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Better forecasts

How can the OBR improve the way it judges the supply-side effects of policy?

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About this report

This report looks at how the Office for Budget Responsibility (OBR) – the UK's official economic and fiscal forecaster – reflects the impact of new government policies on the country's economic potential and makes recommendations for how this can be strengthened further.

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Introduction

The government has made economic growth one of its five missions. Stronger economic growth would help lift living standards and return higher tax revenues and so remove at least some of the unenviable choices between spending cuts and tax rises from the chancellor's desk.[*]

Any actions the government takes to try to boost growth will take time. Easing planning restrictions will not mean building sites spring up overnight; improving education should lead to more productive or skilled workers entering the labour force, but again not immediately. Infrastructure projects are notoriously long running.

Fortunately, the government's fiscal rules are also (and seem likely to remain) forward looking. That means the chancellor needs to show she is on course to have some measure of debt falling and for tax revenues to cover day-to-day spending in a few years' time, rather than immediately. Policies that boost the economy's productive potential in the medium term can make those fiscal rules easier to meet, even if they do not have any immediate impact on growth. As a result, it will be important how the Office for Budget Responsibility (OBR) scores the effect of new policy announcements on *future* economic growth.

This paper sets out how the OBR has done this in the past, how its approach has evolved in recent years, and how it could be strengthened further.

* The Office for Budget Responsibility's latest long-run projections show that, if productivity growth evolves in line with its central expectation, then public sector net debt would be on course to rise from 98% of GDP now to 274% in 50 years' time. However, if productivity growth were 1 percentage point higher (and if government spending does not respond to that), debt would instead fall relative to the size of the economy, reaching just 65% of GDP over the same period. Source: Office for Budget Responsibility, *Fiscal Risks and Sustainability Report: September 2024*, retrieved 12 August 2024, https://obr.uk/frs/fiscal-risks-and-sustainability-september-2024

How does the OBR estimate the impact of policies on the economy?

Estimating how government policies are likely to affect the economy is a process sometimes known as 'dynamic scoring'. This is because these estimates attempt to capture how a policy change will affect economic activity not just in a 'static' or 'snapshot' sense, but through the dynamic response of the people and businesses that are affected.

There are three stages to the OBR's dynamic scoring of policies:[1]

- When costing individual policy measures, the OBR will incorporate any **behavioural responses** that it expects will be large enough to affect the cost of the policy. For example, when estimating the revenue impact of an increase in tobacco duties, the OBR would take account of the expected decrease in tobacco consumption in response to the higher cost. This would partly offset the 'static' revenue gain from simply increasing the duty rate, which would assume the same number of sales being recorded with each bringing in more in tax.

- The OBR's forecast for **aggregate demand** will incorporate an estimate of the overall impact of policy measures. For example, additional government spending on a new road would boost demand for construction companies to carry out the work and for the materials needed. These effects are estimated using fiscal multipliers.[*] These demand-side effects are assumed to fall to zero within five years, as each affected part of the economy adjusts to the changes.

- The OBR's forecast for the **supply side** of the economy takes account of any permanent effects that policies might have on economic supply. New public infrastructure may enable new economic activity as, for example, businesses set up in areas of the country that were previously poorly connected. These supply-side effects would be expected to permanently boost potential economic output. Any policies that have supply-side effects are also likely to have demand-side effects, but these are estimated separately by the OBR.

This paper focuses on these supply-side effects, as this is the channel that has the greatest impact on fiscal sustainability, is the area where the OBR has most significantly adapted its approach in recent years, and where there may be increased scrutiny in the coming years as the new government attempts to bolster long-term economic growth.

* The OBR's fiscal multipliers are the subject of another paper by the authors. See Tetlow G and Pope T, *Fiscal Multipliers: How does the OBR estimate the demand impact of government policies?*, Institute for Government, October 2024, www.instituteforgovernment.org.uk/publication/obr-demand-fiscal-multipliers

How does the OBR forecast potential output growth?

Any impacts of new policies will be layered on top of the OBR's 'baseline' forecast. A crucial input into the OBR's economic forecast is what it assumes about how quickly the country's ability to produce economic output will expand. At any moment in time, actual economic output could be different to its 'potential' level – above, if there is something stoking demand, or below, if something is depressing it. This is often referred to as a positive or negative output gap.

But over time the actual level of economic output would be expected to return to its potential level. This makes the OBR's assumptions about potential output growth the most important determinant of its predictions for long-term economic prospects.[2] The main factors that will determine potential output are:[*,3]

- **Potential labour supply:** this will be driven by the size and demographic structure of the population, which will be affected by birth and death rates and net migration, as well as labour force participation rates, unemployment rates and average hours of work.

- Potential labour productivity: this is driven by a combination of the **capital stock per worker** (what buildings, IT, equipment and intangible assets workers can use to enhance their outputs, which will depend on past and future investment and rates of depreciation) and **total factor productivity** (how efficiently workers can make use of the capital available to them, which is a function of various factors including the state of global technology and knowledge, the degree to which that knowledge is effectively utilised in the UK and the effectiveness of matching between workers and capital[**]).

Estimating current potential output

Estimating the current level of potential output and how it will evolve in future is difficult because, unlike actual output, it cannot be directly measured.

The OBR's starting point is to estimate the size of the current output gap. They do this by combining 'top-down' judgments about the overall size of the output gap with 'bottom-up' estimates (such as of the sustainable rate of unemployment, informed by data on unemployment, vacancies and recruitment difficulties) and iterating between these to reach a view on the most plausible output gap and so the starting level of potential output.[***]

* These could be further broken down – for example, to model human capital (workforce skills) or energy separately as important contributors to potential output. But currently the OBR uses a model that only distinguishes between the three factors set out here.

