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# FISCAL REBALANCING PLANS IN THE MEDIUM TERM: THE CASE OF THE UNITED KINGDOM

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## ABSTRACT

The extraordinary fiscal policy response to mitigate the strong economic impact of the COVID-19 pandemic has pushed public debt notably higher, exceeding its peak levels of the last five decades in the main advanced economies. Additionally, support for the economic recovery will foreseeably require maintaining a sizeable fiscal impulse in the short term. In this setting, announcing medium-term plans to rebalance public finances would be suitable, according to the studies available. These plans recoup the countercyclical room for manoeuvre of fiscal policy, as well as anchor economic agents' expectations and reduce the potential risks of high government indebtedness for future economic activity. This article describes the example of the United Kingdom, the first country to propose a gradual fiscal adjustment programme for the medium term, while maintaining public support for the economic recovery in the short term.

**Keywords:** sovereign debt, fiscal policy, policy coordination.

**JEL classification:** H63, E62, E61.

# FISCAL REBALANCING PLANS IN THE MEDIUM TERM: THE CASE OF THE UNITED KINGDOM

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## The fiscal policy response to the crisis and the increase in public debt

As a result of the COVID-19 pandemic, extraordinary fiscal policy measures have been implemented globally to shore up health systems, mitigate the strong negative impact on households' and firms' income, and sustain the productive system and the economy's growth potential. The persistence of the health crisis and the expiration of several fiscal measures adopted in 2020 H1 prompted the introduction of additional initiatives in most advanced economies. Thus, fiscal policy measures to support liquidity and the widespread preservation of employment have gradually been replaced by measures focused on the hardest hit sectors, such as tourism and hospitality, as well as by strengthening support for the households most affected and by bolstering the solvency of firms. The purpose of this has been to avoid the crisis from damaging the economies' growth potential.[1]

This extraordinary fiscal policy response led to a substantial increase in public debt, which in the main advanced economies exceeds the previous peaks of the last five decades (see Charts 1.1 and 1.2). The public debt-to-GDP ratio for the euro area as a whole stood at 96.9%in 2020, whereas for the United States, the United Kingdom and Japan it amounted to 127.1%, 103.7% and 256.2%, respectively. Differences are observed across the main euro area economies, public debt amounts to 68.9% of GDP in Germany, compared with the higher levels of 113.5%, 155.6% and 120%, respectively, in France, Italy and Spain.

The current low interest rate environment (see Chart 1.3) affords fiscal policy greater room for manoeuvre, despite the high indebtedness situation.[2] In fact, in the main advanced economies, although public debt is at its highest level in many decades, debt servicing payments are at record-low levels (see Chart 1.4).

