

The outlook for the public finances under the long shadow of COVID-19

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1. Introduction

It is clear that the COVID-19 outbreak – and the public health response to it – will dramatically reduce economic activity in the second quarter of 2020. This in turn will depress tax receipts and add to government spending, increasing government borrowing and in turn adding to government debt. The package that, appropriately, the government has announced to help support public services, households and employers will also have the direct impact of increasing borrowing. A key issue is how quickly – and how fully – the economy, and with it the public finances, recover over subsequent years.

This report sets out three scenarios for the outlook for growth over the next five years (Section 2) and describes what in turn these might mean for government borrowing (Section 3) and government debt (Section 4). Finally, in Section 5, we provide some guide to the appropriate fiscal policy response in the short-term, where essentially additional borrowing that will boost subsequent growth is likely to be beneficial given very low interest rates, and in the longer term, where a combination of tax rises and accommodating an elevated level of debt for decades is, perhaps, the most likely outcome.

2. Three scenarios for how the economy might evolve

Data in recent weeks have confirmed the sharpest and deepest economic downturn in a century. Output has fallen to just under 75% of normal levels in April – equivalent to the loss of 18 years of growth in just two months. For Q2 we now expect GDP to fall by 20% quarter on quarter – a little better than the 25% or 35% falls that had been expected by the Bank of England and the Office for Budget Responsibility (OBR), but still by far the largest drop on record. With current government plans indicating a gradual easing of restrictions over the coming months, the key question now is what shape the recovery likely will take. This depends first on what economic ‘normality’ may look like after COVID and second on how quickly households and businesses, and with them the economy, return to ‘normal’.

We have produced three illustrative macroeconomic scenarios, utilising Citi’s models, but which deviate from Citi’s own current central scenario in a few key respects.

The ‘central’ scenario reflects a gradual recovery to an economy that, structurally, appears rather different from that which entered the crisis. Whereas both the Bank of England and the OBR assume a relatively rapid return to pre-COVID ‘normality’, this scenario can instead be thought of as a potential path if more lasting adjustments prove necessary. The risk of this is relatively high. The combined impact of COVID-19, associated changes in household preferences and Brexit increases the risk that the recovery requires not only a rebound in demand but also the restructuring of supply.² This could lead to a slower recovery and lower longer-term trajectory for UK output. Compared with Citi’s own

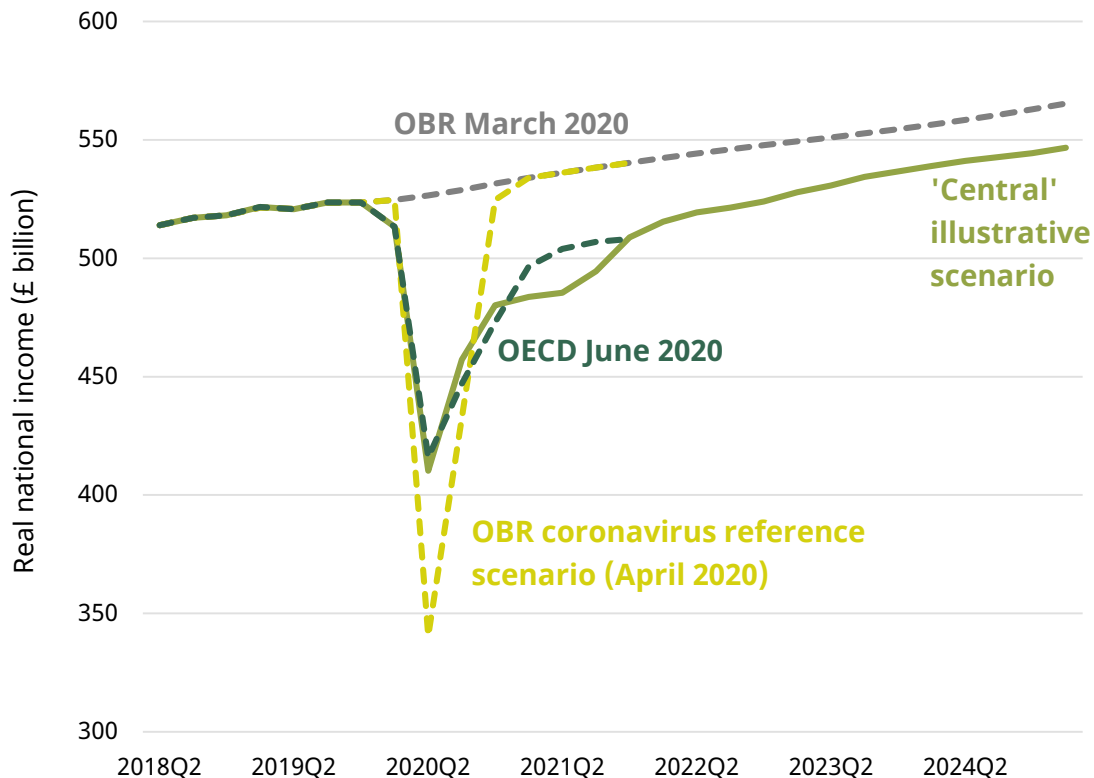
¹ Funding for Emmerson and Stockton was provided by the ESRC-funded Centre for the Microeconomic Analysis of Public Policy (ES/M010147/1).

