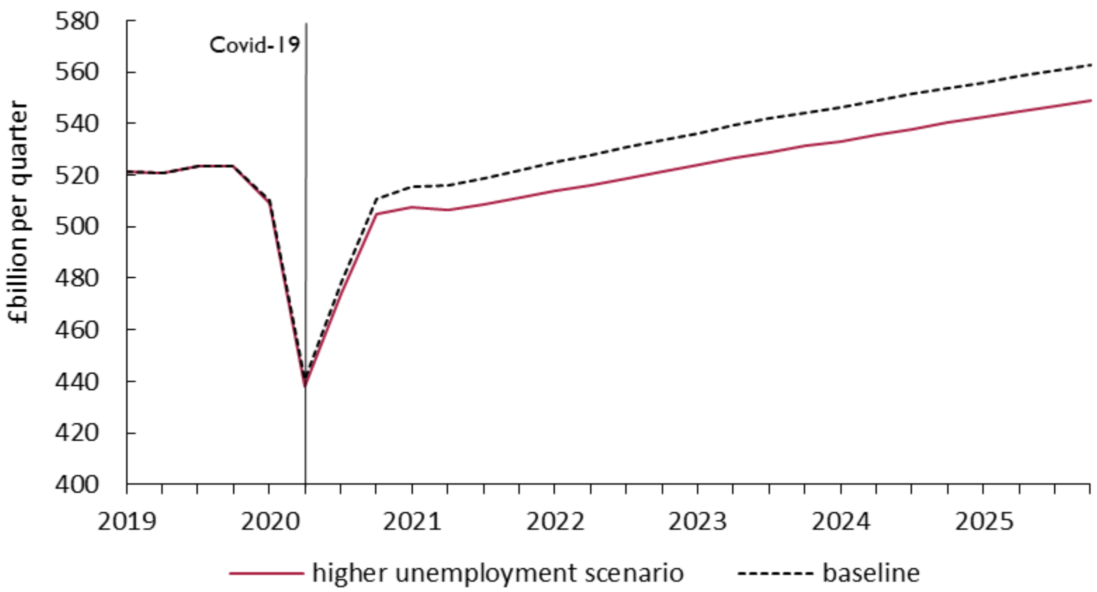
NIESR Analysis Ahead of the Summer Statement: Keep Doing 'Whatever it Takes'

Garry Young, NIESR Deputy Director

8 July 2020



Executive Summary

- The Chancellor should extend the government's jobs furlough scheme, ideally until GDP is back to its pre-Covid 19 level. The scheme has been highly successful in protecting over 9 million jobs over this period and continues to support around 6 million furloughed workers.

- Premature withdrawal of support could lead to higher long-term unemployment and lower productivity. This could be more costly in the long run. An illustration of this where productivity was permanently lower by 1 per cent and unemployment higher by 1 per cent would lead to GDP being about 2.5 per cent lower than it would otherwise be, leading to the need for higher tax rates to make up for lost revenue. This would amount to a permanent loss of GDP of £50 billion per annum (as of 2022) or £750 per person

- The UK should take advantage of the fact that additional borrowing is easily financed at very low interest rates.

- The priority for a new round of spending should be to bring forward as quickly as possible spending already promised as part of the government's levelling up agenda.

- Announcing in advance a reduction in Stamp Duty on property purchases in the autumn would encourage buyers to defer house purchases until then, damaging the housing market in the short term.

- Offering vouchers or a reduced rate of VAT for spending in bars and restaurants will not be the most effective way of helping a sector for which the problem is not a lack of demand but an inability to meet existing demand safely.

Introduction

In March, Chancellor of the Exchequer Rishi Sunak promised to do 'whatever it takes' to see the UK through the Covid-19 crisis. So far he has delivered on that promise with a range of support measures that has shielded people from the full economic fallout of Covid-19.

