Office for Budget Responsibility

Richard Hughes
Chair

102 Petty France
London SW1H 9AJ

obr.uk

Stuart McDonald MP

House of Commons
London
SW1A 0AA

24 July 2023

Dear Stuart,

The Information Commissioner has decided that, in a finely balanced case, the exceptional public interest in the events leading up to former Chancellor Kwasi Kwarteng's 23 September Growth Plan requires us to release our 5 September note to him on the economic and fiscal outlook. I am therefore attaching that note. We are also publishing the note and this letter on our website.

The draft forecasts that are described in the note constitute the first round of a full forecast process that is set out in detail in the *Foreword* of the November 2022 *Economic and fiscal outlook*, which also contains the detail and full breakdown of the final forecast.

To place the note's contents in the context of the key policy and market developments around the time of its production:

- As regards policy measures, the note was produced 18 days ahead of the Growth Plan itself, so does not reflect any of the measures from that statement or from the then Prime Minister's energy price announcement of 8 September.

- As regards financial markets, the draft forecasts presented in the note were conditioned on gas prices across the summer of 2022, which rose to a peak (in terms of daily spot prices) of £6.40 a therm in late August, since when they have since fallen back significantly (to £1.10 at the time of our latest forecast in March 2023). But the note was also prepared before interest rates on government bonds rose sharply following the Growth Plan, and before they have again risen more recently. Bank Rate was expected to peak between 3½ and 4½ per cent in the forecasts presented in the note; it has now already risen to 5 per cent and markets currently expect it to peak close to 6 per cent.

So, relative to what has transpired, the draft forecasts described in the note are conditioned on more challenging wholesale gas prices, more favourable market interest rates, and less supportive near-term fiscal policy.

Warmest regards,

Richard Hughes
Chair

Office for Budget Responsibility

From the Budget Responsibility Committee

5 September 2022

To: Chancellor

Update on the economic and fiscal outlook

1.1 We have prepared this forecast to provide you with an up-to-date picture of the economy and public finances. This is a 'pre-measures' forecast – the economy forecast is based on policies as they stood in our most recent forecast in March, although we provide provisional estimates of the fiscal impact of the May 2022 cost-of-living package and energy profits levy. Under the legislation that established the OBR, we are required to publish at least two forecasts in any financial year, and it is for the Chancellor to decide when those forecasts are published. We would be able to publish an updated version of this forecast alongside any fiscal event planned for later this month, should you ask us to do so. This updated forecast would take on the latest data and the effects of any policy measures you may wish to announce, assuming your officials can inform us of the major policy measures with sufficient time to incorporate them.

1.2 Forecasts are always uncertain, but this one has been, and will continue to be, subject to larger-than-usual movements due to continuing volatility in energy markets and the recent steep rise in the yield curve. This forecast (shown in the blue lines in the charts) is based on a snapshot of energy prices at the end of July, and interest rates from mid-August, which has allowed us to put together a detailed forecast update. Gas price futures at the end of August were higher than at end-July, but well below the highs of late August. European prices have been buffeted by news about the interruption to the Nord Stream pipeline, progress on filling gas storage capacity, and interruptions to alternative energy supplies. And wholesale gas prices initially rose very sharply again today. Given the continued high degree of uncertainty about future European energy supply, whether more recent futures prices are a better guide to the most likely path of gas prices over the next few years is less clear. To give you a sense of where an updated forecast, based on last week's market prices, would land we also provide a 'latest data' scenario (the green lines in the charts), which broadly illustrates their potential impact on inflation, GDP, borrowing, debt, and the current fiscal rules.

1.3 The main conclusions of our updated forecast and latest data scenarios are:

- **Inflation** is forecast to peak at 13.5 per cent in January 2023 and average 8.7 per cent for calendar year 2023. The late-August peak in gas prices would be consistent with a quarterly peak of around 17 per cent.

- The economy is expected to enter a year-long recession in the final quarter of 2022, with **real GDP** falling by 2 per cent in 2023. The contraction is 3 per cent on end-August market prices.

- **Borrowing** is expected to be £122.4 billion (4.8 per cent of GDP) this year and is £21.8 billion (0.8 per cent of GDP) higher per year on average between 2022-23 and 2026-27 compared with our March forecast. Based on the latest market prices, borrowing would be a further £9 billion (0.3 per cent of GDP) higher each year on average over the forecast. This is due to higher debt interest and welfare spending, partly offset by higher receipts.

- Headline **debt** (including the Bank of England) peaks at 100.7 per cent of GDP next year, while underlying debt (excluding the Bank of England) peaks at 89.5 per cent of GDP and is 8.3 per cent of GDP higher in 2026-27 compared to our March forecast. Based on the latest market prices, underlying debt peaks at 89.8 per cent of GDP and is 9.5 per cent of GDP higher in the final year compared to March.

- The existing **fiscal mandate** is for underlying debt (excluding the Bank of England) to be falling as a share of GDP in the third year of the forecast (2025-26). Headroom against this target was £27.8 billion in our March forecast and has fallen modestly to £27.2 billion in this forecast, including the impact of the May policy announcements. Based on latest market prices, the headroom falls to £8.8 billion.

- The supplementary target for **current balance** in the third year of the forecast was met by £31.6 billion in March. In this forecast it is missed by £1.9 billion including the impact of the May announcements, or by £7.2 billion based on latest market prices.

- In addition to the uncertainty around the future evolution of both energy prices and interest rates, there are significant **policy risks embedded in this forecast**, such as next April's sharp rises in fuel duty (of around 25 per cent) and business rates (of around 10 per cent) that may prove undeliverable, and departmental spending totals that are fixed in cash terms despite soaring inflation. Easing these pressures would add to the cost of undoing the NICs and corporation tax rises and raising defence spending.

1.4 The remainder of this note describes our updated economic and fiscal forecast. It has been produced more quickly than normal, so we have focused on key economy forecast judgements: the implications of higher gas prices for inflation, interest rates, consumer spending and real GDP growth in the near term; and updated assumptions about potential output growth over the medium term. The fiscal consequences of this updated economy forecast have largely been calculated in-house rather than running the hundreds of individual receipts and spending forecast models used by government departments that underpin a full *Economic and fiscal outlook* (*EFO*). This generates its own uncertainties, but they are likely to be modest relative to those around the outlook for energy prices and interest rates. We highlight the sensitivity to gas prices and interest rates of key economic and fiscal variables, including inflation, GDP, and borrowing, in the relevant sections.

Economy forecast

1.5 The economic outlook has worsened significantly since we last produced a forecast in March. Historically high gas prices have already driven inflation to its highest level in 40 years and we expect inflation to rise even further over the next few months. Conditioned on no further fiscal support, high inflation delivers unprecedented (in modern times) falls in real disposable household incomes despite rising nominal earnings growth. The resulting sharp drop in real consumer spending in this forecast pushes the economy into a year-long recession with GDP falling from the fourth quarter of 2022 until the third quarter of 2023. On this projection, unemployment rises to a peak of 5.2 per cent in third quarter of 2024. This pre-measures forecast does not include the May cost-of-living support package, which we will incorporate alongside any new policy measures in a future round, but we provide a provisional estimate of the impact of the May measures on real GDP below.

