Office for **Budget Responsibility**

Rachel Reeves MP
Shadow Chancellor of the Exchequer
House of Commons
SW1A 0AA

13 January 2022

**Richard Hughes**
***Chair***

102 Petty France
London SW1H 9AJ

obr.uk

**The potential fiscal implications of higher paths for real GDP growth**

Dear Rachel,

Thank you for letter of 24 December, in which you requested a range of forecast scenarios for the public sector finances based on alternative paths for GDP growth. As you know, the Chancellor has commissioned a forecast from us to be published on 23 March, which will provide our next opportunity to update Parliament in full on the state of the economy and the public finances over the coming five years.

In order to provide the fullest answers we can to your questions in the short period since the Christmas holidays, we have constructed a set of illustrative fiscal implications of alternative paths for productivity and growth drawing on previously published scenarios, but using our latest October 2021 forecast as the baseline. These estimates should be considered as illustrative only, as they are based on a relatively simple, top-down combination of scenarios presented in previous *Economic and fiscal outlooks* (*EFO*s) to estimate potential deviations from our latest central forecast. They do not constitute forecasts in themselves (because they are not constructed bottom-up) and do not cover all possible implications of different growth paths. Most obviously in the current context of high inflation, they do not factor in different paths for inflation due to higher GDP growth (because they draw on scenarios that explored the implications of differences in potential productivity growth rather than different paths for the output gap). As such, they represent stylised illustrations of the fiscal impact of higher productivity and growth on our latest forecast rather than full official forecasts or scenarios endorsed by the OBR.

Our October 2021 forecast for average real GDP growth in the three years to 2026-27 is 1.6 per cent. (It is worth noting that GDP growth over this period is lowered modestly by the closing of the small *positive* output gap that we expect to open up in the near term as a result of the fiscal easing announced in the October Budget and Spending Review.) In the same three years, we forecast public sector net borrowing (PSNB) of £46 billion on average.

When we present our central forecasts in each *EFO*, we always emphasise the uncertainty around them, including via the presentation of alternative scenarios. In Chapter 4 of our March 2020 *EFO* we presented scenarios that assumed two alternative paths for productivity (one weaker and one stronger than our central forecast at the time) and set out the implications of these for both real GDP growth and key fiscal aggregates. To illustrate the fiscal implications of the GDP paths specified in your letter, we have used the

relationship between differences in GDP growth, public sector net borrowing, receipts and spending between the strong productivity scenario and our central forecast in the March 2020 *EFO* to show how our October 2021 forecast might differ under higher productivity growth assumptions. We have augmented this to account for the stronger response of fiscal drag, and thus the tax-to-GDP ratio, to changes in earnings growth at present due to the multi-year cash freeze in income tax thresholds.[1]

The resulting fiscal implications derive from the difference in cumulative real GDP growth from 2023-24 onwards between the scenarios you have specified and our October 2021 central forecast. For example, if growth were to be 2 per cent a year in 2024-25, 2025-26 and 2026-27, real GDP in 2026-27 would be 1.2 per cent higher than in our central forecast; at 2.5 per cent a year the gap would rise to 2.7 per cent; and at 3 per cent a year to 4.2 per cent.

The results of these calculations are presented in the two tables below, both as a proportion of GDP (Table 1) and in cash terms (Table 2).

Table 1 indicates, for example, that a scenario in which GDP grows by 2.5 per cent in each of the final three years of our forecast, rather than the 1.6 per cent average growth rate we forecast in October, would boost receipts in 2026-27 by 0.2 per cent of GDP (primarily as a result of greater 'fiscal drag') and reduce spending by 0.7 per cent of GDP (primarily as a result of the comparison of unchanged cash departmental spending plans to a higher GDP path). In this illustrative scenario, borrowing is therefore 0.9 per cent of GDP lower than our central forecast at 0.7 per cent of GDP in 2026-27. Borrowing in scenarios in which GDP growth is 2 and 3 per cent a year in those three years are 0.5 per cent of GDP higher and lower than in the 2.5 per cent scenario, respectively.

[1] This has been captured using the effects presented in Box 3.2 in our October 2021 *EFO*, which considered the implications of higher inflation and nominal earnings growth for our fiscal forecast. The calculations are based on the simple assumption that productivity-driven increases in GDP growth feed through one-for-one to earnings growth.

