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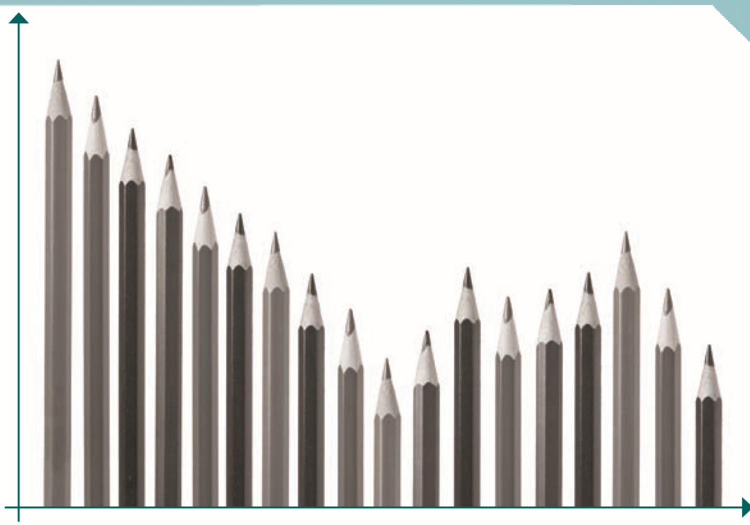
OSBORNE'S CHOICE

Combining fiscal credibility and growth



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Analysis

Responses from Gavyn Davies OBE, Sir Richard Lambert, Evan Davis, Dan Corry & Gerald Holtham

FIRST PUBLISHED BY
The Social Market Foundation,
February 2012

11 Tufton Street, London SW1P 3QB

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Ian Mulheirn was appointed Director of the Social Market Foundation in October 2008. He joined the Social Market Foundation as the Chief Economist in February 2008, after three years as an economic advisor at HM Treasury. He has worked in a variety of policy areas including child poverty, savings & investment, welfare to work and higher education funding. He has also undertaken research into the drivers of worklessness in London and evaluation of the Working Tax Credit and the National Minimum Wage. Ian led the SMF's influential work on welfare-to-work, and was recently a specialist advisor to the Work and Pensions Committee inquiry into the Work Programme.

At last. A paper on fiscal policy that tries to break down the polarised argument we're having between fiscal credibility and growth

Evan Davis, BBC Today Programme

The Mulheirn plan deserves careful consideration from the Coalition

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This is an important new angle to the debate that's largely been overlooked until now

Dan Corry, Chief Executive, New Philanthropy Capital and former Senior Adviser to the Prime Minister on the Economy

It is valuable to step away from the debate about how much deficit or how fast to try and reduce it, and to consider the content of the deficit

Gerald Holtham, Managing Director, Cadwyn Captial

SUMMARY

In November the Office for Budget Responsibility (OBR) substantially downgraded the UK's growth prospects. As a consequence, it indicated the need for a further £15bn of annual tightening by 2016-17 to fill a larger permanent fiscal hole than was previously anticipated.

The UK's growth problem has three parts: weak aggregate demand; reduced supply capacity; and sluggish productivity growth. All of these need to be tackled simultaneously. The difficulty is that with Government and households seeking to pay down debt, and the UK's main export market in the doldrums for the foreseeable future, there is little incentive for firms to invest their surpluses. Unless a way can be found to unlock private investment, the adjustment in public spending will inevitably happen through continued economic slump. This would raise concerns among investors about the UK government's ability to handle its debts.

Nevertheless, there are also risks to investor confidence of the additional government borrowing to boost output that many advocate. Getting public borrowing under control and on a clear path to sustainability is essential given the febrile state of sovereign debt markets. In this context, the need for a further £15bn of tightening raises questions about where this money will come from.

So, in the wake of the OBR's autumn assessment, the Government's fiscal strategy is now vulnerable on two fronts:

- the prospects for growth are increasingly poor, putting greater pressure on plans to cut the deficit, yet there is no apparent strategy to boost it; and
- deficit reduction credibility after 2015 is weakened since they have decided to wait until shortly before a general

election to set out where the extra £15bn of tightening will come from.

In these testing economic conditions, careful stewardship of the public finances is essential. In response to these problems with the current strategy, the Chancellor needs to set out a plan that will achieve three goals at the forthcoming Budget.

First, the plan must strengthen the Government's deficit-cutting credibility; second it must boost economic output now; and third it must expand the growth potential of the economy for long-term prosperity. The current political debate emphasises the trade-offs between these goals. This paper instead highlights the synergies between them and sets out a strategy to achieve all three.

The growth debate is highly polarised and over-simplified, focusing on questions like what impact 'more or less spending' in aggregate will do to output, and treating all changes in spending or taxes as equally beneficial or damaging for the economy. In reality, the impact of fiscal policy on the level of output and its future growth depends on how public money is used, and varies enormously between policies.

This polarised and simplified debate implies that the three goals set out above are incompatible. In reality, by focusing more on the composition of the spending and taxation, rather than the size or speed of cuts, it is possible to achieve all three simultaneously through judicious microeconomic policy.

There are legitimate debates around whether additional, unfunded fiscal stimulus is necessary and/or viable. This paper deliberately does not take a view on that discussion but instead restricts itself to the narrower question: what can be done to boost the economy without borrowing more? The inevitability of a further £15bn of fiscal tightening by 2016-17 creates the opportunity for a potent growth strategy within existing borrowing plans. The Government should:

- Identify the sources of the required £15bn now, targeting policies known to have a low or negative impact on economic output.
- Do so with an eye to using microeconomic policy to unblock imbalances within the UK household sector, to encourage households with the capacity to sustain demand to increase their consumption.
- Make those cuts from April 2012, shifting the saved £15bn to credibly temporary policies with a large positive impact on output and longer-term growth, for each of the four years from 2012-13.

This paper makes the case for five specific growth-friendly consolidation measures that fit these criteria, and which would account for the vast majority of the required tightening. These include:

- Halving higher rate tax relief on pension contributions, saving around £6.7bn annually.
- Capping maximum ISA holdings at £15,000, saving around £1bn per year.
- Rolling Child Benefit into the existing tax credits system, saving some £2.4bn each year.
- Cutting Winter Fuel Payments and free TV licenses to better-off pensioners, saving 1.7bn per year.
- Scrapping free bus travel for the over 60s, saving around £1bn annually.

Recycling £15bn per year raised through such measures into infrastructure capital spending from 2012-13 would return the capital budget to around £63bn in that year, just short of the level it was planned to be at for that year at the time of the 2008 Budget.

Based on OBR estimates of the impact of similar policies, it is possible to estimate that finding the £15bn now and using it to boost capital investment would raise output by around £10bn in each of the next three years, and around half that level in year four. It would also have a material impact on the supply-side of the economy since infrastructure investment lowers costs to firms and households, encourages complementary investment by companies, and substantially reduces the scarring effect of unemployment.

Putting this in the context of the current debate, the SMF plan would yield a fiscal stimulus twice as large as a reversal of the January 2011 VAT rise, suggested by Labour, but without adding a penny to the deficit. A VAT cut to 17.5% would, by contrast, involve borrowing an extra £12bn to £14bn each year. The SMF plan would be three times more effective than an unfunded increase in the personal tax allowance to £10,000 from this April, which would cost around £9.5bn.