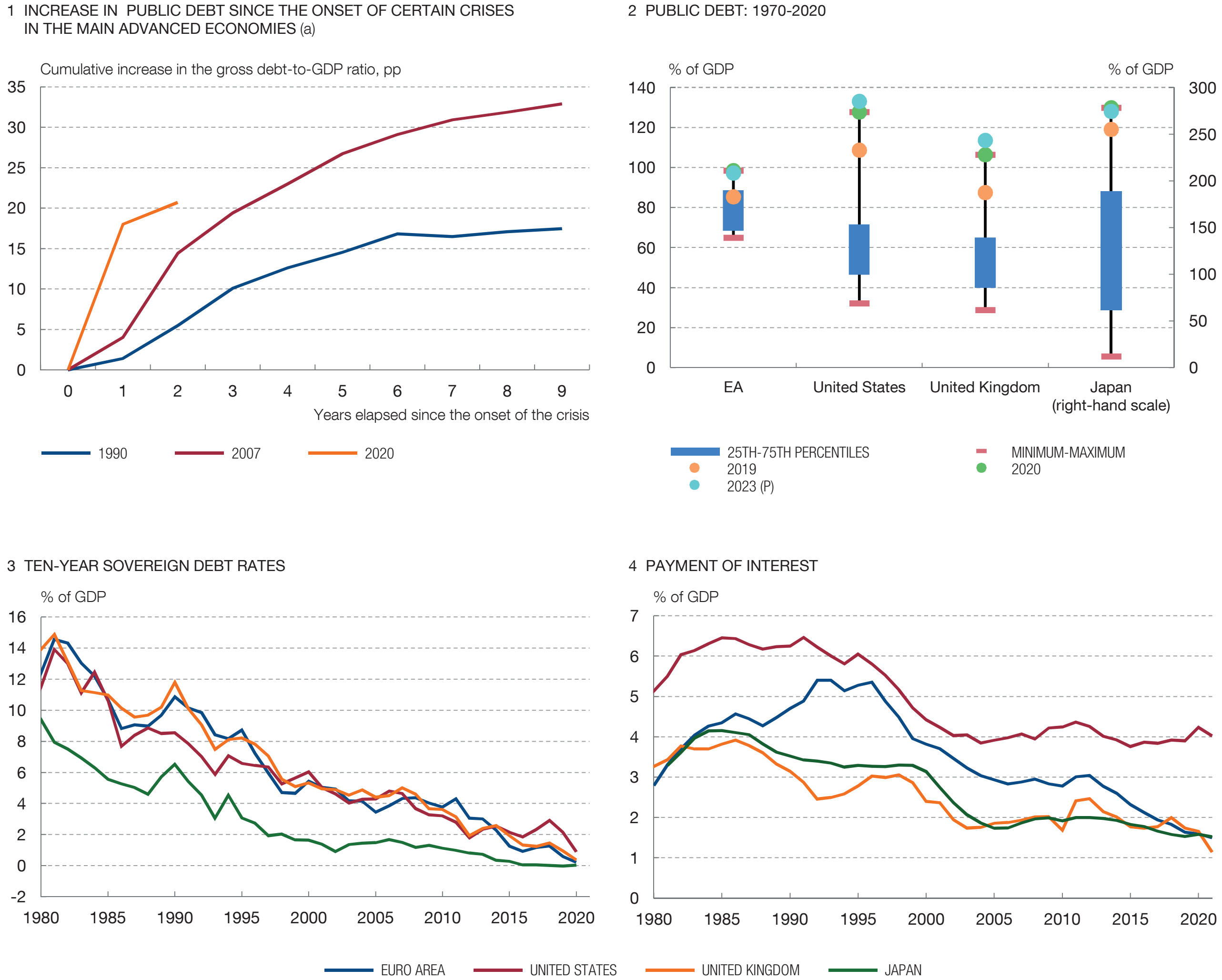
Nevertheless, in the medium term, the persistence of very high public debt levels may ultimately have a negative impact on economic performance. The academic literature shows abundant evidence of the risks associated with this situation.[3] On

1 Cuadro et al. (2020) and Alonso et al. (2021) summarise the variety of fiscal policy measures implemented in the euro area, the United States and the United Kingdom.

2 See, for example, O. Blanchard (2019) and Furman and Summers (2020).

3 See Hernández de Cos, López Rodríguez and Pérez (2018) and the references cited in this paper.

Chart 1
**PUBLIC INDEBTEDNESS IN THE MAIN ADVANCED ECONOMIES**




**SOURCES:** Banco de España, based on Brunet *et al.* (2020), IMF (Fiscal Monitor, April 2021, Historical Public Debt Database) and national sources.

**a** The public debt of the advanced economies aggregate was calculated as a non-weighted average of the debt of the advanced economies which are members of the G-20: Australia, Canada, France, Germany, Italy, Japan, South Korea, the United States and the United Kingdom. A projection is made for 2021.

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one hand, the countercyclical room for manoeuvre of fiscal policy shrinks in the face of possible fresh adverse macroeconomic shocks. On the other, the economies' vulnerability to changes in investor sentiment increases, which affects the public sector's borrowing capacity and the related cost. Lastly, persistently high public debt levels may weaken the medium and long-term growth capacity, insofar as government indebtedness absorbs funds, which could be earmarked for more productive uses, or leads to a tightening of the financial conditions of the economy for this reason.

Against this backdrop, prior experience shows that the most successful government deleveraging processes in the past have been gradual and have been boosted when implemented in macroeconomic settings favourable to economic growth (Alesina et al. (2015)).[4] In turn, a decisive factor of the success of these processes has been the preparation and implementation of multiannual budget deficit reduction programmes (Bi et al., 2013). Accordingly, a credible announcement about the medium-term implementation of a gradual fiscal adjustment programme, once the crisis triggered by the pandemic is over, may be a key factor for anchoring economic agents' expectations and for reducing uncertainty. This has a positive effect on economic activity[5] since it makes it easier for economic agents to take decisions (Fernández-Villaverde et al., (2015)). In this respect, fiscal programmes which include a rebalancing of public finances in the medium term may enhance the credibility of governments and reduce possible inefficiencies such as sharper contractions of economic activity or the use of more distortionary fiscal instruments (Klein et al. (2008)). Furthermore, paths of gradual fiscal consolidation ensure the sustainability of public finances without the need for substantial primary surpluses which require steep increases in taxation or drastic cuts in productive expenditure (Andrés et al. (2020)). In other words, these paths smooth distortions which may bring about abrupt changes in taxes[6] or in government spending. In short, the design and implementation of credible fiscal consolidation programmes which stabilise public debt in the medium term afford greater room for manoeuvre for fiscal policy, even in the short term (Hernández de Cos, (2021)).

