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Press Release

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OBR sets the scene for a painful Budget

The newly created independent Office for Budget Responsibility (OBR) has published its first set of official forecasts for the economy and the public finances. It argues that the economy's growth prospects are weaker than the last government claimed, and that bigger spending cuts and tax increases will be required over the coming years than Labour's final Budget suggested.

Here are some initial thoughts from Robert Chote, Rowena Crawford, Carl Emmerson and Gemma Tetlow on some of the issues raised by the report:

Do the OBR's forecasts make the public finances look stronger or weaker than Alistair Darling's March 2010 forecast?

The OBR has forecast slightly lower levels of headline borrowing over the next few years than Mr Darling did in the March 2010 Budget. Pending any policy announcements in next week's Budget, the OBR expects public sector net borrowing will be 3.9% of national income (£71 billion) in 2014–15 compared to the 4.0% of national income (£74 billion) forecast by Mr Darling in the March 2010 Budget.

But the OBR is less optimistic than Mr Darling was about the amount of spare capacity in the UK economy and therefore believes that there is less scope for borrowing to fall automatically as the economy recovers. In 2014–15 the OBR forecasts structural borrowing – the component of borrowing thought to be impervious to the ups-and-downs of the economic cycle – at 2.8% of national income. This is 0.3% of national income higher than the 2.5% forecast by Mr Darling in the March 2010 Budget. Against this benchmark, the underlying health of the public finances looks slightly worse than Mr Darling suggested.

This 0.3% of national income increase in the expected level of structural borrowing in 2014–15 reflects the net effect of a number of factors:

- The OBR believes that the productive potential of the economy will be 2¼% lower in 2014–15 than Mr Darling forecast in his March Budget. This revision alone would increase the amount of borrowing in 2014–15 that appears to be structural by 1.5% of national income.

- The OBR forecasts assume that the share of VAT revenues that the Government believes it is entitled to, but that are not collected, will remain constant over time as opposed to increasing, as Mr Darling cautiously assumed. Removing this element of caution alone would have reduced forecast borrowing by 0.2% of national income.

- The OBR believes that public spending in 2010–11 will be £4.1 billion lower than forecast in the March 2010 Budget. It has carried this forward into future years, reducing forecast borrowing by 0.3% of national income.

- The OBR expects stronger underlying tax revenues over the next few years, sufficient to reduce forecast borrowing by up to 0.7% of national income. Part of this has already shown up in recent figures showing a smaller budget deficit in 2009–10 than Mr Darling forecast in his March 2010 Budget.

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What do today's figures tell us about the cuts to spending on public services implied by Labour's plans prior to the election?
The OBR's forecasts for total public spending imply that Departmental Expenditure Limits (DELs) – the amount spent by central government delivering and administering public services – would need to be cut in real terms by an average of 2.7% a year from 2010–11 to 2014–15, or by a cumulative 10.2% or £39.3 billion in 2010–11 prices.

Labour had promised to protect non-investment spending on the NHS, Sure Start, schools and 16-19 education in 2011–12 and 2012–13 and to increase spending on overseas aid sharply through to 2013. If Labour had won the election and worked within this DEL envelope, then they would have needed to cut their unprotected DELs by an average of 6.2% a year over the four years starting April 2011 (assuming they extended the protection of their favoured areas of spending to 2013–14 and 2014–15). This equates to a cumulative cut of 22.7%, or £45 billion, by 2014–15. These unprotected DELs include spending on areas such as higher education, defence, transport and housing.

We estimated at the time that the Budget 2010 forecasts implied somewhat larger cuts in overall DELs (3.1%, 11.9% and £46 billion, respectively) and unprotected DELs (7.1%, 25.4% and £52 billion, respectively). The OBR's projected cuts are smaller than our estimates at Budget time partly because market expectations for interest rates have fallen. The OBR has assumed that non-investment spending grows at the same rate as projected in the Budget, so lower debt interest payments within that total imply less need to squeeze DELs. The OBR forecasts that central government gross debt interest payments will rise from £30.9 billion in 2009–10 to £67.2 billion in 2014–15, whereas our calculations suggested that the March 2010 Budget forecasts implied an increase from £30.8 billion in 2009–10 to £73.8 billion in 2014–15. (We also assumed slightly higher growth in spending on social security and other areas of annually managed expenditure than the OBR has forecast today. The former could be explained by the move to central rather than deliberately cautious assumptions for future unemployment. This also relaxes the potential squeeze on DELs somewhat.)

