08.07.15

ESSENTIAL READING

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BUDGET 2015: OVERVIEW

Key Points

- **The government remains on track to meet its fiscal rules (both the existing ones, and the proposed ones to have public debt falling each year and reach a surplus in 2019/20), but the spending profile is now smoother with smaller cuts in the next few years than pencilled in for the March Budget.** (Section A)
- **Real GDP growth is little changed and remains below that in the May Inflation Report. The OBR profile for CPI inflation remains weaker than the May Inflation Report and has been revised lower in the medium term, because of cuts to social housing rents.** (Section B)
- **The Budget contained a series of announcements on changes to taxes and spending. The key changes were an introduction of a National Living Wages, changes to taxation of buy-to-let investments, changes to taxes on banks, changes to welfare spending and proposals to boost productivity.** (Section C)
- *A full set of charts summarising and comparing the OBR and Inflation Report forecasts can be found in*

A) Fiscal forecast

1 The current version of the *Charter for Budget Responsibility* sets out three targets formally in place for this forecast:

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;

Supplementary target: *"an aim for public sector net debt as a percentage of GDP to be falling in 2016-17"*; and

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."*

2 Together with the Summer Budget, a revised draft *Charter* has also been published. It will be laid before Parliament for approval ahead of the OBR's next fiscal forecast. The changes made to the *Charter* would include:

replacing 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";

replacing 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.

Both of these targets would *"…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."*

The **welfare cap** is retained but the permitted level of spending has been changed in this Budget. The new cap is significantly lower than the old.

3 The OBR judge that the three targets set out in the current version of the *Charter*, as well as the new targets set out in the revised draft *Charter* are on course to be met.

4 **Table 1** sets out the forecast for the key fiscal aggregates. The broad picture is one of a moderation in the public services spending squeeze set out in the March Budget, made possible through cuts to welfare, net tax increases and three years of higher government borrowing. The profile for public sector net borrowing has changed since the March Budget, with the steep falls in 2016-17 and 2017-18, having been smoothed through. As a percentage of GDP, borrowing is now projected to be 0.3pp lower in 2015-16 but 0.6pp and 0.5pp higher in 2017-18 and 2018-19, respectively, when compared to the March Budget but little changed by 2019-20. The return to a budget surplus is now delayed by a year to 2019-20. The cyclically-adjusted current balance (CACB) is in surplus by 2017-18, a year ahead of the fiscal mandate. Public sector net debt is expected to have peaked as a share of GDP in 2014-15, falling in each of the following years in the forecast period, and is little changed relative to the March budget by 2018-19 despite the higher borrowing.

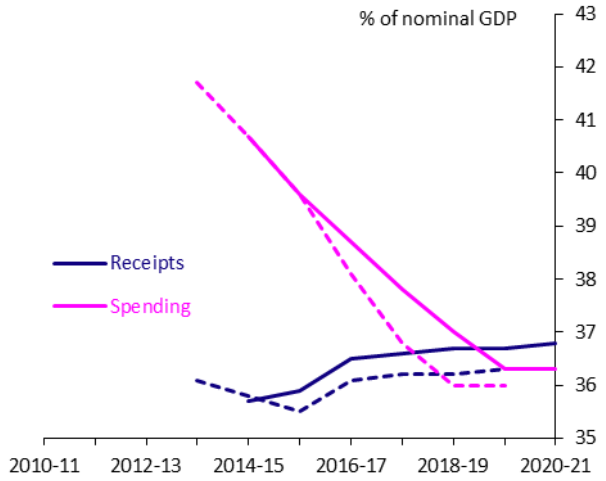
5 Significant changes in government spending and receipts are evident in **Chart 1**. Receipts are expected to be higher in every year, relative to the March forecast. The OBR have revised receipts up by £51.8bn between 2015-16 and 2019-20. The effect of decisions in this budget account for 63% of the expected increase in revenue over the forecast. Cumulative tax cuts costing £24.6bn over the current Parliament (including cuts to corporation tax, an increase in the income tax personal allowance and an extension of inheritance tax relief) are more than offset by £47.2bn worth of cumulative tax increases (from dividend taxation, insurance premium tax, vehicle excise duty, reduction in pensions tax relief, earlier corporation tax payments, and anti-avoidance and evasion measures). The remainder of the increase in receipts is due to a combination of strong outturns on

income tax and NICs at the end of 2014-15, expected higher employment growth, strong VAT outturns in 2014-15 and revisions to environmental levies.

