9 780907 833505

Charter House Essays in Political Economy

The limits of fiscal policy in securing higher productivity & growth

2nd edition

Hambrook Publishing Company

July 2021

Charter House Essays in Political Economy

Charter House Essays in Political Economy are a public record of selected papers produced by the Real Incomes Approach to Economics.

Research and development work giving rise to the Real Incomes Approach was initiated in 1975 and has continued to date..

The limits of fiscal policy in securing higher productivity & growth
Hector Wetherell McNeill
Original medium Charter House Essays in Political Economy
Published by Hambrook Publishing Company, Portsmouth, Hampshire, United Kingdom

First edition: September 2020
ISBN: 978-0-907833-33-8
Second edition: July 2021
ISBN: 978-0-907833-50-5

Contents

The limits of fiscal policy in securing higher productivity & growth

Hector W. McNeill[1]
SEEL[2]

Introduction

This a second updated version of a document of the same name published in September 2020. This version contains additional elaboration on specific sections to improve clarity and advances in analysis have resulted in more transparent explanations for the opinions expressed herein.

The terms, “Build back better” and “Levelling up” have been repeated many times as the objective in the post-Covid-19 period.

There have been extensive discussions and presentation of evidence to members of parliament by stakeholders and representatives of economic institutions concerning the prospects for growth and recovery following the significant impacts of the Covid-19 epidemic on the constituents and economy of the United Kingdom.

During these exchanges it was apparent that some questions made by parliamentarians are not answered adequately. This is because there appears to be an unstated underlying presumption that given the very difficult fiscal circumstances created by government outlays on a range of initiatives to stave off the worst economic impacts of Covid-19, that, by some means, government expenditure might also contribute to desirable changes in productivity and economic growth

This short note sets out some observations on the limitations of fiscal policy in promoting the necessary rises in productivity and economic growth necessary to smooth out any future recovery in a post-BREXIT and post-Covid-19 environments.

What is meant by fiscal policy?

Fiscal policy in this document refers exclusively to various modes whereby government revenue-seeking activities gather money for the public purse and the modes and objectives of government expenditure allocations making use of these funds. During the vert recent period this has involved a large influx of money released through quantitative easing (QE).

Endogenous and exogenous money

Government revenue-seeking activities can raise money by applying taxes and levies to ongoing corporate activities and through personal taxation constituents. These funds are accessed from what are referred to as endogenous money.

---

[1] Hector McNeill is the lead developer of the real incomes approach to economics and director of SEEL-Systems Engineering Economics Lab.
[2] SEEL-Systems Engineering Economics Lab is a division of The George Boole Foundation Limited

Government revenue-seeking activities can also raise money through loans as additional funds to money gathered through taxes and levies. These funds, now augmented significantly through QE, are referred to as exogenous money.

The endogenous-exogenous money balance

Since 1971 the accelerating evolution in financialization has resulted in a faster growth rate in the application of exogenous money both by governments and the private sector over endogenous money in the economy. This process was boosted by the relaxation in financial regulations that were introduced after the 1929 New York Stock Market Crash and the Great Depression. These were designed to separate investment banking from retail banking as well as applying stricter controls on minimum capital holding requirements on banks.

The changes relaxing such constraints were initiated following the movement of the USA from the Gold Standard in 1971. Very soon afterwards Black and Scholes' hedging model gave rise to a rapid rise in computer assisted trading and decision analysis concerning transactions in options and derivatives. This created a very large unofficial grey market for financial securities larger than national economies and beyond any effective control by monetary authorities.

In the 1970s-1980s as financial crisis characterized by slumpflation was caused by a 6-fold increase in the international price of petroleum over this period.

The mis-leading post-1970s "re-direction" of policy

During the late 1970s there were a considerable number of public exchanges between Keynesians and monetarists concerning a quest to identify policies to tackle slumpflation, which combined rising unemployment and inflation. Although the dominant macroeconomic paradigm was Keynesianism, Milton Friedman was a leading spokesman for monetarism and he was successful in persuading governments to place more reliance on monetarism. It is somewhat perplexing as to why monetarism gained any ground at all in this period because the policy instruments available through Keynesianism and monetarism were in fact equally inappropriate in addressing the fundamental cause of slumpflation which was cost-push inflation.

This fact carried an important message which was not fully appreciated at the time. Neither Keynesianism nor monetarism contained, or now contain, any policy instruments or, indeed, policy targets that provide incentives for increases in productivity and real economic growth on a sustained basis.

