

GOING FOR GROWTH

After the Virus

A plan for restoring growth

**BY THE RT HON SAJID JAVID MP AND
THE CENTRE FOR POLICY STUDIES**





About this report

'After the Virus' was produced by a team of researchers at the Centre for Policy Studies, led by the Rt Hon Sajid Javid MP. The chief researcher on the project was James Heywood, working with Nick King, Tom Clougherty & Robert Colvile.

About the Centre for Policy Studies

The Centre for Policy Studies was recently named by Conservative MPs polled by ComRes as the most influential think tank in Westminster. Its mission is to develop policies that widen enterprise, ownership and opportunity. This paper is the first in a major series, 'Going for Growth', devoted to rebuilding Britain's prosperity in the wake of the coronavirus crisis.

Founded in 1974 by Sir Keith Joseph and Margaret Thatcher, the CPS has a world-class track record in turning ideas into practical policy. As well as developing the bulk of the Thatcher reform agenda, it has been responsible for proposing the raising of the personal allowance, the Enterprise Allowance, the ISA, transferable pensions, synthetic phonics, free ports, and many other successful policy innovations. The recent Conservative manifesto drew heavily on CPS proposals, in particular its flagship policies on tax and housing.



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Introduction

The Rt Hon Sajid Javid MP

Although the Covid-19 pandemic began as a public health emergency, it has swiftly developed into the most extraordinary economic crisis of our time.

The threat posed to people's livelihoods is superseded only by the threat to lives themselves.

Because of its service-based economy, the UK is more exposed than most. The Bank of England has suggested that the decrease in output this year could be as high as 14%, the most severe for three centuries. The fall in GDP during March and April alone has already wiped out 18 years of growth. As a result, 2.5 million people could lose their jobs by late summer.

Given the scale of the challenge, the Treasury's response has been deeply impressive. The Chancellor acted decisively to deploy the most significant fiscal firepower since the Second World War with speed and scale. An elixir of job retention schemes, tax cuts and government-backed loans has saved businesses up and down the country.

However, as effective as they have been, the purpose of the Government's interventions to date has been to contain the damage, not to find a cure. Soon, the focus must shift from safeguarding the economy to rebuilding it.

The only way out of this crisis is growth. And although early hopes for a V-shaped recovery proved optimistic and some

long-term damage to the economy is unavoidable, it is still within the Government's power to determine the speed and scale of recovery.

The purpose of this report is to support the efforts of ministers to instigate the strongest possible recovery. It was written in response to a shortage of off-the-shelf solutions to a challenge quite unlike any other. As the Government puts together a stimulus package, it is essential that no stone is left unturned. Boldness, as well as out-of-the-box thinking, is the order of the day.

In this spirit, this report sets out more than 60 specific recommendations, covering everything from taxation to monetary policy. It draws on six years of personal experience as the Secretary of State for five different Departments, as well as a 19-year career in business and finance. It also benefits from the experience and intellect of a team of researchers at the Centre for Policy Studies.

I have no expectation that these recommendations will be adopted wholesale. Instead, they should be thought of as a series of standalone measures - designed to inspire further thought and enhance an eventual recovery plan. But if you only have time to read one section, I recommend that you make it Chapter 2, 'Principles for Recovery'. Our free-enterprise, free-trade economic model has never looked more open to challenge. A conservative insistence on sound money and low taxes is already coming under immense



pressure. If we want to not just repair the economy but rebuild it on firmer foundations, it is these established principles of wealth creation - as well

as a new commitment to investing in infrastructure and levelling up every region of this country - that must form the cornerstone of our recovery.



Key Recommendations

New fiscal rules to gradually eliminate the current budget deficit after the economy recovers, balancing fiscal responsibility with the need to support recovery.

Bringing forward and enhancing plans for major investment in infrastructure and left-behind regions, both to increase economic activity now and to boost long-term productivity.

A revitalised devolution agenda to level-up the UK, with more City Deals and increasing the powers and capacity of devolved authorities to invest for growth.

A relentless focus on jobs, with significant temporary cuts to employer's National Insurance and VAT.

Getting Britain building with major reforms to planning rules and a new generation of development corporations.

Pro-growth tax reform, shifting the burden of taxation away from income and investment in favour of fairer property taxes and tightening reliefs for high earners.

Signalling Britain is open for business by pushing ahead with free trade agreements and new measures to attract talent and investment from across the globe.

Cementing the focus on growth by considering nominal GDP targeting as part of a new 21st century monetary framework for the independent Bank of England.



Chapter 1: Surveying the Damage

We are in the midst of one of the most extraordinary downturns in history.

The coronavirus is an economic crisis without precedent, which has left governments across the globe with no playbook, and no pre-existing package of measures suited to securing their recovery.

Ministers have acted with imagination and decisiveness in coping with the economic consequences of the crisis - the swift and successful implementation of the Coronavirus Jobs Retention Scheme being a case in point.

But over the next few months, they will be required to demonstrate equal resourcefulness and creativity to find a bespoke package of measures capable of rebuilding our economy - not just to restore growth, but to put it on a firmer footing.

The purpose of this paper is to suggest both broad principles and specific ideas which we believe can drive our long-term recovery. We believe they are in tune with the Government's existing agenda, and will help to drive it forward. We present them not as a comprehensive package of measures, but a series of ideas upon which those in Government can draw.

However, before we come to the suggested treatment, we must start with the diagnosis. And on that front, the picture is grim indeed.

The combination of the public health crisis and the measures introduced to combat it have brought an unprecedented fiscal shock. Never before has a government instituted a deliberate shutdown of huge swathes of the economy, with significant restrictions on movement and activity putting a temporary halt to many of our freedoms. Lives have been put on hold and loved ones have been lost.

Initially, many were hoping (based partly on the evidence of previous pandemics) for a 'V-shaped' recovery, with the Government's interventions acting as a bridge across the economic crevice of the second quarter. Once the pandemic was dealt with, the economic activities we had to drop on the floor in March could simply be picked up and dusted off later in the year. Indeed, the 'reference scenario' produced by the Office for Budget Responsibility (OBR) to illustrate the economic and fiscal impact of the crisis, published on April 14, showed a rubber-band rebound in which we experienced no permanent loss of GDP and no increase in structural public borrowing.¹

Even at the time, those assumptions looked questionable - hence the OBR's insistence on referring to this work as a 'scenario' rather than a 'forecast'. Today, the outlook is far bleaker. In this section, we will explore some of the big challenges which will mean lingering damage to our economy and public finances - and which any plan for recovery will need to address.

¹ OBR, 'Coronavirus analysis', [link](#)



GDP

There is no doubt that there will be a significant GDP contraction this year due to the pandemic. The longer the country remains under lockdown measures - and the longer people choose to limit their activities, even after official restrictions are relaxed - the deeper the recession will be.

Estimates by the OECD suggest the initial impact on the UK economy could amount to a 26 per cent fall in GDP for the period of lockdown measures, and a drop in private consumption of as much as 37 per cent. For 2020 as a whole, the OBR model shows a 13 per cent contraction in GDP, instead of the modest growth of 1.1 per cent forecast at the March Budget. The Bank of England modelling illustrates a similar contraction of 14 per cent. This would be the largest annual fall in output on record, exceeding both World Wars. Initial outturn data seems to be bearing out these predictions - the Office for National Statistics (ONS) April GDP update showed GDP in April down by 25 per cent compared to February (the last 'normal' month).

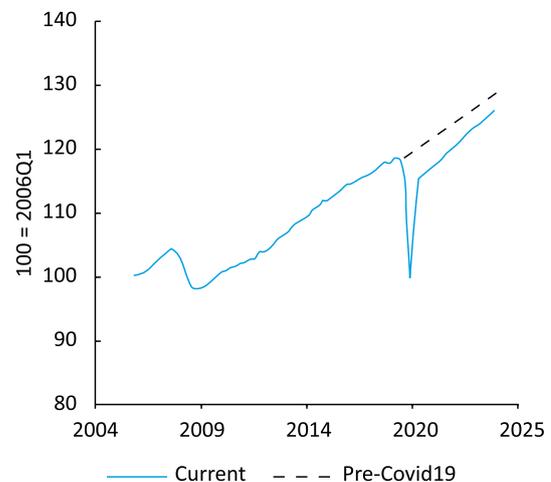
These are not just numbers on a spreadsheet. We are talking about people's livelihoods. Every job lost and every business closed means setbacks, lost dreams, financial worries and hardship.

As will be set out below, it would be complacent and naïve to assume that there will be a rapid and complete economic bounce-back - certainly one significant enough to make up for the growth we have lost. The reality is that bruised investor and consumer confidence as well as scarring effects from the deep recession will almost certainly cause stubborn and long-lasting

damage to the economy. Social distancing is also likely to remain in place for a sustained period in some form, and that will have an impact not just on confidence but on productivity and efficiency – at a very basic level, we just won't be able to use space in shops, offices and factories in an economically optimal way.

The National Institute of Economic and Social Research (NIESR) has put together a main-case scenario which factors in the lingering effects of the pandemic. While the GDP trajectory shown in the graph below suggests a slightly higher growth rate for the next few years after the initial hit from the virus (as the gradual 'return to normal' boosts activity), this is far from sufficient to make up for how far off course the economy will have been blown.

Figure 9. GDP forecast compared to pre-Covid 19 forecast



Source: NIESR.

2 OECD, 'Evaluation the initial impact of COVID-19 containment measures on economic activity', [link](#)

3 Bank of England, 'Monetary Policy Report: May 2020', [link](#)

4 OBR, 'Coronavirus analysis', p8, [link](#)

5 ONS, 'GDP Monthly Estimate: April 2020', [link](#)



Even this scenario, says NIESR, is based on 'optimistic conditioning assumptions' - it is entirely possible, they say, that the road out of lockdown is even rockier. But even under this scenario, they expect permanent scarring. Their conclusion is that: *'Over the next 10 years, this loss of output cumulates to around £800 billion, or £11,000 per head. This is equivalent to a loss of GDP of around 3½ per cent each year over the next 10 years, though the economic cost is front-loaded'*.⁶

Unemployment

One of the Conservatives' proudest achievements since 2010 is to have achieved record high employment rates and helped millions more people into work. At one stage, as we emerged from the financial crisis, Britain was creating more jobs than the rest of the European Union put together - and this incredible performance has continued under a succession of Prime Ministers, even as the Government has significantly raised minimum wages.⁷

Sadly, this proud record is now in jeopardy. Indeed, it is the impact of the coronavirus crisis on jobs and employment that could be its most pernicious consequence.

So far, the Government's Job Retention Scheme has performed a vital role in maintaining employment levels while the country is in lockdown. By June 14, according to HMRC, 9.1 million workers

had been supported through the scheme, helping 1.1 million employers cope with their wage bills and keep people on the payroll.⁸ The Business Impact of COVID-19 Survey, produced by the Office for National Statistics (ONS), suggests that the furlough scheme has been extremely successful, with less than 1 per cent of employees being made redundant across firms.⁹

However, it is important to note that these figures relate only to businesses which still exist. Those who have lost their jobs due to their companies folding are not captured in these figures - nor are those who may operate as contractors or are classed as self-employed workers, who may have been let go without it formally being classed as redundancy. There may also be large numbers of sole traders who, despite the support for the self-employed available, have either slipped through the cracks or will find it hard to maintain their livelihoods once support is withdrawn.

Real time PAYE data from HMRC suggests the number of employees on payroll fell by more than 600,000 between March and May,¹⁰ and figures from the Labour Force Survey suggest a fall in the number of self-employed people of 300,000 by April.¹¹

Claims for Universal Credit and Jobseeker's Allowance certainly suggest that there has been a spike in unemployment - while also showing the impact of the furlough scheme, announced on March 23, in forestalling it.

6 Cyrille Lenoël and Garry Young, 'Prospects for the UK economy', [link](#)

7 Full Fact, 'Has the UK created more jobs than the rest of the EU combined?', [link](#)

8 HMRC, 'Coronavirus statistics: Job Retention Scheme management information', [link](#)

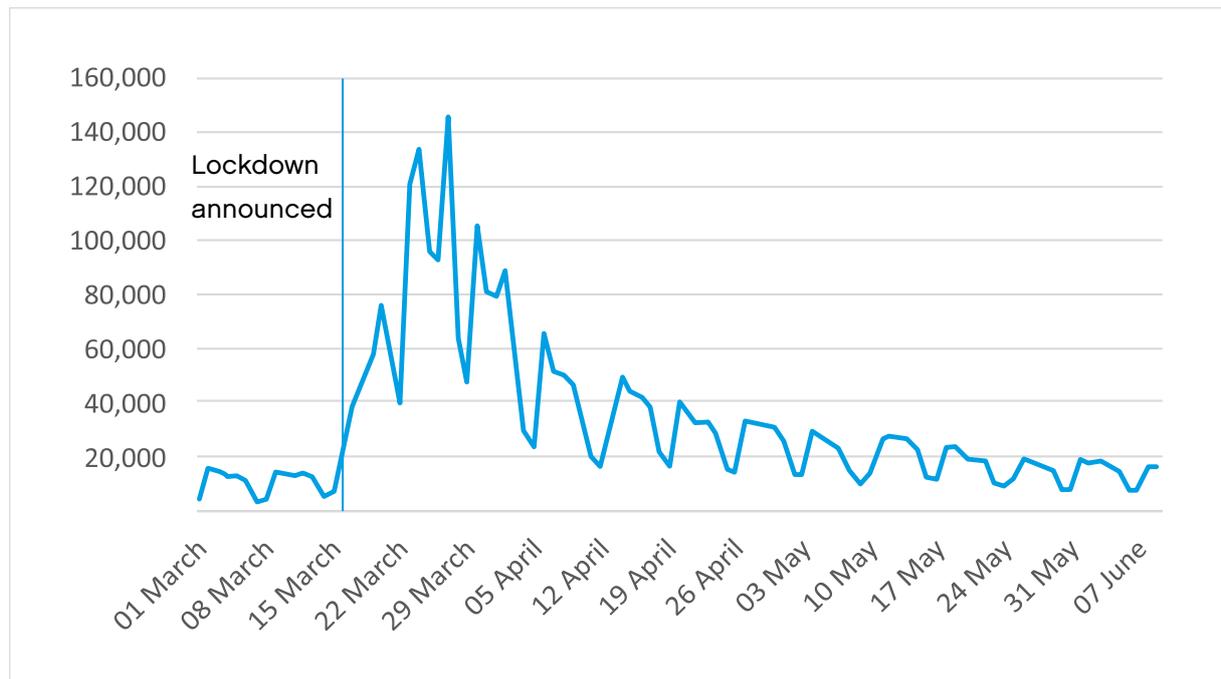
9 ONS, 'Business Impact of Covid-19 Survey results', [link](#)

10 ONS, 'Labour Market Overview: 16 June 2020', [link](#)

11 Tony Wilson, 'Labour Market Statistics, June 2020: IES analysis', [link](#)



New individual claims for Universal Credit each day, March 1 - June 9 2020



Source: DWP management information, UC declarations and advances, June 16 2020, [link](#)

In addition to the 2.3 million individual claims for UC between the lockdown measures being announced on March 16 and early May, there were 250,000 claims for Jobseeker's Allowance and 20,000 for Employment and Support Allowance.¹²

It is important to remember that not all claims for Universal Credit will be for out of work benefits, as it is also available to workers on a low income. However, since the claims rate is vastly higher than usual and is correlated strongly with the lockdown, it is safe to assume most of those claiming have either lost their jobs or had their hours reduced, meaning they have avoided unemployment but are now underemployed.

It is also unlikely that we have seen the last of this trend. While claims numbers

calmed down once the furlough scheme was announced, the baseline for claims was still much higher. It is also highly likely, given depressed demand and the restrictions imposed by social distancing, that many of those currently furloughed will not have jobs or potentially even companies to return to when support is finally withdrawn - however smoothly the transition out of lockdown is managed. The OBR, for example, expects employment to bounce back much slower than output.

This is why, as we outline later, the Government needs to make jobs its core focus - not just to protect as many as possible, but to make it as easy as possible for them to be created and for people to move into them. There is a great deal of economic literature

¹² Thérèse Coffey, 'DWP's response to coronavirus (COVID-19)', [link](#)



on the economic scarring caused by unemployment. Work by the Resolution Foundation, for example has shown that those who left education during the last recession have a lower rate of employment than the year groups above and below even today.¹³

Gaps in employment history, detachment from the labour market, the opportunity cost of years which could be spent in a trade – any period of unemployment has lasting damage for each individual and the wider labour market.

Those leaving education are particularly vulnerable, and may struggle to move into work in the first place. Indeed, we must remember that the rise in unemployment will not only be from people losing their jobs but from fewer new jobs being created. By early May vacancies were down 60 per cent compared to before the crisis.¹⁴

Regional Impact

One of the driving forces behind the current Government's agenda is the need to spread wealth and opportunity more fairly. 'Levelling up' is not just a slogan, but a mission.

Yet it is already clear that this crisis, like so many before it, will exacerbate this

country's already substantial regional inequalities.

As the Bank of England have pointed out, the more labour-intensive an industry is, the harder it has been hit by the lockdown.¹⁵ This inevitably has a geographical dimension. Those sectors which are more capital- or knowledge-intensive have been more cushioned from the crisis, not least because they are more suitable for home working. They are also disproportionately concentrated in London and the South East.

It is, therefore, the regions which were already suffering from low productivity, low levels of capital intensification and lack of investment which have been most affected by the crisis.

ONS survey data shows that, as we might expect, the sectors most able to work from home are Information and Communication (86.6 per cent working remotely) and Professional, Scientific and Technical Activities (77.6 per cent). Those least able are, inevitably, in Hospitality (14.4 per cent) - but areas such as Construction (34.6 per cent), Wholesale and Retail (35.7 per cent) and Manufacturing (26.5 per cent) are also substantially more affected by the shutdown.¹⁶

13 Kathleen Henehan, 'Class of 2020: Education leavers in the current crisis', [link](#)

14 IES, 'Weekly vacancy analysis: Vacancy trends in week-ending 3 May 2020', [link](#)

15 Bank of England, 'Monetary Policy Report: May 2020', p5, [link](#)

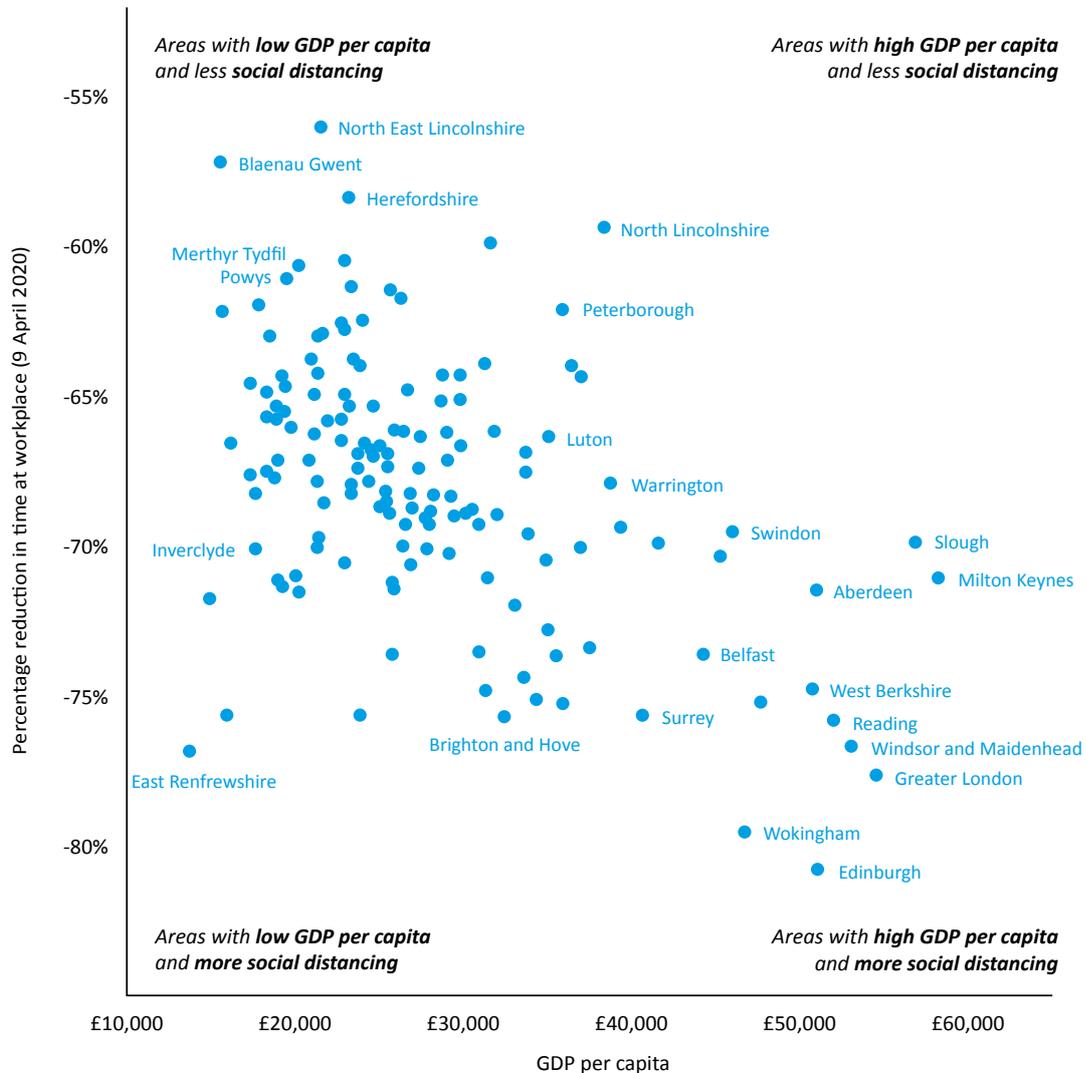
16 ONS, 'BICS Survey dataset, 7 May 2020', Sheet 20: Proportion Working Arrangements, [link](#)



The chart below from Professor Ben Ansell of Oxford University shows the correlation

between GDP per capita and numbers of people still going to work.¹⁷

Reduction in workplace activity vs. GDP per capita, by local authority or country.



