COVID-19: UK Fiscal Path – A New Approach

June 2020

Scottish Government
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Summary

COVID-19 has presented Scotland and the UK, as much of the world, with a twin health and economic crisis with a disproportionate impact on the most vulnerable in society. The Scottish Government does not have the full suite of fiscal powers to respond to the economic challenges we are facing. As such, either the UK Government must take steps to respond to these challenges, or provide the Scottish Government with the powers and responsibilities to deliver the response the people of Scotland need.

The purpose of this paper is to set out how the Scottish Government believes the UK Government should navigate the UK economy through what is expected to be the deepest economic recession in living memory. It requires a new approach.

The paper sets out ten principles we believe the UK Government should follow to manage the UK's public finances and ensure the strongest possible economic recovery for all the UK countries whilst reducing inequalities. All of these refer to areas where responsibility remains reserved to the UK Government and that the Scottish Government cannot implement without further powers.

Both the UK and Scottish Governments have provided unprecedented support to help protect jobs and enable businesses to survive. As we move into the recovery phase from the pandemic, government has a key role to play in ensuring the economic recovery helps us build a society that is fairer and greener. As demand from the private sector has weakened, now is the time for the public sector to lead the way in stimulating the economic recovery.

The UK Government's overall fiscal stance is still a key factor determining the Scottish Government budget. A large proportion of the budget is still determined by the block grant received from the UK Government via the Barnett formula. In addition, the Scottish Government has virtually no borrowing powers to support additional spending on day-to-day public services.

As we emerge from the greatest economic shock of our lifetime, it is essential that fiscal rules do not constrain the fiscal policy response, thereby weakening the economic recovery and doing more harm to the long term fiscal position. Instead, we require a bold and radical new approach from the UK Government, with fresh thinking on how to aid the recovery and deliver a fairer and greener economy that puts wellbeing at its core, while ensuring sustainable public finances.

Internationally, the focus of the fiscal response is beginning to shift from immediate emergency assistance to fiscal policies to kick-start the economy. The crisis is inevitably leading to an increase in public debt. This debt will need to be managed over a long period and in ways that aid, rather than hinder, economic recovery. Businesses and households will need the support of the banking and financial system to recover from the crisis.

Ten principles that should underpin the UK Government's new approach

We propose ten principles that the UK Government should follow to balance delivering a further fiscal stimulus that grows the economy and reduces inequality with the need to manage the debt owed by households, businesses and the government:

Public finances

1. Avoid a return to the austerity of the past and adopt flexible fiscal rules. Growing the economy and reducing inequality should take priority over deficit reduction until the economy has fully recovered.
2. Introduce a fiscal stimulus package worth £80 billion, or 4% of UK GDP, to deliver an investment-led recovery, accelerate the transition to net zero and build an economy which has the broader wellbeing of the population at its heart.
3. Cut the standard rate of VAT to 15% for six months once current restrictions have been lifted across the UK. Reduce VAT for the hospitality sector to 5%.
4. Accelerate major investment in low-carbon, energy efficiency and digital infrastructure and recognise the value of this investment by assessing the government's fiscal sustainability in terms of its public sector net worth.
5. Enable Scotland to shape its own response to the pandemic by providing further consequentials for investment into the Scottish economy and by extending Scotland's fiscal flexibilities.

Support the labour market and improve the welfare safety net

6. Choose to use public money to protect jobs and livelihoods through support schemes and increase the responsiveness, accessibility, generosity of the UK welfare safety net, so that it provides sufficient support for people in and out of work.
7. Introduce a jobs guarantee scheme for young people, increase training, and continue sector-specific employment and business support schemes where needed.
8. Create jobs through a significant reduction in firms' labour costs by cutting employers' National Insurance Contributions and removing the costs of the apprenticeship levy.

Dealing with debt

9. Agree a national debt plan to support businesses, households and the banking system through the economic recovery and manage debt recovery over a longer time period.
10. Reset the monetary policy objective of the Bank of England so that long-term growth and reducing inequality are promoted.

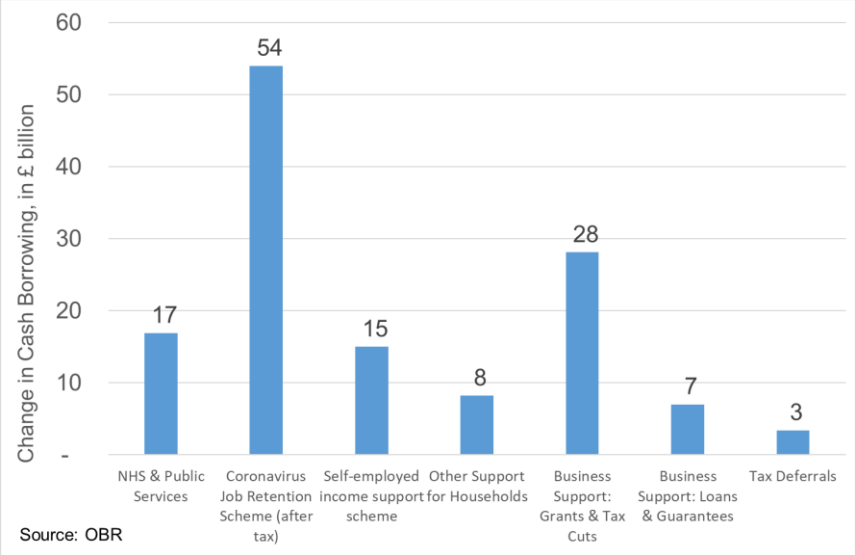
The UK's policy response to the pandemic to date

The coronavirus pandemic has led to a significant contraction of economic activity and record levels of borrowing, as tax revenues have fallen and public spending has increased. As a result, the UK Government, jointly with the Bank of England and the Financial Conduct Authority, is implementing a range of policy measures unprecedented in the UK to support financially strained households, protect people's jobs and help otherwise viable businesses, while also providing sufficient funds for the NHS and other public services. This forms the backdrop against which to assess the outlook for the UK's public finances.

Fiscal policy response

The Office for Budget Responsibility (OBR) estimates that the fiscal aid provided by the UK Government to date will cost £132.6 billion, or around 7% of GDP, in 2020-21. This already exceeds the fiscal support provided at the height of the financial crisis in 2008-09 (0.6% of GDP in 2008-09 and 1.5% of GDP in 2009-10 respectively). The Government's employment support schemes for workers and the self-employed are by far the most costly element of the fiscal interventions, accounting for more than half of the costs, or around £69 billion (see Chart 1). The Scottish and UK Governments have also implemented a package of tax cuts and cash grants to businesses worth £28 billion, and a further £8 billion of support to households in the form of increases in welfare payments and sick pay.

Chart 1. Estimated costs of UK Government fiscal measures in 2020-21 (as of 19 of June)



The UK Government has also provided up to £330 billion (over 15% of GDP) of state-backed loan guarantees. While this will not have an immediate impact on the UK's public finances, it may add to government expenditure in the future if some businesses are unable to repay their loans and the guarantees are called upon, with current OBR estimates suggesting £7 billion of write-off costs for the loan guarantees and trade credit insurance.

Take up of the UK Government's emergency support schemes

It is already clear that these schemes have provided an important lifeline to businesses and households. As illustrated in Table 1, over 970,000 businesses in the UK have been successful in applying for the state backed loan schemes while 9.2 million jobs have been protected by the Job Retention Scheme.

Regional data published by HMRC show that 628,200 Scottish jobs, around 27% of the total Scottish workforce, have been furloughed under the Job Retention Scheme as of 31st May. A total of 146,000 (70%) of eligible 207,000 self-employed individuals made a claim, with Scotland's take-up rate being equivalent to the UK.

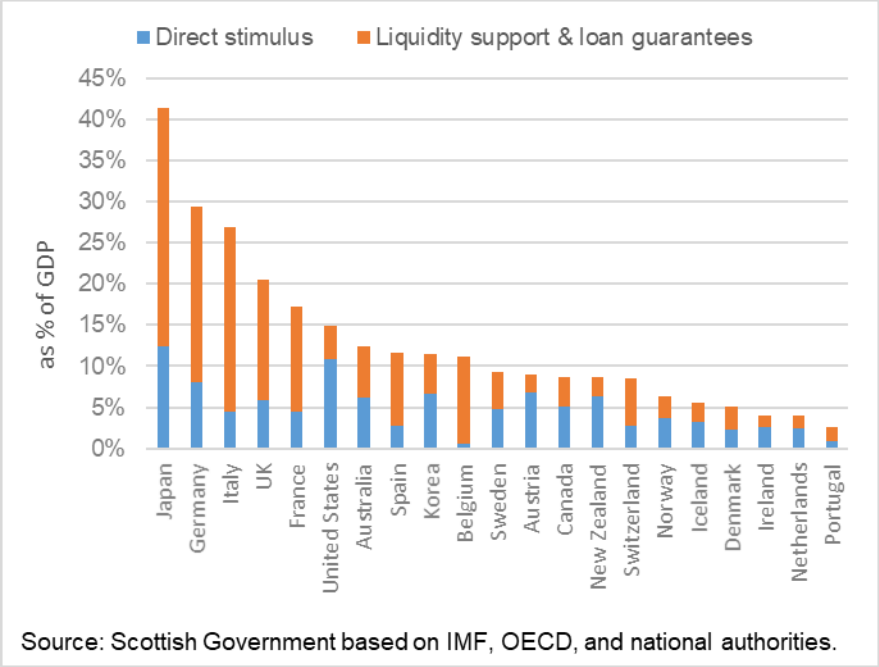
Table 1. Support Scheme Take-up (as of 21 June)	Uptake UK	Value (£bn)
Coronavirus Business Interruption Loan Scheme (CBILS)	50,482 loans	10.5
Coronavirus Large Business Interruption Loan Scheme (CLBILS)	315 loans	2.1
Bounce Back loan scheme	921,229 loans	28.1
COVID-19 Corporate Financing Facility* (CCFF)	63 businesses	18.6
Coronavirus Job Retention Scheme	9.2m jobs furloughed	22.9
Self-employed Income Support Scheme	2.6m claims	7.6
Future Fund	252 loans	0.2

How does the UK compare internationally?

