

THE CHANCELLOR'S CHALLENGE

DELIVERING A STIMULUS FOR POST-PANDEMIC RECOVERY

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EXECUTIVE SUMMARY

We are at a critical point in the course of this pandemic. Decisions taken today will determine whether businesses can recover and the state and shape of the economy for years to come.

There is both spare capacity in the economy and near-zero interest rates. In this context, with monetary policy constrained, a fiscal stimulus is essential to supporting aggregate demand and economic recovery. But fiscal stimulus is also fiscal responsibility, as argued by the International Monetary Fund (IMF). A stimulus will stabilise the public finances, because by shoring up economic activity, tax receipts will be higher.

In this paper, we show that without further policy support, the economy could become stuck in a '93 per cent economy', where many sectors remain far below potential. We estimate that there is a need for a stimulus of £164 billion in 2021/22 to return the economy to near potential by Spring 2022 and address much of the economic damage wrought by the pandemic.

This stimulus would restart the economy and help put it on a sustainable trajectory, preventing significant social hardship. By stimulating employment, it could prevent more than one million layoffs. And, if our recommended 'family stimulus' is included, 700,000 children could be lifted out of poverty.

Even though our stimulus scenario sees higher borrowing overall than a 'no stimulus' scenario, it is superior even in purely fiscal terms. By preventing a slow recovery and directly addressing scarring in the economy, the stimulus would increase GDP more quickly than the debt burden. This means the UK would be left with a smaller (not larger) debt-to-GDP ratio compared to a no-stimulus scenario. Further, public investments would pay off even more later on, by raising productivity and growth in future years.

A stimulus of this size would represent a large redirection of economic resources. The UK faced huge, structural challenges even before the pandemic hit, including deep regional inequalities, an economy in need of fundamental reform and higher investment to deliver rising wages and productivity, and the urgent requirement to decarbonise and restore nature. Government should view spending over the coming years as an investment to build a fairer, stronger and greener economy. Indeed, without this investment, the government will fail to achieve its own priorities on 'levelling up' and meeting the UK's net-zero emissions target.

We set out a detailed package of public spending for next year to achieve this goal. Our three priorities are:

- **Ushering in a new era of public investment for a fairer, stronger and greener economy.** This should begin with a commitment to invest all of the additional £33bn a year needed to deliver the UK's net-zero emissions target and restore nature. This would put the UK on a more certain path to net-zero than the relatively modest increases announced by the government over recent months - including in the prime minister's new 10-point plan. We also recommend the establishment of a National Investment Bank, with strong regional divisions, to increase and direct investment towards the government's industrial strategy, infrastructure and innovation goals.
- **A resilience revolution to restore public services and better support individuals, families and the economy.** That means continuing emergency measures to tackle Covid-19; boosting financial support for families as part of a family stimulus alongside other improvements to universal credit; investing in catch-up funding for health, public health and social care; and restoring spending in all other areas including grants to local government to pre-2010 trends, to reverse effects of austerity.
- **Support for businesses and workers while securing a return for the public.** This means ensuring the labour market can bounce back strongly once restrictions are lifted, through support for work sharing and retraining. Businesses balance sheets – scarred by the crisis - would be bolstered through financial support that is conditional on a financial, social and/or environmental return to the public.

As borrowing costs remain low, a high level of government debt remains affordable and indeed essential to ensure the economy returns to potential. However, once the stimulus has successfully delivered a sustained recovery,

enduring day-to-day spending commitments will need to be financed via taxation.

The bulk of any tax rises should be phased in no earlier than 2023/24. However, this does not mean that we should not contemplate tax reform now. Taxes perform a number of functions in our economy beyond revenue raising, including helping to deliver economic justice and shaping the direction (as well as level) of growth.

We argue that several forms of tax increases could be compatible with a fair, strong and green recovery, and therefore could be introduced or raised sooner than 2023/24. These include, for example, an excess profits tax on those unfairly benefitting from the crisis, behaviour-shaping (or 'Pigouvian') taxes - including on pollution, levies on distorting economic rents, and taxes that rectify unjust exemptions for the wealthy, prevent spiralling inequality.

After the second world war, the government could have tried to cut spending to deal with record debts. Instead, politicians recognised that the crisis was a moment for change, to invest in a better society for the future. The UK government must do the same now. Policy must be commensurate with the scale of the challenge; it is excessive caution that would be risky. Measures taken must both respond to the immediate health and jobs crisis we are facing today, but also set us on a better path for tomorrow. This is the chancellor's challenge.

THE CHANCELLOR'S CHALLENGE

2020 has been an extraordinary and difficult year for people across the country, but also for government. The usual calendar of fiscal interventions has been trampled over by the demands of dealing with a global pandemic and the deepest recession on record (ONS, 2020).

We are at a critical point in the course of this pandemic. While the prospect of a vaccine has offered hope to people - and stock markets - worldwide, there is a long way to go yet. Decisions taken today will determine whether businesses can recover and the state and shape of the economy for years to come. Even once a vaccine is approved, rollout will not be achieved at least for six to twelve months in UK, and longer in a number of countries around the world that the UK trades with and that people travel to (The DELVE Initiative, 2020). All of us are likely to be living under *some* kind of restrictions for months and possibly years to come; and structural changes have already taken place across the economy. There is no 'going back' to the pre-pandemic economy, as if its course had merely been paused.

The pandemic has had dire consequences for people's lives – not just in health terms, but economically. We are approaching a million people having lost their jobs (ONS, 2020a). The number of families with children using foodbanks has doubled during the pandemic (Trussell Trust, 2020). This tide of hardship will only swell without adequate support for the economy, including through 'scarring effects' that will make it harder for businesses and people to survive and thrive. It is in this context that the chancellor will be weighing up his choices and interventions in the coming months – starting with the Spending Round.

There are five principles he must follow in his upcoming interventions, and which inform the recommendations in this paper:

- 1. Economic and public health policy must move in lockstep.** The concept of a trade-off between health and wealth is wrong and is holding back effective policymaking. If consumers are worried about shopping, eating out, or the future of the economy, demand will remain weak.¹ And if businesses are uncertain about future support measures, they might hold back investing. Economic policies must be compatible with and support the public health measures required to control the virus, and prioritisation of the measures we know are the route out of the crisis – such as an effective test and trace system including adequate sick pay; efficient vaccine roll out and treatments are paramount. So too, the course of the pandemic must inform economic policymaking to avoid long-term damage. For example, many businesses that will be viable once restrictions ease may not be able to operate now; withdrawing support measures before restrictions are lifted will destroy viable jobs.

¹ As acknowledged by the chancellor early in the pandemic: <https://www.bbc.co.uk/news/business-52447298> and reiterated by leading economists: <https://www.opendemocracy.net/en/oureconomy/letter-there-no-trade-between-public-health-and-economy/>

2. **Policymakers must get ahead of the pandemic.** Too many decisions have been made at the eleventh hour, and the impact of good policies has been weakened as a result. This has left the government playing catch-up, for example reinstating the Job Retention Scheme after many jobs will have been lost because businesses expected the scheme to end. The government must, as far as possible, anticipate the course of the pandemic and err on the side of providing businesses with stability and protection to avoid needless economic damage.
3. **The response must be commensurate with the scale of the challenge.** Now is not the time to be timid. The UK economy is in a deep crisis and at risk of permanently losing viable, valuable jobs and businesses. That is in addition to stagnating investment and low growth before the pandemic. Looking ahead, the UK is facing a decade of disruption, with the need to address the climate and nature crises looming large, alongside growing regional inequalities, a growing group of people requiring care, and the potential for widescale automation (Quilter-Pinner, McNeil, & Hochlaf, 2020). And, the government must take a holistic approach to the economy, rather than seeing individual policies in isolation. Crucially, it needs to focus on aggregate demand and the interaction of individual policies to ensure a balanced recovery can be achieved.
4. **The recovery must address the UK's deep regional inequalities – including of health, income and power.** The government has committed to a 'levelling up' agenda. This cannot be done on a shoestring, and will require resources, including for areas and places that have been held back by years of underinvestment. This must extend beyond infrastructure projects to, for example, public services and local government that are core to local economies. Neither can it be done without working with and devolving power to local leaders, who hold knowledge, expertise and understanding of their areas.
5. **The recovery must have economic, environmental and social justice at its heart.** Allowing the economy to stagger back without direction from government would be an abdication of responsibility. The pandemic has exposed and exacerbated deep-rooted inequalities that run through our society as well as income and employment insecurity. Public services and local government have been 'run hot' over ten years of austerity. Many families have gone from just about managing to 'just not' managing, bearing their own risks without an adequate social safety net (Nanda, Round, & Rankin, 2020). As the IPPR Commission on Economic Justice set out two years ago, the UK economy is in need of fundamental reform *independently* of the pandemic, with many of its problems – from low investment to regional inequalities - going back decades (IPPR Commission on Economic Justice, 2018).

