Fiscal principles for the future

By Gerard Lyons, Dr Graham Gudgin, Warwick Lightfoot and Jan Zeber

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Contents

A. Executive Summary

***In the Overview, in Section B, Gerard Lyons outlines some of key messages*.**

- In the face of a global health and economic crisis the UK's generous fiscal response is both necessary and justified. We felt the Chancellor got the balance right between difficult policy choices ahead and remaining alert about the size of the debt. It is right to use fiscal policy as a shock absorber, to avoid premature tightening and to direct spending towards capital investment and public services. The main focus has to be on a pro-growth agenda that reduces unemployment and allows the economy to recover.
- Although the ratio of debt to GDP is set to rise in coming years this should not prove onerous to service by historical standards and can then be reduced gradually over time.
- Take advantage of crisis levels of yields to issue very long-dated debt. Perhaps issue new National Infrastructure Bank bonds.
- Economic policies have to be judged in the economic context of the time, and not set on a pre-assigned trajectory.
- Premature fiscal tightening should be ruled out.
- Greater control over future public spending is necessary.
- We have concerns regarding the current debate about future taxes. While taxes are needed to support public services, in a globally competitive world they need to remain low enough to spur investment, innovation and growth.
- How to bring the public finances back into shape has started to emerge recently as an issue, with, it should be said, the chorus calling for higher taxes as the solution coming to the fore. Higher taxes are not the route we favour; policymakers should instead be aiming for stronger sustainable growth.
- We advocate replacing fiscal rules with some principles to guide future policy and we outline ten such principles.

***In section C, Jan Zeber examines the fiscal arithmetic*.**

- One of the most important considerations involved in judging the Government's fiscal position is the cost of debt servicing – as well as its growth trajectory. Debt interest on central Government debt is forecast to fall from £36.7bn in 2019-20 to £23.5bn in 2020-21.

In section D, Warwick Lightfoot discusses public expenditure in a historical context.

- Advanced economies have increased public spending to the point where their marginal benefits do not match the cost of resources deployed.

Section E contains Dr Graham Gudgin's detailed analysis of the OBR's forecasts.

- What the OBR does not say explicitly is that a high proportion of government debt will be held by the Bank of England's Asset Purchase Facility (APF) and hence within the public sector.
- The OBR projections have characteristically been greeted by the media as if they were accurate predictions of the future path of the UK economy. In fact they are, as always for the OBR, in large part assumptions and should be treated as such.
- The OBR always assume a return to a long-term trend over three or four years, but in this case they assume that the long-term trend has itself been undermined by so-called 'scarring'. This may or may not happen and measures should be taken to offset potential scarring.

Section F outlines ten principles to guide future fiscal policy.

In Box A, Warwick Lightfoot looks at issues and principles covering taxation.

Section G contains concluding remarks.

B. Overview

by Gerard Lyons

The focus of this paper is on UK fiscal policy in the wake of this week's Statement by the Chancellor and the latest official forecasts from the Office for Budget Responsibility (OBR). They confirmed what we already knew: that the economy has been hit hard; that unemployment is set to rise; and that the fiscal cost from the pandemic and the approach taken to address it is considerable. But what comes next is key. The Chancellor said that the economic emergency has only just begun. He could equally have said that the economy is set to grow strongly next year and in 2022 – and that, supported by the right strategies, future growth can be strong and sustainable. Then, as the economy recovers, we will reduce the debt overhang far quicker than is appreciated.

One clear message, in our view, is the need for a pro-growth economic strategy.

Earlier this year we called for a three-arrowed pro-growth strategy, one arrow focused on monetary and financial stability; one on fiscal policy; and the third on the supply side of the economy, aimed at boosting the UK's competitiveness through innovation, investment, infrastructure and incentives of lower taxes and smart regulation.[1] In turn, this would boost prosperity and reduce inequality.

Economic policies should be judged in the economic context of the time, and not be based on a pre-assigned trajectory.

In the face of a global health and economic crisis the UK's generous fiscal response to the pandemic and its economic impact has been both necessary and justified. We felt the Chancellor got the balance right between difficult policy choices ahead and remaining alert about the size of the debt.

It is right to use fiscal policy as a shock absorber to avoid premature tightening and to direct spending towards capital investment. Alongside a sizeable increase in infrastructure spending, the annual investment allowance was extended and a new National Infrastructure Bank is to be formed. The main focus now, as we emerge from the health crisis, has to be on a pro-growth agenda that reduces unemployment and allows the economy to recover. This will allow the ratio of debt to GDP to be reduced gradually over time.

The crisis has highlighted the interdependency between monetary and fiscal policy, both in the UK and globally. One reflection of this has been the increasing size of central banks' balance sheets, and their purchase of government debt. The Bank of England, for instance, has bought in the market about half the government bonds issued since this crisis began.

1. Lyons G, Lightfoot W, Zeber J, 'A pro-growth economic strategy', *Policy Exchange*, 4 June 2020, https://policyexchange.org.uk/publication/a-pro-growth-economic-strategy/

One worry is that the fiscal numbers may be vulnerable were growth to disappoint, or if inflation were to soar. Currently, low inflation, rates and yields make it easy to finance this debt. Of course, there is every likelihood that growth will rebound strongly next year, if a vaccine becomes widely available, as alluded to in the OBR's upbeat scenario. This would be helped by the monetary and fiscal stimulus in the pipeline and also by a rebound in confidence; personal savings, for instance, are high. Despite this, unemployment will be high, reflecting that some sectors and many firms have been hit hard. The inflation outlook, meanwhile, needs to be assessed closely but is expected by the OBR to remain low.

We would highlight the following:

- A longer-term focus is needed when assessing the UK's current fiscal position. The ratio of debt to GDP should be reduced gradually, over time, and that requires a pro-growth economic policy as the mainstay of policy – balancing the budget should not be the aim of policy but it would be the consequence of a successful policy that sees economic growth recover. Yet allowing the debt to GDP ratio to rise significantly during the crisis is one thing, but it is important to ensure it does not escalate out of control and is reduced, credibly and sensibly, thus keeping financial markets onside over time. Once the economy has started to recover, the debt to GDP ratio will peak and then the budget gap should be closed, ideally through higher tax revenues as the economy recovers.
- **Take advantage of crisis levels of yields to issue very long-dated debt** as the Government can fund itself cheaply. The expectation is that this low rate and yield environment will continue, but nothing can be taken for granted. The UK's maturity of debt is long, leaving it less vulnerable to shifts in interest rates and yields. But the UK should seek to lengthen its maturity of debt, and if, as we suspect, there is demand from funds and investors alike for such debt, then very long dated-debt should be issued. Perhaps, for instance, this could be thirty to fifty years, depending upon where institutional demand is expected to be. The Government announced the establishment of a new National Infrastructure Bank (NIB) this week. **Perhaps this could even trigger the issuance of new NIB bonds, whose yield would be attractive to funds**, and which could raise significant amounts to fund this infrastructure-focused new institution.
- **Economic policies should be judged in the economic context of the time, and not set on a pre-assigned trajectory.** Yet the ability to take advantage of policy flexibility in difficult times requires the need to return polices to something approaching balance in good economic conditions. **Unconventional monetary policy and unconventional fiscal policy have been the policy responses** to

the 2008 global financial crisis and the 2020 global health crisis. There is considerable economic uncertainty now. That helps explain the importance of using fiscal policy as an economic shock absorber and stabiliser. These unconventional policies are likely to allow UK and global growth to rebound strongly in the immediate years ahead. But, as our principles later in this paper outline, in good economic times, the government should aim to return the budget towards far better shape. That seems a long way away, but the longer-term term plans have to be linked to the economy's future growth potential. Likewise, the current picture of low inflation, rates and yields has allowed policy flexibility. There is always a need to be alert as economic conditions can change.

