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The OBR's *Fiscal Sustainability Report* makes clear the implications of a crisis-driven rise in unemployment for the public finances

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The OBR's latest *Fiscal Sustainability Report* confirms its view that the current crisis could lead to the largest economic contraction in 300 years precipitating a return of unemployment levels not since the 1980s. Given the huge uncertainty, the OBR has produced three scenarios with different assumption about a timetable for finding a vaccine or other long-term solution to the crisis. Those scenarios suggest GDP will fall by between 10.6 and 14.3 per cent this year, and remain up to 6 per cent lower than the OBR's March forecast even in five years' time. The unemployment rate rises substantially in all three scenarios, up to nearly 10 per cent even in its most optimistic scenario, much higher than the financial crisis peak of 8.5 per cent. And, in its pessimistic scenario, the unemployment rate is projected to rise to over 13 per cent – comfortably surpassing the 1980s peak of 11.9 per cent.

The *Report* illustrates the damage to the public finances from this hit to the economy and the policy measures the Government has put in place: under the central scenario, borrowing is expected to rise to £372 billion this year (compared to the £55 billion forecast by the OBR in March). The key point the OBR's analysis makes clear is that, the longer it takes to find a lasting solution to the crisis, the larger the rise in unemployment, the larger the hit to the economy and ultimately the public finances. Indeed, the lasting economic damage from the crisis, coupled with demographic trends that place even more pressure on the public finances, mean substantial action will be required to put the public finances on a long-term sustainable footing. Given the Prime Minister has ruled out a return to austerity, this means the Chancellor will face a huge political challenge in delivering the tax rises that are likely to be required to achieve this.

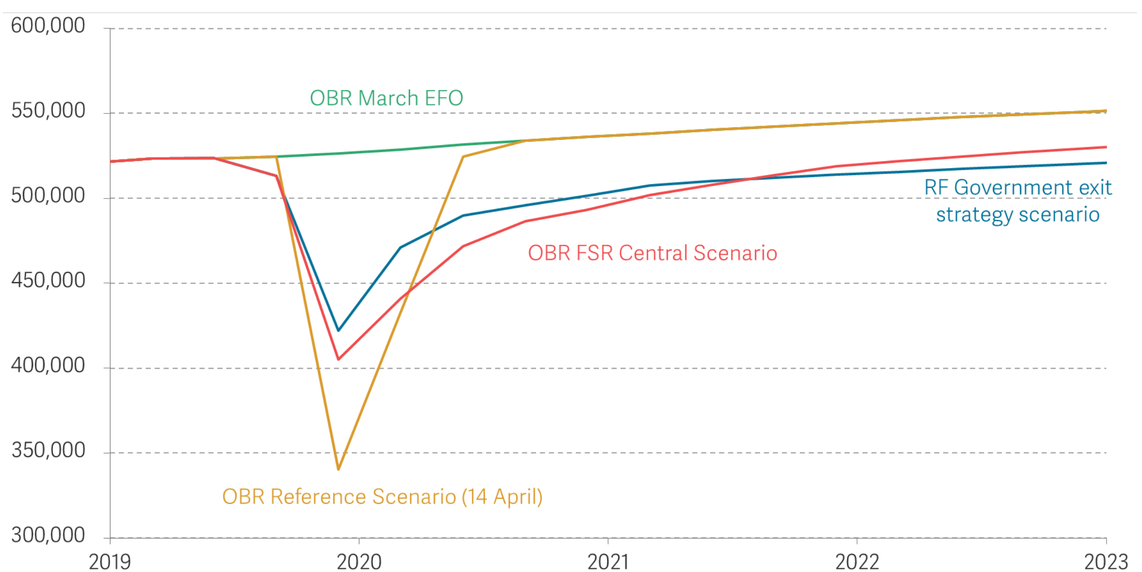
Today the OBR set out detailed analysis of the scale of economic damage from the coronavirus crisis

