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The UK Public Finances

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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

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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 cyclical

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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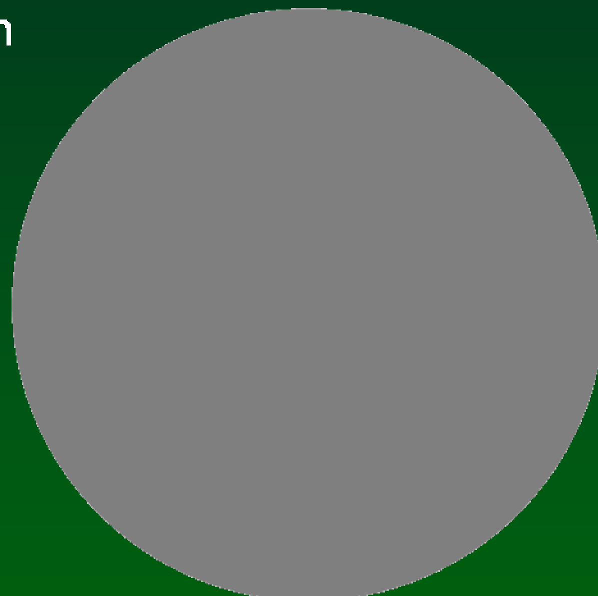
How can fiscal discipline be improved?

- 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*

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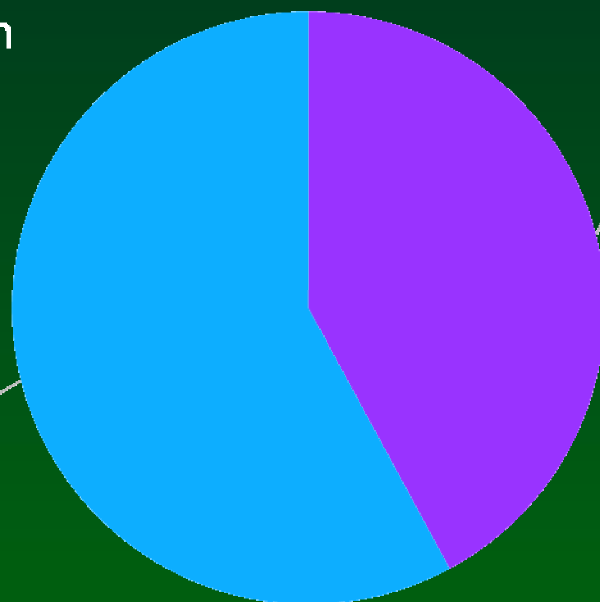
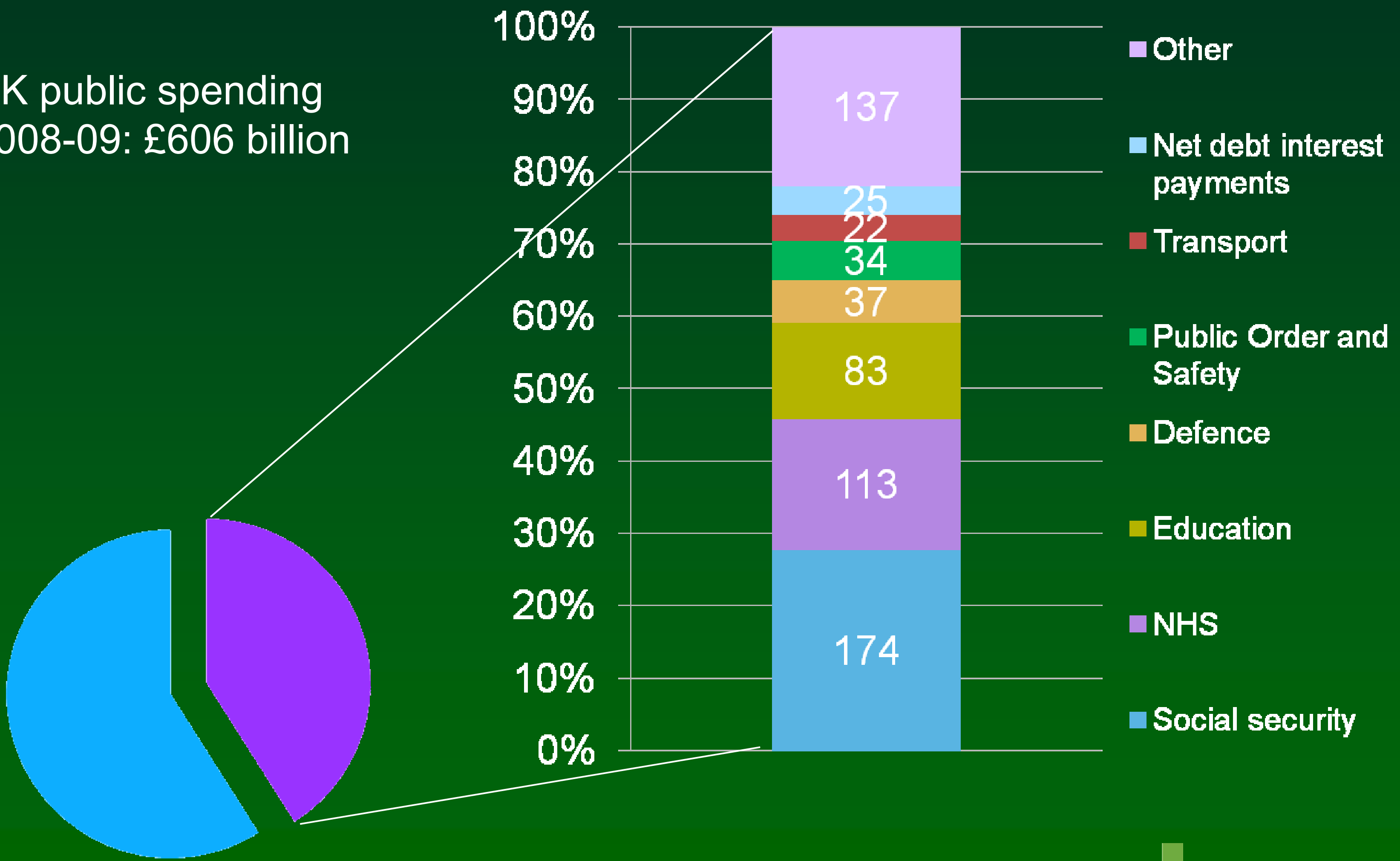


Source: HM Treasury, *Public Finances Databank*

What does it spend it on?

