

**ECONOMIST
IMPACT**

Balancing government budgets amid uncertainty

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Acknowledgments

Balancing Government Budgets Amid Uncertainty is an Economist Impact report, sponsored by Saab AB. It explores the government budget during times of uncertainty and the implications of budget decisions. The report is based on a desk research, expert interviews and a survey on 104 public officials and policymakers across Australia, Belgium, Canada, France, Germany, Italy, Poland, the UK and US. The survey was conducted between September and October 2022.

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- **Cinzia Alcidi**, Director of Research, Centre for European Policy Studies
- **Brian Finn**, Senior Policy Analyst, OECD
- **Stewart McDonald**, UK House of Commons MP and Shadow SNP Spokesperson (Defence)
- **Ivan Miklos**, former Minister of Finance for the Slovak Republic
- **Jacek Rostowski**, former Deputy Prime Minister for Poland

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Executive summary

The current geopolitical context has impacted both national economies and the global economy across numerous channels. Recent shocks, including the Covid-19 pandemic, the war in Ukraine and rising US-China tensions, have impacted households, businesses, governments and intergovernmental relations. Colossal government fiscal responses have been required over the past two years to address the implications of these shocks. All of which will have long-lasting effects for not only governments' ability to overcome these crises but also future shocks. The following is a summary of the research findings.

- **The past three years have given rise to a series of shocks that had vast geopolitical and economic ramifications.** The vast ramifications have led to a significant increase in tensions placed on government budgets. Governments have responded to shocks on an unprecedented scale—borrowing and spending heavily—significantly compounding their deficits, as support was rapidly funnelled to households and businesses to alleviate the immediate consequences of the crises.
- **Traditional government budgetary processes have been upended in response to recent geopolitical shocks, leading to more agility but less transparency.** Governments have tabled successive rounds of budgets, granted extraordinary spending power to executive offices and relaxed the limits on borrowing. This has provided more flexibility by providing executive branches of government with different spending mechanisms. But recent changes have also provided less transparency because of reduced legislative oversight of the budgetary process.
- **Reacting to geopolitical shocks has led governments to finance untargeted spending priorities and higher budget deficits.** Survey results indicate that governments' fiscal strategies during times of uncertainty are predominantly reactionary and focused on the short term, with little evidence from expenditure figures of pursuing longer-term priorities to enhance growth and productivity.



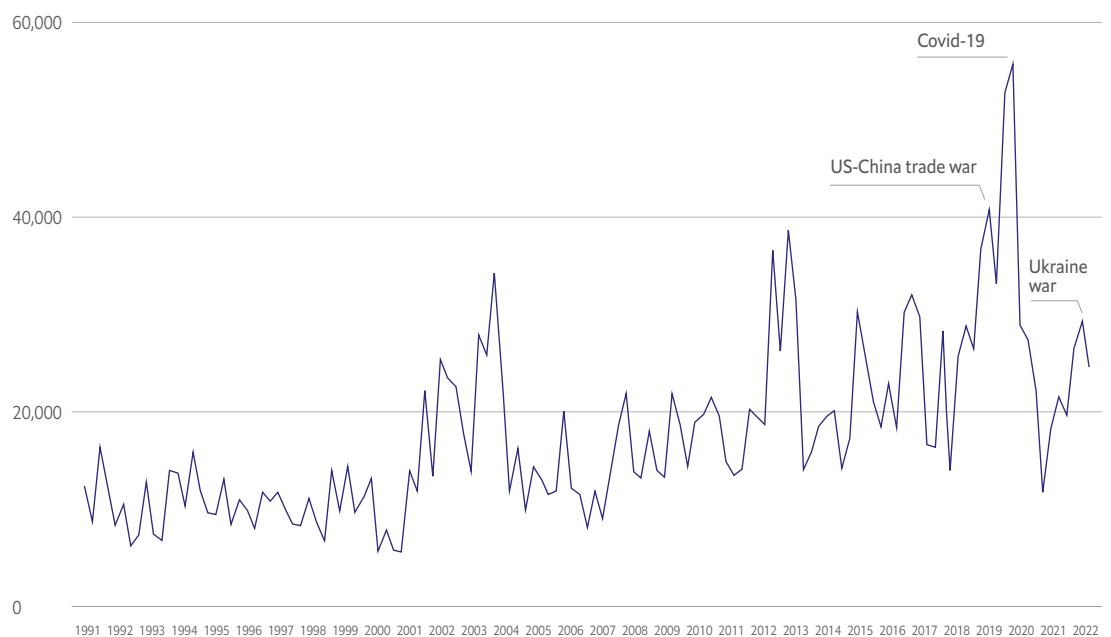
- **Governments are aligned in their ambition to achieve greater economic growth. But without a defined and targeted strategy, this ambition may not transpire.** Survey findings indicate that economic growth has been a priority for governments over the past two years, and will remain the primary objective in the next two years. To achieve this, governments should factor in productivity-enhancing reforms to stimulate economic growth alongside targeting other priorities such as reducing the budget deficit, which will calm markets and reduce the debt servicing burden.
- **While domestic considerations are important, governments should consider a more balanced approach on international priorities.** International alliances play an important role in fostering and maintaining open economies. With the economic benefits that having a more international focus brings, governments should not neglect this area of spending.
- **Shocks are likely to become more frequent. There is a need to build resilience into government budgets to cope with future stresses.** Measures of uncertainty highlight that shocks have become omnipresent over the past three years. As this trend is likely to continue, governments need to enhance their resilience to combat future shocks. Examples include setting up counter-cyclical funds to provide short-term relief for the next crisis without having to shift spending priorities.

