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Budget 2016: Background briefing

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Summary

The briefing sets out the background to the 2016 Budget which will take place on Wednesday 16 March 2016. The Office for Budget Responsibility (OBR) will publish revised forecasts for the economy and public finances on the same day.

Economic situation

Economic growth slowed in 2015 but remained solid at 2.2%, underpinned by strong increases in consumer spending. Inflation has hovered around 0% for most of the past year providing a boost to households' spending power. Given the weak inflation rate, the Bank of England has kept its key interest rate at the historically low level of 0.5%, with most economists expecting them to leave it unchanged in 2016.

GDP growth in 2016 is forecast to be just above 2%, with consumer spending once again providing the impetus. Over the medium term, growth in the 2-2.5% range is forecast. Potential risks could come from the EU referendum in June, weaker-than-anticipated productivity growth, a recurrence of international financial market turbulence and fears over the global economy, particularly in emerging markets.

The number of people in employment rose in 2015, with the proportion of 16-64 year olds in work (74.1%) at its highest level since records began in 1971. Average earnings growth accelerated in the first half of 2015 to near 3%, but slowed towards the end of the year back down to 2%.

Public finances

The budget deficit – the difference between what the Government spends and receives in revenues – is forecast to be £74 billion in 2015/16, this is equivalent to 3.9% of GDP. The Government plans to eliminate the deficit by 2019/20 and the Office for Budget Responsibility's (OBR's) November 2015 forecast suggests it is on course to do so.

At over 80% of GDP, Public Sector Net Debt – broadly speaking the stock of borrowing arising from past deficits – remains high by recent standards. The OBR forecast that the debt to GDP ratio will fall in 2015/16 and continue to do so over the following five years.

During 2015/16 the Government sold a historically high level of assets. In November 2015 the OBR said that these asset sales will "make the difference between debt rising and falling as a share of GDP in 2015/16".

Business rates review

The Government has committed to publishing a review of the administration of the business rates system in England alongside the 2016 Budget. There are few indications of the likely conclusions of the review, but media commentary suggests that no major changes are anticipated.

Pensions tax relief

The Government had been expected to respond in Budget 2016 to its consultation on pensions tax relief. However, over the weekend of 5-6 March, it was reported that no major changes to tax relief on contributions would be announced in this Budget.

Other information

The Library has published a Budget edition of economic indicators.

The Office for National Statistics will publish labour market statistics on the day of the Budget. The Library's Unemployment by Constituency briefing will be published by 2pm on the same day.

1. Economic situation

Summary

Economic growth slowed in 2015 but remained solid at 2.2%, underpinned by strong increases in consumer spending. Households saw their spending power rise due to the combination of improved pay growth (though still below pre-recession growth rates) and very low inflation hovering at around 0% for most of the year. Given the weak inflation rate, the Bank of England has kept its key interest rate at the historically low level of 0.5%, with most economists expecting them to leave it unchanged in 2016.

GDP growth in 2016 is forecast to be just above 2%, with consumer spending once again providing the impetus. Over the medium term growth in the 2-2.5% range is forecast. Potential risks could come from the EU referendum in June, weaker-than-anticipated productivity growth, a recurrence of international financial market turbulence and fears over the global economy, particularly in emerging markets.

The number of people in employment continued to rise in 2015, with the proportion of 16-64 year olds in work (74.1%) at its highest level since records began in 1971. The unemployment rate, currently 5.1%, has fallen back to its pre-recession level. Average earnings growth accelerated in the first half of 2015 to near 3%, but slowed towards the end of the year back down to 2%.

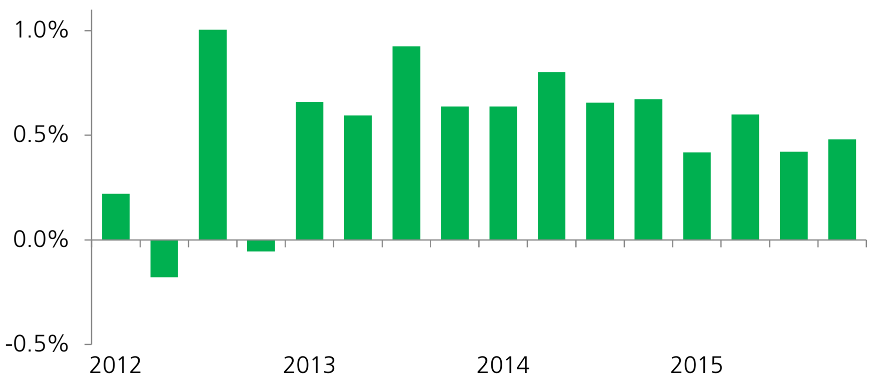
1.1 Growth and economic conditions

GDP growth was 2.2% in 2015, down from 2.9% in 2014

Annual economic growth slowed from 2.9% in 2014 to 2.2% in 2015. While growth can be described as solid, latest figures show annual growth in Q4 2015 easing to 1.9% (compared with the same quarter a year before) – the slowest rate of expansion since the beginning of 2013.

Real GDP growth has been steady in recent years but eased in 2015

% change in real GDP on previous quarter



Source: ONS, series ABMI

Services sector driving economic growth

Growth remained unbalanced in 2015, with the services sector – which makes up nearly four-fifths of the economy – continuing to grow healthily (up by 2.5% in 2015), while manufacturing output fell slightly by 0.2%. Output in the construction sector rose by 3.4%, although output fell in the second half of 2015 after a strong first half.

Box 1.1: Regional economic growth over the recovery

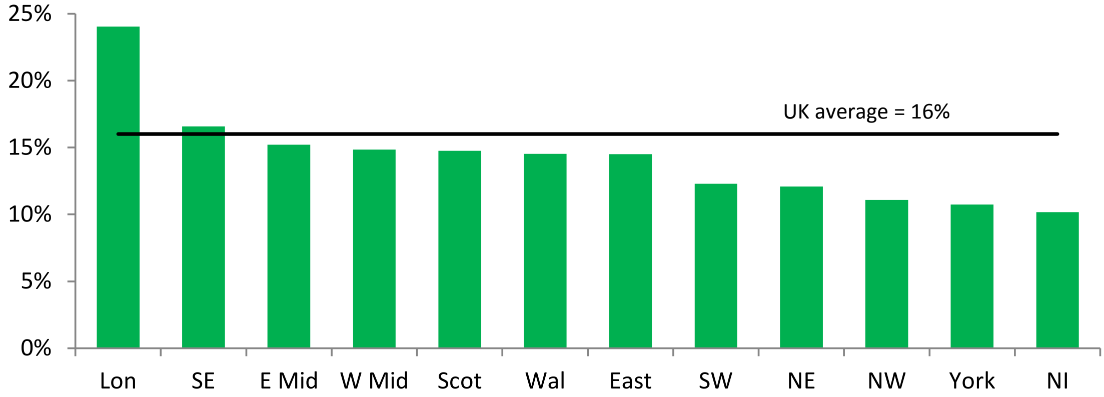
Growth in economic output over the recovery from the 2008/2009 recession has been uneven over the regions and countries of the UK, with London experiencing faster growth than the rest of the country.

Regional/country economic growth figures are available up to 2014 and are not adjusted for inflation, unlike the growth figures we usually use for the UK.

From 2010 to 2014, London saw the fastest growth at 24.0% over this whole period, followed by the South East at 16.6%. Slowest growth was in Northern Ireland (10.2%) and Yorkshire & the Humber (10.7%). The UK average was 16.0%. The chart below shows figures for all regions/countries.

Total GVA growth by UK region/country (workplace based), 2010-2014

Not adjusted for inflation

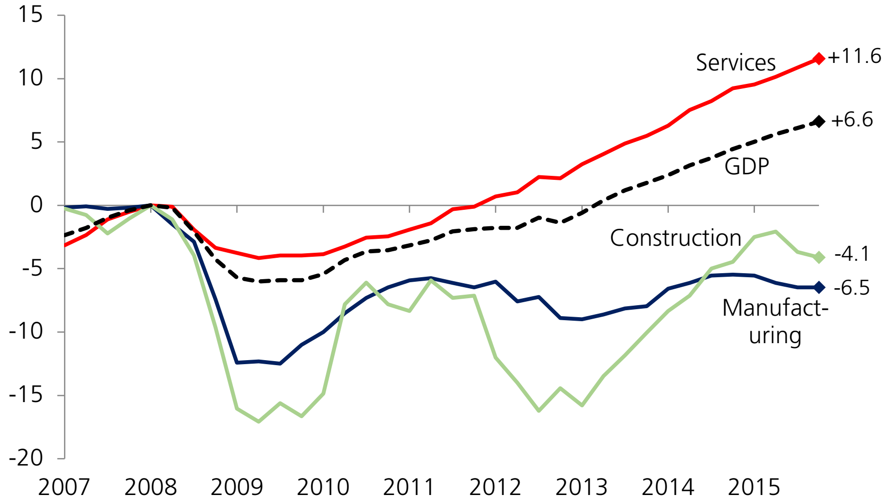


Regional/country figures are slightly different to those we normally use for the UK as a whole, measuring Gross Value Added (GVA) instead of GDP, although they are similar. GVA is GDP excluding taxes and subsidies on production (so GVA does not include VAT, for example). Further information and statistics can be found in the Library Briefing Paper *Regional and local economic growth statistics*.[1]

The chart below shows how the services sector has been the key engine of growth in the economy during the recovery from the 2008/2009 recession. Output in services is now 11.6% above its pre-recession peak level of early 2008. Meanwhile, output in construction is 4.1% below its pre-recession level and in manufacturing it is 6.5% lower.