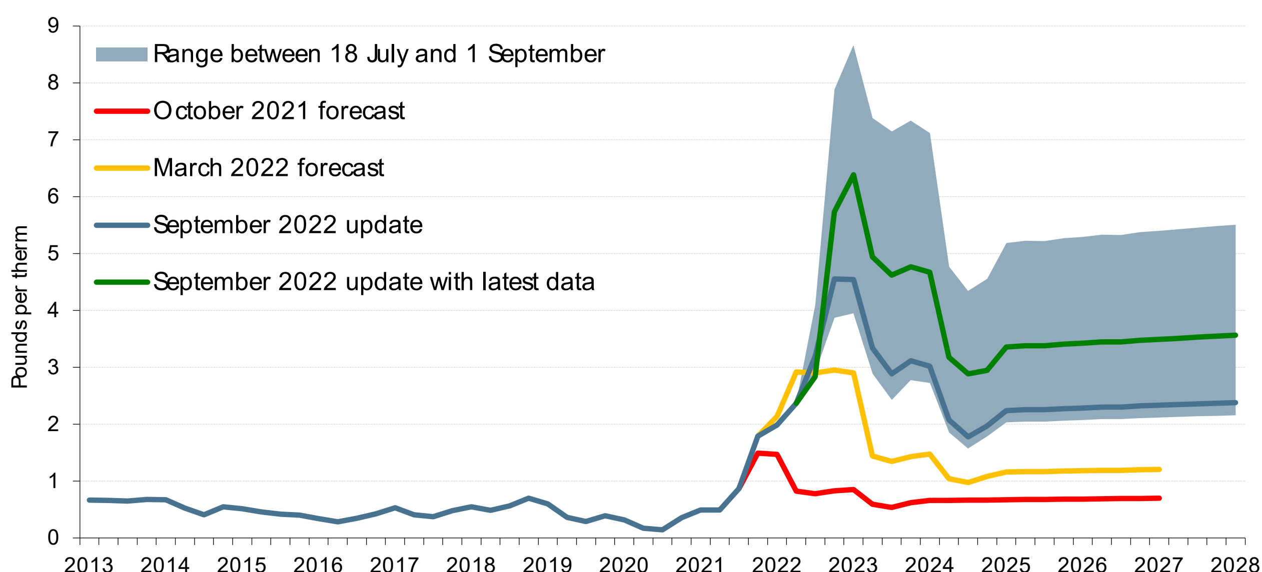
Energy and other commodity prices

1.6 Gas prices have risen since Russia's invasion of Ukraine and now look set to remain higher for longer than assumed in our March forecast (Chart 1.1). The most recent rise in prices is partly as a result of Russia restricting the supply of natural gas and the disruption to alternative energy supplies elsewhere in Europe. We conditioned this economy forecast on gas price futures averaged over the five days to 28 July. Given how volatile gas prices have been over the past month, we also discuss the implications of different assumptions below. Based on late-July gas futures, prices for the first quarter of 2023 had risen by 60 per cent from £2.90 to £4.50 a therm relative to our March forecast assumption, and by 140 per cent since before Russia's invasion of Ukraine. Medium-term prices are also higher – for example, prices in the final quarter of 2024 are up from 90p a therm before the Russian invasion and £1.10 a therm in our March forecast to £2.00 a therm for this forecast update. Oil prices are also higher than in our March forecast, though much less dramatically. Other commodity prices have also risen, notably wholesale food prices.

1.7 As Chart 1.1 emphasises, the volatility in gas prices over the past month has been extreme. At their most recent peak on 26 August, prices for the first quarter of 2023 reached £8.70 a therm, while prices in the final quarter of 2024 hit £4.60 a therm (around twice the level assumed in this forecast). This may have reflected a degree of panic-buying to insure against the possibility of even greater disruption to European gas supplies from Russia than is already being felt. Prices fell back sharply last week as concerns over shortages this winter eased, but even so the average from 30 August to 1 September that will form the basis for our next forecast round was still 50 per cent higher on average over the next two years than the late-July prices used in this update.[1] Prices at end-August reflected the latest news about Nord Stream 1 having been *temporarily* closed for maintenance from 31 August to 2 September. Prices initially rose on Monday morning, following the announcement on Friday (after trading hours) that the closure would instead be for an indefinite period.

[1] To incorporate the extent to which market participants expect gas prices to fall over the medium term, in future forecasts, prices will follow the futures curve until the end of 2025 rather than the end of 2024 (resulting in a similar long-run price to that used here).

Chart 1.1: Gas prices



Note: September 2022 update values are an average of the 5 working days to 29 July. September 2022 update with latest data values are an average of the three working days to 1 September.
Source: Datastream, OBR

Inflation

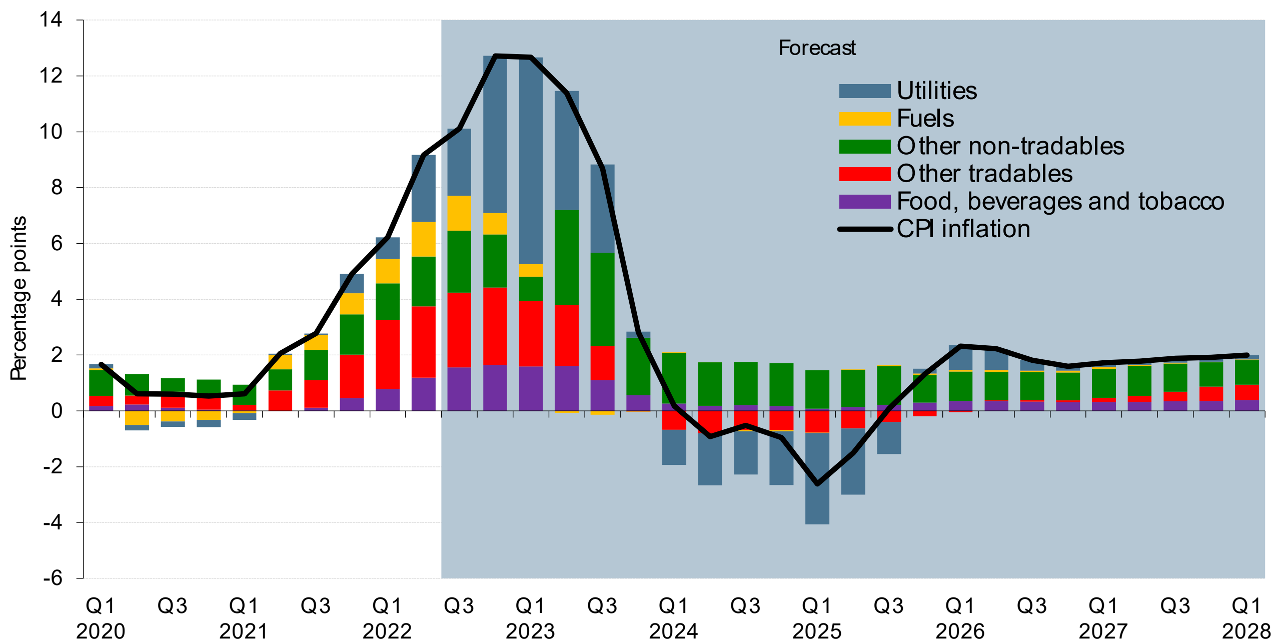
1.8 Based on late-July gas prices, higher domestic energy bills push CPI inflation up to a peak of 12.7 per cent in the fourth quarter of 2022, the highest quarterly rate since the early 1980s. Inflation remains higher for longer than in our March forecast, averaging 8.7 per cent over calendar year 2023, more than twice the 4.0 per cent in March. Utility bills will continue to be the primary driver of inflation (Chart 1.2). The late-July gas prices used in this forecast would see the Ofgem cap rise by around 75 per cent to over £3,400 in October 2022 (close to the rise to £3,549 announced by Ofgem on 26 August) and a further 20 per cent to over £4,100 in January 2023. The 26 August peak in gas price futures would be consistent with the cap rising to £5,500 in January 2023 and then again to almost £7,000 in April 2023, and CPI inflation rising to around 17 per cent in the first quarter of next year (compared to a peak of 13 per cent in this forecast).[2] Inflation is also pushed up by tradable goods prices as supply bottlenecks persist globally, and by food and non-alcoholic beverages inflation, which reached 12.6 per cent in July, the highest rate since August 2008. Price pressures are also broadening into domestically produced goods and services and we expect this to continue as relatively strong nominal wage growth persists.

1.9 Conditional on energy prices falling from the second quarter of 2023 in line with the late-July futures curve, CPI inflation drops rapidly, falling into negative territory at -0.9 per cent in the

[2] The planned rise in the price cap from £1,971 to £3,549 in October announced by Ofgem in August would imply households spending (on an annualised basis) an additional £44 billion on domestic energy bills. So, the £15 billion cost-of-living support package announced in May 2022 will now offset approximately only one-third of the rise in bills from April to October (compared to the two-thirds expected in May, when the price cap was expected to rise to £2,800 – a figure that was in line with our March 2022 forecast).

second quarter of 2024 and remaining negative until the third quarter of 2025. The extent of this deflation depends on both the fall in energy prices and their weight in the inflation basket, and that weight is likely to increase as energy bills make up a higher proportion of households' spending. This forecast includes a preliminary estimate of the impact of changing weights on CPI inflation since this is likely to be material to the outlook, though we will need to refine this in the next forecast round. The sharp fall in energy prices, easing supply bottlenecks, weaker consumption, rising unemployment, and further Bank Rate rises all reduce inflationary pressures from mid-2023, taking inflation below its 2 per cent target. Inflation returns to target by 2026, as the influence of these forces fades and monetary policy eases.

