Section 3

The fiscal outlook

The faster-than-expected recovery in economic activity has materially improved the short-term fiscal position, with borrowing likely to be £20-30 billion lower in 2021-22. But, more important for the Chancellor and the economy is the outlook for the later years of the forecast. Here, again, the main message is one of heightened uncertainty. If the OBR reduces its estimate of 'scarring' from this pandemic to 2 per cent of GDP medium-term borrowing could be around £10 billion per year lower. But that is far from certain, and the OBR's medium-term fiscal forecast could easily end up being little changed since March 2021.

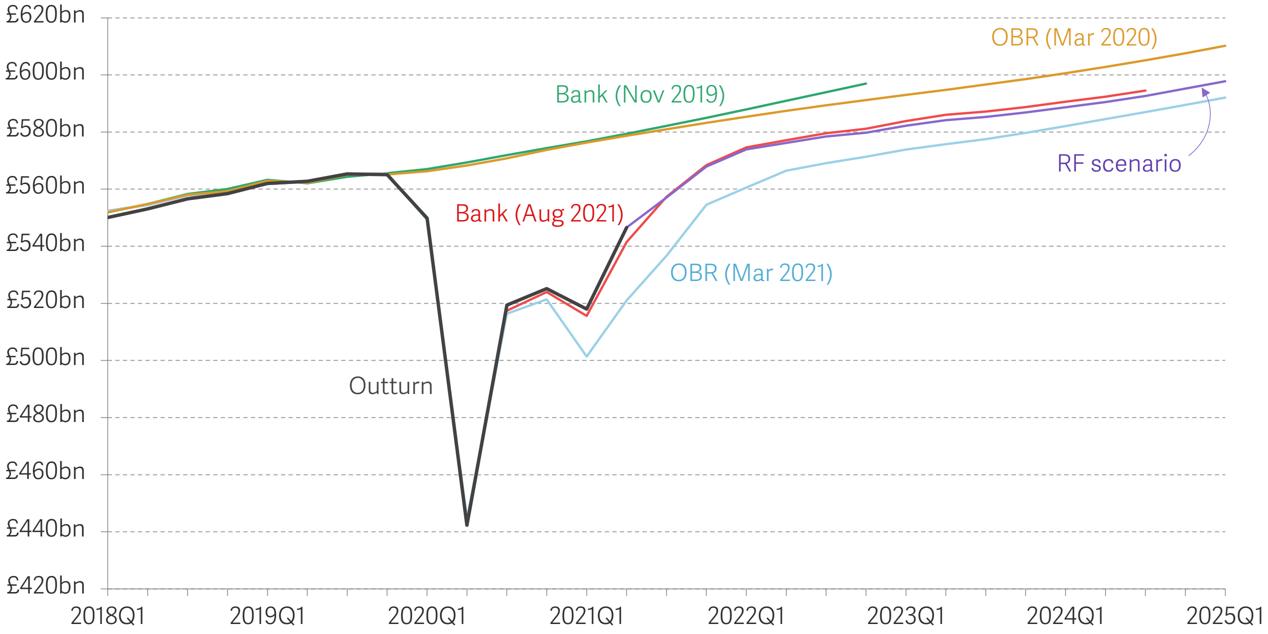
Fiscal policy has out of necessity been the main tool of macroeconomic stabilisation during this crisis. This is partly because the Bank of England was unable to reduce interest rates by as much as in the financial crisis. But it is also because the hugely uneven impact of the pandemic on households and firms required targeted fiscal support. Recent debate about the overall stance of macroeconomic policy has failed to recognise this reality and so focused too much on the stance of monetary policy; increases in interest rates will only play a small role in the overall tightening of policy. Instead, fiscal policy is much more important. In this context, the Chancellor must take the huge uncertainty into account. Given that it would be hard to provide more stimulus in a timely manner if growth stalls, policy should avoid withdrawing fiscal support too quickly, as this risks an unnecessarily protracted recovery. Looking further ahead, Rishi Sunak would like to be in a position to reduce taxes in the coming years. But the uncertainty about the longer-term economic impact of Covid-19 means that he must also prepare for a weaker outlook that could require higher taxes.

The pandemic required huge increases in government borrowing, but the faster-than-expected recovery means that borrowing will fall sharply

To understand how the change in the economic outlook will affect the OBR's fiscal forecasts, we construct a scenario in which we assume that that the OBR adjusts its assessment of the medium-term scarring from the pandemic from 3 per cent to 2 per cent.[22] As Figure 14 shows, this leaves the path of GDP close to the Bank of England's most recent forecast, but slightly lower by the end of the forecast period. Our scenario expands on the GDP outlook to include consistent forecasts for the labour market, inflation and other variables which have a material impact on government finances.

FIGURE 14: **GDP growth has beaten expectations but is set to slow**

Quarterly real GDP, outturns and select forecasts: UK



NOTES: Historic forecasts have been adjusted to reflect ONS revisions to the level of GDP.
SOURCE: RF analysis of ONS; OBR, Economic and Fiscal Outlook, March 2020 and March 2021; Bank of England, Monetary Policy Report, November 2019 and August 2021.

The faster-than-expected recovery in economic activity this year has led to a material fall in borrowing relative to the OBR's March 2021 forecast. So far this year, public sector net borrowing (PSNB) has been £32 billion below expectations.[23] This reflects the improvements in the economy discussed above, which have raised current tax revenues, and related smaller-than-expected expenditure on Covid-19 support measures such as the Coronavirus Job Retention Scheme (JRS).