- **Premature fiscal tightening should be ruled out**. We are in a health and economic crisis. It is only once we have emerged from the health crisis that we can make inroads into the economic crisis, and once out of the economic crisis that we can make inroads into the overhanging public debt. Premature policy tightening should be avoided, and this was something to which the Chancellor alluded.
- **We support the stance taken in this Statement on public expenditure:** (a) Given the degree of economic uncertainty it made sense to unveil a one-year and not a multi-year spending review. (b) The Chancellor was right to avoid austerity, as **Government spending can play a vital role, in helping stabilise the economy** now and in achieving balanced future growth. In particular, public investment should rise, especially on R&D, as we emerge from this economic crisis. (c) The need for near-term flexibility on spending plans is understandable and is reflected in the political decision to freeze some areas of public sector pay, and to increase overseas aid spending by less than the pre-set target. (d) While we do not advocate austerity, **greater control over future public spending is necessary and is preferable to a free-for-all on public spending.**
- **We have concerns about the current debate surrounding future taxes.** (a) The Chancellor served notice that some taxes may rise in the future. We agree that the Chancellor should retain the flexibility to tweak specific taxes at any stage and not box himself in over future economic policy. The danger in announcing that tax rises have been delayed is that this may deter people from spending now, thus damaging the recovery. (b) In our view, tax-rises should be avoided during this stage of the economic cycle. (c) We also would challenge the view that the future trend for taxes is inevitably up. We disagree. The margin of error on one-year ahead fiscal projections is huge, never mind projections over decades. The key is the future trajectory of the economy. While taxes are needed to support public services, in a globally competitive world they need to remain low enough to spur investment, innovation

and economic growth.

- **Replace fiscal rules with principles to guide policy.** Fiscal rules are not needed but some principles may help guide future policy. We outline ten fiscal principles that should help guide fiscal policy, both now and in the future, as we emerge from this crisis.

The scale of the increase in government spending this year has, naturally, led to questions about how we will pay for the impact of, and response to, the pandemic and has triggered fears of higher future taxes and pressure for increased expenditure on other important areas. It is important for a clear plan to reduce the debt to GDP ratio in the future in a credible and understandable way; that the weakness of the economy has necessitated such spending; that the combination of low inflation, rates and yields has reduced debt servicing so much, to allow it; and that the consistency between monetary and fiscal policy is an important part of this policy mix. Key is that economic growth rebounds and that inflation does not soar. In coming years there should be scope to grow our way out of this fiscal situation, as we did after the Second World War, when the ratio of public debt to GDP was even higher than it is now.

C. The fiscal position in context

by Jan Zeber

There is no doubt that the scale of fiscal response to the Covid-19 crisis was unprecedented, and even now – given a huge degree of uncertainty about the future – further large-scale interventions cannot be ruled out, such as fiscal stimulus measures should demand remain subdued. The OBR forecasts provide the latest snapshot of where the fiscal and economic forecaster believes the 2020 fiscal interventions take expenditure, deficit and debt, and their implications.

The figures also give us a complete – if highly uncertain – snapshot of the full cost of Government measures since March 2020, and their impact on the overall fiscal position. While the headline figures are clearly unprecedented in the context of pre-coronavirus Government fiscal targets, it does not follow that we should draw the same conclusions as we would have done had we encountered these figures during normal times.

Table 1: The evolution of spending, deficit and debt projections since March 2020

	£bn 2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
March Budget							
Total Managed Expenditure	887	928	977	1,011	1,045	1,080	-
Public Sector Net Borrowing	47	55	67	61	60	58	-
Public Sector Net Debt	1,799	1,818	1,827	1,900	1,969	2,031	-
July FSR							
Total Managed Expenditure	881	1,062	980	1,010	1,042	1,075	-
Public Sector Net Borrowing	57	322	154	132	123	116	-
Public Sector Net Debt	89	104	104	105	106	102	-
November SR							
Total Managed Expenditure	884	1,165	1,011	990	1,027	1,064	1,106
Public Sector Net Borrowing	56	394	164	105	100	100	102
Public Sector Net Debt	1,801	2,274	2,478	2,602	2,721	2,714	2,817

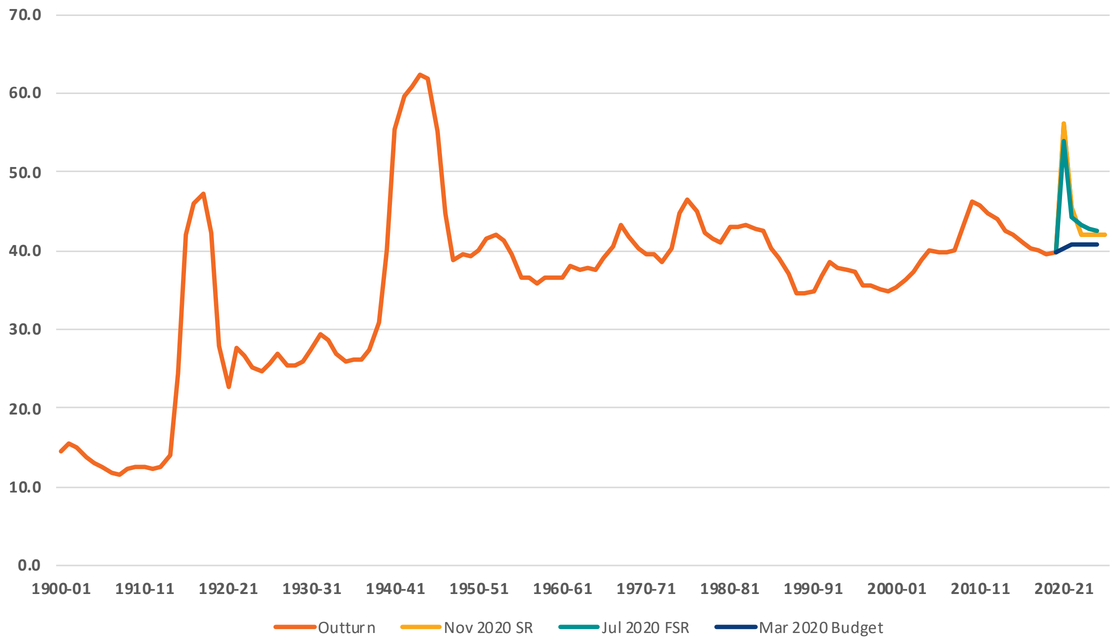
Source: OBR

Spending

According to the OBR, total public spending (as measured by Total Managed Expenditure) for the current fiscal year stood at £1.2tn. This is £237bn more than the OBR predicted the UK would spend just eight months ago. It is then projected to fall to £990bn in 2022-23, before rising again to £1.1tn at the end of the forecast period in 2025-26.

Viewed in historic terms, this takes state spending as a proportion of GDP to its highest for half a century. As temporary economic measures to deal with the Covid-19 pandemic are withdrawn, the level of spending falls rapidly, although it tails off at a higher level than envisaged by the March 2020 forecast – it should be pointed out that in cash terms, the OBR actually envisaged slightly higher overall debt in cash terms in 2024-25 on the March forecast than on the latest one.

