Background to the 2012 Autumn Statement

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The Chancellor will present the Autumn Statement on 5 December. The independent Office for Budget Responsibility (OBR) will present revised forecasts for the economy and the public finances. This note sets out the economic and public finance background to the Autumn Statement.

A separate note has been published since the statement summarising its main points..

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1 Summary

The Chancellor will present the Autumn Statement to the House of Commons on Wednesday 5 December. On the same day, the independent Office for Budget Responsibility (OBR) will present revised forecasts for the economy and public finances. It will also give its assessment of the Government's chances of meeting its fiscal rules.

The economy has a long way to go before it recovers fully from the financial crisis. Economic growth has been sluggish over the last couple of years. GDP is still more than 3% below its pre-recession peak. Independent forecasters expect GDP to fall slightly in 2012 and only modest growth in the medium term. The Office for Budget Responsibility (OBR) is highly likely to downgrade its growth forecasts in the Autumn Statement.

The Chancellor has admitted that it is taking longer than expected to improve the public finances. The OBR is likely to revise up its forecasts for government borrowing and debt. This would make it harder for the Chancellor to meet his fiscal rules without further tax increases or spending cuts. The rule which requires debt to be falling as a percentage of GDP in 2015/16 is thought to be particularly under threat.

There has been speculation that the Autumn Statement will contain a number of measures, including reducing pension tax relief, clamping down on tax avoidance and changes to benefits. It has also been suggested that the increase in fuel duty due in January could be deferred.

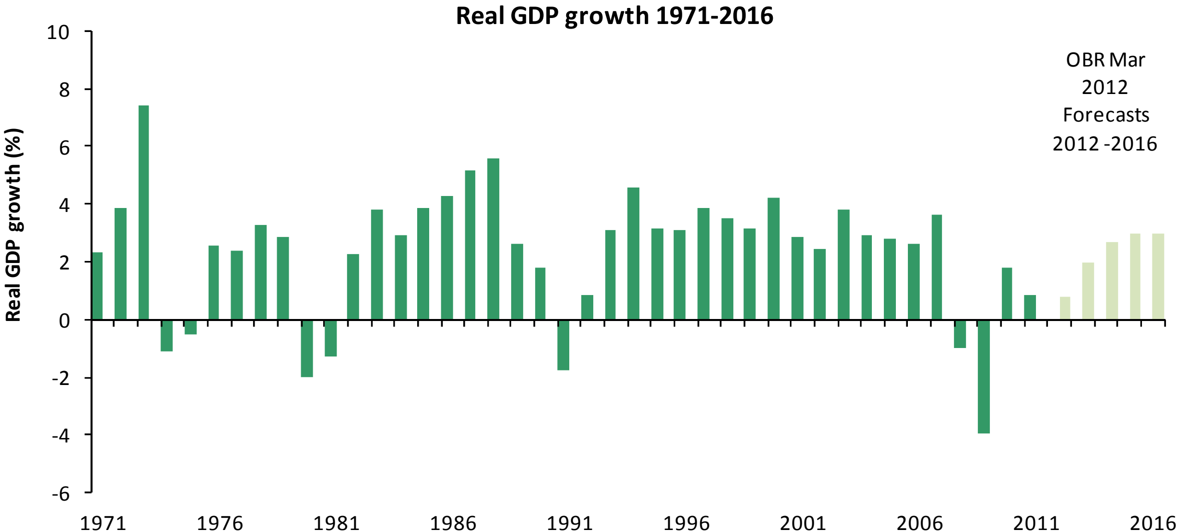
2 The economy

2.1 GDP

The economy has grown slowly since the financial crisis. Growth of 1.8% in 2010 was followed by 0.9% in 2011. The economy has contracted slightly over the first nine months of 2012 compared with the same period in 2011. Output is still over 3% below its pre-recession peak.

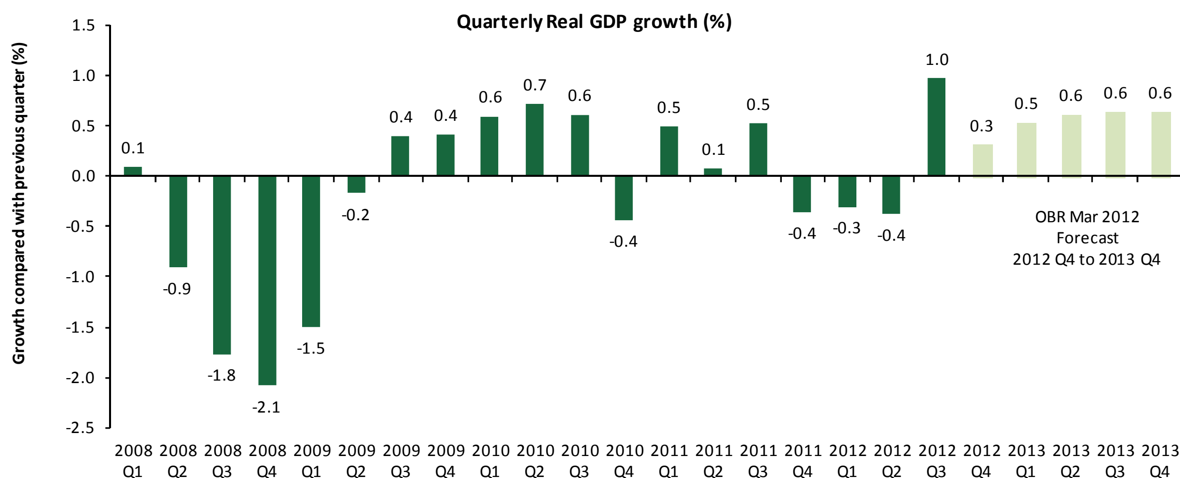
The recent performance of the economy has been worse than many forecasters expected. The OBR has commented on its forecasting record as follows:

> Along with many other forecasters, we significantly overestimated economic growth over the past two years. This likely reflected several factors, including the impact of stubborn inflation on real consumer spending, deteriorating export markets on net trade, and impaired credit conditions, euro area anxiety and demand uncertainty on business investment. Fiscal consolidation may also have done more to slow growth than we assumed. [1]



GDP fell for three consecutive quarters (Q4 2011 to Q2 2012) before the economy emerged from recession in Q3 2012 with growth of 1.0%. Part of the strong growth in Q3 has been attributed to the extra working day (in Q2 there was an extra bank holiday for the Jubilee) and the effect of the Olympic and Paralympic Games.

[1] OBR, *Forecast evaluation report*, October 2012, p 8



The table below shows contributions to GDP in each of the last four quarters by expenditure component. Net trade made the largest contribution to GDP growth in Q3 2012.

Contributions to growth (quarter-on-quarter), of the expenditure components of GDP

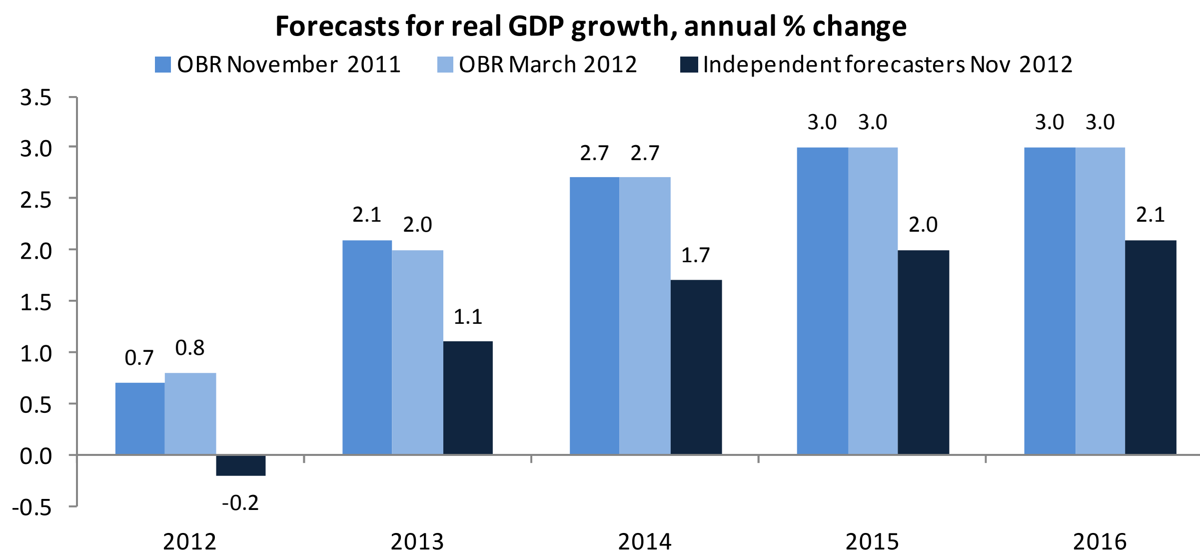
	2011 Q4	2012 Q1	2012 Q2	2012 Q3
Final Consumption Expenditure				
Households	0.1	0.2	-0.1	0.4
Non Profit Institutions Serving Households	0.0	0.0	0.1	0.0
General Government	0.1	0.7	-0.4	0.1
Gross Capital Formation	-0.9	-0.8	0.9	-0.2
of which Gross Fixed Capital Formation	-0.1	0.5	-0.4	0.1
Exports	0.9	-0.5	-0.3	0.5
Imports	0.5	0.0	0.4	-0.1
Net trade	0.4	-0.5	-0.8	0.7
Real GDP growth	-0.4	-0.3	-0.4	1.0