Countries have adopted a mix of conventional fiscal measures, such as tax cuts and increases in welfare payments, as well as less conventional fiscal measures, such as liquidity support and loan guarantees to businesses, to address the crisis. In international terms, the UK has provided one of the most generous fiscal responses across the OECD, together with Japan, Germany and Italy (see Chart 2).

However, international comparisons need be treated with caution as they can reflect a number of factors, including the role and size of government, the fiscal space available, the depth of the crisis and the stringency of the containment measures taken. Further detail is available in Annex A.

Chart 2: COVID-19 – International comparisons of fiscal stimulus (as of 12 of June)



Source: Scottish Government based on IMF, OECD, and national authorities.

Monetary and macro-prudential response

In a synchronised effort, the Bank of England has also significantly loosened monetary policy to support demand in the economy, provide access to finance and stabilise the financial system. The Bank has reduced its interest rate by 0.65 percentage points to a record low of 0.1% while expanding its asset purchase programme by £300 billion. Through its Quantitative Easing programme, the Bank will buy up government and corporate bonds, thus helping the government to fund the significant fiscal interventions at very low interest rates. The Bank also introduced a new Term Funding scheme with additional incentives for SMEs to provide banks with four years of cheap funding so that they can continue to lend through the coronavirus crisis period.

The Financial Conduct Authority (FCA) also introduced a package of targeted, temporary measures to help people with some of the most commonly used consumer credit products, reflecting the challenges faced by people from a fall in income and cash flow challenges. For example, the FCA introduced rules asking lenders to freeze loan and credit card payments and charge 0% on arranged overdrafts up to £500 until the end of October. Households struggling to pay their mortgage due to coronavirus will be able to take a payment holiday, or start making reduced payments.

The case for further fiscal stimulus

Phasing the withdrawal of the existing emergency support package will be crucial to minimise unemployment and protect and support firms whilst the economy transitions and markets and business places change to the new norms which are emerging. Scottish Government analysis shows that the Job Retention Scheme, alongside the other measures taken, is playing a key role in mitigating the impact of the shock on unemployment. While the unemployment rate could still reach 10% in Scotland over the course of this year, the rate could have peaked at 14% in the absence of the scheme. Our modelling also suggests that the UK Government's fiscal policy response to date could have prevented Scottish GDP falling by a further 7.5% in Q2. This highlights the importance of not unwinding the current support schemes too quickly.

Our proposal: Choose to use public money to protect jobs and livelihoods and continue sector-specific employment and business support into 2021

As we move into a new phase of the pandemic, it will be important to ensure that support packages remain available to those who are unable to work, either because they are shielding or because they are self-isolating as a result of the test and protect approach. It may also prove impossible for certain sectors to resume economic activity in a way that is economically viable before the current employment support schemes are due to expire in October 2020. Sectors that may require further emergency support beyond October include, but may not be limited to, tourism and hospitality, arts and culture, oil and gas, childcare, and retail. These industries may also need support to help meet the increasing costs that will fall on employers from August onwards from the Job Retention Scheme.

Other countries have already signalled a more gradual removal of their comparable schemes. For example, France has already committed to extending its employment support scheme for up to two years for those unable to return to full-time employment, Germany has confirmed that its scheme will continue into 2021, and Spain and Italy are also considering sector-specific extensions.

The Job Retention Schemes represents one of the most costly elements of the emergency support package. The OBR estimates that the scheme costs around £9 billion per month (after tax) in its current form, with the UK Government paying 80% of the wages of furloughed workers until August and 60% by October. However, the costs of the scheme are likely to fall as more sectors of the economy are opening up and demand returns. Limiting the support to those sectors most in need would also reduce the costs substantially.

Overall, it will still be more cost-effective in the longer term to protect jobs and livelihoods through support schemes than through paying out for unemployment benefits. If the Job Retention Scheme is not extended until economic activity can safely resume, these jobs have not been saved but the British taxpayer has simply paid the wages of furloughed staff.

However, support should be targeted at those companies for whom the scheme secured their viability. Other means of support, such as grants or government backed loans and guarantees, should be considered where this is not the case but businesses remain financially viable in the longer term. Finally, there will be some business models which may no longer be viable due to changes in consumer behaviour and spending patterns. Rather than providing further employment support to these businesses, appropriate support should be provided to help individuals retrain and adapt their skills to find new employment.

Further stimulus to aid the economic recovery

In addition to phasing out the immediate emergency assistance, which helped households and firms through the economic lockdown by providing liquidity assistance, another set of measures will be required to encourage growth in demand as well as improving the supply of skills and infrastructure, with a view to grow the economy's productive capacity in the longer term.

Internationally, the focus of the fiscal response is also beginning to shift from emergency assistance to fiscal stimulus to kick-start the economy, with the European Commission announcing a €750 billion package to support the recovery over the next three years, around 1.8% of GDP. This will be on top of individual countries' stimulus packages, with Germany announcing a €130 billion support package, around 4% of GDP. This includes a VAT cut, direct funding to families, and a €50 billion climate change and innovation fund.

Such a stimulus package will require a fundamentally different approach from the support offered so far in the crisis which was focused on providing liquidity to businesses and households. A successful discretionary fiscal stimulus should be timely, targeted, temporary and transformative. IMF research also finds that tax cuts appear to be more successful in stimulating growth than spending increases.[1] Timing will also be critical, as the fiscal stimulus would need to coincide with easing of lockdown restrictions to be 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 losses. This underlines the importance of avoiding a second spike in the virus as that would significantly undermine the impact of such stimulus measures.

[1] IMF, 2008 available here.

Our proposal: Introduce a fiscal stimulus package worth 4% of UK GDP to kick-start the economy, reduce inequality and build an economy which has the broader wellbeing of the population at its heart

- Cut the standard rate of VAT to 15% for six months once current restrictions are lifted across the UK. Reduce VAT for the hospitality sector to 5%.
- Accelerate major investment in low-carbon and digital infrastructure.
- Introduce a jobs guarantee scheme for young people increasing training.
- Create jobs through a significant reduction in firms' labour costs by cutting employers' National Insurance Contributions and removing the costs of the apprenticeship levy.

We have set out our ambition to deliver a fairer, net zero economy for Scotland in our Programme for Government, supported by our National Infrastructure Mission. The UK fiscal stimulus package needs to ensure that the environmental benefits that we have seen during the crisis are sustained as we renew and rebuild our economy to address the climate challenge.

As the UK Government decision to leave the EU means that the UK will be unable to benefit from the collective European response to the crisis, it is important that the UK makes up for this in its own policy response. We propose the UK Government follow the example set by Germany and adopt a further fiscal stimulus package of 4% of GDP, or around £80 billion. The need for urgent fiscal stimulus means that the short term stimulus will come primarily through the tax system and grants to businesses and households, which is the fastest way for government to provide fiscal stimulus, although consideration should also be given to short term green capital investment. From 2021-22, the balance of the stimulus will need to shift to focus on delivering the transition to a net zero economy with lower inequality and improved wellbeing.

A stimulus package of 4% of GDP would be able to afford to deliver:

- **Support for consumers and businesses through tax cuts:**
  - Cut the standard rate of VAT to 15% for six months once current restrictions are lifted across the UK. Reduce VAT for the hospitality sector to 5%. This would be one of the quickest ways to provide an additional spending boost to support the sectors of retail, hospitality, leisure and tourism that have been most impacted by the lockdown.
  - A cut in employers' National Insurance Contributions by 2p to reduce the cost of hiring staff and support the labour market recovery.
- **Immediate additional public spending:**
  - Financial support to low and middle income households through a one-off cash grant to stimulate consumption. For example, Germany's stimulus package offers a one-off €300 cash grant per child to each family, at a cost of around £3.8 billion. For better-off families, this is recouped through the tax system.
  - Increase government spending to support the economy whilst demand remains weak, particularly as consumers cannot be asked to immediately return to previous spending patterns.
  - Financial support to the key workers in all sectors who have contributed so much already in the fight against the pandemic.
- **A public sector investment programme:**
  - Investing in a Green New Deal for the UK, and ensure that as we rebuild the economy we also accelerate the transition to a net-zero world whilst lowering inequality and improving wellbeing.

