



# A macro economic policy without fiscal activism in Britain 1976-2008

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# Defining policy approaches and defining success

**Fiscal activism: the active use of discretionary fiscal policy to smooth out the economic cycle.**

**“Without fiscal activism” = fiscal conservatism: the belief that fiscal policy decisions should be aimed only at balancing government income and expenditure.**

**Policy success:**

- **Output growth: stable and in line with productive potential**
- **Inflation: stable and low**
- **Unemployment: stable and low**
- **Downward secular trend for inflation**



# Assessing policy: changes in fiscal deficit 1948-2008

# Policy makers announce a change

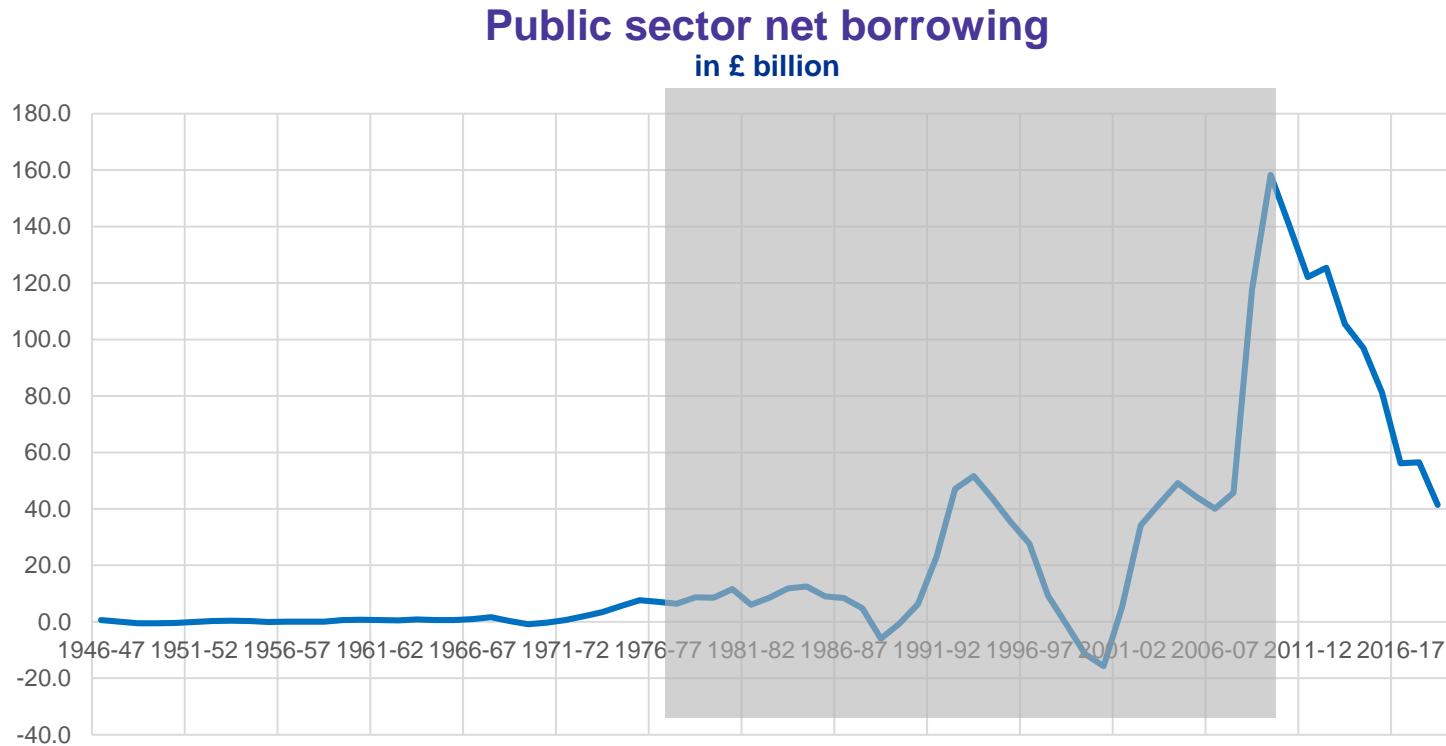
“We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. **I tell you in all candour that that option no longer exists**, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step.”

*James Callaghan, Speech to Labour Party Conference, September 1976*

“I have identified one major and fundamental innovation of policy as the dedication of *macro*-economic policy to the conquest of inflation, and *micro*-economic policy to the conquest of unemployment. Another has been the setting of policy firmly within a medium-term framework... [of which] a major element has been the Medium Term Financial Strategy, the cornerstone of the Government's macro-economic policy.”

*Nigel Lawson, Mais Lecture 1984*

# The change is not obvious looking at fiscal deficits in £bn



Source: OBR

If fiscal activism is measured by changes in the public sector deficit, it has been much **greater** since 1976 than before – but this is largely because of inflation

# Nor from average Budget deficits 1976-2008

## Fiscal deficits as % of GDP

	Mean	Standard deviation
Actual 1948-76	1.3	2.6
Actual 1976-2008	2.6	2.2
Cyclically adjusted 1976-2008	2.6	1.8