Source: Google Community Mobility Reports and ONS. Analysis by Ben Ansell for UK in a Changing Europe.

17 Ben Ansell, 'What explains differences in social distancing in the UK?', [link](#)



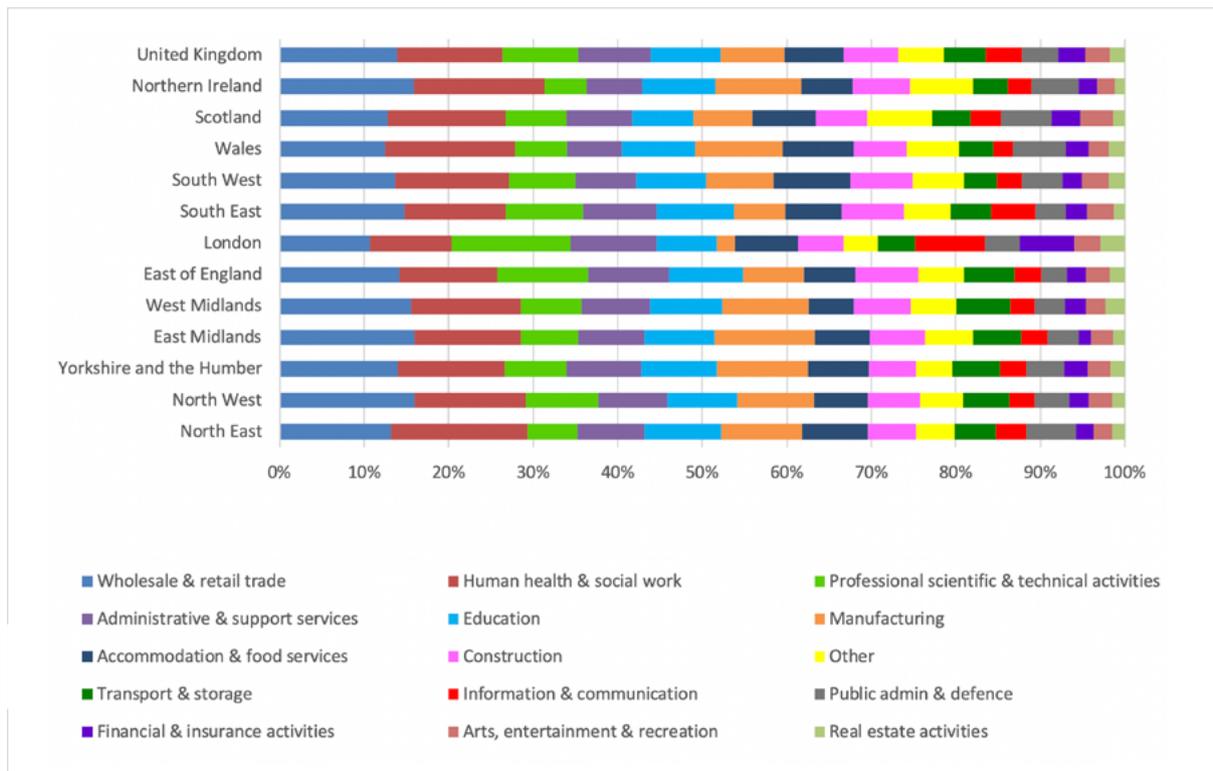
This illustrates not that the areas in the top-left are less affected by the pandemic, but that these are the areas where a higher proportion of people are simply unable to undertake their work from home. This is backed up by recent analysis from the RSA, which found a strong correlation between earnings and ability to continue working from home.¹⁸

While much of this impact will be temporary, it seems likely that for a period of time working from home will become much more prevalent and that some of this will be a permanent shift. Many workplaces may be affected by social distancing for a while to come, and those less able to deal with this by working remotely will be more likely to face higher costs and need to shed staff.

As a result, those regions with disproportionately high numbers of people in higher-end, knowledge-intensive jobs are in the best place to weather the storm. Another piece of research by the RSA concluded that *'most of the less vulnerable areas can be found either in London itself or in the city's surrounding commuter belt'*.¹⁹

We can see from the ONS data that London and the South East have the highest proportion of people working in the two knowledge-intensive, high-value added sectors (Professional Scientific & Technical and Information & Communication). These two sectors combined make up 22.4 per cent of all jobs in London compared to just 8.5 per cent in Wales and 9.5 per cent in the North East.

Proportion of the workforce in each industry sector, by UK region



Source: CPS Calculations based on ONS, Workforce jobs by region and industry, March 2020, [link](#), calculated as a percentage of total jobs (smaller industry sectors such as Mining & Quarrying, Water & Sewerage and Electricity & Gas Supply have been aggregated under 'Other' for simplicity)

18 Fabian Wallace-Stephens and Will Grimond, 'Low pay, lack of homeworking: why workers are suffering during lockdown', [link](#)

19 Alan Lockey and Fabian Wallace-Stephens, 'Which local areas are most at risk of impacts of coronavirus on employment?', [link](#)



Just 2.1 per cent of jobs in London are in manufacturing and 6 per cent in the South East, compared to 11.9 per cent in the East Midlands and 10.8 per cent in Yorkshire and the Humber. The South West has the highest proportion of people in accommodation and food services; the North West has the highest proportion of people in wholesale and retail.

Analysis by KPMG of regional Gross Value Added statistics backs up these conclusions. They find that London's service-heavy economy will be the least affected, while the West Midlands is likely to be one of the hardest hit due to the preponderance of industries such as car manufacturing. They predict that as a result *'the gap between performance in London and the rest of the UK will widen this year'*.²⁰

Within regions, analysis of bank account data by Chris Cook et al. for Tortoise Media suggests those smaller towns which were already suffering from low productivity and low investment are likely to be hit hard. Council wards where sales are down the least seem to be those where the majority of sales are to people who live within a radius of a mile or so, and these areas are disproportionately in city centres.²¹

Businesses

While most of the disruption to economic activity should be temporary, one of the most damaging long-term impacts could be the loss of firms that have been forced to fold.

This is not a conventional recession, where we might expect some 'creative destruction' from inefficient firms leaving the market and allowing a more optimal allocation of resources. Many of the firms

lost to the crisis may be perfectly viable companies without the temporary impact of the shutdown. In the hospitality sector, for example, the only mistake many managers have made is to choose to work in an industry that simply cannot operate with all those involved standing two metres apart.

Analysis by the Enterprise Research Centre in April found that more than 61,000 businesses folded between the start of March and mid-April, and that for March alone there was a 70 per cent rise in businesses folding compared to the same month last year and a fall in new start-ups of almost a quarter.²²

In the ONS Business Impact Survey, around half of respondents said turnover was down over the previous two weeks and almost a quarter said their turnover had been less than half the normal level. More than two thirds of exporting businesses say that their ability to export has been damaged by the pandemic.²³

This loss of firms is not easily reversed once the economy begins to recover. Firms benefit from institutional knowledge, and it can take years to grow from start-up to established firm. Connections between employers and employees, buyers and sellers, and the complex networks involved in modern supply chains can take years to develop.

In other words, the best way to ensure that we have a thriving business population after the crisis is to protect those businesses we have today. The longer the shutdown and reduction in activity continues, the more firms we will lose and the greater the lasting damage will be to the economy - and to the lives and livelihoods of those involved.

20 Yael Selfin, 'Chief Economist's note: Levelling-up and COVID-19' [link](#)

21 Chris Cook, Ella Hollowood and Chris Newell, 'Corona shock', [link](#)

22 ERC, 'UK companies facing COVID-19 pincer movement, data shows', [link](#)

23 ONS, 'BICS Survey dataset, 7 May 2020', [link](#)



The British Chambers of Commerce Coronavirus Business Impacts Tracker has found that more than half of businesses have less than three months of cashflow in reserve.²⁴ Small and family businesses in particular will struggle if starved of cash for too long, not having the reserves which many larger firms have to fall back on.

We must also remember that we live in a highly integrated market economy where businesses, workers and consumers are interdependent across sectors. A recent paper for the National Bureau of Economic Research suggested there may be a 'business exit multiplier' effect, as businesses closing stop buying from their suppliers and paying their workers, and that mechanisms such as this can mean a major supply shock like the one we are currently experiencing can actually lead to an even bigger demand shock.²⁵

Confidence

One of the most important but least certain factors in all of this will be the extent to which the confidence of businesses, investors and consumers will remain low following the pandemic. Confidence - the willingness of consumers to spend and firms to invest - is the fuel on which the economy runs. The longer it remains depressed, the worse the recession will be.

On this score, the early signs are not encouraging. The UK Manufacturing Purchasing Managers Index (PMI) fell to a record low in April of 32.6. The UK Services PMI Business Activity Index fell to a depressing 12.3 in the same month.²⁶

Due to the completely unprecedented nature of this crisis, there is a huge amount of uncertainty about how long

and how deep the recession will be and what lasting impact the pandemic could have on behaviour and policy. That means that businesses are likely to be far more hesitant to invest. This comes on top of years in which some investment may already have been put off due to the uncertainty surrounding Brexit - cruel timing given the widespread expectations of a 'Brexit bounce' following the Conservatives' convincing election victory.

As the OBR notes, one of the key ways in which the crisis could cause permanent scarring even if demand quickly recovers is from the temporary period of lower investment causing a permanent loss to the capital stock and productivity.²⁷

There is also consumer behaviour to consider. In recent years economic growth has exceeded the gloomy forecasts made immediately after the 2016 Brexit vote in large part because consumers have continued spending and have reduced saving. If people are worried about their incomes, they will be unwilling to spend, particularly on large purchases such as cars and white goods - and of course lockdown has made it impossible for them to spend even if they wanted to, with the ONS estimating that 22 per cent of normal household spending has been impossible during lockdown.²⁸

Some may also be looking to replenish their savings after having depleted them during the height of the crisis. Nearly a quarter of those reporting that their finances have been affected by coronavirus say they are having to use their savings to cover living costs, and nearly a third say they have not been able to save as much as they are used to, according to the Resolution Foundation.²⁹

24 BCC, 'Coronavirus Business Impact Tracker', [link](#)

25 Veronica Guerrieri, Guido Lorenzoni, Ludwig Straub and Iván Werning, 'Macroeconomic implications of COVID-19: Can negative supply shocks cause demand shortages?', [link](#)

26 IHS Markit, 'Record declines in UK manufacturing and service sector output as public health crisis continues', [link](#)

27 OBR, 'Coronavirus analysis', paragraph 1.23, [link](#)

28 ONS, 'More than one-fifth of usual household spending has been largely prevented during lockdown', [link](#)

29 Jack Leslie and Charlie McCurdy, 'The economic effects of coronavirus in the UK: Utilising timely economic indicators', [link](#)



It is therefore highly likely that consumers will respond to the uncertainty and lack of opportunities to spend by saving. NIESR suggest that the household savings ratio will shoot up from 6 per cent in 2019 to 17 per cent in 2020.³⁰

Consumer confidence, and behaviour more generally, is something the Government cannot control simply by ending the lockdown. Even after official restrictions have been lifted, a significant minority of the population may still voluntarily choose to reduce their activity and spending, sometimes subconsciously. This is a natural human reaction – people are understandably very concerned and scared for the safety of themselves and those around them.

For both businesses and consumers, the uncertainty will not be helped by the potential for a second wave of the virus casting a shadow over the recovery. In addition, people will now be acutely aware of the risks of similar outbreaks. Just as people underestimate the possibility of 'black swan' events such as the COVID-19 pandemic, for a period of time afterwards they tend to overestimate the likelihood of them happening again. The Bank of England's Chief Economist, Andy Haldane, has pointed out that behavioural psychology would suggest there may be a lingering 'dread risk' as demand remains depressed due to wariness by consumers.³¹

Public spending and debt

Thanks to the tough decisions made by the Conservatives over the last decade, and the hard work of the British people, we went into this crisis with a balanced current budget and a falling debt-to-GDP ratio. This put us in a far better position to tackle the consequences of the coronavirus

pandemic - but that pandemic also risks undoing much of that hard and painful work.

The Government has rightly responded to the crisis with an unprecedented package of measures to mitigate the impact and support businesses and incomes. Policies such as the Job Retention Scheme and the Self-Employment Income Support Scheme are among the most generous of any country.

The result will be that public spending soars this year. The Centre for Policy Studies has estimated that the measures already announced, coupled with the impact of the recession on tax revenues and welfare spending, will see borrowing surpassing £300 billion in 2020-21.³² The OBR estimates that the furlough scheme alone could cost £54 billion this financial year, more than the annual defence budget.³³

To give a sense of the scale of the burden being shouldered by the state, the collapse in economic activity and the decision by government to step in mean that the OBR expects total managed expenditure to account for more than half (51.7 percent) of GDP in 2020-21. For example, with nine million workers on furlough, more than a quarter of the labour force are currently having their wages paid by the Exchequer.

This huge increase in borrowing will add substantially to public sector debt. The OBR numbers show debt rising to 95 per cent of GDP this year, 17 percentage points higher than predicted at the Budget. A quirk of the way the ONS calculate debt-to-GDP ratios means this year's downturn will actually make the official debt level for last year (2019-20) higher (by 13.3 per cent of GDP, on OBR estimates). If the ratio was

30 Cyrille Lenoël and Garry Young, 'Prospects for the UK economy', [link](#)

31 Tim Wallace, "Dread risk" of another virus outbreak could force UK into longer recession', [link](#)

32 Caroline Elsom, 'The Costs of Coronavirus', [link](#)

33 OBR, Coronavirus Policy Monitoring Database: Live Tables, [link](#)



calculated based on financial year GDP, according to the OBR's numbers the debt level for 2020-21 could be an eye-watering 112 per cent of GDP.³⁴

While the OBR reference scenario shows borrowing returning quickly to where it was expected to be before and debt stabilising, in reality the Chancellor will face a number of difficulties in restoring the public finances to health.

Firstly, as set out above, a full recovery is likely to take much longer than the OBR's model assumes, meaning lower tax receipts and higher welfare spending.

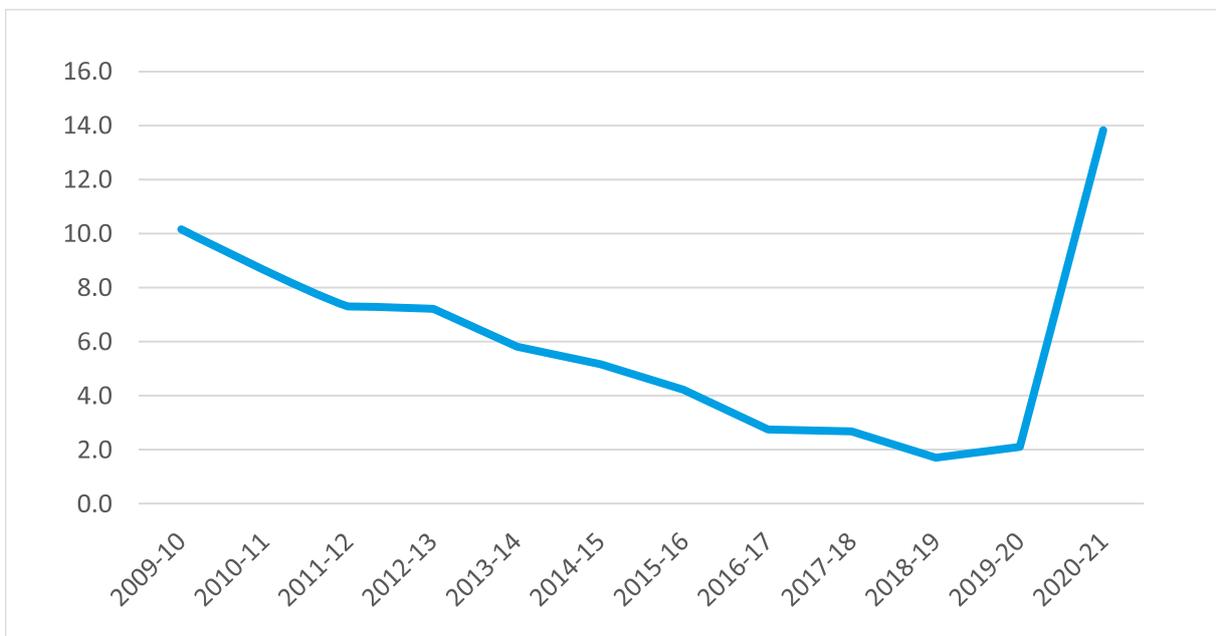
Secondly, the OBR cannot account for the political reality the Government will face when it comes to unwinding the measures it has announced. Some of the increases in spending are likely to be permanent, or at least extremely difficult politically to unwind – for example, nearly a billion pounds of additional spending on housing benefit.

Other measures are in theory temporary but in reality will be very difficult to reverse. It is a lot easier for governments to give than it is to take away again. It would be very difficult, for example, for the Government to cut Universal Credit allowances by £1,000 a year after having raised them at the start of the crisis. It will also be difficult to ask businesses to go back to paying their usual business rates after many have been exempted for a year, especially when some will also have tax bills which have been deferred rather than written off and will come due in 2021.

There has also been a large increase in NHS funding on top of that already promised in the Conservative manifesto, to help it cope with the pandemic, and it seems likely that there will be calls for higher spending still, alongside more funding for social care.

All of this means that we will face a ballooning debt pile.

Public sector net borrowing, % of GDP



Source: CPS adjustment of OBR Public Finances Databank ([link](#)) to reflect OBR Coronavirus Reference Scenario, April 2020, [link](#)

34 OBR, 'Coronavirus analysis', Table 1.10, [link](#)



As the above graph shows, borrowing has been brought down steadily since 2010, only to now shoot up again as a result of the - entirely necessary - response to the virus. When things have returned to some form of normality, fiscal conservatives may have to win the argument all over again.

Sterling depreciation and inflation

In its quarterly report in May, the Bank of England noted that sterling exchange rates have been volatile since the crisis began. In March the trade-weighted sterling exchange rate index was down 9 percent compared to its value in the Bank's January report, with a 12 percent fall against the dollar, though it has recovered somewhat since then.³⁵

A drop in the value of sterling will increase the price of imports and raise costs for UK supply chains. Sterling has already been running at relative lows for a number of years, but its weakness against the dollar is now being exacerbated by the flight to the dollar as a reserve currency during the economic storm caused by the pandemic.

There is debate among economists about what will happen to inflation, but it is likely that price fluctuations will be highly sector-specific (we have already seen evidence of big price rises for some medicines). The Institute for Fiscal Studies has noted that the pandemic poses huge difficulties for official statisticians trying to estimate changes in the actual cost of living, whose indices are vital for calculating things like pensions, pay negotiations and benefits.³⁶

It may be that different pandemic-related forces will put both upward and downward pressure on prices, and roughly cancel each other out. Certainly most forecasters

are not predicting a significant change in inflation in the short term. However, the fact is we simply do not know what an economic shock of the scale and nature we are facing could do to prices. The Bank of England has also cut the bank rate and undertaken substantial open market operations, which we would expect to have some impact over the course of the coming months and years. The Bank will need to be vigilant and the Government will need to let them do their job. Seemingly small fluctuations in consumer prices could have major repercussions, especially if, for example, there is a period of deflation.

Existing problems

The coronavirus crisis did not come out of a clear blue sky. The truth is that even before the virus hit, there were pressing economic challenges which the Government was determined to address - many of which have, as is always the way of these things, been exacerbated by the impact of the pandemic.

There are also areas which formed an important part of the Government's policy agenda beforehand, and will need to be given due weight when developing a renewed agenda for the post-COVID future. These include the Government's commitment to achieving net-zero greenhouse gas emissions by 2050, which will require substantial investment on research, infrastructure and incentive schemes.

There is not space here to carry out a full analysis of these issues. But it is worth noting a few of the most pressing, which cannot be ignored when thinking about our path to recovery and growth.

³⁵ Bank of England, 'Monetary Policy Report: May 2020', [link](#)

³⁶ Richard Blundell, Rachel Griffith, Peter Levell and Martin O'Connell, 'Could coronavirus infect the Consumer Price Index?', [link](#)



Productivity

UK output per hour has barely grown in the last 12 years. Almost all of the UK's GDP growth since the recession has been through strong employment growth. Excepting Italy, the UK has had by far the worst performance on productivity growth of all the G7 countries since the financial crisis.³⁷

We already faced a significant uphill struggle to turn this around. But productivity growth is the only way we can deliver sustainable economic growth and rising real wages in the long-term. This is, and will remain, the key challenge facing the UK economy for the coming years.

Low levels of business investment

Levels of private sector investment have been historically low in the UK relative to other advanced economies, even before the impact of uncertainty over Brexit since 2016.³⁸

A post-Brexit bounce had been hoped for given the greater political and economic certainty that Britain offered, but the virus has brought whole new uncertainties to the investment landscape. Low levels of investment have also been identified as a key factor in the UK's productivity puzzle.

