The Pending Review: Fiscal Policy and Covid-19

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Abstract

The Chancellor's One Year Spending Review provides welcome and much-needed support for many sectors of the economy suffering their largest contraction in modern times. The furlough and business bounce back loan schemes are good examples of how support has been provided but on a time-limited basis. Unfortunately, the temporary nature of many of the plans announced seem unlikely to be able to address long-standing deficiencies in the economic performance of the UK, which have so sadly been exposed by the Covid crisis. In this note we outline the magnitude of the economic shock, its implications for public debt and the strategy for its consolidation, the conundrum over public and private wages at a time of rising unemployment and the need for a new fiscal framework.

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Summary

- The Office for Budget Responsibility is forecasting an extraordinary 11.3 per cent fall in economic activity in 2020, close to the 11.5-12 per cent we estimated earlier this month. Much of this reduction was the instrument of economic policy to stem the spread of the virus, and **without the significant economic fiscal interventions deployed, the economic damage could have been even worse**. The furlough scheme, in particular, has been extremely successful in limiting the increase in unemployment and the scale of economic scarring. However, the effectiveness of these interventions would have been greater had they been clearer and subject to less uncertainty about their withdrawal.
- **The public sector continues to act as a necessary shock absorber**, including providing significant protection to households and businesses from the effects of Covid-19, keeping unemployment down and providing health, social care and education. It is essential that the lessons of the summer are learned and that public spending continues both to protect incomes and to lead the fight against the virus, the defeat of which is crucial to a sustainable recovery. There is **no immediate reason for concern about elevated public debt** resulting from the Government's policy interventions. Interest rates are far lower than at the time of the Global Financial Crisis and are likely to remain low for some time. The maturity of public debt is long, low borrowing costs can and should be 'locked in', and – while borrowing this year has principally been domestic – foreign demand for UK government debt remains robust.
- The principal **exception to the Government's plans to continue fiscal support is the freeze on non-NHS public sector pay, which could save up to £4bn**. With pay accounting for nearly a quarter of public spending, this constitutes a negative shock to government consumption and is scheduled to take place next calendar year and earlier than likely tax increases. It departs from common practice in which public wages act as a stabiliser, catching up on the gains made by the private sector during expansions: accordingly the public sector wage premium has largely been eroded over the past decade.
- The UK remains **in urgent need of a better fiscal framework**: one more focused on long-term decision-making and less *ad hoc* with the objective of headline-grabbing. Decisions made and announced in a hurry, then often reversed or off-set at a later date may not help decision-makers in the rest of the economy. Debates about public sector wage restraint should take into account, for example, the extent to which many parts of it have been relied upon to deal with Covid-19 and the need to attract and retain public sector staff. Long-term concerns about the British economy remain, principally those connected with the low levels of labour productivity and the risks of a No Deal Brexit.

The economic downturn

- The fall in GDP this year is in line with recent NIESR forecasts. However, much of this related to the voluntary closures which were seen during the first lockdown, and which were deemed necessary to halt the progress of the virus. The permanent impact of the virus is likely to be around 3 per cent of GDP, which will have fiscal consequences.
- A considerable part of the increase in borrowing has been to fund increased health spending to fight the infection and to fund furlough payments in order to maintain the attachment of employees to companies, preventing an even sharper increase in redundancies and unemployment. At the same time, loans and guarantees have been made available to companies, mortgage payment breaks arranged for individuals facing potential financial difficulties because of the pandemic and a Stamp Duty 'holiday' announced until the end of March 2021. A further part of the increase in borrowing has resulted from the drop in tax revenues due to reduced economic activity.
- We have long argued that fiscal support should continue until the recovery is on a more secure footing to prevent what is primarily a short-term health crisis from having long-term economic costs. In the lack of sufficient support, lower incomes and business cash flows due to continued lockdowns and weak economic activity could lead to insolvencies and unemployment that may damage the long-term potential of the economy. A sustainable recovery is dependent on dealing with the virus, which requires continued effective public spending on health.
- Without the fiscal response, equivalent this year to around 16 per cent of GDP, the economic and health impacts would have been far bigger and far worse. The public sector has not just led the response to the pandemic, it has acted as a shock absorber for the private sector. However, the impact of policy would have been greater if there had been less uncertainty: most obviously in the repeated changes to furlough. The number of redundancies which will have taken place over the summer would have been lower if it had been announced from the start that the Coronavirus Job Retention Scheme would last for the best part of a year.

