Welsh taxes conference

Good morning. It's a pleasure to be able to join you at this year's conference – though disappointing that we can't meet in person. My name is Andy King. I am one of three members of the OBR's Budget Responsibility Committee, where I focus on the fiscal side of our work.

[SLIDE] I'll spend the next 20 minutes or so taking you through the economic and fiscal scenarios that we published in this year's *Fiscal sustainability report*. That was back in July, which already feels like a lifetime ago. But before I do that, let me provide some background about the OBR's role at the UK level and as the provider of independent forecasts for the Welsh Government.

[SLIDE] The OBR was set up just over a decade ago by the UK's Coalition Government, with the objective of taking the politics out of forecasting and to bring much greater transparency to the process.

To that end, we produce forecasts, assess performance against fiscal targets, scrutinise policy measures, report on fiscal sustainability and evaluate our own past forecast performance. We have had tasks added along the way: forecasting devolved taxes; analysing trends in social security spending; and reporting on fiscal risks.

We have a free hand in all of this, subject to a few statutory limits. First, we must base everything on the current Government's stated policies. Second, we cannot provide policy advice or normative commentary on the merits of different policies, tempting though that can be sometimes.

This year we have provided more of a running commentary than usual: totting up the cost of virus-related tax and spending measures; publishing alternative scenarios; and expanding our monthly commentary on the public finances data, which we have facilitated by presenting monthly profiles consistent with our central scenario.

[SLIDE] The most recent addition to our tasks came last year when we formally took on the role of independent forecaster for the Welsh Government. This built on the work we already did on Welsh taxes for our UK-wide forecasts and the work Bangor University did scrutinising the Welsh Government's forecasts prior to us taking on this role.

Two general points I would make about how we approach this role. First, we are as transparent as possible – about the judgements we make, the risks and uncertainties around them, and the process that sits behind the numbers we publish. Second, we aim to provide central, unbiased forecasts and analysis at all times. What this means is that while it is inevitable that outturns will differ from the central forecasts we publish (as this year has demonstrated rather dramatically), the differences should not fall consistently on one side or the other.

We published our first *Welsh taxes outlook (WTO)* alongside the Welsh Government's draft budget last December. It contained a few innovations, including some analysis of why the amount of income tax raised per person in Wales is so much lower than across the UK as a whole – and perhaps more notably, the OBR's first non-pastel coloured report, as we embraced the red that you see here. Our next WTO alongside the next draft budget will consider what coronavirus might mean for the devolved taxes, which we have yet to explore.

[SLIDE] So with that, let me turn to our *Fiscal sustainability report*. [SLIDE] I'll start with the medium-term economic scenarios we presented. This was unusual territory for us in an *FSR*, where normally we would take our most recently published forecast and use that as the starting point for long-term fiscal projections. But the virus had rendered our March forecast out of date. And the degree of uncertainty around the path of both the virus and the economy could only be meaningfully illustrated via several different scenarios.

[SLIDE] Let me begin by setting out the basic parameters of our three economic scenarios, which were finalised in mid-June. We started with the outturn data available at the time, which showed a 25 per cent fall in GDP between February and April. We did not have any outturn data for May or beyond when we finalised the scenarios.

Our scenarios differ from each other primarily in what they assume about the pace of the recovery and the extent of any permanent scarring – in other words whether the economy returns to the path that we forecast in March or remains permanently below it.

These depend on four main factors:

- The course of the pandemic and the development of effective vaccines and treatments.
- The speed and consistency with which the Government can lift its health restrictions.
- The response of individuals and businesses as it does so.
- And the effectiveness of the policy response in protecting viable businesses and sustaining employment.

The upside, central and downside scenarios have the key features shown on the slide. But these are, of course, only three possibilities of many and you cannot place precise probabilities on them. The upside is probably about as good as one could hope for – relative to the March forecast – but the downside is by no means a worst case. And we certainly did not claim that the central scenario was the most likely of all possible outcomes.

[SLIDE] This chart gives you a summary picture. Here is the path for GDP in our March forecast and [SLIDE] here are the three scenarios. The latest monthly GDP data have shown the economy bouncing back more rapidly than assumed in our central scenario. But sadly the resurgence of the virus, and the reimposition of more stringent public health measures, mean we're more likely to see the economy stall or turn down again over the coming months than to continue on the upward paths shown here.

Let me turn to the labour market. This was a particularly difficult element of the scenarios to put together. In the very short term, the furlough scheme meant that something like a third of workers in the second quarter were employed but working no hours. For those who did lose their jobs, they were very unlikely to be looking for work during lockdown, so would not meet the Labour Force Survey definition of unemployment. To date, the LFS shows little effect of the crisis on unemployment, but income tax data show around 700,000 fewer employees on payrolls while new claims for universal credit soared.

