

The OBR's fiscal powers need a rethink

Policy briefing | Dominic Caddick | October 2024

The Office for Budget Responsibility (OBR), the UK's official fiscal forecaster, doesn't often receive the spotlight before a budget. Yet its forecasts and calculations become gospel to whatever new policies the chancellor chooses to preach. In fact, at this upcoming budget our analysis shows slight changes in how the OBR assumes government spending affects economic growth could unlock an extra £8.2bn for the chancellor to spend. While ultimately how much the chancellor can spend will be limited by her choice of fiscal rules¹, inside of this, the OBR's assumptions play a significant role in exactly "how much" can be spent. It can be argued that these assumptions have continually justified the use of austerity to manage public debt, despite it manifestly failing to get debt falling. If we want to avoid austerity, then along with changing the fiscal rules we need to challenge the economic orthodoxies that have kept forecasting us down the wrong path.

As we approach the new chancellor Rachel Reeves' first budget, the contents of what might appear in her speech seem increasingly uncertain. Rumours that she may redefine the fiscal rules to unlock the ability to borrow upwards of £50bn² are matched by ones where she might not make any changes at all³, and departments may be asked to make further cuts⁴. Labour's election promises to raise VAT on private schools⁵ and close tax loopholes for non-

¹ Keep, M. (2024). *The UK's Fiscal Targets*. House of Commons Library. Retrieved from: <https://commonslibrary.parliament.uk/research-briefings/cbp-9329/>

² Partington, R. & Stacey, K. (2024). *How Rachel Reeves could release billions more for investment in the budget*. The Guardian. Retrieved from: <https://www.theguardian.com/uk-news/2024/sep/27/how-rachel-reeves-could-release-billions-more-for-investment-in-the-budget>

³ Smith, B. (2024). *Budget: No.10 says it will stick with fiscal rules*. Civil Service World. Retrieved from: <https://www.civilserviceworld.com/professions/article/reeves-budget-fiscal-rule-reform-public-sector-net-worth-debt-ippr-report>

⁴ Courea, E. (2024). *Cabinet ministers contest chancellor's planned cuts to their departments*. The Guardian. Retrieved from: <https://www.theguardian.com/uk-news/2024/oct/16/rachel-reeves-tax-rises-spending-cuts-budget>

⁵ Helm, T. (2024). *Doubts grow over Labour's VAT plan for private schools*. The Guardian. Retrieved from: <https://www.theguardian.com/education/2024/oct/05/doubts-grow-over-labours-vat-plan-for-private-schools>

domiciled residents⁶ and private equity firms⁷ may be scrapped while commitments to raise capital gains⁸ and inheritance tax⁹ are gaining traction.

A key source of this uncertainty may be the OBR, whose forecasts will decide if Reeves meets her fiscal rules or not. While much speculation is given to the policy contents of the budget, little attention is given to how the OBR might judge these policies to have effects on growth. Yet, how policies are “scored” by the OBR may decide whether they end up getting adopted. As we detail in this briefing, the default assumptions the OBR applies to policies suggest government spending has no effect after five years, exactly when the fiscal rules bind. The implication of this is governments have often opted to cut budgets expecting debt-to-GDP to fall, without realising that these cuts may affect GDP down the line. Not only are the fiscal rules arbitrary constraints of what we can spend, but the assumptions the OBR make further restrict what we are allowed to spend on within that envelope. As we detail in this briefing, those assumptions directly influence how much the chancellor may allow herself to spend, and we should question if the OBR is appropriately using this power.

The OBR’s economic assumptions

To see why the OBR may be a blocker to revitalising public services and securing more investment, it is key to understand how the OBR forecasts the impact of changes in government spending. By default, any change in government spending is assumed to have an impact on GDP calculated via the fiscal multiplier. The fiscal multiplier simply measures the bang-for-buck of government spending, for every £1 spent on policy how many £s are added to GDP.

