

Fiscal policy under New Labour

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A tale of two frameworks

- “It is universally acknowledged that the current framework for monetary policy is sound and appears enduring”

(Sir Alan Budd, Wincott Lecture, 2004)

- “The golden rule... has been so beaten about the head and generally abused that it has lost all credibility.”

(Jeremy Warner, The Independent, 2005)

Outline

- Labour's critique
- Labour's reforms
 - Fiscal rules
 - *Code for Fiscal Stability*
 - *Spending Reviews*
- Labour's record
- Labour's lessons

Labour's critique of the Tory legacy

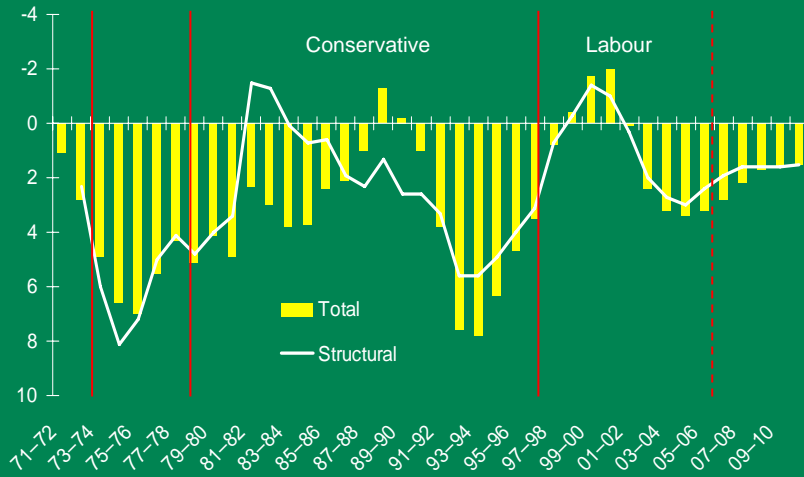
“In 1997, the Government was faced with a large structural deficit, low net investment, rising public debt and falling public sector net worth.”

“Fiscal policy had been an important source of instability in the economy.”

(Balls & O'Donnell 2002)

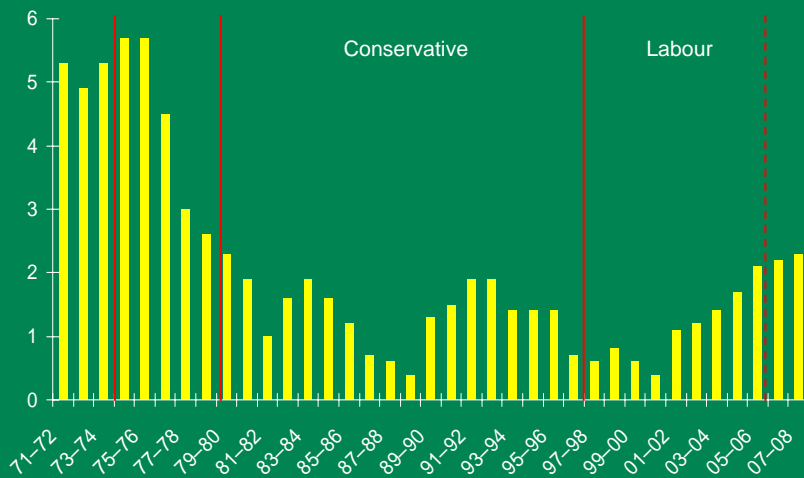
Excessive borrowing?

Public sector net borrowing (% of GDP)



