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ideas with impact

Will the Splurge work?

Will the economy benefit from increased Government borrowing?
Not necessarily.

Summary

Today the Chancellor announced around £20 billion worth of additional borrowing, over and above the around £100 billion the Government would have borrowed anyway. This money will be used to fund a reduction in the VAT rate and a number of other smaller measures. The Government has announced that this additional borrowing will be paid back after the next election by a new 45% top rate of tax for those earning over £150,000 and National Insurance increases of 0.5% for both employers and employees.

Several quite different questions have become confused in the British debate about how to handle the recession:

- Should the Government deliberately loosen fiscal policy - over and above the loosening brought about by the operation of the so-called "automatic stabilisers"?

- If there is to be a discretionary increase in borrowing, should it be used to finance tax reductions or increased public spending? And if there are to be tax cuts, which taxes should be cut?

- Should the Government seek to reduce taxes by reducing unproductive public spending?

Looking at the academic evidence we find that:

- The evidence on deliberate fiscal loosening is ambiguous. There are problems with timing, and also some evidence that fiscal loosening is not always expansionary. Indeed, on some occasions bringing expenditure under control has had expansionary effects. Fiscal loosening cannot be relied upon to solve all our problems.

- If there is to be a stimulus package, tax reductions are clearly to be favoured over higher public spending. Spending programmes are slow to initiate and there is a danger that unproductive projects will be financed.

- We also argue that the Government must now try to reduce the burden of tax by reducing the most unproductive types of Government spending. This will increase the growth rate of the economy in the medium term, but it could also boost confidence and help drag the country out of recession. Looking at evidence from the OECD, taxes on employment - rather than consumption - are probably the most important taxes to cut now.

Background

As well as separating out the different issues, it is important to put the discussion about borrowing more into context. Even on current policies, the UK is on course for a very large deficit and high ratio of public spending to GDP. This will happen anyway as a result of the operation of the automatic stabilisers – in other words, the fact that tax revenues fall and unemployment benefit spending increases during a downturn.

According to the European Commission, the UK will run a deficit of 5.6% and 6.5% of GDP in 2009 and 2010 – the second highest borrowing forecast among the 27 member states. Moreover, the Chancellor indicated today that the deficit will peak at 8% in 2009/10, whilst also confirming last week's reports in the Financial Times that public borrowing will rise to £118bn by 2010.

Although current liabilities are lower than some countries, it is the *speed* at which they are increasing that should cause alarm. Moreover, the official debt level neglects other disproportionately high liabilities such as PFI, public sector pensions and the banking bailout.

The Institute for Fiscal Studies argue in their November 2008 Public Finance Bulletin that: "The economic slowdown, which the Bank of England and other forecasters now predict, is very likely to lead to 'underlying' public sector net debt exceeding 40% of national income next year and possibly sooner. Indeed such a slowdown could push debt closer to 50% of national income." Today's pre-Budget estimate puts the peak figure at 57%.

It is in this context that the UK Government needs to decide whether or not to deliberately borrow and spend more.

Does fiscal loosening always work?

Across the world, countries are facing the difficult task combating the effects of the financial crisis. Gordon Brown has referred to an "international agreement" over the need to increase government spending in order to provide a stimulus. But not all countries are deliberately increasing the deficit. This is partly because each country finds itself in a different situation in terms of their finances. For example,

Angela Merkel has said:

> "I believe that far-reaching financing rules or tax and debt-funded economic growth plans would be the wrong way to [go] because a short-lived flash in the pan won't help the economy,"

What's more, this reflects a wider disagreement over the effectiveness of a Keynesian approach, which advocates increasing the deficit so as to induce positive growth effects. A key aspect to the success of the Keynesian approach lies in its credibility, both with consumers, and the international capital markets.

It has been argued that a temporary tax cut will not immediately feed into the economy if it is perceived that the cut will be reversed at a later stage – a point known in the jargon as Ricardian equivalence. Unusually, the tax reductions now under discussion in the UK are explicitly intended to be reversed within a year or two – potentially blunting their ability to stimulate growth. The credibility of the policy is crucially important: does the consumer believe that the government will stick with its path? Or will today's tax cut make bigger tax rises more likely in the future? In this context the £2 billion which is to be raised by the new 45% rate and the hikes in National Insurance contributions is important because of the message it sends about where Britain is going.