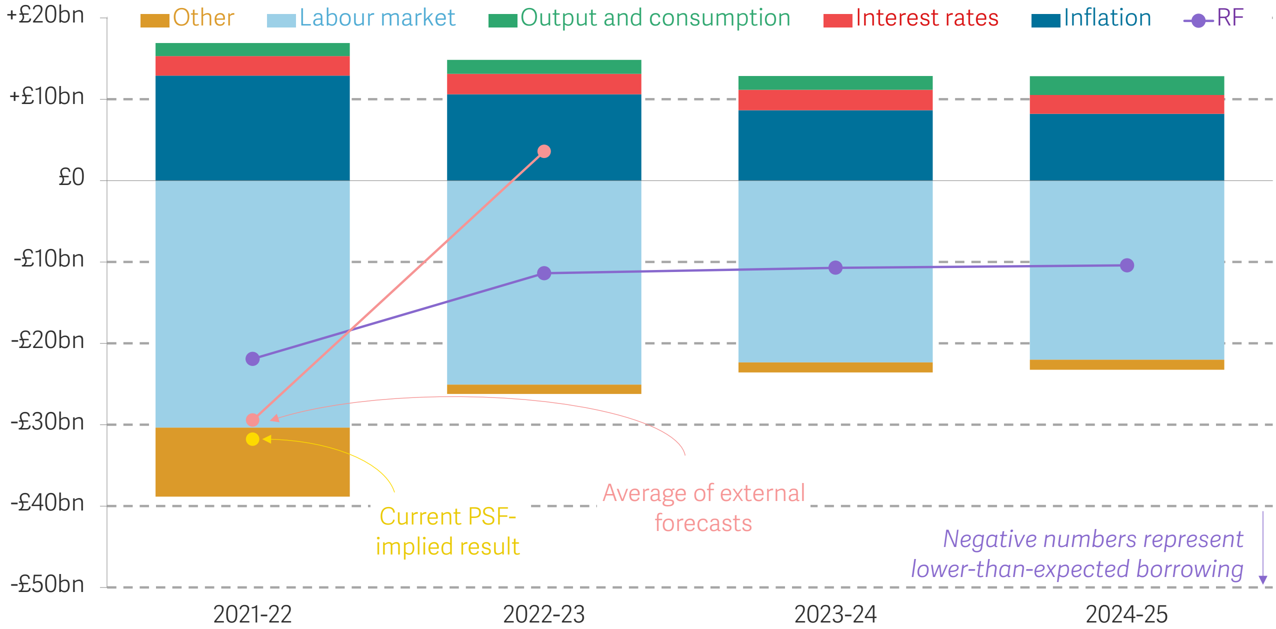
22 The Resolution Foundation fiscal model is used to translate this economic scenario to a revised fiscal forecast. We utilise the OBR's 'ready reckoners' for how changes in the economy feed into government borrowing. Here, the OBR provides summary estimates for how individual economic variables affect specific elements of government spending and revenue. For example, higher employment leads more people to pay income tax and thus higher income tax revenue. These ready reckoners were last published in 2019, so we have amended them to reflect changes in the Government's fiscal position and related policy decisions, although this adds additional uncertainty to our results. For example, we have allowed for the fact that government debt is substantially higher than had been forecast in 2019, and that tax thresholds are different in real-terms from those expected at the time.

23 PSNB has been revised down by an additional £2.5 billion since the OBR's March 2021 forecast due to a change in the discount rate used for public sector pension schemes. This represents an accounting change, rather than something related to changes in the economy or policy, and so we therefore abstract from this revision in subsequent figures. For more information see: ONS, Public sector finances, UK: August 2021, October 2021.

But the economic outlook for the rest of this fiscal year is less positive. Figure 15 shows our central estimate of the change in PSNB since the OBR's March forecast, and the key economic drivers of these changes. We estimate that PSNB in 2021-22 will be around £22 billion below the forecast made in March 2021 – less than the £32 billion improvement seen so far this year. There are good reasons to think that the positive trend seen so far in 2021-22 will not continue into the latter half of this year. For example, some of the improvement in borrowing to date is due to smaller expenditure on government support schemes, like the JRS, which have now ended, and so cannot contribute any more to lower-than-expected spending; and the cost of higher inflation on debt interest is only starting now to have a major effect. Despite this, other external forecasters are currently expecting, on average, borrowing to be £30 billion lower than forecast in March, but there is a huge range in these estimates, ranging from borrowing being £100 billion lower than previously expected to being in line with the OBR's March forecast.[24]

FIGURE 15: **The stronger-than-expected economy since March has improved the fiscal forecast**

Change in public sector net borrowing forecast since the OBR's March 2021 forecast, by economic driver: UK



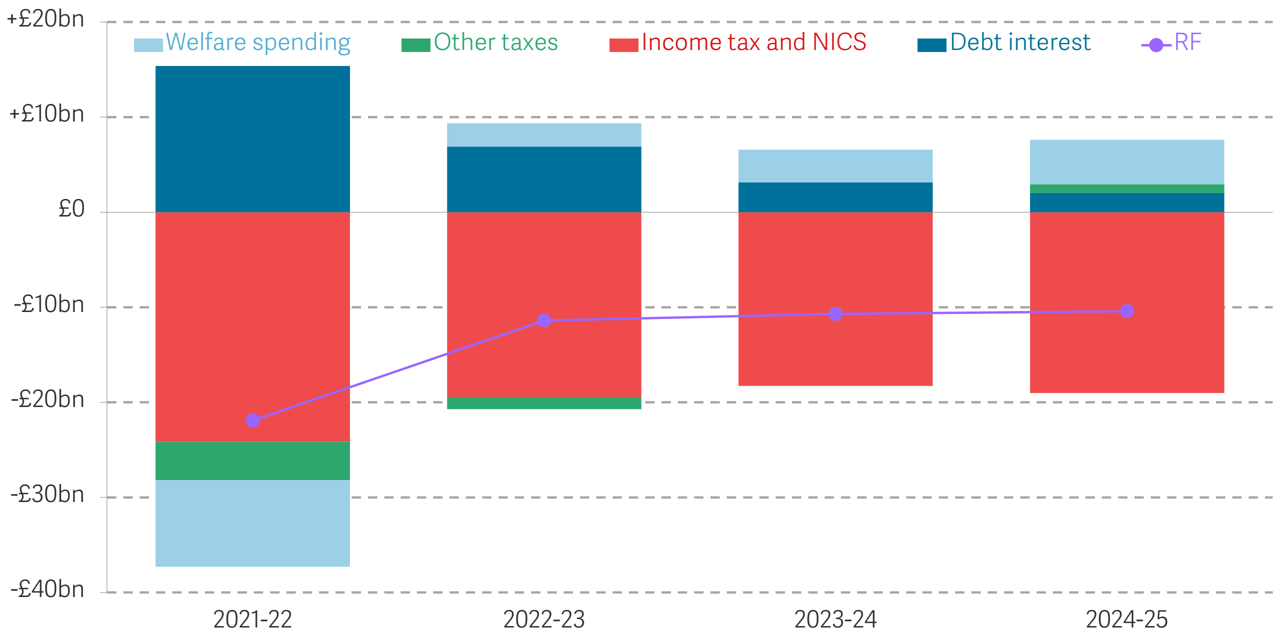
NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming a medium-term scarring assumption of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve; HM Treasury, Forecasts for the UK economy.

