Fiscal stabilisation and EMU

A discussion paper

HM TREASURY

Executive Summary

1 The UK macroeconomic framework is designed to maintain economic stability. Unpredictable fluctuations in output, employment and inflation are disruptive, and can hold back the economy's long-term potential growth. By contrast, economic stability helps firms, households and the Government to plan effectively for the long term, improving the quantity and quality of long-term investment in physical and human capital, and helping to raise levels of productivity.

2 The principal role of current UK fiscal policy is to ensure the sustainability of public finances over the medium term. In addition, the fiscal rules, underpinning the framework, are set over the economic cycle enabling fiscal policy to support monetary policy in smoothing the path of the economy. The purpose of this paper is to assess whether a greater stabilisation role could be delivered through fiscal policy, if the UK were to join EMU.

Policy assignment outside EMU

3 In the current UK policy framework outside EMU, interest rates are the main instrument for demand management. Fiscal policy supports monetary policy in this stabilisation role by helping to smooth the path of the economy primarily via the operation of the automatic stabilisers. When prudent and sensible, discretionary fiscal policy has provided further support to monetary policy, but fiscal policy is not actively used to fine tune aggregate demand.

Policy assignment inside EMU

4 Within EMU, interest rates are set by the European Central Bank (ECB) according to conditions across the entire euro area. When faced with European-wide common shocks which impact similarly on all economies, monetary policy responds in a similar way as if policy were under national control. To the extent that the UK were subject to asymmetric shocks, or symmetric shocks which had an asymmetric impact due to different structures, there would be a case for an enhanced stabilisation role for fiscal policy as an European-wide monetary policy would not adjust fully to address these shocks. In addition, fiscal policy could be more potent in EMU as the monetary policy response to a change in UK fiscal policy would be much more muted.

Fiscal policy and the Stability and Growth Pact

5 Where debt is low and there is a high degree of long-term fiscal sustainability, the case for adopting a tighter fiscal stance to allow room for governments to use fiscal policy more actively is not convincing. Provided that arrangements are put in place to ensure discretionary policy is conducted symmetrically then long-term sustainability would not in any way be put at risk.

6 At the EU level, the Government supports the direction in which the EU fiscal framework is evolving. In the ongoing debate on the interpretation of the SGP, the Government's approach will be to emphasise the significance of the economic cycle, sustainability and low debt, and the important role the Maastricht Treaty gives to public investment, and the implications of this prudent approach for the interpretation of what are 'exceptional and temporary' circumstances in relation to the 3 per cent reference value, for countries with low levels of debt.

7 This paper examines fiscal stabilisation policy from two related perspectives:

- is fiscal stabilisation economically feasible, i.e. does fiscal policy actually work as a stabilisation mechanism? Are there any costs of a more active use of fiscal policy as a stabilisation mechanism? ; and
- is an enhanced role for fiscal stabilisation practically feasible, either through strengthening the automatic stabilisers or discretionary fiscal policy actions which supplement the automatic stabilisers? And what policy developments would be needed to make fiscal policy more effective as a means of conducting stabilisation policy?

Does fiscal policy work as a stabilisation mechanism?

8 Like monetary policy, fiscal policy can have an effect on output and inflation in the short to medium term when wages and prices are slow to adjust. However, the magnitude of the effect will vary in different circumstances. The following key lessons emerge from the economics literature:

- if prices are extremely flexible, fiscal action is relatively ineffective but the effects of demand and supply shocks will be correspondingly less problematic;
- similarly, if consumers are forward-looking and take into account the future tax implications of changes in fiscal policy, then the effects will generally be more muted. But as with price flexibility, this forward-looking behaviour will similarly mitigate the effect of shocks on output and inflation;
- different fiscal instruments have different impacts on output in the short term as well as in the long term. A key issue from a stabilisation perspective is whether policies lead to a change in relative prices; and
- the impact of fiscal policy will vary within different monetary policy regimes. Fiscal policy will tend to have a more powerful stabilisation impact in EMU than the current UK-based inflation targeting regime. This is simply because the impact on UK inflation of a UK fiscal policy change would be much greater than the impact on euro area inflation.

Some of these points, notably the first two, also apply to monetary policy.

9 Evidence from a range of empirically estimated macroeconometric models tends to support the proposition that fiscal policy has significant short-run effects.[1] The evidence generally suggests that consumers and firms are not especially forward-looking or their behaviour is constrained, reinforcing the potential effectiveness of fiscal action. This finding is also supported by survey-based evidence. Given the diverse theoretical and empirical views on the effectiveness of fiscal policy, it would be beneficial if further work was carried out on the fiscal transmission mechanism.

[1] Although the elasticities vary according to a number of factors, including: which instrument of fiscal policy is being used, assumptions about the response of monetary policy, the degree of wage and price flexibility assumed and the degree to which consumers are forward-looking.