- Delivering the priorities of the Committee on Climate Change,[2] creating low-carbon buildings and improving energy efficiency, and investing in the digital infrastructure we require to improve connectivity and reduce inequalities.

- **Support for jobs:**
  - An extension of the furlough scheme, or some other form of wage subsidy, for the hardest hit sectors.
  - A jobs guarantee for young people. It is already clear that the pandemic has a disproportionate impact on young people, who tend to work in sectors hardest hit by coronavirus, while graduates will find it harder to find a job in a recession.
  - Payments to employers that take on apprentices or young workers;
  - Abolish the apprenticeship levy and replace with direct funding. The levy costs businesses £3 billion annually, but in its current form is not fit for purpose and discourages companies to take on more apprentices.
- **Additional funding for the Devolved Administrations**:
  - The stimulus package must include additional Barnett consequentials for Scotland and the other Devolved Administrations to help us tailor our fiscal response to our individual circumstances.

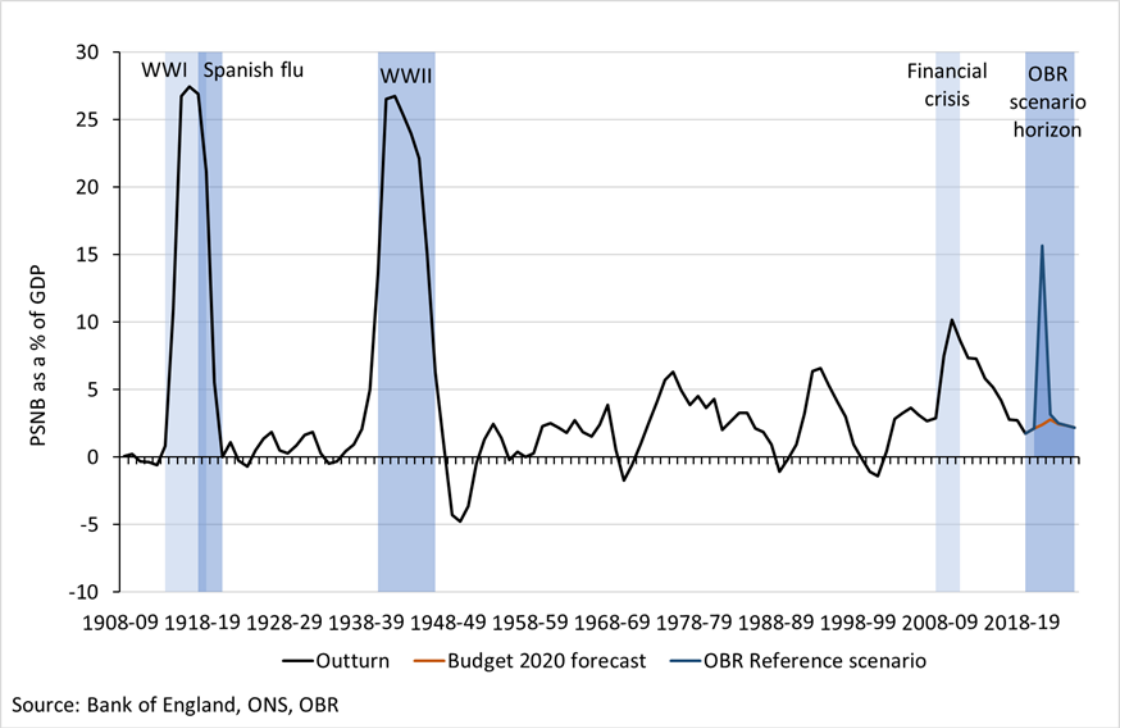
UK public finances and the expected scale of borrowing and debt

Fiscal Outlook

The COVID-19 pandemic, and the resulting reduction in economic activity, will significantly raise government expenditure and reduce tax receipts, with negative implications for borrowing and public sector net debt. In its illustrative scenario for a three-month lockdown, the OBR suggests that borrowing could increase to £308 billion in 2020-21, a £253 billion increase compared to its March 2020 forecast. This would take the fiscal deficit to 15.7% of GDP, its highest level since the Second World War and well above the level seen at the height of the 2008-09 financial crisis (see Chart 3).[3]

[2] The UK Government should take the Committee on Climate Change Committee's recommendations into account when reaching conclusions about the next phase of the economic and fiscal response. Link.
[3] The analysis combines the reference scenario published in April and May 2020 with the latest policy costings by the OBR published on June 4.

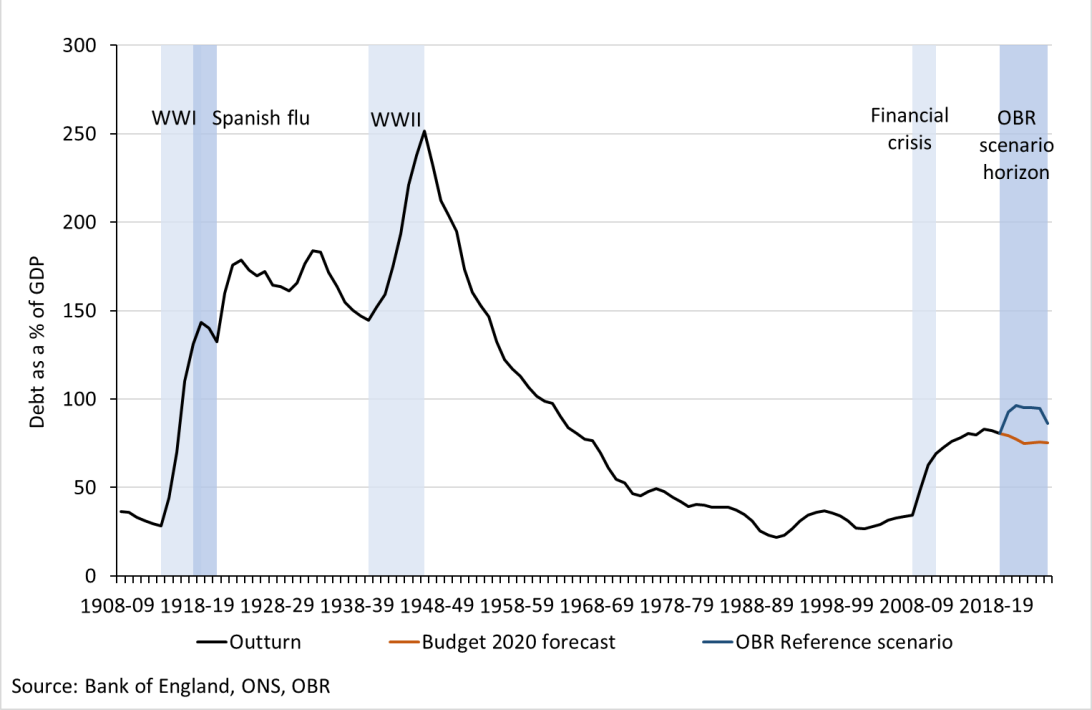
Chart 3: UK public sector net borrowing in historic perspective



Source: Bank of England, ONS, OBR

This economic shock comes at a time when the UK's public finances have not yet fully recovered from the financial interventions to support the banking sector in 2008-09. Public sector net debt is expected to rise by almost 20 percentage points to around 96% of GDP in 2020-21, its highest level since the 1960s. As the rise in the deficit is currently expected to be temporary, debt is expected to remain at a stable, though elevated, level beyond 2020-21. This differs from the debt trajectory following the financial crisis when debt continued to rise as a share of GDP, until 2016-17.

Chart 4: UK public sector net debt in historic perspective



Source: Bank of England, ONS, OBR

Despite this increase in debt, historically low interest rates, supported by an expansionary monetary policy, mean that UK public sector debt remains affordable by historical standards. Indeed, the OBR forecast that debt interest payments will now be lower than before the crisis began, even with the additional borrowing. There are also no signs that the UK Government is struggling to finance itself. Gilt auctions are consistently and significantly oversubscribed and on some issuances yields have turned negative.

However, the fiscal outlook also depends on how quickly the economy recovers and whether there are any long-term scarring effects. A relatively slower recovery than currently suggested by the OBR would impact tax receipts, with higher levels of spend required on benefits and greater risk exposure through defaults on guaranteed loans. For example, analysis by the Institute for Fiscal Studies (IFS) shows that borrowing might remain at over 5% of GDP for years to come - around 3% higher than forecast in the March 2020 Budget.[4] The IFS also takes a more pessimistic view about the longer term outlook for public sector net debt as it expects debt to continue to rise beyond 2020-21.

