



Institute for Fiscal Studies

IFS Green Budget 2020: Chapter 4

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Outlook for the public finances



4. Outlook for the public finances

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Key findings

- 1 **Government borrowing this year is projected to climb to £350 billion which, at 17% of GDP, is a level never before seen in the UK, outside of the two world wars of the 20th century.** This compares with a March Budget forecast of £55 billion. Of this near £300 billion increase in forecast borrowing, just over £200 billion is the cost of the substantial packages of measures set out to help support public services, households and businesses through this difficult time, while the remaining almost £100 billion reflects the direct impact on borrowing of the sharp economic downturn associated with the pandemic.
- 2 What matters more for the long-run health of the public finances – and what is far more uncertain – is how complete the economic recovery will be. Under our central scenario, and assuming none of the temporary giveaways in 2020–21 are continued, **borrowing in 2024–25 is forecast to be over £150 billion compared with the March Budget forecast of £58 billion.** Under our pessimistic scenario, borrowing is forecast to be over £200 billion in 2024–25, while even under our optimistic scenario it is still forecast to be over £90 billion.
- 3 There will be significant pressures to increase public spending above plans by maintaining some of the additional spending used to support the economy, public services and working-age

social security over this year. **If a quarter of the additional public service spending announced in response to COVID-19 were made permanent, this would add £20 billion (in today's prices) to spending by 2023–24.** Depending on the size of any tax rise implemented by that point, this could add up to 1% of national income to forecast borrowing in 2023–24.

- 4 Prior to the pandemic, public sector net debt was around 80% of national income and was forecast to fall slightly over the next few years. This was considerably above the 35% of national income seen in the years prior to the financial crisis. In 2024–25, we forecast public sector net debt to be just over 110% of national income in our central scenario, close to 100% of national income in our optimistic scenario and close to 130% in our pessimistic scenario. **In the central scenario, over three-quarters of the rise in debt will result from lower economic activity rather than the large increases in spending implemented this year.**
- 5 With the government currently able to borrow very cheaply, under each of these scenarios spending on debt interest as a share of revenues would fall even further from its recent historical low. This low cost of borrowing means that **additional spending now that helped to deliver a more complete recovery would almost certainly be worth doing.**
- 6 Once the economy has recovered, **policy action will be needed to prevent debt from continuing to rise as a share of national income.** The scale of the challenge will be considerable, but so is the degree of uncertainty around the size of consolidation that will ultimately be required. Even if the government's cost of borrowing remains low, and ignoring other pressures, under our central scenario a 2.1% of national income fiscal tightening in 2024–25 – £43 billion in today's terms – would still only be sufficient to stabilise debt at over 100% of national income over the next 40 years.

- 7 In fact, **additional spending pressures on health, pensions and social care** are expected by the Office for Budget Responsibility to add 1.8% of national income to spending each decade. They treble the projected necessary policy action, with a fiscal consolidation of 6.6% of national income required if public sector net debt is to be brought down to 100% of national income in 40 years' time.
- 8 While the policy action needed is much lower under our optimistic scenario (the 6.6% of national income falls to 3.6% of national income), a rise in interest rates or **future adverse shocks such as those experienced twice in the UK in the period since just 2007 would make the task of preventing debt from rising further over the next 40 years even more challenging.**
- 9 The Conservative Party manifesto commitment to reduce debt as a share of national income over this parliament will be broken, and the current fiscal targets lie in tatters. But the high degree of uncertainty means that now is not the time to be announcing new targets, or the size, timing or nature of any fiscal tightening. Even the Autumn Budget of 2021 may be too soon for this. Meanwhile, the Chancellor should **recommit to the independence of the OBR and ensure that as far as possible it is able to scrutinise costings in advance of major policy announcements.** More generally, Mr Sunak should champion a general recognition that, once the economy has been restored to health, a fiscal tightening will follow.

4.1 Introduction

The COVID-19 pandemic has caused huge economic disruption: the lockdown halted economic activity in some sectors, consumers have changed their behaviour to reduce the risk to their health and others in their family, and the onset of the recession and uncertain outlook have weighed on confidence (see Chapters 1 and 2). Governments across the developed world have responded with large

interventions to fund public services' response and to help support businesses, jobs and incomes. These interventions are – quite sensibly – leading to sharp increases in government borrowing.

In this chapter, we start by characterising the outlook for the UK's public finances over the next five years. With the economy having only recently begun to emerge from nationwide lockdown and many questions around how the prevalence of the pandemic will develop, the outlook is even more uncertain than usual. To emphasise the range of possible outcomes, we provide three illustrative scenarios for the public finances, based on the conditions set out in three of the economic scenarios described in Chapter 2.

It is worth noting that these scenarios by no means exhaust the full range of possible outcomes. In particular, the pessimistic scenario is not a worst-case scenario, in that it is certainly possible that the eventual economic recovery will be even less complete. More optimistically, it is possible, though unfortunately not in our view likely, that the recovery is swifter and fuller than implied by the upside case that we consider.

In addition, COVID-19 is by no means the only source of uncertainty for the economy and the public finances. The future trading relationship with the European Union is still subject to negotiation. All our scenarios make a common assumption of a smooth transition to a shallow trade deal, although here, too, there are risks both to the downside risks (most obviously, an exit from the transition period on World Trade Organisation (WTO) terms and a long period of uncertainty) and to the upside risks (for example, the eventual agreement of a more comprehensive deal).

Section 4.2 sets out our forecasts for borrowing under each of these scenarios, Section 4.3 shows what these would mean for public sector net debt, while Section 4.4 presents the resulting path of spending on debt interest.

In the second part of the chapter, we turn to the longer-run outlook beyond the COVID crisis. Trends from before the pandemic, including muted productivity growth and the projected public finance costs of an ageing society, already suggested that – over the longer term – considerable tax rises or spending cuts would be needed to ensure the public finances were in a sustainable position. Any enduring harm to economic performance from the current crisis would increase the

eventual need for tax rises or spending cuts, although we stress that now is not the time to embark on this consolidation, or – given heightened uncertainty – even to commit to its shape, size or timing. Section 4.5 presents projections for public sector net debt under different assumptions for the size of the eventual fiscal tightening and the evolution of growth and government borrowing costs. Finally, Section 4.6 concludes with some recommendations for the Chancellor as he prepares for the next Budget which should now, at the very latest, take place in the Spring.

4.2 Borrowing remains elevated in all scenarios

The latest estimate is that borrowing in 2019–20 was £55.8 billion, or 2.5% of national income. This was somewhat higher than the £47.4 billion, or 2.1% of national income, forecast in the March 2020 Budget.

The Budget was prepared largely before any direct impact of COVID-19 on the UK economy had been anticipated by the Office for Budget Responsibility (OBR) or other forecasters. As a result, borrowing this year (in 2020–21) will be substantially higher than was forecast in March. As shown in Figure 4.2, under our central scenario, borrowing this year is forecast to rise to 17.1% of national income (£351 billion), which would be some £296 billion above the £54.8 billion forecast in the March Budget.

There is a great deal of uncertainty even over the range of possible outcomes for borrowing in the current financial year. Under our more optimistic scenario, borrowing this year is forecast to be 16.7% of national income (£345 billion). In contrast, under our pessimistic scenario (in which a second outbreak in coming months forces the reimposition of widespread and stringent lockdown measures), borrowing is forecast to rise further to 18.9% of national income (£376 billion).

The methodology we employ to forecast receipts and spending – and therefore borrowing – under each of the three scenarios for the economy that we consider is set out in Box 4.1.

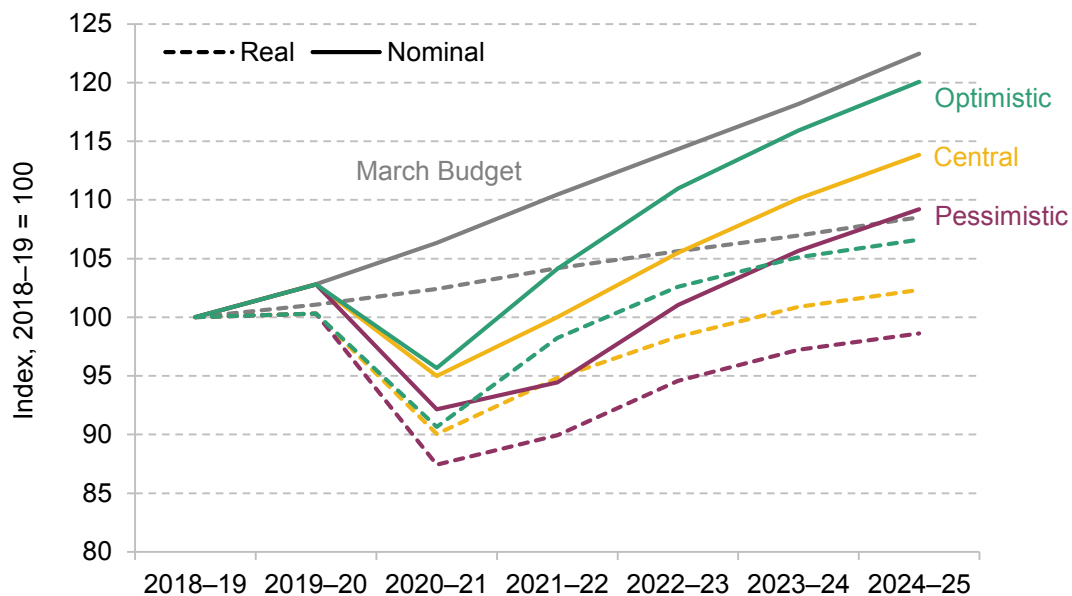
Box 4.1. Methodology

Our scenarios use the change in borrowing between the OBR’s March Economic and Fiscal Outlook and the ‘central’ scenario from its July Fiscal Sustainability Report. We separate the rise in borrowing into discretionary measures, lower spending on debt interest, lower oil prices and the fall in the stock market and we attribute the residual to a ‘pure’ GDP effect (including the drop in tax revenues and the additional social security spending caused by the economic downturn).

We then construct a new forecast using multipliers for both government revenues and government spending backed out from these effects and applying them to the economic variables (interest rates, inflation, oil prices, stock market values and GDP) from Citi’s scenarios.

Figure 4.1 sets out forecasts for national income in real terms (shown by the dotted lines) and in nominal or cash terms (shown by the solid lines) under each of the three scenarios, along with how these compare with the OBR’s March 2020 forecast.

Figure 4.1. Economic growth in three scenarios

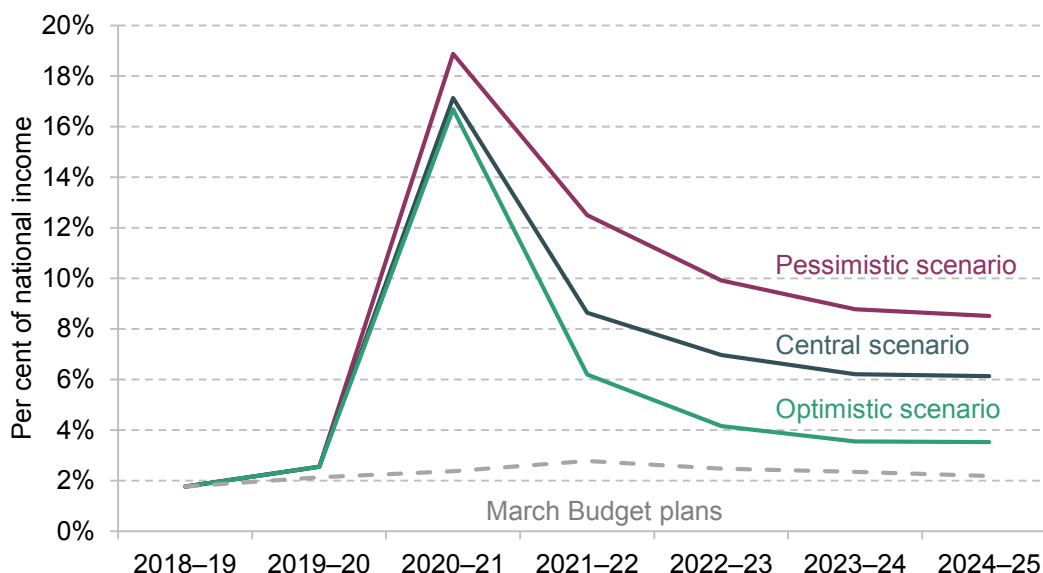


Source: Authors’ calculations using the scenarios prepared by Citi for this year’s Green Budget that are presented in Chapter 2, OBR March 2020 Economic and Fiscal Outlook and OBR July 2020 Fiscal Sustainability Report.

In all three scenarios, national income remains below that forecast in the March Budget throughout the next five years. While the decline in national income this year is greater in the pessimistic than in the central or optimistic scenarios, the chief difference lies in the strength of the recovery.

The expected deflationary impact of the pandemic means that, in each scenario, national income in nominal terms has been downgraded by more than national income in real terms. For the public finances, this is important as revenues are more affected by national income in cash terms than in real terms.

