

COMMENTARY: FISCAL POLICY AND THE FISCAL POSITION

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Introduction

When the Government adopts a fiscal policy framework and target structure, as the current Government did in 1997, there is only limited interest in criticism of the policy framework itself. Inevitably much more attention focuses on whether the Government's targets will be met, rather than on whether those targets are the right targets; this is a simpler focus for debate.

Now, however, that the policy has failed spectacularly, and with discussion of the idea that there should be an independent office of budgetary stability, the related questions (1) what is the appropriate target structure, and (2) what are the implications of this for fiscal policy in the current circumstances, are now highly topical and we focus on these in this commentary.

Fiscal rules

As economics has developed, a number of different fiscal principles have been suggested. Perhaps the oldest principle was that the Government should balance its books. This principle was adopted by the 1979 Conservative Government but they delivered a budget in balance or in surplus only in 1988/89 and 1989/90. The same principle has been adopted in the Stability and Growth Pact, albeit with an element of 'flexibility' which requires countries to keep their budget deficits to less than 3 per cent of GDP except during periods of sharply falling output like the present. This approach was criticised in the 1990s in the United Kingdom on the grounds that, when revenues were weak, it was easier to cut investment expenditure than to reduce current consumption. Thus the principle of a balanced budget seemed to lead to a situation where the public capital stock was deteriorating. By comparison with other countries, the United Kingdom was, in any case, short of infrastructure capital. As a result it was easy to make the case for some alternative principle that would seem less inimical to public investment.

Pigou (1920) had proposed the principle that the

Government should borrow only to invest. While he did not discuss the question of averaging over the economic cycle, this principle, as well as being slightly less old-fashioned than budget balance, seemed to offer an alternative that would limit profligacy while at the same time giving room to improve the nation's infrastructure and was the basis for the current government's first fiscal rule. So as to ensure that it would not lead to excessive public investment, a second rule was introduced, that the stock of net public debt should not exceed 40 per cent of GDP. Since, in practice, investment decisions should be justified by the return on investment rather than by any rationing of investment funds, there is obviously a risk that such a rule could lead to a grossly inappropriate amount of investment taking place. But, given the difficulty of measuring the return to public capital, it is, perhaps fortunately, not possible to say whether there are projects with potentially high returns which are not carried out or alternatively, whether the economy is over-stocked with public investment. The Pigovian principle is, of course, quite divorced from a historical perspective. This shows that the main factors which have led to large-scale government borrowing have been the three big wars of the last two hundred years, the Napoleonic Wars and then the First and Second World Wars.

An alternative and more sophisticated analytical framework was developed by Barro (1979) and Flemming (1988). This is that the goal of fiscal policy is to keep expected future tax rates constant. Given that the Government decided to separate fiscal from monetary policy and use the latter to control inflation, this is the approach that should have been adopted. Barro justified the approach by the argument that, since there were costs to changing tax rates, expected welfare would be at its peak if taxes were not expected to change. Such an argument is not very impressive because it is clear that, while some taxes may be costly to change, others such as national insurance contributions can be changed extremely cheaply; indeed the costs of changes to

contribution rates are probably lower than those of changing interest rates. Flemming's argument was much more sophisticated. It was that expected changes to tax rates affect people's behaviour. If labour taxes are expected to rise, then labour supply will be brought forward to the present; if consumption taxes are expected to rise, then consumption will be brought forward to the present. Flemming showed that expectations of tax changes led to lower welfare than the alternative of setting taxes at a constant rate with the Government relying on credit markets to smooth out timing differences between revenue and expenditure. Thus he provided the coherent theoretical background for the principle.

It should be noted that this argument is superficially similar to the argument, made by politicians in the 1980s and still popular, that tax rates should be stable to facilitate business planning. That argument is, however, weak on two grounds. First of all, if there is a choice between tax rate volatility and interest rate volatility, it is by no means clear that business planning is better served by stable tax rates and highly volatile interest rates than by spreading policy responses across both tax and interest rates should that be possible. Secondly, a goal of keeping tax rates rather than expected tax rates constant inevitably means that adjustments to tax rates are delayed when circumstances change. Thus tax rate stability as a goal can imply welfare-diminishing changes to expected future tax rates.

An obvious criticism of Flemming's approach is that it has to rely on forecasts of both revenue buoyancy and spending needs. On those grounds it might seem as vulnerable to mistaken forecasts as the Government's framework proved to be. Indeed if the only disturbances to revenue were the normal economic cycle, then the goal of balancing the current budget over the cycle might not be very different from the aim of keeping expected future taxes constant. After all, if the current budget is in deficit in periods of weak economic growth and in surplus in periods of strong economic growth and if public investment is stable as a share of trend GDP, then the required target can be met without changes to tax rates during the course of the economic cycle. And, as is well documented, no forecaster anticipated either the current recession or its fiscal impact, as opposed to warning what might happen. Thus Flemming's approach might seem no more helpful than the Government's rules as a guide to fiscal management, while being even more likely to lead to relatively fruitless debates about what the long-term prospects for the economy were. There

are, however, two key differences for an economy structured round Flemming's approach from one based on the Government's fiscal rules, both of which would have pointed to a tighter fiscal policy in the boom.