Chapter one: How governments are responding to shocks

Measures of global uncertainty are on the rise and have been for some time. The World Uncertainty Index (WUI)¹ a quarterly measure of uncertainty across 143 countries confirms this trend as the data shows that shocks have

become more frequent and persistent in the past decade.² More recently, the past three years have given rise to a series of shocks that have had vast geopolitical and economic ramifications, from Covid-19 to the war in Ukraine.³

Figure 1: World Uncertainty Index



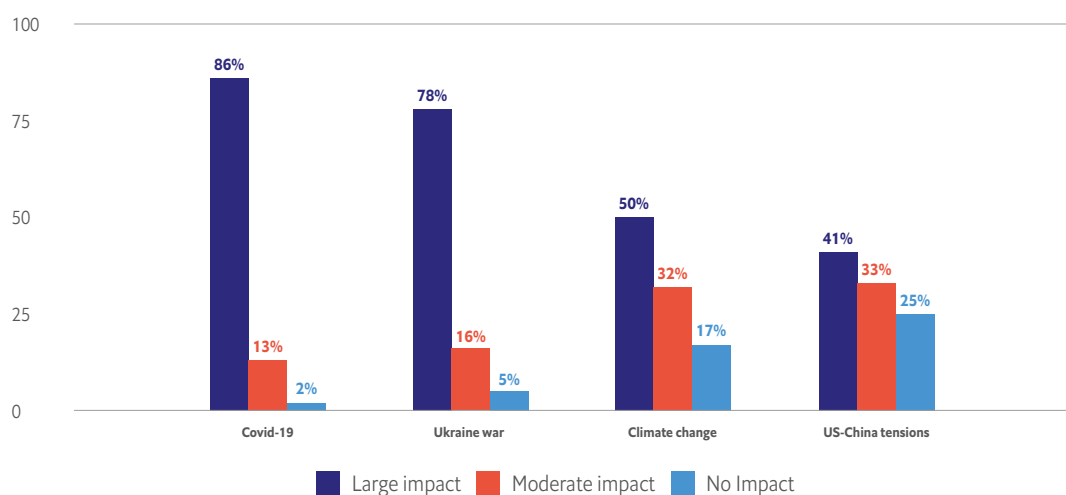
Source: Ahir, H, N Bloom, and D Furceri (2018), "World Uncertainty Index", Stanford mimeo.

¹ Measuring uncertainty by text mining Economist Intelligence Unit's country reports.

² <https://hbr.org/2022/09/visualizing-the-rise-of-global-economic-uncertainty>

³ <https://www.imf.org/en/Blogs/Articles/2022/04/15/global-economic-uncertainty-surging-amid-war-may-slow-growth>

Figure 2: To what extent have the following global events impacted government budget priorities over the last two years?



Source: Economist Impact Survey, October 2022

While the origins and impacts of geopolitical shocks are different in nature, the associated uncertainty has far-reaching effects on economic, social and national security. The effects stemming from uncertainty have obstructed national governments' ability to conduct effective fiscal policy, with fiscal policymakers now focused on responding to these events rather than focusing on broader economic and societal trends.

More specifically, the ongoing climate has shed light on several implications for government spending during times of geopolitical uncertainty. These implications can be categorised in the following ways: revenue concerns (tax receipts and related borrowing); expenditure concerns (public expenditure); and fiscal space (agility when responding to unpredictable and unprecedented shocks).

An Economist Impact survey of fiscal policymakers highlighted how the three most

recent shocks identified by the WUI – US-China tensions, the Covid-19 pandemic and the war in Ukraine – have had a moderate to large impact on revenue, expenditure and time concerns, alongside more entrenched global issues such as climate change. However, all shocks have different implications and therefore require different solutions, placing huge tensions on government budgets.

Implications of US-China tensions on government budgets

US-China tensions have had spillover effects leading to global fragmentation. Over 73% of respondents from European countries stated that US-China tensions had a moderate to large impact on their government budgets⁴, confirming this trend.

Revenue concerns have been confirmed by the International Monetary Fund (IMF), which found that uncertainty around trade policy, stemming from fragmentation, led to a 1%⁵ reduction in

⁴ Economist Impact survey, 2022

⁵ <https://www.imf.org/en/Blogs/Articles/2022/05/22/blog-why-we-must-resist-geo-economic-fragmentation#:~:text=Tensions%20over%20trade%2C%20technology%20standards,percent%2C%20according%20to%20IMF%20research.>

global GDP. But, the consequences are even more severe due to increased protectionism, lower levels of investment and productivity losses linked to fragmentation. Remaining open helps to increase competitiveness, through the adoption of new technologies and access to skilled labour. Furthermore, increasing the size of markets that can be served also increases countries' competitiveness.

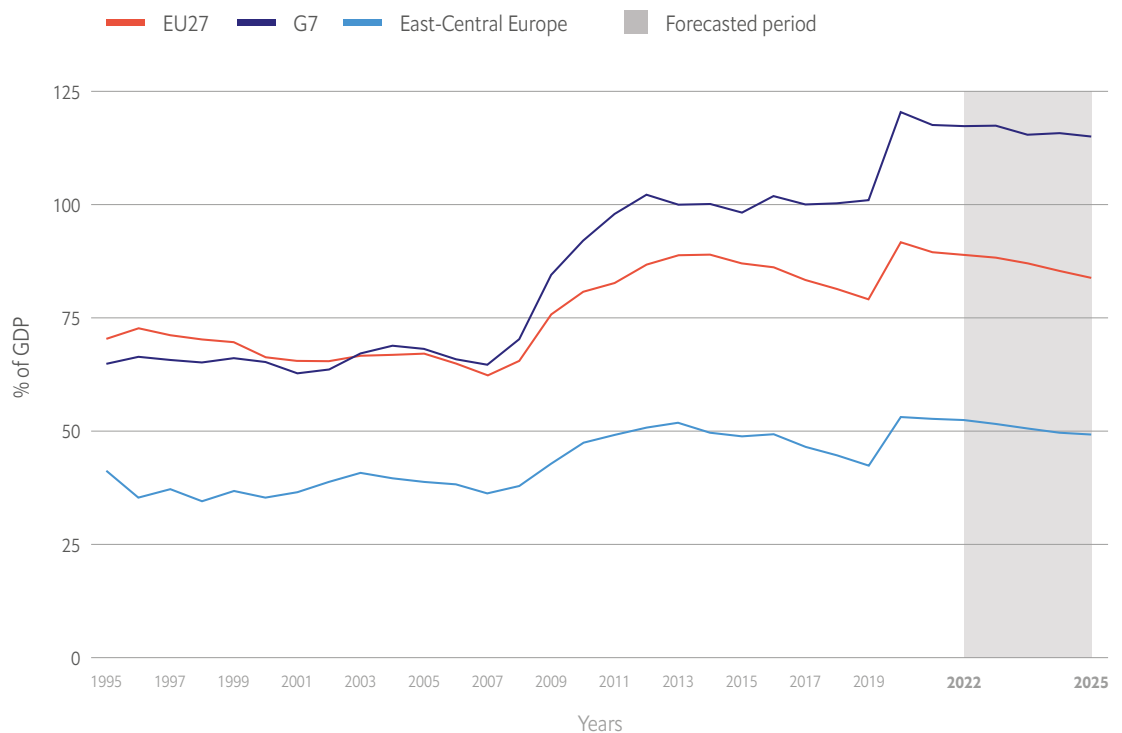
Increased protectionism and domestication as a result of fragmentation also led to **expenditure concerns**. For example, increased investment from the US and European Union (EU) to build up domestic industries, particularly in sensitive areas like semiconductors, as seen in the EU Chips Act (US\$11.5bn in public investment⁶) and the US's Chips and Science Act (US\$280bn in funding⁷). This is additional public spending that cannot then be allocated to other government priorities.

