Autumn Statement 2014: Background briefing

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The 2014 Autumn Statement will take place on Wednesday 3 December. This note sets out the background to the Statement and the forecasts for the economy and public finances which will be published by the Office for Budget Responsibility (OBR).

The Library will publish a special edition of Economic Indicators on Tuesday 2 December.

A separate Library note will be published shortly after the Autumn Statement, summarising its main points.

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1 Summary

The 2014 Autumn Statement comes at a time when the UK economy is experiencing strong growth - the fastest of the G7 economies in 2014 - and a historically high employment level of 30.79 million, with an employment rate back at its pre-recession peak.

Despite the strong labour market, pay growth remains slow and lags behind inflation. However, threats to economic growth largely come from abroad, and in particular the Eurozone where growth is sluggish, unemployment persistent, and deflation a very real risk.

Government borrowing has fallen by over £50 billion since 2009/10 to £98 billion in 2013/14. A further decrease of £11 billion in 2014/15 was forecasted by the OBR in March, but data so far this year have not been promising: borrowing is up 6.1% on the same period in 2013/14. The OBR looks set to decrease its forecast for receipts following weaker than expected performance in the year so far.

An updated Charter for Budget Responsibility will be published alongside the Autumn Statement. Media reports suggest that it will include a target to eliminate the cyclically-adjusted current budget by 2017/18. This measure of the deficit is adjusted for the economic cycle and excludes spending on investment. The current fiscal mandate is for the cyclically-adjusted current budget to be achieved by the end of a rolling five year period.

In his statement to the House the Chancellor is expected to announce the Government's decision on whether to devolve corporation tax powers to the Northern Ireland Assembly. This issue is discussed in full in appendix 3.

2 Economic situation

2.1 Summary

The performance of the economy has been strong during 2014, with annual GDP growth of around 3%. This has been underpinned primarily by consumer spending and investment. Growth has been entirely driven by domestic factors, with weak exports providing no contribution. The overall outlook remains positive, with GDP growth in 2015 forecast to slow only slightly from its current pace. The most prominent risks emanate from abroad, the most serious of which comes from the eurozone.

Weakness in the eurozone is one of the factors that is likely to delay the point at which the Bank of England raises interest rates. Another factor is low inflation. A steep fall in oil prices and declines in food prices have helped lower inflation to 1.3%, well below the Bank's target of 2.0%. Expectations of the first rate rise have been pushed back to the second half of 2015. Earlier this year, most economists thought they would begin to rise in early 2015.

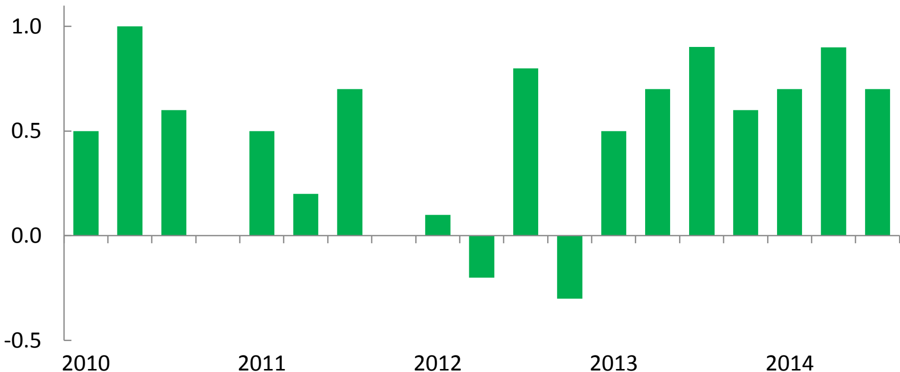
The labour market remains strong with the proportion of the working age population in employment at near-record levels and unemployment falling steeply to 6.0% from 7.6% a year ago. Despite this, growth in earnings remains subdued and continues to lag behind inflation (though there are some tentative signs that pay growth is starting to pick up).

A key influence on the future path of interest rates and fiscal policy is the size of the economy's output gap – the difference between actual output and the output level that could be achieved if the economy was operating at full capacity. Some believe that spare capacity still exists, meaning interest rates can stay low for longer and that some of the budget deficit will disappear once the economy is back to its full potential. However, others think that the economy is already operating at or near its potential, meaning that interest rates may have to rise sooner and that the budget deficit is entirely structural in nature reflecting underlying factors independent from the performance of the economy.

2.2 GDP growth

The UK economy continues to grow briskly, with growth of 0.7% in Q3 2014 compared with the previous quarter. This is in line with average quarterly growth recorded since the beginning of 2013 when the recovery took hold. This period of expansion is the most consistent since before the 2008-2009 recession. The economy is now 3.4% larger than it was at its pre-recession peak level of Q1 2008.

Recovery in real GDP growth has been sustained since early 2013
% change in real GDP on previous quarter

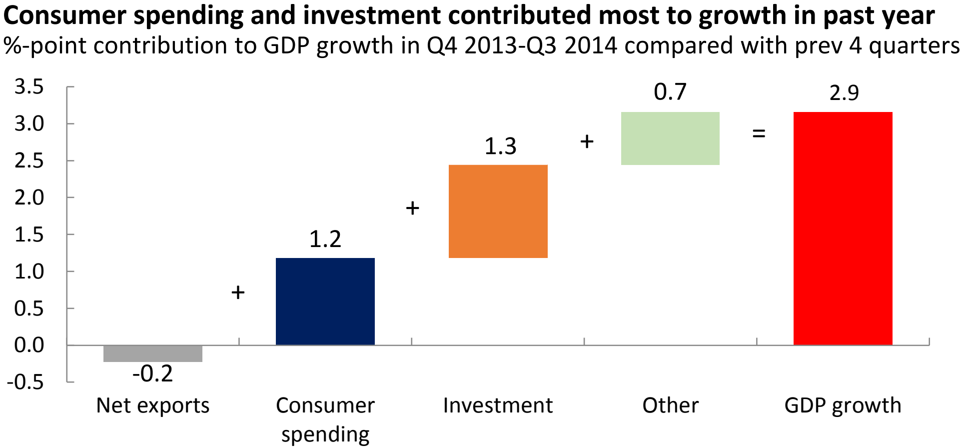


Source: ONS, series IHYQ

Recently-completed changes to the way GDP is measured revised growth since the recession upwards with GDP estimated to have returned to its pre-recession level almost a year earlier than previously estimated – in Q3 2013 instead of Q2 2014.[1] The revisions also changed our understanding of how balanced the recovery has been. The old figures showed that growth was mostly dependent on consumer spending; the new figures show investment making an almost equally important contribution to growth. Net trade (exports minus imports), though, has been a small drag on growth during the recovery. Over the past year, this trend has continued, with growth coming exclusively from domestic sources, with an almost equal contribution from consumer spending and investment (total investment is expected to rise by around 8% in 2014).

Consumer spending and investment contributed most to growth in past year

%-point contribution to GDP growth in Q4 2013-Q3 2014 compared with prev 4 quarters



Source: Calculations based on data in ONS, Second Estimate of GDP Q3 2014

Consumer spending

Household expenditure, or consumer spending, is a crucial part of the economy, accounting for over 60% of GDP. Growth in 2012 (1.5%) and 2013 (1.6%) was steady if unspectacular but has accelerated since the beginning of 2014. In Q3 2014, household expenditure rose by 2.4% compared with the same period in 2013 – the fastest growth rate since early 2008.

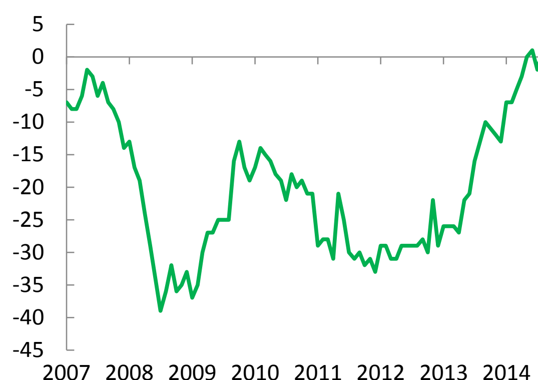
This expansion in consumer spending comes despite sustained declines in real earnings since the recession. Consumers appear to have been more willing to spend more of their income, possibly supported by greater confidence in the economy. The charts below show a general downward trend in the household savings ratio (the proportion of disposable income that is saved) and rising consumer confidence since 2013, as measured by the GfK's consumer confidence index.

[1] For more detail see Library Note SN6982, "GDP and the national accounts: 2014 revisions"

Household savings ratio has fallen
% of disposable income saved

Source: ONS, series NRJS

Consumer confidence has risen
% balance expecting improvement/deterioration



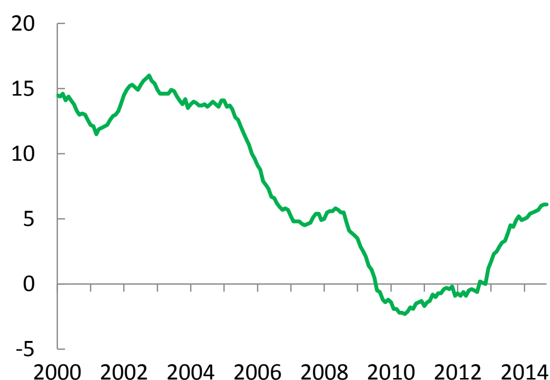
Source: GfK NOP for EC, Consumer Confidence

Other factors lifting consumer spending include the recent strength in the housing market and a rise in borrowing. Growth in personal borrowing (this does not include mortgages or student loans) has accelerated since early 2013. However, growth rates remain at sustainable levels and well below the rapid growth seen in the early- to mid-2000s.

Since the beginning of 2013 the housing market has been buoyant, with average property prices rising by around 16% nationally between January 2013 and September 2014.[2] Higher property prices can boost economic growth as households become wealthier and therefore more confident and secure in their financial situation. This can lead them to spend more of their income, dip into their savings and borrow more (as their underlying financial situation has improved). A rise in the number of housing transactions can also boost growth due to the costs involved in moving and the increased likelihood that those moving home will spend money on new furniture and home improvements.

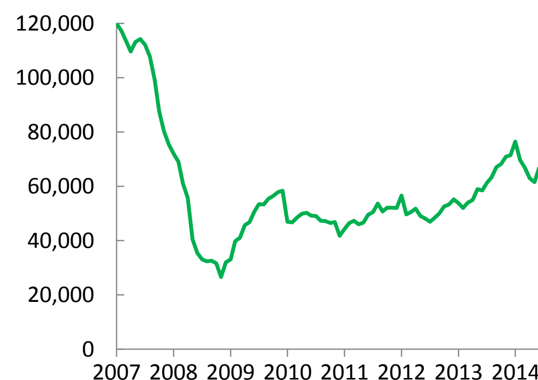
In recent months, there have been signs that the housing market is cooling off. The average UK house price fell slightly in September compared with August and other indicators have also shown the market slowing. Mortgage approvals, a leading indicator of transactions, have fallen by 20% since the beginning of 2014 (see chart). Tougher mortgage rules introduced in the spring may have had an effect, making lenders more cautious, although there may well be a more generalised slowdown underway.

Unsecured personal borrowing has picked up
12-month growth rate



Source: Bank of England, series LPMB4TC

Mortgage approvals have slowed recently
Number approved per month



Source: Bank of England, series LPMVTVX

2 ONS, *House Price Index, September 2014*

For the current pace of consumer spending growth to be sustained it is likely that growth in real household incomes will have to improve. With inflation easing (see section 2.3 below) and some tentative indications that nominal wages growth is picking up, this may well happen. However, many predictions in recent years of faster growth in earnings have come and gone. An increase in already-high levels of household debt could also help sustain consumer expenditure, although the downsides to this scenario are evident in our recent economic history.