24 One area where our central estimate could be too pessimistic is on other areas of government underspend; the latest IFS Green Budget suggests that there will be a £10 billion underspend in the Covid fund , for example (see: S Adam et al., IFS Green Budget 2021, Institute for Fiscal Studies, October 2021). In addition, given the uncertainty around the path of health crisis, it is hard to definitively predict spending demands over the rest of the year, and so we have not allowed for any additional underspending in our 2021-22 forecast.

The improvement to borrowing in later years of the forecast is smaller because it is less affected by the strength of the economy this year, depending instead on the assumption made about the level of scarring. With medium-term economic activity in our scenario roughly 1 per cent higher than the OBR's March 2021 forecast (as a result of a reduced scarring assumption), we estimate that borrowing will be around £10 billion lower than expected. This reflects a stronger forecast for economic output, showing up in a stronger labour market, partially offset by the longer-term effects of the increase in inflation and interest rates in 2021 and 2022.

FIGURE 16: **Higher government spending is more than offset by higher revenue**

Change in public sector net borrowing forecast since OBR's March 2021 forecast, by fiscal driver: UK



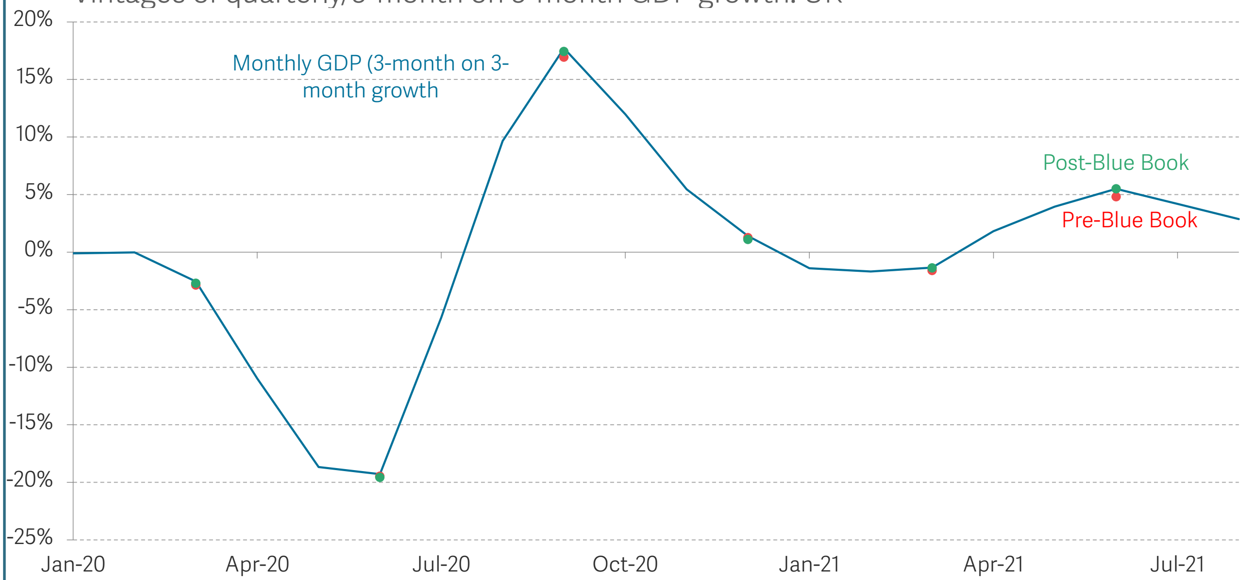
NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming medium-term scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes to the market rates for UK government debt. 'Welfare spending' data includes the impact of lower JRS spending in 2021-22.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

Figure 16 shows the same forecast as Figure 15 but broken down into changes in spending and tax revenue. The impact of higher inflation and interest rates on debt-servicing costs are expected to add substantially to expenditure in 2021-22, but much less so in future fiscal years. This is because the impact of higher inflation on indexed-linked gilts feeds through into measured borrowing at the same time as inflation is elevated (i.e. affecting the 2021-22 fiscal year predominately), and the recent rise in gilt rates have been larger at the shorter end of the gilt curve. The OBR tends to close its forecast several weeks before the fiscal event; this means that more recent rises in gilt rates will not be factored into forecasts.[25] Recent rises in interest rates could add around a further £2 billion to annual borrowing by 2024-25. We discuss the impact of more recent revisions to GDP data in Box 2.

By necessity, the OBR 'closes' its forecast ahead of the forecast publication in order to allow the Chancellor to make fiscal decisions based on a fixed set of projections. This means no new data releases are inputted into projections. For example, in March 2021, the OBR closed the forecast on 5 February, almost four weeks before publication on 3 March.[26] This practice obviously means that the OBR's projections do not always reflect the latest available information, although it has the option of providing additional analysis of how the new information may change its forecast in future. The forecast closed for the upcoming Budget and Spending Review on 24 September – somewhat earlier than the previous forecast.[27]

FIGURE 17: **News in the latest GDP releases is largely offsetting**

Vintages of quarterly/3-month on 3-month GDP growth: UK



SOURCE: RF analysis of ONS, Quarterly National Accounts & Monthly GDP estimate.

Since the forecast closed, there has been material economic news on the size of the economy, raising the question whether our projections –

25 Our forecast uses gilt rates as of 24 September 2021.
26 OBR, Economic and fiscal outlook, March 2021.
27 See C Giles, Sunak to impose tight spending settlement by using 'old' official data, Financial Times, October 2021.

which incorporate more timely GDP outturns – will be consistent with those in the Budget. Figure 17 shows GDP growth from three successive ONS releases. The OBR forecast will only include the data in red. Since then, the level of GDP has been revised up materially (shown by higher growth in the green dots for 2021), and GDP growth has slowed in July and August (shown by the falling blue line). Our view is that these factors are offsetting. This suggests that, had the OBR included the timeliest GDP data in their analysis, changes to its forecast may be relatively small. So, the recent revisions to GDP should not be a significant source of difference between our analysis and the OBR's, particularly in the context of the large uncertainties affecting the fiscal forecast at the moment.