Table 1 below shows the assumptions the OBR makes for the fiscal multiplier¹⁰ which it splits into four different categories: public investment, public spending, welfare, and tax. These multipliers are applied when the government announces a permanent¹¹ change in

⁶ Islam, F. (2024). *Treasury reconsidering Labour plan for non-dom tax status*. BBC. Retrieved from: <https://www.bbc.co.uk/news/articles/c04pe3653k7o>

⁷ Sidders, J. (2024). *Labour Weighs U-Turn on Private Equity Tax Increase, Times Says*. Retrieved from: <https://www.bloomberg.com/news/articles/2024-10-05/labour-weighs-u-turn-on-private-equity-tax-increase-times-says>

⁸ Uddin, R., Dunkley, E. & Mason-Myhill, L. (2024). *UK executives dump shares on fears of Labour capital gains tax raid*. Financial Times. Retrieved from: <https://www.ft.com/content/e95bae86-7c43-4241-a98e-ba6064a6a387>

⁹ Young, V., Zeffman, H. & Mason, C. (2024). *Inheritance tax increases expected in Budget*. BBC. Retrieved from: <https://www.bbc.co.uk/news/articles/c8e13z910r9o>

¹⁰ Office for Budget Responsibility. (2023). *Dynamic scoring of policy measures in OBR forecasts*. Retrieved from: <https://articles.obr.uk/dynamic-scoring-of-policy-measures-in-obr-forecasts/index.html>

¹¹ Temporary changes can also be applied by modelling a permanent increase followed by a permanent decrease (or vice versa). However, note that multipliers are applied from announcement rather than the commencement of the policy. For example, a one-off investment of £1bn in year 2 of the forecast would have an effect of £430m under the OBR’s assumptions.

spending (either negative or positive) in one of these areas. For example, a £1bn increase in public investment would be modelled to increase GDP by £1bn in year 0, while a £1bn cut in public service spending would decrease year 0 GDP by £450m.

In all cases, these multiplier effects taper to zero after five years, meaning that even a permanent change in government spending is not expected to influence GDP after five years. The OBR justifies this as it says these multipliers reflect the response of monetary policy and price changes that completely nullify the government’s impact on the economy over time. Furthermore, with all multipliers below or equal to one it implies that government spending never affects GDP by more than is spent. In fact, when multipliers are below one it means government spending replaces some private spending that would have otherwise taken place – often described as crowding out.

Table 1: The OBR’s multipliers assume fiscal policy has no effect after five years

	Impact of a 1% of GDP increase in category on real GDP					
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Public investment	1.00	0.83	0.43	0.23	0.07	0.00
Public services	0.45	0.42	0.29	0.13	0.04	0.00
Welfare	0.60	0.57	0.43	0.23	0.07	0.00
Tax	0.33	0.30	0.23	0.14	0.05	0.00

Source: Office for Budget Responsibility, *Dynamic scoring of policy measures in OBR forecasts*, November 2023

Are the OBR’s multiplier assumptions too low?

At face value, there are many reasons to question the OBR’s assumptions here. First, we can look at the wider multiplier literature to evaluate OBR’s assumptions. For example, a meta-analysis of over 104 different multiplier studies¹² shows that multipliers are around 1.5 for public investment, around 1 for public services and between 0.6 and 0.7 for tax changes and welfare spending in initial years. Therefore, even when looking at the averages for such categories there is already reason to suggest the OBR’s multipliers may be on the low side, especially for tax and spending on public services and investment.

However, it is worth questioning if all spending within a category should be treated the same. While the OBR may argue its assumptions represent historical averages within categories, policies are often targeted at specific things. Should a welfare policy that directly targets those in the deepest poverty, like removing the two-child limit, really be forecasted to have the same effects as a change in the state pension? When governments take on new

¹² Gechert, S. (2015). *What fiscal policy is most effective? A meta-regression analysis*. Oxford Economic Papers, Vol.63, No.3. Retrieved from: <https://academic.oup.com/oep/article/67/3/553/2362401>

challenges like investments into new green technologies and climate adaptation will our past experience of investment really be representative?

A study of welfare spending focused on poverty reduction across 42 countries¹³ found the multiplier to be significantly above one in the majority of countries, with a median multiplier of 1.5. Similarly, an IMF paper¹⁴ looking at investment multipliers finds these to be much higher for renewable energy projects (between 1.1-1.5) than projects supporting fossil fuels (0.5-0.6). In both cases there would be valid justification to depart from the OBR's standard assumptions.

Furthermore, significant research has explored how multiplier effects can be dependent on economic context. For example, one meta-analysis of 1,800 multiplier estimates¹⁵ suggests spending multipliers are typically 0.7 to 0.9 (every £1 spent generates 70-90p more in GDP) higher during economic downturns compared to normal periods. Another study looking at periods where interest rates have been kept close to zero¹⁶ (i.e. monetary policy is unresponsive) concludes that multiplier effects average around 1.5 inside these periods. Despite these sorts of findings being widely replicated across the literature, the OBR lowered its multiplier estimates during the economic downturn and low-interest environment of the pandemic. It justified this due to the high import content of government spending at the time and lockdown stalling economic activity. While these are sound reasons multipliers may lower, it is notable this is the only time the OBR has directly referenced the economic context to alter its assumptions on multipliers and it did so without direct evidence to draw upon.

