Resolution Foundation

How to throw good money after good

Budget 2021 and the challenge of delivering a rapid recovery from Covid-19

Jack Leslie, Charlie McCurdy, Cara Pacitti & James Smith

February 2021

Acknowledgements

The Resolution Foundation's Macroeconomic Policy Unit Associates (Kate Barker, Wendy Carlin, Jason Furman, Toby Nangle, Jumana Saleheen, Silvana Tenreyro, Gertjan Vlieghe and Tony Yates) are thanked for comments, guidance and support. The authors have also benefited from conversations with colleagues at HM Treasury, the Office for Budget Responsibility and the Bank of England, as well as Nick Oulton and Tim Pitt. Contributions from colleagues at the Resolution Foundation are gratefully acknowledged, particularly Torsten Bell, Mike Brewer, Greg Thwaites, Karl Handscomb, Kathleen Henehan and Daniel Tomlinson. All views and errors remain those of the authors.

This research in this paper uses data from an online survey conducted by YouGov and funded by the Health Foundation. The figures presented from the online survey have been analysed independently by the Resolution Foundation. The views expressed here are not necessarily those of the Health Foundation and are not the views of YouGov.

Download

This document is available to download as a free PDF at:

https://www.resolutionfoundation.org/publications/how-to-throw-good-money-after-good/

Citation

If you are using this document in your own writing, our preferred citation is:

J. Leslie, C. McCurdy, C. Pacitti & J. Smith, *How to throw good money after good: Budget 2021 and the challenge of delivering a rapid recovery from Covid-19,* Resolution Foundation, February 2021

Permission to share

Contents

Executive Summary

After a turbulent year in office, Rishi Sunak faces his second full Budget at a critical moment. Although growth during his first year in office was the weakest in more than three centuries, and borrowing has hit unprecedented peace-time levels, there is a sense that the successful vaccination rollout means a recovery is in the offing. The strength of that recovery will, however, depend not just on the vaccine rollout and the 'roadmap' for easing social distancing restrictions, but also on policy choices taken at the Budget which are the economic counterpart to that reopening plan.

There are two key aspects to those choices. First, and most pressingly, there is the choice about how to support families and firms in the remaining months of social distancing restrictions. Extending the existing support measures is crucial to make sure that households and businesses can emerge from the crisis in a strong position. It is this near-term support that has been the focus of most debate in UK economic policy making right now. The big questions include how and when to phase out the furlough scheme, and whether the £20 a week Universal Credit uplift should be made permanent.

Second, there is the question of how to drive a rapid recovery. In the US, the Biden Plan – the new administration's proposed large-scale economic support package – has sparked a lively debate about the size of support needed to boost the recovery. But in the UK, as in the rest of Europe, discussion of that issue has been largely absent. In this report we aim to help fill that gap.

So, in this final instalment of the Resolution Foundation's four-part series on the recovery plan, we set out our assessment of the economic and fiscal outlook facing the Chancellor, discuss the sort of considerations that should influence the scale and timing of any additional fiscal support, and, drawing on our recent work, set out measures through which such a stimulus could be delivered as we move along the Government's phased unlocking of the economy. Although the health crisis is worse than expected in November, the economy has weathered this better than expected, and the vaccine rollout provides the light at the end of the tunnel

The most important context for the Chancellor's decisions is the new Office for Budget Responsibility (OBR) economic forecast.

Here, a lot has changed since the previous set of OBR forecasts in November. Over 2020, the news is that GDP growth turned out less weak than feared – with the economy shrinking 9.9 per cent rather than the 11.3 per cent expected by the OBR at the time of the Spending Review. Although this is still the weakest year of growth in over three centuries, this means the economy starts the forecast period in a somewhat stronger position. This stronger performance mainly reflects that the economy has been able to adapt to social distancing restrictions, with our new analysis showing that the the UK has been able to sustain a higher level of economic activity in the more recent lockdowns than was the case earlier in 2020.

Turning to 2021, the near-term outlook is weaker, but the vaccine rollout suggests a recovery is in the offing. The deterioration in the health crisis in recent months, with tighter restrictions at the start of the year than expected back in November, means the year starts out on a weaker footing. But the successful vaccine rollout provides hope that social distancing restrictions can be relaxed more rapidly than seemed likely in November. Indeed, although the Government's recently-announced 'roadmap' for easing lockdown restrictions in England is, rightly, cautious about the pace at which restrictions can be eased, it points to a significant reduction over the summer.

For the Budget, this means that, although 2020 was a little better than the OBR feared in November, the outlook for 2021 is somewhat weaker, particularly in the near term. The Bank of England's recent forecast provides a good sense of how the OBR may update its outlook ahead of the Budget. The Bank's projections imply the economy will grow by 5.1 per cent this year – which would be the strongest growth rate since the late-1980s – under the assumption that social distancing restrictions are gradually removed and end completely by September. But that growth rate is weaker than the Bank's November forecast of 7.1 per cent. And unemployment now peaks at 7.8 per cent around the middle of this year, a slightly higher figure than in the Bank's November forecast, reflecting that the Government had announced the extension of the Coronavirus Job Retention Scheme (JRS) to the end of April.

Looking further ahead, we do not expect the OBR to change its view about the longer-term scarring effects of the pandemic on the economy. With only four months since their last forecast, and no material new data on the lasting damage to the supply side of the economy, we expect the OBR to maintain the assumption that GDP will be around 3 per cent lower in the longer-term than it would have been absent the pandemic. We note also that the Bank of England did not change its own, slightly more optimistic, scarring assumption in its recent forecast.

We use a downside scenario to explore the implications of social distancing lasting for longer than expected

Despite the vaccine rollout, the outlook remains very uncertain. There are risks both to the upside and downside, but the key source of that uncertainty remains the progress of the pandemic, particularly the length of time that restrictions will need to remain in place. Reflecting this uncertainty, in this report we discuss how policy makers should react should 2021 not go to plan. We do this using a downside scenario calibrated to assess the impact of social distancing restrictions continuing into next year. There are a number of reasons why this could be needed: for example, the prevalence of vaccine-resistant variants of Covid-19 might increase and require restrictions to suppress their spread across the population. The scenario takes into account the fact that the economy has been more resilient than many feared even a few months ago, reflecting how economic activity has adapted to social distancing restrictions. Nevertheless, GDP growth for 2021 in this scenario would be 1.9 per cent, 3.2 percentage points weaker this year than implied by the Bank of England's forecast.

Crisis-related spending will drive changes in the public finance forecasts, with less borrowing than expected in 2020-21 and more in 2021-22

The other key input to Budget decisions is the state of the public finances.

Again, the good news for the Chancellor is the starting point for the public finances is better than expected in November. Data to January suggest that the deficit for 2020-21 is on track to be around £40 billion lower than expected by the OBR in November. The majority of this improvement reflects lower-than-expected spending by government departments. Our view is that much of this spending is unlikely to be made up, and so will reduce the deficit this year by around £16 billion. We assume this does not change the outlook for subsequent years of the forecast, however.

Just as changes in spending plans – rather than news about the economy – have driven the near-term improvement in the public finances, next year's borrowing will be higher because of policy decisions on spending. Drawing on our updated central case, the stronger-than-expected starting point for GDP offsets the weaker outlook from renewed lockdowns at the start of 2021. But, as has already been trailed in the media, the necessary support programmes – including the JRS, SEISS and Universal Credit uplift, as well as support for businesses – will need to be extended beyond April for the remaining months of restrictions, and it is inevitable that this will increase borrowing. All this means, despite the better-than-expected starting point for the public finances, we now expect borrowing to be £382 billion in 2020-21, somewhat lower than £394 billion expected in November, and around £186 billion in 2021-22, higher than £164 billion previously forecast.

But that additional support will need to be much larger if restrictions continue into 2022. The impact of our downside scenario on the public finances is relatively small, on balance. But once again, it is the additional government spending, rather than the weaker economy, that has the largest impact on the public finances in this scenario. Longer restrictions would necessitate a further extension of support well into the second half of 2021-22. On top of that, we assume that the necessary funding for public services exceeds that set aside in the 'Covid reserve'. In the downside scenario, borrowing in 2021-22 would reach £263 billion, or 12 per cent of GDP – which would be higher than during the financial crisis.

Our downside scenario also incorporates the risk that Covid-related funding will be required beyond 2021-22, something not currently planned by the Government. Reflecting this, we assume that the £10 billion in normal public service spending cuts planned for next year (rising to £13 billion in 2024-25) no longer take place. This reflects the many pressures, including the need for additional spending on education catch-up for pupils, the backlog of NHS procedures, and severe financial strains being experienced by many councils. In the downside scenario, the deficit remains at 5 per cent of GDP by the middle of the decade.

The increased spending on support measures through 2021 means the pandemic will leave Britain with significantly higher debts, peaking at 106 per cent of GDP in the updated central scenario, and 114 per cent of GDP in the downside scenario in 2023-24. But with gilt yields remaining close to all-time lows, so debt interest costs remain at historically low levels. There are reasons for thinking that the era of low interest rates is here to stay, but it is less clear whether government financing costs will remain quite so low. In this context, it is worth noting that the planned pace of quantitative easing (QE) purchases by the Bank of England has slowed in recent months, something that is likely to reduce the downward pressure on the rate at which the Government can borrow.

There is a strong case for £100 billion in additional stimulus to be announced at the Budget

Questions about how to phase out support measures have been widely discussed, but there is also a need to consider what macroeconomic policy needs to do overall to generate a rapid recovery. In the US, the Biden Plan has prompted much debate of this issue, but discussions about the overall stance of fiscal policy have been largely absent in the UK. This is odd given that fiscal policy will be much more material to macroeconomic policy in the year ahead than the much-debated question of whether the UK should put in place negative interest rates.

Overall, our judgement is that significantly more, and longer lasting, fiscal support is desirable. But assessing the right level of that stimulus is far from straightforward. On current plans, macroeconomic policy is set to become a drag on growth in the coming quarters. This is because the effects of last year's stimulus – around £280 billion in additional crisis spending and an additional £450 billion in QE purchases by the Bank of England – will start to wane in the coming quarters, and so become a headwind to growth. It is difficult to quantify precisely the extent of that drag given social distancing restrictions will affect how macroeconomic support works through the economy. But our central estimate is that it would take around £350 billion of additional fiscal measures over the next two years to stop the fiscal impulse turning negative. Such a huge fiscal boost can be thought of as the top end of estimates for what would be comparable to the Biden Plan, but scaled up for the larger hit to the UK economy (US GDP fell by around 3.5 per cent in 2020, compared to 9.9 per cent for the UK). We estimate that this would be enough to boost GDP to around 5 per cent above its pre-pandemic path. The case for stimulus on that scale, then, depends on the ability of those fiscal measures to boost to the economy's productive capacity to well above its pre-crisis path. Our view is that there is little evidence that temporary fiscal measures could have such a large impact.

A more standard way to assess the extent to which a further policy boost is necessary is to look at the difference between actual GDP and its assumed sustainable level – often referred to as the output gap. The idea is that, if there is insufficient aggregate demand, then unemployment will be higher, so there is a key role for policy makers in boosting demand to return to full employment. Unlike simply looking at the fiscal impulse in isolation, this approach has the advantage that it should take into account other factors that affect the economic outlook, such as the unwinding of social distancing restrictions.

Based on the Bank of England's output gap, there is little need for additional stimulus measures. The Bank's forecast – which underlies our updated central scenario – assumes that there is an output gap of just 1 per cent at the start of this despite a shortfall of around 13 per cent in the level of GDP compared to its pre-pandemic path. Put another way, most of the hit to GDP is assumed to be confined to the supply side of the economy, albeit temporarily, with aggregate demand much less affected. Based on the Bank of England's output gap estimate, no additional stimulus would be warranted over the next two years because the output gap is assumed to close completely without additional policy measures in that time.

But our view is that there are two key reasons why this assessment underestimates what is required. First, both the Bank's and the OBR's output gap estimates look small relative to those of other forecasters. The IMF's estimate of the output gap, for example, is much larger, and suggests a stimulus of the order of £85 billion would be needed over the next two years. And second, there is a strong case for aiming to overshoot the amount of stimulus required to close the output gap. This is because we judge the risks from doing 'too much' are far smaller than those from doing 'too little'. There are a number of reasons for this, but a key one is that it may take an extra boost from policy to generate a rapid recovery on the supply side (for example, to ensure that all furloughed workers with viable jobs return to those roles). Although there is considerable uncertainty, our view is that the Chancellor should set out plans for fiscal stimulus equating to roughly £100 billion over the next two years. We estimate that this would boost the economy by enough to close the IMF's estimate of the output gap with a margin of additional stimulus to boost the supply side somewhat.

Although this would be a huge stimulus, a package of around £100 billion would be less than the Biden Plan in the US. This should not be surprising, however, as a number of the pandemic support measures included in the Biden plan are already factored into UK spending plans (such as spending on vaccines). But it would be a major boost relative to the Chancellor's current plans, but those plans risk causing an unnecessarily slow recovery and long-term damage to the economy. One issue that has been discussed in the context of the Biden Plan is that the stimulus measures create significant inflation. Our view is that a £100 billion package in the UK should not raise so many concerns. In part, this is (again) because this package is smaller than the Biden plan. But even if inflation did start to rise, its temporary stimulus-driven nature should mean that it does not feed into longer-term expectations of future inflation: these have remained at levels consistent with the Bank of England's inflation target in recent years, despite inflation rising significantly above the 2 per cent target following the financial crisis.

It is also important to stress that it is important to consider not just how large any support package should be, but also to get the timing right. If support is introduced too early, this risks prolonging the health crisis, as expanding economic activity will inevitably lead to increases in social interactions. In our downside scenario, the longer duration of social distancing restrictions means that the Government would need to provide around £95 billion in additional support in 2021-22. But the additional stimulus measures would need to be delayed until the start of 2022 when social distancing restrictions are assumed to no longer be necessary and it is safe to start to actively stimulate the economy. By the same token, however, introducing a stimulus package too late risks further economic scarring, as low aggregate demand will prevent businesses from bringing back furloughed workers and will prevent a sorely-needed recovery in business investment.

Active policy to boost growth should be enshrined in a new fiscal framework that builds confidence in the recovery

The need for more active fiscal policy reinforces the case for a new fiscal framework to be announced at the Budget. Such a framework could take many forms, but its key role would be in signalling the Government's dual intention to provide adequate levels of support during the recovery and to keep the longer-term fiscal position sustainable. The absence of a new framework creates ambiguity about the objectives of fiscal policy and so creates uncertainty for households and businesses. To reinforce expectations of a fast recovery, such a framework should set out that the Government will not turn to fiscal tightening until the OBR estimates that the output gap has closed.

After that point, the Government should pursue a pace of consolidation consistent with fiscal policy not being a drag on growth while building fiscal space to deal with future downturns. Our previous work set out how that could be achieved through a medium-term consolidation focussed on reaching and maintaining a current balance after 2024-25. On the basis of our updated central scenario, a consolidation of around £30 billion would be required. In our downside scenario, the persistently higher deficit following the pandemic would increase the amount of consolidation to £50 billion.

The choice of fiscal framework will inevitably drive decisions about the nature of that consolidation. In particular, the Chancellor has made it clear that he wants to ensure that fiscal discipline is upheld, defining that largely through the lens of putting debt on a declining path. But, given the deterioration in the public finances, a target of sustainably falling net debt is unlikely to be consistent with existing plans for the highest levels of public investment since the 1970s that he and the Prime Minister talked about before the pandemic hit, and which are needed to drive both the 'levelling up' across regions and the move to net zero, at least without very large tax rises.

In this context, our proposed fiscal rules – which targets net worth rather than net debt – provide a way to reconcile these three apparently competing objectives. Such an approach would give extra fiscal space to undertake welfare-enhancing investments as part of the levelling up and net zero agendas, while still incentivising prudent measures to build fiscal space.

Stimulus measures should be targeted towards the areas of the economy that need it most

Given that there is a compelling evidence for support for the economy, a key question is what measures should be put in place?

Here, policy should be targeted, so as to boost the hardest hit areas of the economy and provide value for money. The table below brings together our proposals for additional support measures in the coming months along with stimulus measures to boost aggregate demand when it is safe to do so. It draws on our recent work on the recovery that has focused on targeted microeconomic measures to support the labour market; the housing market, particularly private renters; and the corporate sector. In each case we have set out policies that respond to the lasting impact of Covid-19 in these key areas, including carefully phasing out the furlough scheme and providing another round of targeted grants to firms in hard-hit sectors. These policies are particularly focussed on reducing the lasting impact of the pandemic on households and firms.

Policy makers should also seek to boost overall demand when it is safe to do so. Given the structure of the UK economy, this means boosting consumption, but increasing investment spending should also be a priority. We therefore recommend:

- Support for re-training and job creation as the JRS and SEISS schemes unwind to reduce the scale of unemployment increase.
- Making the £20 per week uplift in Universal Credit permanent, rather than extending it for 6 months, in order to avoid a sharp fall in incomes in six months' time when unemployment is likely to be higher than it is now.
- A targeted voucher scheme, focussed on high street retail, which is unlikely to see as strong a rebound as the hospitality sector. This will slow, but not stop, the decline of high street retail.
- A further increase in 'green' public investment.

Together, these proposals total around £100 billion, split across the next two years.

Summary of policy measures

Policy measures	Rationale	Total cost: 'central' scenario
Extensions of pandemic support measures		
Continued support for households and firms during the pandemic	To support households and firms while social distancing remains in place.	£28bn
Targeted stimulus		
Support for re-training and job creation	To reduce the scale of unemployment increase when support measures withdrawn.	£27bn
Making the £20 per week uplift in Universal Credit permanent	To avoid a sharp fall in incomes in six months' time when unemployment is likely to be higher.	£19bn
Further increase in 'green' public investment	To boost investment and productivity, while supporting aim of reaching Net Zero	£14bn
Targeted voucher scheme	Focussed on high street retail, where post-pandemic rebound likely to be slower.	£9bn
	Total cost of support and stimulus measures:	**£97bn**

Section 1

Introduction

Rishi Sunak's second full Budget as Chancellor comes at a critical moment in the response to the economic hit from Covid-19. His first year in post saw the weakest economic growth in more than three centuries and unprecedented peace time borrowing but, at the time of writing, an impressively swift vaccine rollout holds out the hope of an imminent economic recovery. The strength and nature of that recovery will depend not just on the pace of vaccinations but on economic policy choices taken in this Budget and beyond.

Two central, and heavily overlapping, questions stand out. First, during the coming months there is the microeconomic question of how best to continue supporting families and firms, particularly those hardest hit, so that they can emerge from the crisis in a strong position. This is the focus of most discussions in UK economic policy making, from how to phase out the furlough scheme to whether the £20 a week Universal Credit uplift should be made permanent.

Second, and the focus of this paper, is the question of how macroeconomic policy can best drive a rapid and full recovery. The debate on how to achieve this is largely absent from the British, and European, policy discussions but has been central the US debate about the merits of the Biden Plan for a huge fiscal stimulus.

In this report we analyse the economic and fiscal outlook faced by the Chancellor, discuss what sort of considerations should influence the scale of any additional fiscal support, and set out measures via which such a stimulus could be delivered.

While there is light at the end of the tunnel, big challenges remain

A year ago, Rishi Sunak presented his first Budget after just four weeks in office. It's focus was on plans to 'level up' the economy, not least via big increase in capital spending. Measures to handle growing worries about the impact of Covid-19 largely took a back seat. Within days the plans in that Budget had been blown wildly off course, with the

Chancellor displaying admirable agility in delivering an unprecedented and necessary package of support for the economy as the depth of lockdowns required to control the virus became clear.

The necessity of those lockdowns enduring through much of the past year, and the economic damage they have brought, has seen regular extensions of government support. The result has been huge falls in GDP, unprecedented peacetime borrowing and government debt rising to levels not seen in nearly 60 years.

Now, with a successful and speedy vaccine rollout underway and the prospect of a way out of renewed lockdowns in sight, it is tempting for economic policy makers to think the heavy lifting is done. But there is a need for more nimble, creative and active policy if we are to escape the pandemic without lasting economic damage.

