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IFS Green Budget Chapter 3
R281

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Outlook for the public finances

3. Outlook for the public finances

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Key findings

1. The government's fiscal mandate **requires debt to fall as a share of national income between years 4 and 5 of the forecast period**. While the idea of getting debt on a falling path over time has its merits, **this specific target is much more poorly designed than most, such that focusing on 'headroom' against this target often gives a misleading impression of the health of the public finances**.

2. No fiscal target is completely game-proof, or applicable to every single conceivable situation. **But because it narrowly targets the change between year 4 and year 5 of the forecast, the fiscal mandate is overly sensitive to assumptions about growth, inflation and interest rates five years hence.** It is also too easy to 'game' by pencilling in policy changes over a five-year period that the government has no intention of actually delivering. And we should remember that of the 14 Chancellors who have served over the 44 years since 1979, only three (Nigel Lawson, Gordon Brown and George Osborne) actually remained in post for more than five years.

3. The supplementary target, which requires borrowing to be forecast to be lower than 3% of national income, is very loose by UK historical standards. **On virtually every occasion in the 43 years since 1980 (outside of the global financial crisis and the COVID-19 pandemic), the Chancellor at the time could have increased planned borrowing without breaching this target.**

4. The welfare cap, which currently places a limit on a measure of social security spending in 2024–25, is likely to remain on course to be missed – with a big factor being the increase in the number of individuals qualifying for incapacity and disability benefits. Rather than attempting to cut around £4 billion from spending in the coming financial year to bring it back to the limit specified by the welfare cap, **this oddly**

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designed fiscal target should join many other badly designed targets in the dustbin of history.

5. At more than 40% of national income, revenues are set to reach historically high levels. In part, these are financing higher spending on debt interest, which we forecast to remain above 4% of national income this year, a level which, before last year, had not been seen since the late 1940s. **Overall public spending was forecast in the Budget to be 46% of national income this year, which would be only just below the pre-pandemic peak seen in 1975–76.** Even by 2027–28, spending was forecast to be 43% of national income, which would be 3% of national income above what was spent in 2007–08, prior to the financial crisis and after a decade of New Labour governments. Of this increase, 1.2% of national income is explained by debt interest spending remaining elevated.

6. Under the March 2023 forecast, borrowing would be 1.7% of national income in 2027–28. If this materialised, it would be the lowest level since 2001–02. But despite this, debt was still only forecast to fall very slightly, highlighting **the difficulty of preventing debt from rising as a share of national income when growth is weak and borrowing costs are high**.

7. **In the first five months of the financial year, tax revenues have run £13 billion, or 3%, ahead of the forecast, reflecting stronger nominal growth in the economy.** As a result, borrowing is running £11 billion, or 14%, below forecast. Under Citi's baseline scenario, some of this persists for the next seven months, leaving borrowing at £112 billion for the year, £20 billion below the Office for Budget Responsibility (OBR)'s March forecast for 2023–24 as a whole.

8. In March 2022, the OBR forecast that debt interest spending in 2026–27 would be £47 billion, but by March 2023 it had revised this up to £89 billion. **Taking current market expectations for Bank Rate alone could push debt interest spending up by a further £20 billion to £108 billion.** But market expectations are volatile. And whereas markets (at the time of writing) expect Bank Rate to be around 4% in 2026–27, Citi's forecast is for Bank Rate to fall to 2% by that year. In that case, debt interest spending would be £12 billion *lower* in 2026–27 than forecast in March. **That is a more than £30 billion swing in forecast borrowing depending on a decision over how best to forecast interest rates.**

9. **The impacts of higher inflation on the public finances are nuanced and partially offsetting.** If inflation proves more persistent, it will result in higher tax revenues as well as higher spending on debt interest and working-age benefits. Spending plans for

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public services would be less generous than intended and the Chancellor would either need to top them up, or accept a reduction in scope or quality of services. **Under a range of plausible inflation scenarios, we can confidently say that borrowing will be comfortably below the 3% cap imposed by the supplementary mandate, but will also be comfortably above what was forecast in Rishi Sunak's final Budget as Chancellor in March 2022.**

10. In a weak-growth environment, **stabilising debt by 2028–29 is likely to rest on pencilling in another year of extremely tight spending plans, which will be very difficult to deliver when the time comes**. Larger realised losses from the Bank of England's quantitative tightening in a high-interest-rate environment could further add to debt (although not borrowing) and hence complicate meeting the letter of the fiscal mandate. Though, as outlined above, whether or not the government has debt falling in one particular year is not a good guide to the health of the public finances.

11. The case for tax cuts is weak. If anything, given the government's appetite for public spending, there is actually a reasonable argument for a net tax rise to be set out for implementation over the medium term. In the current environment of high inflation and rising interest rates, a fiscal loosening would be extremely difficult to justify – especially given the high and volatile costs of servicing debt. **The Chancellor should certainly avoid 'paying for' (certain) near-term tax cuts by pencilling in an (uncertain and difficult-to-implement) extension of the freeze to the personal tax allowance (in 2028–29) or by either tightening, or extending, the squeeze on public service spending beyond March 2025.**

3.1 Where are we and how did we get here?

The March 2023 Budget saw the Office for Budget Responsibility (OBR) forecast borrowing of £132 billion in 2023–24, or 5.1% of national income. This relatively high level of borrowing – largely unchanged as a share of national income from 2021–22 and 2022–23 – was forecast to push public sector net debt up to 92.4% of national income. Government spending, and therefore borrowing, had not fully recovered from the impact of the COVID-19 pandemic and associated government intervention when the cost of living shock came along. As shown in Figure 3.1, total government spending had climbed to 53% of national income in 2020–21, well above the UK's previous record level (46% in 1975–76), before declining to 44½% the following year – still well above its pre-pandemic level. Even by 2027–28, under the OBR's most recent forecast presented in March, spending would be 43% of national income, which would be 3% of national

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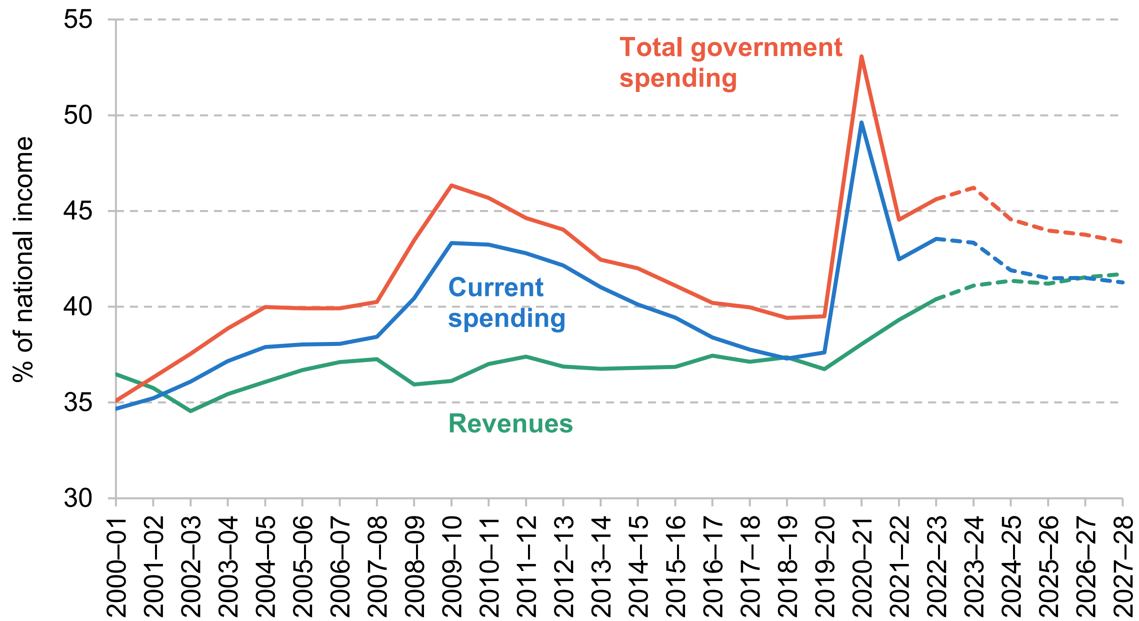
income above what was spent in 2007–08, prior to the financial crisis and after a decade of New Labour governments.

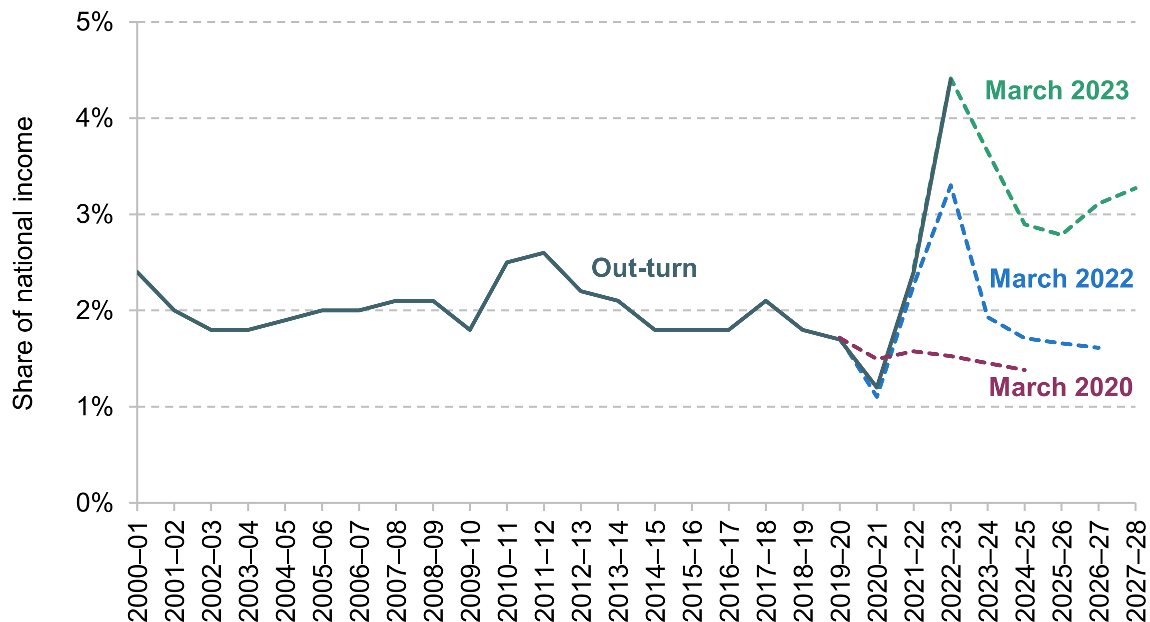
Figure 3.1. Government spending and revenues: out-turn and official March 2023 forecast



Note: Current expenditure including depreciation shown.

Source: OBR's public finances databank (obr.uk/data/).

Figure 3.2. Debt interest spending: out-turn and successive official March forecasts



Note: Central government debt interest net of income from the Asset Purchase Facility shown.

Source: OBR's public finances databank (obr.uk/data/).

