Money for Nothing

Policy Exchange

Rules to secure the UK's fiscal solvency

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Executive Summary

The primary goal of the Coalition Government that came to power in May 2010 was to restore stability to the UK's public finances. Its founding Coalition Agreement went so far as to say that:

> *'deficit reduction, and continuing to ensure economic recovery, is the most urgent issue facing Britain'.*[1]

While its fiscal mandate to 'achieve cyclically adjusted current balance'[2] is still on course to be met, this is due to the fact that it is a rolling target, with the intended date put back to 2017/18.[3] The government's supplementary target is now formally going to be missed.[4] In non-technical terms, the UK government will both be spending more than it takes in, even excluding all borrowing for capital expenditure and with adjustments for the economic cycle, and have a debt burden rising faster than the economy grows, until 2017/18. Unlike the original projections, this leaves much of the work of deficit reduction to be completed after the present Parliament.

Given these realities, the UK's fiscal solvency has been called into question. The UK's credit rating has been downgraded by two of the three main credit agencies (while the remaining one, S&P, has it on negative outlook) and a fierce debate continues in both the academic and political arena as to the scope, speed, duration and composition of the government's fiscal consolidation programme. Given that further cuts across several departments will continue beyond the life of the current Parliament, there is an urgent need to address this issue. Businesses, households and financial markets need to be given confidence that the difficulties that have arisen in the public finances will be addressed and reassured that the institutions and procedures in place are sufficient to ensure it does not arise again. Without this, high tax rises, or painful spending cuts and wider impacts on growth may become a long-term prospect for the UK.

The problem – the UK borrows too much and repays too little

As shown in Figure 1, problems in the UK public finances are no new thing. Since modern records began in 1965, the UK will have run an overall deficit on the cyclically adjusted total budget balance – that is, borrowed more than it has taken in adjusted for the economic cycle – for 49 out of 53 years. It is clear that the UK has a propensity to run significant and ongoing budget deficits. The tendency towards 'booms' and 'busts' in public spending, and a failure to deliver a responsible fiscal path is a clear and long-term issue.

If government consistently takes in less revenue than it spends, it must borrow or print money to make up the shortfall. While this may be inevitable or necessary

1 'The Coalition: our programme for government' 2010, p. 15, www.gov.uk/government/uploads/system/uploads/attachment_data/file/78977/coalition_programme_for_government.pdf

2 Emergency Budget 2010, p. 1, webarchive.nationalarchives.gov.uk/20130129110402/cdn.hm-treasury.gov.uk/junebudget_complete.pdf

3 Budget 2013, p. 29, www.gov.uk/government/uploads/system/uploads/attachment_data/file/188357/budget2013_complete.pdf.pdf

4 Budget 2013, p. 29, www.gov.uk/government/uploads/system/uploads/attachment_data/file/188357/budget2013_complete.pdf.pdf

in the short-term, in the long-term mounting public debt causes serious problems for economic growth.

Since greater debt increases public expenditure on debt payments, this means less is available for social objectives or investment in growth-enhancing expenditure. Resources otherwise available for the private sector or public spending are consumed, lowering the productivity of the economy. Higher taxes to service the resulting interest payments and mitigate these effects can reduce economic activity, further weakening growth.

Carrying very high levels of debt also weakens to ability of government to employ countercyclical fiscal policy in the event of a downturn, as cutting taxes or raising spending cannot be done without incurring some or all of the effects outlined above. It is precisely this factor that played a major role in the UK's fiscal capacity to respond to the financial crisis.

Figure 1: UK budgets, 1965–2018*

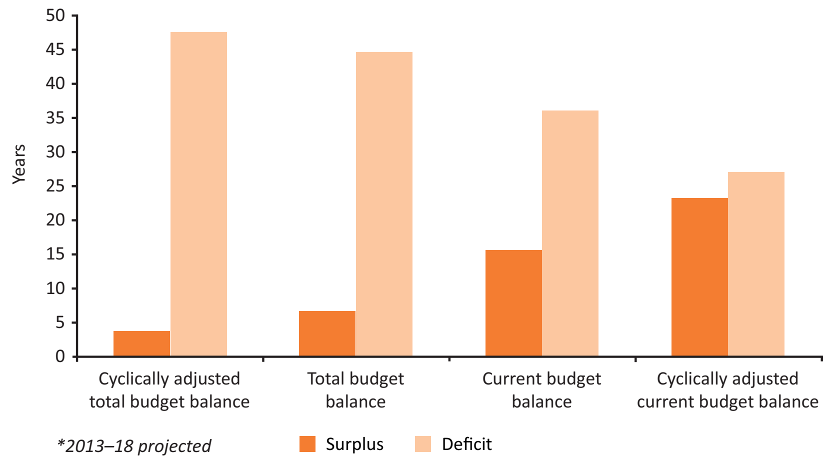
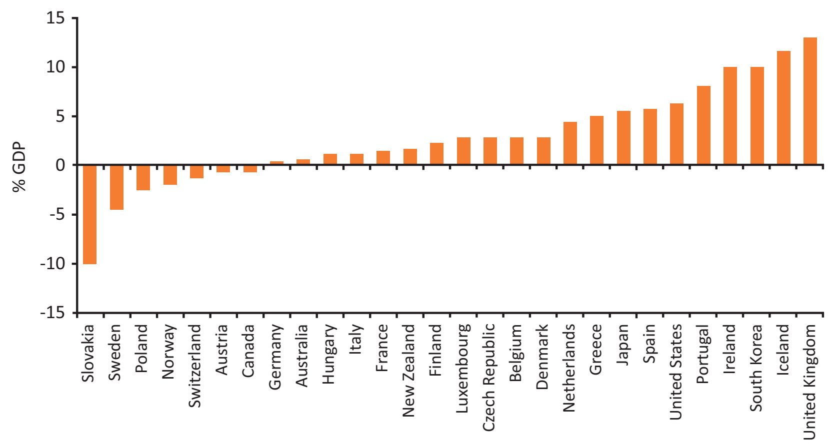


Figure 2: Change in general government total outlays, 1997–2010



Source: Chote R et al., 'Public Spending Under Labour', IFS 2010, www.ifs.org.uk/bns/bn92.pdf, p. 6.

As shown in Figure 2, between 1997 and 2010, the UK saw the largest increase in public spending as a share of national income of any industrialised country for which there is comparable data, from 22nd position out of 28 to 6th: a remarkable rise of some 4.4% per year in real terms.[5] While tax receipts remained relatively stable throughout this period: fluctuating in a fairly narrow band of 36.2% to 38.7% of GDP, public spending rocketed: from 34.6% of GDP in 2000 to 47.4%, in 2010, a level not seen since the UK's IMF bailout in 1976.[6] Just under half this increase (6.2% of the 12.8% of GDP total) had already occurred by 2005: well before the start of the economic crisis. This meant that the UK entered the financial crisis in 2007/8 with an already significant fiscal deficit, limiting its ability to respond with countercyclical fiscal policies.

There is also clear evidence that public indebtedness levels can reach a point beyond which the 'market interest rate rises quite suddenly, forcing painful adjustment.'[7] This suggests that the effect on the UK's sustainable growth rate of pushing the debt to GDP ratio even higher and the long-term effect of higher public spending make it vital that the UK's public finances are brought under control.[8]

However, these problems are not unique to the UK. 'Public debt in most advanced countries has been the ultimate absorber of negative shocks, going up in bad times, not coming down in good times.'[9] Other countries have developed robust fiscal frameworks to tackle this problem. For example, Sweden's reforms to its fiscal and budgetary processes in the 1990s have ensured strong public finances even at the height of the economic crisis, with deficits never rising above 0.9% of GDP. Switzerland's 'debt brake', introduced with 85% approval in a 2001 referendum, mandates a structurally balanced budget each year, capping expenditure to be in alignment with structural revenue, with any difference in outturn transferred to an adjustment account, requiring an adjustment in the target for following years. Such reforms have had significant success in achieving more sustainable public finances and have clear lessons for the UK.

Designing a successful set of fiscal rules requires a careful balance. They must be sufficiently robust to ensure a sustainable path for the public finances, but flexible enough to allow automatic stabilisers to work. They must be compatible with any future governments' democratic mandate and their ability to raise or reduce spending and taxation, while strong enough to provide certainty to financial markets that the rules will be adhered to in the long term.

These proposals have four main objectives:

- To ensure sustainable public finances;
- To be practical and compatible with the economic programme of any future government;
- To minimise or avoid the past mistakes of fiscal planning;
- To increase the political cost of non-compliance to ensure and provide confidence that the rules will be adhered to.

Specifically, this report outlines that a robust set of fiscal rules require:

- Tools to 'shame' governments supporting budgets which breach the fiscal rules in place;

5 Chote R et al., 'Public Spending Under Labour', IFS 2010, www.ifs.org.uk/bns/bn92.pdf, p. 1

6 Public Finance Databank May 2013 aggregates

7 www.ycsg.yale.edu/center/forms/growth-debt.pdf; www.voxeu.org/article/debt-and-growth-revisited

8 papers.ssrn.com/sol3/papers.cfm?abstract_id=1734206&download=yes

9 blog-imfdirect.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies/

- The use of tools to increase the 'transaction cost' for introducing a budget which violates the fiscal rules;
- Making the repeal of fiscal rules sufficiently arduous or politically costly. This would necessarily include establishing credibility of the fiscal rule with all parties.

To achieve these ends, the proposals have three main components:

- Rules – what the targets should be;
- Compliance – how the rules should be enforced;
- Penalties– what should happen in the event of a breach.

The Rules

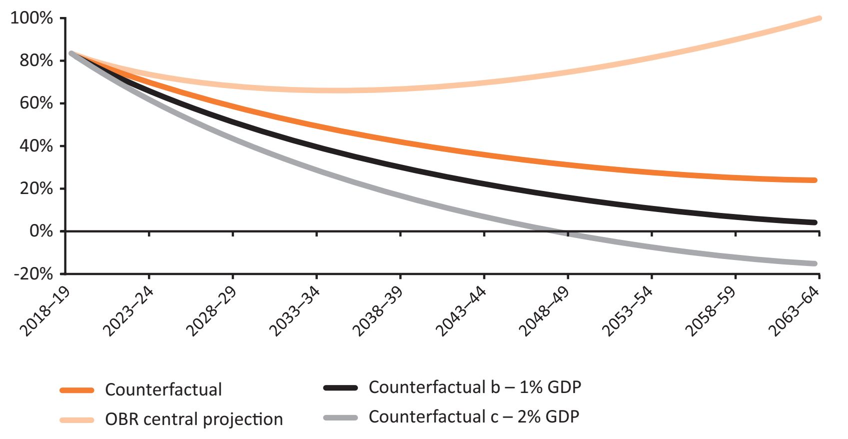
Proposal 1*: The overall fiscal mandate should be based on a zero public sector net cash deficit when the economy is at full output.*

Where there is a positive or negative output gap, the target should be modified by the same amount (i.e. an additional % GDP public sector net borrowing equal to the output gap). This target would be clear and easy to understand: simply, that when the economy is performing at full output, there should not be any net borrowing. This overall objective allows a reasonable balance between financial solvency and allowing sufficient flexibility in the event of recession or overheating. This follows the success of the similar Swiss model. It also allows flexibility for the automatic stabilisers to function, with cyclical increases in spending during a recession, and a budget surplus during a boom.

Proposal 2*: Subsequent to 2017/18, a supplementary rule should target a reduction in the debt-to-GDP ratio to reach a sustainable level by the end of the economic cycle.*

This would involve 'ringfencing' an additional fiscal payback mechanism to 'pay down' debt in addition to the fiscal mandate set out in Proposal 1. This figure

Figure 3: Debt to GDP ratio: OBR central projections and alternative fiscal rules



should be set following consultation. For example, taking the pre-financial crisis level as a baseline, an additional 1% or 2% of nominal GDP fiscal surplus would put public sector net debt on a projected course to return to crisis sustainable level in 16 years (2034/35) and 12 years (2030/31) respectively as shown in Figure 3.

The OBR should consult as to what precise level this payback mechanism will need to be set to achieve this outcome.

Proposal 3: *In the long term, the OBR should endeavour to create a measure of public sector net debt recalculated to include off-balance sheet, accrued and accruing liabilities, such as public sector pensions or PFI contracts. In the long term, this measure should replace the existing debt-to-GDP ratio measure for the purposes of Proposals 1 and 2.*

A 2010 estimate by the Office of National Statistics puts these debts as high as £4,840 billion – several times higher than on-balance sheet debt.[10] As well as presenting a more transparent picture of the true state of the UK finances, this will ensure that governments are not able to covertly spend or commit to the future spending of public money without affecting the fiscal rules.

Compliance

Proposal 4: *The OBR should monitor compliance with the fiscal rules set out in Proposals 1 and 2. It should state the rules to be in breach should either target be missed by more than 1% of GDP per year. It should also publish a range of independent market estimates of compliance, including the use of prediction markets.*[11]

This will ensure that the process of assessing the fiscal rules is transparent and grounded in the existing purpose and expertise of the OBR. By mandating the publication of external estimates, it will also promote transparency.

Proposal 5: *In the event that the fiscal mandate or supplementary rule is in practice breached, a Payback Mechanism should mandate that any deficit outside the rules has to be on course to be repaid on the OBR's central estimate within the 5 years with a 70% probability in addition to requirements above, following the Swiss/Swedish 'debt break' model.*

This guarantees that any breach is not simply passed over without consequence or justified by an aspiration to return to fiscal solvency over the long-term, but has a quantifiable and ongoing impact on the fiscal picture. Governments could no longer move the UK to a higher level of indebtedness without definite plans to recover the shortfall within a politically relevant time horizon. The five year payback period places a strong incentive on governments to return to the fiscal mandate quickly, within a politically relevant time frame and boosts confidence that the rules will, in fact, move back into compliance.

Penalties

Proposal 6: *In the event that the budget is in breach 30 days prior to the beginning of the fiscal year, this will trigger automatic nominal freezes to indexation*

10 www.ons.gov.uk/ons/rel/psa/wider-measures-of-public-sector-debt/july-2010/index.html

11 See Graefe A, Armstrong J, 'Comparing face-to-face meetings, nominal groups, Delphi and prediction markets on an estimation task', International Journal of Forecasting 27 pp. 183–195, 2011., dl.dropboxusercontent.com/u/5317066/2011-graefe.pdf

of tax allowance thresholds, public sector remuneration, the state pension and benefit payments.[12]

This measure would automatically adjust the fiscal position (through cuts to public spending and tax increases through 'fiscal drag') in the event of a breach. This would trigger a budgetary adjustment (i.e. cutting spending and raising taxation) in the absence of remedying government action. The purpose of this trigger would not be that such freezes would be a permanent feature of UK fiscal adjustments or even that such a trigger would actually be implemented. Rather, by including a range of unpopular measures affecting many interest groups (i.e. from pensioners to public sector workers to general taxpayers), this measure provides a very strong incentive for a government to take remedial action.

Proposal 7*: A new Fiscal Accountability Framework should be established. This would require through legislation that, in the event of the fiscal rules being breached, the Chancellor will be obliged to call an Emergency Budget setting out how he intends to return the fiscal balance to compliance and implement the Payback Mechanism outlined in Proposal 5. The Chancellor must also report to the House once a quarter on progress until this is achieved as defined by the OBR, with a new Emergency Budget triggered each six month period the rules remain in breach.*

This would ensure that there will be an autonomous trigger to move fiscal policy back into balance in the event of a breach and significant political consequences (in terms of a new Budget and ongoing enhanced scrutiny) creating a strong incentive to avoid such a breach.

Proposal 8: *If any Budget is determined to be in breach of the fiscal rules, the length of time for scrutiny of budget estimates will be automatically increased from 3 days (applying to compliant budgets) to 30 days.*

This rule, while not interfering with a government's ability to pass a non-compliant budget, does ensure that the rules 'have teeth' and cannot be breached without loss of parliamentary time, potentially impacting on the government's wider legislative agenda. Proposed amendments to the standing orders are listed in the Appendix to this Paper.

