5. The fiscal rules and policy framework

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Summary

- In 1997, the government promised to abide by two fiscal rules that constrain how much it borrows and to what purpose. It claims to have met them over an economic cycle running from 1997 to 2006, but they had already lost credibility as a meaningful constraint on policy prior to the current crisis.
- Having overachieved the golden rule by delivering an average current budget surplus of £2 billion a year over the last economic cycle, Labour now expects an average current budget deficit of £37 billion a year over the next. This would be a much larger average deficit than in either of the two cycles under the previous Conservative government.
- The headline measure of public sector net debt could rise to around 170% of national income now that RBS is to be treated as a public corporation – or to around 240% if Lloyds Banking Group is treated similarly. But whether these investments will increase or reduce debt in the long term remains uncertain.
- Given the scale of the shock to the public finances resulting from the credit crunch, the government has sensibly decided to suspend the rules rather than taking the draconian decisions necessary to adhere to them.
- The government's 'temporary operating rule' offers it considerable flexibility in setting fiscal policy, but it may not be seen as much of a constraint on tax and spending decisions. In practice, the verdict of the financial markets may be the main constraint and the government's loss of credibility in the past may make a rise in its borrowing costs more likely.
- The government should consider adopting a target for future debt servicing costs and other commitments imposed on future taxpayers, rather than the stock of public sector net debt. The government could also commit to overachieving the golden rule by an amount sufficient to 'pre-fund' any increase in public sector pension costs that its actions impose on future taxpayers.
- The government should consider creating a properly funded independent body, with access to all the information currently available to the Treasury, to prepare fiscal forecasts and recommend to the Chancellor what fiscal tightening or loosening would be consistent with meeting the fiscal rules.

5.1 Introduction

On coming to power in 1997, Chancellor Gordon Brown set himself two fiscal rules that were supposed to limit how much the government could borrow and to what purpose. The government claims to have met both rules over the last economic cycle, but now concedes that it is on course to miss them by a large margin over the next cycle as a result of the credit crunch. For the time being, the government will be suspending its previous fiscal rules and instead be adhering to a temporary operating rule. The government needs to consider carefully how best it can inspire confidence in its fiscal management while the rules are suspended and then whether or not they should be readopted in their original form. In addressing both issues, it is important for the government to recognise that public confidence in the rules as a meaningful constraint on its tax and spending decisions had already evaporated before the current crisis erupted.

The government currently argues that the last economic cycle ran from 1997–98 to 2006–07. It complied with the rules over this period because of the substantial fiscal tightening that Mr Brown inherited, implemented and extended over Labour's first term in office. This created a cushion just sufficient to outweigh the impact of repeated over-optimism in his forecasts for public borrowing and debt in Labour's second term. By the middle of this decade, the room to manoeuvre against the fiscal rules had been greatly eroded, and the likelihood of a breach of first the golden rule and then the sustainable investment rule became significant.

The perception that Mr Brown 'moved the goalposts' to ensure that the rules would be met – and his decision not to address the over-optimism of his forecasts through tax-raising measures and cuts in spending plans until just after the 2005 election – undermined the credibility of the rules. In its 2007 New Year survey of the views of independent economists, the *Financial Times* concluded that 'Almost none use the chancellor's fiscal rules any more as an indication of the health of the public finances'.[1]

The November 2008 Pre-Budget Report (PBR) insisted that the government's 'fiscal policy objectives remain unchanged' and that it would merely 'depart temporarily from the fiscal rules until the global shocks have worked through the economy in full'. In the meantime, Chancellor Alistair Darling replaced them with a much less restrictive 'temporary operating rule' under which the government only promises to strengthen the public finances over the medium term.

Section 5.2 assesses Mr Brown's two fiscal rules, and the extent to which the government complied with them. The new 'temporary operating rule' is discussed in Section 5.3. In Section 5.4, we set out a proposal for an improved fiscal framework that would have the virtue of maintaining the many sensible features of Mr Brown's fiscal framework while further enhancing transparency and credibility. Section 5.5 concludes.

5.2 Gordon Brown's fiscal rules

Even in opposition, Mr Brown wanted to persuade voters that he would be a fair and prudent steward of the public finances. He saw a commitment to broad objectives for fiscal policy, operationalised through specific rules against which performance could be judged, as the best way to achieve this. The two specific rules that he adopted were the golden rule and the sustainable investment rule:

- The golden rule required the public sector to borrow only what it needed to pay for capital investment, and to finance its remaining current spending from tax and other revenues. In other words, the government had to keep the current budget (revenues minus current spending) in balance or in surplus. The rule had to be met on average over the ups and downs of the economic cycle rather than every year.

[1] 'Cut spending to reduce borrowing', *Financial Times*, 2 January 2007 (http://www.ft.com/cms/s/683400d2-9a05-11db-8b6d-0000779e2340.html).

- The sustainable investment rule required the government to keep the public sector's debt (net of its short-term financial assets) at a 'stable and prudent' level. This was defined as less than 40% of national income (GDP) at the end of every financial year of the economic cycle that the Treasury now estimates to have run from the first half of 1997 to the end of 2006.

We now describe each rule, and its operation, in more detail.

The golden rule

The golden rule was designed to help achieve intergenerational fairness by ensuring that the current generation of taxpayers pay only for the public spending from which they benefit. It was also intended to remove a possible bias against investment if and when public spending has to be restrained. In such a situation, it might be more tempting to cut capital rather than current spending because it normally takes longer for voters to feel the effects of cuts in capital spending on the quality of public services.[2] Requiring the golden rule to be met only on average over the economic cycle – rather than every financial year, for example – allows fiscal policy to 'support monetary policy'. In other words, it makes it less likely that fiscal policy will have to be tightened as monetary policy is loosened (not that this is always undesirable).[3]

In the next two subsections, we focus on two questions that arise in relation to the objectives of the golden rule:

- Does allowing the government to borrow only to finance capital investment in fact achieve intergenerational fairness?
- Is it sensible to seek to apply the rule over an economic cycle with specific start and end dates?

We then examine the Treasury's compliance with the golden rule over the period since Labour came to power in May 1997.

Intergenerational fairness

For a number of reasons, balancing the current budget as defined for the purposes of the golden rule will not necessarily achieve intergenerational fairness. In particular, it is not clear that, just because tax revenues happen to equal current spending, each generation is paying for the public spending from which it benefits.[4] One obvious example is that debt interest payments might not fall perfectly on the generations that benefit from the debt-financed expenditure. Another example is that the pay-as-you-go nature of many public sector workers' pensions means that these score as current expenditure when the pensions are paid to retirees, which will generally not be when the benefits from the services provided were delivered. Even if a balanced current budget could be relied upon to deliver intergenerational fairness, that is not what Labour's variant of the rule

[2] For a discussion, see HM Treasury, *Fiscal Policy: Current and Capital Spending*, London, 1998 (http://www.hm-treasury.gov.uk/d/530.pdf).

[3] The extent to which fiscal policy has been 'coordinated' with monetary policy since 1997 is discussed in section 2.7 of R. Chote, C. Emmerson, C. Frayne and G. Tetlow, 'The public finances under Mr Brown', in R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007*, IFS Commentary 102 (http://www.ifs.org.uk/budgets/gb2007/07chap2.pdf).

[4] For a detailed discussion, see section 3.2 of R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap3.pdf).

required. Instead, it said the current budget should be in balance or in surplus. But the concept of intergenerational fairness underpinning the golden rule suggests that we should be as concerned if today's taxpayers pay too much for current spending as if they pay too little.

Therefore the golden rule is not an optimal mechanism to achieve intergenerational fairness. But it may well still have value as a rough-and-ready rule of thumb that is reasonable to use as a guide in most, but not all, time periods. In practice, it may not be worth sacrificing the transparency of the rule to get closer to optimality.

Taking account of the economic cycle

There is certainly a powerful case for taking some account of the condition of the economy in assessing the appropriate level of the current budget balance (or any other measure of the fiscal position) at any given time. Government revenues and spending are both directly influenced by fluctuations in income, spending, transactions and employment. Economic activity can be thought of as fluctuating around a rising sustainable level consistent with stable inflation. When the economy is weak and activity is below the sustainable level (i.e. there is a negative output gap), tax revenues will be depressed temporarily and the government is likely to have to spend more on transfer payments for those not in paid work. This will tend to push the current budget towards deficit. Conversely, when the economy is above trend output, the budget will tend towards surplus.[5] Broadly speaking, it might be reasonable to expect cyclical deficits and surpluses to sum to zero over the course of a single symmetric economic cycle. So, if tax and spending decisions also succeed in keeping the structural position in balance on average, the golden rule would be expected to be met.

Allowing borrowing to rise and fall through the economic cycle acts as an 'automatic stabiliser'. The strength of the automatic stabilisers will depend on the size of the public sector and the progressiveness of the tax, tax credit and benefit system, so it may not be optimal from a stabilisation perspective. However, there would be nothing to stop the Treasury from making additional discretionary policy changes in either direction – as it did with the 13-month, £12½ billion, VAT cut announced in the 2008 PBR that was implemented from 1 December 2008 (see Chapter 10). These would, however, need to be balanced out on average over the economic cycle. There is also nothing to stop the government making changes to the tax, tax credit and benefit system in order to change the magnitude of the automatic stabilisers.

But it is one thing to argue that the government should aim to balance the structural current budget over some appropriate time horizon; it is another to argue that it should explicitly date a particular cycle and aim for a balance or surplus on average over that

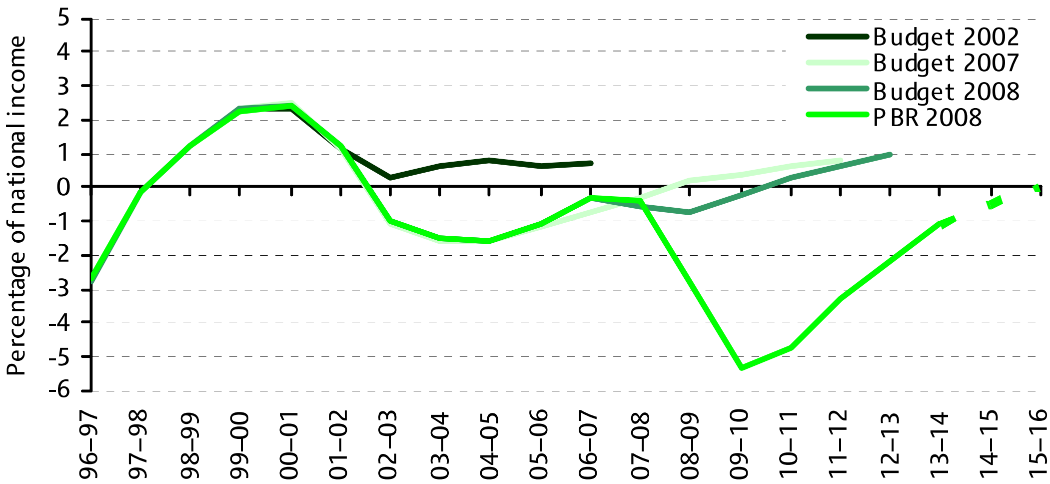
[5] According to Treasury estimates, if national income were to rise by 1% relative to its sustainable level, current spending would be expected to fall by about 0.5% of national income while current receipts would be expected to rise by about 0.2% of national income over the following two years. The net effect is to increase the current budget surplus by about 0.7% of national income. As taxes and spending both equal roughly 40% of the economy, if national income were to rise by 1%, both revenues and spending would fall by about 0.4% of national income when compared with the size of the economy (assuming there were no change in their cash value). Treasury estimates suggest that, in addition to this 'denominator' effect, over the following two years we would see spending on transfer payments and debt interest payments drop by 0.1% of national income and revenues rise by 0.6% of national income. Adding the two effects together, after a 1% rise in national income relative to its sustainable level, we would see current spending fall by about 0.5% of national income while current receipts rise by about 0.2% of national income over the following two years. The net effect is to increase the current budget surplus by about 0.7% of national income. See page 18, table 2.K of S. Farrington, J. McDonagh, C. Colebrook and A. Gurney, 'Public finances and the cycle', Treasury Economic Working Paper 5, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_publicfinances.htm).

period. First, it is not possible to identify accurately 'on-trend' points and the output gap at any given time.[6] Second, picking any fixed period over which to judge the rule means that the amount the government can borrow towards the end of the period is determined by what it has borrowed earlier on. Policy becomes backward-looking as the Chancellor is potentially constrained to compensate for the policy and forecasting errors of the past rather than setting what is necessarily the most sensible policy looking forward.