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Meanwhile, government revenues have been continually rising as a share of national income since 2019–20 to just above 39% in 2021–22. Following Russia's invasion of Ukraine and the subsequent spikes in prices of energy and food among other goods, the size of the state increased again in 2022–23 to almost 46% of national income (and close to that pre-COVID record share). Revenues, having exceeded day-to-day government spending for a brief period in 2018–19, are now not expected to do so until 2026–27 – meaning the government will not run a current budget surplus until that point.

A significant component of the increased government spending over the last year is due to rising inflation and interest rates pushing up the cost of financing much-elevated public sector net debt. Spending on debt interest averaged 2% of national income over the first two decades of the 21st century, but this climbed to 4.4% of national income in 2022–23 – a figure that had not been exceeded since 1948–49. Contrary to the forecast produced in March 2022, as shown in Figure 3.2, the OBR now expects spending on debt interest to remain elevated at around or above 3% of GDP over the medium term, i.e. around a full 1% of national income, or £26 billion a year in today's terms, higher than we had been used to since 2000. In 2007–08, on the eve of the financial crisis and with debt at just 35.8% of national income, debt interest spending stood at 2.1% of national income, 1.2% of GDP less than currently forecast for 20 years later. In other words, financing much higher debt can explain a non-trivial part, but by no means all, of the increase in spending since then.

Public sector borrowing is forecast to drop from 5.1% of national income this year to 3.2% of national income in 2024–25 as the big support packages to help households and businesses with their energy bills expire. The OBR estimates that (gross of the 'windfall tax') these added £58 billion to borrowing in 2022–23 and a further £20 billion in 2023–24, with hardly any cost in subsequent years. After 2024–25 borrowing is forecast to fall only gradually, as shown in Figure 3.3. As a result, underlying public sector debt,[1] as shown in Figure 3.4, is forecast to increase by almost 7 percentage points of national income since 2022–23 and peak at just below 95% of GDP in 2026–27 – a level not seen since 1962–63 (although it was often above 100% of national income before that; see Figure 3A.1 in Appendix 3A).

At the time of the March Budget, the government was aiming to reach its target for debt to fall by the end of the forecast horizon, which at that point was 2027–28, through a combination of spending cuts and tax increases. While current spending is forecast to fall by around 2.3% of national income over the forecast period, government revenues are forecast to increase to around 41.7% of national income – which would be a record level since 1969–70. Within this, tax

[1] 'Underlying' debt excludes the contribution of Bank of England operations such as the Term Funding Scheme set up to support lending during and after the pandemic. It does *not* exclude the government debt *held* by the Bank of England under the quantitative easing programme.

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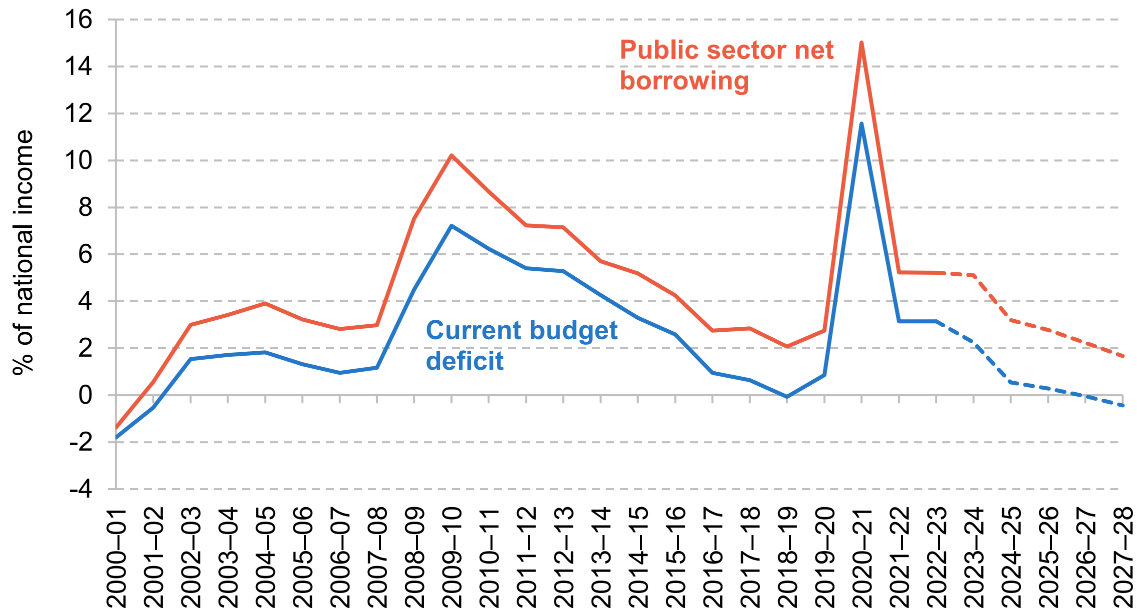
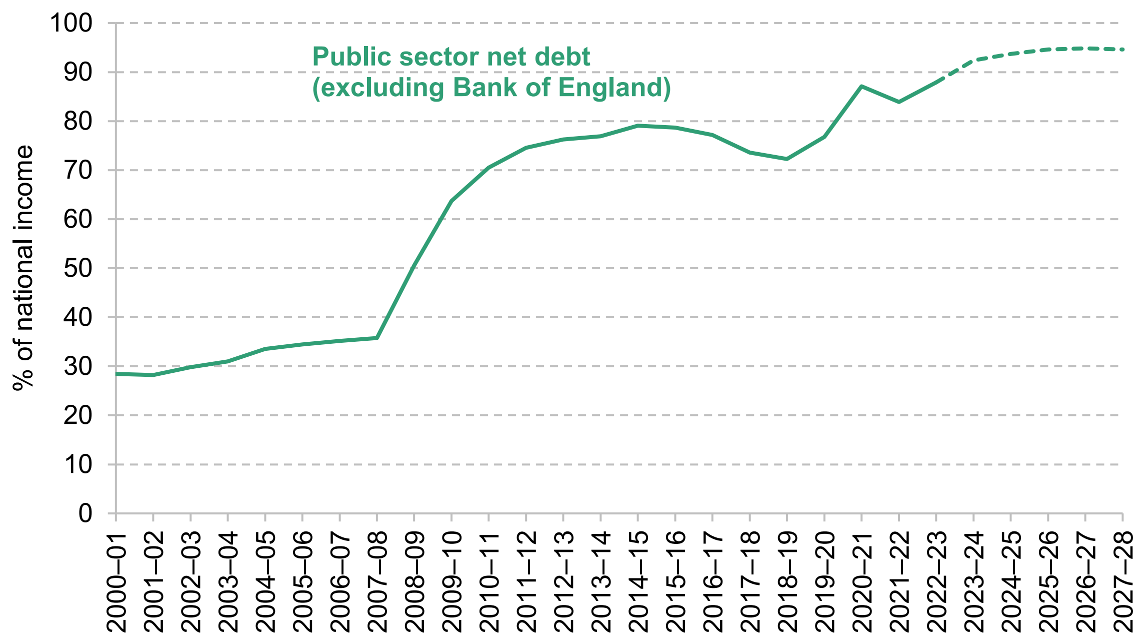
revenues, having risen by the biggest amount in any parliament on record, are forecast to reach a level that has never previously been maintained in the UK (Emmerson, Johnson and Zaranko, 2023).

Figure 3.3. Public sector net borrowing and current budget deficit: out-turn and official March 2023 forecast



Source: OBR's public finances databank (obr.uk/data/).

Figure 3.4. Public sector net debt: out-turn and official March 2023 forecast



Source: OBR's public finances databank (obr.uk/data/).

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This chapter proceeds as follows. Next, in Section 3.2, we set out the Chancellor's three fiscal targets and the extent to which he was meeting them at the time of the March Budget. Section 3.3 describes how the outlook for some of the key fiscal determinants – growth, interest rates and inflation – has changed since the Budget. In Section 3.4, we describe the impact these changes in the economic outlook could be expected to have on the public finances, specifically the outlook for the paths of public sector net borrowing and public sector net debt. Finally, in Section 3.5, we discuss what, given this changing outlook and the uncertainties around it, the Chancellor should – and should not – do in his forthcoming Autumn Statement.

3.2 What is the Chancellor aiming for?

The government currently has three formal fiscal targets in place (HM Treasury, 2023).[2] Two relate to the forecasts for the end of the five-year forecast horizon: the fiscal mandate, which requires debt to be falling as a share of national income in the final year of the forecast, and a supplementary target that requires borrowing to be below 3% of national income in the same year. Compliance with these targets is assessed by the OBR twice a year in in its Economic and Fiscal Outlooks which are published alongside fiscal events. The third target – the welfare cap – requires spending on a certain measure of welfare spending to be under a specific cap in 2024–25. An oddity of this target is that the government has requested that the OBR only formally assesses compliance with it in the first fiscal event of each parliament. This section discusses each target in turn.

The fiscal mandate

This target generally receives most attention out of the three, perhaps because it is currently more binding. It states that debt needs to be falling as a share of national income by the end of the forecast horizon. This is operationalised as a falling ratio of debt to national income between years 4 and 5 of the forecast period.

In general, having debt falling over the medium term is a sensible fiscal policy aim, whether codified as an explicit fiscal rule or not. If we want to reduce vulnerability to risks such as rising interest rates and, *in extremis*, a loss of confidence in the UK government as a borrower, we should avoid debt being on an ever-increasing trajectory. In addition, to preserve 'fiscal space' to respond to emergencies, such as the pandemic, when we will want to increase debt sharply, we ought to reduce debt, at least on average, outside of these periods of crisis. At the same time, it

[2] Sensibly, the government has in place an escape clause allowing it to suspend the rules in the event of a significant adverse shock. In addition – and also sensibly – the Charter for Budget Responsibility states that 'alongside the fiscal mandate and supplementary targets, the Treasury will also consider wider data, analysis and evidence on the affordability of public debt and the strength of the public sector balance sheet, with the aim of supporting the achievement of the fiscal objectives'.

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can be sensible to introduce adjustments gradually rather than all at once, and targeting the medium term is one way to operationalise this.

While the underlying idea to aim for a falling ratio of debt to national income has its merits, the specific fiscal target is more arbitrary and gameable than most. It can be arbitrary whether debt happens to be on course to fall in the fifth year of the forecast specifically; whether debt is forecast to rise up to, or beyond, that specific point does not affect whether the rule is being met. And – relatedly – it can be gameable because (for example) tax cuts or spending increases that are supposedly put in place for three years will not make the target harder to meet even if, every year, these 'temporary' giveaways are subsequently perpetually extended for 'just one more year'. The same issue applies to spending cuts or tax rises that are pencilled in for the final forecast year, but continually 'postponed'.

Targeting the change in debt – or any other element of fiscal plans – in five years' time means targeting a year that, at least based on past experience, will typically be beyond the current spending review period. It is also worth bearing in mind that Chancellors are usually not in office for that long: over the 44 years since 1979, there have been 14 Chancellors, giving an average tenure of just over three years, with only three Chancellors (Nigel Lawson, Gordon Brown and George Osborne) over that period staying in post for more than five years. This could increase the temptation to set unrealistically low spending plans in order to have forecast borrowing and debt in line with the target. There is no single 'correct' way to resolve this trade-off; however, by targeting the last year of the forecast, the government has chosen to prioritise flexibility over accountability to the maximum possible extent.

