

Why we need growth to cut the deficit

Let me have another go at explaining the importance of growth to all those who follow the Treasury/OBR static model. They say we need to raise a tax every time we spend some more money. They miss the dynamics of growth bringing more tax revenues and the dangers of higher tax rates slowing growth and cutting them.

In Budget 2021 the Treasury said the deficit for 2021-2 would be £233.9bn. They used this and related forecasts to insist on tax rises for the following year to bring it down. The outturn as reported in Spring Statement 2022 was a deficit of £127.8bn for 2021-2. So they exaggerated the deficit by £106.9bn. They had made a similar error of overstating the deficit the previous year.

The main reason they got the deficit wrong was they underestimated growth in revenue. The HMRC reported that in 2021-2 total tax revenue rose by a massive 22.9%, far more than the OBR/Treasury model expected. Tax revenue is very sensitive to the growth rate, which outperformed their forecast. They had not put up tax rates that year.

The danger is the OBR/Treasury will lurch from greatly overstating the deficit to understating it as the economy is slowed by higher tax rates, the cost of living squeeze and the monetary tightening now underway. The paradox they need to grasp is higher tax rates could slow growth and so damage the natural growth in tax receipts which you get from a growing economy with a bit of inflation.

The government does need to rein in waste and less necessary spending, but it also needs to promote growth to get fast expanding revenues. 2021-22 shows us that fast growth can come with maintained tax rates and selective tax cuts, clearly assisted by the end of lockdowns. Slow growth or no growth comes from hiking taxes too high, making it more difficult to get the deficit down.