The latest public sector finance data for May 2020, which provides an indication of how the public finances have fared under the pandemic, show that public sector net debt at the end of May 2020 was 100.9% of GDP. While broadly in line with the OBR's expectations, this is the first time that the debt to GDP ratio has exceeded 100% since 1963. Over the financial year to date, the UK Government has borrowed £103.7 billion, the highest borrowing in any April to May period since records began in 1993.

The UK Government's substantial financing needs this year are being supported by the Bank of England's Quantitative Easing programme. In addition, how the UK manages lockdown exit (and the end of the transition period with the EU), relative to other countries, will impact assessments of the risk in investing in the UK, affecting the cost of access to finance for all sectors of the economy.

Lessons from previous periods of debt consolidation

After the Second World War, successive UK Governments paid off the nation's debt, which peaked at over 250% of GDP in 1946-47, over the course of three decades (see Chart 4 above). This was done by using a combination of high taxes on capital, 'financial repression' – where the interest rates at which the government could borrow were held below inflation through a number of institutional and policy factors[5] – and high levels of inflation, which eroded the real value of the debt over time. The post-War baby boom and improved levels of education also helped the UK economy to grow its way out of debt. So although public sector debt increased by 137% over the 30 years to 1976, nominal GDP increased far faster – by more than 1,200%.[6]

After the global financial crisis in 2008-09, the UK Government's answer to the deterioration in the public finances was austerity. Today, we know that the spending cuts and tax rises implemented over the past decade, at a total value of 8.3% of GDP or almost £190 billion in today's terms, have disproportionately affected the most vulnerable and poorest in society, while resulting in chronic underfunding of public services, including the NHS. There is also growing evidence that austerity has undermined economic growth as episodes of fiscal consolidation

[4] IFS, The outlook for the public finances under the long shadow of COVID-19, June 19, available here.
[5] This includes the Bretton Woods system which was characterised by a fixed exchange rate and quantity and price controls on domestic bank lending.
[6] Fiscal Sustainability Report 2013, page 125. Link.

reduce both output and productivity in the economy[7], an issue also highlighted by the OBR.[8] This in turn makes it harder to achieve desired improvements in fiscal sustainability.

A new set of fiscal rules

The scale of the fiscal challenge ahead may require some fresh thinking on how to aid the economic recovery, and a new perspective on what constitutes sustainable public finances in an era of low interest rates. Most importantly, the next generation of fiscal rules will need to allow for sufficient flexibility to address the public health crisis and expected economic downturn, while also setting a longer term path for the public finances.

Indeed, an increasing number of economists appear to agree that reducing the deficit should not be the priority in the upcoming UK Budget, with 63% of economists in a recent survey stating that fiscal consolidation should wait until the effects of the pandemic subside.[9] This assessment is also shared by the IFS: *"Given the low cost of borrowing – due to extremely low effective interest rates on government borrowing – further borrowing in 2020–21 which led to a stronger subsequent economic recovery would most likely be worth doing. And it also means that any new policy action that is taken to reduce borrowing need not – and indeed should not – be implemented until the economy is back to a more normal performance."*[10]
There is also some evidence that implementing fiscal consolidation before the economic recovery is well underway may harm economic output and employment.[11] In this section, we therefore make the case for a more flexible set of fiscal rules that prioritises economic stimulus over deficit reduction in times of crisis, and provides a more comprehensive assessment of the Government's balance sheet once the economic recovery has taken hold.

Why fiscal rules matter

There are a number of benefits from following fiscal rules. Well-designed fiscal targets provide helpful discipline to government spending decisions, anchor firms' and households' expectations by adding transparency to the government's intentions and signal commitment to return the public finances to health, thus lowering borrowing costs. Over the past two decades, the UK's fiscal rules have been designed either to strengthen fiscal prudence in a period of economic expansion (1998-2008) or to return the public finances to health following the financial crisis (2008-2020).

However, while their general benefits are widely acknowledged, now may not be the time to follow traditional fiscal rules. As the UK emerges from the greatest economic shock of our lifetime, it is essential that fiscal rules do not constrain the fiscal policy response, thereby weakening the economic recovery and doing more harm to the long term fiscal position.

[7] Bardaka et al (2020) available here and IMF (2016) available here.
[8] Letter from Robert Chote to Prime Minister, 2013, available here.
[9] See survey by the Centre for Economic and Policy Research, 28 May. Results based on 30 panellists.
[10] IFS, June 19.
[11] Bagaria, Holland and van Reenen (2012), Fiscal Consolidation during a Depression, available here.

Our proposal: Avoid a return to the austerity of the past by adopting flexible fiscal rules

We propose setting a longer-term fiscal anchor, while temporarily suspending the fiscal targets until the economy has recovered. Previous fiscal rules have done this by targeting deficit estimates that accounted for the ups and downs of the economic cycle. As a simple alternative, an escape clause could be introduced into the framework which would see some, but not all, of the fiscal rules suspended for a limited period of time and linked to a measurable set of criteria. Once the economic recovery has taken hold, the rules would be reinstated and the deadline for meeting them reset. To ensure fiscal prudence, the OBR would play an important role as the independent fiscal watchdog in assessing whether the criteria for suspension and reinstatement have been met.

In its 2015 Charter for Budget Responsibility, the UK Government adopted a similar approach, stating that its fiscal mandate would only apply if the OBR were to confirm that the UK economy is not expected to experience a negative shock, defined by the Government as real GDP growth of less than 1 per cent on a rolling 4 quarter on 4 quarter basis.[12] Such an approach is easily understood and could be adopted again. The latest Charter also includes an escape clause in the event of a "significant" economic shock, without providing a measurable threshold, leaving it to the Treasury's discretion to decide whether the fiscal rules are appropriate or not.

Escape clauses are also used by a number of other countries, including Germany, Spain, and Switzerland. For example, in Germany fiscal rules can be suspended in the event of a natural disaster or an unusual emergency situation outside government control, subject to parliamentary approval and as long as a recovery plan is presented. This approach provides flexibility in managing the public finances in times of true crisis.

The UK Government's current fiscal rules

The UK's current legislated fiscal rules require the structural deficit to lie below 2% of GDP by 2020-21 and debt, as a share of GDP, to fall in the same year. However, the 2019 Conservative election manifesto set out a new set of relatively looser fiscal targets which guided the Chancellor's decisions in the (pre-COVID-19) March 2020 Budget:

1. Balance the **current budget** by the third year of a rolling five year period (2022-23), meaning that all spending on day to day public services would be entirely funded from tax revenues. This is similar to the fiscal rules adopted by Labour (1997 to 2008) and the Coalition Government (2010 to 2015);
2. Ensure that **net investment** does not exceed 3% of GDP on average over the rolling 5 year period. Taken together with the first target, this essentially puts a 3% ceiling on the fiscal deficit;
3. If the **debt-interest-to-revenue ratio** is forecast to remain over 6% for a sustained period, the Government will act to ensure the debt-to-GDP ratio is falling. This approach ensures that the overall debt burden remains sustainable by taking account not only of the volume of the national debt, but also its cost and the government's ability to service it.

It is currently unclear if the UK Government is planning on including an escape clause into this framework.

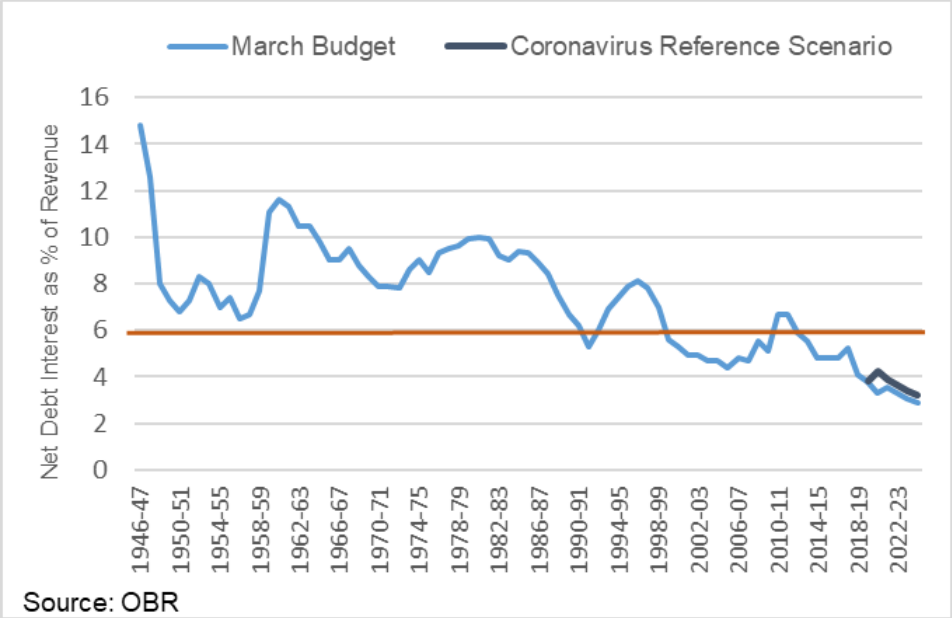
[12] The Charter is available here.

