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Tax Cuts without Pro-Growth Reform Or Spending Cuts Are Simply Tax Hikes Deferred

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Nobel Prize winning economist Milton Friedman once said: “I am in favour of cutting taxes under any circumstances and for any excuse, for any reason, whenever it’s possible.”

As always with the diminutive libertarian, partial quotes are misleading. He went on to explain that government spending, not taxes, was the ultimate burden of the state on the private sector. That was what required restraint.

As the Conservative leadership race intensifies, various candidates and the commentariat are labelling some wannabe PMs as caricatured Friedmanites. Rory Stewart continually draws distinction between being fiscally conservative and a tax cutter. Michael Gove calls the latter “one-club golfers”. Opinion formers exhibit a distinct asymmetry too. They label tax cuts fiscally irresponsible, while welcoming spending proposals and ignoring that Britain’s debt time bomb is driven by growing state pension and healthcare demands.

Genuine concerns about fiscal sustainability are warranted, of course. Maintaining a falling debt-to-GDP ratio today given its current high-level and projected demographic explosion is prudent, economically and politically. One need only observe how Donald Trump’s large deficit-financed tax cuts are loosening constraints for US Democrats to propose mammoth spending splurges to see the pitfalls of a deficit arms race.

But with the tax burden at its highest for five decades and continual sluggish growth, ruling out tax cuts entirely (as Rory Stewart did) is itself the height of irresponsibility. In fact, Britain is crying out for radicalism on taxes. We need a strategic agenda with bold steps towards a more coherent, pro-growth code.

Fiscal conservatism and tax cutting are not mutually exclusive. The way to reconcile them is to cut spending, or else only cut taxes that will substantially grow the economy or reduce tax avoidance. Even beyond that, how you raise revenues for any spending level is an important policy tool in determining the productive potential of the economy. A more pro-growth code facilitates higher GDP, wages and revenues for public services.

Achieving deficit-neutral tax reform is hard politically, however, particularly if spending cuts are off the menu. Reforming taxes inevitably creates financial winners and losers when revenue-neutral, and the latter kick up a political stink. Net tax cuts therefore play a crucial short-term role in greasing the wheels of controversial changes. Changing burdens between taxpayers is political suicide without them.

Yet just as tax reform without net tax cuts is politically damaging, tax cuts without meaningful reform is a wasted opportunity. So far, the leading Conservative candidates have fallen into this trap: making big, expensive retail tax offers that don't maximise opportunities to grow the economy, but would blow up the deficit without requisite spending cuts. Dominic Raab proposes large "cash in the pocket" tax cuts for low earners, for example, by lifting the national insurance starting threshold and slashing the basic income tax rate to 15pc. Yet at a high "cost" of £30bn in lost revenues, neither will do much to improve key economic incentives. If financed by extra borrowing, they amount to just deferred taxation for future generations.

Boris Johnson's headline policy has more economic justification. Raising the 40pc income tax threshold from £50,000 to £80,000 (partly offset by raising the point where employee national insurance rates fall) corrects for it lagging wage and price increases over three decades. This sucked millions of extra people into the 40pc band. Combined with withdrawal of child benefit for families earning more than £50,000, earners in this ballpark often face some of the highest marginal tax rates of any earners.

Yet, again, with a £10bn price tag, it's unclear whether Johnson's policy achieves growth "bang for the buck." For the same revenue outlay, he could have raised the 40pc threshold to just £70,000 and abolished the 60pc effective rate that those earning above £100,000 experience, due to the withdrawal of the personal allowance. In one swoop, that combination would have eliminated the highest marginal tax rates across the whole income tax.

Michael Gove's proposed replacement of VAT with a simple retail sales tax (RST) is the worst proposal of all. Though economically equivalent in theory, RSTs are less efficient in practice. Easier avoidance, given only the final retailer is responsible for payment (rather than collections through the production chain, as with VAT) means no country has sustained an RST beyond around a 10pc rate. This likely means a big revenue fall if the policy is adopted. It would shift the UK away from taxing consumption, even though economists agree this is the least destructive major source of revenue.

Yet if these proposals are the wrong tax cuts priorities given slow growth and the debt outlook, then what are the right ones?

Pro-investment tax changes, such as allowing immediate and full expensing of capital investment, dropping the top rate of capital gains tax, and shifting business rates to a business land value tax to encourage upgrades to buildings, would be obvious candidates. Phasing out stamp duty (a tax on labour mobility) would also improve productivity, particularly if accompanied by land-use planning reform.

In fact, rationalising housing taxation more broadly, taking active steps to merge income tax and national insurance, and eliminating those highest marginal tax rates across incomes as outlined, would also be welcome. Any other changes should adhere to the principles of broadening tax bases, lowering marginal rates and ensuring neutrality across economic decisions.

The UK is crying out for measures to improve the economy's productive potential. Tax cuts and reform should be part of that mix. But to allow big, sustainable broad-based revenue reductions, candidates need to cut spending. If not, they must prioritise tax cut and reform policies with the largest growth impacts. That's the way to synthesise tax-cutting with fiscal conservatism.

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