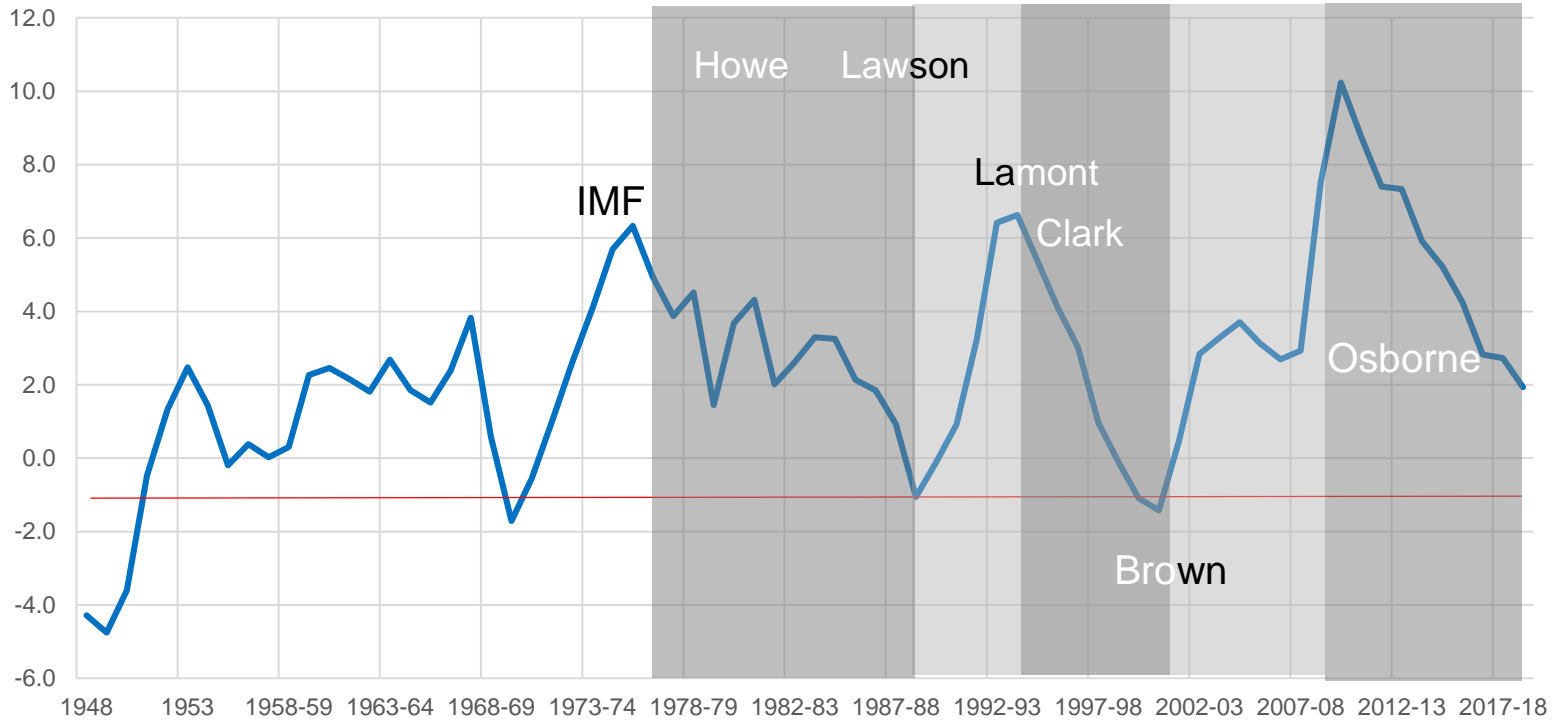
*Source: OBR*

**The fiscal deficit as % of GDP was actually higher on average in 1976-2008 than in the period of fiscal activism from 1948-76**

**There was however a reduction in the variance of the deficit and a greater reduction in that of the cyclically adjusted fiscal deficit.**

# The record shows intermittent periods of conservatism

## Fiscal deficit as % GDP



Source: OBR

Fiscal conservatism prevailed under Howe but Lawson famously presided over a boom

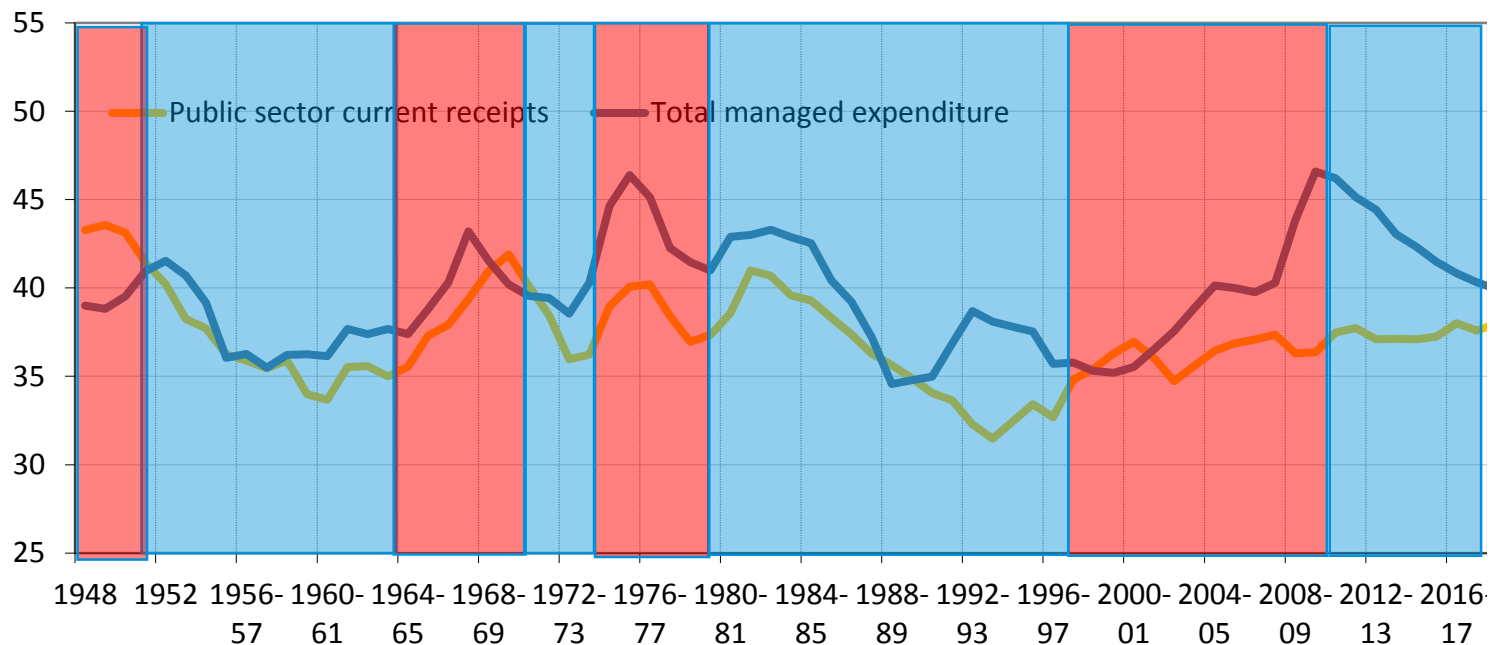
Major and Lamont presided over a pre-election increase in public spending