In the near term, the Chancellor must make sure further support is provided for families and firms during the coming months of social distancing restrictions, resisting the temptation to withdraw support in the face of the eye-watering fiscal cost. That support includes how to phase out the furlough scheme, whether the £20 a week Universal Credit uplift should be made permanent and how much to give in grants to struggling firms. These decisions, discussed in more detail in our recent work, have been the focus of most discussions in UK economic policy making ahead of the Budget.[1]

Looking ahead, there are much more difficult – and much less debated - issues around how to drive a full and rapid recovery. This is important because a weak recovery risks inflicting long-term damage on the economy. Despite this, there has been relatively little debate on how to achieve this in the UK and European context. Instead, policy discussions have focussed on how to phase out near-term support measures. But, in the US, the issue of how to generate a rapid recovery and minimise the longer-term damage on the economy have been framed by a lively debate surrounding the merits of the 'Biden Plan' – a new, large-scale stimulus package proposed by the incoming administration. The context for the debate in the US is different to that here – not least because some aspects of the Biden plan are already included in the UK's policy response. But the question of how to make sure that the overall stance of macroeconomic policy – primarily fiscal policy given the constraints on the Bank of England from the low interest rate environment – is set to deliver a rapid recovery remains crucial and is the main focus of this report.

1 For a discussion on Universal Credit in the budget see: M Brewer & K Handscomb, Half-measures: The Chancellor's options for Universal Credit in the Budget, Resolution Foundation, February 2021. For more on labour market considerations, like the future of the furlough scheme, for the Chancellor see: N Cominetti, K Henehan, H Slaughter & G Thwaites, Long Covid in the labour market: The impact on the labour market of Covid-19 a year into the crisis, and how to secure a strong recovery, Resolution Foundation, February 2021.

In this final instalment of the Resolution Foundation's four-part series on the recovery plan, we bring together our assessment of the outlook for the economy with our analysis of the overall stance of policy and the design of a set of measures to deliver a broad-based and rapid recovery.

To that end, the rest of this paper is organised as follows.

- Section 2 looks at how the economic outlook has changed since the Spending Review, focussing on what we have learnt about the impact of the pandemic and what that implies for the path of the economy.
- Section 3 then considers what impact changes in the economic outlook and policy imply for the fiscal outlook.
- Section 4 then tackles the tricky question of the size and timing of stimulus measures necessary to boost the economy as social distancing restrictions subside.
- And Section 5 then builds on this analysis, setting out a package of targeted policy measures.

Section 2

The economic outlook

The most important context for the Chancellor's decisions is the new OBR economic forecast. Here quite a lot has changed since the OBR's November forecast. The good news is that the economy starts the forecast in a stronger position. This is primarily because economic activity has not been as badly affected during recent lockdowns as at the start of the pandemic. But the deterioration in the health crisis in recent months means a weaker outlook despite the successful vaccine rollout. The Bank of England's February forecast, which incorporates these changes in the outlook, provides a good sense of how the OBR might update its forecast ahead of the Budget. It suggests the economy will grow by 5.1 per cent this year – very strong by historical standards, but weaker than the Bank's November forecast of 7.1 per cent. Unemployment peaks at 7.8 per cent around the middle of this year, slightly higher than the November forecast.

The successful vaccination rollout reduces uncertainty and increases confidence that a recovery can start at some point, but there are still big risks to the outlook. While there are a number of risks both to the upside and downside, the most obvious of these is the possibility that social distancing restrictions may be needed for longer as new variants require additional measures to control their spread. This would certainly delay the recovery – a view supported by evidence from the Resolution Foundation's recent household survey which finds a majority that see the end to social distancing restrictions as the key point at which they will spend more (rather than, for example, when they receive a vaccine). We tackle this key uncertainty head on by calibrating a downside scenario to assess the impact of social distancing restrictions continuing into next year. In that scenario GDP is around 3 percentage points weaker this year as those restrictions weigh on economic activity.

The key backdrop to the Budget will be the outlook for the economy, particularly how the OBR's forecast has changed since November. So in this section we look at how the OBR might update its central forecast for the economy before moving on to discuss the risk that social distancing restrictions may need to be in place for longer than expected. We explore the implications of that risk using a downside scenario.

While the economy starts from a stronger position than expected in November, the near-term outlook is weaker

There have been three key pieces of news for the OBR's March forecast since November.

1. The level of GDP at the start of the forecast is stronger, reflecting how the economy has adapted to social distancing restrictions

The economy has not been as badly affected during recent lockdowns as it was at the start of the pandemic. This reflects an improvement in the amount of economic activity that can be sustained for a given set of social distancing restrictions. For example, the lockdown in England at the start of 2021 is different to that in April 2020 because more sectors of the economy have remained open. For example, the Government has been more explicit that manufacturing and construction could stay open and parts of hospitality have stayed open for takeaway.[2]

To gauge the impact of this, we use high-frequency data on mobility – indicators of the extent to which people are changing physical location.[3] The chart in the left-hand panel of Figure 1 plots the relationship between the strictness of restrictions against this measure of mobility for the UK. It shows that the relationship has shifted to the right: for a given lockdown, there is less of a fall in mobility. This is consistent with the idea that people, firms and sectors have adapted – supressing the virus while allowing some activity to continue. The right-hand panel of Figure 1 then maps this into monthly GDP. Again this relationship has improved: for a given level of mobility, GDP is higher. This is consistent with the idea that more economic activity can now be undertaken virtually without a need for people to change physical locations.

How much improvement have we seen? At the height of economic restrictions, in April, GDP was 23 per cent below its pre-pandemic level (Q4 2019). But by June, when high streets began to welcome customers back, economic activity had recovered to 14 per cent of its Q4 2019 level. As heavier restrictions came into force in November – such as a national lockdown in England – GDP fell to around 6 per cent below its pre-pandemic level. Output increased between November and December, reflecting a partial rebound in

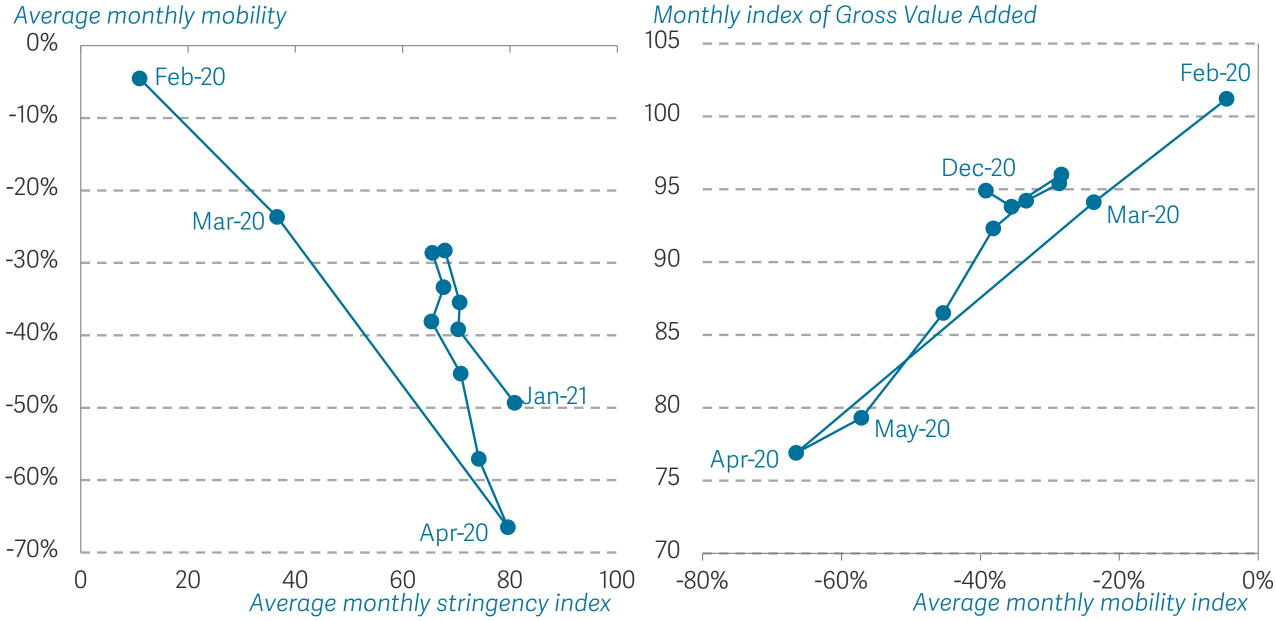
2 For example, the current lockdown guidance states that allowance for leaving home for work purposes where it is unreasonable to work from home explicitly 'includes, but is not limited to, people who work within critical national infrastructure, construction or manufacturing that require in-person attendance'. See: GOV.UK, National lockdown: Stay at Home, accessed 15 February 2021.

3 A similar approach has been taken by others. For example, the OECD and World Bank have compared Google mobility data with economic activity and used the information to 'nowcast' and 'forecast' GDP. See: J Sampi & C Jooster, Nowcasting Economic Activity in Times of COVID-19, An approximation from the Google Community Mobility Report, World Bank Group, May 2020; N Woloszko, Tracking activity in real time with Google Trends, OECD Economic Department Working Papers No. 1634, December 2020.

the services sector on the back of an eased lockdown over Christmas. This improvement in GDP was highly responsive to a relaxation of lockdown rules. Overall, for a given lockdown we can now sustain more economic activity.

FIGURE 1: **Since April the economy has adapted to restrictions meaning we can sustain more movement for a given lockdown**

Relationship between monthly mobility (index, February 2020 = 0) and monthly stringency (index, pre-pandemic = 0) / monthly index of Gross Value Added (index, 2019 Q4 = 100), outturn: UK



NOTES: Google mobility data uses aggregated, anonymised data to chart movement trends over time by geography, across different high-level categories of places such as retail and recreation, groceries and pharmacies, parks, transit stations, workplaces, and residential. Average monthly mobility takes a weighted average of workplace and retail / leisure mobility, weighting each category according to their approximate contribution to overall economic activity (GDP).
SOURCE: RF analysis of Google, Community Mobility Reports; Oxford University, COVID-19 Government Response Tracker; ONS, Monthly GDP estimate.

2. Downside news on the level of activity from renewed lockdowns

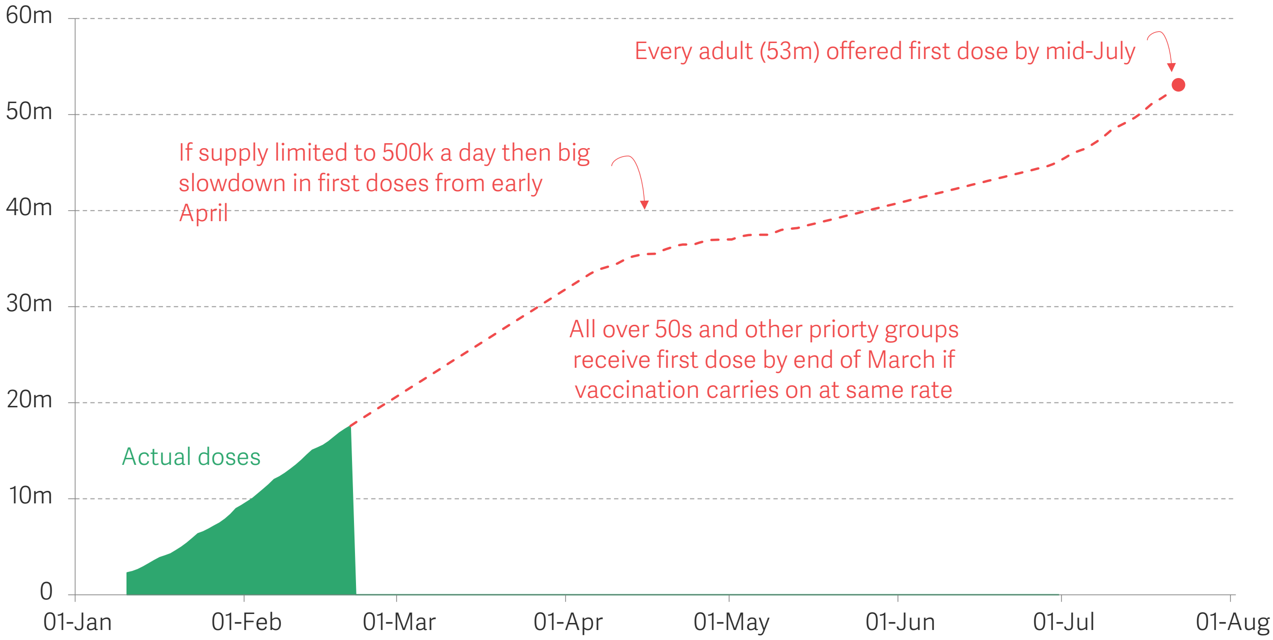
Set against that, the health crisis has deteriorated by more than the OBR expected in November. Back then, the OBR expected the ongoing lockdown in England to end on 2 December and be replaced by regional restrictions broadly consistent with remaining at the equivalent of England's pre-lockdown Tier 3 until the spring. Since then, however, the case load has been higher and social distancing restrictions much more severe than expected, reflecting the spread of new variants of Covid-19. This has led to significantly weaker outlook for the economy at the start of 2021.

3. The vaccine rollout has proceeded faster than expected

The Government is on course to hit or even exceed its target of offering every adult a vaccine by 31 July (Figure 2). This should allow social distancing restrictions to be eased very significantly in the coming months. In November, the OBR's forecast assumed that a vaccine would become widely available during the second half of this year. So there is some upside news about the pace at which the economy can open up.

FIGURE 2: **The Government is on course to offer all adults a vaccination by mid-July**

Vaccine first doses received across the UK, to 20 February: UK



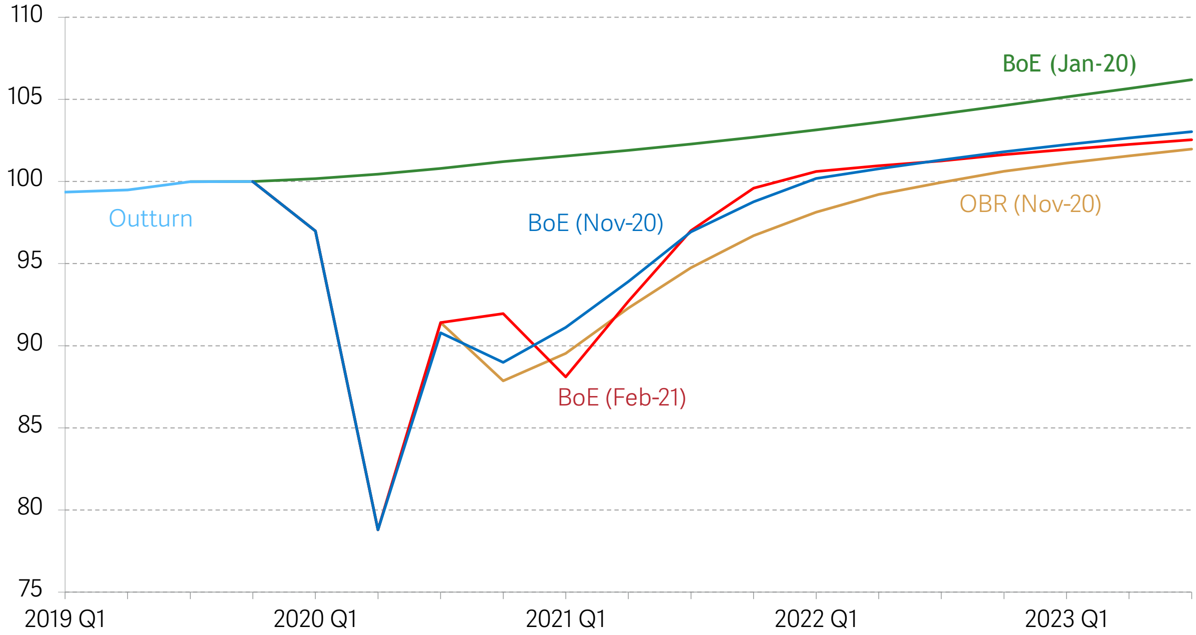
NOTES: In this chart we assume that the supply of vaccinations increases to 500,000 per day.
SOURCE: RF analysis of Government Dashboard, 20 February 2021.

For the Budget, all this means that while the starting point for the economy is a little stronger than the OBR expected in November, the outlook is somewhat weaker in the near term.

One way to gauge how the OBR may update its forecast for these three key developments is to look at the Bank of England's February forecast which incorporates these developments. As shown in Figure 3, the Bank's forecast is for the economy to grow by 5.1 per cent this year – which would be the strongest growth rate since the late 1980s – as social distancing restrictions are gradually removed and end completely by September. But that growth rate is weaker than the Bank's November forecast of 7.1 per cent. And unemployment now peaks at 7.8 per cent around the middle of this year, slightly higher than the Bank's November forecast.

FIGURE 3: **The Bank of England's forecast provides a good starting point for how the OBR may update its forecast**

Selected GDP projections (index, 2019 Q4 = 100): UK

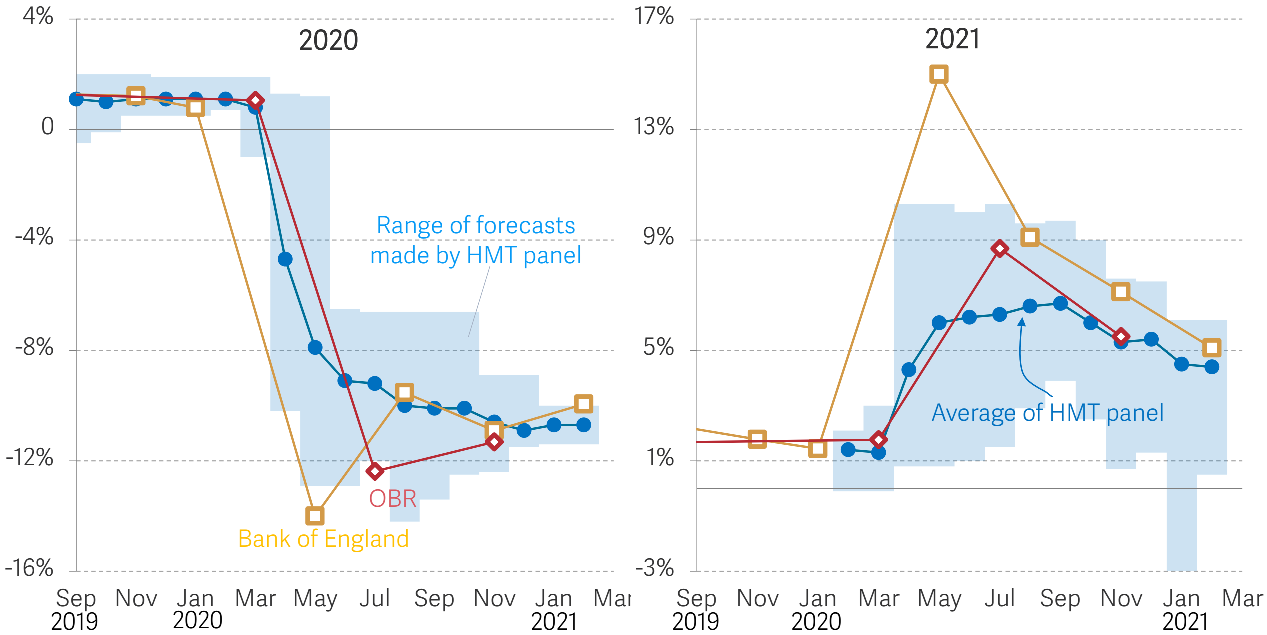


SOURCE: RF analysis of Bank of England, various; OBR, various; ONS, various.

While the Bank of England's forecast is towards the optimistic end of available forecasts, we take it as a good starting point for thinking about how the OBR might update its forecast. As shown in Figure 4, the Bank's forecast is one of the more optimistic available and was previously stronger than the OBR's. It is worth keeping in mind that we might expect the OBR's forecast to be a little weaker than the Bank's if they decide to maintain a slightly more pessimistic outlook. Nevertheless, below we base our view of the updated central scenario on the Bank's forecast. Such differences tend to be small and not material for decisions on policy. But in the current context, judgements about the path of the economy later this year will be important for assessing the overall stance of fiscal policy as we enter the recovery phase. It is important, too, to remember that GDP is not the only economic driver of changes to the fiscal forecast – specifically, the Bank forecast for inflation is that it returns to target quickly, reflecting the economy returning to full capacity quickly (an issue we discuss more in Section 4).