The extent to which debt is forecast to fall (or increase) between years 4 and 5 of the forecast horizon is also extremely sensitive to the predicted growth in the cash size of the economy five years out. That is because, mathematically, for debt to be forecast to fall as a share of national income, it requires the growth in national income to exceed growth in debt. More often than not, successive official forecasts do not contain a significant revision to the prediction of growth in the cash size of the economy five years out. But, on occasion, the revisions have been substantial. For example, over the 41 official forecasts there have been since April 2003, on eight occasions there was an upwards revision to the forecast change in debt in the final year of the forecast horizon of more than the current 'headroom' – and on half of those occasions the upwards revision was £28 billion or more.

Moreover, revisions to the change in the debt-to-GDP ratio between years 4 and 5 do not necessarily give an accurate or comprehensive reflection of how the fiscal outlook has actually changed. In other words, a revision might increase headroom against the target even though the broader fiscal outlook has not improved, or vice versa. Table 3.1 uses some stylised examples to highlight this. These are not fully fledged economic or fiscal scenarios, but merely highlight the

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sensitivity of this particular fiscal rule to illustrative changes in underlying assumptions or example policy decisions.

Under last March's OBR forecast, the target is met by a wafer-thin margin of £6 billion in current terms. The sensitivity of the target to forecast growth in the cash economy is highlighted by rows 2 and 3, which show the impact of economy-wide inflation (as measured by the GDP deflator) being revised up or down by 1 percentage point (and assuming no change to the forecast real rate of growth, or any other determinant of the fiscal forecast). An upward revision could be expected to increase the Chancellor's headroom to around £20 billion. But a downward revision could be expected to lead to the target being missed by £9 billion. In normal circumstances, a revision of forecast economy-wide inflation five years out of 1 percentage point (ppt) would be large. But in recent times – with large increases in the price of imported energy and food – revisions on a similar scale have occurred, and in a world of more volatile supply (see Chapter 2) such changes could become more common. For example, between March and November 2022, forecast economy-wide inflation five years out was revised down by 0.8ppt (alongside a large, more widely publicised, upward revision in the near term).

Table 3.1. Illustrative changes and their effect on meeting the debt rule

	Fiscal rule
1) March 2023 forecast	Met by £6 billion
2) Economy-wide inflation up by 1ppt in 2027–28	Met by £20 billion
3) Economy-wide inflation down by 1ppt in 2027–28	Missed by £9 billion
4) £20 billion fiscal loosening each year until 2026–27	Met by £6 billion
5) £20 billion fiscal loosening in 2027–28	Missed by £9 billion
6) Gilt rates 1ppt higher throughout	Met by £6 billion
7) Gilt rates 1ppt higher, but only in 2027–28	Missed by £19 billion

Note: Amounts in 2023–24 terms. Fiscal loosening assumed to be announced in 2023–24 with a gradually fading stimulus effect.

Because it only targets the change between two specific years, the target is particularly problematic when thinking about changes to the profile of the fiscal outlook over time. This is illustrated by the other examples in Table 3.1. If we add a fiscal loosening of £20 billion each year until 2026–27 – but not in the final year of the forecast – then, as shown in row 4, with typical assumptions about the temporary stimulus effects of such a loosening, which in turn give a short-lived boost to revenues, the target would still be met because debt would still be falling in the last year, when the stimulus has been withdrawn. This would be despite debt being at a higher level in both year 4 and year 5 of the forecast as a result of the earlier fiscal loosening.

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However, things look quite different if we assume that a loosening of the same annual size is announced for just the final year of the forecast. Again, we include a temporary boost to the economy and hence to revenues, although a smaller one since the economy would have had time to adjust in advance.[3] Then, as shown in row 5, the target would be missed by a substantial margin. This is true even though the loosening would be in place for a much shorter time, and its cumulative size therefore much smaller and the level of debt correspondingly lower throughout, than in the scenario shown in row 4.

A similar issue arises with changes to the profile of economic determinants of the fiscal outlook. For example, if we assume interest rates on government bonds are 1ppt higher throughout the forecast, then, as shown in row 6, the target would still be met – debt relative to national income is higher throughout the forecast period, but it would still be on course to fall, albeit fractionally, in the final year. If, on the other hand, interest rates are 1ppt higher in the final forecast year *only* – a less significant deterioration in the outlook – then, as shown in row 7, the target is missed because debt as a share of national income follows the same trajectory during the first four years, and then increases in the final year as the assumed increase in interest rates kicks in.

No fiscal target – ones that have been in place in the past, and ones that have been proposed, including those proposed by authors of this chapter – is completely game-proof, or applicable to every single conceivable situation. Codified fiscal targets cannot substitute for appropriate scrutiny that takes a holistic view of the sustainability of fiscal policy. However, this particular target, with its strong reliance on the profile of uncertain future deflator growth and erratic response to changes in assumptions, is much more poorly designed than most.

The supplementary target

This target places a limit on borrowing of 3% of national income in the final year of the forecast. Borrowing is a salient summary measure of the tightness of fiscal policy and, as mentioned above, it is often sensible to target the medium term with a fiscal rule. This allows Chancellors to 'look through' any temporary economic disturbance, respond to crises, and implement gradual rather than sudden adjustments, all without jettisoning their fiscal target.

There are, of course, trade-offs. A target for overall borrowing means that both investment spending and day-to-day spending are treated the same, whereas a stronger economic case for borrowing on an enduring basis might be made when it is being used to finance investment spending (assuming that spending is done well) than when it is being used to cover day-to-day spending (see Chapter 6).

[3] Preannouncing a fiscal loosening for the last year of the forecast could therefore perhaps be considered an odd course of action.

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In any case, in the current fiscal situation, the supplementary target on borrowing is not the binding constraint. As stated above, the Chancellor is currently meeting his target to have debt falling as a share of national income by just £6 billion in today's terms (as the relevant measure of debt is forecast to fall from 94.8% of national income in 2026–27 to 94.6% of national income in 2027–28, i.e. a margin of 0.2% of national income, or £6 billion in today's terms). In contrast, in 2027–28, public sector net borrowing is forecast to be running at 1.7% of national income, which gives 1.3% of national income – or £34 billion in today's terms – of headroom against the 3% ceiling. If borrowing did follow the path forecast in the March 2023 Budget then, at 1.7% of national income in 2027–28, it would be the lowest level of borrowing since the 0.6% of national income borrowed in 2001–02. The primary balance – i.e. borrowing excluding spending on debt interest – would be in surplus by 1.1% of national income, which similarly would be the biggest surplus since 2001–02 (when it was 1.2% of national income).

A requirement to have forecast borrowing below 3% of national income by the final year of the fiscal forecast is also really not very stringent by UK historical standards. Over the 77 years from 1946–47 to 2022–23, public sector net borrowing averaged 2.8% of national income. So the target could be met despite aiming for an above-average level of borrowing. More relevantly – given that the target applies to forecast borrowing in five years' time – if we take the 70 official forecasts produced over the period March 1980 to March 2023 (inclusive) where the forecast extended at least three years forwards, only on five occasions was borrowing forecast to exceed 3% of national income at the end of the forecast horizon. One was March 1993. The other four (April 2009, November 2009, March 2010 and November 2020) were during the global financial crisis and the COVID-19 pandemic and therefore are all situations in which we might expect the fiscal targets to be suspended anyway. This suggests that on virtually every occasion in the 43 years, the Chancellor at the time could have increased planned borrowing without breaching this target.

The welfare spending cap

The welfare cap, as its name suggests, places a limit on a measure of social security spending. Placing a cap on spending on a particular government function, as opposed to the overall tightness of fiscal policy or debt interest (which no government likes to spend money on), is somewhat unusual territory for fiscal rules. But even taking the goal of the cap as given, the way it is operationalised is rather odd for three reasons: first, the cap is, by default, only set once a parliament; second, the cap only formally relates to spending in a single year; and third, compliance is only formally assessed once a parliament.

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Box 3.1. The welfare cap

The way the welfare cap works is as follows (for more details, see Keep (2023)). In the first fiscal event of a parliament, the Treasury sets a cap on welfare spending for a particular year – along with a margin by which it requires the cap to be met. Changes to welfare spending due to changes in inflation, or due to technical reclassifications, automatically lead to the cap being adjusted. This means that, for example, higher inflation in September 2023 than that forecast by the OBR would not make the cap harder to meet as any deviation would change the level of the cap as well as forecast welfare spending.

The welfare cap applies to about half of UK-wide benefit spending as it excludes spending on the state pension and some of the most cyclical parts of spending (i.e. jobseeker's allowance (JSA), housing benefit for those on JSA, and the equivalent components of universal credit).

The March 2020 Budget – the first of this parliament, and Rishi Sunak's first as Chancellor – set the cap for 2024–25. Alongside that, Mr Sunak set a 'pathway' for spending towards that cap. A margin was set at 0.5% of spending for the current year (then 2019–20), rising by 0.5% a year so that it reached 3.0% of spending in 2024–25.

While the OBR naturally monitors how its forecasts for spending compares with the cap (and the pathway to the cap), and the margin, it has been asked only to assess formal compliance with the cap in the first fiscal event of a parliament. After the pandemic hit, the OBR's forecasts produced in Autumn 2020, Spring 2021 and Autumn 2021 suggested that the cap was on course to be breached. But as these were not the first fiscal event of a parliament, this does not count as a formal breach; that would have required the Secretary of State for Work and Pensions either to set out measures to reduce welfare spending back within the cap or to explain why the breach was justified.

Then, in the Autumn Statement of 2021, Mr Sunak decided to reset the level of the welfare cap to the forecast level of spending (plus a margin that in 2024–25 was now set at 2% rather than 3% of spending), with this change being approved by the House of Commons in February 2022. As a result, the OBR forecasts from Spring 2022 and Autumn 2022 suggested that the cap was no longer on course to be breached.

The huge increases in incapacity and disability benefit claims since have pushed up forecast welfare spending (see Chapter 4) and these do count against the cap and have been sufficient for forecast spending to rise above the cap. The March 2023 Budget forecast that welfare spending in 2024–25 would be £4.1 billion, or 3.0%, above the welfare cap and margin. This is set out in Table 3.2.

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Table 3.2. Latest OBR forecasts for welfare spending and the welfare cap in 2024–25

	£ billion	%
Welfare cap	135.4	
Margin	2.7	2.0% of cap
Welfare cap + margin	138.1	
OBR March 2023 forecast	142.2	
Difference between forecast and cap + margin	4.1	3.0% of forecast spending

Source: Table 5.2 of Office for Budget Responsibility (2023).

The cap currently sets a limit for spending in 2024–25. Further details of the operation of the cap can be found in Box 3.1. A key issue is that, at the time of the March Budget, spending in 2024–25 was forecast to exceed the level of the cap by £4.1 billion, or 3.0% of relevant spending. In other words, cuts of £4.1 billion would need to have been announced if the government had wanted to be on course to meet the rule when it is next formally assessed, which will be the first fiscal event of the next parliament. Of course, the OBR's forecasts will change – though it remains to be seen whether they move in the direction of making the welfare cap easier or harder to comply with.

