	2.1	2.1
Personal tax credits	29.7	29.5	25.3	26.3	27.3	27.5	28.2
Child benefit	11.6	11.5	11.4	11.4	11.3	11.3	11.4
Tax free childcare	0.0	0.0	0.1	0.6	0.6	0.7	0.8
NI social security in welfare cap	3.4	3.4	3.4	3.4	3.4	3.4	3.5
Paternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total welfare cap	119.1	120.6	115.2	114.6	114.0	113.5	114.9
Welfare spending outside the welfare cap							
DWP social security	92.0	94.0	96.1	99.3	102.8	106.0	109.6
of which:							
State pension	86.5	89.7	92.1	95.3	98.7	101.8	105.3
Jobseeker's allowance	3.1	2.2	2.3	2.4	2.4	2.5	2.6
Housing benefit (on JSA)	2.4	1.6	1.7	1.6	1.7	1.7	1.7
Universal credit[3]	0.1	0.5					
NI social security outside welfare cap	2.3	2.4	2.4	2.5	2.6	2.7	2.8
War pensions[4]	0.8						
Total welfare outside the welfare cap	95.1	96.4	98.6	101.8	105.4	108.7	112.4
Total welfare	214.3	216.9	213.8	216.5	219.4	222.2	227.3
Memo: welfare cap as proportion of total welfare	*55.6*	*55.6*	*53.9*	*53.0*	*51.9*	*51.1*	*50.6*

[1] Housing benefit (not on jobseeker's allowance) is made up of a number of claimant groups. The main claimant groups are pensioners, those on incapacity benefits, lone parents, and housing benefit only claimants.

[2] Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

[3] Universal credit actual spending for 2014-15 and 2015-16. Spending from 2016-17 onwards represents universal credit additional costs not already included against other benefits (i.e. UC payments that do not exist under current benefit structure).

[4] Transferred to DEL from 2015-16.

4.99 Table 4.20 shows the changes in our welfare spending forecast since March. Changes before the effect of the Budget policy decisions have been small, both inside and outside the welfare cap. Upward pressures include higher earnings growth this year feeding through to the state pensions forecast (via the triple lock on uprating) and a further small upward revision to our disability benefits forecast, as the caseload for the new personal

independence payment has been revised up again. These have been largely offset by the effect of a slightly lower inflation forecast and other factors.

4.100 By far the most significant changes to our welfare spending forecast reflect the policy measures announced in the Budget. The measures on the Budget scorecard are estimated to reduce spending by amounts rising from £5.6 billion in 2016-17 to £12.5 billion in 2019-20 and £13.3 billion in 2020-21. More than 95 per cent of these savings come from items subject to the welfare cap.

Table 4.20: Key changes to welfare spending since March

	£ billion						
	Estimate	Forecast					
			Welfare cap period				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Welfare cap							
Pre-measures forecast	-0.2	0.3	0.1	0.1	0.0	-0.2	
Scorecard measures		-0.3	-5.5	-6.7	-9.4	-12.0	-12.9
of which:							
Personal tax credits		-0.1	-4.6	-4.2	-4.0	-4.3	-4.4
Housing benefit (not on JSA)[1]		0.0	-0.4	-1.0	-1.7	-2.3	-2.4
Incapacity benefits[2]		0.0	0.0	-0.1	-0.6	-1.0	-1.2
Universal credit[3]		0.0	-0.1	-1.0	-2.1	-3.1	-3.5
Child benefit		0.0	0.0	-0.1	-0.3	-0.6	-0.6
Tax free childcare		-0.2	-0.5	-0.1	-0.1	-0.1	-0.1
Other		0.0	0.0	-0.2	-0.6	-0.8	-0.8
Indirect effects of Government decisions		0.0	-0.3	-0.6	-0.7	-0.8	-1.1
Total welfare cap	-0.2	0.0	-5.7	-7.2	-10.1	-13.1	-14.0
Welfare spending outside the welfare cap							
Pre-measures forecast	0.0	0.0	0.1	-0.3	-0.4	-0.5	
Scorecard measures		0.0	0.0	-0.2	-0.3	-0.4	-0.5
of which:							
Housing benefit (on JSA)		0.0	0.0	-0.1	-0.2	-0.3	-0.3
Other		0.0	0.0	0.0	-0.1	-0.2	-0.2
Indirect effects of Government decisions		0.1	0.0	0.5	1.0	1.1	0.7
Total welfare outside the welfare cap	0.0	0.1	0.0	0.1	0.2	0.1	0.2
Total welfare spending							
Pre-measures forecast	-0.2	0.3	0.2	-0.2	-0.4	-0.7	
Scorecard measures		-0.3	-5.6	-6.9	-9.7	-12.5	-13.3
Indirect effects of Government decisions		0.0	-0.3	0.0	0.2	0.2	-0.4
Total welfare	-0.2	0.0	-5.7	-7.1	-9.9	-12.9	-13.8

[1] Housing benefit (not on jobseeker's allowance) is made up of a number of claimant groups. The main claimant groups are pensioners, those on incapacity benefits, lone parents, and housing benefit only claimants.

[2] Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

[3] Universal credit actual spending for 2014-15 and 2015-16. Spending from 2016-17 onwards represents universal credit additional costs not already included against other benefits (i.e. UC payments that do not exist under current benefit structure).

4.101 The largest single Budget welfare measure is the **four-year freeze in the uprating of working-age benefits, tax credits and local housing allowances** from 2016-17 to 2019-20,

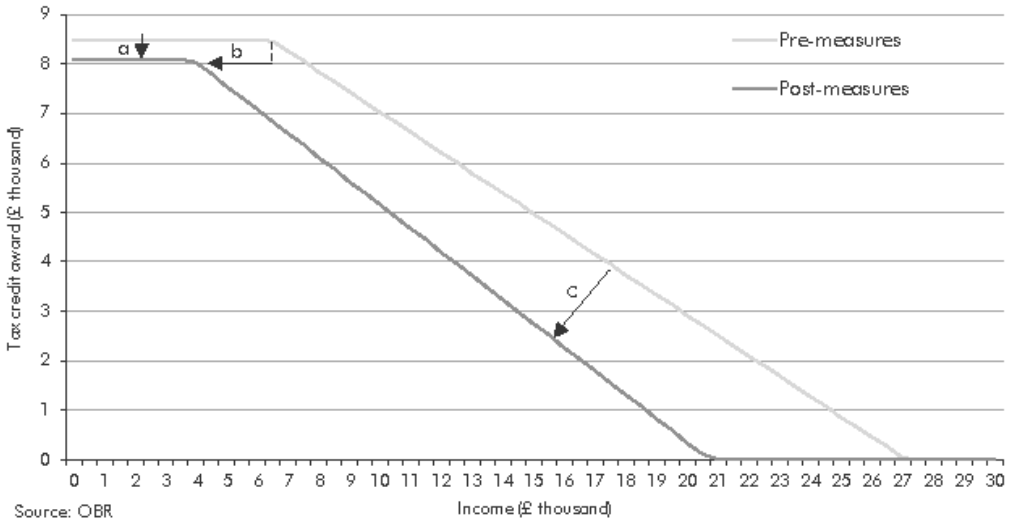
a period over which they were previously assumed to rise in line with CPI inflation. We expect the CPI to rise by a cumulative 4.8 per cent over this period, so the freeze reduces spending by £3.9 billion in 2019-20. As spending then rises from a lower base, the saving increases to £4.0 billion in 2020-21. The largest savings come from tax credits (£2.0 billion in 2020-21), followed by child benefit (£0.6 billion) and employment and support allowance (£0.6 billion).

4.102 The package to reform **tax credits and universal credit** (UC) is estimated to save £4.6 billion in 2016-17, rising to £5.8 billion in 2020-21. The main savings arise from:

- reducing the income threshold in tax credits and work allowances in UC – accounting for over half the estimated saving;
- limiting the child element of tax credits and UC to two children for new claims;
- raising the tax credit withdrawal rate (referred to as the taper) by seven percentage points to 48 per cent, so that the maximum award is withdrawn at a faster rate; and
- removing the family element in tax credits and UC (and the family premium in housing benefit) for new claims.

4.103 Chart 4.10 illustrates the impact of the changes in tax credit awards in 2019-20 for a family with one child, where both adults are working. Average awards are cut in three ways. First, awards fall on incomes below the old first income threshold (£6,420) as maximum awards are lower – mainly due to the freeze in rates (marked 'a' in the chart). Awards then fall on all incomes above the new first income threshold (£3,850) as the lower threshold and much higher taper rate act to withdraw entitlement earlier (b) and at a faster rate (c). Some families will lose entitlement altogether – in this illustration those on incomes between £21,000 and £27,000.

Chart 4.10: Illustrative impact on tax credits entitlement



Source: OBR

4.104 Cuts to **housing benefit** (on top of the working-age benefit freeze) are estimated to save £0.1 billion in 2016-17, rising to £2.0 billion in 2020-21. The largest single measure is the decision to force social sector landlords to cut rents by 1 per cent a year over four years. The pre-measures forecast assumed that rents would rise in line with CPI inflation plus 1 percentage point. The cumulative cut is therefore 12.9 per cent, reducing welfare spending by £2.0 billion in 2020-21. (We assume that the vast majority of this spending cut will reduce the income of housing associations. We have therefore reduced our residential investment forecast to reflect the likely impact on housing associations' new house building (see Box 3.3). If housing associations were to be classified as part of the public sector, this measure would increase – rather than reduce – public sector net borrowing.

4.105 The remaining welfare measures account for £1.0 billion of welfare savings in 2020-21, with the decision to align the work-related activity group rate with jobseeker's allowance for new claims to employment and support allowance making up £0.6 billion in that year. The policy to extend free childcare entitlement for 3- and 4-year olds to 30 hours reduces welfare spending by £0.2 billion in 2020-21, but this represents a small saving relative to the larger increase in the Department for Education's DEL budget to pay for the free childcare.

4.106 Looking at the package as a whole, most of the cuts reduce average awards relative to previous policy and relative to average earnings in the rest of the economy. Changes to eligibility and other factors that are estimated to reduce caseloads play a much smaller role.

4.107 Chart 4.11 shows the generosity of selected welfare benefits. It shows that:

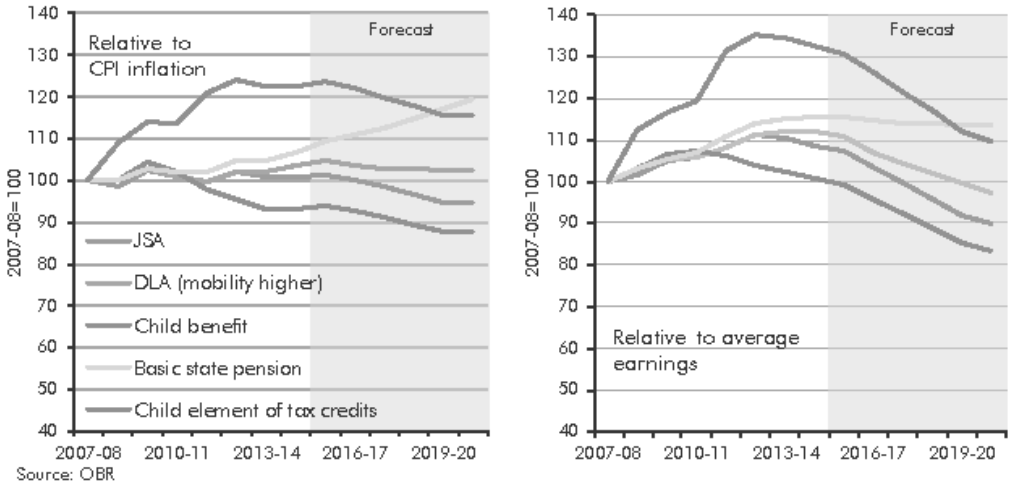
- the child element of tax credits has been increased significantly faster than average earnings since 2007-08, but will rise more slowly than inflation and earnings over the next five years;

- the basic state pension has also risen faster than average earnings since 2007-08 and is expected to rise in line with earnings in each year of the forecast, in line with the triple lock on uprating;

- child benefit rates have will have been frozen in cash terms in seven years out of the decade to 2020-21, having risen by 2 per cent in the three years from 2013-14 to 2015-16. Between 2010-11 and 2020-21, the first child rate will have fallen by 14.4 per cent in real terms (relative to CPI inflation) and by 24.1 per cent relative to average earnings; and

- rates for claimants of the mobility higher element of disability living allowance and personal independence payment are flat relative to inflation through the forecast period as they are not subject to the uprating freeze, but fall relative to average earnings.

Chart 4.11: Generosity of seleded benefit and tax credit rates



Source: OBR

Public service pensions

4.108 The public service pensions forecast covers net expenditure on benefits paid less employer and employee contributions received. It includes central government pay-as-you-go schemes and locally administered police and firefighters' schemes.[9] A breakdown of spending and income for the major schemes covered by our forecast is included in the supplementary fiscal tables on our website.

[9] The police and firefighters' pension schemes are administered at a local level, but pensions in payment are funded from AME, along with other public service pension schemes. They are therefore included in our pensions forecast.

4.109 We have revised up net spending on public service pensions substantially since March. This reflects a significant change in methodology, which relates to our forecast of contributions received. Previously we assumed no change in workforce numbers beyond the current Spending Review period (2016-17 onwards), given the absence of firm departmental plans.[10] Looking ahead to prospective changes in departmental budgets – implied in this forecast, but to be detailed for some years in the forthcoming Spending Review – we felt it was more appropriate to link our workforce assumptions directly to workforce numbers that would be consistent with implied departmental budgets.[11] Our previous approach meant the implied paybill in the pensions forecast increased as a share of implied RDEL.

4.110 Table 4.21 details the changes to our public service pensions forecast since March. It shows:

- we have revised the expenditure side down slightly, mainly because of lower inflation;
- applying our new methodology to receipts has reduced contributions (and so increased net pensions spending) by between £1.5 and £3.7 billion a year, due to the lower workforce and paybill forecasts implied by the path of RDEL and general government employment in March; and
- the significant changes to the path of RDEL spending have fed through to our workforce assumption and contributions. On our new methodology these indirect effects of the new RDEL path add between £0.8 and £2.0 billion to contributions between 2016-17 and 2019-20. This reduces net pensions spending.

4.111 Our public service pensions forecast has not been adjusted for the recent ruling in the GAD Milne court case, which will lead to compensation payments associated with past underpayment in the firefighters' and police pension schemes. This is because, in accordance with National Accounts guidance, these payments will be treated as capital AME (see above). The compensation includes an imputed payment to HMRC for the tax that would be owed on these payments. This will be neutral for borrowing, adding to capital AME and tax receipts by equal amounts.

[10] The only exception to this rule was the Armed Forces Pension Scheme, whose workforce assumptions reflect the set profile laid out by firm Future Force 2020 plans.
[11] Specifically, we assume that paybill will remain constant as a proportion of relevant spending totals, the largest of which is RDEL. We then make an assumption about growth in average paybill per head, from which an implied path of general government employment is derived. This is explained further in Chapter 3 and details are available in the supplementary fiscal tables on our website.

Table 4.21: Key changes to public service pensions since March

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Net public service pensions					
March forecast	11.1	11.2	11.9	12.7	13.8
July forecast	11.1	11.5	12.9	14.5	16.0
Change	0.1	0.3	1.0	1.8	2.2
Expenditure					
March forecast	39.3	40.1	41.6	43.3	45.2
July forecast	39.3	40.0	41.6	43.4	45.3
Change	0.0	0.0	-0.1	0.0	0.1
Income					
March forecast	-28.2	-28.8	-29.7	-30.6	-31.5
July forecast	-28.2	-28.5	-28.6	-28.8	-29.3
Change	0.0	0.3	1.1	1.8	2.2
of which:					
Apply new methodology to March forecast	0.0	1.5	2.9	3.7	3.0
Other forecast changes	0.0	0.1	0.1	0.1	0.1
Indirect effects of Government decisions	0.0	-1.2	-1.9	-2.0	-0.8

EU contributions

4.112 Our forecast for expenditure transfers to EU institutions has been updated to reflect information that became available at the Advisory Committee on Own Resources (ACOR) in May and other changes to determinants of the forecast. In this *EFO* we have extended the forecast to 2020-21, which would include the start of the next Multiannual Financial Framework (MFF). The deadline for the Commission to present initial proposals for that MFF is January 2018, so we have assumed that implemented spending will grow in line with EU GNI in the final year of the forecast.

4.113 Table 4.22 shows changes in our forecast since March. In most years they are relatively small, but we have revised spending up by £0.9 billion in 2016-17. They include:

- an increase in the UK VAT base in every year. This reflects the latest UK VAT forecast for the purpose of EU contributions, using ESA10 data. This feeds through to future years, increasing VAT contributions and other net expenditure transfers to the EU by £0.3 billion by 2019-20. Our forecast also reflects data on other member states' VAT bases from the May 2015 ACOR meeting, where estimates on an ESA10 basis were presented for the first time;

- revised estimates of UK GNI and VAT contributions in 2015 and 2016, also reflecting new ACOR information. For 2015, that determines the actual UK GNI and VAT contributions that will be applied, before any further adjustments in respect of any amending budgets and adjustments in respect of earlier years. (Our central forecast assumes further revisions in respect of 2014 will be made in December 2015);

- changes to our forecast adjustments in respect of GNI and VAT contributions for 2015. Our March forecast was based on 2014 ACOR data, with adjustments to reflect changes that we expected would come through this year. Now that we have 2015 ACOR data, those adjustments have been removed. They have been replaced with new, smaller adjustments in respect of 2015 that will be applied next year, to adjust for expected differences between the ACOR data for 2015 and outturn data. These new adjustments are based on the latest OBR and IMF forecasts, which are more consistent with the rest of our economy and fiscal forecasts. All these forecast adjustments carry similar-sized adjustments to the UK rebate in the following year, which partly or wholly offset the adjustment in the previous year. The net effect of bringing in the actual ACOR data for 2015, removing the previous adjustments and adding the new adjustments is to move about £0.7 billion of contributions, net of rebate, from 2015-16 to 2016-17. The detail of the adjustments included in each forecast is shown in the supplementary fiscal tables on our website;

- the forecast also includes the first ACOR estimate of the UK rebate for 2015, and revised ACOR estimates of the rebate for earlier years. The rebate for 2015 will be received in 2016, and the revisions for earlier years will affect this year's rebate. The historical revisions include a significant reduction to the UK rebate for 2014, which increases net spending in 2015-16 by £0.7 billion. This reflects new data which revealed a strong increase in the UK's structural fund receipts from the EU; and

- the forecast also assumes an increase in the assumed implementation rate for the EU budget in 2015, from 95.4 per cent in March to 97.5 per cent in this forecast. This reflects new information on additional pressures related to the backlog of unpaid claims from the 2007-13 MFF and the 2014 EU budget.

Table 4.22: Key changes to expenditure transfers to EU institutions since March

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
March forecast	11.2	9.4	9.5	10.5	11.0
July forecast	11.3	10.4	9.5	10.8	11.3
Change	0.2	0.9	0.0	0.3	0.3
of which:					
Increases in the UK VAT base	0.0	0.1	0.2	0.3	0.3
Revisions to estimates of UK GNI and VAT contributions for 2015 to reflect the May ACOR bases	0.2	-0.3	0.0	-0.1	-0.1
Revisions to adjustments to GNI and VAT contributions in respect of 2015, following new May ACOR information[1]	-0.9	1.0	-0.2	0.0	0.0
May ACOR rebate estimates	0.6	-0.1	0.0	0.0	0.0
Increase in assumed implementation rate for 2016 EU budget	0.2	0.2	-0.1	0.0	0.0
Other	0.1	0.0	0.1	0.1	0.1

[1] Adjustments to UK GNI and VAT payments in respect of 2014 will be made in December 2015. Adjustments in respect of 2015 will be made during 2016, using the ACOR bases that will be agreed in May 2016. Adjustments to the UK rebate follow a year after the GNI adjustments.

4.114 Future revisions to deal with previous UK GNI reservations could affect our EU contributions forecast. The UK has six remaining Eurostat reservations relating to the UK's GNI statistics under ESA95 for the period 2002 to 2010, which the ONS is aiming to address in the September 2015 Blue Book, in time for adjustments for the UK's historic GNI contributions that will be agreed in December. The ONS recently published an article on the likely impact of the changes to address these remaining reservations, with the net impact on GNI expected to be close to zero. It is not possible to predict the effect of other EU member states revisions to their GNI returns from addressing remaining ESA95 reservations. We are therefore unable to estimate whether the net effect of UK and other member states' future GNI revisions will increase or reduce the UK's contributions to the EU and have not adjusted our forecast, but it remains a source of uncertainty.

4.115 The crisis in Greece could present risks to this forecast if it led to any changes in the EU budget, to the UK's share of EU GNI or VAT bases or the sterling/euro exchange rate. But given the uncertainty associated with a situation that was still unfolding as our forecast was closed, we have not made any adjustments to the forecast at this stage.

Locally financed current expenditure

4.116 We forecast local authority spending by forecasting the sources of income that local authorities use to finance their spending and then the extent to which spending will be higher or lower than income, thereby adding to or subtracting from their reserves. Our forecast therefore encompasses spending financed by grants from central government, which are mostly in DEL, and local authority self-financed expenditure (LASFE) in AME.

4.117 Our forecast for current LASFE is largely driven by our forecasts for council tax and business rates. The council tax forecast is reduced in 2014-15 and 2015-16 by the availability of council tax freeze grant in England, which runs until 2015-16. This meant average council tax increases of 0.9 per cent in England in 2014-15, as 60 per cent of local authorities froze their tax levels and took up the grant. In 2015-16, council tax increases in England average 1.1 per cent, with a slightly lower percentage of councils – 57 per cent – having frozen their tax levels and taken up the grant. After 2015-16, we assume that council tax levels in England and Scotland will rise in line with CPI inflation. Council tax has risen at faster rates in Wales since 2011-12, so we now assume that Welsh council tax will increase in line with the average increase over the last three years.[12]

4.118 Table 4.23 summarises the main changes to our current LASFE forecast. Little new information is available on local authority current spending since our last forecast in March. We do not expect to know provisional outturn on local authority current spending in England in 2014-15 until the end of August. DCLG is currently collating the information it has collected on local authorities current budgets for 2015-16, but this information will not be published until later in July, and the results were not available in time for this forecast.

[12] These council tax increases are assumed to apply in conjunction with an increase in the council tax base, which averages 0.7 per cent a year in England over the forecast period. This is measured net of discounts, including localised council tax reduction schemes. Further details of our council tax assumptions are available in a supplementary fiscal table on our website.

4.119 The few changes in our forecast therefore reflect:

- updates to our forecasts for spending financed by council tax, which we have updated as explained above;
- revised data on capital expenditure financed from revenue (CERA), consistent with the recent DCLG release on provisional capital outturn for 2014-15 and capital budgets for 2015-16. Our revised forecast for CERA in 2015-16 also reflects the latest forecast information provided to us by TfL. This reduces CERA by £0.9 billion, increasing local authority current spending and reducing local authority capital spending by this amount. This change is neutral for TME;
- small reductions in our assumptions for local authorities' net additions to their current reserves, due to the assumed knock-on effects of the in-year spending cuts that were announced in June. These included cuts of £0.2 billion to central government grants to local authorities. We assume that some local authorities will respond to these cuts by reducing the net amount that they would otherwise have added to their reserves, which affects later years too as we assume that English local authorities add to their reserves by decreasing amounts until 2018-19, and that they will be flat thereafter; and
- other small changes which reflects changes to economic assumptions that affect our forecasts for local authority current spending financed by retained business rates and income from interest receipts.

4.120 Full details of our latest local authority current and capital spending forecasts are available in the supplementary fiscal tables on our website.

Table 4.23: Key changes to locally financed expenditure and public corporations capital expenditure since March

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Locally-financed current expenditure					
March forecast	37.6	40.0	41.9	43.6	45.0
July forecast	38.5	40.2	42.1	43.7	45.1
Change	0.9	0.2	0.2	0.1	0.1
of which:					
Council tax	0.1	0.1	0.2	0.1	0.1
Capital expenditure from revenue account (CERA)	0.9	0.2	0.0	0.0	0.0
Net use of current reserves	0.1	0.0	0.1	0.0	0.0
Other	-0.1	-0.1	0.0	0.0	0.0
Locally-financed capital expenditure, and public corporations capital expenditure					
March forecast	14.8	15.8	15.5	13.8	13.7
July forecast	14.4	15.4	15.9	14.2	14.1
Change	-0.5	-0.4	0.4	0.5	0.4
of which:					
Capital expenditure financed by CERA	-0.9	-0.2	0.0	0.0	0.0
Capital spending financed by prudential borrowing	0.2	0.2	0.4	0.4	0.4
Welsh HRA reform[1]	0.9	-	-	-	-
OBR timing adjustment for TfL subsidiaries' capital spending	-0.3	0.1	0.2	0.1	0.1
Use of capital receipts, net of changes in asset sales	-0.2	-0.4	0.1	0.1	0.2
Other public corporations capital expenditure[2]	-0.3	0.0	0.0	-0.1	-0.1
Other	-0.1	-0.1	-0.1	-0.1	0.0
Budget measure (public corporations)	0.0	0.0	-0.2	0.0	-0.1

[1] This is the one-off payment by Welsh local authorities to central government to buy themselves out of the HRA subsidy system. This is offset by a corresponding central government receipt within the forecast for other items in PSGI in AME.