Glossary

- *Total budget balance:* all government revenues minus all government spending (public sector current receipts minus total managed expenditure).
- *Cyclically adjusted total budget balance:* as above, adjusted for the economic cycle.
- *Current budget balance:* all government revenues minus all current government spending (excluding all capital spending).
- *Cyclically adjusted current budget balance*: as above, adjusted for the economic cycle.
- *Fiscal consolidation:* a policy of reducing government deficits and indebtedness.
- *Fiscal framework:* a set of policy objectives governing the public finances given certain macroeconomic projections and fiscal targets.
- *Output gap:* the difference between actual and potential GDP.

12 We note that these freezes should only apply to discretionary spending, rather than retrospective breaches of contractual obligations already undertaken, such as index-linked public sector pensions

1

Introduction: The Current Fiscal Context

The primary goal of the Coalition Government when it came to power in May 2010 was to restore stability to the UK's public finances. Its founding Coalition Agreement went so far as to say that:

> *'deficit reduction, and continuing to ensure economic recovery, is the most urgent issue facing Britain'.*[13]

To meet this objective, the government undertook three main reforms:

- The establishment of a fiscal mandate, to 'achieve cyclically adjusted current balance by the end of the rolling, five-year forecast period';[14]
- A supplementary target that 'public sector net debt as a percentage of GDP to be falling a fixed date of 2015–16;[15]
- Creating an independent Office for Budgetary Responsibility (OBR) to 'examine and report on the sustainability of the public finances.'[16]

The fiscal mandate is still on course to be met, albeit only on a 'technicality' because the target is set on a rolling basis, without having to be met by a particular or the originally specified date. The intended target date for balance has been put back from 2015/16 to 2017/18 and is thus on track to be met within the allotted five (rolling) years, with the OBR most recently giving the target a 70% chance of being met.[17]

However, the supplementary target is now formally going to be missed, being put back two years to 2017/18.[18] Both these facts are due to a significant divergence between fiscal projections laid out in the Emergency Budget and those of today.

As shown in Figures 4 and 5, the two original targets laid out in the Emergency Budget are unlikely to be met, with the intention of meeting the fiscal mandate shown in Figure 4 put back by 2 years, and the supplementary target shown in Figure 5 by 3 years.[19] In non-technical terms, the UK government will both be spending more than it takes in, even excluding all borrowing for capital expenditure and with adjustments for the economic cycle, and have a debt burden rising faster than the economy grows, until 2017/18. Unlike the original projections, this leaves much of the work of deficit reduction to be done after the present Parliament.

Given these realities, the UK's fiscal solvency has been called into question. The UK's credit rating has been downgraded by two of the three main credit agencies

13 'The Coalition: our programme for government' 2010, p. 15, www.gov.uk/government/uploads/system/uploads/attachment_data/file/78977/coalition_programme_for_government.pdf

14 Emergency Budget 2010, p. 1, webarchive.nationalarchives.gov.uk/20130129110402/cdn.hm-treasury.gov.uk/junebudget_complete.pdf

15 Emergency Budget 2010, p. 2, webarchive.nationalarchives.gov.uk/20130129110402/cdn.hm-treasury.gov.uk/junebudget_complete.pdf

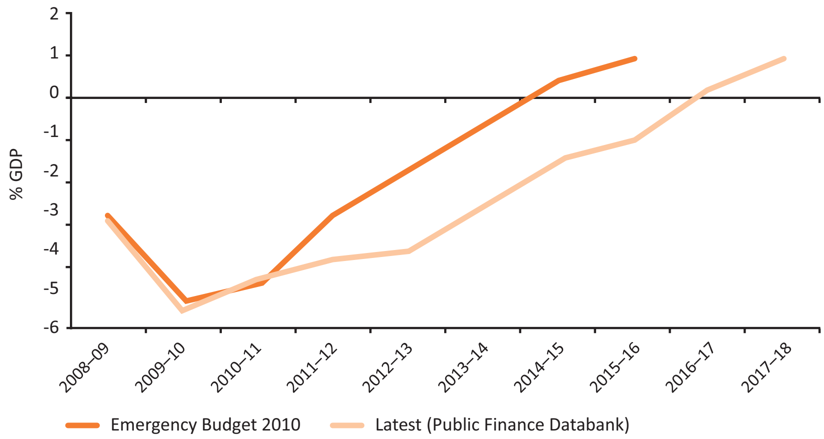
16 budgetresponsibility.independent.gov.uk/

17 Budget 2013, p. 29, www.gov.uk/government/uploads/system/uploads/attachment_data/file/188357/budget2013_complete.pdf.pdf

18 Budget 2013, p. 29, www.gov.uk/government/uploads/system/uploads/attachment_data/file/188357/budget2013_complete.pdf.pdf

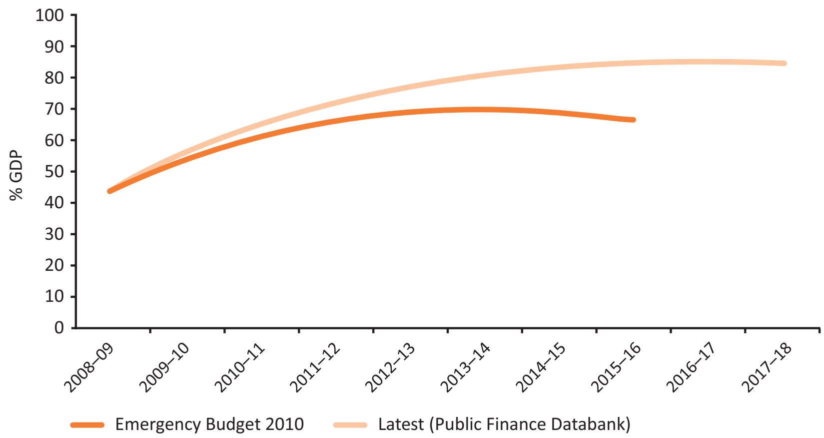
19 We note that the original intention of the Emergency Budget was to meet both targets 'a year early' above the formal targets: i.e. in 2014/15. It could thus also be stated that the fiscal mandate and the supplementary target will be met 1 and 2 years after the originally intended dates respectively

Figure 4: Cyclically-adjusted surplus on current budget



Source: HM Treasury, OBR.

Figure 5: Public sector net debt



Source: HM Treasury, OBR.

(while the remaining one, S&P, has it on negative outlook) and a fierce debate continues in both the academic and political arena as to the scope, speed, duration and composition of the government's fiscal consolidation programme. Given that further cuts across several departments will continue beyond the life of the current Parliament, further reforms to the fiscal framework are being considered.

In total, the UK is projected to borrow an additional £370.7 billion between 2013/14 and 2017/18, increasing public sector net debt to a total of £1,472.3 billion.[20] This leaves much of the repair work necessary to restore the public finances as an ongoing and live policy issue. With the debt to GDP ratio projected to exceed 100% in 2015/16, the highest level since modern records began; this leaves the UK with little or no room to manoeuvre in the event of future economic and fiscal shocks. As the Office for Budgetary Responsibility, in its Fiscal Sustainability Report, commented:

20 Public Finance Databank, 2011/12 prices

> *'Broadly speaking, the fiscal position is unsustainable if the public sector is on course to absorb an ever-growing share of national income simply to pay the interest on its debts… on current policy we would expect the budget deficit to widen sufficiently over the long term to put public sector net debt on a continuously rising trajectory as a share of national income. This would clearly be unsustainable.'*[21]

The urgent need to address these problems is clear. Businesses, households and financial markets need to be given confidence that the difficulties which have arisen in the public finances will be repaired and reassured that the institutions and procedures in place are sufficient to ensure it does not arise again. Without this, high tax rises, or painful spending cuts and wider impacts on growth may become a long-term prospect for the UK.

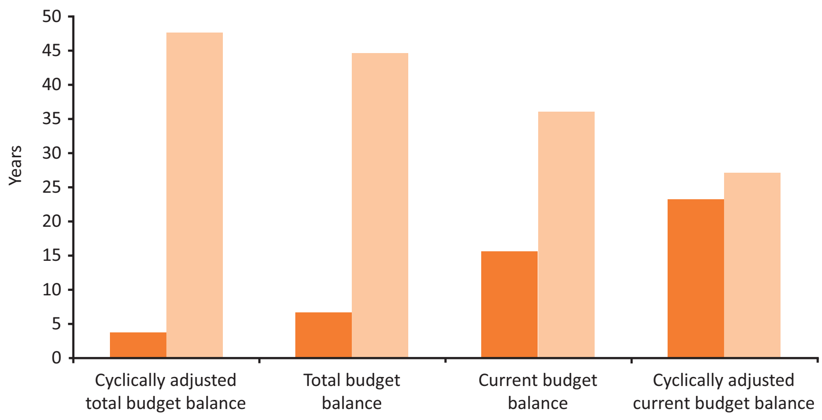
This Report will consider what further revisions need to be made to the UK's fiscal rules and enforcement procedures, and whether these could be used to boost confidence and the sustainability of the UK's public finances. It will examine how the UK can lock in sustainable public finances beyond 2015, what practical changes might be needed and what lessons can be learned from other countries.

The Deficit Bias

> *'King's Speech at opening the Parliament, February 20, 1717: "You are all sensible of the insupportable weight of the National Debt". Answer of the Commons: "We are all but too sensible of the insupportable weight of the National Debt; and, therefore, will not neglect to apply ourselves, with all possible diligence and attention, to the great and necessary work of reducing and lessening by degrees this heavy burden, which may prove the most effectual means of preserving to the Public Funds a real and certain security"'*[22]

As is evident in the quote above, British governments have committed themselves to fiscally responsible public finances for centuries – often with little or only temporary success. The consistent failure to maintain fiscal discipline continues to be evident.

Figure 6: UK budgets, 1965–2018*



*2013–18 projected

21 'Fiscal Sustainability Report', OBR 2013, p. 1, 12, cdn.budgetresponsibility.independent.gov.uk/2013-FSR_OBR_web.pdf

22 Price R, 'An appeal to the public, on the subject of the national debt.', London, 1772, p. 26, digitalcommons.mcmaster.ca/cgi/viewcontent.cgi?article=1069&context=mcmastercollection

As shown in Figure 6, since modern records began in 1965 (and including projected OBR figures to 2017/18), the UK will have run an overall deficit on the cyclically adjusted total budget balance – that is, borrowed more than it has taken in adjusted for the economic cycle – for 49 out of 53 years. In terms of the government's main fiscal mandate (i.e. the cyclically adjusted current budget balance), the UK has spent 24 years in surplus and 28 years in deficit.

In terms of the current budget, both adjusted and unadjusted for the economic cycle, the UK has not run a surplus since 2001/2. Overall (that is, including capital spending), the UK has not run an economically adjusted or unadjusted surplus since 2000/1. Indeed, it is arguable that even this occasion was achieved perhaps more due to politics than fiscal restraint per se – a legacy of Labour's commitment to match Conservative spending plans for the first two years of its Government by the then Shadow Chancellor Gordon Brown in January 1997, using figures which the then Chancellor Kenneth Clarke described as 'eye-wateringly tight' and said he could not have stuck to had the Conservatives won the General Election of that year.[23]

It should also be noted that this relatively poor record is not confined to a particular political party.

Figure 7: Proportion of time budget in deficit by years in office, 1965–2013

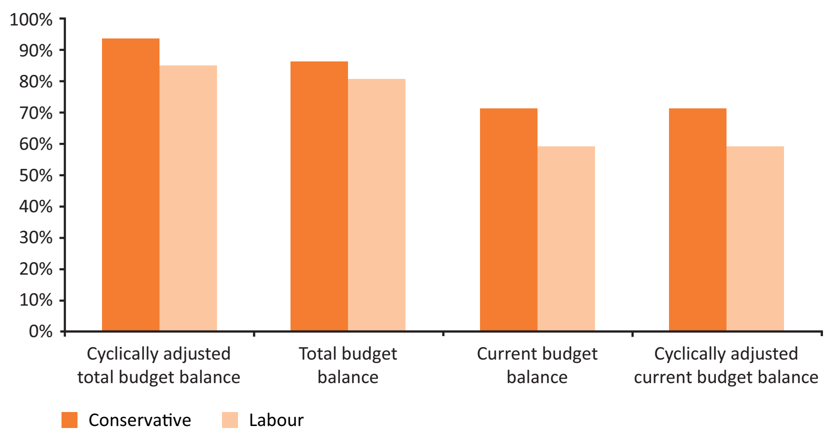
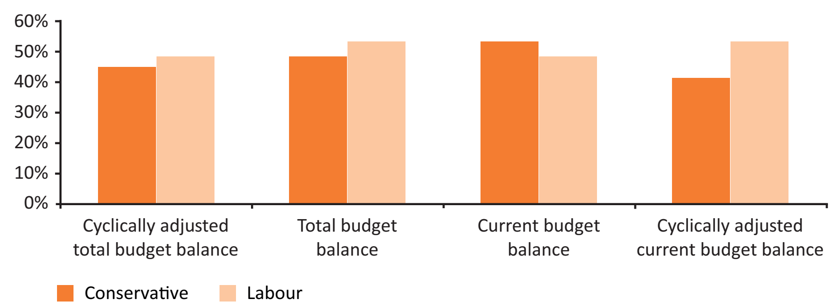


Figure 8: Proportion of period of office fiscal position deteriorated on previous year (% GDP), 1966–2013

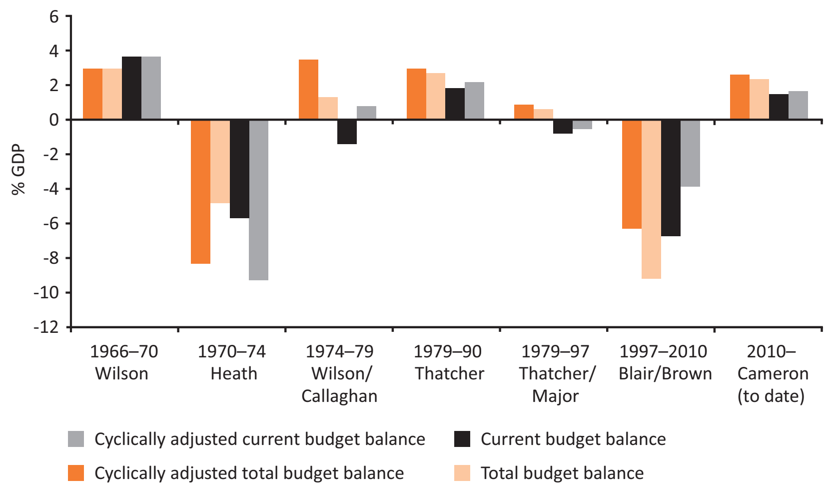


Source: Authors' calculations and Public Finance Databank May 2013 aggregates. Defined by which party was in office for the majority of that fiscal year, including when the largest party in a coalition.

23 Atkinson M, Elliott L, 'Inside the Treasury: Brown's mechanics behind the machinations of government', Guardian 9th November 1999

The Conservatives have historically had greater budget deficits on the main fiscal measures than Labour by proportion of time in office since modern records began in 1965. However, in terms of improving the fiscal position, the Conservatives have a better record than Labour on 3 out of the 4 measures. The record becomes clearer when we compare specific administrations.

Figure 9: Budget change from start to end of government



Source: Authors' calculations and Public Finance Databank May 2013 aggregates. Government's period of office defined by which party was in office for the majority of that fiscal year, including when the largest party in a coalition.

As Figure 9 shows, the fiscal position improved under the Wilson (1966–70), Thatcher and Cameron governments on all four measures used here, whereas the Heath and Blair/Brown governments saw it weakened on every measure. The Heath government has the unique distinction of presiding over deterioration on each fiscal measure for every year of its period of office.