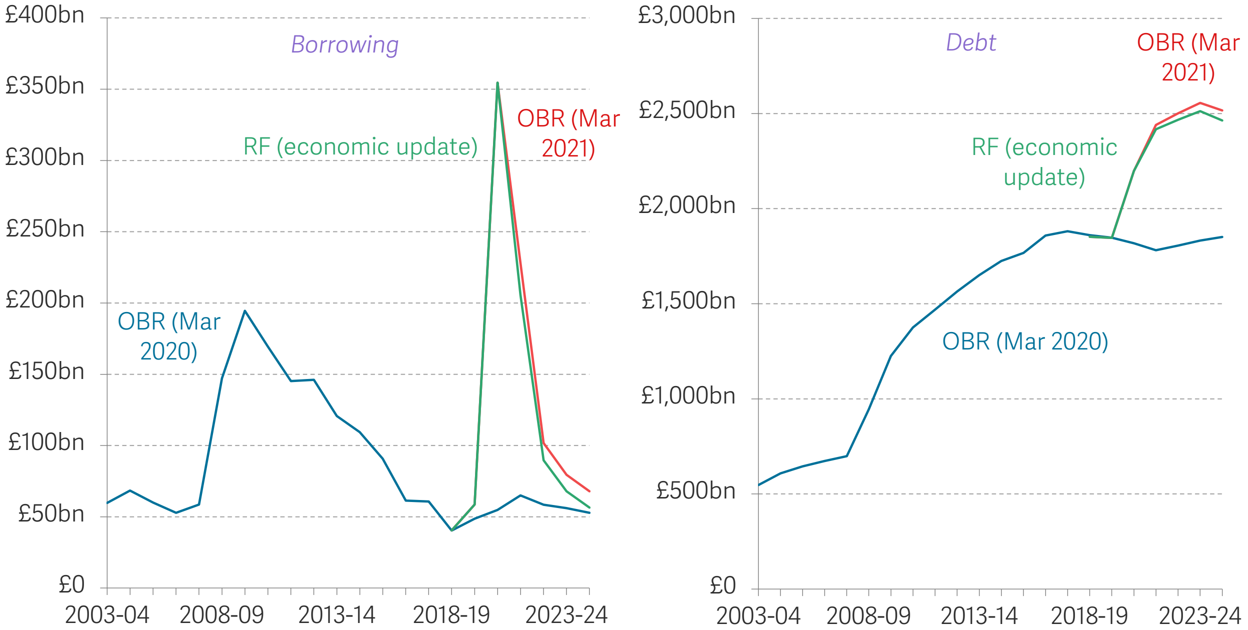
The other major upward pressure on spending comes from higher welfare spending, as many benefit rates are usually increased in line with inflation. But the impact of higher inflation on debt interest costs and welfare spending is more than offset by the increase in tax revenue, particularly from income taxes, as employment and wages are both projected to improve faster than previously expected.

Although these revisions to the borrowing forecast are both material and important, the big picture remains one of extraordinary fiscal support during the pandemic and a swift fall in borrowing back towards pre-pandemic levels (see Figure 18). In historical terms, such a fall in borrowing is utterly unprecedented. Before the pandemic, the fastest recorded fall in PSNB over a five-year period was 6.7 per cent of GDP, following the 1990s recession. The OBR forecast in March was that the five-year fall in PSNB following the pandemic would be more than double that, at 14.1 per cent of GDP.[28] If successful, such a rapid return to lower borrowing would be in marked contrast to the post-financial crisis experience, where a slow economic recovery hampered efforts to improve the Government's fiscal position. From one perspective, this is not surprising: the huge support required during the pandemic largely focussed on one-off schemes (e.g. the JRS), and had to be funded with increased borrowing (unlike in the financial crisis, where some one-off support measures – such as the cost of bailing out banks – did not affect the borrowing figures).[29] But it should also be noted that the fast recovery in the fiscal position is testament to the success of the Government's support schemes in preventing further damage to the supply capacity of the economy. However, although borrowing is set to fall back to pre-pandemic levels, debt will remain elevated, peaking at close to 100 per cent of GDP.

28 This uses OBR data back to 1948. See OBR, Public Finances Databank, August 2021.
29 Purchasing banks as part of the bailout increased debt directly but, as they were accompanied by new public sector assets, did not directly raise borrowing.

FIGURE 18: **the pandemic has led to a significant increase in government debt**

Public sector net borrowing and public sector net debt, outturn and forecasts: UK



NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in the market rates for UK government debt. Figures are shown in 2019-20 prices.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021 and March 2020; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

Current fiscal forecasts are consistent with the Government meeting its expected set of fiscal rules, assuming the economy recovers as expected

At the start of the pandemic, the Government rightly chose not to adopt the fiscal rules proposed in the 2019 Conservative manifesto.[30] Instead the Treasury has acted without a defined fiscal framework throughout the pandemic. This is sensible, given that the fiscal rules in place at the time had no mechanism for the suspension of fiscal targets or their reintroduction after a recession. In any case it would have been economically disastrous for restrictive fiscal rules to prevent the Government from implementing measures to protect the economy and deal with the health crisis. But this is not a long-term strategy, and we expect the Chancellor to lay out a new fiscal framework at the upcoming Budget.[31] This is expected to encompass a commitment not to fund day-to-day spending through borrowing (i.e. not to run a current budget deficit) and to have 'underlying' debt falling (this is the measure of PSND which excludes the effects of the Bank of England).[32]

30 These rules were: (i) to achieve a current balance (i.e. not borrow to fund day-to-day spending); (ii) public sector investment not to average more than 3 per cent of GDP; and (iii) if debt interest reached 6 per cent of tax revenue, then the fiscal strategy would be reviewed. For more detail see: Conservative Party, Manifesto 2019, November 2019.
31 See G Parker & C Giles, Rishi Sunak to set out new fiscal rules to rein in UK borrowing, Financial Times, September 2021.
32 Some Bank of England support measures, such as the Term Funding Scheme, increase measured public sector debt but will naturally unwind once the policy has been withdrawn. For more details see OBR, Economic and Fiscal Outlook, March 2021.