Lamont and Clark took measures to re-establish budget balance.

Brown at first stuck to Conservative spending plans but later became a fiscal activist

# Imminent elections affect fiscal policy, as does their outcome

## Government receipts and expenditure as % GDP



Source: OBR

The most striking feature of the post -1978 period is the long decline in both taxes and spending as share of GDP under Thatcher.

The spending decline was reversed under Gordon Brown, in response to the 2001 global recession but taxes rose less than under the Wilson administration, creating a huge deficit, which was then exacerbated by the banking crisis.

The deficit was reduced by Osborne



# Key fiscal policy episodes since the war

**1945-51** Emergence from war-time levels of tax and spending

**1951-73** Fixed exchange rate, active fiscal policy: Butskellism

**1973-76** Oil crisis leads to floating exchange rates and rampant inflation

**1976** IMF prescribe sharp cuts in public spending

**1980-90** Mrs Thatcher implements Medium Term Financial Strategy

**1987-92** The Lawson Boom and Major-Lamont increase in public spending

**1993-7** Lamont-Clark fiscal retrenchment

**2001-7** Fiscal activism under Gordon Brown

**2008** Banking crisis and bail-outs

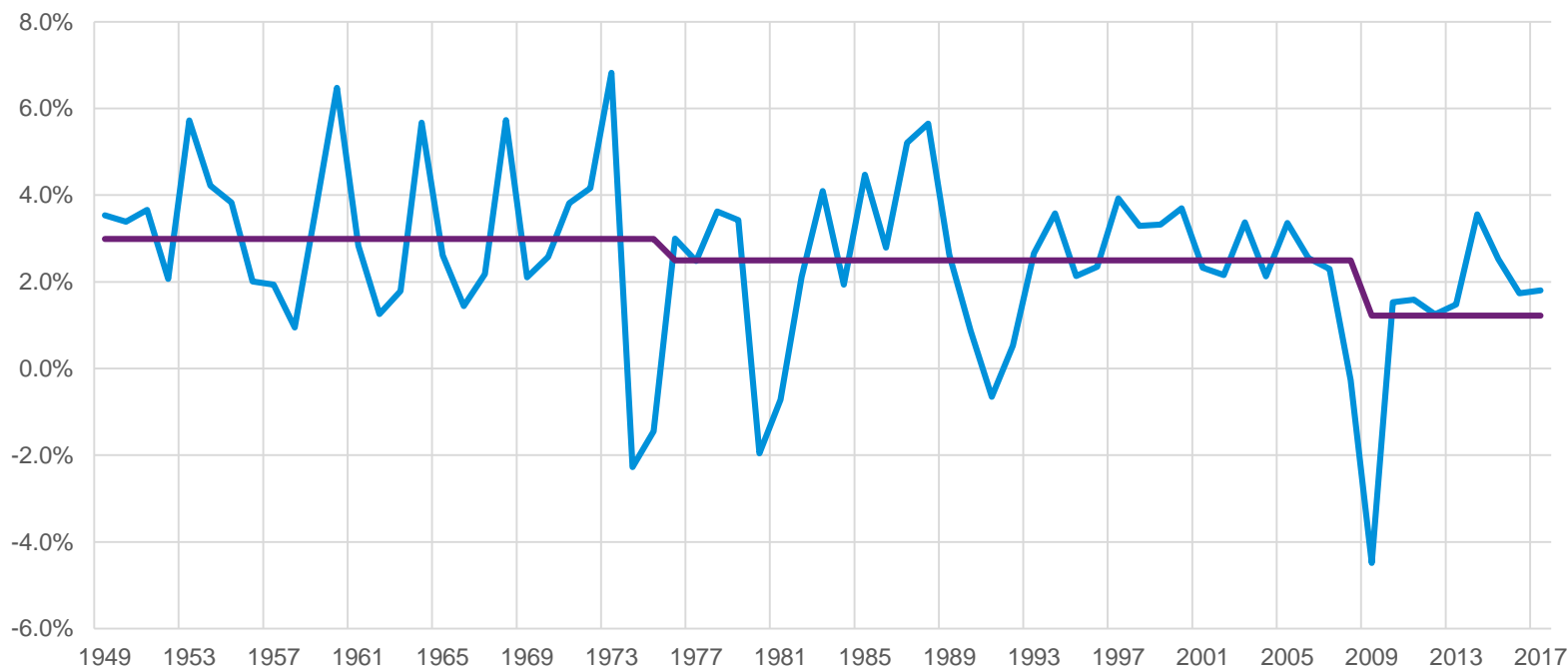
**2010** Fiscal retrenchment under George Osborne