Current Fiscal Headroom

Even prior to the pandemic, and its adverse effect on the public finances, the Chancellor had very little headroom against his proposed fiscal targets. According to the OBR's (pre-COVID-19) March 2020 forecast, he was on course to meet the current budget balance target in 2022-23, with only £12 billion to spare. It is highly likely that this headroom will be eroded further even in the best case scenario of a V-shaped economic recovery. Following significant increases in capital spend announced at Budget, the UK Government also has virtually no headroom against its investment target.

As long as interest rates remain at their current record lows, the debt interest to revenue ratio requirement is unlikely to restrict the Government's room for manoeuvre in the near future. While the UK Government has so far not encountered any problems in funding the significant fiscal interventions, there is a risk that the costs of servicing the countries' debt may rise in the future.

Chart 5: Debt interest to revenue ratio



Most importantly, a high debt interest to revenue ratio does not necessarily mean that debt levels will remain high, nor does a low ratio result in falling debt. As illustrated in Chart 5, this ratio exceeded 6% until 1991-92. This was due to higher nominal interest rates as well as high levels of post-war debt, but the overall debt to GDP ratio fell through most of this period. At the same time, with the exception of two years, the ratio has been below 6% since the financial crisis, despite debt increasing significantly over this period. The significant additional borrowing pencilled in for 2020-21 will make little difference to the ratio, on the OBR's calculations. These considerations are, however, important for the overall management of the country's debt which now stands at £1.8 trillion. Much of the existing debt stock was raised at interest rates that were much higher than the current rates. There may therefore be a case for refinancing existing debt in order to free up further resources for public spending in the short and longer term.

It is clear, therefore, that the UK Government's current, and proposed, fiscal rules are not designed for, or able to support, recovery from this crisis

Our Proposal: Recognise the value of investment by assessing the government's fiscal sustainability in terms of its public sector net worth

While the immediate focus of fiscal policy should be to aid the economic recovery, the UK Government should also review its current, and proposed, fiscal rules to ensure they are still fit for purpose in a world where the government may need to intervene, and potentially invest, in certain sectors of the economy that are unlikely to resume economic activity soon. Setting medium term fiscal targets now would signal a commitment to repair the public finances in the longer term and anchor people's expectations.

One option, also advocated by the Resolution Foundation, is to shift the focus from the narrow definition of public sector net debt to the wider government balance sheet, with a view to capture the full benefits and costs of government interventions in the economy. This would bring the reporting of the public finances in line with accounting practices used internationally by the private sector. HM Treasury also acknowledged the potential benefits of this approach: *"Taking a more comprehensive view of the government balance sheet can help to provide a more complete picture of the sustainability of the public finances and promote greater accountability for the management of public wealth".*[13]

Targeting improvements in public sector net worth (PSNW), rather than public sector debt, would come with clear advantages. PSNW covers all financial and non-financial assets and liabilities (see Annex A). This approach therefore supports borrowing for growth-enhancing investment while also capturing the increasing importance of financial transactions, such as asset purchases and bank nationalisations. These were a key element in bringing the risk onto the government's balance sheet during the financial crisis and similar measures may well have to be adopted to support strategically important businesses – under the Treasury's Project Birch scheme – and industries through the current crisis. Loans, guarantees, and other financial instruments would likewise be captured under this measure. It also encourages governments to manage assets and liabilities responsibly, and for the benefit of future generations, while accounting for the costs of an ageing population. Finally, a strong balance sheet may reduce borrowing costs.[14]

Recent improvements in public sector balance sheet reporting, such as the publication of more frequent and timely data through the ONS, make this approach practically feasible for the first time. In addition, the OBR also forecasts the evolution of the Government's *financial* balance sheet (see Annex). However, the Institute for Fiscal Studies (IFS) voiced some caution about this approach: *"Keeping an eye on public sector net worth certainly makes sense. Targeting it as the key element of your fiscal framework may lack the sort of transparency and credibility required of such a framework. It would need to be combined with a commitment to ensure that policy was consistent with public sector net debt being on a decisively downwards path over the longer term (rather than over a parliament)."*[15] This reflects the fact that public sector debt and borrowing remain important internationally comparable measures.

[13] HM Treasury, Managing fiscal risks: government response to the 2017 fiscal risks report, July 2018, page 116, paragraph 6.2. Link.
[14] Seyed Reza Yousefi (2019), Public Sector Balance Sheet Strength and the Macro Economy, IMF Working Paper WP/19/170. Link.
[15] The IFS Green Budget, October 2019. Chapter 5, page 130. Link.

In conclusion, we therefore propose adding two additional fiscal rules to the UK Government's (pre-COVID-19) fiscal targets:

- **An escape clause** which retains sufficient flexibility to allow for further fiscal stimulus in times of significant economic disruption, based on a set of criteria and assessed by the independent OBR;
- **A net worth objective** which would seek to improve public sector net worth over the next five years as a different measure of fiscal sustainability.

Our Proposal: Enable Scotland to shape its own response to the pandemic by providing further consequentials for investment into the Scottish economy and by extending Scotland's fiscal flexibilities.

The Scottish Government has also taken a series of unprecedented policy actions with significant fiscal implications in response to the crisis: this included £780 million of additional funding in respect of Health and Social Care, £2.3 billion of business support measures as well as a £350 million community support package for those most affected by the pandemic. The Scottish Government has also announced a £230 million investment package to help stimulate Scotland's economy following the pandemic, covering construction, low carbon, digitisation, and business support.

The financial assistance has been targeted to reflect the differences between Scotland's economy and recovery and the rest of the UK, providing additional assistance to groups such as fishermen and small B&Bs. Some of the groups that have been unable to access the UK Government's schemes have also been supported by the Scottish Government's extra funds, such as the £185 million fund to support the recently self-employed and SMEs.

However, Scotland's ability to shape its own response to the pandemic and economic recovery is limited by the fact that a large proportion of the Scottish Budget is still determined by the block grant received from the UK Government via the Barnett formula. In addition, the Scottish Government has virtually no borrowing powers to support additional spending on day-to-day public services. Scotland's capital borrowing powers for growth-enhancing investment are also limited and capped at £450 million per year (0.3% of GDP) and £3 billion in total.[16] This means that the UK Government's block grant is the only significant source of extra funding during the pandemic. This restricts our ability to effectively plan our response as our funding position is not clear until the UK Government has finalised its own funding decisions which might be too late.

Through the operation of the fiscal framework, the relative performance of tax receipts and social security expenditure in Scotland compared to the rest of the UK also plays an important part in determining the Scottish Government's budget. One of the key principles of the fiscal framework is that the UK government should continue to manage risks and economic shocks that affect the whole of the UK. The fiscal framework therefore protects Scotland against UK-wide and symmetric economic shocks, as the fall in receipts would be broadly mirrored by an equivalent fall in the Block Grant Adjustment, as revenues will also decline in the rest of the UK. Welfare spending is similarly affected. However, it offers no protection should the COVID-19 impact be

[16] The Scottish Government can borrow to support resourcing costs only in very specific circumstances: for in-year cash management; and for forecast error in relation to tax receipts and social security expenditure

worse in Scotland than in other parts of the UK, either in terms of health impacts or because of differences in the underlying structure of the economy.

It is becoming increasingly clear that the flexibilities within the fiscal framework are not sufficient to cope with either the fiscal risk of the pandemic, or the demands of rebuilding the economy in future years. This view is also shared by a range of commentators, including the Institute for Fiscal Studies and the Fraser of Allander Institute.[17] This is why the Scottish Government is asking the UK Government for additional flexibilities to ensure that the risks faced by the Scottish Parliament are commensurate with its powers to manage them. Our focus now must not only be on the immediate response, but also on the powers needed to rebuild our economy in the coming years. With interest rates at historic lows, we also propose to reconsider the effectiveness of the current capital borrowing limits and re-examine the merits of a prudential borrowing regime, as recommended by the Smith Commission, to allow the Scottish Government to borrow to invest.

Dealing with the debt overhang of households and businesses

It is not just government that is facing extremely high levels of debt due to COVID-19. The levels of indebtedness for businesses and some households, particularly those households at the lower end of the income distribution, are also elevated due to the impact of the pandemic on business cash flows and household incomes. The banks, as financial intermediaries, have an important role to play in mitigating businesses failures and in stemming a potential tide of defaults on household loans. The balance sheets of households, businesses, banks and governments are all inter-connected with, for example, liabilities on household and business balance sheets being assets on banks' balance sheets.

Businesses and households will need the support of the banking and financial system to recover from the crisis.

Our proposal: Agree a national debt plan to support businesses, households and the banking system through the economic recovery and manage debt recovery over a longer time period.

Households

Channels of impact

Early evidence suggests that the impact on households balance sheets has been different for high and low income families. The immediate impact on household balance sheets has been felt on those households at the lower end of the income distribution who have seen falls in income, particularly those who have lost their jobs. Many of these households were already in debt and many households do not have savings or assets to fall back on.