Fiscal policy in normal times

First of all, the key to Flemming's analysis was that fiscal shocks, such as those associated with major wars, might happen even though they could not be forecast. To put that in its current context, during normal economic times fiscal policy should have been set to save up for a recession even though the timing of it could not be known. There is obviously plenty of room for debate about how much preparation should have taken place. But the point is that the fiscal framework effectively assumed that there was zero chance of a recession; whatever the risk might be it can hardly have been sensible to assume that it was zero.

There are obvious problems in planning for risks which materialise only infrequently. The recessions that the economy has experienced have had very different budgetary effects, in part because policy aims have varied. In 1931 the Chancellor of the Exchequer, Mr Snowden, implemented a range of cuts as a result of which he stated that the budget was securely balanced. The recessions of 1973–6 and 1979–83 were periods of high inflation; this amounted to a hidden tax on the national debt and meant that government debt was not much affected by high borrowing. As a result of the 1989–92 recession, however, public sector net debt rose from 26 per cent of GDP in 1991 to a peak of 42.6 per cent in 1996 (and the decline in public sector net worth, from 78 per cent of GDP in 1988 to 14 per cent in 1998, was much sharper). Debt levels fell to just below 30 per cent by 2002 but rose to 36.5 per cent of GDP by the start of the current recession. Obviously it is highly uncertain how much debt will rise as a consequence of the current recession. Our forecast shows the level rising to around 100 per cent of GDP after taking account of any bank losses which the taxpayer has to bear.

With this background, we set up some simulations taking a perhaps optimistic view that the increase in debt in a recession is 30 per cent of GDP and that on average such a recession occurs one year in twenty. We consider an economy growing at 4 per cent per annum in nominal value in normal times, with an interest rate of 5 per cent per annum. For an economy to stabilise its expected debt at 40 per cent of GDP, an overall deficit of 1.6 per cent of GDP could be afforded if there were no

risk to consider. If there is a one in twenty chance of a recession which adds 30 per cent of GDP to the national debt when it happens, then in normal times a surplus, before allowing for interest payments, of 2 per cent of GDP is needed. With an allowance for average interest payments, the required target for normal times is therefore on average budget balance. This is of course independent of how much public spending goes on investment.

In practice, as the experience of both the last and the current recession shows, deficits do not disappear immediately recessions come to an end. If we assume that a crisis results in a primary deficit of 3 per cent of GDP for ten years, instead of one very bad year, then in normal years a primary surplus of 2.8 per cent of GDP or 0.8 per cent of GDP inclusive of average interest payments is needed; this is perhaps a better guide to policy. It suggests that, if the Government aimed to invest 2 per cent of GDP, its fiscal rule of delivering current balance over the cycle was too slack by about 3 per cent of GDP because it did not pay any attention to the risk of recessions.

Funding age-related expenditure

The second important difference between the fiscal rules and Flemming's approach is the way that they treat the effects of an ageing population. Cardarelli, Sefton and Kotlikoff (2000) explored the sustainability of the UK's fiscal position as it seemed on the basis of policy at that time, on the assumption that there would be no adverse fiscal shocks. They found a reasonable balance, at least on the assumption that there would be no sharp increase in health expenditure.

This assumption was in keeping with government policy at the time, but seemed politically unsustainable given the general upward pressures on health spending. Shortly afterwards, following the Wanless Report (2002), a sharp increase in health spending was announced, financed by a 2 percentage point increase in national insurance contributions (half collected from employees and half from employers). This, in keeping with the other revenue projections, seemed to the Government to be adequate to deliver the fiscal rules. But higher general expenditure on health almost certainly creates further pressures associated with population ageing, and particularly so since healthy life expectancy is rising slower than overall life expectancy (Khomein, Mitchell and Weale, 2008). So a recognition of political pressures for increased spending should also

have led to the expectation of additional spending in the future.

A second feature of the work was that it was done on the basis of the population projections provided by the Government Actuary at the time. The sharp rise in life expectancy which has taken place since then is bound to have increased age-related expenditures as compared with the situation described by Cardarelli and Sefton. Had Flemming's approach been followed, taxes would have been raised in response to each 'surprise' about future life expectancy; in effect the future expenditure would be funded. By contrast, the Government's fiscal rules have simply left this as a problem to be dealt with later.

The implications of current longevity estimates for future expenditures cannot be drawn without repeating Cardarelli and Sefton's calculations. However, a reasonable conclusion is that they will shift the required balance on the government current account further into surplus.