Services sector driving GDP growth

% change in sector's output compared with pre-recession peak output in Q1 2008



[1] Regional and local economic growth statistics, Commons Library Briefing Paper SN5795, 6 January 2016

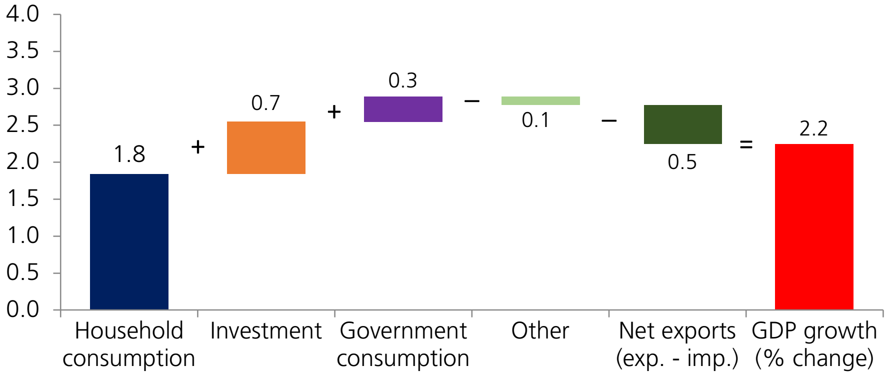
Consumer spending providing impetus to growth…

Looking at expenditure in the economy, GDP growth in 2015 was driven by consumer spending and to a lesser extent investment (see chart below). The domestic economy continues to be the driver of growth, with net exports – the difference between UK exports and imports to the UK – subtracting from growth for the fourth successive year.

Consumer spending provided the main contribution to GDP growth in 2015

Household spending contributed most to GDP growth in 2015

%-point contribution to annual GDP growth in 2015

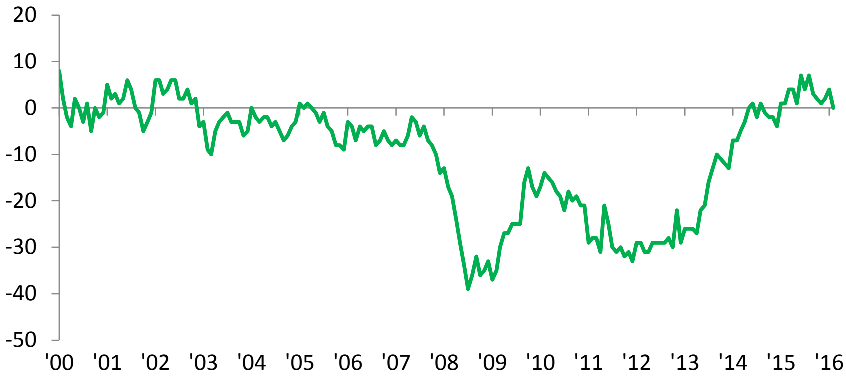


Source: Library calculations based on data in ONS, UK Second Estimate of GDP Q4 2015

Consumer spending was up by 3.0% in 2015 underpinned by strong gains in real disposable income, as pay growth picked up and inflation fell (averaging 0.0% in 2015). Further support was provided by strong employment growth and falling unemployment. In addition, consumer confidence remains relatively high.

Consumer confidence remains high

% balance expecting improvement/deterioration



Source: GfK for European Commission, Consumer Confidence

The outlook for consumer spending may not be quite as favourable this year as it was in 2015. Inflation is expected to rise from its current very low level (see section 1.3 below for more), although this depends a lot on the future path of world energy prices. In addition, recent data on pay growth has been somewhat disappointing. Despite this, most forecasters are expecting earnings growth to accelerate in 2016.

Real household income underpinned by very low inflation

Further support for households includes the expectation that interest rates are not expected to rise from their historic low levels any time soon, and changes to income tax thresholds coming into force from April 2016 – which will raise the tax-free personal allowance and the higher-rate threshold – will also boost incomes. Oxford Economics, a consultancy, estimates that these two tax measures will boost household incomes by £2.9 billion per year.[2] A 50p per hour increase in the minimum wage for over 25s coming into force in April 2016, called the National Living Wage, may also provide a boost to household incomes (see section 1.4 below for more on the National Living Wage).

…with investment also contributing to growth…

Total investment increased by 4.2% in 2015

Total investment grew at a faster rate than overall economic growth in 2015, increasing by 4.2%. Business investment rose by 4.7%. There are a number of supportive factors for investment in 2016. The European Commission, in its latest forecast, cites low borrowing costs, rising profits and strong demand as reasons for healthy growth in capital spending.[3]

There are some risks to this relatively positive outlook for investment. The introduction of the National Living Wage will lead to higher costs for some businesses, as may the introduction in April 2017 of an Apprenticeship Levy, possibly reducing the amount of money available for investment.[4] The EU referendum on 23 June may cause some uncertainty for businesses, potentially delaying or reducing investment (see section 1.2 below for more on the EU referendum).

External factors, such as the economic slowdown in emerging economies, worries over growth in advanced economies and instability in global financial markets, may also lead to companies being more cautious in their investment plans.

…but net exports are not supporting growth

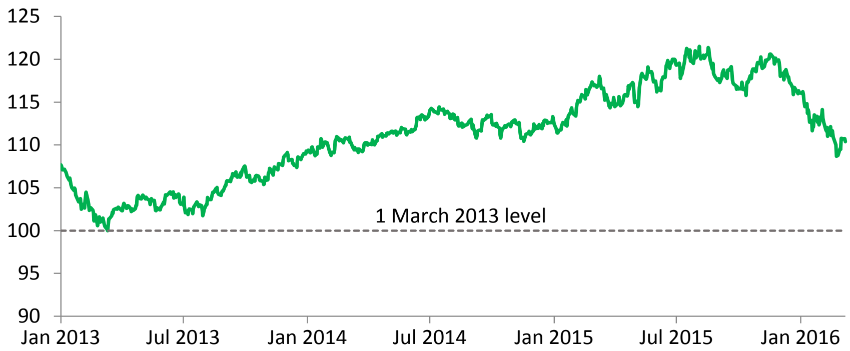
Net trade subtracted from GDP growth for the fourth consecutive year in 2015

The volume of imports to the UK grew at a faster rate than exports from the UK, subtracting from GDP growth in 2015. It's easy to overlook, however, that exports increased by a healthy 5.0% in volume terms, the most since 2011. It was the strength of demand for imports, which rose by 6.2%, that led to net exports detracting from growth.[5]

A weaker pound, which has fallen by 8% against the UK's main trading partners since mid-November, may help provide a boost to exports in forthcoming months. This follows a 20% rise in sterling from March 2013 to July 2015.

[2] Oxford Economics, "The UK economic outlook", as presented in the IFS *Green Budget 2016*, February 2016, p25
[3] European Commission, "Winter 2016 Economic Forecast – UK", February 2016
[4] Further information about the Apprenticeship Levy can be found in the Library Briefing Paper Apprenticeships policy.
[5] These figures ignore the change in the prices of exports and imports, i.e. they show volumes. In value terms, which include price changes, exports and imports fell slightly in 2015 (source: ONS national accounts, tables C1 and C2).

The pound has fallen in recent months but is still up since early 2013
Index (1 Mar 2013 = 100) of sterling versus main trading partners [latest data for 8 Mar]



Source: Bank of England, Effective exchange rate index, daily average, series XUDLBK67

1.2 Forecasts and risks to outlook

Most forecasters expect UK GDP growth to remain steady in 2016 and over the medium term. There are risks to the outlook, both from domestic sources and from abroad.

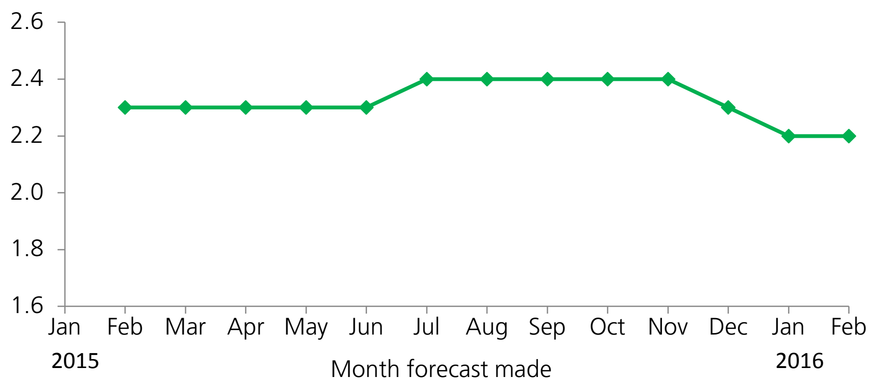
Growth of just over 2% expected in 2016…

Forecasts for GDP growth in 2016 have eased slightly over the last few months due to weakness in some economic indicators, as well as increased risks of a more marked slowdown in global growth and turbulence in international financial markets at the beginning of 2016.