Chart 1.2: CPI inflation forecast update

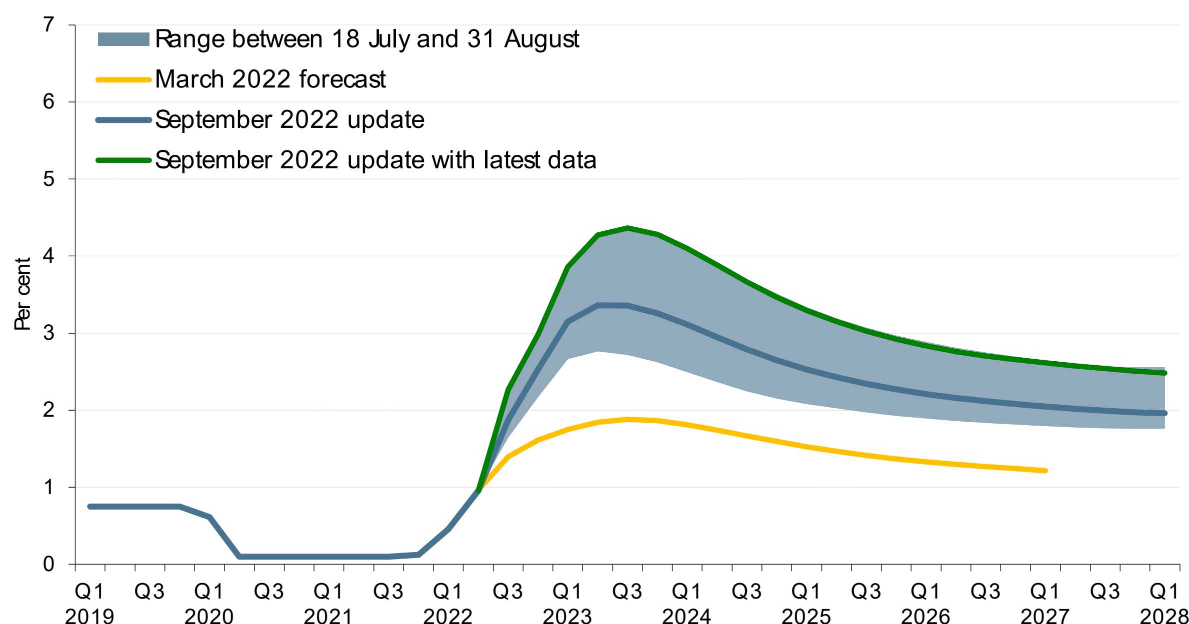


Source: ONS, OBR

Interest rates

1.10 Market participants expect the Bank of England to respond to higher inflation by increasing interest rates, and by significantly more than expected at the time of our March forecast. As shown in Chart 1.3, soon after the Russian invasion of Ukraine, Bank Rate was expected to peak at 1.9 per cent in by the middle of 2023. Our fiscal forecast is conditioned on mid-August market expectations, which had already risen to a peak of 3.4 per cent. Since then, Bank Rate expectations have risen higher still, with the average peak expected on the final two days of August reaching 4.4 per cent. The Government's own borrowing costs have also risen: the yield on a 10-year gilt was only around 1 per cent in March, was 2 per cent in the yield curve used in this forecast, and had reached 3 per cent by the end of August.

Chart 1.3: Bank Rate outturn and market expectations

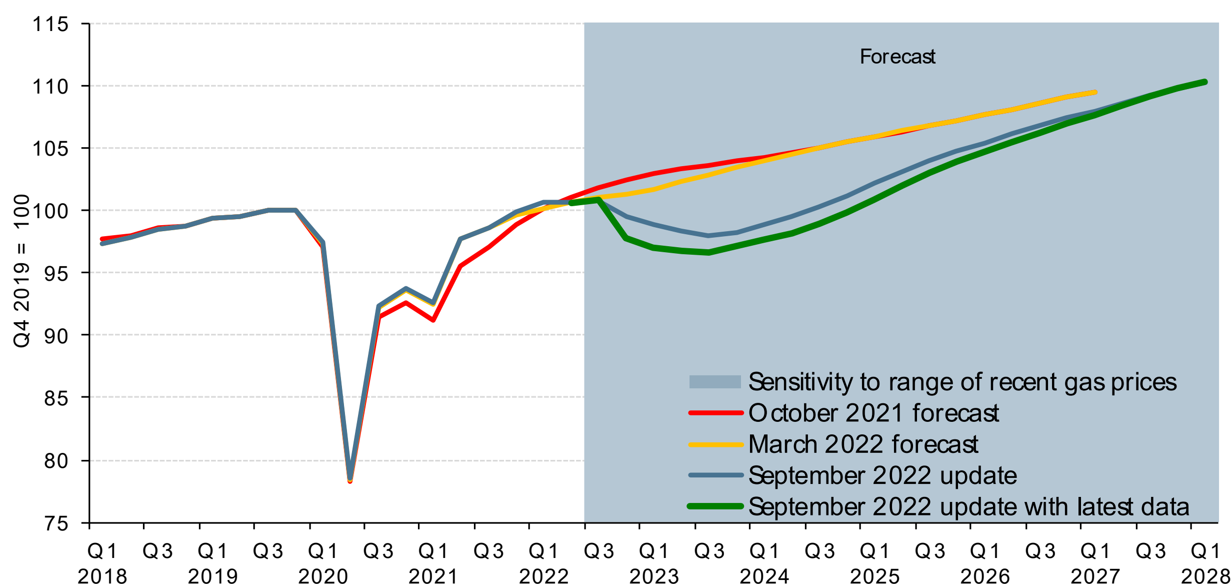


Note: September 2022 update with latest data values are an average of the two working days to 31 August.
Source: Bank of England, Bloomberg, OBR

GDP, the output gap, and potential output

1.11 In our September 2022 update, high inflation pushes the economy into a year-long recession. The level of real GDP in 2023 is 4.1 per cent below our March forecast (Chart 1.4). Soaring costs of energy and other essentials cause a sharp drop in the consumption of non-essentials, a rise in unemployment, and contraction in real output. While we expect some consumption smoothing through the running down of pandemic savings or increases in debt, a large proportion of households will have limited access to savings or credit. We also expect investment to fall due to uncertainty, higher input costs, and rising interest rates, while exports are also likely to be weaker as global trade growth falls. As a pre-policy forecast, these figures do not include the impact of the May cost-of-living package. Our initial estimate is that the package would raise the level of real GDP by a peak of a little more than ½ a per cent in the fourth quarter of 2022. So, were these measures to be incorporated, the economy would still enter a recession but it would, initially, be somewhat shallower.

Chart 1.4: Medium-term forecast for real GDP



Source: ONS, OBR

1.12 The fall in real GDP opens up a large negative output gap, with spare capacity peaking at 4.4 per cent in the third quarter of 2023. As energy prices fall and real incomes recover, GDP growth picks up from the fourth quarter of 2023 and the output gap closes by the forecast horizon. As a result, by the end of the forecast in 2027, real GDP growth moves in line with potential output growth.

1.13 As is the case each year, we have reviewed our medium-term supply-side assumptions for growth in potential output – with analytical input from Treasury colleagues and outside experts. Potential output now grows by 4.1 per cent in 2022 and 2.3 per cent in 2023 as it recovers from the supply constraints of the pandemic. It then averages 1.6 per cent a year from 2024 to 2026, compared to 1.8 per cent in March, before hitting 1¾ per cent in 2027. This is relatively healthy growth in productive capacity by recent historical standards and higher long-run growth than currently assumed by other forecasters including the Bank of England, NIESR, and the OECD. But it is, on average, 0.3 percentage points a year lower growth in potential output than we forecast in March, leaving cumulative growth in potential output from the second quarter of 2022 to the start of 2027 down 1.3 percentage points from that forecast. That reflects the following views on its components:

- Our estimate of the growth in **labour supply**, the equilibrium total hours worked across the economy, is little changed from March and contributes 0.5 per cent a year to growth in potential output. This assumes that older workers' participation is lower than before the pandemic, as some older workers have permanently left the labour force due to ill-health or retirement. And we continue to assume the current migration regime is more restrictive than the previous one, which lowers net inward migration.