It's time move beyond a damaging political debate that starts from the position that boosting the economy in the short-run, expanding its long-run potential, and strengthening investor confidence are incompatible goals. Both the Government and the Opposition characterise their respective approaches to the fiscal debate as the only viable option. But Osborne's choice need not be a Hobson's choice.

1. INTRODUCTION

In November 2011, the Office for Budget Responsibility (OBR) released its Economic and Fiscal Outlook (EFO). The report made for grim reading, showing that output in 2016 is now expected to be fully 3.5% lower than anticipated at the time of the March 2011 EFO. Unemployment, having been projected to fall in the March forecast, now looks set to rise to 8.7%. Earnings are expected to fall in real terms into 2013. And all of this assumes that the turmoil in the Eurozone resolves itself in an orderly way in early 2012.[1]

In large part this rapidly deteriorating outlook was put down to a revision in the OBR's assessment of the potential output of the UK economy and a slower rate of growth of that potential. The result is that without more cuts or tax rises, the Chancellor's plans to eliminate the permanent part of the current spending deficit would have been on course to fail.

In response to this, the Chancellor set out unspecified plans to extend the fiscal consolidation for a further two years beyond the end of the current Spending Review period. Over two years from 2015-16, the Treasury intends to tighten fiscal policy by £15bn per year more than pre-existing plans dictated. The Coalition partners have said that they do not feel that it is necessary to identify the sources of the necessary savings or tax rises immediately, and are sticking to their spending plan for the final three years of the 2010 Spending Review. The Government has said that it will come forward with the detail of where this further tightening will fall well before the next election.[2]

While there are legitimate arguments to be had about the appropriate fiscal stance to maintain fiscal credibility and boost

[1] Office for Budget Responsibility, Economic and Fiscal Outlook (London: HMSO, 2011)

[2] Patrick Wintour, "Lib Dems try to defuse row over £15bn spending cuts deal with Tories", Guardian, 30 November 2011.

growth, this paper takes as given the Treasury's outline plan for public spending to 2017. Within these constraints, it seeks to open up the debate about the kinds of solutions that are available to restore confidence in the public finances and boost growth. There need be no tension between strengthening fiscal credibility in the bond markets, boosting output in the short-run and expanding the growth potential of the economy in the longer term. At the heart of the argument is the need for a more strategic, nuanced and differentiated approach to deficit reduction that informs the macroeconomic strategy with microeconomic insight.

2. THE DEFICIT REDUCTION STRATEGY

With his tough Spending Review in autumn 2010, the Chancellor, George Osborne, won credibility in the markets for getting public spending under control. With the 2009-10 budget deficit running at an unprecedented 11.1% of GDP, this was a valuable commodity, and given the path of the sovereign debt crisis over the past 18 months, it may have been more crucial than many appreciated at the time.

Spending control zeal is, however, a necessary but insufficient condition for achieving fiscal credibility, as some Eurozone Governments are finding out. Fiscal credibility – the attribute of a plan that ensures fiscal sustainability - depends upon achieving the optimal mix of spending cuts (or tax rises), to get outgoings under control, and growth promotion to make a given level of deficit more sustainable. If either is lacking efforts to achieve fiscal credibility will fail.

In this respect, the OBR's reassessment created two problems for the Government's fiscal strategy. The EFO substantially revised down its growth projections for the UK to 0.7% from 2.5% for 2012, and from 2.9% to 2.1% for 2013. It also identified the need for further fiscal tightening. We explore the growth and borrowing problems in turn.

3. THE GROWTH PROBLEM

There are three aspects to the UK's economic malaise:

- a short-run problem of weak demand, causing the economy to operate about 3% below its potential in early 2012 – and remaining more than 2% below capacity until well into 2015 - leading to higher than necessary unemployment; [3]
- an immediate problem of reduced potential economic output since the height of the boom, perhaps the result of the damage to lending capacity wrought by the financial crash; and
- an apparently persistent weakness in the productivity growth rate – the thing that ultimately determines GDP growth and how quickly prosperity will return – with this important variable estimated by the OBR to be running at just 1.2%, well below its long-run average. [4]

These problems are linked. The longer the weakness in demand persists, the more likely it is to drag down the growth rate of productivity as unemployed people lose their skills and under-occupied physical capital depreciates. With rising numbers of long-term unemployed evident in the claimant count, for example, it's clear that this problem is growing.[5]

Households are paying down debt, fearful for their employment prospects. At the same time, government is attempting fiscal consolidation with rapid spending cuts. While the Government had set much store by the potential for strengthening exports to fill the demand shortfall, recent experience[6] and more distant history suggests that, in the wake

[3] Office for Budget Responsibility, Economic and Fiscal Outlook (London: HMSO, 2011), 64.

[4] Ibid, 51.

[5] Ian Mulheirn "Cyclical unemployment turning structural", SMF Market Square (www.smf.co.uk/marketsquare).

[6] Office for National Statistics, "Balance of Payments - 3rd quarter 2011" (http://www.ons.gov.uk/ons/rel/bop/balance-of-payments/3rd-quarter-2011/index.html).

of a major global financial crisis, the road to prosperity through exports may be closed.[7] The on-going Eurozone crisis only serves to underline that analysis. Consequently, with final demand from Government, households and foreigners shrinking away it's hard to see much incentive for investment by domestic firms. Unless we succeed in unlocking this vicious cycle, the result of austerity will be an on-going slump, as the recent -0.2% GDP growth estimate for the final quarter of 2011 portends. [8]

That in turn threatens the UK's fiscal credibility. Despite the Government's unwavering plan to cut the deficit, the credit ratings agency Moody's recently put the UK's Aaa credit rating on negative outlook, citing higher weaker growth prospects and exposure to fallout from the Eurozone.[9]

To the extent that the economy is suffering from weak demand, as in more conventional recessions, traditional Keynesian demand management might be a solution, perhaps in the form of the VAT cut advocated by Labour.[10] But there are two difficulties with this approach.

First, it's clear that at least part of the problem is on the supply side of the economy. Second, in the context of these wider growth problems, the jitters in the sovereign debt markets limit the Government's room to borrow for straightforward consumption in this way. Such a move would run unquantifiable risks with investor confidence. Indeed, the Government has taken the view that the second constraint is

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[7] Carmen Reinhart and Kenneth Rogoff, This *Time is Different: Eight Centuries of Financial Folly* (Princeton University Press: 2009), 270.

[8] Office for National Statistics , Gross Domestic Product Preliminary Estimate - Q4 2011 (http://www.ons.gov.uk/ons/dcp171778_254088.pdf).

[9] Moodys: "Moody's adjusts ratings of 9 European sovereigns to capture down-side risks", (www.moodys.com).

[10] BBC, "Balls unveils five-point growth plan", 26 September 2011 (www.bbc.co.uk).

so serious that tight spending control is the prerequisite of growth, and that any deviation from the plan could destroy confidence.

4. THE BORROWING PROBLEM

While growth is stuttering, new doubt has also been cast on the Government's credibility in getting borrowing under control. A central part of the Coalition's plan before the Autumn Statement was to cut the structural deficit well before the next election, fearing the impact that an uncertain election might have on market confidence. In the wake of the 2011 Autumn Statement, it is now clear that consolidation will have to run two years into the next parliament. The Coalition has said that it will present the detail of that fiscal consolidation in advance of the next election.

