Outline

• Theory
  – What do we want fiscal policy to do?
  – Why is this hard to achieve in practice?
  – Methods to help fiscal discipline

• Public finances in the UK
  – UK public spending
  – Labour’s fiscal rules
  – The effect of the financial crisis on the public finances
  – Fiscal policy in response to the crisis
What are the objectives of fiscal policy?

- **Resource allocation**
  - Public goods
  - Externalities

- **Distributional objectives**
  - Between individuals
  - Between generations

- **Smooth output fluctuations**
  - Automatic stabilisers
  - Discretionary stabilisers
What are the constraints on fiscal policy?

• Intertemporal budget constraint

\[ G_1 + \frac{G_2}{(1+r)} + D_1 = T_1 + \frac{T_2}{(1+r)} \]

• Should be consistent with macro stability and sustained economic growth
  – Internal vs. external borrowing
  – Taxes are distortionary

• Should consider intergenerational equity
  – Avoid excess debt and borrowing
Why is fiscal discipline hard to achieve?

- Political business cycles
  - Voters do not fully reward fiscal discipline
  - Non-negative probability of losing the next election means policy makers place too little weight on the future cost of borrowing

- Asymmetric policies leads to deficit bias
  - In good times there is pressure to spend more or cut taxes
  - In bad times there is pressure not to cut spending or increase taxes

- Imperfect information
  - Often unclear where in the economic cycle we are, therefore how much spending/revenue is structural or cyclic
How can fiscal discipline be improved?

• Make explicit what the government views as desirable policy
• Make sure policymakers’ incentives are better aligned with the optimal outcome
  – Change payoff structure to increase the cost to the government of deviating from desirable policy

• Trade-off between delegation and discretion
  – Delegation: Increases credibility and reduces political risk
  – Discretion: Enables policy makers to respond to shocks

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How can fiscal discipline be improved?

- Levels of delegation
  1. Forecasting
  2. Policy objectives
  3. Instrument

- Possible methods in practice:
  - Fiscal rules
    + Greater political cost associated with breaking a stated rule
    - Temptation to make overly optimistic forecasts
  - Fiscal Agencies
    + Delegates forecasting to an independent body without the political incentive to produce overly optimistic forecasts
    - Still subject to uncertainty
How much does the UK government spend?

UK GDP in 2008-09:
Estimated £1,439 billion

Source: HM Treasury, Public Finances Databank
How much does the UK government spend?

UK GDP in 2008-09: Estimated £1,439 billion

- Private sector: 58% (£833 billion)
- Public sector: 42% (£606 billion)

Source: HM Treasury, Public Finances Databank
What does it spend it on?

UK public spending 2008-09: £606 billion

- Social security: 174%
- Education: 113%
- Defence: 83%
- Public Order and Safety: 37%
- Transport: 34%
- Net debt interest payments: 25%
- Other: 137%

Source: HM Treasury, Public Expenditure Statistical Analyses
How does the government plan spending?

- Total public spending is known as “Total Managed Expenditure” (TME)
- Spending split into two components for planning purposes
  - Annually Managed Expenditure (AME)
  - Departmental Expenditure Limits (DELs)
- Also separate budgets for capital and current spending within each of these
Departmental Expenditure Limits

• Essentially central government spending on public services

• Spending for each government department set for three years in each spending review
  – Originally biennial spending reviews with overlapping years being reassessed, but with a recent move to every three years
  – Spending set in cash terms
  – Treasury asserts spending plans are “firm and fixed”
Annually Managed Expenditure

- Includes the following:
  - Social security benefits and tax credits
  - Local authority self-financed expenditure (council tax)
  - Pensions paid to retired public sector workers
  - Contributions to the EU budget
  - Debt interest payments

- Treasury argues it is not possible to plan in advance
  - Not clear in the case of many social security benefits (most obviously child benefit and state pension)
The UK Fiscal Rules

• Labour introduced fiscal policy rules in 1997

• “Golden Rule”
  – Current budget should be in balance or surplus on average over the economic cycle
  – Borrowing only to invest

• “Sustainable Investment Rule”
  – Debt should be kept at a ‘stable and prudent level’
  – Defined over Brown’s Chancellorship as ≤40% of national income every year
Did the fiscal rules work? – current budget surplus

Percentage of national income

-8.0 -6.0 -4.0 -2.0 0.0 2.0 4.0 6.0 8.0

Current Budget Balance

Output gap

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Source: HM Treasury, Public Finances Databank
Did the fiscal rules work? – current budget surplus

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Source: HM Treasury, Public Finances Databank
Did the fiscal rules work? - debt

Public sector debt: outturns

40% ceiling

Percentage of national income

Source: HM Treasury, Public Finances Databank; HM Treasury Budget 2008
Did the fiscal rules work? - debt

Budget 2008 forecast
Public sector debt: outturns
40% ceiling

Source: HM Treasury, Public Finances Databank; HM Treasury Budget 2008
What were the problems with the fiscal rules?