Figure 4.2. Forecast path of borrowing in our three scenarios compared with the March 2020 Budget



Source: Authors' calculations using the scenarios prepared by Citi for this year's Green Budget that are presented in Chapter 2; Office for Budget Responsibility, 'Economic and fiscal outlook – March 2020', <https://obr.uk/efo/economic-and-fiscal-outlook-march-2020/>; Office for Budget Responsibility, 'Fiscal sustainability report – July 2020', <https://obr.uk/fsr/fiscal-sustainability-report-july-2020/>; Office for Budget Responsibility, Coronavirus Policy Monitoring Database, 14 July 2020, <https://obr.uk/download/coronavirus-policy-monitoring-database-14-july-2020/>; Prime Minister's statement on coronavirus, 17 July 2020, <https://www.gov.uk/government/speeches/pm-statement-on-coronavirus-17-july-2020>. Includes an indicative costing of £1 billion a month for five months, and nothing thereafter, for the Winter Economic Plan.

Borrowing this year in our central projection exceeds the OBR's central scenario from its July 2020 Fiscal Sustainability Report by £29.2 billion in cash terms, and by 0.8% of national income. However, this difference is more than explained by new discretionary giveaways not included by the OBR in its July report. Most obviously, these include the £20 billion costing of the 'Plan for Jobs' announced after the OBR's report in the Chancellor's July Summer Economic Update and the £30 billion of additional public service spending also confirmed in that statement.

The decline in national income this year, in contrast, is actually less severe in our central scenario than in the OBR's central scenario. The story is much different when we consider the end of the medium-term forecast period: in 2024–25, the difference in borrowing between our scenario and the Fiscal Sustainability Report grows to 1.5% of national income, or £34.8 billion in nominal terms, all of which is explained by weaker forecast growth beyond 2020–21.

After this year, borrowing is projected to fall sharply under all three of the scenarios we consider. Nevertheless, borrowing is forecast to remain higher than was forecast in the March 2020 Budget for several years to come. Even in our optimistic scenario, in which fears about the virus dissipate faster and the economy rebounds more quickly and more fully towards its pre-crisis expected trajectory, borrowing remains well above those earlier forecasts throughout the next five years.

Table 4.1 shows the levels of borrowing forecast under each scenario both in cash terms and as a share of national income in 2024–25, and the difference from the March 2020 forecast. In our central scenario, borrowing is forecast still to be 6.1% of national income – almost three times the 2.2% forecast in the March Budget – at the end of the forecast horizon in 2024–25. This is despite the fact that this scenario assumes that there is essentially no temporary discretionary COVID-related spending beyond next March. This means that, for example, the procurement of additional personal protective equipment and services such as NHS Test and Trace will no longer be required (Chapter 6) and increases in the generosity of the working-age social security system will not be made permanent (Chapter 8). As set out in Chapter 6, if a quarter of the additional public service spending announced in response to COVID-19 were made permanent, this would add 1% of national income to spending by 2023–24.

Table 4.1. Borrowing in 2024–25 under our three scenarios compared with the plans announced at the March 2020 Budget

	Borrowing (2024–25 terms)	As a share of national income	Increase relative to March Budget (today's terms)
March 2020 Budget	£57.9bn	2.2%	n/a
Optimistic	£91.3bn	3.5%	£27.4bn
Central	£150.8bn	6.1%	£80.9bn
Pessimistic	£200.6bn	8.5%	£129.7bn

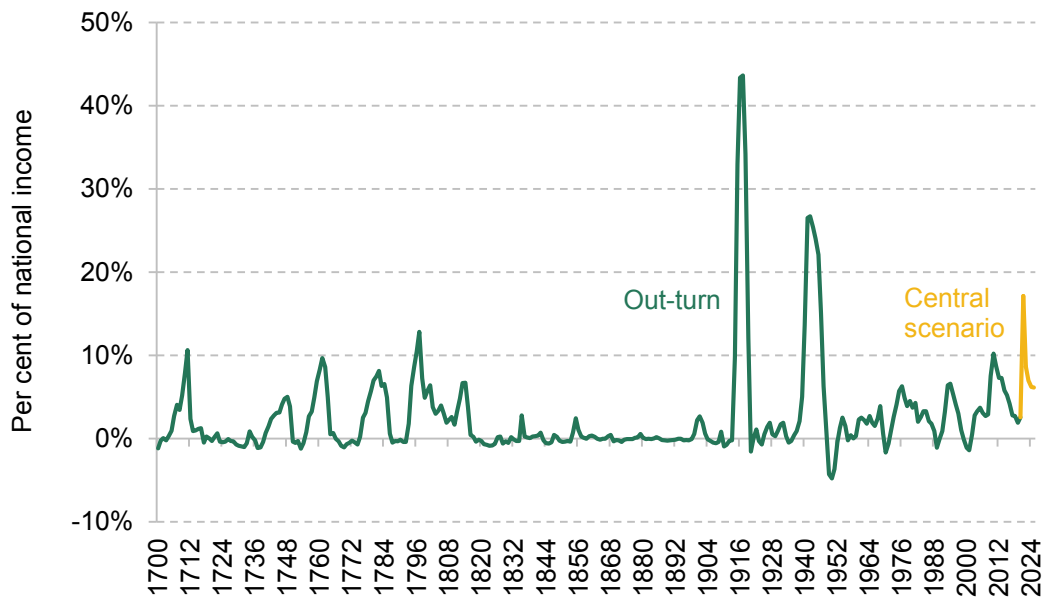
Source: As for Figure 4.2.

But the degree to which borrowing is forecast to remain above the March 2020 Budget forecast in 2024–25 varies hugely between the three scenarios we consider. Under our more optimistic scenario, borrowing (of 3.5% of national income) is less than three-fifths of what it is under our central scenario, while under our pessimistic scenario, borrowing (of 8.5% of national income) is more than a third bigger than under our central scenario.

How does forecast borrowing compare historically?

The current financial year will certainly earn its place in UK public finance history. In each of our three scenarios, borrowing this year is forecast to exceed by a considerable margin the 10.2% of national income borrowed at the peak of the financial crisis (in 2009–10). Furthermore, as shown in Figure 4.3, it will reach the highest share of national income outside of the two world wars that the UK has seen in over 300 years.

Figure 4.3. Borrowing in historical comparison



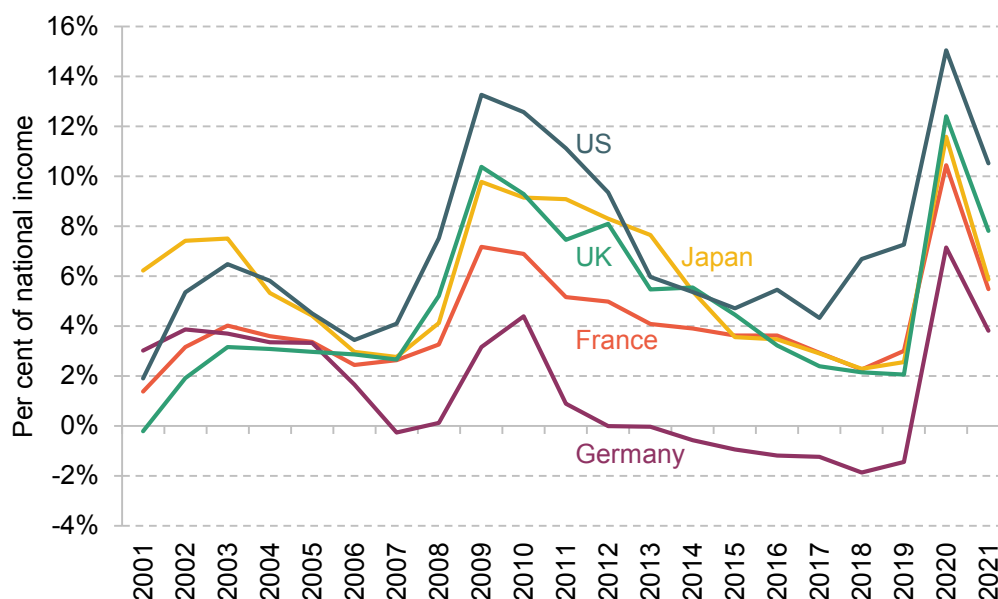
Note: Calendar year central government borrowing until 1920, then public sector net borrowing financial year ending March. Great Britain until 1801, UK thereafter.

Source: As for Figure 4.2; Bank of England, 'A millennium of macroeconomic data', <https://www.bankofengland.co.uk/statistics/research-datasets>; Office for Budget Responsibility, Public Finances Databank, July 2020, <https://obr.uk/download/public-finances-databank-july-2020/>.

How does borrowing compare with that in other countries?

Since the rise in borrowing is the result of the public health and fiscal response to a global pandemic, it is unsurprising that other advanced economies are also experiencing sharp increases in borrowing. Figure 4.4 shows OECD forecasts for borrowing in France, Germany, Japan, the United Kingdom and the United States. Unfortunately, these are from June 2020 and therefore are now somewhat out-of-date as, for example, many countries have announced additional increases in their support packages since then (which will add further to borrowing). For example, in the UK, Chancellor Rishi Sunak's July 'Summer Economic Update' is not included in these figures; as stated above, the OBR estimates that its measures will add around £50 billion – that is, over 2% of national income – to borrowing in 2020–21.

Figure 4.4. OECD forecasts for borrowing in selected large economies



Note: Figures from OECD 'single-hit scenario'. This scenario projects a decline in real UK GDP of 11.5% in 2020, similar to the 10–11% decline in our scenarios. The OECD described the underlying epidemiological assumptions as a successful containment, with effective testing, tracing and treating reducing the effective reproduction rate to below 1 until a vaccine becomes available. In its September interim report, it has revised its GDP estimate upward slightly for the UK, to a decline of 10.1%, but not updated borrowing and debt forecasts.

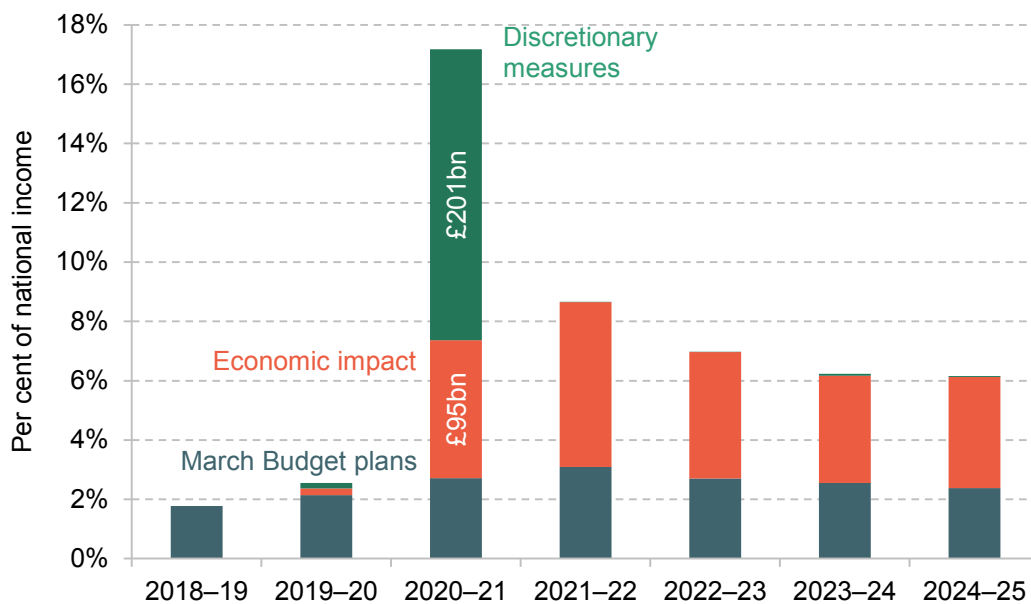
Source: OECD Economic Outlook, June 2020.

Despite this caveat, the overall picture from Figure 4.4 is clear: all five countries see borrowing increase sharply in 2020 to a level that exceeds that experienced at the peak following the financial crisis. While borrowing is forecast to fall back in 2021, it is nevertheless expected to remain well above the levels seen in each country in the last few years.

Drivers of higher forecast borrowing

Figure 4.5 sets out the different drivers of this high level of borrowing. Under the plans set out at the March Budget, the government had indicated that it was already more comfortable with borrowing than its predecessors. These plans were for borrowing to rise between 2018–19 and 2019–20 as increases in spending were not to be matched with increases in tax, and then to stabilise around 2% of national income, with no plans for (further) fiscal consolidation.

Figure 4.5. Drivers of the increase in borrowing in the central scenario



Source: As for Figure 4.2.

However, these increases are dwarfed by the enormous amount of additional borrowing associated with the COVID-19 pandemic. There are two main drivers of the increase in cash-terms borrowing: the automatic impact of the economic disruption on tax revenues and spending, and the government's discretionary giveaways to help support households, firms and public services through the crisis.