The latest consensus of independent economists surveyed by HM Treasury is for growth of 2.2% in 2016.[6] This is similar to latest forecasts from the OECD (2.1%), European Commission (2.1%) and Bank of England (2.2%).[7]

GDP growth of just above 2% forecast for 2016

2016 GDP growth forecasts have fallen slightly in recent months
GDP growth (%), consensus forecast for 2016 GDP growth



Source: HM Treasury survey of independent forecasts

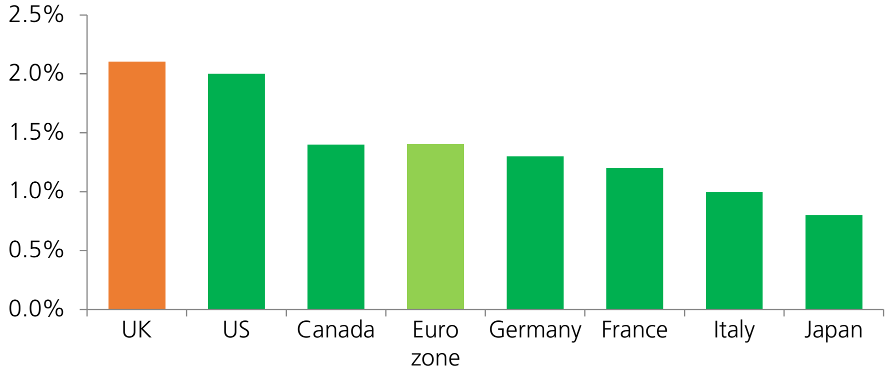
6 HM Treasury, Forecasts for the UK economy: a comparison of independent forecasts, February 2016

7 OECD, Interim economic outlook, 18 February 2016; European Commission, "Winter 2016 Economic Forecast – UK", February 2016; Bank of England, Inflation Report: February 2016

Latest OECD forecasts point to the UK having the highest growth rate of the G7 advanced economies in 2016 at 2.1%.[8] This is only just ahead of the US at 2.0%, with the Eurozone forecast to grow by 1.4%.[9]

UK forecast to have highest growth rate (just) in G7 in 2016

OECD GDP growth forecast from February 2016

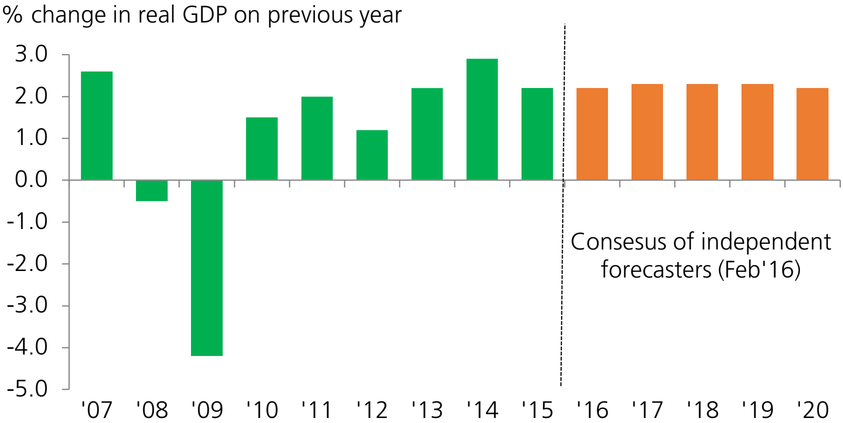


Source: OECD, Interim Economic Outlook, Feb '16

Beyond 2016, most forecasters expect similar growth rates in the UK of between 2-2.5%. These forecasts are usually based on the expectation that productivity growth will recover and produced on the basis of 'current policies' which means an implicit assumption that the UK remains a member of the EU.

GDP growth forecast

% change in real GDP on previous year



Source: ONS, series IHYQ; HM Treasury, Comparison of independent forecasts Feb '16

…but there are risks to the outlook from domestic sources…

Productivity – as measured by economic output per hour worked – grew at its historical average rate of around 2% per year in the decade prior to the 2008/2009 recession. During the recession productivity fell sharply but then failed to pick up lost ground during the recovery. The level of labour productivity in Q4 2015 was roughly the same as it was over seven years earlier in Q2 2008 (its pre-recession peak level).

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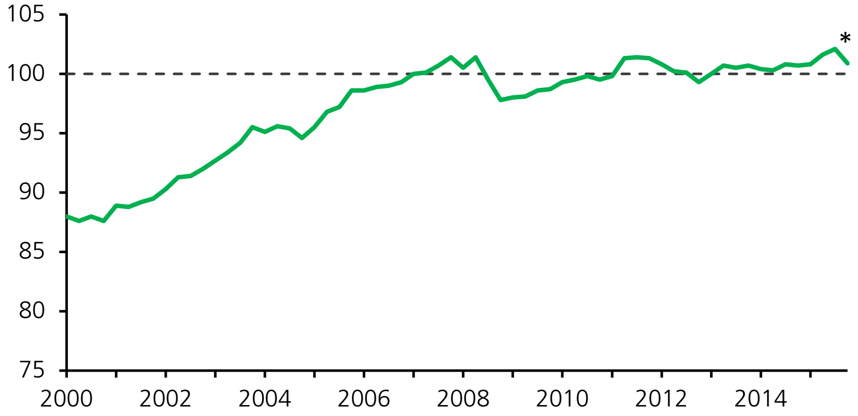
8 In 2015, the UK had the second highest growth rate in the G7 behind the US. Latest GDP growth data for G7 available from this [OECDstat custom table]

9 OECD, [Interim economic outlook], 18 February 2016

Productivity (GDP per hour) has stagnated since 2007

Index where Q1 2007 level = 100 (quarterly data)



* Q4 2015 figure is based on 'flash' preliminary estimate of GDP per hour

An acceleration in annual productivity growth to 1.3% in Q2 and Q3 2015 promptly reversed itself in Q4 2015, with only a 0.2% annual gain recorded.[10] As most UK growth forecasts for the next few years assume that productivity growth will recover to between 1.5-2.0%, an important risk to these forecasts is if productivity continues to underperform. The IMF, in its latest assessment of the UK economy, stated that there could be big implications in such a scenario:

The prospect of continued stagnation in productivity is a key risk to the outlook

> …the degree to which [productivity growth] will recover over the medium term remains highly uncertain. If productivity growth is lower than expected, this would have large adverse implications for medium-term output and incomes.[11]

…including, some believe, from the EU referendum…

A number of economists argue that a vote for the UK to leave the EU in the 23 June referendum could result in increased uncertainty and therefore weaker growth in the short-term.[12] In evidence to the Treasury Committee, Mark Carney, the Governor of the Bank of England, described such a scenario following a 'leave' vote:

> There could be lower levels of activity because of the degree of uncertainty that could affect investment and household spending. That is a reasonable expectation during a period of uncertainty.[13]

Many advocating a 'leave' vote argue that even if there is some short-term disruption to economic activity – and some dispute that this would be the case – there would be larger long-term economic benefits of Brexit, because the UK would be able to negotiate more trade deals with other countries and could implement more business-friendly regulations.[14] Those in favour of the UK remaining in the EU counter that Brexit could lead to higher barriers to trade with the EU (the UK's

10 This is a provisional estimate for Q4 2015.
11 IMF, Article IV consultation for the United Kingdom, February 2016, p8
12 See for example, "Fitch: Brexit Would Drive Short-Term Disruption, Long-Term Risks", Fitch ratings agency via Reuters, 22 February 2016; "Brexit may mean long-term gain – but plenty of short-term pain", Guardian, 24 February 2016
13 Treasury Committee, The economic and financial costs and benefits of UK membership of the EU, 8 March 2016, HC 499, Q1044
14 For example see Gerard Lyons, "The EU is like the Titanic, and we need to jump off before it sinks", Telegraph, 25 February 2016

largest trading partner) and that uncertainty over future trade deals with the EU and other countries would damage UK growth prospects.[15]

Assessing the impact of leaving the EU is difficult without knowing what the UK's post-Brexit relationship with the EU and other countries would look like. Further detailed analysis on the possible economic impact of leaving the EU can be found in the Library Briefing Paper *EU referendum: impact of an EU exit in key UK policy areas*.

The Library has created a dedicated web page collating our briefings on the EU referendum debate.