Today's *Fiscal Sustainability Report* (*FSR*) provided a welcome – if bleak – assessment of the economic impact of the coronavirus crisis. Having published an initial assessment of the economic impact of the crisis on 14 April, an updated estimate of the impact of the crisis was

overdue. This is important because in the Government has announced significant changes to its fiscal policies without accompanying forecasts for the economy or public finances. This includes last week's *Summer Economic Update* (*SEU*). Whereas the OBR's initial assessment for the crisis was decidedly V-shaped – with GDP returning to its pre-crisis path by the first quarter of next year – the updated central scenario features a much slower recovery (Figure 1). The good news here is that the initial hit to GDP is smaller: back in April, the OBR had expected GDP to fall by around 35 per cent in Q2; it is now projecting a fall of 'just' 21 per cent. But GDP growth is still expected to be at its weakest in over 300 years this year as the lingering impact of social distancing restrictions limits the speed of recovery. The overall profile is similar to recent RF analysis of the pace at which sectors can open up (shown in the Government exit strategy scenario in Figure 1).

Figure 1 **The OBR's new central scenario is much less V-shaped than that published in April**

Level of real GDP under alternative scenarios for the pandemic (£ million): UK

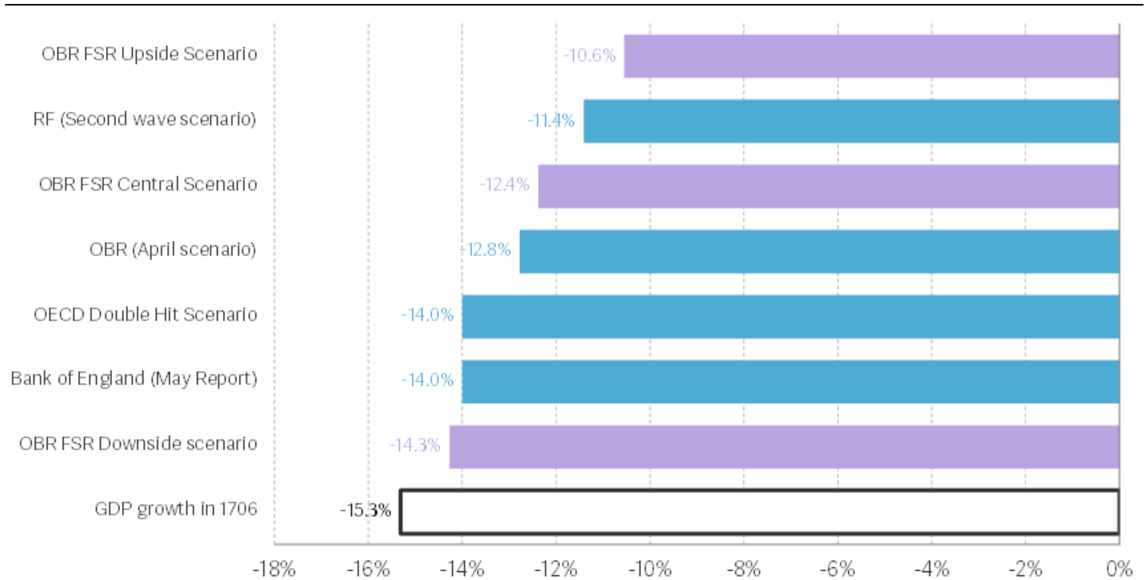


Source: RF analysis; OBR.

In order to illustrate the uncertainty, the OBR has published a range of scenarios for the length of the crisis and the long-term economic damage. The most optimistic of which – the 'upside' scenario – embodies a rapid return to the pre-crisis path with no long-term economic scarring. In the 'central' scenario (shown in Figure 1), which the OBR say is consistent with a vaccine taking around a year to deliver, output recovers more slowly, regaining its pre-virus peak by the end of 2022. GDP is around 3 per cent lower than the OBR's March forecast by the end of the five-year forecast period reflecting the permanent scarring effect of lost investment and persistently higher unemployment. Finally, in the 'downside' scenario, in which a vaccine is not found, output recovers even more slowly, returning to its pre-virus peak only in the third quarter of 2024. In this scenario, the long-term economic damage is double that in the central scenario with real GDP 6 per cent below the OBR's March forecast by the first quarter of 2025. Figure 2 shows that in all cases these

scenarios point to historically very weak GDP growth and, particularly in the downside scenario, are more pessimistic than other forecasters.