Living standards

Real wages have taken a decade to recover from the financial crisis. According to the Resolution Foundation, for some groups incomes may still be lower now than in the mid-2000s.³⁹

Incomes for those in the lower deciles have been supported by the introduction of the National Living Wage and generous real terms increases in its rate each year. But employers will not be able to shoulder this rising cost forever – at some point, wage rises will need to be supported by a more productive economy. There is also a need to address the intergenerational inequalities that have bedevilled the economy, not least in terms of home ownership.

Levelling up

As mentioned above, the Government is committed to revitalising the economies of the regions which have been left behind over the course of the last few decades, through significant investment and pro-growth policies. Too often, decisions about the lives of people in Britain's regions are made in London by people who live and work in London and think the rest of the country is like London. We need to level up our regions and give them more control over the decisions which affect them.

Some have rightly warned against the tendency towards 'now more than ever-ism' when responding to the crisis, with people using it as an opportunity to advance their pre-existing agendas.⁴⁰ But as set out earlier in this chapter, London and the South East really are disproportionately well placed to cope with the economic impact of the pandemic. There will be a need to focus efforts particularly on those regions which may have suffered the most and ensure the gap between them is not simply left to grow even wider.

37 ONS, 'International comparisons of productivity', [link](#)

38 Carl Emmerson, Christine Farquharson and Paul Johnson, 'The IFS Green Budget: October 2018', Figure 2.6, [link](#)

39 Adam Corlett, Stephen Clarke, Charlie McCurdy, Fahmida Rahman and Matthew Whittaker, 'The Living Standards Audit 2019', [link](#)

40 Giles Wilkes, 'Bailout for businesses after coronavirus', [link](#)



Fiscal pressures

Inevitably, there are always a blizzard of competing demands on public spending. For any Chancellor, it is a delicate balancing act to respond to them while maintaining fiscal discipline and keeping within the fiscal rules.

Health and social care spending are under increasing strain due to an ageing population, and social care in particular is long overdue reform of its funding framework. An older population also means more spending on the welfare state through the state pension system and pensioner benefits. Spending on disability benefits has also been rising noticeably in recent years.

After 10 years of fiscal retrenchment there is a general feeling that there is little room for further cuts in spending from other

areas of government - although there is always room for the state to be more efficient in how it operates. But there is equally little room to increase taxes: the tax burden as a proportion of GDP has not historically gone much higher than where it now stands, which is why the Conservatives committed in their manifesto not to raise rates of income tax, VAT and National Insurance, as well as increasing the National Insurance threshold to reward ordinary workers (as recommended by the Centre for Policy Studies). Significant tax increases would not only be unpopular but would be self-defeating and choke off any recovery.

Taken together, the issues outlined in this chapter show just how severe the damage inflicted by the coronavirus threatens to be - and how ambitious any recovery agenda will need to be.



Chapter 2: Principles for Recovery

The bulk of this report is devoted to making specific suggestions for recovery.

But just as we had to first establish the most pressing problems for the Government to address, we also wanted to suggest some high-level principles that should inform that policy agenda. After all, there is no point in setting out a list of economic building blocks without having an idea of the kind of economy you want to use them to build.

This task is all the more important because the COVID-19 crisis has thrown so much up in the air. As the Government mounts market interventions of unprecedented scope and scale, our approach to the economy has rarely looked more open to challenge. For example, some have argued that if we are willing to borrow hundreds of billions to fight a virus, we should be prepared to do the same to tackle climate change. Similarly, they say, if it is good for government to pay people's wages now, why not in any future downturn?

It is therefore worth restating some fundamentals. A significant number of commentators are leveraging the crisis to call for a permanently larger role for the state. But their arguments are often predicated on a misreading of the Treasury's actions, as well as the economic crisis itself.

When Jeremy Corbyn claimed that he has been proved 'right' by increased

government spending in response to the virus, he failed to consider the objective of the spending and its economic context. In truth, our rapidly accumulating debt is swiftly turning into the best argument against the long-term increases in spending he himself proposed at the last election.

Meanwhile, the crisis has also been seized on by protectionists, who have cited the pandemic as proof that our global supply chains are overstretched and too interdependent. Their solution is to scale down our dependency on overseas production and manufacture more of what we consume here.

These concerns are not entirely without merit. If the UK becomes overly reliant on imports for key products, we leave ourselves vulnerable to supply-side shocks. Equally, if we become overly dependent on one country's exports, we grant them geopolitical leverage. But at the same time, Britain's prosperity has been built on an open economy.

The absence of off-the-shelf solutions to the problems we face means that the Treasury will have to design a recovery plan from first principles. And those principles should be straightforward, even if the task at hand is not: **maximise growth, support businesses and employment, and create new jobs at speed to replace those that are lost.**

That can best be done by embracing certain core values, which we believe will underpin the strongest possible recovery, both on a short and long term basis.



Support free enterprise

Overwhelmingly, scrutiny of the UK's response to the pandemic has focussed on the performance of government. Whilst this is appropriate, we should also recognise the contribution of business to our country's fight against COVID-19.

Over the past four months, private businesses have demonstrated their ability to innovate and adapt, responding at pace to the request for ventilators and hand sanitiser and providing vital services for vulnerable citizens such as the home delivery of groceries. Their successes have showcased the value of free enterprise as a force for social good. The actions of business saved lives, and significantly augmented our response to a crisis situation.

Yet beyond its contribution to our initial response, the true value of private business will be as the engine that drives our economic recovery. The pandemic will permanently alter some elements of our economic landscape, but one principle that must survive unchanged is that a free enterprise economy is the most effective way of generating wealth, creating jobs and funding the public services we all rely on.

It is therefore essential that unprecedented state intervention into the market is temporary. We must resist calls for a continuation in peacetime of unaffordable - and often actively counterproductive - measures, especially from those who believe that the pandemic is an argument for a generally greater role for the state.

There will come a time when the interventions that have supported our economy through this crisis become the best way of ensuring we never recover. The majority of the measures implemented by the Treasury were designed to keep the economy in stasis. It follows that

leaving them in place would only serve to frustrate economic growth.

Supporting free enterprise also means reconsidering our approach to regulation. Indeed, not every post-pandemic measure was introduced with the intention of putting the economy into hibernation. The Government actually demonstrated commendable flexibility to ensure that businesses, wherever possible, could continue operating within the COVID-19 regulations.

Removing red tape in order to allow pubs and restaurants to operate as takeaways during the outbreak will have saved jobs and businesses. There is no reason why relaxations such as these should not be retained on a permanent basis.

Small and family firms are among the most vulnerable to the economic downturn, and historically have been the least able to deal even with existing levels of red tape. With a view to accelerating growth during our recovery, the Government should seek to relax regulations acting as a break on their activity and lessen their administrative burden to allow them to focus on getting back to their feet.

This applies to COVID-19 regulations as well as existing requirements. The British public have demonstrated good sense when keeping themselves and their communities safe throughout this crisis. They can be trusted to continue doing so. The restrictions we put in place for businesses should be flexible so as to allow business owners to use their own common sense, with clear minimum standards that must not be breached.

Keep Britain open

Protectionists have cited the pandemic as proof of a trade-off between globalisation and national resilience. They argued that our vulnerability was an unavoidable by-



product of extensive trade routes and economic links.

Concerns about the resilience of our supply chains are understandable. However, as the crisis developed, it became increasingly clear how indispensable free and open trade is for everything from sourcing PPE to putting food on the table.

When it comes to shared challenges, globalisation is less the problem than it is the solution. Where goods and services are able to cross borders, so are knowledge and resources. International cooperation will be key to finding a vaccine and ensuring it is swiftly distributed. Until that point, working with our partners will be essential for reopening our economies and keeping them afloat.

Similarly, once the pandemic is over, we will need to identify those strategically critical weak points in our supply chains that need greater resilience. Yet it would be a huge mistake to reheat the old and disastrous autarky agenda. Protectionism has almost always proved short-sighted. As Ronald Reagan said in 1985, it *'destroys jobs, weakens our industries, harms exports, costs billions of dollars to consumers, and damages our overall economy'*.⁴¹

Free trade has been a significant driving force behind our economic growth over the past few decades. If recovering countries want to rapidly expand their economy at home, one of the places they must look is overseas. Once the crisis has passed, global supply chains will play a critical role in an export-led recovery, cutting costs, improving efficiency and creating more high-value jobs at home.

The United Kingdom has a proud heritage as a global advocate for free and fair

trade. As we become an independent trading nation once more, it is in all of our interests to take up the mantle as its greatest champion once more, and set about breaking down economic barriers with the rest of the world.

But being open, and benefiting from openness, is not just about trade. While acknowledging legitimate public concerns about low-skilled immigration, and our inability while European Union members to control our own borders, it is vital that we ensure that Britain can attract the entrepreneurs and wealth-creators of the future.

It is also about openness to outside capital. Last year, the UK outperformed expectations to become the number one destination in Europe for inward investment. The advantages that we enjoyed because of this - including the creation of jobs, higher wages and heightened competition - will only become more crucial in the post-COVID economy.

As it orchestrates our recovery, the government must consider each of its interventions to ensure that none of the policies it introduces make our country less attractive to overseas investors. The exceptions to this should be on grounds of national security and public health resilience. Where possible, we should seek out opportunities to signal our openness to capital from overseas.

Champion sound money and low taxes

In locking down the country, the state has accepted a duty of care for an immobilised economy and the livelihoods that depend on it. Discharging this duty has required the Chancellor to deploy the most significant fiscal firepower since the Second World War with speed and

41 Lou Cannon, Washington Post, 1985, [link](#)



scale. These interventions haven't so much steadied the economy as put it into a medically induced coma. An elixir of job retention schemes, tax cuts and government-backed loans has staved off the demise of businesses up and down the country.

As mentioned above, this has come at substantial cost. Politically, the easy option would be to accept a permanent increase in public sector borrowing for the rest of this parliament. Indeed, many on the Left have chosen to frame the Government's fiscal response to the crisis not just as vindication of a decade of calls for increased spending, but a case study for how it could be done.

In fact, the reverse is true. The only reason we have the fiscal flexibility to respond to a crisis of this magnitude is because over the past decade consecutive Chancellors have made the decision to put the public finances first, keep spending under control and balance the books. The fiscal rules set out in the Conservative manifesto were written not only to preserve Britain's readiness to respond to an economic shock, but with a break clause in anticipation of one.

As we do not know when the next crisis may come, allowing debt to rise indefinitely is neither responsible nor sustainable. Furthermore, burdening future generations with unserviceable levels of debt would represent a failure to fulfil our responsibilities.

When we emerge from the downturn, we must begin the process of bringing borrowing back under control. That means once more attempting to balance day to day spending, and close the deficit in a reasonable period of time.

In terms of monetary policy, having control of our own currency has put us

at a significant advantage as we seek to mitigate the economic fallout of the pandemic - just as it did in the wake of the 2008 crisis. Unlike the US, however, we do not have a reserve currency, meaning that we do not possess as much fiscal flexibility to run a large cumulative deficit. Policymakers must ensure the credibility of the pound.

First and foremost, that means maintaining a stable monetary environment. In particular, it would be deeply unwise for the Government to try and inflate its way out of an enlarged deficit.

It also means being careful to maintain the credibility of our institutions, including the Bank of England and the Office for Budget Responsibility. Similarly, confidence in our currency is predicated on a strong and respected finance ministry. It is essential that the Treasury continues to be seen as a check and a balance to Whitehall's desire to spend.

Finally, much of the speculation about our post-crisis fiscal policy has focused on taxation. One commonly cited argument contends that after a decade of austerity, balancing day to day spending will require significant increases in tax, though there is little consensus on where the burden should fall.

Yet going into this crisis, the tax burden as a percentage of GDP was already at a 50-year high. While the Government has endeavoured to reduce the direct taxes levied on the poorest in our society, research from the TaxPayers' Alliance has shown that the burden still falls disproportionately on those who can least afford it.⁴² This is not a firm foundation for economic recovery.

Yes, the Treasury will need to maximise revenue - especially if it is to avoid borrowing running out of control. But it

42 TPA, 'The tax burden on households 2019', [link](#)



must be especially careful not to pursue tax increases that weaken the businesses that will drive our recovery. Trying to restore the health of the Government's accounts by clawing back money from Britain's SMEs would take a scythe to any green shoots and stymie economic growth.

If we want to adequately fund our public services, first we must rebuild a sustainable tax base. Taken alongside the

need to restore pre-crisis employment levels, this means that **all elements of our policy package must aggressively pursue growth, powered by Britain's businesses.** Taxation is no exception. That is the only way to escape from the trap of higher spending, higher borrowing and higher taxes.

In the following chapters, we will spell out what that might mean in practice.



Chapter 3: Tax, Spending and Borrowing

Our Recommendations

Reforming the fiscal rules

Balance the current budget within three years of the economy returning to normality. The deficit should fall year on year.

Once the current budget is balanced, the debt-to-GDP ratio should fall year on year. Postpone the planned Comprehensive Spending Review until 2021.

Tax and spending

To avoid permanently higher borrowing, as many of the emergency spending measures as possible should be discontinued after April 2021.

Consider replacing the emergency Universal Credit payment increases with a cut to the taper rate, so that in-work claimants keep more of their earnings.

Take a fresh look at what sensible savings can be made from existing commitments, especially the running of government itself.

Commission a system-wide review of the UK tax system, with a general shift away from taxing incomes and profits towards fairer, more progressive taxation of property and tightening reliefs which favour the wealthy.

Avoid raising headline rates of income tax, VAT or National Insurance.

A full council tax revaluation over this parliament, with revaluations every three years, and reforms to bands and rates.

Consider switching from pension tax relief based on marginal rates to a flat rate bonus paid regardless of your tax code.

Financing the debt

Maintain the target for interest spending as a proportion of receipts to not exceed 6 per cent, but suspend it this year to account for the temporary drop in receipts.

Seek to further reduce the use of index-linked gilts.

Increase average gilt maturities to lock in low rates and minimise refinancing risk, and continue to move towards super long-dated debt.

Conclude the consultation on RPI as soon as possible and ensure the indexation of gilts is based on a fair reflection of UK inflation.



Introduction

Decisions on public spending are among the most important a Government will take.

David Cameron's years in office were largely defined by the hard decisions that he and George Osborne were forced to make to get the deficit under control - which themselves were a response to Gordon Brown's failure to fix the fiscal roof.

The rules established by the Johnson Government were designed to keep taxes down, support the public services, and limit borrowing while making space for a revolution in infrastructure - taking advantage of rock-bottom interest rates to invest in increasing Britain's productivity and levelling up its economy.

At the same time, they acknowledged that these rules could not apply in all circumstances - extraordinary times require extraordinary measures.

Rishi Sunak duly announced at the March Budget that the Treasury would review the fiscal framework in light of prevailing macroeconomic circumstances. This section will set out how our fiscal rules, and approach to fiscal policy, could evolve to cope with the challenges of coronavirus, balancing fiscal responsibility with the need to support the recovery.

To that end, the Government's first priority must be to get the economy moving again and recover lost ground. The Chancellor will have some incredibly difficult judgment calls to make. However, he should be guided by the overriding need to prioritise growth. If the economy ends up permanently smaller than we thought

it was going to be, then to some extent we will have to cut our coat according to our cloth - but not at the cost of stifling the economic recovery via tax rises and spending cuts.

Reforming the fiscal rules

Some have questioned the need for an administration to impose specific rules on itself when it comes to borrowing and spending, especially at a time like this. Others have suggested the pandemic has ushered in a 'new normal' of consistently higher borrowing and turning a blind eye to debt levels. After all, if debt is soon set to be larger than the economy itself, what's a few billion here and there?

But fiscal rules are vital, because they go to the heart of fiscal credibility. The Resolution Foundation, hardly a bastion of right-wing fiscal hawks, said recently that *'While some have been quick to claim that the coronavirus outbreak has sounded the death knell of fiscal rules, it actually makes having a set of long-term fiscal objectives all the more important.'*⁴³ The Institute for Government have stated that *'well-designed fiscal rules can provide an important signal of the Government's plans and are a key part of responsible fiscal management.'*⁴⁴

At the most basic level, they are useful in the same way that you might set yourself a target to go to the gym twice a week or give up chocolate for Lent. Targets serve as a way to measure success and, when they are public, they are a way to be held to account.

But they matter in other ways, too. We rely on investors to buy our debts, and they are reassured if they see the Government is holding itself to a high standard of fiscal

43 Richard Hughes, Jack Leslie, Charlie McCurdy, Cara Pacitti, James Smith and Daniel Tomlinson, 'Doing more of what it takes', p58, [link](#)

44 Thomas Pope, 'Fiscal rules must not follow the chancellor out the door', [link](#)

discipline. Performance against the fiscal targets is assessed at regular intervals by a respected independent body, the OBR, ensuring a transparent and honest account of the state of the finances.

And in terms of discussions and decisions within Government, the need to keep within the fiscal rules is a vital tool in explaining why the money they want is not available.

Fiscal rules, in other words, guard against those short-term temptations in the long-term interests of taxpayers.

In their general election manifesto, the Conservatives set out a clear fiscal framework:

- The current budget should be in balance by the third year of the forecast period.
- Spending on debt interest as a proportion of revenue should not exceed 6 per cent.
- Public sector net investment should not average more than 3 per cent of GDP per year across the five-year forecast (see next chapter: 'Infrastructure and Investment').

These were sensible rules and, because they are rolling targets, they allowed flexibility to respond to unexpected changes in circumstances. However, this crisis is unprecedented. Sticking rigidly to the framework would not make sense. Those rules were designed as a responsible plan for the public finances in normal times – we are no longer in normal times, nor will we be for some time.

For example, one cornerstone of Conservative economic policy, and economic thinking, has been to target the structural (i.e. cyclically adjusted)

budget deficit. The broad principle is that the Government, and the country, should not be spending more than it earns, save for productive investment in long-term infrastructure.

But such a target relies on knowing where you are in the business cycle - which the pandemic has effectively scrambled. Nor would we want to choke off the recovery, for example by retrenching in the teeth of a recession.

Our suggestion, then, would be that **the Government should aim to balance the current budget within three years of the economy returning to normality.** This should be calculated with reference not just to the level of real GDP per capita getting back to the level seen before the crisis, but growth rate being judged by the OBR to be sufficiently stable to accommodate the withdrawal of support. **The Chancellor should still ensure that the deficit falls year on year until the current budget is balanced.**

This would mean that if the recovery takes longer than the OBR and Bank of England scenarios currently assume, then the Government is not forced to either damage the fragile recovery through premature fiscal consolidation or lose credibility by abandoning its rules - while still moving in the right direction in terms of borrowing.

After the deep recession of 2008-9, real GDP per capita took until 2014 to exceed 2008 levels.⁴⁵ If this crisis ends up being as damaging and long-lasting as that, such a rule would give the Chancellor scope to respond.

This might sound at odds with the approach taken by the Conservatives in government after 2010, but the measure being targeted in 2010 was actually the

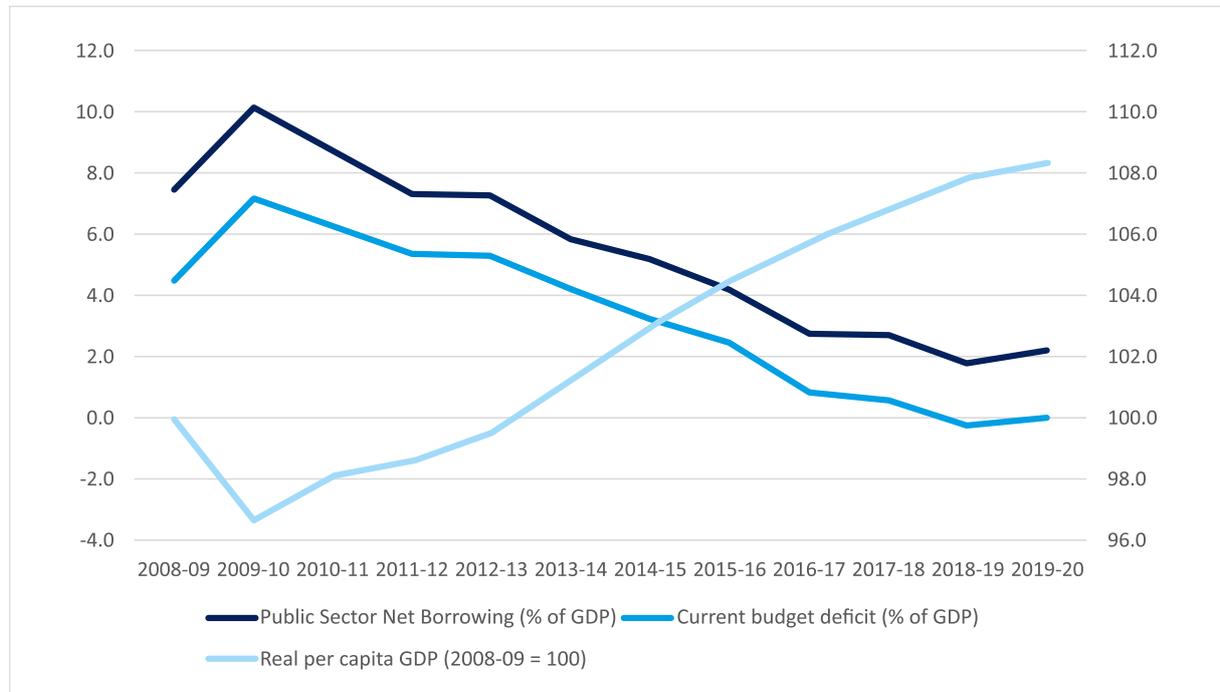
45 OBR, 'Economic and Fiscal Outlook, March 2020', Supplementary Economy Table 1.5, [link](#)



cyclically adjusted current budget deficit, meaning the intention was to target only structural borrowing which would have been there even if the economy was growing at

trend. The approach was gradual, and the current budget was not actually brought into balance until a few years after per capita output had recovered, as can be seen from the chart below.

