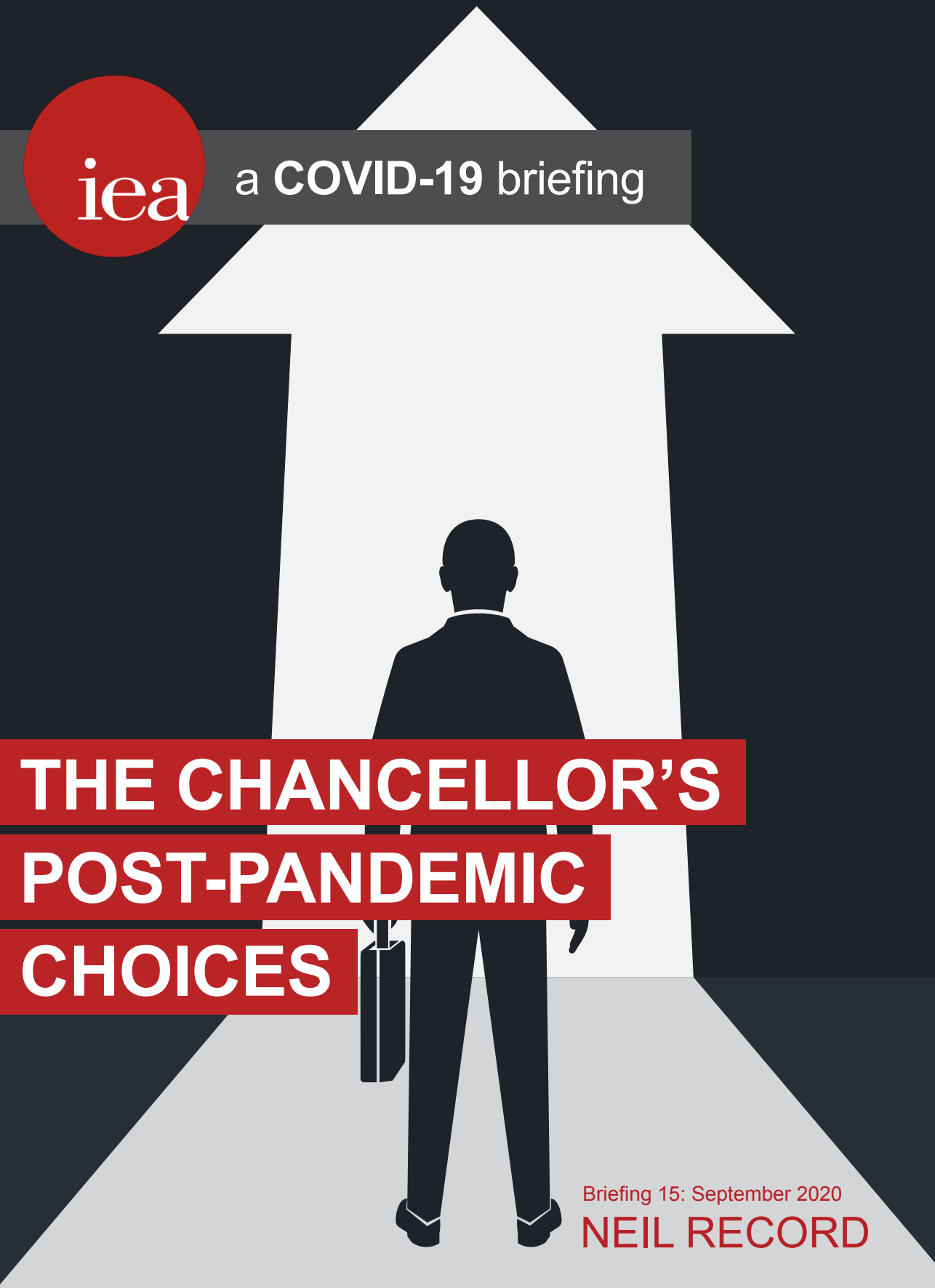
iea a COVID-19 briefing



THE CHANCELLOR'S POST-PANDEMIC CHOICES

Briefing 15: September 2020

NEIL RECORD

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Summary

Conditions for growth are not a mystery – we have seen them in the UK in the recent past. This paper examines the UK's historical record, and identifies the best-performing periods in the past 40 years under two criteria: rising real government revenue and rising labour productivity. It then reviews the economic policies which facilitated these 'golden' periods. As it turns out, the periods largely overlap, but are centred around 1993-2003.

