A Budget action plan

The economic response to the coronavirus

8 March 2020

Torsten Bell, Laura Gardiner, Richard Hughes, James Smith and Tony Yates

Although secondary to addressing the health consequences, it is crucial that policy makers act swiftly to prevent the outbreak of coronavirus becoming an economic crisis, too. This might appear challenging given the eventual effects of an outbreak are very difficult to predict, and because the impact is likely to be unusually concentrated on the supply side. Nonetheless, history has shown the benefits of a timely and comprehensive response. Indeed, such a response should be at the centre of the upcoming Budget.

This response should be geared around three priorities. First, the Government should address the source of the crisis by ensuring funding for health services and supplies. Making a success of the medical response is the first priority for the economic one. Second, policy makers should provide timely support to the overall economy, initially through Bank of England rate cuts, but also through fiscal support. On the latter, the expected increase in government spending in the Budget is fortuitous. But being investment-heavy, it is likely to take time to have an effect on current activity, so the Government should be ready with additional timely, targeted and temporary measures in the event that the situation deteriorates further. And third, the Government should provide direct support to households and firms. Such measures should be targeted at the people and firms most affected, and calibrated to the scale of any outbreak. They should include extending Statutory Sick Pay (SSP) to low earners; protecting firms in the event of very high SSP costs; and guaranteeing lending to firms that suffer a sudden loss in workers, inputs, revenue, or credit.

The health emergency created by the rapid spread of coronavirus should undoubtedly be the top priority for governments around the world. And while *economic* policy comes a distant second, there is a risk that this human crisis could turn into an economic crisis, severely compounding the suffering. Here the concern is that even the *threat* of a disease arriving – and the necessary preventative measures that stop its spread – causes economic harm. This is a particular worry at the moment. That is because policy makers' options are limited by the low level of interest rates (which limits the Bank of England's ability to the support the economy by cutting rates), and because this crisis is very different to economic challenges we have faced in the past. And – as we have said before – those on lower incomes tend to be particularly vulnerable to a major slowdown.

The Government has been setting out day by day the health response to the crisis, but the Budget marks its moment to set out the economic policy response. So how can policy help? There are essentially three things to do…

First, focus on health, which will require an immediate funding injection

This is first-and-foremost a public-health emergency – so top of the Government's to-do list should be supporting Public Health England, the NHS and other organisations directly delivering the medical response. While we leave the nature of the health response to the experts, there are three categories of spending that will need to be resourced. First, raising awareness of simple preventative measures. Second, shoring up supplies of key medicines and other urgent care equipment – most obviously coronavirus testing. And third, providing general support for NHS organisations' budgets, given the significant extra pressure they are going to be under. Given the much more serious risks the disease poses to older people with exisitng health conditions, support for the breadth of organisations within the social care system will also be needed. Such a package of measures will need to be an order-of-magnitude larger than the over £400 million winter 2018 package put in place to deal with the much smaller risk of an outbreak of flu.

Second, provide macroeconomic support for the economy

The right support for the economy will depend on the size and nature of the economic effects caused by the spread of the virus. Here economic policy makers often draw a distinction between 'supply shocks', which affect the production process, and 'demand shocks', which affect spending by households and firms (for example, in comments made by Bank of England Deputy Governor Jon Cunliffe last week). This distinction matters because many of the available policy levers are less effective in the face of shocks to supply.

There are likely to be a number of ways in which coronavirus will affect supply. Most obviously, effects will come from workers falling ill and so not being able to work, or global disruptions preventing firms from importing vital components. And if factories are forced to close to stem the spread of the virus, that output will be lost, also affecting the production of firms further down the supply chain.

But it would be wrong to think that the impact will be isolated to the supply side of the economy, with the spread of the virus leading to weaker demand, too. For example, people may cancel holidays to affected areas, or stop visiting places where others congregate – such as bars or restaurants. Businesses may cancel major investment projects, either because of worries about future sales or because their banks turn them down for credit. And even those effects that seem concentrated on the production process can have a demand component, because those absent from work are likely to experience income falls. These effects can also end up having a long-lasting impact on the economy – for example, if firms go bankrupt because they can't access loans to help them through the period during which the virus is affecting the economy (as Tony Yates explains).

