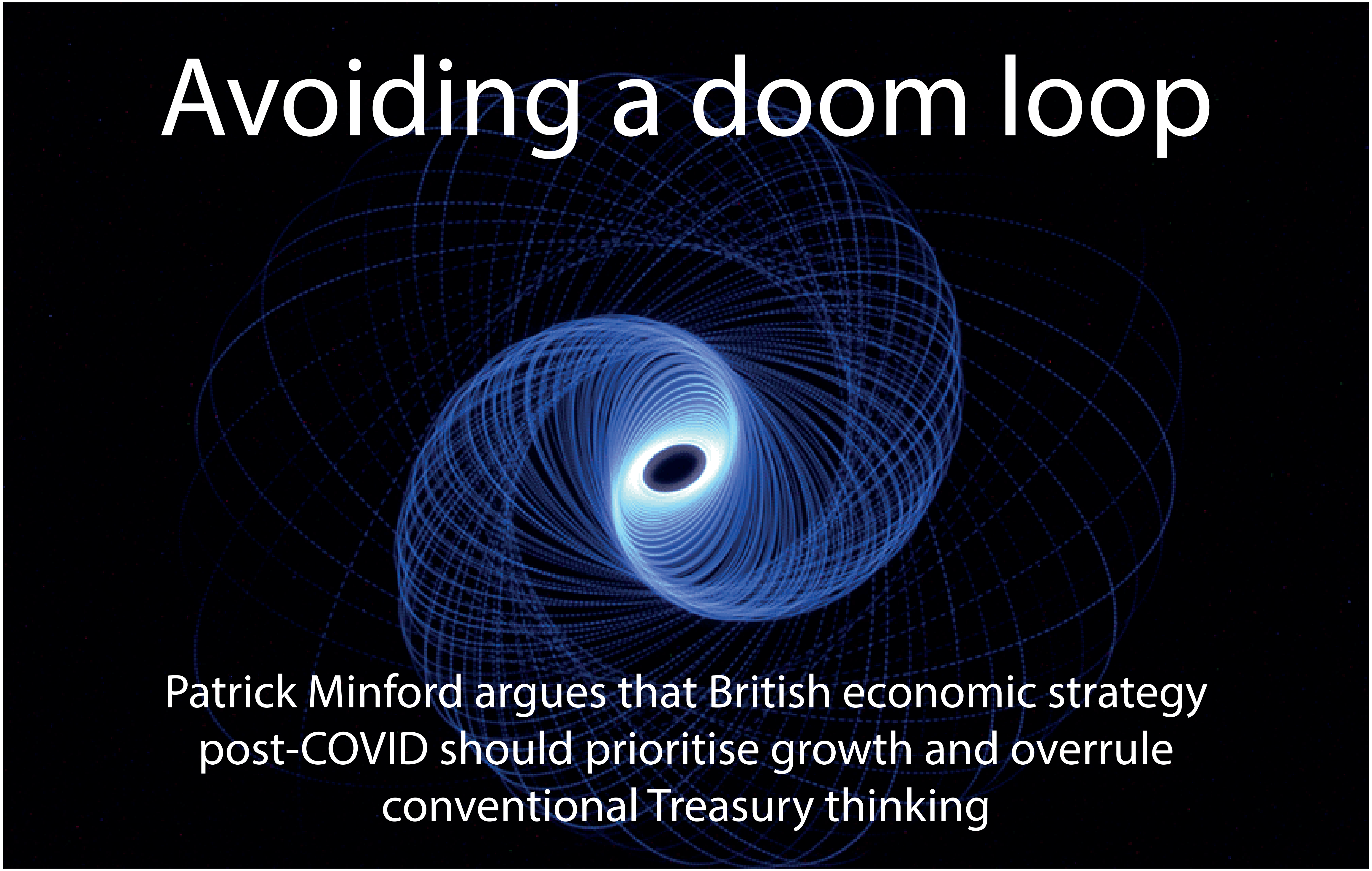
Avoiding a doom loop



Patrick Minford argues that British economic strategy post-COVID should prioritise growth and overrule conventional Treasury thinking

Growth is the sine qua non of Britain's future, just as it is for countries everywhere. With it we can raise productivity, create jobs, generate profits underpinning pension returns and produce the tax revenues to pay for vital public services. As a side effect the state will pay off its debt and bring the public debt ratio down to the low safe level we achieved before the financial crisis.