But this is a politically risky strategy for the Coalition partners. Within months, the electorate will be tiring of the effects of austerity, felt through cuts in public services, benefit reductions and public sector redundancies. In this context, a further £15bn of cuts will therefore be harder to deliver the later the decision is left. What's more, handing out further fiscal pain just before an election could be politically disastrous. The idea that the Coalition partners will go into an election with identical proposals for future fiscal tightening is already adding to disquiet among Liberal Democrats.[11] Strong and decisive action is needed to steer the economy through these troubled times. But in a fiscal crisis, what's politically disastrous can be economically devastating too.

Therefore, following of the OBR's reassessment, the credibility

[11] James Kirkup, "Liberal Democrats: 'Danny Alexander a fool on cuts'", *The Daily Telegraph*, December 3 2011.

of the Government's fiscal consolidation strategy is now vulnerable from two sides:

- insufficient growth raising doubts about the sustainability of the growing debt burden; and
- insufficient clarity and political certainty around the £15bn of additional fiscal consolidation that is now needed.

The Government should act now to strengthen confidence that borrowing is under control. Rather than risking a loss of political resolve as the next election approaches the Chancellor should use his forthcoming Budget to set out a clearly specified plan that is credible on the deficit and also tackles the growth problems the UK faces. Delay will exacerbate the growing structural problems, further deplete investor confidence and raise the costs of future action.

But what should such a plan look like? It must achieve three things simultaneously:

- Boost short-run demand;
- Expand the supply capacity of the economy; and
- Rebuild deficit-cutting credibility by identifying the sources of the additional £15bn consolidation.

5. THE 'GROWTH VERSUS CUTS' DEBATE

A frighteningly wide range of views exists on the relationship between cuts and growth – or at least economic output - among the people we rely upon to know the right answers.

David Cameron and George Osborne have repeatedly stressed the positive impact on output that cuts would have. As Cameron said shortly before the 2010 election: "We do believe that to get the economy moving you've got to lift the black cloud of deficit away. That is what is chiefly, we believe, holding us back."[12] In his February 2010 Mais Lecture, the Chancellor explained the impact of deficit reduction thus: "Businesses can expand safer in the knowledge that an out of control budget is not going to lead to ever higher taxes. Consumers can spend safer in the knowledge that mortgage rates will remain lower for longer."[13] In other words, public spending cuts would increase demand and investment by boosting private sector confidence in the future path of spending and taxes.

The Shadow Chancellor, Ed Balls, by contrast, argues for a 2.5 percentage point cut in VAT, which he claims will "give our stalled economy the jump start it urgently needs and so help get the deficit down for the long term."[14] On this reading, the Government's plan for cutting public spending and raising taxes will have the effect of reducing consumer demand and hence the likelihood of investment by firms.

Bank of England Governor, Mervyn King, on the other hand, is rather more equivocal. When asked if cutting deficits could of itself stimulate economic growth he replied: "I think it depends on the circumstances [...] It's more complicated than just saying, you know, you must always close the deficit immediately."[15] So the Governor thinks the impact of spending cuts on activity elsewhere in the economy is ambiguous.

Clearly these views on the impact on output of cutting the deficit are incompatible. So who is right? Whether a faster or slower consolidation would make for a more credible deficit

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[12] Simon Hayes, "Cameron: Budget within 50 days if Tories win", March 2, 2010, (http://www.wharf.co.uk/2010/03/cameron-budget-within-50-days.html).
[13] George Osborne, "A New Economic Model", Mais Lecture, February 24 2010 (www.conservatives.com/news/speeches/2010/02/George_Osborne_Mais_Lecture_-_A_New_Economic_Model.aspx).
[14] Chris Giles, "Don't put faith in voodoo tax cuts", *Financial Times*, July 27 2011.
[15] Quarterly Inflation Report (London: Bank of England: 2010).

reduction plan depends upon what economists call the 'fiscal multiplier'. The fiscal multiplier is a number that illustrates the impact on national output (or GDP) from a given change in public spending. It is described as the change in national output as a proportion of the change in spending or taxes that caused it. If a pound of government spending increases GDP by the same amount the multiplier is said to be one.

The political rhetoric illustrates two important things about politicians' perceptions of the impact of public spending cuts or tax changes on economic output. First, they have very polarised views about the benefits of discretionary stimulus measures, and second the rhetoric tends to imply a uniform impact of changes in spending regardless of where those changes are made.

6. WHAT DO WE KNOW ABOUT THE SIZE OF FISCAL MULTIPLIERS?

This polarisation of political views reflects the academic debate, where the size of fiscal multipliers is a subject of huge disagreement among economists. Harvard economist Robert Barro has argued that peacetime fiscal multipliers are essentially zero.[16] By contrast, former Whitehouse economic advisors Christina Romer and Jared Bernstein suggest that multipliers for the US are around 1.6.[17] Other researchers find higher multipliers still.[18]

A range of factors affect the size of the fiscal multiplier, not least the openness of an economy to trade, the point in the economic cycle, and the capacity of monetary policymakers to

[16] Robert Barro, "Government spending is no free lunch", *Wall Street Journal*, January 22 2009.

[17] Christina Romer and Jared Bernstein, "The job impact of the American recovery and reinvestment plan" (2009).

[18] Alan Auerbach and Yuriy Gorodnichenko, Fiscal Multipliers in Recession and Expansion (University of California, Berkeley: 2011).

offset any effects of a change in fiscal policy through changes in interest rates.

The OBR's multiplier assumptions – which inform the optimal policy response – are apparently assumed to be constant over the cycle, regardless of whether output is expanding or contracting. This seems very unlikely to be the case (see Box 1). When output is contracting and households are saving, cash hand-outs to middle- and high-income groups are more likely than usual to be saved. At the same point in the economic cycle, public investment is less likely to crowd-out private investment or consumption than in conditions of strong growth, since monetary policy cannot respond to offset it.

But general debate about 'the size of the fiscal multiplier' is unhelpful. The argument among economists and politicians has got stuck on opposing views about whether the determinants outlined in Box 1 justify additional borrowing to support output. This debate is too simplified to be meaningful, and too polarised to allow policymakers to find a better way to simultaneously achieve deficit reduction and support for the economy.

Far too little consideration has been given to the fact that the composition of spending and taxation matters at least as much for fiscal credibility and output as the speed and size of cuts. In other words, the multiplier effect of government spending is liable to vary hugely according to *what policymakers choose to tax or spend the money on.*

Box 1: What determines the size of the multiplier?

The magnitude of the impact of a change in government spending on GDP depends on a huge range of circumstances and conditions. Some of the most important determinants of the fiscal multiplier are the following.

