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Rethinking UK Economic Policy

In common with counterparts in other advanced economies, the UK government reacted quickly to the economic threats from Covid and adopted wide-ranging policies to cushion the economy. Some of these policies were designed and implemented at very short notice, notably a "furlough" scheme to support workers forced to cease activity because of lockdown restrictions.

As the economy recovers, the UK has to contend with not just the aftermath of the pandemic, but also the dislocations resulting from exiting the European Union. In addition, the government has committed itself to a range of strategic policy shifts, some associated with Brexit and others from domestic policy commitments. This article provides an overview of the policy responses, discusses how macroeconomic conditions are evolving, looks at the emerging policy approaches, and assesses the choices made.

RESPONSES TO THE PANDEMIC: A MIXED RECORD

In many respects, the UK's economic policy responses to Covid-19 deserve praise. The furlough scheme appears to have succeeded in keeping workers connected to the labor market and was adapted pragmatically, both in duration and coverage (including the self-employed), as the pandemic evolved. Similarly, emergency "business interruption" loans were offered to companies, initially to SMEs, then also to larger firms. Subsequently the government introduced "bounce back loans" aimed at supporting the recovery.

The Bank of England acted quickly to cut interest rates in March 2020 to the rock-bottom rate of 0.1 percent and worked closely with the government to introduce additional borrowing facilities for both corporates and the banks. There had already been a large-scale program of quantitative easing after the global financial crisis. Also, the Bank eased capital requirements on lenders, and agreed with leading banks to suspend dividend payments and curb bonuses as ways of shoring up financial stability.

During the most acute phases of the pandemic, the government substantially increased spending on the National Health Service (NHS), but its management of the crisis has a mixed record. What rapidly became clear was that the contingency planning was geared towards a flu epidemic and not a new pathogen about which little was known. A lack of personal protective equipment and testing capability were just two of the well-publicized failings, and a policy of decanting elderly patients from hospitals into care homes or the community contributed to a high number of deaths.

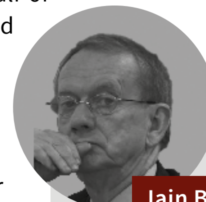
In contrast, quickly taken decisions on investing in research and on placing advance orders greatly facilitated the development and authorization of vaccines, followed by their early rollout to citizens. The combination of the vaccination programs, use of private hospitals, the postponement of routine medical procedures, and the construction at short notice of "Nightingale" hospitals (barely used in the end), enabled the NHS to avoid being overrun.

A first re-opening of the economy in August 2020 proved to be premature and was reversed to be replaced by a more cautious phased approach between March and July 2021. Even so, new infections continue to be recorded at a rate of over one million new cases per month since early summer 2021.

A temporary uplift of GBP 20 per week in the main social benefit, Universal Credit (paid to those on low wages, as well as those not in employment), was adopted early in the pandemic and came to be regarded as a vital element in limiting adverse distributive effects of lockdown. By ending the top-up payment at the end of September 2021, the government has been accused of neglecting poorer people, especially at a time when energy bills are rising. However, recent measures to offset these losses were subsequently introduced, notably a rise in the minimum wage by more than inflation and easing of the 'taper' of benefits as workers earn more, enabling them to retain a higher proportion of the benefit payment.

MACROECONOMIC CONDITIONS

After a decade of austerity policies aimed at gradual consolidation of the public finances, the pre-Covid current balance was close to balance and the debt level had been falling slightly from its peak of around 80 percent of GDP in the first half of the 2010s. The government had fiscal space to enable a Keynesian response to the pandemic and the jump in the deficit was of the order of 14 percentage points of GDP in the fiscal year 2020-21, with debt rising to its highest level for sixty years. Despite the rising deficit and debt, the financing costs have remained low, with the government able to borrow on very favorable terms.



