What is to be done with the British economy?

An audacious agenda: tax cuts, reform, and policy renewal for a modern economy

Warwick Lightfoot

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Executive Summary

The UK needs a modern economic policy that is tailored to the opportunities and constraints of the contemporary international economy. In response to the economic shock of the covid public health crisis and a decade of slow growth and economic stagnation it needs a confident audacious policy based on the three arrows of fiscal policy, monetary policy, and supply side reform to improve incentives and the functioning of markets.

Key Economic Tools

The starting point should be recognition that both arms of macro-economic policy, fiscal and monetary policy, have a role to play in the management of the economy. The role will change depending on circumstances and where the economy is in the business cycle, but they cannot be separated out in the stylised manner that economic policy was framed ahead of the economic crises that started in 2007.

Fiscal policy is a necessary part of macro-economic demand management. When interest rates are zero and monetary policy has run out of road as a source of reliable stimulus, it is the key instrument available to policymakers to stimulate the economy. Exceptionally low nominal and real interest rates remove the constraint of debt service charges on the use of fiscal policy as a stimulus. Allowing public borrowing to act as a shock absorber helps to stabilise the economy and to ensure that it retains the capacity to recover.

Integrated global capital markets mean that government borrowing does not have the sort of crowding out effects it used to have. The world of national segmented capital markets, where state borrowing could crowd out private borrowing for investment are long gone. The UK is exceptionally well placed to take advantage of cheap long-term debt. It has a liquid long-term debt market and one of the longest maturity debt structures among advanced economies. It should now lengthen its maturity further and explore the appetite that international investors have for permanent nonredeemable debt.

Inflation and inflationary expectations remain low. But if inflation should rise over and above a series of relative price effects arising, for example, out of supply chains that are temporarily constrained or rising oil prices, policy makers have a powerful tool in monetary policy to curb it. Interest rates and monetary conditions may have lost their capacity to stimulate, but they have not lost their bite in terms of slowing an economy down, especially in the current environment of corporate leverage upwards. In these circumstances, policy makers should unhesitatingly use monetary

policy to slow the economy and curb inflation.

A return to higher interest rates and a more normal bond market yield curve would improve the micro-economic functioning of money and credit markets, though it may push up the cost of servicing public debt. There would be other potential benefits for economic growth: very low interest rates make it impossible to price different credits, aggravate the scramble for yield and asset price bubbles, and create the conditions for zombie firms.

Guiding Principles

If a further discretionary fiscal policy stimulus is needed, it should be framed as part of an agenda to improve incentives and the functioning of markets. Any temporary stimulus should give people of working age in receipt of transfer payments and taxpayers one-off tax credits and rebates. Tax reform should be directed at improving incentives by removing the Manhattan skyline of marginal tax rates across the earnings distribution, taxes on transactions such as stamp duty should be reduced and eliminated and taxes on business that take no account of their capacity to pay, such as business rates, should be reduced.

An agenda of tax reform to improve incentives should accompany a wider agenda of supply side reform to improve the working of markets. The most important potential supply side reform is a radical liberalisation of the planning system, especially in light of the impact Covid has had on how people expect to live, work and shop. Planning reform, in particular greater freedom in land use, has therefore become even more important.

Policy makers will have to be nimble in adjusting to changing economic circumstances. This paper attempts to highlight the principles that should guide policy and identify the economic policy instruments that ought to be used in changing circumstances. It makes no comment on the scale of further stimulus or tightening that may be needed.

This reflects the fact that in terms of obtaining a purchase on where activity is and the amount of spare capacity available is exceptionally challenging. In terms of the information available and how economic agents will behave, policy makers are effectively flying blind.

The yo-yoing falls and rises of GDP are out of the parameters of the models to forecast the economy; the practical work of data collection by statisticians has been hampered; the weights employed in index numbers are distorted by changing behaviour; and the measurement of the output of the public sector in the national accounts is problematic both for international comparisons and assessment of capacity and demand. Even before Covid, a changing service sector economy that exhibited much greater valued added attached to intangibles and intellectual property rights made the measurement of productivity more problematic and interpretation of data and confidence about previously reliable economic relationships more difficult.

Introduction

The UK economy confronts extraordinary challenges arising from the public health shock of the COVID-19 virus and an environment of chronically slow growth and stagnation in productivity and employment incomes that has been the principal feature of the economic landscape of the previous decade. Both the health shock and the secular stagnation preceding it require policy makers to reassess policy, the preferred tools that should be used, and to confront radical changes in the structure of the economic landscape. It requires bold thought and a willingness to recognise that pieces of economic policy and episodes of experience that may once have been relevant are redundant in the contemporary world. This note does not attempt to exemplify or innumerate the scale of stimulus that may or may not be required or any tightening that may be necessary, it is not a forecast, but an attempt to assess the principal macro-economic tools that should be used to manage the economy. It recognises that a successful growth strategy will require the three arrows of fiscal policy, monetary policy and a supply-side agenda to improve incentives and the functioning of markets.

In many respects this is a particular challenge for policy makers and economists who recognise the efficiency and power of markets, real costs and limits of public expenditure and who recognised that inflation in advanced economies such as the UK, USA and France in the 1970s and 1980s could only be brought under control by an extended period of monetary control. In effect, the sort of polices practiced by Denis Healey after 1976; Sir Geoffrey Howe in the first half of the 1980s in the UK; Paul Volker at the Federal Reserve in the USA (by targeting the supply of non-borrowed reserves to the Federal Funds market); and the *Franc-fort* policy that France followed linking French monetary policy to the Bundesbank via the ERM following the failure of the Programme Common in 1983 that ultimately made France the strongest financial economy in Europe at the end of the 1980s.

Having worked on both public expenditure and taxation at the Treasury and been involved in the preparation of both budgets and public expenditure statements, most of the work of the department is taken up with making specific decisions in relation to spending at the margin and the details of the budget score card. It was surprising to me how little time was spent considering what policy ought to be doing. Even when the Treasury was responsible for the official economic forecast that is now done by the OBR, little time was spent on trying to shape the outcome of the economy in the short term. The results of the Treasury model with

various necessary adjustments to make it cohere to a plausible outcome were simply accepted. The Treasury model's principal property was that whatever happened, everything returned to trend.