This should be obvious. Yet we recently had a Budget in which our Chancellor, Rishi Sunak, presented himself as wanting the low taxes he knows are needed for growth and yet in practice putting taxes up nevertheless, for reasons of public finance. This stance is self-contradictory and flies in the face of economic sense.

The whole point of government borrowing and public finance, is to enable tax and public spending to be set according to the long-term needs of the economy, with short term pressures dealt with by borrowing- an idea known as the 'tax-smoothing' role of borrowing.

Of course, we have just had a good example of that in action during the COVID crisis in which the temporary support needs of the economy were met by borrowing. But just as it would have been wrong not to support the economy during COVID for misplaced fear of borrowing, so it is wrong not to support the economy's need for growth post-COVID on these grounds.

The economy is now recovering from the pandemic and growth in 2021 turned out at 7.5%, a strong recovery from last year's collapse and the resulting run-up in public debt to pay for the emergency. Post-Brexit and post-COVID there are major challenges for government policy; the recovery needs to be sustained, and policies must be put in place for solid long-term growth and 'levelling-up' (catching-up by slower-growing regions). This policy formulation requires the government to take a long-term view and not to panic in the face of short-term pressures.

One of those pressures is the sharp rise in public debt due to COVID, to around 100% of GDP. Over recent years the government has been concerned to bring the debt ratio down, especially after the financial crisis hit.

So the natural instinct of a Conservative government is to revert to the same austerity policies. We recently had a report from the Public Accounts Committee[1], warning us of the dire state of the government finances post-COVID. The PAC joins the lugubrious OBR - the Office of Budget Responsibility - in its reports.

... good policy needs to balance risks against returns; and most important of all, it must take a long-term view at this crucial junction in our history, with the overwhelming need to boost growth and bring down regional inequality

Mind you, we should not be surprised at or critical of these bodies. They were set up with the role of standing guard over the public finances, and their job is, Cassandra-like, to warn about the downside risks.

However, unlike Cassandra, these bodies are wrong in their forecasts; and good policy needs to balance risks against returns; and most important of all, it must take a long-term view at this crucial junction in our history, with the overwhelming need to boost growth and bring down regional inequality.

Currently, there is a huge return from bold policies designed to boost post-COVID growth. It is growth and to a lesser extent inflation that will bring down the ratio of public debt to GDP over the long term, as it has done before in our history, as shown in Figure 1.