The policies that spawned these successful periods have a proven track-record and hence can form a practical basis for policies that could be pursued now to achieve growth. In summary, in the best-performing period there was:

- A top rate of income tax of 40 per cent.
- Corporation Tax ranging from 33 per cent to 19 per cent, falling throughout the period.
- Highest rate of Stamp Duty on residential property rising from one per cent to four per cent.
- VAT rate of 17.5 per cent.
- Capital Gains Tax set at the same rate as income tax, but with Taper Relief (from 1998-99) reducing the rate on shares by up to 75 per cent (i.e. giving a top rate of 10 per cent).

The regulatory burden on all productive sectors was much lighter than in 2020. The best performing periods had much less financial regulation, much less labour market regulation, more targeted health and safety regulation, and much less energy sector regulation, with fewer subsidies.

Governments have choices. This government may not choose to adopt some or any of these successful policies. There will be good reasons for those decisions, but in the round, if the government in general, and HM Treasury in particular, is serious about pulling the UK out of the very serious financial and economic position it currently faces, then the evidence presented here should weigh heavily on their decision-making.

Introduction

Like many people, I have become increasingly concerned about the long-term consequences of the UK government's COVID-19-related extraordinary expenditure. Government finances entered the COVID-19 period in relatively poor shape, and according to the Office of Budget Responsibility (2020), are going to leave it in terrible shape. Faced with the position the government's finances are now in, what would I do if I were Chancellor of the Exchequer?

The answer to that question is to promote and adopt policies that will maximise government revenue growth subject to preserving (and ideally enhancing) the real incomes of the population.

Rather than speculate on policies that *might* work in the future, or build an economic model that *appears* to promote these twin aims, I have instead chosen to concentrate on the past 40 years (i.e. 1979-2019) to find the best 10-year periods measured against the twin aims above. As it turns out (and perhaps not surprisingly) the best periods on each of the two criteria overlap.

I will identify the differences between current policies in terms of tax, expenditure and regulation to identify the policies most likely to have a stimulating effect on tax revenues, economic activity and growth.

The problems in a nutshell

The UK, and HM Treasury in particular, is facing two major and very difficult-to-resolve issues:

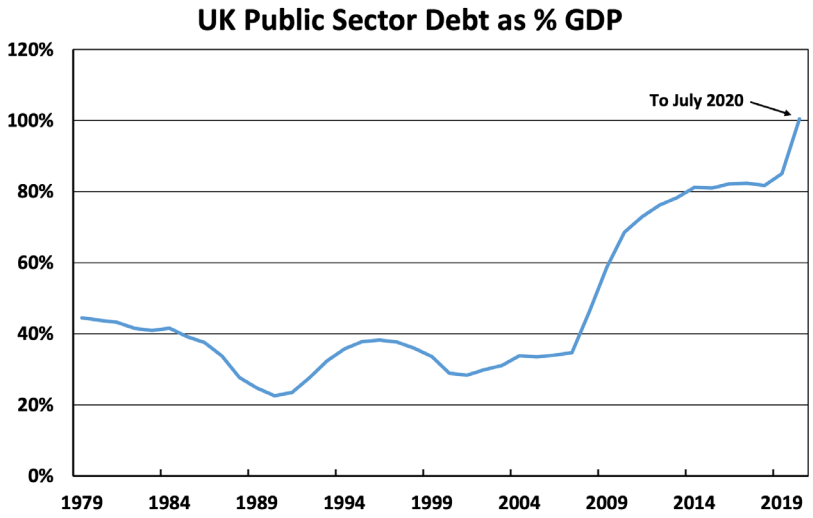
- highly-stressed public sector finances
- lack of labour productivity growth (extending now for 12 years), leading to stagnant real wages and living standards.

There are clearly many other pressing economic issues, but these stand out as secular, rather than just COVID-19-related.

Public Sector Finances

At the end of July 2020, the outstanding stock of UK public sector explicit debt was 100.5 per cent of GDP, or £2,004 billion (ONS 2020a). Figure 1 shows this in the context of the past 40 years.

