

Fiscal Policy: Principles and Practice

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‘Fiscal policy’ is the term used to describe all of the government’s decisions regarding taxation and spending. It covers a huge array of taxes, benefits and public services, and is a powerful tool for changing the performance of the economy and the distribution of resources. So what makes a ‘good’ fiscal policy in theory? And how do we run fiscal policy in practice?

Fiscal policy in theory

What a government regards as ‘good’ fiscal policy will depend upon that government’s political beliefs and objectives. But some general economic principles apply:

How big should the state be?

What share of national income should be taken in taxation and spent by the government? Economics tells us that welfare is maximised if the government spends until the **marginal social benefit** of the last pound spent equals the **marginal social cost** of raising that pound. If the government spent less, then the benefits from increasing public spending would exceed the costs of raising more in taxes. If it spent more, then cutting back taxation and spending would raise social welfare.

What should the state spend money on?

The government should only raise and spend money for reasons of **equity** or **efficiency**.

Equity: Interventions to increase equity range from transfer payments to disadvantaged individuals or groups to subsidising services such as education, health and housing.

Efficiency: Public spending can improve efficiency if there are **externalities**. An externality is a divergence between an individual’s *private* marginal cost of, or benefit from, an activity and the *social* marginal cost or benefit. The divergence means that, in the absence of government intervention, the amount of activity that the individual undertakes is not the amount that would be optimal for society. If, for instance, people who undertake training raise not only their own productivity but also others’, then the marginal social benefit of training exceeds the marginal private benefit. The government could raise social welfare by intervening to lower the cost of training for individuals. There are certain items, known as **public goods**, that are unlikely to be supplied privately. These goods have two characteristics: (i) they are *non-rivalrous*, which means that one person can consume them without reducing the amount available for others to consume; and (ii) they are *non-excludable*, ie, the buyer cannot prevent others from using them without paying. Because it is not possible to exclude non-payers, no one has an incentive to purchase these items. Each person would rather let someone else pay and ‘free ride’. So

the state intervenes to provide public goods, such as national defence and street lighting.

In practice, there may be trade-offs between equity and efficiency: government interventions that improve one of these may worsen the other.

How should the state raise money?

Fairness and **efficiency** are, once again, important concerns.

Fairness: There are two aspects of fairness for the government to consider:

- *Inter-generational fairness:* Different methods of financing spending spread costs across generations in different ways. Paying for something out of tax revenues puts the whole cost on today's taxpayers. Borrowing money instead means that debt can be repaid by current and future generations.
- *Intra-generational fairness:* There are many ways of collecting revenue. Governments can tax income, wealth or consumption, to mention but a few options. The tax itself can be a fixed charge, a flat rate, or a rate that varies with the amount being taxed. Each tax has different implications for the distribution of resources.

Efficiency: Taxes also differ in their efficiencies. A tax on earnings, for example, creates a gap between a worker's marginal product and her marginal benefit (the amount she is paid). This gap causes a **deadweight loss**. Optimal tax theories provide guidance about whom to tax, and how to tax them, to minimise deadweight losses across the economy.

Optimal tax theories generally incorporate a **social welfare function** (which explains how a society's welfare depends on the wellbeing of its members), so they do not ignore the effects that different taxes have on the distribution of resources. But it is worth noting that, as in the previous section, there are trade-offs. Maximising the efficiency of a taxation system can conflict with other objectives, not least achieving certain definitions of fairness.

Fiscal policy in practice

In 1998, the government introduced a **Code for Fiscal Stability**, setting out the principles that would guide the making of fiscal policy. The principles include fairness and efficiency but the Code does not specify what the trade-off between these two concerns should be. Nor does it discuss how big the state should be, or what services it should provide. These issues have no definitive economic answers, so they are decided politically. However, the government did publish two **fiscal rules** in the same year. These explain how the government believes the public finances – ie, the accounting aspects of fiscal policy, such as borrowing and debt – should be managed.

The sustainable investment rule

This states that the public sector's debt should be at a "stable and prudent" level, which the current chancellor judges to be no more than 40% of national income. There is nothing magic about 40% – it could just as easily be 35% or 45%.

The reason for limiting debt levels is that the government, like individuals, can only borrow if its creditors – the holders of government bonds – believe the gains from lending outweigh the risks of non-payment. So bondholders must believe that the government can meet its debt interest payments. As public debt increases relative to tax revenues, so do the debt interest payments, which increases the risk that the government defaults on its debt. Eventually, if this continues, the result is a **debt crisis**, like that which took place in Argentina in 2001–02. Although such a crisis is unlikely in the United Kingdom, its devastating effects make it worth guarding against. Limiting the ratio of national debt to income to a level that is well within the government's ability to repay eliminates the risk of a debt crisis.

The golden rule

This states that the government should only borrow to invest. Accountants define **investment** (or **capital spending**) as spending on lasting assets – property, machinery, etc. Purchases of non-durable items, such as food and wages, are **current spending**. So the golden rule means that the government has to fund its current spending out of today's tax receipts. Only **capital spending** should be financed by borrowing, which is paid back by future generations.

The aim of this is to increase inter-generational fairness, which the government interprets as not making future taxpayers pay for today's spending unless that spending purchases assets of lasting benefit. But the rule only ensures this if the spending financed out of borrowing (ie, capital spending) benefits future generations and none of the spending financed out of tax revenues (mainly current spending) does. In practice, this is unlikely to be true. Spending on schools, for example, is mainly counted as a current spending item, because its biggest component is teachers' salaries. But schooling improves the skills of today's children, who are future taxpayers, and increases their future productivity. Although children's education is not a tangible asset, it benefits future generations. Conversely, there are certain items of capital spending, such as the Millennium Dome, which might not be of significant benefit to future generations.

Ideally, then, we would distinguish more accurately between spending of benefit to future generations and spending of benefit only to today's taxpayers than we do with the existing categories of capital and current spending. But it would be difficult to decide which spending items fell into which category, and a chancellor might be tempted to count too much of his or her spending as beneficial to future generations, in order to finance it through borrowing and pay for it later. Given the difficulties of drawing up a better rule, allowing only capital spending to be financed out of borrowing seems a reasonable

approximation of the government's interpretation of inter-generational fairness.

The golden rule does not guarantee that the marginal social cost of public spending will equal the marginal social benefit. So sticking to the rule will not necessarily make for optimal fiscal policy. But, given the difficulty of measuring even marginal private costs and benefits, let alone social ones, there would be no point in passing a rule requiring the two to be equal.

We have seen how the factors that should influence fiscal policy compare to actual practice. Rather than attempting to run an 'optimal' fiscal policy in some strict and quantifiable sense, the present government has instead chosen to outline its concerns without committing itself to a given size of state or viewpoint about the relative importance of equity and efficiency. With respect to the public finances, the government prefers 'rules of thumb' that are likely to strengthen the link between what each generation pays for and what it receives, while ensuring that policies are financially sustainable.