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The Missed Opportunity of Trussonomics

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October 27, 2022

In Britain, the Trussonomics supply-side experiment of tax cuts and regulatory reform is over, before it really began.

Bond yield spikes and currency volatility following British Prime Minister Liz Truss' mini-budget was interpreted in Westminster as necessitating a corrective fiscal consolidation. With Conservative members of Parliament unwilling to countenance government spending cuts, Truss was forced into a humiliating U-turn on her tax cuts, which meant sacking her own chancellor. In position but no longer in power, her credibility was shot. The Conservative Party duly forced her out and has now crowned Rishi Sunak the new prime minister, a man Truss defeated for the Conservative leadership just seven weeks ago.

Was Trussonomics' demise a missed opportunity for Britain, or an inevitable failure? Understanding the context is crucial. The United Kingdom's growth performance since 2008 has been abysmal, with real GDP per capita barely increasing by 5% in the period since. Labor productivity would be 30% higher today if it had continued growing at its pre-financial crisis trend rate, while total factor productivity has been flat for a decade. Not only are Brits relatively poorer than expected as a result, but they've been falling further behind Germany and the U.S. from a lower base.

Raising the level or growth rate of GDP through policy is hard, but Truss thought the Tories had focused insufficiently on getting the microeconomics right. Under David Cameron and George Osborne, the Conservative Party's guiding policy was fiscal consolidation. Theresa May had taken them in a dirigiste direction, with Brexit raising U.K.-EU trade barriers. Boris Johnson was obsessed with public service spending and government infrastructure projects. Fiscal hawk Sunak, as Johnson's chancellor, demanded permanently higher national insurance taxes and an increase in the corporate tax rate to fund this higher health and pandemic spending. The tax burden was set to hit its highest level since World War II.

Trussonomics as conceived was therefore a supply-side plan to try to break a stagnation doom-loop. Truss wanted to ease the squeeze by increasing the economy's productive growth potential, aiming for a 2.5% growth rate. The Bank of England would grip inflation, but the government would borrow more in the short run (cutting spending in the longer run) to grease the wheels for better tax incentives for sustainable growth. She wanted to start attracting investment by canceling the corporate tax rise from 19% to 25% that Sunak had introduced, reverse his 2.5% marginal national insurance tax increase to improve work incentives, and lower “stamp duty”—a residential property transactions tax—to encourage mobility.

Her bigger growth prize, though, was delivering non-tax regulatory reforms. Truss wanted to use “investment zones” as a means of liberalizing land-use planning for more houses and business premises; to relax Britain’s child care laws to produce more flexible options for working parents; to overhaul environmental review processes to make transport infrastructure quicker and cheaper to build; to open up more legal immigration routes; and to lift the absurd national bans on fracking and new onshore wind capacity to produce more energy.

Each proposal would generate opposition from vested interests and ideological factions within her own party. But she spoiled to fight this “anti-growth coalition,” wearing her willingness to prioritize growth and court unpopularity as a badge of honor. Alas, the mini-budget reaction killed this agenda stone dead. The story of why is a sad tale of misjudgment, impatience and hard luck.

In the buildup to Truss’ leadership win, her opponents had labeled her as someone who would blow up borrowing and undermine the Bank of England’s independence. This charge defied a career of hawkishness on government spending and ignored that Truss’ criticism of the bank was about it being too tolerant of high inflation. But that narrative stuck. With markets already jittery, it was imperative to ensure bond market credibility that she and her chancellor Kwasi Kwarteng show respect for institutional norms and that they took debt seriously.

Sadly, the mini-budget did neither. Rather than setting out tax cuts in a broader fiscal framework to avoid spiraling debt, it launched a more expansionary package than expected, with tax cuts of around 1.6% of GDP relative to baseline. This included the tax policies on which she campaigned, supplemented with unexpected cuts to the basic rate of income tax, several other revenue losers, and a controversial slash in the top marginal income tax rate on high earners from 45% to 40%.

This came on top of a two-year, universal, untargeted energy price cap for households that meant extensive government subsidies to suppliers. Gas prices at the time implied this would cost a massive 2.4% of GDP in 2022-23, with no funding mechanism outlined. Without offsetting spending cuts or a clear means of winding down the energy program before the 2024 election, overall annual borrowing was set to surge in the near term to 7.5% of GDP.