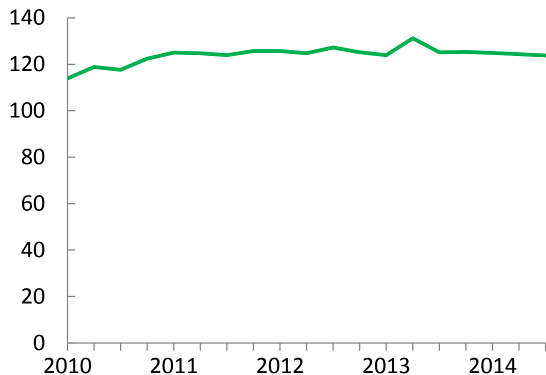
Trade and current account

The contribution of exports to the recovery has been disappointing. The volume of goods and services exports has barely changed over the past four years (see chart). The weak recovery in the eurozone has been one contributing factor. Meanwhile, import volumes over this period have also remained fairly steady, meaning that overall net trade has not contributed at all to GDP growth in recent years.

The UK's current account balance – the trade balance plus the balance in income and transfers moving in to and out of the UK – has deteriorated in recent years. In recent quarters the deficit has been around 5% of GDP, the second largest deficit in the OECD behind Turkey. The last and only time (since at least the war) we have seen a current account deficit as large as this was in the late 1980s, when the UK economy was booming and imports were rising much faster than exports. The reason for the deficit this time is different. The trade deficit is actually at an unremarkable 2% of GDP. The reason for the widening current account deficit is that the return on foreign investments – in the form of profits, dividends and interest receipts/payments – has fallen in recent years. Some of this is likely due to the weakness in the eurozone and low yields on foreign government debt. With some uncertainty as to the full explanation for this decline, economists aren't sure if income earned abroad will pick up again.

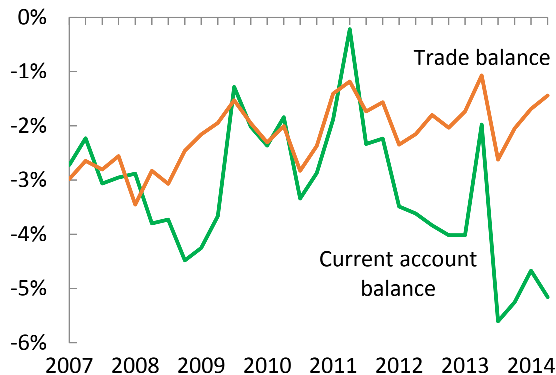
Any deficit is sustainable as long as foreign investors are willing – in the form of foreign direct investment or by lending money to the UK – to fund this deficit. At the moment, this is certainly the case. The UK has no trouble in attracting this foreign money, as evidenced by the stronger pound over the past 18 months. Nevertheless, with a less positive outlook for international growth, exports may weaken, widening the trade deficit and exacerbating the current account shortfall. This may test investors' confidence in the UK and could lead to money being pulled out of the UK, lowering the pound. Of course, there are many hypotheticals in this scenario but it is worth remembering that the current account deficits of this size in advanced economies are unusual.

Export volumes have been flat in recent years
£ billion, quarterly goods and services exports



Source: ONS, national accounts, sereis IKBH

Current account deficit has widened
% of GDP, quarterly data



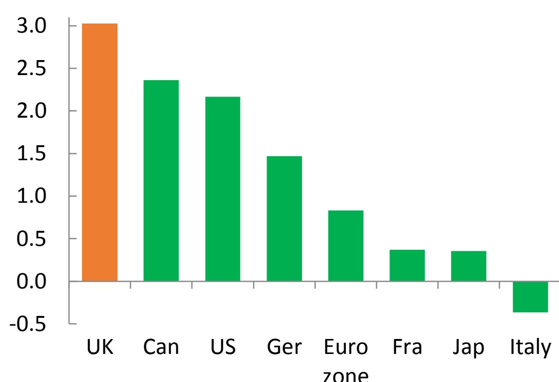
Source: ONS, balance of payments data

Growth forecasts

Growth during 2014 has been slightly faster than forecasted at the time of the Budget in March. Then the OBR and the consensus of independent forecasters was for annual growth of 2.7% in 2014.[3] The current consensus estimate is 3.0%, while the Bank of England's latest forecast expects growth to be higher at 3.5%.[4] For 2015, the OBR in March forecast growth of 2.3% which may be revised slightly higher; the consensus is for growth of 2.6%, with the Bank of England expecting growth of 2.9%.

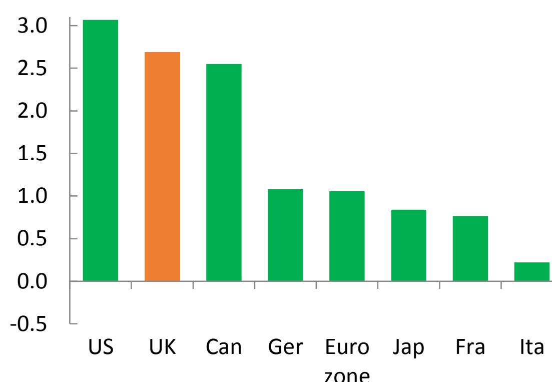
Economic indicators remain generally positive and forecasts for growth in both 2014 and 2015 have remained stable in recent months, although there have been signs of a slowdown in the housing market and in manufacturing. Risks to the outlook though come predominantly from abroad, as weakness in the eurozone economy persists and growth in emerging markets slows (see section 2.9 for more on the international economy). The OECD, in forecasts released on 25 November, expect the UK to have the fastest growth rate (3.0%) of any G7 economy in 2014 and the second highest (2.7%) in 2015 behind the US (3.1%).

UK to have highest growth in G7 in 2014...
OECD GDP growth forecast of Nov 2014



Source: OECD, Economic Outlook

... and second highest in 2015
OECD GDP growth forecast of Nov 2014



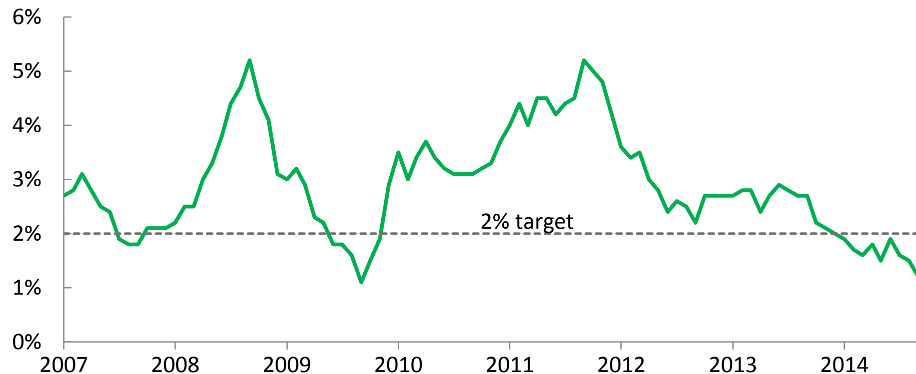
Source: OECD, Economic Outlook

2.3 Inflation and monetary policy

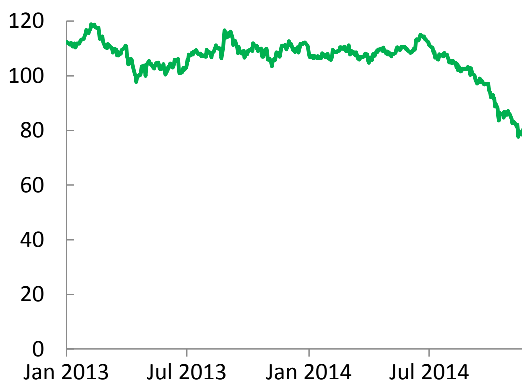
Since topping 5% in the autumn of 2011, inflation has eased and fell below the Bank of England's 2% target rate in January 2014 for the first time since the immediate aftermath of the recession (see chart). Since then, inflation has continued to slow over the course of this year and currently stands at 1.3%.

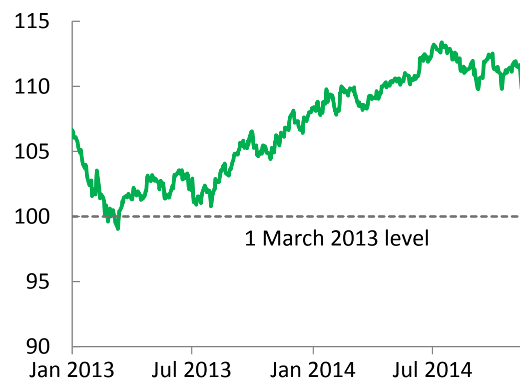
[3] OBR, *Economic and fiscal outlook – March 2014*, p87, table 3.6 and HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, March 2014

[4] Bank of England, "Inflation report press conference – Opening remarks by the Governor", 12 Nov 2014



Falling food and petrol prices are the main factors behind the slowing inflation. Over the past year, food prices have fallen by 1.6%, driven lower by price wars amongst the supermarkets as the discount chains have taken a larger share of the market. Motor fuels have declined at an even faster pace and are 4.8% lower than a year ago, with prices at the pump the lowest since January 2011. This is a result of steep falls in global oil prices (see chart) – down 30% over the past six months – a consequence of increases in supply (most notable from the US) and falling demand from a weak eurozone and slowing growth in emerging economies.[5] Another factor helping to push inflation lower is the rise in the pound since March 2013 (see chart). A stronger pound has made imports of goods and services, including of fuel and food, cheaper.





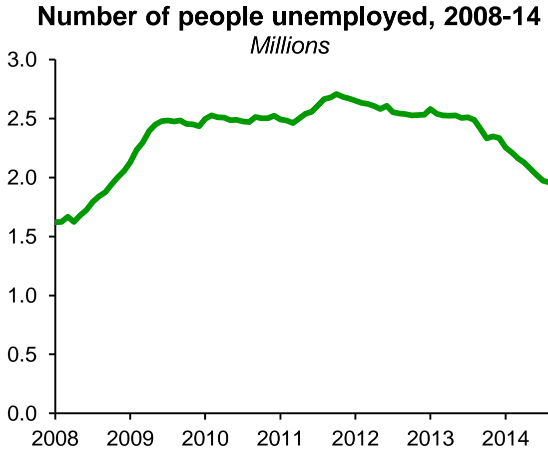
The Bank of England's Monetary Policy Committee (MPC) has not altered interest rates since March 2009. The base rate remains at the historically low level of 0.5%. There had been an expectation earlier this year that due to the stronger economy the MPC would begin to raise rates in early 2015. In recent months, however, lower inflation, evidence of continued weakness in the growth rate of pay and of productivity, and heightened concerns over the outlook for the eurozone have pushed back expectations of a rate rise to the second half of 2015. A recent poll of economists by Reuters found that around two-thirds forecast rates to go up to 0.75% in Q3 2015, while the financial markets are pricing in a rate rise during

[5] ONS, "What is affecting prices in the UK in 2014?", 7 November 2014 and ONS, "Rate of Inflation rises, but food and motor fuels prices continue to fall", 18 November 2014

Q4 2015.[6] So it appears likely that this will be the first Parliament since Clement Atlee was Prime Minister during 1945-1951 to not see any change in the official interest rate.

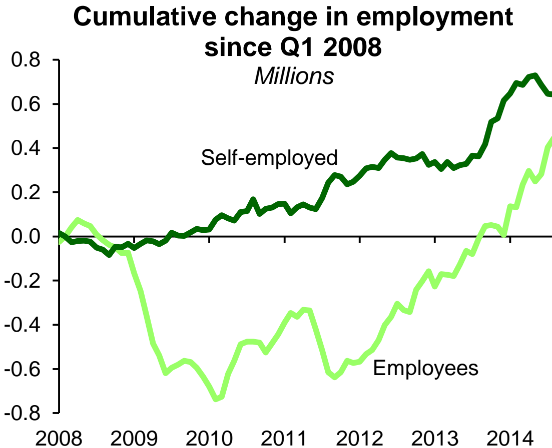
2.4 Strong employment growth since 2013

UK employment has been growing strongly since the spring of 2013 and is currently at record highs. 30.79 million people were in employment at Q3 2014, almost 700,000 more than in the same period the year before. The employment rate (the proportion of people aged 16-64 who are in work) in Q3 2014 was the same as its pre-recession peak of 73.0%, having climbed from 71.6% the year before.[7] The female employment rate was 68.1%, the highest on record.