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Concerns are now being expressed about the consequences of the conjunction of loose fiscal and monetary policy. Inflation, long quiescent, has crept upwards and is expected to reach 4 percent by the end of 2021. Initially, the Bank of England suggested that rising prices were largely attributable to one-off factors and would soon moderate. Andrew Bailey, the Governor of the Bank of England, explained that while there are supply challenges, they do not (or do not yet) justify a change of direction in monetary policy (Bailey 2021). Rising energy prices and pressures on employers to raise wages to attract scarce workers have, however, made a wage-price spiral more likely. If interest rates do start to normalize, the high debt burden would be a problem not just for the public sector, but for those companies which have used borrowing to cushion the effects of the pandemic.

The labor market is puzzling. There was only a small increase in unemployment during the pandemic-induced recession and the most recent data reveal a record number of job vacancies which now stand at 1.1 million (up by 30 percent from the pre-pandemic level of the first quarter of 2020).[1] Total employment fell during the pandemic, but is again showing strong growth. Bailey wonders whether the labor market is, as he puts it on the cusp "of a more far-reaching structural change in the economy which alters relative pay across occupations?" He notes that such changes do arise from time to time, citing the widening of the gap between higher and lower earners in the 1980s.

Although it is difficult at this stage to ascertain whether jobs supported by the furlough scheme until the end of September will remain viable, disruption in the labor market seems unavoidable. Certainly, the messages emanating from government suggest transformation of the labor market is a core policy objective. A sizeable[2] number of workers moved to the UK because of free movement inside the EU, especially after 2003; however, some of these workers have opted to leave as a result of Brexit and the pandemic. Because of this supply of workers, an emerging policy narrative suggests wages were lower and employers had few incentives to train indigenous workers. In addition, companies faced disincentives to invest, precisely because they could use cheaper labor, especially for lower skill occupations.

These assertions are open to challenge and the empirical evidence is mixed, as Jonathan Portes has shown in a 2018 review, with the effects generally found to be at most minor. Work by the Migration Observatory at the University of Oxford (2020) finds a greater effect on lower wage occupations, but stresses the need for nuanced interpretation. Rising wages in some sectors where foreign workers have left in substantial numbers because of the conjunction of the pandemic and Brexit might suggest a more pronounced effect, but firm conclusions must await further research.

Despite these ambiguities, the current thrust of policy is to restrict work visas for lower paid foreign workers. Instead, preference will be given to migrant workers able to fill shortages in skilled occupations. This policy was brought into sharp focus by the sudden shortage of heavy goods vehicle drivers, even though it is a longstanding problem across Europe, and the government was forced to relent by allowing temporary work visas. But its aim remains to push employers to adjust wages as the means of dealing with shortages, while accelerating the rate of innovation. This ambition of creating a high wage, high productivity economy is alluring, but against a backdrop of a lackluster productivity growth in the decade prior to the pandemic, such a transformation will need more than optimistic words.

TOWARDS RECOVERY

Partly in response to the dislocations from Covid, but partly also because of the manifesto commitments of the Conservative Party which won the 2019 general election, the government in 2021 set out a plan for growth entitled *Build Back Better*.[3] The slogan is not original and is used elsewhere, but the plan has a number of key features distinctive to the UK, highlighting several longstanding weaknesses, ranging from skills to innovation, and proposes policies to correct them.

Infrastructure is given considerable prominence. The plan states bluntly that the "quality of our infrastructure is lower than many other countries," and recalls the large amounts already proposed a year earlier for a *National Infrastructure Strategy*. In cash terms, the provisions for infrastructure investment in the period 2021–25 are expected to increase by at least two-thirds the amounts spent in the period 2016–20. These plans are, as always, open to review and there are continuing campaigns against some of the most high-profile components, notably the HS2 (high-speed) rail link from London to the north of England.

A long overdue element of the plan is to accelerate the delivery of major investment programs—the optimistically named "Project Speed"—including using the opportunity of Brexit to simplify procurement processes. However, it is not only cynics who will wonder whether such ambitions can be realized, given the poor past record of the UK in deciding on, and completing, major infrastructure projects. High-profile examples include the repeated delays in completing London's "Crossrail," now expected to open in the

[1] See https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/employmentandemployeetypes/bulletins/jobsandvacanciesintheuk/october2021.

