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Recent Fiscal Developments in the European Countries of the G-7 1/

by

G. O'Callaghan, K. Habermeier, J. Green, S.G.B. Henry, and R. Violi

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Abstract

This paper reviews recent fiscal developments in France, Germany, Italy, and the United Kingdom and decomposes these into their structural and cyclical parts. Developments in each country for the last five years are described in detail to identify likely reasons for the deterioration.

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I. Introduction

Currently all the G-7 European countries have large overall fiscal deficits. In Italy, the fiscal deficit has been substantial for some time, and was still close to 10 percent of GDP in 1993, but in France, Germany, and the United Kingdom, fiscal positions deteriorated markedly in the late 1980s and the early 1990s. On a general government basis, the overall deficit in France was estimated to be near 6 percent of GDP in 1993, in Germany a little under 4 percent, and in the United Kingdom about 8¾ percent. Italy apart, the sheer scale of the deterioration in the public finances of the major European economies has been quite extraordinary. From 1989 to 1993, deficits increased by just under 5 percent of GDP in both France and Germany, and by a remarkable 10 percent in the United Kingdom. As all these countries have been in recession at some time since 1990, at least part of this turnaround in the public finances is cyclical but, and again the exception is Italy, there have also been very large worsenings in structural deficits which will not automatically disappear as economies recover. As shown below, these structural changes have been substantial, especially in Germany where a cumulative increase of almost 3 percent in the structural deficit took place over this period, and in the United Kingdom where an increase of more than 4 percent occurred.

What are the sources of these changes in structural deficits, and do the experiences of any of the European countries show parallels with any of the others? We employ descriptive methods to provide some answers to these questions, using familiar methods to separate overall deficits into their structural and cyclical components. By considering in detail the areas of the public finances which show most significant change, explanations for the structural worsening of the deficit in each country are advanced, together with their estimated size. In the case of Germany the cause of the structural change is unsurprising, largely being transfers to the Eastern Länder following unification, and largely in the nature of a one-off shock. In Italy there have been significant improvements in the non-interest part of the deficit. In France and the United Kingdom, however, the explanation appears to be that structural deficits in the boom years toward the end of the decade, were not fully recognized at the time, due to offsetting effects on the public finances from the cycle, and the necessary corrections were delayed. So, although some commentators appreciated that the cycle had improved the fiscal balance, and that structural deterioration was occurring, the scale of the structural worsening was not recognized. We argue that such developments underline the usefulness of structural indicators in continuously monitoring the changes in underlying fiscal positions.

II. Methodology

The approach used here describes the main changes in structural balances and the primary deficit ratio, from the late 1980s to 1993. In certain cases the narrative goes further back where the sources of the worsening date from the mid-1980s, as was the case with declining oil revenues in the United Kingdom. Throughout, the methods are largely descriptive, the purpose of this article being purposely narrow. It aims to give a factual account of the recent changes in structural deficits in terms of e.g., specific tax or expenditure changes.

To derive fiscal balances, the present paper uses a methodology typically employed at the IMF in deriving fiscal indicators. (For an extensive survey of various aspects of this see Blejer and Cheasty (1993), and Annex I by Jaeger, WEO October 1993.) This assumes that trend output is given by productive potential and the breakdown of the overall fiscal deficit into its components uses the derived output gap and certain simplifying assumptions about revenue and expenditure elasticities. We argue that these simplifying assumptions provide a transparent accounting framework of fiscal changes, even though the distinction between structural and cyclical cannot be applied unambiguously.

To divide the overall fiscal balance into its structural and cyclical components, government revenues and expenditures are separated into cyclical and structural parts using the estimated output gap. Tax revenues can be adjusted, to yield an estimated level if the gap were closed, by applying yield elasticities (estimates of the responsiveness of the yield to changes in the tax base) to the gap. On the expenditure side it is mainly unemployment benefits and social security expenditures received by the unemployed which are adjusted using an estimate of unemployment due to the gap.