Automatic stabilisers

The economic disruption necessitated by the lockdown depressed tax revenues and increased working-age social security spending as more workers became unemployed or saw their earnings fall. For example, over the period April to August 2020, accrued VAT receipts are estimated to have been £51.2 billion. This is £13.5 billion down from the £64.7 billion for the same five months in 2019 – a fall of more than 20%. On the spending side, spending on means-tested financial support has increased to £48.9 billion in the five months since April, an increase of 15%, or £6.5 billion, on the same period last year. In its Fiscal Sustainability Report, the OBR forecasts that employment will, on average, be 2.3 million lower in 2020–21 than it forecast in March and that this will push up social security spending by £25 billion.

The drop in national income this year will push up borrowing by more next year (2021–22) than it does this year (we describe our methodology for forecasting this, based on the OBR’s Fiscal Sustainability Report, in Box 4.1). In part, the impact on borrowing will be somewhat muted in the first year of any downturn – for example, as rising unemployment tends to follow an economic downturn with some delay.

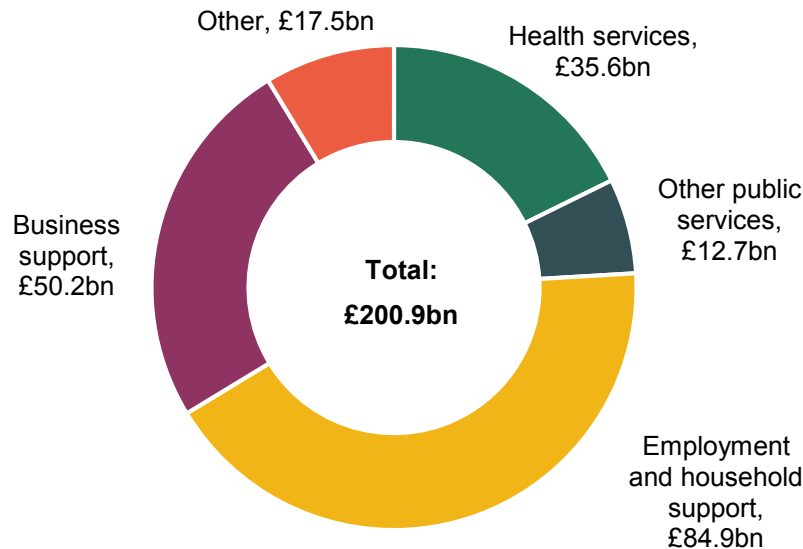
Other factors are specific to the COVID-19 crisis. First, the government has provided an unprecedented level of support to households and businesses since March, which is almost completely unwound after next March in our scenarios, in accordance with stated government plans up until the end of September. While the spending itself is part of the government’s discretionary response, one effect of this support is to help prop up tax revenues this year (with perhaps the obvious example being around £5 billion in income tax and National Insurance contributions expected to be paid on earnings that are covered by the Coronavirus Job Retention Scheme).

In addition, the first part of the COVID-19 recession was unusual in that there was a very significant decline in National Statistics measures of public sector activity. This is because the public sector’s contribution to national income is captured by imperfect measures of output based on, for example, the number of pupils taught in schools and the number of medical procedures carried out in hospitals. Usually these hold up in a recession, but this year they have been considerably lower, which has contributed to a larger fall in measured national income. For example, measured education output in the UK national accounts was 38% lower in the second quarter of 2020 than in the same period in 2019; the national accounts methodology does not incorporate parents’ homeschooling their children as an economic output, and records a reduction in output when schools switch to distance learning. This drop was much bigger than the fall in the service sector as a whole, which contracted by an estimated 21%. But falls in, for example, numbers of pupils taught in schools or the number of medical procedures carried out in hospitals will not have a substantial direct impact on tax revenues.

The discretionary response

The second driver of increased borrowing is the government’s discretionary fiscal policy response – the tax, benefit and public service spending policies it has chosen to introduce in order to help support businesses, households and public services through the pandemic. Quite appropriately, this is a large package – and one that

Figure 4.6. Estimated size of discretionary measures in response to COVID-19 in 2020–21 (announced by 28 September 2020)



Note: 'Other public services' includes public transport, education and local government. 'Other' includes the devolved administrations, revenue measures, the Culture Recovery Fund, the 'Eat Out to Help Out' scheme and several other programmes. Includes an indicative costing of £1 billion a month for five months, and nothing thereafter, for the Winter Economic Plan.

Source: Office for Budget Responsibility, Coronavirus Policy Monitoring Database, 14 July 2020, <https://obr.uk/coronavirus-analysis/>; Prime Minister's statement on coronavirus, 17 July 2020, <https://www.gov.uk/government/speeches/pm-statement-on-coronavirus-17-july-2020>.

has helped prevent even worse economic impacts from the crisis. As shown in Figure 4.5, the discretionary package adds considerably to borrowing in 2020–21, but has almost no direct impact on borrowing in other years. The assumption that this package of measures is only in place in the current financial year, which is stated government policy at the time of writing, is therefore a big driver of the fall in forecast borrowing between 2020–21 and 2021–22.

Figure 4.6 shows the size and decomposition of the discretionary package of measures announced so far for 2020–21. Employment support (the Coronavirus Job Retention Scheme, better known as the furlough scheme, and the Self-Employment Income Support Scheme) and increases in the generosity of the working-age social security system (see Chapter 8) accounted for the largest share of the additional spending. Just under a quarter was spent on direct support for businesses, such as

grants and business rates relief, and a similar amount again on additional public service spending, chiefly on health.

As stated above, virtually all of these measures are not currently planned to be continued beyond the end of the current financial year in March 2021. However, there are many reasons why additional discretionary spending directly or indirectly related to the pandemic may yet be announced for future years.

- There may be additional spending on the NHS to respond to any future flare-up of COVID-19 – for example, personal protective equipment (PPE) purchases or the running costs of an ongoing ‘Test and Trace’ programme – or to tackle a backlog of non-COVID care. Voters, and the government, may want to fund additional capacity or improvements in wages and working conditions in the health and social care system, or invest in stockpiling and disaster preparedness for possible future pandemics or other large emergencies. These and other spending pressures on public services are discussed in more detail in Chapter 6.
- The temporary increases in the generosity of the working-age social security system put in place for the current financial year may also be difficult to roll back fully once the immediate crisis has passed (see Chapter 8).
- Further fiscal stimulus measures may be needed. Indeed, Mr Sunak himself has said, ‘I’m always looking for interesting, creative, innovative and effective new ways to support jobs and employment and people can rest assured that will remain my number one priority’.¹
- Going in the opposite direction, as we set out in Section 4.5, at some point – but not yet – fiscal consolidation measures will most likely be needed. As Mr Sunak has said, ‘Over time and as the economy recovers, we absolutely need to have an eye on our public finances and to make sure that we are in a strong and sustainable position’.²

If some of these additional spending pressures are accommodated, and – as would be sensible – any tax rises are delayed, then borrowing would be pushed up further. As described in Chapter 6, if a quarter of the additional public service spending

¹ Interview with Faisal Islam, BBC Economics Editor, 15 September 2020, <https://www.bbc.co.uk/news/business-54169099>.

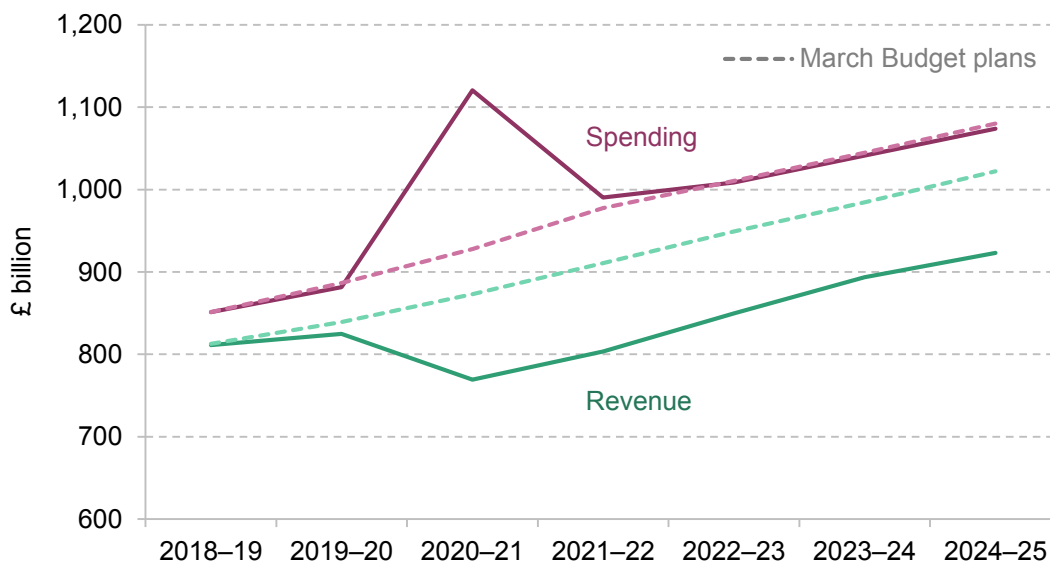
² Chancellor Rishi Sunak speaking at Downing Street press conference following the launch of his Winter Economic Plan, as reported here: <https://www.itv.com/news/2020-09-24/coronavirus-rishi-sunak-announces-government-will-pay-up-to-two-thirds-of-wages-for-people-on-reduced-hours>.

announced in response to COVID-19 were made permanent and non-COVID public service spending continued to grow at the rate planned in March, this would add £20 billion to spending by 2023–24 (in today’s prices). Depending on the size of any tax rise implemented by that point, this could add up to 1% of national income to forecast borrowing in 2023–24.

Tax and spend

Borrowing, by definition, is the gap between what the public sector spends and what it raises in taxes and other revenue. Figures 4.7 and 4.8 separate our forecasts for revenue and spending under the central scenario to show how changes in each drive the large increase in forecast borrowing. The discretionary measures set out in the previous subsection are primarily spending measures, with less than one-tenth of the total taking the form of tax cuts. These discretionary spending measures are the drivers of this year’s spike, and the following sharp drop, in spending measured in cash terms and shown in Figure 4.7.

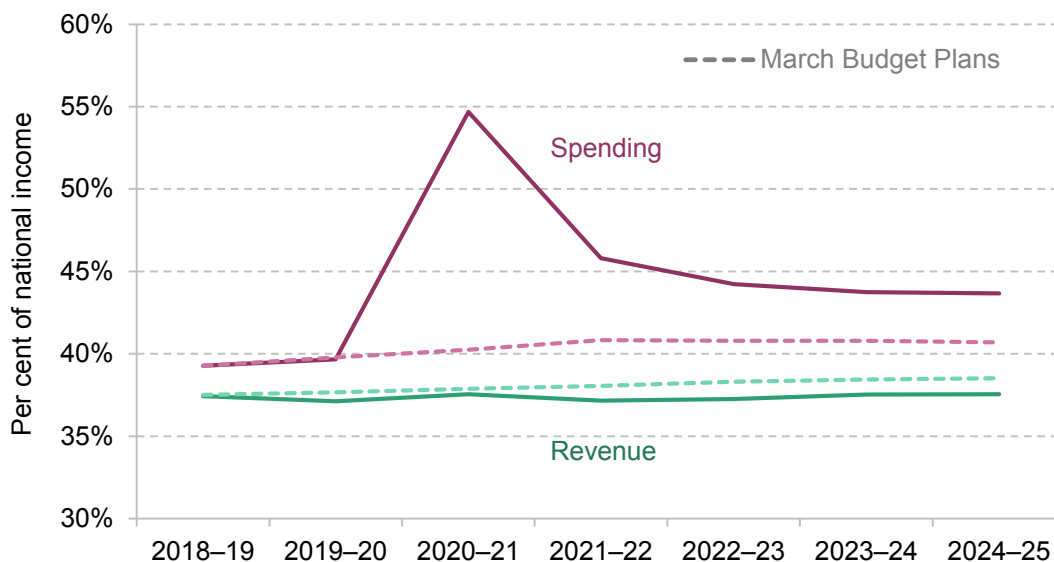
Figure 4.7. Forecast revenue and spending in cash terms under our central scenario



Note: Pale dotted lines represent the March Budget forecast; solid lines represent our forecast under the central scenario.

Source: As for Figure 4.2.

Figure 4.8. Forecast revenue and spending as a share of national income under our central scenario



Note: As for Figure 4.7.

Source: As for Figure 4.2.

In subsequent years, there are two countervailing effects. On the one hand, social security spending remains elevated as the recovery is slow and incomplete. More than offsetting this, debt interest spending is much lower than forecast in March, thanks to record-low interest rates and the expansion in quantitative easing (see Chapter 5). As a share of national income, as shown in Figure 4.8, the spike in spending is even more pronounced, as the economy has shrunk and thus further pushed up cash spending as a share of national income.

As a share of national income, revenues are much more stable than spending. From next year until the end of the forecast period in 2024-25, they are about 1% of national income lower. Revenue in £ billion terms also drops sharply this year, but unlike in the case of spending, this largely arises automatically within the tax system from the sharp fall in economic activity. The gap between the Budget forecast and the central scenario is around £100 billion.