Practical considerations in using fiscal policy as a stabiliser

10 Simulations in econometric models assume policy makers can implement fiscal policy in a timely and well-targeted manner. The experience of the UK in the 1950s and 1960s when stabilisation policy was primarily done through fiscal policy, and the experiences of other countries, illustrates the difficulties in operating an effective counter-cyclical discretionary fiscal policy in practice:

- discretionary fiscal policy often proved pro-cyclical. In particular, there was a tendency to react asymmetrically to an economic shock, given the bigger incentive to ease during a downturn than tighten during an upturn. In a number of countries this led to a sizeable build up in government debt; and
- the lags in implementing fiscal policy and between its implementation and its effect on demand complicated the design of the stabilisation policy, and if prolonged enough, resulted in fiscal policy proving pro-cyclical.

11 A key lesson from the current macroeconomic framework is the importance of the institutional design in ensuring a successful stabilisation policy. Reforms to the fiscal framework to overcome the problems of discretionary fiscal policy in the past should be based on the principles underpinning the current framework. These are: clear and sound long-term policy objectives; pre-commitment through institutional arrangements; and maximum openness, transparency and clear accountability.

Criteria for an effective stabilisation framework

12 The lessons learnt from the history of discretionary fiscal policy in the UK and elsewhere, along with the principles underlying a successful macroeconomic framework, suggest a number of criteria to ensure that fiscal stabilisation policy is effective. These include:

- policies should be designed to be symmetric over the business cycle;
- policy should be forward-looking;
- operating rules should be clear and transparent; and
- the stabilisation policy objective should be clearly distinguished from other fiscal policy objectives.

Criteria for choosing effective fiscal instruments

13 There are also a number of criteria which will be useful to assess specific fiscal instruments:

- an aim of maximising the effect on activity;
- an aim of minimising lags; and
- as with all tax and spending interventions, consideration must be given to the implications for wider government objectives, such as efficiency and equity.

The forward-looking agenda

14 On the basis of the analysis in Sections 2 to 4 of the paper, and the work in the other EMU studies, Sections 5 and 6 of the paper present a forward-looking agenda which considers the developments that could be considered to make fiscal policy more effective as a means of conducting stabilisation policy were the UK to join EMU, both in terms of the case for strengthening the automatic stabilisers, and using discretionary fiscal policy.

Strengthening the automatic stabilisers

15 Currently, the primary stabilisation role of fiscal policy is played by the automatic stabilisers, i.e. those elements of the tax and spending regime which 'automatically' tend to stabilise the economy over the cycle. For example, during an upswing, incomes will rise and tax receipts will increase tending to dampen the cycle. Similarly, in a downturn, unemployment benefit payments will rise tending to moderate the slowdown.

16 The strength of the automatic stabilisers is related to: the size of the government sector, the progressivity of the tax system, the degree to which the tax system taxes cyclically sensitive items, and the level of benefits. Empirical evidence gleaned from a range of econometric models suggests that the automatic stabilisers have a significant stabilising impact in the UK and across the EU. The evidence is less clear-cut on their relative strength in different countries although *a priori* there is reason for thinking the effects in the UK might be a little weaker than the EU average, e.g. reflecting that the UK government sector is not as large as in many other euro area countries. However, the contribution of the automatic stabilisers is not always benign. A temporary adverse supply shock such as a surge in the oil price would boost inflation and depress output. The operation of the automatic stabilisers would help to support output, but could raise inflation further.

Options to strengthen the stabilisers

17 The advantage of increasing fiscal stabilisation by strengthening the automatic stabilisers is that many of the difficulties in operating fiscal policy for stabilisation purposes do not apply to the automatic stabilisers: there are no decision and implementation lags, left to themselves they generally operate symmetrically over the cycle, and they can be reasonably clearly identified and hence separated from other aspects of fiscal policy. However, other considerations apply, in particular, many of the ways to strengthen the automatic stabilisers can have a negative impact on economic efficiency.

18 Any policies to enhance the automatic stabilisers would have to boost one of the factors such as the size of the government sector or the level of benefits, but could have costs, e.g. on making work pay or on the tax burden faced by certain sectors of the economy. It is thus not clear what the 'optimal' degree of automatic stabilisation would be for the UK inside EMU. Further work is required in a number of areas before a properly informed assessment of the case for strengthening the automatic stabilisers can be made.

Developing alternative arrangements for discretionary fiscal policy

19 Even strengthened, the automatic stabilisers can only dampen the effects of a shock and may therefore, on their own, provide an insufficient degree of stabilisation, particularly for large shocks. This suggests that a more active discretionary fiscal policy might be required, although reforms would be needed to ensure that such a policy operated in a transparent, credible, symmetric and timely manner.