NIESR Deputy Director Hande Küçük said:

"The fiscal policy response laid out in the Spending Review today should be put in the context of the economic shock that we face. The Office for Budget Responsibility forecasts are basically in line with NIESR's assessment earlier this month on the size and the duration of the shock, with economic activity expected to contract by more than 11 percent in 2020, not recovering until 2023, and with significant long-term scarring. This outlook justifies continued fiscal support in the coming years especially in the form of public investment to level up the economy and to limit the long-term damage."

Fiscal support

- Elevated public debt levels are not an immediate cause for concern as low interest rates and the Bank of England's quantitative easing programme are likely to keep interest payments affordable for the foreseeable future. The yield on 10-year UK government gilts is currently at historically low levels, hovering around 0.30 per cent, remarkably low compared to the onset of the GFC where it stood around 4 to 5 per cent.
- The Bank of England has increased the size of its quantitative easing programme by £450 billion, almost doubling the size of its balance sheet (Bank of England, 2020) and contributing to lowering the Government's borrowing costs. Moreover, the sharp increase in domestic saving is counterpart to public sector's expanded borrowing, with little additional borrowing from abroad implied. Even if domestic savings fall, stable global demand for UK government gilts is likely to remain, and once the economy is on a sustainable recovery path, debt levels will gradually come down.

Figure 1: UK government debt interest

- The OBR has provided an estimated path for the economic recovery, returning to its pre-pandemic peak at the end of 2022. This provides us with a timeframe for conducting the Comprehensive Tax Review which NIESR has repeatedly called for. This should address the question of how tax policy can contribute to the expected lasting impact of the virus on the deficit.
- Beyond the direct effect of the pandemic, the UK economy is undergoing structural changes that need to be supported by investments in targeted areas. The emergence of a New Digital Economy is likely to boost productivity, but only if it

is accompanied by simultaneous public investments in telecommunications equipment like the 5G network to make sure that every part of the country has access to the appropriate infrastructure. The transition to a Green Economy will also require continuous investment in renewable and low-carbon technologies supported by public funding. And reducing regional disparities as part of the levelling up agenda will require investment in regions that have not benefited from globalisation. Such reallocation of investment across regions should take into consideration the fact that Brexit is expected to have stronger impact on some regions than others.

