Bounce back

How to put Britain on the path to prosperity after coronavirus

ONWARD

About Onward

Onward is a campaigning thinktank whose mission is to develop new ideas for the next generation of centre right thinkers and leaders. We exist to make Britain fairer, more prosperous and more united, by generating a new wave of modernising ideas and a fresh kind of politics that reaches out to new groups of people. We believe in a mainstream conservatism – one that recognises the value of markets and supports the good that government can do, is unapologetic about standing up to vested interests, and assiduous in supporting the hardworking, aspirational and those left behind.

Our goal is to address the needs of the whole country: young as well as old; urban as well as rural; and for all parts of the UK – particularly places that feel neglected or ignored in Westminster. We will achieve this by developing practical policies that work. Our team has worked both at a high level in government and for successful thinktanks. We know how to produce big ideas that resonate with policymakers, the media and the public. We will engage ordinary people across the country and work with them to make our ideas a reality.

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About the authors

Adam Memon

Adam Memon was special advisor and head of economic policy to Sajid Javid as Chancellor. He was previously the Conservative Party's Director of Research from 2017 to 2019 and, prior to that, he was economic advisor to the Chief Secretary to the Treasury, the Justice Secretary and the Environment Secretary.

Neil O'Brien MP

Neil O'Brien is a former economic advisor to Chancellor George Osborne (2012–2016) and Prime Minister Theresa May (2016–17). He is the MP for Harborough (2017–). He grew up in Huddersfield and is a member of Onward's Advisory Board of MPs. He is the former Director of Policy Exchange and Open Europe. He is Parliamentary Private Secretary (PPS) to the Ministry of Justice and was formerly PPS at the Department for Business, Energy & Industrial Strategy.

Mats Persson

Mats Persson was Chief of Staff to former Chancellor Sajid Javid and Special Advisor to former Prime Minister David Cameron 2015-16. Between his two stints in Government, Mats was the Head of EY's International Trade, Economic and Policy Unit, advising companies on how to plan and re-organise their business models in response to macro trends and events. He was the Director of Open Europe 2010-16 and a co-founder of Open Europe Berlin gGmbH. Mats holds a bachelor degree from Liberty University, Virginia and a masters degree from the London School of Economics.

Tim Pitt

Tim Pitt is a partner at Flint Global. He joined Flint from the Treasury where he was a senior advisor to the previous two Chancellors, Sajid Javid and Philip Hammond. Before entering politics, Tim was a corporate lawyer at the City firm Slaughter and May.

Raoul Ruparel

Raoul Ruparel is currently an advisor to Deloitte, covering Brexit, trade, economic policy and Government more broadly. Raoul was the Prime Minister's Special Advisor on Europe under Theresa May. He was previously Special Advisor to the Secretary for Exiting the EU under David Davis. Prior to joining Government he was Co-Director and Chief Economist of the think tank Open Europe, a contributing author for Forbes and a member of the British Chambers of Commerce Economic Advisory Council. He holds two masters degrees from the University of Chicago in Economics and Public Policy and undergraduate degree in Economics and Politics from the University of Manchester.

Will Tanner

Will Tanner advised the Prime Minister Theresa May between 2013 and 2017, as a Special Adviser in the Home Office and as Deputy Head of Policy in 10 Downing Street. He has also previously worked for the leading communications firm, Portland, and for the independent thinktank, Reform.

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Summary of the argument

This is a different economic shock to anything we've seen in the last 100 years. The source – a virus – is entirely exogenous, forcing Governments to impose lockdowns and social distancing measures. The ensuing economic disruption has been extraordinary, with supply and demand shocks feeding into each other, coupled with significant volatility in financial markets.

Consequently, any economic policy response must address and accommodate the unique composition and ferocity of the crisis itself, not just to keep the economy on life support during lockdown but to rehabilitate it and improve its health after it has awoken. This report sets out a strategic plan for tackling some of the most difficult economic headwinds facing the country. The recommendations are deliberately framed around a number of clear principles that should be at the front of policymakers' minds as they decide how to bring the economy back to life:

- **There's no off-the shelf playbook**. The response must involve a mix of approaches, with maximum agility to respond to evolving evidence and data as more becomes known about the virus and businesses and consumers respond in new environments. Hard ideology should be avoided at all costs.
- **Time is of the essence.** Where a policy action is justified across scenarios, there is a premium on speed in deciding and executing policies. If young people spend months unemployed, businesses are unable to restructure their debts, or infrastructure and planning approvals are slow, the recovery will be slow and the scars enduring.
- **The scale of any policies must match the scale of the crisis** but with a relentless focus on improving outcomes – not chasing short-term headlines or tinkering with micro changes that will achieve little.
- **We must not waste the opportunity to drive change.** As with other crises – as horrible as this one is – we should not waste the opportunity to reform outdated institutions and achieve rapid progress on longstanding problems. This should include delivering faster and further on the promise to level up regional growth and boost the long-term competitiveness of the UK economy.

With these in mind, we believe there are four key areas in particular which must be addressed now to ensure a sustainable long-term economic recovery:

1. A new fiscal framework, providing flexibility but retaining confidence.
2. Giving businesses the room to breathe and invest.
3. Getting people back to work, and quickly.
4. Ensuring we have the skills to be a competitive economy.

Recommendations

Recommendations

Area	Problem	Recommendations
Public finances	This is not a time for dogma. There is a good case for being open to higher debt-to-GDP ratios, increased government borrowing and more direct intervention in the economy to mitigate a once-in-a-generation pandemic that every country is facing, and which no business could plan for. But while borrowing costs are likely to remain low in the short or even medium term, the long run picture must be kept in mind. Even before this crisis, the UK was set on a path to see an inexorable rise in debt to GDP, not least due to an ageing population. We propose a new framework to manage these tensions.	1. New fiscal rules should target debt falling as a share of GDP by the end of the Parliament; a debt servicing ratio of 6 per cent or lower. 2. Tax cuts should be temporary and targeted towards productive investment, such as capital allowances and payroll taxes, rather than consumption, such as VAT. 3. Any future tax increases should minimise the impact on work incentives and productivity by targeting environmental externalities and removing reliefs and distortions which privilege certain sectors (e.g. digital).
Corporate Debt	Companies went into the coronavirus crisis with historic levels of debt and debt is rising sharply in the current crisis. There is strong evidence that excessive corporate debt creates a drag on growth as businesses deleverage to repair their balance sheets. The crisis is likely to generate a large number of 'zombie firms', which sap productivity and deprive viable firms of capital and labour. Taxpayers are exposed to a considerable risk of default or bad debt given the extensive use of government guarantees through the crisis. More broadly, firms struggle to access capital beyond just taking on more debt.	4. Ministers should establish a Restructuring Agency to manage firms overloaded with bad debt, in particular government guaranteed loans which have turned non-performing. 5. The Government should be prepared to triple (to £30bn) equity capital availability through the British Business Bank, British Growth Fund and Future Fund, including through the use of convertible loans. 6. The Government should announce a long-term review of the tax treatment of debt and equity after the immediate crisis is over, with a clear signal that changes will be deferred and grandfathered.

Jobs	The likely return to 1980s unemployment would raise the spectre of long-term scarring that could last a generation and severely hamper the recovery. The regional balance of labour market risk threatens to make levelling up considerably harder, with already lagging regions worst affected. The sectors which drove the jobs recovery after the last financial crisis are precisely the sectors worst hit from the pandemic and likely to take longest to recover.	7. Act decisively for those most at risk of scarring. There is a considerable premium on speed to avoid hundreds of thousands of people becoming unemployed when furlough ends. 8. Invest in rapid back to work support and assistance. The DWP should rapidly expand the number of work coaches available and expand their role. 9. Prioritise job creation in sectors with absorptive capacity, such as pharmaceutical and medical device manufacturing, infrastructure, renewable energy and social services. 10. Guarantee every young person an opportunity to earn, learn or serve their community.
Skills	The crisis poses many new challenges for skills policy, including permanent loss of skills from mass unemployment, the limitations of social distancing, and the likely impact on different sectors of the economy. This is exacerbating long standing weaknesses in skill levels across the UK, reducing our competitiveness internationally and entrenching regional divides. Improving skills brings significant benefits to individuals, society and the economy, especially around basic skills and better social support for disadvantaged groups. Education is an unfinished revolution.	11. Establish a new Right to Train for adults 12. Make Maths, English and Digital education compulsory to the age of 18 13. Introduce enhanced children's zones to boost the skills and life chances of disadvantaged children through intensive, multi-agency support. 14. Double Further Education funding and launch a radical wave of reform of the sector 15. Scale up the Catch Up Fund to increase access to small group tuition 16. Develop a National Mentoring Scheme, so that all 14-16 year-olds have a personal mentor by 2024

Sound money

Towards a new fiscal framework for the crisis

There is a broad consensus that the UK Government – along with governments virtually everywhere – was correct to use its balance sheet to cushion the impact of the crisis.

There are several reasons for why this was the correct approach.

At its most fundamental level, this is a crisis triggered by a biologically random event – not irresponsible economic behaviour. Moral hazard considerations are therefore, at least for now, less of a concern.

Secondly, economies were shut down by government mandate, requiring corresponding financial support from taxpayers.

Finally, as we discuss elsewhere in this report, the scarring effect on the economy would have been so profound that exceptional fiscal measures were justified on their own economic merits over the long-term.

However, as a result, the UK's public debt and its deficit stand at extraordinary levels. The latest figures suggest that:

- UK public sector net debt has risen above £2 trillion, meaning the debt-to-GDP is now heading over 100%, compared to 74% before the crisis, and 36% in 2007. The UK is now indebted at around three times the level of the long-run historical average.
- Yet public debt is still well below the debt-to-GDP level experienced after World War I and World War II, which stood at around 150% and 270% respectively.
- The public sector deficit is set to end the year at around 15%, up from under 3% after the Chancellor's March budget. This is significantly higher than the worst year of the financial crisis in 2008/09.
- The UK Government looks set to spend approximately £240 billion – around 12% of GDP – on cushioning the effect of the crisis, with the biggest outright fiscal costs associated with the furloughing of over 10 million people.

There are a very large number of uncertain forces interacting which will determine the precise long-term damage to the public finances of which we have only limited information, including: the speed at which economic activity will return following the easing of the lockdown, the stimulus policy mix and the resumption of global travel and supply chains, to name a few. What is clear, however, is that we are likely to emerge from this crisis with both significantly elevated levels of national debt and a higher structural deficit.

Furthermore, the significant impact of this crisis on deficits and debt is only part of the equation that needs looking at when it comes to the sustainability of the public finances.

First, even before this crisis, the long-term outlook for the public finances in the UK was immensely challenging. Since the OBR started producing their regular fiscal sustainability reports in 2011, the baseline projection in each one has pointed to an unsustainable longer-term fiscal position as the UK faces up to long-term pressures such as an ageing population and rising healthcare costs. In its latest such report in July 2018, it projects that without policy action debt-to-GDP would reach 260% by 2060.

Second, economic shocks and recessions happen periodically, and each one takes its toll on the public finances. In little over a decade, a combination of the financial crisis and Covid will have seen UK debt-as-a-share of GDP almost triple. Any prudent plan for building sustainable public finances needs to consider this.

An analysis of what the government's fiscal strategy should be therefore needs to factor in not only the impact of Covid, but also this already challenging long-term picture.

Within this framework, there are three interrelated questions: Does sovereign debt still matter? If yes, how should we reduce it? And at what pace and sequence?

Do levels of spending and debt still matter?

The short answer is yes. Few mainstream economists would dispute that it is possible for government debt levels to become unsustainable: debt relief and restructuring efforts over recent decades from Latin America to Greece bear witness to this. The question is at what point debt starts to be unsustainable.

Likewise, during the period of fiscal consolidation across developed economies at the start of the last decade there was a lively debate between economists on whether higher sovereign debt is a drag on growth or not.

Whilst this debate is nowhere near settled, there seem to be at least three simple conclusions that enjoy a degree of consensus that are important for where UK public finances go next:

- First, the sensitivity to large levels of debt and deficit depends on the country. The US with a global reserve currency will clearly have more discretion on borrowing; the eurozone – combining a single monetary policy with 19 national democracies, budgets and fiscal cycles – leave some countries vulnerable to increasing borrowing costs; as will a whole host of emerging economies for different reasons.
- Second, it depends on what you borrow for – growth-enhancing spending, for example in economic infrastructure and human capital, is more justifiable than other types of spending if it pushes up trend growth and thus improves longer-term living standards and debt dynamics.
- Third, the underlying economic fundamentals, including economic growth and how it feeds through to the cost of servicing the debt, are just as important than the absolute level of the overall debt.

As such, it is difficult to decouple the debate about acceptable levels of public debt and spending from the view one takes on the shape and pace of the economic recovery itself. We note the following:

- Economically, a series of bold programmes will be needed to move the economy from hibernation to recovery, and play its part as part of a strategy to raise the trend rate of growth. In the short term, this will very likely mean more borrowing;
- Economically, any attempt to raise revenue to close the deficit should avoid stifling a fragile recovery;
- Politically, there is no mandate for a course of action that looks like reducing public spending on essential services such as the NHS.

However, we also note:

- Economically, the most viable path, and the one that has the greatest potential to boost living standards for individuals and families across the UK, involves a vibrant private sector that can produce jobs and growth – not an ever-growing public sector;
- Economically, any increase in the trend rate of growth would have to be substantial if it is to be sufficient in putting the public finances back on a sustainable footing. In its long-term projections for the public finances, the OBR already assumes that trend growth long-term returns to 2% from its current levels closer to 1.5%;
- Politically, while the pandemic is shifting some sentiments and opinion research shows comparatively higher levels of acceptance for fiscal expansion than in recent times, a radical vision for permanently and radically bigger government was rejected by the electorate in December.

All of the above can be true at the same time, which begs the question under what circumstance borrowing goes from part of the solution to part of the problem. We see several key points to consider – discussed below.

Inflection points: why reducing the deficit must remain a priority in the medium-term

Sustainability

As discussed above, even prior to the coronavirus crisis, the UK faced a long-term challenge in managing its debt.

The UK is now an ageing society with worse prospects for growth and relentless upward pressure on spending. Even before the coronavirus crisis the OBR forecast that, in the absence of policy action to address this, these forces will take the UK debt-to-GDP ratio to record levels by the 2060s.

Figure 1: Historic debt and pre-coronavirus OBR forecast

Source: Office for Budget Responsibility and Office for National Statistics.

Further, many of the tools – described as "financial repression" – which enabled governments in the post-Second World War years to reduce debt are no longer available.