[2] This reflects the net change to the forecast for public corporations capital spending, excluding changes to HRA net capital spending and TfL grants to its PC subsidiaries (because changes to those items are already included in the changes above).

Locally financed and public corporations capital expenditure

4.121 Our latest forecasts for locally financed capital expenditure (capital LASFE) and public corporations capital spending are shown in Table 4.23. Capital LASFE is measured net of asset sales. It is also measured net of capital spending by local authorities' Housing Revenue Accounts (HRAs) and the TfL subsidiaries that are treated as public corporations in the National Accounts.[13] We switch these items out of capital LASFE and include them in our forecast for public corporations net capital expenditure to ensure our forecast is consistent with the National Accounts.

4.122 Our forecast for local authorities' capital spending in England remains fairly stable over the forecast period, and continues to assume that spending is boosted by an additional £2½

[13] These TfL transport subsidiaries trade under the company name 'Transport Trading Ltd' (TTL). The ONS currently classifies all the TTL subsidiaries as public corporations apart from Crossrail, which is classified as part of the local authority sector. However, the ONS announced last year that it will be reclassifying several of the other TTL subsidiaries to the local authority sector. We would expect that these reclassifications will have a neutral effect on the public sector finances and we will wait until the ONS implements those reclassifications in the outturn data before we reflect them in our forecast.

billion from capital reserves over the forecast period, mainly related to the closing stages of Crossrail construction. Capital LASFE declines by the end of the forecast period because we assume declining levels of spending financed by prudential borrowing and CERA, while asset sales are projected to rise.

4.123 The forecast for public corporations' capital spending is largely driven by our forecasts of capital spending by HRAs (net of asset sales) and TfL's public corporation subsidiaries. TfL plan to secure £3 billion of savings from additional income over the next ten years, and are moving ahead with a number of property development schemes, including Earls Court. It is possible that some of these property development schemes may generate asset sales that have implications for the public finances.

4.124 Table 4.23 groups our forecasts for capital LASFE and public corporations' capital spending together to show the overall effect of the revisions. The main changes include:

- the changes to CERA explained above;
- an increase in our assumptions for the level of capital spending financed by local authorities' prudential borrowing. These assumptions are highly uncertain. The latest DCLG provisional outturn data for 2014-15 suggest that English local authorities' prudential borrowing outside London is higher than we had assumed in March. We have therefore revised our forecast up;
- a one-off £0.9 billion increase in capital LASFE to reflect Welsh local authorities' payments to central government to buy out their previous liabilities to pay HRA subsidies, as part of the reforms of the HRA. This payment is offset in our forecast by a corresponding central government receipt, which is included in PSGI in AME;
- revisions to our timing adjustment for TfL subsidiaries' capital spending, to reflect changes to outturn and TfL's latest business plans for 2015-16, which suggest that some further capital spending might be delayed into later years of the forecast;
- revisions to our forecasts for asset sales and the use of capital receipts from previous sales to reflect the provisional outturn data, including the latest information from DCLG on HRA sales under the Right to Buy programme, and our latest economic determinants;
- other revisions to our forecasts of HRA and other public corporations' capital spending, reflecting changes to economic determinants and the latest forecast information supplied by TfL; and
- two measures which affect capital spending by HRAs. These are the measures to reduce social sector rents and to require higher income social housing tenants to pay market rents. We estimate that these measures may affect HRA net capital spending by the amounts shown in Table 4.23 above, but these impacts are uncertain.

Central government debt interest

4.125 Central government debt interest payments (net of the effect of the Bank of England's Asset Purchase Facility (APF) holdings of gilts) are forecast by applying interest rates to the stocks of different liabilities. These interest rates are derived from financial market expectations and our inflation forecast (for index-linked gilts).[14]

4.126 Table 4.24 shows changes in our central government debt interest forecast since March. It shows that:

- higher market interest rates have increased spending by rising amounts over the forecast period. This is driven by both higher Bank Rate (which increases payments on the APF loan) and gilt rates. Higher short-term interest rates also affect the cost of Treasury bills and financing through NS&I;
- small downward revisions to our RPI inflation forecast have reduced the debt interest costs on index-linked gilts;
- the total effect of revisions to the financing requirement reduces debt interest spending in each year of the forecast period. A number of factors have driven that change. We have revised our forecast for the central government net cash requirement substantially (as explained in Box 4.3). On its own, the Government's decision to slow the pace of fiscal consolidation would increase the amount of borrowing to be financed, but that has been more than offset by increases to asset sales (particularly the announced sale of three-quarters of the Government's shareholding in RBS); and
- other changes have generally been small and are broadly offsetting by the end of the forecast period.

Table 4.24: Key changes to central government debt interest since March

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
March forecast	33.7	40.4	46.5	49.0	51.1
July forecast	34.6	40.8	47.7	50.7	53.2
Change	0.9	0.5	1.1	1.7	2.1
of which:					
Interest rates	0.6	0.4	1.4	2.3	3.0
Inflation	0.0	0.0	0.0	-0.3	-0.1
Financing	-0.1	-0.3	-0.4	-0.4	-0.5
Other factors	0.4	0.4	0.2	0.1	-0.2

4.127 We have looked back at the performance of the costings that we certified for the issuance of NS&I pensioner bonds, which were available for purchase between January and May 2015. Over that period, the Government raised £13.7 billion of finance through the issuance of

[14] Our forecasting approach was explained in Box 4.4 of our March 2015 *EFO*. We have added a new table to our supplementary fiscal tables that presents the different stocks, flows and effective interest rates that make up our debt interest forecast.

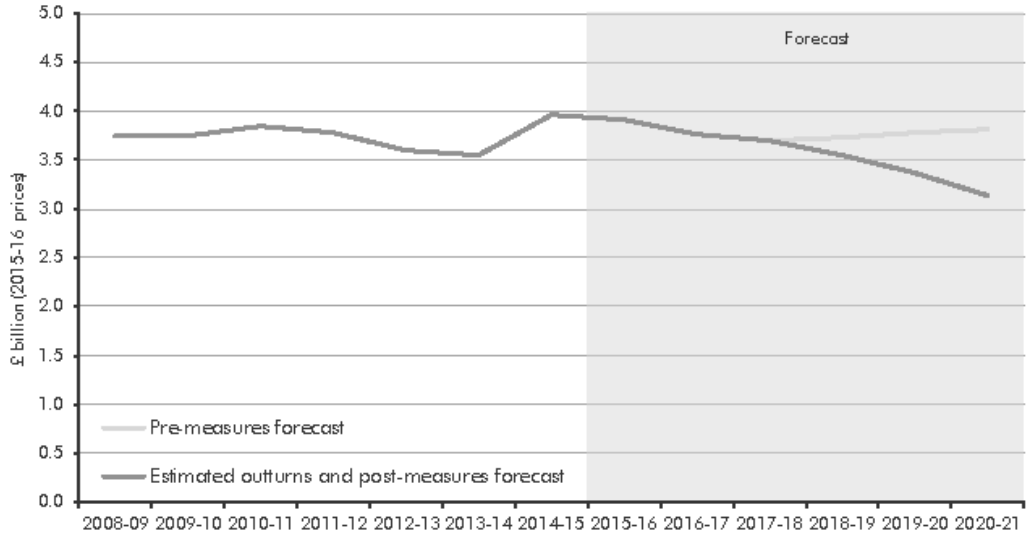
these bonds, which paid a premium relative to gilts of equivalent maturities. The higher debt interest cost associated with them was estimated at £0.5 billion over the five years from 2014-15 to 2018-19. This cost appeared on the Treasury's scorecard partly in Budget 2014 (when the policy was first announced) with the remainder in Budget 2015 (when it was extended). Due to higher than expected take-up and, more importantly, lower than expected gilt yields against which the cost of pensioner bonds is compared, the actual cost to the taxpayer over the five years to 2018-19 is now estimated to be £0.9 billion.

Other AME spending

4.128 Our forecast of **BBC** spending is down significantly from 2018-19 onwards compared to March. Most of the change reflects the Government's decision progressively to stop compensating the BBC for the licence fee revenue forgone by requiring it to provide free TV licences for those aged 75 and over. The licence fee is a tax in the National Accounts. Provision of free TV licences is therefore in effect a tax relief, so it does not affect spending. DWP currently compensates the BBC for that forgone revenue, so that BBC income is unaffected. As the current arrangement is an intra-public sector transfer, spending and borrowing are also unaffected. When the Government begins to withdraw this funding, we assume that the BBC will reduce its spending by almost the same amount, but with some small and diminishing offsetting contribution from its reserves. (We have increased our licence fee forecast slightly relative to March, which would have increased current spending a little in the absence of this measure.)

4.129 Based on the evidence presented to us by the Treasury, we have certified the Government's costing and have therefore reduced our BBC spending forecast by amounts rising from £0.2 billion (5.0 per cent) in 2018-19 to £0.7 billion (17.7 per cent) in 2020-21. Chart 4.12 shows the pre- and post-measures forecasts for BBC current spending in real terms. The forecast assumes that the licence fee rises in line with CPI inflation over the period of the next charter, beginning in 2017-18, on which basis real spending would fall by 19.9 per cent between 2015-16 and 2020-21, compared to a 0.8 per cent real fall in assumed total public services spending over the same period.

Chart 4.12: Real BBC current expenditure since 2008-09



Source: BBC, ONS, OBR

4.130 Our RDEL forecast includes spending on **research & development (R&D)**, which, under the European System of Accounts 2010, is classified in the National Accounts as capital spending. Our forecast for current AME therefore includes an accounting adjustment that removes this spending, and our forecast for capital AME includes an offsetting entry that includes this spending. Our latest forecast includes revisions to 2014-15 that reflect the latest information on departments' forecast outturn data consistent with provisional outturns for PSCE and PSGI published by the ONS. Spending on R&D beyond the years for which firm departmental plans exist (2016-17 onwards) is now assumed to grow in line with RDEL rather than GDP, explaining changes in later forecast years.

4.131 **Other PSCE in departmental AME** is little changed over the forecast period. The increases in **other PSGI items in departmental AME** are largely explained by expected tax litigation costs being moved from negative tax to capital AME spending. The spending in these categories is detailed in the supplementary tables available on our website.

4.132 **Environmental levies** include spending on DECC levy-funded policies such as the renewables obligation, feed-in tariffs and warm homes discount. Most are neutral for borrowing as they are directly offset by receipts. The forecasts are explained in the receipts section.

4.133 **VAT refunds** expenditure is neutral for borrowing, as it is directly offset within receipts. The upward revisions to the forecast are explained in the receipts section above.

4.134 Our forecast for **Network Rail** capital spending has increased by around £4 billion each year since March because we have removed government capital grants to Network Rail from our forecast. This classification change is offset in CDEL, as explained in the DEL

section above. Abstracting from this change, our changes to the forecasts of Network Rail current and capital spending up to 2018-19 mostly reflect changes to the latest forecast profile of spending. The profile of capital spending is subject to particular uncertainty. From 2019-20 onwards, we have revised our forecast to assume that Network Rail's current and capital spending grows in line with total public sector current and capital spending

4.135 The AME forecast includes other **National Accounts adjustments** that are included in the definitions for PSCE and PSGI. Movements in these adjustments over the forecast period typically consist of numerous small, offsetting changes. For 2014-15, they have changed significantly since March because of large residual adjustments between our estimated sum of the detailed components of spending and the latest provisional outturns for PSCE and PSGI published by the ONS. These reflect the extent to which the different sources of estimated outturns are still being revised, but are being picked up in ONS outturns with different timings. We would expect them to diminish after the provisional outturn data published for central government later in July, and for local authority current spending (in England) in August, are reflected in the ONS data.

4.136 Over the forecast period, the main changes to the other National Accounts adjustments reflect revisions to our forecasts of three adjustments for local authority spending. For current spending, these include an adjustment that reconciles the use of different outturn sources of data for local authorities' debt interest payments. For capital spending, they include our latest forecast for local authority financial transactions, which we remove because these are not included in PSGI, and our latest forecast for an adjustment to reflect ONS outturn data for local authorities' receipts of capital grants from the private sector. Further details of our forecasts for all the other National Accounts adjustments are included in the supplementary tables on our website. Explanations and the background to National Accounts adjustments are given in Annex D to PESA 2014.[15]

Loans and other financial transactions

4.137 Public sector net borrowing (PSNB) is the difference between total public sector receipts and expenditure each year, measured on an accrued basis. But the public sector's fiscal position also depends on the flow of financial transactions, such as loans and repayments between government and the private sector, and the sale of financial assets to the private sector. These do not directly affect PSNB, but they do lead to changes in the Government's cash flow position and stock of debt.

4.138 The public sector net cash requirement (PSNCR) is the widest measure of the public sector's cash flow position in each year.[16] It drives our forecast of public sector net debt (PSND), which is largely a cash measure. Estimating the PSNCR also allows us to estimate the central government net cash requirement (CGNCR), which in turn largely determines the Government's financing requirement – the amount it needs to raise largely from treasury bills, gilt issues and NS&I products.

[15] See HM Treasury, July 2014, *Public Expenditure Statistical Analyses 2014*.
[16] Consistent with the measures of debt and deficit used in this forecast, PSNCR excludes the public sector banks.

4.139 Differences between the PSNCR and PSNB can be split into the following categories:

- **loans and repayments:** loans that the public sector makes to the private sector do not directly affect PSNB, but the cash flows affect the PSNCR;
- **transactions in other financial assets:** the public sector may buy or sell financial assets, such as corporate bonds or equities. When it sells an asset for cash the initial transaction does not affect PSNB, whereas the cash received will reduce the PSNCR. But both PSNB and the PSNCR will be higher in future years if the government foregoes an income stream that flowed from the asset sold;
- **accruals adjustments:** PSNB is an accruals measure of borrowing in which, where possible, spending and receipts are attributed to the year of the activity to which they relate. In contrast, PSNCR is a cash measure in which spending and receipts are attributed to the year in which the cash flow takes place; and
- **other factors:** we separately identify transactions relating to UKAR holdings and Network Rail, as well as including some other adjustments that do not fall into the categories above.

4.140 Net lending to the private sector, in particular for student loans, raises the net cash requirement relative to net borrowing in each year of our forecast. Table 4.33 shows the steps from PSNB to PSNCR and Table 4.34 shows the changes since our March forecast.

Table 4.25: Reconciliation of PSNB and PSNCR

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Public sector net borrowing	69.5	43.1	24.3	6.4	-10.0	-11.6
Loans and repayments	16.8	18.1	19.2	19.2	19.8	16.9
of which:						
Student loans[1,2]	11.2	12.9	14.7	16.4	17.3	16.8
DfID	0.0	0.0	0.0	0.0	0.0	0.0
Green Investment Bank	0.5	0.5	0.3	0.0	0.0	0.0
British Business Bank	0.5	0.2	0.3	-0.1	-0.1	-0.1
Help to Buy equity loans	1.5	1.3	1.3	1.2	1.1	-0.6
UK Export Financing	0.2	0.4	0.4	0.4	0.5	0.5
Ireland	0.0	0.0	0.0	-0.4	0.0	0.0
Other	4.0	2.9	2.2	1.7	1.0	0.3
Allowance for shortfall	-1.0	0.0	0.0	0.0	0.0	0.0
Transactions in financial assets	-20.4	-8.6	-8.5	-8.4	-8.2	-0.1
of which:						
Student loan book	-2.3	-2.3	-2.3	-2.3	-2.3	0.0
Royal Mail pension asset disposal	-0.5	-0.5	-0.4	-0.3	-0.1	-0.1
Lloyds Banking Group share sales	-12.9	0.0	0.0	0.0	0.0	0.0
Royal Bank of Scotland share sales	-2.0	-5.8	-5.8	-5.8	-5.8	0.0
Other	-2.7	0.0	0.0	0.0	0.0	0.0
Accruals adjustments	4.9	8.7	1.9	-2.3	-2.0	6.3
of which:						
Student loan interest[1,2]	1.7	2.4	3.2	4.3	5.3	5.6
PAYE income tax and NICs	1.5	2.3	2.1	1.9	2.1	2.4
Indirect taxes	1.6	1.0	0.7	1.0	1.1	1.1
Other receipts	2.1	2.2	2.3	2.4	2.3	2.4
Index-linked gilts[3]	-5.4	-0.1	-8.5	-13.4	-13.4	-5.6
Conventional gilts	3.3	3.1	4.3	3.9	3.3	3.1
Other expenditure	0.1	-2.1	-2.3	-2.4	-2.6	-2.7
Other factors	-20.1	-5.6	-5.2	-4.6	-4.1	-4.0
of which:						
UKAR alignment	-18.7	-4.3	-3.9	-3.3	-2.9	-2.8
Network Rail	0.3	0.3	0.4	0.4	0.5	0.5
Alignment adjustment	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Public sector net cash requirement	50.8	55.7	31.6	10.3	-4.5	7.5

[1] The table shows the net flow of student loans and repayments. This can be split out as follows:

Cash spending on new loans	13.5	15.3	17.1	18.7	19.8	19.2
Cash repayments	2.2	2.4	2.5	2.3	2.5	2.4

[2] Cash payments of interest on student loans are included within 'Loans and repayments' as we cannot easily separate them from repayments of principal. To prevent double counting the 'Student loan interest' timing effect therefore simply removes accrued interest.

[3] This reconciliation to the net cash requirement does not affect public sector net debt.

Table 4.26: Changes in the reconciliation of PSNB and PSNCR

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net borrowing	-5.8	3.7	11.5	11.6	-3.0
Loans and repayments	0.0	0.9	1.8	2.5	2.8
of which:					
Student loans[1,2]	0.0	0.6	1.7	2.7	3.3
DfID	-0.2	-0.1	-0.1	-0.1	-0.1
Green Investment Bank	0.1	0.3	0.3	0.0	0.0
British Business Bank	0.0	0.0	0.0	0.0	0.0
Help to Buy equity loans	0.0	0.0	0.0	0.0	0.0
UK Export Financing	-0.1	-0.1	-0.1	0.0	0.1
Ireland	0.0	0.0	0.0	0.0	0.0
Other	0.2	0.1	0.0	-0.1	-0.6
Allowance for shortfall	0.0	0.0	0.0	0.0	0.0
Transactions in financial assets	-7.7	-5.8	-5.8	-5.8	-5.8
of which:					
Student loan book	0.0	0.0	0.0	0.0	0.0
Royal Mail pension asset disposal	0.0	0.0	0.0	0.0	0.0
Lloyds Banking Group share sales	-3.9	0.0	0.0	0.0	0.0
Royal Bank of Scotland share sales	-2.0	-5.8	-5.8	-5.8	-5.8
Other	-1.8	0.0	0.0	0.0	0.0
Accruals adjustments	0.3	-1.6	-1.8	-1.7	-2.2
of which:					
Student loan interest[1,2]	-0.4	-0.2	-0.1	0.1	0.3
PAYE income tax and NICs	1.2	0.1	0.2	-0.1	-0.3
Indirect taxes	0.9	0.4	-0.2	0.0	-0.2
Other receipts	-0.6	-0.5	-0.5	-0.5	-0.6
Index-linked gilts[3]	0.4	0.4	0.5	0.9	1.1
Conventional gilts	-0.4	-0.8	-0.9	-1.1	-1.5
Other expenditure	-0.9	-0.9	-0.9	-1.0	-1.0
Other factors	0.5	-0.5	-2.1	-1.9	-1.7
of which:					
UKAR alignment	-3.4	1.4	-0.1	-0.2	-0.1
Network Rail	0.0	0.1	0.0	0.2	0.4
Alignment adjustment	4.0	-2.0	-2.0	-2.0	-2.0
Public sector net cash requirement	-12.7	-3.2	3.5	4.7	-9.9

[1] The table shows the net flow of student loans and repayments. This can be split out as follows:

Cash spending on new loans	-0.2	0.5	1.7	2.7	3.3
Cash repayments	-0.2	-0.1	-0.1	0.0	0.0

[2] Cash payments of interest on student loans are included within 'Loans and repayments' as we cannot easily separate them from repayments of principal. To prevent double counting the 'Student loan interest' timing effect therefore simply removes accrued interest.

[3] This reconciliation to the net cash requirement does not affect public sector net debt.

Loans and repayments

4.141 Student loan reforms in recent years have increased the size of the upfront loans, with repayments being made over a longer period. In our 2015 *Fiscal sustainability report (FSR)*,

we estimated that on current policy settings the effect of student loans on PSND would peak at 8.8 per cent of GDP in the late 2030s before falling to 8.0 per cent of GDP in 2064-65.

4.142 We have revised up our forecast of student numbers since March, which increases loan outlays. In part this reflects the latest data on student applications that indicate higher application rates in 2015-16 than we expected in March. In subsequent years, we assume that student numbers will rise a little further from this higher starting point as trends in application and acceptance rates more than offset the projected decline in the number of 18 to 20 year olds in the population. These changes add around £¼ billion to lending by 2020-21.

4.143 The Government has announced that it will convert student maintenance grants to loans from 2016-17. That involves lending to students from lower-income households that would previously have received grants. It increases outlays by amounts that rise to around £3 billion in 2020-21, but it has no effect on repayments within the forecast period.[17] On the assumption that lifetime earnings are positively correlated with parental household income, write-off rates on these loans would be higher than in the student loan population as a whole. Any PSNB cost of student loan write-offs does not occur until 30 years after the loan is made.

4.144 Our forecast for student loan repayments is little changed since March. We have introduced an alignment adjustment to move from the latest HMRC outturn data for 2014-15 (which are lower than our March forecast implied) to the level of repayments implied by the BIS model (which is more suited to longer-term projections).

4.145 Providing support for mortgage interest (SMI) is another measure that converts support previously provided via public spending into loans. Those loans will be repayable after moving off the benefits that lead to eligibility for SMI or when a property is sold. As a second-charge secured loan, write-off rates would be expected to be smaller than for an unsecured loan, but would still be likely to build beyond the scorecard period as the stock of outstanding loans increases over time. This measure increases our loans forecast by about £250 million on average from 2018-19 to 2020-21.

4.146 Other loans include a range of other Government schemes, including loans to Ireland. In order to inform our forecast, we ask the Government to provide us with an estimate of the planned lending by each institution or scheme. We have made relatively small and broadly offsetting revisions since March. They include an upward revision to lending by the Green Investment Bank of around £0.3 billion in 2016-17 and 2017-18. We have not changed our assumption that overall lending will fall short of plans by £1 billion in 2015-16, reflecting the tendency for new schemes to take longer than originally planned to deliver the amount targeted and existing schemes lending below their plans. We have also added the Government's contributions of £80 million a year for five years to the new Asia Infrastructure Investment Bank.

[17] The additional loans will be on top of tuition fee loans. Students pay a fixed rate above the income threshold regardless of the size of their overall loan, so this measure will only extend the repayment period for some students (up to a maximum of 30 years), and not their upfront repayments.