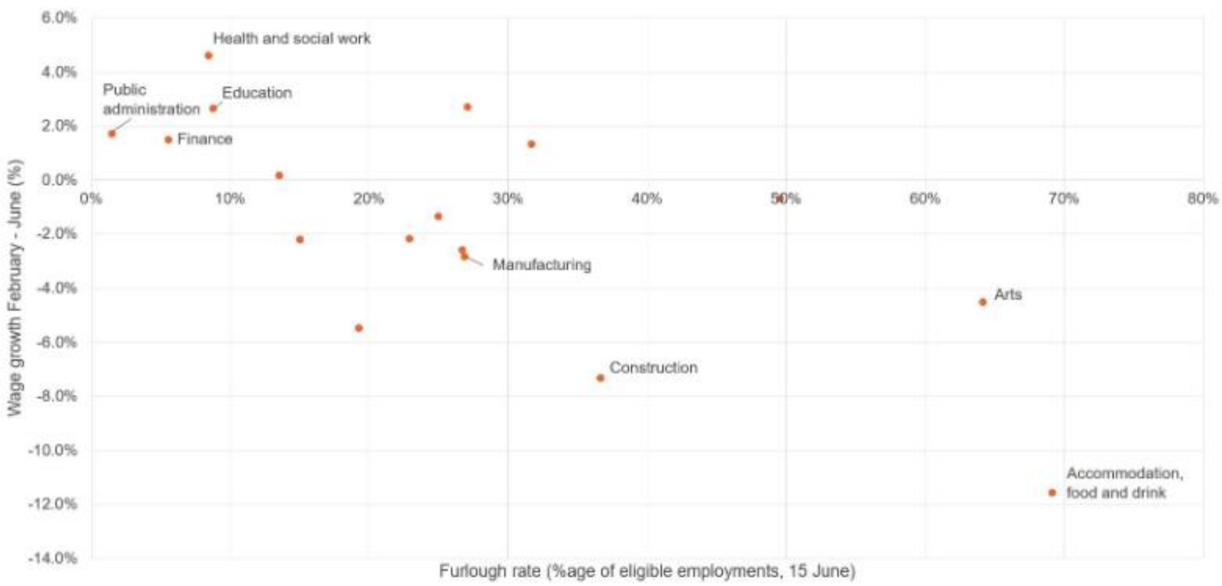
NIESR Senior Economist Cyrille Lenoel said:

“The need for continued monetary and fiscal support until the economy recovers from the pandemic is likely to push up public debt next year and in the following years, as we explained in our November forecast. The OBR today revised up its central estimate of debt-to-GDP from 103.6 per cent to 108 per cent in 2021-22 and now sees it peaking at close to 110 per cent in 23-24. With long-term UK gilt yields at historically low levels, the projected rise in debt should not be a concern for policy makers in the short term. A comprehensive fiscal strategy will have to formulate a credible plan on how to reduce debt-to-GDP towards low and stable levels with some tough decisions on expenditure and/or taxes in the years to come, but actual fiscal consolidation should wait until the recovery is on a more secure footing.”

Employment and wages

- Extension of the furlough scheme until the end of March next year, announced before the Spending Review, will support recovery and limit long-term economic damage due to higher unemployment. NIESR called for the extension of furlough in our August *Review*. As the uncertainty regarding the end-date of the furlough scheme is postponed to next March, businesses are now more likely to retain workers attached to their jobs until Covid-19 uncertainty dissipates with the help of vaccine roll-out. The cost of the scheme will naturally decline as the economy recovers and businesses bring staff back to work.
- We have emphasized before that government policies will be critical in facilitating job creation and the reallocation of labour from contact intensive sectors to sectors such as infrastructure, education, social and health care. The Spending Review includes labour market policies to support this reallocation, with £2.9bn of spending over three years on a 'Restart' programme to help workers find jobs, plus £1.4bn of new funding to increase the capacity of the Jobcentre Plus network to help more people back to work. Our November *Review* examined the potential for active labour market policies.
- The uneven impact of the virus goes some way to accounting for the difference between in public and private sector wage growth. Private sector workers have been much more likely to be furloughed and, with the Government only replacing 80 per cent of furloughed workers' wages, private sector wages have been severely negatively impacted this year as a result.

