

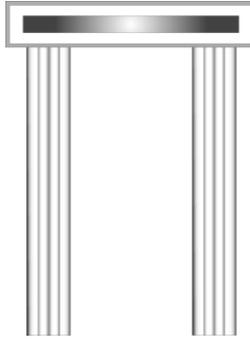


David B. Smith

The UK's Taxable Capacity
Has Britain Already Reached
the Upper Limit?

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Introduction

The first Budget of a new Parliament is unusually important because it provides a once-and-for-all opportunity to take a long-term strategic view and set the economic and fiscal tone for the next five years, before the administration gets bogged down by the pressure of day to day political events. This is particularly true at present because of the imminence of Brexit and the need to ensure that the UK economy is ‘match fit’ to cope with the structural changes required, if Brexit is not to become a failure in the eyes of the electorate. In the event, the changeover of Chancellor’s at a late stage of the Budget planning process, together with the uncertainties associated with the corona virus, make it probable that the 11th March UK Budget will represent a holding operation, rather than the bright sunburst of a new economic dawn.

I

A Blessing in Disguise?

However, while a holding operation, may lose the government much of its strategic political initiative, it may prove a blessing in disguise if it stops the fiscal authorities from pursuing a ‘Big-Government’ approach that clashes with the need to change the domestic production matrix to cope with the new threats – but also new opportunities – arising from Brexit. Unfortunately, it seems that rather than endeavouring to maximise the supply side potential of the British economy by pursuing fiscal parsimony, tax cutting and de-regulation, Mr Johnson’s administration is engaged in a political strategy of trying to lock in the votes of the former ‘red wall’ old-Labour constituencies, almost regardless of the fiscal and economic costs.

Because: 1) the government has almost no resources of its own; and 2) in logic, cannot tax itself, all additional government expenditure implies raising the already high tax burden on the wealth-creating sectors of the economy. This may either be immediately or in the future when the debt interest payments on public borrowing need to be serviced. Higher taxes seem to crowd out at least a similar volume of private sector activity.

The Office for Budget Responsibility (OBR), for example, appear to assume that the Keynesian ‘multiplier’ is zero after three years, implying that each £1bn on government spending is eventually £1bn off private expenditure. Since only the private sector can generate taxes in an economically meaningful sense, this means that today’s public spending represents tomorrow’s lost taxes – arguably, around £350m, in this example, so that the total worsening in the Budget deficit becomes £1.35bn – if one is thinking purely in Keynesian demand-side terms. However, if one then allows for the adverse supply side effects of the enhanced tax burden on the incentives to supply goods and services, it is not difficult to see how a vicious circle can develop, and today’s fiscal extravagance can lead to a fiscal stabilisation crises in a few years’ time, often when the government is already losing favour with the electorate for other reasons¹.

¹ Alesina, Favero, and Giavazzi (2019) is extremely relevant here. The authors performed a definitive analysis of thousands of fiscal measures adopted by sixteen advanced industrial economies from the late 1970s onwards. Their results are consistent with, but far richer, than the comment above. They also confirm that higher taxes are far more damaging than lower government expenditure.

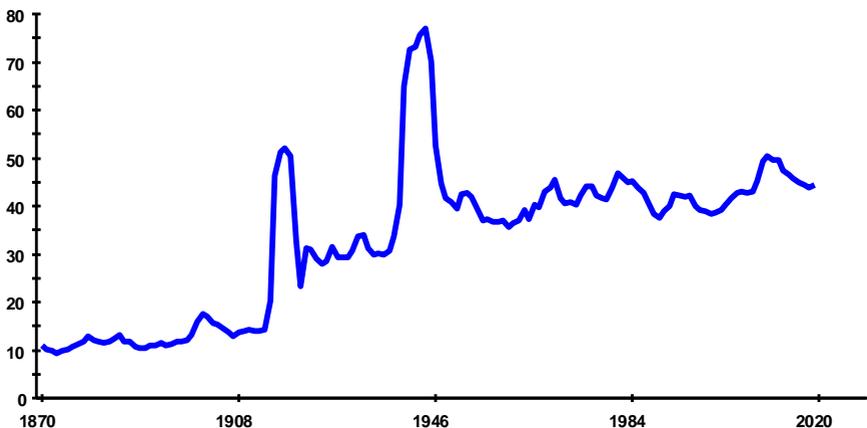
II

The Long Term Picture

After this sermon, the remainder of this paper simply tries to analyse where we are now in terms of government spending and taxation, using both long runs of annual data and shorter-term quarterly figures. The results suggest that the government spending burden remains high by historic standards, especially given the tightness of the labour markets and other signs that the UK economy is operating at or above full capacity, such as the balance of payments deficit. In addition, the tax burden already appears to be at the upper limit of historic sustainability. Chart 1 (below) shows the ratio of UK general government spending to national output from 1870 to 2019. The methodology and data sources were explained in Chapters 2 and 3 of Booth (Ed. 2016) and Smith (2006) and will not be repeated here.