** This may depend, in turn, on factors such as the skill level of the workforce.

*** The OBR has updated its methods for estimating the output gap over time. In its early days, the OBR was somewhat more formulaic in its approach than it now is, see: Office for Budget Responsibility, *Estimating the output gap*, Briefing paper No.2, April 2011, https://obr.uk/docs/dlm_uploads/briefing%20paper%20No2%20FINAL.pdf and Murray J, *Output gap measurement: judgement and uncertainty*, Working paper No.5, Office for Budget Responsibility, July 2014, https://obr.uk/docs/dlm_uploads/WorkingPaperNo5.pdf

Estimating future growth in potential output

Once this has been established, its future path depends on the assumptions the OBR makes about the rate of growth of the various determinants of potential output.

The factors determining future potential labour supply (as outlined above, such as the projected size and demographic structure of the population) are not known with certainty. But the OBR can draw on various sources of evidence to inform its judgment.

The size of the capital stock also affects the level of potential output, as workers will produce more with more equipment and buildings. The evolution of the capital stock depends on both public and private investment and how quickly existing assets depreciate.[*] As the UK's capital stock is very large, it takes time for a change in investment – even a permanent one – to translate into a large change in capital stock (and therefore higher growth).

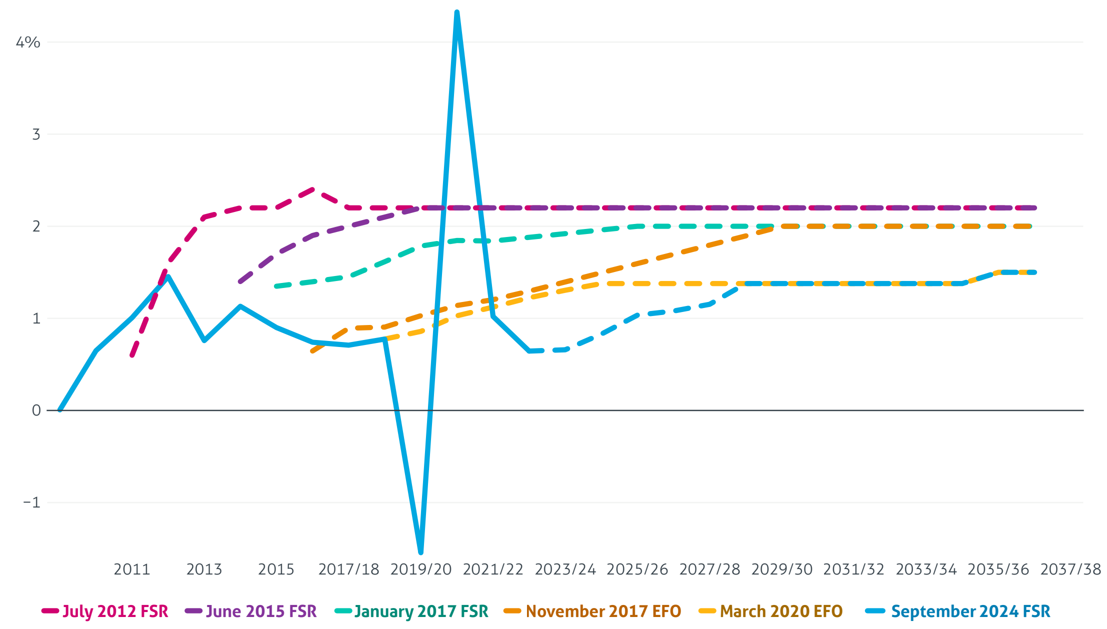
Evidence is much more scant on the likely future path of productivity, not least because understanding of what has driven past trends in productivity is lacking, including concerning the slowdown experienced after the 2008 financial crisis.[4] One source of information is how quickly productivity has grown in the past. Currently, the OBR essentially assumes that productivity growth in the UK will in future be somewhere between the pre-2008 rate (around 2.1% a year) and the rate since (around 0.4%).[**] But various commentators have suggested the OBR is too optimistic and should adopt an assumption closer to the post-crisis norm.[5]

This element of the OBR's forecast is subject to considerable uncertainty and is often amended as new information becomes available, as Figure 1 shows.

* Both public and private investment is measured in national statistics; there are some difficulties in doing this, particularly for intangible investments (such as in management capacity). Depreciation depends on well-established accounting assumptions but these can be imperfect – for example, they do not distinguish between well-designed projects that prove to have enduring value and poorly designed ones that quickly become obsolete.

** ONS series LZVB (output per hour). Average growth rate is 2.1% from 1971-2007 and 1998-2007

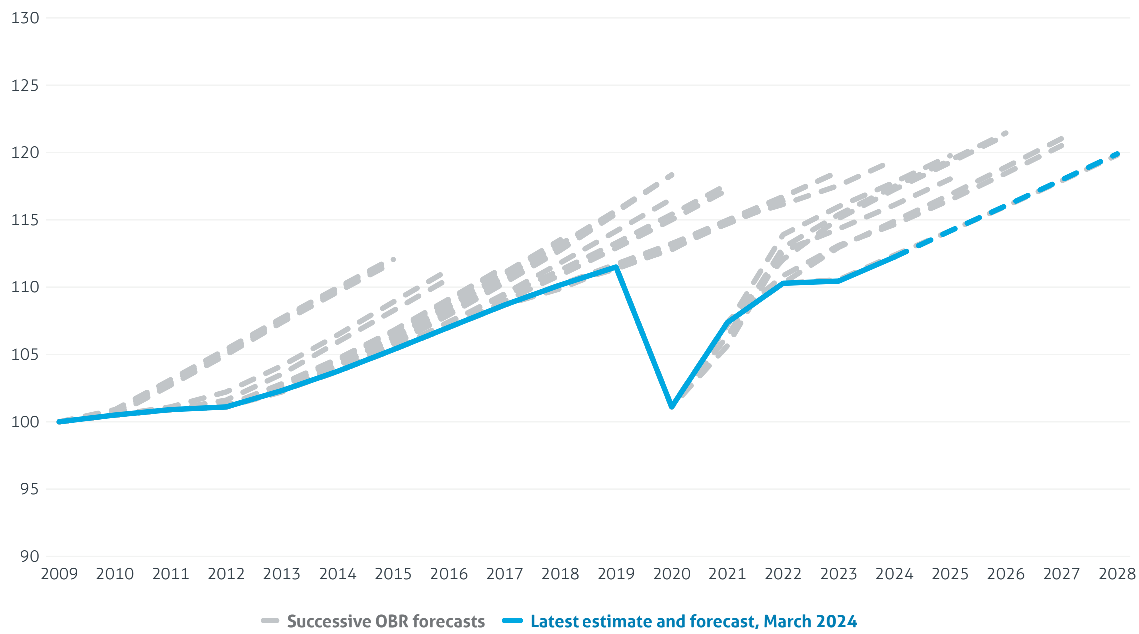
Figure 1 **Successive OBR forecasts for potential productivity**