Figure 1: UK public sector debt (1979-2019)



Source: ONS Series HF6W/YBHA

In addition to explicit debt, the government also owed £1,894 billion in 2018/19 (87 per cent of GDP) to its public sector pensioners in the form of employer-contractual unfunded Public Service Pension promises[1]. I discount state pensions from the list of contractual obligations, as they are a political promise, not a contractual obligation. Although you could consider them unfunded implicit debt, alongside ageing-related increases in spending on healthcare and social care. These are all promises rather than contractual obligations, but they would be politically very hard to fully renege on.

The explicit debt is currently financed at historically low rates of interest, including £684 billion[2] (i.e. 34 per cent) held by the Bank of England (BoE) and funded at an interest rate of 0.1 per cent per annum (BoE base rate) by deposits from the banking system (called 'Reserves' in the BoE balance sheet, but in effect, a Bank of England overdraft with the commercial banks).

1 Whole of Government Accounts 2018-19: https://www.gov.uk/government/publications/whole-of-government-accounts-2018-2019 Note that percentages of GDP may sometimes look inconsistent with money values as the denominator's date varies according to the latest available data.

2 Bank of England Weekly Report, 26 August 2020. Loan to Asset Purchase Facility = £684.5 billion (£684.5 billion/£2,004 billion = 34.2 per cent) https://www.bankofengland.co.uk/weekly-report/2020/26-august-2020

The Public Service Pension debt obligation is long-tailed, but crucially owed entirely to the approximately 20 per cent of the workforce in the public sector. This will not only create a heavy burden on future government spending, but will lead to government-sponsored 'retirement inequality' as private defined-benefit pensions mature and fall away, to leave 80 per cent of the workforce at the mercy of financial markets without a pension guarantee.

The Office of Budget Responsibility (2020: 9, Table 2) forecasts that the public sector is likely to run a £322 billion (16.7 per cent of GDP) deficit in 2020-21, as public sector revenues fall to £740 billion (38.2 per cent of GDP), and public sector expenditure rises to £1,062 billion (54.9 per cent of GDP).

Whether or not the OBR central scenarios are accurate or not is largely irrelevant; it is clear that the commitments of the public sector (the combination of outstanding debt and future spending commitments) are higher now than at any time since the aftermath of the Second World War, and that this level of borrowing and spending is unsustainable.

Labour productivity and real wage growth

One of the unsolved economic problems of the past decade has been the failure to grow labour productivity, and hence a failure to substantially raise real wages. There are many complex reasons for this, but the evidence we present is that from a policy perspective the government is now regulating high-productivity sectors much more heavily than in the successful periods of the recent past. It is clear that heavy regulation is damaging to innovation and productivity, and we will look at the evidence for this.

There is a politically sensitive sector whose (historically high) productivity is also falling rapidly. This is the energy sector. The UK government has now committed to reducing the UK's dependence on fossil fuels to zero by 2050. In pursuit of this aim, the government has imposed obligations on electricity suppliers to provide consumers with an increasing proportion of electricity generated from renewables. Renewables benefit from subsidies which guarantee electricity prices well above the market rate. In calculating labour productivity, the Office for National Statistics strips out these subsidies, which helps explain the energy sector's falling productivity. (The problem is, of course, not confined to the energy sector: higher energy costs have knock-on effects on most sectors of the economy.)

There is a great deal of official data on labour productivity, but most of it (apart from whole-economy productivity) only goes back to 1994. To allow fuller analysis of sectoral productivity, we will use 1994 as the earliest start date. Ten-year whole-economy labour productivity growth peaked in 1990-2000, but remained high until 1997-2007, so the lessons learned from this slightly later-than-ideal period still apply.