² See J. Kozłowski, L. Veldkamp and V. Venkateswaran, ‘Scarring body and mind: the long-term belief-scarring effects of Covid-19’, *Covid Economics: Vetted and Real-Time Papers*, 2020, 8, 1–26, <https://cepr.org/sites/default/files/news/CovidEconomics8.pdf>.

current forecasts, this illustrative scenario does not allow for any additional fiscal easing later in 2020 as the purpose of this exercise is to examine the outlook for the public finances under current stated government policy. In this scenario, we continue to assume the UK leaves the EU with a rudimentary deal by the end of 2020. This also necessitates additional structural economic adjustments, weighing on growth.

A slower recovery, in this scenario, is primarily driven by a weaker outlook for household consumption. Households are the primary beneficiaries of relatively generous levels of income support through the crisis. A key question for the recovery is whether households feel confident to lever stronger balance sheets later as compulsory saving is unwound (returning to shopping at a similar scale and with a similar composition to that before the crisis) or whether unease lingers. This scenario assumes persistent increases in precautionary saving associated with, first, lingering virus concerns and, second, persistent increases in unemployment. The latter reflects the impact of continued social distancing in some sectors, while changes in household preferences away from consumer services also incentivise a reallocation of workers across sectors. This would result in more persistent increases in unemployment – weighing on household sentiment and pushing precautionary savings yet higher. This scenario has GDP falling by 10.9% in 2020 and growing by 6.0% in 2021. Further monetary easing (including further cuts to Bank Rate) would be likely.

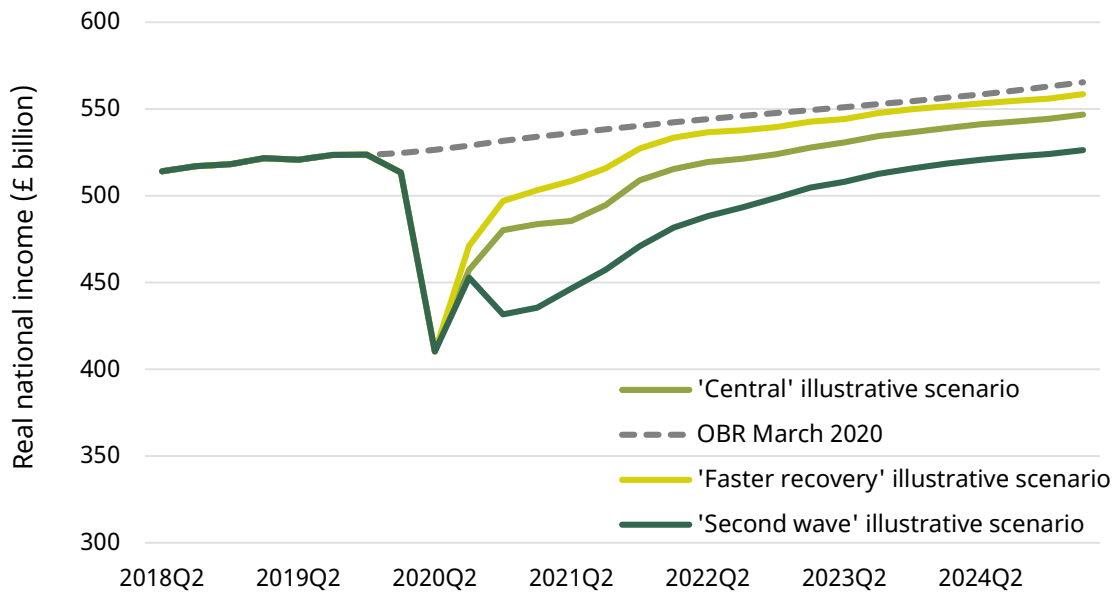
Figure 1. Quarterly GDP under a ‘central’ illustrative scenario, the OBR’s pre-COVID forecast, and post-COVID forecasts from the OBR and OECD



Note: Chained volume measures shown. OBR scenario is taken from OBR coronavirus reference scenario published 14 April. The OECD is taken from the June World Economic Outlook.