How large is the impact on demand likely to be? That is – of course – very uncertain. But asset prices have already fallen a lot (the FTSE 100 is down more than 10 per cent over the past couple of weeks), which will make people feel poorer and raise the costs of borrowing for firms. Based on the effects seen so far, the Organisation for Economic Co-operation and Development has marked down its forecast for world GDP growth by 0.5 per cent in 2020, and the UK by 0.2 per cent. But the impact would be much larger in the event of further spread of the virus to the UK. There is significant uncertainty about how such a scenario might play out, however, with the impact depending on the extent of the spread. This uncertainty is reflected in a wide range of estimates: the National Institute for Economic and Social Research, for example, points to a GDP loss of 0.5 per cent this year if the spread of the virus is relatively limited; but Simon Wren-Lewis, in a much more severe scenario, finds that GDP could eventually fall by as much as 6 per cent.

Taken together, all this suggests that coronavirus will reduce demand, possibly very significantly. Given this, there is a strong case for decisive policy action to support demand, and to do so promptly (as others have suggested).

Support from the Bank of England

The first step is for the Bank of England to cut rates. Some have argued that the Bank should keep its 'powder dry' until it has more evidence of the size of the effects on the economy. But given it takes time for rate cuts to affect the economy, and that it is clear from what has happened so far in other countries and financial markets that the UK outlook has weakened, the Bank should act quickly. This means cutting rates from their current 0.75 per cent to around 0.25 per cent at the next opportunity (26 March), if not before. (This would mean Andrew Bailey, the new Bank of England Governor, would have cut rates by more in his first fortnight than Mark Carney did in his near seven-year term.)

Such a prompt move would be in line with the US Federal Reserve, which cut rates by 0.5 per cent earlier this week, with more expected in the coming weeks. That action was timely and welcome, but would have been better coming as part of coordinated central bank loosening, given the global nature of the threat posed by the virus (indeed, this week's G7 communiqué suggested central banks would "cooperate" to provide "timely and effective measures".)

Unfortunately – as set out in previous Resolution Foundation work – there is far less scope for the Bank to support the economy than we would like. A cut in interest rates of 0.5 per cent *might* be enough to support the economy in the face of developments so far (we would typically think of that as boosting GDP by around 0.25 per cent). But it would not be enough in the likely event that the situation deteriorated. The Bank could always expand its bond-buying programme (so-called 'QE') or provide promises to keep rates low. Indeed, Mark Carney has said recently that the Bank can provide additional support (through wider monetary policy action pushing down longer-term interest rates) equivalent to around a further 1.75 percentage points of traditional cuts in short-term interest rates. This could, in principle, provide around 0.8 per cent of additional GDP support. But given recent falls in longer-term interest rates to all-time lows, this should be seen as an upper bound on the support from monetary policy. And while the Bank can – and should – take steps to make sure that the threat from coronavirus does not lead to even a tame form of the 'credit crunch' seen in 2008 (for example by extending the Term Funding Scheme scheme), there is a significant risk that it will not be able to provide sufficient support.