In isolation, each of the tax policies was hardly radical. The overall tax burden would have fallen back only to its 2021 level, given the revenue boon of keeping income tax thresholds frozen in this high inflation environment. New Labour policies under Tony Blair and Gordon Brown instituted a top marginal income tax rate of 40% for the party’s whole time in office. And if Sunak had not set in train the corporate tax hike, few would be clamoring for it, with Britain on the brink of recession—needing to attract post-Brexit foreign direct investment—and with faster deficit reduction baked in than in most other countries.

But the macroeconomic context mattered. With bond yields already rising and inflation high, the U.K. government was sticking its neck out from the pack by apparently disregarding debt and justifying certain tax cuts as "putting pounds back in pockets" (i.e., as demand-side measures). A huge, unbounded risk was being taken onto the government's balance sheet through the energy policy, too.

Crucially, the government had spurned the opportunity to allow the Office for Budget Responsibility to publish detailed deficit forecasts and map out the path of government debt these policies would produce. The uncertainty this created was compounded by Kwarteng defending the measures in the immediate aftermath by promising further tax cuts in 2023. Bond yields shot up further, and the pound plunged. Mortgage rates started surging, and in the U.K., around 20% of holders are on variable rate contracts.

Economists have various theories about why financial and currency markets reacted so wildly. Obviously, borrowing more is likely to push up real interest rates, but these usually strengthen the currency in the near term. Some believe markets worried that the Bank of England would tolerate higher inflation to avoid a government interest cost doom loop (so-called fiscal dominance). Others think large net tax cuts produced radical interest rate uncertainty. Without knowing whether and how spending would be tamed, the future path of short-term U.K. interest rates became unclear, making the future prices of U.K. assets themselves uncertain, thereby encouraging people to reduce exposure to them.

One theory blames the Bank of England as a financial regulator. Sharply rising bond yields exposed huge over-leverage in the pension system. Funds had bought gilts with borrowed money, and as bond prices fell, this generated huge collateral demands. "To raise the necessary cash," Bloomberg columnist Narayana Kocherlakota has said, "they had to sell more gilts, creating a doom loop in which declining prices and forced selling compounded one another." This pushed bond yields yet higher.

Whatever the cause, once government borrowing costs became inextricably linked to U.K. political developments—falling every time policy reversals were mooted—Truss was under severe pressure to backtrack. Her team flew kites for spending cuts to protect the core tax policies, but these were rebuffed by Tory MPs, not least because of the optics of reducing welfare or public service spending to protect the tax rate cut for high earners. U-turns thus became inevitable and Truss doomed.

Why did she sequence events this way? With just two years before an election, Truss wanted time for her policies to produce results. In hindsight, waiting a few months to lay out proper tax and spending plans could have avoided such a drastic reaction, especially given that gas prices in

Europe have since fallen. But at the time, Truss wanted to prevent household energy costs from dominating the political debate and to signal a decisive shift in policy direction with the tax cuts.

This is why the mini-budget excited libertarians so much. It wasn't so much the content, but the direction of travel. After a decade of fairly low borrowing costs that hadn't spiked even with massive pandemic spending, people became sanguine about red ink. Adding in controversial measures, such as cutting the top income tax rate to attract footloose talent, or ending the cap on bankers' bonuses, was deliberate, too. Truss wanted to signal her willingness to prioritize growth.

Alongside these economic errors, though, this was a huge political miscalculation, because these specific tax cuts would not, by themselves, have generated surging productivity. Far from greasing the wheels for her more important supply-side reforms, including extremely controversial measures created ardent opposition among Tory MPs, strangling the prospects for spending cuts or regulatory reform from the start.

The tragedy of Truss' failure is that Conservative MPs, many of whom had no interest in supply-side reform anyway, will use the episode as justification for their illiberalism on supply issues writ large. One, Robert Halfon, already alludes to markets having reacted to "libertarian jihadists," rather than too much borrowing. Sunak's first acts as prime minister have been to reintroduce bans on fracking and onshore wind farm developments, while scrapping the Truss' government's proposals on housing, infrastructure and child care reforms.

Those of us who want to prioritize growth must learn important lessons from this political disaster, to wit: Pitch-roll your arguments, work within institutional norms, take the macroeconomic context seriously, realize that tax rates aren't the be-all and end-all, and play down your radicalism, rather than leading with your chin.

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