Source: Institute for Government analysis of Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2020, November 2020, October 2021 and March 2024 and *Fiscal Sustainability Reports*, 2022 and 2024.

The OBR has revised its forecasts for potential output growth several times, as new evidence emerged. Figure 2 shows the revisions that have been made over time to the OBR's forecasts for total potential output.

Figure 2 **Successive OBR forecasts for potential output (June 2010 to March 2024)**



Source: Institute for Government calculations using Office for Budget Responsibility, Historical Forecasts Database.
Note: Potential output growth calculated as real GDP growth minus the change in the output gap.

Following the **financial crisis**, the OBR initially assumed that potential productivity growth in the UK would eventually rebound to its pre-crisis rate of just over 2% a year. However, as time went on and potential output growth (particularly productivity growth) remained sluggish, it pared back its assumptions about the prospects for long-term potential productivity growth – to just 1.5% between November 2015 and March 2020. It also pushed back the date at which this rate of growth was expected to rematerialise, as Figure 1 shows.[6]

The OBR also updated its expectations of potential output growth during the **pandemic**, eventually concluding that Covid would reduce the level (though not the growth rate) of potential output by 2% compared to its pre-pandemic expectation, as a result of foregone investment, business failures, loss of skills and increases in labour market inactivity.[7]

Any assumptions that the OBR makes about how individual policies affect the supply side (discussed in the next section) are layered on top of their underlying forecast for future economic growth. Even before trying to factor in any precise impacts of policy, the forecast is highly uncertain, with the OBR having been repeatedly over-optimistic about the prospects for potential output growth.

Such over-optimism in official forecasts is far from new. The economic boom of the late 1980s turned out to be unsustainable but was misread at the time, leading to the Treasury under-estimating the scale of the structural deficit. It was a similar story before 2008, when strong growth in financial sector activity ultimately proved to be unsustainable. Indeed, the main rationale for creating the OBR in the first instance, in 2010, was to try to avoid these problems in future by tackling politically motivated wishful thinking.

When and how has the OBR factored in effects of policy on supply?

The OBR has historically been reluctant to assume that new policy announcements will affect potential output growth, applying a high bar to making any such changes. There are at least two important reasons for this.

First, the evidence base proving the effect of specific types of policy changes on potential output is often limited or highly uncertain. Second, as described above, the OBR's assumption about the future path of productivity growth is in large part informed by evidence on how productivity has evolved in the past – but that rate of growth has itself been influenced by policy decisions made by previous governments. Therefore, if the incumbent government is about as good as previous governments have been in adopting productivity-enhancing policies then it is right for the OBR to assume that new policy announcements will have no *additional* effect on top of what they are already factoring into their baseline assumption about productivity growth.

The OBR makes clear that it will only take explicit account of those policy measures that it judges meet four 'tests':

- **Significant** in size, such that they can make a marked difference to the large existing stocks of labour and capital, or how efficiently those are combined to produce economic output.
- **Durable**, in the sense that they are expected to have a lasting impact on the economy's productive potential.
- **Additional**, in that the new policies are more than simply a continuation of previous governments' efforts to support the economy's productive potential.
- **Evidence-based**, meaning there needs to be clear empirical evidence of the likely effectiveness of the policy in changing potential output. This evidence can be from the UK or other countries, provided the results apply in the UK context.[8]

Since its creation the OBR has adjusted its forecasts for potential output to reflect some policy decisions. It has made these adjustments to the *level* of future potential output per worker, rather than affecting the growth rate in perpetuity.

The largest change made was following the decision to leave the EU on the terms ultimately agreed: the OBR estimated that higher tariff and non-tariff barriers would reduce the scope for the UK to realise its comparative advantages and exploit economies of scale, as well as migration being permanently lower, leading to potential output ultimately being 4% smaller in the long run.[9]

The OBR also adjusted its forecast for potential output following the 2015 announcement of the National Living Wage,[10] which was expected to lower labour supply but increase productivity. In March 2020 (before the pandemic hit in earnest) the OBR estimated that the increase in government capital spending announced in that budget would be likely ultimately to increase potential output but that this would happen beyond the five-year forecast horizon.[*,11] This was then negated when capital spending plans were revised down in November 2022.[12]

Various changes to migration policy have also led to changes in the forecast for migration, and therefore the size of the labour force. For example, in March 2020 the OBR assumed that the new post-Brexit migration regime would reduce the forecast population in 2024/25 by 0.4%, though this was subsequently revised.[13]

These adjustments have typically been described in a box in the relevant *Economic and Fiscal Outlook* report (EFO), setting out 'the economic effects of policy measures'. However, in July 2015, it dedicated an entire annex of the EFO to explain its approach to scoring the effects of the National Living Wage.[14]

How has the OBR changed its approach in recent years?