Figure 2 **Growth forecasts are weak even in the OBR's most optimistic scenario**
Forecasts for GDP growth in 2020: UK



Source: RF Analysis of Bank of England; OBR; OECD.

The OBR's scenarios highlight the risk of a sharp rise in unemployment

Perhaps the most striking feature of these scenarios are the sharp rises in unemployment. Even in the upside scenario, unemployment is projected to rise to nearly 10 per cent – much higher than its financial crisis peak of 8.5 per cent. But in the downside scenario, unemployment rises to over 13 per cent – comfortably surpassing the 1980s unemployment peak of 11.9 per cent (which is matched in the central scenario).

Mechanically the large rise in unemployment in these scenarios reflects the composition of the jobs lost. In particular, the OBR's analysis points to the workers who have lost their jobs or been furloughed disproportionately coming from lower-paying (and so lower-productivity) sectors. These changes are assumed to outweigh any reductions in productivity for people who have continued working. This is consistent with recent RF analysis as well as published figures on the falls in hours worked (which suggest average hours fell over 20 per cent between early March and the last week of April).

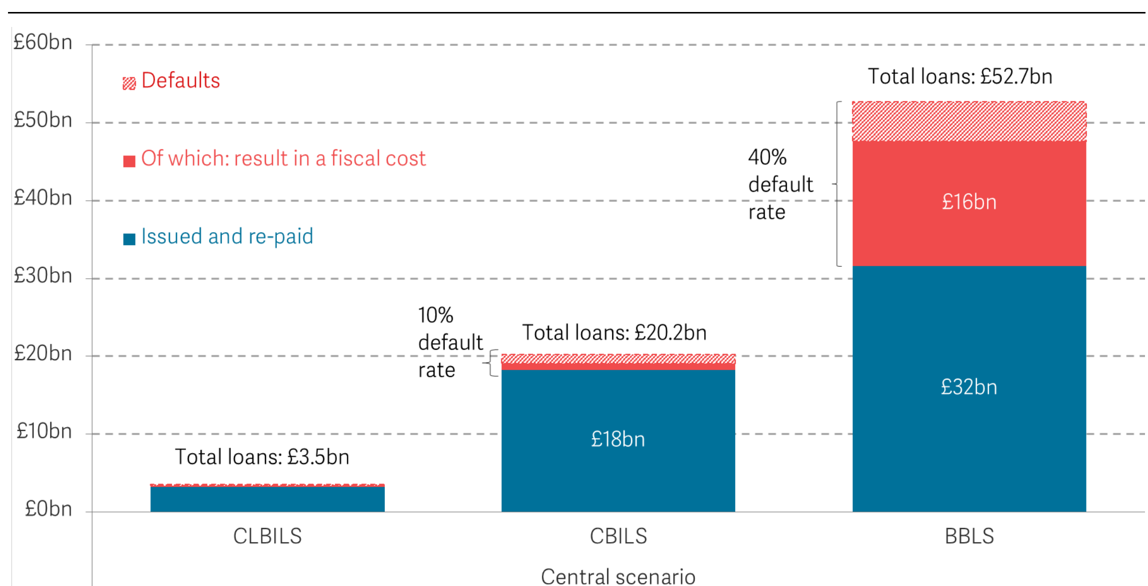
These scenarios make the risk of a sharp rise in unemployment clear. Indeed, in the OBR assumes that many furloughed workers do not have jobs to return to. In the central scenario, for example, one-in-seven, or 1.3 million, become unemployed. Given this sharp rise in unemployment, the long-lasting hit to the economy translates into a persistent rise in unemployment as those who become unemployed struggle to find jobs again. All this illustrates why taking pre-emptive action to limit the number of furloughed workers who become unemployed is so important.

A key question, then, is can the Government afford to take such action? The OBR's *FSR* also provided new costings for recently announced policy, as well as an assessment of the impact on the overall fiscal position, which we turn to next.