- **What point in the economic cycle the economy is at**. While it stands to reason that the multiplier effect of public spending is likely to vary according to the point in the economic cycle, few empirical estimates of the multiplier take account of this. When an economy is contracting and households and firms are hoarding cash, the risk that any public investment crowds out private investment is dramatically reduced. One study that has attempted to quantify this cyclical variation, concluding that fiscal multipliers range from around zero in expansions to between 1 and 1.5 during recessions.[a]

- **The 'openness' of the economy**. The more open is an economy the greater the likelihood that any fiscal stimulus will dribble overseas in the form of higher imports, and a stronger exchange rate reducing exports. One cross-country study indicates that the openness of the economy can have a marked effect on the fiscal multiplier, with countries for which exports and imports are less than 60% of GDP showing large multipliers of 1.6 in the long-run and more open country multipliers of zero.[b] UK trade is slightly below the 60% of GDP benchmark implying that the effect may be somewhere in between these extremes.[c]

- **The effectiveness of monetary policy**. In an economy with a floating exchange rate, and hence an independent monetary policy, there is a risk that fiscal expansion crowds out private investment and spending. This occurs in normal times because increased economic output results in higher interest rates, which choke off other sources of demand and lead to small, arguably negative, multipliers in the long-run. In conditions where monetary policy is operating at the lower bound and the credit transmission mechanism is severely impaired, (particularly when, as described above, firms and households are saving heavily) this effect seems unlikely to be a concern. As a consequence of these conditions, the multipliers might more closely resemble those in an economy with a fixed exchange rate since monetary policy ceases to offset changes in fiscal policy. Ilzetski et al. estimate that fixed exchange rate economies can face multipliers of around 1.5 by year two.

All of this means that in a stagnant or shrinking, medium-sized economy, with impaired monetary policy and interest rates at the lower bound (as in the UK in 2011), public spending cuts are at least likely to be a substantial drag on economic growth: the multiplier is likely to be well above zero.

[a] Alan Auerbach and Yuriy Gorodnichenko, Fiscal Multipliers in Recession and Expansion (University of California, Berkeley: 2011).

[b] E. Ilzetzki, E. Mendoza and C. Vegh, How big are fiscal multipliers?, CEPR Policy Insight No.39 (CEPR: 2009), 3.

[c] The Economist, Pocket World in Figures, 2010.

Regardless of politicians' views about the effects on output of tax or spending changes in aggregate, it is hard to disagree with the idea that the effect varies substantially from policy to policy. Indeed, key parameters of the OBR's economic model confirm this.

The OBR estimates that the fiscal impact multiplier for a lump sum tax cut administered through a higher personal allowance, such as that proposed in the Coalition Agreement and reiterated by the Deputy Prime Minister recently, is around 0.3.[19] [20] In practice, the impact multiplier on some policies such

[19] HM Treasury, *Budget 2010* (London: HMSO, 2010), 95.

[20] Nick Clegg, speech to The Resolution Foundation, 27 January 2011

as incentives to save is likely to be negative, since the tax break is only triggered when people choose to take it out of the economy.

By contrast, the OBR assumes an impact multiplier of 1 for departmental capital expenditure like infrastructure.[21] Even within the capital expenditure category there is likely to be variation in the multiplier effect between, say, building a new school and relieving a major transport artery by building a new road. Such variation implies that it important to distinguish between the multiplier effect of different microeconomic policy interventions.

And it's not only the short-run impact on demand that should taken into account when thinking about the most growth-friendly composition of public spending and taxation. The long -term impact of different measures should also inform the decision. While some stimulus measures may boost consumption in the short-run, they may have little persistent effect on the output of the economy or its capacity to grow. But infrastructure investments – better road capacity, more punctual trains, and cheaper energy - are also capable of boosting the long-run potential of the economy as they cut the costs that otherwise weigh on households and firms.

7. DESIGNING A FISCALLY CREDIBLE GROWTH PLAN

The economic situation therefore suggests making use of two principles to cut the deficit and boost growth.

Principle 1– Shift from low– to high-impact policies

The idea of variability in the multiplier and variation in the long-term effects of different forms of spending has important implications for designing a potent growth strategy within the

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[21] HM Treasury, *Budget 2010* (London: HMSO, 2010), 95.

Government's existing deficit plans – and one that doesn't rely on mainly mythical benefits of aggressive deregulation that some have argued for. By reallocating resources from areas with low multipliers to policies with high ones, the stimulus effect would be substantial without any additional borrowing. Careful reassignment of spending could also have a permanently positive impact on the potential of the economy through its effects on the supply side.

For additional public, or public-private investment in capital infrastructure projects to be worthwhile, the multiplier effect of that spending simply needs to be higher than that on the measure that funds it. Regardless of one's view on the pace of deficit reduction, both sides of the debate should be able to agree that it would therefore be growth-enhancing within the Government's existing borrowing plans to reallocate spending from low multiplier policies to high multiplier ones. Taking a less aggregated view of the multiplier effect of different microeconomic policies can therefore cut through the polarised debate.

Principle 2– Use policy to unblock sectoral imbalances

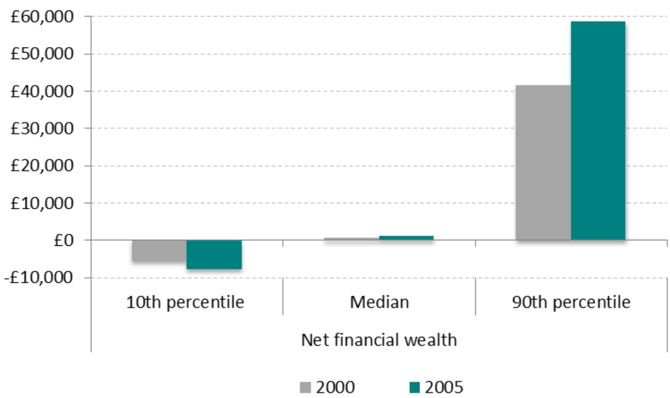
But we can go further than simply changing the composition of taxation and spending in a mechanical fashion to raise output. Rather the microeconomic aim of policy shifts should also be to tackle domestic imbalances in order to create sustainable demand sufficient to unlock private investment.

As described above, the UK growth problem can be explained in terms of domestic sectoral imbalances that are the reflection of international imbalances. Firms are running a surplus of around 4% of GDP. With employment insecurity on the rise, many households, too, are paying down debt, albeit passively. In an environment of weak household demand, falling government spending, and chronic weakness in our major export markets, it is hardly surprising that UK firms are sitting on large cash balances rather than seeking to invest.

But household demand need not be so weak across the board. While there are many over-indebted households for whom paying down debt is the right course of action (from a macroeconomic perspective), there are many other households with entirely sustainable finances. Yet uniform policies that treat all households as average are too blunt to exploit this variation in the pursuit of sustainable growth.

Evidence of the varying savings behaviour for UK households in the run-up to the crisis supports this. In the years between 2000 and 2005, analysis of the British Household Panel Survey shows how households who were indebted (had negative financial wealth) in 2000 had sunk further into debt by 2005, at the height of the boom. The wealthiest households, by contrast, cemented their position with financial wealth of those at the 90th percentile jumping by around £17,000 to almost £59,000.[22] The highly skewed distribution of wealth is also strongly correlated with age.

Chart 1: Net financial wealth distribution, 2000 to 2005[23]



[22] Thomas Crossley and Cormac O'Dea, *The wealth and saving of UK families on the eve of the crisis*, (London: Institute for Fiscal Studies, 2010), 14.
[23] Ibid, 14

8. PUTTING IT ALL TOGETHER

These two principles are overlooked in the current polarised and simplified political debate. Yet they point to a substantial area of common ground between those who prioritise deficit cutting and those whose first concern is growth. Policies that reduce the savings and boost consumption among better-off households will help to create sustainable demand for UK firms. A government tax and spending shift from low- to high-multiplier activities like infrastructure investment will boost output and contribute to long-term growth. Combined, these mutually reinforcing approaches hold part of the answer to unlocking corporate investment and sustainable growth.