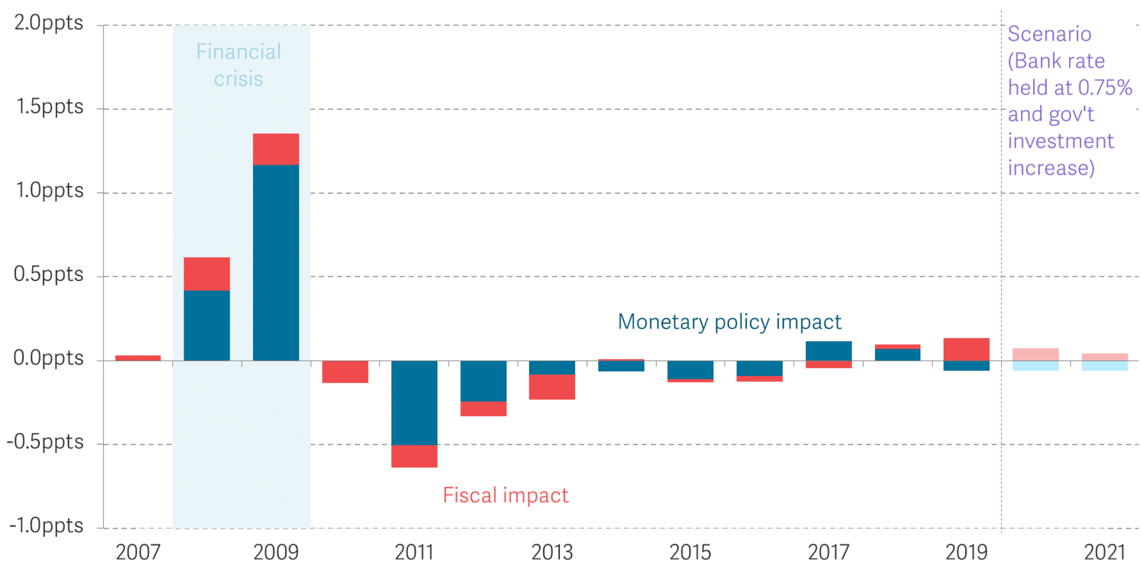
Support from fiscal policy

The next port of call is fiscal policy, where action is aided by the fact that interest rates are low and getting lower. It makes sense to turn to this given that by definition we are talking about a temporary shock (for most people and firms), with less damaging longer-term implications for the public finances. Indeed, policy interventions have the potential to make the shock even more temporary.

Fortunately, in this context we are already expecting a significant loosening of the government purse strings in the upcoming Budget. Indeed, following the election and last year's Spending Round, we now anticipate that fiscal policy will provide the first sustained boost to growth in over a decade, as Figure 1 shows.

Figure 1 **Fiscal policy is likely to be boosting growth for the first time since the financial crisis**

Contributions to growth from fiscal and monetary policy: UK



Notes: Monetary policy impact is calculated using estimates from P Bunn, A Pugh & C Yeates, The distributional impact of monetary policy easing in the UK between 2008 and 2014, Bank of England Working Papers No. 720, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in the Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the Office for Budget Responsibility's estimate of fiscal multipliers. The values for 2020 and 2021 are based on assuming the Bank rate is held at 0.75 per cent and the Government increases investment spending in line with the plans outlined in the Conservative manifesto. This is assumed to be an additional public sector investment of 2 per cent of GDP in 2020, and a further 0.2 per cent in 2021. Future current spending is assumed to be neutral for growth, and so does not represent a full forecast. Annual values are averages of the calendar year quarters.
Source: RF analysis of ONS; Bank of England.

But the fact that this stimulus is only coincidental to the virus outbreak means it will neither be optimally timely or targeted. Much of the expected fiscal boost will come through higher investment, which takes time to ramp up in a way that is effective (as we explained in a recent report). So if the outlook deteriorates sharply, there is a risk that more support will be needed in the short term as monetary policy runs out of road. And waiting until an Autumn Budget to provide that support could lead to a more painful slowdown than is necessary, particularly for those on lower incomes. So there is a strong case for the Chancellor to use this Budget to say more about what he would do to provide additional support to the economy should he need to (as advocated recently by the International Monetary Fund).

In providing more support to the economy, fiscal policy should rely on measures that are temporary, targeted and timely. In previous work we have highlighted two such measures that may complement additional capital spending, and that are suitable for the temporary effects of coronavirus. First, cuts in VAT, which can be enacted quickly and benefit all consumers. And second, one-off increases in working-age benefits. Such a boost can be effective in providing stimulus partly because such payments provide targeted support for poorer households who may be more affected by a recession, and partly because history has shown that it is easier to reverse real increases in welfare spending by freezing payments than it is to raise taxes on incomes.