Path of borrowing (left axis) and GDP (right axis) after 2008



Source: OBR Databank, Aggregates (per cent of GDP), [link](#); OBR Economic and Fiscal Outlook, Supplementary Economy Table 1.5, March 2020, [link](#)

Note that this is about eliminating the deficit on day-to-day spending. As long as our costs of borrowing remain manageable, it is reasonable for the Government to borrow to fund investments in infrastructure which will provide a return. The same basic laws of finance that applied before the virus will apply after it. If we can return to growth and balance the current budget, we can deliver a gradual fall in debt relative to output while also borrowing to invest in future growth. We discuss this in more depth in the next chapter.

At the same time, we must not allow debt to spiral out of control. As set out below, a larger debt burden increases our exposure to rising debt interest - and the longer we maintain a high level of debt the greater

the risk that we eventually hit a spike in financing costs. The corollary of the rule set out above is that **once the recovery is secure, public sector net debt would start to fall year on year**. This strikes a balance between allowing us to borrow while we nurture the economy back to health while ensuring debt does not rise indefinitely. A balanced current budget should be sufficient to deliver this target if we have moderate growth and capital spending is not excessive.

Just as the fiscal rules should accommodate the current uncertainty, so should our spending plans. We therefore suggest that the Chancellor **postpones the planned Comprehensive Spending Review until 2021**, when he will



have a better idea of how the coronavirus has affected the public finances and economy. Instead, he should conduct a one-year spending round (as happened in 2019).

Tax and spending

While the OBR has said that borrowing could return to pre-virus levels relatively quickly, that does not factor in the lasting impact of scarring on the economy, nor can the OBR take account of the likely political situation.

Besides the impact of lower GDP, the public finances could remain in a much worse state than the official forecasts suggest because the OBR 'reference scenario' is founded on an assumption that all of the policy response will be temporary. In their scenario, *'the rise in the deficit is only temporary'* and this *'contrasts with the financial crisis, after which a large structural deficit persisted and debt continued to rise as a share of GDP'*.⁴⁶

The reality is there will be huge political pressure for some of the measures to be retained. It would require tough decisions and political resolve to roll back some of the major spending changes.

For example, the £20 per week increase in the Universal Credit standard allowance was a desirable temporary measure because the need to incentivise earning a wage relative to claiming benefits is irrelevant during this crisis. But when things go back to normal, it will be hard to return that amount to its original total. The increased generosity in welfare alone has added £8 billion to expenditure, and if unemployment remains stubbornly high for some years the cost of making these changes permanent would be even higher.

In those areas where it is politically impractical to unwind additional spending, we must ensure that it is targeted as effectively as possible. For example, on welfare, the Government should explore the idea of shifting that extra support from a flat increase to benefits to improving work incentives within Universal Credit. This would reflect the need to shift the policy response from supporting incomes during the lockdown to encouraging economic activity for the recovery.

This could take the form of a cut to the taper rate, so that in-work claimants keep more of every extra pound they earn – effectively a tax cut for the lowest paid.

In terms of public spending more broadly, polls suggest that the country is not ready for a repeat of the austerity measures we saw during the David Cameron era - necessary though they were. However, voters have also decisively rejected the Labour Party's approach, which calls for significantly higher public spending on the basis that it will be an investment in economic growth.

Spending in and of itself does not provide a sustainable boost to our growth potential. Too often the calls from the left for 'investment' have been calls for increases in day-to-day spending on things like abolishing tuition fees, increasing benefits, public sector wages and services in general. More spending on some of these things may sometimes be a very good thing, but it is disingenuous to say it will 'pay for itself'.

To avoid permanently higher borrowing, as many of the emergency spending measures as possible should be discontinued after April 2021. The Government should be clear that such measures are temporary.

⁴⁶ OBR, 'Coronavirus analysis', p13, [link](#)

We should also take a fresh look at what sensible savings can be made from existing commitments, especially the running of government itself. For example, there has long been talk of merging some government departments, in addition to the recent combination of DfID and the FCO. The Centre for Policy Studies has also highlighted the savings if non-unitary local authority areas across England adopted a unitary model, which government could incentivise. The reforms to childcare proposed later in this report, while primarily targeted at reducing the cost of living and encouraging parents to return to work, could also rein in the Government's multi-billion-pound childcare bill. The CPS has also long been critical of the 'triple lock' on pensions, although we recognise that this is a politically sensitive area and the Government will be reluctant to set aside its manifesto commitments.

In terms of taxation, reports are already widespread that the Treasury are considering additional revenue raising measures for next year to try to close the gap in the finances. We believe that, wherever possible, the state should minimise the amount it is taking out of people's hard-earned pay-packets.

In particular, the Conservative election manifesto pledged not to raise headline rates of income tax, National Insurance and VAT. This promise will come under intense pressure - not least as there will be pressure on Government to look at simple solutions to raise revenue. There will also be some who call for increased taxes on business - even though it is the private sector that will drive any recovery.

The best approach, we suggest, is for the Government to consider how we can reform the tax system to improve incentives, minimise distortions and also raise more revenue without increasing tax rates. What

really matters is not raising a few extra billion in the next couple of years but the long-term revenue potential of our tax structure.

The Government should commission a system-wide review of the UK tax system. This should be done with a view to delivering a moderate increase in revenue over the medium-term through improved incentives and higher growth. There should be a general shift away from taxing incomes and profits towards fairer, more progressive taxation of property and tightening tax reliefs which unduly favour the wealthy.⁴⁷

The Government should avoid raising headline rates of income tax, VAT or National Insurance - indeed, we point out later that temporary cuts in VAT and Employer's National Insurance are extremely good candidates for stimulus spending, as are reforms to our business investment regime. If increases in headline rates of those three taxes are judged necessary over the long term, they should not take effect within this Parliament.

The tax review should also look at cutting distortionary taxes such as Stamp Duty Land Tax for primary residences - the Centre for Policy Studies has done work on the galvanising effect this would have on the housing market, for a surprisingly low cost.

Ultimately, the only way to square the fiscal circle is to drive up growth - generating the tax revenue to pay for public services while keeping taxes low. Tax rises should always be a last resort. But if the Government does need to raise revenue, there are two areas where it could do so while ironing out existing injustices - and, indeed, where it would be sensible to act even if the results were revenue-neutral.

The first is council tax. The current system is highly regressive, not least because it is

⁴⁷ A good place to start would be the principles set out in the seminal Mirrlees Review (though we would not necessarily endorse every one of its recommendations). See: James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James M. Poterba, 'Tax by design', [link](#).

based on property values nearly 30 years ago. The result is that when a newly built property is valued for council tax, a bizarre process takes place in which an estimate has to be made of the value the property would have had on April 1, 1991.

This means the system undercharges wealthy homeowners in London and the South-East, who have seen the value of their homes soar relative to the rest of the country in recent decades, at the expense of those in the North and Midlands. In fact, the average council tax bill in London is roughly the same as in the West Midlands, despite Londoners having higher average incomes and much greater housing wealth.⁴⁸ This is not the only discriminatory consequence: council tax bills for the lowest income decile are almost 10 per cent of average household income, or around 4 per cent on average once council tax support is factored in, compared to less than 2 per cent for the richest decile.⁴⁹

The Government should consider carrying out a full council tax revaluation over this parliament, with revaluations every three years, and reform bands and rates to make council tax bills more proportional to today's property values.

Reform of how pension contributions are taxed is another example of low-hanging fruit. The Centre for Policy Studies has argued in favour of comprehensive reforms to encourage saving, but Governments have consistently baulked at the prospect of meaningful reform and instead sought to make savings through tweaks to the existing system, which has ultimately created controversial distortions such as the effect of annual allowance changes on doctors.

The principle behind the current system is that relief on contributions is paid at a

taxpayer's marginal rate of tax, to account for the fact that tax will be due when income is drawn in retirement. But the cost of the relief far outweighs the tax paid by retirees on pension payouts. Even after taxes paid in retirement are netted off, the cost of the various reliefs currently available comes to a huge £35 billion a year.⁵⁰

Using marginal rates to calculate relief also means the vast majority of this money only benefits higher earners, while low earners who pay no tax get no benefit. The last time a breakdown by income was released, it showed nearly 60 per cent of relief being paid to the richest income decile alone and 75 per cent to the top quintile, while only 8 per cent goes to the entire poorer half of the population.⁵¹

We suggest switching from pension tax relief based on marginal rates to a flat rate bonus paid on contributions up to a generous annual allowance, regardless of your tax code. This would significantly increase the incentive to save for low earners and the self-employed while also potentially bringing substantial savings for the Exchequer. Previous CPS research has suggested combining such a flat-rate savings bonus with a broader shift to an ISA-style pension system, which we urge the Government to consider.

Financing the debt

As part of its fiscal rules, the Government included a ceiling on debt interest spending. This was about recognising that when we have been targeting falling debt levels in the past, it was on the basis that high debt is unsustainable if the costs of servicing it become excessive.

The good news is that so far, the gilt market has held up relatively well and

48 Stuart Adam, Louis Hodge, David Phillips and Xiaowei Xu, 'Revaluation and reform: bringing council tax in England into the 21st century', Figure 2.2, [link](#).

49 Stuart Adam, Louis Hodge, David Phillips and Xiaowei Xu, 'Revaluation and reform: bringing council tax in England into the 21st century', Figure 2.7, [link](#).

50 HM Revenue and Customs, 'Registered pension schemes costs of tax relief', [link](#)

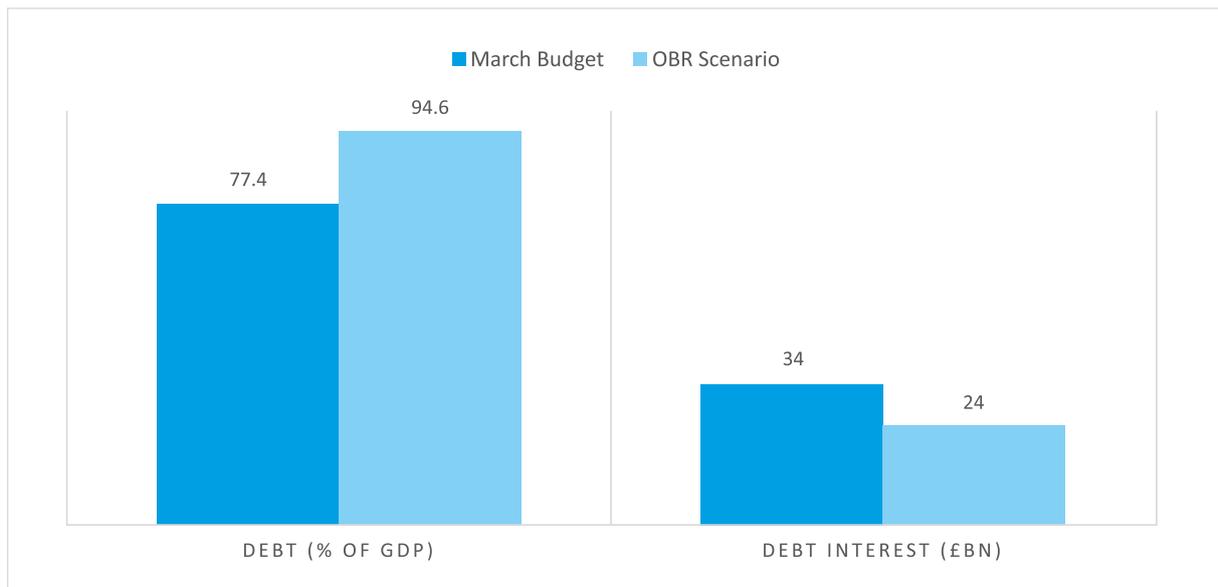
51 Pensions Policy Institute, 'Pension facts: private pensions', Table 29, [link](#).



the Treasury has been able to issue very substantial amounts of new debt without investors demanding a premium. Yields are very low, partly due to the side effects of the Bank of England's latest quantitative easing programme and rate reduction, and partly due to the search for security at a time of great uncertainty and low yields across most asset classes.

In fact, despite the jump in debt this year due to increased borrowing, the OBR expects spending on debt interest will actually be lower than it forecast before the pandemic, as shown in the chart below.

Public sector net debt and interest payments before and after the impact of Covid-19, 2020-21



Source: OBR, Coronavirus Reference Scenario, Charts and Tables, Tables 1.5 and 1.8, April 2020 [link](#). Debt interest is given net of the Asset Purchase Facility.

However, there will be a limit to this. The Treasury has already found it necessary to request an extension of the Ways and Means Facility, meaning that the Bank of England has been directly providing it with cash so that gilt issuance can be spread across a longer timeframe. Some people have already talked of allowing this to evolve into direct monetary financing, with the Bank creating new money to fund fiscal policy. As we argue in the final chapter of this report, that would be completely irresponsible – we cannot print our way out of this crisis.

And while it is fortunate in the present circumstances that the Government can

borrow at real interest rates which are comfortably negative, most of the wider causes of that phenomenon are not desirable over the long-term.

As the OBR itself has pointed out, a significant increase in the stock of public debt also increases the potential volatility of the public finances.⁵² More debt means that spending on debt servicing, and by extension the overall budget deficit, is more exposed to changes in interest rates and inflation (due to the link between gilts and RPI). Small fluctuations in these variables will make a substantial difference to spending.

52 OBR, 'Coronavirus analysis', p20, [link](#)



Direct impact on spending if different variables were 1 percentage point higher across the forecast

	£ billion			
	2020-21	2021-22	2022-23	2023-24
RPI inflation	4.9	5.5	6.1	6.4
Gilt rates	1.5	2.4	3.3	4.2
Short rates	5.5	5.7	5.8	5.9

Source: OBR, Fiscal Risks Report, July 2019, spending ready reckoners, [link](#)

As an illustration of the level of exposure the public finances already had to variations in debt servicing costs, in December 2014 the OBR forecast that in 2019-20 interest spending would be around £60 billion, but due to consistent falls in interest rates this figure ended up coming in around £25 billion lower at just £35.8 billion.⁵³ In other words, the deficit could have been 50 per cent higher last year if not for the fall in interest rates. What goes down can go up again just as easily, and with a much bigger debt pile after the pandemic the risk posed by a sudden rise in interest spending will be acute.

More importantly, every pound we have to spend on servicing our debts is a pound in the pocket of a bondholder instead of a pound to spend on our schools and hospitals. Our public services should

not lose out because we are having to spend tens of billions every year in debt interest. Indeed, one of the reasons the finances remained in good shape at the March Budget was that a £7.4 billion upwards revision in the OBR's spending expectations was fully offset by a £7.4 billion downwards revision in interest spending – the less we spend on interest, the more we can spend elsewhere, or return to the public via tax cuts.⁵⁴

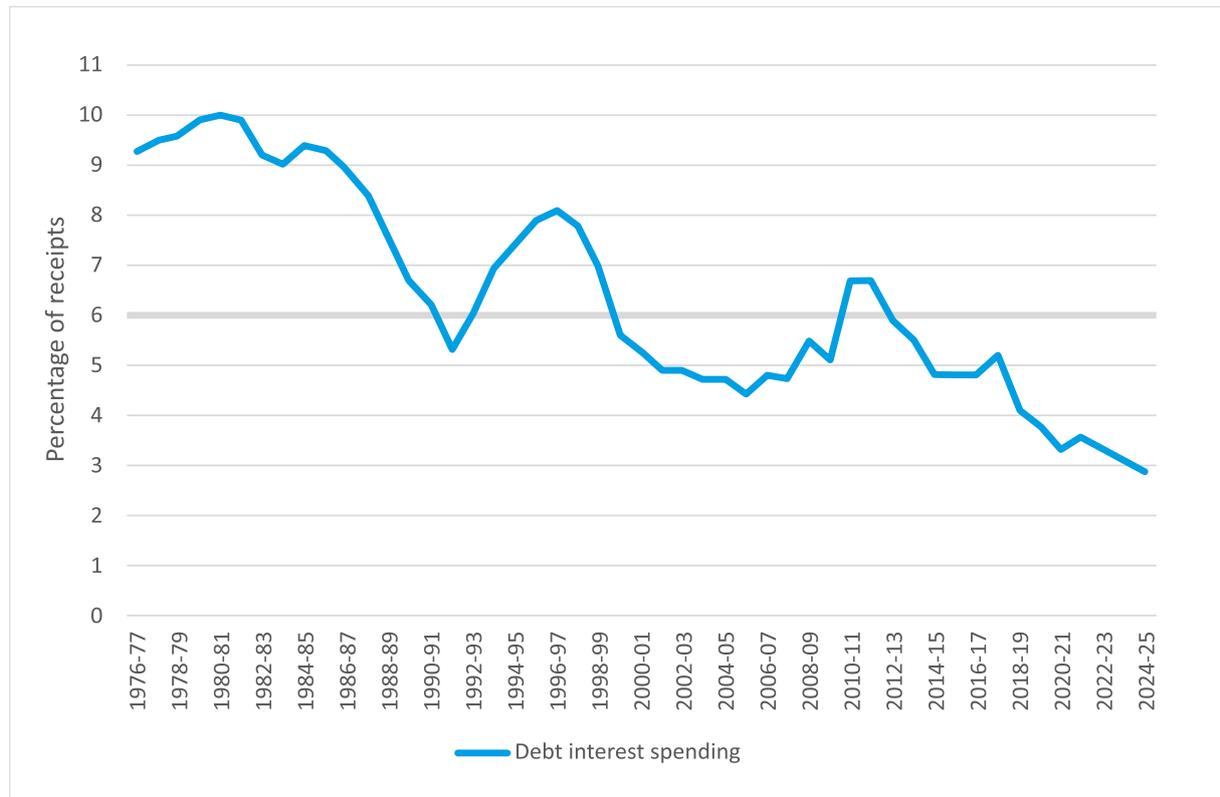
This is more important to remember than ever now that we have little choice but to accept a rising debt-to-GDP ratio in the short-term. The graph below shows that, despite rising debt, interest spending as a proportion of receipts has been falling consistently and is comfortably below the 6 per cent ceiling set last year.

⁵³ Carl Emmerson and Isabel Stockton, 'For sale: £45 billion of gilts', [link](#); OBR, 'Data: Public finances databank', [link](#)

⁵⁴ OBR, 'Economic and Fiscal Outlook, March 2020', Section 1.28, [link](#)



Spending on debt interest, 1976-2025



Source: OBR, Economic and Fiscal Outlook, March 2020, Charts and Tables: Chapter 4, [link](#). Figures post-2019-20 are forecasts.

While the debt will be significantly higher than when that rule was set, the cost of borrowing has also fallen as set out above. **The Government should therefore maintain the target for interest spending as a proportion of receipts to not exceed 6 per cent, but this should be suspended for the current financial year to account for the necessity of a temporary drop in receipts.**

The proportion of our debt which is inflation index-linked is high by international standards and has doubled since 2005 from 14 per cent to 28 per cent.⁵⁵ The Treasury has recently become aware of its increased exposure to price level fluctuation and asked the Debt Management Office (DMO) to look at reducing the amount of index-linked debt being issued. **In light of the substantial increase in public sector net debt which**

is likely to occur due to Covid-19, we recommend that the Government seeks to further reduce its reliance on index-linked gilts.

We can also use longer debt maturity to lock in record low rates and reduce exposure to refinancing risk. We are lucky that the UK already has comfortably the longest dated government debt in the OECD on average, and the DMO has been steadily lengthening maturities in recent years.⁵⁶ There is a well-established market for long-dated UK gilts which we can take advantage of. **The Treasury should ask the DMO to further increase average gilt maturities to lock in low rates and minimise refinancing risk, and continue to move towards super long-dated debt issuance such as ‘century bonds’.**

⁵⁵ HM Treasury, ‘Debt management report 2020-21’, [link](#)

⁵⁶ OECD, ‘Sovereign Borrowing Outlook for OECD Countries 2020’, [link](#)



Furthermore, there is an ongoing consultation on the future of the Retail Price Index (RPI). It is widely recognised that RPI in its current form is not an appropriate measure of changes in UK retail prices, but the use of RPI is also embedded in many areas of our economy. The Government recently announced a consultation on proposals from the UK Statistics Authority to reform the RPI.⁵⁷ This consultation has now been delayed due to the pandemic. The longer this process is drawn out, the longer there will be uncertainty for gilt investors. At the

same time, some have made the case that since the RPI appears to systemically overestimate inflation, the use of RPI for index-linked gilts may mean the Exchequer is overpaying. The OBR estimated last year that correcting the RPI methodology would reduce interest spending by £4.4 billion annually after a few years.⁵⁸ **Since the exposure of the public finances to inflation levels will be increased by rising debt, the Treasury should seek to conclude the consultation on RPI as soon as possible and ensure the indexation of gilts is based on a fair reflection of UK inflation.**

⁵⁷ UK Statistics Authority, 'UK Statistics Authority Statement on the future of the RPI', [link](#)

⁵⁸ OBR, 'Fiscal risks report: July 2019', Box 7.1, [link](#)



Chapter 4: Infrastructure and Investment

Our Recommendations

Exploiting cheap borrowing

Protect investment in cash terms by basing investment rules on pre-pandemic GDP forecasts.

