

# 9 Revisiting fiscal policy and supply-side policies

## Case studies

### Case study 9.1

- 1 Writing these answers in January 2016, no changes have occurred since 2015 in the rates at which the UK's main taxes have been levied, and no new taxes have been introduced or old taxes abolished. This may change in the future.
- 2 A mansion tax is a tax levied on expensive residential properties of a value in excess of a particular sum, such as £2 million. It is a tax on housing wealth. An advantage is that it will slightly reduce inequalities in the distribution of wealth. A disadvantage is that it will be unfair on pensioners and others who are 'wealth rich' but 'income poor'. The tax could lead to such people down-sizing to smaller and cheaper properties, thus freeing up large houses for larger families. However, these would still be well-off rather than poor families, especially as only the better-off can afford to pay a mansion tax.

### Case study 9.2

- 1 A balanced budget occurs when government spending equals tax revenue and revenue from other sources ( $G = T$ ) or, if we are talking about the whole of the public sector and not just government, when public sector spending equals public sector revenue.
- 2 The table below, taken from a 2015 House of Commons briefing paper *Government borrowing, debt and debt interest: historical statistics and forecasts*, shows how public sector net borrowing (a measure of the state of the public finances) changed between the financial year 1987/88 and the financial year 2014/15. A plus sign indicates a budget deficit while a negative sign indicates a budget deficit in the public sector as a whole:

	£bn		£bn		£bn
1987/88	+ 4.7	1997/98	+5.9	2007/08	+41.0
1988/89	-6.0	1998/99	-4.5	2008/09	+101.6
1989/90	-0.6	1999/00	-14.6	2009/10	+153.4
1990/91	+6.2	2000/01	-17.1	2010/11	+134.8
1991/92	+23.0	2001/02	+0.6	2011/12	+113.5
1992/93	+47.1	2002/03	+26.8	2012/13	+119.6
1993/94	+51.6	2003/04	+31.5	2013/14	+100.9
1994/95	+43.8	2004/05	+43.8	2014/15	+89.2
1995/96	+35.3	2005/06	+41.7		
1996/97	+27.7	2006/07	+37.1		

The table shows two periods of budget surplus, first in 1988/89 and 1989/90, and second in the early years of the Labour government from 1998/99 to 2000/01. Both of these were periods of economic boom. However, the public sector finances deteriorated in the second half of the Labour administration, particularly from the 2008 recession onward. In the final years of the data series, from 2011/12 to 2014/2015, the Conservative/Liberal Democrat coalition government achieved some improvement in the public finances.

- George Osborne's view is encompassed in his comment in the 2015 Autumn Financial Statement that the long-term economic plan is to fix the public finances, return the country to surplus and run a healthy economy that starts to pay down its debt.

### Case study 9.3

- Deficit bias:** the tendency of governments to allow deficit and public debt levels to increase.  
**Pro-cyclicality:** a term related to economic fluctuations. It is the opposite of counter-cyclical and relates to an economic variable that is positively correlated with the economic cycle or business cycle.
- According to the Office for Budgetary Responsibility (OBR), 'fiscal watchdogs' or 'fiscal councils' exist to provide authoritative and non-partisan analysis of public sector finances, in the UK's case to the Treasury. Some countries have had fiscal watchdogs for many years — the Netherlands since 1945, Denmark since 1962, the USA since 1974 and Belgium since 1989.

By contrast to a watchdog, which essentially guards against future dangers, a lapdog is a person or institution anxious to do another's bidding, especially in order to maintain a position of privilege or favour. The OBR has been accused by the government's political opponents of adopting 'lapdog tendencies' toward the Treasury, especially in the years in which the office was located in the Treasury building in Whitehall. In its advice on setting up the permanent body, the OBR recommended that it be located outside the Treasury, while noting that it would be difficult to have a close working relationship with the Treasury if it was located too far away. The OBR is currently located in the National Audit Office in Victoria, London.