These large increases in employment have been accompanied by steep falls in unemployment, which stood at 1.96 million in Q3 2014. This is 529,000 lower than the year before (in fact, the annual reduction in unemployment in the year to June-August 2014 was the largest since comparable records began in 1971) but is still higher than pre-recession levels: there were 1.62 million people unemployed at the start of 2008. The unemployment rate was 6.0%, down from 7.6% in Q3 2013.

This recent employment growth reflects both rising numbers of employees and people working as self-employed: in the year to Q3 2014, employee numbers increased by 454,000 (1.8%) and self-employment increased by 279,000 (6.6%). Self-employment rose sharply during late 2013 and early 2014, but dropped in the most recent quarter (down 88,000) as shown in the chart.



2.5 But pay growth remains muted

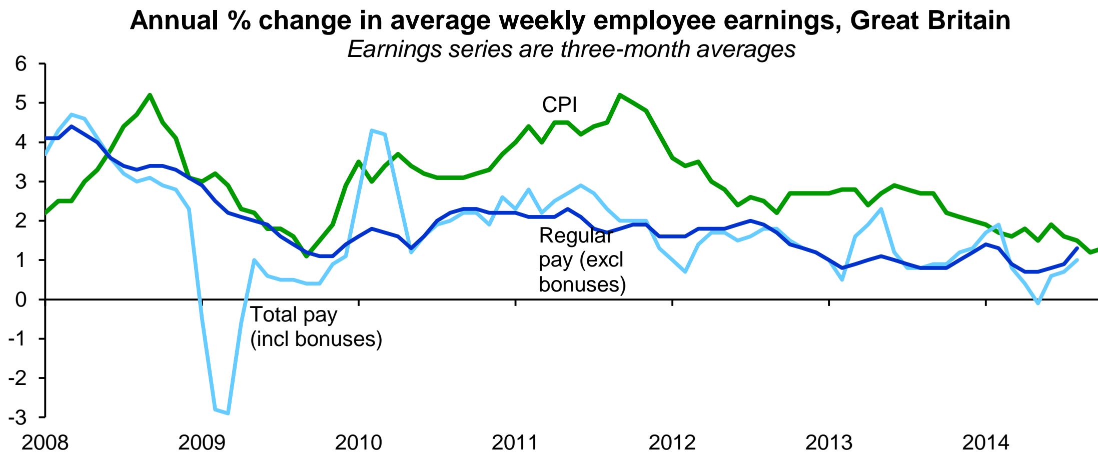
Despite the recent rises in employment and reductions in unemployment, growth in employee earnings has remained stubbornly low and continues to lag behind inflation.

Average weekly employee pay in Great Britain was 1.0% higher in the three months July-September 2014 compared to the year before, or 1.3% higher excluding bonus payments. By

6 "First BoE hike pushed to Q3 2015 - Reuters poll", Reuters, 27 November 2014

7 All data in this section are taken from ONS *Labour Market Statistics, November 2014*, 12 November 2014

comparison, CPI inflation was 1.2% in September (over the three months July-September, it averaged 1.5%), leading some commentators to suggest that pay is finally catching up with inflation. This does not disguise the fact that earnings growth has remained weak in nominal (i.e. cash) terms and has been lower in recent quarters than in 2011 and 2012.[8]



More detailed earnings data for April 2014 show that median weekly pay (the level at which half of workers earn more and half earn less) of full-time employees in the UK grew by 0.1% between 2013 and 2014, to £518 – the smallest annual growth since the start of the series in 1997, and equivalent to a real terms fall of 1.6%. However, for full-time employees who had been in post for at least one year, median weekly pay was 4.1% higher in April 2014 than the year before.

2.6 Lower-paid jobs

Some of the recent weakness in earnings growth may be attributable to changes in the composition of the workforce. If new entrants to employment take up jobs on relatively low earnings, this will pull down earnings on average. The Bank of England has observed that recent employment growth has been skewed towards lower-skilled occupations, which tend to attract lower levels of pay:[9]

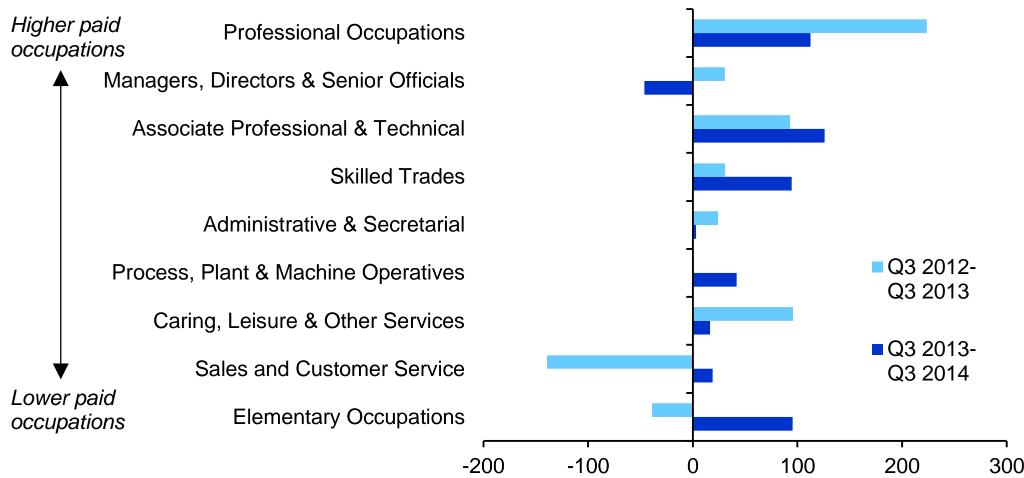
> Most of the net increase in employment between 2010 and 2013 reflected rises in the employment of older people, more highly qualified people, and those in relatively high-skilled occupations. More recently, however, employment growth has been concentrated among the lower skilled … These changes in the composition of the workforce are likely to have weighted on the average level of pay in the economy, and therefore reduced average pay growth, in recent quarters.

In the year to Q3 2014, there was a smaller increase in the number of employees working in the highest paid occupational groups compared to the previous twelve month period, but there were larger increases in the numbers of people working in sales & customer service and elementary occupations:

[8] ONS *Labour Market Statistics, November 2014*, 12 November 2014 and ONS, *Consumer Price Inflation, October 2014*, 18 November 2014

[9] Bank of England, *Inflation Report*, 12 November 2014, Chapter 3, p28

Annual change in employee numbers by occupational group
Thousands, not seasonally adjusted



Note: occupations ranked by median gross hourly pay for all employees at April 2014, as published in ONS, *Annual Survey of Hours and Earnings, 2014*. Source: ONS, *Labour Force Survey*

The chart shows the change in employee numbers only. There were also large increases in the number of self-employed people working in skilled trades as well as associate professional & technical occupations in the year to Q3 2014.

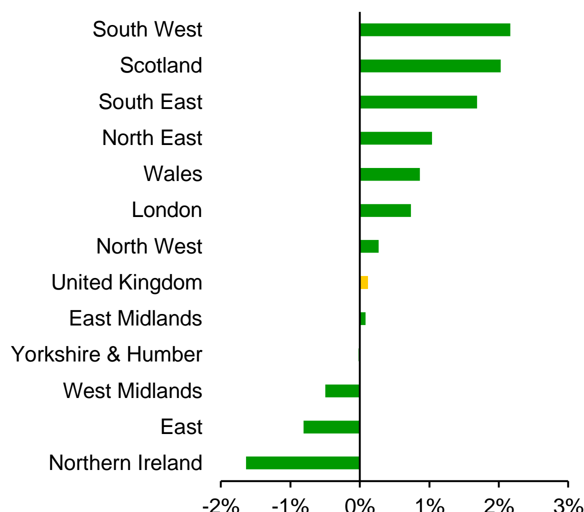
The evidence available suggests that earnings from self-employment tend to be lower than employee earnings.[10] ONS analysis of data from the *Family Resources Survey* suggests that median income from self-employment fell by 22% in real terms (adjusted for CPI) between 2008/09 and 2012/13.[11]

2.7 Employment and earnings by region

Employment growth was strongest in London in the year to July 2013-June 2014. In the year to April 2014, growth in full-time employee earnings was highest for people living in the South West, followed by Scotland and the South East.

[10] Joseph Rowntree Foundation, *Monitoring Poverty and Social Exclusion, 2014*, 24 November 2014, Chapter 3, p71. See also: OBR, *Forecast Evaluation Report – October 2014*, 16 October 2014, Chapter 3, p56

[11] ONS, *Self-employed workers in the UK, 2014*, 20 August 2014



2.8 The output gap and its implications for interest rates and the budget deficit

One of the key questions that determines monetary and fiscal policy is how much spare capacity there is in the economy. An economy operating at full capacity is one that is fully utilising its resources in a sustainable fashion. In other words an economy that is: (i) not overheating (operating above capacity); or (ii) with lots of idle resources (such as a high number of people unemployed). The level of economic output that is produced once it is at full capacity is known as 'potential output'. The difference between this and the actual level of output an economy produces is called the 'output gap'.

A country's output gap is typically large and negative (actual output is below potential output) during a recession when resources are underutilised. In such circumstances, interest rates are usually lowered to boost growth and end the recession. If the output gap is positive (the economy is operating above capacity) then interest rates need to rise to lower economic growth and make it more sustainable. Higher rates may also reduce inflationary pressures which could be building. So interest rates are likely to stay lower for longer if the Bank of England believes there is still spare capacity in the economy.

The biggest problem policymakers have is that the level of potential output and therefore the output gap cannot be directly measured. Therefore economists must estimate what the output gap is. Currently in the UK there is a debate about whether there are still underutilised resources in the economy as a consequence of the recession. The economy's output is well below what it would have been if it had grown at the same pace since the recession as it did before. However, it is widely believed that the economy has permanently lost some of this output as a result of the recession. The big question is how much?

Some economists believe that there still remains a decent amount of spare capacity in the economy – a negative output gap. They cite the very weak growth in nominal earnings, suggesting employers are not having to offer higher wages to hire or retain workers, as one reason that slack remains in the labour market.

Others believe that we are close to operating at full capacity, citing evidence such as the steep decline in the unemployment rate and rise in the number of people employed. The OECD in its most recent forecasts released on 25 November is in this camp, with a forecasted output gap of just -0.3% in 2014.[12] The Bank of England's Monetary Policy Committee believes that there is a little more spare capacity, with an output gap of around -1%.[13]

The question of whether or not the economy is operating at full potential also has important implications for fiscal policy. If there is a negative output gap and the economy is operating below capacity then we can expect some of the budget deficit to disappear once the economy gets back to full potential. This would happen as expenditure on things like unemployment benefits would fall and tax revenues would rise. However, if the OECD is right and the economy is operating at full capacity, then all of the deficit would be 'structural' reflecting underlying factors not dependent on the performance of the economy. Therefore the judgement of the OBR on the size of the output gap will be crucial in determining the scale of the challenge this and future Governments face in tackling the deficit.