Table 1: Administrations entering office with fiscal deficit: change by end of office (1965–2013)

Party in office, change in deficit by end of office	Cyclically adjusted total budget balance	Total budget balance	Current budget balance	Cyclically adjusted current budget balance
Labour, improved	Wilson, Wilson/ Callaghan	Wilson, Wilson Callaghan	N/A	Wilson/ Callaghan
Labour, worsened	Blair/Brown	Blair/Brown	Wilson/ Callaghan, Blair/ Brown	Blair/Brown
Conservative, improved	Thatcher/ Major, Cameron	Thatcher/ Major, Cameron	Cameron	Cameron
Conservative, worsened	N/A	N/A	Thatcher/Major	Heath, Thatcher/Major

Source: Authors' calculations, Public Finance Databank May 2013. Wilson: 1966–70; Wilson/ Callaghan: 1974–79. Cameron 2010–13.

It is worth noting that there is no particular party political angle to this analysis. The Wilson/Callaghan governments of 1974–1979, for example, improved the fiscal balance on most measures. The Heath government during the 'Barber boom' saw very high deterioration of the fiscal position – even more so than the Blair/Brown governments of 1997–2010. The current coalition government – perhaps pushed by necessity – has improved the fiscal position on every measure.[24] As shown in Table 1, both the Conservative and Labour parties have historic examples in government of reducing the deficits of their predecessors and worsening an existing deficit.

It is difficult to conclude from these figures that either Conservative or Labour governments were particularly 'saints or sinners' when it comes to setting out a responsible fiscal path. Nor should it be taken to infer that these statistics alone are a fair 'appraisal' of each government's period of office, subject as they are to unique fiscal circumstances; external, cyclical and one-off factors such as 'the position of the economy in the economic cycle' and 'shocks to the world economy'.[25] Nevertheless, it is clear that the UK has a propensity to run significant and ongoing budget deficits. The tendency towards 'booms' and 'busts' in public spending, and a failure to deliver a responsible fiscal path is a clear and long-term issue.

24 However, we note that with public sector net borrowing and cyclically adjusted net borrowing are both forecast to rise in 2013/14

25 Emmerson C, Frayne C, Love S, 'Updating the UK's Code for Fiscal Stability', p. 5, eprints.ucl.ac.uk/2853/1/2853.pdf

2

Why it is a Problem

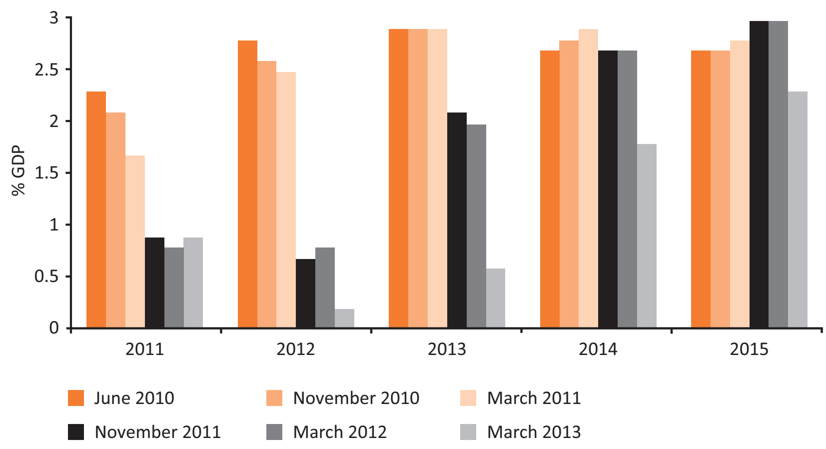
> *Experience has taught us that fiscal policy needs to be governed by rules: it cannot simply be left either to the calculations of economists or those of politicians. If the state runs budget deficits through good and bad times, it loses all ability to exercise any stabilising influence on the business cycle.*
>
> Lord Skidelsky, HL Deb 24 November 1994 vol 559

The recovery has been slow…

Before considering what issues there are surrounding the formulation of new fiscal rules for the UK and what these should be, it is important to examine why the existing rules are not on track.

The primary reason that the UK's fiscal consolidation programme is taking longer than thought is that GDP growth has not materialized at the rate originally forecast. Though projections have improved recently, Figure 10 shows that growth forecasts have been downgraded since the Emergency Budget by the OBR, with no return to growth approaching the trend growth rate until 2015. A global slowdown, lack of credit growth, static consumption and investment and continued problems with the Eurozone continue to pose serious challenges to the UK.

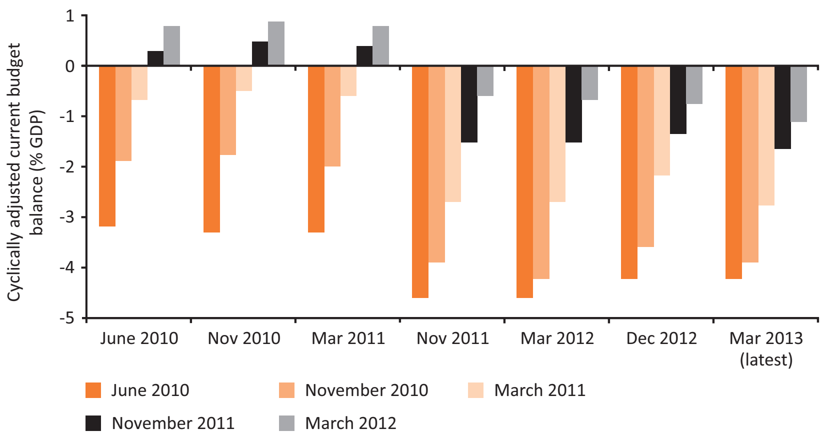
Figure 10: Real economic growth projections by year



Source: OBR.

In terms of the measure on which the fiscal mandate is based, the intention of achieving a cyclically adjusted current budget balance – the original intention of June 2010 – to be achieved a year earlier than the formal target in 2014/15 – has been pushed back beyond the life of this Parliament. The continued relative weakness of the economic recovery and a now protracted pattern of fiscal target dates being pushed back, highlights just how difficult successfully implementing a future set of fiscal rules could be.

Figure 11: OBR projections of fiscal position



Source: OBR.

The UK is heavily in debt

However, government indebtedness is only part of the problem facing the UK, forming only one element of a historically very high level of indebtedness across the economy. Global deleveraging began with the end of the 'great credit super-cycle'[26] in 2008, as firms, businesses and governments began reducing their debt burden. The UK, buffered by large government deficits and historically low interest rates, is only just beginning this process, having run up some £1.1 trillion of public and private debt between 1998 and 2012, while GDP increased by only around £350 billion. As shown in Figure 12, the total debt burden of the UK is in excess of 500% of GDP, proportionately higher than any of the other top ten largest developed economies. This presents particular challenges in delivering sustainable growth in the UK economy and restoring solvency to the public finances.

"Government indebtedness is only part of the problem facing the UK, forming only one element of an historically very high level of indebtedness across the economy"

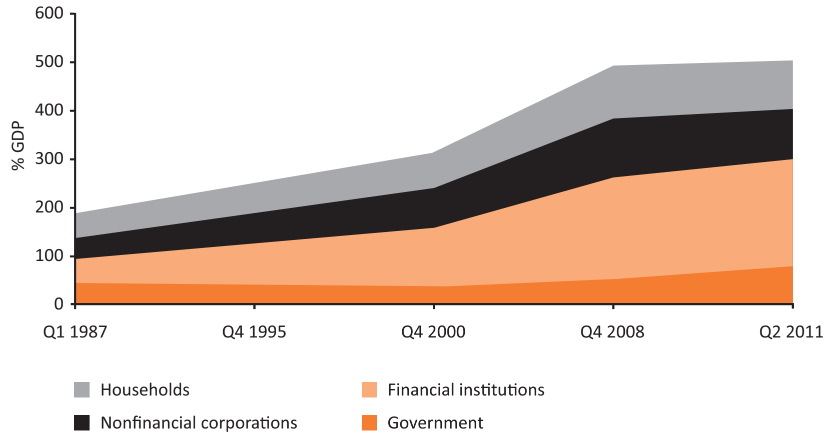
It has been noted that:

> *'The debt ratio that matters as a guide to the country's overall solvency is not the much-quoted ratio of net public debt to gross domestic product but total external debt, public and private sector combined.'*[27]

26 Morgan T, 'Perfect storm; energy, finance and the end of growth', Tullett Prebon, www.tullettprebon.com/Documents/strategyinsights/TPSI_009_Perfect_Storm_009.pdf

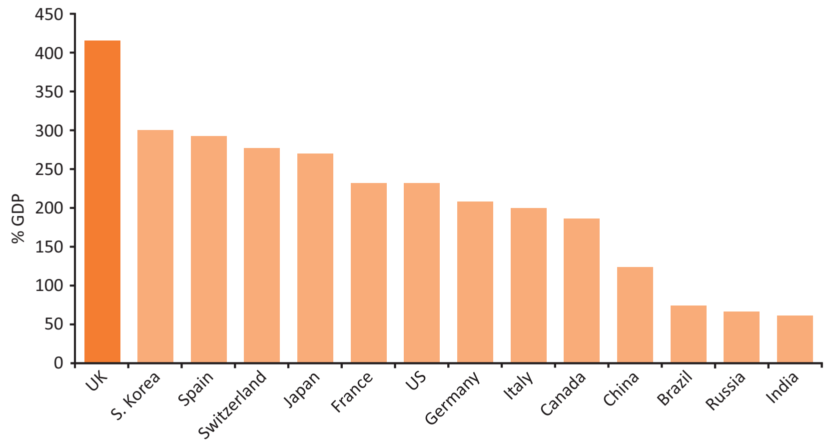
27 Wolfgang Münchau, www.ft.com/cms/s/0/4d433ec6-de93-11e2-b990-00144feab7de.html#axzz2XmwrqUBX

Figure 12: UK total debt to GDP ratio



Source: 'Debt and deleveraging: Uneven progress on the path to growth', McKinsey Global Institute.

Figure 13: International private sector debt, Debt by country, 2008



Source: McKinsey Global Institute, Exhibit 7, 'Debt and deleveraging: The global credit bubble and its economic consequences', January 2010.

Household indebtedness poses a particular problem. Since the mid-1980s, UK household consumption expenditure has exceeded 60% of GDP and contributes around the same proportion of annual growth. This means that, in an era of relatively flat incomes, households' attempts to pay down debt will involve cuts to consumption likely to have a continued impact on the UK's medium term growth rate.

Why are high deficits a problem?

If government consistently takes in less revenue than it spends, it must borrow or print money to make up the shortfall. While this may be inevitable or necessary in the short-term, in the long-term mounting public debt causes serious problems for economic growth.

Since greater debt increases public expenditure on debt payments, this means less is available for social objectives or investment in growth-enhancing expenditure. Resources otherwise available for the private sector or public spending are consumed, lowering the productivity of the economy. Higher taxes to service the resulting interest payments and mitigate these effects can reduce economic activity, further weakening growth.

Finally, if debt levels become so high that it is no longer possible to service the debt (or raise taxes sufficiently to do so), borrowing costs rise as financial markets begin to factor in a material risk of sovereign default, further weakening the prospect of sustaining the debt without inflation, and further increasing the possibility of outright default. This will further weaken investment and confidence in the wider economy, an effect that will normally last for several years.[28]

Carrying very high levels of debt also weakens the ability of government to employ countercyclical fiscal policy in the event of a downturn, as cutting taxes or raising spending cannot be done without incurring some or all of the effects outlined above. This factor played a major role in the UK's fiscal capacity to respond to the financial crisis. In summary: it is very difficult to replace weak private sector demand with additional government spending if such spending would make the debt burden prohibitively high, potentially even pushing the sovereign into explicit or implicit default. The resulting fiscal policy by necessity will be pro-cyclical, further exacerbating a downturn, increasing volatility and damage to long-term output.

Table 2: The relationship between debt and growth

Report	Size of sample	Debt/GDP ratio threshold	Effect of a 10 basis point rise in debt/GDP ratio
Jumar M, Woo J, 'Public debt and growth', IMF, July 2010.	38 advanced and emerging market economies, 1970–2007	90%	-0.17 ppt
Caner M, Grennes T, Koehler-Geib F, 'Finding the tipping point – when sovereign debt turns bad', World Bank July 2010.	79 advanced and developing economies, 1980–200	77%	-0.17 ppt
Cecchetti S, Mohanty M, Zampolli F, 'The real effects of debt', Reserve Bank of Kansas symposium, August 2011, pp. 145–96.	18 OECD economies, 1980–2006	84%	-0.13 ppt
Baum A, Checherita-Westphal C, Rother P, 'Debt and growth: new evidence for the euro area', ECB 2012.	12 euro area economies, 1990–2010	96%	-0.59 ppt

Source: Bank for International Settlements Annual Report 2013, www.bis.org/publ/arpdf/ar2013e4.pdf.

There are several studies comparing correlations between debt and growth. Adjusting for cyclical fluctuations and things like population growth,

28 Reinhart C, Reinhart V, Rogoff K, 'Public debt overhangs: advanced-economy episodes since 1800', Journal of Economic Perspectives, vol 26, no 3, June 2012

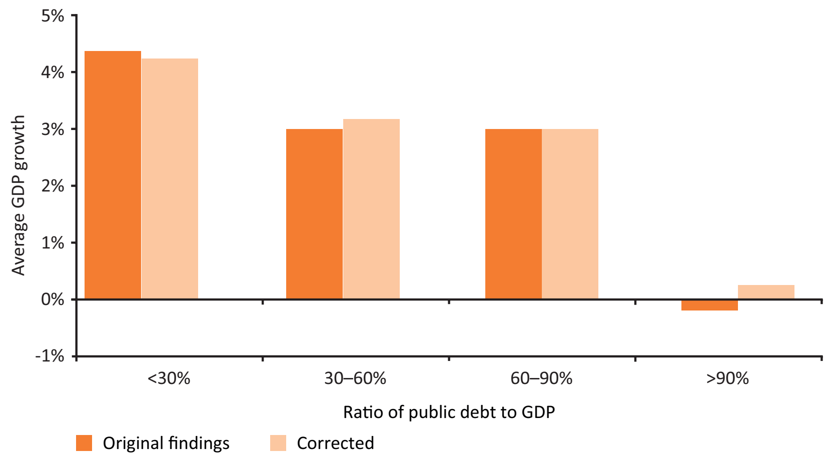
demographics, education and trade, as the Bank for International Settlements has concluded, the academic literature is:

> *'consistent and unambiguous: a 10 percentage point increase in the debt-to-GDP ratio is associated with a 13–17 basis point decline in trend per capita GDP growth for debt levels above about 80%.'*[29]

While a short-term increase in public indebtedness may be the inevitable consequence of a downturn or unexpected shock to the economy, high debt levels are the direct consequence of policy choices made by the government over the long-term.

The relationship between higher public indebtedness and lower growth – and in particular, the validity of findings which pioneered this view: that of Carmen Reinhart and Kenneth Rogoff, that government debt exceeding a level of 90% of GDP is associated in advanced economies with a reduction of the median annual growth rate of around 1%, among others,[30] have reignited this debate.[31] Despite considerable controversy arising from the discovery of a coding error,[32] this finding is still valid.[33]

Figure 14: Debt and GDP across advanced economies, 1946–2009



Source: Original findings – Reinhart C, Rogoff K, 'Growth in a time of Debt'. Corrected – Herndon T et al., 'Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart *and Rogoff'.*

The precise level at which public debt starts to materially affect growth is somewhat incidental. It is clear that the UK's level of public indebtedness is already very high: exceeding 90% of GDP. While this is not an arbitrary threshold in the way some commentators have interpreted it, as we have seen there is clear evidence that public indebtedness levels can reach a point beyond which the 'market interest rate rises quite suddenly, forcing painful adjustment.'[34] This suggests that the effect on the UK's sustainable growth rate of pushing the debt to GDP ratio even higher and the long-term effect of higher public spending (Afonso & Furceri, Mo) make it vital that the UK's public finances are brought under control.[35]

A particular pertinence is given to this objective by the UK's circumstances in 2013. A relative uptick in short-term growth bears striking resemblance to the

29 Bank for International Settlements Annual Report 2013, ch. 4, www.bis.org/publ/arpdf/ar2013e4.pdf

30 Cecchetti S, Mohanty M et al., 'The real effects of debt', BIS Working Paper 352, 2011, www.bis.org/publ/othp16.pdf

31 Reinhart C, Rogoff K, 'Growth in a time of Debt', NBER Working Paper 15639, www.nber.org/papers/w15639.pdf

32 For example see www.slate.com/blogs/moneybox/2013/04/16/reinhart_and_rogoff_respond_researchers_say_high_debt_is_associated_with.html

33 Herndon T et al., 'Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff', PERI Massachusetts University 2013, www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_301-350/WP322.pdf

34 www.ycsg.yale.edu/center/forms/growth-debt.pdf; www.voxeu.org/article/debt-and-growth-revisited

35 papers.ssrn.com/sol3/papers.cfm?abstract_id=1734206&download=yes

growth seen before the financial crisis, with credit-driven consumption growth, government deficits and ultra-low interest rates all playing a significant role. While these immediate circumstances should not be the basis of a medium or long-term strategy, they are indicative of a medium term picture of economic recovery which is choppy, uneven and uncertain.