Over the last couple of years, the OBR has become more willing to adjust its forecasts for potential output to factor in the effects of new policies and has been more transparent about what adjustments it has made and why, as outlined in Box 1. Implicitly, it has lowered its threshold for 'significance' when it comes to supply-side forecast judgements. A greater focus on scoring the supply-side impacts of policies is in line with similar bodies internationally. For example, in the US, the Congressional Budget Office is exploring how it can better account for the supply-side impact of policies.[15]

Box 1 **The OBR has made more frequent and larger adjustments to its forecasts for potential output in response to new policies**

In March 2023, the OBR adjusted its forecast in response to a set of measures announced by the Sunak government that affected labour supply: these included more generous childcare support and changes to the annual and lifetime allowances for pension tax relief.[16] These policies were a mixture of changes to tax, welfare spending and departmental spending. They ranged in size from around £50 million a year for additional childcare support for universal credit claimants to around £5 billion a year for a new entitlement to free childcare for working parents with children between nine months and three years old.

The OBR judged that, taken together, the new measures would increase the level of employment by 0.3% (or 110,000 people) and the level of GDP by 0.2%, although these were almost exactly offset by an underlying forecast reduction in workforce participation that the OBR would have made whether or not the

* The elasticity of economic output with respect to public capital spending that the OBR set out in this analysis (0.1) is the same as the conclusion it reached in its more recent, more detailed analysis of the supply-side impacts of public investment, described below.

measures were introduced.[17] The OBR provided a high-level summary in the EFO of the adjustments it had made and the evidence and assumptions that had informed those.

In November 2023, the chancellor announced that employees' National Insurance contributions would be cut by 2 percentage points and those for the self-employed would be cut by 1 percentage point. The OBR again judged that this would boost full-time equivalent employment and so GDP – in this instance by 94,000 (0.3%) and 0.2%, respectively. Two other policies in that budget were also judged by the OBR to boost potential output: permanent full expensing of capital investment for firms (which was estimated to increase GDP by 0.1%) and various changes to welfare policies (which were estimated to increase employment by 50,000 and GDP by less than 0.1%).[*,18] The OBR provided a summary of the adjustments it had made and the evidence that informed those in the EFO. It also followed up, a few months later, with more detailed papers describing the modelling and assumptions underpinning the adjustments they had made in response to the NICs and full expensing policies.[19] These papers also invited feedback on the appropriateness of the OBR's assumptions and modelling.

In March 2024, National Insurance rates were cut again, alongside changes to the high-income child benefit charge – and again the OBR judged that these would feed through into higher employment and potential output. These measures were assessed to increase full-time equivalent employment by 100,000, resulting in a 0.2% boost to output. The vast majority of this impact was judged to come from the NICs cut, with changes to the high-income child benefit charge on its own providing just a 0.03% increase in GDP. The EFO provided a brief summary of these adjustments.[20]

These are larger and more explicit adjustments to the OBR's forecast for potential economic output than the OBR has typically made in the past. For example, the Johnson government's announcement, in November 2021, of a new health and social care levy of 1.25% to be levied on earnings and profits did not prompt a change from the OBR, which assumed that "the new health and social care levy leaves labour supply unchanged, with income and substitution effects assumed to offset".[21]

And again, in November 2022, it concluded in response to a large package of new measures including the abolition of the health and social care levy, freezing income tax and NICs thresholds and reversing a planned cut in the basic rate of income tax: "The net effect of the new measures…on potential output is neutral over the forecast period, reflecting several small changes in both directions that offset over time."[22]

* This package of measures was expected to cost around £400m a year in the near term and then ultimately to deliver savings in welfare spending. The OBR documents are not completely explicit about which labour market participation policies were considered in the supply-side scoring. But the largest single measures announced by the government were an expansion of the Restart employment programme (expected to cost around £300m a year) and changes to eligibility for incapacity benefits (expected to save around £1bn a year). The smallest were an expansion of individual placement and support (costing a gross amount of around £50m a year) and changes to sanctions (costing around £10m a year).

The OBR anticipates future requests

Demand for greater assessment of supply-side effects is likely to grow even more. There was a lot of discussion among Labour Party supporters in advance of the election about the importance of public investment to achieve net zero carbon emissions and to boost economic growth.[23] Many have made the case that restricting public investment in the near term in pursuit of lower public debt is self-defeating because it will hamper long-term economic growth and so longer term fiscal sustainability.[24]

Perhaps anticipating a renewed focus on investment from the Starmer government, the OBR published a discussion paper in August 2024 setting out its approach to modelling the impact of extra public investment spending on economic output in both the long and short term.[25] This is the first time the OBR has pre-emptively set out in detail how it would go about modelling potential future policy changes. That paper sets out the parameter estimates the OBR currently uses and asks for feedback on the appropriateness of its assumptions, and provides much more detail than was set out when the OBR previously described the adjustments it might make in response to earlier government announcements on the level of public investment.[26]

The paper makes clear the many difficult judgments the OBR would need to make to estimate how a change in public investment would affect potential output. Though there is a reasonably strong theoretical case for believing that some types of public investment, if done well and at sufficient scale, would boost potential output, there are many uncertainties about how a specific announcement of extra money would translate into potential output. That ultimate economic impact depends on:

- **What types of projects are chosen** – this also means that the OBR faces an important decision about whether to adjust its economic forecast at the point that the government announces a change to the overall level of public investment, or only at the point at which sufficient detail is available on how the money will be allocated, to know that the investments will be growth-enhancing.

