

## November 2020 Spending Review

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It's a old political saw but when Harold Macmillan responded, "Events, dear boy, events" to a question regarding what he feared most in politics and although he actually said the "opposition of events," it could hardly ring more true than of the Covid crisis today. Covid has thrown the economy entirely off course and rewritten, at a terrible cost, the role of government in the functioning of the economy.

Keynes' most famous insight is probably the notion that the economy in aggregate is not the same as an individual household or business. Whilst in a period of difficulty it makes sense for an individual or corporation to trim its sails, if governments do the same the result is more recession and deeper depression.

Governments can always step in and replace private spending in an emergency since they are not time constrained, have recourse to a permanent stream of income, namely taxation, and are the safest credit of all borrowers (banana republics notwithstanding).

So, the rather alarmist rhetoric that greeted the current Chancellor of the Exchequer, Rishi Sunak's, Spending Review this week is mostly misplaced although the numbers do make striking headlines.

Since 2000, the average UK deficit, the annual gap between government expenditure and revenue, has run at 4% of GDP. The post financial crisis policies of "austerity" brought that ratio down to 2-3% in 2016/17/18 with the annual cash deficit running at around £50bn per annum.

Covid has upended this environment beyond recognition. In 2020 the Office of Budgetary Responsibility (OBR) estimate that the current year deficit will rise to £394bn – eight times the recent average and £250bn more than in the dark days of the depth of the financial crisis in 2009. At the same time, in common with much of the developed world, the UK debt ratio, the total stock of debt relative to total GDP, is greater even than the immediate post-World War II peak of 100%. As an aside, the total stock of global debt is greater than global GDP, roughly \$85trillion, of which 25% resides in the US.

The question is what should Mr Sunak and his successors do about it?

Our answer, in the first instance would be, nothing. Whilst the economy is unable to function due to a temporary external shock, the government should maintain spending to keep the fabric of the economy intact, avoid hysteresis effects and maintain the capital stock. In other words, create the conditions for a sharp economic recovery as pent-up demand is released as Covid abates through a combination of better treatment, vaccinations and the erosion of viral toxicity which is typical of the pathology of novel parasitic disease.

What of the future?

Clearly, at some point the public finances need to be brought into balance.

In modern political history there is always a tension between the demand for government services and what the public is willing to pay for them. The UK, as it often has, prefers the US model of low taxation but also European levels of social provision. A version of Mr Johnson's "cakeism."

The current ratio of pre-Covid government revenue to GDP is 36% of GDP. We should expect that to drift upwards toward 40% over time. That means higher taxes for most people over time.

The better way to stabilize and bring down the debt ratio is, of course, to expand the denominator in the relationship by developing an economic strategy to accelerate growth. A bigger economy can sustain higher spending.

Such a strategy is within reach and it involves the so-called "Green Revolution" or "Green-energy Transition."

We are seeing much more demand for ESG investment (Environmental, Social and Governance) both from our investors and institutions who are pushing corporations down this route. It would not be surprising to see a Chancellor, maybe even this one, level the playing field between equity and debt by removing the tax deductibility of interest payments on debt whilst maintaining that privilege for "Green Bonds."

Reconstruction after Covid, devastating as it has been, is nevertheless replete with opportunity to create a greener, more sustainable and profitable economy.

As Mr Churchill once put it, "Never let a good crisis go to waste!"

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