Extending borrowing now also impacts the international capital markets. If it is perceived that a government will continue to issue government bonds in order to spend its way out of trouble then the markets may demand a higher interest rate in return for increasing amounts of lending. Indeed, this ought to be a concern in the UK because the fiscal rules have been suspended. This forces up long-term interest rates, which can choke off a recovery, as happened to some extent in Japan. The Bank of England has made it clear that the fiscal decisions being taken by the Government will affect their decisions on interest rates. The minutes of the MPC meeting on 5/6 November note that:

> "The Government had already announced its intention to bring forward some planned spending commitments. Moreover, the changing composition of output would lead to a fall in effective tax rates from those assumed in the projections. Consequently, it would make sense for the Committee to reassess the required scale of monetary easing after the Chancellor's Pre-Budget Report."

Problems with timing

Even if we assume that increasing the deficit is expansionary (which it may not be), there are several other problems with using fiscal policy (and particularly increased spending) to manage the economy.

In a 2004 lecture at York University, Ed Balls gave three reasons why it had proved difficult to manage the UK economy using fiscal policy:

> "Rather than taking a symmetric approach to the economic cycle, there was a bias towards loosening - it was always easier to loosen fiscal policy when the economy was weaker, but much harder to tighten fiscal policy when the economy was stronger; the existence of long decision and implementation lags meant that, too often, what governments thought were counter-cyclical policy decisions tended to be pro-cyclical and therefore destabilising; and there was a lack of coordination between spending and tax decisions with spending decisions often more than offsetting adjustments on the revenue side done for demand management reasons."

Balls argued that this did not rule out the use of fiscal policy, but argued that it is "inherently more complex and less predictable than monetary policy."

But bringing forward public spending is, by its very nature, a difficult process to achieve: work cannot start tomorrow on building new houses, schools, railways or hospitals. Major infrastructure projects require consultations and years of legal work. For this reason there is a relatively high level of agreement among economists that any stimulus package should probably be delivered via tax cuts.

Martin Weale from the National Institute for Economic and Social Research summarized the argument for a temporary stimulus: "The argument for fiscal action is that by the time the debt is repaid the economy will be running smoothly again and people who want to work will be able to so that, over time, total output is increased." However, this is a based on an assumption that within a year or so the economy will be returning to normal. This may be correct. But what if the tax has to be paid back in the middle of the recession?

In contrast, the operation of the "automatic stabilisers" does not rely on political guesswork in this way. In a downturn these should always kick in: tax receipts will fall, and borrowing will automatically go up.

Could fiscal consolidation boost growth?

Other economists have reported evidence that reducing the deficit – consolidating public expenditure – can actually have a *positive* growth effect. There are several channels which may explain why this happens.

First, the role of expectations: if the Government can demonstrate that is has controlled unproductive spending and reduced taxation in a sustainable way, then people's expectations about future income growth may be increased, leading to expansion.

Second, spending control may help to reduce long term interest rates (particularly for countries with large deficits), as the markets anticipate reduced government borrowing and therefore push down the level of interest rates.

Finally, there can be a boost to the supply side. Controlling spending and tax may increase international competitiveness and crowd in investment.

In order to achieve the positive growth effects, the academic evidence points strongly to cutting unproductive government spending rather than increasing taxes. To quote from a study for the IMF by Alesina and Perotti:

> "fiscal adjustments that rely primarily on spending cuts in transfers and the government wage bill have a better chance of success and are expansionary. On the contrary, fiscal adjustments that rely primarily on tax increases and cuts in public investment tend not to last and are contractionary."

There have been a large number of empirical studies in recent years which have found evidence of effects which counteract or outweigh the traditional Keynesian effects of an increase in the deficit, particularly in cases where there is already a high deficit.