Overall there is a strong case for coordinated and timely action to support the economy. But such measures should be reinforced by targeted action to help those families and businesses directly affected.

Third, support families and businesses

Support for workers and their families

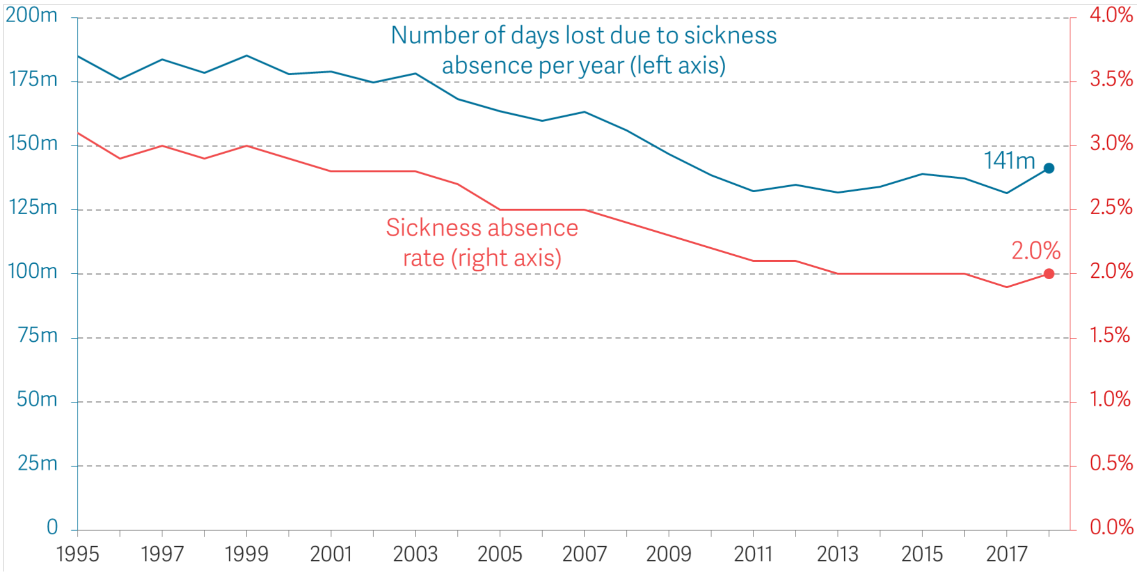
Containing the virus, and medical care for those who do contract it, are obviously the highest priorities – from both a human perspective and an economic one. Such efforts would be significantly undermined by those who may have coronavirus continuing to work. Ensuring that workers are able to follow guidance around self-isolation and staying at home when ill is a must.

What kind of numbers might we be talking about? Government guidance suggests that up to a fifth of employees may be absent from work at the peak. That is a lot more than normal: as Figure 2 shows, around 2 per cent of working time is lost due to people being off sick in the UK, a figure that has been falling steadily over the course of this century.

So what are the financial implications for individual workers when they self-isolate or take time off sick? This is where sick pay arrangements come in. Legally, employers are required to pay Statutory Sick Pay (SSP) to eligible workers, at a rate of £94.25 per week from the fourth day of sickness absence through to 28 weeks off sick.

Figure 2 **Sickness absence from work has fallen over time**

Days lost to sickness absence and sickness absence rate: UK



Notes: A day is defined as 7.5 hours of work. The sickness absence rate is the proportion of working hours that are lost due to sickness absence. This analysis covers all people in employment aged 16 and over.
Source: RF analysis of ONS, Labour Force Survey.

The UK's sick pay system stands out in comparison to other European countries for its long but relatively ungenerous flat-rate payment. Many employers therefore go further than the legal minimum and offer contractual or occupational sick pay (OSP) schemes. OSP policies typically involve employees getting paid their full salary from day one of sickness for a number of days or weeks, in effect meaning no financial penalty for many people as a result of a temporary period of sickness absence.