Looking ahead, the outlook for unemployment depends in large part on the proportion of furloughed staff who flow into unemployment rather than back into work. We assumed 10, 15 and 20 per cent in the three scenarios. We also assumed that the structural rate of unemployment rises by 1 percentage point in the central scenario and by 2 points in the downside one.

[SLIDE] This gave us the following profiles for the unemployment rate, although we recognised that initially some of the increase would be recorded as higher inactivity in the official data. As you can see, the peak rates of unemployment in the different scenarios are roughly 10, 12 and 13 per cent. The latest Bank of England forecast peaks considerably lower, at around 7½ per cent. The average external forecast for the end of the year is around 8½ per cent.

[SLIDE] Before turning to the fiscal scenarios, let's have a quick look at how the shortfalls in GDP in each scenario – relative to our March forecast – compare to the shortfall in GDP [SLIDE] during and after the financial crisis, relative to the Treasury's pre-crisis forecast in March 2008. You can see here that the pandemic has prompted a much larger and swifter decline in GDP than we saw in the financial crisis, but that the shortfall against forecast following that earlier episode continued to increase because the underlying growth rate of the economy was persistently weaker than the Treasury – and other forecasters – had assumed pre-crisis. Our central and downside scenarios assume a permanent hit to the level of GDP from the pandemic, but not to the underlying growth rate. If that rate were also to slow, then the fiscal outlook would be even more challenging.

[SLIDE] So let's move on to the fiscal scenarios.

[SLIDE] This chart shows you that our estimate for the budget deficit in the current fiscal year moved from £55 billion in the March Budget to £322 billion in our central scenario. [SLIDE] Just under half the difference (£125 billion) reflected the lockdown (mostly via lower tax receipts and higher welfare spending, partly offset by lower debt interest spending), while [SLIDE] just over half (£142 billion) reflected the fiscal policy response (in particular support for households via the furlough scheme and support for business via grants, business rates relief and guaranteed loans). [SLIDE] We then needed to add the cost of the Chancellor's Summer Economic Update, which was finalised too late to include in the *FSR* itself. Our best guess was that this would increase borrowing by a further £50 billion, lifting the projected deficit to £372 billion.

Since then, receipts have outpaced our central scenario, much as the wider economy has. And the Chancellor has announced more support measures in the Winter Economy Plan, alongside which a further £24 billion of public services spending was disclosed. We will estimate the overall cost of this and any other forthcoming measures in our next *Economic and fiscal outlook* in November.

[SLIDE] If we look at the increase in projected borrowing since March over the central scenario as a whole, you can see that the impact of the policy measures on the budget deficit is very heavily concentrated in the current fiscal year, as most of the support is time-limited. But borrowing is still pushed higher in later years because the economy is permanently smaller and tax revenues thus remain depressed relative to March.

[SLIDE] Where does all this leave the key fiscal aggregates?

Receipts fall significantly in cash terms in each scenario, mostly because the economy is smaller. The combination of higher cash spending and a smaller economy pushes the ratio of spending to GDP sharply higher this year – to above 50 per cent in all three scenarios. And it remains higher in the central and downside scenario) because of the lasting hit to GDP.

The combined effects of lower receipts and higher spending for the budget deficit are shown here. It spikes to 13, 16 or 21 per cent of GDP this year – each significantly higher than the peak following the financial crisis (the previous peacetime record). Including the costs of the Summer Economic Update, the rise is to 15, 19 and 23 per cent. By 2024-25, the deficit is little changed from March in the upside scenario, but still stands at 4.6 per cent of GDP in the central scenario – implying lasting fiscal damage of 2.4 per cent of GDP since March.

[SLIDE] If we look at the scenario paths for public sector debt, we see them moving from less than 80 per cent of GDP in the medium term in March to more than 100 percent in all but the upside scenario. The lines dip in 2024-25 as the Bank's Term Funding Scheme loans are repaid. Excluding the impact of the Bank's measures, the ratios are all lower but rise steadily year by year in both the central and downside scenarios.

[SLIDE] So now let us move on from the medium-term outlook to the longer term. These long-term fiscal projections were prepared using a much simpler approach than we would normally use in an FSR.

As always, the major drivers of the long-term outlook for spending, borrowing and debt are the ageing of the population and non-demographic cost pressures in health and social care. The long-term outlook also depends to a considerable degree on the state of the public finances at the end of the medium term – what we call the 'jumping-off point' – and that of course has deteriorated as a result of the pandemic.

This chart starts at the bottom with the long-term debt-to-GDP projection corresponding to the October 2018 pre-measures forecast – ancient history now – in which the government was on course to balance the budget by the jumping-off point. The ratio falls for some time, but eventually rises again as health costs in particular put the primary balance back into deficit and debt interest spending rises over time. Next up is our March forecast, by when the fiscal loosening during the May and Johnson premierships has increased the deficit at the medium-term horizon, thereby pushing the debt-to-GDP ratio onto a more steeply unsustainable trajectory even before the pandemic took hold. Under each of the coronavirus scenarios, the trajectory is steeper still.