Should the government still wish to comply with the welfare cap, it is getting late to make welfare cuts to bring that about. A more sensible approach to policy in this area would be to get rid of the welfare cap, and instead for the government to keep the welfare system under review in the light of changing circumstances and where appropriate implement reforms to improve its operation. The existing welfare cap does not help bring that about: the levers available to reduce welfare spending by £4.1 billion in 2024–25 are already limited and could be non-existent by the first fiscal event of the next parliament – not least because that could conceivably be in Spring 2025!

3.3 How has the economic environment changed since the Budget?

We now turn to how some of the key determinants of the public finances – the outlook for growth, interest rates and inflation – might have changed since the March Budget. One big change to the economic data relates to the data for 2020 and 2021. In September 2023, the Office for National Statistics published upwards revisions to the GDP data for these years. In particular, these now suggest that the real size of the economy at the end of 2021 was 0.6% above the pre-pandemic (2019Q4) level, rather than 1.2% below. But these revisions do not

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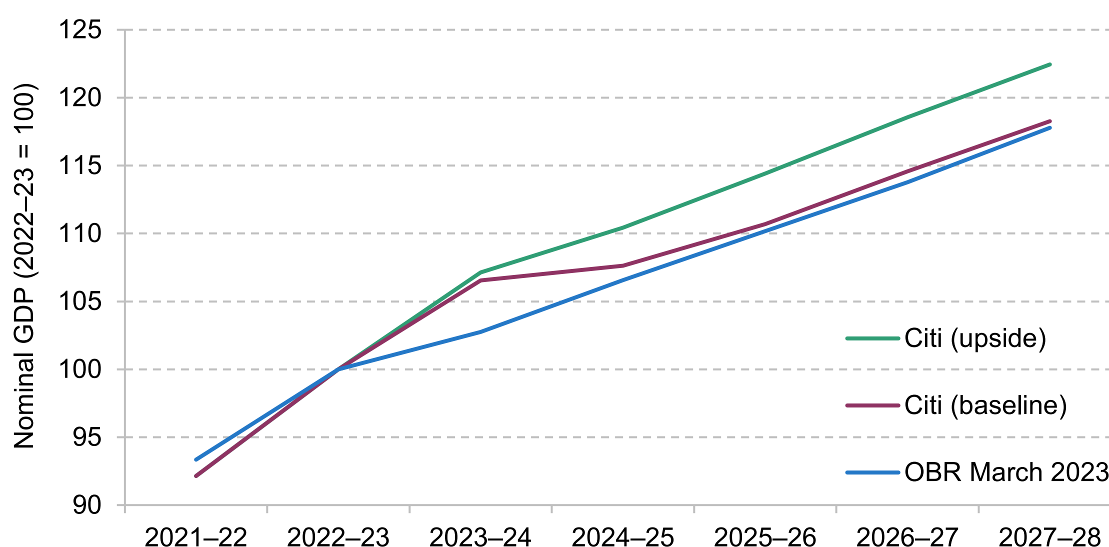
substantively change estimates of the nominal size of the economy, and do not change estimates of public sector revenues or spending in those years at all. They will only change the outlook for the health of the public finances if they affect forecasts for growth, or the efficiency of the public sector (and therefore desired public service spending), going forwards.

The growth outlook

One of the key determinants of the fiscal outlook is the cash size of the economy. Since taxes are typically levied on cash quantities (such as incomes, profits and spending), higher growth in cash terms can be expected to translate into higher cash revenues for the government. This is true whether higher cash-terms growth reflects faster growth in output or is driven by higher inflation. This is particularly true when tax thresholds – such as income tax thresholds – are being frozen in cash terms (see Chapter 4).

Figure 3.5. Forecasts for growth in the cash size of the economy



Source: OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

Under Citi's main scenario, considerably faster nominal growth this year is followed by a shallow recession, leaving the nominal size of the economy almost unchanged from the OBR's March forecast over the medium term (shown in Figure 3.5), though the real size would be smaller. For this Green Budget, Citi have also produced an 'upside' scenario, where additional nominal growth is more persistent. It is important to note that this scenario is not universally a better world to be in: higher nominal growth only partly reflects additional output, and is largely driven by more persistent inflation. This scenario is also associated with interest rates staying higher for longer. We refer to it as an 'upside' scenario on the basis that it is associated with a larger cash economy and slightly lower borrowing (see Section 3.4). For a discussion of the real growth outlook under these scenarios and how they compare with other forecasters, we refer the interested reader to Box 3.2.

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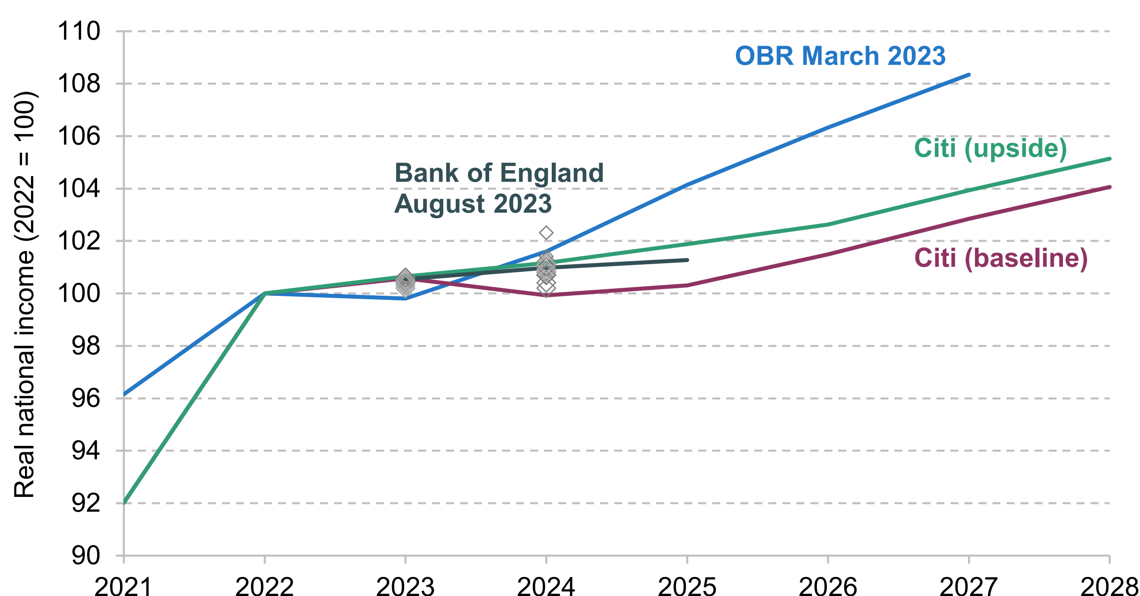
Box 3.2. Real growth under different scenarios

Whilst the cash size of the economy matters most for revenues, real growth is a more important determinant of how the output of the country is changing, and therefore the private and public consumption that we can enjoy. Under Citi's main scenario, the economy contracts in real terms next year (Figure 3.6). More importantly, however, the recovery in real growth after this is very poor in this scenario: real growth is just 1.0% on average between 2025 and 2028. In contrast, average growth in the four last years of the OBR's March forecast is 2.1% – well above the 1.8% average in the 20 years before the pandemic. Over the next few years, the OBR is also more optimistic than most other independent forecasters surveyed by the Treasury (as indicated by the diamonds), as well as, notably, the Bank of England.

Figure 3.6. Real growth forecasts



Note: Grey diamonds represent independent forecasters polled by HM Treasury (omitting Citi).

Source: HM Treasury's 'Forecasts for the UK economy: August 2023', Bank of England's Monetary Policy Report (August 2023), OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

Citi's alternative, 'upside' scenario assumes substantially higher nominal growth. However, this is not driven by a much better real growth performance – while a real-terms contraction is avoided in the near term, in the medium term growth remains worse than that forecast by the OBR in the March 2023 Budget. Instead, the 'upside' news for the public finances comes mainly in the form of more persistent inflation, which helps boost revenues (see the section 'Which kind of inflation?' below) while reducing the real-terms generosity of any public service spending plans that remain fixed in cash terms.

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Interest rates

The 2010s saw a long period of falling debt interest spending. This was even more remarkable since it came alongside a doubling of debt as a share of national income (see Figures 3.2 and 3.4). In the first year of the COVID pandemic, this pattern looked set to continue, with another large increase in debt accompanied by historically low and falling debt interest spending. Yet in the following two years, debt interest spending has increased substantially, reaching a share of national income last seen in the immediate post-war period, when public sector debt stood at upwards of 200% of national income.

Whereas at the time of the March 2022 Budget, the OBR expected this spike to be wholly temporary, it revised this expectation this past March, forecasting higher debt interest spending even after this year's spike has passed.

The OBR bases its debt interest forecast on market expectations for interest rates. One important such expectation is the one for Bank Rate, a measure of a risk-free rate in the economy, since commercial banks can receive this interest rate on deposits with the central bank. Figure 3.7 shows market expectations for Bank Rate at three points in time. Just after the 'mini Budget' in September 2022, markets expected Bank Rate to climb all the way to 6.4%, and to remain above 4% five years out. Subsequently, expectations fell from this high, but remained high and volatile. At the time of the March 2023 Budget, the OBR incorporated market expectations for Bank Rate into its forecasts which implied Bank Rate peaking at around 4.7% and then falling gradually to around 3.5%. Since then, market expectations have risen again and, at the start of October, markets expected Bank Rate to peak at around 5.4%.

Under Citi's baseline forecast, Bank Rate would peak at its current level of 5.25% and then come down much more quickly than the market expects, falling to around 2% from the middle of 2025 onwards. In other words, interest rates would be higher in the short term, but much lower in the medium term, than under the OBR's March forecast. This would mean a reduction in debt interest spending of £17 billion in 2025–26 and 2026–27, relative to the OBR's March forecast. Even under the Citi 'upside' scenario, where inflation is more persistent, Bank Rate would follow recent market expectations over the next three years, and then fall lower than recent market expectations from 2026 onwards (settling at 3.5% – i.e. very close to the market expectations that were used in the March 2023 Budget). The differences between those paths for interest rates are large, and would have a big impact on debt interest spending. The impact of this on overall borrowing levels will depend on other factors – including on whether a higher path for Bank Rate is associated with higher inflation. We discuss these impacts in Section 3.4.

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Figure 3.7. Forecasts and market expectations for Bank Rate

'Mini Budget': September 2022
Latest: 2 Oct 2023
Budget March 2023
Citi (upside)
Citi (baseline)
Per cent
0 1 2 3 4 5 6 7
Sep 2022 Sep 2023 Sep 2024 Sep 2025 Sep 2026 Sep 2027 Sep 2028

Source: https://www.bankofengland.co.uk/statistics/yield-curves.

Figure 3.8 puts these movements in Bank Rate expectations into a longer-term context, highlighting two things. First, expectations for Bank Rate are much higher than we had become used to during the 2010s and early 2020s, and this rise happened with little anticipation – expectations started to climb only shortly before actual Bank Rate did. Second, they have also become much more volatile, with large movements in a short space of time. Before 2022, the expected peak almost never moved more than a percentage point within a month – this was true on just seven occasions, or one in every 470 days, and all before 2014. Since 2022, this has been true a quarter of the time. This can be seen more clearly in Figure 3.9, which zooms in on the period since January 2022. As we go on to set out in the next section (Table 3.3), conditioning on recent market expectations for Bank Rate, as the OBR is set to do in its forecast at the Autumn Statement, would push up forecast debt interest spending substantially. Equally, volatile expectations mean that this methodology is now, more than in previous years, extremely sensitive to the timing of when the forecast is closed, as the conditioning expectations average over just two weeks.