Alternative policy initiatives

Two new approaches to economics emerged in the 1970s to address slumpflation and both initiated their development around 1975. These approaches were:

- Supply side economics
- Real incomes approach to economics

Supply side economics, in spite of its name, is an extension of fiscal policy applied as a centrally directed marginal reduction in taxation rates. On theoretical grounds it was assumed that this would result in more investment in productivity-enhancing processes, economic growth and falling unemployment accompanied by a reduction in inflation. In practice, when applied, sustained economic growth was not achieved because of a lack of incentives to maintain traction.

The real incomes approach, is more recognizable as being defector supply side because it places the control of the policy instruments in the hands of supply side (microeconomic) decision makers and provides market generated financial incentives to encourage productivity enhancing investment, lower inflation and a sustained economic growth designed to lower unemployment and arrest inflation on a sustained basis. This was to be achieved through an adapted incentive scheme that would maintain policy traction. The real incomes approach has been untested in practice.

A significant difference between Keynesianism, monetarism and supply side economics, on one hand, and the real incomes approach, on the other, is that the real incomes approach establishes real incomes as the main policy target because it remains the most reliable indicator of economic performance under all conditions. It is not subject to being replaced by other emerging priorities or selected indicators moving in opposite directions. This is because the targets of inflation, unemployment, balance of payments and others are all factors that are either determinants or symptoms of the state of real incomes.

The real incomes approach is based on a productivity-promoting incentive mechanism made up of a performance measure, the Price Performance Ratio and a policy instrument, the Price Performance Levy. These constitute a microeconomic rules-based incentive for enhanced productivity gained through investment and unit output price setting. This "policy package" proactively promotes productivity growth.

The price performance ratio (PPR) is the ratio of percentage changes in unit output prices[3] and changes in aggregate unit costs[4] over a specific period. For example, some key PPR values attained by companies can provide an indication of its significance as a useful indicator. If a company has a PPR of less than unity (<1.00) it is reducing inflation; a PPR of unity (1.00) indicates a company is simply passing input inflation on to output price inflation and a PPR of more than unity (>1.00) indicates a company's activities are contributing to a rise in the rate of inflation.

The price performance levy (PPL) is applied in proportion to the PPR value so that a company with a PPR of less than unity pays a lower levy because inflation is being reduced. A company with a PPR of unity pays a higher PPL and the levy rises as the PPR exceeds unity.

Managers can manage inputs, investments and unit output prices to manage their PPR values and even end up paying no PPL. Such a policy is truly supply side because all of the decision-making rests on the supply side. Because the setting of the PPR is in accord to the specific circumstances of each company, which will be unique, there is no arbitrary central state impositions such as interest rates, money volumes and changes in taxation that generate winners, losers and those who remain in a neutral policy impact state.

[3] Unit prices are the sales prices of single items (goods and/or services)
[4] Aggregate unit costs are the total costs of those portions of individual input costs assignable to a unit of output, including overheads.

Productivity and growth

It is now very apparent that during the last 30 years, at least, the rapid growth in exogenous money-based macroeconomic policies have suppressed productivity-enhancing investment associated with a stagnation in real wages leading to profits as a share of GNP rising over the period while the share of real wages has declined.

At the same time, the monetary policy inflation target of 2% represents a reduction in real incomes of 18% each decade if nominal wages remain fixed and in the absence of nominal incomes accompanying that rise. Nominal incomes have not risen in line with inflation over the period concerned.

Did we ever get this right?

Robin Matthews completed a research study to enquire as to why the United Kingdom underwent unprecedented growth in the period 1945 to 1965. The results were published in the Economic Journal. The economy maintained a low level of unemployment, raised real wages in a more or less equitable fashion and the standards of living rose while a National Health Service was introduced. Although this period is sometimes referred to as the *"Golden Period of Keynesianism",* Matthews found that Keynesian policies were not in fact applied and the government ran a positive current account throughout the period and policy was highly deflationary. Therefore, something other than macroeconomic policy was the reason for this relative economic success.

One has to conclude that this period marks a period when "we got things right" by not allowing macroeconomic policies to interfere in the activities of constituents and companies going about their business and who, left to their own devices, got things right on their own accord. There is no doubt that post war reconstruction was an important factor.

The positive current account message tells us that the government was not indulging in the application of exogenous money as a policy instrument which, of course, Keynes' General Theory recommended for situations of rising unemployment and sluggish growth, but in this period the low unemployment rates and sound growth did not require any such action.