Concerns around fiscal space as a result of US-China tensions were less of a concern for governments as the immediate impact was placed on businesses. Many businesses, both inside and outside of China and the US, had to alter their strategies and operations because of these tensions. This highlights that the effects of the shock vary depending on the event.

Implications of the Covid-19 pandemic on government spending

The magnitude and duration of the Covid-19 pandemic has had short- and long-term fiscal implications for national governments. Survey results align with these trends as 85% of policymakers and government officials suggested that the Covid-19 pandemic and subsequent supply chain disruptions had a large impact on government budgetary priorities over the last two years.⁸

Figure 3: Debt to GDP levels (1995-2026)



Source: Economist Intelligence Unit

⁶ https://ec.europa.eu/commission/presscorner/detail/en/qanda_22_730

⁷ <https://www.cov.com/en/news-and-insights/insights/2022/08/significant-funding-and-tax-credit-opportunities-in-the-chips-and-science-act>

⁸ Economist Impact Survey, 2022

The pandemic initially caused severe **revenue implications** for governments across Europe as lockdowns precipitating the shutdown of business activity led to a fall in tax revenue. Global statistics reveal that 94% of Fortune 1000 companies saw supply chain disruptions, 75% of companies have had negative or strongly negative impacts on their businesses and 55% of companies planned to downgrade their growth outlooks (or have already done so).⁹

The pandemic also led to serious **expenditure implications** for all governments. Many states in Europe reallocated public funding to crisis priorities—strengthening healthcare systems, buttressing small and medium-sized enterprises, protecting populations at risk and focusing on regions explicitly hit by the crisis. Furthermore, two thirds of OECD countries loosened fiscal limits, leading to further borrowing.¹⁰ For example, the EU suspended Stability and Growth Pact (SGP) spending limits, allowing governments to deviate from the set spending rules. Coupled with an expansion in counter-cyclical fiscal policy, funded through borrowing, government debt increased significantly.¹¹

Average sovereign debt-to-GDP ratios grew by 19% in 2020, from 2019 levels, across G7 economies. Despite relatively lower levels of indebtedness, debt-to-GDP ratios jumped by 11% across Central and Eastern European (CEE) countries, over the same period.¹²

With the need to act swiftly and decisively on policy to support economic recovery and health, governments also faced **fiscal space and operational pressures**. Flexibility and responsiveness were handled differently across Europe, with some countries undergoing

successive rounds of budget bills, while others granted exceptional spending power to executive authorities.¹³ Most countries attempted to fast-track spending abilities to ministries and departments beyond what would normally be required by national legislation.¹⁴

Implications of the Ukraine conflict on government spending

At a time when governments were reducing their high legacy deficits from Covid-19, the war in Ukraine triggered additional economic and geopolitical problems, placing further pressure on government budgets. The majority of respondents (79%) stated that the war in Ukraine had a large impact on government budgets.¹⁵

Pressure on governments persisted on the **revenue** side, despite broad increases in government tax revenue in 2021 as a result of the strong rebound in growth and productivity as lockdowns eased. Because of the conflict, Europe's growth is expected to slow due to supply disruptions, particularly in energy.¹⁶

Central banks are now increasing interest rates to target mounting inflation, so debt sustainability now poses a concrete threat to public finance sustainability. Overall debt levels remain high—117.5% and 52.7% of GDP in 2021 across G7 and CEE countries, respectively¹⁷—as governments manage the high borrowing levels of the Covid-19 pandemic. Supply-side issues stemming from the conflict are also hindering growth.

Governments across Europe are incurring additional **expenditure** to protect vulnerable households and businesses from the cost-of-living crisis. Primarily this stems from price spikes

⁹ <https://www.accenture.com/be-en/insights/consulting/coronavirus-supply-chain-disruption>

¹⁰ <https://www.oecd.org/coronavirus/policy-responses/territorial-impact-of-covid-19-managing-the-crisis-across-levels-of-government-d3e314e1/>

¹¹ <https://www.oecd.org/coronavirus/policy-responses/tax-and-fiscal-policies-after-the-covid-19-crisis-5a8f24c3/>

¹² The Economist Intelligence Unit, 2022.

¹³ <https://www.oecd.org/coronavirus/policy-responses/government-financial-management-and-reporting-in-times-of-crisis-3f87c7d8/>

¹⁴ <https://www.oecd.org/coronavirus/policy-responses/government-financial-management-and-reporting-in-times-of-crisis-3f87c7d8/>

¹⁵ Economist Impact survey, 2022.

¹⁶ <https://www.eib.org/en/stories/ukraine-trade-inflation#:~:text=Real%20economic%20growth%20in%20the,the%20European%20economy%20into%20recession.>

¹⁷ The Economist Intelligence Unit, 2022.



in energy and food, with Russia and Ukraine being major suppliers of these goods. Governments have introduced non-targeted price control measures¹⁸ while disbursing some level of income support.¹⁹ For instance, Germany announced its largest package thus far, amounting to nearly US\$210bn “economic defence shield” to tackle rising gas prices.²⁰ Similar to the Covid-19 pandemic, governments have acted to funnel support to households and businesses outside of the traditional budget calendar.

With the rise of geopolitical tensions, security and defence considerations also pose significant operational and fiscal space concerns. EU governments and NATO members have committed to increase their defence spending to meet the NATO target of 2% of GDP, with some pledging amounts beyond this commitment.

But, as Stewart McDonald, SNP Defence Spokesperson in the UK House of Commons stated, countries will need to “spend money to replenish weaponry stocks because of the support provided to Ukraine”. So, more than 2% of GDP may be required. Survey respondents believe their defence spending increases will persist for the next two to three years. Whether this surge in defence spending will be financed by tax increases or additional borrowing remains uncertain, particularly in the face of tensions placed on budgets from other shocks. However, geopolitical shifts in country relationships post-war are likely to continue, as the Economist Intelligence Unit (EIU) predicts that the war will become protracted as the issues at stake are existential for both sides.