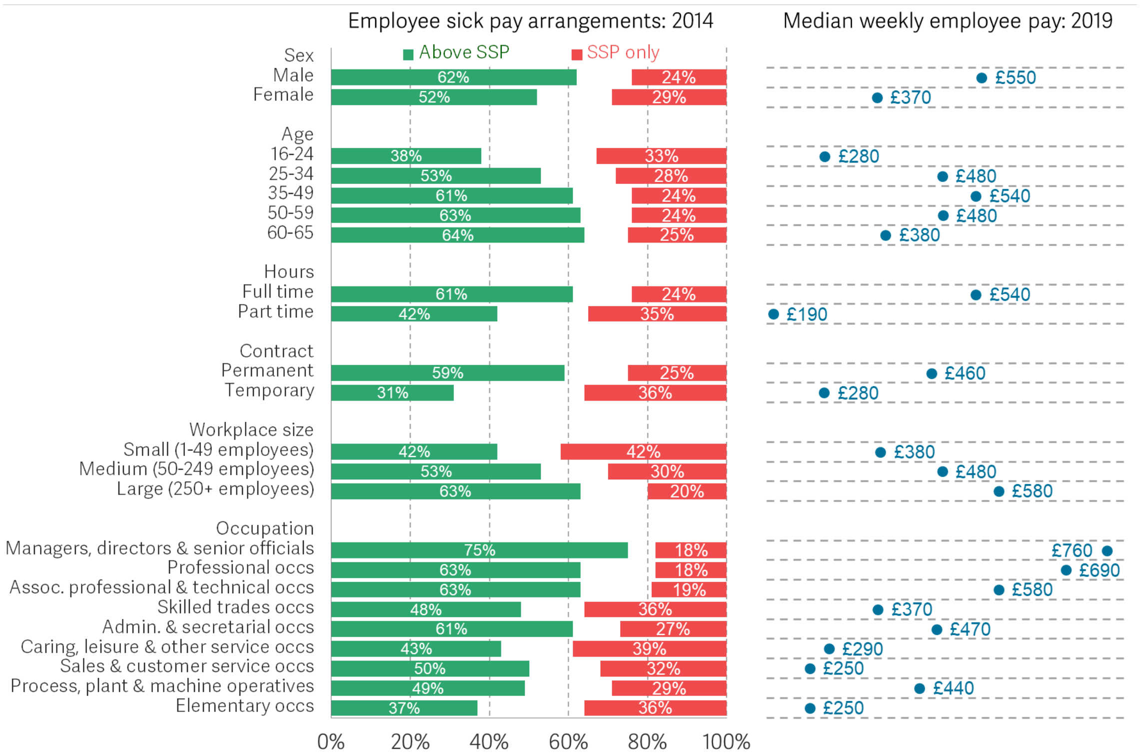
However, as Figure 3 shows, such arrangements are much less common for lower earners. In other words, lower-paid workers bear more of the financial risk of a period of temporary sickness absence,[i] such as coronavirus entails, even if they are eligible for SSP.

On this basis, there's a need for more financial support for those not protected by OSP schemes. This will not only make it easier for them to do the right thing in the event of a widespread coronavirus outbreak in the UK, but also reduce the size of the demand shock to the economy by cushioning the hit to the incomes, and therefore consumption, of those individuals directly affected. This is particularly important given the rising proportion of lower-income families without savings to fall back on to support their consumption in the face of a shock, shown in Figure 4.