Given these circumstances and the non-trivial risk of a further downturn driven by international factors, the need to have sufficient fiscal flexibility to adopt a countercyclical policy in the event of such a circumstance is very real. The need to 'prepare for the next time' must be a key objective in an uncertain global outlook. This will allow automatic stablisers to function and ensure there is greater flexibility in fiscal policy to respond to a future crisis than existed at the onset of the 'Great Recession' of 2008–9.

Why now?

Some commentators have noted that financial markets have, by and large, not responded adversely to very large increases in government borrowing by going on a 'gilt strike' or sharply increasing the interest rate charged since the financial crisis began. On the contrary, despite a recent uptick, overall UK interest on government debt has fallen substantially. Some economists have suggested that that government should increase borrowing still more rapidly in response, taking advantage of the cheap servicing costs of debt to finance new spending and projects.[36]

> "Despite a recent uptick, overall UK interest on government debt has fallen substantially"

It is worth noting the extraordinary circumstances of the financial crisis post-2007 that have, in consequence, made the need for sound public finances seem relatively minor on the surface. This is due to a unique combination of one-off factors that combined have made for a temporarily 'soft landing' for the UK public finances. In particular: Quantitative Easing, historically low interest rates and returns on investment, and a 'flight to quality' both from other asset classes as well as more risky sovereign debt. This has given the UK, despite some of the highest levels of borrowing in the developed world since the crisis began (the third biggest rise of any of the largest 18 developed economies: some 51.6% of GDP),[37] significant falls in borrowing costs since the 2010 Spending Review. Yields on UK ten-year gilts fell from around 3.5% to less than 2% by May 2012 (having only begun to rise significantly recently). This puts current debt interest costs and forecast yields significantly lower than the OBR's original assumptions.[38] One estimate puts the saving at £28.8 billion by 2015/16;[39] with Treasury estimates at £31 billion.[40] Yet, for the present, this windfall provides an unexpected cushion for meeting the fiscal mandate, mitigating somewhat the impact of falling growth projections. However, this is likely to prove ephemeral, for several reasons.

First, the present bull market in sovereign debt relies on financial markets continuing to accept negative real interest rates (at present, heavily driven by regulation-driven purchasing of gilts as financial institutions recapitalise). Ultra-low central bank interest rates cannot be sustained forever. The Bank of England's Monetary Policy Committee has announced its intention to raise the Bank Rate once unemployment falls below 7% – and potentially sooner should it

36 For example, see niesr.ac.uk/blog/pasty-tax-could-pay-%C2%A330-billion-infrastructure-programme-four-charts-show-why-history-will#.Uf_atdK1Gxo

37 Bank for International Settlements Annual Report 2013, ch. 4, www.bis.org/publ/arpdf/ar2013e4.pdf, Public Finance Databank May 2013, OBR

38 Office for Budget Responsibility, Fiscal sustainability report Annexes, budgetresponsibility.independent.gov.uk/wordpress/docs/FSR2011Annexes.pdf

39 Citi, Sterling Weekly, 14th October 2011, p. 4

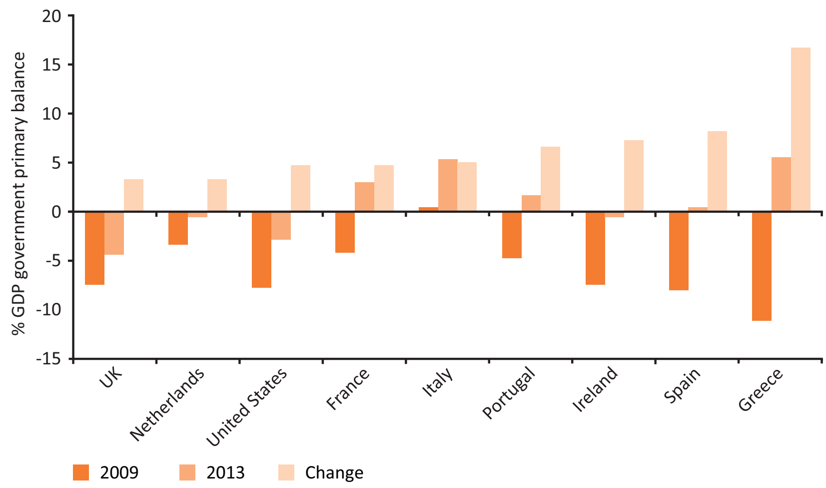
40 Spending Round 2013, p. 14, www.gov.uk/government/uploads/system/uploads/attachment_data/file/209036/spending-round-2013-complete.pdf

forecast inflation to rise above 2.5% in the medium term[41] In addition, the risk of contagion from the Eurozone remains non-trivial.

In the long-term, other factors are likely to push up borrowing costs. The savings glut in emerging economies – which push down yields in the developed world – will eventually come to an end as investors seek alternative assets, greater capital domestically and aging populations run down their pension assets. As the Bank for International Settlements pointed out in its annual Report, the long-term yield on 10 year government debt in developed economies was around 6% over the twenty year period before the financial crisis: more than double the rate prevailing at present. Once monetary easing ends, a return to this prevailing rate (which could happen over a relatively short period – a 2% rise occurring in 1994 alone) would have a drastic effect on bond prices and government finances. The loss for UK bondholders would exceed 25% of GDP.[42] Just a 2% rise in UK gilt yields could increase public indebtedness to over 200% of GDP by 2050. Put simply:

> *'the consolidation needs of countries experiencing low interest rates would be greater if their growth adjusted interest rates were to rise.'* [43]

Figure 15: Bottom of the pack? Change in general government primary balance 2009 v. 2013



Source: IMF, OECD.

Unfortunately, the UK has not taken sufficient advantage of this breathing space. As can be seen from Figure 15, the primary balance (i.e. excluding debt interest payments) of the UK has a uniquely poor record: both one of the worst deficits in the developed world in 2009 and record of improving this position worse than several countries (Greece, Spain, Ireland and Portugal) in a state of near or *de facto* sovereign default.

As we have seen, some economists have not taken this into account. They have argued that historically low interest rates on government debt mean that we should not be concerned with levels of public indebtedness. We believe the opposite is true. The very transient nature of these one-off factors, which will

41 www.bankofengland.co.uk/publications/Pages/news/2013/096.aspx

42 Bank for International Settlements Annual Report 2013, ch. 4, www.bis.org/publ/arpdf/ar2013e4.pdf

43 www.bis.org/publ/arpdf/ar2013e4.pdf, p. 47

inevitably recede in the medium term, combined with the major work which still needs to be done to repair the public finances make it still more necessary for the UK to have a sustainable basis for its fiscal planning.[44] This will allow the UK to be prepared for future economic downturns and to have sufficient flexibility to adopt a countercyclical fiscal policy and allow automatic stabilisers to function. If the fiscal position is not sustainable even when interest rates are unusually low, they will become still more unmanageable when rates normalise. Assuming this historically unique position will continue indefinitely is simply not realistic.

44 Rogoff K, 'Britain should not take its credit status for granted', Financial Times October 2nd 2013, www.ft.com/cms/s/0/b933e5e8-29ef-11e3-9bc6-00144feab7de.html#axzz2kKgYcFAS

3

Issues in Developing the Rules

> *"with the best will in the world, with their current records, any British politician standing up and swearing fiscal responsibility is, at best, like a reformed alcoholic declaring teetotalism. Even if you believe their sincerity, you don't want to give them the key to the drinks cabinet, just in case."*
>
> Former Labour adviser Hopi Sen

In Chapter 1, we examined how the original fiscal targets laid out in 2010 are likely to be missed and that this is part of a consistent pattern of weakness in the UK's public finances (regardless of which party is in power). Chapter 2 explored how the current situation is likely to be unsustainable due to a weak economic recovery and high levels of debt across the economy, and why high public borrowing is a problem for long-term growth and the ability of governments to respond to economic downturns with fiscal policy. It also explained why a temporarily benign environment for UK borrowing costs will not be sustained, making robust fiscal rules necessary. This Chapter will explore the issues regarding the design of these rules for the UK.

Designing and implementing a fiscal rule

Parliamentary sovereignty

Designing a successful set of fiscal rules requires a careful balance. They must be robust enough to ensure a sustainable path for the public finances, but flexible enough to allow automatic stabilisers to work. They must be compatible with any future governments' democratic mandate and their ability to raise or reduce spending and taxation, while strong enough to provide certainty to financial markets that the rules will be adhered to in the long term.

However, there are limits to how binding any set of rules can be. In particular, the fiscal primacy of Parliament is an ancient, well established element of the UK constitution. Any fiscal rules framework could ultimately be repealed and any such legislation could be undone through any regular Finance Bill. Any budget that planned non-compliance with the fiscal framework could still be passed in the normal way by simple majority of the House of Commons. This does not mean that implementing a successful fiscal rule is impossible, but that the structure of the UK constitution requires consideration of other strategies in order to be successful. Specifically:

- Tools to 'shame' governments supporting budgets which breach the fiscal rules in place;

- The use of tools to increase the 'transaction cost' for introducing a budget which violates the fiscal rules;
- Making the repeal of fiscal rules sufficiently arduous or politically costly. This would necessarily include establishing credibility of the fiscal rule with all parties.

We will examine these factors in turn.

The use of tools to 'shame' governments into compliance

This approach has been taken previously by fiscal rules – the simple political 'shame factor' of breaking the rule. However, this has run into serious difficulties in the past. Such rules were often monitored internally, making compliance easy to manipulate. Short-term budgetary adjustments (e.g. proceeds from one-off revenue sources) can mean that targets are met technically whilst in actual fact the longer-term pattern is unsustainable.

However, the introduction of the Office for Budget Responsibility means that external analysis is less likely to be subject to manipulation. Provided that the guidelines the OBR and other bodies use are effectively designed, effective use of the 'shame' factor should be possible.

Increasing the transaction cost of noncompliance

Public 'shaming' may well not be enough to guarantee budgetary compliance in many cases. The temptation to enact costly but popular policies may appear harmless in the short-term, especially if the cost is deferred. An important element of an effective fiscal rule is thus to deter this behaviour.

Achieving this means that breaches of the fiscal rule must be less attractive to governments in the short-term. The 'shame' factor plays a part in this decision, but it could be increased and complemented by procedural tools which increase the difficulty of passing budgets which do not comply with the fiscal rule. This could have three effects:

- Making passing a noncompliant budget significantly more difficult, reducing the chance it will occur and increasing the chance that steps will be taken to make the budget more fiscally responsible;
- Increasing the chance that steps will be taken to make the budget compliant with the fiscal rule;
- Increasing the political capital required to push through a noncompliant budget, thereby increasing the political significance and the 'shame factor' if one is passed. This would be especially acute if pushing through a noncompliant bill necessitated repealing large amounts of the bill encouraging fiscal responsibility.

Making the process of repeal sufficiently arduous and politically costly.

None of these elements would prove to be cast-iron restraints, and a repeal of them could easily be included as part of the groundwork for a noncompliant budget. However, in the absence of comprehensive repeal efforts, procedural restrictions may be of assistance.

The staying power of procedural barriers and the credibility of 'shaming' devices rely upon the fiscal rule itself being credible both in design and enforcement. This means that design of any new system must be part of a political consensus, and represent purely a commitment to sustainable and credible public finances, rather than a particular bias towards particular tax and spending policies. As such, it should concern itself purely with the overall budgetary position.

Similarly the timing of the introduction of fiscal rules will be sensitive and must not be seen to be an attempt to constrain a particular future government from action, but rather to ensure the UK's long-term solvency. Designing a fiscal rule with sufficient flexibility and impartiality will be necessary to make it a consistent and lasting part of the budgetary landscape

Who's afraid of Robert Chote?

The OBR is a significant improvement in the UK's fiscal policy formulation. Policy Exchange advocated the formation of an 'Independent Fiscal Committee' in 2007.[45] It acts as a discipline on the system and a means of providing forecasts of important macroeconomic statistics independent of Treasury control. As the Chancellor George Osborne stated when the OBR was introduced:

> *'I recognise that this will create a rod for my own back … and for the backs of future chancellors. That is the whole point. We need to fix the budget to fit the figures, not fix figures to fit the budget.'*[46]

Some have felt that OBR has been too sympathetic to the government's position, downgrading short-term growth forecasts but mitigating the impact by a projecting a strong return to recovery in the medium term.[47] However, this seems more a product of existing 'reversion to trend' growth assumptions which may not apply in the aftermath of a financial crisis rather than a particular desire to make projections which are uncontroversial.

On the contrary, in its short existence, there have been notable occasions when the OBR has not proved politically convenient – for example, the OBR downgrade of growth forecasts for 2012 and projections that the original supplementary (debt) target would not be met significantly impacted on the Autumn Statement that year.[48] Where the OBR has felt there views have been misrepresented by the Chancellor, they have publically made this clear.[49]

Nevertheless, the power of the OBR at present to enforce significant fiscal discipline is limited beyond stating whether the government is on track to meet its targets or not. Since this is heavily reliant on Treasury data and resources, the same economic models and staffed with largely the same officials, the extent to which the OBR is likely or able to have the flexibility to make projections significantly different from those made by the Chancellor and his officials must be open to question. It lacks the influence of comparable international institutions such as the *Finanspolitiska radet* (Swedish Fiscal Policy Council) which is widely cited in the Swedish media and regularly comments on government actions – from the accuracy of specific tax receipt estimates to the efficiency of specific fiscal targets.[50]

The OBR's approach is more cautious and limited in scope: largely confined to projecting whether the government has a greater than 50% chance of meeting its stated fiscal targets and related forecasts.[51] Once it makes such a pronouncement, to coincide with the normal cycle of the Spending Review, Autumn statements

45 www.policyexchange.org.uk/images/pdfs/first%20ten%20years%20of%20px%20web.pdf

46 George Osborne, speech 17th May 2010

47 For example, see Mark Field MP, conservativehome.blogs.com/platform/2013/05/from-markfieldmp-1.html

48 www.gov.uk/government/topical-events/autumn-statement-2012

49 budgetresponsibility.independent.gov.uk/wordpress/docs/Letter-from-Robert-Chote-to-Prime-Minister.pdf

50 For example, see www.finanspolitiskaradet.se/english/swedishfiscalpolicycouncil.4.6f04e222115f0dd09ea80001437.html

51 budgetresponsibility.org.uk/about-the-obr/what-we-do/

and Budgets, the government of the day has every opportunity to widely trail that the target has been missed and to incorporate this fact into its communications strategy. If this is done effectively, there is no need for it to pay a significant price, political or otherwise, for the target to be missed. There is no enforcement mechanism or trigger that give the rules any 'teeth' either in spending, political or legislative terms. Even when targets are explicitly missed or rolled over to be met at a future date, there is little in the way of censure for the government.

However, for the OBR to remain independent, it must be – and be seen to be – above everyday politics. Despite an environment where fiscal policy is a high-profile controversial topic, it has maintained this position with considerable success. Giving the OBR an expanded role in overseeing the UK's fiscal framework must be done without imperilling this impartiality.