## The United Kingdom's medium-term fiscal plan

The United Kingdom is the first country to have recently proposed a gradual fiscal adjustment programme for the medium term, while maintaining public support for the economic recovery in the short term.[7] Chart 2 shows the main components of

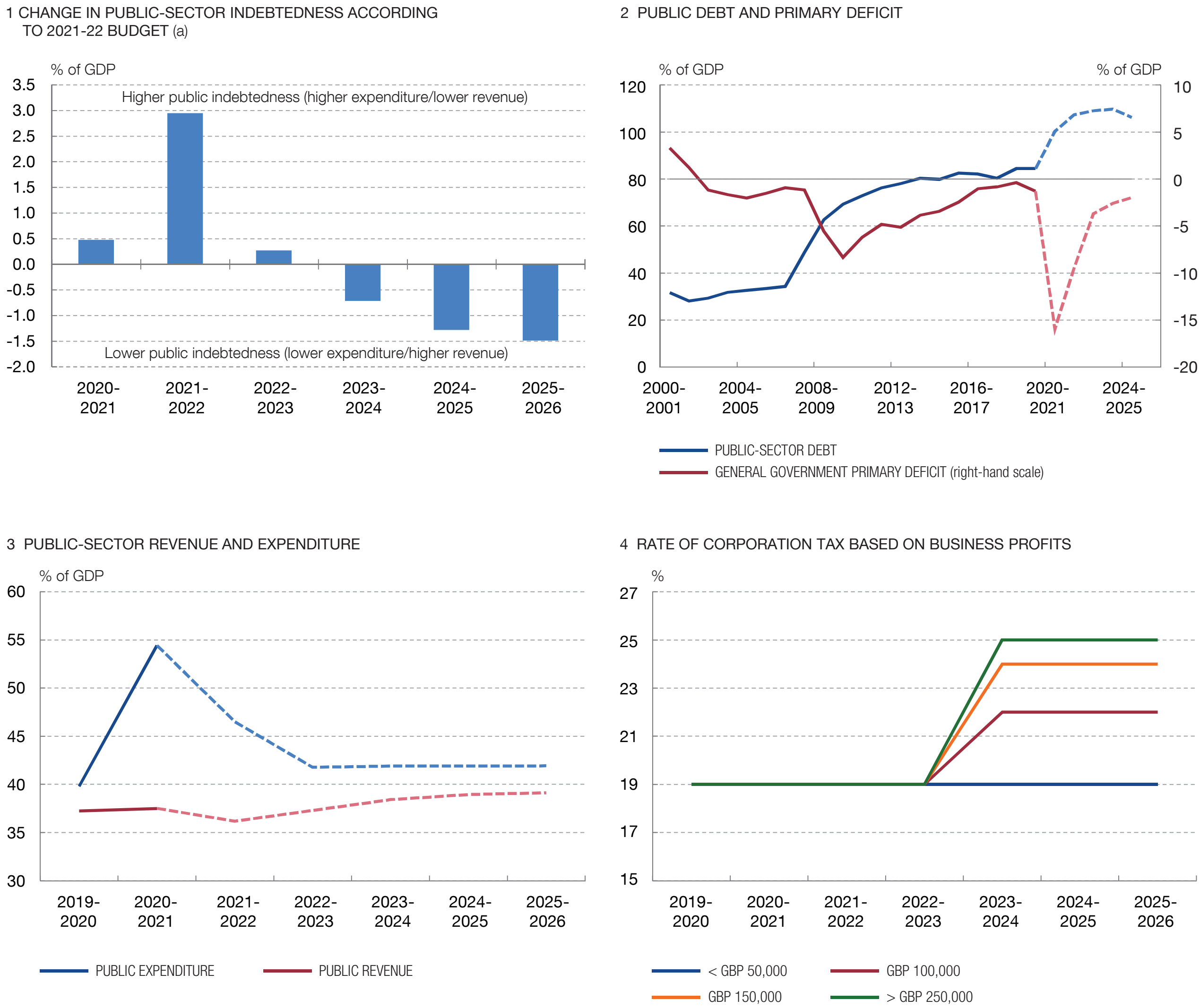
4 According to the available studies, suitable management of the public debt structure can strengthen governments' commitment to fiscal consolidation programmes, in addition to reducing public-sector borrowing costs and the risks associated with changes in investor sentiment. The optimal structure of government debt hinges, among other factors, on the spread between the interest rates on bonds with different maturities, and their volatility and covariance with GDP growth and inflation. Independent monetary policy and the monetary policy stance are other significant factors in determining the composition of the optimal government debt portfolio. See the International Monetary Fund's and World Bank's guidelines (2014) on optimal management of public debt and, for example, the papers by Missale (2012), Missale et al. (2002), Debortoli et al. (2017) and Bacchiocchi and Missale (2005).