…and also from the global economy

Weaker growth in some emerging economies – with deep recessions in Russia and Brazil alongside a slowdown in China – has raised fears over global growth prospects. In addition, concerns over advanced economies have come to the fore in early 2016, with some major central banks including the European Central Bank and Bank of Japan implementing additional policies to try to generate inflation and support growth in their economies. Meanwhile, in contrast, the US Federal Reserve in December 2015 raised interest rates for the first time since the global financial crisis on the back of a stronger economy.

The combination of these factors caused turbulence in financial markets at the beginning of 2016, with borrowing costs rising, stock markets falling and money flowing out of emerging markets to traditional safe haven markets. In recent weeks, financial markets have stabilised, but the potential of a further episode of turmoil is still present.[16] The risk to the UK economy from such a scenario would come mostly from the financial sector and its exposure to emerging economies such as China, as well as from a decline in business and consumer confidence.

1.3 Inflation and monetary policy

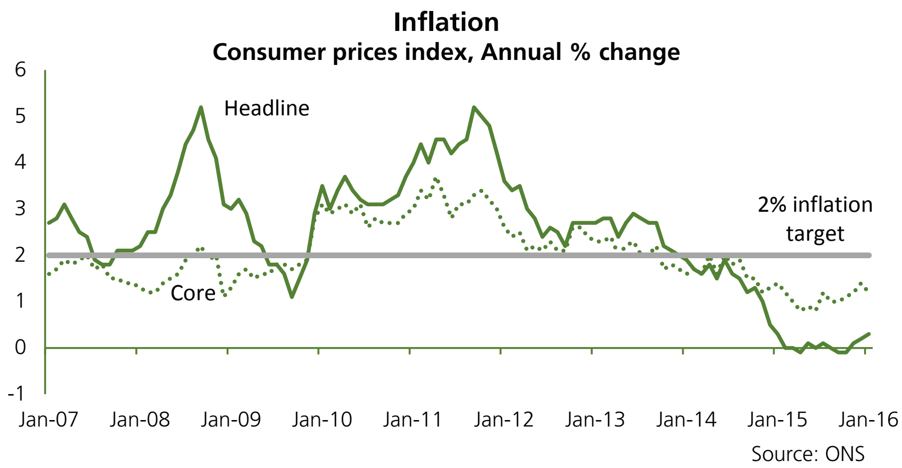
Inflation was close to zero for most of 2015…

Headline inflation is currently very low. Inflation was close to zero for most of 2015 and in some months was slightly negative. As measured by the Consumer prices index (CPI), inflation was 0.3% in January. The current level of inflation is lower than in recent years. Inflation averaged 2.6% in 2013 and 1.5% in 2014. The Bank of England's February 2016 Inflation Report said that while CPI inflation had started to increase, it was still close to zero, mainly as a result of falls in the price of energy, food and other imported goods.[17] Core inflation, which excludes energy, food, alcohol and tobacco, was 1.2% in January. It has fluctuated between 0.8% and 1.4% over the last year.

The UK is not alone in experiencing very low inflation, or deflation, at the moment. The latest figures show the Eurozone back in deflation: inflation is provisionally estimated as -0.2% in February, down from

15 For example, "The real danger of Brexit", The Economist [Leader], 27 February 2016
16 For more on the early 2016 turbulence see Bank for International Settlements Quarterly Review, "Uneasy calm gives way to turbulence", 6 March 2016
17 Bank of England, Inflation Report, February 2016, p32

+0.3% in January. Inflation in the US was 0.3% in the year to December.



…and is forecast to rise to around 1% by the end of 2016

Inflation is forecast to remain low for the rest of this year. Independent forecasters expect inflation to be 1.1% in Q4 2016 and 2.0% in Q4 2017.[18] In November, the OBR forecast that inflation would rise to 1.0% in 2016, 1.8% in 2017 and eventually reach the 2% inflation target in 2019. The OBR's forecast is affected by a number of factors. Upward pressure on inflation is expected to come from increases in wages and the fact that recent falls in petrol prices are likely to drop out of the calculation of inflation.[19]

Interest rates remain at the historically low level of 0.5%, with most expecting no change in 2016

The Bank of England's Monetary Policy Committee (MPC) has kept the base rate at the historically low level of 0.5% since March 2009. While the headline rate of inflation is currently very low, this is in part due to temporary factors. The MPC tends to place relatively little weight on these focusing more on the underlying drivers of inflation. At its meeting in February, the MPC voted unanimously in favour of maintaining interest rates at 0.5%. Only one member, Ian McCafferty, has voted for an increase in interest rates in recent months. Following publication of the Bank's February Inflation Report, many commentators now expect no change in interest rates until for at least another year.[20]

1.4 Labour Market

Over the last four years, the employment rate in the UK has been rising, it is now at its highest level in at least 45 years at 74.1%. Unemployment is not at its record low, but at 5.1% it is back at pre-recession levels. Average earnings growth accelerated in the first half of 2015, although growth slowed in the latter part of year.[21]

18 HM Treasury, Forecasts for the UK economy: a comparison of independent forecasts, February 2016
19 Office for Budget Responsibility, Economic and Fiscal Outlook, November 2015, para 3.51-3.52
20 "UK interest rate rise kicked into the long grass", *Financial Times*, 4 February 2016
21 Labour market data are taken from ONS, Labour market statistics, February 2016

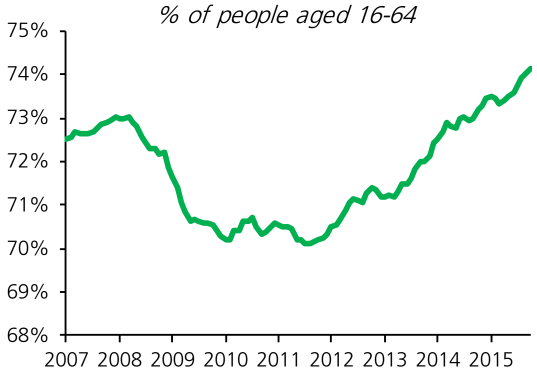
Employment and unemployment

UK employment increased by 521,000 in the year to October-December 2015, to 31.42 million. The number of people working full-time rose by 387,000 while part-time employment increased by 134,000.

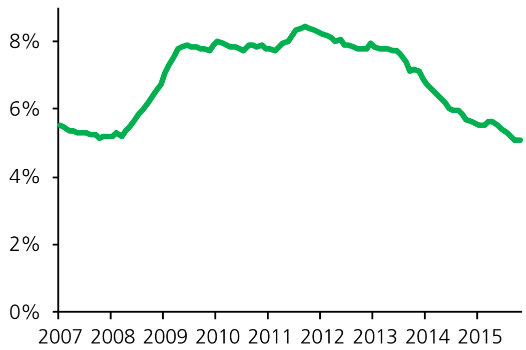
The employment rate – the proportion of people aged 16-64 in work – was 74.1% in October-December 2015. This is the highest rate of employment since comparable records began in 1971. Some of the increase in the headline employment rate for people aged 16-64 can be attributed to the rising State Pension Age (SPA).

Employment rate, 2007-2015

% of people aged 16-64



Unemployment rate, 2007-2015



As employment has increased, unemployment has fallen back to its pre-recession levels. In October-December 2015:

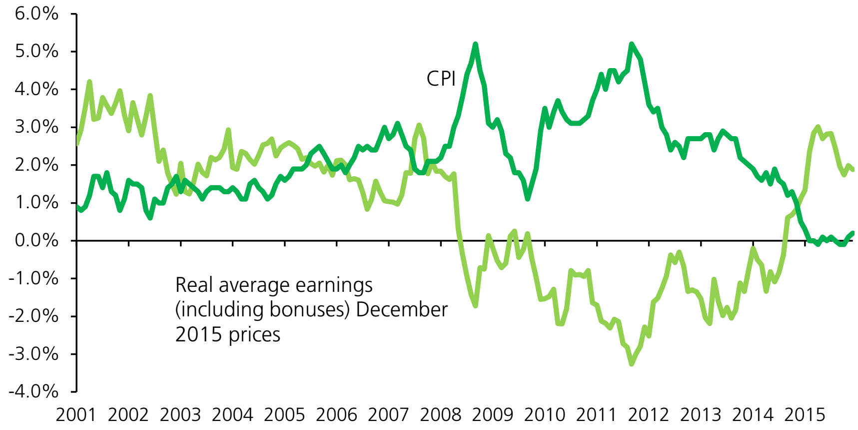
- 1.69 million people were unemployed, down 172,000 on the previous year
- the unemployment rate was 5.1%, its lowest level since the start of 2006
- there were 622,000 unemployed 16-24 year olds, 118,000 fewer than the previous year
- the youth unemployment rate was 13.6%, the lowest rate since the end of 2005

Earnings

In nominal terms, average weekly pay increased by 1.9% including bonuses and by 2.0% excluding bonuses in the year to October-December 2015.

In the private sector, regular pay excluding bonuses was up 2.2% on the previous year, compared to a rise of 1.4% in the public sector.