Assessing compliance with the golden rule

In understanding how Mr Brown chose to interpret and apply the golden rule in practice over recent years, it is important to remember that almost all the Treasury's forecasts for the public finances since 2001 have been overoptimistic and have hence been revised down in successive Budgets and PBRs (indeed, the only recent Budget not to have done this was the Budget 2006 projection for the strength of the public finances in 2006–07[7]). In particular, following the stock market decline between 2000 and 2002, tax revenues from the financial sector were much weaker than had been expected by the Treasury. The latest succession of downgrading of fiscal projections, in the 2007 PBR, the 2008 Budget and the 2008 PBR, again in part reflects downward revisions to expected revenues from the financial sector.

Figure 5.1. Treasury current budget balance forecasts



Sources: Successive Budgets and 2008 PBR; all documents available at http://www.hm-treasury.gov.uk/bud_bud08_index.htm.

Figure 5.1 shows the Treasury's forecasts for the structural current budget balance from Budget 2002 (before the forecasts first started to prove significantly overoptimistic), from Budget 2007 (before the current credit crunch began), from Budget 2008 and from the latest PBR. It shows that in 2002, the Treasury expected current budget surpluses over the entire medium-term forecasting horizon, clearly implying that the golden rule would be met over any economic cycle of plausible duration. However, in 2002–03, the

[6] This is perhaps best demonstrated by the Treasury's announcement in July 2005 that, in the light of new evidence, the then current economic cycle was believed to have begun eight rather than six years earlier. See HM Treasury, *Evidence on the UK Economic Cycle*, July 2005 (http://www.hm-treasury.gov.uk/d/economic_cycles190705.pdf).

[7] See page 13, chart 2.D of HM Treasury, *End of Year Fiscal Report,* November 2008 (http://www.hm-treasury.gov.uk/d/pbr08_endofyear_403.pdf).

current budget moved sharply into deficit. The Treasury's expectations of a swift return to the black were repeatedly frustrated and by Budget 2008 a current budget surplus was not expected by the Treasury until 2010–11: an expected run of eight years of successive deficits. Since then, things have deteriorated much further and the Treasury is now not expecting balance on the current budget until 2015–16: two years beyond the end of its normal medium-term forecasting horizon. This would mean 13 years of deficits following four years of surpluses.

As Mr Brown's hopes of continued surpluses were dashed and deficits began to mount up, the exact method of calculating the cumulative budget balance and the precise dating of the cycle became increasingly important in determining whether or not the golden rule was on course to be met – and, if so, with what degree of comfort. Changes were made that increased the extent to which the public finances could be claimed to be on course to meet the golden rule:[8]

- First, the methodology employed to calculate cumulative current budget surpluses that Mr Brown reported in his Budget Speeches was modified.
- Second, the estimated start date for the economic cycle was moved by two years at precisely the point at which, without this change, the government looked on course to break rather than meet the golden rule.
- Third, in evidence to the Treasury Select Committee, Treasury officials left open the option of dropping the approach of counting the last year of one economic cycle as the first year of the next economic cycle.

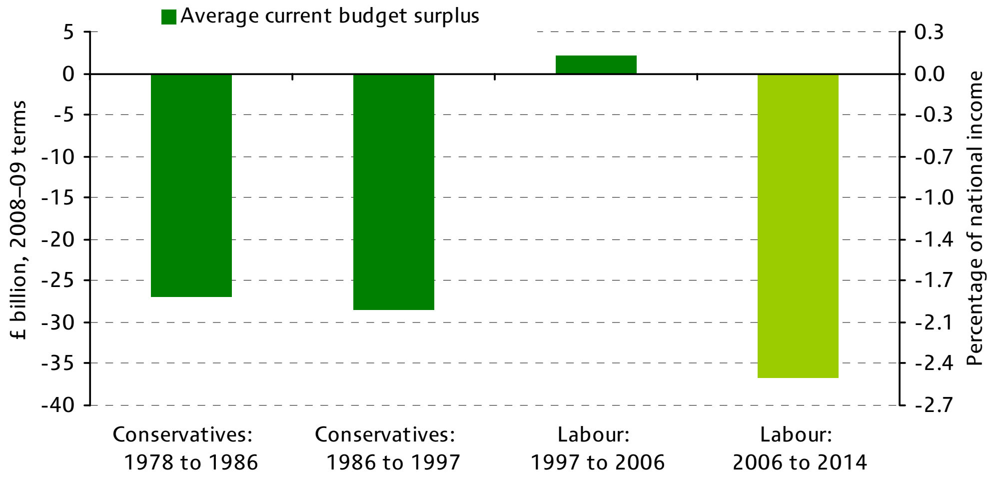
All of these changes could be justified in their own right. But the fact that they all made it easier to meet the golden rule at convenient times undermined the credibility of the policy framework and created suspicion that Mr Brown would 'move the goalposts' rather than face the embarrassment of missing this target.

Over the economic cycle that the Treasury estimates ran from 1997–98 to 2006–07, there was a cumulative surplus on the current budget and therefore the golden rule was met over this period. An alternative possibility is that this economic cycle started in 1999–2000, as the Treasury believed up until July 2005 and is also implied by the statistical filter set out in Table 4.3, and still closed in 2005–06. Ironically, if this were the case, then the golden rule would still have been met and therefore, with the benefit of hindsight, the revision to the start date of the economic cycle did not make the difference between missing and meeting the golden rule over this cycle.

The average surplus over the 10-year cycle was 0.14% of national income per year, which is equivalent to £2 billion per year in 2008–09 terms. While this is an extremely small margin of error, it is in marked contrast to the experience under the Conservatives. Over the economic cycles judged by the Treasury to have run from 1978 to 1986 and from 1986 to 1996, the golden rule – had it been in place – would have been missed by £26.8 billion per year and £28.4 billion per year in today's terms, respectively. This is shown in Figure 5.2.

[8] For a detailed discussion, see section 3.2 of R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap3.pdf).

Figure 5.2. Meeting or missing the golden rule?



Notes: Figure shows cumulative current budget surplus as a share of national income over 1978–79 to 1986–87, 1986–87 to 1997–98, 1997–98 to 2006–07 and 2006–07 to 2013–14. On the left-hand axis, this is expressed in 2008–09 terms using the 2008 PBR projection of GDP of £1,463 billion.
Source: HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls).

Looking forwards, the current budget is expected by the Treasury to be more in deficit on average over the next economic cycle than it was over the two economic cycles under the Conservatives. The 2008 PBR forecast implies an average current budget deficit over the new economic cycle, thought by the Treasury to run from 2006 to 2014, of £37 billion per year in 2008–09 terms. As will be discussed in Section 5.3, such an out-turn would no longer represent a breach of the Treasury's fiscal rules as these have been suspended. Moreover, even if the current budget had evolved as expected in Budget 2002, the large deterioration now expected over the next few years would still have brought about a sizeable current budget deficit. In this scenario, it would still have been more sensible to suspend the golden rule over the next cycle than to implement the tax increases and/or spending cuts necessary to expect to meet it over that period.

The sustainable investment rule

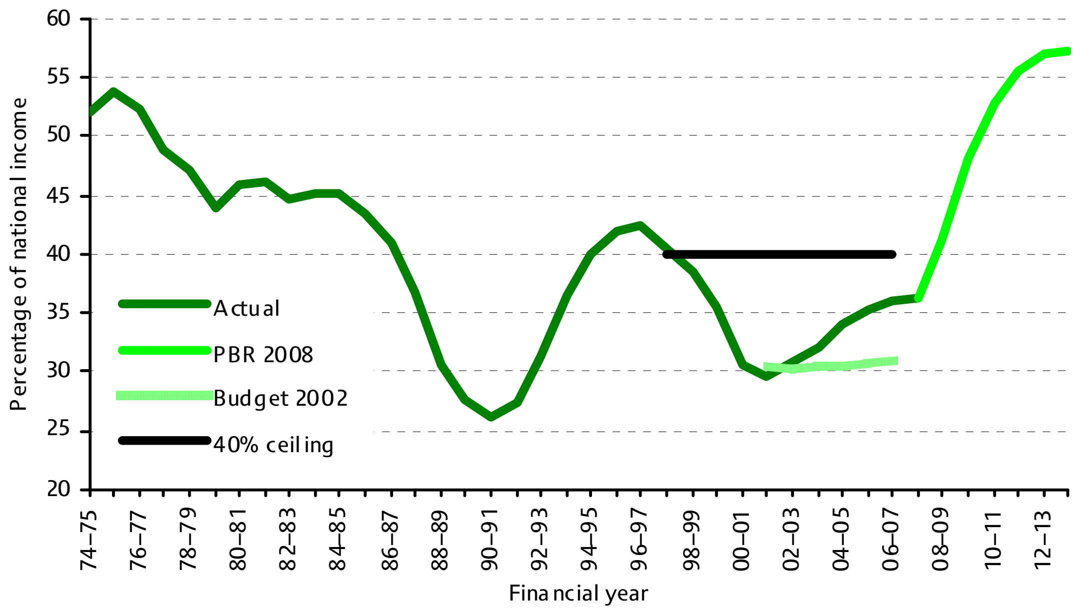
The sustainable investment rule stated that the public sector's debt (net of its short-term financial assets, such as foreign exchange reserves) should be kept at a 'stable and prudent' level. More precisely, over the economic cycle that the Treasury estimates ran from 1997–98 to 2006–07: 'To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle'.[9]

As with the golden rule, the sustainable investment rule was met over the period from 1997–98 to 2006–07 but has now been suspended. Figure 5.3 shows that in each year of the economic cycle that the Treasury estimates ran from 1997–98 to 2006–07, public sector net debt was below 40% of national income (with the exception of 1997–98, but the incoming new Labour government had limited opportunity to reduce debt in that financial year). The projection from Budget 2002 was that public sector net debt would

[9] Page 20, paragraph 2.13 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr07_index.htm).

remain only slightly above 30% of national income. Instead, debt increased throughout Labour's second term, and by the end of the economic cycle in 2006–07 it had reached 36.0% of national income. Since then, it has climbed further, and the 2008 PBR forecast that debt would rise above 40% of national income this year (41.2%) and continue rising sharply, peaking at 57.4% of national income in 2013–14. This would be the highest level of public sector net debt in 40 years. Furthermore, the measure of public sector net debt presented in Figure 5.3 excludes the impact of recent financial sector interventions – described in more detail later in this section.