- We have revised down our estimate of overall growth in **labour productivity** by 0.3 percentage points a year on average, so that it now contributes 1.3 percentage points to potential output growth. Of this 1.3 per cent growth in output per hour worked:

(a) **capital deepening** contributes 0.6 per cent a year. This is lower than implied in our March 2022 forecast, reflecting the impact of the weaker-than-expected business investment in outturn and the predicted downturn in investment over the forthcoming recession. This also includes a modest drag on business investment from raising the main corporation tax rate next April, which our forecasts have incorporated since the measure was announced in Budget 2021; and

(b) growth in **total factor productivity (TFP)** averages 0.7 per cent a year. This is also lower than implied in our March 2022 forecast and brings our estimate of long-run TFP growth into line with post-financial crisis outturns, rather than assuming a recovery toward pre-financial crisis rates.

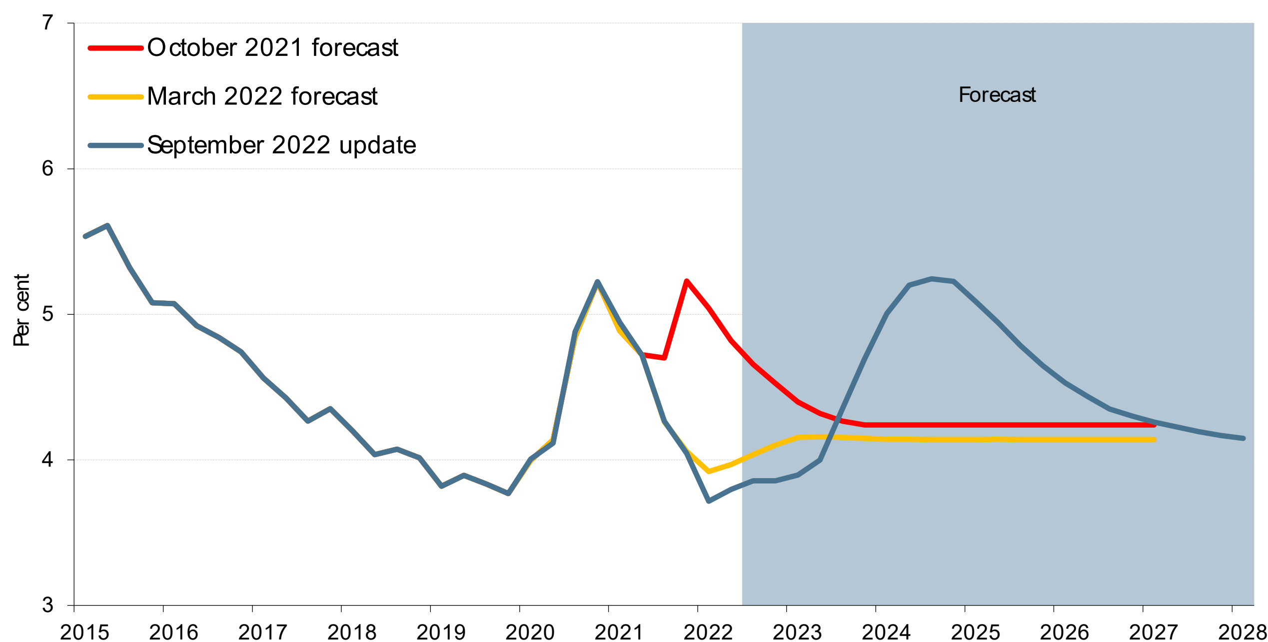
1.14 These revisions partly reflect the consequences of developments in energy prices since our March forecast, which we now expect to be higher and more persistent. As discussed in our July *Fiscal risks and sustainability* report, this is expected to lower the productive potential of the economy by reducing the volume of goods and services it is profitable for firms to produce when the price of a key, largely imported, input rises. To the extent that energy prices subsequently fall back further in the longer run than assumed in our forecast, the 1.3 percentage point hit to cumulative potential output growth in this forecast would be smaller.

1.15 Nominal GDP is the key driver of our fiscal forecast and we expect it to drop below our March forecast as lower real GDP more than offsets a higher economy-wide price level. By the forecast horizon, nominal GDP is 1.1 per cent lower than in our March forecast. It may be surprising that high inflation has not led us to revise nominal GDP up despite the modest downward revision to real GDP in the medium term. This reflects the fact that it is largely import prices that have pushed CPI inflation higher, which drives a wedge between CPI inflation (which measures price increases for consumers) and the GDP deflator (which measures price increases for good and services produced domestically and is used to calculate nominal GDP). This is what happens when a terms-of-trade shock such as the current energy crisis hits the economy, causing a sharp rise in import prices relative to the prices of exports and other domestically produced items.

Employment and unemployment

1.16 This forecast – conditioned on late-July gas prices and no further fiscal support – sees unemployment rise from 3.8 per cent in the second quarter of this year to a peak of 5.2 per cent in the third quarter of 2024 – a rise of 510,000 to peak at 1.8 million – before falling back to 4.1 per cent by the forecast horizon as the economy recovers (Chart 1.5). The labour market is currently very tight, with high vacancies and survey evidence suggesting that workers have temporarily increased their hours to compensate for labour shortages. This means the rise in unemployment is likely to lag the fall in GDP as vacancies and hours drop first before unemployment starts to rise.

Chart 1.5: Unemployment



Source: ONS, OBR

1.17 Employment falls 1.5 per cent (490,000) below our March forecast as unemployment rises. This drop comes on top of a relatively weak recovery in employment from the pandemic, with employment still 140,000 (0.4 per cent) below pre-pandemic levels in the latest data, driven by higher inactivity largely due to more people long-term sick. We expect some of the rise in inactivity since the pandemic to unwind over the forecast period, but the participation rate will remain broadly flat at around 63 per cent due to the ageing population.

Earnings and household incomes

1.18 We expect higher inflation to push up nominal earnings growth to almost 6 per cent in 2022 before falling to just under 5 per cent in 2023, 0.4 and 1.9 percentage points stronger than our March forecast, respectively. This boosts the near-term labour share of national income (a key determinant of the tax-to-GDP ratio) relative to our March forecast. Average weekly earnings growth was 5.1 per cent on the total pay measure in the second quarter of 2022 compared to an average of 3.0 per cent since 2000. We judge that higher inflation will push up nominal earnings while the labour market remains relatively tight. However, higher nominal pay is not enough to fully compensate for higher inflation and real wages therefore fall by 1.9 and 3.1 per cent year-on-year in 2022 and 2023 respectively, before recovering to rise by around 2 per cent in both 2024 and 2025. As inflation erodes real incomes, real household disposable income (RHDI) falls by 3.3 per cent this year and 3.0 per cent in 2023 and does not recover its pre-pandemic level until 2025.

Comparison to external forecasters

1.19 Chart 1.6 compares this forecast to those from the Bank of England and from a range of external forecasters compiled by the Treasury in August. It shows that:

- We have relatively similar forecasts to **the Bank** for 2023, but the Bank forecast has higher CPI inflation and lower GDP growth in 2024. These differences are largely because the Bank conditioned its forecast on energy prices following the future curve over just the next six months and then staying constant at near its peak in real terms, whereas our forecast follows the rise and fall of futures over the next two years before remaining constant in real terms thereafter.

- **External forecasters** expect much lower inflation than we do in 2023, possibly reflecting the earlier vintages of many of these forecasts, some of which may have been produced before gas prices rose further over the past month. Last week, Goldman Sachs predicted that inflation could hit 14.8 per cent in January, compared to the 13.5 per cent peak in our forecast, while its upside risk scenario saw inflation peaking at 22.4 per cent. The stronger GDP growth expected by external forecasters next year is likely to reflect this lower inflation, as well as the impact of the May policy package and, in some cases, expectations of further fiscal support later this year.