The OBR has increased its estimate of the cost of crisis support measures

Starting with the cost of the Government's already announced policies, the *Report* suggests that measures announced since the March forecast may cost around £10 billion more than previously expected. This partly reflects the impact of increases in the generosity of Universal Credit in the more pessimistic scenarios, which is expected to be £1.3 billion higher than the £8 billion originally announced. This reflects higher uptake in the more adverse central scenario. But, more significantly, the Government's loan schemes are now assumed to cost £15 billion more. This is partly because take up is assumed to be higher: with total lending now expected to reach £76 billion in total, much higher than the £50 billion previously incorporated into the OBR's costings. There is also a significant increase in the assumed default rates. As shown in Figure 3, in the central scenario, 40 per cent of loans issued under the BBLS will be written-off, resulting in a £16 billion cost (£20 billion including write-offs in the CLBILS and CBILS). This is significantly more than previous OBR assumptions of a £5 billion cost of write-offs.

Figure 3 **Bounce back loans could see a 40 per cent default rate, costing £16 billion**
Total loan stock, projected defaults, and impact on borrowing, by loan scheme: central scenario: 2020-21



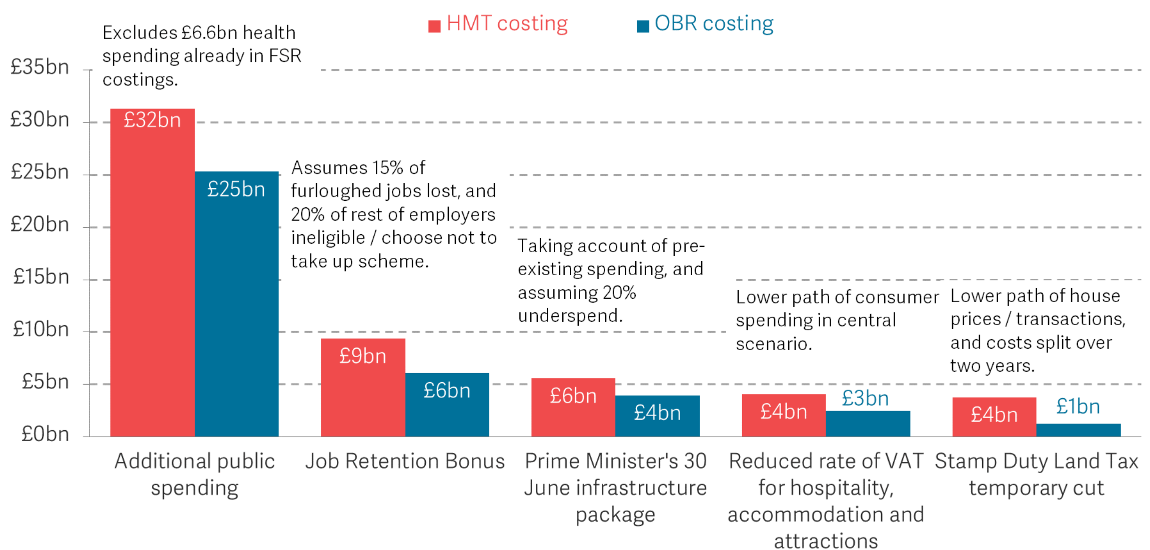
Source: OBR, Fiscal sustainability report, July 2020.

Against this, the cost of the Coronavirus Job Retention Scheme (CJRS) has been revised down from £54 billion to £47 billion. This primarily reflects a reduction in the assumed average subsidy per job reflecting the nature of jobs that have been furloughed.

All this leaves the cost of crisis-support policies announced before last week's *SEU* at £142 billion, around £10 billion higher than previously estimated.

Against this, costings for spending announced in the *SEU*, published alongside the *FSR*, are lower than initially set out by the Treasury. This is, however, less good news for the Chancellor as the OBR's assumptions suggest significant challenges to the implementation of these schemes, as shown in Figure 4. Particularly in the case of the Job Retention Bonus, the OBR's central assumption assumes 15 per cent of those furloughed become unemployed, but also that a further 20 per cent of firms are ineligible or choose not to claim the bonus. These costing assumptions also reflect the significant challenges associated with ramping up investment spending, assuming a 20 per cent under-spend, compared to the totals announced. In total, of the £61.9 billion in additional spending announced at the *SEU*, the latest OBR estimates suggest that around £50.2 billion will be spent. In terms of the economic impact of the stimulus measures announced, the first provisional estimates of the OBR is that they will save around 140,000 jobs. While that is a lot, it pales into comparison with the sharp rises in unemployment discussed above.

