Social Sciences & Humanities 7

COVID-19 Recovery

Fiscal Policy

A series of statements from national social science and humanities bodies in the G7 on one of the greatest challenges we face: the COVID-19 pandemic and our recovery from its impacts.

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The following are seven broad recommendations for governments.

1. Unwind fiscal support carefully

Many governments have appropriately enacted unprecedented levels of support for households, public services and businesses during the crisis. Many of the specific policies – including, for example, tax breaks for businesses, tax payment holidays and enhanced furlough schemes – will need to be unwound as the crisis abates. This requires a careful balancing act: remove policies too quickly and viable businesses and jobs will be lost causing unnecessary harm in both the short and long-term; retain policies for too long and productivity enhancing resource reallocation will be hampered as businesses and jobs are kept going through taxpayer subsidy despite being ultimately unviable. Getting this right will require careful planning, good communication, and the ability for policymakers to be nimble in the face of changing circumstances and new evidence.

Governments may also wish to unwind some of the more general support – such as higher welfare payments or increased unemployment insurance – that has been enhanced during the crisis. Here the concern about higher support hampering reallocation may be less stark. This suggests benefits from unwinding different policies at different speeds; and it may be desirable for some of the enhancements to general support to be retained over the longer-term.

Phasing out of policies will also need to be staged to sit well with other reforms. This will include reforms that: help the management of the economy and the public finances; fix deficiencies in the tax and benefit system that the pandemic has revealed; tackle new inequalities and other challenges created by the pandemic and policy responses to it.

2. Where a short-run fiscal stimulus is warranted, ensure it is targeted, temporary and timely

It is uncertain how quickly demand will return once restrictions on supply are eased and eventually lifted. It is clear that, on average, higher income families have saved during the pandemic while less well-off families have seen their incomes drop by more than their spending. Some households may return to pre-pandemic levels of spending relatively quickly, while some may even go further and choose to spend down some of the additional savings they have accumulated since the crisis began. But others – perhaps because of ongoing concerns about the virus, or continued heightened uncertainty, or more simply due to social distancing constraints remaining in place – may choose to continue to spend less.

There is also uncertainty about the extent to which patterns of demand will be permanently changed by the crisis. For example, while much spending in hospitality may eventually revert to its pre-pandemic path, any permanent changes in spending and working habits will necessitate some structural changes in the economy. The latter could render a short-term stimulus less effective – and possibly counterproductive if it impinges on reallocation – and may require differently structured support to ease the pain from any transition. Due largely to these uncertainties, economists disagree in their views of whether significant stimulus will be needed, and the extent to which one would be effective.

In general, to work well a fiscal stimulus that is aimed at boosting short-run demand needs to be targeted, temporary and timely. Getting this right is crucial. There are some particular challenges with designing a fiscal stimulus in the current context. Timing is difficult because there is uncertainty around when social distancing measures will be lifted (and some forms of stimulus – for example to consumer spending – could be counterproductive during periods where supply remains constrained). An additional challenge is uncertainty – consumers and firms will be less likely to respond to a stimulus while uncertainty remains high.

There are ongoing debates – most notably in the USA in relation to President Biden's proposed stimulus package – about how big any stimulus should be if there is to be one. One risk to making a stimulus too large is that it may stoke inflation, and (more problematically) expectations of future inflation. Again, the effects on inflation are uncertain in large part because it is difficult to predict how much consumer spending will increase in coming months, and with it how quickly supply will respond.

3. Focus on measures that assist the recovery and meet long run challenges

The COVID-19 pandemic will leave all countries with a series of specific problems. For example, there has been a loss of education, particularly for children from lower income families, and less work based-training. There are also backlogs in healthcare and elevated unemployment particularly among some groups. Some such problems will have long-lasting effects – such as increased inequalities within and across generations – that governments should tackle. And, as highlighted above, there will be a role for government in easing the pain from any substantial adjustments in the structure of the economy. These pandemic related issues come against a backdrop in which most countries are seeking to navigate a path towards net-zero and to meet the public finance pressures of an ageing society.

In practice, there will often be a blurry line between measures to stimulate the economy towards recovery in the short-run and measures that meet longer-run goals and improve growth potential. Governments would be wise to seek measures that do both: measures that increase productive capacity will lessen the chance of inflation, and even if a boost to demand turns out to be inflationary the policies can still deliver longer-term benefits. For example, investments in physical or human capital that could provide short run stimulus while also helping to mitigate long-run effects of the pandemic or meeting other future challenges.

Increased public investment will be particularly appealing and should play a central role in the recovery from the pandemic if: governments can lock-in low borrowing costs over the longer-term and investment spending can be done and done well. Governments should be seeking to undertake investments that encourage, rather than crowd-out, greater private sector investment. A focus on making increased investments as part of a package of policies – that also include other policies which incentivise the private sector to decarbonise, for example – should be a priority.