- Surprise inflation (for example 25% inflation in 1975 alone) is ruled out by an independent inflation-targeting central bank. The growth of index linked debt as a share of the total since the 1980s would blunt its impact anyway.
- Capital controls and extensive controls over private lending, which enabled governments to force down interest rates, have been dismantled. These measures were automatically reducing the debt by 3–4% GDP a year in the post-war years – but they are no longer available.
- While real interest rates and borrowing costs have been low in recent years, it would not be prudent to rely on this continuing forever. As the OBR has pointed out, long-run data since the year 1900 suggests that an increase in borrowing costs is more likely than a decrease, with the potential to make the forecast increase in debt over coming decades.

Debt servicing costs

Some would argue that higher debt levels are appropriate because interest rates are (permanently) lower and so debt servicing costs (which determine debt sustainability) are lower.

There is something in this. At the present time, borrowing costs are famously low, with real-term interest negative on some maturities. In May, for example, the Debt Management office sold three-year bonds with a yield of -0.003%.

Spending on debt interest has also fallen significantly over the last three decades, down to around 3.5% of tax receipts and projected to fall further – compared to around 10% at the start of the 1980s or 1960s (when debt to GDP was last at 100%) and close to 7% after the financial crisis.

This reduction reflected a mixture of debt reduction followed by lower nominal rates as inflation fell across the developed world.

At such rates, borrowing to invest in for example infrastructure – for which the multiplier on economic growth is high - or to cushion the crisis via a temporary furlough scheme looks justifiable.

However, the volatile history of interest rates should make us wary of thinking low real interest rates are here forever. Indeed, there are reasons to think this might unwind.

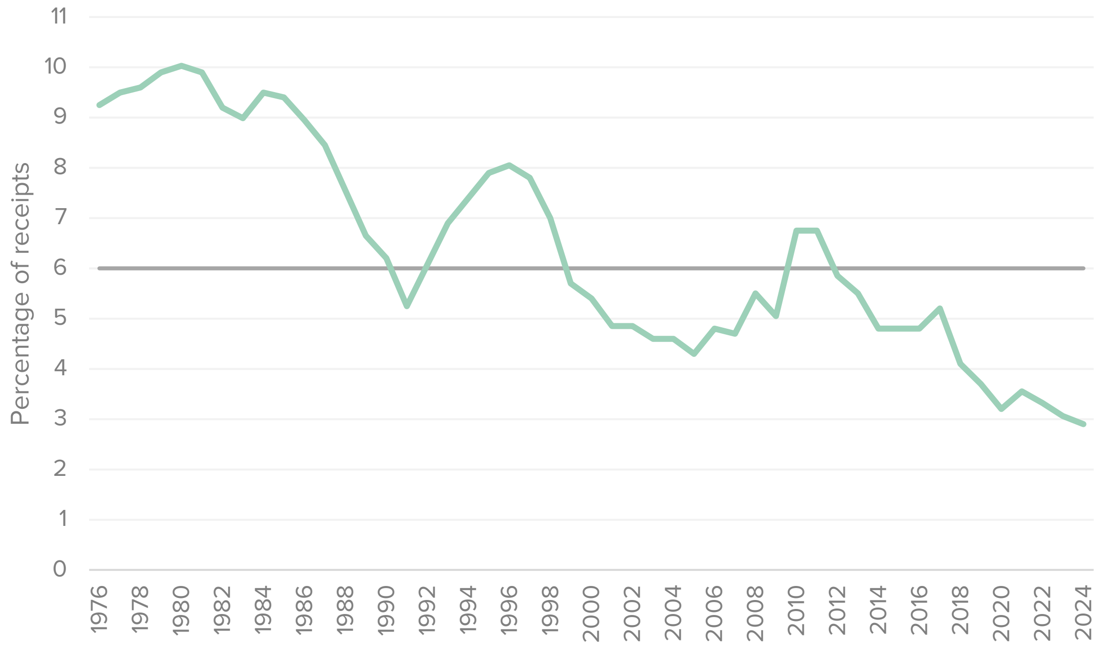
One reason for lower rates was a global savings glut driven by high savings rates in countries like China. As China ages rapidly and dependency ratios converge on the West over this decade it is likely that this source of exported savings will dry up.

Bond yields are the product of a complex mix of economic fundamentals, policy and sentiment. They are not always fully understood and are in part beyond both the Government's and Bank of England's control.

It is also not only about demand versus supply. For example, a significant share of gilts pay an amount linked to RPI inflation (index-linked gilts). There are also scenarios in which borrowing costs can jump in both low inflation and high inflation environments (see below), even if demand persists.

Figure 2: Spending on debt interest, 1976 to 2025

Source: OBR and ONS



Therefore, interest rates and borrowing costs are, inherently, uncertain.

With the much higher level of debt we are likely to have post-crisis, changes in interest rates which are small by historical standards could have a large effect on the amount that the Government has to spend on debt servicing, rather than more productive investments. There is a precautionary rationale to controlling debt levels.

An important consideration is the interaction between the interest on debt and the nominal growth rate (growth plus inflation). This is an area which has been extensively examined in the academic literature. Fundamentally, as long as the annual nominal growth rate is outstripping the annual interest cost of debt then overall debt can potentially continue to be on a downward trajectory. This in turn suggests this debt will not create a burden on future generations. This is of course not enough alone since the Government deficit will also factor, but it is a useful illustrative threshold in our mind of when the cost of debt becomes counterproductive.

Nevertheless, even at the lower levels of debt which prevailed before the coronavirus crisis, the OBR suggests that a relatively small change in interest rates could have substantial impacts on debt interest spending. We can see in our recent history much larger changes which were not anticipated.

Table 1: Direct impact on spending if different variables were 1 percentage point higher across the forecast

Source: OBR, Fiscal Risks Report, July 2019, spending ready reckoners, link

	£ billion			
	2020-21	2021-22	2022-23	2023-24
RPI inflation	4.9	5.5	6.1	6.4
Gilt rates	1.5	2.4	3.3	4.2
Short rates	5.5	5.7	5.8	5.9

Given our debt will be substantially higher coming out of the crisis, the UK's exposure to even small changes in interest rates will be significant. If rates rise to the Bank of England's estimated equilibrium rate of 2.25% for a sustained period, the Resolution Foundation have shown that even on their most optimistic scenario for the public finances post-Covid, the Government's debt-service-to-revenue ratio by 2025 would move well above the 6% allowed by current fiscal rules. Under the most pessimistic scenario, it would reach double that to 12%, levels not seen since the 1980s – which would mean annual interest payments close to £100 billion in today's terms.[1]

Few expect interest rates to rise anytime soon. But it is important to remember they can rise suddenly and unexpectedly, meaning elected governments find their options constrained in a future crisis.

The UK's average debt maturity of 15 years gives it some insulation from rising rates in the short term but given the high levels of debt, a large amount needing to be rolled over each year and a potentially increased structural deficit, it is possible to see how the pass through could happen and lead to a sharp spike in debt service costs.

To keep debt at elevated levels, without the tools that enabled its reduction in the post-war years, is risky. To do so in an ageing society, on an assumption that interest rates will never rise substantially, would be irresponsible.

Triggering high inflation

There is broad consensus that we should not worry about runaway inflation. Consumer Price Inflation has dropped to a four-year low of 0.5%, down from 1.8% in January 2020. Across Western economies, inflation is well below central bank targets and will likely continue to be that way given the rising levels of unemployment and precautionary saving.

But the possibility of surprise inflation still exists. In the 1970s, inflation peaked at over 25% in the UK, a level few had predicted only a few years earlier. The conditions of the current crisis and the economic implications of social distancing and supply chain disruption are inherently unpredictable, making interaction between commodity and food prices, the labour market (including wages) factors and expectations that are used to assess inflation, an unknown.

In this cocktail of uncertainty, as Olivier Blanchard and others have noted, there are scenarios in which inflation could rise steeply, in a way that is actively damaging to the economy and recovery.

For example, household consumption could recover faster than expected but with continuing supply chain constraints and a large fiscal stimulus. This could see a period where demand growth significantly outstrips supply, driving prices higher. This would likely be temporary, but damaging.

Monetary policy, in turn, is likely to remain ultra-loose and the risks of monetary and fiscal policy becoming ever more enmeshed could, if taken too far, undermine the credibility of the UK's macroeconomic institutions. A period of stagflation in which inflation rises alongside weak economic recovery would result in further pressure to maintain a loose monetary settlement, leading to greater price volatility and inflation.
Furthermore, while we do not expect the forms of financial repression mentioned above to return, it is not impossible given the shifting political and economic landscape.

We should also not forget that attempting to inflate away extraordinary public debt has its problems. To make any difference, inflation would need to be higher than the growth in debt (i.e. the deficit), likely requiring inflation of over 5%.

While isolating the impact of such inflation is difficult, evidence suggests that such high levels of inflation tend to hit the poorest parts of society hardest, as they spend relatively more of their income on everyday products as well as housing costs. They also obviously have little cushion to absorb higher costs, especially if wages do not keep pace with the price rises. In the end it depends on exactly the type of inflation and the wider economic context of the country.[2]

Towards a new fiscal rulebook

The Government's fiscal approach must therefore deliver two aims that sit in tension, but not in competition. It must on the one hand create fiscal space to throw the kitchen sink at growth-enhancing spending and tax reductions to aid the recovery now, and simultaneously deliver confidence that extra borrowing will be paid for in the medium term. This means returning debt to a downward trajectory once the recovery is secure and ensuring there is a clear plan to achieve the sustainability of the public finances over the long-term in the face of pressures from ageing and rising healthcare costs.

This balancing act should be addressed in the review of the fiscal framework ahead of the Spending Review that the Chancellor announced in the March Budget and which is underway in the Treasury.

Recommendation: The Government's new fiscal framework should create flexibility in the short-term, but which taper as the recovery gathers pace.

This means:

- Maintaining the spirit of the commitment in the Conservative Manifesto that borrowing to invest in growth-enhancing spending is acceptable but that other types of spending need to be funded from tax revenue.

- Explore whether human capital - including investing in skills - should be considered "capital" for the purposes of borrowing and investment. This would also, for example, reflect a parallel debate in the corporate world around how to account for and value investment into intangible assets.

- Maintaining the commitment in the Conservative manifesto that debt interest will not breach 6 per cent of revenue.

- Replacing the now-unreasonable expectation that debt will be lower at the Parliament's end than at its start with a pledge that debt will be falling by the end of the Parliament.

Recommendation: Tax cuts to spur the recovery should be targeted and, in most cases, temporary

This means:

- Making clear that any tax cuts to spur the recovery now should be temporary and targeted.

- Targeting tax cuts to stimulate demand and investment at areas where they are likely to have the most sustainable and broad-based economic benefit, for example encouraging capital investment and reducing costs of employment by making the Annual Investment Allowance more generous and reducing the burden of the employer NICs.

- Considering cutting headline VAT only if there's clear evidence going into the autumn that such a cut would alter consumer behaviour (as opposed to other government policies and psychological factors).

Recommendation: Initiate a sweeping reform of the tax system to achieve a simpler and fairer system

This means:

- Simplifying and reducing the UK's current 1,100 tax reliefs, with particular focus on removing any exemptions that fulfill no obvious social or economic benefit or that creates perverse incentives.
- In particular, reforming business and property taxes, including revaluation of Council Tax.
- Updating the tax system for the digital age, including achieving greater equity between the level of taxes on physical traders and various forms of e-commerce. This should be prioritised regardless of concerns from partners such as the US over a digital services tax.
- Focussing any tax increases on environmental externalities, simplification and removing over-generous and unnecessarily reliefs. Avoid tax increases on income or profit.

Recommendation: Protect and maintain the integrity of the UK's economic institutions

This means:

- Maintaining the independence of critical institutions such as the Office for Budget Responsibility and the Bank of England, whose authority is increasingly essential to market confidence. The swiftness and competence that have characterized both HMT's and BoE's response to this crisis have offered a stark reminder of why institutional integrity and deep expertise matter.

Breathing space

Ensuring excessive debt does not hold back the recovery

Given its scale more firms will likely fail as a result of this crisis than as a result of any economic downturn in the last several decades. It would be neither possible nor desirable for the Government to de facto bail out every company in trouble – expectations need to be reset to reflect that.

However, absent some innovative government tools and frameworks, there is a considerable risk that vulnerable or failing corporate balance sheets become a drag on growth, investment and wages, significantly delaying the recovery. There are several and often mutually reinforcing micro-drivers that risk spilling over to the macro-level:

- The need for firms to deleverage, meaning holding back on investment in people, automation, machinery etc.
- The lack of sustainable sources of corporate financing going forward, particularly for SMEs.
- The large number of firms that risks become unviable once Government and BoE schemes end, risking a large chunk of government debt never being repaid.
- The growing number of 'zombie firms' which struggle to make a profit and only survive thanks to cheap financing currently available through loose monetary policy.
- The need to manage a large number of corporate debt restructurings or insolvencies in a way that maximises the chances of preserving asset value and jobs.
- The unique sector impact of the Covid-19 crisis and the potential longer-term changes to the structure of the economy creating unique pressures on certain firms.

Below we touch on these various challenges, the various solutions that are currently being discussed and then put forward our own recommendations.