Once a government has established a coherent economic and financial programme, it is understandable for ministers and officials to get on and apply it rather than pointlessly debate matters that should have been settled. Yet when things are going wrong, I was struck by the timidity of the Treasury in confronting the obvious. In the late 1980s the big thing that had gone wrong was inflation. Domestic monetary conditions were too loose for about five years, a matter aggravated by a de facto exchange rate policy target shadowing the Deutsche Mark, with inflation heading towards 10 per cent. At the same time, the UK had transformed a Public Sector Borrowing Requirement into a Public Sector Debt Repayment as the Treasury Weekly Brief put it – week in and week out – inflation would be controlled by appropriate monetary policy 'buttressed by an exceptionally tight fiscal stance'.

The 1980s offered two interesting radical Conservative experiments in economic management. In the UK, Mrs Thatcher brought budget deficits down by raising the overall tax burden while improving incentives to work, save, and invest, by cutting marginal tax rates and using high interest rates to disinflate the economy between 1979 and 1983. This led to a sustained recovery in output that started in 1981 and was then followed by strong above trend growth stimulated by strong growth in £M3 after 1985. In the USA, President Reagan's administration pursued a radical agenda of tax cuts financed through large continuing deficits, while the Federal Reserve under the leadership of Paul Volker and Alan Greenspan maintained realistically tight monetary conditions until Alan Greenspan had to respond to the wealth effects generated by the falling equity prices in the Autumn of 1987. At the end of the 1980s, there was a debate about whether the UK or the US after long periods of sustained expansion would suffer a hard landing. On balance, it was assumed that the Federal deficit would scupper the US and that the UK's budget surpluses would see it through to an approximation of a soft landing. Instead, it was the UK that suffered an unambiguously hard landing as a result, having to raise interest rates to 15 per cent and then locking sterling into the ERM at a high rate against the Deutsche Mark to fight inflation.

The lesson of this episode was that the UK invested in the wrong policy. A strong budget balance was put ahead of radical supply orientated tax reform and the consequences of domestic monetary incontinence were resolutely ignored until there was a serious inflation problem. In the US, large deficits pretty much took care of themselves, an effective monetary policy kept the lid on inflation and the US had an approximation of a soft landing. Later in the 1990s the positions were reversed. The US enjoyed strong growth supported by loose domestic monetary conditions and reflected in the equity price bubble that led to the *techwreck* fall in equity prices and recession in 2000. Exceptional fiscal surpluses did not prevent the US economy from over-heating in the absence of an inappropriate

monetary policy. After 2001, President Bush's tax cuts and fiscal stimulus were effective in reviving the economy and offered the first rigorously tested evidence that fiscal policy could play a useful role as a reliable stimulus in a modern economy.

The lessons yielded by these episodes is that policy makers must employ the right instruments of economic policy in the right circumstances and that circumstances change. In the present world, very low interest rates and exceptionally loose monetary conditions following the Great Recession make monetary policy an unreliable source of economic stimulus. The banking crisis itself showed that fiscal and monetary policy could not be neatly separated out and became completely fused when the banks were rescued. Over the last decade, fiscal policy has been increasingly recognised internationally as the key instrument to revive economies. Yet if inflation were to return, it would be a serious error not to recognise the role that monetary policy would have to assume to control it. Moreover, in the context of increased leverage, interest rates and tighter monetary conditions may be a more powerful instrument to curb economic activity than it was twenty years ago.

The UK needs an audacious economic programme to respond to the economic shock generated by the COVID-19 public health crisis and to address the continuing consequences of the Great Recession and credit crisis between 2007 and 2010. The scope to use monetary policy as an active form of economic stimulus is limited and the opportunities to use fiscal policy in a context of low interest rates and an integrated international capital markets are significant. This programme of economic recovery should take into account the constraints and opportunities that have arisen in the current economic climate, while at its heart recognising that individuals and businesses respond to incentives, market economies are dynamic, and their functioning and outlook can be improved by reform. An ambitious growth strategy based initially on a fiscal stimulus and an agenda to improve the micro-economic functioning of markets would also offer the potential to rebalance macro-economic policy instruments by returning the economy to a position where monetary policy could regain its role as a macro-economic tool if policy has to be tightened at some stage. Given the yo-yoing of output, the disruption of supply chains and uncertainties about the behaviour of economic agents and consumers in particular policy makers with must be nimble in judging economic conditions and the appropriate policy mix.

Principles to guide an appropriate economic response to the COVID-19 shock

An audacious economic policy to meet the challenges of the COVID-19 shock and a decade of poor economic performance

The COVID-19 crisis has shaken employment, consumption, and supply chains. The enforced lockdown has prevented large swathes of the economy from operating at all, with other sectors forced into mandatory working from home. GDP fell by a record 20.4 per cent in Q2 2020 and contracted by 9.9 per cent over the whole of 2020, the largest annual fall on record for UK GDP.[1] Uncertainty over future mutations of the virus and vaccine resilience to such new strains, as well as significantly slower global vaccination rates than those seen in the UK will affect the rate at which the economy recovers.

This crisis compounds the economic challenges that emerged in advanced economies as a result of the financial crisis and policies implemented to remedy the accompanying recession. Very disappointing productivity growth, economic growth, and growth in incomes since then have combined to imply that the UK, along with other major advanced economies, was entering some form of stationary state analogous to the challenges faced by the Japanese economy since the 1990s.