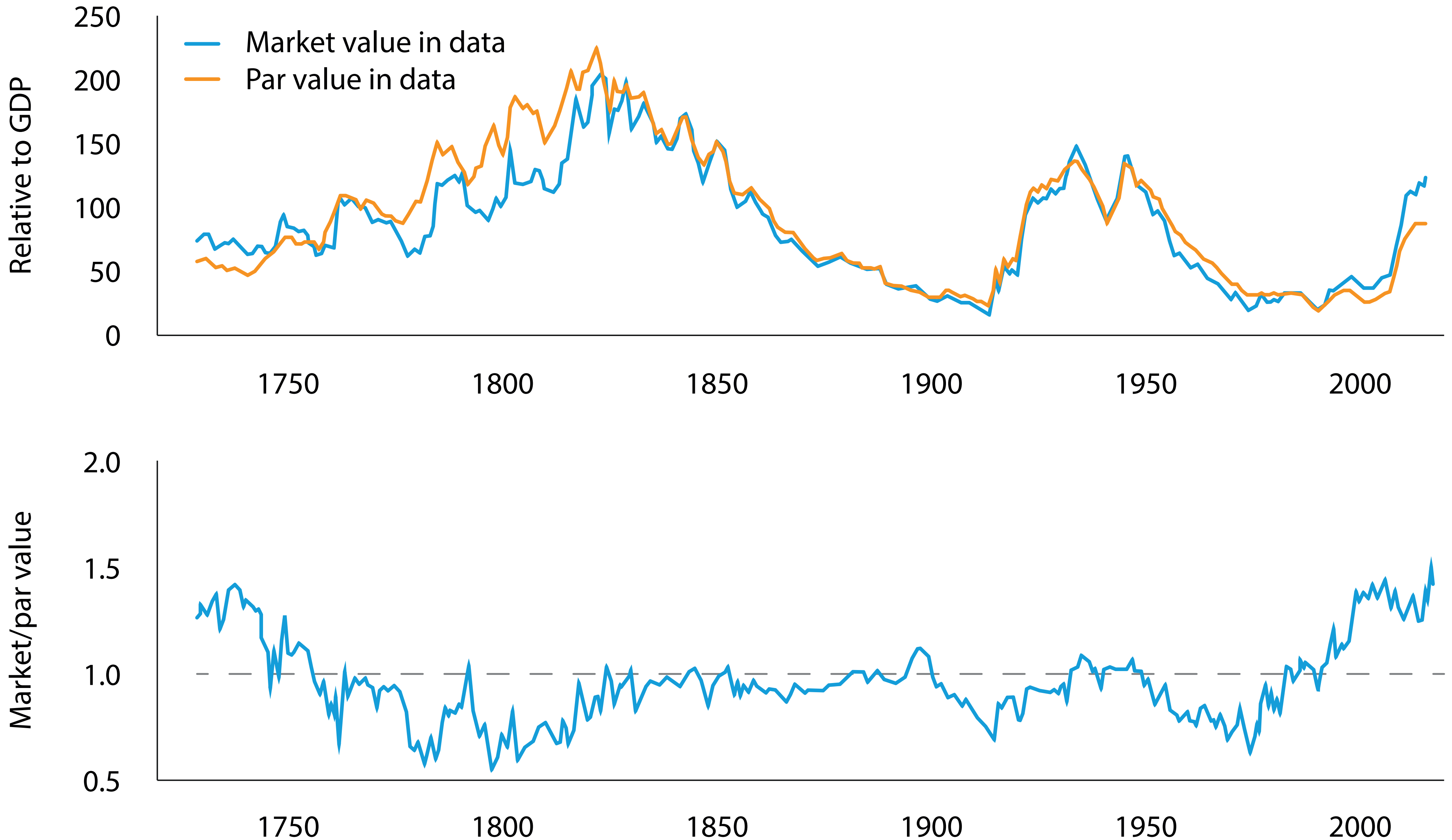
You can see the gradual fall of the debt ratio from peaks of over 200% after the Napoleonic wars and WW2. During these long adjustments there was never any panic over UK solvency, as can be seen in the second chart of market/par value.

This fluctuates around unity; the fluctuation reflects fluctuating market interest rates compared with issue rates. Feared insolvency would show up as a collapse in the ratio, which we do not see. The UK has never defaulted; and it is not about to do so now.

The OBR has been too gloomy about growth and the finances: without tax increases the debt ratio will fall steadily anyway

In the current post-COVID situation, there has been a big bounce back in GDP, and with it will come a bounce back in tax revenues net of welfare payments, with a fall off too in emergency spending.

Figure 1. Market value of debt in UK since 1694



Source: Ellison and Scott (2017) '323 years of UK national debt'.

So the PSBR, the Public Sector Borrowing Requirement, will fall back to a modest level quite quickly. A cautious approach to the finances implies keeping the PSBR low enough to ensure that growth in nominal GDP gradually brings down the debt ratio.