# Assessing economic outturns

# GDP growth was higher under fiscal activism

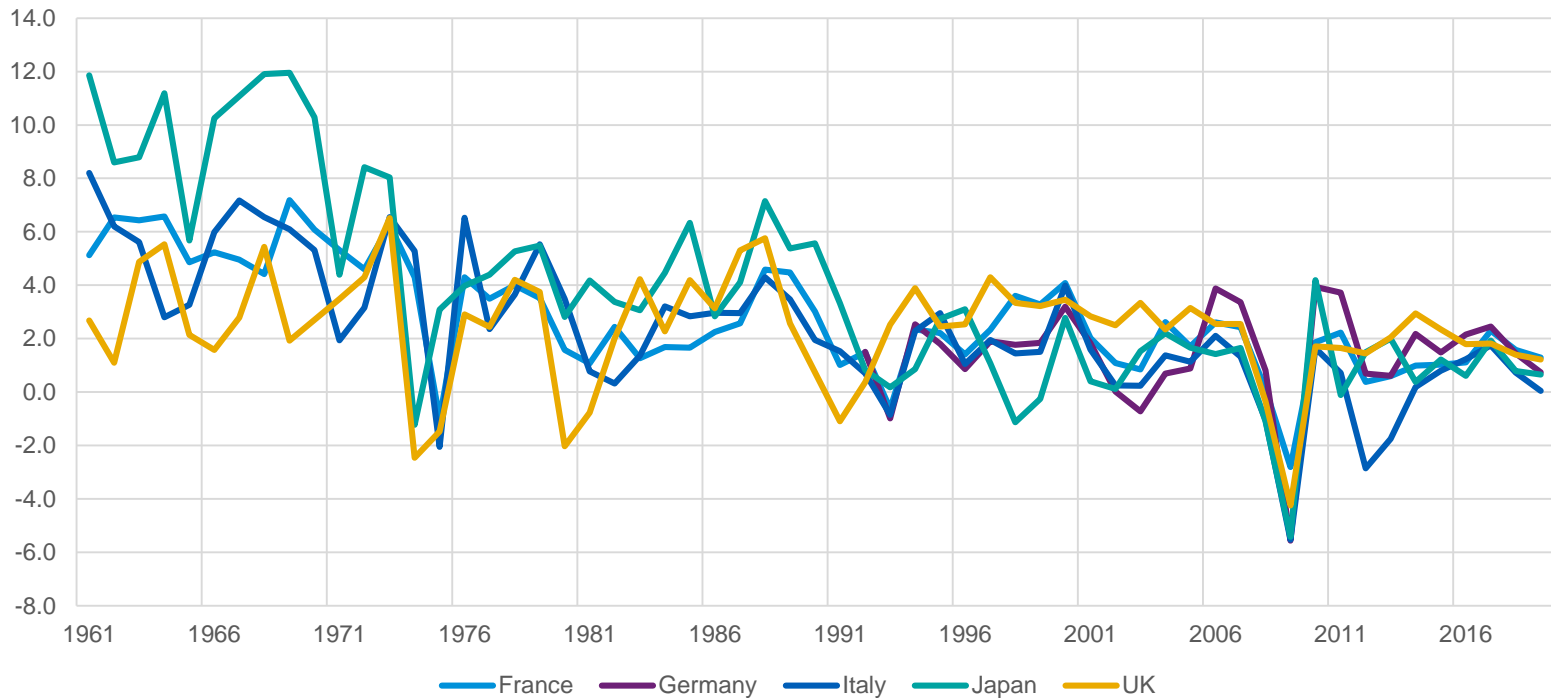
**Real GDP Growth**  
% per annum



Source: *A Century of UK Economic Trends*

Period	1948-76	1976-2008	2008-15	1948-71
Average growth	3.0%	2.5%	1.2%	3.2%
Standard deviation	2.1%	1.7%	2.3%	1.6%