The fiscal cost of doing whatever it takes

But doing 'whatever it takes' is costly. The Office for Budget Responsibility (OBR) estimates that the direct cost in the current financial year of all the government support measures announced so far is £132.6 billion. That figure does not include the various indirect costs in terms of lost tax revenue that come from a smaller economy. With GDP expected to be around ten per cent smaller this year the government is likely to need to borrow around £300 billion, representing around 15 per cent of pre-crisis GDP. The figure could be even higher if there was a second wave of the virus and lockdown measures needed to be reintroduced.

It is not surprising therefore that the Chancellor is facing some pressure to reduce the extent of fiscal support and focus it where it is most needed. But it is important that the support is not withdrawn prematurely. After all, the Chancellor has described the support as "a bridge over what will be a sharp and significant crisis" and a bridge will not serve its purpose if it does not go all the way.

The importance of support measures

One of the main justifications for the support measures is to prevent what is primarily a short-term health crisis from having long-term economic costs. That could happen when weaker activity affects incomes and business cash flows, leading to insolvencies and unemployment that damage the long-term potential of the economy. Providing support to businesses and keeping jobs alive is a way of avoiding that outcome.

Keep the furlough scheme for as long as it takes

This is especially relevant to the government's furlough scheme, known formally as the Coronavirus Job Retention Scheme (CJRS). Initially planned to last until the end of June, the scheme has since been amended and extended to the end of October. The CJRS has been very successful in protecting over 9 million jobs over this period and continues to support around 6 million furloughed workers. But according to the OBR it will cost around £60 billion this financial year, close to half of the estimated direct cost of all government support measures.

The CJRS will become less generous in the coming months with employers expected by October to contribute 20% of furloughed workers' pay and all their usual national insurance and pension. This could be too much for employers whose cash flow is stretched and may have already contributed to some of the job losses that have been announced in recent weeks. Premature closure of the scheme risks undoing much of the good it has done. The cost of the scheme will naturally decline as the economy recovers and businesses bring staff back to work.

Provide reassurance

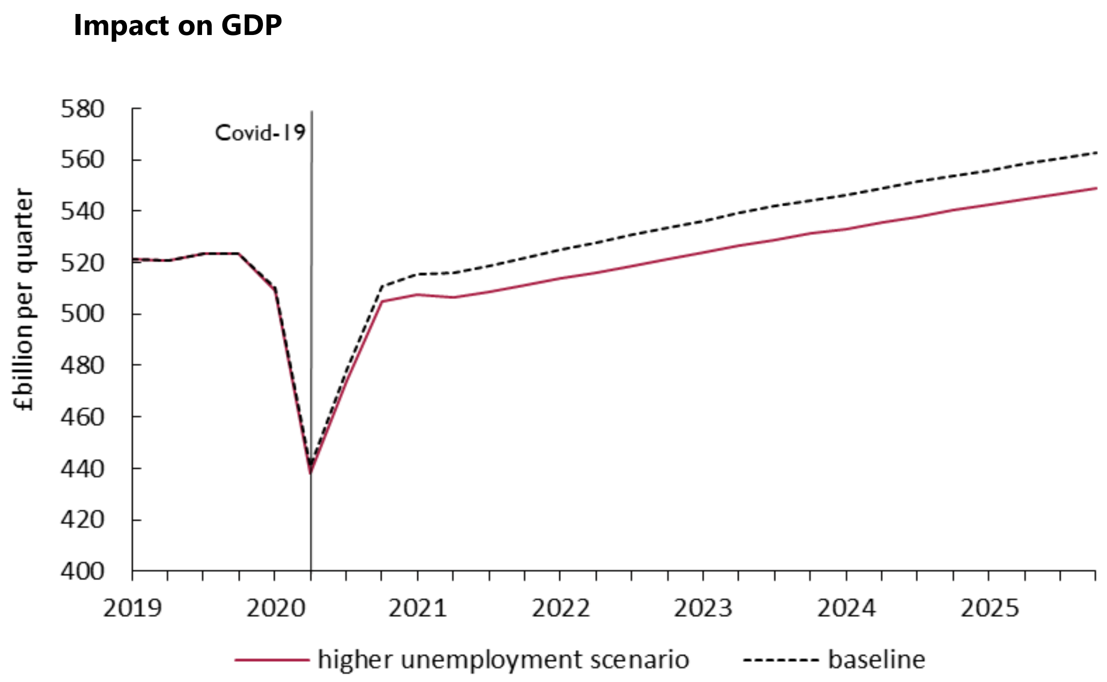
It would be better for the Chancellor to communicate clearly that the scheme will be available for so long as it is needed consistent with the 'whatever it takes' message. This could be defined formally as say 'until GDP is back to the level in 2019', before Covid-19 became an issue.