Source: ONS, Statistical bulletin: Second estimate of GDP - 3rd quarter 2012

2.2 Growth forecasts

In March, the OBR forecast growth of 0.8% in 2012. Growth of 2.0% was forecast for 2013. In the medium term, the OBR expected growth of 2.7% in 2014 and 3.0% in 2015 and 2016.

The chart below compares the OBR's March 2012 forecast with the latest average independent forecast and the OBR's November 2011 forecast. It shows that the OBR's March forecasts are much higher that the current average independent forecast. It seems highly likely that the OBR will downgrade its growth forecasts in the Autumn Statement.



The table below shows the extent to which independent forecasters have downgraded the growth outlook for the UK economy. This time last year, independent forecasters were expecting growth of 1.2% in 2012. They are now forecasting -0.2%.

Forecasts of GDP growth in 2012 (%)	
OBR	
Pre - Budget 2010	2.8
Post-Budget 2010	2.8
Nov-10	2.6
Mar-11	2.5
Nov-11	0.7
Mar-12	0.8
Average of independent forecasts	
Nov-11	1.2
Dec-11	0.6
Jan-12	0.4
Feb-12	0.4
Mar-12	0.5
Apr-12	0.6
May-12	0.4
Jun-12	0.3
Jul-12	0.1
Aug-12	-0.2
Sep-12	-0.3
Oct-12	-0.3
Nov-12	-0.2

Source: HMT, *Forecasts for the UK Economy: a comparison of independent forecasts* ; OBR

The OECD forecasts that GDP will fall by 0.1% this year. Growth of 0.9% is forecast for 2013 and 1.6% in 2014.[2] The OECD places the UK sixth out of the G7 countries for growth in 2012, third in 2013 and fourth in 2014. The IMF forecasts are broadly similar to the OECD's with GDP falling by 0.4% in 2012 and the economy returning to growth in 2013 and 2014.

[2] OECD, *Economic Outlook database*, November 2012

OECD/IMF forecasts for real GDP growth, %

	OECD			IMF		
	2012	2013	2014	2012	2013	2014
UK	**-0.1**	**0.9**	**1.6**	**-0.4**	**1.1**	**2.2**
Canada	2.0	1.8	2.4	1.9	2.0	2.4
France	0.2	0.3	1.3	0.1	0.4	1.1
Germany	0.9	0.6	1.9	0.9	0.9	1.4
Italy	-2.2	-1.0	0.6	-2.3	-0.7	0.5
Japan	1.6	0.7	0.8	2.2	1.2	1.1
US	2.2	2.0	2.8	2.2	2.1	2.9
Eurozone	-0.4	-0.1	1.3	-0.4	0.2	1.2
OECD	1.4	1.4	2.3	...	...	...

Sources: OECD, *Economic Outlook*, No 92, November 2012
IMF, *World Economic Outlook update*, October 2012

The OECD's *Economic Outlook* commented that:

> Growth is projected to recover gradually and gain momentum towards the end of 2013, as exports and household spending pick up as confidence recovers.
>
> The Bank of England is providing significant support to the economy through quantitative easing, which should continue. With the fiscal deficit and public debt still high, the policy of fiscal consolidation remains appropriate to ensure the sustainability of the public finances. In the event of lower than expected growth, the flexibility of the fiscal mandate should be utilised to allow the automatic stabilisers to continue to operate, even though this may imply pushing out the debt target. The strong institutional framework and medium-term structural consolidation plans should be maintained to ensure credibility. The governments' fiscal plans allow reprioritising spending to focus further on long-term growth enhancing infrastructure investment. Recent and planned structural reforms, especially on planning and work incentives, should boost growth over time. [3]

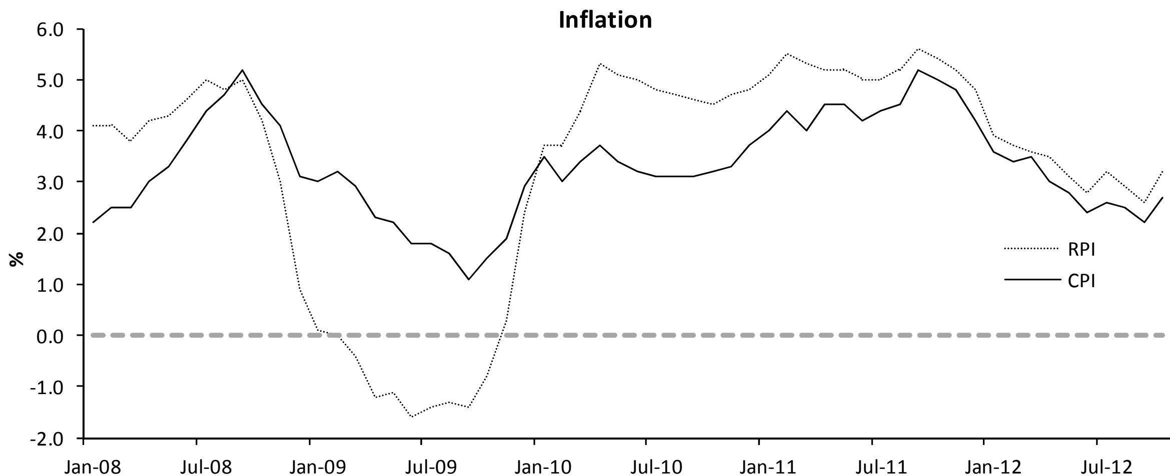
2.3 Inflation

Inflation rose to high levels in 2011 on both the retail prices index (RPI) and the consumer prices index (CPI) measures, before falling back as the impact of the increases in the standard rate of VAT has subsided:

- RPI inflation reached 5.6% in September 2011 - its highest value since June 1991 - it fell to 2.6% in September 2012 before rising to 3.2% in October due to increases in tuition fees and higher energy costs.

- CPI inflation peaked at 5.2% in September 2011 before falling back to 2.2% in September 2012 and stood at 2.7% in October (see chart below).

[3] OECD, *Economic Outlook*, November 2012, p100



Inflation has been above the Bank of England's 2% CPI target for the last 35 months. In March, the OBR forecast that CPI inflation would fall over the next few years. It forecasts 2.8% inflation in 2012 (compared with 4.5% in 2011), 1.9% in 2013 and 1.9% in 2014. The OECD forecasts CPI inflation in the UK of 2.6% this year and 1.9% next year.