With the Government committed to undertaking an additional £15bn of consolidation by 2016-17, the threat to deficit-cutting credibility also presents an opportunity. Credibility would be greatly enhanced by announcing imminently the sources of the £15bn of fiscal tightening required by 2016-17. These measures will affect a variety of people and the attendant political pain is inevitable. But since there is little to be gained by withholding these cuts for another three years, and since the markets would worry that an imminent election might increase the chance that tough but necessary decisions would be shirked, it makes sense to set out and implement the necessary measures in the 2012 Budget.

Of course, it would be unwise to take £15bn of demand out of the economy in a year of such weak growth. The savings should therefore be reallocated to output-boosting measures that are easily wound-down by 2016-17 without political difficulty. Spending and tax-breaks for better-off households should be switched away from areas with low or negative fiscal multipliers into infrastructure investment for four years from 2012-13 to 2015-16, encouraging a sustainable and balanced revival in consumer spending and private sector investment in the process.

Recycling £15bn per year of current spending into capital spending from 2012-13 would return the capital budget to around £63bn in that year, just short of the level it was planned to be at in the 2008 Budget.[24] All of this could be done within existing deficit reduction plans and the positive impact on output through the period would be substantial. We estimate the scale of the possible impact in Section 10.

By way of illustration, the following section identifies around £12.8bn of consolidation measures that fit the above principles. However, the core argument of this paper is not dependent on any specific set of measures and there may be better alternatives.

9. FIVE MEASURES TO CUT THE DEFICIT AND BOOST GROWTH

Cut higher rate income tax relief on pensions saving

Currently savers are entitled to tax relief on pension contributions at their marginal rate of income tax. The total net tax relief for private pensions in 2009-10 was estimated at over £30bn.[25] For basic rate taxpayers, income tax relief effectively offers them a 25p match for each pound of pension saving. For higher-rate taxpayers, who are much more likely to save regardless, and who are by and large in a relatively strong financial position, income tax relief is an effective 66p match per pound. As a result of more generous relief and higher savings rates, higher and additional rate taxpayers benefit from 60% of the £30bn giveaway, despite representing just 11.5% of taxpayers last year.[26]

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[24] HM Treasury, *Budget 2008* (London: HMSO, 2008), 184.

[25] Pensions Policy Institute, *Pension Facts* (London: PPI, 2011), 14.

[26] HM Revenue and Customs, "Income tax liabilities statistics", (http://www.hmrc.gov.uk/stats/income_tax/liabilities-january2011.pdf), 15.

But while there are sound reasons for reducing this tax break on distributional fairness grounds, the growth argument for doing so is even more compelling. Government spending on a measure that only pays out when people take cash out of the economy is precisely the kind of contractionary policy that should urgently be cut, since it drains demand from the economy. Targeting the cut at households in a relatively strong financial position would also support domestic demand.

The Government should therefore bring tax relief on pension contributions made by higher rate savers into line with that of basic rate savers at 20%. In practical terms, this could be achieved by allowing higher rate taxpayers to claim marginal rate relief on 75% of their annual pension subscriptions, which would be equivalent to claiming basic rate relief on the full sum. This measure would save around £6.7bn per year in steady state, although it could save more if the change had a significant behavioural effect on savings decisions.[27]

Halve higher rate tax relief on pension contributions	Annual saving: £6.7bn

Cap ISA holdings

Individual Savings Accounts took the place of Tax-Exempt Special Savings Accounts (TESSAs) in 1999. TESSAs were introduced by John Major, when Chancellor in 1990, specifically to take cash out of an overheating economy by getting people to save rather than consume. Clearly we face the opposite

[27] Author's calculations. Value of net pensions tax relief, less employers' NICs relief, multiplied by the proportion of tax relief received by higher rate taxpayers. Pensions Policy Institute, *Pension Facts* (London: PPI, 2011).

problem today. Yet ISA limits continue to rise, and with them the stock of savings. In the three years from 2008 to 2011, almost £100bn more has been saved in ISAs, taking the total market value of ISA funds to £385bn – a rise of 32%.[28] Tax relief on these funds was estimated at £2.1bn in 2010-11 and is sure to rise once interest rates normalise.[29]

The latest ISA statistics from HMRC suggest that around two-thirds of ISA funds are held by people with more than £15,000 in tax free savings – precisely the households with spending headroom, who should be encourage to use it rather than save yet more. Unlimited ISAs are therefore an expensive give-away to the better-off that drains demand from the economy and reinforces domestic household imbalances.

Assuming that tax relief accrues in proportion to savings held by each person, it is possible to estimate that capping the maximum tax free ISA holding at £15,000 per person would save around £800m on current costings. It seems likely that this saving would rise once interest rates normalise, we therefore assume the medium-term saving to be in the order of £1bn.

Cap ISA holdings at £15,000	Annual saving: £1bn

Roll Child Benefit into the tax credits system

In October 2010 the Chancellor announced that from 2013, families with a higher rate taxpayer will cease to be eligible for Child Benefit, saving around £2.5bn per year. This has caused some disquiet because it is possible that couples on a combined income of up to around £85,000 per year could

28 HM Revenue and Customs, "Individual Savings Account Statistics" (London: HMRC, 2011).

29 HMRC, "Estimated costs of the principal tax expenditure and structural reliefs", (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf).

continue to receive the benefits, while a single-earner family on just around £43,000 per year would lose it. What's more, the immediate withdrawal of the entire benefit at the higher rate threshold creates perverse incentives for people with earnings around that point. Finally, there are concerns that since the income tax system is individualised, the Child Benefit cut may be unenforceable.[30]

The Government was right to look for savings to Child Benefit from higher earners. Give-aways to more affluent families are no longer affordable, and, perhaps more importantly for growth, much of the money given to them will not find its way into the economy. Once again, transfers to better-off families do not help to unwind household imbalances and sustain demand. However, the administrative difficulties of the current proposal suggest that a better solution is required, and one that goes further than current plans.

The Government should use the existing means-testing mechanism provided by the tax credits system to allocate child benefit more fairly and on a household income basis. Implementation would cost nothing, unlike the current proposals; there would be no risk that families with higher incomes would get more in benefits; and perverse incentives would be minimised. In effect, rolling Child Benefit into the tax credits (and, from 2014, the Universal Credit) system would further cut entitlement for any family in the top half of the income distribution, saving around £2.4bn per year.[31]

Roll Child Benefit into the existing tax credits system	Annual saving: £2.4bn

[30] Iain Martin, "Child benefit cut 'unenforceable', Treasury in a flap", *The Wall Street Journal*, October 28, 2010) (http://blogs.wsj.com/iainmartin/2010/10/28/child-benefit-cut-unenforceable-treasury-in-a-flap/)

[31] Value of Child Benefit less planned savings on higher rate taxpayers from 2013, less spending on current tax credit claimants receiving more than the Family Element.