[2] Recent figures, based on those applying for settled status following Brexit, suggest the headline total might be some 2 million higher than the 3.7 million previously estimated.

[3] See https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/969275/PfG_Final_print_Plan_for_Growth_Print.pdf.

first semester of 2022, over three years late, and the procrastination in agreeing on, let alone building, new airport runway capacity in South-East England.

LEVELLING-UP

A key promise to the electorate from the Johnson government was to promote "levelling-up," aimed at communities—especially in the Midlands and North of England—perceived to have been relative losers from the economic effects of market liberalization and integration in recent decades. Although the intuitive meaning of the term is obvious, the government (and Johnson in particular) has been criticized for being vague about what the policy will mean in practice. It is expected to encompass spatially targeted boosts to education, skills, transport, and other infrastructure, along with the fostering of innovation and various other forms of support. In presenting his budget on 27 October 2021 formally confirmed a variety of new or additional allocations of funding, including a hefty £7 billion for transport in the midlands and north of England.

New financing mechanisms are being established to support place-based economic development. However, there are few details as yet on their scope and capabilities, making it hard to assess their likely impact. A new Shared Prosperity Fund is due to be launched in April 2022 and has been described in the House of Commons[4] as "the successor to EU structural funds, with decisions about how taxpayers' money is spent being taken in the United Kingdom, rather than in Brussels." The government has asserted that it will at least match the funding previously received from the EU funds, although it is worth recalling that in the run-up to Brexit, UK receipts from these sources had shrunk compared with previous decades to around GBP 1.5 billion per annum.

The distribution of the funding is, however, likely to differ from the most recent allocations from the EU in which only two regions (Cornwall and the Isles of Scilly, and West Wales and the Valleys) were eligible for the highest levels of support. Moreover, the role of central government will be enhanced, potentially leading to clashes with the devolved administrations (Northern Ireland, Scotland, and Wales) or English local governments accustomed to having the relevant powers under EU Cohesion Policy. According to the Institute for Government (2021) this arrangement "risks damaging trust between the UK and devolved administrations and undermining the UK government's key objective of binding the four nations of the UK closer together."

Also at issue is the approach to regional policy. Under EU Cohesion Policy, a notable feature was the strategic nature of programs, both in relation to the broad thematic coverage of policy support and its duration. Although attention has been drawn to this aspect of future policy by various commentators, it remains uncertain whether some of the features central to EU regional policy will be adopted.

One recent innovation is the designation of a number of "freeports," spread across the country, reversing a decision taken in 2012 to close the then existing ones. Freeports are intended to provide opportunities for business to locate in areas with much reduced administrative obligations and customs rules and are, de facto, akin to export processing zone across the world. Whether they will succeed in attracting new inward investment to post-Brexit UK or fall victim to the same sort of displacement effects that affected previous initiatives of this sort is one of many open questions about these policies.

TRADE POLICY

Like many other advanced economies, the UK has become acutely aware during the pandemic of its vulnerability to supply-chain bottlenecks. There have been hints from policymakers about wanting action to promote import substitution, but the language stops short of the "strategic autonomy" discourse promoted by a number of EU leaders. One explanation is that the UK already faces significant trade policy challenges in the aftermath of Brexit. In this context, the term "global Britain" has been much used by government ministers, implying a pivot away from the EU as the principal trading partner.

After the fraught negotiations leading to the Trade and Cooperation Agreement concluded at the end of 2020, the UK continues to have free trade in goods with the EU, but even so there are increased frictions at the borders. Brexit was always susceptible to such frictions, adding to the costs of trade with the EU. The particular difficulties in Northern Ireland—with a political choice made to create a de facto border in the Irish Sea, so as to avoid one on the island of Ireland—are giving rise to significant challenges. There are also new barriers to trade in services, especially affecting the UK's competitive financial and business services sectors. Government policy is to try to mitigate these barriers and frictions, but it will be difficult in the face of resistance from the EU side.