OECD forecasts for inflation, %

	2012	2013	2014
UK (CPI)	**2.6**	**1.9**	**1.8**
Canada	1.6	1.4	1.8
France	2.2	1.3	1.2
Germany	2.1	1.9	2.0
Italy	3.2	1.9	0.9
Japan	0.0	-0.5	1.3
US	2.1	1.8	2.0
Eurozone	2.4	1.6	1.2

Source: OECD, *Economic Outlook*, No 92, Nov 2012

In its latest *Inflation Report*, the Bank of England has suggested that:

> [...] a key uncertainty relates to the outlook for external cost pressures, particularly commodity prices. Idiosyncratic influences, such as domestic energy prices and university tuition fees, are set to put upward pressure on inflation. On balance, the Committee's best collective judgement is that, over time, CPI inflation is likely to come down to around the 2% target as a revival in productivity growth alleviates pressures on companies' costs. The risks to inflation are judged to be broadly balanced around the 2% target for much of the second part of the forecast period.[4]

2.4 Employment

The number of people in employment has been rising during 2012. Latest data show that it increased by 100,000 over the last quarter and was up by 513,000 over the last year, to 29.58 million in the three months to September 2012.

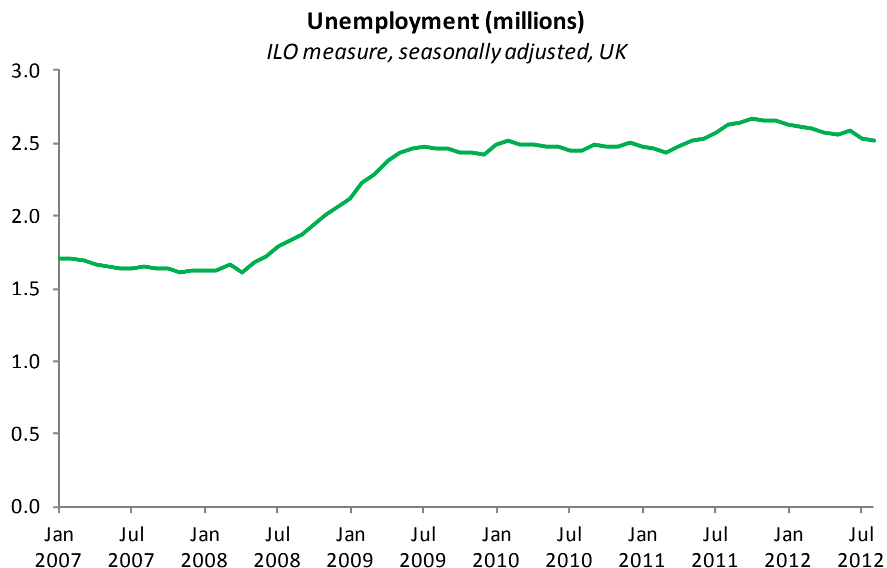
The employment rate (the proportion of the population in work) for those aged 16-64 was 71.2% in the three months to September 2012, up 0.2% points from the last quarter and up

[4] Bank of England, *Inflation Report*, November 2012, p39

1.0% points from the year before. This compares to a pre-recession peak of 73.0% in March-May 2008.

2.5 Unemployment

Unemployment fell to 2.51 million in the three months to September 2012, a decrease of 49,000 compared with the previous quarter and 110,000 lower compared with a year earlier. This represents 7.8% of the economically active population, the lowest the unemployment rate has been since the three months to April 2011.



The unemployment rate in the UK is the same as the OECD average and in the middle of G7 countries. It is lower than in France and Italy but higher than in Canada, Germany and Japan. It is the same as in the US.

International comparisons of unemployment
OECD Harmonised unemployment rates
%, September 2012 (except where stated)

UK	**7.9 (a)**
Canada	7.4 (b)
France	10.8
Germany	5.4
Italy	10.8
Japan	4.2
US	7.9 (b)
Eurozone	11.7
OECD	7.9

Notes: (a) July 2012; (b) Oct 2012
Source: OECD

The OBR's latest forecasts from March 2012 were for the unemployment rate to average 8.7% in 2012 and 8.6% in 2013, before falling to 8.0% in 2014, 7.2% in 2015 and 6.3% in 2016. Given that the data we already have for most of 2012 shows the unemployment rate below that forecast by the OBR in March, it is likely that they will revise down their forecasts for 2012, at least.

The OECD's unemployment forecasts are shown in the table below. In the UK, unemployment is forecast to increase from 8.0% in 2012 to 8.3% in 2013, before falling back to 8.0% in 2014. This would mean UK unemployment being the third highest in the G7 in 2013, below France (10.9%) and Italy (11.8%). UK unemployment would remain well below that of the Eurozone average and around the OECD average throughout this forecast period.

OECD unemployment forecasts, %

	2012	**2013**	**2014**
UK	**8.0**	**8.3**	**8.0**
Canada	7.3	7.2	6.9
France	9.9	10.7	10.9
Germany	5.3	5.5	5.6
Italy	10.6	11.4	11.8
Japan	4.4	4.4	4.3
US	8.1	7.8	7.5
Eurozone	11.1	11.9	12.0
OECD	8.0	8.2	8.0

Source: OECD, Economic Outlook No. 92, November 2012

2.6 The global and eurozone economies

The global economy[5]

The global recovery slowed during 2012 as questions about the future of the eurozone and the path of US fiscal policy weighed down on economic activity and sentiment. Most forecasters predict a slight pick-up in growth at a global level, and within advanced economies and the eurozone, in 2013, but these projections are contingent on progress being made to resolve the euro crisis and an agreement being reached in the United States on taxation, spending and the debt ceiling that prevents a sharp fiscal consolidation there in 2013.

In the **eurozone**, widespread fiscal consolidation, together with falling household spending and business investment have caused the currency union to fall into recession, with accompanying increases in unemployment. Despite recent progress (see below), confidence in the ability of policymakers to tackle the root causes of the crisis is low, and is unlikely to have been improved by the drawn-out rescue package agreed for Greece on 27 November. There remain significant political obstacles to the pooling of resources, liabilities and sovereignty among countries within the currency union, something that many see as necessary to restore confidence in the euro.

European countries experiencing recession* in 2012 (in red)

* defined as two consecutive quarters of negative growth during 2012, based on either two or three quarters of GDP data

Source: Eurostat database

Two recent developments in particular have given cause for some optimism, and helped to bring about a degree of stability. Firstly, the European Central Bank has agreed to buy government bonds in potentially unlimited quantities from countries under certain conditions. For the moment, the mere commitment to do this has been enough to bring Spanish and Italian government borrowing costs under control and quell speculation that these countries are at serious risk of leaving the euro. Secondly, an agreement in principle to allow the permanent eurozone rescue fund, the European Stability Mechanism, to recapitalise the banks of beleaguered eurozone countries directly, rather than channel funds through their governments, has raised hopes that the link between banking debt and government debt might eventually be broken.[6] However this second measure depends on eurozone countries reaching agreement on a banking union, something which looks likely to be beset by significant delays and may, in its final form, be insufficient to break the link between banks and governments.

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[5] This section draws on analysis from the IMF *World Economic Outlook* (Oct-12), OECD *Economic Outlook* (Nov-12) and European Commission *Autumn Economic Forecast* (Nov-12)

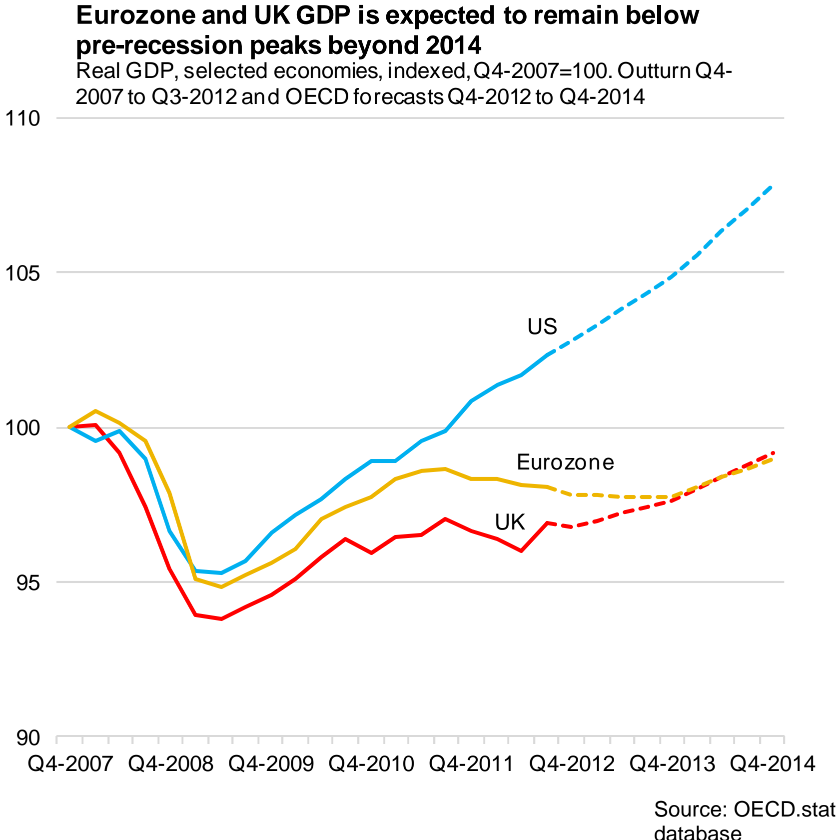
[6] This arises when governments are forced to recapitalise banks and/or guarantee their liabilities to avert a financial crisis. The size of these commitments raises questions about governments' solvency, pushing up their borrowing costs, and making them reliant on those same banks to lend money to them. The rise in government borrowing costs also imposes losses on bank holdings of government debt, creating further pressure on the financial system.