### Case study 9.4

- Originally attributed to President J. F. Kennedy of the USA, the saying has recently been used by chancellor George Osborne in his argument that the government's budget should be in surplus when the economy is doing well so that the national debt can be run down before the economy faces more adverse conditions.
- At the time of writing this answer in January 2016, the economy is functioning 'normally' in the sense that there is steady if unspectacular growth taking place. George Osborne's Fiscal Charter requires that the government runs a budget surplus by the next general election in 2020, and in all subsequent years when the economy is in 'normal times'. 'Normal' is defined as an economy growing by more than 1% a year. Growth of 1% a year is well below trend, which leads economists to question the aim of achieving a surplus when growth is as low as 1%. No previous postwar British government has achieved this. The government's interpretation of 'normal times' means that a deficit would be permitted if the economy experienced recession (negative growth for two quarters or more). It can also be argued that when interest rates are as low as they currently are, the government should borrow to finance spending on infrastructure, which is another of the government's commitments.

### Case study 9.5

- A budget deficit is a *flow* concept, the difference between the *flow* of government revenues and the *flow* of government or public sector spending. Whenever there is a *flow* of new borrowing (to finance the budget deficit), the new borrowing adds to the *stock* of the national debt.
- Since this answer was written in January 2016, it was not possible to describe actual changes since 2015. A House of Commons briefing paper published on 22 December 2015 used ONS and OBR forecasts to estimate that the public sector net debt, which includes the debt of central government (the national debt), would rise from an estimated £1,599 billion in

2015/16 to £1,715 billion in 2020/21, but that it would fall during these years from 82.5% to 71.3% as a percentage of nominal GDP. The fact that public sector debt was expected to fall as a percentage of nominal GDP might be explained by the expectation that the economy would grow faster than the public sector debt. In January 2016, the latest official figures suggest that this prediction is too optimistic.

The public sector net debt is expected to increase because the public sector budget will still be in deficit throughout these years, though the government is hoping that a falling deficit will be followed by a surplus in 2020/21. The ‘headline’ measure of the public sector debt is public sector net borrowing (PSNB), while the measure used for central government is the central government net cash requirement (CGNCR). According to the chancellor’s Autumn Statement published on 27 November 2015, the CGNCR is expected to fall from £75.5 billion in 2015/16 to £64 billion in 2016/17, to £32 billion in 2017/18, to £13 billion in 2018/19 and to £1 billion in 2019/20. The PSNB is expected to move into surplus in 2019/20. Again, these projections are likely to be too optimistic.

## Case study 9.6

- 1 Announced on 6 May 1997, only five days after that year’s general election, the MPC was officially given operational responsibility for setting interest rates in the Bank of England Act 1998.

The OBR was formally created in May 2010 following the general election of that year (although it had previously been constituted in shadow form by the Conservative Party opposition in December 2009). The OBR was placed on a statutory footing by the Budget Responsibility and National Audit Act 2011.

- 2 Gordon Brown was judged harshly partly as a result of his optimistic statement, often repeated during his 10 years at the Treasury, that his prudent fiscal policy would ensure there would never be a return to ‘boom and bust’ economics. The house price boom in 2006 and 2007, followed by the ‘bust’ of recession in 2008/09 (by which time Brown had become prime minister), destroyed much of his reputation as a prudent chancellor. To some extent this was just bad luck. Brown’s policies had indeed been prudent and worked well from 1997 to 2002, and it can be argued that the worldwide financial crisis which led to the 2008 recession was much more the fault of the international banking system than of the Labour chancellor.

Time will tell as to whether George Osborne will be judged more harshly than Gordon Brown. At the time of writing in January 2016, it looks as if history may be repeating itself, with a house price boom and rampant consumer spending possibly leading to another recession. George Osborne’s recent very optimistic financial predictions may be about to unravel. However, I may be wrong.

## Test yourself

### Test yourself 9.1

Chloé’s average or mean score for her first five tests in 90.6. This means that the minimum score Chloé needs on her sixth test to reach her target of achieving a mean score of 90 is 89.