¹⁸ Price control measures include reduced electricity charges, network fees, VAT

¹⁹ <https://www.oecd.org/ukraine-hub/policy-responses/why-governments-should-target-support-amidst-high-energy-prices-40f44f78/>

²⁰ <https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices>

Chapter two: Government spending priorities during times of uncertainty

Traditional government budgetary processes have been upended in response to recent geopolitical shocks, leading to more agility but less transparency.

The global rise in uncertainty has considerably altered the traditional conduct of government budgeting. To be able to tackle shocks with agility, governments have evolved their systems, which include not only deviating from the traditional budget calendar but also relaxing limits on borrowing and creating further flexibility by providing executive branches of government with different spending mechanisms. Governments believe these new systems provide them with more tools to meet the immediate needs of households and corporations.

Both G7 and CEE countries have deviated from the fixed budget calendar, the macroeconomic forecasts calendar and the allocation of resources to specific programmes over the last two years. These have taken the form of successive supplementary budget bills (mini-budgets); granting exceptional spending powers to executive cabinets; or using resources from extra-budgetary funds.²¹ Sweden, for

example, tabled successive budgetary bills for parliamentary approval, while the UK granted the government prior authorisation for expenditures in advance of parliamentary scrutiny.²² These enhanced flexibility measures were introduced to enable governments' immediate response to ensure the stability of their society and national economy during times of uncertainty.

To complement this additional fiscal space, extra-budgetary measures—general government transactions with separate banking and institutional arrangements that allow for exclusion from the annual state budgets—were also implemented. Hungary set up the Economy Protection Fund directed at supporting its economy and job market. The Polish government also channelled huge amounts of expenditure through extra-budgetary funds, such as the additional liquidity available for businesses through the Polish Development Fund. These measures not only provide a way to avoid the appearance of budget deficit increases²³ but are also subject to minimal parliamentary scrutiny, thereby providing executive branches of government with greater flexibility.²⁴ Ultimately, however, they have succeeded only in increasing confusion

²¹ <https://www.oecd.org/coronavirus/policy-responses/government-financial-management-and-reporting-in-times-of-crisis-3f87c7d8/>

²² <https://www.oecd.org/coronavirus/policy-responses/government-financial-management-and-reporting-in-times-of-crisis-3f87c7d8/>

²³ <https://www.imf.org/external/pubs/ft/tnm/2010/tnm1009.pdf>

²⁴ Jacek Rostowski, Economist Impact Expert Interview 2022

and obfuscation due to a reduction in the transparency of the budget process.

Europe-wide measures have also facilitated flexibility in spending. Since the Covid-19 pandemic, the EU has suspended the Stability and Growth Pact (SGP)—the EU’s rules on fiscal spending—enabling Member States to borrow more on markets and increase both their deficit and debt levels. The measure has been carried forward into the Ukraine conflict, with the EU Commission extending the moratorium on EU SGP fiscal rules until the end of 2023.²⁵ This has allowed, and will continue to allow, Member States across the EU to increase borrowing to meet societal and economic needs in the short-term as they contend with higher inflation, specifically energy and food costs. Comparisons with the 2008 global financial crisis reveal that the added flexibility in government spending has allowed governments to deliver large response packages more quickly.²⁶

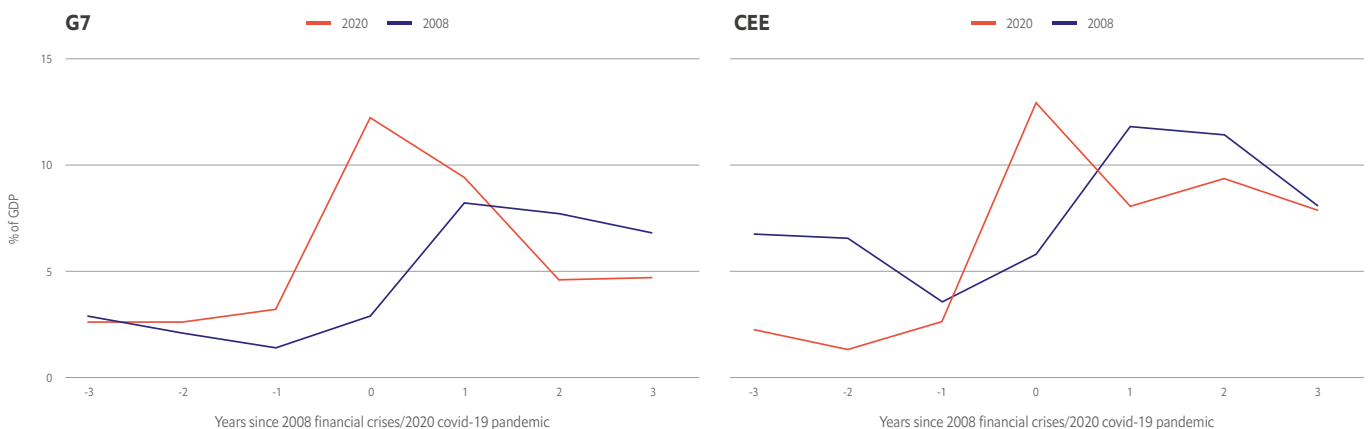
Flexibility in government spending has shown to be essential during times of crisis to channel support to affected households and businesses effectively. While this is critical, it does reduce

transparency as markets cannot comfortably predict future government spending. Furthermore, according to Jacek Rostowski, former Minister of Finance for Poland, there has been no tendency to reverse the flexibility model once it has been introduced into the system, as in the EU SGP case.²⁷ Maintaining these alternative budgetary processes may lead to higher deficits and, therefore, debt to GDP levels, as governments use them routinely to respond to future shocks. Higher debt levels can only reduce governments’ ability to respond to future shocks. So, decisions around the budgetary process should factor in a longer-term perspective, focusing on increasing their credibility with creditors as to the management of the debt burden over time.

Governments are focusing their spending on domestic priorities and in reaction to shocks. This leads to untargeted spending and higher budget deficits.

