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COVID-19: UK Fiscal Path

November Update

November 2020

Summary

As the need to suppress COVID-19 has continued across the UK, the challenge of helping businesses and people through the crisis and supporting the economic recovery has become more acute. Although the UK and Scotland face similar challenges, the Scottish Government does not have the full suite of fiscal powers to respond to these. As such, the UK Government must either increase its fiscal support, or provide the Scottish Government with the powers and responsibilities to deliver the response the people of Scotland need.

The economic outlook has worsened since we published our paper *UK Fiscal Path: A new Approach* in June 2020, strengthening the need for the UK Government to adopt a new long term approach. The recent resurgence in coronavirus cases, and the introduction of further restrictions to limit its spread, has slowed the economic recovery, while the continuing uncertainty around the future trade arrangements with the EU poses significant downside risks to economic activity. In addition, the economy's resilience has significantly weakened, with many businesses and households struggling financially, particularly those in the hardest hit sectors and regions. At the same time as dealing with the challenges presented by COVID-19, the risks from EU Exit will weaken the resilience of the economy further.

With the economic outlook increasingly fragile, and as the UK Government prepares for Spending Review 2021-22, it is imperative that the UK Government provides confidence and certainty by extending its fiscal support into the next year and delaying any fiscal consolidation efforts or tax rises until the economic recovery is well underway. In the short term, suppressing the virus and supporting the economy and jobs through public spending will create the confidence which will allow the economy to recover. The UK Government should therefore go above and beyond the fiscal support extended to date and introduce a fresh fiscal stimulus of at least 5% of GDP (£98 billion). In particular, it should:

1. Delay fiscal consolidation, avoiding a return to the austerity of the past;
2. Increase day to day government spending to aid the economic recovery;
3. Prioritise spending to support people in and out of work;
4. Create new jobs, good jobs, and green jobs by investing in a Green New Deal;
5. Support households and businesses to manage the debt overhang, for example through the introduction of a No-Interest Loan Scheme to protect lower income earners.

As the scale of the challenges facing businesses and households has increased, so has the need for additional stimulus. In particular, the Chancellor should commit now to extending the income support schemes and emergency welfare measures well into the next financial year. This support would be on par with the economic recovery packages and renewed emergency support provided by our main European partners, such as Germany and France.

Fiscal Policy Response to Date

Economic Outlook

In June 2020, the Scottish Government published a paper, *UK Fiscal Path: A new Approach*, setting out 10 principles that should govern the UK Government's fiscal response to the pandemic.¹ This envisaged that the economy would make a steady recovery, and that the virus would be successfully contained as the economy reopened. Indeed, the latest economic data suggest that the unprecedented collapse in economic activity in the second quarter of 2020 was followed by a bounce back in economic activity over the third quarter. Nevertheless, economic output still remains below its pre-pandemic levels, with the Scottish economy remaining 9.4% lower in August 2020 than in February 2020.

However, since then, it has become increasingly clear that the economic recovery has stalled. Many countries, including the UK, have had to tighten restrictions and re-impose national lockdowns in the light of rising infections. Although economic activity data are still emerging for the final quarter of 2020, they suggest that the recovery is losing momentum and independent forecasters expect the economy to contract in the final quarter. Looking ahead, the impact of EU Exit will also start to weigh on economic activity.

The effects of COVID-19 on the labour market are still only just emerging. The most recent labour market figures for the period July to September 2020 show that a record surge in redundancies pushed the UK's unemployment rate to 4.8%. The latest Bank of England forecasts suggest that unemployment in the UK will peak at 7.75% in the second quarter of 2021.

Fiscal Policy Response

Fiscal policy continues to play a central role in mitigating the immediate economic disruption from COVID-19 by supporting businesses and households. According to the Office for Budget Responsibility (OBR), the UK Government's fiscal interventions were worth £192.3 billion, or around 10% of GDP as of the 14th July. This estimate does not yet include the Chancellor's Winter Economy Plan – now in its fifth iteration – which extended the furlough scheme and support for the self-employed until the end of March 2021.

The UK is also one of at least nine advanced economies that already announced fiscal stimulus measures to help kick-start the economic recovery when the pandemic subsided in the summer. Although the UK saw the second largest fall in GDP across European countries, the scale of the UK's recovery package² (around 1% to 2% of GDP) remains below that announced by other countries, including New Zealand (5% of GDP) as well as Germany and France (4% of GDP respectively). The EU €750 billion recovery fund will provide loans and grants to EU member states from 2021 to the end of 2023, although payments will be front-loaded.