Table 1: Key fiscal aggregates (% GDP)

	Per cent of GDP						
	Outturn	Forecast					
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Headline fiscal aggregates							
Public sector net borrowing	4.9	3.7	2.2	1.2	0.3	-0.4	-0.5
Cyclically adjusted net borrowing	4.1	3.2	2.0	1.1	0.3	-0.5	-0.5
Current budget deficit	3.2	2.2	0.8	-0.2	-1.1	-1.8	-1.9
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	80.8	80.3	79.1	77.2	74.7	71.5	68.5
	Changes since March forecast						
Headline fiscal aggregates							
Public sector net borrowing	-0.1	-0.3	0.2	0.6	0.5	-0.1	
Cyclically adjusted net borrowing	-0.1	-0.4	0.1	0.5	0.5	-0.1	
Current budget deficit	0.1	0.3	-0.2	-0.6	-0.6	0.1	
Fiscal mandate and supplementary target							
Cyclically adjusted deficit on current budget	0.1	0.4	-0.1	-0.5	-0.6	0.1	
Public sector net debt	0.4	0.0	-0.6	-0.6	-0.1	-0.1	

Chart 1: Receipts and spending[(a)]



(a) Dotted lines are March Budget

6 Total managed expenditure is higher throughout the forecast from 2016-17 onwards, largely driven by changed to increases in the Resource Departmental Expenditure limits (RDEL). Provisional spending assumptions suggest that RDEL spending, covering the day-to-day spending by central government, is likely to be £83.3bn higher over the current Parliament than expected in March. These plans suggest that the forthcoming Spending Review will be materially less challenging than it would have appeared in March, due to more of the reductions falling on the welfare budget.

B) Economy forecast

7 The OBR is now forecasting 2015 real GDP growth of 2.4%, 0.1pp lower than at the time of the March Budget. While the Q1 outturn of 0.4% GDP growth was lower than the 0.7% the OBR expected (the OBR have no equivalent back casting assumption to us), the OBR do not expect this weakness to persist and expect 0.6% growth thereafter. They then forecast 2.3% GDP growth in 2016 (unchanged from the March Budget). GDP growth thereafter is 2.4%, very slightly stronger than assumed in March. Our May IR projections remain stronger over this period (at 2.6% in 2015

and 16, and 2.5% in 2017). The OBR have not adjusted their forecast for 'instability in the euro area', but note that 'the experience of 2011 and 2012 … shows that international shocks … can damage growth prospects'.

8 The OBR output gap estimate suggests there was 0.6% slack in Q1 – 0.1pp more slack than assumed in March. This judgement is the bottom of the range of estimates from the OBR's suite of models, but the OBR place more weight on those models that point to more slack given the past weakness in wages. The OBR expect the output gap to close by 2018/19. The OBR have revised up their estimate of trend average hours so that actual hours are now in line with their sustainable level. The OBR made two offsetting changes to their estimate of the long-term equilibrium unemployment rate. The OBR first revised it down from 5.35% to 5.2% because of an ageing population, greater flexibility in the labour market from self-employment and past welfare reforms, and the limited growth in wages despite the rapid fall in unemployment. But they expect the natural rate to rise to 5.4% over the next five years because of the introduction of the National Living Wage (see section C). Potential output growth is assumed to pick up from 2.1% in 2015 to 2½% by 2020, driven by a pickup in productivity growth as a normalisation in the financial sector aids the reallocation of resources to more productive uses.