Overleaf is an updated forecast by my Cardiff research group for the public finances to the 2030s, assuming no change in policies. It also projects 2% growth with no change in policies; this is about the same as growth over the past thirty years on average (1989-2019).

The OBR has been too gloomy, as the tables show. In spring 2021 - Table A - they said growth in 2021 would be only 4%; it has come out at 7.5%. Even the Consensus, hostile to Brexit and so gloomy too, was closer to the outcome. The OBR has also had to revise its March 2021 PSBR forecast down for 2021-22 - Table B - as the outturns have improved.

Turning to the latest OBR forecasts for the economy and public borrowing, they remain excessively gloomy. As just noted, this comes from the OBR's professional bias as the appointed 'keeper of the budget rules'. The OBR figures are overleaf.

As can be seen from our forecasts set out, they are for much larger borrowing than ours. For example, borrowing in 2024-25 is £46 billion in the OBR forecast, against £22.7 billion in ours, where the economy returns to its trend.

The discrepancy comes about from the OBR's pessimistic GDP outlook; GDP grows by 15.9% from 2020 to 2024, against our 20.9% in our Quarterly Bulletin of the same date.

Table A. The OBR forecast of GDP for 2021

	OBR	Cardiff	Consensus	Latest estimate
GDP growth (%) 2021	4.0	5.4	5.4	7.5 (latest ONS)
PSBR (£billion) 2021	234	140	223	183 (Jan 2022 consensus)

Source: OBR, Office of National Statistics, ONS, and HM Treasury 'Forecasts for the UK economy — a comparison of independent forecasts'; Consensus is forecast average.

Table B. OBR forecasts of the PSBR

	£ billion						
	Outturn	Forecast					
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
March 2020 forecast	54.8	66.6	61.5	60.2	57.9		
March 2021 forecast	354.6	233.9	106.9	85.3	74.4	73.7	
October 2021 forecast	319.9	183.0	83.0	61.6	46.3	46.4	44.0

Source: OBR Report on Economy, October 2021.

Table 1. Basic Forecast - Public Finances without tax increases

	Nom PSBR	Nom GDP	Nom Pub Spend	Spend/ GDP	PSBR/ GDP	Nom debt	Debt Interest	Debt/ GDP	Net Taxes	Net Tax Rate
2019/20	49.1	2,196.3	472.2	21.5	2.2	1,621.0	48.1	73.8	471.2	21.5
2020/21	306.6	1,990.1	468.9	23.6	15.9	1,932.2	39.8	97.1	202.1	10.2
2021/22	179.5	2,307.1	526.7	22.8	7.8	2,111.7	42.6	91.5	389.8	16.9
2022/23	57.8	2,562.1	561.2	21.9	2.3	2,169.5	41.1	84.7	544.5	21.3
2023/24	42.0	2,721.0	600.5	22.1	1.5	2,211.5	42.9	81.3	601.4	22.1
2024/25	23.3	2,859.9	639.5	22.4	0.8	2,234.8	41.1	78.1	657.4	23.0
2025/26	3.7	2,974.3	669.5	22.5	0.1	2,238.5	44.7	75.3	710.4	23.9
2026/27	0.2	3,093.3	720.9	23.3	0.0	2,238.7	48.0	72.4	768.8	24.9
2027/28	0.2	3,217.0	780.5	24.3	0.0	2,238.9	51.2	69.6	831.5	25.8
2028/29	0.0	3,345.7	845.1	25.3	0.0	2,238.9	54.3	66.9	899.4	26.9
2029/30	0.0	3,479.5	915.6	26.3	0.0	2,238.9	57.1	64.3	972.7	28.0
2030/31	0.0	3,618.7	992.2	27.4	0.0	2,238.9	59.9	61.9	1,052.1	29.1
2031/32	0.0	3,763.4	1,075.5	28.6	0.0	2,238.9	62.5	59.5	1,138.0	30.2
2032/33	0.0	3,914.0	1,165.9	29.8	0.0	2,238.9	65.0	57.2	1,230.8	31.4
2033/34	0.0	4,070.5	1,264.0	31.1	0.0	2,238.9	67.3	55.0	1,331.3	32.7
2034/35	0.0	4,233.4	1,370.4	32.4	0.0	2,238.9	69.5	52.9	1,439.9	34.0

This 5% discrepancy has a massive effect on net revenue/GDP, the average net tax rate, as we will explain in more detail below, implying a difference of 2.3% of GDP, or about £50 billion pa. by 2024. So the OBR is greatly downplaying the way recovery will raise gross revenues and lower benefit payments.