Transactions in other financial assets

4.147 We only include the impact of financial asset sales or purchases in our forecasts once firm details are available that allow the effects to be quantified with reasonable accuracy and allocated to a specific year. There are now a number of asset sales that meet these criteria, the scale of which is illustrated in Chart 4.12. These include:

- at Autumn Statement 2013, the Government announced its intention to sell part of the student loan book, which it expected would raise around £12 billion over five years from 2015-16. This intention was reiterated in March 2015 and again in this Budget. In March, we explained that there had been some changes in the form of the expected sale that implied that a larger quantity of loans would need to be sold to meet the Government's £12 billion central estimate for the proceeds from the sale. The new Government has confirmed that it intends to proceed on this basis. Selling the loan book affects the flow of receipts, with more recorded upfront as sales proceeds, and less in future years, as future loan repayments will flow to the private sector rather than the Exchequer. As in March, we have made a neutral assumption that sales will be evenly spread across the five years from 2015-16. The sales are expected to reduce the flow of repayments to the Exchequer by around £1.8 billion by 2020-21;

- our forecast in March included the Government's planned sales of £9 billion of Lloyds Banking Group share. Share sales through the ongoing trading plan have been proceeding faster than was factored into our March forecast. In addition, in June the Chancellor announced the Government's intention to *"return Lloyds to the private sector over the coming year"*. We have therefore revised up the amount we expect the Government will sell in 2015-16 to around £13 billion. We assume that these sales will be made through a continuation of the trading plan, along with institutional and retail placings. As a result of these share sales, our forecast for dividend receipts – which includes an estimate of dividends on Lloyds shares – is lower by around £¼ billion a year from 2016-17 onwards;

- the Government has announced in this Budget that it also intends to sell three quarters of its stake in the Royal Bank of Scotland (RBS) over the course of this Parliament. Based on faster than expected sales of Lloyds shares and RBS-specific evidence we considered for this forecast, we have included the proceeds of the planned sale. The Government has committed to begin the sales in this fiscal year, which we expect to raise around £2 billion. Over the rest of the Parliament to 2019-20, we have assumed that the Government would raise £5.8 billion a year for four years to reach a shareholding of around 25 per cent. There is currently greater uncertainty over RBS share sales than the sale of Lloyds shares due to the existence of the 'dividend access share' and the fact that RBS is not yet paying dividends, although the uncertainty associated with these factors is expected to recede over time; and

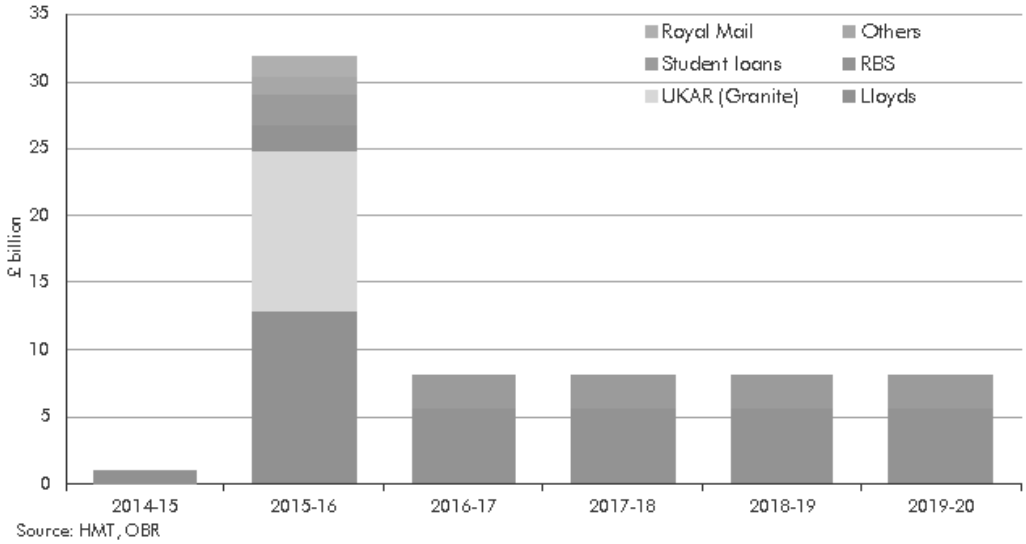
- we have also included the proceeds of the sale of the Government's remaining 30 per cent stake in Royal Mail for just under £1.5 billion. This includes the sale of the 15 per cent on 10 June that raised £750 million and the sale of the remaining 15 per cent

stake (a 1 per cent stake will be given to staff, which appears as a £50 million capital DEL cost on the Treasury scorecard). The Government has committed in the Budget to completing the sale in 2015-16. At the current share price, this will raise a further £705 million. We have also included the sale, for an estimated £360 million, of the Government's shareholding in King's Cross Central Partnership.

4.148 The Government recently announced its intention to move the Green Investment Bank (GIB) into private sector ownership, subject to value for money considerations. Given the uncertainties around the timing and the value of this proposed sale, we have not included it in our forecast.

4.149 Chart 4.13 shows that the expected proceeds from major asset sales over the forecast amount to £32 billion in 2015-16 and a further £32 billion over the remainder of the Parliament to 2019-20.

Chart 4.13: Expected proceeds from major asset sales



Source: HMT, OBR

Accruals adjustments

4.150 To move from PSNB to PSNCR, it is also necessary to adjust for the likely impact of timing differences between cash flows and accruals. For example, if receipts are forecast to rise over time, the cash received in any given year will generally be lower than the accrued tax receipts.

4.151 A large component of the receipts timing adjustment relates to the interest on student loans. This is included in the accrued measure of public sector current receipts as soon as the loan is issued. However, cash repayments are not received until the point at which former students earn sufficient income. Interest payments before the Budget announcement on the switch of maintenance grants to loans are lower than in March reflecting the effects of

slightly lower RPI inflation on the interest rate applied to these loans, hence accruals adjustments are also lower than in March. This is more than offset in the final two years of the forecast by the Budget announcement. This adds £0.5 billion to interest on student loans by 2020-21.

4.152 Similar timing adjustments are made for expenditure. The largest is for the timing of payments on index-linked gilts. This is very sensitive to RPI inflation, as well as to the profile of redemptions, which is uneven from year to year. Positive RPI inflation raises the amount government will have to pay on index-linked gilts when they are redeemed. This commitment is recognised in PSNB each year, but the actual cash payments do not occur until redemption of the gilt, which may be many years in the future. Since March, the small downward revision to RPI inflation has reduced accrued debt interest, with a largely offsetting change in the accruals adjustment.

4.153 There are also lags due to the timing of cash payments through the year and from auction price effects. For gilts sold at a premium, the cash payments to cover coupons will be larger than the amounts accrued in debt interest. Lower gilt issuance and increases in gilt rates since March have reduced the projected premia on conventional gilts, whereas lower real yields have increased premiums on index-linked gilts. We have also made some corrections to our accrual adjustments, including to the student loans interest and debt interest payments related to PFI loans.

Other factors

4.154 The rundown of the Bradford & Bingley and NRAM plc (B&B and NRAM) loan books directly reduces the net cash requirement, in addition to net interest which also reduces net borrowing. Since March, we received more details on the planned sale of NRAM plc assets, principally the Granite securitisation vehicle, held by UK Asset Resolution (UKAR), announced by the Chancellor in March 2015. The latest forecast includes an additional £0.9 billion sale of related unsecured loans and other assets. Despite this further detail, a number of important uncertainties remain around the form and timing of this sale. We continue to assume that there will be sufficient private sector demand that the sale will be successful, that UKAR will sell at a price consistent with its book value at the time of the sale, and that the sale will be completed by March 2016.

4.155 Cash flows are invariably more volatile than the underlying accrued position of the public finances and reconciling borrowing and estimating the net cash requirement has recently proved difficult. The net cash requirement has come in lower than the bottom-up receipts, expenditure and financial transactions forecasts we use to project it would suggest.

4.156 In March, we had identified an £11 billion gap between our estimate for the cash requirement in 2014-15 and expected outturns for the year. We assumed this gap would narrow to £6 billion in 2015-16. Since March, extensive analysis of the reconciliation between the accruals and cash measures of borrowing has allowed us to identify most of the reasons for the original £11 billion gap. As a result, we have reduced the 'alignment adjustment' in 2015-16 to £2 billion. We now believe that this remaining difference is more

likely to persist than to be a timing effect, so we have included a £2 billion adjustment in future years too. Box 4.4 describes these changes in the context of other revisions to our cash and accruals borrowing forecasts.

Central government net cash requirement

4.157 The central government net cash requirement (CGNCR) is important because it is the main determinant of Government's net financing requirement. Table 4.35 shows how CGNCR relates to PSNCR and Table 4.36 sets out the changes in this relationship since March. The CGNCR is derived by adding or removing transactions associated with local authorities and public corporations to the PSNCR. We expect local authorities and public corporations to be net lenders over the forecast period.

4.158 The classification of B&B and NRAM plc and Network Rail in the central government sector means that the CGNCR is no longer simply a measure of the cash required by the Exchequer to fund its operations, which forms the basis for the Government's net financing requirement.[18] This has three effects:

- the banks' own cash requirements are now included in the headline CGNCR. Running down the banks' loan books (including through asset sales) reduces CGNCR by almost £19 billion in 2015-16, falling to around £3 billion by 2020-21, but this does not directly affect the Exchequer (this forecast is shown towards the bottom of Table 4.25);

- interactions between the Exchequer and these bodies net off within the headline measure. The banks' loan repayments to the Exchequer vary from around £3 billion to £7 billion a year; and

- the Treasury will finance Network Rail new and maturing debt in future, for which Network Rail will pay a fee. Refinancing needs are projected at £3 billion in 2015-16 but decline over time. We previously double-counted the financing of Network Rail's new debt, which is already included in PSNB.

[18] The Government is publishing a revised financing remit for 2015-16 alongside the Budget. The OBR provides the Government with the forecast of the CGNCR for this purpose, but plays no further role in the derivation of the net financing requirement.

Table 4.27: Reconciliation of PSNCR and CGNCR

	£ billion					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Public sector net cash requirement (NCR)	51	56	32	10	-5	8
of which:						
Local authorities and public corporations NCR	-2	1	0	-1	-3	-2
Central government (CG) NCR own account	53	55	32	12	-2	10
CGNCR own account	53	55	32	12	-2	10
Net lending within the public sector	2	1	1	1	1	1
CG net cash requirement	55	56	33	13	-1	11
B&B and NRAM adjustment	14	1	0	0	0	0
Network Rail adjustment	3	2	1	1	-1	0
CGNCR ex. B&B, NRAM and Network Rail	72	59	34	14	-2	11

Table 4.28: Changes in the reconciliation of PSNCR and CGNCR

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net cash requirement (NCR)	-13	-3	4	5	-10
of which:					
Local authorities and public corporations NCR	1	1	2	2	2
Central government (CG) NCR own account	-14	-4	2	3	-12
CGNCR own account	-14	-4	2	3	-12
Net lending within the public sector	1	-1	-1	-1	-1
CG net cash requirement	-13	-5	1	2	-13
B&B and NRAM adjustment	3	-4	-1	-1	-2
Network Rail adjustment	-4	-4	-4	-4	-4
CGNCR ex. B&B, NRAM and Network Rail	-14	-13	-4	-3	-18

Box 4.3: Revisions to the central government net cash requirement forecast

CGNCR ex is the measure of borrowing that feeds directly into the Government's gilt issuance plans. It differs from PSNB – the proposed fiscal target measure – in terms of coverage (it is narrower) and timing (it records cash flows as they happen). We forecast CGNCR ex by adding to, adjusting or removing various items from our PSNB forecast.

We noted in March that after making these adjustments, a large unexplained residual remained and that we would be working with the Treasury to identify and resolve sources of this difference. In essence, CGNCR ex outturns were significantly lower than seemed consistent with the rest of our fiscal forecast. That work has led to a number of changes in our latest forecast, which in total mean CGNCR ex has been revised down significantly in all years despite upward revisions to PSNB in some years.

Table C decomposes the revisions to CGNCR ex since March into changes in PSNB and the subsequent adjustments to get to PSNCR, to CGNCR and finally to CGNCR ex. (The last two transitions do not affect public sector net debt.) It shows that:

- we have revised PSNB down in 2015-16 and 2019-20, and up in the intervening years, for reasons detailed in the rest of this chapter;
- we have revised the PSNCR down relative to a given path of PSNB. The analysis we have undertaken with the Treasury since March identified a number of issues that have led to corrections to various accruals adjustments that affect all years (including student loans interest and debt interest payments related to some PFI loans). These have reduced the PSNCR relative to PSNB in every year. Having made those corrections, we have reduced the 2015-16 alignment adjustment from £6 billion to £2 billion, and pushed that adjustment through to the rest of the forecast. That raised PSNCR relative to PSNB in 2015-16, but reduced it thereafter. Finally, we have revised up our forecast of asset sale receipts in each year of the forecast, which lowers PSNCR relative to PSNB;
- CGNCR has been revised down further relative to PSNCR. This essentially unwinds upward revisions to local authorities and public corporations net borrowing, which increase the public sector but not central government net cash requirement; and
- CGNCR ex has been revised down relative to CGNCR, mainly reflecting a correction to the treatment of Network Rail grants, which had incorrectly been added back to CGNCR ex in previous forecasts. That adjustment had been equal to around £4 billion a year. We have also revised up the speed at which UKAR repays its government loans.

Table C: Revisions to CGNCR ex since March

	£ billion				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
March[1]	86	72	38	17	17
July	72	59	34	14	-2
Change	-14	-13	-4	-3	-18
of which:					
PSNB	-6	4	11	12	-3
PSNB to PSNCR adjustment	-7	-7	-8	-7	-7
PSNCR to CGNCR adjustment	-1	-2	-2	-3	-3
CGNCR to CGNCR ex adjustment	-1	-8	-6	-5	-6

[1] Our March forecast for 2015-16 has been adjusted in this table to reflect the £6.7 billion correction to the treatment of UKAR cash receipts from the Granite sale. The background to this is explained in a letter from the Treasury to the OBR, available on the March 2015 *Economic and fiscal outlook* page of our website.

We have not been able to resolve all the differences between our forecast and outturns, so have retained a £2 billion a year downward alignment adjustment in the reconciliation from PSNB to PSNCR. We suspect that may be related to the many sources of small amounts of income to the Exchequer – for example, court fines or fees charged by smaller public sector bodies including public corporations – and will continue to explore the issue with Treasury and ONS officials.

The key fiscal aggregates

4.159 Our central forecast for the key fiscal aggregates incorporates the forecast for receipts, expenditure and financial transactions set out earlier in this chapter. In this section we explain the changes in five key fiscal aggregates:

- **public sector net borrowing:** the difference between total public sector receipts and expenditure on an accrued basis each year. As the widest measure of borrowing, PSNB is a key indicator of the fiscal position and is useful for illustrating the reasons for changes since the previous forecast. It will be used as the target measure for the Government's proposed fiscal mandate;
- **cyclically adjusted net borrowing:** public sector net borrowing adjusted to reflect the estimated impact of fluctuations in the economic cycle. It represents an estimate of underlying or 'structural' net borrowing, in other words borrowing we would expect to see if the output gap was zero;
- the **current budget**: the difference between public sector current expenditure and receipts each year. In effect, this is public sector net borrowing excluding borrowing to finance investment;
- the **cyclically adjusted current budget**: the current budget adjusted to reflect the estimated impact of fluctuations in the economic cycle. It is used as the target measure for the current fiscal mandate; and
- **public sector net debt**: a stock measure of the public sector's net liability position defined as its gross liabilities minus its liquid assets. In broad terms, it is the stock equivalent of public sector net borrowing, measured on a cash basis rather than an accrued basis. It is used for the Government's current and proposed supplementary fiscal targets.

Public sector net borrowing

4.160 Public sector net borrowing peaked at 10.2 per cent of GDP (£153.5 billion) in 2009-10 as the late 2000s recession and financial crisis dealt the public finances a significant blow. Fiscal consolidation and economic recovery then reduced the deficit to 4.9 per cent of GDP (£89.2 billion) by 2014-15. Table 4.29 shows that we expect the deficit to continue falling, and the budget to move into surplus in 2019-20, a year later than in our March forecast.

4.161 Table 4.29 breaks down the revision in borrowing since March into different sources of change. (The table shows the effect of revisions on borrowing, so an upward revision to receipts is shown as a negative since it reduces borrowing.)

4.162 We have revised borrowing down by £5.8 billion in 2015-16. That reflects:

- stronger than expected receipts growth, particularly income tax, VAT and stamp duty on property transactions; and

- Government decisions that bear down more heavily on the deficit this year, including in-year cuts to DEL spending, raising the insurance premium tax rate and the decision to delay the introduction of tax-free childcare following a legal challenge.

4.163 We have revised borrowing up in 2016-17 and more significantly in 2017-18, while the surplus of £5.2 billion in 2018-19 that we forecast in March is now expected to be a deficit of £6.4 billion. The higher borrowing over these three years reflects the net effect of:

- upward revisions to our receipts forecast (before the effects of Budget policy decisions). The biggest source of improvement has been income tax and NICs. Receipts have also been boosted relative to March by a classification change, with expected costs of tax litigation cases switched from negative tax to capital grants (in line with National Accounts guidelines) and by an upward revision to environmental levies, which are neutral for borrowing because they increase spending equally;

- upward revisions to annually managed expenditure (AME) (again, before the effects of Budget policy measures). A methodological change raised our forecast of net public service pension costs, while higher gilt rates, the revisions to environmental levies and the treatment of tax litigation costs also raised AME. Our forecast for payments to EU institutions is higher for 2016-17 than in March, due to a change in the expected timing of adjustments to UK contributions. Debt interest payments are also higher;

- the receipts and AME measures on the Budget 'scorecard' reduce borrowing by £12.8 billion a year on average. These include a net tax increase averaging £5.3 billion a year and cuts in welfare spending averaging £7.4 billion a year. We note in Annex A that the uncertainty around the expected yield from many of the revenue-raising measures exceeds that around most of the tax cuts;

- the scorecard measures are more than offset by the Government's decision to increase provisional departmental spending totals significantly relative to the amounts penciled in by the Coalition Government in March. The increases in day-to-day spending on public services, grants and administration (RDEL in the table) by £24.2 billion a year on average. Relative to March, RDEL has been increased by around 6 per cent in 2016-17, 9 per cent in 2017-18 and 10 per cent in and 2018-19. Conversely, capital DEL has been reduced by a relatively modest £1.6 billion a year on average. (We treat changes in DEL spending as policy decisions, as the Government is aware of the rest of our forecast when setting the path of spending from which DELs are inferred); and

- part of the overall fiscal loosening is unwound through its indirect effects on the economy and therefore net borrowing. The largest indirect effects come through higher income tax receipts (due to higher nominal GDP growth) and lower net public service pension costs (due to smaller falls in the workforce making contributions to the

schemes). The introduction of the Living Wage Premium also has a very small net effect on borrowing, as described in Annex B.

4.164 In 2019-20, we have revised the expected surplus up a little. The Government chose to increase RDEL by less than for the earlier years, which means that scorecard measures were sufficient to offset forecast changes that would otherwise have reduced the expected surplus.

4.165 The surplus rises very slightly in 2020-21, as the Government has chosen to increase RDEL as a share of GDP. This offsets various factors that would otherwise have increased the surplus further. (In Table 4.29, this increase in RDEL as a share of GDP explains why the change in cash terms is shown rising from £12.1 billion in 2019-20 to £21.6 billion in 2020-21.) The underlying factors that would have increased the surplus include fiscal drag in the tax system (when income tax thresholds rise by inflation, but earnings rise faster because of productivity) and in the welfare system (when benefits rise by inflation, reducing average awards relative to average earnings in the wider economy).

Table 4.29: Public sector net borrowing

	£ billion						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
March forecast	90.2	75.3	39.4	12.8	-5.2	-7.0	
July forecast	89.2	69.5	43.1	24.3	6.4	-10.0	-11.6
Change	-1.0	-5.8	3.7	11.5	11.6	-3.0	
Changes to the receipts forecast[1]	-1.9	-5.5	-10.3	-12.6	-13.5	-10.0	
Forecast changes	-1.9	-4.9	-3.7	-4.0	-3.5	-3.1	
Effect of Government decisions	0.0	-0.6	-6.5	-8.5	-9.9	-6.9	-8.2
of which:							
Scorecard measures	0.0	-1.0	-4.0	-5.1	-6.8	-5.8	-6.5
Indirect effect of Government decisions	0.0	0.4	-2.5	-3.4	-3.1	-1.1	-1.7
Changes to current AME spending[1]	0.6	2.2	-2.3	-2.0	-2.5	-3.7	
Forecast changes	0.6	2.2	4.1	6.0	8.8	10.1	
Effect of Government decisions	0.0	0.0	-6.5	-8.1	-11.3	-13.8	-15.7
of which:							
Welfare scorecard measures	0.0	-0.3	-5.6	-6.9	-9.7	-12.5	-13.3
Other scorecard measures	0.0	0.1	0.0	0.0	-0.1	-0.3	-0.6
Indirect effect of Government decisions	0.0	0.2	-0.9	-1.2	-1.5	-1.0	-1.8
Changes to RDEL spending[2]	0.9	-1.3	17.2	27.0	28.3	12.1	21.6
Changes to capital spending[1]	-0.5	-1.3	-0.8	-0.9	-0.8	-1.3	
Forecast AME changes[3]	-0.1	-0.3	0.9	1.4	0.1	0.4	
Scorecard AME measures	0.0	0.0	0.0	-0.2	0.0	-0.1	-0.1
Changes to CDEL spending[2,3]	-0.5	-1.0	-1.8	-2.1	-0.8	-1.6	-1.9
	Summary of changes						
Total forecast change	-1.4	-3.0	1.3	3.4	5.4	7.4	
Total effect of Government decisions	0.4	-2.8	2.4	8.0	6.3	-10.4	-4.3
of which:							
Scorecard receipts and AME measures	0.0	-1.2	-9.6	-12.2	-16.7	-18.7	-20.5
RDEL and CDEL changes[3]	0.4	-2.3	15.4	24.8	27.5	10.5	19.8
Indirect effect of Government decisions	0.0	0.6	-3.4	-4.6	-4.6	-2.2	-3.5

[1] 2014-15 has been adjusted to remove the effect of ONS measurement differences. See supplementary tables published on our website for more information.

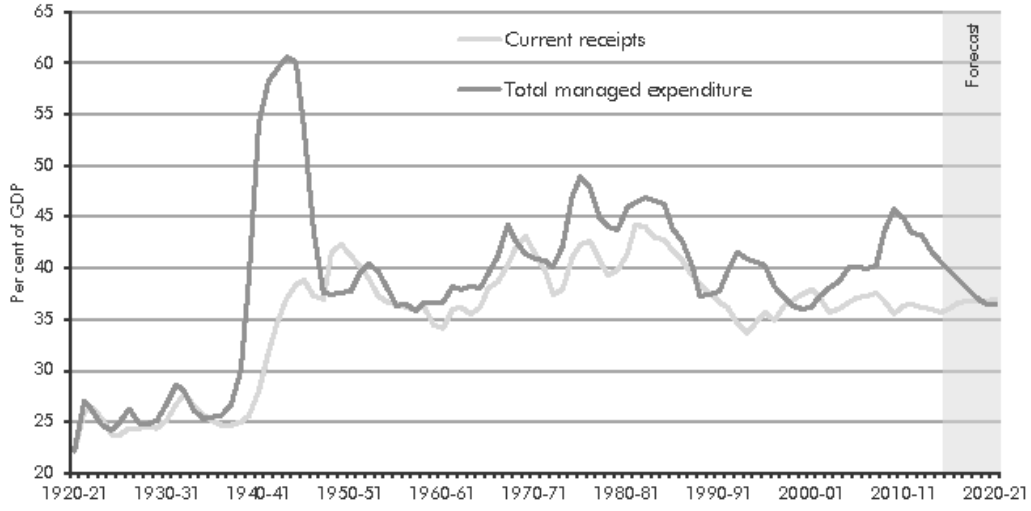
[2] The change in 2020-21 is relative to a baseline that assumes spending by departments would otherwise have remained constant as a share of potential GDP.

[3] CDEL and capital AME changes have been adjusted to exclude the £0.9 billion switch from CDEL to capital AME in 2015-16 as a result of the GAD-Milne case, and to exclude the switch from CDEL to capital AME that reflects the reclassification of government grants to Network Rail in our forecast, which is explained in note 1 of Table 4.17.

Note: this table uses the convention that a negative figure means a reduction in PSNB, i.e. an increase in receipts or a reduction in spending will have a negative effect on PSNB.

4.166 Chart 4.14 shows current receipts and total managed expenditure as a share of GDP since 1919-20 using Bank of England and ONS data. Total spending falls to 36.3 per cent of GDP, which is fractionally higher than the previous post-war lows of 35.8 per cent in 1957-58 and 36.0 per cent in 1999-2000. Current receipts as a share of GDP are forecast to remain at similar levels to those seen over the last few decades.

Chart 4.14: Total public sector spending and receipts



Source: Bank of England, ONS, OBR

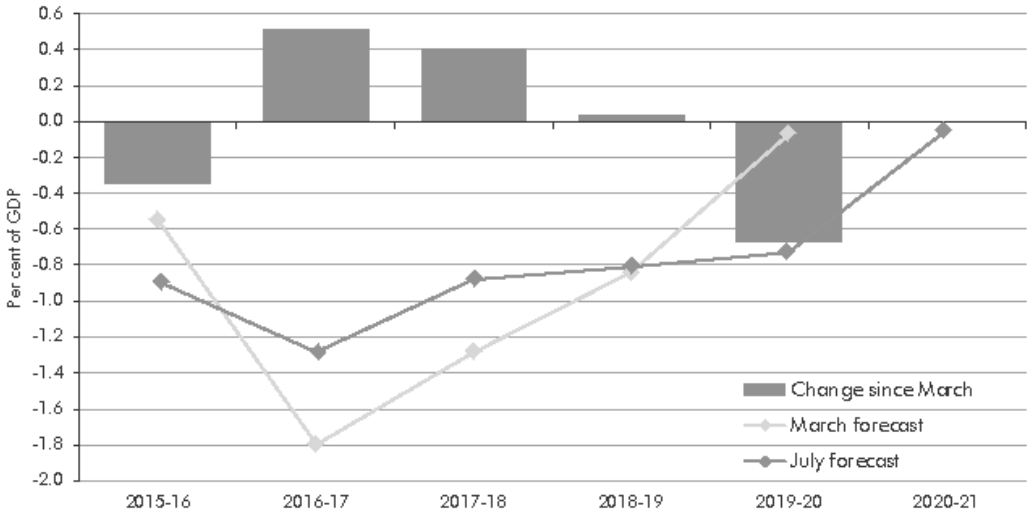
Cyclically adjusted net borrowing (the structural fiscal position)

4.167 Our estimate of the margin of spare capacity in the economy is small in 2015-16 at just 0.6 per cent of potential output and we expect this 'output gap' to close in 2018-19. So the path of structural borrowing is similar to that of headline borrowing described above.

4.168 The year-on-year change in the structural budget deficit – public sector net borrowing adjusted for the size of the output gap – is a common measure of the pace of fiscal consolidation. It has drawbacks when estimates of potential output change significantly, but is more useful when, as currently appears the case, potential output growth is more stable.