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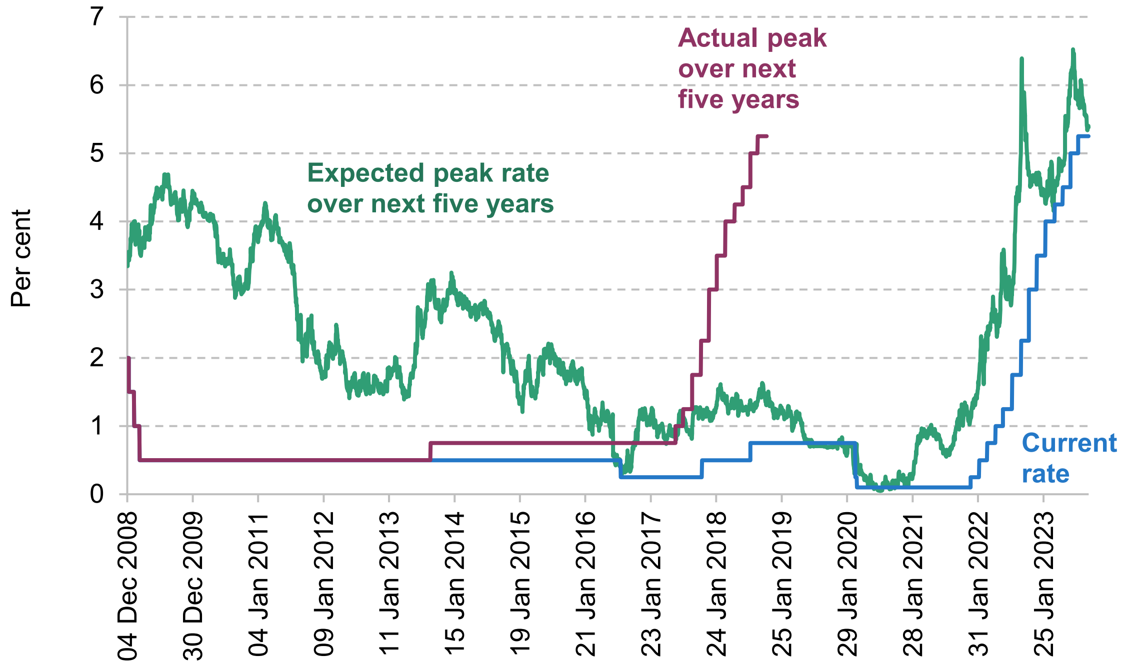
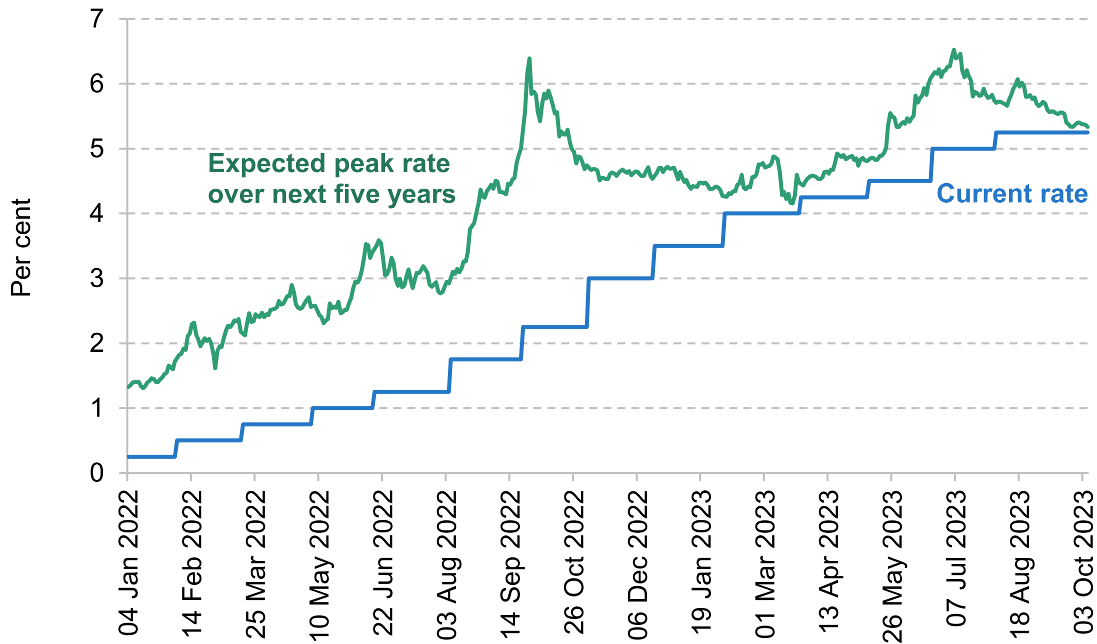
Figure 3.8. Bank Rate and expectations in a longer-term context



Source: www.bankofengland.co.uk/boeapps/database/.

Figure 3.9. Bank Rate and expectations since January 2022



Source: www.bankofengland.co.uk/boeapps/database/.

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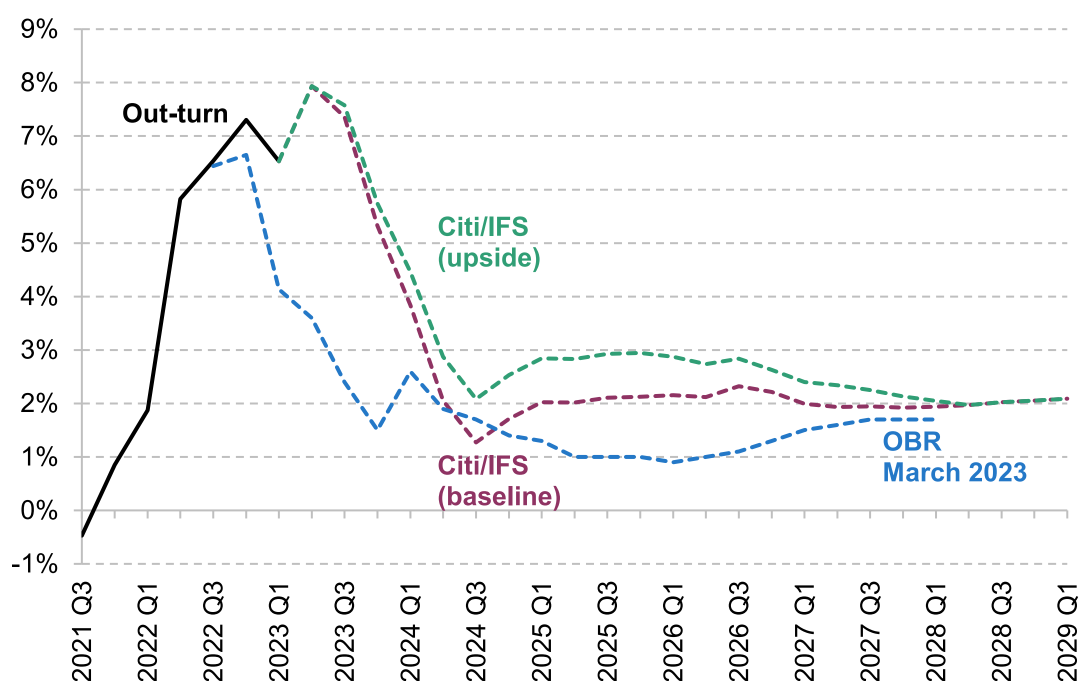
Which kind of inflation?

Inflation affects the public finances in a number of ways, with different types of inflation having different impacts. A bigger economy – even if it is only bigger in cash terms, rather than actually producing more goods and services – can help the public finances in the short term, first and foremost by increasing tax revenues. This is especially true in an environment where personal tax thresholds are frozen in cash terms (see Chapter 4).

The most recent out-turn data have shown the cash size of the economy growing faster than under the OBR's March forecast, with a corresponding boost to tax revenues. Tax revenues in the first five months of the current financial year are running £13 billion, or 3.3%, ahead of forecast. As a result, borrowing is running £11 billion, or 14%, below forecast. A simple extrapolation suggests that, if the strength in revenues persisted for the remaining seven months of the financial year, revenues would be £32 billion higher than forecast.

Under Citi's main forecast, this improvement in revenues dissipates over time, with the cash size of the economy from 2025 onwards almost exactly the same as it would be under the OBR's March forecast. Lower real-terms growth (Figure 3.6) is offset by higher economy-wide inflation (Figure 3.10), especially in 2025 and 2026, when the OBR's March forecast predicts extremely low inflation.

Figure 3.10. Economy-wide inflation: out-turn and forecasts



Note: GDP deflator growth shown.

Source: Office for National Statistics (series YBGB) and OBR's Economic and Fiscal Outlook (March 2023).

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The ‘upside’ scenario instead assumes that the economy is permanently bigger in cash terms. Correspondingly, revenues would be permanently higher than under the OBR’s March forecast in the ‘upside’ scenario – by some £45 billion – but there is little difference in the baseline scenario.

On the spending side, near-term spending plans within the current spending review period, which runs to 2024–25, are fixed in cash terms. So higher inflation in 2024–25, as forecast in both Citi forecasts (relative to the OBR’s March 2023 forecast), would lead to these settlements being less generous in real terms. This is the key mechanism by which higher inflation can reduce borrowing; it leads to real-terms spending plans being less generous than planned. For the period beyond March 2025, provisional spending totals have not yet been allocated to specific departments. We assume that cash spending totals are topped up to preserve the 1% real-terms overall increase allowed for in the March 2023 Budget. This still makes for an extremely challenging set of spending plans to deliver (see Chapter 4). However, the Chancellor *could* opt to squeeze public services even more (or at least, to claim that intention for the period post-2025) by maintaining the same cash totals, and leaving departments to absorb higher inflation from existing budgets. This would ‘save’ £8 billion in 2027–28 in the baseline scenario, rising to almost twice as much (£15 billion) in the ‘upside’ scenario.

In contrast to departmental spending plans, most welfare spending is, by default, uprated with inflation – albeit with a lag. But it is uprated with consumer prices, not economy-wide inflation. This is sensible if the policy aim is to preserve benefit claimants’ purchasing power. One key difference between consumer price inflation and economy-wide inflation is imports: changes in the prices of imported goods feed into consumer price inflation, but not economy-wide inflation (and hence the cash size of the UK economy). This has made things particularly difficult for the public finances during the current cost-of-living crisis – high import prices (particularly of energy and food) have pushed up consumer prices and put pressure on welfare spending, without a corresponding increase in revenues (as higher inflation is associated with lower real incomes, and a greater share of household spending will go on domestic energy and food which are both subject to a lower rate of VAT). Under Citi’s baseline forecast, higher CPI inflation (Figure 3.11) would add £10 billion to welfare spending in 2027–28 relative to that forecast in the OBR’s March 2023 Budget. As shown in Figure 3.11, rather than inflation being particularly high in the Citi scenario, this difference is more due to the OBR’s March forecast for CPI inflation to be very low in 2024, 2025 and 2026 – including running at around 0% for four quarters from 2025Q2.