The other general indicator used in this paper is the primary deficit, which is defined as the non-interest part of the overall deficit. The distinction between overall and primary deficits is important in describing recent fiscal developments, especially in Italy, as changes in the primary deficit have had an important role there. 1/

III. An Overview: Structural and Primary Fiscal Balances

We begin with the general behavior of the fiscal deficits for the four countries, the main features of which are shown in Table 2. This gives the breakdown of the fiscal balance for the G-4 European countries using the methods already described, together with the estimates of the output gap used in the calculation.

There is evidently a very substantial structural worsening in these countries taken as a whole, although the deterioration is most pronounced in the United Kingdom and France. The structural position in Italy has improved, but from an extremely adverse starting point, so its underlying fiscal position remains critical. Here the important change is the marked improvement in turning its primary deficit to a surplus, the cumulative change being some 3.4 percentage points of GDP from 1989 to 1993.
Table 3 compares the present estimates with those reported by the OECD (see "OECD Economic Survey", 1993; Table A2b), which reveals a broad similarity in the estimates.

1/ This paper is not directed at the issue of debt dynamics or the sustainability or otherwise of debt to income ratios in the countries under review. Sustainability calculations for the major industrial countries--including those reviewed here--are reported in the IMF's "World Economic Outlook" for October 1993. (see Box 4, pp. 58-59). These calibrate long run debt to income ratios for the period 1993-1998, on alternative assumptions about deficit consolidation in each country, for given interest rate and activity assumptions.

Table 2. General Government Overall, Structural, and Primary Balances (Deficits (-)/Surpluses (+))

(In percent of GDP)

	1989	1990	1991	1992	1993
France					
Overall	-1.3	-1.5	-2.1	-3.9	-5.9
Structural	-2.2	-2.5	-2.3	-3.4	-3.7
Primary	1.5	1.4	1.0	-0.5	-2.8
Output gap	2.2	2.2	0.4	-0.7	-3.8
Germany 1/					
Overall	0.1	-1.9	-3.1	-2.7	-3.6
Structural	0.2	-3.0	-4.7	-3.6	-2.3
Primary	2.8	0.6	-0.4	0.6	--
Output gap	0.1	1.9	2.7	1.6	-1.8
Italy 2/					
Overall	-10.3	-11.4	-10.7	-10.0	-9.9
Structural	-10.8	-11.9	-10.8	-9.5	-7.9
Primary	-1.0	-1.3	--	1.9	2.4
Output gap	0.9	0.8	0.0	-1.1	-3.5
United Kingdom					
Overall	0.9	-1.3	-2.7	-6.2	-8.6
Structural	-1.5	-3.2	-2.3	-3.8	-5.7
Primary	5.0	4.1	2.3	-0.9	-4.3
Output gap	4.5	2.5	-2.1	-5.0	-5.3

1/ Data for Germany before 1990 refer to West Germany.
2/ Including latest payments on tax refund liabilities.

What is already clear from this general account is that the nature and scale of the changes in fiscal deficits has differed, in certain cases quite markedly between these countries.

IV. Structural Fiscal Developments in the G-4 Countries

This section describes the structural changes that have occurred in each country, before advancing some general explanations for these.

Table 3. Structural Government Balances: IMF and OECD

	1989	1990	1991	1992	1993
France					
IMF	-2.2	-2.5	-2.3	-3.4	-3.7
OECD	-1.5	-1.8	-1.5	-2.8	-3.2
Germany 1/					
IMF	0.2	-3.0	-4.7	-3.6	-2.3
OECD	0.0	-3.5	-5.2	-4.5	-3.7
Italy 2/					
IMF	-10.8	-11.9	-10.8	-9.5	-7.9
OECD	-10.5	-11.4	-10.1	-8.6	-7.6
United Kingdom					
IMF	-1.5	-3.2	-2.3	-3.8	-5.7
OECD	-1.6	-2.9	-1.9	-3.5	-5.0

Sources: Staff estimates; OECD Economic Outlook, December 1993.

1/ Data for Germany before 1990 refer to West Germany.
2/ Including latest payments on tax refund liabilities.

