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Is There Any Money Left?

The UK Economy After Covid

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With Covid restrictions finally lifted, the country's attention is turning from public health back to the economy. Cost of living pressures, the balance between tax, spending and debt, and the pressing need to raise Britain's mediocre long-term growth rates are once more at the forefront of the policy debate – and rightly so.

Britain faces almighty economic and fiscal challenges in the months and years ahead. So it is worth setting out the full grim detail of the pandemic's impact on the economy, and what it should mean for the Government's priorities.

- The economy has not quite recovered to its pre-pandemic size, and there is still a lot of lost ground to make up.
- Moreover, the public sector finances have taken a hammering unprecedented in peacetime, limiting the Government's room for manoeuvre.
- Tax rises are set to squeeze businesses and households, disincentivising investment, worsening the outlook for growth and hitting taxpayers and consumers in their wallets at the worst possible time.
- Meanwhile, Britain is entering into a cost of living crisis, with inflation on track to hit a 30-year high in the coming months even as taxes are going up.
- There is therefore a pressing need for radical policy action to boost growth, ease cost of living pressures and shore up the public finances via supply-side reforms, tax cuts and fiscal restraint.

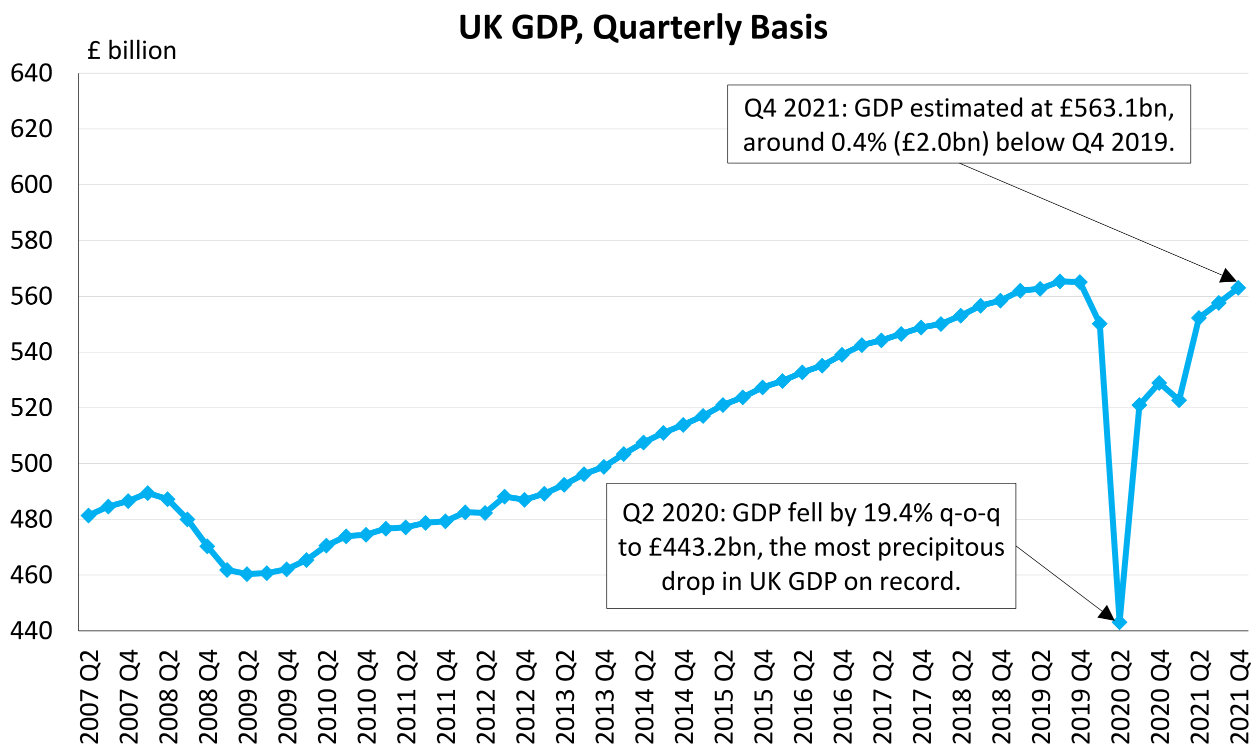
Where are we after two years of Covid-19?

The economic and fiscal landscape has changed utterly since February 2020. While Covid persists, any assessment can only be provisional. That said, there are six key points to make about this landscape and its implications for economic and fiscal policy in 2022.