Summary of the problems

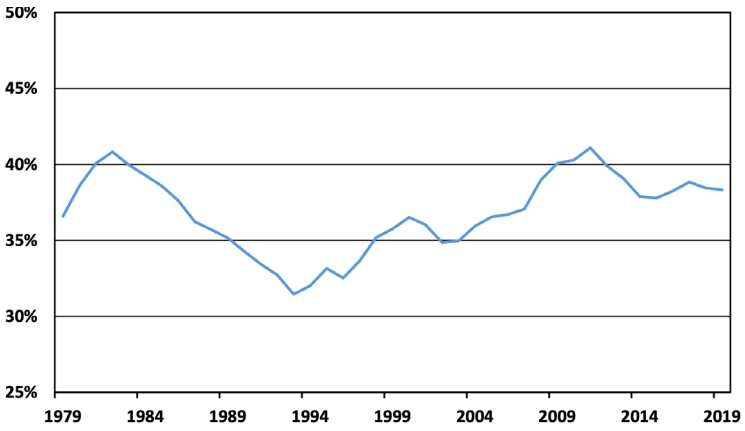
Much of the short-term COVID-19-related government spending will fall away in the short-to-medium term, but unless HM Treasury manages to encourage (or perhaps it is better to say, chooses not to prevent) strong growth in the underlying economy, the weight of the public debt burden and spending commitments will weigh very heavily on a whole generation, and possibly longer. It is perfectly possible to imagine, despite continuing technological improvements, that the weight of these obligations and the increasing regulatory burden will mean that labour productivity per hour, GDP per head, and real wages, will actually decline (rather than just fail to rise) in the decades to come. This would undoubtedly bring unprecedented moral, societal and political problems. The burden is also likely to fall most heavily on the poorest sections of society.

The analysis we conduct in this paper should give the government some useful guidance as to which policies may mitigate the difficulties outlined here, and offer a practical blueprint for laying the foundations for a resumption of improving living standards. It is not intended in any way to be a prescription – it is essentially a review of the available evidence.

Analysis of public finances

The UK, with its open and flexible economy, has found it very difficult to raise more than 40 per cent of GDP in public sector revenues. In 2019, total current revenue was £849 billion, or 38.3 per cent of GDP[3], as shown in Figure 2.

Figure 2: UK public sector revenue as a proportion of GDP



Source: ONS Series ANBT/YBHA

Why is it so difficult to raise more tax than this? Surely very high tax rates will raise a large amount of tax? The explanation is clear; led by Professor Laffer, who studied income tax rates in the US from the 1950s, and echoed,

3 ONS, PS: Total current receipts: https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/timeseries/anbt/pusf £m Current Prices, Not Seasonally Adjusted (NSA), divided by Series YBHA: GDP at market prices seasonally adjusted current prices.

inter alia, by a 2012 HMRC paper which illustrates the effect: as tax rates rise from zero, revenues rise to a ceiling, but with increasing tax rates they then fall as the tax 'base' begins to evaporate in the face of punitive tax rates (HMRC 2012: 51).

And 'evaporate' doesn't just mean 'tax avoidance' or 'tax evasion' (unless you define 'tax avoidance' in the broadest possible sense), it means that the base itself disappears. In 1978-9, the highest UK rate on personal tax on dividends was 98 per cent (the top rate of income tax being 83 per cent, plus the Investment Income Surcharge of 15 per cent), but very little tax was raised in this way because the vast majority of individuals chose either not to hold shares directly or, if they did, requested or instructed their firms not to pay dividends at all.

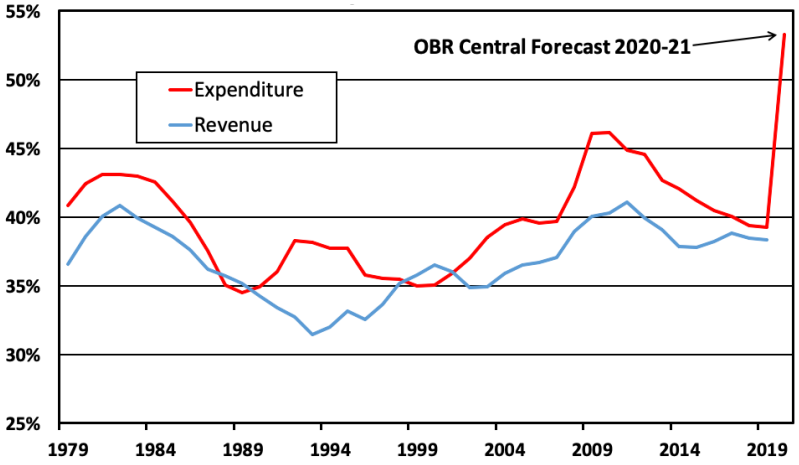
Another clear example is in the behaviour of corporation tax receipts. In 1980-1, the UK corporation tax rate was 52 per cent, and corporation tax revenue was 2.3 per cent of GDP[4]. In 2018-19, the corporation tax rate was 19 per cent and corporation tax revenue was 2.5 per cent of GDP[5]. The casual observer might imagine that in this example, the 'Laffer Curve' does not matter very much (since the tax raised was much the same), but this would be a mistake: this is precisely the Laffer Curve in action. An economy which taxes any sector or income-stream particularly highly will find itself deficient in the contribution that sector makes to the economy. It is difficult to grow labour productivity without increasing private sector capital intensity – and high taxes on capital are, by this argument, almost certain to limit the amount of productive capital in the economy.