4.169 Chart 4.15 shows how the Government's decision to slow the fiscal tightening and smooth the path from year to year implies a more even pace of consolidation than in our last forecast. The figures assumed by the Coalition in March implied a substantial acceleration in the consolidation next year, with the planned reduction in the structural budget deficit rising from 0.5 per cent of GDP in 2015-16 to 1.8 per cent in 2016-17. (That would have equalled the sharpest tightening on this measure since 1981-82.) Thanks to the in-year spending cuts announced in June and the stronger-than-expected receipts growth this year – followed by the Government's willingness to allow more headline borrowing in 2016-17 – the acceleration in the consolidation next year is now much less marked, with the structural deficit falling by 0.9 per cent of GDP in 2015-16 and then 1.3 per cent in 2016-17.

Chart 4.15: Year-on-year changes in cyclically adjusted net borrowing



Source: OBR

Current budget

4.170 The current budget balance, which excludes borrowing to finance net investment spending, is estimated to have been in deficit by £58.3 billion in 2014-15, down from a peak of £103.3 billion in 2009-10. The current budget moves into surplus in 2017-18 and the surplus increases thereafter to reach £43.7 billion in 2020-21.

Cyclically adjusted current budget

4.171 The cyclically adjusted current budget (CACB) moves from a deficit of 1.7 per cent of GDP in 2015-16 to a surplus of 1.9 per cent of GDP in 2020-21, with the balance moving into surplus in 2017-18. The CACB balance is weaker between 2016-17 and 2018-19, reflecting the Government's decision to slow the pace of fiscal consolidation. The surplus on this measure is then slightly larger in 2019-20. The CACB is discussed further in Chapter 5.

Public sector net debt

4.172 We forecast that public sector net debt (PSND) as a share of GDP will start to fall this year – by a small margin – and will fall materially in each subsequent year to reach 68.5 per cent of GDP in 2020-21. By then, around a quarter of the rise in the debt-to-GDP ratio between 2007-08 and 2014-15 would have been reversed.

4.173 As Table 4.29 showed, the changes described above mean we expect the budget balance to improve in every year of the forecast, but less quickly than was expected in March. We also expect debt to fall as a share of GDP in every year of the forecast. As well as changes to borrowing, our public sector net debt (PSND) forecast has been revised substantially due to the further asset sales announced in the Budget and by a number of changes to the way we

convert our borrowing forecast (which is an accrued measure) to an estimate of the net cash requirement (the cash measure of borrowing that drives changes in net debt). Table 4.30 shows that:

- upward revisions to our nominal GDP forecast have reduced the ratio in most years, but the downward revision in 2019-20 has had the opposite effect;
- changes to net borrowing have added £17 billion to debt by 2019-20;
- additional asset sales have taken a further £8 billion off net debt in 2015-16, rising to £31 billion by 2019-20. The biggest effect over the forecast comes from the Government's announcement that it will sell three quarters of its holdings of RBS shares over the Parliament. We have assumed that this will raise £25 billion in total, with £2 billion raised this year and around £6 billion a year thereafter. (The Treasury also informed us of a change to the detail of its announcement on the sales of RBS shares on 3 July – the deadline for delivering final policy decisions for inclusion in the forecast – in a way that was sufficient to push our forecast for PSND as a share of GDP in 2019-20 from slightly higher than it had been in March to slightly lower); and
- revisions to outturn data have raised net debt in 2014-15, which is pushed through to subsequent years of the forecast. A correction to the treatment of APF cash balances in our forecast has also increased debt from 2015-16 onwards.

Table 4.30: Changes in public sector net debt since March

	Per cent of GDP						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
March forecast	80.4	80.2	79.8	77.8	74.8	71.6	
July forecast	80.8	80.3	79.1	77.2	74.7	71.5	68.5
Change	0.4	0.0	-0.6	-0.6	-0.1	-0.1	
of which:							
Change in nominal GDP[1]	0.1	0.1	-0.4	-0.4	-0.2	0.3	
Change in cash level of net debt	0.3	-0.1	-0.2	-0.1	0.1	-0.4	
	£ billion						
March forecast	1479	1533	1580	1606	1617	1627	
July forecast	1486	1532	1576	1603	1619	1618	1627
Change in cash level of net debt	6	-1	-5	-3	1	-9	
of which:							
Changes to borrowing	-1	-7	-3	8	20	17	
Asset sales	0	-8	-14	-19	-25	-31	
Gilt premia	1	4	3	1	0	0	
Asset purchase facility	0	2	2	2	2	2	
Outturns	3	3	3	3	3	3	
Other factors	3	4	4	2	1	0	

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

Table 4.31: Fiscal aggregates

	Per cent of GDP						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Receipts and expenditure							
Public sector current receipts (a)	35.7	35.9	36.5	36.6	36.7	36.7	36.8
Total managed expenditure (b)	40.7	39.6	38.7	37.8	37.0	36.3	36.3
of which:							
Public sector current expenditure (c)	37.0	36.0	35.2	34.4	33.5	32.9	32.9
Public sector net investment (d)	1.7	1.5	1.5	1.4	1.4	1.4	1.4
Depreciation (e)	2.0	2.1	2.1	2.1	2.1	2.1	2.0
Deficit							
Public sector net borrowing (b-a)	4.9	3.7	2.2	1.2	0.3	-0.4	-0.5
Current budget deficit (c+e-a)	3.2	2.2	0.8	-0.2	-1.1	-1.8	-1.9
Cyclically-adjusted net borrowing	4.1	3.2	2.0	1.1	0.3	-0.5	-0.5
Primary balance	-3.4	-2.1	-0.4	0.8	1.7	2.4	2.3
Cyclically-adjusted primary balance	-2.6	-1.7	-0.2	0.9	1.7	2.4	2.3
Fiscal mandate and supplementary target							
Cyclically-adjusted deficit on current budget	2.4	1.7	0.5	-0.3	-1.1	-1.8	-1.9
Public sector net debt[1]	80.8	80.3	79.1	77.2	74.7	71.5	68.5
Financing							
Central government net cash requirement	5.2	2.9	2.9	1.6	0.6	0.0	0.5
Public sector net cash requirement	4.5	2.7	2.9	1.6	0.5	-0.2	0.3
Stability and Growth Pact							
Treaty deficit[2]	5.1	4.0	2.3	1.4	0.5	-0.3	-0.4
Cyclically-adjusted Treaty deficit	4.3	3.6	2.1	1.2	0.4	-0.3	-0.4
Treaty debt ratio[3]	88.5	87.6	86.8	85.2	82.8	79.8	76.4
				£ billion			
Public sector net borrowing	89.2	69.5	43.1	24.3	6.4	-10.0	-11.6
Current budget deficit	58.3	40.8	14.7	-3.5	-22.9	-40.4	-43.7
Cyclically-adjusted net borrowing	74.9	60.8	38.3	22.0	5.8	-10.0	-11.6
Cyclically-adjusted deficit on current budget	44.0	32.2	9.8	-5.8	-23.4	-40.4	-43.7
Public sector net debt	1486	1532	1576	1603	1619	1618	1627
Memo: Output gap (per cent of GDP)	*-0.8*	*-0.6*	*-0.3*	*-0.1*	*0.0*	*0.0*	*0.0*

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

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

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

Risks and uncertainties

4.174 As always, we emphasise the uncertainties that lie around our central fiscal forecast. We expose our judgements to different sensitivities and scenarios in Chapter 5. While there are some risks and uncertainties common to all forecasts, in this *EFO* we have highlighted:

- global and domestic risks associated with the economy, notably the recent escalation of the Greek debt crisis (paragraph 3.110);

- the effects of a number of significant policy changes announced in the Budget, including tax-raising measures that target avoidance, evasion and compliance issues (Annex A) and the introduction of a National Living Wage (Annex B);
- other policy-related risks, including the Government's commitment to increase the income tax personal allowance to £12,500, which has only partly been delivered in this Budget (paragraph 4.25) and the boost to expected growth in self-assessment receipts associated with previously announced policies (paragraph 4.30);
- uncertainties around the large financial asset sales – including the Government's shareholdings in Lloyds Banking Group and RBS – that are planned to take place this year and over the Parliament (from paragraph 4.147);
- uncertainty associated with potential future costs from tax litigation cases (Box 4.1); and
- a possible future classification risk associated with policies affecting housing associations, which are currently classified in the private sector and carry significant amounts of debt (paragraph 4.12).

International comparisons

4.175 International organisations, such as the European Commission and the International Monetary Fund (IMF), produce forecasts of deficit and debt levels of different countries on a comparable basis. These are based on general government debt and borrowing and are presented on a calendar year basis. To facilitate comparisons, Tables 4.32 and 4.33 present our UK forecasts on a comparable basis. With both modelling and reporting of much tax and expenditure done primarily on a financial year basis, the calendar year forecasts are illustrative and have been derived by weighting the financial year forecasts.

Table 4.32: Comparison with European Commission forecasts

	Per cent of GDP					
	Treaty Deficit[1]			Treaty Debt[2]		
	2014	2015	2016	2014	2015	2016
UK (July EFO)	5.8	4.3	2.8	89.3	87.9	87.1
UK (EC)	5.7	4.5	3.1	89.4	89.9	90.1
Germany	-0.7	-0.6	-0.5	74.7	71.5	68.2
France	4.0	3.8	3.5	95.0	96.4	97.0
Italy	3.0	2.6	2.0	132.1	133.1	130.6
Spain	5.8	4.5	3.5	97.7	100.4	101.4
Euro area	2.4	2.0	1.7	94.2	94.0	92.5

[1] General government net borrowing.

[2] General government gross debt.

Source: European Commission, European Economic Spring 2015; OBR

Table 4.33: Comparison with IMF forecasts

	Per cent of GDP					
	General government net borrowing			General government net debt		
	2015	2016	2020	2015	2016	2020
UK (July EFO)	4.3	2.8	-0.3	79.9	79.2	69.8
UK (IMF)	4.8	3.1	0.3	82.6	83.1	74.7
Germany	-0.3	-0.4	-0.6	46.9	44.7	37.1
France	3.9	3.5	0.4	89.3	90.4	84.4
Italy	2.6	1.7	-0.3	111.8	111.1	102.3
Japan	6.2	5.0	4.4	129.6	131.9	138.7
U.S	4.2	3.9	3.9	80.4	80.7	82.1

Source: OBR, IMF, World Economic Outlook, April 2015

5 Performance against the Government's fiscal targets

Introduction

5.1 This chapter:

- sets out the Government's current and proposed medium-term fiscal targets (from paragraph 5.2);
- examines whether the Government has a better than 50 per cent chance of meeting them, given our central forecast (from paragraph 5.8); and
- assesses how robust these judgements are to the uncertainties inherent in any fiscal forecast, by looking at past forecast errors, sensitivity to key parameters of the forecast and alternative economic scenarios (from paragraph 5.34).

The Government's fiscal targets

5.2 The *Charter for Budget Responsibility* requires the OBR to judge whether the Government has a greater than 50 per cent chance of hitting its fiscal targets under current policy.

5.3 The current version of the *Charter* (updated by the Coalition Government in December 2014 and available on our website) sets out three targets formally in place for this forecast:

- the **fiscal mandate**: *"a forward-looking aim to achieve cyclically adjusted current balance by the end of the third year of the rolling, 5-year forecast period"*. For the purposes of this forecast, the third year of the forecast period is 2018-19;
- a **supplementary target**: *"an aim for public sector net debt as a percentage of GDP to be falling in 2016-17"*; and
- the **welfare cap**: a ceiling on cash spending on a subset of social security benefits and tax credits *"at a level set out by the Treasury in the most recently published Budget report, over the rolling 5-year forecast period."* We assess performance against the cap formally at each Autumn Statement and monitor progress in our Budget forecasts.

5.4 But alongside the Budget the new Government has now published a revised draft *Charter* that will be laid before Parliament for approval ahead of our next fiscal forecast. This would:

- replace the current fiscal mandate with *"a target for a surplus on public sector net borrowing by the end of 2019-20"*. Once a headline surplus has been achieved the mandate will require *"a target for a surplus on public sector net borrowing in each subsequent year"*; and

- replace the supplementary target with *"a target for public sector net debt as a percentage of GDP to be falling in each year"* to 2019-20.

5.5 According to the draft *Charter* *"these targets apply unless and until the OBR assess that there is a significant negative shock to the UK. A significant negative shock is defined as real GDP growth of less than 1 per cent on a rolling 4 quarter-on-4 quarter basis."* This assessment would be made alongside our forecasts, at the same time as we carry out our assessment of performance against the fiscal targets.

5.6 The draft *Charter* retains the welfare cap as a target. But the Government has reset the permitted level of spending in this Budget, as the *Charter* requires it to do at the start of each Parliament. The new cap is significantly lower than the old, with the Government choosing to lock in the savings from the package of working-age welfare spending cuts that it has announced in the Budget.

5.7 In this chapter, we assess the Government's performance against both the current fiscal targets and the proposed new ones. On our central forecast, all are on course to be met.

The implications of our central forecast

5.8 Table 5.1 shows our central forecasts for the fiscal aggregates relevant to the current and proposed new fiscal targets: the cyclically adjusted current budget deficit (CACB); public sector net debt (PSND); public sector net borrowing (PSNB); and spending within the welfare cap. These forecasts are described in detail in Chapter 4. They are median forecasts, so we believe it is equally likely that outturns will come in above them as below them.

Table 5.1: Performance against the Government's fiscal targets

	Per cent of GDP						
	Estimate	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Cyclically adjusted current budget deficit							
March forecast	2.5	2.1	0.4	-0.8	-1.7	-1.7	
July forecast	2.4	1.7	0.5	-0.3	-1.1	-1.8	-1.9
Public sector net debt							
March forecast	80.4	80.2	79.8	77.8	74.8	71.6	
July forecast	80.8	80.3	79.1	77.2	74.7	71.5	68.5
Public sector net borrowing							
March forecast	5.2	4.3	2.2	0.8	0.0	-0.1	
July forecast	4.9	3.7	2.2	1.2	0.3	-0.4	-0.5
	£ billion						
Spending within the welfare cap							
March forecast	119.4	120.6	121.0	121.8	124.0	126.5	
July forecast	119.1	120.6	115.2	114.6	114.0	113.5	114.9

The current fiscal mandate

5.9 Table 5.1 shows that our central forecast is for the CACB to be in surplus by 1.1 per cent of GDP in 2018-19. This means that there is a greater than 50 per cent chance of the Government meeting the current fiscal mandate. The surplus rises further in 2019-20 and is broadly stable in 2020-21.

5.10 Chart 5.1 uses cyclical-adjustment coefficients for different types of receipts and spending[1] to show how about the CACB is expected to move from deficit in 2014-15 to surplus in 2018-19:

- the CACB is expected to improve by 3.5 per cent of GDP between 2014-15 and 2018-19, with lower spending contributing 2.9 per cent and higher receipts 0.7 per cent. These magnitudes are all similar to those reported in our March *EFO*, but now take place over four years rather than the three the Coalition Government aimed for then;

- in the current year (2015-16), the CACB falls by 0.7 per cent of GDP (£13 billion). Cuts in spending, in particular a structural reduction in day-to-day departmental spending (RDEL in the chart), explain all the change;

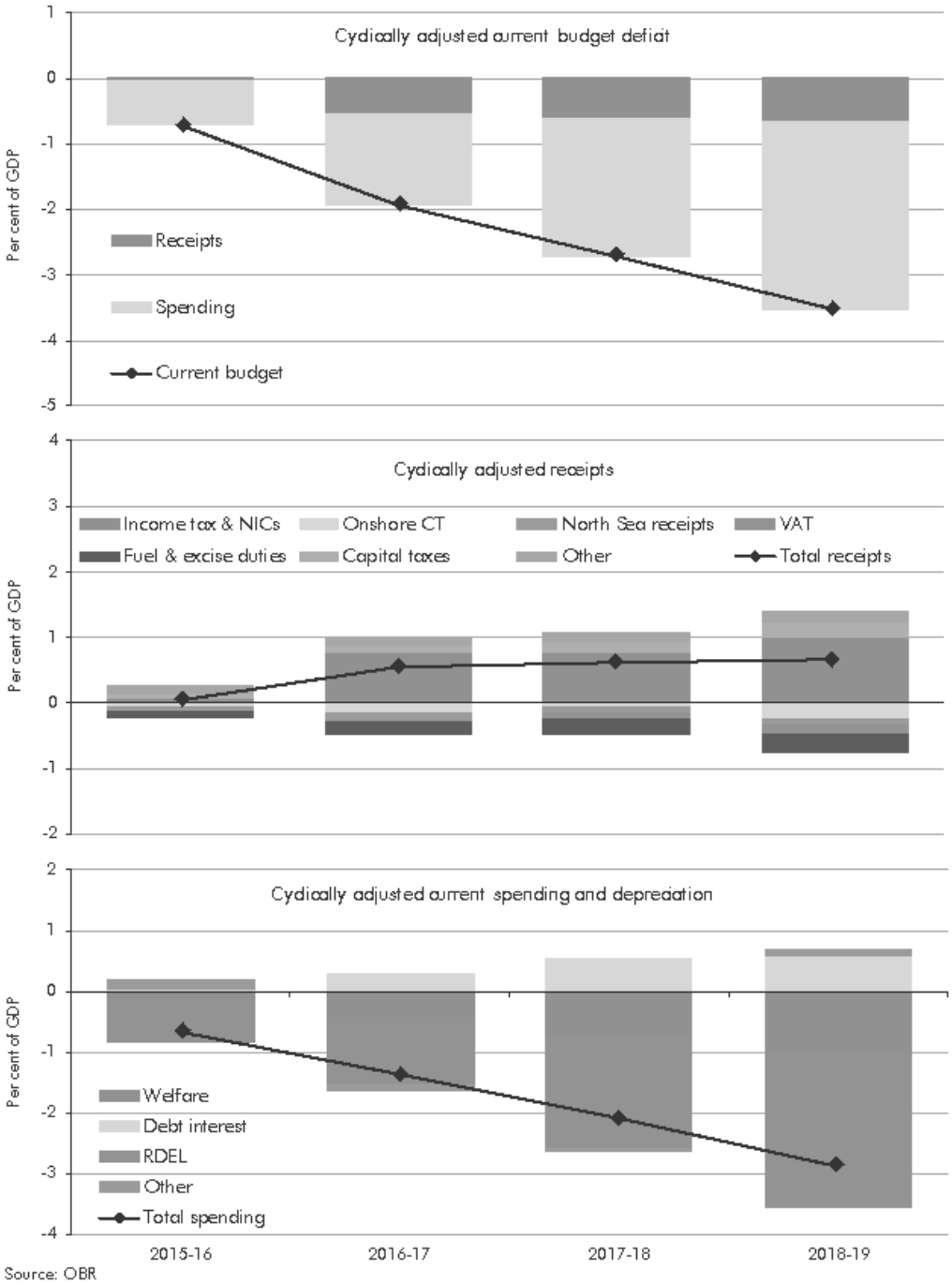
- as in March, the CACB is forecast to improve most in 2016-17 – by 1.2 per cent of GDP (£24 billion). This is a smaller margin than the 1.7 per cent of GDP (£33½ billion) improvement forecast in March, as the Government has assumed a less severe cut in RDEL spending. A combination of cuts in public service spending and welfare cuts account for the majority of the improvement of the CACB in 2016-17 (around £14 billion in structural terms). The structural rise in receipts from income tax (£8 billion) and NICs (£6 billion) also contributes. The latter largely reflects the abolition of

[1] Further details can be found in Helgadottir *et al* (2012), *Working Paper No.4: Cyclically adjusting the public finances.*

the NICs contracting out rebate in April 2016. Around two thirds of the £5 billion of additional receipts from that measure is expected to come from public sector employers, adding to the pressure on implied departmental budgets; and

- in 2017-18 and 2018-19, the CACB improves by around 0.8 per cent of GDP a year (£17 billion on average). These improvements are almost entirely driven by the Government's decision to hold RDEL spending roughly flat in cash terms in those years, therefore reducing it sharply as a share of GDP (equivalent to £15 billion a year on average in structural terms). Again, the pace of cuts is less severe than had been penciled in by the Coalition in March.

Chart 5.1: Year-on-year changes to the cyclically adjusted current budget from 2015-16 to 2018-19



Source: OBR

5.11 In our March forecast, the fiscal mandate year was 2017-18. Our latest forecast shows that the margin by which the mandate would have been met in that year has fallen from 0.8 per cent of GDP to just 0.3 per cent of GDP. The CACB surplus is also expected to be lower in 2018-19 than we forecast in March.

5.12 Table 5.2 decomposes the changes in our forecast of the CACB since March. It shows that:

- the Government's decision to increase RDEL spending more than explains the overall reduction in the CACB surplus between 2016-17 and 2018-19;
- Budget scorecard measures – notably the cuts to welfare spending, but also net tax rises – partly offset the effect of higher departmental spending, improving the CACB by 0.6 per cent of GDP on average between 2016-17 and 2018-19;
- cyclically adjusted receipts (before the effects of policy measures) have been revised up, providing a further small offset to higher spending;
- non-departmental spending (again before the effects of policy measures) has also been revised up. Part of the higher receipts and spending reflects revisions to items that affect both equally (such as environmental levies); and
- overall the CACB has deteriorated slightly in 2016-17, but more significantly in 2017-18 and 2018-19, reflecting the slower pace of fiscal consolidation the Government has chosen in this Budget.

Table 5.2: Changes to the cyclically adjusted current budget deficit since March

	Per cent of GDP					
	Estimate	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
March forecast	2.5	2.1	0.4	-0.8	-1.7	-1.7
July forecast	2.4	1.7	0.5	-0.3	-1.1	-1.8
Change	-0.1	-0.4	0.1	0.5	0.6	-0.1
of which:						
RDEL	0.0	0.0	0.8	1.2	1.2	0.5
Budget measures	0.0	-0.1	-0.5	-0.5	-0.7	-0.8
Other receipts	0.0	-0.4	-0.2	-0.2	-0.1	-0.2
Other spending	-0.2	0.1	0.1	0.1	0.2	0.4

The current and proposed supplementary targets

5.13 The *current* supplementary target requires public sector net debt (PSND) to fall as a share of GDP between 2015-16 and 2016-17, with that year fixed. The *proposed* supplementary target requires it to fall in every year to 2019-20 (absent GDP growth falling below 1 per cent on a four-quarter-on-four-quarter rolling basis, which we do not forecast). As in March, we expect this to be the case, so that the Government is on course to meet both the current and proposed supplementary targets in our central forecast.

5.14 Debt would still be rising as a share of GDP in 2015-16, but for significant sales of financial assets (most of which are expected to take place late in the fiscal year). This is because the primary budget deficit (the difference between non-interest receipts and spending) and net lending to the private sector (mostly in student loans) are putting upward pressure on the debt-to-GDP ratio this year, outweighing the fact that nominal GDP growth is higher than the effective interest rate on the government's debt. In subsequent years the impact of net lending to the private sector and the differential between the growth rate and the interest rate are broadly stable, while the primary balance improves sufficiently to keep the debt-to-GDP ratio falling without the need for further significant asset sales.

5.15 More specifically, Chart 5.2 decomposes year-on-year changes in the debt-to-GDP ratio over the forecast period. It shows that:

- changes in the year-on-year profile of the debt-to-GDP ratio typically reflect changes in the primary balance. But the debt-to-GDP ratio falls in 2015-16 and 2016-17 despite the primary balance being in deficit by 2.1 and 0.4 per cent of GDP in these years;

- significant asset sales more than offset the effect of the primary deficit to reduce the debt-to-GDP ratio in 2015-16. Our latest estimates of these sales include around £13 billion of Lloyds Banking Group shares, around £12 billion of UK Asset Resolution assets, £2 billion of RBS shares, £2.3 billion of student loan book sales, £1.5 billion from the sale of the Government's remaining stake in Royal Mail and around £0.4 billion from its stake in King's Cross Central Partnership. In total, asset sales and effects of running down UKAR assets are expected to reduce PSND by £39 billion or 2.0 per cent of GDP in 2015-16. Further sales of RBS shares over the rest of the Parliament also affect the year-on-year profile of PSND. (Financial asset sales typically bring forward cash that would otherwise have been received in future revenues, in the shape of mortgage repayments and dividends, so they only temporarily reduce the debt-to-GDP ratio. In broad terms, financial asset sales leave the public sector's net worth unchanged);

- the fact that nominal GDP growth exceeds expected interest rates would, all else equal, be sufficient for debt to fall by over 1¼ per cent of GDP in every year, and by 1.6 per cent of GDP in 2020-21. This differential is an extremely important component of public sector debt dynamics, especially over longer timeframes. In our annual *Fiscal sustainability reports*, we analyse the impact of different assumptions on our results;

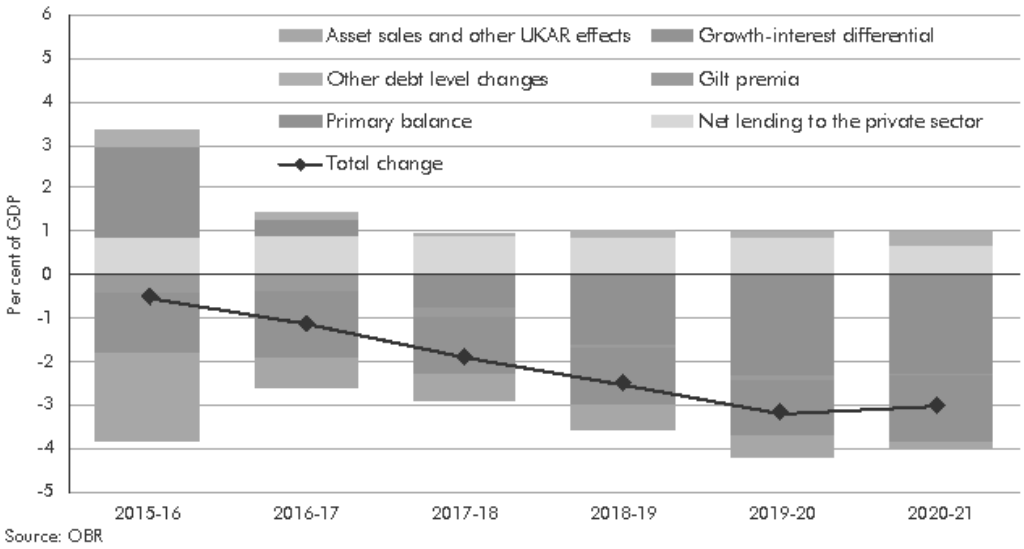
- net lending to the private sector – mainly student loans – increases net debt in every year (but, as a financial transaction, it does not directly affect measures of the deficit);

- issuing debt at a premium to its nominal value reduces net debt over the forecast period. But this is ultimately only temporary and will unwind over the long term; and

- other changes, mainly relating to the Asset Purchase Facility and timing effects, are relatively small. Accrued receipts exceed cash receipts over the medium term, partly

because some receipts are collected with a lag (including interest on student loans, where the lag can be many years).