• Golden rule imposed insufficient discipline
  – Forecasts were consistently too optimistic
  – Spent surpluses during the good times
  – Problems dating the cycles
The effect of the crisis: fiscal policy

• Automatic stabilisers
  – Spending increases (social transfers)
  – Tax revenues fall

• Discretionary stabilisers: £30bn fiscal stimulus
  – 13 month reduction in VAT
  – Early up-rating of child benefits
  – Additional payments to pensioners
  – Car scrappage scheme
  – Public investment spending brought forwards

• Cyclical borrowing increased
The effect of the crisis: fiscal rules

- The old fiscal rules were suspended
  - Justified on grounds that economic shocks could not have been anticipated and fiscal policy needs “the flexibility to respond appropriately to those shocks”

- A new ‘temporary operating rule’ introduced:
  - “…improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full”
The effect of the crisis: borrowing

-2
0
2
4
6
8
10
12
14

Percentage of national income


- Additional structural borrowing - no policy changes post 2009-10
- Additional cyclical borrowing
- Budget 08 forecasts
- Outturns

Source: Chote et al (2009)
The effect of the crisis: borrowing

- Increase in structural borrowing of 6.4% national income

- HM Treasury believes that productive potential of the economy is 5% lower each year than assumed in Budget 2008
  - Credit shock = increased price of credit = lower capital stock
  - Reduction in forecast size of the labour force

- Falling house and share prices

- Weaker outlook for the financial sector

- Will permanently reduce the amount of tax revenue

- Will permanently increase level of spending when measured as a share of national income (denominator effect)
The effect of the crisis: debt

- 40% ceiling under "sustainable investment rule"
- Budget 09 Extrapolation - no policy changes post 2009-10
- Structural deterioration only

Source: Chote et al (2009)
Planned fiscal tightening

- Budget 2009 planned a fiscal tightening starting in 2010-11
  - To reduce borrowing back to a sustainable level
  - To halt and then reverse the increase in debt

- The Treasury plan:
  - 3.2% GDP tightening 2010-11 to 2013-14
  - 3.2% GDP unspecified further tightening 2014-15 to 2017-18
Implications of planned tightening: borrowing

Additional structural borrowing - no policy changes post 2009-10
Additional cyclical borrowing
Budget 08 forecasts
Outturns

Percentage of national income


© Institute for Fiscal Studies
Source: Chote et al (2009)
Implications of planned tightening: borrowing

Additional structural borrowing - with planned fiscal tightening
Additional cyclical borrowing
Budget 08 forecasts
Outturns

© Institute for Fiscal Studies
Source: Chote et al (2009)
Implications of planned tightening: debt

- 40% ceiling under "sustainable investment" rule
- Budget 09 Extrapolation - no policy changes post 2009-10
- Budget 09 extrapolation - with planned fiscal tightening

Source: Chote et al (2009)
Planned tightening: 2010-11 to 2013-14

- Fiscal tightening of 3.2% GDP planned over 2010-11 to 2013-14
Planned tightening: taxation

• 0.7% GDP fiscal tightening from tax increases by 2013-14
• Including:
  – Increases in income tax for those on very high incomes
  – Increases in National Insurance for those on above average earnings
  – Increase in fuel duties affecting motorists
Planned tightening: 2010-11 to 2013-14

Source: Chote et al (2009)
Planned tightening: spending

• 2.5% GDP fiscal tightening from spending cuts by 2013-14

• Planned average real growth in total spending of -0.0% a year
  – Social security: 1.4%
  – Debt interest payments: 11.1%
  – Other annually managed expenditure: 3.1%

• Leaves spending on departments to be cut by an average 2.9% a year in real terms for 3 years

• Who will bear the brunt of the cuts?
Planned tightening: 2014-15 to 2017-18

• Further fiscal tightening needed over 2014-15 to 2017-18 of 3.2% of national income
Planned tightening: 2014-15 to 2017-18

Percentage of national income

- Unknown or tax or current spending
- Investment changes
- Current spending changes
- Tax changes

Source: Chote et al (2009)
Planned tightening: 2014-15 to 2017-18

- Further fiscal tightening needed over 2014-15 to 2017-18 of 3.2% of national income

- If half from tax increases and half from spending cuts:
  - Need tax increases of £22.5bn (~£715 per family)
  - Possible cuts to departmental spending of 3.0% a year in real terms
Implications of further tightening: spending

Source: Chote et al (2009)
Alternatives to the HMT planned tightening?

- How big does the tightening need to be?
  - Bigger?
  - Smaller?
- When should it start?
  - Sooner?
  - Later?
- How rapidly should it be completed?
  - Quicker?
  - Slower?
- How should the pain be shared between tax increases or spending cuts?
The public finances in the longer term

- First objective of future governments will be to reduce borrowing and debt
- Will need a new framework to help ensure fiscal discipline
  - Need for flexibility has been highlighted
  - Ensuring credibility will be harder in future
Proposals for a new fiscal framework

• Conservative proposal: Independent Office for Budget Responsibility
  – Independent forecasting and monitoring, focusing on budget balance and sustainability
  – Composition of tax and spending left to politicians
  – Need to ensure the same expertise and data access as HMT forecasting team

• Labour proposal: Fiscal Responsibility Act
  – “we will introduce a new Fiscal Responsibility Act to require that the Government reduces the budget deficit year on year, ensuring that the national debt remains sustainable in the medium term”
  – Need caveats to ensure flexibility…
  – ... which could diminish the power the Act
Conclusions

• Good fiscal discipline is hard to achieve
• Labour’s fiscal rules were suffering before the fiscal crisis
• The financial crisis has had serious and lasting consequences for the public finances
• Aim of the government for at least the next 2 parliaments will be to reduce debt and borrowing
• A new fiscal framework will need to be developed to help ensure fiscal discipline
References


- Outturns and forecasts for UK public finances
  - http://www.hm-treasury.gov.uk/data_index.htm