# A SWITCH TO ACTIVE FISCAL POLICY: NIESR RESPONSE TO BUDGET 2020

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# A Switch to Active Fiscal Policy: NIESR Response to Budget 2020

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*Abstract*

On Wednesday 11th March 2020, Chancellor Rishi Sunak delivered his first Budget only 27 days after being appointed. The Chancellor delivered this first, post-Brexit Budget for this Government, which has a strong mandate after its comprehensive election victory in December that should be strong enough to implement a strategy for reform over the whole of this parliament.

The opening section of this analysis provides an overview and response to the 2020 Budget, followed by comments on the following topics before concluding:

- Increase in the National Living Wage
- R&D Investment
- Increase in the Immigration Health Surcharge
- Broadband Investment
- Investment in Housing
- Initiatives to help the NHS Tackle the Coronavirus

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## Overview of Financial and Monetary Policies on Budget Day

The government and Bank of England have announced a substantial package of emergency measures to support the economy through the Covid-19 outbreak. This is a welcome, co-ordinated response to a serious health crisis that could spill over to the economy and thereby cause widespread hardship. On top of this, the Budget also contains a large fiscal boost aimed at improving the long-term performance of the economy. Together these measures provide substantial short-term support to the UK economy and set a course for much higher public investment in the longer term, to be financed by higher borrowing.

The Chancellor also stated in his Budget that he would review the fiscal rules this autumn that guide government decision making. The recognition that we can arrive at better monetary-fiscal-financial with co-ordination is very welcome. The lack of appropriate co-ordination has been the source of many of our macroeconomic problems.

### Response to Covid-19 Coronavirus

The government has pledged to ensure that public services are given the resources to respond effectively to the health crisis. In addition, together with the Bank of England, the government is addressing the main priority from an economic perspective of preventing the health crisis leading to unnecessary hardship. The risk that the authorities are trying to avoid is that a temporary disruption to supply chains and weaker activity affects incomes and business cash flows, leading to insolvencies and unemployment. To prevent a persistent downturn or worse still a downward economic spiral, the government is supporting incomes, providing safety nets and giving lenders the confidence to extend credit through a loan guarantee scheme.

### Reaction to Budget Measures to Covid-19

The Chancellor announced a £30 billion fiscal stimulus in the current year.

This includes:

- Extra resources for NHS to deal with coronavirus;
- Support for household finances, including statutory sick pay available to all who are advised to self-isolate and making it easier to access benefits. This adds £500 million to welfare bill;
- Support for businesses by refunding statutory sick pay to businesses and allowing businesses and self-employed to defer tax payments. The Chancellor announced a new coronavirus loan scheme with a guarantee of up to 80 per cent of loans made and temporary abolition of business rates for small businesses.

These measures seem proportionate to the potential scale of the health crisis and the risks to people's livelihoods. They are likely to lead to a significant rise in government borrowing in the short term. But it is entirely appropriate that government borrowing should rise in these circumstances. It is quite right for net debt to increase in response to an emergency. With interest rates at very low levels, a discussion of how to pay for the crisis can be deferred until it is over and even until after we have had the spending review.

## Reaction to Bank of England Measures

The health crisis has triggered a substantial response from the Bank of England, including a 50bp emergency cut in Bank Rate, a new SME term funding scheme and a relaxation of the counter-cyclical buffer. The Bank of England has done as much as it can within its remit to support the economy. The interest rate cut and establishment of the term funding scheme aimed at small businesses are welcome. These measures are underpinned by a government-backed credit guarantee scheme that will give banks the confidence to lend.

## Reaction to Long-term Measures in the Budget

The Chancellor announced plans for substantial additional public investment. This is now forecast to rise to 3 per cent of GDP by 2022-23 and then remain at that level. It is important to recall that this will be a process for the long haul. It will take a number of years for public investment to feed through into long term capacity. **The OBR estimates that additional public investment will add 2.5 per cent to potential output in the long term. This is a similar positive supply side response to the one projected by the Institute in its *February 2020 Review*.** It is also the case that building up public investment will require more current expenditure on workers in order to deliver services.

