“The difficulty lies not so much in developing new ideas as in escaping from old ones”

John Maynard Keynes
DEALING WITH COVID-INDUCED GOVERNMENT SPENDING IS NOT A PROBLEM

OUR PROVOCATION

• Post-COVID government debt is not a major or insoluble issue for a UK government that has sovereign control of its own currency

• Taxes should be seen as an inflation-taming tool not primarily as the route to cutting government debt or funding government expenditure

• There is no imperative to start considering tax rises now or in the near future. Incipient inflation not government debt levels should be the trigger for considering tax rises

• Fiscal policy may be a better route to dealing with any excess inflationary pressure, should it materialize, than are higher interest rates

• Taking this perspective also has political advantages for the government in a post-Brexit, post-COVID world and relative to the issues that will likely plague the Eurozone

• Political objections that may be ideologically driven.

THE FRAME

One of the main issues of political economy to be addressed in 2021 and beyond is how to deal with government finances and the sovereign debt induced by the massive fiscal support provided during the pandemic. The Chancellor has already started making noises around the idea of ‘fiscal prudence’ and the dangers to the government’s finances should interest start to rise.

It remains to be seen whether these comments turn out to be meaningful in practice or whether they are statements intended to test the political waters.

GOVERNMENT DEBT

Although UK government debt has increased as a result of pandemic-related expenditures, in a low interest environment the cost of servicing the debt has decreased. The levels of debt are therefore perfectly sustainable at current interest rates. Further, a proportion of the debt is held by the Bank of England (BoE) and is effectively cost free for the government.

There is nothing to stop the BoE buying an even greater proportion of government debt than it does now. For a government that controls its own currency, placing debt with the private bond markets is a choice not a necessity. At an extreme, all UK government debt can be placed with the BoE thereby cutting bond markets out of the picture altogether.

In short, government financing need not be a problem for the UK unless it is willfully made to be
a problem by an inability to break out of conventional thinking or for political/ideological reasons.

**INTEREST RATES ARE NOT-automatic**

Interest rates do not just rise or fall according to some pre-determined act of fate. The policy rate is determined by the BoE. Changing the policy rate is a conscious policy choice that should only happen if:

(i) interest rates are the appropriate policy choice in the round

(ii) the advantages outweigh the disadvantages.

**INTEREST RATES ARE A POLICy CHOICE - DO THEY WORK?**

In general, the policy rate is increased by the BoE as a counter to rising inflation. However, a number of factors are considered:

- Fighting incipient or established inflationary pressures while encouraging balanced economic growth and not putting government debt servicing costs under pressure.

- The effectiveness of rising interest rates as a route to combating inflation – something that has been the subject of much economic analysis without any firm conclusions. This raises the question as to whether interest rate rises have become an inflation-fighting tool because they work best or because that’s just what we do.

- The BoE has other tools at its disposal should inflationary pressures become evident. It would, presumably, initially start to wind down its asset purchase programme – particularly non-government assets – before raising interest rates.

- A combination of fiscal and monetary action is more likely to be effective than relying on monetary policy alone.

**GOVERNMENT POLICY CHOICES**

Let us imagine that inflationary pressures start to raise their head some time in 2021 and beyond. What options are open to the government?

The first option is to do nothing and leave it all to the BoE. This is likely to be less effective.

The second option is to take money out of circulation by raising taxes. In an age of fiat money, taking money out of circulation is, after all, the primary function of the tax system, not, as we have been indoctrinated to believe, to fund government expenditure*.

- Using fiscal policy in this way as a counter to inflationary pressures (rather than as a budget balancing tool) has many advantages:

  - Its effects are much more direct and likely to be more effective more quickly in taming inflation than are rising interest rates

  - Interest rates are a blunt instrument. Tax rises can be targeted. They can target those who can afford to pay them while protecting the less well-off who are more prone both to be borrowers simply to make ends meet and to suffer from inflationary pressures on essential goods. Taxes can be used to target policy objectives: push forward the government’s green agenda; turbo-charge the leveling up agenda; help with the much-needed uplift in social cohesion; etc. In other words, fiscal policy can be structured to have much more positive social and environmental effects than monetary policy – and distributional effects would be underpinned with appropriate democratic legitimacy

  - Tax rises have the added advantage (Note: added advantage not primary purpose) of increasing government revenues enabling a

**FISCAL POLICY MUST PLAY ITS PART IN TACKLING INFLATION**

* This concept has been part of economic thinking for many decades before the false concept of “taxpayers’ money” became a popular slogan. It has recently been revived as part of Modern Monetary Theory.
reduction in the legacy debt burden if the government feels that is an appropriate use of funds

- Tax rises have less of a negative effect on the supply side of the economy. They are less likely to decrease industrial investment (a pre-tax expenditure) and would not push up the value of the currency to the disadvantage of exporters (the UK has the largest trade deficit with the rest of the world of any rich country). Fiscal policy can therefore be calibrated to control inflationary pressures without unduly weakening employment and continued economic recovery

- There would be no need to cut public investment or spending on public services – actions that would open the government up to charges of repeating the now widely discredited ‘austerity’ policies – besides the economic damage such austerity would inflict.

The Blocks and Objections

The blocks to using fiscal policy in the way described above are primarily political.

Nobody likes tax rises and governments don’t like to do them if they can be avoided. Washing one’s hands of the necessary changes and leaving it all to the BoE may be politically convenient but poor governance.