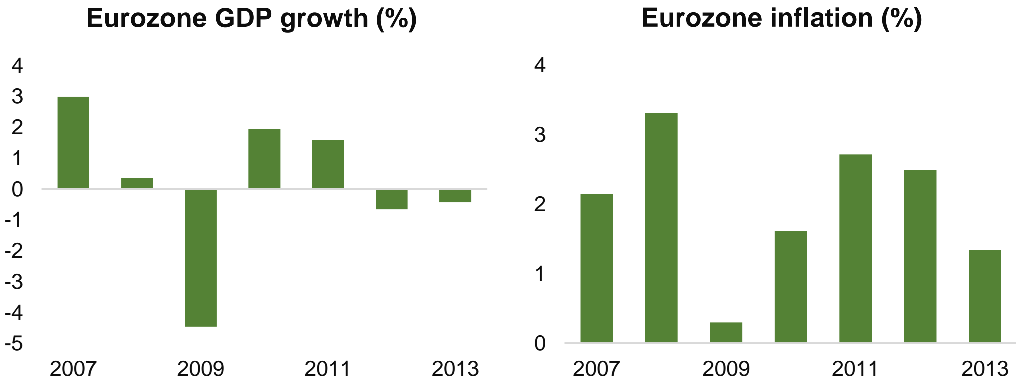
2.9 International economic outlook[14]

Eurozone

The eurozone economy faces a range of economic problems including sluggish growth, high unemployment and the risk of deflation. The eurozone grew by just 0.2% in Q3 2014, after growth of 0.1% in Q2. Growth has been weak in most of the major eurozone economies: Germany grew by just 0.1% in Q3 2014, France by 0.3% while output fell by 0.1% in Italy. Spain grew slightly faster at 0.5%. The OECD forecast eurozone growth of 0.8% this year and 1.1% in 2015.

The eurozone is facing the dangers of deflation. In October 2014, inflation was only 0.4% in the eurozone as a whole, down from 0.7% a year ago. There is deflation in Greece and Spain.

Unemployment remains high in the eurozone. In September, the unemployment rate was 11.5%, marginally lower than a year ago. Unemployment is particularly high in Spain (24%) and above the eurozone average in Portugal (13.6%), Italy (12.6%) and France (10.5%). The unemployment rate in Germany is 5.0%.



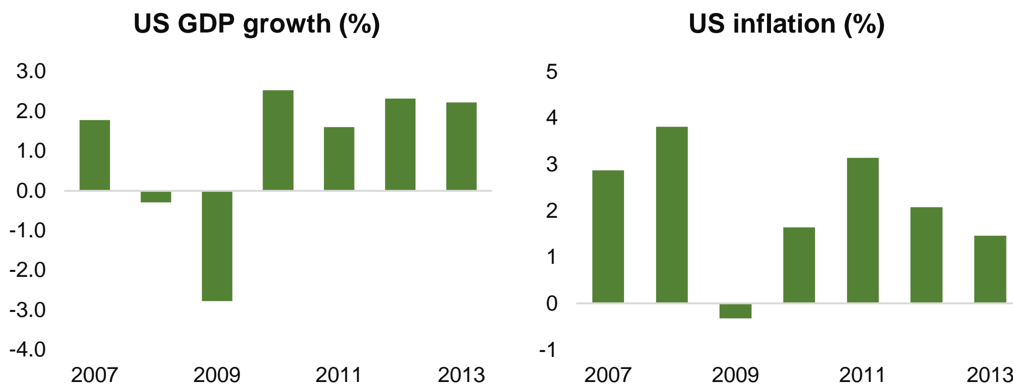
[12] OECD, *Economic Outlook*, November 2014, Annex table 10

[13] Bank of England, "Inflation report press conference – Opening remarks by the Governor", 12 Nov 2014

[14] The data for the charts in this section are from the IMF World Economic Outlook, October 2014

US

The US economy grew by 2.2% in 2013. The OECD forecast growth of 2.2% in 2014, rising to 3.1% in 2015. The Federal Reserve had engaged in a policy of QE but announced in October that this was coming to an end, due to the improvement in the economy. Unemployment is falling: in October, the unemployment rate was 5.8%, down from 7.2% a year earlier and the lowest since mid-2008. Unemployment peaked at around 10% in 2009. Despite the recovery and fall in unemployment, inflation remains relatively low. It was 1.5% in 2013 and is forecast by the OECD to be 1.7% in 2014 and 1.4% in 2015.

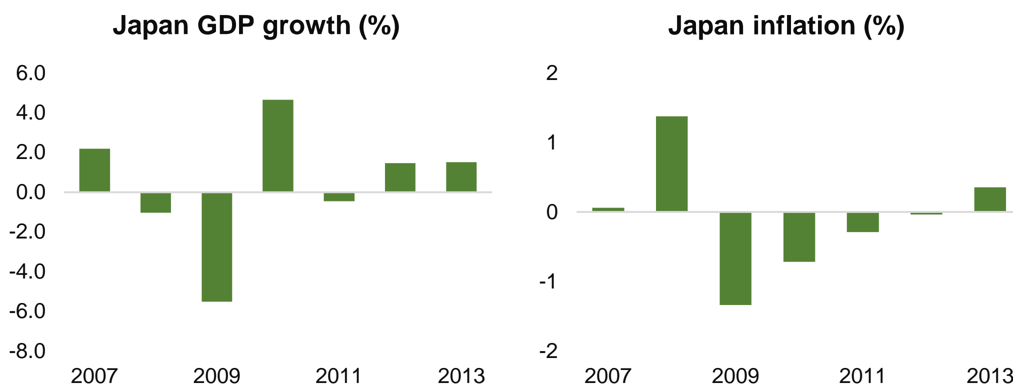


Japan

Japan's prime minister, Shinzo Abe has called a snap election for 14 December seeking a renewed mandate for his "Abenomics" economic strategy. This has three main parts: substantial support for the economy through monetary policy, increased public expenditure and structural reforms. These policies aim to tackle the problems of poor growth and deflation faced by the Japanese economy.

The Japanese economy has seen sluggish growth in recent years. The economy grew by 1.5% in 2012 and 2013 but fell back into recession in November 2014. An increase in the consumption tax from 5% to 8% in April 2014 was a major factor behind the economic slowdown. A second increase in the tax, due in October 2015, looks likely to be delayed. The OECD forecasts growth of 0.4% in 2014 and 0.8% in 2015.

The economy is also battling deflation. Prices fell in 2009, 2010 and 2011. Since then, inflation has been very low. The Bank of Japan has undertaken a policy of quantitative easing and surprised the markets at the end of October by announcing an expansion of QE. Unemployment is relatively low: the unemployment rate was 3.6% in September.



3 The public finances

3.1 Summary

The Autumn Statement will present updated plans for public spending and a new set of OBR forecasts for the public finances, revising data published in March 2014 on the deficit and debt.

The deficit, as measured by public sector net borrowing, has reduced by over £50 billion since 2009/10. The OBR have forecasted a further fall of £11 billion in 2014/15, but data for the year so far suggests that borrowing may struggle to fall by quite this extent. Weaker than expected receipts have contributed to increased borrowing, and the OBR looks set to decrease its receipts forecast for the year.

Debt continues to rise. Public Sector Net Debt reached 79% of GDP in 2013/14; the OBR expects it to start falling in 2016/17.

A new Charter for Budget Responsibility will be published alongside the Autumn Statement. Media reports suggest that this will include a formal target to eliminate the cyclically adjusted current deficit by 2017/18. The current fiscal mandate is that this should be balanced at the end of a rolling five-year period.

Public sector finances: 2014 revisions

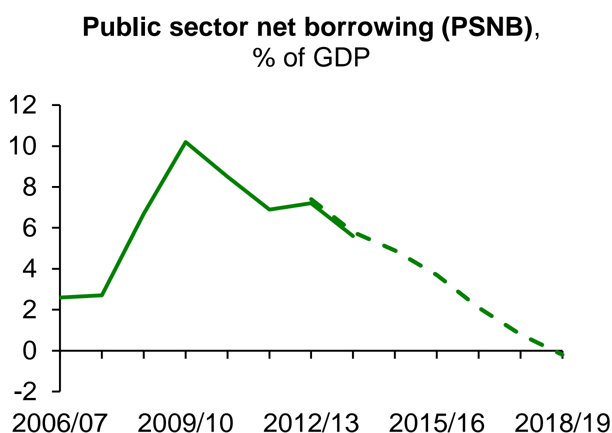
The forecasts published alongside the Autumn Statement will be the first produced by the OBR since the ONS made significant revisions to how the public finances are measured. Revisions are discussed in the Library note Public sector finances: 2014 revisions.

The revisions mean that outturn figures up to and including 2013/14 are not comparable with forecasts presented in the main report of OBR's Economic and fiscal outlook March 2014.[15] In March 2014, however, the OBR produced illustrative forecasts based on what was known about ONS' revisions at the time.[16] These illustrative forecasts are incorporated below.

3.2 Public sector net borrowing[17]

Public sector net borrowing is the difference between the government's spending and its revenues. Borrowing has fallen considerably since the very high levels it reached during the financial crisis.

Borrowing was £153 billion in 2009/10. It fell to £98 billion last year.[18] In its March 2014 assessment, the OBR forecasted that borrowing would fall until reaching a small surplus in 2018/19.



[15] OBR. Economic and fiscal outlook, March 2014, Table 1.2.

[16] OBR. Economic and fiscal outlook, March 2014, Appendix B.

[17] All the figures in this note exclude public sector banks. All data in charts are sourced from the following: ONS. Public Sector Finances, October 2014; OBR. Economic and fiscal outlook, March 2014, Appendix B.; and, OBR. Public Finances Databank.

[18] These figures are in nominal terms. Borrowing as a share of GDP is shown in the chart and table.

Public sector net borrowing

	£ billion			% GDP		
		OBR illustrative data			OBR illustrative data	
	ONS Outturns	Implied outturn	Implied forecast	ONS Outturns	Implied outturn	Implied forecast
2006/07	36.3	..	..	2.6	..	..
2007/08	40.3	..	..	2.7	..	..
2008/09	100.3	..	..	6.7	..	..
2009/10	153.0	..	..	10.2	..	..
2010/11	133.9	..	..	8.5	..	..
2011/12	112.4	..	..	6.9	..	..
2012/13	119.4	120.1	..	7.2	7.4	..
2013/14	97.5	..	98.2	5.6	..	5.8
2014/15	..	..	86.6	..	..	4.9
2015/16	..	..	68.7	..	..	3.7
2016/17	..	..	41.6	..	..	2.1
2017/18	..	..	16.0	..	..	0.8
2018/19	..	..	-4.9	..	..	-0.2

Sources: ONS, OBR

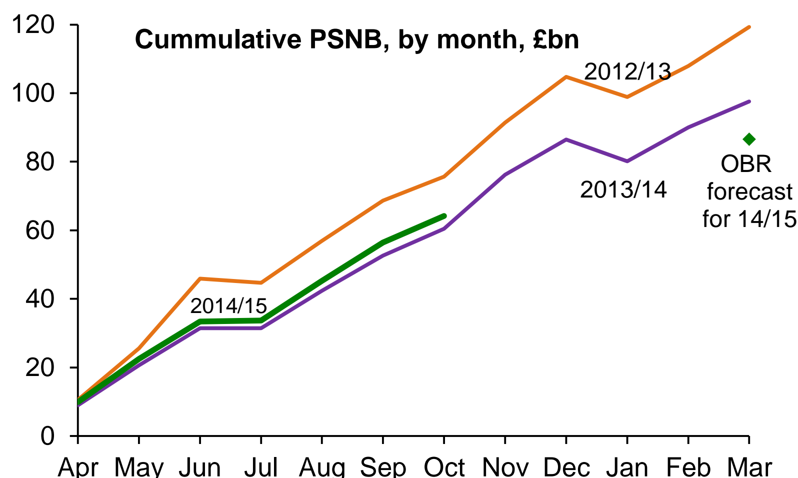
Notes: figures exclude public sector banks

outturns are based on post-Sep 2014 method for calculating the public finances

The year so far: April - October 2014/15

Just over halfway through 2014/15, borrowing is up on the same period in 2013/14. Borrowing of £64.1 billion in the first seven months of 2014/15 is 6.1% higher than during the same period in 2013/14.