Chart 2: Real GDP

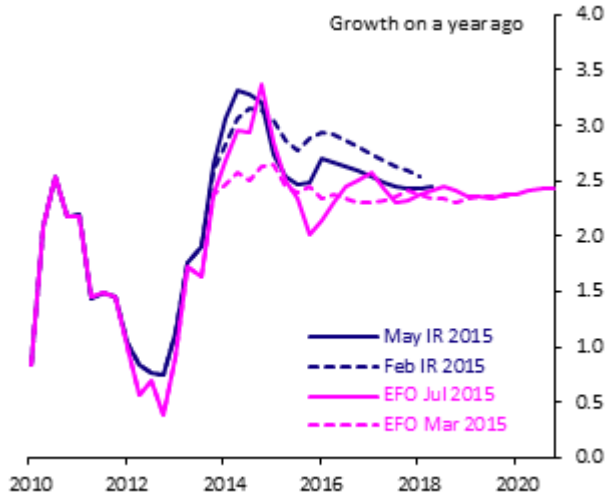
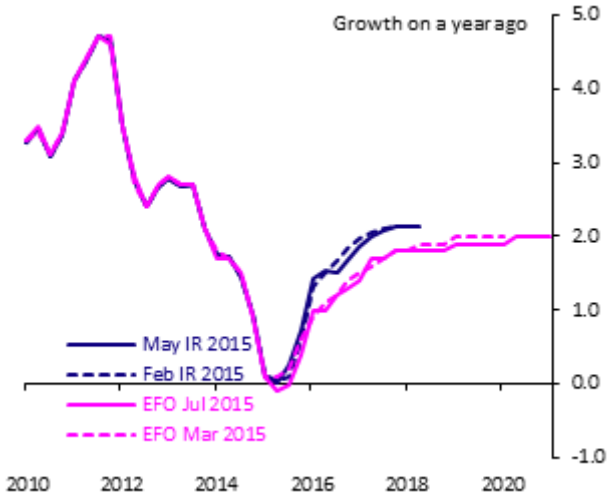


Chart 2: CPI



9 Three announcements will have an impact on CPI inflation. First, from November 2015 insurance premium tax is to rise by 3.5pp to 9.5%: we estimate the CPI impact of that to be small, at 0.03pp. Second, the government will oblige local authorities and housing associations to cut rents by 1% a year for four years, beginning April 2016: we estimate that to reduce CPI inflation by 0.1pp a year over that period. Third, Vehicle Excise Duty (VED) is to be restructured for cars purchased from 2017: the OBR expect this to increase CPI inflation by approximately 0.1pp. Over time that effect will wane as the stock of cars slowly rolls over onto the new standard rate system. Over our forecast

horizon, the net effect of these announcements is therefore likely to be a small drag over the 2016/17 financial year but otherwise neutral over the next three years.

10 The OBR have revised down its CPI forecast slightly relative to March. Late changes to the proposal for VED after the OBR completed their forecast mean that the boost to inflation in the OBR forecast is less persistent than the likely effects of the actual policy: this means the OBR forecast slightly overstates the net drag on inflation from the changes announced in the Budget. Inflation in Q4 2015 is forecast to be 0.4%, rising to 1% in 2016Q1. Inflation is forecast to reach 1.7% by mid-2017, but does not reach 2% until 2020. The OBR partially attribute the slow return to target to the lagged effects of import price weakness following sterling's recent appreciation and falls in global commodity prices and changes in housing rents. The OBR notes that they have assumed that the MPC will look through the effects of changes in social housing rents when setting monetary policy.

11 The Chancellor announced that public sector pay awards would be limited to 1% over the next four years. The OBR has reduced its projection for public pay growth by just under 1% per year over the next three years before returning to the March forecast for 2018-19. Public sector employment however will not fall as fast as was assumed in March (with public sector employment 10% higher in 2017-18 than previously forecast); with private sector employment conversely increasing at a slower rate. Total employment has been revised up marginally.

12 Elsewhere in the OBR's economic projections, their forecast for the household saving ratio was revised down by almost 1pp in 2015 to 6½% (partly reflecting revisions to data in 2014). Upward revisions to the forecast from 2017, mean the savings rate is assumed to rise to 7½% by 2019 (about 2pp higher than the May *Inflation Report*). The OBR expect household consumption to slightly outstrip the growth of household disposable income over the forecast period (placing downward pressure on the household saving ratio), but this is offset by an increase in pension saving because of auto enrolment and rising gilt yields (which are used by the ONS in the calculation of imputed pension saving). The current account deficit is assumed to fall from 5.9% in 2014 to a little under 3% in 2020, mainly reflecting an improvement in net investment income. Big picture though, the OBR's forecasts for the sectoral balances continues to imply that the main counterpart to the ongoing fiscal consolidation is an improvement in the UK's external position. That stands in contrast with the narrative in the May IR that also relies on some shift to domestic private sector dissaving (mainly by households).