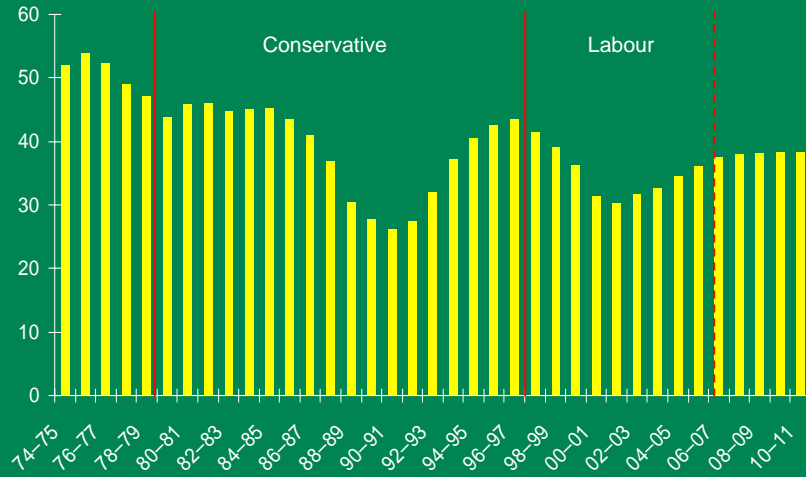
Inadequate investment?

Public sector net investment (% of GDP)



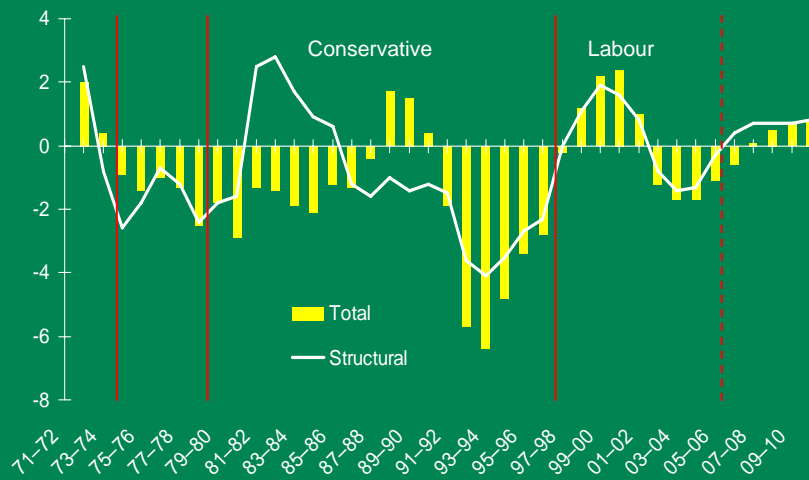
Rising public debt?

Public sector net debt (% of GDP)

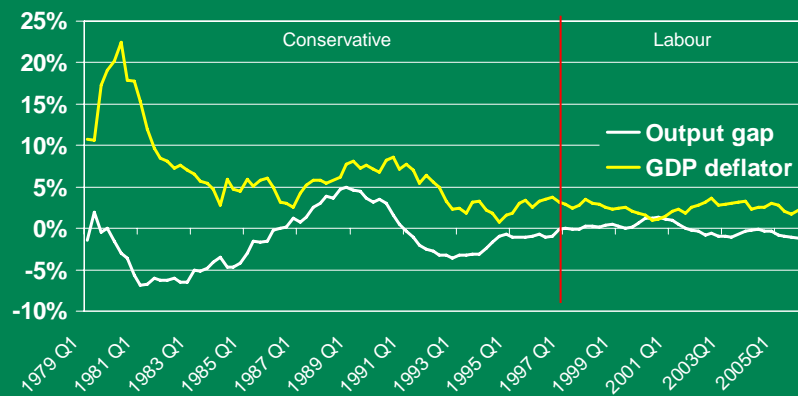


Falling public sector net worth?

Public sector current balance (% of GDP)



Macroeconomic instability?



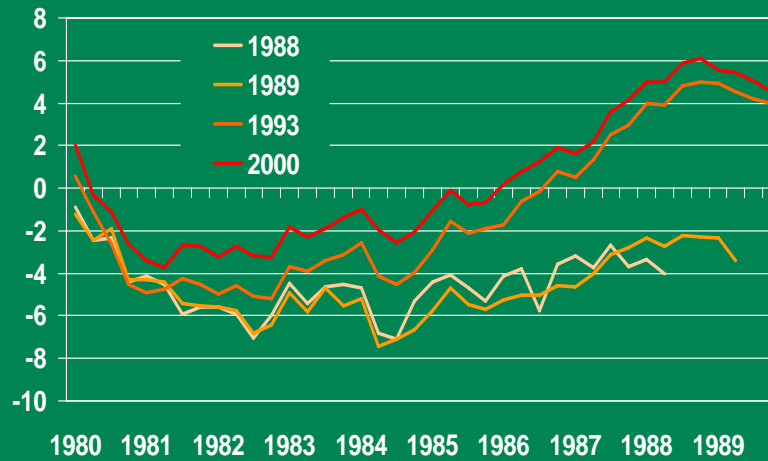
Macroeconomic instability?