The Institute for Fiscal Studies advise caution against concluding that higher borrowing in the year so far means borrowing will increase over the year, "not least because there are a number of factors that are known to affect the timing of borrowing this year compared to last".[19]



However some commentators are questioning whether borrowing will reduce by the forecasted £11bn in 2014/15.[20]

[19] IFS. IFS public finance bulletin: October 2014

[20] See for instance: 'Weak oil and tax revenues weigh on public finances, data show', *FT*, 21 November 2014; 'Government's deficit target still off course despite strong October', *The Guardian*, 21 November 2014; 'Osborne set to miss deficit target', *Daily Mail,* 21 November 2014

Weaker than expected receipts

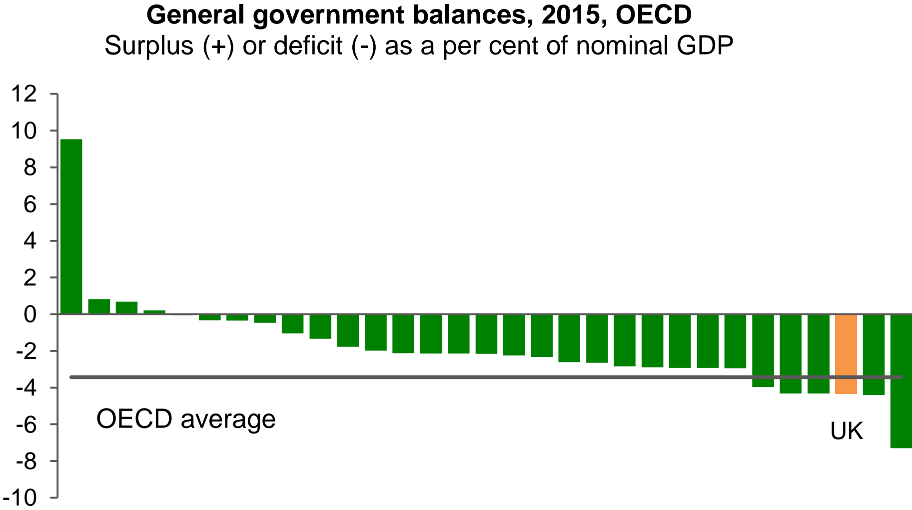
Slightly higher spending and weaker receipts than forecasted have contributed to increases in borrowing this year.[21] The weak receipts have received the majority of attention from commentators.

Receipts for the year so far are up 2.2% on the same period in 2013/14, some way below the full-year forecast of growth of a little under 5%. The OBR now expects receipts for 2014/15 to be lower than forecasted, despite end loading of some receipts.[22]

Despite strong employment growth (see section 2.4) income tax and National Insurance Contributions are performing below expectations. The weak performance of these receipts has been attributed to weak wage growth, and new jobs being created in low paid roles (see sections 2.5 and 2.6), that generate little to no income tax.[23] Lower than expected residential property transactions (see section 2.2), impacting on property revenues, and lower oil and gas revenues have also contributed to weak receipts growth.

International comparisons

Despite the fall in UK government borrowing over recent years, it remains high by international standards. The OECD forecast that borrowing in the UK will be 4.4% of GDP in 2015 compared with the OECD average of 3.4% and 2.3% in the Eurozone. The OECD believe that the UK, US, France and Spain will have similar borrowing; only Japan is expected to have significantly higher.[24]



[21] IFS. IFS public finance bulletin: November 2014

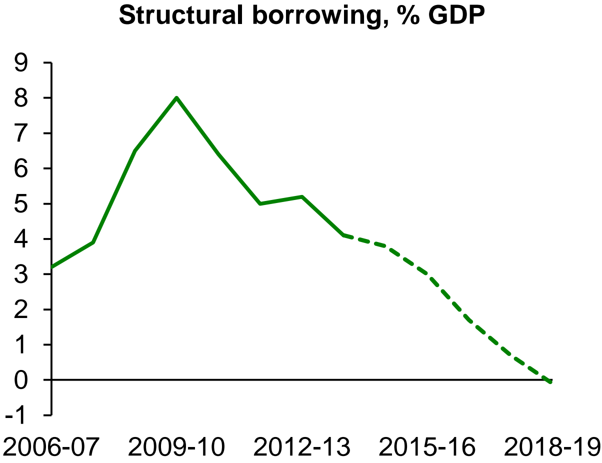
[22] Income tax receipts in particular are expected to be end-loaded.

[23] OBR. Commentary on the Public Sector Finances release: October 2014, 21 November 2014; and, The Guardian, Income tax revenue could be lower than expected, finance watchdog says, 13 October 2014

[24] OECD. Economic outlook, analysis and forecasts, November 2014

3.3 Structural 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”.

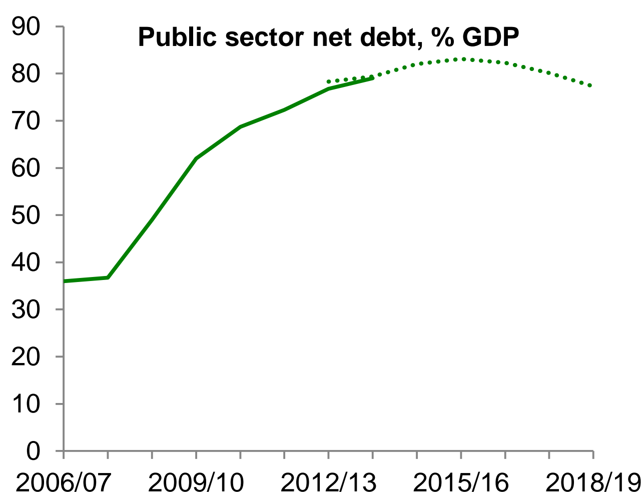
- Structural elements of the deficit are the underlying or persistent part of government borrowing which are unrelated to the economic cycle. The structural deficit is measured by cyclically-adjusted measures of borrowing.[25]

The distinction is important as the “headline” borrowing figures may mask underlying trends unless the economy’s position in the economic cycle is taken into consideration. Estimating how much of the deficit is cyclical and how much is structural is far from easy. This requires an assessment of where the economy is in the economic cycle, measured by the OBR through the output gap (see section 2.8). It can be difficult to determine where the economy is in relation to its “trend” level of output. This is particularly the case when the economy is coming out of recession as it requires a calculation of how much of the lost output is purely cyclical and how much is permanent. These problems mean that estimates of the structural deficit need to be treated with a degree of caution.

The structural deficit is estimated to have been around 3-4% of GDP immediately before the financial crisis. It increased to 8% of GDP in 2009/10. The OBR forecasts structural borrowing of 3.8% of GDP in 2014/15. It is then forecast to fall, reaching a small surplus in 2018/19. The OBR has not produced illustrative forecasts of the structural deficit, so these forecasts do not include any adjustment for ONS’ revisions.

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

3.4 Public sector net debt

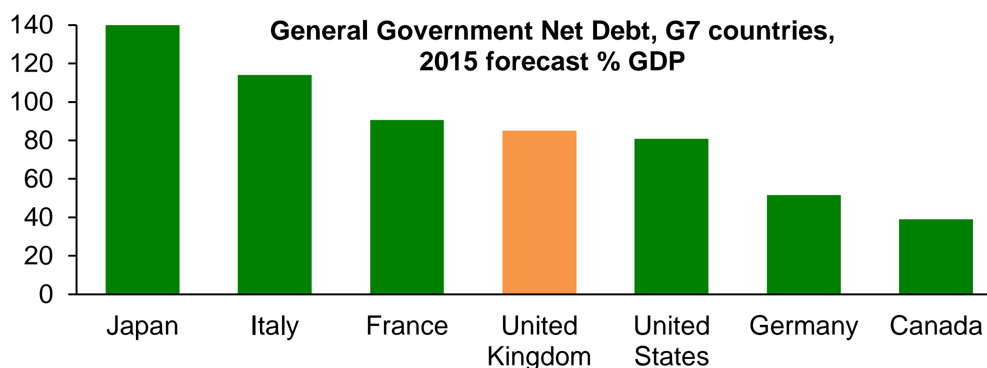


Public sector net debt is the overall level of government indebtedness, built up over many years. Broadly speaking, it reflects the accumulated level of government borrowing.

Before the financial crisis, public sector net debt was around 36% of GDP. As a result of the crisis, debt has increased sharply reaching 79% in 2013/14.

The OBR expects public sector net debt to begin falling in 2016/17.

Compared with the other G7 countries, the forecasted level of UK government debt is similar to the US and France, well below Italy and Japan but well above Canada and Germany.[26]



Public sector net debt

	£ billion			% GDP		
		OBR illustrative data			OBR illustrative data	
	ONS Outturns	Implied outturn	Implied forecast	ONS Outturns	Implied outturn	Implied forecast
2006/07	527	..	..	36.0	..	..
2007/08	558	..	..	36.7	..	..
2008/09	724	..	..	49.0	..	..
2009/10	956	..	..	62.0	..	..
2010/11	1,101	..	..	68.7	..	..
2011/12	1,191	..	..	72.3	..	..
2012/13	1,299	1,298	..	76.8	78.3	..
2013/14	1,402	..	1,390	79.0	..	79.4
2014/15	..	..	1,492	..	..	82.0
2015/16	..	..	1,576	..	..	83.1
2016/17	..	..	1,633	..	..	82.3
2017/18	..	..	1,662	..	..	80.1
2018/19	..	..	1,675	..	..	77.3

Sources: ONS, OBR

[26] IMF. World Economic Outlook Database, October 2014

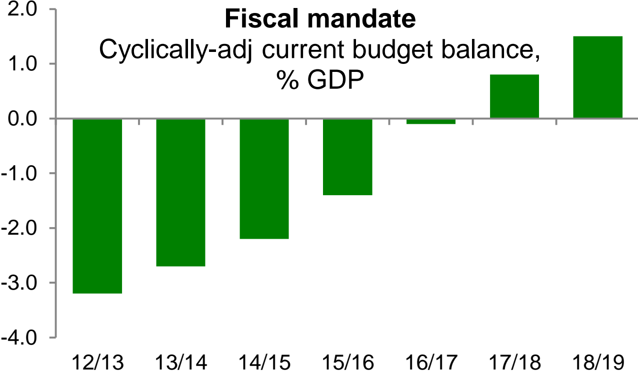
3.5 Charter for Budget Responsibility: fiscal rules and the welfare cap

The Charter for Budget Responsibility lays out the Government's targets for borrowing (the fiscal mandate) and debt (supplementary debt rule). Budget 2014 introduced a further measure to supplement the 'fiscal mandate'; a measure commonly known as the welfare cap. The OBR will report on progress against these in the Autumn Statement.

The Government will publish an updated Charter for Budget Responsibility alongside the Autumn Statement, concluding a review which began in the 2013 Autumn Statement.

Fiscal mandate and debt rule

The Government's first Budget in June 2010 announced a "fiscal mandate." This required the cyclically-adjusted current budget to be balanced by the end of a rolling five year period (currently 2018/19). The current balance is the difference between government revenue and current, rather than capital, expenditure. Focusing on the current budget therefore protects public sector investment. The rule uses a measure of the budget balance, adjusted for the economic cycle. This allows flexibility to run a deficit during recessions and a surplus during booms.



Note: negative figures indicate deficit, positive indicate surplus.

The OBR assesses performance against the fiscal rules. Its March 2014 forecast shows a surplus of 1.5% for the cyclically-adjusted budget balance in 2018/19, showing that the government is on course to meet the fiscal mandate. The mandate would be met a year early on the OBR's March 2014 forecasts as these also indicate a surplus in 2017/18.

Besides the fiscal mandate, there is a supplementary debt rule. This requires public sector net debt, as a share of GDP, to fall in 2015/16. Unlike the fiscal mandate, this date is fixed. The OBR's forecasts show that this target will be missed. Debt does not begin to fall as a share of the economy until 2016/17.

Welfare cap

Budget 2014 set a cap on the amount that can be spent on certain benefits in the four financial years beginning in 2015/16. The OBR will report alongside the Autumn Statement on whether the cap has been breached.