At the same time, the climate and nature crisis requires swift and decisive action from government. The UK is presently set to miss its legally binding fourth and fifth carbon budgets and is also failing to make progress on international targets on halting and reversing biodiversity loss (Jung &

Murphy, 2020b). Without stronger and more rapid near-term action, the Climate Change Committee (CCC) has warned that it will quickly become infeasible to decarbonise sufficiently to reach net zero GHG emissions by 2050 without significant additional costs and greater disruption to people's lifestyles (Climate Change Committee, 2019).

Given these challenges, every pandemic intervention from government must be focused on rebuilding a fairer, stronger and greener economy. Interventions should seek to protect the parts of the economy and places that people collectively value, and that can thrive if guided through this crisis. To grow the jobs and industries that will enable us to reach net-zero. And children and families should not face hardship when crisis hits – now, or next time round. These goals are not in conflict but support one another.

This will require a triple focus. First, the pandemic must mark a turning point in the UK's efforts to address the climate and nature crisis, with an investment-led recovery focused on job-creation across the country through decarbonisation and restoring nature. Second, the lesson from shocks like Covid-19 is clear: we must 'future-proof' our welfare state – from public services to the social safety net – now, to ensure we are ready for them. Third, as the economy is rebuilt, it must be hard-wired for both prosperity and justice.

In this paper, we set out a package of public spending for next year to support the economy, boost economic activity and create jobs. We argue that stabilising and growing the economy will require an ambitious fiscal stimulus. We set out key priorities to direct resources to rebuild in a way that aligns with the principles set out above. And we show how this is not just affordable but required – along with a discussion of how the tax system could be used to support a fair, strong and green economy.

In his speech to Conservative Conference this year, Boris Johnson said:

"In the depths of the second world war, in 1942, when just about everything had gone wrong, the government sketched out a vision of the post-war new Jerusalem that they wanted to build. And that is what we are doing now – in the teeth of this pandemic."²

After the second world war, the government could have tried to cut spending to deal with record debts. Instead, politicians recognised that the crisis was a moment for change, to invest in a better society for the future. The UK government must do the same now. Measures taken must both respond to the immediate health and jobs crisis we are facing today, but also set us on a better path for tomorrow. This is the chancellor's challenge.

² See: <https://www.theguardian.com/politics/2020/oct/06/covid-can-change-uk-like-1940s-new-jerusalem-johnson-claims>

A STIMULUS IS REQUIRED

The pandemic and restrictions are set to reduce economic activity

As set out above, economic policy must be compatible with and respond to the public health outlook. We foresee two phases of economic policy required: 'rescue', and 'reopening', defined below. In reality, unforeseen events may necessitate backwards as well as forwards steps in the path of the pandemic and measures; however, our proposals are based on our current baseline scenario:

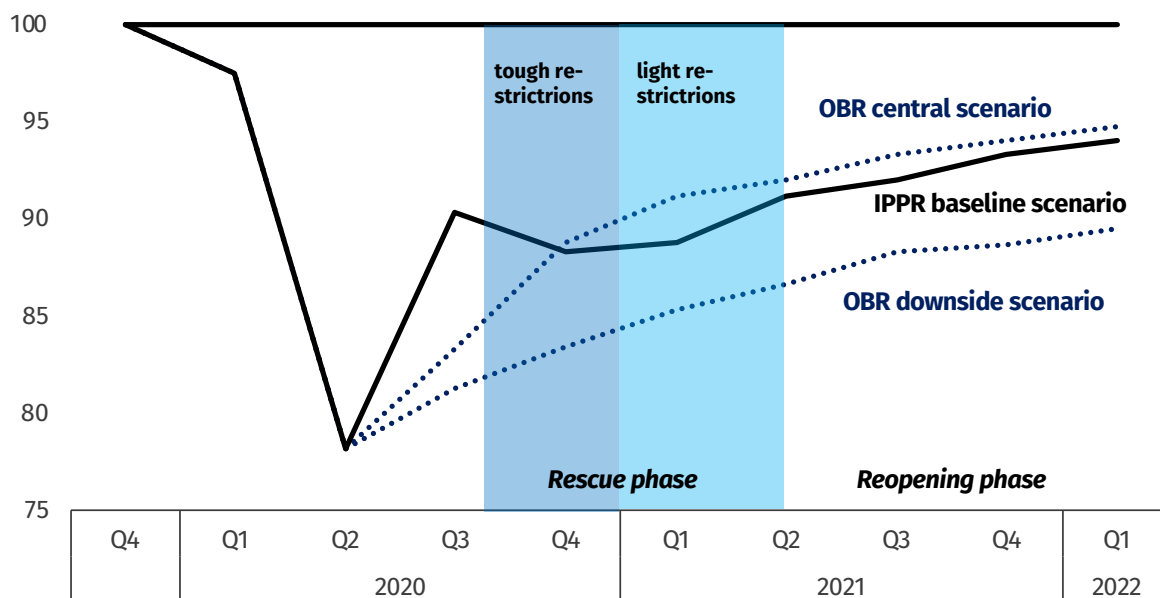
- The effects of the resurgence of Covid-19 in the UK, and the renewed tough restrictions, will likely limit the recovery throughout Q4 (even if restrictions are lifted in early December as is currently still planned). We thus assume that some of the GDP gains made by October will be reversed and Q4 GDP turns out in line with NIESR's projection of 2.2 per cent below Q3 – leaving GDP at the end of 2020 about 11.7 per cent below pre-pandemic trend.
- With a vaccine now on the horizon, Q1 and Q2 2021 could see a very gradual but possibly permanent easing of restrictions. From then our scenario sees GDP slowly recovering – following the OBR's central scenario but delayed by one quarter. That said, there will likely still be a high need for 'rescue' policies: scaling up test and trace, rolling out vaccine delivery, supporting businesses that are operating far below capacity as a result of restrictions.
- From Q3 2021 onwards, what we call 'reopening phase' begins – meaning most businesses can open but with some social distancing restrictions still in place. In this scenario, business investment and aggregate consumption recover only slowly, implying the need for fiscal stimulus to prevent a sluggish recovery of GDP, employment and living standards which would scar the economy (IMF, 2020a; Macqueen, 2020)

We find that without further policy support, the economy could remain on average more than 7 per cent below trend growth in 2021/22. We describe this as the risk of the UK being stuck in a '93 per cent economy', where activity improves, but in many sectors remains far below potential. Like the OBR, we assume a smooth Brexit transition. In reality, the transition could be far from smooth – which would affect these estimates.

FIGURE 1

Without further policy support the economy could remain more than 7 per cent below trend growth in 2021/22

Per cent of GDP (pre-crisis trend = 100)



Source: IPPR analysis of OBR (2020), NIESR (2020), IMF (2020a), Jung & Murphy (2020a).

A stimulus is needed to support economic activity and jobs

In upcoming fiscal interventions, starting with the one-year spending review, policy should correspond to the two above phases: ‘rescue phase’ and ‘reopening phase’. Different measures – both in quantity and quality – will be required in each phase. The ‘rescue phase’, in the first and second quarters of 2021, will require continued fiscal support aimed at maintaining incomes and preventing otherwise viable businesses from going under. The ‘reopening phase’, which with vaccine rollouts we anticipate beginning in Q3, will require economic policy that is compatible with much lighter restrictions, designed to support aggregate demand and economic activity.

We estimate the size and composition of the required stimulus as follows:

- For the current fiscal year, we use OBR costing assumptions and estimate remaining Q1 2021 costings based on Treasury announcements. This includes an estimate for the cost of employment schemes and an estimate for the additional public service costs which consist mainly of health spending (eg test and trace).
- **Top-down approach for size of stimulus.** For fiscal year 2021/22 we estimate a top-down envelope of fiscal stimulus needed to bring GDP back to potential. The size of the stimulus is calculated such as to close the output gap as much as possible given the supply constraint presented by the pandemic (see Annex).