13 The OBR have made relatively small adjustments to their residential property forecasts. The forecast for property transactions is a little stronger this year than forecast in March, in part reflecting the pick-up in mortgage approvals in recent months. The OBR have revised down the forecast for house price growth, having taken the view that the 'rationing effects of the regulatory and banking environment are likely to persist for longer than we assumed in March'. Their forecast

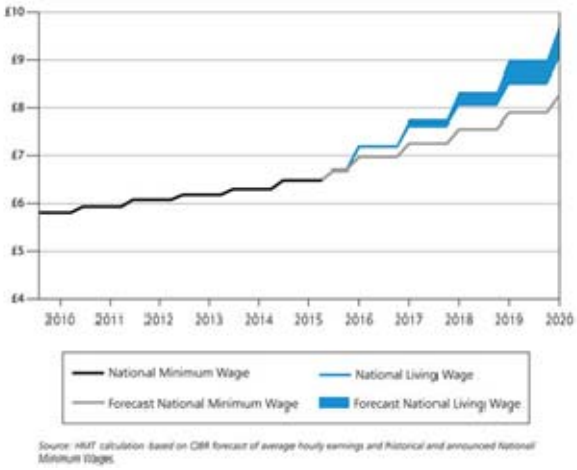
for annual house price inflation is now slightly weaker than the May IR forecast – remaining below 6% for the rest of the decade. The OBR residential investment forecast is now stronger in the near term than in March (partly reflecting revisions to ONS data) and growth is faster than the May IR dwellings forecast throughout the forecast.

C) Key policy announcements

14 In the budget, the Government announced the introduction of a **National Living Wage (NLW)** for employees aged 25 and over starting from April 2016. This will be achieved through the introduction of a Living Wage Premium which will apply on top of the National Minimum Wage (NMW), which will continue to be set for all employees aged 21 and over.

15 The April NLW rate will be set at £7.20 an hour, 50p higher than the NMW rate of £6.70 that will apply from October 2015. From April 2017 the Low Pay Commission will have responsibility for recommending a Living Wage Premium yearly profile that takes the NLW to over 60% of median hourly earnings of those aged 25 and over by 2020. This will take the NLW to around £9.35 in April 2020 (Chart 4).

Chart 4: National Minimum Wage and National living wage, historical and forecast



16 The OBR has estimated that this policy will increase the level of compensation by 0.3% by 2020. The OBR assume a labour elasticity of -0.4 (acquired from the literature) and that labour demand reductions fall evenly across both hours and employment; resulting in an increase of structural unemployment by 0.2pp and reduction in trend average hours of around 0.2%. It is assumed this increase in unemployment will come from lower productivity workers, so hourly productivity increases by 0.3%. The OBR estimates of the effects on GDP, prices and earnings are summarised in table 2 below.

Table 2: 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				

17 The most relevant housing measure included in the Budget is the **restriction of the mortgage interest relief for buy-to-let investors** to the basic income tax rate (20%). At the moment, landlords

in the highest income bracket enjoy a tax relief of up to 45%. This change will phase in gradually, over a four year period, starting April 2017. Moreover, starting from April 2016, landlords will no longer be able to claim 10% of their rent as `wear and tear allowance', but will only deduct actual costs incurred. These measures will reduce the expected returns from buy-to-let investments, unless landlords will be able to pass on some of the costs in the form of higher rents. In his speech, the Chancellor explicitly mentioned that the Bank of England has warned about the risk of rapid buy-to-let growth for financial stability. According to the OBR, the effect of these changes on house prices will be negative, but small and offset by the positive effect of the change in inheritance tax (see below) – therefore the OBR has not adjusted its house price forecast. The Budget document predicts £665m in additional tax revenues by 2020/2021 as consequence of the reform.