Figure 3

Higher earners have more generous sick pay arrangements

Sick pay arrangements and earnings, by employee characteristic: GB

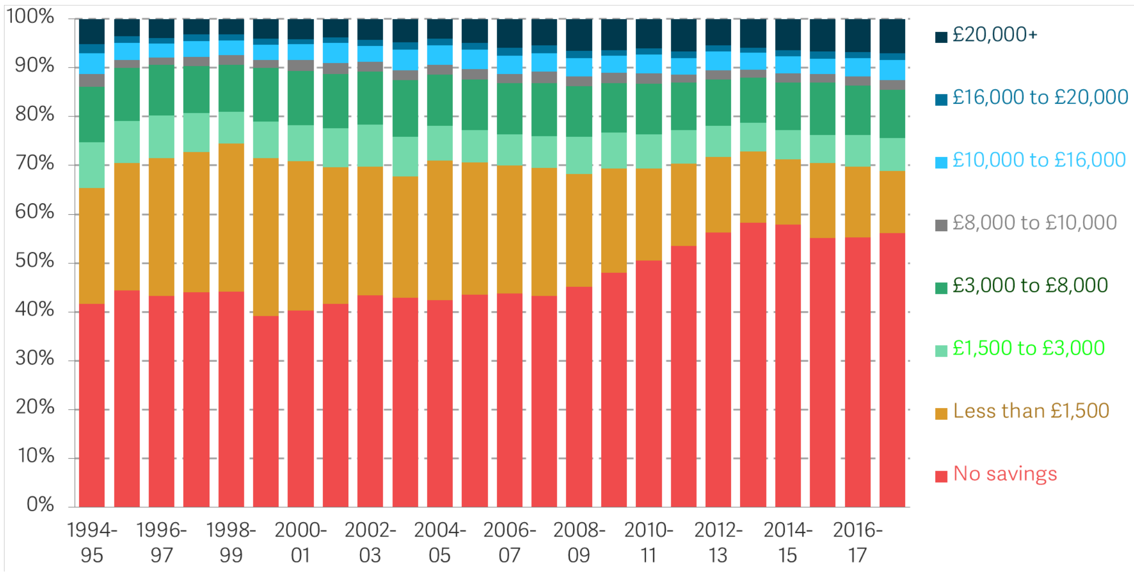


Notes: The gap between those with 'above SSP' sick pay and 'SSP only' sick pay reflects employees who did not know their sick pay arrangements. People not eligible for sick pay are excluded from this analysis.
Source: RF analysis of DWP, Health and wellbeing at work: a survey of employees, 2014; ONS, Labour Force Survey.

Figure 4

The proportion of low-to-middle income households with no savings has spiked since the financial crisis

Savings and investments (nominal) of adults in low-to-middle income households: UK



Notes: UK from 2002-2003, GB before. Savings figures are not adjusted for inflation. Low-to-middle income households are those of working age in the bottom half of the income distribution in which at least one person works.
Source: RF analysis of DWP, Households Below Average Income.

Recognising that the SSP waiting period is one factor that might put workers off taking time away from the office, the Government has taken the welcome step of announcing that SSP will be paid from day one of sickness or self-isolation for those affected by coronavirus. This will reduce the financial penalty for workers entitled to SSP only – increasing the SSP payment for a five-day-a-week worker self-isolating for a fortnight by up to two-thirds.[ii]

But there is a need to go further, most obviously in terms of the two groups who will miss out on the benefits of this policy change because they are ineligible for SSP: self-employed people, and the 2 million[iii] workers earning less than £118 per week (in each of their jobs if they have more than one).

This £118 threshold is the lower earnings limit for National Insurance contributions, stemming back to SSP's origins as a contributory benefit that the state reimbursed the costs of. However, SSP is now firmly an employment right, rather than a benefit: employers have borne the vast majority of SSP costs for over two decades, and paid all of them since 2014. So the question is, why do we give more employment rights to higher-paid workers than lower-paid ones? With no justification for this distinction, the Budget should announce the end of this earnings threshold in SSP.

The good news is that, building on the Taylor review recommendation that SSP be extended to include low earners, the previous Government consulted last year on exactly this. It proposed that those earning below £118 per week receive SSP at 80 per cent of their usual pay.

The second group for whom there is a clear SSP gap is the self-employed. As a quid pro quo for equalising their tax treatment, and alongside other benefits like Statutory Maternity Pay and Statutory Paternity Pay, we've previously recommended that the Government should explore ways of paying some form of SSP to the self-employed. This is less straightforward than for lower-earning employees, for two reasons. First, the Government would likely need to bear the costs – we've estimated that introducing SSP for the self-employed could cost £340 million per year given steady-state illness prevalence, meaning the costs may be higher in the case of a coronavirus outbreak. Second, there would need to be appropriate mechanisms for ensuring that those claiming are suffering from genuine health problems (or genuinely need to be off work, in the case of coronavirus). The current situation ramps up the need for the Government to come up with an answer on sick pay for the self-employed, while broader questions about their rights, entitlements and tax treatment shouldn't be forgotten in the longer term.