Chart 5.2: Year-on-year changes to the debt-to-GDP ratio



Source: OBR

5.16 While our forecast continues to show net debt falling as a share of GDP each year from 2015-16 onwards, the pace of decline has changed relative to our March forecast. Table 5.3 decomposes changes in the profile of net debt since March. It shows that:

- in 2015-16, the extent to which debt falls has increased since March. Lower borrowing and an increase in expected asset sales have increased the margin by which debt falls. That has more than offset downward revisions to the extent by which gilt premia and differences between the cash and accrued measures of borrowing will reduce debt. We have also corrected the PSND treatment of derivative positions in the UKAR balance sheet, which has added to the margin by which debt falls in 2015-16;

- in later years, the Government's decisions at this Budget have added significantly to cumulative borrowing, particularly between 2016-17 and 2018-19. This slows the pace of debt reduction each year. The biggest effect comes from the decision to increase RDEL spending by around £17 billion in 2016-17, £27 billion in 2017-18 and £28 billion in 2018-19. This is partly offset by the welfare spending cuts and net tax increase shown on the Treasury's scorecard of policy decisions and the decision to sell three-quarters of the Government's RBS shareholding over the Parliament. Other forecast changes to net borrowing have a small effect in most years;

- gilt premia effects move proportionately with the changes in borrowing, but in the opposite direction (since for a given premium rate, issuing more debt implies the total amount of premia will be higher in cash terms). We have also introduced a negative

adjustment between the accrued and cash measures of borrowing in the medium term, which reflects our judgement that some cash income received by the Exchequer is not currently captured in our accruals-based forecast for PSNB. That reduces debt a little faster each year;

- changes in the profile of nominal GDP growth have subtracted from the year-on-year change in the debt-to-GDP ratio in 2016-17, but added to it in 2018-19 and 2019-20. In 2016-17, that mostly reflects the boost to nominal GDP growth from the fiscal easing announced in the Budget (largely via the direct effect of higher RDEL on the government consumption deflator, rather than a multiplier effect from the overall package to real GDP growth). At the end of the forecast, that effect works in the opposite direction, while we have also our revised judgement about the path of the GDP deflator once the output gap has closed; and

- other changes are relatively small and mostly offsetting.

Table 5.3: Changes in the profile of net debt since March

	Per cent of GDP				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
March forecast	-0.2	-0.5	-2.0	-3.0	-3.2
July forecast	-0.5	-1.1	-1.9	-2.5	-3.2
Change	-0.4	-0.7	0.1	0.5	0.0
of which:					
Nominal GDP[1]	0.0	-0.5	0.0	0.3	0.4
Net borrowing changes	-0.3	0.2	0.6	0.5	-0.2
Asset sales and other UKAR effects	-0.6	-0.2	-0.3	-0.2	-0.2
Gilt premia	0.2	-0.1	-0.1	-0.1	0.0
Accruals to cash adjustment	0.2	-0.1	-0.1	-0.1	-0.1
Other factors	0.1	0.0	0.0	0.1	0.1

[1]GDP is centred end-March.

The proposed fiscal mandate

5.17 The Government's proposed new fiscal mandate requires it to achieve an overall budget surplus (in other words negative public sector net borrowing) in the fixed year of 2019-20. Our latest central forecast shows a surplus of 0.4 per cent of GDP in 2019-20, which means the Government is more likely than not to meet its new target.

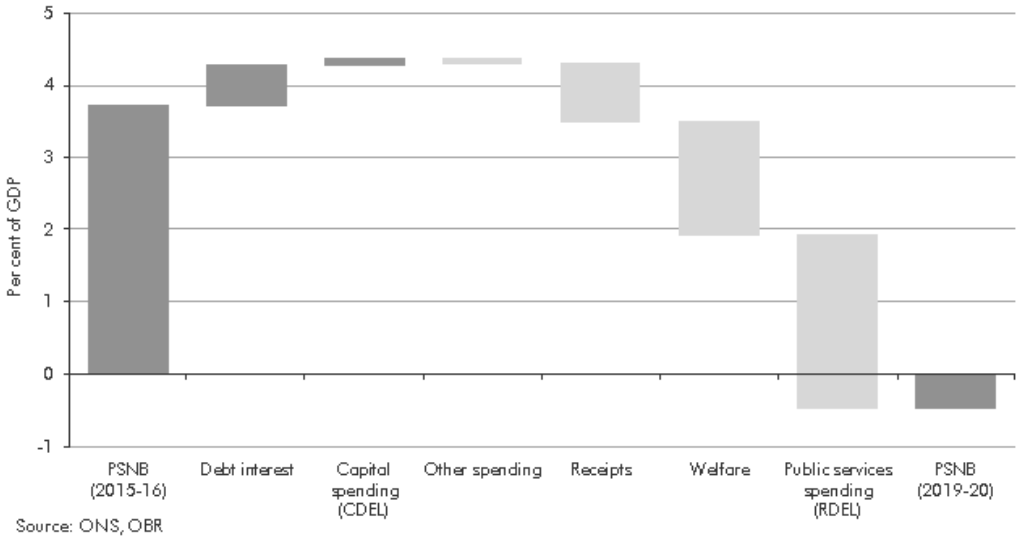
5.18 The draft *Charter* says that, once a headline budget surplus has been achieved, the fiscal mandate will be *"a target for a surplus on public sector net borrowing in each subsequent year"*. This is ambitious relative to the fiscal performance of past governments. The public sector has run a surplus in only five of the last 40 years – and in four of those that was only because economic activity was running above its sustainable level (at least with the benefit of hindsight). Our central forecast of a structural budget surplus of 0.5 per cent of GDP in 2019-20 and 2020-21 would be the largest in at least 40 years – just topping the 0.4 per cent in 2000-01.

The path from deficit to surplus

5.19 Chart 5.3 illustrates how, on the basis of our latest forecast, the Government intends to remove the remaining deficit (which we expect will be 3.7 per cent of GDP in 2015-16) and deliver a headline budget surplus of 0.4 per cent of GDP in 2019-20. The main (negative and positive) contributions are:

- an increase in **debt interest** spending of 0.6 per cent of GDP, as interest rates are assumed to rise in line with market expectations (although these remain well below historical averages at the end of the forecast period);
- a small increase in **departmental capital spending** (0.1 per cent of GDP);
- small reductions in **AME spending other than on debt interest and welfare** (less than 0.1 per cent of GDP);
- a 0.8 per cent of GDP rise in **receipts**, largely due to income tax and NICs receipts rising by 1.2 per cent of GDP, which reflects the resumption of fiscal drag, the abolition of the contracting out rebate in 2016-17 and the net effect of Budget policy measures. This is partly offset by smaller falls across other taxes;
- a 1.6 per cent of GDP fall in **welfare spending**, which mostly reflects average awards rising more slowly than earnings, partly due to policies announced in the Budget. Spending within the welfare cap accounts for 1.3 per cent of GDP of the fall, while spending outside falls by 0.2 per cent of GDP. Spending on state pensions, which are outside the welfare cap, continues to be uprated with the 'triple-lock' so – unlike most working-age benefits – their average awards do not fall relative to earnings;
- **day-to-day spending on public services and administration**, reflecting the Government's chosen RDEL spending numbers for 2016-17 onwards, contributes 2.4 per cent of GDP to the movement from deficit to surplus – the largest share. But that represents a smaller contribution to the overall change than in March, when the Coalition Government had penciled in plans for RDEL to contribute 3.0 per cent of GDP to the improvement in the budget balance over the 2015-16 to 2019-20 period.

Chart 5.3: Sources of deficit reduction from 2015-16 to 2019-20

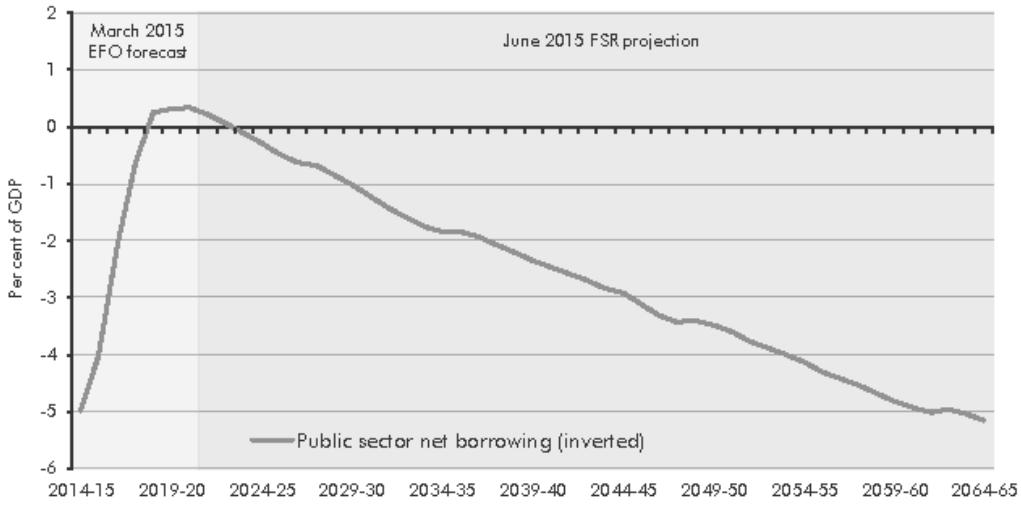


Source: ONS, OBR

Longer-term pressures on the public finances

5.20 The draft *Charter* says that once a headline surplus has been achieved the mandate will require *"a target for a surplus on public sector net borrowing in each subsequent year"*. Our 2015 *Fiscal sustainability report (FSR)* contained a long-term projection for PSNB. This was consistent with our March medium-term forecast, but given the small revisions to the PSNB surplus in 2019-20 in this forecast, that should not materially alter the conclusions we reached in the *FSR*. It showed that – on the basis of the simplifying assumptions that we use when producing long-term projections – spending pressures associated with an ageing population would be likely to push the budget back into deficit in the longer term. Our projection is shown in Chart 5.4, with PSNB inverted so that positive values are surpluses and negative values are deficits.

Chart 5.4: Long-term projection of the headline budget balance



Source: OBR

The negative shock threshold

5.21 The draft *Charter* says that the proposed fiscal mandate and supplementary target *"apply unless and until the OBR assess that there is a significant negative shock to the UK. A significant negative shock is defined as real GDP growth of less than 1 per cent on a rolling 4 quarter-on-4 quarter basis"*.

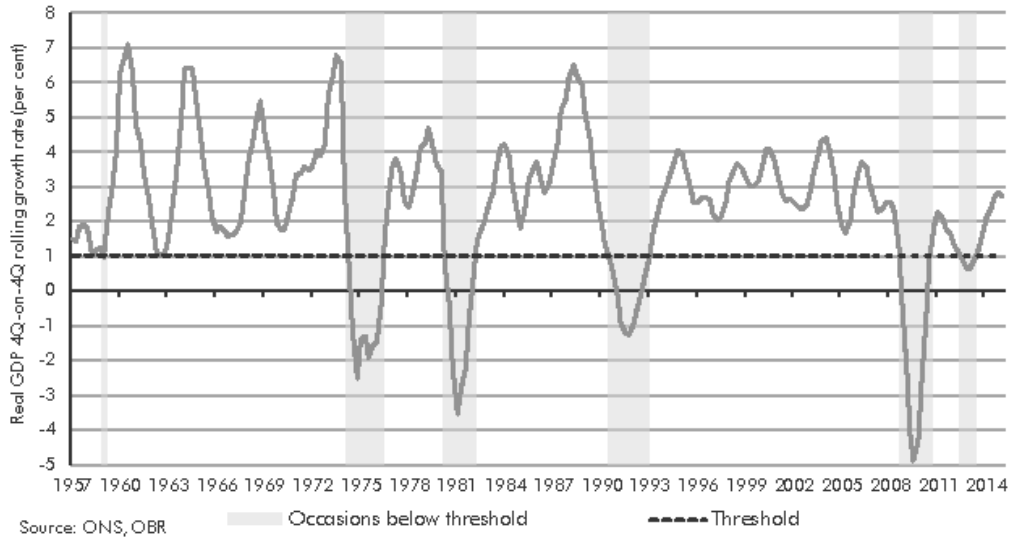
5.22 Chart 5.5 presents GDP growth on the measure set out in the draft *Charter* over the past six decades. The rolling four quarter metric is relatively smooth, since in any given quarter only one of the eight quarters in the calculation is new. The chart shows that there have been 40 quarters since 1957 in which this measure was below the 1 per cent threshold. In 14 of those quarters, not only was rolling 4-quarter growth below 1 per cent, but the economy was also in recession (defined as a fall in quarterly GDP that was part of a period of consecutive falls of two or more quarters). The main period when GDP growth on the rolling four quarter metric fell below 1 per cent without the economy also falling into recession was the recent slowdown in 2012.

5.23 One factor that would affect our future assessment of this metric is prospects for underlying potential output growth. For a given variability of GDP growth, the 1 per cent criterion would be hit more frequently if potential output growth was lower.

5.24 It is worth noting that Chart 5.5 presents GDP growth according to the latest vintage of GDP data. But, as we have shown in previous reports, the ONS frequently rewrites history when it revises GDP estimates in light of new data or changes in methodology. As discussed in our October 2014 *Forecast evaluation report*, revisions to National Accounts data on the path of real GDP during the recessions that started in 1990 and 2008 have been sizable. For example, the recession of the early 1990s now appears shorter, shallower and followed by

a stronger economic recovery than was the case in early estimates of GDP data. The draft *Charter* sets out that once a shock has been triggered according to the 1 per cent growth threshold, that will remain the case *"regardless of future data revisions"*.

Chart 5.5: Past episodes of 'normal' and 'non-normal' times



Source: ONS, OBR

The welfare cap

5.25 The welfare cap has been reset at this Budget in line with our latest forecast. The welfare cap was initially set in line with our March 2014 forecast for the items of spending that lie within it. We are required to assess the Government's performance against the cap formally at each Autumn Statement, and did so for the first time in our December 2014 *EFO*. In this *EFO*, we provide an update on performance against the cap, but will not make a formal assessment until the next Autumn Statement.

5.26 Table 5.4 shows our forecast for spending subject to the welfare cap in each year to 2020-21, as described in Chapter 4. Comparing that forecast with the welfare cap that applied in March, spending continues to be higher than the cap in 2015-16, but within the permitted forecast margin. It is also lower than the cap between 2016-17 and 2019-20, but by much bigger margins than in March given the welfare spending cuts announced in the Budget.

Table 5.4: Performance against the welfare cap

	£ billion					
	Forecast					
	Welfare cap period					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Welfare cap (March)	119.7	122.3	124.8	127.0	129.8	
2 per cent forecast margin (March)	2.4	2.4	2.5	2.5	2.6	
March forecast	120.6	121.0	121.8	124.0	126.5	
July forecast	120.6	115.2	114.6	114.0	113.5	114.9
Change	0.0	-5.7	-7.2	-10.1	-13.1	
of which:						
Forecast changes	0.3	0.1	0.1	0.0	-0.2	
Budget scorecard measures	-0.3	-5.5	-6.7	-9.4	-12.0	-12.9
Indirect effects of Government decisions	0.0	-0.3	-0.6	-0.7	-0.8	-1.1
Difference between July forecast and March welfare cap	0.8	-7.1	-10.2	-13.0	-16.3	
Welfare cap (July)		115.2	114.6	114.0	113.5	114.9
2 per cent forecast margin (July)		2.3	2.3	2.3	2.3	2.3

Forecasting changes

5.27 The welfare cap includes a 2 per cent margin that allows spending to be higher than the cap for forecasting reasons, but not for policy reasons. We therefore need to track the sources of changes to our welfare cap spending forecast in order to assess performance against the cap. As discussed in Chapter 4, forecasting changes since March have been small.

Policy changes

5.28 The Government has announced a number of policy measures in the Budget that cut spending subject to the welfare cap by significant amounts. In total, the direct effects of Budget scorecard measures are expected to reduce spending by an average of £9.3 billion a year between 2016-17 and 2020-21. The scale of the cuts rises over time, reaching £12.9 billion in 2020-21. The biggest sources of lower spending include:

- the four-year freeze in the uprating of most working-age benefits from 2016-17 to 2019-20 – reducing spending by £4.0 billion in 2020-21;
- the package to reform tax credits and universal credit (on top of the working-age benefit freeze) – estimated to save £4.6 billion in 2016-17, rising to £5.8 billion in 2020-21; and
- cuts to housing benefit (also on top of the working-age benefit freeze) – estimated to save £0.1 billion in 2016-17, rising to £2.0 billion in 2020-21.

5.29 We estimate that the indirect effect of Government decisions in this Budget have reduced spending subject to the welfare cap. This includes the effects of introducing a National Living Wage, which are described in Annex B.

Risks to performance against the welfare cap

5.30 Developments in the economy – notably the labour and housing markets – pose important risks to our welfare spending forecast. Typically, inflation would also be an important source of risk because the welfare cap is set in cash terms and changes in inflation typically feed through to spending via uprating. But the four-year uprating freeze on roughly 75 per cent of spending subject to the cap means that, for most of the forecast period, welfare cap spending will be relatively insensitive to changes in inflation.

5.31 We highlighted other key sources of uncertainty – and therefore risks to the forecast – in our 2015 *Welfare trends report*, in particular related to reforms to incapacity and disability benefits, and the rollout of universal credit. These include the effect on caseloads and average awards as the systems are changed, as existing caseloads are migrated from old to new benefits, and as savings are assumed to flow from the associated reassessment processes.

5.32 We also discussed how estimates of the impacts of previously announced policy measures have changed over time. This highlighted that:

- errors in our economic forecasts can be significant sources of error in costings themselves. This was particularly relevant to the major uprating policy measures in the last Parliament: the triple lock on state pension uprating; switching from RPI to CPI inflation uprating for most benefits and tax credits; and later limiting the uprating of most working-age benefits to 1 per cent for three years; and

- costings associated with structural changes to the welfare system are subject to even greater uncertainty. This is reflected in the changes to our estimates of the switch from incapacity benefit to employment support allowance, from disability living allowance to the personal independence payment, the rollout of universal credit, and the introduction of the high-income child benefit charge.

5.33 The lessons learnt in this area have been applied to the estimated savings from the measures announced in this Budget. The biggest measures have been simpler changes to rates and/or withdrawal rates rather than large structural changes to the system in the last Parliament. In that sense, the delivery of this package of measures poses lower risks to the welfare cap than those introduced in the June 2010 Budget, for example. But the estimated savings remain sensitive to the economic forecasts on which they are based, in particular the inflation and earnings growth assumptions.

Recognising uncertainty

5.34 Past experience and common sense suggest that there are significant upside and downside risks to our central forecasts for the public finances. These reflect uncertainty both about the outlook for the economy and about the level of receipts and spending in any given state of the economy. The size and composition of the remaining fiscal consolidation – and its impact on national income and spending – create additional uncertainty.

5.35 Given these uncertainties, it is important to stress-test our judgements that the Government is on course to meet its fiscal targets – current and proposed. We do this in three ways:

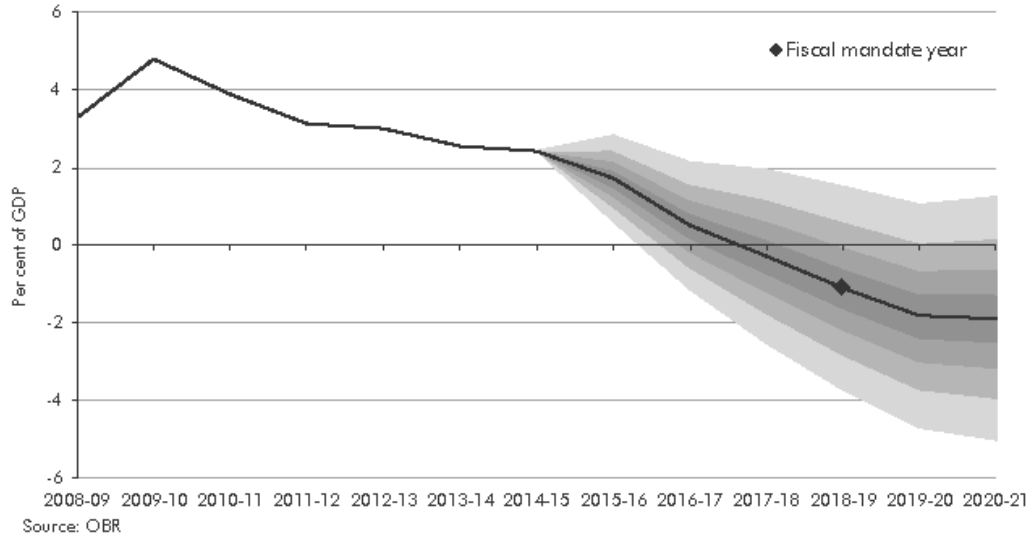
- by looking at the evidence from past forecast errors;
- by seeing how our central forecast would change if we altered some of the key judgements and assumptions that underpin it; and
- by looking at alternative economic scenarios.

Past performance

5.36 One relatively simple way to illustrate the uncertainty around our central forecast is to consider the accuracy of previous official public finance forecasts. This can be done using fan charts like those we presented for GDP growth in Chapter 3. These fan charts do not represent our assessment of specific risks to the central forecast. Instead they show the outcomes that someone might anticipate if they believed, rightly or wrongly, that forecast errors in the past offered a reasonable guide to likely forecast errors in the future.

5.37 In this spirit, Chart 5.6 shows the probability distribution around our central forecast for the CACB deficit, based on past official forecast errors. The solid black line shows the median forecast, with the successive pairs of lighter shaded areas around it representing 20 per cent probability bands. This implies that, based on current policy, there would be an 80 per cent probability of the outturn lying within the shaded bands. A direct reading of the chart would imply that the Government currently has a roughly 70 per cent probability of achieving a surplus on the CACB in 2018-19 and thereby meeting the current mandate. The probability of achieving a surplus rises from 35 per cent in 2016-17 to 80 per cent by 2019-20.

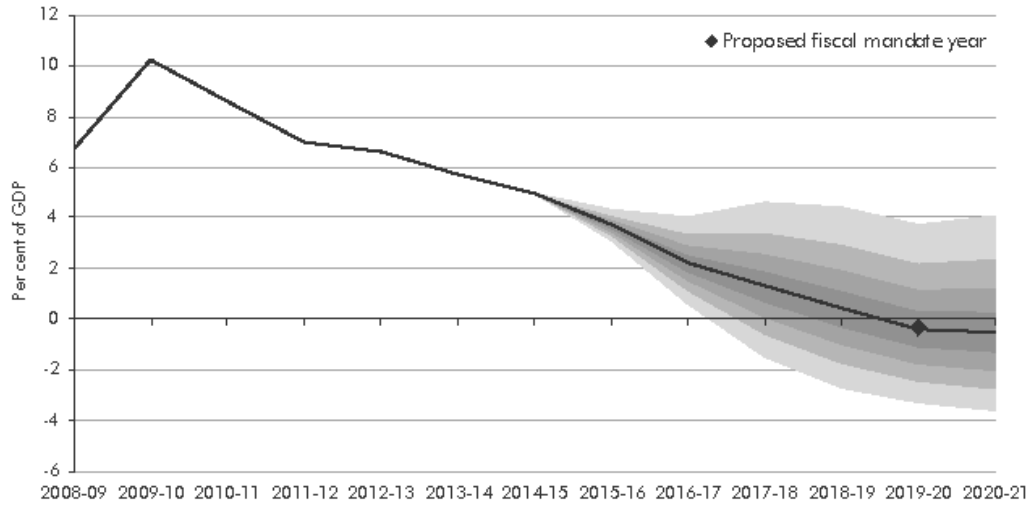
Chart 5.6: Cyclically adjusted current budget deficit fan chart



Source: OBR

5.38 Chart 5.7 shows our central forecast for PSNB on the same basis. Again, a direct reading of the chart would imply that the probability that PSNB will reach balance rises from 30 per cent in 2017-18 to 45 per cent in 2018-19 and 55 per cent in 2019-20. The Government therefore has a margin against its proposed new mandate that is fairly small relative to past forecast errors and to that against the current mandate.