In the main, the description centers on developments in general government finances, thus facilitating inter-country comparisons.

1. France

In France, the estimated general government structural budget deteriorated from 1.1 percent of GDP in 1987 to almost 3.5 percent in 1992 and 3.7 percent in 1993. The explanation advanced here is that this deterioration was largely due to two consecutive changes in policy. The first was structural loosening--mainly revenue reductions--undertaken during the boom (an indication of which was deficits which declined only slowly during that time) and second the social security changes made by the authorities for countercyclical reasons following the onset of the downturn.

Thus, half of the deterioration in the structural deficit in 1987-93 had occurred by 1990--i.e., before the onset of the cyclical downturn. The changes made were largely revenue reductions given by the lowering of a series of tax and contribution rates. They included reductions in the top marginal income tax rate, the corporate tax rate, and the top rate of VAT. (It should be added that these last two also represented French moves toward closer harmonization of tax structures within Europe). The estimated effect of these combined tax measures is over one percentage point of GDP. At the same time expenditure controls on items such as employee compensation (which fell by one percentage point of GDP) were introduced, but these did not prove sufficient, and structural expenditure also increased over the period by half a percentage point of GDP. Consequently, although the actual deficit as a proportion of GDP fell at this time, this fall was mainly due to the effects of the cycle and masked a significant deterioration in the underlying structural position.

From 1991 onwards, countercyclical measures started to play an increasing role in accounting for structural changes. There were increases in structural expenditures in 1992, which included both measures to stimulate employment and changes in social security payments. To quantify these changes it is necessary to consider the changes in the central, local, and social security accounts separately.

a. Central government

Table 4 shows central government deficits for 1991-1993, which massively exceeded those budgeted. Over this period, most of the shortfalls were on the revenue side, amounting to about 1.2 percent of GDP in 1992, as

GDP growth was lower than projected when each of the budgets was formulated. 1/ However, there were also significant expenditure overruns in 1992-93, amounting to 0.7 - 1.1 percent of GDP, of which about one-third were related to increased interest payments on government debt.

Table 4. Central Government Finances
(in billions of francs)

	1991 Budget	1991 Outturn	1992 Budget	1992 Outturn	1993 Budget	1993 Outturn
Expenditure	1290.2	1301.0	1334.6	1387.9	1378.3	1458.2
Revenue	1209.5	1169.3	1244.7	1161.6	1212.9	1142.5
Balance 2/	-80.7	-131.7	-89.9	-226.3	-165.4	-315.7
(percent GDP)	(-1.2)	(-2.0)	(-1.3)	(-3.2)	(-2.2)	(-4.5)

1/ Expenditure includes the effect of temporary operations but excludes the effect of expenditure overruns associated with Fonds de Concours. Revenue outturns also exclude Fonds de Concours.
2/ Excluding Exchange Stabilization Fund.

In May 1993 a series of corrective measures was announced, including increases in income and excise taxes, and a reduction in employers' social security contributions combined with some expenditure and revenue measures. A subsequent increase in expenditure of F 40 billion was announced to stimulate employment and the construction sector and, even though it was planned to finance this by privatization receipts, it served to add to the general government deficit (on a national accounts basis), increasing it to 5.9 percent of GDP.

1/ In Table 4, budgeted deficits are expressed as a proportion of projected GDP while outturns are expressed as a proportion of actual GDP.

b. Social security and local authorities

Social security expenditures increased by about 1.5 percentage points of GDP from 1987 reflecting increased payments associated with the economic downturn, as well as significant structural imbalances and demographic problems associated with an aging population. The increase in the general social contribution rate in 1993 was expected to provide F 50 billion (0.7 percent of GDP) toward funding these additional expenditures in a full year. Finally, the unemployment insurance system (UNEDIC) also incurred deficits, of about F 15 billion in 1992.

Local authority expenditures increased substantially over the past few years, with increased devolution of powers to local authorities. Expenditures grew at an annual rate in excess of 6 percent while the growth rate of tax revenues (especially property taxes and the *taxe professionelle* on businesses) fell by 3 percentage points in the past two years.