In the **United States**, a recovery is underway, with output rising at an annualised rate of 2.7% in the third quarter of 2012,[7] and labour and housing market conditions improving, albeit very gradually. The Federal Reserve has made two important pre-commitments: firstly, to purchase mortgage-backed securities at a rate of $40bn per month (quantitative easing) until there is 'ongoing, sustained improvement in the labour market'; secondly, to maintain interest rates at close to zero until at least mid-2015. These measures have provided confidence about the future path of monetary policy.

Such certainty does not exist, however, about fiscal policy. At the end of 2012, the US faces a so-called 'fiscal cliff' as a number of stimulus measures expire and, as a result of the 2011 deal that raised the US debt ceiling, automatic spending cuts begin. The effects of the consolidation would accrue gradually, the longer an agreement is delayed beyond 1 January 2013, and are expected to reduce US GDP by 2.9% in 2013 if the issues are left entirely unaddressed.[8] The cliff is the consequence of the patchwork approach to fiscal policy that has prevailed since the Democrats lost control of the House of Representatives in 2010 and because Congress has in the recent past eventually reached a compromise in such situations, most forecasters consider it unlikely that no agreement could be reached on any elements of the 'cliff'.

Eurozone and UK GDP is expected to remain below pre-recession peaks beyond 2014

Real GDP, selected economies, indexed, Q4-2007=100. Outturn Q4-2007 to Q3-2012 and OECD forecasts Q4-2012 to Q4-2014



Source: OECD.stat database

The pace of growth in emerging economies has slowed, partly reflecting the impact of the recession in Europe, and partly as a result of monetary policy tightening (raising of interest

[7] Equivalent to a quarter-on-quarter rate of 0.7%.
[8] Congressional Budget Office *Economic effects of policies contributing to fiscal tightening in 2013*, Nov-12

rates) earlier in the year in response to fears about economic overheating. Fiscal and monetary stimulus is expected to result in a pick-up in growth during 2013.

The eurozone crisis and the UK

Despite the focus on the eurozone's problems, the UK's economy has not grown significantly faster than the eurozone over the past two years, and its output remains further below the pre-recession peak (see chart).

The Government has distanced itself politically from the currency union through its refusal to sign the 'fiscal compact' Treaty, and the urgency of responding to the crisis has meant that the idea of a 'two-speed' Europe is being openly accepted even in Germany.[9] But despite the changing relationship between the eurozone and the rest of the EU implied by imperatives of the crisis response, and more vocal euroscepticism in the UK, the eurozone and UK economies for the time being will remain intertwined. Strong links through trade and the financial sector mean that, were the eurozone crisis to continue or worsen, it could further stifle the UK's faltering recovery. The importance of developments in the eurozone for the UK economy was underlined (not for the first time) in the Bank of England's Quarterly Inflation Report, published in November:

> The future path of GDP will depend critically on developments in the global environment, with strains in the euro area posing the greatest risk to a sustained recovery. [10]

Trade

With domestic demand weak, confidence low and credit conditions tight, exports are expected to make an important contribution to growth over the next two years. Most of the UK's exports to the eurozone go to 'core' countries (40% to France and Germany alone) that have performed far more strongly than the beleaguered periphery in the past, but which have recently started to see the effects of the crisis. This may account for a recent decline in the share of UK goods exports going to the eurozone (see chart). Demand for UK exports might also be affected were the euro to fall significantly against sterling, as might happen were the crisis to worsen. In light of these risks, Ministers have been speaking of cultivating 'alternative' export markets in emerging economies and the Commonwealth with a view to reducing the UK's reliance on the eurozone's fortunes.[11]

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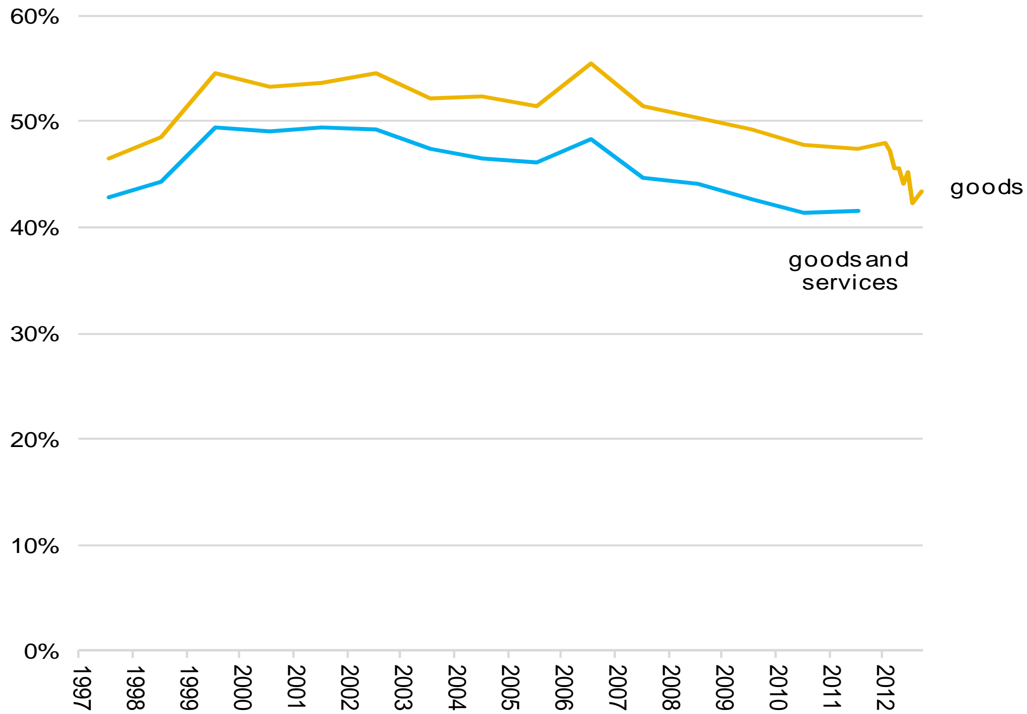
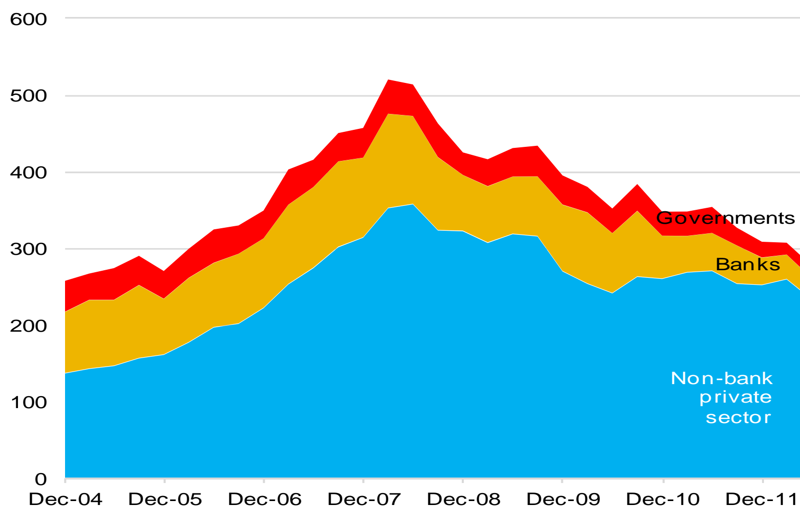
[9] See, for instance, "Merkel insists on two-speed Europe", *Financial Times*, 7 June 2012
[10] Bank of England *Quarterly Inflation Report*, November 2012
[11] See, for instance, speech by Mark Hoban MP, 8 December 2011



Financial sector

The UK's financial institutions are not heavily exposed to peripheral eurozone sovereign debt: total outstanding lending to the Greek, Irish, Portuguese, Italian and Spanish governments stood at $16.3bn at the end of June 2012, down from $40bn three years before. UK banks have scaled back their exposure across other sectors too (see chart), and total exposure to these countries across all sectors stood at $277bn at the end of June 2012.