# But it slowed in peer countries too



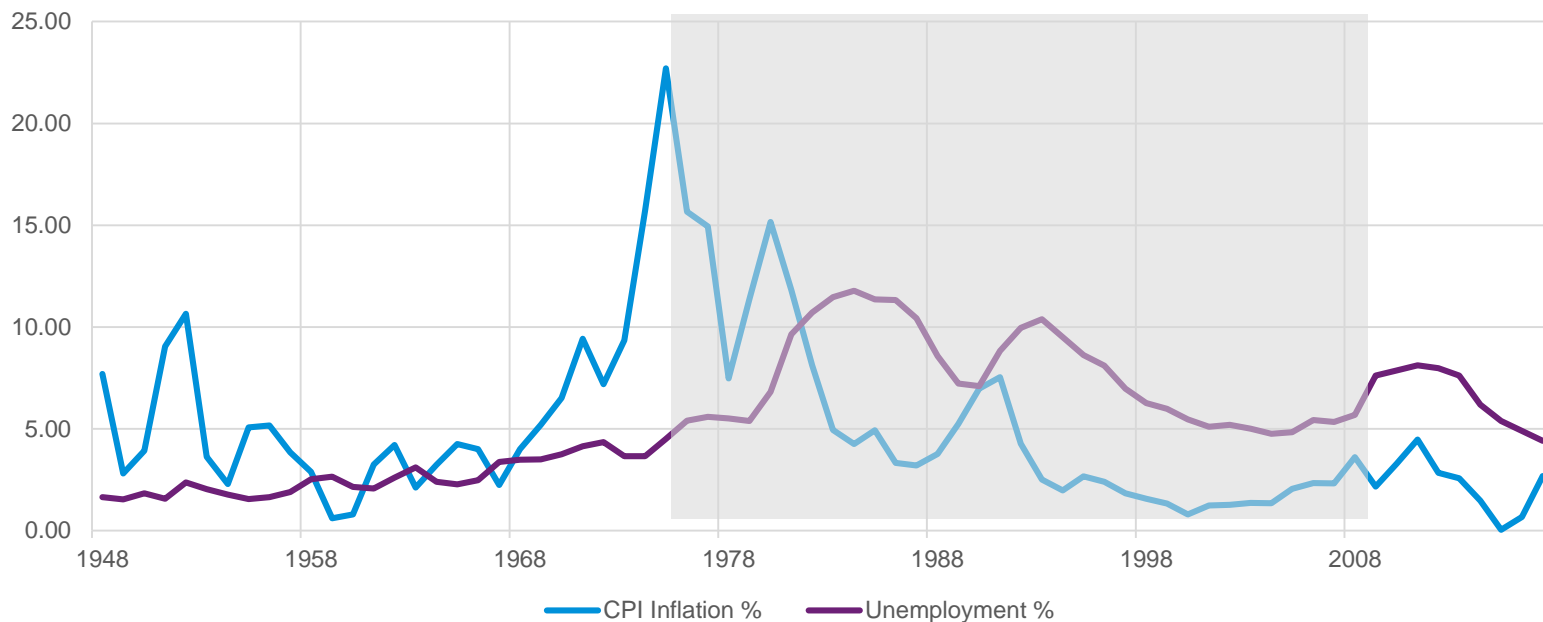
Source: OECD

	France	Germany	Italy	Japan	UK
1961-73	5.1	5.2	4.9	8.0	2.8
1973-2008	2.5	1.5	2.3	2.9	2.5

**So slower growth should not be blamed on fiscal conservatism**

# Inflation fell but unemployment was higher

**Inflation and Unemployment**  
% pa and % of labour force



Source: *A Century of UK Economic Trends*

		Mean	Standard deviation
Inflation	1948-76	6.1	5.0
	1976-2008	5.0	4.3
Unemployment	1948-76	2.8	1.0
	1976-2008	7.6	2.4

# Conclusion

**The long-term time series evidence is inconclusive – it is not a controlled experiment.**

**Many things other than the fiscal policy approach changed after 1976 compared with 1948-76:**

- **Floating vs fixed exchange rates;**
- **Monetary targeting;**
- **Global growth performance.**

**But it is clear that under fiscal activism inflation rose and under fiscal conservatism it fell.**



# Fiscal conservatism: three episodes

The Budgets of 1981, 1988 and 1993-1994

# Activism vs conservatism: policy prescriptions

		Real economy		
		Strong	Weak	
Budget target	Below	Contract, higher taxes <i>e.g. 1988</i>	Expand, lower taxes	ACTIVIST
	Above	Expand, lower taxes	Expand, lower taxes	CONSERVATIVE
Deficit target	Below	Contract, higher taxes	Expand, lower taxes <i>e.g. 1981</i>	ACTIVIST
	Above	Contract, higher taxes	Contract, higher taxes	CONSERVATIVE

KEY    Expansion, higher deficit    Contraction, lower deficit

**Surplus tax revenues do not always coincide with surplus capacity in the real economy and shortages of tax revenues do not always coincide with excess demand in real economy**



# Tax increases dominated spending cuts in short term

## The Medium Term Financial Strategy in the 1981 Budget

PUBLIC SECTOR BORROWING 1979-80 prices (£ billion)

	1979-80	1980-81	1981-2	1982-3	1983-4
Total general government expenditure	88.8	91.5	91.5	90	87.5
Total general government receipts	-78.4	-79.5	-82.5	-84	-85
Implicit fiscal adjustment	-	-	-	1	2
PSBR	9.9	11.5	8	6.5	4
(as percentage of GDP at market prices)	5	6	4.5	3.25	2

Source: Financial Statement and Budget Report 1981-1982

	1981	1982	1983	1984	1985	1986	1987
Inflation % per annum	10.9	7.9	4.9	4.3	4.9	3	3.3
GDP growth % per annum	-0.7	2.1	4.1	1.9	4.5	2.8	5.2
Unemployment % of labour force	9.6	10.7	11.5	11.7	11.4	11.3	10.4

Source: A Century of UK Economic Trends

**Unemployment, a lagging indicator, reached a low of 7.2% in 1989**

# An expansionary fiscal contraction: how?

In the HM Treasury model, the consumption function posited that households aim to hold a stock of savings  $S$  proportional to their income  $Y$ :

$$(1) \quad S = kY$$

Taking first differences and dividing through by income gives the result:

$$(2) \quad \frac{dS/Y}{\text{Savings ratio}} = \frac{dY/Y}{\text{rate of nominal income growth}}$$

**It follows that if inflation falls, the savings ratio falls.**

The savings ratio fell from a cyclical peak of 13.6% in the fourth quarter of 1980 to 9.3% in the first quarter of 1983, a fall of over 4%.