1. **The UK economy has not quite recovered to its pre-pandemic size, and there is still a lot of lost ground to make up**

   According to estimates from the Office for National Statistics (ONS), GDP increased by 0.7% m-o-m in November 2021, with output around 0.5% above its February 2020 level.

   However, before popping the champagne corks, there are a couple of important caveats to consider. First, the ONS uses different methods for computing headline quarterly and monthly GDP figures. The latter measure has diverged from the former over the course of the pandemic, consistently showing firmer growth. Using the less optimistic but perhaps more accurate quarterly estimates, and given the latest downwards revisions, UK GDP in Q4 2021 was still 0.4% below its Q4 2019 level.



The emergence of the omicron variant led to renewed restrictions at the end of November, following which hospitality, travel and high street retail took another battering over the festive period (especially outside England). Overall retail sales fell by 3.1% m-o-m in December.

Business sentiment therefore nosedived: the Institute of Directors' economic confidence index – tracking net positive survey responses from members – plummeted to minus 17 in December, its lowest level since last winter. The UK economy in fact contracted by 0.2% m-o-m in December, dashing hopes that UK would start 2022 with an economy on par with the start of 2020, back before the pandemic.

On the other hand, in recent weeks much more clarity has emerged over the public health impact of the omicron variant. With the 'Plan B' restriction lifted, the economic outlook for the immediate future seems a little more positive than a few weeks ago – even if consumer sentiment remains depressed.

In short, it looks like that the economy will return to its pre-pandemic size in Q1 2022. Nevertheless, celebrations should be muted. **Even getting back to the economy's previous size represents the annihilation of over two years of economic growth, which should have added 3.6% to the size of the British economy by now**, according to Office for Budgetary Responsibility (OBR) forecasts published in early March 2020.[1]

2. **Structural changes to the UK economy are likely to have far-reaching implications for employment, productivity and GDP growth**

The pandemic has brought about a radical shift in attitudes towards working from home and accelerated the shift away from the high street towards delivery services and online retail. Homeworking saw household consumption patterns shift, with spending on restaurants and hotels 38% lower in the first three quarters of 2021 than the same period in 2019, while spending on household goods and services was up by 14%.

While some rebalancing should probably be expected when the threat of Covid eventually fades, there are also signs of 'a permanent structural shift towards a post-Covid economy'. Omicron might not be the last vaccine defying variant to emerge. There could be more lockdowns. And even moderate restrictions – or just confidence-sapping speculation about restrictions – can be highly damaging, as we saw in December.

Employers and workers thus face the prospect of a jerky, stop-start economy, as policymakers slam on the brakes every few months, creating an incredibly unstable environment for businesses. Optimism about a 'rebound' in businesses investment in 2022, helped by the 130% capital investment 'super-deduction', may therefore turn out to be misplaced.

Moreover, in this environment, some sectors could end up permanently smaller. A large part of business travel is probably gone forever. And sectors such as hospitality, transport and tourism are

[1] See also the OBR's retrospective analysis of its recent forecasts in the October 2021 EFO, esp. Chart 2.10.

struggling in other ways, with the record 1.25m job vacancies recorded in the October-December period partly reflecting people's reluctance to pursue uncertain careers in at-risk sectors.

One silver lining from the pandemic is that there has not been the predicted spike in unemployment. Another piece of good news is that this has come about not because people are being kept on by unprofitable zombie firms, propped up by furlough and other business support schemes, but because they are finding new jobs. Employment data shows unemployment spiking following the ending of furlough, as many businesses and jobs proved unviable. But subsequently it has trended downwards to 4.1% – just 0.1pps above pre-pandemic levels, and so near record lows. Encouragingly, ONS statisticians also perceive some evidence of a shift from lower to higher productivity sectors in the process, although it is still too soon to tell for sure.