FIGURE 4: **The Bank's forecast for GDP is towards the top end of available forecasts**

Calendar-year forecasts for real GDP growth, by date of forecast: UK



SOURCE: RF analysis of HM Treasury; Bank of England; OBR.

We use a downside scenario in order to illustrate the implications of longer lasting social distancing measures for the Budget

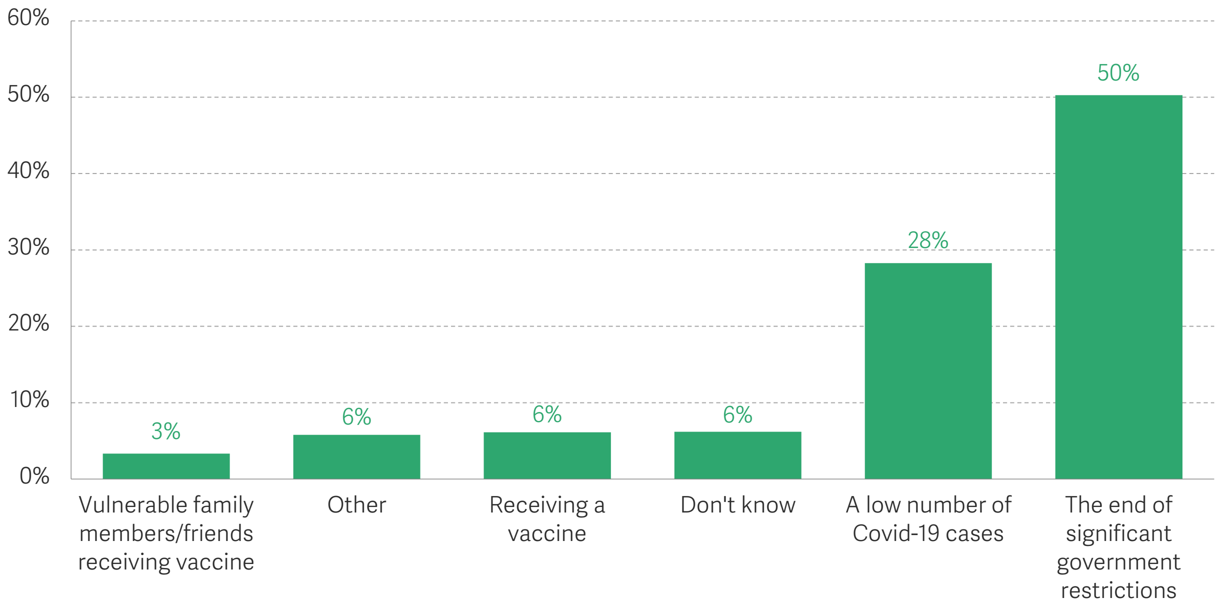
Although the vaccine means that a recovery is in sight, there is still massive uncertainty about the outlook for the economy. So while the Bank of England forecast provides a good basis for thinking about the most likely path for the economy, it is prudent to think about alternative scenarios for the economy. There are a range of risks. On the upside, as discussed in Box 1, there is the possibility of a jump in spending on social consumption once restrictions are lifted. But our view is that such a scenario would be temporary – with a couple of quarters of strong growth that will not translate into a longer-lasting boom, given the likelihood of higher unemployment. Instead, the key risk is that social distancing restrictions may be needed for longer in order to supress the spread of new variants of Covid-19. Below we discuss what such a scenario might look like, and what implications it could have for the path of the economy.

BOX 1: In an upside scenario, low Covid-19 cases and an end to restrictions will mark the end of the pandemic for most people – and a likely bounce back in social consumption

A majority of people see the end of the restrictions as the end of the pandemic – and we know from experience that we can only relax restrictions when cases are low. As Figure 5 shows, both a low number of Covid-19 cases and the end of restrictions are seen as key barometers for the end of the pandemic. Half (50 per cent) of working-age adults mark the end of significant government restrictions as the key event ending the pandemic with over a quarter (28 per cent) responding that a low number of Covid-19 cases signifies the end of the pandemic. The Bank of England forecast for economic activity assumes restrictions are entirely lifted by September, but a key risk is that new variants of Covid-19 become more prevalent, necessitating further restrictions to stop their spread.

FIGURE 5: **Half of working-age adults see the end of restrictions as the key event marking the end of the pandemic**

Proportion of working-age adults reporting the key event that will mark the end of the pandemic: UK, 22-26 January 2021

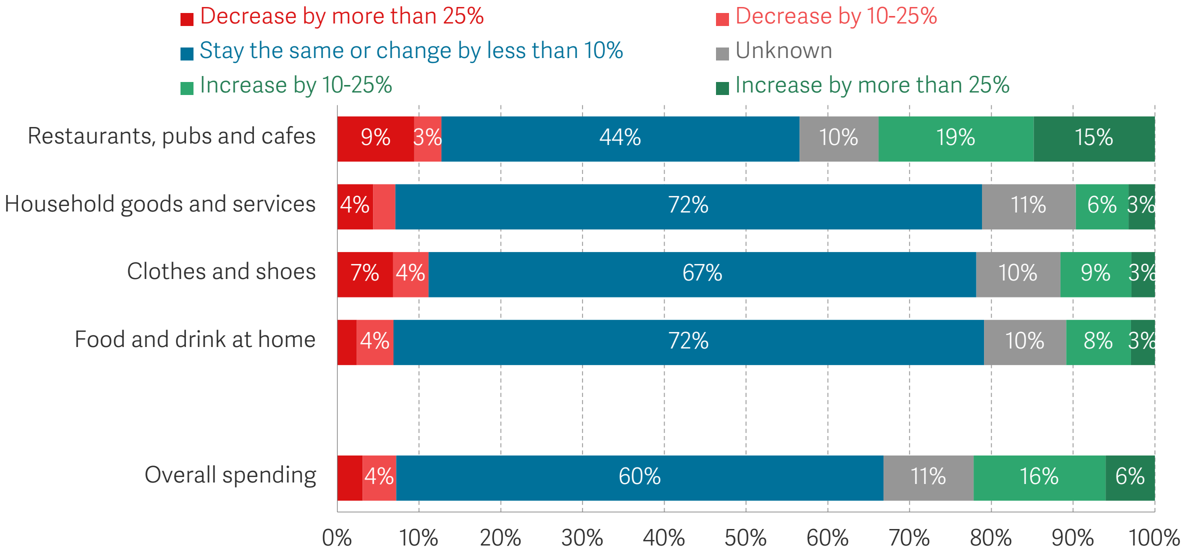


NOTES: Base = all UK adults aged 18-65 (n=6,389). The base for each sub-group in the chart are: Vulnerable family members/ friends receiving vaccine (n=213), Other (n=370), Receiving a vaccine (n=391), Don't know (n=396), A low number of Covid-19 cases (n=1,807) and The end of significant government restrictions (n=3,212). These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, UK Adults aged 18 to 65 and the coronavirus (COVID-19) – January 2021 wave.

Once restrictions are eased, consumer behaviour will respond to that change. As previous Resolution Foundation research has highlighted, (particularly high income) households have built significant savings over the pandemic.[4] Those same households have held back on their usually high social consumption during the crisis. As Figure 6 shows, over a third (34 per cent) of working-age adults intend to increase spending on restaurants, pubs and cafes after the pandemic, compared to just over a fifth (22 per cent) of adults who say they will increase overall spending. These findings support a potential upside scenario in which the removal of restrictions result in a jump in social consumption spending.

FIGURE 6: **Around a third of working-age adults intend to increase spending on restaurants, pubs and cafes after the pandemic**

Change in working-age adult spending following the end of the pandemic relative to spending prior to the pandemic, by spending category: UK, 22-26 January 2021



NOTES: Base = all UK adults aged 18-65 (n=6,389). These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, UK Adults aged 18 to 65 and the coronavirus (COVID-19) – January 2021 wave.

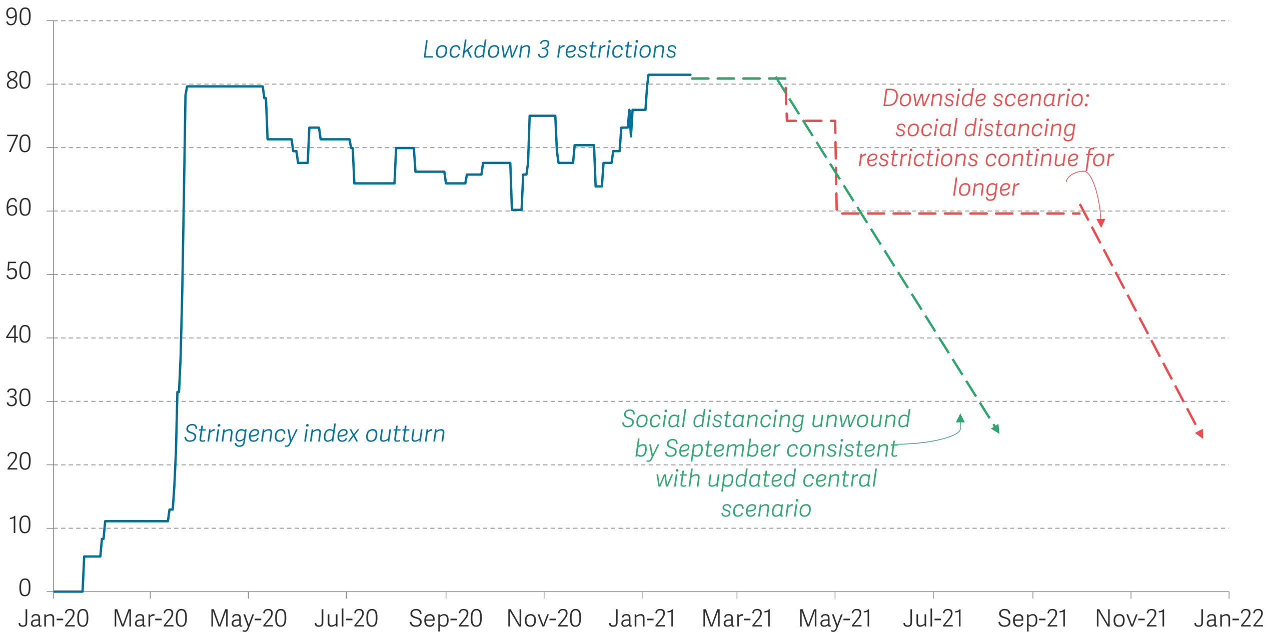
What might that downside scenario look like? To start, Figure 7 shows the relative stringency of social distancing restrictions in the UK since the start of the pandemic.[5] It is worth highlighting that the UK was one of the last developed (G7) countries to

4 T Bell et al., The Macroeconomic Policy Outlook Q4 2020, Resolution Foundation, December 2020.
5 Stringency here is based on the Oxford COVID-19 Government Response tracker that collect information on policy responses, including 'strictness' of lockdown with sub-domains like school and workplace closures and restrictions on internal and international travel. The index records the number and strictness of government policies and should not be interpreted as scoring the effectiveness of a response to the Covid-19 pandemic.

impose strict lockdowns and has maintained them for longer.[6] Based on the vaccine rollout, it is certainly possible that restrictions could be eased considerably over the summer.[7] This means the end of social distancing could come quicker than seemed likely in November. Indeed, while the Government's recently announced 'roadmap' for England is rightly cautious about the pace restrictions can be eased, it points to a very significant reduction over the coming months with few restrictions in place by July.[8] This chimes with Bank of England forecast assumptions that restrictions remain in place from January to March and, if all goes to plan, are gradually phased out and end completely by September. An illustrative path for this central case is shown by the green dotted line in Figure 7.

FIGURE 7: **Downside risks like virus mutations could mean social distancing kept in place for longer**

Outturn stringency index and illustrative scenarios of future restrictions: UK



SOURCE: RF analysis of Oxford University, COVID-19 Government Response Tracker.

But what if all doesn't go to plan? In our illustrative downside scenario (the red dotted line), restrictions are required until October and then phased out to January 2022. The key reason why this would be necessary is if the case load remained high (R remains stubbornly high). This could happen for a number of reasons, but one explanation could be that the prevalence of new, vaccine-resistant variants of Covid-19 become

6 S Dey-Chowdhury, N McAuley & A Walton, International comparisons of GDP during the coronavirus (COVID-19) pandemic, ONS, February 2021.
7 I Mulheirn, Lockdown Lessons: Five Steps That Should Guide the UK's New Roadmap, Tony Blair Institute for Global Change, February 2021.
8 HM Government, COVID-19 Response – Spring 2021, February 2021.

more common and require restrictions in order to suppress their spread across the population.[9] We assume that for both scenarios, some level of restrictions on travel into or out of the country remain in place which explains why in neither of the downside or updated central scenario the stringency index falls all the way back to zero.

So what does all this imply for the economy? To answer that question, we use our analysis of the link between lockdowns and economic activity discussed above. In this context, as discussed above, a key development has been the extent to which the economy has adapted to social distancing restrictions. In the January 2021 lockdown, mobility was down 49 per cent on pre-pandemic levels. This compares to 79 per cent during the April 2020 lockdown. Based on our downside scenario (the red dotted line in Figure 7), social distancing restrictions remain at current levels until the end of March, at which point some restrictions like meeting outdoors and re-opening schools are eased, before easing significantly in May (consistent with last year), but then remaining significant throughout the summer until restrictions are phased out between October 2021 and January 2022. In converting this to the implications for GDP, we assume there is no further improvement in the relationship between lockdown stringency and GDP.

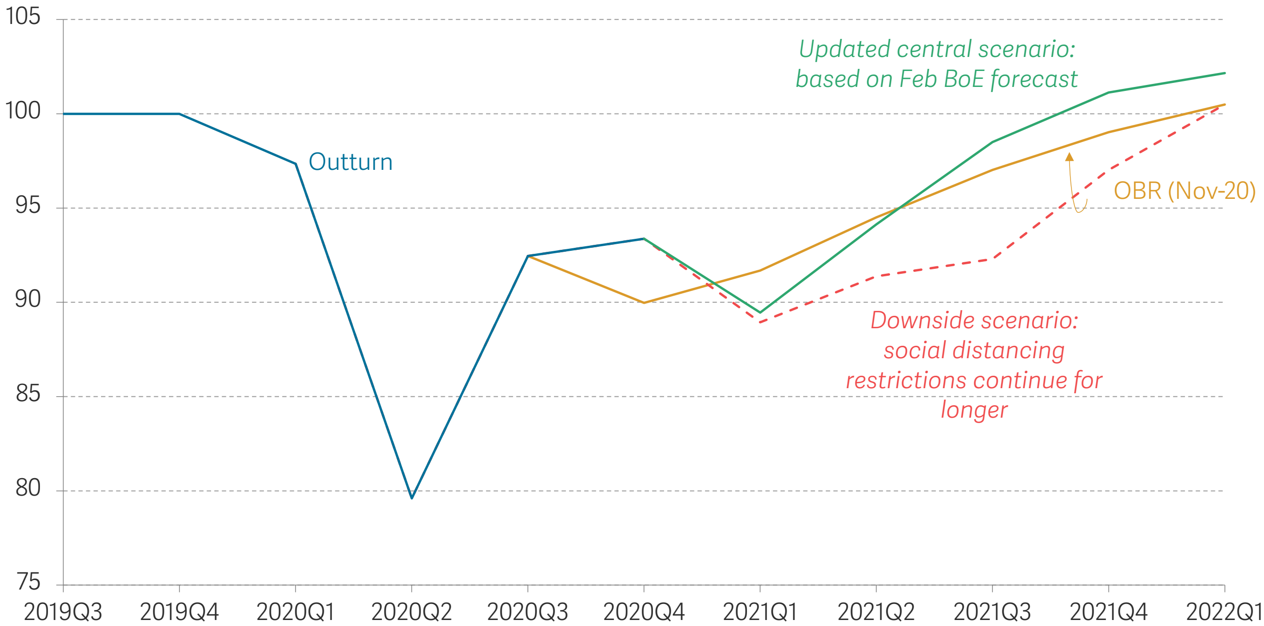
Based on all this, what are the near-term implications for GDP? Bringing together what we have learnt over the last year on restrictions and mobility, Figure 8 plots our downside scenario against the Bank of England's forecast for economic activity. In our illustrative scenario, restrictions weigh down on activity in the first quarter of 2021, but – in a similar way to 2020 – restrictions ease in late spring and summer. Figure 8 shows that in our downside scenario GDP falls by 4.8 per cent between Q4 2020 and Q1 2021, which is weaker based on the Bank of England's forecast (a 4.2 per cent fall). This slightly weaker-than-expected start to the year is supported by the activity of sectors like retail.[10]

9 Despite unprecedented take-up, initial estimates point to between one and two million of the four most at-risk groups opting out of the vaccine. Source: Department of Health and Social Care, UK COVID-19 vaccine uptake plan, February 2021.

10 For example, retail sales were down by 8 per cent in January 2021 from December. See: ONS, Retail sales, Great Britain, A first estimate of retail sales and value terms, seasonally and non-seasonally adjusted, February 2021.

FIGURE 8: **Despite upside news from the Bank, we should be wary of continued restrictions on economic activity**

Outturn and selected projections for quarterly index of GDP (index, Q4 2019 = 100): UK



SOURCE: RF analysis of Google, Community Mobility Reports; Oxford University, COVID-19 Government Response Tracker; ONS, Monthly GDP estimate; OBR, Various; Bank of England, Monetary Policy Report – February 2021.

In our updated central scenario, restrictions are eased significantly in late spring and early summer, but in our downside scenario they remain in place (in order to keep R below one). This translates into a growing gap between our two scenarios between Q1 2020 and Q3 2020. Even though activity recovers in the last quarter of 2021, overall GDP growth in 2021 (see summary in Table 1) is just 1.9 per cent in our downside scenario compared to 5.1 per cent in the central scenario based on the Bank of England's February forecast. This demonstrates that the future path of GDP is unusually uncertain and will depend on measures to prevent the transmission of current and future strains of the virus and restrictions on economic activity. As discussed in Box 2, prospects for the economy will also depend on how households' balance sheets recover.

