Don’t rush, get it right

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Tread carefully, advises ***Dean Turner****. There is plenty of time to fix the public finances without resorting to urgent tax rises or swingeing cuts in spending.*

Arguments about what actions the government took to lessen the economic impact of the pandemic will rage for years. But it was right to allow spending to soar to fund the NHS and promote vaccine research. It was also right to support businesses small and large and, crucially, support the income of workers whose jobs ground to a halt as lockdowns hit. The largest peacetime budget deficit ever recorded is a small price to pay given the alternative.

It would be wrong to think that this level of fiscal support can continue. With recent evidence suggesting the economy fared better than feared through the latest phase of lockdown, the worse has been avoided but a likely budget deficit of around 5% of GDP when the dust settles will still need tackling.

The immediate options are clear: spend less, or tax more. Tomes have been written since the global financial crisis about the consequences of cutting spending, and its impact on the speed of economic recovery, investment, and job creation. What these well-versed arguments sometimes overlook is arguably a more concerning legacy of this period—rising inequality.

Given of the hit to demand for goods and services, a legacy of rising inequality, and structural upheaval facing the economy from a fourth industrial revolution, further cuts to spending are not the solution. Which leaves taxes.

The Chancellor is looking closely at this, but he needs to tread carefully, or he risks doing more harm than good. The UK tax revenue base is concentrated—just under two-thirds comes from income tax, national insurance, and VAT. Raising £5 billion is easily achieved by putting a penny on the basic rate of income tax; this rises to £6 billion if 1% is added to VAT. But this would have a direct hit on consumption at a time the economy needs it most.

Modest raises to corporation tax by a small amount could be considered, although this accounts for less than 7% of total tax take. Beyond this, a greater emphasis is needed on levelling the playing field for individuals, businesses, and ensuring that online and overseas firms pay their fair share.

The trends of the fourth industrial revolution are already well established—just look at how our working and shopping habits have changed over the past year. Distortions in the income tax system, where salaried employees end up paying more than self-employed workers, is one area. With self-employed workers comprising roughly one-sixth of all employees and likely to grow, the case for this discrepancy is waning. Another area to look at is the way we tax digital companies, something that will require international coordination to remove the disadvantage that is currently placed on traditional businesses.

Wealth taxes, or property taxes, are another option, but can be a double-edged sword. Blanket levies on wealth will raise revenue, but they may hit some who can least afford it. For example, pensioners who have lived in their houses for 40 years or those who are cashflow poor If wealth taxes are set too high, they will also discourage entrepreneurs and starve the UK of much-needed investment.

We need to raise more revenue to return the budget to a sustainable footing, but carefully, and gradually, with consideration for the long-term needs of the economy.

It is not just the budget deficit that draws attention; so does total UK government borrowing which is almost certain to soar above 100% of GDP. Much like the budget deficit, the peak in debt/GDP is likely to occur this year before improving in 2022, largely driven by a growing economy.

When debt is high, a common concern is the fear that investors will be less willing to, or will demand a higher price for, lending to the UK. This argument is valid. To be sure, if this ratio were to keep on growing, there could theoretically come a point where investors refuse to lend the UK money. However, nobody knows where this threshold is. In comparison to its peers, UK does not look particularly out of line here.

More important than total borrowing is the cost of debt servicing. Interest rates globally have fallen, and there seems little prospect that they will rise dramatically soon. As a share of government revenues, the UK pays a little over 4% in interest costs, around the same as the decade before the financial crisis, when debt/GDP averaged around 40%. Therefore, there is little pressure on the government to reduce borrowing.

It is better to instead focus on policies that can boost the denominator in this equation—nominal economic growth. Debt ratios rise and fall through every cycle, but rarely because governments repay debt. If a government enjoys a budget surplus, or one that is close to balance, it will borrow less as a share of GDP in the future as an when its existing liabilities come due. Put simply, for as long as the growth of new borrowing in nominal terms doesn't exceed that of the economy, then the ratio falls.

Although the state of the public purse is currently unsustainable, there should not be an immediate rush to fix it. Austerity is not the answer. Raising taxes in the future will help, but even here the message is to tread carefully. Arbitrarily raising taxes could reduce investment and spending in the UK; what is needed is a strategic focus on strengthening the tax base, making it more sustainable and fit for the future economy.

The other key thing that is needed is time. The good news is that in a low interest rate world, there is an abundance of this. The shock to public finances we have seen over the last year is, we hope, a once-in-a-generation event; repairing the situation should also be viewed in this context. Attempting to do so sooner risks creating further economic harm, making the job even harder.

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