Source: OBR, OECD, Office for National Statistics, Institute for Fiscal Studies and Citi Research.

Figure 2. Three alternative illustrative scenarios for the UK economy



Note: Chained volume measures shown.

Source: OBR, Office for National Statistics, Institute for Fiscal Studies and Citi Research.

Clearly this is not the only possible course. In addition to our base scenario, we have also specified a more optimistic illustrative scenario. This has unemployment still increasing in the second quarter of 2020, but then falling back relatively sharply. In this scenario, relatively subdued virus fears mean there is little virus-related precautionary saving, and household demand also returns to a similar composition to that at the end of 2019. All of this implies a stronger rebound in consumption, as well as a more limited structural reconfiguration. In this scenario, output would fall by 9.5% in 2020 but then rebound by 8.6% in 2021. Compared with the Bank of England and OBR, a slightly weaker rebound in 2021 is partially the result of the impact of the transition to a new EU-UK trading relationship. Otherwise, this 'faster recovery' scenario is somewhat closer to both respective illustrative scenarios.

Lastly, we include an illustrative scenario that includes a severe resurgence of the virus in the last quarter of 2020. In this scenario, we assume critical care capacity risks becoming overwhelmed and strict social distancing measures are subsequently reimposed. Rather than a repeat of the national lockdown in Q1, the specified scenario includes a more targeted set of regional measures. Alongside learning from the experience during the first outbreak, we think this means output would not fall to the same lows observed in April. These measures would, however, likely have to remain in place for longer as a larger reduction in new cases would likely be necessary. With balance sheets already weakened by the first outbreak, we think this would likely result in a greater increase in firm bankruptcies and an associated tightening in credit conditions. Household sentiment would also likely remain weaker for longer – weighing on the recovery. In this 'second wave' scenario, GDP would fall by 13.5% in 2020, with growth limited to 0.1% in 2021. Further monetary policy support would be likely here – given the costs imposed on the financial sector, we suspect this would be limited to additional asset purchases. The scenario also assumes that the Coronavirus Job Retention Scheme and the Self-Employment Income Support Scheme are reintroduced, providing more support to households and also adding further to government borrowing in 2020-21 (see below).

3. How might public sector net borrowing evolve under these scenarios for the economy?

The considerably weaker economic performance set out in the scenarios above would adversely affect the public finances for the remainder of the parliament. Tax revenues would be depressed as incomes, profits and spending were all lower than they would otherwise have been. Rising unemployment and reduced earnings would also push up spending on universal credit. In addition, the cash budgets of departments delivering and administering public services would represent a greater share of a lower national income.

This will be particularly true in the current year – where economic activity is clearly going to be extremely depressed and where cash budgets for departments were set in advance of the crisis. Going forwards, it will be less true as the economy recovers and, potentially, if cash spending plans are adjusted down in the light of reduced national income. But for as long as weakness in the economy relative to pre-COVID-19 plans continues, government borrowing will continue to be elevated. This is really the key issue for the UK public finances – not the extent to which there is a one-off sharp increase in borrowing during a period when interest rates are very low, but rather the extent to which borrowing is increased for a prolonged period.