**Table 1: Illustrative implications of different GDP growth scenarios for receipts, spending and borrowing as a proportion of GDP**

| | Per cent of GDP | | |
|---|---|---|---|
| | 2024-25 | 2025-26 | 2026-27 |
| **October 2021 forecast** | | | |
| PSNB | 1.7 | 1.7 | 1.5 |
| *of which:* | | | |
| Receipts | -39.8 | -39.9 | -40.0 |
| Spending | 41.6 | 41.6 | 41.6 |
| **Difference from October 2021 forecast** | | | |
| **Scenario of 2% real GDP growth in the final three years of the forecast** | | | |
| PSNB | -0.2 | -0.3 | -0.4 |
| *of which:* | | | |
| Receipts | -0.1 | -0.1 | -0.1 |
| Spending | -0.1 | -0.2 | -0.3 |
| **Scenario of 2.5% real GDP growth in the final three years of the forecast** | | | |
| PSNB | -0.3 | -0.6 | -0.9 |
| *of which:* | | | |
| Receipts | -0.1 | -0.1 | -0.2 |
| Spending | -0.1 | -0.4 | -0.7 |
| **Scenario of 3% real GDP growth in the final three years of the forecast** | | | |
| PSNB | -0.4 | -0.9 | -1.4 |
| *of which:* | | | |
| Receipts | -0.2 | -0.2 | -0.2 |
| Spending | -0.2 | -0.7 | -1.1 |

Note: This table uses the convention that a negative figure means a reduction in PSNB.

Table 2 shows that in cash terms, the 2.5 per cent GDP growth scenario equates to borrowing being £25 billion lower in 2026-27. This is more than explained by higher receipts, with a partly offsetting increase in spending when viewed in cash terms. By 2026-27, receipts would be 3.1 per cent higher in cash terms (with 2.7 percentage points due to higher cumulative GDP growth and the remaining 0.4 percentage points due to the tax-to-GDP ratio rising) – an extra £36 billion. But spending would also be higher (by £11 billion or 1.0 per cent) thanks to higher debt interest spending and a higher cost of the state pension triple lock outweighing downward effects on spending in some other non-departmental spending lines. As noted, departmental spending is assumed to remain fixed at the cash levels set out in the 2021 Spending Review. Cash differences for the 2 and 3 per cent scenarios are also presented, with borrowing being around £14 billion higher and lower than in the 2.5 per cent scenario, respectively.

Office for
Budget
Responsibility

**Table 2: Illustrative implications of different GDP growth scenarios for receipts, spending and borrowing**

| | £ billion | | |
|---|---|---|---|
| | 2024-25 | 2025-26 | 2026-27 |
| **October 2021 forecast** | | | |
| PSNB | 46.3 | 46.4 | 44.0 |
| *of which:* | | | |
| Receipts | -1,061 | -1,102 | -1,148 |
| Spending | 1,108 | 1,148 | 1,192 |
| **Difference from October 2021 forecast** | | | |
| **Scenario of 2% real GDP growth in the final three years of the forecast** | | | |
| PSNB | -3.8 | -7.6 | -11.0 |
| *of which:* | | | |
| Receipts | -8.4 | -12.5 | -16.3 |
| Spending | 4.6 | 4.9 | 5.3 |
| **Scenario of 2.5% real GDP growth in the final three years of the forecast** | | | |
| PSNB | -6.9 | -15.8 | -24.6 |
| *of which:* | | | |
| Receipts | -15.3 | -25.5 | -36.0 |
| Spending | 8.4 | 9.8 | 11.4 |
| **Scenario of 3% real GDP growth in the final three years of the forecast** | | | |
| PSNB | -10.1 | -24.1 | -38.7 |
| *of which:* | | | |
| Receipts | -22.2 | -38.7 | -55.9 |
| Spending | 12.1 | 14.6 | 17.3 |

Note: This table uses the convention that a negative figure means a reduction in PSNB.

The outlook for productivity growth is highly uncertain – for at least three reasons. First, the persistently weak performance after the financial crisis was an enduring puzzle that clouded our pre-Brexit and pre-Covid forecasts – it was repeatedly highlighted as the most important judgement for our fiscal forecasts. Second, there remains uncertainty around the 4 per cent long-term reduction to productivity from Brexit assumed in our forecasts – although initial trade outcomes suggest that the reduction in trade intensity underpinning this assumption is materialising. And third, the degree of long-term economic scarring from the pandemic also remains highly uncertain. In this letter we have illustrated the potential consequences of the three upside scenarios you requested, but the past decade warns that further downside surprises are possible too. We will continue to explore the implications of all these issues in future reports.

Warmest regards,

Richard Hughes
Chair