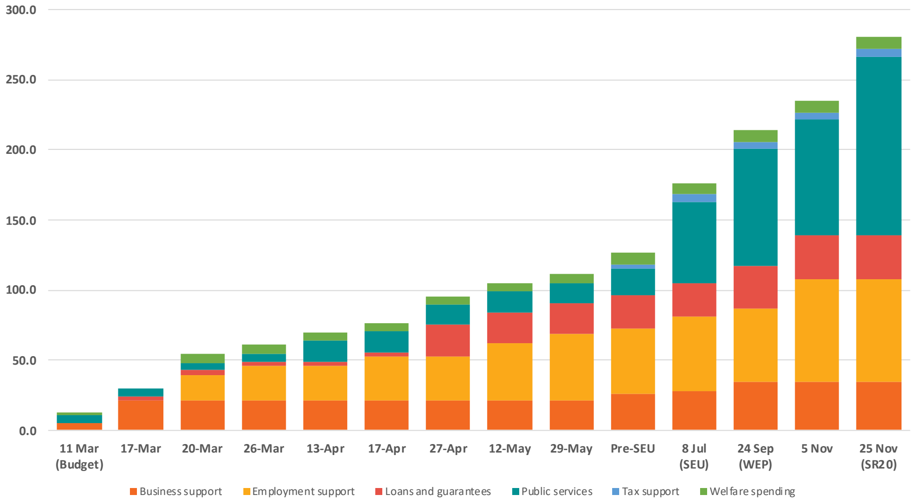
Graph 1: Public spending (TME) 1900-01 to end of forecast period (% GDP)



Source: OBR

The majority of that increase naturally went towards Covid-19 related measures. Cumulatively since March 2020 to date, the Government has spent a total of £34bn on business support measures, £74bn on employment support measures, £31bn on loans and guarantees, 127bn in additional funds for public services, 6bn on tax support and £8bn on additional welfare spending, **which comes to a total of £280bn spent of Covid-19 economic support measures since March 2020.**

Graph 2: Cumulative spending on Covid-19 economic measures since March 2020 (£bn)



Source: OBR

Looking more closely, the Government's flagship Coronavirus Job Retention Scheme (CJRS) – colloquially known as 'furlough' – is due to cost £54bn for the period March 2020 to March 2021. The Self-Employed Income Support Scheme – the labour market measure equivalent of the furlough scheme for the self-employed – is due to cost £20bn in total by the end of the third grant on 31 January 2021. Additional funding for public services rivals the employment support bill in its extent, costing £58bn in 2020-21. Against this backdrop, additional welfare spending such as an increase in Universal Credit (UC) seems relatively small at £8.3bn in total, with £6.4 accounted for the increase in UC in 2020-21. Whether UC is reduced next spring, as currently planned, remains to be seen. Also, it should be noted that the Treasury Select Committee has previously pointed out that, despite these generous schemes, a significant number of people were, for various reasons, excluded from receiving them, with the key factor being whether – at the point of the measures being introduced – one was in or out of employment.

Borrowing

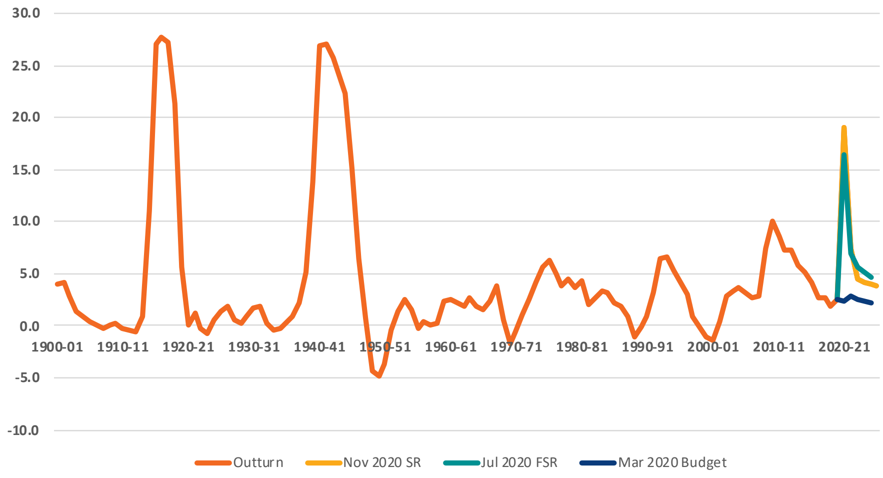
The resulting increase in public sector borrowing and debt is similarly significant. The latest deficit (measured by PSND) forecast for the current fiscal year is £394bn. This is £338bn higher than the pre-pandemic March 2020 forecast. It is then projected to fall rapidly, to £164bn in 2021-22, £105bn in 2022-23 and around 100bn at the end of the forecast period in 2025-26.

Comparing the last forecast period from the March 2020 Budget, the budget deficit is predicted to be £42bn higher – or 72% higher – in 2024-25 on the latest forecast than the OBR envisaged in March.

This is the '£40bn gap' (approx. 4% of GDP) in public finances to

which a number of economic commentators refer. Nevertheless, that level of deficit would not be unprecedented, considering the deficit peaks of the early 2010s or the mid-1990s. It would be premature – given the uncertain economic outlook – and, in our view, the wrong approach to take to conclude that such a gap would necessitate tax hikes.

Graph 3: Public borrowing (PSNB) 1900-01 to end of forecast period (% GDP)



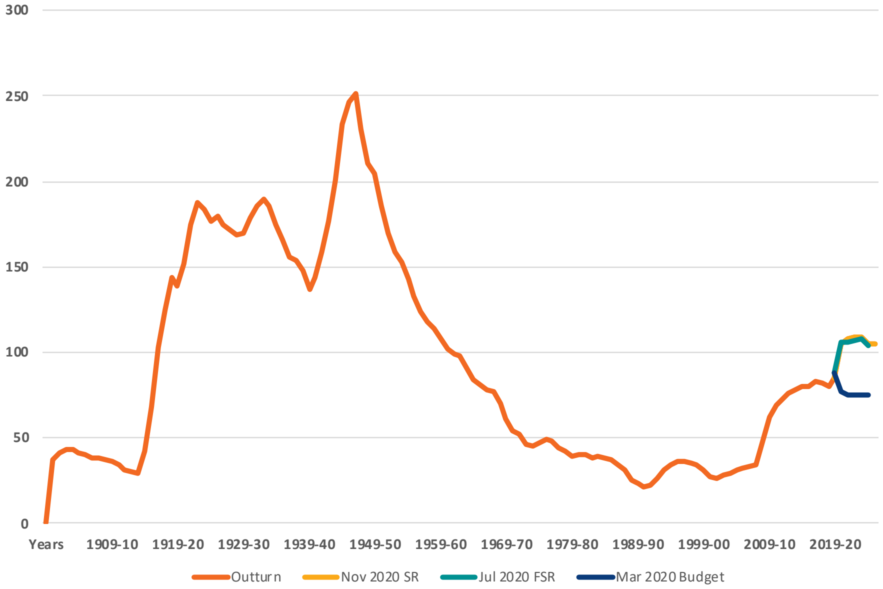
Source: OBR

Debt

Looking at the overall level of public debt, it is estimated to be around £2.3tn in this fiscal year, or 105% of GDP – £456bn higher than it was estimated to be at the beginning of the fiscal year in March. Unlike both the deficit and borrowing, it is not expected to fall in cash terms during this forecast period, rising to £2.8tn in 2025-26. In percentage of GDP terms, total public debt peaks at 109% of GDP in 2023-24, before – unlike the overall amount – falling back to 105% of GDP as the overall economic growth picks up.