In cash terms, in 2024-25, elevated borrowing is entirely explained by tax revenues being lower than forecast in the March 2020 Budget. However, when comparing the shares of national income, a different picture emerges: tax receipts being lower as a share of national income only explains about one-quarter of the increase in

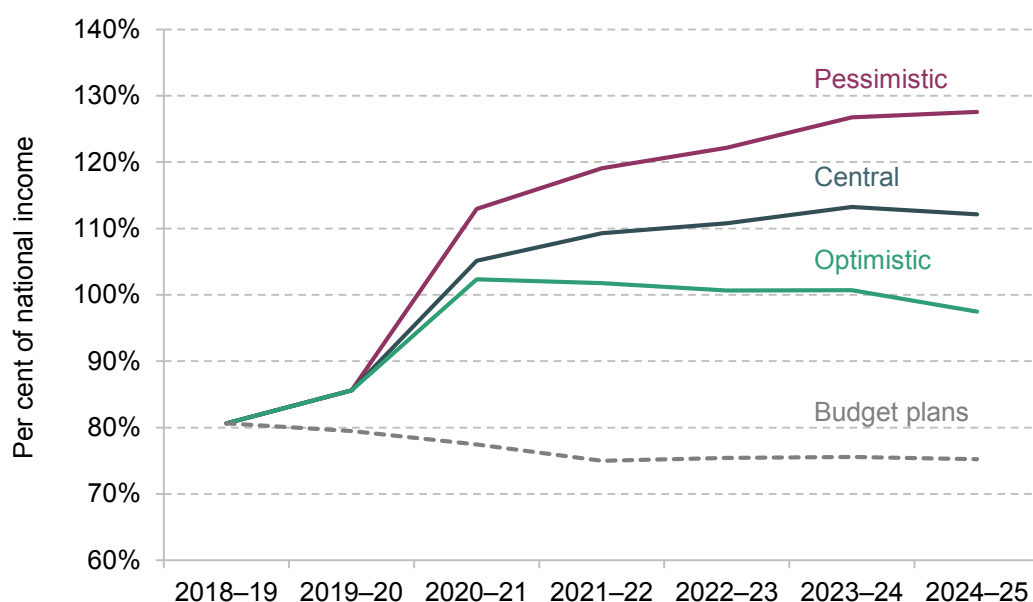
borrowing, with higher spending as a share of national income explaining the remaining three-quarters. This broad picture – with receipts being more depressed in cash terms, while spending pushed up more as a share of national income – relative to previous forecasts was also seen as a result of the 2008 financial crisis and associated recession.

4.3 Where would this leave the debt burden?

The 2019 Conservative general election manifesto made the promise that ‘debt will be lower at the end of the Parliament’ (Conservative Party, 2019, p. 7). Under March Budget plans, before the impact of the pandemic could be included in the forecasts, headline debt as a share of national income was already forecast to fall only very slowly. Moreover, this fall was entirely explained by the anticipated repayment of loans that had been made under the Bank of England’s Term Funding Scheme, which had been introduced to support the financial sector in the wake of the Brexit referendum. Excluding the impact of Bank of England interventions, and therefore focusing on the part of debt that is directly influenced by government policy,³ debt as a share of national income was already forecast to remain flat. In other words, it was already touch-and-go whether or not debt as a share of national income would be lower at the end of this parliament than at the start.

With this year’s huge spike in borrowing, the manifesto commitment to reduce debt over the parliament will be missed by a very wide margin. Figure 4.9 shows the forecast for public sector net debt under each of our scenarios compared with the March 2020 Budget forecast. Under our central scenario, following the sharp increase in debt between last year and this year, persistently large borrowing combined with ongoing weakness in the economy continues to push debt up as a share of national income, climbing above 110% of national income from 2023–24. Under our pessimistic scenario, debt rises further, climbing to almost 130% of national income in 2024–25. In contrast, under our optimistic scenario, debt remains around 100% of national income over the next few years. But even under

³ This strips out the oddity that the liabilities created by the Bank of England to finance its Term Funding Scheme count towards public sector net debt but the assets acquired by that funding – that is, the loans that were made – are not netted off.

Figure 4.9. Forecasts for headline debt under our three scenarios

Source: As for Figure 4.2.

this scenario, public sector net debt is forecast to be over 20% of national income higher in 2024-25 than was predicted in the March Budget, and more than 15% of national income higher than it was in 2018-19. Again, none of these scenarios allows for ongoing top-ups to the spending planned in March.

Whilst there is no particular reason to believe that the level of debt in 2018-19, or the level expected for the end of the medium-term forecast horizon back in March, was the ‘right’ one, it illustrates the sharp change in outlook for the public finances since then.

Drivers of higher forecast debt

The difference in the forecasts for debt as a share of national income in 2024-25 can essentially be split into three components:

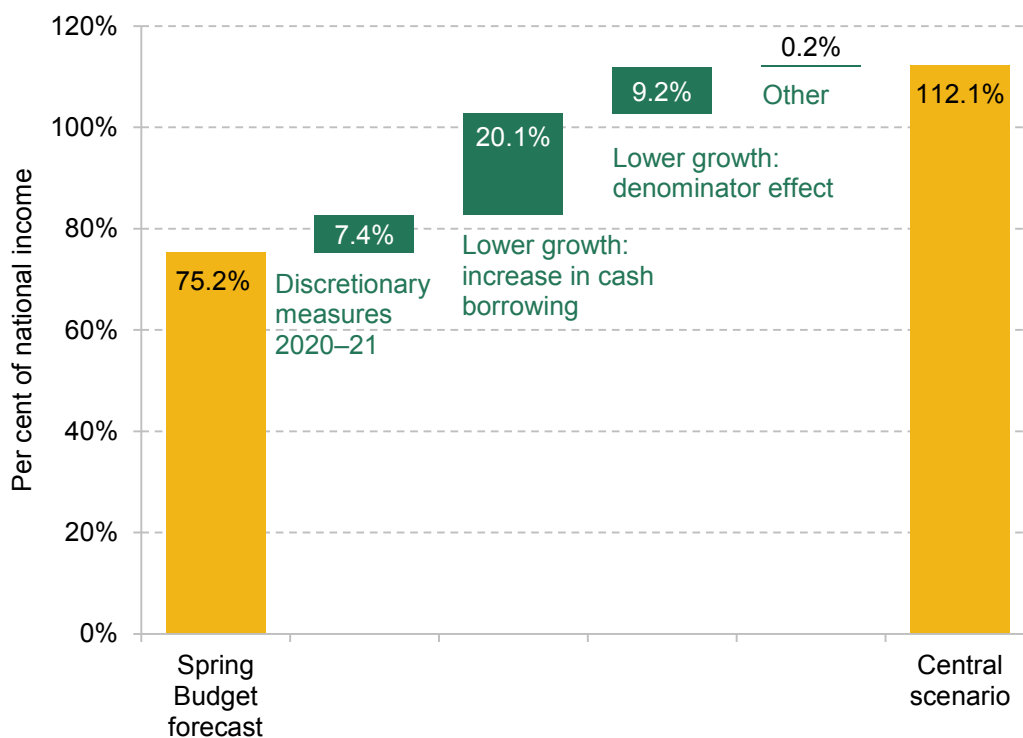
- the impact of **discretionary new measures** (assumed to be almost entirely in 2020-21, as per current government plans) pushing up cash borrowing over the period (by raising spending or cutting taxes in response to the crisis);

- the impact of **weaker growth** leading to higher cash borrowing over the period (because of higher spending through the existing social security system and, in particular, lower tax receipts from existing taxes); and
- the impact of weaker growth on the size of the economy (the **denominator effect**), meaning that the already-planned cash debt for 2024–25 will now represent a larger share of national income.

Figure 4.10 decomposes the difference in the forecast debt burden in 2024–25 between the March Budget and our central scenario into these three components.

The new discretionary measures, which push up borrowing in 2020–21, will have the direct impact of adding just over 7% of national income to public sector net debt in 2024–25, as shown in the figure.

Figure 4.10. Drivers of the higher debt burden in 2024–25 under our central scenario compared with the March Budget forecast



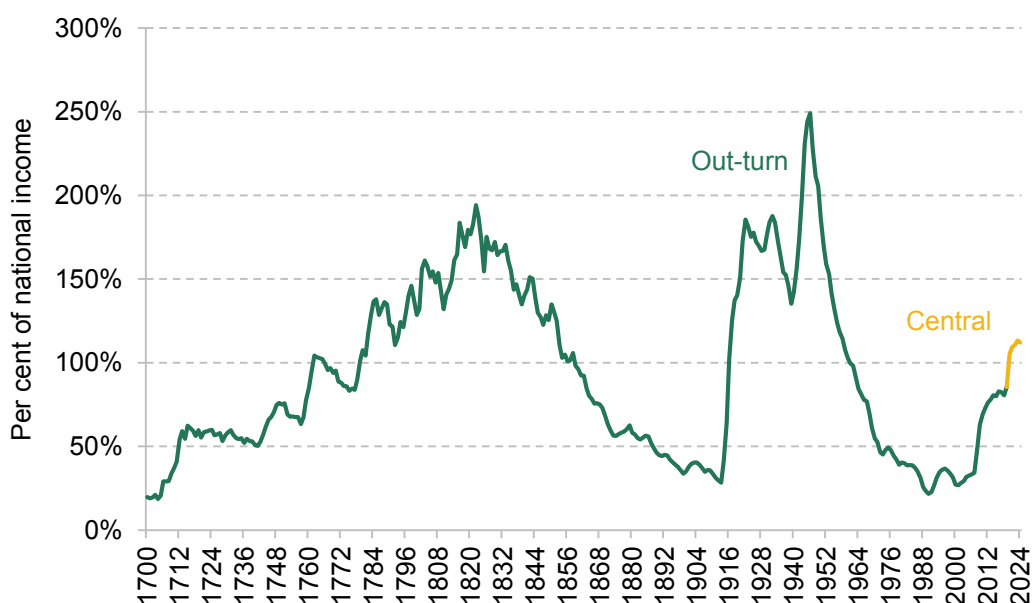
Source: As for Figure 4.2.

But a more important driver of higher debt as a share of national income is lower growth over this period. Figure 4.5 showed (in red) how the economic impact of the crisis led to higher forecast borrowing over the period from 2020–21 through to 2024–25. This has the direct impact of increasing public sector net debt by just over 20% of national income in 2024–25. In addition, the previously planned cash level of debt will represent a larger share of a now smaller national income. This ‘denominator effect’ adds 9% of national income to forecast debt in 2024–25. (Some other minor factors, including new Bank of England loans and reduced debt interest costs, almost exactly cancel one another out.) Overall, over three-quarters of the 30% of national income forecast increase in debt between 2018–19 and 2024–25 can be explained by weaker growth over this period.

How does forecast debt compare historically?

Together, these factors will push the debt burden up to a share of national income that was last seen in the UK 60 years ago. But taking a much longer view, this level is by no means unprecedented, as shown in Figure 4.11. The debt burden was even higher during the first half of the 19th century, in the inter-World-War period and during the Second World War.

Figure 4.11. Public sector debt in historical comparison



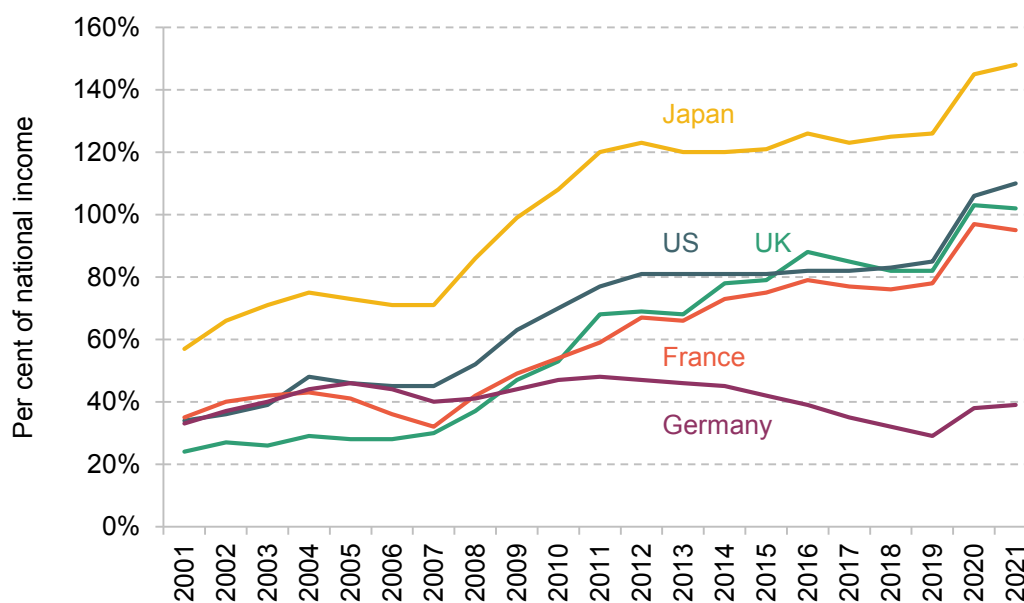
Note: Calendar year until 1920, then financial year ending March. Includes Ireland pre-1920.