1. 'GDP monthly estimate, UK: December 2020', *Office for National Statistics* (12 February 2021) https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/december2020 ; 'GDP first quarterly estimate, UK: October to December 2020', *Office for National Statistics* (12 February 2021) https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/octobertodecember2020

Figure 1: Real GDP in the UK, 1995-2020, index: 2007 = 100.[2]

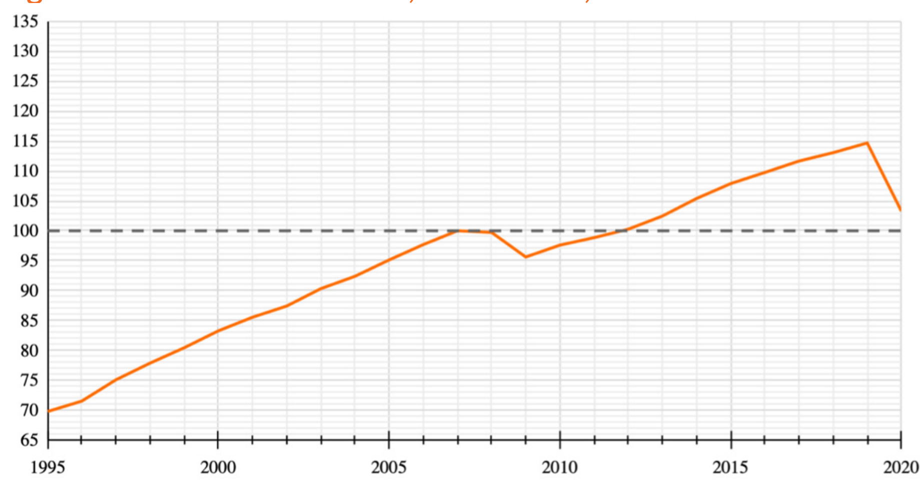
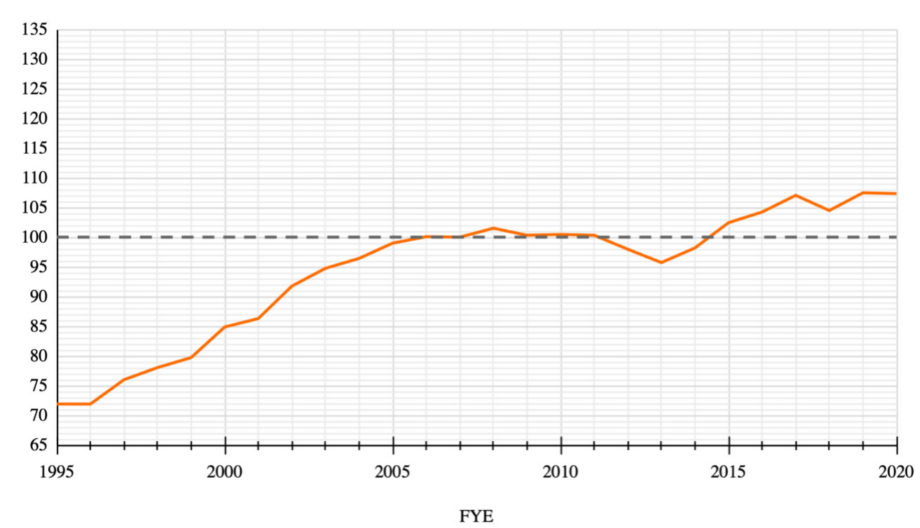


Figure 2: Median Equivalised Disposable Income for the UK, financial year ending 1995 – 2020, index: 2007 = 100.

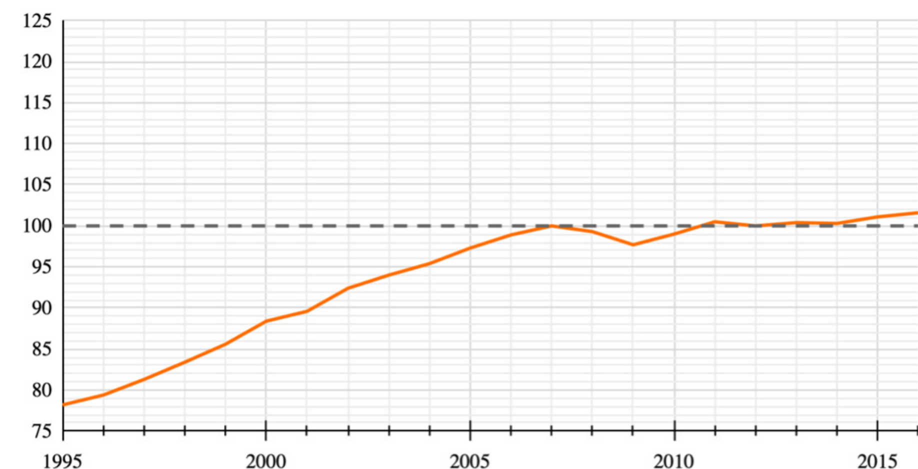


Incomes are adjusted for inflation using the consumer prices index including owner-occupiers' housing costs.[3]

UK GDP and median incomes grew by an average of 3.1 per cent per year in the ten years preceding the financial crisis (1997-2007). Although GDP growth somewhat recovered, averaging 1.9 per cent per year post-crisis and pre-covid, median wage growth did not. Between 2012 and 2019, median incomes grew by 0.9 per cent annually.

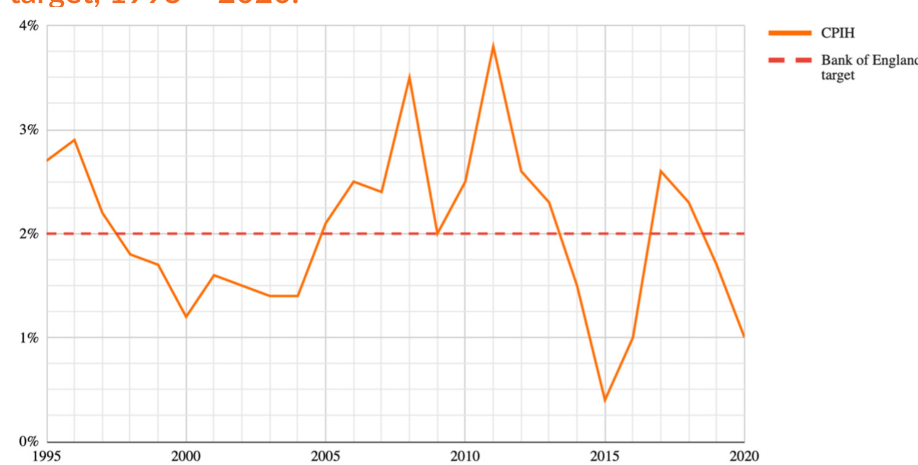
2. 'Gross Domestic Product: chained volume measures: Seasonally adjusted £m', *Office for National Statistics* (12 February 2021) https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/abmi/pn2
3. 'Average household income, UK: financial year 2020', *Office for National Statistics* (21 January 2021) https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/householddisposableincomeandinequality/financialyear2020

Figure 3: Constant price GDP per hour worked in the UK, 1995-2016, index: 2007 = 100. [4]



Like most advanced economies, the UK has experienced disappointing productivity growth over the last decade. Although in the past UK labour productivity grew by around 2 per cent per year, it has stagnated since the Great Recession. In 2015, UK productivity was 19 per cent lower than the G7 average and in 2017, the level of labour productivity was still 0.5 per cent lower than what it had been in 2007.[5] Identifying plausible explanations for stagnating productivity internationally has not been easy for economists, but policy makers should identify obvious impediments to economic activity that are directly within their control and can be modified through policy measures.