Figure 5.3. Treasury forecasts for underlying public sector net debt



Sources: HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls); HM Treasury, *Budget 2002*, April 2002 (http://www.hm-treasury.gov.uk/bud_bud02_index.htm); HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

As was the case with the current budget balance and the golden rule, it would be difficult to argue that the Treasury should have conducted fiscal policy in a way that would have avoided the situation where the suspension of the sustainable investment rule was now the most appropriate course of action. Even if public sector net debt had remained at around 30% of national income – as forecast in Budget 2002 – the expected 21% of national income increase in underlying public sector net debt between 2007–08 and 2013–14 would still have pushed debt significantly above the 40% of national income ceiling set by the sustainable investment rule.

Given that debt is forecast to peak considerably above the previous ceiling of 40% of national income, to what extent should we simply continue to carry this debt forward and to what extent should we aim to bring it back down? Governments take on debt for much the same reason that individuals and firms do – to smooth their spending. Whilst the biggest changes in government debt levels in this country have been driven by the need to finance the two World Wars (see Figure 2.5), in more normal circumstances there are three main reasons why governments might take on debt:

- First, it can be both fair and efficient to smooth the cost to taxpayers of public spending that yields a flow of (typically non-financial) benefits into the future.

- Second, it may make sense to smooth payments for current spending over the ups and downs of the economic cycle to help stabilise activity and alleviate pressure on monetary policy.
- Finally, and less commendably, governments may seek to push the costs of current spending onto future taxpayers and future governments for political advantage, because they believe that voters are short-sighted.

Why impose a debt ceiling?

When does debt – taken on for any or all of these reasons – become 'unsustainable'? As the Treasury argues, 'There are many possible definitions of sustainability. One definition is that a government should be able to meet its obligations if and when they arise in the future'.[10] As debt increases, the cost of servicing it also increases. In principle, the cost could rise so high that the economy produces too little output to meet it. But, in practice, sustainability becomes a political judgement long before then: the ability of a government to meet the obligations it undertakes or inherits will depend on the willingness of future taxpayers to provide the revenue or to sacrifice other spending.

As experience in various emerging market countries has shown over the decades, *in extremis* governments may find it more attractive to lift the burden of meeting their financial obligations from taxpayers and concentrate it instead on their domestic and/or international creditors through rescheduling, default or inflation. Conscious of this danger, investors will become more reluctant to lend to a government if its policies look likely to impose a politically unacceptable burden on future taxpayers. By increasing interest rates and reducing economic growth, such investor fears can become self-fulfilling by further increasing the government's obligations and simultaneously shrinking the resources available to meet them. Even in the absence of significant default risk, interest rates may rise as government debts increase, weakening growth by 'crowding out' private investment.

Given these dangers, it may be sensible for a government to make a clear public commitment to limit its obligations to some level that would not (under plausible economic circumstances) impose an unacceptable burden on future taxpayers. As Treasury officials have argued, 'Committing to a clear benchmark level of debt helps to anchor expectations and helps avoid self-fulfilling losses of credibility in fiscal policy'.[11]

The height of the debt ceiling

Choosing where to set the debt ceiling is no easy task. For one thing, taxpayers' willingness to meet the obligations implied by past policy decisions may depend on a whole host of factors: the existing tax burden they face, the size of the debt interest bill, the reason the debt was incurred, the identity of the creditors and so on. Attempts have been made to infer an optimal debt ratio from comparisons with the debt/equity ratios prevailing in the private sector and from theoretical and empirical analyses of the relationship between debt levels, interest rates and economic growth rates. None has given a precise or robust result.

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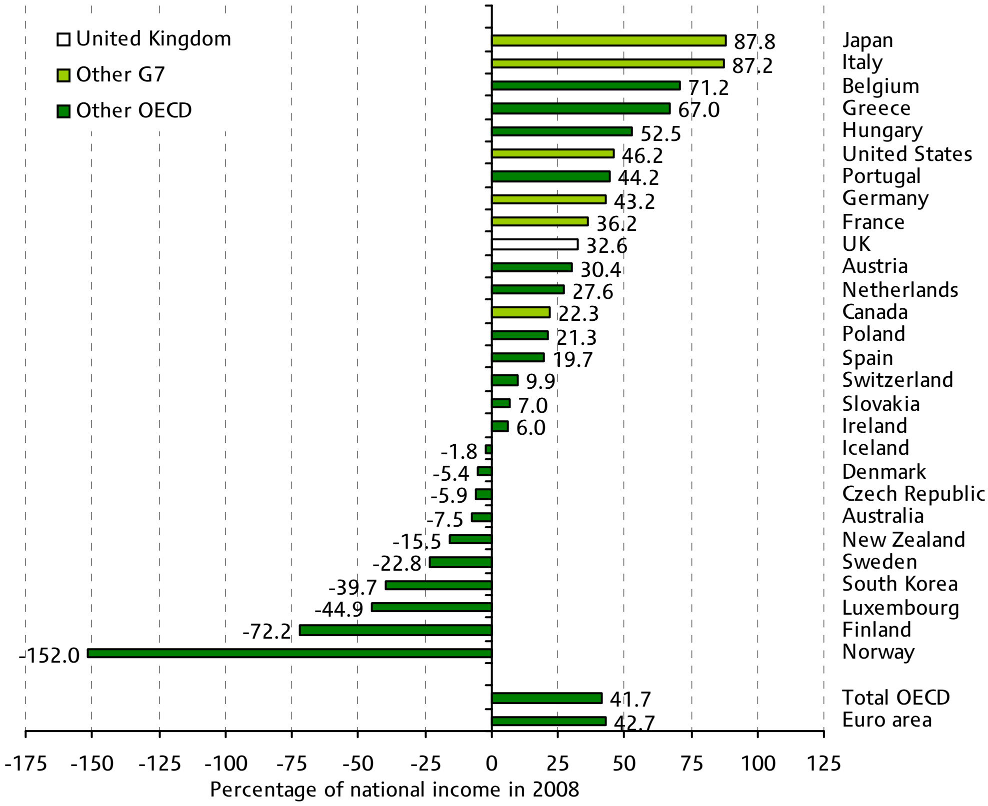
[10] Page 19 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 (http://www.hm-treasury.gov.uk/prebud_pbr06_adlongterm.htm).

[11] R. Woods, 'The role of public debt in the UK fiscal rules', paper presented at the 6th Banca d'Italia Public Finance Workshop, 2004 (http://www.bancaditalia.it/studiricerche/convegni/atti/publ_debt/session2/333-366_woods.pdf).

It certainly seems implausible to suggest that a debt ratio of up to 40% of national income would be sufficient to trigger a sovereign debt crisis, especially for a developed country such as the UK that has long been able to borrow in its own currency with relative ease. (Box 7.1 notes that there has been a rise in some market measures of the probability that the UK government will default on its debt, as the outlook for the public finances has worsened. But it argues that this overstates any change in investors' true assessment of the probability of default.) The current government appeared to have chosen the 40% ratio in effect as a commitment not to allow debt to rise above the level it had inherited. Assuming that the golden rule was met, a debt ceiling of 40% of national income was also sufficiently high to permit a higher level of public sector net investment in the long term than Labour inherited.

Figure 5.4. General government debt ratios in OECD countries in 2008



Source: Annex table 33 of OECD, *Economic Outlook No. 84*, November 2008 (http://www.oecd.org/document/18/0,3343,en_2649_33733_20347538_1_1_1_1,00.html).

The Treasury estimates that public sector net debt will be 41.2% of national income this year (i.e. it would have breached the 40% ceiling had this still been in place). Figure 5.4, which uses a different definition of debt to facilitate international comparison, shows that, with the notable exception of Canada, UK government debt is low relative to the other G7 countries. But there are other industrial countries with much stronger net debt positions, including Australia, New Zealand and the Scandinavian countries. Ten out of the 28 OECD countries shown in the graph have more financial assets than debt – for example, Norway (to smooth spending financed by its oil revenues) and South Korea (which has built up enormous foreign exchange reserves to try to limit the rise in its exchange rate).

So what factors might influence the UK's choice of debt ceiling?

- First, the desired debt ratio will depend on the desired level of public sector net investment over the long term. If we were to assume that the golden rule was met exactly, whole-economy inflation is 2½% a year and the economy grows in real terms by 2½% a year, then the government could sustain public sector net investment of 2% of national income a year while keeping public sector net debt at 40% of national income.[12] If we believe that public sector net investment should be higher than 2% of national income in the long term, this argues for raising the debt ceiling above 40% unless the golden rule was to be consistently overachieved or cash growth in the economy exceeds 5% a year. Conversely, if we wished to invest less than 2% of national income, the debt ceiling could be lowered.

- Second, a Chancellor might move the debt ceiling if he or she believed that the underlying level of current spending was likely to rise (or fall) at some point in the future. This could limit economically costly variation in tax rates. This could be done without altering the level of investment by deliberately over- (or under-) achieving the golden rule for a while and temporarily reducing (or increasing) the debt ceiling. Some economies are currently deliberately pursuing low or negative net debt positions because they believe that the ageing of their populations will require more public spending on the elderly in future decades. By running tight fiscal policies today, and giving themselves greater scope to borrow more in the future, they can limit future increases in tax rates and the associated disincentives to work and save.

  From the UK's perspective, in March 2008 the Treasury estimated that on existing policies, public spending would, as a result of changing demographics, rise from 40.5% of national income last year to 44.5% in 2057–58 – an increase of 4.0% of national income or almost £60 billion in today's terms.[13] Individuals are likely to wish to smooth their consumption in the face of an expected rise in tax rates to pay for these increases in spending, but some will be more aware of the necessary adjustments and better placed to make them at low cost than others. On these grounds, it may be thought preferable for the state to help make the adjustment by increasing tax rates now (aiming for a lower debt-to-national-income target) to reduce the increase required in the future (when the debt ratio would be allowed to rise again).

- Third, the higher the cost of financing debt, the less borrowing the government would want to do. In part, the financial cost will depend on the market assessment of the creditworthiness of the UK relative to other countries. Looking at the change in net debt over the period from 1996 to 2007, the majority of OECD countries have reduced their net debt by more than the UK did over this period (see Table 2.1). This suggests that many countries are trying to reduce their level of net debt, whereas in the UK Labour has only sought to prevent it from rising. Similarly, neither the opposition Conservative nor Liberal Democrat Party has set out policies to achieve anything significantly different. The fact that many countries have done more to reduce their net debt also suggests why – going forwards – it might be desirable for UK policymakers to try to bring debt back down as a share of national income rather than simply aiming to stabilise it at a higher level. Moreover, the trend of the UK's

[12] Debt interest payments would also not rise as a share of national income as long as nominal interest rates were not above 5% p.a.

[13] Source: Table 4.1, page 36 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, March 2008 (http://www.hm-treasury.gov.uk/d/bud08_longterm_586.pdf).

debt position showing less of an improvement, or more of a deterioration, relative to other countries is forecast by the OECD to continue. It forecast that the UK's debt will increase by 10.5% of national income between 2008 and 2010 and that of the 28 countries in Figure 5.4, only Ireland (13.9%) and the US (11.6%) will have a bigger increase over this period. In contrast, the majority of these 28 countries are forecast to have an increase in debt of 3% or less. Relative to the G7 countries, the UK is forecast to be at a similar level to both France and Germany by 2010.