If such targets are announced, it would mean that there is a clear consensus between the Conservative and Labour parties that these are the appropriate metrics to target. However, the horizon over which these rules should be achieved has not been made clear by either party. And there is also a broader question over whether this consensus is merited – this is discussed further in Box 3.

BOX 3: **Fiscal rules for the Covid recovery**

The choice of fiscal rules plays an important role in guiding fiscal decisions in the UK. They help enshrine a government's medium-term economic strategy, help set expectations for future policy, and (if well defined) encourage countercyclical policy helping to stabilise the economy through booms and busts. A good fiscal framework should incentivise policy that drives a rapid recovery in the short-run and that repairs the public finances thereafter.

Our previous work set out a set of fiscal rules which could ensure long-term fiscal sustainability while facilitating the key economic reforms the Government intends to pursue, such as achieving its Net Zero and levelling-up agendas, and ensuring appropriate counter-cyclical fiscal policy.[33] This crisis has – if anything – strengthened the case for such a set of rules. Each of the rules – and their key justification – are summarised below:

- A Net Worth Objective: to deliver an improvement in public sector net worth as a share of GDP over five years. This would incentivise prudent investment decisions to address the long-term challenges facing the UK.
- A Structural Current Balance Target: to achieve a cyclically-adjusted public sector current balance of 1 per cent of GDP (and no less than minus 1 per cent) over five years. This requires the Government to keep receipts and day-to-day spending in broad balance (indeed, it means that not only could the government not run a current deficit but it must run a 1 per cent surplus) but would allow it to borrow to invest.
- A Debt Interest Ceiling: to ensure the proportion of revenue spent on debt interest does not exceed 10 per cent. This would ensure that the overall debt burden remains sustainable at all times by taking account of not only the level of debt but also what it costs to service.
- An 'escape clause': to recognise the need for more active fiscal policy given the constraints on monetary

33 R Hughes, J Leslie, C Pacitti & J Smith, Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, October 2019.

policy. The net worth and structural current balance targets would be suspended if the economic outlook deteriorated significantly.

The 'escape clause' is particularly important because, to date, governments faced with economic downturns have simply jettisoned rules and left themselves without a fiscal anchor. One of the points of having fiscal rules is precisely to give guidance on how a government would respond to changed economic circumstances, so constantly abandoning rules is not a good strategy for conducting predictable and effective fiscal policy.

Transitioning back to a defined fiscal framework is helpful as the economy normalises, for all of the reasons highlighted, above but there are some specific challenges with the rules the Chancellor is expected to announce. In particular, our view is that these rules are likely to prove too tight in the near term and too loose in the medium term. This is because the envisaged rules will set out a specific *time* horizon for tightening policy, rather than setting out the *circumstances* in which policy will tighten. This means there is a high likelihood that policy will prove too tight. Another issue is that the expected framework does not fully recognise the new environment of low interest rates. Low rates mean that monetary policy cannot fulfil the primary stabilisation tool for macroeconomic policy. This is because there is simply not enough room to cut interest rates sufficiently in a downturn. This means that fiscal policy must support the economy more during downturns and recoveries. But, equally, policy will need to be ready to do this again during the next recession. To prevent a 'ratcheting' effect, whereby the fiscal position deteriorates during every recession but never recovers, fiscal policy needs to be tighter during boom periods to offset the larger rise in debt during recessions. A simple 'debt falling' rule does not deliver this feature.

One clear issue is that the focus on debt limits hampers the ability to meet the country's Net Zero commitments: achieving Net Zero will require substantial public sector investment, and fiscal rules need to take that into account (as would be the case under a net worth rule).[34]

Finally, a set of fiscal rules without an escape clause (or another mechanism to ensure that stimulus can be provided during a recession) will result in the framework being dropped as soon as a downturn starts. This leaves the Government with no medium-term fiscal strategy and heightens policy uncertainty.

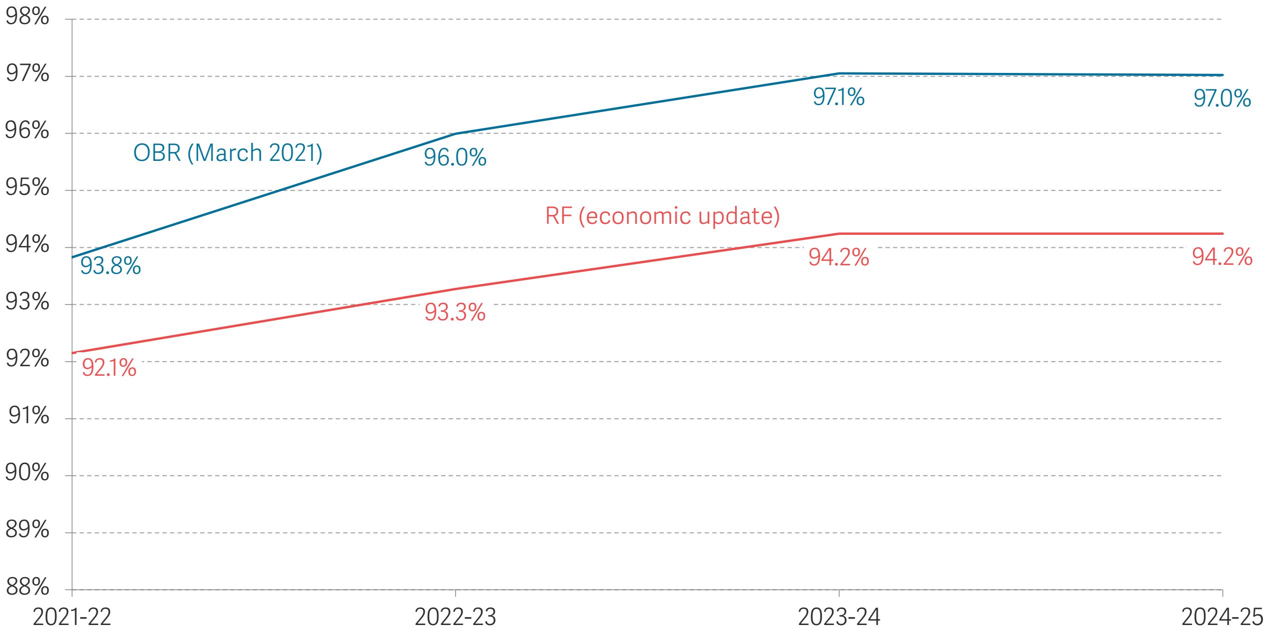
34 For more on the net zero challenges see: J Marshall & A Valero, The Carbon Crunch: Turning targets into delivery, The Economy 2030 Inquiry, September 2021.