Looking more closely at the end of March 2020 forecast period (2024-25), the gap between the March forecast and the current one rises to £683bn. Like the level of borrowing, it is expected to hit a peacetime peak.

Graph 4: Net debt (PSND) 1900-01 to end of forecast period (% GDP)

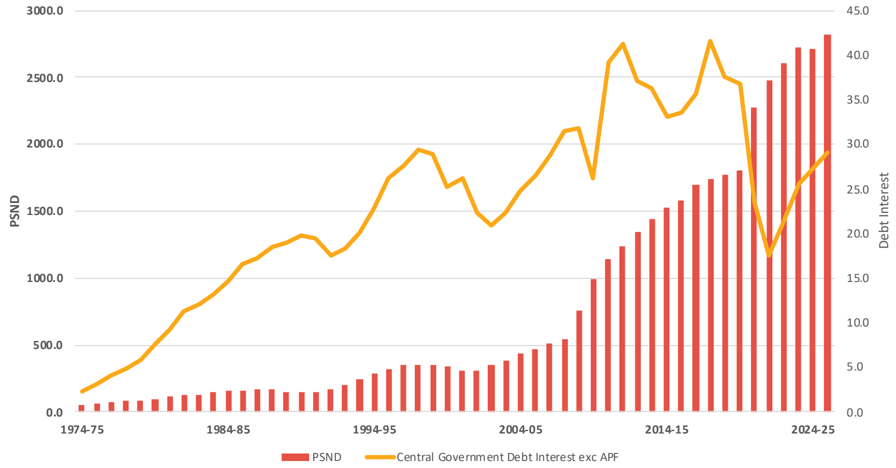


Source: OBR

One of the most important considerations involved in judging the Government's fiscal position is the cost of debt servicing – as well as its growth trajectory.

As the graph below shows, while net debt is forecasted to increase by £1bn between 2019-20 and 2025-26, debt interest is actually forecasted to decrease: while it stood at £36.7bn in 2019-20, for the OBR forecast period beginning in 2020-21 it is projected to be £23.5bn, £17.6bn, £21.2bn, £25.5bn, £27.3bn, and £29bn in 2025-26.

Graph 5: Public Sector Net Debt (PSND) vs Central Government Debt Interest net of APF, 1974-2025 (£bn)



Source: OBR

D. UK public expenditure in a historical context

by Warwick Lightfoot

This current picture, highlighted above, of rising public expenditure reflects a public expenditure challenge that has arisen, over time, in many modern advanced economies.

This arises from the huge expansion of the functions of the state through the 20th century, when universal welfare states were established and comprehensive social safety nets collectively provided important services in kind such as health, secondary education and significant parts of higher education, as well as smoothing individual and household incomes over the life cycle with transfer payments such as pensions.

The result was that by the late 1960s governments absorbed a much higher proportion of national income than they did before the First World War. The ratio of public expenditure within GDP rose from around twelve to fifteen percent to over a third. This big increase in the role of the state and public spending was accompanied by significant increases in social and economic welfare. Educational outcomes and health all improved and economic performance was enhanced. In the thirty years that followed, public expenditure as a ratio of GDP rose further across the OECD to average in the low to middle forty per cent.

This increase arose partly from inevitable costs associated with a maturing welfare state and an ageing demography, but it also arose from increased discretionary spending to address disappointing outcomes from the welfare state and as a result of rent-seeking behaviour from public sector interests and employees. By the 1960s it was also clear that many of the complex social pathologies that policy had been expected to eliminate or significantly mitigate, such as cycles of intergenerational poverty, remained entrenched. The response by successive governments in the UK to address these challenges by higher public expenditure from the 1960s onwards yielded disappointing substantive results, yet contributed to a progressively deteriorating economic performance compared to the decades of economic growth that had followed the end of the Second World War.

Part of the explanation lies in diminishing marginal returns. As more is spent, the effect of the additional marginal pound spent is lower. Economists have noticed this in relation to infrastructure investment. In an economy with few good road and rail connections a basic network of highways and railways will yield significant returns, whereas in an advanced economy that has an extensive transport infrastructure a marginal increase in the road and rail network will result in relatively fewer identifiable benefits.

The result is that advanced economies have increased public spending to the point where their marginal benefits do not match the cost of resources deployed. This dynamic is aggravated given that most governments do not take account of the deadweight costs of public expenditure. The full economic cost of public spending is greater than its cash cost given the distortions to economic activity that arise from its cost of finance in terms of the way in which the incentives of economic agents are modified.

Once economies begin to spend more than around two-fifths of national income through the public sector on a permanent or structural basis they encounter an opportunity cost that begins to crowd out the private sector. This slows the future growth of the private sector and limits the future growth of the tax base to finance higher spending as the economy grows. In an environment of reliable economic growth there is therefore a trade-off between public spending to-day and less economic growth and relative less growth in spending on public services in a future economy that will be relatively smaller than otherwise.

When the economy is growing, decisions about the relative size of the public sector are more manageable. This is regardless of whether the political objective is to increase public spending and the role of the state or to reduce it. In the 1960s and 1970s Anthony Crosland argued that future economic growth could be allocated to the public sector and the pursuit of an egalitarian political agenda while not impinging on the private living standards of the newly mass affluent. In the same way radical Conservative Governments led by Mrs Thatcher were able to limit the scale of the public sector within national income without having to cut spending on things such as health, education and social security absolutely, and indeed such spending actually rose. Economic growth avoids zero sum political choices. This is an important lesson for coming years.

In an environment of slow growth or complete stasis or stationary state of the sort explored by classical economists, choices about spending are more explicit and politically difficult.

A programme to engineer a structural increase in the level of UK public expenditure decisively on a permanent basis by several percentage points of national income would involve replacing private spending on consumption and investment undertaken by private households and firms with higher public spending. In the context of a growing economy this would mean slower future economic growth and the proceeds of economic growth being allocated to the political priorities of the state with no change or growth in private living standards.

Crucially, however, in the context of a static economy it would involve the reduction of private consumption and spending. It would not involve an obvious future cost in terms of slower economic growth leading to a relatively smaller economy than otherwise. However, the explicit transfer of resources from the private sector to the public sector would be challenging, not least in terms of the efficient use of resources.

E. An assessment of the OBR's forecasts

by Graham Gudgin

The current year, 2020, has been the most difficult and economically disastrous of several centuries. The Economic and Fiscal Outlook report (EFO) of the Office for Budget Responsibility (OBR) provides a good account of the impact of Covid-19 in 2020. This includes both the impact on the economy at large and on the public finances. The OBR also provide predictions for the next five years based on assumptions about progress in dealing with the pandemic medically, and about government measures to continue to offset the damage to the economy. Given the huge uncertainties, both medical and economic, these predictions must be viewed as little more than informed best guesses, but they do provide a guide for discussion about the economy over the next few years.

The OBR adopt three Covid forecast scenarios:

- *The **central scenario** assumes that: 'health restrictions depress activity over the winter, until the warmer weather allows an easing of health restrictions in the spring. Effective vaccines become widely available by the latter half of next year, permitting a gradual return to more normal life thereafter, although we assume that the virus has a lasting adverse impact on the economy'.*
- *In the **upside scenario** lockdown succeeds in bringing the second wave of infections under control and the rapid rollout of effective vaccines enables output to return to its pre-virus level late next year, with no medium-term economic scarring.*
- *In the **downside scenario** lockdown has to be extended, vaccines prove ineffective in keeping the virus in check, and a more substantial and lasting economic adjustment is required with economic activity only recovering to its pre-virus level at the end of 2024 and more substantial economic scarring.*

In the upside scenario, output eventually returns to its pre-virus trajectory, but in the other two scenarios output is left permanently scarred by the pandemic by 3 and 6 per cent respectively. All three assume a smooth transition to a free-trade agreement with the EU in the new year. The OBR also describe an alternative scenario in which the Brexit negotiations end without a deal. This would further reduce output, in their view, by 2 per cent initially and by 1½ per cent by 2025.

