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Fiscal sustainability report – July 2020

Public sector borrowing to hit a peacetime record

The coronavirus outbreak and the public health measures taken to contain it have delivered one of the largest ever shocks to the UK economy and public finances. Assessing fiscal sustainability in this context is challenging – it is difficult to predict what might happen from one month to the next, so projecting the fiscal position decades into the future might seem futile. But the pandemic has not displaced the long-term pressures that we typically focus on in our *Fiscal sustainability reports* (*FSRs*), although it has significantly changed the baseline against which their impact will be felt. To capture those changes, this *FSR* presents three potential medium-term economic and fiscal scenarios ('upside', 'central' and 'downside'), assesses their implications for fiscal sustainability, and discusses how the pandemic and policy response has altered our assessment of fiscal risks.

The UK is on track to record the largest decline in annual GDP for 300 years, with output falling by more than 10 per cent in 2020 in all three scenarios. This delivers an unprecedented peacetime rise in borrowing this year to between 13 and 21 per cent of GDP, lifting debt above 100 per cent of GDP in all but the upside scenario. As the economy recovers, the budget deficit falls back. But public debt remains elevated, continuing to rise in the central and downside scenarios.

That said, the outlook would have been much worse without the measures the Government has taken. These have provided additional financial support to individuals and businesses through the lockdown. They should also help to limit any long-term economic 'scarring', by keeping workers attached to firms and helping otherwise viable firms stay in business.

Our scenarios incorporated the total cost of the Chancellor's coronavirus policy interventions that had been announced by 26 June, which raised borrowing in 2020-21 by £142 billion in our central scenario. The further package of measures announced in the Chancellor's Summer Economic Update on 8 July was finalised and notified to us too late to incorporate into our scenarios. As described below, we estimate that these add a further £50 billion to borrowing this year, with more modest effects in other years. This would increase borrowing this year in our scenarios to between 15 and 23 per cent of GDP, raising the path of public sector net debt over the medium term, but would have little effect on the medium-term structural deficit.

Our upside scenario assumes that long-term economic scarring is avoided, but in the central and downside scenarios it reduces output in the medium term by 3 and 6 per cent respectively. By 2024-25 the budget deficit falls back to close to our March forecast of 2.2 per cent of GDP in the upside scenario (at 2.4 per cent), but it remains higher – at 4.6 and 6.8 per cent – in our central and downside scenarios. None of the scenarios assume persistently lower growth in potential GDP, as was the case after the financial crisis and which would result in the loss of output and fiscal damage increasing over time. And they all assume that very low interest rates persist in line with market pricing, cushioning the fiscal blow. This helps stabilise public debt as a share of GDP.

The pandemic has hit the public finances at the end of two years during which fiscal policy has already been eased materially. This started in June 2018, when Prime Minister Theresa May announced a large NHS spending settlement, and was accelerated in Chancellor Rishi Sunak's Spring Budget this year. In it, he set out plans to borrow significant sums on an ongoing basis and merely to stabilise, rather than reduce, the debt-to-GDP ratio.

A key risk to this pre-virus fiscal strategy was that the highly favourable financing conditions the Government currently enjoys might not persist. In that event, the longer-term pressures from health costs and demography we routinely highlight would be faced against a backdrop of greater upward pressure on the ratio of debt to GDP. In the short term, the pandemic has seen borrowing costs fall even further, which all else equal increases the scope for running a fiscal deficit while keeping debt stable as a share of GDP. But higher public debt also increases the sensitivity of the public finances to higher interest rates, increasing the risks from pursuing a fiscal strategy that assumes that financing conditions will remain favourable over the longer term. And having experienced a public health crisis on this scale, there are also likely to be pressures to devote a higher share of GDP to spending on the NHS and wider care services in the future, including on adult social care.

In the short term, the Government understandably remains focused on controlling the virus and reviving the economy. But at some point, given the structural fiscal damage implied by our central and downside scenarios, the longer-term pressures on spending, and the range of fiscal risks we identify, it seems likely that there will be a need to raise tax revenues and/or reduce spending (as a share of national income) to put the public finances on a sustainable path.

The Government's *ability* to push the deficit ever higher rests in part on the credibility of the institutional framework that gives investors confidence that the value of the government bonds they purchase will not be deliberately eroded in the future. Its *willingness* to push the deficit higher points to an increased reliance on the use of fiscal policy in 'bad' times, which implies that debt will also need to fall more quickly in 'good' times to build up fiscal space. But the case for precautionary investment in fiscal space in good times runs directly against the encouragement to run larger deficits created by the favourable financing conditions. These conflicting pressures will no doubt figure in the Chancellor's deliberations as he designs the UK's sixth set of fiscal rules in 10 years to guide his Autumn Budget and beyond.

Summer economic update measures

The Chancellor announced a further package of measures on 8 July. These included "*up to £30 billion*" in tax and spending measures designed to support employment and £32.9 billion of additional public services spending revealed via a footnote to the accompanying 'Plan for Jobs' publication. Table 1 provides our initial assessment of the costs of these announcements relative to what was assumed in our central scenario. It gives an overall cost of £50 billion in 2020-21 and £51 billion overall. This overall figure is £13 billion less than the Treasury's. This reflects several factors, including that around £3 billion of the public services spending announcement was already reflected in our numbers, that our estimate of the cost of the Job Retention Bonus is roughly £3 billion lower than the Treasury's upper limit, and that the VAT and stamp duty holidays cost less against the lower paths for consumer spending and property transactions in our scenarios. These initial estimates are subject to considerable uncertainty – several are sensitive to the pace at which the economy and labour market recover and by the rates at which different schemes are taken up.