Therefore, there is reason to be concerned that the OBR's multiplier assumptions may be too low, unprecise and inflexible to economic context. This in turn undervalues opportunities to revitalise public services and kick-start public investment. Significantly, with multiplier assumptions below 1, the implication that government spending always "crowds out" private spending makes it harder for policies to be adopted, especially under fiscal rules. However, if assumptions reflected evidence on higher multipliers, like those found for poverty reduction, green spending or in downturns and low-interest environments, then we

¹³ Cardoso, D. et al. (2023). *The multiplier effects of government expenditures on social protection: A multicountry study*. Research Center on Macroeconomics of Inequalities. Retrieved from: https://madeusp.com.br/wpcontent/uploads/2023/08/wp18_vf_site_att.pdf

¹⁴ Batini, N. et al. (2021). *Building Back Better: How Big Are Green Spending Multipliers?* International Monetary Fund. Retrieved from: <https://www.imf.org/en/Publications/WP/Issues/2021/03/19/Building-Back-Better-How-Big-Are-Green-Spending-Multipliers-50264>

¹⁵ Gechert, S. & Rannenberg, A. (2018). *Which multipliers are regime-dependent? A meta-regression analysis*. *Journal of Economic Surveys*, Vol.32, No.4. Retrieved from: <https://onlinelibrary.wiley.com/doi/abs/10.1111/joes.12241>

¹⁶ Klein, M. & Winkler, R. (2018). *The government spending multiplier at the zero lower bound: International evidence from historical data*. University of Antwerp. Retrieved from: <https://ideas.repec.org/p/ant/wpaper/2018001.html>

could say government spending “crowds-in” private spending instead. In fact, such change is needed to even model the intended effects of Labour’s national wealth fund multiplying every £1 of government investment into £3 of private investment¹⁷. Overall, the OBR’s multiplier assumptions must increase to truly reflect the benefits of specific policies, otherwise they risk being scrapped.

Are the OBR’s multiplier assumptions too short-term?

The idea that a change in government spending might have no effect on GDP after five years might seem strange to most people. In our day-to-day lives we experience the effects of government spending through how well our health, social care, and welfare systems provide support when we need it, how well the education system generates a knowledgeable and skilled population, how well transport and communication infrastructure keeps us all connected, and how well our energy and housing infrastructure provides us a warm, safe and affordable place to live. Intuitively, when governments change how much they spend, it makes a big difference to our lives, and it is unlikely this would only cause a compositional change in GDP.

The question of longevity is especially pertinent given the way the fiscal rules bind in the fifth year of the OBR’s forecast. Since the OBR’s multiplier effects all fall to zero in the year 5, government spending cannot influence GDP in that year. The only way a government can lower debt-to-GDP in the fifth year of the forecast is by lowering debt and cutting the amount it borrows. Under this framework, any extra borrowing can only increase debt-to-GDP and only cuts in borrowing can decrease debt-to-GDP.

Again, the OBR’s assumptions are not forgone conclusions in the literature. The earlier-mentioned studies of multipliers for green technology¹⁸ and poverty reduction¹⁹ found that multipliers were persistent for at least five years and the heightened multipliers from unresponsive monetary policy last as long as interest rates are kept close to zero. Other studies²⁰ have repeated the result for welfare spending having long-lasting impacts and an

¹⁷ HM Treasury. (2024). *National Wealth Fund: Mobilising Private Investment*. Retrieved from: <https://www.gov.uk/government/publications/national-wealth-fund-mobilising-private-investment/national-wealth-fund-mobilising-private-investment-accessible>

¹⁸ Batini, N. et al. (2021). *Building Back Better: How Big Are Green Spending Multipliers?* International Monetary Fund. Retrieved from: <https://www.imf.org/en/Publications/WP/Issues/2021/03/19/Building-Back-Better-How-Big-Are-Green-Spending-Multipliers-50264>

¹⁹ Cardoso, D. et al. (2023). *The multiplier effects of government expenditures on social protection: A multicountry study*. Research Center on Macroeconomics of Inequalities. Retrieved from: https://madeusp.com.br/wpcontent/uploads/2023/08/wp18_vf_site_att.pdf

²⁰ Gechert, S., Paetz, C. & Villanueva, P. (2021). *The macroeconomic effects of social security contributions and benefits*. *Journal of Monetary Economics*, Vol.117. Retrieved from: <https://www.sciencedirect.com/science/article/abs/pii/S0304393220300416>

IMF study²¹ suggests infrastructure spending has a multiplier of 1.4 after four years. However, it is worth noting that many multiplier studies only focus on short-term effects. This may be because calculating long-term effects can be very difficult, as it can be hard to isolate the impact of a policy on GDP when many other factors can change over time. Although, in some cases the way multipliers are estimated uses techniques that exclude the possibility of long-term effects in the first place²².