However, three data caveats are in order. First, although provisional figures for UK Gross Domestic Product (GDP) are available up to the final quarter of last year, the detailed government accounts are only available up to 2019 Q3. The Beacon Economic Forecasting (BEF) model has been used to plug in the missing quarter².

Chart 1: Ratio of UK General Government Expenditure to UK GDP at Factor Cost 1870 to 2019 (%): Annual Plots



² The preliminary fourth quarter data should appear on 23rd March.

Second, there have been numerous technical changes to the official figures and there are some noticeable differences between the new calculations and earlier ones, carried out using previous generations of official figures. This means that all such estimates should be considered as rough approximations, not precise figures.

Third, the annual government accounts extend back to 1946 and the yearly GDP data back to 1948. Earlier historic series have been chain-linked on to maintain consistency, as described in my previous work.

Finally, I have deliberately chosen to use the factor cost based measure of GDP, which excludes indirect taxes and subsidies, because this provides a more accurate and historically consistent measure of the tax and spending burdens (Smith (2006)). Using factor cost GDP, the general government spending burden was 44.3% last year, compared with 38.9% if the officially preferred market price GDP measure is employed and 43.5% if basic price GDP (also called Gross Value Added - GVA) is used.

Chart 2: Ratio of UK Non-Oil taxes to UK GDP at Factor Cost 1900 to 2019 (%): Annual Plots

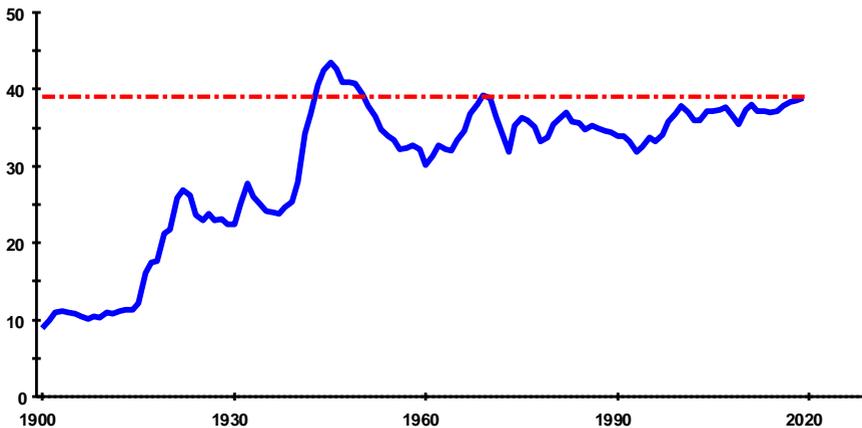


Chart 2 shows the equivalent calculation for the non-oil tax burden expressed as a share of non-oil GDP (a chart of total taxes/total GDP is also available). Oil revenues are trivial nowadays but were significant in the

1980s, for example, and tend to distort the historic record. The ratio of non-oil taxes to non-oil GDP at factor cost was 39% in 2019. This ratio was 38.5% if total GDP at factor cost is employed and 33.8% and 37.9%, respectively, if market-price GDP and GVA are used instead.

One thing apparent from chart 2 is that it is difficult to get the non-oil tax burden to exceed 39% of factor-cost GDP for any length of time (dotted line above), despite massive changes to the structure of taxation and the various key rates of tax over this period. Between 1940 and 1945, the tax burden measured 37.5%, with a temporary peak of 43.5% in 1945, despite all the rigours of wartime controls. The only other breach of the 39% ceiling occurred in 1969, following the International Monetary Fund (IMF) bail out of the British economy.

There are extremely good Laffer curve and supply-side arguments to explain why some such barrier exists, although these would require a fuller exposition than is possible here (Smith (2006)). It is also noteworthy that the severe tax squeeze imposed by the then Chancellor Roy Jenkins in 1969 – which largely represented the post-dated bill for the Wilson Labour government's manic spending after it won the 1964 election - reduced the sustainable growth rate of the UK economy from the 3% to 3½% range considered normal in the 1950s and 1960s to some 1½% in the 1970s. This supply withdrawal contributed substantially to the economic and political crises of the pre-Thatcher era.

