



The Daily Dish

Markets and the U.K.

DOUGLAS HOLTZ-EAKIN | SEPTEMBER 30, 2022

Financial markets have reacted strongly to the announcement of a so-called “mini-budget” by the government of new Prime Minister Liz Truss. As [reported](#) by CNBC, “Finance Minister Kwasi Kwarteng said the government wanted a ‘new approach for a new era focused on growth’ and was targeting a medium-term 2.5% trend rate in economic growth.” Again, as reported by CNBC, “The measures include:

- Cancellation of a planned rise in corporation tax to 25%, keeping it at 19%, the lowest rate in the G-20.
- A reversal in the recent 1.25% rise in National Insurance contributions — a tax on income.
- A reduction in the basic rate of income tax from 20 pence to 19 pence.
- Scrapping of the 45% tax paid on incomes over £150,000 (\$166,770), taking the top rate to 40%.
- Significant cuts to stamp duty, a tax paid on home purchases.
- A network of “investment zones” around the U.K. where businesses will be offered tax cuts, liberalized planning rules and a reduction in regulatory obstacles.
- A claim-back scheme for sales taxes paid by tourists.
- Scrapping of an increase in tax rates on various alcohols.
- Scrapping of a cap on bankers’ bonuses.”

Examined individually, there doesn’t seem to be a lot of drama in the proposals. There are even some basic reductions in marginal tax rates on capital and labor that should be part of every tax policy whenever possible. Yet the announcement of the mini-budget caused a financial freakout (technical term) featuring a sell-off of British government securities – and when prices fall, interest rates rise – as well as a sell-off of the British pound. What is going on?

Eakinomics is not sure. But here are some angles to think about.

The tax cuts are too large and not accompanied by spending controls that make the budget add up? There are certainly no spending proposals, and hopefully no claims that tax cuts will pay for themselves, so budget deficits will be larger. But the government estimates the tax cuts will total £45 billion by 2026-27, and that is only about 2 percent of GDP. That’s significant, but hardly catastrophic. (Some have argued that it is £45 billion *over* five years; if so, it is very small.)

The proposals work at odds with the Bank of England's (BoE) anti-inflation strategy? The BoE has already engaged in a strategy of rate hikes and had forecast a recession as part of addressing inflation. Some argue the tax cut is at odds with this strategy as a short-run demand stimulus. The response of the Truss government and U.S. supply-siders is that this will expand supply. Perhaps, over time. But in the short run, a big investment boom is simply demand stimulus; the supply effects take time for both capital and labor.

Thinking further, one might fear that the BoE will be even more aggressive to cut off any nascent capital formation, with the result that you get lower revenue without any growth payback. This would be a good reason to sour on British bonds and the economy more generally. In any event, the resulting sell-off forced the BoE to make £65 billion in bond purchases – exactly the opposite of an anti-inflation strategy.

This highlights two important differences between the United Kingdom and the United States. In Britain, most mortgages are relatively short-term and have floating rates – rate increases matter a lot. And the U.K. is the classic small economy in open global capital markets. It must live by the terms set by international investors; when demand for U.K. bonds drop, the funds are exiting the economy and the pound falls as well.

The proposals unduly reward the rich. This tired argument has been rolled out yet again. Bond markets don't care about distributional tables unless they dictate macro performance in the future. It is hard to believe this is behind the financial market turbulence.

The bottom line is at least that the Truss government has failed to communicate its plans to market participants and caught both participants and the BoE by surprise. It also appears unwise to roll out one-half of a budget plan (tax cuts) without a compelling proposal to make the budget add up overall. This adventure is far from over.