In view of the difficulty of raising more than 40 per cent of GDP in public sector revenue, under any sustainable future path, public expenditure will have to fall and remain at or near that level. Figure 3 shows total public sector expenditure superimposed on revenue, and illustrates the scale of the problem (ONS 2020b).

4 Corporation Tax receipts 1980-81 = £6.1 billion (Source HMRC: Corporation Tax tables from the 1985 Inland Revenue Statistics publication); GDP 1980-81 at market prices (current prices) (ONS Series YBHA) = £267.4 billion. Corporation Tax as per cent GDP = 6.1/267.4 = 2.3 per cent.

5 Corporation Tax receipts 2018-19 = £55.1 billion (Source HMRC: Annual UK Corporation Tax Statistics 2019, Table 11.1A, Total Corporation Tax Receipts (including Bank Surcharge) 2018-19); GDP 2018-19 at market prices (current prices) (ONS Series YBHA) = £2,164.9 billion. Corporation Tax as per cent GDP = 55.1/2,164.9 = 2.5 per cent.

Figure 3: UK public sector expenditure and revenue



Source: ONS Series ANBT/YBHA; KX5Q/YBHA

To compensate as far as is practicable the difficulties which will be engendered by the necessary future public sector restraint, policies should be designed to encourage real per-capita GDP growth (hence allowing public services to at least maintain their current real level).

If the UK manages to re-establish more than two per cent real annual labour productivity growth (which was achieved on average over the whole of the period 1955-2008), and hence real per-capita GDP growth, then we have a good chance of re-establishing prosperity for the general population, and sustainability and security for the public sector. But what has history taught us is the best way to do this?

Raising public sector revenue/reducing public sector debt

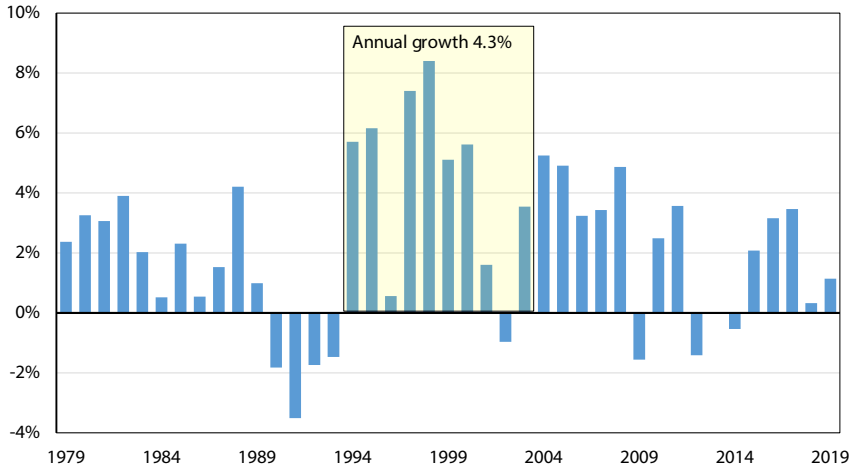
In searching for a fiscal strategy, we are looking for past success in raising new real (i.e. inflation-adjusted) revenue. Interestingly, real revenue rises are not the only important measure in the government's current predicament, because the majority of explicit public sector debt is nominal. Nominal revenue growth also matters. However, since inflationary spikes (1980-82 and 1988-91 in this 40-year period) also have a wide variety of undesirable effects, we assume that HM Treasury will seek to maintain the two per cent annual inflation target, and not attempt or allow inflation to accelerate the devaluation of its large stock of nominal debt. There is some alignment of incentives here; rising inflation would possibly mean rising nominal

interest rates, and given the near-zero duration of the Bank of England's QE funding (financed mainly by 'at will' deposits by the commercial banking sector) the negative effects on the public finances would be immediate.