Figure 4 **Summer Economic Update costings are projected to be lower than planned**
Impact on borrowing of selected SEU measures, HMT and OBR costings: 2020-21



Source: RF analysis of OBR, Fiscal sustainability report, July 2020; HM Treasury, Summer economic update, July 2020.

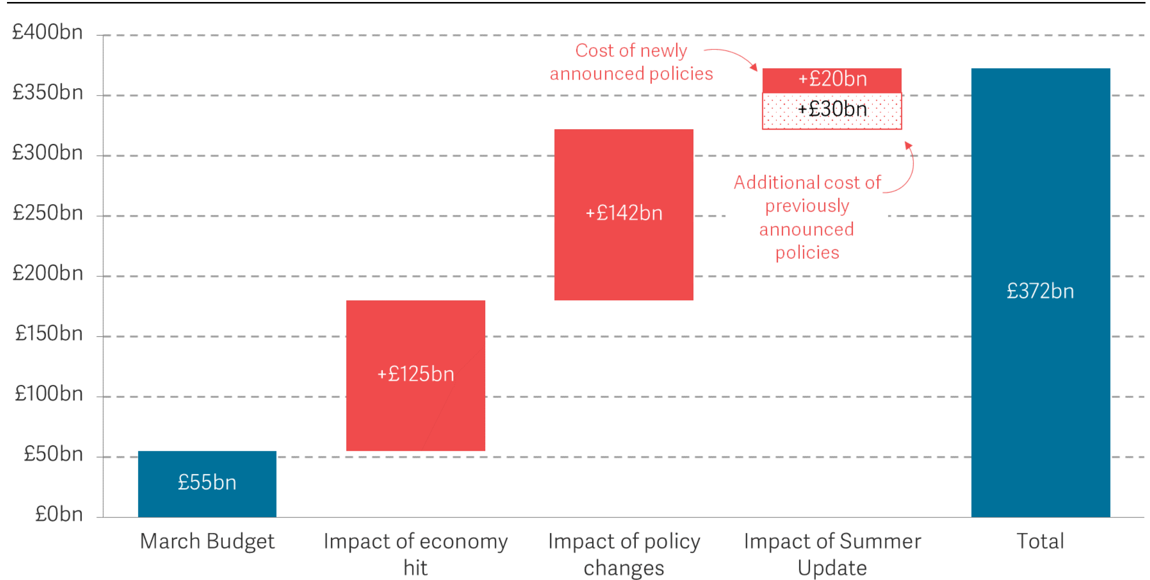
In all scenarios there is a big fiscal hit

Based on its scenarios for the economy and these updated costings, the OBR estimates translate into a huge hit to the public finances. The OBR's central scenario points to the biggest peacetime increase in borrowing – reaching £372 billion this year (compared to the £55 billion forecast by the OBR in March). Figure 5 breaks down that increase in the borrowing forecast for 2020-21 by underlying driver, and includes the impact of announcements in the *SEU*. To be clear, there are three key elements to this rise:

- First, the deterioration in the economic outlook implied by the central scenario leads to falling government revenue and increasing spending which combine to increase borrowing by £125 billion under the OBR's central scenario;

- Second, as discussed above, the Government's crisis economic support has added an additional £142 billion in new policy measures; and
- Third, the additional *SEU* measures, at £19.8 billion coupled with the higher spending on previously announced measures, at £30.4 billion.