Source: As for Figure 4.3.

How does debt compare with that in other countries?

Debt is also forecast to rise sharply in 2020 in France, Germany, Japan and the United States. A comparison of OECD forecasts is shown in Figure 4.12. This year's increase in debt comes after substantial increases in debt seen during the financial crisis, since when only Germany had seen a clear reduction in its ratio of debt to national income. As a result, 2020 is forecast to see debt rise to its highest level since the turn of the millennium in all these countries except Germany. On this internationally comparable measure of debt,⁴ the UK has similar levels of debt to France and the United States, with higher debt than Germany but substantially lower debt than Japan.

Figure 4.12. OECD forecasts for net financial liabilities as a share of national income in selected large economies



Note and source: As for Figure 4.4.

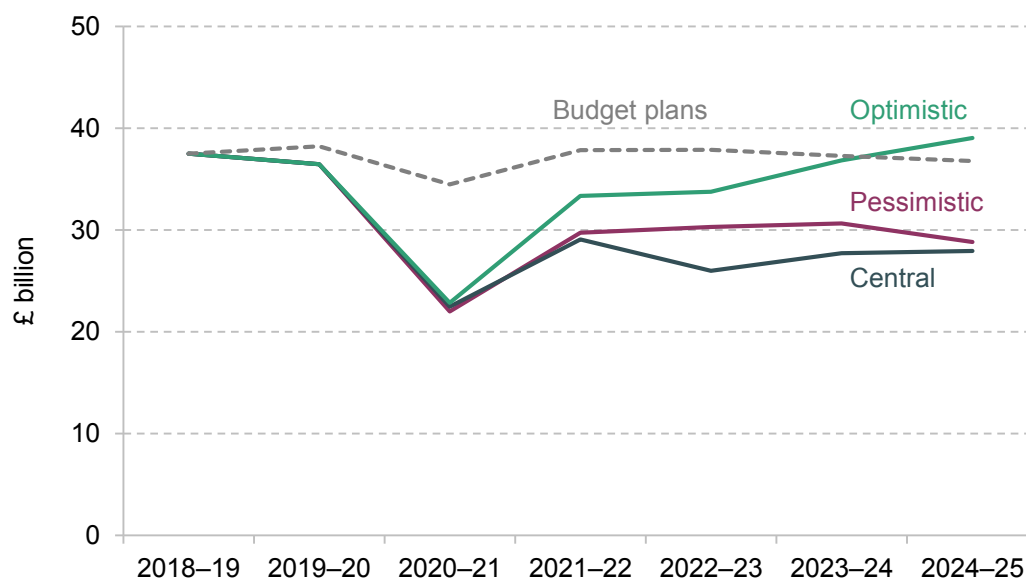
⁴ This measure is for general government (that is, central and local government), whereas the measure we use elsewhere in this chapter is for the whole of the UK public sector, including public sector corporations. The latter measure is preferable for its greater generality but harder to get on an internationally comparable basis.

4.4 The cost of servicing the UK's debt

If the debt burden has been this high and higher before, is it really a problem? One reason to be concerned about a high level of public debt is the cost of servicing it, which essentially means taxes are raised to pay interest charges rather than funding other priorities. But, as we will show, spending on debt interest has fallen to a record low and, despite the large increase in the stock of debt over the next five years, is forecast to fall further in all three scenarios, only reaching the previously forecast level by the end of the forecast period in the optimistic scenario. This is shown in Figure 4.13.

Low debt interest spending does not necessarily indicate healthy public finances. For example, debt interest spending is actually forecast to be higher under our optimistic scenario than in our central or pessimistic one. This is despite the much lower forecast for debt in the more optimistic of the three scenarios (as shown in Figure 4.9). In this optimistic scenario, the economy is deemed to be doing well enough for the Monetary Policy Committee of the Bank of England to begin to increase interest rates, putting some upward pressure on debt interest spending. In

Figure 4.13. Debt interest spending in three scenarios



Note: Debt interest spending net of income from the Asset Purchase Facility.

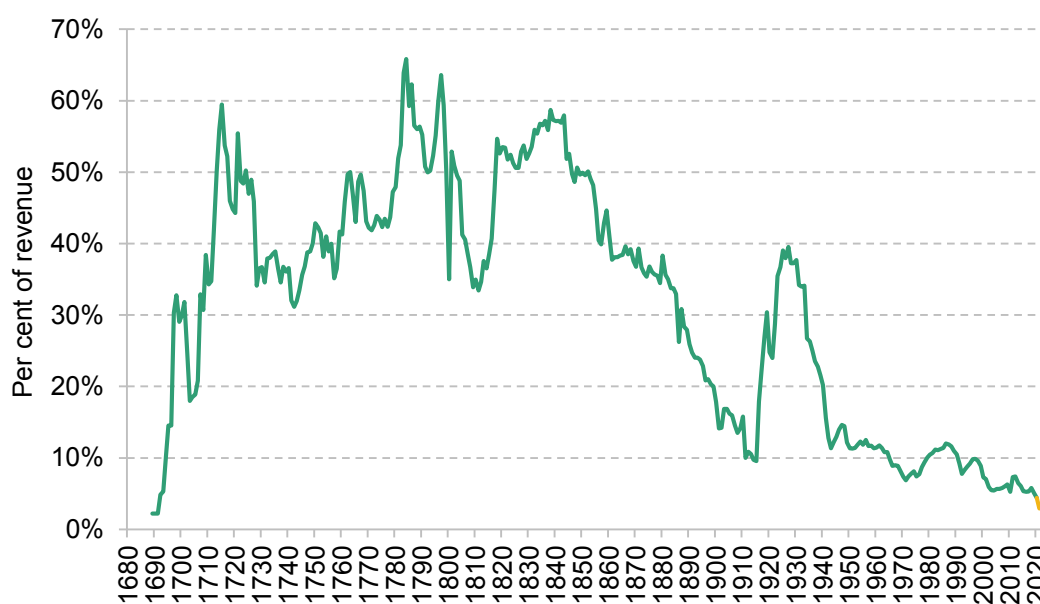
Source: As for Figure 4.2.

contrast, in the central scenario, the interest rate is reduced further in 2021, reaching negative territory in the third quarter, and the Bank purchases an additional £80 billion of gilts through its quantitative easing programme by mid 2022. Further discussion of the risks to debt interest spending is provided in Chapter 5.

How does forecast debt interest compare historically?

Debt interest spending in the very long run, relative to total government revenue, is shown in Figure 4.14.⁵ For the 20 years from 1997 to 2017, the low cost of servicing government debt relative to revenues has been virtually unprecedented historically, and since then it has fallen even further. As a result, in 320 years, debt interest has never claimed such a small share of revenues as it does at present. For much of our past, paying interest on the national debt required a large share of

Figure 4.14. Debt interest as a share of total revenue in historical comparison



Note: Financial year basis (breaks in the length of the financial year in 1751, 1800 and 1855).

Source: As for Figure 4.3.

⁵ Note that this measure is closely related to, but not exactly the same as, the one used in the government's stated fiscal target to reconsider its investment plans if debt interest payments rise above 6% of revenues. The latter uses the share of *non-interest* revenues.

government revenue (although it is worth noting that the size of the state was also much smaller, and so this amounts to a large share of a much smaller pie). The current low cost of servicing the UK public sector debt means that the high debt burden at present is much less worrying than it would have been at other points in history.

Scope for an additional giveaway?

The previous subsections have shown that debt interest spending is forecast to remain low due to a low cost of government borrowing and that the biggest driver of the increase in debt over the forecast period is the shortfall in economic activity as the UK economy recovers from the pandemic. This raises the question of whether additional giveaways in the short term could help secure a quicker or more complete recovery and therefore ‘pay for themselves’, leading to only a minimal cost, or even a net benefit, to the public finances.

The answer depends crucially on the size of the immediate boost to demand in the economy from the additional spending, the extent to which this fades over time as other activity is crowded out, and whether additional spending now can lead to a permanent increase in supply later on.

In ‘normal’ times, the OBR assumes that additional investment spending has a multiplier of 1 when it is first introduced.⁶ In other words, an additional £10 billion of investment spending – for example, building a new railway line – would generate an additional £10 billion of output. This additional activity would, in turn, generate some additional revenue. The multipliers for spending on day-to-day public services, social security payments and tax cuts are lower, generating £9 billion, £6 billion and £3¼ billion of additional output for every £10 billion of additional fiscal loosening, respectively. This is because some of the money spent (or not raised in taxes) will not boost the UK economy as some will instead either be saved or be spent on imports, thereby limiting the boost to the UK economy from additional consumption.

Crucially, these multiplier effects are assumed by the OBR to be temporary: after four years, prices (including exchange rates, interest rates and wages) adjust to the

⁶ Office for Budget Responsibility, 2019b, chart 2.B.

giveaways, leading to the additional spending crowding out some other economic activity and overall demand in the economy being no bigger than it would otherwise have been.

In this scenario, the case for a giveaway would be stronger if the additional spending is thought to have a more permanent effect by raising productivity, and therefore economic performance, in an enduring way. But achieving such effects is easier said than done and even a very effective boost to investment spending of, say, £10 billion could only have a limited impact on an economy that in 2019–20 generated an estimated £2.2 trillion of output.

These are far from normal times, though, and multipliers might differ from their usual size in both the short and the long term. For example, households that have suffered income drops in the last six months might be particularly likely to spend rather than save any tax cuts they receive. On the other hand, if people are very uncertain about the future, they may be more likely to save any additional income instead of spend it.

Perhaps most importantly, if the economy is undergoing a fundamental transition and its post-COVID, post-Brexit structure looks very different from its current structure, there could be greater long-term benefits from spending that successfully helps firms and workers adjust to this ‘new normal’. Examples could include helping firms whose business model relies heavily on European integration pivot to a different way of operating, investment that facilitates productive home working, or retraining for workers in declining sectors.

However, while pay-offs to well-chosen spending may be especially high in the middle of this big transition, these investments may also be riskier than usual. For example, it is not easy to predict what types of retraining would best help workers find a job once the economy has fully adjusted to both Brexit and COVID, and whether investment in faster rail links is going to be as productive as we once thought if widespread home working persists. Moreover, any desire to do investment spending quickly would likely clash with the goal of doing investment spending well: identifying, designing and delivering the right projects in the right way is always a challenge, and even more so if it also needs to be done quickly and in a period of much-heightened uncertainty.

The pandemic may also leave long-lasting scars on the economy by making people believe that further big negative shocks might come down the line. This type of scarring could make consumers more cautious and permanently hurt demand, which could be very costly for future growth (see Chapter 2 and Kozłowski, Veldkamp and Venkateswaran (2020)). Additional spending might make the experience of the pandemic less traumatic, reassure consumers that there is a safety net in place beyond their personal savings, and so reduce the instinct to save rather than spend. This could have a long-lasting pay-off for the economy as a whole. In addition, preserving jobs that will still be viable after the crisis – a clear aim of the government’s Coronavirus Job Retention Scheme and, to a lesser extent, the Job Support Scheme – could strengthen the recovery by avoiding the loss of investments in job-specific skills, training and the employer–employee relationship. However, these pay-offs, while potentially important, are also of uncertain scale.

4.5 The long-term outlook

We have seen that the sharp reduction in economic activity caused by the public health response to the coronavirus pandemic, and the fiscal measures implemented to support public services, households and employers, are causing a huge increase in borrowing in the current financial year. In the long run, this one-off increase in debt matters far less for the public finances than the scale of the economic recovery (or otherwise) and the ongoing policy choices that government makes about taxes and spending.