The increase in corporate debt and why it matters

Companies went into the crisis with historic levels of debt, driven by growth since the financial crisis, and unexpectedly the picture is now worsening:

- In 2019, the OECD estimated that non-financial corporate debt totalled a record $13.5 trillion, noting that this stock of debt has “lower overall credit quality, higher payback requirements, longer maturities and inferior covenant protection” compared to previous credit cycles. UK non-financial corporations faced the fifth highest debt-to-surplus ratio in the developed world even if their debt service ratio (the share of income needed to service debt) is relatively low, at 35%, compared to countries like Canada (55%) or France (58%).[34]

- Corporate debt is now rising sharply. The Bank of England Q1 Credit Conditions Survey estimated a perceived increase in demand for lending of 90.2% from small businesses and 77.2% from medium sized firms.[5] In its May Interim Financial Stability Report, the Bank noted that “net bank lending to UK corporates spiked to over £30 billion in March, up from an average of just over £1 billion per month over the past three years.[6] The same report estimated that before the crisis only one third of UK companies held liquidity buffers that were larger than three months’ worth of their turnover[7]. Higher debt burdens will be compounded by lower demand and disrupted activity, leaving many firms less able to service their debt.[8]

- There is strong evidence that excessive corporate debt creates a drag on growth as businesses deleverage to repair their balance sheets. Lim (2019) found that “increases in the share of total debt to GDP leads to a contraction in the GDP growth rate”, particularly in the first quarter following the shock.[9] The Bank of England has observed that “papers studying the global financial crisis provide ample evidence that firms that needed to roll-over large amounts of debt during the [financial] crisis experienced larger employment losses (Giroud and Mueller, 2017), invested substantially less (Kalemli-Ozcan, Laeven and Moreno, 2020) and experienced a persistent decline in total factor productivity (Duval, Hee Hong and Timmer, 2019).”[10] The OECD has been warning since 2018 that “in the case of a downturn, highly leveraged companies would face difficulties in servicing their debt, which in turn, through lower investment and higher default rates, could amplify the effects of a downturn.”[11]

- Naturally, the crisis is likely to generate a large number of zombie firms', which struggle to make a profit and only survive thanks to cheap financing currently available through loose monetary policy. Previous literature (Caballero et al. 2008) suggests that banks (whose balance sheets have so far held up well) typically maintain funding to zombie firms to avoid impairing their own balance sheets further in the wake of a crisis. In 2019, KPMG estimated the number of zombie firms in the UK at a historically high level of between 8% and 14%. Travel and leisure (12%), real estate (11%) and listed automotive firms (17%) have some of the highest rates - all sectors hit hard by the Covid-19 crisis.[12] A survey from R3 (the restructuring and insolvency trade body) at the end of 2018 found that 11% of UK companies is just paying the interest on its debts, rather than repaying the debt itself and 8% would be unable to repay their debts if interest rates were to increase by a small amount.[13]

Figure 3: Non-financial corporate debt as a share of GDP

Source: IMF

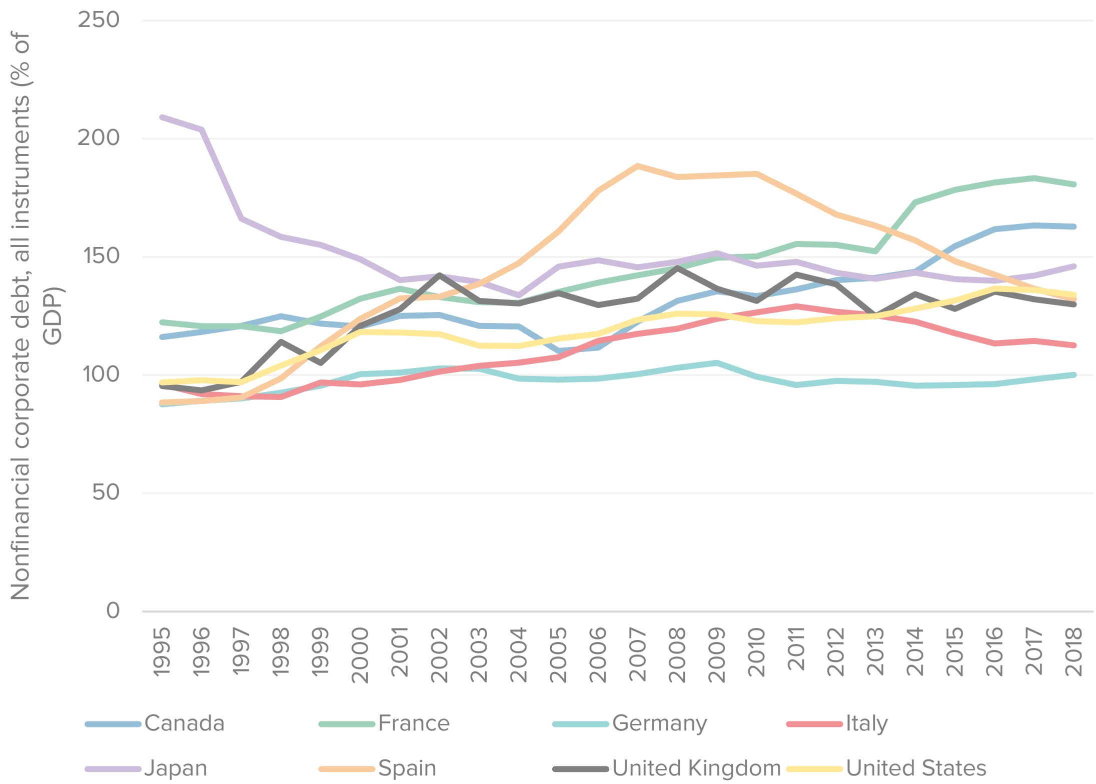
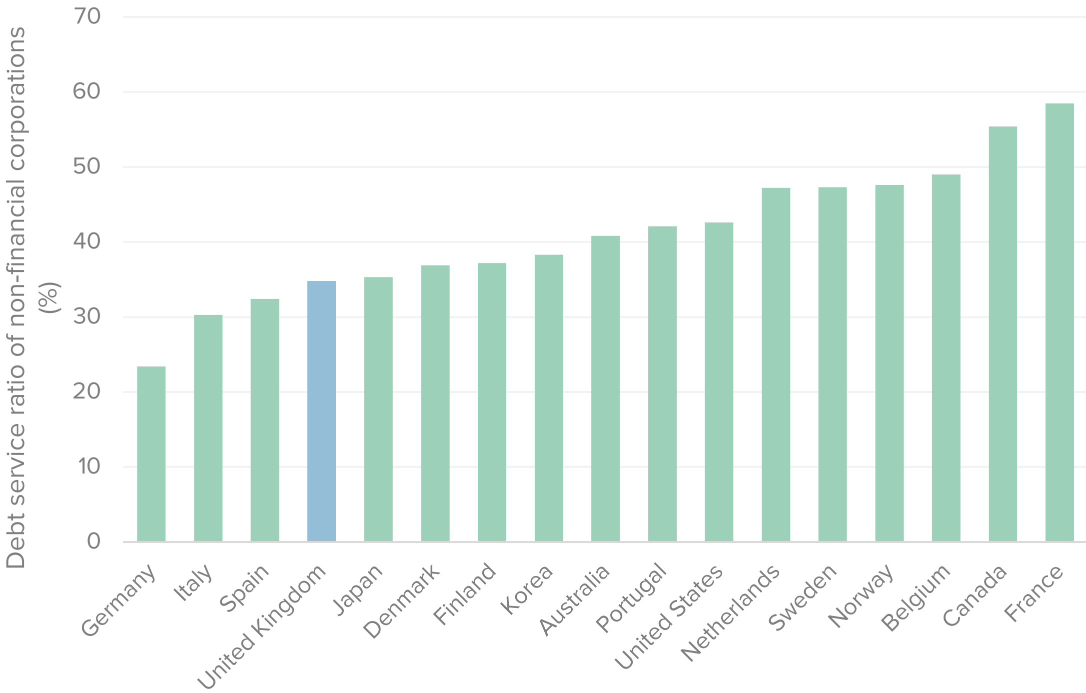


Figure 4: Corporate debt service ratio, by select countries

Source: Bank for International Settlements



The risks of a balance sheet recession

These factors create risks of a form of balance sheet recession. These traditionally occur after a debt-financed asset bubble bursts, which leaves businesses and potentially households with significant liabilities. The fall in asset prices pushes investors into negative equity, driving them towards debt minimisation rather than profit maximisation and creating a negative cycle of weak investment, high debt and low growth.[14]

Examples include Japan's Great Recession from 1990 and, at least in part, the United States following 2008.[15] As figures 6 and 7 below show, the pattern is one of a rapid ramp up of credit in the run up to the crisis, followed by a plateau and then a prolonged drop off during a period of deleveraging.[16] The US remains in its plateau period to this day.

Figure 5: Total credit to non-financial corporations in Japan

Source: Bank for International Settlements

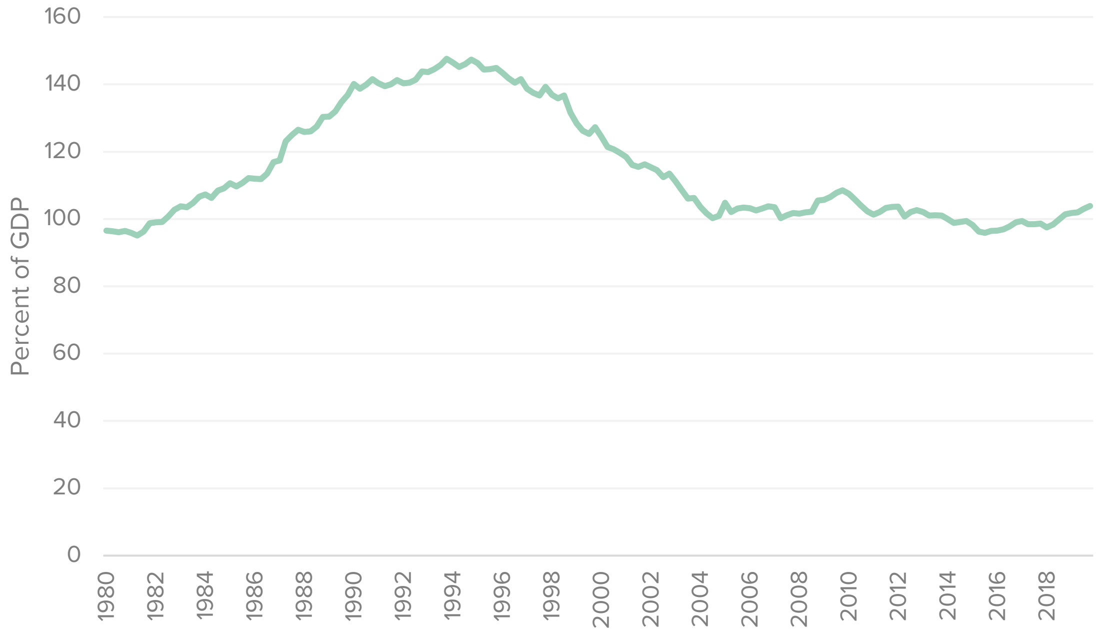
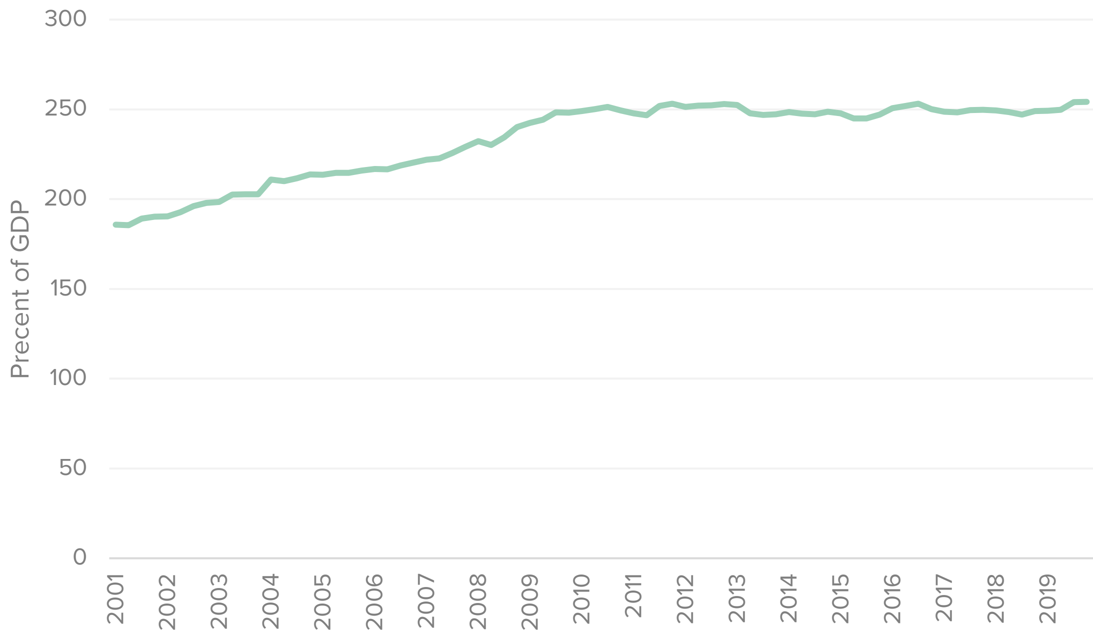


Figure 6: Total credit to non-financial corporations in the United States

Source: Bank for International Settlements



While the current crisis is markedly different in many respects, it shares some of the characteristics and therefore carries some of the risks. There has been a sharp drop in asset prices across the board – a recent study by Baker et al of the US stock market found the impact from coronavirus far outstripped that of previous pandemics in 1918-19, 1957-58 and 1968,[17] driven in part by weaker finances heading into the pandemic.[18]

This may be compounded by the psychological uncertainty created by the pandemic itself,[19] as managers may maintain higher capital buffers or reduce debt quicker to build resilience to withstand further lockdowns, a second spike in transmissions, or changes to government support schemes.[20]

The implications of debt for the recovery

The next few years could therefore be characterized by perfectly viable firms of all sizes holding back on investment and instead focusing on cutting costs, paying down debt or building up cash reserves. This would likely mean a slower and less stable economic recovery, which in turn means higher and more prolonged levels of unemployment (which itself is a significant challenge for the future of the UK economy as we discuss in the next chapter).

A continuing low interest rate environment may provide fertile ground for zombie firms, sapping the productivity needed for economic recovery. Such firms tend to be less productive themselves and crowd out resources – both capital and labour - for more productive enterprises, raising prices and reducing allocative efficiency. Possible benefits during a sharp downturn, for example that zombie firms may keep some workers in the labour market for longer, are outweighed by negative costs in the medium term.

Furthermore, because a considerable amount of recently acquired debt is issued by the government, the taxpayer is more exposed to the risks of default than it would normally be. A recent survey by the Business Banking Resolution Service found that 43% of those businesses who had accessed Government loans said they do not expect to repay them, either because they do not think they will be able to, or because they do not believe that the Government will pursue the debt – despite this being a matter for the banks.[21] As of 21 June 2020, the Government has issued:

- 50,482 loans of up to £5 million through the Coronavirus Business Interruption Loan Scheme (CBILS), totalling more than £10.5 billion. Under CBILS, the government guarantees 80% of the finance to the lender and pays interest and any fees for the first 12 months. 51% of applications have been approved.
- 315 loans of up to £200 million through the Coronavirus Large Business Interruption Loan Scheme (CLBILS). Under the large business scheme, additional accreditation is required for loans of more than £50m and companies are subject to restrictions to restrictions to dividend payments, senior pay and share buy-backs during the period of the loan. 44% of applications have been approved.
- 921,229 loans of up to £50,000 under the Bounce Back Loan Scheme (BBLS), totalling £28.1 billion. The BBLS provides loans of up to £50,000 to small businesses with a 100% government-backed guarantee for lenders. 40% of applications have been approved.
- 252 convertible loans to start-ups through the Future Fund, totalling £236 million. These loans are co-funded with venture capital and private equity investors and will be converted into government equity on preferential terms if the company is unable to pay. 82% of applications have been approved.

