Budget 2021: The big questions

The outlook for public spending, taxation and debt

Deloitte.

Rarely has there been more uncertainty regarding the course of the public finances over the next five years. In this note we aim to answer some of the big questions for the economy in light of the 2021 budget.

1. What is the outlook for the public finances? The pandemic and the largest recession in over 300 years are likely to leave lasting scars on the economy and the public finances. Further ahead, pressure for new spending is only likely to rise. *(page 2)*

2. What has the chancellor announced? Support for the recovery is the priority for this year. Further ahead, tax rises have been pencilled in through higher rates of corporation tax and the freezing of income tax thresholds. *(page 3)*

3. Is now the right time to tackle the debt? The chancellor has embraced the broad economic consensus that governments should borrow to support demand in the short-term. However, it is not too early to start thinking about the longer-term sustainability of the public finances. *(page 4)*

4. How could the chancellor close the deficit? The political appetite for austerity has waned leaving tax rises as the likely tool for any adjustment. By committing not to raise income tax, national insurance or VAT, the chancellor may need to look to other taxes to raise revenues. *(page 5)*

5. Whatever happened to fiscal rules? The pandemic has blown the last set of published fiscal rules well off course. However, the chancellor did offer some clues as to his guiding principles for stewardship of the public finances. *(page 6)*

6. What has changed since the global financial crisis? Following a sluggish recovery from the last crisis, a sea-change in economic thought has led to a radically different response to that seen after 2008. *(page 7)*

7. What happens if interest rates rise? Despite the increasing stock of public debt, the cost of financing it has fallen since the start of the pandemic. However, as the chancellor was keen to stress, even small rises in interest rates could have significant consequences for the public purse. *(page 8)*

8. What about other scenarios? The likely fiscal adjustment needed in the years ahead rests on the unusually uncertain outlook for the economy. The Office for Budget Responsibility set out three scenarios for the economy and the public finances. *(page 9)*

9. Will we see a permanently larger state? Previous crises and wars have left a legacy of larger government. The COVID-19 pandemic is unlikely to be different. *(page 10)*

10. How do the government's spending plans fit with levelling up and the transition to net zero? Before the pandemic, the government stated its goal to tackle climate change and reduce regional inequalities. Increased capital investment and a new infrastructure bank may further its ambitions in these areas. *(page 11)*

Authors

Ian Stewart
Chief Economist
020 7007 9386
istewart@deloitte.co.uk

Tom Simmons
Economist
020 7303 7970
tsimmons@deloitte.co.uk

Peter Ireson
Economist
0117 984 1727
pireson@deloitte.co.uk

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1. What is the outlook for the public finances?

Since the last assessment of the public finances by the Office for Budget Responsibility (OBR) in November, the UK economy has performed slightly better than expected. The outlook too has improved and, for now, it looks likely the worst case scenario for growth and the public finances will be avoided.

Despite the more positive news, the OBR's latest forecast predicts that, in the long term, the UK economy will still be 3% smaller than it would have been had the pandemic not happened.

A smaller economy contributed to public borrowing reaching its highest level since the second world war last year. It is likely to remain elevated this year.

Despite this, the cost of financing the public debt has fallen even as the overall stock of debt has risen. In part, this is because the UK is far from unique in borrowing large sums to respond to the economic consequences of the pandemic.

The government faces new pressures on spending even as the economy recovers. Clearing backlogs in the NHS, helping children to catch up on missed education and maintaining preparedness for future pandemics will all require funds.

This is in addition to the government's ambitions for levelling-up and the transition to a low-carbon economy.

Further ahead, an ageing society will add to the already considerable spending pressures. Even before the pandemic, the OBR expected debt to rise significantly over the long term.

Barring an unexpectedly strong recovery, unless the government curtails its spending ambitions or significantly raises taxes then the national debt is likely to remain elevated in the years ahead.