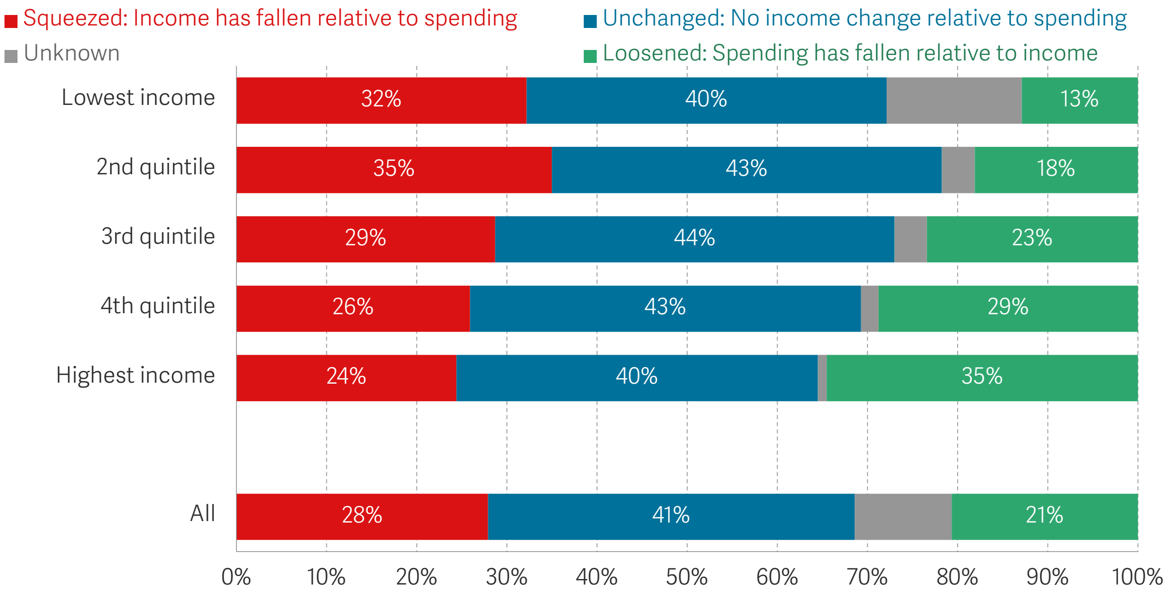
BOX 2: **Savings and debt during the crisis**

The pandemic has not had an even effect on households' balance sheets. While recent data from the Bank of England shows the largest reduction in consumer credit debt on record, with £16.6 billion in net repayments in 2020 and the total stock of consumer credit 11 per cent lower compared with a year ago in December 2020,[11] ONS data shows that over eight million people have reported needing to borrow more money as a result of Covid-19.[12]

Our previous work has discussed the drivers of this divergence. Here a key factor has been the uneven impact of Covid-19 on incomes. More than a quarter of adults (28 per cent) saw their income fall relative to their spending during the middle of the crisis (Figure 9).[13] The largest income falls were concentrated among those who had stopped working without furlough pay, and the self-employed – with more than half of each group reporting their incomes falling by more than 25 per cent.[14]

FIGURE 9: **Families with the lowest savings were most likely to see their financial position worsen over the crisis**

Change in household income and spending during re-opening (July-September) compared to February 2020, by pre-pandemic household income quintile: UK, 17-22 September 2020



NOTES: Base = all adults aged 18-65 with valid income data (n=3,128), apart from the 'all' category where the base is all UK adults aged 18-65 (n=6,061). Family income distribution based on equivalised, disposable benefit unit incomes among 18-65-year-old adults, excluding families containing retired adults or nonworking adult students (see annex for more details). Categories calculated based on answers to questions on changes to household income and household spending (see annex for more details). These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, UK Adults Age 18 to 65 and The Coronavirus (Covid-19) – September wave.

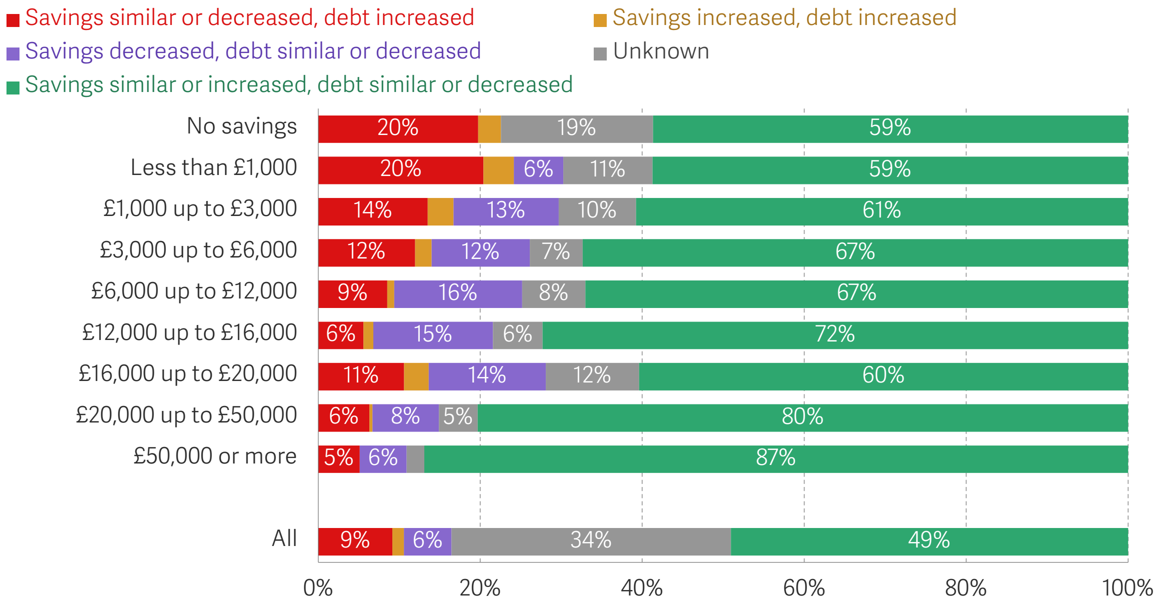
11 Bank of England, Consumer Credit.
12 ONS, Personal and economic well-being in Great Britain, January 2021.
13 First published in: K Handscomb & L Judge, Caught in a (Covid) trap: Incomes, savings and spending through the coronavirus crisis, Resolution Foundation, November 2020.
14 Ibid.

In our more recent January survey, we asked respondents about their (and their partner's) level of savings before the crisis and at the time of responding, as well as their change in debts (excluding mortgage debt). In line with the Bank of England data and the ONS survey, we find that half of our respondent families (49 per cent) had seen household balance sheets improve, or at least remain unchanged (see Figure 10). However, some 9 per cent of families saw their debts increase, while their total savings – if they had any at all – remained unchanged or decreased.

Worryingly, those with the lowest levels of savings before the crisis, were most likely to have deteriorating balance sheets. One-in-five families with no savings or savings less than £1,000 saw their household balance sheet get worse over the course of the crisis.

FIGURE 10: **Families with the lowest savings were most likely to see their financial position worsen over the crisis**

Change in families' debt and savings since February 2020 by level of pre-crisis savings: UK, 22-26 January 2021



NOTES: Unweighted bases: All adults (6,389), No savings (922), £0-1000 (604), £1,000-3,000 (497), £3,000-6,000 (476), £6,000-£12,000 (474), £12,000-£16,000 (231), £16,000-£20,000 (167), £20,000-£50,000 (500), £50,000+ (714). Weights have been adjusted for number of adults in each family. Savings change defined as change up or down savings bands (as in the figure), debt change directly reported. These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, UK Adults Age 18 to 65 and The Coronavirus (Covid-19) – January wave.

This finding is not unexpected. Our previous survey (see Figure 9) showed that those on the lowest incomes were more likely to be financially squeezed by this crisis, and at the outset of Covid-19, we already knew that lower income households were less likely to have sufficient savings to withstand an income shock.[15]

Other research has also shown that some households have been affected by increasing levels of debt. For example, recent survey work showed that, by October last year, around 38 per cent of adults had seen their financial situation worsen as a result of Covid-19, with 14 per cent seeing an increase in the amount of unsecured debt they owe.[16] Separate research conducted in September also found that one million more people had fallen into debt to make ends meet since the start of the Covid-19 crisis.[17] All this suggests that a significant minority of households are likely to emerge from the pandemic with significantly weaker balance sheets.

To draw out the implications of these economic scenarios for the Budget in the next section we analyse their implications for the public finances. In addition, we look at how economic support measures may need to be adjusted in the light of these two scenarios.

TABLE 1: **A potential downside scenario could see GDP grow by just 1.9 per cent in 2021**

Public health assumptions and the economic effects of a potential central and downside scenario for the virus: UK

	Virus scenarios	
	Central	Downside
Public health assumptions		
Material restrictions end	October 2021	January 2022
Vaccine rollout complete	July 2021	July 2021
Prevalence of new variants	Low	High
Economic effects (per cent, unless otherwise stated)		
Real GDP growth in 2021	5.1	1.9
Average inflation rate	1.4	1.4
Long-term GDP scarring	3.0	3.0

SOURCE: RF analysis of Google, Community Mobility Reports; Oxford University, COVID-19 Government Response Tracker; ONS, Monthly GDP estimate; OBR, various; Bank of England, Monetary Policy Report – February 2021.

15 See Figure 39 in: G Bangham & J Leslie, Rainy days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020
16 Financial Conduct Authority, Financial Lives 2020 survey: the impact of coronavirus, February 2021.
17 StepChange, Tackling the coronavirus personal debt crisis, November 2020.

Section 3

The fiscal outlook

The fiscal implications of the scenarios set out in Section 1 are discussed in this Section. As set out above, there is significant economic uncertainty in the months and years ahead. However, in terms of public spending, the key uncertainty remains spending policy, which dominates both past and future changes to the public finances. In the near term, there is some upside news, with borrowing likely to be lower in 2020-21 than forecast in November. This is largely down to lower central government spending than forecast, although the revised economic scenarios also reduce borrowing somewhat.

However, looking ahead, borrowing may not fall as quickly as forecast next year, again largely due to policy costs, and further support measures that we expect to be announced at the Budget. In our downside scenario, it is also assumed that some of this spending will continue into the later years of the forecast, as public services deal with the longer-term effects of the pandemic on health, education and local government. The overall fiscal picture during the pandemic is still a historic hit to the UK's public finances, with borrowing reaching its highest level since the Second World War this year. But, the public finances nonetheless remain manageable, with debt interest payments close to their lowest levels in over a century in all scenarios.

In addition to the economic outlook covered in the previous section the other key input to the Chancellor's decisions at the Budget is the state of the public finances. Approaching the Budget on the 3rd March, the fiscal impact of the path of the economy in both the near and medium term will be in the spotlight. Building on the two economic scenarios set out in Figure 8, this Section looks at their impact on key fiscal aggregates, as compared to the OBR's forecasts at the November Spending Review, and the March 2020 Budget. In addition, and more dramatically altering the fiscal scenarios, this section also looks at the likely effects of Government policy on spending in this year, and over the forecasting period.

Despite the pandemic taking a turn for the worse, borrowing is likely to be lower than forecast in 2020-21

Back in November, borrowing was forecast to reach levels unseen outside of peacetime in 2020-21, at around 20 per cent of GDP. The vast majority of this is the result of Government policy, with the OBR forecasting £278 billion increases in borrowing this year due to policy decisions, out of a total increase of £339 billion. This spending is the result of a decision to socialise the economic costs of the pandemic, and support incomes, for example through the furlough scheme. Failing to do this would not have resulted in lower borrowing, given the high fiscal costs to the economic scarring that would have resulted from, for example, a sharp spike in unemployment at the start of the pandemic, absent the furlough scheme.

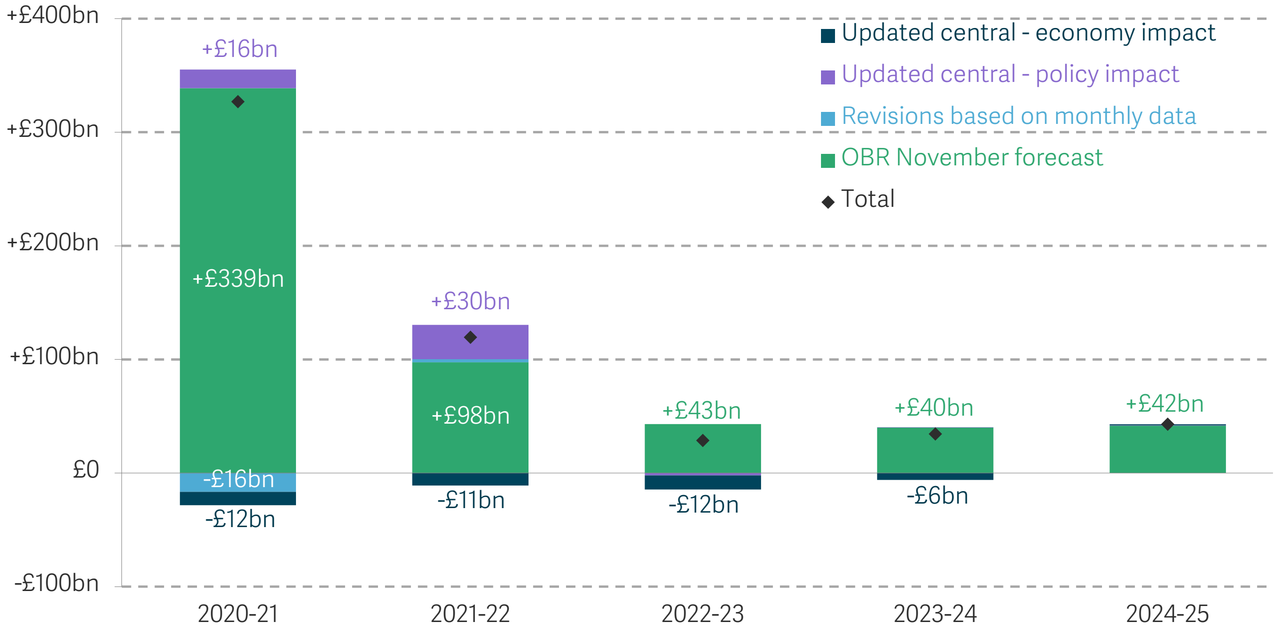
However, since November, monthly public finances data published by the ONS has suggested that total borrowing for this year is likely to be substantially lower than forecast.[18] According to the OBR, borrowing for the year to end-January is around £40 billion lower than expected, compared to their November forecast (excluding the effects of the different treatment of loan scheme write-offs in the ONS statistics).[19] This reflects three factors: stronger-than-expected self-assessment and capital gains receipts, higher VAT receipts and lower-than-expected central government expenditure. For the fiscal scenarios below the impact of the less weak than expected starting point for the economy is reflected in our updated central scenario which embodies higher tax receipts reflecting the Bank of England's updated forecast for GDP.[20] Similarly, some of the drivers of changes to central government expenditure (including welfare spending, interest payments, and costings for the JRS and SEISS schemes) are already reflected in our revised economic forecasts – with a stronger GDP path lowering welfare spending, for instance. However, there is around £16 billion that is not accounted for by these economic drivers, and this we incorporate into the November 2020 forecast baseline for our scenarios, reducing borrowing estimates in 2020-21.[21] The Budget should bring more clarity on the source of this under-spend, and whether it is likely to be recurring, or deferred (increasing borrowing next year). But for the purposes of the scenarios below, we assume an intermediate case of a 'one-off' underspend with no implications for future borrowing.

18 ONS, Public sector finances, UK: January 2021, February 2021.
19 OBR, Commentary on the public sector finances – January 2021, February 2021.
20 However, based on the ONS release data, we have chosen to exclude some of the 'timing effect' assumed by the OBR relating to self-assessment and capital gains receipts. In the November forecast, it was assumed that a proportion of these receipts would be deferred under the Government's 'self-serve time-to-pay scheme', announced in the Spending Review, and so would increase borrowing in 2020-21, and reduce it in 2021-22. We assume half of the forecast take-up does not occur, on the basis of the strong receipts reported in January, increasing borrowing by £2.6 billion in 2021-22.
21 This £16 billion relates to the difference from April to end-January in cumulative central government current expenditure on goods and services and subsidies between monthly profiles of the OBR's November forecast and ONS monthly outturn data, excluding differences in JRS and SEISS funding.

Moving to the economic impact of the updated central scenario set out above, despite uncertainty in the economic context, and shifts in the health response to the pandemic due to vaccines and new variants, the impact of adjusting in line with the Bank of England's latest forecasts is small in terms of the public finances. Figure 11 illustrates the increases in borrowing since the March 2020 Budget. The green bar illustrates the OBR's most recent forecasts from the November Spending Review, with the light blue bars illustrating the revisions based on monthly outturn data set out above. The darker blue bars show the impact of the changes in the economic path in our updated central scenario. Higher output and a stronger labour market lead to higher receipts and lower welfare spending than forecast in November, meaning borrowing is reduced across the forecasting period. This effect is reduced in the later years of the forecast, as higher inflation and interest rates lead to higher debt interest payments.

FIGURE 11: **In the updated central scenario, the revised path of the economy reduces borrowing, with policy costs increased in the near term**

Breakdown of additional public sector net borrowing since the March 2020 Budget, November OBR forecasts and RF updated central scenario: UK, 2020-21 to 2024-25



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; Bank of England, Monetary Policy Report, February 2021.

However, changes in policy are likely to add to the deficit. The purple bars in Figure 11 illustrate additional policy costs in the updated central scenario, adding to borrowing in this year, and next. Policy costs in this scenario are assumed to be the minimum further support the Chancellor is likely to announce at the Budget in order to protect incomes – namely temporary extensions of the JRS, SEISS and Universal Credit uplift, as well as support for businesses, while restrictions remain in place.[22] It is assumed that the Chancellor resists calls to make the £20 per week uplift in Universal Credit permanent, choosing instead, as trailed, to extend by just six months.[23] Taken together, the policy and economic impacts on borrowing of the updated central scenario largely 'net-out' over the near term – and do not radically alter the overall fiscal picture.

As set out in previous publications, this minimal additional support is less than is needed to generate a rapid recovery, and sets out the lower bound of what the Chancellor should announce at the Budget. Extending these support schemes not only while the pandemic is ongoing, but also to support the transition into the recovery and beyond is crucial to avoiding an economic disaster. It is true that in extending this support, the Chancellor runs the risk of supporting non-viable jobs and businesses. But our view is that this additional policy support is crucial to avoiding viable businesses from becoming bankrupt,[24] and to stop workers being made redundant from viable jobs.[25] These would lead to lasting economic damage. Moreover, failing to at least extend the £20 per week Universal Credit uplift would be a living standards catastrophe – with a permanent uplift a far better policy option (as explored in previous work,[26] and set out in Section 4).

If social distancing restrictions continue for longer, the Chancellor will need to spend significantly more

However, as set out in Section 2, given significant uncertainty around the path of the health crisis, policy should be robust to the possibility that social distancing measures are needed for longer, and that the path out of lockdown is less straightforward than planned. As the many rounds of successive policy announcements over the past year have shown, support will need to continue if the path of the pandemic, and intensity of social distancing restrictions requires it.

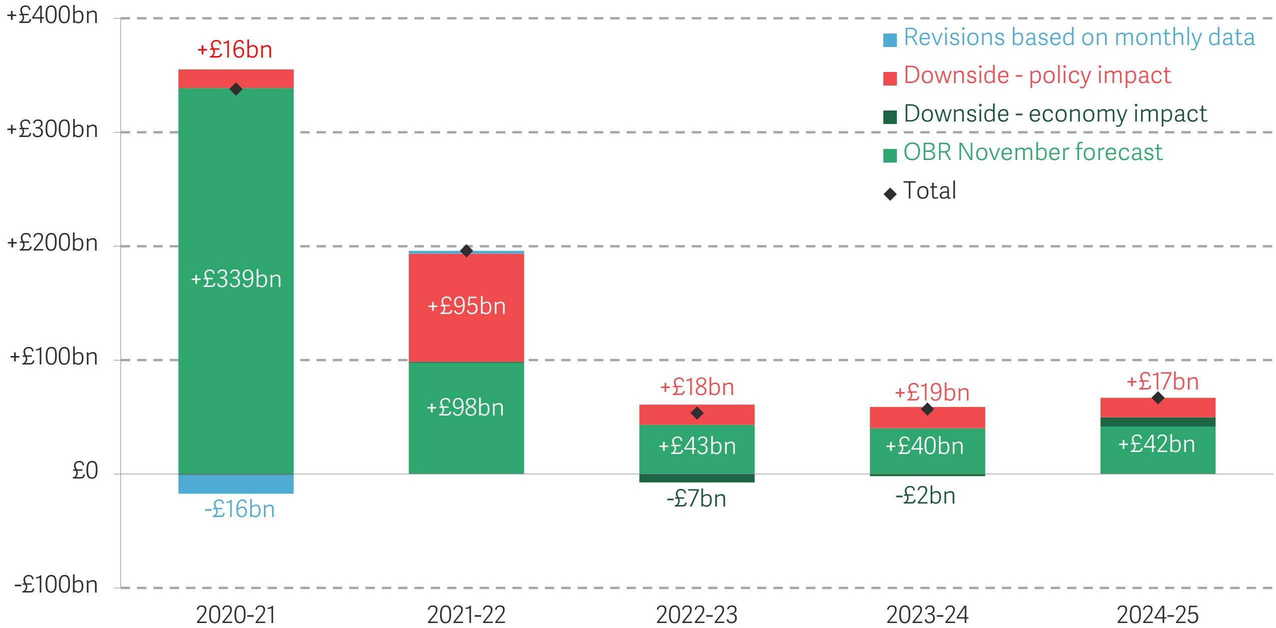
The downside scenario set out in Section 2 therefore results in more pressure on the public finances. The dark green bars in Figure 12 illustrate the revised economic path, with a more pessimistic near-term GDP forecast than the updated central scenario, but still stronger than the OBR's November forecast. This means borrowing is reduced by less than in the updated central scenario. Given inflation is still higher in this scenario, debt

22 Here we are assuming JRS and SEISS schemes remain in place until end-September. Tapering of the JRS over the final months of the scheme reduces costs. The SEISS is assumed to be renewed for a fifth payment, but adapted in line with recommendations in: N Cominetti, K Henehan, H Slaughter & G Thwaites, Long Covid in the labour market: The impact on the labour market of Covid-19 a year into the crisis, and how to secure a strong recovery, Resolution Foundation, February 2021. A further round of business grants totalling £4.6bn is assumed, and a further 3 months of business rates relief.
23 See ITV News, 'Universal credit £20 uplift to continue for another six months',19 February 2021.
24 For more on likely support needed for businesses at the Budget, see N Cominetti, J Leslie & J Smith, On firm ground?: The impact of Covid-19 on firms and what policy makers should do in response, Resolution Foundation, February 2021.
25 N Cominetti, K Henehan, H Slaughter & G Thwaites, Long Covid in the labour market: The impact on the labour market of Covid-19 a year into the crisis, and how to secure a strong recovery, Resolution Foundation, February 2021.
26 See M Brewer & K Handscomb, Half measures: the Chancellor's options for Universal Credit in the Budget, Resolution Foundation, February 2021.

interest payments do not 'net off' with this reduction, meaning borrowing is elevated by the end of the forecasting period. Ultimately, these impacts from the revised economic forecast remain small.