Beyond these two groups, there is the issue of ensuring that the law is enforced and those eligible for SSP receive it, with evidence that groups including agency workers often miss out. The Conservative manifesto promise of a single labour market enforcement body appears timely. But such a body doesn't currently exist, meaning that mechanisms such as employer guidance and the HM Revenue and Customs employees' enquiry line should be used to full effect in the short term.

What support is there for people who remain ineligible for SSP, or for whom the amount of money they get from their employer while away from work falls short? The Government has pointed people towards Universal Credit (UC), the new in-work and out-of-work benefit that is designed to adjust according to people's earnings and other income. This has provoked an angry response given UC's well-publicised challenges, including the five-week wait for the first payment.

It's true that UC's wait for the first payment brings challenges for new claimants who fall out of work, or who may make a new claim because their earnings fall due to sickness. In the legacy system, an initial Jobseeker's Allowance or Employment and Support Allowance payment (if not a tax credits award) would have been made faster. UC's benefit advances system – loans against future benefit entitlements to mitigate the five-week wait – is the most obvious and easiest answer here, with the option of easing repayment schedules or writing some advances off entirely. Depending on the degree of isolation needed to contain the spread of coronavirus, the Department for Work and Pensions will also need to ease job-search conditionality for some new and existing claims.

But UC is actually probably better than the legacy system in responding to a coronavirus outbreak for those already claiming it. If a low earner already on UC has to self-isolate for a fortnight in May and their pay falls to SSP levels (or to zero if they are self-employed or earn too little to be eligible), their UC award will go up in June. A participant in our recent qualitative research on UC who had had time off due to sickness summed up UC's advantages in this regard:

> *"If you're in an agency – where your money can vary from week to week – or you're off sick, then [Universal Credit is] good. Because they get notification of your wages before you even get them and they'll give you money accordingly."*
>
> Single parent

The tax credits system, however, is far less responsive, with any adjustments for temporary lower earnings only coming through at the end of the tax year, and only if your annual income falls by over £2,500. And falling out of work entirely necessitates a new benefit claim.

So, UC provides better support than the legacy system in the face of coronavirus for those in work and already on it, but not for those coming to it for the first time. The unfortunate irony is that current benefit caseloads are the opposite way around. With UC only around a third of the way through its roll out, its caseload is mainly composed of out-of-work recipients (who make up 64 per cent of the total), while most in-work claimants remain on tax credits.

A broader conclusion from this discussion is that our welfare and employment rights system (considered broadly) is relatively bad at protecting workers against risks, shocks and uncertainty. Workers bear the brunt of the effects, and it is those at the bottom who can least afford to do this.

Sick pay for low earners, the rights and tax treatment of the self-employed, our labour market enforcement systems, and the functioning of Universal Credit need policy attention quite apart from the threat of a coronavirus outbreak. So too do our systems for preventing health-related employment outflows for those with longer-lasting conditions, as previous Resolution Foundation research has explored. It shouldn't take a crisis for these things to get the attention they deserve. Any short-term fixes in the coming weeks and months should be followed up by more substantive policy change in the years ahead.

Support for businesses

What support will businesses need in the face of widespread coronavirus impacts? An obvious starting point stems straight from the discussion of sick pay, above. SSP has shifted over time from a contributory social insurance benefit to an employment right (and because the UK has no short-term sickness benefit, SSP payments last a comparatively long time). This means that employers unlucky enough to have a particularly large number of employees off sick due to a coronavirus outbreak will both have their output hardest hit and bear the full burden of any increase in SSP payments. Extensions to SSP – such as the removal of waiting days already announced, and the proposed extension to low earners – amplify this. Given a range of other pressures on firms stemming from a coronavirus outbreak, there is a need to think about employers for which SSP becomes particularly expensive at the worst possible time for them.