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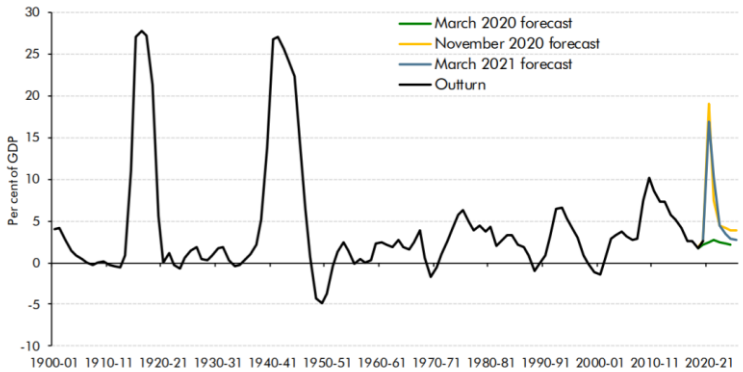
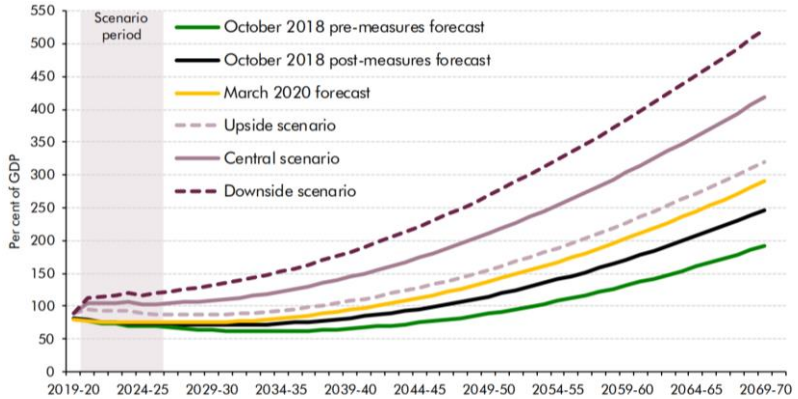
Chart 1.3: Public sector net borrowing since 1900



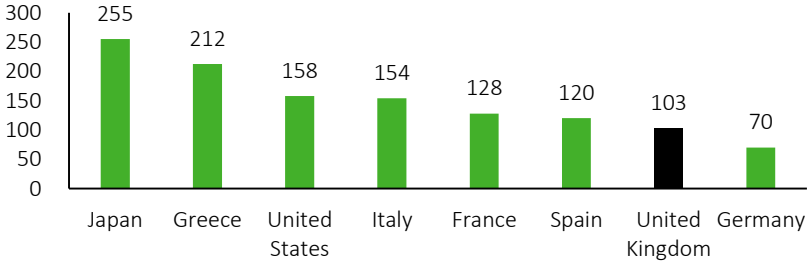
Source: ONS, OBR

OBR long-term public sector net debt projections, July 2020



Note: The October 2018 forecasts' 2024-25 jumping-off points are assumed to equal their 2023-24 medium-term horizon values.
Source: ONS, OBR

General government debt as a % of GDP in Q3 2020



Source: OBR, OECD

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2. What has the chancellor announced?

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Although the government's 'roadmap' for lifting COVID-19 restrictions envisages that all restrictions may be lifted from late June, the budget announced that many of the policy measures in place to support the economy will be extended until September.

These included an extension of the furlough scheme and further support for the self-employed, including some who had previously been ineligible for support. An extension of the universal credit uplift will assist those out of work or on low incomes.

Businesses in the hardest hit sectors such as hospitality and leisure will benefit from grants, and further VAT and business rates holidays.

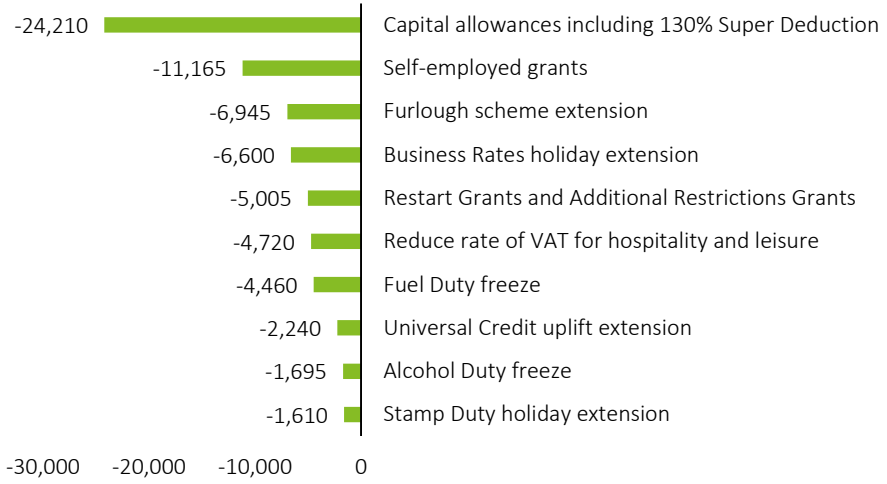
To support the housing market, the stamp duty holiday was extended, despite strong growth in house prices over the last year.