But UK banks are also indirectly exposed to the eurozone periphery through their lending to other banks that do have significant exposure to these countries, most notably in France and Germany. Reflecting these financial linkages, 68% of respondents to the Bank of England's Systemic Risk Survey identified sovereign risk (for most, this meant the risk of a country defaulting and possibly leaving the euro)[12] as the single most important threat to UK financial stability, up from 60% in the first half of 2012.[13] Uncertainty and the risk of losses posed by UK financial institutions' exposure to the eurozone is also, according to the Bank, resulting in higher funding costs for banks, and hence tighter lending conditions for businesses and individuals.

In the worst case scenario of a disorderly eurozone breakup, the linkages between the eurozone and the UK would, in the view of many, precipitate a banking crisis in the UK and the requirement for urgent recapitalisation, possibly using public funds.

[12] Of those responses that indicated a particular area of sovereign risk, 79% cited Europe.
[13] Bank of England *Systemic Risk Survey Results H2 2012*

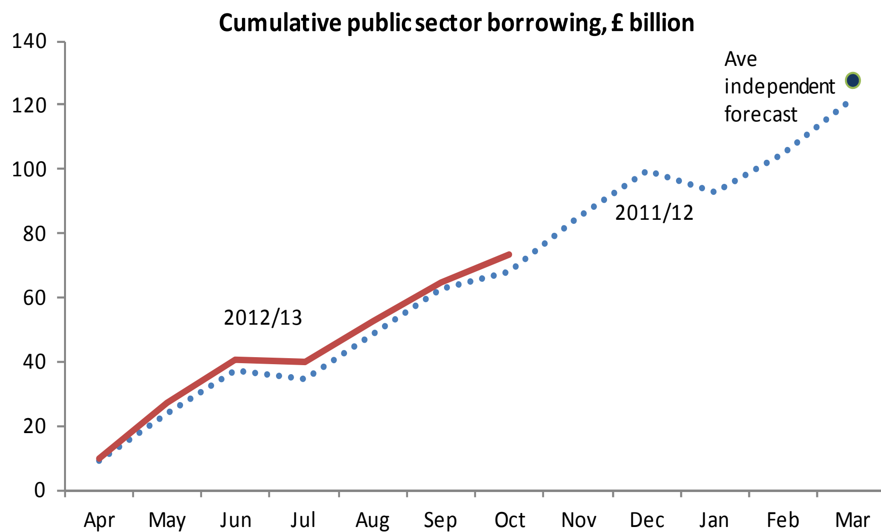
3 The public finances

3.1 Public sector net borrowing

Public sector net borrowing has fallen from 11.2% of GDP in 2009/10 to 8.0% in 2011/12. In cash terms, this is fall from £159 billion to £121 billion. At the Budget, the OBR forecast that borrowing would fall this year to 7.6% of GDP or £120 billion (5.8% of GDP or £92 billion if the effect of the Royal Mail pension fund is included – see box below for an explanation of this).

Borrowing this year is higher than in the same period last year (see chart below). Between April and October 2012, borrowing was 7.4%, or £5 billion, higher than in the same period of 2011/12, excluding Royal Mail. Over the year so far, central government receipts have increased by 0.4%, compared with the OBR's forecast of 3.7%. Corporation tax receipts have fallen by nearly 10% against a forecast increase of 4.0%.[14] The IFS has said that the fall in tax receipts is greater than that implied by low economic growth in 2012.[15] Public spending has also grown more slowly than forecast over the first seven months of this year, partially offsetting the shortfall in revenue. Between April and October, central government current spending grew by 2.3% compared with the same period last year. The OBR's March forecast was for growth of 3.0% in 2012/13 as a whole.

It seems likely that the OBR will revise up its forecast for borrowing in 2012/13 in the Autumn Statement. On average, independent forecasters currently predict borrowing in 2012/13 will be £8 billion higher than the OBR forecast. The IFS forecast that borrowing will be £13 billion higher.



14 OBR, *Commentary on the Public Sector Finances release: October 2012*, 21 November 2012

15 IFS, *Autumn Statement 2012: More fiscal pain to come*, 26 November 2012

Royal Mail pension fund and government borrowing

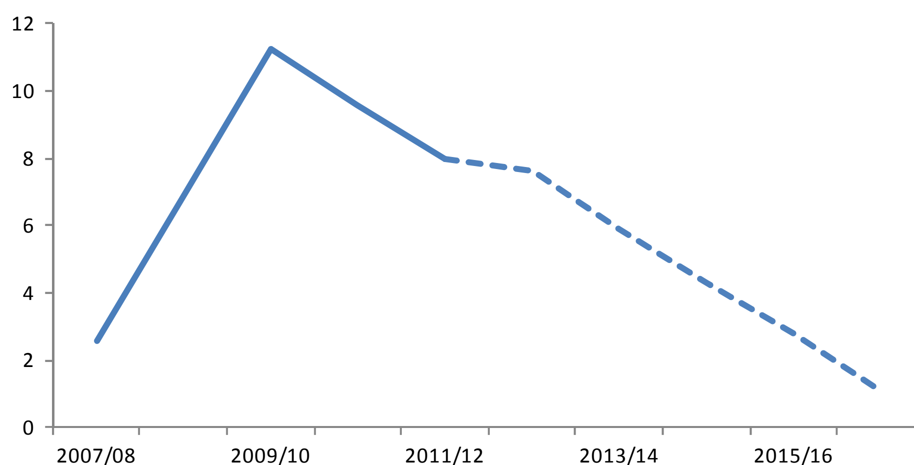
Government borrowing in 2012/13 is affected by the transfer of Royal Mail's historic pension deficit. This has a one-off effect of reducing borrowing by £28 billion (1.8% of GDP) in 2012/13. The figures in this note exclude this effect, except where stated otherwise, as this gives a better guide to the underlying state of the public finances. Further information is in Box 4.1 of the OBR's March 2012 *Economic and fiscal outlook.*

In March, the OBR forecast that borrowing would fall to 1.1% of GDP in 2016/17. Figures on government borrowing are in the table and chart below.

Public sector net borrowing

	£ billion	% GDP
2007/08	36.7	2.6
2008/09	97.5	6.9
2009/10	159.0	11.2
2010/11	141.7	9.6
2011/12	121.4	8.0
2012/13 (a)	120	7.6
2013/14	98	5.9
2014/15	75	4.3
2015/16	52	2.8
2016/17	21	1.1

Sources: ONS and OBR
Note (a): excludes effect of Royal Mail pension transfer in 2012/13
If this included, the figures are 5.8% of GDP and £92 billion in 2012/13



The IFS has also published forecasts for borrowing on two scenarios:

- An "optimistic scenario" in which the recent deterioration in the economy is mainly temporary
- A "pessimistic scenario" in which the recent deterioration in the economy is mainly permanent

In both cases, the IFS forecast for public borrowing is higher than the OBR's March forecast. Even under the optimistic scenario, the IFS forecast borrowing of 2.3% of GDP in 2016/17, compared with the OBR's 1.1%. In the pessimistic case, the IFS forecast borrowing of 3.1% of GDP in 2016/17.