The debt burden over the next 40 years

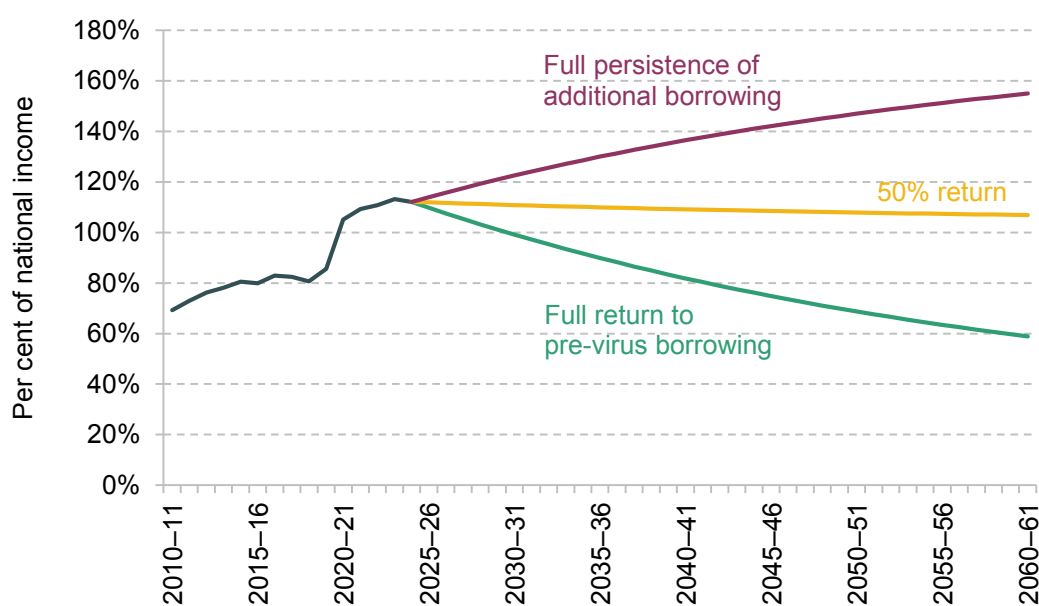
Figure 4.15 shows three potential long-run paths for the debt burden, all of which take as their starting point in 2025 the ‘central’ scenario from Section 4.3. The first debt path, shown in green, assumes that the pandemic only leads to borrowing being elevated temporarily and that any other spending increases (for example, to accommodate the public finance pressures of an ageing population, which we discuss later) or tax cuts are paid for by spending cuts or tax rises. In other words, the primary balance (borrowing excluding debt interest spending) as a share of national income in 2025–26 falls to the level forecast in the March 2020 Budget for 2024–25 and remains at that level thereafter.

Our central scenario from earlier already assumes that there is no more borrowing related to discretionary policy measures by 2025–26, but returning the primary

balance to March 2020 forecasts means also eliminating any extra borrowing due to ongoing economic weakness (which is shown in red, in the medium term, in Figure 4.5). This could either happen naturally (if the economic impacts of the pandemic have disappeared by 2025) or, more plausibly, be the result of tax rises / spending cuts implemented to offset fully the deterioration in the medium-term borrowing position seen since March.

If economic scarring persists at the level that the ‘central’ scenario predicts for 2024–25, that would require a tax rise or spending cut of 4.2% of national income. This is equivalent to £86 billion in today’s terms, and equivalent to, for example, cutting expenditure by around a tenth. For comparison, previous research at IFS has estimated that the fiscal consolidation implemented over the decade following the financial crisis totalled around 10% of national income or roughly £200 billion.⁷

Figure 4.15. Debt as a share of national income under different assumptions for a post-COVID tightening



Note: Long-term nominal growth (3.9%) from the 2020 Fiscal Sustainability Report. Effective interest rate assumed constant after 2025.

Source: Office for Budget Responsibility, ‘Fiscal sustainability report – July 2020’, <https://obr.uk/fsr/fiscal-sustainability-report-july-2020/> and authors’ calculations.

⁷ https://www.ifs.org.uk/tools_and_resources/fiscal_facts/fiscal-response-crisis.

Even if lingering consequences of the pandemic were either absent or compensated by additional fiscal tightening, keeping the primary balance at this low level would require absorbing (or finding a way to avoid) other pre-existing spending pressures – arising, for example, from Brexit⁸ and the ageing of the population – through tax increases or spending cuts.

We assume that effective interest rates in this scenario remain at the very low level currently forecast by the OBR for 2024–25. This means that, despite having to finance the one-off additional spike in debt taken on during the pandemic and in its immediate aftermath, the government does not spend more on debt interest over the next 40 years than had been forecast in March.

Put together, the reduction in debt interest spending and the large fiscal consolidation would put debt on a decisively downward path as a share of national income. Nevertheless, it would still take until 2040 to return the ratio of debt to national income to the pre-virus level of 80%, and it would not return to the much lower level seen before the financial crisis – where public sector net debt remained below 35% of national income over the decade up to 2007–08 – over the whole of the 40-year projection horizon.

There are, of course, many reasons why borrowing might not return to pre-virus plans. The likelihood of no persistent weakness in the economy is remote given that many will unfortunately experience unemployment, some otherwise viable businesses will fail, and the pre-COVID structure of the economy will need to adapt to any permanent shifts in working patterns and consumer behaviour. There will also be post-COVID pressures for additional public spending in areas such as the NHS (see Chapter 6), to deliver the government’s ‘levelling-up’ agenda (Chapter 7) and on working-age social security (see Chapter 8). The government may decide against implementing tax rises or spending cuts to maintain borrowing at its pre-pandemic forecast, and prefer instead to accommodate at least some of the additional borrowing. Finally, the government may want to accommodate long-

⁸ In addition to its expected indirect cost to the public finances, Brexit generated a (much more modest) direct fiscal saving from the reduction and eventual fading-out of the UK’s EU contributions under the Financial Settlement. This saving has already been ‘recycled’ into domestic spending under March Budget plans. Beyond the Budget horizon, remaining planned transactions (mainly relating to pension liabilities and the repayment of UK capital in the European Investment Bank) will have only a small impact on the public finances, amounting to less than £0.5 billion a year and further decreasing over time.

standing spending pressures that existed before the pandemic, in particular those related to the ageing of the population – a point we will return to later.

The other two debt paths in Figure 4.15 show two illustrative scenarios where borrowing does not return to pre-virus plans. In one, there is no fiscal consolidation beyond the end of the five-year forecast horizon, and additional borrowing is left unchecked (labelled ‘full persistence of additional borrowing’ and shown in purple). This leads to a rising debt burden over the whole 40-year projection horizon. A scenario such as this, where debt is allowed to increase continuously over this period even before allowing for any further adverse shocks, is unlikely to prove sustainable. And this is a scenario where interest rates are assumed to remain very low. Were investors – especially foreign investors, who most obviously have other options – to take the decisively upwards path of debt as a sign that the UK government was not serious about the prudent management of the public finances, they could demand a higher price (interest rate) for lending to it. This would push up debt interest spending and worsen the outlook for debt. Tax rises or spending cuts would almost certainly have to be implemented in response.

The other alternative scenario shown in Figure 4.15 is one in which half of the increase in borrowing seen since March is accommodated while half is offset with a combination of tax rises and spending cuts (labelled ‘50% return’ and shown in yellow). This would imply a fiscal tightening of 50% of the £86 billion required in the ‘full return to pre-virus borrowing’ scenario (2.1% of national income instead of 4.2%). Reflecting a compromise between a very strict and painful fiscal tightening, and a full accommodation of the forecast increase in borrowing since March, it is perhaps the most plausible of the three scenarios. Under this scenario, debt as a share of national income would broadly level off but it would not be on a decisively downwards path, even despite the assumption that interest rates remain very low throughout the next 40 years.

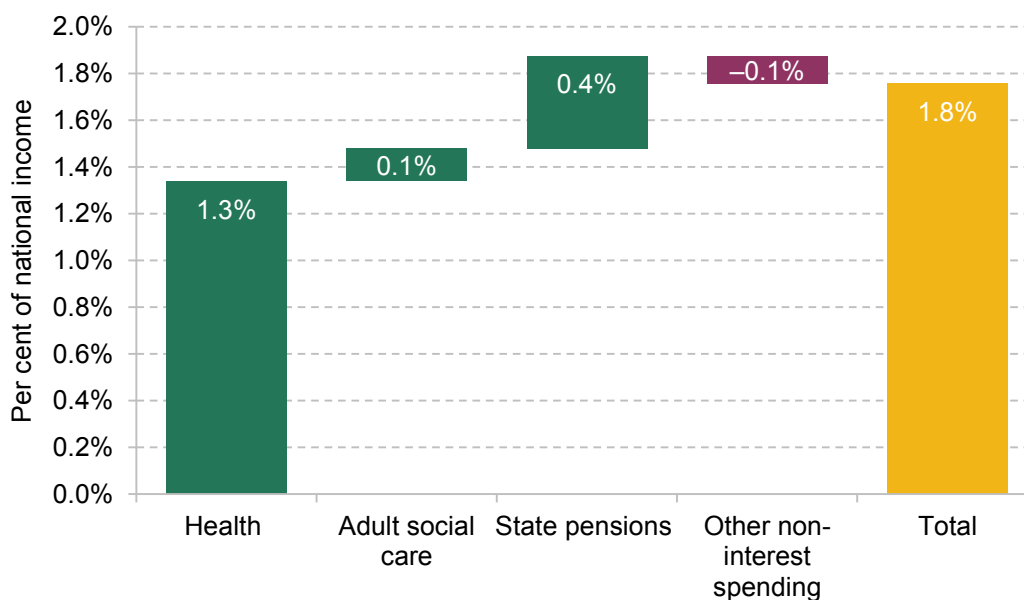
Projected public finance implications of an ageing population

Even if any longer-term post-COVID increase in public sector net borrowing is fully and immediately offset by tax increases or spending cuts, maintaining borrowing at this level over the long run would still be a challenge. In particular, the ageing of the population is projected to put upwards pressure on public spending, and if this is to be accommodated while holding borrowing down then a combination of cuts to spending in other areas and increases in tax will be needed.

Much of the projected growth in costs is related to the ageing of the population through rising life expectancy at older ages and reductions in the birth rate. In addition, the OBR's most recent long-term projection assumes lower immigration, which also contributes to population ageing since immigrants are younger than natives on average.

Since older people typically require more, and more expensive, health care and are also much heavier users of social care, population ageing is expected to drive up health and social care costs. In addition, there are non-demographic cost pressures. In particular, new medical technologies and drugs – while delivering many benefits – are often expensive, at least initially. On top of this, more people are being treated for chronic conditions (including diabetes and dementia), especially for multiple chronic conditions at once; this trend is expected to continue and drive up the cost of care. In contrast, scope for cost-saving innovations – in particular, any kind of automation reducing the need for labour inputs – has historically been limited in the health and social care sector, and so new cost-saving developments are not expected to offset these spending pressures (Johnson et al., 2018).

Figure 4.16. Projected per-decade spending increase in areas affected by an ageing population



Source: Office for Budget Responsibility, 'Fiscal sustainability report – July 2020', <https://obr.uk/fsr/fiscal-sustainability-report-july-2020/>.

The latest projections from the OBR's Fiscal Sustainability Report for the per-decade increase in cost in areas that are affected by population ageing over the next 50 years (which also include the non-demographic cost pressures in health and social care) are shown in Figure 4.16. Together, if ageing and cost pressures are accommodated (so that on top of non-demographic cost pressures in healthcare, age-adjusted spending per capita grows in line with per-capita national income), these pressures could see spending on health and social care rise by 1.5% of national income each decade. Of this, 1.3% of national income is from healthcare.

The other area where the ageing of the population is projected to increase spending substantially is state pensions. The OBR projects that spending will rise by an average of 0.4% of national income a decade over the next 50 years, despite increases in the state pension age over this period. One key driver of the increase in projected state pension spending is the 'triple lock', whereby each year the state pension is increased by the greatest of growth in earnings, growth in prices or 2.5%. This means that the value of the state pension 'ratchets up' over time, growing at least as fast as earnings each year and sometimes faster. Previously, the OBR has estimated that just over half of the projected increase in state pension spending as a share of national income is due to the triple lock⁹ and highlights that, at some point, the triple lock will need to be abandoned: it will not be possible over the very long run to increase the state pension more quickly than growth in average earnings.

Modestly offsetting the projected pressures for increased spending on health, social care and state pensions is a projected fall in spending in other areas. In particular, spending on education is projected to fall slightly due to a fall in pupil numbers. Overall, population ageing – and the cost pressures within the healthcare system – are projected by the OBR to add an average of 1.8% of national income to spending each decade over the next 50 years.

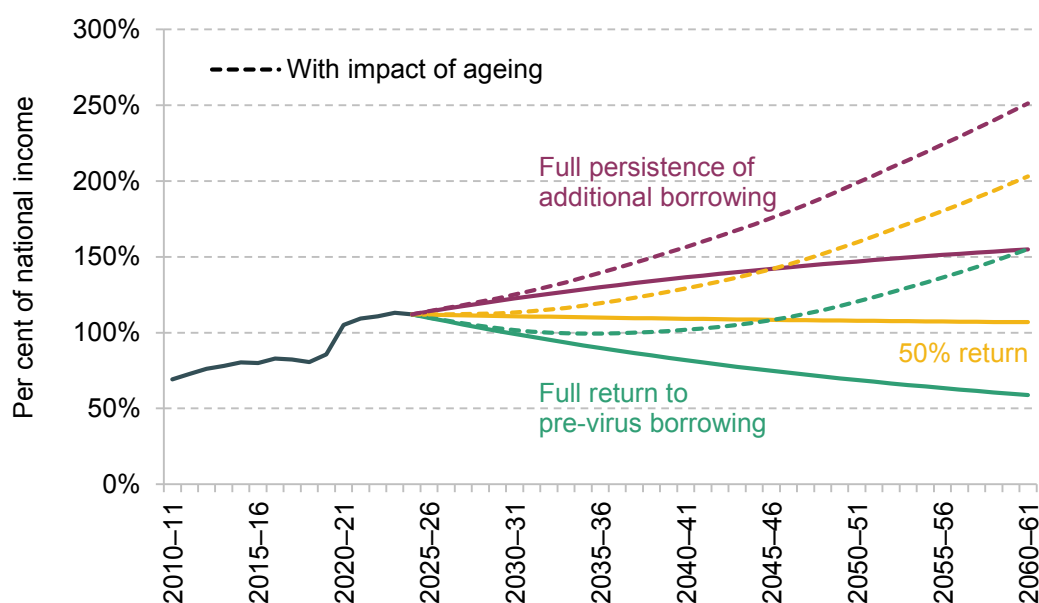
In Figure 4.17, we show the same three scenarios as in Figure 4.15 – a full return to pre-pandemic borrowing, a 50% return, and full persistence of additional borrowing. These are shown by the three solid lines. The three dotted lines then add on what would happen to debt were the projected increase in public spending in areas related to ageing to occur, and if this additional borrowing were accommodated through additional higher borrowing – in other words, if

⁹ Office for Budget Responsibility, 2018, chart 3.14, p. 83.

policymakers were to attempt to allow this increase in spending to occur and not offset it with spending cuts elsewhere or increased taxes. Even if lingering effects from the pandemic were fully compensated by tax rises or spending cuts, the spending pressures on health, social care and pensions would be enough to put the debt burden on a rising path (shown by the green dashed line). Essentially, this shows that population ageing meant that some combination of tax rises and spending cuts was required even prior to the pandemic. The economic weakness from the pandemic means that an even larger fiscal consolidation is needed if we do not want debt rising over the next 40 years – even with the benefit of the current ultra-low interest rates.