UK public spending 2008-09: £606 billion



Source: HM Treasury, *Public Expenditure Statistical Analyses*

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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

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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)

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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 $\leq$40% of national income every year

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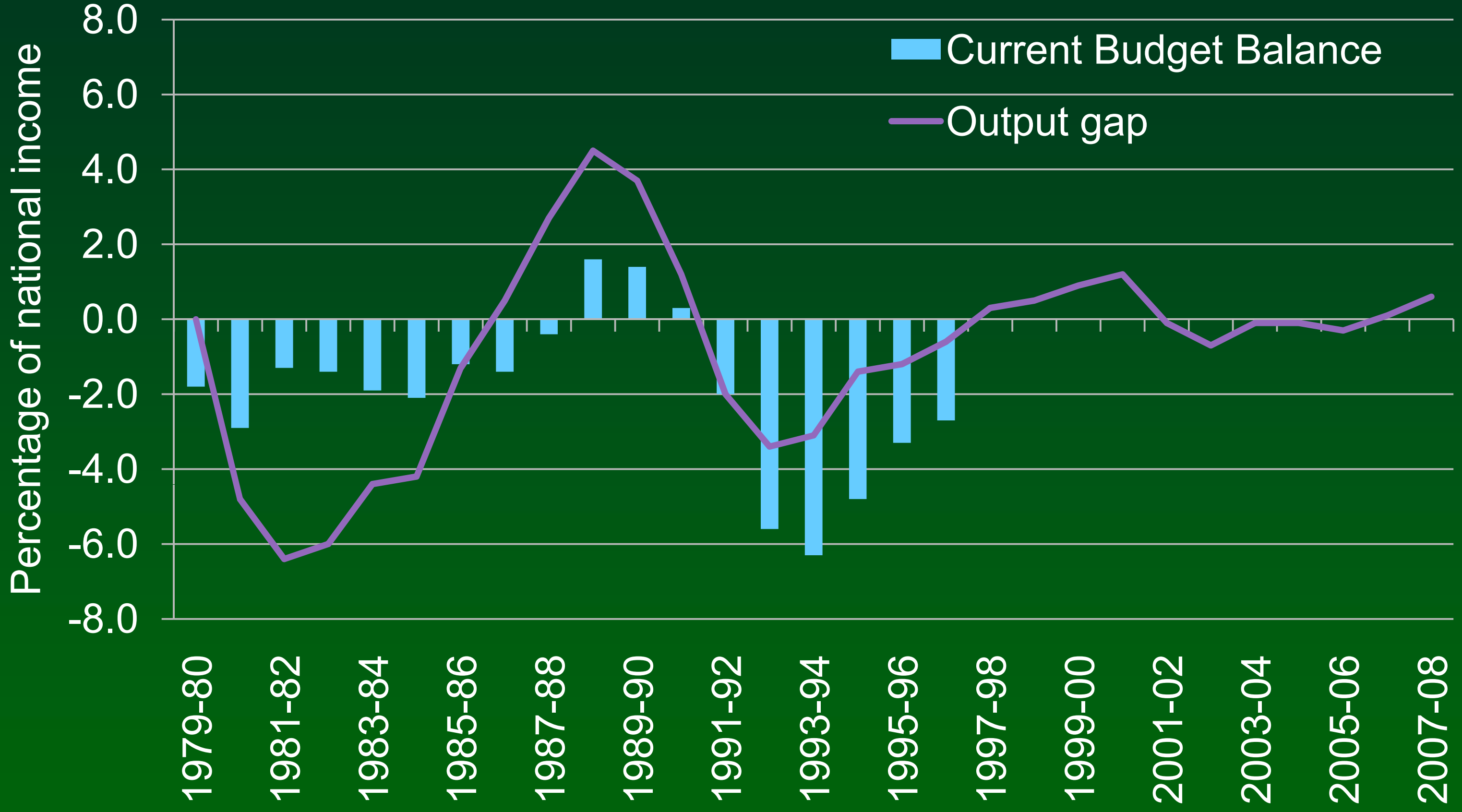
Did the fiscal rules work? – current budget surplus



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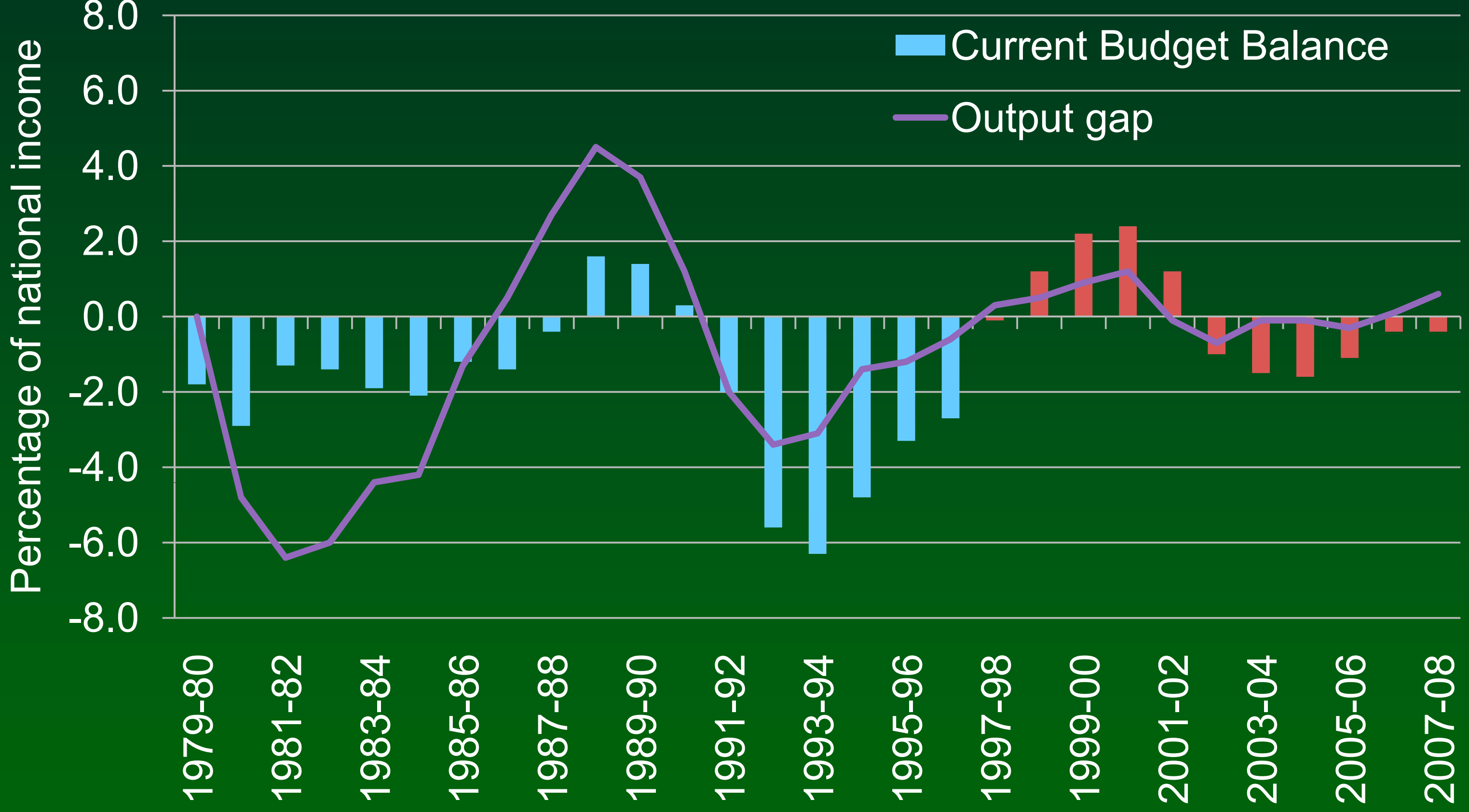