Recent OECD forecasts suggest that UK government borrowing will remain high by international standards. In 2014, UK government borrowing is forecast to be 6.0% of GDP. This is higher than all other G7 economies, except Japan, and higher than both the Eurozone and OECD average.[16]

OECD forecasts of government borrowing (a)

% GDP

	2012	2013	2014
UK	**6.6**	**6.9**	**6.0**
Canada	3.5	3.0	2.5
France	4.5	3.4	2.9
Germany	0.2	0.4	0.7
Italy	3.0	2.9	3.4
Japan	9.9	10.1	7.9
US	8.5	6.8	5.2
Eurozone	3.3	2.8	2.6
OECD	5.5	4.6	3.6

Source: OECD Economic Outlook, No. 92, November 2012

(a) general government financial balance

3.2 Public sector net debt

Before the financial crisis, public sector net debt was below 40% of GDP. It has increased rapidly over the last few years, reaching 66% of GDP (just over £1 trillion) in 2011/12. In March, the OBR forecast that debt would continue to increase as a percentage of GDP until 2014/15, reaching 76.3% before falling to 76.0% in 2015/16.

[16] The OECD figures show borrowing increasing in 2013. This is presumably because the OECD figure for 2012 includes the effect of the Royal Mail pension transfer.

Public sector net debt

Outturns and OBR forecasts

	£bn	%GDP
2007/08	527	36.4
2008/09	624	44.5
2009/10	770	53.1
2010/11	910	60.4
2011/12	1,025	66.2
2012/13	1,159	71.9
2013/14	1,272	75.0
2014/15	1,365	76.3
2015/16	1,437	76.0
2016/17	1,479	74.3

Sources: ONS, OBR

Note: excluding financial interventions

The IFS has produced debt forecasts under optimistic and pessimistic scenarios (for details of these, see under borrowing above). Both these cases show higher debt levels than the OBR's March forecast.

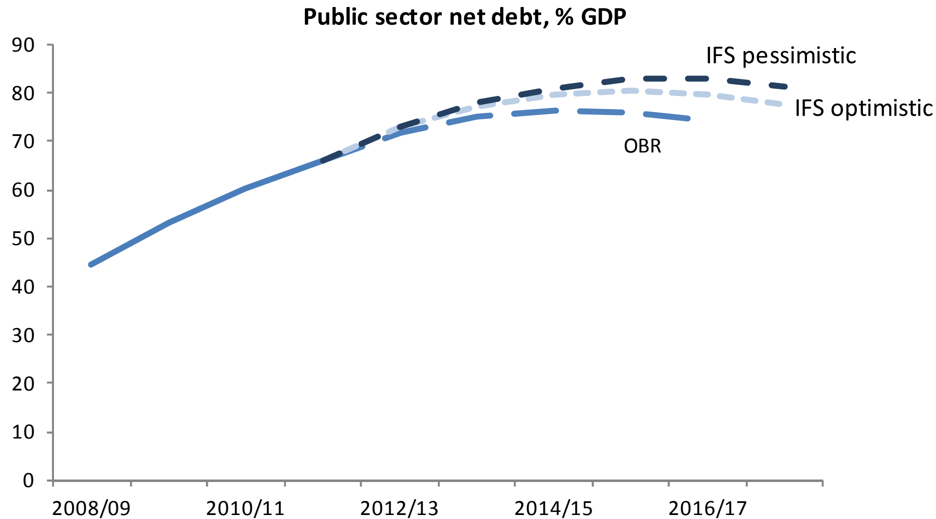
Public sector net debt: OBR and IFS forecasts

% GDP

	OBR	IFS optimistic	IFS pessimistic
2012/13	71.9	73.1	73.1
2013/14	75.0	77.1	77.9
2014/15	76.3	79.5	81.1
2015/16	76.0	80.5	82.8
2016/17	74.3	79.7	82.8
2017/18	..	77.5	81.2

Sources: OBR, IFS

Note: excluding financial interventions



The OECD's forecasts suggest that the UK's level of government debt, as a percentage of GDP, will be similar to the OECD average but higher than the Eurozone average. By 2014, UK government debt is forecast to be similar to that of the US and France, below Italy and Japan but higher than Canada and Germany.[17]

OECD forecasts of government debt (a)
% GDP

	2012	2013	2014
UK	**105.3**	**110.4**	**113.9**
Canada	85.8	85.5	86.0
France	105.1	108.2	109.7
Germany	87.6	86.2	85.1
Italy	127.0	129.6	131.4
Japan	214.3	224.3	230.0
US	109.8	113.0	114.1
Eurozone	100.6	102.5	103.4
OECD	108.7	111.4	112.5

Source: OECD Economic Outlook, No. 92, November 2012
(a) general government gross financial liabilities

[17] OECD figures are for gross debt. Figures for the UK published by the ONS are for net debt (ie they net off liquid financial assets).

3.3 The Government's fiscal rules

In its first Budget, the Government announced two fiscal rules relating to borrowing and debt. It is widely expected that the OBR's Autumn Statement will show that the debt rule will be broken, unless the Chancellor announces further tax increases or spending cuts.

The rules

In his first Budget, the Chancellor announced a "fiscal mandate":

> To achieve cyclically adjusted current balance by the end of a rolling five year period[18]

The current balance is a measure of government borrowing, excluding investment spending. There are a number of arguments for excluding investment spending from fiscal rules. First, it allows such spending to be protected. The 2011 Budget said that the fiscal mandate would focus on the current budget "to protect the most productive public investment expenditure."[19] In the past, public investment has sometimes been cut severely during times of public expenditure restraint.

Second, focusing on the current budget allows borrowing for the purpose of investment. This is often justified on the grounds that while future generations will pay for the borrowing, they will also get benefits from this spending.

The fiscal mandate also looks at a cyclically-adjusted measure of the deficit. This means that the mandate takes into account the fact that government borrowing fluctuates with the economic cycle. As a result, the mandate focuses on the structural, or underlying, element of the deficit.

In addition to the borrowing target, there is a supplementary target for government debt. This requires public sector net debt to be falling as a percentage of GDP at a fixed date of 2015/16.

Compliance with the borrowing rule

In March, the OBR concluded that the Government was on course to meet the fiscal mandate. The cyclically-adjusted current budget was forecast to move into surplus in 2016/17.

The borrowing rule has some built-in flexibility both in that it is measured at the end of a rolling-five year period and because it is measured adjusted for the economic cycle. This means that there is a greater chance that it will be broken if more of the downturn is attributed to structural factors. The more this is the case, a greater proportion of the deficit will be due to structural factors and less to the economic cycle. This, in turn, will increase cyclically-adjusted measures of borrowing and leave the Government less room for manoeuvre again its borrowing rule. It is, therefore, not so much changes in the growth forecasts, as the OBR's view on the structural position of the economy, which is relevant to the Government's chances of meeting its borrowing target.

This is illustrated by the IFS's recent forecasts. Under its optimistic scenario, higher borrowing is temporary and cyclical and the fiscal mandate would still be met. Under its pessimistic scenario, however, more of the higher borrowing is structural. As a result, the

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[18] At the 2012 Budget, the end of the five year period was 2016/17. In the Autumn Statement it will move forward by a year to 2017/18.

[19] HM Treasury, Budget 2011, para 1.25

fiscal mandate would be missed and the IFS estimate that the Government would need to find an extra £23 billion in tax increases or spending cuts to meet the borrowing target. This would be equivalent to increasing VAT from 20% to 25%.