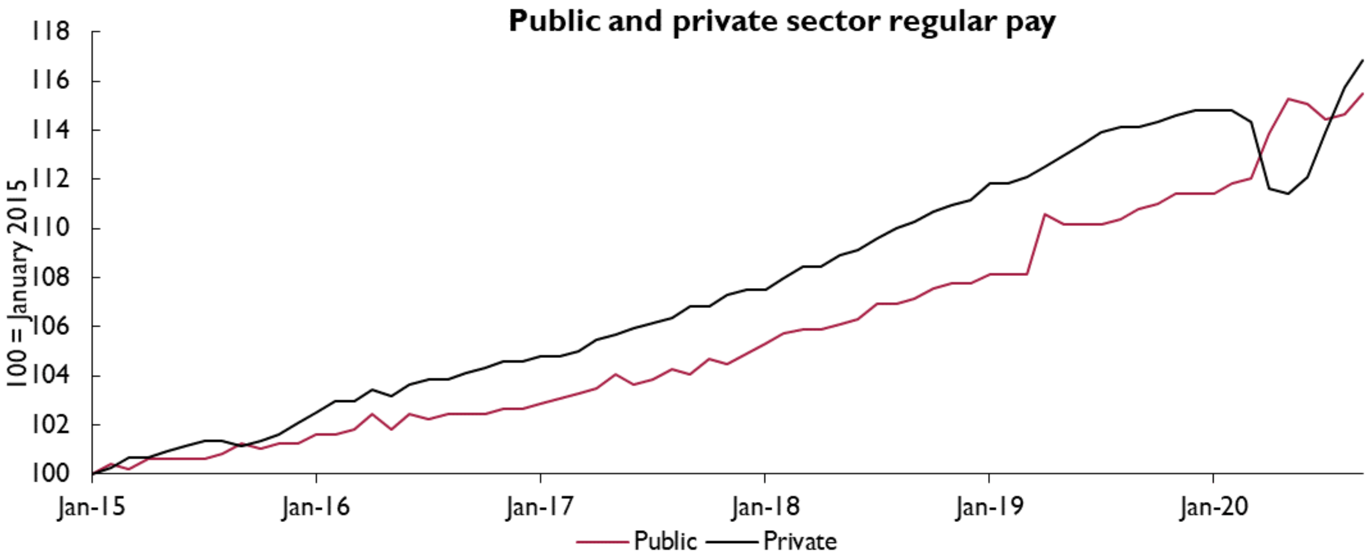
Figure 2: Wage growth and furlough use by sector during the first lockdown period



Source: NIESR

- Holding back public sector pay will close some of the gap between private and public sector pay growth that occurred since the start of the pandemic but its contribution to deficit reduction will be relatively modest and sectoral inequalities due to Covid-19 will remain. It also follows a prolonged period of falls in public sector pay relative to the private sector (see Figure 3).

Figure 3: Public and private pay growth



NIESR Principal Economist Rory Macqueen said:

"Given that the strain of responding to this crisis has fallen, by and large, on the public sector it is surprising that the Government has chosen to front-load this element of fiscal consolidation. This may impact on the resilience of the public sector as it continues to shield us from the effects of this pandemic."

The need for proper fiscal policy

- NIESR has long argued that arbitrary fiscal rules and the current fiscal framework, focusing on deficits over the Parliament, do not match the long run requirements of society. It is very unlikely that the path of fiscal expenditures and revenues will coincide with economic and political cycles. And forcing such a conformity, as is the case with the current generation of fiscal rules, seems likely to be sub-optimal. Confronting risk and uncertainty is actually the objective of fiscal policy but the responses will vary according to the shocks that strike an economy which simply cannot be predicted. And so a framework that allows for fiscal flexibility within the confines of a commitment to target low and stable levels of public debt as a share of income in the medium to long run will make most sense. Such a framework will include a more rigid timetable for fiscal events, fuller explanation of how spending decisions are prioritised and the adoption of statements that encompass multi-year plans, as well as analyse the impacts at the regional and household level.

NIESR Director Jagjit Chadha said:

"We urgently need a fiscal framework that addresses the issue of how to manage an economy in periods of rapid and more normal adjustment to shocks and yet retains strong foundations of sound money. This means a consistent multi-year approach to the capital gap and to addressing regional and household inequalities. Policy by soundbite and leak does not a long-term plan make."

Further Reading

https://www.niesr.ac.uk/publications/fiscal-rules

https://voxeu.org/content/time-uk-s-budgetarians-make-way-some-proper-fiscal-policy