Other liabilities: public-service pensions and PFI contracts

As well as future debt repayments due to current borrowing, the government has made promises of other future payments in a number of ways. One example is future payments arising from many public sector workers' pensions, including those in the NHS, the armed forces, teachers, civil servants, police, firefighters and the judiciary. Another example is future payments made under Private Finance Initiative (PFI) contracts, under which private firms undertake some capital spending on behalf of the public sector, with the public sector paying private firms a rental price for use of a capital asset, in addition to payments for any current goods and services, that the private sector delivers. Despite not appearing in the headline figures for debt, these future payments are important as they will reduce the amount of income that future generations will be able to spend as they choose. The opposition Conservative Party has argued for 'A broader measure of the sustainability of the public finances, including all future government liabilities and the pressures from an ageing population'.[14] This is to alleviate concerns about the size of the liabilities that are not counted in public sector net debt and therefore were not constrained (at least in the short and medium term) by the sustainable investment rule.

Arguably more important than the level of these liabilities are whether or not the total indebtedness of the public sector is increasing and the appropriateness of the financing tool used. Financing this spending through means that do not immediately score against public sector net debt would be inappropriate if it is done in order to keep the headline net debt figure low rather than for reasons of economic efficiency. For example, in last year's Green Budget, Bozio and Johnson put forward the argument that better value for money for the taxpayer might be achieved through a combination of less generous pensions for public sector workers compensated in part with higher pay.[15]

How large are these commitments that are not included in public sector net debt (PSND)? Due to intrinsic differences in their nature, comparable figures (based on consistent underlying assumptions) for different components of public sector indebtedness are not available. Bearing in mind this important caveat, Table 5.1 compares the size of PSND with official estimates of public sector pension liabilities and an estimate of the value of the future flow of payments to PFI providers under contracts already signed (which assumes that the private sector providers do fulfil the terms of these contracts). Quantitatively speaking, compared with the latest official measure of PSND, PFI liabilities and public sector pension liabilities were significant in size, with official estimates suggesting that the latter are larger than net debt itself. Total liabilities of the public

[14] See Conservative Party, *Reconstruction: Plan for a Strong Economy – Plan for Change*, September 2008 (http://www.conservatives.com/~/media/Files/Downloadable%20Files/Reconstruction_-_Plan_for_a_strong_economy.ashx?dl=true).

[15] A. Bozio and P. Johnson, 'Public sector pay and pensions', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap8.pdf).

sector from these three sources are therefore estimated to be around 90% of national income.[16]

Table 5.1. Estimated value of various future public sector obligations based on official estimates

		£ billion	% of GDP
(1)	Public sector net debt, March 2008	526.8	36.5
(2)	Estimated unfunded public sector pension liabilities, March 2006 (official estimate)	≈650	≈45
(3)	Estimated future PFI payments, signed current deals, October 2008 (IFS estimate based on official numbers)	≈130	≈9
(4)	Total (rows 1, 2 and 3)	**≈1,300**	**≈90**

Sources: Public sector net debt from tables A7 and A8 of HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls). Public sector pension liabilities from page 38, box 4.3 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, March 2008 (http://www.hm-treasury.gov.uk/d/bud08_longterm_586.pdf). Estimated future PFI payments from page 37, table 2.6 of HM Treasury, *2008 Pre-Budget Report: The Economy and Public Finances – Supplementary Material*, November 2008 (http://www.hm-treasury.gov.uk/d/pbr08_chartstables_501.pdf) with payments discounted to 2008–09 by future nominal national income (assuming real growth of 2½% p.a. and economy-wide inflation of 2.7% p.a. from April 2014 onwards).

There are two key differences between both estimated public sector pension liabilities and estimated future PFI payments and conventional public sector net debt. First, both will be sensitive to the choice of discount rate. For example, the official estimated liabilities of unfunded public sector pension schemes increased from £530 billion in March 2005 to £650 billion in March 2006, and £98 billion of this £120 billion increase was due to a lower discount rate rather than an actual increase in the expected future annual payments.[17] Second, governments might be able to reduce these future payments. In the case of public sector pension liabilities, this could be done by further reducing the generosity of future accrual of public sector workers' pension rights. However, such a change could have implications for other components of the remuneration package required to attract and retain public sector workers of the desired quality and motivation. In the case of PFI contracts, a future government might well be able to negotiate a lower payment from the public purse in return for a reduction in services provided, in particular where these are for current rather than capital goods.

Scheduled changes to the accounting standards applied by central government departments (a shift to International Financial Reporting Standards) might affect the treatment of some PFI deals. Budget 2007 stated that this change was to come in from April 2008, but Budget 2008 announced a delay to April 2009. Currently, of the £62.8 billion of capital value of live PFI deals signed up to November 2008, 40% is on the public sector balance sheet (£24.8 billion) and 60% is not on the public sector balance

[16] A more detailed discussion of the treatment of both public sector pensions and PFI contracts in the public finances can be found in section 3.3 of R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap3.pdf).

[17] Source: Page 38, box 4.3 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, March 2008 (http://www.hm-treasury.gov.uk/d/bud08_longterm_586.pdf).

sheet (£38.0 billion).[18] The change in accounting rules might increase the proportion on the public sector balance sheet; but due to differences in accounting regimes, this might not affect the headline measure of public sector net debt.[19]

There are also a number of liabilities that would only be incurred should certain events occur ('contingent' liabilities). One that has been the subject of much discussion in recent years is Network Rail. If Network Rail got into serious trouble, it is likely that the Government would take greater control and that it would be reclassified from being part of the private sector to being part of the public sector for the purposes of the National Accounts (even if it were not formally renationalised). This would bring Network Rail's debt – which stood at £20.5 billion at the end of September 2008[20] – into public sector net debt.

Other liabilities: recent financial market interventions

The government's recent interventions in the financial sector have also led to a large increase in the headline measure of public sector net debt, with further large increases likely. However, these liabilities are intrinsically different from those arising from, for example, public-service pensions and PFI contracts, since the government's intention is to unwind these interventions once the current market turmoil has eased. They include the nationalisations of both Northern Rock and Bradford & Bingley and also the Bank Recapitalisation Fund that has injected £37 billion of equity financed by the taxpayer into Royal Bank of Scotland (RBS) and the new Lloyds Banking Group (comprising the recently merged Lloyds TSB and HBOS).

In the case of Northern Rock and Bradford & Bingley, the Office for National Statistics (ONS) has ruled that, as the public sector has the power to control the general corporate policy of the companies, their assets and liabilities should be moved onto the public sector balance sheet. Such a ruling does not require the organisation to be nationalised: the liabilities of both of these banks have been included in measures of net debt prior to their nationalisations.[21]

Moving these institutions onto the public sector balance sheet has a large impact on the headline measure of public sector net debt. This is because all of the liabilities are added to public sector net debt less any short-term financial assets, but not less any physical assets or long-term financial assets. The latter are particularly significant in the case of these institutions, which have large mortgage books that count as long-term financial assets. As shown in the top panel of Table 5.2, moving Northern Rock onto the public sector balance sheet added about £82 billion or 5.6% of national income to public sector

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[18] HM Treasury, 'PFI Signed Projects List – November 2008' (http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm).

[19] See pages 28–30 of House of Commons Treasury Committee, *The 2008 Budget*, Ninth Report of Session 2007–08, HC 430 (http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/430/430.pdf) and M. Kellaway, 'Private Finance Initiative and public debt', *Economic & Labour Market Review*, 2(5): 21–22, May 2008 (http://www.statistics.gov.uk/elmr/05_08/downloads/ELMR_May08_Kellaway.pdf).

[20] Source: http://www.networkrail.co.uk/aspx/5327.aspx.

[21] In the case of Northern Rock – which was nationalised on 17 February 2008 – this reclassification was made from 9 October 2007. This was the date that the loan was made from the Bank of England that required Northern Rock to obtain the Bank's permission to restructure, change its business, pay dividends, or acquire or dispose of certain types of assets. In the case of Bradford & Bingley, its inclusion on the public sector balance sheet is from 26 September 2008, whereas it was actually nationalised three days later (on 29 September 2008). For details of the ONS decision on Northern Rock, see M. Kellaway and H. Shanks, 'Northern Rock plc', NACC Decisions, 7 February 2008 (http://www.statistics.gov.uk/articles/nojournal/Rock_article.pdf), while IFS analysis can be found at http://www.ifs.org.uk/pr/Northern_Rock.pdf. For details of the ONS decision on Bradford & Bingley, see the ONS News Release at http://www.statistics.gov.uk/pdfdir/cbb1108.pdf.

net debt. The ONS has not yet been able to complete the necessary calculations to include the impact of Bradford & Bingley on public sector net debt, but Bradford & Bingley's last interim reporting statement suggests that this is likely to add a further £41–51 billion to public sector net debt.

Table 5.2. Actual and possible impact on public sector net debt from recent financial sector interventions

	Amount paid for acquisition	Equity acquired	Gross liabilities net of short-term financial assets £bn	% of GDP
Nationalisations				
Northern Rock	To be decided	100%	81.9	5.6
Bradford & Bingley	To be decided	100%	41–51	2.8–3.5
Bank Recapitalisation Fund				
Royal Bank of Scotland	£15bn ord. shares £5bn pref. shares	63%	Up to £1,845	Up to 125%
Lloyds Banking Group	£13bn ord. shares £4bn pref. shares	44%	Up to £1,017	Up to 70%

Sources: Gross liabilities net of short-term financial assets: Northern Rock for 2008Q3 from table PSF1 of Office for National Statistics, *First Release: Public Sector Finances, November 2008*, 18 December 2008 (http://www.statistics.gov.uk/pdfdir/psf1208.pdf); Bradford & Bingley from Interim Results for half year ended 30 June 2008 (http://www.bbg.co.uk/bbg/ir/news/releases/groupnews/gn2008/2008-08-29/2008-08-29.pdf); Royal Bank of Scotland from Interim Results for half year ended 30 June 2008 (http://www.investors.rbs.com/downloads/interim2008.pdf); Lloyds TSB from Interim Results for half year ended June 2008 (http://www.investorrelations.lloydstsb.com/ir/company_reports_page.asp#2008); HBOS from Interim Results for half year ended June 2008 (http://www.hbosplc.com/home/includes/RNS_Interims_2008.pdf). Amount paid, and equity acquired, by the Bank Recapitalisation Fund from statement by Chancellor of the Exchequer Alistair Darling to the House of Commons on financial markets, 13 October 2008 (http://www.hm-treasury.gov.uk/statement_chx_13_10_08.htm).

The Bank Recapitalisation Fund is also yet to have any impact on public sector net debt. However, the ONS has recently stated: [22]

> As part of its plans to recapitalise the banking sector, HM Treasury has acquired 57.9 per cent of the Royal Bank of Scotland's issued ordinary share capital, at a cost of almost £15bn. This gives HM Treasury control over more than half of the voting shares which is sufficient to move RBS into the public sector. HM Treasury has also acquired £5bn of new preference shares issued by the bank. Both transactions took place on 1 December, and will therefore feed into the December PSF [public sector finances]. ONS will publish a formal classification decision relating to RBS when it has completed its analysis of all the relevant documentation.

RBS has assets and liabilities of around £1,845 billion, which is 125% of national income. Therefore, depending on how many of the assets are either physical assets or long-term financial assets, the inclusion of RBS on the public sector balance sheet could lead to an enormous increase in the headline measure of public sector net debt. The new Lloyds Banking Group is also large, with assets and liabilities totalling around £1,017 billion, equivalent to 70% of national income. However, in this case it remains to be seen

[22] Source: Page 6 of Office for National Statistics, *First Release: Public Sector Finances, November 2008*, 18 December 2008 (http://www.statistics.gov.uk/pdfdir/psf1208.pdf).

whether or not the ONS will rule that the public sector has effective control over its corporate policy: one reason this is less likely than in the case of RBS is that the public sector currently only owns a minority shareholding in the new Lloyds Banking Group.

