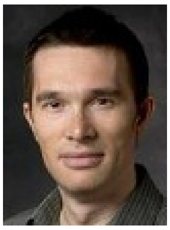
Budget 2012: Ideology 1, Evidence 0



The Chancellor delivered his third budget yesterday. CEP Director **Professor John Van Reenen** *gives his initial reaction. There were some positive steps such as the extension of personal allowances, but the Budget had an empty core. There is a missed opportunity for coherent tax reform, no retreat from a failing macro-economic policy, insufficient attention to policy evaluations and most damagingly, no credible plan for long-term growth.*

What was the problem with the 2012 budget? The problem was not so much what the Chancellor did but rather what he did not do. There was precious little in this budget to address the most pressing need of the British economy – and indeed the world economy – the need for growth. But the budget does reveal a lot about the government's economic strategy and inadvertently shines a light on why it is failing.

Tax Troubles: A lack of principles

Take the Big Media Story first. The Chancellor fed some red meat to the Tory heartland by reducing the top income tax rate from 50 per cent to 45 per cent but needed to sell this to his Lib Dem partners. This was done by a number of wheezes including the hopes-spring-eternal tightening of tax loopholes. But the main soak the rich policy was a new 7% rate of land stamp duty rate on houses worth over £2m. Her Majesty's Treasury puts the cost of the 45p tax at only about £100m per year, but the stamp duty revenues at well over £200m per year. What could be better? More tax revenue and the only people complaining are the London prime real estate agents and the whinging Labour front bench!

Unfortunately, the Chancellor has missed a chance to make a real reform to the dumb tax of stamp duty. Basic public finance principles say that taxing an immobile factor like land is a good thing because it creates less distortions to behaviour – for example it cannot up sticks and leave the country. But Principle 2 says that we should tax property values rather than just the proceeds from selling a house. Someone who doesn't sell a house has been sitting on a huge untaxed capital gain. Council taxes hardly touch this, not least because successive governments have backed away from properly revaluing the housing stock for fear of upsetting voters. But taxing transactions reduces the incentive to move, say for purposes of finding a job. Rather than reform the tax system to make it "fairer, more efficient and simpler", this complicates it further.

Reducing taxes on the very rich such doesn't seem fair in an age of austerity, but will the reduction in the top rate of tax make a big difference to incentives? The truth is, as my CEP colleague Alan Manning has written, no one really knows. The lower than expected tax take from the 50p tax could simply be because of changing wage patterns rather than the rich slacking off.

Reducing child benefit for the rich is a reasonable move, but it would have been better to integrate this properly into the existing system of child tax credits and benefits. Instead it is being bolted on to the whole system which is going to create more complexity and perverse incentives.

What this whole episode of tax at the top illustrates is the triumph of political manoeuvres over sound public policy principles.

The Big Picture: We need an alternative to Plan A

As expected there was no movement away from the Chancellor's current austerity programme. In my view, the rate of fiscal consolidation is too fast and unnecessarily raising unemployment and slowing growth. Economic forecasting is a conservative profession but most regard austerity as directly knocking a third of a percent off growth last year and more this year. Unfortunately macro models do not fully factor in the way in which austerity damages the productive potential of the economy as unemployment begets more unemployment as scrapped workers lose their skills and motivation. Putting these in to their equations would result in an even larger depressing long-term effect of austerity on growth. And since in 2011 GDP growth was a pathetic 0.8 per cent, this is a big, big cost.

The Chancellor's defence of his tight fiscal stance is that it is needed to calm the nerves of over-anxious bond traders. But I can see no reason why the markets would panic from a set of policies to boost government investment in shovel-ready projects like school buildings or road repair. Unfortunately these types of investments have been curtailed the most severely over the last few years. Nor do I see major costs to our fiscal credibility in offering temporary NI breaks to mitigate the scourge of young unemployment which is at record levels.