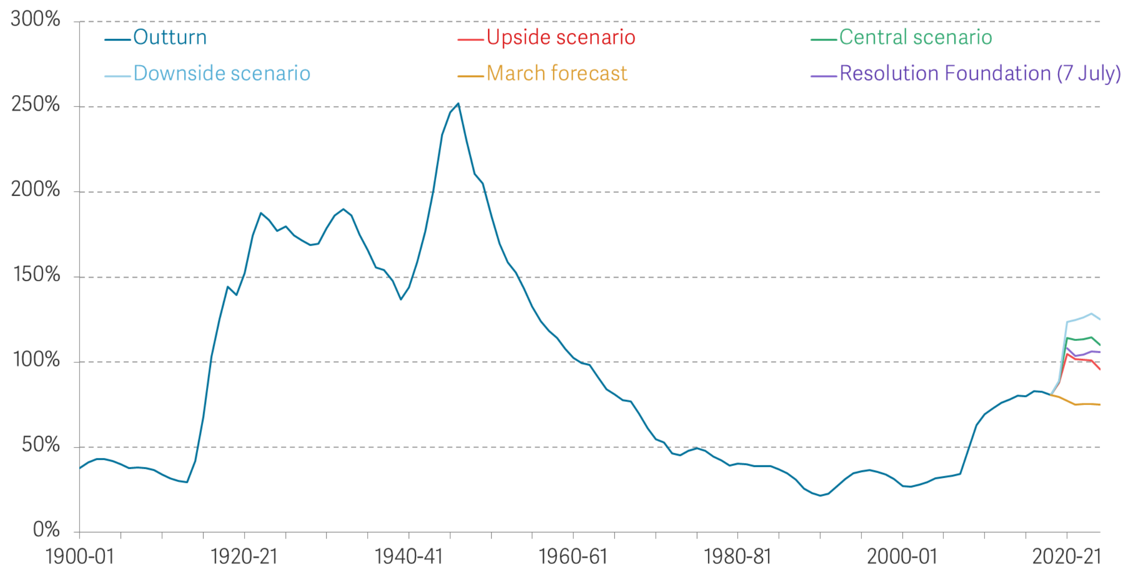
Figure 5 **A worsening economy and government stimulus are pushing up borrowing**
Changes in OBR's central forecasts for public sector net borrowing: 2020-21



Source: RF analysis of OBR, Fiscal Sustainability Report; HM Treasury, A Plan for Jobs.

Figure 6 puts that additional borrowing in 2020-21 in context. Public sector net debt is expected to peak at 105 per cent of GDP this year under the OBR's optimistic scenario (after adjusting for the impact of the SEU) before falling back below 100 per cent by 2024-25. In contrast, under the OBR's downside scenario, debt increases sharply to 129 per cent of GDP in 2023-24 and is expected to trend upwards over the long-term. Even in this scenario, however, debt remains well below the levels generally seen during the first half of the 20th Century.

Figure 6 **Debt is expected to rise dramatically but settles well below previous peaks**
Public sector net debt outturns and scenario forecasts



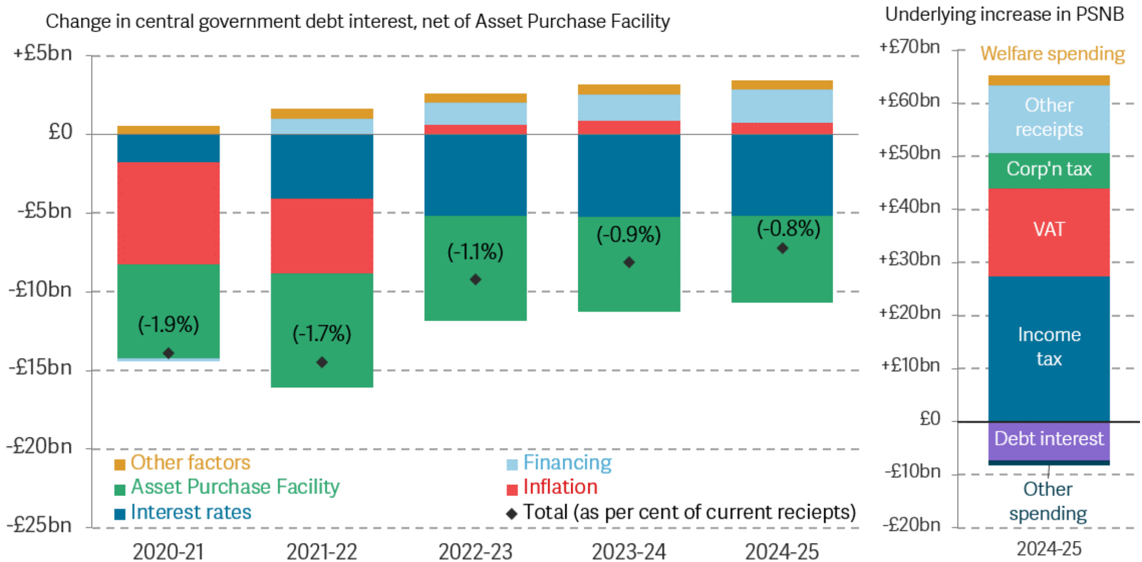
Notes: The estimated impact of the Chancellor's announcements at the Summer Economic Update have been included in all forecasts. The Resolution Foundation forecast is based on the 'Government Exit Strategy' scenario included in L Gardiner et al, Easing does it: Economic policy beyond the lockdown, 7 July; policy costings in this scenario have not been updated with revisions published by the OBR in the Fiscal Sustainability Report.
Source: RF analysis of OBR, Fiscal Sustainability Report; HM Treasury, A Plan for Jobs.