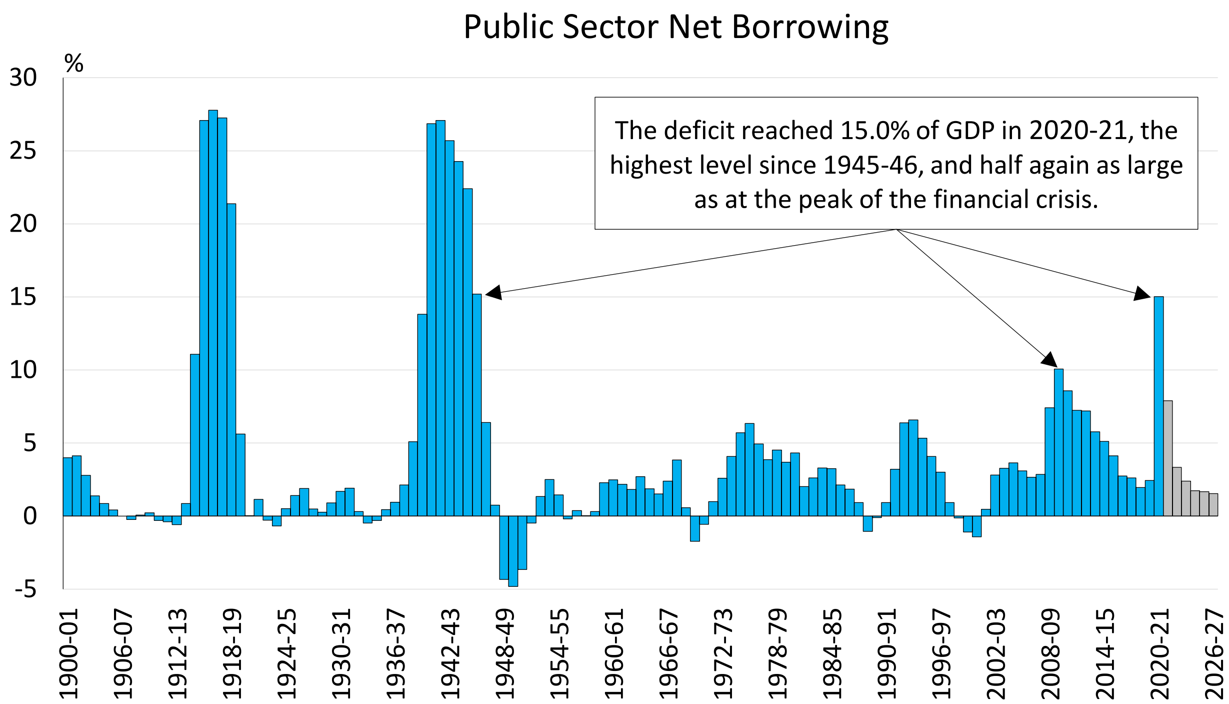
However, labour is sticky, and some people will have trouble retraining or moving location for work. On top of this, some older people have dropped out of the workforce and more young people have remained in education through the pandemic. At 75.5%, the age 16-64 employment rate is still 1.1pps below pre-pandemic levels, while the inactivity rate, at 21.3%, is 1.0pps above.

The big risk here is a lost generation of workers – elevated structural unemployment among under-25s whose educations, career prospects and life outcomes have been blighted by school and university closures, bodged exam results and lost work experience opportunities.

In addition, while working from home might provide a long-term boost to productivity (though this is far from guaranteed and can vary by demographics, industry and occupation), this is less likely to be the case for new entrants to the labour market. Younger people stand to miss out on career opportunities arising from networking, not to mention the chance to pick up tacit knowledge and ad hoc training from their more experienced colleagues.

Trends in productivity need to be closely monitored. In the first place, the vision of a 'high-wage, high-skill' economy depends upon productivity gains. But more than that, as we noted in our October Budget briefing, 'The Age of the Trillion-Pound State', the Government's tax and spending plans rest upon some pretty firm GDP forecasts, which in turn are linked to some extremely bullish productivity projections. Measured in terms of output per hour worked, productivity is projected to grow by an average of 0.32% per year across 2022-27. The average annual increase in output per hour worked in the decade following the financial crash was barely half that, at just 0.17%. **If that predicted boost to productivity does not materialise, it will tank growth forecasts – and the Chancellor's chances of cutting taxes to ease cost of living pressures**