Table 1: Direct Effects of Some Illustrative Tax Changes (£'s million)

	2020-21	2021-22	2022-23
Change basic rate income tax by 1P	4,500	5,650	5,600
Change all main income tax allowances, starting and basic rate limits by 1%	1,000	1,200	1,150
Increase Corporation Tax by 1p	2,000	2,800	3,100
Change class 1 employee main rate by 1p	4,200	4,300	4,450
Change class 1 employer rate by 1p	6,150	6,350	6,550
Change standard rate VAT by 1P	6,650	6,850	7,050

Source: HM Revenue & Customs, Direct Effects of Illustrative Tax Changes, 26th April 2019.

The concern now must be that the present UK trend growth of around 1½% would collapse to zero, or turn negative, if the Johnson government embarks on a governmental spending spree that subsequently needs to be retrospectively funded through viciously higher taxes in, say, three years' time. According to the official tax ready reckoner: a 1 percentage point hike in basic rate income tax would generate £4.5bn in fiscal 2020-21; an equivalent rise in VAT would raise £6.65bn, and a 1 percentage point hike in Corporation tax £2.0bn.

However, these are purely static calculations that do not allow for adverse second round effects that rapidly come to outweigh the initial effects when simulated on properly specified macroeconomic forecasting models. At best, these suggest that only around one third to one half of any *ex ante* tax hike is achieved *ex post*, while the likelihood of Laffer curve effects (i.e., rate cuts inducing higher receipts) should rise as the aggregate and individual rates of tax goes up. Even a purely static calculation implies that the extra £38bn or so spending already conceded by the Conservatives last year under May and Johnson might imply a 25% VAT rate, a 22.8% rate of Employers' NIC's or a 28% standard rate of income tax, if just one of these were to be the sole chosen funding method.

III

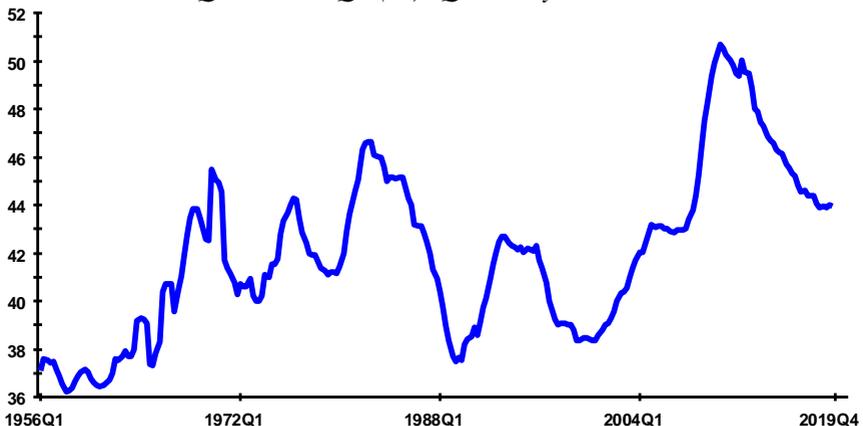
Recent Quarterly Data

It is possible to redraw both the above charts using quarterly data from 1955 Q1 onwards. This has the advantage that it brings out the more recent experience better and is, arguably more relevant from a political perspective. However, it has the drawback that the government expenditure and tax figures are not seasonally adjusted even though they contain marked seasonal swings. This means that that the raw data plots look like a porcupine's back and it is difficult to discern the signal amidst the seasonal noise. As a result, the charts use four-quarter running totals divided by four. Pedantically, this means that the series have been shifted forward by two quarters (i.e., 2019 Q3 should really be centred on 2019 Q1). However, it was decided not to correct for this. Also, and because of the loss of some quarterly data at the start of the series, the charts both start in 1956 Q1.

The larger scale of this quarterly chart shows how far the UK has come off the unsustainable peak in the spending ratio recorded in 2010 but also confirms the suggestion in Chart 1 that the spending ratio has passed its lower point of inflexion and is now heading upwards from what is already a historically high base.

Chart 4 shows the equivalent quarterly plot to Chart 2. The chart confirms that it is extremely hard to push the tax burden up through 39% of factor cost GDP. It also reveals how close the UK economy now is to that historic limit with a ratio of 38.7% being recorded in the four quarters to 2019 Q3.