Inflation and earnings
% change on previous year



In the middle of 2014, earnings began growing for the first time since the start of the recession. Partly as a consequence of low inflation, real-terms earnings have increased by around 2% in 2015.[22]

Pay growth is yet to return to pre-recession levels, when average pay grew by around 3% in real terms between 2005 and 2007.

The weakness in pay growth is at odds with the improvement in the general labour market. The Bank of England have suggested that one of the reasons for this may be slower growth in productivity. This coupled with changes in the composition of the workforce, where jobs in lower pay sectors are forming a larger than usual share of net employment growth, will have slowed wage growth.[23]

Box 1.2: The National Living Wage

At the July 2015 Budget, the Chancellor announced the introduction of a new higher minimum wage of £7.20 for people aged 25 and over, called the National Living Wage (NLW). The NLW will come into force on 1 April 2016.

The Government has set a target that the NLW will reach 60% of median hourly earnings (£9.30 based on current hourly earnings) for this age group by 2020. The Low Pay Commission (LPC) – the independent body which advises the Government about the minimum wage – has been asked to set out how this may be achieved.

The OBR has estimated that the NLW will result in higher hourly earnings to 6 million employees in 2020. The Resolution Foundation has suggested that more female employees will benefit than male employees, since women are more likely to be employed in low-paid roles.[24] However, there may be an adverse impact on employment. The OBR estimate that the NLW may lead to an increase in the unemployment rate of around 0.2% points in 2020. These estimates are highly uncertain and starting off from slightly different assumptions is likely to lead to different conclusions.

It is uncertain how employers will adapt to the NLW. Some may look to make changes to their workforce, perhaps by reducing staff numbers or hours. Some may change the composition of their workforce: staff aged 24 or under are not eligible for the NLW, so there may be an incentive to replace those aged 25 and over with younger staff. Alternatively some employers may pass on the higher wage

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22 Prices measured by CPI inflation
23 Bank of England, [Inflation Report](), February 2016, p 25
24 Resolution Foundation, [Higher ground: Who gains from the National Living Wage?](), 2 September 2015

cost to consumers in the form of higher prices. Recent research from the Resolution Foundation suggests that Small and Medium sized Enterprises (SMEs) are more likely to absorb the cost and reduce pay differentials between employees.[25] Large employers on the other hand are more likely to seek out improvements in productivity and make efficiency savings.

Further information can be found on the Library Briefing Paper Economic impacts of the National Living Wage: in brief.

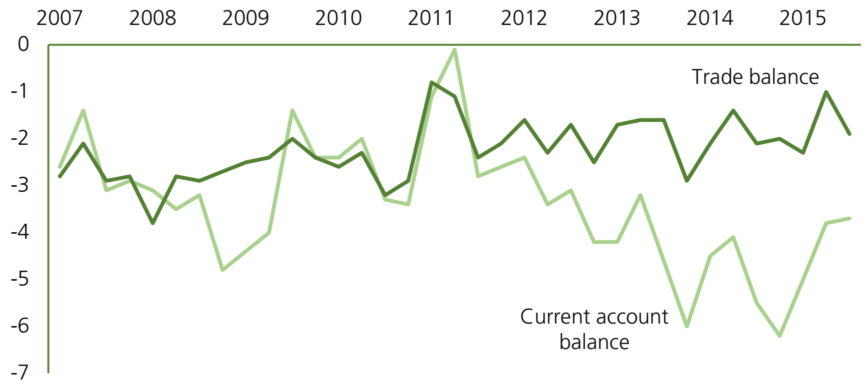
1.5 Trade and current account

A current account deficit of 5.1% of GDP in 2014 was the most since at least 1948

The UK's current account balance – the trade balance plus the balance of income and transfers moving into and out of the UK – has deteriorated in recent years. In 2014, the current account deficit was £92 billion, equivalent to 5.1% of GDP. This is the highest annual figure since records began in 1948. There were some signs of improvement during 2015, however, with the current account deficit falling to 3.7% of GDP in Q3. The current account deficit with the EU was £104 billion in 2014 while the UK ran a surplus of £11 billion with non-EU countries.

The main reason for the rise in the deficit is not the trade deficit – the difference between exports and imports – which was a relatively modest 1.9% of GDP in 2014. More important is the worsening primary balance which measures flows of profits, dividends and interest between the UK and abroad. The primary balance was in surplus every year between 2000 and 2012, peaking at 2.5% of GDP in 2005. It went into deficit in 2013 and the deficit was 1.8% of GDP in 2014. There has been some improvement in recent quarters with the primary account deficit falling from 2.5% of GDP in Q4, 2014 to 0.7% in Q3, 2015.

Current account and trade balance, % GDP



Source: ONS

It is unclear whether this is a temporary change or a more permanent structural effect. In November 2015, the OBR forecast that the current

[25] Resolution Foundation, Weighing up the wage floor: employer responses to the National Living Wage, February 2016

account deficit would be 3.0% of GDP this year, falling to 2.1% in 2020.[26]

Some have argued that a Brexit might make the current account deficit more difficult to finance. In evidence to the Treasury Committee, the Governor of the Bank of England described Brexit as a risk to domestic financial stability and said it had the potential to amplify risks around the current account.[27] Supporters of the UK's exit from the EU argue that no longer contributing to the EU budget would help the current account deficit.[28]

[26] Office for Budget Responsibility, Economic and Fiscal Outlook, November 2015, Table 3.6, p86

[27] Treasury Committee, The economic and financial costs and benefits of UK membership of the EU, 8 March 2016, HC 499, Qq1120-21

[28] John Redwood MP, "We Tories are all Eurosceptics now", *Financial Times*, 8 January 2016

2. Public finances

Summary

The budget deficit – the difference between what the government spends and receives in revenues – is forecast to be £74 billion in 2015/16. The Government plans to eliminate the deficit by 2019/20 and the OBR's November 2015 forecast suggests it is on course to do so.

At over 80% of GDP, Public Sector Net Debt – largely the stock of borrowing arising from past deficits – remains relatively high by recent standards. The OBR forecast that the debt to GDP ratio will fall in 2015/16, albeit slightly, and continue to do so over the following five years.

During 2015/16 the Government sold a historically high level of assets. In November 2015 the OBR said that these asset sales will "make the difference between debt rising and falling as a share of GDP in 2015/16".

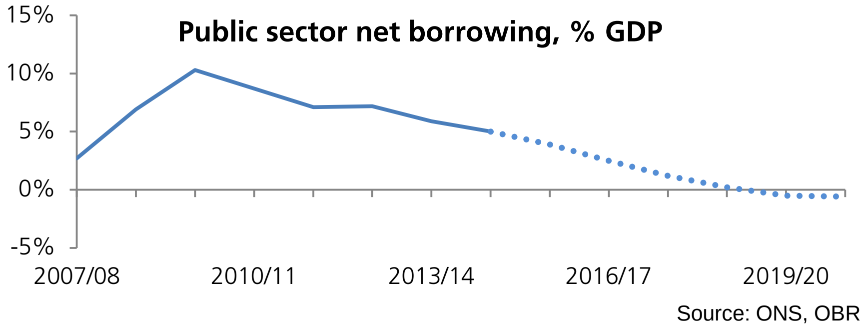
The welfare cap, which sets a limit on the amount that can be spent on certain benefits, will be reset in the Budget. The cap will be reset using the OBR's forecast for relevant welfare spending.

2.1 The deficit: public sector net borrowing

Public sector net borrowing, commonly known as the deficit, is the difference between government spending and revenues. Borrowing has fallen considerably since the high levels it reached during the financial crisis. Borrowing has fallen from £155 billion in 2009/10 to £92 billion in 2014/15, and is forecast to fall to £74 billion in 2015/16; this level of borrowing is equivalent to 3.9% of GDP.[29]

Public sector net borrowing, commonly known as the deficit, is forecast to be £74 billion in 2015/16; equivalent to 3.9% of GDP.

The Government's interim target for the public finances – its 'fiscal mandate' (see Box 3.1) – focuses on this measure of the deficit. The Government's mandate is for public sector net borrowing to be in surplus by the end of 2019/20.[30] A surplus is reached when a government spends less than it receives from taxes and other receipts.



In November 2015 the OBR forecast that the Government was on course to meet the fiscal mandate. The OBR forecast a surplus of £10 billion, or 0.5% of GDP, in 2019/20.[31]

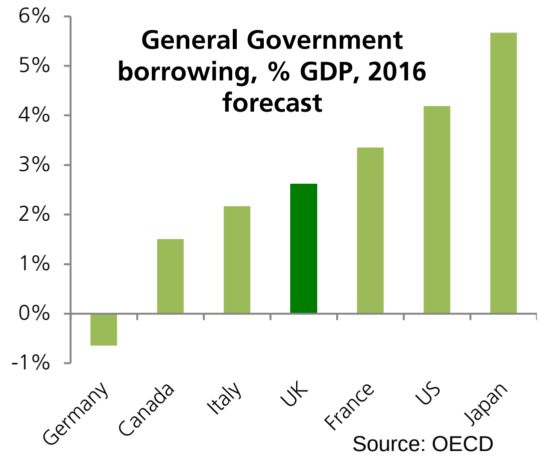
29 These figures are in nominal terms. Borrowing as a share of GDP is shown in the chart. All public sector figures exclude public sector banks.