Although Rishi Sunak has stated his ambition to return to a more "sustainable fiscal position" he only announced limited tax rises, most of which will not take effect straight away.

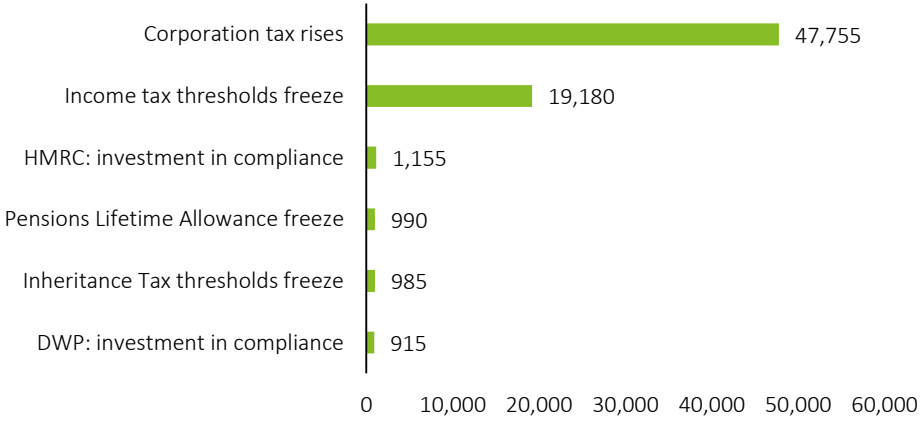
The increase in the corporation tax rate was higher than some had expected, and although the chancellor was keen to stress the headline rate remained the lowest in the G7, the effective rate paid doesn't compare as favourably.

Perhaps to temper the potential disincentive for business to invest, a novel policy of allowing businesses a tax 'super-deduction' for investment expenditure aims to encourage business spending as the economy exits COVID-19 restrictions.

Cost of selected tax cuts and new spending from 2020-21 to 2025-26 (£m)



Selected new revenues or savings from 2020-21 to 2025-26 (£m)



Source: HM Treasury

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3. Is now the right time to tackle the debt?

Deloitte.

As the chancellor stated in his budget speech, reducing the national debt relative to the size of the economy would give the UK more space to respond to future crises.

After the global financial crisis there were also concerns that if debt kept rising then investors would shun government debt, leading to rising borrowing costs.

These concerns are muted today, after a decade of falling interest rates and sluggish economic growth.

Indeed, despite public debt being forecast to rise to levels not seen since the late 1950s, the government is able to borrow at rock-bottom interest rates.

Promoting growth and avoiding long-term damage to the economy and labour market are rightly the priority in the short term.

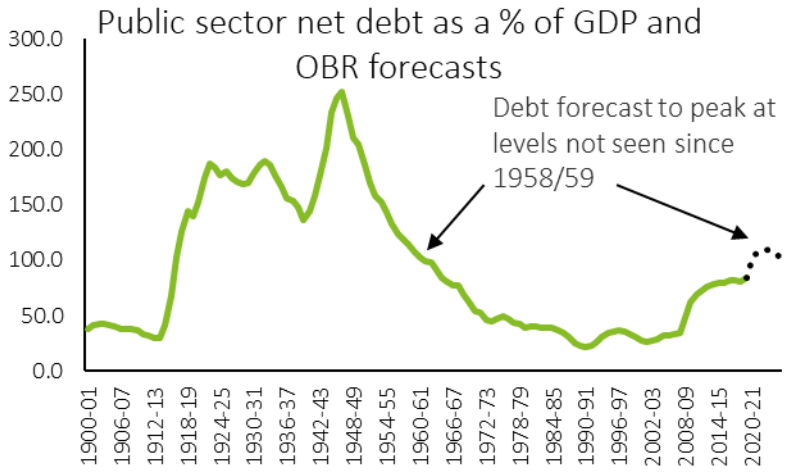
Well targeted stimulus through spending or tax measures can hasten the return of economic activity to its pre-pandemic peak.

Public investment financed through borrowing can also raise the growth potential of the economy for many years through productivity gains and the 'crowding in' of private investment.