A summary of the actual and projected costs of the governments Covid-related expenditure is shown in the table below.

Total Covid-related spending is expected to be £280 billion in the current financial year and £53 billion in 2021-22 but minimal thereafter. The huge cost of Covid in this year is equivalent to one seventh of the UK's GDP.

Table 2: Covid-19 related spending decisions

	£ billion						
	Outturn Forecast						
	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Public services	0	127.1	58.8	-0.1	-0.3	0	0
Employment support	1.8	73.3	-2.5	0	0	0	0
of which:							
CJRS	1.8	53.7	0	0	0	0	0
SEISS	0	19.6	-2.5	0	0	0	0
Loans and guarantees	0	31.4	0.4	0	0	0	0
Business support	0.2	34.1	-6.5	0.6	0	0.1	0.1
Welfare spending	0	8.3	1.7	1.3	0.8	0.5	0.3
Other tax measures	-0.1	5.7	0.8	0.1	0.2	0.1	0.1
Total	**1.9**	**279.9**	**52.7**	**1.9**	**0.7**	**0.7**	**0.5**

The OBR's economic forecasts

Using data from the Office of National Statistics, the OBR estimate that GDP will fall by 11.3% in 2020 followed by a partial recovery up to 2023 and (slowish) trend growth thereafter. The GDP figure attempts to measure real activity. Activity has fallen dramatically in a range of sectors, notably including retail, catering and transport due to the two lockdowns and a public desire to avoid infection, and activity in health and education fell considerably due to school closures and the cancellation of operations and medical procedures. Unlike almost any previous recession, earnings and employment were largely maintained. This occurred through the furlough scheme and other government measures. While consumers were unable to spend as much, mainly due to lockdowns and fear of infection, households saved instead, and bank balances increased. Many of the nine million people on furlough accepted or even enjoyed the experience of enforced leisure and many did not greatly resent the delay in consumption. Delayed hospital operations have been an undoubted burden for those affected and permanent damage may have been done to children's education, although in both cases the long term effects depend on the extent to which schools and hospitals can make up for the losses over the next year or so.

To an extent, the government has been successful in mitigating the economic impact of the pandemic, albeit at the cost of a huge expansion of its borrowing. The question now is whether that success can be maintained. The figures below, based on the OBR's central scenario, suggest that GDP will only return to the pre-pandemic level by 2023 (to be precise by 2022Q4) but growth will not be sufficient to return to the pre-exiting growth trend. Public sector investment is planned to continue as intended prior to the pandemic, and business and household investment will recover, although huge uncertainties surround all of the forecasts for private sector activity.

Table 3: Overview of the OBR's central economic forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn	Forecast					
	2019	2020	2021	2022	2023	2024	2025
Output at constant market prices							
Gross domestic product (GDP)	1.3	-11.3	5.5	6.6	2.3	1.7	1.8
Household consumption	0.9	-15.1	7.5	9.7	1.7	1.2	1.5
General government consumption	4.1	-7.9	21.1	-3.8	1.2	2.4	2.0
Business investment	1.1	-18.1	1.2	13.7	9.7	6.2	4.6
General government investment	4.0	7.0	5.5	6.1	2.7	1.5	1.5
Net trade[1]	-0.2	2.8	-4.5	-0.3	-0.2	-0.4	-0.2
CPI Inflation	1.8	0.8	1.2	1.6	1.7	1.9	2
Employment (million)	32.8	32.7	31.9	32.2	32.7	33.1	33.2
Average earnings	2.9	1.2	2.1	2	2.4	3	3.5
LFS unemployment (rate, per cent)	3.8	4.4	6.8	6.5	5.4	4.5	4.4

The OBR expect that the pre-pandemic trend in GDP will not be recovered, at least within their forecast horizon of 2026. The reason for this is what is termed 'scarring' or permanent damage to the supply capacity of the economy. The main contributor to lower real GDP is a 2-percentage point scarring effect on productivity, with smaller contributions coming from a smaller population (due to lower migration), lower labour force participation and a slightly higher equilibrium unemployment rate.

The OBR state that scarring can arise through a variety of channels:

- deferred or cancelled investment in physical capital and lower innovation as a result of the heightened uncertainty and increased levels of debt incurred during the pandemic;
- the destruction of valuable firm-specific capital and knowledge arising from business failures;
- a loss of human capital due to sustained unemployment as the economy restructures away from contact-intensive sectors;

- earlier retirement from the labour force prompted by the pandemic; and
- increased loss of days worked due to sick leave as it becomes unacceptable to turn up to work showing virus-like symptoms.

The pandemic could also generate some lasting positive effects. For example, the accelerated adoption of new technologies could bring forward productivity gains, as could the more rapid shift from physical to online retailing and towards a cashless economy. But the OBR judge it unlikely that such benign consequences will outweigh the adverse effects.

The OBR are clear about the difficulties of estimation in this respect. *'The degree of scarring will be affected by how quickly the virus is brought under control, the pace of the recovery, and the effectiveness of policy in keeping workers attached to employers and viable firms in business. Many of the Government's measures have been designed to minimise avoidable scarring. But it is difficult to know how large such scarring effects will prove to be as there is little relevant historical experience to draw on'.*

The OBR's long-term scarring effects are based on external estimates[2] and in particular the IMF projections of scarring at between 3 and 6 per cent of GDP below its pre-virus trend in the medium term. Official forecasts for other European countries also assume similar levels of output loss. The Bank of England assume a somewhat lower degree of scarring, at around 1¾ of potential GDP, though that does not incorporate any long-term impact from changes in how people work in the future[3].

he OBR use a 3 per cent virus-related scarring assumption for their central scenario (and 6% for the lower scenario). This is calculated as follows:

- Lower productivity accounts for 2 percentage points of the pandemic-related hit. In the short term, this is related to the immediate need for businesses to organise production in less efficient ways so as to meet social distancing requirements. This eventually eases but is replaced by the cumulative effects of depressed investment and capital scrapping on the capital stock, overlaid by the effect of higher business debt and an increase in business failures on innovation and total factor productivity.
- The pandemic discourages migration, a temporary fall in net inward migration and a consequent reduction in the size of the population. That lowers potential output by 0.2 per cent relative to our March forecast. Operational challenges implementing the new points-based immigration regime following the end of the Brexit transition period could also impede inflows.
- Participation rates will be lower as some older workers are likely to decide to retire earlier as a result of the pandemic. The decline in hiring during the pandemic is also likely to discourage unemployed people from actively seeking work. While most of these should re-enter the labour market when conditions improve, some may not. Reduced inward migration will also lower participation

2. See: J. Portes, "The lasting scars of the Covid-19 crisis: Channels and impacts", VoxEU, June 2020; R. Hughes et al, *Doing more of what it takes*, Resolution Foundation, May 2020; and C. Lenoel & G. Young, "Prospects for the UK Economy", *National Institute Economic Review*, April 2020. T. Pujol, *The long-term economic cost of Covid-19 in the Consensus Forecasts*, Covid Economics (44), August 2020
3. "The Potential long-term effects of Covid", Speech by Dave Ramsden at the Institute for Policy and Engagement, University of Nottingham, November 2020.

as migrants are more likely to be in or seeking work. We have assumed that these effects together lower potential output by 0.5 per cent at the forecast horizon.