3. The public sector finances have taken a hammering unprecedented in peacetime



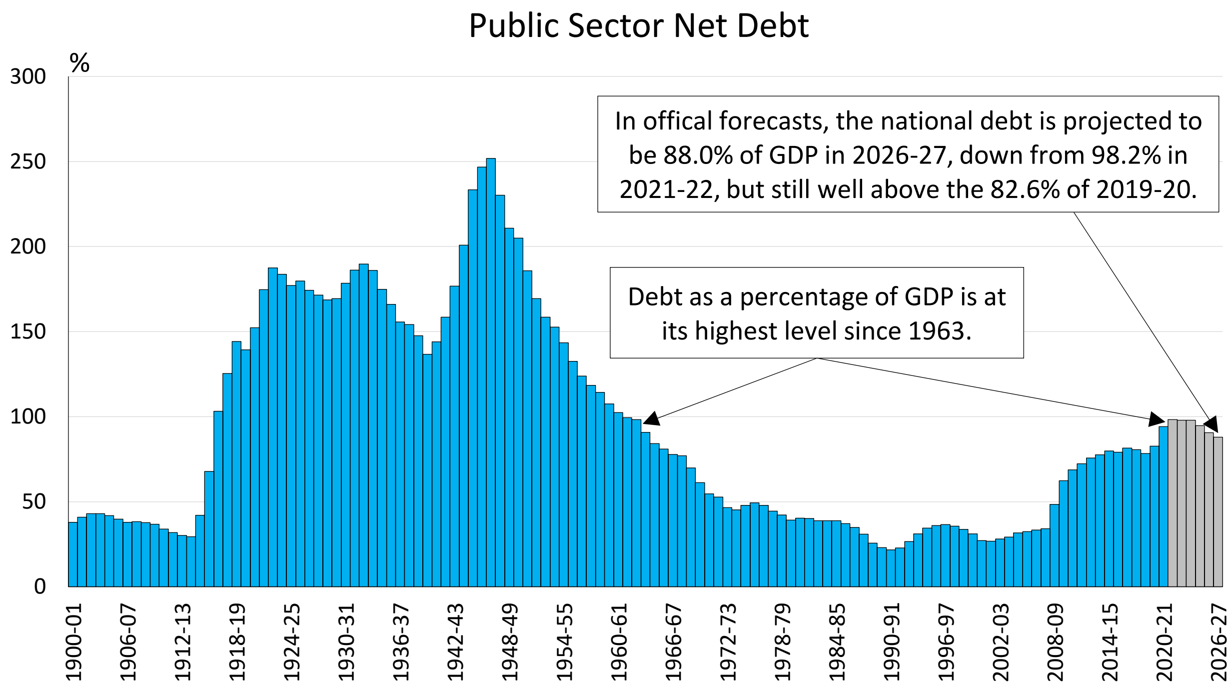
The good news is that government borrowing (PSNB ex) in the first eight months of the 2021/22 financial year, at £147bn, was down by 47% on the same period in 2020/21.

The bad news is that that comes after the highest level of borrowing since the end of the Second World War – £322bn or 15% of GDP. In comparison, borrowing in the wake of the financial crisis in 2009/10 amounted to 10% of GDP.

Just looking at the most recent data, borrowing stood at £16.8bn in December 2021 – a decrease of 31% y-o-y, but still the fourth-highest December borrowing since monthly records began in 1993.

This colossal, ongoing deficit spending is driving a vertiginous increase in public sector net debt, which reached an estimated £2,340bn in November 2021, up by an astonishing 31% in the 22 months since February 2020. The debt-to-GDP ratio was 81.9% in February 2020; in December 2021, it stood at

96%. This is the highest ratio since [March 1963](), when the country was still paying off the debts of two global total wars. And of course, it is still growing.



Unlike in the postwar decades, however, governments are not going to be able to inflate away this debt so easily. Around a quarter of public sector debt is index-linked to inflation. This is already adding to the costs of servicing the debt, spending on which was up by 200% y-o-y in December 2021, at £8.1bn. In order to quash inflation, the Bank of England (BoE) is now moving definitively in the direction of raising interest rates. But this is going to feed through into debt costs in another way. **Whatever happens, the cost of servicing the national debt will only grow in 2022, to the detriment of other priorities. Rebalancing the books, meanwhile, is going to be a long, uncertain and exacting process.**

4. **Tax rises are set to squeeze businesses and households, disincentivising investment, worsening the outlook for growth and hitting taxpayers and consumers at the worst possible time**