### Test yourself 9.2

Adding up all the items in Figure 9.4, total public sector spending in 2015/16 was expected to be £742.5 billion — according to the summer 2016 budget. Expressed as percentages of £742.5 billion and in rounded figures, spending on the NHS was 15.1%; spending on education was 7.2%; spending on defence was 3.8%; spending on other public services was

17.0%; spending on investment was 9.2%; spending on state pensions was 12.4%; spending on other welfare was 12.9%; spending on tax credits was 4.0%; spending on debt interest was 4.5%; and finally other spending was 14.5%.

## Questions

- 1 With regard to the canons or principles of taxation, taxpayers commonly view all taxes as ‘bad’, in the sense that they do not enjoy paying them, although most realise that taxation is necessary in order to provide for the useful goods and services provided by the government.

A good starting point for analysing and evaluating whether a tax is ‘good’ or ‘bad’ is Adam Smith’s four principles of taxation, which are also known as the canons of taxation. Adam Smith suggested that taxation should be equitable, economical, convenient and certain, and to these we may add the principles of efficiency and flexibility. A ‘good’ tax meets as many of these principles as possible, although because of conflicts and trade-offs, it is usually impossible for a tax to meet them all at the same time. A ‘bad’ tax meets few if any of the guiding principles of taxation.

A first objective of taxation is to raise the revenue required to finance government spending. Second, taxes can be used to alter the relative prices of goods and services in order to change consumption patterns. Demerit goods, such as alcohol and tobacco, are taxed in order to discourage consumption. Taxes are also used to finance the provision of merit goods such as education and health care, and public goods, such as defence, police and roads. Also, under the ‘polluter must pay’ principle, taxes are used to discourage and reduce the production and consumption of negative externalities, such as pollution and congestion.

Taxation can also be used to deter monopoly by taxing monopoly profit through removing the windfall gain accruing to a monopolist as a result of barriers to entry and inelastic supply.

Ultimately, however, the aims of taxation depend on the underlying philosophy and ideology of the government in power. They differ significantly, for example, between Keynesian and free-market- or supply-side-inspired governments.

- 2 The cyclical part of a budget deficit is the part of the deficit which rises in the downswing of the economic cycle and falls in the upswing of the cycle. In the cyclical downswing, tax revenues fall but public spending on unemployment and poverty-related welfare benefits increases. As a result, the government’s finances deteriorate. Conversely, in the recovery and boom periods, tax revenues rise and spending on benefits falls.

By contrast, the growth in the structural component of the budget deficit relates to the changing structure of the UK economy. (It also relates to government policy decisions, such as the significant increase in defence expenditure in December 2015, which was a response to perceived terrorist threats.) In recent years, a number of factors and trends have contributed to the growth of the structural budget deficit. These range from deindustrialisation and globalisation eroding the tax base, via the movement of industries to central Europe and Asia, through to an ageing population and the growth of single-parent families dependent on welfare benefits.

- 3 Automatic stabilisers dampen or reduce the multiplier effects resulting from any change in aggregate demand within the economy, thereby reducing the volatility of the ‘ups’ and ‘downs’ in the economic cycle. In modern parlance, by letting automatic stabilisers operate, a government may achieve a ‘goldilocks’ outcome whereby the economy ends up being ‘not too hot and not too cold’.

In the recessionary phase of the economic cycle, a collapse of confidence or export orders may have caused aggregate demand to fall. National income then also begins to fall, declining by the initial fall in demand. But as national income falls and unemployment rises, *demand-led* public spending on unemployment pay and welfare benefits also rises. If the

income tax system is progressive, the government's tax revenues fall faster than national income. In this way, increased public spending on transfers and declining tax revenues inject demand back into the economy, thereby stabilising and dampening the deflationary impact of the initial fall in aggregate demand, and reducing the overall size of the contractionary multiplier effect.

Automatic stabilisers also operate in the opposite direction to dampen the expansionary effect of an increase in aggregate demand. As incomes and employment rise, the take-up of means-tested welfare benefits and unemployment-related benefits automatically falls, while at the same time tax revenues rise faster than income. By taking demand out of the economy and reducing the size of the expansionary multiplier, automatic stabilisers reduce overheating in the boom phase of the economic cycle.