FIGURE 12: **In the downside scenario, borrowing is significantly increased by additional policy measures**

Breakdown of additional public sector net borrowing since March 2020 Budget, November OBR forecasts and RF downside scenario: UK, 2020-21 to 2024-25



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; Bank of England, Monetary Policy Report, February 2021.

However, the red bars in Figure 12 illustrate increased policy costs in the downside scenario, which have a far more significant impact on borrowing. In 2021-22 this is largely due to the assumed extension of support schemes until December (when restrictions lift in the scenario set out in Section 2). However, on top of this, it is assumed that the public services funding required will exceed that set aside in the 'Covid reserve', and will cost a further 50 per cent of the funding budgeted for covid-related support in 2021-22, given the extended duration of social distancing measures (£27 billion). Looking ahead, this scenario also incorporates the risk that Covid-related funding will be required after 2021-22, when it is currently forecast to end. Reflecting this, it is assumed there are further RDEL pressures in the final years of the forecast with the spending cuts set out in Spending Review unrealised – adding around £13 billion per year to borrowing over the forecast. On top of this, further spending on schools catch-up, health backlog and local government is incorporated – resulting in a further £9 billion increase in borrowing in 2022-2023, which tapers off towards the end of the forecast.[27]

Pulling these scenarios together in Figure 13, borrowing is likely to be lower than forecast back in November in 2020-21, due to lower government spending in the outturn data, but higher next year, down to likely policy announcements to come. The borrowing in the 'OBR November forecast' in Figure 13 has been reduced from the OBR's £394 billion to £377 billion to reflect changes in monthly outturn set out above. Borrowing is slightly elevated by policy costs in both the updated central and downside scenarios in this year, but due to the stronger GDP path assumed, remains around 18 per cent of GDP.

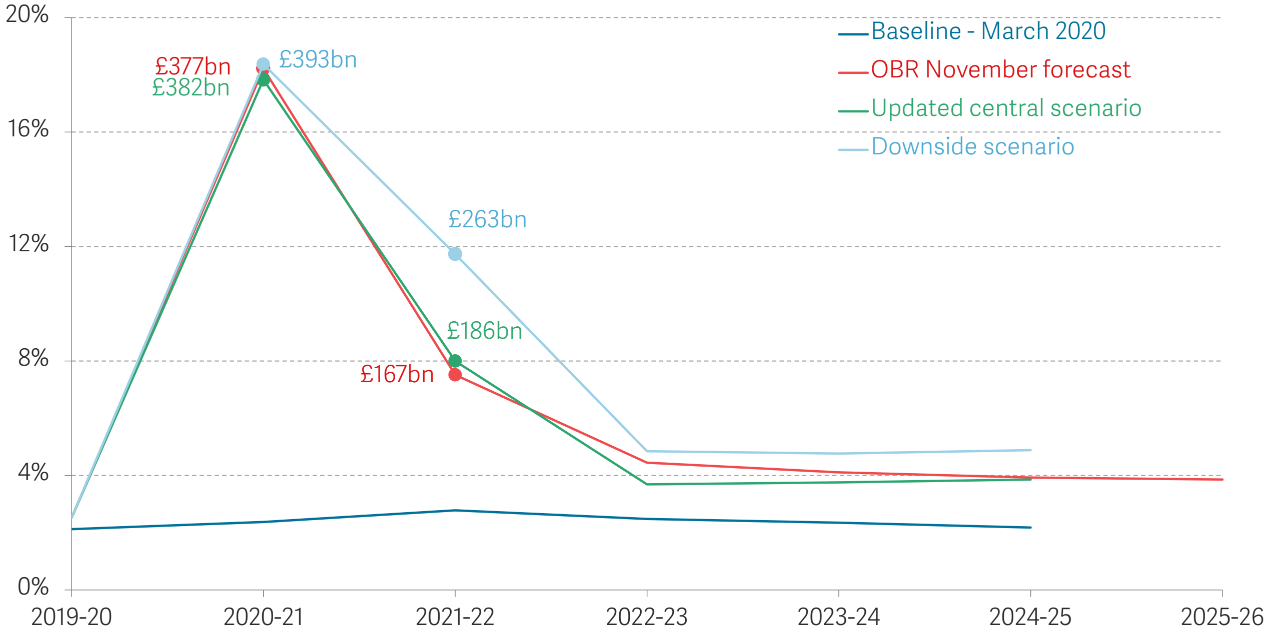
However, borrowing next year is much more uncertain. In the updated central scenario, policy boosts borrowing in 2021-22, but the higher level of nominal GDP in the scenario means that borrowing again remains relatively similar to the November forecast as a proportion of GDP, at 8 per cent. Looking at the downside scenario, policy costs are much higher in 2021-22, with borrowing reaching £263 billion (12 per cent of GDP). Over the medium term, the level of GDP converges to the baseline given no further assumed economic scarring, but policy adds persistent costs that elevate the deficit to 5 per cent of GDP by the middle of the decade in the downside scenario. Looking beyond the point at which the recovery is secured, our previous work set out a medium-term consolidation that focussed on reaching and maintaining current balance after 2024-25, in order to build fiscal space to deal with future crises. Reaching current balance in 2024-25 would require a consolidation of £28bn in the updated central scenario, or £52bn in the downside scenario.[28]

27 This would mean spending continuing in 2022-23 at levels equivalent to that budgeted for in 2021-22 in the November 2020 Spending Review costings for Covid-related support for the NHS recovery (£3bn), local authority grant funding (£2.2bn), support for passenger rail services (£2.1bn), and support for the justice system and other public services (£0.3bn). Schools catch-up is assumed to cost more than currently budgeted for in 2021-22, and here we are factoring in costs continuing at the higher level assumed for 2020-21 (£1.4bn).

28 G Bangham et al, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

FIGURE 13: **Borrowing looks set to reach around £400bn in 2020-21, but borrowing next year is far more uncertain**

Public sector net borrowing as a proportion of GDP, OBR March and November forecasts, and RF 'central' and 'downside' scenarios: UK, 2019-20 to 2025-26

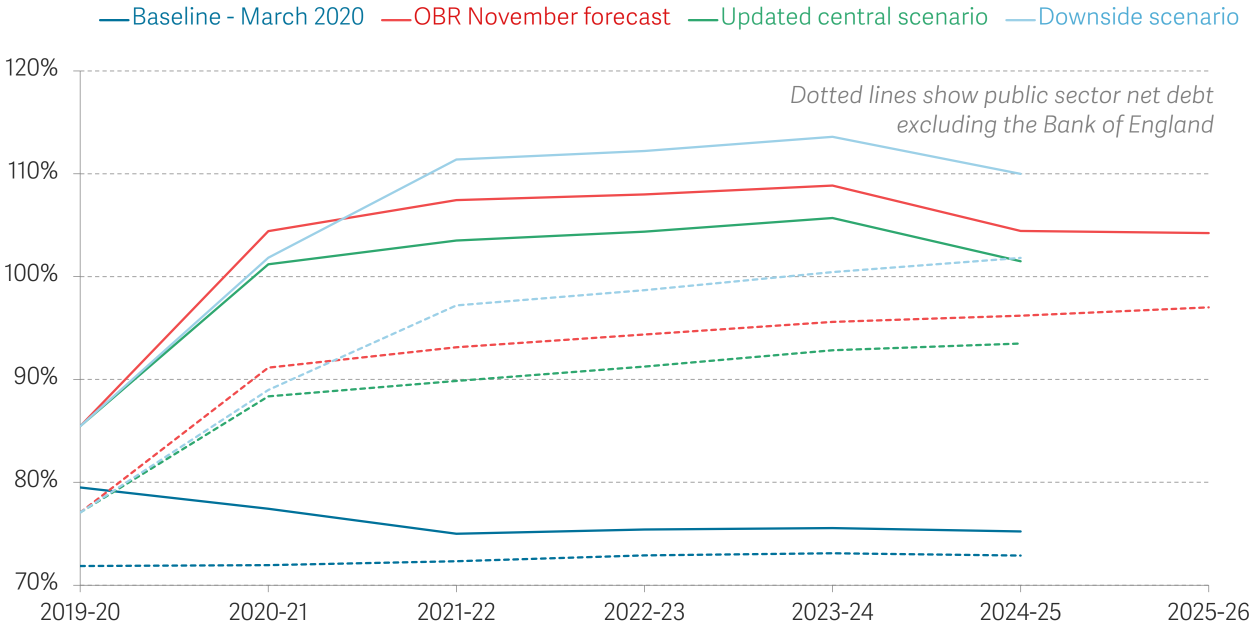


SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; Bank of England, Monetary Policy Report, February 2021.

Increases in borrowing feed through into higher debt stocks in both the updated central and downside scenarios in nominal terms. However, again, the stronger path of GDP than forecast in November means that debt in the updated central scenario remains lower than forecast as a proportion of GDP. As illustrated in the dotted lines in Figure 14, debt is rising by the end of the forecast in both scenarios, when the impact of Bank of England schemes is excluded. However, this does not necessarily imply that future fiscal consolidation should focus on this metric – with alternatives covered in Section 4.

FIGURE 14: **In both scenarios, debt excluding the Bank of England is rising**

Public sector net debt as a proportion of GDP including and excluding Bank of England, OBR March and November forecasts, and RF updated central and downside scenarios: UK, 2019-20 to 2025-26



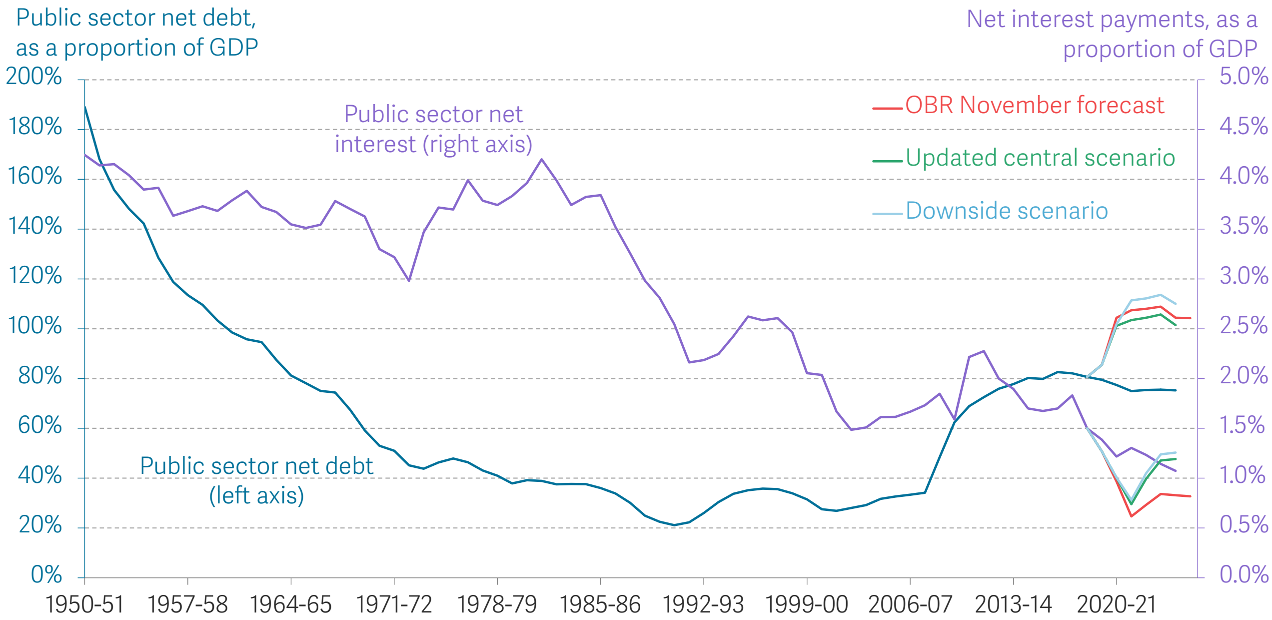
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; Bank of England, Monetary Policy Report, February 2021.

Financing conditions remain favourable but a slowing in QE purchases will reduce the downward pressure on debt servicing costs

As set out in previous work, while borrowing is still forecast to reach levels unseen outside of wartime, this remains affordable due to low interest rates. In both scenarios, debt interest costs as a share of revenues fall in the near term, relative to levels forecast pre-pandemic. However, as mentioned above, higher inflation and increases in market interest rates in both our scenarios lead to higher debt interest costs by the end of the forecasting period. But, crucially, as shown in Figure 15, debt interest costs remains at a historically low level in both scenarios and, given the pressing needs to continue to support the economy in the near-term, should not be driving policy at this point. The question of consolidation is addressed in Section 4.

FIGURE 15: **Higher inflation means debt servicing costs are likely to be higher than forecast in November, but remain at their lowest level in decades**

Public sector net debt and net interest payments, as a proportion of GDP: outturn, OBR March and November forecasts, and RF updated central and downside scenarios: UK, 1950-51 to 2025-26



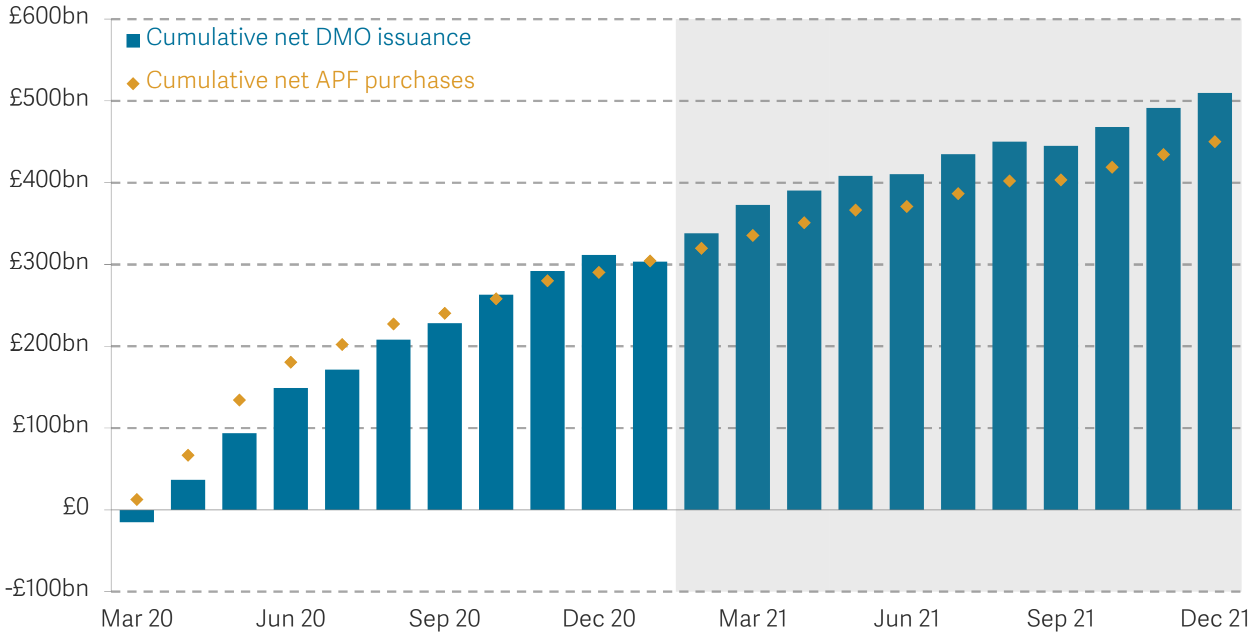
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2020 and November 2020.

How confident can we be that favourable financing conditions will continue? Since the start of the crisis, the additional issuance of government debt has been hoovered up by additional QE purchases by the Bank of England (Figure 16). Those purchases have slowed in recent months and – relative to a counterfactual of a constant flow of purchases – this slowing will reduce downward pressure on borrowing costs. However, recent Bank of England analysis illustrates that, looking at these series in flows terms, the Bank has been purchasing gilts below the pace of Debt Management Office issuance for the past six months or so.[29] This, alongside the fact that yields on government debt remain close to all-time lows reached last summer (despite having risen somewhat in recent weeks) would suggest that any upward pressure on yields from this source has not been all that large. Our view, then, is that the risk that financing costs may rise should not be the Chancellor's primary concern at the Budget.

29 G Vlieghe, An update on the economic outlook, speech given at Durham University, February 2021.

FIGURE 16: **Bank of England gilt purchases have slowed since the start of the pandemic**

Cumulative monthly net Debt Management Office gilt issuance and net Asset Purchase Facility gilt purchases: UK, March 2020 to March 2022



SOURCE: RF analysis of DMO, Bank of England.

In fiscal terms, the picture remains one of borrowing falling from next year but, given the need to support policy, less quickly that previously forecast. The fall in borrowing could be slower still if the relaxation of social distancing is less smooth than expected. However, this additional spending remains both affordable and necessary to avoid further economic scarring. Beyond the immediate crisis support measures discussed in this section, a key question is how much additional fiscal stimulus is required to ensure a rapid recovery. We turn to that question next.

Section 4

Macroeconomic policy during the recovery

The upcoming Budget will set out the Government's plans to extend and subsequently phase out the crisis support – macroeconomic considerations need to be a core part of that. The macroeconomic debate, or the top-down view on how much Government support is needed in the economy, has largely been missing from policy discourse in the UK, in stark contrast to the US since Biden took office. The answers are not straightforward. We know that monetary policy alone will not be anywhere near enough to generate a rapid recovery. Therefore, more fiscal stimulus will be needed as there is likely to be a material output gap over the next two years. Failing to provide support would leave unemployment higher than necessary and could increase long-term economic damage – or scarring – from the crisis, which would reduce living standards for years to come.

But calibrating the right amount of support is very difficult given a number of key uncertainties. There is a clear case for erring on the side of doing 'too much' rather than doing 'too little'; not least because the risk of long-term increases in inflation are unlikely because inflation expectations appear well-anchored and the weakness in the labour market will hold back wage growth. That is clearly the view of the Biden administration in the US as it pushes to enact a $1.9 trillion package of support. A direct read-across to the UK is difficult because both the package of support covers areas already captured by UK policy and because the UK's economic decline during 2020 was much more severe. Taking the top-end of what would be equivalent in the UK suggests stimulus of nearly £350 billion over the next two years, enough to boost GDP to around 5 per cent above its pre-pandemic path. Here the case for stimulus on that scale depends on the ability of fiscal policy to provide a meaningful boost to the economy's productive capacity. An approach which takes a more pessimistic view on the ability of fiscal policy to affect productivity suggests spending should merely aim to close the estimated output gap. Here, again, estimates vary but the Bank of England's most recent output gap forecast would suggest there is no need for fiscal policy to do more than it already has.