In total, this equates to more than £39 billion extended by taxpayers to businesses already. If the 43% figure proves broadly correct, that would mean an estimated £16.8 billion of bad debt has already been accumulated. The Interim Report of the CityUK Recapitalisation Group estimates that by March 2021, this figure will have risen to £32-36 billion in unsustainable debt owed to the Government. The Government therefore needs to consider how to manage the stock of bad debt.[22]

Meanwhile, high rates of default on corporate debt held by banks and asset managers could precipitate the next financial crisis. The OECD estimates that in 2018 financial institutions in the UK accounted for 98% of domestic corporate bond ownership, higher than in the US (86%), Japan (86%) or the Eurozone (93%). In a speech in May last year Deputy Governor of the Bank of England John Cunliffe also warned that, “We know much less about how this channel of finance will behave under stress say, following the loss of confidence in an asset class such as high yield corporate debt and leveraged loans.”[23]

This is to say nothing of the risks to the UK of unprecedented levels of corporate debt globally. The UK is far from the worst offender when it comes to highly leveraged corporate balance sheets. From 2018 to 2019, economic growth in the UK has significantly outstripped the growth in corporate debt, whereas the opposite is true in the US, Japan, Germany and France.[24] The overall debt to equity ratio of the UK's corporate sector is around 70%, well below the 85% peak before 2008.[25] The Bank of England has also previously suggested that post financial crisis net debt amongst UK corporates fell from over 40% of GDP to 20% by 2015, while in the US it has remained relatively stable near 35% of GDP.[26]

Counter-intuitively, the crisis also creates an opportunity to consider the long-term problems associated with the reliance on debt financing within the economy. It is increasingly clear that overreliance on debt financing as compared to equity instruments, particularly through the use of commercial loans and non-investment grade corporate bonds, creates long term risks for the economy. Addressing this imbalance may be a longer-term priority but should not be lost as the economy recovers.

Why different parts of the economy will suffer more

These risks will be particularly acute for different parts of the economy.

For example, small and medium sized firms' traditional difficulties accessing capital markets will be compounded by higher indebtedness and the fact equity financing has nowhere near the volumes needed, as referenced recently by TheCityUK.

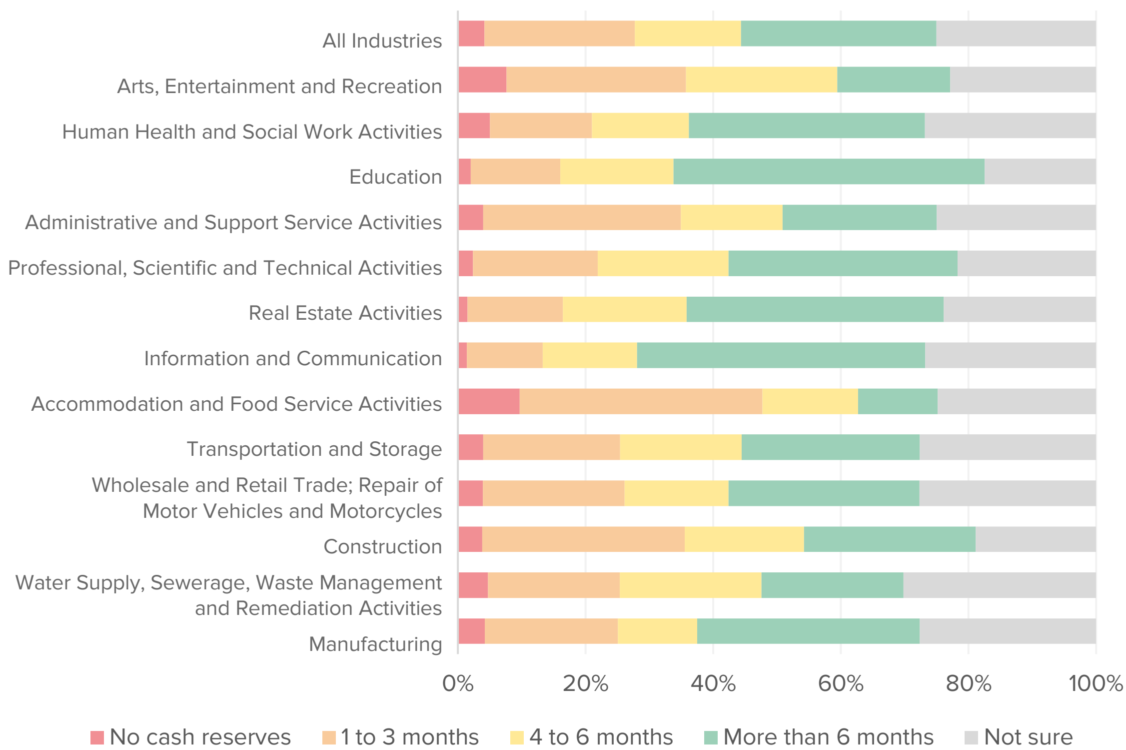
Similarly, in sectors most affected by social distancing, such as hospitality, travel and tourism, previously profitable businesses may have become unviable overnight. In strategically significant sectors such as aerospace and automotive manufacturing, working capital may run out before global demand returns.

The ONS' regular surveys of business leaders reveal how some of these concerns play out by sector.[27] Across all industries, around one in four (27%) firms believe they only have cash reserves to last them a further 1 to 3 months or have no cash reserves at all. The sectors with the tightest reserves are those with some of the smallest margins: accommodation and food services, construction, arts, entertainment and recreation and administrative and support services.

A further 20-25% of firms in all sectors are not sure what their cash reserves are, creating a significant amount of uncertainty. In the most resilient sectors, education and information and communication, close to half of all firms have more than six months' worth of reserves.

Figure 7: How long do you think your enterprise's cash reserves will last? (4 May to 17 May)

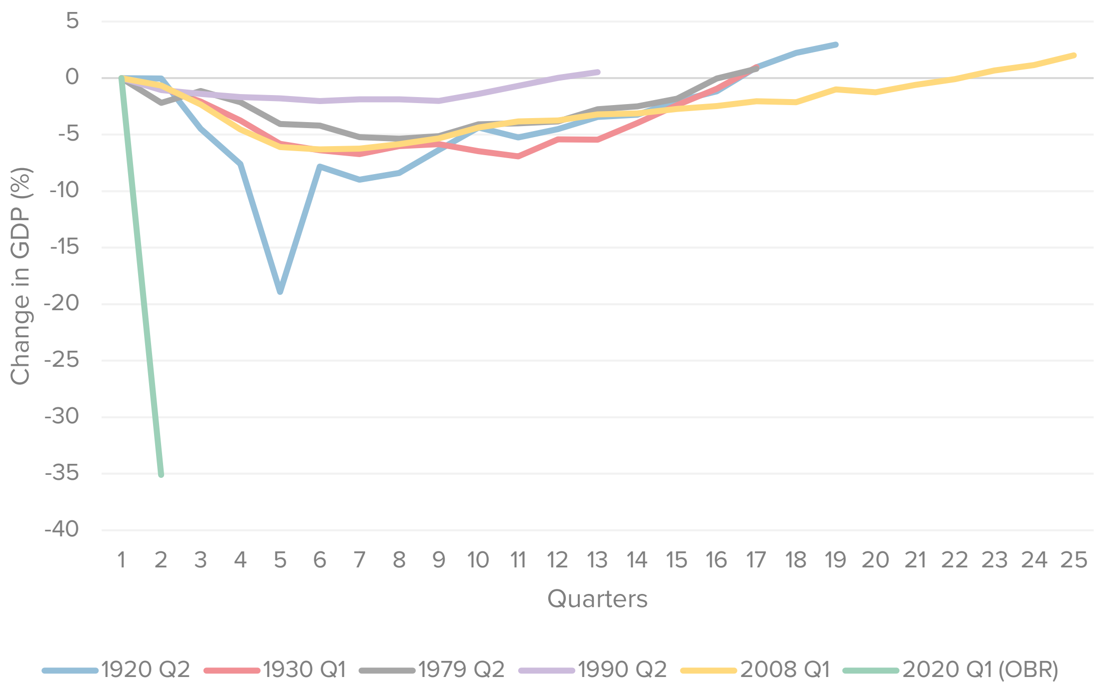
Source: ONS, BICS



However, these initial surveys provide only a partial picture. We do not yet know the trajectory of the virus or how quickly confidence will rebound. Historical data shows that this recession far outstrips any seen before. The time taken to recover from serious recessions over the past century in the UK has been on average 17 quarters (over four years), while it took the best part of seven years for GDP in the UK to return to pre-crisis levels after 2008. On 14 April, the OBR estimated a 35% during the second quarter of 2020, following the 20.4% month-on-month fall in GDP in April, eclipsing the quarterly fall experienced in any previous recession over the last century and suggesting a longer path to pre-crisis levels.

Figure 8: GDP recovery following recessions over the last century

Source: OBR and Bank of England, A millennium of macroeconomic data for the UK



How the Government can prevent a period of deleveraging

The evidence above suggests the Government will need to act to prevent a period of deleveraging. By managing the debt which businesses have taken on, by helping them to secure additional capital without taking on further debt, and by acting to prevent defaults or restructuring liabilities, ministers stand a chance of a quicker and more balanced recovery.

The question is how to remove that drag. Numerous groups have put forward solutions of the kind we detail below. The key insight we put forward is that different tools will be needed for different kinds of company and debt, just as a variety of schemes have been used to issue loans to firms on distinct terms and with varying levels of conditionality attached. Ministers will need a mix of policies, deployed as a sliding scale over time according to how the virus and recovery pans out. There will be a temptation to create new institutions to deal with this problem, but the Government should be cautious about doing so just for the sake of it. There are existing institutions which can be utilised. Furthermore, while the UK faces challenges on this front, they are not yet on the level faced by other economies. While it depends somewhat on the pace of the recovery, the initial approach should be for targeted interventions rather than economy wide programmes for debt relief.

Debt restructuring

If corporate debt is dragging on the recovery, the first port of call should be to identify ways to make repayments more manageable. There are four main ways in which this can be done:

1. **Forbearance**. Traditional forbearance tools include extending the length of the loans to avoid a repayment falling due at a difficult time, capital repayment holidays, or even full moratoria on loans. Such measures are only useful for firms facing a temporary liquidity crisis rather than a risk of insolvency. Furthermore, if incorrectly applied these types of measures can propagate zombie firms, which would hurt rather than help in the medium and long term.

2. **Debt forgiveness**. At some point, it may be better to simply write debts off, and accept a one-off hit to the government balance sheet (which can be smoothed over time with low cost borrowing) than suffer the capital destruction of widespread insolvency. While moral hazard risks should be taken seriously, there is a case for limited forgiveness on the basis that the pandemic is an uninsurable event which has made many viable businesses unviable through no fault of their own. Even if the rationale for debt relief is accepted, you need a clear mechanism to avoid distorting the market. In particular, those who have sought Government help cannot be treated more favourably or be left at a competitive advantage compared to firms that have not relied on Government lending schemes.

3. **Debt for equity swaps.** The Government could also explore the possibility of exchanging debt for equity. The benefit of such an approach is that it not only removes the debt which needs to be repaid at some point but also removes the continuous need for interest payments to service that debt. Under a debt for equity swap, returns would be based on dividends which should only be paid out once the firm becomes profitable again. There are however serious pitfalls in determining fair value for equity (especially when a firm is at risk of insolvency); ensuring clear routes

for future disposal (to avoid the Government becoming a permanent shareholder in thousands of firms) and identifying the right vehicle for managing equity stakes on behalf of taxpayers.

4. **Contingent Tax Liability**. This would see a tax liability created for each firm which is only paid if and when the company becomes profitable again, fixed at a set percentage above the taxable profits of the firm. This approach may be better suited for smaller firms or private firms where the ability to do a debt for equity swap is less clear cut and harder to value, but these tools have their drawbacks – not least the potential to reduce firms' incentive to return to profitability.

It seems clear that while traditional forbearance tools should be used in the first instance, the depth and likely length of the downturn (especially in some sectors), and the extensive use of government-issued debt, mean it will be necessary for more novel and contentious tools to be introduced. There are also three points which need to be considered around how and when any of these options are deployed:

- **Trigger point for any intervention.** At what stage should the above tools be deployed? An obvious trigger would be a default, but by that point there would already have been a lot of value and jobs destroyed. As such, there may be a need for a bespoke framework for assessing at what point to intervene. This could be done on a purely case by case basis or by using a common set of indicators of financial distress.

- **Which firms warrant support and which do not.** HMT has a set of principles in place for assessing government interventions which are broadly sensible, for example those designed under Project Kingfisher. Naturally to limit moral hazard, the bar for intervention needs to be high, both with respect to the viability of a firm and what constitutes national "strategic importance".

- **Does it apply purely to Government backed loans?** In many cases it may well be simpler to apply it just to Government backed loans due to complexity around involving private creditors but there are two reasons it must not be strictly limited to this. First, it would create perverse incentives whereby those firms that have had to rely on Government support may end up in a more competitive position than those that did not. Second, it would significantly limit the scope of any restructuring, thereby undermining the potential effectiveness.

Improving capital allocation and diversifying away from debt

The problem is not only the rising stock of debt but the reliance on debt as the primary method of financing, particularly for capital investment. As part of the longer-term economic recovery, the Government should consider how to help firms tap into pools of capital not weighed down by interest and capital repayments. There are two main options for ministers to consider, one short-term and the other longer-term:

1. **Boost equity financing vehicles.** The British Business Bank and British Growth Fund both operate as government-led vehicles to provide equity financing to start-ups and scale-ups. British Patient Capital provides the same for longer-term investment opportunities. These vehicles could be supplemented and scaled to provide higher levels of equity financing as an alternative to market debt. This would require a step change in terms of the amount of capital provided and the amount underwritten by the Government, which is currently around £10 billion combined. It would likely require these vehicles to use government-guarantees to raise funds on the market to then reinvest or at least use the funds to help underpin the use of equity-driven instruments.

2. **Equalise tax treatment of debt and equity.** The growth of debt financing is supported by the preferential tax deductibility of debt interest. A major reform Government could consider would be to review this approach and indicate a long-term intention to equalise the tax treatment of debt and equity, either by reducing tax deductibility of debt interest or provide greater incentives for equity investment. The benefit of boosting equity financing would be to move away from the trend of ever-increasing firm leverage and remove or reduce the burden of interest and capital payments on debt. Instead, these would be replaced by dividend and tax payments which are only relevant when the company is performing well and is profitable.