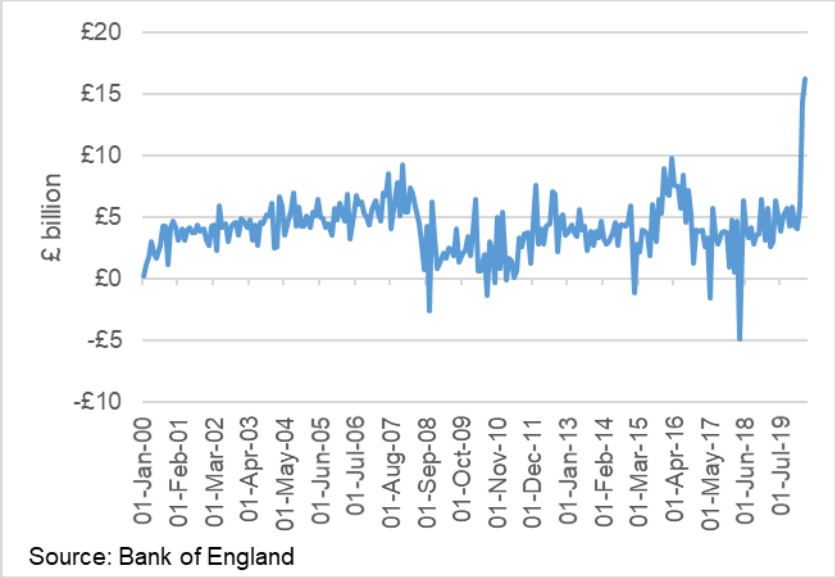
Analysis by the Resolution Foundation[18] finds that a typical worker in a shut-down sector, such as Wholesale and Retail, had average savings of just £1,900 per adult compared to £4,700 for households who have been able to work from home during the crisis. Households in distress will build up debt and can no longer afford to pay major monthly outgoings such as Council Tax and

[17] See for example IFS, 15 March, or Fraser of Allander Institute, 26 May, available here.
[18] Resolution Foundation, Rainy Days, 22 June 2020.

there is a risk that these may resort to high-cost credit to pay for essential goods. The results of a national financial impact tracker published by Standard Life Foundation show 50 per cent of UK households believe they will struggle to meet their financial commitments over the next three months. [19]

For other households the impact has been to decrease their household expenditure and this has led to increases in savings and household deposits (Chart 6).

Chart 6: Monthly change in UK household deposits

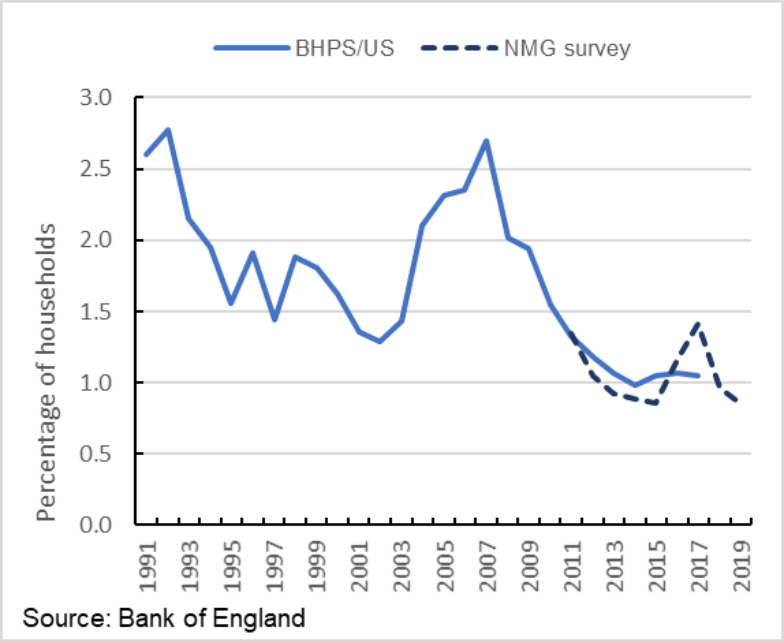


Scale of debt

At the aggregate level, in March 2020, UK households' balance sheets were in a stronger position than prior to the global financial crisis. The share of households with a mortgage debt-servicing ratio at or above 40% — a level above which households are more likely to experience payment difficulties — has remained at around 1% over the past two years, compared to 2.7% in 2007, according to the NMG Consulting survey (Chart 7).[20]

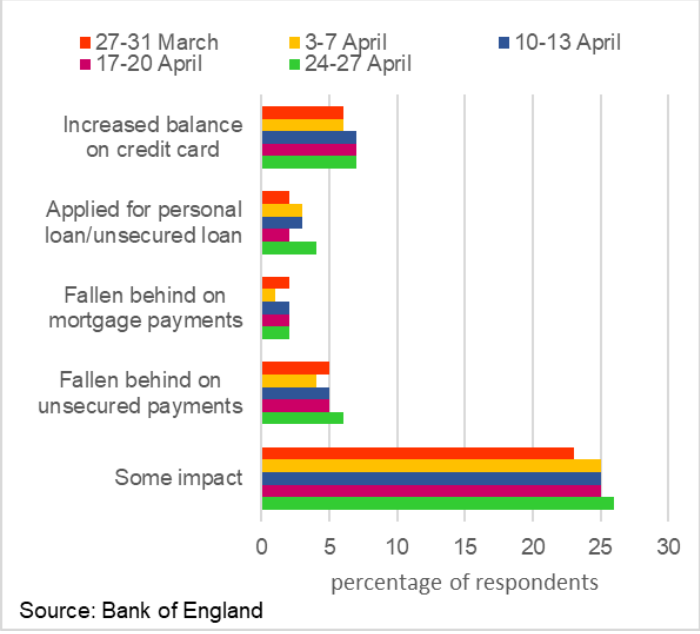
[19] https://www.standardlifefoundation.org.uk/our-work/coronavirus-finance-tracker2/coronavirus-finance-tracker/cfit-june
[20] Interim Financial Stability Report, May 2020, Bank of England, page 49. Link.

Chart 7: Percentage of households with mortgage-debt servicing ratio at or above 40%



Although at the aggregate level, household balance sheets were in strong shape pre-crisis, there were already a significant number of households experiencing some financial difficulty — in terms of meeting payments or increasing demand for credit (Chart 8).

Chart 8: Proportion of individuals reporting that they have missed payments or increased demand for credit



Options for dealing with household debt

Current schemes have supported employment and household incomes and without them the share of highly indebted households would already have risen materially since the start of the pandemic.

Our proposal: Increase the responsiveness, accessibility, generosity of the UK welfare safety net, so that it provides sufficient support for people in and out of work.

For households at the lower end of the income distribution, there will be a growing need for effective welfare support and safety net programmes. The accessibility and generosity of welfare benefits is key. Although the UK Government has temporarily increased the standard allowance rate for Universal Credit, this does not go far enough nor does it help those who are in receipt of 'legacy benefits', such as Employment and Support Allowance or Jobseeker's Allowance, that have not seen any comparable uprating, and provision of housing support remains an issue for many. The UK Government should take the opportunity to address these known issues within the benefit system, along with others including removing the benefit cap, scrapping the two child limit and replacing debt inducing advance payments for Universal Credit with non-repayable hardship grants. These changes, combined with a concerted benefit uptake campaign, could ensure that those who are eligible for welfare support are willing and able to access it.

The Treasury could accelerate the introduction of a No-Interest Loan Scheme to target lower-income earners who cannot afford to repay interest on loans which at present has been announced as a pilot. This could help avoid households building up further debt.

For those households with assets such as mortgages, given that mortgages are lenders' largest loan exposure in aggregate, it is in the collective interest of the UK banking system to continue to support households through this period of disruption.[21] The continuation of payment holidays offered by lenders — for both mortgages and unsecured loan products — will be necessary, otherwise households may struggle to service their debt once the payment holiday measures end.[22] Should lenders opt to end payment holidays then it will be critical that they agree new payment plans with households in difficulties. The work of the Financial Conduct Authority will continue to be vital in driving creditors into offering payment holidays.

The package of measures on dealing with household debt should form part of a national debt plan.

Businesses

Channels of impact

In general, business balance sheets are currently weak as a result of shocks to cash flow. Government support schemes are offering grants and loans to maintain productive capacity by dissuading businesses from making redundancies or allowing capital to depreciate. However, some of these government support measures leave businesses with higher debts and businesses will need to find a way to transition away from such support in the longer term.

The level of indebtedness could limit future investment and growth of businesses. Moreover, the changing conditions and elevated uncertainty means that decision making within businesses will have changed to the extent that the COVID-19 'break-even point' is different and businesses are likely to exhibit a considerable degree of caution over major investment decisions, with a preference for stronger balance sheets and less debt.

[21] Interim Financial Stability Report, May 2020, Bank of England, page 50. Link.
[22] Interim Financial Stability Report, May 2020, Bank of England, page 50. Link.