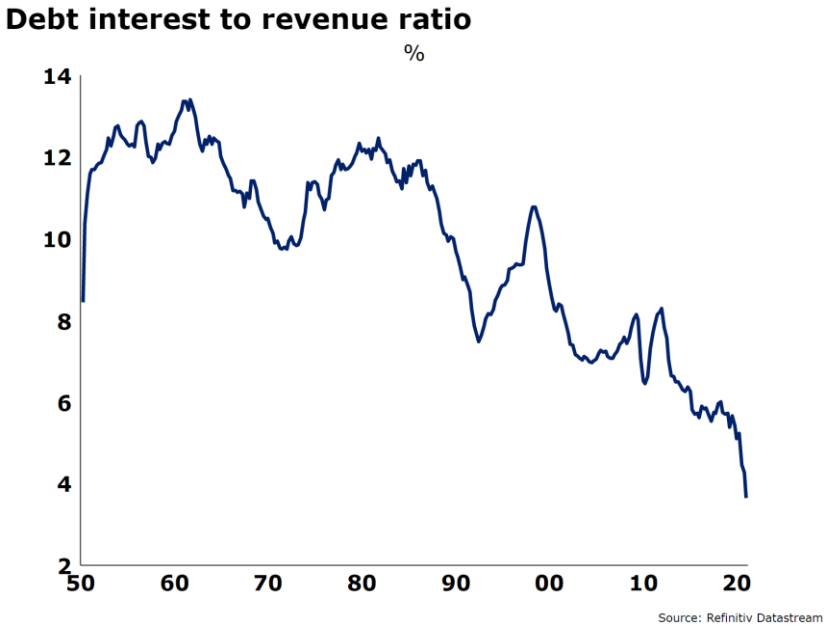
Greater spending has the potential to boost growth and if the economy is growing faster than stock of debt, then the debt-to-GDP ratio can fall even if the UK continues to borrow.

Not all spending and tax cuts are created equal. In the short-term, the challenge for the chancellor is to pick the policies and investments that deliver the greatest support to the recovery at the lowest cost to the public finances.

However, it is not too soon to start considering what measures may need to be taken to stabilise the public finances once the recovery has taken hold. The chancellor clearly agrees, choosing to boost spending this year while pencilling in tax rises in the years to come.



Source: OBR



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4. How could the chancellor close the deficit?

Deloitte.

If the chancellor decides to follow through on his ambition of moving the public finances to a more sustainable footing he faces a difficult set of political and economic choices.

The political zeitgeist and public mood is against a repeat of the austerity seen under David Cameron and George Osborne. It seems likely then that the heavy-lifting of any deficit reduction would be accomplished through tax rises rather than significant spending cuts.

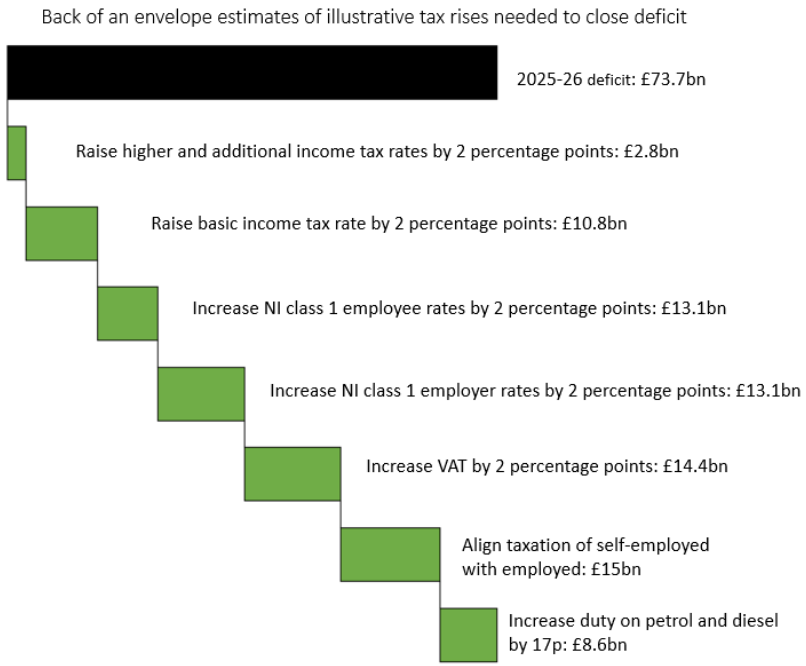
The Office for Budget Responsibility forecast that at the end of their forecast horizon the deficit will be £73.7bn. To completely eliminate this would require significant tax rises.