Source: HM Treasury, *Public Finances Databank*

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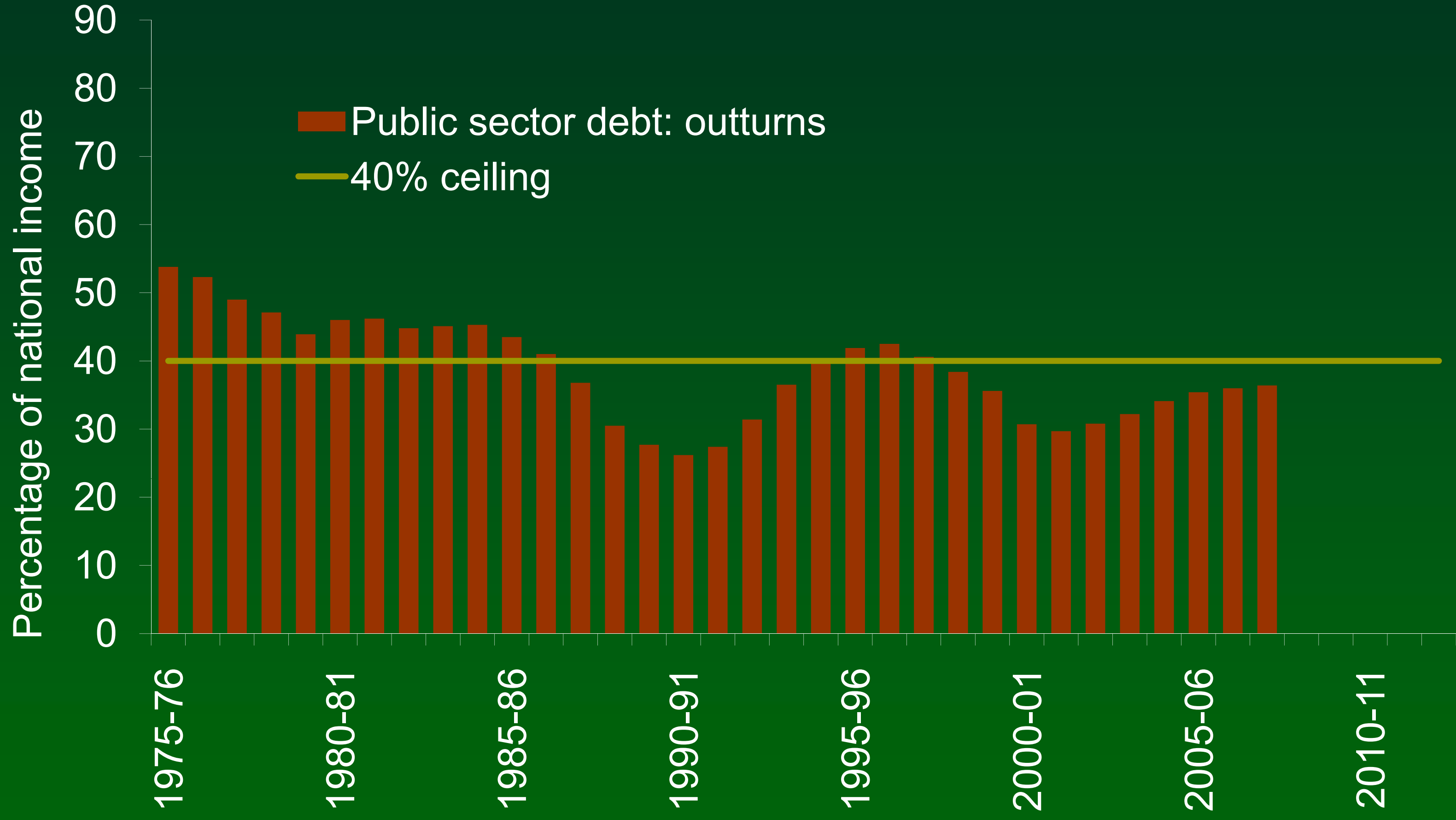
Did the fiscal rules work? - debt



Source: HM Treasury, *Public Finances Databank;* HM Treasury *Budget 2008*

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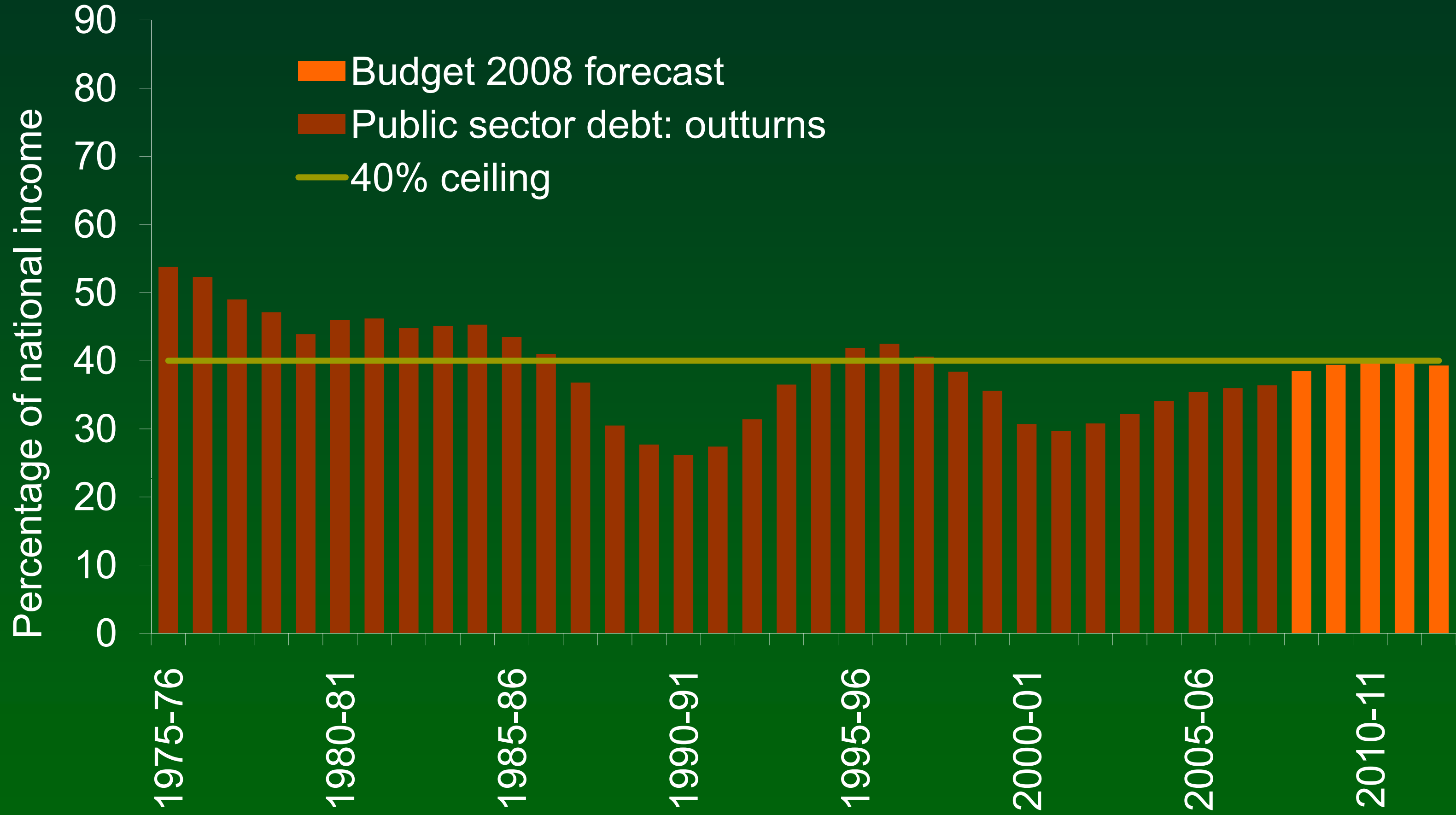