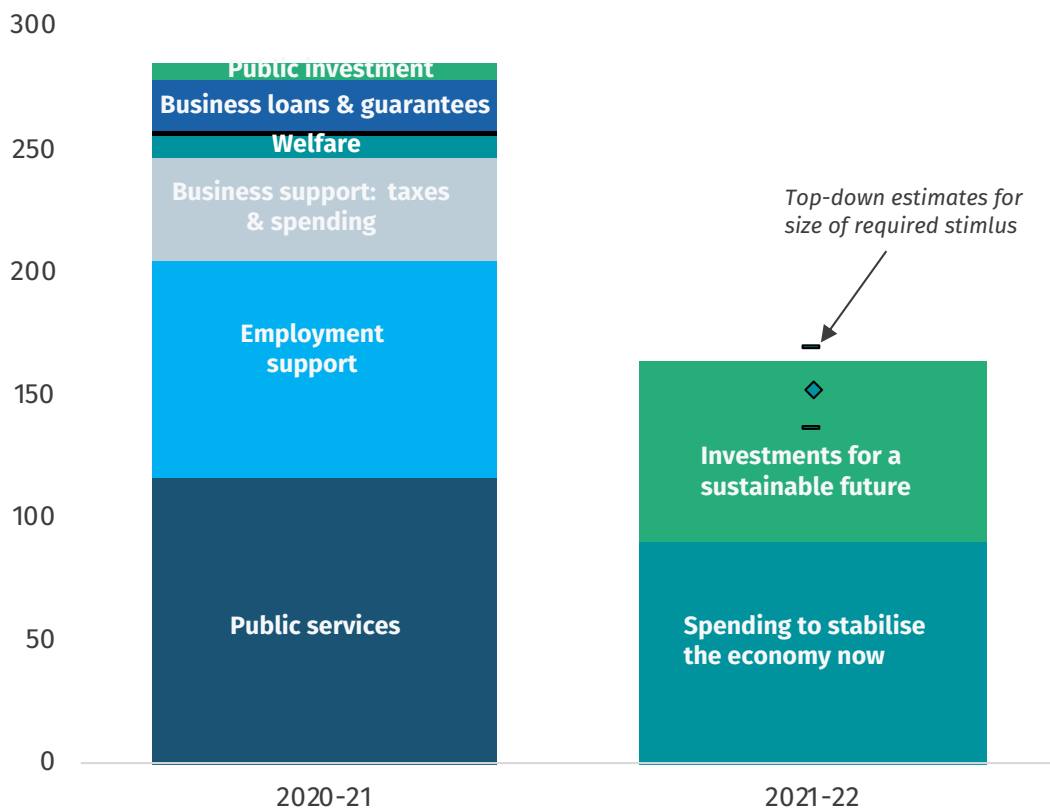
- Bottom-up approach to determine the composition of the stimulus.**
 We next impose various assumptions to determine the component parts of the stimulus. This includes Q2 seeing continued large spending on public services, including test and trace, and support for devolved nations and local government. And it includes a large role for investment spending in stabilising GDP but also ensuring future growth. In this approach we take into account that different spending items have different short run multipliers.

Based on this, we estimate that there is need for a stimulus of £164 billion in 2021/22 (right-hand column in figure 2). This would be about 40 per cent less than the government is likely to have spent beyond the OBR’s March 2020 projection in this fiscal year (left-hand column). Building on our bottom-up approach, detailed in the next section, we argue that just over half of stimulus spending should be focused on stabilising the economy now (including through spending on public services and a welfare stimulus which will primarily benefit the economy now). The remainder should focus on investing in delivering sustainable growth in the future (through public investment and equity stakes). Also shown in figure 2 is our top-down estimate for the size of the stimulus.³

FIGURE 2

Continued large stimulus spending will be needed to maintain GDP

Spending above March 2020 baseline (£ billion)



³ This compares to approx. £110 billion stimulus called for by the Resolution Foundation (Gardiner et al, 2020). We interpreted two of their approaches as calling for £220 billion over two years.

Source: IPPR analysis of IPPR baseline scenario (above), OBR (2020), IMF (2020a), HMT(2020a, 2020b, 2020c), Conservative Party (2019), Jung & Murphy, 2020, McNeil et al (2020).

Notes: The diamond marker on the right-hand side indicates the top-down estimate for the required size of the stimulus, based on the IPPR baseline scenario. The two other markers indicate how large the stimulus would have to be if growth in 2021/22 turned out one percentage point weaker (upper marker) or stronger (lower marker) than in the IPPR baseline scenario. As also shown in Figure 4, 'investments for a sustainable future' include public investment and public equity stakes, with 1-year multipliers below 1. 'Spending to stabilise the economy now' includes current spending with multipliers above 1.

HOW CAN GREATER SPENDING SUPPORT THE ECONOMY AND 'BUILD BACK BETTER'?

A stimulus of the size we set out would represent a large redirection of economic resources. It is critical that the investment is spent effectively. The UK faces huge economic, social and environmental challenges; this stimulus is a major opportunity to set the country on a better path.

Government should view spending over the coming years as an investment to build a fairer, stronger and greener economy and society. As well as the quantity of spending, how investments are made will shape their impact on this long-term goal. We recommend below institutional and policy reform to support spending, including for example through a National Investment Bank. Our proposals would enable devolved governments, as well as local leaders, to put in place the measures they need to rebuild. Previous and upcoming IPPR research describes how these ideas could be implemented.

In particular, effective spending does not only mean spending to maximise GDP. Not all economic activity contributes equally to broader social goals and a fairer, stronger and greener economy: *how* money is spent matters. It is critical that stimulus measures accelerate the UK's path to net-zero and restoration of nature; and provide jobs and opportunity across the country, including in places that have been badly affected by previous recessions.

With this in mind, we set out three broad spending priorities:

1. Ushering in a new era of public investment for a fairer, stronger and greener economy

The IMF and the OECD have made clear that across countries – and particularly in the UK – public investment has been neglected at the expense of economic prosperity and the wellbeing of citizens. The IMF (2020b) all but calls for a revolution in the role of public investment in driving the recovery from this crisis.

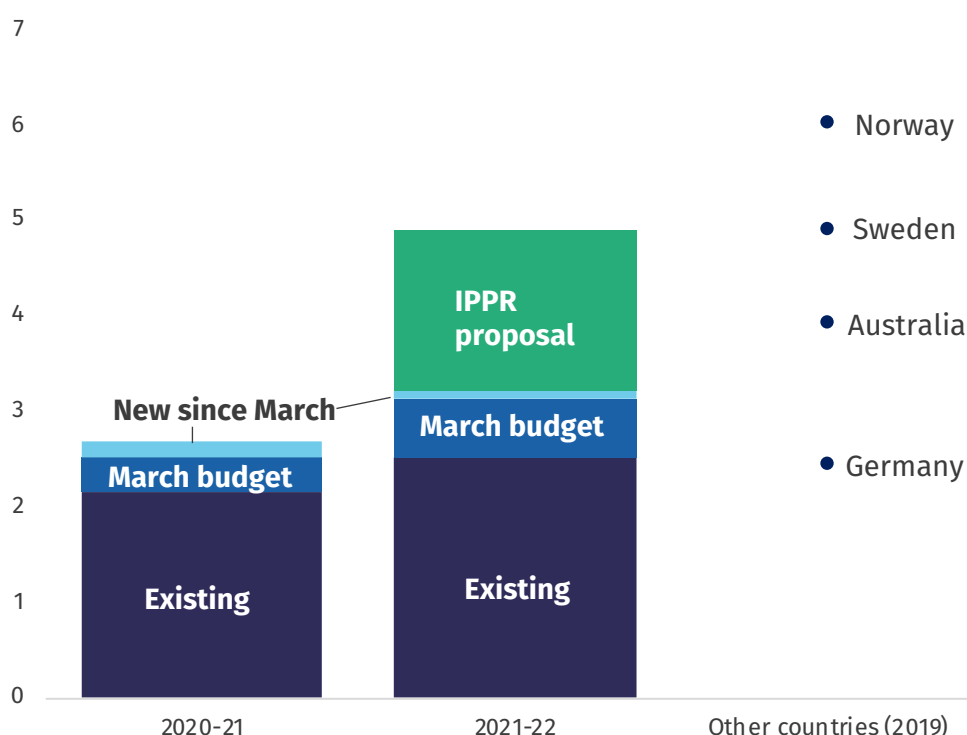
Yet, the government's investments announced since March 2020 will only get the UK to the international average public investment rate of about 3 per cent of GDP (figure 3). The IMF attests that years of underinvestment mean that higher rates of investment could be productive. We thus propose the government go further. An investment stimulus in green and social infrastructure, adding to existing investment commitments, could take the UK total to just under 5 per cent of GDP,

about the same level as Sweden and about a percentage point lower than that of Norway (figure 3). Given the UK's huge social and environmental needs, there is a strong case that the number of productive projects is large. Two thirds of the investment stimulus could comprise the clean investments such as those outlined below; the remaining third could include capital investment for health and social care and pulling forward already committed funds, for infrastructure and research and development.