How does the OBR's estimate of the damage done to the UK's public finances from the financial crisis and associated recession compare to Mr Darling's March 2010 Budget estimate?

We estimated that Mr Darling's March 2010 Budget forecasts implied that the financial crisis and associated recession had brought about a permanent weakening in the UK public finances of 4.7% of national income (£69 billion). (This was estimated by comparing the forecasts in the March 2010 Budget with those produced in the March 2008 Budget, i.e. before the main part of the financial crisis had hit, and adjusting them for the estimated direct impact of policy measures announced in the intervening period.) As set out above, the OBR's forecast is that the structural budget deficit in 2014–15 will be 0.3% of national income worse than Mr Darling forecast in the March 2010 Budget. This implies that the estimate of the permanent damage to the UK's public finances from the financial crisis and associated recession has risen from 4.7% of national income (or £69 billion) to 5.0% of national income (or £74 billion).

What does this imply for the policy action that Chancellor George Osborne will announce in the new coalition Government's first Budget next Tuesday?

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The new coalition Government has yet to confirm what its target level of borrowing is, whether it will choose to aim to overachieve this target (in order to be cautious), or the extent to which spending cuts or tax rises should be used to achieve the desired level of borrowing.

On January 5th, when Mr Osborne published draft legislation for the new OBR, he announced that he would aim for "a cyclically adjusted balanced current budget by the end of the forecast horizon". If the new coalition Government chooses to retain this target for 2014–15 (the last year of the forecast horizon in today's OBR report and in next week's Budget), then this will necessitate spending cuts and tax rises of 1.6% of national income (£24 billion) on top of the 3.4% of national income (£51 billion) already planned by Labour.

Prior to the financial crisis Gordon Brown and Alistair Darling chose to aim for a surplus on the cyclically-adjusted current budget of around 0.7% of national income by the end of the forecast period. Replicating this goal to incorporate caution would bring the required combination of spending cuts and tax rises up to 2.3% of national income (£34 billion) on top of the 3.4% of national income (£51 billion) already planned by Labour.

This latter illustrative scenario suggests a total tightening of £85 billion would be needed by 2014–15. The Conservative Party general election manifesto states a preference for the tightening to be delivered in a ratio of 4:1 spending cuts to tax rises (i.e. 80% spending cuts and 20% tax rises). To achieve this would imply spending cuts of £68 billion and tax rises of £17 billion. We estimate that, based on Treasury figures, the tax rises put in place by Labour would increase tax revenues by £18 billion. This suggests that a 4:1 ratio of spending cuts to tax rises, with "a significantly accelerated reduction in the structural deficit over the course of a Parliament", could be brought about without any further net increase in taxes. However it does imply that any new tax cuts would need to be financed through tax rises. So, for example, the new coalition Government's commitments to increase the income tax personal allowances, to recognise marriage in the income tax system, and to offset the increase in employers' National Insurance Contributions planned for April 2011 would need to be financed through tax rises elsewhere. At least in part these revenues could come from the pledges in the coalition agreement to increase Capital Gains Tax and to increase taxation on air travel.

The spending cuts implied by this scenario would be deeper than those implied by Mr Darling's March 2010 Budget. Without cuts to spending on welfare benefits, we estimate that spending on DELs would need to be cut in real terms by an average of 5.5% a year from 2010–11 to 2014–15, or by a cumulative 20.3% or £78 billion. The coalition agreement commits to year-on-year increases in the total NHS budget and to sharp increases in spending on overseas aid. Even if the NHS increase was just 0.1% a year this would increase the DEL cuts needed elsewhere to 9.4% a year, or a cumulative 32.7% or £82 billion. So far the coalition Government has announced cuts to unprotected departments amounting to around £6 billion; the remaining cuts required to unprotected DELs may well be deemed prohibitively large.