Chart 5.7: Public sector net borrowing fan chart



Source: ONS, OBR

5.39 Unfortunately, we cannot estimate the probability of achieving the supplementary targets as we do not have the joint distribution that would allow us to apply the same technique. But our central forecast shows the debt-to-GDP ratio falling in each year of the forecast, meeting both supplementary targets. We also do not have a long enough disaggregated series of past welfare spending forecasts to produce a fan chart for the welfare cap projections.

Sensitivity analysis

5.40 It is very difficult to produce a full subjective probability distribution for the Government's target fiscal variables because they are affected by a huge variety of economic and non-economic determinants, many of which are correlated with each other. However, to recognise the uncertainty in our forecast we can go further than using evidence from past forecast errors by quantifying roughly how sensitive our central forecast is to changes in certain key economic parameters.

5.41 In thinking about the evolution of the public finances over the medium term, there are several parameters that have a particularly important bearing on the forecast. In this section we focus on three in particular:

- the level of potential output;
- the speed at which the output gap closes (i.e. the pace of economic growth); and
- the sensitivity of the headline surplus to changes to the level of GDP, effective tax rates, inflation and interest rates.

The current fiscal mandate and supplementary target

5.42 Our central forecast is based on a judgement that the economy was running 0.6 per cent below potential in the first quarter of 2015, and that the output gap will close slowly over the forecast period, reaching zero at the start of 2018-19. But neither the level of potential output nor the pace of recovery are possible to estimate with confidence, not least because the former is not something that can be observed directly in economic data. So what if the medium-term level of potential was higher or lower than our central estimate, and what if the output gap closed earlier or later?

5.43 Tables 5.5 and 5.6 present illustrative estimates of the impact on:

- the level of the CACB deficit in 2018-19; and
- the change in PSND as a share of GDP between 2015-16 and 2016-17.

5.44 For practical reasons, we have not undertaken complete forecast runs for each variant, but have instead used ready-reckoners and simplifying assumptions to generate illustrative estimates. We assume that a lower or higher level of potential is reflected in our starting output gap, rather than errors in forecasting trend growth over the forecast period.

5.45 The cyclical adjustment ready-reckoner assumes that a 1 per cent change in GDP will result in a 0.7 per cent of GDP change in PSNB and the current budget after two years. The actual change would depend on many other factors, including the composition of growth, inflation and the labour market response. Bearing in mind the limitations of this top-down approach, applying these ready-reckoners yields the results shown in the tables below.

5.46 Table 5.5 shows that the level of potential output has a big effect on the size of the CACB deficit in 2018-19. The lower potential output – and therefore the smaller the negative output gap or the larger the positive output gap – the larger the proportion of the deficit that is structural and the less margin the Government has against the current fiscal mandate. Conversely, if potential output is higher, less of the deficit is structural and the Government has a greater margin against this mandate.

5.47 Closing the output gap at a different pace would typically result in a change in cyclical borrowing, but would have little effect on the structural balance. For example, closing the output gap more slowly would result in a lower growth path, leading to more cyclical borrowing but a broadly similar level of structural borrowing.

5.48 In broad terms, the level of potential output would need to be around 1½ per cent lower in 2018-19 than in our central forecast to make it more likely than not that the mandate would be missed.

Table 5.5: Cyclically adjusted current budget deficit in 2018-19

		Per cent of GDP		
		Output gap closes		
		2016-17	2018-19	2020-21
Level of potential output in 2020-21 relative to central forecast (per cent)	-2	0.3	0.3	0.3
	-1	-0.4	-0.4	-0.4
	0	-1.1	-1.1	-1.1
	1	-1.8	-1.8	-1.8
	2	-2.6	-2.6	-2.5

5.49 Table 5.6 shows that the Government would continue to meet the current supplementary target unless the output gap was materially smaller than in our central forecast, which would imply more structural borrowing.

Table 5.6: Change in public sector net debt between 2015-16 and 2016-17

		Per cent of GDP		
		Output gap closes		
		2016-17	2018-19	2020-21
Level of potential output in 2020-21 relative to central forecast (per cent)	-2	0.7	0.0	-0.2
	-1	-0.3	-0.5	-0.6
	0	-1.3	-1.1	-1.0
	1	-2.3	-1.7	-1.5
	2	-3.3	-2.2	-1.8

The proposed new fiscal mandate

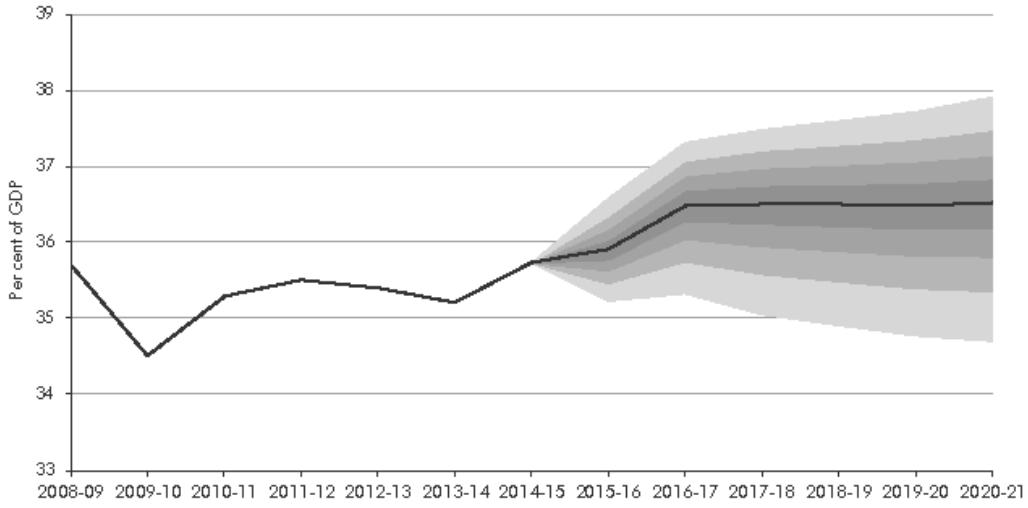
5.50 We have already shown that, on the basis of past forecast errors, there is around a 45 per cent probability that the budget will be in deficit rather than surplus in 2019-20. There are many reasons why we could see such an outcome. For example, economic developments could be less favourable than we forecast or we could be wrong about prospects for receipts or spending for a given state of the economy. And while our forecasts are conditioned on current Government policy, that may also evolve over time.

5.51 In Annex B of our March *EFO*, we presented a range of ready-reckoners that show how the public finances could be affected by changes in selected economic determinants of our fiscal forecast. It is important to stress that these were stylised quantifications that reflect the typical impact of changes in economic variables on receipts and spending. They are subject to significant uncertainty. But with those caveats in mind, we can use these ready-reckoners to calibrate a number of possible negative surprises relative to our central forecast that would be sufficient to push the budget from surplus to deficit in 2019-20. Where possible, we assess the probability of such a surprise on the basis of past forecast errors.

5.52 This analysis suggests that the 0.4 per cent of GDP surplus in 2019-20 could fall to zero if:

- **real GDP** was to be 0.7 per cent lower than in our central forecast in 2019-20. Based on past forecast errors, there is a 45 per cent probability of that occurring;
- the **effective tax rate** – as measured by the tax-to-GDP ratio – was 0.4 per cent of GDP lower than in our central forecast. This could be because the composition of GDP was less tax rich than expected, or asset markets underperformed our assumptions, or the income distribution was skewed towards people with lower effective tax rates. Chart 5.8 presents a fan chart for receipts as a share of GDP using a similar methodology to that used in the CACB and PSNB fan charts above. It suggests there is a 35 per cent chance that receipts could be 0.4 per cent of GDP lower than forecast;
- planned **spending cuts** – which reduce RDEL by 2.4 per cent of GDP between 2015-16 and 2019-20 in our forecast – fell short by around a sixth;
- a jump in **RPI inflation** could increase accrued interest on index-linked gilts. Taken in isolation, if RPI inflation was 2.1 percentage points higher than expected in 2019-20, that alone would add 0.4 per cent of GDP to debt interest costs. Based on past forecasts errors, there would be a 15 per cent probability of that happening. Of course, such a shock to inflation would be likely to have other material effects on the public finances; and
- higher **interest rates** pushed up debt interest spending. If interest rates were 1.5 percentage points above market expectations by 2019-20, this would be sufficient to add 0.4 per cent of GDP to spending on debt interest. Again, such an effect would not happen in isolation – for example, a boost to interest receipts on the government's stock of financial assets would partly offset higher debt interest.

Chart 5.8: Receipts fan chart



Source: ONS, OBR

Scenario analysis

5.53 The sensitivity analysis discussed above focuses on individual factors and therefore only offers only a limited assessment of potential uncertainty. In this section, we set out the fiscal implications of illustrative alternative economic scenarios, designed to test how dependent our conclusions are on key judgements that are subject to debate in the forecasting community. We stress that these scenarios are not intended to capture all possible ways in which the economy might deviate from the central forecast and we do not attempt to attach particular probabilities to them occurring.

5.54 As this is our first forecast of the new Parliament, we have looked back at the first OBR forecast of the last Parliament in June 2010 and the errors to which it was subject in order to frame three scenarios:

- a 'history repeats' scenario, in which we assume that we have made similar errors in our latest forecast to those that we made in June 2010. In this scenario, employment would be around 1 million higher by the start of 2020, implying total growth of around 2 million over the next five years, but GDP and productivity growth would be significantly weaker than in the central forecast. We have adjusted the mix between higher population growth and a higher participation rate relative to the June 2010 forecast errors because we now expect upward trends in age-specific participation to offset much of the downward pressure on participation from an ageing population. About two-thirds of the stronger employment is therefore assumed to be explained by higher population growth (which over a five-year horizon would reflect higher net inward migration) and one-third by a higher employment rate;

- an 'employment-rich growth' scenario, in which employment again grows by 1 million more than in our central forecast, but we hold our central GDP forecast unchanged. This scenario would be more consistent with our recent forecast errors, where GDP growth errors have generally been small, but we have continued to see stronger than expected employment growth and weaker than expected productivity growth; and

- a 'strong GDP growth' scenario, in which higher employment is accompanied by our central productivity forecast, implying faster GDP growth. This would reflect a significant upside scenario relative to the experience of recent years.

5.55 Taking these scenarios in reverse order – from most to least favourable – Table 5.7 sets out the implications of each for the Government's current and proposed fiscal targets:

- under the 'strong growth' scenario, cash receipts rise in line with GDP, but a significant proportion of spending remains fixed in nominal terms – implying lower spending per head. The fiscal balance therefore improves more quickly, moving into surplus a year earlier than in our central forecast. The Government's current and proposed fiscal mandates and supplementary targets would be met with greater room to spare, but additional population growth would raise welfare spending in cash terms (and lower it as a share of GDP), moving spending above the new welfare cap but remaining within the permitted 2 per cent forecast margin;

- the 'employment-rich growth' scenario would deliver a very similar, but marginally weaker, outcome to our central forecast. Lower productivity is assumed to reduce earnings proportionately, which reduces the effective tax rate on personal incomes. This is partly offset by lower state pensions, since these are uprated with earnings through the triple lock. State pensions are outside the welfare cap. Spending subject to the welfare cap would be higher, with stronger population growth again increasing welfare spending in cash terms, and lower earnings increasing income-related benefits such as tax credits. Welfare cap spending would remain with the permitted 2 per cent forecast margin; but

- the Government would miss all its current and proposed fiscal targets under a 'history repeats' scenario. This scenario assumes that productivity growth would remain flat at around ½ per cent a year, leaving potential output materially below our central forecast even as employment picked up more strongly. The additional structural borrowing would push back the initial fall in the debt to GDP ratio to 2017-18, and also lead to the CACB moving into balance a year later than required by the current fiscal mandate. The Government would continue to borrow in 2019-20, although relatively weak structural growth would increase the possibility that shocks would trigger a move out of 'normal times'. Spending subject to the welfare cap would exceed the permitted 2 per cent forecast margin in the final years of the forecast.

Table 5.7: Key economic and fiscal aggregates under alternative scenarios

	Per cent (unless otherwise stated)					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Central forecast						
Economic assumptions						
GDP growth	2.2	2.5	2.4	2.4	2.4	2.4
Productivity per worker	0.9	1.7	2.0	2.0	1.9	1.9
Fiscal outcome (per cent of GDP)						
Welfare cap margin (per cent)	0.0	0.0	0.0	0.0	0.0	0.0
Public sector net borrowing	3.7	2.2	1.2	0.3	-0.4	-0.5
Cyclically adjusted current budget	1.7	0.5	-0.3	-1.1	-1.8	-1.9
Public sector net debt	80.3	79.1	77.2	74.7	71.5	68.5
Strong GDP growth scenario						
Economic assumptions						
GDP growth	2.4	2.9	3.2	3.2	3.1	3.1
Productivity per worker	0.9	1.7	2.0	2.0	1.9	1.9
Fiscal outcome (per cent of GDP)						
Welfare cap margin (per cent)	0.0	0.1	0.1	0.2	0.3	0.4
Public sector net borrowing	3.7	2.0	0.8	-0.4	-1.3	-1.6
Cyclically adjusted current budget	1.7	0.3	-0.7	-1.8	-2.7	-3.0
Public sector net debt	80.1	78.5	75.6	71.9	67.4	63.0
Employment-rich growth scenario						
Economic assumptions						
GDP growth	2.2	2.5	2.4	2.4	2.4	2.4
Productivity per worker	0.7	1.2	1.2	1.2	1.2	1.2
Fiscal outcome (per cent of GDP)						
Welfare cap margin (per cent)	0.0	0.2	0.4	0.7	0.9	1.0
Public sector net borrowing	3.7	2.2	1.2	0.4	-0.4	-0.4
Cyclically adjusted current budget	1.7	0.5	-0.2	-1.0	-1.8	-1.8
Public sector net debt	80.3	79.2	77.3	74.8	71.7	68.7
History-repeats scenario						
Economic assumptions						
GDP growth	1.9	1.6	1.6	1.6	1.6	1.6
Productivity per worker	0.4	0.4	0.4	0.4	0.4	0.4
Fiscal outcome (per cent of GDP)						
Welfare cap margin (per cent)	0.1	0.5	1.1	1.9	2.8	3.8
Public sector net borrowing	3.9	2.7	2.0	1.5	1.0	1.3
Cyclically adjusted current budget	1.9	1.0	0.6	0.1	-0.3	0.0
Public sector net debt	80.7	80.7	80.1	79.2	77.8	76.9

A Summer Budget 2015 policy measures

Overview

A.1 Our *Economic and fiscal outlook (EFO)* forecasts incorporate the expected impact of the policy decisions announced in each Budget and Autumn Statement. In the run-up to each statement, the Government provides us with draft estimates of the cost or gain from each policy measure it is considering. We discuss these with the relevant experts and then suggest amendments if necessary. This is an iterative process where individual measures can go through several stages of scrutiny. After this process is complete, the Government chooses which measures to implement and which costings to include in its scorecard. We choose whether to certify the costings as 'reasonable and central', and whether to include them – or alternative costings of our own – in our forecast.

A.2 In this Budget, we have certified all but one of the costings of tax and annually managed expenditure (AME) measures that appear in the Government's policy decisions table as reasonable and central. We were unable to certify one element of the welfare savings package in the time available, but we have included the Treasury's estimate of its impact in our forecast and will return to the costing at our next forecast.

A.3 Table A.1 reproduces the Treasury's scorecard, with further details set out in Chapter 4 and in the Treasury's *Summer Budget 2015 policy costings document*, which summarises the methodologies used to produce each costing and provides some information on the main areas of uncertainty within each.

A.4 As in March, the policy costings scrutiny process was particularly difficult for this Budget as we were not given details of costings for a large proportion of significant policy measures until just before our deadlines. That contributed to us being unable to complete enough of the iterative process to reach a position where we could certify the costing that removes the first child premium in universal credit for new claims as reasonable and central.

A.5 The Treasury also informed us of a change to the detail of its announcement on the sales of RBS shares on 3 July – the deadline for delivering final policy decisions for inclusion in the forecast – in a way that was sufficient to push our forecast for public sector net debt as a share of GDP in 2019-20 from slightly higher than it had been in March to slightly lower.

Uncertainty

A.6 In order to be transparent about the potential risks to our forecasts, we assign each certified costing a subjective uncertainty rating, shown in Table A.1. These ratings range from 'low' to 'very high'. In order to determine the ratings, we have assessed the uncertainty arising from each of three sources: the data underpinning the costing; the complexity of the modelling required; and the possible behavioural response to the policy change. We take into account the relative importance of each source of uncertainty for each costing. The full breakdown that underpins each rating is available on our website. It is important to emphasise that, where we see a costing as particularly uncertain, we see risks lying to both sides of what we nonetheless judge to be a reasonable and central estimate.

Table A.1: Treasury scorecard of Budget policy decisions and OBR assessment of the uncertainty of costings

		Head	£ million						
			2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	Uncertainty
Personal tax									
1	Personal allowance: increase to £11,000 in 2016-17, with equal gains to higher rate taxpayers	Tax	0	-1,055	-1,160	-1,195	-1,160	-1,200	Medium
2	Higher Rate Threshold: increase to £43,000 in 2016-17	Tax	0	-90	-200	-190	-255	-310	Medium
3	Inheritance Tax: £1m couples allowance from 2020 through new main residence nil-rate band phased in from 2017	Tax	0	0	-270	-630	-790	-940	High
4	Pensions tax relief: restrict for gross income over £150,000 from 2016-17	Tax	-70	+260	+425	+900	+1,180	+1,280	Very high
5	Rent-a-room relief: increase to £7,500	Tax	0	-5	-10	-10	-10	-15	Medium
Childcare									
6	Childcare: 30 hour entitlement for working parents of 3 and 4 year olds	Spend	0	0	-365	-640	-660	-670	N/A
7	Tax Free Childcare: updated rollout	Spend	+165	+370	-95	-130	-90	-40	Medium-low
8	Adoption reform	Spend	-20	-20	0	0	0	0	N/A
Business and Growth									
9	Corporation Tax: reduce to 19% from 2017-18, and 18% from 2020-21	Tax	0	-10	-605	-1,600	-1,870	-2,475	Medium-low
10	Annual Investment Allowance: set at new permanent level of £200,000	Tax	-5	-215	-850	-895	-840	-795	Medium
11	Banks: 8% Corporation Tax Surcharge and changes to Bank Levy	Tax	0	+415	+555	+365	+225	+105	Very high
12	Corporation Tax: bringing forward payments for large groups	Tax	0	0	+4,495	+3,135	+140	+60	Medium-low
13	Employment Allowance: increase by £1,000 from 2016-17	Tax	0	-630	-670	-685	-700	-695	Medium-low
14	Oil and gas: expand investment allowance	Tax	*	-5	-5	-5	-5	-10	Medium-low
15	Transport for the North and Midlands Connect: set up costs	Spend	-15	-10	-10	0	0	0	N/A

Reform and sustainability									
16	Dividends tax: abolish credit, introduce new £5,000 allowance, and increase effective rates by 7.5pp	Tax	0	+2,540	-890	+1,120	+2,055	+1,960	Medium-high
17	Residential property: restrict finance relief to basic rate, phase from 2017	Tax	0	0	0	+225	+415	+665	Medium
18	Residential property: reform wear and tear allowance	Tax	0	0	+205	+165	+165	+170	Medium
19	Insurance Premium Tax: increase by 3.5pp to 9.5%	Tax	+530	+1,460	+1,510	+1,530	+1,550	+1,580	Medium-low
20	VED: reform for new cars purchased from 2017, hypothecated to roads fund from 2021	Tax	0	+250	+195	+670	+940	+1,425	Medium-high
Imbalances in the tax system									
21	Non-domiciles: abolish permanent status	Tax	0	0	-15	+475	+380	+385	Very high
22	Non-domiciles: IHT on UK residential property	Tax	-5	-5	+35	+100	+75	+85	Very high
23	Climate Change Levy: equal treatment for generators	Tax	+450	+490	+575	+685	+800	+910	Medium
24	Intangible assets: remove relief for new claims	Tax	+35	+100	+165	+220	+280	+320	Medium
25	Employment Allowance: withdraw from single person companies	Tax	0	+80	+95	+100	+105	+110	Medium-low
26	Tax Motivated Incorporation: reduction due to dividend tax reform	Tax	0	+190	+360	+445	+505	+565	Very high
Avoidance and tax planning									
27	Capital Gains Tax: avoidance by private equity and hedge funds	Tax	0	+265	+375	+390	+390	+375	Very high
28	Controlled Foreign Companies: loss restriction	Tax	+65	+140	+190	+165	+150	+150	High
29	Corporation Tax: intra-group transfers	Tax	+15	+30	+30	+20	+15	+15	Low
30	Indirect tax: overseas insurance	Tax	0	+5	+5	+5	+5	+5	Low
Evasion and compliance									
31	Large Business: enhanced compliance	Tax	0	+40	+170	+340	+480	+625	Medium-high
32	Specialist Personal Tax: enhanced compliance	Tax	0	+5	+40	+110	+195	+280	Medium-high
33	Wealthy: enhanced compliance	Tax	0	-65	+40	+185	+260	+280	High
34	Tackling illicit tobacco and alcohol	Tax	0	+15	+115	+285	+430	+450	High
35	Hidden economy	Tax	0	+15	+110	+195	+255	+285	Medium-high
36	Local compliance	Tax	0	+15	+135	+360	+640	+920	Medium-high

Welfare									
37	Uprating: freeze working-age benefits, tax credits and Local Housing Allowances for 4 years from 2016-17	Spend	0	+90	+940	+2,325	+3,885	+4,010	Low
38	Benefit cap: reduce to £20,000, and £23,000 in London	Spend	0	+100	+310	+360	+405	+495	Medium
	Tax credits and Universal Credit								
39	Limit child element to 2 children for new births in tax credits and new claims in UC	Spend	0	0	+315	+700	+1,055	+1,365	Medium-low
40	Remove family element in tax credits and UC, and the family premium in Housing Benefit, for new claims	Spend	0	+55	+220	+410	+555	+675	Medium-low
41	Increase tax credits taper rate to 48%	Spend	0	+1,475	+1,035	+600	+345	+245	Low
42	Reduce income thresholds in tax credits and work allowances in UC	Spend	0	+2,880	+3,060	+3,180	+3,310	+3,440	Medium-low
43	Reduce income rise disregard in tax credits	Spend	0	+170	+225	+250	+180	+110	Medium-low
44	UC waiting days: revised schedule	Spend	-5	0	0	0	0	0	Low
	Housing Benefit								
45	End automatic entitlement for out-of-work 18-21 year olds	Spend	0	0	+25	+35	+35	+40	Medium
46	Reduce social sector rents by 1% each year for 4 years from 2016-17	Spend	0	+165	+475	+875	+1,320	+1,445	Medium
47	Pay to stay: higher income social housing tenants to pay market rents	Spend	0	0	+365	+185	+245	+240	High
48	Limit backdating awards to 4 weeks	Spend	0	+10	0	*	*	*	Medium-low
49	Support for Mortgage Interest: change from welfare payment to loan; maintain capital limit at £200,000	Spend	0	-30	-35	+270	+255	+255	Medium-high
	Employment and Support Allowance								
50	Align Work-Related Activity Group rate with JSA for new claims	Spend	0	0	+55	+225	+445	+640	Medium-low
	Other								
51	UC parent conditionality from when youngest child turns 3	Spend	0	0	-5	-5	+35	+30	High
52	Fraud, error and debt: tax credits changes	Spend	+60	+55	+30	*	*	*	Medium

Changes to spending									
53	In-year savings[2]	Spend	+2,595	0	0	0	0	0	N/A
54	HMRC funding	Spend	-60	-225	-270	-270	-265	-255	N/A
55	Discretionary Housing Payments	Spend	0	-150	-185	-170	-155	-140	N/A
56	Other welfare funding - including Youth Obligation and extra JCP support	Spend	-10	-100	-205	-285	-300	-325	N/A
57	TV Licence: BBC funding for over-75s	Spend	0	0	0	+200	+445	+745	Medium
58	Efficiency and reform	Spend	-55	0	0	0	0	0	N/A
59	Equitable Life: doubling payments to Pension Credit recipients	Spend	-50	0	0	0	0	0	Medium-low
60	Royal Mail share scheme	Spend	-50	0	0	0	0	0	N/A
	TOTAL POLICY DECISIONS		**+3,570**	**+9,075**	**+11,035**	**+15,095**	**+17,065**	**+18,885**	
	Total spending policy decisions		+2,590	+5,095	+5,945	+8,270	+11,280	+12,415	
	Total tax policy decisions		+980	+3,980	+5,090	+6,825	+5,785	+6,470	
	Total welfare policy decisions		*+55*	*+4,970*	*+7,015*	*+9,410*	*+12,070*	*+12,990*	
	Total receipts from avoidance and tax planning, evasion and compliance, and imbalances in the tax system		*+560*	*+1,320*	*+2,425*	*+4,080*	*+4,965*	*+5,760*	

** Negligible*

[1] Costings reflect the latest economic and fiscal determinants.