STUDY	SAMPLE	Findings
Giavazzi and Pagano (1995)	19 OECD countries,1970-1992	"The cross-country evidence on private consumption confirms that fiscal policy changes - both contractions and expansions - can have non-Keynesian effects if they are sufficiently large and persistent"
Alesina and Perotti (1996)	20 OECD countries, 1960-1994	"We find that fiscal adjustments which rely primarily on spending cuts on transfers and the government wage bill have a better chance of being successful and are expansionary"
McDermott and Wescott (1996)	20 OECD countries, 1970-1995	"fiscal consolidation need not trigger an economic slowdown. Fiscal consolidation that concentrates on the expenditure side, and especially on transfers and government wages, is more likely to succeed in reducing the public debt ratio than tax-based consolidation."
Alesina and Ardagna (1998)	All OECD countries,1960-94	One interpretation is that a serious fiscal tightening increases demand… For this effect to produce an expansion, the tightening must be sizeable and occur after a period of stress when the budget is quickly deteriorating and public debt is building up. Another interpretation emphasizes the supply side… Based both on statistical evidence and on a detailed analysis of ten cases of major fiscal adjustment, this article provides cautious support to the supply-side view"
Caselli and Rinaldi (1999)	The EU	Depends on the exchange rate regime: "If home authorities alone are responsible for pegging the exchange rate, a fiscal adjustment leads to a decrease in the real interest rate, [and] stimulates private consumption"
Alesina et al. (1999)	20 OECD countries, 1960-1995	"Expansionary fiscal consolidations are on average implemented mostly by spending cuts, whereas contractionary ones are characterized by tax increases."
Perotti (1999)	19 OECD countries, 1965-1994	"In the 1980s several countries with large government debt or deficit implemented substantial, and in some cases drastic, deficit cuts. Contrary to widespread expectations, in many cases private consumption boomed rather than contracted."
Giavazzi, Jappelli and Pagano (2000)	18 OECD countries, 1970-1996	Non-Keynesian effects "tend to be associated with large and persistent fiscal impulses… and also tend to occur in periods in which debt is accumulating rapidly,
Giudice et al (2004)	14 EU countries, 1970-2002	"Cross-country analysis shows that roughly half of the episodes of fiscal consolidations that have been undertaken in the EU in the last 30 years have been followed by an acceleration in growth. The consolidations that turned out to be expansionary were, in general, based on expenditure cuts rather than on revenue increases."
Alfonso (2006)	15 EU countries	"The results show some evidence in favour of the existence of expansionary fiscal consolidations, for a few budgetary spending items"
Hauptmeier et al (2007)		"The study finds that ambitious expenditure retrenchment and reform coincides with large improvements in fiscal and economic growth indicators."

(Adapted from Briotti, 2004)

There is an active and ongoing debate in the literature about these findings. Some argue that fiscal consolidation might be expansionary, but only under specific circumstances. Others argue that the effects can be explained away by central banks' reactions to the fiscal consolidation (e.g Canale et al 2007). Others simply reject the idea (e.g. Hjelm 2002 and Hemming et al 2002).

Nevertheless, there is a wealth of empirical evidence that suggests a "non-Keynesian" growth response to consolidations involving spending cuts. At the very least, we should not take it for granted that running a higher deficit always has expansionary effects.

Should the Government seek to reduce taxes by reducing unproductive public spending?

Quite apart from the long run arguments for reducing taxes by cutting unproductive spending, funded reductions in tax could help fight the recession by boosting confidence about future growth.

The Chancellor has indicated some sympathy for funded tax reductions. He told Sky News that "People will be expecting the government to tighten its belt just as they are tightening theirs." (18 November)

Intuitively it is easy to see why there may be more scope to stimulate the economy by reforming public spending rather than by adding to borrowing. The government will add an extra £20 billion to its total borrowing, which has been forecast at around £80 to £100 billion next year. While this is significant – it is unlikely to radically change the trajectory of the economy. Given that the government's total managed expenditure for 2008/9 is £618 billion, we can see why there might be greater potential to stimulate the economy by shifting money out of unproductive public spending and back into the wider economy.

There is a final question about where to target any tax cuts. There is a rich economic literature on which taxes are most distorting and most damaging to growth.

The Government will spend most of the fiscal stimulus on a reduction in VAT. But the OECD argue that this would be one of the least effective courses of action. The OECD's Secretary-General, Angel Gurría argued in a speech earlier this year that:

> "The distortionary effects of collecting revenue from different sources can be very different. It is highly likely that there could be efficiency gains from replacing part of the revenues from income taxes with revenues from less distortionary taxes such as consumption or property taxes. Our recent work on "tax and growth" suggests that corporate taxes are most harmful for growth, followed by personal income taxes, and then consumption taxes. Finally, recurrent taxes on immovable property seem to be the least harmful for growth." (Stockholm School of Economics, 22 April 2008)

As well as the general question about which taxes are likely to boost growth, in the current context there is also a question about which tax reductions might be most appropriate in the context of rising unemployment and stalling growth. Although it is disputed, there is some evidence that unemployment is persistent. Being unemployed itself makes people less employable: their skills become out of date, and they become demoralised (Layard and Nickell, 1987).

The current danger is that a sharp recession might lengthen out into a prolonged slump. So in this context a cut in employers' national insurance (which is a relatively highly distorting tax anyway) might be even more beneficial than it would be at a time of full employment. Today's announcement of an increase in this tax, albeit delayed, could undermine the fight against unemployment.