30 The fiscal mandate is laid out in the Charter for Budget Responsibility. Further information is available in the Library briefing, The Office for Budget Responsibility and Charter for Budget Responsibility.

31 OBR. Economic and Fiscal Outlook – November 2015, para 5.8

International comparisons

The OECD forecast that borrowing in the UK will be 2.6% of GDP in 2016, similar to the average for all OECD nations. The UK's forecast borrowing lies in the middle of the G7 countries – three countries are expected to borrow more than the UK, and three less than the UK.[32]



Source: OECD

Box 3.1: The Government's fiscal mandate and supplementary debt target

The fiscal mandate

The Government's interim fiscal mandate is for public sector net borrowing to be in surplus by 2019/20. A surplus will be achieved if government spending is less than the taxes and receipts it receives. Once a surplus has been reached the target is for a surplus to be achieved in every year when the economy is in 'normal times'.

Supplementary debt target

Until 2019/20 the fiscal mandate will be supplemented with a target for public sector net debt to fall as a percentage of GDP in each year.

Twice a year – alongside the Budget and Autumn Statement – the OBR judges whether the Government is more likely that not to meet its fiscal targets

Normal times

The above targets will apply unless the OBR assess that there has been a significant negative shock. If annual real growth in the UK economy is less than 1% the OBR will judge there to have been a significant negative shock, and the economy will be out of normal times.

If the OBR judges that a negative shock has occurred, or will occur over the forecast period, the fiscal targets will be suspended. The Treasury must then set out a plan to return the budget to surplus including temporary fiscal targets. The plan must be approved by a vote in the House of Commons.

Further information on the current and previous fiscal rules can be found in the Library Briefing Paper The Office for Budget Responsibility and Charter for Budget Responsibility.[33]

2.2 The current budget deficit

The current budget deficit is the difference between government current spending – day-to-day spending on running public services, grants and administration – and revenues. It doesn't include investment spending and therefore is said to measure the degree to which taxpayers meet the cost of paying for the services provided to them.

The current budget deficit is forecast to be £40 billion in 2015/16; equivalent to 2.1% of GDP.

The current budget deficit was £57 billion in 2014/15, and is forecast to fall to £40 billion in 2015/16, before reaching surplus in 2017/18.

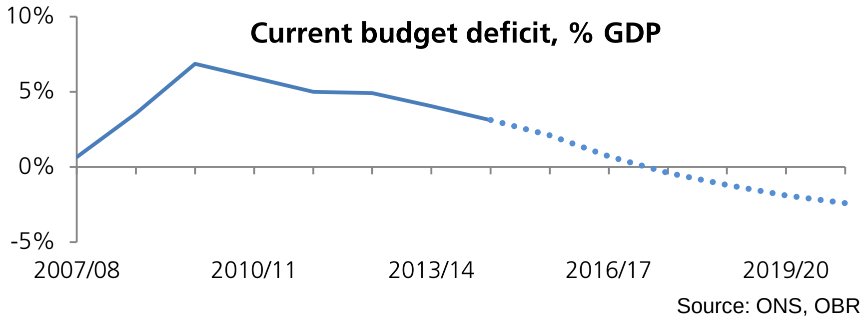
Labour's Shadow Chancellor, John McDonnell MP, has said that the party would aim to reach a surplus on the current budget deficit, rather than the overall deficit.[34] Labour would aim to balance the current

[32] OECD. Economic Outlook Annex Tables, February 2016. The IMF also produce forecasts – these are discussed in the Library briefing Government borrowing and debt: international comparisons.

[33] The Office for Budget Responsibility and Charter for Budget Responsibility, Commons Library Briefing Paper, SN05657, 6 November 2015

[34] 'Labour announces 'fiscal credibility rule'', *BBC,* 10 March 2016

budget over a rolling five year forecast.[35] Focusing on the current budget would allow borrowing for investment purposes.

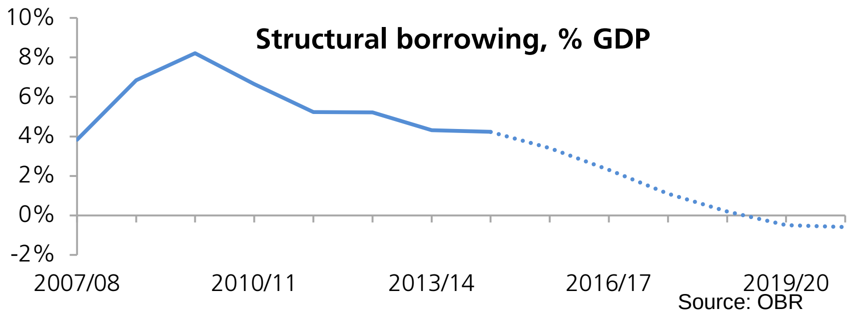


2.3 Structural borrowing

Structural borrowing – the underlying element of government borrowing – is forecast to be 3.4% of GDP in 2015/16

Structural borrowing is the level of borrowing we would expect to see if the economy was running at full potential. Structural elements are the underlying or persistent part of government borrowing, which are unrelated to the economic cycle (see Box 3.2).

Structural borrowing is estimated to have been around 3-4% of GDP immediately before the financial crisis. It increased to just over 8% of GDP in 2009/10. The OBR forecast structural borrowing of 3.4% of GDP in 2015/16, and that structural borrowing will reach a surplus in 2019/20.



Calculating structural borrowing requires an assessment of where the economy is in the economic cycle, this is measured by the OBR through the output gap (see Box 3.3).

Box 3.2: Cyclical and structural elements of borrowing

A distinction is often drawn between the 'cyclical' and 'structural' elements of Government borrowing:

- Cyclical elements of the deficit refer to the effect of the economic cycle on the level of Government borrowing. In a recession, government borrowing tends to increase as tax receipts are reduced and spending on benefits increases. The reverse happens when the economy is growing strongly. These effects are sometimes known as the economy's 'automatic stabilisers'.

- Structural elements of the deficit are the underlying or persistent part of government borrowing, which are unrelated to the economic cycle. The structural deficit is measured by cyclically-adjusted measures of borrowing.[36]

35 "Labour bids to win back economic credibility as John McDonnell vows to balance Budget over five years", *Independent*, 11 March 2016

36 There are various cyclically adjusted measures of borrowing. The figures in this section are for cyclically-adjusted net borrowing.

Box 3.3: The output gap

The difference between the actual level of economic output and what could be achieved if the economy was operating at full potential is known as the 'output gap'.

A negative output gap suggests that the economy is operating below its potential level and has idle resources. A positive output gap suggests that the economy is operating above potential or overheating.

A big problem for policymakers is that the level of potential output cannot be directly measured and consequently neither can the output gap. Therefore economists must estimate what the output gap is. The OBR estimates that the output gap was close to -4% of GDP in 2009/10 and is currently around -0.6% of GDP.

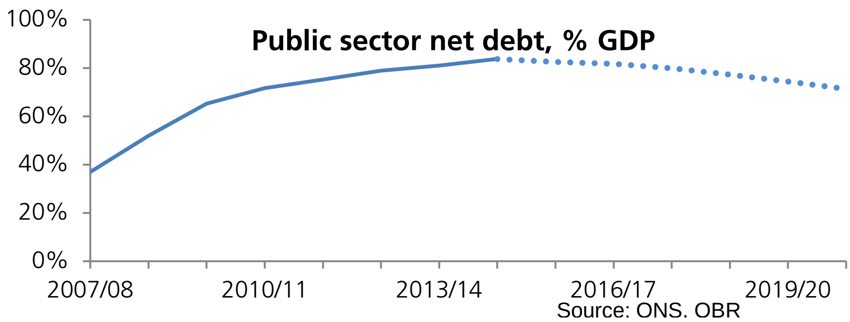
2.4 Public sector net debt

Public sector net debt – broadly speaking the stock of borrowing from past deficits – is forecast to be 82.5% of GDP at the end of 2015/16.

Public sector net debt is the overall level of government indebtedness, built up over many years. Broadly speaking it is the stock of borrowing arising from past deficits.

