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The nation's finances must not be tied to highly speculative forecasts

Ryan Bourne

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Wednesday's Spending Review, alongside new economic forecasts from the Office for Budget Responsibility (OBR), made two things abundantly clear. Covid-19 has been an unprecedented shock to the UK economy. Yet nobody really has a clue what its lasting economic effects will be, including on the public finances.

That suggests we should push back strongly on those calling for major, damaging commitments to tax hikes soon in the name of reducing the deficit.

It is now thought GDP will fall by 11pc this year, the biggest contraction in output since the Great Frost of 1709.

The resultant collapse of tax revenues by £55bn, coupled with £280bn in new spending on treating the infected, containing the virus, subsidising medical innovation, and vast relief for households and businesses, is expected to see public borrowing soar to £394bn, or 19pc of GDP – the highest peacetime deficit on record.

Yet as shocking as those statistics sound, the unusual nature of this recession means its longer-term consequences on the public finances are less clear. As with demobilisation after war, emergency virus spending will simply stop as the Government decovidises its budget.

The Government will throw an extra £45bn of Covid-related expenditure in 2021-22, most of which will be on test and trace and the vaccine rollout. But most pandemic-specific spending will simply end once the inoculation programme is complete.

We will be left with a significant uplift in the level of accumulated government debt, making the public finances more vulnerable to fluctuating interest rates. But the deficit itself will plunge again as spending is cut and tax revenues rebound from liberated activity.

Economic scars

With markets seemingly content to lend to the Government on the path to recovery, what will really determine if additional deficit reduction is ever needed is whether this crisis itself has "scarring" consequences on our economy's growth potential.

On this, the OBR is hedging its bets. This week's forecast mapped out three scenarios, including an "upside" one where this lockdown was successful, a test-and-trace system was then effective, and a vaccine was rolled out by spring.

In its "central" case, we continue firefighting the virus inadequately until a vaccine is delivered through the second half of next year. In the optimistic scenario, the crisis is forecast to have no impact on our economic potential – GDP shoots back to the pre-crisis path predicted in March's Budget by late next year.

Yet in the case where we struggle with the virus and take slightly longer to get the vaccine to people, the OBR predicts the economy will be about 3pc smaller by 2025 than was envisaged pre-Covid.

Absurdly pessimistic

There's good reason, of course, to think that this crisis will indeed hurt the growth potential of the economy. Some businesses will go bust and others that would have been created will not be. The lack of face-to-face meetings will curb innovation that is dependent on sharing ideas, while the uncertainty of this period has depressed business investment, harming future productivity. Inward migration will likely fall, some people might retire earlier, and "structural" unemployment is likely to rise, as pandemic-induced changes to our consumption and work habits lead to some permanent job losses.

But the magnitudes in the OBR's scenarios make no sense. Some of these damaging consequences are baked-in already, meaning the full bounce-back in GDP in the "upside" scenario looks extremely rosy. Yet the central scenario's guess that we will lose nearly a year and a half's growth potential, permanently, as a result of this crisis, seems absurdly pessimistic.

The OBR has also admitted that it did not account for the positive Oxford-AstraZeneca vaccine news, which may speed up achieving herd immunity through vaccination.

What the large range of their "long-Covid" impacts shows, I suspect, is that the OBR, just like everyone else, doesn't really know how much this crisis will drag on future economic performance.

It might even be that the pent-up demand for activity after this pandemic is such that we see a more rapid recovery than expected, just as the Roaring Twenties followed the Spanish flu. We therefore must be careful to avoid a self-fulfilling prophecy of gloom.

Too soon to raise taxes

The OBR's forecasts are treated as gospel by the media and various think tanks, setting the baseline for expected fiscal policy. The pessimistic 3pc GDP hit trailed as its central forecast would, if true, mean £27bn-£40bn more in tax rises or spending cuts being required in the coming years.

But committing to jacking up an already historically high tax burden before we even know the lasting damage of this crisis could be self-defeating.

We are still in the depths of the crisis. If broad tax rises become expected, including, as some at the Resolution Foundation have been pushing for, on businesses, then what do we think the impact will be on struggling investment?

Now, more than ever, we need to be clear about the uncertainties facing us. Remember that the OBR itself forecast in July that the unemployment rate would peak at 11.9pc, but this week revised that down to just 7.5pc. Between April and October, public sector borrowing was actually £75.6bn below what it was expecting too.

The longer-term effects of this episode, especially when you add in interactions with Brexit, are more difficult to predict still.

While additional fiscal repair will probably be needed eventually, now is not the time for rash commitments to future tax hikes.

The OBR’s forecasts highlight the priority of delivering the vaccine swiftly. But their uncertainty shows why we should avoid a message of doom that causes businesses and households to prepare for private sector austerity that might not even be needed.

Ryan Bourne holds the R Evan Scharf chair for the public understanding of economics at the Cato Institute