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Tax more or spend less? Asymmetries in the UK revenue–expenditure nexus

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Abstract

Unlike previous research on the causal relationship between government revenues and expenditures in the United Kingdom, this study estimates an asymmetric error correction model within a momentum threshold autoregressive framework over the period 1955–2009. The results indicate that government revenues respond to short-run changes in government expenditures as well as asymmetrically to budgetary disequilibrium. With respect to the asymmetric adjustment, the response of government revenues to a worsening budget is faster (in absolute terms) than to an improving budget. Thus, contrary to previous studies on the UK, the empirical findings lend support for the spend–tax hypothesis.

JEL classification: C54; H6

Keywords: Revenues; Expenditures; Budget deficits; Asymmetries

1. Introduction

In the past few decades persistent budget deficits of industrialized countries have caused some concerns for policy makers. The use of budget deficit financing and the sustainability of budget deficits have generated considerable interest by policy makers and researchers alike. Moreover, questions in terms of the causes and consequences of budget deficits are of particular interest.

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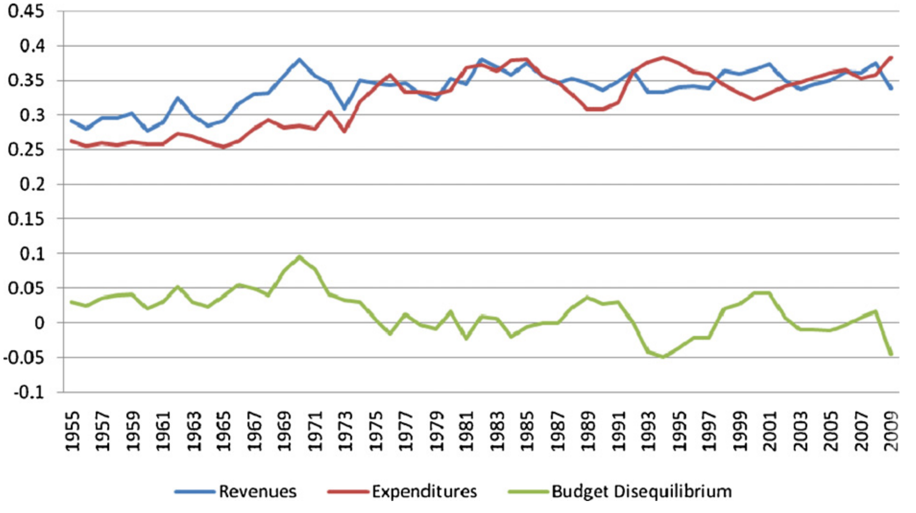

Fig. 1. Revenues and expenditures as a share of GDP and budget disequilibrium 1955–2009.

Though the United Kingdom (UK) has undergone changes within its fiscal framework since their acceptance into the European Union (EU) in 1973 and the adoption of the Maastricht Treaty in 1992, there has been concern over deficit sustainability. In 1997, the UK government introduced the principles-based Code of Fiscal Stability framework. The Code outlines five broad principles of fiscal responsibility underlying the operation of fiscal policy: transparency, stability, responsibility, fairness, and efficiency. The Code requires that the government specifies its fiscal objectives which are, in turn, achieved through operating rules known as the golden rule and the sustainable investment rule. The golden rule states that over the economic cycle the government should borrow only to invest and current consumption should be paid for by taxation. The sustainable investment rule requires that over the economic cycle the net debt as a percentage of GDP be kept at a stable and prudent level.[1]

As shown in Fig. 1 which plots government revenues and expenditures as a share of GDP as well as budget disequilibrium from 1955:1 to 2009:1, the UK has recorded deficits from 1991 until a surplus in 1998. Since the introduction of this new fiscal framework in 1997–1998, the UK maintained improvements in its budget position with strong growth in revenues and decreases in expenditures as a share of GDP. However, around 2001–2002, the budget moved into deficit as a result of the expansion in public expenditures capital and resource budgets for education and health services while revenue growth from income and corporate taxes were less than expected from projections. With the onset of the financial crisis in 2007–2008, the rules associated with the Code of Fiscal Stability were suspended in late 2008 in order to introduce temporary fiscal stimulus measures: a reduction in the VAT and acceleration of planned capital expenditure projects. As a consequence of these actions, the budget deficit and debt burden increased. Recognizing the implications of such fiscal actions on the country's deficit and debt situation, the UK government outlined a plan for fiscal consolidation to move the budget back in balance by 2015–2016. The

[1] See OECD (2009, chap. 2, pp. 59–61) for a nice summary of the Code of Fiscal Stability. Criticisms of fiscal rules in general are discussed on pp. 61–64. See also Anderson and Minarik (2006).