The right answer lies somewhere between the two. The IMF's estimate of the output gap suggests stimulus of the order of £85 billion over the next two years, but the Chancellor should build in a margin of error given the asymmetry in risk of doing too much versus too little. Therefore our view is that the Chancellor should set out plans for fiscal stimulus equating to roughly £100 billion over the next two years, over and above the policy measures factored into the forecasts mentioned above.

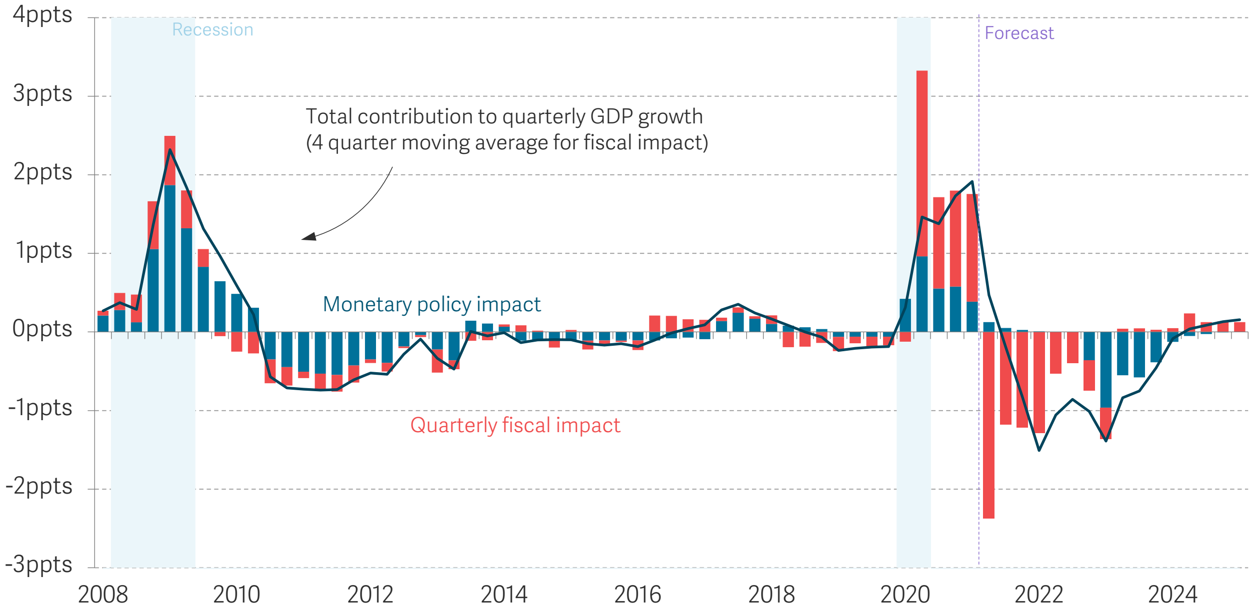
Perhaps even more important than the size of any support is its timing: if stimulus is introduced too early, this risks prolonging the health crisis as expanding economic activity will inevitably lead to increases in social interactions; too late risks further economic scarring as a low aggregate demand environment will prevent businesses from bringing back furloughed workers once the scheme has ended and will prevent a sorely needed recovery in business investment.

Current fiscal plans assume a sharp retraction of economic support over the next year. As shown in Figure 11, current Government policy is for fiscal support to be withdrawn quickly over the coming year, and this will have a direct impact on the economy. Figure 17 shows our estimate of the impact of macroeconomic policy on quarterly GDP growth – fiscal policy is estimated to have boosted quarterly GDP growth by at least 1 percentage point every quarter in 2020-21.[30] Although this boost to GDP growth in 2020 will continue to support the GDP level over the coming years, fiscal policy is set to become a substantial headwind to growth over the next year. This naturally raises the concern that the speed of the economic recovery could be harmed.

30 These estimates are based on the fiscal plans as at the OBR's November 2020 forecast, plus the additional government policy measures announced since then.

FIGURE 17: **Fiscal policy is set to become a drag on GDP growth**

Estimated impact of macroeconomic policies on quarterly GDP growth, history and forecast: UK



NOTES: Monetary policy impact is calculated using estimates from P Bunn, A Pugh & C Yeates, 'The distributional impact of monetary policy easing in the UK between 2008 and 2014', Bank of England Working Papers no.720, Bank of England, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the OBR's estimate of fiscal multipliers. The values for 2020 and 2021 are based on assuming Bank rate is held at 0.1 per cent and the OBR's central scenario from the November Economic and Fiscal Outlook.
SOURCE: RF analysis of OBR, various; ONS; Bank of England.

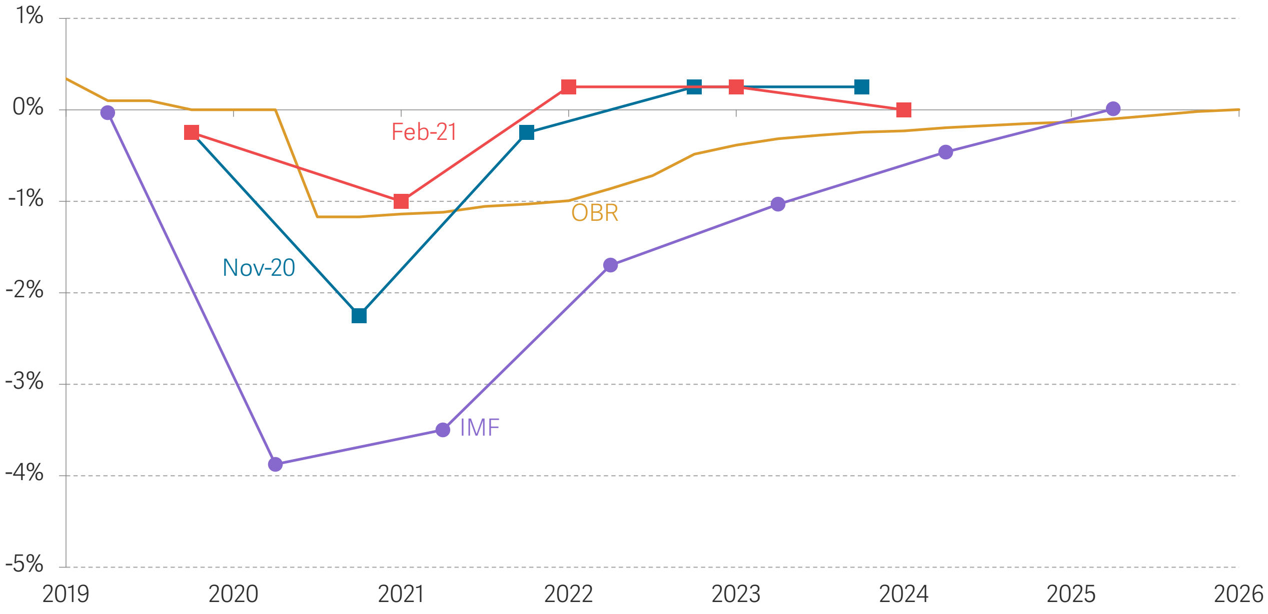
Fiscal policy becomes a drag on growth at the same time as estimates suggest there is a material output gap: there is a clear case for more fiscal support. The timeless objective of macroeconomic policy is to close the output gap, reducing unemployment and keeping inflation low and stable. Typically, this objective largely falls to monetary policy but with rates as close to as low as they can go and limited additional benefit from further QE purchases, fiscal policy must play the role of macroeconomic stabiliser.[31]

Estimates of the current UK output gap vary widely as do forecasts for how it is likely to evolve, as shown in Figure 18 . At one end of the spectrum, the Bank of England forecast suggests the economy is currently operating close to its sustainable level and, during the recovery, temporary supply constraints from social distancing withdraw at the same rate as demand recovers. This means that the output gap also closes quickly. At the other end of the spectrum, the IMF assessment is that the UK economy is substantially below its productive capacity and will remain so for the next few years.

31 J Smith et al, Recession ready? Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019.

FIGURE 18: **The Bank's output gap measure suggests very little spare capacity**

Range of forecasts for the output gap: UK

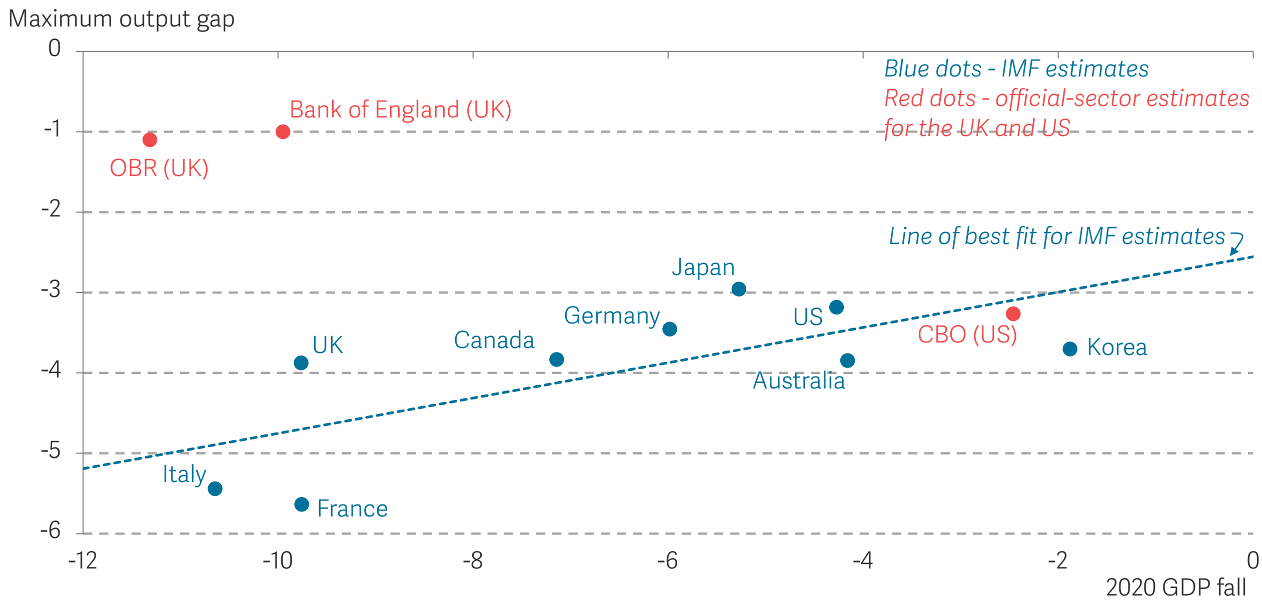


SOURCE: RF analysis of Bank of England, Monetary Policy Report, November 2020 and February 2021; IMF, World Economic Outlook, October 2020; and OBR, Economic and Fiscal Outlook, November 2020.

As the size of the output gap is a crucial component of assessing the need for fiscal stimulus, it is instructive to consider cross-country estimates – where the UK official-sector forecasts appear to be smaller than other estimates. As shown in Figure 19, countries with larger falls in economic activity during 2020 are estimated to have had a larger output gap; this makes sense as only part of the fall in GDP reflects a reduction in supply (either temporary due to restrictions on social interactions or 'permanent' as a result of scarring effects from the economic downturn) while the rest comprises a larger fall in aggregate demand. But even for those countries which have had relatively small falls in GDP in 2020, estimates of the output gap are larger than the Bank of England and OBR's are for the UK.

FIGURE 19: **Countries with larger falls in GDP are also estimated to have larger output gaps**

Cross-country estimates of output gaps compared to falls in 2020 GDP



SOURCE: RF analysis of IMF; CBO; OBR; & Bank of England.

There are two main sources of uncertainty on what this means for the required level of fiscal stimulus – the balance between supply and demand falls during the crisis, and to what extent supply falls are temporary or permanent.

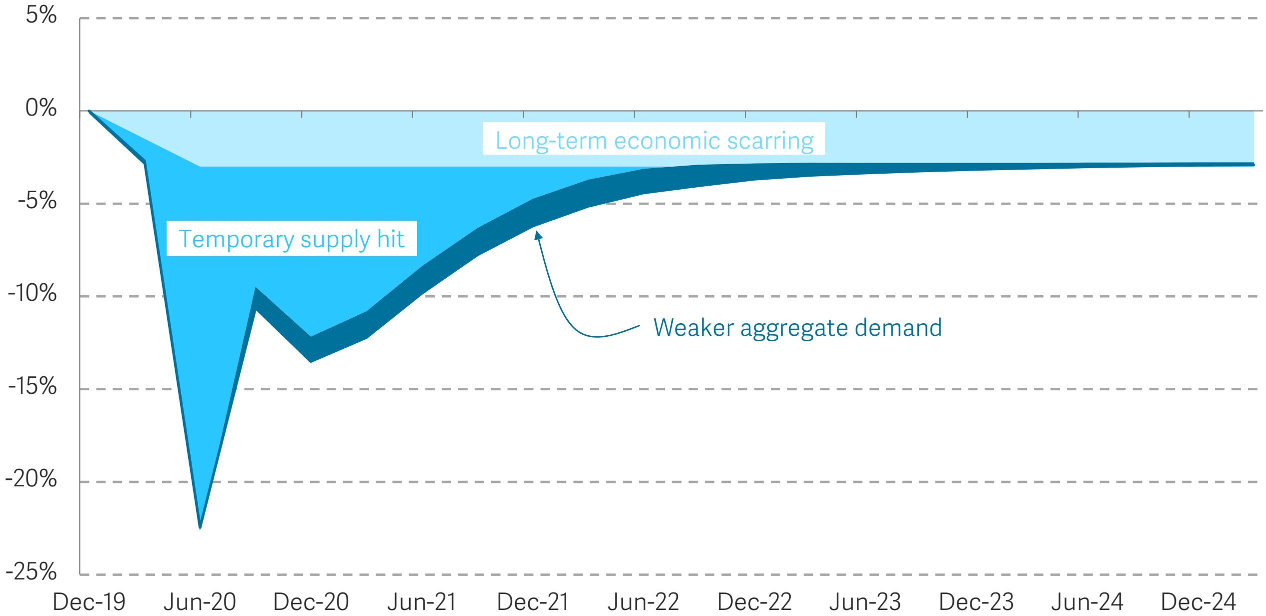
- First, estimates of the output gap vary widely. The trough in the output gap represents an estimate, narrowly defined, of how much macroeconomic policy can boost economic activity without generating sigifnificant inflationary pressure. Forecasting the output gap is always difficult, it requires forecasting both economic output and potential output. But the task is even harder in this crisis because the health crisis has required direct temporary constraints on supply. The large differences between estimates of the UK output gap partially reflect contrasting views on the balance between temporary supply constraints and more permanent reductions in productive capacity. Figure 20 provides a decomposition of the OBR's forecast for GDP, using the output gap and estimate of long-term scarring. This shows that the vast majority of the reduction in GDP can be explained by the temporary reductions in supply rather than weakness in demand or permanent scarring. Implicitly, this is also the view of the Bank of England, where its forecast for the output gap and GDP effectively assumes that almost all of the GDP fall is temporary supply constraints and that demand will recover almost one-for-one as restrictions are eased – leading to a small trough in the output gap and it closing within a year. The IMF view is that demand weakness plays a much larger role with a larger and more persistent output gap.

- Second, given the nature of this crisis, the output gap may be a poor lens through which to assess the necessary macroeconomic stimulus. Typically, macroeconomic policy is assumed to have little effect on the growth in productive capacity in the economy – rather it targets aggregate demand. For example, the OBR's fiscal multipliers (its estimate of the impact of fiscal policy on the economy) assume no effect on the level of GDP after five years. This crisis has had particularly large impacts on productive capacity through a variety of channels, not just social distancing requirements, for example: falls in business revenue have impacted firm balance sheets and investment,[32] and long-term non-work is affecting a significant minority of the labour force (potentially impacting skills and labour force participation).[33] Fiscal policy may be able to reduce these effects – indeed a large part of the rationale for the Government's successive crisis support packages was to protect productive capacity in the economy. In practice, this means that the output gap may underestimate how much support fiscal policy should provide because it may be able to boost supply at the same time as demand and therefore increase economic activity to a higher level without the risk of rising inflation. One concrete example of this is that as the furlough scheme eventually comes to an end, if the economy is operating close to pre-crisis levels of demand the vast majority of furloughed workers will be able to go back to their old jobs. But, if demand is low due to a lack of fiscal support, many of these workers may lose their jobs and thus lead to a longer-term fall in economic activity.

32 N Cominetti, J Leslie, & J Smith, On firm ground? The impact of Covid-19 on firms and what policy makers should do in response, Resolution Foundation, February 2021.
33 N Cominetti et al, Long Covid in the labour market: The impact on the labour market of Covid-19 a year into the crisis, and how to secure a strong recovery, Resolution Foundation, February 2021.

FIGURE 20: **The vast majority of falls in economic activity can be explained by temporary constraints on supply**

Fall in output between the OBR's March 2020 forecast and that for November 2020, by assumed source of economic weakness: UK



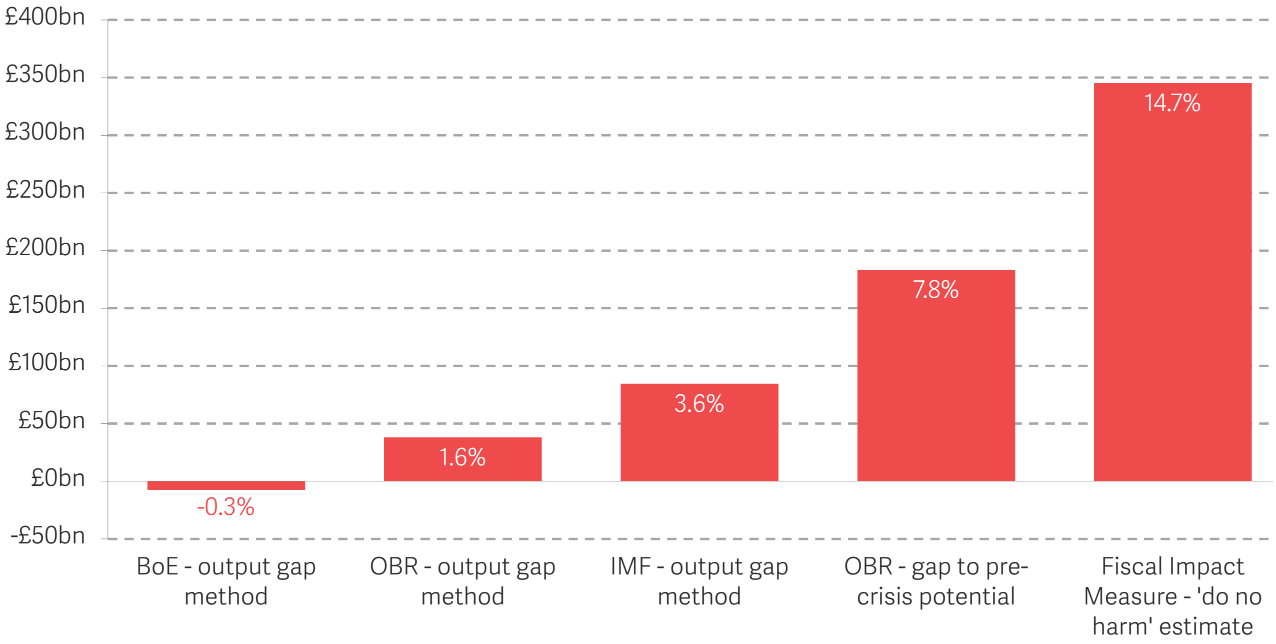
NOTES: This decomposition is based on a combination of the non-oil GVA foreast, estimates of the output gap, and a decomposition of changes in supply provided in the OBR's November Economic and Fiscal Outlook publication. The OBR's output gap is defined in terms of non-oil GVA.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020.

So what does this mean for Government policy in practise? The uncertainties in the output gap and path of economic recovery make estimating an exact level of required fiscal stimulus difficult. Figure 21 provides a range of estimates using a variety of plausible methods for the total level of fiscal stimulus needed in addition to existing plans across 2021-22 and 2022-23. The first three bars utilise the output gap estimates from the Bank of England, OBR and IMF – combined with the weighted average fiscal multiplier for Government spending from the OBR.[34] The Bank's estimate implies no additional stimulus is required over the next two years as the output gap closes by itself and inflation returns to target without additional fiscal support – of course this calculation implicitly assumes that fiscal policy cannot have an effect on boosting productive capacity. In contrast, the IMF's estimate of the output gap suggests substantial additional support is needed.