Look to increase planned investment, temporarily relaxing the 3 per cent average investment ceiling.

Improving public investment

Ask the National Infrastructure Commission (NIC) to urgently evaluate which projects could be commenced quickly to boost GDP and employment during the recovery.

Local Project Facilitation Funds should be made available to local authorities through a bidding process.

Revise the Treasury 'Green Book' to specifically prioritise 'levelling up'.

Beef-up the NIC into a cross-government coordinating body, established on a statutory basis.

Ask the strengthened NIC to review the UK's complex system of infrastructure responsibilities to improve strategic coordination.

Establish a British Infrastructure Bank, based outside London, with seed capital to fund infrastructure and leverage private capital.

A 'Future Growth Fund', with a specific remit for strategic investment in growth sectors.

Levelling up

Change road improvement plans to bring spending forward to 2020.

Set out a fully funded path full fibre and gigabit-capable networks in every part of the country by 2025.

Target increased R&D spending on new opportunities outside the South East.



Pushing forward devolution

A renewed agenda for English devolution with the promised White Paper published as soon as possible this year.

Devolve more powers to unitary authorities and extend the reach and coverage of devolved mayoralities and combined authorities.

Integrate the roles of new devolved bodies with both the new British Infrastructure Bank and newly strengthened National Infrastructure Commission.

Provide dedicated funding for combined authorities to expand their capacity to assess potential investments, present business cases, and deliver projects.

Extend the borrowing powers of combined authorities and allow them to use 'tax increment financing'.

'Earn back' arrangements should become the norm in all city deals.

Reforming planning

Planning rules should focus on minimum housing supply, broad land uses, basic design codes, and guidance on significant alterations to existing properties.

Review permitted development rights to allow more work to be carried out without going through the planning process.

Covid-related adaptations to increase capacity for social distancing should be fast-tracked for planning permission, with a specific grant made available.

Encourage a new generation of development corporations and give them the powers of a local planning authority.

Establish more new towns and garden cities.

Fast-track reclassification of green belt where it is both necessary and popular.



Introduction

One of the real difficulties in deciding on spending priorities is that the areas where there is most political pressure to increase spending rarely overlap neatly with the things which will boost growth. These competing priorities have sometimes led governments to neglect long-term investments.

When the Conservatives came into government in 2010, for example, they failed to reverse the sharp reductions in capital spending pencilled in by Labour. That allowed them to protect public services - but in the long term, the best and only way to pay for increased spending on those services is through a growing economy.

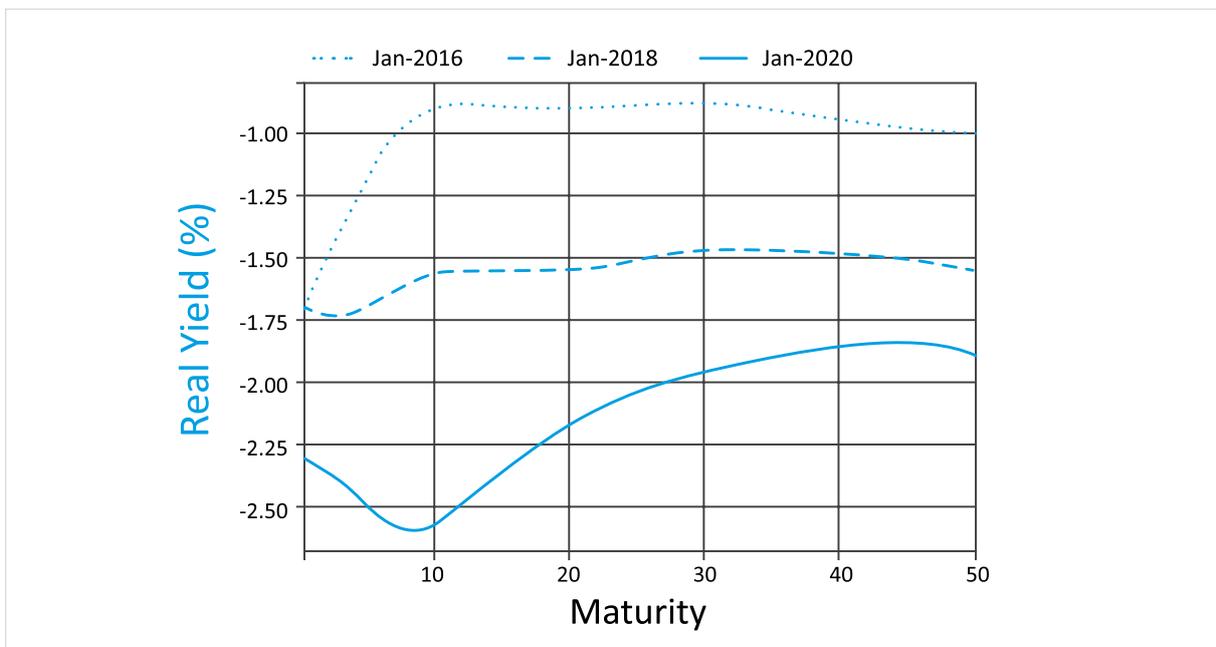
The Johnson Government switched tack, taking advantage of the low cost of capital to fund infrastructure investments. It argued that these boosted connectivity and productivity, thereby driving up growth in the long run, as well as spreading it more evenly across the country.

The benefits of such a programme of public investment are twofold. There is an immediate economic benefit from the investment spending itself and the associated multiplier effect, and then there is the long-term benefit of the assets, such as improved connectivity from road and rail investments.

With the urgent need to recover from the economic shock of the pandemic, the case for such spending has strengthened.

Exploiting cheap borrowing

As we set out in the previous section, the cost of borrowing for the Government was already incredibly low before the crisis, and is now even lower. Investor demand for a secure long-term asset class has meant the UK can borrow at real interest rates well below zero. Some recent academic work has theorised that this could be a long-term trend.⁵⁹



Source: DMO, Debt management report 2020-21, [link](#)

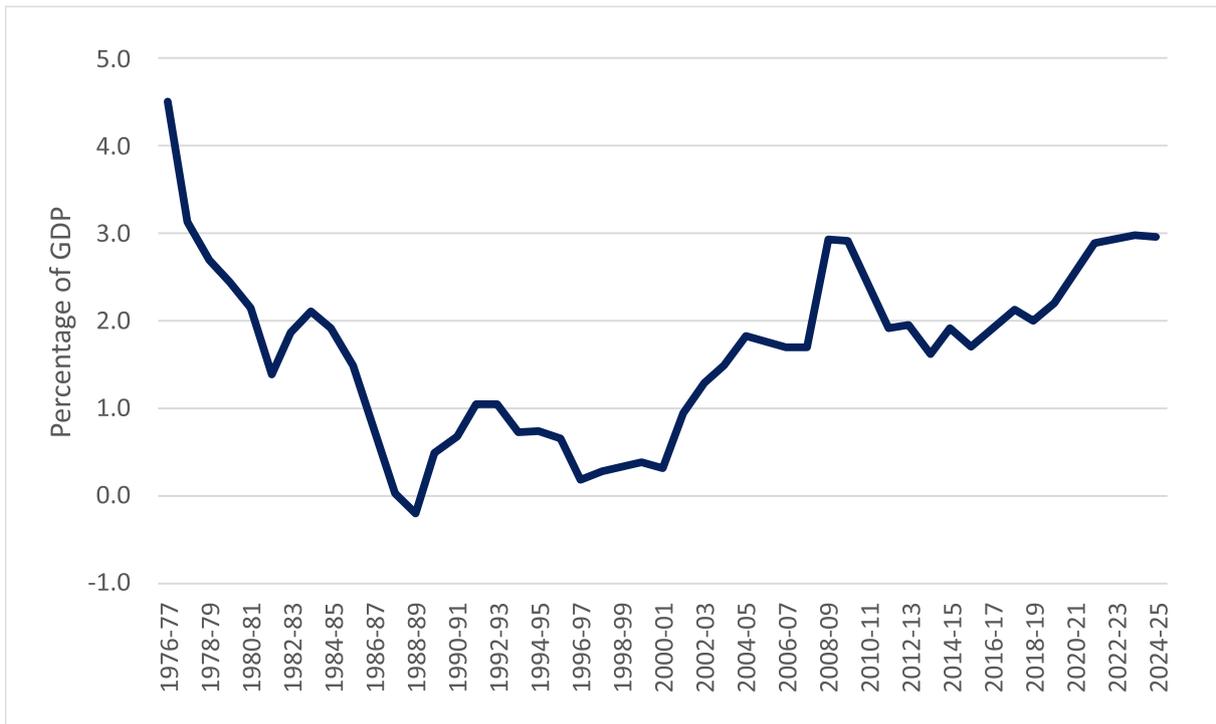
59 Bank of England, 'Eight centuries of global real interest rates, R-G, and the supra-secular decline, 1311-2018', [link](#)



Even relatively recently, negative real rates were such an unexpected concept that the Treasury models for assessing returns to capital did not even take account of them as a possibility. Yet now, investors are effectively paying for the privilege of lending to us.

Before the crisis, the Government put in place a fiscal rule that allowed it to substantially increase public investment while limiting it to no more than 3 per cent of GDP on average over the forecast horizon, in order to ensure the UK could get debt stable or falling slightly while still borrowing to invest.

Public sector net investment, 1976-2025



Source: OBR Databank, aggregates (per cent of GDP), [link](#)

With the current crisis, we have accepted that debt will have to rise in the short-term to allow fiscal policy to nurse the economy through the downturn and back to health. At the same time, the Government can now benefit from an even lower cost of borrowing than before. But if GDP is expected to be substantially lower than forecast in March, the logic of the current rules would imply investment spending should be cut. This is clearly wrong. **The Government should therefore protect its capital budget in cash terms by basing the calculation of its investment rules on the OBR's pre-pandemic GDP forecasts in March.**

There is a strong case, indeed, that the **Government should not only maintain but increase its planned investment in the light of the coronavirus crisis, particularly where there is a solid case that doing so will drive long-term growth. The 3 per cent average investment ceiling should therefore be relaxed temporarily**, to allow the Government to fund additional projects that can support jobs and growth during the recovery and represent value for money. They can do this without jeopardising our long-term financial health as the historically low cost of borrowing means that interest spending is comfortably below the 6 per cent ceiling, and likely to remain so.



We do not want to pretend that increasing infrastructure spending is as simple as increasing a number on a spreadsheet. In March, when factoring in the increases in capital spending already announced, the OBR stated that they assume 20 per cent of the money allocated would end up going unspent, which reflects the difficulty previous governments have had with ramping up capital spending over a short timeframe.⁶⁰ In the wake of the coronavirus, we need to bring forward shovel-ready projects - but we also have to look at the fundamentals of how decisions will be made and how we get the biggest bang for our buck.

Improving public investment

This new infrastructure programme should have at its heart three key objectives:

- To support the immediate need for economic recovery and a return to growth.
- To increase the UK's long-term growth potential through productivity gains.
- To level up areas with relatively low levels of well-paid employment and productivity.

Public investment can play a major role not just in boosting productivity in the long-term but in supporting economic activity and employment as we steer a course out of the coronavirus crisis. Capital expenditure has a higher multiplier effect than current spending and that effect is likely to be even higher in an environment where the economy is operating well below capacity and investment levels are depressed, because spending is less likely to crowd out the private sector. It may therefore end up being fortunate that the planned National Infrastructure Strategy was delayed in March - because we now need to put it at the heart of the recovery.

We sincerely hope that the Government has already commissioned the National Infrastructure Commission to assess which projects are the most 'shovel-ready'. If not, **it should ask the NIC to urgently evaluate which projects could be commenced quickly, taking into account the potential benefits on GDP and employment during the recovery. This should be used to inform the National Infrastructure Strategy due to be published later in the year, to ensure the Strategy takes account of the changed economic circumstances and the need to support recovery.**

To facilitate this work on the ground, local leadership should be involved in identifying valuable projects. Local authorities and LEPs have already, reportedly, been asked to identify shovel-ready projects in their area which could be off the ground this year. **We recommend the Government puts additional funding into dedicated Local Project Facilitation Funds, which would be made available to local authorities and local enterprise partnerships through a bidding process either via central government or combined authorities.** The process used to implement the Housing Infrastructure Fund would be a good template.

The Treasury has already begun work on reforming the 'Green Book' - the way in which it conducts cost-benefit analyses and signs off on infrastructure decisions. This currently tends to favour areas which already have high levels of gross value added, i.e. London and the South East. **The Treasury should revise the Green Book as quickly as possible to better account for the dynamic effects of infrastructure investment and to specifically prioritise 'levelling up' by making economic benefits in left-behind regions and localities a key factor when assessing projects.**

60 OBR, 'Economic and Fiscal Outlook, March 2020', p14, [link](#)



The way decisions on infrastructure are made in Whitehall is also disjointed. According to the Institute for Government, there are 26 different ministers with some responsibility for infrastructure, stretching across eight departments.⁶¹ At a sub-national level there is a hodgepodge of different local and regional bodies, and the overall framework can be complex and confused.

We need to improve and simplify the way infrastructure is planned and delivered, both to speed up decisions and to ensure all efforts are directed towards the National Infrastructure Strategy. The decision to actually develop and publish a National Infrastructure Strategy is a good start.

However, we recommend that the Government beefs-up the National Infrastructure Commission into a cross-government coordinating body with responsibility for ensuring all parts of the public sector are working towards the vision set out in the Strategy. This could involve establishing it on a statutory basis, with regular reporting on progress in the same way that the OBR publishes updates on fiscal policy. The first job of this strengthened institution should be to conduct a review of the current complex framework of responsibilities across the public sector and produce recommendations for how to simplify the system and improve strategic coordination.

To complement this, we need a new institution which can work alongside public sector bodies to direct some of the increased public investment and facilitate the necessary links between the public and private sectors for delivering major projects. **The Government should establish a British Infrastructure Bank, based outside London, with seed capital to fund infrastructure across UK regions**

and leverage private investment. Some of the work already done to replace the role of the European Investment Bank would prove useful. The model could be similar to the Green Investment Bank, which was set up in 2012 and proved a success for funding green infrastructure projects by leveraging in third party investment, attracting £3 of private capital for every £1 it invested.⁶²

There is increasing talk of the potential benefits of a sovereign wealth fund in the UK. Such entities tend to be set up by countries that are running budget surpluses and have low levels of public debt, often with large natural resource reserves such as oil. We are not such a country, so we remain unconvinced of the feasibility of a sovereign wealth fund on the model of a country like Norway.

However, one part of this programme of public investment could be a dedicated fund to provide the super-patient capital which is sometimes lacking for projects which can have major long-term economic benefits. **The Government could put some additional capital funding into creating a 'Future Growth Fund', with a specific remit for strategic investment in growth sectors and projects which will drive productivity growth and innovation.**

This entity would be led not by civil servants but by a board of investment experts from a wide range of sectoral and geographic backgrounds. One model for this is the Ireland Strategic Investment Fund (ISIF), which has a statutory mandate to support domestic economic activity and employment, and is designed to provide long-term capital in areas where investment is lacking, rather than simply crowding out private investors in search of fund growth.⁶³

61 Daniel Slade and Nick Davies, 'How to design an infrastructure strategy for the UK', [link](#)

62 Department for Business, Energy and Industrial Strategy and UK Green Investment Bank, 'Green Investment Bank to boost support for low carbon projects as government confirms sale to Macquarie', [link](#)

63 Ireland Strategic Investment Fund, 'How we invest', [link](#)



Levelling up

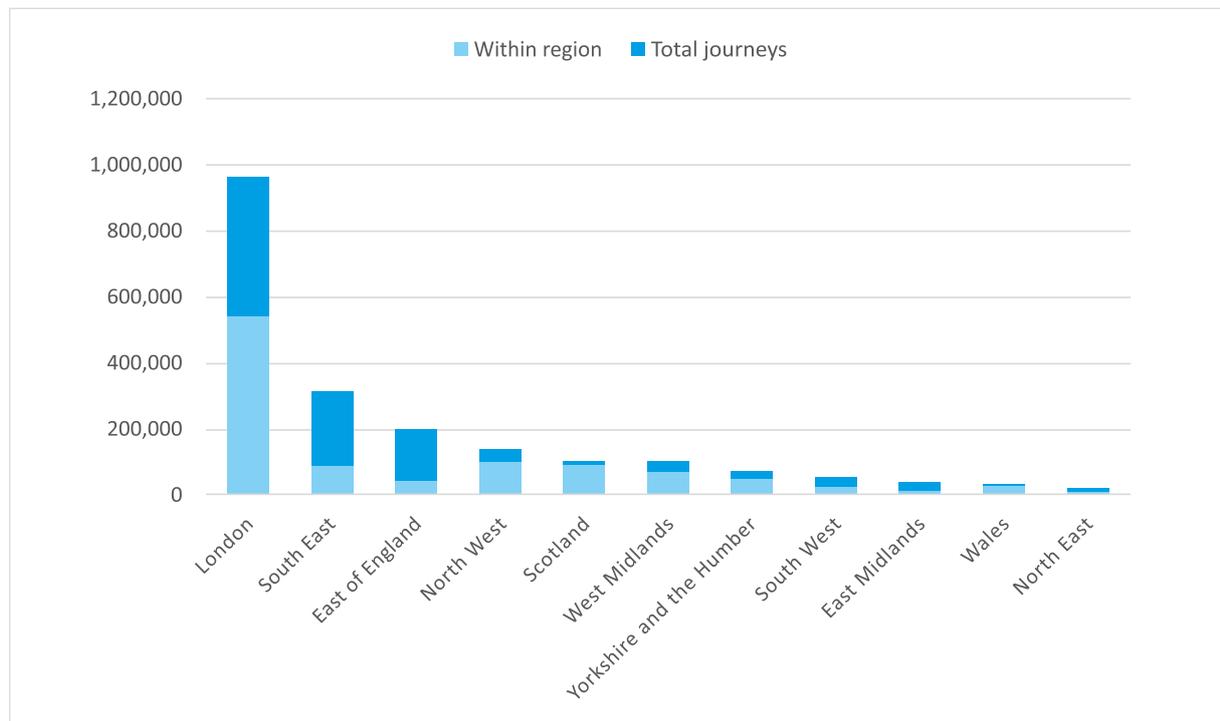
As we set out in Chapter 1 of this report, the impact of the Covid-19 outbreak is likely to exacerbate the regional disparities which the Government committed to tackling in its manifesto last December.

Those regions which have lost out in the economic game over recent decades

should be able to benefit from a thriving private sector, good jobs, higher wages and inward investment.

Part of the reason London is able to garner significant agglomeration benefits is because it is so well connected, both within the city itself and with other regions. More intra-regional rail journeys were taken in London in 2018-19 than within all the other regions of the UK combined.

Rail journeys in 2018-19 by UK region



Source: Office of Rail and Road, Regional Rail Usage, Annual Data Tables, Table 15.13, [link](#)

It is striking that the other great cities and towns of the UK are significantly less productive than comparable conurbations in other advanced economies. One familiar statistic is that GVA per worker is 30 per cent lower in Birmingham than in Lyon.⁶⁴ Improving the transport infrastructure mix for travel to, from and perhaps most crucially within those urban areas is key to improving their economic performance.

Of course, the graph above also reflects the fact that outside London most people

do not use trains regularly and road travel tends to dominate. Some have argued that there has been too much focus on railways in the levelling up debate, and to an extent we agree with that assessment: given that most train journeys are taken by a minority of people who are disproportionately affluent and disproportionately South-Eastern, levelling up cannot just be about big new railway lines.

However, at the same time, it's important to remember that in a way what we actually

64 Centre for Cities, 'City factsheet: Birmingham', [link](#)



want is for more people in the regions to resemble the affluent commuters of the South East. Successful regions tend to have reliable rail transport options for people to commute to high-end jobs and meet with other thriving businesses and people, so rail investment has to be part of the answer for levelling up.

It shouldn't be an either/or debate, and neither is it about saying 'Let's just build everything!'. What we need is a complementary mixture of transport solutions, thinking intelligently about what works for individual places and people, and crucially also about how different parts of the infrastructure network interact.

For example, some who have suggested the money spent on HS2 would be better spent on connecting our northern towns and cities through the proposed Northern Powerhouse Rail programme seem not to appreciate that those plans are contingent on the completion of HS2. The whole point of Northern Powerhouse Rail is to connect the new HS2 hubs with as many places across the North as possible to maximise the benefits – it is intended to complement HS2, not as an alternative to it. Indeed, ensuring that plans for wider investment in the Midlands and North are complementary to the HS2 project is the main purpose of the Integrated Rail Plan currently being developed.⁶⁵

Yet even after a significant expansion of rail provision, regular rail travel still isn't going to be an option for many. While only 28 per cent of Londoners drive to work, 80 per cent of people in the West Midlands do and 76 per cent in the North West.⁶⁶ One of the easiest wins for public investment, therefore, is a major programme to improve our roads.