In any case, there would need to be consideration to doing this hand in hand with wider regulatory changes. This is particularly true of current prudential regulation which requires lenders to hold certain assets on their balance sheet - often bonds of a certain rating/quality. As such, changing the tax incentive to a particular form of debt and therefore the likely availability of that debt could have significant knock-on implications and may cause scarcity in some required assets. There is also a wider point that much of the financial regulatory approach is more tailored towards holding debt due to its stability and liquidity as an asset.

Establish new vehicles for delivery

All of the approaches above will require some form of long-term management and oversight. Ideally, these should also not be solely public endeavours but public-private partnerships. There are a number of forms which this could take, of which more than one may be needed. These include:

1. **Underwrite a bad bank.** The logic behind a bad bank is that bad loans weigh on bank balance sheets following a crisis, forcing them to reduce risk and limit lending. In some cases, the level of bad loans could put the solvency of the bank into question. A bad bank is an entity, usually underwritten by the Government, to which the bad loans can be transferred and wound down over time. The key question is at what price the loans are transferred. Banks will take some losses but are better for it in the medium term as they can return to more normal operations. While this is a tried-and-tested policy during financial crises, as it's not yet clear that corporate debt will prove to be a source of instability in the financial sector, we're not convinced that a bad bank is the right approach at this stage.

2. **Establish a development bank.** Development banks are used around the world, in both advanced and emerging economies, to help drive investment. Usually, they are public institutions with some government funding and capital which is leveraged through the markets and/or by using public/private partnerships. The UK already has a development bank in the form of the British Business Bank, which has played a large role in the crisis so far. However, the BBB has a particular focus and way of operating focused on SMEs. Furthermore, it doesn't tend to provide any funding directly but to link those in need with partners. It does sometimes provide Government guarantees for loans as we have seen during the crisis. The scope and purpose of the BBB could be expanded to create a development bank more like KfW in Germany, which focuses on a range of activity from export finance to housing and the environment.

3. **Seed a UK sovereign wealth fund or asset management corporation.** This would see the creation of a central asset management corporation or sovereign wealth fund specifically to take over the ownership and management of government-guaranteed loans and other business stakes which the Government has taken on during the crisis. This vehicle could also be used to drive new forms of investment for firms and to help those who should not be taking on more debt. This is not dissimilar to the role played by the British Growth Fund. This has quite a wide and varied remit, the main constraint

is the level of capital and funding involved with investments typically totally between £1m and £15m. One option would be to simply expand the size of the BGF.[28] Indeed, of all the existing vehicles the BGF looks to have the widest and most varied remit, although it was established by a group of large banks, not by the Government.

4. **Invest in a patient capital approach.** Another option would be to adopt some of the recommendations of the 'Patient Capital Review', originally conceived to consider how to drive investment for firms beyond the initial start-up stage and which are looking to expand rapidly.[29] In 2018, British Patient Capital was funded with £2.5 billion to invest over 10 years in long-term investment positions, with any funds recouped reinvested. This could help by demonstrating that the funding provided during the crisis is part of a long-term investment into the future of the UK economy.

5. **Create a temporary UK restructuring agency.** The Government could create a public entity to oversee and manage the restructuring of corporate debt. The agency would work in conjunction with the existing bankruptcy and insolvency system to ensure that debt issues are tackled as quickly as possible.[30] This is not dissimilar to the bad bank or sovereign wealth options above, given it involves moving government guaranteed loans off banks' balance sheets, but would be more focused on restructuring than holding loans, with additional powers to do so. It should also address debt held by private creditors under the right circumstances.

In all options, consideration will need to be given to state aid constraints and whether the funding might impinge on both domestic and international rules. Depending on what is agreed in the Future Relationship between the UK and EU, there could be more binding constraints in this space. Considering all of these options, and the specific nature of this crisis and how it feeds through to the health of corporates, we recommend the following:

Recommendation: The Government should establish a Restructuring Agency to manage government-guaranteed loans which have turned bad.

This vehicle should draw inspiration from the Industrial Revitalisation Corporation of Japan. The IROJ was created in 2002 after the fragility of banks and high levels of corporate lending meant that distressed firms neither failed nor undertook major financial restructurings. The organisation helped 41 firms over the course of its life by purchasing the bad loans from banks and restructuring them. In the end, it returned money to the national treasury, essentially providing a profit for taxpayers.[31]

There is an opportunity for the UK to introduce a similar regime, taking on loans to viable but debt-laden companies and restructuring their liabilities using a combination of forbearance, debt for equity swaps and, in very limited cases, debt forgiveness to help firms to recover. The eligibility criteria for such support would be high. The entity should have the ability to use Government guarantees to borrow on the market and purchase struggling firms' debt from private sector creditors as well as taking over management of government backed loans which need to be restructured.

Recommendation: Significantly boost equity capital availability

The Government should inject fresh capital into vehicles that offer equity financing to start-up and scale-up firms, including the British Business Bank, the British Growth Fund and the Future Fund. Government capital should be used to crowd in considerable institutional and private investment into these funds, building on the existing public-private partnership involved in each.

The BBB and Future Fund should be encouraged to expand the use of the convertible loan agreement as a primary mechanism to drive funding to those firms and sectors which need it most in the coming months, on the proviso that government funding is always being deployed alongside private sector investment. At the same time, the Future Fund should be expanded beyond its current £250 million funding base and narrow remit of firms which are between funding rounds and cannot access other Government support schemes due to being in the pre-profit or even pre-revenue stage of their development. Furthermore, these institutions should be able to support a wider range of firms in a wider range of sectors - the current focus is very much on SMEs in high productivity areas.

In addition, the Government should work with banks and institutional investors to bolster the assets under management of the British Growth Fund. The BGF has indicated its desire to raise up to £15 billion from public and institutional sources. This is a step change on its current asset portfolio but its investment record and the scale of likely demand during the recovery mean it is in the right order of magnitude.

Currently, the combined weight of these funds is around £10 billion. We recommend that the Government aim to increase this to around £30 billion given the size of the corporate debt challenge, the number of firms which will require debt restructuring and the need for forms of capital beyond debt. This can be done through government guarantees, direct capital injections and through allowing these institutions borrowing on markets to be underwritten by the Government's balance sheet.

Recommendation: Announce a long-term review of the tax treatment of debt and equity

There is a strong case for acting to equalise the treatment of debt and equity financing. Corporate debt was already at worrying levels and the crisis will push it higher. However, the eye of the storm is not the time to do it: it would undoubtedly elicit a strong market reaction, potentially raise costs for borrowers, and poses a particular risk for highly leveraged sectors with expensive capital requirements, such as utilities, in particular.

Ministers should therefore announce a long-term review of the issue, to engage widely and to propose changes that would be both deferred beyond the crisis and grandfathered so that they would only apply to future financing arrangements rather than existing debt.

One option would be to create a similar tax allowance for the return on equity, either only new equity or total stock of equity. A similar variation would be to adopt a notional interest deduction, as introduced in Belgium in 2006, a study of which by the Bank for International Settlements in 2015 found that it successfully and significantly increased the share of equity in the capital structure of firms.[32]

Back to work

Building the jobs recovery

Since the beginning of the crisis, employment forecasts have been sobering.

No forecast has predicted a return to pre-crisis employment before 2022, and the forecasts have worsened in recent weeks, as more jobs and vacancy data has become available and the effects of the lockdown have become more visible.

Table 3: Unemployment forecasts

Source: NIESR, Bank of England, OBS, OECD

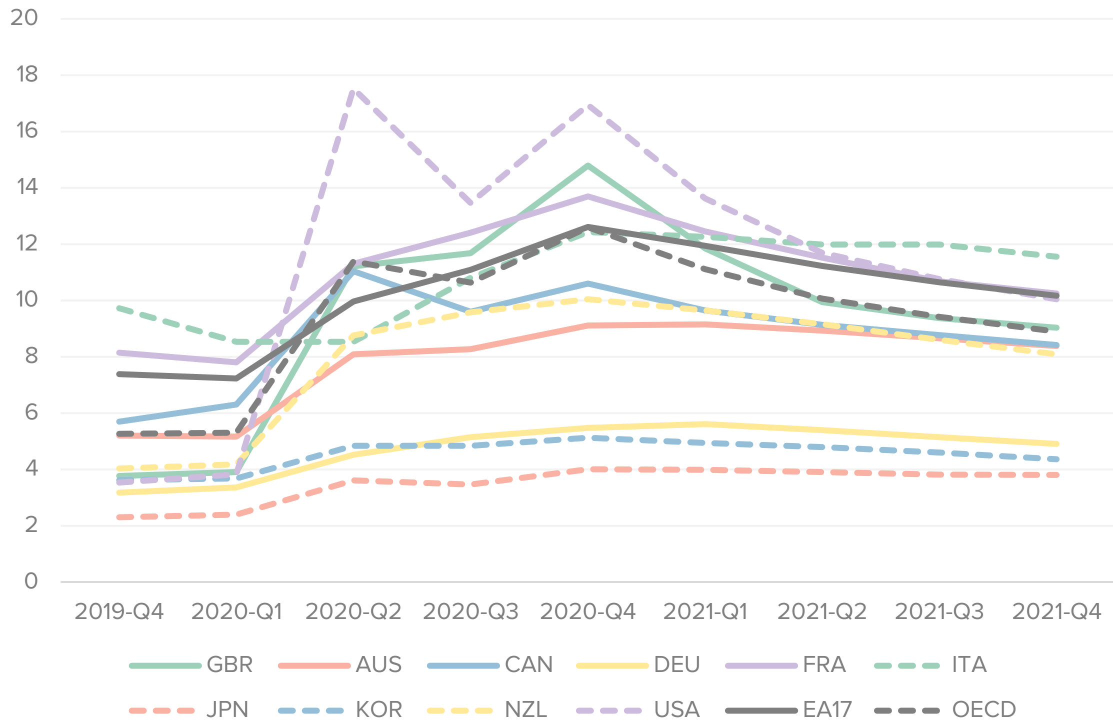
Predicted unemployment rate[33]	Date of forecast	Q2 2020	2020	2021	2022
NIESR	28 April	8	8.5	6.5	5.4
Bank of England	6 May	9	8	7	4
OBR	14 May	10	7.3	6.0	4.5
OECD	10 June	11.2	9.1	7.8	-

The latest available data suggests the UK will be relatively worse hit compared to comparable countries. The most recent OECD economic outlook suggests the UK will experience unemployment equivalent to France in Q2 2020, despite starting the crisis with an unemployment rate half as large - although UK unemployment is predicted to fall quicker over the next 18 months.

These forecasts appear dire today but soon may look optimistic. Labour market data tends to be a lagging indicator and the most recent data suggest an enduring downturn. The number of vacancies fell by 170,000 quarter-on-quarter in the three months to April, meaning there were 365,000 fewer jobs available than a year earlier.

Figure 9: Projected unemployment rate, OECD countries, Q4 2019 to Q4 2021

Source: OECD, Economic Outlook, June 2020



HMRC estimates that in the week to 21 June, 9.2 million jobs had been furloughed by 1.1 million employers with a total value to taxpayers of £22.9 billion. An additional 2.6 million self-employment claims had been made with a value of £7.6 billion.[34]

The latest ONS survey data suggests that more than four-fifths (79%) of businesses applied to the CJRS between 18 and 31 May, of which 95% received funds. A further 74% intended to use the scheme in the following two weeks. On average businesses have furloughed 34% of staff.[35]

Between 6 April and 19 April, 36% of trading businesses had already laid off staff in the short term and 31% had reduced working hours.[36] At the same time, DWP received 3.4 million claims for Universal Credit between 1st March and the end of June.

Figure 10: Real-time paid employment, to May 2020

Source: ONS

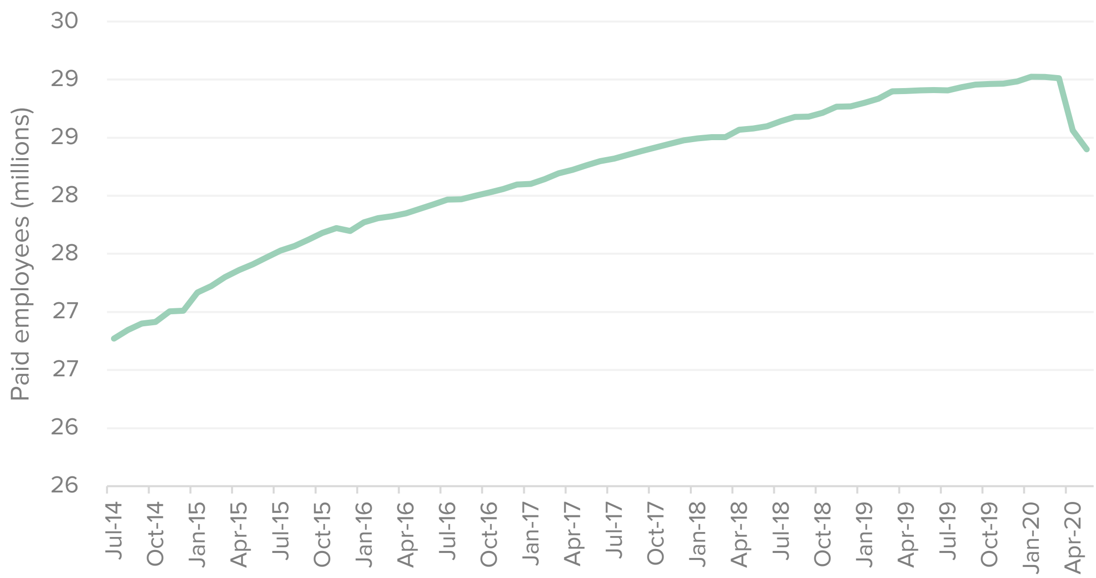


Figure 11: Real-time vacancies, to May 2020

Source: ONS

The regional impact of unemployment

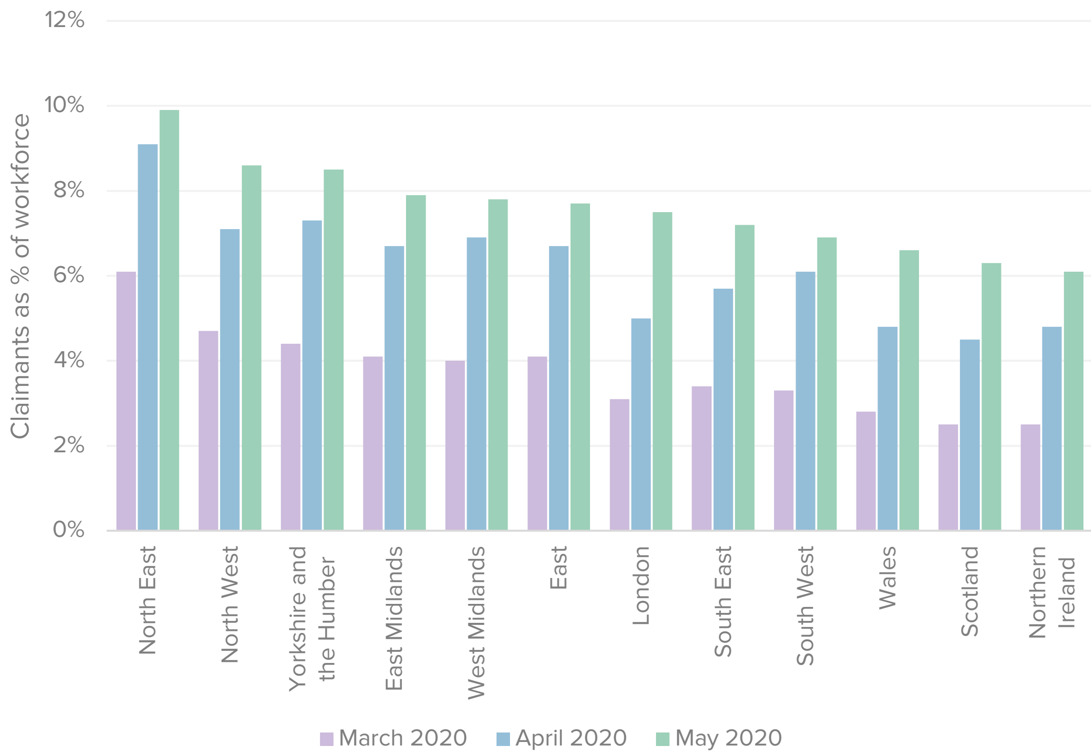
Different parts of the country are experiencing the crisis in different ways.