History provides us with a good approach. Prior to 2014, the percentage threshold scheme (PTS) compensated employers in any month in which their SSP payments were more than 13 per cent of their National Insurance contributions. This was abolished to fund the 'Fit for Work' occupational health service, which never got off the ground and has since been abolished itself. The PTS is well-calibrated to target those firms most affected, and would ramp up support according to the severity of coronavirus impacts. On that basis, there's a very good case to bring a version of it back, with a similar or lower threshold for support.

How else could businesses be supported? While lower Bank of England policy rates will reduce borrowing costs throughout the economy, this would provide only minimal support for companies that are highly exposed to the economic fallout from the spread of the virus. An obvious example is airlines – where travel restrictions and changes in official advice have already resulted in a precipitous fall in bookings. But any business that involves congregations of people outside their homes is likely to be affected, severely in the case of service-sector firms like pubs and restaurants. Also affected will be any business that has its production process disrupted due to supply chains that involve severely affected countries. Crucially, as Simon Wren-Lewis notes, these are temporary effects that policy is well placed to respond to. To address this, it will be crucial for the Bank of England and Treasury to work together to target support for businesses, particularly small ones, that are most affected. The most obvious way for this to proceed is for the Bank of England to provide guarantees for commercial banks offering short-term lending to such businesses, with any losses being underwritten by the Treasury. The financial crisis provides a clear precedent for such fiscal policy to be decided on by the Government but administered by the Bank.

Such temporary credit support for firms is best administered through commercial banks, to take advantage of existing credit relationships, risk management systems, and ease of payment. Government-guaranteed loans of up to a year (reviewable in the event that the virus lasts longer than a few months) could be extended to firms that can demonstrate that either their (i) own production, (ii) that of their suppliers or intermediate purchasers, or (iii) end consumers has been affected materially by the outbreak. Such a material effect could be defined as reducing annual revenue by more than 25 per cent, or more than 10 per cent in any given month, taking account of the three months' cash reserves held by a typical firm. Guarantees could be partial to give banks an incentive to perform due diligence on creditors, but carry a very low interest rate equal to the cost of administering the loan. Recipients would be required to certify that employees were either retained on the payroll or being paid SSP over the period for which the loan is outstanding.

In tandem with HM Revenue and Customs, which through the Time to Pay scheme can temporarily ease the tax burden on businesses struggling to cope with the effects of an outbreak, this approach would ensure that banks are part of the answer for businesses facing short-term problems during the crisis, rather than part of the problem.

Conclusion

The outbreak of coronavirus in the UK is first-and-foremost a health crisis, and efforts to contain the virus and treat those who fall ill are undoubtedly the top priorities. But policy makers should also act swiftly to ensure that the health challenges are not compounded by an economic crisis. Inevitable uncertainty about the eventual size and nature of the effects should not be a reason for inaction. Instead, policy should respond decisively in three main areas. First, it should ensure funding for addressing the health consequences of the outbreak directly. Second, it should support the economy, both through interest rate cuts and a looser fiscal policy. And third, policy makers should support the people and firms most likely to be affected. The Budget is the new Government's opportunity to address these issues. Tackling coronavirus should be at the heart of what is announced.

---

[i] The SSP rate of £94.25 a week will represent less of a drop in pay for lower earners than higher ones, which may justify OSP schemes being more common for higher-paid workers. However, given the prevalence of OSP schemes that include a period of full pay, it is very likely that lower earners still bear the greatest financial risk from a period of temporary sickness.

[ii] Because the four-day waiting period for SSP includes non-working days, the uplift from this policy change would be less for those whose waiting days span non-working days, such as weekends.

[iii] Estimated on the basis of the 2018 pay distribution, applied to the number of employees in the UK today. Source: RF analysis of ONS, Annual Survey of Hours and Earnings; ONS, Labour Market Statistics.