Income disparity

Whereas during the period 1945 through 1965 income disparity was significant when comparing highest and lowest incomes it was reduced between 1945 and 1956. However, this measure has become more extreme over the last 30 years and has accelerated during the last decade of QE. This unfortunate evolution resulted in criticism of the Quantity Theory of Money (QTM) not being able to explain this phenomenon. Analysis into the nature of the QTM identity (formula) exposed the fact that it was an incomplete determinate model because many of the destinations for QE funds do not feature in the QTM. This is why the effects of QE were not predicted with any degree of certainty. Therefore, a substitute for the QTM was published by the real incomes approach, in the form of the Real Money Theory[5] (RMT). This new identity is able to trace the concentration of money in various asset markets and this diversion reduced circulation of money in goods and service sector transactions and the supply side in general. The QTM's error was the non-inclusion of non-circulating funds in the form of assets, savings

[5] McNeill, H. W., *"A Real Money Theory"*, Development Intelligence Organization, HPC, July 2020.

and leakage into offshore investment, whereas the RMT includes these variables and therefore provides a transparent and precise explanation of the mechanism of this negative impact of QE on the supply side (or real economy).

The question of monetary policy and inflation

The RMT correctly predicts that current monetary policy, and QE in particular, creates inflation in asset markets while also creating a relative depression in goods and services markets and real incomes of wage earners. It also causes an inflationary leakage from the asset markets via the rising prices and rents of land, farmland, housing, retail units, offices and small and large industrial units affecting the supply side and wage earners.

It is notable, therefore, that the main current cause of inflation is not excessive demand or money volumes, as such, but rather speculative activities in the asset markets fueled by money volumes associated with very low interest rates flowing into assets. This diversion of funds away from supply side activities is simply that speculative markets provide a shorter term and perceived to be lower risk when interest rates are so low. Lending for corporate production investment is considered to be troublesome and risky because the general draining of funds from the supply side depresses the prospects of supply sectors. As a result, interest rates are higher in the light of the perceived elevate risk factors.

This state of affairs is a milder form of the slumpflation situation in the 1970s-1980s caused by cost-push inflation and for which Keynesianism and monetarist policy instruments have no solutions. This is because policy instruments to control inflation assume it is caused by high demand or too much money in circulation; conditions that do not exist while inflation does.

It is worth noting in this context that in 1976 the real incomes approach had established a logical explanation as to why money volume does not generate inflation in goods and services markets as predicted by the flawed QTM. Inflation results from price decisions and price setting by individual supply side production and service units. Keynes referred to this fact but for some reason the logic of what turns out to be a flawed identity (the QTM) remained the only logic supporting this assertion. To date, no one has created a model that demonstrates the mechanism whereby money volumes generate inflation in goods and service markets. Milton Friedman's only explanation was that this happens in the long run but this is not an explanation of the mechanism. This is in spite of the fact that the simple leakage theory outlined above is self-evident and can be observed in current circumstances from published statistics.

It was this discovery of the main cause of inflation being cost-push, by the real incomes research, that gave rise to the identification of the means of controlling it through the combined adaptable instruments of price performance ratio and the price performance levy as a real incomes policy by providing a practical means of helping companies escape from this trap.

Rational objectives for post-BREXIT and post-Covid-19 recovery

As the Bank of England increases QE under an indication that it will act "big and fast" if needed to support recovery, the likelihood of increasing cost push inflation originating in the real estate price and rental areas also increases. In the 1970s-1980s the final attempt to reduce inflation was to raise interest rates to unprecedented levels causing families to lose their homes and affecting almost 1 million people. This cost the Conservative party dearly and it was this experience that convinced Gordon Brown to make the Bank of England independent and responsible for monetary policy so as to distance any future decisions that turn out badly from the government party.

All the way through the last century macroeconomic policy has failed to create a stable framework of incentives that enable constituents and companies to adjust to circumstances according to their desires, capabilities and full potential according to their access to resources. The reliance on centralized market interventions such as in interest rates and money volumes and government revenue seeking have introduced severe distortions. The results are very apparent today. For example, corporate taxation and the national accounting norms place labour as a cost item in tension with profits leading to a strong disincentive for companies to raise wages.