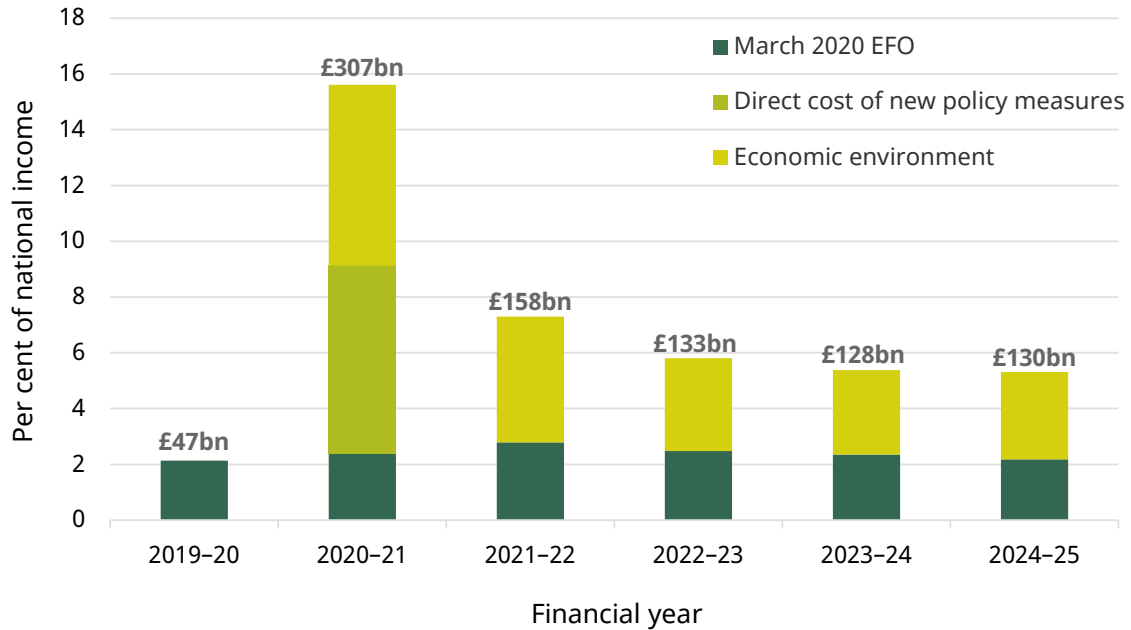
The fiscal policy measures that the government has announced since the Budget – in order to support public services, household incomes and businesses through the COVID-19 crisis – would also have the direct impact of reducing tax revenues and increasing public spending. Our ‘central’ scenario only includes policy measures announced so far and otherwise assumes that government tax and spending policies remain as currently stated. In practice, it is quite likely that, for example, some elements of the increased generosity to working-age benefits and support for public services that have been announced and implemented since the COVID-19 outbreak will be extended, which would further increase spending beyond 2020–21.

These effects are offset partially, but only very partially, by reduced spending on debt interest, which arises due to lower RPI inflation, lower interest rates and an expansion in the programme of quantitative easing.

Of course, quantifying these effects with any precision is difficult. The actual path of the economy – and what impact the economy will have on the public finances – is always uncertain, and this will be particularly so in the current climate. A projection for borrowing under our ‘central’ scenario set out above is presented in Figure 3. This shows projected borrowing as a share of national income over the period to 2024–25 decomposed into three parts:

- borrowing that was already forecast by the OBR at the time of the March 2020 Budget, which suggested that borrowing would remain relatively flat as a share of national income over the next five years;
- the direct cost of the fiscal policy measures – estimated by the OBR on 4 June at just over £130 billion – announced since the Budget, most notably including the Coronavirus Job Retention Scheme which has an estimated cost of £60 billion;

Figure 3. Projected public sector net borrowing under our ‘central’ illustrative scenario



Source: Office for Budget Responsibility, Economic and Fiscal Outlook (EFO), March 2020 and coronavirus policy monitoring database, version 4 June 2020; Institute for Fiscal Studies; Citi Research.

- the additional impact of a weaker economy pushing up government borrowing. This is calculated by scaling the impact of reduced economic activity on increased forecast borrowing from the recent OBR coronavirus reference scenario.³

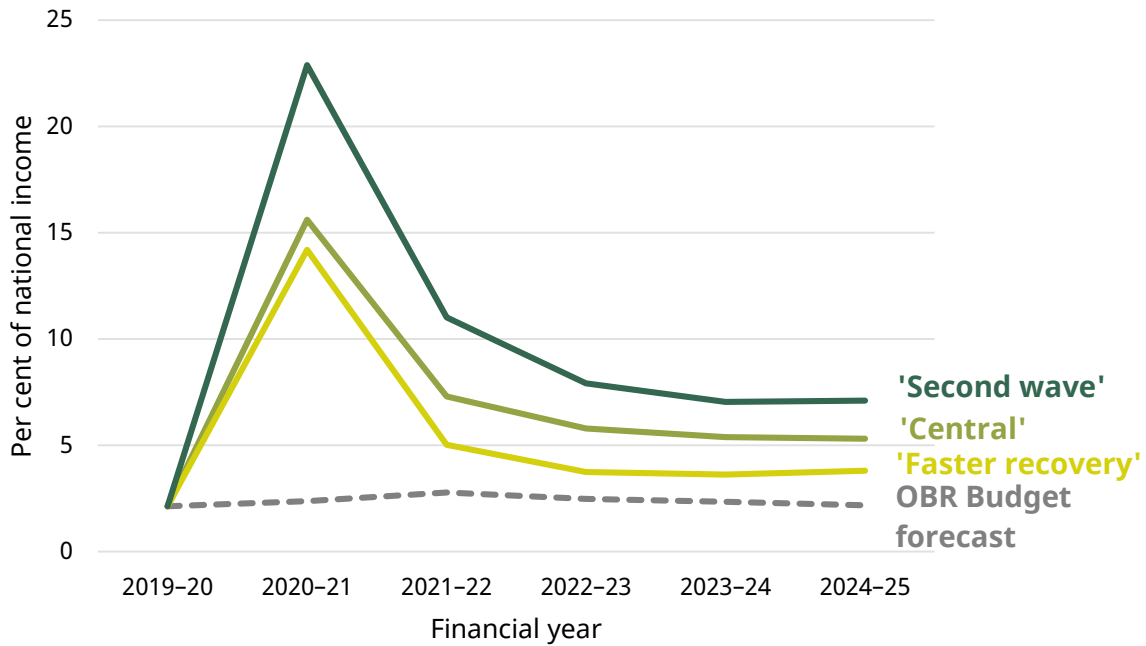
Under this scenario, borrowing is projected to increase to over 15% of national income – or over £300 billion – in the current financial year. This would represent the highest deficit since the Second World War (borrowing ran at around 25% of national income in each of the four years 1940–41 to 1943–44 – see Figure 6). The increase in the deficit between 2019–20 and 2020–21 would be the biggest increase in the deficit from one year to the next since at least 1920. Roughly half of the increase in the deficit relative to that forecast by the OBR in March would be attributable to the direct (gross) cost of the fiscal measures announced since the Budget and the remaining half to the much weaker level of economic performance.