¹ The paper is available [here](#).

² As set out in the Plan for Jobs and the Winter Economy Plan although certain elements, such as the Job Retention Bonus, have since been abolished.

However, with the recent resurgence of the virus threatening and delaying the economic recovery, some countries have now reverted to extending emergency fiscal support instead to help businesses who will be affected, either directly or indirectly, by newly imposed restrictions and lack of demand through the winter months. This funding comes on top of the recovery packages announced earlier in the summer. For example:

- France is providing €20 billion (0.8% of GDP) in additional support to help businesses and households through the second lockdown. Small businesses hit hardest by the new restrictions will have access to €10,000 per month in assistance, employees will continue to receive short-time work assistance, and people who struggle paying rent will also receive assistance, amongst other measures.
- The German government will provide up to €14 billion (0.4% of GDP) in additional support to businesses which will be affected by the partial one-month lockdown which started on November 2, such as restaurants and cinemas. A further €22 billion (0.6% of GDP) is reportedly to be disbursed to self-employed individuals and businesses between January and June 2021.
- Germany and France have also extended their short-time working schemes until December 2021 and July 2022 respectively.

Whilst the impact of COVID-19 on the public sector finances remains uncertain, the Institute for Fiscal Studies (IFS) forecast in October that net borrowing may reach £350 billion (17% of GDP) this year – its highest peacetime level in over 300 years. In their central scenario, the IFS forecasts public sector net debt to reach 110% of national income in 2024-25, compared to 80% before the pandemic and 35% prior to the 2008-09 financial crisis.

Principles that should underpin the UK Government's Spending Review

In the light of the challenges that have emerged with the resurgence of the virus, it is clear that the Chancellor needs to review his fiscal approach and go further in supporting the economy. We therefore call upon the UK Government to use Spending Review 2021-22 to deliver value for money and consider the following proposals, building on, and aligning with, the principles we set out in the paper, *UK Fiscal Path: A New Approach* in June 2020.

1. Delay fiscal consolidation, avoiding a return to the austerity of the past

Growing the economy and reducing inequality should take priority over deficit reduction until the economy has fully recovered. There is a growing consensus from international bodies, academia, think tanks, and indeed the public, that now is the time to invest for recovery rather than balance the books. Indeed, with interest rates at historic lows, any additional borrowing now that would enable a more complete recovery would certainly pay off in the longer term. Tightening fiscal policy too quickly or too early risks undermining the nascent economic recovery. For example, the Resolution Foundation recommends that a gradual fiscal consolidation should not commence until 2023-24, or until the economic recovery has taken

hold.³ By contrast, fiscal consolidation measures in 2021-22 would increase inequalities and hamper the economic recovery.

A return to austerity as a way out of the crisis must be avoided and it has been repeatedly rejected by the Scottish electorate. We know that the spending cuts and tax rises implemented over the past decade disproportionately affected the most vulnerable and poorest in society, while resulting in chronic underfunding of public services, including the NHS, and a marked deterioration in the quality of the services provided. There is also growing evidence that austerity has undermined economic growth as episodes of fiscal consolidation reduce both output and productivity in the economy.

2. Increase day to day government spending to aid the economic recovery

The importance of fiscal stimulus has never been greater because fiscal multipliers will be large in the current economic climate where monetary policy is reaching the limits of its effectiveness. This means there is a strong case for increasing day to day government spending to support the economy whilst demand remains weak. The stimulus package must also include additional Barnett consequentials for Scotland – alongside an extension of Scotland’s fiscal flexibilities – to help us tailor our fiscal response to our individual circumstances. Such a stimulus package will require a fundamentally different approach from the emergency measures which were focused on providing liquidity to businesses and households. A successful discretionary fiscal stimulus should be timely, targeted, temporary and transformative. In particular, the timing is critical and it needs to coincide with lifting of lockdown restrictions across all UK nations and regions to be most effective. An ill-timed fiscal stimulus would risk having less of a positive economic impact if consumers cannot make use of tax incentives as shops remain closed or decide to save any increase in disposable income out of concerns about future job or income losses.