Another channel through which inflation affects the public finances is through debt interest spending. Debt interest spending on index-linked (‘inflation-protected’) government bonds is linked to the Retail Prices Index (RPI). In the first five months of the financial year, £26 billion of debt interest spending – 18% of the total – was on the ‘inflation protection’ portion, rather

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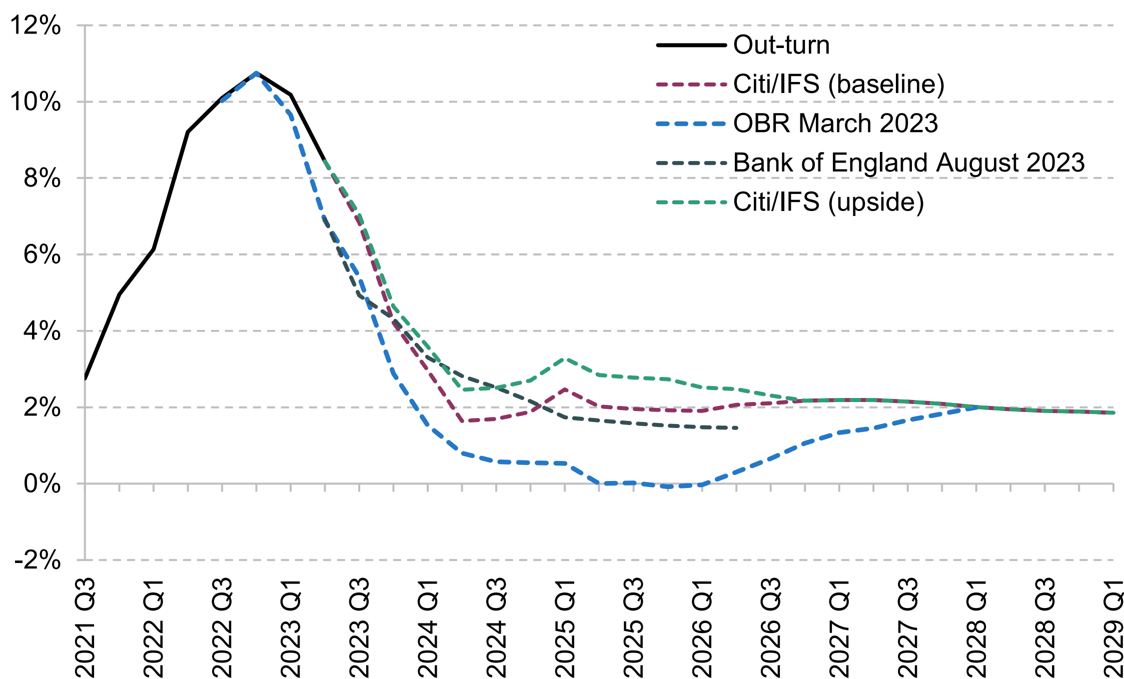
than on debt interest more narrowly speaking, and hence reflected the rise in the RPI.[4] Under Citi's baseline forecast, the RPI would grow by 19% more than under the OBR's March forecast over the period until 2027–28, and add £8 billion to debt interest spending in each of the next two years. Under Citi's 'upside' scenario, where inflation is more persistent, this would rise to £13 billion next year and £14 billion in 2025–26. The sensitivity of forecast debt interest spending to assumed interest rate is shown in more detail in the next section (Table 3.3).

Figure 3.11. Consumer price inflation: out-turn and forecasts



Source: Office for National Statistics (series D7BT) and OBR's Economic and Fiscal Outlook (March 2023).

3.4 Outlook for borrowing and debt under current economic expectations

In this section, we show what the changes in the economic environment described above, combined with standard assumptions about their proportional effect on revenues and spending, would mean for the outlook for borrowing and, consequently, debt.

[4] The 18% figure relates to central government spending on debt interest. Like other public finance quantities (such as borrowing), debt interest spending is an accruals measure, i.e. the impact is accounted for near-contemporaneously with the increase in the RPI. In cash terms, the impact is delayed, since the government does not actually hand over inflation compensation to lenders until much (in many cases, years or even decades) later.

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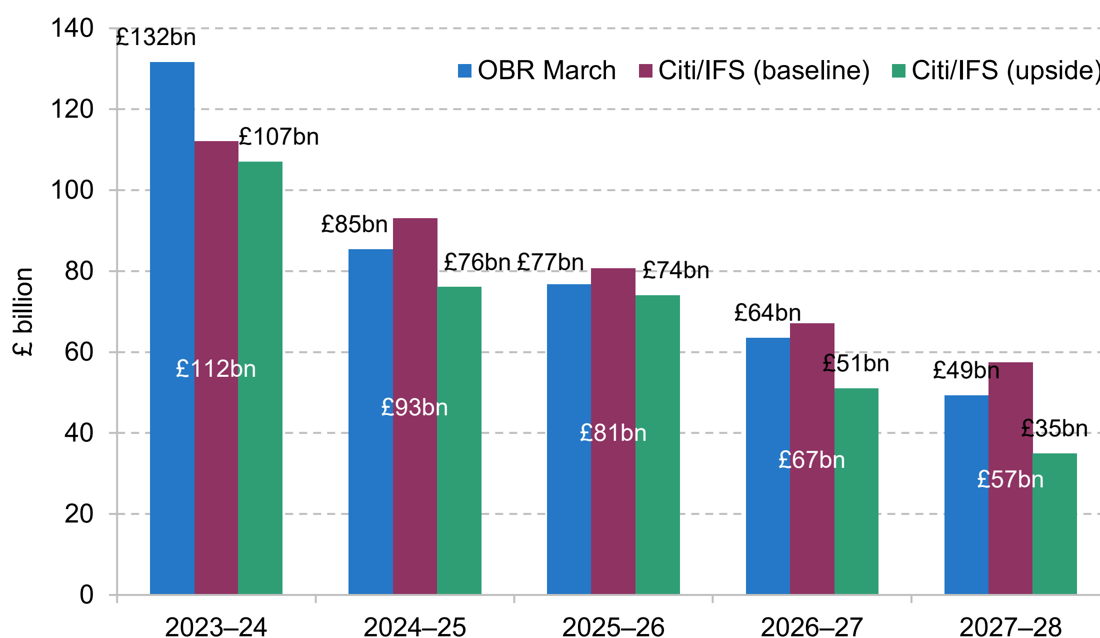
Borrowing

As described previously, revenues have outperformed the forecast in the first five months of the financial year, reflecting a stronger GDP out-turn in cash terms. Under Citi's baseline forecast, this largely persists for the remainder of the year, and borrowing is £20 billion lower than the March OBR forecast for 2023–24 as a whole.

In contrast, borrowing in the next four years is slightly higher under Citi's baseline forecast than under the OBR's March forecast (by between £4 and £8 billion), as shown in Figure 3.12, but slightly lower under Citi's 'upside' scenario.

Figure 3.12. Borrowing forecasts in £ billion



Source: OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

This reflects a range of partially offsetting factors. Figure 3.13 decomposes the overall change for the last year of the forecast (2027–28) under the baseline scenario into the following components:

- a £5 billion boost to revenues from higher nominal GDP growth, which is much smaller than this year;
- a weaker performance of the stock market over the last few months, which is assumed to persist throughout the forecast horizon, depressing tax revenues by £6 billion;
- lower debt interest than under the OBR's March forecast from 2025–26 onwards, by £9 billion in 2027–28 (we describe the sensitivity of this forecast to different interest rate assumptions below);
- £10 billion higher welfare spending to reflect uprating by higher consumer prices;

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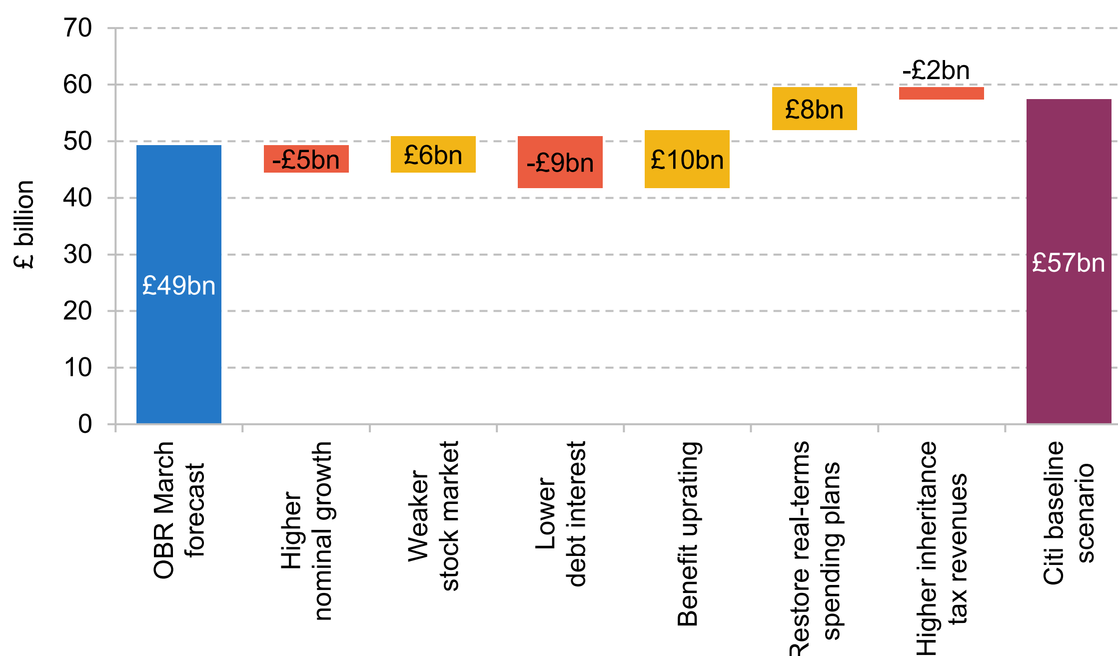
- an additional £8 billion of cash spending on public services to maintain the 1.1% real-terms increase;
- an adjustment for IFS's most recent inheritance tax forecast (see Chapter 7), which increases revenues by £2 billion.

Figure 3.13. Changes to borrowing in 2027–28 between the OBR's March forecast and Citi/IFS's baseline scenario



Source: OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

Overall, this leaves borrowing in the final year of the forecast £8 billion higher than under the OBR's March forecast. Under the 'upside' scenario, a bigger boost to revenues from higher nominal GDP outweighs the impact of higher interest rates and added expenditure on index-linked debt, social security benefits and public services triggered by higher inflation. This would leave forecast borrowing in 2027–28 at £35 billion, which would be £14 billion lower than forecast by the OBR in March and £22 billion lower than under the Citi baseline scenario.