“In the past, the failure of policy to be sufficiently forward-looking and transparent often led to interest rates being changed too late and fiscal policy being loosened at the wrong moment – increasing the volatility of policy as attempts were made to ‘catch up’ and destabilising the economy in the process.”

(HM Treasury 1998)

Macroeconomic instability?

'Real time' output gap estimates (% Trend GDP)



Labour's critique

- Stronger:
 - Low public sector net investment
 - Taxes too low to cover current spending
- Weaker:
 - Unsustainable borrowing and debt
 - No boom/bust if fiscal framework better

Motivation for reform

- Seek to convince people that Brown would avoid past Tory and Labour errors
- “Constrained discretion” + tools to deliver
 - Fiscal rules
 - Code for Fiscal Stability
 - Spending reviews

Fiscal policy goals

- Tax and spend while avoiding an unsustainable and potentially damaging rise in public sector debt;
- To ensure that future taxpayers are not left to pay for public spending from which they will not benefit;
- To avoid a bias against investment if and when public spending has to be restrained;
- To ‘support’ monetary policy in stabilising economic activity and keeping inflation on target.

Gordon's fiscal rules

- Golden rule
 - only borrow to invest
 - receipts must cover current spending
 - implies surplus or balance on current budget
 - on average over economic cycle, not every year
- Sustainable investment rule
 - keep debt at a "stable and prudent" level
 - defined as below 40% of national income
 - to be met every year in current economic cycle

Does the golden rule deliver intergenerational fairness?

- Capital versus current
- General equilibrium
- Time profile of debt versus benefits
- Intergenerational progressivity
- Legacy of past breaches
- And if it does, why is it asymmetric?

Golden rule and the cycle

- Adjusting for cycle makes sense: revenues and spending affected by economic activity
- Monetary policy should eliminate cyclical deficit
- Automatic (but not necessarily optimal) stabiliser
- But can we date cycles reliably?

Cycle? What cycle?

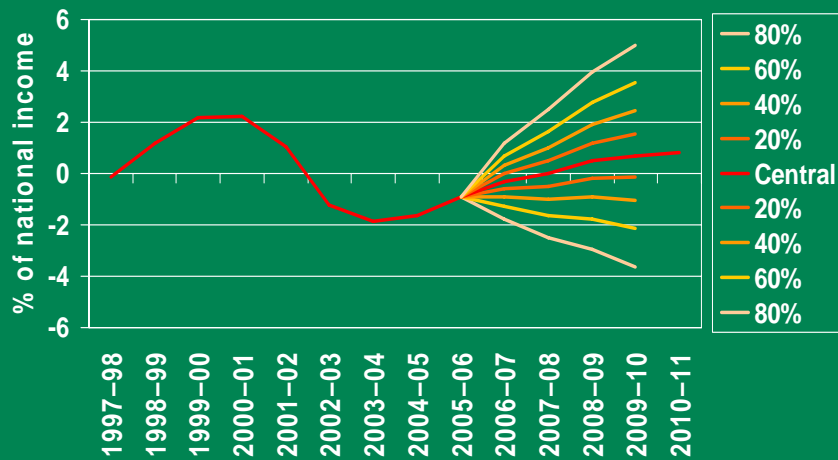
“I am not even sure if the output gap is terribly well defined. To put precise numbers on it is pushing beyond the bounds of the plausible. The Bank and the Treasury have a very different view of how to think about the cycle. We don't like this sort of fixed dating and we have a different way of thinking about the productive potential of the economy and how it evolves. I am not even sure it makes sense to think about a cycle as if it is a well-defined phenomenon.”