With the literature varied it may be useful to understand the theory behind why multiplier effects may persist in the long-term. One common explanation is the idea of hysteresis²³, which posits that economic phenomenon can have effects that last even once the original cause is removed. For example, unemployment can have hysteresis effects, as the longer someone is unemployed the harder it may be to find a job, amongst other explanations²⁴. Therefore, if government spending causes changes that persist then the multiplier effect is likely to persist too. Another explanation may be for policies that can prevent economic harm. If a policy can avoid crisis it will reduce economic damages in the future, avoiding the redirection of demand and extend its impact on GDP of a policy into future years. For example, recent analysis from the US's Congressional Budget Office²⁵ suggests for every \$1 spent on flood defences, \$2-6 in future damages are averted.

With some empirical and theoretical backing for long-term multiplier effects how does the OBR justify always assuming effects disappear after five years? This is likely because the OBR uses a different framework to look at economic policies with long-term effects²⁶. To do this the OBR tries to measure "potential output" - the theoretical level of GDP when all resources are being fully utilised in an efficient way. When the OBR describes monetary policy and prices adjusting to nullify the multiplier effects, they are describing these processes reducing the difference between potential output and forecast GDP, ie closing the output gap.

²¹ Abiad, A., Furceri, D. & Topalova, P. (2015). *The Macroeconomic Effects of Public Investment: Evidence from Advanced Economies*. International Monetary Fund. Retrieved from:

<https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-Macroeconomic-Effects-of-Public-Investment-Evidence-from-Advanced-Economies-42892>

²² Blanchard, O. & Quah, D. (1989). *The Dynamic Effects of Demand and Supply Disturbances*. The American Economic Review, Vol.79, No.4. Retrieved from:

<https://uh.edu/~bsorensen/BlanchardQuah1989.pdf>

²³ Cerra, V., Fatas, A. & Saxena, S.C. (2020). *Hysteresis and Business Cycles*. International Monetary Fund. Retrieved from: <https://www.imf.org/en/Publications/WP/Issues/2020/05/29/Hysteresis-and-Business-Cycles-49265>

²⁴ Blanchard, O. & Summers, L. (1986). *Hysteresis in Unemployment*. European Economic Review, Vol. 31, No. 1/2. Retrieved from: <https://www.nber.org/papers/w2035>

²⁵ Congressional Budget Office. (2024). *Federal Spending for Flood Adaptions*. Retrieved from: <https://www.cbo.gov/publication/59971>

²⁶ Office for Budget Responsibility. (2022). *Forecasting potential output – the supply side of the economy*. Retrieved from: https://obr.uk/docs/dlm_uploads/BriefingPaperNo8.pdf

In fact, how long multiplier effects last are directly linked to its conception of the output gap and when it closes. Therefore, for a policy to have long-term effects under the OBR's framework it must influence how the OBR measures potential output, as the output gap is always forecast to close at the end of the OBR's five-year forecast. However, under the OBR's framework potential output is completely determined by supply-side factors focusing solely on the size of the labour force, the amount of capital (ie private business and government physical assets) and underlying productivity. This is despite the fact that there is little agreement over the size of the output gap²⁷, how it is calculated²⁸, when it will close²⁹ and if output gaps and potential output are coherent measures at all³⁰.

The application of this approach also appears ad hoc and selective. For instance, the OBR chose to increase its estimate of potential output when department capital spending was announced to rise by 30% in real terms in the March 2020 budget³¹. Yet when capital budgets were cut by 30% in real-terms between 2009-2012³² no equivalent downwards adjustment to potential output was made. This ad-hoc nature has seemed to encourage politicians to lobby the OBR to score their policies as having supply-side effects, from Jeremy Hunt with childcare³³ to Rachel Reeves with Labour's planning reform³⁴.