It wasn't just the 1981 budget. High interest rates and a strong exchange rate were also powerful factors bringing down inflation, and thereby boosting consumer spending.

## The 1988 Budget: contractionary fiscal expansion

# Unexpected revenues from 1985 onwards

### Targets for PSBR as % of GDP in successive Budgets

£ bn FY	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Budget 1980	4.75	3.75	3	2.25	1.5								
Budget 1981	5	6	4.25	3.25	2								
Budget 1982			5.7	4.25	3.5	2.75	2						
Budget 1983			3.5	2.75	2.75	2.5	2						
Budget 1984				3.3	3.25	2.25	2	2	1.75	1.75			
Budget 1985					3.2	3.25	2	2	1.75	1.75			
Budget 1986						3.1	2	1.75	1.75	1.5	1.5		
Budget 1987							1.6	1	1	1	1	1	
Budget 1988								0.9	-0.75	-0.75	0	0	
Budget 1989									-0.75	-3	-2.75	-1.75	-1
Budget 1990										-3	-1.25	-0.5	0

1981-4 O > T  
1985-8 O < T

O = Outturn  
T = Target

Source: Financial Statement and Budget Reports from 1980 to 1990

## The 1988 Budget: contractionary fiscal expansion

# Despite the giveaways, the budget deficit kept falling

£ billion	1980-81	1981-2	1982-3	1983-4	1984-5	1985-6	1986-7	1987-8	1988-9	1989-90	1990-1
Effect of Budget measures	-0.8	-3.3	1.3	1.6	1.8	0.8	1.0	2.5	4.0	1.9	0.0
Privatisation proceeds			0.5	1.1	2.0	2.5	4.7	5.0	5.0	5.0	5.0
North Sea revenues	3.4	5.3	6.7	7.5	9.5	9.5	6.4	6.4	5.7	4.7	4.2
	3.4	5.3	7.2	8.6	11.5	12.0	11.1	11.4	10.7	9.7	9.2

Source: *Financial Statement and Budget Reports from 1980 to 1990*

	£bn	% GDP
Cumulative discretionary fiscal changes (1)	10.8	3.1
less Change in North Sea revenues	2.9	0.8
Change in privatisation proceeds	5.0	1.4
<b>Cumulative fiscal expansion net of windfalls</b>	<b>2.9</b>	<b>0.8</b>
Change in observed fiscal deficit (1)	-8.0	-2.3
Change in observed fiscal deficit (2)		-3.4
<b>Change in cyclically adjusted deficit</b>		<b>-2.2</b>

(1) From successive FSBRs, 1980-81 to 1992-3

(2) From OBR database

Source: *Financial Statement and Budget Reports from 1980 to 1990, OBR*

The government gave away £2.9bn on top of the windfalls from North Sea oil and privatisation.

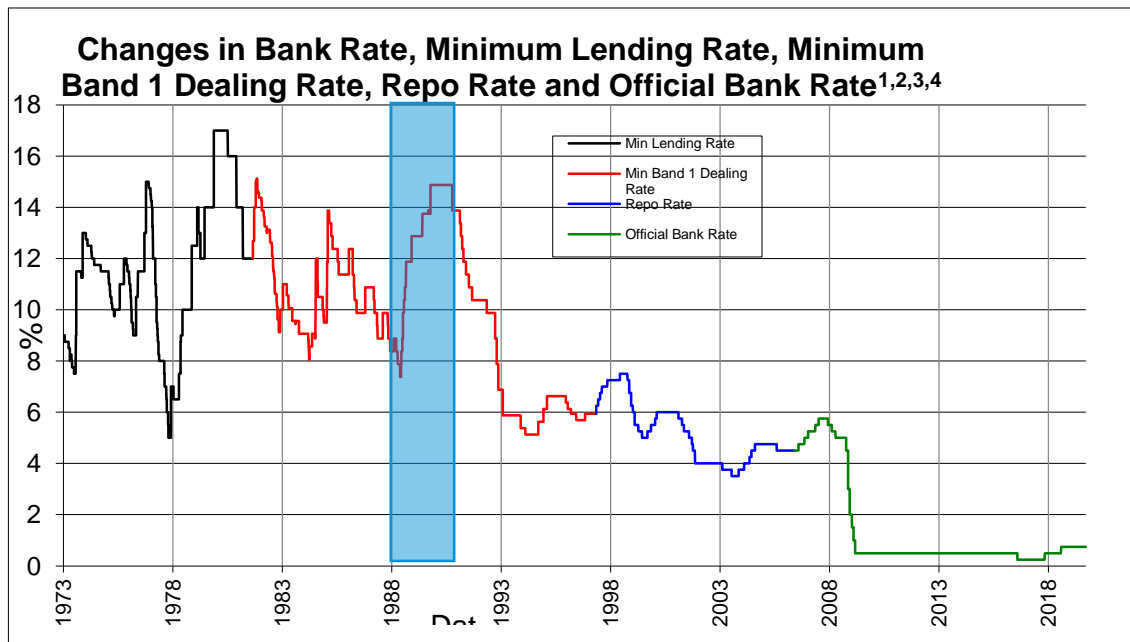
Yet the cyclically adjusted deficit fell by 2.2% of GDP