Table 4.2 shows the tightening required to return debt as a share of national income to 80%, approximately its pre-pandemic level, in 40 years' time. There is no particular reason to require debt to return to this level, so we also show scenarios under which debt would remain at 100% of national income. These make clear the potentially enormous scale of the challenge of putting debt on a decisively falling path. As in Figures 4.15 and 4.17, this assumes that the effective interest rate

Figure 4.17. Projected debt as a share of national income under different assumptions for a post-COVID tightening and accommodating the impact of ageing



Note and source: As for Figure 4.15.

Table 4.2. Fiscal tightening required to return debt to 80% or 100% of national income in 40 years

	Return to 80%		Return to 100%	
	In today's terms	As % of national income	In today's terms	As % of national income
Excluding the projected impact of pressures in areas affected by ageing				
Optimistic scenario	£6bn	0.3%	–£12bn	–0.6%
Central scenario	£67bn	3.3%	£49bn	2.4%
Pessimistic scenario	£111bn	5.6%	£94bn	4.7%
Including the projected impact of pressures in areas affected by ageing				
Optimistic scenario	£93bn	4.5%	£75bn	3.6%
Central scenario	£154bn	7.5%	£136bn	6.6%
Pessimistic scenario	£195bn	9.8%	£177bn	8.9%

Note and source: As for Figure 4.15.

remains at the low level we currently expect for the end of the medium-term projection in 2024–25, and that the economy grows in line with the OBR's long-run projection.

The large variation across scenarios once again illustrates the importance of the strength of the medium-term recovery and also the scale of the public finance challenge from an ageing population. The top panel of Table 4.2 ignores spending pressures in areas affected by ageing, while the bottom panel incorporates these spending pressures.

Ignoring ageing pressures and taking the optimistic scenario, the required consolidation of £6 billion – at 0.3% of national income – is modest. In contrast, in the pessimistic scenario, a very large consolidation of £111 billion would be required – almost 20 times as much as in the optimistic scenario. The numbers are also sensitive to the desired target level of debt: under our optimistic scenario, debt

could be kept at 100% of national income without any further fiscal consolidation. Under the central scenario, putting debt on a path to reach 80% of national income in 40 years would, excluding population ageing, require a tightening of £67 billion.

Allowing for projected spending pressures in areas affected by ageing adds considerably to these numbers. To put debt on a path to reach 80% of national income in 40 years' time would require a fiscal tightening of £154 billion under our central scenario. While it is much lower under our optimistic scenario, it is still close to £100 billion; under our pessimistic scenario, the required tightening is almost £200 billion. Even taking the optimistic scenario and settling for debt in 40 years' time to be 100% of national income would require a fiscal tightening of £75 billion.

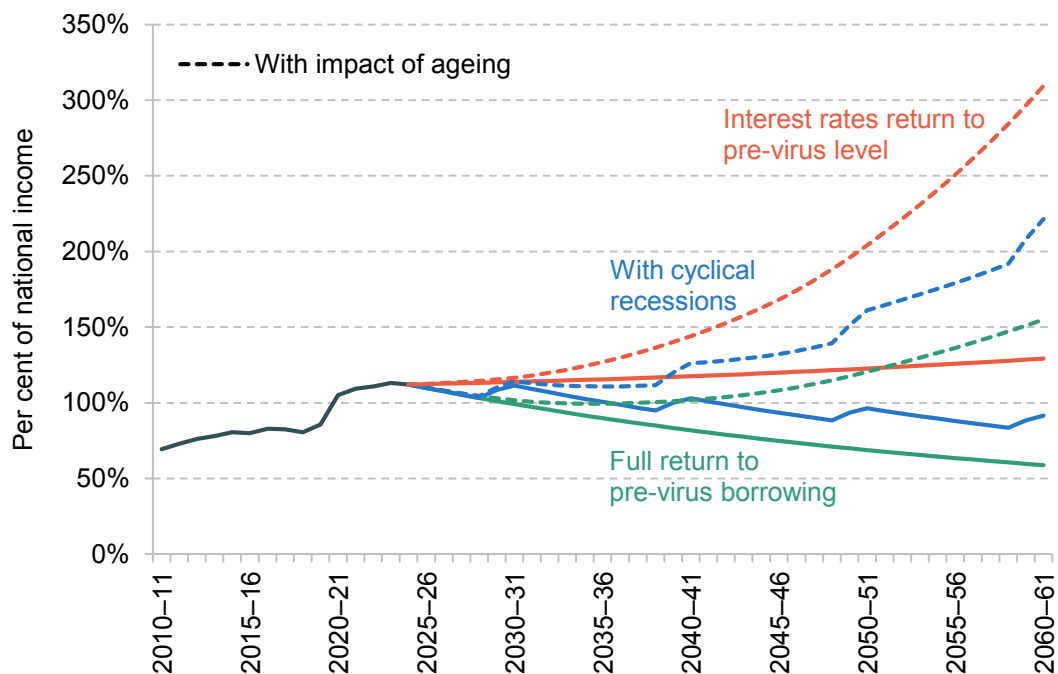
Risks around the long-run path of debt: how will growth and interest rates evolve?

Of course, in practice, public sector net debt will not follow the projected paths shown in Figure 4.17. The amount of borrowing the government does each year will not be a fixed share of the economy,¹⁰ the size of the existing debt stock as a share of national income will vary with fluctuations in the annual growth rate, and the amount spent on servicing that debt will change as interest rates change. Therefore, there are risks – to the upside as well as to the downside – around each of the projections shown in Figure 4.17. The assumptions made over the path of growth and interest rates (and specifically the relationship between the two) are particularly important when debt is elevated.

In Figure 4.18, we repeat the optimistic projection for the path of debt, shown in green in Figure 4.17, where borrowing is assumed to return in the medium term to that forecast in the March 2020 Budget – either without the projected costs of increased spending in areas affected by ageing (shown by the solid line) or with them included (as shown by the dotted line). We also present two alternative scenarios, both of which are less rosy about the future. In the first one, shown in blue, growth turns out lower (but interest rates stay at their same low level); in the second (shown in red), interest rates turn out higher (but growth is left unchanged).

¹⁰ Strictly, the primary deficit – that is, borrowing excluding spending on debt interest.

Figure 4.18. Risks to the projected path of debt even if borrowing returned to pre-pandemic path, accommodating the impact of ageing



Note: Primary balance returns to March Budget plans (0.78%) in every scenario and remains there ever after. Nominal growth 3.9%, except in recession years in the relevant scenario. Effective interest rate constant after 2025 at level expected in 'central' medium-term scenario, except in 'interest rates return' scenario.

Source: As for Figure 4.15.

In the first scenario, we assume that instead of growth following a smooth path, it is periodically interrupted with recessions. The OBR estimates that the chance of a cyclical recession in any five-year period is about one-in-two; therefore we assume that the next recession hits in 2029–30 and then one hits every decade thereafter. These stylised recessions see real output shrink by 1.7% in the first year and by 0.2% in the second, which is the average of the three cyclical recessions in the early 1980s, early 1990s and late 2000s. These recessions – which are not intended to illustrate financial crises or the current recession induced by the public health response to a pandemic – increase borrowing via the automatic stabilisers (lower tax revenues and higher working-age social security spending). However, there is no discretionary response (in either direction) from government. This means that the ratcheting-up of debt during these recessions is moderate compared with what occurred on average during the last three recessions (and especially so when compared with the recession following the financial crisis, which was associated

with very low inflation and hit relatively tax-rich parts of the economy especially hard). Much less optimistically, outside of recession years, the economy is assumed to grow at the same rate as in the baseline scenario, which is itself a weak growth performance.

Under these assumptions – and assuming that the public finance pressures of an ageing population do not add to borrowing – the reductions in debt in the ‘good’ years are still sufficient to reduce the debt burden over the very long run, but only at an extremely slow pace: even by the late 2050s, it would still not have returned to its pre-COVID level of 80%. But adding in the projected public finance pressures of an ageing population puts debt on a rising path.

The ‘cyclical recessions’ scenario presented above is in some respects relatively pessimistic about future growth as it assumes the long-run OBR growth rate in eight years of every decade but has a lower growth rate in the remaining two years when a recession hits. So essentially the scenario assumes a ‘bust’ without a ‘boom’. But our assumption of a ‘typical’ recession (in terms of the hit to growth) every decade might not be so pessimistic given that a clear lesson of the period since 2007 is that atypical, but very adverse, shocks will also periodically come along. After all, with the financial crisis and the COVID-19 pandemic, the UK public finances have seen two large shocks arrive within little more than a decade. The OBR suggests that a financial crisis might be expected to happen once every 50 years, while the last global pandemic was the Spanish Flu of 100 years ago. As we have shown, the financial crisis and the COVID-19 pandemic will have pushed public sector net debt up from around 35% of national income in 2007–08 to over 100% in 2020–21. There are few – perhaps no – plausible scenarios that could have a positive effect on the public finances of a similar magnitude, and at least some events that would have a large negative effect might now be expected to happen more frequently than in the past – for example, due to climate change or increased vulnerability to infectious diseases due to travel patterns and antimicrobial resistance.

The elevated level of debt compared with 2019, let alone with 2007, makes the public finances vulnerable to interest rate increases that are not accompanied by faster growth and higher tax revenues. To illustrate this, the final scenario in Figure 4.18 again assumes that borrowing (excluding interest spending) is returned to that forecast in March 2020 – with or without the projected spending pressures in areas affected by ageing adding to borrowing – and that growth follows the latest OBR projections, but now assumes that the effective interest rate on government

borrowing also returns to its pre-virus forecast for 2024–25 (as set out at the Budget in March 2020) and that it remains at this (still historically very low) level for the next 40 years.

Under this scenario, and despite the fact that interest rates would still remain extremely low by historical standards (and much lower than the level they are assumed to reach by the OBR in its Fiscal Sustainability Report), debt would not be on a falling path even if we exclude any possible increase in borrowing arising from an ageing population.

This highlights the vulnerability of the public finances to even modest increases in interest rates that are not associated with stronger economic growth. Under this scenario, the stock of additional debt accumulated during the current crisis (and the interest that would need to be paid on it) would mean that overall public sector net debt would rise over the next 40 years even if borrowing beyond 2024–25 were held at the level forecast in the March 2020 Budget for 2024–25.

While the increase in effective interest rates on government borrowing in this scenario is large in absolute terms – they are assumed to rise from 1.0% a year to 1.8% – they would still be low by historical standards. Moreover, with the economy assumed to be growing in nominal terms by 3.9% per year, the relationship between growth and interest rates is very favourable to the public finances by historical standards (the interest-rate–growth differential ‘ $r-g$ ’ is much more negative than has usually been the case in the UK¹¹). In contrast, the OBR assumes that this relationship returns to its long-run average such that effective interest rates rise to 4.1% (‘ $r-g$ ’ rises to +0.2). As a result, the projected debt paths in the OBR’s July 2020 Fiscal Sustainability Report (chart 4.5) are more explosive than those shown in Figure 4.18. Such an interest rate rise is by no means implausible, though it would be much higher than is implied by the current long-run interest rates on government borrowing; this fact underpins the recommendation that we make in Chapter 5 that a much higher proportion of gilt issuance over the next few years is done on a long-term basis.

Figure 4.18 also reiterates the point made in Figure 4.17 that the spending pressures associated with an ageing society make the challenge of keeping debt on a

¹¹ Office for Budget Responsibility, 2019a, chart 7.6, p. 209.

sustainable path much greater. If these spending pressures were accommodated through higher borrowing and interest rates rose modestly (the dotted-line version of the last scenario), debt would be projected to rise to over three times national income by 2060.