Our forecast by contrast shows the PSBR dropping steadily and both enabling public spending to rise and pushing the debt ratio down to around 50% by the mid-2030s. There is no need for tax increases.

This clearly implies that the tax increases imposed in the Budget are a bad mistake. These include not indexing income taxes to inflation, so pushing people into higher bands; raising National Insurance Contributions by 1.25% for both employees and employers; and raising Corporation Tax from 19% to 25%.

These tax increases will depress growth, investment and employment; and they should be rescinded as soon as possible, as now widely demanded in response to the fall in living standards looming over the coming year.

However, a serious strategy for growth would not merely rescind these wrong-headed tax rises but go a lot further and cut the UK tax burden over the longer term.

This, our research finds, would not just stimulate growth but do so relatively more in the 'northern' slower-growing parts of the UK, so contributing to the levelling-up objective of this government. In the next section I explain how this programme would work.

Instead of tax rises tax cuts are both necessary for growth and affordable

Hence we must not forget that tax/spending policy must not merely avoid damaging growth but also sustain and encourage it. In truth projected growth of 2% with constant policies is low and we can do better. Higher growth in turn will bring down the debt ratio, so in effect paying for those policies.

These growth-supporting policies involve supply-side tax-cuts and spending rises whose short-term effect is of course to increase the deficit. But in the long run they bring the debt ratio down, so in effect paying for themselves- as I illustrate below.

These very policies also generate levelling-up where growth in the North exceeds that in the South- we define the South as consisting of London, the South East and the South West and the 'North' as all other regions (with apologies to Wales, the Midlands and the east).

My research group in Cardiff has been working for the past two years on a new regional model of the UK to frame the best way for policy to address this agenda. Our work[2] produces the policy results shown in Table 2.

Table 2. Long run effects of different tax/regulative measures on North and South according to Regional Model - each measure costing £10 billion pa.

Percentage change in	GDP_N	GDP_S
Cut standard rate of income tax or VAT or other general income/consumption tax	1.1	0.5
Cut corporation tax rate	0.8	0.4
Cut marginal tax rate and regulative burden on entrepreneurs/SMEs	2.0	17.0
Increase infrastructure spending in North	1.6	-

The model is based on well-known and well-tried ideas of supply-side channels through which targeted tax cuts and regulative reform raise entrepreneurial incentives to innovate as well as creating labour market flexibility and lowering labour costs.

Previous work has shown that these sorts of policy have worked well in the UK to boost the economy in the 1980s and 1990s. Later in this piece I show fuller details of these effects, in the form of a full proposed policy package combining them all.

Much policy commentary has criticised the government for aiming at levelling-up without any strategy for achieving it. I show here that there is a potential strategy that is feasible without affecting public sector solvency; also, that it levels up the North without cutting down the South - all boats rise in this strategy.

To embark on this strategy the main need is to close our ears to the voices of gloom that urge the need to raise taxes and cut spending to reduce the COVID debt - that way lies only a downward spiral of falling growth and a rising debt ratio - a 'doom loop' of stagnation, austerity and worsening finances.

I now turn to the prospects for growth, taxes and debt in the context of the post-COVID economic prospects. Begin by noting that the progressiveness of our tax and benefit system causes a 1% rise in GDP to raise net taxes, ie. taxes minus benefits (tax credits) by about 3%, an 'elasticity' of 3. By implication the average net tax rate rises by 2%, an elasticity of 2.