In sum, the experience of France provides an interesting lesson for fiscal policy formulation, and of the usefulness of measures of the structural deficit. In the period from 1987-91, during which half of the structural deterioration occurred, fiscal policy had aimed at maintaining a constant nominal deficit. Due to the economic upswing, operating this rule allowed a reduction in the burden of taxation on the economy and an increase in spending. Such a fixed budget rule implies the imposition of corrective fiscal measures in a later downswing of course. In the event, it was not possible to make corrective measures in the downswing, and the fixed budget rule was abandoned. In the period after 1990, rather than reversing the build-up in the structural deficit, further discretionary measures to alleviate the effect of the recession on the economy added to the heightened base.

2. Germany

The important changes in the public finances in Germany took place well before the onset of the current economic downturn and were almost completely accounted for by the fiscal costs of German unification. Between 1989 and 1991, the first full year following unification, the general government structural balance, on a national accounts basis, deteriorated by 5 percent of GDP, a figure approximately equal to the volume of fiscal transfers to east Germany. The bulk of these transfers served to cushion the east German population against the dislocations brought about by the rapid transformation of east Germany's centrally planned economy into a "social market economy" on the west German model. It is likely that significant transfers of this kind will be required for the foreseeable future.

The initial rounds of free collective bargaining in east Germany led to a sharp increase in wages as labor unions sought to reduce the wage gap between the two parts of the country. The rising disparity between wages and productivity was one reason for the emergence of substantial unemployment, but the closing of many traditional markets and substantial restructuring in the economy were also important. Not surprisingly, therefore, labor market expenditure accounted for more than one third of all net fiscal transfers to east Germany in 1991-93, and by 1993, gross expenditure on labor market measures in east Germany had increased to DM 50 billion or 2½ percent of GDP, of which almost half was attributable to active policies such as job creation and retraining. Rapidly rising east

German wages have also been reflected in the personnel expenditure of the east German state and local governments, which have increased by about 50 percent between 1991 and 1993, and now amount to almost 30 percent of east German GDP, compared with less than 10 percent of GDP in west Germany. The pension system in east Germany, too, was adapted to west German standards and began to incur a deficit which was covered by transfers.

Only part of the fiscal cost of unification, however, was reflected in the general government data, and the increase in the public sector borrowing requirement was even larger than indicated by the national accounts statistics referred to earlier. As shown in Table 5, the combined borrowing of the major public enterprises, i.e. the Treuhand privatization agency, the postal and telecommunications agencies, and the railways, has increased from ½ percent of GDP in 1990 to 2 percent of GDP in 1993. Much of this borrowing has funded a large and successful program of industrial restructuring and infrastructure modernization in east Germany. Although the deficits of these public enterprises have been "off-budget", the accumulated debts of the Treuhand and the railways will be serviced from 1994 and 1995 onwards by the federal government through a variety of special funds that are included in the accounts of the territorial authorities and hence the general government. The cost of this debt service will amount to about 1 percent of GDP and should be considered as part of the general government structural deficit.

First steps towards fiscal consolidation were already taken in the first half of 1991, and further measures were introduced in 1992 and 1993. These included, among many others, an increase in fuel and social security taxes in 1991, a temporary surcharge on income taxes from mid-1991 to mid-1992, and an increase in the standard VAT rate from 14 to 15 percent at the beginning of 1993. These measures contributed to an increase in the general government revenue ratio by more than 6 percent of GDP in 1991-93; part of the increase is also explained by the strong economic performance in west Germany in 1991 and the first half of 1992.