The inclusion of Northern Rock increased public sector net debt from 38.3% to 43.9% of national income (2008Q3). Once Bradford & Bingley is included, this could be increased to around 47% of national income. The inclusion of RBS from 1 December 2008 could increase public sector net debt to as much as 170% of national income. The additional inclusion of the new Lloyds Banking Group, which is less certain, could increase it to as much as 240% of national income.

But none of these interventions is intended to be permanent; as they are unwound, their impact on public sector net debt will decline as all of the institutions have significant assets. The focus for fiscal policy should be whether the public sector expects to make a profit or a loss once these positions have been unwound (i.e. whether or not the significant assets that are not taken into account in public sector net debt are worth more or less than the significant liabilities, which are). As is discussed in detail in Chapter 8, the situation is extremely uncertain and the public sector will not necessarily make a loss. Previous experience suggests the public sector can profit from such interventions: the Norwegian central bank has calculated that its government made a profit on its temporary bank investments during the Nordic banking crisis of the early 1990s (though this is in contrast to similar Swedish and Finnish interventions).[23] Therefore, sensibly, the Treasury has published and is focusing on measures of public sector net debt excluding the impact of Northern Rock and it has said that it will do the same with other similar financial market interventions.

More generally, the turmoil in financial markets and the deterioration in the outlook for the economy have led to several new policies that directly increase the risk faced by the taxpayer. These include the following:

- the Special Liquidity Scheme, introduced in April 2008, under which the Bank of England provides liquidity support to the financial sector;
- the Credit Guarantee Scheme, introduced in October 2008, under which the Treasury guarantees the new issuance of bank debt in the event of default;
- credit extended to the financial sector via the Financial Services Compensation Scheme, in the autumn of 2008, to protect some depositors in, among others, Bradford & Bingley and Landsbanki;
- the Working Capital Scheme, announced in January 2009, under which the Treasury underwrites a portion of certain new loans to small business.

All of these are contingent liabilities. As with the Bank Capitalisation Fund, in aggregate the public sector could actually make a direct profit from these interventions since in many cases a fee is being charged for the insurance being provided. However, even if the public sector expected to make an overall direct loss from these specific interventions, this would not necessarily mean that they were the wrong policies to pursue. This is because the expected outcome for society could be significantly worse without the support that these policies are expected to provide. The uncertainty over whether these

[23] See table 3, page 104 of K. Sandal, 'The Nordic banking crises in the early 1990s – resolution methods and fiscal costs' in T. Moe, J. Solheim and B. Vale (eds), *The Norwegian Banking Crisis*, May 2004, Norges Bank Occasional Paper (http://www.norges-bank.no/upload/import/publikasjoner/skriftserie/33/chapter3.pdf).

policies eventually directly increase or reduce public sector net debt means that it is appropriate for the government to wait until the dust has settled before any adjustment to taxation or public spending is made in response. A further discussion is provided in Chapter 8.

As we showed at the start of this section, underlying public sector net debt is forecast by the Treasury to exceed 40% of national income in 2008–09 and then to climb to a 40-year high of 57% of national income in 2013–14. This has led to the suspension of the sustainable investment rule and the introduction of a new temporary operating rule, which is discussed in the next section.

5.3 A new temporary operating rule

It is clear that the unusually large adverse shocks to the economy that have occurred since the summer of 2007 have led to a sizeable deterioration in the outlook for the UK public finances, much larger than the average error in such forecasts.

For example, the January 2007 IFS Green Budget and the subsequent March 2007 Budget both forecast that the current budget balance in three years' time (2009–10) would be 0.4% of national income. If the November 2008 PBR is correct, 2009–10 will actually see a current budget deficit of 5.3% of national income. An error of 5.7% of national income on the current budget three years out has only been made in two out of the Treasury's 26 Budget forecasts for public sector net borrowing since the March 1980 Budget. The two exceptions both came prior to the sharp recession of the early 1990s: the projection made in the March 1990 Budget for 1992–93 and the projection made in the March 1991 Budget for 1993–94, both of which underestimated public sector net borrowing by 5.9% of national income.

It would therefore have been difficult for the Chancellor and his predecessor to have built up a sufficient cushion to insulate fully against a shock to the public finances of this size. In any case, taking action by increasing taxes or cutting spending to ensure that the fiscal rules continue to be met would clearly not now be appropriate. Both fiscal rules are sensible rules of thumb in most periods. But the current period is one of those when the suspension of the rules is clearly more appropriate than slavish adherence to them.

Sensibly, the Code for Fiscal Stability[24] allows the government to depart from its stated fiscal rules temporarily so long as it specifies:

- the reasons for departing from the previous objectives and operating rules;
- the approach and period of time that the government intends to take to return to the previous objectives and operating rules; and
- the objectives and operating rules that shall apply over this period.

Given that the outlook for both the economy and the public finances is particularly uncertain at the moment, it would not be appropriate to place a firm timescale on when either the previous – or preferably improved – fiscal rules should be readopted. Indeed, all the Treasury has stated is that 'The Government will depart temporarily from the

[24] HM Treasury, *The Code for Fiscal Stability*, November 1998 (http://www.hm-treasury.gov.uk/ukecon_fisc_code98.htm).

fiscal rules until the global shocks have worked their way through the economy in full'.[25] In the meantime, it has set a 'temporary operating rule' committing the government 'to set policies 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'.[26] Section 3.2 suggests that if the Treasury's PBR 2008 projections are extended, it could be 20 years before public sector net debt is back below 40% of national income.

Another feature of Labour's temporary operating rule – announced in the November 2008 PBR – is that it is almost identical to one of the proposals for improvements to the fiscal framework put forward by the Conservative Party two months earlier in September 2008. This stated that the next Conservative government will introduce a mandate for the public finances 'at the end of a forecast horizon: falling debt as a percentage of GDP and a balanced current budget, adjusted for the cycle'.[27] Indeed, the only key difference is that Labour has stated that its new rule would only be in place temporarily (albeit potentially for a considerable period), whereas the Conservatives presumably envisage it being a permanent feature.

The attraction of such a temporary operating rule – and the flexible timescale over which it is set to operate – is that it allows considerable flexibility for fiscal policy to respond if the outlook for the economy deteriorates by more than the Treasury currently expects. For example, in the face of a sharper-than-expected deterioration in economic activity, it might be appropriate for the government to announce a further temporary fiscal stimulus package. Such an outcome would still be consistent with this temporary operating rule as long as the government could still point to a forecast improvement in the cyclically-adjusted current budget and a falling ratio of debt to national income at the end of the forecast period.

The potential downside is that it may be so much less constraining than the already discredited rules that it replaced as to offer little reassurance that it will encourage prudent tax and spending decisions. For example, there may be concerns that in the run-up to the next general election, a more flexible fiscal rule could be used to excuse lower taxes or higher levels of public spending for reasons of pure electoral advantage rather than as an appropriate decision over the extent to which fiscal policy should stimulate economic activity.

Instilling and increasing confidence that the government would not engage in such activities was recognised by Mr Brown as an important objective of policy going forwards from 1997, and a failure of Treasury policy prior to 1997. In 2002, he wrote 'We recognised too [on coming to power in May 1997] that the discretion needed for effective economic policy could only be possible within an institutional framework that commanded market credibility and public trust'.[28] One of the two lessons claimed to have been learned by the Treasury was the need to 'set stable fiscal rules and explain clearly

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[25] Paragraph 1.11 of HM Treasury, *The Government's Fiscal Framework*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_fiscalframework.htm).

[26] Paragraph 1.12 of HM Treasury, *The Government's Fiscal Framework*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_fiscalframework.htm).

[27] See page 6 of Conservative Party, *Reconstruction: Plan for a Strong Economy – Plan for Change*, September 2008 (http://www.conservatives.com/~/media/Files/Downloadable%20Files/Reconstruction_-_Plan_for_a_strong_economy.ashx?dl=true).

[28] Source: Foreword to E. Balls and G. O'Donnell, *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, Palgrave Macmillan, 2002.

fiscal policy decisions' since 'throughout the last cycle the stated fiscal objectives changed on a number of occasions as the fiscal position evolved'.[29]

A commitment to deliver a reduction in both the cyclically-adjusted current budget deficit and public sector net debt as a share of national income at the end of the forecast period potentially allows the government a great degree of flexibility when making fiscal policy decisions. Indeed, the most significant constraint is likely to be credibility with the financial markets and the interest rate that the government needs to pay to finance its new issuance. While greater flexibility may well be needed over the next few years, it remains to be seen whether it will be used appropriately.

The fiscal tightening recommended in previous IFS Green Budgets (2003, 2004 and 2005) was not announced until after the 2005 general election and was not set to be implemented fully until 2010–11. Even if it had been announced and implemented sooner, it would not have been sufficient to avoid a breach of the rules. However, if he had acted earlier in the past, Mr Brown might now be able to make a more convincing case than he is currently able to that he will restore the public finances to health as swiftly as it is sensible to do so. By eroding the credibility of the government's fiscal management prior to the crisis, his earlier decisions may now increase the risk that the government will see its borrowing costs increase at a time when it has a large and persistent stock of debt to service.

5.4 An improved fiscal framework

In this section, we set out some potential reforms to the fiscal framework that would build on the many welcome features of the one introduced by Mr Brown in 1997. We do this in three parts.

- First, we discuss improvements to the golden rule that would make it more forward looking and perhaps more likely to deliver its objective of intergenerational fairness.
- Second, we set out a proposal for a 'sustainable commitments rule', which would be an explicit limit on the extent to which future taxpayers are projected to have to finance commitments already made, as a step forwards from a ceiling on public sector net debt.
- Third, we set out how this government, or its successor, could boost confidence that it was striving to deliver its stated fiscal objectives.

In each case, we also assess the Conservatives' proposed fiscal framework.

An improved golden rule

There are at least three dimensions in which the operation of the golden rule could be improved if and when it is readopted:

- First, some changes might be possible to ensure that compliance with the golden rule was more likely to be consistent with the government's stated objective of intergenerational fairness.

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[29] Page 1 of HM Treasury, *Fiscal Policy: Lessons from the Last Economic Cycle*, November 1997, London: HM Treasury (http://www.hm-treasury.gov.uk/d/lessons.pdf).

- Second, transparency could be enhanced further by taking greater account of the uncertainty in any fiscal projection.
- Third, a target for the projected medium-term current budget surplus would eliminate the problems of both dating an economic cycle and the fact that the golden rule becomes inappropriately backward looking whenever the end of an economic cycle approaches.

We discuss each in turn.

Enhancing intergenerational fairness

In principle, it would be possible to have a more sophisticated distinction between public spending that solely benefits the current generation and public spending that, in part, benefits future generations. However, the benefits of abandoning the familiar National Accounts distinction between current and capital spending may well not exceed the costs in terms of transparency and predictability.

An improvement to the golden rule that would enhance intergenerational fairness would be to make it symmetric, like the inflation target. This would require the government to pursue a point target for current budget balance rather than 'balance or surplus'. Symmetry seems a more appropriate way to pursue intergenerational fairness, and it also avoids the problem of the Chancellor needing to decide – implicitly or explicitly – what safety margin to aim for to give an acceptable probability of falling the right side of the pass/fail line. This is a nice feature of the Conservatives' proposed fiscal framework as they have said that they would aim for a balanced current budget, rather than a balance or surplus on the current budget.