- **How quickly projects are delivered**

- **How quickly people and businesses take advantage of new investments**

- **What economic benefits the new investments offer.**

Some empirical evidence is available but, in many areas, robust, independent analysis is lacking – often because it is inherently very difficult to reach robust conclusions from real world data. The OBR concludes, based on the evidence, that on average public investment does improve productivity, though by relatively modest amounts, especially over the first few years.

Other experts have suggested that the OBR's estimates might be on the low side,[27] in part because the model it employs does not account for the ways in which public investment might 'crowd in' further private investment by, for example, improving the quality of road infrastructure used by private companies or improving the prospects of emerging technologies. However, it is also possible that additional public investment could 'crowd out' private investment by leading to higher interest rates or by investing in projects the private sector would otherwise have invested in.

The challenge of knowing how policy changes might translate into supply-side improvements could be even harder for some other types of policies beyond public spending and tax. For example, improvements to planning policy ought, in principle, to boost potential output. However, there can be a large gap between the ambition of planning reforms that are initially announced and what ultimately is put in legislation and so the OBR has previously been reluctant to anticipate substantial positive benefits via pre-emptive forecast adjustments.[28] Another reason why it may be difficult to estimate the potential supply-side impacts of new policies is if the policy being considered is novel and therefore there is a lack of relevant existing evidence – for example, a new model of employment support.

In the remainder of this section, we assess the impact the OBR's changed approach has had so far and then set out our recommendations for how it could change its approach to manage these additional requests in future.

The OBR's new approach has resulted in more focus on supply-side effects of policies...

We understand that the OBR's greater willingness to allow for policy changes to affect potential output has shifted the nature and focus of discussions around policy development in the Treasury. For example, it seems this was one reason why Jeremy Hunt opted to cut National Insurance rates, rather than income tax, because – for a given reduction in tax revenues – the former was judged by the OBR to do more to boost labour supply than the latter.

Good policy making principles suggest that officials and ministers always ought to have regard to the structural economic effects of their decisions. But as we noted in a previous paper – under the last government at least – fiscal policy decisions had become dominated by consideration of their near-term fiscal impact.[29] So the OBR's willingness to factor in explicit improvements to the outlook for potential output, particularly where those were expected to materialise within five years, did encourage ministers to consider more seriously policies that had potentially positive supply-side effects and to seek the OBR's views on what effect they might have.

...but there are weaknesses in the 'tests' the OBR applies...

This is a positive development in some ways. However, it could have undesirable impacts if departments start trying to design policies specifically to ensure that they are scored by the OBR rather than based on their view about what policies will best achieve their objectives. There are some aspects of the OBR's four tests for deciding what should and should not be scored as having a supply-side impact that are problematic and these problems are more severe the more open the OBR is to scoring supply-side impacts.

First, the requirement for policies to be evidence-based risks biasing against novel policy ideas. There may be good theoretical reasons to think that a new policy will help boost economic supply even if it lacks an evidence base. An alternative approach could be for the OBR to be more open to scoring effects up front from novel policy interventions, coupled with a more robust process for monitoring and evaluating the evidence on policy effectiveness as it becomes available, which would then allow the OBR to update its assumptions if appropriate.

Second, the requirement for something to be sufficiently significant in size – either on its own or in combination with other measures announced at the same time – creates a bias towards large policies or storing up smaller policy ideas to announce in one go. This too would be undesirable.

Third, the OBR will face an increasingly difficult task of identifying what policies are 'additional' now that it has cast its net more widely. There are clearly established conventions for what counts as 'existing policy' on tax and welfare, with new policies costed against those baselines in every fiscal event. However, there are less clearly established conventions for departmental spending. To the extent that the OBR has in the past drawn a distinction between 'existing' and 'new' departmental spending plans, these have usually related to overall levels of departmental spending, rather than exactly how that money is spent, though it is the latter that matters for determining economic supply. When the OBR decided in March 2023 that the government's new childcare offer would boost labour supply, it made this judgment on the basis that this policy came on top of the spending plans that had already been outlined at the 2021 spending review. But the OBR's task of defining whether a policy is additional will be far harder at the next spending review, when the government will be allocating money both to continuing existing policies and introducing new ones – as well as potentially (implicitly or explicitly) cutting some existing programmes.

Similarly, it is not clear what the OBR would now do if faced with a policy package like in November 2021 when the government announced a new health and social care levy to 'pay for' extra spending on the NHS and social care. Would it account not only for the negative labour supply effects of higher taxes but also for the potential positive supply effects of higher health spending? Or, to put it another way, what would it judge would have happened to the level of health and social care spending without this policy announcement?

On the other hand, the fact that the OBR has lowered its threshold for 'significance' may have helped mitigate one of the problems with its four tests. That is, the OBR's requirements that policies should be significant and evidence-based has always risked creating a situation in which the OBR's forecast is not a central forecast because any policy that fails to clear the significance or evidence-based tests simply gets scored as having zero impact.

...and the OBR's approach can be gamed

There are real risks that the OBR's processes could be gamed by the Treasury and other departments. This could lead to significant extra burdens on the OBR and to unduly optimistic forecasts.

People we have spoken to inside government suggest there has so far been an element of departments 'throwing everything at the wall and seeing what sticks'. This increases potentially unproductive demands on the OBR and officials in departments. But worse than that, there is an incentive for departments to behave asymmetrically – sending the OBR extensive details of policies they believe will have positive supply effects but failing to highlight those that might harm supply.

Over the past two years, since the OBR started to take a more expansive approach to factoring in supply-side impacts, it has only done this for policies that have a positive effect on potential output. Some policies that might have had a negative effect – such as cuts to capital spending set out in November 2022 – were announced shortly before the OBR changed its approach and were not explicitly modelled.