Of course, at any given time, the potential unpopularity of tax increases has to be balanced with the adverse effects of alternative measures such as cutting government investment or public services, putting homeowners under pressure through rising mortgage interest rates, increased pressure on the indebted poor, etc.

Tax rises as an inflation-control measure may also be more acceptable since controlling inflation preserves purchasing power.

A further objection is that, in order for tax rises to be effective as an anti-inflationary measure, they would have to be changed often and titrated to macro-economic developments. Annual changes in a government budget may not be effective enough. Such frequent adjustments to tax levels would be highly disruptive.

There is validity to this argument. However, fiscal policy need not be the only inflation-taming measure. Our contention is that there should be more coordination between fiscal and monetary policy.

FISCAL POLICY GIVES BETTER CONTROL OF DISTRIBUTIONAL IMPACTS

Tax take also self-adjusts. With tax rates at any given rate, the absolute amount of money taken
out of circulation will automatically increase when companies and individuals are making more money and falls when they are making less.

With a suitably progressive tax system, the distributional impact changes accordingly – and more favourably.

Since it has not, to date, been mainstream policy, it is also not clear that tax adjustments to fight inflation will be needed quite as frequently as interest rate adjustments.

There is a hypothesis to be tested that, if tax adjustments were to be the more effective inflation fighting tools, they would not have to be adjusted quite as frequently as interest rates. That the need for constant tinkering with interest rates is simply evidence of their relative ineffectiveness and the long time-lag between interest rate rises and any noticeable effect on inflation.

For those who believe in small government as a sine qua non of liberal prosperity, the idea that government expenditure is not limited by a combination of tax income and the ability to raise money in the bond markets strips them of a 'sound economics' platform for cutting back government activity.

Slogans with little meaning, like 'magic money tree' and 'there is no free lunch', will continue to be deployed.

But some would argue that the root objections might lie in an ideological rejection of any significant role for government in the economy and in society.

Finding the balance

There is a balance to be struck. How much government expenditure is it reasonable to deploy without undercutting the essential role of the private sector in the economy? That is a political choice. But the choice is not dependent on access to financing.

The reality is that in an age of fiat money, all money is simply created out of thin air. The only questions are

(i) who is creating the money

(ii) for what purposes, and

(iii) how much of it is it reasonable to create and leave in circulation without adverse consequences that outweigh the benefits.

Some will also believe that the abandonment of the tall tale of 'fiscal rectitude' will undermine their main advantage over Labour in voters’ eyes. That

THE POLITICS

Of course, the discussion about government debt is a political one as much as it is an economic one.

The current Conservative government likely faces different and opposing views within its own party as to how to handle Covid-induced government debt.

The Objectors

There may be a section that continues to believe ideologically in 'fiscal rectitude' and would like to come closer to the German 'Black Zero' world view even as Germany is itself slowly abandoning that stance. Such a position incorrectly treats government finances as though they were household finances, and the BoE balance sheet as though it were a corporate balance sheet.

‘FISCAL RECTITUDE’ HAS STRONG IDEOLOGICAL FOUNDATIONS

www.radixuk.org
the Conservative party is the only proper steward of the economy as opposed to a profligate Labour party that will 'bankrupt the country.'

Of course, this latter objection can be turned on its head in that a Conservative government that can find a way to support public services and government investment without bankrupting the country removes one of the main pillars of Labour’s potential appeal.

Conversely, starting out with needless austerity policies opens the government to criticism for subjecting the population to unnecessary hardship and willing to risk tanking a post-Covid economic recovery for ideological reasons.

Fiscal policy based economic management as described above may also meet with objections from the Tory party’s donor base who might be personally adversely hit by progressive tax policy.

The Supporters

There will also be supporters within the Conservative group.

This will include those who remember the economic, social and political damage inflicted by the coalition government following the financial crash and understand that those, like the IMF, that supported such policies then, have realized the error of their ways and are actively arguing against a repeat performance.

Other supporters will be those who understand that mistaken views on fiscal policy will put paid to any hopes of the government being able to deliver on either a quick economic recovery post-Covid, or on the promised leveling-up agenda on which may depend retention of many of the former Red Wall seats.

Finally, the approach put forward above will highlight the UK advantage from not being part of the Eurozone where embarking on such policies is by and large impossible. It could give the UK a significant advantage in boosting the post-Covid recovery relative to the likely problems the Eurozone will face.

How the political calculus will play out, and which story the Chancellor and the government will believe to be the most politically advantageous, remain to be seen.

THERE WILL BE SOME WHO HAVE LEARNED FROM PAST ERRORS

AND WHO WISH TO RETAIN THE PREVIOUS ‘RED WALL’ SEATS

About ‘Provocations’

Our aim in this series is to be provocative enough to challenge conventional thinking in an effort to stimulate a civil discussion that drives change. We hope you might find much to disagree with - and maybe something to agree with.

Do get in touch to discuss further.

‘Provocations’ reflect the opinions of the individual authors.

About Radix

Radix is a non-aligned public policy think tank for the radical centre. Its aim is to re-imagine the way government, institutions and societies function based on open-source, participative citizenship. To kick-start the thinking that is needed for politics to embrace technology, innovation, social and cultural change.

Contact: hello@radixuk.org  www.radix.uk.org

© Copyright Radix Group Ltd. All rights reserved.