Figure 4: UK Annual Consumer Price Index including owner occupiers' housing costs (CPIH) and the Bank of England inflation target, 1995 – 2020. [6]

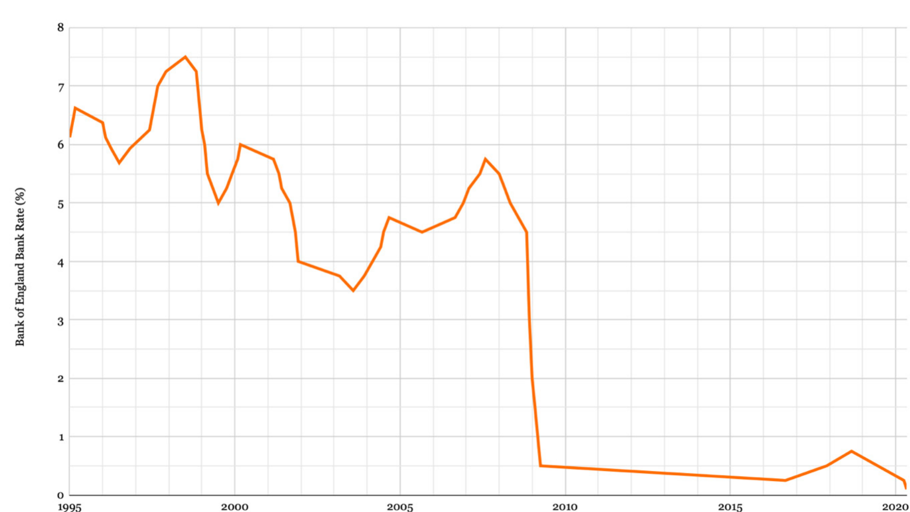


Inflationary pressures in the UK have remained low, with CPIH falling to 1.7% in 2019 and 1% in 2020 (for a discussion of the collection and reliability of economic data during the pandemic, see p.23). Although the CPI is expected to rise due to the reversal of VAT cuts, changes in the

4. 'International comparisons of productivity', *Office for National Statistics* (6 April 2018) https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/internationalcomparisonsofproductivityfirstestimates
5. 'Productivity in the UK', D. Harari, *House of Commons Library Briefing Paper*, September 2017, https://commonslibrary.parliament.uk/research-briefings/sn06492/
6. 'CPIH Annual Rate 00: All Items 2015=100', *Office for National Statistics* (17 February 2021) https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l55o/mm23

oil price being passed on to consumers and a recovery of commodity prices, rising unemployment, spare capacity, a flexible labour market that exhibits little in the way of a trade union mark up along with the potential for a higher sterling exchange rate may contain any implied inflation. Transient inflationary pressures arising from temporary interruptions of supply chains can be allowed to pass through without the central bank accommodating inappropriate inflation, given the low rate of inflation and the years when it has been below 2 per cent.

Figure 5: Changes in the Bank of England Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate, 1995-2020. [7]



We have had a decade of exceptionally loose monetary policy, with interest rates remaining below one since the financial crisis (Figure 5). This is in stark contrast to the 2000's, where interest rates hovered around five per cent. This has two important implications for the Government's response to the Covid crisis. The first, as we discuss later in the paper, is that monetary policy in the current economic climate is ineffective as a stimulus and fiscal policy must therefore take the lead. The second implication, which ties into governments use of fiscal policy as a stimulus, is that despite rising levels of national debt, the cost of servicing debt has remained constant at around two per cent of GDP (Figure 6 and 7). It is worth noting that with higher levels of national debt, the cost of servicing the debt will be more volatile, as small changes to interest rates have a greater effect on the overall cost.

7. 'Changes in the Bank Rate, Minimum Lending Rate, Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate', *Bank of England* (accessed February 2021) Link

Figure 6: UK historical and projected public sector net debt as percentage of GDP for the FYE ending 1995-2026.[8]

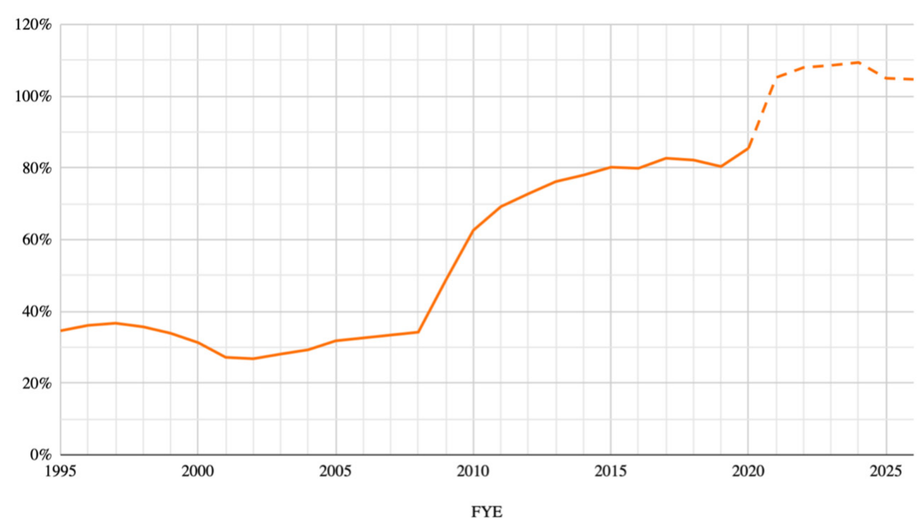
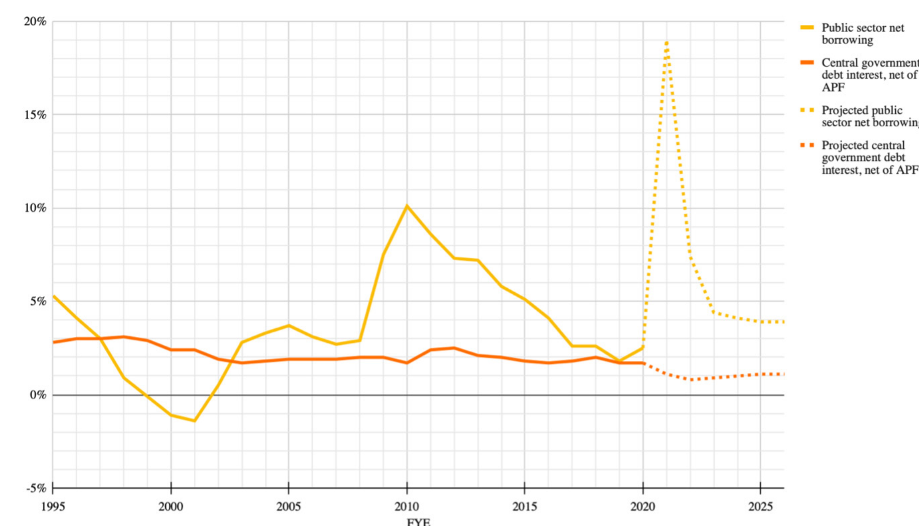