18 Other housing-related measures in the Budget include a **change in inheritance taxes**: from 2017, a new £175,000 allowance for homes will be phased in, on top of the existing £325,000 inheritance tax threshold (which will be fixed until the end of fiscal year 2020-2021). These allowances are transferrable to a spouse/partner, meaning that up to £1,000,000 in wealth can now be passed on without being taxed. Homeowners who downsize will not lose these allowances. According to the OBR, these changes will potentially put upward pressure on house prices but, as mentioned above, this pressure will be offset by the new buy-to-let tax rules. Another tax measure relates to the relief for those who rent out a room in their home, which will be lifted from £4,250 to £7,500. Moving on to the social housing sector, the Chancellor said that subsidies for social housing will be phased out for local authority and housing association tenants in England who earn more than £30,000, or £40,000 in London. Moreover, rents paid in the social housing sector will be reduced by 1% a year for the next four years – which will pull down on CPI inflation by around 0.1pp (see section B). Since this is likely to reduce the incentives to invest in housing, the OBR have reduced their forecast of housing investment by 0.7 percent by the end of the forecast period, consistent with 4,000 fewer houses built in 2020/21. (In total, 14,000 fewer affordable homes will be built over the forecast period).

19 The Chancellor announced reductions to the rate and scope of the **Bank Levy and a new supplementary 8% rate of Corporation Tax applying to banks and building societies**. The different measures will be phased in at different rates with the Bank Levy being phased lower while the additional tax rate applies in full from the start of 2016. The Bank Levy will be gradually decreased from 0.21% to 0.1% (still twice the initial 2011 rate) between 2016 and 2021. From 2021, the scope of the levy will also be reduced for UK banks, from covering total global liabilities (minus certain deductions) to UK liabilities only. The OBR projects that lenders will pay an additional £1.6 billion in tax over the next five years due to these measures with the majority of the additional contribution coming in the next two years. It gives this projection a 'very high' uncertainty rating however since it depends critically on assumptions around the profitability of banks over the forecast period. With

the tax take shifting from the Bank Levy – a balance sheet metric – to a tax on profits there will be a differentiated impact across the industry with poorly performing banks potentially paying less tax in total under the new arrangements.

20 The Chancellor announced a series of initiatives to boost productivity (a **productivity plan** will be published on Friday). The most important changes are legislation requiring major UK banks to share SME credit information, an aspiration for 3 million new apprenticeship starts in England during this Parliament, and the removal of the cap on university student numbers (funded by the end of maintenance grants). The first is closely related to Bank (FSSR) work to improve lenders' access to SME credit data to support diverse sources of finance. Apart from the effects of the National Living Wage, the OBR have not factored in any adjustments to their productivity forecast for initiatives announced in the Budget.

21 The Budget included cumulative **cuts to welfare spending** of £34.9 billion over this parliament. This includes cuts to working family tax credits, a reduction of the benefit cap to £20k (£23k in London) and the end of an automatic entitlement to out-of-work benefits for those aged 18-21. The OBR have not made adjustments to labour supply because of the changes in welfare announced in this Budget.

22 Alongside the Budget, the Government announced a **review into pension tax relief**, and what regime would provide the best incentives for individuals to save more for retirement.[1] One option is to retain the current regime, where tax is levied on pension income in retirement rather than on contributions, subject to lifetime allowances. An alternative regime set out in the *Green Paper* is a system where tax is levied on income prior to contributions, with no tax liability thereafter on pension saving.

23 There are three main issues motivating the review, which the Green Paper a move to the alternative regime could effectively address. First, the current pension regime is expensive – around £44 billion in forgone tax per year according to government estimates. Second, there are concerns the current regime doesn't incentivise sufficient pension saving, because pension fund management is opaque. Third, there are some concerns that pension investment funds have higher costs, and are less innovative, than investment fund available to ISA customers: if pension saving is more like an ISA, that could reduce the costs associated with retirement saving.

[1] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/442159/Strengthening_the_incentive_to_save_consultation__print_.pdf.