In the North East, 1 in 10 people were claiming unemployment benefits in May, a 4.2 percentage point increase from March and a 4.4 percentage point increase on this time last year. This compares to fewer than 1 in 20 people in London and the South East, who have also experienced smaller rises in employment of 1.9 and 2.1 points respectively.

Analysis of multiple vacancy databases shows a marked contrast between regions. The IFS analysis of Find A Job Database finds the steepest falls in vacancies can be found in the North East and North West, which already had low numbers of vacancies. The Institute for Employment Studies analysis of Adzuna data shows that the number of unemployed people for every vacancy ranges from nearly 18 in Northern Ireland and 16 in the North East to just over 2 in London and the South East.

Figure 12: Regional claimancy data, March to May 2020

Source: ONS



This is in some respects reflects considerable sectoral variation. 96% of accommodation and food service businesses are using the CJRS to furlough an average 76% of staff. This compares to 75% and 19% respectively for education enterprises.

Unsurprisingly the highest employment regions have also been the greatest beneficiaries of government efforts to insulate jobs from the crisis. The two regions with the highest levels of employment, the South East and South West, have been among the greatest beneficiaries of the Government's CJRS. Meanwhile, the North East and Wales, which have some of the lowest unemployment rates, drew down relatively less from the furlough scheme.

Table 4: Regional labour market overview, to May 2020

Source: ONS and DWP

Country / Region	Furlough rate	Employment rate	Inactivity rate	Unemployment rate
England	21.1	76.8	19.9	3.9
North East	23.0	73.9	22.2	5.2
North West	21.8	75.9	20.8	4.1
Yorkshire and the Humber	21.6	74.0	22.9	3.9
East Midlands	22.6	78.1	18.8	3.7
West Midlands	23.9	74.5	21.7	4.8
East	21.5	78.0	18.9	3.6
London	17.5	76.4	19.9	4.6
South East	21.1	79.5	17.9	3.0
South West	21.5	78.9	18.5	3.0
Wales	21.3	74.4	23.2	3.0
Scotland	22.3	74.3	22.1	4.6
Northern Ireland	23.0	71.6	26.7	2.3

The impact of long-term scarring

Previous recessions provide considerable evidence that the experience of long-term unemployment, particularly while young, can cause lasting 'scars' on a person's future economic prospects, reducing their ability to find work and a long-term reduction in earnings and job quality.

Table 5: Summary of studies of economic scarring from youth unemployment

Study	Cohort	Scarring effects
Gregory and Jukes (2001)[37]	British men, 1984-94	Unemployment reduces wages on re-entering work by an average 10%, which erodes over two years, with an extra year adding a further 10% penalty. These duration effects are more substantial for the young than the old.
Gregg (2001)[38]	UK 16-23 year-olds at age 33 in 1991	Controlling for other factors, men who experience 3 months out of work between ages 16-23 years old spend an average extra 1 ⅓ months out of work between ages 28-33 years old.
Cockx and Picchio (2011)[39]	School leavers in 1990s Netherlands	A year's delayed entry into the job market reduced likelihood of finding a job in the following two years from 60% to 16% for men and from 47% to 13% for women.
Gregg and Tominey (2004)[40]	UK 23-year-olds entering the labour market in 1981	Scarring from early unemployment in the magnitude of 12% to 15% at age 42. The cohort was earning between 13% and 21% less, on average, in 2000.
Clarke (2011)[41]	UK education leavers between 1990-2013	Those starting their careers in a downturn see a reduction in real hourly pay of around 6% one year after leaving, and their wages do not recover for up to 6 years. Graduates are 30% more likely to be in low skill jobs and less educated young people are 20% less likely to be in work.

This hysteresis is generated by unemployment, which causes workers' human capital to depreciate, their skills to decline and their earnings to be reduced and loss of job-matching capital, the economic loss from being separated from a job in which they had accumulated expertise and skills. These effects are worse the longer someone stays out of employment and larger for younger cohorts of people.

Box 1

The 1980s: A cautionary tale

A number of academics and politicians, including three former Chancellors, have warned of unemployment rising to similar heights as the 1980s. It is worth reiterating exactly what the UK labour market experienced in the 1980s:

- Between 1979 and 1980, registered male unemployment doubled and then doubled again between 1980 and 1981. After this upsurge, unemployment continued on an apparently inexorable upward trend, although at a diminishing rate, until 1985-86.[42]
- Total yearly unemployment was 1.39 million people (5.7%) in 1979. In 1982 it rose above 3 million for the first time and stayed there until 1987, with a numerical peak of 3.29 million (11.0%) in 1986. The total unemployment rate did not fall below 10% until 1988. The non-seasonally adjusted claimant count rose from below 4% at the beginning of the 1970s to 12.2% in 1982.[43]
- The consequence of the seven-year rise in unemployment from 1979 to 1986 was people being unemployed for longer, and an increase in long-term unemployment. By 1986, over half the men aged over 25 on the unemployment register had been unemployed for more than a year.[44]

Box 1 contd.

The effects of the rate and duration of unemployment on the economic fortunes of those who found themselves unemployed during this period were significant. Longitudinal studies of those in the labour market at that time have found, in keeping with international experience, that:

- Workers suffered a wage penalty of between 8-10%, attributable to both job interruption (becoming unemployed) and the duration of unemployment, with scarring increasing in a non-linear fashion with the length of unemployment. Arulampalam finds that this wage effect has an inverted U-shape, 6% in the first year of re-entry, increasing to 14% over the following three years and then falling back to 11%.
- Using a larger sample, Gregg and Jukes find that job interruption delivered an average wage effect of 10% over the first year, decreasing to about 7% in the second year, with a long-run or permanent penalty estimated at 1.9%. This was supplemented by a penalty that varied by length of unemployment, with six months unemployment associated with a 5.1% penalty and a year's spell unemployed associated with a further 11.1% unemployment.[45]

These estimates both imply a wage penalty of between 8-10% on average, rising to 13%-15% for those unemployed for 6 months and up to 18% for those unemployed for over 12 months. Wage penalties are greatest among young people. Gregg and Tominey (2004) estimate a wage scar of 13-21% for labour market entrants 20 years after the economic event.[46]

What can government do to give people back their futures?

The Government has a daunting task ahead of it to counteract these effects.

The Chancellor promised to do whatever it takes to get the UK through the crisis and threw the kitchen sink at sustaining the economy through lockdown. He will have to go further to get the labour market out the other side.

Policymakers are not helped by the fact that evidence on the effectiveness of active labour market policies (ALMPs) interventions is mixed at best. Results only become visible after several years and, despite vast sums of money being spent around the world, the evidence base is weak. There are several high-profile examples of well-intentioned schemes making people *less* likely to find sustained employment. For example, only one-third of global programmes for youth unemployment show significant positive impacts on employment rates or earnings.

This is made worse by the fact that the post-pandemic economy defies historical comparison. What worked previously may not work today. The pace of the jobs recovery will be determined to a large degree by social distancing and the hangover from corporate indebtedness. This will likely to slow employment growth (and increase redundancy) in some of the highest volume sectors, including hospitality, food and retail. There were over 3 million people furloughed in these sectors in April 2020, according to the Coronavirus Job Retention Scheme data.

The Government should therefore develop a response that is tailored to the specific circumstances of the pandemic. We propose the Government focuses on the following interventions:

Recommendation: Act decisively for those most at risk of scarring

There is a premium on speed. It took the last Labour Government 12 months after the collapse of Lehman Brothers to announce the Youth Guarantee and Future Jobs Fund. By September 2009, there were 157,000 additional unemployed 18-24 year-olds and youth unemployment was over 250,000. The 1980s and 1990s recession offer clear evidence of the enduring effects if government does not act quickly to support those most at risk.

Analysis by the TUC and Institute for Employment Studies have demonstrated the specific risk to young people. Young workers are overrepresented in industries that are at particular risk of job losses due to social distancing: 37 per cent of those working in the accommodation and food industry, and a quarter of those working in the arts, entertainment, and recreation industry are aged 25 or under. These same industries have made most use of the CJRS, meaning many young people will have been inactive for several months even before becoming unemployed.

The recovery will also be geographically uneven, potentially compounding the existing regional disparities between places. Ensuring that labour market programmes create jobs in the places where they are needed rather than merely further imbalancing the economy will be essential to delivering the Government's levelling up agenda and encouraging a rapid recovery (given evidence that more regionally balanced economies grow faster).

To achieve this in a way that avoids picking winners and introducing inadvertent political bias into the system, the Government could allocate spending for job creation and subsidy programmes on the basis of relative uplift in employment by local area, rather than the absolute number of jobs created. This would ensure funding was weighted towards low employment areas.

Recommendation: Invest in rapid back to work support and assistance

Most studies of active labour market interventions find strong evidence for the effectiveness of job search assistance schemes, to help people find and secure private employment. These schemes rely on there being ample private sector vacancies available to direct jobseekers towards, but they offer some of the best value for money of any intervention. This is especially the case when job search assistance is combined with retraining, and tends to work best for young people and the long term unemployed.

However, job search assistance necessarily relies on the existence of jobs to direct jobseekers towards. This may not be the case in 2020. As in 2008-09, the number of vacancies has fallen sharply since the outbreak of the virus and the initiation of social distancing in March. In the three months to May, there 476,000 vacancies, around 365,000 fewer than the previous quarter and 210,000 fewer than at the same point in 2019. These are the lowest vacancies figures since April-June 2012.

The Department for Work and Pensions will need to rapidly expand the number of work coaches and expand their role for a job-scarce labour market. The department currently has somewhere above 13,000 work coaches for an unemployment rate of 3.9%, with an average caseload of around 130 cases. A rise in unemployment to 10% would require a near tripling of work coaches, to accommodate this additional demand for job search assistance. This is not unprecedented: in 2008, the department had plans to employ 1,000 job advisors a month for three years to keep up with demand from jobseekers. Given job scarcity, this new army of work coaches should provide support that blends traditional job search assistance with intensive digital training and mentoring.

This should make active use of the Get Help to Retrain platform, the first part of the National Retraining Scheme that the Department for Education is piloting in five areas already, which combines digital training and support with tailored career advice. The Government's £2.5 billion National Skills Fund, announced in last year's manifesto, could provide the funding resource to roll out accessible, targeted and good quality training to those that need it.

Recommendation: Prioritise job creation in sectors with absorptive capacity

Many economic organisations, including NIESR and the TUC, have argued for a national job creation or guarantee scheme to be introduced to stimulate hiring. There is some evidence to suggest that job creation schemes can be effective, including for the UK, but they are hard to get right and tend to be effective in the long term. Many areas of the economy will also continue to be subdued for some time. The Government should therefore target job subsidies in areas where there is capacity to absorb large numbers of additional workers and a clear route to longer term employment.

The Future Jobs Fund is a good example of the trade-offs. Official evaluations demonstrate a persistent uplift in employment and wages from participation compared to a control group, leading to the creation of around 100,000 additional jobs and a positive cost benefit ratio. However many of these effects took several years to take effect and almost 42% of Future Jobs Fund participants who began participation between October 2009 and March 2010 claiming working age benefits 20 months after starting on the Future Jobs Fund.[47]

Similar schemes in other countries have had negative effects on the employment prospects of participants, especially in the short term. This is because workers suffer "locking-in effects" that reduce job searching activity for the period of employment. It can take up to 36 months before the positive effects of job creation schemes are felt,[48]with the negative effects heightened during turbulent economic periods.[49]

If the Government does seek to emulate the success of the Future Jobs Fund, it should do so in a way that reflects the current state of the economy. There may be limited value funding additional jobs in sectors still operating at 50% capacity. Such a scheme should therefore be focused on areas of strategic importance, such as pharmaceutical and medical device manufacturing, and long-term productivity benefit, such as infrastructure, renewable energy and health and social services.

Recommendation: Guarantee every young person an opportunity to earn, learn or serve

The Government has recognised that young people will be hit hardest by the coming jobs crisis. It is not unforeseeable that youth unemployment will reach one million. It is imperative – for the speed of the recovery, the health of the future economy, and the prospects of today's younger generations, that everything is done to ensure that the cohort of 2020 is not resigned to short-term listlessness or long-term scarring.

The Prime Minister has already proposed introducing a guaranteed internship for every young person. This is an admirable aim: there is good evidence for the effectiveness of apprenticeships, the levy system introduced in 2013 provides a reliable framework for distributing funding to employers, and training quality and standards are improving following recent reforms.