Furthermore, even if the OBR does recognise a policy to have a supply-side effect these can often be small. Given it calculates potential output based on the size of the labour force and amount of capital in the economy, any significant change must significantly affect one of

²⁷ Chen, J. & Górnicka, L. (2020). *Measuring output gap: is it worth your time?* International Monetary Fund. Retrieved from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3553185

²⁸ Schuster, F., Krahé, M., Sigl-Glöckner, P. & Leusder, D. (2021). *The cyclical component of the debt brake: analysis and a reform proposal*. Dezernat Zukunft. Retrieved from: https://www.dezernatzukunft.org/wp-content/uploads/2021/11/Konjunkturkomponente_eng_final_2.pdf

²⁹ Office for Budget Responsibility. (2013). *Is it plausible to assume a negative output gap after five years?* Retrieved from: <https://obr.uk/box/is-it-plausible-to-assume-a-negative-output-gap-after-five-years/>

³⁰ Tily, G. (2019). *From false multipliers to 'nonsense output gaps'*. Progressive Economy Forum. Retrieved from: <https://progressiveeconomyforum.com/wp-content/uploads/2019/10/Tily-Multiplier-and-nonsense-output-gaps.pdf>

³¹ Office for Budget Responsibility. (2022). *Forecasting potential output – the supply side of the economy*. Retrieved from: https://obr.uk/docs/dlm_uploads/BriefingPaperNo8.pdf

³² Hoddinott, S., Fright, M. & Pope, T. (2022). *'Austerity' in public services: lessons from the 2010s*. Institute for Government. Retrieved from: <https://www.instituteforgovernment.org.uk/sites/default/files/publications/austerity-public-services.pdf>

³³ Office for Budget Responsibility. (2023). *The economic effects of policy measures*. Retrieved from: <https://obr.uk/box/the-economic-effects-of-policy-measures-19/>

³⁴ Partington, R. (2024). *Reeves pushes for OBR to upgrade growth forecasts amid planning reforms*. The Guardian. Retrieved from: <https://www.theguardian.com/business/2024/sep/26/rachel-reeves-obr-growth-forecasts-planning-budget>

these variables. In a recent OBR paper³⁵, it stated that a 1% per year increase in public investment only increases potential output by 0.5% after five years but 2.5% after 50 years. In fact, once the OBR's multiplier effect and supply-side effects are combined the impact of public investment on GDP is precisely at its lowest point in the fifth year, when the fiscal rules bind. Therefore, even if a policy is deemed to have supply-side effects the impact on GDP is still arguably too small – as recent work from NIESR highlights³⁶. Despite these small effects, the fact that politicians have been found to lobby for their inclusion clearly implies they matter.

The OBR underestimated the impact of austerity, and it will likely do it again

Now, with an understanding of how the OBR makes its economic forecasts it is important to reflect on one of its biggest misses – underestimating the impact of austerity on the UK economy. In its own forecast evaluation reports the OBR has continued to recognise it has often been over-optimistic of the UK's economic outlook. For example, it consistently overestimated GDP growth³⁷ between 2010-2016 by 0.5-1.5 percentage points – quite significant in an era of 1-3% growth rates. The OBR offers many explanations for this that fit within its potential output framework – such as the unexpected and lengthy effects of the financial crisis, the eurozone crisis and Brexit on productivity, investment and labour supply all given as reasons their forecasts were over-optimistic.

However, notably missing is how the OBR's assumptions on multipliers could explain such a trend. One paper from the IMF³⁸ estimates that multipliers during the austerity period were substantially above 1, another calculates more precisely³⁹ a permanent multiplier effect between 1.2-1.5 and another paper shows⁴⁰ that austerity measures have led to the forecast of potential output being revised down. Together, these papers suggest cutting government spending leads to falls in GDP larger than the initial cut and, for the latter two papers,

³⁵ Suresh, N., Ghaw, R., Obeng-Osei, R. & Wickstead, T. (2024). *Public investment and potential output*. Office for Budget Responsibility. Retrieved from: <https://obr.uk/public-investment-and-potential-output/>

³⁶ Samiri, I., Caswell, B., Millard, S. & Chadha, J.S. (2024). *Public investment and potential output*. National Institute for Economic and Social Research. Retrieved from: <https://www.niesr.ac.uk/publications/public-investment-and-potential-output?type=topical-briefing>

³⁷ Office for Budget Responsibility. (2017). *Forecast Evaluation Report*. Retrieved from: https://obr.uk/docs/dlm_uploads/Forecast-Evaluation-Report-2017_Web-Accessible.pdf

³⁸ Blanchard, O., & Leigh, D. (2013). *Growth Forecast Errors and Fiscal Multipliers*. International Monetary Fund. Retrieved from: <https://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf>

³⁹ Gechert, S., Horn, G. & Paetz, C. (2017). *Long-term effects of fiscal stimulus and austerity in Europe*. Macroeconomic Policy Institute. Retrieved from: https://www.boeckler.de/en/faust-detail.htm?sync_id=7815

⁴⁰ Fatás, A., & Summers, L. (2016). *The Permanent Effects of Fiscal Consolidations*. National Bureau of Economic Research. Retrieved from: <https://www.nber.org/papers/w22374>

highlight how these effects persist. Importantly, these papers can help us understand why austerity can be self-defeating⁴¹. Instead of debt-to-GDP reducing when borrowing is cut, if the cut in borrowing is focused in areas with higher and persistent multipliers, then the reduction in GDP may outweigh the fall in debt.

