Fiscal frameworks in radically uncertain times:

lessons from expenditure control 1993-2015

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Outline

- Fiscal policy and ‘radical uncertainty’
- Understanding and confronting uncertainty
- Preliminary findings
- Lessons for fiscal frameworks

Fiscal policy and ‘radical uncertainty’

- The fundamental objective of fiscal policy is to manage the sharing of society’s risks and resources within different groups and across generations

- Fiscal policy does so by ensuring the provision of public goods that would otherwise not be supplied to a sufficient degree by the private sector or the third sector.

- The fiscal position is the government’s choice over the path of public expenditure and revenue raising from taxes, which is influenced by the extent to which it adds to (or takes away from) aggregate demand and thereby mitigates the scale and impact of the business cycle.

Fiscal policy and ‘radical uncertainty’

- Faced with exogenous and/or endogenous shocks, a key objective of fiscal policy is to reduce uncertainty in the economy, whether through automatic stabilisers, medium/long-term investment or short-term discretionary spending.
- The Covid-19 crisis introduces radical uncertainty, as we do not know much about its incidence or duration, but we are assuming that it is likely to be a temporary shock with persistent effects.
- Unlike the ‘usual’ causes of economic fluctuations, this contraction does not result directly from monetary, fiscal or regulatory laxity. Thus providing some degree insurance is not subject to the problem of moral hazard. In large part, the economic crisis is the outcome of a policy aimed at guarding the nation’s health.

Fiscal policy and ‘radical uncertainty’

- The implication then is that large-scale temporary fiscal (and monetary) support must be supplied.
- Two questions arise:

(1) How suited are fiscal rules? We will look at the period 1993-2015 to assess the advantages and limits of fiscal rules

(2) Have UK decisions on public spending in response to shocks such as Covid-19 reduced or increased uncertainty?

Understanding and Confronting Uncertainty

- How the UK government has responded and should respond to evolving demands on its expenditure plans.
- Changes in our knowledge of the state of the economy induce significant shifts in the path of public spending. They force governments to make choices about expenditures that may not match the social needs of the economy.
- Uncertainty about the economy is both the missing constraint and the missing lever of power in any analysis of government expenditure.

Understanding and Confronting Uncertainty

- main data sources: OBR's historical official forecast &NIESR's own NiGEM model
- revision : $\varepsilon_{t,h} = \frac{TME_t^h - TME_t^{h-1}}{TME_t^{h-1}}$

Where TME_t^h is Total Managed Expenditure for fiscal year t announced by HMT at fiscal event $h \leq t$

- subcomponents of TME: **DEL** (e.g. hospitals, schools, etc.) & **AME** (e.g. welfare, pensions, debt interest payments)
- period of interest for the study: 1993 - 2015
- key challenge: DEL and AME did not exist prior 1998

Understanding and Confronting Uncertainty

Dependent variable	(1) TME	(2) TME	(3) DEL	(4) DEL	(5) AME	(6) AME
	t=h	t=h	t=h	t=h	t=h	t=h
GDP growth	-0.850**	-0.876***	-0.408	-0.451*	-1.188***	-1.388***
	(0.40)	(0.27)	(0.25)	(0.27)	(0.40)	(0.51)
Claimant		-0.204*		-0.014		-0.103
		(0.10)		(0.20)		(0.19)
Bank Rate		0.251**		0.108		0.096
		(0.10)		(0.12)		(0.18)
Election		-0.036		-0.431		-0.473
		(0.31)		(0.31)		(0.57)
Conservative		0.999**		-0.424		1.540
		(0.48)		(0.59)		(1.11)
Constant	0.027	-0.354	-0.156	0.189	-0.015	-0.002
	(0.13)	(0.33)	(0.21)	(0.56)	(0.29)	(0.99)
Observations	58	58	44	44	44	44