However, increasing quantity has in the past led to a diminution of quality and the programme was underspent by £400m in March, suggesting a lack of demand from employers even before the pandemic hit. Even if the Government funds every new apprenticeship to 100% of wage costs, it is not immediately clear employers will increase take up.

Instead, the Government should extend the guarantee to give young people the guaranteed ability to “earn, learn or serve”. This threefold commitment would offer every young person aged 18-25, who has been out of work for 3 months or more, the guarantee of:

- **Earning:** through a paid job with a private employer, with their wages paid by the taxpayer, through a version of the Future Jobs Fund tailored to growing and strategic sectors, as set out above.
- **Learning:** through a full-time apprenticeship, with the wage costs supported by directly topping up the apprenticeship levy account of their employer, or an additional year-long course at college or university, supported by the taxpayer.
- **Serving:** through service towards social and environmental causes in their community, employed by local authorities, housing associations, public services, charities and community organisations. This would be paid at apprenticeship rates and treated as a “social apprenticeship”.

This commitment would ensure that the scale of opportunities for young people is sufficient to meet the likely levels of demand in the coming months while creating an offer that suits individual jobseekers’ needs. It would ensure that no young person has to endure months and years of unemployment for want of a job, education of community service opportunity.

Skills gap

Supporting employment and wages through training

Historical UK and cross-cutting international research consistently shows that productivity is the key driver of living standards and that there is still a strong correlation between productivity and real earnings in the UK despite evidence of a decoupling internationally.

Skills are a key driver of productivity growth. Whilst, skills interventions are not a solution in isolation: the interaction of skills with other drivers of growth, particularly employer demand and socio-economic factors is crucial. Before the 2008 financial crisis, UK growth was mostly driven by a combination of capital and Total Factor Productivity (TFP). Since 2008, skills growth has been relatively steady, while capital and TFP have stagnated.

There are several ongoing reforms which will help to improve the skills pipeline:

- T-Levels, co-designed with employers with an element of on-the-job training could become high quality vocational qualifications. However, it is not clear how deliverable industry placements on the necessary scale will now be and there is limited capacity in the FE sector to deliver a full-scale programme.
- The reforms of the apprenticeships programme to focus on quality and incentivise employers to invest in high quality training. However, starts have declined and there are major projected overspends alongside persistent complaints from business over the inflexibility of the apprenticeship levy.
- More recently, the £1.8 billion investment in the Further Education college estate in the manifesto and set out at the March Budget will help bring the entire estate up to good condition, providing better learning conditions.
- The £1 billion catch-up fund for schools and small group tuition will help address some of the most egregious consequences of school closures until September. The Education Endowment Fund expects to see the learning gap between disadvantaged pupils and their peers increase by more than a third.

The crisis poses many new challenges for skills policy

First, elevated unemployment creates the risk of permanent loss of skills. Widespread business failures will lead to the loss of institutional knowledge and technical capacity; sustained unemployment risks skills atrophy hitting long term growth. The end of the furlough scheme and weak domestic consumption will bear down on employment in the short term. Declining investment, changing patterns of demand and weak external demand risks structurally higher unemployment in the medium term.

Second, social distancing will hinder much traditional retraining. A lot of classroom based and on-the-job training will become impossible, restricted or just more difficult and expensive to deliver.

Third, retraining needs are heterogeneous across the country. The hits to output and employment vary by region and sector and will thus necessitate different retraining needs. Construction, manufacturing, retail and hospitality face acute challenges and graduate job vacancies opening from autumn 2020 will be particularly hit. Some sectors may never return to pre-crisis trends. Survey data suggests more than 40% of people expect to make fundamental changes to how they shop.

Fourth, the effectiveness of different interventions varies substantially. The UK has a long history of failed skills policies and the evidence base on which retraining interventions are most effective is not rich. British Governments have launched new skills policies roughly once a year for the last 40 years. Yet despite some limited successes, skills are still a major drag on productivity.

Fifth, in-work training budgets will be under pressure. Employer investment in training never properly recovered from the 2008 financial crisis. Many revenue-constrained businesses will be looking to cut non-essential costs in order to get through this new crisis. This is likely to put employer training budgets under yet more pressure.

This is exacerbating long standing weaknesses in skill levels across the UK

Large numbers of people across the UK have not had the opportunity to develop key skills. England performs poorly amongst OECD countries for literacy and numeracy among 16-24 year-olds and 49% of adults (16-65) have only Level 3 and 15% for literacy.[50]

Nearly a quarter (23%) lack one of five basic digital skills and 8% have no basic digital skills at all[51] and more than 750,000 adults in the UK report not speaking English well, or at all.[52] Meanwhile, there is a substantial array of literature showing skills shortages across numerous sectors such as construction.[53]

Analysis from the Industrial Strategy Council found that by 2030, 7 million additional workers could be under-skilled for their job requirements. Two thirds of the workforce could face some level of under-skilling in basic digital skills of which 5 million workers are expected to be acutely under-skilled and a further 1.5 million workers acutely under-skilled in at least one STEM workplace skill [54].

Four fifths (80%) of the workforce in 2030 is already in the workforce today. So, while improving the education system for children is vital, we cannot hope to deliver meaningful improvements to productivity through skills interventions over the next decade if we don't act to improve the skills of adults already working.

Improving skills brings significant benefits to individuals, society and the economy

Achieving an English or Maths qualification is associated with higher earnings and improved employment outcomes. There is evidence that the strongest wage increases are seen on achieving a Level 2 qualification and for younger adults aged 19-24, but a positive effect exists at all levels and for all ages.[55]

It is clear that basic literacy and digital skills are essential for labour market progression too. Adults who achieve an ESOL qualification secure a wage premium and most employers say they would not interview an entry level candidate without basic digital skills.

Qualitative evidence also suggests improvements in Maths and English skills are associated with benefits to mental health, social integration and civic awareness, family relationships and further progression in learning.[56]

Table 6: Improvements in Maths and English increase earnings and employment

Source: Urwin (2016) [57]

Highest learning aim	Earnings increase for learners 19-24	Earnings increase for learners 25+	Employment uplift for learners 19-24	Employment uplift for learners 25+
Entry level English or Maths	5%	3.1%	1ppt	1.5ppt
Level 1 English or Maths	Not available	7.8%	1.7ppt	1.5ppt
Level 2 English or Maths	8.5%	3.8%	3.1ppt	2.3ppt

However, adult education funding (excluding apprenticeships) has seen substantial reductions over the last decade – a fall of around 40% in cash terms between 2010/11 and 2018/19. Simultaneously, there is a low awareness of available training, limited outreach work or promotion of courses and sustained recruitment and retention challenges of FE teachers – with pay around £7,000 per annum lower than for school teachers.

Adult participation in training has fallen since 2010. Primarily this is due to costs and time but also lack of employer support, lack of digital access and an unfair perception that they are too old to learn. People with low skills have often also suffered from multiple aspects of disadvantage, and are more likely to be BAME, have learning difficulties or disabilities or to have had a disadvantaged childhood[58].

People with stronger basic skills perform better in the labour market and have better social outcomes. In 2014, Pro Bono Economics put the cost of poor numeracy alone at £20 billion[59]. Given the catastrophic effects of higher unemployment about to hit the UK, it is likely that these costs are now much higher.

Education is an unfinished revolution

Education is widely assumed to be a social leveller – a tool that enables anyone prepared to work hard enough to succeed. But while a good education will always improve a child's life chances, the current system too often enables those with the means to get ahead, at the expense of everyone else, passing advantage and disadvantage on from one generation to the next.

For too many children, disadvantage is cumulative. Children from disadvantaged backgrounds are less likely to enjoy the stable, supportive home environments associated with positive cognitive and behavioural outcomes. They are therefore less likely than their more affluent classmates to arrive at school equipped with the knowledge and skills they need to get the most out of their education, and are more likely to find themselves expelled before they reach 16.[60]

While the results gap between disadvantaged children and their peers had narrowed before this crisis, it remained the case that children on Free School Meals were nine and a half months behind by the end of primary school, and over 19 months behind by the end of secondary school[61]. They are both less likely than their peers to go to university at all and less likely to attend selective institutions associated with secure, high paying jobs.

They are more likely to experience periods of unemployment as adults and the minority who successfully break into professional careers are likely to earn less than their middle-class colleagues with identical qualifications.

The educational outcomes of disadvantaged children, relative to their more affluent peers, are worse in the UK than in many other countries. Research conducted by the Institute of Education at UCL shows that children from disadvantaged families in the UK are more likely to have lower education, be out of work and experience poverty in adult life than their peers in all but two European countries. The experience of a jobless household at age 14/15 is also more closely tied to poor life outcomes in the UK than in most of Europe.[62]

The reversal of the progress in reducing the attainment gap from the extended school closures under lockdown is an economic and social disaster on top of an already dire situation. Attainment gaps are widening at every stage of education, demonstrating the scale of the challenge. The fact that disadvantage is cumulative emphasises the need both for early intervention and for a system that supports opportunity at every stage of life with a culture that enables people to up-skill and retrain throughout their working lives.

Recommendation: Establish a new Right to Train for adults

The Government should extend the financial support available for university student loans to vocational courses and alternative academic study. This could take the form of a £50,000 repayable loan, available to all adults without a degree at any stage of their career for full and part-time students. People should be free to use the value of the funding on different qualifications and at different stages of their life if they so wish.

In addition, for those aged under 30 and all adults of any age who have lost their job in this crisis and are now eligible for UC, this should be topped up with a £10,000 grant which can be used for living, travel and other costs explicitly associated with studies. This grant funding could be drawn from the National Skills Fund (NSF) – which in turn should see a substantial increase on the £3 billion set out so far. Given the scale of the challenge, a tripling of the NSF should not be out of the question.

Governments have spoken enthusiastically about the need to foster parity of esteem between different post-18 options, yet the funding of academic and technical routes fails to bear this out. While 18-year-olds aspiring to university are able to apply for both tuition and maintenance loans, repaid on favourable terms when they can afford to do so, financial support for technical and vocational study is significantly more limited. A right to train which is neutral across academic and vocational training will go some way to build that parity of esteem. This new approach could replace the system of Advanced Learner Loans, which have suffered low take up.

The Government fully funds learners aged 19 to 23 to undertake their first full Level 3 qualification. However, older learners are required to fund training themselves, meaning that many adults aged 24 and above are unable to obtain the qualifications that employers and higher-level FE providers require as a minimum entry requirement. So we should expect that the Right to Train should be mainly used for courses from Levels 4 to 6 but also allow some flexibility for older workers who would benefit from a Level 3 course.

Recent analysis conducted by the OECD found that while England has been effective in activating highly skilled adults, pronounced inequalities between the highly skilled and those who have not had those opportunities remain. Concerningly, this is particularly true among young adults.[63] ONS evidence shows that at present, adults they deem low skilled are the least likely to access training opportunities.[64] the certainty of some sectors facing permanently different growth paths following this crisis, a Right to Train will also facilitate the move from shrinking to growing sectors.

This will help to develop a genuine marketplace of competitive, easy to navigate training opportunities that are accessible to learners throughout their working lives. Making funding available throughout people's working lives would ensure that communities affected by labour market flux would be able to retrain and take advantage of new opportunities. Loans could only be withdrawn to support approved courses and would be repaid as a percentage of learners' monthly salary once their income exceeds a certain threshold.

This model, inspired by the recommendations of the Augar Report, will need to be based on a simple and transparent system for calculating each learner's entitlements so that funds can be allocated swiftly. Strong quality assurance mechanisms will ensure value for money and to support rigorous courses and qualifications. The Right to Train should give learners genuine control over the money in their own name so that they are encouraged to carefully consider each choice they make. It should be portable over time and between jobs so that learners feel constantly engaged in decisions about when to use their funding.

Employers could be encouraged to support this training through the introduction of a human capital tax credit, as previously proposed by Onward, to allow businesses to offset training costs in the same way they can do for R&D. This would reverse the situation in recent years whereby employer-related training spend and quality has been in steep decline, despite repeated warnings from employer groups about skills gaps in the UK workforce and the introduction of the Apprenticeship Levy. It would also address the situation identified by IPSE that a significant contributing factor to the low uptake of training among self-employed professionals is financial limitation.[65]

These findings are reinforced by the FSB, which found that a deficit of technical abilities within small UK firms restricted productivity levels and limited growth.[66]Ensuring that businesses can gain favourable tax treatment for training investment should help to stimulate a longer-term shift towards employer investment in their workers – which is vital for productivity prospects.

Recommendation: Make Maths, English and Digital education compulsory to the age of 18

Young people lag behind their international counterparts on basic skills, meaning that, in time, the basic skills of the English labour force could fall further behind those of other countries. The share of young people with qualification levels below level 2 in England is 48 per cent, compared with 29.8 per cent across the OECD.[67]

The OECD highlights the implications of a lack of such skills, saying, for example, these 9 million people may struggle to estimate how much petrol is left in the petrol tank from the sight of the gauge, or not be able to fully understand instructions on a bottle of aspirin. Weak basic skills reduce productivity and employability, damage citizenship, and are therefore profoundly implicated in challenges of equity and social exclusion.[68]

Analysis from the ONS has found that some of the most vulnerable members of society have the least access to the training and learning that could help boost their career prospects. Adults with the lowest levels of educational attainment are among those missing out on the opportunity to improve their life chances[69]. Young people with GCSEs as their highest qualification perform less well on basic skills, particularly numeracy, than their counterparts in many other countries. Around 30 per cent of young people with GCSE or equivalents have low basic skills.

Low skills may cause unemployment directly, but they can also lead to a sequence of insecure jobs. Since skills decay through lack of use, low basic skills may also result from unemployment, or unskilled employment. Someone who starts their career with low basic skills can therefore become entrenched in a career trajectory in which their pattern of employment both reinforces, and is reinforced by low basic skills.

Workplaces with a basic skills gap report a range of cost to their business with efficiency-related costs being most common. Between a third to a half of employers with a basic skills gap reported constraints on the introduction of new or more efficient process and a reduction in productivity.[70] 85 per cent of employers do not provide any form of basic skills training, with the majority (90 per cent) saying they have no need for it. Only 2.4 per cent of employees per workplace are undertaking publicly funded basic skills training.[71]

In order to address the adult skills deficit, the Government should improve the standard of basic schooling in England, improving both average and minimum standards. Basic skills should be developed and sustained throughout every stage of the education system and into adult life. One powerful step to do this would be make some form of English, Maths and Digital education compulsory for all people up to the age of 18.