The above can partially explain why, despite the UK having fiscal rules requiring debt-to-GDP to fall since 2009⁴², the ratio has consistently risen instead. Yet this is only a partial explanation as governments have also consistently borrowed more than the OBR expected⁴³. In general, politicians have failed to keep to promises on borrowing and have tended to borrow more to meet new costs. Where these costs have risen due to rising demand for public services⁴⁴ the OBR's multiplier effects may still be to blame. As we mentioned earlier, one reason multiplier effects may be expected to last long-term is they can prevent economic harms down the line. Therefore, when these sorts of effects are ignored their associated costs down the line will be ignored too, from the cost of increased poverty to the cost of people coming to public services in crisis when local early-intervention provision has been scaled back. Ignoring these costs, inherent in assuming multipliers effects are only short-term, will mean borrowing is underestimated too.

Despite all this, the OBR says it regularly reviews its multiplier estimates – so why have there been no major changes? One explanation is that the OBR tries to situate itself in the middle of the literature. Yet, often, higher multiplier estimates in the literature are reserved for particular economic contexts or policies which by design the OBR does not make special account for. In fact, in 2012, the OBR itself calculated that if its forecast errors were caused by its multiplier assumptions then the average multiplier it applied to spending cuts would have to be 1.3 to explain the stagnant growth, more than double its average assumption⁴⁵. However, instead of taking this as impetus to reflect on its multiplier assumptions carefully it doubled down on other supply-side explanations for its forecast errors. Since the OBR was initiated, its multiplier estimates have only changed very slightly, highlighting that there has been very little change in thinking.

⁴¹ Holland, D. & Portes, J. (2012). *Self-defeating austerity?* National Institute Economic Review. Retrieved from: <https://journals.sagepub.com/doi/full/10.1177/002795011222200109#bibr9-002795011222200109>

⁴² Pope, T. & Hourston, P. (2022). *Fiscal rules in the UK since 1997*. Institute for Government. Retrieved from: <https://www.instituteforgovernment.org.uk/explainer/fiscal-rules-history>

⁴³ Atkins, G. & Lanskey, L. (2023). *The OBR's forecast performance*. Office for Budget Responsibility. Retrieved from:

https://obr.uk/docs/dlm_uploads/Working_Paper_19_The_OBRs_forecast_performance_Aug23.pdf

⁴⁴ Hoddinott, S., Rowland, C. & Davies, N. (2024). *Fixing public services: summary*. Institute for Government. Retrieved from: <https://www.instituteforgovernment.org.uk/publication/fixing-public-services-labour-government/summary>

⁴⁵ Office for Budget Responsibility. (2012). *Forecast Evaluation Report*. Retrieved from: <https://assets.publishing.service.gov.uk/media/5a755ad3ed915d6faf2b2587/9780108511981.pdf>

While the OBR justifies itself on an evidence-based approach to multipliers it defers long-term effects to an approach based around potential output and assumes the output gap always closes in its forecasts. This is despite the OBR's own research⁴⁶ highlighting how estimating the output gap and potential output is highly uncertain and is sensitive to modelling assumptions, making no choice of potential output measure free from judgment.

Therefore, the OBR should realise the same is true for its multiplier assumptions. Trying to situate itself in the middle of the literature doesn't make itself neutral, instead it endorses a certain type of result with certain types of effects. No choice of multiplier assumption can truly be neutral, but if the OBR were to take a similar approach to potential output it would at least be informed by a variety of different estimates. If the OBR does not change tact, it will repeat the same mistakes.

The interaction between multiplier assumptions and headroom

To see how multiplier assumptions can ultimately affect politicians' decisions we look specifically at the measure of "fiscal headroom". The fiscal headroom measures the margin at which the fiscal rule is being met. Our fiscal rules currently specify that the government debt-to-GDP ratio must be falling in the fifth year of the OBR's forecast. At the March 2024 spring statement, when the debt-to-GDP ratio was expected to fall from 93.2% in the fourth year of the forecast to 92.9% in the fifth year, headroom can be calculated as 0.3% of fifth year GDP or £8.9bn. This is often then translated into the maximum amount the chancellor can borrow per year without breaking fiscal rules⁴⁷.