Uncertainties – the output gap and revision of estimates

Any fiscal rule also requires a certain degree of flexibility to reflect changing circumstances. The need of public policy to take account of uncertainty – not only about the future in general but the accuracy of existing facts, predictions and analysis – is well established in the academic literature.[52]

A key component of this need in the context of a cyclically adjusted fiscal rule is the sensitivity of public spending plans to the accuracy or otherwise of the 'output gap' – that is, the difference between actual and potential GDP.

Since the cyclical position of the economy – whether it is in a state of growth, boom, or recession – has a significant effect on public sector receipts and spending (for example, revenue from income tax is likely to go up when the economy is growing at the same time as welfare spending caused by unemployment is falling, and vice versa), the measurement of the output gap is essential in determining whether the UK's fiscal position is sustainable over the long term or not. If the public finances are in deficit due to an output gap, this deficit is said to be 'cyclical' and thus assumed temporary; disappearing once the economy returns to normal potential. If there is a deficit even when the economy is at or above potential, this indicates a 'structural' deficit which needs to be addressed.

> "For the OBR to remain independent, it must be – and be seen to be – above everyday politics"

The sensitivity of fiscal planning to measurement of the output gap is thus very high. Unfortunately, accurate measurement of the output gap is difficult and the results uncertain, having no observable, empirical metrics as such. The main methodologies for its calculation rely on limited historic output gap data and its relationship to the previous fiscal position and using this to calculate spare capacity, long-term growth or supply potential. One-off changes in international or domestic circumstances, such as changes in asset prices or the composition of GDP, or unaccounted for policy changes can significantly affect the sustainability of the public finances. This can happen regardless of the normal economic cycle without being in any sense predicted or accounted for in the coefficient estimates. Equally, the current economic cycle may not be similar to previous ones and thus may not be reflective a calculation based on historic data series.

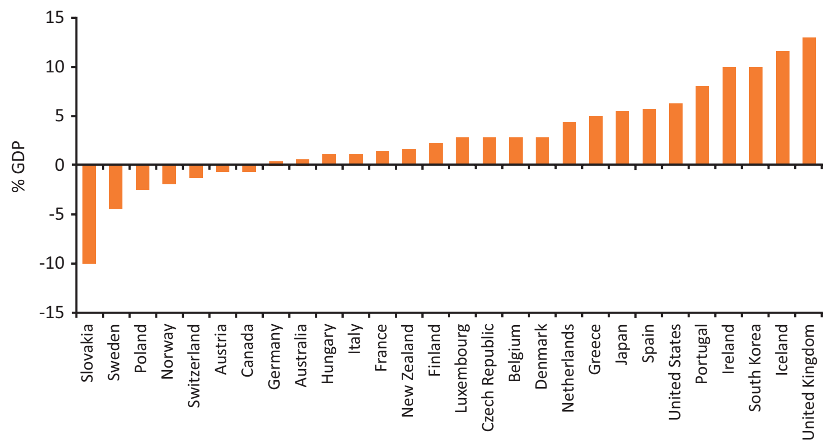
It is not the purpose of this Report to discuss the efficacy of different measures of the output gap or what methods might be most appropriate for the UK.[53] Instead, it

52 For example, see Manski, C, 'Public Policy in an Uncertain World', Harvard University Press 2013, www.hup.harvard.edu/catalog.php?isbn=9780674066892

53 For a good overview of this subject, see Helgadottir T et al, 'Cyclically adjusting the public finances', Working Paper No. 3, OBR 2012, budgetresponsibility.independent.gov.uk/wordpress/docs/Working-paper-No3.pdf

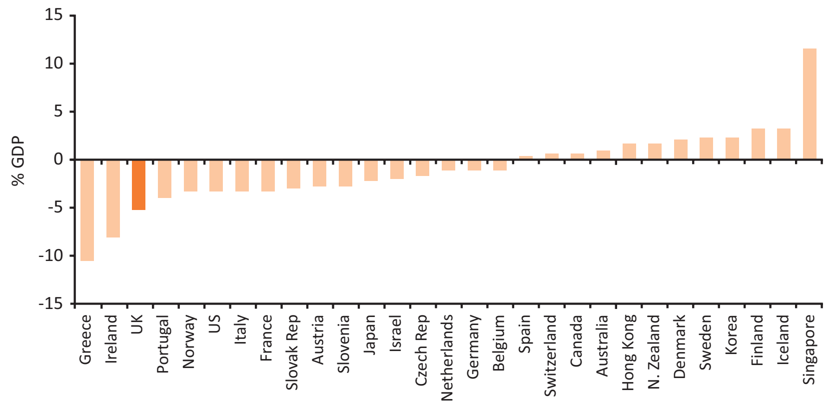
is important to emphasise the uncertainty with which any set of fiscal rules has to operate. Assuming these estimates are likely to be subject to significant revision means building the capacity to adapt to these new circumstances in the fiscal framework. We believe this requires a cautious but flexible approach to the UK's public finances.

Figure 16: Change in general government total outlays, 1997–2010



Source: Chote R et al., 'Public Spending Under Labour', IFS 2010, www.ifs.org.uk/bns/bn92.pdf, p. 6.

Figure 17: Cyclically-adjusted structural budget deficit 2007 (% GDP)



Source: IMF, Fiscal Monitor, 'A progress Report on Fiscal Adjustment, October 2012', www.imf.org/external/pubs/ft/fm/2012/02/fmindex.htm

The reason for this is straightforward: there is a significant difference between the government overspending than underspending. If the government is underspending, it is relatively straightforward to identify new additional priorities targeted at certain economic or social objectives, and increase spending accordingly to compensate. In contrast, there is far less flexibility if problem is overspending. Once obligations have been made and expectations created of a certain programme being undertaken, it is much more difficult both practically and politically to pull back. The temptation to 'keep the party going' with continued expansion of spending during economic expansions, and the reluctance to exacerbate cyclical asymmetries occurring during a slowdown or contraction, means, as we have seen, that deficits in 'bad' times are rarely matched by the surpluses in 'good' times. If the overspend has occurred during a boom (when the output gap is positive), it is very difficult to deliver additional fiscal stimulus, or to rein in spending in an economy with weak demand, leaving far less room for a countercyclical policy.

Figure 18: Receipts and expenditure, 2000–10

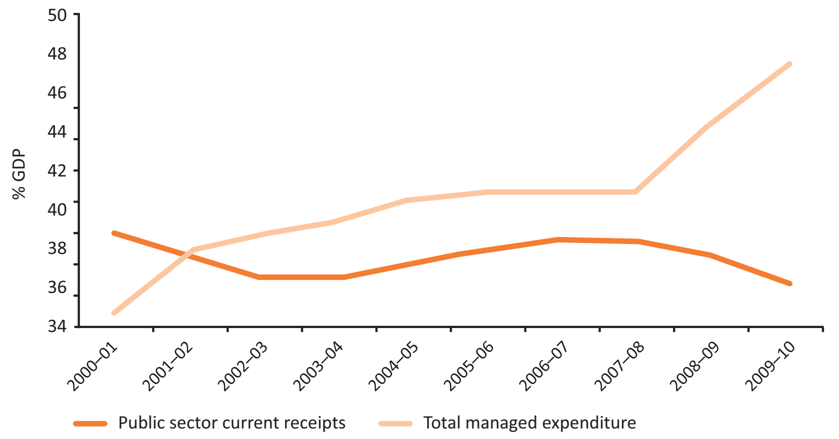
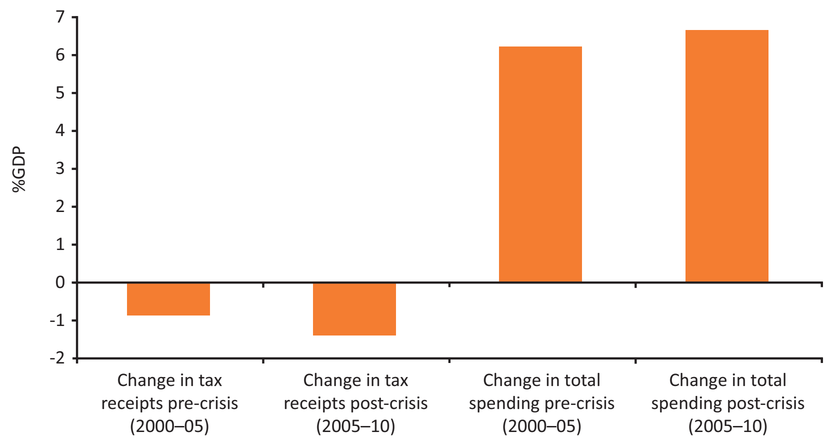


Figure 19: Tax and spending changes, 2000–10



Source: Public Finance Databank.

These graphs illustrate very clearly the story of the UK's fiscal position leading up to the financial crisis and subsequent efforts to tackle it. As shown in Figure 16, between 1997 and 2010, the UK saw the largest increase in public spending as a share of national income of any industrialised country for which there is comparable data, from 22nd position out of 28 to 6th: a remarkable rise of some 4.4% per year in real terms.[54] While tax receipts remained relatively stable throughout this period:

54 Chote R et al., 'Public Spending Under Labour', IFS 2010, www.ifs.org.uk/bns/bn92.pdf, p. 1

fluctuating in a fairly narrow band of 36.2% to 38.7% of GDP, public spending rocketed: from 34.6% of GDP in 2000 to 47.4%, in 2010, a level not seen since the UK's IMF bailout in 1976.[55] Just under half this increase (6.2% of the 12.8% of GDP total) had already occurred by 2005: well before the start of the economic crisis. This meant that the UK entered the financial crisis in 2007/8 with an already significant fiscal deficit, limiting its ability to respond with countercyclical fiscal policies.

Public sector net borrowing in 2010 was higher than at any time since records began in 1948 and higher than any member of the G20 except the United States.[56] As Anders Borg, the Swedish finance minister commented at the April 2013 IMF meeting, there is 'really only one way to avoid painful fiscal consolidation for countries with very high debt and that was never to get yourself into such a mess in the first place.'[57]

A sensible route would be a set of fiscal rules that 'errs on the side of caution', building up fiscal shock absorbers in case the economic situation is worse than projected rather than being reliant on the (frequently wrong) assumption that the output gap is correct. With continuing uncertainty in the global economic outlook, the case for developing a set of credible fiscal mechanisms, which deliver flexibility for the UK to adapt to circumstances for the long-term, and to be ready when the next economic downturn inevitably arrives, is even stronger.

Adaptation to other long-term issues (demographic changes, fiscal shocks, decline of North Sea oil revenue etc.)

A significant issue for the existing fiscal framework is that it does not respond to one-off unexpected shocks or major changes that exist outside the normal economic cycle. This is especially true of long-term factors. There are several of these that may impact significantly on the UK's fiscal position, including:

- Demographic pressures on the labour market (an aging population and rising dependency ratio); (*negative*)
- Pressure on public spending from the above such as pensioner benefits and health care; (*negative*);
- Declining North Sea Oil production and revenues; (*negative*)
- The development of oil and gas shale resources; (*positive*)
- Public sector pension liabilities and uncosted accruals; (*negative*)
- Maturation of off-balance sheet liabilities; (*negative*)

Several of these factors are reflected in the OBR's (long-term) Fiscal Sustainability Report but have little or no impact on the government's immediate fiscal planning, which stretches only to the year after the general election without accounting for adjustments that might be needed further into the future. The OBR compounds the relatively low profile of this Report with some very generous estimates of future public spending and productivity. Remarkably, the OBR asserts that:

> *'In our central projections, our assumption for unchanged policy is that beyond 2017–18 underlying spending on public services, such as health, rises in line with per capita GDP'*[58]

Given the factors outlined above, this seems an unjustifiable premise on which to base long-term fiscal planning. Even with this generous assumption, this

55 Public Finance Databank May 2013 aggregates

56 IMF Fiscal Monitor, October 2012

57 Warner J, 'On public finances, Britain is still living in cloud-cuckoo land', Telegraph, 15th July 2013, www.telegraph.co.uk/finance/comment/jeremy-warner/10181272/On-public-finances-Britain-is-still-living-in-cloud-cuckoo-land.html; also see: www.imf.org/external/meetings/schedule.aspx?meetingid=3

58 OBR Fiscal Sustainability Report 2013, cdn.budgetresponsibility.independent.gov.uk/FSR_2013-execsummary.pdf

projection still shows a long-term rising level of indebtedness. Unfortunately, it seems likely that most of these unaccounted for factors will lead to an overall deterioration of the UK's fiscal position well beyond the OBR's central projection. In particular, rising public service pressures due to an aging population – with the number of people over 65 years old expected to increase by 51% by 2030 and the number over 85 to double[59] – are likely to create additional pressures on public expenditure that are currently unaccounted for. Other 'unknown unknown' factors will no doubt have a further impact. Nevertheless, a prudent fiscal policy should attempt to account for these factors wherever possible.

Even beginning to address these long-term problems means more than simply attempting to 'balance' the budget each year over the economic cycle. Rather, to begin to prepare for these looming fiscal challenges, the UK needs to begin a long-term unwinding of sovereign and off-balance sheet debt. Developing a set of fiscal targets will be necessary to ensure we are able to meet these targets over the long term.

Short term politics, long-term fiscal problems.

> *'Government is like a baby. An alimentary canal with a big appetite at one end and no responsibility at the other.'*
>
> Ronald Reagan, during his 1965 campaign for Governor of California, New York Times, 14th November 1965.

> *'Panis et circenses' (bread and circuses).*
>
> Juvenal's Satire X

Chapter 1 showed why the failure to deliver a sustainable fiscal balance for the UK economy is a long-term issue. However, this is just a specific example of a broader problem in public spending policy. The wider issue is that longer-term reductions in the level of public spending (either in nominal terms or as a proportion of GDP) are very difficult to deliver or credibly commit to. Short-term pledges to increase expenditure may be popular and effective for a government with short-term political time horizons without necessarily reflecting the long-term impact on the economy, growth and long-term living standards. Once spending has been driven up in one area, perhaps during recessions, it often proves 'sticky' and difficult to reduce significantly during expansions, the so-called 'ratcheting' effect.[60] No government wants to take 'away the punch bowl'[61] during an economic boom by trimming spending plans or hiking taxes, policies likely to be unpopular and perceived at the time as unnecessary. It is equally the case that during a recession, it is easier (though not necessarily correct) to make the case for ever-higher stimulus and to defer the prospect of moving to a sustainable fiscal path for another day.

During the next Parliament, it is likely that the UK will have achieved the objectives defined by its two main fiscal targets. Our previous report, *Controlling Spending and Government Deficits,* noted that:

'Fiscal rules, on the other hand, have tended to be used much more often after successful consolidations, in an attempt to lock in success, and as an expression of a "just do it" culture in respect of spending control.'[62]

59 www.parliament.uk/business/publications/research/key-issues-for-the-new-parliament/value-for-money-in-public-services/the-ageing-population/

60 Hercowitz Z, Strawczynski M, 'Cyclical Ratcheting in Government Spending: Evidence from the OECD, www.tau.ac.il/~zvih/pdf/HercowitzStrawczynski02.pdf

61 William McChesney Martin, Jr., former Federal Reserve Chairman, Time magazine interview 1970

62 www.policyexchange.org.uk/images/publications/controlling%20spending%20and%20government%20deficits%20-%20nov%2009.pdf, p. 13

During the next Parliament, after the fiscal consolidation that began with the Emergency Budget in 2010, the UK should have passed through this 'just do it' phase, with a cyclically adjusted current budget surplus and falling public sector net debt. The Chancellor has set out an ambition to run a budget surplus in 'good times' during the next Parliament (i.e. by 2020), but has yet to spell out the details.[63] To consolidate these gains it will be necessary to develop longer-term fiscal institutions which respond to economic needs outside those of the electoral cycle. To do this, it is important to consider what the future of the UK's fiscal rules should look like and what alternative methods there are to give credibility to the UK's fiscal plans over the long-term.