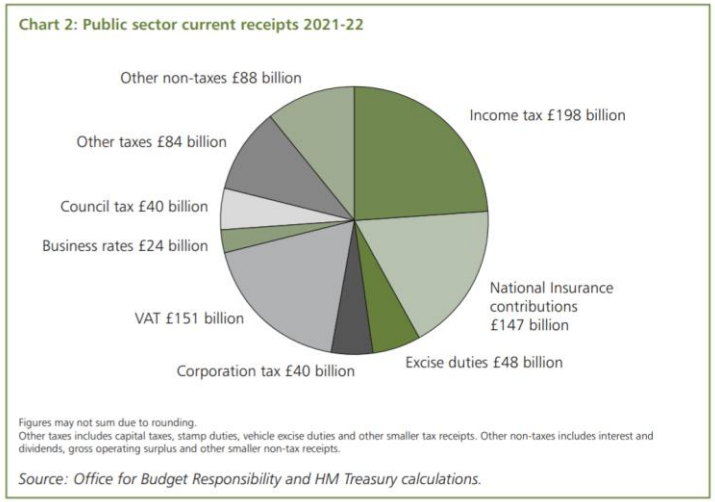
To illustrate the scale of the task we have done a back of an envelope calculation of the tax rises that would be needed to completely eliminate the 2025-26 deficit (see right).

Our judgment is that such a significant rise in taxes is unlikely. Not least as the government committed not to raise the rates of VAT, National Insurance or Income Tax (the so-called 'triple lock'). By doing so, the government has ruled out significant revenue increases from the taxes that raise over 60% of its total receipts.

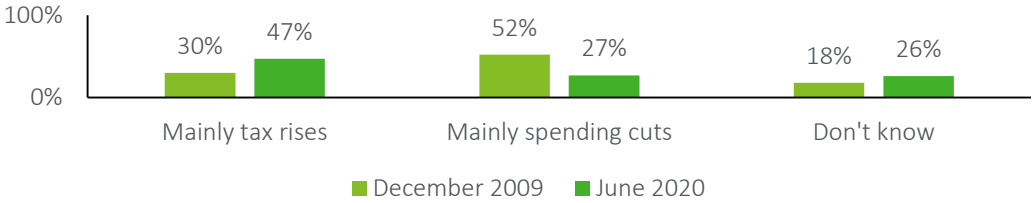
The government is planning to launch a consultation on taxes at the end of March, suggesting it may look to raise revenue in other areas.

There are longstanding calls for reform to a tax system that includes a number of taxes and rules seen as distortionary, inconsistent or unfair. The need for new sources of revenue may present a rare opportunity to simplify or reform some of these. Politically however, any tax reform which raises tax liabilities for a group of individuals is likely to create vocal opponents.





How should the government reduce the deficit?



Source: YouGov, HM Treasury, Deloitte calculations

5. Whatever happened to fiscal rules?

Deloitte.

The Conservative Party's 2019 manifesto set out three fiscal targets that guided the 2020 budget, outlined below in bold. In the latest budget, the chancellor said it **"is not the time to set detailed fiscal rules, with precise targets and dates to achieve them by"**. But he did set out three guiding principles, which are in italics beneath the relevant original fiscal rule.

1. To have the current budget in balance no later than the third year of the forecast period

- *"First, while it is right to help people and businesses through an acute crisis like this one, in normal times the state should not be borrowing to pay for everyday public spending"*

2. To limit public sector net investment to 3% of GDP

- *"It is sensible to take advantage of lower interest rates to invest in capital projects that can drive our future growth"*

3. To reassess plans in the event of a pronounced rise in interest rates taking interest costs above 6% of government revenue

- *"Over the medium term, we cannot allow our debt to keep rising, and, given how high our debt now is, we need to pay close attention to its affordability"*

Relative to the fiscal targets that guided the 2020 Budget, the latest forecast and the Chancellor's Budget decisions suggest that a focus on the current balance is retained, but the goal of achieving that by the third year of the forecast period is not; and the focus on stabilising debt has increased. The chancellor has indicated net investment is likely to rise and so seems less focused on the previous ceiling set on investment as a percentage of GDP in 2020.