Better account of uncertainty in fiscal forecasts

The Treasury should present its forecasts for the fiscal aggregates in such a way that they explicitly quantify the uncertainties around the central estimate – for example, with a 'fan chart' similar to that which the Bank places around its inflation target. We place similar fans around our forecasts in Chapter 6 and the National Institute for Economic and Social Research (NIESR) places them around its forecasts in its quarterly *Review*.[30] The baseline forecast should also be a genuinely 'central' forecast, rather than one based on 'cautious' economic assumptions that inject deliberate bias. These changes would focus attention on the extent to which subsequent out-turns were surprising given the forecasts made and the uncertainty around those forecasts, rather than on whether a particular target or point estimate had been 'met' or 'missed'.

A forward-looking approach

The Treasury should no longer seek to meet the golden rule over a specific dated economic cycle. Instead, it should say that it is aiming for a target level for the current budget balance over an appropriate time horizon. It can be argued that the Treasury had in effect been doing this prior to the recent suspension of the fiscal rules, with a rolling target (now being missed) to achieve a current budget surplus of around ¾% of national income after five years. Such a forward-looking approach is explicit in the Treasury's new temporary operating rule that states that the cyclically-adjusted current budget deficit should fall over time. It is also a sensible feature of the Conservatives' proposed

[30] See http://www.niesr.ac.uk/pubs/review.php.

framework, as their proposed target of a balanced current budget is for the end of the forecast horizon.

One problem with operationalising such an approach is that the Treasury's forecasts for tax revenues typically include an automatic tightening of around ¾% of national income over a five-year time horizon as a result of 'fiscal drag'. This means that the government could run a current budget deficit every year of ¾% of national income, by giving away the proceeds of fiscal drag in tax cuts or higher spending each year, and always assert that it is on course to achieve a current budget balance in five years' time on 'unchanged policies'. This strengthens the case, which is already strong on transparency grounds, for changing the definition of unchanged policy to one in which income tax and National Insurance thresholds are assumed to rise in line with average earnings (or alternatively the projected growth in their underlying tax base) rather than prices. A similar, but in aggregate quantitatively less important, case could be made for other taxes (such as stamp duty land tax and inheritance tax) in which the tax base is expected to grow in real terms over time. Successive Chancellors have found it convenient to exploit fiscal drag as a 'stealth tax' that raises revenue over time, so such a change is unlikely to find favour with the Treasury.

The use of a fixed, dated cycle means that policy is unnecessarily and unhelpfully backward looking, with tax and spending decisions today in principle depending on past policy and forecast errors and on changing assessments of the start date of the cycle, rather than on the most appropriate path looking forward. It is also worth bearing in mind that Mr Brown's Chancellorship was unusually long: he and Denis Healey are the only Chancellors in the last half a century to have served for a full economic cycle.

Protecting future generations: a 'sustainable commitments rule'

The key rationale for a debt ceiling is to limit the impact on future taxpayers of tax and spending decisions made today. This could be justified both on the grounds of ensuring financial sustainability and on the grounds of fairness.

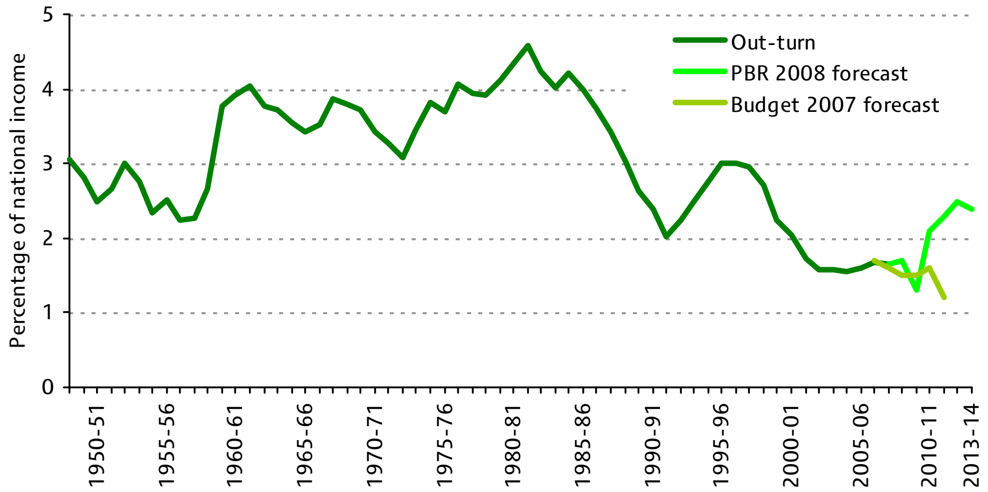
Compliance with the sustainable investment rule would have largely achieved this by placing a limit on the outstanding stock of public sector net debt. In contrast, neither the government's 'temporary operating rule' nor the Conservatives' proposed fiscal framework would place any constraint on the total size of commitments that future generations might face. Both simply commit to having debt (as a share of national income) falling at the end of the forecast period. Both would therefore still be met even over a period in which debt increased sharply before being projected to fall back slightly. In any case, compliance with the 'golden rule' component of their respective fiscal rules[31] would more than likely imply a falling level of debt at the end of the forecast period, unless public sector net investment was increased sharply. Therefore, once we are through the current period of economic turmoil, a return to a simple ceiling for public sector net debt (or perhaps a broader measure of indebtedness) would be preferable to the framework that the Conservatives have proposed.

But, if it is the burden on future taxpayers that is of concern, perhaps we should focus on the cost of servicing the debt that they will have to pay, rather than the outstanding stock of debt itself. The key difference is that, if the rate of interest at which the government can

[31] At the end of the forecast period to have a falling cyclically-adjusted current budget in the case of Labour or a cyclically-adjusted balance in the case of the Conservatives.

borrow falls (rises), it would seem reasonable to carry out more (less) investment projects from which current and future taxpayers can benefit. A ceiling on public sector net debt would not allow this, but a ceiling on future public sector net debt interest payments would. This section outlines what such a "sustainable commitments rule" might look like.

Figure 5.5. Public sector net debt interest since 1948–49

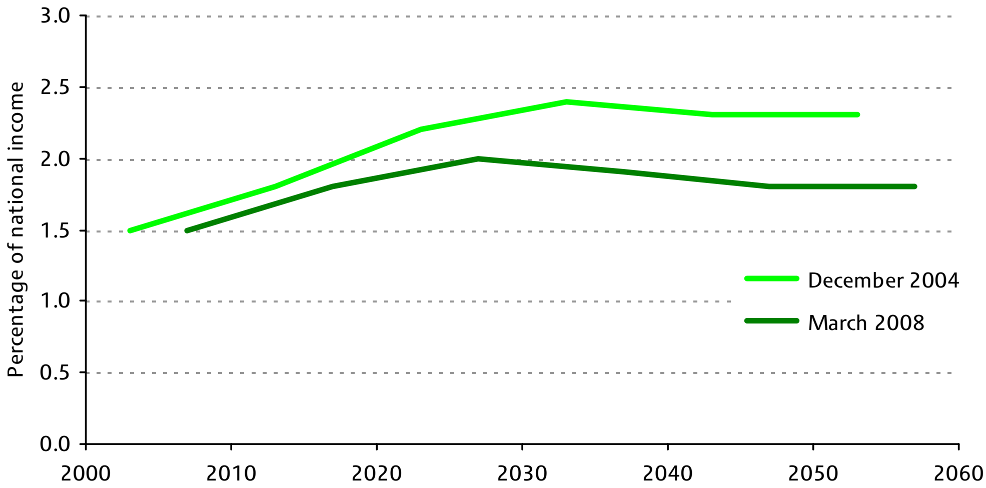


Sources: Public sector net debt interest is gross interest paid less gross interest received. Measures of gross interest are ONS series ANLO and ANBQ, from table 2.3C of *Financial Statistics Freestanding Time Series Data*. Projections from HM Treasury, *Budget 2007* (http://www.hm-treasury.gov.uk/bud_bud07_index.htm) and *Pre-Budget Report 2008* (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

In Figure 5.5, we show the evolution of public sector net debt interest as a share of national income since 1948–49. Also shown are the forecast for public sector net debt interest projected in the November 2008 PBR and the forecast from the March 2007 Budget, which pre-dates the current economic turmoil. In the 1950s, public sector net debt interest payments fluctuated between 2.0% and 3.0% of national income. In the 1960s and 1970s, they were higher, fluctuating between 3.0% and 4.0% of national income. In 1981–82, they had reached a post-Second-World-War peak of 4.6% of national income and then declined sharply to 2.0% in 1991–92. On coming to power in 1997, Labour inherited a public sector net debt interest burden of 3.0% of national income, and this fell to a post-Second-World-War low of 1.6% of national income in the middle of this decade. This was a result of a combination of falling public sector net debt until 2001–02 and falling interest rates on the stock of government borrowing on average over the whole period. Budget 2007 forecast that public sector net debt interest payments would remain around this low level. The November 2008 PBR forecast that they would rise back to 2.5% of national income as a result of higher borrowing. If correct, this would still be lower than the level that Labour inherited from the Conservatives.

A focus on the commitments made for future taxpayers, and a consideration of the expected future stream of public sector net debt interest payments, also lends itself more easily to the inclusion of some of the other commitments that the public sector has made that are not scored in public sector net debt (since the estimates will not be sensitive to the choice of discount rate). The latest forecasts (March 2008) for public spending on future public-service pension payments over the next half a century are shown in Figure 5.6, alongside the earliest vintage of forecasts that we have been able to locate (from December 2004). The latest Treasury projections suggest that spending on public-service pensions will increase from 1.5% of national income in 2007–08 to 2.0% of national income in 2027–28 before dropping back to 1.8% of national income by 2047–48. In other words, they are of a similar magnitude to the net annual servicing cost of the entire stock of debt. An earlier projection from December 2004 suggested that spending would climb to 2.4% of national income. This difference, at least in part, is likely to be due to the recent reforms to public sector pensions, such as increasing the normal pension age for new entrants and raising future employee contributions.[32] Ideally in Figure 5.6, we would also have shown similar projections prior to April 1999 before recent increases in public sector pay and public sector employment had fed into expected future public-service pension payments, but to our knowledge these December 2004 projections are the earliest available.

Figure 5.6. Estimated future public-service pension payments

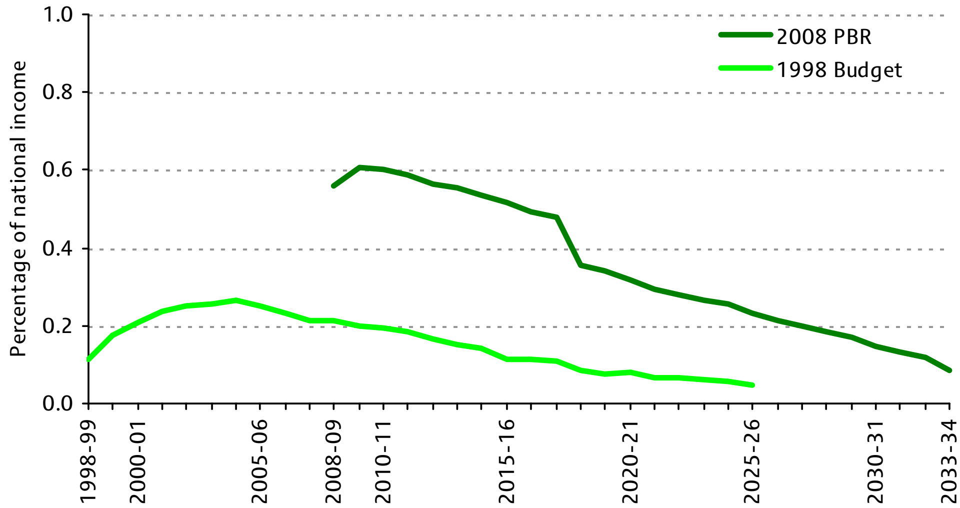


Note: Years refer to the financial year in which three quarters of the calendar year lie.
Sources: HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2004 and 2008 (both available from http://www.hm-treasury.gov.uk/bud_bud08_longterm.htm).