As described in Section 3.3, the medium-term cash size of the economy is close to the OBR's March forecast in Citi's baseline scenario, but higher in their 'upside' scenario. This is reflected in the path of borrowing as a share of national income shown in Figure 3.14, where the gap between the OBR's March forecast and Citi's baseline scenario on the one hand, and Citi's upside scenario on the other, is amplified. Nevertheless, borrowing under Citi's upside scenario is still persistently higher than the OBR had forecast in March 2022, before the onset of the cost-of-living crisis. The dashed line in Figure 3.14 shows the (large) impact of simply adjusting the OBR's March forecast for the increase in market expectations for interest rates. Without any counteracting effects on revenues for higher inflation (or indeed any other economic

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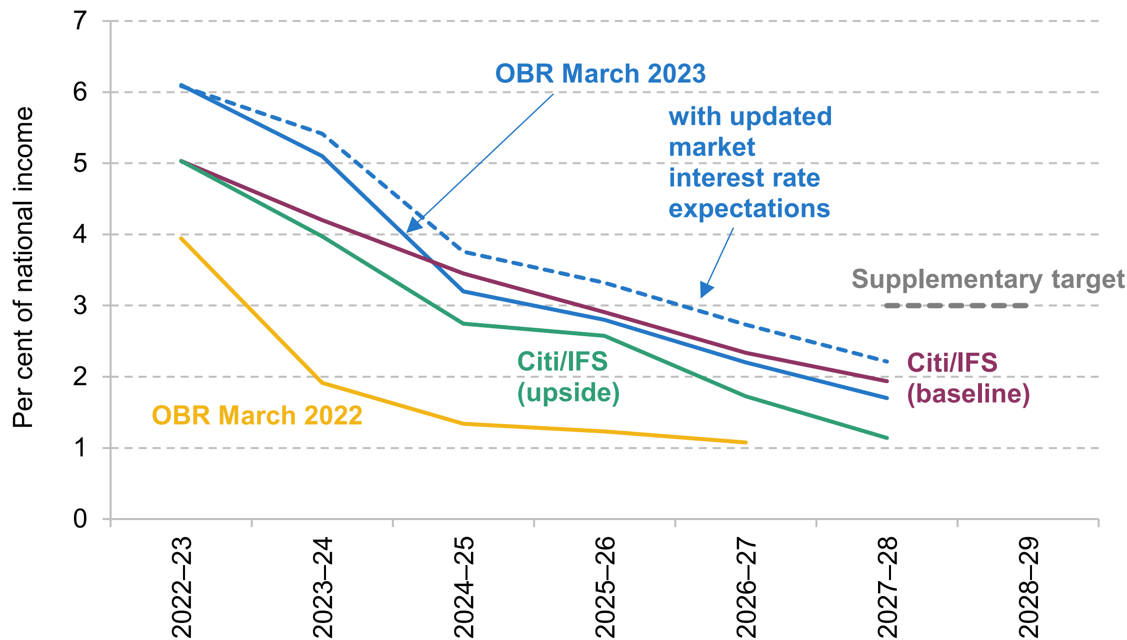
developments), this adjustment alone would increase borrowing by between 0.3% and 0.6% of national income; though despite this, borrowing would still be forecast to fall as a share of national income over time.

Figure 3.14. Borrowing forecasts as a share of national income



Source: OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

In the final year of the (current) forecast, 2027–28, borrowing falls to 1.9% of national income in Citi's baseline scenario, and 1.1% in the upside scenario. In both these cases, the supplementary target – specifying a 3% cap on forecast borrowing five years out – would comfortably be met if the same level of borrowing were maintained for another year. Assuming investment plans are unchanged in cash terms, this level of overall borrowing would leave the current budget essentially in balance in 2026–27 and 2027–28, with a small deficit of 0.1% of national income in the former year and a small surplus of 0.2% in the latter.

Debt

Figure 3.15 adjusts the OBR's March forecast for underlying debt for these changes to borrowing under Citi's two scenarios. Changes to borrowing are not the only determinant of changes to underlying debt. In particular, if losses forecast to be realised during the Bank of England's unwinding of its quantitative easing (QE) programme are revised up due to higher interest rates, this would add to underlying debt. This would make the letter of the Chancellor's

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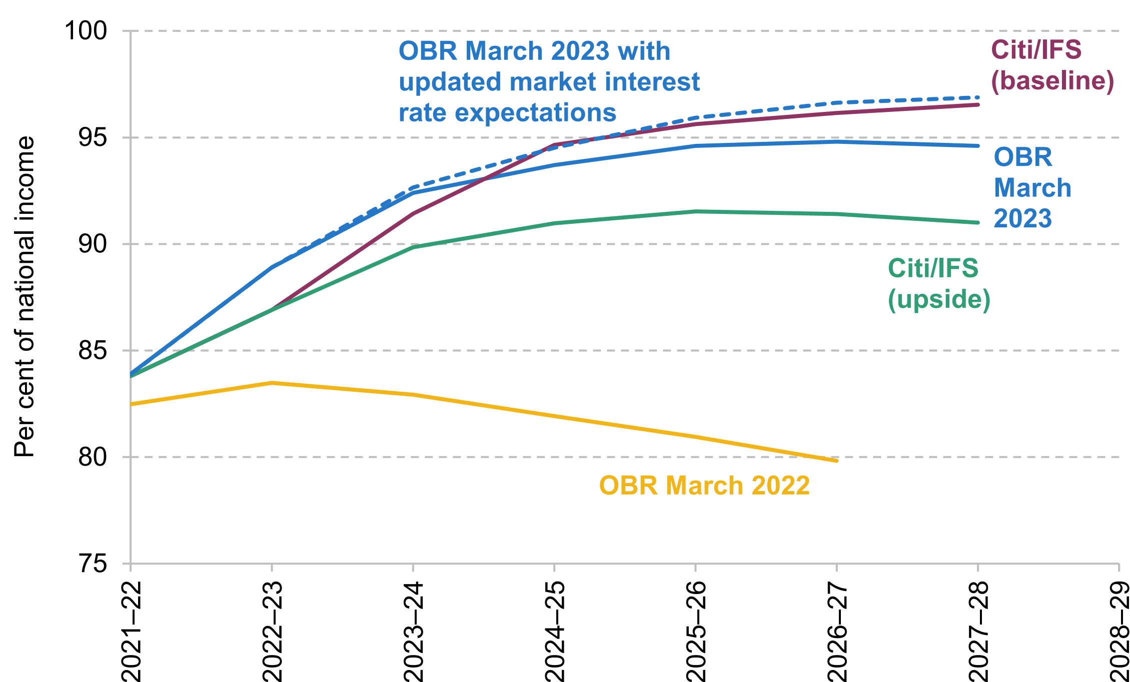
fiscal rule harder to meet.[5] Under Citi's baseline scenario, the path of underlying debt as a share of national income – while lower in the current year – is higher than under the OBR's March forecast in later years. It is also continuing to rise, albeit very slightly, in 2027–28. Purely adjusting the OBR's March forecast for the increase in market interest rate expectations could add a similar amount to debt as a share of national income in 2027–28 to what the more complex interplay of partially offsetting factors in Citi's baseline scenario does. As discussed above in Section 3.2 as a flaw of the fiscal mandate, this may have little impact on 'headroom' against this rule, even though the adjustment represents a clear-cut deterioration in the fiscal outlook and does not include any countervailing fiscal benefits of Citi's 'upside' scenario.

Figure 3.15. Underlying debt under Citi's scenarios



Source: OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

At the Autumn Statement, the OBR will add an additional year to the forecast, and the Chancellor's fiscal target will 'roll over' another year. So the fiscal mandate will require debt to be forecast to fall as a share of national income in 2028–29 (rather than 2027–28 as is currently the case). Adding another year outside the current spending review period means that the Chancellor seems likely to pencil in yet another year of tight spending plans for public service spending (without specifying where exactly the axe would fall). This could be sufficient to ensure that debt is again forecast to fall in the fifth year of the forecast horizon – indeed, the fact

[5] If QE were used again in future, serious consideration should be given to the option of designing the programme (e.g. interest paid on central bank reserves) in a way that limits losses to the government (see chapter 7 of last year's Green Budget).

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that this is so ‘easy’ to do highlights one of the issues with the target described in Section 3.2. In Citi’s ‘upside’ scenario, debt is much lower throughout. However, when it comes to ‘headroom’ against the fiscal target, this will not matter – what matters is how steeply debt falls at the end of the forecast horizon. Under this scenario, debt is falling (albeit very gradually) from 2025–26 so the target to have it falling in 2028–29 would most likely be met. But in all these scenarios, debt is much higher than, and not falling as quickly as, was forecast in the March 2022 Budget.

A key economic risk: debt interest spending

The OBR’s official forecasts are conditioned on market expectations for interest rates. At the time the March forecast was closed, those implied a lower peak of Bank Rate this year than subsequently occurred (and is hence built into both of Citi’s scenarios). This pushes up debt interest spending this year. In later forecast years, Citi’s main scenario – which has Bank Rate close to 2% from 2025–26 onwards (see Figure 3.7) – has much lower interest rates than the market expectations used for the OBR’s March 2023 forecast, let alone the latest market expectations which would presumably be used by the OBR were it to produce a forecast now.

Table 3.3. Debt interest spending in 2026–27 under different scenarios

	Debt interest spending, £ billion	Debt interest spending, % of GDP
OBR March 2023	£89bn	3.1%
Illustrative: with market rate expectations	£108bn	3.8%
Citi/IFS baseline scenario	£76bn	2.7%
Citi/IFS ‘upside’ scenario	£103bn	3.5%
OBR March 2022	£47bn	1.6%

Note: Central government debt interest net of income and losses from the Asset Purchase Facility shown. Market expectations as of 2 October 2023.

Table 3.3 compares debt interest spending in 2026–27 under different assumptions. This provides an indication of what the OBR’s new forecast for debt interest spending is likely to be if market expectations do not change between now and the time it closes its forecast. It also illustrates how sensitive spending forecasts are to changes in assumptions – an important thing to keep in mind in an environment where expectations are volatile, as set out in Section 3.3. If we plug in current market expectations, as the OBR will do (unless its methodology changes) at the Autumn Statement, we estimate that debt interest would be forecast to be £20 billion higher in 2026–27 than was forecast in the March 2023 Budget. In contrast, under Citi’s baseline scenario, in 2026–27 debt interest is £12 billion lower than under the March forecast (and £32 billion lower than what it would be under current market expectations), reflecting the impact of lower forecast interest rates. In Citi’s upside scenario – which includes stronger growth but

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also more persistent inflation – Bank Rate stays (somewhat) higher for longer, pushing debt interest spending closer to that implied by taking current market expectations.

We note, however, that while debt interest spending in the baseline scenario looks low compared with that under other assumptions, including what the OBR forecast back in March 2023, it would still be almost £30 billion higher than under the OBR's March 2022 forecast, the timing of which meant it incorporated only a very limited effect of Russia's invasion of Ukraine and its subsequent economic consequences.

In 2024–25 and 2025–26, inflation is higher under Citi's baseline scenario than under the OBR's March forecast, which includes a long bout of substantially below-target inflation in those years (see Figure 3.11). This increases spending on index-linked debt in Citi's scenario, especially in the middle of the forecast period, with a modest effect still present in 2026–27.