5 Some research suggests that the announcement of future fiscal consolidation could contribute to improving economic activity in the short term due to changes in economic agents' behaviour prior to its implementation. For example, Mertens and Ravn (2011) find that the announcement of a tax hike in the United States gives rise to an increase in GDP, investment and hours worked prior to its implementation. Leeper et al. (2012) also apply these findings to changes in government consumption.

6 See Chapter 12 of Romer (2018) and the references cited in this textbook.

7 Other economies are also considering fiscal plans comprising a partial rebalancing of public finances in the medium term, although they have still not materialised in specific legislative actions. For example, the European Union announced that it would increase its own resources as from 2028 to repay the debt arising from the financing, beginning in 2021, of the "Next Generation EU" programme and in the United States, President Biden's recent proposal in the American Jobs Act includes the announcement of future tax increases for large corporations.

Chart 2
**THE UNITED KINGDOM'S PUBLIC FINANCES**




**SOURCES:** IMF, UK Office for National Statistics and UK Office for Budget Responsibility.

**a** The support measures include aid for households and firms, and are in addition to the funds already earmarked to this end for households and firms prior to the 2021 budget. The stimulus measures include tax subsidies for investment. The consolidation measures include an increase in corporation tax and income tax. The data as from the 2020-21 tax year relate to projections made in March 2021. The date indicates the British tax year: from April to March of the following year.

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the general government budget for the 2021/22 tax year.[8] The funding of the main programmes to mitigate the economic impact of the pandemic on households and firms is being extended in the short term, for example, the furlough schemes, subsidies and the temporary VAT reduction for firms in the hospitality industry. In addition, the budget includes a series of measures to support the economic recovery over the next two years, such as the introduction of corporate income tax deductions

8 The UK tax year runs from 1 April until 31 March of the following year.

to encourage business investment. Also, a new government-guaranteed loan scheme replaces the schemes set up at the onset of the pandemic to provide continued support to firms' financing needs. As shown in Chart 2.2, overall these measures would situate the primary deficit over the next three tax years at around 16%, 10% and 4% of GDP, respectively.

A medium-term fiscal consolidation programme is under consideration in order to improve the sustainability of public finances. The plan centres on increasing taxation which would raise government revenue by around 4 pp to approximately 40% of GDP by the end of the fiscal programme in 2026 (see Chart 2.3). Specifically, it includes hikes in corporation tax and income tax. As from 2023 the corporate income tax on firms with annual profits of more than £50,000 will rise from 19% to a maximum of 25% (see Chart 2.4). As from 2022, the higher rate threshold for income tax and personal deductions will not be indexed to inflation. It is estimated that, overall, these measures will contribute around 1 pp to the increase in tax revenue as a percentage of GDP over the horizon of the programme, while the remainder of the increase in the ratio of government revenue-to-GDP will be attributable, based on the British government's projections, to the vigour of the economic recovery and the withdrawal of the 2021 temporary tax cuts. The gradual withdrawal of short-term stimulus measures will reduce public spending to approximately 42% of GDP, bringing it once again close to the levels observed during the last decade. Consequently, if this fiscal adjustment programme is fully implemented, it is estimated that it would contain the increase in the public debt-to-GDP ratio which would drop from a peak of around 110% of GDP in the 2023/24 tax year to 106% of GDP in 2025/26 (see Chart 2.2).

6.5.2021.

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