Figure 19 presents our updated estimate of underlying debt as a share of GDP, compared to the OBR's March 2021 forecast. In the new forecast, debt is expected to reach 94.2 per cent of the economy in 2024-25, compared to 97 per cent in March.

The level of debt is lower in the updated forecast for two reasons: first, borrowing is expected to be lower throughout the forecast, and so adds less to the debt stock each year; second, the economy is now expected to be larger, which means the debt stock is smaller in relative terms. But what matters for meeting the expected fiscal rule is that debt is on a falling path. In March 2021, the OBR expected this to be the case by 2023-24, but this would only just be met. Our updated forecast also shows that debt is expected to fall only slightly between 2023-24 and 2024-25; this is because GDP growth is, in our scenario, expected to be somewhat slower in 2023-24, offsetting the impact of the lower stock of debt in absolute terms.

FIGURE 19: **Underlying government debt is expected to increase until 2023-24**

Forecasts of public sector net debt excluding the Bank of England, as a share of GDP: UK

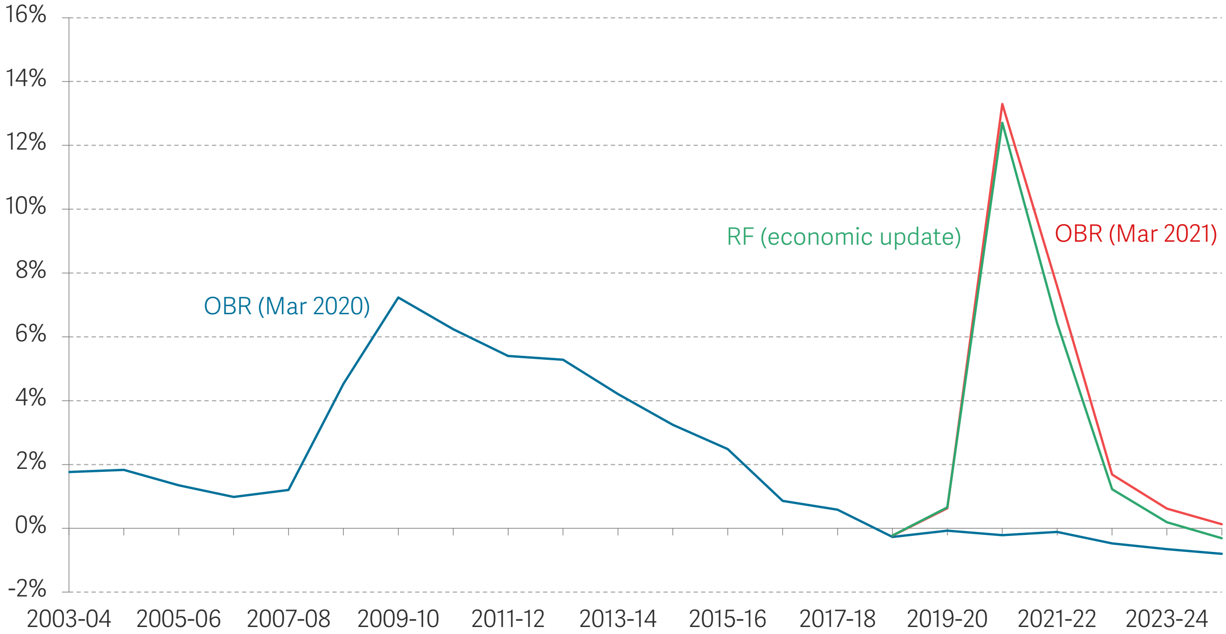


NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

There has been a clearer improvement in the forecast for the current deficit. Figure 20 shows that the current deficit should be -0.3 per cent of GDP by 2024-25; the OBR's March forecast expected a deficit of -0.1 per cent that year. This change reflects that assumed improvements in the medium-term economic outlook will reduce borrowing, and the additional day-to-day spending commitments since the March Budget have been funded with additional taxation.

FIGURE 20: **Forecasts now indicate the Government will achieve a current surplus in 2024-25**

Outturn and forecasts of the current deficit, as a share of GDP: UK



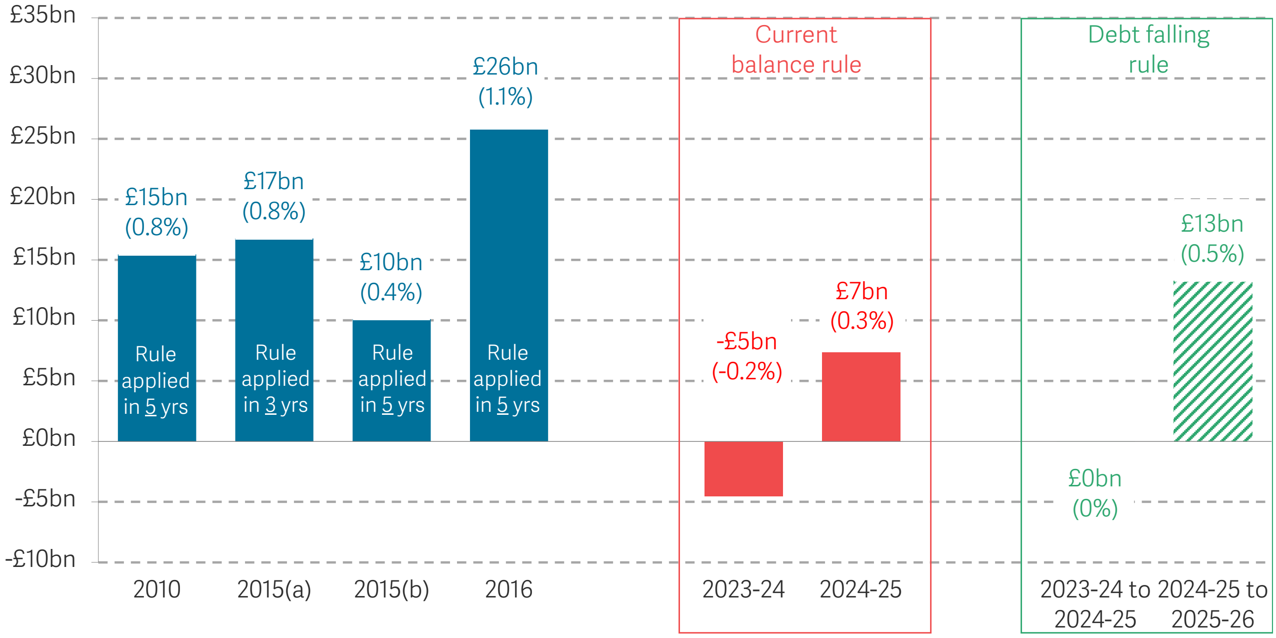
NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming a scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021 and March 2020; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