Level of the welfare cap set out in *Budget 2014*, *£ billions*

	2015/16	2016/17	2017/18	2018/19
Welfare cap	119.5	122.0	124.6	126.7

Source: HM Treasury, *Budget 2014*, 19 March 2014, Table A.1, p87
Note: a 2% margin above the cap allows for forecast fluctuations each year

How the cap works

At Budget 2014 the Government set a limit on what can be spent on certain types of welfare in each of the next four financial years. At each subsequent Autumn Statement, the

Government will announce a cap for a further year – so alongside the Autumn Statement 2014, the Government will set the cap for welfare spending in 2019/20.[27]

The OBR will report on whether it forecasts that relevant welfare spending will meet or exceed the cap level set by the Government for the forthcoming year. So, alongside Autumn Statement 2014, the OBR will report whether relevant welfare spending is set to meet or exceed £119.5 billion in 2015/16.

If the OBR forecasts that relevant welfare will exceed the cap level (plus 2% if the cap is exceeded because of forecast changes and not policy changes), then the Government propose policy measures to reduce welfare spending, seek approval for the cap level to be increased or explain why a breach of the cap is justified. The Government must introduce a votable motion to the House of Commons within 28 sitting days seeking approval for these actions.

The Government has chosen to use the OBR's forecast of welfare spending on relevant benefits as the cap level.

What is included in the Welfare Cap?

Around 55% of all welfare spending is included in the Welfare Cap. The elements of welfare spending that are excluded are:

- Jobseeker's Allowance (JSA) and housing benefit for people on JSA,
- Local Authority spending on Council tax benefit and Discretionary housing benefit
- State pension

All other welfare spending is included within the cap, including incapacity benefit, child benefit and personal tax credits.[28]

Meeting the cap

The OBR published it first annual *Welfare trends report* in October 2014, which contains information on the "trends and drivers of welfare spending within the cap."[29] Although this report does not reveal whether the cap has been met or exceeded, it does highlight some of the likely reasons for a possible breach:

- **High inflation**: the level of inflation in September normally determines the extent to which welfare payments are increased in the following year. If inflation in September were unexpectedly high, then this might push welfare spending in the following year above the cap level.

- **Operational changes**: alterations to the rules governing who can claim certain benefits often reduce the number of people who can receive those benefits and therefore the amount of money spent on them. If these changes are introduced on a different timetable to the one initially anticipated, the amount spent on welfare will fall more slowly than anticipated, potentially pushing relevant spending beyond the cap level.

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[27] The Government has chosen to use the OBR's forecast of welfare spending on relevant benefits as the cap level.

[28] HM Treasury, *Budget 2014,* Table A2, p88

[29] OBR, *Welfare trends report*, October 2014, p 1

- **External factors**: changes to the international economy or unexpected events might cause welfare spending to rise beyond the cap level.

It should be noted that the OBR has not made any announcements on the likelihood or otherwise of the cap being breached.

Further discussion of "risk factors" associated with meeting the cap can be found in the recent Institute of Fiscal Studies article, *Will the welfare cap fit?*.

Updated Charter for Budget Responsibility

The 2013 Autumn Statement announced a review of the fiscal framework.[30] The government will conclude this review by publishing an updated Charter for Budget Responsibility alongside the 2014 Autumn Statement.

Media reports[31] suggest that the updated Charter will include a target to eliminate the cyclically-adjusted current deficit by 2017/18. The fiscal mandate currently states that this measure should be balanced by the end of a five-year rolling period, which means the end point is never reached. As discussed previously, the cyclically-adjusted current budget is forecasted to be in balance by 2017/18.

The Charter was last updated in March 2014 and any changes must be approved by a resolution of the House of Commons.

[30] HM Treasury, Autumn Statement 2013, December 2013, para 1.132-1.137
[31] 'Osborne to pledge balanced budget law', *FT*, 25 November 2014

4 Infrastructure

Infrastructure has risen up the political agenda in recent years and the Government has stated its commitment to improving the UK's infrastructure, most recently in a speech from David Cameron.

As well as the short term boost to employment that major infrastructure projects provide, high quality infrastructure has a long-term positive impact on the economy. Reliable transport and power makes investing in a country more attractive. Efficient infrastructure enables higher productivity which helps to drive up GDP.

The Autumn Statement will be accompanied by a new National Infrastructure Plan which sets out Government policy on infrastructure and an analysis of the current strengths and challenges facing UK infrastructure. This document accompanies the Infrastructure Pipeline (updated in September 2014) which brings together all the major projects which are planned or underway in the UK.

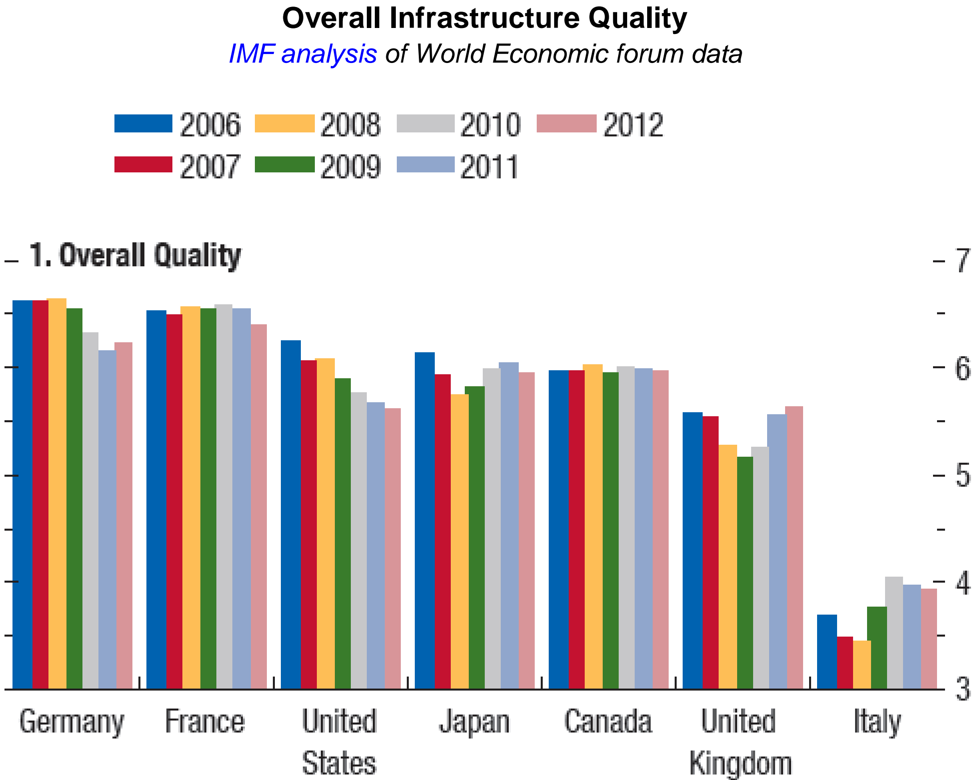
UK infrastructure quality

The UK is ranked 27th the in the world in terms of the overall quality of its infrastructure, behind France (10th), Germany (11th) and the USA (16th), according to the World Economic Forum.[32]

However, in contrast to many advanced economies, the UK has seen improvement in the quality of its infrastructure in recent years, although from a comparatively low base.

Overall Infrastructure Quality

IMF analysis of World Economic forum data



[32] World Economic Forum, *Global Competitiveness Report 2014/15*, September 2014, Pillar 2

Infrastructure funding

This recent improvement in the quality of infrastructure in the UK followed increased government funding in the three years from 2008/09.

Public Sector Net Investment in the UK
£ billions, 2013/14 prices

In today's prices, government spending on infrastructure increased from £35.4 billion in 2007/08 to £53.8 billion in 2008/09, a 52% increase. Infrastructure spending remained elevated in 2009/10 and 2010/11. It has since fallen but is still above the long term average. In 2013/14 government infrastructure spending was £25.4 billion, 1.5% of GDP.

The private sector also provides considerable finance for infrastructure projects. The Treasury estimates that total investment in infrastructure (including funding from the public and private sectors) averaged £41 billion between 2005 and 2010 and £45 billion between 2011 and 2013.

Increasing funding for infrastructure

However, there is consensus that current levels of infrastructure investment are inadequate. The OECD, for example, has argued that there would be detrimental "implications for living standards and quality of life" and that competitiveness would be "blunted" without infrastructure investment of 3.5% of GDP each year to 2030. Applying this proportion to the UK suggests that £60 billion a year in infrastructure investment is required.[33] Policy Exchange, has argued that £50 billion a year is required by 2020 – a 10% increase on the Treasury estimate of the current level of investment.[34]

Investment on the scale needed to make up this shortfall is unlikely to be provided by the public sector alone, meaning that private sector finance will be required if the infrastructure 'finance gap' is to be overcome.

The Coalition Government has introduced a number of policies to address this issue:

- The **UK Guarantees Scheme** provides a guarantee that any funding shortfall for certain infrastructure projects will be met by the Government.

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[33] OECD, *Infrastructure to 2030*, 2007, p15
[34] Policy Exchange, *Delivering 21st century infrastructure for Britain*, May 2009

- The **Pension Infrastructure Platform** provides expertise and support to pension funds in order to encourage them to invest in infrastructure projects – in 2013 it was announced that the Platform had raised its first £1 billion in committed funds.

- The **Green Investment Bank** uses Government capital and leverages more investment from the private sector for environmentally-friendly infrastructure projects – the Bank has so far supported 37 projects, involving over £5 billion of investment.

5 Appendix 1: Sources of further information

HM Treasury

Budget 2014

Budget 2013

Autumn Statement 2013

Office for Budget Responsibility

Economic and fiscal outlook, March 2014

Economic and fiscal outlook, December 2013

Economic and fiscal outlook, March 2013

Monthly commentary on the public finances

Public finance databank

Institute for Fiscal Studies

Budget and Autumn Statement analysis

Green Budget 2014

Monthly commentary on the public finances

House of Commons Library

Economic indicators (a special Autumn Statement edition will be published on 1 December)

External users can access this from (see under "Research Papers"): http://www.parliament.uk/topics/Economic-situation.htm

House of Commons Treasury Select Committee

Report on Budget 2014

Report on Autumn Statement 2013

6 Appendix 2: Economic and public finance data 1979-2018

Economic data, 1979-2018

	Real GDP growth %	Inflation RPI %	Inflation CPI %	ILO Unemployment %
1979	3.7	13.4	..	5.4
1980	-2.2	18.0	..	6.8
1981	-0.8	11.9	..	9.6
1982	2.1	8.6	..	10.7
1983	4.2	4.6	..	11.5
1984	2.3	5.0	..	11.8
1985	3.5	6.1	..	11.4
1986	3.2	3.4	..	11.3
1987	5.5	4.2	..	10.4
1988	5.9	4.9	..	8.6
1989	2.5	7.8	5.2	7.2
1990	0.5	9.5	7	7.1
1991	-1.2	5.9	7.5	8.9
1992	0.4	3.7	4.3	9.9
1993	2.6	1.6	2.5	10.4
1994	4.0	2.4	2	9.5
1995	2.5	3.5	2.6	8.6
1996	2.7	2.4	2.5	8.1
1997	2.6	3.1	1.8	6.9
1998	3.5	3.4	1.6	6.2
1999	3.2	1.5	1.3	6.0
2000	3.8	3.0	0.8	5.4
2001	2.7	1.8	1.2	5.1
2002	2.5	1.7	1.3	5.2
2003	4.3	2.9	1.4	5.0
2004	2.5	3.0	1.3	4.8
2005	2.8	2.8	2.1	4.8
2006	3.0	3.2	2.3	5.4
2007	2.6	4.3	2.3	5.3
2008	-0.3	4.0	3.6	5.7
2009	-4.3	-0.5	2.2	7.6
2010	1.9	4.6	3.3	7.9
2011	1.6	5.2	4.5	8.1
2012	0.7	3.2	2.8	8.0
2013	1.7	3.0	2.6	7.6
2014	2.7	2.6	1.9	6.8
2015	2.3	3.2	2.0	6.5
2016	2.6	3.6	2.0	6.1
2017	2.6	3.8	2.0	5.7
2018	2.5	3.9	2.0	5.4