Chart 1.6: Comparison of forecasts for inflation and real GDP

Note: CPI forecasts for the OBR and BoE in 2022 are both 9.6 per cent. Independent forecasts compiled by the Treasury in August.
Source: Bank of England, HM Treasury, OBR

Sensitivity to energy prices

1.20 With energy prices and inflation (and any further associated fiscal support) being the key drivers of near-term economic prospects, this picture will continue to change – perhaps materially – as wholesale gas prices move. In broad terms, each 10 per cent rise in anticipated wholesale gas prices over the coming 12 months adds around 0.4 percentage points to the forecast of CPI inflation (via the energy price cap and knock-on effects throughout the economy). Higher inflation would then weaken GDP growth. Chart 1.4 shows a potential range of outcomes if the gas prices we use to forecast energy bills when producing our CPI inflation forecast were at the maximum or minimum of the range of expected prices seen since 18 July. If gas prices over 2023-24 were at the

top of the range (£7.20 a therm on average), real GDP could be around 3 per cent lower than our forecast in that year. If gas prices were at the bottom of the range (£2.70 a therm), real GDP could be a little over ½ a per cent higher in 2023-24. The chart also shows the effect of higher prices in the medium term: each 10 per cent rise in gas prices could subtract up to 0.1 percentage points from potential output.[3]

1.21 Table 1.1 below sets out the main elements of our economy forecast, together with the changes since March 2022.

Table 1.1: Economy forecast update and changes since March 2022

	Percentage change on a year earlier, unless otherwise stated							
	2015-19	Outturn	Forecast					
	average	2021	2022	2023	2024	2025	2026	2027
Output at constant market prices								
Gross domestic product (GDP)	1.6	7.4	3.3	-2.1	1.6	3.5	2.8	2.3
GDP levels (2021=100)	99.0	100.0	103.3	101.2	102.8	106.4	109.5	112.0
Nominal GDP (£ billion)	2096	2317	2517	2561	2618	2729	2863	2986
Output gap (per cent of potential output)	-0.1	1.3	0.5	-3.8	-3.6	-1.8	-0.7	-0.2
Expenditure components of GDP								
Household consumption	1.8	6.2	4.0	-2.6	1.0	2.8	2.7	2.3
General Government consumption	1.1	14.3	0.7	3.7	1.6	1.6	2.0	2.2
Business investment	1.0	0.8	5.2	-0.7	3.6	7.2	5.1	4.5
Net trade[1]	0.0	-1.5	-2.8	1.8	0.9	0.5	0.0	-0.2
Inflation and the labour market								
CPI	1.5	2.6	9.6	8.7	-0.6	-0.7	2.0	1.8
Employment (millions)	32.1	32.4	32.8	32.8	32.6	32.9	33.2	33.4
Average earnings	2.3	6.0	5.8	4.8	1.7	1.5	2.3	3.4
ILO unemployment (% rate)	4.5	4.5	3.8	4.2	5.2	4.9	4.4	4.2
Productivity (output per hour)	0.6	0.8	-0.6	-0.8	1.1	2.1	1.8	1.5
	Changes since March 2022 forecast							
Output at constant market prices								
Gross domestic product (GDP)		0.0	-0.5	-3.8	-0.5	1.8	1.2	
GDP levels (2021=100)		0.0	-0.5	-4.5	-5.1	-3.3	-2.1	
Nominal GDP (per cent)		0.0	1.7	-1.4	-3.1	-2.6	-1.4	
Output gap (per cent of potential output)		0.1	-0.2	-3.5	-3.6	-1.9	-0.7	
Expenditure components of GDP								
Household consumption		0.1	-1.5	-3.6	-0.5	1.6	1.5	
General Governement consumption		-0.2	-1.9	2.5	0.2	0.0	0.0	
Business investment		1.5	-5.4	-6.3	0.0	1.8	0.6	
Net trade[1]		-0.3	-2.2	1.9	0.4	0.4	0.1	
Inflation and the labour market								
CPI		0.0	2.1	4.7	-2.1	-2.6	0.0	
Employment (millions)		0.0	0.1	0.0	-0.5	-0.3	-0.1	
Average earnings		-0.2	0.4	1.9	-0.9	-1.4	-0.9	
ILO unemployment (% rate)		0.0	-0.2	0.1	1.0	0.7	0.3	
Productivity (output per hour)		-0.5	-0.4	-1.8	-0.4	0.7	0.5	

[1] Contribution to GDP growth

[3] To provide a better picture of the sensitivity of future potential output forecasts to long-run gas prices, we have based the medium-term potential output impacts in Chart 1.4 on the narrower range of gas prices implied by using three years of the futures curve.

Fiscal forecast

1.22 Higher inflation, a weaker real economy, and rising interest rates mean that the fiscal outlook has also deteriorated materially since March – despite the boost from soaring oil and gas revenues as profits in the North Sea boom. As with the economy forecast above, this section describes a pre-measures forecast conditioned on end-July gas prices and mid-August interest rates. It reflects a summer round of updates from individual receipts and spending forecast models to take on modelling improvements and reflect the latest data. To this we have added, largely in-house, calculations of the fiscal consequences of our updated economy forecast. We provide indicative figures for the additional cost of the May 2022 cost-of-living package and the new energy profits levy. In addition, we illustrate, in broad orders of magnitude, what taking on the latest (end-August) energy prices and interest rates would imply for the pre-measures borrowing and debt outlook.

1.23 We also reflect the latest changes to the way the public finances will be recorded by the ONS so that the forecast is consistent with how outturn statistics will be presented. In this forecast we have reflected the new treatment of central government leases that will be reflected in September's ONS data release. This increases borrowing by £1.5 billion a year on average and, alongside revisions to public corporations data, raises the starting point for debt in the forecast by £23.7 billion. In the next round we will reflect a change to the methodology for business rates and the reclassification of Bulb into the public sector.

Receipts

1.24 Table 1.2 summarises the changes in the main taxes in our pre-measures forecast update relative to our March forecast. Receipts have been revised up by an average of £21.4 billion this year and next, with little change thereafter (reflecting the modest downward revision to nominal GDP offset by a slightly higher tax burden). The main changes include:

- **Income tax, NICs and health and social care levy** receipts have been revised up this year and particularly next year (by £10.1 billion) and then revised down in each year thereafter, by amounts increasing to £6.6 billion in 2026-27. The near-term strength reflects modestly higher nominal wage growth (and a temporarily higher labour share of output), combined with frozen tax thresholds meaning that there is no *negative* fiscal drag from CPI inflation exceeding wage growth. Downward revisions in the later years reflect lower aggregate wages and salaries, which flows largely from the somewhat weaker outlook for potential productivity growth.

- **Onshore corporation tax** receipts have been revised up in each year (by an average of £3.0 billion) reflecting our assumption that some of the strength in outturn data in the early months of this year will persist, partly offset by the weaker outlook for profits as margins are squeezed. The drivers of the current strength in outturn receipts are not immediately clear given the fact that higher energy bills and higher unit wage costs are hitting already, so this forecast is particularly uncertain.

- **VAT** receipts have been revised up in each year of the forecast, by an average of £2.6 billion, reflecting stronger outturn data (which is likely in part to reflect higher-than-expected inflation). This more than offsets the effect of lower nominal consumer spending from next year onwards and the VAT receipts lost due to high energy prices (which shift spending towards energy bills that are taxed at 5 per cent and away from standard-rated goods and services).

- **Oil and gas revenues** have been revised up by an average of £2.7 billion in each year of the forecast, reflecting higher gas prices. The £9.0 billion pre-measures revenues forecast for this year – alongside £6.2 billion from the energy profits levy announced in May – would represent an all-time cash-terms high for North Sea revenues, and the highest as a share of GDP since 2008-09. Volatility in energy prices means oil and gas revenues are a particularly uncertain element of our forecast at present. Based on last week's gas prices, they would be around a further £3 billion (50 per cent) a year higher on average than in this forecast update.

1.25 Table 1.2 also shows the latest estimates of the revenue raised by the three main tax rises introduced since the pandemic: the freezing of income tax thresholds, introduction of the health and social care levy, and rise in the main rate of corporation tax. These collectively raise receipts by £64.2 billion in 2025-26, with the latest upward revisions to CPI inflation raising the yield from the income tax threshold freezes by £9.9 billion to £27.3 billion in that year. The yield from the health and social care levy is little changed since March, while the yield from raising the corporation tax rate to 25 per cent has been revised up modestly (by £1.6 billion in 2025-26).