By contrast, there was comparatively little action to rein in public expenditure, with subsidies for agriculture, coal mining, and housing in west Germany remaining virtually untouched. Overall, these subsidies are comparable in magnitude to the volume of net fiscal transfers to east Germany, and subsidies to coal mining alone amount to more than DM 10 billion annually (½ percent of GDP). The strong revenue performance in 1991-92 also induced many west German state and local governments to embark on new expenditure programs, and the large and growing numbers of immigrants and asylum-seekers imposed an additional burden on the finances of the local authorities. Moreover, the public health insurance funds began to incur substantial deficits as earlier cost-cutting packages failed to dampen the growth of health care expenditure. Nonetheless, the consolidation measures allowed the structural deficit of the general government to decline in 1992 and 1993 by almost a cumulative 3 percent.

The weakening of economic performance in Germany and elsewhere in Europe that began in 1992 led to a purely cyclical deterioration of the public finances in 1993. Tax receipts were substantially weaker than anticipated, and the federal government was obliged to repeatedly increase its transfer payments to the Federal Labor Office to cover rising expenditure on unemployment compensation. At nearly DM 25 billion, this transfer was almost ¾ percent of GDP higher than budgeted. As a result, the deficit of the federal government, which had been reduced to less than DM 40 billion in 1992, increased to a record level of about DM 70 billion in 1993, compared with an initial estimate of DM 50 billion. Weaker revenue performance also contributed to sharply higher deficits at the state and local government levels. The marked deterioration in the finances of the territorial authorities was partly offset by an improvement in the financial position of the health insurance funds following the introduction of new cost-containment measures at the beginning of 1993. On balance, the deficit of the general government increased to about 3½ percent of GDP in 1993.

3. Italy

The overview in Section III described the general improvement in the primary deficit in Italy, which moved from deficit to a surplus by 1992-93. The main theme in the present assessment of the fiscal position in Italy then is its improvement in structural receipts and expenditures.

The structural overall balance for the general government improved between 1989-92 by some 1.3 percent of GDP, more than the overall total balance improvement of 0.3 percent of GDP over the same period. The improvement of the structural primary balance was much larger--some 4 percent of GDP--while the actual primary balance improved by 2.9 percent of GDP to a surplus of almost 2 percent of GDP (see Table 6). The improvement in the primary balance was not fully passed through to the overall balance because of the growth in interest payments during this time. The latter mostly reflected the sharp rise in real interest rates during the

Table 5. Germany, Public Sector Borrowing
(In billions of deutsche mark)

	1990	1991	1992	1993 1/
Territorial authorities deficit	94	124	116	158½
Federal	48	53	39½	73½
State and local, west	23½	23	22½	36½
State and local, east	--	14½	26	32
German Unity Fund	20	30½	-2	13½
Other	2	3	6	2½
Adjustment 2/	20	-6	-13½	-6
Borrowing of:				
Territorial authorities 3/	114	118	102½	152
Borrowing of major public enterprises and entities:	12½	36	58	63
Treuhand	4½	20	29	38
Railways	3	5½	13½	14
Post Office	5	10½	15½	11
Total borrowing	126½	154	160	215
Percent of GNP	4.7	5.4	5.3	6.9
Memorandum items:				
Public sector deficit 4/	106½	160	174	222
Percent of GNP	4.0	5.7	5.7	7.1

1/ Estimates.
2/ Change in liquid reserves (+=buildup).
3/ Same coverage as total borrowing, but excluding the adjustment for buildup or drawdown of liquid reserves.
4/ Borrowing as estimated by the difference between the deficit and change in liquid reserves.

period--notably in 1992--the gradual rise in the debt/GDP ratio, and the increasing proportion of debt at market rates. The improvement in the primary balance, both actual and structural, came from increased revenues, while the primary spending of the general government actually increased somewhat as a ratio to GDP. Revenue increases came from tax measures and, to a lesser extent, higher social security contributions. However, some of the increase in actual tax revenues reflected one-off measures, notably an amnesty on income tax and VAT (estimated at 1 percent of GDP), wealth taxes on bank deposits in 1992 (0.5 percent of GDP) and on company real estate holdings (0.4 percent of GDP). The more permanent increase in tax revenues to 1992, (some 1.5 percent of GDP), resulted almost equally from a small increase in marginal income tax rates, the upward adjustment of VAT rates in line with EU harmonization, and the introduction of a new excise tax on gas and higher social security contributions rates.