[2] This measure forms part of the £3 billion departmental savings identified in 2015-16. See also the financials transactions policy measures table.

A.7 Table A.2 shows the detailed criteria and applies them to a sample policy measure from this Budget: 'Insurance Premium Tax: increase by 3.5pp to 9.5%'. This is estimated to raise around £1.5 billion a year on average over the forecast period. For this policy we have judged that the most important source of uncertainty will be data, followed by behaviour, with the least important being modelling. The data used to estimate this measure are high quality HMRC administrative data on insurance premium tax (IPT) receipts, so we consider this to be a 'medium-low' source of uncertainty. The likely behavioural response is based on elasticities that have been estimated by HMRC. There is some uncertainty here because IPT receipts have fallen short of our forecasts since the main IPT rate was increased to 6 per cent in 2011-12. This could reflect changes in the insurance market or a bigger than expected behavioural response to that rate increase. But the costing is relatively insensitive to varying the assumed elasticities, so we deem this a 'medium' source of uncertainty. The modelling is based on a simple HMRC forecasting model, so we regard this as a 'medium-low' source of uncertainty. Taking all these judgements into account, we have assigned the costing an overall uncertainty rating of 'medium-low'.

Table A.2: Example of assigning uncertainty rating criteria: 'Insurance Premium Tax: increase by 3.5pp to 9.5%'

Rating	Data	Modelling	Behaviour
Very high	Very little data Poor quality	Significant modelling challenges Multiple stages and/or high sensitivity on a range of unverifiable assumptions	No information on potential behaviour
High	Little data Much of it poor quality	Significant modelling challenges Multiple stages and/or high sensitivity on a range of unverifiable assumptions	Behaviour is volatile or very dependent on factors outside the tax/benefit system
Medium-high	Basic data May be from external sources Assumptions cannot be readily checked	Some modelling challenges Difficulty in generating an up-to-date baseline and sensitivity to particular underlying assumptions	Significant policy for which behaviour is hard to predict
Medium	Incomplete data High quality external sources Verifiable assumptions	Some modelling challenges Difficulty in generating an up-to-date baseline	Considerable behavioural changes or dependent on factors outside the system
Medium-low	High quality data	Straightforward modelling	Behaviour fairly predictable
Low	High quality data	Straightforward modelling of new parameters for existing policy with few or no sensitive assumptions	Well established, stable and predictable behaviour
Importance	High	Medium	Low
Overall		Medium-low	

A.8 This Budget contained an unusually large number of HMRC compliance measures, which all shared a significant uncertainty associated with the baseline against which they should be assessed. In the absence of firm spending plans beyond 2015-16, it was not clear what should be assumed as the 'business as usual' compliance activity implicit in our pre-measures forecast. The approach we took to assuring ourselves that the scorecard measures were additional to the baseline is explained from paragraph A.17.

A.9 Using the approach set out in Table A.1, we have judged 12 measures in this Budget scorecard to have 'high' or 'very high' uncertainty around the central costing. These represent 24 per cent of the measures in the Budget by number and 14 per cent by absolute value (in other words ignoring whether they are expected to raise or cost money for the Exchequer). In net terms, they are expected to raise the Exchequer £12.3 billion in total over the forecast period. The measures are:

- **Non-domiciles: abolish permanent status:** This measure aims to increase the amount of tax paid by non-domiciled individuals on their worldwide income. It receives a 'very high' uncertainty rating. This arises from two main sources. First, HMRC does not hold detailed information on the value of offshore incomes and capital gains that would become subject to UK tax, so there is significant scope for error in the construction of the tax base. Second, the post-behavioural costing contains a particularly uncertain adjustment. There are four main potential responses considered in this costing: do nothing and pay the extra tax charge; increased tax planning; become non-resident for tax purposes; or leave the UK completely. The behaviour of high net worth individuals who are already actively altering their behaviour in response to the tax system is difficult to predict, especially in relation to how many will leave the UK as a result of this measure. The final scorecard costing of this package of measures that has been included in our forecast was more than 50 per cent lower than the (already uncertain) estimate of the static pre-behavioural costing;

- **Non-domiciles: IHT on UK residential property:** This measure receives a 'very high' uncertainty rating. It charges inheritance tax on UK residential property held indirectly through offshore structures by non-domiciles. The uncertainty in this costing arises from the behavioural response. It is assumed that most of the individuals who hold UK residential property in offshore structures are doing so to avoid inheritance tax. There is particular uncertainty around how many individuals will decide to 'de-envelope' their property, thereby no longer being liable for the annual tax on enveloped dwellings (ATED), and how many will find another way to avoid inheritance tax. Some of the behavioural responses designed to reduce future inheritance tax liabilities lead to more tax being paid over the short term. Again, the behaviour of high net worth individuals who are already actively altering their behaviour in response to the tax system is difficult to predict;

- **Capital Gains Tax: avoidance by private equity and hedge funds:** this measure receives a 'very high' uncertainty rating. It levies a capital gains tax (CGT) charge on the gains made by certain private equity and hedge fund managers. There is particular uncertainty around both the tax base and the behavioural response to the policy. The tax base has been imputed from external sources rather than detailed HMRC administrative data. There is a large, uncertain behavioural adjustment in this costing to reflect the established ability and willingness of these individuals to find new avenues of avoidance;

- **Banks: 8% Corporation Tax Surcharge and changes to Bank Levy:** this costing receives a 'very high' uncertainty rating, due to the element that imposes a surcharge of 8 per cent on the profits of banking companies. The yield from this measure is based on uncertain assumptions around the profitability of banks over the scorecard period – a key source of uncertainty in our corporation tax receipts forecast – and their behavioural response. In particular, we consider the modelling to be both complex and important for the costing. If the banking sector makes lower gross profits than expected over the next few years then the yield could be considerably lower. Similarly, a quicker return to historically normal levels of profits could push the yield higher;

- **Pensions tax relief: restrict for gross income over £150,000 from 2016-17:** This costing receives a 'very high' uncertainty rating. It restricts the tax relief on pension contributions available to additional rate taxpayers. HMRC does not hold detailed administrative data on the level of pension contributions that have been relieved at the additional rate. Highly complex modelling bringing together data from a variety of internal and external data sources was used to estimate the pension contributions targeted by this measure. The behavioural response is also particularly uncertain. The ability of individuals to tax plan around it is a key source of this extra uncertainty;

- **Tax Motivated Incorporation: reduction due to dividend tax reform:** This measure receives a 'very high' uncertainty rating. It captures an uncertain estimate of the behavioural response to a measure that we consider 'medium-high' uncertainty on its own. There is no agreed definition of a tax-motivated incorporation, so outturn estimates reflect HMRC judgements about the proportion of total incorporations that were tax motivated. And the modelling of how behaviour will be affected by changes in the tax system that alter the incentives to incorporate adds a further layer of uncertainty on top. The estimated effect of the overall scorecard on tax-motivated incorporations is set out from paragraph A.26;

- **Inheritance Tax: £1m couples allowance from 2020 through new main residence nil-rate band phased in from 2017:** This costing receives a 'high' uncertainty rating. It introduces a new relief from inheritance tax for main residences and extends the freeze of the existing nil rate band up until 2020-21. The main uncertainty is with the behavioural response of individuals. The costing rests on an uncertain judgement over how many individuals will restructure their wills in order to take advantage of the new relief. As noted in Box 3.3 in Chapter 3, this measure introduces new uncertainties into our economy forecast due to its potential effects on the housing market;

- **Tackling illicit tobacco and alcohol:** This package of measures receive a 'high' uncertainty rating. It provides HMRC with additional resource to tackle illicit tobacco and alcohol. The yields are based on how effective the additional resource will be at stopping illicit excise entering the UK market. The most uncertain part of the costing is the behavioural element. This includes both a displacement effect as criminals learn how to circumvent the rules and the response of individuals who will now be forced to buy higher priced duty paid goods. These effects reduce the final scorecard yield of the package;

- **Wealthy: enhanced compliance:** This package receives a 'high' uncertainty rating. It is another set of HMRC compliance measures. It includes extending the client relationship manager regime to another group of high net worth individuals and extra resource for HMRC to lead criminal investigations. This is based on uncertain assumptions around how many successful criminal cases HMRC can pursue in a given year. As each full-time equivalent compliance officer will only work a small number of complex high-yield cases, this assumption is sensitive to the assumed success rate, which could be higher or lower than factored into the costing. It is also based on how effective

customer relationship managers will be at ensuring extra compliance from lower risk, less wealthy individuals;

- **Controlled Foreign Companies: loss restriction**: This package receives a 'high' uncertainty rating. The measure prevents a UK company from setting its own losses and surplus expenses, or those of other companies in its group, against its controlled foreign company (CFC) profits. The main uncertainty is with the data available to construct the tax base and the likely behavioural response. Any measure that targets companies already actively changing their behaviour in response to the tax system is particularly uncertain;

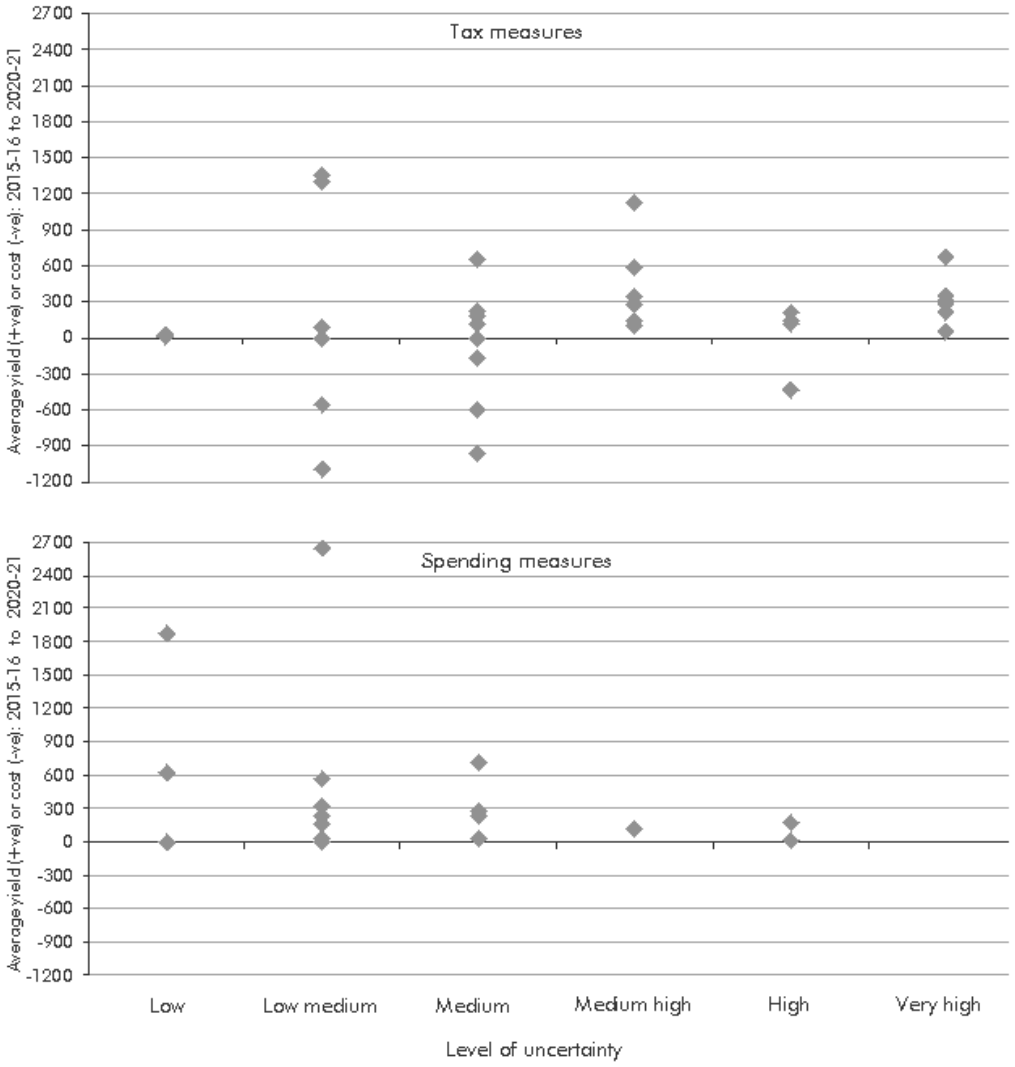
- **Pay to stay: higher income social housing tenants to pay market rents**: This costing receives a 'high' uncertainty rating. It requires social landlords to charge higher rents to households that earn above a defined threshold. The main uncertainties in the costing arise from the modelling assumptions and the behavioural adjustments. The baseline of the measure draws on 2012-13 data, so there is uncertainty in the modelling assumptions used to project the income levels of social tenants up to 2015-16 and beyond. The costing is sensitive to the amount of fiscal drag that has occurred in this group. There is also uncertainty around how individuals will behave. For example how many will choose to exercise their 'Right to Buy'; and

- **UC parent conditionality from when youngest child turns 3**: This costing receives a 'high' uncertainty rating. Under this policy, responsible carers claiming universal credit who have a youngest child aged 3 or 4 and whose household earnings are below the lower conditionality threshold will be placed in the 'intensive' rather than the 'work preparation' regime. The entire estimated saving from this measure reflects the assumed behavioural response from lone parents moving into work as a result of being placed into the 'work preparation' regime. DWP has good evidence on the impact of previous lone parent obligation changes, but it is not clear how applicable this is to parents with even younger children. They may face very different barriers of entry into the labour market.

A.10 We have judged 21 measures to have 'low-medium' or 'high-medium' uncertainty around the central costing, with a further five having 'low' uncertainty. That means that 67 per cent of the Budget measures have been placed in the medium range (74 per cent by absolute value) and 10 per cent have been rated as low (12 per cent by absolute value).

A.11 Chart A.1 plots these uncertainty ratings relative to the amount each policy measure is expected to raise or cost. One feature of the distribution of measures by uncertainty is that the welfare spending measures (as defined by the Treasury), which together are expected to raise £13.0 billion in the final year of the scorecard period, are typically assigned lower uncertainty ratings, while the tax raising measures, which together are expected to raise £15.9 billion in 2020-21 are typically assigned higher uncertainty ratings than the tax cuts. This is particularly true for the measures that aim to raise money from individuals with high incomes and high wealth who are already actively planning their affairs to reduce their tax liabilities.

Chart A.1: OBR assessment of the uncertainty of costings



Longer-term uncertainties

A.12 For most policy costings, the five-year scorecard period is sufficient to give a representative view of the long-term cost or yield of a policy change. Typically, that effect is either zero – because the policy has only a short-term impact that has passed by the end of the scorecard period – or it would be reasonable to expect it to rise broadly in line with nominal growth of the economy. In this Budget, the final year effects of most scorecard measures are representative of the longer-term cost or yield.

A.13 There are two measures that convert public spending into loan schemes. Within the scorecard period, these reduce spending (which lowers PSNB) and increase government

lending to the private sector (which raises net debt, but not PSNB). Beyond the scorecard period, there will be a PSNB cost associated with any loans that are written off. Specifically:

- **BIS: switching maintenance grants to loans:** This involves lending to students from lower-income households that would previously have received grants. On the assumption that lifetime earnings are positively correlated with parental household income, write-off rates on these loans would be higher than in the student loan population as a whole. Any PSNB cost of student loan write-offs does not occur until 30 years after the loan is made; and

- **Support for Mortgage Interest: change from welfare payment to loan; maintain capital limit at £200,000:** This converts the existing support for mortgage interest for people in receipt of specific benefits into a loan that is repayable after moving off benefits or when a property is sold. As a second-charge secured loan, write-off rates would be expected to be smaller than for an unsecured loan, but would still be likely to build beyond the scorecard period as the stock of outstanding loans increases over time.

Small measures

A.14 The BRC has agreed a set of conditions that, if met, allow OBR staff to put an individual policy measure through a streamlined scrutiny process. These conditions are:

- the expected cost or yield does not exceed £40 million in any year;
- there is a good degree of certainty over the tax base;
- it is analytically straightforward;
- there is a limited, well-defined behavioural response; and
- it is not a contentious measure.

A.15 A good example of a small measure announced in this Budget is the 'Corporation Tax: intra-group transfers', which clarifies the tax treatment of transfers between related or connected parties of trading stock and intangible fixed assets. This costing was based on known avoidance by the groups involved in this behaviour. The modelling is straightforward and the behavioural adjustment involves assumptions about the proportion of the yield that will be lost to attrition.

A.16 By definition, any costings that meet all of these conditions will have a maximum uncertainty rating of 'medium'.

HMRC operational measures

A.17 In this Budget, the Government has announced a package of measures designed to increase the level and quality of compliance activity carried out by HMRC. This was a

particularly challenging set of measures to scrutinise ahead of the forthcoming Spending Review (SR). Without an explicit forecast of the compliance activity necessary to meet the assumptions implicit in our pre-measures forecast. Without knowing how HMRC's SR settlement will impact on its compliance activity, it was difficult to certify that the new activities would be truly additional.

A.18 In order to certify the measures that have been announced in the Budget, we needed to satisfy ourselves about both the baseline assumptions and that the scorecard measures would be additional to that baseline. This was done in two stages:

- we scrutinised evidence on the performance of HMRC compliance activity over the last Parliament and its implications for the compliance productivity growth that would be required to offset any staff reductions that follow in the SR. This is subject to significant uncertainty – HMRC's measure of compliance activity does not translate directly into the National Accounts receipts that we forecast and it relates to estimates of non-compliant activity that is itself difficult to measure. But we were satisfied that the assumptions that would be required about baseline activity were reasonable; and

- we asked the Treasury to provide assurances that HMRC would receive the funding necessary to achieve the baseline compliance activity implicit in our forecast. The Treasury has provided this assurance by stating that *"As well as announcing additional resource for the measures announced today on evasion and non-compliance, the Government is committed to providing HMRC with the funding it needs to maintain its current level of compliance performance, whilst making efficiencies. HMRC's compliance yield targets will increase to reflect the impact of the Budget measures"* and by setting out the resource and capital DEL it expects to provide in the SR for HMRC's compliance activity. The figures are shown in Table A.3.

Table A.3: HMRC compliance: DEL commitment and DEL elements of related measures

	£ million					
	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
HMRC compliance baseline (RDEL)	1190	1150	1110	1085	1065	1045
Investment to support HMRC's operational package (RDEL)	50	165	215	220	225	225
Investment to support HMRC's operational package (CDEL)	10	60	55	50	40	30

A.19 There were numerous sources of uncertainty associated with this package of measures. General concerns related to the average yield of each additional full-time equivalent staff member and to implementation risks. In many cases we asked for costings to incorporate increased time lags before new staff were assumed to be fully productive, in line with previous experience of such operational changes. We also carefully considered the likelihood of diminishing returns from additional staff as they were assumed to be working progressively more difficult compliance interventions.

A.20 We have certified the yields presented in the Treasury scorecard for these measures as reasonable and central. We will return to these assumptions once HMRC's full SR settlement has been published.

Interactions

A.21 An added difficulty when estimating the effects of a package of measures is estimating the interactions between all the different elements of the package. For example, changing the parameters associated with one benefit may alter the caseload for another, which would affect the costing of a measure that targeted that caseload. The order in which the measures appear on the scorecard is therefore important when estimating interactions, as the measure scored first can affect the costing of those further down – but not vice versa.

Welfare package

A.22 In the run up to this Budget, we worked closely with HMRC, DWP and the Treasury to make sure that we captured all the relevant interactions in the costings and avoided double counting. An example of the type of interactions captured is that tax credit awards feed into the income calculation for housing benefit. This means that cuts to tax credits would – all else equal – result in a corresponding increase in housing benefit spending.

A.23 Interactions between different measures mean that the order in which they are scored (and in which they therefore appear on the Treasury scorecard) can make a potentially significant difference to the cost or saving attributed to each measure. The cut in the 'benefit cap' is a case in point. Logically, you might score the benefit cap last as it is a cap applied to people's aggregate entitlement to benefits once all other reforms have taken place. But the Treasury has chosen to place it part way through the scorecard. This increases the estimated savings, because the cap is assumed to apply to a more generous welfare system than that which will actually be in place following the enactment of all the Budget measures.

A.24 Table A.4 shows that the scorecard saving from the benefit cap increases to £495 million in 2020-21. But if it were in last place on the scorecard, reflecting the reduced generosity of other benefits and tax credits, the saving would be less than half as large at £195 million.

Table A.4: The effect of interactions on estimated savings from reducing the benefit cap

	£ million				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
No interactions	100	310	360	405	495
Estimate with main interactions	95	225	195	165	195
of which:					
Child tax credit	0	-40	-80	-115	-215
Other benefits	-5	-45	-85	-125	-85
Total difference from interactions	-5	-85	-165	-240	-295

A.25 It is important to remember that changing the order that measures appear on the scorecard will not alter the net impact of the package as a whole. If the benefit cap was scored last, then the measures that precede it on the scorecard would save correspondingly more.

Effect on tax-motivated incorporations

A.26 Within our receipts forecast, we include an expected flow of tax-motivated incorporations (TMIs) and their impact on receipts. When individuals choose to form companies to lower their tax bills, this reduces income tax receipts and NICs, but raises corporation tax receipts, with the net effect negative for receipts overall. Many measures announced in this Budget will affect the incentives to incorporate by altering the differential between the two tax regimes. Apart from 'Dividends tax: abolish credit, introduce new £5,000 allowance, and increase effective rates by 7.5pp' where the yields are shown separately in the scorecard, the TMI effects are included in the costs of these measures.

A.27 HMRC's TMI model was used to estimate the effect of changes in incentives on the flow of TMIs over the scorecard period and applied the new incentives to the flow. The results are shown in Table A.4. As with any forecast of a behavioural response to the tax system, these estimates are subject to significant uncertainty.

A.28 The largest additional incentive to incorporate comes from the cut in corporation tax rates, but this is more than offset by taxing dividends more heavily. Overall, we have judged the net effect of the measures affecting incorporation is to reduce the flow of TMIs with the resulting increase in tax receipts reaching £425 million in 2020-21.

Table A.5: Scorecard effects on tax-motivated incorporations

	£ million				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
Pre Measures TMI	-1055	-1235	-1400	-1515	-1660
Personal allowance: increase to £11,000 in 2016-17, with equal gains to higher rate taxpayers	0	0	0	0	0
Higher Rate Threshold: increase to £43,000 in 2016-17	0	-5	-5	-5	-5
Corporation Tax: reduce to 19% from 2017-18, and 18% from 2020-21	0	-35	-105	-125	-175
Employment Allowance: increase by £1,000 from 2016-17	0	-10	-10	-15	-15
Dividends tax: abolish credit, introduce new £5,000 allowance, and increase effective rates by 7.5pp	190	360	445	505	565
Employment Allowance: withdraw from single person companies	35	45	45	50	55
Post Measures TMI policy	-835	-880	-1030	-1100	-1235

Departmental spending

A.29 We do not scrutinise the costings of policies that reallocate spending within departmental expenditure limits (DELs), since the total cost or yield is wholly determined by a Government policy decision. Neither do we typically scrutinise the DEL implications of measures that

affect current receipts or AME spending, where those are also wholly determined by Government policy decisions. (The HMRC compliance measures at this Budget have been an exception to this normal practice.) Instead we include the overall DEL envelopes for current and capital spending in our forecast, plus judgements on the extent to which we expect those be over- or underspent in aggregate. We judge – in line with historical experience and our recent forecasts – that they will be modestly underspent in 2015-16.

A.30 Beyond the current SR period from 2016-17 onwards, the Government provides us with figures for the amount of departmental spending that it assumes it would wish to spend. These do not appear on the Treasury's scorecard, but we show changes in them as the effects of Government decisions in our forecast (see Table 4.3).

Indirect effects on the economy

A.31 This Budget contains a number of policy changes that we have judged to be sufficiently large to justify adjustments to our central economic forecast. These include:

- the pace and composition of fiscal consolidation has changed significantly. Bigger cuts in public spending in 2015-16 have reduced quarterly growth in late 2015 and early 2016. The significant slowing in the pace of spending cuts thereafter has raised quarterly growth through the rest of 2016. We have assumed that changes in later years will have only small effects on growth as the Bank of England will be able to factor them into its judgements when setting monetary policy;

- our inflation forecast has been affected by a number of policy measures, the most significant of which have been the increase in vehicle excise duty rates in 2017 and the decision to force social sector landlords to reduce rents by 1 per cent a year from 2016. As these are administered prices, we have assumed that the Bank of England will look through these effects when setting monetary policy; and

- we have made small adjustments to our assumptions for structural unemployment and potential output in light of the Government's decision to introduce a Living Wage Premium on top of the National Minimum Wage for people aged 25 and over. The response of firms and the impact on the labour market are subject to significant uncertainty. Annex B describes how we have estimated these effects, and the uncertainties around them.

B The National Living Wage

Introduction

B.1 The Government has announced that from April 2016 it will introduce a Living Wage Premium (LWP) that will apply on top of the National Minimum Wage (NMW) for employees aged 25 and over to deliver a National Living Wage (NLW) for those people. The main NMW will continue to be set for all employees aged 21 and over, so that those aged 21 to 24 will continue to be subject only to that rate.