Putting aside the overall fiscal position though, there are two concerns over the Chancellors' economic strategy. First the fact that ideology has being trumping evidence and second the lack of direction on a decent growth strategy:

Ideology: 1, Evidence: 0

Too many spending cuts that have been based on a kneejerk slash and burn approach rather than a calm assessment of which of Labour's policies were valuable and which could be lost. For example, the government abolished the Educational Maintenance Allowance which evaluations have shown to be an effective way of getting kids from poor families to stay in school. By contrast, it has kept the awful "patent box" policy which rewards old IP rather than new innovation and will cost in the order of a £1b a year. It abolished investment subsidies for SMEs in struggling regions, but kept them for large firms who just pocket the money without creating new jobs.

Sadly, there is almost no allowance made in the government for proper evaluation of the multiple policies it is putting in place. It is another example of placing ideology over evidence. And it is depressing – running experiments to evaluate policies is nigh impossible in macro, but it is technically easy and morally imperative to do this for micro economic policies.

Wanted: A proper Growth Strategy

The really big problem with the Coalition is the lack of any idea of any sensible growth plan. The attitude seems to be that given the austerity programme, the micro-economics will look after themselves. The government cannot come out and say this explicitly however (except when Vince Cable's frustrated memos get leaked), so it covers up its immodesty with some warm words. In particular the hapless Department of Business announced a Growth Plan this time last year and the Budget trumpets the success made towards this grand plan.

Unfortunately, closer examination reveals less a plan than a mish-mash of contradictory and confused ideas. There are too many small scale initiatives without any thought on how these can be linked to really make a return to sustained growth. The Plan for Growth has over 250 reforms, the slogan seemingly "never mind the quality, feel the width". The Budget has put in such measures as tax relief for the video games and animation industry and enhanced capital allowances for "Enterprise Zones". Each initiative will cost the government the princely sum of £5m each next year, or a whopping 0.0003% of GDP. The aspiration to raise apprenticeships is good, but the sums are paltry and the focus is on adults whereas it should be on young people. Credit easing for SME finance is also desperately needed, but again the Chancellor is short of change.

There is no coherent narrative of how these 250+ measures will deal with our longstanding problems. Unfortunately, it is like déjà vu all over again – too much like the numerous "eye-catching" measures in Gordon Brown's budgets which tinkered policies too much for too little effect.

The LSE Growth Commission is addressing this problem by asking; (1) what are the conditions for sustainable growth and (2) how can the state have a more pro-active plan for growth? Our first thoughts are here and we welcome contributions from all sources. I will lay out some of the ideas in a Special Session at the Royal Economic Society in Cambridge on Monday 26th March 2012.

Some ideas include:

- Improving human capital through overhauling schooling
- Radical changes to the tax system such as moving to a frequently updated property tax, ending the tax preference to debt and removing the tax subsidies for family ownership
- Changing planning and local incentives to allow more homes and businesses to be built
- Tackling the “too big to fail” problem in finance structurally
- Dealing with the UK’s deficit in managerial capability
- Getting science out of the lab and into new start-ups

But government can go further than just getting the environment right. It must actively scan where the UK has relative strengths in the future and where global growth is likely to come from. In these areas polices must take a laser-like focus, removing regulatory and other barriers in these sectors as well as considering ways to bolster the strength of firms in these areas. This is what I label “Plan V” – an example is immigration policy. The government’s foolish plans to curtail skilled immigration will undermine the Higher Education sector one of the strongest areas of future growth. An open immigration policy is good for productivity growth as well as the public finances.

But it’s not all bad news…

There are many welcome aspects of the Budget – the increase in personal allowances, longer term government bonds, credit easing, and implementation of the Vickers proposals to reform banking. There are worthy consultations over local pay, integrating NI with income tax and controls over tax deductions. Of course we need to see whether consultation becomes action. But none of these welcome moves are enough to counter the deeper intellectual vacuum at the heart of the Budget and the government’s whole approach to economic growth.

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Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics.

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