Source: HM Treasury, *Public Finances Databank;* HM Treasury *Budget 2008*

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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

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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

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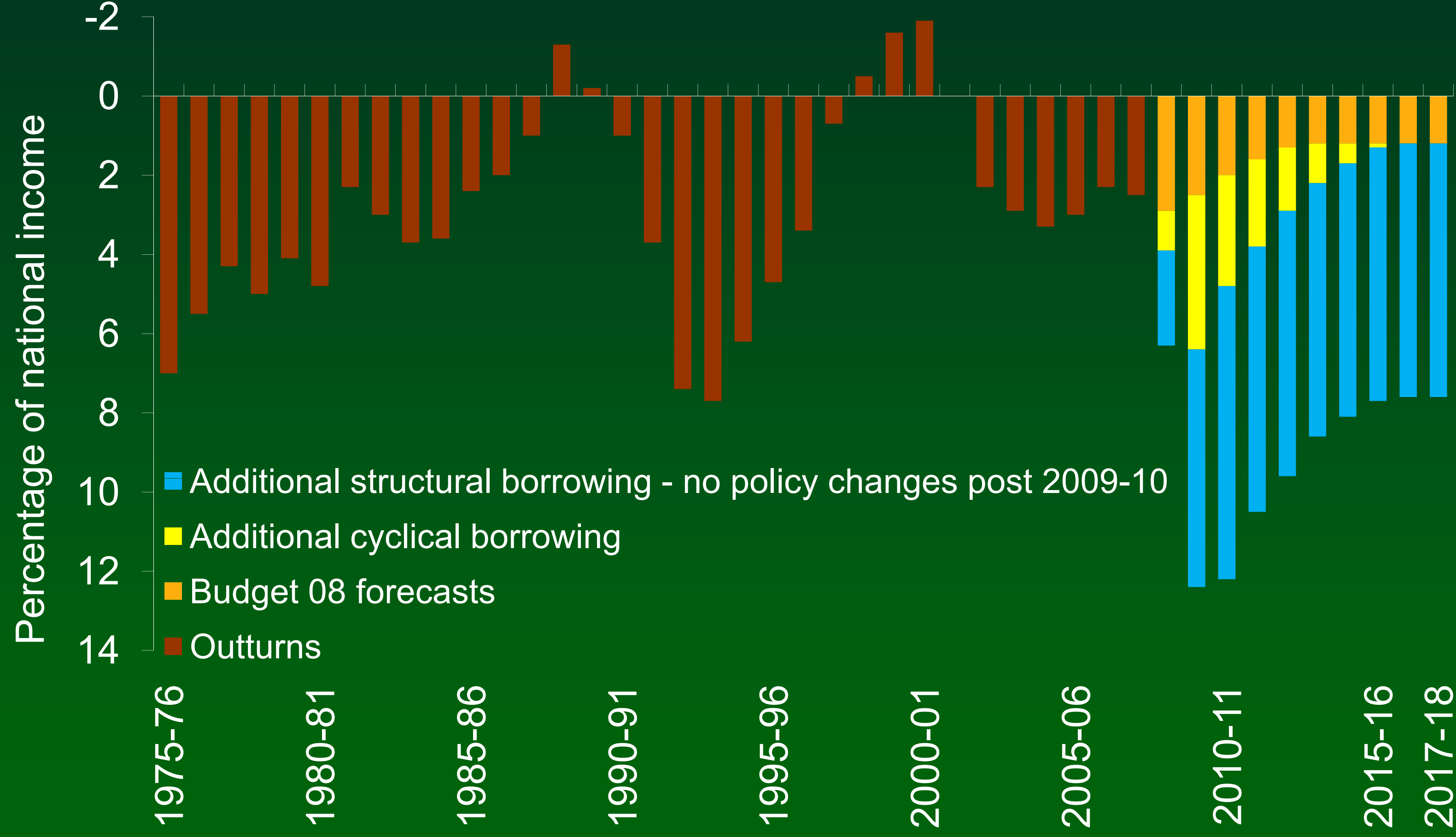
The effect of the crisis: fiscal rules

- 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



Source: Chote et al (2009)

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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)

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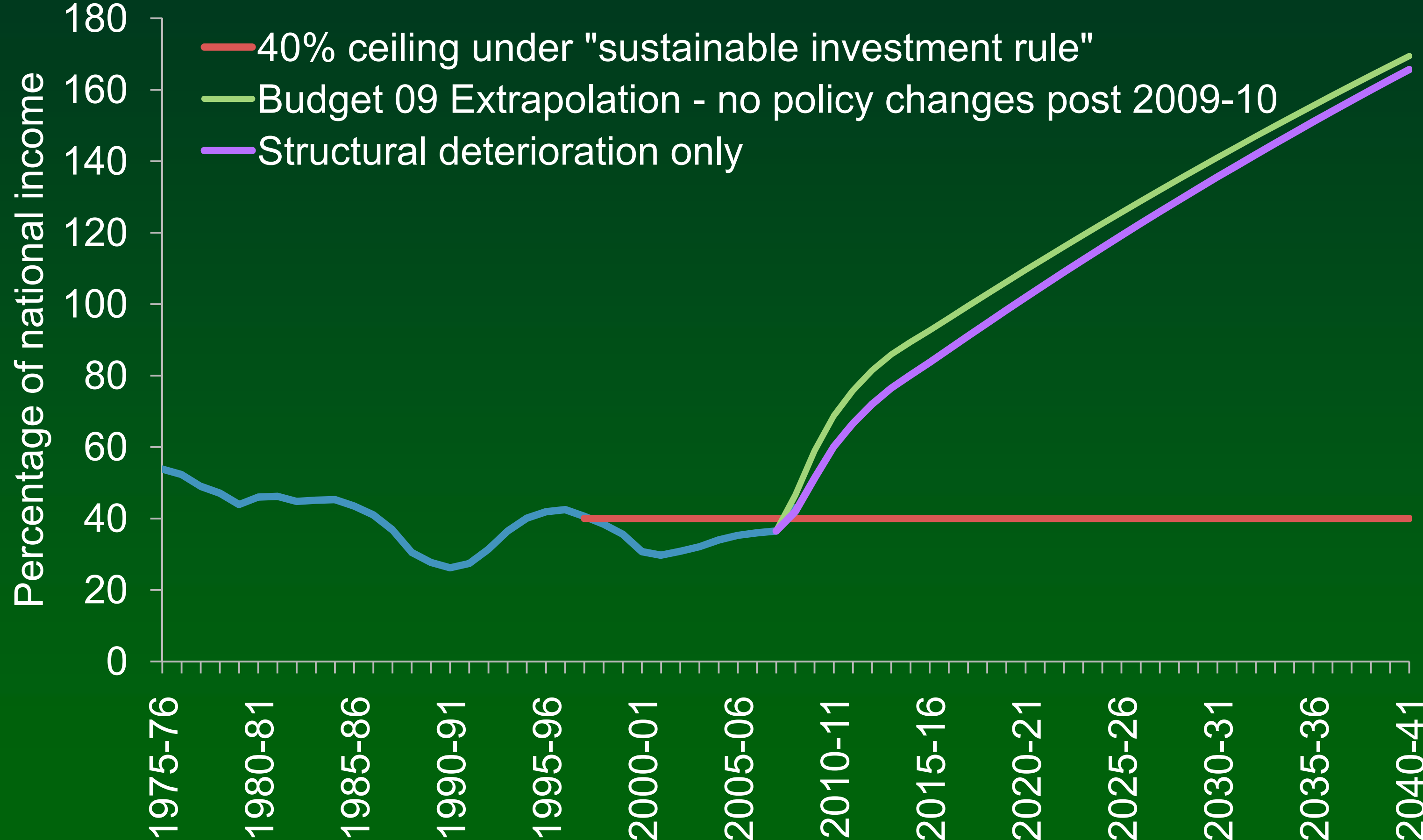
The effect of the crisis: debt