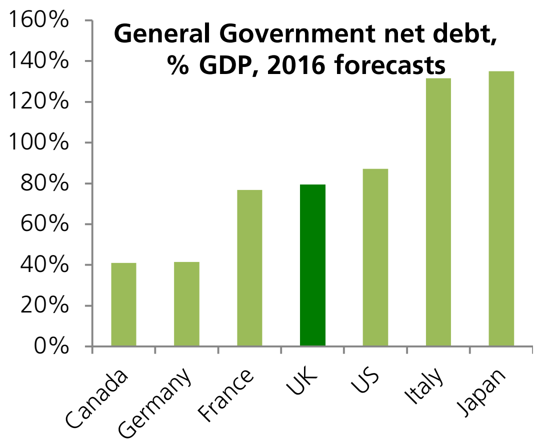
Before the financial crisis, public sector net debt was around 36-37% of GDP. As a result of the crisis, debt increased sharply reaching close to 84% of GDP at the end of 2014/15: a debt to GDP ratio not seen since the mid to late 1960s.[37]

In November 2015 the OBR forecast that the debt to GDP ratio will begin to fall in 2015/16 and will continue to do so over the following five years. The OBR therefore judges that the Government is on course to meet its supplementary debt target (see Box 3.1).[38]



International comparisons

UK government debt is forecast to be similar to that of the US and France in 2016, well below Italy and Japan but well above Canada and Germany.[39]



[37] Bank of England, Three centuries of macroeconomic data – version 2.2
[38] OBR. Economic and Fiscal Outlook – November 2015, para 5.17
[39] OECD. Economic Outlook Annex Tables, February 2016

2.5 Asset sales

In the 2015 Summer Budget, the Government announced a major programme of asset sales for 2015/16.

The 2015 Summer Budget announced the sale of £31 billion worth of assets which would be the most ever achieved in a single year.

'Record' asset sales

In July 2015, the Chancellor announced that around £31 billion of 'financial and commercial assets' would be sold by the Government during 2015/16.[40]

The Government argued – using House of Commons Library data – that the forecast income from these sales…

> …amounts to the largest privatisation proceeds in a single year ever. This is over £10 billion higher in real terms than the previous record in 1987-88.[41]

The OBR stated that asset sales will "make the difference between debt rising and falling as a share of GDP in 2015/16."[42]

The OBR also noted that using asset sales to reduce debt was not straightforward because:

- Selling financial assets brings forward money that would have been received later (for example, from mortgage repayments), so only reduces debt temporarily.
- Giving away assets (as happened with some of the Royal Mail shares) raises less than the actual worth of the asset, meaning that the public sector's net worth is reduced.[43]

Box 2.3: What did the Government plan to sell?

In the 2015 Summer Budget, the Government stated its intention to raise the following amounts from asset sales in 2015/16:[44]

- £13 billion from Lloyds shares (a 'retail offer' to individuals was anticipated)
- £12 billion from UK Asset Resolution (UKAR) shares
- £2.3 billion from the sale of the student loan book
- £2.0 billion from Royal Bank of Scotland (RBS) shares
- £1.5 billion from the sale of the remainder of Royal Mail
- £1.2 billion from other smaller share and asset sales

Plans scaled back

In late January 2016, the Treasury announced that the Government was to delay the sale of the final tranche of Lloyds shares until after Easter 2016.

According to the Financial Times this was to "end speculation" about the Chancellor's intentions in this area: previously it had been suggested

40 HM Treasury, *Summer Budget 2015*, July 2015, p29
41 *Ibid*
42 OBR, *Economic and fiscal outlook November 2015*, p8
43 *Ibid*
44 OBR, *EFO July 2015*, Chart 4.13

that a large part of the sale in the form of a 'retail offer' to individuals would be announced in the Budget.

The Treasury commented that "market uncertainty" made a share sale unwise in 2015/16.[45] George Osborne added that the sale of Lloyds shares would continue "when turbulent markets have calmed down."[46]

What has been achieved?

Most of the Government's intended asset sales had gone ahead earlier in 2015, or were unaffected by the decision to delay the sale of Lloyds shares. For example, the sale of UKAR shares had actually delivered greater returns than initially expected – £13 billion as opposed to the £12 billion initially forecast – and the sale of Royal Mail shares was completed in October.[47]

So, despite the announcement of the pause in the sale of Lloyds shares, the Government has achieved historically high asset sales in 2015/16.

The OBR stated that as of November 2015, asset sales in 2015/16 totalled £24 billion, and that "around £6 billion of proceeds are expected in the remaining months of [2015/16], in large part from the remaining Lloyds share sales."[48]

Between November 2015 and the end of January 2016, total income to the Government from the sale of company securities totalled £4.9 billion.[49]

So although asset sales in 2015/16 will probably be below the Government's initial forecast of around £30 billion, income will not fall far short of this total.

2.6 Welfare cap

The welfare cap was introduced in Budget 2014 and sets a limit on the amount that can be spent on certain benefits, including tax credits, incapacity benefit and most housing benefit. It excludes Job Seekers Allowance, Universal Credit and the state pension.[50]

The cap covers each year of the forecast period – currently 2016/17 to 2020/21 – and is set according to the OBR's forecast for welfare spending in scope. The OBR will produce new forecasts for this sort of spending in the 2016 Budget, so the cap will be reset. The definition of 'welfare in scope' will not change.

The cap as it was set out in the Summer 2015 Budget is below.

45 Financial Times, *Osborne blames delayed Lloyds share sale on market volatility*, 28 January 2016
46 Twitter account of George Osborne, *28 January 2016, 11.08 AM (GMT)*
47 OBR, *Economic and fiscal outlook November 2015*, p157
48 *Ibid*, p156
49 ONS, Public sector finances – January 2016, ONS code ABIF
50 HM Treasury, *Budget 2014*, March 2014, para 1.76, p26

Level of the welfare cap set out in *Summer Budget 2015*, *£ billions*

	2016/17	2017/18	2018/19	2019/20	2020/21
Welfare cap	115.2	114.6	114.0	113.5	114.9

Source: HM Treasury, *Summer Budget 2015*, July 2015, Table 1.7, p25
Note: a 2% margin above the cap allows for forecast fluctuations each year

The OBR assesses whether the cap has been observed or breached at the time of the Autumn Statement so no assessment will be published in the Budget.

At the time of Autumn Statement 2015, the OBR assessed that relevant welfare spending would breach the cap in three of the following five years, following the cancellation of proposed changes to tax credits that had been proposed in the Summer Budget 2015.[51]

The cap was comprehensively breached – by around £2 billion a year – in 2016/17 and the following two years. The Government's response to this was to 'justify' the breach to Parliament, rather than take any action to remedy the situation.[52] The Government's response has led the Institute for Fiscal Studies to question the efficacy of the cap.[53]

51 OBR, *Economic and Fiscal Outlook*, November 2015, pp 192,193
52 HC Deb. 16 December 2015:c1633-1650
53 IFS, *2016 Green Budget*, February 2016, p74

3. Business Rates Review and pensions tax relief

Summary

Business rates review

The Government has committed to publishing a review of the administration of the business rates system in England alongside the 2016 Budget. The review has been ongoing for some two years in various forms. There are few indications of the likely conclusions of the review, but media commentary suggests that no major changes are anticipated.

Pensions tax relief

The Government had been expected to respond in Budget 2016 to its consultation on pensions tax relief. However, over the weekend of 5-6 March, it was reported that no major changes to tax relief on contributions would be announced in this Budget.

3.1 Business rates review

The Government announced its intention to review the business rates system in England in the 2013 Autumn Statement. This review published terms of reference in February 2014 and an interim report in December 2014.[54] A discussion paper was published on 10 April 2014. A summary of responses to the paper, and an interim response from the Government, were published on 10 December 2014.[55]

This review was then superseded by a consultation paper entitled Business rates review: terms of reference and discussion paper, published in March 2015. This is expected to report alongside the 2016 Budget.

The review covers the administration of the business rates system. There is no direct link between it and the Chancellor's announcement, in October 2015, that by 2020 the Government would permit local government to retain 100% of business rates revenue and would abolish the standard multiplier.

The review is expected to:

- conduct a robust analysis of trends in the use of non-domestic property and property values
- review alternative and international examples of local property and business tax systems and draw lessons from them
- consider the impact of the current system of business rates on businesses' decisions to invest, grow and create jobs – this will include evaluating the effectiveness of existing

[54] HM Treasury, Business Rates Administration Review: terms of reference, February 2014

[55] See also the published responses to the interim response, from July 2015

reliefs and exemptions that are designed to support particular types of ratepayers

- consider the role of business rates within the wider tax system, including its responsiveness to economic conditions
- assess the impacts of any potential changes on the ability of the business rates system to deliver fairness, simplicity and stability to ratepayers
- encourage a wide-ranging debate among stakeholders of potential options for reform and their impacts.[56]

There has been little indication of the progress of the review. An article in the *Guardian* in September 2015 suggested that little change was anticipated:

> Mike Spicer, the director of research and economics at the British Chambers of Commerce, said Treasury officials were "dumbing down expectations" about the outcome of the review.
>
> "All the noises have been: 'Don't get your hopes up, there is not going to be any change'," he said.
>
> In a statement, the British Retail Consortium said: "Retail supported the government's decision last year to take a proper look at the inequities of this system.
>
> "Three-quarters of the way through this 'radical' review, we are all looking for some sign that the government intends to keep to the spirit in which the review was announced….[57]

An article in the Daily Telegraph on 21 February 2016 made similar comments:

> British retailers want more frequent revaluations of property, while the Confederation of British Industry wants the tax to be shifted in line with the consumer price index (CPI), rather than the retail price index (RPI).
>
> Unlike CPI, RPI includes housing costs, which considerably inflates the rate and has largely fallen out of favour as an economic measure. Such a move could save UK companies £1.5bn, the CBI has said, and would ensure business rates do not outpace the official measure of inflation.
>
> Properties are revalued every five years, with the next review in 2017 expected to mean 324 retail centres across Britain will see a decrease in business rates, according to Colliers International, the commercial property agency.
>
> However, the Government is understood not to be in favour of either amendment.[58]

Business rates appeals: new system

The Government published a consultation paper in November 2015 entitled Check, challenge, appeal: reforming business rate appeals. This proposed a new appeals system for business rates, in response to the findings in the interim response published in December 2014. It is not

56 HM Treasury, *Business rates review: terms of reference and discussion paper*, 2015, p.8
57 Graham Ruddick, "Treasury reining in 'radical' business rates review, say retailers", *Guardian*, 28 September 2015
58 Ashley Armstrong and Elizabeth Anderson, "UK firms braced for 'watered-down' business rates review", *Daily Telegraph*, 21 February 2016

clear whether a response to this consultation is to be published alongside the 2016 Budget. Clauses enabling a new system to be introduced have been included in the *Enterprise Bill 2015-16*.[59]

3.2 Pensions tax relief

The Government had been expected to respond in Budget 2016 to its consultation Strengthening the incentive to save: a consultation on pensions tax relief.