These assessments mean that the Government is on-track to meet its (expected) fiscal rules by 2024-25, but only just. Figure 21 presents our forecasts for the headroom against both rules in the years 2023-24 and 2024-25, compared to the headroom against previous fiscal rule regimes at their announcement. Based on our economic scenario and announced spending and tax plans, the Government is on-track to meet the proposed rules by 2024-25 (by £7 billion and £13 billion for the current balance and debt rules respectively. The current balance rule is projected to be the harder constraint to meet – on current plans, it is set to be missed by £5 billion in 2023-24.

However, the horizon over which these rules are to be set is currently unclear. There is potentially a political incentive to choose a short horizon: the fact that the Government is meeting a set of rules as it heads into the next election would allow it to tell a story of fiscal responsibility, and possibly even indicate that taxes could be cut or spending increased. However, as our updated forecasts suggest, the underlying fiscal position is likely still to be improving by 2024-25, and setting the horizon of any fiscal rule too early would necessitate tighter fiscal policy during the recovery, which would be costly for the economy.

FIGURE 21: **The Government's likely fiscal rules are on track to be met in 2024-25, but headroom is small relative to previous rule regimes**

Headroom against previously announced fiscal rules and forecast headroom to meet a current balance and debt rule: UK



NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt. The forecast for debt changes between 2024-25 and 2025-26 relies on an extrapolation of the Resolution Foundation's fiscal model as the core forecast is only available up to 2024-25; this adds additional model uncertainty to that result. Figures in brackets show headroom as a proportion of contemporaneous GDP.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; OBR, Historical Forecasts Database; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

Forecasts that show the fiscal rules being met ignore the huge amount of economic uncertainty, and this uncertainty should be influencing policy at the Budget

The estimates of the amount of headroom shown in Figure 21, however, do not account for the unusually high level of economic uncertainty over the next few years. A simple rule-of-thumb suggests that a 1 per cent increase in the size of the economy would result in an improvement in the fiscal position of around a £10 billion fall in annual borrowing.[35] Figure 13 showed the range of estimates of the medium-term pandemic scarring impact

35 This is a very simple calculation relating the tax share of the economy to the increase in the size of the economy – in practise, all things being equal, the improvement would be somewhat larger as spending would likely not rise by as much as the increase in the size of the economy.

from the pandemic is huge. The optimistic end of these estimates would result in the Government easily meeting its fiscal rules. But even a small downgrade in our 2 per cent scarring assumption could result in the rules being missed. Even in less economically-uncertain times, previous Chancellors have chosen fiscal positions that gave them materially higher headroom against their targets (averaging £17 billion since 2010). Having additional headroom enables a government to absorb any deterioration in the economic forecast or unexpected additional spending requirements without requiring a change in the fiscal framework. The implication is, given that the Government's expected rules are set to be only narrowly met, that new tax rises or further spending cuts are likely if the economy does not recover as quickly as expected. But a deterioration in the economy as a result of weak demand should normally be met with more fiscal support, not less – a well-functioning fiscal framework would allow for this, rather than prevent it.

There are also (as ever) longer-term uncertainties. For example, interest rates could rise materially in the future, and this would eventually raise the cost of servicing government debt.[36] There will, without doubt, be recessions in the future, requiring additional fiscal stimulus (as discussed in Box 2). Both of these risks should be taken into account in the Government's plans. Previous Resolution Foundation analysis has found that ensuring that public sector net worth remains stable across the economic cycle requires the Government to target a current balance at the end of the forecast of around £40 billion.[37] Meeting this would ensure that the Government continues to have fiscal space to stimulate the economy in future recessions and limit the cost associated with a possible rise in interest rates.

Given the risks from rising inflation and a possible slowdown in the recovery, the most pertinent risk is that the slowing economy will need more support

The emphasis in the current public debate on when monetary policy should tighten is misplaced given the small role it is playing. The key policy discussion should instead be about fiscal policy, given that small changes in the monetary policy stance will have relatively little impact on the economy. Fiscal policy has played an outsized role in this crisis in part because low interest rates left little room for monetary policy to act. But it has also been the right policy choice: the economic impact of Covid-19 has varied enormously across firms and households, necessitating targeted policy support, rather than a broad-brush stimulus. This change in relative importance is demonstrated in our