- The structural unemployment rate is likely to rise for a while due to permanent behavioural changes prompted by the pandemic (such as more working from home, less business travel and the shift to online retail) that require labour to shift across occupations, sectors and regions, compounding the restructuring necessitated by Brexit.

Labour Markets

The OBR state that '*the effect of the pandemic on the labour market has been dramatic. But the presence of the Government's support schemes, especially the CJRS, means that the adjustment to the collapse in output has been markedly different from that seen in previous recessions, when the fall in total hours worked was split roughly equally between heads and average hours worked. On this occasion, firms have furloughed employees rather than cut jobs and average hours have cratered instead*'.

Projected changes in unemployment are based on assumptions. In the central scenario the OBR assume that '*the structural unemployment rate rises to around 5.5 per cent in the second quarter of 2020 and then gradually falls back as reallocation takes place, reaching 4.4 per cent at the forecast horizon, up from 4.1 per cent in March. That small increase reflects the fact that it can take a long time for some unemployed workers to retrain or relocate appropriately. This reduces potential output relative to March by around 0.3 percentage points by 2025*'.

These estimates must thus be taken with a large pinch of salt. Up until today the Chancellor has acted flexibly, introducing new schemes or extending existing schemes as necessitated by the progression of the pandemic and by official regulations to deal with the spread of infection. The OBR necessarily work within the context of current and planned government policies, but these policies are likely to evolve in the light of events. If the closure of businesses begins to accelerate, and the number of unemployed begins to escalate, it is reasonable to expect that further extensions of existing schemes will occur. As we suggest below, we do not believe that the constraints imposed by public sector deficits and debt are serious enough to prevent such actions.

Nonetheless, we can expect some rise in unemployment. Significantly, the number of company closures has fallen by 40% from pre-pandemic levels and we must assume that furlough schemes, low-cost loans and deferment of taxes and other payments have all saved companies which might otherwise have failed, even in the absence of a pandemic, from going under. The inevitable unwinding of these schemes and the need to repay loans will naturally mean that many of these firms will finally succumb to financial pressures and close their doors. A surge in closures is likely to be interpreted as a consequence of Covid but much of it will be the delayed impact of normal events.

Fiscal Projections

Aside from expenditure directly on Covid-related economic measures the November Spending Review reported some planned cuts to expenditure relative to previous plans. These amount to £12-14 billion over the forecast period and include a £4 billion reduction in foreign aid and a wage freeze for public sector workers except those in the NHS. Public sector wages will however increase by 1% per annum for public sector employees on or below the median wage. Total managed expenditure is planned to remain at close to 42% of GDP after the Covid-related spending is expected largely to have ceased. This allows for a rise in infrastructure spending which is still planned to remain close to the 3% of GDP promised in the 2019 Conservative manifesto. Expenditure is also planned to rise for health and defence.

The problem is that government receipts are expected to grow slowly in an economy scarred by the pandemic. Even with current receipts at a relatively high level of 38% of GDP, government net borrowing is expected to remain close to £100 billion (close to 4% of GDP) into the middle of the current decade. With nominal GDP expected to grow at 3-4% per annum, net borrowing at this level will allow a small reduction in public sector net debt but not by much. The OBR expect public debt in 2025 to be as high as in 2020 at 105% of GDP.

Table 4: Overview of the central fiscal forecast

	Percent of GDP						
	Outturn	Forecast					
	2019	2020	2021	2022	2023	2024	2025
Public sector current receipts	37.3	37.3	38.2	37.7	38	38	38.1
Total managed expenditure	39.8	56.3	45.6	42.1	42.1	42	41.9
Current budget deficit	0.6	15.1	4.6	1.5	1.2	1.1	1
Public sector net investment	1.9	3.9	2.8	2.9	2.9	2.9	2.8
Public sector net borrowing	2.5	19	7.4	4.4	4.1	3.9	3.9
Public sector net debt	85.5	105.2	108	108.6	109.4	105	104.7
Public sector borrowing (£bn)	56.1	393.5	164.2	104.6	100.4	99.6	101.8

Bank of England

What the OBR does not say explicitly is that a high proportion of the government debt will be held by the Bank of England's Asset Purchase Facility (APF) and hence within the public sector. Currently the APF holds 27% of public sector net debt and 37% of government bonds (gilts). Under an arrangement since 2011 the APF returns most of the interest on bonds to the Treasury in the form of a dividend. In addition, with interest rates at very low levels the total interest paid by the government on its debt is low at close to 1% of GDP through to 2025. This compares with 17% in 2019/20 and a range of 2-3% of GDP in the decade following the banking crisis of 2008.

Although the government debt is large by the standards of pre-Covid decades and compared to the Maastricht limit of 60% of GDP, it is thus eminently affordable as long as interest rates remain low. Currently the Bank rate is effectively zero at 0.1% and the yield on 10-year gilts is at a rock-bottom 0.3%. The OBR expect interest rates to rise a little by mid-decade (to 0.4% for short rates and 0.8% for the gilts average) but not by enough to significantly raise the government's cost of borrowing.

To conclude, the OBR projections have characteristically been greeted by the media as if they were accurate predictions of the future path of the UK economy. In fact, they are – as always for the OBR – in large part assumptions and should be treated as such. The OBR always assume a return to a long-term trend over three or four years, but in this case they assume that the long-term trend has itself been undermined by so-called 'scarring'. In their central scenario they assume that future growth will remain permanently 3% below the previous trend. This may or may not happen and measures should be taken to offset potential scarring.

Even if the recovery from 2021 does prove to be incomplete and public sector debt remains over 100% of GDP, we do not regard this as a reason to raise taxes or to reintroduce austerity. First, interest rates are very low and likely to remain quite low, leading to low costs of government borrowing. Secondly, a substantial part of public sector debt is held not by UK or foreign private sectors but by the Assets Purchase Facility which is a branch of government. Interest on government bonds held by the APF is largely returned to the Treasury, again reducing the burden of debt.

The potential problem lies in the longer term if inflation, and hence interest rates, begin to rise to higher levels. However with perhaps a third of government bonds still held by the APF in the second half of the current decade, it is unlikely that the interest costs would rise above even the amount experienced in the aftermath of the banking crisis. The question then is whether a future government sets a priority on reducing public sector net debt from its mid-decade level of 105% of GDP or around 75% of GDP net of APF holdings. It is easy to suggest that debt reduction should not be a priority and certainly not at the cost of renewed austerity, and hence that there should be no downward pressure on economic growth. The debt can be left to subside slowly as the economy grows, as happened in the aftermath of the Second World War, or, as is currently happening in Japan, where the debt to GDP ratio is in excess of 200%.

F. Ten principles to guide future fiscal policy

by Gerard Lyons

The UK has had a plethora of fiscal rules over recent decades. All have been unveiled with varying degrees of fanfare by different Chancellors but none have stood the test of time. The UK needs to avoid fiscal rules that both lack credibility and impose unnecessary constraints on future policy. In a similar way, political commitments to not raise taxes or to commit to pre-set spending targets, often made in election campaigns, can impose unnecessary constraints that lack economic credibility.

Instead, we would advocate some fiscal principles. These should allow maximum flexibility for policy while allowing a credible policy framework that is clearly understood.

Principle 1: Governments should aim for the public finances to be in good shape to cope with future shocks

If interest rates and yields stay low for some time, then the pressure to reduce the budget deficit is reduced. That is the reality of the situation. That being said, and as noted above, the economic outlook could change. In view of this, a degree of prudence needs to be factored into policy thinking, but not in isolation from the other principles below, particularly the need for flexibility.