Debate had centred on three possible approaches: providing relief on pension contributions at a flat-rate; moving to a system where contributions are made out of taxed income and pension income is tax-free; and retaining the current system, with some modifications.

However, over the weekend of 5-6 March, it was reported that no major changes to tax relief on contributions would be announced in the Budget.[60]

Further information can be found in the Library Briefing Paper Reforming pension tax relief.

[59] The relevant clause in the Bill is an enabling clause. The details of the new system, as set out in the consultation paper, are to be introduced in regulations. See the Library briefing paper *Enterprise Bill [HL] 2015-16*.

[60] 'Pensions: George Osborne drops plans to cut tax relief', *the BBC,* 5 March 2016

Appendix 1: Sources of further information

HM Treasury

Summer Budget 2015

Budget 2015

Budget 2014

Autumn Statement 2015

Office for Budget Responsibility

Economic and fiscal outlook, November 2015

Economic and fiscal outlook, July 2015

Economic and fiscal outlook, March 2015

Monthly commentary on the public finances

Public finance databank

Institute for Fiscal Studies

Post-Autumn Statement Briefing 2015

Post-Summer Budget Briefing 2015

Post-Budget Briefing 2015

Post- Autumn Statement Briefing 2014

Green Budget 2016

Monthly commentary on the public finances

House of Commons Library

Economic indicators (an edition will be published on 11 March 2016)

External users can access this from (see under "Commons Briefing Papers"):

http://www.parliament.uk/topics/Economic-situation.htm

House of Commons Treasury Select Committee

Inquiry into the Autumn Statement 2015

Inquiry into the Summer Budget 2015

Inquiry into Budget 2015

Report on Autumn Statement 2014

Report on Spending Review 2010

Appendix 2: Economic and public finance data 1979-2021

Economic data, 1979-2020

	Real GDP growth %	Inflation RPI %	Inflation CPI %	ILO Unemployment Q4, %
1979	3.7%	13.4%	..	5.5%
1980	-2.2%	18.0%	..	8.0%
1981	-0.8%	11.9%	..	10.2%
1982	2.1%	8.6%	..	11.1%
1983	4.2%	4.6%	..	11.7%
1984	2.3%	5.0%	..	11.6%
1985	4.1%	6.1%	..	11.3%
1986	3.2%	3.4%	..	11.3%
1987	5.6%	4.2%	..	9.7%
1988	5.9%	4.9%	..	8.0%
1989	2.5%	7.8%	5.2%	7.0%
1990	0.6%	9.5%	7.0%	7.5%
1991	-1.3%	5.9%	7.5%	9.5%
1992	0.4%	3.7%	4.3%	10.4%
1993	2.6%	1.6%	2.5%	10.3%
1994	4.0%	2.4%	2.0%	9.0%
1995	2.5%	3.5%	2.6%	8.3%
1996	2.7%	2.4%	2.5%	7.8%
1997	3.1%	3.1%	1.8%	6.5%
1998	3.4%	3.4%	1.6%	6.1%
1999	3.1%	1.5%	1.3%	5.8%
2000	3.8%	3.0%	0.8%	5.2%
2001	2.8%	1.8%	1.2%	5.2%
2002	2.5%	1.7%	1.3%	5.1%
2003	3.3%	2.9%	1.4%	4.9%
2004	2.5%	3.0%	1.3%	4.7%
2005	3.0%	2.8%	2.1%	5.1%
2006	2.7%	3.2%	2.3%	5.5%
2007	2.6%	4.3%	2.3%	5.2%
2008	-0.5%	4.0%	3.6%	6.4%
2009	-4.2%	-0.5%	2.2%	7.8%
2010	1.5%	4.6%	3.3%	7.9%
2011	2.0%	5.2%	4.5%	8.4%
2012	1.2%	3.2%	2.8%	7.8%
2013	2.2%	3.0%	2.6%	7.2%
2014	2.9%	2.4%	1.5%	5.7%
2015	2.2%	1.0%	0.0%	5.1%
2016	2.4%	2.0%	1.0%	5.1%
2017	2.4%	2.9%	1.8%	5.3%
2018	2.5%	3.2%	1.9%	5.3%
2019	2.4%	3.2%	2.0%	5.4%
2020	2.3%	3.2%	2.0%	5.4%

Sources: ONS (series, IHYP, CZBH, D7G7, MGSX)
OBR, Economic and fiscal outlook, November 2015, Table 3.6, and Economy Supplementary Tables 1.6 & 1.7

Public finance data 1979-80 to 2020-21

	Public sector net borrowing		Structural deficit	Public sector net debt	
	£ billion	% GDP	% GDP	£ billion	% GDP
1979/80	8.5	3.9%	4.2%	98.2	45.0%
1980/81	11.5	4.6%	3.2%	113.8	45.6%
1981/82	6.0	2.2%	0.0%	125.2	45.3%
1982/83	8.5	2.8%	0.8%	132.5	43.9%
1983/84	11.8	3.6%	2.3%	143.6	43.6%
1984/85	12.5	3.5%	3.1%	157.0	44.3%
1985/86	9.0	2.3%	2.3%	162.5	41.7%
1986/87	8.4	2.0%	2.2%	167.8	40.1%
1987/88	4.7	1.0%	2.2%	167.4	35.6%
1988/89	-6.0	-1.1%	0.9%	153.7	29.3%
1989/90	-0.6	-0.1%	1.3%	151.9	26.2%
1990/91	6.2	1.0%	0.8%	151.1	24.2%
1991/92	23.0	3.5%	2.1%	165.8	25.2%
1992/93	47.1	7.0%	5.3%	201.9	29.0%
1993/94	51.6	7.2%	5.9%	249.8	33.9%
1994/95	43.8	5.8%	5.0%	290.0	37.5%
1995/96	35.3	4.4%	3.2%	322.1	39.2%
1996/97	27.7	3.3%	2.9%	347.0	39.7%
1997/98	5.9	0.7%	1.8%	358.6	39.1%
1998/99	-4.5	-0.5%	0.9%	357.8	37.3%
1999/00	-14.6	-1.5%	-0.1%	349.1	34.4%
2000/01	-17.1	-1.6%	-0.5%	316.4	29.9%
2001/02	0.6	0.1%	0.7%	323.3	29.3%
2002/03	26.8	2.3%	2.4%	355.2	30.3%
2003/04	31.5	2.6%	2.9%	394.2	31.8%
2004/05	43.8	3.4%	4.1%	449.2	34.3%
2005/06	41.7	3.1%	3.6%	492.0	35.4%
2006/07	37.1	2.6%	3.1%	529.3	36.1%
2007/08	41.0	2.7%	3.8%	561.5	36.9%
2008/09	104.1	6.9%	6.7%	769.9	51.9%
2009/10	154.7	10.3%	8.1%	1,004.3	65.2%
2010/11	136.8	8.7%	6.5%	1,149.9	71.7%
2011/12	115.9	7.1%	5.1%	1,242.6	75.2%
2012/13	121.1	7.2%	5.1%	1,352.7	78.9%
2013/14	103.0	5.9%	4.2%	1,459.0	81.0%
2014/15	91.9	5.0%	4.1%	1,546.8	83.7%
2015/16	73.5	3.9%	3.4%	1,599.3	82.5%
2016/17	49.9	2.5%	2.3%	1,652.3	81.7%
2017/18	24.8	1.2%	1.1%	1,684.7	79.9%
2018/19	4.6	0.2%	0.2%	1,701.8	77.3%
2019/20	-10.1	-0.5%	-0.5%	1,708.4	74.3%
2020/21	-14.7	-0.6%	-0.6%	1,714.6	71.3%

Source: OBR, ONS

Note: figures exclude public sector banks

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