Sources: ONS (series, IHYP, CZBH, D7G7, MGSX)
OBR, Economic and fiscal policy, March 2014, Table 3.6

Public finance data 1979-80 to 2017-18

	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
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	143.8	43.6
1984-85	12.5	3.5	3.1	157.2	44.3
1985-86	9.0	2.3	2.3	162.7	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	153.9	29.3
1989-90	-0.6	-0.1	1.3	152.2	26.2
1990-91	6.2	1.0	0.8	151.3	24.2
1991-92	23.0	3.5	2.1	166.1	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	3.3	322.1	39.2
1996-97	27.7	3.3	3.1	347.0	39.9
1997-98	5.8	0.6	1.9	358.6	39.3
1998-99	-4.6	-0.5	0.8	357.8	37.5
1999-00	-14.8	-1.5	-0.3	349.1	34.6
2000-01	-17.2	-1.7	-0.3	316.4	30.1
2001-02	0.6	0.1	0.5	323.1	29.3
2002-03	26.6	2.3	2.2	354.9	30.3
2003-04	31.5	2.6	2.9	393.6	31.7
2004-05	43.6	3.4	4.2	448.1	34.3
2005-06	41.0	3.0	3.8	490.2	35.4
2006-07	36.3	2.6	3.2	526.7	36.0
2007-08	40.3	2.7	3.9	558.2	36.7
2008-09	100.3	6.7	6.5	724.4	49.0
2009-10	153.0	10.2	8.0	956.4	62.0
2010-11	133.9	8.5	6.4	1,101.0	68.7
2011-12	112.4	6.9	5	1,190.9	72.3
2012-13	119.4	7.2	5.2	1,299.1	76.8
2013-14	97.5	5.6	4.1	1,402.2	79.0
2014-15	86.6	4.9	3.8	1,492.0	82.0
2015-16	68.7	3.7	3.0	1,576.0	83.1
2016-17	41.6	2.1	1.7	1,633.0	82.3
2017-18	16.0	0.8	0.7	1,662.0	80.1
2018-19	-4.9	-0.2	-0.1	1,675.0	77.3

Source: OBR and ONS

Note: figures exclude public sector banks

forecasts of Public Sector Net Borrowing and Public Sector Net Debt are based on OBR's assessment of ONS' revisions to public sector finance methodology. These are contained in Appendix B of the March 2014 Economic and Fiscal Outlook

7 Appendix 3: Devolution of powers to set corporation tax in Northern Ireland

One issue that the Chancellor is expected to discuss in his statement to the House is the Government's decision whether to devolve powers to set the rates of corporation tax to the Northern Ireland Assembly.

The Coalition Government set out its priorities for taxation in its agreement, published in May 2010. In its discussion of its policy in Northern Ireland, the Government announced that it would "work to bring Northern Ireland back into the mainstream of UK politics, including producing a government paper examining potential mechanisms for changing the corporation tax rate in Northern Ireland."[35]

In March 2011 the Government published a paper setting out options for 'rebalancing' the economy in Northern Ireland, as the private sector has been much weaker than in other parts of the UK;[36] this included a series of tax changes – principally, to allow Northern Ireland to vary corporation tax rates:

> A lower corporation tax rate would, on its own, be likely to have a positive effect on local private sector investment and foreign direct investment (FDI) by increasing the return on capital to investors. In addition, a lower corporation tax rate means that businesses may have more post-tax profits available for internal investment. Increased investment, other things being equal, typically leads to increased growth and employment.[37]

Many commentators have argued that the strong growth of the Irish economy in the mid-1990s was driven, in part, by the Republic maintaining a very competitive rate on trading profits to attract foreign direct investment.[38] The Treasury's paper noted that there were a number of reasons why one could not simply assume that the Irish experience would be reproduced north of the border, if Northern Ireland had lower rates of corporation tax:

> The Republic of Ireland provides an important comparator in judging the potential impact of a lower corporation tax rate in Northern Ireland. From the mid-1990s until the recent recession the Republic of Ireland enjoyed a period of very strong economic growth, supported by large inflows of FDI. Different explanations can be, and have been, offered for the Republic's performance. Prominent among these is the Republic's corporation tax regime which has recently been described by the Republic's then Minister for Finance as the, "cornerstone of Irish industrial policy".[39] Although the Republic enjoys a very low rate of corporation tax on trading profits, at 12.5 per cent, its tax rate on non-trading profits is, at 25 per cent, higher than the rate will be in the UK.
>
> The Republic's corporation tax system differs from the UK's in respects other than headline corporation tax rates, which may result in companies paying less tax than the headline rate implies. In addition to an entirely different system of reliefs and allowances, significant differences between the corporation tax systems in the UK and the Republic relate to rules governing Controlled Foreign Companies, transfer pricing, thin capitalisation and the taxation of dividends.

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[35] HM Government, *The Coalition: our programme for government*, May 2010 p28

[36] HC Deb 24 March 2011 c59WS. Details are collated on the Treasury's site.

[37] HM Treasury, *Rebalancing the Northern Ireland economy*, March 2011 para 4.5

[38] For a discussion of the evidence see, Sir David Varney, *Review of tax policy in Northern Ireland*, HM Treasury December 2007 paras 1.60-1.63

[39] Ministerial Statement by Brian Lenihan, Department of Finance, Dublin, 1 October 2010.

> Because of differences in effective corporate tax rates, and due to the large range of factors that determine investment levels, it is necessary to be cautious in assuming that a lower corporation tax rate would have the same effect in Northern Ireland as it had in the Republic.[40]

The paper listed a number of potential benefits from cutting corporation tax:

> Academic literature on corporation tax suggests that the most significant benefits of a reduction in the corporation tax rate in Northern Ireland would come through additional investment in both new foreign-owned firms and in existing firms. Increased investment, other things being equal, typically leads to increased growth and employment.
>
> Some foreign-owned firms may also shift profits from the rest of the world into Northern Ireland to benefit from the low tax regime, and a lower corporation tax rate in Northern Ireland may enable some profit to be retained in the UK from companies that would otherwise shift it abroad, though a proportion of increased investment in Northern Ireland would be at the expense of investment in other parts of the UK.
>
> The impact of changes in corporation tax rate will depend upon other components of the corporation tax system, such as capital allowances and any tax credits available for Research and Development (R&D). When investing it is likely that firms will take both their overall tax rate into account (the average effective tax rate) as well as the tax rate on the particular investment project they are considering (the marginal effective tax rate). The statutory or "headline" rate also has a role to play in terms of the signals it sends to overseas investors.[41]

It went on to underline that any devolution of tax varying powers would have to comply with EU law; specifically, that it should not constitute State Aid:

> Devolving any tax rate varying power must satisfy the European Court of Justice (ECJ) decision on the "Azores Case", which set out the criteria which would need to be met for regional differences in direct taxation not to involve State Aid, and to be compliant with EU law.[42]
>
> These conditions are:
>
> - The decision to introduce the regional difference in direct taxation must have been taken by the region which has a political and administrative status separate from that of the central government (*institutional autonomy*)
> - The decision must have been adopted without the central government being able directly to intervene as regards its content (*procedural autonomy*)
> - The full fiscal consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government (*fiscal autonomy*).[43]

The department took the view that Northern Ireland would meet the first two of these tests, but to meet the fiscal autonomy condition, the Northern Ireland Executive "would need to bear the full fiscal consequences of changes in tax revenues resulting from a new Northern Ireland corporation tax rate":

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[40] *Rebalancing the Northern Ireland economy*, March 2011 paras 4.9-11

[41] *op.cit.* para 4.12-4

[42] Commission v Portugal C88/03

[43] *Rebalancing the Northern Ireland economy*, 24 March 2011 para 4.29. For a summary of EU State Aids legislation see, HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: Competition and Consumer Policy Report*, July 2014 pp25-28

It is expected that Northern Ireland would meet the Azores criteria of institutional, procedural and fiscal autonomy:

• The NIE already has institutional autonomy as the Northern Ireland Assembly is elected by a separate process to that of the UK Government and has autonomy over a wide range of spending and policy issues.

• The Northern Ireland Assembly would also have procedural autonomy, as the NIE and Assembly would have the power to decide whether to raise or lower the rate of corporation tax. HRMC (the UK wide tax administration) could continue to collect receipts.

• In order to meet the fiscal autonomy condition, the NIE would need to bear the full fiscal consequences of changes in tax revenues resulting from a new Northern Ireland corporation tax rate. This means that Northern Ireland's block grant would be adjusted to reflect the fiscal costs of a reduction in the rate of corporation tax.[44]

The paper also provided some estimates of the costs of setting a Northern Ireland rate at 12.5%, akin to the rate on trading profits charged in the Republic. There are a number of uncertainties inherent in this type of calculation. First, it requires an estimate of the share of UK corporation tax receipts accruing in Northern Ireland, as HMRC does not collect corporation tax receipts by location of activity. In this case the department estimated that 1.5% of UK 'onshore' receipts (ie, ignoring corporate tax receipts from the North Sea) could be attributed to Northern Ireland, and used this as their baseline. Given the weakness of the economy, the paper also presented estimates based on a 1.25% share, copied below:

Table 4.B: 1.25 per cent assumption - direct costs NIE of reduced corporation tax rate

£ million (National Accounts basis)	Year 1 [13]	Year 2	Year 3	Year 4	Year 5
Direct effect:					
a) Main rate	-90	-150	-155	-150	-150
b) Small profits rate (SPR)	0	-35	-50	-55	-60
c) Marginal SPR[14]	0	-10	-15	-15	-15
Total Direct Effects[15]	-90	-200	-220	-220	-225
per cent of NI block grant	0.9	1.9	2.1	2.1	2.2

In October 2014 HM Revenue & Customs published more detailed estimates for the shares of UK taxes arising in the four parts of the UK, which suggest that Northern Ireland's share of revenues has declined over the last few years, and is now about 1.2% of UK onshore corporation tax receipts.[45]

The paper also presented some estimates of how these costs would be increased by certain behavioural changes, as companies and individuals sought to exploit the lower NI rate – either by 'shifting' profits to NI subsidiaries, or choosing to incorporate:

As well as the direct costs associated with a reduction in corporation tax, there will be a number of behavioural effects. These are more difficult to assess than the direct fiscal costs. The behavioural effects discussed below arise because of the difference in

[44] *op.cit.* para 4.30

[45] HMRC, *National Statistics : A disaggregation of HMRC tax receipts between England, Wales, Scotland & Northern Ireland*, October 2014 p18

corporation tax rates between Northern Ireland and the rest of the world, between Northern Ireland and the rest of the UK and because of the difference between tax paid by employed and self employed individuals and companies. The first two effects are known as profit shifting and the latter as tax motivated incorporation.

- Profit shifting arises where companies artificially manipulate transactions so that their taxable profits arise in low tax jurisdictions, while the activities generating those profits remain in a high tax jurisdiction. The assumptions that are used to estimate profit shifting from the rest of the world into Northern Ireland are based on OBR approved methodology.[46]

  This effect results in additional corporation tax being paid in Northern Ireland and serves to reduce the direct cost of the rate reduction. A similar methodology, consistent with the Varney Review, is used to estimate the effect of profit shifting from the rest of the UK to Northern Ireland. This cost is additional to the direct cost of the reduction in the corporation tax rate, because the overall level of corporation tax paid within the UK is reduced.

- A lower rate of corporation tax would apply to the Northern Ireland profits of all companies, including small and medium sized ones. This would increase the tax differential between incorporated and unincorporated businesses, which would lead to more unincorporated businesses, with activity in Northern Ireland, incorporating to reduce their tax bill. Tax motivated incorporation (TMI) assumptions are as agreed with the OBR at the June Budget 2010.

  TMI would increase as the corporation tax rate falls and the differential between income tax and corporation tax rates increases. An increase in TMI results in higher corporation tax receipts although this will be more than offset by falls in income tax and NICs receipts and therefore result in a cost additional to the direct cost.