The government though will have to locate appropriate investment opportunities and ensure that investment is laid down not only quickly but consistently over a number of years. While this is a welcome first step it does not by itself support a sufficient response of the supply side to deal with public underinvestment by successive governments or the challenges of Brexit.

## Reaction to OBR Forecasts

The OBR has produced new forecasts for the UK economy. This does not include the full short-term effect of the Coronavirus or the additional measures to mitigate its effects.

| | **GDP growth** | | **LFS unemployment rate** | | **PSNB (financial years)** | |
|---|---|---|---|---|---|---|
| | **OBR** | **NIESR** | **OBR** | **NIESR** | **OBR** | **NIESR** |
| 2019 | 1.4 (1.2) | 1.3 | 3.8 (4.1) | 3.8 | 2.1 (1.3) | 2.2 |
| 2020 | 1.1 (1.4) | 1.3 | 3.8 (4.1) | 3.8 | 2.4 (0.9) | 2.3 |
| 2021 | 1.8 (1.6) | 1.6 | 3.8 (4.1) | 4.0 | 2.8 (0.7) | 2.8 |
| 2022 | 1.5 (1.6) | 1.6 | 3.9 (4.0) | 4.1 | 2.5 (0.6) | 2.9 |

Numbers in parentheses are from March 2019 OBR forecast.

The new OBR economic forecasts are relatively little changed from a year ago and are in line with our most recent forecasts published last month. The main change is to the fiscal outlook where the deficit forecast has been revised up since last year, but again is broadly in line with our most recent forecasts.

## Reaction to Fiscal Framework

The Chancellor has announced a review of the government's fiscal rules, but in the meantime has set policy very broadly within the scope of the fiscal rules proposed in the Conservative election manifesto.

We have argued that fiscal policy should be framed in terms of the public sector's overall balance sheet rather than arbitrary constraints on the amount that can be borrowed in the short term. Taking decisions from this perspective means that borrowing can rise flexibly in response to short-term shocks and be repaid at a later date. It can also rise to pay for economically viable investment projects that pay off for all of society in the long term.

Of course, there needs to be a discussion of how much the government should spend and how this should be financed. But arbitrary, fiscal rules are not the answer. Governments have struggled to define fiscal rules that are fit for purpose in guiding long-term budgetary choices. They are also very hard to monitor and have been subject to constant revision.

The latest version of the fiscal rules, which were announced almost out of the blue in November 2019, is especially poor. The requirement to balance current spending (excluding investment) by 2023 fails to take account of the current economic circumstances – especially in the wake of the outbreak of the COVID-19 coronavirus. The upper limit for government borrowing for investment to be no more than 3% of the size of the economy is likely to end up an incentive to make investment even when it is not required, but worse, an artificial constraint when significant investment is required, as now. Additionally, the cap on interest payments as a fraction of revenues takes no account of the revenue generating potential of public sector investment.

The Treasury should lay out a long-term objective for its balance sheet – assets and liabilities - as the best way of ensuring it can meet current and future socioeconomic risks. The exact balance between assets and liabilities will depend on the long-term cost of borrowing, as well as a judgement about how spending and tax capacity is likely to evolve over time as a result of the demands of an ageing society. It would then need to explain how current and future fiscal balances should move to meet its balance sheet objectives. Large expenditure shocks, which may arise from dealing with a war or a medical emergency, should generally be financed by gradual increases in taxes and immediate, but strictly temporary, increases in public debt. There may be merit in devolving some of the decisions over the short term path of fiscal policy to an independent authority.

## Reaction to Long-Term Measures

**Garry Young**, Director of Macroeconomic Modelling and Forecasting at NIESR, said:

"The Chancellor announced plans for substantial additional public investment. This is now forecast to rise to 3 per cent of GDP by 2022-23 and then remain at that level. It is important to recall that this will be a process for the long haul. It will take a number of years for public investment to feed through into long term capacity.

"The Office for Budget Responsibility estimates that additional public investment will add 2.5 per cent to potential output in the long term. This is a similar positive supply side response to the one projected by the Institute in its *February 2020 Review*. It is also the case that building up public investment will require more current expenditure on workers in order to deliver services.