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6. What's changed since the global financial crisis?

Deloitte.

Governments have eased fiscal policy far more aggressively than in response to the global financial crisis, and debt has therefore risen faster.

Government deficits in advanced economies ballooned to 13.3% of GDP last year, twice the levels seen in the financial crisis in 2009.

Economists and policymakers have changed their stance on the need to address higher levels of debt. After the financial crisis the IMF and OECD encouraged governments to focus on paying back debt.

In recent months, both of those organisations have urged governments to rethink constraints on public spending, warning them against prematurely limiting the recovery by tightening fiscal policy too early.

The change in thinking is mainly due to the historically low borrowing costs for sovereigns. Low inflation, low interest rates, a strong appetite for government debt and large amounts of quantitative easing have driven down and subdued borrowing costs.

The IMF recommends that governments lock in record-low interest rates and borrow, and spend, in support of the recovery.

For now, economic policy is very much focused on the risks of not doing enough to support growth.

There is, as yet, no strong pressure or constituency for fiscal tightening. But as the economy recovers the assumption that low interest rates will continue forever could face challenges.

Headlines from the Global Financial Crisis

IMF warns rich countries on debt

Boehner: Debt a 'moral threat' to U.S.

ECB's Trichet: austerity plans don't risk stagnation

Mervyn King attacks Alistair Darling over 'extraordinary' budget deficit

• Debt should be cut more quickly, he tells MPs

Headlines from the COVID-19 pandemic

OECD warns governments to rethink constraints on public spending

IMF says austerity is not inevitable to ease pandemic impact on public finances

Nations that can borrow freely can stabilise debt without fiscal adjustment, fund suggests

Fed's Powell is chief cheerleader for fiscal stimulus

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7. What happens if interest rates rise?

Deloitte.

The debt interest to revenue ratio is lower in every year of the OBR's forecast compared to the March 2020 forecast, despite debt being materially higher due to the pandemic.

This is thanks to lower interest rates, especially at shorter maturities, and the doubling in quantitative easing by the Bank of England, which further reduces debt interest.

However, a rise in market interest rates could sharply increase the government's cost of borrowing.

The OBR's numbers reflect interest rates as they stood on 5 February, before the rise in market interest rates in recent weeks. If the debt interest forecast had been based on market interest rates as they stood on 26 February, spending would have been £6.3bn higher in 2025-26.

According to the OBR's ready reckoner, a one percentage point increase in the interest rates paid on government debt could add £21bn to the annual debt interest bill.

If inflation and interest rates rise more than forecast, borrowing costs will increase, which could make high levels of debt unsustainable.

However, the most likely cause of rising inflation would be a stronger-than-expected economic recovery. As long as the rate of economic growth outstrips the accrual of debt, the ratio of debt-to-GDP should begin to unwind organically.

Table 3.23: Central government debt interest net of the APF: changes since March 2020 and November 2020

	£ billion						
	Outturn	Forecast					
	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
March 2020 forecast	38.0	34.5	37.8	37.9	37.3	36.7	
November 2020 forecast	36.9	23.5	17.6	21.2	25.5	27.3	29.0
March 2021 forecast	36.6	23.9	24.8	24.5	27.7	31.1	33.7
Change since November	-0.3	0.4	7.2	3.3	2.2	3.8	4.7
Change since March	**-1.4**	**-10.6**	**-13.0**	**-13.4**	**-9.6**	**-5.6**	
	Total changes since March 2020						
Total	**-1.4**	**-10.6**	**-13.0**	**-13.4**	**-9.6**	**-5.6**	
of which:							
Interest rates		-1.9	-3.7	-3.7	-2.5	-0.9	
Inflation		-3.5	-3.2	-4.3	-2.6	-0.6	
Financing		0.6	1.9	2.7	2.8	2.5	
Asset Purchase Facility		-5.8	-8.1	-8.0	-6.7	-5.3	
Other factors		0.0	0.0	-0.1	-0.6	-1.3	

Source: OBR

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8. What about other scenarios?

Deloitte.

The path of the pandemic is the key risk to the public finances.

The OBR's central forecast has GDP recovering to pre-pandemic levels by the middle of 2022. This assumes the government sticks to its reopening plan.