Figure 7: UK Historical and projected public sector net borrowing and central government debt interest, net of APF, as a percentage of GDP, for the financial year ending 1995-2026.[9]



A modern economic purpose

The UK needs an economic policy that matches contemporary challenges, frames economic policy in a confident manner and offers a modern economic purpose. The starting point is to recognise that the economy will need a sustained stimulus if it is to avoid wasted resources, idle capacity, and aggravated scarring because of the COVID-19 shock.

As an effective economic instrument of stimulus monetary policy is highly constrained. The Monetary Policy Committee projects that the Bank Rate will be 0.1 per cent in 2021 Q1, and -0.1 per cent in 2022 Q1 and 2023 Q1.[10] Unlike over the course of 2008 where interest rates were cut from five per cent to two per cent, there is clearly little scope for loosening monetary policy in the current environment.[11] Any required stimulus will

8. 'Public Finances databank – November 2020', *Office for Budget Responsibility* (November 2020) https://obr.uk/public-finances-databank-2020-21/
9. 'Public Finances databank – November 2020', *Office for Budget Responsibility* (November 2020) https://obr.uk/public-finances-databank-2020-21/
10. 'Monetary Policy Report', *Bank of England Monetary Policy Committee* (February 2021) https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2021/february/monetary-policy-report-february-2021.pdf?la=en&hash=3638A7091B34164428A54277B55BD6901709AA44.
11. 'UK interest rate moves since 2007 - timeline', J. Kollewe, *The Guardian*, August 2016, https://www.theguardian.com/business/2016/jul/14/uk-interest-rates-timeline-bank-of-england-uk-economy

therefore have to come from fiscal policy. Negative interest rates would be ineffective and their use by the authorities would be an illustration of the ineffectiveness of monetary policy as a source of stimulus in present circumstances. Negative interest rates do not create worthy investment opportunities and are often not passed on to the consumer.

A growth policy based on supply side reform, supported by fiscal stimulus

To support a policy of economic expansion in the short-term and while it is needed, borrowing should be used to finance stimulus. To provide the Government with the tax base in the future to meet the aspirations the public have for higher living standards and better public services, there needs to be an economic programme that improves the functioning of the economy's markets and the capacity of its supply-side. That will involve improving incentives and removing obvious obstacles that impede the economy from operating effectively by adjusting to changing circumstances and evolving opportunities.

In response to the present crisis, the UK should marry its macro-economic stimulus policies with a micro-economic agenda to improve the supply-side of the economy. A central part of this agenda should be a reduction in taxes that will improve incentives and the working of the economy. Policy should recognise that economies are not static, they change and have the capability of exhibiting dynamic improvements when demand and better incentives are aligned.

Economic Reform

Principles to inform an agenda of tax cuts

Several principles should inform an agenda of tax cuts. If discretionary stimulus is needed tax cuts should be used and directed to bolster demand by putting money immediately into the hands of households and businesses. They should remove impediment's that deter people from working, saving, and investing. Taxes should be focused on recurrent flows of expenditure and income. The deadweight costs of taxation should be minimised by reducing the double taxation of savings and investment and complexity should be removed. The thresholds should be high, tax bases should be broad and tax rates and marginal tax rates should be low. The tax system should be neutral, tax expenditures should be minimised, and it should focus on generating buoyant revenue to fund expenditure. The tax system should realistically focus on taxing financial flows where the taxpayer has the capacity to pay the bill without having to rearrange their balance sheet or liquidate their capital.

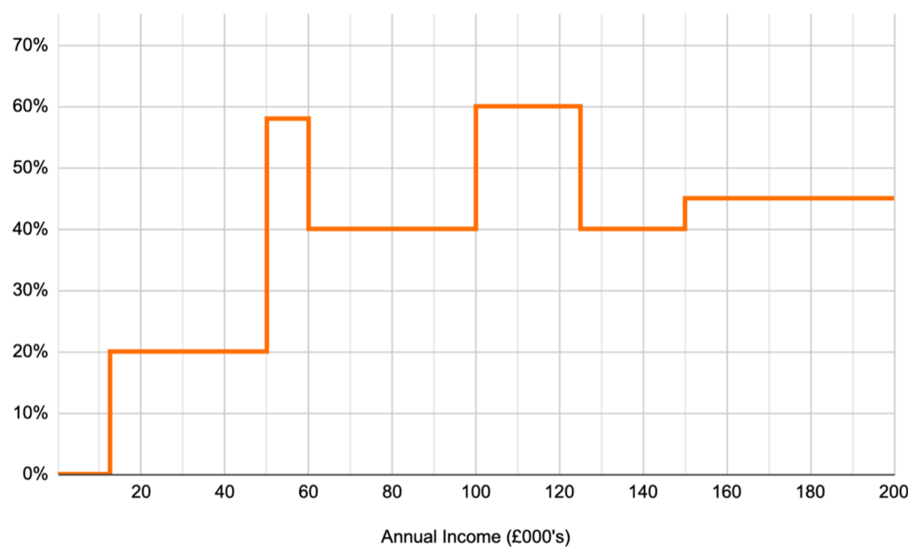
A medium-term agenda of tax cuts

All taxpayers and households in receipt of work-related transfer payments should receive a one-off tax rebate. This will provide households with money and will give them the confidence to spend. A one-off rebate is preferable to a temporary tax cut as it does not undermine future revenue from income tax or risk permanently remitting part of the present tax burden, should the political will to restore taxes to previous levels fail.