Table 1: Summary of Summer Economic Update measures

	£ billion				
	2019-20	2020-21	2021-22	2022-23	Total
Job Retention Bonus					
Job Retention Bonus	-	6.1	-	-	6.1
Supporting jobs					
Kickstart Scheme	-	0.7	1.4	-	2.1
Boosting worksearch, skills and apprenticeships	-	1.6	-	-	1.6
Protecting jobs					
Reduced rate of VAT for hospitality, accomodation and attractions	-	2.5	-	-	2.5
Eat Out to Help Out	-	0.5	-	-	0.5
Creating jobs					
Infrastructure package	-	4.0	-1.3	-1.3	1.5
Public sector and housing decarbonisation	-	1.1	-	-	1.1
Green Homes Grant	-	2.0	-	-	2.0
Stamp Duty Land Tax temporary cut	-	1.3	1.3	0.0	2.5
Plan for Jobs measures	-	19.8	1.4	-1.3	19.9
Additional public services spending and other measures	0.5	30.4	0.6	-	31.5
Total announced on 8 July 2020	**0.5**	**50.2**	**2.0**	**-1.3**	**51.4**

Note: additional public services spending and other measures includes cultural recovery fund and the extension of the zero rate of VAT on PPE.

Our estimates of the costs of these measures are detailed in the latest update to our policy monitoring database. The key elements include:

- The **'Job Retention Bonus'** of £1,000 for every furloughed employee who remains continuously employed to the end of January 2021. This is assumed to cost £6.1 billion in our central scenario, based on 15 per cent of the 9.4 million jobs furloughed to date being lost and a further 20 per cent reduction due to factors like normal churn in the labour market, the pay floor limiting eligibility and (as is usual) some employers choosing not to take it up.

- A **'supporting jobs'** package of labour market interventions. We have used the Treasury's estimate of a £3.7 billion cost, of which £2.3 billion is assumed to be incurred in 2020-21.

- A **'protecting jobs'** package to support the hospitality and accommodation sectors, and 'attractions'. This costs £3.0 billion, somewhat less than the Treasury's estimate. The difference relates to the temporary cut in the rate of VAT from 20 to 5 per cent for those sectors, where we have aligned the underlying tax base assumption to our central scenario.

- A **'creating jobs'** package composed of spending on infrastructure, 'green' investment and a stamp duty holiday that increases the nil-rate band for residential stamp duty land tax (SDLT) transactions from £125,000 to £500,000 from 8 July to 31 March 2021. The infrastructure package largely brings forward previously announced spending commitments, so it mostly reprofiles, rather than increases, expenditure over the medium term. This is the main reason why the total cost of this package is £7.1 billion relative to our scenarios, as opposed to the £12.5 billion reported in the Summer Economic Update.

- An extra £31.5 billion for **public services spending**. The 'Plan for Jobs' document disclosed £34.2 billion of additional spending, relative to the figures in our most recent published database from 19 June (£1.3 billion for culture announced on 6 July and £32.9 billion announced on 8 July). Of that, £2.7 billion had already been incorporated in our scenarios (for example, an additional £1 billion for schools), with £31.5 billion therefore adding to spending and borrowing relative to our scenario assumptions.

It would not be meaningful to estimate exactly how these announcements would have affected our economic scenarios, since they start from assumptions about output growth post-measures. This contrasts with the approach we would take in a medium-term forecast, where the outlook for the economy absent policy measures would then be adjusted to reflect the effects of new policy announcements. It is, however, possible to say what the normal toolkit we use for this process would imply about their economic effects more generally:

- By far the most important effect would come via the £51 billion of **overall fiscal easing**. Given the composition of the package, our usual 'fiscal multipliers' suggest this would raise GDP in 2020-21 by around 1½ per cent – a temporary boost that would fade over time. Assessing the associated effects on employment, average hours worked and productivity is complicated by the atypical nature of the shock to the economy and the way it has fed through those channels. But if our standard relationship between GDP and employment were still to apply, it would imply around 140,000 higher employment.

- The **temporary VAT cut** would reduce CPI inflation by around 0.8 percentage points while it is in effect, then raise it correspondingly when the 20 per cent rate is restored.

- The **SDLT holiday** will affect house prices and, more significantly, property transactions. Based on the relationships that have underpinned our assessment of previous SDLT measures – adjusted to reflect the temporary nature of this one – we would expect it to increase the number of property transactions in 2020-21 by around 100,000, with around a quarter of those being truly additional while three-quarters would be brought forward from 2021-22. House prices would be around 0.5 per cent higher, with the effect smaller than the SDLT saving for buyers as a result of the tax cut being temporary.

It is unclear how the various labour market policies will affect employment over and above the demand effects of the fiscal loosening though their effects on incentives. The Kickstart Scheme is based on a similar scheme that was deployed after the financial crisis with apparently positive results. And additional work coaches should facilitate the matching of workers to vacant jobs. But many of the claims under the Job Retention Bonus are likely to be in respect of employees who would have been retained anyway.

Notes

1. The OBR is the UK's independent fiscal watchdog. We produce forecasts for the economy and the public finances, assess progress against the Government's fiscal targets, and report on long-term fiscal sustainability.
2. All the documents and supporting material published today is available on our website: http://obr.uk/
3. Questions about the *Fiscal sustainability report* should be sent to OBR.Press@obr.uk