3. Prioritise spending to support people in and out of work

This should be done by extending, and not withdrawing too early, the furlough and other support schemes as long as they are needed, and possibly till the end of 2021. The support should be targeted at individuals and sectors most in need, such as hospitality and the arts, to ensure an efficient use of public funds, while avoiding last minute changes to allow businesses to plan ahead. Eligibility criteria for the self-employed scheme should also be reviewed to ensure resources are not inadvertently channelled to self-employed individuals who have seen no fall in their profits. The International Monetary Fund argues that it is paramount for governments not to withdraw economic support too early to avoid a surge in unemployment and bankruptcies. Moreover, EU Exit is likely to exacerbate the need for support schemes to stay in place longer in the UK than in some other countries.

The COVID-19 outbreak has highlighted pre-existing vulnerabilities in the UK social security system and we would urge the UK Government to take the opportunity now to address known issues with the benefits system to better support the economic and social recovery. The UK Government cannot continue to make last minute welfare decisions that leave hundreds of

³ Resolution Foundation, 11 November, available [here](#).

thousands of households in Scotland living in uncertainty. They should confirm that they will keep the £20 uplift to Universal Credit and Working Tax Credit now, not in April of next year. The Institute for Fiscal Studies (IFS) has estimated that this will cost around £6.6 billion (0.3% of GDP).⁴ Nevertheless, this would only undo a fraction of the cuts to benefits implemented since 2010. Scottish Government analysis indicates that if the two main emergency welfare measures in response to COVID – the £20 uplift and the suspension of the minimum floor – were to be withdrawn in April 2021, the poorest 10% of Scottish households would lose on average 6% of their income while 60,000 people, including 20,000 children, would move into relative poverty.⁵

Further to this, people facing financial hardship would be better supported if the UK Government removed the benefit cap, scrapped the two-child limit and replaced the five-week wait and debt-inducing advance payments for Universal Credit with non-repayable hardship grants.

4. Creating new jobs, good jobs and green jobs by investing in a Green New Deal

We must ensure that, as we rebuild the economy, we also accelerate the transition to a net-zero world whilst lowering inequality and improving wellbeing. This should include delivering the priorities of the Committee on Climate Change, creating energy efficiency in buildings, renewable power generation and distribution, electric vehicle production and charging infrastructure, and carbon capture, utilisation and storage, as well as investing in the digital infrastructure we require to improve connectivity and reduce inequalities. We welcome the UK Government's announcement of a 10 point plan for a Green Industrial Revolution. However, only a fraction of the £12 billion plan, and possibly as little as £4 billion (0.2% of GDP), are new commitments. This is nowhere near the scale of investment needed for a transformational change, and far short of the extra spending of around 1.2% of GDP for climate related policies that Germany and France have announced as part of their stimulus packages.⁶

Green jobs should be at the heart of the economic recovery plan but it is also essential that job creation is fair and targeted at population groups that have been disproportionately affected by the health and social impacts of Covid, and which can be expected to be hardest hit financially by the uncertainty around EU Exit, including low earners, young people, women, minority ethnic people, disabled people, those living in most deprived areas, and lone parents.

5. Support households and businesses to manage the debt overhang, for example through the introduction of a No-Interest Loan Scheme to protect lower income earners.

We continue to believe that a National Debt Plan is needed to provide a strategic approach to improving the finances not just of government, but of the businesses and households which have been forced to borrow to survive this crisis. Business resilience is weakening and survey evidence suggests that many businesses have very weak cashflow. In the second half of

⁴ IFS Green Budget, October 2020.

⁵ The analysis is available [here](#).

⁶ Germany and France have earmarked around €40 billion and €30 billion of their recovery packages respectively for climate related policies.

October, 28.6% of businesses reported they had no or less than three months cash reserves.⁷ EU Exit is likely to weaken the financial position of businesses further.

Recent research by the Resolution Foundation shows that serious financial stress is building, with more than half of adults from families in the lowest income quintile having borrowed in recent months to cover everyday costs such as housing and food.⁸ The pilot for no-interest loans for people on low incomes, which was being considered by HM Treasury prior to the pandemic, should therefore be introduced to prevent people in need turning to high-cost credit. Funding and guarantees from the UK Government would provide capital for the pilot, incentivising other sources to match it. For businesses, we should consider scrapping interest charges on COVID-19 related loans, or converting these loans to equity, managed by public policy banks such as the Scottish National Investment Bank.

⁷ BICS weighted Scotland estimates: data to [wave 16](#)

⁸ Resolution Foundation, 15 November, available [here](#).



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