In parallel, the UK is keen to use its freedom from EU rules to conclude new trade deals. There has been success in rolling over many of the deals to which the UK was previously party because of its EU membership, and it is even claimed that in some cases (for example, Japan) the new deal goes further. But the prize of a deal with the US is looking increasingly unlikely. Some new deals may offer new opportunities—Australia is one such example—but it is doubtful how much impact they will have because of the limited scope for increasing total UK trade to these partners.

[4] See https://hansard.parliament.uk/Commons/2021-06-23/debates/DCA75415-E60F-4ACD-81D3-9EA18A69D9F2/Scotland.

HEALTH

In health, emergency measures have caused a lengthening of waiting lists for other medical conditions and have pushed the government to find additional resources for the NHS. The government has also announced its intention to boost provision for social care, with the aim of resolving the shortcomings of a system that successive governments have recognized, but failed (or lacked the political will) to address. A decision to fund these increased social outlays by increasing national insurance—a levy on labor, paid by both employers and employees, though not hypothecated completely to social spending as in many continental European systems—has provoked objections about its fairness. Critics argue that it penalizes the current workforce in order to protect the capital of the economically inactive, and would have preferred some form of wealth tax (notably on property owners).

ASSESSMENT

Much of UK economic policy is in flux as the government tries to construct a post-Brexit economic model, while also building on lessons from the pandemic. Ambitious, but costly, plans for moving earlier to "net-zero" carbon emissions have also been set out by the government, keen to set a good example for other participants in the CoP 26 summit in Glasgow. These and other spending decisions taken since summer 2021 will mean the share of public expenditure in the economy rising from a pre-pandemic level of just under 40 percent of GDP, to 45 percent in the 2021-22 fiscal year before settling at around 42 percent in the following two fiscal years (HM Treasury 2021).

However, despite sanguine rhetoric from the Prime Minister and other ministers, the UK economy also continues to be under the shadow of Brexit. Many of its effects had been predicted and should not have come as surprise, but were masked by the pandemic and it is only latterly that some of the consequences have become visible.

There was considerable pessimism in the course of 2020 about the magnitude of the economic downturn and the time it would take to return to the pre-Covid level of GDP, with many projections placing the UK at the lower end of the OECD league tables. However, the outlook improved subsequently, despite a renewed surge of infections early in 2021, and revised data for the second quarter of 2021 showed higher growth than previously estimated. The projections announced in the 27 October budget speech by Rishi Sunak, the Chancellor of the Exchequer, suggest UK GDP will be back to its pre-pandemic level by mid-2022.

This improved growth trajectory, as the Institute for Fiscal Studies (2021) makes clear in its October 2021 commentary and Sunak has now confirmed, greatly improves the outlook for the public finances compared with the government's projections from as recently as spring 2021. In addition to the beneficial effects of strong growth, tax rises already in the pipeline will add to revenue. An objection from many in the Conservative Party is, however, that these rises will raise the share of tax as a proportion of GDP and boost rather than curb the role of the state in the economy.

While the latest growth forecasts are encouraging, there is hesitation about cutting-back on measures to stimulate economic activity because of uncertainty about whether the recent spike in inflation will prove temporary or not, and a reluctance to put the recovery at risk by implementing a premature fiscal consolidation. Deciding on and restoring credible fiscal rules will soon be on the agenda and could well provoke disputes at a time when big increases in expenditure have been announced.

In conclusion, the UK is undertaking potentially far-reaching economic policy developments, but they are at a relatively early stage and achieving them will be difficult. There are worries about the UK becoming more prone than elsewhere to a period of stagflation as a result of cost-push pressures, rising interest rates and higher taxes. Sunak has gambled on growth being the answer, enabling him to honor the government's many spending commitments without putting fiscal sustainability at risk. More generally, in the face of so many uncertainties and a patchy track-record in policy delivery, the question is whether outcomes can match the expectations that have been engendered. Interesting times lie ahead.

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