Govermnent's fiscal mandate
Cyclically-adjusted current budget in balance or surplus by 2016/17

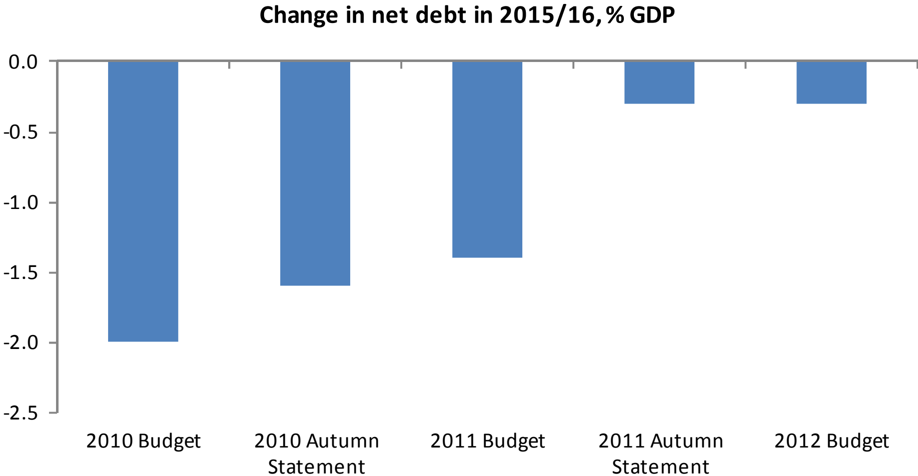
% GDP	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
OBR, March 2012	-4.2	-2.7	-1.5	-0.7	0.5	..
IFS Optimistic scenario, Nov 2012	-4.9	-2.8	-1.5	-0.7	0.5	0.6
IFS Pessimistic scenario, Nov 2012	-5.1	-4.2	-3.3	-2.7	-1.6	-1.5

Source: OBR, Economic and fiscal outlook, March 2012, Table 4.29, IFS, Autumn Statement 2012: more fiscal pain to come?
Note: (a) negative figures indicate deficit, positive figures indicate surplus
(b) the reference year for the fiscal mandate is currently 2016/17. At the Autumn Statement w ill be 2017/18

Compliance with the debt rule

The supplementary debt rule is much less flexible than the fiscal mandate: it is not adjusted for the cycle and the date when it must be achieved is fixed. In the Budget, the OBR's central forecast was that debt would fall from 76.3% of GDP in 2014/15 to 76.0% in 2015/16 (see chart below). The debt rule would be met on the basis of this forecast but only by 0.3% of GDP. It would take only a small deterioration in the economic outlook for the rule to be breached.

The margin by which the debt rule is met has become much smaller over time, as the chart below shows. In the Government's first Budget, debt was forecast to fall in 2014/15 – a year earlier than required by the rule – and to fall by 2% of GDP in 2015/16. The OBR's March forecasts show that debt starts to fall in 2015/16 by only 0.3% of GDP.



The narrow margin by which the rule is met, together with the weaker performance of the economy since the Budget, has led to speculation that the supplementary debt target may be breached. This is because borrowing over the next few years is likely to be higher than

forecast at the Budget. The latest independent forecast is for borrowing of £83.5 billion in 2015/16, compared with the OBR's Budget forecast of £52 billion.

The debt rule would be broken on both the IFS's scenarios: debt increases in 2015/16 by 1.0% of national income under their optimistic scenario and by 1.7% under the pessimistic scenario. The IFS calculate that taxes would have to rise and/or spending be cut by £16 billion under the optimistic scenario or £27 billion under the pessimistic for the debt rule to be met.

Govermnent's supplementary debt rule

Public sector net debt to be falling in 2015/16 as a % of GDP

% GDP	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**
OBR, March 2012	71.9	75.0	76.3	76.0	74.3	..
IFS Optimistic scenario, Nov 2012	73.1	77.1	79.5	80.5	79.7	77.5
IFS Pessimistic scenario, Nov 2012	73.1	77.9	81.1	82.8	82.8	81.2

Sources: OBR, Economic and fiscal outlook, March 2012, Table 4.29
IFS, Autumn Statement 2012: more fiscal pain to come?

The IFS have criticised the debt rule on the grounds that it does not ensure fiscal sustainability as it relates to only a single year. In addition, attempting to meet the rule, irrespective of the state of the economy, could lead to policy being tightened too much. The IFS recommend that the Treasury abandon the debt target and consult on finding a replacement which brings about long-term sustainability.[20]

[20] IFS, *Autumn Statement 2012: More fiscal pain to come*, 26 November 2012

Quantitative easing and the public finances

The Government has announced that interest payments on government debt held by the Bank of England under quantitative easing will be returned to the Treasury. Until now, these have been held by the Bank of England in the Asset Purchase Facility. The sum of money involved is considerable: it is estimated that £35 billion will have accumulated by March 2013. £11 billion of this will be transferred to the Exchequer in 2012/13 and £14 billion in 2013/14. From 2013/14, the ongoing cash surplus will be transferred on a quarterly basis. According to the Government, this change will allow it to manage its cash more efficiently as it will no longer need to borrow to fund interest payments going to the Bank. The Government says the measure will also improve transparency and bring UK practice into line with other countries, including the US and Japan.

In the short term, this measure will reduce borrowing. In the longer term borrowing may increase as the cash flow is reversed, for example to cover capital losses on gilts as QE is unwound. The OBR commented on this as follows:

> Today's decision should not in itself have a significant impact on the eventual aggregate net profit or loss to the Exchequer from QE. That said, the Government is likely to issue fewer gilts in the near term and more in the longer term than it otherwise would have done. And if government borrowing costs rise over time as the economy recovers, or for other reasons, then debt interest payments will be higher in the future. This may outweigh the lower costs in the preceding years. (Source: OBR Press Notice, *Asset Purchase Facility*, 9 November 2012)

The ONS is yet to make a decision on how the change will be reflected in the public finance statistics and will not publish its view until January. The OBR has suggested that the transfer of the £35 billion expected to have accrued by March 2013 would reduce debt but not borrowing while ongoing transfers would affect both.

The IFS has recommended that the fiscal rules be assessed using public finance measures which exclude the effect of this change. In the past, credibility has been damaged when accounting or other changes have been introduced with the effect of making the fiscal rules easier to meet at a time when they were in danger of being breached.

The Chancellor said that the impact of this decision would be set out in the OBR's *Economic and fiscal outlook* published alongside the Autumn Statement. In response to a question from Ed Balls, the Chancellor said:

> Finally, let me deal with the asset purchase facility coupons. This was done with the support and acceptance of the Governor of the Bank of England and the Monetary Policy Committee, which discussed it and agreed that that was a more transparent way of accounting for the quantitative easing coupons and how they will affect the public finances through the coming years. I can confirm for the right hon. Gentleman that when the Office for Budget Responsibility produces its report next week for the autumn statement, it will clearly show the impact of the APF coupons on the public finances, both before and after. (HC Deb 26 November c25)

3.4 Public spending after 2014/15

In last year's Autumn Statement, the Government set out plans for total public spending in 2015/16 and 2016/17 to grow at the same rate as over the period 2010/11 to 2014/15. The Government also announced that capital spending would be held constant in real terms from 2014/15 onwards.[21]

The 2012 Budget contained a discussion of how this overall reduction in public spending could be achieved by looking at the trade-offs between welfare and other types of spending.[22] Without further reductions in welfare spending, departmental spending would be cut by more on average in 2015/16 and 2016/17 than during the period covered by the 2010 Spending Review.[23] If further reductions in welfare spending could be found, this would reduce the savings in departmental spending needed to keep within the Government's limits for total spending. The Budget provided an illustrative example of the trade-off showing that an extra reduction in welfare spending of around £10 billion (£8 billion at today's prices) by 2016/17 would be required to keep the reductions in departmental spending in 2015/16 and 2016/17 at the same level as the 2010 Spending Review period.

Under the IFS pessimistic scenario, greater cuts in public spending would be needed:

> Under our 'pessimistic' scenario, most of the additional short-term borrowing would be structural. As a result, an additional £23 billion of tax increases or spending cuts would need to be announced on top of those planned in the March 2012 Budget, to come in no later than 2017–18, if the Chancellor wished to continue to meet his fiscal mandate. Under this outlook, even if the Chancellor extended to 2017–18 the same average squeeze on public service spending that is currently planned for the Spending Review 2010 period, and implemented the £8 billion of welfare cuts mooted in his March Budget Speech, he would still need to plan for a further £11 billion of tax increases or welfare cuts in order to comply with his fiscal mandate.[24]

3.5 Fuel duty

Fuel duty is due to rise by 3p in January 2013. This increase was due to be introduced in August 2012. However, the Government announced in June that this would be postponed until January, at a cost of £550 million. The cost is to be met through greater than forecast savings in departmental budgets. Details are to be provided in the Autumn Statement.[25]

The Labour Party has called for January's increase in fuel duty to be postponed until at least April, paid for by clamping down on tax avoidance.[26] In the debate on 12 November 2012, Exchequer Secretary David Gauke defended the Government's record on fuel duty:

> We know that high oil prices are causing real difficulties in ensuring that motoring remains affordable. We have listened to hard-pressed motorists and businesses, and we have acted. This Government have acted by easing the burden on motorists by £5.5 billion between 2011 and 2013 and by cutting fuel duty. We acted by cancelling the previous Government's fuel duty escalator for the rest of the Parliament and by

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21 Excluding one-off investments in infrastructure announced in the 2011 Autumn Statement .