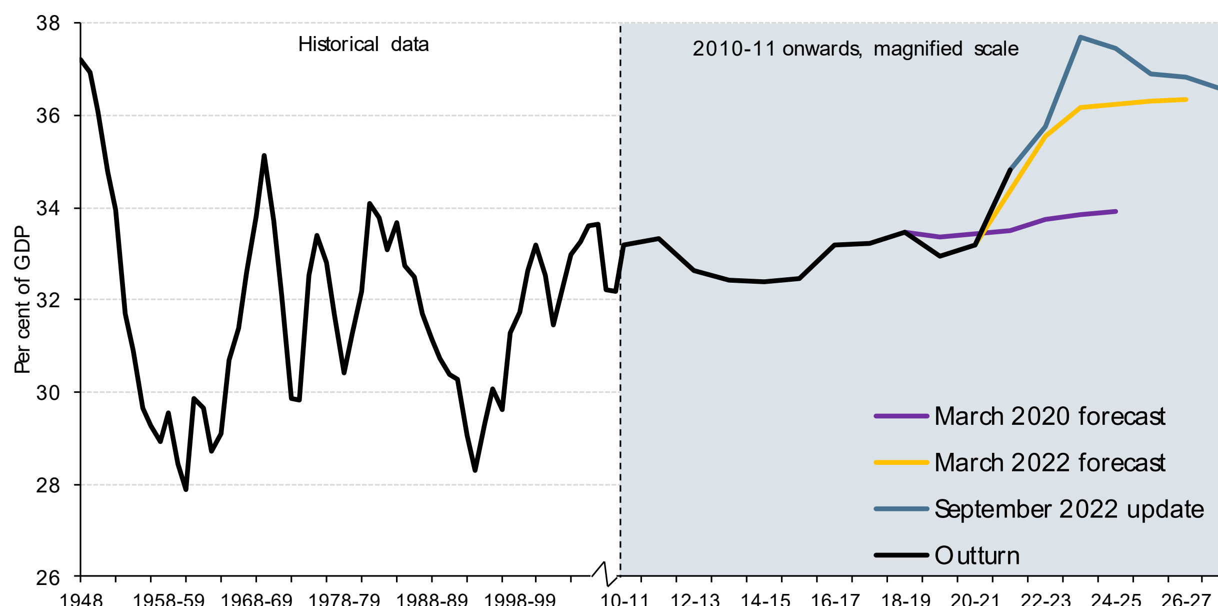
Table 1.2: Receipts forecast update in detail

	£ billion					
	Forecast					
	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
March 2022 forecast	987	1,050	1,090	1,131	1,175	
September 2022 update	1,005	1,075	1,095	1,131	1,180	1,221
Changes	17.5	25.3	5.0	0.2	5.8	
of which:						
Income tax, NICs and H&SC levy	1.8	10.1	-2.9	-6.9	-6.6	
Onshore corporation tax	4.6	0.8	0.8	3.2	5.3	
VAT	3.0	2.9	1.7	2.2	3.1	
Oil and gas revenues	1.2	5.7	3.6	1.6	1.3	
Other receipts	6.9	5.8	1.7	0.1	2.7	
Memo: Amounts raised by key post-pandemic tax measures						
Income tax threshold freezes	*2.8*	*14.2*	*27.5*	*27.3*	*29.0*	*30.5*
Health and social care levy	*17.2*	*17.3*	*17.0*	*17.3*	*17.9*	*18.6*
Corporation tax rise	*2.6*	*13.8*	*18.2*	*19.6*	*20.5*	*21.2*
Total	*22.6*	*45.3*	*62.7*	*64.2*	*67.4*	*70.3*

1.26 When combined with the lower path for nominal GDP, the revised receipts outlook raises the tax burden (i.e. the ratio of National Accounts taxes to GDP) on a pre-measures basis by between 0.2 and 1.5 percentage points relative to our March forecast. It now peaks at 37.7 per cent of GDP in 2023-24, which would be a post-war record (Chart 1.7). The upward revision to the tax burden since March reflects several factors, the most important of which are: (i) oil and gas revenues being buoyed by higher gas prices; (ii) income taxes being supported relative to GDP by a higher

labour share and not falling (as would normally happen when real incomes fall) due to frozen thresholds; and (iii) VAT being supported by a higher consumption share of GDP, despite the lower effective tax rate that comes from more consumer spending going on energy bills.[4]

Chart 1.7: National Accounts taxes as a share of GDP



Note: We have increased the GDP denominator in forecast years for our previous forecasts by the upward revision to 2020-21 nominal GDP in the recent Quarterly National Accounts data. This is to enable like-for-like comparisons with our March 2022 forecast.
Source: ONS, OBR

Spending

1.27 Table 1.3 summarises the changes in the main areas of spending in this pre-measures forecast update relative to March. Spending has been revised up by £40.8 billion this year and then by an average of £30.6 billion in future years. The main changes include:

- **Central government debt interest spending (net of APF flows)** has been revised up by £39.1 billion this year, taking it to £122.1 billion, the highest in cash terms on record and the highest post-war as a share of GDP. Spending has then been revised up by around £17 billion a year in future years, apart from a downward revision of £5.6 billion in 2024-25 when RPI inflation turns negative. In the short term, these revisions largely reflect a higher and more sustained rise in RPI inflation hitting index-linked debt (adding £29.3 billion to spending in 2022-23), with Bank and gilt rate rises increasing debt interest in the later years of the forecast. If conditioned on last week's gas prices and interest rates, debt interest spending would be a further £13 billion a year (20 per cent) higher on average across the forecast.

- **Welfare spending** has been revised up next year and all years thereafter, by a maximum of £22.9 billion in 2024-25. The vast majority of this upward revision reflects the implications of CPI inflation for working-age benefits and the triple lock – both the higher near-term peak

[4] We have not yet updated our forecast for the environmental levies – notably contracts for difference – that are treated as taxes in the National Accounts. High energy prices will result in downward revisions to these 'taxes', which will reduce the measured tax burden.

and the fact that benefit rates do not fall when inflation turns negative. Higher unemployment also raises spending modestly.

- **Departmental resource spending** has been revised up by £1.7 billion in 2022-23 and by £0.9 billion in 2023-24, in part due to classification changes, and also due to a £2.5 billion reduction in the level of assumed underspending in 2022-23 (and a £0.7 billion reduction in 2023-24) on the back of higher inflation and wage rises. But this still reflects departmental limits set in cash terms by the Treasury last year. The huge extent of the upside surprise in inflation and the real-terms public sector pay cuts that have resulted may ultimately lead to those limits being revisited. And our forecast does not anticipate how the pledge to raise defence spending to 3 per cent of GDP by 2030 might affect the path of total departmental spending over the next five years.

Table 1.3: Spending forecast update in detail

	£ billion					
	Forecast					
	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
March 2022 forecast	1,087	1,100	1,127	1,166	1,206	
September 2022 update	1,127	1,131	1,148	1,203	1,239	1,282
Changes	40.8	30.6	21.0	37.6	33.0	
of which:						
Debt interest (net APF)	39.1	18.2	-5.6	15.6	16.9	
of which due to:						
RPI inflation	29.3	0.3	-21.3	-0.6	-1.0	
Interest rates	8.3	16.3	13.4	12.9	13.6	
Other factors	1.5	1.6	2.3	3.2	4.2	
Welfare spending	2.2	10.2	22.9	19.2	14.0	
Other spending	-0.4	2.2	3.6	2.9	2.2	

Borrowing

1.28 Putting receipts and spending together, public sector net borrowing (PSNB) is £21.8 billion (0.8 per cent of GDP) higher on average between 2022-23 and 2026-27 compared to our March forecast and reaches £58.8 billion (2.0 per cent of GDP) in 2026-27, compared to £31.6 billion (1.1 per cent of GDP) in March. The latest estimate of PSNB in 2021-22 of £144.1 billion (6.1 per cent of GDP) is significantly higher than in our March forecast thanks to departmental spending coming in much higher than expected. Based on late-July gas prices and mid-August interest rates, pre-measures PSNB then falls modestly in 2022-23 and sharply in 2023-24, before following an uneven path over the following four years. The sharp fall in borrowing over the next two years reflects higher tax receipts, while the uneven path over the five years reflects large movements in the accrued cost of servicing index-linked debt due to the gyrations of RPI inflation, described above. In summary:

- **Relative to our March forecast** (Table 1.4), pre-measures PSNB has been revised up by £23.3 billion in 2022-23, £5.2 billion in 2023-24, and by an average of £26.9 billion a year between 2024-25 and 2026-27. The revision this year reflects higher debt interest spending outweighing higher receipts. Next year, higher welfare and debt interest spending are largely offset by stronger receipts. Thereafter, higher welfare spending dominates, with receipts little changed from March.