Table 6. Italy: State Sector and General Government Balances, 1991-93
(In percent of GDP)

	1991	1992	1993
State sector			
Revenues	33.8	34.2	35.0
Expenditures 1/	44.9	45.3	45.5
Interest 1/	10.6	11.6	12.1
Primary balance	-0.5	0.5	1.7
Overall balance 1/	-11.1	-11.1	-10.4
General government			
Primary balance	--	1.9	2.4
Overall balance	-10.7	-10.0	-9.9

Sources: Bank of Italy, Treasury, and Fund staff estimates.

1/ Includes imputed interest on tax refund liabilities not replaced by government bonds, equivalent to about 0.5 percent of GDP annually during the period.

Moving to 1993, the budget originally targeted a reduction in the state sector deficit (a concept which broadly corresponds to the central government) to Lit 151.2 trillion (9.6 percent of GDP), compared with a deficit of Lit 159.8 trillion (10.6 percent of GDP) in 1992. It also targeted the largest primary balance in more than two decades, at just over 2.6 percent of GDP. Measures adopted in September 1992 were estimated to yield over 5 percent of GDP, relative to an otherwise deteriorating trend. On the revenue side, the most important of these measures were the introduction of a new presumptive tax (minimum tax) on the self-employed and a tax on company net worth, the partial abolition of the indexation of tax brackets, and the imposition of limits to income tax allowances. On the expenditure side, the measures aimed at keeping current primary spending constant in nominal terms by freezing government employment and the pay scale of civil servants, as well as reducing transfers to public sector agencies and local governments.

Early in 1993, it became clear that the budget targets would not be achieved, due to weaker-than-expected economic activity and slippages in the implementation of some of the planned spending cuts. In May, the new government introduced a supplementary fiscal package which, while relaxing the pace of fiscal adjustment in view of the weaker economy, aimed to partly offset the slippages in the implementation of the budget. The additional measures, roughly evenly divided between revenues and expenditures, were intended to keep the primary surplus at 2 percent of GDP. Savings on interest payments implied that this primary surplus target corresponded to new overall deficit of 9.7 percent of GDP. These targets were finalized in the July Documento di Programmazione Economico-Finanziaria (DPEF).

Actual performance in 1993 has been broadly in line with the revised targets. The primary surplus of the state sector is estimated at about 1.7 percent of GDP (with a larger surplus registered for the general government, on a national accounts basis). Additional interest savings with respect to the revised budget has brought the deficit of the state sector to slightly below 10 percent of GDP (on the official definition, 10.4 percent including imputed interest on tax refund liabilities), while that of the general government was 9.5 percent of GDP according to preliminary Bank of Italy estimates (or 9.9 percent on the IMF definition).

4. United Kingdom

The causes of the deterioration in the fiscal deficit in the United Kingdom were at work before 1989, when the public surplus reached its peak. In the first half of the 1980s, North Sea Oil production contributed around 4 percent of GDP to public revenue, but oil revenue fell away with the collapse in world oil prices in 1985-86. The effects of this were not evident as non-oil revenue began to pick up with the buoyant recovery. Finally some of the expenditure savings measures adopted in the early 1980s proved unsustainable resulting in upward pressure on expenditures by 1987. As a consequence, the public surplus in 1988/89 was probably more temporary than recognized at the time making its erosion to a deficit of more than 8 percent of GDP in 1993 less surprising. Although at the end of the 1980s, it was generally recognized that the U.K. economy was overheated, the main policy concerns at the time focused on rising inflation. Fiscal policies then looked toward a balanced public account while, with hindsight, further consolidation would have been appropriate.

