Deficits and growth

One of the features of the OBR/Treasury model that works badly is the ability to forecast the all important public sector deficit or amount that the state needs to borrow each year. This is all important as the forecast drives tax policy. Whenever the model forecasts a high or rising deficit the cry goes up to increase taxes.

The last two years saw massive over forecasts of the likely deficit. It seems the model underestimates the impact of recovery or growth in output and incomes on the deficit. Faster growth spurs considerably more revenue, as each marginal pound of extra personal and company income is taxed more highly than average income. It is also more likely to spent more on discretionary items that attract more VAT and transaction taxes than purchases of the basics.

There is also an inbuilt hostility to any laffer effect. Cutting Stamp duty to stimulate transactions recovering from covid for example was scored as cutting revenue but the overall boost to taxable activity was positive and Stamp duty itself overall rose.

This financial year we may discover the model makes these errors in reverse when there is little or no growth. I expect the deficit to exceed the OBR forecast of £99 bn given the big hit to real incomes and the marked slowdown in activity. The bizarre way of counting so called debt interest at a time of high and rising inflation will also push up the stated deficit. So far this year the government has paid bond holders just £11.6bn of debt interest in cash payments. It is scored as £39.8bn of spending given inflation effects on indexed debt with no accounting offsets for gains on erosion of real value of the bulk of the debt from inflation.