34 Fiscal multipliers are a crucial part of this calculation and represent another significant source of uncertainty. As previous RF research has shown(see G Bangham et al, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020), the range of plausible estimates is wide. We have taken the Government's official estimates as the baseline; were fiscal policy to be more effective at stimulating the economy, less fiscal stimulus would be needed and vice versa were it to be less effective.

FIGURE 21: **Estimates of necessary fiscal stimulus vary widely**

Top-down estimates of required stimulus for 2021-22 and 2022-23: UK

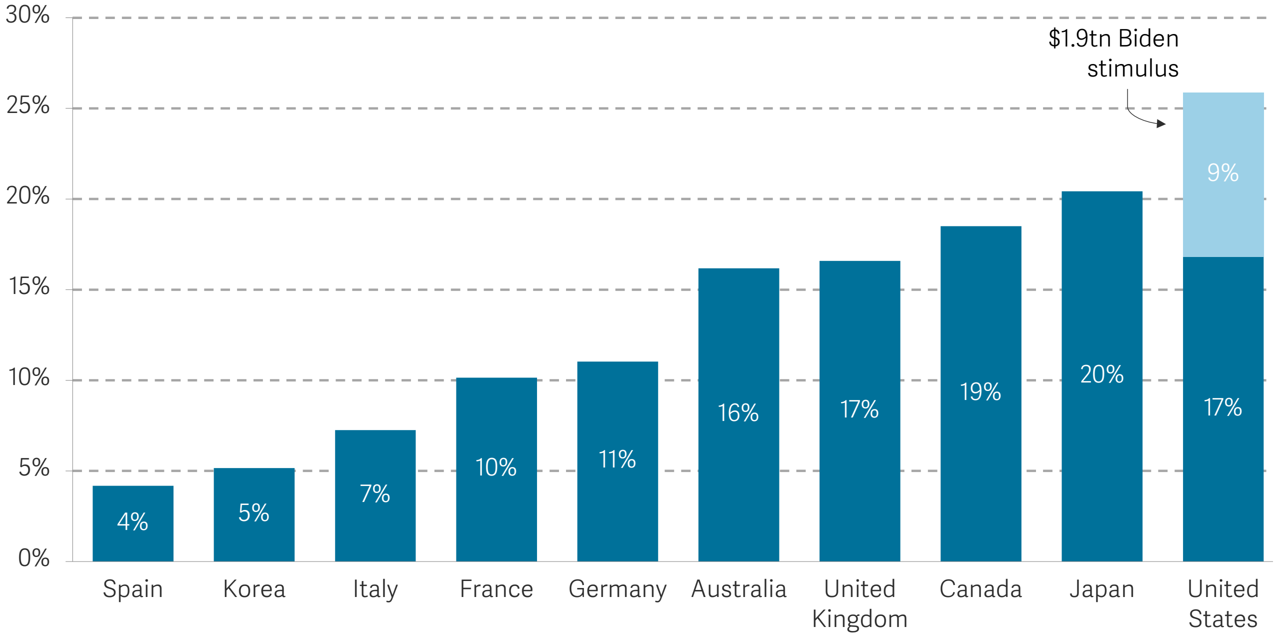


NOTES: Labels show the stimulus size as a share of nominal GDP in 2022. The output gap-based estimates translate the forecast output gaps over 2021-22 and 2022-23 using the OBR's multipliers into a total required stimulus amount. The OBR "gap to pre-crisis potential" does the same but uses the OBR's pre-coronavirus crisis forecast for output as the potential output level in the economy. The "FIM 'do no harm' estimate" is based on the minimum required stimulus that would mean that fiscal policy does not detract from quarterly GDP growth over the next two years using the policy-adjusted November 2020 OBR fiscal and economic forecasts and the Resolution Foundation's Fiscal Impact Model.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; Bank of England, Monetary Policy Report, February 2021; IMF; RF's Fiscal Impact Model.

Output gap-based estimates may represent an underestimate of optimal fiscal stimulus due to supply effects. This is fundamental to the more developed debate in the US, sparked by the Biden administration's substantial additional stimulus package – which is set to take the US' fiscal response to the top of the table of major economies (Figure 22). Figure 21 therefore also includes estimates which are more similar in scale to the new US package of support. The fourth bar is an estimate which assumes that instead of filling the output gap, fiscal policy should aim to get GDP back to its pre-crisis path – effectively assuming that the economy can leave this crisis with no economic scarring. And the final bar represents an even larger package which is calibrated to match the necessary fiscal spending needed to ensure that the contribution of fiscal policy to quarterly GDP never becomes negative over the next two years (in other words setting the red bars for 2021-22 and 2022-23 in Figure 17 to zero).

FIGURE 22: **If enacted, the Biden Plan means the US will have provided the most support of all major advanced economies**

Covid-19 policy response, as a proportion of GDP: selected countries, 2020



NOTES: Only reflects 'Above the line measures' including additional spending or foregone revenues, but excluding loans, or contingent liabilities incurred as part of the policy response. Policy response as of December 2020, other than proposed Biden stimulus package.
SOURCE: IMF, Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic, January 2021.

The context for the US fiscal support plan is fundamentally different to the UK's position, which means simply replicating the Biden plan in the UK would be a mistake. The key differences include:

- Much of the US package is comprised of measures which are already in place in the UK. For example, a quarter of the total package is targeted at enhanced unemployment insurance (effectively covered in the UK through the furlough scheme) and direct health spending with a focus on speeding up the vaccine rollout (already well underway in the UK).[35]
- The UK's tax and benefit system already provides a higher level of automatic stabilisers than in the US; so, for a given fiscal response to a crisis, the US needs to make more active policy decisions than the UK.[36]
- The UK's economic hit from this crisis has been substantially larger than in the US (Figure 19), although comparisons across countries are made harder by substantial

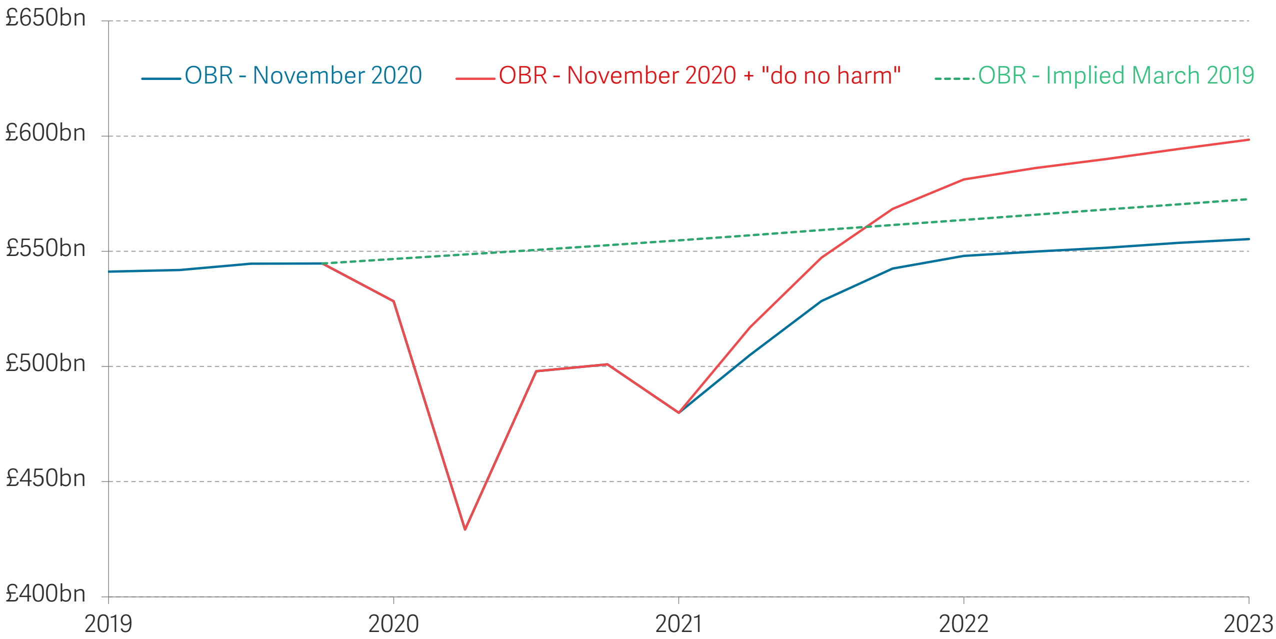
35 For more detail of the package breakdown see: O Blanchard, In defense of concerns over the $1.9 trillion relief plan, Peterson Institute for International Economics, February 2021.
36 For more on international comparisons of automatic stabilisers see: A Caldera et al, Strengthening automatic stabilisers could help combat the next downturn, VoxEU, March 2020. And for a discussion of stabilisers in the UK see: J Smith et al, Recession ready? Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019.

methodological differences in the calculation of GDP.[37] This suggests that the UK response needs to be proportionally larger than the US.

Given these differences, it is not clear what a Biden-esque plan would mean in the UK. At one extreme, taking the full Biden stimulus and adjusting for the larger fall in GDP in the UK would imply a stimulus package broadly in line with the largest of our top-down stimulus estimates in Figure 21.[38] Figure 23 compares the estimated impact of this stimulus on the level of quarterly GDP with the OBR's November forecast and the implied pre-crisis trend path in the economy. It shows that this level of fiscal support implies that GDP would rise to 5 per cent above its pre-crisis path.

FIGURE 23: **The upper-end of stimulus estimates imply GDP rising above the pre-crisis path**

Quarterly GDP and OBR estimates of the pre-crisis and crisis growth paths and the impact of stimulus package: UK



NOTES: The "do no harm" estimate takes the OBR's November 2020 GDP forecast and adds on the estimated impact of additional fiscal stimulus in order that fiscal policy does not have a negative impact on any quarter's GDP growth until the end of 2023.
SOURCE: RF analysis of ONS, Quarterly National Accounts; OBR, Economic and Fiscal Outlook, various.

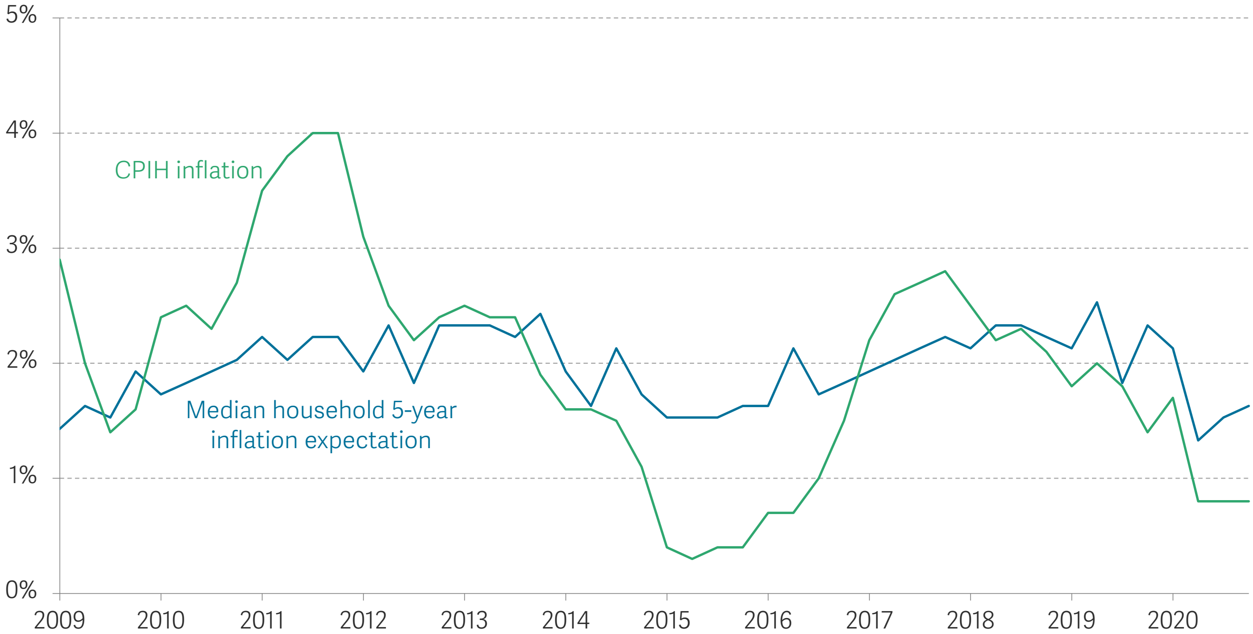
GDP rising to this extent would undoubtedly lead to a rise in inflation unless there was a response from potential supply. The worst-case scenario here is that this level of stimulus would raise inflation and de-anchor inflation expectations such that a harmful

37 See Chris Giles, UK's poor GDP performance rooted in weak household spending, Financial Times, November 2020.
38 The Biden plan amounts to around 9 per cent of US GDP and the UK's economy declined by an additional 6 percentage points in 2020. Taking these together suggests an equivalent plan in the UK would be 15 per cent of GDP – equating to our top-end estimate of macroeconomic stimulus. In practise, the overlap in spending measures, differences in automatic stabilisers and the amplification of the UK GDP contraction due to the ONS' calculation of the Government consumption deflator would reduce this total somewhat but sizing an exact equivalent plan in the UK would be impossible.

contraction in macroeconomic policy is required to bring the path of inflation back to target.[39] In practise this risk is limited in the UK context: inflation expectations have remained stable for a decade despite the large post-financial crisis and somewhat smaller post-2016 EU referendum spikes in inflation (Figure 24). Furthermore, the UK's labour market has a low level of collective wage bargaining (see Figure 25) so there is no aggregate route for inflation rises to semi-automatically pass through to wage increases. Any inflation-wage spiral would have to be driven by individual-to-firm level negotiations which are unlikely to lead to material wage rises given the substantial anticipated slack in the labour market. Nevertheless, a harmful persistent increase in inflation does remain a risk which increases the further stimulus pushes the economy above its long-term potential.

FIGURE 24: **Long-term household inflation expectations have been stable for over a decade**

Adjusted median household annual price inflation expectations in five years' time and actual annual CPIH inflation

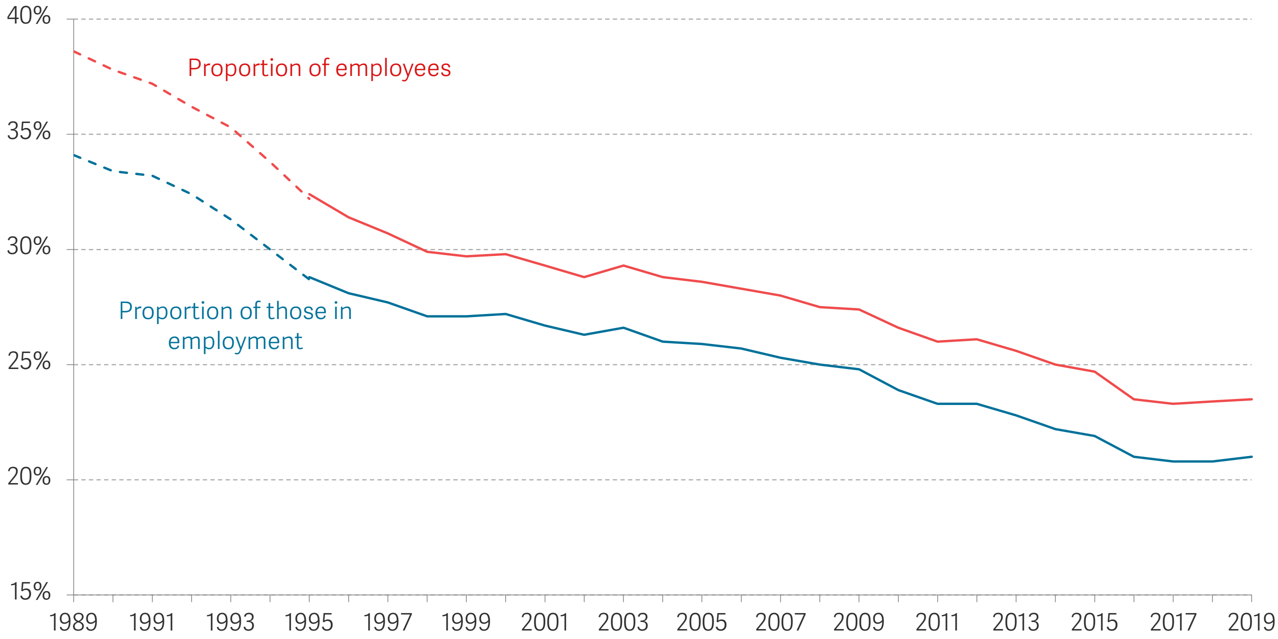


NOTES: Household inflation expectations are calculated using a survey-based measure and has been mean-adjusted to match the observed CPIH average from 2009 to 2020; the unadjusted survey measure of expectations is roughly 1.3 percentage points higher than the average actual inflation rate. The survey question asks "And how about the longer term, say in five years' time. How much would you expect prices in the shops generally to change over a year then?".
SOURCE: RF analysis of Bank of England/Kantar, Inflation Attitudes Survey; ONS, Consumer Prices.

39 A de-anchoring in inflation expectations is not the only channel through which a rise in inflation could have negative consequences. A spike in inflation which is not matched by changes in wages would result in potentially very large falls in real incomes, as happened after the financial crisis, with profound effects on living standards. But importantly, a rise in inflation as a result of a temporary rise of GDP above potential is better thought of as a temporary price dislocation where incomes would quickly catch-up with the new price level.

FIGURE 25: **Union membership has fallen significantly in the UK**

Union membership as a share of total employees and employment: GB/UK



NOTES: Figures prior to 1995 are for Great Britain and after are for the whole of the UK.
SOURCE: BEIS, Trade union statistics 2019.

But risks of inflation do not outweigh the risk of doing 'too little stimulus': fiscal policy needs to be aggressive in the coming two years. Doing too little risks entrenching poor economic growth, as we saw following the financial crisis. This is a particular concern in the aftermath of the coronavirus crisis because without support, some of the temporary supply constraints could easily become permanent. For example, a slow recovery in the hospitality sector could mean that business sites which are currently temporarily closed never reopen. The distributional effects of a slow recovery are also important. Evidence is clear that disadvantaged groups: workers from ethnic minorities, younger workers, and disabled workers are all more likely to experience longer-term unemployment, which can be reduced by a fast recovery to a tight labour market.[40]

The Government's fiscal strategy should directly incorporate the huge uncertainty in how much stimulus is required into its approach. As we have made clear, the asymmetry of risk suggests the Government should aim towards the upper end of our estimates but, given the lack of evidence that fiscal policy is able to improve the long-term trend growth rate in the economy, the highest estimate of the output gap is a good starting point. Concretely, this means starting with the £85 billion estimate implied by the IMF's forecast of the output gap and building in a margin for error. The Chancellor should plan for £100 billion of additional stimulus over the coming two years.

40 H Hoynes, D Miller, & J Schaller, Who Suffers during Recessions?, Journal of Economic Perspectives, Vol 26, No 3, Summer 2012.

The timing of the stimulus package is also crucial. On one side, it is hugely important that the Government does not introduce direct stimulus measures which would lead to an increase in social interactions before the health crisis is fully under control. If not, this will either necessitate an increase in restrictions on social interactions to limit a rise in virus cases (effectively reducing fiscal multipliers to zero) or will lead to a rise in Covid cases and deaths. But stimulus needs to be provided as early as possible to ensure a swift recovery and minimise any transition of temporary supply constraints into a more permanent loss of productive capacity. A big part of the problem with US debate, which we shouldn't import, is that it is focused on the question of how big the immediate stimulus package should be.

Ensuring sufficient stimulus is provided for the right length of time will also be critical to ensuring a strong recovery. Our range of estimates of the necessary stimulus directly incorporate this question by considering the stimulus needed across both of the next two years. In our view, the IMF's forecast for a persistent output gap is likely given the UK's slow recovery after the financial crisis[41] and historical experience of global pandemics.[42] A more persistent output gap requires fiscal stimulus to be in place for longer, and the current lack of capacity for further monetary policy stimulus makes this especially true in this crisis.