This swing in the government finances over the period 1988/89-1992/93 is only partly explicable by the recession, as Section III shows. 1/ To shed further light on this issue we look at the changes in revenues and expenditures for factors contributing to the emergence of the significant fiscal imbalance. The conclusion is that about two thirds of the

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1/ In this section figures refer to budget years following national convention. To facilitate cross-country comparison, estimates of the structural imbalance are presented on a calendar year basis.

deterioration in the fiscal position was due to an increase in expenditures, largely reflected increases in noncyclical spending. A fall in revenue as a proportion of GDP also contributed to the worsening in the fiscal imbalance, reflecting a cyclical erosion in the tax base, and changed corporate tax regulations and a reformed national insurance system.

a. Revenue

Government revenue rose sharply in the first years of the 1980s reflecting both a buildup in oil revenue and the increase in the VAT rate from 8 percent to 15 percent. Non-oil revenue peaked at 39 percent of GDP in 1981/82. Thereafter, it declined somewhat in the period to 1985/86 reflecting mainly lower income tax rates and despite economic growth above potential. Falling oil prices put further pressure on general government revenue in the period to 1988/89 when the overall ratio fell to 39½ percent. The revenue ratio fell to 37½ percent in 1992/93 (see Table 7 below), the major part of the fall being in non-oil revenue.

The fall in revenue in recent years was in large part attributable to declining corporate tax receipts which went from an historically high level of 4 percent of GDP in 1989/90 to 2½ percent of GDP in 1992/93. This fall was partly a cyclical phenomenon reflecting the high sensitivity of corporate profits to economic activity. However, it also reflected certain one-time factors connected with the corporate tax reform of 1984 which had a large impact on collections as profits began to decline in the recession. Moreover, the lowering of corporate tax rates from 35 to 33 percent and the extension of loss carry-forward provisions from one to three years, has also reduced the corporate tax take over the past two years. Although the 1992 budget introduced a 20 percent income tax band, the revenue implications of this shift were partially offset by higher excise taxes and changes to the basic rate limit and other allowances. 1/ The impact of these and earlier changes in tax law are summarized in Table 6.

Despite the downward trend in non-oil revenue since 1981/82, the tax burden appears largely unchanged when compared over the slightly longer period 1980/81 to 1991/92, two years which are broadly comparable on a cyclical basis. The large aggregate tax increases in the early years of the conservative government were in part used to fund reductions in income tax rates and other structural adjustments.

Table 7. Taxes and Social Security Contributions 1/
(Percent of GDP)

	1988/89	1989/90	1990/91	1991/92	1992/93
Total taxes 1/ and social Security contributions	37½	37	36¾	36	34½
of which:					
Income tax	9¼	9½	10	10	9¼
Corporation tax	4	4¼	3¾	3¼	2½
VAT	6	5¾	5½	6¼	6¼
Excise duties 2/	4¼	4¼	4	4¼	4¼
Social security and contributions	7	6½	6½	6¼	6
Community charge/ council tax and rates	4	4	2	1¼	1½
Memorandum item					
General government revenue	39½	39¼	39¼	38½	37

Source: Financial Statement and Budget Report, March and November, 1993.

1/ National accounts definitions, including community charge/council tax.
2/ Including vehicle excise duty.

1/ The 1993 budget was largely revenue neutral for fiscal year 1993/94.

b. Expenditures

The improvement in the United Kingdom's fiscal position in the 1980s was achieved through a substantial cut in the ratio of general government expenditure to GDP that, together with buoyancy in on-shore tax collections more than offset the loss in North Sea oil revenues. Expenditures (excluding privatization receipts) were reduced to a low of 39¼ percent of GDP in 1988/89. Debt interest and defense expenditures were the main categories contributing to the decline in the overall expenditure ratio. Capital spending was also cut sharply over the period.

From 1988/89, however, the government expenditure ratio rose steeply, to 44¾ percent in 1992/93. 1/ This increase mainly reflected the rise in "control total" or non-cyclical spending. 2/ Cyclical spending--for example unemployment benefits and income support--also increased, to about 2¼ percent of GDP in 1992/93, but only accounts for a small proportion of the rise in overall spending (see Table 8).