FIGURE 3

Investment must be scaled up significantly to deliver a clean recovery and upgrade the UK's infrastructure

Public investment as a percentage of GDP



Source: Jung & Murphy (2020a), OECD (2019) and sources in figure 2.

Notes: The post March announcement includes the prime minister's 10-point plan announcements, which are assumed to all accrue in over the next three years until the end of parliament. For the investment envelop announced (but not specified) in March 2020, we make the same assumption as the OBR that only 80 per cent are delivered. The pre-March series is derived as the difference between the OBR's March baseline and 80 per cent of the capital envelope.

In previous work, IPPR has set out the need for an additional £33bn of investment per year, if the UK is to achieve net-zero emissions by 2050 and restore nature (Jung & Murphy 2020a). Announcements made since this figure was calculated in Spring, including the prime minister's 10-point plan for a green industrial revolution, only make up a fraction of the amount needed. Making this investment, together with meeting workforce needs in the low-carbon health and care sectors, could create 1.6 million jobs over the next decade (Jung & Murphy 2020b).

Investments that could create jobs, decarbonise the economy and restore nature include:

- **Homes and buildings:** the government should go beyond its existing green voucher scheme and set out a 'Home Improvement Plan' (Webb et al 2020). This would be a large-scale energy efficiency programme to significantly raise the energy efficiency of homes and buildings across England and shift to low-carbon heat. The UK government should prioritise electric heat pumps, heat networks and energy efficiency upgrades as the main technologies for retrofitting homes. Our estimates suggest that an additional £8 billion is needed each year.
- **Nature restoration:** Invest in tree planting and peatland restoration across the country. This should include the expansion of green spaces including parklands, with a particular focus on deprived areas without current access to green space to ensure fairness and justice is at the heart of these schemes. Our estimates suggest that an additional £4.7 billion is needed each year.
- **Transport infrastructure:** Invest to significantly expand low carbon public transport infrastructure by bringing forward investment in rail and electric buses and bus networks. Such investment, in buses in particular, will benefit poorer households who are disproportionately reliant on the bus network for their travel needs. Our estimates suggest that an additional £10.3 billion is needed each year in sustainable forms of transport.

As the IMF (2020b) and OECD (2017) stress, effective delivery of public infrastructure will be key. Therefore, across departments, day-to-day spending will need to be devoted to identifying, devising and supervising investment projects; as well as training programmes to ensure sufficient skills supply. With this focus, the New Economics Foundation estimates that one million jobs could be created within the next 18 months, including 400,000 related to green infrastructure (Krebel et al 2020).

To increase UK investment, the government should establish a National Investment Bank, with strong regional divisions (IPPR Commission on Economic Justice, 2018).⁴ This should direct investment towards the government's industrial strategy, infrastructure, and innovation goals, including addressing regional imbalances and decarbonisation, and be able to offer equity investment. Such a bank should have clear objectives to 'crowd-in' private sector investment by giving certainty to new industries and technologies, and by investing to enhance productivity and competitiveness in the economy as a whole. A UK national investment bank would go some way towards replacing investment in the UK by the European Investment Bank which has invested a total of €53 billion since the last financial crisis.

⁴ To operate alongside the existing Scottish National Investment Bank.

2. A resilience revolution: restoring public services and strengthening the safety net

Our research has shown that disinvestment in the welfare state through a decade of cuts, and the transfer of risk from collective solutions to individuals, has resulted in five social deficits, in: care, skills, health, income security and community (Quilter-Pinner, McNeil, & Hochlaf, 2020). Public services and the social safety net have responded quickly to needs of people during the pandemic. But they did so from a weak starting point: a decade of austerity has ripped the resilience from the state and we have been playing catch-up ever since. Put simply: running each of these critical elements of the welfare state 'hot' has weakened the UK's resilience to this and future crises. This may well partially explain the diverse experiences of different places during the pandemic. For example, areas like the North suffered more from austerity, and subsequently from Covid-19 (Bambra, Munford, & et al, 2020).

For those claiming universal credit for the first time, the inadequacy of our social safety net has been revealed. The UK's welfare system provides a very poor level of earnings replacement and benefit levels bear no relation to the actual costs of making ends meet (McNeil et al 2019). Because of the complex eligibility criteria for Universal Credit, many who are in need of support lose out. This not only directly causes hardship but has an indirect impact on the economy. Our social security system should be acting as an 'automatic stabiliser' in this recession, smoothing incomes and helping to maintain a level of demand in the economy. So long as benefit levels are low and coverage is poor, it will not fulfil this function.

Rather than patching up the holes when they appear, the welfare state should be strengthened now. This means putting in place emergency measures to directly support individuals and families struggling through the pandemic, and support the economy by maintaining spending. Over the course of the parliament, it would mean moving from a consolidation state to an investment state, and a long-term funding settlement for public services and welfare.

Our public services priorities include⁵:

- Maintaining emergency funding for public services, including health, test and trace (improving these schemes to be effective), as well as devolved and local governments, mainly focused on the rescue phase. Some public services, like childcare, face major challenges from the pandemic and should also be supported (Parkes, McNeil, & Jung, 2020).
- Urgently needed 'catch-up' funding for health, public health and social care. NHS Providers estimate £3-4bn is needed in the short-term for the NHS in England (NHS Providers, 2020). IPPR has called for this to disproportionately go to the community sector, and also for an immediate £1bn uplift to public health budgets (Thomas, 2019). Some funding should go towards a pay boost for staff in recognition of their commitment through the pandemic (Thomas & Quilter-Pinner, 2020). To meet demand in social

⁵ Where figures are for England only, devolved administrations would receive consequential funding.

care, and also ensure social care workers receive pay rises in line with the NHS pay deal for 2018-2021, an additional £1.4bn is needed in England.⁶

- Restoring current spending outside of health and social care to pre-2010 trends by the end of the parliament. This would include a large proportion of cuts to local government through the MHCLG budget. This could incorporate pay rises for public sector workers at least in line with inflation, ensuring those who have taken risks through the pandemic are rewarded and boosting aggregate demand.
- While this spending review is only for one-year, the urgency of a longer-term plan for social care is clear. We recommend that by the end of the parliament, personal care is made free at the point of use, and access levels restored to 2010 levels, alongside a living wage for all staff to improve workforce issues (Quilter-Pinner, 2019).

Our priorities for the social security system include:

- a much-needed boost to the income of hard-hit families through a “family stimulus”. Increasing the child element of universal credit (UC) and child tax credit (CTC) by £20 per week per child and removing the two-child limit would inject £14 billion into the economy and lift 700,000 children out of poverty (Parkes, McNeil & Jung, 2020).
- Maintaining the £20 uplift to the basic rate of universal credit when it is due to be removed at the end of March and extending this to legacy benefits, and also extending the uplift in Local Housing Allowance to the 30th percentile of local market rents. We argue this should be raised to 50 per cent of market rents, although this option is not costed in our stimulus package.⁷
- Other proposals to strengthen the safety net are not specified here but should be considered. For example, to support effective social isolation and control the pandemic, statutory sick pay should be raised and extended, including to those with no recourse to public funds (Parkes & Rankin, 2020; Patel, Treloar, & Kapoor, 2020). The New Economics Foundation has proposed a more generous, temporary, ‘minimum income guarantee’, which would provide security while the economy is restricted by offering a guaranteed income equal to the Minimum Income Standard (Stirling & Arnold, 2020).
- The lesson from shocks like Covid-19 are clear: we must ‘future-proof’ our welfare state now to ensure we are ready for them. This should include a shift from individuals taking on risk, to collective solutions to pool risk. It should mean that rather than letting social security entitlements be eroded over time, they should always be maintained – for instance through a triple lock, as exists for pensions. IPPR’s Future Welfare State programme will make proposals in this area over the coming year.⁸

⁶ IPPR analysis of Health Foundation (2020)

⁷ See: <https://www.ippr.org/news-and-media/press-releases/ippr-immediate-action-needed-to-prevent-surge-in-homelessness-this-winter>

⁸ See: <https://www.ippr.org/future-welfare-state/>

3. Supporting businesses and workers while securing a return for the public

Businesses and workers form the backbone of the economy. If businesses go bankrupt and workers become unemployed, the economy can lose valuable productive capacity. The government has been right to provide a wide range of rescue policies to preserve this capacity, such as the Job Retention Scheme, and Coronavirus Business Interruption Loan Scheme (CBILS), though policy decisions would have been more effective if made earlier.