Borrowing is then forecast to fall sharply between 2020–21 and 2021–22 (this would be the biggest fall in the deficit between one year and the next since that seen between 1945–46 and 1946–47). Along with a partial economic recovery, this is due to the assumption that the fiscal measures announced since the Budget will not be extended further and therefore they would not have a direct impact on borrowing in 2021–22.

The enduring economic weakness would, however, continue to elevate the deficit, with borrowing still projected to be running at over 5% of national income, or £130 billion in 2024–25. This would be 3% of national income higher than forecast in the March Budget, with the cash borrowing forecast about £70 billion higher.

³ Taken from the 14 April 2020 vintage of the OBR’s coronavirus reference scenario (<https://obr.uk/coronavirus-analysis/>).

Figure 4. Projected public sector net borrowing under different illustrative scenarios for the economy



Source: Office for Budget Responsibility, Economic and Fiscal Outlook (EFO), March 2020 and coronavirus policy monitoring database, version 4 June 2020; Institute for Fiscal Studies; Citi Research.

Projected borrowing under our 'central' scenario is compared with that under both the 'faster recovery' and the 'second wave' scenarios in Figure 4. This gives some sense of the uncertainty around the central scenario we consider. Under the faster – and fuller – recovery scenario, the deficit would rise to over 14% of national income but would then fall more quickly over subsequent years. Between 2022–23 and 2024–25, the deficit would be running at just below 4% of national income. Even in this more optimistic scenario, borrowing in 2024–25 would be about £40 billion, or two-thirds, higher than forecast just three months ago in the March 2020 Budget.

In the depressing scenario of a second COVID-19 outbreak this autumn, the economic damage is greater, further depressing revenues and increasing spending. In addition, we assume that second rounds of the Coronavirus Job Retention Scheme and the Self-Employed Income Support Scheme are implemented, substantially increasing the direct cost of policy measures.⁴ Under this scenario, the deficit is projected to be pushed above 20% of national income, though still to remain below the share of national income borrowed each year during the Second World War. Crucially, more of this deficit would persist in the medium term, as the economy struggled to get back to its pre-COVID-crisis path, and even in 2024–25 borrowing would be over 7% of national income or £170 billion. This would be more than £100 billion more than, or almost three times, the amount forecast in the March 2020 Budget.