Hence growth has a tonic effect on taxes and the public finances. Our research in turn shows that the policy package proposed in Table 3 will raise growth by 2.3% per annum, that is to 4.3% against the 2% baseline assumed

Table 3. A fiscal stimulus package costing £100 billion pa.

Tax cuts	Amount
Cut corporation tax by 10%	£32 billion
Abolish the very top additional 5% rate	£1 billion
Cut the top rate of income tax to 30%	£15 billion
Cut the standard rate of income tax by 5%	£28 billion
Total Tax cuts[1]	£76 billion
Public spending[2]	£24 billion
Total package	£100 billion

1 Representing a weighted average tax cut across all income of about 15%
2 On public services and infrastructure

Table 4. Effects on growth in Regional Model (% of GDP over next decade) from full policy package of £100 billion pa.

Percentage change in	GDP_N	GDP_S	GDP
Cut standard rate of income tax or VAT or other general income/consumption tax	3.3	1.5	2.4
Cut corporation tax rate	2.4	1.2	1.8
Cut marginal tax rate and regulative burden on entrepreneurs/SMEs	20.0	17.0	18.5
Increase infrastructure spending in North	3.8	-	1.9
Total	29.5	19.2	24.6

above (see Table 4 for the model-based growth effects). For the sake of caution we will assume only a 1% uplift to 3% per annum in our projections for the finances in Table 5.

In Table 5 I show projected rising spending against rising tax receipts net of tax credits. In the Base Run forecast shown above, where current policies continue, the debt/GDP ratio falls to 52% by 2034/35, illustrating the point that there is no need to rush and pay off a large debt ratio after a crisis such as a war or COVID - it will fall steadily to a safe sustainable level with growth.

Then when we implement the Fiscal-Fund-plus-Reform package of tax cuts and infrastructure spending, we get the forecast set out in Table 5 below. As noted above, according to our Regional Model the package raises growth by 2.3% pa. over the decade to 2034/35; but in Table 5 we have conservatively projected a higher growth rate of only 1% pa. to remain on the cautious side.

With this higher growth comes a rising average net tax rate after the initial drop in revenues from the programme. Again the debt ratio falls with now faster growth to a safe and sustainable 45% by 2034/35. In effect the package pays for itself.

These tables show that the fiscal package pays for itself via higher growth. What does it do for the regional picture according to our new Regional Model?

On our cautious assumptions in Table 5 the gap is reduced by 4%, even while both North and South grow more strongly, with average GDP up 10% over the decade. During this period the growth of the North is roughly double that of the South. The policy effect is therefore levelling up without pushing down.

Table 5. Variant Forecast — Public Finances including Fiscal Stimulus Package, with assumed effect on growth of +1% pa.

	Nom PSBR	Nom GDP	Nom Pub Spend	Spend/ GDP	PSBR/ GDP	Nom debt	Debt Interest	Debt/ GDP	Net Taxes	Net Tax Rate
2019/20	49.1	2,196.3	472.2	21.5	2.2	1,621.0	48.1	73.8	471.2	21.5
2020/21	306.6	1,990.1	468.9	23.6	15.9	1,927.6	39.8	96.9	202.1	10.2
2021/22	179.5	2,307.1	526.7	22.8	7.9	2,111.7	42.6	91.5	389.8	16.9
2022/23	57.8	2,562.1	561.2	21.9	2.3	2,169.5	41.1	84.7	544.5	21.3
2023/24	42.0	2,721.0	600.5	22.1	1.5	2,211.5	42.9	81.3	601.4	22.1
2024/25	127.9	2,859.9	662.8	23.2	4.5	2,234.9	41.2	81.8	576.1	20.1
2025/26	97.6	3,002.9	693.6	23.1	3.2	2,437.0	45.2	81.2	641.2	21.4
2026/27	80.7	3,153.0	745.1	23.6	2.6	2,517.7	49.2	79.9	713.6	22.6
2027/28	63.8	3,310.7	804.9	24.3	1.9	2,581.5	53.2	78.0	794.3	24.0
2028/29	42.7	3,476.2	869.7	25.0	1.2	2,581.5	57.1	75.5	884.0	25.4
2029/30	17.4	3,650.0	940.4	25.8	0.5	2,641.6	60.9	72.4	983.9	27.0
2030/31	-13.4	3,832.5	1,017.4	26.5	-0.3	2,628.2	64.4	68.6	1,095.1	28.6
2031/32	-50.4	4,024.2	1,100.9	27.4	-1.3	2,577.9	67.6	64.1	1,218.9	30.3
2032/33	-94.5	4,225.4	1,191.6	28.2	-2.2	2,483.3	70.4	58.8	1,356.6	32.1
2033/34	-147.0	4,436.6	1,290.1	29.1	-3.3	2,336.4	72.8	52.7	1,509.9	34.0
2034/35	-209.1	4,658.5	1,397.0	30.0	-4.5	2,127.3	74.4	45.7	1,680.5	36.1