The top marginal rate of tax should be lowered to 40 per cent. This will simplify the tax system.

The Manhattan skyline of marginal tax rates across the earning distribution should also end. Under the present system, marginal tax rates over the income distribution shift from 20 per cent to around 60 per cent, back down to 40 per cent then up to 60 per cent then back to 40 per cent and finally rising to 45 per cent at the top (Figure 8). The withdrawal of child benefit between £50,000 and £60,000 should end to eliminate the 60 per cent marginal tax rate for people with two children, as should the withdrawal of personal allowances after £100,000 that generates a 60 per cent tax rate for individuals earning between £100,000 and £125,000. These changes would create a simpler tax system that improves the incentives to work, save and invest for some of the most productive people in the labour market.

Figure 8: Marginal tax rates in the UK for households with two children, taking the withdrawal of child benefit and personal allowances into account.[12]



The reduction in stamp duty should be retained and there should be further reductions in stamp duty on property with the ultimate objective of removing the charge. As highlighted in Policy Exchange's 2021 report, *Helping Generation Rent become Generation Buy*, removing stamp duty would reduce friction in the housing market, ensuring that people can move frequently enough so that they are living in appropriate properties, while making the market more accessible to first time buyers.[13] Stamp duty on shares should go to ensure that London remains an attractive and dynamic international financial centre. This is particularly important post-Brexit.

The UK taxes property more heavily than almost any advanced economy except for the USA. Property taxes are easy to assess and collect, but do not offer a buoyant source of rising revenue and are often levied on taxpayers whether they are businesses or households irrespective of income, profit or turnover. These do not always have the capacity to pay the charges easily and eventually have to vacate the premises because they cannot pay the tax bill. Business rates are a good example of that. Considering other Government objectives, such as saving the high street, the Government should maintain its present relief and progressively reduce the tax in the medium terms.

Tax reform cannot be made in a static revenue neutral manner, as winners must be offset by losers. The UK should use this opportunity of a need for a fiscal stimulus to embark on a programme of tax cuts that contribute to creating a tax system that has greater incentives to work, save, and invest, while immediately stimulating demand. The above tax cuts are proposed as they will stimulate the economy today, while setting out a direction of travel for future tax reform and the evolution of the tax system.

12. 'Income Tax rates and Personal Allowances', *GOV.UK* (accessed February 2021) https://www.gov.uk/income-tax-rates ; 'Withdrawal symptoms: the new 'High Income Child Benefit charge', R. Joyce, *Institute for Fiscal Studies* (4 January 2013) https://www.ifs.org.uk/publications/6527
13. 'Helping Generation Rent become Generation Buy', G. Lyons, *Policy Exchange* (7 February 2021) https://policyexchange.org.uk/publication/helping-generation-rent-become-generation-buy/

More effective regulation and a radical reform of the planning system

An ambitious agenda of tax reduction and supply side reform of incentives should be matched by an ambitious reform of regulation that focuses on identifying and auditing risk and protecting the public in a proportionate and cost-effective manner. The UK should take the opportunity presented by Brexit to interrogate its stock of regulation to ensure that it is properly framed for the social, environmental, and other challenges that confront modern society. This is equally about identifying risks that need managing as it is about better controlling the costs of regulation.

The biggest area of regulation that needs fundamental reform is that of land use and planning. This has nothing to do with Brexit and represents unfinished business in terms of dismantling the socialist controls of the post-war economy constructed in the 1940s. It offers the greatest potential yield in terms of deregulatory reform.

The Government's proposed reforms to planning take in added urgency because of the Covid shock, which appears to have expedited trends in the use of technology, remote working and internet shopping. This will result in a reallocation of capital and resources and will require flexible labour, product and capital markets to smooth what may be a process of radical evolution. The property market will be an important part of this process of adjustment and will need to be more flexible, as there is changing demand for the location and nature of homes, business premises, office space and the use of buildings in city centres. Fundamental reform of the planning system will ease these shifts in demand that Covid accelerated, allowing for a more efficient and productive use of land and capital.

Managing the Economy beyond COVID

Macro-Economic Policy turned on its head

Macro-economic policy has been turned on its head. Over the last forty years the principal instrument of macro-economic policy in terms of demand management was monetary policy. Central banks set policy rates and pen market operations directed at controlling the price of money and interest rates. Monetary policy had a swift direct effect on all decisions made by economic agents about consumption, saving, borrowing and investment. The collapse of the banking system and the credit crisis drove down interest rates and removed monetary policy as an effective tool of economic stimulus.

After ten years of insipid macro-economic performance where central banks have attempted to breath life into monetary policy by an extraordinary range of unconventional novel instruments and practices, economists, including economists that have led central banks such as Ben Bernanke and Janet Yellen, have concluded that as a source of effective stimulus, monetary policy had run out of road and that fiscal policy must take on a central role in macro-economic management.

This represents a significant reversal of roles. Until the 1970s and 1980s, fiscal policy was perceived as the central instrument of economic stimulus, but the disappointing results of deficit finance in the 1970s gradually discredited fiscal policy as an effective tool. Its principal defects were its tardy effects that tended to make fiscal policy pro rather than counter cyclical, that higher domestic borrowing by governments in their own currency raised interest rates and crowded out private sector spending and investment and for medium sized economies led to leaks of demand through the balance of payments current account. This resulted in deficits stimulating neighbouring economies and trading partners, but vitiating demand in the domestic economy.