B.2 The Government has specified that the April 2016 NLW rate will be set at £7.20 an hour, which is 50p higher than the main NMW rate of £6.70 that will apply from October 2015. From April 2017, in addition to setting the main NMW, the Low Pay Commission (LPC) will be tasked with recommending a yearly profile for the LWP that takes the hourly NLW applying to those aged 25 and over to 60 per cent of the median hourly earnings of that group by April 2020. Unfortunately, we were unable to discuss with the LPC how they might approach setting out the precise trajectory ahead of its public announcement.

B.3 This represents a significant change to labour market institutions that could be expected to have material implications for the economy and public finances. But estimating the size of those effects requires a number of assumptions about how the policy will be implemented and how firms will respond that are subject to great uncertainty. This annex therefore:

- sets out the approach we have taken and the adjustments that have been made to our central economy forecast;
- presents some plausible ranges around the central estimates we have made and describes some of the wider uncertainties that we have not tried to quantify; and
- shows how our fiscal forecasts have been affected by the adjustments we have made to the central economy forecast.

Estimating the effects on our central economic forecast

Policy-related assumptions

B.4 The first step in estimating the effect of the NLW on the economy is to make assumptions about what hourly wage rates it implies and how much they differ from the hourly wage rates implied in our economic forecast in the absence of this policy change. This is a similar process to that taken for scorecard policy measures, where we produce a pre-measures forecast on the basis of existing policy and then adjust it for the effects of new policies. But it

is made more complicated by the fact that our economic forecast is a top-down macroeconomic forecast, so we do not explicitly forecast the earnings distribution or employment among different age groups. We must therefore make an assumption about what is implicit in our baseline forecast.

B.5 For the purpose of estimating the effect of introducing the NLW, we have assumed that:

- the earnings distribution in our pre-measures forecast does not change from year to year. As such, median earnings at all ages are assumed to rise in line with the average hourly earnings forecast that is implied by our central forecasts for whole economy wages and salaries, employment and average hours worked;
- the NMW would have risen in line with that average hourly earnings forecast in the absence of the NLW policy;
- the NMW will continue to rise at the rate assumed in the baseline forecast – i.e. the existence of the NLW will not lead to decisions to raise or lower the NMW in response. (Since the NMW is a parameter in some aspects of the benefits system – and the Government has stated a goal of setting the income tax personal allowance so that people working 30 hours a week at the NMW pay no income tax – this assumption is of greater importance to the public finances forecast than to our economic forecast);
- the NLW will rise from £7.20 in April 2016 (equivalent to around 55 per cent of estimated median hourly earnings for employees aged 25 and over) to around £9.35 in April 2020 (reaching 60 per cent of expected median hourly earnings for that group) in steps that imply the rise relative to median hourly earnings is a straight line. The effective minimum wage for the affected age group will therefore be over 13 per cent higher in 2020 than would otherwise have been the case; and
- for simplicity, compliance with the NLW is assumed to be complete. In practice, there has been some non-compliance with the NMW, though it appears to be concentrated at younger ages or in specific sectors.[1] It is possible that the 13 per cent increase in the effective minimum wage implied by the policy could lead to an increase in non-compliance.

B.6 Setting aside the uncertainties inherent in our central forecast, there are clearly significant uncertainties around each of these assumptions. Mean and median earnings tend not to move precisely in line with each other, which would affect the assumed cash value of the NLW in 2020. It is also not clear at this stage how the Low Pay Commission will act upon this new remit or the decisions the Government would take in response. But at this point the Government has confirmed that these are the appropriate assumptions to make in order to capture the intended effect of the introduction of the NLW and LWP. As with any reform that affects a large proportion of the population, there will be risks of unexpected consequences when the policy comes to be implemented.

[1] These issues have been explored further in recent Low Pay Commission reports.

Estimating the direct effect on the earnings distribution, wage costs and profits

B.7 The next step in estimating the effect of the NLW on the economy is to quantify how its introduction would change the earnings distribution for those aged 25 and over, and how much that would increase the whole economy wage bill and reduce whole economy profits. To do this, we need to make assumptions about the number of employees that will be affected and by how much. We do that by:

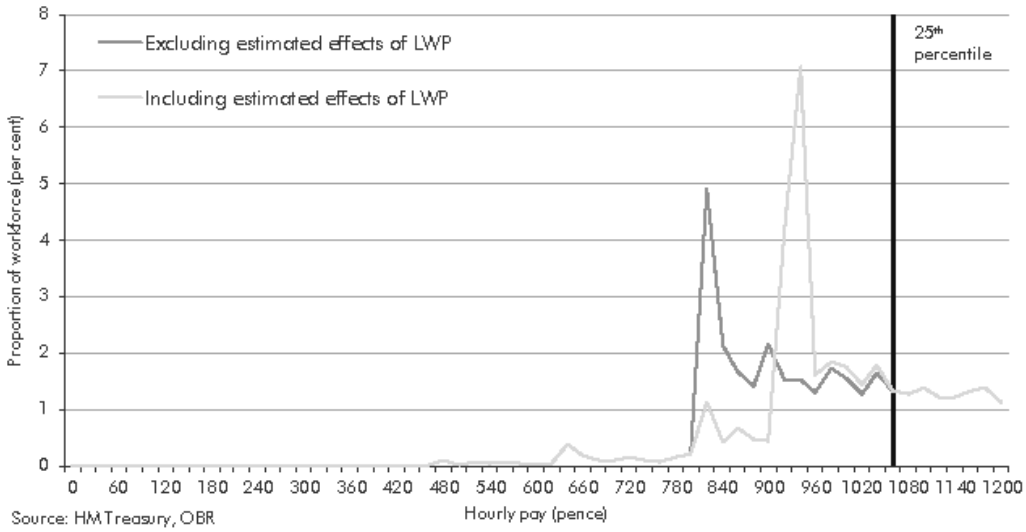
- starting from data from the ONS 2014 Annual Survey of Hours and Earnings (ASHE), which is based on a 1 per cent sample of all employees;
- projecting the ASHE-derived earnings distribution forward using our baseline employment and hourly earnings forecasts;
- assuming that the effect on hourly earnings would be the full amount for those earning precisely the NMW in the pre-measures earnings distribution and would taper thereafter, such that those earning below the NLW in the baseline distribution would earn that amount after its implementation; and
- assuming that in addition to the effect on people earning between the pre-measures NMW rate and the post-measures NLW rate, there will be spillover effects further up the earnings distribution, preserving some of the pre-measures earnings differentials. Based on research published by the Low Pay Commission,[2] we have assumed that spillover effects would extend to the 25th percentile of the earnings distribution. We also allow for spillovers to some people under 25 years old.

B.8 Using this approach, by 2020 we estimate that, absent any indirect effects, around ¾ million people aged 25 and over would move from receiving the NMW to the higher NLW. Just under an additional 2 million people would move from having hourly earnings between the £8.25 assumed NMW and the £9.35 assumed NLW to at least the NLW. Hourly earnings of around £9.35 would place an individual at the 16th percentile of the earnings distribution. Assuming that spillover effects extend to the 25th percentile implies that an additional 3¼ million people will also be affected, taking the total number of people affected to around 6 million. The post-NLW earnings distribution would be more compressed among those at the bottom of the distribution.

B.9 Chart B.1 shows how these assumptions feed through to the implied earnings distribution in 2020 of those aged 25 and over.

[2] Butcher, Manning and Dickens (2012) *"Minimum Wages and Wage Inequality: Some Theory and an Application to the UK"*, Discussion Paper (Low Pay Commission; University of Sussex; London School of Economics).

Chart B.1: Illustrative earnings distributions in 2020 before and after the estimated effects of the Living Wage Premium



Source: HM Treasury, OBR

B.10 In order to estimate how these changes might affect the economy, we need to turn this effect on the earnings distribution into an effect on the wage bill and profits at the whole economy level. Assuming no change in employment or hours worked, that will equal the product of the weighted cash increase in hourly compensation and the number of people affected. In 2020, it would be almost £4 billion, which is equivalent to 0.3 per cent of whole economy compensation of employees and just over 1 per cent of corporate profits (as measured in the National Accounts).

B.11 Imposing the assumption of no change in employment or hours worked makes this a pre-behavioural or 'static' estimate of the impact of new policy. In reality, firms and the economy will adjust to the policy change. This adjustment process is what we try to capture in the behavioural effects of scorecard policy measures (described in Annex A) and the indirect effects of larger policies that we judge to be material to our macroeconomic forecast (described in Box 3.3 in Chapter 3). They involve more challenging assumptions and greater uncertainty.

Estimating the indirect effects on the economy

B.12 We can think about how the economy would adjust to a 0.3 per cent increase in wage costs from a microeconomic firm-level perspective or from a macroeconomic whole economy perspective. In this section we cover the range of possible adjustment channels and the evidence we have drawn on to settle on the assumptions used in our central forecast.

B.13 Our first and overarching assumption is that because the introduction of the NLW represents a change to labour market institutions, once the transition has been completed its effects on

the economy are structural. That means that any changes to the labour market or to GDP will be reflected in potential output.

B.14 At the firm level, employers that are affected by the higher wage costs associated with the NLW would, absent adjustment, face a loss of profits. Those employers could respond in a variety of ways to try to offset that loss:

- reducing the number of hours worked by their existing employees;
- reducing the number of people employed, either by firing existing employees or by hiring fewer people until attrition has reduced the workforce by the desired amount;
- changing the composition of their workforce, potentially by replacing those who are 25 years old or older with those aged 24 or less; or
- increasing prices in order to pass on the higher wage costs to their customers.

Such responses would have knock-on effects to the demand for firms' output, thereby leading to further changes in employment and profits.

B.15 Aggregated to the whole economy level, these adjustment processes could lead to:

- a reduction in total hours worked – either via the employment rate or average hours – which would feed directly into a reduction in potential output;
- changes in hourly productivity. We would not expect these changes to affect hourly productivity for specific individuals, but the composition of employment could change sufficiently to affect the average;
- changes in the profile of the output gap during the adjustment phase;
- increases in the whole economy price level, which will depend on how much of the resulting hit to profits firms choose, and are able, to pass onto consumers; and
- changes in the labour share of income, which will depend on the assumptions made about the extent to which firms are able to recover the static hit to profits and the method by which they do so.

B.16 Making assumptions about the relative importance of these channels will determine the size and income composition of GDP after the NLW has reached steady state in 2020. We then need to make a final set of assumptions about how any changes in household and corporate incomes affect the composition of GDP by expenditure.

B.17 For our central estimate of the effect of introducing the NLW on the economy, we have assumed:

- an elasticity of demand for labour of -0.4 (which we discuss further below). This means total hours worked fall by 0.4 per cent for every 1.0 per cent increase in wages;
- half the effect on total hours will come through employment and half through average hours;
- the concentration of the fall in total hours at the bottom of the earnings distribution implies a positive compositional, or 'batting average', effect on hourly productivity at the whole economy level. We assume that the wage costs that would otherwise have been paid in the absence of this policy provide a rough guide to the average productivity of the hours lost;
- that firms pass on around half of the increase in unit labour costs to consumers through price increases, meaning that profits are slightly lower; and
- for simplicity, that the household saving ratio will not be affected by the NLW (so changes in household income have a proportionate effect on household consumption) and capital spending as a proportion of corporate income will be unaffected (so changes in profits have a proportionate effect on business investment). The implications at the macroeconomic level of varying either of these assumptions would be small.

B.18 The consequences of these assumptions for our economy forecast are summarised in Table B.1, which shows:

- the structural unemployment rate has been revised up by around 0.2 percentage points – equivalent to around 60,000 people in 2020 – and trend average hours have also been revised down by around 0.2 per cent. This results in a reduction in total hours worked per week of almost 4 million;
- the level of real potential output has been revised down by 0.1 per cent by 2020, which is equal to the effect on total hours adjusted for the assumption that the lost hours are from those who are less productive than the average worker;
- as the output gap is unchanged, lower potential output means we have revised down the level of real GDP by the same amount;
- the additional wage costs are split between lower profits and higher prices. We have assumed that profits are around 0.3 per cent lower, reducing nominal GDP by just under 0.1 per cent. The price level has been revised up by 0.1 per cent, which is equivalent to adding small amounts a year to CPI inflation and the GDP deflator. As a result, nominal GDP is little changed by 2020; and
- average earnings across the whole economy have been revised up by around 0.4 per cent by April 2020, which is equivalent to adding less than 0.1 percentage points a

year to average earnings growth. This reflects both the higher average earnings of groups directly affected and the change in the composition of employment.

Table B.1: Estimated effects of the Living Wage Premium on our 2020 economy forecast

Percentage point change in forecast					
Real GDP	-0.1	Nominal GDP	0.0	Average earnings	0.4
of which		*of which*			
Unemployment rate	-0.2	Real GDP	-0.1		
Average hours	-0.2	Prices	0.1		
Hourly productivity	0.3				

Uncertainties and sensitivity analysis

B.19 Table B.2 shows the effects on GDP and employment of varying some of the key assumptions described in the previous section.

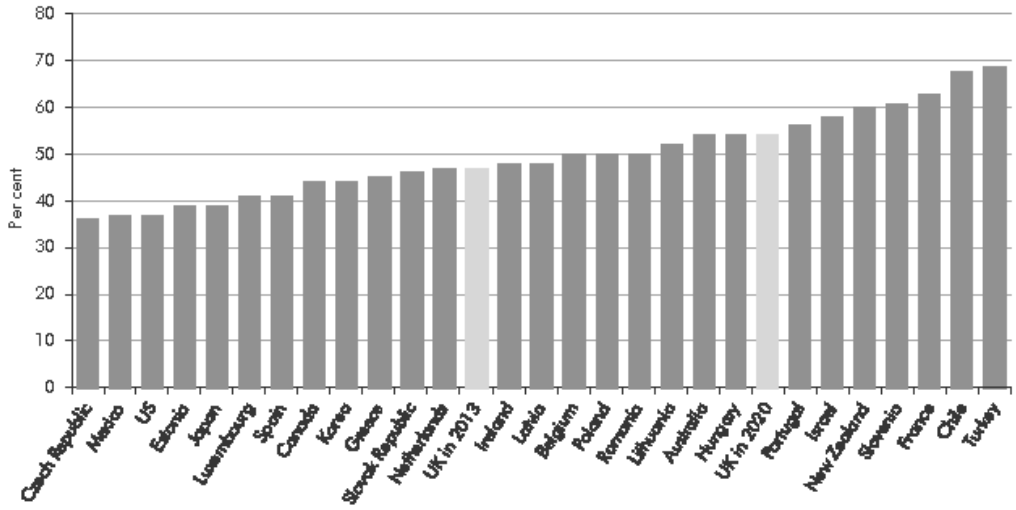
B.20 The elasticity of demand we have assumed lies within a relatively wide spectrum of empirical estimates, including the low-to-high range of -0.15 to -0.75 in Hamermesh (1991).[3] This is a key assumption, with the overall effects moving linearly with it.

B.21 Academic evidence suggests that changes to the NMW have led to only limited demand effects in the UK to date. The types of jobs that will be affected are relatively labour-intensive, which may limit the scope for firms to substitute towards using capital (and so dampen the labour demand effect). Firms may also be expected to shift demand in favour of the under-25s given that they will not be subject to the NLW, which all else equal would lead to a smaller reduction in aggregate labour demand. Some of the reduction in employees could also be partially offset by a rise in self-employment.

B.22 But increasing the NLW further up the earnings distribution may lead to bigger effects than have been witnessed in the past. As Chart B.2 shows, the ratio of the UK's NMW relative to full-time median earnings currently sits in the middle of the pack for OECD economies, but would move up that range.[4]

[3] Hamermesh (1991), *"Labour demand: What do we know? What don't we know?"*. Loeffler, Peichl, Siegloch (2014), *"The own-wage elasticity of labor demand: A meta-regression analysis""*, present a median estimate of -0.39, within a range of -0.072 to -0.446.
[4] Dolado et al (1996), *"The economic impact of minimum wages in Europe"* explores cross-country differences.

Chart B.2: Adult minimum wage relative to full-time median earnings in 2013



Source: OECD, OBR
Note: The 2020 UK figure relates to the NLW, not the NMW.

B.23 Assuming a lower labour demand elasticity of -0.15 would reduce the effect on real GDP by more than half and the effect on unemployment to just over 20,000. Conversely, a higher elasticity of -0.75 would increase the real GDP effect to 0.2 per cent and the employment effect to around 110,000.

B.24 There has been clearer evidence of changes in labour demand resulting in lower average hours worked.[5] There are a wide range of factors that will shape firms' choices as to whether to reduce labour inputs through lower employment or lower average hours, including the adjustment horizon, firing and hiring costs, worker preferences and flexibility in determining operating hours. Many of these will be firm- or sector-specific choices, with some skewed towards one or the other. We have taken the broad judgement that, at the macroeconomic level, the adjustment will be evenly split between employment and hours. But while the estimated employment effect is sensitive to this assumption, the overall economic and fiscal effects are not.

B.25 All else equal, assuming 100 per cent of the total hours effect came through employment would double the unemployment increase to 120,000, while assuming 25 per cent came through employment would reduce it by half, to 30,000. To the extent that firms choose to reduce headcount, they could choose to reduce disproportionately either the number of full-time or part-time workers, which adds another source of potential uncertainty.

[5] Bryan et al. (2013), *"The Impact of the National Minimum Wage on Employment Retention, Hours and Job Entry"*, find that in response to the introduction and uprating of the NMW, hours of young people fell by 3 to 4 hours. Dickens et al. (2009), *"The Employment and Hours of Work Effects of the Changing National Minimum Wage"* find some evidence of hours falling in response to the large NMW increases of 2001 and 2003. Swaffield & Stewart (2008), *"The other margin: do minimum wages cause working hours adjustments for low-wage workers"*, find that the introduction of the minimum wage reduced average hours of low paid groups by 1 to 2 hours per week.

B.26 Over and above the reductions in costs stemming from lowering labour inputs, there is only limited evidence relating to how far firms are able to pass higher minimum-wage induced costs on to prices. Pass-through may be more likely if most firms within a particular industry are affected in a similar way. All else equal, higher pass-through would lead to higher nominal GDP but would not affect real output. If instead the additional costs were entirely absorbed, then nominal GDP would move in line with our real GDP adjustments, and so decline by 0.1 per cent.

Table B.2: Sensitivity analyses

		Per cent, unless otherwise stated		
		Real GDP	Nominal GDP	Unemployment ('000s)
Central		-0.1	0.0	60
Labour elasticity:	-0.15 to -0.75	-0.1 < to -0.2	0.0	20 to 110
Proportion of effect through heads:	25 to 100	-0.1	0.0	30 to 120
Proportion of prices relative to profits:	0 to 100	-0.1	-0.1 to 0.1	60

Implications for our fiscal forecast

B.27 The estimated effect on the public finances of introducing the NLW is, of course, sensitive to the assumptions that are made about how firms and the economy adjust to higher wage costs. Given the uncertainties around these assumptions, it is clearly possible to reach different conclusions using plausible assumptions.

B.28 The channels by which the public finances will be affected include:

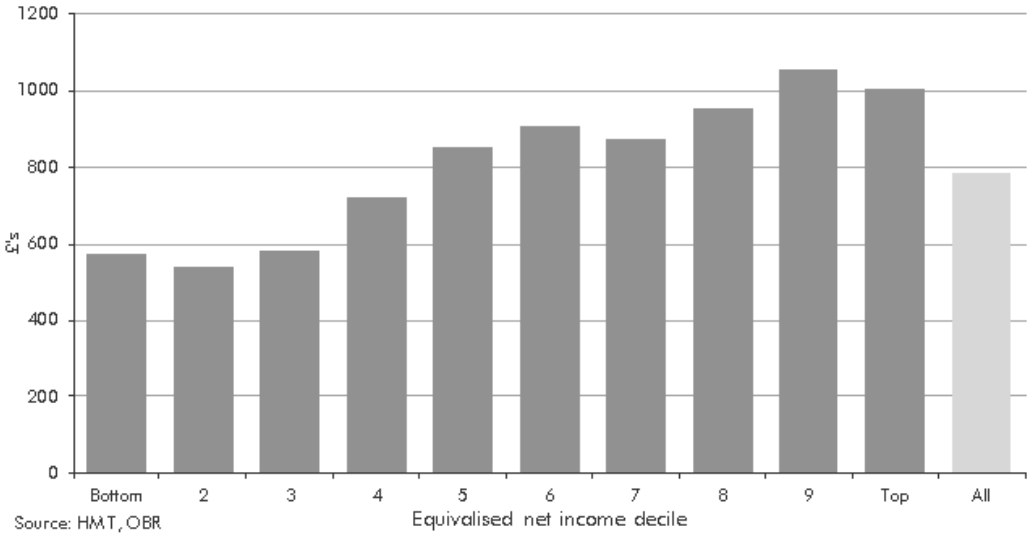
- higher labour income (in cash terms) potentially raising income tax and national insurance contributions (NICs) (although these effects would be expected to be relatively small, given our assumption that incomes are only affected up to the 25th percentile of the earnings distribution) and reducing income-related benefit spending, particularly tax credits and housing benefit;
- changes to the price level will affect the uprating of tax thresholds and benefits, and payments on index-linked gilts. In this forecast, the Government's decision to freeze most working-age benefits rate for four years means the assumed effect of the NLW on prices will not feed through to higher spending on those benefits and tax credits subject to the freeze;
- higher average earnings growth will also feed through to the basic state pension via the triple lock on uprating, with a smaller effect on pension credit;
- higher unemployment will lead to higher spending on jobseeker's allowance and associated housing benefit;
- higher household consumption (in cash terms) will raise VAT and excise duties receipts; and

- changes in profits and investment would feed through to corporation tax receipts. The size of any effect will depend on assumptions made about the extent to which firms are able to offset increased wage costs through the adjustment channels described above.

B.29 The change in the shape of the earnings distribution at the bottom end – and the associated employment effects – is particularly important for the effect on spending on tax credits and housing benefit. But there is an important additional consideration, in that both benefits are conditioned on household income, whereas the NLW will affect the incomes of individuals within households.

B.30 Although the NLW boosts individuals' earnings towards the lower end of the individual income distribution, it is expected to have a more even effect on the distribution of household incomes, since many workers on the NLW will be households' second earners. Indeed, around half the cash gains in household income may accrue to the top half of the household income distribution, in part because workers in higher income deciles that do gain from the measure will receive a larger average cash amount (Chart B.3).[6]

Chart B.3: Average annual gains to gaining households in 2020



Source: HMT, OBR

B.31 Table B.3 shows our estimate of the overall effect on our public sector net borrowing (PSNB) forecast of the introduction of the NLW. It shows that overall – based on the assumptions described in this annex – we have revised PSNB down by small amounts that rise to £0.2 billion in 2020-21. This reflects the net effect of:

[6] NMW workers are more concentrated within the third to sixth deciles of the household income distribution. Lower deciles tend to have relatively more pensioners and unemployed people, and Brewer, May and Phillips (2009), *"Taxes, benefits and the national minimum wage"*, show that NMW workers are more likely to be within the bottom two deciles of the working age household income distribution. They also show that second earners are concentrated around the middle deciles of that distribution, which is otherwise skewed towards the higher end.

- reductions in tax credits and housing benefits – the largest effect – reach £0.8 billion in 2020-21;
- income tax and NICs are expected to be up by only small amounts, with an additional increase in VAT receipts due to higher nominal household consumption;
- marginally higher whole economy earnings growth increases the cost of uprating pensions. Higher inflation also has small effects on tax and welfare upratings, in addition to raising the cost of payments on index-linked gilts;
- higher unemployment and lower profits lead to further increases in borrowing; and
- there may also be other indirect effects on the economy that go on to affect receipts and spending (for example through house prices), but these have not been explicitly modelled.

Table B.3: Effects on net borrowing of introducing the Living Wage Premium

	£ billion				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
Average earnings	-0.2	-0.3	-0.4	-0.5	-0.6
of which:					
Tax credits and housing benefit	-0.2	-0.3	-0.5	-0.7	-0.8
Income tax and NICs	0.0	0.0	0.0	-0.1	-0.1
Pension upratings	0.0	0.1	0.2	0.2	0.3
Employment: welfare	0.1	0.1	0.2	0.2	0.2
Inflation: upratings and debt interest	0.1	0.1	0.2	0.2	0.3
Profits: corporation tax	0.0	0.1	0.1	0.1	0.1
Consumption: VAT	0.0	-0.1	-0.1	-0.1	-0.2
Other economy effects	0.0	0.0	0.0	0.0	0.0
Total effect on net borrowing	0.0	-0.1	-0.1	-0.2	-0.2

B.32 In the time available, we have not been able to run the range of alternative economic assumptions through the different receipts and spending forecast models to test fully the sensitivity of the results in Table B.3 to different assumptions. But we would stress that – as with the effects on the economy forecast – these results are subject to considerable uncertainty.

Next steps

B.33 Evidence on the effect of the first rise to £7.20 in April 2016 should become available relatively soon, but the full adjustment to 60 per cent of median hourly earnings will remain a factor relevant to our forecast judgements over the next few years. Ahead of our next forecast, we intend to engage with the Low Pay Commission, our expert Advisory Panel and others on the analysis set out in this annex in order to inform any future revisions that prove necessary.

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