Among the various government functions, noncyclical social security spending increased most, by 2 percent of GDP, reflecting increases in real pension costs of about 3 percent a year over the period. Spending on health, education, and protective services also increased more quickly than

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1/ According to the November 1993 Financial Statement and Budget Report, spending will peak at 45 percent of GDP in 1993/94, well below the 47 percent reached at the trough of the last recession. Owing to ambitious spending targets in the budget, the spending ratio would fall to 41 percent by decade-end.

2/ The control total concept was introduced in the 1992 Autumn Statement as a replacement for the planning total. The advantage of the control total concept is that it excludes most cyclical spending as well as debt interest payments which should allow for tighter spending controls.

income over the past five years while debt interest payments declined to less than 3 percent of GDP in 1990/91 where they remained through 1992/93.

Table 8. General Government Expenditure
(Percent of GDP)

	1988/89	1989/90	1990/91	1991/92	1992/93
Total 1/	39.3	39.7	40.1	42.0	44.7
By selected function					
Law, order, and protective services	4.6	4.8	4.8	5.1	5.4
Health	4.8	4.8	5.0	5.4	5.8
Education	4.6	4.8	4.8	5.1	5.4
Social security	10.5	10.3	10.7	12.0	12.4
Of which: Cyclical unemployment and income support	1.5	1.3	1.4	1.9	2.2
Debt interest	3.9	3.6	3.3	2.9	2.8
By selected economic category					
Pay	11.4	11.2	11.6	11.9	--
Grants to private sector	11.1	11.0	11.5	12.9	14.1

Source: Public Expenditure Analysis to 1995-96 statistical supplement to the 1992 Autumn Statement; Financial Statement and Budget Report 1993, Financial Statistics.

1/ Excluding privatization.

During this period public sector wages rose as evidenced by the rise in total public sector pay even though the number of employees declined slightly. In the first half of the 1980s, however, as expenditure growth was reduced, average earnings in the public sector did not keep up with earnings in the whole economy. This pattern was reversed beginning in 1987 as some catch up relative to the private sector occurred. The rise in public spending over the past five years represented a rebound from the low levels of spending following the tight policies adopted in the early 1980s. As indicated above, there have been sizable expenditure increases on health, education, and transport in particular, that mainly reflect public demands for increases in these services from earlier levels.

V. Conclusions

It should be stressed that although the emphasis in the paper has been on the sources of fiscal deterioration, it is important to acknowledge the steps which the authorities in each country have taken to rectify this. Policy initiatives of various sorts have been taken in each of the countries reviewed here to consolidate the medium term fiscal position.

In spite of the well known difficulties in defining and estimating structural deficits, this paper has aimed to illustrate the usefulness of such fiscal indicators in a period of rapid change to fiscal balances. The detailed account presented here shows that--to some extent--each country had special factors underlying the changes in the structural part of their accounts. This is most obvious in the case of Germany where large fiscal changes were the result of reunification, which was a "one-off" fiscal change, although its effects may be long lasting. Italy also stands apart in terms of the key factor in its overall fiscal deterioration. In this case the outstanding feature is its interest payments on a huge debt ratio; as noted several times in the text, the Italian primary accounts are presently in surplus.

In each of the two other countries, France and the United Kingdom, there has been a very serious worsening in structural balances, and some parallels can be drawn between them. What is common is that in both France and the United Kingdom structural worsening emerged during the boom at the end of the decade, when masked by cyclically buoyant net revenues during the boom, and was difficult to counteract as the economies contracted. Although some commentators at the time recognized that the overall fiscal position was substantially affected by the economic cycle, nonetheless it was difficult to estimate the scale of the structural worsening that was then in train.

The United Kingdom, in spite of the loss of revenue from North Sea oil, the lower tax rates and shrinking tax bases introduced in the tax reforms of the second half of the 1980s did not lead quickly to overall deficits, because of the strength of the boom. In France, a similar pattern emerged although here the problem was that the authorities had adopted a policy rule which did not enable the opportunities presented by the cyclical upturn to reduce structural deficits. Consequently, France still had a substantial overall deficit at the height of the boom.

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