While this description of headroom is common it should be highlighted that it is not a literal interpretation of the fiscal rules. For example, if the chancellor did "spend" their headroom with £8.9bn extra borrowing per year then it is not certain if the fiscal rules will be met, broken or imply more room to borrow. This is because the fiscal rules only require debt-to-GDP in the fifth year to fall relative to the fourth. As "spending" headroom affects borrowing it increases the fourth year and fifth year debt level while also affecting fourth year and fifth year GDP through multiplier effects. Therefore, there are many different ways the fourth and fifth year debt-to-GDP ratios can change and this will determine if the rules are met or broken.

⁴⁶ Murray, J. (2014). *Output gap measurement: judgement and uncertainty*. Office for Budget Responsibility. Retrieved from: https://obr.uk/docs/dlm_uploads/WorkingPaperNo5.pdf

⁴⁷ Cooper, O. (2024). *What key budget terms mean - fiscal headroom, income tax thresholds and much more*. Sky News. Retrieved from: <https://news.sky.com/story/what-key-budget-terms-mean-fiscal-headroom-income-tax-thresholds-and-much-more-13012840>

Another criticism of translating headroom as room to borrow is it downplays the impact multiplier effects could have⁴⁸. While this fits in with the way the OBR assumes all multiplier effects are zero in the fifth year, as we have discussed, there are numerous policies that can reasonably be assumed to have persistent effects. If we assumed borrowing funded policies which had higher multiplier effects in the fifth year, we could achieve higher levels of borrowing without increasing the fifth year debt-to-GDP ratio. Below we explore how different multiplier effects could alter how much borrowing the government may consent to.

Even before any new policies are announced at Reeves' first budget, it is unlikely that there will still be £8.9bn headroom left for the chancellor. In fact, the Resolution Foundation estimate that, due to increased government costs and the economic forecast changing, there may only be £0.5bn of headroom left⁴⁹. With such little leeway it seems to make rumours that Labour will change the definition of debt in the fiscal rules more likely. For example, one of the more conservative options being considered is to switch from public sector net debt excluding the Bank of England (PSND ex BoE) to public sector net debt (PSND). Such a change would reduce the impact of the timing of the Bank of England's quantitative tightening and resulting central bank losses on fiscal headroom. If applied at the March 2024 spring statement, the PSND definition would have increased headroom by just under £16bn, to £24.9bn.

With these caveats, we look at what would happen if the government were to "spend" this headroom and borrow £24.9bn more a year. This would increase debt in the fifth year of the OBR's forecast by 149.4bn (including borrowing in year 0). This would imply a debt-to-GDP ratio of 98.9% in the fifth year, using the OBR's default multiplier assumption of no impact on year 5 GDP from the extra borrowing. However, if we assume a multiplier of 1.5, towards the upper end of the literature previously discussed, we find that the chancellor could have £8.2bn extra spending power without the debt limit rising above 98.9%, as seen in Figure 1 below.