A more active approach to supply-side scoring requires more resource and has created uncertainty

Having a lower threshold for scoring supply-side impacts creates additional work for the OBR and additional need for exchange of information between the OBR, the Treasury and other government departments. The OBR needs to understand the detail of the policies to judge whether they meet its four tests, departments need to know what judgment the OBR will reach, but the OBR in turn may rely on the relevant department to provide detailed evidence on the potential impacts. This greater focus on estimating the supply-side impacts of policies is likely to have increased the overall demands on staff time in both the OBR – including the three members of the Budget Responsibility Committee – and other government departments. The Treasury provided the OBR with an additional £250k (a 6% increase in its originally allocated budget) in 2023/24 to help resource its new supply-side unit.[30]

The greater focus on supply-side impacts also potentially affects the timing, and timescales, for decision making and forecast development. The OBR goes through several rounds of iterating on its economic and fiscal forecasts as new data becomes available and as the government provides new information on the policies it is considering.

This process is more complicated if new fiscal policies are expected to affect the supply side of the economy. It will therefore be more complicated – requiring more early exchange of information on potential policies – when the OBR applies a lower threshold for policies having an effect on the supply side.

For the March 2024[31] and October 2024[32] forecasts, the OBR carried out an additional round of post-measures forecast iteration compared to the norm prior to autumn 2022. This provides more opportunity for the OBR and Treasury to iterate on their assessment of the supply-side impacts of policies – but has come at the cost of one fewer round of *pre*-measures forecasting. This means the underlying economic and fiscal forecasts will have received less scrutiny. More time would need to be added to the forecast process to allow for the same degree of scrutiny of the pre-measures forecast as used to take place. Currently the OBR goes through five forecasting rounds during the 10-week forecast process.

There are well-established processes for estimating and reviewing the direct fiscal and economic effects of new policies, known as the 'policy costings' process. But the process for estimating indirect effects on potential output of a wider range of policies is relatively new.

Since April 2017, the OBR's memorandum of understanding with the Treasury, DWP and HMRC, has stated that

> **"an indirect effects process... will be coordinated jointly by the Treasury and the OBR in the run-up to fiscal events, to consider the potential effects of policy priorities and decisions on the economic and fiscal forecast, beyond those reflected in the direct costings".**[33]

The MoU was updated in November 2023 to make clear that "meetings will be iterative and where possible will begin early on in the lead up to a fiscal event".[34] This recent addition helps recognise the greater role that indirect effects of policies on the supply side are now playing in the OBR forecast. However, departments and people outside government are still learning what evidence the OBR will draw on and how it reaches its judgments about the supply-side impacts of policies.

The OBR's greater openness to recognising the supply-side benefits of policies creates a risk of the perception – if not the reality – that the OBR's independence could be undermined. Government departments face a strong incentive to put pressure on the OBR to view new policies favourably or to be selective about what evidence they highlight. Similarly, as set out above, there will be an incentive for departments to be economical in highlighting the existence of and evidence on policies that might be detrimental to economic output.

The OBR, Treasury and other government departments need robust guidance and systems in place to ensure the OBR's new, more expansive approach to scoring supply-side impacts of policies has a positive, rather than a negative effect on the policy making process.

Recommendations

It is important that the government's official forecasts account for the supply-side benefits of policies, both to ensure the forecasts are as accurate as possible – a worthwhile goal in itself – and to incentivise politicians to enact growth-enhancing policies. So it is welcome that the OBR has taken a more active and open approach to scoring these effects in recent years. But it is also important that this approach is unbiased – considering all relevant policies, not only those that aim to boost the economy's supply potential – and that it does not place an unsustainable burden on the OBR or government departments.

The OBR's consideration of more possible supply-side effects has effectively created a new strand of the forecast development process and does create a risk that the OBR could come under pressure from government to be excessively optimistic in its forecasts. The approach is still relatively new, and there are several ways in which the OBR can clarify how it will account for supply-side effects of policies. This will have five main benefits:

- **ensuring the process is efficient** so resources both in the OBR and across government are not wasted through a 'trial and error' approach to scoring policies' supply-side impacts

- **ensuring the government is appropriately incentivised to prioritise growth-enhancing policies**, by clarifying how the OBR's treatment of policies' growth impacts reflects the evidence on what is likely to be most effective

- **encouraging the development of a more robust evidence base on the supply-side effects of policies**, both from within government and produced by external researchers, by specifying the types of evidence the OBR will use and where evidence gaps are greatest

- **making the process more transparent** to increase public confidence that the OBR is taking a consistent approach to scoring policies and not coming under undue political pressure

- **improving the monitoring and evaluation of policies designed to boost growth** to support a more rigorous process of reviewing assumptions and impacts.

We set out five ways the process could be clarified and improved to achieve these aims.

1. Provide clearer information on what policies will be considered

As noted above, the OBR only scores policies that are 'significant' and 'additional'. These are reasonable criteria, but they are vague standards, and the OBR has not set out clear guidance on how it will assess policies against them.

The March 2023 budget provides a good example of the ambiguity. The OBR's forecast accounted for the combined impact of several policies, which together were judged to have a 'significant' impact on labour supply but some of which individually were very small and would not previously have been accounted for; the OBR did not specify at the time whether it accounted for these small policies only because they were part of a larger package. And there were other smaller policies announced at the same time that were designed to affect participation but which were not scored. The OBR did not specify whether this was because they were too small, not additional, or whether the evidence base was not sufficient to score them.

The OBR should **set out how it will go about assessing the 'additionality' of resource departmental spending plans**. Important decisions will be made in the forthcoming spending reviews about how much money to spend through government departments and on what programmes. Since one of the government's five missions is growth, ministers will clearly be hoping that these decisions will boost growth compared to business as usual. The OBR will face a difficult task in identifying what policies are genuinely new and what may have been cut, particularly as departments will face a strong incentive only to highlight those with positive – not negative – growth impacts.