- 4 Whether budget deficits and government borrowing are viewed as causes for concern depends to a significant extent on whether one is a Keynesian or an anti-Keynesian economist. According to Daniel Shaviro of the University of Chicago (a generally anti-Keynesian seat of learning), budget deficits are blamed by the general public and the media 'for all manner of economic ills, ranging from high interest rates to unemployment to the trade deficit to the low rate of national saving to low productivity growth — whichever seems most crucial at the moment — but little attention is paid to why it might have any of these effects'. Shaviro goes on to state that 'the near unanimity in public discourse about the evil of deficits might seem to suggest that economists are similarly unanimous. In fact, however, they disagree fundamentally about whether deficits matter, and, if so, then why. They have been debating these issues for more than two centuries, with consensus occasionally emerging but not persisting.'

Picking up on the explanation of automatic stabilisers in the answer to the previous question, Keynesian economists argue that, if responsibly managed, deficits perform a useful economic function, smoothing the path of the economy over time. Deficits grow 'naturally' in a cyclical downswing, and it is an economic folly to try to eliminate a deficit at all times. Anti-Keynesians, by contrast, argue that deficits can surge out of control, and that they raise interest rates and contribute to 'crowding out' processes, through the growth of a big and unproductive state which displaces private sector entrepreneurial flair.

- 5 The government I shall consider in this answer is the UK government in the year 2015. Since May 2010, but then in a coalition government with the Liberal Democratic Party, the Conservative chancellor George Osborne has been implementing a fiscal policy aimed at rebalancing the government's budget deficit within 'about five years'. In 2010, this was seen to be 2015, but with a failure to meet this target, the goal has been moved forward to the financial year 2019/20, with a budget surplus thereafter – provided future years are judged to be 'normal' years. It remains to be seen whether this target will be met.

In the meantime, the main effect of trying to rebalance the budget has been fiscal austerity, or to use Osborne's preferred words, fiscal consolidation or restraint. George Osborne believes that severe cuts in government spending free resources for the private sector to use. Osborne argues that the private sector makes better use of these resources than the government. If this is the case, workers who lose their jobs in the public sector are soon employed more productively in the private sector. This view on the effects of cuts in public spending is sometimes called 'expansionary austerity'.

Like a magician pulling a rabbit out of a top hat, or a desperate man searching for money at the back of the sofa to pay the family grocery bill, in his 2015 Autumn Financial Statement, George Osborne claimed to have found the small sum of £27 billion which he did not know he had. This allowed Osborne to increase certain elements of public spending and to delay further welfare spending cuts, but it remains to be seen whether the budget can be rebalanced by 2019/20.



Osborne's opponents claim that the austerity programme has slowed down economic growth and recovery since the 2008/9 recession and that, as many of the cuts have fallen on the poor, income and wealth differentials have unnecessarily widened.

Finally, it is worth noting that prior to the summer 2015 budget, the government had set itself the task of achieving a surplus on the 'current' budget (current spending, not investment) and not on the overall budget. That was as much as the Conservatives could commit to when they were in the coalition government with the Liberal Democrats.

However, from May 2015 onward, the Conservatives have been in government on their own and they want an overall surplus, with no exclusion for investment spending. This means that public sector investment in infrastructure projects such as roads may suffer in future years, if the government makes every effort to achieve a budget surplus by 2019/20.

- 6 The answer to this question is 'no'. These days, many economists, including those of a supply-side persuasion, take the view that the successful implementation of supply-side policies is a *necessary* condition for obtaining a sustainable and satisfactory rate of (long-run) economic growth, but that it is not a *sufficient* condition. In order for growth to be sustained, there must be sufficient aggregate demand in the economy to absorb the extra output produced by the supply-side policies.

To illustrate this argument, consider George Osborne's decisions in the 2015 summer budget and Autumn Financial Statement to raise the national minimum wage rate, and to set the new national living wage rate at levels higher than those necessary to keep pace with inflation. Although Osborne favours supply-side policies, he recognised that an increase in real aggregate demand was also necessary to enable sustainable economic growth to continue.