Downside: more onerous restrictions are imposed through the spring of this year and re-imposed in the winter. This requires a more substantial and costly economic adjustment, activity recovers at the end of 2024

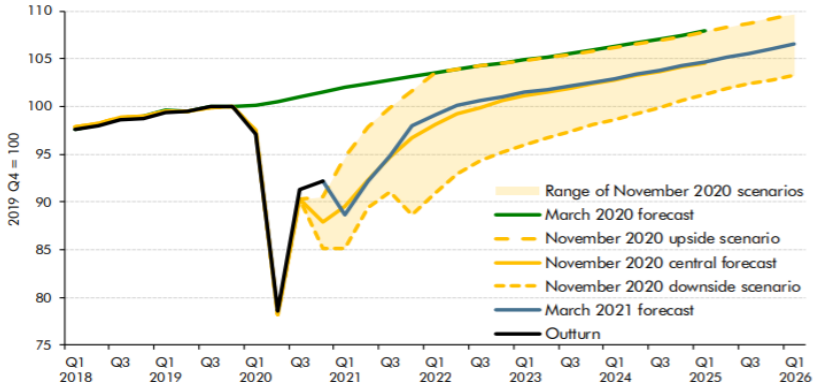
Upside: Effective control of the virus allows for an earlier easing of restrictions, with output recovering by end 2021

Receipts fall roughly in line with the economy and therefore differ only moderately as a share of GDP across the scenarios. By 2025-26, receipts are 1.8 per cent of GDP lower in the downside scenario than in the central scenario.

Spending in each scenario moves with the Government's policy decisions as they stood in November. In 2021-22, spending is 3.6 per cent of GDP higher in the downside scenario than in the central case, reflecting higher public spending and a smaller economy. By 2025-26, the 1.5 per cent of GDP difference between the scenarios is almost wholly accounted for by differences in GDP.

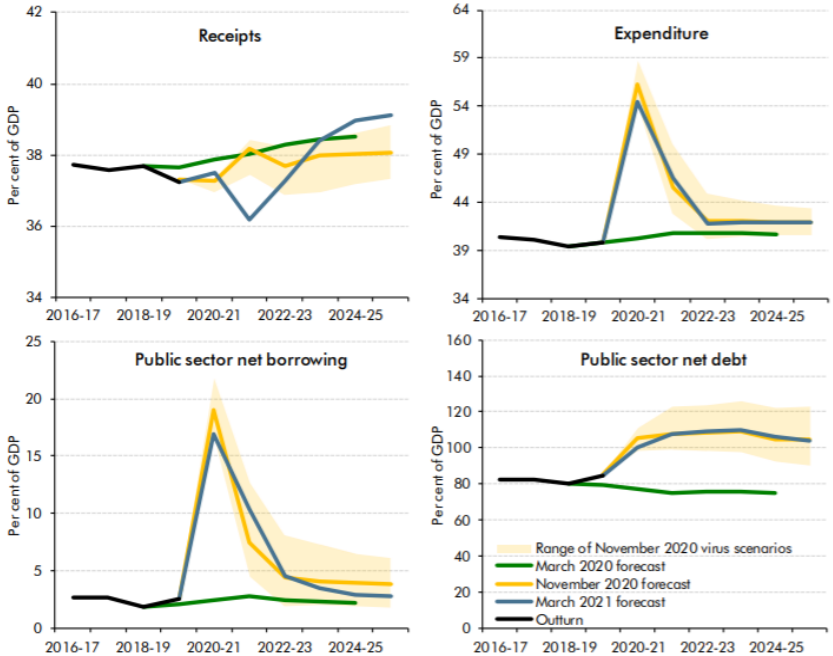
By 2025-26, borrowing is 3.3 per cent of GDP higher in the downside scenario and public sector debt is 19.3 per cent of GDP higher.

Chart 1.5: Real GDP: central forecast and scenarios



Source: ONS, OBR

Chart 3.11: Key fiscal aggregates in scenarios



Source: ONS, OBR

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9. Will we see a permanently larger state?

Deloitte.

After previous crises, most obviously WW1, WW2 and to a lesser extent the global financial crisis, public sector spending as a percentage of GDP remained elevated for some time.

The government faces new pressures on spending even as the economy recovers. These include clearing backlogs in the NHS, helping children catch up on missed education, the transition to a low-carbon economy, levelling up and maintaining preparedness for future pandemics.

The OBR expect public spending to rise from 39.8% of GDP in 2019-20 to 41.9% in 2025-26.