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

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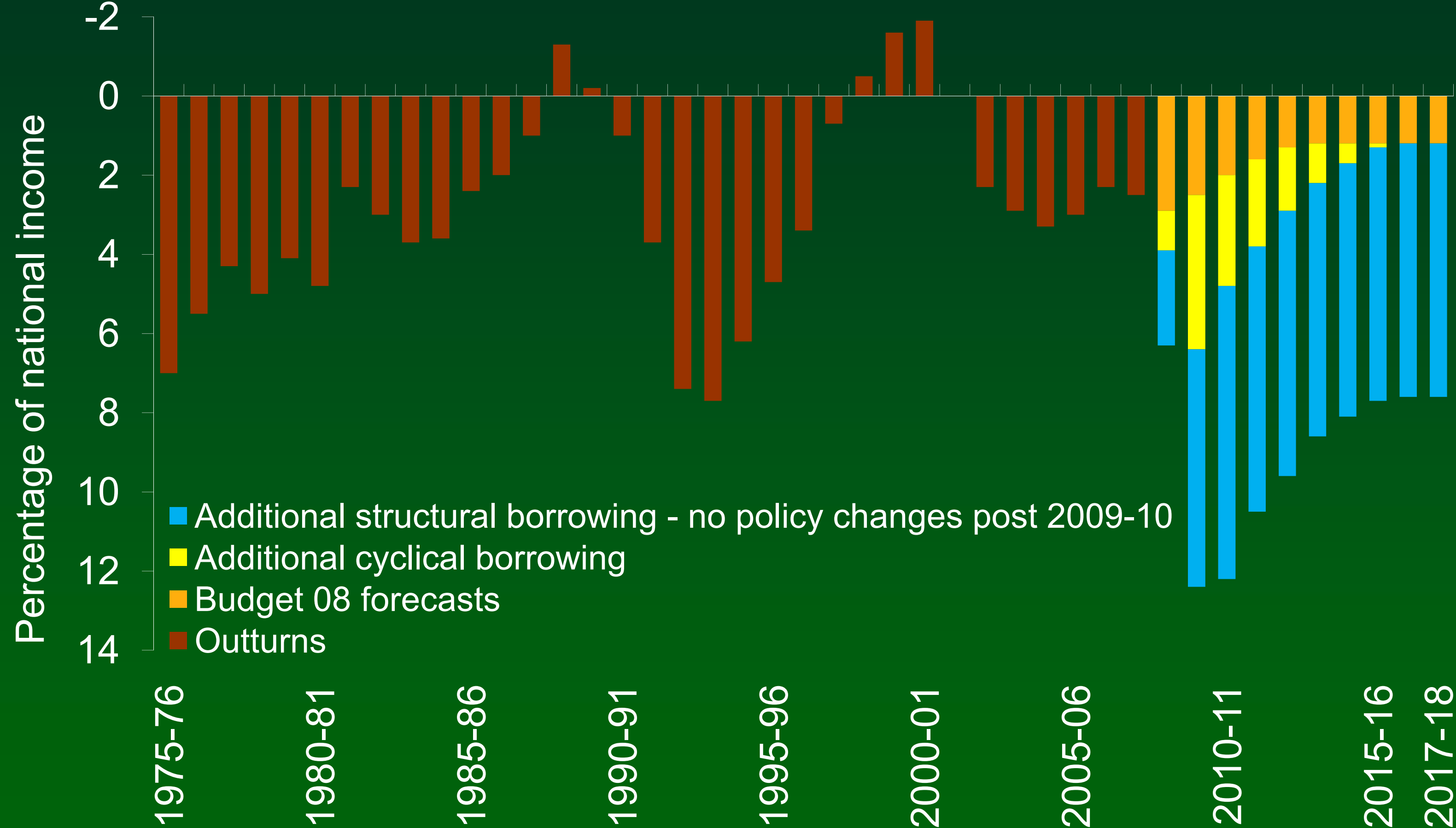
Implications of planned tightening: borrowing