Chart 3: Ratio of UK General Government Expenditure to UK GDP at Factor Cost 1956 Q1 to 2019 Q3 (%): Quarterly Plots



It is hard not to conclude that the UK is almost at the historic upper limits of taxable capacity and sustainable government spending, even without the further increases that appear likely from now on. Also, there must be some concern about what happens when the outstanding stock of government debt needs to be rolled over, possibly at significantly higher gilt yields³. So far, the financial markets have given British Government Securities the benefit of the doubt. However, market confidence is a fragile vase that cracks easily. It is not clear what price bond markets would demand if international investors decided that the British government was suffering from feckless ‘Big Government Conservatism’ along the lines of Edward Heath or George W Bush.

³ Fortunately, the average maturity of UK government debt appears to be quite long at around 15.8 years. The long period of artificial bond markets associated with Quantitative Easing appears to have led to a significant atrophy in the institutional capacity of global bond markets. This implies that price swings have potentially become a lot more volatile.

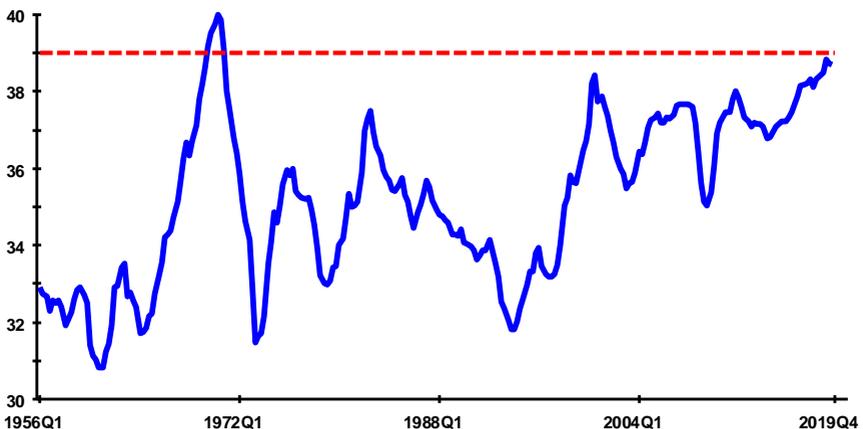
IV The Latest GDP Figures

Against this background, the UK national accounts data released on 11th February incorporate some disturbing features that have not been widely picked up on.

First, the annual growth in the volume of general government current expenditure picked up from 0.4% in 2018 to 3.6% last year but accelerated through 2019 to reach 4.4% in the final quarter of last year, four times the 1.1% increase in real GDP. However, the inclusion of government spending in GDP has masked the extent to which private activity is being crowded out by the state. The Office for National Statistics (ONS) concept of market sector output, which corresponds more closely to the ‘tax base’ than total GDP rose by a 1.1% in 2019 and only 0.6% in the year to 2019 Q4.

Second, the cost of general government consumption is also rising rapidly in cash terms, with a 5.5% annual average rise in 2019, and a 7% increase in the year to the fourth quarter. This is well above the 2.9% rise in money GDP over the same period.

Chart 4: Ratio of UK Non-Oil taxes to UK GDP at Factor Cost 1956 Q1 to 2019 Q3 (%): Quarterly Plots



Third, and despite the official emphasis on government capital formation, the volume of general government fixed capital formation rose by a relatively modest 2.1% on average last year but actually fell in the second, third and fourth quarters to leave the final quarter of 2019 3.5% down on a year earlier. A possible conclusion is that the fiscal authorities are failing to control properly the composition, as well as the extent of, public spending.

IV Conclusion

The main conclusion from the long run analysis is that, ahead of the 11th March Budget, the government spending and tax burdens are already high by historic standards, especially given that the economy is at near full employment. Furthermore, these exacerbated burdens seem to be crowding out private activity and the tax base and slashing potential future growth in the longer term. There is also the ‘political business cycle’ issue that governments normally like to retrench on the expenditure side immediately after the election in order to be able to ease up ahead of the following poll. Mr Johnson’s administration appears to be intending instant political gratification now, at the risk of a potential fiscal stabilisation crisis a year or two from the next election. This just seems slightly odd. However, the main conclusion is that there is already a grave need for fiscal stabilisation, even without the prospective further diminution of responsible parsimony from now on.

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