Future commitments under PFI contracts that have already been signed are presented in Figure 5.7. These are now published biannually by the Treasury and cover the next 25 years (by which time the expected future payments are very low as most contracts that have already been signed will have been completed). The latest projections from the November 2008 PBR are shown alongside the projections from the March 1998 Budget. As a share of national income, future payments to PFI providers are expected to gradually decline over time, with a step down in 2018–19 caused by the structure of the three Department for Transport London Underground contracts (which, by capital value, are the three largest PFI deals signed to date, representing £17.6 billion out of the total £62.8 billion of the current signed deals by capital value). It is also clear from Figure 5.7 that the last 10 years have seen a sharp increase in the use of PFI arrangements to deliver public services. At the time of Budget 1998, annual payments under PFI contracts would have peaked at below half the 0.6% of national income that was actually paid in 2008–09.

[32] For a discussion of the impact of these reforms, see, for example, A. Steventon, *An Assessment of the Government's Reforms to Public Sector Pensions*, Pensions Policy Institute, London, 2008 (http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/PPI_public_sector_pensions_16_Oct_2008.pdf).

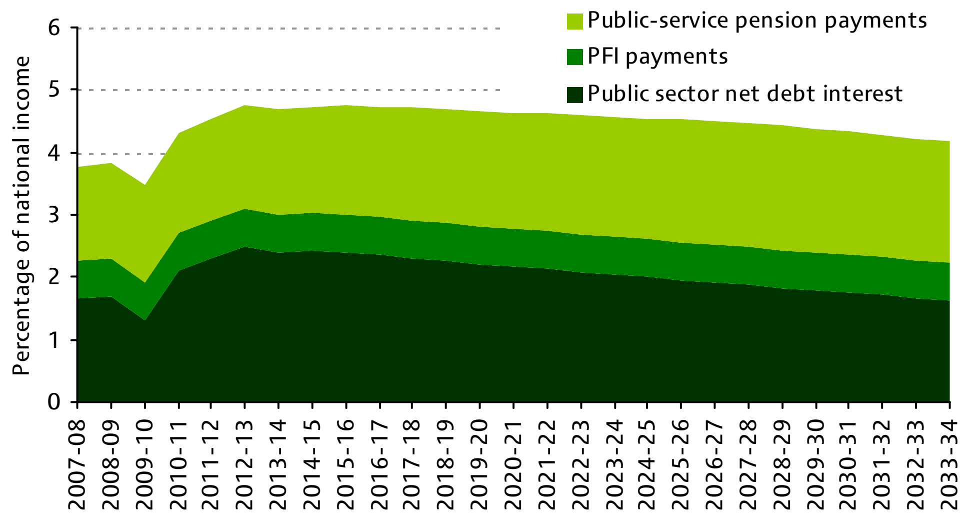
Figure 5.7. Estimated future payments under PFI contracts



Sources: Table B16, page 126 of HM Treasury, *Financial Statement and Budget Report*, Hc620, London, March 1998. Estimated future PFI payments from table 2.6, page 37 of HM Treasury, *2008 Pre-Budget Report: The Economy and Public Finances – Supplementary Material*, November 2008 (http://www.hm-treasury.gov.uk/d/pbr08_chartstables_501.pdf).

Future commitments from public sector net debt interest payments, public-service pension payments and PFI contracts are brought together in Figure 5.8. The figures for debt interest payments are those presented in Figure 3.3; they assume that over the medium term, revenues and non-debt-interest spending stabilise as a share of national income at the level indicated by the Treasury in PBR 2008 for 2015–16. The figures further assume that the effective interest rate on government debt remains at its 2013–14 level. For the case of future PFI commitments, rather than assume these will decline over time – as was shown in Figure 5.7 – we instead assume that new deals will continue to be signed such that annual payments remain at the current (peak) level of 0.6% of national income. The total of these commitments is projected to increase from 3.8% of national income in 2007–08 to 4.8% of national income in 2012–13. This 1.0% of national income increase represents £15 billion in today's terms, which is a considerable increase. In addition, even by 2033–34, outgoings on public sector net debt interest, public-service pensions and PFI contracts would still not have returned to the level they were at in 2007–08. This increase is due to the rise in public sector net debt interest payments over the period from 2009–10 to 2012–13 and the more gradual projected increase in public-service pension payments over the period to 2027–28.

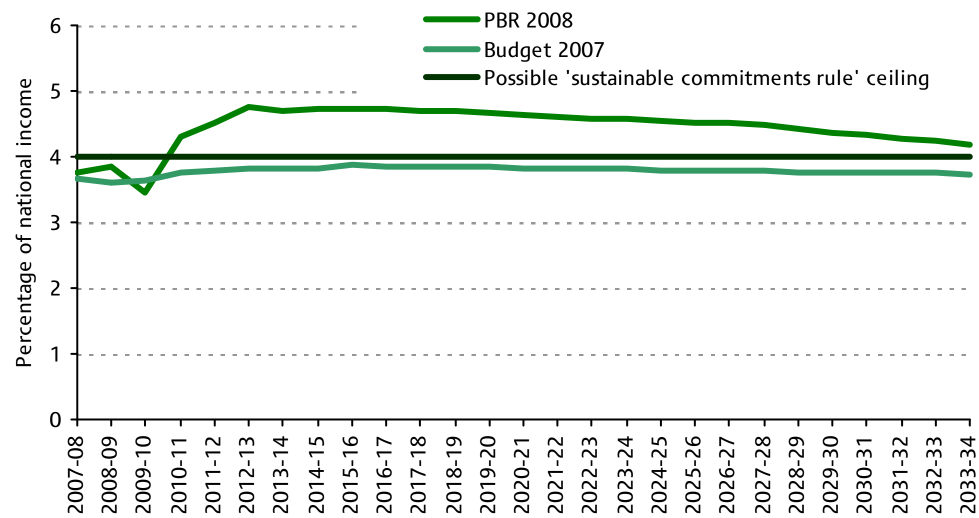
Figure 5.8. Estimated commitments for future taxpayers, PBR 2008



Sources: As Figures 5.5, 5.6 and 5.7.

Figure 5.9 shows how these estimated commitments for future taxpayers based on PBR 2008 compare with similar calculations based on Treasury figures from before the current economic turmoil. This shows that instead of reaching 4.8% of national income in 2012–13, projections on the same basis using Budget 2007 figures would have implied these commitments remaining below 3.9% of national income per year throughout the whole forecast period. At the time, public sector net debt was forecast to remain below 40% of national income throughout the period to 2011–12, so this suggests that a 40% ceiling on net debt, along with current commitments on PFI contracts and public-service pensions, might have implied similar constraints to a 'sustainable commitments rule' ceiling of 4.0% of national income per year.

Figure 5.9. Compliance with a possible 'sustainable commitments rule' ceiling, PBR 2008 compared with Budget 2007



Sources: As Figures 5.5, 5.6 and 5.7, and HM Treasury, *Financial Statement and Budget Report*, March 2007 (http://www.hm-treasury.gov.uk/bud_budget07_repindex.htm).

The idea of a 'sustainable commitments rule' needs further investigation before being put forward as a firm policy proposal. But it would seem to have the strengths of the sustainable investment rule objective of targeting public sector net debt, along with the additional advantages of allowing higher government borrowing when such finance was cheaper and of taking into account a more comprehensive set of commitments affecting future taxpayers. Were the government to move towards such a target, it should continue to publish data on public sector net debt alongside other measures of the state of the public finances. This is consistent with current practice, as the Treasury provides data on, among other measures, 'core debt', 'net worth' and the 'primary balance' in Budgets and PBRs.[33]

Which commitments should be encompassed by such a rule would need to be considered very carefully. For example, we have included expected public-service pension commitments, but there is a strong argument that these should instead be constrained by an enhanced golden rule as the benefits they deliver may have largely already been delivered. Were such pensions funded, or notionally funded, the Treasury could include new accrual of public-service pension rights within the target set by the golden rule. To the extent that current accrual of public-service pensions is associated with the delivery of benefits for current taxpayers, this would enhance intergenerational fairness. In effect, it would be treating current pay for public sector workers on an equal footing to that of the accrual of their pension rights, and would therefore help ensure that the government had the right incentive to offer the appropriate mix of pay and pensions in the remuneration packages of public sector workers. Such a change would, however, come at the not inconsiderable cost of such an enhanced golden rule not being based on National Accounts measures of fiscal aggregates, which would risk loss of transparency and potentially confidence in the rules.

Restoring confidence: a fiscal policy committee

Mr Brown's move in 1997 to grant an independent Bank of England control over interest rates has been widely hailed as taking the politics out of monetary policy, even by those who disagree with decisions that the Monetary Policy Committee has taken. The same cannot be said of fiscal policy, where the serial overoptimism of the Treasury's forecasts, the conveniently timed redating of the economic cycle and the decision to delay significant policy tightening until just after the 2005 general election all contributed to the widespread sense – well before the current crisis – that the rules were less of an influence on the government's tax and spending decisions than politics (see Section 5.2).

Given the erosion in the credibility of the rules prior to the crisis, the government's claims in the November 2008 PBR that its 'fiscal policy objectives remain unchanged' and that it would merely 'depart temporarily from the fiscal rules until the global shocks have worked through the economy in full' are unlikely to inspire much confidence, especially as it could be 20 years or so before public sector net debt is back below 40% of national income (see Section 3.2). If the government is to restore people's confidence in its management of the public finances, the first task will be to restore confidence in its determination to deliver on its short- and medium-term goals, not on its distant aspirations.

[33] See, for example, table B3, page 190 of HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm).

Given the continued broad support for central bank independence (for the time being at least), does this model hold any lessons for how we might reassure people that fiscal policy decisions are being taken in the pursuit of long-term sustainability rather than short-term expediency?

Alesina and Tabellini[34] identify four criteria to help decide when it is appropriate for politicians to delegate policy decisions to independent bodies:

- First, we should expect that there would be a risk of deliberately socially harmful distortions to policy decisions that are left to politicians. If not, why delegate them?
- Second, there needs to be a broad consensus over what constitutes 'good policy' in the area in question. This ensures that the mandate given to the independent body is seen as technical rather than political.
- Third, delegated policy decisions should not create big winners and losers. Elected politicians need to take such decisions if they are to be seen as legitimate (especially by the losers).
- Fourth, policy decisions should not be delegated when this gives rises to significant coordination problems with policy decisions taken by others.

These four criteria suggest that some fiscal policy decisions might be ripe for delegation, but that many would not be. Specifically, it might be sensible to delegate the tasks of forecasting tax revenues and non-discretionary spending and determining whether the government is on course to raise sufficient revenue to meet its spending plans and comply with any fiscal rules that it has set itself. But it would not be sensible to delegate the choice of how much to spend (and on what) or how exactly to structure the tax system to raise the necessary revenue.