"The government will have to locate appropriate investment opportunities and ensure that investment is laid down not only quickly but consistently over a number of years. While this is a welcome first step it does not by itself support a sufficient response of the supply side to deal with public underinvestment by successive governments or the challenges of Brexit."

Please read more in the UK Forecast chapter of our February Review here.

## Reaction to Increase in the National Living Wage

**Johnny Runge**, Senior Researcher at NIESR, said:

“Last year, an independent review for the government, conducted by internationally renowned expert Professor Arindrajit Dube, found there is still scope to explore even higher minimum wages in the UK. As such, the government’s ambition to do so should be welcomed.

“Today’s budget delivered on the Conservatives’ manifesto commitment, as the Chancellor announced a new remit for the Low Pay Commission, to ensure the National Living Wage reaches two-thirds of median wages by 2024, estimated to be £10.50 an hour.

“The proposed change is large, with an ambitious timescale, which would take the UK into uncharted waters. It is therefore important that the employment prospects of low-paid workers are monitored carefully, so any negative impacts on jobs can be detected in time, and if necessary be reversed.

“It was therefore welcome that the Chancellor added that the formal rule would only apply *‘as long as economic conditions allow’*. It is important that this is not just empty words. The LPC needs to have the power to step back and reconsider the path of the National Living Wage, in case it turns out that the proposed increases could harm the very same people it was intended to help.”

See more detailed NIESR thoughts on this in our 2019 General Election briefing here.

## Reaction to R&D Investment

**David Nguyen**, Senior Economist at NIESR, said:

“The Budget included a number of announcements in the area of research and development (R&D), including investing at least £800 million to establish a new research agency focused on ‘blue-skies research’. At this point little is known regarding the types of projects that could be funded under this new agency, but it appears to be focused on ‘high-risk, high-reward science’.

“What is not obvious is why this requires an entirely new agency, considering the existence of UK Research and Innovation. There is a risk that a good part of the £800 million will be spent on duplicating existing administrative capabilities and not end up funding actual blue-skies research.

“Announcements also included increasing public investment in R&D to £22 billion by 2024-25 and raising the Research & Development Expenditure Credit from 12 per cent to 13 per cent in order to boost private sector R&D investment. This could also include investment in data and cloud computing, which are increasingly enabling and enhancing new (and old) business models.

"Related to this, it is also encouraging to see that the government is accepting all strategic recommendations from the Furman Review to boost competition in the digital economy. This includes a new cross-regulatory taskforce at the Competition and Markets Authority (CMA) that is supposed to report on digital platform markets within six months."

## Reaction to Increase in the Immigration Health Surcharge

**Chiara Manzoni**, Senior Social Researcher at NIESR, said:

"Non-EEA citizens applying to remain in the UK for more than six months must pay the Immigration Health Surcharge which stands at £300 for students and £400 for other visa and immigration applications. In today's budget, the Chancellor has announced that the surcharge will increase from £400 per person per year to £624. From January this healthcare surcharge will also apply to new EU migrants.

"This surcharge represents an additional charge to the existing Home Office application fees and on top of other work-related taxes. It applies regardless of migrants' use of the health system and may contribute to the narrative that immigrants are to blame for pressures on the NHS. But migrants in the UK are generally young, healthy and typically in work. There is evidence which shows that immigrants overall contribute more to the NHS than they take out.

"This substantial increase makes it more expensive for migrants to come to the UK and could represent a disincentive to potential newcomers. The surcharge will also impact on those already here, making their lawful immigration status more expensive."

For more details see NIESR 2019 General Election briefing on immigration here.

## Reaction to Broadband Investment

**David Nguyen**, Senior Economist at NIESR, said:

"The plan to spend £5 billion to bring gigabit broadband to the places that are most difficult to reach is a step in the right direction and in line with the promises outlined in the 2019 Conservative manifesto. It is good for people and businesses in places where the provision of high-speed internet is not necessarily commercially viable.

"However, there is a concern that high-speed internet could potentially increase spatial disparities over the longer term. This is because businesses from elsewhere can more easily provide digital services to peripheral places and displace local economic activity there. For example, the additional announcement of the £8 billion Digital Trade Network to support digital exports of UK businesses is likely to be more beneficial to businesses in urban areas. This does not mean that the Digital Trade Network is a bad idea in itself, but like many policies it has a spatial dimension to it that needs to be appreciated.