There are benefits to the OBR of retaining flexibility in how it judges its criteria. It will be difficult to fully specify all potentially relevant circumstances. And, more importantly, setting too firm a standard that gave it no wiggle room would make it easier for the government to game the process by choosing policies that just meet the thresholds set. However, the current approach risks increasing the OBR's and departments' workloads on relatively small measures and could lead to criticism if the OBR does not appear to take a consistent approach to scoring policies of a similar size over time. To address this, **the OBR should clarify how it assesses significance and additionality**, including whether small measures as part of a larger package will be treated differently to the same measures if they were introduced in isolation, while still retaining some flexibility to exercise its judgment on how its tests should be applied in specific circumstances.

The OBR should make these changes to ensure central government departments face the right incentives to develop growth-enhancing policies. However, **the Treasury and other departments should also ensure the OBR's approach to scoring is not the only, or even the main, factor they consider when designing policies**. They should continue to rely on the internal appraisal process to ensure they are designing policies in a way that best meets their objectives rather than how the OBR will respond.

2. Provide clearer information about what type of evidence is required

Another of the OBR's conditions for a supply-side adjustment is that it must be evidence-based. However, as with the other conditions, the OBR has not clearly laid out the threshold for how strong the evidence needs to be.

A similar trade-off between flexibility and consistency applies for whether the evidence base is strong enough as for whether effects are significant. The nature of evidence may be different for different types of policies: for example, there might be more policy evaluation evidence for effects on participation rates than effects on productivity. However, without boxing itself in, the OBR should clarify further what standards it applies. This will help guide evidence development and limit the volume of policies government departments attempt to get scored.

We recommend that **the OBR should set out general principles for what constitutes sufficient evidence as an 'evidence standard'** to guide government departments as they develop policy. An evidence standard would also help external researchers conducting and presenting analysis that they hope will have policy impact. Guidance from the What Works Centres[35] provides an example of how this could be done, although the OBR may wish to adopt a lower bar than the very stringent, and therefore quite limiting, standard they adopt.

In addition, **the OBR should clarify how it will deal with situations where there is a policy that is likely to have a significant, durable and additional impact, but it is difficult to precisely quantify what that will be**. This could happen when a literature review reveals overwhelming support for a significant effect but a wide range of estimates. It could also happen when a policy is fundamentally different from anything government has attempted before but operates through a mechanism that is known to generally lead to meaningful long-term impacts.

Genuinely radical planning reform might fall into this category. The OBR's approach in this instance could include the use of sensitivity analysis, as the OBR adopted when assessing the likely effects of the National Living Wage in 2015,[36] with assumptions being revisited at subsequent forecasts. Not scoring these policies at all is unlikely to be the right approach since it would result in biased forecasts and would incentivise governments to adopt smaller, certain interventions over bigger changes that might have more positive effects.

As well as laying out its general approach more explicitly, **the OBR and government departments should also take a more proactive and comprehensive approach to assessing the quality of evidence in different areas and identifying evidence gaps**.

There are two main ways this could be done:

- The recent OBR paper on public investment is an excellent model to follow:[37] it reviews the evidence and explains the framework the OBR would use for future changes in public investment. More such working papers setting out the evidence in other areas (for example, the effects of tax and benefit changes on participation, or the effect of planning reform on infrastructure and housing investment) would be welcome. Since the OBR has limited resources, there is an important role for government departments to play in producing this kind of evidence synthesis and putting it in the public domain for the OBR and others to draw on.

- In addition, the OBR could compile a comprehensive list of indicative supply-side relationships. This could include indicating where evidence is not sufficient to reach a robust judgment. It should always be free to deviate from these assumptions if it felt that specific policies warranted a slightly different approach, just as it does with applying its fiscal multipliers to estimate the demand impacts of policies.[38] But a list of this sort would help to clarify the OBR's approach and provide a clear call to action to external researchers to prioritise filling those gaps. This could fulfil a similar role to departmental areas of research interest (ARI) documents that identify areas where external evidence is needed.[39] It would also have the benefit of bringing together the various supply-side assumptions the OBR uses in one place, when at present they are spread across several documents.

3. Set out how evidence has been used

In addition to clarifying the approach to using evidence in general, the OBR should provide more information about how evidence has been used in practice to reach supply-side judgments. The OBR has taken markedly different approaches on different occasions in the past: sometimes it has provided a detailed description of its approach, either alongside or after the relevant forecast, while on other occasions it has given only a short summary in the forecast document.

Providing more information helps to make the process more transparent, allowing external researchers to check the OBR's working and assumptions. It also helps policy officials in government to understand how the OBR has assessed the evidence and helps external researchers to understand how research might be used to improve judgments in future.

To better explain its approach to scoring specific supply-side impacts, the OBR should as standard **produce a supply impact document setting out its assumptions about the supply impact of new policies and how these judgments were reached**. This would be somewhat akin to the Treasury's policy costings document at each fiscal event, which explains how the direct fiscal effects of policies have been arrived at.[40] But it should be more detailed, providing the sort of information on the assumptions made and evidence used that the OBR provided in its papers describing how it estimated, for example, the supply-side impacts of the recent NICs cut or the National Living Wage.

Even better would be for the OBR to **take ownership of the policy costings document and present supply-side effects alongside more detailed information on the assumptions used to reach the scorecard estimates for all policies**.

It would be difficult for the OBR to do this at the same time as the EFO, as that would require drafting this additional information at a time when the OBR is already at full capacity. The proliferation of measures that the OBR might consider to have supply-side impacts means it would be difficult to provide the detail included on the National Living Wage in July 2015 on every measure.