The formulation of the intellectually flashy Neo-Ricardian Equivalence Theorem by the Harvard economist Robert Barro, who applied the concept of the permanent income hypothesis to an assumption of an intergenerational bequests motive to assert that any form of short-term stimulus generated by a deficit would be offset by an equal rise in the savings ratio, as forward-looking economic agents modified their consumption in anticipation of an increase in the future tax burden, did not help. The slow and clumsy character of fiscal policy tarnished confidence in its practically

and Robert Barro buried fiscal policy intellectually.

Macro-economic policy has not only shifted as the perceived effectiveness of fiscal and monetary policy has changed, different Chancellors have used macro- and micro-economic policies differently to target a range of economic outcomes. In the 1960s and 1970s, fiscal policy had a macro-economic role directed at maintaining full employment and growth and micro-economic measures were increasingly taken to control inflation, such as pay policies and direct controls of prices and dividends. In the 1980s that was reversed. Fiscal policy was increasingly framed to improve micro-economic incentives by widening tax bases and lowering marginal tax rates and micro-economic controls to address inflation, such as prices and incomes policies, were abandoned.

The British Chancellor of the Exchequer Nigel Lawson set out a cogent analysis of this evolution of policy in the fifth *Mais* lecture in 1984, 'The British Experiment'. Lord Lawson assigned macro-economic stability and inflation control to macro-economic policy, with growth and employment assigned to micro-economic measures, through improvements in the supply side of the economy. He also recognised that the distinction may not always be clear cut and that there could be circumstances where macro-economic policy should play a supporting role in maintaining economic activity if there was a threat of a deflationary slump.

A novel feature of the present economic challenges is that there is a genuine micro-economic issue in monetary policy that needs to be addressed, as well as looking at monetary policy and monetary conditions simply through the lens of macro-economic demand management and the price level.

Monetary policy going forward

In an environment of historically low inflation and interest rates and modern integrated capital markets, borrowing, debt and the public sector balance sheet should take the strain of stimulating the economy and reforming its structure of incentives.

Now with interest rates close to zero, monetary policy is ineffective as a stimulus, but it retains its power and bite as a potential brake on economic activity. In the present environment of corporate leverage upward (global nonfinancial corporate debt increased by 78 per cent between 2007 and 2017, from $37 trillion to $66 trillion), movements in interest rates will have greater impact than before the financial crisis in 2007.[14] A one percentage point increase in interest rates is likely to be equivalent to a three or four percentage point increase in interest rates twenty years ago.

Therefore, if there is an unexpectedly powerful recovery from the shocks of the pandemic and a genuine inflation dynamic were to ignite (one that goes beyond the short-term price effects and bottle necks that could generate powerful relative price pushing up measured price indexes on a short-term basis), decisive action should be taken by monetary authorities to contain short-term inflationary measures. In those circumstances, monetary policy should be used as the necessary tool in macro-economic

14. 'Rising Corporate Debt: Peril or Promise?', *McKinsey Global Institute*, June 2018, https://www.mckinsey.com/~/media/mckinsey/business%20functions/strategy%20and%20corporate%20finance/our%20insights/rising%20corporate%20debt%20peril%20or%20promise/mgi-rising-corporate-debt-discussion-paper-oct-2018.ashx

policy to control inflation. If these measures involve a return to higher short-term interest rates and a more normal yield curve this should not be resisted. It would contribute to removing advanced economies such as the UK from the stationary state that it had been appearing to enter progressively since 2010.

Higher interest rates and a more normally structured yield curve would have the merit of returning monetary policy to a position where it could be used to stimulate economic activity as part of macro-economic policy. This would improve our management of the economy and yield important micro-economic benefits. Monetary policy and monetary conditions are normally analysed through the lens of macro-economic policy, yet very low interest rates over a protracted period of over a decade have created awkward micro-economic consequences. Negative and zero interest rates mean that capital and credit cannot be appropriately priced. The price of borrowing for different credit risks has become too closely compressed. In the same way that high and unstable interest rates damaged the information of price signals in labour markets and had malign consequences for wage determination and employment, so very low rates have in micro-economic terms distorted capital and credit markets. This is exemplified by the phenomena of zombie firms. It helps to explain the scramble for yield, inappropriate incurring of risk and the creation of asset price bubbles.

Why has fiscal policy come back?

Fiscal policy has returned to life as part of active macro-economic management for two reasons. The first is that monetary policy lost its capacity to stimulate economic activity reliably and second because in the first years of the 21st century, US policy makers demonstrated to the surprise of many economists that a fiscal stimulus could be made timely and effective. President Bush's stimulus after the recession following the stock market *tech-wreck*, worked. Tax rebates got into bank accounts and showed up in consumption data (panel data on the credit card spending) giving the economy the kind of boost it needed in 2001. This resulted in an informed discussion among American economists and policy makers who recognised that active fiscal policies should form part of the macro-economic tool kit in modern economies. These included Robert Rubin, Michael Boskin and Martin Feldstein, none of whom could be described as apologists for deficit spending or unnecessary public sector intervention.

A third fact that should be recognised that makes the context of fiscal stimulus and the financing of deficits completely different from the 1970s is the context of global integrated capital markets. Globally integrated capital markets mean that the actions of one government's actions are insufficient alone to change the global flow of funds.

Integrated international capital markets transform the financing of deficits

International capital markets are globally integrated. Capital markets are no longer segmented into national domestic markets where the actions of the government borrower could easily swamp the flow of funds available for local private use. The actions of individual governments have little impact on interest rates, which are largely determined by international flows and what is happening in the US Treasury market.

The practical constraint of debt service costs and the awkward implications of public debt for the price level are not present in the context of low inflation and historically low interest rates. The UK should explore opportunities to lock in low borrowing costs by extending the maturity of its debt and the extent to which the National Debt Office could issue permanent debt that does not have to be repaid. Historically the UK made great use of permanent non-redeemable consols and should explore possibility of such bonds again.

Flying blind – the difficulty of assessing the economy post pandemic

One of the challenges for economic policy makers in interpreting the scale of the shock generated by the Covid public health crisis is that it has aggravated the difficulty of interpreting conventional statistical data about economies and the behaviour of economic agents that may be inferred from it.

Practical constraints

Statisticians have encountered practical problems in collecting data. Some statistical series such as data on consumer prices are based on them going out to physical locations and manually recording it. This has been disrupted by lock downs where the statisticians could not get out and by the closure of the locations they would normally visit.