Why might we want to delegate the task of overall revenue forecasting? Governments might often have an incentive to overstate the amount of revenue that they expect to raise from an existing tax system, so as to be able to delay the announcement of unpopular revenue-raising measures. Governments might believe they can get away with such overoptimism because they can always claim to have more information from the tax-collecting authorities than they are able to share with the general public. They also have more resources to devote to the forecasting process than outside, independent commentators. This makes it hard for outsiders to prove the government is engaged in wishful thinking. There is some tentative evidence that governments in the UK have succumbed to this temptation. Both the Conservatives after being re-elected in the 1992 general election, and Labour after being re-elected in the 2001 and the 2005 general elections, chose to announce considerable tax-raising measures in the following 12 months despite these not being mentioned in their election manifestos.

And why might such behaviour be a problem? Delaying the tax increases required to pay for a given spending programme accumulates additional public sector debt and means that larger and more distorting tax increases may be required later, once the need to raise revenue can no longer be avoided. In the case of the recent serial overoptimism of fiscal forecasts in the UK, avoiding corrective action earlier meant that the government had no room for manoeuvre to deal with a modest downturn in the economy. While the fiscal costs of the current financial crisis are unlikely to have been absorbable within any

[34] A. Alesina and G. Tabellini, 'Bureaucrats or politicians?', Bocconi University, IGIER Working Paper 238, 2003 (http://www.igier.unibocconi.it/index.php).

reasonable degree of caution, the current suspension of the fiscal rules will do little to boost confidence that going forwards the government's tax and spending decisions will be appropriately constrained, especially in the short period between now and the next UK general election.

What about the other criteria identified by Alesina and Tabellini?

- There is a widespread consensus that the government should raise enough revenue to avoid relying on unsustainable levels of borrowing to finance its spending, so this in itself is unlikely to be politically contentious.
- The size of the budget deficit does not have significant distributional consequences in any given year, which avoids the issue becoming politically controversial for that reason. The size of the deficit does have distributional consequences across generations, as it pushes the cost of today's spending onto future taxpayers. Arguably, this strengthens the case for delegation, as future taxpayers are un- or under-represented in the political process.
- Delegating decisions regarding the overall level of revenue and the budget deficit may reduce the danger of coordination problems, as it further reduces the likelihood that fiscal and monetary policy will be used to influence overall spending in the economy in inconsistent ways.

In contrast, as Debrun and others at the International Monetary Fund point out,[35] policy decisions serving primarily distributional objectives, such as the progressivity of the tax system or the size of social transfers, are not good candidates for delegation:

> Even though political decisions on them might create economic difficulties, there is no broad consensus on what constitutes sound policy in these areas. Aspects of fiscal policy that are so highly dependent on social preferences should clearly remain under the control of the political process.

Debrun et al. identify six illustrative models for fiscal agencies through which the delegation of decisions over revenue or the budget balance could be achieved:

- Independent fiscal authorities
  1. Setting long-term objectives and consistent short-term targets
  2. Setting targets consistent with a given fiscal rule
  3. Adjusting some predetermined tax and spending packages
- Fiscal councils
  4. Providing objective analysis of fiscal policies
  5. Providing independent budget forecast
  6. Providing normative assessment and recommendations.

They note that there have been plenty of proposals for independent fiscal authorities along these lines, but that no country had implemented one to date. For a number of reasons, these models may take delegation too far.

[35] X. Debrun, N. Hauner and M. Kumar, 'The role for fiscal agencies', in M. Kumar and T. Ter-Minassian (eds), *Promoting Fiscal Discipline*, International Monetary Fund, 2007.

Central bank independence in the UK is seen as democratically legitimate because the elected government sets the target and gives the central bank a policy instrument to vary in pursuit of it. Allowing an independent body to set long- or short-term targets for fiscal policy would lack the same legitimacy. The third variant – allowing an independent body to vary a particular spending total or tax rate – might appear closer to the practice of central bank independence in the UK, but while there is general agreement that (in normal circumstances at least) the Bank of England's short-term interest rate is the best instrument for monetary policy, it is less clear that there would be agreement over which tax or spending parameter the independent body should be allowed to vary – and whether it should be the same one at all times.

Some form of fiscal council seems a more attractive route, and various countries have adopted variants of this model. For example:

- The **Belgian High Council of Finance** recommends specific annual borrowing requirements for all levels of government. It then recommends the fiscal stance consistent with those borrowing requirements.
- **Denmark's Economic Council** analyses fiscal and structural policies and recommends changes. It is chaired by three 'wise men' (usually academics), but includes representatives of trade unions, employers, central banks and the government.
- The **German Working Group on Tax Estimates** publishes regular estimates of tax revenues. It comprises government officials, academics and representatives of the advisory Council of Economic Experts, and has a reputation for relative independence, according to Debrun et al.
- The **US Congressional Budget Office** produces economic forecasts and baseline projections of federal revenues and spending. But the task of assessing the revenue implications of particular pieces of proposed tax legislation lies with the Congressional Joint Committee on Taxation.

As suggested earlier, in the UK such a body could forecast revenues and non-discretionary spending and reach a view on how much the government would need to raise – or could afford to give away – while meeting its spending plans and adhering to its fiscal rules. In descending order of delegation, the government might promise (a) to take the council's advice under all circumstances, (b) to take the council's advice under most circumstances, explaining publicly if it chose not to, or (c) simply to take account of the council's advice in deciding what to do.

IFS researchers have advocated introducing greater independence in the fiscal forecasting process in recent Green Budgets. Drawing on this and other recommendations,[36] the opposition Conservative Party in the UK put forward a proposal to create an Office for Budget Responsibility (OBR) in September 2008. This body would:

[36] For example, T. Kirsanova, C. Leith and S. Wren-Lewis, 'Optimal debt policy, and an institutional proposal to help in its implementation', paper prepared for a workshop organised by DG Ecfin of the European Commission on the Role of National Fiscal Rules and Institutions in Shaping Budgetary Outcomes, Brussels, November 2006 (http://www.economics.ox.ac.uk/members/simon.wren-lewis/docs/eu_paper_on_fiscal_institutions_4.pdf).

- be responsible to Parliament;
- be made up of a small number of experts appointed for single non-renewable terms and supported by a permanent staff of economists and tax experts;
- have privileged access to information from the Bank of England, the Treasury, HMRC and the Office for National Statistics;
- produce fiscal forecasts at least once a year in advance of the Budget, plus estimates of the scale of all future government liabilities;
- state how much loosening or tightening of fiscal policy would be necessary by the end of a given forecast horizon to meet the government's fiscal rules.

The OBR would be a purely advisory body. The Treasury would retain the capacity to make its own forecasts, suggesting that the OBR would duplicate the Treasury's current fiscal forecasting role rather than replace it. The decision on how much to loosen or tighten would remain with the Chancellor, although he or she would have to explain to Parliament if they disagreed with the OBR's analysis.

This does raise the question of how much of an advance this would represent on current independent scrutiny of the public finances. Indeed, questioning Conservative leader David Cameron on the proposal, the BBC's Andrew Marr said: 'It just sounds like the IFS on steroids'.[37] Mr Cameron responded that it would be a properly funded government office and argued: 'Think of the enormous consequences if a Chancellor and a Prime Minister cast them aside and say "we're not going to do that". We're making a rod for our own backs.'

Proper funding, privileged access to official information on revenues and spending, and official status akin to that of the National Audit Office might well make such a body a useful addition to existing independent scrutiny of the Treasury's forecasts.

In developing this or similar proposals, the Conservatives and the other parties would need to address a number of issues. For example:

- Should the independent body carry out its own macroeconomic forecasts or simply forecast fiscal outcomes conditional on someone else's macro forecasts being correct? Judgements regarding the medium-term outlook for growth in national income and its key components are crucial in assessing whether a given set of tax and spending plans are fiscally sustainable. But there is no reason to believe that such a new body would be a better macroeconomic forecaster than anyone else. An obvious possibility would be to require the Bank of England to produce a set of macroeconomic assumptions consistent with its own published forecasts, although the Bank may feel that this would drag it unhelpfully into debates over fiscal policy.
- How should the independent body interact with the Treasury – if at all – during the process of policy development? For example, if the system had been up and running prior to the November 2008 PBR, should the Treasury have been talking in advance to the independent body regarding its assessment of the amount of revenue that would be raised by its proposed income tax reforms? Interaction might improve the quality of policy decisions, and avoid unnecessary public disagreement, but having the independent body assess their impact only after the event would enhance the

[37] http://news.bbc.co.uk/1/hi/programmes/andrew_marr_show/7640418.stm.

perception of independence from the Treasury. If the body were to comment on policy proposals after a Budget or PBR, it would have to decide whether to do so quickly (for example, in time for Treasury Select Committee hearings) or only when it produces its next baseline forecast.

- What should the structure and governance of the new body be? Given the nature of the forecasting and policy judgements that it would be tasked with making, it seems unlikely that having a large body of individually accountable voting members – like the MPC – would be sensible. More plausible would be a relatively small group (perhaps a Chairman and two deputies) tasked with reaching a consensus view, supported by a professional staff.
- Finally, there might be a trade-off – particularly in the short term – between the technical quality of the underlying forecast and the credibility gained from having the OBR rather than the Treasury produce the forecast. Even if the OBR is given as much access to privileged data as the Treasury, at least initially it will have less in-house forecasting expertise. Ensuring that the OBR has sufficient resources would help, as would taking some high-performing staff from the Treasury (but, of course, this might be at the expense of the Treasury's own forecast). But it might still suggest that an appropriate model might be for a new OBR to be given time to establish its track record before the government considers precommitting itself to take its advice.

5.5 Conclusions

Given the scale of the deterioration in the public finances revealed in the PBR, it is important for the government to convince voters and investors that it will manage the public finances appropriately and, in particular, do what is necessary to repair any remaining damage once the economy has stabilised. Failing to do so could make it more expensive for the government to borrow, further increasing the rise in interest payments that will result from the increase in indebtedness.

That task has not been made any easier by the fact that the government's famous fiscal rules had lost credibility as a meaningful constraint on its tax and spending decisions long before the impact of the credit crunch required them to be suspended. Under these circumstances, we cannot expect people to have a great deal of faith in the 'temporary operating rule' that has replaced them for the time being. In any event, the Treasury has had to extend its usual forecasting horizon to claim to be on course to meet even its new rule at the outset. Going forwards, the new rule will not be particularly constraining.

Given the huge uncertainties around the current fiscal outlook, it is not clear that any temporary limits on borrowing and debt could be tight enough to appear to act as a constraint without offering a hostage to fortune if the recession is deeper or longer than expected. For now, credibility rests more on the government's ability to persuade people that it will indeed deliver the spending squeeze and tax increases that it has signalled from 2010–11 onwards – and more if that turns out to be necessary. The verdict of the financial markets will be crucial.

This strengthens the case made in past Green Budgets for introducing greater independence into the official fiscal forecasting process, to dispel suspicions of politically motivated wishful thinking in revenue and spending projections. The Conservative proposal for an Office for Budget Responsibility is a useful starting point, but with some important issues to be clarified.

In the longer term, there is the question of whether the government should readopt the old fiscal rules as originally defined. We argue that some important reforms should be considered. The golden rule should be symmetric and more forward looking; it should perhaps also require any future increases in unfunded public-service pension commitments to be matched by a surplus on the current budget. As for the sustainable investment rule, this or a future government may wish to consider the merits of a ceiling on future interest (and other similar) payments, rather than a ceiling on the stock of public sector debt.