There is no ‘magic’ ratio of debt to national income where the debt burden suddenly becomes unsustainable. However, none of the major UK political parties has suggested purposefully placing debt on what would be projected to be an ever-increasing path (at least for the next 40 years) and that would certainly be a risky strategy.

While there is currently spare capacity in the economy, this can patently not be true forever, and inflationary pressures will eventually return. At that point, interest rates will have to rise if the central bank remains committed to its inflation target. If we instead follow the prescriptions of Modern Monetary Theory and engage in monetary financing, that framework still prescribes tax rises (or spending cuts) to siphon off excess demand from the economy and bring inflation under control once spare capacity is exhausted. So either way, we would see a fiscal tightening – and a rise in interest rates – once spare capacity in the economy was eliminated.

The government could be forced to embark on such a consolidation in a sudden and disorderly way if inflation and interest rates rise. Trust in the monetary and fiscal institutions could be damaged, and difficult to rebuild. Consolidation might therefore be more efficient and less painful if its size and timing are planned, rather than forced by events.

The amount of fiscal tightening necessary to stabilise the debt burden, or bring it back down to benchmark levels, will hinge on what happens to growth and interest rates. With a less favourable relationship between the two, fiscal sustainability will be harder to achieve; a more favourable relationship would make it much easier. This is discussed in more detail in Chapter 5.

How has the UK reduced a high debt burden in the past?

At a basic level, reducing a high debt burden over time requires the stock of debt to grow less quickly than the economy. One way to reduce debt is to increase taxes or cut spending in order to reduce borrowing, and therefore the growth in the debt stock. Another is to have higher growth. Growth in real output can always fulfil this

role, and surprise inflation (which is not priced in to interest rates) will also reduce debt as a share of national income if debt is issued in nominal terms.¹²

Between 1815 and the end of the 19th century, the government ran a fiscal surplus in three out of every five years (as was shown in Figure 4.3), and any borrowing was typically modest in size, allowing debt over this period to be paid down (Ellison and Scott, 2017). This was seen in the fall in debt as a share of national income over most of the 19th century that was shown in Figure 4.11.

In the 20th century, the relationship between interest rates and growth mattered more for the trajectory of debt than fiscal strategy. After the First World War, the government ran large surpluses, but was nevertheless unable to reduce debt substantially as a share of national income during an unpleasant period of deflation. Following the Second World War, on the other hand, debt fell rapidly as a share of national income mainly as nominal growth was high and interest rates were low. High nominal growth was in part due to inflation unexpectedly being much greater than it had been in the past. Alongside this, the institutional and policy environment was designed to keep interest rates low: for much of this period, interest rates were set with at least one eye on the management of the national debt rather than achieving an inflation target. In addition, capital controls prevented investors choosing alternatives elsewhere (Crafts, 2016).

How have other advanced economies reduced public debt in the recent past?

These episodes of debt reduction in the UK are now fairly distant, but we can also consider more recent episodes of substantial consolidation in other advanced countries. Figure 4.19 shows 10 advanced economies that have reduced their debt-to-GDP ratio by 10% of national income or more over a decade, since 1980. Table 4.3 gives selected fiscal and economic indicators for these countries. Clearly, the circumstances these countries were in enabled a number of different strategies to achieve this reduction in the debt burden.

¹² The fact that the UK has a relatively high share of index-linked gilts makes this less of an option than for other countries – or indeed than it was in the UK prior to 1980. See Chapter 5.

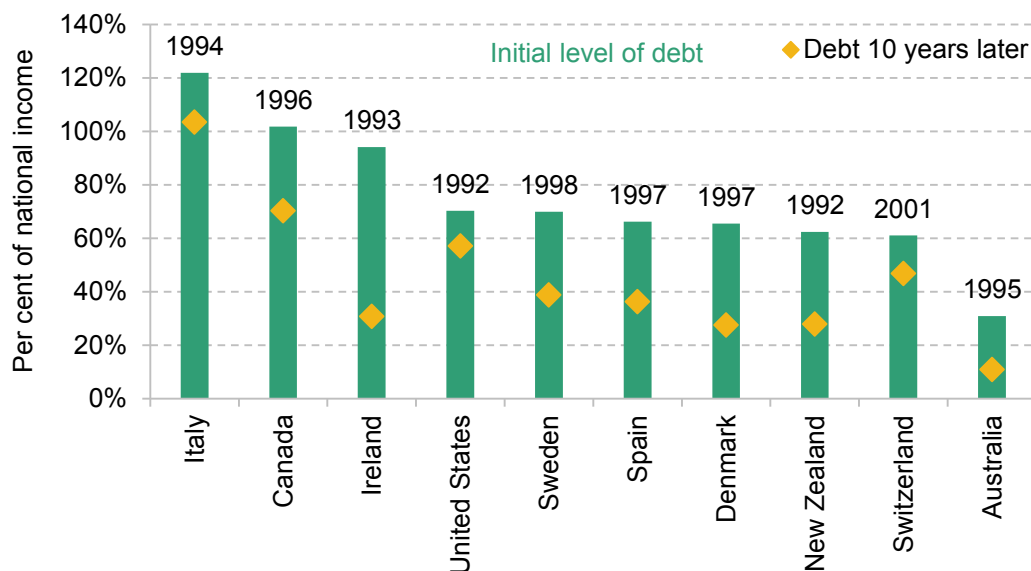
Table 4.3. Selected fiscal and economic indicators (as a % of national income unless otherwise stated) for countries that reduced debt

	Change		Average		
	Revenue	Primary spending	Interest spending	Growth rate (%)	Inflation (%)
Italy 1994–2004	–0.4	0.6	4.8	1.7	3.0
Canada 1996–2006	–3.0	–2.5	4.3	3.3	1.9
Ireland 1993–2003	–8.4	–6.1	1.2	7.5	4.5
United States 1992–2002	–0.8	–2.1	2.8	3.2	1.9
Sweden 1998–2008	–5.8	–4.2	1.6	3.2	1.6
Spain 1997–2007	3.5	0.6	1.6	3.8	3.5
Denmark 1997–2007	–0.5	–2.4	1.6	2.1	2.2
New Zealand 1992–2002	–6.1	–9.5	1.8	3.5	1.7
Switzerland 2001–2011	–0.8	–0.1	0.4	1.7	1.0
Australia 1995–2005	1.8	–0.3	1.4	3.8	2.6

Note: ‘Interest spending’ is interest paid on public debt. ‘Growth rate’ is the real GDP growth rate in %. Countries are listed in order of initial debt burden.

Source: IMF Global Debt Database.

Figure 4.19. Selected international examples of recent substantial reductions in debt as a share of national income



Note: Debt is gross public debt.

Source: IMF Global Debt Database.

Ireland, New Zealand and Sweden all cut spending substantially. However, in Sweden, even after these cuts, government expenditure excluding debt interest still exceeded 50% of national income, so the initially high level of spending might have made it relatively easy to cut spending so substantially. Only two countries out of our 10 examples (Spain and Australia) increased the share of national income that they raised in taxes and other government revenue.

Ireland in particular stands out as having been able to slash its debt-to-GDP ratio relatively easily thanks to a period of extremely high economic growth (averaging 7.5% a year in real terms) alongside high inflation (averaging 4.5% a year). In part, this strong growth was made possible by Ireland having relatively low national income to start with; it was also boosted by favourable demographics and increasing female labour supply, and by relatively strong growth over the period 1993 to 2003 in the neighbouring UK (with which Ireland does much trade). It is clear that this does not provide a feasible blueprint for the UK to copy in the 2020s or beyond. But growth at more modest, but still healthy, levels can also contribute to outgrowing a high debt burden: six of the other countries that we consider also grew at more than 3% a year in real terms on average over the period.

The burden of financing the debt was also very different between countries: Switzerland spent less than ½% of national income on interest on average, whilst Italy, which started with a much higher initial debt burden and faced higher interest rates, had to spend almost 5% of its national income on servicing its debt.

4.6 Conclusion: a new fiscal strategy?

It is abundantly clear that the Conservative Party's manifesto commitment to reduce debt as a share of national income over the current parliament will be missed by a wide margin. Its other fiscal targets are also already in tatters. Investment spending this year will breach the government's 3% of national income cap, due to depressed national income and the new business loans scoring as investment spending, while the current budget – that is, borrowing which is not explained by that used to finance investment spending – will not be forecast to be in surplus in three years' time. Abandoning these commitments would therefore merely be a matter of recognising reality. No fiscal target will be appropriate in every situation. And any fiscal target set in 2019 with the intention of playing a useful role in tying the hands of policymakers would be unlikely to have survived 2020 intact.

The public finance forecasts presented in this chapter show that, under all three scenarios that we consider, borrowing will this year reach the highest level seen in the UK since at least 1700, outside of the two world wars. Under current policy, with the temporary measures put in place in response to COVID-19 largely set to expire in or before April 2021, borrowing will fall between this year and next. But it will then remain elevated for several years to come. What is really not certain is how elevated it will be. Under our central scenario, borrowing in 2024–25 is forecast to be £151 billion, compared with a March 2020 Budget forecast of £58 billion. In our optimistic scenario this falls to £91 billion, while in our pessimistic scenario it rises to £201 billion. It could easily fall outside of this range.

Public sector net debt has already risen above 100% of national income in August 2020, up from 80% in 2018–19 (and from 35% in 2007–08). Over the next few years, under our central scenario it is forecast to rise to over 110% of national income, under our optimistic scenario it remains around 100% of national income, while under our pessimistic scenario it rises further to almost 130% of national income.

To say that there is now huge uncertainty over the likely evolution of the economy and the public finances is an understatement. The evolution of the virus, and our ability to contain it, will be an important factor in the degree to which the economy can make a swift and full recovery. But with rising unemployment, some otherwise viable businesses failing, and seemingly likely permanent large changes in ways of working and consumer preferences, it will be many years before the economy will be as productive as it would have been had the virus not hit (if ever). The harder question is quantifying how full or, on the flip side, how incomplete the recovery will be. There is also considerable uncertainty over what the UK's trading relationship with the EU – our nearest trading partner, and one of our richest ones – will be in less than three months' time. The size and scope of tariff and non-tariff barriers between the UK and the EU from January 2021 will be an important determinant of how economically damaging Brexit turns out to be.

This uncertainty means that now really is not the time to announce yet more new fiscal targets or set out a detailed fiscal consolidation strategy to reduce borrowing in response to much-elevated government debt. Both should follow in time. But in both areas, decisions should be left until the Autumn 2021 Budget at the earliest.

Instead, in the Spring 2021 Budget – or perhaps even sooner than that – the Chancellor ought to set out the broad economic strategy he intends to follow. A key part of this strategy should be ensuring confidence in the policymaking process. One key pillar is the Office for Budget Responsibility. Mr Sunak should recommit to its independence and to the important role it plays in scrutinising the public finances. Should further sizeable fiscal events be necessary, the OBR should be asked to interrogate the costing of policy measures while they are in preparation. This unfortunately did not happen before the Chancellor's substantial July 2020 Summer Economic Update, which contained measures that the OBR subsequently costed at £50 billion in 2020–21; and neither did it happen with the Chancellor's Winter Economic Plan which was released without even Treasury costings, let alone costings that had been scrutinised by the OBR.

Currently, the government can borrow at exceptionally low interest rates – as highlighted by the fact that forecast debt interest has fallen since March despite forecast government borrowing being much higher. This means that we should be willing to borrow to fund further measures if they are temporary and if we are confident that they can secure a more complete economic recovery.

The Chancellor will also need to make decisions over whether any of the temporary measures put in place since the pandemic should be extended in some form. While perhaps most attention has been focused on the Coronavirus Job Retention Scheme and its replacement with the Job Support Scheme, there are also decisions to be made on measures such as the additional support for local authorities and the temporary boost to working-age benefits. The latter – which is discussed in detail in Chapter 8 – cost £9 billion in 2020–21 and, while it could be allowed to expire, this would leave many low-income families seeing a sizeable fall in their income between March and April 2021. The Chancellor will also need to set departmental spending plans for at least 2021–22, which will involve many tricky decisions not least over what the NHS budget should be. So spending in 2021–22, and beyond, could easily be higher than the scenarios in this chapter assume.

Until there is more certainty about the scale of consolidation required, it would not be appropriate to start announcing the size, timing or nature of future tax rises (let alone to start implementing them anytime soon, given current weakness in the economy). However, Mr Sunak should champion a more general recognition that, once the economy has been restored to health, a fiscal tightening will follow.

At that point, the government will face unattractive choices over a combination of spending squeezes and tax increases. Spending cuts are one option. But with many public services already showing signs of strain after a decade of cuts (Chapter 6) and the working-age benefit system made considerably less generous by reforms implemented during the 2010s, it is not clear whether further cuts would be acceptable to voters or consistent with the government’s stated objectives. This suggests that tax rises are likely. If so, another key part of the appropriate fiscal strategy will be to ensure that these are well designed so that they do not do more economic harm than is absolutely necessary.

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