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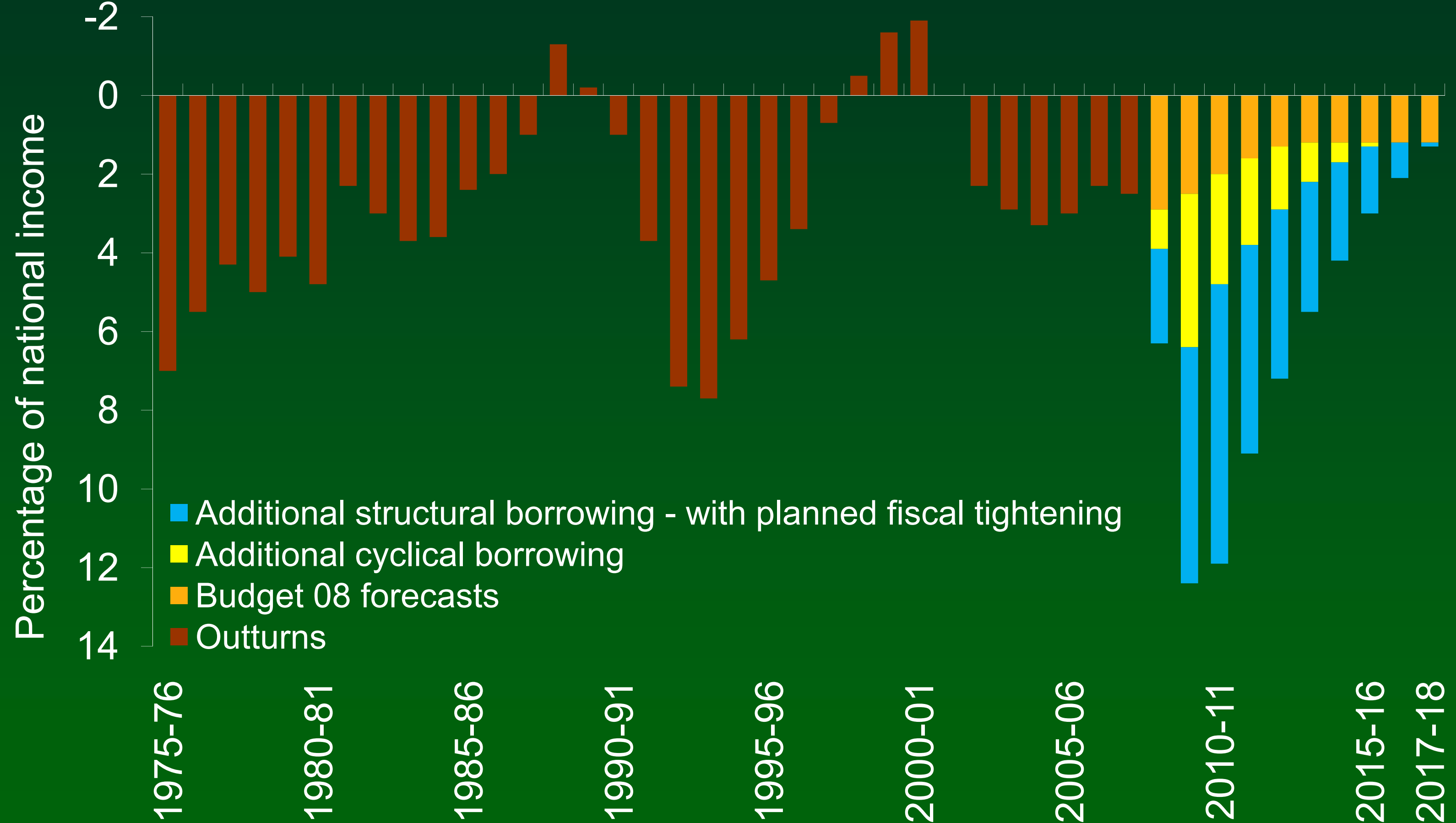

Source: Chote et al (2009)

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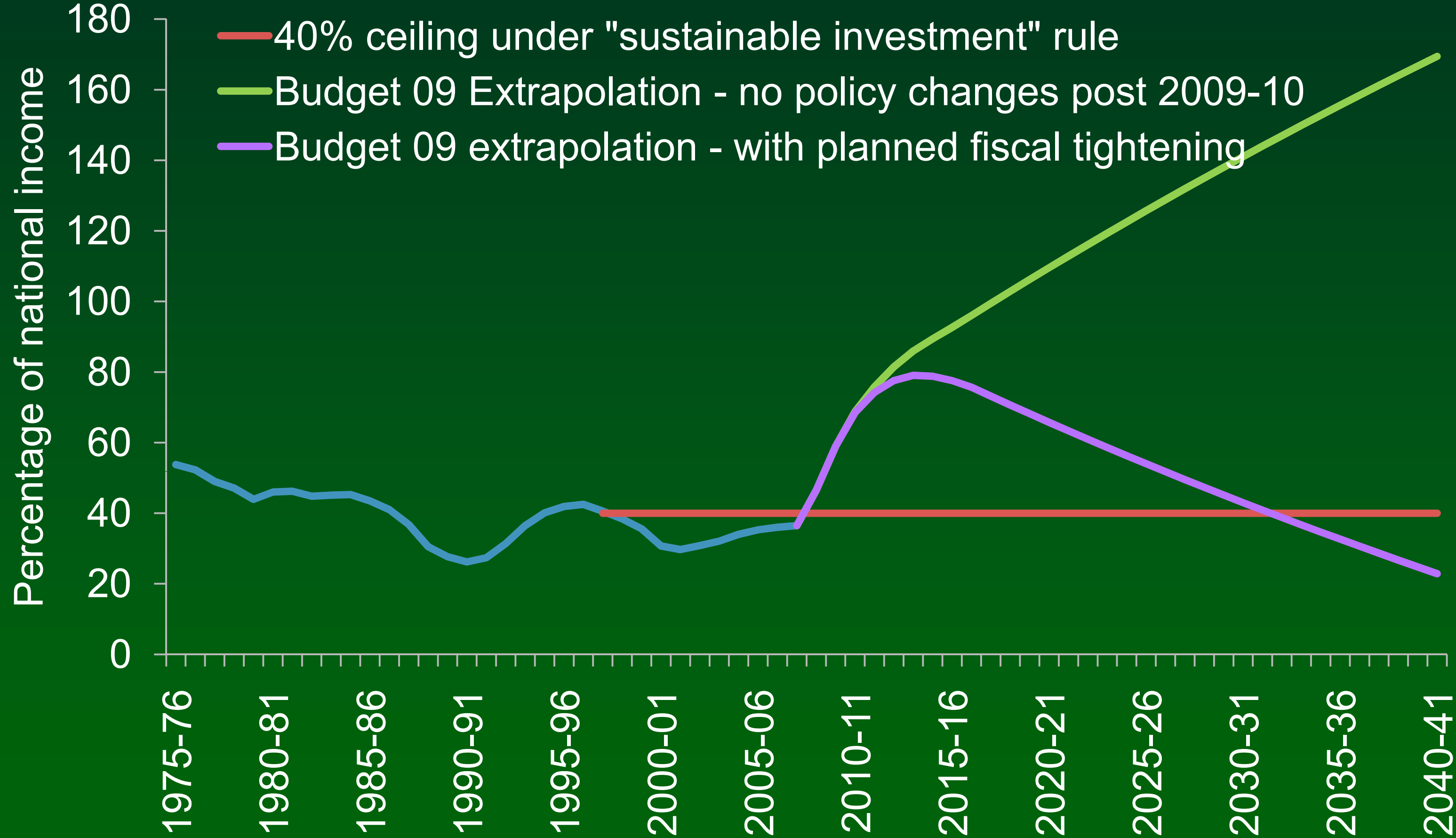
Implications of planned tightening: debt



Source: Chote et al (2009)

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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