4. Address structural deficits over the medium run

Even a successful recovery is unlikely to return the economy – and with it tax revenues – to its pre-pandemic path. The crisis will have led to some valuable businesses and jobs being destroyed, there will be enduring harm done from the loss of in-person teaching in the education system, and any post pandemic changes to work, commuting and spending patterns will require the economy to make adjustments that will not be cost free. These types of factors will lead economic outputs to continue to run below their pre-crisis path for at least many years to come, depressing government revenues and thus increasing government borrowing.

Once the recovery is secure, fiscal tightening may be appropriate to bring the enduring level of government borrowing down towards its pre-pandemic path. In principle, this could come from cuts to spending or from increases in taxation. But spending cuts will be made more difficult from additional spending pressures – both those arising from the pandemic (and the need to be better prepared for the next pandemic) and those arising from pre-pandemic factors such as ageing populations and the need to decarbonise the economy. Spending cuts would also be difficult in countries – like Japan and the UK – where substantial cuts to many areas of spending have been delivered over the last decade.

5. Reform taxes to make tax rises less painful

Tax rises are likely to be considered in many countries. Governments would be wise to look not just to raise revenues but also to take the opportunity to improve the structure of their tax systems. Each tax system will have its own inefficiencies, distortions and unfairness's, and they will usually be worse at higher rates of tax. Poorly designed taxes do more damage to living standards than is needed. This is important at all times but should be of particular concern when seeking to navigate a recovery from the largest economic crisis in peacetime.

One clear example of this relates to the taxation of capital incomes. Capital incomes arise disproportionately at the top of the income distribution and are usually more lightly taxed than labour incomes. There are growing calls to raise capital income taxes significantly on equity grounds. This has gained added impetus because falling interest rates have led to asset values holding up well during the crisis, and have continued to perform much better than wages. Raising existing taxes on capital incomes in isolation would often act to worsen distortions, including to investment incentives, that arise from poorly designed tax bases. Reform to the tax base – for example to ensure that the full cost of investment is deductible from tax – could significantly lessen this trade-off and mean that further increases in rates can raise revenue in a progressive way without doing as much harm to investment and therefore subsequent living standards.

Another example relates to corporation tax. The UK has announced plans to increase its corporation tax rate significantly; President Biden would like to do the same. In principle, taxing economic rents (or 'excess profits') is highly attractive. The key challenges is that corporate rents are mobile. Most countries have recently agreed to proceed with OECD plans to implement a global minimum corporate tax and to adjust where some of the profits of the largest multinationals are taxed. This is a complex area with many details still to be finalised and new laws yet to be written. The proposals should act to raise some additional corporate tax revenue from large multinationals. Much of the impact is likely to be on *where* the revenue is raised and the location of taxing rights. For any individual country, the additional tax revenue is expected to be a relatively small amount. There are likely to be ongoing debates in coming years about reforms to corporation tax.

6. Look to environmental taxes, but not as long-run revenue raisers

In light of the need to need to decarbonise economic activities, governments should be looking at the incentives created by their tax systems. This should include not only consideration of new carbon (and carbon border adjustment) taxes, but the much larger set of taxes that affect incentives – for example, the tax treatment of different fuels and types of transport. New environmental taxes could raise some additional revenue. But at the same time, governments will lose the (often large) revenues they currently raise from taxing the burning of fossil fuels – most obvious through taxes on petrol and diesel used in motor vehicles. Importantly, environmental taxes should be designed with a view to achieving environmental goals, and not with a view to raising revenue. But if the pandemic creates the opportunity to improve the design and operation of these taxes it is one that should be taken.

7. Ensure well designed fiscal rules and strong institutions are supporting the management of public debt

The huge sums borrowed by governments since the crisis began will have elevated government debt to levels that will persist for many decades and require careful management. This will require thorough consideration of the structure of the debt, for example ensuring that where appropriate it is financed on a long-term basis in order to reduce the exposure of the public finances to unexpected increases in interest rates. More generally it means more emphasis on supporting – and where possible enhancing – the institutional structure of fiscal and monetary policy.

Well-designed fiscal frameworks and fiscal targets can impose discipline on governments who might otherwise be prone to deficit bias, and provide important transparency to foreign investors and the wider public. But this is not achieved through poorly designed fiscal targets. These lack credibility and will frequently either need to be broken or abandoned, or – likely even worse – inappropriately adhered to. There should be no rush to reimpose pre-existing fiscal targets or to impose new ones, not least because heightened uncertainty means that it will be difficult to put rules in place that are appropriately constraining while still giving governments the flexibility that they may need should recoveries falter. Rather, governments should take time to ensure that any fiscal rules that are introduced are carefully designed and tailored to the new economic environment. Alongside this governments should seek to enhance, and certainly not to undermine, the independence – and credibility – of their independent central banks and independent fiscal councils (with the introduction of independent fiscal councils where these do not already exist). This will help reinforce commitments to the careful management of the long-term public finances, and not to resort to inflation in an attempt to reduce the real value of elevated public sector debts, all of which should help to keep borrowing costs low.