20 The institutional arrangements for fiscal policy could be developed to ensure the clear identification of stabilisation policy from other policy objectives, and to ensure that discretionary fiscal policy operates symmetrically, minimises lags and enhances transparency.

New fiscal stabilisation objective and rule

21 The adoption of an explicit stabilisation objective and a new fiscal rule would help ensure pre-commitment and that policy was operated in a symmetric way. While the existing fiscal rules, the golden rule and the sustainable investment rule, allow for the full use of the automatic stabilisers and where appropriate for discretionary fiscal policy, the new fiscal rule would impose a symmetric constraint on the operation of discretionary fiscal policy.

22 One credible option would be a rule under which the Government would commit to a discretionary fiscal policy response if the forecast of the output gap exceeded, say, plus or minus 1 or 1.5 per cent of GDP unless the Government believed that there was a strong case against discretionary fiscal policy action. In either case, the Government could be required to write an open letter to Parliament. This could explain why the output gap was expected to exceed the pre-announced trigger value, how the action it is taking is consistent with achieving greater stabilisation or its reasons for not taking discretionary fiscal policy action, the period in which it expects the output gap to reduce to within the range and how this approach meets the other fiscal policy objectives. In this way, the output gap forecast would act as a symmetrical trigger to discretionary fiscal policy with the Government required to respond equally to large forecast positive and negative output gaps.

Improving credibility and transparency

23 Given the complexities of operating a more active fiscal stabilisation policy, there is a case for enhancing independent surveillance. This could be achieved by increasing the role of independent analysis (e.g. for technical elements such as 'dating' the economic cycle) or strengthening the monitoring of fiscal policy, through existing structures such as the EU. The publication by the Government of a regular Stabilisation Report would further enhance transparency and openness. Some authors have argued, drawing explicit parallels with monetary policy, for the delegation of fiscal stabilisation policy to an independent committee (an independent Fiscal Policy Committee). However, the establishment of such a body would be inconsistent with parliamentary tradition in the UK, and would challenge parliamentary sovereignty.

Minimising lags

24 A more active role for discretionary fiscal policy would require the lags in the policy process to be minimised. Conducting policy on a forward-looking basis would help to take account of the existence of lags. There is also a case for making more use of the existing tax regulators which allow rates of VAT and duty to be varied outside the Budget process using secondary legislation, and for modernising them to increase their suitability for this purpose. The paper considers issues such as the role of Parliament, design considerations and the scope for new tax regulators.

Specific fiscal instruments

25 The paper considers various fiscal instruments that could be used in a discretionary manner for stabilisation purposes. Key criteria for such instruments are to maximise the impact on activity for a given change in the deficit, minimise lags and to minimise any adverse impacts on wider government objectives such as equity and efficiency. Frequent changes in government expenditure would conflict with the current multi-year spending review structure and could impact on other public policy objectives such as delivering public services. Hence the focus is on tax instruments, such as:

- **direct taxes:** however, varying income taxes or national insurance contributions is likely to generate significant practical problems and may have only a relatively limited stabilisation impact. They are thus unlikely to be suitable instruments for stabilisation purposes;

- **consumer credit tax:** such a tax could impact on household spending decisions through the effect on borrowing to finance consumption. However, the paper concludes that such a tax would not be feasible, all the more so in an integrated EU financial market;

- **investment instruments:** temporary tax credits could, for example, be used to stimulate investment in a recession. However, the effectiveness of such a measure might be limited, and frequent use of temporary tax incentives could increase uncertainty, damaging lon-run investment in the economy;

- **housing taxes:** fiscal instruments impacting on the housing market could help reduce volatility in this sector of the economy, through automatic stabiliser properties, as well as potentially providing an additional discretionary stabilisation tool. The paper looks at stamp duty and at the wide variety of property taxes levied in other countries; and

- **expenditure taxes:** temporary changes to a combination of expenditure taxes, for example through the regulator power, could prove useful instruments with limited undesirable impacts on incentives, the supply side or the overall equity of the tax system.

Conclusions

26 The degree of stabilisation may not be sufficient inside EMU where the absence of a UK-specific monetary policy may cause macroeconomic volatility to increase. This paper explores a number of policy options to make discretionary fiscal policy more effective for stabilisation purposes and strengthen the automatic stabilisers. The paper considers the robust institutional framework required to ensure an enhanced fiscal stabilisation policy operates symmetrically, credibly and transparently, and which policy levers are likely to prove most effective. Credible policy options include a new symmetrical fiscal rule to trigger the Government to consider taking action, publishing a Stabilisation Report to enhance transparency, increasing the role of independent audit, a greater role for the tax regulators and specific fiscal instruments that could be used for stabilisation purposes. The Treasury will conduct further analysis into these issues to ensure the policy proposals would deliver effective counter-cyclical stabilisation of the economy were the UK to join EMU.