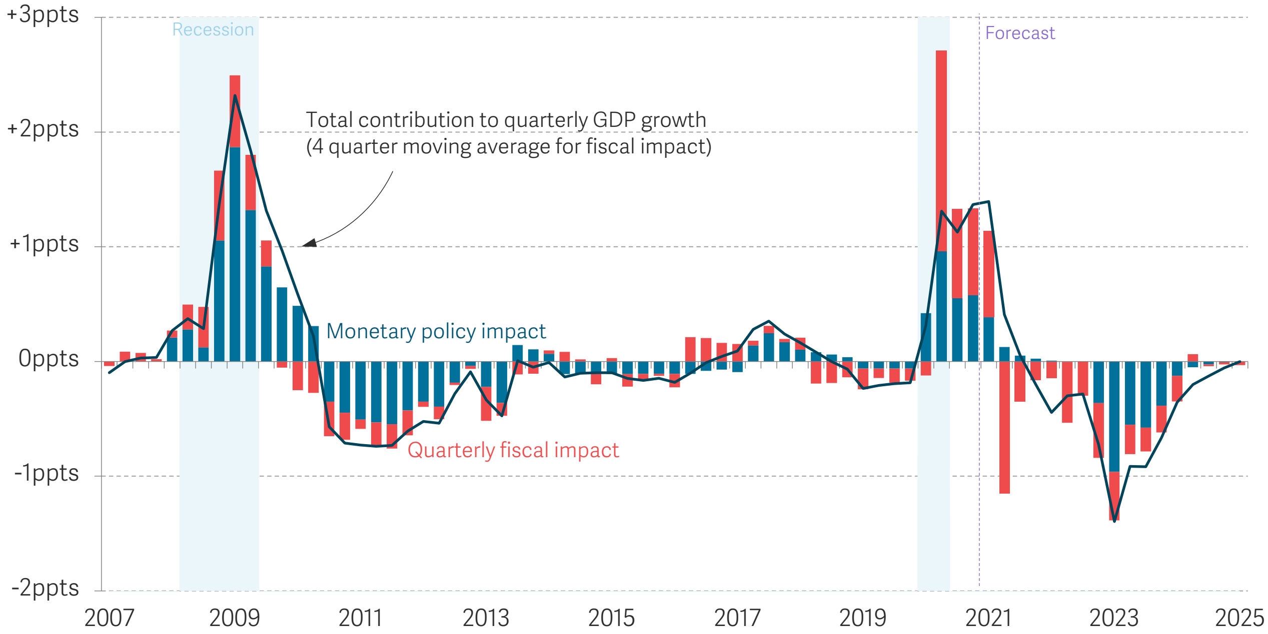
36 Rising long-term interest rates would likely also be accompanied by an increase in trend growth rates, which would make debt servicing easier. See, for example, T Laubach & J C Williams, Measuring the Natural Rate of Interest, The Review of Economics and Statistics 85 (4): 1063–1070, November 2003.

37 See G Bangham et al., Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

estimate of the macroeconomic stimulus from monetary and fiscal policy over time, shown in Figure 22.

FIGURE 22: **Fiscal policy has become a drag on economic growth**

Estimated impact of monetary and fiscal policy on quarterly GDP growth, history and forecast: UK



NOTES: Monetary policy impact is calculated using estimates taken from P Bunn, A Pugh & C Yeates, 'The distributional impact of monetary policy easing in the UK between 2008 and 2014', Bank of England Working Papers no.720, Bank of England, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the OBR's estimate of fiscal multipliers. The values for 2020 and 2021 are based on assuming Bank rate is held at 0.1 per cent and the OBR's March 2021 Economic and Fiscal Outlook.
SOURCE: RF analysis of OBR, various; ONS; Bank of England.

It is clear that fiscal support has now entered an economically-contractionary period, having made up around two-thirds of the policy support during the pandemic, substantially higher than its share of policy support during the financial crisis (roughly a quarter of which was from fiscal policy). The support from fiscal policy is now estimated to have turned negative, i.e. quarterly GDP growth is lower than it would have been – by around 0.5 per cent a quarter – in the absence of fiscal policy. This is caused by the direct withdrawal of support measures, including the JRS and the end to the Universal Credit uplift, and, as they come into effect, increases in taxes (e.g. the corporation tax rise in 2023). But it is also turning negative because the impact of previous support schemes on the level of GDP is estimated to have fallen, thus creating a negative contribution to quarterly growth rates. Indeed, the UK is a relative outlier in the G7 in how fast macroeconomic support is to be withdrawn; only Canada is expected to raise interest rates faster than the UK, and only the US is introducing substantial new taxes during the recovery.[38]

There are two pressing macroeconomic risks, discussed in detail above: the rise in inflation, which some argue risks becoming entrenched; and the slowing rate of the recovery. Given that fiscal policy is currently the primary tool of macroeconomic stabilisation, what is the right fiscal strategy during the recovery?

One key point is that these risks are not symmetric. For example, were the economic recovery to speed up and inflation to rise as the economy reaches its productive capacity, then the Bank of England could quickly tighten policy.[39] But if the opposite were to happen – the economy started to slow while the government was actively reducing support programmes and raising taxes, as could happen at the end of this year – then monetary policy could do little, and fiscal policy would be much less quick to respond, potentially leading to an unnecessary loss of income for households. In other words, there is a clear asymmetry to these risks because policy has much more scope to reduce demand if it proves too strong, rather than provide more stimulus if the outlook deteriorates.

It is also important for policy makers to consider the relative likelihood of each risk. As discussed in Section 2, the Bank of England now expects inflation to peak at over 4 per cent in 2021 and 2022. But these rises have been driven by normalisation in goods prices from their pandemic lows, as well as supply constraints in specific industries. Broad-based cost pressure from rising wages is yet to materialise and is unlikely to do so while the economy is still below pre-crisis levels (real GDP is still estimated to be below pre-pandemic levels, let alone recovering to the pre-pandemic trend). Even if there is clear evidence that they have materialised, the Bank of England has plenty of scope to raise rates and reduce demand in order to reduce inflationary pressure. So, while reasonable people can disagree, our view is that the risk from high inflation appears limited and relatively easy to contain.

On the other hand, as previously discussed, there are already signs that the economic recovery is slowing, with GDP growing just 0.3% in July and August this year. In addition, the pandemic is not over, both in the UK and globally, and there remain substantial risks to the recovery from increases in case levels during the winter. On balance, we view that a slowdown in economic growth is both a costlier risk and one that is more likely to materialise, and this suggests fiscal policy should be more accommodative over the next year than currently planned.

38 It is also arguable that the tax rises intended in the US are more reflective of the Biden administration's plans to expand the size of the state, alongside the large expansion in government spending.

39 We discussed these issues in more depth in J Leslie & J Smith, Macroeconomic Policy Outlook Q3 2021, Resolution Foundation, August 2021.