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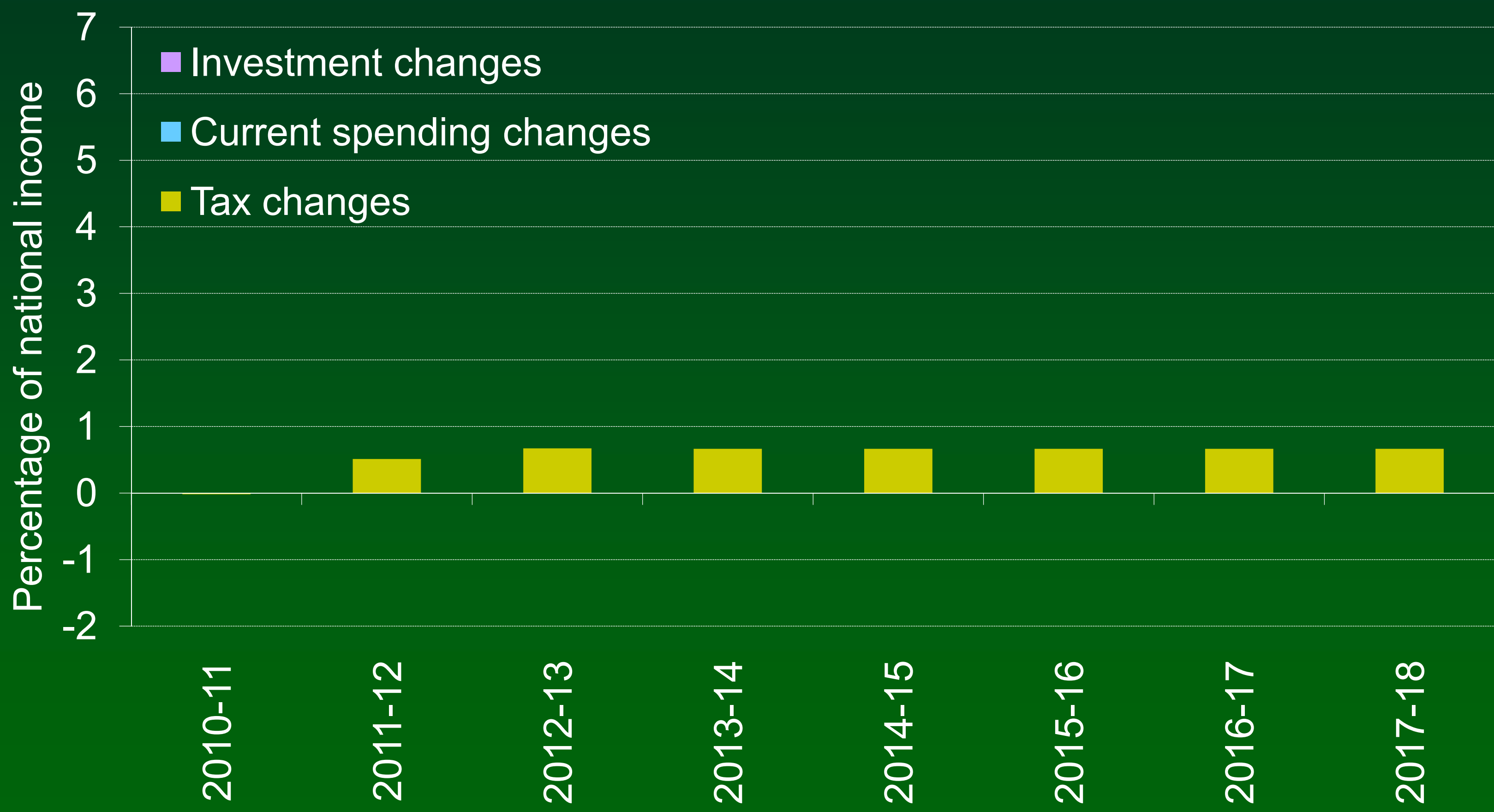
Planned tightening: 2010-11 to 2013-14



Source: Chote et al (2009)

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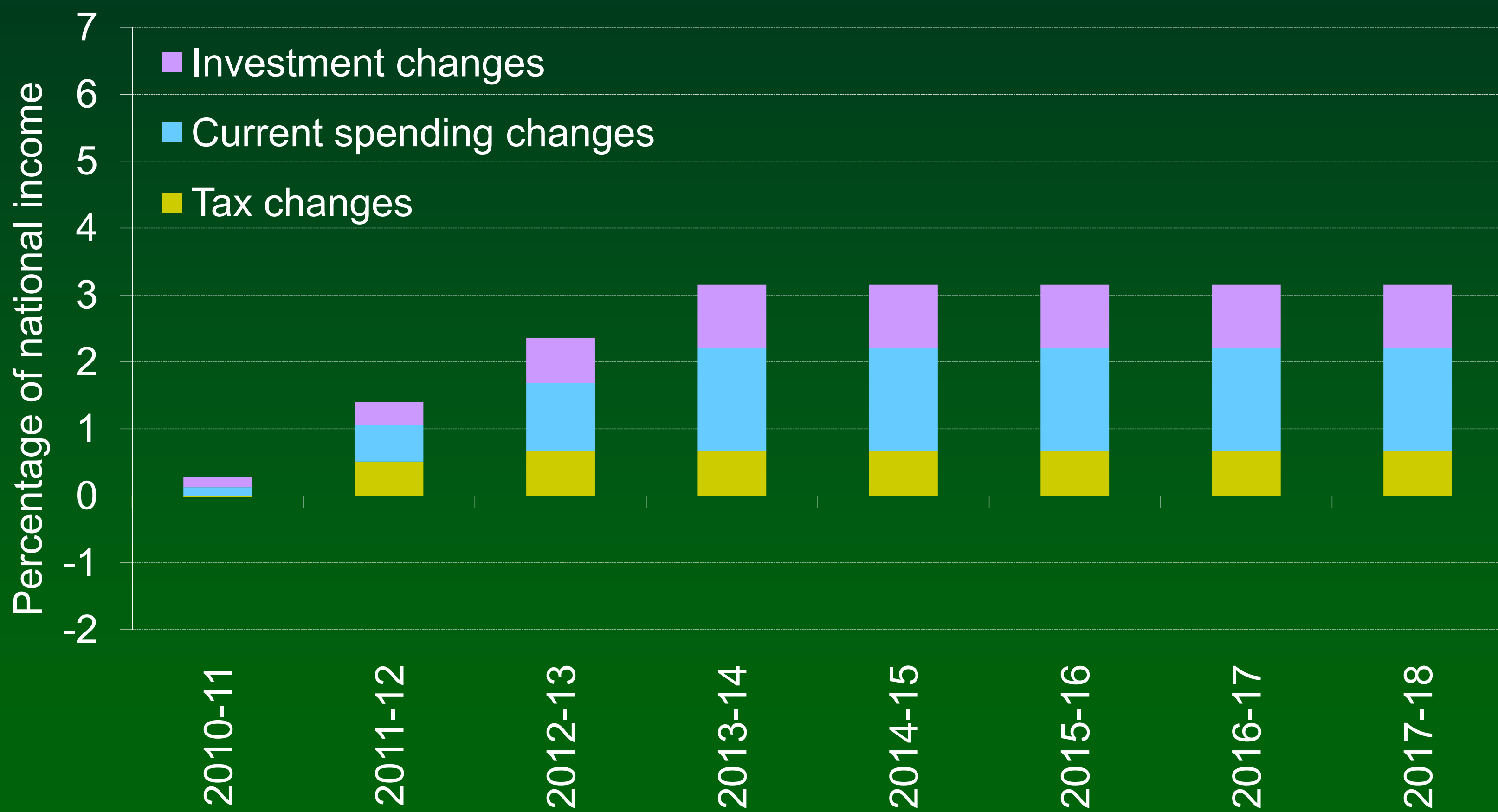
Planned tightening: spending