Difficulty of constructing reliable index numbers when behaviour modifies weight

Where price data has been collected, the previous weights used from the construction of the index numbers reflecting usual spending patterns based on expenditure survey information is redundant because patterns of spending changed due to the health crisis.

Distortion of employment data

Special measures taken by governments to protect household incomes and employment mean that data on employment and unemployment collected through the Labour Force Survey do not simply suffer because of the lagging factor of data collection, but do not give an accurate guide to idle resources in the economy. That is better inferred from the fall in the number of hours worked.

Swings in economic activity outside scope of macro-economic models

There have been huge swings in output and economic activity over the last year. At one stage GDP in the UK had fallen by 20.4 percent. It then recovered towards the end of the year and ended 9.9 per cent down. Movements in economic activity on this scale are out with the parameters of conventional economic models that rely on equations based on long

runs of historical data. Interpreting such overall swings and what they imply for the near future is difficult.

The savings ratio

In terms of the UK and US economic recovery, the behaviour of households and their consumption will be critical as consumption accounts for around two thirds of spending in the economy. Although the savings ratio fell to a near 50-year low in 2019 of five per cent, the ratio rose to a record 28 per cent during Q2 2020, as consumers could not get out and spend in conformity to their usual pattern.[15] There is a big and now unknown question about how households with savings will chose to spend when public health restrictions end. There could be a huge increase in spending as consumers express their pent-up demand or households may exhibit greater caution and a desire for a permanently high financial buffer given the Knightian uncertainties that the pandemic has illustrated. After the Second World War when US service personnel received financial compensation for injury and Jewish victims of the German Nazi regime received reparation payments, the way they used the windfall became the basis of the consumption function and permanent income hypothesis in modern economics. When people received the unexpected windfall, they spend some of it but saved most of it and only appeared to spend an approximation of the income that they might expect to get in the long-term. Households will have experienced greater risks and may have less confidence about the future than before, and income returns on assets have gone down rather than up. It is not clear how consumers will behave and what will happen to the savings ratio.

National accounting conventions and international comparison

The way national accounting statisticians chose to measure the output of the public sector has resulted in added complications in making international comparisons of output. Historically, national accounts simply scored the output of the public sector as the sum of its inputs, making no estimate of its outputs because of the difficulty and in many cases the subjective character of the judgements that an output or productivity measure would involve. International conventions developed by the UN over the last twenty-five years and adopted as the preferred approach to the question by Eurostat for EU members states national accounts suggests that public sector output should be directly measured. Among member states in the years following the adoption of the New European System of Accounts, UK national accounts made more progress in applying these revised guidelines than other member states. The result has been interesting measurement of the output and productivity of the public sector.

It was the publication of the first fruits of this important technical innovation after 2004 that showed that the very large discretionary increase in public expenditure between 1998 and 2010 had not yielded a matching increase in measured public sector output and that public sector

15. 'UK Savings Ratio At Historic High', *Flagstone* (17 August 2020) https://www.flagstoneim.coma/news/uk-savings-ratio-at-historic-high/

productivity had fallen. The same methodology applied to the covid shock has scored public sector output as falling. This does not necessarily suggest either lower demand or spare capacity. Given that other former EU partners of the UK have either not applied the new accounting conventions in the same manner, the measurement of public sector output is not consistent for the purposes of international comparison. National Accountants in the US have not for example adopted the UN national income accounting guidance in the manner of that Eurostat did.

The monthly profile of recorded public sector borrowing

Given the erratic and delayed collection of taxes such as VAT and Corporation Tax, the monthly reported level of borrowing involves statisticians making an estimate of likely tax revenue that is subject to later revision in normal circumstances. This makes the figures erratic but that is aggravated given the scale of the present shock.

Measuring and interpreting modern advanced economies was problematic pre-covid

Before the covid public health crisis there were increasing difficulties with measuring output and interpreting data and the behaviour of economic agents. The New European System of National Accounts changed the numeraire and made historical comparisons more difficult and there was an increasing disjunction between measured transactions resulting as artifacts of national accounting treatment and genuine transactions made by households and firms in the economy. An increasingly service based economy where intangible assets, such as brand, patents and intellectual property rights modified previously reliable economic relationships that could be inferred from economic data no longer held. The measurement of investment returns on capital and of productivity all became more problematic.

These challenges of measurement are part of the interest in new real time source of data such as the use of credit cards and road travel as proxies for economic measurement given the limitation and deficiencies in conventional survey measures and national accounts. In a similar manner economists have used measures such as electricity consumption to gage the scale and growth of Chinese economic output given the reservations that they had about the accuracy of the country's national accounts.

These challenges of measurement and interpretation were present before the covid pandemic, but the disruption to data collection will make it much more difficult to interpret what is going on, how much spare capacity there is and distinguishing transient price pressures arising from relative price effects generated by temporary bottlenecks and supply disruptions from a more general inflation that policy makers will not want to accommodate.

Conclusion

UK policy should be explicitly framed in an audacious manner to stimulate the economy and to ensure that it operates at a realistic assessment of its productive capacity. It should look to the three arrows of fiscal policy, monetary policy and supply-side reform. In the present context the role of stimulus will fall to fiscal policy. The fiscal stimulus measures should be married in a coherent manner with an agenda to improve work, saving and investment incentives. An agenda of reforming tax cuts should be financed along with the rest of the stimulus by borrowing and taking advantage of very low interest rates and very low rates of inflation. In terms of managing debt service and future debt burdens the UK should extend the duration and maturity of its debt and it should explore opportunities to lock into very low long-term rates on a permanent basis. If the economy exhibits a recovery in output so strong that it implies the recovery of inflationary dynamic inconsistent with a target roughly comparable to consumer inflation of no more than about 2.5 per cent on average over the medium term, decisive action should be taken to rebalance macro-economic policy by tightening monetary conditions and restoring interest rates and the yield curve to a more normal structure. As well as being necessary for macro-economic stability and stable and manageable inflationary expectations, more normal monetary conditions would enable credit and capital markets to function better in assessing risk and containing asset price bubbles. An ambitious growth strategy initially based around an immediate fiscal stimulus could have the beneficial consequence of returning the economy to a position where monetary policy is once again an effective instrument of policy.

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