So which was the best ten year period in the past 40 on these measures?

The answer is the period 1993-2003 – a decade which both pre- and post-dates a long period of prosperity and growth. Real public sector revenue growth over this period was 4.3 per cent per annum, amounting to a remarkable increase in real government income of 51 per cent in just ten years. Figure 4 illustrates.

Figure 4: UK government real revenue growth (1979-2019)



Source: ONS Series ANBT (Total PS Receipts) / L8GG (GDP Deflator)

But this improvement in the government finances did not go hand-in-hand with public sector austerity. Real public spending rose by 3.3 per cent per annum, or by 38 per cent over the period (ONS 2020b). More spending was therefore available for healthcare, education, pensions and all the other government obligations.

Was this the result of higher taxes? No. Tax rates remained stable or fell modestly over this period. Was this the result of government borrowing? No. Outstanding public sector debt in 1993 was 32.3 per cent of GDP; in 2003, it was 29.6 per cent (ONS 2020c).

Was it just inflation that reduced the debt as a per cent of GDP? No. CPI inflation averaged 1.6 per cent per annum over this period (ONS 2020d).

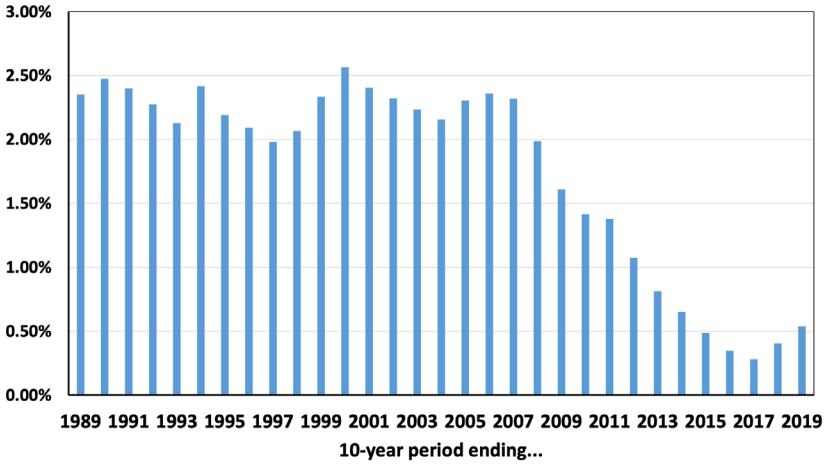
The lessons from this are clear. Economic prosperity is the key to healthy public finances and to real increases in public income and spending, not rising or high tax rates. The evidence of the 1970s (outside the scope of this paper) is that high tax rates stifle innovation and growth, and therefore ultimately public revenue.

So in the current context, when a cut in the proportion of public spending as a share of GDP is needed, this can only be achieved, without real cuts in expenditure, by strong real GDP growth in the economy as a whole.

Analysis of labour productivity

The decade with the highest growth of real productivity (Gross Value Added per hour worked) since 1979 was (by a slim margin) 1990-2000; although all of the period 1979-2007 was characterised by high (at least two per cent) annual growth. Figure 5 illustrates.

Figure 5: Labour productivity (1979-2019)



Source: ONS: UK Whole Economy: Output per hour worked
SA: Index 2016 = 100; Series LZVB

However, Office for National Statistics sectoral productivity data, which is very helpful in analysing how growth arises, only starts in 1994, so using that as the start date (and therefore 2004 as the earliest end-date), the highest full 10-year period that we can interrogate is 1996-2006 (ONS 2020e). It is likely that the lessons learned from this period are similar to those from adjacent periods in any case.

This successful period was characterised by rising GVA per hour worked in the highest value-added sectors, and by their rising in weight in the economy. Only one large sector (manufacturing) suffered a fall in its weight combined with rising productivity. This was largely prompted by the flight from lower-value-added manufacturing in the face of competition from developing countries (particularly south-east Asia) in basic manufacturing (heavy industries; textiles).