(Mervyn King 2005)

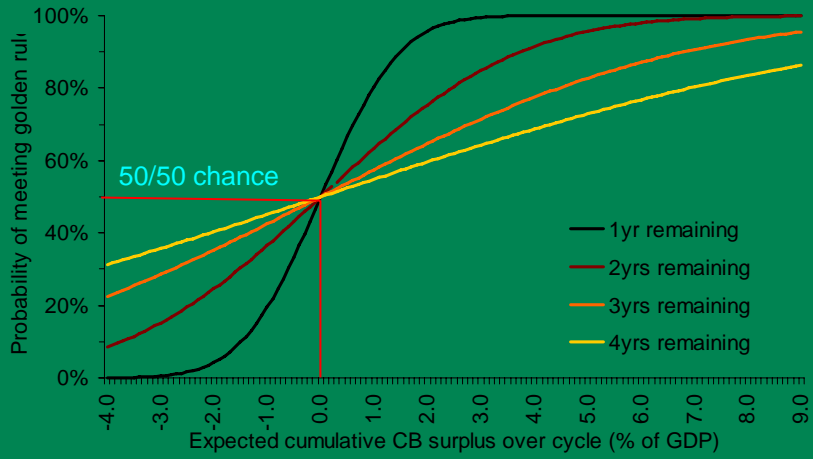
Dealing with uncertainty?

- Pursuing asymmetric target over dated cycle creates unambiguous pass/fail test – unlike inflation target
- But current budget very hard to forecast
 - Average error = 1% GDP / £12bn just 1 year ahead
- Implies probabilistic approach
 - Private or public?
 - Parallel with monetary policy

Current budget balance probabilities

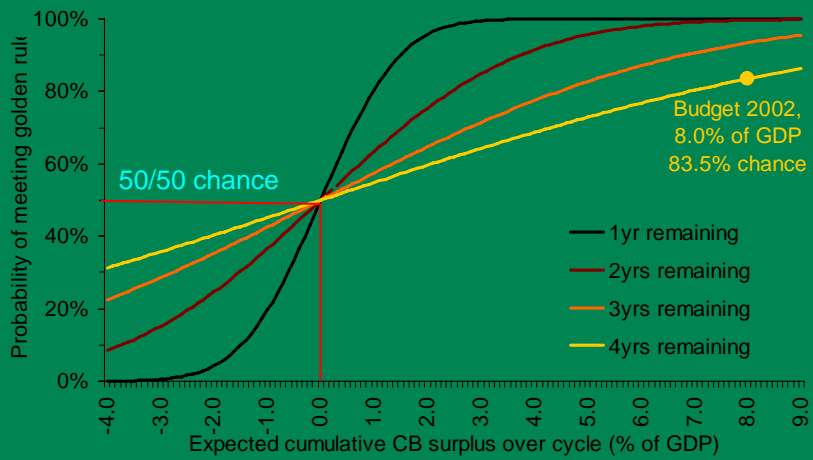


Will the golden rule be met?



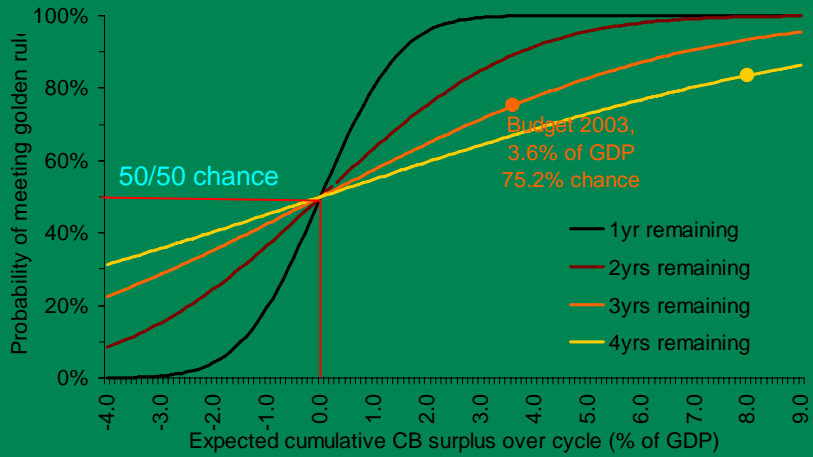
Source: HM Treasury; IFS

Will the golden rule be met?