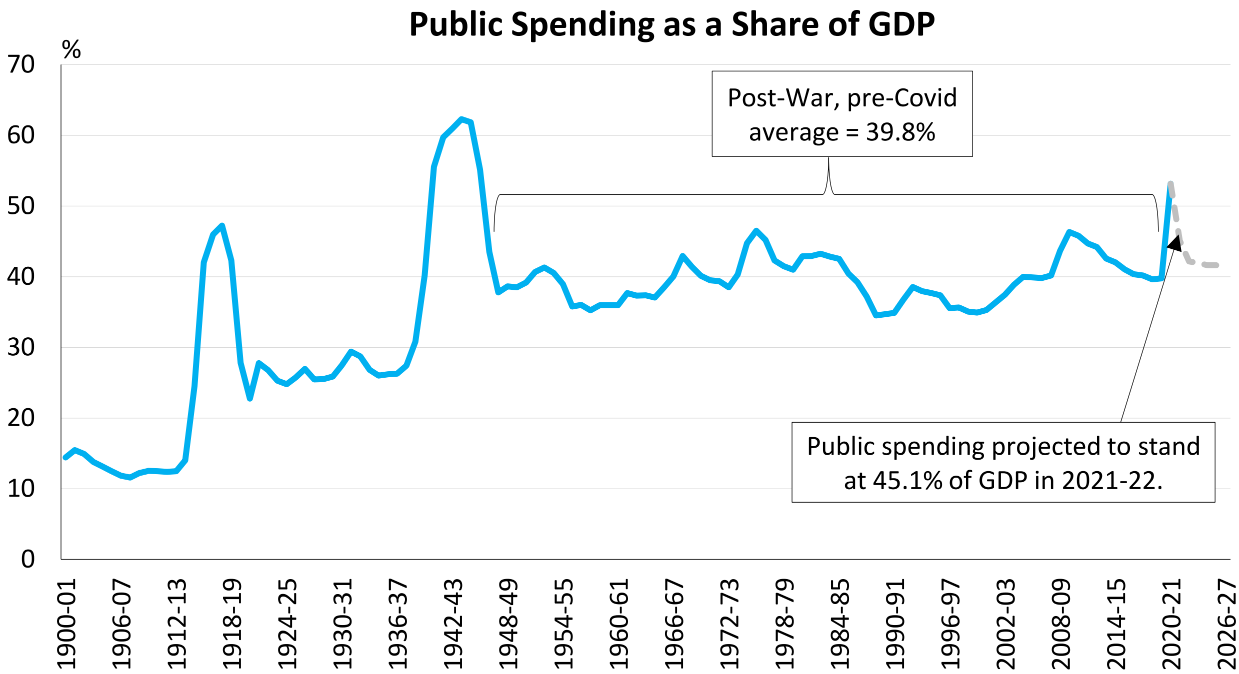
Two years of Covid spending has seen the size of the British state balloon. Although public sector spending is trending downwards from the 53% of GDP it reached in 2020, the OBR still expects it to be 41.6% of GDP by 2024/25 – almost two percentage points higher than in 2019/20.[2]

In an attempt to pay for all this without pushing Britain still further into the red, the Government has resorted to a series of planned tax rises. First is the Health and Social Care Levy, which from April this year will add 1.25% to employers' and employees' National Insurance (NI). Ostensibly to pay for fixing social care in the longer term, in reality this is likely to be swallowed up by the NHS. Either way

[2] See in particular Chart 3.7 in the October 2021 EFO.

though, the levy is a tax on jobs and job creation coming at a time when employment patterns are in flux.

This is set to coincide with a 6.6% increase in the National Living Wage (from £8.91/hour to £9.50/hour), further increasing the burden on employers and distorting the labour market. Official forecasters expect higher unemployment as a result.[3] The workers most likely to be impacted by this are young people working in sectors such as hospitality – i.e. those facing the greatest uncertainty in the post-Covid economy.



Businesses are also looking ahead to a corporation tax cliff edge in April 2023. The headline tax rate is due to rise from 19% to 25%, the super-deduction is scheduled to expire, and the Annual Investment Allowance is set to fall from £1 million to £200,000. This comes after what is likely to be an unsettled environment for business investment in 2022.

Analysis from the CPS and the US-based Tax Foundation shows that, coming on top of the Health and Social Care Levy, **these tax hikes will see the UK's international tax competitiveness ranking plummet from 22nd to 30th out of 37 OECD nations**. The impact on the competitiveness of our business tax regime will be even worse. This prospect will already be affecting companies' investment decisions for 2022. Perhaps the super-deduction will crowd forward some investment – the CBI is reporting that plant and machinery investment intentions for the next 12 months (compared to the previous 12) are at their strongest since 1988, as business activity recovers from the depths of the pandemic. But overall, corporate tax rises are bound to have a negative impact on investment and growth.