Finally, our calculations adjust debt interest spending for changes in interest rates that reflect the path of Bank Rate and allow for a proportional change in gilt rates. If there are additional changes in the market for government debt – for example, because of declining demand for long-term government bonds from UK pension funds and the Bank of England moving from being a buyer to a seller – debt interest spending could be pushed up further.

3.5 Budget judgement

In the March 2023 Budget, the Chancellor presented an OBR forecast that had him meeting his fiscal mandate for debt to be forecast to fall as a share of national income in 2027–28 by a hair's breadth. This was despite this fiscal target being much looser than those that the UK has typically had since 1997. The requirement for borrowing to be forecast to be below 3% of national income in 2027–28 was met by a much more substantial margin. But this is a target that we would not expect to bind: it is a soft target. On only one occasion (March 1993) over the last 40 years has the official forecast – outside of the global financial crisis and the height of the COVID-19 pandemic – suggested borrowing of more than 3% of national income five years out. Nevertheless, actual borrowing ended up exceeding 3% on 23 occasions over this period. Under the latest official forecast, borrowing in 2027–28 would be 1.7% of GDP which, if it materialised, would be the lowest level since 2001–02. The fact that despite this, debt was still only forecast to fall by the slightest of margins highlights the difficulty of preventing debt from rising as a share of national income when growth is weak.

While no formal assessment of the welfare cap was made – as that only occurs in the first fiscal event of a parliament – rising spending on disability benefits and on supporting those with health conditions means that spending was forecast to exceed the cap by £4.1 billion in 2024–25.

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The forecasts set out in this chapter have some near-term good news for the Chancellor. Stronger nominal growth in the economy so far this year is boosting revenues, with the result that borrowing in 2023–24 is likely to come in lower than the £132 billion forecast in March. Under our central scenario, it would be £20 billion lower at £112 billion. But it should be remembered that this would still be more than £60 billion more than the £50 billion that was forecast for 2023–24 in Mr Sunak's final Budget as Chancellor in March 2022. At 4.2% of national income, borrowing would also still be well above that seen just prior to the pandemic (2.8% of national income in 2019–20).

A difficult medium-term outlook

The medium-term outlook has, in many ways, changed quite substantially since March. But these changes have offsetting impacts on the public finances. The March 2023 Budget forecast included very low inflation in coming years (with CPI inflation clearly below 2% from 2024Q1 to 2027Q4 inclusive, including four quarters with zero growth in prices); whereas more normal rates of inflation now seem more likely. Under the Citi central scenario, this avoids lower real growth translating into a hit to revenues, although it also adds to social security spending (by £10 billion in 2027–28 under our central scenario), adds to spending on index-linked debt interest, and requires a top-up to the cash spending plans pencilled in for 2025–26, 2026–27 and 2027–28 (by £8 billion in 2027–28 under our central forecast), unless they are made even tighter in real terms.

Market expectations for how interest rates are likely to change from their current level have been extremely volatile since the summer of 2022. Interest rates are now expected to be higher, and for longer, than was expected at the time of the March Budget – but are thought to now be at or near their peak. At the time of writing, market expectations imply £20 billion more spending on debt interest in 2026–27 than what the OBR forecast in March (£108 billion compared with £89 billion). However, Citi expect Bank Rate to fall more quickly than the path implied by market expectations, which would suggest debt interest spending could be £12 billion lower than the March 2023 Budget forecast (£76 billion versus £89 billion). This would, however, still be almost £30 billion higher than in the forecast presented one year before, in the March 2022 Budget. And, at least to date, the OBR's methodology for forecasting debt interest spending has been to condition on market expectations for interest rates in the run-up to fiscal events, which suggests that that part of the fiscal numbers will be unpleasant reading for the Chancellor. Given the current volatility of market expectations, we should expect this forecast to continue to be subject to substantial revision, and with debt elevated the future path of interest rates will be one key risk to the forecast going forward. This is one reason why precisely targeting the change in debt five years out, as the fiscal mandate does, is not a sensible choice.

Further out, under our central scenario, the fiscal forecasts are similar to those in the March Budget, especially given the huge uncertainty around them. Borrowing is forecast to be slightly

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higher over the period from 2024–25 to 2027–28 (with £8 billion of additional borrowing in the final year, at £57 billion compared with £49 billion). At 2% of national income, and falling over time, the Chancellor could still expect to meet his target of having forecast borrowing below 3% five years out by some margin. Our central scenario also has public sector net debt higher than forecast in the March Budget, and still rising as a share of national income in 2027–28. It would remain touch-and-go whether it would be on course to fall in 2028–29, with much hinging on the spending plans that the Chancellor chooses to pencil in for that year, and whether he chooses to claim that the freeze on personal tax thresholds will be extended by yet another year. Another year of tight spending growth could easily ensure that debt is forecast to fall in that year, although this would not mean that pressures on debt have been contained in any material sense. The fact that borrowing is set to fall over the next few years from the very high levels incurred during the cost-of-living shock does not provide a good justification for tax cuts, or another fiscal loosening. Indeed, the recognition that crises periodically occur, and that the state will step in with support and allow borrowing and debt to rise sharply, is one of the reasons why it is prudent to aim to reduce debt outside of these periods of crisis.

As described in Chapter 4, there are also a number of policy pressures on the forecasts. Continuing to freeze fuel duties at their current cash levels, as the government surely intends, would reduce revenues by around £6 billion a year at the end of the forecast horizon. Making the corporation tax full-expensing policy permanent, as the Chancellor has said he wants to do, would add up to £10 billion a year to measured borrowing in the near term (though the true long-run cost of this policy would be much lower – see Chapter 10). It also remains to be seen whether the freeze to direct personal tax thresholds can continue through to 2027–28. The spending plans beyond March 2025 are also less generous than Mr Sunak bequeathed in his final Budget as Chancellor, and now imply real-terms cuts to the day-to-day budgets of many departments (totalling £9 billion in 2027–28 in the scenario we set out in Chapter 4) and falling real-terms spending on investment in public services.

So, what should the Chancellor do? While striving to have debt falling over the medium term is sensible, a narrow focus on achieving that in year 5 of the forecast should be avoided. He will continue to meet by some margin his supplementary target to have forecast borrowing below 3% of national income in five years' time. The welfare cap is likely to remain on course to be missed – with a big factor being the increase in spending on incapacity and disability benefits. Rather than attempting to cut around £4 billion from spending in the coming financial year, this fiscal target should be abandoned – after all, abandoning fiscal targets is something many Chancellors have found very easy to do over the period since 2016. Reforms to welfare spending should be judged on their individual merit, not solely on whether total spending happens to be just above or just below what was forecast a couple of years earlier.

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The case for net tax cuts is weak

There is clear pressure for the Chancellor to cut taxes, and doubtless those calls will grow louder if, as we forecast, borrowing this year turns out lower than forecast. Those calls should be resisted. This is not the time for a net tax cut, for three reasons:

- First, while borrowing may be lower than forecast in March 2023, it is very unlikely to be lower than forecast in March 2022. Spending the windfall from improvements in the fiscal outlook, while absorbing the impact of deteriorations, leads to a 'ratcheting' effect over time, as we describe in detail in Chapter 5. This behaviour should be stopped.
- Second, the current environment of high inflation and rising interest rates is one where a fiscal loosening is difficult to justify in the face of high and volatile costs of servicing debt, and where there is no case for a temporary fiscal stimulus. As stated in Chapter 2, a substantial pre-election tax cut could risk shifting the UK into a higher-inflation paradigm, the cost of which could be a protracted monetary-policy-induced recession.
- Third, the case for permanent tax cuts rests on the medium-term outlook for the public finances and the desired level of public spending. A government that wants to fund pressures on health and social care in order to deliver a similar breadth and quality of services, as well as extend the welfare state to new services such as early years childcare, is likely to find its scope for tax cuts severely restricted – and particularly so in an era of elevated debt and higher interest rates – unless growth turns out much better than expected.

The forecasts in this chapter particularly focus on the third of these arguments (Chapters 5 and 2 of this Green Budget address the first and second, respectively). The central outlook is one where debt is only roughly stable over the medium term, and even that requires one to assume policy settings that in the case of fuel duties, and possibly also personal tax thresholds and planned spending on public services in late 2020s, are far from certain to be implemented. Given these, there is actually a reasonable argument for a *net tax rise* to be set out for implementation over the medium term. Failing that, the Chancellor should avoid 'paying for' (certain) near-term tax cuts by pencilling in an (uncertain and difficult-to-implement) extension of the freeze to the personal tax allowance (in 2028–29) or by either tightening, or extending, the squeeze on public service spending beyond March 2025. That would be poor policy indeed.

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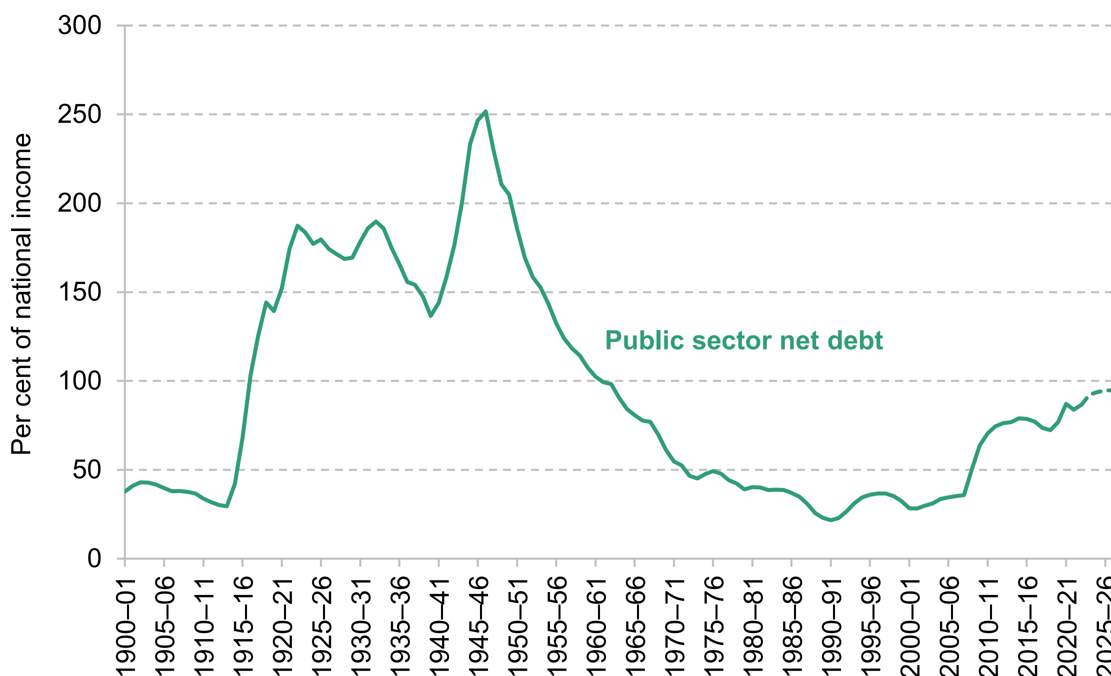
Appendix 3A

Figure 3A.1. Historical data of public sector net debt: out-turn and official March 2023 forecast



Note: The time series excludes the Bank of England from 1997–98 as defined by the UK's fiscal mandate.

Source: OBR's public finances databank (obr.uk/data/).

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