Clearly one consequence of getting the timing right on fiscal stimulus is that, should restrictions on social interactions be needed longer, as covered in our downside scenario, fiscal stimulus would need to be delayed. The levels of crisis support have largely been enough, in aggregate, to stabilise households and firms (although recognising the big distributional effects is always important). This suggests that, assuming crisis support continues at levels we have seen over the past year, the final amount of stimulus during the recovery phase would not necessarily need to increase in the downside scenario. The Budget should be clear that fiscal support is tied to the state of the health crisis.

In summary, then in this section we make the following policy recommendations:

- Fiscal support in next two years likely needs to be at least £100 billion. The Chancellor must do this given the likely impact on the economy.
- It should be conducted when the virus is fully under control in the UK – until then more support needed as discussed above.
- There should be a clear objective to boost productive capacity.

41 See N Cominetti, J Leslie, & J Smith, On firm ground? The impact of Covid-19 on firms and what policy makers should do in response, Resolution Foundation, February 2021.
42 See R Hughes, Safeguarding governments' financial health during coronavirus: What can policymakers learn from past viral outbreaks?, Resolution Foundation, March 2020.

To reduce uncertainty and build confidence the Chancellor should enshrine these policy objectives in a new fiscal framework

The need for more active fiscal policy provides a clear case for a new fiscal framework to be announced at the Budget; without a fiscal framework, uncertainty for households and businesses is increased. Fiscal rules play a key role in signalling the Government's intention to provide adequate levels of support during the recovery and to keep the longer-term fiscal position sustainable. This is particularly important given the greater role fiscal policy is playing in supporting the economy, given monetary policy is constrained at the zero lower bound, and the importance of expectations about the future in driving macroeconomic outcomes.

The current absence of a fiscal framework does not bode at all well for prospects for using fiscal policy to drive a rapid recovery. In this context, perhaps the most important aspect of the fiscal framework, is announcing the circumstances under which the Government would return to a set of fiscal rules. In other words, the Government should announce their fiscal framework now but as part of that any longer-term fiscal consolidation does not begin until the recovery is entrenched. Our view is that any consolidation should not take place until the OBR estimates that the output gap has closed. This has several advantages, but the key one is that this provides confidence that the Government will continue to support the economy until the recovery is secure.

Drawing on our previous work, our view remains that the best framework is one that has net worth targeting at its heart. Resolution Foundation analysis from 2019 provides the basis for a set of fiscal rules which could ensure long-term fiscal sustainability while facilitating the key economic reforms the Government intends to pursue, such as achieving its net-zero and levelling-up agenda.[43] This crisis has not changed the analysis which underlay the proposed fiscal rules, and so those proposals remain a well-founded sensible approach for this and future governments to take.

Those rules should be:

- A Net Worth Objective: to deliver an improvement in public sector net worth as a share of GDP over five years. This would incentivise prudent investment decisions to address the long-term challenges facing the UK;
- A Structural Current Balance Target: to achieve a cyclically-adjusted public sector current balance of 1 per cent of GDP (and no less than minus 1 per cent) over five years. This requires the government to keep receipts and day-to-day spending in broad balance but would also allow it to borrow to invest;

43 R Hughes, J Leslie, C Pacitti & J Smith, Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, October 2019.

- A Debt Interest Ceiling: to ensure the proportion of revenue spent on debt interest does not exceed 10 per cent. This would ensure that the overall debt burden remains sustainable at all times by taking account of not only the level of debt but also what it costs to service; and,
- An 'escape clause': to recognise the need for more active fiscal policy given the constraints on monetary policy. The net worth and structural current balance targets would be suspended if the economic outlook deteriorates significantly.

There is a political as well as economic imperative for that framework to target net worth

The difficult choices the Chancellor faces create incentives for the Government to delay the implementation of a new fiscal framework. In particular, he has made it clear that he wants to ensure that fiscal discipline is upheld and by 'balancing the books' and putting debt on a declining path. But, given the deterioration in the public finances, the Government won't simultaneously be able to maintain spending commitment on 'levelling up' while also honouring the Conservatives manifesto commitment to avoid major tax rises.

Our proposed fiscal framework would allow the Chancellor to continue to progress manifesto commitments while also providing much-needed certainty around the path of fiscal policy. If rather than adopting a narrow debt target, he adopts a net worth target, this will give extra fiscal space to undertake welfare enhancing investments while still keeping fiscal discipline. Our view remains that tax rises will be necessary at some stage – but that reflects the need to build future fiscal space.

In this section we have set out how the overall stance of fiscal policy should be set to deliver a rapid recovery. In this next section we discuss specific, targeted measures that deliver that boost as effectively as possible while also helping the hardest hit sectors and delivering value for money.

Section 5

Targeted stimulus measures

Following on from the top-down estimates of necessary fiscal stimulus in the previous above, this section sets out specific policies that can deliver that stimulus effectively, in a targeted way that also provides value for money. These measures build on those designed to provide fiscal support while social distancing restrictions remain in place, discussed in Section 3 above, that include the extension of the furlough scheme and in total cost £30 billion.

There are two areas in which additional measures are proposed. First, a series of policies that seek to reduce the lasting impact of Covid-19 in key areas of the economy. These draw on our recent work that has focussed on how that is best done when it comes to: the labour market; the housing market, particularly regarding rental arrears; and the corporate sector.

Second, policy makers should also seek to boost overall demand when social distancing restrictions have been eased and it is safe to do so. Given the structure of the UK economy this means boosting consumption, but increasing investment spending should also be a priority. Alongside the scale of additional spending, how these policies are targeted will be crucial to their effectiveness.

The specific measures we propose in this regard include steps to support employment as the Chancellor's furlough scheme unwinds, by facilitating re-training and job creation. Alongside this, the £20 per week uplift in Universal Credit should be made permanent. In contrast to expectations that the Budget will extend the uplift for a further six months from its current end in April, this would avoid a sharp fall in incomes in six months' time when unemployment is likely to be higher than it is now. The package also includes a targeted voucher scheme, focussed on high street retail, as well as further 'green' public investment. Together, these proposals total around £70 billion, split across the next two years.

In this section we set out an illustrative package of measures to boost the economy that broadly match the overall size of required stimulus discussed in the previous section.

The objectives of policy must be to boost the economy in areas where it has been hardest hit

It is not just the level of stimulus but its nature that will drive its effectiveness. A successful fiscal stimulus must recognise the impact of the pandemic– both in terms of near term priorities, such as supporting the labour market as support is withdrawn, as well as broader macroeconomic support.[44] In that context, the objectives of the policies set out below are twofold:

- First, as we have set out in our recent work on the recovery, policy makers should respond to the impact of Covid-19, addressing near-term priorities to support individuals and firms as support measures are withdrawn. Our work has here focussed on support for three key sectors: the labour market; the housing market; and the corporate sector.
- And second, provide targeted support for the macroeconomy, through more traditional fiscal stimulus aimed at boosting aggregate demand. Given the composition of demand this means by boosting consumption rapidly when it is safe to do so and in a way that recognises the specific sectoral and distributional impact of this crisis, particularly in services like non-food physical retail. Increasing investment spending is also desirable. Here the emphasis should be on greater public investment targeted at projects that would have high social value irrespective of the progress of the virus, such as those that advance progress towards zero carbon targets and improve social infrastructure.

Having set out these broad principles, below we briefly discuss details of specific policy measures. The package is summarised in Table 2 below and totals just under £70 billion over 2021-22 and 2022-23. This is on top of the £30 billion of estimated additional crisis policy measures for 2021-22 outlined in Section 3; the largest of which are the extension of the JRS, additional SEISS and expanded business grants. The total package therefore comes to the £100 billion that the macroeconomic evidence presented in this report suggests is needed over the next two years.

1. Policies set out in our previous work to support: the labour market, housing market and corporate sector

Around £28 billion of this total relates to the labour market, housing policies and the corporate sector – as set out in our other pre-Budget Resolution Foundation

44 L. Gardiner et al, Easing does it: Economic policy beyond the lockdown, Resolution Foundation, July 2020.

publications. The measures in those papers are designed to support employment and re-training,[45] reduce the impact of the build-up of housing arrears,[46] and to ensure productive capacity is maintained in the corporate sector and the impact of higher debt levels does not weigh on future growth.[47]

2. Support for the macroeconomy: boosting aggregate demand

A key part of any stimulus package are measures that boost overall aggregate demand. Given around two-thirds of UK final demand is accounted for by private consumption, measures to boost that component of demand will be central. While investment is smaller, sustained increases in investment are also important for longer-term growth, as increasing the stock of physical capital both in the public and private sector will boost output in future.

Measures to boost consumption are best targeted at those on lower incomes. While that is worth persuing in general it is all the more crucial because the very uneven impact of this crisis on household balance sheets has seen higher income households save significant sums.[48] We recommend a central feature of stimulus should be delivered through Universal Credit (with matching changes made to legacy benefits). A £19 billion package would make the £20 per week uplift in Universal Credit permanent, along with the scrapping of the two-child limit and re-instatement of the family element. This represents significant demand stimulus, targeted at those on low incomes, which also aims to tackle the catastrophic, pre-pandemic decline in unemployment benefits to their lowest level in real terms since the early 1990s.[49]

The package also includes a £9 billion voucher scheme, amounting to a £150 voucher per adult, and £75 per child. These vouchers could be spent in physical non-food retail, where there is more likelihood that consumption is likely to re-bound more slowly than in other services such as pubs and restaurants.[50] Figure 6 in Section 1 suggests this is likely to be the case, with more survey respondents reporting plans to increase their spending on restaurants and pubs after the pandemic than decrease spending, but roughly equal proportions of respondents suggesting they would increase or decrease their spending on clothes and other retail. Reflecting the dangers in terms of unemployment from a very

45 For more details on these proposals see: N Cominetti et al, Long Covid in the labour market: The impact on the labour market of Covid-19 a year into the crisis, and how to secure a strong recovery, Resolution Foundation, February 2021; and for training and education policies: K Henehan, Class of 2020: Education leavers in the current crisis, Resolution Foundation, May 2020.
46 For more details on proposals to deal with rental arrears see: L. Judge, Getting ahead on falling behind: Tackling the UK's building arrears crisis, Resolution Foundation, February 2021.
47 For more details see: N Cominetti, J Leslie & James Smith, On firm ground?:The impact of Covid-19 on firms and what policy makers should do in response, Resolution Foundation, February 2021.
48 See K Handscomb & L Judge, Caught in a (Covid) trap: Incomes, savings and spending through the coronavirus crisis, Resolution Foundation, November 2020.
49 M Brewer et al, The Living Standards Outlook 2021, Resolution Foundation, January 2021.
50 A previous version of this policy involved broader sectoral targeting including hospitality. But the experience of last summer, and the build-up of significant savings by households, means we believe this sector is likely to see a strong demand recovery once restrictions are lifted see L. Gardiner et al, Easing does it: Economic policy beyond the lockdown, Resolution Foundation, July 2020 and ONS, GDP quarterly national accounts, UK: July to September 2020, December 2020.

swift decline in the high street, this temporary voucher scheme would slow but not halt the longer-term trend towards online retail.

Finally, the stimulus package should include public investment measures specifically aimed toward climate change adaptation and mitigation. As set out in Section 2 and advocated by organisations such as the IMF,[51] investment is likely to be central to a successful economic recovery. Potentially constraining Government ambitions in this area are the already high levels of public investment spending committed at the March 2020 Budget. This amounts to a total of around £110 billion in net investment over 2021-22 and 2022-23 (in 2019-20 prices). Given this significant ramping up of public investment, the OBR has already forecast significant underspends against this total, amounting to around 8 per cent of additional investment, based on the average underspends in a previous drive to increase investment in the decade before the financial crisis.[52]

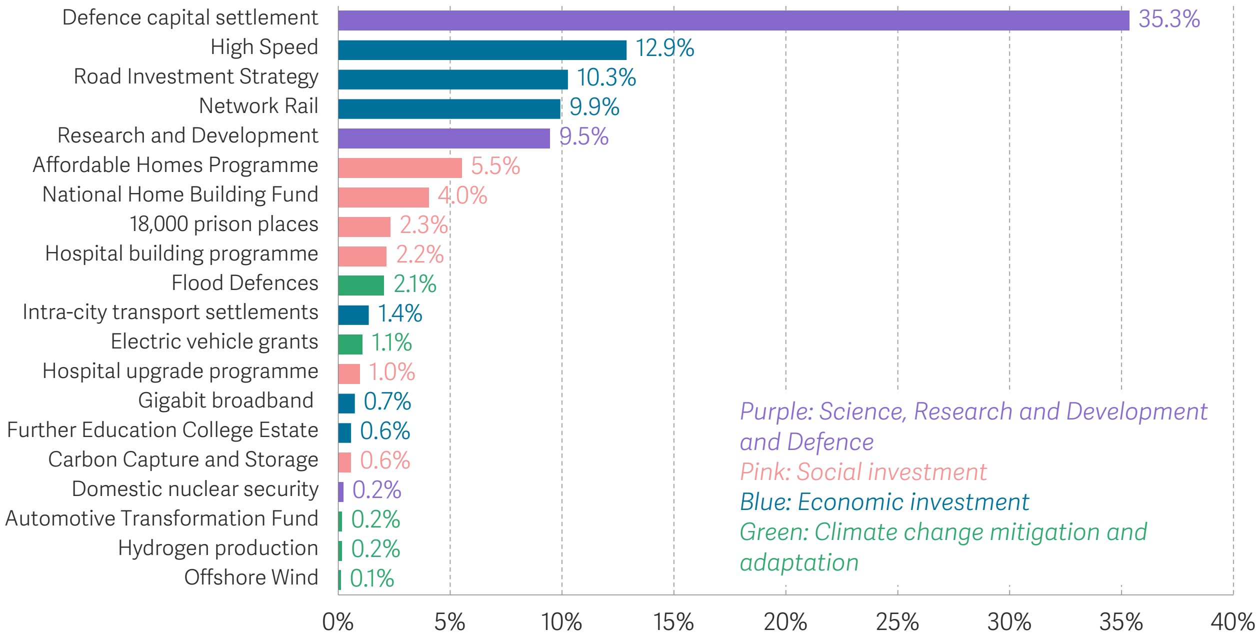
However, investment increases after recession periods have been large in the past, with the three years after the financial crisis seeing a 57 per cent increase in average public sector net investment compared to the three years pre-crisis. This compares to a 50 per cent increase currently forecast for average public sector net investment from 2020-21 to 2022-23 compared to the three years preceding the pandemic. This suggests there is potentially some limited room for further public investment, which should be taken advantage of, given the high fiscal multipliers associated with capital spending, as well as the long-term challenges facing the UK, which will require structural change and investment.

With this in mind, one key area that should be targeted with further investment is climate change adaptation and mitigation. Figure 26 sets out the proportion of the total value of the multi-year capital spending settlements announced at the Spending Review by scheme, of which only 4 per cent relates to 'green' investment programmes. While this does not represent all capital spending announced by the Government, given projects related to climate change are likely to need long-term funding certainty, this appears to be a current gap in their investment strategy. Some of this may be filled by private investment, particularly that 'crowded in' through the proposed UK Infrastructure Bank, depending on the focus of its investment programmes.[53] However, the Committee on Climate Change assumes that a further £4-7 billion per year will be required in public investment to facilitate a transition to Net Zero,[54] and we include the upper end of this estimate in our fiscal stimulus package below.

51 See International Monetary Fund, Fiscal Monitor: Policies for the Recovery, October 2020.
52 For more detail, see Box 3.2 in Office for Budget Responsibility, Economic and Fiscal Outlook, March 2020.
53 M Mazzucato and L Macfarlane, Opinion: How a national infrastructure bank could transform the UK economy, December 2020.
54 See Table 6.1 in the Committee on Climate Change, The Sixth Carbon Budget: The UK's path to Net Zero, December 2020.

FIGURE 26: **Green investment accounted for 4 per cent of the value of total multi-year capital settlements announced at the Spending Review**

Proportion of total value of multi-year capital settlements announced at Spending Review 2020, by scheme: UK, 2021-22 to 2024-25



SOURCE: RF analysis of HM Treasury, Spending Review documents, November 2020.

While private corporate investment makes up a relatively small share of the total economy, it has typically played a disproportionate role in shaping the speed of post-recession recoveries in the UK. We have covered the corporate sector in more detail in one of our other pre-Budget reports.[55] One clear finding was that there has been a rise in the aggregate cash holdings of the corporate sector (despite pockets of growing distress for smaller businesses and those in shut down sectors). These cash holdings reflect the increase in uncertainty over the economic outlook and are largely matched by increases in aggregate debt holdings. Encouraging a recovery in business investment should be an important economic objective for the Government. While many firms are likely to choose to pay down debt during the recovery phase, the Government can facilitate a return to business investment by providing the right macroeconomic environment. Specifically, reducing uncertainty with a strong and credible plan to ensure no return to high-levels of Covid-19 cases is fundamental but so too is ensuring a swift recovery in consumer demand. This would give businesses the confidence to use cash and raise other finance to spur investment. Our proposed macroeconomic package is targeted to achieve that objective.

Below is a summary of the full package proposed, and the proposed allocation of funding over the next two years, totalling just over £70 billion.

55 See N Cominetti, J Leslie & J Smith, On firm ground?: The impact of Covid-19 on firms and what policy makers should do in response, Resolution Foundation, February 2021.

TABLE 2: **An illustrative fiscal stimulus package could total around £70 billion**

RF costings of an illustrative fiscal stimulus package: UK, 2021/22 and 2022/23

	Scheme	Cost 2021/22	Cost 2022/23	Cost Total	Detail
Support for the rental sector and the labour market	Tenant Loan Scheme	£0.1bn	£0bn	£0.1bn	Targeted loan write-offs for tenants in rent arrears.
	NICs cut for new hires	£1bn	£1bn	£2bn	Raising the employer NICs threshold to £15,000 for additional workers for their first year, for two years.
	Job Protection Scheme	£5bn	£5bn	£10bn	Targeted scheme to subsidise labour costs in hardest hit sectors, and incentivise re-hiring of furloughed workers.
	Social care job creation	£5bn	£6bn	£11bn	Creation of 180,000 jobs in social care, which would bring the ratio of care workers to the over-70 population back to its 2014 level.
	Further education scheme	£2.6bn	£0bn	£2.6bn	Proposals from 'Class of 2020' to help education leavers to stay on in education for longer.
	Extension of Kickstart Scheme	£0.3bn	£1bn	£1.3bn	Extension of Kickstart Scheme for a further 12 months, assuming the creation of around 165,000 further jobs.
	Extension of Lifetime Skills Guarantee	£0.5bn	£0bn	£0.5bn	Extending Guarantee to unemployed adults who already have a Level 3 qualification, but not a degree, who are currently excluded.
Support for aggregate demand	Universal Credit boost	£8bn	£11bn	£19bn	Making £20 per week uplift in UC permanent. Scrapping of the two-child limit and re-instatment of family element over both years.
	Targeted voucher scheme	£9bn	£0bn	£9bn	£150 vouchers per adult, £75 per child - targeted towards high street retail.
	Further green public investment	£7bn	£7bn	£14bn	Investment in line with Committee for Climate Change's December estimates of additional green investment required.
	Total:	**£38.5bn**	**£31.0bn**	**£69.5bn**	

NOTES: Table excludes costs of support for the corporate sector, including the scheme of loan write-offs set out in N Cominetti, J Leslie & James Smith, On firm ground?:The impact of Covid-19 on firms and what policy makers should do in response, Resolution Foundation, February 2021. These costs are likely to be small, but are highly dependent on the performance of the economy.
SOURCE: RF analysis.

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged.

We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

For more information on this report, contact:

James Smith
Research Director
james.smith@resolutionfoundation.org

Resolution Foundation

2 Queen Anne's Gate
London SW1H 9AA

Charity Number: 1114839

@resfoundation
https://www.resolutionfoundation.org/publications/