## The 1988 Budget: contractionary fiscal expansion

# So a £4bn stimulus was applied in 1988

	1988	1989	1990	1991	1992	1993	1994
Inflation % per annum	4.1	5.4	6.9	7.6	4.7	3.1	2.3
GDP growth % per annum	5.7	2.6	0.9	(0.7)	0.5	2.7	3.6
Unemployment % of labour force	8.6	7.2	7.1	8.8	9.9	10.4	9.5

Source: A Century of UK Economic Trends



Source: Bank of England

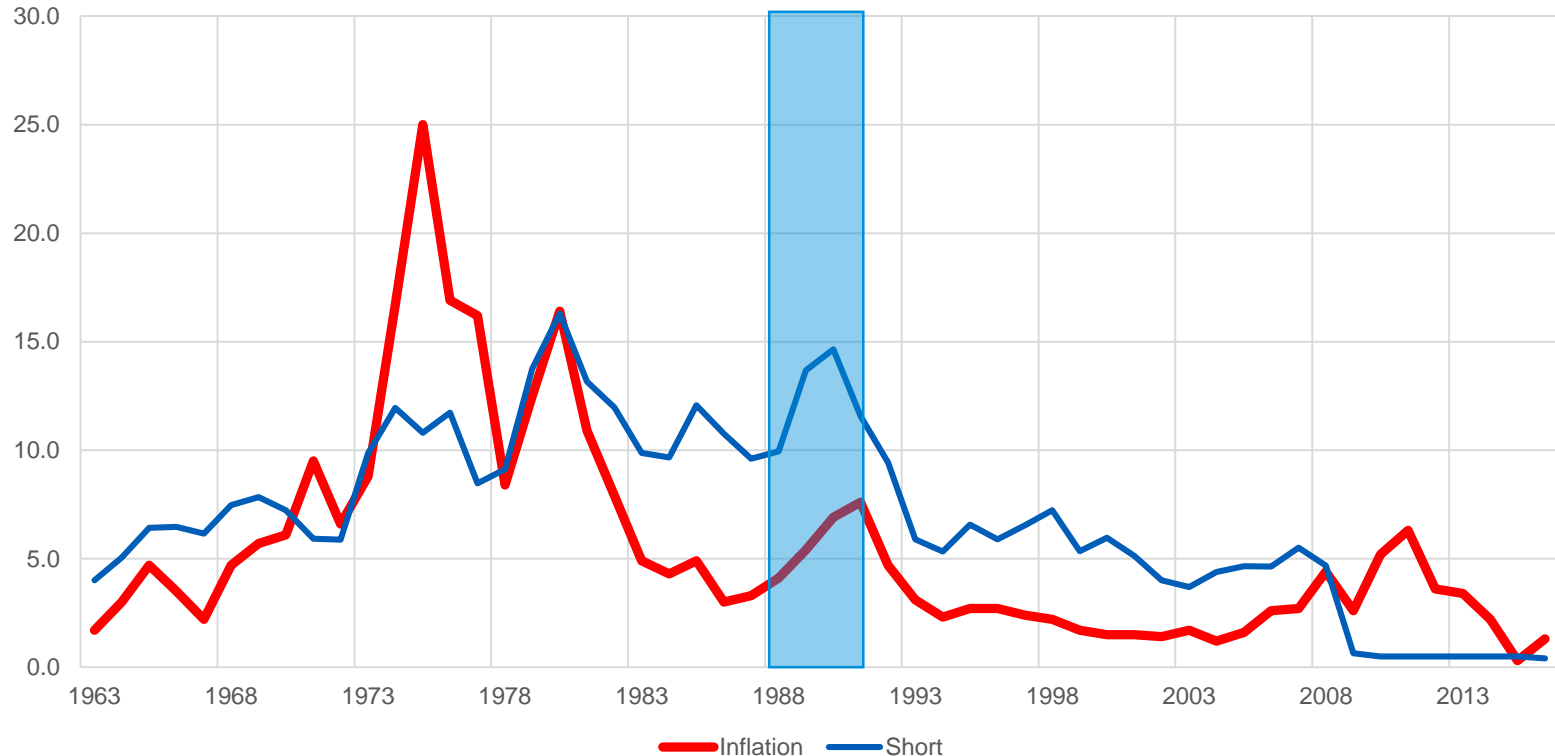
<u>Min.Band 1 Dealing Rate</u>				
1988	1	Feb	8.8750	
	17	Mar	8.3750	Tax cutting Budget
	8	Apr	7.8750	
	17	May	7.3750	
	3	Jun	7.8750	
	10	Jun	8.3750	
	24	Jun	8.8750	
	7	Jul	9.8750	
	21	Jul	10.3750	
	8	Aug	10.8750	
	25	Aug	11.8750	
	25	Nov	12.8750	
1989	25	May	13.7500	
	31	Aug	13.8438	
	4	Sep	13.8750	
	8	Sep	13.7500	
	6	Oct	14.8750	Lawson resigns
1990	8	Oct	13.8750	Britain joins ERM
1991	13	Feb	13.3750	
	27	Feb	12.8750	
	22	Mar	12.3750	
	12	Apr	11.8750	
	24	May	11.3750	
	12	Jul	10.8750	
	4	Sep	10.3750	
1992		April		Election
	5	May	9.8750	
	22	Sep	8.8750	Britain leaves ERM
	16	Oct	7.8750	
	13	Nov	6.8750	