An alternative scenario would be to stick to the DEL totals implied by today's OBR report. This (as discussed above) would still require total DELs to be cut in real terms by an average of 2.7% a year from 2010–11 to 2014–15, or by a cumulative 10.2% or £39.3 billion; and DELs outside the NHS and overseas aid would be cut by an average of 4.6% a year from 2010–11 to 2014–15, or by a cumulative 17.3% or £44 billion. It would also require a cut to spending on welfare benefits of £30 billion: equivalent to reducing all welfare payments by 18%. Such welfare cuts are likely to seem prohibitively large. This suggests that next week's Budget may contain some combination of an additional

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squeeze on DELs, cuts in welfare payments and net tax increases so as to spread the pain. Alternatively the Government may adopt a less ambitious target than the one we have illustrated here.

What about the link between fiscal policy and monetary policy?

In preparing its macroeconomic forecast the OBR has assumed that interest rates move in line with the expectations implied by gilts prices, rather than estimating for itself the monetary policy decisions the Monetary Policy Committee of the Bank of England would need take to keep inflation in line with the target it has been given. As it happens, the OBR believes that the gradual rise in short-term interest rates back to around 4% in 2014–15 expected by the market would be consistent with keeping consumer inflation at its 2% target rate from late 2012 onwards.

The OBR concedes that this assumption creates a "possible inconsistency", because current gilts prices probably incorporate an expectation that the new government will adopt a more rapid fiscal tightening than that assumed in Labour's last Budget and in the OBR's report. If the coalition Government decided to stick with Labour's plans then interest rate expectations would probably be higher and growth lower than these forecasts suggest.

This could create presentational difficulties for the Government when the Budget is published next week. The OBR will produce a new macroeconomic forecast incorporating the impact on growth of what is likely to be an additional fiscal tightening. But it will continue to assume that interest rates move in line with market expectations – and these may not move much until investors see the Budget details. Comparing the OBR's two macroeconomic forecasts may thus overstate the negative impact of the fiscal tightening on growth, because there will be no offsetting loosening of monetary policy.

Is the OBR forecast a welcome innovation?

The decision to transfer responsibility for official economic and public finance forecasts from ministers to independent experts is a very welcome one. It does not guarantee that the forecasts will be accurate, but it will reassure people that they reflect professional judgement rather than politically motivated wishful thinking. Such suspicions had damaged the credibility of the last government's fiscal management, even before the dramatic deterioration in the public finances we have seen over the past two years.

The OBR's first forecast publication contains some very welcome innovations that IFS researchers have been advocating for some time. In particular:

- The OBR's forecasts are central estimates rather than supposedly 'cautious' ones. Governments are right to be cautious in managing the public finances, but it is much better that this is reflected in their policy goals and decisions than in the forecasts they publish.

- The OBR's forecasts for the budget deficit are presented with a fan chart showing how close we might expect the outturn to lie relative to the forecast, based on past Treasury forecasting errors. We have used this approach in the annual IFS *Green Budget* for some years.

- The OBR has published much more detail on the assumptions underlying its forecasts and on the impact that changes in those assumptions would have on revenues and spending. (Table 4.2 is

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worth the price of the book on its own!) This increase in transparency should further increase confidence in its forecasts.

Given the short period of time it has had since the election, the interim OBR has done a very impressive job. There is plenty of scope for the permanent OBR to build upon these initial achievements. This would further increase people's understanding of – and confidence in – the forecasts upon which ministers base the policy decisions that rightly remain in their hands.

ENDS

Notes to Editors:

1. IFS will hold a briefing on 23 June 2010, the day after the Emergency Budget: http://www.ifs.org.uk/events/565

   Please let bonnie_b@ifs.org.uk know if you wish to attend.

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