From Q2 2021 onwards, businesses and workers will require support policies that are tailored to the reopening stage of the pandemic. As most sectors should be able to reopen, businesses will continue trading, but demand will initially remain subdued. For this situation:

- A support scheme will still be required – reflecting the realities of the pandemic – but the (full time) furlough scheme should be replaced with a scheme that encourages work sharing, via a part-time work subsidy (McNeil et al 2020; Jung & Parkes, 2020).
- Alongside schemes to protect jobs, workers also need to be offered bridges to their next job. For those on furlough, and those likely to lose their job, we propose a Job Retraining Scheme, providing a personal budget for training to enable workers to access jobs in other sectors (Quilter-Pinner 2020).

Further support for businesses will be needed but a situation where risks are socialised and benefits privatised must be avoided. If the state steps in to protect businesses, the public should be assured a return; this doesn't have to just mean a financial return, but also in social and environmental terms, for example through high-quality and secure jobs; action on the climate crisis; corporate governance and where a company incurs tax. Future schemes should be set up to achieve this. This could be, for example, through:

- Conditionality on grants and loans to achieve compliance with wider government agenda
- Convertible loans where the state receives a share of ownership of the company if the loan is not repaid (already offered through government schemes such as the Future Fund delivered by the British Business Bank)
- Public equity finance in circumstances and for types of business where this is the optimal form of support
- New institutions to govern these equity stakes such as Wealth Funds (Blyth & Lonergan, 2020; Detter et al., 2020)
- Specific bailouts for firms which have exhausted other options of government support, but are strategically important or otherwise financially viable (known as Project Birch)
- Worker-led strategies for industry diversification that focus on the production of social goods, learning from the missed opportunity of the

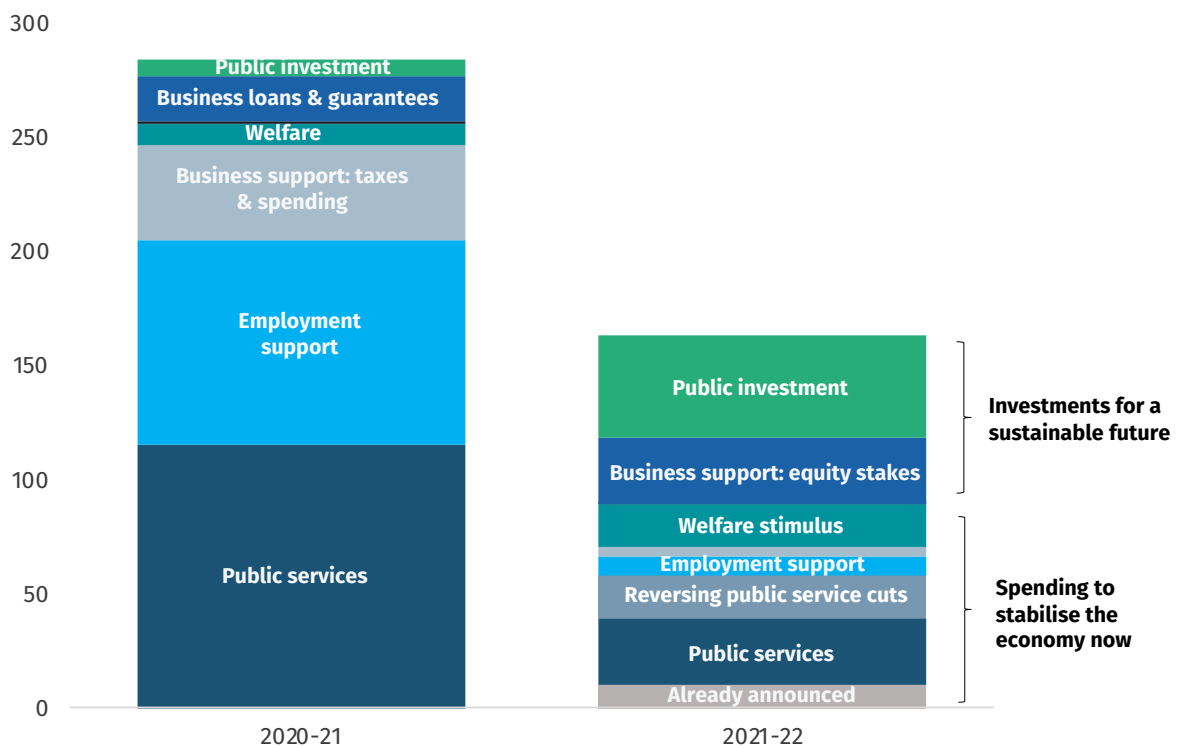
Lucas Plan. This should include not just ownership of the process but also potential worker and community ownership of legacy assets.⁹

Building on the above priorities, figure 4 shows our proposed breakdown of the stimulus in 2021/22.

FIGURE 4

Investment, public services and business support are the biggest items in our 2021/22 stimulus proposal

Spending above March 2020 baseline (£ billion)



Source and notes: same as figure 2.

- The focus strongly shifts toward **public investment**. This consists of the £33bn additional climate investments (an estimated £4 billion have been committed to this since March 2020, including through the PM’s 10-point plan on climate¹⁰). In addition, there should be £17 billion investment in other priorities, including a £ 4.3 billion increase in capital investment for health and social care (Thomas, 2019) and pulling forward already

⁹ The Lucas Plan was a counterproposal developed by staff and workers of Lucas Aerospace in response to management announcing the need to cut jobs in response to increased international competition and technology change. The plan derived from extensive consultation with the Lucas Aerospace’s own workers who developed 150 product ideas to diversify the company in a way that kept jobs whilst also creating socially beneficial products such as medical equipment. While the plan was rejected by management, the model received international support and the Combine of workers who formed to develop the plan attracted charitable funding and set up educational institutions to further their ideas (Salisbury 2020).

¹⁰ We include this in the ‘already announced’ category, together with the £4.1billion annual spending announced for the military.

committed funds, for infrastructure and research and development (see Annex).

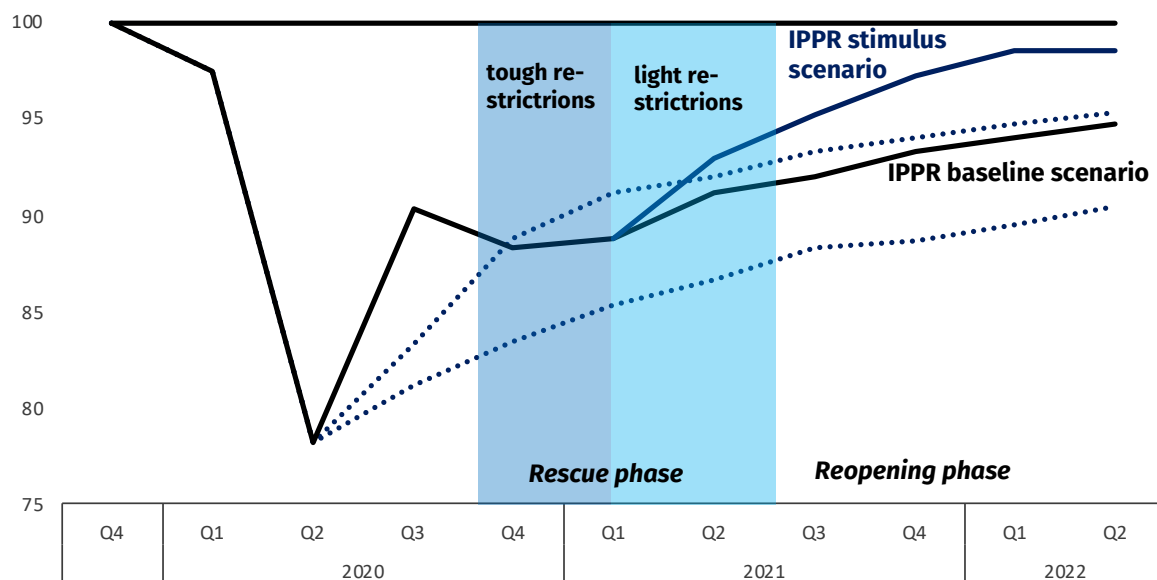
- **Welfare** takes up a much larger share than in 2020-21, rising by about £19bn. About half of this is for our proposed family stimulus.
- We anticipate lower expected spending on **public services** than in the current fiscal years, including emergency health measures, as the pandemic subsides. However, our proposal includes boosting public service spending to reverse cuts since non-health and social care cuts since 2010.
- **Business support** remains high at about £34bn, but with a shift to grant funding and equity stakes. The remainder of business support is the continuation of key support schemes, such as the 'Cultural Recovery Fund', which we assume will continue to be required throughout 2021/22.
- **Employment support** takes up a much smaller share. From Q2 onwards, we assume that the JRS is replaced with IPPR's Coronavirus Work Sharing Scheme (Jung & Parkes, 2020), costed at £7 billion for Q2-Q3 2021, assuming that initially 3 million workers would be on the part time scheme.