- 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: 2010-11 to 2013-14



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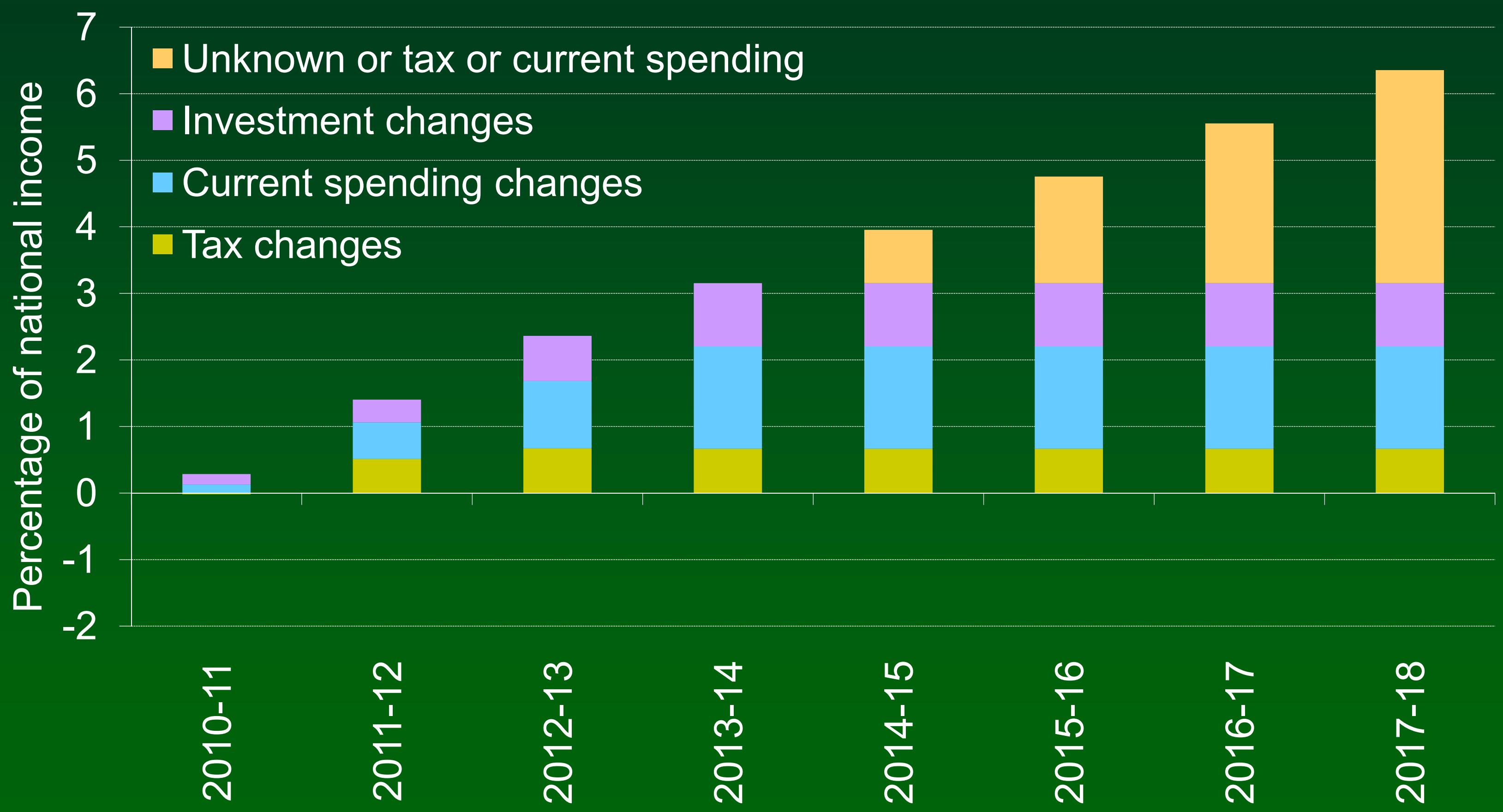
Planned tightening: 2014-15 to 2017-18

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

Planned tightening: 2014-15 to 2017-18



Source: Chote et al (2009)

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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

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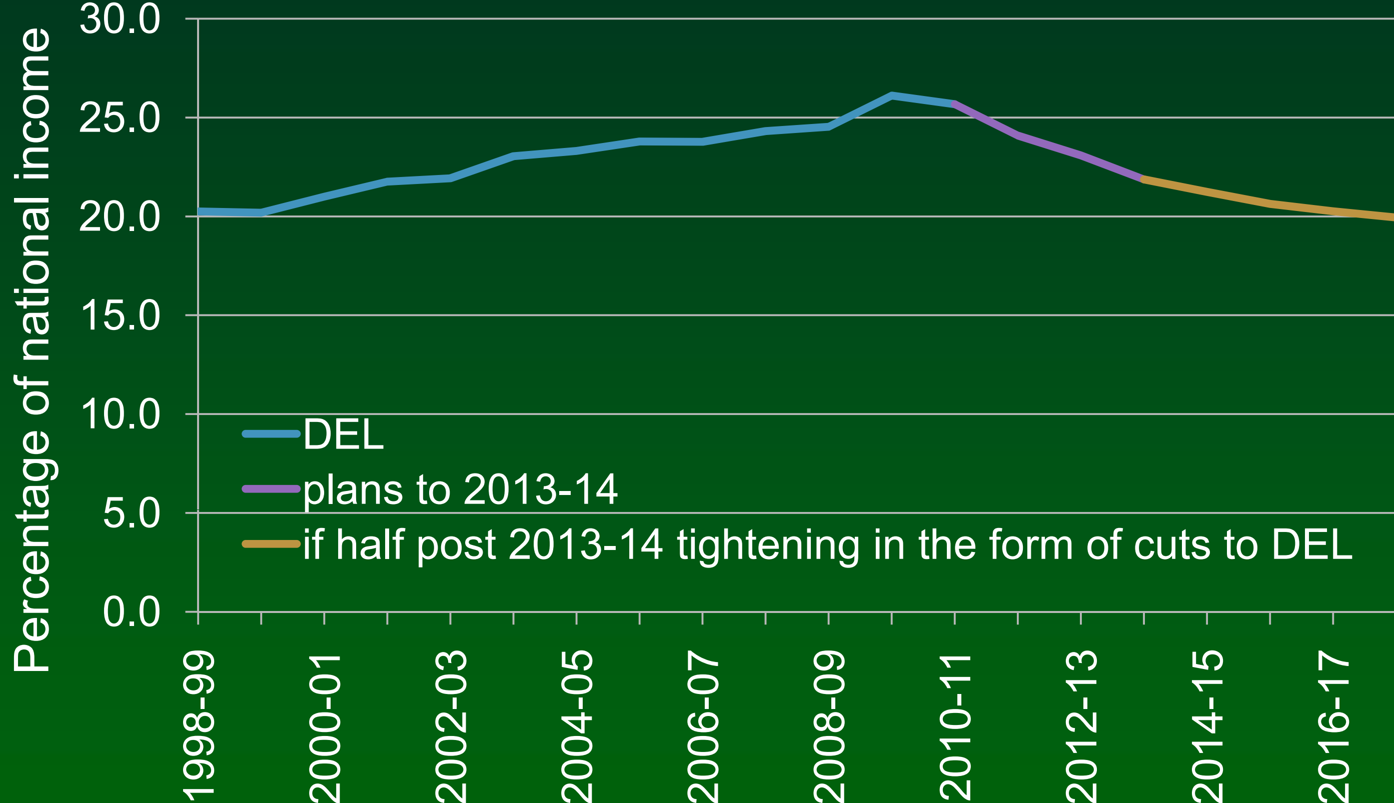
Implications of further tightening: spending



Source: Chote et al (2009)

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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?

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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

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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

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