Scale of debt

The uptake of Government loans schemes illustrates the scale of debt that has been accumulated. But the debt is not equally spread across the economy. The take up of the initial schemes was greater for large companies, as shown in Chart 9. This led to the introduction of the Bounce Back Loan scheme in May, which has significantly improved access to credit for many businesses. Different sectors have also been more affected than others, with the transport sector in particular seeing a large increase in loans, see Chart 10. This debt will need to be managed and repaid. We need to consider how companies can manage their debts.

Chart 9: Annual growth rate of lending to businesses

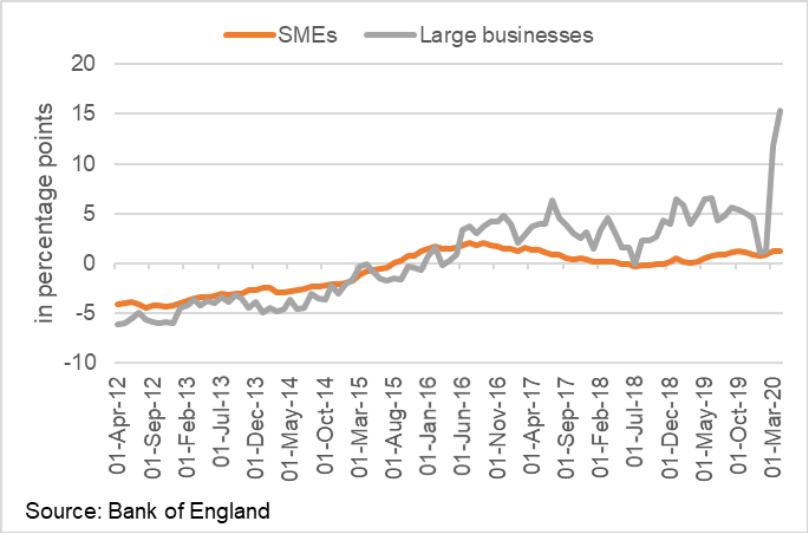
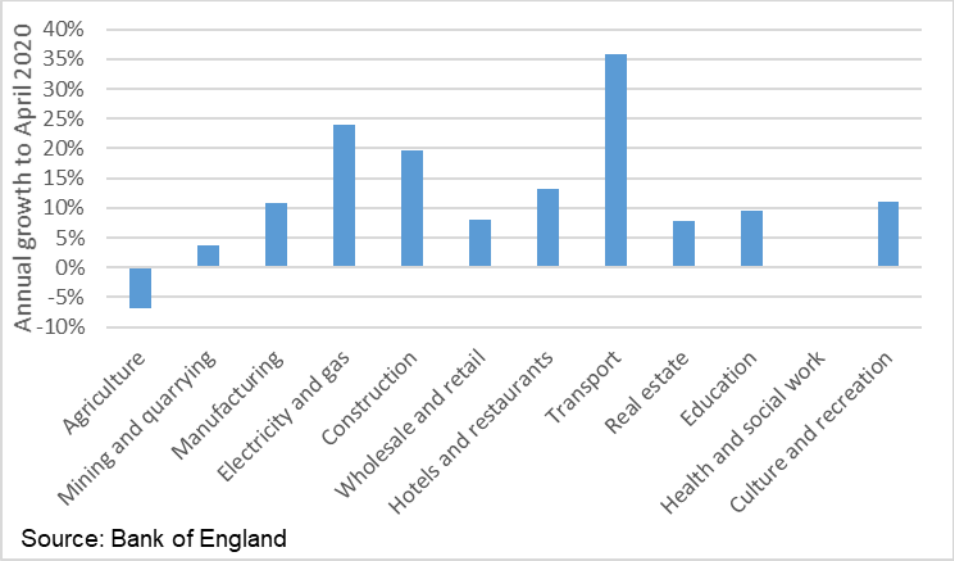


Chart 10: Annual growth in lending to large businesses by industry



The interim report by the Recapitalisation Group[23], led by TheCityUK and EY, suggests that the recapitalisation needs of UK small or medium sized enterprises (SMEs) are particularly acute, given the low volume of equity raised by SMEs (an average of £7.2bn p.a. from 2017 to 2019).

[23] The CityUK. Recapitalisation Group Interim Update, June 2020. Link

Options for dealing with business debt

It is not merely a question of managing down the debt of businesses. Many businesses will seek to take on additional debt, both to maintain their productive capacity and to build precautionary cash buffers. Continual supply of credit from the Banks will be key to supporting businesses.

For sectors with a longer recovery time – financial viability needs to change with a recognition that banks will need to continue some debt deferment and those sectors will need ongoing support.

Options for dealing with debt include:

- Transferring existing loans into patient capital fund, which could delay the point that interest repayments had to commence.
- Government support for strategic companies, transforming loans into equity investments.
- New sectoral banking products to meet the differential needs of sectors in the economy..
- Supporting SMEs by providing incentives to banks that increase lending to small and medium-sized enterprises.
- Transferring loans to a public policy bank, that could continue to support firms unable to manage commercial loans.

The package of measures on dealing with business debt should form part of a national debt plan. Further options for businesses lie primarily with the banking sector and are discussed in the next section.

The role of the banking and financial system

Channels of impact

Banks' balance sheets have been strengthened since the financial crisis, with the introduction of the Basel III accords and the regular stress testing of their finances by the Bank of England. However, they have issued significant amounts of new loans as a result of the crisis. Much of this debt expansion is through the government's lending guarantee schemes and as such, banks are therefore assumed to face a materially lower level of losses than would be the case without the guarantee. Most loans are guaranteed up to 80%, as such only 20% of banks' lending through these schemes results in additional credit risk for banks. For the Bounce Back Loan Scheme for small businesses, 100% of the loan is guaranteed.

However, the expectations of pay back on some of the government loans scheme are low. An interim report by the Recapitalisation Group projects that businesses will be saddled with between £97bn to £107bn worth of unsustainable debt by March 2021.[24] Many of these businesses, in banking terms, are no longer seen as viable.

Scale of debt

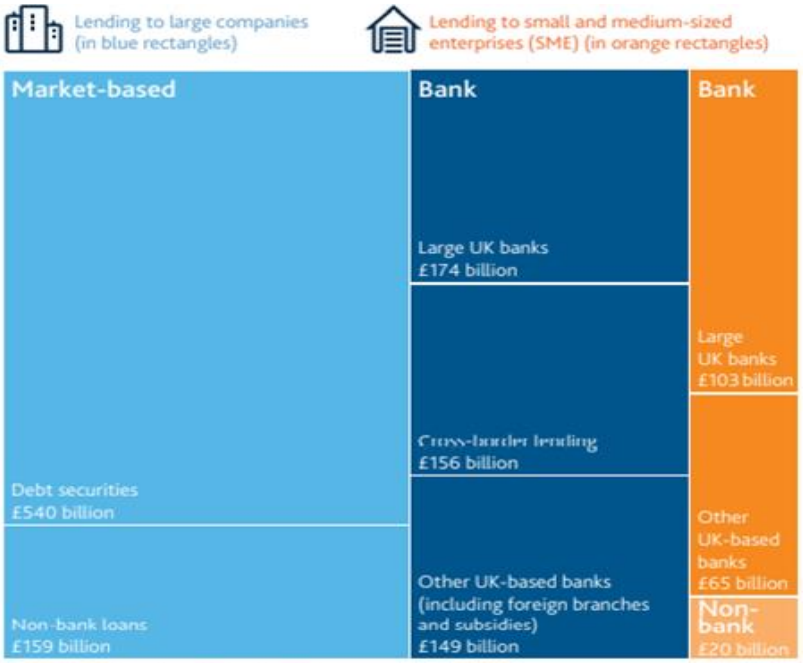
In an economic downturn, banks would expect to incur significant credit losses on their loans and to experience weaker capital positions. The Bank of England[25] suggest that the extent to which this may happen will depend on:

[24] The CityUK. Recapitalisation Group Interim Update, June 2020. Link

[25] Interim Financial Stability Report, May 2020, Bank of England, page 16.

- The size of the economic shock faced by households and businesses to which banks have extended loans, which determines the level of impairment on banks' existing loan books;
- Policy measures that are put in place by the government and authorities to support the ability of borrowers to continue to service loans and avoid default through the economic shock.

Chart 11: Estimated stock of UK private non-financial corporate (PNFC) sector debt



Source: Bank of England

Capital markets will also continue to play a key role in supporting larger corporates and accounted for more than half of debt outstanding in 2019 (Chart 11). Although the cost of market-based funding for corporates increased sharply in March as result of COVID-19, market conditions have stabilised somewhat.

The role the banking and financial system

Banks have a critical role to play in in assisting businesses in meeting cash flow deficits by expanding the supply of credit to the economy. As argued by the Bank of England, it is in the collective interest of the banking system to continue to support businesses through this period and the transition away from current support schemes.

There is a risk that individual banks have a preference to withdraw from under-performing credit provision. However, if all banks were to do so, more businesses would fail due to cash flow shortfalls, triggering bigger losses for banks on their existing corporate loans and, by pushing unemployment higher, bigger losses on existing household loans too. This action would also shift business debt onto the government's balance sheet.