The economy as a whole

With the exception of the comments on spending in recessions, the analysis above has been entirely in terms of the financing needs of the public sector considered in isolation. In that sense it is firmly pre-Keynesian. The broad lesson from Keynes was that policy instruments should be set not with respect to narrow goals but with reference to the needs of the whole economy. On these grounds Weale *et al.* (1989) argued that fiscal policy should reflect the savings requirements of the economy as a whole. The costs of financing the Second World War meant that the ratio of the nation's produced wealth (net foreign assets plus domestic capital goods excluding land) to GDP fell from three times GDP in 1938 to twice GDP by 1944. The capital loss was made good by the mid-1970s. But since the mid-1980s the ratio has again fallen from three times GDP to around twice GDP; the explanation is probably that rising land prices have crowded out produced capital and Khomein and Weale (2008) have argued that the economy is now short of savings, in that current consumption patterns cannot be afforded. Even before the current recession, their results showed that without an increase in working lives, consumption needed to fall by about 8 per cent to move onto a sustainable basis. There is a strong argument that the policy framework should take account of the funding needs of the economy as a whole, and not simply those of the public sector. But that is a separate issue. To establish the principle that in normal times the current

account on the budget should average a surplus of 1 per cent of GDP would be a considerable improvement on the budgetary mismanagement of the past few years.

The current fiscal position and the medium-term outlook

Since the risk of a substantial economic slowdown first became apparent, in the Spring of last year we argued that it would be a mistake to tighten fiscal policy. As the recession developed we argued prominently for a fiscal stimulus, although also that a VAT reduction was less suitable than a tax rebate (see Barrell and Weale, 2009). Despite the arguments above for a fiscal surplus in normal periods, the case for a further fiscal stimulus in the recent budget was strong. But given that the Government decided against this, attention has instead focused on the medium-term prospects for the public finances.

As always in looking at long-term fiscal forecasts, the key determinants are (i) the normal level of output, (ii) the trend rate of growth, (iii) the extent to which any deviation from trend is closed, and (iv) the tax take (the share of taxes in GDP). It is generally recognised that increased risk premia in financial markets are likely to reduce long-run output, and also that shrinkage of the financial sector is likely to lead to a further reduction. The National Institute sees an output fall similar to that of the Treasury, but notes that losses in the banking system mean that income (which provides the tax base) is likely to decline more than output. Two other factors lead to a more substantial gap in actual output projections. First of all we see the economy as being further above trend in 2007 than the Treasury had assumed and secondly we see the trend growth rate being slightly lower. These taken together lead us to expect output to be about 2 ¼ per cent lower than the Treasury has probably assumed for 2017. We also expect prices to rise less rapidly, but this affects nominal rather than real aggregates.

If we let real government spending grow by 0.7 per cent

per annum, measured with reference to the GDP deflator in the period from 2013/4 to 2017/8, while we let social security benefits grow in line with underlying GDP and reflect changes in labour force participation and population structure, we then find that nominal spending on goods and services has to stagnate from 2012 onwards. Real spending measured with reference to the GDP deflator falls at about 1¾ per cent per annum from 2012/3 to 2017/8, giving an overall annual decline of nearly 1 per cent per annum over the period 2009/10 to 2017/8 and taking the share of public consumption in GDP down to levels not seen since the Second World War. Freezes on public sector pay will be needed if cuts in public services are to be avoided. Obviously the squeeze on public consumption could be mitigated by reducing social security benefit entitlements. Even with this squeeze tax increases of about 2p in the standard rate of income tax are needed to bring the current account deficit to just below 4 per cent of GDP.

An alternative would be to let public spending grow faster, to sustain positive real growth of consumption of goods and services of 0 to 1 per cent per annum from 2012/3 onwards and over the whole period from 2009/10 to 2017/8, as measured with reference to the GDP deflator. This would maintain the share of public consumption in GDP at its average for the first part of this decade. But it would require an increase in the standard rate of tax of 9–10p in the pound, taking the share of taxes in GDP to a record level while once again leaving the deficit on the current account at just under 4 per cent of GDP. These choices are summarised in table 1. The fiscal tightening needed to deliver the 1 per cent budget surplus we propose for 2017–18 is simply unimaginable without major structural change to the economy. Barrell and Kirby (pp. 61–5 of this *Review*) discuss the fiscal position in more detail.

Conclusions

A sound fiscal policy framework would take account of the risk of recessions and their budgetary implications. It would also take account of the costs associated with an

Table 1. The budgetary choices for 2017

	Government consumption average annual growth 2009/10–2017/8	Standard rate of income tax	Total tax revenue (% of GDP)	Government current account balance in 2017
Severe squeeze	–0.9% p.a.	22p	36.1	–3.8%
High taxes	0.6% p.a.	30p	39.2	–3.8%

ageing population and attempt to offset low saving by the private sector. Simply to take account of the risk of recession suggests that a budget surplus of the order of close to 1 per cent of GDP in normal economic times is probably desirable. This is obviously also practical in policy terms since it is similar to the tax share of the early 1980s.

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