In the wake of this crisis one issue in the policy debate is likely to be about how much room there is for policy manoeuvre, were the economy to be hit by another shock. We have now suffered two extreme shocks: the 2008 global financial crisis and this global health crisis. Thus, at an appropriate future time, aiming for this principle should be a legacy of this crisis – but it seems likely to be so far off in the future that it is unlikely to gain traction.

The first principle is the economic equivalent of fixing the roof when the sun is shining. It is, though, not clear whether this should be to run budget surpluses, or, at the very least, run low deficits in times when the economy is in good shape, growing solidly. The UK has run only six budget surpluses since 1970. This highlights the challenge, as there is little political appetite to run surpluses, or even, sometimes, small deficits.

Principle 2: Fiscal flexibility is necessary

Fiscal policy can – and should – play an important and necessary stabilising economic role. If governments fail to run budget surpluses in good times, or have low budget deficits, it means that they are already at a disadvantage if an economy either slips into recession or weakens – or is hit by an economic shock as during the global financial crisis or this pandemic. Both crises have highlighted the importance of fiscal flexibility and of a counter-cyclical fiscal policy. As an economy enters recession, people and firms avoid spending, which then puts the onus on governments to act in a counter-cyclical way – spending when both the economy and demand are weak.

Principle 3: Fiscal policy must be judged in the context of the time

A large budget deficit during normal economic conditions is very different to one now, during a crisis. The combination of low inflation, rates and yields provides governments, in the UK and elsewhere, with increased room for policy manoeuvre at the current time.

The Government has ruled out austerity. That does not, or at least should not, mean a free-for-all on public spending, but control of it is needed. It has, however, fed a view that taxes will have to rise – perhaps sharply. This latter view has been fed too by the belief that Britain's ageing population points to the need for a necessary upward rise in the tax take. We disagree.

The decade since the global financial crisis has seen unconventional monetary policies in the UK and across the globe – with policy rates close to zero, borrowing yields low, and central banks' balance sheets bloated, through quantitative easing. While central banks are doing even more during this crisis, the pandemic has highlighted the effectiveness of fiscal policy.

Principle 4: Take advantage of low borrowing rates to fund the deficit with debt of as long a maturity as possible

One response to the present circumstances is that the UK Debt Management Office should, in our view, issue much longer-dated debt. The appetite for sovereign debt is currently high. This includes new green sovereign bonds, to support the UK's commitment to the green agenda and a net carbon zero economy by 2050. Prior to this crisis the maturity of UK debt was around sixteen years, which is high by international standards. The longer the maturity of debt the less susceptible the finances are to changes in interest rates. After all, the external environment is uncontrollable, and while it may be possible to forecast it, it can change unexpectedly. This factor means it is important to remain alert about high debt levels. In the present context, the UK should determine, if possible, what the appetite – among domestic and global funds – is for very long dated debt, and to issue for maturities as long as possible, even fifty or a hundred years if that were seen as credible. If such an appetite exists then we think it should be seized. Yields would be higher than on shorter-maturity debt, but are unlikely to be that high in current circumstances.

Principle 5: Avoid pro-cyclical fiscal policy

Although this is always important it is particularly relevant now. At a time of a large deficit and high debt, as now, there may be pressure to tighten fiscal policy when it is not appropriate to do so. Premature fiscal tightening must be avoided, and indeed the Chancellor alluded to this, this week. It fits with the need to allow the economy to return to a much sounder footing. This means ruling out tax increases or large-scale spending cuts. It is not necessary to balance the budget all the time. But deficits need to be closed. Many routes can be cited to achieve this, including a squeeze on government spending or higher taxes.

Our preference is to avoid tax increases, keep a firm control over public spending and to grow the economy and in the process boost the tax take so that this closes the budget gap.

Principle 6: There should be a focus on debt and debt servicing in the present time

The ratio of debt to GDP has exceeded 100%, which as noted earlier is the highest since 1960, when the ratio was still falling in the wake of the Second World War. It has been boosted by Bank of England asset purchases. In his speech this week, the Chancellor stated, "*Underlying debt – after removing the temporary effect of the Bank of England's asset purchases – is forecast to be 91.9% of GDP this year. And due to elevated borrowing levels, and a forecast persistent deficit, underlying debt is forecast to continue rising in every year, reaching 97.5% of GDP in 2025-26. High as these costs are, the costs of inaction would have been far higher. But this situation is clearly unsustainable over the medium term.*"

The post-war lesson is still relevant now. Then, the ratio of debt to GDP reached around 260% and was subsequently reduced, gradually, based on higher nominal growth in GDP, alongside what has been called financial repression, with rates low. The important point was that with the right domestic economic strategy – and higher growth – the debt ratio could be reduced without destabilising the economy or spooking the markets. It also feeds directly into the next principle.

Principle 7: There is a need for consistency between fiscal and monetary policy

Consistency is essential between fiscal and monetary policy. Central banks cannot afford to be independent in the policy stance they adopt if overall economic policy is to be effective. The current combination of unconventional monetary and fiscal policy has seen the Bank of England – like a number of other central banks – fund a significant portion of government debt during this pandemic. There are potential monetary implications associated with this, which always should be monitored. It also raises the question as to what level yields would be at without such action. In this paper we are not focusing on the implications of this for monetary policy, inflation, or its sustainability. But in terms of fiscal policy it has a number of impacts, including reducing the amount of outstanding debt held by the private sector, and also the yield at which the debt is financed.

In the post-war period, the UK has witnessed four booms that became busts. The idea of a boom may seem like a distant possibility currently, but they highlight the need to remain vigilant about the fiscal numbers running out of control. The four boom-busts occurred under Chancellors Maudling, Barber, Lawson and Brown.

From a fiscal policy perspective, perhaps the most interesting was Chancellor Lawson's late-1980s boom and bust. At that time there was a popular misconception that a healthy fiscal position was bound to mean economic stability and that promoted a relaxed attitude about what lay ahead, with a credit boom occurring, reflected in rising private-sector debt. Despite healthy public finances, such private sector liabilities fed the boom that prompted interest rates to rise sharply, followed by a bust.

In addition to accommodating fiscal policy, as now, monetary policy has the ability to counteract inflation were it to rise unexpectedly as we emerge from recession. This is not our view, but it is a fear that is expressed. In terms of stimulus fiscal policy is best placed to stimulate economic activity in present circumstances.

Principle 8: Decisions on tax and spending should be based on what is best for economic growth

In the present debate there is already too much premature talk about the need to raise taxes in the future, either to close the perceived £40 billion budget gap alluded to earlier, or to compensate for a future ageing population. We don't share that thinking. For a start the margin of error on fiscal forecasts is high, even one year ahead, while economic forecasts, particularly in the aftermath of this crisis, should be treated with caution as mentioned above.

While the current position of the deficit will always, naturally perhaps, influence the debate on spending and tax the priority should be that decisions on these are driven by what is seen as being in the best interests of economic growth. This will influence the relationship between tax and spending, and also between capital and current spending. Hard and fast rules on these should be avoided and instead decisions should be based on driving economic growth.

Our preference would be to avoid higher taxes. It would also be to encourage more R&D, thus ensuring that taxes, like public capital spending, were aimed at ensuring the economy is competitive.

Principle 9: The Government's balance sheet matters

This could equally be called 'bear future generations in mind'. Debts should always be considered alongside assets when a country's balance sheet is being drawn up. It might be said that this is not focused upon enough and it should be. In the banking crisis, the debts were socialised, as the taxpayer helped bail out the banks. A government should leave its fiscal position in good shape, both to cope with shocks, and so as not to place burdens on future generations.