Survey results indicate that governments’ fiscal strategies during times of uncertainty are predominantly reactionary and focused on the

Figure 4: G7 vs CEE Public sector net borrowing before and after the 2008 financial crises and the covid-19 pandemic



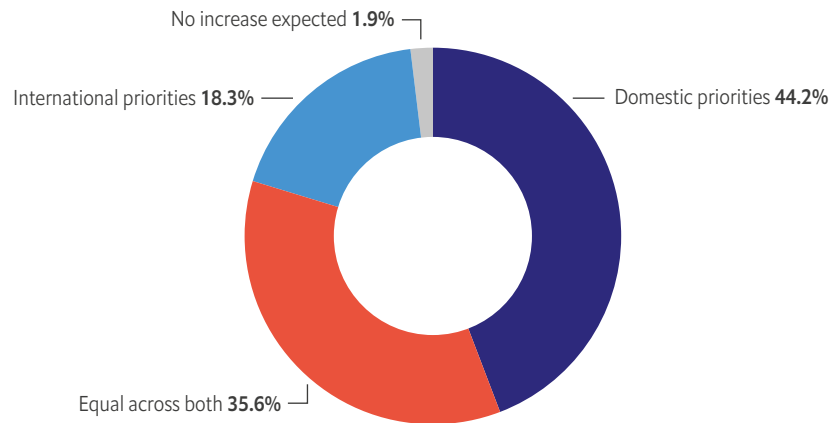
Source: Economist Impact calculations, based on the Economist Intelligence Unit

²⁵ <https://www.bloomberg.com/news/articles/2022-05-19/eu-to-extend-suspension-of-fiscal-rules-until-end-of-next-year>

²⁶ Economist Impact calculations, based on data from the EIU and OECD

²⁷ Jacek Rostowski, Economist Impact Expert Interview 2022

Figure 5: Will domestic and international priorities see a greater percentage increase in government spending over the next two years to overcome the effects of recent global events?



Source: Economist Impact Survey, October 2022

short term, with little evidence from expenditure figures of pursuing longer-term priorities. Trends from past crises confirm this as governments expand spending during crises, particularly on social protection, and scale back as the economy recovers.^{28,29} In these cases, the welfare state (spending on social protection) can act as an effective automatic stabiliser,³⁰ reflecting its counter-cyclical objective.

Evidence from the Economist Impact survey of policymakers shows that governments have drastically increased spending in response to recent crises. The majority of survey respondents also highlight that government spending within these functions is expected to last three years or longer, with the only exception being development aid. As such, high deficit and debt levels are expected to remain for some time.

Global government debt is now projected to be 91% of GDP in 2022, which is around 7.5

percentage points above pre-pandemic levels.³¹ Now confronted with a global food and energy crisis, government spending, particularly in Europe, is only intensifying. Germany has nationalised Uniper, its biggest gas importer; France is capping energy prices and has nationalised EDF, an electric utility company; while the UK may borrow as much as 6.5% of GDP to cap energy prices.³² If governments do not reign in spending, government budgets will come under mounting pressure due to the high cost of servicing debts.

Significantly, governments are also looking inward, placing more importance on domestic priorities compared with international ones. According to Economist Impact's survey of public officials and policymakers, 42% of respondents suggested a greater attention to domestic priorities, compared with 18% of respondents pointing to international priorities. The largest spending items during the peak of the Covid-19 pandemic in 2020 across G7

²⁸ http://real.mtak.hu/89355/1/EJES2018_0902_ORO.pdf

²⁹ Economist Impact calculations, based on EIU data

³⁰ http://real.mtak.hu/89355/1/EJES2018_0902_ORO.pdf

³¹ <https://www.imf.org/en/Publications/FM/Issues/2022/10/09/fiscal-monitor-october-22>

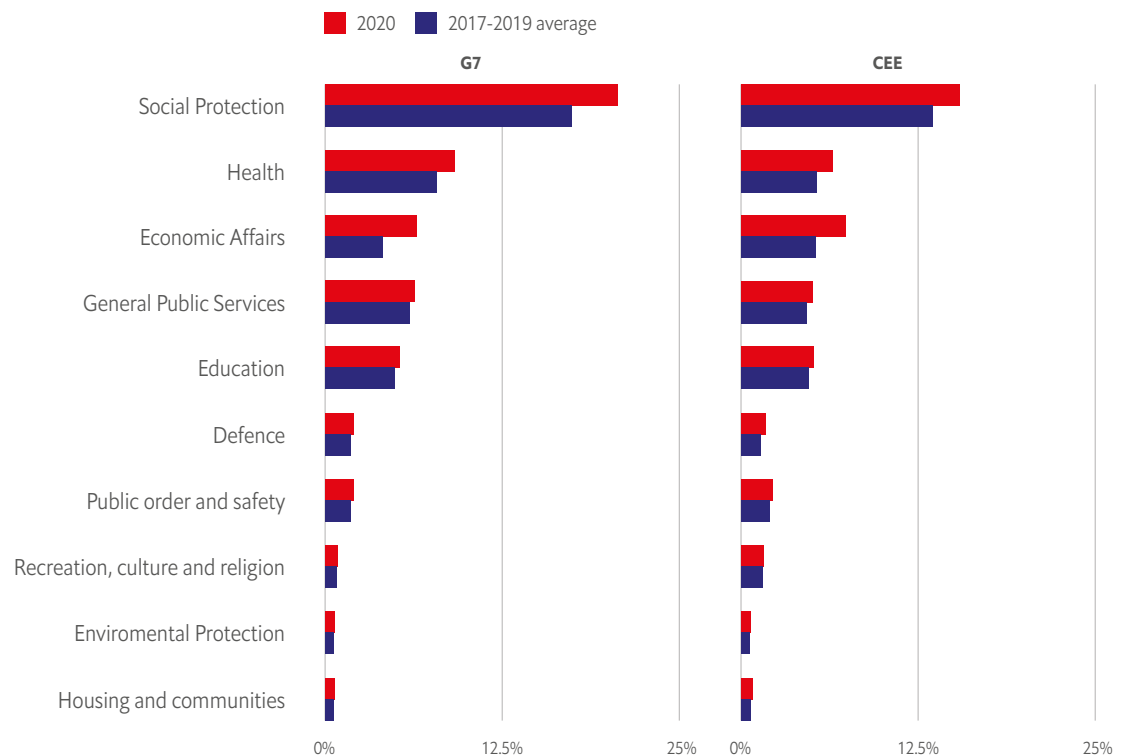
³² <https://www.economist.com/special-report/2022/10/05/inflation-and-rising-demands-on-governments-are-changing-economic-policy>

countries were social protection (20.5% of GDP, 18% increase year-on-year), health (9.1% of GDP, 17% increase year-on-year) and economic affairs (6.4% of GDP, 59% increase year-on-year).³³ Similarly, across CEE economies, priority expenditures were on social protection (15.3% of GDP, 14% increase year-on-year), economic affairs (7.3% of GDP, 40% increase year-on-year) and health (6.4% of GDP, 19% increase year-on-year). This reflects governments' priorities to respond to internal issues first through the delivery of fiscal firepower to keep impacted households and companies afloat.