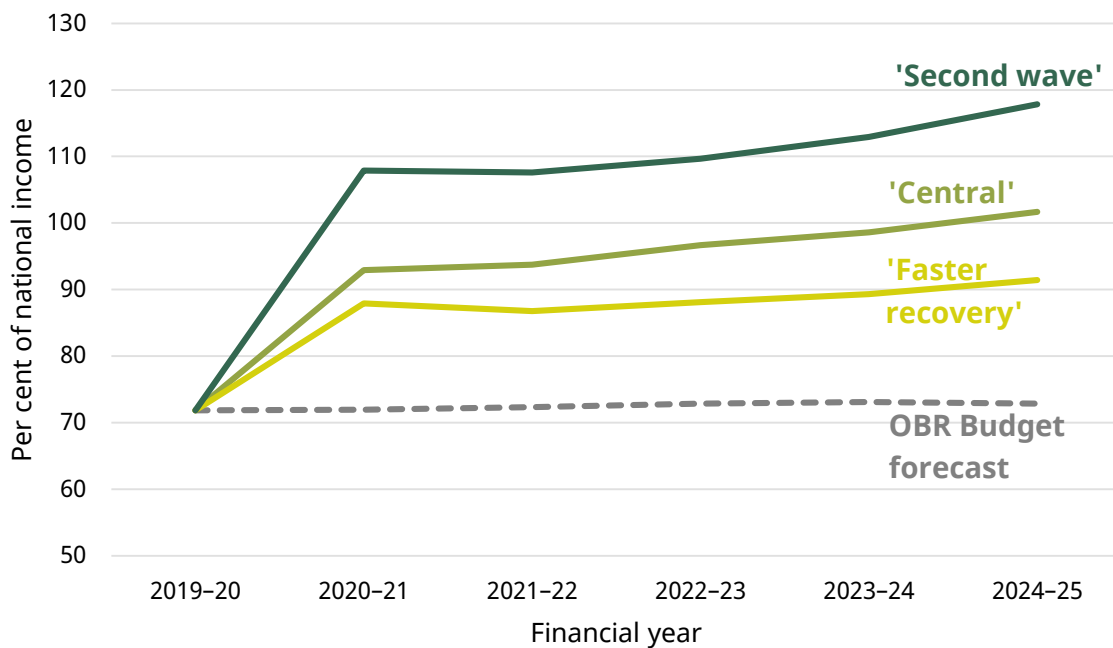
⁴ For illustrative purposes, we assume these would cost the same as the first round of these measures. If some of the employees who were furloughed during the first wave had been laid off, and were therefore unable to benefit from the scheme a second time round, this would reduce the cost of the scheme. However, the group of employees furloughed during a second wave would be likely to include more full-time employees on relatively higher earnings, countervailing this effect.

4. How might public sector net debt evolve under these scenarios for the economy?

The spike in borrowing in 2020–21 – and any enduring increase in borrowing – will lead to public sector net debt (which is, roughly speaking, the total amount of borrowing to date) being pushed up. The March 2020 Budget forecast that headline public sector net debt would fall as a share of national income. However, this was entirely driven by the expected repayment of loans made by the Bank of England under its (first) Term Funding Scheme. A more meaningful measure of public sector net debt that excludes these effects was already broadly flat. It therefore remained touch-and-go whether the Conservative government was on course to meet its manifesto commitment to reduce debt as a share of national income over this parliament.

As a result of the COVID-19 outbreak, and the public health measures put in place to combat it, debt will increase sharply this year. As shown in Figure 5, under all three scenarios debt would be projected to be on a rising path, albeit only modestly so in the scenario of a faster recovery. Under our 'central' scenario, debt would reach 100% of national income in 2024–25. This would be the highest level of debt in the UK since the early 1960s but, for example, would be well below the 250% of national income peak seen during the Second World War (see Figure 6).

Figure 5. Projections for debt excluding the Bank of England under different illustrative scenarios for the economy



Source: Office for Budget Responsibility, Economic and Fiscal Outlook (EFO), March 2020 and coronavirus policy monitoring database, version 4 June 2020; Institute for Fiscal Studies; Citi Research.