Sectoral Analysis

To better understand the dynamics of this period, let us look at some of the key sectors – their changing weights in the economy, their changing productivity (real GVA per hour), and their effect on the economy's productivity as a whole:[6]

6 Data sources: Hours worked by sector: ONS Labour Productivity Statistical Bulletin Q1 2020; Gross Value Added (GVA) by the same sectors: GVA: ONS Lower-level aggregates Q2 2020, Chain Volume Measure (which attempts to strip out price/ inflation changes) (CVM). Sector weights: Calculated from the ONS Lower-level Aggregates. More recently, the ONS has published volume GVA per hour worked by sector in Compendium of Productivity data 1997-2019.

Table 1: Contributors to growth 1996-2006

Contributors to growth 1996-2006					
Sector	Sector size % 1996	Sector size % 2006	GVA/hour 1996 £2016 constant prices	GVA/hour 2006 £2016 constant prices	Contribution to whole economy growth % p.a.
Whole Economy	***100%***	***100%***	***25.7***	***32.5***	***2.37%***
Financial Services	5.3%	8.0%	34.1	65.9	0.65%
Manufacturing	15.4%	12.0%	23.2	35.1	0.58%
IT, communication, publishing, broadcasting	3.2%	5.5%	23.3	42.9	0.31%
Rent and property leasing	2.1%	3.0%	62.7	72.6	0.16%
Transportation and storage	4.4%	6.1%	21.5	29.6	0.15%
Legal, accounting, professional & scientific	4.4%	6.1%	18.2	25.9	0.15%
Government: Public Administration & Defence, Education, Health, Social and Residential Care	21.0%	19.2%	26.5	27.5	0.09%
Construction	7.0%	6.5%	23.4	25.1	0.06%
Total contribution from these sectors % p.a.	***62.9%***	***66.6%***			***2.10%***

There are three big stories here. The rise in the size and productivity of the financial sector was the largest contributor to productivity growth over this period. The continuing fall in the size, but strong rise in the productivity, of the manufacturing sector was the next largest contributor, and finally the rise of the ‘information economy’, embodied in the IT, communication, publishing and broadcasting sector, was the third most important contributor.

The environment in this period was encouraging of these sectors, and they flourished. Together they contributed two-thirds of the productivity growth over this period. It is notable that the government sector made a modest positive contribution by shrinking – it is a low-productivity sector, with low growth.

What about the most recent ten years?

Table 2: Contributors to growth 2009-2019

Contributors to growth 2009-2019					
Sector	Sector size % 2009	Sector size % 2019	GVA/hour 2009 £ 2016 constant prices	GVA/hour 2019 £ 2016 constant prices	Contribution to whole economy growth % p.a.
Whole Economy	***100%***	***100%***	***32.3***	***34.1***	***0.54%***
IT, communication, publishing, broadcasting	5.9%	7.3%	43.9	50.2	0.15%
Construction	5.7%	6.3%	22.2	27.6	0.12%
Rent and property leasing	3.6%	4.2%	43.9	50.2	0.07%
Legal, accounting, professional & scientific	6.4%	8.1%	27.2	30.4	0.06%
Manufacturing	10.9%	9.8%	35.6	38.1	0.06%
Government: Public Administration & Defence, Education, Health, Social and Residential Care	19.9%	17.9%	27.2	27.1	0.03%
Transportation and storage	4.4%	4.2%	26.5	26.1	0.00%
Financial Services	8.9%	6.5%	70.6	62.9	-0.33%
Total Contribution from these sectors per cent p.a.	***65.8%***	***64.3%***			***0.20%***

As shown in Table 2, all the main contributors to growth in the best period, and particularly the top three, failed to deliver any growth in the post-credit-crunch era. What changed, fundamentally, in this period?

The regulatory burden

It appears that two connected trends emerged – both damaging to productivity growth. The first, and most explicit, was a backlash against the excesses and failures of the UK and global banking sector. The wake of the credit crunch brought extra taxes on the banking sector, but much more importantly, a tightening grip of financial regulation; a grip that has continued to tighten in the succeeding decade. The rule book of the Financial Conduct Authority (FCA) now exceeds 3,600 numbered paragraph headings; and several major new regulatory edicts (MiFiD I & II; Senior Managers and Certification Regime) have cowed this previously vibrant and inventive sector. Note that the financial services sector is not just banking – the 'culprits' of the 2007-9 credit crunch – but also securities broking, FX trading, securities issuance, private equity, venture capital, insurance & re-insurance, custodian services and a multitude of highly specialised and globally important niches.