Governments are aligned in their ambition to achieve greater economic growth. But without a defined and targeted strategy, this ambition may not transpire.

During times of uncertainty, economic growth seems to be the top priority for governments. Survey findings indicate that economic growth has been a priority for governments over the past two years, and will remain the primary objective in the next two years.³⁴ However, this focus is at odds with other priorities

Figure 6: Evolution of General Government Expenditure by function in G7 and CEE, 2017-2020

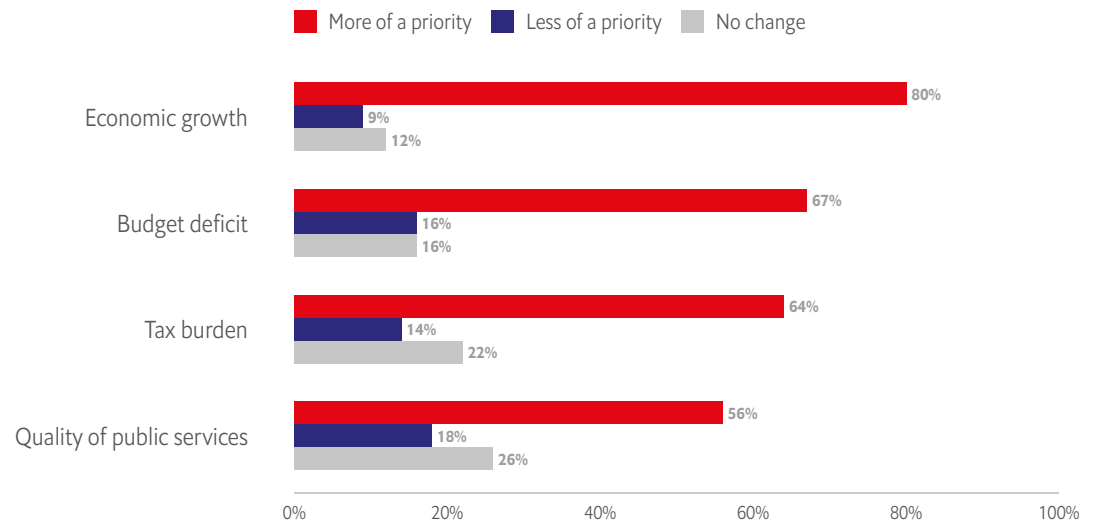


Source: Economist Impact calculations based on figures from OECD, average values

³³ Economist Impact calculations, based on EIU data

³⁴ Economist Impact Survey 2022

Figure 7: Over the past two years, have the following become more or less of a priority for your government?



Source: Economist Impact Survey, October 2022

policymakers have deemed important, including reducing the budget deficit, lessening the tax burden and improving the quality of public services.³⁵ These tensions raise questions about governments' ability to maintain current levels of public spending while targeting debt-reducing objectives.

Economic growth will be challenging with worsening macroeconomic conditions. Evidence from the survey suggests a lack of a coherent strategy to achieve economic growth, particularly in Europe. Survey results indicate that 67% of policymakers stated that reducing the deficit was a priority for their government. But the survey also showed that so were tax cuts (64% of respondents) and increasing the quality of public services (56% of respondents). This is representative of government policy at odds. A government is able to achieve two of these objectives at once, but not all three. A more strategic and targeted approach to today's budget priorities is required.

Scenario planning is one such approach. To be effective, it should factor in a credible medium-term plan, commit to more sustainable levels of public spending, align with monetary policy to address inflation concerns and target policies to increase productivity in the future.

Scenario planning should transcend political party ideology during this time of geopolitical uncertainty. Stewart McDonald, SNP Defence Spokesperson in the UK House of Commons, stated that "the UK's response in support of Ukraine has cross-party support, and this will remain until a positive outcome is achieved for the people of Ukraine."³⁶ Fiscal policymaking needs to be brought into this cross-party work, to coalesce around pragmatism, as it has been with countries' responses to the war in Ukraine. By doing this, spending priorities will have more consistency, thereby providing greater stability to households and businesses both in the short and long term.

³⁵ Economist Impact Survey 2022

³⁶ Stewart McDonald, Economist Impact Expert Interview 2022

Chapter three: Implications of crisis spending

Shocks are likely to become more frequent. There is a need, therefore, to build resilience into government budgets to cope with future stresses.

As shown by the WUI in Figure 1, shocks to the global economy have become more frequent in recent years. Adam Tooze, a distinguished historian, confirms this by stating we are living through a ‘polycrisis’.³⁷ The Economist Impact survey highlights the magnitude of each crisis that governments are faced with (see Figure 2). Economist Impact believes that shocks to the global economy will continue; but, owing to current strained budgets, how governments are likely to respond to future events and how they would want to respond may look very different, unless governments reduce their debt burden to build more resilience into government budgets.

The UK context has proved that unless governments show they have a good handle on debt and fiscal policy, the markets will rebel. The large, unfunded tax cuts from the UK’s ‘mini-budget’, drafted by former UK Prime Minister Truss in October 2022, put the UK’s macroeconomic framework under threat. So, further increases in any government deficits

without a plan to reduce them in the future only increases this instability.³⁸

Tensions will remain on government budgets for years to come. Governments need to take a longer-term approach to achieve better balance by factoring in growth and resilience.

With interest rate hikes to curb inflation, the cost of borrowing is increasing, making public debt more burdensome. Jacek Rostowski, former Minister of Finance for Poland, commented that advanced economies with lower debt-GDP ratios will be “well placed” to deal with the current crises. This is because the sharp rise in interest rates in the Eurozone is a real problem as debt service costs are rising,³⁹ meaning that much-needed finance for public services will instead go to servicing debt. The more capital that is used to pay old debts, the less capital governments have for future needs.

The survey shows that spending over the past two years has increased across all functional areas listed in the survey (see Figure 8). This is only increasing government deficits. Continuing to borrow and spend in untargeted

³⁷ <https://www.theatlantic.com/ideas/archive/2022/07/adam-tooze-chartbook-substack-newsletter-inflation-crisis/661467/>

³⁸ <https://www.bis.org/publ/work1028.htm>

³⁹ Jacek Rostowski, Economist Impact Expert Interview 2022

and contradictory ways will only mean that governments are spending more and more to service debt.