63 www.conservativepartyconference.org.uk/Speeches/2013_George_Osborne.aspx

4
Fiscal Rules Proposals in UK/ Other Countries

The 'optimism bias' – the golden and sustainable investment rules

The fiscal framework enacted by the incoming Labour government in 1997 consisted of two key elements, formalised in the Code for Fiscal Stability 1998.[64] These were:

> *'the golden rule: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and*
>
> *the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40% of GDP over the economic cycle.'*[65]

However, neither of these rules prevented an unsustainable level of borrowing. They explicitly stated that 'the Government may depart from its fiscal objectives and operating rules', providing it explains how and over what timescale it intends to return to them.[66] Neither had any formal enforcement mechanism in the event of a breach. Remarkably, as late as November 2006, the Institute for Fiscal Studies was still asserting that:

> *'Under the present forecasts, the government is set to meet its rules over both the current cycle and future economic cycles'.*[67]

This was the result of an 'optimism bias' in the government forecasts. In particular, the redefinition of the economic cycle, and revisions to estimated trend growth rates allowed deficits to accumulate even when the economy was in a state of sustained expansion. For example, the Treasury's redefinition of start of the economic cycle in July 2005 from mid-1999 to mid-1997 conveniently removed a projected breach of the golden rule (in effect, now counting surpluses run between 1997 and 1999 to pay for otherwise unpaid for spending some 6 years later) with little more economic justification than was evident than in previous years.[68] With optimistic projections that the economy would return to higher growth quickly, or future surpluses would make up for present day deficits, deficits were allowed to persist when the promised surpluses did not occur.

64 Financial Statement and Budget Report in July 1997, Code for Fiscal Stability Finance Act 1998 section 155

65 Pre-Budget Report 2008, p 36, para 2.92

66 Code for Fiscal Stability 1998, p. 6, webarchive.nationalarchives.gov.uk/20070701080508/hm-treasury.gov.uk/media/6/A/CodeForFiscalStability.pdf

67 Emmerson C, Frayne C, Love S, 'The Government's Fiscal Rules', p. 14, www.ifs.org.uk/bns/bn16.pdf

68 IFS Green Budget 2008, pp. 39–40. www.ifs.org.uk/budgets/gb2008/08chap3.pdf

This tendency towards optimistic estimates is a perennial problem in government forecasting, as shown in Figure 20. Over the decade 2000 to 2009, the cyclically adjusted budget balance forecast for three years hence in each budget was overoptimistic by an average of 2.8% of GDP, or a remarkable 6.6% of average total government spending over the same period. This tendency was even pronounced before the economic crisis, with the 2000–2004 Budgets (i.e. forecasting up to 2007/8) being on average 1.5% of GDP more optimistic and the 2005–2009 Budgets (forecasting up to 2012/13) more optimistic than the outturn, by 4.1% of GDP.

Figure 20: Cyclically-adjusted surplus on current budget balance by Budget forecast 3 years ahead, 2000–9

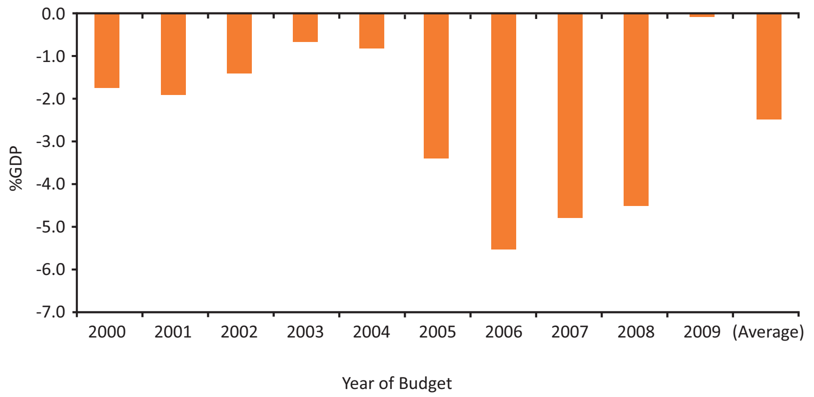
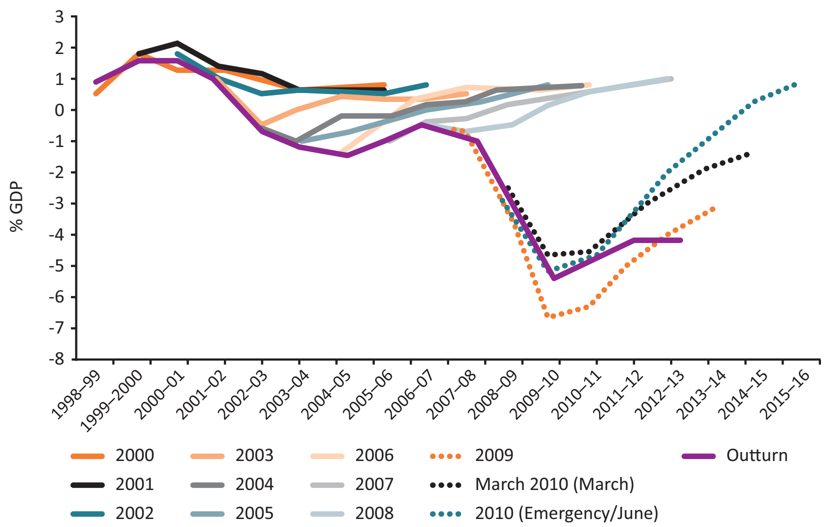


Figure 21: On the never-never... Cyclically-adjusted surplus on current budget balance by Budget forecast, 2000–16



Source: October 2011 Forecast evaluation report – historical budget forecasts, OBR 2011, budgetresponsibility.independent.gov.uk/category/topics/forecast-performance/

This problem is also common internationally. A study by Jeffrey Frankel found that the unsustainability of government finances and their noncompliance with existing fiscal frameworks is often compensated by more optimistic budget forecasts.[69] This tendency clearly worsened for more long-term forecasts: 33 countries showing budget balance forecasts 1 year forward 0.2% of GDP, 2 years forward 0.8% and 3 years 1.5% better than they were in reality (with the UK one of the worst performance with a 3 year forecast 3% more optimistic). Frankel suggests this is due to governments taking advantage of greater uncertainty the further out forecasts are.

Rules after the financial crisis

Both the golden and sustainable investment rules were suspended in the 2008 Pre-Budget Report to be replaced by a temporary operating rule, which set out an ambition to:

> *'improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full'.*[70]

However, this was judged too vague and unlikely to enforce fiscal discipline.[71]

This was replaced by the Fiscal Responsibility Act 2010. However, the Coalition Government considered this too lax, with public sector net borrowing only needing to fall to 5.5% of GDP by 2013/14 (though in fact outturn was 6.8%). More recently, the Chancellor has set out an ambition to achieve a budget surplus during the next Parliament.[72]

Despite appearances to the contrary, there is often a surprising degree of consensus between the political parties over the baseline of public spending, if not the exact details. Labour famously committed to stick to Conservative spending plans in 1997 for the first two years of its government, while the Conservatives pledged to continue with Gordon Brown's spending plans for 3 years in 2007 (though later reversed this pledge).[73] The Labour Party again pledged to stick by government current spending limits for 2013.[74] There is thus an opportunity to build a consensus around a lasting fiscal framework.

Box 1: Case studies

The Sinking Fund: 18–19th Century UK

A particular example in the UK of a form of fiscal rule was the 'Sinking Fund', most notably used during the eighteenth and nineteenth centuries for the purposes of retiring national debt. A similar modern example is the proposed European Redemption Pact to reduce the debts of Eurozone states in breach of the Maastricht debt-to-GDP ratio of 60%.[75]

The basic concept underlying such schemes that the national debt should be reduced in the long-term and that it 'shall be appropriated, reserved and employed to and for the discharge of the principal and interest of such national debts and encumbrances as were incurred… and to and for no other use, intent or purpose whatever.'[76] A set

69 Frankel J, 'Over-optimism in forecasts by official budget agencies and its implications,' Oxford Review of Economic Policy, OUP, vol. 27(4), pp536–562, 2011, www.nber.org/papers/w17239

70 Pre-Budget Report 2008

71 www.ifs.org.uk/wps/wp0429.pdf

72 George Osborne to the Conservative Party conference 2013, www.conservativepartyconference.org.uk/Speeches/2013_George_Osborne.aspx

73 www.telegraph.co.uk/news/uknews/1562023/Tories-vow-to-match-Labour-spending.html

74 www.huffingtonpost.co.uk/2013/06/21/labour-spending-cuts-hars_n_3480442.html

75 'The European Redemption Pact: An Illustrative Guide', German Council of Economic Experts, 2012, www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/working_paper_02_2012.pdf

76 Price R, 'An appeal to the public, on the subject of the national debt.', London, 1772, p. 24, digitalcommons.mcmaster.ca/cgi/viewcontent.cgi?article=1069&context=mcmastercollection

amount of money would be set aside each year by the Government and would be invested in stocks in order that returns would further augment the effectiveness of the scheme.

While such a Fund seemed to serve its function during periods where the public finances were not strained (for example, the Fund introduced by William Pitt the Younger in 1786 successfully reduced the national debt by £10 million – around 6.3% of GDP or £1.33 billion in 2012 prices), its effect tended to be diluted during times of fiscal stress (the latter fund being largely wiped out by the Napoleonic Wars and finally abolished in the 1820s).[77]

Slovenia

In May 2013, the centre-left Slovenian government responded to its fiscal crisis by adopting a new balanced budget law, alongside a wider package of tax rises and spending cuts. This responded to a recession beginning in 2011, a downgrade of the government's debt to junk status in late April, continuing problems in its banking sector and serious concerns in financial markets that the Eurozone country could need a bailout. It commits to balancing the general government budget every year from 2015, except in 'extraordinary circumstances' through a constitutional amendment. The law passed with bi-partisan support. Further measures limiting the power of referendums to alter budgetary, tax or spending plans were also passed.[78]

Sweden

The fiscal, economic and financial crisis that engulfed the Swedish economy in the early 1990s, with a deficit of 11% of GDP, soaring levels of public indebtedness and an economic contraction of 4.3% in real terms between 1991 and 1993 led to a serious rethink of the country's economic policies.[79]

Ultimately, it led to the non-partisan development of a robust fiscal framework. The rules require a budget surplus of 1 percent of GDP over the economic cycle, with exemptions for structural deficits during recessions. Annual nominal spending targets are set three years in advance, meaning the budget each year has been set three years' previously. A Fiscal Policy Council dominated by independent academic economists assesses whether the government's fiscal plans comply with the targets and its forecasting methods, and has a wide remit over whether its fiscal policy is consistent with long-term growth and stability.

This budgetary process continues to command widespread political support and has ensured continuing fiscal stability even in the face of the recent financial crisis, with a deficit never rising above 0.9% of GDP.

Chile

Chile is often singled out as having an effective fiscal framework. It introduced a structural balance regime in 2000, including mandating of surpluses if GDP (or the price of copper, a key export) are above their long-term trends, with a committee of independent experts calculating the output gap every second quarter.[80] This has prevented the 'optimism bias' of fiscal projections evident in other countries – actually showing a slight pessimism bias, even in booms.

77 Pitt W, Note on the Sinking fund established in 1786, in 'Classic Writings on Economics, Volume 4: Scarce and Valuable Tracts on the National Debt and the Sinking Fund.'

78 www.globalpost.com/dispatch/news/afp/130524/under-pressure-slovenia-adopts-fiscal-golden-rule-0

79 IMF, www.imf.org/external/datamapper/index.php

80 Frankel J, 'Over-optimism in forecasts by official budget agencies and its implications,' Oxford Review of Economic Policy, OUP, vol. 27(4), pp536–562, 2011, www.nber.org/papers/w17239

Australia

The Charter of Budget Honesty (1998) requires that all governments spell out their objectives and targets for fiscal policy, and requires that the government deal with financial risks, include 'risks arising from excessive net debt'.[81] It does not have a formal enforcement mechanism.

New Zealand

The Fiscal Responsibility Act 1994 requires that public sector net debt must be reduced to a prudent level, with operating surpluses to achieve this end and balanced budgets thereafter.[82]

Spain

A Fiscal Stability Law passed in 2004 has mandated budget surpluses at every level of government.

United States

A Budget Enforcement Act of 1990 mandated that all future changes to legislation affecting tax or spending outcomes had to be 'paid for' or budget neutral over a five year time frame. The Act expired in 2002.

European Union

The Stability and Growth Pact from 1997 has theoretically required EU members to target a maximum budget deficit of 3% of GDP and a debt-to-GDP ratio of 60% of GDP.[83]

While an excessive deficit procedure (caveated to provide opt outs for exceptional circumstances in 2004) could be enacted to fine member states which breached the Pact repeatedly, in practice no significant penalties have ever been levied against these countries. In practice the Pact has stood in abeyance since the financial crisis.

Switzerland

Switzerland saw gradually rising debt levels throughout the 1990s, with the debt-to-GDP ratio rising from 30% in 1989 to over 70% by 2005. A constitutional amendment introduced in 2001 and known as the 'debt brake' passed with 85% approval in referendum, requiring the federal government to run a structurally balanced budget each year. This works by setting an expenditure cap for the following year's budget which must be aligned with structural revenue (i.e. adjusted for trend GDP). The rule excludes one-off revenue such as asset sales and extraordinary spending such as disaster relief, which can be sanctioned by both houses of parliament.

Any difference in outturn is debited or credited to an adjustment account, requiring compensation in the next year's target (or, if the deficit exceeds 6% of expenditure, over 3 years). While subsequent adjustment can be made to the budget, this must all be reflected in the compensation account as must any other measure affecting the fiscal position. This has had the effect of significantly reducing the growth of government spending.[84]

81 www.comlaw.gov.au/Details/C2012C00230

82 www.treasury.govt.nz/publications/research-policy/wp/2001/01-25/04.htm

83 ec.europa.eu/economy_finance/economic_governance/sgp/

84 Mitchell D, 'How the Swiss 'Debt Brake' Tamed Government', Wall Street Journal, 25th April 2012, online.wsj.com/article/SB10001424052702303459004577361622927199902.html

'Fixing the roof while the sun is shining'– Osborne's new fiscal rule

At the 2013 Conservative Party Conference, the Chancellor George Osborne announced a new fiscal principle to be applied subsequent to existing spending plans applying up to 2017/18:

> *'Surely the lesson of the last decade is that it's not enough to clean up the mess after it's happened? You've got to take action before it happens. It should be obvious to anyone that in the years running up to the crash this country should have been running a budget surplus. That's what we mean when we say they didn't fix the roof when the sun was shining. So I can tell you today…*
>
> *we will have a surplus in good times as insurance against difficult times ahead. Provided the recovery is sustained, our goal is to achieve that surplus in the next Parliament. That will bear down on our debts and prepare us for the next rainy day…*
>
> *We also want to go on investing in the essential infrastructure of our country…*
>
> *So we should commit, alongside running a surplus and capping welfare, to grow our capital spending at least in line with our national income. These principles will form the foundation of our public finance policy and I will set out the details next year.'*[85]

It is unclear at the time of writing what having a 'surplus in good times' could mean in practice. It might, as some commentators have suggested, simply be a commitment to continue the existing target of a cyclically adjusted current budget surplus.[86] Others have suggested it could mean an elimination of the overall deficit in cash terms including capital spending, providing there is no recession.[87] We note that factors the target could incorporate include:

- An adjustment for the condition of the economy (e.g. output gap or the business cycle);
- Including or excluding different types of spending (e.g. capital spending, debt interest);
- Differing definitions of when the target is to be met (e.g. a rolling or fixed date); and
- Including or excluding conditions on particular types of spending (e.g. 'ringfenced' budgets, caps on Annually Managed Expenditure, growth rate of capital spending).