Cut Winter Fuel Payments and free TV licenses to all but poorest pensioners

The annual winter fuel payment is made to pensioners to help them afford to heat their homes. The basic payment currently has two rates: £300 for those over 80 and £200 for those over 60. The cost of the policy is more than £2.1bn this year. Some nine million pensioners benefit from the money. Free TV licences for the over-75s cost around a further £600m each year.[32]

While protecting the elderly from the cost of rising energy prices is admirable in principle, it is no longer defensible for the money to go to well-off pensioners for two reasons: first that these recipients are likely to save rather than spend the value of the windfall, and second, on the grounds of fairness.

The lifecycle savings hypothesis suggests that in retirement people should stop saving and start spending any accumulated wealth towards the end of their lives. On this basis, it would seem like give-aways to pensioners would have a high multiplier effect, with most of the cash getting into the economy. Unfortunately, the evidence suggests otherwise. High-income pensioners, in particular, are substantially more likely to save income than are poorer pensioners.[33]

Better-off pensioners are by far the wealthiest age group in society, which raises questions about why less well-off working age people are being taxed to pay for their Winter Fuel Payments. Nor is it clear why older, wealthier pensioners should receive more money than poorer, younger ones.

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[32] Department for Work and Pensions, "Benefit expenditure tables", (http://research.dwp.gov.uk/asd/asd4/medium_term.asp0).

[33] Naomi Finch and Peter Kemp, "Which pensioners don't spend their income and why?", (London: Department for Work and Pensions, 2006),24-5.

For these reasons, eligibility for Winter Fuel Payments and free TV licenses should be restricted to pensioners on the Pension Credit. With 3.35 million individuals and couples receiving pension credit in 2010, this change would safeguard the poorest and most vulnerable pensioners, saving around £1.7bn per year.[34]

Cut Winter Fuel Payments and free TV licenses to better-off pensioners	Annual saving: £1.7bn

Axe free travel for the over 60s

Since 2008, the Exchequer has funded free bus travel for those over the age of 60. This perk is now estimated to cost around £1bn per year.[35] It is unclear what the multiplier effect of this spending is, since the state effectively reimburses transport providers for any lost revenue. What is clear, however, is that there are more growth-enhancing uses for this money and that there are higher priorities for this spending in the long-run. The policy should now be scrapped.

Scrap free bus travel for the over 60s	Annual saving: £1bn

[34] Assumes that savings are in proportion to the proportion of Pension Credit recipients in the pensioner population.
[35] Department for Transport, http://www.dft.gov.uk/consultations/closed/specialgrantfunding/consultationqa.pdf.

10. QUANTIFYING THE STIMULUS EFFECT

Almost all of the above policies transfer money to, or provide tax breaks for, middle or high-income groups – those with the highest propensity to save the money, and those with the greatest headroom to support aggregate demand. Moreover, around half of the possible savings and tax rises identified are currently deployed *actively encouraging the wealthiest people in society to save more*. The fiscal multiplier on these spending policies is likely to be negative. By contrast, the infrastructure projects outlined in Government's national infrastructure plan are liable to have a strong positive effect on output.[36]

But, in quantifying the stimulus effect of switching spending and taxation into the latter it is fair to use conservative estimates. The impact multiplier of the tax and spending measures, taken together, might at most approximate that of a change in taxation via the personal allowance. The OBR gives the multiplier for such a change as 0.3. A boost to government departmental capital expenditure, by contrast, carries a multiplier of 1.

On this basis, the change in GDP from switching £1 of spending or taxes from the former to the latter category would be £0.70. Using the £15bn of savings (most of which are) outlined above to boost capital investment would therefore raise output by around £10bn in each year. This implies an economy around 0.7% larger in each year from 2012-13 to 2014-15 than would be the case if tax and spending remained in their current configuration.

But the effect of this sustained boost to demand would be more than just a temporary increase in the level of economic

[36] HM Treasury, *National Infrastructure Plan* (London: HM Treasury and Infrastructure UK,2011), 131.

activity. It would positively affect the supply side of the economy in three ways.

- First, as mentioned above, by switching spending into infrastructure investment and away from consumption, the plan would directly add to the capital stock, permanently enhancing productive potential by cutting costs for firms and households.
- Second, the infrastructure boost would encourage – or 'crowd-in' - complementary investment by firms.
- Third, higher output would substantially lower unemployment throughout the period, by tens if not hundreds of thousands. It would therefore prevent the deterioration of workers' skills and employers' capital, with positive implications for long-run prosperity, not to mention the unquantifiable personal and social benefits of higher employment.

These are big numbers, but how does this stimulus package compare to the other ideas that currently feature in the fiscal stimulus debate?

The SMF plan would yield a fiscal stimulus twice as large as Labour's plan to reverse the January 2011 VAT rise, but without adding a penny to the deficit.[37] This is because the OBR estimates the VAT multiplier to be 0.35. A VAT cut to 17.5% would, in contrast to the SMF plan, involve borrowing an extra £12bn to £14bn each year. The Coalition is committed to raising the personal tax allowance to £10,000 by the end of the parliament. The SMF plan would be three times more effective than an unfunded increase in the personal tax allowance to achieve the pledge from this April – a move that would cost £9.5bn per year.

[37] This assumes that there is no inter-temporal substitution of consumption that could occur with a temporary VAT cut.

11. CONCLUSION

The Government's 2010 deficit reduction plan has come under pressure from both weaker than expected growth and the need for as yet unspecified further fiscal consolidation. In refreshing the strategy in the 2012 Budget, the Chancellor needs to achieve three things urgently: strengthen deficit reduction credibility in light of the need for a further £15bn per year of tightening; stimulate aggregate demand; and expand the long-run growth potential of the economy.

All of this means that more tough decisions will have to be made soon, before the new measures must be implemented. But the fact that additional consolidation from 2015 is unavoidable also opens up new opportunities for stimulating output and strengthening long-term growth.

Since the political pain of further deficit reduction is inevitable, the responsible policy would be to pick low-growth policies and cut them now, rather than waiting to 2015. The four years' savings should then be ploughed into the most demand-boosting and long-run growth promoting projects available.

By informing the marcoeconomic strategy with microeconomic insight, it is possible to achieve such a growth strategy by resolving domestic sectoral imbalances – encouraging households with sound finances to spend rather than save - and cutting costs for businesses to encourage them to invest and increase their productive potential. A combination of measures such as these would unambiguously further each of the three headline goals of UK economic policy: boosting the economy in the short-run, expanding its long-run potential, and strengthening investor confidence.

It's time move beyond a damaging political debate that starts from the position that these three goals are mutually exclusive. Both the Government and the Opposition characterise their respective approaches to the fiscal debate as the only viable option. But Osborne's choice need not be a Hobson's choice.

Response from Gavyn Davies OBE

The political debate on fiscal policy in the UK has become increasingly polarised. The government and opposition both accept that there is a need to reduce the budget deficit, but the speed at which this should be done represents a key polemical difference between the parties. Whether the difference is really as great as the polemics make it seem is another matter.

George Osborne's rhetoric supports a more rapid fiscal tightening than Ed Balls', though it is noticeable that the Chancellor did not actually implement that tightening last year in the face of slowing GDP growth. Instead, he simply accepted the over-run in the budget deficit in the near term, and vaguely promised further unspecified public spending cuts after 2015. He is not quite as inflexible on the fiscal path as he is often painted.