22 HM Treasury, *Budget 2012*, Annex A

23 Departmental spending refers to resource Departmental Expenditure Limits (DEL). This excludes Annually Managed Expenditure (AME). Welfare spending is the largest elements of AME ,although it does include debt interest payments.

24 IFS, *Autumn Statement 2012: More fiscal pain to come*, 26 November 2012, p21

25 *Chancellor announces support for motorists,* HM Treasury Press Notice, 26 June 2012

26 See Opposition Day debate, HC Deb 12 November 2012, cc89-141

> introducing a fair fuel stabiliser, so that fuel duty will increase by inflation only when oil prices are high. We acted to ensure that there will be no increase in fuel duty this year by deferring the next increase to January. That action ensures that duty at the pump will have been frozen for 21 months, and pump prices are now 10p lower than under Labour's plans. Even following the inflation increase in January, average pump prices could still be approximately 6p a litre lower than if we had implemented the previous Government's fuel duty escalator in 2011 and 2012. That means that a typical Ford Focus driver will be £159 better off between 2011 and 2013, and that the average haulier will benefit by approximately £4,900 during the same period.[27]

There has been speculation that the Government might announce a further deferral of the fuel duty increase in the Autumn Statement.[28]

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[27] HC Deb 12 November 2012, cc131-2

[28] See, for example, *Guardian*, "Treasury to defer planned increase in fuel duty" 13 November 2012 and "Planned 3p petrol increase could be abandoned", *Telegraph website*, 11 November 2012

4 Links to further information

HM Treasury
Budget 2012: http://www.hm-treasury.gov.uk/budget2012.htm

2010 Autumn Statement: http://www.hm-treasury.gov.uk/as2011_index.htm

Forecasts for the UK economy, a comparison of independent forecasts:
http://www.hm-treasury.gov.uk/data_forecasts_index.htm

Public finances databank: http://www.hm-treasury.gov.uk/psf_statistics.htm

Office for Budget Responsibility

Economic and fiscal outlook, March 2012
http://budgetresponsibility.independent.gov.uk/wordpress/docs/March-2012-EFO1.pdf

Economic and fiscal outlook, November 2011
http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/

Commentary on monthly public finance figures
http://budgetresponsibility.independent.gov.uk/category/topics/monthly-public-finance-data/

Institute for Fiscal Studies

Autumn Statement 2012: More fiscal pain to come http://www.ifs.org.uk/bns/bn136

IFS Autumn Statement page: http://www.ifs.org.uk/projects/401

Commentary on monthly public finance figures:
http://www.ifs.org.uk/publications/browse?type=pf

Treasury Select Committee

Report on 2012 Budget:
http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1910/191002.htm

Government response:
http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/422/42202.htm

House of Commons Library

Economic Indicators Research Paper: http://hcl1.hclibrary.parliament.uk/wdw/subject/ei.asp
External users:
http://www.parliament.uk/briefing-papers/commons-research-papers/economy-and-finance/economic-situation/

5 Economic and public finance data since 1979

Economic data 1979-2016

		Inflation		Claimant count
	GDP growth, %	RPI, %	CPI, %	millions
1979	2.8	13.4	..	1.06
1980	-2.0	18.0	..	1.35
1981	-1.3	11.9	..	2.15
1982	2.2	8.6	..	2.52
1983	3.8	4.6	..	2.76
1984	2.9	5.0	..	2.89
1985	3.9	6.1	..	3.00
1986	4.3	3.4	..	3.07
1987	5.2	4.2	..	2.78
1988	5.6	4.9	..	2.25
1989	2.6	7.8	..	1.77
1990	1.8	9.5	..	1.65
1991	-1.8	5.9	..	2.27
1992	0.9	3.7	..	2.74
1993	3.1	1.6	..	2.88
1994	4.6	2.4	..	2.60
1995	3.2	3.5	..	2.29
1996	3.1	2.4	..	2.09
1997	3.9	3.1	1.8	1.58
1998	3.5	3.4	1.6	1.35
1999	3.2	1.5	1.3	1.25
2000	4.2	3.0	0.8	1.09
2001	2.9	1.8	1.2	0.97
2002	2.4	1.7	1.3	0.95
2003	3.8	2.9	1.4	0.93
2004	2.9	3.0	1.3	0.85
2005	2.8	2.8	2.1	0.86
2006	2.6	3.2	2.3	0.95
2007	3.6	4.3	2.3	0.86
2008	-1.0	4.0	3.6	0.91
2009	-4.0	-0.5	2.2	1.53
2010	1.8	4.6	3.3	1.50
2011	0.9	5.2	4.5	1.53
2012	0.8	3.2	2.8	1.65
2013	2.0	2.3	1.9	1.64
2014	2.7	2.5	1.9	1.52
2015	3.0	3.6	2.0	1.35
2016	3.0	4.0	2.0	1.19

Sources: ONS series: GDP ABMI, Inflation CZBH, D7G7, Claimant count BCJD
Forecasts are from OBR, Economic and fiscal outlook, March 2012, Table 3.1

Public finance data since 1979-80 to 2016-17 - outturns and OBR forecasts (March 2012)

	Public sector net borrowing		Structural deficit	Public sector net debt
	£ billon	% GDP	% GDP	% GDP
1979-80	8.5	4.1	4.0	44.0
1980-81	11.5	4.8	3.4	46.1
1981-82	6.0	2.3	-1.5	46.1
1982-83	8.5	3.0	-1.4	44.8
1983-84	11.7	3.8	0.0	45.1
1984-85	12.2	3.7	0.6	45.1
1985-86	8.7	2.4	0.6	43.2
1986-87	8.1	2.0	1.9	40.9
1987-88	4.4	1.0	2.2	36.6
1988-89	-6.4	-1.3	1.3	30.4
1989-90	-1.0	-0.2	2.6	27.5
1990-91	5.8	1.0	2.6	26.0
1991-92	22.5	3.7	3.3	27.2
1992-93	46.6	7.4	5.5	31.4
1993-94	51.0	7.6	5.4	36.5
1994-95	43.3	6.1	4.7	40.1
1995-96	34.7	4.6	3.8	41.9
1996-97	27.1	3.4	2.8	42.1
1997-98	5.8	0.7	0.6	40.4
1998-99	-4.5	-0.5	-0.2	38.2
1999-00	-15.6	-1.7	-1.1	35.7
2000-01	-40.0	-4.1	-1.1	30.8
2001-02	0.8	0.1	0.2	29.8
2002-03	26.0	2.4	1.9	30.9
2003-04	33.3	2.9	2.6	32.2
2004-05	41.1	3.4	3.1	33.9
2005-06	37.9	3.0	2.8	35.1
2006-07	33.1	2.5	2.3	35.8
2007-08	36.7	2.6	2.6	36.4
2008-09	97.5	6.9	6.4	44.5
2009-10	159.0	11.2	8.9	53.1
2010-11	141.7	9.6	7.0	60.4
2011-12	121.4	8.0	6.4	66.2
2012-13	120	7.6	4.0	71.9
2013-14	98	5.9	4.1	75.0
2014-15	75	4.3	2.9	76.3
2015-16	52	2.8	1.9	76.0
2016-17	21	1.1	0.7	74.3

Sources: ONS series -J5II, J5IJ, HF6X, HM Treasury Public finances databank, Table A1 and OBR, March 2012, Table 4.29
Note: figures exclude temporary effects of financial interventions and the effect of Royal Mail pension transfer