How each of these details are incorporated will have a significant impact on the fiscal sustainability of the UK public finances. As an illustration of this, we have analysed one possible interpretation of the Chancellor's pledge – that there should be no overall public sector net cash deficit (i.e. the minimum definition of what a 'surplus', statistically insignificant from zero, could mean) when the output gap is zero – that is, the economy is performing at its full productive potential (i.e. a reasonable definition of 'good times'). When there is an output gap (i.e. aggregate demand is less than productive potential), we assume a deviation from that target equal to that spare capacity (i.e. % GDP public sector net borrowing equal to the output gap), and, a contrariwise public sector net surplus when the output gap is positive (as one possible interpretation of how the target could change to reflect the economy's deviation from the central 'good times' scenario).[88]

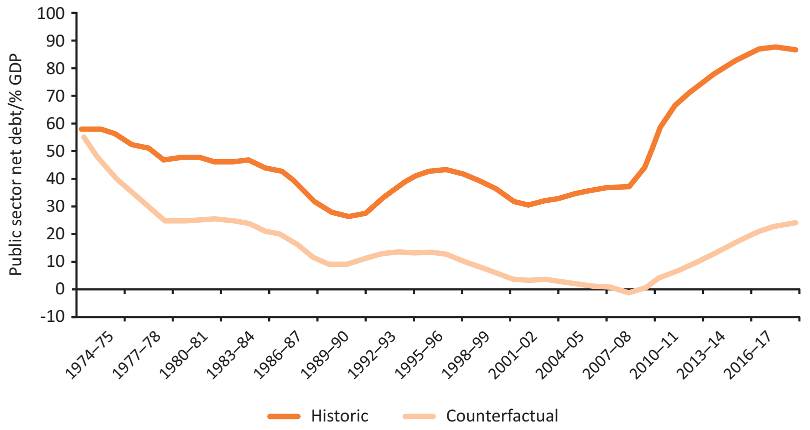
85 George Osborne, 30th September 2013, www.conservativepartyconference.org.uk/Speeches/2013_George_Osborne.aspx

86 www.cnbc.com/id/101075889

87 www.bbc.co.uk/news/uk-politics-24339347

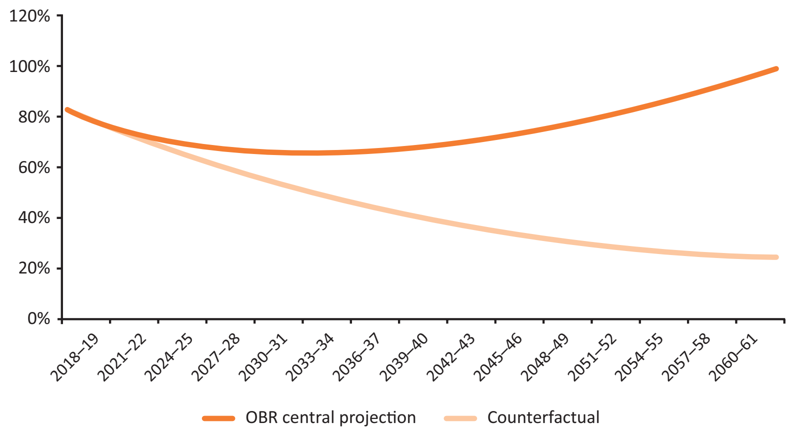
88 The commitment to raise capital spending in line with national income, affecting the composition of spending only and is thus excluded

Figure 22: Historic debt/GDP ratios and counterfactual application of potential fiscal rule



Source: Authors' calculations and Public Finance Databank May 2013 aggregates.

Figure 23: Debt to GDP ratio: OBR central projections and proposed fiscal rule



Source: Authors' calculations assuming long-term mean output gap and OBR fiscal sustainability report 2013, supplementary tables chart 3.8.

Figure 22 applies this rule to historic output gap and GDP data. It should be noted that this graph is not an assessment of what the outcome would have been had such a rule been in place.[89] Nevertheless, it does illustrate how significant such a rule might be. Broadly, it mandates more aggressive debt reduction during expansions (even briefly eliminating net debt completely in 2007/8) and more moderate borrowing during contractions.

Applying the same rule to the OBR's central projection for the debt/GDP ratio puts the UK on a significantly more benign debt trajectory, returning the ratio to the pre-recession level of 37% by 2043/4 or 25 years after the rule is introduced.

89 We note that this does not include dynamic macroeconomic effects, assumes perfect compliance and other factors which could affect outcome

‘Black swan’ events

The financial crisis beginning in 2007/8 and culminating in a major recession put significant pressure on the public finances, with public sector net debt only forecast to begin falling as a proportion of GDP by 2017/18. There may thus be significant difficulties in returning public indebtedness to a reasonable level before the end of the economic cycle and its associated hikes in government borrowing occurs. A simple modification could be to ringfence a further percentage of GDP in fiscal tightening supplementary to the mechanism set out above. This would allow the debt ratio to fall faster, preparing the UK economy for the beginning of a new business cycle or the event of tail-end or ‘black swan’ scenario which would require greater flexibility to deploy a countercyclical fiscal policy.

Figure 24: Debt to GDP ratio: OBR central projections and alternative fiscal rules

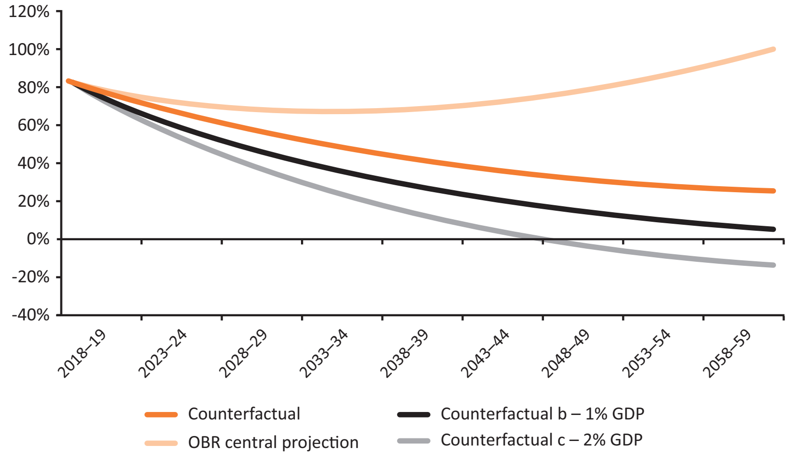


Figure 24 shows two further forecast scenarios: that on a central ‘good times’ scenario when the UK is at full output, a further 1% or 2% of nominal GDP is ‘set aside’ to pay down public debt. This would put public sector net debt on a projected course to return to its pre-financial crisis level earlier: in 16 years (2034/35) and 12 years (2030/31) respectively.

5
Proposals/Options

'da mihi castitatem et continentam, sed noli modo' (*'Give me chastity and continence, but not yet.'*)
St. Augustine, Book 8 Chapter 7 'Confessions'

This Paper demonstrates a serious and long-term failure to provide a sustainable basis for the UK's public finances, regardless of which political party has been in government. We have explained why this is a problem for the UK's long-term growth prospects, what a new set of fiscal rules require and what issues need to be overcome to ensure that they are complied with over the long-term. This Chapter outlines what these fiscal rules should look like and how they should be implemented.

The new fiscal rules

A prerequisite for a strong fiscal framework is that the budget should be in cyclically adjusted balance and that short-term political time horizons need to be overcome with a commitment to longer-term fiscal planning. Similarly, we note that the Chancellor has announced a desire to achieve 'a surplus in good times as insurance against difficult times ahead.'[90] To achieve this, we propose:

Proposal 1*: The overall fiscal mandate should be based on a zero public sector net cash deficit when the economy is at full output.*

Where there is a positive or negative output gap, the target should be modified by the same amount (i.e. an additional % GDP public sector net borrowing equal to the output gap). This target would be clear and easy to understand: simply, that when the economy is performing at full output, there should not be any net borrowing. This overall objective allows a reasonable balance between financial solvency and allowing sufficient flexibility in the event of recession or overheating. Unlike the 'Golden Rule', it requires spending to be in structural balance each year, rather than over an economic cycle, of which 'uncertainties… in particular those relating to further possible revisions', prevail.[91] This follows the success of the similar Swiss model. It also allows flexibility for the automatic stabilisers to function, with cyclical increases in spending during a recession, and a budget surplus during a boom.

As this report shows, the UK has a long-term tendency to build up higher levels of debt. This forms part of a longer-term failure in the developed world to tackle fiscal problems during times of expansion to offset increase indebtedness during recessions. As the International Monetary Fund has commented:

90 George Osborne to the Conservative Party conference 2013, www.conservativepartyconference.org.uk/Speeches/2013_George_Osborne.aspx

91 HM Treasury, Evidence on the economic cycle, November 2008, p. 3

> *'High public debt tends to raise interest rates, lower potential growth, and impede fiscal flexibility. Since the early 1970s, public debt in most advanced countries has been the ultimate absorber of negative shocks, going up in bad times, not coming down in good times. In the G-7 average, gross debt was 82 percent of GDP in 2007, a level never reached before without a major war.'*[92]

To address this, it is necessary for the UK, under normal circumstances, to be reducing its debt burden and this should be a long-term objective for fiscal policy. It should also provide flexibility to temporarily allow increased indebtedness in order that automatic stabilisers are able to function during a recession. However, in the medium-term, we also require a means to reduce debt to a sustainable level before the end of the economic cycle to ensure that the UK has sufficient flexibility to employ a countercyclical fiscal policy during a downturn. We therefore propose:

Proposal 2*: Subsequent to 2017/18, a supplementary rule should target a reduction in the debt-to-GDP ratio to reach a sustainable level by the end of the economic cycle.*

This would involve 'ringfencing' an additional fiscal payback mechanism to 'pay down' debt in addition to the fiscal mandate set out in Proposal 1. The OBR should consult as to what precise level this payback mechanism will need to be set to achieve this outcome. For example, taking the pre-financial crisis level as a baseline, an additional 1% or 2% of nominal GDP fiscal surplus would put public sector net debt on a projected course to return to crisis sustainable level in 16 years (2034/35) and 12 years (2030/31) respectively as shown in Figure 24.

> "It is necessary for the UK to be reducing its debt burden and this should be a long-term objective for fiscal policy"

This rule provides an overall framework for reducing the UK's debt-to-GDP ratio and a requirement that, under normal economic circumstances, this ratio should be falling. In concert with proposal 1, it also gives scope to relax the rule if the economy is performing below potential.

A significant issue regarding the UK's financial solvency is the accumulation of off-balance sheet debt, accruing through unfunded liabilities such as public sector pensions and PFI contracts. Preventing the accrual of such debt without appropriate offsetting, or even acknowledgement of its scale must be a key priority in getting the UK's long-term debt burden down.

Proposal 3: *In the long term, the OBR should endeavour to create a measure of public sector net debt recalculated to include off-balance sheet, accrued and accruing liabilities such as public sector pensions or PFI contracts. In the long term, this measure should replace the existing debt-to-GDP ratio measure for the purposes of Proposals 1 and 2.*

A 2010 estimate by the Office of National Statistics puts these debts as high as £4,840 billion – several times higher than on-balance sheet debt.[93] As well as presenting a more transparent picture of the true state of the UK finances, this will ensure that governments are not able to covertly spend or commit to the future

92 blog-imfdirect.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies/

93 www.ons.gov.uk/ons/rel/psa/wider-measures-of-public-sector-debt/july-2010/index.html

spending of public money without affecting the fiscal rules. This will not be easy. For example, a necessary first step will be publication in full of total capital spending through PFI schemes to date.[94]

It also provides a medium-term discipline on governments to begin addressing the accrual of rising or uncosted long-term liabilities.

Monitoring compliance with the rules

Proposal 4: *The OBR should monitor compliance with the fiscal rules set out in Proposals 1 and 2. It should state the rules to be in breach should either target be missed by more than 1% of GDP per year. It should also publish a range of independent market estimates of compliance, including use of prediction markets.*[95]

This ensures that the process of assessing the fiscal rules is transparent and grounded in the existing purpose and expertise of the OBR. By mandating the publication of external estimates, it also promotes transparency.

As outlined in Chapter 2, once debts and deficits have accumulated, it is often very difficult for a subsequent government to redress the problem in the future. Deviation from existing targets is rarely corrected for, with the objective of merely putting public finances back 'on course' to meet the target in the future, without any 'backward look' to account for difficulties which arose in the past. This has had the effect of preventing such rules having last impact on public indebtedness. To correct this, we propose:

Proposal 5: *In the event the fiscal mandate or supplementary rule is in practice breached, a Payback Mechanism should mandate that any deficit outside the rules has to be on course to be repaid on the OBR's central estimate within the 5 years with a 70% probability in addition to requirements above, following the Swiss/Swedish 'debt break' model.*

This guarantees that any breach is not simply passed over without consequence or justified by an aspiration to return to fiscal solvency over the long-term, but has a quantifiable and ongoing impact on the fiscal picture. Governments could no longer move the UK to a higher level of indebtedness without definite plans to recover the shortfall within a politically relevant time horizon. The five year payback period places a strong incentive on governments to return to the fiscal mandate quickly, within a politically relevant time frame and boosts confidence that the rules will, in fact, move back into compliance.

To ensure this compliance, however, we also believe it is necessary to introduce clear procedures to ensure that the government of the day sets out the means by which it intends to return to its fiscal rules, rather than simply missing them without further action being taken.

New penalties if the targets are missed

A further iteration of fiscal rules could involve direct effects on government spending through automatic triggers. These could be used to reduce government spending in the event of a breach without any further action. This form of (potentially unpopular) 'nudge' action could be a further lever to incentivise government action.

94 Emmerson C, Frayne C, Love S, 'Updating the UK's Code for Fiscal Stability', p. 11, eprints.ucl.ac.uk/2853/1/2853.pdf

95 See Graefe A, Armstrong J, 'Comparing face-to-face meetings, nominal groups, Delphi and prediction markets on an estimation task', International Journal of Forecasting 27 pp. 183–195, 2011., dl.dropboxusercontent.com/u/5317066/2011-graefe.pdf

Proposal 6: *In the event that the budget is in breach 30 days prior to the beginning of the fiscal year, this will trigger automatic nominal freezes to indexation of tax allowance thresholds, public sector remuneration, the state pension and benefit payments.*[96]

This measure would automatically adjust the fiscal position (through cuts to public spending and tax increases through 'fiscal drag') in the event of a breach. This would trigger a budgetary adjustment (i.e. cutting spending and raising taxation) in the absence of remedying government action. The purpose of this trigger would not be that such freezes would be a permanent feature of UK fiscal adjustments or even that such a trigger would actually be implemented. Rather, by including a range of unpopular measures affecting many interest groups (i.e. from pensioners to public sector workers to general taxpayers), this measure provides a very strong incentive for a government to take remedial action, either to avoid the breach in the first place, or to take swift remedial action to ensure the breach is remedied. This sharply increases the political cost of inaction over the simple declaration that the target or targets have been missed. The inclusion of benefit changes in this rule also acknowledges the role of benefit expenditure as a significant element of public spending which should be subject to normal budgetary control.[97]

Proposal 7*: A new Fiscal Accountability Framework should be established. This would require through legislation that, in the event of the fiscal rules being breached, the Chancellor will be obliged to call an Emergency Budget setting out how they intend to return the fiscal balance to compliance and implement the Payback Mechanism outlined in Proposal 5. The Chancellor would also need to report to the House once a quarter on progress until this is achieved as defined by the OBR, with a new Emergency Budget triggered each six month period the rules remain in breach.*

This ensures there is an autonomous trigger to move fiscal policy back into balance in the event of a breach and significant political consequences (in terms of a new Budget and ongoing enhanced scrutiny) creating a strong incentive to avoid such a breach.

As we noted in Chapter 3, a key issue in increasing the transaction cost of non-compliance with the rule is the sovereign right of Parliament to pass budgets. We thus believe that changes in the estimates process would be an effective way of penalising any breach of the rule.

Proposal 8: *If any Budget is determined to be in breach of the fiscal rules, the length of time for scrutiny of budget estimates will be automatically increased from 3 days (applying to compliant budgets) to 30 days.*

This rule, while not interfering with a government's ability to pass a non-compliant budget, does ensure that the rules 'have teeth' and cannot be breached without loss of parliamentary time, potentially impacting on the government's wider legislative agenda.