The result of the stimulus would be to bring growth close to pre-crisis trend (figure 5).

FIGURE 5

A stimulus would return the economy towards potential much more quickly, producing jobs growth and tax revenues for the Treasury

Per cent of GDP (pre-crisis trend = 100)



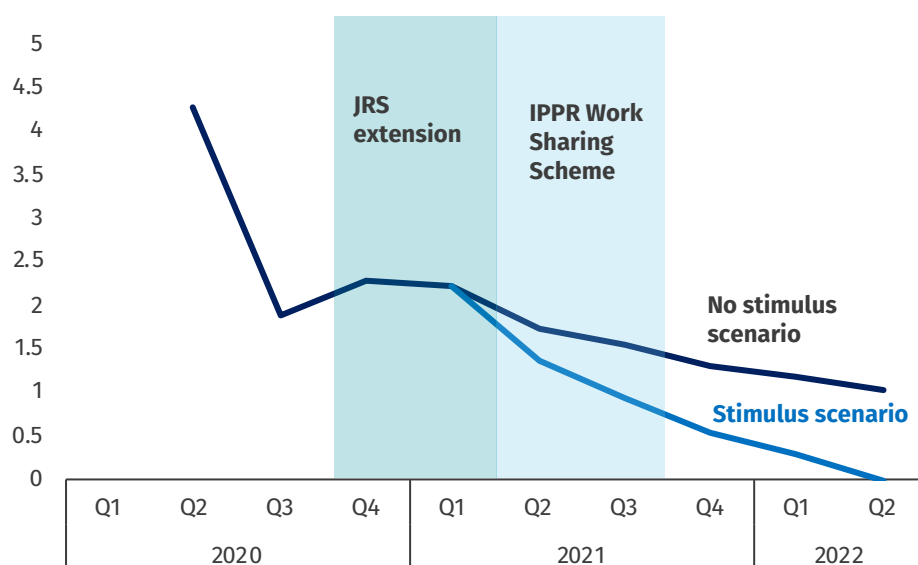
Source: Same as figure 1 and stimulus dynamics discussed in annex.

Another outcome of the stimulus would be that the labour market would recover more quickly. Figure 6 shows how the stimulus could lead strong employment growth and thereby quickly reduce the need by workers for employment support schemes. We estimate that by Q1 2022 one million fewer people would be in need of a support scheme.

FIGURE 6

With a stimulus, the macroeconomic need for part-time work schemes would ebb in the second half of 2021

Workers requiring job support (millions)



Source: IPPR analysis of HMRC (2020), IPPR baseline and stimulus scenarios and the methodology in McNeil et al (2020).

“FISCAL STIMULUS IS FISCAL RESPONSIBILITY”

The measures set out above would require substantial public spending, at a time when tax receipts will be reduced due to lower economic activity. This has caused a focus in the media on whether support measures are affordable.¹¹ However, there is a strong argument for Keynesian spending in time of recession, especially given near-zero interest rates mean the Bank of England has limited capacity to stimulate the economy. Accordingly, the IMF (2020a) argues “in many countries, the benefits of a stimulus outweigh the cost of increasing public debt.” This is amplified by the fact that the UK currently faces near-zero interest rates. This means that any growth-increasing spending, effectively, reduces the debt to GDP burden. It is for this reason that the Chief Economist of the IMF says, “fiscal stimulus is not just economically sound policy but also the fiscally responsible thing to do” (Gopinath, 2020).

Our proposed stimulus would strongly revive economic activity and improve tax revenue and stabilise the debt level. Below we find that – with a stimulus – the UK debt-to-GDP level would be *lower* than without the stimulus. Only a strong economy will put finances on a sustainable footing.

Note that taking net debt as a measure of sustainability is an overly conservative approach to assessing public finances. It focusses too much on the liability side of the public sector’s balance sheet and ignores illiquid but valuable elements on the

¹¹ See: <https://www.bbc.co.uk/news/business-52663523>

assets side of its balance (as well as implicit liabilities, such as those from pensions). Given the large amount of public investment we recommend, this makes a big difference, as the public sector would acquire a substantial amount of illiquid assets. The IMF (2018) also agrees that this is a limiting approach. A more comprehensive assessment of public finances would take a 'net worth' approach, which would allow a much clearer assessment of how public finances are affected by investment decisions.

Borrowing requirements

Given the second wave of the virus, the associated health measures and lockdown, borrowing requirements in the current fiscal year are significantly higher than for instance the OBR predicted earlier in the year.

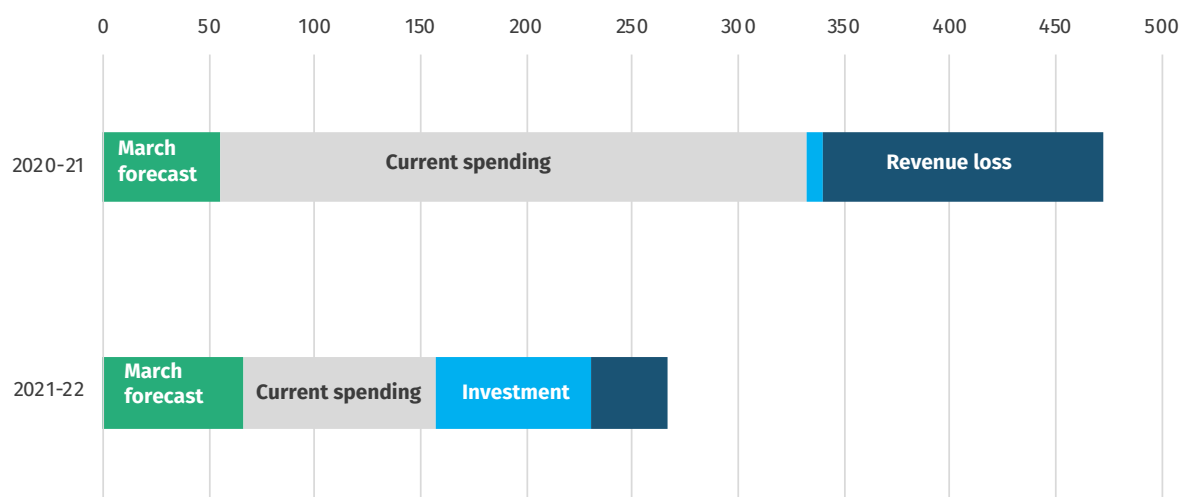
Figure 7 shows the implications of stimulus spending and reduced tax receipts for public borrowing. We find that borrowing in the fiscal year 2021/22 would be £267 billion in our stimulus scenario, about 44 per cent lower than in 2020-21. The deficit would fall from 21 per cent of GDP in 2020-21 to 12 per cent in 2021/22.

The additional borrowing for 2021/22 is about £100 billion more than the OBR's central scenario. This is driven, on the one hand, by significantly higher spending due to the resurgence of the virus which was not accounted for the OBR scenario. The OBR scenario also contains no stimulus in 2021/22 (as they only cost announced policies). Given we include a stimulus, in our scenario, revenue losses are significantly smaller (by about £30 billion), because the stimulus will have a positive fiscal effect: it stabilises GDP, shores up economic activity, thereby increasing tax receipts. As figure 7 shows, tax receipts significantly recovery in our scenario for 2021/22.

FIGURE 7

In our stimulus scenario overall borrowing is expected to decrease by 44 per cent in 2021/22

Public sector net borrowing (£ billion)



Source: IPPR analysis of OBR FSR (2020) and same as figure 4.

Notes: The investment spending category includes public investment as well as public equity stakes.