This could be done in a phased way with Maths and English more easily made compulsory likely to come first, followed over time by Digital skills. This will take a number of years to introduce, requiring an increase in school, sixth form and FE capacity with a ramp up in teacher recruitment and training. It need not be a standard qualification for all 17 and 18 year-olds but work could be done to identify what proportion of total study this could take and how progress should be assessed.

Research suggests that people are more receptive to basic skills training when it is firmly grounded in the workplace, with reference to practical, real-life work examples. Employers are able to recognise the importance of basic skills training to the daily activities of their employees. This relevance helps secure employers' support and commitment to work-based training, which is vital if employees are to be given access to further learning and progression opportunities[72].

For employees, basic skills training, which is authentic and explicitly related to work activities, tends to be better received and has positive repercussions for attendance and motivation. This is especially relevant for those who may not have experienced success in previous school-based or more formal learning environments[73].

The Government should therefore also consider the introduction of more business-specific basic skills training, and jointly fund (with business) for employees to attend such courses. Much like Universal Credit work coaches can refer claimants to government funding training, employers should be able to direct employees looking for additional training to such schemes.

Recommendation: Introduce enhanced children's zones to boost the skills and life chances of disadvantaged children through intensive, multi-agency support

Every person – no matter where they are born, or which school they attend – should be able to go as far as their talent takes them. However, the reality is that where children are born does matter. The Social Mobility Commission identified 65 'social mobility cold spots' which offer children born into disadvantage little chance of escape.

Disadvantaged children are 14 percentage points less likely to be school-ready at age five in social mobility 'coldspots' than in 'hotspots'. 51 per cent of London children on free school meals achieve A* to C in English and Maths GCSE, compared with an average of 36 per cent in all other English regions.[74] The Government cannot credibly claim to level up opportunity whilst such pronounced geographical inequalities exist.

DfE's Opportunity Areas have been an attempt to address the social mobility barriers children growing up in these areas face. These target local authority areas were identified because of the social, economic and cultural challenges they face. But while Opportunity Areas were a welcome start, they are not sufficiently resourced to deliver the radical interventions necessary. As the Social Mobility Commission has argued 'something much bigger is needed'. This is even more the case given the widening attainment gap following school closures.

The Government should move towards the model of intensive, multi-agency working pioneered in the Harlem Children's Zone. This should harness corporate social responsibility and provide funding to scale up existing Opportunity Areas. Schools should be made the centre of social service networks in these new zones. This would establish a community-led taskforce responsible for the delivery, and consistent assessment of interconnected skills and social mobility programmes.

The zones should deliver interventions pioneered in the Harlem Children's Zone (HCZ). The HCZ designs, funds, and operates a holistic system of education, social-services and community-building programs in Harlem to counter the negative influences of crime, drugs and poverty, helping children complete college and go on to find employment with a 'cradle to career' philosophy.

Inspired by HCZ, the West London Zone (WLZ) is supporting 15 schools to steer children in one of the most deprived areas in the country away from a life of hardship and into university. Each participating school has a WLZ link worker on site, who matches selected children with services provided by 24 partner organisations, including one-to-one tutoring, confidence building, counselling and sporting activities.

The WLZ has also delivered encouraging results. At the end of the first cohort's first year, 80 per cent of the 132 participants improved in attainment, attendance or wellbeing. 54 per cent of the WLZ cohort lifted themselves out of bottom 20 per cent nationally in reading.[75]

Newly created Children's Zones in low opportunity areas could offer:

- Free workshops for parents of children aged 0–3 which could dramatically improve the first and most formative years of a child's life.
- All day pre-nurseries which would be eligible for children of single parents, which would ensure children are getting the correct food and nurture in early years.
- Age-appropriate character education, helping students at every level build crucial non-cognitive skills too.
- Health clinics and community centres for children and adults during after-school, weekend and holiday hours.
- Higher salaries for teachers, reflecting additional time commitments and attracting the best people to the programme.

Recommendation: Double Further Education funding and launch a radical wave of reform of the sector

While the education reforms introduced since 2010 are delivering improved results for school-aged children, sixth forms and colleges have not received the same degree of attention. Britain is still battling the stigma that university is the only route to well-paid employment and since 2010, not enough has been done to reform the FE sector.

Despite some improvements, there are still major skills gaps in important growth industries. Research from the City & Guilds Group found that 68 per cent of young people plan on going to university, and yet only 30 per cent of the future jobs actually require a degree. In addition, CIPD found that 59 per cent of graduates hold non-graduate jobs.[76]

Some research has suggested that increasing vocational skills could boost GDP by over £150 billion over the next decade, while a 10 percentage point increase in the number of upper secondary school pupils enrolled in vocational education could lead to a 1.5 percentage point reduction in youth unemployment rates in the UK[77].

Funding for colleges was cut by almost 30 per cent from 2009 to 2019 and research by the Education Policy Institute found 54 per cent of maintained schools with sixth forms had in-year deficits last year, compared with just 37 per cent nine years ago.[78] Between 2010-11 and 2018-19, real terms funding per student in school sixth forms, sixth form colleges, and further education colleges declined by 16 per cent. This is twice the rate that the overall schools budget fell by between 2009-10 and 2017-18[79].

A-Level providers are funded for an average of 600 planned hours per year per full-time student, equating to 15 hours of contact time per week. This provides little scope to sit additional exams and means that resources for extra-curricular provision are extremely limited. The average number of teaching hours A-Level students has fallen gradually since earlier in the decade.[80]

Complex funding arrangements complicate an already confusing range of FE options. There are over 13,000 technical courses that 16-19 year-olds can choose from and until recently there were 12,500 approved qualifications, offered by 130 awarding organisations. Without good information on quality or value for money, it is not clear that this vast array of options is a sensible way of operating the further education sector[81].

There is also significant regional variation in performance as different institutions have different blends of provision. Nearly 8 per cent of academic sixth forms and colleges in Yorkshire and the Humber have value-added progress scores that fall below the minimum standards set by the Department for Education, compared with 3 per cent in the South West[82].

Meanwhile, the substantial pay differential between schools and FE colleges makes recruitment and retention – difficult across the board – particularly acute for FE colleges. Further education lecturers are estimated to earn around £7,000 less than school teachers on average and it seems likely that the pay gap will increase.[83] At the 2019 Spending Round, the Chancellor announced that teacher starting salaries would rise to £30,000 by 2022 – a powerful step forward. However, no such commitment has yet been made for FE colleges.

The £400m for 16-18 year-old education announced at the 2019 Spending Round and the £1.8 billion investment in getting the entire further education college estate to good condition are important steps but must only be the precursor to a more radical set of reforms and a more substantial funding increase.

The Government should formally place Further Education colleges in the public sector. This is not an ideological question, rather it is about ensuring that we remove the constraints on driving a more fundamental restructuring of the further education sector and intervening in poorly performing colleges. We should be willing to see through the impact this reclassification will have on the public sector finance statistics.

At the next Spending Review, even if overall it is just a one-year rollover, the Government should seek to deliver a five-year spending settlement for FE with a transformative increase in core funding and certainty over the coming years. FE colleges provide the majority of public spending on adult education and have been neglected for too long, it is time that the investment we put in is commensurate with our ambitions for growth.

Research produced for the DfE in February – even before the heightened financial pressures caused by the crisis – showed that the FE sector was under considerable pressure including over its financial viability. Surveys of sixth forms and colleges showed that 51% had dropped courses in modern foreign languages due to funding pressures, 38% had dropped STEM courses, 78% had reduced or removed student support services or extra-curricular activities and 81% were teaching students in larger class sizes[84].

So, this 5-year settlement should set out a long-term ambition to double public funding for FE colleges with a shorter term goal of equalising the base rate of funding for 16-17 year-olds with the £5,000 in secondary schools from the approximately £4,188 now. The same should apply for 18 year-olds over time too from the estimated approximately £3,455[85].

This increase in funding should allow the Government to target overall funding more effectively at improving take-up of high value subjects and exploring wider options to increase the extent of conditionality on the base rate. This should come alongside a move towards a rationalisation of the qualifications landscape, scrapping low quality, low value courses.

This increase should also fund a big-bang recruitment and retention package. With pay so low relative to schools and average staff turnover near to 17% - the need was high even before the crisis[86]. This should involve a major uplift in FE college pay with the eventual ambition to match the future school starting salary of £30,000. It should also involve greater investment in ongoing retraining and attracting high-fliers from other industries to enter FE colleges.

In his most recent annual report, the FE Commissioner described the ‘poor governance and leadership’ that over a number of years had resulted in ‘weak decision-making[87]’ So alongside the increase in funding should come new powers to intervene and replace leaderships when evidence of sustained poor performance comes to light and new measures to encourage more local employers to work with FE colleges to better match skills and jobs. This could also come with new measures to facilitate college mergers so that there are more flagship institutions potentially forming a hub and spoke college model.

Recommendation: Scale up the Catch Up Fund to increase access to small group tuition

One in three disadvantaged children arrive at school below the expected level of development in language. Ofsted have found that for these disadvantaged children, learning to read is the most important purpose of the first year at school.

Speech, language, literacy and communication are a persistent challenge to reception classes, and research shows the problem is more acute in disadvantaged areas. Up to 50 per cent of a class has been known to present with delayed speech, language and communication in an area of social disadvantage[88]. Tackling the attainment gap in the early stages of education is vital – as children get older, the gap widens and becomes more entrenched. Forty per cent of the gap at age 16 has already emerged by age five[89].

Small group tuition promises to provide intensive learning which can close the opportunity gap in children's lives sooner, supporting not only those who are struggling but also enabling talented young people from less privileged backgrounds to thrive. In England, there are big gaps between children of different socio-economic backgrounds in time spent on additional instruction beyond the core school hours. For pupils of the same levels of achievement, well-off pupils receive 2.5 hours more additional instruction than less well-off pupils[90].

However, at present private tuition is the preserve of children from wealthier families. Students who receive private tuition disproportionately are those who are already advantaged and research has shown that about twice as many attend private schools as in the national population as a whole.[91]

Rates of private tuition have risen significantly in recent years, leading the Sutton Trust to describe it as 'the hidden secret of British education'. The proportion of 11-16 year-olds receiving private tuition increased by a third between 2005 and 2016.[92]One in three 11-16 year old state school students in England and Wales report having had private tuition at some point in their life – rising to almost half of young people in London. The industry is worth an estimated £2 billion a year to the UK economy[93].

Small group tuition can be as effective as one to one to tuition and helps to control costs. Short regular sessions over a focused period of time are the best way to achieve the optimum impact. According to the EEF, one-to-one tuition, five days a week over a 12-week term, costs approximately £700 per pupil. The majority of this cost is teaching time[94].

Our approach must be to ensure that children of all abilities and attainment levels are able to fulfil their potential. Bright but poor pupils currently receive much less support than their better-off peers. There are again substantial differences in the use of one-to-one tuition by socio-economic and achievement groups in England. Whereas around a third of low-achieving pupils from advantaged backgrounds receive one-to-one tuition in science or mathematics, this falls to around one-in-twelve of high-achieving young people from disadvantaged backgrounds[95].

The £1bn set aside for the Catch Up Fund – with £650m for schools to spend as they wish and £350m for a National Tutoring Programme are welcome steps but are unlikely to be sufficient to deal with the scale of the catastrophic effects on young learners from the lockdown and school closures.

The Government should provide funding for the National Tutoring Programme for the rest of the Parliament beyond just the 2020/21 academic year and contingent on successful early implementation of the scheme. It should also go much further and seek to introduce free, small group tuition for all reception-aged children to tackle the early attainment gaps that so profoundly shape children's longer-term outcomes. The Government will also have to be prepared to increase on the £650m of extra resource spending it allocated to primary and secondary schools at the Spending Review later this year.

Recommendation: Develop a National Mentoring Scheme, so that all 14-16 year-olds have a personal mentor by 2024

Many young people lack the confidence, knowledge, support and networks to make their aspirations a reality. Whereas advantaged young people are likely to have ready access to a rich network of adult support, disadvantaged young people more likely to rely on their schools for careers advice.

However, the standard of provision in schools is highly variable. In 2016, the Sub-Committee on Education, Skills and the Economy reported that 'careers advice and guidance is still poor in so many schools.'[96] The parliamentary accounts committee recommended that schools be specifically rated by Oftsed on the quality of their careers advice, reflecting concern about existing provision.[97] Teach First reported that just 32 per cent of disadvantaged pupils found the careers advice provided at school helpful[98].[108]

If access to good careers advice is unevenly distributed along socio-economic lines, it will increase social stratification by allowing the advantaged to become more skilful in maximising their advantages. With this in mind the APPG on Social Mobility has argued that: 'a particular appeal of mentoring… is that it can enable less advantaged young people to develop relationships with older, more experienced people, in the way that more affluent children are often able to do informally.'[99] There is limited exposure to different careers and this leads to limited perceptions of the range of jobs available among disadvantaged young people.

Alongside providing careers advice and practical support, mentoring can help develop communication skills and build mentees confidence. EEF research found that mentoring was linked to improved attitudes towards school, attendance and behaviour.[100]

Government policy since 2010 demonstrates appreciation of the positive impact mentoring schemes can have. However, provision has been targeted and localised, meaning that many teenagers are without access to a mentor. Since 2010 there have been a number of specialised mentoring programmes aimed at, for example: 'struggling teens', children in care and high achieving disadvantaged pupils.[101] Government also supported a number of localised schemes, including a mentoring programme for 'the most vulnerable' in Doncaster Opportunity Area.[102]

In 2010 the Coalition Government discussed a 'national mentoring scheme'. However, it was not the government's intention that this would be funded, owned or run by government.[103] Government investment focused on raising awareness of the benefits of mentoring, improving accessibility for mentors and mentees, providing guidance on quality standards and short-term capability building.

In 2016 the Government invested £14 million into what was described as a 'national mentoring scheme'. However, provision was not universal, but targeted 25,000 of the country's 'most disadvantaged' young people.[104]

Given the widely recognised benefits of mentoring, we should move away from targeted provision and consider a national ambition, so that all year 10 and 11 pupils benefit from the support of a mentor by 2024. Developing a truly national mentoring scheme will normalise support and prevent young people from falling through the cracks.

The quality of mentoring is important. There are risks associated with unsuccessful mentor pairings, which may have a detrimental effect on the mentee. As such, training for mentors will be an important part of the national service.

So far as possible, mentors should be drawn from local businesses, so that as well as developing relationships between mentors and mentees, the scheme supports closer relationships between schools and their local business communities. Establishing a point of contact would encourage businesses to support schools in other ways.

An online platform could be developed to supplement face to face support, ensuring that communication is sustainable for mentors and mentees alike. This work could build on the National Tutoring Programme.

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