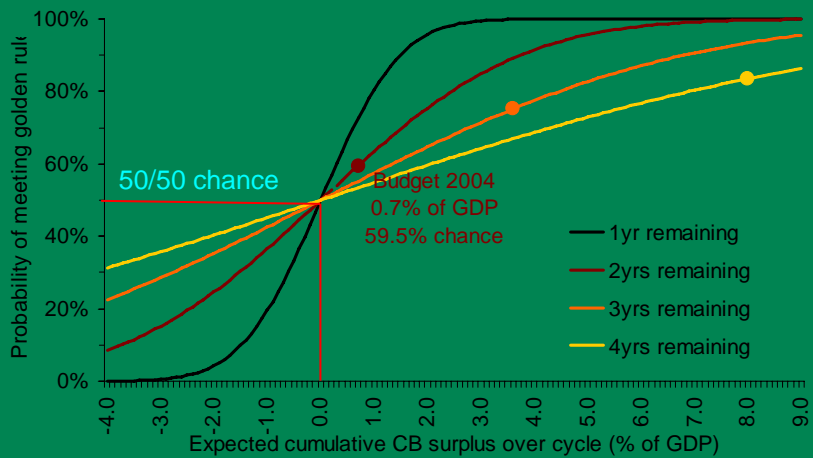
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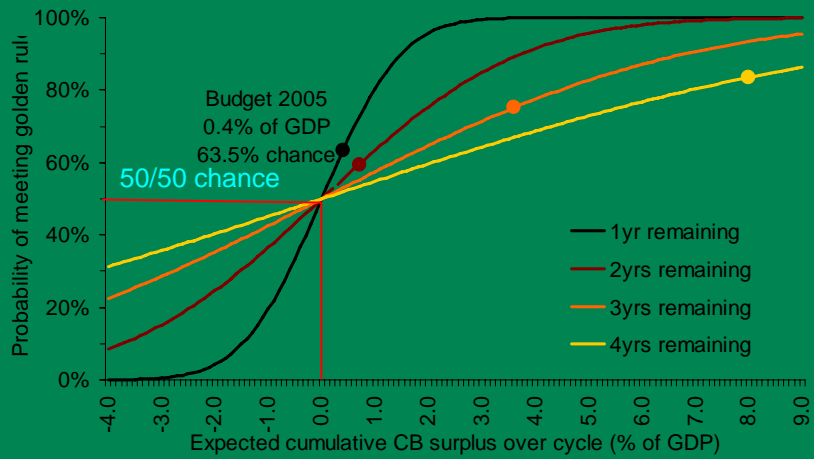
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Will the golden rule be met?



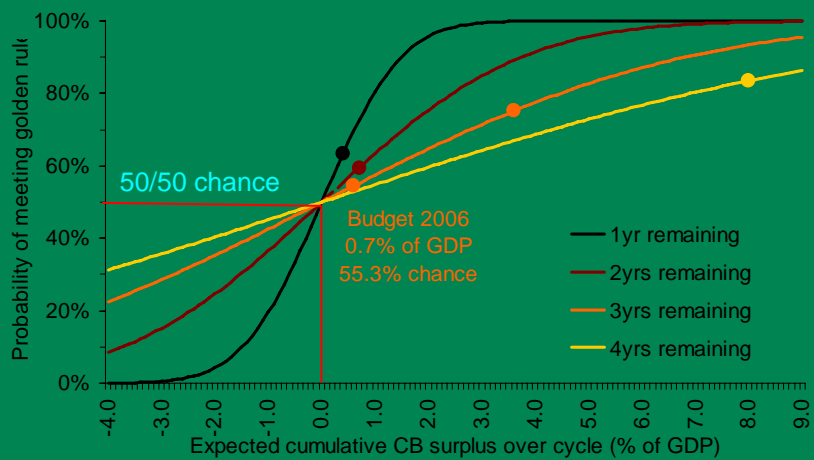
Source: HM Treasury; IFS

Will the golden rule be met?



Source: HM Treasury; IFS

Will the golden rule be met?