This situation has been exacerbated by the rise of the concept of shareholder value and the fact that companies can purchase their own shares to drive up their price on a speculative basis. This has destroyed the normal relationship between share prices and earnings. This manipulation is used as a basis for offering share options to executives as bonuses for increasing share prices. The rate of speculative price rises far exceed the relatively depressed "real economy", or supply side production of goods and services, where the majority of constituents earn their income. As a result, during the last decade, the rate of real incomes rises of asset holders has far outstripped those of wage earners leading to increased income disparity. This is a direct outcome of QE as clarified by the RMT.

The Catch-22 resulting in a failure to change policies

The separation of "mandates" of the Treasury and the Bank of England and the "independence" of the Bank of England has resulted in a Catch-22 which appears repeatedly in parliamentary committee sessions where representatives of these institutions, in responding to questions concerning states of affairs that reflects poorly on the outcomes of policy, demonstrate a strong tendency to avoid any need to admit any institutional responsibility by stating that lack of action in the area concerned is the result of this area of responsibility not falling within their mandate. Thus, the issues of income disparity caused by QE and outlined in the previous section can be put down to government not taking decisions on minimum wages or the government not admitting that the corporate tax code is a major incentive for companies to cap wages and simply stating that they are trying to "encourage" companies to rationalize pay.

The failure of financial regulations to curtail share buy backs by companies is a case in point lying squarely in within the mandate of the BoE but nothing is done to control this. This sort of behavior has many ramifications, the most obvious of which is distortion in market signals to the market. Indeed, the BoE sees a vibrant stock market as one of the indicators of a healthy economy. But the ease with which companies under a QE regime can make use of this facility is one of the contributing factors in income disparity.

The flow of cheap QE funds into the asset markets, by-passing the real economy, was acknowledged by Meryn King, the BoE governor-before-last, as he was retiring from that position. In spite of this observation, which should have been taken as a warning, investigated and acted upon, both the BoE and government have permitted the process to continue with both sharing an unavoidable joint responsibility for the outcome.

This Catch-22 is a constant source of parliamentarians not receiving adequate replies to important questions. It is revealing how the parliamentarians accept this as given rather than questioning this more than apparent intentional blurring of responsibility created by so-called BoE independence. In any case the post-2008 growth of QE has advanced as a result of a very close collaboration between the Treasury and the BoE making independence largely theoretical.

The role of fiscal policy in promoting productivity and economic growth

It is interesting to observe parliamentarians raise relevant questions as to the potential role of selective government expenditures in different sectors as a means to stimulate productivity and economic growth. Crucial sectors such as education, research and development, such as the so-called DARPA model, whose cost-effectiveness is exaggerated, do have a medium to long term impact on productivity and economic growth. It is far more important to apply policies that can have an immediate impact on productivity and economic growth; especially now.

In so far as the government revenue-seeking arm of corporate taxation provides an incentive for companies to not raise wages it is important to question the accounting norms and methods of raising revenue. Because of the national accounts approach to these types of analysis the trade-offs in terms of where will the lost corporate tax income come from becomes a zero-sum game.

However, the real incomes approach to this particular issue is relatively simple. It provides direct incentives for companies to raise wages in an orderly fashion by linking a price performance levy rebate scheme to unit price setting in response to higher input cost either from variable inputs or decisions to raise wages. This provides companies with an immediate bonus payment based on the price performance ratio achieved.

Note that this is not a central government-imposed tax since the money concerned and rebates all come from a company's cash flow. However, this scheme encourages higher productivity in a regime of moderated and sometime even reduced unit output prices. With wage rises and moderated prices the likelihood of raised real incomes, rises as a result of the combined effects of raised productivity and unit price setting at the microeconomic level.

In terms of the overall macroeconomic impact of the impact of the real incomes approach, there should be a general reduction or moderation in the unit prices of goods and services thereby reducing the cost of living of wage earners. Under such circumstances the real incomes of wage earners will rise even when there have been no rises in nominal wages. As a result, the pressure on companies on the nominal wage front is reduced and the general levels of contentment with policy increased.

Where companies struggle to reduce their price performance ratio which can happen when immediate productivity enhancing technological solutions are not immediately available the withheld bonus does not become government revenue but it is placed into a Sustainability Fund as a future contribution to investment for such companies when they have discovered a way to improve productivity. Companies unable to perform on the PPR front have a direct claim on the monies transferred to the Sustainability Fund since it is their money. This process therefore is not a graded tax scheme where non-performant companies pay a higher tax but it is a counter-inflationary and productivity enhancing scheme serving as a permanent provision of incentive that accompanies the natural rate of innovation across all sectors, including public sector operations.