The NIC has pointed out that our roads have been neglected, with six per cent of urban A roads in poor or very poor condition, and

that this is a false economy as it often means roads need to be closed for emergency repairs. There is an opportunity to frontload the £500 million per year Potholes Fund announced at the Budget to take advantage of lower traffic levels while social distancing and widespread working from home are still in place. Full road resurfacing is also preferable to simply filling potholes when it comes to long-term resilience, and such work can be organised relatively quickly compared to other infrastructure decisions. **We recommend that the Government changes its road improvement plans to bring forward as much spending as possible to 2020.**

Cities like Birmingham, Manchester and Leeds need investment in roads and bus services both to improve existing routes and increase capacity, and to connect more people with the city. They should also be able to benefit from the level and quality of intra- and inter-city rail connectivity, plus light-rail and trams where appropriate, that the citizens of the most successful and productive cities in the developed world have been enjoying for decades.

When a town or city does not have adequate transport connections, its size is effectively reduced. Tom Forth of the Open Data Institute has used data on bus journeys in Birmingham to estimate that, if we define the size of the city as the number of people who can reliably get to the city centre within 30 minutes during peak time, then Birmingham is really only a city of 0.9 million rather than its official population of more than twice that.⁶⁷ We are wasting the potential of our urban areas by not enabling the agglomeration effects which lead to higher productivity. The chart on the following page, shows there is a clear correlation between the average distance people in different regions travel to work and output per head.

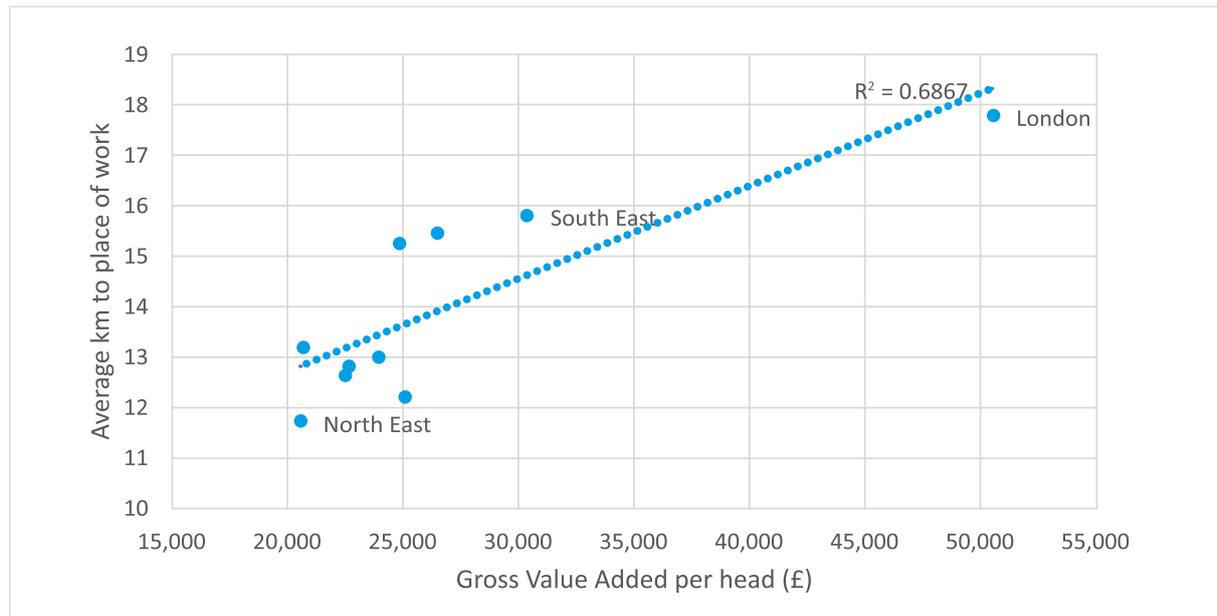
65 Department for Transport, 'Terms of reference for an integrated rail plan for the north and midlands', [link](#)

66 Department for Transport, 'Modal comparisons (TSGB01): Usual method of travel to work by region of residence', [link](#)

67 Productivity Insights Network, 'Real Journey Time, Real City Size, and the disappearing productivity puzzle', [link](#)



Correlation between distance travelled to work and GVA per head by UK region



Source: ONS, Regional gross value added (balanced) per head and income components, 2018 data, [link](#); UK Data Service, Total and average distance travelled to place of work - Local Authority and above, 2011 Census Data, [link](#)

There is a crucial point to be made from this. The levelling up agenda is not simply about a more ‘just’ distribution of prosperity between regions - it is a vital part of solving the UK’s productivity puzzle. It’s not just a case of choosing to redirect investment outside the South East for the sake of fairness or for some political agenda around the former ‘Red Wall’. Levelling up is an economic decision based on recognising that we have towns and cities with massive untapped potential which are underperforming compared to their European counterparts due to lack of investment.

This is also not just about transport. The pandemic has shown how modern technology can enable new modes of working and that good digital connectivity is vital for economic resilience. For our left-behind regions to thrive we need to invest in world-leading digital infrastructure. **The National Infrastructure Strategy should set out a fully funded path for achieving the manifesto commitment of full**

coverage of full fibre and gigabit-capable networks in every part of the country by 2025. We should also set an ambition to have a full fibre national network by the end of the decade. Other large nations, such as Japan and Spain, are far ahead of us on digital connectivity - we need to put that right as quickly as possible.

Another regional imbalance which must be addressed is on research and development. Recent analysis from Nesta has shown that public spending on R&D is actually more concentrated in the South-East than private sector R&D spending. In particular, London, Oxford and Cambridge account for 46 per cent of public R&D spend but just 31 per cent of business R&D spend.⁶⁸ The commitment at the Budget to increase R&D spending to £22 billion a year by 2025 is welcome but this should be seen as an opportunity to level the playing field. **The Government should target increased public R&D investment on new geographies and new opportunities, rather than entrenching existing spending disparities.**

68 Tom Forth and Richard A.L. Jones, ‘The Missing £4 billion: Making R&D work for the whole UK’, [link](#)



Pushing forward devolution

The best people to make decisions about the right mix of infrastructure investment in our cities and regions - and about many other issues too - are those closest to them. We have seen some major changes in the UK in recent years, with moves towards business rates retention for local authorities and the development of combined authorities and eventually metro mayors empowered by City Deals. This has been a huge success, with mayors such as Andy Street in the West Midlands and Ben Houchen in Tees Valley leading the way in a new generation of enhanced local leadership.

The Government has rightly recognised that we should build on this success and devolve deeper and wider. In the Conservative manifesto we committed to publishing an English Devolution White Paper in 2020, but with the disruption of the pandemic this risks being delayed. It can take years to develop the detailed plans involved when transferring responsibilities to entirely new institutions. **Local leadership should play a major role in the expanded programme of public investment, and there should therefore be as much haste as possible in developing a renewed agenda for English devolution; the promised White Paper must be published as soon as possible this year.**

This should focus both on increasing the powers of existing devolved authorities and expanding those models which have proved successful to more areas. Even taking account of the West Yorkshire City Deal signed in March, nearly 60 per cent of the population of England are still not going to be benefitting from a devolution deal.⁶⁹ **We need to make sure we have the right powers at the right level, for example by devolving more powers to unitary authorities and extending the reach and**

coverage of devolved mayoralities and combined authorities.

As part of this, the Government should ensure that the influence and powers of local areas and metro mayors specifically relating to capital expenditure decisions are a priority consideration. There should be a clear plan for how to integrate the roles of new devolved bodies with both the new British Infrastructure Bank and newly strengthened National Infrastructure Commission. Currently only 36 per cent of investment spending is managed by sub-national bodies in the UK, compared to 51 per cent on average across OECD countries.⁷⁰

If devolved bodies are to play their part in delivering the National Infrastructure Strategy and driving the return to growth, they also need to be able to rely on the same level of expert advice and evidence base which central government can. **The Government should provide dedicated funding for combined authorities to expand their capacity to assess the economic benefits of potential investments, present reliable business cases, and actually deliver projects. This could include plugging them into the roles of the existing Infrastructure and Projects Authority and the Major Projects Leadership Academy.**

Part of the role of devolved bodies will be to make the case to central government for projects in their area, as will already happen with the new intra-city transport settlements announced at the Budget. But this cannot just be about Whitehall waving its wallet over the heads of metro mayors and seeing who can jump highest and shout loudest. Local bodies should also be able to both raise funds themselves and to borrow against future revenue streams, just as Transport for London can.

⁶⁹ Akash Paun, James Wilson and Elspeth Nicholson, 'English devolution: combined authorities and metro mayors', [link](#)

⁷⁰ Andrew Bailey, Richard Hughes, Lindsay Judge and Cara Pacitti, 'Euston, we have a problem: is Britain ready for an infrastructure revolution?', [link](#)



There are already examples of success we can draw on from outside London. The Greater Manchester Combined Authority (GMCA) set up Transport for Greater Manchester (TfGM) to bring together local transport responsibilities under a single strategic body. As part of their funding settlements with TfGM, the GMCA have used their borrowing powers to finance extensions to the Metrolink, and a portion of the revenue stream from running the Metrolink is then allocated to covering the financing costs associated with the investment.⁷¹ **The Government could extend the borrowing powers of combined authorities by lifting borrowing limits and allowing them to use ‘tax increment financing’ to borrow against future revenues. It could also explore innovative ways for central government to allow sub-national bodies to benefit from the record low borrowing costs it currently enjoys.**

Greater Manchester also benefits from an ‘earn back’ arrangement. Central government provides an ongoing revenue stream of grant funding for Greater Manchester based on additional tax revenues generated from previous infrastructure investments. This provides a ‘revolving infrastructure fund’ for reinvesting revenues in future projects, as well as giving GMCA an incentive to choose the most economically beneficial investments. This was how the Trafford Park extension of the Metrolink was funded. **‘Earn back’ arrangements should become the norm in all city deals.**

Devolved authorities could also be given more opportunities to capture some of the value uplift resulting from projects, by giving them more flexibility with how they can levy precepts on local rates, as suggested in the NIC’s National Infrastructure Assessment in 2018.⁷²

Reform planning

Our planning system is holding back housing supply and contributing to low productivity and declining rates of home ownership.

Building more and better homes is an absolutely vital part of the economic jigsaw. That is why it is so encouraging that the Government is reportedly treating this issue as a priority. The Planning White Paper that is due to be published should now be seen as an opportunity to increase housebuilding to boost the economic recovery and to massively simplify and rationalise the planning system.

Our view is that **national and local planning regulations should focus on minimum housing supply, broad land uses and associated transport infrastructure, basic design codes, and guidance on significant alterations to existing properties (where these affect neighbours)**. An overhauled system should also be as rule-based as possible, limiting the discretionary powers of councils and policymakers – and thus bringing us into line with most other countries.

Businesses will need to make adaptations to their premises and potentially construct extensions to allow them to operate with social distancing measures. We should take this opportunity to bring more flexibility into our planning system, both to help cope with the current crisis and to allow greater freedom for improvements in the future. Permitted development rights allow improvements or extensions to be made without the need to seek planning permission. **We recommend the Government reviews permitted development rights with a view to broadening the scope of these rights to allow more work to be carried**

71 Transport for Greater Manchester, Greater Manchester Combined Authority and Greater Manchester Local Enterprise Partnership, ‘Greater Manchester Transport Strategy 2040: Draft Delivery Plan (2020-2025)’, p80, [link](#)

72 NIC, ‘National Infrastructure Assessment 2018’, p121, [link](#)



out without the burden of going through the planning process. Ministers should be prepared to speedily amend the legislation to facilitate this. In addition to this, **Covid-related adaptations to increase capacity for social distancing should be fast-tracked for planning permission, and the Government should provide a specific grant for small businesses to adapt their properties in this way.**

The Government is currently consulting on reforming our approach to development corporations.⁷³ A development corporation can be an excellent model for delivering regeneration and new housing supply, combining long-term public sector commitment and powers with private sector involvement, expertise and investment. Legislation now allows combined authorities to set up their own development corporations, which Tees Valley has already done.

We recommend the Government encourages a new generation of development corporations by developing a template model for their creation and giving greater autonomy to local areas and combined authorities to allow them to do so. All development corporations should be given the powers of a local planning authority to coordinate planning and manage development. They should be able to capture value from planning uplift through Section 106 payments and Community Infrastructure Levies and reinvest this in local development.

The housing crisis cannot be solved by piecemeal additions here and there. **We also need to think imaginatively about new towns and garden cities.**

Our approach to the green belt also needs to change. It is right that some areas are protected and we should maintain the existing protections for green belt land. But in many areas land that is classified as green belt is of very poor quality or is inaccessible. Work by the London Chambers of Commerce and Industry found that London's metropolitan green belt contains derelict and unused land equivalent to 500 football pitches, capable of accommodating 20,000 homes.⁷⁴

Nobody wants to see the green belt concreted over or protections removed - but local authorities and local communities currently find it almost impossible to get green belt plots reclassified even when there is an overwhelming case for doing so and strong local support. The current process is arduous and long, involving a requirement to review green belt for the entire area - and even then can simply be quashed by the Secretary of State. **So to fast-track reclassification of green belt where it is both necessary and popular, the Government should allow reviews of specific plots without the need to review the entire area. MHCLG should publish clear guidance defining the criteria for reclassification to give local authorities confidence that the process is worthwhile, and should commit to significantly shortening the average time from application to resolution.**

73 p42, after sentence "The Government is currently consulting...", insert reference 73 Ministry of Housing, Communities and Local Government, 'Development corporation reform: technical consultation', [link](#)

74 p42, after "20,000 homes" insert reference 74 London Chamber of Commerce and Industry, 'Building on poor quality green belt would help solve housing crisis says business survey', [link](#)



Chapter 5: Employment and Enterprise

Our Recommendations

A drive for better data

The Treasury and BEIS should urgently form a joint Covid-19 Data Taskforce to coordinate between policymakers and statisticians.

The DWP and HMRC should conduct an assessment of what real-time data from their systems could reasonably be collated and published to help monitor economic trends during the recovery.

Jobs

Substantial temporary reductions in Employer's National Insurance – we set out a range of options for how this could be done.

A one-year reduction in VAT.

Business investment

Introduce full expensing in the UK through an unlimited Annual Investment Allowance.

Let companies immediately 'cash out' any accumulated tax credits or deductions.

Tighten limits on interest deductibility and reduce companies' ability to carry forward interest expenses.

Improvements to business premises, or construction of new ones, should be disregarded in business rates valuations.

Working with the Bank of England, the Government should consider introducing a 'bad bank' scheme.



Regulation

A moratorium on all new non-urgent regulation on business, and a cross-government review of which regulatory measures could be delayed or waived.

Regulators should help pave the way for innovations to be brought to market through regulatory support for firms and automatic updating to accommodate new technologies and concepts.

Reform Britain's bankruptcy rules, making it easier for firms to restructure, keep paying workers and prevent creditors from forcing a premature shutdown with layoffs.

Relax regulations on childcare provision in order to allow the flexibilities, and much lower costs, which are the norm in most other European countries.

Skills

The types of training which qualify under the apprenticeship levy should be broadened, perhaps evolving it into a 'skills levy'.

A time-limited labour market programme focused on young people living in unemployment hotspots.



A green recovery

A major programme of incentives for households to replace older boilers.

A car scrappage scheme, with a discount on new electric or hybrid cars if the purchaser is replacing a diesel or older petrol car.

Bring forward existing commitments to significantly increase coverage of electric charging points.

Openness

A visa scheme to automatically allow recent graduates from the top 50 academic institutions globally into the UK for work and research.

Any restrictions on overseas investment must be strictly related to national security and/or public health needs.

A time-limited, tax-efficient investment vehicle to give people a strong incentive to bring money into the UK from overseas.

Seek to agree the widest possible trade deals with the United States and other countries to increase trade volumes and open up new markets for UK exports.



Introduction

Infrastructure investment from government is important - but its purpose and value is in providing the best possible environment for businesses to create jobs, to invest, to innovate. One of the fundamental principles of this report, and any plan for recovery, is that it is only the enterprise and innovation of the private sector which can lift us out of this crisis and deliver the growth we need.

But for that to happen, we need to make sure that the tax and regulatory environment is geared towards growth.

Low-tax Conservatives are not just averse to taking money from people who have worked hard for it, much as that instinct is strong. They recognise that if we are to compete in the modern, global economy, we need to be a country which attracts investment and rewards hard work and enterprise. We also need to give businesses the flexibility and freedom to participate efficiently in competitive markets – for it is only by harnessing the power of markets that we will rebuild our economy.

Britain has millions of businesses of all shapes and sizes. They are the backbone of our economy. Many are now struggling through a period of severe and unexpected shock, in which economic activity has been deliberately limited in response to the public health crisis.

As we saw in Chapter 1, and we are seeing every day in the data, a modern economy cannot simply shut down for half a year and then return to how things were before. As businesses fold, jobs are lost and investments are cancelled, permanent damage is done. This section will set out how the Government should be looking to galvanise the private sector, ensuring businesses can not just survive but thrive.

A drive for better data

The first crucial point to understand is that we are in completely uncharted waters. This is an economic crisis the likes of which we have never seen before. We simply do not know what the ultimate impact of the lockdown measures will have been on the economy, nor do we know the extent to which behaviours such as social distancing will persist even after measures are eased and how this will affect businesses.

That means that monitoring the recovery and collecting as much immediate and detailed data as possible should be an absolute priority. The ONS has been doing some excellent work on this already with its fortnightly Business Impact of COVID-19 Survey and other rapid response surveys,⁷⁵ as well as developing new indicators such as using data from online job search website Adzuna to estimate vacancy rates.⁷⁶ The Resolution Foundation has also carried out work designed to 'plug the gap' left by traditional economic indicators which are not timely enough to be of any use to policymakers during the fast-moving crisis.⁷⁷

Good data is vital for forming opinions and developing policy. Even in normal times, there are sometimes surprising gaps in our evidence base, which places limits on government's ability to make informed decisions. Often the best indicators are not available for some time, so that decisions are being made in 2020 based on statistics which may only reach up to 2018.

Given there has been so much sudden, dramatic and unpredictable change in the last few months, it will be more important than ever to have reliable and up-to-date data. It is notable, for example, that we

⁷⁵ ONS, 'Coronavirus and the latest indicators for the UK economy and society: 4 June 2020', [link](#)

⁷⁶ ONS, 'Using Adzuna data to derive an indicator of weekly vacancies: experimental statistics', [link](#)

⁷⁷ Jack Leslie and Charlie McCurdy, 'The economic effects of coronavirus in the UK: Utilising timely economic indicators', [link](#)



spent the first few months of the lockdown having little clue of what was really happening to unemployment because of the time lag on the official statistics; the Resolution Foundation used Google search term data to give an indication of job losses.

The Treasury and the Department for Business, Energy and Industrial Strategy (BEIS) should urgently form a joint Covid-19 Data Taskforce to coordinate between policymakers and statisticians. This would be designed to allow officials, advisers and ministers to quickly communicate what information they need to inform policy responses and ensure policy is based on the best possible evidence. This could involve commissioning new experimental statistics and exploring how to disaggregate existing indicators to give a more detailed picture of geographic, demographic and sectoral variations. The Taskforce would also consider how best to engage with actors on the ground to gather qualitative evidence, and share information and lessons learnt with industry to quickly disseminate best practice.

We are fortunate to have the Universal Credit system in place. It is perhaps the most advanced digital benefit system in the world, and its use of real time information (RTI) is invaluable for a number of reasons. First, it allows the payment system to respond quickly to falls in a claimant's income, where the legacy tax credit system would not have picked up those changes until next year. Second, the system has coped admirably with the flood of claims. Third, the speed and detail with which the UC system collects data can be a crucial tool for monitoring the economic impact of the pandemic and planning for the recovery.

The Department for Work and Pensions (DWP) has already been publishing some ad-hoc UC management statistics during the lockdown to illustrate the increase in claims.⁷⁸ HMRC have also recently published experimental statistics using RTI from the Pay As You Earn system.⁷⁹ **The DWP and HMRC should conduct an assessment of what real-time data from their systems on claims, earnings, employment status and other areas could reasonably be collated and published and be useful for monitoring economic trends during the recession and recovery.**

Jobs

With the unemployment rate already having risen rapidly, and with many more jobs at risk once the Job Retention Scheme is wound down, we could be facing a joblessness crisis which blights a generation. We have to do everything we can to support employment - but we are also now at the stage where we need to be shifting from simply maintaining the labour market as it was pre-pandemic towards allowing it to evolve.

That means we need to strike a delicate balance, making sure firms are given every possible opportunity to keep people on while they work through this period of difficulty, while reducing the extent to which the Government is actively paying wage bills, ultimately to zero. We want as many people as possible to keep their jobs, but some churn in the jobs market is also necessary for the economy to adjust to a changed world - so we should also be encouraging firms in healthier sectors to get hiring and quickly soak up those who have lost their jobs.

In the context of the pandemic, tax measures are an attractive policy tool

⁷⁸ Department for Work and Pensions, 'Universal Credit declarations (claims) and advances: management information', [link](#)

⁷⁹ HMRC and ONS, 'Earnings and employment statistics from Pay As You Earn (PAYE) Real Time Information (Experimental Statistics)', [link](#)



because they are much quicker and easier to implement than creating new bureaucratic government schemes. They are also a way of rapidly increasing demand.

If we want to support and stimulate employment, then axiomatically the best option is to cut the payroll tax - Employer's National Insurance. Tax employment less, and all other things being equal you will end up with more of it.