Source: HM Treasury; IFS

Probabilistic approach: the HMT view

‘How you would fit a probabilistic system like this onto fiscal policy decisions in the way we take them, I am not very clear. We accept that there is uncertainty. We use cautious assumptions. We set out clearly what we do and we say, for credibility reasons: “This is the rule and we will meet it”

(Jon Cunliffe, 2nd Perm Sec, HMT)

Gordon’s fiscal rules

- Sustainable investment rule
 - keep debt at a “stable and prudent” level
 - defined as below 40% of national income
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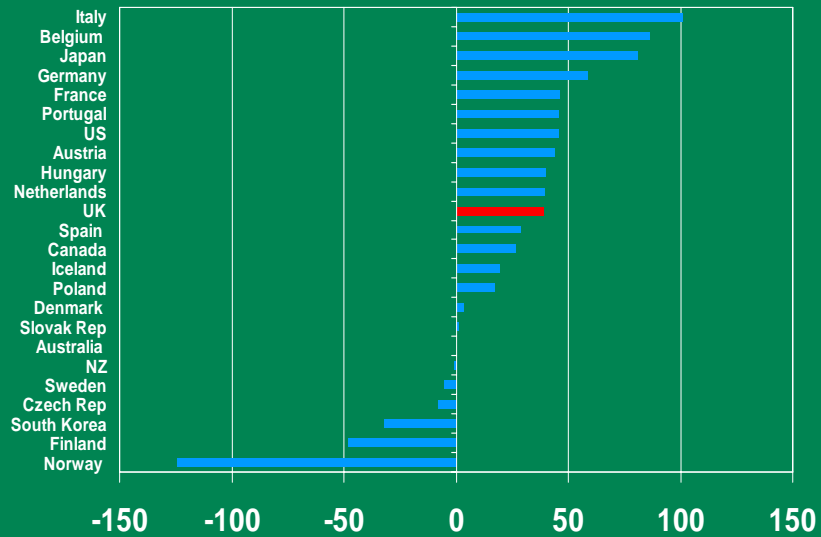
Rationale for debt ceiling

- Like individuals, governments take on debt to smooth spending over time
 - Because investment yields benefits over time
 - Automatic stabiliser
 - Political advantage: voter short-termism
- When does debt become 'unsustainable'?
 - Political judgement
 - Public ceiling may reassure creditors

Why set debt ceiling at 40%?

- No clear theoretical/empirical guidance
- Roughly the level Labour inherited
- No clear guide from international practice

General government debt (% GDP)



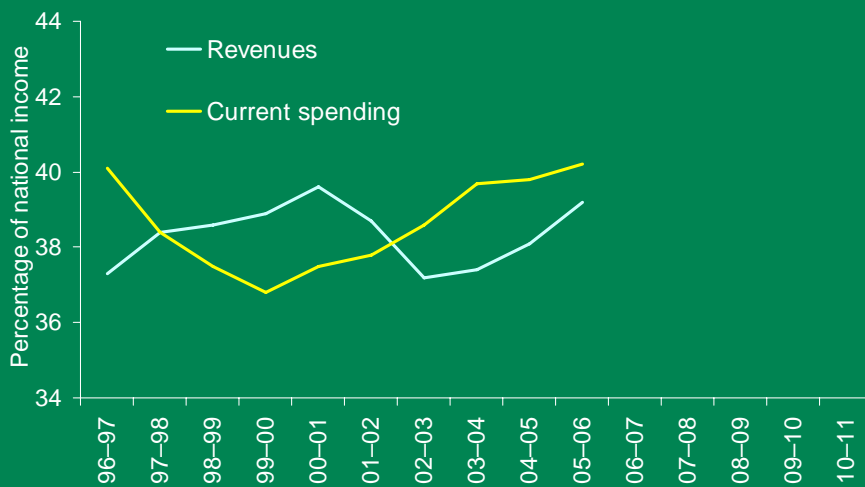
Justifying different debt targets

- Higher
 - Invest more than 2% of GDP in steady state
- Lower
 - Tax smoothing given spending pressures