- **The package of cost-of-living support and the energy profits levy announced in May** will raise borrowing this year – with a provisional estimate of £8.4 billion, reflecting £14.6 billion of cost-of-living support partly offset by the £6.2 billion yield from the energy profits levy. The package then lowers borrowing by between £1.7 billion and £5.6 billion a year in the three years thereafter, while the temporary energy profits levy is still in place, and raises it by £1.2 billion a year in the final two years of the forecast due to the clawback of the universal energy support payment having been cancelled.

Table 1.4: Public sector net borrowing: Forecast update versus March 2022

	£ billion						
	Outturn	Forecast					
	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
March 2022 forecast	127.8	99.1	50.2	36.5	34.8	31.6	
September 2022 update	144.1	122.4	55.4	52.5	72.3	58.8	61.7
Change	34.5	23.3	5.2	16.0	37.4	27.2	
of which:							
Receipts	3.5	-17.5	-25.3	-5.0	-0.2	-5.8	
Spending	31.1	40.8	30.6	21.0	37.6	33.0	
of which:							
Debt interest	0.0	39.1	18.2	-5.6	15.6	16.9	
Welfare spending	0.0	2.2	10.2	22.9	19.2	14.0	
Other spending	31.1	-0.4	2.2	3.6	2.9	2.2	
September update with May package	144.1	130.8	49.9	49.1	70.5	59.9	62.9
Changes vs pre-measures forecast update	0.0	8.4	-5.6	-3.4	-1.7	1.2	1.2
of which:							
Cost-of-living package		14.6	1.2	1.2	1.2	1.2	1.2
Energy profits levy		-6.2	-6.8	-4.6	-2.9	0.0	0.0

Note: This table uses the convention that a negative figure implies a reduction in PSNB, i.e. an increase in receipts or a reduction in spending will have a negative effect on borrowing.

1.29 The volatility in gas prices and interest rates at present means the fiscal outlook – like the economic one – is particularly uncertain, as illustrated in Chart 1.8. It shows:

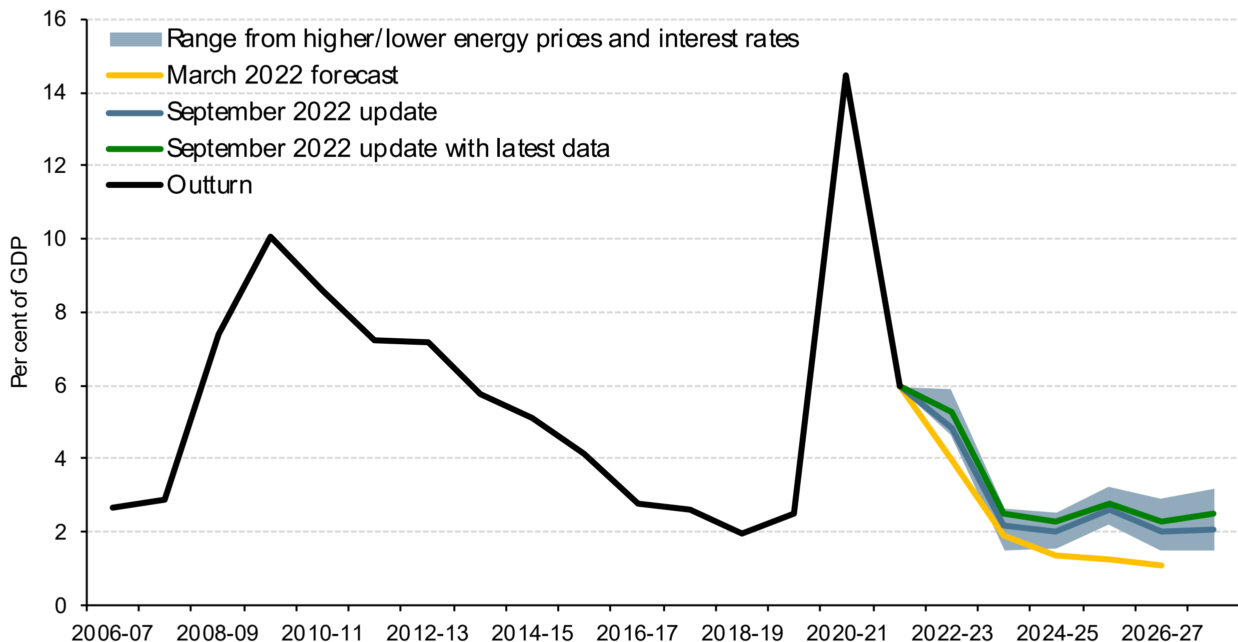
- A £27 billion deterioration by 2026-27 between March and **the forecast update** outlined above, which reflects an economy forecast conditioned on late-July market prices (the move up from **yellow line to blue line**).

- The large **illustrative range of borrowing outcomes** that would be consistent with gas prices and interest rates seen over the past month (the **blue swathe**, the top of which reflects the highest gas prices and interest rates of the past month and the bottom of which reflects the lowest). The top of this range is around £34 billion (1.1 per cent of GDP) higher than our pre-measures forecast update at the forecast horizon, while the bottom is a more modest £11 billion (0.4 per cent of GDP) below it.

- An indication of where **the next round of our forecast** might settle on the basis of gas prices over the three days to 1 September and interest rates over the two days to 31 August (the **green line**). This is below the top of the range thanks to the fall in gas prices from their peak the week before, but it reflects the continuing rise in interest rates over the past week. On this basis, borrowing would be around £9 billion (0.3 per cent of GDP) higher each year than

in the forecast update and £13 billion higher at the forecast horizon. Given the large movements involved and the simplified mechanical way in which this indicative path has been constructed, it should be treated as showing the approximate rather than precise magnitude of pre-measures forecast revisions that will follow in the next round.

Chart 1.8: PSNB: forecast update and gas price/interest rate sensitivities



Source: ONS, OBR

Debt

1.30 Pre-measures public sector net debt (PSND) peaks at 100.7 per cent of GDP in 2023-24, 6.7 per cent of GDP higher than in March, before falling in every year thereafter to 89.8 per cent of GDP by 2027-28. Public sector net debt excluding the Bank of England (PSND ex BoE) – the underlying measure that is targeted by the fiscal mandate and excludes uneven movements related to the Bank's Term Funding Scheme – peaks at 89.5 per cent of GDP in 2023-24, before falling in every year thereafter (Table 1.5 and Chart 1.9). The debt-to-GDP ratio on this measure has been revised up from our March forecast by 2.9 per cent of GDP this year and by an average of 7.5 per cent of GDP over the rest of the forecast, reflecting downward revisions to nominal GDP and in particular higher cash debt.

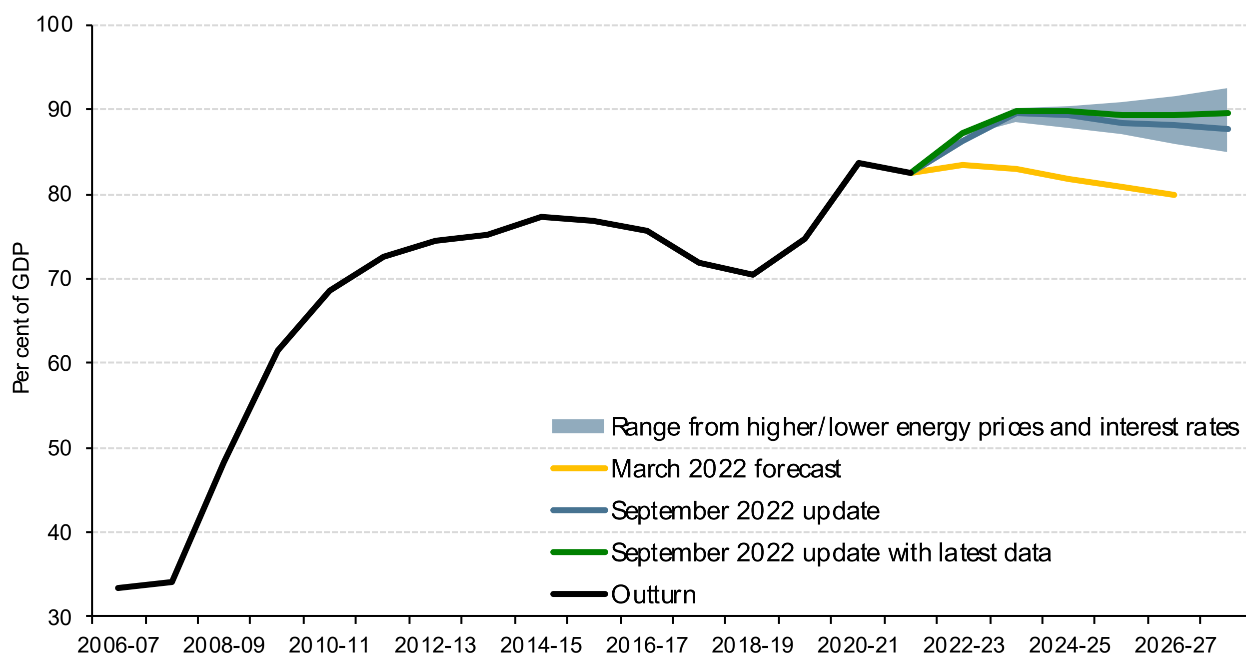
Table 1.5: PSND excluding the Bank of England: forecast update versus March 2022