The statistics on the Sustainability Fund entries provide a national level strategic insight to where assistance is needed on the innovation front. Therefore, if governments wish to assign public money to areas of need for technological innovation this would be a way to do this in a focused and incremental fashion. This would be superior to funding in a somewhat blind fashion vertical sector or horizontal schemes where priorities have been established by committees, academics or various other means whereby government pinpoint priorities for action.

Currently some government expenditures go into R&D and selective grants to encourage certain types of development but the sums available are tiny in comparison with the sums already available in the supply side which can be guided towards more productive use. The motivation to secure solutions is far greater when a company wishes to become more competitive and has identified the specific areas of technological or knowledge gaps holding them back. Under such circumstance a systems engineering economic approach can often secure effective solutions within a very short time frame using state-of-the-art technologies.

Notice that, like the period 1945-1965, this policy approach minimizes policy interference in the economy but encourages companies of all types and in all sectors to innovate at the pace of state-of-the-art innovation and best practice at a minimum cost to the public purse.

Where, after all, does economic growth come from?

Nicholas Kaldor published an important description of a growth model incorporating technological progress in 1957 and later Kenneth Arrow added the human dimension to this concept of endogenous growth in 1962 by describing the contribution of learning by doing to economic growth. Paul Romer in 1986 elaborated this approach into a theory of endogenous growth.

It is worth reminding ourselves that all of this was built into the economic growth practice referred to by Adam Smith and Jean Baptiste Say whose model was completely based on endogenous money and reinvestment in improved technologies leading to economic growth. This worked well in the 18th and 19th Centuries as it did between 1945 and 1965.

For something like 60 years now, if has been more common knowledge amongst economists, and certainly amongst business people, that economic growth comes mainly from learning, the accumulative experience gained from carrying out repetitive tasks and refining capabilities (tacit knowledge) and sharing experience and lessons (explicit knowledge) helping contribute to analysis and the identification of current or emerging gaps, needs and constraints leading to innovation and more productive ways to achieve objectives. The learning process alone has a significant impact on the economy in use of resources and time leading to quantifiable reduced costs

Unfortunately, Keynesian and monetarism as institutions have not adapted to this reality. Thorstein Veblen considered institutions to be essentially modes and habits of thought, values and analytical procedures and, as he observed, institutions are formed by the needs of the past and, as a result, are never in tune with the needs of the present.

Economists often lament the lack of data upon which to base decisions so that they can decide where to allocate public money. This is an outdated mode of operation. What is needed is proactive policies whose operations and success rely on the engagement with economic and social constituents throughout the economy and which allow the decisions of performance to remain with the actors themselves based on transparent incentive policies. The real incomes approach is such a decentralized supply side policy, which has no centrally imposed one-size fits all impositions through arbitrary interventions in markets. It doesn't lament the lack of data but rather embraces the reality of the immense complexity and heterogeneity of economic activities and the relevant data is applied immediately where it matters to generate beneficial economic growth.

Monetarism evolved centuries ago from Royalty needing money possessed by successful businessmen which initiated the Charter schemes in the 1600s under James 1st and colonization starting in Ireland and Scotland and then other places.

Taxation was often introduced to pay for wars.

Keynes added a variant just after universal suffrage was secured in this country.

However, none has adapted to the reality of what generates economic growth nor to a full acceptance of the importance of effective oversight by the constituents of this country. Parliamentarians need to be more insistent in pursuing lines of enquiry that bring about change to focus attention of the means whereby economic growth can be secured on a sustained basis by the social and economic constituencies of this country.

Given the urgency of this need, any hope that fiscal policy linked to the current legal and regulatory structures managed by the government and BoE will be very inefficient or not very effective.

Hector McNeill

SEEL-Systems Engineering Economics Lab

7th September, 2020

Version 2: 24th July, 2021

The author:

Hector Wetherell McNeill

Hector McNeill is a British economist and systems engineer.

Alma maters Cambridge and Stanford Universities.

He is the leading developer of the real incomes approach to economics.

http://www.realincomes.org.uk

He has worked for the European Commission, the World Bank and Food and Agriculture organization of the United Nations.

He is the director of SEEL-Systems Engineering Economics Lab

Current research: the application of locational-state theory to process complexity and decision analysis models of the economy to trace the significance of time as a critical factor in macroeconomic analysis of real income disparity.