Even though our stimulus scenario sees higher borrowing overall, it is superior even in purely fiscal terms. By preventing a slow recovery and directly addressing scarring in the economy, the stimulus would increase GDP faster than the debt burden. As a result, as shown in figure 8, the 2021/22 debt burden would be 0.5 per cent *lower* than under the scenario without a stimulus. The stimulus would stabilise the debt burden at around 116 per cent of GDP.¹² This is in line with the IMF's (2020c) simulation of a similar scenario. They find that the "fiscal expansion would not necessarily increase the debt-to-GDP ratio in 2021 because of higher projected growth." It is for this reason that a fiscal stimulus can be very much furthering the aim of fiscal responsibility.

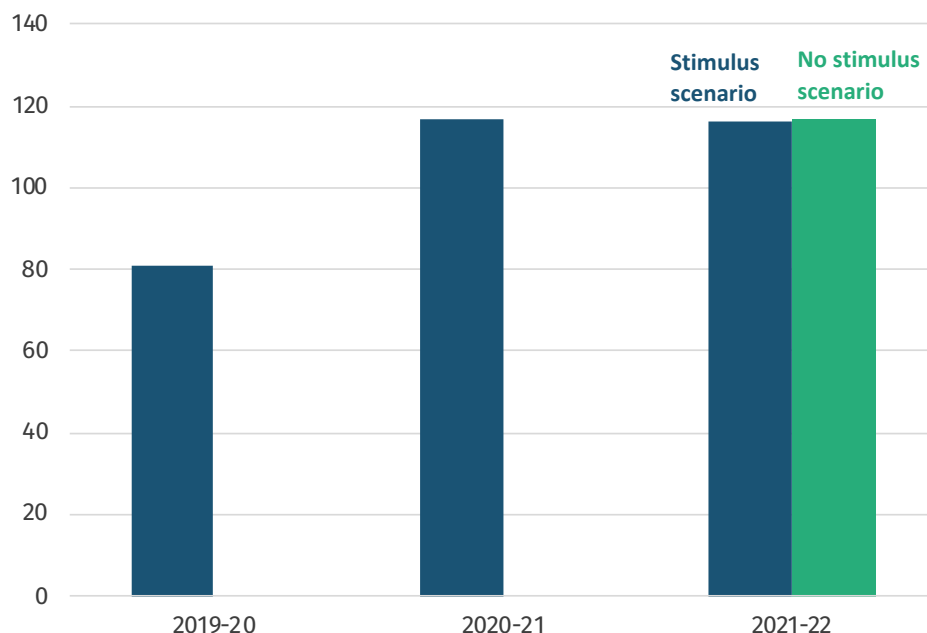
Moreover, the proposed stimulus will have further fiscal benefits after 2021/22. That is because the investment multipliers are low in the first year of investment (about 0.65) but are significantly higher (above 2.5) beginning in the second year, according to the IMF (2020). This means that public investments pay off even more later on. If they are of sufficiently high quality, they can increase the size of the economy while also shifting it to more sustainable activities. And a larger economy, in turn, means a lower debt-to-GDP ratio – making debt more sustainable.

¹² This means debt would be about 35 percentage points higher than before the crisis, which is fully accounted for by the shock in 2020-21.

FIGURE 8

Not pursuing a stimulus would leave the UK with a higher debt to GDP ratio

Public sector net debt (per cent of GDP)



Source: IPPR analysis of OBR FSR (2020) and same as figure 4.

Note: given public equity stakes in firms are liquid assets they are excluded in from net debt, but not from our public borrowing estimate.

(When) should taxes be raised?

As borrowing costs remain low, a high level of government debt remains affordable. In fact, interest rates are currently so low that even a doubling of the UK's debt would still mean the Treasury pay less to service the debt in the future than in the past, as a share of tax receipts (Gardiner et al 2020). The Bank of England plays an important role in that it helps keep interest rates on new debt low by effectively creating new money that is helping to finance the deficit. In this low interest rate environment, even with more borrowing, only a small share of annual tax revenues would need to be spent on servicing the debt each year.¹³

However, once the stimulus has successfully delivered a sustained recovery, borrowing will need to be reduced. In particular, any enduring day-to-day spending commitments (such as paying wages of health and social care workers) will need to be financed via taxation. Public investment, on the other hand, does not need to be paid for by contemporaneous taxation, because it will yield future returns (if investment is done wisely) that will facilitate future repayment as well as increase the public sector's net worth (Quilter-Pinner & Hochlaf, 2019).

The Resolution Foundation (Bangham et al. 2020) estimate there is a need for increased taxation of £40bn. As above, they argue that this should take place

¹³ At the moment new government debt is financed in roughly equal amounts by private investors and the Bank of England.

once the recovery has taken hold, which they expect not to be before 2024-25. Our analysis differs to theirs in two regards.

First, given the size of our recommended stimulus, the need for tax increases is somewhat larger – for instance, reversing cuts to public services are costed at £56 billion. Secondly, our assessment of the prospect for the economy is more optimistic than that of the Resolution Foundation. That is because the large investment package suggested here could shift the economy towards a more sustainable pathway but also significantly improve economic prospects. This would bring in more tax receipts and somewhat lower the tax gap, but not eliminate it.

That said, major rises in tax revenue are not required for several years for fiscal sustainability. The bulk of any tax rises should be phased in no earlier than 2023-24. Low interest rates on public debt and the expected return to growth mean the debt burden will remain in check in the meantime.

However, this does not mean that we should not contemplate tax reform now. Taxes perform a number of functions in our economy beyond simply revenue raising, including helping to deliver economic justice and shaping the direction (as well as level) of growth.

We argue that some of the tax increases could already happen in the fiscal year 2021/22, because this can be done in a way that is compatible with recovery – not just to pre-crisis GDP, but to a fairer, stronger and greener economy. For example:

- The crisis, as well as measures taken to counter it, are likely to significantly exacerbate existing structural inequalities. Creditors and asset-owners have been insulated from the worst effects of the pandemic while many of the most financially vulnerable have been driven deeper into debt (Berry, Macfarlane, & Nanda, 2020; Nanda, Round, & Rankin, 2020). Savings at the top of the wealth and income distribution, if not taxed, are likely to be in substantial part invested in property, raising prices, potentially exacerbating housing affordability issues and resulting in windfall gains for homeowners. To support a fairer post-pandemic economy, a range of tax measures could be considered, including a net wealth tax; raising capital gains and dividend income tax to more closely mirror income tax as IPPR has previously proposed (Nanda & Parkes, 2019); property tax measures (and at a minimum ending the stamp duty holiday).
- An excess profits tax (EPT) could be used to tax large profits made by firms as a result of a crisis rather than as result of genuine productivity improvements. It is aimed at addressing a market failure, by redressing temporary anti-competitive developments. EPTs have been deployed at various point in history. For instance, they were used in the first and second world wars in the UK, and in both world wars as well as the Korean War in the US, to tax profits that arose as a result of war, and to share the financial burden.
- Taxing broader economic rents, which do not contribute to the productive economy. This could include targeting specific rentier sectors like natural monopolies, IP and finance.

- Behaviour shaping taxes, such as green taxes and for example a levy on unhealthy, non-essential foods (Thomas & Hochlaf, 2020).

IPPR will be exploring the tax options above, and how they could be designed to ensure a strong recovery, in future work.

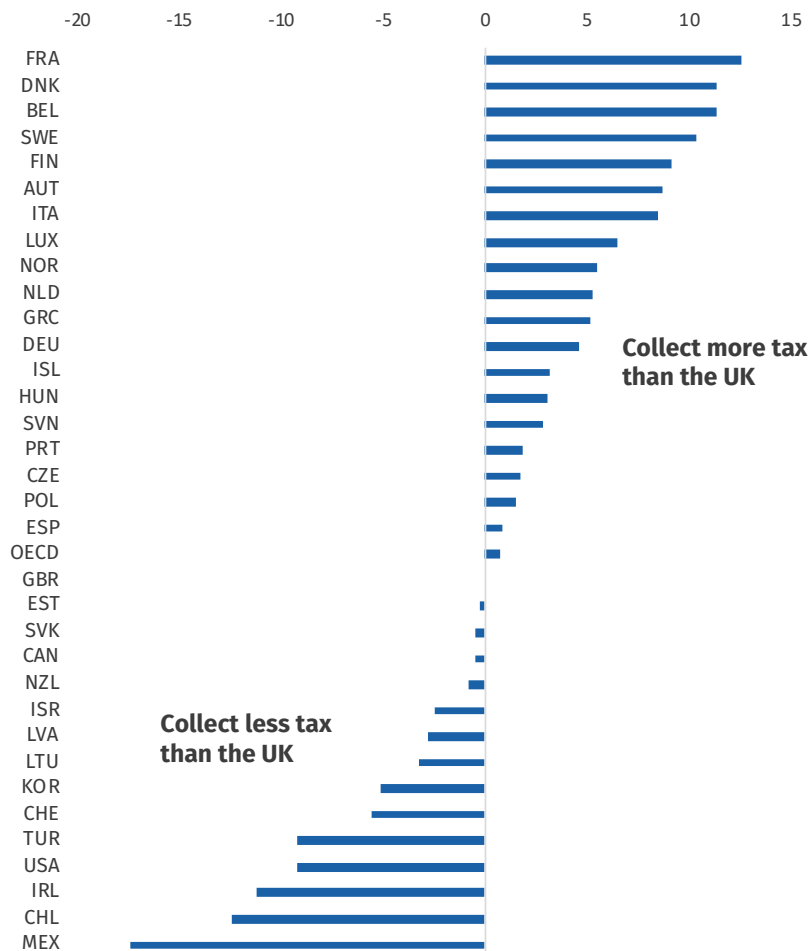
Some argue that any tax raises would risk recovery of GDP. However, the IMF (2020b) finds that that the multiplier of some forms of tax increases is actually quite low. The tax multiplier is estimated to be as low as 0.3 (short-term) and 0.1 (long-term). This means that raising taxes in a recession might be not as damaging to growth as the same amount of spending cuts which has much higher multipliers. The upshot of this is that targeted tax increases – for instance if offset by some spending increases – can be in line with boosting the recovery. Further still, some tax increases can increase the long-run growth potential, and/or can contribute to goals beyond GDP. As Mian et al (2020) have shown, a huge increase in saving by top earners can have a detrimental impact on growth.

