Press Release

An initial reaction to the OBR’s first economic and fiscal outlook

Outlook for growth and borrowing

The OBR today revised up its forecast for economic growth in 2010 from 1.2% to 1.8%, while revising down slightly its medium term forecasts: from 2.3% to 2.1% in 2011 and from 2.8% to 2.6% in 2012. From 2012 onwards the OBR forecasts that the economy will be 0.2% larger than it forecast in June.

Despite the revisions to growth, the OBR’s forecast for borrowing in 2010–11 was essentially unchanged from its June Budget forecast – down by just £0.6 billion to £148.5 billion. This small change is due to the offsetting effects of an increase in its forecast for tax receipts (up by £2.0 billion), largely VAT, and an increase in forecast spending (up by £1.4 billion).

Over the medium term the OBR has reduced its forecasts for tax revenues, with lower forecast receipts from property transactions and the corporate sector outweighing higher forecast VAT revenues. This gloomier outlook for receipts is offset by the OBR’s assessment that expenditure will be lower over the medium term than forecast in June, largely as a result of lower debt interest costs and lower net spending on public service pensions. This leaves borrowing forecasts over the medium term largely unchanged from the June forecast – down by £2.2 billion to £18 billion in 2015–16.

The OBR revised up slightly its forecast for the cyclically-adjusted current budget (i.e. borrowing that is not explained either by investment spending or temporary weakness in the economy) in 2015–16 from 0.8% of national income to 0.9% of national income. Its central estimate is therefore that the Government will now meet its first fiscal mandate – that the cyclically adjusted current budget should at least be in balance by the end of the forecast horizon (currently 2015–16) – with a 0.1% of national income larger margin than it thought in June. The OBR has revised down slightly its forecasts for debt in every year between 2010–11 and 2015–16, and its current assessment is still that debt will be falling as a share of national income from 2014–15, a year earlier than required by the Government’s second fiscal mandate.

Revisions to previous costings

The OBR updated its assessment of the savings made from welfare cuts announced in October’s Spending Review. Overall they now estimate that the direct impact of these cuts will be to reduce government spending (and therefore household incomes) by £9.6 billion, which is nearly £1 billion less than was estimated last month. One major factor contributing to this downwards revision is that they now estimate that spending on the Employment and Support Allowance (ESA, which is aimed at those out of work due to ill health), in the absence of the Spending Review reforms, would be lower than they had previously thought. This is because the Department for Work and Pensions now expects that more current recipients will be deemed fit for work by the recently introduced Work Capability Assessment.
and therefore no longer qualify for ESA. Thus the additional reforms announced in the Spending Review, which are intended to reduce further the number eligible for ESA, are now expected to save less than originally estimated; but because this arises from a lower level of baseline spending this does not mean that social security spending is higher overall.

Risks

As the OBR highlights, there is considerable uncertainty around the outlook for the public finances. The OBR estimates that, if its forecasts are as accurate as previous Treasury forecasts, there would be a seven-in-ten chance that the Government’s first fiscal mandate will be met without subsequent policy changes. Or, looking at it the other way: there is a three-in-ten chance that further tax rises or deeper spending cuts will be needed for borrowing to fall sufficiently to meet the Government’s first fiscal mandate.

Encouragingly for the Government, the OBR forecasts that the Government’s first fiscal mandate would still be more likely to be met than missed under two less optimistic alternative scenarios for the economy.

But there are two particularly important risks to its projections.

- First, that the OBR’s central estimate might overstate the sustainable level of output in the economy and therefore the scope for above trend growth before inflationary pressure emerges. For example the OBR’s judgement assumes that the cuts announced in the Spending Review will have no impact on the sustainable level of output. These announcements included large welfare cuts (some of which is expected to boost potential output) and cuts to spending on transport (some of which might reduce potential output). If potential output in the economy were around 1½% below the OBR’s judgement, this would – according to the OBR’s illustrative estimate – eliminate the margin for error in the fiscal forecasts. Conversely, if potential output was 1½% higher than the OBR’s judgment, this would roughly double the margin with which the Government’s first fiscal mandate is expected to be met.

- Second, the OBR forecasts naturally assume that the Government implements its plans for increasing taxes, cutting welfare benefits and delivering deep cuts to spending on public services. The impact of the cuts on the quantity and quality of public services that will be provided is particularly uncertain. One risk for the public finances therefore is that the Government chooses to top up the plans for spending on public services and for this to be financed through additional borrowing rather than further cuts to welfare spending or increases in taxes.

Longer-term pressures on the public finances

The Government’s immediate focus is, no doubt, on tackling the currently high level of public sector borrowing and successfully implementing the announced tax increases and spending cuts. Implementing these plans is – on the OBR’s central forecast – consistent with returning the structural current budget to balance and having the ratio of debt to national income declining by 2015–16. However, the OBR’s report also highlighted that this stable fiscal position may be short-lived if further tax increases or spending cuts are not implemented to address the rising costs of an ageing population. The estimates used by the OBR suggest that the ageing population in the UK will increase requirements for spending on healthcare, long-term care and state pensions (with no effect on spending on public-service pensions and a small
fall in education spending). The OBR’s preferred set of assumptions suggests that spending on healthcare will rise by 2.6% of national income by the middle of this century, while spending on long-term care and state pensions could increase by 1.0% and 1.3% of national income respectively. Figure 5.6 of the OBR’s report shows that, in the absence of further tax increases or spending cuts, these increases in age-related spending would mean UK debt would not return below 50% of national income – and could be rising from the late 2020s onwards. This shows that policy makers need to focus on not only the Government’s two fiscal mandates but also the longer-term sustainability of the UK’s public finances.

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Notes to Editors:

1. This research was funded by the ESRC Centre for the Microeconomic Analysis of Public Policy at the IFS.
2. The Office for Budget Responsibility’s November 2010 Economic and Fiscal Outlook can be downloaded from http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html