But the enthusiasm for regulation, which was sparked by the credit crunch, has found its way into every corner of business. The list of new, and onerous, burdens on business is long. I will look briefly at one – labour market regulation.

Employing anyone in the UK brings a bewildering array of costs and obligations. The obvious costs are the obligations to pay Employers' National Insurance contributions, holiday pay, sick pay, pension contributions and maternity pay. These are not new (although pension and maternity obligations have been much extended in the past decade), and because markets are ultimately flexible, explicit pay will have most likely fallen to compensate for the extra costs that employers bear.

But there are a range of (largely) new obligations, which are not explicit costs, but are 'risks'. They are risks in the same way that an insurer takes risk when it takes on, say, a motor insurance contract. The most likely outcome of such a contract is no net cost in any one year; the next most likely is some modest cost now and again, but occasionally, there is an enormous, and unpredictable cost.

If you are an insurance company, these are planned for, and charged for by way of premiums. But employers take them on without wishing to; without being able to avoid them, and without receiving any premium for them. This is not so much a 'cost' as a strong disincentive to become an employer, since some of these risks could bankrupt even a well-capitalised employer.

What are these risks? Many of them are associated with shedding staff, sometimes with hiring staff, and occasionally with ongoing employment. Disability discrimination, racial discrimination, sexual or sexual orientation discrimination and age discrimination have all reached the statute book, or been significantly reinforced, in the past 20 years[7]. Many of these statutes are borne of noble intentions – discrimination on irrelevant grounds is unacceptable in a civilised society – but most employers find that these laws simply raise the cost of hiring, firing and re-organisation while having little or no effect on discrimination.

The numbers of self-employed may be an inverse indicator of the general regulatory employment burden on business. There has always been demand for self-employment from single-handed craftsmen with multiple small customers, but it is indicative that the ranks of the self-employed, swelled from 3.7 million in 2009 to 4.7 million in 2019, an annual growth rate of 2.3 per cent (ONS 2020f). By contrast, the self-employment growth rate in 1996-2006 (when real per capita growth was much stronger) was 0.4 per cent per annum (ibid.). Many of these 'self-employed' jobs are individuals working for organisations who would not take them on as employees with all the attendant regulatory obligations, but are prepared to pay for their labour services on a 'pay-as-you-go' basis, without the burdensome obligations of an employer.

A key route to resuming productivity growth could be a return to the lighter regulation of the employment market. This would allow employers to more accurately match skills with tasks, and allow small firms to grow faster without the worry of the obligations that employing staff currently brings.

7 These obligations are embodied, inter alia, in the following laws or Statutory Instruments: Employment Rights Act 1996; Working Time Regulations 1998; Employment Relations Act 1999; The Maternity and Parental Leave etc. Regulations 1999; Part-Time Workers (Prevention of Less Favourable Treatment) Regulations 2000; Transfer of Undertakings (Protection of Employment) Regulations 2006; Equality Act 2010; Agency Workers Regulations 2010; Data Protection Act 2018.

The evidence presented here shows that allowing market forces to mould our sectoral balance, and allowing the animal spirits of the UK population to thrive, without undue regulatory interference, is now, and was in the past 40 years, the route to growth.

This briefing has argued for an economic policy framework more similar to the one that characterised our best period in recent history, in order to get us back onto the growth path we were on then. There is, of course, no reason why that should be the limit of our ambitions – we can go beyond, and do even better.

Evidence from the US shows that liberalising land-use planning laws, in order to facilitate housing development, can raise GDP by about 10 per cent (Hsieh and Moretti 2015). This is mainly because it enables more people to relocate from low-productivity to high-productivity cities and regions. If this is true for the US, it is likely also to be true for the UK, where land use planning laws are far more restrictive still.

Even in the good times, our tax system has been too complex, too distortionary, and not sufficiently investment-friendly. We need major tax simplification, and a shift in the burden of taxation from more distortionary to less distortionary taxes.

Brexit entails short-term disruptions, but it also opens up new policy avenues that were not available to UK governments of the 1990s and 2000s, especially in the areas of trade and regulation.

Getting us out of the post-Covid mess requires learning from best practice. Ideally, this would mean both learning the right lessons from our own recent past, as well as from international best practice.

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