Finally, any tax increases should be seen in international context. The UK's tax take significantly below other countries such as France, Denmark, Belgium, and Sweden (figure 9) and about 5 percentage points below Germany. This shows that there is significant scope for funding strong public services and fixing the fault lines of the welfare system.

FIGURE 9

The UK has significantly lower taxes than most other developed economies of comparable size

Percentage point difference to UK tax take (pp of UK GDP), 2018



Source: OECD (2019).

CONCLUSION

The chancellor faces a near unprecedented challenge. Amidst high uncertainty, he must stabilise the economy, and set policy to address not just the pandemic but a series of deep-rooted weaknesses and urgent crises. Our proposals for an ambitious stimulus package describe how he could achieve this, rebuilding a fairer, stronger and greener economy, and how this is not just possible and responsible - but required.

ANNEX: METHODOLOGY

IPPR baseline scenario

- The effects of renewed tough restrictions will likely limit the recovery throughout Q4 (even if they are lifted in early December as is currently still planned). We thus assume that some of the GDP gains made by October will be reversed and Q4 GDP turns out in line with NIESR's projection of 2.2 per cent below Q3 – leaving GDP at the end of the year about 11.7 per cent below pre-pandemic trend. This is in line with NIESR (2020)'s forecast of a 2.5 per cent contraction of Q4 GDP compared to end-Q3.

Costs for fiscal year 2020-21

- We add to the OBR FSR baseline additional schemes announced since June, such as additional public services and business support. In addition, we added all announcements of schemes since summer, taking into account their duration. For schemes that ended before Q2 2021 (eg self-employed support) we extrapolated the costs such as for them to run up to the end of Q1. For Q2 2021 we assume that the quarterly costs of support schemes will be the same as those of Q1.

Size of the 2021/22 fiscal stimulus

- We estimate the need for fiscal stimulus based on GDP shortfall implied by our baseline scenario and assuming that the continued social distancing requirements suppress potential GDP by 3.5 percentage points over the rest of the year (IMF 2020a, p. 13).
- But we argue that investment, if scaled-up significantly and targeted at shovel ready projects, including in low-carbon housing, care and transport could by the end of 2021/22 make up for 2 percentage points of this supply shortfall. We calculate this based on job creation potential estimated in Jung & Murphy (2020b). We assume that much of the job creation potential in housing insulation, heat pump installation and care jobs can be realised in the short term through public investment, following figure 3.1 in *ibid*. This job generation potential divided by the size of the labour force yields an approximately 2 percentage point shift in the employment structure of the economy, which we assume translates into an equivalent shift in the structure of (potential) GDP. The reasoning behind this is that most of the scarring from the pandemic will be due to continued low demand for sectors where there is still (or used to be) social distancing requirements. By unlocking jobs in these new sectors (such as low-carbon housing and social care), slack in the labour market is reduced, partly closing the potential supply gap caused by the pandemic.
- As such, an ambitious investment programme can tackle the issue of scarring head on and enduringly transform the economy towards sustainable means of production.
- For 1-year fiscal multipliers, we use estimates by IMF (2020b) and IMF (2020c). These are 1.3 for government purchases, 1.3 for targeted transfers, which also aligns with our estimates in Parkes, McNeil & Jung (2020) and 0.65 1-year multiplier for investment spending. Note that they find the 2-year investment multiplier to be above 2. Finally, we assume

that public sector balance sheet support for corporations, through public equity stakes, does not function as a stimulus in the same way as other spending does. It has large benefits, including preventing inefficient bankruptcies, which preserve the economy's productive capacity. As such, it is focused on bolstering the supply side of the economy, which is why we assume it does not have a stimulating effect on the demand side.

- In terms of the composition of the stimulus, we assume the size of the public investment element as given, as described in the next section. For this we apply the fiscal multiplier as stated above. The remainder of the stimulus thus comes from the current expenditure (including public service spending transfers). With the above multipliers we estimate the residual current expenditure envelope required to fill the GDP gap.

Composition of the 2021/22 stimulus

- **Investment.** The costing of the investment stimulus is based on Murphy & Jung (2020a) who estimate, a £33 billion annual additional stimulus is needed to address the climate emergency (which includes the approximately £4bn already announced for 2021/22). In addition, we assume that the non-climate share of the capital spending envelope outlined in the March budget is indeed spent in 2021/22 and the spending allocated to 2022/23 is pulled forward by one year, to support the stimulus. The non-climate share is calculated based on the Conservative manifesto costings document. In addition, we add a £ 4.3 billion increase in capital investment for health and social care as argued by Thomas (2019).
- **Welfare.** The costing from the continuation of the boost to Universal Credit are taken from the OBR FSR costing. In addition, we assume the implementation of a family stimulus for 2021/22 (as developed in Parkes, McNeil & Jung (2020) but costed for only 12 months rather than 18 months as suggested in the paper).
- **Business support.** The majority of this (£28.5 billion) is earmarked for public equity stakes in firms, in corporations in order to prevent excessive leverage and ensure their long-term viability. The size of the funding need is based on the Bank of England's (2020) estimate for firms' cash flow deficits after the government loans. We assume that this deficit will be to one half filled by additional borrowing by firms from the private sector and that the other half through a public equity stake in these firms. The remainder of business support is the continuation of key support schemes, such as the 'Cultural Recovery Fund', which we assume will continue to be required throughout 2021/22.
- **Public services.** The costing for 2021/22 of *additional* public service spending is costed at £31 billion, which we base on an extrapolation of pandemic-related cost announcements in recent months. It consists of health-related spending (including test and trace) and additional transfers to devolved nations and councils. We also include £3.5 billion 'catch-up' funding for health, public health and social care and, to meet demand in social care, £1.4 billion required for pay rises to attract staff (as outlined in the main text above) .
- **Public services – reversing cuts.** We take the Resolution Foundation (Corlett, Leslie & Tomlinson 2020) estimate that reversing all non-DHSC RDEL cuts on a per capita level to pre-2010 levels would cost £56 billion

per annum. We assume that this is done over parliament with the first third of the reversal taking place in 2021/22.

- **Job support (Q4 2020 – Q1 2021).** The costing of the Job Retention Scheme builds on McNeil, Jung & Hochlaf (2020). Using the updated projection of the Job Retention Scheme usage, implies 2.3 million workers on the scheme in Q4 2020 (up from estimated likely below 2 million in October) and 2.2 million in Q1. We assume all workers on the scheme are fully furloughed and earn the average wage of furloughed workers as estimated by the OBR (2020).
- **Job support (Q2 2021 – Q3 2021).** As the stimulus improves the labour market, we find that the need for job support schemes declines steeply after the economy reopens. Our proposed Coronavirus Work Sharing Scheme (Mc Neil, Jung & Hochlaf, 2020), in operation from Q2-Q3 2021 would cost an estimated £7.5 billion, assuming that work would be shared between 3 million workers over this time horizon. As we have argued (Jung & Parkes 2020), a part-time work subsidy provides economically optimal incentives for retaining workers during the reopening period.

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