According to the Regional Model (Table 4), the extra growth is more than double what is assumed in Table 5, implying even stronger finances, with growth in the North nearly 3% pa. higher than base and in the South, about 2% higher, and the North-South gap reduced by 8% over the decade.

To look at this another way, our Regional Model implies that we could achieve the same growth outlook assumed in Table 6 at just a third of the fiscal cost in tax cuts and higher spending; that would mean that by 2035 the debt ratio would have fallen to 32% of GDP.

Conclusions: low taxes boost growth and make all round sense for the economy

In spite of all this, some voices have been raised recently to urge tax rises and expenditure cuts by the government to push down the high post-COVID public debt/GDP ratio rapidly; these voices are dominant in UK official circles, led by HM Treasury, and as we have seen have led to substantial announced tax rises.

However, for the long-term good of the country fiscal policy should now focus on boosting growth, particularly in the 'Northern' regions outside the relatively prosperous South.

As we have seen, our research implies that reversing the announced tax rises and instead embarking on a bold package of tax cuts and targeted spending on infrastructure will boost growth across the country, but particularly in the North, reducing the North-South gap, and will also pay for itself through its long-term effect on the public finances.

According to our Regional Model, to get these growth effects the package adopted need only be a third of the size I have set out above.

The Chancellor, Rishi Sunak, claimed in his budget that there was a 'morality' behind low taxes and controlling the size of the state. Nevertheless, his plans push up the prospective UK tax take to over 36% of GDP, while projecting real growth of public spending of 3% per annum.

His reasons for the spending rises are simply plain politics: the government needs them to satisfy public opinion on the requirements of the NHS and other key public services, plus the levelling-up agenda.

His reason for raising taxes was to satisfy short run budget rules on borrowing. The latest form the 'rules' have taken is that the current budget must be balanced over the forecast horizon.

These rules, to repeat, make no sense. The government on behalf of the people it serves must simply obey the arithmetic of the government budget and so be solvent, which means that it must commit to raising in future taxation sufficient in present value to pay the interest on its debts; in practice it means that the public debt ratio will come down in the long term to a safe level.

It can do this in numerous ways; there is nothing that compels it to balance the current budget at any pre-set point in time. As I have shown above, there is a baseline downtrend in the debt ratio.

Furthermore, lowering taxes boldly would increase growth and push that trend down further. So there is no case for raising taxes now that is based on solvency considerations.

However, the Treasury, backed by the OBR, has pushed the government into raising taxes prematurely. The Chancellor says he aims to cut them later. But by then the damage to growth will have been done.

Better to support growth now through low taxes. That is best both for the economy and the public finances in the long run. ■

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Endnotes
1. Covid19 Cost Tracker update - https://committees.parliament.uk/publications/6953/documents/72750/default/
2. Written up in http://carbsecon.com/wp/E2020_14.pdf