But this document could be published in the weeks following the EFO. This information is not necessary on the day of the EFO itself and would still be useful if published later to inform how decisions have been made, provide transparency that builds trust in and understanding of the process, and would be useful for analysts inside and outside government.

Once the supply-side impact of a policy has been scored, it becomes a permanent feature of the forecast. The OBR should routinely revisit the supply-side assumptions it has reached in previous forecasts. To do this effectively, it should demand evidence from departments, as described in more detail below.

4. More clearly present the longer term benefit of supply-side policies

Taking account of the supply-side impacts of policies should encourage politicians to announce pro-growth policies. However, the OBR's biannual forecast only extends five years into the future, and most policies will take longer than that to realise their full supply-side benefits.

The OBR's recent paper on public investment demonstrates this: because the public capital stock is large, a permanent increase in investment has only a small effect on the supply side of the economy within five years, but it has a growing impact over time. As a result, if the OBR's analysis of policies in the EFO only covers the effects within five years, politicians may not be incentivised to announce policies that mostly pay off beyond this – even if these have a greater long-run effect on growth.

It is right that the OBR focuses most of its EFO on the five-year forecast horizon. Extending the forecast horizon longer would cause some forecasting challenges. The fifth year of the forecast is already contingent on highly uncertain assumptions about the path of public spending and the uprating of tax thresholds that would be even greater in a 10th year.[41] However, the OBR could still highlight in the EFO the longer term effects of policies – for example, in an analysis box. This is something the OBR's recent paper on investment did well.

Specifically, **the OBR should set out 10- or 20-year supply-side impacts for relevant policies in the EFO**, ensuring that these numbers are given prominence in the OBR's commentary and wider analysis. Where necessary, this longer term analysis should rely on simplified scenarios (like in the public investment paper) rather than extending the full forecast model.

5. Changing resourcing and timetables

If the OBR is to continue factoring in supply-side effects of a wider range of policies – and to do that without reducing the depth or resilience of other areas of its forecasting – it **may need some additional resources**. In 2023/24, the OBR received an additional £250k to set up a new supply side analysis unit.[42] At the spending review, the Treasury and OBR should assess whether this level of funding is sufficient to carry out the role now expected of the OBR.

There may also be **a case for providing the OBR with a research budget** so that it can commission analyses on relevant issues from external experts, particularly where evidence is weak and further primary research is required. This would bring the OBR into line with the Climate Change Committee and National Infrastructure Commission, which have annual research budgets of £1m and £900,000 respectively.[43,44]

However, any process for scoring the supply-side effects of measures will also rely on analysts in government departments, in the same way that the policy costings process relies on analysts in HMRC and DWP. These departments, along with the Treasury, should therefore devote more resource to the analysis of the supply-side effects of measures. Other departments will also need to do this for policies outside of tax and welfare – for example, childcare provision, transport infrastructure and education and skills policy.

The government should also ensure the process of providing information to the OBR is well managed. **The Treasury should set up a coordination team within its economics group to ensure evidence, monitoring and evaluation is appropriately curated for the OBR.**

In addition, the monitoring and evaluation of policies will need to be conducted primarily by departments. A more detailed 're-costings' process for supply-side measures, as we recommend above, will require more analyst time, more systematic and better policy evaluation, and more detailed monitoring of policies. **The OBR should require this additional information from departments**, who are obligated to provide the OBR with all necessary information "which it may reasonably require for the purpose of the performance of its duty" under the Budget Responsibility and National Audit Act 2011.[45] It should be made clear that the onus is on departments to share any relevant information, rather than relying on the OBR to ask direct questions. It will not always be easy to identify the effect of policies on nationwide growth, but by monitoring the progress of policies and requiring evaluation evidence the OBR can ensure its forecast is still based on reasonable assumptions while also improving the evidence base.

Finally, the additional time supply-side analysis takes may require broader changes to the forecasting and policy development process. To allow time to reinstate a third pre-measures forecasting round, alongside the three post-measures forecasting rounds that have been run in 2024, **the OBR would need to be given more than the current 10 weeks' notice before fiscal events**.

The OBR can only incorporate the indirect effects of policy on the supply side into its forecasts if it is notified of the policy early enough. **So the Treasury and other government departments may need to develop policy ideas earlier** than previously: there have been several occasions when the OBR has had to note that its economic forecasts do not contain the full effects of policies, as the policy decisions were made too late.*

Lastly, **the OBR will also need to make sure that its processes are not gamed** – that is, it needs to ensure that the Treasury does not face an incentive to notify the OBR early of policy measures that might boost supply, while delaying notification of policies that might reduce supply until it is too late for these effects to be captured in the forecast. The OBR could do this, for example, by clearly spelling out the supply-side effects of any late measures in its subsequent supply-side effects document and in the next EFO.

* See, for example, the *Economic and Fiscal Outlook* published in November 2017, March 2020 and November 2022.

Conclusion

Overall, the OBR's decision to take greater account of the supply-side effects of policies is welcome. It should improve the incentives for politicians to develop good policy, ensure that the central forecast is indeed central and help to improve the evidence base for the economic impact of policies. The additional information the OBR provides around the effects of policies in its *Economic and Fiscal Outlooks* already helps to ensure the process is transparent and its workings are clear.

The recommendations we make in this paper are designed to ensure supply-side scoring does have the intended positive effects. As with any new process, as this one still is, there is still scope to refine it to enhance the positive incentives and minimise the negative ones. In particular, we have made recommendations for how the OBR can ensure the process cannot be gamed by the Treasury and other departments, and that it leads to the development of more and better evidence. Making the process even more transparent will also protect the OBR from accusations of partiality.

The Labour government has already set growth as its defining mission. An improved supply-side scoring process will ensure that the chancellor is incentivised to introduce policies that drive growth, well-informed about what policies are likely to be effective, and that she will receive due credit when she does.

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