Understanding and Confronting Uncertainty

	TME	TME	DEL	DEL	AME	AME
	t=h+1	t=h+1	t=h+1	t=h+1	t=h+1	t=h+1
GDP growth	-1.325	-1.704*	0.362	0.794	-2.165	-1.721
	(0.90)	(0.96)	(1.41)	(1.49)	(1.39)	(1.64)
Claimant		-0.239		-0.151		0.369
		(0.16)		(0.36)		(0.44)
Bank Rate		0.349**		-0.091		-0.177
		(0.15)		(0.19)		(0.28)
Election		-0.074		-0.732		-0.568
		(0.51)		(0.82)		(1.12)
Conservative		1.103		-1.299		-1.141
		(0.74)		(1.07)		(1.21)
Constant	0.370*	-0.470	0.291	2.014*	0.016	-0.394
	(0.19)	(0.73)	(0.44)	(1.04)	(0.43)	(1.26)
Observations	54	54	34	34	36	36

Understanding and Confronting Uncertainty

Preliminary findings:

- Using the NiGEM historical database, the study finds that expectations about the state of economy this year and next are subject to significant revisions.
- There are significant year-to-year revisions in government spending plans at short and long-run horizons.
- The most significant factor in explaining these revisions is the change in the view on the state of the economy.

Lessons for fiscal frameworks

- Since 1993, the response to the question of fiscal credibility (to pay interest service and repay debt) by successive governments has been to try and shore up the plans for debt repayment by setting up mechanisms for expenditure control – informal rules (1993-97) & then formal rules (1997-2015)
- This action was done first with plans to conform to set plans for expenditure in line with a medium-term economic strategy.
- But latterly it has become subsumed in a ritual that assesses whether the government will meet a particular path for the deficit and a level of public debt relative to income.

Lessons for fiscal frameworks

- The overall objective is to give the impression of rules-based policies that conform to the expectation of financial markets that public debt will be repaid on schedule.
- The plans and the act of planning has some considerable merit as they can force government departments to confront their individual inefficiencies and jointly meet a given expenditure target.
- But as far as the actual practice of expenditure control and planning is concerned, what happens in reality turns out to the quite different.

Lessons for fiscal frameworks

- We find that expenditure plans and expected revenue receipts are significantly affected by revisions to forecasts of economic activity.
- This is because of both surprises in the evolution of demand in the short run and as a result of the difficulty of understanding long-run trends in productivity capacity.
- It is also clear that certain elements of planned expenditure such as public investment have been hard to implement over time because of the difficulty of identifying appropriate projects and garnering local political and business support.

Lessons for fiscal frameworks

- It is also the case that there are revisions from changes in political preferences e.g. when there is a change of government or a change of leadership within the governing party.
- All this means that when the government alters it fiscal expenditure plans it is signalling something about its revised view of the state of the economy and/or its preferences on how it wishes to meet the economy’s risk.

Lessons for fiscal frameworks

Conclusions and lessons

- the sequence of arbitrary fiscal rules that have been formulated by successive governments in the past two decades do not make much economic sense as they do not match a well-defined social welfare criterion.
- We need a fiscal framework that is both more flexible and more rigorous.

Five elements for a new fiscal framework

1. Faced with a lockdown that is an intentional supply shock aimed at controlling the spread of Covid-19, fiscal policy needs to sustain not just aggregate demand but also business confidence. NIESR has argued for an extension of (a version of) the CJRS – delaying this decision has increased uncertainty;

Five elements for a new fiscal framework

2. The lockdown reduces the overall labour supply but while there is excess labour supply in some areas such as recreation, travel and the restaurant sector, there is a shortage in others, e.g. healthcare, agriculture and childcare. Government could help divert labour to areas where required and provide basic training for necessary skills development;

Five elements for a new fiscal framework

3. The economic shock more obviously affects those households who cannot work on a sustained basis in a remote manner, many of those who are self-employed and those without sufficient savings to sustain expenditure patterns for necessities. This will tend to affect those in the lower income deciles, which requires a considerable effort on targeted policies to fight rising levels of destitution;

Five elements for a new fiscal framework

4. Using the list of identified projects at the National Infrastructure Commission, we should aim to bring forward public investment as soon as lockdowns are eased. If we are heading for a sequence of lockdowns, then any projects that can be completed quickly, at the local authority level or for social housing, should be deployed;

Five elements for a new fiscal framework

5. At a time when the monetary policy space is constrained and when demand falls so rapidly, it seems very likely that fiscal multipliers are quite large – that is for every pound spent the impact on the economy will not be to crowd out private sector activity but rather to sustain and enhance it