While helpful, public sector net debt does not provide a complete picture of the UK's long-term fiscal sustainability. Figure 7 shows two other important metrics: the cost of government debt financing, and an estimate of the underlying annual increase in borrowing due to economic scarring from the crisis. Counterintuitively, the latest forecast for government spending on debt interest is between £10 billion and £15 billion *below* the equivalent forecast from March. This is driven mainly by a fall in interest rates on the Government's debt. Under this metric, then, the Government's fiscal position has actually improved since March as debt interest payments have fallen. However, if interest rates were to rise in future these costs could increase materially.

Under the OBR's central and downside scenarios, there is assumed to be a long-run reduction in UK economic activity as a result of the scarring effects of the crisis. This results in a persistent increase in annual borrowing based on current spending and taxation plans. The right-hand panel of Figure 7 shows the estimate of the impact of lower economic activity in 2024-25 on public sector net borrowing. This shows that the primary driver of increased borrowing is lower revenue in labour, consumption and corporate taxes.

Figure 7 **Debt interest is expected to fall this year but scarring effects will push up annual borrowing in the long-term**

Change in central government net debt interest and public sector net borrowing (PSNB) forecasts since March



Notes: These forecasts do not include the impact of the Summer Economic Update. The Asset Purchase Facility provides interest payments to the Government and these are expected to increase in the coming year leading to lower net debt interest. Income tax includes national insurance contributions and VAT includes fuel, alcohol, tobacco and air passenger duties.
Source: RF analysis of OBR, Fiscal Sustainability Report.

Looking further ahead, tax rises will be needed to put the public finances back on a sustainable path

The higher structural deficit will tend to increase borrowing in the longer-term, pushing up on government debt, and will require lower spending or higher taxes (than pre-crisis) to ensure fiscal sustainability. Looking to medium, and longer-term fiscal sustainability risks, the FSR comes to similar conclusions as set out in recent work that debt interest costs remain low and financing constraints appear manageable. However, the OBR also estimates that a fiscal tightening of around 3 per cent of GDP (or £64 billion) decade-on-decade to reach a more 'sustainable' debt stock of 75 per cent of GDP by 2069-70. This reflects the lasting economic damage from the pandemic, coupled with demographic trends that place even more pressure on the public finances.

All this emphasises the need for a credible fiscal framework that returns the public finances to sustainability. Given that the Prime Minister has ruled out of a return to spending cuts as a way of returning the public finances to sustainability, this will mean tax rises. The Chancellor will face a huge political challenge of delivering the rises likely to be required to put the country's public finances on a solid long-term footing.

The welcome update to the OBR's assessment of the economic impact of coronavirus illustrates the extent of the gamble that the Government is taking with unemployment

In conclusion, while much depends on the progress in fighting the virus and in finding a long-term solution, the fact that even in the central scenario unemployment returns to levels not seen since the 1980s illustrates the importance of policy measures to reduce that rise in unemployment. While the large-scale, targeted measures needed to achieve that would be

expensive, the analysis from the OBR illustrates that the Government *can* afford to take them, as long as the costs of servicing those debts remains low. As today's Report emphasises, the key to that will be having a credible plan to ensure the public finances return to a sustainable position.