Other liabilities

- Public sector pensions
 - End 2003: >£500bn vs £380bn net debt
- Private Finance Initiative
- Contingent liabilities (eg Network Rail)

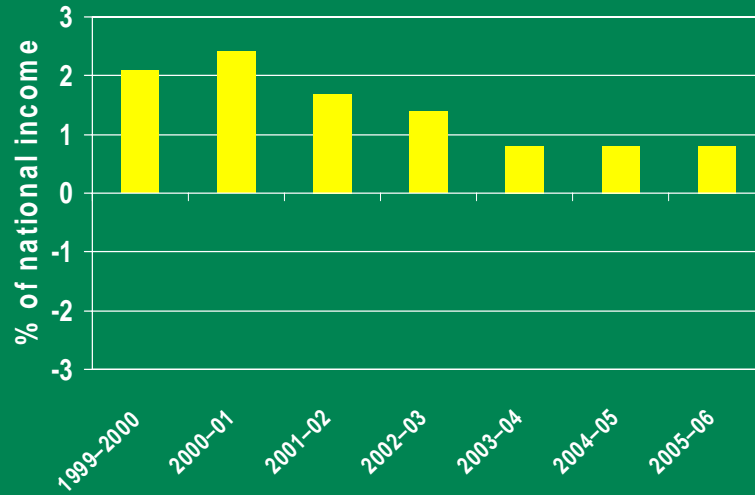
Labour's record



Source: HM Treasury

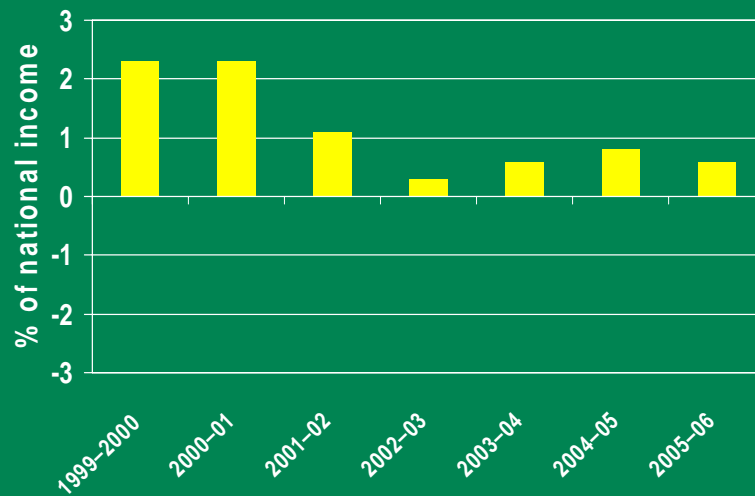
Fiscal position weakens

Current budget balance (Budget 2001)



Fiscal position weakens

Current budget balance (Budget 2002)



Fiscal position weakens

Current budget balance (Budget 2003)



Fiscal position weakens

Current budget balance (Budget 2004)

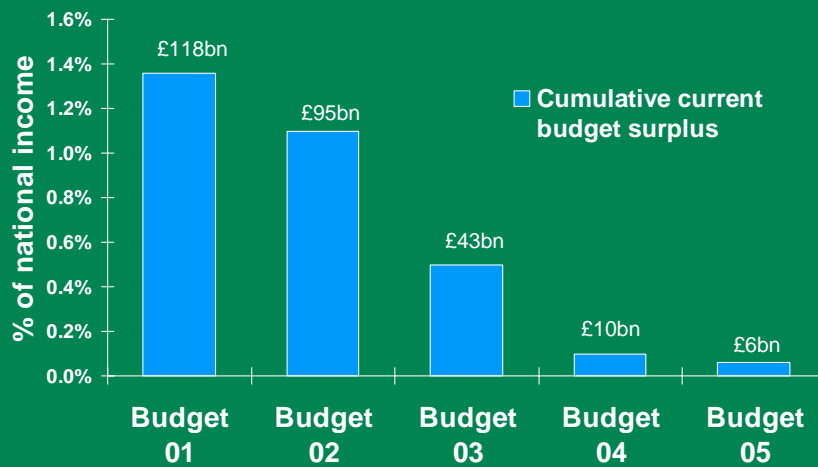


Fiscal position weakens

Current budget balance (Budget 2005)