[3] See the October 2021 EFO, p.32.

Indeed, due to the impact of Covid, the tax-to-GDP ratio is also on course to reach 36.2% within five years. **The tax burden will then be at its weightiest since the heyday of state socialism in 1951**, when Clement Attlee was Prime Minister and George VI sat the throne.

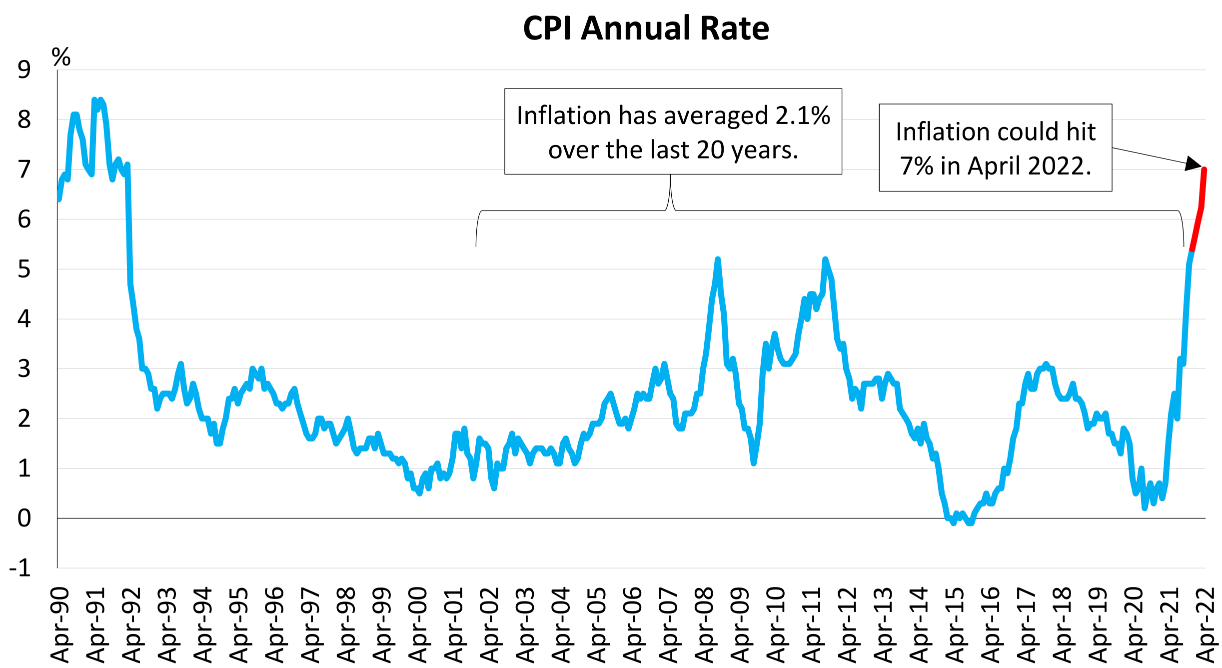
5. **Britain is facing a cost of living crisis, with inflation on track to hit a 30-year high even as taxes are going up.**

Inflation as measured by the Consumer Price Index (CPI) was 5.4% in the 12 months to December 2021, with prices having risen across a range of goods and services.

Different components of the index are undergoing inflation for different reasons. In some cases, seasonal or boom-and-bust commodity price cycles are a factor, just as they might be in any year. In other cases, temporary bottlenecks in the manufacture of key inputs such as semiconductors are limiting the output of finished products such as cars. All this is exacerbated by dislocations and supply chain snarl-ups as demand grows, but Covid outbreaks continue to shut down factories, ports and logistics hubs globally. This gives the Government few levers to pull.

Debate continues over how transitory or persistent (or even structural) UK inflation will prove in this context. There is a pretty strong consensus that prices will continue to increase well into 2022. But this is less to do with logistics, where industry associations are reporting improvements, and more to do with energy prices – the other major inflationary factor in recent months.