There is a difficult balance to be found between supporting businesses through the crisis and directing support to those businesses which will be viable in the longer term. There is a risk that businesses become dependent on low-cost finance which cannot be withdrawn, which was seen as part of the reason for the slow recovery in the economy and productivity after the financial crisis. An alternative approach may be for a public policy bank to take on the loans of less viable companies, to allow the banking system to focus on companies requiring less support..

The development of new recapitalisation instruments may provide alternative options. The interim report by the Recapitalisation Group[26] outlines a number of potential recapitalisation instruments. These fall into three groups:

- Transforming debt into equity – so that it becomes an income stream when businesses return to profit;
- Collecting debt via the tax system – so that companies pay debt out of their profits;
- Debt forgiveness – for businesses in extreme distress.

The package of measures that the banks and financial system introduce should form part of a national debt plan.

Our Proposal: Reset the monetary policy objective of the Bank of England so that long-term growth and reducing inequality are promoted.

The Bank of England will continue to have a central role to play to deliver the Bank's statutory responsibilities for monetary and financial stability. This will include protecting and enhancing the resilience of the system as a whole and supervision of banks and insurers. It is clear, however, that COVID-19 is creating new challenges for the financial system and, since regulation is a means not an end, a renewed debate over the outcomes that regulation should achieve is required.

This debate should also include careful consideration over whether the Bank's current objective of maintaining price stability in the UK is the right one in these challenging times. The Bank's own assessment of the impact of quantitative easing after the financial crisis found that richer households gained more than poorer households, with the poorest 10% actually seeing their incomes fall as a result of the interventions.[27] It is important to learn from the unintended consequences of previous policy intervention, to prevent this from happening again. The Bank's remit should be broadened to ensure that monetary policy, in line with wider government policy, contributes toward rebuilding a fairer economy.

[26] The CityUK. Recapitalisation Group Interim Update, June 2020. Link

[27] Bank of England. The distributional impact of monetary policy easing in the UK between 2008 and 2014.

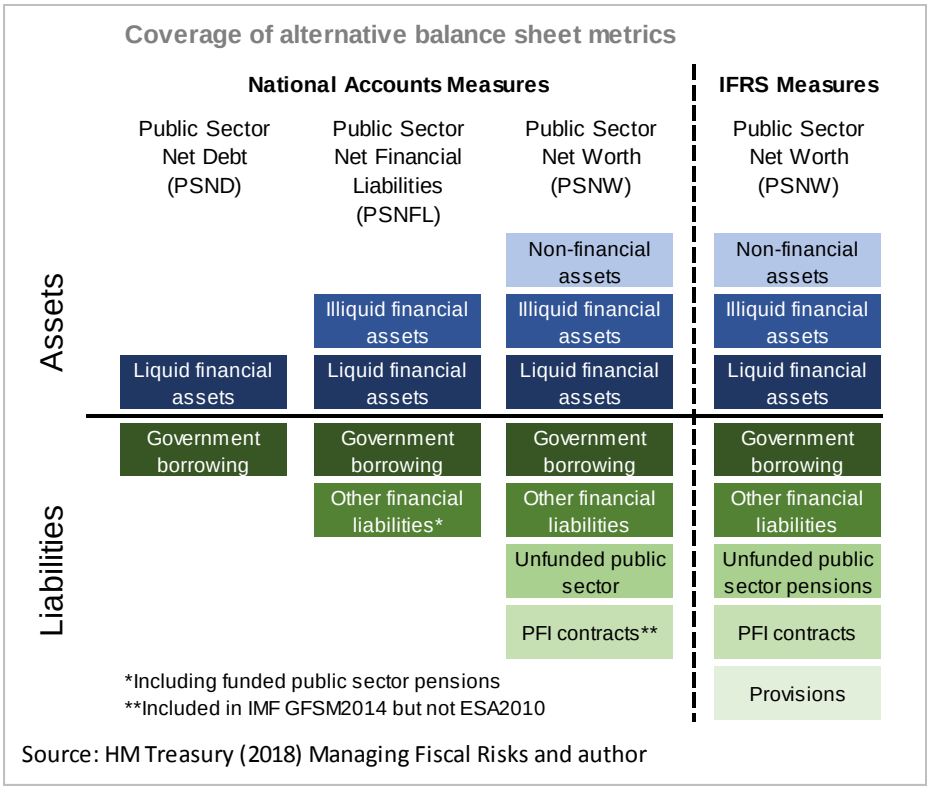
Annex A: Further details of analysis

1. The Public Sector Balance Sheet

As illustrated in Chart 12, there are various statistical measures available to assess the health of the public sector finances. The UK Government's current preferred balance sheet measure, public sector net debt (excluding public sector banks), compares total outstanding government borrowing against liquid financial assets such as bank deposits and foreign exchange reserves.

Public sector net financial liabilities (PSNFL) include all financial assets, such as loans to students to pay for tuition feeds, derivatives and equity investment and the corporate bonds acquired by the Bank of England through its credit easing operations. Any sale or transfers of assets above/below their retention value would show up as a gain/loss to the taxpayer. The ONS began publishing quarterly data on PSNFL in November 2016 while the OBR began forecasting PSNFL in its 2016 Autumn Statement.

Chart 12: Different public sector balance sheet measures



Public sector net worth (PSNW) is the most comprehensive measure which compares debt with all of the Government's assets, including physical assets to deliver services such as infrastructure, hospitals and schools as well as unfunded public service pension. It also includes environmental assets, such as forests and water resources and any depletion in those would reduce measured net worth. The ONS has started publishing estimates of PSNW as part of its wider reporting of public sector finances.

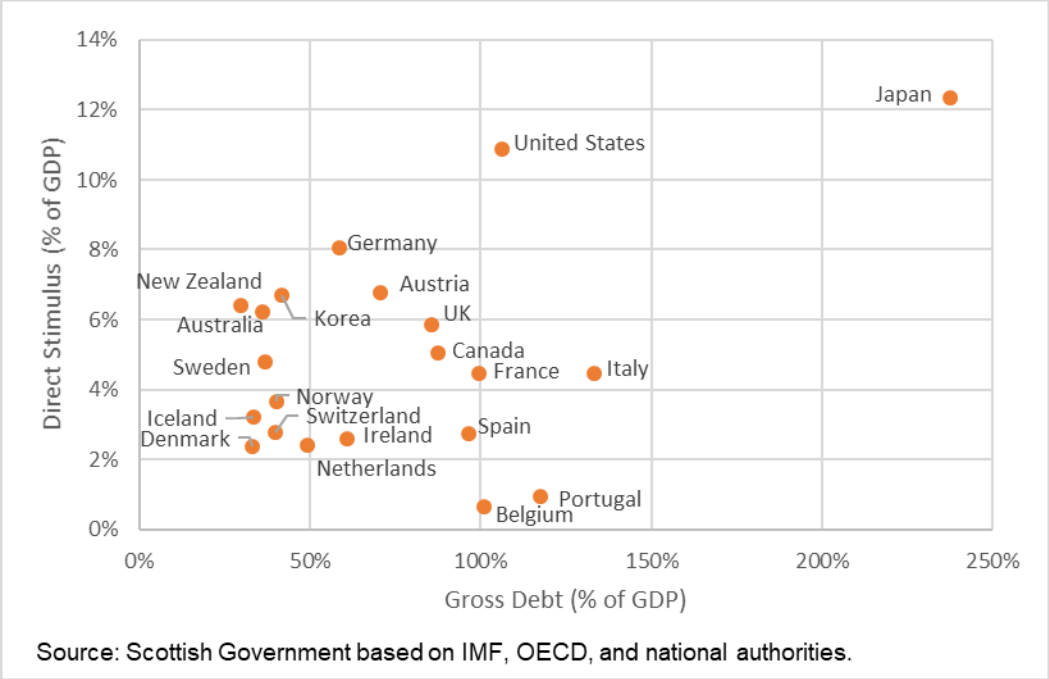
2. International Comparisons

The COVID-19 pandemic is having profound economic consequences and there has been an unprecedented fiscal policy response from governments around the world although the scale and design of the fiscal stimulus varies across countries.

Countries with larger fiscal headroom, as measured by low levels of debt and high credit ratings, tend to have more scope to provide sizeable fiscal stimulus packages (see Chart 13) with Japan, one of the most indebted countries in the world being a notable exception. This may be due to the fact that Japan's debt is mostly held by domestic investors rather than by foreigners. Similarly, the United States is another example of a country with a sizeable fiscal aid package despite high levels of public debt. However, US Treasuries are generally considered one of the safest assets so that the US is likely to be able to borrow more easily to fund these measures.

So far, there are only a handful of countries, including Germany and New Zealand, which have moved on from providing emergency assistance to a post-coronavirus fiscal stimulus pack. This follows a period of prudent fiscal management which saw Germany reduce is public sector debt by running sustained budget surpluses.

Chart 13: COVID-19 – Direct fiscal stimulus and debt levels



Source: Scottish Government based on IMF, OECD, and national authorities.

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