5. Conclusions and implications for policy

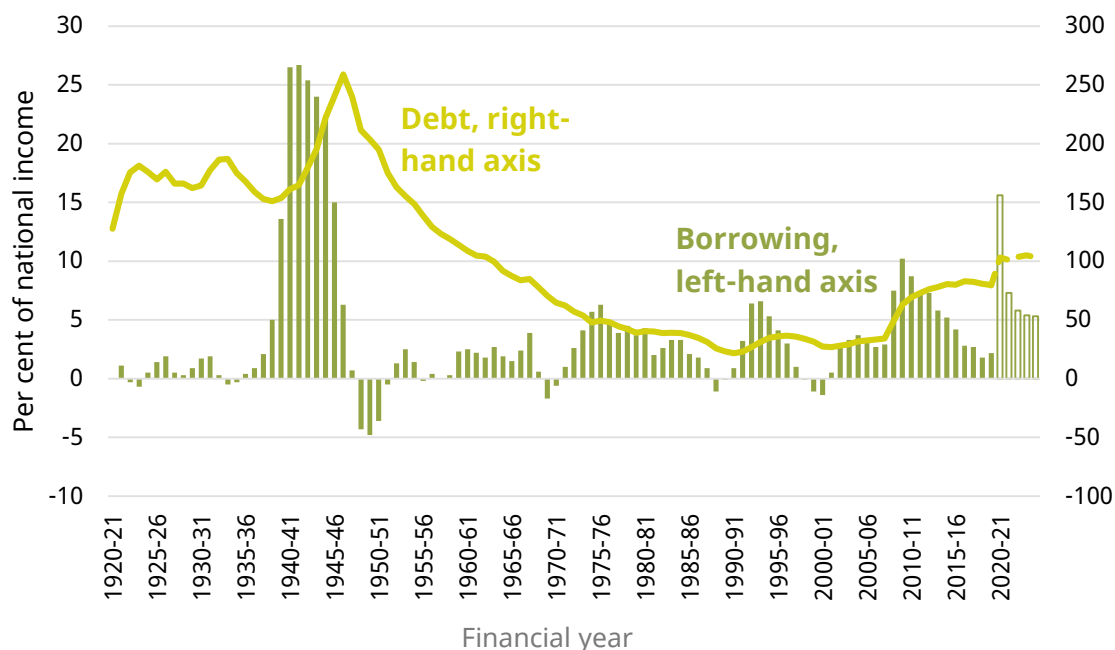
While there is considerable uncertainty over the path of the economy and the resulting impact on the public finances, it is clear that government borrowing will be substantially increased in 2020–21 and about as certain as it is possible to be with the public finances that it will reach levels not seen since during the Second World War. This would be the case as long as the deficit surpasses the 10.2% of national income seen at the height of the financial crisis and associated recession in 2009–10, as shown in Figure 6. Even once

COVID-19 has passed – and the public health measures put in place to combat it have been largely lifted – it is likely to be the case that the economy will remain impaired for some time. One important reason for this is that it will take some time for those who become unemployed during the current year to return to as good work as they would have had absent the current crisis. This will lead to borrowing continuing to run substantially above the levels forecast just three months ago in the March 2020 Budget. Public sector net debt will rise sharply in 2020–21 and is likely to continue rising as a share of national income over subsequent years.

It is important to note that under all three scenarios we consider in this piece, most of the increase in public sector net debt occurs in the current financial year. Given the low cost of borrowing – due to extremely low effective interest rates on government borrowing – further borrowing in 2020–21 which led to a stronger subsequent economic recovery would most likely be worth doing. And it also means that any new policy action that is taken to reduce borrowing need not – and indeed should not – be implemented until the economy is back to a more normal performance.

Furthermore, as long as the government can continue to borrow cheaply, it seems appropriate to be comfortable with elevated levels of public sector net debt. Indeed, under all of our scenarios, debt interest spending would be lower over the next five years than was forecast in March. A key risk with such an approach is that the cost of government borrowing may rise. This risk is particularly important to highlight given the Bank of England’s programme of quantitative easing, which has the effect of increasing the exposure of the public finances to changes in interest rates with borrowing being effectively financed at Bank Rate rather than being locked in at longer-term gilt rates.

Figure 6. UK public sector net borrowing and public sector net debt since 1920–21 and going forwards under the ‘central’ illustrative scenario



Note: Headline debt (including Bank of England) shown.

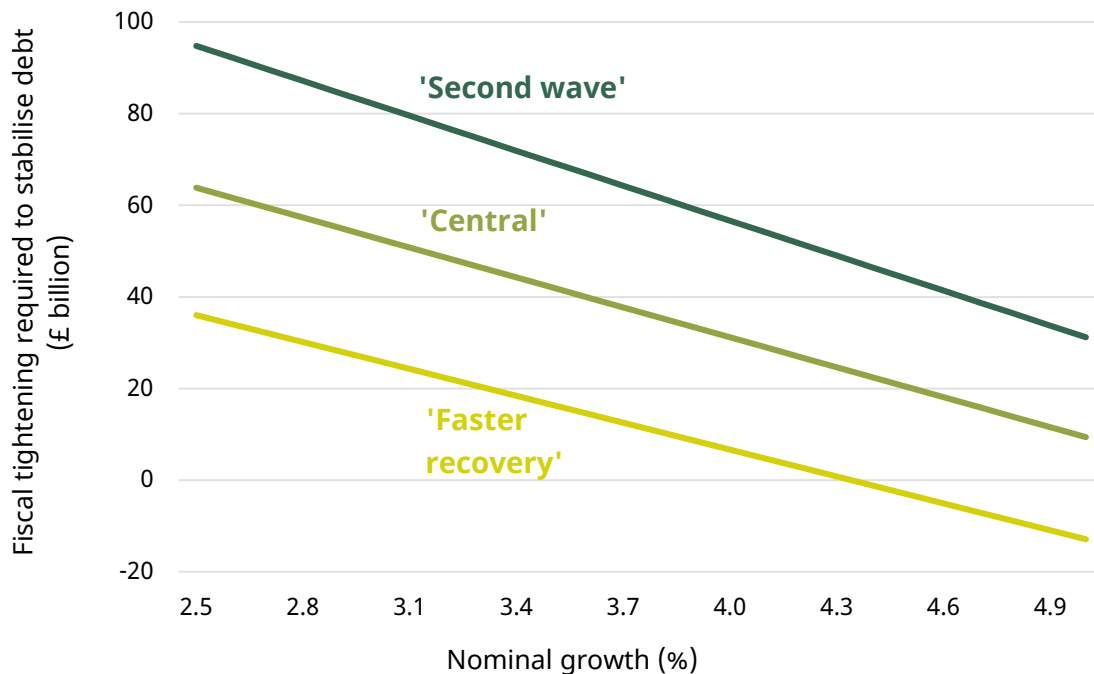
Source: Out-turn from OBR’s public finances databank, May 2020 (<https://obr.uk/data/>).