There is little concern that high levels of public borrowing and spending might 'crowd out' private sector borrowing and activity, the main threat is insufficient demand.

Investors in the US appear to see the benefits of greater fiscal stimulus under a Biden administration more than outweighing any negative effects from higher taxes or greater regulation.

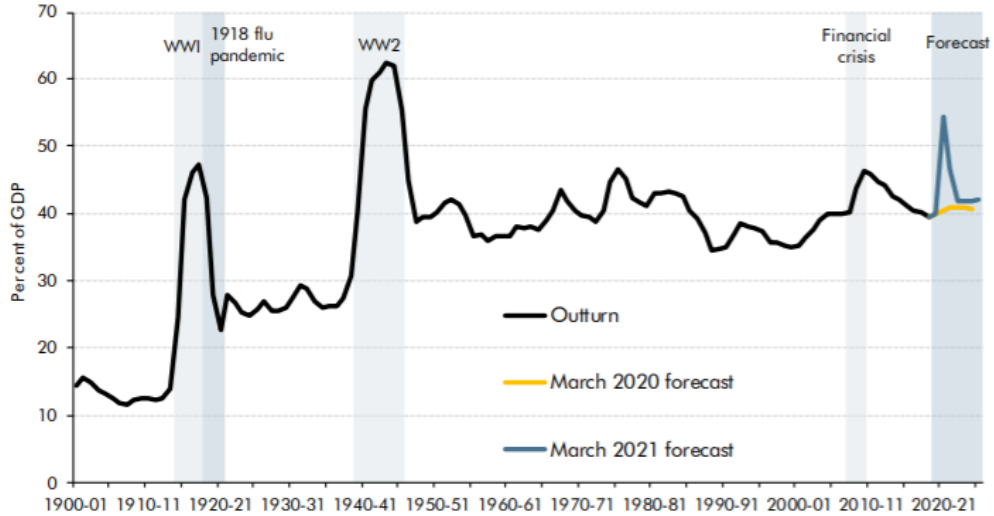
It is likely therefore that we will see a permanent increase in the size of the state and higher amounts of public spending, to levels not seen for many decades.

Table 1.2: Overview of the fiscal forecast

	Per cent of GDP, unless otherwise stated						
	Outturn	Forecast					
	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Revenue and spending							
Public sector current receipts	37.2	37.5	36.2	37.3	38.4	39.0	39.1
Total managed expenditure	39.8	54.4	46.5	41.8	41.9	41.9	41.9

Source: OBR

Chart 3.6: Public spending as a share of GDP



Source: Bank of England, ONS, OBR

Deloitte.

10. How do the government's spending plans fit with levelling up and the transition to net zero?

In the Budget the chancellor signaled his intention to increase investment spending saying "It is sensible to take advantage of lower interest rates to invest in capital projects that can drive our future growth".

Public sector net investment rises significantly from its pre-pandemic level of 1.9 per cent of GDP to an average of around 3 per cent of GDP over the next five years.

In addition, the Government announced the establishment of a new UK Infrastructure Bank (UKIB) this year to help deliver on its National Infrastructure Strategy. Like the European Investment Bank (EIB) of which the UK is no longer a member, the UKIB will extend loans, equity financing and guarantees to fund projects that will help tackle climate change and to support regional and local economic growth.

The Government forecasts that the UKIB will lend and invest around £1½ billion a year (net of lending to local authorities that would otherwise have taken place through the Public Works Loans Board). This would be equivalent to around a third of the financing that was provided by the EIB prior to the EU referendum.

The government have previously announced regional funding as part of their 'levelling up' agenda, as well as money set aside for the prime minister's ten-point green industrial revolution.

In line with the government's levelling up agenda, the chancellor announced the UKIB will be based in Leeds and there will be a new northern Treasury campus in Darlington.

Table 3.34: Fiscal aggregates: central forecast

	Per cent of GDP, unless otherwise stated						
	Outturn	Forecast					
	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Receipts and expenditure							
Public sector current receipts (a)	37.2	37.5	36.2	37.3	38.4	39.0	39.1
Total managed expenditure (b)	39.8	54.4	46.5	41.8	41.9	41.9	41.9
of which:							
Public sector current expenditure (c)	35.6	48.2	41.3	36.5	36.5	36.6	36.6
Public sector net investment (d)	1.9	3.6	2.7	2.8	2.9	2.8	2.7

Source: OBR