Meanwhile, the Shadow Chancellor calls for a cut in VAT, but this does not seem sufficient to place the economy on a radically different path from the one which is emerging from the government's strategy. Although Mr Balls' repeated warnings about the results of austerity in the 1930s suggest that he favours a much more full-blooded Keynesian response to the crisis, he knows that this is not something which the public would accept at present. At least for now, the Tories have won the political debate on borrowing, even if the substantive debate in the economics profession is far from over.

Should fiscal policy be eased in the immediate future? Certainly, it would result in stronger GDP growth for a while, and Mr Osborne would be wrong to deny this. The Chancellor is right, however, to suggest that it would also involve a greater chance of a fiscal crisis which could ultimately prove very difficult to reverse. Just because the fiscal crisis has not happened yet, this does not mean that it will not ever happen. But the trade-offs between immediate GDP gains versus increased, and hard-to-measure, "tail" risks of a crisis later are opaque, complicated and very difficult to translate into practical politics. So both sides make large claims about the relatively small differences between them.

Ian Mulheirn says that this is all rather depressing, and he is right. He therefore suggests a useful package, which would increase taxation and cut spending in areas where the impact on demand is small, while also increasing infrastructure spending, where the impact on demand (and supply) might be fairly large. Since the infrastructure spending would be time-limited, this package would temporarily boost GDP, while also allowing the government to achieve the long term control over public debt which it desires.

The Mulheirn plan makes use of what economists call the "balanced budget multiplier". The budget deficit does not change, but aggregate demand does. Since almost half of UK GDP passes through the hands of the government, there is plenty of scope to reshuffle the government's tax and spending activities to impact both aggregate demand and long term productivity, without increasing public borrowing.

The specifics of the Mulheirn plan, though well argued, are perhaps less important than that central principle. It deserves careful consideration from the coalition.

Gavyn Davies is a macroeconomist who is now chairman of Fulcrum Asset Management and co-founder of Prisma Capital Partners. He was the head of the global economics department at Goldman Sachs from 1987-2001, and was chairman of the BBC from 2001-2004. He has also served as an economic policy adviser in No 10 Downing Street, an external adviser to the British Treasury, and as a visiting professor at the London School of Economics.

Response from Sir Richard Lambert

George Osborne is at least as interested in the political as he is in the economic cycle. The Conservatives' key campaign strategist, his priority is to get the economy into the sort of shape that will be required to win an outright election victory in the Spring of 2015. And if past form is any guide, his approach to this challenge will not be timid.

When he moved into the Treasury in 2010, his hope was that two or three years of fierce austerity would be enough to create the fiscal room that would be required for crowd-pleasing budgets in the run up to 2015. That turned out to be much too optimistic.

So as he prepares next month's budget, his thinking will be guided instead by four different principles: we could call them "golden rules".

Rule number one is to do nothing today that could make his problems worse in 2014-15. The impact of any significant loosening fiscal policy this year would be forgotten well before the voters made their decision, and could create the kind of market uncertainty around the time of the election that he must want at all costs to avoid.

Rule number two: don't leave any painful measures that may have to be made until late in the election cycle. Last November, the Office for Budget Responsibility said that another £15bn of annual spending cuts or tax rises might be required by 2016-17, and that could turn out to be an underestimate. Whatever the economics might suggest, the politics say that he will need to address this problem well before the campaign gets going.

Rule number three: if you are going to do anything really unpopular –especially in the heartland of your voters – 2012 is going to be about your last opportunity. That gives time for the bad memories to fade, and for the benefits you are hoping to flow from such policies to kick in.

So if benefits for better-off taxpayers are ever going to be trimmed, now is the time - especially if such changes are likely to have little impact on demand in the economy. Maybe the pill could be sweetened by doing something bold with the 50p top rate of personal tax, which is both wildly unpopular and very inefficient as a revenue raiser.

Rule number four: retain your hard-won policy credibility. That means sticking to the overall spending limits – and even being ready to tighten further if necessary. That's why a further spending review next year already looks quite probable.

But credibility requires two other qualities as well. It needs a reasonable measure of economic growth in the years ahead, without which the numbers won't add up. And it means convincing the markets that the Government will continue to stick on its fiscal course, which will be hard to do if it is not on track when the campaigning season starts to draw close.

For all these reasons, Mr Osborne could just be gearing himself up for a little budget excitement next month.

Sir Richard Lambert is the former Director-General of the CBI, the present Chancellor of the University of Warwick, and a former member of the Bank of England's Monetary Policy Committee. He was editor of the Financial Times from 1991 to 2001.

Response from Evan Davis

At last. A paper on fiscal policy that tries to break down the polarised argument we're having between fiscal credibility and growth. Ian is right to suggest that we might usefully think about *how* government spends rather than just the amount it spends, in order to stimulate demand while sticking to the fiscal plan.

I like his "wheeze" that you bring forward £15 billion of austerity measures that have yet to be devised for the next parliament, and spend the money now on growth stimulating infrastructure.

I have just three points to add.

First, I'm rather sceptical of Ian's specific suggestions for raising £15 billion of revenue. I haven't given each of his proposals much thought, but I think they might benefit from closer scrutiny. He has selected them to suit his (perfectly noble) economic goal. Alas, the road to a messy and illogical tax system is paved with good macro-economic intentions. We should avoid making long term mistakes for short term gain. For example, while abolishing higher rate pension relief may or may not be justified, that should be determined on the principles of efficient tax systems not short term expediency.

I'm happy if macro-economists want to devise some time-limited measures that could boost growth without long term damage to anything. But otherwise, I'd prefer us to get the nation's best *micro*-economists to work on tax and benefits.

My second point is that there's only one thing tougher than raising £15 billion of revenue, and that is working out how to spend it constructively. Infrastructure is undoubtedly "a good thing", but there may not be enough shovel-ready projects to spend that money on. More work on that front is needed, and preferably on the Chancellor's desk as soon as possible.

My third point – again on the how-to-spend-it issue – is that it would be enormously beneficial to the UK if government could find ways of facilitating the economic transition the nation is striving to make at the moment. We know that we need to export more and import less and to that end have to build up the tradeable sector of our economy (the part that exports or substitutes for imports) at the expense of the non-tradeable sector. We also know that industries in the non-tradeable sector, like government services and retailing are facing austerity. What we have singularly failed to do so far is build up the tradeable to any degree. That is why we are in such tough times. Whoever can identify a place to invest a few billion pounds worth of Ian's money to promote the new industrial economy we need to build would be making a huge contribution.

The point is that the while promoting extra spending in the economy is bound to be helpful when the economy is so obviously flat-lining, it is far better if the spending itself promotes the supply-side changes that have to be made sooner or later anyway.

Evan Davis joined the presenter team on BBC Radio 4's Today programme in April 2008 following a six-and-a-half year stint as the BBC's economics editor. Before his promotion to editor, Evan worked for BBC Two's Newsnight from 1997 to 2001 and as a general economics correspondent from 1993.

He previously worked as an economist at the Institute of Fiscal Studies and the London Business School.

Evan is writing here in a personal capacity

Response from Dan Corry

It is clear that the fiscal impact of different forms of expenditure vary greatly. As Ian points out, even the OBR – who tend to stick as close as they can to the consensus (which is almost always, as Robert Chote often tells us, wrong about the medium to long term) - believe that the multiplier for infrastructure is much higher than that for certain tax changes. So this is an important new angle to the debate that's largely been overlooked until now.

