The Telegraph

What is the correct fiscal policy now we want Out?

ROGER BOOTLE
10 JULY 2016 • 9:44PM

The right fiscal policy changes with circumstances CREDIT: REUTERS

What is the right fiscal policy? People differently placed on the politico-economic spectrum will give you radically different answers.

At one extreme, you have the hairshirt fiscal purists who think government borrowing is always wrong and who won't be happy until all that debt has been repaid. At the other, you have the Keynesian fundamentalists who believe that the Government can carry on borrowing until the cows come home.

A lifetime in economics has taught me that the right fiscal policy changes with circumstances. And ours have been through a revolution.

When the Coalition government took office in 2010, although we hadn't reached the stage of absolute panic about the public finances, there was a distinct danger on the horizon of things running out of control.

After the financial crisis of 2007-8, not only had GDP fallen significantly but there was also no assurance that it could soon recover and, what's more, it was widely believed that if and when it did recover, the potential growth rate would be much lower.

Across the world, the financial markets were anxious about the stability of the public finances in umpteen countries. The UK faced a real risk of seeing its debt classed with some of the most worrying cases.

So, there was a strong argument for seeking to bring the debt ratio down soon, by radically reducing the gap between government spending and tax revenues.

The only real issues were about the optimal speed of this reduction and where the financial pain should fall. Although I had some doubts about the details, I was broadly in sympathy with the Coalition's plans for deficit reduction.

In practice, though, government borrowing fell more slowly than envisaged. Indeed, it ended up higher even than it had been under the plans of the previous Labour chancellor, Alistair Darling. Wisely, in my view, George Osborne did not seek to reduce the deficit more quickly by imposing further fiscal stringency.

George Osborne, the Chancellor, has abandoned his target to restore government finances to a surplus by 2020 CREDIT: JULIAN SIMMONDS

After the return of a Conservative government in 2015, however, Mr Osborne still had the stabilisation of the public finances as his overwhelming objective. He actually tightened fiscal policy by setting an objective for the budget, including investment spending, to be running a surplus by 2020. He even enshrined it in law that in normal times the public finances should be in surplus.

Would it be too cynical to believe that this objective was driven less by a careful consideration of economic imperatives and more by Mr Osborne's political ambitions?

So the current stance of fiscal policy may well have been seriously inappropriate before the Brexit vote upset the apple cart. But if it was inappropriate then, it is doubly so now. Because of widespread fears about the consequences of Brexit, there is a realistic danger of substantially weaker GDP growth in the near term.

Meanwhile, the costs of a less restrictive fiscal policy have sharply diminished. The prospect of lower interest rates sustained for a long time has reduced the cost of borrowing.

Far from taking fright over the UK's post-Brexit future, or worrying about the unsustainability of British public finances, investors have been falling over themselves to buy government bonds. Their yields are now at an all-time low. Indeed, in some maturities they are even negative.

The plans to move the budget into surplus by 2019-20 involved a fiscal tightening, that is to say, cuts in spending and/or increases in taxes, of 4pc of GDP. But this objective is seriously inappropriate in today's circumstances.

There is no reason to aim to run a surplus, and no need to reduce the deficit so quickly. So the Chancellor is right to have abandoned his fiscal objective.

Of course, other things equal, this implies that the deficit will still be about 4pc of GDP in 2020, which could mean that the debt ratio continues to rise. But other things are not equal.

The fiscal projections assume that there is very little spare capacity in the economy, so that virtually all the deficit reduction has to be achieved by discretionary fiscal tightening.

By contrast, if, as I believe, there is substantial spare capacity, then some of the deficit could be eliminated as the economy recovers. The weaker pound may well help here because, even though exports do not yield much tax revenue directly, an export surge will concentrate demand on areas where production can readily expand.

Meanwhile, not having to contribute to the EU budget will give us about 0.5pc of GDP to spend elsewhere. And the balance of spending needs to be shifted towards investment.

The Treasury needs to be jolted out of its obsession with using investment spending as an easy source of savings and into developing programmes of infrastructure spending which can give good returns for the economy, even if they result in higher borrowing in the immediate future.

But there should be no let-up in the pressure on the spending departments. Structural reform and the efficiency drive in public spending should continue. Quite apart from efficiency being desirable for its own sake, it is vital for the retention of financial market confidence that the Government is seen to be making hard choices.

The markets are not obsessed with achieving a particular deficit number by a particular date. If they can see a sound rationale for a looser fiscal policy within a disciplined framework, they can be remarkably compliant. What they will recoil from, however, is the sense that all fiscal restraint has been abandoned.

Post-referendum, the UK is at a crossroads – rather like 1979. This is a time of great opportunity to make radical changes, including to fiscal policy. We should seize it.

Roger Bootle is executive chairman of Capital Economics