	Per cent of GDP						
	Outturn	Forecast					
	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
March 2022 forecast	82.5	83.5	82.9	81.9	80.9	79.8	
September 2022 update	83.9	86.4	89.5	89.5	88.6	88.2	87.7
Change	1.5	2.9	6.6	7.5	7.6	8.3	
of which:							
Change in nominal GDP[1]	0.0	0.0	2.6	2.6	1.2	0.8	
Change in cash level of net debt	1.5	2.9	4.0	4.9	6.4	7.5	
Memo: PSND incl Bank of England	*97.0*	*98.4*	*100.7*	*98.6*	*93.0*	*90.8*	*89.8*

[1] Non-seasonally-adjusted GDP centred end-March.

1.31 Chart 1.9 shows the illustrative range of PSND ex BoE outcomes that would be consistent with gas prices and interest rates seen over the past month, and an indication of where the next round of our forecast might settle on the basis of last week's energy prices and interest rates. On this basis, underlying debt would peak 0.3 per cent of GDP higher next year (at 89.8 per cent of GDP) and remain roughly flat at that level for the following four years, which would be an average of 8.6 per cent of GDP higher than in our March forecast.

Chart 1.9: PSND excluding the Bank of England



Source: ONS, OBR

Performance against legislated fiscal targets

1.32 Table 1.6 presents the implications of the three variants of our forecast update – (i) the full pre-measures update based on late-July gas prices and mid-August interest rates; (ii) including the implications of the cost-of-living support and energy profits levy announced in May; and (iii) an indicative pre-measures estimate based on the latest gas prices and interest rates – for the three

main fiscal aggregates that are the subject of the current legislated fiscal targets.[5] In our next published forecast the third year of the rolling forecast period moves to 2025-26, so this is the year in which the first two of these targets apply.

1.33 Based on **late-July gas prices and interest rates**:

- The fiscal mandate to have **debt excluding the Bank of England** as a per cent of GDP falling in the third year of the rolling forecast period continues to be met, with the headroom reducing only slightly: from £27.8 billion to £25.6 billion based on our pre-measures forecast, and to £27.2 billion once the impact of the May announcements is taken into account. This relatively unchanged picture reflects the fact that underlying cash debt is both higher and rising faster in 2025-26 than in our March forecast, but this is almost completely offset by faster growth in nominal GDP as we emerge from recession. The headroom is reduced by £5.8 billion from sales or redemptions of gilts held in the Bank of England's Asset Purchase Facility at prices below their purchase cost. Differences between the purchase and nominal value of gilts held in the APF are recorded on the Bank's books until they are sold or redeemed, at which point they crystalise into a cash demand on the Treasury, in effect moving the debt into the fiscal mandate measure of PSND ex BoE. The margin by which underlying debt as a share of GDP falls in the final years of the forecast falls by more than half to £11.7 billion on a pre-measures basis in 2026-27 and to £15.0 billion in 2027-28.

- The **current balance** target is no longer met. The £31.6 billion surplus in 2024-25 that we forecast in March has worsened sufficiently to become a deficit of £2.7 billion in 2025-26 based on our updated pre-measures forecast, and a deficit of £1.9 billion once the impact of the May announcements is taken into account.

- The headroom against the **net investment** target has not changed materially since our March forecast, reflecting little change to our expectations for this area of spending.

1.34 Based on **the latest energy prices and interest rates** seen last week:

- the headroom against the debt target falls to just £8.8 billion, reflecting both slightly faster growth in underlying cash debt (due to a larger budget deficit) and also slower growth in nominal GDP; and

- the current balance target would be missed by even more, with the current deficit rising to £7.2 billion in 2025-26.

[5] We have not yet assessed performance against the welfare cap, which includes an inflation adjustment that is not straightforward.

Table 1.6: Performance against the Government's fiscal targets

		Per cent of GDP		£ billion	
		Forecast	Margin	Forecast	Margin
Year-on-year change in public sector net debt excluding the Bank of England in 2025-26					
March 2022 forecast[1]	Met	-1.0	1.0		27.8
September 2022 update	Met	-0.9	0.9		25.6
September 2022 with May package	Met	-1.0	1.0		27.2
September 2022 update with latest data	Met	-0.0	0.0		8.8
Current budget surplus in 2025-26					
March 2022 forecast[1]	Met	1.2	1.2	31.6	31.6
September 2022 update	Not Met	-0.1	-0.1	-2.7	-2.7
September 2022 with May package	Not Met	-0.1	-0.1	-1.9	-1.9
September 2022 update with latest data	Not Met	-0.3	-0.3	-7.2	-7.2
Net investment (< 3% GDP average over five years)					
March 2022 forecast[1]	Met	2.5	0.5		13.8
September 2022 update	Met	2.5	0.5		13.3

[1] Target year is 2024-25 as was the case at our March forecast.

Risks and uncertainties

1.35 The fiscal update presented here needs to be considered in the context of the elevated risks to economic and fiscal prospects at present. While borrowing falls to around 2 per cent of GDP in the final years of our forecast update – a level achieved in 2018-19 and prior to that not since 2002-03 – there are several risks that could significantly worsen this outlook.

1.36 Volatility in energy prices and interest rates is a particular source of uncertainty, as we have demonstrated via the indicative assessment of the implications of last week's price data, which add £13 billion (0.4 per cent of GDP) to borrowing at the forecast horizon. These volatilities are layered on top of the more conventional sources of economic risk that we typically flag in our *EFO*s – chief among them the supply-side performance of the economy – the most important long-term driver of all the major tax bases and one that has fallen short of our forecasts more often than not over the past decade.

1.37 Beyond these economic uncertainties, there are significant risks around the implementation of stated policy that have emerged or been amplified in recent months. These include:

- The prospect of **historically large increases to particular inflation-linked tax rates in April next year** given the rise in inflation. For example, the CPI-linked rise in business rates raises that tax burden by 10.1 per cent (around £3 billion), while reversing the temporary 5p cut in fuel duty and reinstating RPI indexation would require a 13p (25 per cent) rise – the first cash increase in fuel duty since January 2011, the largest cash increase ever, and the largest percentage increase since 1981.

- **Frozen thresholds for income tax and NICs bringing more taxpayers into higher rates of tax** relative to what would have happened with CPI-linked thresholds over the next four years. In our March forecast, we estimated (based on our outlook for inflation and earnings at that point) that the policy would increase the number of higher-rate taxpayers by 42 per cent

(from 4.8 million to 6.8 million) in 2025-26. The latest upward revisions to the inflation outlook would raise the uplift further still.

- **The pressure of higher inflation on departmental budgets** set in last year's Spending Review. Upward revisions to GDP deflator growth and CPI inflation in the period up to 2023-24 imply pressure of between £18 billion and £47 billion on departmental resource spending in that year. We take as given departmental cash spending limits set by the Treasury in our forecasts, so this pressure is not currently reflected in our forecast update bar a small downward revision to our underspend assumptions.

1.38 Finally, policies that your Government announces in the coming weeks will have potentially large impacts on economic and fiscal outcomes. Further support to households in the face of even higher energy bills, to limit the rise in the tax burden, or to begin the process of raising defence spending to 3 per cent of GDP by 2030, would boost economic activity but would also add to borrowing (more so in the short term than the longer term). Should you ask us to produce a forecast soon, we will account for the economic and fiscal effects of all new policy measures in an updated version of this forecast.