There are good theoretical reasons why different ways of achieving a fiscal boost might have different effects. The impact of income tax cuts, unless directed at the poor (a hard task since most of the poor do not pay tax), get diluted as people save the sudden windfall and don't spend it all, while corporation tax cuts may only improve the profits of banks and not induce more investment from the bulk of the industrial sector. Other forms of stimulus also leak abroad as some of the newly created demand is met from imports.

Of course other factors also come into play. How far can the stimulus be implemented and how quickly will it work? The need for fast action, easily delivered, lay behind some of what New Labour did in response to the recession when in government. A sharp VAT tax cut (and one that people knew would be reversed as we pre-announced it), was something that could be done fast and could and did have positive effects on consumer behaviour. The same argument applies today.

The simplistic multiplier calculation in any case misses out to my mind the fact that active government is trying to influence confidence as well. Whether it works or not depends on the circumstances, the tone, and the way it is done. Econometric analysis of previous efforts only tells a bit of the story. So the rapid action on VAT, home repossessions, business failures and the ilk[a] were aimed at showing the government was not going to stand by and leave everyone to cope for themselves. Those effects on confidence - hence behaviour, hence on the real economy - cannot be underestimated.

And then we come to capital spend. Ian is totally right to look for more of this. The multipliers are good and anyway investment adds to the productive capacity of the economy. But having 'shovel ready' projects ready is not easy, so there are always time delays that can be substantial.

In 2008-10 we moved fast where there was already a lot of thinking about what was wanted, where planning permission had already had been achieved and where the only restraint was cash. This lay behind the 'Kick Start' policy to get housing developments that had stalled due to the crash going again. It applied to some of the Building Schools for the Future accelerations. And some roads and other bits of infrastructure were advanced. More of this is surely possible but I doubt there is as much as Ian hopes and Whitehall is not great at pushing it through. Maybe give an increased pot to the major city regions (since the obvious delivery mechanism the RDAs have been scrapped and their replacement the LEPs, are just not up to it).

Ian suggests several ways of releasing room for capital spending by reducing current spend. I will leave him to that – they all look politically challenging and may not all be as obviously welfare enhancing as a first look suggests. Some look progressive but their impact on overall demand is not in truth clear – at least in the short term. But in any case we are in a crazy situation where necessary capital spending with a good positive return cannot be added to the economy at this point because people think the markets would panic if that happened.

Finally although in an aside Ian says that he does not necessarily believe the OBR numbers, he does base his approach assuming they are right. I continue to think that a more sensible fiscal policy will help the economy secure growth and that the output gap is not as small as the pessimists think.[b] For those who believe that growth is being unnecessarily kept low through fiscal policy, accepting the constraint that this paper imposes is not the best way to go.

Dan Corry is a former Treasury and Downing Street adviser. He is currently CEO of New Philanthropy Capital and is writing here in a personal capacity

[a] Dan Corry *Labour and the Economy, 1997-2010: More than a Faustian Pact* in Diamond, Patrick and Kenny, Michael (eds.) "Reassessing New Labour: Market, State and Society under Blair and Brown", Political Quarterly Special Issue, Ocotber 2011 , John Wiley & Sons

[b] Corry D, Valero A and van Reenen J, 'UK Economic Performance since 1997: Growth, Productivity and Jobs', Centre for Economic Performance, London School of Economics & Political Science, November 2011

Response from Gerald Holtham

It is valuable to step away from the debate about how much deficit or how fast to try and reduce it, and to consider the content of the deficit. Which public expenditures are likely to promote growth in the long and short term and so should be protected or expanded and which others must therefore bear the brunt of necessary economies? While I agree with Ian Mulheirn that this is a good question, I do not agree with all his answers.

In the first place he seems to be concerned about excess saving in the private sector and is concerned to tailor tax or expenditure decisions in order to encourage consumption. It seems clear, however, that British households do not save enough to cover their own retirement requirements and the economy as a whole does not save enough to finance the investment levels observed in the more vigorous of our European neighbours. Effort should not be directed at raising consumption therefore, let households save as much as they like, but on raising investment.

It can be protested that stimulating or organising investment takes time but the pace of deficit reduction can be adjusted accordingly. Mr Mulheirn is right that there must be a credible plan of deficit reduction but the degree of concern he expresses about an imminent revolt by the bond-market vigilantes is excessive. Japan and the United States both have worse debt/deficit situations than the UK and lower long-term interest rates. Moreover I do not believe in any case that macroeconomic management can be precise enough to make a material difference to private consumption in the short term by altering tax expenditures within an unchanged deficit envelop. I would prefer to accept a slower rate of deficit reduction caused by the sluggish economy and focus on raising investment materially over the next one to three years.

This can be done by a massive increase in state-sponsored investment in the provision of marketed services. There are plenty of large projects that the private sector is ready to undertake given an element of state sponsorship. A private consortium would build the Severn barrage, a multi-billion pound scheme to supply 5 per cent of the UK's total electricity needs if the UK government would guarantee electricity prices. The scheme would be long in gestation but money would be spent immediately on preparations given the go-ahead. The government could increase its own investment spending rapidly on things like toll roads, that produce a revenue stream. And it could enfranchise the fabled green investment bank to start lending to energy producers at the interest rates available to the British government, with or without price guarantees for 'green' suppliers. Instead of reducing the subsidy for installation of solar panels why not increase it and put a levy on the suppliers, effectively increasing the business and sharing the proceeds with suppliers in order to defray costs to the taxpayer?

State enterprise of that kind would be facilitated by a change in accounting practice to bring the UK into line with the rest of the civilized world. The fiscal target should be the general government deficit, for it is that which represents a call and a burden on future tax payers. The borrowing of state corporations, like a green bank, which are financed from user charges are no different in principle from the borrowing of private companies which will be financed by the revenues of the business. Certainly the tax payer has a contingent liability if there are no private shareholders but that can be assessed and put on the government's balance sheet. For infrastructure projects the risk is generally low, a handful of percentage points at most of the capital value, not the 100 per cent implied by targeting the PSBR as at present. It defies comprehension that the Treasury postpones the operation of the Green Bank for several years because its capitalisation would add to public sector borrowing and our archaic and illogical practices make the PSBR the fiscal target rather than the general government deficit.

Finally, a footnote: rather than means testing benefits or abolishing them, why not subject them all to taxation? For example, free bus travel for the elderly is a boon to them but its annual value in any area can be assessed and it should be taxed as income. Poorer pensioners would be unaffected; the well-to-do would pay much of it back. Anyone whose use of the concession was worth less than the tax bill it incurred would not claim it. The same would apply to winter fuel allowance.

Gerald Holtham is visiting professor at Cardiff Business School and Managing Partner of Cadwyn Capital LLP, a fund management boutique. He is a former Chief Investment Officer of Morley Fund Management (now Aviva Investors) and chief economist at Lehman Brothers, London.

He has worked on public policy issues as a former director of IPPR and as head of the General Economics Division in the Economics Department of the OECD. His previous academic positions include Fellow of Magdalen College, Oxford, and Visiting Fellow of the Brookings Institution, Washington DC.