There is plenty of academic literature to support the positive impact on employment rates of reducing non-wage labour costs, of which employer NICs make up a significant proportion in the UK.⁸⁰ The biggest bang measure we could take would be to eliminate them altogether - but given that Employer's National Insurance contributes approximately £80 billion to the Exchequer every year, this is impractical.⁸¹

There are however a range of measures to choose from (including significantly raising the threshold or simply cutting the rate), and **we urge the Treasury to evaluate which will do most to maintain and stimulate employment.**

For example, some firms may want to keep staff on because they are confident business will return, but are going to struggle with costs in the meantime, especially when the furlough scheme is withdrawn. The Government has already increased the Employment Allowance, which gives businesses a discount on their NICs bill, from £3,000 to £4,000. The Chancellor could bring in a substantial increase to this allowance for SMEs to, say, £20,000 to massively reduce the tax bills associated with keeping people in employment. This would cost around £7

billion using the current rules, although the Government could also consider widening eligibility to larger employers as well.

Another option would be to temporarily raise the threshold above which employers pay NICs from the current £8,788 per year to £12,500, in line with the income tax personal allowance. The annualised cost of this would be roughly £13 billion, but could make a big difference as a temporary measure, reducing the cost of employing any full-time employee by more than £500.⁸²

In other countries, such as the Netherlands, the equivalent of our JRS support has been based on looking at how much a firm's revenue has fallen since the outbreak of Covid-19.⁸³ Another option, targeted particularly at firms in sectors such as hospitality and tourism, would be to offer a complete NICs holiday until April 2021 to firms with fewer than 250 employees who have seen a fall in quarterly revenue of more than 25 per cent. This would strike a balance between helping firms with labour costs in the short term while trying to ensure employers are only retaining jobs they believe will still be viable once measures have been eased.

It is also imperative that new jobs are being created as fast as possible and there are opportunities for those people who have lost their jobs to find new work. This could be encouraged via a two-year complete employer NICs holiday for all net new hires, effective immediately. This would give employers an incentive to take on new staff by lifting all newly created jobs out of employer NICs. To prevent employers laying off and rehiring, it should only apply to net job creation, with rehires of employees not qualifying. Obviously the cost would depend on how many new

80 Raul Ramos, Enrique López-Bazo, Carlos Vacas, Vicente Royuela, Rosina Moreno, Christian Dreger, John Hurley and Jordi Suriñach, 'Employment effects of reduced non-wage labour costs', [link](#)

81 OBR, 'Economic and Fiscal Outlook, March 2020: supplementary fiscal tables – receipts and other', Table 2.4, [link](#)

82 Cost of Employment Allowance increase based on policy costing of the £1,000 increase in the Employment Allowance announced at Budget 2020; cost of increasing the employer NICs threshold based on Treasury ready reckoners, [link](#)

83 Netherlands Enterprise Agency, 'Corona crisis: temporary emergency bridging measure NOW', [link](#)



jobs are created, but given the employer NICs bill for a worker on average wages is around £3,000 per year, a rough estimate would be £3 billion per million jobs.⁸⁴

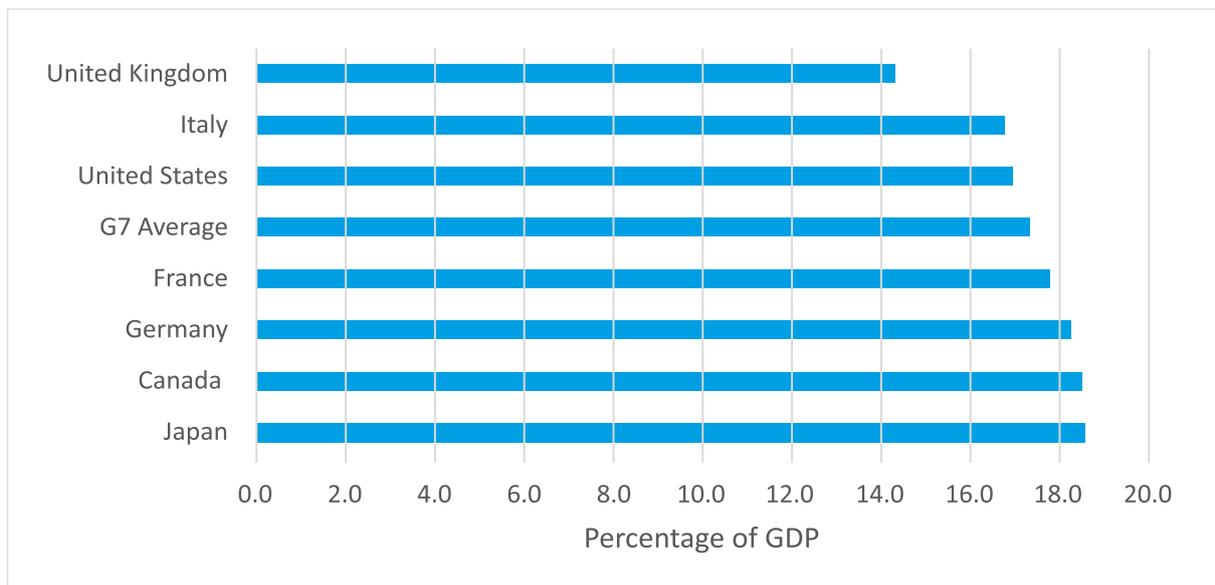
Finally, supporting employment is also about ensuring businesses remain viable, which will require supporting consumer demand at a time when many will be cautious about spending. **To provide a temporary boost to consumer spending and support economic activity and employment, the Government should consider a one-year reduction in VAT, as happened in the wake of the financial crisis.** A cut from, say, 20 per cent to 17 per cent would cost around £21 billion, but as a one-off fiscal hit to give consumers more bang for their buck, it could be a vital tool for ensuring businesses can weather the storm and retain staff.⁸⁵

Business investment

In the last chapter, we focused on the need to increase public sector investment - but one of the UK's other great economic problems is its relatively low levels of private sector investment. While this has been exacerbated by Brexit uncertainty in recent years, the phenomenon is not new. It is also, for many economists, a key explanation of the UK's equally disappointing productivity performance.

The chart below shows that between 1997 and 2017 levels of spending on gross fixed capital formation (a measure of net investment) by the private sector were lower in the UK than in any other G7 economy. And the present incredible uncertainty about the future, thanks to the pandemic, will weigh on investment decisions even more.

Average non-government spend on Gross Fixed Capital Formation, 1997-2017



Source: ONS, An international comparison of gross fixed capital formation, November 2017, Table 2, [link](#)

⁸⁴ Based on average weekly earnings of £585 per week; ONS, 'Employee earnings in the UK: 2019', [link](#)

⁸⁵ HM Revenue and Customs, 'Direct effects of illustrative tax changes', [link](#)



Again, the tax system is the best way to solve this problem, and give firms a reason to invest again. That is particularly important because the UK has one of the least investment-friendly regimes of any major economy when it comes to the way our corporate tax system treats investment spending by firms.⁸⁶

Capital allowances can have a much more positive impact on growth than a simple cut in corporation tax rates because they specifically incentivise investment spending. The US-based Tax Foundation has found that, per dollar of forgone revenue, full expensing for capital expenditure can have a growth effect double that of cutting the headline corporate tax rate. A UK study in 2016 from the Oxford University Centre for Business Taxation found that access to more generous capital allowances for SMEs pre-2008-09 increased the investment rate by 11 per cent.⁸⁷

Under our current regime, the Annual Investment Allowance (AIA) allows firms to write-off a certain amount of investment spending on plant and machinery each year for tax purposes. The AIA is currently set at a temporarily high level of £1 million but is due to fall back to £200,000 at the end of this year.

The potential benefits of more generous capital allowances are so great that, given our need for radical policies to turbocharge investment and growth, we recommend introducing full expensing in the UK through an unlimited AIA.

The initial costs of this to the Exchequer would be high, as you would effectively be bringing forward tax allowances from future years. However, the costs diminish significantly over time - and this should be considered in the context of having already accepted borrowing this year

will necessarily be on an unprecedented scale to bridge the economy through the pandemic.

Calculations by the Centre for Policy Studies show that an unlimited AIA would under normal circumstances cost the Treasury around £10 billion of revenue in the year after it was introduced - but this would fall to approximately £1.5 billion a year, which does not include the benefit of the increase in economic activity it would generate.⁸⁸ Bringing in this reform at a time when economic activity is depressed due to COVID-19 would also be substantially cheaper than when the economy is firing on all cylinders. However, this should not be just a temporary post-Covid measure, but a permanent reform to boost investment levels (and thus productivity) over the long term. **At a bare minimum, the £1 million AIA should be made permanent.**

One way to boost businesses now, while also smoothing the transition to a corporate tax system based on full expensing, would be to **let companies immediately 'cash out' any accumulated tax credits or deductions** that they could otherwise use in future years.⁸⁹ Instead of, say, rolling forward losses for several years, or gradually deducting past investments through the existing system of capital allowances, businesses would be able to opt for an immediate payment equivalent to 19 percent of the accumulated total (reflecting the corporation tax rate). The up-front cost of such a policy could be significant, and the government may want to put a cap on how much can be claimed. But, importantly, you would only be bringing future tax deductions forward to the present day – this proposal does not affect the government's long-term

⁸⁶ Elke Asen, 'UK Taxes: Potential for Growth', [link](#)

⁸⁷ Giorgia Maffini, Jing Xing, Michael Devereux, 'The impact of investment incentives: evidence from UK corporation tax returns', [link](#)

⁸⁸ Centre for Policy Studies, 'A Budget for No Deal', [link](#). Estimates have been amended to reflect the decision to maintain the corporation tax rate at 19 per cent.

⁸⁹ For more on this idea (in the US context) see Scott A. Hodge et al., 'Tax Policy After Coronavirus: Clearing a Path to Economic Recovery', Tax Foundation (April 2020), [link](#)



fiscal position in any meaningful way. There is precedent for this, as a similar principle already exists for claiming R&D tax credits for expenditure on intangible assets.⁹⁰

To complement these reforms and to offset some of the costs, we should tighten the rules on tax deductibility of interest for companies. Companies can currently reduce their tax bills by offsetting profits against debt financing costs, and this encourages companies to take on debt in the UK while offshoring profits to minimise tax liability.⁹¹ **The Government should tighten limits on interest deductibility (currently set at 30 percent of earnings before interest, tax, depreciation and amortisation or EBITDA) and reduce companies' ability to carry forward interest expenses.**

This combination of measures would be designed to shift incentives in favour of greater equity-financed investment in jobs and growth in the UK.

Businesses should also be encouraged to invest in their premises. Considering social distancing may require some firms to build extensions or find other ways to increase the capacity of their premises, **we suggest that any improvement of business premises, or construction of new ones, should be disregarded for the purposes of business rates valuation.** While this policy could be limited to the immediate recovery period after coronavirus, it would ideally prepare the ground for much broader reform of the business rates system as part of the Government's upcoming review.

Bank lending is another crucial component of business growth. The Bank of England's Financial Policy Committee published an interim Financial Stability Report to assess the risks to UK financial stability from the pandemic.⁹² Given that UK banks have

dramatically increased capital since the 2007-8 financial crisis, it was not surprising that the report concluded that the UK banking sector is stable and resilient, and can withstand this economic shock. We need banks, however, to be more than stable. To support the economic recovery we need a banking sector that is proactively lending to businesses, without government guarantees. Given the losses that banks are expecting on their existing portfolios, it is unlikely that banks will adopt such a proactive position soon. **Therefore, working with the Bank of England, the Government should consider introducing a "bad bank" scheme.** Such a scheme would offer banks support with loans that have become non-performing as a direct result of the lockdown in exchange for increased bank lending to business, especially privately owned non-financial enterprises.

Regulation

When firms are struggling through an unprecedented situation like this, the last thing they need is new red tape. We need to ensure that the regulatory burden on business is as limited as possible while the economy gets back on its feet. We also need to get better at how we do regulation in this country, creating a pro-business, pro-innovation environment for the long-term.

Some of the measures already announced by the Government are very welcome, such as deferring the introduction of new IR35 reporting requirements until next year. However, we need to go further: **there should be a moratorium on all new non-urgent regulation on business.** In addition, **we suggest that BEIS lead a cross-government review both of what scheduled new measures affecting businesses could be delayed to 2022, and what existing rules could be temporarily waived.**

90 Forrest-Brown, 'Intangible assets and R&D tax credits', [link](#)

91 HM Revenue and Customs, 'Corporation Tax: tax deductibility of corporate interest expense', [link](#).

92 Bank of England, 'Monetary Policy Report and Interim Financial Stability Report - May 2020', [link](#)



In the longer term, the UK's regulatory regime needs to be geared towards accommodating innovation and change. The UK has the opportunity to be a world leader in a number of high-growth technology sectors such as artificial intelligence and life sciences, but innovative new products and services can pose challenges for regulatory regimes.

Firms need to know how their innovations will fit into the regulatory environment and that they will not be held back by out-of-date rules. The Financial Conduct Authority (FCA) have been doing some great work in recent years on helping innovative firms bring products to market through advice and 'regulatory sandboxes', which allow firms to test new concepts and products in a controlled environment with supervision and advice from the regulator. To build on good work such as this, **the Department for Business, Energy and Industrial Strategy should help pave the way for innovations to be brought to market through regulatory support for firms and automatic updating of regulations to accommodate new technologies and concepts.** This could be done directly through a cross-regulatory 'single entry point' for innovators, as proposed by Nesta, or via sectoral regulatory bodies. We need regulators to channel their inner Gromit, constantly laying down the new track in front of it to allow the innovation train to speed onwards, embedding a system-wide 'anticipatory regulation approach'.⁹³ This initiative could also bring together the various regulatory sandboxes under one roof and host the sort of digital sandbox currently being piloted by the FCA.⁹⁴

The UK's insolvency laws are also not ideal in the current circumstances, and we should consider relaxing the rules to reduce the power of creditors and give firms

more breathing space. The Government has already announced some relaxations to waive the 'wrongful trading rule' under which directors can be prosecuted if they know the business is insolvent but choose to continue trading. We welcome this but think there is scope to go further. **We need to reform Britain's bankruptcy rules with a US-style Chapter 11 provision, making it easier for large firms to restructure, keep paying workers and prevent creditors from forcing a premature shutdown with layoffs.**⁹⁵ Trading would still take place under the supervision of the court, and firms would have greater opportunity to reorganise and make themselves viable. **We should also strengthen the concept of 'debtor in possession'.**

Some of our regulations are also increasing the cost of living for households by restricting supply or imposing overly strict standards requirements. For example, regulations on childcare are unnecessarily inflating costs for working families through restrictions on how many children each carer can legally be responsible for and excessively high qualification requirements. A Government review in 2016 concluded that *'the rigid application of the ratios and – depending on qualifications – who, and who isn't able to be counted within the ratios is having a negative impact on the potential growth and flexibility in the sector'*, but previous plans to relax the rules were dropped after opposition from the sector.⁹⁶ **We would support relaxing regulations on staff to child ratios in childcare, and reviewing qualifications guidelines, in order to allow the flexibilities, and much lower costs, which are the norm in most other European countries.** This would also make it easier for parents to return to the workforce, further strengthening the recovery.

93 Nesta, 'Renewing regulation: "Anticipatory regulation" in an age of disruption', [link](#)

94 FCA, 'Digital sandbox – coronavirus (Covid-19) pilot', [link](#)

95 Jones Day, 'Comparison of Chapter 11 of the United States Bankruptcy Code and the System of Administration in the United Kingdom', [link](#)

96 HM Government, 'Cutting Red Tape: Review of childcare', [link](#)



Skills

There will undoubtedly be a long-term impact from the pandemic on the nature of work and the labour market. The rapid shift to remote working and learning, and even greater focus on sectors such as digital and software, will change the skills people need to succeed in the labour market. Employers will also want to ensure they can bring their existing workforce along with these new trends through training and development.

The current operation of the apprenticeship levy is not working as it should. Employers are paying billions every year into their apprenticeship levy accounts but only around 10 per cent of the funds are actually being drawn on for apprenticeships, because the restrictions on what the money can be used for prevent many firms from being able to use the funds.⁹⁷ **To give employers more flexibility to re-skill their workforces after this crisis, the types of training which can qualify under the apprenticeship levy should be broadened substantially, perhaps even reforming the levy into a broader 'skills levy'.**

There also needs to be a strong focus on youth unemployment. Recessions are always worst for those who are new to the labour market, who find their careers permanently scarred. Coronavirus makes this that much worse as the sectors that are worst affected, such as hospitality, tend to be those where many young people get their start. We need to make it as easy as possible for them to find work. It is reported that the Prime Minister has ambitious plans on this score, but we would certainly **support a time-limited labour market programme focused on young people living in unemployment hotspots.**

A green recovery

It is not an exaggeration to say that we are effectively going to be rebuilding our economy after this crisis. With that in mind, it makes sense to build back in a way that prepares us for the future, and that means building a greener economy. The Conservatives are committed to Net Zero greenhouse gas emissions by 2050 - and while they hope to achieve this in ways that maximise the economic and environmental benefits, they have also recognised there will be costs involved in the transition, in particular in terms of infrastructure investment.

The economic recovery therefore provides an opportunity to use the need for investment and transition to greener technologies to drive growth and create jobs. A recent CPS report, for example, focused on the potential of hydrogen both as a way to decarbonise heavy vehicles and as a potential source of jobs and growth.

One of the major areas where we need to reduce emissions is domestic heating - and one of the major obstacles to reducing household emissions is the upfront capital cost of installing a new boiler. Newer, more efficient boilers and heat pumps can substantially reduce energy usage, saving consumers money while also saving the planet. **The Government could establish a major programme of incentives for households to replace older boilers.** This could take the form of generous interest-free finance to cover new boilers or heat pumps and their installation, with repayments based on the savings the household enjoys going forward.

⁹⁷ House of Commons Library, 'Apprenticeships and skills policy in England', [link](#)



This might also be a good opportunity to move more people to greener vehicles by providing incentives to buy a new electric or ULEV car. **The Government could work with the automotive industry to develop a car scrappage scheme, offering a discount of perhaps £3,000 on any new electric or hybrid cars if the purchaser is replacing a diesel or older petrol vehicle.** The discount would be funded jointly by government and industry, similar to the car scrappage scheme of 2009-10, and should be a welcome boost to car manufacturers.

To support this, the Government should bring forward its commitment to significantly increase coverage of electric charging points across the UK. This is the sort of infrastructure investment which can be brought forward relatively easily compared to major projects, and could support economic activity.

Openness

Our economy should be open to the world for investment and trade. Not only does that benefit businesses, consumers and workers here in the UK, it also means more tax revenue for the Exchequer.

We absolutely do not want to return to the bad old days of unrestricted immigration - particularly at a time of high unemployment. But in order to help create those jobs, we need to remain open to the best and brightest from around the world. **To attract elite talent and skills from across the world, we recommend the Government introduces a visa scheme to automatically allow those who have graduated from one of the top 50 academic institutions globally within the last five years into the UK for work and research.** This would be aimed at facilitating greater interaction between UK industry and institutions and the cream of global talent in science and technology.

We also want to maintain our reputation as a safe and attractive place for individuals and companies to invest. **This means that any restrictions on overseas investment must be strictly related to national security and/or public health needs,** rather than extending the concept of 'strategic industries' from areas such as vaccine or PPE production to manufacturing or yoghurt-making. We also want to ensure that individual investors are encouraged to come to the UK, and use their assets to invest in our prosperity. **The Government should consider setting up a time-limited, tax-efficient investment vehicle that would give people a strong incentive to bring money into the UK from overseas, while also ensuring that investment was directed towards productive ends rather than property speculation.**

Nothing is more important to an open economy than free trade. There is a debate underway about whether to reduce trade barriers with other countries in post-Brexit trade deals or maintain tariffs and strict standards to protect domestic producers. We are firmly in the former camp. Freer trade is a win-win situation. Globalisation has benefited both the poorest in the world and consumers in developed countries. Trade deals can increase consumer choice and reduce the cost of living through cheaper imports and increased competition, which is also a good thing for the long-term efficiency and competitiveness of our domestic industries.

A world-leading standards regime can facilitate more trade and help UK exporters if used as a way to decrease trade friction across borders, not to shield domestic producers from legitimate competition.⁹⁸ **We should absolutely maintain good food safety and animal welfare standards, but these should not be a tool for protectionism. Deliberately**

98 Centre for Economics and Business Research, 'The Economic Contribution of Standards to the UK Economy', [link](#)



increasing prices and restricting choice for consumers and businesses to protect uncompetitive producers is exactly what we should be leaving behind when we leave the EU. We should look to agree the widest possible trade deals with the United States and other countries to

increase trade volumes and open up new markets for UK exports. We should also explore the possibility of Britain joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, the successor agreement to the Trans-Pacific Partnership.



Chapter 6: Monetary Policy

Our Recommendations

The Bank of England's remit

Conduct a review of the framework within which the Bank of England operates, while maintaining the commitment to full operational independence.

As part of the review of the Bank of England's remit, strong consideration should be given to the idea of nominal GDP targeting.



Introduction

One of the strangest aspects of the economic debate in Britain is the way in which so many in politics and the media ignore the vital importance of monetary policy.

A relatively small tax tweak can dominate the headlines for weeks, while the purchase of hundreds of billions in bonds by the Bank of England passes almost unnoticed.

The coronavirus crisis has shown, yet again, how important monetary policy actually is. Throughout the crisis, the Treasury and the Bank of England have worked closely together to mitigate the economic effects – even to the point, as mentioned above, of the Bank directly assisting with the financing of Government operations.

This chapter, however, will not contain a long list of recommendations – because the most important thing we can do in terms of monetary policy is to follow the old medical maximum of ‘First, do no harm’.