The exact amendments to the standing orders are listed in the Appendix to the Paper. Whilst these reforms could be repealed through amendment of the standing orders, finding an appropriately balanced procedural hurdle and making its trigger as external to the political process as possible should go some way towards giving it a greater level of permanence.

96 We note that these freezes should only apply to discretionary spending, rather than retrospective breaches of contractual obligations already undertaken, such as index-linked public sector pensions

97 See Oakley M, 'Capping Welfare', Policy Exchange 2013, www.policyexchange.org.uk/publications/category/item/capping-welfare

Assessing the proposals

These proposals have four main objectives:

- To ensure sustainable public finances;
- To be practical and compatible with the economic programme of any future government;
- To minimise or avoid the past mistakes of fiscal planning;
- To increase the political cost of non-compliance to ensure and provide confidence that the rules will be adhered to.

To achieve these ends, the proposals have three main components:

- Rules – What the targets should be;
- Compliance – How the rules should be enforced;
- Penalties, enforcement – what should happen in the event of a breach.

How each of these proposals meet these objects is given below.

Table 3: Analysis of the proposals and their objectives

	Sustainable public finances?	Practical/ politically acceptable?	Prevent mistakes of the past?	Increased cost of compliance?
Rules				
No cash deficit when economy at full output	Yes – sets a standard that the budget should be balanced and allows automatic stabilisers to function.	Debatable – the Coalition's Fiscal Mandate and Labour's pledge to match current spending for 2015/16 excludes capital spending.[98]	Yes – attempts to balance the budget each year there is no output gap, not over economic cycle (as did previous golden rule).	Marginal – no additional enforcement mechanism, but target more onerous as it applies to every year.
Target reduction in debt-to-GDP ratio to reach sustainable level by end of economic cycle	Yes – targets a sustainable debt level by the end of the economic cycle.	Yes – the basis of existing supplementary target that the ratio should be falling.	Yes – targets falling debt ratio when the economy is growing normally.	No – little change from existing mechanisms.
Include off-balance sheet liabilities in debt in the long term	Yes – would include consideration of accruing liabilities currently unaccounted for.	Debatable – not included in the current targets and may require significant further fiscal adjustment in the long-term.	Yes – would prevent additional public spending off-balance sheet without consideration of effect on fiscal sustainability.	Marginal – widens the scope of the fiscal targets but little change to target mechanisms.
Compliance				
OBR to monitor compliance	Yes – continues OBR's existing mandate to ensure sustainable public finances.	Yes – continues existing arrangements.	Yes – Builds on the success of OBR's independent fiscal monitoring.	Marginal – expands OBR's existing mandate.

98 www.politicshome.com/uk/article/85310/ed_balls_conference_speech.html

Payback mechanism for deviation	Yes – ensures that any missed target is corrected for in the long-term.	Debatable – follows existing practices in other countries, but little considered in the UK.	Yes – prevents indebtedness increasing from targets being missed but not corrected for.	Yes – makes current targets account for past deviations, not just to be adhered to in future.
Penalties				
Automatic nominal freezes to indexation	Yes – would ensure an automatic trigger to increase taxes and reduce benefit and other AME spending in the event of a breach.	Debatable – freezes would be very controversial were they to be enforced. Potentially issues around retrospective policy and legacy liabilities.	Yes – provides trigger to reform in the event the rules are in breach.	Yes – high political cost if the targets are missed and no correction made.
Emergency Budget triggered	Debatable – will ensure that the Chancellor has to address any deviation.	Debatable – Emergency Budgets have been called in the past, but there may be procedural/political reluctance to an automatic trigger.	Debatable – unlike previous misses, would ensure a 'moment of change' when the fiscal targets are not met.	Yes – higher levels of accountability in bringing attention to the issue when the targets are not met.
Increase in time to scrutinise budget estimates	No – will not affect the public finances directly.	Debatable – issues around parliamentary procedure and timetable.	Debatable – would increase accountability and scrutiny of fiscal targets over historic budgets which missed targets.	Yes – would make the rules tougher and more difficult to break.

Conclusion

The new fiscal rules would come into force after the next General Election. These rules would be an effective way to provide long-term stable public finances for the UK following the successful implementation of similar policies in Sweden and Switzerland, and to lock in the success of the government's fiscal consolidation programme.

Perhaps more importantly, the rules are compatible with the democratic mandates of any government to increase public spending or cut taxation, as long as this is 'paid for'. It will allow a government to pledge not to increase taxes (as the current Chancellor has pledged after the General Election)[99] or cut spending, as long as this is paid for through, respectively, increased taxation or reduced public spending.

It places a strong discipline on the system to return to the mandate quickly and ensures that any deviation is clearly defined as outside the needs of the economic cycle, and carries a greater political cost through loss of parliamentary time, greater scrutiny and transparency, and a definite 'moment of reckoning' through

99 www.telegraph.co.uk/news/politics/10175419/Osbornes-tax-pledge-could-mean-cuts-to-NHS-and-pensions-experts-warn.html

the triggering of an Emergency Budget or various automatic freezes coming into force automatically should a government decline to act.

It also reduces or eliminates the opportunity for governments to escape existing fiscal rules by:

- Eliminating the 'escape clause' of redefining the economic cycle, 'getting around the rule', or through spending on off-balance projects that do not appear in the headline numbers.
- Never quite reaching the mandated fiscal discipline through 'rolling' targets that never have to be met, but simply theoretically be on course to be met, paying little political cost for getting off-track, and simply mandating getting back on track without correcting for the diversion.
- Correcting an arguable disconnect between (short-term) political time horizons for the perception of fiscal prudence and the (long-term) economic needs for the UK to have a fiscally sound path for its future growth and development.

Appendix: Amendment to Standing Orders for Implementation of the Fiscal Rules[100]

Standing Order 3

1. The Chairman of Ways and Means or a Deputy Chairman shall take the chair as Deputy Speaker when requested so to do by the Speaker, without any formal communication to the House.
2. Whenever the House shall be informed by the Clerk at the Table of the unavoidable absence or the absence by leave of the House of the Speaker, or where paragraph (3) of this order applies, the Chairman of Ways and Means shall perform the duties and exercise the authority of the Speaker in relation to all proceedings of this House, as Deputy Speaker, until the Speaker resumes the chair or, if he does not resume the chair during the course of the sitting, until the next meeting of the House, and so on from day to day, on the like information being given to the House, until the House shall otherwise order:

   Provided that if the House shall adjourn for more than twenty-four hours the Chairman of Ways and Means shall continue to perform the duties and exercise the authority of the Speaker, as Deputy Speaker, for twenty-four hours only after such adjournment.
3. For the purpose of paragraph (2) of this order, the Speaker shall have leave of absence, if he thinks fit, on any Friday on which the House sits.
4. Whenever the House has been informed by the Clerk at the Table of the unavoidable absence or the absence by leave of the House both of the Speaker, and of the Chairman of Ways and Means, the First Deputy Chairman of Ways and Means shall perform the duties and exercise the authority of the Speaker in accordance with paragraph (2) of this order; and if the House should be so informed of the unavoidable absence or the absence by leave of the House of the First Deputy Chairmen also, the Second Deputy Chairman shall perform those duties and exercise that authority.
5. *Whenever consideration by the House of estimates is due to occur, for the purposes of the process laid out in paragraph (3) of Standing order No. 145 the Chairman of Ways and Means shall issue a ruling as to whether the estimates are compliant with the agreed Fiscal Accountability Framework of this Parliament. This ruling should be based upon:*
   - i) *Compliance with the Fiscal Accountability Framework.*
   - ii) *The opinion issued by the Office for Budget Responsibility, the body set up in accordance with the Budget Responsibility & National Audit Act.*
   - iii) *No other considerations external to those highlighted in paragraph (5) of this Standing order.*

100 We note that these specific amendments are not approved by the House of Commons authorities for their efficacy or the specific purposes outlined in this Paper. They are provided as a guide for reference purposes only. Additions to the Standing Orders are italicised and underlined, deletions are provided in strikethrough.

Standing Order 54

1. ~~Three days~~ *A number of days so determined by the Liaison Committee under paragraph [x] of Standing order No. 145*, other than Fridays, shall be allocated in each session for the consideration of estimates set down under the provisions of the consideration of estimates set down under the provisions of paragraph (3) of Standing order No. 145 (Liaison Committee); and not more than one day so allocated may be taken in the form of two half days, not being Fridays.
2. On any such day
   a) Consideration of estimates or reports of the Liaison Committee relating thereto shall stand as first business; and
   b) Other business may be taken before the moment of interruption only if the consideration of estimates has been concluded.

   Provided that the foregoing provisions of this paragraph shall not apply on any day on which time has been allocated pursuant to paragraph (2)(b) of Standing Order No. 24 (Emergency debates).
3. On any such half day
   a) proceedings of consideration of estimates or reports of the Liaison Committee relating thereto, standing as first business, shall be interrupted at seven o'clock on Monday, four o'clock on Tuesday or Wednesday or two o'clock on Thursday; or
   b) notwithstanding the provisions of paragraph (2) of this order, consideration of estimates or reports of the Liaison Committee relating thereto may be set down for consideration at the hour specified in sub-paragraph (a) above and shall be entered upon at that time:

   Provided that on days on which time has been allocated pursuant to paragraph (2)(b) of Standing Order No. 24 (Emergency debate) or the Chairman of Ways has set down opposed private business under paragraph (5) of Standing Order No. 20 (Time for taking private business), proceedings under this sub-paragraph shall not be entered upon until the business in question has been disposed of and may then be proceeded with for three hours, notwithstanding the provisions of Standing Order No. 9 (Sittings of the House).
4. On any day or half day allocated under this order, questions necessary to dispose of proceedings (other than a dilatory motion) on the estimates on which debate has been concluded shall be deferred until the day and hour prescribed under paragraph (6) of this order.
5. Any estimates on which questions have been deferred to another day in accordance with the provisions of paragraphs (4) and (6) of this order, together with any questions so deferred, and all other estimates appointed for consideration on any previous day or half day allotted under this order shall be set down for consideration on the day to which the questions have been deferred.
6. On the day to which the provisions of paragraph (2) or (3) of Standing Order No. 55 (Questions on voting of estimates, &c.) apply which falls after or on any day or half-day allotted under this order, the Speaker shall, at the time prescribed in paragraph (1) of that order, put successively, any questions deferred under paragraph (4) of this order on the day and any questions necessary to dispose of proceedings on all other estimates appointed for consideration on any day or half day allotted under this order.

Standing Order 55

1. On any day to which the provisions of paragraph (2) or (3) of this order apply, at the moment of interruption or as soon thereafter as proceedings under the proviso to paragraph (3)(b) of Standing Order No. 54 (Consideration of estimates) have been disposed of, the Speaker shall (after putting any questions required to be put under paragraph (6) of Standing Order No. 54) put the questions on:
   a) any outstanding vote relating to numbers for defence services;
   b) any motion authorising amounts set out in outstanding estimates.
2. The provisions of paragraph (1) of this order shall apply on a day not later than 18 March, if any of the following total amounts have been put down for consideration:
   a) votes on the account for the coming financial year;
   b) supplementary and new estimates for the current financial year which have been presented at least fourteen days previously;
   c) votes relating to numbers for defence services;
   d) excess votes, provided that the Committee of Public Accounts has reported that it sees no objection to the amounts necessary being authorised by excess vote.
3. The provisions of paragraph (1) of this order shall apply on a day not later than 5 August in respect of any motion authorising amounts set out in outstanding estimates.
4. At least two days' notice shall be given of the motions which are to be put down for consideration under paragraphs (2) or (3) of this order.
5. The provisions of this order shall not apply to any vote of credit or votes for supplementary or additional estimates for war expenditure.

Standing Order 56

When a motion shall have been made for the second reading of a Consolidated Fund or an Appropriation Bill, the question thereon shall be put forthwith, no order shall be made for the committal of the bill and the question for third reading shall be put forthwith; and the said questions may be decided at any hour, though opposed.

Standing Order 145

1. A select committee shall be appointed, to be called the Liaison Committee:
   a) to consider general matters relating to the work of select committees,
   b) to give such advice relating to the work of select committees as may be sought by the House of Commons Commission, and
   c) to report to the House its choice of select committee reports to be debated on such days as may be appointed by the Speaker in pursuance of paragraph (15) of Standing Order No. 10 (sittings in Westminster Hall).
2. The committee may also hear evidence from the Prime Minister on matters of public policy.
3. <u>*Regarding the consideration by the House of estimates, the committee shall:*</u>
   a) <u>*Determine the amount of time to be allocated for the consideration of estimates, taking into account the ruling made by the Chairman of Ways and Means, pursuant to paragraph [x] of Standing order no. [x] allocating either:*</u>

i) *Three days in the case that the estimates are deemed to be compliant by the Chairman of Ways and Means with Parliament's fiscal goals.*

ii) *A minimum of thirty days in the case that the estimates are deemed to not be compliant by the Chairman of Ways and Means with Parliament's fiscal goals.*

b) *Reports its recommendations as to the amount and allocation of time for consideration by the House of the estimates on any day or half day which may be allocated for that purpose; and upon a motion being made that the House do agree with any such report the questions shall be put forthwith and, if that question is agreed to, the recommendations shall have effect as if they were orders of the house.*

~~report its recommendations as to the allocation of time for consideration by the House of the estimates on any day or half day which may be allocated for that purpose; and upon a motion being made that the House do agree with any such report the question shall be put forthwith and, if that question is agreed to, the recommendations shall have effect as if they were orders of the House.~~

4. The committee shall have power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to report from time to time.
5. Unless the House otherwise orders, each Member nominated to the committee shall continue to be a member of it for the remainder of the Parliament.
6. The committee shall have the power to appoint two sub-committees, one of which shall be a National Policy Statements sub-committee.
7. A National Policy Statements sub-committee-

a) shall be composed of –

i) *those members of the committee who are members of the Communities and Local Government, Energy and Climate Change, Environment, Food and Rural Affairs, Transport and Welsh Affairs Committees; and*

ii) *up to two other members of the committee, one of whom shall be appointed chair of the sub-committee;*

b) shall report to the committee on the use of the committee's powers under paragraph (1) of Standing Order No. 152H (Planning: national policy statements); and

c) may report to the committee on matters relating to national policy statements under the Planning Act 2008.

8. Each sub-committee shall have –

a) a quorum of three; and

b) power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to report to the committee from time to time.

9. The committee shall have power to report from time to time the minute sof evidence taken before any sub-committee.
10. The quorum of the committee shall be as provided in Standing Order No. 124 (Quorum of select committees), save that for consideration of a report from a National Policy Statement sub-committee under sub-paragraph (7) (b) the quorum shall be three.

Footnotes

1. www.politicshome.com/uk/article/85310/ed_balls_conference_speech.html

Policy Exchange

The Coalition Government which came to power in 2010 described deficit reduction as 'the most urgent issue facing Britain.' However, the fiscal mandate is being met only due to the technicality it is a rolling target; while its supplementary target is going to be missed. This is not a new problem, with successive governments breaking their own fiscal targets.

This report argues that to reduce the detrimental effects of high indebtedness and to allow policymakers to better respond to future economic shocks, future governments must commit themselves to paying down the national debt under a set of strict fiscal rules. It proposes new tools to 'shame' governments which breach the rules, to make the passing of a non-compliant budget more difficult, and to make the rules more difficult to repeal. Where a target is missed, it proposes that a Payback Mechanism is implemented so that the additional borrowing is reflected in subsequent targets, preventing governments moving the UK to a higher level of indebtedness without definite plans to recover the shortfall.

Where the public finances are in breach of the rules, it proposes triggering automatic emergency budgets to hold the government to account, increased time for Parliamentary scrutiny of non-compliant budgets, and triggering automatic freezes to tax allowance thresholds, public sector pay and benefit payments – not in expectation that these would actually be implemented, but to provide a strong incentive for a government to take remedial action to avoid unpopular measures. These reforms would complement the Chancellor's aspiration to run a budget surplus by the end of the next Parliament.

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