Overachieving the golden rule



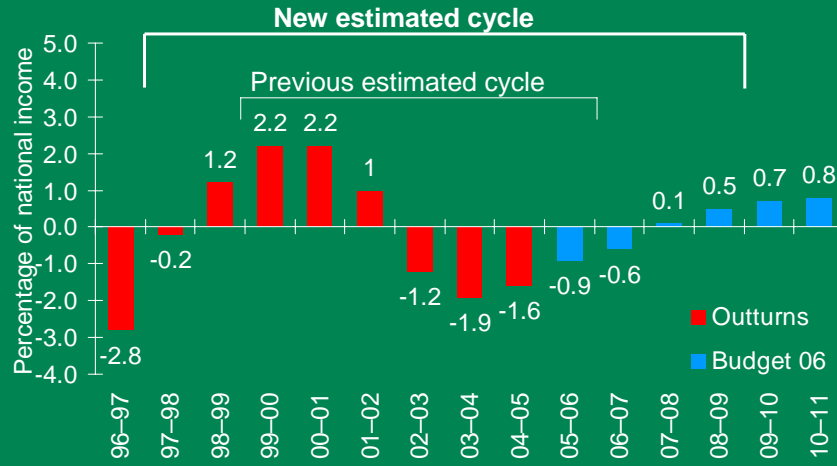
No problem before 2005 election



But different story after the election

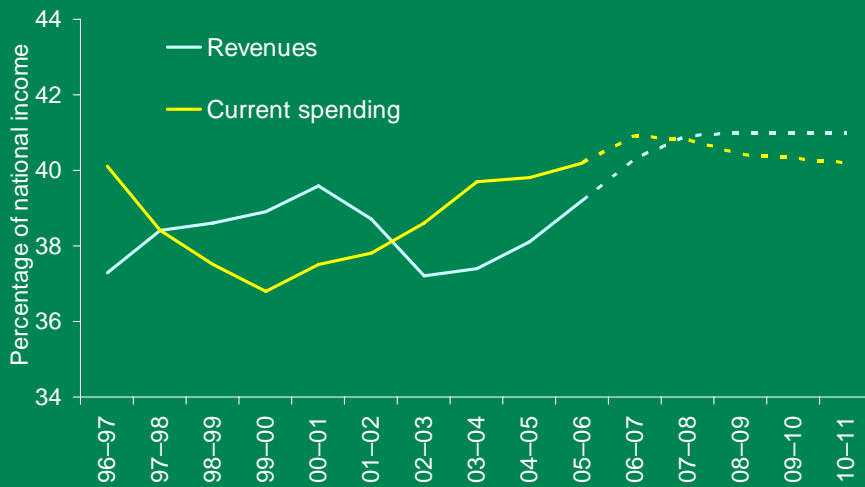
- Cycle re-dated to increase room for manoeuvre against golden rule by £13bn
- £3bn tax increase (North Sea oil)
- £7bn cut in spending/GDP pencilled in

Current budget balance



Source: HM Treasury

Tax and spend under Labour



Source: HM Treasury

Headroom under debt ceiling

HMT net debt forecast at 5-year horizon	% of national income
Budget 2001	31.0%
Budget 2002	30.0%
Budget 2003	33.8%
Budget 2004	36.4%
Budget 2005	37.1%
Budget 2006	38.4%

Monetary/fiscal coordination

- HMT says framework has improved it
- In practice HMT sets the monetary/fiscal mix
 - Needs to understand Bank's reaction function
- Fiscal stance tightened when economy above trend; loosened when below trend
- But partly because of fiscal forecast errors
- No significant re-balancing yet attempted

Lessons

- Critique somewhat overstated
- Rules not optimal, but probably reasonable
- Search for credibility prompted setting of pass/fail test and conviction forecasting
- Serial over-optimism required choice:
 - Breach rule, tighten policy or move goalposts?
 - Tough choices delayed beyond election
- Spending: first famine, then feast, then diet
- Move to forward-looking symmetric target
- Independent analysis of cycle/revenues