Principle 10: Avoid a debt trap

A debt trap provides little room for manoeuvre and should be avoided. It happens when two factors are in place: a country's debt outstrips its economy, which means that debt is more than 100% of GDP; and the interest rate paid on debt is higher than the rate of economic growth.

Box 1: Public Finance and Principles of Taxation

By Warwick Lightfoot

In any discussion of fiscal policy, it is important to separate out several different dimensions: the role of fiscal policy as a tool of short-term demand management at different stages of the economic cycle on the one hand; the economic and financial sustainability of a given level of public expenditure and public debt in the long term; and the structure of public expenditure and taxation.

In public finance, the overall level of public expenditure is the key question. All other questions relating to how it is to be financed – whether by taxation or borrowing – are secondary. Public expenditure in the long run involves a real resource cost and an opportunity cost between publicly decided and collectively provided goods, services and transfer payments and private consumption. The economic cost of public expenditure is, moreover, greater than its cash cost, given that its financing involves a deadweight cost arising out of the distortions it creates.

In framing the structure of taxation policy, policymakers need to clarify their principal objectives. The aim should be to develop a tax system that in the long term moves the economy towards an optimal supply-side that promotes economic activity, innovation and growth. The first and principal purpose of the tax system should be to raise revenue to finance public expenditure and to do so in a manner that involves least distortion and deadweight cost. In the context of public services that absorbs around two fifths of national income, reliable and sustainable revenue from the tax system is an important challenge. Doing so in a manner that involves least deadweight cost and distortion is an even more significant matter.

The broad principles that should inform the evolution of the tax structure are that it should be as broad, neutral and non-discriminatory as possible. It should not be biased against different activities, such as saving, consumption and investment. It should not structurally result in the double or triple taxation of economic activities. And its effects at the margin should do as little as possible in modifying economic behaviour.

These general principles point to broad based taxes on recurrent flow of expenditure and income. Recurrent flows of economic activity offer a buoyant (and usually growing) tax base and a rising source of revenue. The broader the tax base, the lower the top marginal rate of tax required to raise the necessary revenue, ensuring that marginal tax rates' effects on economic behaviour and incentives are limited.

The principles of neutrality and non-discrimination point to a preference for raising revenue from comprehensive expenditure taxes on the broad models of valued added taxes used in the EU and the goods and services taxes in Australia and Canada. Taxation of income and capital automatically involves the double taxation of income – money earned and taxed once is then taxed again when it is saved. The double taxation of income was first identified by John Stuart Mill when Britain reintroduced income tax to raise revenue to replace the money lost through tariffs reform after the abolition of the Corn Laws.

Economists generally prefer expenditure taxes to income and capital taxes to avoid such double taxation, given that it would erode in the long term the incentive to save, invest and accumulate capital. Taxes on events such as capital gains, estate duties and stamp duties hinder economic activity and capital accumulation, and impede economic agents from engaging in what would otherwise be beneficial transactions. These have malign effects on saving and capital formation.

The taxation of capital and wealth does not offer reliable, buoyant sources of revenue yield. Defining, measuring and calculating the value of capital as a whole versus individual assets in particular is exceptionally difficult. This is especially true when the assets being valued trade irregularly in inefficient and illiquid markets such as property and non-traded private company shares. Even shares in companies traded on public exchanges are sometimes relatively illiquid as, for example, when bought and sold in large, one-off transactions where shares are tightly held by a limited number of investors and there may sometimes be few reliable market makers. The value of art and object d'art is particularly difficult to determine.

Moreover, when property is infrequently traded, a few additional transactions can result in market prices plummeting. Valuing capital even in conventional markets is plainly difficult. It is not an accident that in the 1950s and 1960s some of the finest minds in economics were tied up in a protracted, contentious debate about the measurement and valuation of capital that became known as the capital controversy, with little in the way of satisfactory conclusion. The suggestion that an audacious programme to tax wealth and capital could yield reliable recurrent flows of tax revenue invites scepticism.

G. Concluding comments

In the UK during the first half of this fiscal year, 2020-21, the budget deficit reached £208.5 billion. This is a staggering figure, by any measure. This is £174.5 billion higher than in the corresponding period a year earlier.

Similar questions are now facing a host of countries, namely, "How do we pay for this pandemic?" and, "Who will bear the burden when we do?". While we focus here on the UK, this is a global message. At its recent annual (virtual) meeting, the IMF, traditionally the doyen of austerity, argued against tightening fiscal stances too soon.

Policymakers face an immediate challenge in working out the extent to which, following the impact of the pandemic and measures taken to contain the public health emergency, there is sufficient demand in the economy to fully employ its productive capacity. The economy, while set to recover next year, will still be below its pre-crisis peak for some time, with high rates of unemployment. Thus, premature policy tightening – fiscal, or monetary – would likely derail the economic recovery.

Each stage of the pandemic has led the government to unveil new, often generous, but necessary measures. It has certainly highlighted the ability of fiscal policy to act as an economic stabiliser, helping the economy when it is in difficulty.

Despite the need to avoid such premature tightening, the debate about the fiscal outlook is starting to heat up. Recent weeks, for instance, have seen calls for higher taxes, with the debate including talk of higher capital gains tax. At the same time, there is a debate about the longer-term fiscal outlook. For instance, there have been calls for road pricing taxes to offset the expected future tax shortfall as electric vehicles replace fuel-driven ones. Also, at a recent Treasury Select Committee, the OBR set out their case for a net increase of tax of around 3 per cent of national income, each decade, in coming decades to address the future ageing population. The point is that it is not just cyclical challenges that the UK faces regarding its public finances, but also deep-rooted, longer-term issues.

The UK – like many western economies – has seen a combination of unconventional monetary policies and unconventional fiscal policies. The policy cupboard is not bare, as there is still more stimulus that can be provided. But the scale of the policy stimulus to date should be raising questions about where fiscal and monetary policy need to return to, as the UK and world economy continue to recover.

It is easy to understand why there is so much uncertainty here in the UK. In the aftermath of the 2008 global financial crisis, there was a sharp rise in the budget deficit, peaking in 2009-10. Then, in subsequent years, the budget deficit trended lower, and in 2018-19 it was about one-third of its 2009-10 level. It rose slightly in 2019-20, as the pandemic impacted towards the end of that fiscal year.

In September, for instance, central government spending on day-to-day activities alone was £77.8 billion, or £2.6 billion per day. This was equivalent to £41,164 per person per day. While this has been bloated by the pandemic even in September a year ago, such spending was £59.7 billion, or almost £2 billion per day.

While the release of this briefing paper occurs in the wake of a Comprehensive Spending Review that has been truncated to one year ahead, the message from it is long-lasting and should be seen as the background against which to judge fiscal policy and public spending decisions as we emerge from this pandemic.

The UK – like the rest of the world – has experienced a global health crisis that, in turn, has triggered a global economic crisis. The possibility of a vaccine – plus the large-scale fiscal and monetary policy easing that has already been unveiled – points to the likelihood of a rebound in economic activity during 2021 to 2022. But this should not divert attention from deep-rooted economic problems. Also, it highlights attention on future fiscal and monetary stances. Here we have focused on the UK's fiscal stance.

How to bring the public finances back into shape has emerged as a dominant issue, with those calling for higher taxes as the solution coming to the fore. Higher taxes are not the route we favour; policymakers should instead be aiming for stronger sustainable growth.

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