So far British consumers have been protected from the worst of record natural gas wholesale prices due to the energy price cap, with a swathe of energy companies going bust instead. But when the cap is raised in April, annual energy bills for the average household will go up by £693. The IMF forecasts inflation will hit 5.5% in April, while the Bank of England and some independent forecasters project it



to reach around 7%. **April 2022 could thus see the highest level of inflation in the UK since March 1992, when it was at 7.1%.**

The causes of soaring energy prices are complex. They include: a period of global underinvestment in hydrocarbon extraction (except in the US) following the 2014 oil price downturn; the post-Fukushima backlash against nuclear in Japan and Germany; Russian foreign policy; and energy policy and recent natural disasters in China. UK energy policy has been a mess for decades too: new nuclear projects have been delayed time and again, for example.

All this is to say, **the Government has very few direct levers it can pull that will have an effect on energy prices in the short term**. It has announced measures to allow many households reduce or defer some of the pain from the energy price cap increasing, including through council tax rebates. But with taxes rising elsewhere, this is very much a case of giving with one hand and taking with another.

Indeed, the Government has rejected the suggestion from us and others that it should cancel – or at least push back – the Health and Social Care Levy. As things stand, April will be a decisive and painful month. Not only does the energy price cap move upwards, but NI will increase to pay for the Health and Social Care Levy. Take-home pay will go down while bills will surge. Voters are likely to be less than amused.

Despite the talk of building a high-wage economy, relying on pay rises to offset rising prices and tax increases is unrealistic. Outside of a few specific sub-sectors such as HGV drivers, robust wage growth in 2021 mainly reflected statistical artefacts: 'base effects' (rapid growth from a low base, in this case a product of reduced working hours and the furlough scheme), and 'compositional effects' (more low-wage workers lost their jobs; fewer low-wage workers in the workforce pushed average earnings up).

In fact, the latest ONS data points towards a firm decline in real wages in November 2021 – inflation stood at 5.1% whereas wage growth stood at 4.2%. The April 'jobs tax' is only going to put more pressure on worker's pockets. Give that the clamour to mitigate cost of living pressures is only going to grow as 2022 progresses, the Government would do well to get ahead of the game.

6. **Covid has taken up so much bandwidth that other vital policy areas have been sorely neglected**

This is obviously an analysis that could apply to number of policy areas. But there are three that are particularly pressing.

Firstly, there is monetary policy. The persistent environment of ultra-low interest rates, monetary expansion and stable inflation since 2008 has allowed policymakers to focus on the fiscal rather than monetary side of things. However, things are beginning to change, with quantitative easing giving way to quantitative tightening. This is going to impact growth in the short term and change the parameters of the debate across all sorts of areas. This includes cost of living, with higher interest rates increasing pressures for many ordinary homeowners (though far fewer than would have been the case 20 years ago, given changes in the mortgage market). If policymakers are going to address voters' concerns, they need to start taking monetary policy seriously again.

A second major issue is planning and housebuilding. There is a wealth of evidence showing that the housing shortage is one of the biggest barriers to productivity and hence GDP growth in the UK. It also remains one the most intractable policy issues, with the can having been kicked down the road again following last year's Chesham and Amersham by-election. But Covid does not mean the problem has gone away. Quite the reverse: the average UK house price passed £250,000 for the first time ever in early 2021 and stood at £271,000 in November, according to data from HM Land Registry. For first-time buyers in London and the South-East in particular, getting a foot on the first rung of the housing ladder has never looked more difficult.

A third major issue is business rates. Some welcome measures on business rates were announced in the October 2021 Budget, but the sweeping reform that the system needs has been postponed again. If the goal is to encourage investment, we ought to remove all improvements from the tax base and levy business rates solely on underlying site values. As it is, UK taxes on business property remain very heavy by international standards. With corporation taxes and other burdens on business set to rise, this problem is only going to become more pressing.

So what is to be done?

Faced with the scale of these economic challenges, the worst thing would be a policy of drift: drift towards tax-and-spend, drift towards a big state, drift towards demand-side interventions to address supply-side problems.

The Government needs to prioritise economic growth – which helps with so many other problems – via supply-side reforms, lower taxes and business-friendly policies. It needs to ease the cost of living crisis by reducing the tax burden and preparing now for the deprivations of winter 2022/23. And it needs to square this with sound public finances via spending restraint and enhancing public sector productivity.

Against a dispiriting economic backdrop, it is more important than ever to make the case for markets, freedom, enterprise, opportunity and ownership as the pathways to prosperity. That agenda will remain at the heart of the Centre for Policy Studies' work, and future instalments of our Economic Bulletin. To quote F.A. Hayek: 'If old truths are to retain their hold on men's minds, they must be restated in the language and concepts of successive generations'.