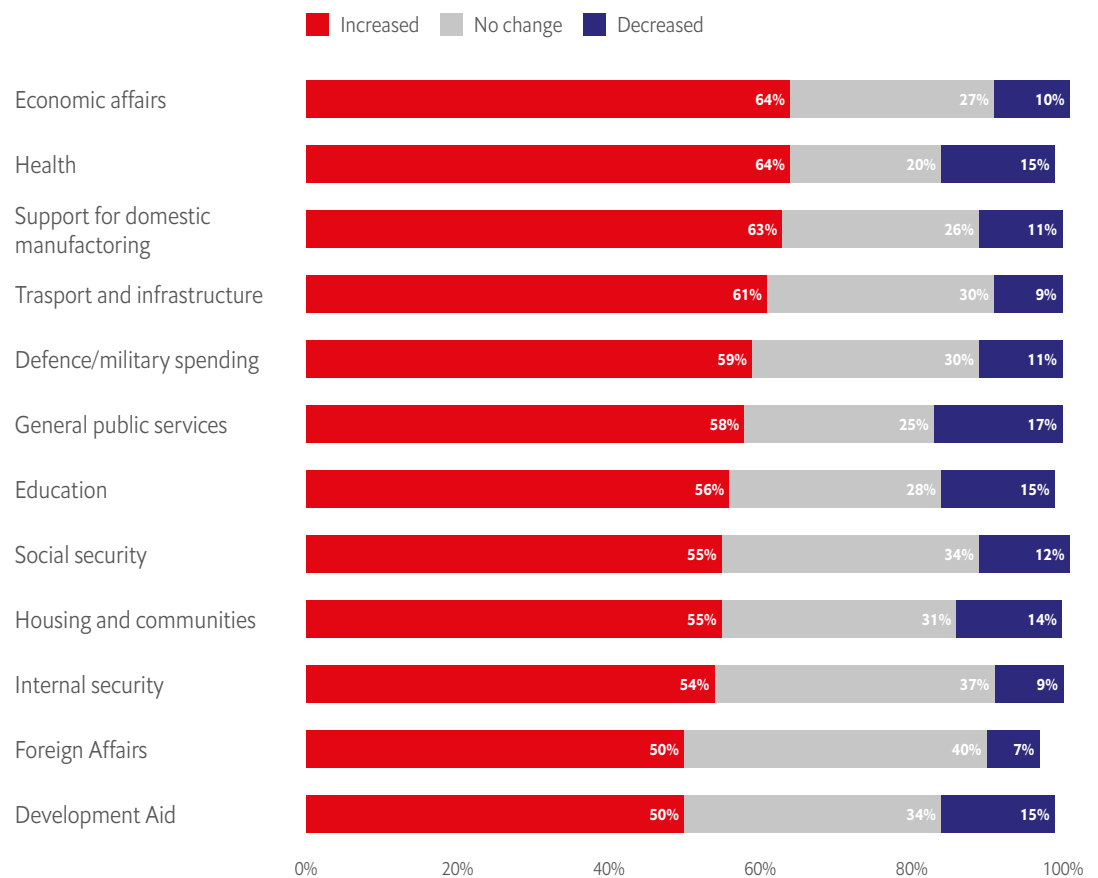
Borrowing either due to a lack of strategy or to put off the hard choices will not suffice. Ivan Miklos, former Minister of Finance for the Slovak Republic, commented that “there is a conflict between short-term political priorities, to spend, and medium- and long-term priorities, to have a healthy and sustainable public finance system.”⁴⁰ So, an emphasis on scenario planning that factors in trends rather than events would provide a longer-term approach to fiscal policymaking. This would provide more fiscal flexibility for governments

to respond to future crises, as an indebted society lacks this option. Economics, not politics, needs to be prioritised to ensure the future health of national economies.

Governments need to focus on productivity and, therefore, medium-term policies to achieve their objectives for economic growth and to build resilience to absorb future shocks and tensions on government budgets.

As Economist Impact’s survey highlights, economic growth is the top priority for fiscal policymakers. To achieve this, policymakers will

Figure 8: How has your government’s spending in the following budget areas changed over the past two years?



Source: Economist Impact Survey, November 2022

⁴⁰ Ivan Miklos, Economist Impact Expert Interview 2022



need to spend on areas that provide an increase in productivity and growth in the longer term. If spending is targeted in such a way, borrowing can be beneficial as further growth would help to reduce the debt in the medium to long term. Building deficits through borrowing is viable only when an economy is growing quickly and absorbing a lot of investment or when it contributes towards higher productivity in the future. However, Economist Intelligence Unit data shows that growth rates across Europe are not expected to be strong and, in some cases, will contract⁴¹ in the short term. The survey results show that borrowing, particularly in European countries, is being used to fund spending in response to shocks. If government priorities remain focused on the short-term, they are unlikely to solve the productivity challenges that many economies require in the medium term. Only a renewed focus on

improving productivity will support growth in the long term.

In light of priorities toward short-term needs, which will have less of an impact on economic growth, governments should not lose sight of trimming budget deficits.⁴² Brian Finn, an expert on expenditure frameworks at the OECD, supports this, stating, “countries with a record of fiscal prudence are the ones who were best able to respond to the recent crises as their track record and strong public finances allowed more flexibility.” All governments need to target their policies toward promoting medium-term growth to reduce the risk of pro-inflationary spending, which central banks are trying to tame. It would be a drastic oversight if governments continued to accumulate debt simply because of a lack of a medium-term strategy or to put off the hard choices.

Governments should also focus on setting up ‘rainy-day funds’ in light of assumptions that geopolitical shocks and uncertainty will become more commonplace in the foreseeable future. In Ireland, for example, had there not been the National Pensions Reserve Fund (which they liquidated to support banking institutions) their position would have been even worse in the aftermath of the 2008 financial crisis. The Irish government has learnt from this and now puts money into a ‘rainy-day fund’ to weather future shocks. Such funds will mean that governments deviate less from the longer-term objective of balancing the books or longer-term priorities.

To achieve economic growth, there is a need to take a more balanced approach to international vs domestic spending.