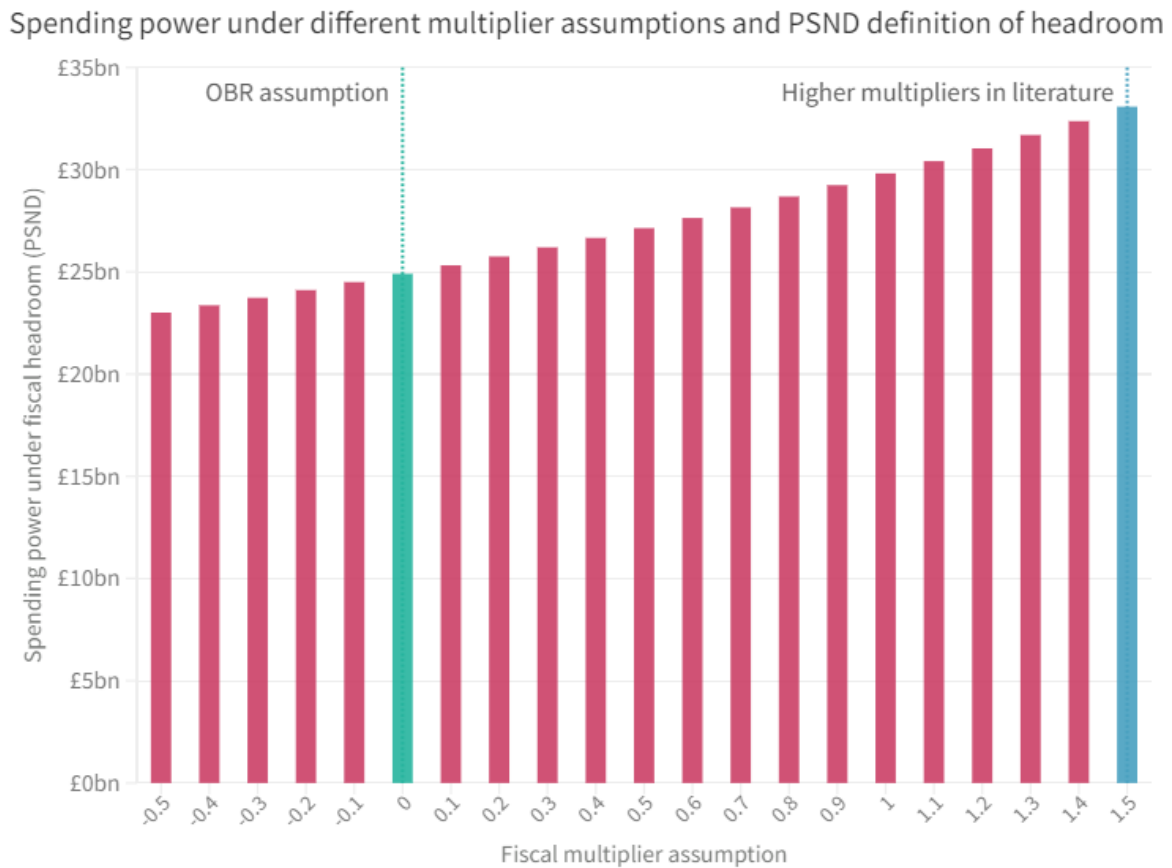
Therefore, together with the change in debt definition, more generous multipliers could have given the chancellor £24bn more spending power at the last budget, allowing for borrowing up to £33bn a year. However, it is worth noting that as our calculation of spending power is not a literal interpretation of the fiscal rules it would still depend on what happens in the fourth year of the forecast to determine whether the fiscal rules had been met or not. However, at the very least, our results show higher multipliers allow more borrowing for the same debt-to-GDP ratio. Therefore, our results show how significant the

⁴⁸ Coyle, D. (2024). *Jeremy Hunt and the fiscal headroom fallacy*. Financial Times. Retrieved from: <https://www.ft.com/content/661aa9b4-0b53-4b02-a1d7-76c373c2817b>

⁴⁹ Fry, E., Pacitti, C. & Smith, J. (2024). *Great expectations in hard times?* Resolution Foundation. Retrieved from: <https://www.resolutionfoundation.org/publications/great-expectations-in-hard-times/>

OBR's assumptions may be to the chancellor's perception of her room spend, especially if she is limited by debt-to-GDP.

Figure 1: A combination of a rule change and generous multiplier assumptions could unlock £24bn extra public spending a year



Source: NEF analysis of OBR March 2024 Economic and Fiscal Outlook assuming economic context stays fixed apart from changes to fiscal policy and growth.

Note: NEF analysis of OBR March 2024 Economic and Fiscal Outlook assuming economic context stays fixed apart from changes to fiscal policy and growth. For spending power within the fiscal headroom, we calculate how much extra borrowing could happen per year while stopping fifth year debt-to-GDP from rising above 98.9% - the debt level implied if all headroom was spent under OBR assumptions.

Conclusion

While political decisions are the primary cause, the OBR's assumptions of low and short-term multiplier effects enabled austerity by predicting spending cuts would make debt fall. Instead, as austerity ravaged the economy debt grew simultaneously. Now, we are left to live with the consequences of spending cuts that have harmed public services, livelihoods and investment which together have dragged down GDP causing debt-to-GDP targets to be missed.

Even if multiplier effects weren't grossly underestimated, the rigid application of multipliers limits the assessment of innovative policies, particularly with pressing challenges like climate change. A more flexible approach to multipliers, reflecting contemporary evidence and embracing uncertainty when needed, could provide a better foundation for future policy evaluations.

Changes to fiscal rules will likely offer Rachel Reeves more room for spending, but persuading the OBR to adjust multipliers for policies like green investment and poverty reduction could unlock further space. As we approach the budget, we should recognise the power the OBR has to make a difference in the budget and question how it is using its fiscal powers.