Were interest rates to rise alongside an increase in economic prospects, this might not be so problematic: rising debt interest costs in cash terms could potentially be covered by the additional tax revenues that would flow from stronger economic performance. An interesting example can be seen from the UK experience in the 1960s. Over that decade, debt fell from 108.8% of national income in 1960–61 to 64.7% of national income in 1970–71 (see Figure 6). While deficits were reasonably low during this period (averaging 1.8% of national income), the economy also grew very strongly: real growth averaged 3.4% per year over this decade, while economy-wide inflation averaged 4.8% per year (so total nominal growth averaged 8.3% per year). The OBR has shown that this high growth – and the fact it exceeded interest rates at the time – explained much of the decline in the debt-to-GDP ratio enjoyed over this decade.⁵

Therefore, more precisely, the risk to the public finances from elevated debt is that the cost of government borrowing rises and this is not associated with an increase in growth prospects.

Even if we are comfortable accepting the temporary increase in borrowing associated with the pandemic and its immediate aftermath and merely wanted to stabilise debt at its higher level at the end of our scenario horizon in the mid-2020s, the challenge could be substantial, as Figure 7 shows. For any given nominal growth rate, this shows the size of fiscal tightening required to stabilise debt – over and above any adjustments needed, for example, to meet the public finance costs of an ageing population or any changes to debt interest spending arising from rising interest rates.

Figure 7. Stabilising the debt burden at its 2024–25 level in each scenario



Note: Stabilisation of debt excluding the Bank of England at 102% of national income in the 'central' scenario, at 118% in the 'second wave' scenario and at 92% in the 'faster recovery' scenario. Deficit in 2019–20 terms.

⁵ See chart 7.5, page 208, of Office for Budget Responsibility, *Fiscal Risks Report: July 2019* <https://obr.uk/frr/fiscal-risks-report-july-2019/>.

Under our 'central' scenario and assuming that growth follows the OBR's long-run growth projection from 2025 onwards, a fiscal tightening of 1.5% of national income – about £36 billion in today's terms – would be required to keep the debt burden at its new level of just over 100% of national income. The OBR long-run projection assumes real growth averages 1.5% over the long run – much lower than its average in the previous century, but above the very disappointing growth observed in the last two years. With economy-wide inflation constant at 2.2%, nominal growth in this projection averages around 3.8%.

In the more benign 'faster recovery' scenario, the deficit in the mid-2020s, while still elevated compared with pre-crisis expectations, is lower than in the other two scenarios. But even then, if the economy grows in line with the OBR's long-run growth projections, to keep the debt burden stable would require a fiscal tightening of 0.5% of national income – or about £11 billion in today's terms. Under this scenario, being able to avoid a fiscal tightening while maintaining a stable debt-to-GDP ratio would require the economy to grow by 4.4% annually in nominal terms, which would be above the OBR's long-run projection (3.8%) and above the average in the 2000s and 2010s. And, of course, this would be a situation where no attempt to reduce debt below 90% of national income is made.

Delivering a fiscal tightening of £36 billion would require difficult choices to be made. It could involve spending cuts but, given the cuts to the budgets of many public services – and to the generosity of the working-age benefits system – already seen in the last decade, it is perhaps more likely that it would involve tax rises. Any such tax rises would also need to come on top of those that might be needed to address any other additional pressures for increased public spending – for example, if the ageing of the population, or the longer-term impact of the COVID-19 crisis, pushed up desired spending in areas such as health and social care.