The unfortunate truth is that many of the ideas proposed for reform of monetary policy in the UK are very bad ones. That is because they mostly come from those on the Left who want to find a pretext for massively increasing state spending – without owning up to the huge tax rises on ordinary Britons that such a programme would require.

For example, while it is absolutely right that the Treasury and the Bank of England have worked closely together during this crisis, it would be a huge mistake if this led to any long-term change in the status of the Bank of England, making it completely subordinate to the economic policies of the government of the day. The Bank’s operational independence is critical - it lends it invaluable credibility in

the markets and ensures that politicians cannot drive the economy to overheat simply because there is an election looming.

Likewise, while the Treasury has found it necessary to request an extension of the Ways and Means Facility, we cannot allow this to evolve into direct monetary financing, with the Bank creating new money to fund fiscal policy on an ongoing basis. We cannot print our way out of this crisis or any future ones – and resorting to the magical money tree would result in us reaping the bitterest of fruit. Wringing inflation out of the economy was a hard-fought process, but has delivered incalculable economic benefits. To let it rip once again would be to voluntarily expose ourselves to a crippling and debilitating economic disease.

This is why any temptation to inflate away the debts we have incurred from coronavirus must be resisted. Such an approach would be like the swingeing one-off taxes on wealth that many on the Left would like to see – not a responsible harvest, but a pulling up of the crop by the roots which would leave us far poorer in the long term. Sound money has been, and must be, a cornerstone of Conservative economic doctrine.

So what can we do - beyond ensuring that monetary policy is as accommodative as possible during the recovery?

One suggestion is that, while the Bank of England’s operational independence must be maintained, it may well be time to review the *framework* within which the Bank of England operates. This is very much a matter for Parliament and the Government to consider – especially because that framework has remained essentially unchanged since Bank of England independence was introduced in 1997.

In recent years, an alternative to inflation targeting, based on nominal GDP growth,

has been gaining support in academic and policymaking circles. Because this is such a big idea, we want to take the time to explore the argument more fully than elsewhere in this paper – although any change should only be made after extensive review, with the full engagement of the Treasury and the Bank.

The inflation targeting regime

We have been targeting inflation since the early 1990s, and in many ways that regime has been a success. It has certainly increased transparency and boosted confidence in the financial markets. Most importantly, it has kept inflation low and stable. It is easy to take that for granted now, but it was definitely not the case in the 1970s and 1980s.

The Bank of England currently targets a 2% annual rate of CPI inflation. If inflation departs from that target, the governor of the Bank of England has to write a letter to the Chancellor explaining what has gone wrong, and how the Monetary Policy Committee intends to get things back on track.

Yet since the financial crisis, it has become increasingly clear that inflation is not always the best guide to what monetary policymakers should do at any given moment in time.

The big problem is that inflation can change for reasons that don't actually require a monetary response. For example, if cheaper imports or rising productivity cause prices to fall, the Bank of England should not loosen monetary policy to bring prices them back up, as it would risk building up unsustainable bubbles or causing the economy to overheat. Some people argue that this is precisely what happened in the run-up to the financial crisis.

Conversely, inflation sometimes rises above target because commodities like oil become more expensive, taxes go up,

or barriers to trade increase. Tightening monetary policy to bring inflation down would choke the economy when it was already weakened by other factors.

In some ways, then, inflation targeting is already a polite fiction. Under a strict interpretation of its remit, the Bank of England would have tightened monetary policy in response to a no-deal Brexit, on the grounds that inflation would spike as imports got more expensive. This would have triggered a sharp economic downturn at the worst possible moment. In reality, just as the Bank sensibly responded to the Brexit vote by loosening monetary policy, it most likely would have done the same in the event of no deal.

The Bank of England, in other words, frequently 'looks through' short-term inflation figures in its efforts to get monetary policy right – and its remit explicitly recognises that economic shocks can knock inflation off target.

The trouble is that it isn't always clear in real time what is causing inflation to rise and fall. And making the wrong judgement – as arguably happened before the financial crisis and in its early stages – can have very serious consequences.

There are two further problems. Firstly, a monetary policy regime that requires the Bank of England to effectively ignore its central target on a regular basis is bound to lose credibility over time. Secondly, a target that tends to point in the wrong direction in times of crisis is bound to inhibit monetary policymakers from responding as rapidly and as dramatically to unfolding events as the circumstances may require.

We certainly should not cast aside inflation targeting without a second thought. But given its apparent weaknesses – which appear to be becoming more pronounced over time – it is right we ask whether we can improve on the current regime.



Targeting nominal GDP

Many outstanding economists and central bankers have been putting forward different views of how monetary policy should work going forward. But we are most persuaded by the idea of nominal GDP targeting as a potential alternative – not least because of the difficult economic situation we currently find ourselves in.

For those who are unfamiliar with the concept, nominal GDP growth is a measure that combines real economic growth (the numbers we are used to seeing) and inflation. So if you had 2% growth and 2% inflation, your nominal GDP growth rate would be 4%. Another way to look at this is to say that nominal GDP is equivalent to the total level of spending in the economy over a given period.

It makes sense for the Bank of England to target nominal GDP, because this total spending is a vitally important variable in the modern economy. It basically determines how much money is available to pay wages, honour debts and meet other financial obligations. Pretty much every contract out there is implicitly based on certain expectations of future spending growth, so if total spending is suddenly lower than expected, there won't be enough money to go around. The result is that workers will lose their jobs, debts will go unpaid, and companies will fall into bankruptcy.

On a micro level, this happens all the time – it is part of the cut and thrust of a dynamic, competitive economy. But when such a spending shortfall happens at a national level, the result is recessions, and sometimes even depressions.

Nominal GDP targeting, then, means setting monetary policy so that total spending grows at a stable, predetermined rate. If total spending fell below expectations, the Bank of England would loosen monetary policy to bring it back up to target, by reducing the interest rate it pays on

commercial bank reserves (the base rate) and/or buying more assets (quantitative easing). If total spending grew too fast, the opposite would occur – the Bank would tighten monetary policy by selling assets or raising the base rate (or some combination of the two).

Since nominal GDP is effectively composed of real growth and inflation, keeping it on a stable growth path implies lower inflation when the economy grows strongly, and somewhat higher inflation when it grows slowly, or even shrinks. This is actually one of the great advantages of targeting nominal GDP: it ensures that monetary policy is automatically countercyclical, keeping the economy from overheating in good times but also stimulating demand when times are tough. And as with the current inflation targeting regime, it never lets the inflation genie out of the bottle.

Targeting nominal GDP – or total spending – has a number of other advantages:

- 1) A nominal GDP target combines the Bank of England's primary objective (controlling inflation) with its secondary objective (supporting the Government's economic policy) in a single, independently verifiable metric. By focusing on a target that encapsulates different aspects of the Bank's remit, we would increase its transparency and accountability, while also preserving its operational independence.
- 2) Under nominal GDP targeting, the Bank would no longer have to make difficult judgements about why inflation was happening in real time. Monetary policymakers would simply focus on keeping total spending on a stable path and rely on their control of the money supply and their influence on money demand to hit the target. Central banks can't determine how nominal GDP breaks down between inflation and real growth, but they can almost always determine the level of total spending in the economy.

3) Nominal GDP targeting is a very effective tool for ensuring that unemployment never rises too far above its 'natural' level. Generally, when total spending in the economy falls, employers find they don't have enough money to meet wage demands. So you get mass unemployment and the downward economic spiral that entails. If wages could quickly adjust to changed economic conditions, this mass unemployment would not occur. But that doesn't happen because wages are 'sticky' – employers seem to prefer making redundancies to cutting pay, and employees find it hard to accept falling wages because their biggest expenses (like rent or the mortgage) are fixed.

With nominal GDP targeting, the moderately higher inflation you would get during a downturn would mean that most businesses would still have enough cash coming in to pay existing wages. Real (i.e. inflation-adjusted) wages would be falling to reflect lower real output, but you wouldn't get economy-wide layoffs.

We need to stress here that nothing the Bank of England does can save every job or protect every business. That's not how markets work – the economy will always have to adapt to changed circumstances and sometimes that adjustment can be painful. The point of nominal GDP targeting is to avoid a generalised slump and ensure that workers who are laid off are able to find work fairly quickly elsewhere. It's also worth pointing out that nominal GDP targeting could help to boost real wages when the economy grows strongly, by keeping inflation lower than the existing 2% CPI target.

4) Nominal GDP targeting is also a very good way of ensuring financial stability throughout the economic cycle.⁹⁹ Higher

inflation during a downturn means that the real burden of debt falls, so borrowers are more easily able to keep up with repayments. At the same time, the lender makes a lower real return. In a sense, then, nominal GDP targeting shares the risk of an economic downturn between the borrower and the lender.

The same thing happens, but in reverse, when the economy booms. Rapid economic growth would usually mean windfall gains for borrowers. However, if inflation is unexpectedly low during a boom – as would be the case with nominal GDP targeting – real debt payments would effectively rise. This would mean that the gains from a growing economy would be shared between the borrower and the lender – just as the losses were in the previous example.

Another way to put this is to say that nominal GDP targeting would, because of its counter-cyclicality, make debt function a lot more like equity, with both upside rewards and downside risks shared between both parties. Nominal GDP targeting would therefore make the financial economy significantly more resilient to wider economic shocks. That can only be a good thing.

5) Nominal GDP targeting offers a path towards monetary policy normalisation in the medium term.

Ever since the financial crisis, we have become used to extraordinary monetary policy, with interest rates at or close to zero, and central banks making wave after wave of large-scale asset purchases. For the most part, this has been entirely necessary – but that doesn't mean it isn't an unhealthy state of affairs over the long run.

⁹⁹ For a good explanation of this idea, as well as references to recent academic work on the topic, see David Beckworth, 'Facts, Fears, and Functionality of NGDP Level Targeting: A Guide to a Popular Framework for Monetary Policy', Mercatus Center, p14, [link](#)



Raising total spending to hit a nominal GDP target would not change this in the short run: in times like these, it would mean more quantitative easing and maintaining a low Bank of England base rate. But over time, so long as the Bank's commitment to keep nominal GDP on a stable growth path was seen as credible and binding, market expectations for inflation and total spending would start to rise, pushing up nominal interest rates. In turn, this would allow the Bank to raise the base rate away from the zero lower bound and reduce its reliance on quantitative easing. It could also let its stock of government and commercial debt dwindle as it matured, or sell assets back into the market if spending growth took off. In other words, a nominal GDP target could eventually help to shrink the Bank's balance sheet and get interest rates back to historically 'normal' levels.

Incidentally, this also explains why we should avoid the siren call of those who say we can reduce government debt by simply having the Bank of England write-off gilts it has acquired through quantitative easing. Such a step would, of course, amount to direct monetary financing on a massive scale – abolishing the all-important distinction between fiscal and monetary policy, undermining Britain's reputation as a responsible borrower, and potentially causing long-run inflation expectations to get out of control. But it would also, crucially, deprive the Bank of the tools it needs to manage the money supply in future. Monetary policy should never be seen as a one-way street, on which 'expansion' is the only direction of travel. At some point, economic conditions will dictate a different approach, and the Bank will want to sell assets to tighten the money supply. Cancelling government debt held by the Bank would undermine that possibility.

The targeting transition

Before any change in the monetary framework took place, we would need to work out how to make such a transition at a time of major economic upheaval.

Clearly, there would be no sense in the Bank of England trying to produce, say, 4% nominal GDP growth this year. The coronavirus pandemic has led to a massive fall in real output and the inflation necessary to hit that 4% nominal GDP target would be hugely distortionary.

Similarly, given how much economic activity has been suppressed this year, you would both want and expect much faster 'bounce-back' growth in 2021.

But a properly designed targeting system would accommodate such exceptions – because the best way to do nominal GDP targeting is not by simply aiming for an annual growth rate, but instead by targeting a predetermined path for total spending over the years ahead. If you deviate from that path in year 1, you should try to make up the difference in subsequent years, so that total spending gets back on track. This is an idea that economists call 'level targeting'.

One of the big advantages of level targeting is that it offers strong 'forward guidance' to financial markets and helps to shape expectations in a positive way. And because level targeting requires the central bank to make up for past problems or mistakes, you don't get the slippage in market expectations over time that occurs with the current inflation-targeting regime.

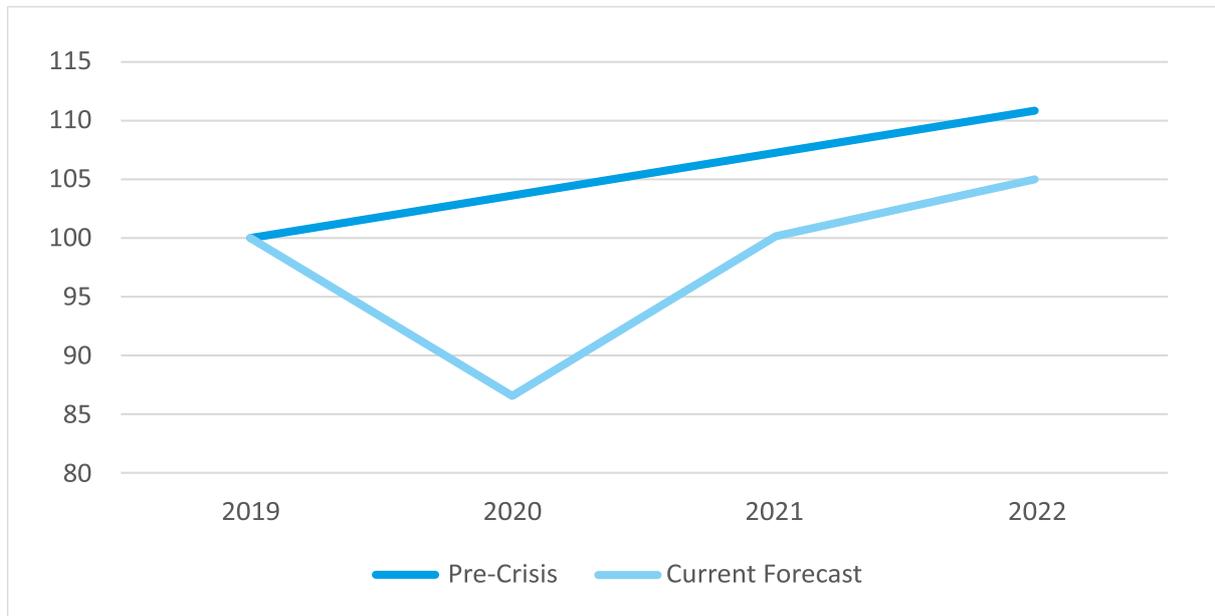
Our suggestion for implementing nominal GDP targeting, then, would be as follows. First, take an average of market forecasts of nominal GDP growth in 2020, 2021 and 2022 from before the coronavirus pandemic hit. Second, use those forecasts to plot



an expected path for nominal GDP over the same years. Third, charge the Bank of England with getting our actual nominal GDP numbers to converge with that pre-crisis path by the end of 2022. The Bank should pledge to do whatever it takes to meet this objective.

The graph below gives an indication of how this might work. The darker line represents the path of a nominal GDP index as professional forecasters expected it to look before the current crisis. The lighter line shows how the Bank currently expects nominal GDP to develop, based on its latest forecasts.

The Nominal GDP Gap¹⁰⁰



The initial goal of the new monetary regime would be to make these two lines converge before the end of the forecast period, setting whatever base rate and conducting whatever open market operations as might be necessary to do so. If this results in inflation being slightly higher than would otherwise have been the case, so be it – but once we commit to getting total spending back on track after lockdown is over, we will give the private sector the confidence it needs to generate more real growth as well.

Looking further ahead, you would want the Government to set a clear target for the future path of nominal GDP growth. Four per cent annual growth is the number usually suggested and given current

inflation expectations and trend growth rates that would make a lot of sense. Ultimately, though, the exact number matters a lot less than the commitment to hit some credible target and to make up for any inevitable deviations from the target path in future years.

Of course, we do not want to make it sound like nominal GDP targeting is some kind of panacea. It is obviously only part of the solution to our current economic problems – an improvement over the status quo, but not a silver bullet. We also want to be clear that there is plenty of room for discussion here. Nominal GDP targeting has been an increasingly popular idea among monetary economists over the last decade or so. Leading British

100 For a detailed exploration of this concept, see David Beckworth, 'The Stance of Monetary Policy: The NGDP Gap', Mercatus Center, [link](#)



thinkers such as Lord O'Neill and Gerard Lyons have endorsed it in recent weeks.¹⁰¹ And we are persuaded by its benefits. But before making any decision of such enormous consequence, we need to have open and honest debate about its merits.

In particular, we think there are three fears about nominal GDP targeting that its advocates are going to have to address.

Firstly, we know that our existing GDP data can be unreliable and subject to frequent (and sometimes significant) revisions. This could pose practical problems for a central bank relying on nominal GDP to make monetary policy decisions. This is another reason why, as outlined above, we need to use technology to improve the speed and accuracy with which we gather economic data.

Another possibility is that the Bank of England could focus on surveys of professional forecasts and market expectations when making its policy decisions, rather than relying on outturn data. This is what Scott Sumner, the economist who popularised nominal GDP targeting after the financial crisis, favours. As well as helping to overcome the data problem, he says that 'targeting the forecast' would make the Bank's decisions more forward-looking and proactive.¹⁰²

Secondly, people worry that nominal GDP targeting might cause inflation to be more volatile than we have become used to in the last 20 years. Unexpected inflation always has economic costs, making it harder for individuals and businesses to plan for the future, so this is a concern that we ought to take very seriously.

Some variability in inflation is inherent to nominal GDP targeting. And for the

most part this is a feature rather than a bug, since it makes monetary policy under nominal GDP targeting strongly countercyclical. Research from the US suggests that nominal GDP targeting would not lead to wild swings in inflation.¹⁰³ But we would need to conduct our own detailed analysis on this issue before making any definitive shift away from inflation targeting.

Finally, and arguably most importantly, there is the issue of public understanding. Whatever its flaws, inflation targeting is at least well understood by the British people. That helps the Bank to anchor our expectations and helps us to hold the Bank to account. By contrast, nominal GDP is a widely discussed concept among economists, but quite obscure to the general public. This should not stop us adopting nominal GDP targeting if it is the right thing to do. But we would need to work hard to educate the public, developing accessible ways of presenting and talking about the relevant economic data so that people understand what is happening and why. Transparency and clear communication from both the Treasury and the Bank of England would be essential to making any change to our monetary framework a success.

Ultimately, whatever changes we might make to monetary policy, we need to be absolutely clear about the fact that no central bank can, by itself, generate real growth or long-run improvements in living standards. Only a dynamic, free market economy, supported by an efficient and effective government, can guarantee that.

What monetary policy can do, however, is create the macroeconomic conditions in which a competitive private sector is

101 Jim O'Neill, 'It's Time to Target Nominal GDP', Project Syndicate, link: Gerard Lyons, Warwick Lightfoot, and Jan Zeber, 'A Pro-Growth Economic Strategy', Policy Exchange, pp27–28, link

102 See Scott Sumner, 'The Case for Nominal GDP Targeting: Lessons from the Great Recession', Adam Smith Institute, link

103 David Beckworth, 'Facts, Fears, and Functionality of NGDP Level Targeting: A Guide to a Popular Framework for Monetary Policy', Mercatus Center, p20, link



able to thrive. And in our view, **adopting nominal GDP level targeting could be the best possible way to ensure that such a macroeconomic environment prevails in the years ahead.** We therefore urge the Treasury, in consultation with the Bank of England, to start thinking about and planning for a hypothetical transition, while taking the public – and the financial markets – with them every step of the way.

If we did adopt nominal GDP level targeting as our new monetary framework,

it would require the Bank of England to keep total, economy-wide spending on a stable growth path, and make up for any deviations from that path in subsequent years. Yet monetary policymakers do not have it within their power to determine how that spending breaks down between real output and inflation. It would still be up to the government to maximise real growth by pursuing the kind of policies we have outlined elsewhere in this report – policies that boost investment, promote enterprise, and advance prosperity.



Conclusion

The Rt Hon Sajid Javid MP

The coronavirus crisis represents an extraordinary economic challenge for governments across the Western world, Britain's included. Coping with the consequences will require a blend of agility, flexibility, imagination and bravery.

The early talk of a V-shaped recovery may have died away. It is clear already that the impact of the crisis, the need to maintain forms of social distancing, and the blow to consumer and business confidence, are going to represent formidable headwinds to renewed economic growth.

But it is still within Government's power to determine much of the speed and scale of recovery. Indeed, this is - alongside containing the pandemic itself - the single most important task facing my former colleagues in the Cabinet.

This report contains dozens of recommendations. I have no expectation that they will be adopted wholesale. Instead I, and my co-authors from the Centre for Policy Studies, offer them to the Government as the best measures we can think of at this time to promote recovery.

More important than the specific details, however, is the spirit which animates them - and which should be central to any recovery agenda, especially one overseen by a Conservative Government.

This relies on a recognition that flexibility is needed to cope with the consequences of the crisis - that we should not rush to raise taxes or slash spending if it will choke off the recovery. But we need to remain committed in the medium and long term to those vital values of sound money, balanced budgets, low borrowing and low taxes. And to those we need to add a new commitment to invest in infrastructure in order to drive growth across every region of this great country.

Growth, indeed, is the only thing that will get us out of this crisis. And that growth can only be driven by a robust private sector, supported by world-class infrastructure and incentivised to hire and invest. If we get it right, we can not only rebuild the economy but put it on even firmer foundations than before.



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