A consequence of the US-China tensions has been a rise in global fragmentation. Stemming from this has been a rise in protectionism and

⁴¹ https://viewpoint.eiu.com/analysis/article/892514872?utm_source=mkt-newsletter&utm_medium=email&utm_campaign=Intelligence-today-27/10/2022&utm_term=image&utm_content=anchor-4&mkt_tok=NzUzLVJJUS00MzgAAAGHt84EOAMes_Rl3TGTqr-zlZT8FrQhg6ihLt4QSQmPQy7i010QV-mRQfOOUMygqjvotvN-q70t9rfddpj0M1xjvjNj-UlCt1vkJcrHtcWbKnyvw

⁴² <https://www.imf.org/en/Publications/FM>

nations increasingly turning inward.^{43,44} Particular examples include US President Biden's pivot toward a domestic agenda over an international one and a focus on reshoring or friendshoring trade; European countries nationalising energy companies as is the case in Germany and France; and the UK's withdrawal from the EU. But retaining open economies and maintaining international alliances are central if governments want to prioritise economic growth, particularly for low and middle-income countries, such as those found in CEE.

Evidence shows that trade and market openness has consistently led to more prosperous economic growth,⁴⁵ creating new opportunities for workers, consumers and businesses. The most obvious case for openness can be seen after China joined the World Trade Organisation (WTO) in 2001. This led to an explosion in growth, going from the sixth- to the second-largest global economy and increasing its GDP 11-fold,⁴⁶ eliminating vast amounts of poverty within its borders. The positive effects were also felt outside of China, with benefits going to businesses across the globe. In 2000, the EU Chamber of Commerce in China represented 51 companies, now it represents over 1,700.⁴⁷ Not only China, but the rapid rise of the East Asian Tigers—Hong Kong, Singapore, South Korea and Taiwan—has been widely put down to the opening of their economies and increased integration.^{48,49} Whilst the Global North has already been through the developmental phase of their economies, continued openness will be necessary for further growth and productivity gains through the movement of labour, increased innovation and investment, and lower consumer prices.

As stated in chapter two, governments are increasingly turning inward by focusing more on domestic over international policies. But given the economic benefits of a more international focus, governments should not neglect this area of spending. International alliances play an important role in fostering and maintaining open economies. There is a fundamental relationship between economics and politics that alliances represent, with economic growth being a central aspect of many international alliances.⁵⁰ International alliances also help to reduce the effects of geopolitical shocks through the coordination of policy responses by member countries.

International alliances are also inherently linked to security issues. With the current geopolitical shocks involving both economic and security concerns, remaining open through various alliances would help to address numerous security concerns associated with these events. Stewart McDonald stated that, “you cannot have any other type of security, be it economic or social security, without first thinking about national security”. A focus on international alliances through defence, development, diplomacy or trade is essential to achieve countries' primary goal of economic growth. But as Stewart McDonald also stated, “countries need to ensure they have a strong economy and society in order for public support for international priorities to remain”. So, it is a symbiotic relationship and governments cannot neglect either domestic or international spending priorities. However, governments need to ensure that each provides good value for money and is subject to a rigorous impact analysis when determining their viability.

⁴³ <https://link.springer.com/article/10.1007/s11558-022-09468-y>

⁴⁴ <https://www.iisd.org/publications/iisd-trade-sustainability-review-volume-1-issue-3-july-2021>

⁴⁵ <https://onlinelibrary.wiley.com/doi/abs/10.1002/pa.2081#:~:text=The%20results%20confirm%20that%20a,increase%20economic%20growth%20by%200.365>

⁴⁶ https://www.wto.org/english/news_e/news21_e/acc_10dec21_e.htm#:~:text=The%20continued%20opening%20up%20and,to%20almost%20USD%2015%20trillion

⁴⁷ <https://www.globaltimes.cn/page/202112/1241173.shtml>

⁴⁸ <https://www.business-sweden.com/contentassets/c5d9f4d114f14219a3f0be9c3ac80145/the-rise-of-the-southeast-asian-tigers.pdf>

⁴⁹ <https://documents1.worldbank.org/curated/en/975081468244550798/pdf/multi-page.pdf>

⁵⁰ Link, A and Antonello, C. (2016). *Strategic Alliances: leveraging economic growth and development*. Routledge

Conclusion

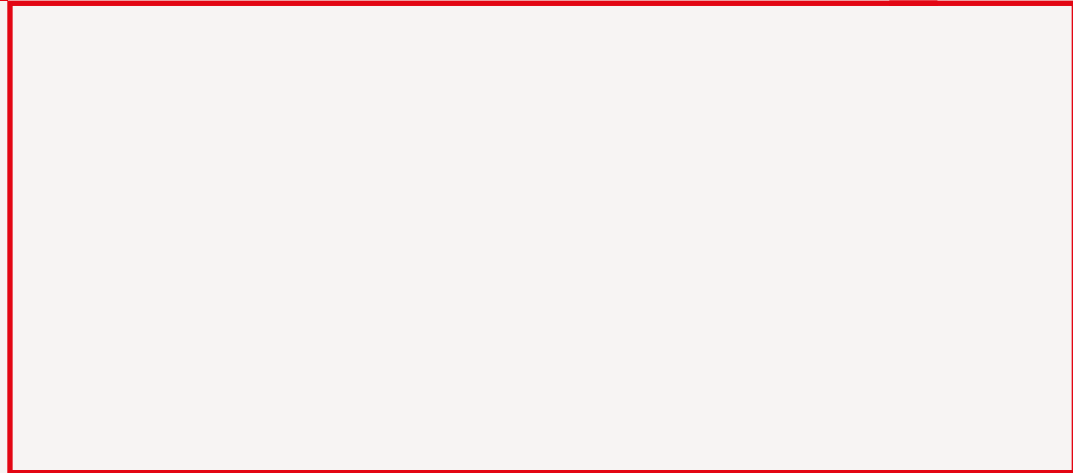


This report has highlighted the punishing objectives that governments have to balance: increasing resilience into government budgets by managing debt levels, continuing to build in automatic stabilisers to prop up vulnerable households and businesses, and focusing on increasing productivity in the medium term. These objectives are extremely difficult to achieve. But achieving them is critical if governments are to steer their countries through these challenging times.

Effective scenario planning that accounts for these objectives will help. Effective scenario planning would also quell market concerns about spiralling deficits, higher inflation and negligible economic growth. Quelling such concerns requires fiscal policy to align with monetary policy to reduce inflationary pressures. Alignment in these areas will help to highlight governments' credibility with markets. This would provide more fiscal space for governments to balance short-term relief with medium-term spending to increase productivity.

Scenario planning is also crucial for governments to maintain resilience for future shocks. Building in resilience will be central to this scenario planning as we are living in the age of polycrisis. As such, governments need to plan for today but also for future events. The recommendations included in this report, to have a renewed focus on managing debt levels; to have more targeted spending and to maintain international alliances are all central to building this resilience. Only governments that take a holistic view will be able to steer their economies through this time of uncertainty successfully.

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