**Output growth was unsustainable, inflation rose, interest rates were sharply increased and the Lawson boom gave way to the 1990-91 recession**

## The 1988 Budget: contractionary fiscal expansion

# The Lawson boom led to sharp rise in real interest rates

**Inflation and short term interest rates**  
% per annum



Source: *A Century of UK Economic Trends*, Bank of England

**which then remained high in order to keep sterling in the ERM**

# Fiscal policy was tightened after the 1992 election

	1993-4	1994-5	1995-6	1996-7
Total effect (£m) of 1993 Budget changes	365	490	6,725	10,305
PSBR as % GDP	5.75	8.0	6.5	5.5
Total effect (£m) of 1994 Budget changes		1,675	4,895	6,075
PSBR as % GDP	7.75	5.5	4.5	2.75

Source: *Financial Statement and Budget Reports 1993, 1994*

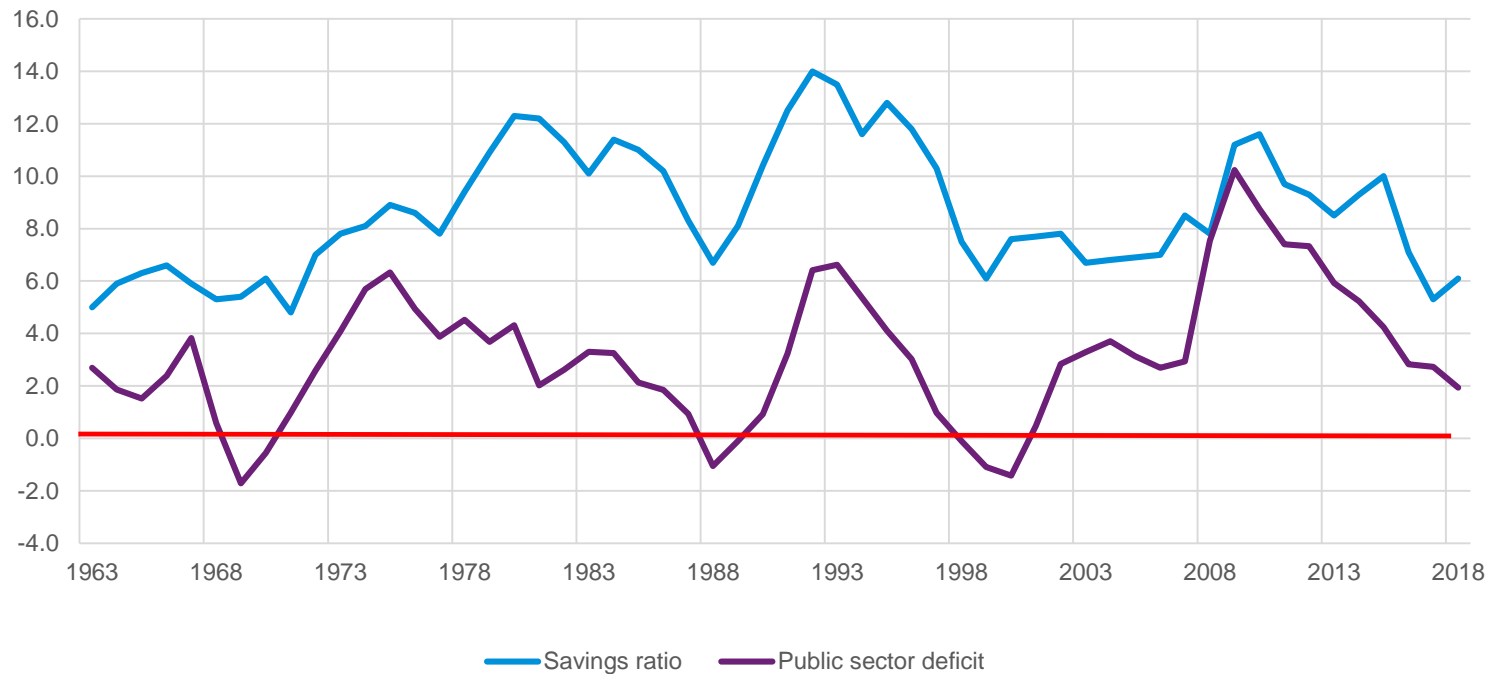
	1993	1994	1995	1996	1997	1998	1999
Inflation % per annum	3.1	2.3	2.7	2.7	2.4	2.2	1.7
GDP growth % per annum	2.7	3.6	2.1	2.3	3.9	3.3	3.3
Unemployment % of labour force	10.4	9.5	8.6	8.1	7.0	6.3	6.0

Source: *A Century of UK Economic Trends*,

**These measures set the fiscal deficit on a downward path towards surplus and ushered in a long period of steady growth with low inflation**

# Conclusions

## Savings ratio and public sector deficit as % disposable income and % GDP



**Private saving does usually offset public borrowing – by variable amounts and with variable lags**



# Conclusions

- 1. Fiscal contractions are often followed by lower inflation and higher growth (1976 until oil crisis, 1981, 1993-94)**
- 2. Fiscal expansions are often followed by higher inflation and lower growth (1972 Barber boom, 1988 Lawson boom) but not always (Brown 2000)**
- 3. Fiscal decisions cannot be made looking only at the state of the public finances (Lawson boom caused by this mistake)**
- 4. The fiscal deficit is inherently subject to large swings, making a balanced budget policy difficult to achieve**
- 5. Outturns are influenced by a mix of fiscal and monetary policy, as well as outside shocks.**



Thank you