In practice, no government could allow net debt to persist for long on these explosive paths, as it would find it hard to finance its mounting deficits. One way that we illustrate the challenge of restoring sustainability is to ask by how much fiscal policy would need to be tightened each and every decade to ensure that by 2069-70 the debt-to-GDP ratio was back at 75 per cent – roughly the level that the Government seemed to think acceptable at the time of the March Budget. On our March forecast, the required tightening would be 1.8 per cent of GDP (or roughly £40 billion in today's terms). In the central scenario it would be 2.9 per cent (or £64 billion).

[SLIDE] Finally, let me turn to the risks around the public finances, above and beyond the choice of coronavirus scenario. In the FSR we discussed these in the same categories that we use in our regular *Fiscal risks report*.

[SLIDE] The first category of risks we look at are those related to the macroeconomy and the financial sector. We have often noted that history suggests there is a 50-50 chance of a recession in any five-year forecast period. That risk has crystallised with a vengeance this year and we should always remember that there will be more downturns in future.

More than that, it is striking that the UK has been subject to two 'once in a lifetime' shocks in a little over a decade. Each has pushed the budget deficit above 10 per cent of GDP, whereas no previous post-war recession pushed it above 7. Perhaps that's just bad luck, but if very large shocks are going to be more common in future than we have so far assumed, policymakers may need to re-evaluate what constitutes a prudent fiscal policy during normal times to ensure they have the fiscal space to respond to these blows when they land.

In addition to shocks and cycles, there remains a risk around estimates of the long-term growth rate the economy can sustain. This has been highly uncertain ever since the financial crisis (thanks to the productivity puzzle), on top of which is the hard-to-quantify potential impact of

Brexit. We can now add the virus as another source of uncertainty, in the event that the 'new normal' requires structural economic change.

As regards the financial sector, so far this has been the dog that has not barked during the pandemic period. In part that reflects the additional loss-absorbing capacity that regulators have required the banking system to build up. But, perhaps more importantly, the Government has already taken on a large portion of the potential risk itself by supporting individuals and businesses and by guaranteeing new loans.

[SLIDE] The largest risks to future revenues are those that affect the whole economy, as we are seeing right now. But the pandemic will also generate or exacerbate other risks listed here. One that is already proving challenging to understand the evolution of tax debt – the overall value of tax that initially goes unpaid and how much of it is then subsequently repaid. Tax debt has spiked and some firms will go out of business before they can pay it off. But so far it appears that more is being paid off quickly than we assumed back in July.

These risks apply to differing extents to the devolved taxes. Tax debt and subsequent repayments have been a particular issue for PAYE income tax of late. There are likely to be differences in how the Welsh labour market and property markets are affected this year and how they bounce back. And so on. As ever, their effects on the Welsh Budget will be complicated by the operation of the fiscal framework.

[SLIDE] Spending could potentially be the more significant source of risks in the coming years – both at the UK and the Welsh Government levels:

- Having experienced the current health crisis, the Government may well face pressure to devote a higher share of GDP to the NHS and wider care services, including adult social care, where proposals for reform have been pushed back repeatedly.

- Health and welfare costs may also increase if chronic health conditions become more widespread, for example as a result of higher unemployment or Long Covid.
- Some temporary measures to support individuals and businesses could become permanent if the Government wishes to avoid creating some politically sensitive cash losers. (For example, the millions of families who will be hit when the £20 a week boost to universal credit and working tax credits is withdrawn next April.)
- And there are many other individual spending risks either created or exacerbated by the crisis. Among them pressures on local authorities that central government may feel it has to ease.

[SLIDE] In addition to revenue and spending, there are risks that could affect the public sector balance sheet listed here. In particular, the eventual cost of the billions in guaranteed loans under the Bounce Back and other loan schemes will depend on the proportion of loans that go bad. We assumed a £20 billion cost in the central scenario and £39 billion in the downside. This would be a bigger hit than following the financial crisis, largely because more of today's guarantees have been offered to smaller firms – for which default rates are typically higher.

[SLIDE] So let me conclude. [SLIDE] The coronavirus has dealt an unprecedentedly large and abrupt shock to the public finances, both because of the lockdown and the necessary policy response. The big uncertainty looking forward is how much of the resulting economic and fiscal damage turns out to be permanent rather than temporary. One silver lining to the current fiscal cloud is that it remains relatively cheap for the government to borrow – and indeed it has become more so. But that could lull policymakers into a false sense of security. In addition to its long-standing priorities for public services and capital spending, the pandemic may put additional upward pressure on spending and downward pressure on receipts. And meanwhile the long-term pressures from the ageing population and other health costs have not gone away. Against this backdrop, the government must decide how to balance the priorities of today with the need to invest in fiscal space to confront the shocks of tomorrow.

Thank you.