CITY A.M.

'Fiscal Phil' has one chance to live up to his namesake

Ryan Bourne

November 21, 2017

For five years, the Conservatives made deficit reduction the key plank of their economic platform.

Yet, strangely, chancellor Philip Hammond now finds himself under pressure from much of his own party to substantially loosen the fiscal purse strings.

Conventional wisdom says the country is weary of austerity. More money is needed for public services. Committed Brexiteers seem to want the chancellor to bank on some future Brexit dividend to justify yet higher spending and tax cuts. And there are still those who believe that anything labeled "government investment" must by necessity be economically beneficial and worthy of higher public borrowing.

But the economic case for higher UK government spending right now is weak.
Keynesian economists would suggest that so-called stimulus spending through borrowing is needed when there is lots of spare capacity in the economy and the Bank of England has exhausted lowering interest rates.

But with unemployment at 4.3 per cent and the Bank having recently raised rates, the country is not in any need of some "demand-side boost" through more public spending, even if one believes it could at other times be beneficial.

The key issue for the UK's growth prospects is now the outlook for productivity – or the supply-side.

Claiming more borrowing will be "good for the economy" is really an argument that the borrowing will boost the country's growth potential.

Tax cuts and commitments to eliminate tariffs after we leave the EU could play a role here. By sharpening incentives to save, produce and invest, or by opening up industry to the productivity-enhancing effects of competition, cutting taxes can raise the potential size of the economy.
However, if the path of government spending (the true burden of government) is not adjusted downwards too, tax cuts today are in large part tax rises in future, and blunt much of this growth-inducing impact.

Theoretically, some spending on infrastructure investment could enhance productivity too, if the government invested well in high-impact schemes. But that's a big "if".

Actual government experience of projection selection on infrastructure suggests it unlikely. The UK 2010 Comprehensive Spending Review, for example, deferred, cancelled or placed under review strategic road schemes with average benefit-cost ratios of 6.8, 3.2 and 4.2 respectively, yet persisted with HS2 with an estimated benefit-cost ratio of 1.2.

If anything, a government concerned about long-term economic growth might be thinking about constraining spending further. With the tax burden already set to hit the highest level as a proportion of GDP since Harold Wilson was Prime Minister, cutting spending would leave more resources in the private economy, and create space for future cuts to marginal tax rates that will be good for growth.

The case for more spending restraint can be justified from a public finance perspective too. The UK is still running a modest deficit of around 2-3 per cent of GDP a decade after the crisis. The government's independent fiscal watchdog – the Office for Budget Responsibility – considers this deficit almost entirely structural.

As a result, the UK's national debt is rising and is headed towards 90 per cent of GDP, leaving the UK government finances in a vulnerable position given the unknown risk of a potential recession and the known headwinds of an ageing population.

The government really should be seeking to get the debt-to-GDP sustainably on a downward path in the coming years, rather than continually pushing off fiscal balance. Again, the implication is tighter control of spending, not loosening it.

All this is not to suggest the chancellor should be unambitious this week. There is plenty of scope for him to use the upcoming Budget for pro-growth tax reform.

As the main economic ministry, the Treasury should be pressing colleagues to overhaul Britain's growth-suffocating land-use planning laws. Even for a given amount of funds, Hammond could reorient spending to achieve a bigger economic return.

But calls for the chancellor to open the spending taps again are deeply irresponsible.
Those who supported Brexit should be honest enough to recognise that it comes with significant uncertainties in the near term.

To make it a success requires long-term economic liberalisation with the newly repatriated powers over trade, regulation, and public money. But that liberalisation requires actually doing the hard work of regulatory reform, gaining public acceptance for freer trade, and limiting the size of the state to enable low taxes.

All this could enhance growth in future and provide more resources for public services. But to simply tell the chancellor to be more optimistic about Brexit and use that as justification for more public spending is to put the cart before the horse. The case for fiscal restraint is as strong today as ever.

Ryan Bourne occupies the R. Evan Scharf Chair for the Public Understanding of Economics at Cato.