The cost of not keeping the furlough scheme

Ending the scheme prematurely could lead to permanent long-term damage to the economy if those who become unemployed as a result lose their skills and attachment to the labour market. This would lead to permanently higher unemployment and weaker productivity. In our last forecast, published in late April, we thought it was quite likely that unemployment would rise to more than 10 per cent of the workforce in the second half of this year before declining somewhat in 2021 as the economy recovered. Such forecasts are very uncertain, but there is a clear risk of a significant jobs shake-out later this year. If this does occur then it is also likely that without support many of those who lose their jobs could be without work for a long time.

The extent of any such increase in long-term unemployment is very uncertain, but to give a sense of the long-term cost of not providing short-term support through the crisis we have run a simulation of our global macroeconomic model of what might happen if support is withdrawn prematurely. In this simulation productivity is permanently lower by 1 per cent and unemployment is permanently higher by 1 percentage point as a consequence of not providing a bridge to the end of the crisis. As the figure shows, this would lead to GDP being about 2.5 per cent lower than it would otherwise be, worth around £50billion per annum in 2022, around £750 per person, causing a need for higher tax rates to make up for lost revenue.

Figure 1: What if productivity is lower and unemployment higher due to premature withdrawal of fiscal support?



Source: NiGEM simulation

So, one clear justification for keeping fiscal support measures going is that it makes economic sense. Premature withdrawal of the measures could mean that the long-term adverse impact on the public finances ends up being worse than the cost of continued short-term support.

Additional borrowing is easily financed at low interest rates

Another justification is that the additional borrowing is easily financed at low interest rates. The nature of the Covid-19 crisis means that the government is effectively borrowing from households who are unable to spend to support the incomes of those who are unable to work. In other words, the borrowing is being financed from within the United Kingdom and as a country we are not building up debts with the rest of the world. This means that the issue is distributional: the country has the resources and the government is borrowing to deploy them so that they go to where they are needed. Once the crisis is over, those who have lent to the government will want to be repaid and this will likely require higher taxation of those who can afford to pay. Such taxation would be less onerous for the country as a whole if the economy was larger as a result of being supported through the crisis.

What other options does the Chancellor have?

The key policy imperative for the Chancellor is to provide reassurance that he will continue to do 'whatever it takes' so that people do not fear the future. This may involve some new policies.

It has been rumoured that the Chancellor will promise to reduce stamp duty on property purchases from the Autumn. While stamp duty is not a good tax, it would be a mistake to encourage people to believe that it will be lower in the near future as this would encourage them to defer house purchases until then, damaging the housing market in the short term. This would have the opposite effect to what is intended.

It has also been rumoured that he would offer vouchers or a reduced rate of VAT for spending in bars and restaurants. This would have the advantage of targeting a sector that is likely to be more damaged than others by the need to maintain social distancing. But it is not obvious that the problem for this sector is lack of demand rather than the inability to meet existing demand safely.

Bring forward levelling up investment spending

Probably the most important policy measure the Chancellor could take would be to bring forward spending already promised as part of the government's levelling up agenda. In his March budget, the Chancellor announced plans for substantial additional public investment. This was forecast to rise to 3 per cent of GDP by 2022-23 and then remain at that level. When aspects of this policy were discussed following the general election, we cautioned that with the economy operating at full capacity it would not be straightforward to raise investment as quickly as intended and that it would have less impact than at a time of spare resources. The economic environment has changed in a way that then seemed unthinkable and there is no better time than now for the government to invest more. This would increase demand in the UK economy and provide support when it is most needed.