"Finally, the announcement of spending of £510 million to bring 4G coverage to 95% of the country ignores the fact that 5G is the future of mobile broadband. It is noticeable that the Budget does not mention 5G at all, considering its role as a critical element of future digital infrastructure. If the UK really wants to become a global leader in terms of technology and innovation in an increasingly data-driven global economy this shortcoming needs to be addressed, despite the associated political challenges."

## Reaction to Investment in Housing

**Xuxin Mao**, Principal Economist at NIESR, said:

"The Budget aims to tackle the housing crisis of the UK with measures focusing on development and planning. One key measure is a £12bn multi-year settlement for a new Affordable Homes Programme, a £3bn increase on the current five-year programme. The funding is projected to bring in a further £38bn in public and private investment.

"While the ambitious measure to increase supply of affordable houses should be welcomed, more details should be examined on how to achieve the further £38 billion funding through public and private investment to help more people into homeownership and help those most at risk of homelessness.

"Meanwhile, the UK government should learn lessons from their experiences in delivering such investment through public-private partnership projects. Proper allocation of risk and reward, clear and achievable objectives, manageable project complexity, good market assessment and management, and adequate project governance are the key areas to monitor if the biggest domestic policy challenge of our generation is to be tackled properly."

## Reaction to Initiatives to help the NHS Tackle the Coronavirus

**Peter Dolton**, Research Director at NIESR and Professor of Economics at Sussex University, said:

"Whilst the immediate £30bn cash injection into the UK economy in today's Budget as a response to the Covid-19 virus is to be welcomed, there are concerns that this is potentially a blunt instrument which may be too little, too late.

"Undoubtedly the measures to help those individuals with sick pay who may be reluctant to report their illness due to them being self-employed or on zero hours contracts is to be welcomed. Also welcome is the announcement of help for small businesses who will be under considerable short-run financial strain.

"But the reality is that the average value of sick pay in the UK is around £95 a week. This is around a third of the equivalent sum in Ireland, France and Germany. Arguably the measures put in place by today's Budget are too little and possibly not enough to avoid the problem of infected people turning up sick at work and unwittingly spreading the epidemic much more widely. But there is an even more pressing problem of why they may still turn up at work – namely that they have not been tested. Currently the NHS is inundated with requests for tests for Covid–19 and it cannot cope with the demand.

"We know that the brunt of the fatalities that will happen in the UK in the next month will be amongst the elderly with pre-existing conditions. This is precisely where the present social care services are most stretched. Currently there are over 100,000 unfilled job vacancies in social care. As reported in a recent NIESR report, this problem will only get worse after the UK has fully engaged with Brexit.

"Yesterday, Health Secretary Matt Hancock announced in parliament that all the necessary resources would be given to the NHS – but then added that all GPs would be receiving a parcel of face masks and thermometers and basic equipment next week. The most effective way of tackling this epidemic is a radical programme of testing, isolation, tracing and treatment. However, there is no doubt that we are far too late in getting this off the ground.

"Whilst it is clear that the present government does not want to spread alarm or breach civil liberties, it is abundantly clear from the international data we already know that the best way to bring the epidemic under control is to be very proactive – as we have seen from the evidence from China and South Korea. A targeted programme of taking body temperature at all public events and getting onto public transport would hardly be an infringement of personal freedom – but would stop this virus in its tracks."

## Conclusion

The health crisis has triggered a co-ordinated response by monetary, financial and fiscal policies: a 50bp emergency cut in Bank Rate, a new SME term funding scheme and a relaxation of the counter-cyclical buffer. In the Autumn, the Chancellor seems likely to move decisively moved away from arbitrary fiscal rules in an attempt build up public investment. Ensuring that there is a sustained increase in public investment to the regions will not be a simple matter, but we welcome this as a first step. We will need careful selection of projects that will generate prosperity and a sustained level of public investment over a number of years and the common recognition that the responses in economic capacity will take more than a decade to be delivered.

We have suffered from the wrong mix on monetary and fiscal policy for some years and it is with some irony that a threat to our national health has forced us to consider more joined up thinking with more active fiscal policy finally coming to the fore.