It is likely these effects would need to be factored in to the block grant adjustment.[47]

Table 4.D: 1.25 per cent assumptions - behavioural response

£ million	Year 1	Year 2	Year 3	Year 4	Year 5
Behavioural Response:					
a) Profit shifting from the rest of the world to NI	15	30	30	30	30
b) Profit shifting from GB to NI	-35	-60	-65	-60	-55
c) Tax Motivated Incorporation	-10	-25	-35	-45	-50
Total behavioural effect	-30	-55	-70	-75	-75

The paper also looked at the potential long-term impact from a cut in corporation tax boosting profits, and in turn boosting consumption, and receipts from taxes based on consumption. The Treasury suggested that these ‘dynamic effects’ might “recover 15-21 per cent of the foregone corporation tax receipts.” However, there was a great deal of uncertainty over these estimates, and, as the paper went on to underline, relying on revenues from corporation tax had some risks:

[46] At Budget the Office for Budget Responsibility (OBR) approved an assumption of around 40 per cent for the portion of profits in the tax base that are mobile for the UK economy. An elasticity of 2 has been applied to these profits so that for every 1 percentage point decrease in the corporation tax rate the result is a 2 per cent increase in the size of the mobile profit base.

[47] *Rebalancing the Northern Ireland economy*, 24 March 2011 para 4.38-40

> These costings represent the Government's estimate of the cost to Northern Ireland of the corporation tax cut. However, as with any estimate, there is a degree of uncertainty. Should the tax cut result in more investment than estimated here, then the extra corporation tax associated with this increase would be passed on to the NIE. Conversely, if the tax cut failed to attract as much investment, the NIE would need to make up the difference. Similarly, the risk associated with profit shifting from the rest of the UK would lie with the NIE.
>
> Since company profits tend to fluctuate over the economic cycle, corporation tax revenues also fluctuate by a significant margin. For instance UK corporation tax revenues fell from £38 billion in 2006-07 to only £31 billion in 2009-10. Such fluctuation would be expected to continue if responsibility for the tax was transferred to the Northern Ireland Assembly. The risks that accompany such fluctuations are heightened in a region such as Northern Ireland with its relatively small corporate base.
>
> Furthermore, by potentially increasing the proportion of receipts in Northern Ireland from large companies, a reduction in the corporation tax rate is likely to increase the volatility of Northern Ireland corporation tax receipts. Where a significant share of corporation tax receipts derive from a small number of companies, this would increase the fiscal impact on the NIE if these companies were to experience a significant downturn in profitability or, given the UK's relief rules, had significant losses to set against profits.[48]

In May 2011 the Northern Ireland Affairs Committee published a report on this issue, concluding that "on balance, we believe there is a convincing case for reducing the corporation tax rate in Northern Ireland, not least so it can better compete with the Republic of Ireland." The Committee acknowledged that, as consequence of the Azores judgement, "Northern Ireland would not be compensated from HM Treasury for any tax loss", and noted a number of uncertainties about how, exactly, the NIE's block grant would be cut:

> Any method of calculating the reduction in the block grant must strike a balance between many factors, most notably simplicity and accuracy. It must also conform with EU law. The calculation of the reduction in revenue in future years would be complicated by factors such as UK growth and inflation assumptions, the extra business which Northern Ireland would attract, and be adjusted according to the variations in what we know to be a volatile source of income. Furthermore, this may be complicated by any decision of the UK Government to increase or reduce the block grant, or change the Barnett Formula altogether. Any transitional arrangement would make assessing the amount of money going to the Northern Ireland administration, and therefore its own public expenditure planning for the next three to five years difficult.[49]

Following the Committee's report several commentators noted the risks to devolving this tax power.[50] In a press notice the Chartered Institute of Taxation argued that this was not "a one way bet … there is no guarantee that the books would balance in the Executive's favour."[51] Alan Trench, professor of politics at University of Ulster and a major commentator on devolution matters who had given evidence to the Committee, noted the inherent uncertainties to devolution:

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48 *Rebalancing the Northern Ireland economy*, 24 March 2011 para 4.46-8

49 *Corporation Tax in Northern Ireland*, 24 May 2011, HC 558 of 2010-12 p3, para 57, para 71

50 See, "Call to let Belfast set business tax rate" & "Corporate levy as tool for rebalancing the economy", & "N Ireland wrangles over rates reform", *Financial Times*, 25 May & 22 August 2011

51 CIOT press release, *NI corporation tax devolution 'not a one-way bet'*, 24 May 2011

> No proposition can be 'convincing' when you have no idea how it will work, how much it will cost, or what its benefits might be. The reality is that to comply with EU law, a substantial and irrevocable cut in the block grant will have to be made, based on present tax receipts. If – as is generally assumed – Northern Ireland were then to cut the rate of corporation tax, that would affect its revenues, and require immediate reductions in spending. In the longer term, there might well be a gain, both in overall economic activity and total tax receipts (maybe even corporation tax; even in its present recession, this has been the main source of revenue for the Republic). While those gains may be expected, they can't be predicted, and might turn out to be smaller than the assumptions of [those making the case for devolving this tax].[52]

The Committee's report had been welcomed by Alex Salmond, then Scotland's first minister, as buttressing the SNP's case for devolving this power to the Scottish Parliament.[53] In his blog post Professor Trench went on to argue that one could not consider this question without considering the implications for the rest of the UK:

> If corporation tax were to be devolved to Northern Ireland, there can be no good argument of principle for not devolving it to Scotland as well … If the UK Government were to decline to do so, it would be a reflection of sheer cussedness rather than a desire to maintain the integrity of the UK economy (for example). Such a decision would have profound implications for the regionalisation of the UK economy, and for such long-established principles as relating public spending to need. These are big decisions with wide implications.[54]

It is also worth underlining that the focus of the SNP's case for devolving corporation tax to Scotland has been on facilitating tax competition, primarily *with other parts of the UK*.[55] The Calman Commission, which had reviewed Scotland's devolution settlement in 2010, and whose recommendations underpinned the *Scotland Act 2012*, had opposed devolving this power for just this reason.[56] In their report of the *Scotland Bill*, published at this time, the Scottish Affairs Committee agreed with the Commission and those witnesses who had emphasised the risk that devolution would result in the 'cannibalisation' of the UK tax base, while observing that, "this is not necessarily a concern for those who wish to consider the financial position of Scotland in isolation."[57] Professor Jim Gallagher, who had been secretary on the Commission, addressed this point when he appeared before the Committee:

> People often cite the Republic of Ireland for its very low corporation tax rate as being an advantageous thing, and for them it certainly has been pretty advantageous, despite their present circumstances. What they fail to mention is that they have quite a big corporation tax income because many multinationals book their profits in Ireland. The devolution of corporation tax within the UK would be a way of ensuring that we cannibalised our own tax revenue. If it is devolved to Scotland and Scotland takes, for the sake of argument, 10p off the corporation tax, there is a strong incentive for companies not to change their actual economic behaviour but to change their

52 "Devolving corporation tax in Northern Ireland: the Commons Northern Ireland Affairs Committee reports", *Devolution Matters blog*, 25 May 2011

53 Scottish Government press notice, *Corporation tax*, 24 May 2011

54 *Devolution Matters blog*, 25 May 2011

55 In March 2011 the Scottish Parliament's Committee published its report on the *Scotland Bill*. The majority had approved of the UK Government's decision not to include the devolution of corporation tax in the Bill. The SNP members of the Committee submitted a minority report, arguing that "without this power … Scotland is missing out on the opportunity to give itself with a competitive edge over the rest of the UK." (*1st Report* (Session 3), 3 March 2011 - Annexe A).

56 For details of the changes made by the Act see, *The Scotland Act 2012: devolution of tax powers to the Scottish Parliament*, Library standard note SN5984, 10 October 2014

57 *Fourth report*, 21 March 2011 HC 775 2010-11 para 106

> corporate structures so that they book their profits in Edinburgh and pay less tax. The net effect of that is that the UK as a whole gets less tax and we have simply cannibalised our own tax income.[58]

A report for the Northern Ireland Assembly by its Research and Information Service published at this time noted that the debate had tended to be quite narrow – focusing on the anticipated economic benefits, "with any discussion of the ethics of pursuing mobile international capital" being "quite muted."[59] Certainly it was striking how divisive Ireland's practice of tax competition proved among other EU Member States, during the negotiations over the Republic's bail out agreement.[60] Similarly the tax campaigner Richard Murphy has argued that the Irish approach to cutting corporate taxes had been morally wrong, *and* economically damaging.[61]

In January 2102 the Government published its response to the Committee's report, confirming that it had not yet taken a decision over the devolution of this power. It gave some details of the responses it had had to the consultation paper:

> The Government has received over 700 responses to its consultation. Responses showed strong support for the rebalancing agenda. Around three quarters of responses were in favour of corporation tax devolution, of which around two thirds were from Northern Ireland businesses or business owners. Additionally, the main Northern Ireland political parties have expressed their support for corporation tax devolution. However, support has not been universal and a number of respondents pointed to the complex issues inherent in devolving these powers, many of which were identified in the consultation document as requiring extra work and consideration.[62]

The Committee had noted the complexities to adjusting the NIE's block grant, should corporation tax be devolved, and on this point the Government acknowledged there was more work to do:

> The Government has established a joint ministerial working group, comprising ministers of the UK Government and the Northern Ireland Executive, to consider issues raised by the consultation … [The process for calculating reductions to the block grant] will form part of the consideration being taken forward in the agreed workplan. It is essential that the process of determining any reduction in the block grant is transparent, equitable to both the UK Government and Northern Ireland Executive and based on the best data available … Further work is needed on the administration of a devolved system of corporation tax in Northern Ireland and on the behavioural effects which might arise because of any difference in corporation tax rates between Northern Ireland and the rest of the UK including profit shifting and tax motivated incorporation.[63]

The joint ministerial working group completed its work in December 2012,[64] and Ministerial discussions continued over the next few months. In April 2013 the Committee Chair, Laurence Robertson, bemoaned the delay in the Government taking a final decision,[65] though in answer to a PQ at this time the Financial Secretary, David Gauke, observed, "the

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[58] HC 775-II 2010-11 Q23 Ev7-8. See also, "Editorial: Devolution too far", *Financial Times*, 24 August 2011
[59] *Devolution of Corporation Tax Paper 57/11*, June 2011 p4
[60] "Ireland defends low corporate tax", *Financial Times*, 15 April 2011
[61] "Tories are foolish to line up Northern Ireland as a tax haven", *Guardian*, Tuesday 18 May 2010. Mr Murphy made the case at greater length in a report he produced for the TUC: *Pot of gold, or fools gold?*, October 2010
[62] *First special report*, 30 January 2012 HC 1767 of 2010-12 p3
[63] *op.cit.* p2, p5. The report and the Government's response were the subject of a debate in Westminster Hall in March that year: HC Deb 1 March 2012 cc151-98WH
[64] HC Deb 10 December 2012 c165W
[65] Northern Ireland Affairs Committee press notice, 2 April 2013

issues involved are complex and a decision cannot be rushed." The Minister went on to confirm that a decision would be made "in the autumn of 2014."[66] The Government remains committed to publishing its decision "no later than Autumn Statement 2014."[67]

During the Scottish referendum campaign, the main party leaders make a commitment that the Scottish Parliament should have "extensive new powers", should Scotland remain within the Union.[68] Following the vote, Lord Smith was appointed to lead a commission to reach cross-party agreement on what these should be. The Commission published its report on 27 November: while the parties had agreed that the Scottish Parliament should have to power to set the rates and thresholds of income tax, they also agreed that "all aspects of corporation tax will remain reserved."[69]

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[66] HC Deb 17 April 2014 c405W. see also HMG/NIE, *Building a Prosperous and United Community*, June 2013

[67] HL Deb 20 October 2014 cWA49.

[68] For more details see, *Scotland: Devolution proposals*, Library Standard Note SN6987, 15 October 2014

[69] *The Smith Commission*, 27 November 2014 p23